Value, opportunity and liquidity in the Asia credit market

15 April 2020

Key takeaways:

- While the COVID-19 global pandemic has had a bigger negative impact on financial markets than anything since the global financial crisis in 2007/2008, we believe these situations can throw up amazing opportunities
- We believe that the rate of defaults now discounted by the Asia credit market is significantly higher than the range of likely outcomes
- Our own bottom up research indicates a default rate across the Asia credit market of 0.5% (horizon of 12 months) based on our central scenario of a modest recovery in the general economic outlook in three months' time, while we forecast a default rate of 1.3% in a worse case where the pandemic shows no sign of improvement for at least six months
- Our bottom up process is dedicated to avoiding severe credit deterioration and default, which should reduce the risk of capital loss further
- Our sector selection would also tend to be underweight those sectors and countries/regions where we believe the default risk is the highest
- Although there may be a perception that Asian corporate bonds are riskier than those issued by companies in the US or Europe, the Asian investment grade universe – which makes up around 80% of the Asia credit market – is mainly made up of bonds issued by very large, stable and often government related institutions
- There are steps we have taken to ease risks in periods of volatility, by diversifying our portfolios, maintaining holdings in more liquid bonds and ensuring the structure of our funds remains consistent with daily dealing

HSBC Global Asset Management

The COVID-19 global pandemic has had a bigger negative impact on financial markets than anything since the global financial crisis in 2007/2008, with even high grade credit taking a big hit. The Asia credit market saw a decline of nearly 7% in total return terms in the month of March.

But these situations can throw up amazing opportunities. If a bond is going to repay its capital and income, then clearly the markdown in price will present an opportunity for investors to buy exactly the same asset – because the coupons and capital repayment will remain the same – at a substantially cheaper price. So if we can potentially avoid the bonds which will default, then we will achieve extremely competitive returns over time.

What default rates are now being discounted by the Asia credit market?

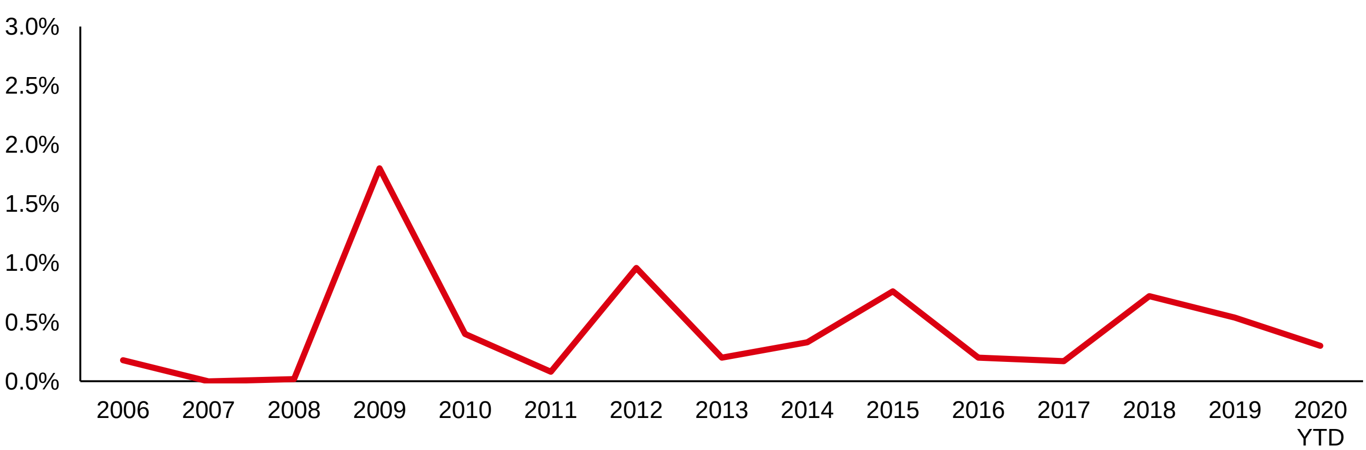
During the panic which followed the realization of the seriousness of the pandemic, the Asia credit market widened in spread terms from 250bp on average to around 435bp currently and spreads are now at their widest since the global financial crisis in 2008. The spread level of a corporate bond is meant to compensate the investor for the default risk assumed by buying the bond and holding it throughout its life.

If we assume a recovery rate of 25% upon any bond default, the recent spread widening in very broad terms implies a default probability of around 6% (credit spread of 435bp), increased from around 3.3% (credit spread of 250bp). *Please note that these default rates are expressed as a percentage of the overall market – the normal market convention would be to express them as a total of the high yield market as investment grade bonds rarely default without being downgraded to high yield first.*

What default rate should we expect?

