Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

Andrew Wong
+65 6530 4736
WongVKAM@ocbc.com

Wong Hong Wei, CFA
+65 6722 2533
WongHongWei@ocbc.com

Seow Zhi Qi, CFA
+65 6530 7348
zhiqiseow@ocbc.com

In the Race to Zero

As the Fed pulled a 100bps rate cut in an unscheduled meeting, how are SGD corporate bonds reacting?

- While a 100bps rate cut had been priced in by the market, the timing has caught the market by surprise. The immediate reaction in the SGD corporate bond market is a continuation of last week's market illiquidity that has seeped into the SGD corporate bond space, with investors and dealer's alike taking a more defensive stance.
- Notwithstanding credit fundamentals having weakened and we expect pockets of credit stress, the current situation in our view is driven by knock-on effects from what is happening outside of the SGD corporate bond market, rather than a signal of SGD corporates entering into a broad default wave per se.
- The size of the SGD corporate bond market indicates that Singapore corporates are still highly reliant on access to bank debt markets, which in our view continues to provide a "backstop" to refinancing needs.
- Should a zero rate environment become a longer term structural phenomenon, we expect heightened non-call risks at first call for perpetuals though expect high grade bond prices to increase as markets enter into a normalcy of zero-rates with investors benefitting from capital gains.
- While we may not be at the absolute bottom, at OCBC Credit Research we find it more instructive to think about who the quality issuers are within the SGD bond space and start positioning for that. For investors already invested, we recommend to continue holding high grade senior bonds, senior bank papers and Tier 2 capital instruments of select high grade issuers (Neutral (3)) and above.

Background

The Federal Reserve slashed its benchmark interest rate by a full percentage point to near zero on Sunday. The last time key rates were this low was during the 2008 financial crisis. While the market had already priced a cut of this extent, the timing caught the market by surprise. Along with this action were reducing reserve requirement ratios to 0%, launching a massive USD700bn asset purchase program entailing Treasuries and mortgaged-backed securities and allowing banks to borrow from the Fed for up to 90 days at just 0.25%. All of which were not expected. While the measures were aggressive, the market responded negatively. In the SGD space, the SGD swap curve flattened further with the 10Y swap rate down 14.5bps to 1.08%

Credit indices had a torrid week with the spread on Bloomberg Barclays Asia USD IG Bond Index average OAS widening 40bps to 191bps w/w while the Bloomberg Barclays Asia USD HY Bond Index average OAS widened 216bps to 803bps w/w. Elsewhere, the Markit iTraxx Asia ex-Japan rose 60bps w/w for the biggest weekly jump since 2011 while the Bloomberg Barclays EM Asia USD Credit Average OAS rose 79bps w/w for its largest move since 2012. Credit indices in the US and Europe ended the week on a positive note following stimulus measures on Friday however sentiments look set to reverse this week. Primary markets for US IG had stayed open although US HY markets continue to be shut, with no new deals brought to market after 5 March 2020. In our view, should the US HY primary markets continue to be shut for an extended period and the banking sector does not step in to fund upcoming refinancing, this would very likely lead to credit stress exacerbating in the USA, with negative risk sentiments spilling over into Asiadollar and the SGD corporate bond market. Mitigating this from happening is the relatively small size of upcoming HY maturities at USD4.2bn for the next 30 days and less than USD8.2bn at the BBB-/Baa3 level (the lower IG tier) per Bloomberg data as of writing.

What is the biggest risk for SGD corporate bond markets in the next 30 days?

Since the heightened volatility in the past two weeks, we have seen market illiquidity seep into the SGD corporate bond space, with investors and dealers alike taking a more defensive stance (as suggested by shading of prices and widening of bid-ask spreads) and sellers finding it a difficult environment to get optimal prices. While we have observed deterioration in credit fundamentals among issuers under our coverage and expect pockets of credit stress as highlighted in our Singapore Credit Outlook 2019 and re-iterated in Singapore Credit Outlook 2020, much of the current market illiquidity in our view are knock-on effects from what is happening outside of the SGD corporate bond market, rather than a signal of SGD corporates entering into a broad default wave per se. We think the Fed's move on Sunday had crystallized heightened fear of recession risk with SGD corporate bond spreads widening as investors start pulling out of risk asset markets alike.

