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Rating Research Services

Executive Comment:

Volatile Global Markets Could Slow Growth In Taiwan Bond Issues

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Tepid global economic recovery coupled with bond market uncertainty over when the U.S. Federal Reserve will back off its quantitative easing measures could constrain new bond issuance in Taiwan over the next two quarters. New issuance volume dropped noticeably year-on-year in the first half of 2013, with a particularly sharp drop in June 2013. Taiwan Ratings Corp. also believes the likelihood of lukewarm economic growth in Taiwan and major Asian countries will somewhat soften domestic demand for corporate bonds to fund business expansion over the next few quarters.

However, we believe that credit spreads (the yield difference between five-year nongovernment and government bonds) are unlikely to change markedly over the next six months. We base this view on our assessment of Taiwan's generally stable credit environment as well the majority share of domestic investors in the local bond market. Nevertheless, we expect the government benchmark rate to climb along with increases in global bond rates, though to a lesser extent. This could result in a potential rise in borrowing costs for issuers over the next few quarters.

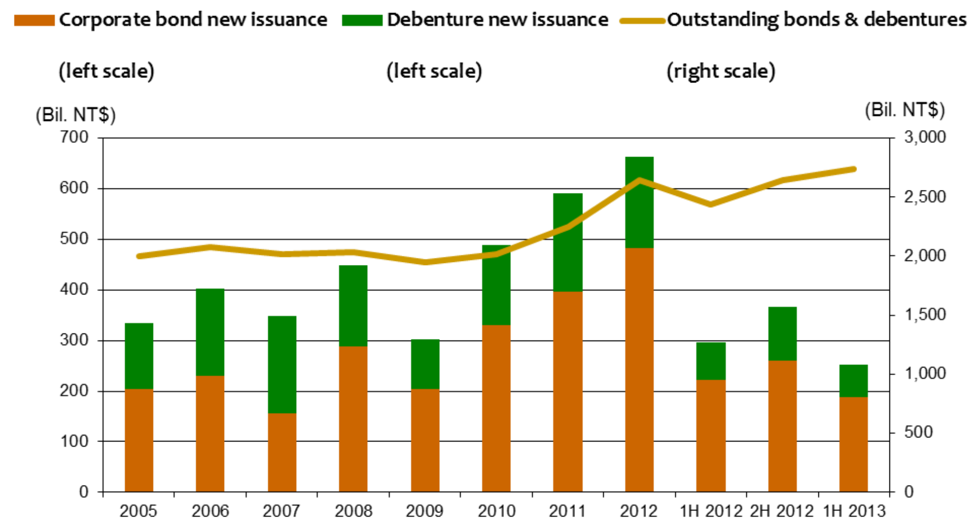
Overview:

- Fluctuating bond performance in global markets and a tepid economic growth outlook for the second half of 2013 will slow domestic new bond issuance.
- Long-term growth prospects for the recently launched Formosa bond market are uncertain.
- Higher-rated issuers still dominate the local bond market, while lower-rated issuers face obstacles in issuing bonds at a favorable rate.
- Credit spreads are likely to be less volatile than those in overseas markets.

Global Market Volatility Could Slow New Bond Issuance In Second-Half 2013

Despite the limited linkage of international financial market performance with Taiwan's bond market, we believe recently rising volatility in global bond markets could somewhat discourage new domestic bond issuance in the second half of 2013. Global bond market volatility has increased markedly since May 2013, as seen in the sharp rise in U.S. government and corporate bond yields following the Fed's announcement of a possible winding down of its quantitative easing program in the next 12 months. Taiwan issuance is likely to remain low in the second half also because interest rates could start to rise, and local investors remain risk-averse. New bond issuance dropped 15% year-on-year in the first half of 2013, with June being particularly slow following the Federal Reserve's hint that quantitative easing could be wound down next year (see chart 1).

