

# Solutions for a low-yield world

## UBS Asset Management | China High Yield (USD)

We believe US dollar-denominated China high yield bonds are currently a standout asset class in a world of low-to-sub-zero yields, and we see an attractive entry point for investors now. Find out why.

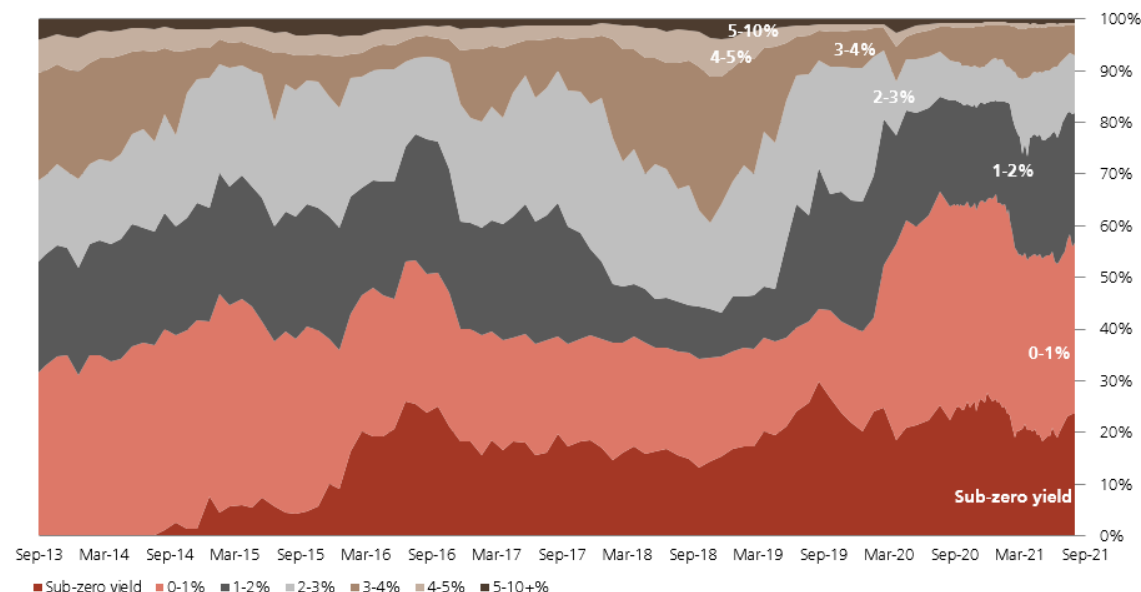


- China's "Three Red Lines" regulations are driving what we believe is a fundamental, credit-positive re-rating process in the real estate sector which should be good for long-term bond investors.
- Given that yields and spreads are close to historical highs, we believe USD-denominated, offshore China high yield credits are a standout in a world of low-to-sub-zero yields.
- Now could be an entry point because we believe there is potential for strong returns from the asset class over the medium to longer term.
- However we do believe investors should be prepared for further volatility over the coming months until the issues in the real estate sector are seen to be resolved, either by moves from the central bank or by local or central government bodies.

## China high yield is a standout solution in a world of low to sub-zero yields

Globally, if you are searching for yield, you are facing a challenge. Loose monetary policies across the world means that over 50% of the bonds within the Bloomberg Global Aggregate index - a key global fixed income benchmark - offered yields of 1% or less at the end of July 2021 (Chart 1). Bonds yielding 0% or less did not start to appear until 2014, and now account for about 20% of the market. In total, around 80% of the market now yields less than 2%.

