One-on-one interview

Asia credit:
Navigating the winds of change

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Elizabeth Allen

Head of Credit Research,
Asia Pacific, Fixed Income

Alfred Mui

Head of Asian Credit

Key takeaways:

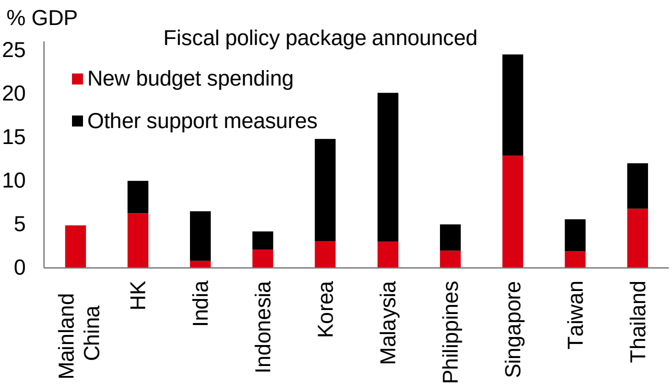
- We expect policy response in Asia to continue to remain accommodative, given the low inflationary environment
- While we are not completely out of the woods, we expect that the need for precautionary savings would subside, and the extra cash that was previously injected would start circulating in search for yield. In this respect, Asia credit has a yield advantage in the current environment and stands out from a risk-reward perspective
- For 2020, the default rate in the Asia high yield market is forecasted to be lower than in other global markets
- Our baseline forecast expects about 14 fallen angel names in the region, and that is only about 2.5% of the investment grade market. The low fallen angel risk for Asia is a reflection of the structural situation of the market as well as the strong and stable credit quality of Asia investment grade companies
- While markets are not as cheap as they were back in early April, Asia credit still offers attractive valuations. Asia investment grade bonds and Asia high yield bonds offer a significant yield premium versus their US and Euro (USD hedged) counterparts
- Technicals are strong for Asia credit. On the supply side, the lower issuance in 2020 for high yield corporates is a reflection of Asian companies tapping their respective onshore markets for funding to take advantage of cheaper costs

HSBC
Global Asset
Management

How much more room do Asian central banks and governments have to inject stimulus?

Alfred: Monetary policies and fiscal support unveiled and implemented so far this year – across Asia and the rest of the world – came with surprising scale and speed. We expect policy response to continue to remain accommodative, given the low inflationary environment. Inflation in Asia is expected to remain benign due to the negative output gap, high unemployment and low capacity utilisation.

Fig. 1: Increased fiscal policy support



Source: CEIC, Bloomberg, government/budget announcements, June 2020

The good news is that most Asian economies have lower external debt to GDP ratios versus developed markets, which could provide more fiscal flexibility to support regional growth. The low rate environment should also help to improve the refinancing capability of corporate issuers.

Additionally, unconventional monetary policies have also been used by Asian central banks. In China, rediscount and relending rates were cut, which could benefit credit transmission. India has been implementing special "twist" open market operations, intended to lower elevated term premiums and improve rate transmission. Indonesia's central bank has been buying bonds from primary issuance directly from the government as a means to counter the increasing budget spending.

It is also likely that the full force of liquidity from monetary stimulus is yet to be seen. The high levels of this year's quantitative easing (QE) should translate to a significant increase in broad money supply, however this has not happened. The recent sharp rise in uncertainty proxies has exaggerated the true need for precautionary savings and only a modest portion of the extra liquidity has been deployed. While we are not completely out of the woods, we expect that the need for precautionary savings would subside, and the extra cash that was previously injected would start circulating in search for yield. Against this backdrop, Asia credit's yield advantage in the current environment allows it to stand out from a risk-reward perspective.

How do you assess the default rates in the Asia high yield market versus the rest of the world?

Elizabeth: Despite the rise in defaults in 2020, the default rate in the Asia high yield market is forecast to be lower than in other global markets. This can be attributed to a number of factors. Firstly, Asian issuers went into the pandemic on a strong footing, particularly given the heavy issuance in 2019 and the access to capital through the last few years. Secondly, recovery is underway for certain Asian markets, especially Mainland China. Mainland China's Q2 GDP increased by 3.2% and a few North Asian economies are also faring quite well compared to the rest of the world. Thirdly, the negative impact of the oil price plunge on Asian issuers is manageable, due to the limited exposure to the oil sector within the Asia credit universe. Lastly, state-owned enterprises make up a high proportion of the Asia credit universe, which is a positive in this environment, as strong government support could help relieve the stress on companies' financial profile.

We expect defaults in Asia to be idiosyncratic and spread across sectors. We see rising credit stress in smaller commodity, industrial and consumer companies; however these sectors make up a small portion of the Asia credit market – the oil and consumer sectors only comprise about 1-2% and 5% of the Asia credit universe respectively. Instead, the Asia credit market is dominated by property developers and financial issuers – which combined account for about 50% of the total market – and we expect these two sectors to remain relatively stable this year.

