CCXI & CCXAP – Research & Commentary

Marginal Tightening of the Financing Environment Leads to Bond Repricing; Meticulous Bond Selection Unlocks Structural Opportunities

Hong Kong, 3 February 2021 -- China Chengxin International Credit Rating Co., Ltd. ("CCXI") issued a report entitled *"Marginal Tightening of the Financing Environment Leads to Bond Repricing; Meticulous Bond Selection Unlocks Structural Opportunities: 2020 Review and 2021 Outlook of High-yield Bond Market"*. According to the report, as the economy further recovers, the credit financing environment may experience a marginal tightening in 2021, and the public offering market will possibly see its default ratio going up to 0.70-0.80%. At the same time, the default risk will probably release in a more orderly process. It becomes less likely to trigger unexpected default events, which provide opportunities for investing the accidentally oversold high-yield bonds.

From the perspective of investment strategy, the divergence of regional valuation may intensify for high-yield urban infrastructure investment bonds. Under this expectation, regional factors will possibly have a greater influence on the selection of urban infrastructure investment bonds. It is necessary to be vigilant against policy risks. Non-urban infrastructure investment state-owned enterprises (SOEs) hold a weakened appeal for investors, some industries are under refinancing pressure, and weakly-qualified entities may speed up their clearing process. Therefore, it is recommended to guard against the contagion of credit risks among enterprises in the same region. For non-state-owned enterprises, the financing environment can hardly be substantively improved. Meticulous bond selection unlocks structural opportunities in sectors such as the real estate and pro-cyclical sectors.

The report holds that the operation of the high-yield bond market revealed the following three major features in 2020: First, the issuance scale crossed the RMB1 trillion mark, the issuance interest rate fell to the low of the year in October, and nearly 90% of new bonds would mature or exercise put option within three years (inclusive). Benefiting from the macro environment of "loose fiscal and credit", 1,661 new high-yield bonds were issued in total throughout 2020, which led to a cumulative issuing volume of RMB1,042,072 million. Of these, those going to the infrastructure investment and financing industry made up the bulk share. The issuance interest rates kept fluctuating slightly and edging down from the beginning of the year to the annual low in October. Shocked by the default of SOE bonds, the rates edged up in November and fell back at the end of the year. **Second, the high-yield bond market took on a trend of "first rise and then fell". Since the end of October, the tail risks have been exposed at a faster pace.** Due to the unconventional monetary policy, the bond market yields declined rapidly from early 2020. Since the end of April, the marginal tightening has occurred to liquidity and the unconventional monetary policies started to exit successively. The bond market, therefore, transited from a stage of bull steepens to a stage of bear flatteners. Judging from the CCXI passive index for high-yield bonds, the high-yield bonds revealed a trend of "first rise and then fall" throughout the year. In the second half of the year, the industrial high-yield bond indices delivered a divergent performance and became more volatile. Only the chemical industry net price index yielded positive returns. Since urban infrastructure investment bonds haven't lost their appeal substantially, the net price index of urban infrastructure investment bonds remained stable, and generated the highest returns after risk adjustment. **Third, the secondary market of high-yield bonds witnessed a high level of trading and investment activity, and the shocks brought about by the defaults of SOEs amplified the trading momentum and deviation.** In 2020, the high-yield bonds posted a cumulative trading volume of RMB1.82 trillion and an average daily trading volume of RMB7,505 million. Specifically, the transactions were quite sluggish and only stood at a scale of RMB36,804 million, affected by the pandemic outbreak in the first quarter. The trading activity picked up gradually, with the trading volume reaching RMB417,335 million and RMB497.770 million in the second and third quarters, respectively. Since the end of October, the impacts caused by the defaults of SOEs have amplified the trading momentum. Consequently, the transaction interest rates went up, net price deviation rose, and expectation gaps emerged among investors. There followed an increase in game sentiment and risk premium demand.

