LOMBARD ODIER
INVESTMENT MANAGERS

# 2020 Outlook

## Asia Value Bond Strategy

**High Conviction • Fixed Income** January 2020

## ASIAN CREDIT – ANNUAL OUTLOOK 2020

In our 2019 Asian Credit Outlook last January, we categorically expressed our bullishness. Emerging market (EM) credit yields were at elevated levels after the sell-off in 2018, US Treasury yields were significantly higher than US trend growth and inflation, the Federal Reserve had just started communicating its stance towards accommodation whilst China had announced policy loosening. In all honesty, it wasn't a difficult call except for market participants who were overly worried about short-term volatility.

"Cheap" and oversold markets typically do not last long, and true enough, emerging credit delivered double-digit returns in 2019. Overall, yields have dropped to levels that can hardly be considered attractive any longer on an absolute basis. Despite that, in recent weeks since December, we witnessed a further "melt-up" in conditions where both emerging Investment Grade (IG) spreads and high yield (HY) yields capitulated tighter.

It would be easy for us to diss these "melt-up" rallies as ones caused by year-end technical factors or temporary fund flows. Instead, we believe structural factors are very much at play, and they are the same factors that have been with us for the last many years – shifting demographics, high system-wide indebtedness in developed markets, lack of room for fiscal stimulus in most emerging markets, low productivity and a growing savings glut. Various regions are now facing secular stagnation, where the desired savings are bigger than investments, with no policy solution in sight.

As such, **we are faced with the single biggest challenge for fixed income investors** – where to find safer and reasonable yielding investments. We believe this is going to get even harder going forward in 2020, as demand from retirement savers in the US and North Asia soar at a time of declining growth of net new supply of credit bonds in major global markets.

As fixed income investors we cannot escape this trend, but we can estimate the upcoming imbalance of demand and supply, and subsequently calibrate our portfolios with adequate yield, duration and duration-times-spread. Reinvestment risk has risen substantially in our opinion, and hence our bias is to run our credit portfolios with longer spread-duration.

From a cyclical perspective, we believe global EM growth will likely pick up and that the gap between EM and developed market (DM) growth will likely widen from 230 bps in 2019 towards 250 to 300 bps, after years of staying at depressed levels. This will, in turn, likely drive higher capital flows into Asia and EM, and hence support higher yielding assets and sentiment. The expected stabilisation of growth in China after its settlement of the phase 1 trade deal with the US, as well as China's continued accommodative fiscal and monetary stance, form a reasonable part of this thesis.

In this year's report, our key themes for 2020 centre around the imbalance in global high-grade markets that will likely be supportive for credit spreads in Asia (items 1 and 2 below) and certain evolving market segments where we can find reasonably attractive credit spreads on a relative basis (items 3 to 7).


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## Key themes for Asian credit in 2020

1. Richer US valuations in the US to tilt investors' marginal allocation towards EM and Asia IG
2. Asian credit technicals to strengthen further amid lower net supply and new investor groups
3. China property: industry consolidation and business transformation to dominate in 2020
4. China's Greater Bay Area to provide increasing investment opportunities
5. Asia's evolving energy transition to come into focus
6. Indonesia HY continues to offer value
7. The Middle East's growing high grade universe offers spread and diversification opportunities

Overall, we expect spreads to grind tighter and spread volatility to drop in emerging markets, albeit from already optically-tight and low levels respectively. Investors would need to work doubly hard to identify yield opportunities and grab them ahead of other investors before they seemingly disappear. Two dampeners that we see for portfolio returns are single credit blow-ups in HY that can easily eat into portfolio returns given the overall low portfolio yields, and any potential steepening of the US Treasury curve as global growth stabilises in 2020 from its weak patch in 2019. Putting aside these, we firmly believe the single biggest challenge for fixed income investors is set to intensify in 2020 – where to find safer and reasonably yielding investments.

