

# IFR ASIA

INTERNATIONAL FINANCING REVIEW ASIA **ROUNDTABLE**

MARCH 2019

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## OUTLOOK FOR ASIAN CREDIT

Clearer skies

# FOREWORD

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The skies have cleared, and Asian credit is on a roll. After the end of 2018 produced one of the stormiest periods in years, the retreat of major headwinds has helped cement a solid backdrop for Asian bonds at the start of 2019. The US Federal Reserve has slammed the brakes on monetary tightening, trade tensions have subsided for now, and market stability has become a top priority for China as it wrestles with deleveraging its economy.

Investors have taken this as a glaring sign that it was time to return to Asian credit, and in a big way. So far this year, they have pounced on opportunities to buy Chinese high-yield bonds, and those that were brave enough to take positions during the volatility of late last year have made handsome returns.

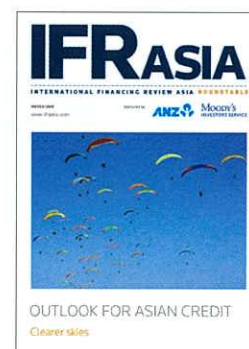
IFR Asia convened a panel of specialists in Hong Kong on March 1 to discuss the extent of the rally, and panelists unanimously agreed that there is still some room to go. From a ratings perspective, the outlook for credit is stable, while tight onshore yields have the potential of luring more Chinese investors back to US dollar markets.

This comes among signs that the market is also maturing as a whole. After a series of bond defaults, offshore and onshore investors are learning that the practice of ignoring the underlying credit is not the right path to investing in Chinese bonds – even when the issuers appear to be backed by local governments.

These realisations are driving a clearer distinction between issuers that are worthy of international capital, and those that aren't. After years of one-way traffic, investors are now focusing on fundamentals and picking their spots carefully.

Challenges still abound. One panelist raised concerns about how China's deleveraging campaign leaves pockets of tight credit conditions that could slow down the country's economic rebalancing, while expectations of massive supply from the PRC banks, simmering trade disputes, Brexit and geopolitical crises could all turn the tide.

Investors will need to stay disciplined about credit differentiation, but this period of stability looks to have longer to run – barring, of course, any nasty surprises.



**COVER**

Paragliders fly in the sky attempting to break a record in Gunung Payung, Badung regency, Bali, Indonesia. REUTERS/Antara Foto

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## Roundtable participants



### MONICA HSIAO

#### Triada Capital

Monica Hsiao is founder and CIO of Triada Capital, a pan-Asia credit multi-strategy manager based in Hong Kong focused on event-driven and fundamental credit plays in Asia. Prior to launching Triada, Monica worked at UK-based hedge fund CQS as senior PM and head of Asian credit strategies. She set up this business for them from inception in 2009. She has also worked as a proprietary trader in London at both Merrill Lynch and Credit Suisse.



### KJ KIM

#### ANZ

Kang Jae Kim is head of Asia debt capital markets for ANZ, where he joined in June 2012. Prior to the role, KJ was head of the frequent issuer and financial institutions business for DCM in Asia and the Middle East until 2017. Before joining ANZ, KJ worked at Bank of America Merrill Lynch, last assuming the role of head of South-East Asia DCM and responsible for FIG DCM for Asia. He also worked at Deutsche Bank and Goldman Sachs DCM in Hong Kong and London.



### MORGAN LAU

#### Fidelity International

Morgan Lau is a portfolio manager at Fidelity International, and has 11 years of fixed income experience. Before joining Fidelity in 2018, he worked at Allianz Global Investors, where he was responsible for supporting the Hong Kong-based fixed income team across their suite of product strategies. Before that, Morgan was at BEA Union Investment (Hong Kong) as a portfolio manager responsible for Asian and China bond strategies as well as global government multi-currency strategies.



### JINI LEE

#### Ashurst

Jini Lee is a partner at Ashurst, specialising in debt capital markets and has over 10 years of experience working on international capital markets transactions. She regularly advises top-tier investment banks, commercial banks and issuers who are active in Greater China. Her range of expertise includes standalone bonds across all currencies, including offshore RMB bonds, medium-term notes and commercial paper programmes, liability management exercises, equity-linked transactions as well as regulatory capital.



### CLIFF TAN

#### MUFG Bank

Cliff Tan is East Asian head of global markets research at MUFG Bank, focusing mainly on the foreign exchange and interest rate markets, macro-economics and trends. He has more than 20 years of work experience, serving in senior positions such as managing director and head of G10 and EM FX research at Societe Generale and head of Asian local markets strategy at Citigroup. In government, he served as the Greater China economist at the US Federal Reserve Board.



### MICHAEL TAYLOR

#### Moody's Investor Service

Michael leads regional research, particularly with a cross-sectoral and macro credit focus, as well as coordinating major regional analytical initiatives. Michael joined Moody's after positions at the Bank of England, the International Monetary Fund and the Hong Kong Monetary Authority as head of banking policy. He was also the advisor to the governor of the Central Bank of Bahrain.



### ED TSUI

#### Deutsche Bank

Ed Tsui is a managing director at Deutsche Bank and his current role is head of Asia debt syndicate. The Asia debt syndicate desk is responsible for managing new issues for a wide spectrum of Asian issuers including sovereigns, investment grade corporates, financial institutions, and high yield corporates. Prior to joining Deutsche Bank in 2016, Ed spent 12 years at JP Morgan in Hong Kong holding various roles in DCM, equity-linked, and debt syndicate.



### FRANCES YOON

#### Deputy Head of Asian Credit, IFR Asia (Moderator)





**IFR ASIA:** WELCOME EVERYONE TO IFR'S ROUNDTABLE ON ASIAN CREDIT. WE'RE HERE TO FIND OUT WHAT IS DRIVING THIS ROBUST RALLY IN ASIAN CREDIT. HOW LONG WILL IT LAST, AND WHAT ARE THE CHALLENGES THIS GROWING MARKET FACES? THE PACE OF THIS RALLY HAS BEEN REALLY SURPRISING FOR MARKET PARTICIPANTS, EVEN THE MOST OPTIMISTIC OF US. KJ, WHAT DO YOU THINK?