The bulk of defaults year-to-date in the Asia credit market has come out of the Chinese industrial space; these companies that have defaulted or are in potential default situations tend to be small and have limited transparency. We expect a few more defaults to happen in this space. We are also likely to see more defaults from India and Indonesia in 2020. A strong credit selection process is crucial to avoid investments in securities with default potential.

Fig. 2: High yield markets: default rates

	2019 Actual	2020 YTD	2020 Forecast
Asia	**1.6%**	**1.9%**	**4.0%**
EM Europe	0.0%	2.2%	4.0%
Latin America	2.0%	3.4%	5.4%
MENA	1.6%	1.4%	7.2%
EM (total)	1.2%	2.3%	4.8%
US	2.9%	4.8%	8.0%

Source: JPMorgan as of July 2020

Should investors be concerned about the "fallen angel" effect in Asia credit?

Elizabeth: Fallen angels refer to investment grade bonds that are downgraded to high yield. This is a topic that has raised a lot of interest, particularly in the US. The broader concern on this matter is that if a large number of BBB bonds are downgraded to high yield, the high yield market, which has a different subset of investors, would not be able to absorb such a big volume of bonds. Structurally and fundamentally, the context for Asia is quite different versus the US and Europe. The size of the Asia credit market's BBB rated bonds is about the same as its high yield universe. In contrast, the size of BBB rated bonds in Europe and the US is about three to four times their respective high yield markets.

In the work done by our credit research team, we have attempted to work out the fallen angel risk for Asia credit. Our baseline forecast expects about 14 fallen angel names in the region, and that is only about 2.5% of the investment grade market (or 8.5% of the high yield market). We find this to be manageable. If we take an extremely conservative approach of assuming that both India and Indonesia sovereign ratings are downgraded to high yield – although we do not expect this to happen in the near term – about 6.5% of the investment grade universe could be downgraded to high yield. The low fallen angel risk for Asia is a reflection of the structural situation of the market as well as the strong and stable credit quality of Asia investment grade companies. Plus, the Asia investment grade bond market has many sovereign related names as well as national champions, and the potential support from the government can offset the companies' fundamental weakness to a large extent, especially in the current environment. As a result, we expect strong rating stability in the Asia credit BBB universe.

Even though downgrades for Asia credit names have surged in March, so far it has not reached the peak levels seen in previous cycles. The pace of downgrades has moderated significantly in May and June as compared to March and April. However, many issuers still have a negative outlook from the agencies and we expect more downgrades to come through in the second half of the year.

Fig. 3: Baseline forecast assuming no sovereign downgrades

Potential fallen angels (by market value):	Number	% of Asia credit market	% of total Fallen Angels
SOEs*	6	0.89%	44.50%
Mainland China	7	0.90%	44.84%
Macau	1	0.52%	26.33%
India	2	0.37%	18.38%
Hong Kong	4	0.21%	10.45%

**We expect 4 Mainland China and 2 India State Owned Enterprises to be downgraded to below investment grade. This only includes names contained in the JPMorgan Asia Credit Index*

Source: HSBC Global Asset Management as of July 2020.

How has HSBC been managing the default situation in its Asia credit portfolios?

Elizabeth: We have a very clear focus on credit selection and we aim to avoid investments with potential credit deterioration and defaults. With our commitment and a very disciplined approach to credit selection, we have been able to avoid investments in positions that faced default situations in our Asia high yield strategy since its inception in 2011. We will continue with our thorough credit research and analysis and maintain an inquisitive and questioning mindset.

As we expect the default rate in the Asia high yield market to increase to 4% in 2020, it is crucial for managers to have a strong credit selection team and process in place, particularly in this type of environment.

We have a team of very experienced analysts across Hong Kong, Mainland China and India, and most of us have 10 to 20 years of experience in the credit research field. Given that Asia credit markets are still young, people with such rich experience are very valuable. Our credit research analysts have mastered not only the sectors or companies under their coverage but also the macro context of the environment. While 2020 has so far proved to be a challenging period, the new questions we are facing are keeping us sharp and on our toes. We remain proactive in the current situation and we completed the in-house default analysis in a timely manner – in early March – which helped the team better position the portfolios during the crisis.

Fig. 4: Asia high yield default rates vs HSBC Asian High Yield Bond strategy

	Defaults as % of Asia high yield bond market	Default situations as % of HSBC Asian High Yield Bond strategy
2012	2.7%	0.0%
2013	1.2%	0.0%
2014	1.5%	0.0%
2015	3.1%	0.0%
2016	1.0%	0.0%
2017	0.9%	0.0%
2018	2.5%	0.0%
2019	1.6%	0.0%
2020F	4.0%	?

Source: HSBC Global Asset Management as of July 2020.

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Can you talk about the rebound seen in the Asia credit market and why Asia credit is still a good investment opportunity at this time?

