MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – MARCH 2020

MARKETING MATERIAL

FOCUS

THE FINANCIAL HEALTH OF CHINESE SOEs AND CORPORATES

EQUITIES

STRONG MOMENTUM IN QUALITY GROWTH IN RESPONSE TO BETTER EARNINGS

This is an excerpt of our Monthly House View. Should you wish to receive the full version, please contact us.

EDITORIAL

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VIRAL ECONOMICS

"There are times in history where the one who dares to say that 2 + 2 equals 4 is sentenced to death."
Albert Camus, La Peste

Dear Reader,

Over the past month, most economists and strategists have been struggling to evaluate the macro-economic impact of the coronavirus (COVID-19[1]) with a great variety of approaches, sometimes guided by anxiety and rush, too often relying on the past experience of the SARS[2] in 2003 - a time when Chinese GDP was nine times smaller than today. It is all the more difficult to run the numbers on this issue given the importance of the confidence and viral anxiety component of the macro-economic feedback loops.

In these circumstances and in the absence of relevant macro data, bottom-up signals can sometimes better enlighten our vision.

What do they tell us? Locally, several industries face a double-digit slowdown in sales volumes, and notably travel, tourism, logistics and shipping, as well as physical retail are all suffering from the freezing effect of the coronavirus (COVID-19) containment measures, and luxury-goods sales and real estate sales have been put on hold. Some companies have started to emit warnings regarding their results due to either weakening sales in China or to supply-chain issues. Assessing the contagious effect of the epidemic in our global economy is our concern as asset allocators.

However, we would guard against drawing any hasty conclusion regarding the imminent end to this cycle of global growth. The impact on China's GDP in the first quarter of this year will be significant, and will weigh on global growth as well in the first part of the year. World GDP growth could indeed dip below the 3% threshold if the situation were to worsen from here. Countering such an outcome is of course the accommodative policy of the Chinese central bank and additional stimulus can be expected. The Fed too is monitoring closely the situation and its impact on the world economy. Investors have responded to the crisis by pushing long-term yields down and equity investors are selling cyclical names and buying quality/defensive companies. So far this makes sense, and so far it has been justified, given the solid Q4 earnings released by US in particular the larger capitalisations in the technology and consumer sectors. In spite of the tragedy of the coronavirus (COVID-19), markets are still supported by what remains a rather goldilocks-type late cycle environment.

Nevertheless, this trend of bearish bond markets and bullish equity markets could reverse at some point. Either we realise that this was a short-term phenomenon, if the number of infected people peaks in March, and if we see a rebound in macro data in the second quarter. In that case, we could see a rotation into cyclical and value stocks, and from US to emerging market (EM) assets. Or, alternatively, macro-data weakness is worse than expected and shows a reduction in investments and trade, pushing global growth lower. The latter is not our current scenario. The biggest risk for equity markets in the short term would be an acceleration of profit warnings of global companies exposed to China.

In any event, it is too early to make a bullish or bearish call and it is never a good idea to over-react or extrapolate too much. In this situation, we prefer to stick to our 2020 strategy: keeping our equity exposure, reducing exposure to low yielding credit, and keeping our macro hedges which reduce portfolio volatility in difficult times.

1 - COVID-19 is the new name given to the coronavirus by the World Health Organisation (WHO).
2 - SARS (Severe acute respiratory Syndrome), is a viral respiratory disease.

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THE CHINESE GOVERNMENT'S ACTIONS

The People's Bank of China recently offered CNY 200 billion (USD 29 billion) in one-year loans at a rate 10 basis points below the previous offer and at 3.15% it is now the lowest since 2017. Beijing has given a green light to provincial-level governments to issue a further CNY 290 billion (USD 42 billion) of special-purpose bonds early, adding to the RMB 1 trillion of such debt approved in November to boost infrastructure spending amid a slowing economy that is set to take an additional hit from the coronavirus (COVID-19) epidemic. Special-purpose bonds are recourse debts and contain payment guarantees from the local governments. These bonds allow the central government to have a view on the local governments' financial health to eliminate any hidden debts.

FEARS OF MORE LOCAL GOVERNMENT AND SOE (STATE-OWNED ENTERPRISE) DEFAULTS

On the downside, the higher debt at the local government level could magnify their vulnerability. The central government is clear that it will not bail out local government debts but leave market forces to address debt restructurings to reduce moral hazards especially amongst non-strategic SOEs. Between 2016 to present, SOE defaults accounted for only 6% of total Chinese corporate defaults in the offshore market (see chart below) or 19% of combined Chinese onshore and offshore corporate defaults. The offshore Chinese bond market refers to those issued outside mainland China in which foreign and Chinese investors can invest and trade bonds easily, and where our focus is.