**Chart 1: The compression in global bond yields since 2013**

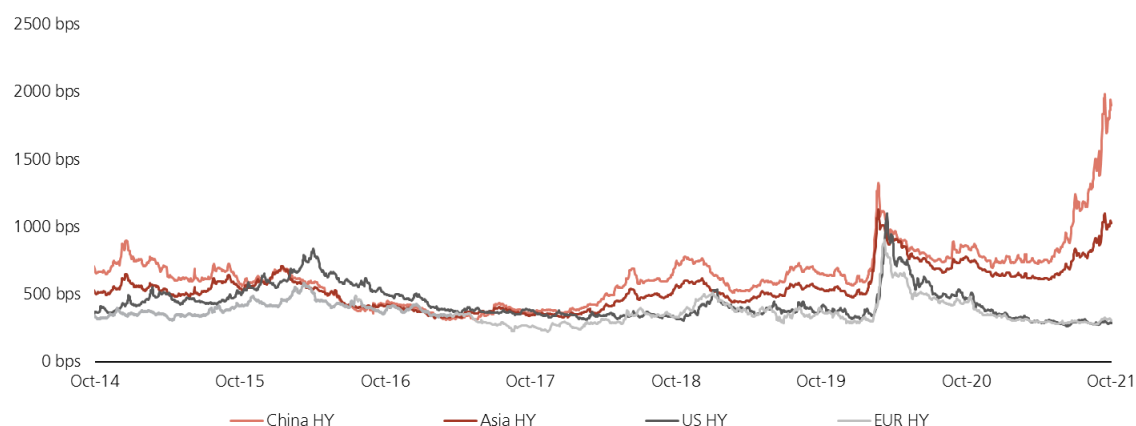


Source: Bloomberg, Bloomberg Global Aggregate Index MV USD. As of end September 2021

## Yields on China high yield credits are close to historic highs

But that's where we believe US dollar-denominated China high yield bonds can offer a solution. China high yield offers yields of almost 20% and spreads of around 1,900bps<sup>1</sup> - significantly higher than high yield markets in the US and Europe, which have diverged markedly from Asian credits during the past six months (Chart 2).

**Chart 2: High yield credit markets compared: China, Asia, US and Europe**



Source: Bloomberg, J.P. Morgan. Spreads as of 31 October 2021

<sup>1</sup> Source: Bloomberg, J.P. Morgan. As of 31 October 2021

But how did we get here, and what explains current levels in China's high yield markets relative to other markets? We see four factors:

1. Continued monetary support has suppressed yields in the US and Europe.
2. Although a flexible and targeted monetary policy is still in place after China's rapid post-COVID-19 economic rebound, the Chinese government overall adopted a less dovish monetary policy compared to policymakers in the US and Europe.
3. Further regulatory measures targeted at the technology, education and healthcare sectors announced in 3Q 2021 heavily impacted investors' sentiment toward Chinese assets.
4. The real estate bond sector, which dominates the high yield space and accounts for around 70% of the JP Morgan Asia Credit Index (JACI) China High Yield, has seen an increase in regulatory constraints which led to the sector experiencing price pressures recently.

However, we believe that whilst the Chinese government's intent of de-leveraging the real estate sector is a good one in terms of achieving their economic aims of more "quality growth" and "common prosperity", this needs to be balanced against the potential for country-wide contagion risks due to overly tight real estate regulations.

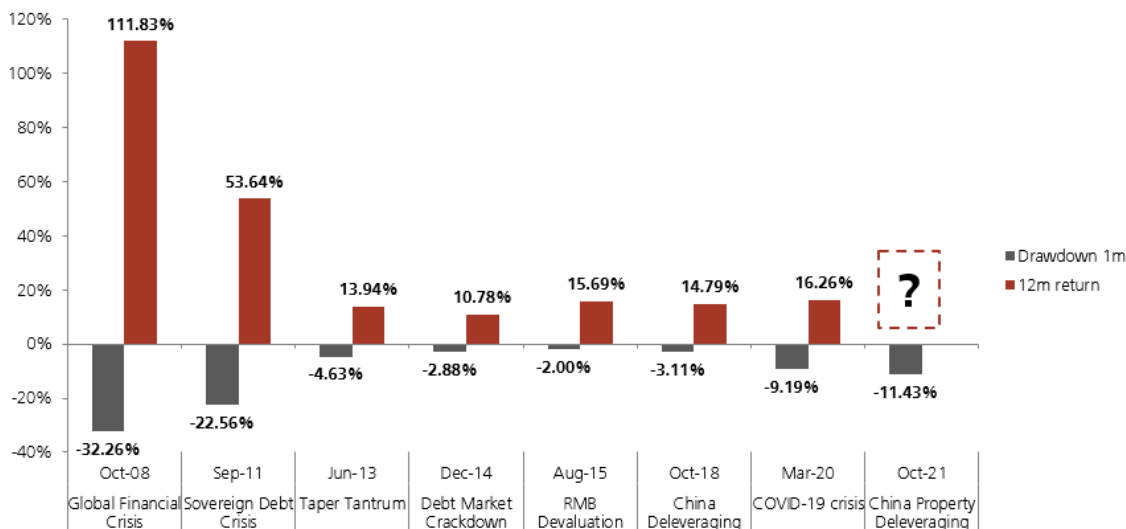
#### A potential entry point for investors?

