LOMBARD ODIER
INVESTMENT MANAGERS

2019 Outlook
Asia Value Bond Strategy

High Conviction • Fixed Income January 2019

ASIAN CREDIT – ANNUAL OUTLOOK 2019

2018 was a difficult year for us. Low Treasury yields and credit spreads at the start of the year left little room for error, and the resulting US-China trade tensions, as well as China's deleveraging campaign, had a far more negative impact on Asian USD credit spreads than we could have imagined. That, coupled with exogenous risks from bouts of currency depreciation in emerging markets, spiking Treasury yields, and adverse risk-off sentiment made it a perfect storm for Asian credit.

In our last annual outlook, we opined that Treasury 10-year yields would move into the 2.6% to 2.8% yield range from 2.4% at the start of 2018, whilst shorter duration high yield (HY) could provide stability to returns in 2018. Instead, Asia HY moved from lows of 5% YTW in 2017 to highs of over 9% by end 2018, levels not seen since the post-crisis years of 2009-2011. Treasuries on the other hand, moved well past 3% to 3.25%, although ending the year closer to our initial expectation of 2.68%.

Simply put, annual outlooks tend to be very humbling experiences with the passage of time, especially for long-only investors who tend to be boxed in. The best on the sell-side do not seem to fare much better either. In 2018, most sell-side investment banks had Treasury year-end forecast of well above 3% or around 3.5%, but 10-year yields closed at only 2.68%. The inversion of the yield curve also surprised many.

Consequently, instead of yield projections, we have chosen to highlight a few key themes for Asian credit for the year, as follows:

Key themes for Asian credit in 2019

1. A more accommodative Fed with the passing of peak global growth
2. China – Policy loosening will lower Chinese USD yields
3. Indonesia – Strong macroeconomic response likely to inspire a long-bond duration rally
4. India – Elevated IG spreads likely to drive better performance; prefer IG to HY
5. Asia supply to be more diverse in 2019
6. Low dollar cash-priced bonds have opened a strong potential upside scenario

We are bullish on the outlook for the asset class for the coming months. Yields have started the year at elevated levels, leaving good room to run with the more accommodative Fed stance of late. China's policy loosening, greater policy leeway for India and Indonesia, post their tightening in 2018, lower projected net new issuances in various segments of the market, and pent-up demand for emerging fixed income asset class could add wings to a rally. After all, the best returns in credit tend to come after periods of sharp negative total return.

We hope you find our report useful, and we would be delighted to hear feedback and opposing market views, if any.

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1. A MORE ACCOMMODATIVE FED WITH THE PASSING OF PEAK GLOBAL GROWTH

We believe that the Fed's recent shift in policy rhetoric in 4Q2018 from a hawkish tone to a more moderate one will set the tone for the Asia USD credit landscape in 2019.

The illusion of runaway US growth and synchronised global activity that was the market's focus in early 2018, has given way to the reality of policy unorthodoxy by the US. In a new environment where nationalistic stances are rising at the expense of free trade, labour mobility and international alliances, global growth momentum will suffer. These trends, coupled with the reality of already high debt levels and an aging world, mean it was only a matter of time before the Fed had to step back from its auto-pilot rate hike programme.

Table 1 Drivers of changes in Fed policy outlook

Slower US GDP growth	• IMF has revised down longer term US GDP growth on expectations that a burst of strong growth, boosted partly by tax cuts, will taper off. US real GDP is predicted to fall to 1.8% in 2020[1] from 2.9% in 2018. • Mid-term elections led to Democrats controlling the House, likely leading to greater difficulty for the current administration to enact further stimulus.
Slower global growth	• Global growth predicted to be 3.5% in 2019, down from the previous 3.7% forecast.[2] • Trade tensions between the US and China, slowing economic momentum in the Eurozone, Brexit worries and sharply declining equity markets are all factors. • EM central banks have raised interest rates in 2018 by an average 4.3%.[3]
Lack of US inflation	• Despite robust 2018 US growth, US Core PCE is only running at 1.9% year-on-year, a touch below Fed's 2% target. • Drop in energy prices in H2 2018.
Tighter credit conditions	• US credit market conditions have tightened in 2018.[4] • Fears of over-levered BBB-rated[5] US corporate issues that could be downgraded to non-investment grade, particularly as growth slows. • Tighter liquidity conditions owing to Fed balance sheet roll-off.[6]

Source: IMF, Bloomberg, Lombard Odier calculations. As at 22 January 2019.

The change in the Fed's policy rhethoric is conducive for Asian and Emerging market ("EM") USD credit asset classes. Compared to 2018, EMs will have significantly less pressure in hiking interest rates and enacting emergency-like measures to stem another bout of currency declines. Higher EM domestic rates,[7] readjusted EM currencies and more palatable US rate path in 2019 (two hike projections by the Fed, instead of 2018's four hikes) will likely allow EMs to focus on growth once again, albeit at a more moderate pace.

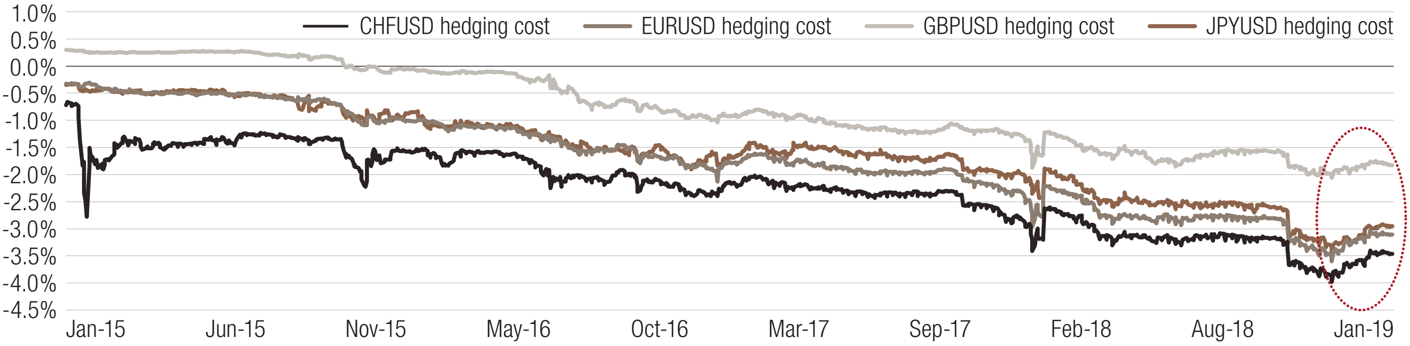
Table 2 Outcome of the recent shift in Fed policy

Lower Fed Funds Rate ("FFR") path in the US[8]	• FOMC's dot-plot that projects the median expectations for the Fed Funds Rate ("FFR") for 2019 has been shifted from 3.125% to 2.875%. • The "terminal rate," i.e. the long-term FFR, has been shifted down from 3.0% to 2.75%.
Stronger EM currencies and better YOY growth	• 2018 saw various EMs hiking local rates, in order to increase their real interest rate in light of USD strength. • Fed's policy shift means EMs have more room away from further tightening domestic conditions and favour greater growth policy measures in 2019.
Lower USD hedging costs	• Lower FFR outlook lends support to (a) less strong USD than previously anticipated, and (b) lower forward interest rate differentials between US and other weaker developed economies. • This likely leads to lower hedging costs for non-USD investors going forward, which had risen in recent years owing the divergence in rates in the US versus other major economies (see chart below).

1 IMF US real GDP forecast, Bloomberg. 22 January 2019.
2 IMF Global real GDP forecast, Bloomberg. 22 January 2019.
3 EMs with investable USD credit markets. Equal weighted average of increase in policy rate over 2018. Countries included: Pakistan, Indonesia, Philippines, Russia, Turkey, Argentina, India Mexico, Malaysia, South Africa.
4 There was no US HY issuance in December 2018.
5 BBB-rated issues now represent more than half of the US investment grade corporate universe.
6 Since October 2017, the Fed has been trimming US Treasuries, agency debt and MBS every month from its balance sheet. At its peak, the Fed's balance sheet was ~USD 4.4 trillion and has shrunk to USD 4 trillion currently.
7 India, Indonesia, Malaysia, Philippines, Thailand, Turkey, Argentina, Mexico, South Africa were amongst EMs that raised rates in 2018.
8 Changes made on FOMC's meeting on 19 December 2018.

