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CHINA'S GREAT OPENING: THIS TIME IT'S REAL !

Emerging Markets Fixed Income

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

CHINA'S GREAT OPENING: THIS TIME IT'S REAL !

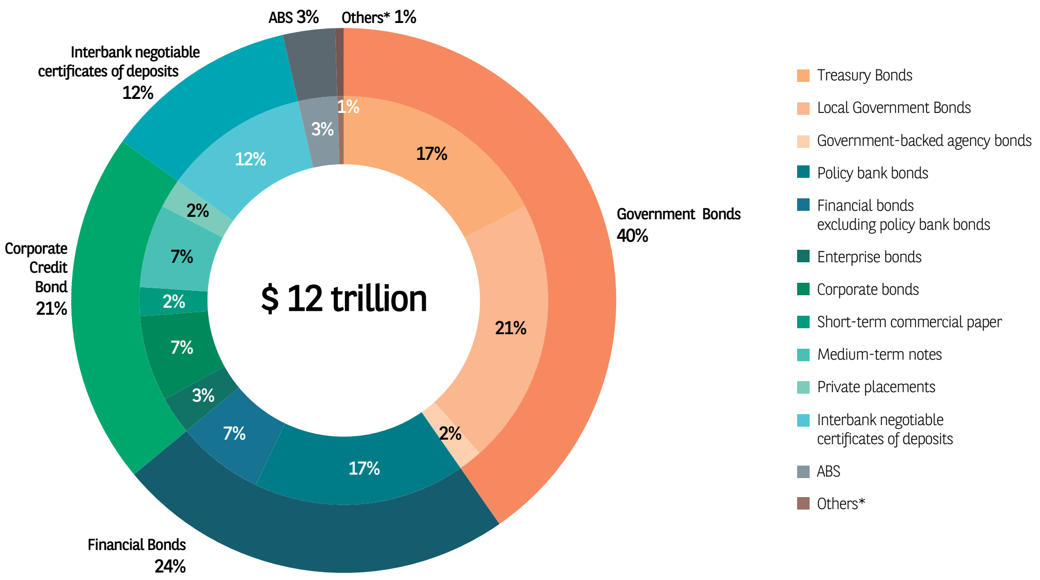
With China now in the process of being included in key global fixed income benchmarks, the opening of the onshore Chinese bond market is finally happening. We think this will trigger the need for investors to make a radical change in their asset allocation. As this change materialises, it is our belief that inflows to onshore fixed income could dwarf other types of portfolio inflows into China and could become the most significant game changer of fixed income investing of current times. We also believe that, on the external debt side, the dominance of Chinese debt denominated in US dollar is unstoppable.

In this document, we will discuss the developments that have led to this point that make us believe that the Chinese onshore markets will become a dominant source of alpha for active investors. We will also look at the Chinese offshore fixed income market, discussing in more details why we find both Chinese high yield and some investment grade corporates to be fundamentally mispriced and why in depth fundamental research will continue to provide some great alpha opportunities to investors.

THE OPENING OF THE 3RD LARGEST MARKET IN THE WORLD

Quite simply, the scale of the Chinese bond market is vast! Standing at around USD 12 trillion (including both China rates and credit bonds as shown in Figure 1 below), it is the third largest bond market in the world, behind only the US and Japan. It is likely to overtake Japan relatively soon given its very rapid growth. While being already large, this market only accounts for around 85% of GDP while most developed markets are in excess of 200% of GDP. As China is graduating to a developed market status, we would expect the Chinese bond market to continue to grow fast.

Figure 1: Breakdown of the Chinese bond market

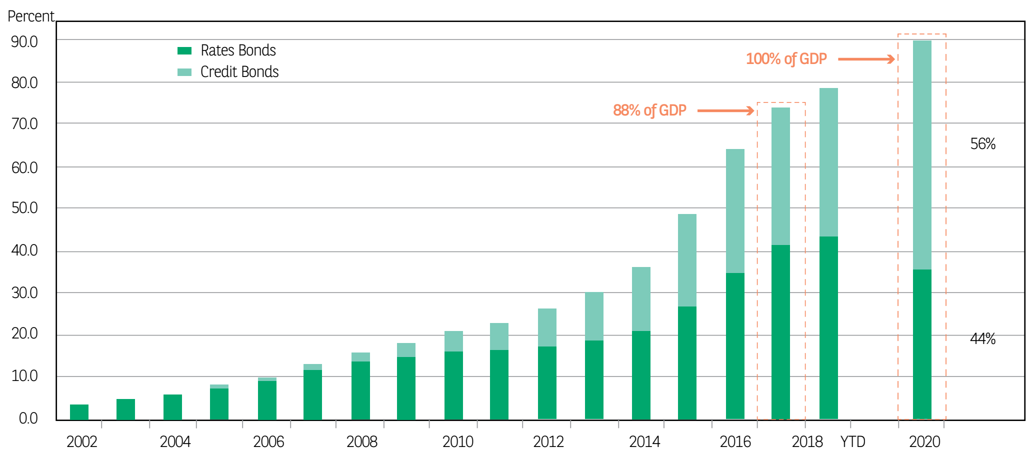


Source: Source: Wind, Golden Credit, December 2018

*Others includes convertible bonds, exchangeable bonds and foreign institution bonds

Figure 2 below shows the rapid growth in the amount of bonds oustanding to date and expectations until 2020.

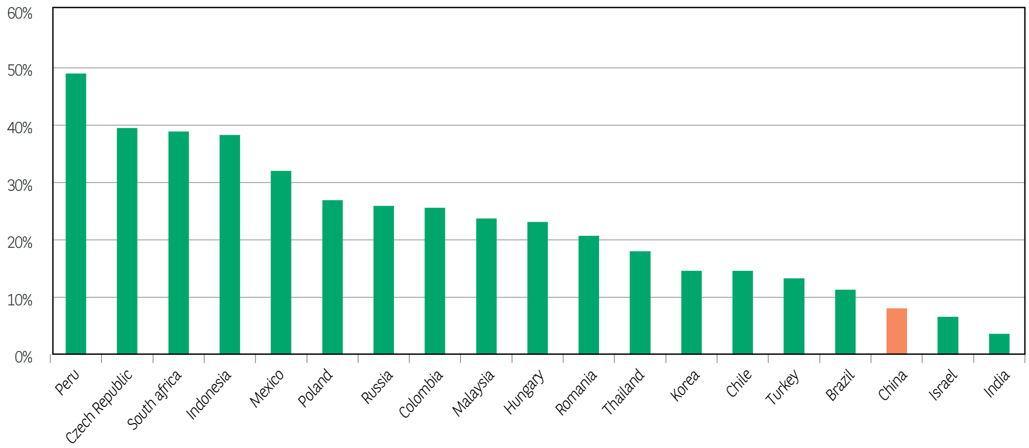
Figure 2: Total amount of Chinese debt outstanding



Source: BIS, Wind, BNP Paribas, simulated data for 2020

Surprisingly then perhaps, is that China is still one of the most under-owned bond markets in the world, as can be seen in Figure 3, reflecting years of capital controls, regulatory uncertainties and relative illiquidity.

