

# Rating Research Services

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## Executive Comment:

### Taiwan's Weak Economy Could Slow The Local Bond Market's Recovery

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## Executive Comment: Taiwan's Weak Economy Could Slow The Local Bond Market's Recovery

Taiwan's sluggish macroeconomic recovery is likely to increase credit risks for the island's bond issuers in the second half of 2012, with credit spreads (the yield difference between five-year bonds and government bonds with the same tenor) widening over the next few quarters. Credit spreads began to widen in the second quarter of 2012, ending a period of successive narrowing since late 2009. Taiwan Ratings Corp. believes that wider spreads will make it more difficult for issuers with weaker credit profiles to issue bonds at a favorable price. However, we expect continued high issuance from issuers with stronger credit profiles to prevent a substantial decline in the volume of new bonds over the next few quarters. Taiwan's bond market actually grew moderately in the first half of 2012 despite the weak local economy.

In addition, we expect the prevailing low interest rates and lower bond yields to attract new issuers to local bond and debenture markets in the second half. This is despite our expectation of heightened credit risks and widening credit spreads, which our increasingly negative rating bias on rated bonds reflects. However, not all issuers are likely to benefit from the market's current abundant liquidity. In the corporate bond market, in particular, investors remain wary of the heightened credit risk associated with issuers with weaker credit profiles.

### Overview:

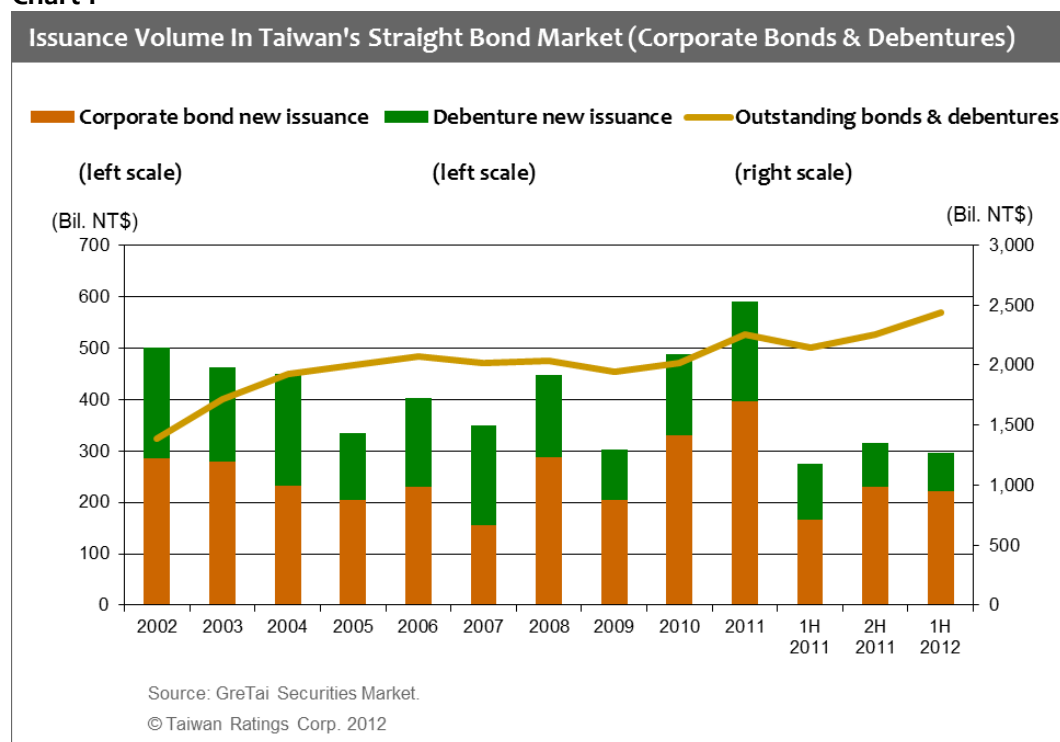
- Credit spreads are likely to further widen amid Taiwan's faltering economic recovery.
- Economic uncertainty increases the difficulty for lower-rated issuers to raise funds through bond issues.
- Higher-rated issuers will continue to dominate Taiwan's bond market over the next two quarters, preventing a substantial decline in the total volume of new bonds.
- Taiwan's convertible bond market is likely to contract further over the next two quarters.

