Outlook for China dollar bonds in 2023

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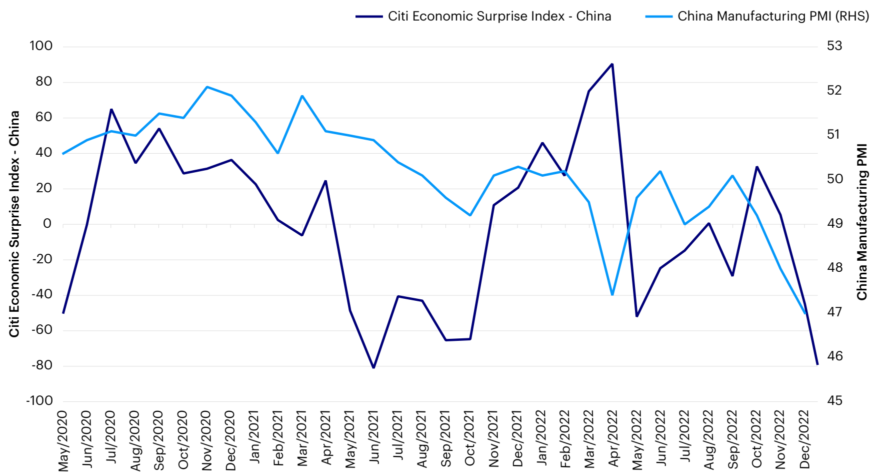
Executive Summary:

We are positive on China dollar bonds for 2023. China's economic growth has bottomed out and is starting to embark on a strong recovery trajectory. We believe that while China USD credit performance was extremely strong in the past month but could still have legs.

China's economic growth has bottomed out and a recovery is in sight
China's "Dynamic Zero COVID Policies" (DZCP) during 2022 combined with the property market slump have caused the country's economic activity to drop to the lowest levels since the COVID broke out in early 2020 (Figure 1).

Figure 1: China's economic activity has hit a post-COVID low



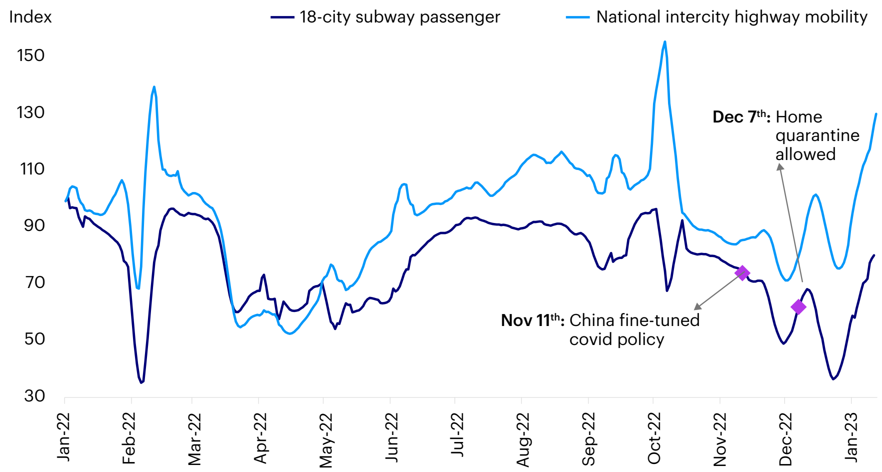
Source: Bloomberg, Invesco. Data as of 16 Jan 2023.

However, we expect a strong recovery on the back of supportive policies in Q1 2023. Since China has started moving away from DZCP in early November 2022, we have seen high frequency data trending upward. The government also rolled out the following policies [i] to stabilize the property sector in early January:

i. China Goes All Out to Rescue Its Ailing Property Sector, January 2023, https://www.bloomberg.com/news/articles/2023-01-06/china-goes-all-out-to-rescue-its-ailing property-sector

- **Issuing state-guaranteed corporate bonds:** Property developers can issue corporate bonds that are guaranteed by the China Bond Insurance Company on a regular basis.
- **Bank loan extensions: :** Chinese banks have been instructed to renew and extend credit lines to property developers.
- **Fine-tuning escrow deposits:** Property developers can partially withdraw funds from escrow accounts to settle project-related expenses and loans.
- **Resumption of A share placement:** Property developers can sell shares to raise funds in onshore markets.
- **Offshore loan financing:** Chinese banks can now provide offshore loans to property developers that are backed by their onshore guarantees.
- **Other policies:** Support scheme to strengthen balance sheets of quality developers; easing of "three red lines"; resumption of approvals for private real estate funds; mortgage rate cuts for first home buyers; loosened home purchase restrictions in several cities.

