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Investment viewpoint

Asian credit: emergence of a new asset class

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Executive summary

Asian credit[1] has emerged as a new sub-segment within the global fixed income market. Over the past ten years, market capitalisation has grown significantly, and diversity and credit quality have improved.[2] This differentiates Asian credit from other major emerging markets (EMs).

The divergence stems from the high average rating of USD-denominated debt issued by Asian borrowers compared to the lower (and typically deteriorating) rating quality of other EM credit markets.[3] The variance is driving increased interest from non-Asian investors to allocate to Asian credit on a standalone basis as part of a broader credit allocation.

We believe global credit investors should build a dedicated allocation to Asian credit based on the opportunity to fund the growth and expansion of companies in the fastest-growing region of the world, and an increasingly diverse issuer base.

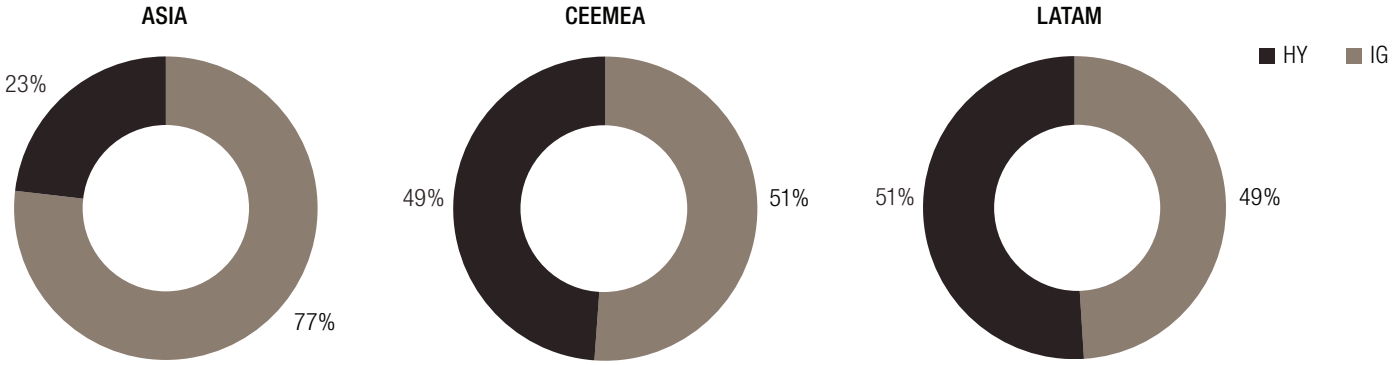
Asian credit's size and creditworthiness stand out

The nominal amount of Asian credit denominated in hard currency has grown from USD 250 billion in 2007 to more than USD 1.2 trillion in 2019.[4] Such significant growth has meant the Asian component of the market comprises more than 50% of the wider EM, USD-denominated credit universe.[5]

The average credit quality of Asian borrowers is investment grade (IG) on a market cap basis, compared to other major EM markets (such as LATAM, CEEMEA) which have both slipped into high yield (HY). Since 2014, large non-Asian sovereigns, including Brazil and Turkey, have lost their IG ratings, in turn negatively affecting quasi-sovereign and corporate issuers. Conversely, India and Indonesia – which historically were seen as "crossover" sovereigns with

[1] This paper uses the term "Asian credit" to refer to debt issued by Asian borrowers in hard currency.
[2] Source: Moody's, JP Morgan, October 2018.
[3] As measured by the JP Morgan JACI is investment grade (BBB) with a split of 78% IG versus 22% HY. Source: JP Morgan JACI constituents. As at 30 August 2019.
[4] Source: JP Morgan. August 2019.
[5] Source: JP Morgan. August 2019.

FIG. 1 ASIAN CREDIT QUALITY IS STRONGER THAN CEEMEA AND LATAM



Source: Lombard Odier calculations using JP Morgan Index data. Indices used: JPM JACI for Asia, CEMBI Broad sub-components for CEEMEA and LATAM. Index data as at 30 August 2019. Non-rated bonds included in HY percentage.

split ratings of investment grade and sub-investment grade – are now firmly in the BBB category of the IG rating spectrum (see Figure 1). This ratings evolution has resulted in a rise in Asia's share of overall EM IG issuance.

End of commodity super-cycle supports Asia

Following the abrupt end of the commodity super-cycle in 2015, many commodity-exporting nations experienced rating downgrades due to lower commodity prices. For instance, Brazil's credit rating was cut to HY from IG, while sovereign ratings in the Middle East suffered multiple-notch downgrades – fiscal pressures remain acute in Bahrain and Oman.

Asia is a net importer of commodities and has benefited from lower commodity prices. With the drop in oil prices from over USD 100/bbl from 2014 onwards, emerging Asian countries such as India and Indonesia have stopped providing fuel subsidies domestically since 2015, which consequently lowered the fiscal burden. The consumers and businesses there have since gone through a period of adjustment, and inflation risks have been well-absorbed. The reverse is the case for commodity-producing counties including Brazil, South Africa and Russia for instance, which have seen higher fiscal pressures after 2014.