Figure 3: Foreign ownership (%) of local bonds outstanding

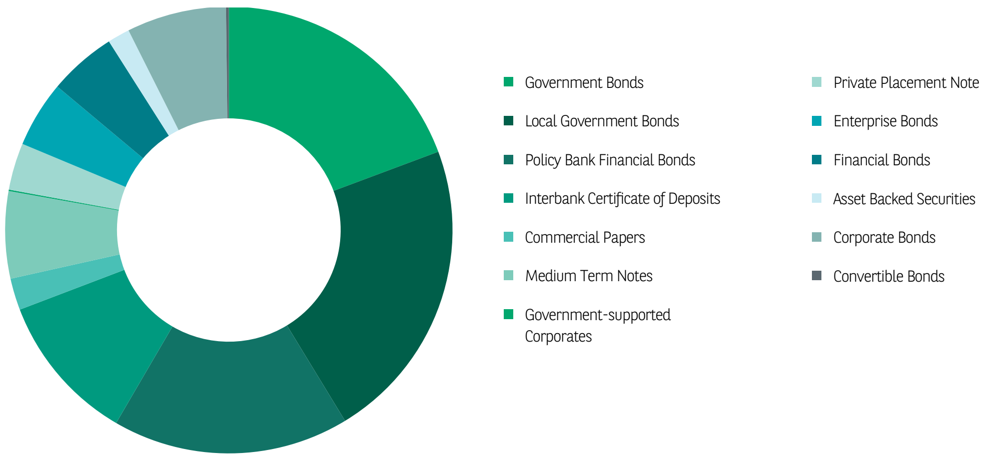


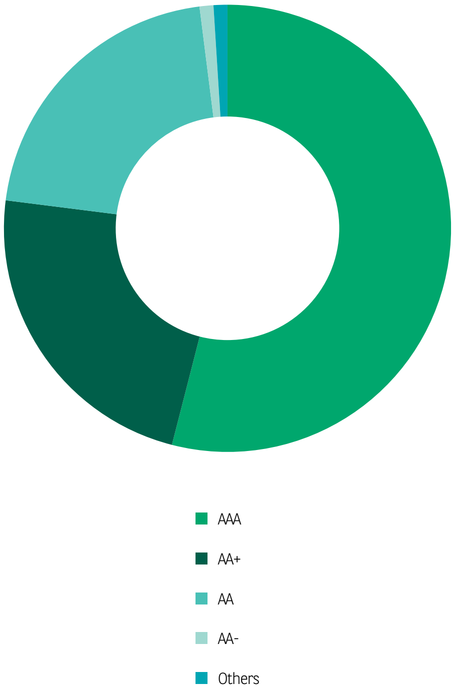
Source: JP Morgan, official sources, end of February 2019

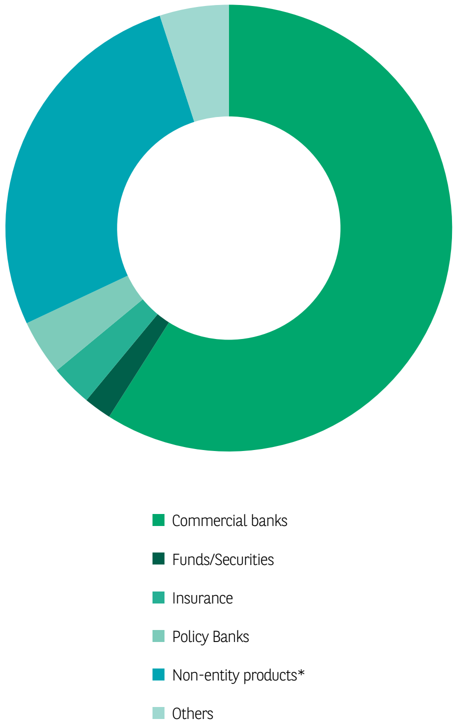
EXTENSIVE ALPHA OPPORTUNITIES AVAILABLE

Not only is it huge, but the onshore Chinese fixed income market is also relatively diverse. For those able to successfully navigate it, the market offers investors access to a wide range of instruments. However, the diversity in credit profiles is sometimes hidden by still early stage methodology for onshore rating (2/3rd of the onshore market is rated AAA even though part of this universe carries significant credit risk) and is still predominantly owned by commercial banks (see Figure 4, below). The picture is changing, however, as ownership by pensions funds, insurance companies and asset management companies have been recently growing.

