S&P Global Ratings

Regional Credit Conditions Chair

Terry E Chan, CFA
Melbourne
terry.chan
@spglobal.com
+61-3-9631-2174

Credit Conditions Asia-Pacific:

U.S. Poses Trifecta Risk: Trade, Spreads, And Cycle Turn

June 28, 2018

Key Takeaways

- **Overall:** Macroeconomic and financing conditions continue to be favorable in Asia-Pacific but risks emanating from the U.S. are increasing, given the China-U.S trade dispute, rising interest rates and spreads, and a possible turn in the U.S. credit cycle.
- **What's changed:** Trade interruption risk is on the rise as the U.S. and China impose 25% tariffs on each other. Meanwhile, there appears to be upward pressure on interest rates and spreads, and investor sentiment points to a potential turn in the U.S. credit cycle.
- **Risks and imbalances:** With China's debt overhang risk relatively stable, the U.S. poses a triple whammy of risk: (1) trade interruption from tariffs; (2) higher interest rates and wider spreads affecting asset pricing, and (3) investors' concerns about a turn in the U.S. credit cycle, which could lead to a liquidity pullback from emerging markets.
- **Financing conditions:** After improving for the past three quarters, financing conditions in emerging Asia--while still favorable--may start to face headwinds later in the year.
- **Macroeconomic conditions:** The positive macroeconomic story is still intact. However, worry lines are forming with trade flattening and currencies continuing to decline against the U.S. dollar, and market interest rates rising in some places as well.
- **Sector themes:** Ratings trends continue to be positive, benefitting from the macroeconomic environment and still favorable financing conditions. Indeed, the net rating bias has eased to -1% in May 2018 from -5% in February 2018.

Contents

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Latin America, North America, and Europe, the Middle East, and Africa). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the Asia-Pacific committee on June 25, 2018.)

With China's debt overhang risk relatively stable, the primary source of regional risks is external. These take the form of a trifecta of U.S.-related risks: potential trade interruption; higher U.S.-dollar interest rates and wider spreads, which would affect asset pricing and financial markets; and global investors' concerns about a turn in the U.S. credit cycle, which could threaten an eventual pullback of liquidity in Asia-Pacific's emerging markets.

Front of mind is the U.S.-China trade dispute which is now in earnest following the recent tit-for-tat exchange of a 25% tariff imposition, by the U.S. and then China, on each other's imports. This is valued at $34 billion effective July 6, 2018, and the threat of more tariffs on a further $16 billion of products later. Arguably, the impact on the U.S. would be somewhat disproportionate given that $50 billion (i.e. $34 billion plus $16 billion) represents about 38% of U.S. exports to China, while the same amount only represents 10% of China's exports to the U.S. The U.S. has also threatened to consider 10% tariffs on a further $200 billion of Chinese imports. While the tariffs are unlikely to materially threaten the economies or overall corporate credit health of either country, the imposition of tariffs moves the risks up a notch. A breakdown in negotiations or policy missteps could lead to a full-blown trade war, which would damage global business and consumer confidence, investment prospects, and growth.

Table 1

Top Asia-Pacific Risks

Trade interruption and geopolitical tensions

Risk level*	Very low	Moderate	Elevated	High	Very high	**Risk trend****	Improving	Unchanged	Worsening

The U.S-China trade dispute is now in earnest with the two countries set to impose 25% tariffs on each other's imports valued at $34 billion effective July 6, 2018, and threatening another $16 billion. The U.S. is also considering 10% tariffs on a further $200 billion of Chinese imports. Geopolitically, the summit between the U.S. president and North Korea's leader augurs well for an easing of geopolitical tensions.

Asset price volatility and Liquidity pullback

Risk level*	Very low	Moderate	Elevated	High	Very high	**Risk trend****	Improving	Unchanged	Worsening

Volatility during first quarter-2018 in global asset prices underlines the significant risk of sharp corrections. This is against the backdrop of the multi-year hunt for yield and rising risk allocation in a prolonged low interest-rate environment. While a liquidity withdrawal is inevitable after the near decade-long era of easy money, the duration or specific trigger of such an event is hard to identify.

China debt overhang

Risk level*	Very low	Moderate	Elevated	High	Very high	**Risk trend****	Improving	Unchanged	Worsening

Credit growth appears to be slowing. Still, China's high-risk nonfinancial corporate debt now represents 30% of the world's total, exceeding Europe and America's 20% share. While China's debt is largely domestic-funded, a disorderly deleveraging could destabilize asset and commodity markets.

Sources: S&P Global Ratings.

* **Risk levels** may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high.

** **Risk trend** reflects our current view on whether the risk level could increase or decrease over the next 12-months

Regional credit conditions

What's changed?

Credit conditions continue to be generally favorable across the Asia-Pacific, benefitting from the global macroeconomic environment and still favorable financing conditions. Indeed, the net rating bias of the rated issuer portfolio in the Asia-Pacific has eased to negative 1% in May 2018 from -5% in February 2018.

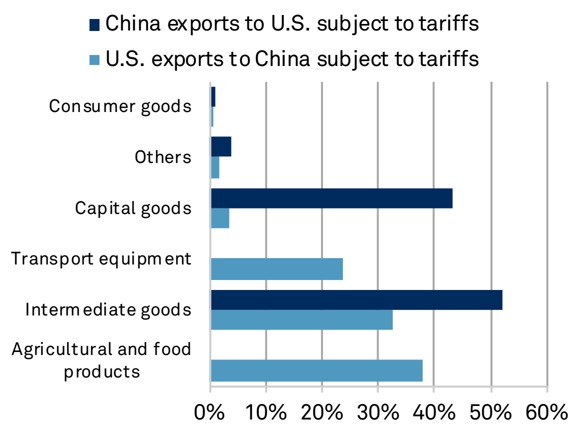
Credit conditions continue to be generally favorable

Assessment of key risks

We regard the Asia-Pacific's top risks as trade interruption and geopolitical tensions; asset price volatility and liquidity pullback; and the China debt overhang (see table 1). These regional vulnerabilities substantially overlap with our top global risks of trade and investment interruption; geopolitical tensions; asset-price volatility and liquidity reversal; benign U.S. credit cycle threatened by debt build-up; China debt overhang; populism and anti-globalization sentiment; and cybersecurity threats to business activity.