The latest SOE to default in 2020 was Qinghai Provincial Investment Group Co Ltd. It is an integrated aluminium producer and fully owned by the Qinghai local government. It missed the coupon payment on its USD 300 million offshore bonds in January which triggered the default. Although the Qinghai government had previously bailed out this SOE's missed coupon payments in 2019 with a 5-day delay, the government was not able to provide the needed financial support this time around. This SOE is highly leveraged with an adjusted debt-to-EBITDA ratio of 49 times (S&P, 2018). Qinghai has a high funding gap of over 80% and a very high debt-to-fiscal revenue ratio of over 100% (National Bureau of Statistics, Provincial Finance Departments).

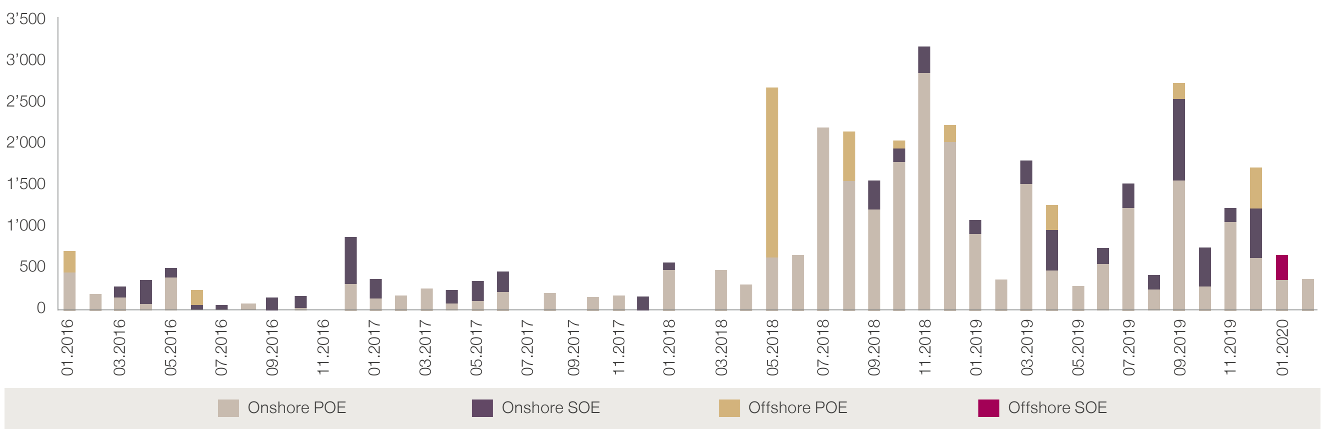
THE DISTINCTION BETWEEN CENTRAL AND LOCAL GOVERNMENT SOEs

The liquidity crunch in two Tianjin local SOEs involved in commodity trading and real estate stemmed from weak profitability and unsustainable debt-servicing obligations. Tianjin's GDP growth has been merely half of the national level since 2017. Its SOE assets as a percentage of provincial GDP is also quite elevated at 176%, above the national level of 117%. Moreover, Tianjin government debt has risen by double-digits in both 2017 and 2018 as the local government tried to mitigate the economic slowdown by spending large which makes potential bailouts on SOEs' debt increasingly difficult.

FINANCIAL HEALTH CHECK OF RATED CHINESE PROPERTY DEVELOPERS

Corporate bonds issued by Chinese property developers account for around half of all Chinese high-yield bonds, but property developers' historical default rates are indeed significantly lower than that of the energy and industrial sectors, thanks to the rising value of their land-bank reserve over time and their ability for timely asset disposals to shore up liquidity when needed.

CHINESE ONSHORE AND OFFSHORE CORPORATE DEFAULTS SPLIT BY SOE AND POE IN VALUE, USD MILLION, 2016 TO PRESENT



SOEs: State-Owned Enterprises, POEs: Privately-Owned Enterprises.
Source: Bloomberg, Indosuez Wealth Management.