Figure 2: China's mobility recovery is visible

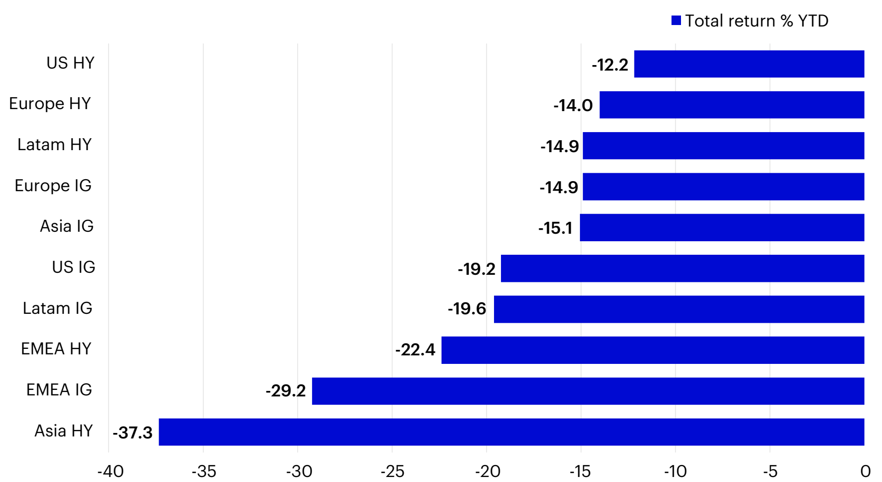


Source: Wind, CEIC, Morgan Stanley. Data as of 13 Jan 2023.

Given the speed at which top-down policies have translated into economic activity in China in the past, we have no reason to doubt that this time could be any different.

China USD credit performance has been extremely strong YTD but could still have legs
We believe that USD bonds issued by high quality investment grade (IG) Chinese issuers may continue to provide good carry. We expect that dollar bonds issued by high yield (HY) Chinese issuers will see further spread tightening on the back of supportive policies, better economic growth, and low new bond issuances in 2023. Thus, we believe that the current attractive carry is what investors are likely to receive in the worst case (Figure 4). The potential for underlying risk-free rate tightening combined with favourable moves in credit spreads could provide excess returns on top of the carry.

Figure 3: Global fixed income performance – Asia HY has massively underperformed



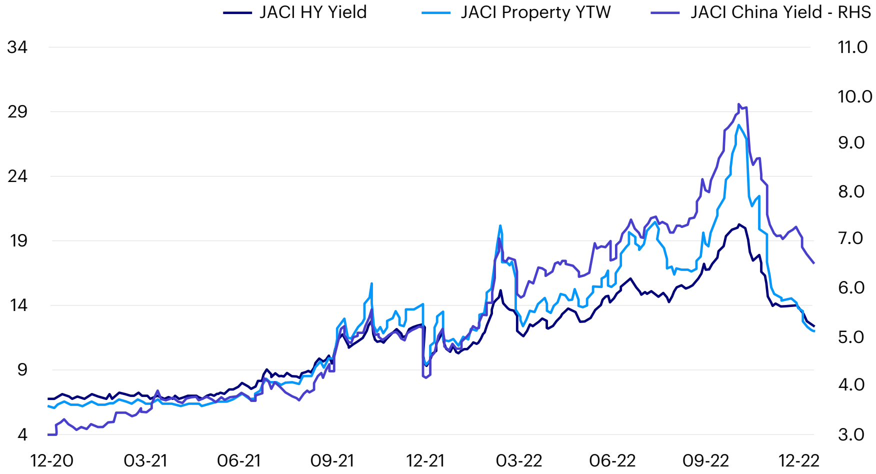
Source: Bank of America, Invesco, data as of October 30, 2022. **Past performance does not guarantee future results.**

Outlook for China dollar bonds in 2023

USD bonds issued by Chinese issuers was the worst performing asset class in the first 10 months in 2022 among the major hard currency bonds. The total return for China HY was down 58.8% in the first 10 months of 2022 [ii], which dragged down the Asia HY to become the worst performing against other IG and HY USD bond indexes.