Chart 1

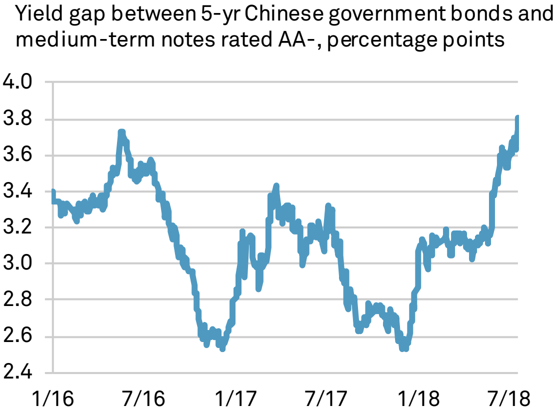
Import Tariffs Between China And U.S.



Source: Peterson Institute for International Economics

Chart 2

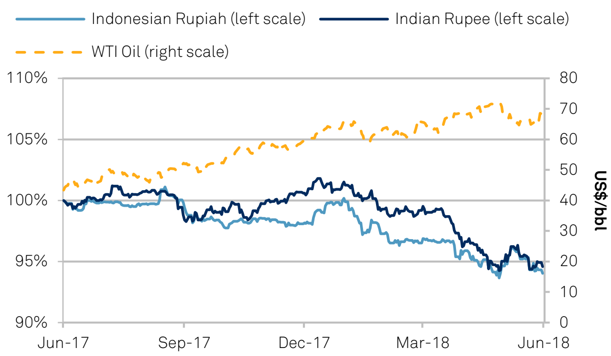
China Credit Spreads Widen



Source: CEIC, S&P Global Ratings

Chart 3

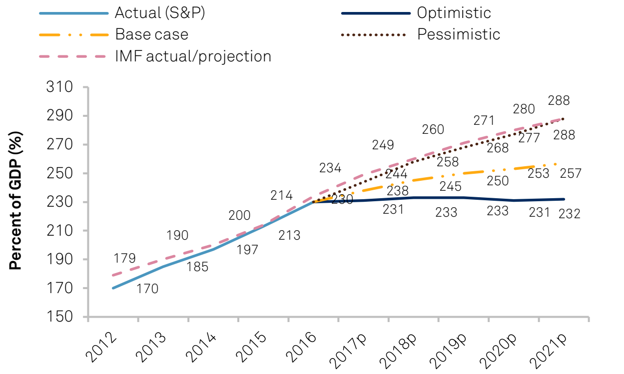
Trend In Crude Oil Prices And Emerging Market Currencies



Source: S&P Global Market Intelligence, S&P Global Ratings

Chart 4

China's Total Credit (Percentage Of GDP)



p --projection. Source: IMF (International Monetary Fund's Country Reports No. 17/248 and No. 17/247, People's Republic of China, August 2017), S&P Global Ratings.

Our assessment of the risk levels and trends remains unchanged from the last quarter:

Trade interruption and geopolitical tensions (high, worsening). Heated rhetoric, escalating trade tensions, and tit-for-tat retaliatory tariffs between the U.S. and major trading partners threaten global trade and investment. The U.S. and China are set to impose 25% tariffs on each other's imports valued at $34 billion effective July 6, 2018, and are threatening tariffs on a further $16 billion[1]. The affected goods are shown in chart 1 The U.S. is also considering 10% tariffs on a further $200 billion of Chinese imports[2]. Companies connected to cross-border integrated supply chains could feel the impact through multiple channels if tariffs sap demand for their exports and also raise import costs for the intermediate inputs they source abroad.

Geopolitically, the U.S.-North Korea summit augurs well for an easing of geopolitical tensions.

Asset price volatility and liquidity pullback (high, unchanged). Refinancing risk is in focus for select emerging markets where rising U.S. rates and a stronger U.S. dollar are reviving capital outflow pressures. The Institute of International Finance cites trade fears as a factor in China outflows. Selling of corporate vs. sovereign and local currency vs. U.S. dollar-denominated assets signals declining risk appetite. Volatility of global asset prices during the first quarter of 2018 underlines the significant risk of sharp corrections. While a liquidity withdrawal is inevitable after the near decade-long era of easy money, the duration or specific trigger of such an event is hard to identify. In China, credit spreads hit their widest level in nearly two years recently (see chart 2). Some emerging market currencies have come under pressure. In the Asia-Pacific, India's and Indonesia's currencies also weakened (see chart 3).

China's debt overhang (elevated, unchanged). Credit growth appears to be slowing. Still, China's high-risk nonfinancial corporate debt now represents 30% of the world's total, exceeding Europe and America's respective 20% shares. While China's debt is largely domestically funded, a disorderly deleveraging could destabilize asset and commodity markets. In recent weeks, several domestic corporate bonds have defaulted in China. In the first quarter of 2018, several property developers delayed their interest payments on bank loans and trust loans. We believe these developments show a deterioration of liquidity as funding windows are closed on weak borrowers[3]. Despite the Chinese government's deleveraging campaign, our base case scenario still estimates debt to GDP to rise to 257% in 2021 (see chart 4).