With credit spreads widening even for high grade senior bonds (highest it has been in the past five years or since time of pricing for newer issues), the biggest risk in the next 30 days in our view is that there are no high grade buyers stepping into the market to take advantage of this down market. In the event this scenario occurs, it indicates that investors are unwilling and/or unable to come back to the market to bring it back to supply-demand equilibrium. While we have not seen widespread bottom fishing yet, we expect investors to eventually come back into the market given strong demand for SGD-denominated assets.

The second biggest risk in our view is that issuers with upcoming maturities whom we expect to be able to get refinanced via bank debt markets enter into defaults or debt restructurings instead. Based on the Monetary Authority of Singapore's preliminary numbers for January 2020, total loans and advances of Domestic Banking Units to non-bank customers (ie: corporates) amounted to SGD428.3bn while this was SGD628.1bn from the Asian Currency Units. As of writing, the SGD corporate bond market (excluding statutory bodies and government bonds) has SGD108.7bn of bonds outstanding. While disintermediation has gained pace in Singapore, Singapore corporates are still highly reliant on the banking sector and in our view, barring banks pulling the plug on corporate loans; we are unlikely to see similar levels of corporate credit stress in Singapore as those we saw in US credit markets. Thus far, domestic Singapore banks have committed to roll out assistance to small and medium enterprises (particularly in assisting clients face liquidity stresses) facing COVID-19 however the assumptions driving this assistance may not be relevant anymore.

Table 1: Bid-ask Spreads of Selected Benchmark SGD Corp Bonds

	Average Bid-Ask (March 2020)	Average Bid-Ask (October 2019- February 2020)
Ppt	0.503	0.301

Source: Bloomberg as at 16 March 2020, OCBC Credit Research
Note: Based on 10 liquid issues issued by MCTSP, CCTSP, CAPITA, MLTSP, KEPSP, AREIT, CMZB, DBSSP, CAPLSP, GUOLSP

Table 2: Schedule of bonds maturing in the next 30 days

Issuer Name	Ticker	Mature/Call in 2020 (whichever earlier if both)	Days to Maturity/Call	SGD mn
CWT Pte Ltd	CWTSP	18/03/2020	2	100
Neptune Orient Lines Ltd/Singapore[1]	NOLSP	27/03/2020*	11	300
Singapore Post Ltd	SPOST	30/03/2020	14	200
Perennial Somerset Investors Pte Ltd	PERSOM	31/03/2020	15	229
Aspial Treasury Pte Ltd	ASPSP	01/04/2020	16	182
City Developments Ltd	CITSP	02/04/2020	17	125
Logindo Samudramakmur Tbk PT	LEADIJ	02/04/2020	17	50
FCT MTN Pte Ltd	FCTSP	03/04/2020	18	90
Ascendas Hospitality Trust	ASCHTS	07/04/2020	22	70
SingTel Group Treasury Pte Ltd	STSP	08/04/2020	23	600
Hotel Properties Ltd	HPLSP	08/04/2020	23	50
Sembcorp Financial Services Pte Ltd	SCISP	09/04/2020	24	300
Croesus Retail Trust	CROESP	13/04/2020	28	42
Neptune Orient Lines Ltd/Singapore[1]	NOLSP	13/04/2020*	28	280
Hyflux Ltd[2]	HYFSP	13/04/2020*	28	400
First Sponsor Group Ltd	FSGSP	14/04/2020*	29	148
OUE Ltd	OUESP	15/04/2020	30	300
Logan Property Holdings Co Ltd	LOGPH	16/04/2020*	31	200

Source: Bloomberg as at 16 March 2020
Note: (*) Call dates
(1) Maturity on 9 September 2020
(2) Issuer is in default and undergoing in-court restructuring

What is the biggest risk for SGD bond markets post 30 days?

Thinking of the biggest risks come mid-April and beyond means that hopefully the biggest risks in the next 30 days from today have ultimately come to pass. The COVID-19 spread will have found its peak and be on the decline, aggressive central bank policies did their work and credit markets began to thaw. Markets find a floor and large bond funds begin to deploy capital again. High grade deals begin to get priced again albeit at a higher cost while higher yielding credits find some liquidity either from banks (with no doubt tighter lending conditions and higher costs) or from private credit. That said, bank balance sheets will still feel somewhat fragile and it will take time for risk taking to normalize. The biggest risk going forward will be that assumptions that moved the market back to normality in the first 30 days do not come to fruition. Corporate balance sheets will be injured from this episode while still carrying higher leverage, so the margin for error for these corporates will remain thin. Offshore oil and gas services companies know only too well how perilous it is to navigate operating conditions that are not fully recovered. The world will also no doubt remain nervous about an escalation in COVID-19 again.