At these heavily discounted prices, policy support has led to massive tightening of spreads. The recent rally in China credits has brought the yield levels of China USD bonds back to those seen in March 2022 (Figure 4). However, current levels still provide attractive carry and decent room for further tightening.

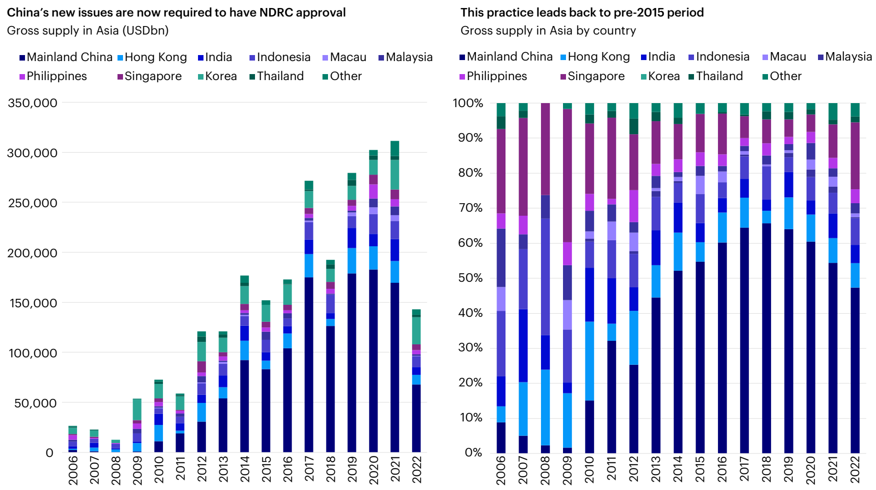
Figure 4: JPMorgan Asia Credit Index (JACI) high yield, property and China yield levels (%)



Source: Bloomberg, Invesco. Data as of 16 Jan 2022. An investment cannot be made directly into an index.
Past performance does not guarantee future results.

We expect lower supply in the USD bond market from Chinese issuers in coming months as the National Development and Reform Commission (NDRC) has recently announced a foreign borrowing approval requirement for China-based issuers where these issuers will need to demonstrate reasonable foreign funding needs. As a result, we believe that only issuers with foreign debt repayments or substantial international business are likely to be able to tap the dollar bond market in the future. NDRC also requires issuers to present: (1) analysis of necessity, practicality, economic viability, and financial sustainability before borrowing and (2) demonstrate measures to ensure debt repayment and prevent onshore default risk spillover to offshore market. We believe China USD bonds are therefore likely to be more "secured" with repayment risks constantly being monitored by regulators (Figure 5).

Figure 5: NDRC's new requirement may indicate minimal/negative net supply in the future



Source: BofA Global Research, Bloomberg, as of end 2022

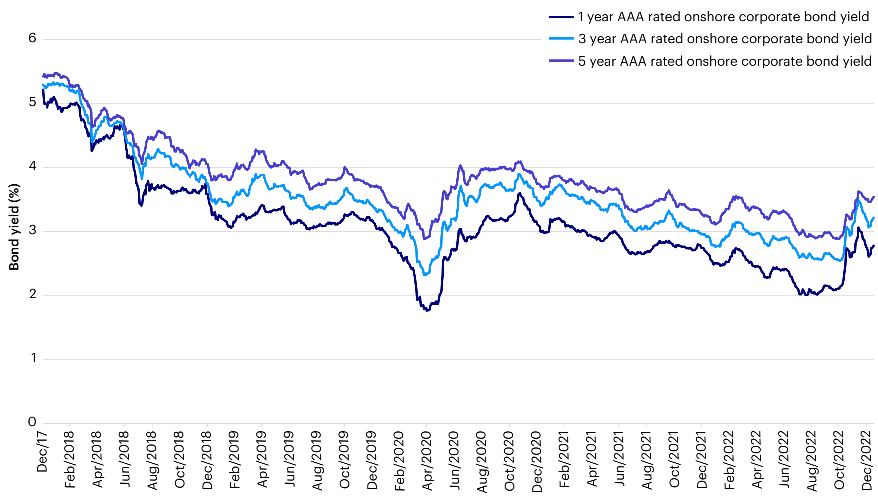
ii. Bank of America, data as of October 2022.