**KJ KIM, ANZ:** That's a good question. Last year was an interesting year because it was the first time we saw quite a bit of sustained volatility and uncertainty in the markets where issuers and investors were truly tested. With the volatility in rates, the uncertainty with the Fed's direction, coupled with the US trade war dynamics, there was a large amount of unease that had built up, and at the back end of the year we saw a test of how well technicals would hold up against these growing concerns.

So far this year we have seen favourable technical factors, particularly the supply-demand dynamics and better valuation for investors, outweighing any diminishing uncertainties surrounding fundamentals. US trade war tensions are easing and there is more confidence around the Fed's outlook for the year. As a result the liquidity in the primary and the secondary markets has been outstanding in the first two months.

The key question is whether the rally will last – in my view, we will see a similar pattern this year to the last couple of years. We typically find that at the start of the year, there is a lot of liquidity in the system and this year, we have been helped by a large portion of Chinese issuers staying onshore for their issuance. If you look at the mix of China's SOEs and IG corporates, versus high yield, those dynamics have played in the favour of offshore capital markets.

The positive sentiment may last a little longer for the short term. In my view, uncertainties will start creeping back in again: there will be growing questions about the Fed's stance, the overall global fundamentals outlook, and elections in countries like India, Indonesia, Thailand and Australia will no doubt raise questions around the political direction. Liquidity is likely to hold up, but the supply is expected to be larger this year versus what we saw last year, particularly with the redemption calendar coming through. We will probably start seeing a bit of a tapering of the rally towards year-end.

**IFR ASIA:** ED, WHAT IS YOUR OUTLOOK FOR PRIMARY ISSUANCE, AND WHAT CAN YOU TELL US ABOUT THE CHANGES IN DIRECTION OF CHINESE CAPITAL?

**ED TSUI, DEUTSCHE:** There were two key factors that prompted this year's rally. In the second week of January, the Fed changed from being a headwind for EM credit last year to a tailwind when the Fed chairman hinted that the Fed will consider market reactions when raising rates. That was a 180 degree change in narrative.

The second big factor was that going into the year, most asset managers were under-positioned versus the benchmark. Last year, you beat the benchmark by holding a higher proportion of cash. This year, many funds were holding too much cash and/or holding shorter duration portfolios so funds had to catch up and deploy capital in a more aggressive way.

In terms of China flows, last year was an outflow story. The marginal dollar from Chinese investors was going back to the onshore bond market, which was very strong. If you look at 10-year CGBs, it went from 3.9% in the beginning of last year to 3.2%





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currently, but this year the narrative is different. The rally in the onshore bond market is less definitive and a lot of the capital gains may have been captured already.

This year, we hear from investors that there are RFPs going out for bond fund mandates coming through QDII quota and from offshore corporates/high-net-worth individuals. We are seeing some of the marginal dollar coming back into the Asia offshore credit market, which has been contributing to the rally.

In terms of this rally, the pace of re-pricing will slow down from here on. There was a massive re-pricing early on this year. There was US\$14bn of EM credit inflows, or US\$2bn average a week, so I don’t foresee the same magnitude ahead. But I expect secondary levels will be fairly stable on a tightening bias going forward. The fact that the Fed is not raising rates is helpful to Asian FX, and that we are in a decelerating global growth and low inflation environment means you’re supposed to be in EM credit. Where we might start to see some credit spread widening is if we see some earnings disappointment or slowdown in global growth at the back end of this year. That’s when credit spreads may start to widen.

**CLIFF TAN, MUFG BANK:** It’s interesting because, despite the rally, I still get the feeling that people are underinvested in both equities and fixed income.

**IFR ASIA: IT’S GREAT THAT THE INVESTORS ARE HERE TO HELP US ANSWER THESE QUESTIONS. DO VALUATIONS LOOK ATTRACTIVE TO YOU? WHY ARE WE SEEING SUCH A HUGE AMOUNT OF SUPPLY BEING SO WELL DIGESTED RIGHT NOW?**

**MONICA HSIAO, TRIADA CAPITAL:** On the trading of technicals, we did sense by last year-end that there

were quite a few funds of our type that still were short or underweight on the beta-oriented bonds, and many started to chase to add only by the second half of January. Also I think, from the street dealer side, it did not feel like many brokers held much inventory through the end of last year, so the street positioning probably helped contribute to set up for this rebound.

On our side, we did put our money where our mouth was at the end of last year. I thought then that things were very cheap fundamentally, and I put myself out on record to say it was the best time to buy into Asia credit last December after seeing last year’s dramatic re-pricing. I think that particularly in the last half, post some of the announcements of China policy easing – even though we would agree that for every dollar that is put in we may not be getting as much productivity out of any sort of easing or infrastructure spending – the fact is that there was a turn. It was certainly a turn from putting a pause on the deleveraging side, which helped.

The other factor, I would say, is that not enough attention was paid to the fact that onshore yields had dramatically decreased and more channels were open to some of the high-yield issuers that we were tracking to be able to access certain channels of financing.