Despite the recent changes in dot-plot and terminal rate projections, one area where the Fed has not provided further transparency is its balance sheet roll-off (MBS, agency, Treasuries) programme, i.e. quantitative tightening ("QT") programme. The Fed currently has it on autopilot, and we believe with slowing US growth and a peaking rate cycle, the Fed should likely revisit its stance this year and set a path to end QT. We believe a reduction in the QT programme – i.e. the Fed does not shrink its balance sheet further and once again resumes purchases of bonds – could start as early as in 2020.

Figure 1 – Hedging costs from USD into major currencies (3m annualised, in %)



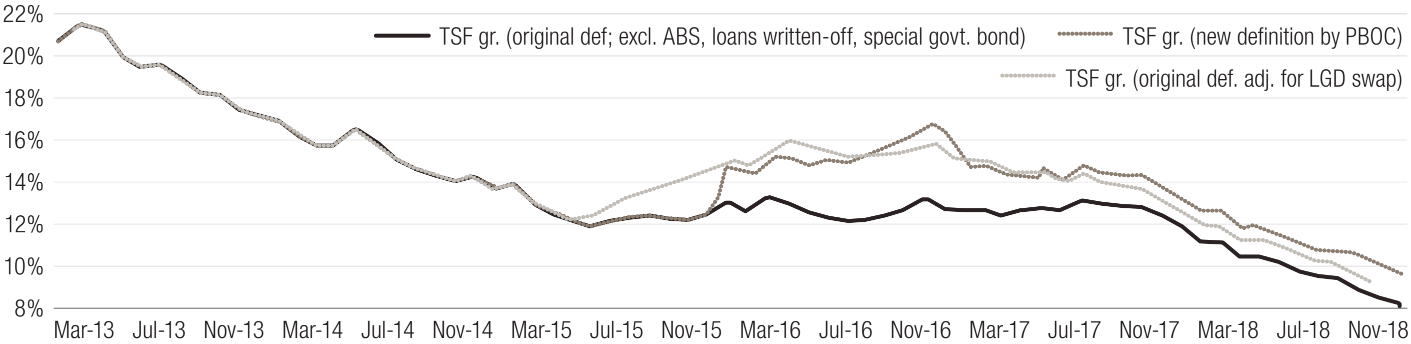
Source: Bloomberg, Lombard Odier. 21 January 2019.

2. CHINA – POLICY LOOSENING TO LOWER CHINESE CORPORATE USD YIELDS

Deleveraging campaign in 2017-2018 resulted in a self-imposed credit squeeze and a higher default rate

Over the past few years, Chinese authorities have shown progress in their deleveraging efforts to restrain growth in shadow banking and interbank activities. By early 2018, tighter regulations on shadow banking pressured the Chinese financial system and resulted in system-wide tighter liquidity conditions. The shadow banking sector contracted by RMB 3.6 trillion in the first nine months of 2018, to RMB 62.1 trillion, despite the need of additional credit for positive GDP growth country. As such, total social financing (TSF) growth decelerated from the peak of 16.9% in November 2016 to 9.9% in November 2018 (according to the PBOC's new definition).

Figure 2 – Total Social Financing growth has slowed down YOY

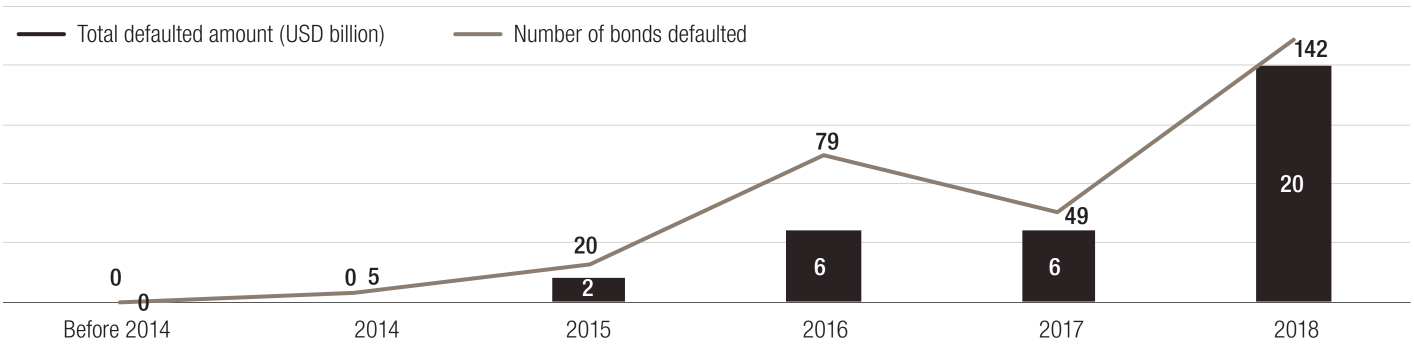


Source: JP Morgan Research.
Note: TSF refers to the aggregate volume of funds provided by China's domestic financial system to the private sector of the real economy within a given frame. It is comprised of a total of 10 sub-indices including RMB loans, Foreign currency loans, Entrusted loans, Trust Loans, Undiscounted bank bills of acceptance, Corporate bonds, Non-Financial corporate domestic equity financing, Insurance company repayments, investment property, and Financing via other financial instruments. (Source: China Banking News).

Therefore, it is not surprising to see a higher default rate in 2018 due to deleveraging policies and a tighter liquidity environment in China. In the Asian USD credit market, there were seven credit defaults (including Noble Group and Hsin Chong Construction), totaling USD 6.1 billion, which pushed up the Asia ex-Japan USD bond default rate to 2.5% in 2018. However, for the onshore RMB bond market, there were 142 companies totaling USD 20 billion worth of defaults in 2018. This is the highest level on record including a wide spectrum of sectors for onshore China.

In 2019, we expect the onshore default rate to stay at elevated levels, due to (a) higher refinancing needs and (b) investors' increasingly selective appetite owing credit quality concerns. We anticipate a higher default rate for the Chinese industrial sector, due to its small operating scale, weak corporate governance and limited funding channels. The fact that a Chinese industrial company, Kangde Xin Composite Material Group, was the first to default in 2019[9] highlights the fragility of the sector.

Figure 3 – Sharp increase in onshore China bond defaults in 2018



Source: WIND and J.P. Morgan.

[9] Kangde Xin Composite Material Group has 300 milion amount of USD bonds outstanding.

Chinese authorities took further aim at the real estate market, with the intentions to cool the physical market. The tight liquidity situation in the onshore market, due to the curb on the onshore shadow banking system, caused Chinese property developers to look to offshore funding channels to refinance debt – this triggered the heavy supply in the offshore USD bond markets in 2018.

The result was an unprecedented spike in bond yields of real estate firms, many of them amongst the largest in the world, which were posting record sales and profitability during the course of 2018.

Table 3 Unprecedented yield increases of property firms despite no rating downgrade or outlook revisions to negative

COMPANY NAME	SECURITY NAME	MATURITY	RATING	YTW AT 2-JAN-2018	YTW AT 31-DEC-2018	YTW CHANGE
Country Garden	COGARD 4 3/4 07/25/22	7/25/2022	BB+	4.7	7.6	2.9
Sunac	SUNAC 7.95 08/08/22	8/8/2022	B	7.5	9.8	2.3
Agile	AGILE 5 1/8 08/14/22	8/14/2022	BB-	4.4	8.2	3.8
CIFI	CIFIHG 5 1/2 01/23/22	1/23/2022	BB-	5.4	8.7	3.3
Evergrande	EVERRE 8 1/4 03/23/22	3/23/2022	B	6.4	9.5	3.1
Shimao	SHIMAO 8 3/8 02/10/22	2/10/2022	BB	4.7	6.2	1.5
Future Land	FTLNHD 5 08/08/22	8/8/2022	BB	5.4	8.7	3.3

Source: Bloomberg, JP Morgan Research. As at 31 December 2018. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

In the China credit market, we prefer large-cap IG rated credits including policy banks and state-owned enterprises. Within HY, we prefer large-cap nationwide property developers, who are leading in the sector despite industry consolidation, as well as established leaders in various industries such as renewable energy.

