Manulife Asset Management

Investment Note

25 May 2017

Moody's downgrades China and Hong Kong

On 24 May 2017, Moody's Investors Service (Moody's) downgraded China's long-term currency and foreign currency issuer ratings from Aa3 to A1 (stable outlook). In addition, Hong Kong's sovereign rating was downgraded from Aa1 to Aa2 (stable outlook) on the following day. Overall, the price reaction was generally muted, as the downgrade was widely expected by most market participants, whilst some investors took the opportunity to buy on dips.

Endre Pedersen, Manulife Asset Management's Fixed Income (Asia ex-Japan) Chief Investment Officer, sees the downgrade as having minimal market impact as it was largely priced in by the market. Though we do not expect a significant credit spread widening in Chinese corporate bonds, some Chinese banks' subordinated debt issues may experience a downgrade from investment grade to high yield.

What's new?

On 24 May 2017, Moody's downgraded China's long-term currency and foreign currency issuer ratings to A1 from Aa3; the outlook was also changed from 'negative' to 'stable.' Moody's downgraded China's sovereign credit rating for the first time in roughly 30 years. The ratings agency cited several risks to the economy that would 'erode its financial strength': rising debt levels, slowing potential growth, and economic reforms that would not likely prevent a further (material) rise in debt over the short-term.[1]

Following Moody's decision to downgrade China's sovereign rating, Moody's has also downgraded the ratings of 26 Chinese nonfinancial corporate and infrastructure government-related issuers (GRIs) and rated subsidiaries by one notch from their previous levels. In addition, Hong Kong's sovereign rating was downgraded from Aa1 to Aa2 (stable outlook) on the following day.

What's the impact?

The market reaction to China's credit downgrade was tepid: regional equity markets initially fell on the news and then recovered with both the Shanghai and Shenzhen Composites moving marginally higher, 0.07% and 0.53%, respectively, on the day. The renminbi was largely unchanged against the US dollar following the news[2].

Endre Pedersen, Manulife Asset Management's Fixed Income (Asia ex-Japan) Chief Investment Officer, commented on the market's reaction to the downgrade. "The (downgrade's) impact is still working through the market. The general reaction of the market, especially for Asia regional-based investors, is taking the opportunity to buy on the dip, given

[1] Moody's Investors Service, 25 May 2017.
[2] Bloomberg, as of 25 May 2017.

China's US dollar-denominated investment grade corporate bonds' relatively attractive yields. As a result, we do not expect a significant credit spread widening in the US dollar-denominated China corporate bond space. However, some Chinese bank subordinated debt may become 'fallen angels,' (bonds that are downgraded from investment grade to non-investment grade status). These bonds may be sold by investors who follow stricter credit requirements; we believe the potential credit spread widening for these banks would be driven by technical factors rather than fundamentals."

Pedersen also pointed out that recent yield increases in the onshore China bond market were the result of numerous factors such as government policies to deleverage and a regulatory crackdown on opaque financial products rather than concerns over a credit downgrade, as the onshore China bond market is dominated by local institutional investors. Currently, foreign investor ownership in the onshore China bond market below 3%[3], but it is expected to grow going forward.

For Hong Kong, there may be some downgrades of quasi-government entities, which have majority ownership by the Hong Kong government. Nevertheless, we believe the overall impact on the Hong Kong bond market to be limited, as the downgrade was largely expected by market participants. Hong Kong remains the second-highest quality bond market in Asia after Singapore.

Portfolio impact and outlook

Though our Asian bond portfolios have Chinese debt holdings, we have been focusing on fundamentally-sound companies such as national champions with stable cash flow profiles in sectors such as real estate and energy. Given the relatively tight credit spread environment market participants have been facing since the start of the year, our portfolio managers have been holding cash as ammunition to be deployed selectively should wider credit spread levels emerge, leveraging our on-the-ground Chinese credit research capabilities.

Finally, China remains an investment-grade bond market with the likes of Japan (A1/A+/A). We believe China's central bank and its regulators remain in control of the situation. Subsequently, we do not expect any material outflows from Chinese bonds nor do we expect a meaningful impact on the renminbi's outlook for the rest of 2017.

[3] ChinaBond, as of 30 April 2017.

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