Chart 1
Issuance Volume In Taiwan's Straight Bond Market (Corporate Bonds & Debentures)



Source: GreTai Securities Market.
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In addition, we expect tepid economic growth in Taiwan and neighboring export markets to somewhat hinder further capital expenditures in the second half of 2013. Standard & Poor's Ratings Services forecasts moderate GDP growth of 2.8% for Taiwan in 2013. At the same time, the rating agency revised down its forecast on China's GDP growth from 8% to 7.3% in 2013 (see "Credit Conditions: Increased China Downside Risk Dampens Asia's Growth," published on RatingsDirect on July 30, 2013). The continued decline in economic activity in China is the main risk we see for the Asia Pacific credit condition to weaken. Together with a potential rise in borrowing costs, we expect that bond issuers will be relatively hesitant over the next few quarters.

We believe that banks' need to strengthen their capital under stricter Basel III capital requirements will sustain bank debenture issues over the next few quarters compared to the expected slowdown in new corporate bond issuance. Under Basel III, banks' subordinated debentures must embed several features similar to those of equities, including a non-viability clause, which result in lower ratings because we notch down such hybrid issues by two notches from the issuer's standalone credit profile ratings (see "Credit FAQ: How A Debt Issue Rating Differs From An Issuer Credit Rating," published on Rating Research Services on July 29, 2013). A non-viability clause stipulates what action should be taken in the event the bank is in breach of or about to breach the regulatory requirement for its license. However, the market views the likelihood of non-viability as relatively low given the current credit conditions in Taiwan.

Uncertain Growth Prospects For RMB-denominated Formosa Bond Market

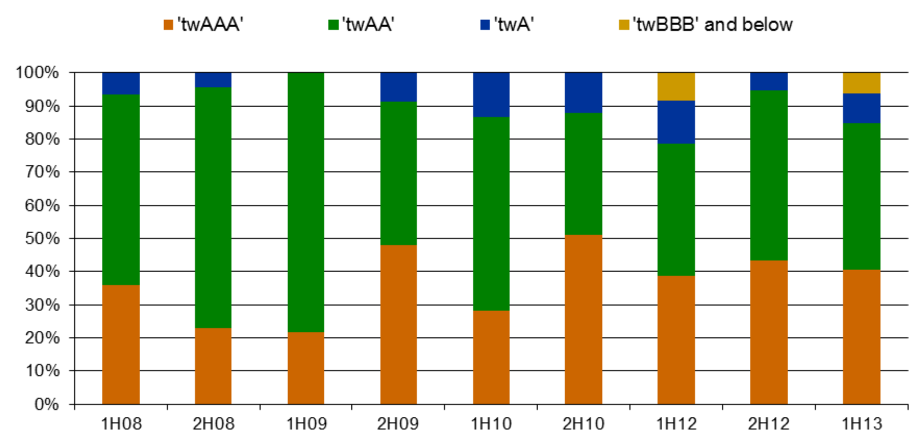
Chinese renminbi (RMB)--denominated Formosa bonds debuted in Taiwan's capital market in the first half of 2013 and quickly earned investor popularity amid widening deregulation of offshore RMB banking and increasing market demand for RMB-dominated investments. New issuance was relatively strong, with five new issues totaling RMB 3.9 billion by the end of the second quarter.

However, we believe it will take time to ascertain the long-term growth prospects for the Formosa bond market. The Formosa bonds will need to attract a growing and diversified array of issuers, as well as offer an expanded range of issue credit quality through the established regulatory structure to compete with other offshore Chinese RMB-denominated bonds such as the Dim Sum bond (RMB-denominated bonds issued in Hong Kong's capital market). Meanwhile, the potential for the RMB to appreciate and uncertainty over China's economic growth prospects will also play an important role in the demand for such bonds from potential investors.