[1] *Global Trade At A Crossroads: The Risk Of An All-Out China-U.S. Trade War Moves Up A Notch, June 18, 2018*

[2] *Global Trade At A Crossroads: U.S. Quadruples Down In China Dispute, Sparking Wider Fears Of An All-Out Trade War*, June 19, 2018

[3] *What's Behind The Recent Bump In China's Default Rates?,* May 13, 2018

Financing conditions

Primary contacts

Diane Vazza
New York
diane.vazza
@spglobal.com
+1 212 438 2760

Sudeep Kesh
New York
sudeep.kesh
@spglobal.com
+1 212 438 7982

Xu Han
New York
xu.han
@spglobal.com
+1 212 438 1491

(Editor's Note: The following views are those of S&P Global Fixed Income Research. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)

Favorable conditions. The Institute of International Finance's (IIF) Lending Conditions Survey for emerging Asia reflected expansive lending conditions in the first quarter of 2018, compared with the end of 2017. The Institute projects improving demand for loans, funding conditions, and trade finance by the end of the second quarter. After improving for the past three quarters, financing conditions in emerging Asia--while still favorable—may however start to face headwinds later in the year. Nonperforming loans could become a problem, particularly those areas with higher exposure to international funding.

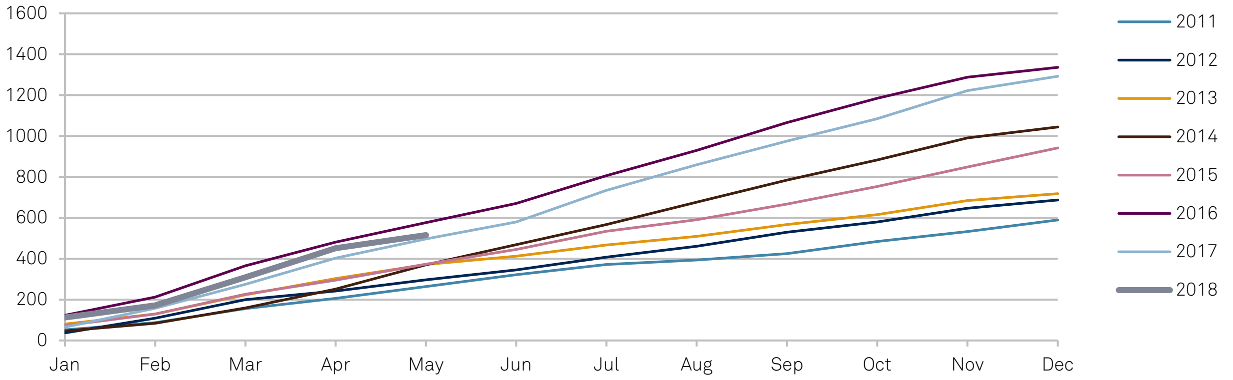
Maturing debt. S&P Global Ratings expects $1.1 trillion of rated Asia-Pacific financial and nonfinancial corporate debt to mature from 2018 through 2022 -- about 11% of the total maturing globally. Asia-Pacific corporate debt maturities are scheduled to rise to a peak of $253 billion in 2020, from $206 billion in 2018. Nearly two-thirds of the debt from the region is from companies in Japan, Australia, and New Zealand, while about 19% is from mainland China. Of the $1.1 trillion of Asia-Pacific rated corporate debt set to mature from Jan. 1, 2018, through end-2022, financial services companies (including banks, financial institutions, and insurance companies) account for 54%. In the current period of accommodative financing conditions, we expect that refinancing demands should be largely manageable, particularly for investment-grade rated companies.

New issuance. Despite a backdrop of geopolitical risks and active deleveraging policies on the part of the Chinese government, May 2018's total of $515 billion is higher than that of last year (see chart 7). So far in 2018, about two-thirds of new issuance hails from Greater China, followed by Japan with 11% and Australia with 10%. We do expect China's deleveraging policy, as well as a rise in interest rates globally to mute the pace of issuance growth in Asia-Pacific. The global new bond issuance through April 2018 totalled $2.07 trillion, a 1% increase relative to the same point in 2017. This represents a marked change from a relative decline of 6% through March. The largest driver of this year-to-date growth was a 27% year-over-year increase in Chinese corporate (nonfinancial and financial services) bond issuance through April. We expect global bond issuance in 2018 to decline by roughly 2.3% from the 2017 total. Relative to the last quarter, our base case assumptions have changed little but now factor in heightened market volatility, which arrived sooner in the year than expected.

Financing conditions are good but headwinds may emerge later this year

Chart 5

Asia-Pacific Corporate Cumulative Bond New Issuance



Source: S&P Global Fixed Income Research. Data as of May 24, 2018.

Macroeconomic developments and assumptions

Primary contacts

Paul Gruenwald
Singapore
paul.gruenwald
@spglobal.com
+65 6216 1084

Vincent Conti
Singapore
vincent.conti
@spglobal.com
+65 6216 1188

Vishrut Rana
Singapore
vishrut.rana
@spglobal.com
+65 6216 1008

(Editor's Note: The views expressed in this section are those of S&P Global Ratings' economics team. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)

The macroeconomic environment remains broadly positive in Asia Pacific in the second quarter despite the ratcheting up of trade tensions between the U.S. and China. Economic activity in China looks steady, where ongoing deleveraging has curiously not led to lower GDP growth. India and Australia both had strong first quarter numbers, led by investment growth. Japan, in contrast, surprisingly had negative growth as domestic demand expenditure contracted. Economic momentum in the Tiger Economies and ASEAN remains strong.

Monetary policy in the region has finally begun to move, with India, Indonesia, and the Philippines raising rates this quarter. These economies joined Malaysia and South Korea, who had raised their benchmark rates in the first quarter and late last year respectively. The key drivers for policy tightening have been higher oil prices and capital outflow pressures partly arising due to the stronger U.S. growth and the Federal Reserve's ongoing monetary policy tightening. Capital outflow pressures in Asia have been much more modest compared with 2013. Inflationary pressures, meanwhile, remain subdued across much of the region.

