Asian credit

The path to higher yields could be through Asian credit

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Key takeaways:

- Policy rate cuts globally in support of growth have resulted in a sharp jump in negative-yielding debt – totaling 26% of investment grade (IG) bonds – and are leading to demand for higher-yielding assets. This has made Asian credit more appealing with its yield advantage and potential diversification benefits
- Prospects of continued global monetary easing are positive for Asian USD credit spreads. Asian credit, particularly Asian high yield (HY), offers attractive investment opportunities. On a relative basis, the Asian HY market is offering spread pickup over its US and emerging market peers
- Overall Asian credit fundamentals are solid and the default rate is expected to remain stable. The pick-up in defaults in the onshore Chinese bond market may cause volatility in the offshore market, but China's policies are expected to provide adequate liquidity in the onshore market, ensuring effective liquidity transmission to the private sector

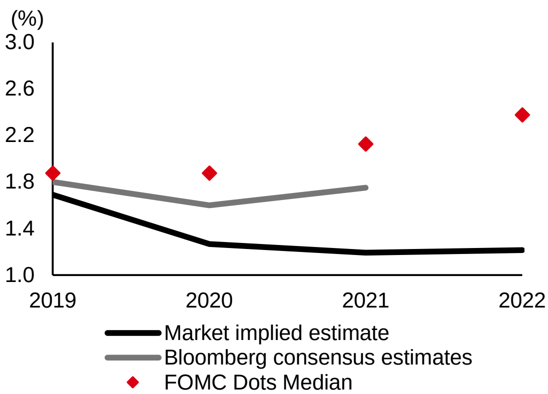
Source: Bloomberg as of 17 September 2019

Global monetary easing

As we enter the fourth quarter of the year, we are seeing an environment of coordinated monetary easing among global central banks. Most recently on September 18th, the US Federal Reserve (Fed) reduced interest rates for the second time this year, as expected by the market, to the target range of 1.75%-2.00%. The Fed's policy statement seems to indicate the possibility of another rate reduction in the future.

The market is pricing in a 65% chance of another 25 basis point (bps) cut this year and also pricing in a 50bps cut in 2020, which is more aggressive than FOMC views (see Figure 1). USD credit investors should consider the risk of Fed policy disappointment.

Fig. 1: Market expectations lower than FOMC views



Source: Bloomberg, as of September 18, 2019. Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets.

The European Central Bank (ECB) also delivered a monetary easing package this month, which included of a renewed bond-buying program and a cut in the bank's deposit rate, among other easing measures. In Japan, the central bank kept policy unchanged at its September meeting, reiterating its dovish bias and signalling willingness to ease more aggressively should downside risks affect Japan's economy.

In China, the central bank continued to roll out measures to boost liquidity in the system. On September 6th, the People's Bank of China (PBoC) announced a 50bps reduction in the reserve requirement ratio (RRR) for all banks starting September 16th and an additional 100bps reduction in qualified city commercial bank RRR in two steps on October 15th and November 15th. This marks the second announcement of broad-based reduction in the RRR this year and comes on the back of an economic slowdown and ongoing trade tensions with the US. These cuts add liquidity to the banking system and should support lending growth to the private sector.

Monetary policy support in China also came in the form of interest rate reforms unveiled in August, with the central bank linking the new loan prime rate (LPR) to the PBoC's medium-term lending facility (MLF) rate, which is a better reflection of the funding conditions for banks and can help improve monetary transmission to smaller private firms. While this is an effort to lower funding costs for the economy, we believe further reforms are needed given certain limitations associated with the new LPR and the market consensus that the reference rate is too high.

Elsewhere in Asia, almost all central banks have already cut rates and have further room to continue their expansionary monetary policies in the face of the latest Fed move.

Quarter-to-date, and particularly in August, financial markets have undergone bouts of increased volatility amid ongoing US-China trade tensions, other geopolitical risks and concerns over headwinds to growth. These conditions have led to demand for safe-haven assets and monetary policy easing bias globally, resulting in a general shift downward in bond yields and a sharp jump in negative yielding debt.