### Economic Uncertainty Could Slightly Reduce New Bond Issuance Over The Next Few Quarters

In our view, the weak economy will constrain growth in Taiwan's bond markets because of businesses' reduced capital demands to support their expansion over the next two quarters. According to Standard & Poor's Ratings Services, Taiwan's GDP is likely to grow 1.7% in full-year 2012, a significant drop from 4% growth in 2011 (for more information see "**Asia-Pacific Real GDP Growth Forecasts: Economic Uncertainties Continue**," June 12, 2012). This somewhat bleak outlook could result in more conservative capital spending in the corporate sector. Meanwhile, heightened credit risks look set to further dampen investors' interest in lower-rated corporate bonds.

Nonetheless, we expect strong liquidity in Taiwan's financial systems and the current low interest rates to help sustain new issuance in Taiwan's straight bond market (corporate bonds and debentures) in the second half of 2012, particularly from higher-rated issuers (see chart 1). Despite the weak macro economy, the amount of new corporate bond issuance grew substantially in the first half of 2012. This was because companies with a high credit standing took advantage of prevailing low bond yields to increase their bond issuance at a lower funding cost.

**Chart 1**



We expect the implementation of stricter regulations on local banks' subordinated debentures under the Basel III accord to constrain financial debenture issuances starting in 2013. In order to meet the BASEL III requirement, banks' subordinated debentures must embed several features similar to those for equities, which will likely result in lower ratings and higher funding costs. Nonetheless, we believe there could be a slight increase in debenture issuance in the second half of 2012 from banks seeking to enhance their official capital adequate ratio under the more advantageous current regulations.

We also expect higher-rated domestic issuers to continue to dominate corporate bond and financial debenture issuances over the next few quarters amid continued investor caution about the local economy (see charts 2 and 3). We assigned a 'twAA-' or higher rating on about 80% of the corporate bonds and financial debentures that we rated in the first half of 2012. About 70% of issuances with 'twBBB' ratings were from financial holding companies, and the lower ratings mainly reflected the holding company's subordination to core subsidiaries and the bond's deferred clause terms. The remaining issuances were from smaller domestic banks. Nonetheless, these lower-rated issuances carry significantly higher bond yields, averaging 50-100 basis points (bps) above those of higher-rated bonds.