Markets Continue To Favor Higher-Rated Corporate Bonds

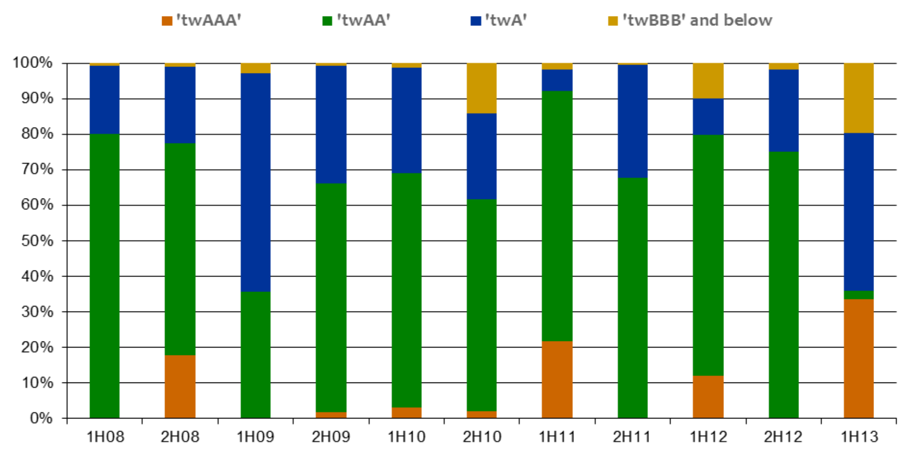
We expect higher-rated corporations to continue to dominate corporate bond issuance while lower-rated bonds will remain limited under the current economic climate and investors' risk aversion. Over 85% of the corporate bonds and 80% of debentures on which Taiwan Ratings assigned ratings in the first half of 2013 received a 'twAA-' rating or higher, which included bonds with strong creditworthiness issued by **Taiwan Power Co.**, **Taiwan Semiconductor Manufacturing Co. Ltd.** (TSMC) and **HSBC Bank (Taiwan) Ltd.** Lower-rated ('twBBB' and below) corporate bonds and financial debentures began to test market sentiment in 2012, and several were issued in the first half of 2013. These generally carried bond yields averaging 100-150 basis points (bps) above those of higher-rated bonds (see charts 2 and 3). However, we expect local investors' smaller risk appetite for speculative-grade bonds to limit demand for such lower-rated issues over the next few quarters.

Chart 2
Distribution Of Publicly Offered Corporate Bond By Issuer Rating Category



Note: Data include only publicly offered corporate bonds with issuers or guarantors on which Taiwan Ratings Corp. has assigned a rating. Source: Taiwan Ratings Corp.

Chart 3
Publicly Offered Bank Debenture Issuance By Issuer Rating Category

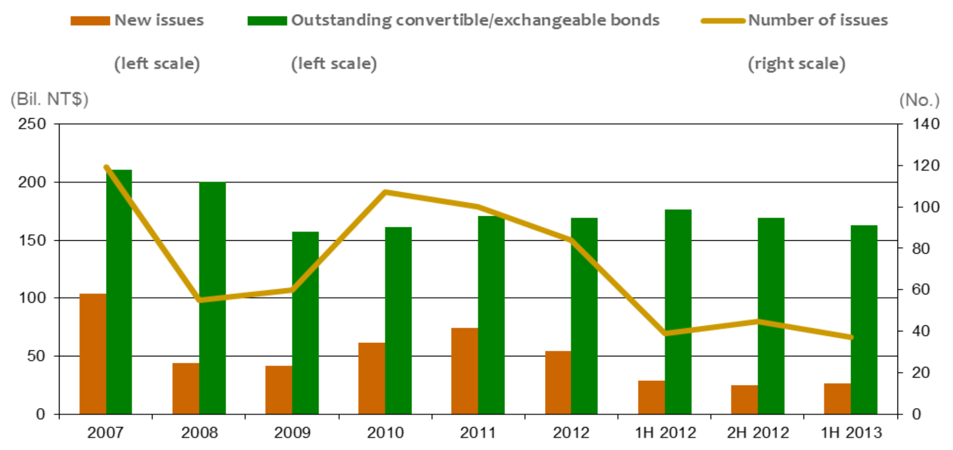


Note: Data include all publicly offered bank debentures. Source: Taiwan Ratings Corp.