Longer term, stronger credits armed with confidence and the backing of lenders may seek to pursue mergers and acquisitions in the hope that challenges have passed and that now presents an opportunity to solidify their business risk profiles. Based on where we are today, this could very much be however a good problem to have.

Figure 1: Issuers by Credit Risk Profile

Issuer	Issuer Profile	Issuer	Issuer Profile
Australia & New Zealand Banking Group Ltd	2.0	CapitaLand Retail China Trust	4.0
DBS Group Holdings Ltd	2.0	Credit Suisse Group AG	4.0
Hongkong Land Holdings Ltd	2.0	Fraser and Neave Ltd	4.0
National Australia Bank Ltd	2.0	Frasers Commercial Trust	4.0
United Overseas Bank Ltd	2.0	Hotel Properties Ltd	4.0
CapitaLand Mall Trust	2.5	Keppel Infrastructure Trust	4.0
HSBC Holdings PLC	2.5	Keppel REIT	4.0
Singapore Telecommunications Ltd	2.5	Landesbank Baden-Wuerttemberg	4.0
Westpac Banking Corp	2.5	Mapletree Greater China Commercial Trust	4.0
Ascendas REIT	3.0	Mapletree Logistics Trust	4.0
BNP Paribas SA	3.0	Metro Holdings Ltd	4.0
BPCE SA	3.0	Societe Generale SA	4.0
CapitaLand Commercial Trust	3.0	Standard Chartered PLC	4.0
CapitaLand Ltd	3.0	Starhill Global REIT	4.0
CapitaLand Ltd / Ascott Capital Pte Ltd	3.0	Suntec REIT	4.0
China Construction Bank	3.0	Wing Tai Holdings Ltd	4.0
Credit Agricole AG	3.0	Wing Tai Properties Ltd	4.0
Frasers Centrepoint Trust	3.0	Barclays PLC	4.5
Lendlease Group	3.0	Cache Logistics Trust	4.5
Mapletree Commercial Trust	3.0	Commerzbank AG	4.5
Mapletree Industrial Trust	3.0	ESR REIT	4.5
Singapore Post Ltd	3.0	Frasers Property Ltd	4.5
StarHub Ltd	3.0	Keppel Corp Ltd	4.5
Wharf Holdings Ltd/The	3.0	Shangri-La Asia Ltd	4.5
Wheelock & Co Ltd	3.0	Singapore Airlines	4.5
ABN AMRO Bank NV	3.5	CITIC Envirotech Ltd	5.0
Ascott Residence Trust	3.5	GuocoLand Ltd	5.0
City Developments Ltd	3.5	Hong Fok Corp Ltd	5.0
Frasers Hospitality Trust	3.5	China Aoyuan Group Ltd	5.5
Julius Baer Group Ltd	3.5	Golden Agri-Resources Ltd	5.5
UBS Group AG	3.5	Heeton Holdings Ltd	5.5
		Olam International Ltd	5.5
		OUE Ltd	5.5
		Oxley Holdings Ltd	5.5
		Sembcorp Industries Ltd	5.5
		BreadTalk Group Ltd	[illegible]
		Lippo Malls Indonesia Retail Trust	[illegible]
		Perennial Real Estate Holdings Ltd	[illegible]
		Aspial Corp. Ltd	[illegible]
		Century Sunshine Group	[illegible]
		CMA CGM (Parent of Neptune Orient Lines)	[illegible]
		First REIT	[illegible]

Source: OCBC Credit Research
Note: (1) In order of issuer profiles – green denotes those with higher Issuer Profile Scores and whom we are more likely to keep stable while red denotes the other end of the spectrum

We are not intending to downgrade any issuers in the next 30 days although are intently monitoring developments as follows:

