Chilton Investment Services
Weekly Update
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Little Trouble In Big China? Invest But Exercise Caution

In our update dated October 2nd, we outlined our views on Asia as a destination for bond investors. The market is considered fully valued *(a similar view could arguably be taken for many asset classes!)* yet we believe it remains a region with solid long term fundamentals and represents a good opportunity for incremental credit spread pickup relative to the US credit markets (Table 1). **The most important Asian market is China which represents 52% of the market[i] and we believe investors should hold some exposure to this dynamic, emerging economy. Given our fundamental outlook, we prefer a cautious approach of shorter duration, higher quality companies in sectors considered strategically important by the central government.** Specifically:

- Commercial Banks – we approve the 4 largest state-owned commercial banks with preference for the Bank of China
- Energy – we approve the 3 largest state-owned oil & gas companies with preference for China National Petroleum Corporation
- Technology – we approve the 3 preeminent technology firms with preference for Alibaba and Tencent

Table 1: Asia Credit Offers Attractive Yield For IG Credit Quality

	Duration	Quality	Yield	OAS
BB US Corporate	4.31	BB	4.47	195
Asia EM USD Corporate	5.03	BBB+	3.5	141
IG US Corporate	4.41	A-	2.75	72

Source: Bloomberg Barclays Intermediate Corporate Total Return Index, Bloomberg Barclays Emerging Markets Asia total Return Index & Bloomberg Barclays BA US High Yield Total Return Index

Fundamental Outlook

As the 3rd largest economy in the world, China is too big to ignore, despite high leverage levels and an increasingly authoritarian government. The country's burgeoning middle class should provide a growth tailwind for decades to come provided the government is at least moderately successful in executing a transition from an investment-driven economy (fixed-asset investment represents 43% of GDP) to household consumption (38%)[ii]. The country has annually been among the strongest worldwide in terms of GDP growth, averaging 7.3% over the past 5 years. However the veracity and quality of these figures has often been called into question, prompting questions around the sustainability of China's growth. The recently concluded Communist Party congress offered some interesting insights in this regard - **the omission of a specific GDP growth target in President Xi Jinping's opening speech has raised speculation that the government is finally willing to tackle more structural reforms and allow deleveraging at the expense of maintaining artificially high growth rates.** There is some flexibility to address these issues – the central government's direct debt burden is moderate, external liabilities are low, foreign currency reserves are approximately $3 trillion and the central government budget deficit (officially at least) is a moderate 3.4% of GDP. In a vote of confidence from the markets, the government sold its first sovereign debt issue in over 10 years last week, raising $2 billion in a deal that was reportedly 11 times oversubscribed[iii]. Pricing on the 5 year bond was just 15 bps over U.S. Treasuries while the 10 year bond offered 25 bps more yield than the U.S. equivalent. This is especially notable when considering the bond was unrated although China carries outstanding sovereign ratings of A1/A+ from Moody's & S&P, respectively.