China's shift to an accommodative monetary and fiscal policy stance

Whilst the Chinese authorities have implemented deleveraging policies since 2016 in order to cool excessive credit growth and distortions in the economy, finding a right balance between reducing credit growth and keep economic growth stable is no easy task. The tighter than expected credit conditions that transpired in both the onshore and offshore Chinese market, and rising exogenous risks including trade tensions the US, probably prompted the authorities to adjust its policy stance to be more accommodative in order to support the broader economy.

From 2H 2018, China has started to embark wide-scale monetary and fiscal easing measures. These measures include injecting liquidity (cutting the banks' Reserve Ratio Requirements, "RRR") into the onshore credit market, and encouraging financial institutions to provide support to LGFVs (local government financing vehicles), private-owned enterprises (POEs) and small and medium enterprise (SMEs). At end 2018, Chinese authorities also signalled a policy shift for the property sector, which will take some pressure off financing for developers. Meanwhile, an income tax reform has also been implemented as of 1 January 2019 in order to boost domestic consumption.

Looking into 2019, a weaker USD leaves more room for easier monetary policy in China going forward, in our opinion. We expect the People's Bank of China (PBOC) to lower the RRR further and inject liquidity via the targeted medium-term lending facility (TMLF). On the property sector, more easing is likely to be announced in Q2 2019, which should support property sales in Tier-1/-2 cities. Should the economic situation soften further, we believe there will be a higher chance of a cut in the benchmark lending rate.

Table 4 Key Policies Announced in China since June 2018 to stabilise growth

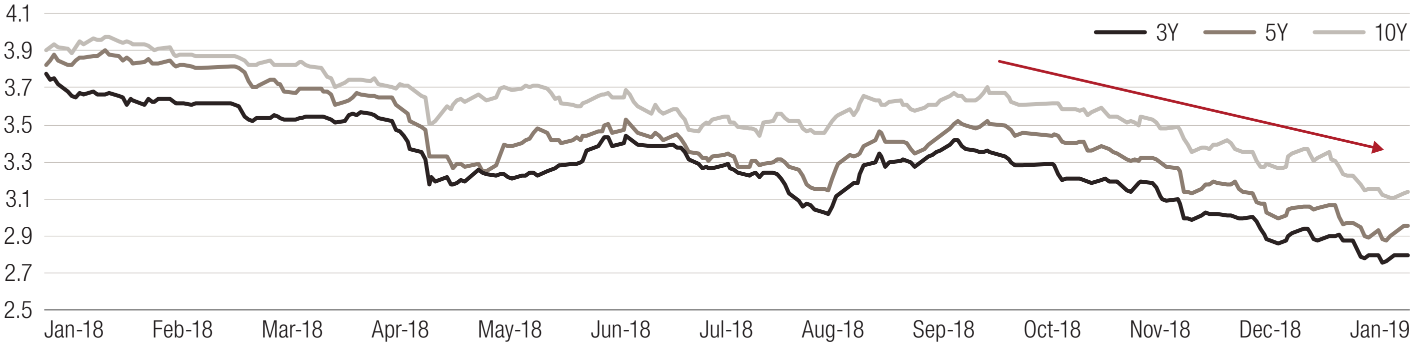
MONTH	KEY POLICY
June-2018	• The PBOC cuts banks' RRR by 50 bps and releases RMB 700 billion in liquidity, effective since 5 July 2018
July-2018	• The China Banking and Insurance Regulatory Commission ("CBIRC") releases new draft rules to strengthen supervision of commercial banks' wealth management products (WMPs) • The draft rules confirm that publicly offered WMPs can invest in non-standard debt assets until the end of 2020 • **First sign of policy easing with regard to shadow-banking**
Aug-2018	• The CBIRC issues a statement to encourage banks and other financial institutions to extend more credit and support the real economy • The regulator asks banks to support the reasonable demand from financing from LGFVs and to support struggling small private business, agriculture and export-oriented firms • The statement aims to **help alleviate funding pressure and avoid a potential liquidity crunch from some marginal borrowers**
Oct-2018	• The PBOC cuts banks' RRR requirement by 100bps, effective 15 October; **this cut spurs bank lending to SMEs and POEs** • The PBOC also announces that it will increase the re-lending and re-discounting quota by RMB 150 billion • Politburo meeting on 31 October 2018 signals China government will stabilise economic growth amid external challenges • Action indicates that **China authorities will put the stabilisation of economic growth as their first priority** • Market expects more precise measures and policy easing to be announced soon in order to restore confidence in the economy • China considering cutting car purchase tax, in order to boost car sales • China announces its plan to cut personal income taxes from the start of 2019, which is intended to boost domestic consumption • The State Council issues a guideline to promote infrastructure investment, which **aims to strengthen financial support for ongoing infrastructure projects and major projects,** and to ensure reasonable financing demand from LGFVs
Nov-2018	• Some local governments announce a relaxation of home-purchase-restrictions (such as Suzhou) and commercial banks cut mortgage rates for some cities, such as Beijing, Shenzhen, Guangzhou, etc.
Dec-2018	• **China Housing Ministry issues a statement allowing different cities to implement different policies,** noting that local governments should be responsible for their own property market. This statement ends this round of property tightening cycle • **Some local governments announce several city-specific policy fine tuning to support physical market;** Guangzhou and Hangzhou gradually allow some projects with average selling price increase of 5%; Heze (a small city in Shandong) scrapped a two-year holding restriction on new homes • **The National Development and Reform Commission (NDRC) issues guidance to support qualified developers to issue enterprise bond,** which provides a diversified funding channel for property developers despite the restrictive requirement on the use of proceeds
Jan-2019	• The PBOC cuts RRR by 1% to further support the real economy; Market expects banks to release about CNY 1.5 trillion in funds into the financial system • Selective cities continue to announce easing policies in the property market; the government signals a policy shift, while **commercial banks have also begun to trim mortgage interest rates for the first-time buyers**

Source: Moody's, Bloomberg, LO Fixed Income Research.

China Government Bond (onshore CGBs) Yield declines will make onshore issuance more attractive for high-grade credit issuers

Monetary policy easing, including four RRR cuts in 2018, replenished liquidity in the system and propped up onshore credits. At the same time, China government bonds started showing better performance as China resumed its credit easing cycle, while the US Fed remained on a rate-hiking path and the ECB looked to normalise monetary policy. 10-year onshore Chinese government bonds finished 2018 at 3.23%, a decline about 67bps compared to the start of the year.

Figure 4 – China Government Bonds (onshore CGBs) Yields have been declining



Source: Bond Radar, Bloomberg, J.P. Morgan estimates.

With the expectation of further easing, higher budget deficit and no inflation concerns, we expect CGB yields to stay low over 2019. Lower CGB yields would mean high-grade credit issuers could find lower domestic all-in-yields more attractive to issue bonds there, than in the international USD bond market where Treasury yields have risen and credit spreads are elevated. This then sets the scene for lower additional new supply of Chinese USD bonds into the international market.

Table 5 China Government Bond (onshore CGBs) Yields to Stay Low in 2019

	4Q2018	1Q2019E	2Q2019E	3Q2019E	4Q2019E
1-year Best lending (%)	4.35	4.35	4.30	4.30	4.30
CGB 10-year (%)	3.31	3.34	3.34	3.24	3.25
USDCNY	6.88	6.90	6.86	6.85	6.80
CPI	2.2	2.4	2.5	2.3	2.2

Source: Bloomberg (as 17 January 2019).

Newly introduced diversified funding channels to lower funding costs in onshore market

Both onshore and offshore bond markets have continued to grow in 2018. Compared to 2017, there are now wider onshore funding channels available to Chinese issuers, despite a decrease in shadow banking activities. These include the domestic asset backed securities (ABS) market, which showed a 44% yoy growth to account for 3% of the overall outstanding bond market in China. The government intends to develop this as a new funding channel for selected issuers.