Figure 4: RMB onshore bonds trading





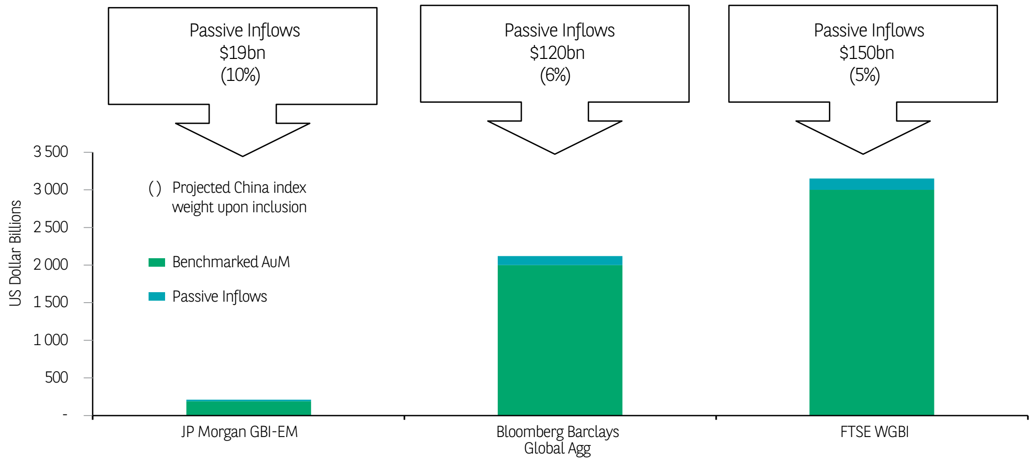


Source: JP Morgan, official sources, end of February 2019

Overall, we think that the long term story for rates and policy banks is positive. Although we do expect some rising supply at the sub-sovereign level (especially provincial level), the combination of contained inflation off the back of only moderate fiscal and monetary stimulus and incremental foreign demand should help keep yields low. In the shorter term however, we do expect some volatility as many local investors are likely to shift from money market or conservative fixed income funds to more aggressive equity funds so the domestic demand side could weaken a bit.

Index inclusion is a game changer. The final weight of China in the Bloomberg Global Aggregate index will be in excess of 6% (the inclusion will be gradual and will continue until November 2020). Current rules for index inclusion are pretty strict: bonds have to pay a fixed coupon, have an outstanding amount of at least RMB 5 bn and a remaining tenor of 1 year or above. Over time, Bloomberg could consider including local government bonds, corporate bonds and asset backed securities in the Bloomberg Global Aggregate index which could trigger additional inflows and a higher weight for China. Based on our estimate, passive inflows linked to this inclusion could amount to USD 120 bn over the next couple of quarters. In addition to this, the likely inclusion in JP Morgan GBI EM Global Diversified could trigger roughly USD 20 bn and potential inclusion into FTSE WGBI another 150 bn (Figure 5 below). Total passive inflows could be in the tune of USD 250-300 bn. Should this market eventually catch up with levels of foreign ownership seen in mature markets or in smaller emerging markets, this would translate potentially into several USD trillions of inflows in the years to come.

Figure 5: Expected passive inflows from index inclusion



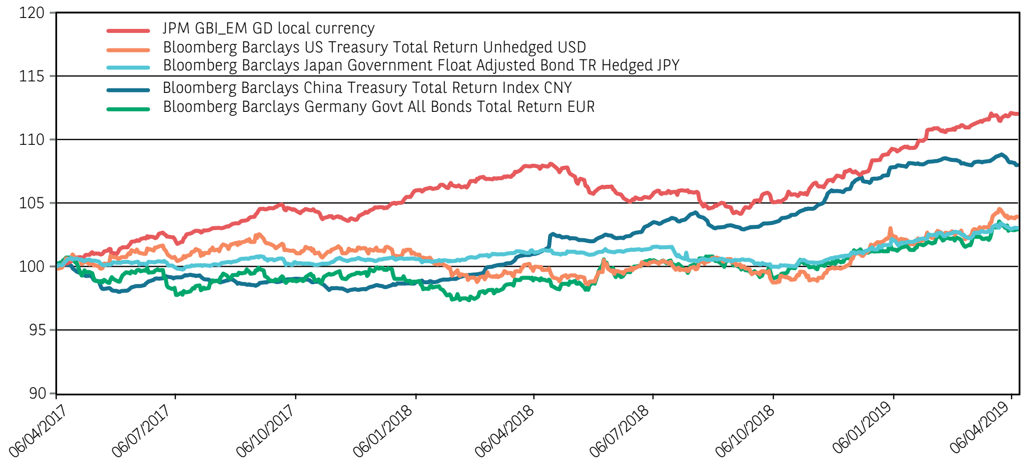
Source: BNPP AM, JP Morgan, Bloomberg, FTSE Russell, BNPP AM, February 2019

JP Morgan GBI-EM = JP Morgan Government Bond Index-Emerging Markets Index; Bloomberg Barclays Global Agg = Bloomberg Barclays Global Aggregate Bond Index; FTSE WGBI = FTSE World Government Bond Index

On top of index inclusion, we think we are only at the beginning of the allocation of Central Banks' reserves into the onshore Chinese market. The weight of China has recently been increasing and is now approaching 2%; roughly in line with allocations to the Australian dollar and the Canadian dollar. Overtime, we think the weight of RMB denominated assets (CGBs and policy banks) could well be in excess of 5%.

This fundamental mispricing of the onshore market has to do with the structure of the demand. For onshore investors, Chinese rates (including policy banks bonds) are "risk off", i.e. their own risk free rate. The correlation is usually negative with the A-share equity market. However, from a foreigner's perspective, adding China rates risk is seen as "risk on" with low correlation with other types of global emerging markets local currency debt instruments. This divergence in views naturally creates some mispricing and allows opportunity for alpha generation. Given these atypical features, the Chinese bond market usually displays relatively low correlation with both developed markets' rates as well emerging market local currency debt as well as relative stable return, as shown in Figures 6 and 7. The risk/reward profile is unique compared to other emerging markets instruments.

Figure 6: Performance of CGBs vs EM and DM



Source: BNPP AM, Bloomberg, April 2019

DM: Developed Markets

Figure 7: Correlation over two years of CGBs vs EM and DM

	CGB	GBI EM	DBR	UST	JGB
CGB	1.00	0.34	-0.05	-0.02	0.33
GBI EM		1.00	-0.22	0.11	0.34
DBR			1.00	0.74	0.62
UST				1.00	0.61
JGB					1.00

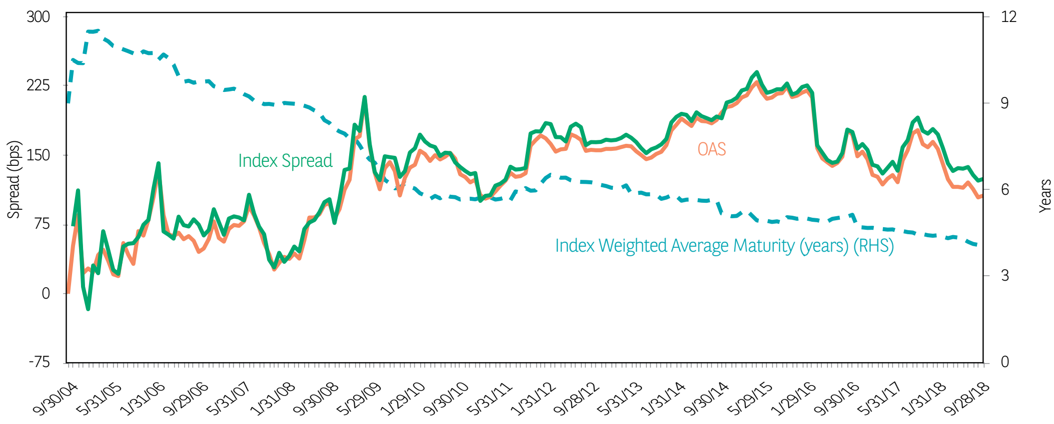
Source: BNPP AM, Bloomberg, monthly returns over two years to April 2019

