

CCXI & CCXAP – Research & Commentary

Recovery of Market Sentiment Leads to Fewer Crisis-driven Opportunities, and Tail Risk Orderly Release with Bond Market Stratification

Hong Kong, 3 August 2021 -- A report titled “Recovery of Market Sentiment Leads to Fewer Crisis-driven Opportunities, and Tail Risk Orderly Release with Bond Market Stratification: Review and Outlook of High Yield Bond Market in H1 2021” (hereinafter referred to as “the Report”) has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. (“CCXI Research Institute”). The Report forecasts that the default rate of the public offering bond market will reach 0.70-0.80% throughout the year of 2021, considering many factors such as the marginal weakening of momentum needed by economic recovery, the tightened issuance review, the considerable pressure from bond maturity and put-back in the second half of the year, and the continuous exposure of credit risks. On the one hand, regulatory authorities continue to improve the bond market systems in terms of information disclosure, defaulted bond disposal, and many other aspects; prevent issuers from malicious evasion of debts; and strive to guide the orderly release of credit risks. With these steps, the bond market is more likely to experience an orderly clearing process. On the other hand, as investors’ risk appetite declines, medium to high-grade bonds will see their interest spreads narrowing down constantly and investors have reservations about the “credit sinking” strategy. Coupled with the influence of new regulations for asset management and wealth management products, the demand for long-duration and high-volatility assets may further weaken. As a result, credit stratification will continue as a trend. **From the perspective of investment strategies, high-yield urban construction investment bonds face the tightened policy environment. Especially the heavily-indebted, poorly-qualified platforms are under refinancing pressure, and regional differentiation gets intensified. For the next step, it is suggested to follow up with such strategies as structural adjustments in the central region, appropriate extension of bond duration, and selection of lower-rated bond types. It is still a key test whether state-owned enterprises (SOEs) can renew their mid-to-long-term high-yield industrial bonds upon their maturity. As crisis-driven trading opportunities are gradually tapped by the market, it is currently seen that the risk to reward ratio has fallen somewhat and the room for short-term game has narrowed. There are frequent negative credit events of industrial bonds issued by private enterprises. Financing, trading and investment sentiment are becoming more fragile, especially in the real estate industry. It is, therefore, recommended that investors should select bonds carefully by taking into account many factors such as cash flow stability, operating turnover ratio, on/off-balance-sheet debts, and asset quality.**

The Report holds that the operation of the high-yield bond market revealed the following three major features in the first half of 2021. First, urban construction investment bonds demonstrated the intensified regional divergence and industrial bonds continued their structural contraction in the primary market. In the first half of the year, 943 high-yield bonds were issued in the primary market, which totaled RMB521.957 billion, a year-on-year increase of 3.79%. Of which, high-yield urban construction investment bonds accounted for over 80%.

New bonds were mainly concentrated in regions such as Jiangsu, Hunan, and Anhui, indicating the worsened regional divergence. High-yield urban construction investment bonds saw their issuance rates dropping significantly, and the risk premium of private enterprises rose somewhat due to negative credit events. In terms of maturity structure, new high-yield bonds were mainly made up of three-year and five-year bonds, with offering periods shortened slightly. With respect to industry distribution, the overwhelming majority of new bonds went to the infrastructure investment industry, which indicated the greater industry concentration. **Second, the CCXI high-yield bond net price index (hereinafter referred to as “the net price index”) declined amid fluctuation with a cumulative drop of 0.44% from January to June 2021. Tail risks got unleashed at a faster pace.** In January and February, the SOE’s industrial bonds in the high-yield bond market had their risk repricing still under way. Compounded with the accelerated release of debt risks by large private enterprises represented by China Fortune Land Development, investors became more risk averse. The net price index lost 0.60%. From March, some local governments took multiple measures to boost investor confidence in response to the continuous outflow of net financing. Consequently, the trading & investment sentiment in the secondary market recovered gradually. Coupled with the investment needs of institutions for high-yield assets, the net price index stopped falling and picked up. It cumulatively gained 0.44% from March to May. In June, some large-scale private enterprises triggered a spate of negative news and tail risks were released faster than before. As a result, the net price index fell again. From the perspective of sub-indices, the net price indices of high-yield urban construction investment delivered a divergent performance in different regions. Debt-driven regions such as Tianjin, Yunnan, and Guizhou broadly underperformed and became more volatile compared with the previous period. A look at the net price indices of key industries reveals that the index of the non-ferrous metal industry secured the sharpest increase and the indices of the wholesale & retail, real estate, and other industries suffered a considerable drop. **Third, trading activity in the secondary market remained at a high level, and market sentiment was restored gradually with crisis-driven opportunities for gaming weakening.** Since November 2020, high-yield bonds have managed to raise their trading activity by leaps and bounds. The cumulative transaction volume of such bonds from January to June 2021 amounted to RMB1,796.613 billion (RMB782.139 billion in the same period of a year earlier), accounting for 11.40% of the narrow credit bonds traded (5.25% in the same period of the previous year). Seen from the transaction scale of tail bonds with a yield of 10% or above, the bonds traded at a discounted price of below RMB80 were mainly the bonds of some private real estate companies such as China Fortune Land Development and Blue Ray Corporation, poorly-qualified SOE bonds in coal and comprehensive industries, and urban construction investment bonds in regions including Guizhou. Regarding transaction price deviations, the proportion of abnormal transactions rose first and then fell. Since the second quarter, market sentiment has gradually recovered. The net prices of some actively traded high-yield SOE bonds (not in urban construction investment) have risen significantly, which make opportunities for gaming crisis-driven high-yield bonds weaken.