Taiwan's Convertible Bond Market Is Unlikely To Bounce Back Soon

The island's convertible and exchangeable bond market is unlikely to make a full recovery in terms of issuance volume until local investors grow less risk-averse to issuers with weaker credit profiles. The amount of new convertible bond issuance dropped by 8% in the first half of 2013 compared to the same period in 2012 (see chart 4), and we expect full-year 2013 issuance to be on par with that in 2012. 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 bonds are mostly issued by emerging companies with good equity market outlooks but with weaker credit profiles that make them less attractive to investors when markets turn more conservative.

Chart 4
Taiwan's Convertible And Exchangeable Bond Market

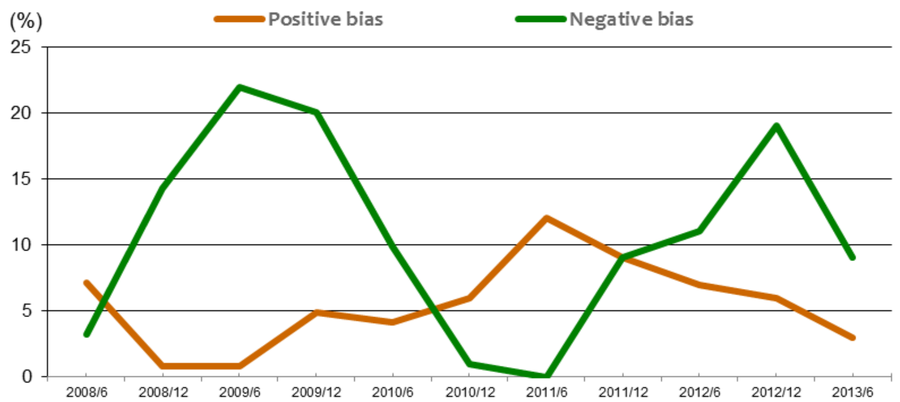


Source: GreTai Securities Market and Market Observation Post System.

Taiwan's Credit Spreads Are Less Volatile Than Those In Overseas Markets

The credit quality of most of our rated issuers remained stable in first half of 2013, underpinned by Taiwan's relatively steady economy. Our rated pool of corporate and financial services issuers displayed a slightly negative bias of 9% at the end of June 2013 (see chart 5) but continued to be below the five-year average of 12%. The level of negative rating bias was also significantly below the 19% level for the second half of 2012. The decrease was mainly due to our outlook revision on some insurance companies from negative to stable in June 2013. This reflected our view that the possibility of a rating cut as a result of industry challenges on Taiwan life insurers has moderated following the introduction of a formal framework of assessing insurance industry country risks under our revised methodology on rating insurers.

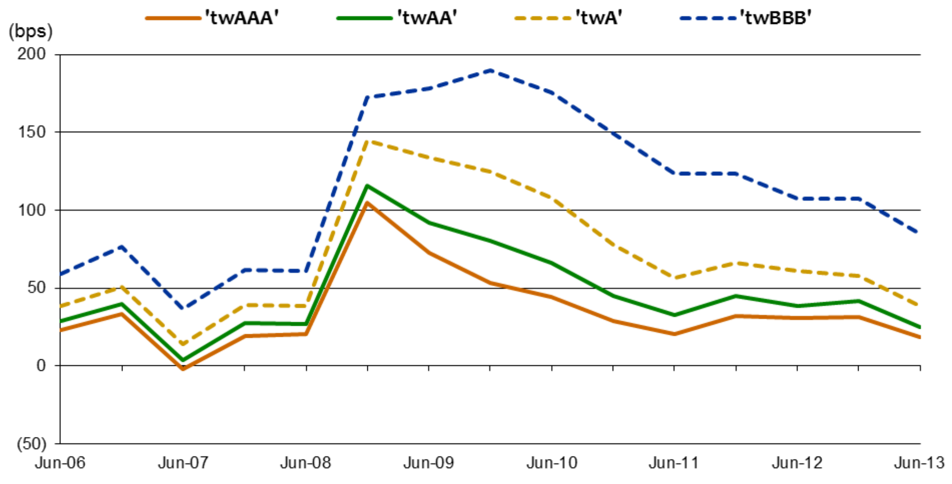
Chart 5
Rating Bias Of Taiwan Ratings' Issuer Rating Pool



Note: Positive bias refers to the percentage of Taiwan Ratings' issuer ratings with positive outlooks or placed on CreditWatch Positive. Negative bias refers to the percentage of Taiwan Ratings' issuer ratings with negative outlooks or placed on CreditWatch Negative. Source: Taiwan Ratings Corp.