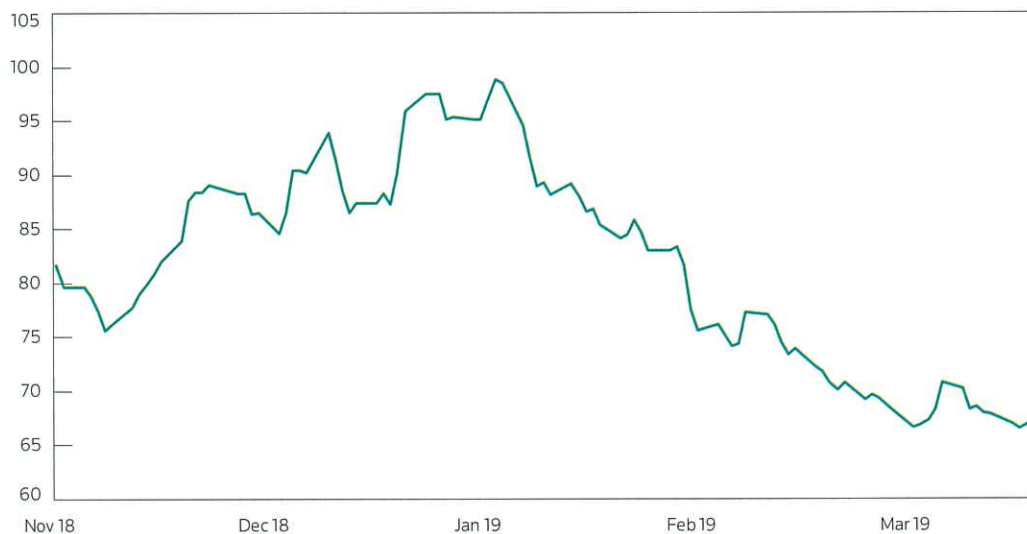
The other thing to keep in mind is that last year, never mind what was publicly placed, there were a number of private placements and certain clubby deals. So, I think there was a lot more liquidity there to actually take down debt and provide financing for some of these issuers than would have been seen on record of bond supply.

Fundamentally, if you even look from a ratings perspective, we saw more upgrades than downgrades in the first half of the year in a number of the property developers.

There certainly was justified fear from the number of defaults increasing. That said, I don’t think we

**CDS SPREADS TIGHTEN**

IMPROVING PRIMARY BACKDROP CUTS DEFAULT PROTECTION COSTS ON ASIAN CREDIT (ITRAXX ASIA IG INDEX; BP)



Source: Refinitiv





should have thrown out the baby with the bathwater and so we saw spots to pick. I think that coming into this year, as others have already noted, I think the Fed Put kind of coming back, helped. That's certainly supportive for broader EM. Within broader EM, Asia did really look cheap. If you look at the premium, even today, even post this rebound, Asia high-yield is still providing a premium of somewhere in the range of 500bp spread on the high-yield side. Personally, I don't think Asia high-grade (on a T-spread) is as attractive if you compare it to other markets.

I think also that, if today we still can find two years and under duration – modified duration – paying high single to double-digits, and you can be comfortable with their ability to refinance, as well as looking at their top-line revenue growth and so forth, we still can find spots that are relatively cheap.

The next leg now will be determined, I think, by the continuation of the technicals of the flows. As always, what we do is really about stock picking, so I think in every environment there are still going to spots to be picked.

I look at this year to date; and we're up almost 7% on a net returns basis through February, and we achieved this on practically no leverage – and also on a book with average duration of under two years. Last year you just had to look at the number of high-yield curves that were reflecting an overly high probability of default, and I would argue it was completely unjustified to have some inverted and flat curves that made bonds look super cheap in the front particularly.

**CLIFF TAN, MUFG BANK:** The Fed's on hold for a while. You shouldn't be this short duration, should you?

**MONICA HSIAO, TRIADA CAPITAL:** It's a good question as to what optimal duration to hold today when looking at risk-reward of spreads. I don't know about 'should'. I would say that we're constantly monitoring both the technicals and the fundamentals. Fundamentally you can argue about where that extension risk should be from two-year to three-year, and three-year to four-year, which will shift with beta.

I would say that, in the first half of last year, people were still looking at what that normalised curve theoretically would be for every year extension. We used to bootstrap on an average spread per year. Today we wouldn't do that. Today we would be very much having a view of a tailored spread of where one to two, two to three, and three to four would be, which would be relatively different.

If you look at the Double B space today, you are still getting anywhere between 30bp and 60bp that we have been able to see on extending from three-year to four-year, on average, which you can argue is fair to still cheap, although in absolute spreads, the bonds have rebounded a long way back to March levels of last year. But I would say that, because of how much has been issued in the front end – particularly 360-day paper last year – you can argue that the wider range may actually be justified, as well. So, I'm not sure I would say that extending





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duration that much is necessarily that desirable now on a risk-adjusted spread basis.\*

On the Single B side, I would say I still find more value because we are seeing some extension risk priced at 50bp–70bp on average. So, yes, you could argue it’s cheaper, but then the Single B names there have more fundamental concerns. We are investing in longer duration now, in certain names, but I wouldn’t say we are comfortable with extension risk across the board yet.

**IFR ASIA: MORGAN, LAST YEAR INVESTORS SAW LONGER DURATION AS A RISK, EVEN FOR THE HIGH-QUALITY NAMES. WHAT IS YOUR VIEW ON DURATION RIGHT NOW?**

**MORGAN LAU, FIDELITY:** If we looked at the older HY bonds issued early in the decade, we would see higher coupons like 8%–9%, or even in double digits. Having come down drastically to the 5%–7% level three to four years ago, household high-yield names are now issuing at similarly high coupons again.

For HY funds like ours, high-coupon bonds are good for providing income. Longer duration bonds are quite attractive from an income angle because we don’t have to worry about reinvestment risk.

But we are not seeing enough of those longer-duration, high-coupon bonds, because there weren’t many issuances during the rally in the last couple of months, and the rally ran so fast that the coupon may not be attractive enough, should a longer dated issue come out now.

Hopefully, if we see the rally slow down, we can see good yielding new issues coming for another few months.

In the last few months, many EM and HY funds saw inflows. I think this rally in EM is running

ahead of the Asian market, from a simple measure of the spread ratio between EM and Asia. If you look historically in the last three to five years, EM spreads are actually tight relative to Asia from the spread ratio.

We have seen more EM sovereign and EM high-yield borrowers issuing. That’s going to put pressure on the rally for EM, whereas Asia has some way to go. At the beginning of the year, when you looked at the index yield, we were at 10% and so when you’re looking at high-yield and short duration, it’s going to be quite attractive for many investors. Right now I think we’re back to about 8% for high-yield bonds. Given the much lower expectation of rate hikes, I think 8% and potentially lower would still be quite attractive.

