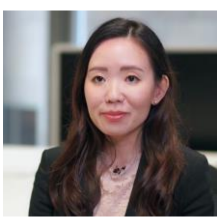
Asia credit update

An expanding opportunity set

March 2019

Asian credit started the year on a strong footing, returning 3.9% on total return terms (as of 18 March), with Asian high yield outperforming Asian investment grade. One of the factors attributing to the change in market sentiment has been a shift in China's policy direction, which is now targeting economic growth rather than deleveraging. However, given the strong performance so far this year, we are expecting greater differentiation in credit risk pricing going forward and for credit selection to remain key to outperformance.



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Year-to-date market review and strategy

The Asian credit market year-to-date has been strong, especially for high yield corporate bonds which have seen spreads tighten by 102bp to 519bp (as of 18 March). Investment grade corporate bonds have also done well, with spreads narrowing by 19bp to 209bp. This follows the year of 2018 where the Asian credit markets saw spreads widen by 69bp amid a US rate hiking cycle and concerns on slowing growth in China.

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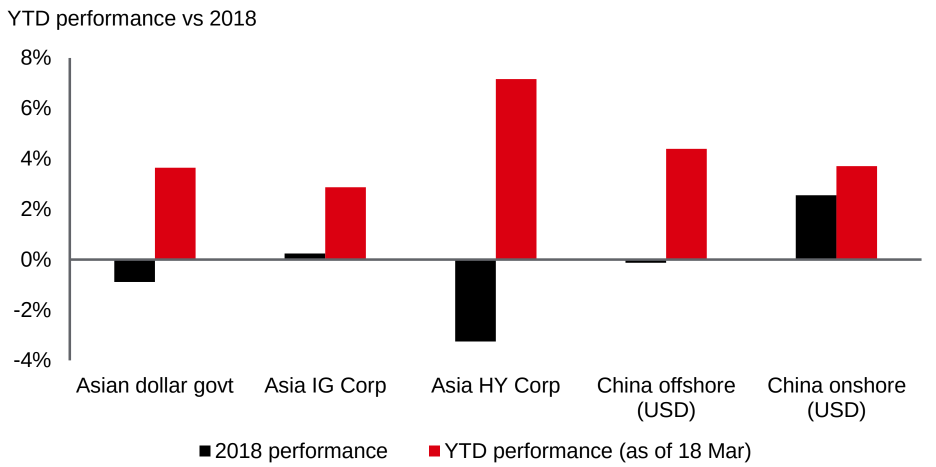
In 2019, two key developments have supported the Asian credit markets – investors have re-priced the path of US Fed rate policy and Chinese authorities have turned policy focus to boosting economic growth. In total return terms, the Asian credit market has already more than recouped the losses from 2018, rallying 3.9%, with investment grade corporates rising 2.9% and high yield corporates up 7.2%.

Figure 1: Performance of Asian fixed income markets



Source: Bloomberg, BAML as of 18 March 2019. Investment involves risks. Past performance is not indicative of future performance.

The change in the expectations around the Fed's rate hiking path has taken the pressure off emerging market currencies, which had experienced a dollar shock in 2018. This more favourable backdrop for emerging market currencies also means that we are now able to find more attractive opportunities in emerging Asian markets. In Indonesia, for instance, we are finding opportunities in quasi-sovereigns and high yield property, and in India, we favour investment grade Indian oil & gas and utility names. Meanwhile, we continue to like select Chinese property names, due to the shift in policy focus in China and also due to attractive relative valuations.

Valuations have cheapened since May 2018. Despite the year-to-date rally, we think valuations are at attractive levels overall, with Asian credit yields still trading above the five-year average. Asian credit continues to offer a yield premium with lower duration as compared to other global markets; yields for Asia IG corporates are trading about 360bp above Europe IG and 70bp above US IG. Similarly, Asia high yield corporates are trading at 380bp and 90bp above Europe HY and US HY respectively.

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China: Supportive policy alleviating refinancing pressure for corporates

The environment for China credit so far this year has been rather different from what we saw in 2018. The focus has shifted away from deleveraging and the government is now placing more emphasis on economic growth: we saw an indication of this right off the bat when the PBoC cut the RRR by 100bp in early January 2019.

