Nordea

Market insight – China

November 2016

Should China's rising debt discourage investors from Asian high yield bonds?

With more than USD 13 trillion worth of bonds in the market having negative yields, investors have been shifting towards debt in emerging markets. Amongst emerging markets, China stands out for its high economic growth as well as the attractive yield generated in the credit market.

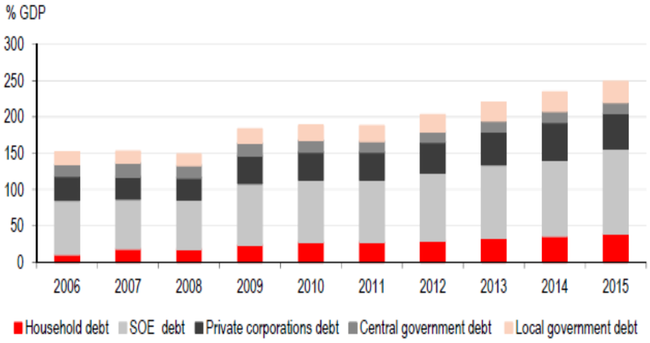
However, China's high debt/GDP level (around 250%) and Chinese banks' rising Non-Performing Loan ("NPL") ratio have come under scrutiny not only as red flags for the banking system, but also as a systemic risk to the entire economy.

Income Partners Asset Management, an Asian fixed income specialist, shares its view why the concerns are inflated, analyses how the government has been taking measures to mitigate risks, and highlights why investors should not turn their back on the attractive opportunities of the Asian HY credit market.

How do you evaluate China's debt levels?

From the Chinese real estate asset bubble to the currency-fixing rate adjustment and subsequent devaluation, China's economic issues have made headlines in recent years, and investors around the world have been closely monitoring China's gradual but steady slowdown. The government employed its array of monetary and fiscal stimulus to stabilize the growth, and recent data suggests that the stimulus is taking effect. Yet investors are now shifting their focus from economic growth to the country's high debt levels and rising NPLs, which pose a potential structural issue especially as the government continues to ease policy to support growth.

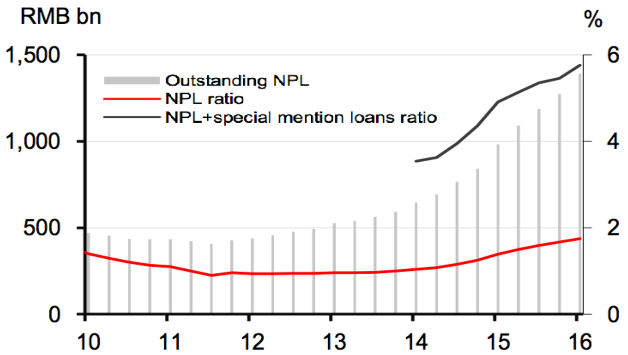
Graph 1: China's total debt



Source: HSBC, May 2016

Rising debt and NPLs decrease the commercial banks' earnings and their risk appetite in credit expansion.

Graph 2: China's NPL ratio



Source: HSBC, June 2016

Official data indicates that although China's NPL ratio has stayed around 2%, outstanding NPLs and special mention loans, which are loans that are at risk of becoming NPLs, is increasing at an alarming rate. This appears to justify investors' concerns. More bearish estimations have claimed that China's NPL ratio could rise to as high as 20%.

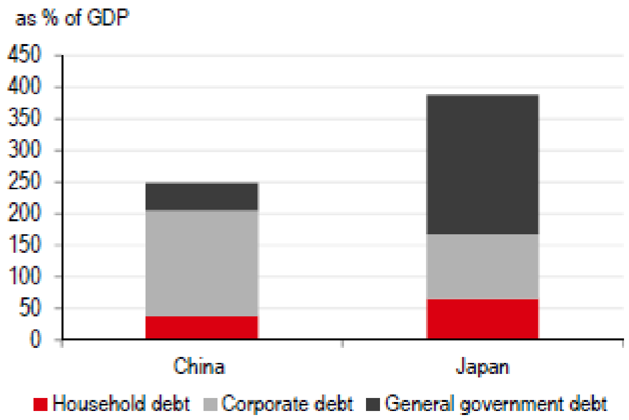
However, a deeper dive into the economic data reveals that the situation is not as dire as many fear. Debt can be largely classified into three categories: household, corporate, and government debt. As we will elaborate further below, the government has taken steps to alleviate the debt issue while attempting to maintain healthy economic growth.