In addition, NDRC in December 2018 announced a new funding programme for property developers, the "enterprise bond" channel. Issuers that can tap this new funding channel have to meet certain criteria, which tends to favour large-cap companies with lower leverage and gearing ratios. Key criteria for enterprise bond issuances include (a) total company assets greater than RMB 150b, (b) total revenue greater than RMB 30b, (c) leverage lower than 85% (total liability / total assets), and (d) domestic credit ratings at the "AAA" level. Based on our analysis, the following developers may benefit from the new enterprise bond issuance programme.

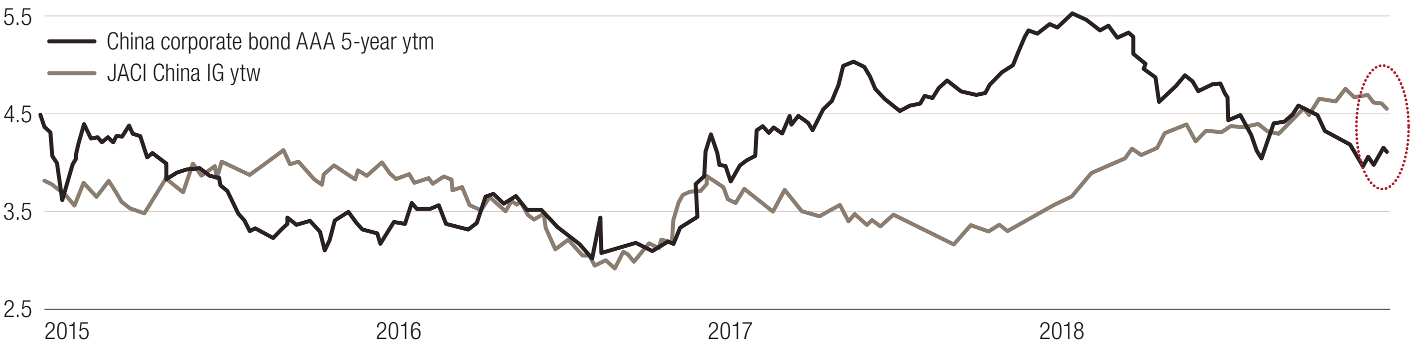
Table 6 Beneficiary Developers from NDRC Enterprise Bonds

CHINA VANKE CO LTD-H	CHINA JINMAO HOLDINGS GROUP
CHINA RSOURCES LAND LTD	SINO-OCEAN GROUP HOLDING LTD
CHINA OVERSEAS LAND & INVEST	AGILE GROUP HOLDINGS LTD
LONGFOR GROUP HOLDINGS LTD	CHINA FORTUNE LAND DEVELOP-A
SHIMAO PROPERTY HOLDINGS LTD	CHINA MERCHANTS SHEKOU IND-A
GUANGZHOU R&F PRPERTIES-H	SHENZHEN OVERSEAS CHINESE-A
CIFI HOLDINGS GROUP CO LTD	GEMDALE CORP-A

Source: Bloomberg, Company Data, LO FI Research. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

With the policy easing measures, onshore funding levels have started to decline from their peak levels since September 2018. In the offshore USD bond market, yields have started to tighten only since December 2018 and remain at wider levels compared to onshore ones. **Going forward into 2019, we continue to expect funding costs to further reduce. However, credit differentiation is key as weaker credits are likely to continue to have lesser access to existing and newly introduced diversified funding channels.**

Figure 5 – Relative Value of CNY versus USD Bonds – Investment Grade (as December 2018)



Source: Wind and J.P. Morgan. Yields are subject to change and can vary over time.

Figure 6 – Relative Value of CNY versus USD Bonds – High Yield (as December 2018)

Source: Wind and J.P. Morgan. Yields are subject to change and can vary over time.

In addition, technical support is likely to be in favour of China USD credit in 2019. We identify the following drivers:

Demand-side technicals:

- Attractive valuation of IG spreads and HY yields versus comparable global credit.
- Expected inflows into EM corporate bond investment mandates.
- Resumption of Chinese and HK investment accounts purchasing offshore Chinese bonds after the hiatus experienced in 2018, owing to policy uncertainty. China offshore bonds still offers attractive pickup compared to the onshore market, as such, this asset class remains appealing for China onshore investors despite the tightened capital controls.

Supply-side technicals:

- The gross supply for China offshore US bonds is expected to be only USD 139 billion in 2019, which is lower compared to 2018's USD 152 billion. We expect the proceeds of these new bonds to be used mainly for refinancing and coupon payments (maturity schedule remains heavy for 2019), which results in an even lower net refinancing amount.
- In particular, for the China HY property sector, net supply is expected[10] to moderate to USD 10 billion in 2019 from a record of USD 28 billion in 2018. This is as Chinese issuers have more available refinancing alternatives onshore, such as the recently announced enterprise bonds and ABS programmes. We expect issuers to make use of these refinancing tools owing to lower funding costs.

[10] Source: JP Morgan. January 2019.

3. INDONESIA – STRONG MACROECONOMIC RESPONSE LIKELY TO INSPIRE A LONG-BOND DURATION RALLY

Indonesia, which has been a poster child for macroeconomic prudence in emerging markets, has progressively moved from HY to IG[11] over the past few years. More recently, however, the country has faced challenges stemming from higher oil prices, USD strength and tighter global liquidity conditions. At the lowest point during 2018 (October), the IDR was down almost 11.7% for the year against the USD, while the domestic equity market fell by as much as 9%, in IDR terms. Meanwhile, onshore bond markets were also rattled as local currency government IDR 10-year bond yields climbed >270bps to a high of 8.9%.

Policy response has laid foundations for an IDR recovery

In response to these external risks, the Indonesian government and its central bank have enacted proactive and coordinated policy responses in a very timely manner, as summarised in the table below:

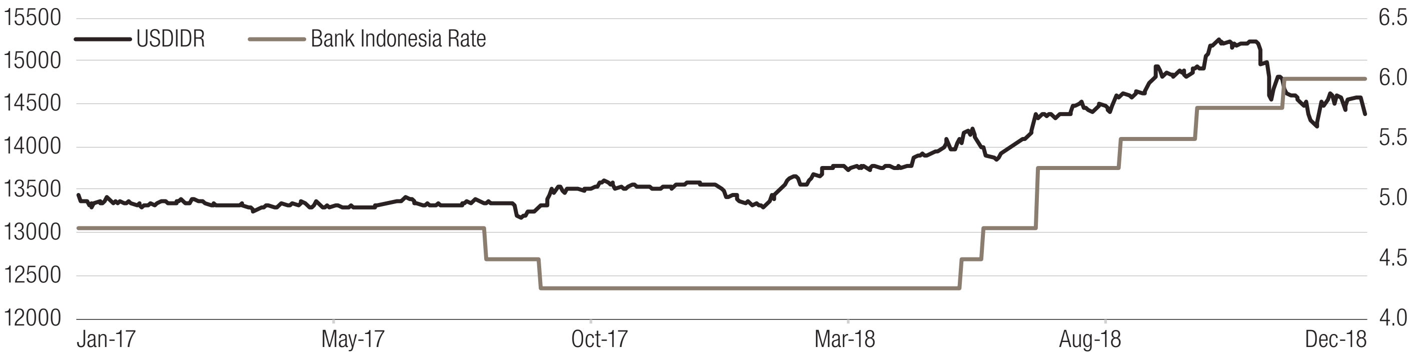
Table 7 Strong and timely policy response by the Indonesian authorities

Attract capital inflows	• Pre-emptively raised its benchmark policy rates by 175bps during the year to 6% currently • Maintained consistent and regular communications by policymakers to market participants • Dual market intervention in both FX and rates market • Pre-emptively signed bilateral swaps with Singapore and Japan
Reduce deficit (current account)	• Increased the contribution of biodiesel to 20% of the energy mix from 7% to reduce fuel imports • Raised import taxes on consumer goods • Delayed some national infrastructure projects which have yet to secure financing • Required companies in certain sectors such as metals and mining to repatriate export earnings back to Indonesia or to hold them in offshore branches of local banks to boost dollar liquidity
Continuous improvement in ease of doing business	• Introduced the 16th economic package, which included several regulatory changes such as: 1) tax breaks for the agriculture and digital industry sectors; 2) opening up a larger amount of sectors for partial or full foreign ownership; 3) tax cuts for commodity exporters.