CGB: China Government Bond; GBI EM: JP Morgan Global Bond Index Emerging Markets; DBR: German government bonds; UST: US Treasury; JGB: Japan Government Bond

On the other side of the sprectrum, onshore credit spreads always had the tendency to be tight in China (see Figure 8), the main reason being that there was no price discovery mechanism. Credit risk traditionally tended to be priced from a top down perspective (i.e. trying to assess the level of government support) rather than attempting to price stand alone credit risk.

We think we are now at a major inflection point: policy makers are willing to inject more credit risk into the system. In the short term, onshore credit spreads are likely to widen as the credit ratings are reassessed and brought more in line with other global issuers. Until now, Chinese domestic rating agencies have been way too complacent and many AAA rated Chinese corporates actually carried significant credit risk. However, the gradual opening to foreign rating agencies seems to be encouraging. **We would expect higher corporate spreads in the short term and a rise in onshore corporate defaults which might be painful in the short term but should be seen as a healthy longer term development.**

Figure 8: Bloomberg Barclays China Corporate Total Return Index Unhedged USD and Index Spread



Source: BNPP AM, Bloomberg, April 2019

OAS: Option adjusted spread

THE REGULATORY JOURNEY SO FAR

As we documented back in November 2017 in our paper, Time to buy Chinese Onshore renminbi (RMB) bonds, despite its size and its economic prowess , the Onshore RMB market has been closed to foreign investors due to regulatory hurdles.
However, since then, there have been further significant moves by regulators as they prepare to internationalise the bond market and open it up to foreign investors.

IN SUMMARY

▼

October 2016
Inclusion in the IMF Special Drawing Rights (SDR) basket at a weight of 10.92%. The next IMF review will take place by September 2021

....

March 2017
Bloomberg Barclays launched a new Global Aggregate + China index, as well as EM + China indices Citigroup announced that it would include China's bonds in Emerging Market and Regional indices

....

July 2017
Launch of the Bond Connect program for easier access to the onshore bond market by offshore investors International credit rating agencies given access to rate onshore issuers

....

November 2017
PBOC issued detailed operational guidance for foreign investors' onshore RMB bond investments, including on account registration, settlements and tax rates

China announced further opening up of its capital account by reducing limits around foreign ownership in select finance businesses, as well as reducing tariffs on certain sectors

....

March 2018
Bloomberg announced that it would include onshore Chinese government and policy bank bonds in the Bloomberg Barclays Global Aggregate Bond Index beginning in April 2019, phased over 20 months, conditional upon resolving certain operational aspects

....

August 2018
China State Council announces 3 year tax waiver on China bond investments for foreigners

Bond Connect offers real time Delivery Versus Payment (DVP) settlement

Bond Connect launches block trading allocations, allowing asset managers to allocate block trades to multiple client accounts prior to undertaking trades

China has also recently overhauled its regulatory framework in order to have better centralised coordination and enforcement among the different regulatory bodies to make central policy initiatives more effective.

This has included:

- Merger of the banking regulator (CBRC) and the insurance regulator (CIRC) into a new body CBIRC.
- Broadening of the PBoC's remit to include drafting key legislation for banking/insurance and for macro-prudential regulation.

The key regulators now operating in the Chinese bond market space are outlined in Table 1 below.

Table 1: Chinese Regulators

Full name	Scope
People's Bank of China (PBOC)	Chinese central bank which controls monetary policy and regulates financial institutions in China. It has a dual mandate around monetary and financial stability.
China Central Depository and Clearing Corporation (CCDC)	Centralised depository and settlement for the interbank bond market
China Foreign Exchange Trade System (CFETS)	Supervises interbank lending, bond and FX markets (a subdivision of PBoC)
China Securities Regulatory Commission (CSRC)	Regulates China's securities markets and in charge of qualification approval of Qualified Foreign Institutional Investor (QFII) and (RMB or RQFII)
State-Owned Assets Supervision and Administration Commission (SASAC)	Performs investors' responsibilities, supervises and manages the assets of the state-owned enterprises under the supervision of Central Government
State Administration of Foreign Exchange (SAFE)	Regulates foreign exchange administration system and manages the country's foreign exchange market. Regulates foreign invested enterprise's RMB fund raising approval and their FX payments and guarantee.

ACCESSING THE CHINESE ONSHORE BOND MARKET

The scale and diversity of investment options available to the uninitiated could well feel overwhelming given legacy access issues. It is indeed true that there have been many hurdles with one of the most serious concerns being that of taxation uncertainty. However, we have now had clarification that foreigners will be exempted from paying taxes until end of 2021. The settlement process has been simplified and trading has been facilitated (see Table 2 below which shows the different routes to accessing the Chinese bond market).