Moreover, China not only has the capability to navigate through the slowdown and keep the economy afloat, it has also proven to be able to resolve this issue in the recent past when the NPL ratio soared over 20% in the 1990s. Through capital injection and government-owned asset management companies, the government was able to restructure all the major commercial banks and create a foundation for the fast economic growth we have witnessed between 2002 and 2011.

What can Chinese authorities do to avoid hard landing?

In order to solve China's debt problem, the government must remove existing bad debts and prevent the growth of new bad debts by bankrupting zombie companies and being more disciplined in credit expansion. Currently, the vast majority of China's debt is issued by corporates.

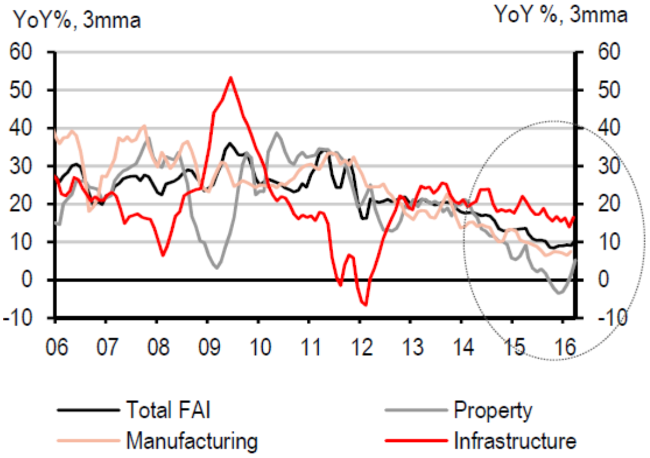
Graph 3: China's debt composition



Source: HSBC, May 2016

However, corporates have become less aggressive in debt financing as growth in fixed asset investments, which includes manufacturing and real estate ('old' economy), fell to their lowest levels in 10 years.

Graph 4: Fixed Asset Investment Growth



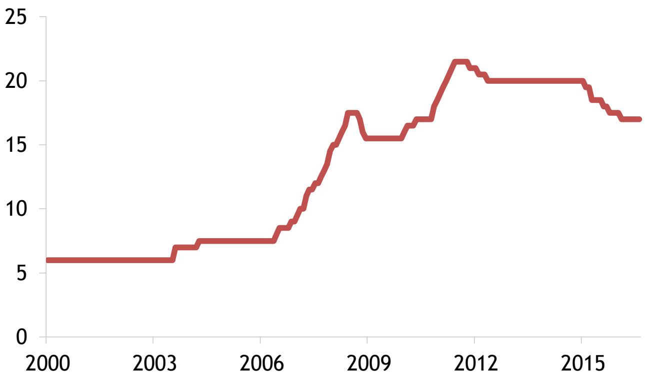
Source: HSBC, May 2016

As a result, corporate loans are expected to decrease as a proportion of total debt for the foreseeable future. In particular, in sectors with overcapacity issues (such as steel, cement, coal, mining, etc.), investment growth has slowed down to near zero or negative levels.

In order to stimulate growth and stabilise the economy to make up for the slowdown in private investment, the government has slightly increased its infrastructure investment. While the aggregate debt/GDP ratio is unlikely to decrease in the near future, the composition of debt is expected to slowly shift and "bad debt" in the private sector will get more under control.

In addition the government also has plenty of room to ease its monetary policies. Despite multiple cuts over the past five years, China's Reserve Requirement Ratio (RRR) remains at 17%, one of the highest rates in the world. Compared to the Eurozone and the US, where monetary easing have become increasingly ineffective, China has yet to enforce its stash of policies to their full effect.