We have no doubt that the impact of the pandemic will cause some bonds to default which would not otherwise have done so. But we believe a default rate across the whole market of 6% is extremely pessimistic. Even during the global financial crisis, which was at its heart a credit event, the highest annual high yield default rate was around 9%, which implies a default rate across the whole market of around 1.2% (the high yield component of the Asia credit market being around 20%). This market is now very different to how it was in 2008 – it is a lot larger, more diversified and changed in sector and geographic composition, so comparisons to the global financial crisis period have to be seen in that context. But if anything, it implies that the market is now more robust and less vulnerable to idiosyncratic risk.

Asia credit default rate (whole market-interpolated)



Source: Bloomberg, Moody's, S&P, Goldman Sachs Global Investment Research, HSBC Global Asset Management, as of March 2020

So what is a more reasonable likely outcome for Asia credit defaults? Latest research from JP Morgan forecasts that the default rate for Asian high yield bonds will be 4% in 2020, which is a rise from their previous forecast of 2%. This would be the equivalent of an increase from around 0.4% to 0.8% across the whole market. When we factor in a recovery rate of the defaulted bonds – again of 25% – then the extra loss to be compensated would only be around 0.3%. So we could argue – again in round numbers – that spreads have 'overshot' by around 150bp (spreads should have only widened by around 30bp rather than the 185bp we have seen), even if we assume that in subsequent years the levels of default remain elevated. We note that the latest Goldman Sachs forecast also indicates a high yield default rate of around 4%, which is calculated using a slightly different methodology (using the price implied distress of individual issues rather than also including bottom up fundamental assessment of issuers).

HSBC Global Asset Management forecast for Asia credit default rates

Our own bottom up research indicates a default rate across the Asia credit market (investment grade and high yield) of 0.5% (horizon of 12 months) based on our central scenario of a modest recovery in the general economic outlook in three months' time. We can also forecast a default rate of 1.3% in a worse case where the pandemic shows no sign of improvement for at least six months. Because we have conducted this analysis based upon our outlook for individual issuers, we can also drill down further and look at the default rate forecast for each sector and country.

Asia credit: 2020F potential default rate by sector

	Base Case	Downside Case
Real Estate	0.18%	0.62%
Consumer	1.04%	2.10%
Financial	0.26%	1.62%
Industrial	1.20%	2.66%
Utilities	0.20%	0.20%
TMT	0.42%	0.60%
Banks	0.00%	0.00%
Basic Materials	1.94%	4.94%
Coal	1.62%	2.56%
Oil & Gas	0.72%	5.30%
Government	0.00%	0.00%
Diversified	0.00%	3.10%
Total	**0.48%**	**1.26%**

Asia credit: 2020F potential default rate by country/region

	Base Case	Downside Case
China	0.30%	0.62%
Hong Kong	0.12%	0.12%
India	1.64%	4.78%
Indonesia	2.02%	5.76%
Philippines	0.00%	0.00%
Singapore	1.12%	3.56%
Macau	0.00%	2.68%
Malaysia	0.00%	0.88%
S. Korea	1.04%	1.04%
Vietnam	0.00%	0.00%
Thailand	0.00%	0.00%
Cambodia	0.00%	0.00%
Mongolia	0.00%	10.00%
Total	**0.48%**	**1.26%**

Source: HSBC Global Asset Management as of 31 March 2020. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target. For illustrative purposes only.

Suffice it to say that our funds are not investing in the bonds we expect to default or those we believe are vulnerable to our 'downside case'. Our sector selection would also tend to be underweight those sectors and countries/regions where we believe the default risk is the highest.

What other steps have we taken to reduce default risk?

Before the panic began, we had already taken the decision that we were not being adequately compensated for buying the riskiest bonds, and therefore our exposure to the parts of the market most likely to default had been reduced. At the end of February – before the market turmoil began – our funds had no exposure to the riskiest bonds rated CCC or below. They also had around 4% fewer non-rated bonds than their benchmarks (benchmark weight around 5%), and although unrated bonds do not necessarily imply poor credit quality, they do tend to be less easy to sell and can be at the most speculative end of the credit spectrum. By the end of March, our funds contain no bonds which are trading under 50 in price, which would imply severe credit distress.

Meanwhile, our bottom up process is dedicated to avoiding severe credit deterioration and default, and in this we have generally been successful in the Asia credit market. Our peer group performance rankings in the Asia credit strategy indicate a strong relative track record of credit analysis and sector allocation. Our HSBC Asia bond strategies rank in the first quartile in the Morningstar category of Asia bond funds in the 1-year, 2-year and 3-year periods as of 31 March 2020.

The enduring qualities of Asia credit

Although there may be a perception that Asian corporate bonds are riskier than those issued by companies in the US or Europe, the Asian investment grade universe – which makes up around 80% of the Asia credit market – is mainly made up of bonds issued by very large, stable and often government related institutions. This is also a universe which includes a significant proportion of issuers from markets which would not usually be considered ‘emerging’ such as South Korea, Singapore and Hong Kong (which together make up around 30% of the market) as well as the strong credit from China (around 50% of the market) which includes some of the largest companies, banks and government related institutions in the world. This gives the Asian investment grade universe good diversification within itself – being made up of at least 11 major markets – but also adds potentially attractive diversification qualities to a global portfolio.

