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Research on Bond Market

Credit Bond Market

January 1 to March 31, 2019

The prospect for bond market in Q2 is mixed, watch out for higher volatility in yields-

Credit bond market review for Q1 and outlook for Q2, 2019

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Main Opinions

- **Market environment:** China's economy showed a slower but stable performance in Q1, with GDP growing at 6.4%, flat with Q4 last year. The monetary policy tone remained to be "eased or tightened to the right degree". Although the net fund withdrawals from open market increased year-on-year (YoY), PBOC (People's Bank of China) bolstered the market liquidity expectation and kept liquidity neither too loose nor too tight by expanding the coverage of inclusive finance and cutting reserve requirement ratios. The price of funds was generally stable in January and February, but edged up in March due to PBOC's less frequent open market operations and seasonal factors. As of the end of March 2019, the pledge-style repo rates within one month were mixed compared with the end of 2018 but fell sharply YoY. The overall price of funds stayed at a fairly low level.
- **Credit risk:** The number of negative rating actions increased in Q1 YoY, and the risk of bond defaults remained frequently exposed. 30 issuer ratings were downgraded across the market in Q1, accounting for 66.67% of total rating adjustments, an increase of 8.78 percentage points YoY. Total bond defaults was RMB27.973 billion in Q1, a record high for the same period. Private enterprises were still the main defaulters. The main causes of defaults were aggressive business expansion, excessive debt burden, cash flow tightness worsened by litigations or share pledges and tightening industry policies. All defaulters were industrial bond issuers and their industries were still scattered. The local government financing vehicles (LGFVs) has not defaulted on bonds, but non-standard debt repayment crises occurred from time to time, and their credit risk deserve vigilance.
- **Market performance:** Credit bond performance improved significantly in Q1, evidenced by a rise in both quantity and prices in primary and secondary markets. Credit bond issues increased significantly YoY. The median rating of new bond issues moved up further and the bond issue rates turned down with fluctuations. The turnover of credit bonds increased YoY, with a yield down by 4 bps to 59 bps from the end of last year. In terms of credit spread, short-term and medium-term credit spreads narrowed while long-term spreads expanded significantly.
- **Market outlook: Bond issues are expected to increase, yields to be more volatile and credit risk to be further exposed.**

  In the primary market, bond issues are expected to increase in Q2. With financing support strengthened and issue rates remained low, enterprises will be more willing to issue bonds. The increase in enterprises' refinancing demand and foreign investors' allocation demand will further boost bond issues. In addition, to achieve the target of special bond issues, special bond issues will gain pace in Q2 and Q3.

  In the secondary market, fundamentals and liquidity environment are conducive to the bond market development in the long run. On the one hand, China's economy is in a downturn, expected to be weaker than last year. On the other hand, China's monetary policy is positioned to be "eased or tightened to the right degree", and the slowdown in the Federal Reserve's interest rate hikes has given China more flexibility in monetary policy, so the market still expects a structurally loose monetary policy. **However, the secondary market yields also faces some disturbing factors such as short-term economic recovery, rising inflation expectations, increasing pressure on bond supply and fund diversions to stock market. With so many negative factors, the yield volatility is likely to increase in Q2.**

  In terms of credit risk, it is expected that the risk of bond default in Q2 will not be significantly weakened and will continue to be exposed. In Q2, industries that deserve extra attention include farming, forestry and food processing, film and television entertainment, chemical and real estate. In addition, LGFVs will pose a higher risk on non-standard debts. It is necessary to guard against the risk of non-standard debt transmission to the bond market.

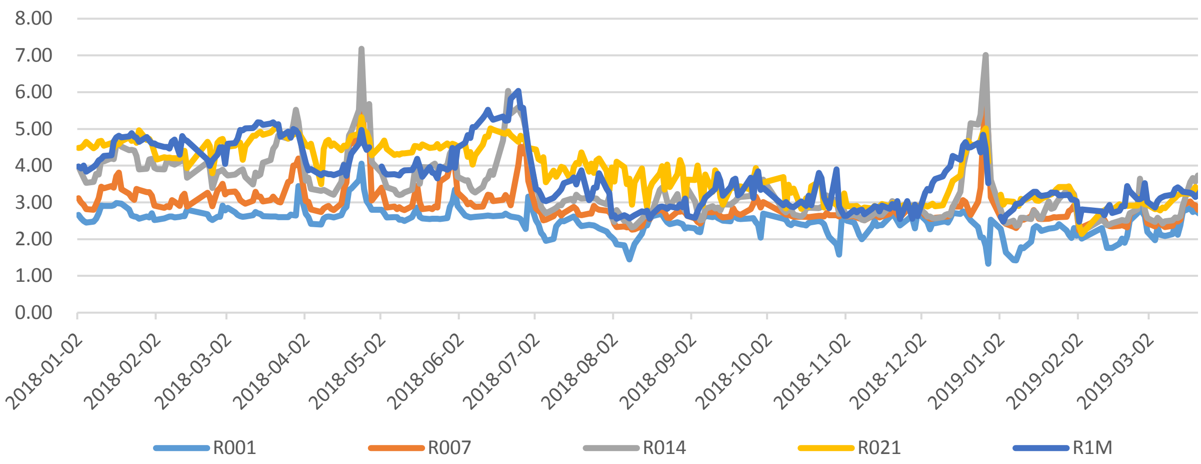
I. Market environment: The macro-economy has shown a short-term recovery, with monetary policy focusing on being "eased or tightened to the right degree"

China's economy showed a slower but stable performance in Q1 2019, with GDP growing at 6.4%, flat with Q4 2018. In terms of leading indicators, manufacturing PMI showed a decline in January and February, but rose above the boom-bust line to 50.5% in March. In terms of price indices, PPI showed slow YoY growth, while CPI dropped to 1.5% in February, the lowest since February 2018. Although CPI rebounded somewhat in March, the overall inflationary pressure is still relatively controllable. In terms of global environment, US-China trade frictions have eased compared with Q4 2018, yet still in uncertainty. Overall, given the still-weak demand, the economic growth in 2019 is expected to remain lower than in 2018 and show a slower-and-then-stable trend through the year.

In 2019, PBOC keeps the monetary policy prudential and set the tone on liquidity as being "eased or tightened to the right degree". In terms of specific operations, PBOC changed the assessment criteria for loans to small and micro businesses targeted by the reserve requirement ratio (RRR) cut for inclusive finance from "less than RMB5 million per borrower" to "less than RMB10 million per borrower" on January 2, 2019, thus expanding the coverage of the targeted RRR cut policy for inclusive finance. In addition, PBOC lowered the deposit reserve rate by 1.0% accumulatively on January 2 and January 4, 2019, releasing about RMB1.5 trillion of liquidity in total. In terms of money supply, PBOC withdrew a total of RMB1,889 billion of funds from the open market in Q1 2019 through reverse repurchase, medium-term lending facility (MLF) and treasury cash management time deposit, a substantial rise from the net withdrawal of RMB514.5 billion in the same period of 2018. However, taking into account the RMB1.5 trillion of liquidity released by PBOC in Q1 through RRR cuts and expanded coverage of inclusive finance, the total amount of money withdrawn from the money market is basically flat with one year ago. In terms of monetary policy rates, the interest rate of some open market operation instruments were lowered. On January 24, PBOC cut the interest rate of one-month treasury cash management time deposits by 72 bps. In addition, PBOC created the targeted medium-term lending facility (TMLF). Although the term of operation is one year, as it can be renewed twice upon maturity according to the needs of financial institutions, the actual term can reach three years, while its interest rate is 15 bps lower than the one-year MLF. Overall, the monetary policy in Q1 remained prudential and neutral, a policy tone set in 2018. PBOC kept the liquidity neither too loose nor too tight through flexible adjustments, such as targeted RRR cuts and lowered interest rates of selected monetary policy instruments.