Graph 5: China's RRR (%)



Source: Bloomberg, September 2016

The government's plan to reduce capacity in the steel, cement and coal mining industries, as well as to expand the economy's credit through infrastructure investments are steps in the right direction. This, combined with the government's ability to deploy fiscal and monetary stimulus, could amortise China's debt over time and return it to a more sustainable level without undergoing a hard landing.

How will the currency be affected amidst this transition?

Much like the economy, RMB has undergone significant changes in the past few years. One of the recent changes is that the mechanism of determining the RMB exchange rate (as controlled by the daily USDCNY fixing rate), it is now linked to a trade weighted currency basket, and the PBOC publishes its value in RMB on a weekly basis.

As a result, the RMB shifted its pegging from USD to a more diversified basket of global currencies currency, hence reducing its dependency on USD appreciations/depreciations. We believe that this should help China to maintain a relatively stable RMB over time.

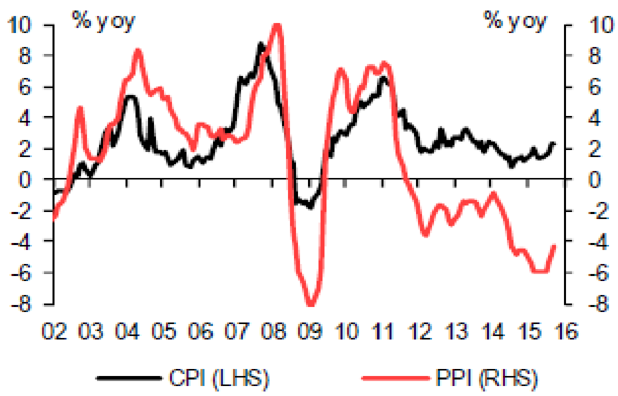
What opportunities does the transition to the 'new' economy offer investors?

Although we believe there is ground for optimism for China's economy, growing pains are inevitable and investors must be cognisant of the fact that the heavy debt burden will hamper the country's real growth rate for the foreseeable future.

However, we believe that the slowdown will happen in a more controlled setting, which is positive for rates and high quality credits. The debt and NPL issues will mainly affect the aforementioned sectors plagued with overcapacity issues, and investors should be very cautious and selective when investing in them. A deep knowledge of the local credit market is essential.

It is also worth noticing that China's consumption remains resilient as the Chinese economy transitions from a manufacturing and investment based economy to a more consumer-driven one (the "new economy").

Graph 6: Consumer and Producer Price Index



Source: HSBC, May 2016

The bearish sentiment clouding China for the past two years has depressed the valuation both for Chinese credits and for the entire region issuers, creating opportunities to select undervalued credits in sectors such as consumer goods, healthcare, and IT.

How can investors benefit from it?

Raymond Gui, Senior Portfolio Manager at Income Partners and responsible for the Nordea 1 - Renminbi High Yield Bond Fund (launched in May 2015) believe that this fund offers investors an opportunity to gain exposure to attractive Chinese and Asian credits.

Currently, the fund has an exposure of about 60% to China, which is the region's most important market, while the remaining 40% is invested across a dozen of other Asian nations (such as India, Indonesia, Philippines, etc.). The reason for investing across Asia is so that investors can benefit from exposure to a more diverse economic growth and, therefore, reduce dependency from the development of single market.

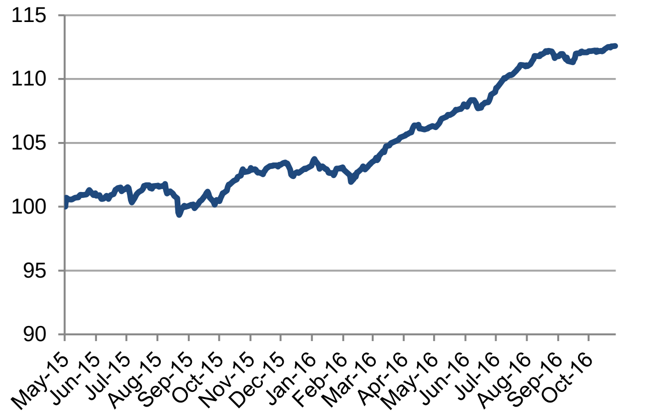
The fund's investment universe currently consists of the offshore RMB high yield bond market (with a market cap of around USD 15 billion) and the Asian USD high yield bond market (market cap of around USD 200 billion). As a consequence, the fund invests about 10% in offshore RMB high yield bonds and the rest is invested in Asian USD high yield bonds, which are then hedged into RMB. This is done to gain a positive carry and to offer international investors the possibility to tap into its attractive long-term FX opportunity following the so called RMB internationalization.