Chart 2

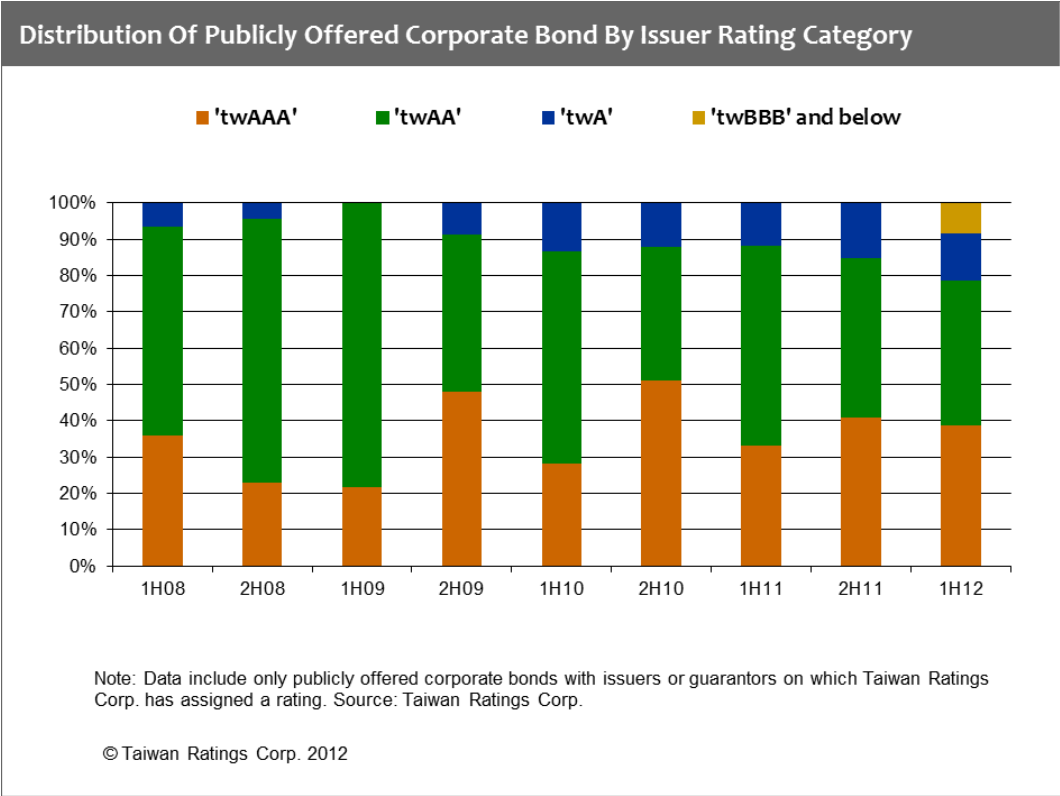
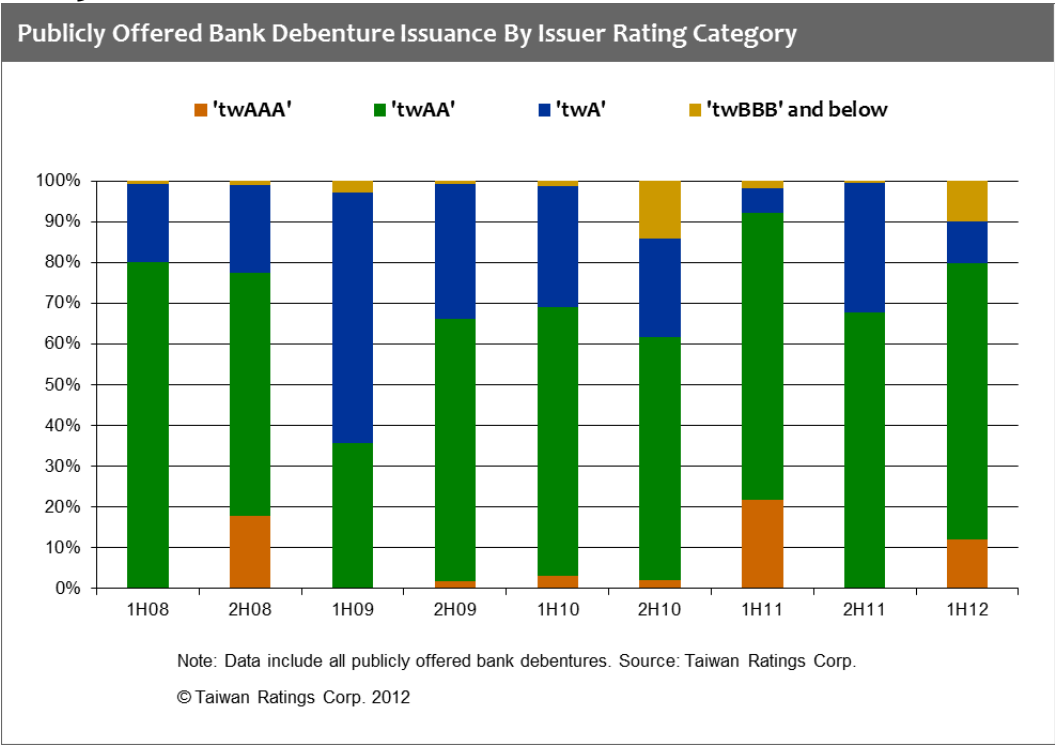