In terms of money market rates, in January and February 2019, though PBOC made a huge net withdrawal through open market operations in January and February 2019, the market liquidity expectation was stabilized through targeted RRR cuts and expanded coverage of inclusive finance, and the price of funds was generally stable. The low frequency of open market operations and seasonal factors in the middle and late March drove up the price of funds moderately. As at the end of March 2019, the 14-day and 21-day pledge-style repo rates dropped significantly by 27 bps and 104 bps respectively compared with the end of 2018, while the overnight, 7-day and 28-day pledge-style repo rates increased slightly by 7 bps to 36 bps over the end of 2018. The price of funds dropped by 73 bps to 185 bps in March YoY, remaining generally low through Q1.

Figure 1: Changes in pledge-style repo rates in Q1 2019



Data source: Compiled by CCXI

China's economy showed a slower but stable performance in Q1 2019, with GDP growing at 6.4%, flat with Q4 2018. The monetary policy remained prudential and neutral. PBOC kept the liquidity neither too loose nor too tight through flexible adjustments, such as targeted RRR cuts and lowered interest rates of selected monetary policy instruments. PBOC made a net withdrawal of RMB1,889 billion in Q1 through open market operations, a substantial increase over one year earlier. Taking into account the liquidity unleashed by RRR cuts and other operations in Q1, the liquidity position was generally stable. In terms of the tends in money market rates, the money market rates fluctuated at lows in January and February, but went up in March, albeit moderately, on conventional seasonal factors and less frequent open market operations. As of the end of March 2019, the pledge-style repo rates for various terms were mixed compared with the end of 2018. But the price of funds dropped by 73 bps to 185 bps in March YoY, remaining generally low at present.

II. Credit risk: Negative rating actions increased and defaults reached a record high for the same period

1. Rating adjustments: The downgrades in issuer and facility ratings increased YoY, either by quantity or by percentage of total, with private enterprises accounting for a larger proportion of downgrades.

Negative rating actions increased YoY in Q1 2019. Specifically, In Q1 2019,there were 30 downgrades in issuer ratings and 75 downgrades in facility ratings, with an increase of 8 and 24 respectively compared with the same period last year. In addition, **downgraded ratings (either issuer or facility) accounted for a larger proportion of total rating adjustments YoY**. Specifically, issuer rating downgrades accounted for 66.67%, an increase of 8.78 percentage points YoY, and facility rating downgrades took up 72.12%, a slight increase of 2.26 percentage points YoY.

According to the latest outlook, there were 41 assignments to negative rating outlook or rating watch list in Q1 2019, 1.52 times that for the same period last year. In Q1 2019, there were 17 issuers involved in downgrades of issuer ratings, an increase of 4 compared with the same period last year. Among them, Easterm Gold Jade, Kangdexin, Zhongpin Food, Guogou Investment and Baota Petrochemical[1]were

[1] Eastern Gold Jade Co.,Ltd., Kangdexin Composite Material Group Co., Ltd., Henan Zhongpin Food Co., Ltd., Guogou Investment Co., Ltd., Baota petrochemical group co., Ltd.

issuers with more than one downgrade in Q1 and all defaulted.

Figure 2: Negative rating actions increased YoY

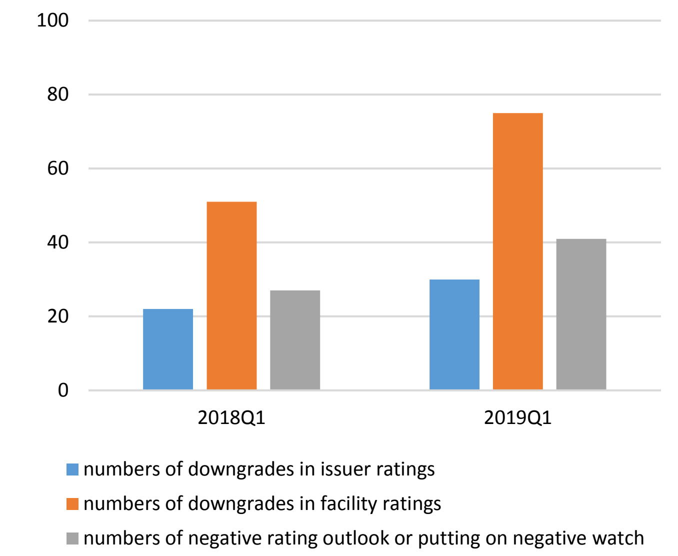


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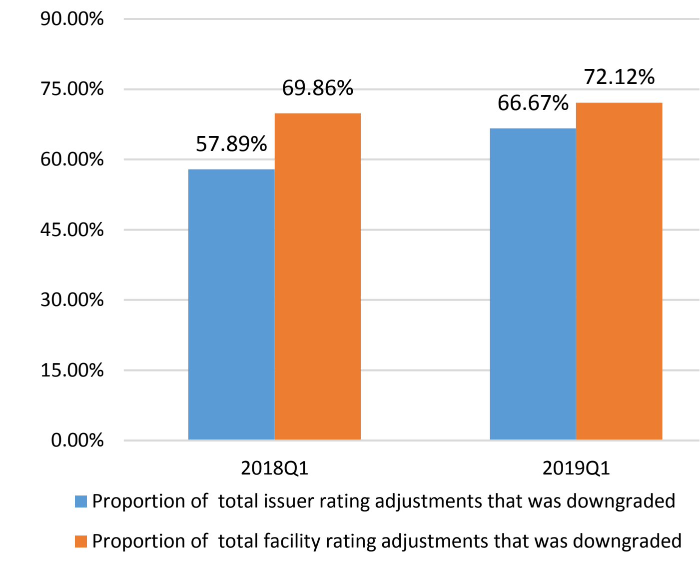
Figure 3: Issuer and facility rating downgrades both accounted for a larger proportion of total ratings adjustments YoY



Data source: Compiled by CCXI

By type of issuers, private enterprises took up a larger proportion of downgrades than other issuers in Q1 2019, also showing a significant YoY increase. Specifically, private enterprises received 24 downgrades in Q1 2019, accounting for 80% of total downgrades, an increase of 20.91 percentage points YoY.

As for cause of rating adjustments, all LGFVs with rating adjustment were upgraded, involving 4 issuers, mostly due to rapid regional economic growth, substantial improvement in capital strength and stronger government support. There were 29 downgrades in industrial bond issuers, compared with 9 upgrades in industrial bond issuers. Industrial bond downgrades were principally attributable to the issuers' expected losses in fiscal year 2018, and other causes include weaker solvency, high share pledge ratio of controlling shareholder and suspected disclosure non-compliance. Upgrades were mostly driven by better profitability, stronger shareholder support and improved capital strength or solvency. In terms of financial institutions, one rural commercial bank was involved in downgrades due to its provision coverage ratio seriously lower than the regulatory requirement, substantial deterioration in asset quality and marked decline in net profits.

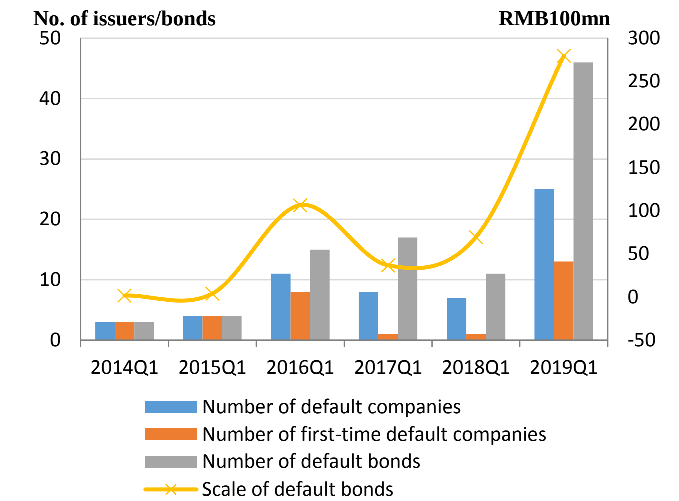
2. Default risk: Total bond defaults was RMB27.973 billion in Q1, private enterprises still posing a risk of default

The default risk outbreaks in the bond market slowed down in Q1 2019 than in Q4 2018, but the number of defaulters, scale of defaults and number of defaulted bonds all hit a record high for the same period. According to CCXI data, 46 bonds were defaulted in Q1, totaling RMB27.973 billion. In spite of its sharp decline by 36.5% from 4Q 2018, that scale represented a two-fold increase over one year ago. By type of defaulted bonds, the number of exchange-traded corporate bonds defaulted accounted for 63% of total, still posing a high redemption risk. In terms of defaulting issuers, **there were 25 defaulting issuers in Q1, of which more than half were first-time defaulters. Private enterprises accounted for 90% of defaulting issuers, still the largest group of defaulters.** Since April[2], another 7

[2] As of the end of April 25.