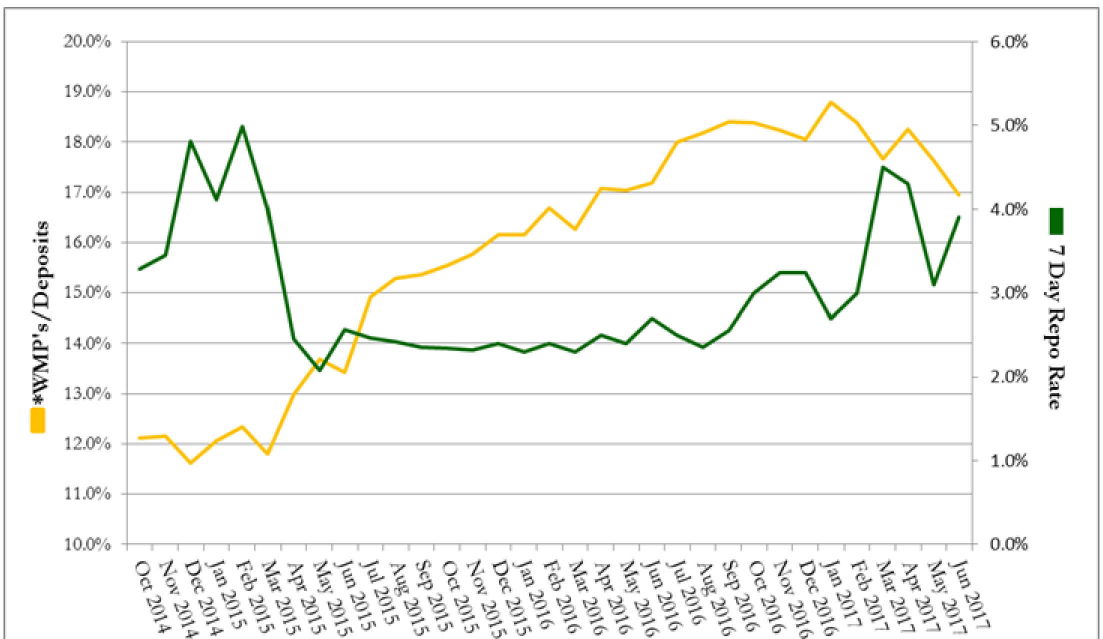
Nonetheless, with a GDP of $11.2 trillion versus liabilities at State-owned enterprises estimated at anywhere from 90-125% of GDP[iv] and overall debt levels approximating 2.5x GDP (U.S. figure is ~2.5x as well)[v] there is far too much leverage in the Chinese financial system for us to

<u>Investing Options:</u>

The Chinese bond market can be broadly divided into 2 segments: 1) <u>Onshore (~$9 trillion outstanding)</u> bonds are issued in Chinese financial markets and denominated in Renminbi (RMB). This can include bonds of Chinese entities or foreign issuers, the latter of which are referred to as "Panda" bonds; 2) <u>Offshore (~$1.1 trillion outstanding)</u> bonds are issued in overseas markets by Chinese issuers and denominated in either Yuan ("dim sum"; ~$400 billion) or a foreign currency, primarily the U.S. dollar (~$700 billion). **We currently focus on the offshore U.S. dollar segment as this issuance is typically sold under a legal system providing strong investor rights (i.e. Hong Kong), is often rated by the leading global rating agencies, carries stronger disclosure requirements than onshore markets and is much less vulnerable to capital controls.**

recommend an overweight to the country at this time. The domestic property market has received very high levels of speculative investment partly as a result of the government's efforts to restrict domestic capital outflows. **We believe the country is in the early stages of a gradual, government-engineered credit market adjustment which could last several years.** Regulatory measures initiated in 2016 (collectively known as the Macro-Prudential framework) and a tightening of short-term borrowing rates have begun to bear fruit with a notable decline in off-balance sheet products known collectively as "wealth-management products" (WMP's) in the first half of 2017 (Chart 1). Yet leverage continues to rise in other sectors, including state-owned enterprises involved in the government's infrastructure push and property market investors / speculators. It seems likely that the government will allow a certain level of defaults as it seeks to wean investors off over-reliance on the implicit state guarantee for weaker companies and local governments. **However we believe the effects will be felt asymmetrically given that government support for the largest, most strategically important government-owned entities and businesses will remain high.** Of note, the largest 4 state-owned banks have relatively low exposure to WMP's typically averaging 2-4% of deposits versus double-digits for many joint-stock and city commercial banks.