Meanwhile, governments throughout the world and the Asia region have been providing extraordinary levels of stimulus to economies in the shape of both fiscal and monetary easing. These moves include cuts in interest rates, extra liquidity injections into the financial system, tax cuts and targeted assistance for companies and employees. Asian economies are generally in a good position to provide this support as most have sound public and external finances. Most are also net importers of commodities and oil, and therefore benefit from a reduction in the oil price and other commodities. Moreover, the Asia credit market does not have significant exposure to oil, and includes both upstream and downstream companies, the latter of which actually benefit from lower prices. There are also alternative energy companies in the universe which should fare well in the current environment.

An added benefit of investing in Asia credit at the moment could be the more advanced stage of the pandemic in much of the region. Although we are not complacent to the possibility of a second wave of infections in mainland China, South Korea, Hong Kong, Singapore and Taiwan, the current situation seems more under control in these territories than in parts of Europe and the US. The news from China is particularly encouraging, with high frequency data showing industrial production returning to 80%-90% of pre pandemic levels and electricity production at a similar 90% level compared to long term averages. Although we accept that this may not fully mitigate the stress of exporting companies experiencing a drop in global demand, most domestically focused Chinese companies should be able to service their debts.

Finally, the stability of Asia credit is bolstered by much lower levels of duration than other global credit markets. Investment grade Asian corporates have on average a duration of just over 4 years, compared to the US at about 7.5 years and Europe at 5 years. Asian high yield bonds also have a duration at least a year shorter than their global counterparts.

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What could the recovery look like?

As discussed, although the drop in credit markets can be vicious and quick, the rebound tends to also be rapid and sharp. Here's some statistics on how long it took the Asia credit market to start to rally again after the largest falls (these are the times when the market has fallen by more than 5% according to the JPMorgan Asia Credit index) and the very attractive returns following the rebound.

Performance of the Asia credit market

	Fall began	Fall ended	Duration (days)	Loss during Fall	Return in following month	Return in following 6 months
Lehman crisis	15-Sep-08	24-Oct-08	49	-21.56%	7.35%	24.02%
Interest rate fears	9-Sep-11	4-Oct-11	27	-6.72%	6.38%	10.72%
Taper tantrum	9-May-13	25-Jun-13	46	-7.65%	3.00%	4.80%

Source: HSBC Global Asset Management, JP Morgan, as of 31 March 2020. Investment involves risks. Past performance is not indicative of future performance.

This sharp rebound in bond markets is probably due to the fact that investors can begin to enjoy the higher yields immediately. If you find the yield attractive and you believe the issuing entity will not default, then you could potentially get a good return over time, irrespective of short term volatility.

Should we be concerned about liquidity?

One of the issues facing bond markets at the moment is liquidity – the ability to buy and sell securities at will without excessive bid-offer spreads. Bonds are generally not traded on exchanges and are transacted bilaterally between independent counterparties. So when everyone wants to sell and very few investors want to buy, it is more difficult to match up the buyers and sellers in order to ensure a good two-way flow. This means that valuation prices can get marked down viciously as the clearing price in the market can be much lower than the fundamental value of the security. Meanwhile, if investors cannot sell their riskiest bonds, they may be forced to sell some of their safer holdings, and this is why prices in even the safer parts of the bond market collapsed so suddenly when the market began to take on the full implications of the pandemic in March.

We would like to reassure investors that our Asia credit strategies have taken a number of steps to maximize liquidity during this difficult period:

- Going into the period of volatility, our strategies were already avoiding the very riskiest parts of the market (see above) and concentrating on bonds which were giving a good combination of yield and likelihood of capital preservation – these bonds tend to be more liquid
- We have bolstered the liquidity profile of our strategies with allocations to the most liquid parts of the bond market, including US treasury bonds and bills
- Our portfolios are highly diversified – the maximum holding in any one bond in an Asian bond strategy is 2.1%, which is a China Policy Bank (government owned) bond, while over 90% is invested in holdings of less than 1%. The portfolio holds 445 bonds
- We keep overall fund and capability capacity under review at all times to ensure that we are always able to adequately actively manage our funds and can be selective about the bonds we buy, without having to make the unsavoury compromise between diversification and populating our portfolios with bonds which we are less confident about

Conclusions

The global pandemic has caused severe stress for global credit markets. But credit markets often recover very quickly, and the enduring qualities of Asia credit means that we have a high degree of confidence that this market should provide good returns in the coming quarters. The default rate discounted by the market is, by ours and others' analysis, too high. Meanwhile, we can further reduce this default risk by carefully managing the sectors and individual bonds we invest in. Although there have been periods when liquidity has been difficult in markets since March, there are also steps we have taken to ease these risks by diversifying our portfolios, maintaining holdings in more liquid bonds and ensuring the structure of our funds remains consistent with daily dealing.

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