China is a net creditor to the world

Unlike most emerging markets, China (rated A+/A-) is not reliant on funding from global markets as a whole. Its debt market is largely "closed" in nature, with the Chinese themselves owning a significant amount of Chinese-issued debt. This not only means that China's external vulnerability owing to global portfolio flows is minimal, but also means second order destabilising forces to the rest of Asian debt markets and economies are minimal.

Additionally, under President Xi Jinping's leadership since 2013, a financial reform agenda has been pursued to ensure a hard landing would be avoided. Old economy sectors have witnessed streamlining, the shadow banking sector has been curtailed, the banking system strengthened and financial regulatory bodies have been made more sophisticated, amongst others. China is now focusing on making its debt markets more market-based, ie closer to the Western model where defaults are market dependent rather than problem debt absorbed by the state.

Asian credit markets increasingly diverse

The economic growth and development of the region has given rise to new credit sectors, which did not previously exist. New issuers have come to the market in sectors which did not exist as recently as 5-10 years ago.

In our view, Asian hard currency credit offers large cap and diverse sector exposure not similarly present in the wider EM credit universe and Asia local currency bonds. Amongst others, these include leading firms in i) renewable energy, ii) technology as well as iii) real estate.

Asian corporates are less aggressive in terms of leverage

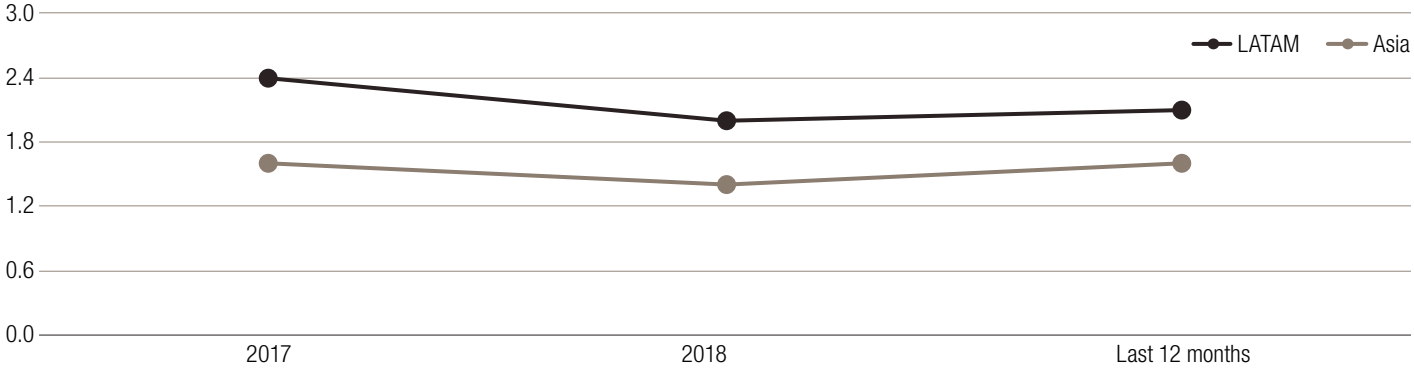
In fact, net debt/EBITDA ratios for Asian credits have been declining since 2013 (see Figure 2). During this period, Asian corporates have generally prioritised profitable growth over debt-funded expansion.

This is because:

- State-owned enterprises (SOEs) constitute a large part of the corporate (non-bank) market across China, Indonesia and India and hence are not prioritising high ROE at the expense of stretched balance sheets
- Banks have greater state-ownership than those in US and Europe, and are hence less expansion-driven
- Economic growth is higher than other regions, leading to better debt servicing capability
- Authorities in major Asian markets (e.g. China and India) allow corporates to issue USD bonds only if they meet certain criteria – this tends to reduce the reckless pursuit of debt-funded growth business strategies

[6] Source: Moody's, S&P, as at September 2019.

FIG. 2 ASIA CORPORATE NET LEVERAGE LOWER THAN LATAM



Net leverage refers to net debt/EBITDA. Source: J.P. Morgan, Bloomberg, CapitalIQ. As at July 2019. Last 12 months incorporates 2018 and partial 1Q19 earnings.

Since 2013, we have seen higher US short-term rates and long-end Treasury yields, a strong USD as well as QE tapering in the US. All of these factors resulted in tighter liquidity conditions in emerging markets. Ahead of and throughout this period, Asian governments and corporates have prepared accordingly and maintained stable and relatively low leverage.

Default rates are low

Corporate default rates in Asia are low at 2.2%,[7] especially when compared to other regions. Historical default rates in Asia have also been lower than in Latin America during times of market stress. For instance during 2013 (taper tantrum) and 2016 (aftermath of the end of commodity super-cycle), the Asia HY default rate remained well below the default rate for LATAM HY.[8] The lower average quality of many emerging markets outside of Asia, chiefly Latin America, makes these markets much more vulnerable to external shocks and outflows in times of crisis.