For forward-looking, long-term investors, we believe that now could be a good entry point into the US dollar China high yield asset class.

In our view, yields are currently attractive, and we see strong potential for positive returns over the longer term. Although regulatory changes and uncertainty caused a market drawdown in July, previous drawdowns and jitters in the China high yield market since 2008 subsequently provided strong returns in the following 12 months (Chart 3).

**"Yields are currently attractive, and we see strong potential for positive returns over the longer term."**

**Chart 3: Subsequent 12 month returns (%) in Chinese credit markets following a large monthly drawdown**



Source: J.P. Morgan Asia Credit Index (JACI), UBS Asset Management. Data as of end July 2021. \*Measured from the month with the largest drawdown in a crisis year

We believe that there are three key factors which may drive returns over the next 12 to 24 months:

- Firstly, Chinese policy statements indicate strong support for financial market stability, suggesting limited rollover risk for onshore credits that should allay fears of a spike in liquidity pressure and defaults. This should also have a positive knock-on impact on the USD China high yield market.

- Secondly, we believe the tone and substance of government policies will likely soften in the coming months, particularly as key indicators, such as industrial output and retail sales, have shown weaker growth recently.
- Finally, we expect to see a credit-positive, re-rating process play out within China's real estate sector, mainly because of the long-term impact of the government's Three Red Lines policy.

### Three Red Lines

In August 2020, China's government introduced the 'Three Red Lines' regulation on real estate developers. The Three Red Lines are metrics to gauge developers' financial strength and they are:

- Liability-to-asset ratio (excluding advance receipts) of less than 70%
- Net gearing ratio of less than 100%
- Cash-to-short-term debt ratio of more than 1x

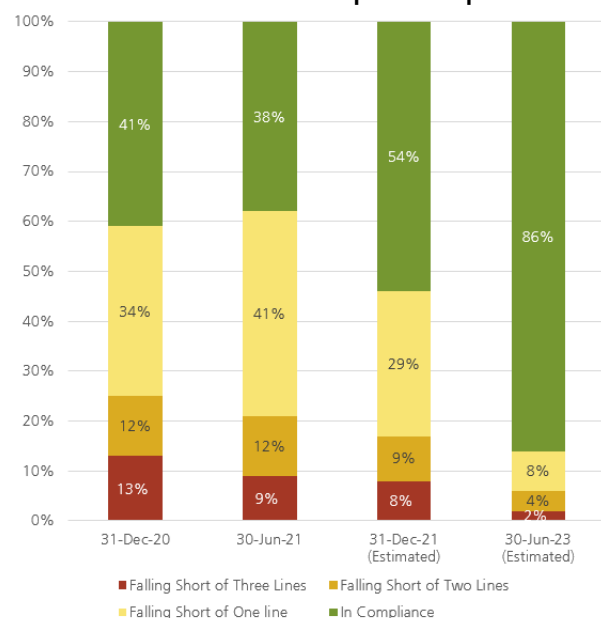
Regulators will limit debt growth based on the number of 'Three Red Lines' metrics breached.

Color code	Number of red lines breached	Allowable annual growth in debt
Green	0	15%
Yellow	1	10%
Orange	2	5%
Red	3	0%

Simply put, the 'Three Red Lines' compels the deleveraging of China's real estate developers, many of whom have aggressively used debt to expand in recent years. And the Chinese government is serious about it.