We have seen measures aimed at lowering the funding costs in the economy

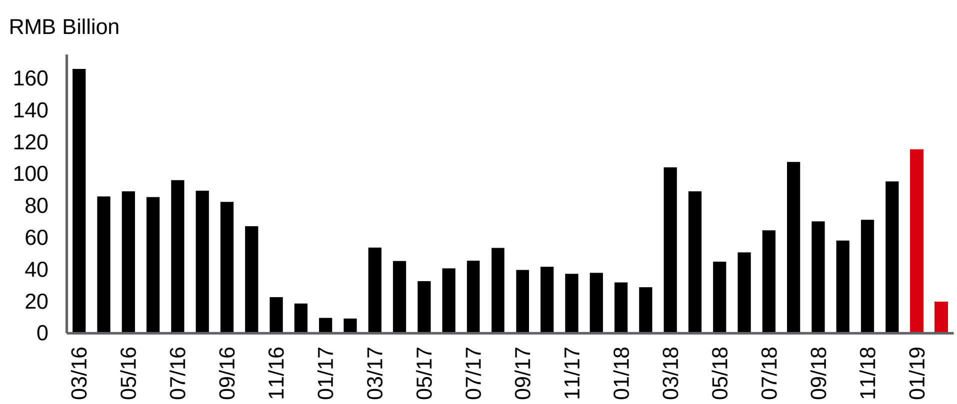
In addition, we have seen other measures aimed at lowering the funding costs in the economy and a policy focus on facilitating greater credit transmission to the private sector. The government work report for 2019 also explicitly urged the use of quantitative and pricing instruments to encourage banks to increase credit extension and lower borrowing costs of the real economy. As such, we expect the PBOC to keep liquidity ample in the financial market and to potentially introduce more incentive policies for lending to small and medium enterprises (SME). We also expect more proactive fiscal policy and increased local government bond issuance.

As onshore liquidity improves, the new issuance bond market onshore is also picking up.

As onshore liquidity improves, the new issuance bond market has also been picking up. Refinancing channels are more accessible as compared to 2018 and even lower rated corporate bond issuance has improved, reflecting Chinese authorities' efforts to channel credit to the real economy. Loosening conditions for onshore funding is a positive development for the offshore USD China bond market for two reasons. First, lower funding costs onshore provide greater incentive for issuers to also issue bonds in the onshore market, thereby easing the supply pressure in the offshore market. Secondly, lower onshore yields would increase the appeal of offshore bonds, which can lead to increased demand for offshore bonds from onshore investors – onshore investors have grown to become a major investor group for Asian credit.

In China, we prefer top tier SOEs as they have attractive yields and are benefiting from the reduced focus on deleveraging in China. We also like select Chinese high yield property names: Chinese property has seen its share of turbulence in 2018 but has rallied year-to-date. Despite the rally, demand continues to be strong and valuations remain attractive. While sector fundamentals are stable, we can expect to see some level of divergence between the large and small property developers going forward.

Figure 2: Active issuance for onshore Chinese property issuers



Source: Bloomberg, HSBC Global Asset Management, as of 26 February 2019

Indonesia: Improved outlook for high yield credit

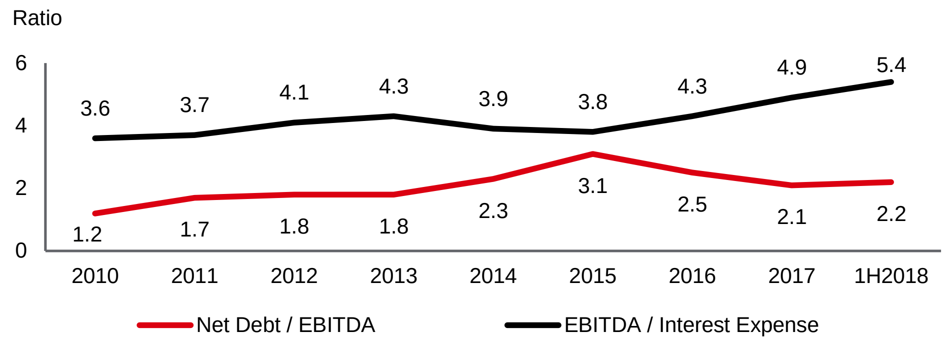
Amid a near-term dovish US Fed tilt, there is scope for Bank Indonesia (BI) to adopt a more neutral stance, particularly as Indonesia's yield spreads over US Treasuries remain attractive. The outlook for emerging market currencies, including the IDR, has improved along with the change in market expectations in the path of US Fed rate policy.

We believe that Indonesian high yield credit is likely to benefit from the stabilised IDR given its traditionally high correlation with the currency.