Alfred: Asia credit, like other global credit markets, suffered a poor first quarter, owing to the COVID-19 crisis. But the Asia credit market has already seen an impressive rebound of 9.4% (as of July 21) from the trough in March. Historically, this has been a pattern of Asia credit markets, in which, following drawdowns, they tend to bounce back quite decently. Currently, we don't expect the Asia credit market to revert to the weakened position seen earlier in the year, given the extraordinary amount of liquidity, the rapid recovery so far in the markets and the improving economic data, especially from Mainland China, which is showing signs of recovery.

While markets are not as cheap as they were back in early April, Asia credit still offers attractive valuations. Asia investment grade bonds and Asia high yield bonds offer a significant yield premium versus their US and Euro (USD hedged) counterparts. Asia USD bonds are also running very short duration profiles, which adds to the asset class' stability.

Fig. 5: Investment grade markets

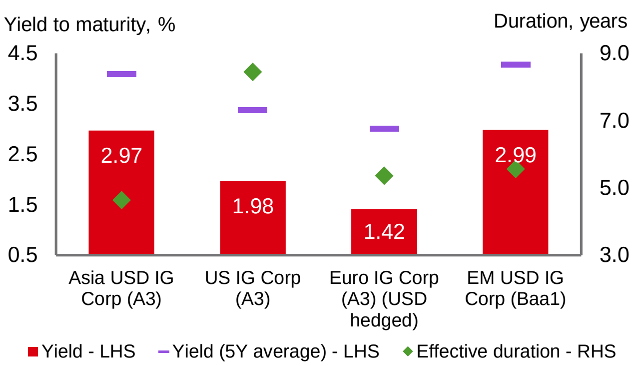
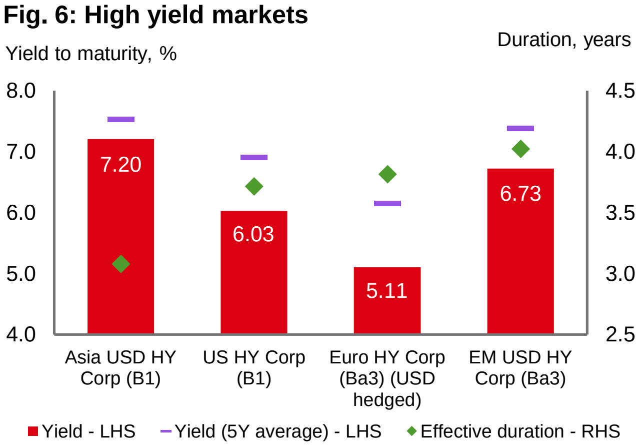


Fig. 6: High yield markets



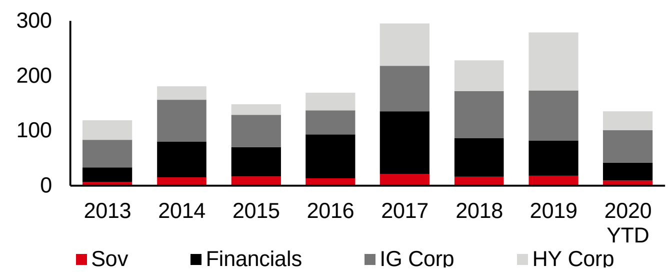
Source: JP Morgan, BAML, as of 31 July 2020

Further, a manageable default trend and the relatively solid Asia macro outlook make up a supportive backdrop for Asia credit.

Technicals are also strong. On the supply side, year-to-date, while Asia investment grade corporate issuance is up 10% versus the same period last year, high yield corporate issuance is 40% lower. The lower issuance is a reflection of Asian companies tapping their respective onshore markets for funding to take advantage of cheaper costs, as interest rates were lowered with ample liquidity injected by Asian central banks in the midst of the coronavirus pandemic. In contrast, the US corporate bond market's issuance year-to-date has already far surpassed the same period last year.

On the demand side, Mainland Chinese investors have accelerated their offshore bond purchases for yield pick up and asset diversification. A similar trend is playing out in Taiwan, Hong Kong, Singapore and Korea, where investors are increasingly investing outside of their domestic market/currency. We expect a majority of outbound flows to go into Asia dollar bonds given Asian investors' high participation and preference for the asset class, keeping technicals for Asia credit well supported.

Fig. 7: Net supply in 2020 for the Asia credit market has declined



Source: JPMorgan, as of June 2020

Given the dominance of China property in Asia credit, can you speak to the opportunities in this space and if the spread tightening recently means the risk-reward has decreased?

Alfred: We continue to stay constructive on the China high yield property sector. Contracted sales have quickly picked up in the past few months and in June exceeded the year-to-date sales from last year (+1% year-on-year). We expect developers to speed up the launches to ramp up sales and the full year sales to be up 5-10% year-on-year. Favourable policies such as lower mortgage rates in certain cities, tax cuts and sales discounts should also help support the demand recovery.

Despite tightening in spreads since March, we believe we are still seeing sufficiently wide spreads now in the China property sector and with less default stress as most of developers have finished refinancing and they are equipped with more diversified funding channels both onshore and offshore. Credit selection is extremely important as we expect more variance in terms of performance and opportunities.

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