Outlook for China dollar bonds in 2023

China investment grade bonds are expected to trade stable
Although China investment grade (IG) bonds have tightened to relatively tight levels in recent months, we do not expect spreads significantly widening out for these bonds in Q1 2023 aside from local government financing vehicle (LGFV) bonds.

The three main types of investment grade-rated China USD bonds are state-owned enterprise (SOE) names (excluding LGFVs in this case), privately-owned enterprise (POE) names and the LGFV names. We have seen SOE issuers continue to enjoy financing support in both onshore and offshore markets. SOE issuers are mostly rated triple-A in the onshore market and their dollar-denominated bonds are rated investment grade. Although the recent rebound in growth expectations has pushed yields wider for onshore SOE names, absolute levels are still quite low (Figure 6).

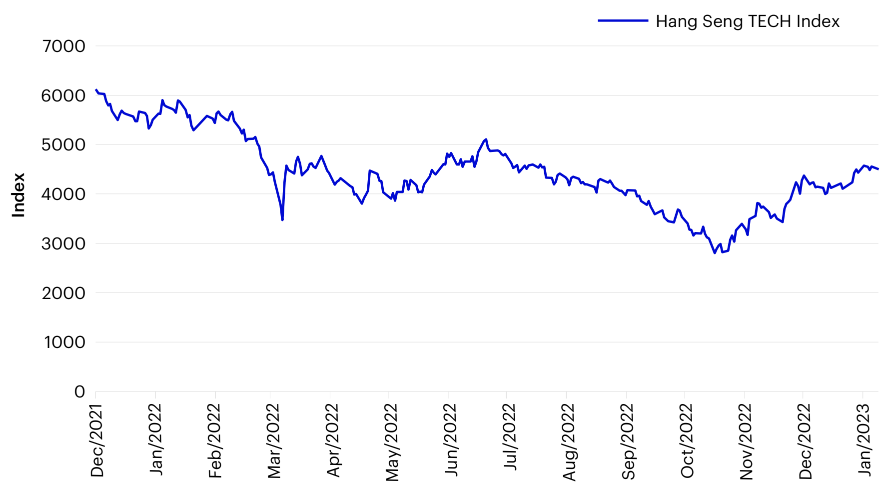
Figure 6: Onshore corporate bond yields still relatively low



Source: Wind and Invesco. Data as of 16 Jan 2023.

Chinese POE issuers that enjoy investment grade ratings are typically market leaders in their respective markets. We expect the government's pro-growth policy stance to boost financing conditions for these sector leaders in 2023. We saw the Chinese government trying to curb the aggressive expansion in the tech sector in previous years. However, the policy direction has already turned as we entered the second half of 2022. We continue to see credit positive policies being reported in the media in the first half of January 2023. Chinese regulators are moving to take "golden shares" in local units of large Chinese e-commerce giants. Recent media reports have also stated that the People's Bank of China (PBoC) vows to release more financial support measure for tech companies. Finally, China's major ride-hailing app has been reported to be allowed back into domestic app stores. We have also observed strong performance in both tech stocks and USD bonds issued by Chinese technology, media, and telecoms (TMT) firms.

Figure 7: Hang Seng Tech Index has rebounded by more than 60% in the past 3 months



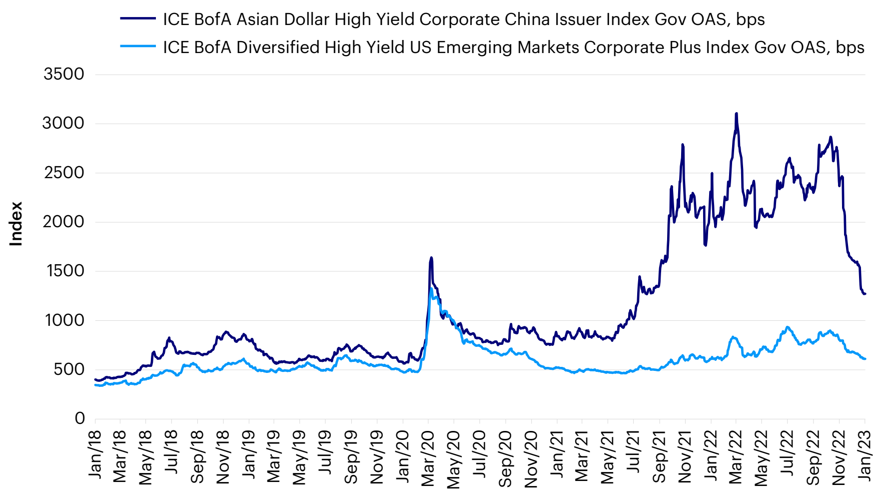
Source: Bloomberg and Invesco. Data as of 16 Jan 2023. An investment cannot be made directly into an index.
Past performance does not guarantee future results.