At the beginning of the year some investors were relocating their investment into corporate bonds, and that could partly be where we saw the inflows from. Some investors are still sceptical of the rally in the equity markets, so we could still expect more allocations into the credit market.

If 2018 was the perfect storm for fixed income, the beginning of 2019 was, sort of, the reverse of that. We’re seeing interest from PB and institutional clients. Even guys that would normally do more conservative investments are enquiring about more risky mandates.

I think the Asian capital market has developed to the point where fixed income has moved from a speculative asset class to a regular asset allocation. With all these factors, my view on the rally is that it has a bit more to go.

**KJ KIM, ANZ:** In terms of duration, it’s a fine balance between what the investor wants to see and how the issuer feels about duration and valuation. Last year, over 50% of issuance was in the one to three-year



\* Hsiao has updated her views on risk-reward returns with the latest spreads and added additional commentary on the value of duration extension.





tenors. Issuers who may have wanted to go longer chose not to, because of where valuations were.

For this year, with the rally in spreads and, as Cliff suggested, with the view that the Fed is on hold, appetite for duration may be better. We're seeing heightened demand on the longer end of the curve and as a result better relative value for issuers, which hopefully will fuel issuance at the longer end. We want to see more duration, because last year we saw an oversupply in the short end.

**IFR ASIA: MICHAEL, HOW DO CREDIT FUNDAMENTALS FIT INTO WHAT WE'VE HEARD SO FAR?**

**MICHAEL TAYLOR, MOODY'S:** Towards the end of last year, when we had such a dire outcome in the markets, there were three big fundamental issues that were really driving things. The first one was the Fed.

The second factor, which we haven't talked about, was trade and the growing trade tensions between the US and China, which I think weighed on sentiment very heavily last year. Again, that came as a bit of a surprise because we went through the first year of the Trump administration, where the rhetoric from the campaign hadn't really carried through in terms of policy.

Then, starting round about this time last year, that's when we started to see the policies actually being adopted that led then to a recalibration in terms of what the global growth outlook might be, the possibility of further tensions between the

US and China. That certainly weighed on market sentiment.

Then the third fundamental which came into play was the slowdown in China, which to a large extent was domestically generated. It wasn't as a result of the trade tensions, but it was as a result of the deleveraging policy and the attempt to address financial risks.

Again, we started off last year with a very strong print in terms of China's GDP numbers: first quarter 6.9% growth. Everyone started to get very optimistic about this deleveraging campaign going on, but it isn't really having a big impact in terms of GDP growth. Which was a bit perplexing because, when you started to see how tight credit conditions were on the mainland this time last year, to get that kind of growth outturn didn't really make a lot of sense.

I think essentially what happened was, towards the end of the year, the GDP numbers started to catch up with where we were in terms of credit conditions. So, we had these three big fundamental factors weighing on the market towards the end of last year, and they all came together. To a certain extent, what's happened this year is that they've all retreated at the same time.

We have seen a diffusion of the trade tensions, and our baseline expectation is that there will be some kind of agreement.

That's not going to be the end of the story. It's going to come back again because these tensions





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are about a lot more than just trade, but, as far as the immediate trade concern is concerned, that seems to have been pushed back as well. Then we’re starting to see in China some of the policy towards stabilising the growth rate – not so much in terms of monetary stimulus, where the PBOC is still being quite cautious, but we have seen a bit of a pullback in terms of the regulatory clampdown on shadow banking, and we’re seeing more fiscal stimulus coming through.

It’s a bit different to last time. It’s not a big infrastructure investment push. It’s more in terms of tax cuts encouraging consumption and at the moment it isn’t clear how well that will work. Nonetheless, I think again market sentiment has improved because the authorities have been taking these actions to try to stabilise the growth rate and to prevent growth in China slowing down too much.

**CLIFF TAN, MUFG BANK:** They ‘cautiously’ added 5% of GDP in credit and loans in January. They’re being very ‘cautious.’

**MICHAEL TAYLOR, MOODY’S:** We’re not seeing a big reversal.

**CLIFF TAN, MUFG BANK:** It’s a joke, but 5% of GDP is 60% in a year of credit and loans, so, no, I don’t agree they’re being cautious at all.

**MICHAEL TAYLOR, MOODY’S:** My point, really, was that we had these three factors, these three fundamental factors that were weighing on the market last year. To a large extent, so far this year they’ve been pulled back. I think that’s been one of the things that have supported the market.

**CLIFF TAN, MUFG BANK:** Michael, sorry, I was not actually disagreeing with you. From our point of

view, China has been easing since about May last year, so in my write-up I’ve called it ‘Chinease’. I think deleveraging is, to my mind, largely a myth because, if you look at aggregates of credit around China, they’re just continuing to rise and so it’s really hard to see where the deleveraging is.

**MICHAEL TAYLOR, MOODY’S:** I think the numbers around shadow banking have certainly been impacted by the deleveraging campaign. Shadow banking has fallen from a peak of 87% of GDP at end 2016 to 68% of GDP at end 2018. That has been compensated for – well, partly compensated for – by an increase in bank lending, in formal bank lending. There’s been a, sort of, switch from shadow banking to formal bank lending, but then the problem that the Chinese authorities face is that shadow banking performed a very important economic function, which was that it provided credit to sectors of the economy which weren’t very well served by the formal banking system.