Table 2: 4 different routes to access Onshore Chinese bonds

Investment Scheme	CIBM Direct	Bond Connect	QFII Qualified Foreign Institutional Investor	RQFII RMB Qualified Foreign Institutional Investor
Eligible Investor	• Overseas Central Banks, Supranational, Sovereign Wealth Fund (FOIs) • Asset Managers, Funds, Insurance companies, Securities companies, Commercial bank	• Overseas Central Banks, Supranational, Sovereign Wealth Fund • Asset Managers, Funds, Insurance companies, Securities companies, Commercial bank	• Asset Managers, Funds, Insurance companies, Securities companies, Commercial banks, others (pension funds, government institutions...)	• Financial institutions with principal place in approved RQFII jurisdictions with an asset management licence
Eligible Investment Scope	• CIBM • Bonds • Bond lending, Bond forward, interest rate derivatives • FX derivatives • Repo	• CIBM • Bonds • FX derivatives • Note: Future investment scope will expand to bond repurchase, bond lending, bond forward and interest rate derivatives	• Fixed income products listed and traded in • CIBM, and • Exchange markets	
Quota	• No quota limitation	• No quota limitation	• Base quota mechanism • SAFE registration/approval for quota	
Access	• Register with PBoC through a Type A Interbank Bond Settlement Bank • FOIs can access directly or entrust PBoC / Type A bank as agent	• Register with Bond Connect Company Ltd. • Rely on existing Global custodian who appoints a CMU member in Hong Kong to be the offshore custodian	• For CIBM Investment: Entrust a Type A Interbank Bond Settlement Bank • For exchange market investment: Entrust onshore custody for cash settlement, and onshore brokerage	

CMU: Central Moneymarkets Unit

Sources: BNP Paribas, CSRC, PBoC, SAFE

There are now many options to access the market. The main differences between Bond Connect and CIBM are outlined in Table 3 below. While the universe is basically the same for now and Bond Connect is sometimes seen as easier and quicker, we think overtime having genuine onshore access should allow investors to have access to a broader array of tools including onshore derivatives.

Table 3: Bond Connect vs CIBM Direct

	Bond Connect (Northbound)	CIBM Direct
Set-up process	• Simpler application process and shorter expected turnaround	• Longer set-up process
Eligibility	• Same as CIBM Direct Access	• Financial institutions; medium to long-term investors
Product scope	• Cash bond and FX derivatives for hedging purposes • No access to onshore repo • FX spot conversion and hedging; FX hedging pending more control/ monitoring details – via the appointed HK Settlement Bank	• Cash Bond, interest rate and FX derivatives for hedging purpose • Onshore repo for commercial banks • FX spot conversion and hedging - via the appointed BSA
Registration	• Registration with PBOC through BCCL • Registration could be at company or product level	• Registration with PBOC through settlement agent bank • Registration needs to be at product level for fund managers
Trading Platform	• International trading platforms such as Tradeweb currently and Bloomberg expected at a later stage • Additional cost charged for connectivity (1bp on notional) • Unable to negotiate prices on electronic platform	• OTC trading with agent bank who trades on investors' behalf on CFETS or RFQ basis • Able to negotiate prices with counterparties
Quota	• No quota is imposed or needs to be indicated	• No quota is imposed, but investment is subject to registered amount indicated by investors
Settlement/custody	• Rely on existing Global Custodian which has already appointed a local custodian in HK (acting as HK CMU member) • Investor has no contractual relationship with onshore settlement agent. Back to a normal custody and legal framework: (Investor/Global Custodian/Sub Custodian) • Account structure in CMU (segregated at investor level). Account structure in CCDC and SHCH: One omnibus CMU account opened as nominee • Settlement cycle same as CIBM Direct Access	• DVP settlement for CCDC & SHCH • Need to open accounts directly with Settlement agency, CCDC and SHCH. • Settlement cycle : T+0, T+1 and T+2 settlement
Ownership structure	• Nominee structure held via CMU	• Bond held onshore by investor directly
Restrictions	• Same as CIBM Direct Access	• No lock-up period or repatriation restrictions
Tax	• Tax rates clarified • How and when to be collected remain unclear • No capital gain tax • Coupon tax: Waived for Govi and municipal bonds and , 16% on rest of the bonds; • Coupon interest income received by overseas institutional investors in China bond market will temporarily be exempted from corporate income tax (CIT) and value added tax (VAT) for three years.	• Tax rates clarified • How and when to be collected remain unclear • No capital gain tax • Coupon tax: Waived for Govi and municipal bonds, 16% on rest of the bonds; • Coupon interest income received by overseas institutional investors in China bond market will temporarily be exempted from corporate income tax (CIT) and value added tax (VAT) for three years.

Source: PBoC, BNP Paribas, PwC China. Invesco

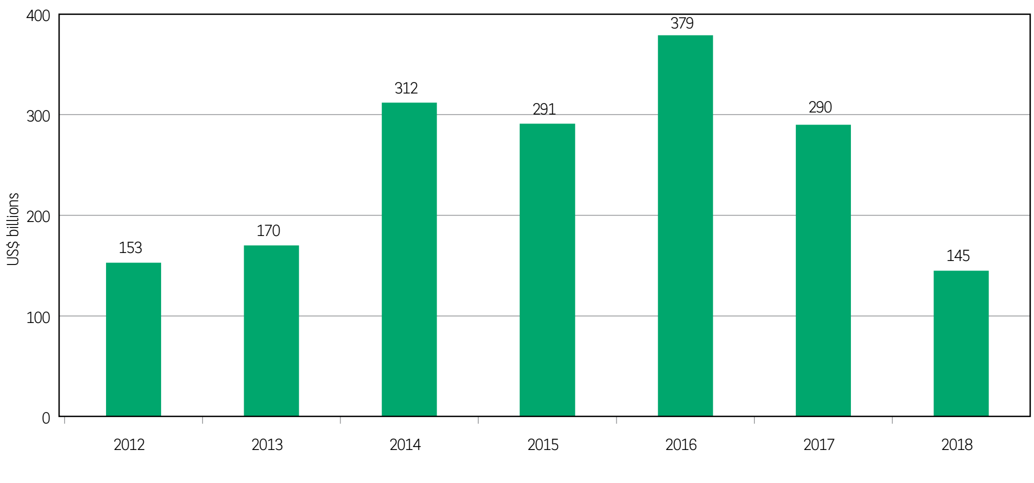
CHINA'S US DOLLAR DEBT: TIMES ARE ALSO CHANGING

It's not only the Chinese onshore market that is evolving rapidly, Chinese debt denominated in US dollars has also surged in the past decade. The uncertainties surrounding the Balance of Payments and RMB in 2018, raised concerns when it comes to refinancing risks. However, for professional investors who closely follow the developments and remain aware of the issues, the advances in the asset class provide ample opportunity for generating alpha.