As for LGFV bonds, our base case is that there will be no public bond defaults in 2023. However, more and more incidents related to LGFV bank loans or trust loans have started to surface in the onshore market. We believe the spreads of the USD bonds issued by LGFV names could widen in the coming months. Technical support on these bonds has also been poor, especially on longer dated bonds from relatively weak regions.

China high yield bonds have legs

As for China high yield bonds, although the spreads have tightened massively, the index yield level is still relatively attractive compared to other HY USD bond indices (Figure 8). Our fundamental outlook has turned positive in this asset class while other spaces may see downside risks due to global macro factors.

Figure 8: China HY bonds have traded much wider than emerging market (EM) HY peers



Source: Bloomberg and Invesco. Data as of 16 Jan 2023. An investment cannot be made directly into an index.
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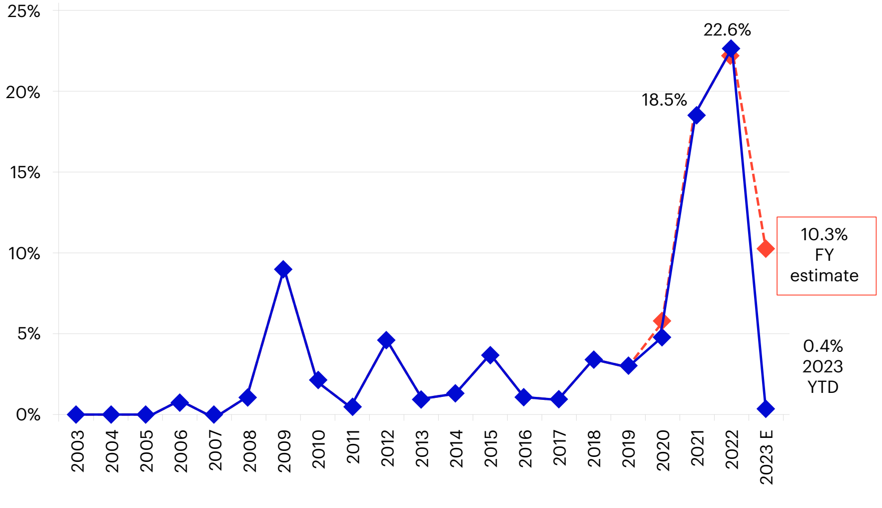
We believe the recent policies supporting the sector will reverse the defaults that we saw in 2022. Our current base case is that surviving scalable developers will not go into default in 2023 although we cannot fully rule out further defaults from smaller sized property developers. If there are more default cases, we believe these will likely only happen to issuers with bond prices at deep discounts. Therefore, market participants are not likely to be surprised as they were back in 2021 and 2022.

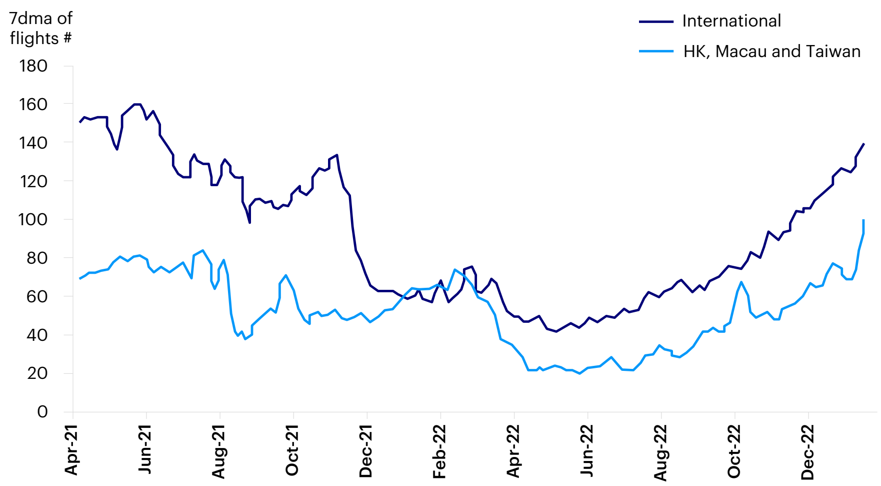
Figure 9: Default rates for Asia G3 HY Bonds



