

# Asia credit poised to roar back in the Year of the Dragon

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The reputation of Asia credit, and especially the high yield market, has taken something of a beating in the last couple of years, almost entirely due to the China real estate funding crisis, which resulted in multiple defaults in what was a significant sector.

However, this does not mean that the asset class is either enduringly flawed nor that it isn't providing lucrative opportunities. Indeed, we would argue that the negative sentiment is potentially giving investors a good entry level at the very point at which the prospects for the market are brightening. Our total returns analysis imply an allocation to Asia credit should produce good risk adjusted performance over the coming 12 months. Meanwhile, the enduring technical qualities of the market, including low spread correlation to other markets and shorter duration, make it a strong candidate as a strategic allocation in global bond and credit portfolios.

**The Asia investment grade market (including Mainland China) has given investors a potentially better quantity and quality of returns compared to US investment grade, while even now offering similar yields. We believe the dynamic of better risk adjusted returns will continue.**

**Fig 1: Characteristics of investment grade markets: Asia vs US**

	Asia IG	US IG
5 yr return	12.91%	10.78%
Annualised return	2.47%	2.08%
Annualised volatility (5yr weekly returns)	4.57%	8.50%
Spread to worst (bps)	102	105
Yield to worst	5.14%	5.26%
Modified duration (years)	4.79	6.74

Indices used: Asia IG: JPMorgan Asia Credit Index Investment Grade; US IG: ICE BaML US Corporate Index  
Source: JPMorgan, ICE Indices, Bloomberg, 5 February 2024.

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It may confound the conventional narrative to observe that Asia IG credit has performed well on a relative basis over the last five years. With all the noise around China and assumptions that developed markets have outperformed, it is sometimes forgotten that the drivers of bond returns are the ability of individual institutions to repay their debt, and the exposure of individual bonds to interest rate risk.

The key technical reason for these better risk adjusted characteristics of the Asian universe is the relative modified duration (interest rate sensitivity) of the two universes (4.79 years for Asia vs 6.74 years for US). With a fundamental perspective, we see the consistent credit quality of Asia IG issuers, with a high proportion of national champions and government related entities, leading to stability of spreads. As markets stand at the moment – investors still have a less volatile investment in Asia without a material give up in yield. Even though there are expectations of lower US interest rates which might be seen to favour adopting higher duration, a good deal of easing is already priced into market levels, while we have seen sharp spikes in yields when data are released which are stronger or more inflationary than expected – this is likely to see a continuation of the greater volatility of US bonds.

Meanwhile, the probability of weakening economies or even recessions in the US and Europe, under the burden of the higher interest rates implemented to control inflation, may increase the fallen angel count and lead to wider spreads in these regions. By contrast in Asia, where monetary policy has either been pre-emptive, or where economies are strong or have very low inflation, there are, we believe, better growth prospects and more supportive credit dynamics.

Our forecast for total returns in the Asia investment grade market, based on the weighted expectation of our favoured macro scenario forecasts, shows a strong return for the following 12 months, but importantly with a positive skew of probable outcomes, based on the strong technical setup of the Asia IG market and the supportive fundamental drivers.

**Fig. 2: Asia investment grade forecast scenarios**

<b>Asia IG</b>	<b>Bear case</b>	<b>Base case</b>	<b>Bull case</b>
<b>Expected change next 12 months</b>			
Credit spread (bp)	50	0	(10)
Roll down (bp)	(10)	(10)	(10)
UST move (bp)	40	(40)	(110)
<b>Total</b>	<b>80</b>	<b>(50)</b>	<b>(130)</b>
10-year UST rate	4.1%	4.1%	4.1%
<b>10-year UST rate +12m</b>	<b>4.5%</b>	<b>3.7%</b>	<b>3.0%</b>
Current YTW	5.3%	5.3%	5.3%
YTW forecast +12m	6.2%	4.9%	4.1%
<b>YTW - average (forecast)</b>	<b>5.8%</b>	<b>5.1%</b>	<b>4.7%</b>
<b>Duration</b>	<b>4.75</b>	<b>4.75</b>	<b>4.75</b>
<b>Expected return next 12 months</b>			
from carry	5.8%	5.1%	4.7%
from credit spread	-2.4%	0.0%	0.5%
from roll down	0.5%	0.5%	0.5%
from UST move	-1.9%	1.9%	5.2%
<b>Total returns</b>	<b>2.0%</b>	<b>7.5%</b>	<b>10.9%</b>
<b>Probability</b>	<b>15%</b>	<b>65%</b>	<b>20%</b>
<b>Asia IG probability weighted expectation next 12 months</b>		<b>7.3%</b>	

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The Asia High Yield market has been transformed as a result of the challenges in China real estate, and importantly this sector now makes up less than 5% of the Asia high yield universe. Credit quality and fundamental trends are sound in the vast majority of the rest of the market, meaning that negative sentiment towards the asset class is providing good valuation opportunities and the likelihood of high total returns.