Looking into 2021, the CCXI Research Institute believes that the financing environment will experience a marginal tightening, and the default rate may rise somewhat compared with 2020. With the further recovery of the economy, the unconventional monetary policies will exit successively. However, since the economy has not yet resumed its autonomous growth, the monetary policies will still maintain a steady tone overall, become more reasonably moderate, flexible and precise, and prioritize forestalling risks and stabilizing growth. In this context, the financing environment won't become overly tense. Instead, it is more likely to experience a marginal tightening compared with 2020. At the same time, corporate profits may undergo a marginal improvement. However, the recovery will be possibly not well-founded. Coupled with the recent resurgence of the pandemic, the recovery of corporate profitability may come under some negative influence. There is still a certain degree of uncertainty about their ability of subsequent recovery. The default rate of the bond market may edge up compared with 2020.

The report also points out that the bond market is more likely to experience an orderly clearing process in 2021. The possibility of unexpected defaults will decrease. The high-yield bond market as a whole may present fewer opportunities to invest in accidentally oversold bonds. There is an increase in the probability of non-conventional defaults and negative credit risk events, as well as in the possibility of non-exercise of redemption rights over perpetual bonds, extension waivers, and other operations. Investor risk appetite has declined, after the credit risk event of SOEs in November 2020. Coupled with the tightened credit financing environment in 2021, the companies with flaws (such as weakly qualified SOEs and private businesses at the tail) are more susceptible to the negatively homogeneous market expectations. Low-qualified issuers at the tail face greater clearing pressure. Given the maturity and put-back of high-yield bonds, the principal size of bonds due in 2021 will be RMB10,158,803 million, and the bonds entering the put-back period will amount to RMB737,373 million. The pressure from centralized redemption will be concentrated in January, March, and April. Non-urban infrastructure investment SOE bonds and private enterprise bonds will have to deal with a higher level of such pressure than that urban infrastructure investment bonds. **As to high-yield bond investment**, the regional valuation divergence in **urban infrastructure investment bonds** intensifies. In the future, regional factors may have a greater impact on the selection of urban infrastructure investment bonds.

Opportunities to invest in high-yield urban infrastructure investment bonds may arise from the process in which local governments implement plans to resolve or swap the debts for their weakly qualified platforms with tight cash flows. **Non-urban infrastructure investment SOE bonds** will hold less appeal for investors, and bond repricing will continue. The divergence of credit qualification among issuers may intensify, and some debt-ridden and poorly-profitable SOE issuers will accelerate their clearing process. In this context, it is necessary to return to the fundamental analysis. It is recommended to guard against the contagion of corporate credit risks within a region. For **non-SOE bonds**, the financing can hardly see a substantial recovery, the high-risk enterprises at the tail will speed up their clearing process. Affected by the increasingly tightened policies, real estate enterprises will still face challenges from sales proceeds, land acquisition, and financing. The divergence within the industry will further intensify. It is advised to select bonds carefully by taking into account such factors as business turnover, comprehensive calculation of on- and off-balance-sheet debts, and asset quality. In addition, as the global economy recovers, it is highly probable for pro-cyclical industries to improve their credit standing. It is suggested that investors pay particular attention to the segments of the booming industries such as non-ferrous metals and chemical industries to spot the companies that are well-positioned to embrace a fundamental recovery.

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中诚信国际
CCXI

中诚信国际信用评级有限责任公司
地址：北京市东城区朝阳门内大街
南竹竿胡同 2 号银河 SOHO6 号楼
邮编：100020
电话：(8610) 6642 8877
传真：(8610) 6642 6100
网址：http://www.ccxi.com.cn

China Chengxin International Credit Rating Co., Ltd
Address: Building 6, Galaxy SOHO,
No.2 Nanzhugan hutong, Chaoyangmennei Avenue,
Dongcheng district, Beijing, 100020
Tel: (8610) 6642 8877
Fax: (8610) 6642 6100
Website: http://www.ccxi.com.cn

中誠信亞太
CCXAP

中国诚信(亚太)信用评级有限公司
地址：香港中环康乐广场 1 号
怡和大厦 19 楼 1904-1909 室
电话：(852) 2860 7111
传真：(852) 2868 0656
网址：http://www.ccxap.com

China Chengxin (Asia Pacific) Credit Ratings Company Limited
Address: Suites 1904-1909, 19/F, Jardine House, 1 Connaught Place,
Central, Hong Kong
Tel: (852) 2860 7111
Fax: (852) 2868 0656
Website: http://www.ccxap.com