Macroeconomic environment remains broadly positive

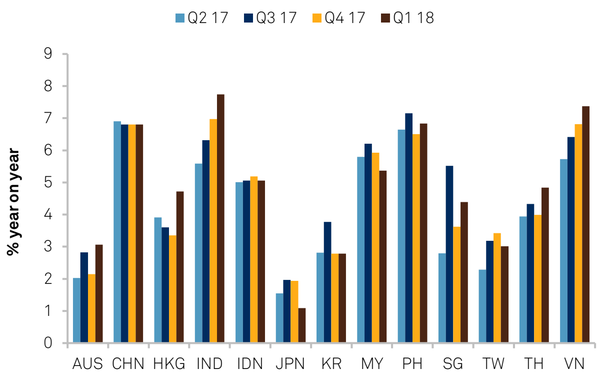
Trade developments were choppy this quarter, with the more open, manufacturing export economies picking up momentum on the back of improved U.S. growth. On the other hand, trade momentum elsewhere in the region has slowed. Higher oil prices pushed imports up and trade balances down in some countries, notably in India.

Our baseline economic outlook remains broadly unchanged, although we will be marking down Japan's growth forecast following a weak Q1 and a lackluster bounce-back in Q2. Chinese growth looks slower judged by higher frequency indicators, although overall GDP numbers may not be affected. We are watching for the impact of deleveraging efforts. Growth in ASEAN remains steady as we expected, and this is set to continue.

Our risk ordering has shifted with trade-war spillovers becoming the top concern as U.S. action has spread to its allies including Europe and Canada, and the U.S. and China trade tensions continue to simmer. The objectives of U.S. trade policy remain unclear given the alternating focus on bilateral trade balances and broader investment and intellectual property concerns. On the brighter side, the U.S.-North Korea summit has eased tensions in Northeast Asia for now, and the Chinese deleveraging looks to be orderly for now.

Chart 6

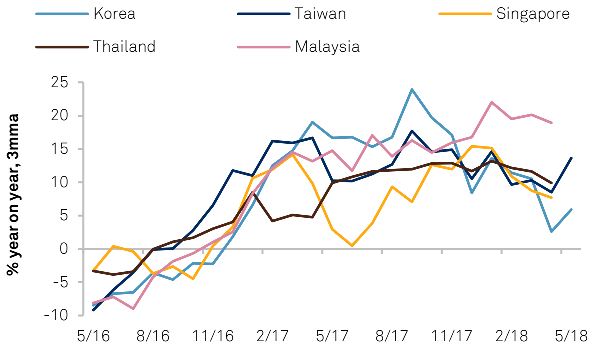
Asia Pacific GDP Growth Solid



Source: CEIC, S&P Global Economics

Chart 7

Asia Pacific Export Growth Choppy



Source: CEIC, S&P Global Economics

Sector themes

Rating trends are positive

Rating trends continue to be favorable across most sectors and geographies in Asia-Pacific (see chart 8 and table 2 in Appendix 1), benefitting from the macroeconomic environment and still favorable financing conditions. Indeed, the net rating bias has eased to negative 1% in May 2018 from -5% in February 2018 (see table 2).

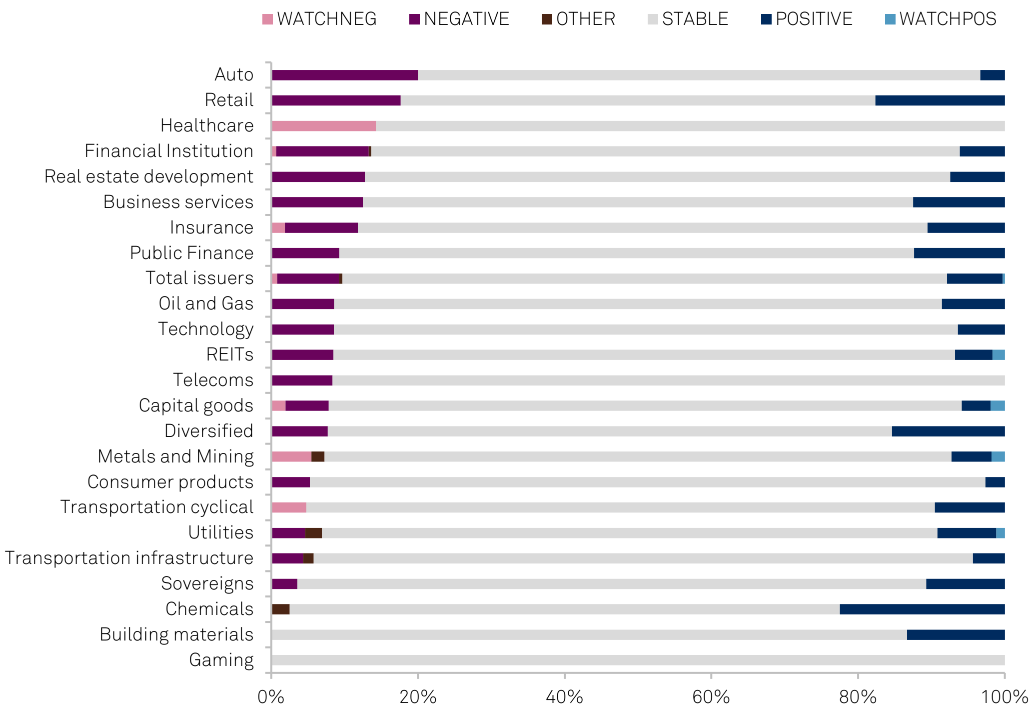
(We calculate the net rating bias by deducting the percentage of negative outlooks and CreditWatch listings against the percentage of positive outlooks and CreditWatch listings. A minus figure indicates that the percentage of negative outlooks and CreditWatch listings exceed the percentage of positive outlooks and CreditWatch listings; and a positive figure, vice versa.)

In summary, the main rating developments in Asia-Pacific are:

- The net rating bias for nonfinancial corporates is 0% in May 2018, i.e. neutral. This is a marginal improvement over the negative 1% in February 2018. Momentum from economic growth continues to be generally supportive of credit profiles although there is competitive pressure in some sectors.
- For financial institutions, the net rating bias is down to around negative 6% at May 2018 from negative 10% in February 2018. This improvement was mainly driven by the positive outlooks on the issuer credit ratings on nine systemically important Japanese banks following a similar rating action on the Japanese sovereign.
- On insurance, economic conditions have allowed the rating bias to ease to negative 1% in May 2018, a significant improvement over the negative 8% in February 2018.
- The net rating bias for both sovereign and international public finance have moved into positive territory after many years, to 7% and 3% respectively for May 2018 (negative 4% and negative 8% in February 2018).

