One-on-one interview

Asian high yield strategy: Positioning for the win

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Head of Asian Credit

Following a volatile year of rising US Fed rates, emerging market vulnerabilities and geopolitical uncertainties, Asian high yield has emerged a very attractive asset class. In this interview, Alfred Mui, Head of Asian Credit, discusses his views on the Asian credit markets going into 2019, fundamentals in the Asian high yield space, and the investment opportunities he is seeing.

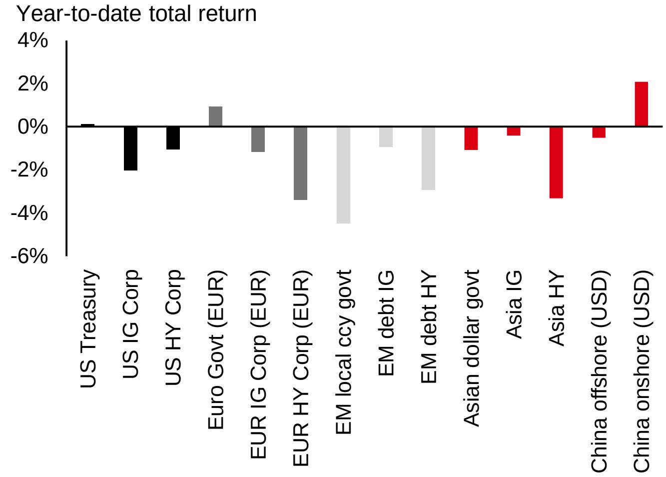
2018 has been an eventful year for Asian credit markets. Can you break it down for us?

Global markets saw a re-pricing of US rates along with the strengthening of the US dollar in 2018. These key macro events brought the US 2-year bond yields to 2.64%, which is 76bps wider than the beginning of the year. The appreciation of the US dollar against most other major currencies resulted in a dollar shock for emerging market investors. Other emerging market vulnerabilities also came to light, adding to volatility amidst an already tense backdrop of geopolitical uncertainties.

In the Asian credit market, spreads widened by 64bp to 287bp (as of 19 December), while spreads for the Asian high yield market widened by 165bp to 602bp. Earlier in July, spreads did come in, particularly in the high yield space, but began to widen again in October, with weakness in part driven by concerns over China's growth moderation, still tight credit conditions in China, trade tensions, US dollar strength, and secondary market re-pricing due to heavy primary supply pipeline.

In total return terms, the Asian credit market is down 1.1% year-to-date (as of 19 December). The Asian investment grade market remained relatively resilient and is down 0.4% year-to-date, while the Asian high yield market was more badly hit – down 3.3%.

Fig 1: 2018 has been a challenging year for fixed income



Source: Bloomberg, BAML as of 19 December 2018. Investment involves risks. Past performance is not indicative of future performance

Is the performance of the Asian high yield market this year reflective of its fundamentals?

While emerging markets have experienced a host of shocks in 2018, Asian credit has been less volatile than other emerging market peers, and at times, even less volatile than US peers; a strong local investor base is one of the reasons for Asia's relatively lower vulnerability to the shift in emerging market sentiment.

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Another factor that has helped Asian economies weather the recent geopolitical uncertainties has been their solid economic position. When compared to the taper tantrum in 2013, for instance, Asian economies are mostly stronger today, with manageable external debt, reduced fiscal shortfalls, and mostly better current account balance. Inflation outlook remains benign in most economies in the region. There has also been a rebuilding of foreign exchange reserves, and these economies should be more resistant against external shocks now.

Despite the negative performance of Asian high yield in 2018, fundamentals of the asset class are on an improving trend, with lower leverage and higher interest coverage (see Figure 2). Overall cash to total debt should help with issuers' repayment capabilities in funding markets experiencing heightened market volatility.

Defaults in the Asian high yield space have increased as compared to the previous year, but the biggest contributions to the default rate in 2018 were from two large issuers. And while these two defaults brought the default rate up to 2.4% in 2018, we believe the defaults this year are not systemic in nature. Despite this rise in default rate, there is evidence of improving balance sheet strength in high yield corporates in general, along with favourable macro fundamentals and more policy easing measures. Against this backdrop, we are seeing more mispricing opportunities, which can be exploited with the rigorous credit selection involved in our investment process, one that combines macro view on sector/industry with bottom up credit analysis.

