Focus on Superior Coupon Rate Strategies for High-yield Bonds and Credit Repair-brought Opportunities for Laggard Play amid the Eased Credit Risk and Continued Divergence

Hong Kong, 29 August 2022 -- The Research Institute of China Chengxin International Credit Rating Co., Ltd. (hereinafter referred to as "the CCXI Research Institute") recently released a report titled "Focus on Advantages of Coupon Rate Strategies and Credit Repair-brought Opportunities for Laggard Play amid the Eased Credit Risk and Structural Market of High-yield Bonds". According to the report, though the high-yield bond market saw its issue size drop significantly and trading activity decline in the first half of 2022 due to the structural supply-demand imbalance, the wealth index returned 3.10%, outperforming the Chinese government bond (CGB) and debenture indices, benefiting from the eased credit risk and the high coupon rate. **Looking ahead**, China's macro economy is expected to get stabilized and rally up in the second half of the year, with liquidity remaining reasonably abundant. Despite the undiminished maturity pressure in the bond market, **credit risk in the second half of the year would be basically manageable** as the entities with weak qualifications and poor risk resistance might have released their credit risk gradually in previous periods. **From the perspective of investment strategy**, the terminal interest rate may go up slightly from the first half of the year against the backdrop of economic recovery, there is some risk for the medium to high-grade debentures to fall back, and **high-yield bonds will generate prominently competitive coupon yields**. In addition, **it is expected that the high-yield bonds will still present a structural market**. On the one hand, urban construction investment bonds in some weakly qualified regions may become laggard plays, and high-quality real estate enterprises are on track to bottom out. On the other hand, tail issuers still face a high level of financing pressure, and the number of abnormal transactions has increased since the second quarter. It is important to track the tail risk and the uncertainty about debt repayment brought by the issuers who roll over their bonds.

The operation of the high-yield bond market in January-June 2022 mainly reveals the following three characteristics. First, the structural supply-demand imbalance pared back the issuance volume of high-yield bonds significantly. New high-yield bonds in the first half of the year amounted to RMB307,081 million, down 40% compared with both the second half and first half of the previous year. Structurally, the rigid control over urban construction investment bonds reduced the supply of high-yield bonds; the lingering disruption in the real estate sector led to the contracted demand of related sectors, with long-term, privately-offered bonds in the significantly shrinking supply; and influenced by the continuously shortened maturity, high-yield bonds saw their coupon rates and interest spreads moving divergently. **Second, CCXI's high-yield bond wealth index rose by 3.10% cumulatively in the first half of the year, highlighting the advantages of high-yield bond coupon rate strategies.** Benefiting from the overall slowdown in credit risk release and the low incidence of surprise events, the high-yield bond wealth index returned 3.10% cumulatively, outperforming CGBs and debentures; and the net price index hit a periodic bottom in mid-March and underwent a bumpy downturn of 0.27% in the first half of the year. **Third, trading/investment**

activity declined in the secondary market, with market sentiments diverging and abnormal transactions increasing in number. The cumulative turnover of high-yield bonds in the first half of the year stood at RMB1.80 trillion, indicating a downturn in trading/investment activity. Among the tail transactions of bonds with a yield of 10% or higher, the medium to long-term urban construction investment bonds in the weakly qualified regions and the private real estate bonds made up the bulk. The abnormal transactions accounted for 16.97%, up 3.74 percentage points from the second half of the previous year. It is advised to follow the risk of valuation fluctuations among the weakly qualified issuers.