Source: Bloomberg, Lombard Odier. January 2019.

Unlike other EM countries (for instance Turkey), the message from Indonesia was clear and timely. The government also remains committed to improve its business/investment environment, which should in turn encourage greater investments, exports, capital inflows and boost growth in the medium term.

Figure 7 – An aggressive rate hike schedule has arrested IDR weakness



Source: Bloomberg Finance L.P., Lombard Odier. As at 31 December 2018.

[11] Upgraded to IG by S&P, Fitch and Moody's in 2011, 2017, and 2012, respectively.

In summary, we think that the government has built a credible and sustainable macroeconomic policy framework. Indeed, the IDR quickly recovered in Q4, closing only 5.7% down for the year. Key highlights are:

- Inflation remained firmly anchored, with the CPI inflation holding below the 3.5% target for 2018.
- In spite of the upcoming 2019 elections, fiscal spending remains in check.
- According to the Finance Minister Sri Mulyani Indrawati, 2018 (unofficial) budget deficit shrunk to only 1.72% of GDP, the smallest since 2012 and well below the budget estimate of 2.19%
- Projected 2019 budget deficit is only expected to be 1.85% of GDP

Table 8 Indonesia has balanced low deficits against moderate GDP growth and low inflation versus its peers

	CURRENT ACCOUNT DEFICIT			FISCAL DEFICIT			GDP GROWTH			INFLATION		
	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F
Indonesia	(1.7)	(2.8)	(2.6)	(2.9)	(2.1)	(2.0)	5.1	5.2	5.1	3.8	3.2	3.8
India	(2.8)	(2.6)	(2.5)	(3.6)	(3.4)	(3.3)	6.7	7.3	7.3	4.0	3.8	4.5
Brazil	(0.3)	(0.8)	(1.5)	(8.9)	(7.4)	(6.5)	1.1	1.3	2.5	3.5	3.7	4.0
Russia	2.1	6.4	4.8	(1.7)	2.1	1.8	1.6	1.7	1.5	3.7	2.9	4.9
Mexico	(1.6)	(1.6)	(1.6)	(1.1)	(2.2)	(2.5)	2.0	2.1	2.0	6.0	4.9	4.1
Turkey	(5.2)	(4.1)	(3.0)	(1.5)	(2.7)	(3.1)	7.4	3.2	0.3	11.1	16.2	17.8
Argentina	(5.1)	(4.5)	(2.3)	(1.0)	(5.6)	(3.6)	2.9	(2.4)	(1.0)	23.6	34.2	37.0
South Africa	(2.4)	(3.6)	(3.6)	(4.4)	(4.0)	(4.0)	1.3	0.7	1.5	5.3	4.7	5.2

Source: Bloomberg Finance L.P., Lombard Odier (all forecasts are consensus estimates).

National elections in 2019 should not throw Indonesia off-course

Looking ahead into 2019, the market's biggest focus remains the Presidential and Parliamentary elections on 17 April 2019. In our view, President Jokowi's chance of re-elections remain high, and a second term will likely see a continuation of the emphasis on structural reforms and distributive policies. Unemployment has fallen to a 20-year low of 5.13% under Jokowi's watch, which should be supportive of his re-election bid. Public polls remain in Jokowi's favour at this point, but we do not rule out increased uncertainties as election campaigns heat up.

Regardless of the election results, macro conditions should remain broadly stable for 2019. GDP for 2019 should grow at a 5.0% - 5.4%[12] pace with low and stable inflation. Consumption growth should remain resilient, reflecting stable labour market and election-related spending. The central bank would also work to keep the current account deficits at around 2.5% of GDP in 2019, while the government is planning for a 1.8% fiscal deficit. While FX reserves have declined in 2018, as the central bank sought to stabilise the currency, we note a rebound in October and should continue to recover on the back of IDR strength.

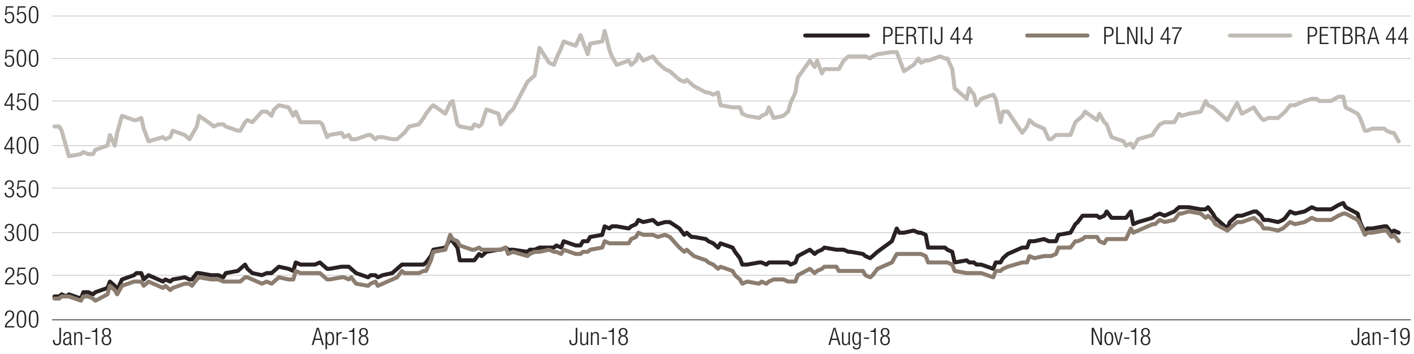
On the negative side, the country could see some headwinds from weaker coal and palm oil prices, should external demand soften. The impact of weak commodity prices is not only on consumption in commodity-rich areas, but also due to the risk of wider trade deficits. As far as the IDR is concerned, with a more dovish view on the USD, we think that the IDR will broadly stabilise around the 14,000-14,500 area.

Long-end quasi-sovereigns to be the first beneficiary of a more positive macro environment

With a broadly stable IDR, sanguine economic outlook and excellent steering of the EM macro risks by the Indonesian authorities in 2018, we believe the market will recognise the value in long-end quasi-sovereign Indonesian bonds. Indonesian quasi-sovereign long bonds have underperformed their EM BBB-rated peers, and in some cases, even BB rated peers such as Petrobras.

[12] Based on Bank Indonesia's forecast.

Figure 8 – Indonesian long-end quasi-sovereign (BBB-) has widened out much more than Brazil's Petrobras (BB-)[13]



Source: Bloomberg Finance L.P., Lombard Odier. As at 18 January 2019.

Meanwhile, for corporates (non-quasi-sovereign) which are HY rated,[14] we see the following trends.

- Stable leverage and interest coverage should remain at broadly healthy levels.
- Limited refinancing needs in 2019 and 2020, reducing near-term default risk.
- Supportive market technicals as supply from Indonesian issuers should remain small given current spreads. Any issuances from new corporates would likely only come in H2 2019 after the elections.

Table 9 Summary of our views by sector

SECTORS	OUTLOOK
Quasi-Sovereign	• Likely to benefit from underlying improvement of the economy, especially with IDR stability • Lower expected new issuance than in 2018
Real estate	• Positive on the low-mid tier residential and industrial space, which could benefit from a rebound in "pent-up" demand post-elections • Remain cautious on high-end segments • Real estate companies which suffer from FX mismatch and should benefit from stable IDR
Oil and Gas	• Neutral view. Stable oil prices should support upstream margins
Metals and Mining	• Cautious on coal miners, as low quality coal prices have weakened in light of China import curbs • While we think prices should rebound in the short term, it is unlikely that we will see a sharp run up as in 2017-H1 2018. Divergence between high and low quality coal is likely to remain "extraordinary" high
Other Industrials	• Positive on palm oil companies as palm oil prices have likely bottomed out • Neutral on textile companies as companies have already worked on liability management exercises; working capital expected to remain high

[13] Ratings are Bloomberg composite ratings.

[14] Majority of Indonesian corporates (non quasi-sovereigns) are rated HY as they are capped by the sovereign rating at Baa2/BBB- by Moodys/S&P.