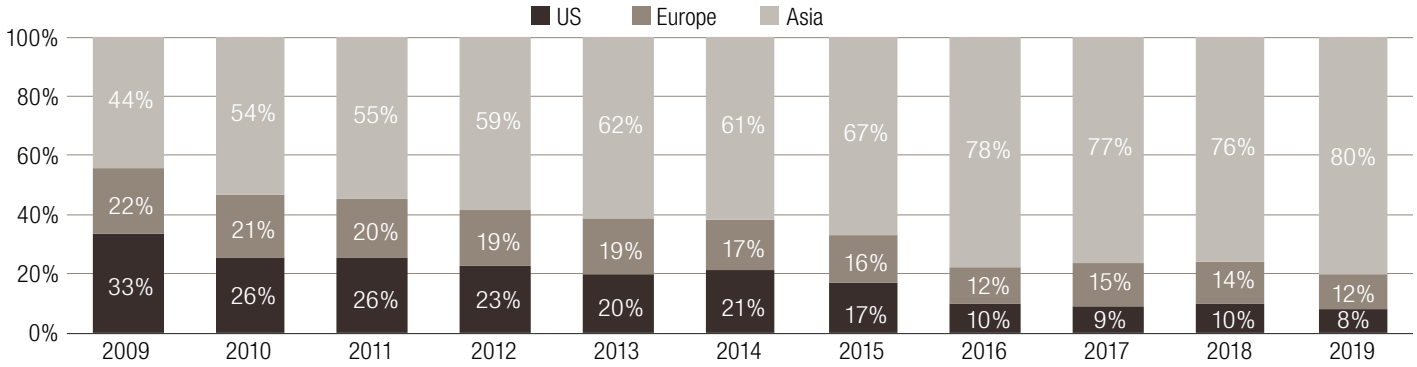
Strong demand structure: Asian investors buying Asian debt

A favourable market structure for USD debt in Asia has diminished the market's vulnerability to external factors. Domestic investors own a large and increasing share of the Asian USD debt market, meaning that Asia is much less prone to "hot money" flows from international investors. The allocation of new Asian USD issues in primary markets to Asian investors has been gradually increasing and is now over 80%, as shown in Figure 3.

The increase in structural demand by local Asian investors is driven by:

- Current account surpluses in many large Asian economies
- High savings rates in the region and an aging population spurring appetite for yield
- Banks diversifying currency exposure on their balance sheets, thus increasing demand for USD debt

FIG. 3 ASIA ACCOUNTS FOR THREE QUARTERS OF NEW ISSUE ALLOCATIONS



Source: Bond Radar, Bloomberg, J.P Morgan estimates. August 2019.

[7] Source: Moody's Investor Service. As at June 2019.

[8] Source: JP Morgan. As at January 2019. According to JP Morgan the default rate (ex 100% quasis) in 2013 was 1.2% for Asia and 10.6% for Latin America. In 2016, the default rate was 1% for Asia and 9.2% for Latin America.

- Asian investors exhibiting "home bias," mirroring similar preferences in the US and Europe
- Chinese investors in particular considering China credit as a core asset class. The Chinese are the largest investors in Chinese debt, including USD-denominated credit

The size of the Asia hard currency market is small compared to GDP, which fuels technical demand.

Going unconstrained to improve portfolios

The most widely followed market benchmark for Asian credit in hard currency is the JP Morgan Asia Credit Index (JACI). We believe the index may not be the most efficient starting point for asset allocation owing to country and sector concentrations.

For instance:

- The country weight for China is 51%[9]
- The IG portion of JACI includes large weights in sovereigns such as Indonesia (5.1%) and the Philippines (3.1%), both of which we believe are tight in spread
- Large portion of quasi-sovereign bonds in low yielding markets such as South Korea (rated AA) and the Philippines (rated BBB)
- HY composition includes weak sovereigns such as Pakistan (B-/B3) as well as distressed names, which have governance concerns and often face binary outcomes of debt repayment

We believe investors can construct more diversified and attractive portfolios by country, sector, maturity and single-name selection using an unconstrained and active approach. In addition, the wider Asia Pacific USD bond market is not included in JACI or most Asian credit indices. This includes opportunities in Australia, Japan, and even the Middle East, which offer attractive USD debt from high quality issuers.

Conclusion

Asia has undergone tremendous structural reform in the past decades. Beyond export-oriented growth, the region has seen increased economic diversification, greater government transparency and deepening capital markets. To sustain continued growth, many Asian enterprises are increasingly tapping into the international USD debt markets. As a result, the region offers a growing diversity of credit opportunities as well as improving credit quality. We believe this justifies a dedicated allocation to Asian credit in investor portfolios as part of a wider global credit allocation.

[9] Source: JP Morgan as at 31 July 2019.

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