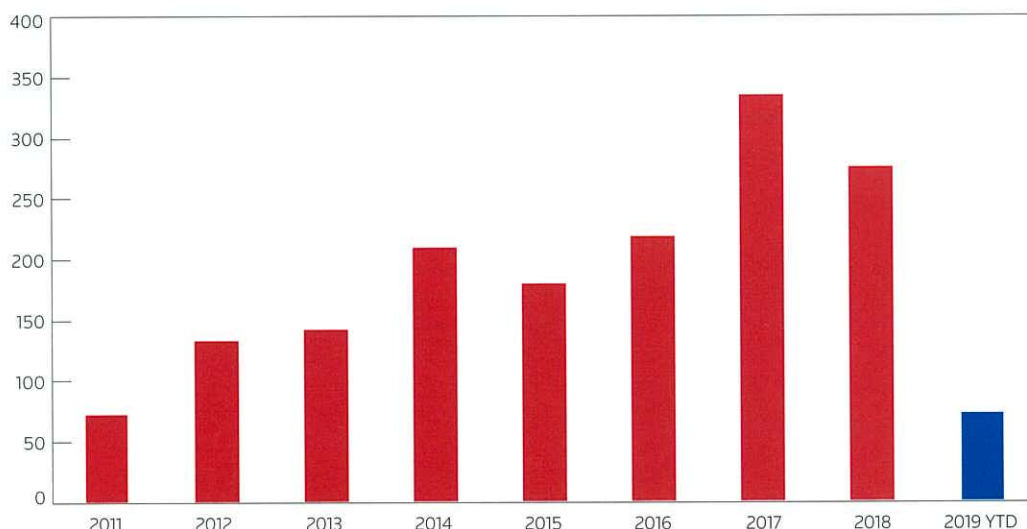
**CLIFF TAN, MUFG BANK:** The Chinese have announced that they want the state-owned banks to set targets by the end of this month for lending to the private enterprises. This is, by the way, the first time in the history of modern China that I’ve ever seen the government care about the private enterprises.

They want to set this target at around 30% year over year, by the end of this month [March]. Growth in lending to those companies last year was 21%. That’s not enough. I just see a lot of fan dancing here, a lot of reality versus fiction, and I don’t really like some of what I’m hearing.

**IFR ASIA:** YOU ALSO TALK ABOUT HOW YOU FIND VERY LITTLE EFFORT FROM THE GOVERNMENT TO DELEVERAGE. CAN YOU TALK MORE ABOUT THAT,

ASIAN CREDIT RALLY

ASIA EX-JAPAN G3 BOND VOLUMES ARE SET FOR ANOTHER GOOD YEAR (US\$BN)



Source: Refinitiv (SDC CODE: AR02)





**AND WHY THAT'S PROBLEMATIC, AND HOW THAT COULD IMPACT US?**

**CLIFF TAN, MUFG BANK:** As I said, we had these nosebleed kind of numbers in January in China in terms of both loans and aggregate social financing. Before the global financial crisis – you guys were all around – you might want to remember that aggregate social financing for China for the whole year was a number like around Rmb4trn. Now we've gotten to a stage where aggregate social financing for January was Rmb4trn.

The problem with that is that probably my guess is that half, maybe 60% by now, of that credit is just being used to roll credit. It's not actually going into new economic activity. Then, on top of that, more recently we've got the government worried about wage arrears, which we hadn't seen for a while. That means workers aren't getting paid, so a lot of this money is going to pay off workers for back wages, which will help. It will, maybe, slow down the fall in consumption, but it's not new economic activity, so that's one of the problems.

Our sense is that even the state banks, these monsters, these giants, are actually becoming more and more like regular companies. They care about profit and loss. They would like to be a regular business like everybody else. As part of that, they care about credit risk, so, when the government tells them, "lend," to these guys who can't get money any

other way, they're going to be going, "Hmm, do I really want to do that?"

I think there is a lending strike, even by the big banks, which is why the government's been on the hobbyhorse: "Please, you're not doing your job. You're not lending to the private companies. You're not lending to the SMEs." I'm thinking, "When have I ever heard the government care about the private sector and the SMEs?" The answer is never. I've never heard that. This is just a politically correct way of saying, "Lend, okay? It doesn't matter who you lend to." Anyway, so the banks are being very rational.

China may find it very difficult to use the old tools to stimulate the economy. I think the bang for the buck is going to go down this year.

**MONICA HSIAO, TRIADA CAPITAL:** But I guess I would argue that the Chinese government is realistic enough that they're not necessarily expecting to stimulate in order to achieve that much growth. Their goal is more to stabilise. I think stability of the credit markets is a pretty high priority for them. For them to implement the reforms that they want to, they have to guarantee interbank liquidity, for example.

We've seen the recent policies where they've expanded the definition of what they can accept for collateral. Things like that are really about ensuring that the credit markets are functioning. That's their goal, which I would argue they are achieving right now.





“Market volatility is not going to go away. We’ve been through a period in the last two months where we’ve seen a recovery in markets, but that may not last. Some of the issues, I think, have been driving the markets could well come back.”

As Morgan alluded to, I think this is the year where it should actually be quite favourable for us in Asia credit – not only just from the backdrop of EM markets but mainly because we do have, effectively, Chinese QE, and again not necessarily for growth but for credit stability – so that at least we can return to look at credit differentiation and fundamental value.

Forward looking, I would say that credit for this year still would be, relatively speaking, more attractive than equities, exactly to Cliff’s point about growth. To Michael’s point, I do agree that a lot of this – the deleveraging and not only the actions but the talk of the deleveraging, and the shadow banking and so forth – it really definitely limited the access to capital from some of the high-yield issuers that we saw last year, particularly through trust financing, right? The availability of that, we saw, started to come back end of last year.

You can argue about whether trust financing is good or bad, but the reality is it was serving a purpose that the banks were not doing. I think it’s great that there is a lot more talk and lip service to providing more financing for POEs, but, like you said, the banks are cautious about where they’re going to lend to.

**MORGAN LAU, FIDELITY:** The Chinese economy is really, really big, with a lot of people of various wealth and education levels, so it’s going to take some time to reform.

In the last four or five months, we’ve definitely seen some changes in client enquiries and sell-side market commentaries. Two to three years ago, the focus was on how to access the China onshore bond markets, about the basic supply demand dynamics of CGBs and onshore rates, etc. In the last four or five months, we are seeing more people talking and asking about onshore investment-grade or high-yield credits.