4. INDIA – ELEVATED IG SPREADS LIKELY TO DRIVE BETTER PERFORMANCE; PREFER IG TO HY

Indian macro faced several headwinds in 2018, both from global developments as well as internal issues. While global pressures (tighter US monetary policy, stronger USD and higher oil prices) were somewhat anticipated and manageable given India's low inflation rate, high growth, diversified economy and lack of external USD funding requirements at the sovereign level,[15] the internal issues that had surfaced in 2018 had a considerable negative sentiment on credit markets.

Table 10 Internal issues in 2018 that were a credit negative

Deficit concerns (fiscal and current account)	• Lower GST collection[16] • Potential stimulus for the rural sector[17] prior to national elections in 2Q2019 • Uncontrolled merchandise imports, as well as portfolio outflows
IL&FS default and NBFC credit squeeze	• Default of highly levered industrial and financial group IL&FS in Aug 2018 that led to a credit squeeze in the Indian shadow banking market • Sharp tightening in liquidity/funding channels for Non-Bank Financing Companies ("NBFCs") and Housing Finance Companies ("HFCs") • Impact on growth as NBFC sector accounted for ~30% of incremental credit growth system-wide in India
RBI-government tussle	• Unexpected departure of former RBI Governor Dr. Urijit Patel in Dec-18, who was believed to be opposing government's efforts withdraw part of RBI's reserves[18] for use in fiscal spending • This is the second RBI governor who has been pressured to step down, with the predecessor Raguram Rajan stepping down in 2016

The result was a depreciation of INRUSD by 10% in 2018, pressured by a higher current account deficit (2.9% at Sep-18 from 1.9% in FY Mar-18). Authorities were slow to react to all the pressures, unlike the proactiveness displayed by their Indonesian counterparts. Nevertheless, they:

- raised local interest rates from 6.0% to 6.5%, despite inflation being within RBI's target,
- injected liquidity into the interbank markets via open market operations,
- relaxed lending requirements by banks to corporates, and
- increased purchase of loan assets by state owned banks from capital-starved NBFCs

Despite the hiccups of 2018, we consider 2019 to provide optimism on a few fronts. National elections due in April-May 2019 are widely talked about and could bring short-term volatility, but we believe fiscal consolidation has been widely accepted by the two major political parties. Overall, we consider that the Indian economy has generally continued to perform irrespective of election outcomes.

Table 11 Supportive factors for 2019 likely in place

Potentially lower oil prices supportive of INR	• Current account deficits should likely improve from about 2.5% of GDP in 2018 considering average crude oil prices are expected to remain lower than in 2018's USD 72/bbl • Capital flows likely to be better than in 2018 given receding expectations of rate hikes from US Fed
RBI potentially moving to easing stance	• Inflation remains subdued, driven largely by low food prices • There is some distress in unorganized/SME sectors following NBFC credit squeeze, which might justify easing rates
Bank Recap and NPLs bottoming	• Government is likely to infuse additional capital of INR 400 billion in public sector banks by Mar-19, over and above the INR 2.1 trillion recapitalisation plan announced in 2017 • NPL cycle likely peaked, therefore fresh bank lending would be supportive of growth
GST collection to increase	• We expect GST implementation (first implemented in Jul-2017) to pick up pace which would provide support to fiscal deficit targets in 2019 (3.1% of GDP in FY20, versus estimated 3.3% for FY2019)

Source: Bloomberg, Lombard Odier. January 2019.

Indian IG corporate spreads experienced dramatic widening in 2018 on the back of poor macro sentiment. Indian IG corporates underperformed rest of Asia IG by more than 10% of relative credit spread widening. This was despite (a) no corporate non-bank IG issuers being downgraded to junk and (b) India IG net new issuance being at only USD 0.6 billion versus historical average of USD 2.9 billion (2014 to 2017 average).

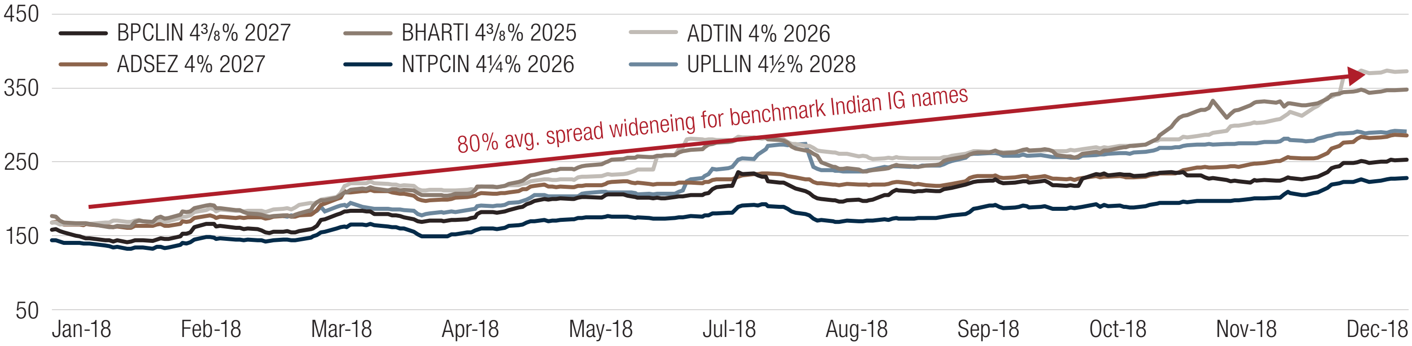
[15] India does not have any USD sovereign debt outstanding.

[16] GST (Goods & Services Tax) revenue peak run run-rate at ~INR 900 billion/month in 2018 versus target of INR 1.05 trillion

[17] Potential stimulus to farmers in distress, who are faced with sustained low agricultural prices.

[18] The government considers RBI's capital reserve of INR 9.6 trillion is in excess of INR 3.6 trillion. RBI's capital-to-assets ratio is now 30%, which the government thinks is excessively conservative, compared with only 1% at the US Federal Reserve.

Figure 9 – Credit spread widening of Indian IG corporates in 2018 (Z-spread bps)



Source: Bloomberg, Lombard Odier. As at 31 December 2018.

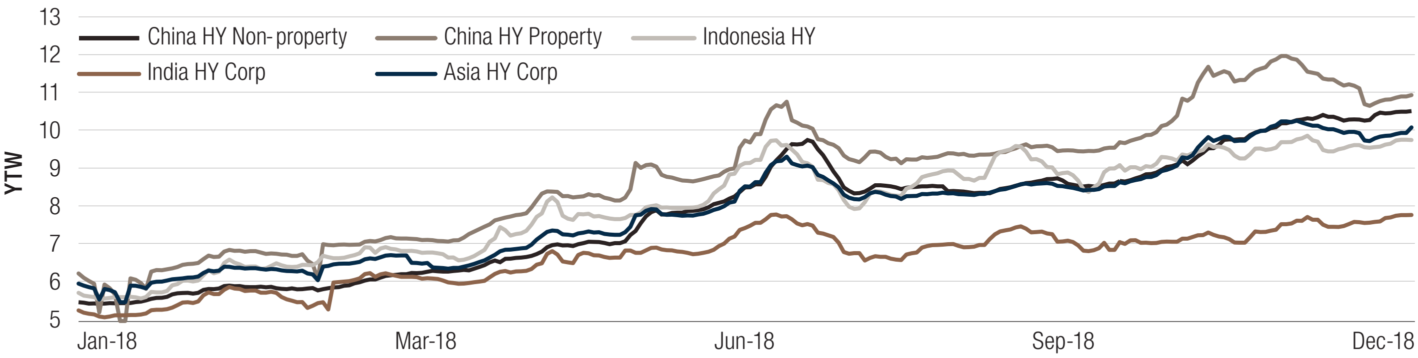
Table 12 Indian IG spreads widened by c. 80% on average through 2018

(Z-SPREAD, BPS)	2 JANUARY 18	31 DECEMBER 18	CHANGE IN Z-SPREAD (BPS)	% CHANGE IN Z-SPREAD
BPCLIN 27s	158	253	95	60%
BHARTI 25s	177	348	172	97%
ADTIN 26s	168	373	205	122%
ADSEZ 27s	168	286	118	70%
NTPCIN 26s	144	228	84	59%
UPLLIN 28s[19]	173	291	118	68%
Average	164	296	132	80%

Source: Bloomberg. [19] For UPL from issuance date of 01 March 2018.