We believe that Indonesian high yield credit is likely to benefit from the stabilised IDR given its traditionally high correlation with the currency. Additionally, current valuations are particularly compelling for Indonesia high yield, which saw a significant correction in 2018 but have recovered somewhat year-to-date. Credit fundamentals of Indonesia high yield have also been improving with stable net leverage, improving interest service and lower interest expense.

We favour quasi-sovereign and corporate bonds over sovereign bonds in Indonesia. We remain selective in the corporate space, favouring names with solid credit fundamentals, particularly in the high yield property sector.

Figure 3: Net leverage and interest coverage ratios of Indonesia high yield



Source: JP Morgan as of January 2019

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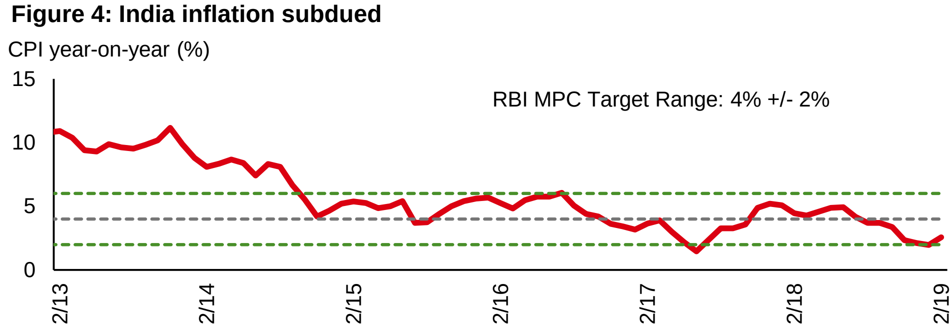
India: Favourable monetary and fiscal policy backdrop for credit

In India, we have seen a largely favourable turn of events with a more dovish monetary policy stance undertaken by its central bank coupled with an expansionary interim budget, both of which are generally supportive of credit. In February, the Reserve Bank of India (RBI) changed its policy stance from "calibrated tightening" to "neutral" and unexpectedly cut the repo rate from 6.50% to 6.25%. The central bank also lowered its inflation projections, with balanced risks. The rate cut opens the door for further accommodation and points to the RBI's focus on addressing growth – although remaining a secondary objective to price stability. We believe a more accommodative stance in monetary policy should help liquidity and therefore credit in general for Indian credit.

Figure 4: India inflation subdued



Source: Bloomberg as of February 2019.

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In India, we retain our overweight in commodity related sectors, favouring names with solid credit fundamentals and attractive yields.

Uncertainties surrounding the upcoming general election can potentially to add to volatility in this market. Current valuations of Indian corporates are somewhat reflecting the higher macro risk expected in 1H2019. We are keen to search for opportunities with strong credit profiles in this market to further diversify our portfolio holdings.

Within India, we like investment grade corporate names as they are likely beneficiaries of the improved fund flows from global investors as sentiment towards emerging markets continues to improve. In particular, we favour the utilities sector for its defensive nature. We also like oil & gas names given reduced policy risk as oil prices stabilise. At the same time, we also retain our overweight in commodity related sectors (particularly the steel sector), favouring names with solid credit fundamentals and attractive yields.

Other opportunities

Elsewhere, we like select opportunities in emerging market sovereign bonds, including markets such as Pakistan and Sri Lanka. We believe these bonds are offering attractive yields, and at the same time, sovereign risks have improved over the past few months. For instance, Pakistan's key concerns are around macro stability risks, but liquidity support coming from various countries are easing near-term funding pressure, which is giving the government more time to negotiate an IMF programme. In Sri Lanka, we are expecting a resumption of the IMF programme, which was suspended in Q4 2018 due to the political crisis.

We are also looking at opportunities in high-yield-like securities, particularly those issued by stable investment grade names. For instance, we favour subordinated debt issued by banks with strong capital to take advantage of their capital structures. Other areas include corporate perpetuals with high steps ups.

Summary

We expect the market to see greater differentiation in credit risk pricing going forward.

Even though recent macro developments have created a favourable backdrop for Asian credit, particularly as concerns around refinancing have eased considerably, defaults in Asia are expected to continue in 2019. We may see a greater number of smaller sized defaults this year as compared to 2018, which would potentially result in a similar default rate as 2018. Whether the market can sustain the strong performance so far this year is also in question. We believe the market will see greater differentiation in credit risk pricing going forward. All this paints a strong case for an investment approach that incorporates a proven credit research process. Our Asian credit strategy combines macro views with bottom up credit analysis, which is supplemented by rigorous credit selection, that aims to take advantage of mispricing opportunities. This, we believe, remains critical to outperformance.

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