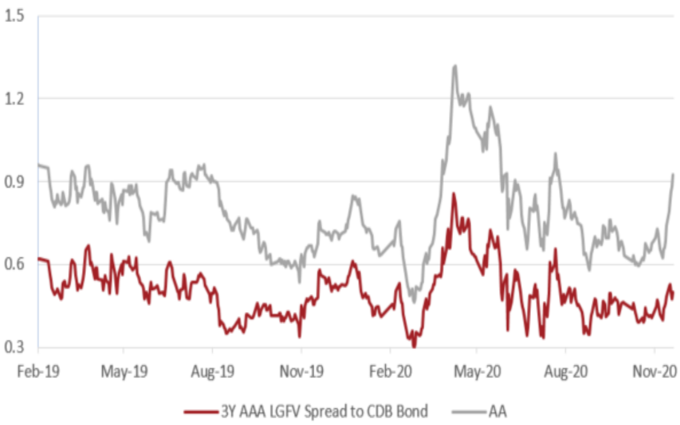
China Bulletin: Market View



The unexpected default of a local SOE in China caused widespread speculation that more heavily indebted issuers may follow, although the bond market remains relatively calm with sufficient liquidity from PBoC. The defaulted issuer, a coal miner in central China, is seeing improving fundamentals and cash flows, which has led to growing market suspicion that local government may be either unwilling or unable to honor the debt. Both scenarios seem disastrous to bond investors. The incident is diminishing confidence in local government and local SOEs. It has had a more profound impact than previous defaults as its influence may extend to Local Government Financing Vehicles (LGFVs), who issue about half of all the non-financial corporate bonds. Additionally, the deadline for fully implementing the New Asset Management Rule has been extended by 1 year to the end of 2021, which will further squeeze the financing channels of lower tier LGFVs and threaten their ability to repay maturing debt. The credit market is expected to see a structural change going forward.

The combination of slower credit growth and normalized monetary policy has implications for equity markets and a low volatility portfolio is still preferred. The healthcare sector and tech names may be less popular because of a lower risk appetite and a current extremely optimistic valuation. Commercial banks are still in a good mood and the trend may continue in a tighter credit environment. Cyclical names are outperforming the market at present, and inflationary expectations are rising as well. Though we still doubt that there is solid ground for sustainable inflation given the considerable slack in the economy.

Economic data continues to point to a recovery and broad policy support is gradually withdrawing. Policy makers continue to understate their GDP target and underline the through-cycle feature of policies. The Manufacturing sector is still favoured by policy, though the level of growth may only be high single digits. The Real estate sector remains contained, especially given the current monetary policy easing. Infrastructure investment has grown slower than the market expected and may decelerate further if pressure on LGFVs' financing mounts in 2021.

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