TURN-AROUND IN LOCAL GOVERNMENT FINANCING VEHICLE (LGFV) SECTOR

During past economic slowdowns, government stimulus involved increasing financing channels to LGFVs in a bid to boost demand through infrastructure projects and spending. Much has been said on these vehicles: opaque source of financing, risks of overleverage, and systemic risks. We actually think that active monitoring of policy direction combined with bottom up credit research could help investors to find mispriced opportunities in that segment. Since mid-2018, the government relaxed guidelines on trust loans and non-bank financial institution asset management products, which are typically a key source of demand for LGFV bonds. During the 2019 National People's Congress, the government announced it will extend its local government debt swap program, where the government issues bonds to replace debt of LGFVs and other quasi-fiscal entities, to ease the interest burden of local governments. Further relaxation recently announced allows LGFV bonds to be sold on the domestic stock exchange if the proceeds are used for refinancing. These initiatives are in line with the importance placed by the central government on preventing systemic risk concerns from arising. Figure 9 below shows the LGFV onshore bond issuance over recent years. While, the recent tone has been focusing less on deleveraging and more on stimulating the economy again, we do not think thing that LGFVs leverage is likely to spiral out of control.

Figure 9: Figure 9: China onshore LGFV bond issuance



Source: WIND, JP Morgan, June 2018

Offshore supply risk is mostly behind us. With $14 bn or approximately 1/3rd of total outstanding LGFV offshore bonds maturing in 2019 and the bulk of remaining maturities due in 2020-2021, the government's change of policy tone has reduced the sector's refinancing risk despite still high leverage and 2019 onshore issuances gathering steam again.

DIFFERENTIATION AMONG LGFVS BASED ON POLICY IMPORTANCE IS NECESSARY

We think that over time, a bottom up differentiated approach to LGFVs investing will be required as some highly leveraged one could be forced to restructure their debt while some systemic ones could provide some interesting investment opportunities.

Government support differentiates from one LGFV to another and is more likely for those carrying policy mandates and thereby having greater strategic importance. Such LGFVs comprise high-tier issuers with provincial or provincial capital administrative ranking and/or engaged in public transportation, infrastructure construction and utilities sectors. Policymakers are likely attuned to minimizing risks such that in the event that strategically important LGFVs were to experience solvency issues or defaults, financial market and/or social instability may result. Hence, investment preference is in LGFVs with clearly delineated policy role and domiciled in cities/provinces with higher administrative significance.

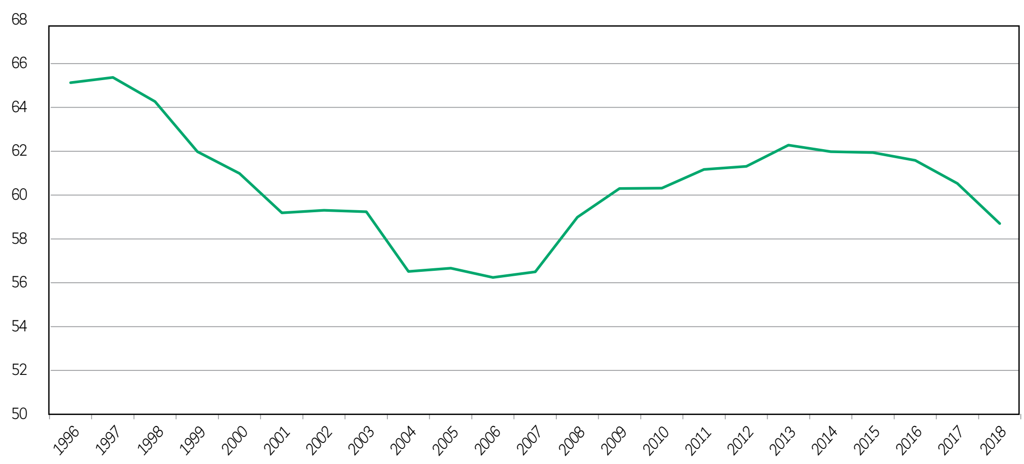
Government support is less likely for LGFVs that are small in scale, domiciled in low-tier cities and/or with extensive commercial operations such a property development, industrial investment and commodity trading. This was manifested in the recent late coupon payment on Qinghai Provincial Investment's 2020 USD bonds, where the LGFV is involved in aluminium production which is considered more commercial than having significant policy responsibility. This recent incident is a reminder of the necessity to combine top down and bottom up research.

SUSTAINABLE PERFORMANCE FOR CENTRAL STATE-OWNED ENTERPRISES (SOES)

Central SOE issuers enjoy a broad and stable investor base in the offshore market and their onshore funding access remains strong. During 2018, China central SOEs were relatively resilient to rising US Treasury yields and tightening funding conditions.

Fundamentals have been improving: On the back of State Council efforts to reduce SOE leverage by 2 percentage points (liabilities to assets) by the end of 2020 and SASAC (State Owned Assets Supervision and Administration Committee) imposing borrowing restrictions on any central SOE if the firm's liability to asset ratio rises above 70%, central SOE fundamentals are expected to be stable to improving. According to State Council figures, the average liability to asset ratio of central SOEs was 66% by end 3Q 2018. Figure 10 below shows the evolution of Chinese SOE's liability-to-asset ratio.

Figure 10: Figure 9: China onshore LGFV bond issuance



Source: WIND, JP Morgan, June 2018

In terms of technicals, controlled capex and lower overseas mergers and acquisitions (M&A) activity is expected to result in less net issuance from central SOEs. Despite this improving technical background, in terms of valuations, top-tier central SOEs involved in strategically important sectors such as utilities and oil exploration and production are trading only marginally wider (10 to 20 bp) vs Korean quasi sovereigns that are rated 2 notches higher. It is hard to see value in those. It is only the less researched SOEs in China which offer some value.

Considering these factors, investment preference is for mid-tier SOEs which offer stable or deleveraging credit profiles, fulfilling strategic policy objective while offering meaningful spread pickup over the top tier SOEs.

THE CHINESE HIGH YIELD MARKET

The Chinese high yield market is booming. China accounts now for 22.6% of CEMBI Diversified and just the HY segment for 6.2% (see Table 4). Despite its size, however, it is fundamentally mispriced and default risk of issuers therein is sometime overestimated. Although financial communication can be relatively opaque, credit opportunities abound in these extensive markets if you are prepared to do the donkeywork and learn how to avoid the blow-ups.