Chart 1: Tighter Monetary Policy Reduces Off Balance Sheet Debt



Source: Bloomberg LP, Bank Financial Statements *WMP's/Deposits= Wealth Management Products as percentage of commercial bank depostits

Investment Recommendations

Given our fundamental outlook on China, any client allocation will bias toward shorter / intermediate bond maturities and higher quality companies. There are 3 areas we currently consider investable:

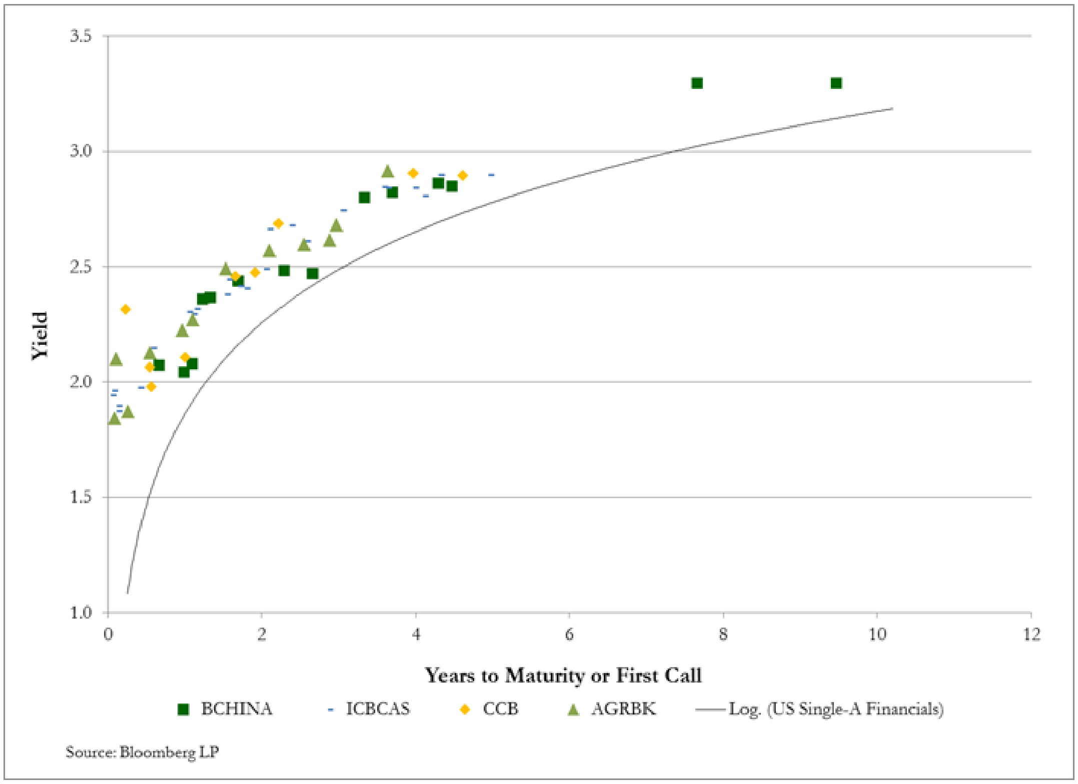
1. **Financials: Short-maturity bonds of state-owned banks with preference for Bank of China**

The banking sector in China is comprised of several tiers: state-owned large commercial banks, state-owned policy banks, joint-stock commercial banks and city commercial banks. Of these we focus on the 4 largest state-owned commercial banks which comprise approximately 70% of the banking systems total assets and which would almost certainly enjoy support in the event of a solvency or liquidity shortfall. Precedent for such support is very strong and effectively enshrined in the country's financial system with the creation of dedicated asset management companies tasked with assuming bad loans for each of these 4 leading banks following the Asian Financial Crisis in the late 1990's. Lending priorities are heavily influenced by the central government's "national strategy" which currently involves a number of large infrastructure projects (most notably the Belt and Road initiative[vi] which was recently written into the country's Constitution). Our outlook for the banking sector is stable given slowing but still positive loan growth, the government's prosecution of "prudent but neutral" monetary policy, current regulatory focus on deleveraging, and modest but stabilizing profitability and asset quality trends.