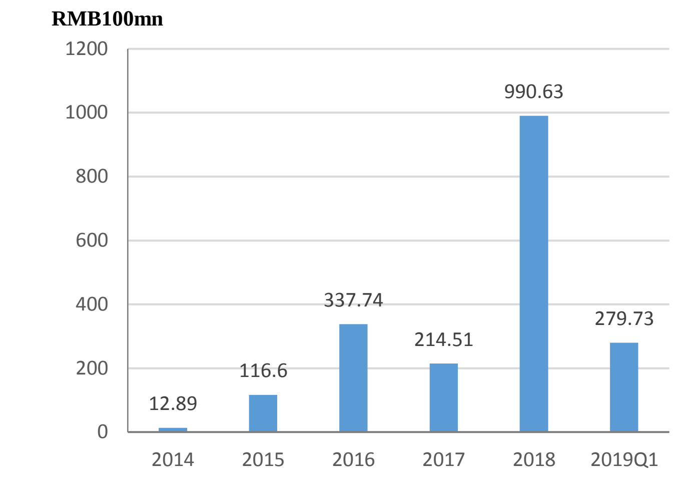
bonds of 6 issuers have been defaulted with a total amount of RMB8.058 billion. All these issuers are private enterprises, including two new defaulters. Overall, **private enterprises still pose a default risk in 2019, with the risk of more than one bond defaults of the same issuer remaining in ferment.**

Figure 4: Defaults in bond market in Q1



Data source: Compiled by CCXI

Figure 5: Scale of bond defaults in recent years



Data source: Compiled by CCXI

In terms of the cause of default, the new defaulting issuers in Q1 2019 mainly showed the following five causes of default: **First, the earlier rapid business expansion and over-reliance on debt financing led to a substantial increase in the debt burden of issuers. Cash flows were drained out due to poor in-house liquidity and obstructed external financing.** In order to maintain its asset-intensive business model, Pang Da Automobile Trade had to increase its liabilities. In spite of its bail-in attempts such as share-backed loans, asset disposals and layoffs to ease fund shortfalls, the company ended up in a default. Kangdexin relied too much on external financing in pursuit of business expansion and had a large scale of accounts receivable and prepaid, suffering a serious shortage in cash. Negative media coverage sent the company into a default due to illiquidity resulting from blocked access to financing. **Second, the issuer suffered tight liquidity and had already gotten involved in debt default or lawsuits; the issuer or its controlled subsidiary had its shares frozen or in a high pledge ratio, quickening its cash flow deterioration and resulting in bond default.** Qiulin Group's cash assets and all its shares were frozen due to involvement in several lawsuits and its executives going out of contact, resulting in a cash flow disruption. Baota Petrochemical, Easterm Gold Jade and SanPower Group all got involved in risk events, such as overdue debt or default of asset management plans, before their first default. The freeze on shares and excessive debt burden accelerated the exposure of issuers' debt risks. **Third, industry factors affected the issuer's operating conditions and weakened the its ability to create cash flows, adding to its liquidity pressure.** Zhongpin Food's profitability had fallen substantially by the "hog cycle" and had a long accounts receive period, which seriously affected its own liquidity. Techcent Environment entered the environmental business sector by acquiring overseas environmental companies. However, the continuous high pressure from environmental policies has weakened its profitability and made its cash flows insufficient to cover its debts, resulting in a default. Affected by the fluctuation of the real estate market and the change of the credit environment, Guogou Investment's operating performance declined, project sales and accounts receivable collections were weak, and access to external financing was poor, further aggravating the company's liquidity pressure. **Fourth, the accepted filing for bankruptcy reorganization led to accelerated maturity of all outstanding bonds.** SNTON Group filed an application for bankruptcy reorganization with the court due to its failure to repay matured debts and its insolvency. All of its nine outstanding bonds matured on an accelerated basis when the application was accepted, resulting in a default. **Fifth, technical errors resulted in failed bond redemption as scheduled. Involved issuers are Orient Landscape, HNA Group and Qingdao City Construction Investment Group.** In addition, defaults reoccurred to a number of existing defaulters in Q1 as their bonds matured successively. Involved issuers include Neoglory, Tongyi Industry, Huayang Economic and Trade, Wintime Energy, Shanghai Huaxin, Luowa Technology, Foshan Zhongji, China City Construction and DMG Entertainment.

By industry of defaulter, **all defaulters in Q1 were industrial bond issuers from a wide range of industries** (11 industries in total, namely real estate, chemical, farming, forestry and food processing, environmental protection, wholesale and retail trade, energy, construction ， transportation and so on). **No LGFVs defaulted on bonds in Q1, but non-standard debt risk events occurred from time to time, showing noticeable relevant risks.** According to non-exhaustive statistics, LGFVs experienced four risk incidents regarding non-standard debt repayment in Q1 2019 involving four financing entities. In terms of the type of product, all the four incidents were about trust plans. By type of underlying assets, two incidents fell in the category of pooled fund trust plans for receivables investment and the other two in the category of pooled fund trust plans for project loans. By geography, incidents were still concentrated in the western region that is less developed in economy and higher in debt ratio. As a large part of the non-standard debt funds have been channeled into LGFVs' infrastructure and real estate projects, LGFVs may face certain refinancing pressure as the debt matures. It is necessary to pay due attention to the debt risks of LGFVs with weaker regional economic environment and lower administrative levels, and to guard against the contagion of non-standard debt risks to the bond market.

For the follow-up actions on defaults, in the public offering market, there were three defaulting issuers who paid for the default debt in full or in part with substantial progress. Specifically, Orient Landscape completed the interest payment for "18 Orient Landscape CP002" on the next day of default. SanPower Group has completed the payment of principal and interest on the "12 SanPower Bond" to individual investors, and will further negotiate with institutional investors. Jinhong Holding completed the payment of remaining interest on "16 Petrochina Jinhong MTN001". In addition, according to media reports, another two privately placed bonds, "16 HNA 01" and "18 Qingtou PPN001", completed redemption within 1 to 2 days after the default occurred. As of the end of March 2019, a total of 303 bonds had been defaulted in the bond market, involving a total amount of RMB195.76 billion and 126 issuers. Of the 172 bonds defaulted in the publicly offered bond market, 37 have completed follow-up disposal and 29 have completed full redemption. Overall, the progress of default disposal is still slow.

Negative rating actions increased in Q1 2019 YoY, and the risk of bond defaults remained frequently exposed. 30 issuers rating downgrades occurred in Q1 2019, an increase of eight downgrades YoY. Issuer rating downgrades accounted for 66.67% of total issuer rating adjustments, up 8.78 percentage points YoY. A total of 46 bonds were defaulted in Q1, involving an amount of RMB27.973 billion and 25 issuers, all a record high for the same period. More than half of defaulting issuers in Q1 were first-time defaulters. Private enterprises accounted for 90% of defaulting issuers, still the largest group of defaulters. The main causes of defaults were aggressive business expansion, excessive debt burden, cash flow deterioration accelerated by litigations or share pledges and tightening industry policies. A few issuers' defaults were caused by bankruptcy reorganization and technical factors. By industry mix, all defaulters in Q1 were industry bond issuers decentralized across a large range of industries. No local government financing vehicles (LGFVs) defaulted on bonds, but non-standard debt repayment crises occurred from time to time, and their credit risk deserve vigilance.