Table 4: China's presence in JP Morgan CEMBI and JACI

% of Benchmark	JP Morgan CEMBI	JP Morgan JACI
Asia	45.3%	100.0%
- of which is China	22.6%	50.9%
HY/NR	39.9%	22.2%
- of which is Asia	11.83%	0.0%
Of which is China	6.2%	11.9%

Source: JPM as at 15 April 2019

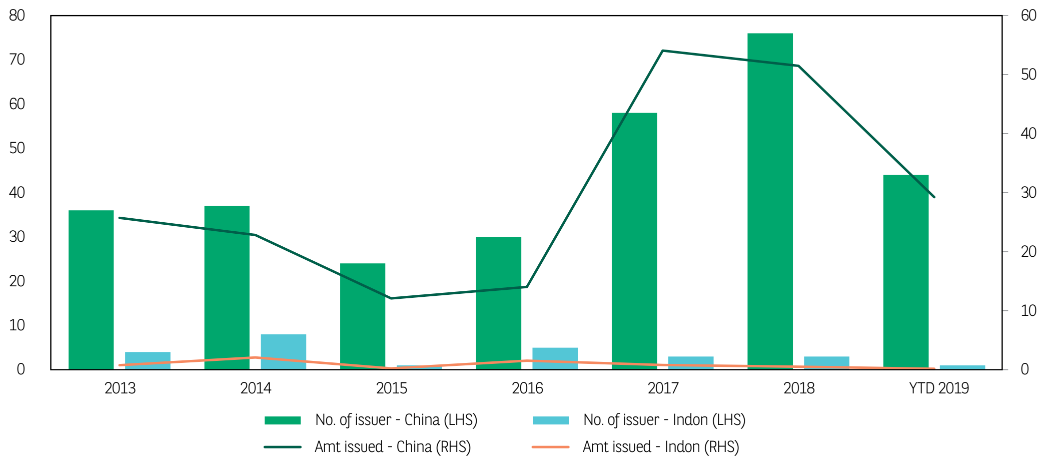
SPOTLIGHT: CHINA'S PROPERTY SECTOR

Not only large, the Chinese HY market is increasingly diversified and sectors differ greatly to each other. Across them, we find Chinese property to be the most mispriced.

The EM property sector has been the subject of increased attention over the last two quarters on the back of the sector's strong rebound from the cyclical trough realised in October last year. Increased government policy support coupled with cheap valuations, good fund flows and the absence of new macro and/or elevated macro concerns have been the key drivers for the sector's recovery. This has, as a result, enabled developers to address their funding needs as they used the opportunity to tap offshore USD markets at lower costs and longer tenors.

The successful refinancing of the outstanding debt has effectively partially reduced the liquidity risk faced by the sector with the additional recent policy loosening of the government providing an extra boost. The presence of Chinese issuers in the USD bond markets has also significantly changed during this period on the back of substantial issuances by Chinese developers. According to Bloomberg, USD25.72 bil was issued across 36 Chinese developers in FY13. This increased by 2x to USD51.5 bil in FY18 across 76 issuers with lower-rated developers also tapping the market. Comparatively, the issuances from Indonesian developers are still confined to the 7-8 well-known names. These dominance of China HY issuances are highlighted in Figure 11 below.

Figure 11: US$ notes issued by developers in China and Indonesia 2013 – 2018

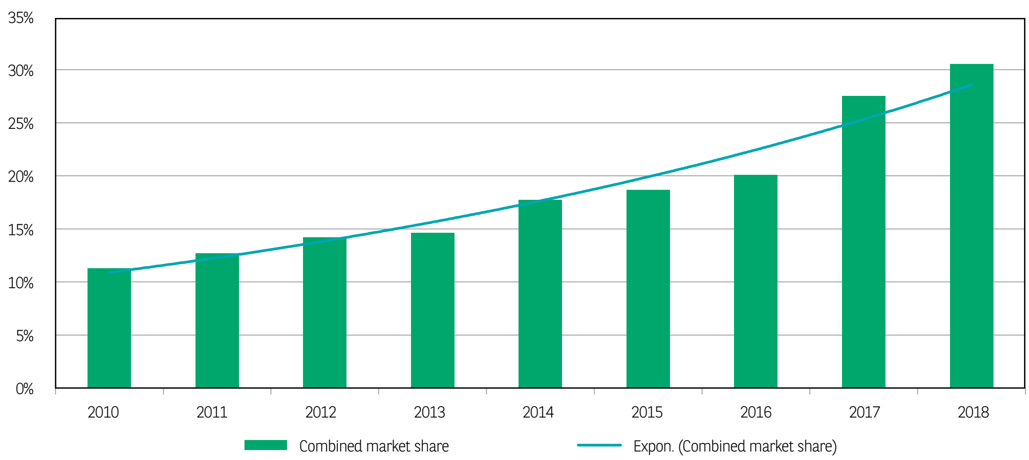


Source: BNPP AM, Bloomberg, as at 8 April 2019

In our view, developers in EM are navigating through a different cycle vs their DM peers. Specifically, in China, the sector has gone through a rapid expansion period again after the market downturn in FY14-15. The industry transaction amount increased to CNY14 tri in FY18 from a low base of CNY8.7 tril in FY15. During that period, developers relied on their onshore and offshore funding channels for land banking and M&A activities. The debt-funded expansion spree has, as a result, led to material leverage deterioration across some developers, more specifically in the case of Evergrande and Sunac.

We, however, note that the property sector in China has entered into a new phase of market consolidation as a result of tightening credit conditions and more stringent government control which has triggered fears among investors that defaults were just around the corner for many property developers. The recent change in policy direction got many investors wrong footed. In our view, larger developers will stand to benefit from their better funding capabilities and sales execution abilities resulting in driving smaller players out of the market. Figure 12 below highlights the increase in market share held by the top 10 developers in China. During this consolidation phase, we expect to see improvement in both leverage and liquidity of the larger, more stable Chinese property issuers. Overall, while leverage is high, we think fundamentals are likely to gradually improve rather than deteriorate.