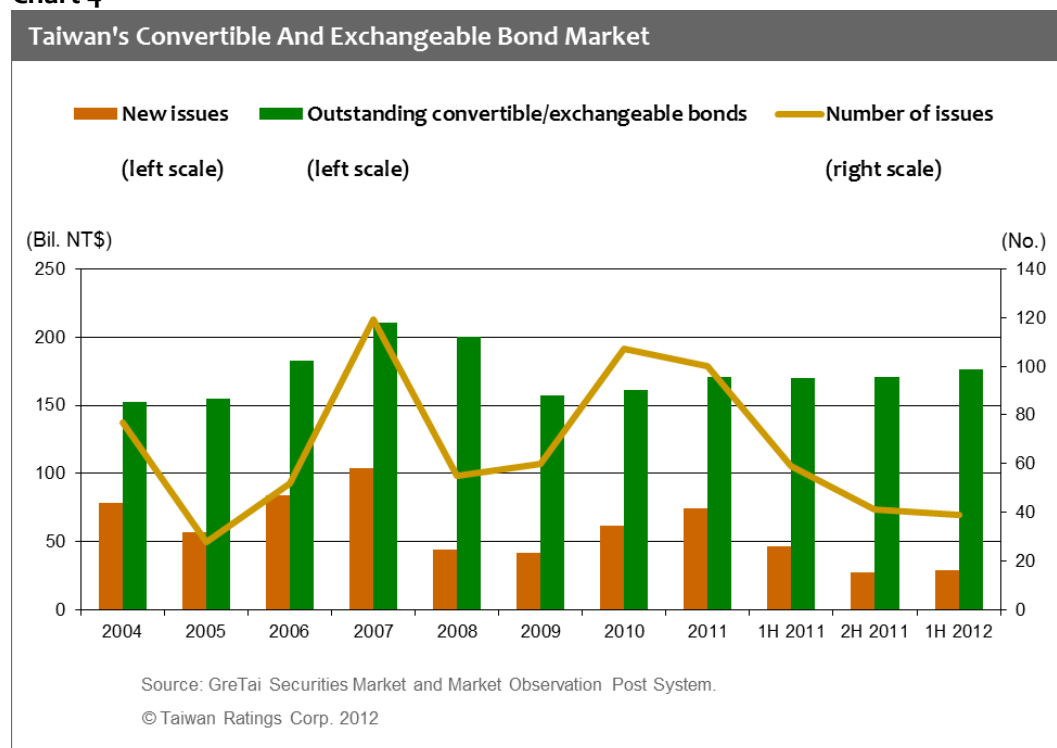
Chart 3



## Taiwan's Convertible Bond Market Remains Sluggish

Convertible and exchangeable bond issuance could diminish over the next few quarters given local investors' increasing risk aversion. Convertible bonds offer holders the option to exchange the bond for a specific amount of the issuing company's preferred stock or common stock at a predetermined price, while the underlying asset of an exchangeable bond may be the preferred stock or common stock in a subsidiary or affiliate of the company. Convertible bond issuers are generally emerging companies with good equity market outlooks but weaker credit profiles, which makes them less favorable to investors when market sentiment turns more conservative. The number and amount of new convertible bonds issued in Taiwan in the first half of 2012 dropped by over one-third compared to that in the same period in 2011 (see chart 4).

