Value, opportunity and liquidity in the Asia high yield market

2 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 high yield market is significantly higher than the range of likely outcomes
- Our own bottom up research indicates a high yield default rate for Asia of 2.4% (horizon 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 6.3% 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 liquidity has been difficult in markets in the last few weeks, 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

HSBC
Global Asset
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The COVID-19 global pandemic has had a bigger negative impact on financial markets than anything since the global financial crisis in 2007/2008, and up until last week we saw large falls in many markets, with global high yield bonds amongst the worst hit. The Asia high yield market has seen a decline of around 12% in total return terms since the beginning of 2020.

But these situations can throw up amazing opportunities. If a bond is going to repay its capital and income, then 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 could potentially achieve extremely competitive returns over time.

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

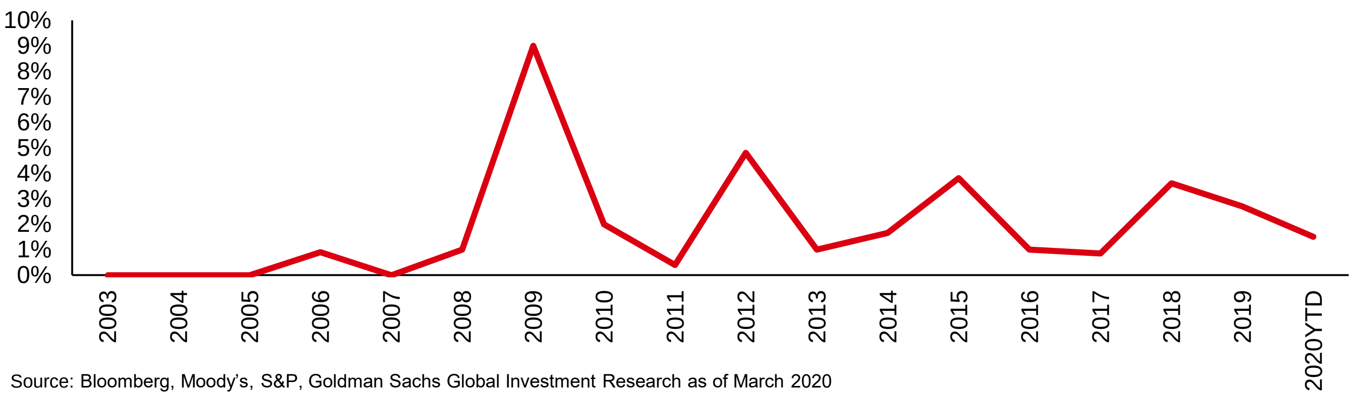
During the panic which followed the realization of the seriousness of the pandemic, the Asia high yield market (with an average duration of around 3 years) widened in spread terms from 550bp on average to around 920bp currently and spreads are now at by far their widest since the global financial crisis 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 11% (credit spread of 920bp), increased from around 6% (credit spread of 550bp).

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 an enduring high yield default rate close to 11% is extremely pessimistic. Even during the global financial crisis, which was at its heart a credit event, the highest annual default rate was around 9%.

Asia high yield default rate



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

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 and the Asia high yield market do not have significant exposure to oil, and include 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.

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%. 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 1.5%. So we could argue – again in round numbers – that spreads have 'overshot' by around 200bp (spreads should have only widened by around 150bp rather than the 370bp 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 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 high yield default rates

Our own bottom up research indicates a high yield default rate for Asia of 2.4% (horizon 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 6.3% 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/region.

Asia high yield: 2020F potential default rate by sector

	Base Case	Downside Case
Real Estate	0.9%	3.1%
Consumer	5.2%	10.5%
Financial	1.3%	8.1%
Industrial	6.0%	13.3%
Utilities	1.0%	1.0%
TMT	2.1%	3.0%
Banks	0.0%	0.0%
Basic Materials	9.7%	24.7%
Coal	8.1%	12.8%
Oil & Gas	3.6%	26.5%
Quasi sovereign	0.0%	0.0%
Diversified	0.0%	15.5%
Total	**2.4%**	**6.3%**