Since August 2020, credit conditions have noticeably tightened, resulting in cases of distress for selected credits in the China high yield space. But more broadly, developers are moving into compliance with the Three Red Lines (Chart 4), and we believe this signifies a positive re-rating process for China real estate credits.

**Chart 4: Listed Chinese Developers' Compliance with Three Red Lines**

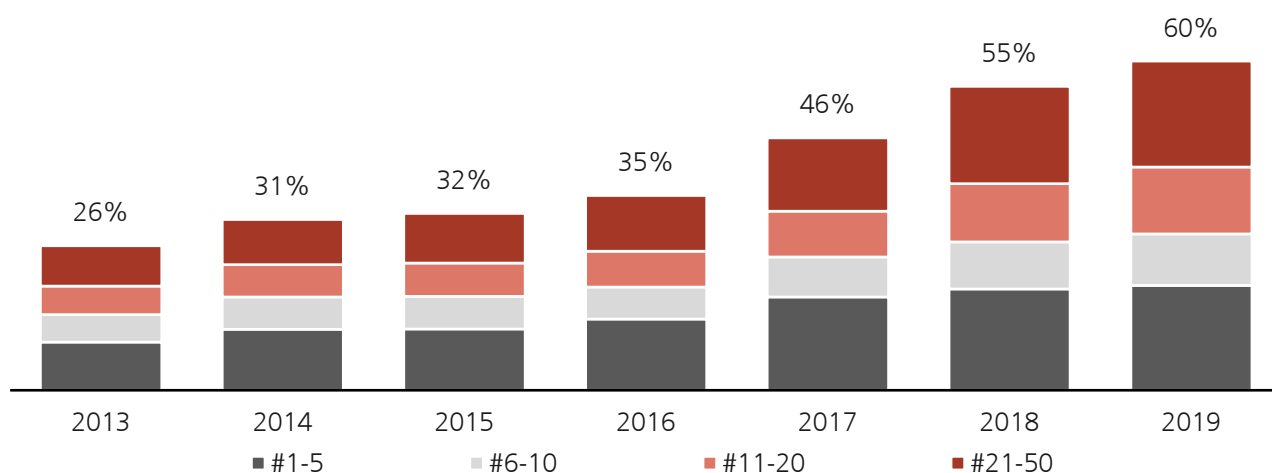


Source: BQuant, Company Filings, Bloomberg Intelligence as of 8 October 2021. Data compiled based on 181 listed Chinese developers as of 1H 2021. Perpetual capital is treated as equity when calculating net debt to equity ratio. Percentage shown represents a portion of each rating category that falls short of the requirement.

Furthermore, we believe the Three Red Lines policy campaign will accelerate three specific long-term, credit-positive trends in the sector:

1. **Continued credit rationing for weaker players:** The Three Red Lines will add extra impetus to the government's longer-term efforts to discipline the sector by restricting weaker players' access to credit.
2. **Industry rationalization:** Larger developers are likely to scale up and grow their market share via M&A.
3. **Increased diversification:** Industry rationalization and M&A would mean that larger players have operations across many real estate markets and have less concentrated exposure to one area.

**Chart 5: China top 50 developers' market share, 2013-2019**



Source: Bloomberg, WIND. As of end February 2021

### Selection is key, and watch out for volatility

So in summary, while we do not expect a full recovery soon, we do see current valuations as attractive, compared to historical levels as well as to other international high yield markets. While the months ahead are likely to be further impacted by heightened uncertainty and risk aversion, keeping market volatility high, we also expect some regulatory and financial support from the government in order to calm down the uncertainty in one of the most important domestic sectors of China's economy.

In our view, valuations have become more attractive for issuers with solid fundamentals, which have been negatively affected by the general market contagion. Selecting the right names remains paramount: China's high yield market is diverse, with different norms which may not be intuitive to those used to operating in developed markets such as the US and Europe. But that's where on-the-ground expertise can make the difference.

Bottom-up insights from research teams based in China can provide insights that cut through the reams of market noise around the Chinese economy. Combining this in-country expertise with an active investment approach can also help uncover unappreciated opportunities.

And that's particularly relevant for China, which remains relatively under-researched compared to more developed markets.

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