Looking ahead, the CCXI Research Institute suggests spotting superior coupon rate strategies for high-yield bonds and credit repair-brought opportunities for laggard play amid the eased credit risk and continued divergence. China's macro economy is expected to get stabilized and rally up in the second half of the year, with liquidity remaining reasonably abundant. Credit risk would be basically manageable as the entities with weak qualifications and poor risk resistance might have released their credit risk gradually in previous periods. In 2022, overall credit risk is expected to be flat or slightly lower than that in 2021, and the annual default rate of the publicly offered bond market may range between 0.40% and 0.50%. Furthermore, credit levels/performances of entities will remain diverging, given their differences in profitability restoration. From the perspective of investment strategy, the terminal interest rate may go up slightly from the first half of the year against the backdrop of economic recovery, there is some risk for the medium to high-grade debentures to fall back, and high-yield bonds will generate prominently competitive coupon yields. In addition, it is expected that the high-yield bonds will still present a structural market. On the one hand, urban construction investment binds in some weakly qualified regions may become laggard plays, and high-quality real estate enterprises are on track to bottom out. On the other hand, tail issuers still face a high level of financing pressure, and the number of abnormal transactions has increased since the second quarter. It is important to track the tail risk and the uncertainty about debt repayment brought by the issuers who roll over their bonds.

By sector, high-yield urban construction investment bond financing may make marginal improvement. It is important to pay attention to regional divergence and the evolution of credit risk induced by platform companies themselves in the context where bond planning is made province-wide. Given the introduction of such policies as stabilizing infrastructure construction and advancing county urbanization, financing platform companies involved in key areas and key projects may benefit from favorable policies, such as the "23 measures" of the People's Bank of China (PBOC), which required meeting the reasonable financing demands of the financing platform companies as per the market-based principles. In this case, financial institutions may marginally relax their tightened grip over platform financing, but the overall principle of strictly controlling hidden debt will not change. Besides, the central government and many local governments have recently notified the accountability cases related to hidden debts, which makes it possible to form a pattern where hidden debt risk could be mitigated on a province-wide scale. Therefore, it is recommended that investors track the hidden debt resolution processes in the weakly qualified regions, guarding against the refinancing risk and valuation fluctuation risk that platforms or the regions where they are located may face due to such factors as regulatory accountability and punishment.

High-yield bonds of state-owned enterprises (SOEs) not engaged in urban construction

investment saw their earnings and financing both improved, with particular attention paid to the intensified corporate credit divergence caused by the policies on peaking carbon emissions and achieving carbon neutrality ("the dual carbon policies"). This year, SOEs outperformed private enterprises in terms of profit and financing. This is especially true for SOEs in the cyclical industries such as coal and iron & steel. As these SOEs' profit improved remarkably in the support of industry prosperity, credit supply was gradually redirected to their high-yield bonds. In the first half of 2022, CCXI's high-yield bond index for non-urban construction investment SOEs gained 4.01% cumulatively, demonstrating an obvious advantage over others. However, we also note that CCXI's net price index of high-yield bonds in the coal industry peaked and started to fall from the second quarter. As a result, the trend opportunities brought about by credit sinking decreased and the margin of safety fell, which might trigger the risk of pullback. In addition, under the pressure from green and low-carbon transformation and upgrading, some carbon-intensive enterprises have increased their capital expenditure, which would add to their debt burden. Subsequently, particular attention should be paid to the intensified credit divergence and tail risk elevation among carbon-intensive enterprises in their pursuit of green development.

In regards to high-yield bonds of non-SOEs, high-quality real estate enterprises are expected to bottom out, and it is recommended to take note of the uncertainty about debt repayment by the troubled real estate enterprises. Guided by the principle that houses are for living in, not for speculation, many ministries and commissions of the central government have this year reiterated a stance of stabilizing the real estate sector, emphasizing support for basic and improved housing needs at a Political Bureau meeting. In May, the central bank cut the lower-bound range of mortgage interest rates and benchmark interest rate, a move further manifesting the "one policy for one city" principle and helping boost the gloomy real estate market. In this context, it is expected that high-quality real estate enterprises will enhance their refinancing capabilities in the second half of the year, with the gradual easing of downward pressure on sales and the support from credit protection tools. So investors are advised to pay due attention to trading opportunities of related entities. Meanwhile, the troubled and debt-ridden real estate enterprises will remain in a state of persistent liquidity crunch and balance sheet reduction, so their credit position may continue to weaken. Attention should be paid to the uncertainty about subsequent debt repayment by relevant issuers.

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