Asia high yield: 2020F potential default rate by country/region

	Base Case	Downside Case
China	1.5%	3.1%
Hong Kong	0.6%	0.6%
India	8.2%	23.9%
Indonesia	10.1%	28.8%
Philippines	0.0%	0.0%
Singapore	5.6%	17.8%
Macau	0.0%	13.4%
Malaysia	0.0%	4.4%
S. Korea	5.2%	5.2%
Vietnam	0.0%	0.0%
Thailand	0.0%	0.0%
Cambodia	0.0%	0.0%
Mongolia	0.0%	50.0%
Total	**2.4%**	**6.3%**

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 in the riskiest parts of the market, and therefore our exposure to the parts of the market most likely to default had been reduced. This shows in the following tables. Figure 1 shows the breakdown by rating of our Luxembourg domiciled fund (HSBC Global Investment Funds Asia High Yield Bond) compared to its benchmark, the JP Morgan Asia Credit Non-Investment Grade Corporate Index, which shows that we are overweight the safer parts of the market and in particular have very low exposure to non-rated bonds. Figure 2 shows how much of the fund is trading at different price levels. We have fewer bonds trading in the implied most distressed buckets of 30 to 50 and 50 to 70. We would also take some encouragement from the fact that there are so few bonds trading at this level in the whole market implying that, despite the significant drawdown, the assessment of the vast majority of individual credits is not too pessimistic.

Figure 1: Breakdown by credit rating

Credit rating	HSBC GIF Asia High Yield Bond fund	Asia high yield market (JACI Non-Investment Grade Corporate Index)
Investment grade	10.6%	0.2%
BB	42.6%	39.7%
B	39.8%	30.5%
CCC	1.1%	1.4%
Below CCC	0.0%	0.1%
Non-rated	5.8%	28.0%
Total	100%	100%

Figure 2: Breakdown by price levels

Yield level	HSBC GIF Asia High Yield Bond fund	Asia high yield market (JACI Non-Investment Grade Corporate Index)
Below 30	0.0%	0.0%
30 to 50	0.0%	1.0%
50 to 70	2.1%	3.9%
Above 70	97.9%	95.1%
Total	100.0%	100.0%

Any performance information shown refers to the past and should not be seen as an indication of future returns. Investment involves risks.
Source: HSBC Global Asset Management, JP Morgan as of 1 April 2020.

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 long-running Asia high yield strategy is ranked as the top performing fund (number 1) in its peer group, across all standard periods including 1-year, 3-year and 5-year periods (as of 27 March 2020), while our Luxembourg domiciled HSBC GIF Asia High Yield Bond fund, which was launched in November 2019, is ranked in the top quartile across the 1-month and 3-month periods (as of 27 March 2020)[1]. Our peer group performance rankings for our Asia high yield funds indicate a strong relative track record of credit analysis and sector allocation.

Past performance is not indicative of future performance.

Note 1: Source is Morningstar as of 27 March 2020. Peer ranking is based on the Asia high yield bond universe under Morningstar category. Any performance information shown refers to the past and should not be seen as an indication of future returns. Investment involves risks.

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 high yield 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 JACI Non-Investment Grade Index) and the very attractive returns following the rebound.

Performance of Asia high yield 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	39	-34.16%	10.22%	43.48%
Interest rate fears	9-Sep-11	4-Oct-11	25	-11.54%	11.56%	18.16%
Taper tantrum	9-May-13	25-Jun-13	47	-8.23%	3.40%	7.51%

Any performance information shown refers to the past and should not be seen as an indication of future returns. Investment involves risks.
Source: HSBC Global Asset Management, JP Morgan, as of 31 March 2020.

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 will 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 a couple of weeks ago.

We would like to reassure investors that our HSBC GIF Asia High Yield Bond fund has taken a number of steps to maximize liquidity during this difficult period:

- Going into the period of volatility, our funds 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 funds 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 high yield bond in our Asian high yield funds is much less than 2%, with over 60% in holdings less than 1%
- Our funds are relatively small compared to some in the market. This means that we can be more selective about the bonds we buy and don't have to make the unsavoury compromise between diversification and populating our portfolios with bonds which we are less confident about. 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 to the best advantage of our clients

Conclusions

The global pandemic has caused severe stress for global credit and particularly high yield markets. But for the discerning investor, we believe that there is an unusually attractive developing opportunity in Asia high yield bonds. 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 liquidity has been difficult in markets in the last few weeks, there are also steps we can take 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.

Important information

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