Chart 8

Net Outlook Bias Distribution Of Asia-Pacific Issuers By Sector, May 2018



Source: S&P Global Ratings. REITS – real estate investment trusts

Non-financial corporates

Primary contact

Paul Draffin
Melbourne
paul.draffin
@spglobal.com
+61-3-9631-2122

- Momentum from economic growth continues to be generally supportive of credit profiles although there is competitive pressure in some sectors.
- Our key base case assumptions include continuing steady economic growth and still favorable, albeit slightly tighter, financing conditions.
- Key risks are similar to that of the broader portfolio i.e. trade interruption stemming from the U.S-China tariff dispute, liquidity pullback, asset price volatility, and, albeit more stable, the China debt overhang.

What's changed?

Momentum. The momentum from global economic growth continues to be supportive of revenue. Building materials, capital goods, chemicals, gaming, metals and mining, oil and gas, real estate development, real estate investment trusts, retail, technology, transportation cyclical, transportation infrastructure, and utilities should see steady or even slightly improving credit profiles.

Competition. However, competition is heightening in some sectors. Automakers and suppliers are facing intensifying competitive pressure while telecommunications players in a few Southeast Asian countries, India, Australia, and Taiwan are dealing with mounting competition.

Key assumptions

Steady growth. For our base case scenario, we assume continuing steady economic growth and still favorable, albeit slightly tighter, financing conditions. We do not anticipate, nor factor in, extensive debt-funded M&A activity in any given sector.

Key risks

Trade. With China remaining a growth engine for the region, trade interruption caused by the U.S-China tariff war is a clear and present risk to business confidence.

Financing. Financing conditions are still favorable but tightening, whether by domestic lenders or offshore investors, which could trigger a liquidity pullback from more leveraged borrowers. Asset price volatility is another risk although somewhat subdued this quarter.

China. Credit growth in China appears to be slowing and, barring an unlikely policy misstep, should be stable. An unexpected slowdown in China's economy is another risk for some sectors.

Regulation. For a few sectors, such as gaming, transport and utilities, government policy and regulation is an additional risk.

What to look for over the next quarter

Business and investor confidence. While still expected to be of low impact, there is the risk of adverse business conditions triggered by the China-U.S. trade war. Another complication is investor sentiment toward the risk-return equation.

Financial institutions

Primary contact

Gavin Gunning
Melbourne
gavin.gunning
@spglobal.com
+61-3-9631-2092

- High private sector debt in many Asia Pacific jurisdictions is a key risk factor.
- Elevated property prices, higher U.S. interest rates, and other market and liquidity risks pose threats.
- Potentially lower government support may negatively affect credit quality.

What's changed?

Rating trends are stabilizing. The net negative rating outlook bias of about--6% as of May. 31, 2018 (indicating negative rating outlooks exceed positive rating outlooks) improved from--10% in quarter two over 316 rated financial institutions in 20 Asia-Pacific countries. This improvement was mainly driven by the positive outlooks on the issuer credit ratings on nine systemically-important Japanese banks following a similar rating action on the Japanese sovereign. Across the region, 79% of rating outlooks are stable.

Negative rating bias persists. Despite the positive outlooks in Japan, the stand-alone credit profiles of Japanese banks are under pressure because of weakening bank profitability caused by persistent low interest rates and stiff competition. Negative rating outlooks on systemically-important Australian banks reflect pressures on Australian sovereign creditworthiness and a possible tempering of our current highly supportive opinion concerning the Australian government's tendency to support banks. Booming property prices, fast credit growth, and inextricable linkages to China could contribute to further negative ratings trends in Hong Kong.

Key assumptions

Largely stable asset quality. Our outlook for asset quality remains relatively stable. Our base case is that nonperforming loans should remain relatively low in some jurisdictions (including Taiwan, Australia, Hong Kong, and Japan) but will remain much higher in some others, notably India. Recent capital infusions by the Government of India will improve the balance-sheet quality of Indian public-sector banks.

Key risks

High private-sector debt and property prices. High private-sector debt in China, Hong Kong, Australia, Korea, Singapore, Malaysia, and Thailand is a key risk factor, particularly should there be a reversal of current trends of low interest rates and unemployment. High property prices are a risk in China, Hong Kong, Australia, and New Zealand. Higher U.S interest rates and a strengthening U.S. dollar could ultimately weaken financial institutions' credit quality. A downside risk of a sharp correction in asset prices, particularly if associated with a pullback in market liquidity, will likely lead to negative ratings momentum.

What to look for over the next quarter

Low probability high impact negative scenario. With numerous negative ratings revisions over the past year or so affecting our banking industry country risk assessments and/or bank ratings – including in China, Japan, India, Hong Kong, Australia, and New Zealand - our current base case is for relative ratings stability. High debt levels across the region and globally, high asset prices, and skittish bond markets could set the stage for a high-impact event that could have secondary impacts on banks and cause us to revise our view. This scenario remains a low probability one, however.

Possible diminution in government support. The transition to resolution frameworks that imply a lower likelihood of government support is a risk to bank ratings.

Insurance

- The negative rating bias for the region's insurers is mainly due to the ratings on their parent groups.
- Strengthening regulatory discipline signals a return to fundamentals for insurers.
- Insurers' hunt for yield through increasing exposure to risk assets is likely to moderate the impact of lower margins from underwriting

Primary contact

Eunice Tan
Hong Kong
eunice.tan
@spglobal.com
+852-2533-3553

What's changed?

