Bond Blog

PGIM FIXED INCOME

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NAVIGATING CHINA’S CREDIT CRACKDOWN

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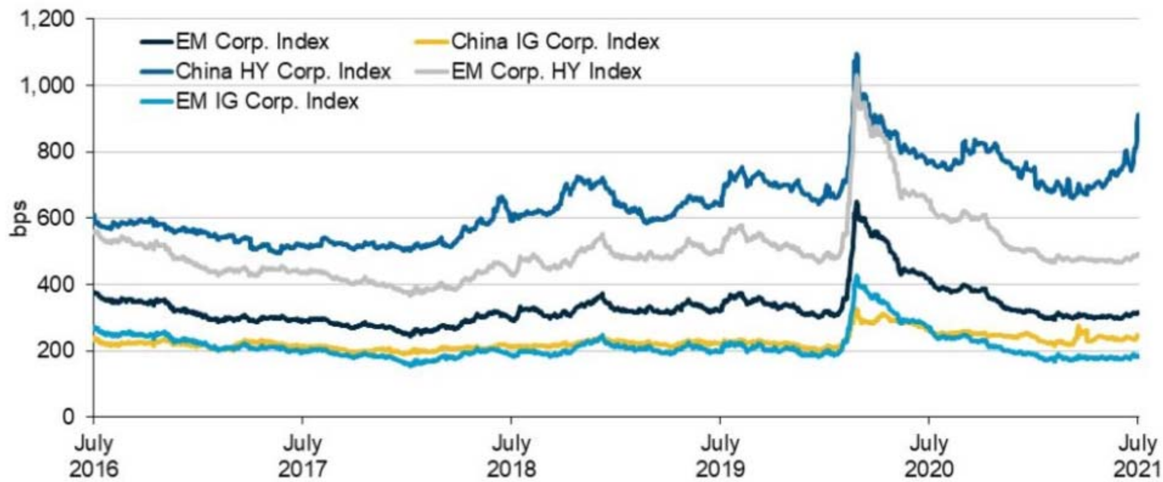
Scenery Journey, Proven Honour, and Easy Tactic could have been compelling band names. Instead, these are the Chinese bond issuers that have recently become the focus of the government’s numerous regulatory or policy directives. For bondholders of the respective credits, the recent journey has been anything but scenic.

China’s regulatory push and the resulting credit concerns have driven a significant correction in spreads across Chinese high yield credits as they have widened almost 300 bps to 900 bps. The spread differential between China high yield (average rating BB-) and the broader EM high yield corporate index (average rating BB-) of 400 bps is at historical highs vs. a longer-term average of 150 bps.

FIGURE 1: HIGH YIELD CHINA SPREADS REACH HISTORICAL WIDES VS. BROADER EM HY INDEX



Source: J.P. Morgan

While the headlines will likely continue given the political priorities, the regulatory drive may be more targeted going forward, and our outlook for EM corporate high yield defaults remains unchanged at 2.5-3.0%. Chinese authorities have reached out to investors and provided their the rationale for the recent clampdowns. This outreach is encouraging, and we believe the authorities will be more mindful of market reactions going forward. However, those investors waiting for government bailouts for highly levered privately owned enterprises will likely be disappointed as the credit issues for the most indebted borrowers persist.

The regulatory crackdown also requires some broader context. These measures are part of the government’s social and financial stability goals. The political landscape, with President Xi and his allies preparing to continue their generational leadership with the approach of the next Party Congress and new Five Year Plan in 2022, sheds light on the desire to refocus. Given how wealth inequality affects the delivery of healthcare, education, and housing access, it is no surprise that officials are targeting certain sectors. The subtext is a shift from some market-based capitalism to more of a state capitalism model. These developments should also be seen through the lens of demographic pressures given China's aging population and its need to increase population growth.

FIGURE 2: CHINA'S TARGETED REGULATORY CRACKDOWN

Segment	Policy Goal	Encouraged vs. Discouraged Business Models and Practices
Education	To ensure a fair and inclusive education system	✓ Public school education, vocational training X Profit-oriented afterschool tutoring
Tech giants	To promote corporate social responsibility	✓ Take up responsibility on employee and consumer welfare X Monopolistic behavior with disregard for social welfare
ADR & overseas listings	To reduce national security risks in a data-driven, multipolar world	✓ Mainland & Hong Kong listings X
Fintech	To curb regulatory and financial stability risks	✓ Regulated and licensed businesses with proper oversight on data usage X Unlicensed operations with high leverage and product/credit concentration risks

Source: Morgan Stanley and PGIM Fixed Income.

China's regulatory landscape, particularly as it pertains to the tech sector, has emerged as a key risk that we've been monitoring within the EM corporate sector. With respect to portfolio positioning, we have navigated the crackdown on China credit by avoiding exposures in the asset management sector (e.g. Huarong) and lower-rated property names (credit ratings of mid-B and below, such as Kaisa and Evergrande) while preferring a diversified basket of higher-rated (B+ and better) property names. In the IG space we have preferred centrally owned companies, such as Chemchina and Sinopec, while remaining underweight in technology. We had also opportunistically invested in some new issues in the China industrial space, e.g. ENN Clean Energy and Hongqiao. Overall, we are sticking to our strategy of overweighting the better capitalized names, while monitoring distressed issuers as they get closer to recovery values.

In the context of our overall EM corporate exposure, China external bond names are limited, and we express our bottom-up views by issuer selection. It's important to draw a distinction between local central government bonds (CGBs) as our view on the asset class remains more constructive than our view on corporates. In this regard, we believe authorities will continue to signal that this market is "open for business," and our overweight positioning reflects attractive value relative to other local markets.

FIGURE 3: THE PLAYERS IN CHINA'S REGULATORY CRACKDOWN

Company/Sector	Regulator	Objective
Ant Financial/fin tech	PBoC and CBIRC	Financial risk control
Alibaba/platform tech groups	State Administration for Market Regulation	• Better conditions for gig workers • More bargaining power for SMEs • Protection for tech small caps
Didi and new foreign IPOs	Cyberspace Administration of China	"Data security is national security"
Private education	Ministry of Education	Demographics and social security
Real estate	NDRC, PBoC, Ministry of Housing and Urban-Rural Development	• Deleveraging • Demographics • Carbon neutral • Re-allocation of capital

Source: TS Lombard and PGIM Fixed Income.

Looking ahead, downside risks within the sector include further clampdowns in the property and technology sectors as well as U.S. regulatory measures targeting Chinese IPOs. These risks could be offset by domestic infrastructure related spending and a continuing recovery in the global economy.

As investors, how do we interpret the recent developments in China? Growth may slow, but the measures are designed to avoid a hard-economic landing. Corporate leverage remains high, and authorities recognize the risk to financial stability if they continue to pursue leverage-induced growth. It also appears that the economic leadership is not attempting to squash the dynamic sectors of the economy, but rather to redirect them to more stable-growth models. Indeed, the regulatory crackdown on internet companies does not mean that China is going to target the entire tech sector, and support for key firms, such as Huawei, and key initiatives, such as artificial intelligence, will continue. Put further, China does not want engineering and entrepreneurial skills to be overly concentrated within internet platform companies, rather it aims to see these skills applied across sectors that help the advance China's global influence.

The complex combination of macro and micro issues underscores the need for investors to remain selective about how they gain exposure to the different sectors of the Chinese market and consider how foreign investors might be treated in certain circumstances.

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