China – Downgraded not Degraded

ANALYSIS

October 2017

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With its second downgrade in less than six months, should investors be concerned about China's creditworthiness?

On 21 September, S&P downgraded China one notch to A+ Stable from AA- Negative Outlook. However, the downgrade was well-flagged and comes on the heel of Moody's downgrade in May. All rating agencies are now in line: A1 STABLE/A+ STABLE/A+ STABLE (Moody's, S&P and Fitch).

Overall, we believe the downgrade is not worrisome; even at A+ China is one of the world's higher-rated sovereigns. The country is now in-line with Japan (A1/A+), but has a lower rating than smaller Asian economies like Taiwan (Aa3/AA-) and Korea (Aa2/AA-).

In our view, the reason for the downgrade was well advertised and rational. The central government itself does not have much debt, but the built-up leverage in local governments and in the state-owned-entity (SOE) sector needed to be reflected by a lower rating. This was the same rationale behind Moody's downgrade. Anyone following China should expect this adjustment.

What could have worried the markets was a potential repricing of the US$185bn quasi-sovereign sector - all those credits linked to the sovereign. The sovereign does not have any external US dollar debt (only two lone US$100m bonds issued some time ago). Thus the SOEs that issue debt in US dollars are the next best thing to China sovereign paper.

The China quasi-sovereign sector represents one-fifth of the entire amount of US dollar-denominated debt issued by Asian corporates and sovereigns. Therefore, a downgrade could have had an impact on one-fifth of the Asian US dollar market.

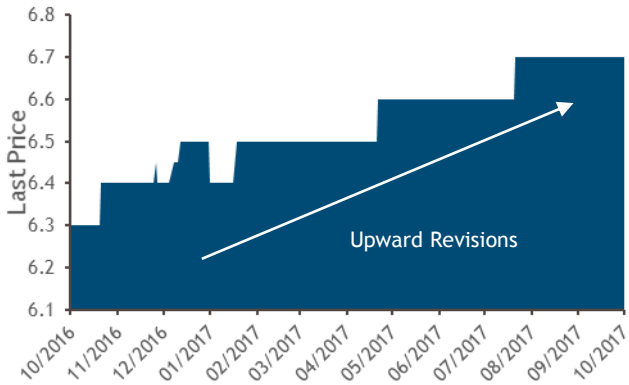
It did not. Chinese SOE bonds traded unchanged. China credit default swaps (CDS) also remained virtually unchanged. In fact, China CDS has been trading lower all year; even with the Moody's downgrade in May, CDS did not react at all. The China CDS chart opposite shows the market's view of China risk has actually fallen all year.

Risk Sentiment Towards China Has Fallen

Source: Bloomberg, as of 3 October 2017. China Government USD CDS 5-year.

We share the market's view that China risk has fallen. We think hard landing fears that surrounded China in 2016 are remote and that the managed slow-down of the economy is working. We also believe that China has been implementing some important reforms that go far beyond a much-overdue adjustment in ratings.

Economic Sentiment Has Trended Higher



Source: Bloomberg, as of 5 October 2017. Economic forecasts based on poll of economists.

In August 2017, China announced it would issue its first new US dollar bond since 2004. The issue amount is expected to be US$2bn - a tiny amount for such a massive country. Why bother for only US$2bn issue?

The view is that China wants to show it can fund itself cheaply, despite the downgrade in May. The expectation is that China will try to fund at a spread below where the CDS is trading – to show that it can.

If the new issue comes significantly inside where China CDS is trading, the wishful thinking is that this US$2bn China sovereign debt might reprice the quasi-sovereign sector TIGHTER.

Asian investors have been buying China-linked sovereign debt trading at a wide spread to where the theoretical sovereign will trade. Our view is that, whilst there might be some repricing, it is a bit far-fetched for US$2bn of debt to reprice US$185bn of debt.

While we will monitor this latest sovereign issuance, we think it will again be a non-event for Asian markets.

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Based in London, Christina manages the Muzinich Asia Credit Opportunities Fund. Prior to joining Muzinich, she was a Director and Credit Specialist within the Global Rates Division at Deutsche Bank, managing credit risk within collateral pools, CDS counterparties and other rates vehicles. Prior to this she was a Lead Credit Analyst at Schroders Investment Management and a Senior Analyst for fixed income research at Commerzbank. Prior to Commerzbank, Christina worked for Fitch Ratings (1995-2000) where she was responsible for rating Korean banks during the Asian crisis 1996 - and Japanese bank during their banking crisis. Christina holds a B.A. from the University of Oxford and an M.A. from the University of London. She was also awarded the Yamamuro Trust Foundation Scholarship for a 1-yr International Politics program at Keio University, Tokyo.

Important information