Stabilizing economic growth prospects. The improving economic outlook, albeit still low interest rates, will facilitate a gradual recovery in Asia-Pacific insurers' revenue and profitability.

Regulatory developments. The tougher stance by regulators, particularly in China, signals tighter discipline among insurers and increasing compliance costs.

Key assumptions

Earnings pressure to stay. The availability of underwriting capacity and a catastrophe-benign environment continue to keep premium rates low for property and casualty (P&C) insurers and reinsurers. Low interest rates would lead to high insurance reserves.

Rising investment risks. The credit risk exposure of Asia-Pacific insurers is rising following an increasing allocation toward higher-yielding investments. This is especially so in China, given the higher uptake in infrastructure and real estate investments.

Key risks

Volatile investment markets. Insurers' pursuit of more aggressive investments to enhance profits, amid intensifying market competition across the region, expose them to greater investment volatility. Insurers' capitalization will be facing pressures to weather asset valuation movements.

Higher compliance costs. Tightening regulatory and accounting developments are pushing up compliance costs for Asia-Pacific insurers, placing more strain on profitability. While these costs may be transferred to policyholders, competitive pressure would force insurers to absorb the impact. Greater efforts to contain costs will likely propel insurers to undertake larger investments in technology.

What to look for over the next quarter

Higher sensitivity to macroeconomic trends. Insurers, particularly life insurers, are undertaking bigger roles to provide funds for longer duration loans, where collateral is often infrastructure and real estate-related. These instruments have less liquidity and increase insurers' sensitivity to macroeconomic downturns.

Potential catastrophe risks. Changing weather patterns and increasing urbanization will increase insurers' exposure to natural and manmade catastrophe events. These risks continue to weigh on insurers operating in emerging markets with less claims experience.

Public finance

Primary contact

Xin Liu
Beijing
xin.liu
@spglobal.com
+611-6569-2956

- High debt burden remains as the key credit weakness for China's local and regional governments.
- Their debt servicing capacity will continue to be supported by further debt-restructuring with lengthening of debt maturities.
- The Chinese authority's policy rigor to control local government debt risk is set to hit infrastructure investment growth.

What's changed?

Credit trends vary by country: Credit divergence continues for Asia-Pacific's public finance entities. Most ratings on Australian states remain on negative outlook, reflecting the negative outlook on the sovereign rating. The outlook on Japanese local and regional governments (LRGs) Japanese was revised to positive from stable following a sovereign action. For Chinese LRGs, their creditworthiness largely remains stable amid heightened central government policy rigor in controlling LRGs' off-budget borrowing.

Key assumptions

Chinese LRGs' debt growth to moderate: We expect Chinese LRGs' debt burden to remain high, but with a stable trend. China's deleveraging policy theme continues to intensify, constraining credit supply to local governments. As a result, infrastructure investment year-on-year growth dipped to 12.4% in April from last year's pace of around 20%.

Continued debt restructuring: The central-government initiated debt-restructuring will continue to support Chinese LRGs' debt-servicing capacity amid very high debt burdens. In 2018, debt maturities will be around Chinese renminbi (RMB) 700 billion, before peaking around 2021 or 2022. However, we believe that the current maturity profile will be effectively further lengthened for Chinese LRGs, given that they are now allowed to issue 15-, 20-, and 25-year tenor bonds.

Key risks

China's financial deleveraging: The current comprehensive policy and regulatory tightening will constrain credit flow in the quasi-public sector. A too-blunt heavy hand will have a severe impact on new funding sources as well as refinancing channels. Such a financial distress scenario may test LRGs' willingness and capacity to support their LGFVs, and translate into unexpected fiscal costs for local governments.

What to look for over the next quarter

Funding costs: Even though the new policy initiative could constrain new infrastructure spending and slow down debt accumulation, a large stock of old off-budget borrowing debt remains, most of which will need refinancing. This is pertinent given rising funding costs, which will add further refinancing pressure for the state-owned enterprise (SOE) sector to roll over their debt. Unfavorable market conditions could increase the probability that LRGs' contingent liabilities will materialize.

Sovereign

Primary contact

KimEng Tan
Singapore
kimeng.tan
@spglobal.com
+65-6239-6350

- We believe steady economic conditions in major developed economies and gradual deleveraging in China will help provide sovereign support across the Asia-Pacific.
- Geopolitical tensions pose tail risks for sovereigns in the Asia-Pacific, as do potential trade policies

What's changed?

Steady growth supports exports. We see steady economic performance in developed markets helping to support external demand for Asian exporters. By anchoring confidence in these economies, it also helps to ward off large swings in capital flows in and out of the region.

Japan's economy has sound prospects. Economic growth accelerating as tourism exports and demand for health care rises support upward pressure on the rating on Japan.

Key assumptions

China's deleveraging impact. Policymakers are putting in place policy changes across a number of areas that are helping to rein in credit expansion. Tighter credit conditions in the country could moderate growth somewhat but could also reduce the likelihood of an abrupt economic correction in the future.

Key risks

Sudden capital swings. Abrupt international capital flow reversals continue to be a risk that could sharply increase financing costs, damaging confidence and short-term growth prospects in economies that are reliant on external funding.

Unsteady or slow deleveraging in China. If negative developments hurt confidence in the Chinese growth story, the deleveraging policy could temporarily halt or even reverse. That is likely to weaken sovereign credit support for the government due to growing risks of financial instability. If the loss in confidence spreads across the region, then other Asia-Pacific sovereigns could also be negatively affected.

What to look for over the next quarter

Geopolitical tensions in Asia, and rising protectionism. Tensions in a number of areas in Asia such as the South China Sea and Korean peninsula could evolve into significant conflicts that affect the credit metrics of a number of sovereigns. Further, protectionist trade policies between China and the U.S. could intensify, weighing on growth prospects.

