

Scouting opportunities on the Asian credit market

July 2018



Global credit markets have been challenged in 2018 and spreads have widened. Asian issuers have not been immune from this volatility. Following another default by a Chinese issuer, we take stock of where markets are currently, what opportunities (if any) are present in the region, and outline how investors can gain exposure to the asset class if desired.

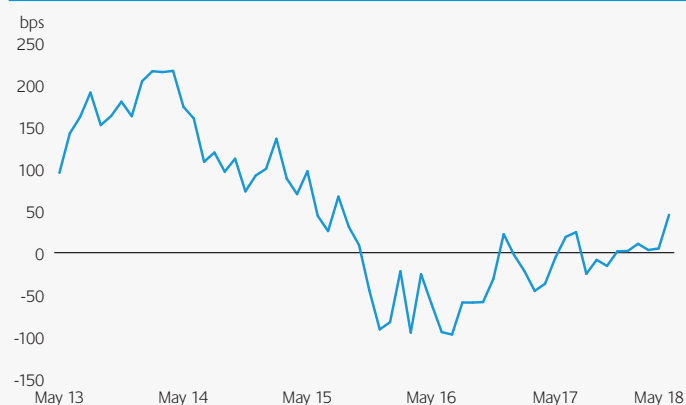
Asian credit markets – taking stock

Historically, Asian Investment Grade and High Yield credit spreads have traded at a premium relative to US issuers. Towards the end of 2015, however, demand for Asian High Yield exploded, resulting in spread narrowing. In fact, for most of the following two years, Asian High Yield spreads were narrower than High Yield spreads in the US. Brief periods where Asian High Yield spreads widened during this period saw buyers emerge in force, capping any widening. As shown in Figure 1, this demand meant Asian High Yield spreads traded in line with US High Yield spreads at the end of 2017.

Whilst for long periods the fundamentals for Asian High Yield were – and may remain – sound, we believe investors were placing too much emphasis on yield. When considering investment drivers, it is important to consider multiple drivers such as fundamentals and liquidity, as well as yield.

For some time, we have felt that it may be more prudent to pay greater attention to liquidity rather than yield (or even fundamentals) when investing in Asian High Yield credit. A simple, common sense approach has served us well in assessing liquidity.

Figure 1: Asia HY spreads over US HY



Source: BBG and Barclays Index. Data as at 31 May 2018.

By January 2018, High Yield spreads had narrowed to their tightest levels since 2008 in both Asia and the US and there was little difference in spreads between the two markets. In considering liquidity as a driver, however, we note that the size of the Asian High Yield market is around USD200 billion. By comparison, at around USD2 trillion, the US High Yield market is roughly ten times larger. In short, investors were paying insufficient attention to liquidity. Perhaps investors should have been paying more attention to the relative illiquidity of the Asian market. In 2018, Asian High Yield spreads have widened sharply, from a low of 277bps in mid-January to 469bps at the end of May.

It is important to note that using the index spread as a gauge is a blunt measure of performance. We have observed an increased dispersion in the performance of High Yield bonds in the Barclays Bloomberg Asian USD High Yield Index, underpinning the need for quality credit research, active management and the use of non-traditional gauges of risk, such as ESG. Some individual names have performed significantly worse than the broader universe. While we continue to hold some Asian High Yield names in our mixed grade strategies, a focus on quality and liquidity in our credit research process has, on the whole, helped us avoid the underperformers.

In comparison, the Asian Investment Grade sub-sector has remained reasonably resilient and we continue to promote this lower volatility option to investors. Asian Investment Grade spreads narrowed to post-2008 tightness in January 2017, but have tracked US Investment Grade spreads wider since, highlighted in Figure 2 below.