Table 3: Pressure points for Key SGD bond sectors

Key Corporate Bond Sector	What we are Monitoring for Potential Downgrades
Financial Institutions	• Rising loan losses impacting earnings, spike in wholesale funding costs and • Significant drawdowns of undrawn credit commitments both of the aforementioned to impact capital ratios, possible negative intervention by governments for banks to support the wider economy.
Property Developers	• Property prices may plunge if unemployment rates rise and liquidity pulls back. • If prices do fall, property developers will face (1) Slower sales and (2) significantly reduced margins. Unsold inventory will weigh on working capital, liquidity position and balance sheet of developers. • Developers most exposed to the Singapore property market include Oxley Holdings Ltd, City Developments Ltd and GuocoLand Ltd. • Investment properties provide some hedge though we will be wary if rentals and prices begin to collapse.
REITs	• Significant decline in occupancy rate and high negative rental reversion. • Spike in percentage of encumbered assets. • Inability to term out maturities due to lack of support from banks and financial markets.
Airlines	• Prolong travel bans beyond 6 months leading to a pullback in consumer demand including from non-passenger flight revenue. • Existing banking lines gets exhausted and shareholder capital support is not forthcoming.
Conglomerates	• Financial injection into subsidiaries/ businesses which are underperforming. • Debt-fuelled acquisitions into new, unproven businesses and geographies.

Source: OCBC Credit Research

What would happen to high grade SGD bonds in a zero-rate environment?

Should a zero-rate environment (and subsequently negative rates) becomes a structural issue more akin to Europe and Japan, we expect the conventional case of bond prices increasing when rates are lower to kick in for existing high grade bonds.

In our view, should these rate levels become the market norm in Singapore; spreads between high grade bonds and benchmark rates would widen, making it attractive for investors to pile back into the market, especially those who require sustainable income. The path towards zero should also generate capital gains, boosting total returns.

Nonetheless, a zero-rate environment is ultimately negative to bank earnings in our view and instruments offered by banks would widen to reflect the heightened operating risks. We also expect volatility to continue in credit markets for some time and expect there may be days when prices go lower. As such, we continue to advocate a strong focus on fundamentals and quality issuers within the SGD space and to start positioning for that.

What happens to perpetuals in zero-rate environment?

As a recap of our publication on Perpetuals Tetralogy: Step-ups Matter, the likelihood of issuers exercising the call will be lower when interest rates head lower as issuers may prefer to exercise prudence by not calling in order to conserve cash. For most perpetuals in the SGD space, it also looks uneconomical to call and refinance with another perpetual, especially if there is insufficient step-ups at the first call date. In other words, very often there is little or no penalty to the issuer if the perpetuals do not get called.

Perpetuals do not enjoy the upsides as a bond because it will be treated more equity-like (distributions not guaranteed, no maturity date) by issuers in today's environment. If liquidity remains tight, we think it will be possible for issuers to skip distributions to perpetual holders entirely in order to preserve cash. In this scenario, perpetuals with non-cumulative structures (i.e. deferred distributions are not accumulated) will be at elevated risk. Perpetuals with non-cumulative structures include REITs and bank capital instruments.

At zero swap rates, a significant number of perpetuals would reset down to 2-3% distribution rates, based on the reset spread (e.g. MLTSP 3.65% PERP resetting to 1.815%, HSBC 5% PERP resetting to 2.665%, HPLSP 4.65% PERP resetting to 2.685%). If equity risk premiums and credit spreads remain at elevated levels as they are in today's environment, 2-3% distribution rates will look very unexciting (as a comparison, high grade seniors such as CITSP 2.7% '25s are already trading around 3.0% bid as of writing). That said, if rates were to continue staying low at zero for an extended period of time while equity risk premiums and credit spreads compress to 2019 levels, we believe this level of distribution rates could be the new norm for perpetuals.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Strategy & Research
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Terence Wu
FX Strategist
TerenceWu@ocbc.com

Howie Lee
Thailand, Korea & Commodities
HowieLee@ocbc.com

Wellian Wiranto
Malaysia & Indonesia
WellianWiranto@ocbc.com

Carie Li
Hong Kong & Macau
carierli@ocbcwh.com

Dick Yu
Hong Kong & Macau
dicksnyu@ocbcwh.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo, CFA
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei, CFA
Credit Research Analyst
WongHongWei@ocbc.com

Seow Zhi Qi
Credit Research Analyst
ZhiQiSeow@ocbc.com

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