Structured finance

Primary contact

Erin Kitson
Melbourne
erin.kitson
@spglobal.com
+61-3-9631-2166

- Synchronized improvement in macroeconomic conditions underpins the stable performance in structured finance markets as loss of income is a key cause of default across asset classes.
- Rising interest rates could create debt serviceability pressures for some borrowers, particularly those with higher loan-to-value (LTV) ratios.
- Refinancing conditions may be tougher for certain borrower types and loan products as banks continue to reprice risk.

What's changed?

Credit enhancement buildup for ABS. For asset-backed securities (ABS) transactions, high amortization rates (especially in Chinese auto loan ABS) limit the risk exposure horizon and contribute to a strong build-up of credit enhancement to senior classes of notes.

Modest LTVs provide a buffer against a softening in Australian property prices. The weighted average LTV of the Australian residential mortgage-backed securities (RMBS) sector is around 60%. This provides a level of buffer to weather a moderate deterioration in property prices. Given the high seasoning of most loan portfolios, many loans have benefited from strong property price appreciation in recent years, particularly those in located in the more populous capital cities of Sydney and Melbourne.

Key assumptions

Stable employment. Under our base case, we expect asset performance including arrears and losses to remain low given that we forecast employment conditions will remain relatively stable in the region's major securitization markets. This will help to offset the impact of a softening in property markets in Australia and rising interest rates more broadly.

Key risks

Increasing regulatory scrutiny in China. We expect market interest rates to be relatively high in China due to the central bank's efforts to temper shadow banking activities. Consumers relying on refinancing to repay debt could also face reduced credit availability as a result of regulatory moves toward cash loan businesses.

Interest rate rises in Japan and Australia. This risk is generally mitigated for Japanese structured finance because the majority of outstanding RMBS are backed by fixed-rate residential mortgage loans. Australian RMBS are more exposed to this risk as the majority of underlying mortgages are variable rate contracts. Tightening in debt serviceability standards should help to manage this risk.

What to look for over the next quarter

Transition of interest-only loans to amortizing loans. Around 50% of interest-only loans in Australian RMBS transactions will reach their interest-only maturity dates by 2019. Interest-only loans underwritten prior to 2015--when lending standards for interest-only loans were less stringent--may be more exposed to repayment shock.

Related research

- Global Trade At A Crossroads: U.S. Quadruples Down In China Dispute, Sparking Wider Fears Of An All-Out Trade War, June 19, 2018
- Global Trade At A Crossroads: The Risk Of An All-Out China-U.S. Trade War Moves Up A Notch, June 18, 2018
- What's Behind The Recent Bump In China's Default Rates? , May 13, 2018
- Global Issuance And Financing Conditions: Bond Issuance Is Up 1% Through April On Strong Chinese Totals, June 8, 2018

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Appendix 1: Ratings trends

Table 2

Net Ratings Bias Of Asia-Pacific Issuers By Sector, May 2018

	May. 2017	Aug. 2017	Oct. 2017	Feb. 2018	May. 2018	No. of entities	Notional average rating
Auto OEM and suppliers	7%	4%	-10%	-14%	-17%	30	BBB
Building materials	-17%	-8%	17%	23%	13%	15	BBB-
Business services	-13%	0%	0%	0%	0%	8	BB
Capital goods	-21%	-15%	-14%	-2%	-2%	51	BBB-
Chemicals	-6%	0%	18%	19%	23%	40	BBB-
Consumer products	3%	0%	0%	0%	-3%	38	BBB-
Diversified	-31%	-8%	0%	8%	8%	13	BBB+
Gaming, media and entertainment	-18%	-17%	-15%	-4%	0%	24	BB
Healthcare	-33%	-33%	-38%	-38%	-14%	7	BBB-
Investment Company	-20%	-10%	0%	0%	0%	8	BBB+
Metals and mining	-21%	-9%	-4%	2%	2%	55	BB+
Oil and gas	-29%	-19%	-5%	0%	0%	35	BBB
Project finance	-10%	0%	0%	0%	0%	9	A-
Real estate development	-18%	-21%	-14%	-11%	-5%	93	BB-
Real estate investment trusts	-5%	-9%	-5%	-2%	-2%	59	A-
Retail	-15%	-10%	-11%	-5%	0%	17	BBB-
Technology	-10%	-7%	-2%	0%	-2%	46	BBB-
Telecommunications	-13%	-12%	-9%	-9%	-8%	36	BBB
Transportation cyclical	-21%	-10%	-5%	-5%	5%	22	BBB+
Transportation infrastructure	-6%	-3%	2%	0%	0%	67	BBB-
Utilities	-2%	-2%	5%	2%	5%	87	BBB+
Total corporates	**-12%**	**-9%**	**-4%**	**-1%**	**0%**	**760**	**BBB-**
Financial Institutions	-18%	-18%	-13%	-10%	-6%	316	BBB+
Insurance	-8%	-10%	-7%	-8%	-1%	161	A
Public Finance	-4%	-3%	-3%	-4%	3%	96	BBB
Sovereign	-16%	-19%	-11%	-8%	7%	28	A
Total issuers	**-12%**	**-11%**	**-7%**	**-5%**	**-1%**	**1,361**	**BBB**

Light blue colored cells indicate improvement from prior period, navy blue deterioration.

Appendix 2: Economic data and forecast summaries

For a fuller discussion please see *Economic Research: APAC Economic Snapshots*, published June, 2018.

Table 3

Real GDP Scenarios

(%)	2017	2018f	2019f	2020f	2021f
Australia	2.20	2.90	2.90	2.90	2.80
China	6.90	6.50	6.30	6.10	6.00
India	6.70	7.50	7.80	7.90	8.00
Japan	1.70	0.90	1.20	0.10	1.20
South Korea	3.10	2.70	2.60	2.80	2.60
Hong Kong	3.80	3.80	3.30	2.90	2.90
Indonesia	5.10	5.20	5.50	5.70	5.70
Malaysia	5.90	5.40	5.10	4.90	4.80
New Zealand	3.00	2.60	2.70	2.70	2.60
Philippines	6.70	6.70	6.80	6.60	6.60
Singapore	3.60	3.20	3.10	2.80	2.90
Taiwan	2.90	2.80	2.50	2.50	2.50
Thailand	3.90	4.10	3.80	3.80	3.80
Asia Pac*	5.60	5.50	5.50	5.30	5.40
EM Asia*	6.20	6.10	6.10	6.00	6.00
NIE*	3.20	2.90	2.70	2.70	2.60
ASEAN*	5.20	5.20	5.30	5.30	5.30

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21, 2021 = FY 2021-22. + NIE: Hong Kong, Singapore, South Korea, Taiwan; ASEAN: Indonesia, Malaysia, Philippines, Thailand. EM Asia: China, India, NIEs and ASEAN; Asia Pac: Australia, Japan, EM Asia. f = forecast.