Fig 2: Improving corporate fundamentals in the Asian high yield market

	Net debt / EBITDA	EBITDA / Interest expense	Cash / Total debt
2016	4.7	2.6	31%
2017	4.3	3.1	31%
20181H	3.6	3.7	30%

Source: JP Morgan, as of November 2018

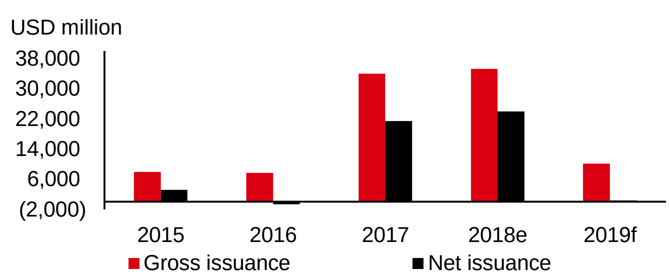
What is your view on the events surrounding the Chinese property high yield market?

Recent policies affecting property issuers in China and concerns over refinancing risks have impacted market sentiment for Chinese property bonds. With Chinese authorities tightening onshore liquidity, developers have been tapping the offshore dollar market, particularly as there is a large refinancing need. In June, we also saw regulators place restrictions on the usage of proceeds from offshore bonds issued by property developers; proceeds are not permitted to be used for domestic property projects or for working capital and should be used to repay debt. We are seeing that, under this market environment, it is difficult for property issuers of lower quality to obtain financing.

While Chinese property issuers can access the offshore US dollar market as a funding channel, whether or not they can obtain funding at reasonable spreads and durations is another question. In the last few months, we have seen a large amount of primary issuance of Chinese property bonds, some at high coupon rates that effectively re-priced the secondary market. In fact, 2018 marks a record year of offshore bond issuance from both investment grade and high yield China property developers, totaling year-to-date amounts of USD 9 billion and USD 35 billion respectively, although a much lower supply is expected for 2019. We think refinancing risk is contained as the government loosens its regulatory grip in the onshore funding market and as it addresses refinancing needs of private firms and SMEs with the roll out of more credit risk refinancing tools and the newly proposed "one two five" bank lending policy.

We still favour the Chinese property high yield market but are very selective – our credit selection has benefitted our strategy amidst the recent volatility. We like names in tier-1 and tier-2 cities that have shown a strong track record on execution and asset turnover.

Fig 3: Gross and net issuance of China property bonds expected to come down in 2019



Source: HSBC Global Research, as of December 2018

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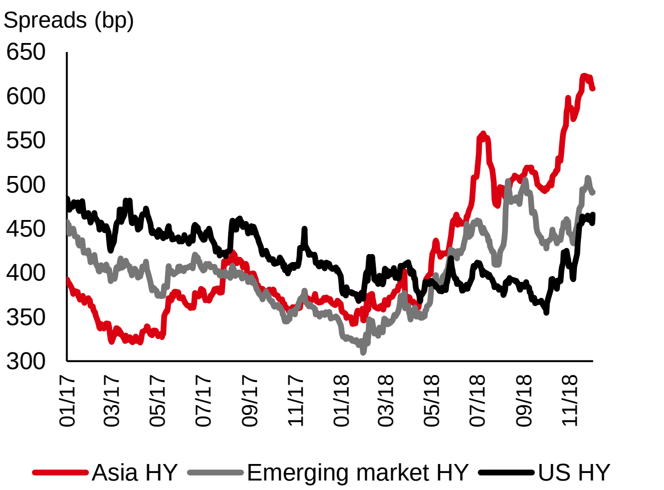
Following the correction in the fixed income markets this year, how are you seeing valuations in the Asian high yield space?

The valuation narrative is particularly compelling in the Asian high yield space, where corporate yields are at 8.96% – yields at this level are around 160bp above the 5-year average. These movements in yields have been occurring without any real change in the fundamentals – in fact fundamentals have been generally improving as compared to the end of 2017, which means that investors may now be getting paid more without a material increase in risk.

On a relative basis, the Asian high yield market is also attractive, offering a spread pickup over US peers of 143bp and over emerging market peers of 117bp (See Figure 4).

Fig 4: Asian high yield credit – attractive spread levels



Source: JP Morgan, as of 4 December 2018

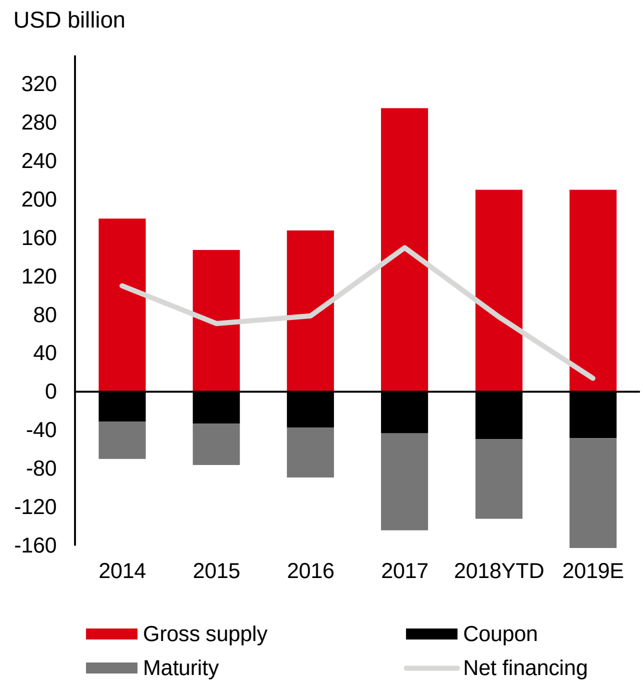
What is your outlook for 2019?