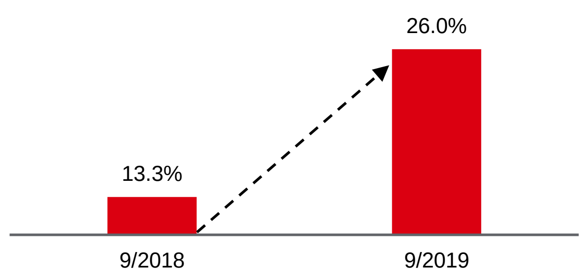
Asian credit investment implications

Fund flows to higher yielding bonds

Global policy rate cuts and the resulting increase in negative-yielding debt, which totals about 26% of global IG bonds (Figure 2), is likely to lead to more demand for higher-yielding assets. This can be seen with the strong flows of USD 45 billion year-to-date (YTD) into emerging markets (EM) hard currency bond funds—to put this in perspective, flows for the entire 2018 year were USD 9 billion. This low- to negative-yielding environment has increased the appeal of Asian credit with its yield advantage and potential diversification benefits.

Fig. 2: Sharp jump in global negative-yielding bonds

Percentage of outstanding bonds with negative yields in the Bloomberg Barclays Global Aggregate Index



Source: Bloomberg as of 18 September 2019. Past performance is no guarantee of future results.

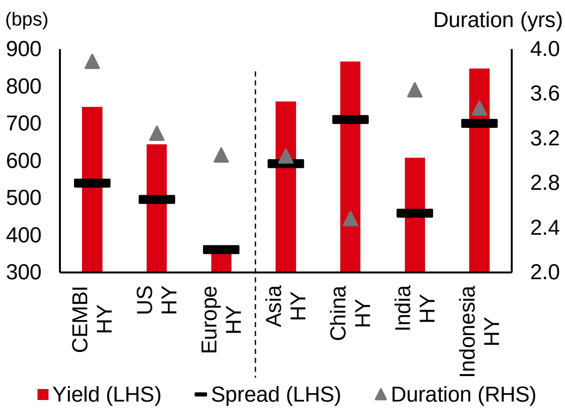
Asian credit investment implications (continued)

Attractive valuations

Prospects of continued global monetary easing bias are positive for Asian USD credit spreads. With the recent volatility in the market, Asian credit, particularly Asian HY, offers attractive investment opportunities, given the spread widening seen in August. On a relative basis, the Asian HY market is trading at attractive spread levels, offering a spread pickup of 95bps over its US peers and 52bps over its EM peers (Figure 3).

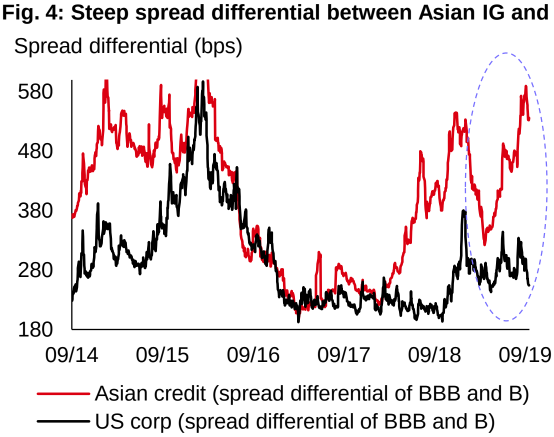
The steep spread differential between HY and IG within the Asian credit market – in contrast to the US credit market where the spread differential is a lot lower – further points to the attractiveness of Asian high yield (see Figure 4).

Fig. 3: Asian HY trading at a yield premium to other markets



Source: JP Morgan, BAML, as of August 31, 2019. Past performance is no guarantee of future results.

Fig. 4: Steep spread differential between Asian IG and HY



Source: JP Morgan, BAML, as of September 18, 2019. Past performance is no guarantee of future results.

*Source: Bloomberg, JP Morgan as of September 16, 2019.

Asian credit as a safe haven within EM

The recent sovereign credit upgrades of Indonesia (in May from BBB- to BBB) and the Philippines (in April from BBB to BBB+) by S&P have helped to solidify the appeal of these markets further, and of Asian credit as a whole. As global investors seek safe-haven assets in this market environment, Asian credit provide the opportunity to invest in higher-quality credits, compared to non-Asian EM, with relatively higher yields. As a result, Asian credit in general is increasingly attracting more developed market IG-focused investors, bringing in a new wave of buyers.