Source: Goldman Sachs. Data as of 7 Jan 2023.

Which other countries or regions could benefit from China's recovery story?
As China moves away from DZCP, we expect Chinese tourists to travel overseas. We expect the usual popular tourist destinations to benefit from China lifting their mandatory quarantine policy on arrival, namely Hong Kong, Macau, Thailand, Maldives, etc.

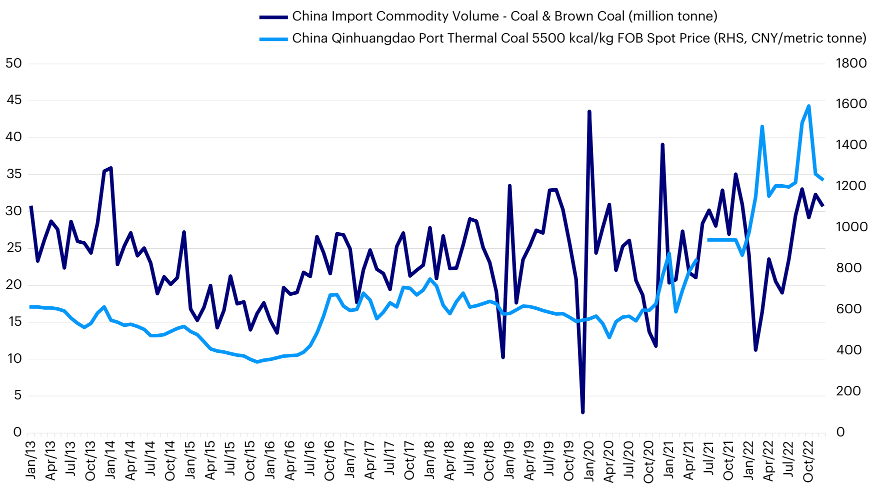
Figure 10: Number of cross-border flights from China



Source: Wind, Nomura Global Economics. Data as of 16 Jan 2023.

However, we do not expect commodity exporting countries to be the clear winners in 2023 on the back of better China growth. Commodity prices have benefitted from economic accelerations in China during previous economic cycles. This time around, we suspect that this will not necessarily be the case. China has firmly moved away from being an investment and export-driven economy. The still on-going credit issues in corporates and local governments are a perfect reminder for the country to not go back down this familiar road. Data shows that commodity prices already traded at very high levels in 2022 due to supply chain hiccups and the war in Ukraine. China's imports of raw commodities recovered in 2H 2022 and were not strongly impacted by the strict DZCP in Q3 2022.

Figure 11: Monthly China coal import volumes and prices for the past five years



Source: Bloomberg and Invesco. Data as of 31 Dec 2022.

External headwinds are the main risk factors to watch
The main external headwind we expect is the Federal Reserve's rate-hiking cycle and debate around the severity of the potential recession in the US. There is no doubt that USD bonds, regardless of the issuer, will be impacted by the rate cycle in the US. A deep slowdown in the US can also have a fundamental impact on credit globally.

However, we are of the view that USD bonds issued by Chinese issuers will outperform their emerging market peers. China, with its large economy, moves independently in terms of its economic cycle and monetary and fiscal policies as compared to other emerging market countries. As we have shown in Figure 7, Chinese credits still offer relatively wider credit spreads compared to the USD bonds of other emerging markets. When we consider a more structural supply/demand dynamic, we expect supply elsewhere in the world picking up after US treasury yields come down from the recent high levels. At the same time, China USD bonds could drift lower on the back of the new NDRC regulations on issuing offshore bonds.

Given the current high yield levels offered by China USD bonds, we believe positive factors outweigh the negative and are positive on this asset class in the short to medium term.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

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