III. Regulatory observation: A combination of measures have been taken to support SME development, and the bond market has further opened up

1. Regulators have stepped up efforts to improve the SME development and financing environment

In Q1 2019, the Central Government still attached great importance to improving the quality and efficiency of financial services for the real economy. In particular, to support the financing of SMEs and micro businesses, a number of central authorities issued documents in Q1 to encourage the financing of private enterprises, SMEs and micro businesses. Regulators' efforts are focused on helping ease SMEs' and micro businesses' difficulties in accessing affordable financing. The State Council decided at its executive meeting on January 9 to launch a number of new inclusive tax reduction measures for small and micro enterprises, including a substantial relaxation of the criteria for small and micro enterprises eligible for preferential enterprise income tax, and an increase in the preferential income tax treatment. These measures are estimated to reduce the tax burden on small and micro enterprises by another RMB200 billion[3] a year. On January 14, CBIRC issued a guideline on the development of rural commercial banks, requiring rural commercial banks to increase the financial resource supply to "agriculture, farmers and rural areas" and small and micro enterprises, and increase the credit supply to them. In February, the General Office of the State Council issued Document No. 6. The document not only provides guidance on the sound development of government-led financing guarantees and re-guarantee agencies, but also emphasizes that guarantee agencies should focus their business on supporting small and micro enterprises and agriculture-related fields. CBIRC also issued the *Notice on Further Strengthening the Financial Services for Private Enterprises* in February, detailing the relevant measures for implementing financial services for private enterprises, including establishing a long-term mechanism for boosting the "readiness, willingness and ability to lend" and strengthening supervision and inspection. With respect to lending to private enterprises, the notice also calls for establishing as soon as possible the fault tolerance and correction mechanisms and the mechanisms for ensuring no one who has fulfilled their duties is held liable. At the press conference of the NPC and CPPCC, PBOC Governor Yi Gang vowed to further strengthen support for small and micro enterprises and private enterprises and reduce their financing costs. On March 13, CBIRC issued another document setting a growth target for loans to small and micro enterprises, requiring banks to keep loans to small and micro enterprises at a reasonable level, increasing the tolerable non-performing ratio of small and micro loans and guiding commercial banks to further strengthen credit support for small and micro enterprises.

The easy credit policy also continued through Q1. On January 23, PBOC decided to create the Central Bank Bills Swap (CBS) and add banks' perpetual bonds with an AA or higher issuer rating to the scope of eligible collaterals for MLF, TMLF, SLF and re-guarantee, with the aim of improving the market recognition and liquidity of banks' perpetual bonds and supporting banks' capital replenishment through perpetual bond issues. CBIRC issued a document allowing insurance institutions to invest in tier-2 capital bonds and perpetual bonds issued by qualified banks, thereby expanding the scope of investors in banks' capital instruments. In late March, PBOC included China Bond Insurance Corporation (CBIC) in the list of primary dealers in the open market, broadening its access to funds and giving positive signals. In addition, Shanghai and Shenzhen stock exchanges have further improved their rules for credit protection instruments, in a bid to boost the sound development of credit protection instruments and unleash their role of credit support better in bond financing.

Overall, regulators have been stepping up efforts to ease SMEs' difficulties in accessing financing since this year began. A number of high-level institutions have expressed their resolve to support SME development, marking the issue a big concern of the Central Government, which has introduced a wide variety of supportive measures. Firstly, regulatory authorities have taken various measures to channel more financial resources into SMEs. On the one hand, regulators have placed certain regulatory pressure on financial institutions by setting growth targets for SME loans, thus increasing loan support for SMEs. On the other hand, regulators support commercial banks in capital replenishment and credit space

[3] Data are from the official press release of the Executive Meeting of the State Council available at http://www.gov.cn/premier/2019-01/09/content_5356305.htm

expansion, and also have moderately relaxed risk constraints to restore commercial banks' risk appetite, so as to encourage commercial banks to strengthen credit support for SMEs by various means. Secondly, regulatory authorities have endeavored to open up the space for financing of SMEs. In addition to credit supply, regulators also provide financing support for relevant enterprises by encouraging the development of private enterprises' bond financing instruments and facilitate the reduction of relevant enterprises' financing costs. In addition, fiscal and tax support policies have been improved to expand the coverage of tax incentives and reduce the tax burden on related enterprises. A series of policies reflect the Central Government's determination to support the development of SMEs and private enterprises, which undoubtedly plays a positive role in improving the financing environment of relevant enterprises.

As for policy effect, the bond market has not yet felt the effect of the favorable financing policies for private enterprises in Q1. 152 private enterprise bonds in a total amount of RMB111.296 billion were issued in Q1, showing a decline in issue scale YoY and QoQ. Matured bonds totaled RMB163.211 billion. The net financing amount of private enterprises continued to be negative and the gap widened. Most issuers of private enterprise bonds are rated AA+ or above, suggesting that lower-rating private enterprises still face some difficulties in access to financing. A total of 33 CRMWs were created in Q1, down 34% from Q4 2018. The subject issuers of CRMW is still mostly rated AA+. The related bonds are mostly commercial papers. Perhaps because of low comprehensive yield, the substantially smaller scale of CRMWs than bond issues and the low diversity of subject issuers, the demand for CRMW allocations has weakened and CRMW issues have cooled down. Private enterprises showed slightly weaker performance in debt financing in Q1, and it may take some time for relevant financing support policies to begin to work. Given the possible non-sustainability of financial institutions' willingness and motivation to support SMEs and private enterprises, to improve their financing environment, regulatory authorities need to provide stronger support in terms of easier access to credit and risk appetite recovery of financial institutions. The high risk premiums of enterprises also need to be eased through interest rate liberalization and supply-side structural reform in the financial sector. It is noteworthy that some SMEs and micro businesses still face significant business risks in the current economic environment. Risks should be forestalled while supporting their development, so as to maintain proper tradeoffs between stable growth and risk prevention.

2. Opening-up is likely to accelerate.

China's bond market was opened further to the outside world in an orderly manner in Q1. In early February, NAFMII issued the *Guidelines on Debt Financing Instruments for Overseas Non-financial Enterprises (Trial)*. The guidelines set out requirements for information disclosure and use of proceeds, aiming to address the cross-border alignment of rules and practices, build the panda bond market system and further open up the interbank market. Another milestone is that 364 RMB-denominated government bonds and policy bank bonds have been officially included in Bloomberg Barclays indices since April. After full inclusion, they will account for 6.03% and become the fourth largest currency component. After inclusion in these indices, China's bonds will attract more investors. Foreign investors tracking these indices are likely to invest in Chinese bonds, thus bringing additional funds to the domestic bond market and further opening up the bond market to the outside world. Meanwhile, another two major bond indexes, JPMorgan Emerging Market Government Bond Index and FTSE World Government Bond Index, also said that they would discuss whether to include Chinese bonds in their indexes this year. PBOC Deputy Governor Pan Gongsheng made it clear at the press conference of the NPC and CPPCC this year that expanding the opening-up is one of the key tasks for the bond market. In addition, Premier Li Keqiang said in late March that China would continue to expand the financial sector opening-up and opening-up measures would be implemented vigorously this year. With financial infrastructures improved progressively, the bond market is expected to open up faster. As shown by the bond custody data of CCDC and Shanghai Clearing House, foreign institutions held a total of RMB1.76 trillion of domestic bonds as at March 2019, up 35.21% YoY, and also up slightly from the end of 2018. Foreign institutions' bond holdings accounted for 2.28% in March, a bigger share than one year ago but still a low level. As the market is further opening up, there is still room for overseas institutions to increase their positions. Meanwhile, it should be noted that the financial market opening-up may bring new financial risks, which undoubtedly poses certain challenges to supervision.

Since the beginning of this year, regulators have been stepping up efforts to ease SMEs' difficulties in accessing financing. A number of financial institutions have expressed their resolve to support SME development, marking the issue a big concern of the Central Government. The Central Government has introduced a wide variety of measures to help improve the development and financing environment for SMEs, such as guiding financial institutions to strengthen their credit support for SMEs, opening up space for financing of enterprises and reducing the tax burden. In terms of financing in Q1, private enterprises showed slightly weaker performance in debt financing, for it will take some time for relevant financing support policies to begin to work. Given the regulatory orientation, we believe that SMEs and private enterprises are likely to see the financing environment improving in the future, but regulators need to provide stronger support in terms of easier access to credit and risk appetite recovery of financial institutions, and to maintain proper tradeoffs between stable growth and risk prevention. China's bond market opened up further in Q1. With financial infrastructures improved progressively, the bond market is expected to open up faster.