That’s a big change in the capital market. Even foreign investors care and have the confidence to look into the onshore credit market. Looking at the really big January aggregate financing figure, part of that had to do with the front loading of local government bonds issuance. This could be a way of replacing the role of allocating credits in shadow banking, in the form of letting local governments do their local financing. Just like Monica was saying, when the Chinese government wants to lend, they will lend. But there’s always the missing mechanism of going from the top level of easing, to the SME needing the money. And that’s one thing the large traditional commercial banks have not been efficient with over the years.

It was never just about leveraging or deleveraging in China, even in the last two years, but it was about the reallocation of credit. It hasn’t really worked for the last two years, but I’m seeing a bit of hope in terms of capital market development, as we are seeing more credit differentiation.

It’s a roundabout way, but, now that we have more local government bonds being issued, the hope is that they might go to the right place.

**ED TSUI, DEUTSCHE:** I agree with Cliff’s observation, and the manifestation of that in last year’s offshore credit market was very clear. There were clearly the “haves,” which had ample access to onshore liquidity, and the “have-nots” of property names which found securing onshore liquidity more challenging. In some of the conversations we had with investment-grade SOE issuers which were clearly in the “haves” camp, they felt pricing on the dollar offshore deals was very expensive versus onshore funding rates, and chose not to access the offshore markets. On the other hand, it would be interesting to monitor whether China property







developers regain better access to the onshore financing markets. When issuers have diversified funding channels, that's when you could see offshore credit spreads tighten.

**JINI LEE, ASHURST:** I think the story on the haves and the have-nots is really quite an interesting one. That's really consistent with what we hear, talking to issuers and talking to bankers. You can get a really quite disparate story. You talk to a bunch of people and they're saying how terrible it is. It's the worst market they've seen. They can't access any funding.

Really, that's the have-nots. They're really struggling to meet all their repayments. There have been a lot of companies that have raised very short-term paper last year, so 360 is actually not bad. We've seen some 180-day paper, right? You're talking about that type of maturity.

**CLIFF TAN, MUFG BANK:** The commercial paper.

**JINI LEE, ASHURST:** Yes, but you've got to ensure that you've got steady access to capital.

**ED TSUI, DEUTSCHE:** At double digits.

**JINI LEE, ASHURST:** At that sort of pricing, it really is quite frightening. Then you talk to another bunch of people and they say, "the market is awash with cash. There's a lot of supply." It's really quite interesting how different that story is, really, depending on

who you talk to. I think I'm not sure how much convergence we're going to see in that this year, but the rally in these two months, we're not quite sure how long it's going to last.

**IFR ASIA: TALKING ABOUT THE HAVE-NOTS, WE SAW QINGHAI PROVINCIAL INVESTMENT RUN INTO TROUBLE. WHAT ARE THE MAIN TAKEAWAYS FOR PROSPECTIVE OTHER DEFAULTS THAT COULD HAPPEN THIS YEAR?**

**JINI LEE, ASHURST:** They missed a coupon payment last Friday. I've looked at documents and technically there is no grace period for a missed coupon, so essentially they have defaulted, which will cross-default on their other financing, including the other offshore bond they have due 2021.

We hear some rating agencies have said that "We're going to give them a couple of days' grace period to see if they pay up." I hear that the payment probably will go through this week, so that essentially will get cured, but it just kicks the can down the road.

There are other big payments coming due soon, so it's pretty tough, I think, for some of the issuers out there at the moment. I think the credit differentiation point is a really important one. Obviously, the rating agencies have a big part to play in that.

**MICHAEL TAYLOR, MOODY'S:** We've been saying for some time that credit differentiation is the name





“it would be interesting to monitor whether China property developers regain better access to the onshore financing markets. When issuers have diversified funding channels, that’s when you could see offshore credit spreads tighten.”

of the game. When we’ve been looking at various categories of issuers in China, especially the likes of local government financing vehicles, we’ve been saying for some time that the old assumption around everyone essentially getting bailed out and all issuers effectively being equal in that respect, that assumption really has given way.

**JINI LEE, ASHURST:** It’s actually an interesting one on LGFVs because, if you read the prospectus or the offering circular, there is a risk factor to say that local government funding vehicles do not have implicit government support. The government is not obliged to bail them out.

**MORGAN LAU, FIDELITY:** Yes. The Chinese government advised the local governments that unless it’s related to the daily life of citizens, like utilities and transportation, local authorities are not actually allowed to bail LGFVs out anymore.

**JINI LEE, ASHURST:** Sure, and I think you do see that in the rating reports in terms of how important that local government funding vehicle is to the local economy, how many jobs it provides, whether or not the local government can really afford for this company to go under, because of the wider impact it will have on the local economy. As lawyers, we do our jobs, we do our due diligence, we write it in the documents, but obviously that’s got to be set in context with what the wider economic repercussions will be.

**IFR ASIA: CAN STRUCTURES BECOME MORE INVESTOR FRIENDLY, GIVEN THIS CHAIN OF EVENTS?**

**JINI LEE, ASHURST:** Yes, when the markets were really quite exuberant a couple of years ago when they were starting to open up, we saw quite a lot of inverted structures that were really designed to get around difficult governmental approvals, such as approval from the NDRC that was required for direct issues. That’s where we started seeing keepwell structures, equity interest purchase undertakings and agreements to provide liquidity.

NDRC regulations have been amended for the quota system to allow PRC companies to issue directly so the structures are more straightforward. Otherwise there are cross-border guarantees from the onshore parent, which are a lot more straightforward than the structures before.

I think in terms of structuring a deal in China, it really is around the regulators and what sort of consents issuers are willing to get, because for them direct issuance or a guarantee will give you the best pricing, rather than a convoluted subordinated structure. We always work with issuers to see what they’re trying to achieve, and usually pricing is key.

**MORGAN LAU, FIDELITY:** I think overall it’s an education process. Comparing what we know about LGFVs now and three years ago, we have become more educated. Even onshore investors are more aware of the risk involved.