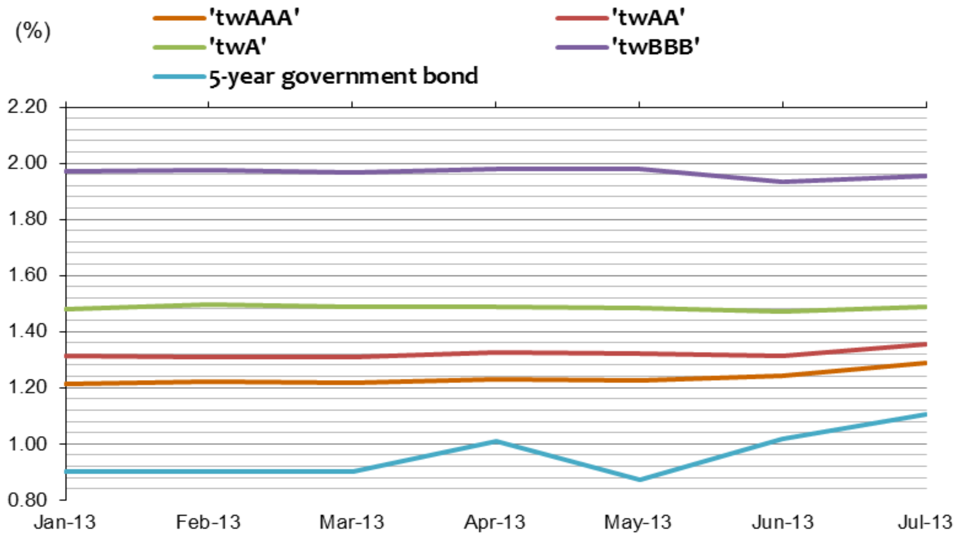
We don't expect credit spreads between five-year corporate bonds (including debentures) and government bonds to keep narrowing in the second half of 2013 due to growing volatility in the global capital markets and the market's expectation of rising interest rates over the next few quarters. Moreover, we believe the movement of credit spreads will remain limited compared to the global average. This is partially due to limited foreign investments in New Taiwan dollar-denominated bonds, as well as Taiwan central bank's adequate management on the foreign exchange market that largely shields the local market from international financial market fluctuations. The credit spread between five-year corporate bonds (including debentures) and government bonds has been relatively stable over the past year. However, the five-year government bond yield rose in the second quarter of 2013 as a result of short–term trading volatility (see charts 6 and 7).

Chart 6
Credit Spread Of Corporate Bonds Over Government Bonds



Source: GreTai Securities Market. © Taiwan Ratings Corp. 2013

Chart 7
5-Year Corporate Bond Yield Versus Government Bond Yield in 1H13



Source: GreTai Securities Market. © Taiwan Ratings Corp. 2013

Taiwan's Strong Market Liquidity Tempers Most Bond Market Volatility

We expect less volatility in Taiwan's bond market compared to the global bond market over the next few quarters, thanks to strong liquidity in Taiwan's financial system and limited foreign investments. Despite the risk that potential interest rate fluctuations could deter new bond issuance in late 2013, we expect most Taiwan-based corporations and financial institutions will maintain adequate access to liquidity from the island's competitive banking sector. This in turn could help the island's businesses avoid immediate financial stress if their respective markets deteriorate suddenly.

Related Criteria And Research

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- **The Fed's Possible Taper Hits Bond Returns Like A Hammer, July 3, 2013**
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