IV. Market performance: The credit bond performance improved, with interest rates declining in both primary and secondary markets

1. Primary market: Credit bond issues and net proceeds increased significantly YoY, with short-term bond issue rates falling with fluctuations

Credit bond issues and net financing increased significantly YoY

The total credit bond issues in Q1 2019 increased significantly YoY. Credit bond issues totaled RMB2,737.283 billion in Q1, an increase of RMB987.675 billion or 56% YoY, yet down RMB247.928 billion when compared with Q4 2018. Meanwhile, RMB1,818 billion of credit bonds matured in Q1, up RMB499.015 billion YoY. Due to the substantial increase in issues, however, **net financing in the credit bond market in Q1 2019 totaled RMB919.288 billion, up RMB488.66 billion YoY,** but showing a decline from Q4 2018. As for the monthly net proceeds of bond issues, the net proceeds in January and March increased significantly YoY, compared with the weaker YoY growth in February due to less net financing resulting from seasonal factor (i.e. Chinese New Year).

Figure 6: Total Credit bond issues and net financing rose significantly YoY

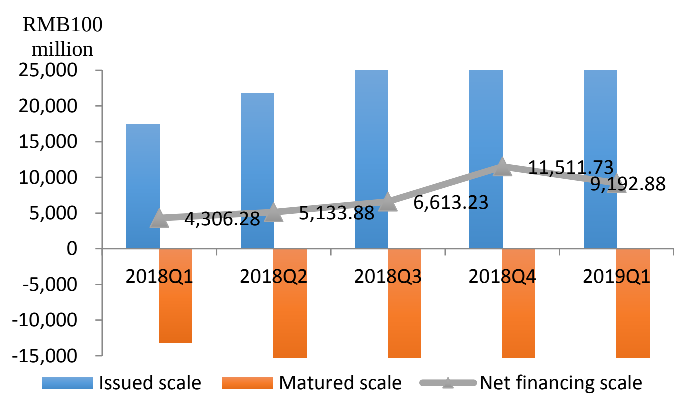
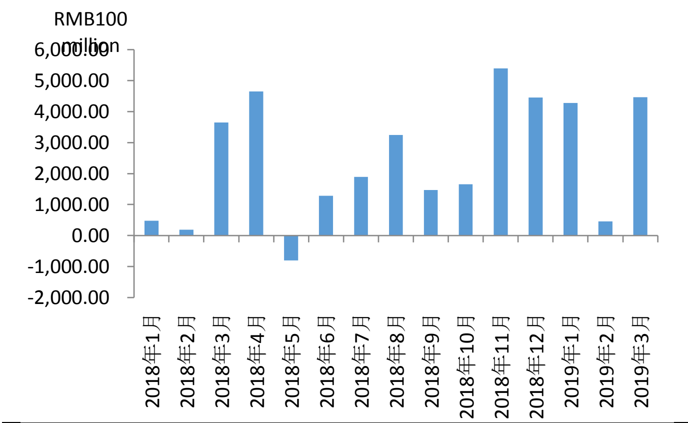


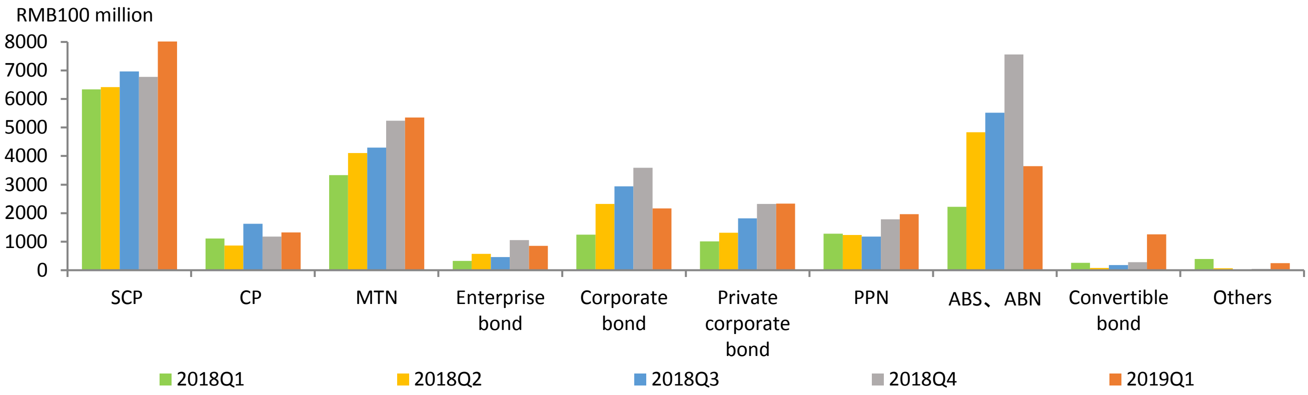
Figure 7: Net financing grew significantly in January YoY



All types of credit bond issues increased YoY, super-short-term commercial papers (SCPs) remained the primary component

All types of credit bond issues increased in Q1 2019. In particular, unlisted company bonds, privately-placed listed company bonds and convertible bonds registered stronger growth at 164.47%, 131.58% and 362.71% YoY, respectively. Compared with Q4 2018, unlisted company bonds, publicly-offered listed company bonds and securitization products recorded a decline in issue size, while all other credit bond issues expanded. In terms of issue structure, SCPs remained the largest component of credit bond issues in Q1, with a total issue size of RMB822.79 billion, accounting for 30.06% of total. Medium-term notes (MTNs) and asset-backed securities (ABSs) came second and third, accounting for 19.54% and 13.33%, respectively.

Figure 8: Main types of credit bond issues increased YoY, SCPs remaining the largest component

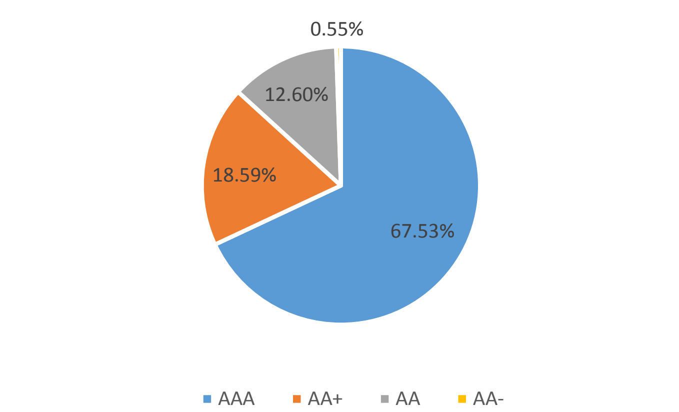


Data source: Compiled by CCXI

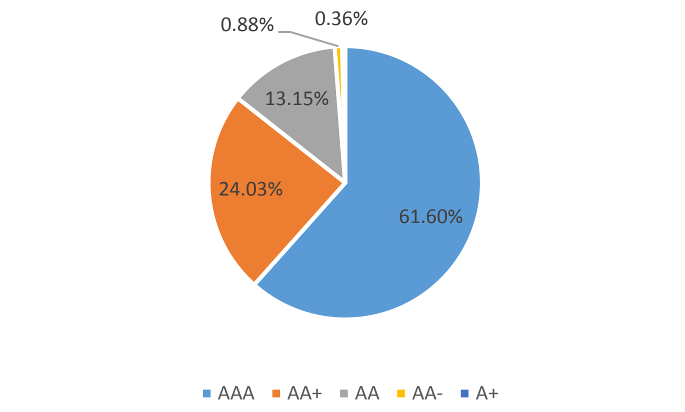
Most of newly issued bonds were AAA-rated, with issue rates falling amid fluctuations

67.53% of bonds issued in Q1 2019 were AAA-rated, up about 6 percentage points over 2018. AA+ bonds accounted for 18.59%, down 5 percentage points from last year. Bonds with AA or lower ratings accounted for about 13.15%, nearly flat with one year earlier. Overall, **new bond issues were mostly AA or higher rated, and further concentrated in higher ratings.**

Figure 9: Rating distribution of bonds issued in Q1 2019	Figure 10: Rating distribution of bonds issued in 2018