Fortunes were dramatically different for India HY in 2018, which significantly outperformed the rest of Asia HY. Indian USD HY issues, many of which are household names amongst the rich international Indian community, continued to be held tightly by non-institutional investors for their familiarity and attractive yield-to-duration ratio, despite being tighter in yield versus China, Indonesia and other Asia HY issues. On the other hand, Indian IG USD issues tend to be bought by the international institutional community.

Figure 10 – India HY outperformed rest of Asia in 2018; and provides little relative upside in our opinion



Source: Citi Research.

We believe a more positive sentiment towards Indian macro will have a greater effect on IG versus HY spreads. This is because IG's elevated corporate spreads and higher duration can drive performance in 2019 whilst limiting downside should the national elections outcome be unfavourable.

5. ASIA SUPPLY TO BE LOWER AND MORE DIVERSE IN 2019

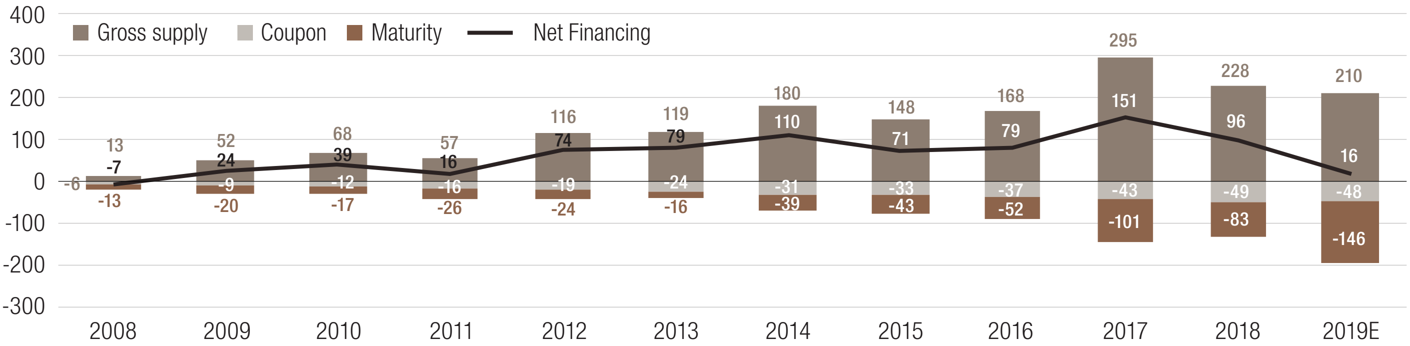
Asian USD bond issuance has grown at break-neck speed over the past 10 years, with the universe of Asian credit now over USD 1 trillion.[20] It has been the fastest growing major credit market globally, and recorded net issuance of over USD 100 billion in 2018 despite its EM regional counterparts Latam and CEEMEA having negative net issuance last year. Similarly, in developed markets, we have witnessed a trend of shrinking HY bond markets in Europe and US as issuers are increasingly favouring loan markets.

Based on projections by JPMorgan for the JACI[21] index, we note two distinct highlights for Asian supply in 2019:

1. Net issuance is expected to be extremely low, at levels last seen during 2011
2. Issuance expected to be more diverse by geography, with increase in issuance away from China

Such reduced net supply is likely to provide a very strong technical backdrop for the Asian USD credit spreads to tighten, especially if demand for the asset class is higher with investor inflows.

Figure 11 – Asia Ex-Japan Net supply in 2019 likely to be lowest since 2011



Source: J.P. Morgan. Bond Radar, Bloomberg.

Should we expand the universe beyond the JACI one, we estimate 2019's gross supply to be about USD 250-270 billion, implying net issuance (after coupon repayments) of only about USD 40-60 billion, which will again be the lowest net supply since 2011.

China net supply growth is expected to sharply reduce this year. It has been the largest issuer by far in recent years and accounted for 65% of 2018's USD issuance in Asia. However, with (a) Chinese policy loosening, (b) opening of new funding channels in onshore China, and (c) lower projected CNY yields, it is likely that private Chinese firms will require less funding from the international USD bond markets this year.

[20] Including Australia and Japan USD corporate and financial bonds.

[21] JACI: JPMorgan Asia Composite Index.

Table 13 Key supply trends for 2019

65% yoy drop in net supply from China HY property – biggest issuer by sector within HY	• JPM estimates net supply from China HY property to drop to only USD 10 billion in 2019 from an all-time high net issuance of USD 28 billion in 2018 • With the expected improvement in onshore financing conditions within China, we expect Chinese HY property developers to rely on cheaper onshore funding to refinance/fund land purchases • Tightening in approval process from NDRC since Jun-18, with offshore issuance to be used only for refinancing – is a big change from the past, when it was primarily used for land purchases
SE Asia issuance to be higher	• IG issuance from Indonesia, Philippines corporates/quasi-sovereigns likely to be higher as market sentiment improves • HY issuance from Indonesia likely to be muted aside from potential liability management exercises, given no maturities in 2019 and higher yields for Indonesian issuers
India IG issuance to be higher	• We expect gross supply from Indian IG corporates to be higher to around USD 5-6 billion (2018: USD 2 billion) given increasing capex requirements/share buy-backs at SOEs • IOCL and BPCL have already issued USD 1.4 billion YTD, taking advantage of RBI's relaxation on borrowings for oil marketing companies • HY issuance however will likely remain muted again (2018: USD 1.3 billion) as higher market yields restrict issuance due to L+450bps cap mandated by RBI
Sovereign issuance to pick up	• Asian sovereign issuances will likely be higher, with Pakistan, Sri Lanka facing significant offshore loan/bond refinancings (~USD 6-7 billion) • Indonesia/Philippines to remain opportunistic issuers while China could continue to build out its sovereign USD curve
Asian financials supply to be higher	• China financials issuance will likely pick up in 2019 versus 2018 (USD 45 billion), given increased refinancing needs (2019: USD 49 billion, 2018: USD 15 billion). We see issuance pickup mainly in hybrid space (AT1 & subordinated), while lower for Chinese state-owned asset management companies due to sector deleveraging • AT1 issuance from Chinese banks likely to be about USD 21 billion as per the current approvals • Indian financials space should be active too with issuances from SBI, HDFC, Indian Railways, other banks as well as Power Finance/Rural Electric during the year. SBI has already issued USD 1.25 billion YTD

Source: JP Morgan, Lombard Odier, Bloomberg. January 2019.

As per JPM estimates, net issuance (for the JACI) is expected to be only about USD 16 billion – lowest in years, which provides a very strong technical backdrop for the Asian USD credit spreads to tighten.

6. LOW DOLLAR CASH PRICED BONDS HAVE OPENED UP A STRONG POTENTIAL UPSIDE SCENARIO

Asian HY bonds have dropped meaningfully in cash price in 2018

2018 was a very challenging year for Asian HY. Based on the JACI non-IG index, Asian HY bonds on average would have **lost 9.2% in cash price during 2018**. As at end-2018, **the average cash price (ask) of a BB bond in Asia stands at 94.4, while the B bonds is lower at 91.0**.

Indeed, the sell-off in cash prices was particularly acute in 2018, mostly due to the larger amount of low coupon bonds issued between H2 2017 and Q1 2018. With lower coupons, the duration of these bonds becomes extended and more vulnerable to yield increase.