Looking to the performance of the high-yield bond market in the year, CCXI Research Institute believes that the monetary policy will continue to remain stable, debt management will be tightened, pressure for credit risk release will linger, and structural stratification will continue. As the macro economy enters the period of the post-pandemic recovery, corporate earnings expectations have improved marginally, but the foundation for

repair may still need to be consolidated. Considering that the massive redemption following the maturity and put-back of bonds in the third and fourth quarters, there will still be the pressure for credit risk release. On the one hand, regulatory authorities continue to improve the bond market systems in terms of information disclosure, defaulted bond disposal, and many other aspects; strive to guide the orderly release of credit risks; and prevent issuers from malicious evasion of debts to further enhance investor protection. On the other hand, investors' risk appetite declines after the Yongcheng Coal defaulted. Affected by the mindset of investors to huddle together, medium to high-grade bonds see their interest spreads narrowing down constantly and investors have reservations about the "credit sinking" strategy. Coupled with the influence of new regulations for asset management and wealth management products, the demand for long-duration and high-volatility assets may further weaken. As a result, credit stratification will continue as a trend. **From the investment perspective, high-yield urban construction investment bonds face the continuously tightened regulatory environment. Investors care more about government strength.** Affected by the tightening of financing policies, it has become more challenging for the weak-qualified platforms to resolve their short-term debt pressure by adopting the "time-for-space" strategy. As a result, tail risks will diverge faster. In the early stage, institution investors mostly followed the strategy of "strong regions + weak qualifications", which has resulted in the narrowed interest spreads and the lower investment risk to reward ratio in high-quality regions. **Investors are advised to follow up with such strategies as structural opportunities in the central region, appropriate extension of bond duration, and selection of lower-rated bond types. Attention should be paid to the hidden debt entities that may have the characteristics of "high interest rates, a wide range of stakeholders, and high expectations of rigid redemption",** because they are more likely to be replaced preferentially and dissolved smoothly. **At the same time, it is recommended to remain vigilant when deciding to invest in the regions with their economic and fiscal strength (like financial resources) apparently departing from their debt expansion and with limited capabilities to coordinate regional debts** and to strengthen the monitoring of platform companies in terms of asset integration and transfer, defaults of non-standard assets, and guaranteed compensation over loans, among other aspects. **As to high-yield SOE bonds (not in urban construction investment), their room for short-term game has narrowed and there is a long way to go for the SOE reform over the long run.** Since the Yongcheng Coal defaulted, credit contraction has been a sweeping trend, accelerating the risk repricing process of SOEs' industrial bonds. Provincial governments have explicitly indicated/reiterated the strict prohibition on evading debts as a bottom line and adopted multiple measures to boost investor confidence in industrial bonds of SOEs. Coupled with the high prosperity of upstream industries, the pressure from the concentrated bond maturity of some entities has been relieved. It is expected that interest spreads will gradually narrow in the future. At present, the risk to reward ratio falls somewhat and the room for short-term game narrows. However, as the refinancing capacity of the primary market has not been restored to the level before the Yongcheng Coal defaulted, it is still a grueling test whether issuers can renew their mid-to-long-term bonds upon their maturity. In the long run, SOEs that issue high-yield industrial bonds generally shoulder some burdens left over from the past. So there is a long way to go for the SOE reform. Investors are advised to find the trading & investment opportunities arising from professional integration and structural adjustment of related industries and to follow closely up with their credit fundamentals dynamically. **With regard to high-yield non-SOE bonds, the frequent negative credit incidents lead to fragile**

financing, trading and investment sentiment. Since 2021, the negative credit incidents triggered by some large-scale private enterprises such as China Fortune Land Development, Suning, and Blue Ray Corporation have pushed up the credit premium of high-yield private enterprise bonds. Compounded with the increased negative rating actions by private enterprise issuers, it is difficult for private enterprises to substantially improve their financing environment in the short run. The secondary market witnesses the fragile trading & investment sentiment, increased abnormal transactions, and intensified valuation volatility. In the **real estate industry** where policy tightening continues, cash flow balancing ability has increasingly become an important factor to measure the safety margin of investments in high-yield real estate bonds. **It is recommended that investors should select bonds carefully by taking into account many factors such as cash flow stability, operating turnover ratio, on/off-balance-sheet debts, and asset quality.** In addition, with the recovery of the macro economy and the gradual rally of downstream demand, the price of the non-ferrous metal industry has rebounded to a historically high level, and it may stay there in the short term. **With issuers underpinned by strong internal cash flow, the net price index of the non-ferrous metal industry continues to lead the rise. Its overall credit quality is expected to remain stable.** Some industries such as light manufacturing and pharmaceuticals hold a small-scale stock of high-yield bonds. With the continuous outflow of net financing, these industries may experience a worsened divergence.

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