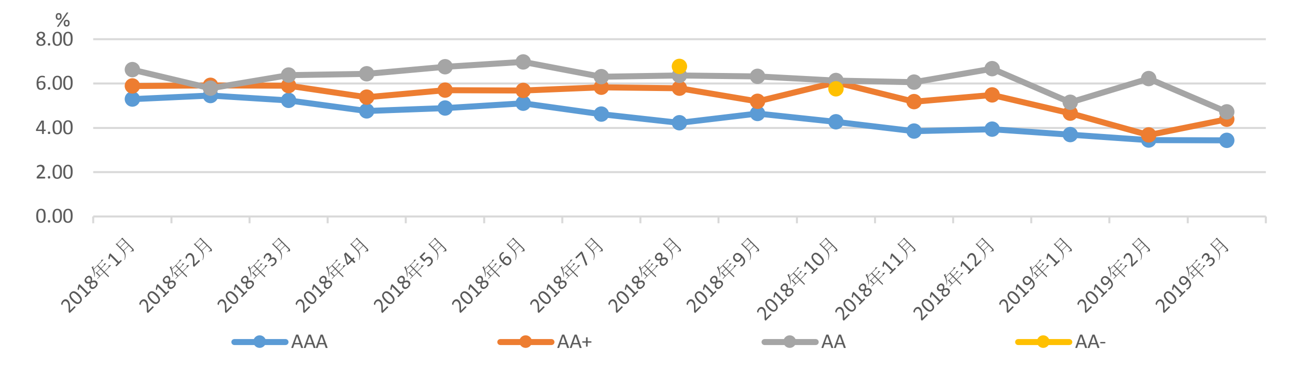
Data source: Compiled by CCXI



Data source: Compiled by CCXI

In terms of issue rate trends, taking one-year commercial papers (CPs) for example, **the issue cost in Q1 moved in a downtrend with fluctuations.** In January 2019, PBOC announced to expand the coverage of targeted RRR cuts for inclusive finance and reduced the RRR twice. It also created TMLF, an instrument with longer term and lower interest rate than MLF. These moves kept the liquidity neither too loose nor too tight. The market expected structurally relaxed liquidity. In such a context, the overall cost of bond issues fluctuated in a downtrend. As of the end of Q1 2019, the average issue rate of AAA CPs was 50 bps lower than that at the end of last year, compared with a more than 100 bps decline in the issue rate for AA+ and AA ratings. As of the end of March, the average issue rate for AAA, AA+ and AA ratings was 3.44%, 4.28% and 5.36% respectively.

Figure 11: 1-year CP issue rate fell with fluctuations



Data source: Compiled by CCXI

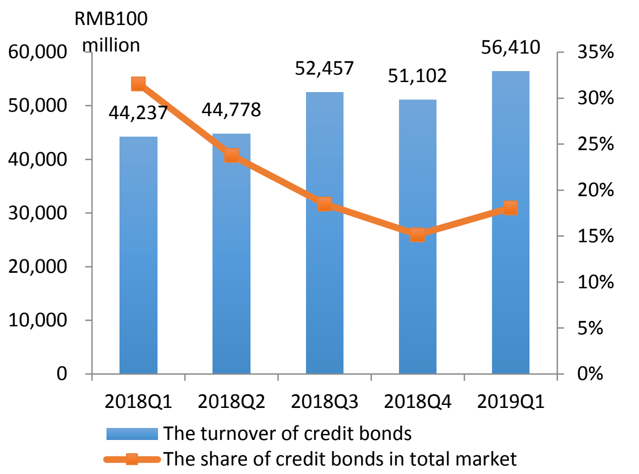
Overall, credit bond issues totaled RMB2.74 trillion in Q1 2019, showing a YoY expansion for all major types of bond. By ratings, the median rating of newly issued bonds moved up further, with the percentage share of AAA bonds rising by 6 percentage points over 2018. Bond issue rates fell with fluctuations. As at the end of Q1, the 1-year CP issue rate dropped by 50 bps to 194 bps from the end of 2018.

2. Secondary market: The credit bond performance improved, bond yield declined markedly and the credit spread narrowed

Turnover of credit bonds increased, with CPs traded most actively

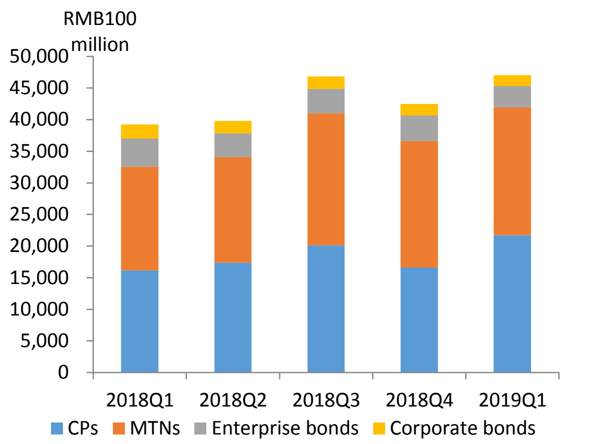
The turnover of spot credit bonds stood at RMB5.64 trillion in Q1 2019, representing an increase both YoY and QoQ. The turnover of credit bonds accounted for 10.08% of total bond market turnover, slightly higher than the previous quarter but substantially lower than one year earlier. From a view of type of bond, CPs[4] were most actively traded in Q1, followed closely by MTNs. Enterprise bonds and corporate bonds were less traded. Compared with the same period of last year, CPs and MTNs showed a rise in turnover, while enterprise bonds and corporate bonds bonds shrank in turnover.

Figure 12: Turnover of credit bonds increased both YOY and QOQ



Data source: Compiled by CCXI

Figure 13: Trading in short- and medium-term notes remained relatively active



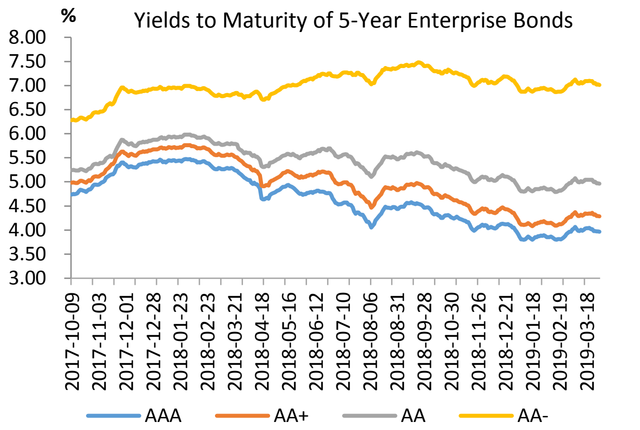
Data source: Compiled by CCXI

Bond yields declined, credit spread trends varying with term In Q1 2019, treasury bond yields first fluctuated in a downtrend and then staged a pickup. Overall, yields for all terms fell to various degrees, in a range of 1 bp to 16 bps, from the end of 2018. The yield of 10-year treasury bonds was 3.07% at the end of March, 16 bps lower than the end of 2018. In April, however, treasury bond yields picked up markedly, resulting from the stronger expectations of economic stabilization, market concerns over the possibility of tightening monetary policy and weaker-than-expected bidding in the primary treasury bond market, which all weighted on the bond market sentiments.

Credit bond yields have slumped since the beginning of 2019 due to improved liquidity environment and good primary market conditions. Though macroscopical environment is beneficial for development of bond market, the bond market has entered into a stage of bull/bear wrestling as the earlier favorable factors have been absorbed by market, while there were more interfering factors, such as accelerated local government bond issues occupied part of the credit bond investment demand and the short-term liquidity was depressed. With the 1-year interest rates appearing volatile in a downtrend, long-term credit bond yields showed fluctuations within a narrow band. Since late February, the stock-bond "seesaw" pattern has emerged as the A-shares went up, the credit bond yields picking up markedly. Then the credit bond yields returned to a narrow band of fluctuations. For all of Q1 2019, credit bond yields fell back from the end of 2018. Yields of 1-year to 7-year enterprise bonds with all ratings were down by 4 bps to 57 bps, and those of 1-year to 5-year medium- and short-term notes dropped by 8 bps to 59 bps. Relatively short/medium terms and low ratings saw a bigger yield decline. When it came to April, yields of treasury bonds ushered in a correction and yields of credit bonds generally went up.