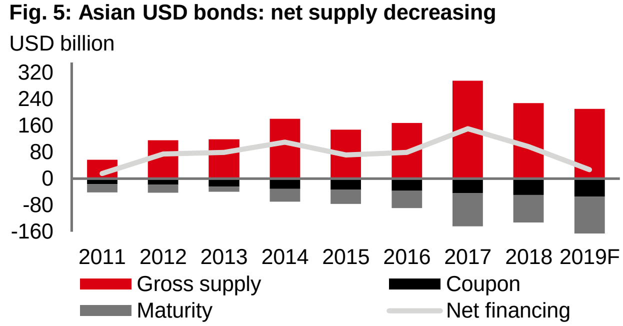
Asian credit: YTD review

The Asian USD bond market has returned 9.6% YTD (as of September 16th), driven by lower US Treasury yields and tighter credit spreads. US Fed movements/ market expectations and China's policy support measures have acted as important drivers for the Asian credit market. JACI has delivered positive monthly returns for every month of 2019 so far. Asian HY (+10.3%) has outperformed Asian IG (+9.5%) YTD; however, on a quarter-to-date basis, Asian IG has outperformed.*

Spreads for Asian IG and HY have tightened by 41bps and 68bps, respectively, YTD (as of September 16th). They reached their lowest levels of the year in early May and have widened out since then (most noticeably in August). Following the volatility, valuations have become more attractive, particularly for Asian HY.

About two-thirds of Asian USD bond issuance YTD has come from China, continuing the trend over the last few years; some of the factors helping ease supply pressure in the offshore market include a slowdown of National Development and Reform Commission (NDRC) quota approvals for USD bond issuance, targeted at property developers and local government financing vehicles (LGFVs), and lower funding costs onshore. Overall, we expect to see net refinancing fall in 2019 amid heavy maturities.

Fig. 5: Asian USD bonds: net supply decreasing



Source: JP Morgan, as of July 2019. Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets.

Asian credit: YTD review (continued)

At the same time, the Asian USD bond market this year has also seen a larger proportion of Asian HY primary issuance versus prior years. Longer-dated issuance is also coming to the market, which is helping spread out debt maturity while lowering refinancing risk.

Overall Asian credit fundamentals are solid and the default rate is expected to remain stable. While there has been an increase in onshore China defaults this year, it is important to note that defaults are occurring mostly in private bonds, which is only a small subset of the market, and the annualized default rate for 2019 YTD is still under 0.4% for the onshore China bond market. Given the relatively small size and the limited investor participation in China's private bonds that have been defaulting, we do not see much contagion impact and do not expect this to trigger systemic risk. Though onshore China bond defaults may cause volatility in the offshore market, China's policies are expected to provide adequate liquidity in the onshore market, ensuring effective liquidity transmission to the private sector.

While the US-China trade disputes, along with other geopolitical uncertainties, may dampen risk sentiment, we believe this also increases the appeal of Asian credit, given the region's solid macro and corporate fundamentals. Additionally, markets of Indonesia and Vietnam are likely to benefit from potential trade diversion.

Asian credit continues to present attractive valuations, higher yields and shorter duration relative to other major credit markets. Combined with the low correlation of Asian credit to other fixed income markets, the asset class offers good potential diversification benefits for global investors.

Asian HY investment opportunities

We continue to take a total return approach when investing in Asian HY. We prefer the short end of the curve, while remaining selective in the long end. In China, we like select HY property names; the recent market volatility has provided pockets of attractive valuation in the sector. In Indonesia, we continue to favor select names in the utilities and property sectors as their yields are attractive and their fundamentals remain sound. In India, we like select names in the renewables sector and stable short-dated industrial names. We are invested in EM sovereigns, with some of the exposure likely beneficiaries of potential trade diversion; in addition, we like exposure to local currency bonds on a hedged basis to ride the trend of easing rates within the regional markets. We also continue to explore HY-like securities issued by stable IG names, including bank subordinated debt.

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