Table 14 Price declines for selected Asian HY bonds in 2018

COMPANY	COUPON	MATURITY	OFFER PRICE (31 DEC 17)	OFFER PRICE (31 DEC 18)	DECLINE IN BOND PRICE
Republic of Sri Lanka	6.125	2025	105.9	90.8	(15.1)
Country Garden Holdings Co Ltd	4.75	2023	99.7	87.7	(12.0)
KWG Group Holdings Ltd[22]	5.875	2024	97.8	82.2	(15.5)
CIFI Holdings Group Co Ltd	5.5	2023	99.5	87.3	(12.2)
Sawit Sumbermas Sarana Tbk PT[22]	7.75	2023	99.0	87.0	(12.0)
Agung Podomoro Land Tbk PT	5.95	2024	101.7	70.3	(31.5)
Tata Steel Ltd[22]	5.45	2028	100.0	85.9	(14.1)
GMR Hyderabad International Ai	4.25	2027	98.9	83.1	(15.8)

Source: Bloomberg Finance, Lombard Odier ([22] Bond prices as at issuance in 2018). Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

In terms of sectors, Chinese property HY bonds were the first to be repriced wider, as the tighter onshore liquidity drove a sharp increase in offshore issuance in Q1 2018. The larger amount of issuance also coincided with fund outflows in Asia, worsening the sell-off. For instance, China property benchmark issuer CIFI Holdings Group raised USD 300 million of 5-year bonds at 5.5% on 16 January 2018. By the end of the year, the company was only able to issue USD 400 million of 2.25-year bonds but at a much higher coupon of 7.625% in December 2018.[23] Meanwhile, Indonesian HY corporate credits sold off significantly after Q1, in line with the weaker sentiments for EM credits.

Having said that, not all HY bonds that experienced price declines were due to market driven factors. Some individual credits saw fundamental credit problems including corporate governance, increasing leverage and higher refinancing risks. The Chinese industrial space saw the most number of idiosyncratic issues and corporate governance concerns. Many of these names fell into distressed state due to promoter share pledges, transparency issues, and liquidity concerns.

Now that mark-to-market losses has been painfully absorbed in 2018, we believe low cash price bonds can actually be a bright spot going into 2019 and this should be one of the key themes for Asian credit investors in 2019.

Issuers may opportunistically conduct liability management exercises

With the low cash prices on their outstanding bonds, issuers may engage in opportunistic liability management exercises. This is what some issuers such as **Vedanta** and **Indika** have done post the commodities sell-off in 2015. Examples of such exercises include repurchase of bonds from the market, partial or full tender of outstanding bonds, or exercising the call options. With the flatter yield curve, stronger IG corporates may also swap their shorter-dated bonds with new longer-dated debt maturity. From the issuers' point of view, these exercises potentially allows them to recognize a profit on the balance sheet, reduce funding cost and rapidly deleverage. On the other hand, bond investors benefit from quick gain in bond prices, and stronger technical on the remaining bonds.

[23] CIFI did not experience any rating downgrades by Moody's, S&P or Fitch during the period Jan to Dec 2018. In fact, it was placed on Positive outlook by S&P in Mar 2018, and continues to be on positive outlook by Moody's and S&P.

Table 15 Recent liability management exercises in Asia

COMPANIES	IMPACT
Pan Brothers	In September 2018, Pan Brothers offered to repurchase up to USD 40 million bonds between 92-95c, funded by excess cash. As bonds were offered in the market at 91c prior to the tender, this exercise not only helped the company deleverage, it also provided stronger technical support for the remaining bonds.
Sri Rejeki Isman Tbk	On 4 January 2019, PT Sri Rejeki Isman Tbk launched a tender offer to repurchase up to USD 185 million of its 6.875% of 2021 bonds at 104.25 (YTM: 6.3%). The tender would be funded by a new syndicated unsecured bank loans with an expected all-in cost of only LIBOR+269bps. Once successfully executed, the company will not only increases its average debt maturity, but also reduce its overall interest costs.
Softbank Group	In mid-January 2019, Softbank Group offered to repurchase up to USD 750 million of its outstanding bonds, using proceeds from the recent IPO of its Japanese telecommunications business. The tender displays the group's intention to prudently manage its liabilities.

In our view, more of such opportunistic exercises could take place in 2019. Corporates could tap on their strong banking relationships, engage in non-core asset sale plans, or simply utilize their excess cash on balance sheet from business activity[24] to (partially) tender for bonds. In our view, such companies are likely to come from Hong Kong, India and Indonesia where liquidity is more available in the bank loan and private placement bond markets.

Bond investors get better risk-returns by investing in lower cash price bond

For most typical fixed income instruments, the payoff profile of the investment at par is capped on the upside (i.e. coupons payments), while the downside is much larger. The downside is broadly the difference between the current cash price and the "theoretical recovery value" upon default. This is in contrast to equities, where the payoff profile is linear.

Hence, as a bond moves lower in cash price, its risk-return profile shifts sharply in favour of the investor. The upside potential will increase due to the capital gains, while the downside risk is reduced as the cash price moves closer to the theoretical "recovery value." For example, a 5% coupon bond with a 5-year remaining maturity which is trading at 80c would offer an upside total return of 45 points over the 5-year period, and the percentage returns on cost would be higher at 56%. Meanwhile, assuming a "theoretical recovery value" of 40c, the potential downside would be 40 points, as compared to 60 points for a bond trading at par. This provides a more asymmetrical risk-returns relationship in favour of the investor. In fact, the lower the cash price, the more advantageous for bond investors.

Table 16 Asymmetric risk-reward of investing in low-cash price bonds

Entry Price for a 5% 5-year Bond	100c	80c	60c
Cummulative Potential Upside[26]	25%	56%	108%
Downside Risk in case of default	-48%	-34%	-13%

Note: For illustrative purposes only. Assume no compounding of returns. Assume with a 40% recovery rate, with default at mid-point of life of the bond.

While it might sound very simplistic to just invest in low cash price bonds, the reality can be rather difficult as the space is littered with potential default and/or debt restructuring candidates. Hence, it is very important to understand the reason for the lower cash price, the probability of default, and have a detailed analysis on the "theoretical recovery value." According to Moody's research, the average global senior unsecured bond has an actual recovery value of 38.2%. However, based on our experience and analysis, the range could rather diverse depending on the asset value and capital structure. For instance, Kaisa Group's[25] default saw an average recovery of about mid-60%, while a recent distressed exchange by Indonesian MNC Investama Tbk saw a recovery rate of ~94%. Going back longer in history, Indonesian property developer Pakuwon Jati's restructuring in 2009 also saw no principal haircut and a recovery value of 76%.

[24] Reduce capital expenditure to increase free cash flow generation.

[25] Large cap China HY property developer than defaulted in 1Q 2015.

Indonesian HY property sector – likely a prime candidate to provide double-digit returns in 2019 given low cash price as the starting point

One sector within Asia HY that has stood out in terms of drop in bond cash price in 2018, is Indonesian real estate. The sector was hit not only on weakening macro sentiment towards Indonesia, but also by the weak property market domestically which led to lower sales volumes and higher leverage. Yields increased, which created difficulty for these companies in accessing the bond capital markets should they have wished to. Such reduced access to liquidity became one of the reasons for rating agencies to downgrade their ratings – which in turn further amplified selling in the bonds, further increased the yields and dried up access of the firms to bond markets yet again. Such a negative loop often transpires in the credit markets, especially in emerging markets.

However, given the nature of the sector which is cyclical and one with high asset coverage, we have good reason to believe that many of the bonds are trading below their "theoretical recovery value" that we would assign as par. That is because potential asset coverage can be well above 100%, even after factoring in reasonable haircuts to asset valuations.

Table 17 Indonesian property developers that we believe are trading below their respective "theoretical recovery value," according to our in-house estimates

	COUPON	MATURITY	MOODYS	S&P	ASK PRICE	YTW	POTENTIAL ASSET COVERAGE
Alam Sutera Realty Tbk PT	6.63	4/24/2022	B2	B -[27]	89.37	10.56	>100%
Lippo Karawaci Tbk PT	6.75	10/31/2026	B3	B-	71.65	12.56	>100%
Lippo Karawaci Tbk PT	7.00	4/11/2022	B3	B-	78.15	15.92	>100%
Agung Podomoro Land Tbk PT	5.95	6/2/2024	B1		71.61	13.57	>100%
Kawasan Industri Jababeka Tbk	6.50	10/5/2023		B	87.57	9.86	>100%
Modernland Realty Tbk PT	6.95	4/13/2024	B2	B	87.15	10.18	>100%

Source: Bloomberg Finance, Lombard Odier ([27] Bond prices as at 17 January 2019). Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.