Figure 2: Asia IG spreads over US IG



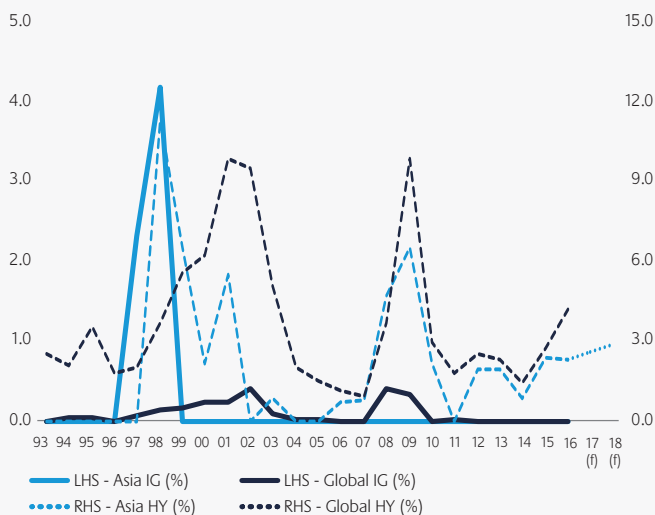
Source: BBG and Barclays Index. Data as at 31 May 2018.

The drivers of volatility – global versus regional

The re-pricing of credit markets globally is not coincidental. Having ended January 2018 in great shape, a barrage of events have weighed on credit markets in spite of the global synchronised growth outlook and favourable credit fundamentals. When markets become expensive (for example in January when credit spreads were tight and when equity markets were hitting highs), they typically look for reasons to correct. Indeed since January there has been no shortage of issues for investors to agonise over. From Trump to North Korea, the prospect of trade wars, rising US rates, the end of QE in Europe, the rise in Libor-OIS, emerging market jitters in Argentina and Turkey and, most recently, political uncertainty in Italy. What next? Given the amount of uncertainty and geopolitical risk in the world, it certainly appears unlikely that markets will calm in the immediate future. Investor behavior has changed in recent months in response to these issues. Abundant liquidity in recent years saw investment into fixed income that was almost price-insensitive. But the world is changing. Liquidity taps that have been held open by central banks for so long are being reduced to a trickle, or even being turned off completely. Investor behaviour is changing in recognition of this.

In 2018, Asian fixed income investors have become far more discerning in their behaviour, compared with the indiscriminate purchasing in recent years. As well as dealing with uncertainty associated with the above events, Asian fixed income markets have seen defaults in China – albeit modest in quantum – on their doorstep. We anticipate further defaults, although see this as a healthy evolution of an efficient market and preferable to Chinese authorities supporting poor quality institutions. There were 20 bond defaults in China in the first five months of 2018, but the onshore default rate remains lower than Chinese banks’ non-performing loans and is significantly lower than the global average default rate. If we assume the recent pace of Chinese defaults will continue and use Chinese onshore defaults as a proxy for Asia High Yield more broadly, the outcome and outlook for the local market appears more favourable than the global high yield average.

Figure 3: Global Corporate Defaults



Source: S&P. Data as at 31 December 2016.
*Default rate. **Asia, excluding Japan

Opportunities and options

Depending on your outlook for global market volatility, it may or may not be time to look more closely at those names that have driven the dispersion in the Asian High Yield Index. Whatever view held, the shift in markets appears likely to be permanent. A disciplined, discerning, research-backed approach will be key in selecting the best companies from the not so good, underlining the importance of active management in this sector.

Investors seeking access to Asian credit essentially have two options available. If they believe the volatility backdrop will continue, a focus on Asian Investment Grade Credit may suit. If they believe the repricing of assets has added value to markets but that volatility will continue, a mixed grade Asian strategy managed by a highly experienced team of professional investors may be preferable.

Performance

Annualised Performance in SGD (%)				
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.9	N/A	N/A	-0.8
Fund (Inc initial charges)	-5.9	N/A	N/A	-3.2
Benchmark*	-0.9	N/A	N/A	0.0

Cumulative Performance in SGD (%)					
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.4	-1.9	N/A	N/A	-1.4
Fund (Inc initial charges)	-5.4	-5.9	N/A	N/A	-5.3
Benchmark*	-0.7	-0.9	N/A	N/A	-0.1

Fund refers to the First State Asian Quality Bond Class A – Dist. Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 June 2018. Fund inception date: 1 November 2016.* The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

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