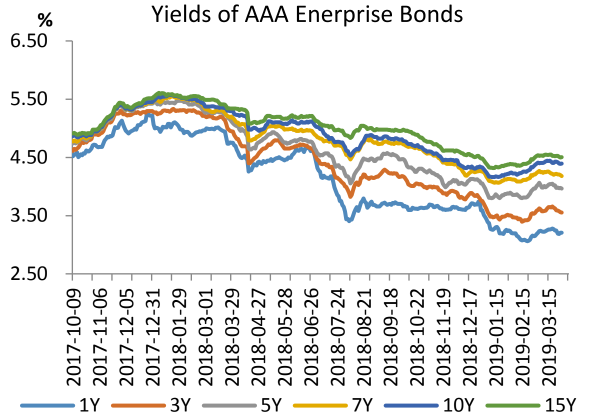
[4] This part of CPs includes SCPs, CPs of enterprises and CPs of securities companies.

Figure 14: Yields of 5-year enterprise bonds fell



Data source: Compiled by CCXI

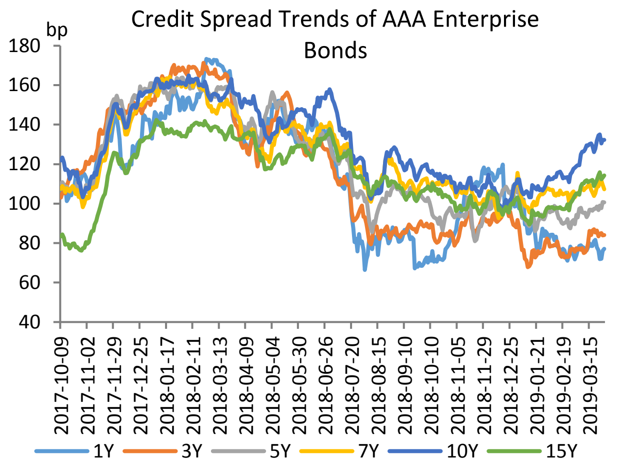
Figure 15: Yields of AAA enterprise bonds fell for all terms



Data source: Compiled by CCXI

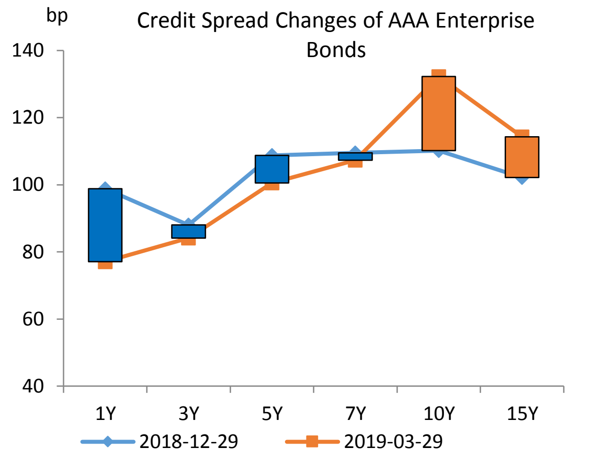
In terms of credit spread, AAA enterprise bonds were taken as examples, credit spread trends varied with term in Q1. Specifically, 1-year credit spread fluctuated in a narrower trend, 3-year to 15-year credit spreads shrank first and then expanded, and the longer the terms, the greater the expansion. 10-year and 15-year risk premiums rose markedly from the end of 2018. In the end of March, the 1-year to 7-year credit spreads narrowed by 2 bps to 22 bps when compared with the end of last year. Credit spreads for longer terms expanded, and the gap between the long-term and short-term credit spreads was widened markedly.

Figure 16: 1-year credit spread continued to shrink, while credit spreads for other terms fell first and then rose



Data source: Compiled by CCXI

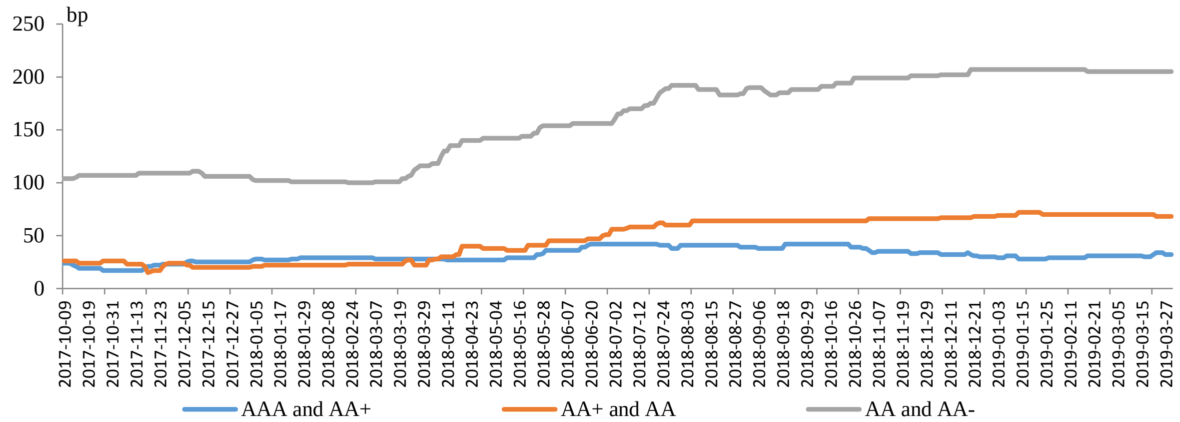
Figure 17: 1-year to 7-year credit spreads shrank from the end of 2018, while 10-year and 15-year credit spreads widened



Data source: Compiled by CCXI

In terms of rating spread, 5-year enterprise bonds with various ratings were taken as examples, the spread between AAA and AA+ expanded mildly in Q1. The rating spread between AA+ and AA stayed stable in an interval of 68 bps to 72 bps. The spread change between AA and AA- did not exceed 2 bps. In terms of spread level, the spread between AA and AA- was obviously wider than that between other adjacent ratings, suggesting that investors still required higher risk premium on AA- bonds.

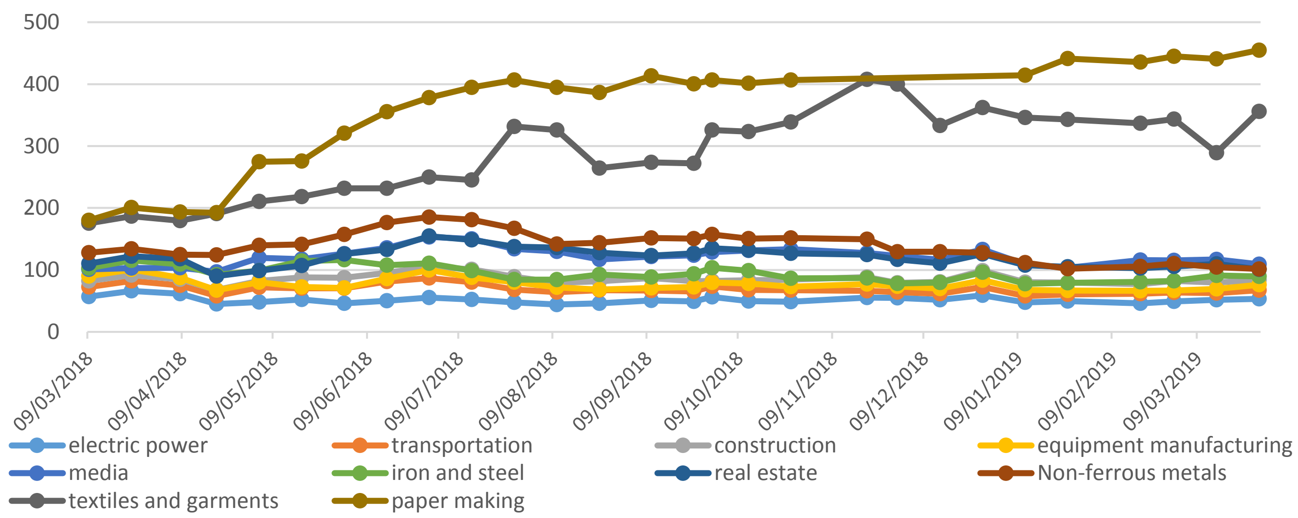
Figure 18: The spread between AAA and AA+ expanded mildly, while the spread between AA and AA- remained large



Data source: Compiled by CCXI

In terms of industry, spreads of electric power, transportation and equipment manufacturing remained at low levels. Non-ferrous metals, real estate and media showed slightly higher risk premiums, while textiles and garments and paper making had substantially higher spreads than other industries. The industry ranking by credit spreads did not change significantly. In terms of spread changes, except for paper making and textiles and garments with notable expansion in interest rate spreads, most industries showed relatively minor changes in the median spread.