Fig 3: Characteristics of high yield markets: Asia vs US

	Asia HY	US HY
5 yr return	-7.24%	21.98%
Annualised return	-1.49%	4.05%
Annualised Volatility (5yr weekly returns)	10.66%	9.46%
Spread to worst (bps)	971	371
Yield to worst	13.98%	7.77%
Modified duration (years)	2.52	3.33

Indices used: Asia HY: JPMorgan Asia Credit Non-Investment Grade Index; US HY: ICE BaML US High Yield Index.  
Source: JPMorgan, ICE Indices, Bloomberg, 5 February 2024.

It perhaps goes without saying that the Asia high yield market has underperformed the US in the past five years. In fact, outside China real estate, the market has performed without drama with low default rates and positive total returns, but the contagion from China real estate has led to a huge gulf in valuation which we now believe favours an allocation to Asia high yield. In our return simulation below, we have been ultra conservative in our yield estimates in order to show the likely return from a portfolio which is not reaching down into the depths of poor quality credit and distressed real estate names. Even through this lens, our weighted expectation, based on our favoured macro scenario forecasts, shows an overall return of 11.2% over the coming 12 months.

Fig. 4: Asia high yield forecast scenarios

Asia HY	Bear case	Base case	Bull case
<b>Expected change next 12 months</b>			
Credit spread (bp)	220	(10)	(110)
Roll down (bp)	(20)	(20)	(20)
UST move (bp)	40	(40)	(110)
<b>Total</b>	<b>240</b>	<b>(70)</b>	<b>(240)</b>
10-year UST rate	4.1%	4.1%	4.1%
<b>10-year UST rate +12m</b>	<b>4.5%</b>	<b>3.7%</b>	<b>3.0%</b>
Current YTW	9.9%	9.9%	9.9%
YTW forecast +12m	12.5%	9.4%	7.7%
<b>YTW - average (forecast)</b>	<b>11.2%</b>	<b>9.7%</b>	<b>8.8%</b>
<b>Duration</b>	<b>2.55</b>	<b>2.55</b>	<b>2.55</b>
<b>Expected return next 12 months</b>			
from carry	11.2%	9.7%	8.8%
from credit spread	-5.6%	0.3%	2.8%
from roll down	0.5%	0.5%	0.5%
from UST move	-1.0%	1.0%	2.8%
<b>Total returns</b>	<b>5.1%</b>	<b>11.4%</b>	<b>14.9%</b>
<b>Probability</b>	<b>15%</b>	<b>65%</b>	<b>20%</b>
<b>Asia HY probability weighted expectation next 12 months</b>		<b>11.2%</b>	

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The key elements of the bond mathematics which lead to such a good skew of likely outcomes are the high carry and low spread duration, which means that there is a thick cushion of yield which would require a very sharp widening of spreads to overcome.

On the fundamental side, we see that better macro tailwinds in Asia will keep defaults low (nb speaking of default 'rates' in this market at the moment is probably not useful as there will likely be more defaults in China property, but these are already discounted in price and are unlikely to feature in our portfolios). Indeed, we believe we should be able to avoid defaults with the conservative high yield portfolio in the illustration above. Meanwhile, we can look forward to a modest tightening of spreads as confidence is restored.

**We see ample opportunities across the Asia region and throughout the credit spectrum. Despite the well-publicized challenges facing the Chinese economy, we continue to see value and good potential returns in some sectors of the Greater China complex, as well as in Asean and India.**

In terms of any opportunity in the mainland China real estate sector, we remain selective, overweight only in State Owned Enterprise (SOE) related names and underweight the private sector, with only exposure to those whose fundamentals and cashflows are more predictable. Though China property stimulus is likely to be intensified, we don't expect a major turnaround in the sector as it is hard for the new home sales recovery to maintain momentum without any meaningful turnaround in income and employment.

Of course, we also see other opportunities in mainland China outside the property sector, including in the Telecoms, Media and Technology sector with a reduction of regulatory risks and improving sector fundamentals, while we are also investing in the mainland China consumer and industrial sectors in a selective manner. Although restrictive policy has already been abandoned and more fiscal support introduced to address the consumption gap, we are not necessarily expecting a sharp improvement in the economy. This may not be a bad thing for a quality biased credit investment strategy with focus on downside protection, with surviving credits delivering more stable performance in the coming quarters.

Outside of mainland China we see improving fundamentals in Asean and India driven by positive macro tailwinds. In the investment grade market, we prefer Thailand, Singapore and Korea subordinated financials for their relatively attractive risk adjusted yields. We believe that India and Indonesia corporates will be solid in line with their fast growing economies, while we favour Japanese banks and financials as an off-benchmark position. In the more diversified high yield market, the Macau leisure sector continues to enjoy post COVID revenue recovery, while again selected Indian and Indonesian companies should prosper in their high growth environments.

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