Table 4

CPI Inflation

(%)	2017	2018f	2019f	2020f	2021f
Australia	1.90	2.20	2.40	2.30	2.20
China	1.50	2.40	2.30	2.30	2.20
India*	3.60	4.70	4.50	4.50	4.50
Japan	0.50	1.20	1.20	1.90	1.60
South Korea	1.90	1.70	1.90	1.80	1.60
Hong Kong	1.50	2.50	2.20	2.10	2.20
Indonesia	3.80	3.50	3.80	3.90	4.00
Malaysia	3.80	2.30	2.90	3.00	2.90
New Zealand	1.90	1.70	2.00	2.10	2.20
Philippines	2.90	4.30	3.40	3.00	3.00
Singapore	0.60	0.80	2.10	2.40	2.10
Taiwan	0.60	1.50	1.30	1.40	1.20
Thailand	0.70	1.10	1.60	1.80	2.00

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21, 2021 = FY 2021-22.

Table 5

Policy Rates, End-Of-Year

(%)	2017	2018f	2019f	2020f	2021f
Australia	1.50	1.50	1.75	2.00	2.25
India*	6.00	6.50	6.50	6.50	6.25
Japan	(0.06)	(0.04)	(0.04)	(0.04)	(0.04)
South Korea	1.50	1.75	2.00	2.00	2.00
Indonesia	4.25	5.25	5.25	5.00	4.50
Malaysia	3.00	3.25	3.75	3.75	3.75
New Zealand	1.75	1.75	2.25	2.50	3.00
Philippines	3.00	3.75	4.25	4.25	4.50
Taiwan	1.38	1.63	1.63	1.63	1.63
Thailand	1.50	1.50	2.00	2.25	2.50

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21, 2021 = FY 2021-22.

Table 6

Policy Rates, Average-Over-Year

(%)	2017	2018f	2019f	2020f	2021f
Australia	1.50	1.50	1.66	1.97	2.22
India*	6.08	6.31	6.50	6.50	6.31
Japan	(0.05)	(0.05)	(0.04)	(0.04)	(0.04)
South Korea	1.27	1.56	1.88	2.00	2.00
Indonesia	4.59	4.88	5.25	5.19	4.56
Malaysia	3.00	3.23	3.53	3.75	3.75
New Zealand	1.75	1.75	1.94	2.34	2.81
Philippines	3.00	3.38	4.13	4.25	4.50
Taiwan	1.38	1.47	1.63	1.63	1.63
Thailand	1.50	1.50	1.69	2.09	2.41

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21, 2021 = FY 2021-22.

Table 7

Exchange Rate, Yearly Average against USD

(%)	2017	2018f	2019f	2020f
Australia	0.77	0.77	0.74	0.76
China	6.76	6.39	6.40	6.39
India*	64.45	66.75	67.03	68.18
Japan	112.10	109.50	110.60	111.70
South Korea	1,131.00	1,075.80	1,079.40	1,083.80
Hong Kong	7.79	7.84	7.82	7.78
Indonesia	13,379.00	13,811.00	13,831.00	13,693.00
Malaysia	4.30	3.98	4.06	4.00
New Zealand	0.71	0.71	0.70	0.71
Philippines	50.40	52.50	52.80	51.60
Singapore	1.38	1.33	1.32	1.29
Taiwan	30.44	29.57	29.55	29.35
Thailand	33.94	31.52	31.11	30.85

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21.

Table 8

Exchange Rate, Year-End Against USD

(%)	2017	2018f	2019f	2020f
Australia	0.78	0.75	0.75	0.76
China	6.51	6.39	6.37	6.40
India*	65.04	67.00	67.50	69.70
Japan	112.69	110.52	110.72	112.12
South Korea	1,071.40	1,071.12	1,081.11	1,085.45
Hong Kong	7.81	7.84	7.80	7.76
Indonesia	13,484.00	13,880.89	13,815.07	13,636.27
Malaysia	4.06	4.07	4.04	3.95
New Zealand	0.71	0.69	0.70	0.71
Philippines	49.92	52.89	52.53	50.42
Singapore	1.34	1.33	1.31	1.29
Taiwan	29.85	29.59	29.44	29.18
Thailand	32.68	31.38	30.93	30.77

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21.

Table 9

Unemployment

(%)	2017	2018f	2019f	2020f	2021f
Australia	5.60	5.40	5.40	5.30	5.20
China	3.90	3.90	3.90	4.00	4.00
Japan	2.80	2.60	2.60	2.70	2.70
South Korea	3.70	3.80	3.80	3.50	3.30
Hong Kong	3.10	2.90	3.00	3.00	3.10
Indonesia	5.40	5.00	5.00	4.90	4.60
Malaysia	3.40	3.40	3.30	3.30	3.30
New Zealand	4.70	4.40	4.30	4.30	4.30
Philippines	5.70	5.20	5.10	4.90	4.10
Singapore	2.20	2.00	2.00	1.90	1.90
Taiwan	3.80	3.50	3.40	3.10	3.10
Thailand	1.20	1.20	1.20	1.20	1.30

* For India, 2017=FY2017-18, 2018=FY2018-19, 2019 = FY 2019-20, 2020 = FY 2020-21.

spglobal.com/ratings