Figure 19: Spread trends by industry



Data source: Compiled by CCXI

The turnover of credit bonds expanded in Q1 2019, both YoY and QoQ, yet taking up a smaller share of total market turnover than one year earlier. The most actively traded securities were commercial papers (CPs) and medium-term notes (MTNs). In terms of bond yield trends, the yields of credit bonds dropped in Q1 slightly, by 4 bps to 59 bps, from the end of last year. In terms of credit spread, the AAA credit spread trend varied with term. The 1-year to 7-year credit spreads narrowed, while longer-term spreads expanded significantly compared with the end of last year. The gap between the long-term and short-term credit spreads was widened markedly. As for rating spread, there were minor changes in the spread between adjacent ratings.

Outlook: The bond market will stage mixed performance in Q2, with bond issues expected to heat up, yields to be more volatile and credit risk to be further released.

The bond market is expected to show mixed activity in Q2. On the one hand, the bond issues are very likely to pick up on the structurally easy monetary policy and the stronger financing support for private enterprises. In addition, the liquidity environment will still bolster the bond market activity, which, coupled by the inclusion of China's bonds in the Barclays indices, will bring additional funds to the domestic bond market. On the other hand, however, bond market also face some disturbing factors such as short-term economic recovery, rising inflation expectations, increasing pressure on bond supply and fund diversions to stock market, which may add to the yield volatility. In addition, taking into account the increase in credit bonds maturing in Q2 and the continuing debt rollover pressure on enterprises, some private enterprises with a weak credit standing will still pose a high default risk. Defaults of individual bonds are expected to occur frequently in Q2. Extra attention should be paid to the risk performance of farming, forestry, food processing, film and television entertainment, chemical and real estate industries.

1. Primary market: Bond issue are expected to pick up

Bond issues are likely to continue picking up in Q2 as regulators increase policy support for financing and the prudent monetary policy remains neither too tight nor too ease. On the one hand, the financing environment is expected to improve on the stronger policy support for debt financing of private enterprises. Bond issue rates will still fluctuate at lows, expected to boost enterprises' willingness to issue bonds. On the other hand, the bond refinancing pressure is generally high in Q2 as a conventional peak period of bond supply. China's bond market was included in the Bloomberg Barclays indices in April 2019, further expanding the channel for foreign investment in Chinese bonds. Either the financing demand of enterprises or the investors' demand for bond investment will be further improved to boost bond development. In addition, in terms of local government bond issues, there is still a large unused balance of special bond issue quota in spite of the obviously faster pace of local government bond issues in Q1 this year. Considering the plan of the Executive Committee of the State Council to basically complete the special bond issues by the end of September this year and PBOC's vow to accelerate local government bond issues, special bond issues will gain pace in Q2 and Q3 and the total scale is estimated to be bigger than Q1. That will be one of the drivers of primary market pickup in Q2.

2. Secondary market: Yields are expected to be more volatile

In the secondary market, the 2019 work report of the Chinese government shows the Central Government's higher tolerance of economic downturn. Though public spending is increased, it is just intended to slow down the economic deceleration but difficult to reverse the downtrend of the Chinese economy, which is expected to be weaker than last year. In the current stage, China's local governments and private enterprises are still under a refinancing pressure. The rising financing costs are expected to make it difficult to defuse local government debt risks and the financing difficulties of SMEs and micro businesses, which does not conform to the policy orientation. Thus the market still expects a structurally easy monetary policy. In terms of external environment, the Fed's interest rate forecasts in Q1 turned dovish, which, coupled by the inverted US treasury yields, worsened the market concerns over a slowing US economy. In addition, the Fed's slower pace of hikes may give greater flexibility to China's monetary policy. Moreover, against the backdrop of the global economy facing a downward pressure, Brexit standoff and the ongoing US-China trade frictions, some investors may rush into the bond market as safe heaven. The inclusion of Chinese bonds in the Bloomberg Barclays indices may attract more foreign investments into the bond market. Above all, **fundamentals**

and liquidity environment are conducive to the bond market development in the long run.

But it should be noted that the secondary-market yield decline also faces some resistance. Firstly, as the easy credit has gradually taken effect, the improvements in economic and financial data in March also had an impact on the market and strengthened market expectations of economic stabilization in Q2. Secondly, the currently low inflation is likely to pick up and a higher inflation pressure will curtail interest rate decline. Thirdly, the regular large scale of bond issues in Q2 and the accelerated local governance bond issues will add to the supply pressure, which will test the strength of the bond market demand. In addition, if the A-share market activity is strong, a stock-bond "seesaw" effect may emerge and the SSE STAR market launch will result in a fund runoff from the bond market. Overall, **with so many negative factors, the yield volatility is likely to increase in Q2.**

3. Credit risk: The risk of bond default in Q2 will continue to be exposed

In terms of credit risk, it is expected that the risk of bond default in Q2 will not be significantly weakened and will continue to be exposed. A total of over RMB5 trillion credit bonds (including repos) are expected to mature in the coming three quarters of 2019, a bigger scale than that in the same period of 2018 and showing a larger proportion of bonds rated AA+ or below. As lower-rating bonds usually have a big ratio of sellbacks requested by investors, issuers face a big refinancing pressure. Private enterprises will see an improving environment of bond financing as the policy support for private enterprises is advanced and taking effect. Investors will have a stronger preference to private enterprises with better credit standing, while credit risk events will continue to occur among private enterprises with lower credit ratings. **In Q2, industries that deserve extra attention include farming, forestry, food processing, film and television entertainment, chemical and real estate.** Specifically,

1) Enterprises in the farming, forestry and food processing industry, in particular pork-related food manufacturers, are affected by the spreading African swine fever. The accelerated over-capacity cuts in the hog production market and the further decline in hog stock result in a significant shrink in pork supply. The ratcheting up pork price will adversely affect the operations and profit of relevant enterprises.

2) Enterprises in the film and television entertainment industry are mainly private businesses with volatile profits, and some of them have the problems of goodwill depreciation, share pledge, etc. Their financing environment is still not positive in the context of strict industry regulation. Cash flow risks of such enterprises deserve vigilance.

3) In the chemical industry, some SMEs are forced to cut production or shut down under the tightening environmental policy and tough environmental crackdown measures. These SMEs are experiencing extreme deterioration in operating conditions, posing a prominent risk of default. In addition, some enterprises have hidden troubles in safety management. Chemical enterprises have frequently undergone safety accidents since last year, which adds to the negative impact on the chemical industry. The risk levels in the industry will become further divergent in the future.

4) In the real estate industry with a strong financing demand previously, most property developers chose to "borrow news loan to repay outstanding loans" when 2019 began as the financing policy got relaxed. The industry as a whole is under a large debt service pressure. In late February this year, CBIRC and PBOC successively vowed to forestall financial risks in the real estate industry, strengthen prudent management of real estate finance and implement a long-acting mechanism for steady and healthy development of the property market. That points to the unlikeness of expansionary credit for the real estate industry. Due attention should be paid to the refinancing risk in the real estate industry.

In addition, as for LGFVs, the majority of provinces remain debt ridden at present. Under the pressure of maturing debts in the future**, LGFVs will pose a higher risk of default on non-standard debts. It is necessary to guard against the risk of non-standard debt risk spreading to the bond market.**

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