Figure 12: Market share of Top-10 Developers in China



Source: Citi Research, April 2019

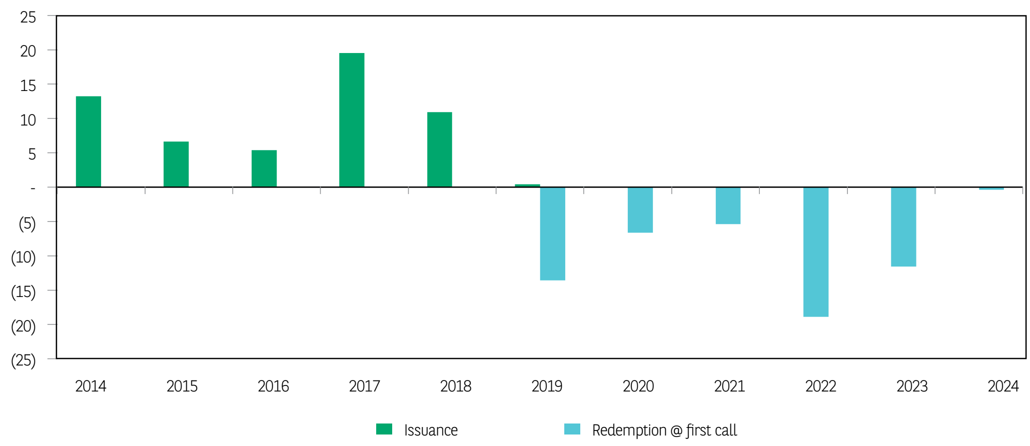
Chinese property developers tend to trade wider than their peers across DM with excess spreads ranging from 50bps to 250bps depending on tenors for the same credit rating. In our view, we find the spread pick up difficult to be justified. This excess spread is likely to compress over time. In our view, the spread reflects information asymmetry, investors' preference on the back of their understanding of each specific issuer and EM volatility. We have recently seen efforts from institutional investors to gain an edge and minimize the information risk by positioning local expertise locally in the field. The property sector remains a purely domestic story that has perhaps resulted in them being less understood, and subsequently feared and overlooked. This mispricing will continue to create interesting alpha opportunities.

We are only at the early stage of the globalization of the investor base for Chinese property developers. Even though the sector has realised rapid market growth coupled with material changes in market dynamics, the investor profile has remained constant. Based on the distribution statistics disclosed, the proportion of bonds from Chinese developers allocated to Asian investors have been stable at 90% between 2016 and 2018. We believe the investor mix will gradually change along with further industry developments while investors continue to better understand the industry. In the meantime, investors can still stand to benefit from the spread opportunity in EM vs DM subject to better understanding the underlying credits.

ISSUANCES OF SUBORDINATED PAPERS FROM CHINESE FINANCIALS: ANOTHER MISPRICED OPPORTUNITY

AT1s are still underresearched. Originated on the back of the global financial crisis of 2008-2009 where public funds were used to bail out large banks, additional Tier-1 capital securities or AT1s, are contingent capital instruments (CoCos) designed to absorb losses on a going concern basis. The most important characteristic of AT1s, as a result, is that they contain loss absorption features allowing for an orderly re-capitalization of banks at the expense of creditors instead of tax payers. From the banks' point of view, CoCos (including AT1s) are a cheaper source of funding than equity while addressing the obligations of their respective regulator on capital requirements. The first Basel-III compliant USD AT1s in Asia was issued by China CITIC Bank International (CINDBK 7.25% perp) in April 2014, a year after the first issuance in Europe by BBVA (Spain) in April 2013. AT1 supply from Asian banks have totalled over USD50 bil since the first issuance in 2014 with both Chinese and Hong Kong banks largely contributing to the total issuance. Figure 13 below shows the timeline of Asia banks AT1 issuance and redemption.

Figure 13: Asia banks AT1 issuance and redemption timeline



Source: BNPP AM, Bloomberg, April 2019

Those could be relatively complex instruments.From an investors' point of view, the downside risks they face when investing in AT1s include: 1) these instruments are deeply subordinated in the liability structure; 2) the structure allows for a coupon skip as dividends are discretionary; 3) the structure allows for an extension or a non-call event; and 4) loss absorption risk.

The market has initially been cautious on these new AT1 issuances on the back of a still opaque banking sector and concerns surrounding genuine levels of non-performing loans (NPLs). We think this sector remains fundamentally mispriced as investors have been generally asking for higher yields to offset the relative opacity of China's banking sector.

Technicals remain supportive. The local bid is supportive when it comes to Chinese banks' AT1s where we have also seen banks cross-buying each other's AT1s. China banks' AT1s went through a period of underperformance in FY18 on the back of leverage note unwinding raising concerns of large supply materialising from Chinese banks due to TLAC shortfalls specifically with the large state-owned commercial banks. We expect this underperformance to reverse as USD AT1 issuances are likely to be significantly lower on the back of Chinese authorities' measures to support the banks' perpetual bond issuances. On 25 January 2019, Bank of China priced the first bank perpetual in the China onshore bond market with a 4.5% coupon. As issuing cost is lower onshore for Chinese banks versus offshore, we believe supply risk for offshore AT1s will be significantly reduced.

Our assessment of risk exposure to Asian AT1s is therefore more positive than those issued by their similarly rated DM peers due predominately to the two following factors:

1. Strong government support – although AT1s are designed to bail-in banks while avoiding tapping into public funds, in practice, due to Asian banks' large government ownership, the government is more likely to take pre-emptive measures to support the banks before they become non-viable. We believe that capital support will be forthcoming, hence lowering the risk of conversion to equity or a coupon skip event. In Asia, most banking regulators including those in China, India and Korea are supportive, except for in Hong Kong where a resolution regime is more advanced but also strong fundamentals stand to partially mitigate any potential risk to investors.

2. Lower non-call risk – we believe that the incentives for banks to call AT1 bonds on their first call dates are high especially for large banks due to reputation risk and aiming to maintain favourable funding costs for future issuances. This is reflected in the strong performance of Asian AT1s despite the recent European first non-call event of Santander's AT1. Our preference remains to pick banks with strong capitalization buffer and a high re-set coupon rate as a non-call event will, in our view, be less likely.

CONCLUSION

THE EPICENTER OF EM DEBT IS MOVING EAST

The moment we have all been waiting for has arrived and stars are now aligned: the opening of the Chinese onshore bond market is finally real and the inclusion of Chinese bonds in global indices should trigger sizeable inflows. This is just the beginning of what will inevitably be a prolonged catch up process as allocation to Chinese local debt will have to increase significantly in the years to come.

On the US dollar denominated side, the dominance of Chinese issuers is also unstoppable, both for investment grade issuers as well as their high yield counterparts. Some sectors remain underresearched or penalized compared to developed markets which, with rigorous research, create alpha opportunities to be seized over the years to come.

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