By assets, **Industrial & Commercial Bank of China (ICBCAS)** is the largest in the world with ¥25 trillion ($3.8 trillion). The bank's focus has historically been on serving large, state-owned enterprises. **China Construction Bank (CCB)** is a close second with ¥22 trillion ($3.2 trillion) and was established to fund manufacturing and infrastructure assets. As the name indicates, **Agricultural Bank of China (AGRBK)** focuses on less-developed, rural areas. Consequently loan quality is marginally weaker than peers with a current non-performing loan ratio of 2.2% (versus <2% at peers). Profit is also weaker with a pre-provision profit 2.8% of assets (vs. >4% at peers). **Bank of China (BCHINA)** is the most international (19% total revenue), specializing in areas such as foreign exchange, trade finance and raising capital overseas. The bank intends to continue growing its overseas presence, in particular via the Belt and Road initiative.

The yield differential has compressed over the past year and these 4 banks now offer relatively modest 10-30 basis points of spread pickup relative to U.S. single-A rated financials (Chart 2). As shown, this pickup appears slightly more pronounced on the short end of the yield curve, perhaps reflecting investor concerns over leverage, credit market adjustment and geopolitical tensions. Our preference is for BCHINA which reports the strongest asset quality, lowest exposure to the shadow-banking sector and has the largest international presence of the 4.

Chart 2: China Banks vs. U.S. Single-A Financials



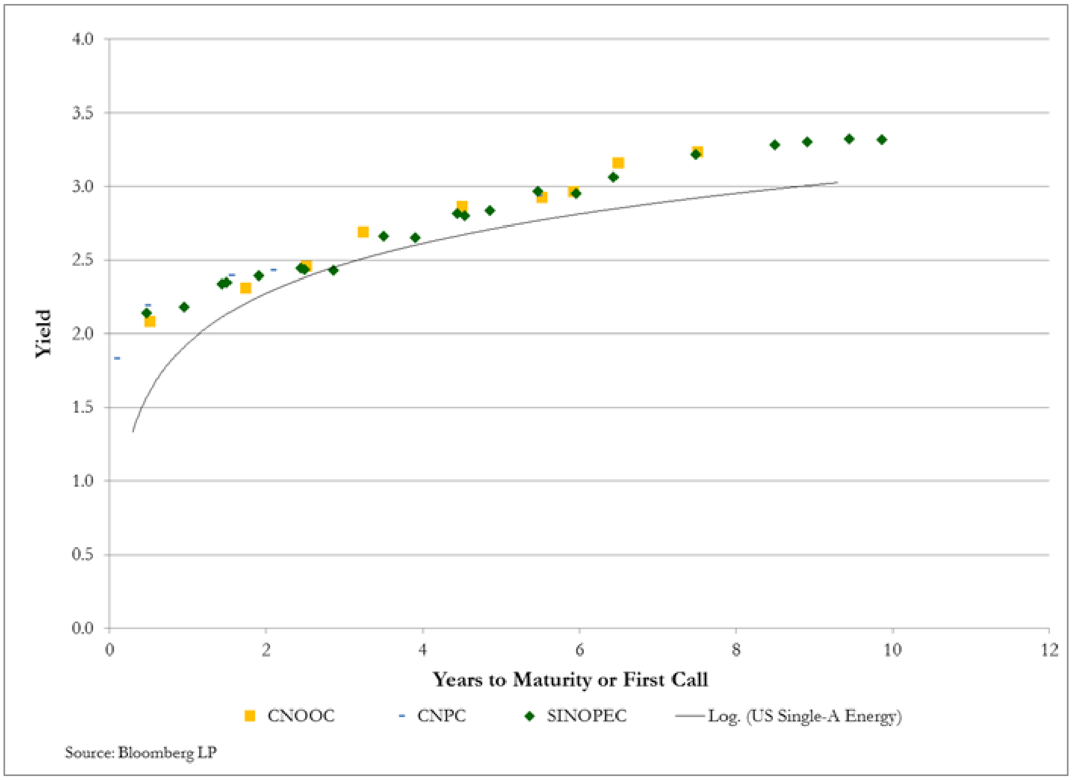
2. **<u>Energy: Short maturity bonds state-owned energy companies with preference for China National Petroleum Corporation</u>**