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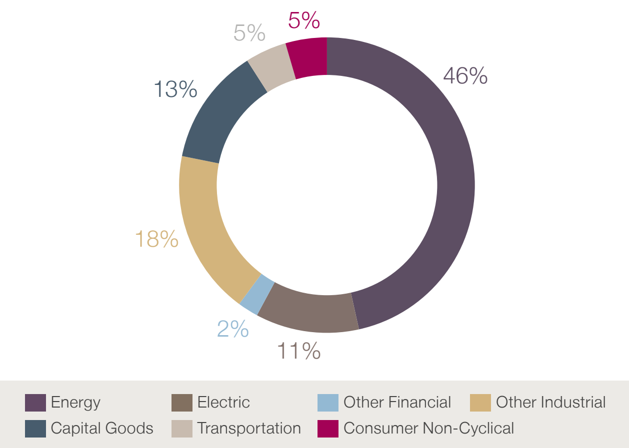
THE FINANCIAL HEALTH OF CHINESE SOEs AND CORPORATES

Among all rated Chinese property developers on our radar, nearly all of them have a land-bank reserve equivalent to 3 to 4 years of future developments. Their Wuhan/Hubei exposures are also fairly manageable between 0 and 6% of their total land-bank reserve. It is true that during the first week of February, home sales in the major 36 cities in China plunged 90% year on-year in volume. As a result, some developers' liquidity could be squeezed as the usual upfront funding from property pre-sales dries up while continued replenishing of land-banks is still needed. Developers with a sizeable land-bank reserve can afford to suspend land-bank purchases temporarily.

In terms of historical defaults by sector, in fact, nearly half of defaulted Chinese corporate bonds came from the energy sector (chart below), while industrial and capital goods sectors make up of one-third of the total. Many of these defaulted corporates are rated by neither S&P nor Moody's. They generally have poor financial disclosure in foreign languages and tend to have high capital expenditure, poor cash flow generation, and less valuable fixed assets to weather any cyclical shocks. Bonds which are rated at least by two international rating agencies generally provide better and more timely financial disclosures which make credit monitoring for investors easier.

CHINESE OFFSHORE CORPORATE DEFAULTS BY SECTOR, % OF TOTAL, 2016 TO PRESENT



Source: Bloomberg, Indosuez Wealth Management.

REGULATORY SUPPORT FOR PROPERTY DEVELOPERS

Given the sizable contribution of the property market directly and indirectly to the country's GDP (estimated to be around 7% and 20-25% respectively), the National Development Reform Commission (NDRC) recently allowed developers with an existing offshore bond issuance quota to extend their quota expiry date by six months so as to give developers more breathing room in their bond issuance plans which are being disrupted by the coronavirus (COVID-19) outbreak. The recent Politburo meeting pledged to assess further tax relief measures and keep monetary policy flexible to provide financial support for the most affected regions and private sectors.

IMPACT ON THE CHINESE AVIATION INDUSTRY

Another sector which is exposed to the impacts stemming of the coronavirus (COVID-19) is the airlines. Two-thirds of China's passenger planes have been grounded as travel restrictions and fears sparked by the outbreak of the virus have hit passenger numbers sharply. The total number of passengers carried by Chinese airlines from the end of the lunar new year break on 27 January to 12 February was 10.2 million, down 70% compared with the same period a year ago.

Whilst the largest carriers (Air China, China Eastern Airlines and China Southern Airlines) will be able to navigate the choppy environment, smaller and more indebted airlines will be vulnerable should the virus continue to spread. Chinese cities and provinces own stakes in about 20 regional airlines and it is expected that the authorities will bail out local airlines through cash infusions, loan repayment waivers or more favourable aircraft leasing terms should they run into difficulties. However, this could place additional financial pressure on local governments that are already struggling to deleverage.

The most recent case is that of HNA Group, a Chinese conglomerate that owns Hainan Airlines and several other airlines and is highly indebted as a result of past acquisitions and is struggling with its financial obligations. The local government of the southern island province of Hainan may be in talks to seize control of the group and sell-off its airlines assets to other domestic carriers.

CONCLUSION

We believe that the magnitude of government stimulus to specific regions and sectors will depend on the duration of the disruption. Avoiding moral hazard and a sharp surge in defaults remain high on Beijing's agenda.

The normalisation of some sectors (such as property) is likely to occur earlier than others, notably tourism. Beyond China, neighbouring countries including Thailand, South Korea, and Singapore, have quickly responded with new tax benefits and financial support for corporates affected by the outbreak in order to mitigate the spill-over effect on supply chains.

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