I remember a discussion I had with some onshore bond portfolio managers during a conference in Shanghai two-ish years ago. I was telling them about an offshore new issue by a privately owned Chinese developer that performed really well, and they told me that they wouldn’t buy that because of the lack of government background of the issuer. Then they told me of the LGFVs they would buy and I told them that offshore, we would be cautious of those. That kind of view is converging over the last two years. Offshore managers like us are learning more about the LGFVs, and onshore they are also differentiating between different provinces. I think it’s a very healthy development of the market although there will be growing pains. The market will continue to buy bonds from Chinese issuers, but investors will factor in those lessons and ask for the right price. That’s going to be quite healthy for the offshore and onshore markets.

**MONICA HSIAO, TRIADA CAPITAL:** I think we need to see more test cases, but I do think that the market has at least wisened up to, again, differentiating on what kind of assumptions to assign to credit enhancement packages and coming back to at least having a discussion about the underlying standalone credit first. I think we should always be starting with that and then thinking about layering what sort of assumptions of support based on the strategic value of the business.

**KJ KIM, ANZ:** One thing that we will have to monitor is how the China bid plays out. Whilst we have international investors here at the table, historically a large part of the LGFV demand has been from the Chinese investor base. Similarly to what Morgan has said, our conversations with investors onshore now show they’ve really woken up to the growing risks and they are not just buying anything anymore. That credit differentiation is happening onshore, as well as the Chinese investors offshore.

The international investors have been a lot more alert to the trend early on. In the past Chinese investors had been a little bit more indifferent when it came to their investment decisions, but now they’re clearly taking a look at this. That’s going to be a major factor, going forward, in terms of the haves and have-nots. We are going to see a clearer separation and a growing numbers of issuers potentially not being able to come back into the markets.

**CLIFF TAN, MUFG BANK:** I hope that China will read all the rules and figure out what’s the right thing to do, but in the rest of Asia – in Japan, and I can certainly tell you about the rest of Asia outside of China – you did not see the issuers’ behaviour really change until after the Asian financial crisis. That is, after actual consequences struck.

**IFR ASIA: MICHAEL, WHAT’S YOUR TAKE ON LGFVS FROM A RATINGS POINT OF VIEW?**

**MICHAEL TAYLOR, MOODY’S:** There have been a whole series of government documents that have tried to





enforce this kind of differentiation, but again, as we've been talking about it, a lot of it comes down to whether or not this actually happens in practice. There have been a lot of government directives in terms of this not providing bailouts and support for LGFVs, and making this kind of differentiation, and restricting access to credit for those that are deemed to be performing a more, kind of, commercial function. All of these things have been around for some years.

I think we are now starting to see the cumulative impact of these different documents, although again I think, as we've been talking about, it comes back to incentives. You can produce all kinds of government directives, administrative decrees, but, if the incentive structure itself isn't addressed, then trying to implement these directives is very difficult.

I think we are seeing more differentiation, though. The automatic bailout has effectively been ended.

**IFR ASIA:** I WANT TO TURN OUR QUESTIONS TO SPECIFIC AREAS OF THE ASIAN CREDIT MARKET. ANY IDEAS ON ISSUANCE EXPECTATIONS FOR THIS YEAR?

**ED TSUI, DEUTSCHE:** From our analysis, we see refinancing needs including bonds that are callable at approximately US\$170bn this year. Net new financing last year was in the context of closer to US\$135bn. I think net new financing comes down this year as there is heightened economic uncertainty, so I would expect net new financing

to be in the context of US\$100bn, so call it total US\$275bn of issuance this year.

If you look at the supply dynamics so far this year, we're up about 5% year-on-year, while corporate high yield is up over +50% yoy and investment grade is down -5% yoy. You can see that a lot of the high yield issuers who had a more challenging time in accessing financing last year have really jumped in to opportunistically access this strong offshore credit market.

**MORGAN LAU, FIDELITY:** Bonds by Chinese issuers account for over 50% of offshore outstanding issuances right now. But as the local market develops, will we see less offshore issuance two to three years down the road, just like how local capital markets in Malaysia and India led to less issuance offshore from these countries?

**KJ KIM, ANZ:** There's going to be more offshore issuance from China, but as a percentage I don't think it will increase a great deal. If you look at dollar G3 issuance from Asia, close to 70% comes from China. Whilst I think the overall volume will grow, is that going to increase in a percentage? I don't think so. As a percentage, we feel that ex-China issuance will hold its own. If you look at the issuance growth in the other major centres I don't think Korean volume will increase materially. Korean volume is very much just refinancing every year with the usual US\$20bn-\$25bn gross issuance per year. In South-East





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Asia there’s more legs, particularly in terms of where you see economic fundamentals and potential for investment growth. India in particular – whilst we’ll have to see where the elections fall out, looking at issuance patterns and the investments the corporate sector is looking to make – we’re hoping to see larger volumes.

China, however, will continue to take the majority of offshore volume unless we see the continued trend to what we’ve already seen this year – i.e. a prolonged outperformance of the onshore market. A large part of the refinancing coming due this year is in the SOE corporate and financial sector; whilst the financials will continue to issue internationally for their offshore requirements, we may see a drop in corporate issuance if they continue to favour the onshore market.

Just going back to your question in terms of where we think overall issuance will fall, I agree with Ed in that gross numbers are going to be up, we’re estimating a 15% increase, largely driven by a 50% jump in redemptions due; but overall net numbers are likely going to be down. We’ll most likely lose a part of the refinancing volume to the onshore markets but also to the other financing alternative – the loan market, which has been very strong recently.

**IFR ASIA: JINI, DO YOU KNOW IF WE’LL CONTINUE TO SEE PRIVATE DEALS? WE SAW QUITE A BIT OF THAT ACTIVITY, ESPECIALLY IN THE CHINA HIGH-YIELD SPACE.**

**JINI LEE, ASHURST:** We did see quite a big number of private-placement club deals last year. It’s just that when they’re building the book, I think there’s so much risk when they go out on a public deal that, if they manage to just get a couple of investors and get

it done quickly, they do, because why not?