Energy has historically been viewed as a strategic industry with the government promoting exploration and development of domestic resources in a bid to wean the country off oil imports. However, since the passage of the Renewable Energy Law in 2005, the country's energy policy has shifted toward renewable resources with a goal of meeting 20% of energy demand from such sources by 2030. The government also heavily subsidizes and provides regulatory incentive for the production and sale of so-called "new energy vehicles", seeking to phase out the use of combustion engine vehicles. While this is undoubtedly a longer term concern for the fossil-fuel sector, the reality is that refined petroleum products are likely to remain the primary source of vehicle fuel for decades to come, particularly if the government is forced to curtail expensive renewable energy subsidies. Furthermore, natural gas remains a favored fuel source with the government seeking to increase gas to 15% of total energy demand by 2030 from 5.9% as of 2015.

China National Petroleum Corporation (CNPC) and **China Petroleum & Chemical Corporation (SINOPEC)** are integrated oil and gas companies, engaging in exploration, production, transportation and refining of energy resources. CNPC owns ~80% of the country's natural gas pipelines. Sinopec also owns a number of critical gas assets including the first shale gas field in China and storage and pipeline infrastructure serving the populous southeast coast. **China National Offshore Oil Corporation (CNOOC)**, by contrast, operates exclusively as an exploration / production company with a focus on offshore resources. In addition, it is the largest operator of liquefied natural gas (LNG) terminals in the country, an essential asset given China's reliance on gas imports to meet demand. All 3 are undoubtedly exposed to regulatory risk and are confronting weak productivity in their domestic oil fields. However, state-ownership and low leverage levels offset these factors in the medium term.

The energy companies offer roughly similar yields and trade tightest to the equivalent US curve of all the sectors we profile in this publication (Chart 3). Following a recent tightening in CNOOC spreads, we now prefer CNPC given the higher proportion of reserves in natural gas (64% versus 49% at Sinopec and 35% at CNOOC), longer reserve life (14 years vs. 7.5 at CNOOC and 5.7 at SINOPEC) and dominant position in the nation's natural gas pipeline infrastructure. This stronger operating profile offsets credit metrics which are modestly weaker but still satisfactory. All 3 companies are owned by the central government.