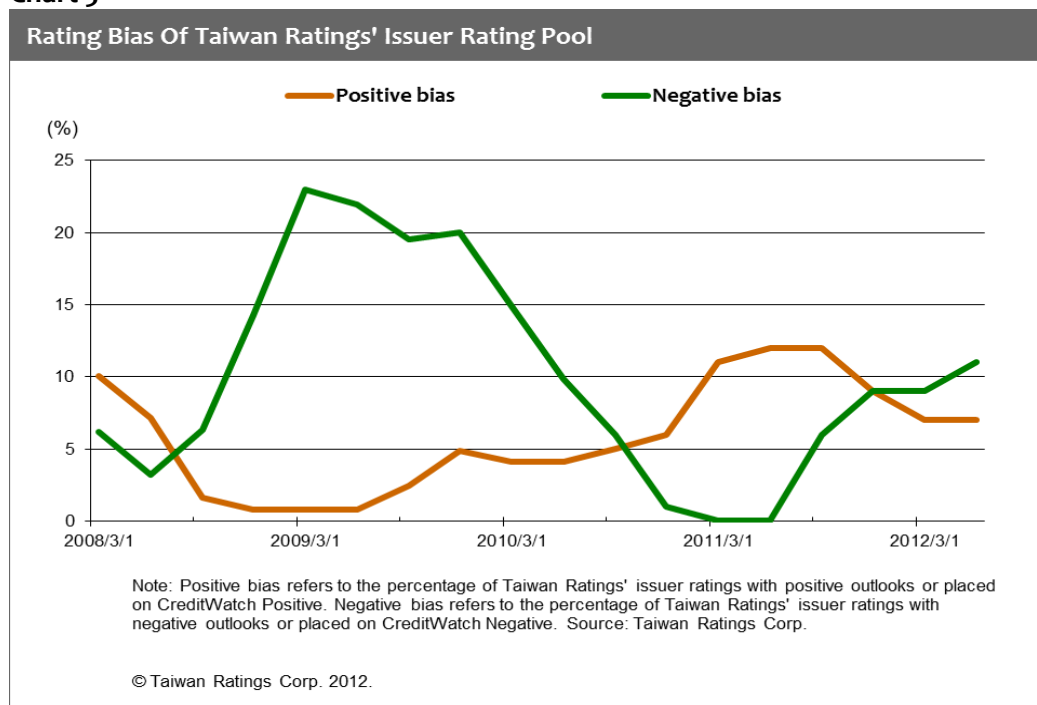
Chart 4



## Our Increasingly Negative Rating Bias Reflects Weaker Credit Profiles And Widening Spreads

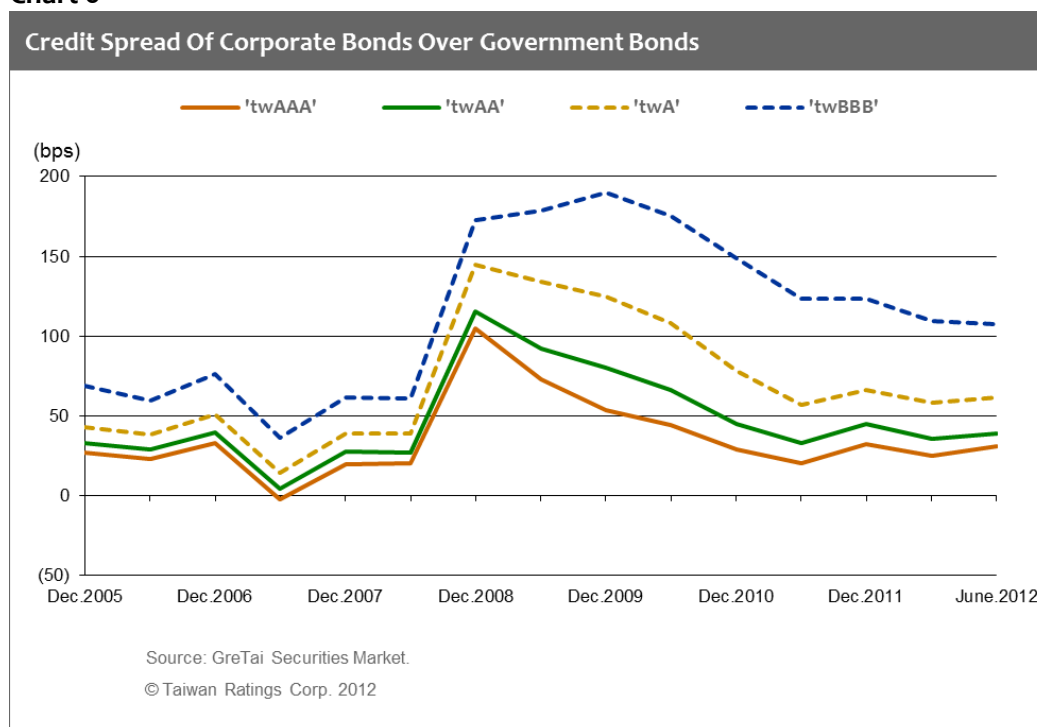
We expect credit spreads to continue to widen over the next few quarters as global economic uncertainty continues to weaken local corporate credit profiles. The percentage of issuer ratings with negative outlooks in Taiwan Ratings' rating pool has increased significantly in the 12 months through July 2012, reflecting these obligors' deteriorating credit profiles (see chart 5). This increase in our negative rating bias has been more pronounced in corporate sectors that rely heavily on export activities.

Chart 5



The spread between five-year corporate bonds (including debentures) and government bonds with the same tenor has widened since the second quarter of 2012 amid growing market concern about the global economy (see chart 6). Over the next few years, credit spreads are likely to remain noticeably higher than they were before early 2008, when significant volatility hit the global financial markets.

Chart 6



## Market Volatility Is Unlikely To Ease Over The Next Few Quarters

We expect the performance of Taiwan's bond market to remain volatile over the next few quarters until momentum in the global economy restores. The current weak global economic outlook threatens to exacerbate credit risks in Taiwan's export-driven economy, which could further erode the credit quality of key financial and corporate sectors. Accordingly, we expect local issuers with weaker credit profiles to be at most risk from ongoing economic uncertainty. Meanwhile, higher-rated issuers will remain more attractive to investors, allowing them to take continued advantage of low interest rates to support their funding needs in the second half of 2012. Nonetheless, we also believe that strong liquidity in Taiwan's financial system will prevent credit spreads from rising sharply. In addition, the Taiwan government's actions to stabilize the economy through flexible monetary policies will help to alleviate the market's growing risk aversion, in our view.

## Related Criteria And Research

- **Asia-Pacific Real GDP Growth Forecasts: Economic Uncertainties Continue**, June 12, 2012
- **Asia-Pacific Markets Outlook: Banking In 2012**, March 29, 2012
- **Sector Review: Taiwan's Bond Market Faces Higher Credit Spreads And Slower Issuance In 2012**, [rss.taiwanratings.com.tw](http://rss.taiwanratings.com.tw), March 15, 2012
- **Report Card: Asia-Pacific Sovereigns: Mixed Outlook In An Uncertain Year**, March 5, 2012
- **A Slowdown In Europe And China, And Sluggish Exports Moderate Asia-Pacific Credit Outlook In 2012**, Dec. 20, 2011
- **Growing Global Risks Eclipse Asia-Pacific Economic Growth in 2012**, Dec. 16, 2011

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