I think this year is different, at least at the start because the quotas have been easier to get from NDRC – and some of the issuers are also doing it to increase their publicity offshore. We’ve heard that even though offshore is, maybe, more expensive – and we asked them, “So, why would you want to issue offshore?” – they just want to build up their brand recognition. They want to diversify their investor portfolios, all of those reasons.

Yes, I think there will still be a healthy sort of private market there, which we’re happy for because things get quicker and there is more certainty to the deal getting done.

**IFR ASIA: ARE DOCS EASIER TO DO FOR PRIVATE PLACEMENTS?**

**JINI LEE, ASHURST:** Yes, because private placements generally are done where the investors are “big boys” and may know the name already, so documentation is lighter and often in the space of public disclosure. They may also be well known to the investor or have tapped the market before.

**KJ KIM, ANZ:** The thing that’s going to throw everything out the door is China’s TLAC in the next couple of years. There are estimates of TLAC requirements of US\$0.5trn and up, with potentially half onshore. That means US\$250bn plus has to come to the international markets.

**MORGAN LAU, FIDELITY:** Don’t we have, like 10 years’ time to do that?

**KJ KIM, ANZ:** Regulators have stated, by 2025 they will need to start implementing TLAC for 2028, but if the corporate and financial debt to GDP ratio in







China hits the FSB's 55% threshold they will need to accelerate implementation. With the debt to GDP ratio already at 50% and talking to the banks now, they are already assessing the markets. They will, however, have to wait to see whether the regulators come out with the allowed issuance structures and then assess the market accessibility. This is not an immaterial amount. If we're talking north of US\$250bn over the next five years that's potentially going to be 20% of the Asia USD market annually.

**IFR ASIA: DO YOU HAVE ANY INITIAL THOUGHTS ON TLAC RIGHT NOW, BECAUSE I HEARD THAT THE FIRST TLAC CHINA DEAL COULD COME AS EARLY AS THE END OF THIS YEAR?**

**MORGAN LAU, FIDELITY:** I think it's a bit like, when offshore AT1s first came out, people were very concerned with the senior to AT1 spread ratios, and then after a while it became run-of-the-mill as AT1 curves are established. Same with Tier 2 when it first came out. As all those TLAC capital deals gained popularity, real senior bonds become a thing of the past, like those from Japanese banks. I think the same thing is going to happen with TLAC from China as well. When I think about it, I don't just think about what bond issuance we're going to see. I think about how that is going to change the business of the banks because, when 20% of your funding is going to come from capital markets rather than the deposit

base, it's going to change how you do business as well. It might even signal changes for the depositor. They might be pushed to buy more investment products and money managers like us are going to be investing more in deposit-like issuances. I think it's going to have deeper implications to the market and to the economy than we think.

**CLIFF TAN, MUFG BANK:** Do you get a sense, say among pension funds, that there will be a reasonable amount of appetite for this kind of stuff?

**KJ KIM, ANZ:** It will depend on the structure. If we look at the different TLAC structures: you have the holding company TLAC from the likes of Japan and the US, so effectively investors have been looking at this as senior debt from the hold-co, subordinated to op-co, and therefore the structure has been more palatable for pension funds and insurance companies; but when you start moving into the senior non-preferred, Tier 3 type structures, with the whole bail-in-able contractual language, it starts getting a little bit hairy for some of the more conservative funds. Having said that, the investors here have become accustomed to loss-absorption language from Basel III.

We will have to bear in mind the stance the regulators takes on the banks, as well. If they start imposing heavier capital penalties on holding each others' TLAC, we'll start seeing a reduction in investor appetite from the banking community.





Particularly for China, because China banks buy China banks to a large extent, a reduction in bank appetite will see a lot more paper flooding into other investor classes, which in turn will put pressure on the overall market.

**MONICA HSIAO, TRIADA CAPITAL:** I guess it will also depend on, in the first generation, how much premium you guys will pay us.

**ED TSUI, DEUTSCHE:** My thought is the premium will always be larger for the first issue.

**MONICA HSIAO, TRIADA CAPITAL:** Exactly.

**ED TSUI, DEUTSCHE:** The premium will only get smaller with greater market adoption.

**IFR ASIA: BEFORE WE END THE DISCUSSION, MICHAEL, ARE THERE ANY AREAS IN ASIAN CREDIT WHERE YOU SEE MORE DOWNGRADES OR UPGRADES?**

**MICHAEL TAYLOR, MOODY'S:** Overall, our view on Asian credit is quite stable. If you look at the balance of outlooks across all of the different sectors, most of them have a stable outlook. That said, I think we do expect credit conditions to become more challenging this year. We've been talking about the recovery in the market since the start of the year. As I explained, I think there are fundamentals driving that, but

I think, if we look at the year as a whole, we still expect it to be quite a challenging year.

Market volatility is not going to go away. We've been through a period in the last two months where we've seen a recovery in markets, but that may not last. Some of the issues, I think, have been driving the markets could well come back. Cliff had mentioned about the Fed not really being that clear in terms of where it's going, and I think that there is a question mark there in terms of the future direction of US interest rates.

I think trade is certainly not going to go away. We see that as being the big driver of credit in 2019: that these trade tensions are going to resurface from time to time. Even if we do get an agreement between the US and China in the coming weeks, there are going to be other trade tensions that surface. We haven't talked about some of the geopolitical risks that are outside the region, but we've got Brexit, we've got Italy within the EU. There are a whole number of issues that could flare up over the course of the year, so we're expecting still quite a challenging year.

In terms of how does that impact in sectors and particular industries, obviously there'll be quite a varied impact there, but I think, if trade does resurface as an issue, as we expect it to, that will certainly imply more market volatility, and probably slower economic growth across the G20.

**IFR ASIA: THAT'S ALL THE TIME WE HAVE FOR TODAY. THANK YOU SO MUCH FOR JOINING US.**