Chart 3: China Energy vs. U.S. Single-A Energy



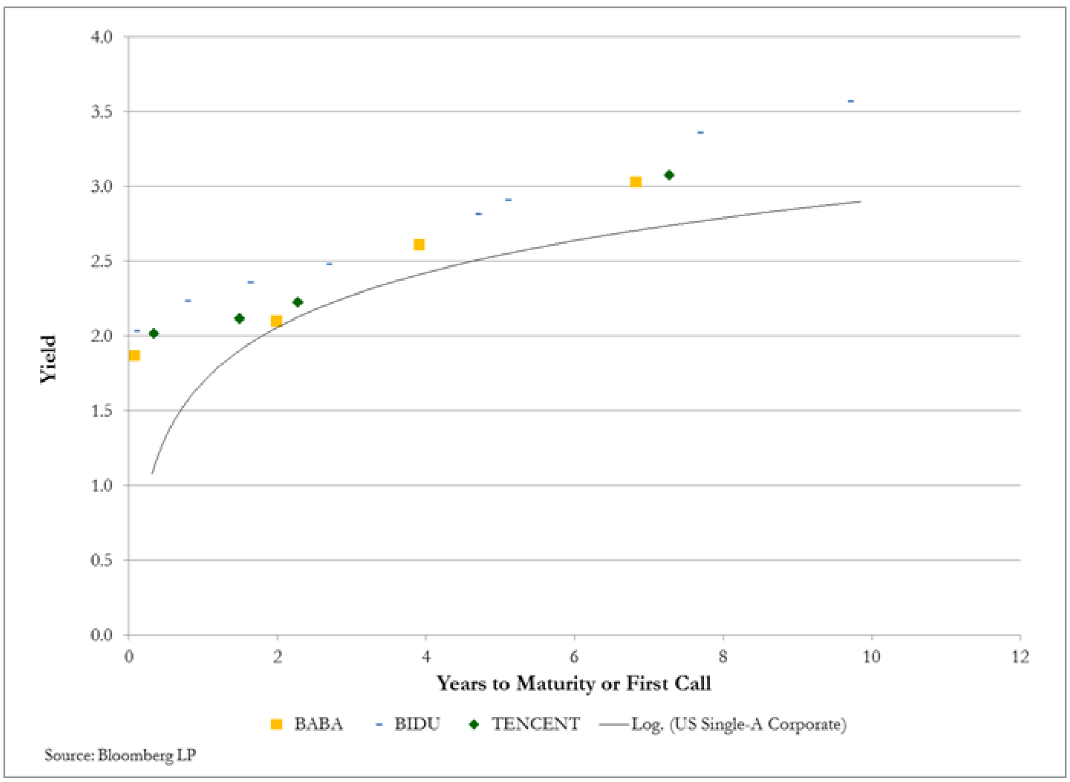
3. Tech: prefer Alibaba and Tencent on a leverage-adjusted basis

Technology is an area which features heavily in China's public policy with the "Made in China 2025" initiative intended to improve China's competitive position in many areas including semiconductors, artificial intelligence, autonomous driving and robotics. A significant growth area has been consumer technology with China's growing middle class providing an attractive end-market for retail, internet search and social media companies. As such, we view the sector positively, believing that even with slowing birth rates, higher household incomes will provide a tailwind for decades to come.

The industry has historically been shielded from direct foreign competition, allowing domestic companies to develop into global leaders. **Alibaba (BABA)** is effectively China's Amazon and Ebay, operating a number of hugely popular online retail sites - including Taobao and Tmall - which together account for the largest volume of e-commerce in the world. The company also holds the leading share (~40%) of China's burgeoning cloud computing market. **Tencent** is China's leading social media company with its various networking, messaging, gaming and other mobile applications holding a roughly 50% share of the Chinese social media market. Tencent Video shares market leadership in streaming / mobile video with **Baidu (BIDU)** which operates the leading search engine in China (market share ~75%) and video service iQiyi.

Unlike the energy companies and commercial banks highlighted previously, the tech companies are not government-owned. This perhaps accounts for some additional spread pickup versus the U.S. single-A corporate market (Chart 4). While the government may be looking to increase ownership in the sector based on recent media reports[vii], we believe this will remain largely benevolent in the near term in support of the further development and application of technology into emerging industries. Our preference is for BABA and TENCENT which each offer greater amount of spread compensation than BIDU on a leverage-adjusted basis.

Chart 4: China Tech Companies vs. U.S. Single-A Corporates



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[i] Market defined as Bloomberg Barclays Emerging Market Asia Total return Index
[ii] UN Data; data.un.org
[iii] "China Says Sovereign Dollar Bond Demand 11 Times Deal Size", Bloomberg News, October 26, 2017
[iv] "China's state oil giant to complete ownership reforms by Nov", Reuters, August 14, 2017 & "China's Deleveraging Campaign Takes On Toughest Target Yet", Bloomberg News, July 20, 2017
[v] "China's Economic Rise: History, Trends, Challenges, and Implications for the United States", Congressional Research Service, September 15, 2017
[vi] The Belt and Road initiative is a multi-year infrastructure development foreign policy intended to foster closer economic integration with dozens of countries deemed important to China's global trade and economic development.
[vii] "Beijing Pushes for a Direct Hand in China's Big Tech Firms", Wall Street Journal, October 11, 2017