We are expecting to see a continuance of credit divergence in 2019 – as we saw in 2018 – where lower quality names were sold off while better quality names remained resilient. Defaults in the Asian high yield space should remain manageable, with more smaller-sized defaults, bringing the default rate to a similar level as 2018. Systemic crisis triggered by China defaults is also off the table, as the government continues to facilitate refinancing and focus on credit transmission. While US-China trade negotiation may remain an ongoing topic in 2019, opportunities should emerge from Asian countries that benefit from trade divergence and capital flows.

On the technicals side, we are expecting gross supply to remain similar to 2018, but are expecting net supply to be a lot lower than 2018 (See Figure 5).

Going into 2019, valuations and fundamentals of Asian high yield look very attractive, however, selection remains critical, both in sectors and bonds. Our strategy will focus on total returns, placing particular emphasis on credit selection. We remain prudent and vigilant in our Asian high yield strategy and are focusing on relative value opportunities rather than taking a directional bet.

Fig 5: Net supply expected to come down



Source: JP Morgan, as of November 2018

How are you positioning your high yield strategy in 2019? What investment opportunities are you seeing?

We are in favor of defensive sectors including utilities and stable industrials, while remaining cautious on commodities and cyclical sectors against an environment of global economic slowdown. We are also looking into high-yield-like securities issued by stable investment grade names but taking advantage of their capital structures (eg. bank subordinated debt).

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Another area where we are finding interesting opportunities is in EM sovereigns and quasi-sovereigns. These bonds may potentially benefit from market re-pricing of the US rates outlook and better EM prospects given their relatively longer duration versus corporate bonds. Investing in EM sovereigns/quasi-sovereigns brings additional alpha sources from duration and curve positioning strategies, resulting in a more flexible allocation strategy overall, which is capable of navigating different market environments. We believe this will be particularly beneficial in 2019 when the market potentially begins to price in a slowdown or even the end of the hiking cycle in the US.

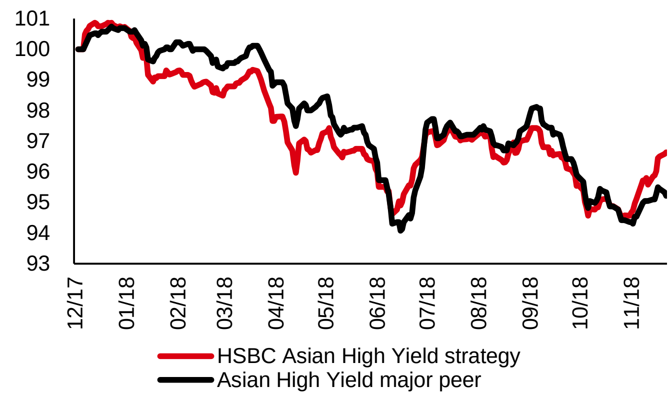
Regionally, we like Indonesia – its macro situation looks strong, and its fiscal prudence has helped the central bank maintain a flexible monetary policy; Indonesia's inflation has been below target and their FX management has been supportive. Within India, we have been reducing exposure to commodity names as well as banking names; however, we continue to hold short-dated healthcare and stable industrials. For China, we remain selective, but we like select Chinese property names and corporate perpetuals with high steps ups.

How is your Asian high yield strategy differentiated from your peers?

As we expect that defaults, while manageable, will continue in 2019, credit selection remains especially critical. Our Asian high yield strategy focuses on selecting the right bond and the right segment, and we are willing to forego opportunities in certain high yielding securities where the fundamentals do not match up. This approach and our focus on better quality non-investment grade bonds have benefitted us this year as broad based risk-off sentiment has resulted in increased credit differentiation in the market and we have been able to outperform some of our major peers. We also produce alpha from multiple sources, including from our duration strategy, curve positioning and currency exposure, ultimately contributing to optimal capital appreciation potential.

Fig 6: Performance comparison year-to-date

31/12/2017=100



Source: Bloomberg as of 18 December 2018. Peer selected is based on the largest competitor in the Asian high yield space

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