Sector-wise, the fund has been underweighting areas that are related to China's investment growth (e.g. real estate, building materials, industrial), and overweighting sectors that could benefit from China's economic transition (e.g. consumer, retail, automobile, technology). In addition, the fund has also allocated to defensive sectors such as telecom, utilities, and transportation.

In the current investment environment, the fund has been very selective on credits. With an average credit rating of BB+ (by Moody's/S&P/Fitch rating standards), the fund has a high allocation to high quality credits and undervalued credits that are expected to be stable in the current environment, albeit maintaining a good upside potential.

As of October 31, 2016 the fund's retail share class (BP-CNH) had returned +12.58% since its inception (9.25% YTD) with around 3% volatility. It has duration of 2.8 years, and a yield (in RMB) of 6.1%.

Graph 7: Fund's performance (BP-CNH) since inception

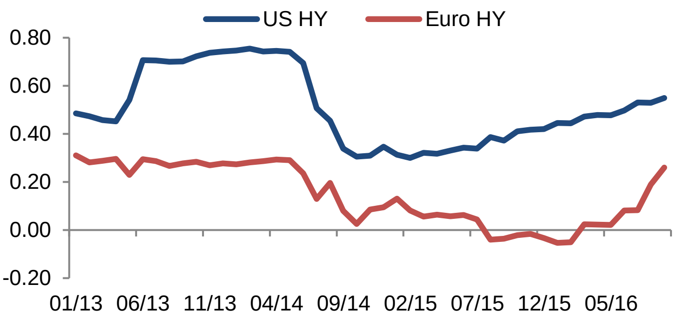


Source: Nordea Investment Funds SA. Period under consideration: 02.05.2015 - 31.10.2016. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

Asian high yields vs. international high yield bonds

From an asset allocation perspective, the fund should provide diversification benefits to investors whose existing fixed income investments are denominated in USD and EUR. Historically, the Asian high yield market has low correlation to US and Euro high yield markets due to the differences in sector allocation (particularly in the energy sector), as well as the economic growth of the emerging markets in Asia relative to the growth in the US and Europe.

Graph 8: Asian high yield market 1-year rolling correlation vs. other high yield markets



Source: Bloomberg, September 2016

Hence, the Asian high yield market was able to hold firm while US and Euro high yield markets suffered in 2015 due to the selloff in commodities. This was again the case during the days immediately after the Brexit vote when the European and the US high yield spreads were noticeably volatile. Asian high yield remained positive and stable, providing a viable investment alternative amidst the global political and economic uncertainty.

Table 1: High yield market performance

	Asian HY (USD)	US HY (USD)	Euro HY (EUR)
2015	+5.2%	-4.7%	+1.5%
2016 YTD	+11.9%	+15.7%	+8.1%

Source: J.P. Morgan, Merrill Lynch. October 2016. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested**

The fund offers investors an ideal vehicle to **benefit from the growing importance of China and the RMB currency**, **low correlation to traditional asset classes** and more importantly, more **stable high yield bond performance** compared to other high yield markets.

To invest in the Nordea 1 - Renminbi High Yield Bond Fund, Nordea offers:

- **CNH share class**, the base share class of the fund, is suited for investors that have deposit accounts in CNH and want to invest directly in local currency
- **EUR** or **USD share classes** are available for investors that look to take advantage of the long-term internationalisation process of the RMB, betting on the appreciation effects of a more globally used RMB