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

Dhiraj Bajaj,
**Head of Asian Fixed Income**
**On behalf of LOIM Asia Fixed Income Team**

## 1. RICHER VALUATIONS IN THE US TO TILT INVESTORS' MARGINAL ALLOCATIONS TOWARDS EM AND ASIA IG

At the start of 2019, with higher all-in yields (US Treasury + credit spreads), European and Japanese investors put on the "obvious" trade of buying US IG with cross-currency hedging. This yielded a decent relative value pick-up over their domestic bonds. Fast forward to now, we have much lower US Treasury levels and tighter credit spreads. Despite relatively lower hedging cross-currency costs, the trade does not look attractive at these levels given this price action. Still, the wave of global flows that we see from these regions needs to find a home. We expect that this will translate into demand tilting toward emerging markets and Asia where the spreads still offer relative value compared to developed market peers.

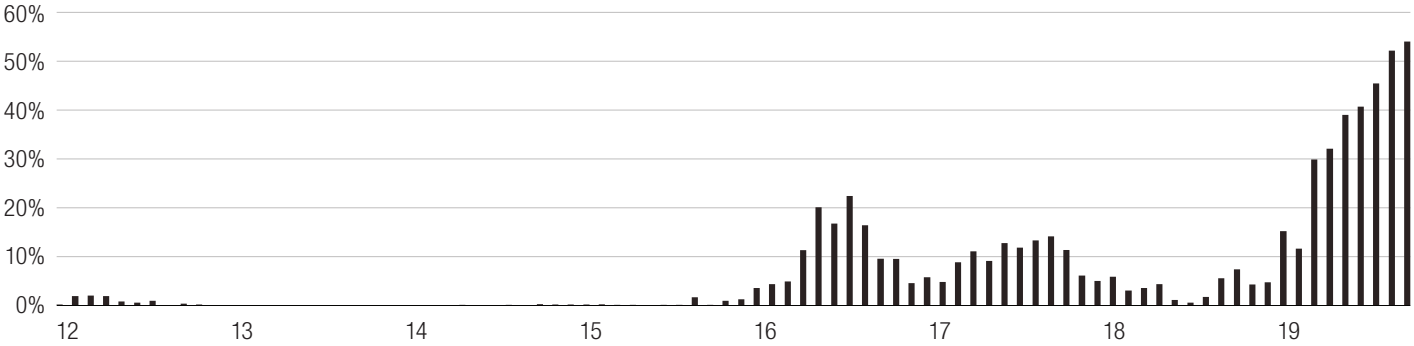
Since 2015, US IG has offered at least a 50bp yield benefit over the next best asset class for JPY investors, but that's no longer the case today. Other alternatives such as Agency US MBS (currency-hedged) and EUR credit (currency-hedged) provide even lower yields to Japanese investors. For EUR investors, more than half the US IG market moved to a negative currency-hedged yield by end 2019. **This makes the US IG diversification calculus much harder for these investors.**

**Despite US IG's reduced attractiveness to global investors, we expect its spreads to be range-bound and not widen owing to lower net supply.** While gross US IG bond issuance is expected to be USD 1 trillion in 2020, these will also be met with large redemptions that leave net supply at USD 267 billion.[1] *This would be 36% lower compared to 2019.* Partially underpinning this trend in the US is a lower expectation of debt-funded M&A activity, itself due to rich equity market valuations.

**Meanwhile, the stock of negative yielding debt continues to rise in Europe and Japan.** 2019 saw a large increase in the stock of negative yielding bonds globally following the Fed's dovish pivot early in the year amid escalating trade tensions, weak global growth and soft inflation. This paved the way for a marked dovish shift by the ECB and the BOJ, which sent yields further into negative territory in the developed world.

**We estimate additional demand could be several hundred billion in 2020-2021 for positive yielding (currency-hedged) global USD high grade.** European pension funds and insurance

### Figure 1 – % of USD North America IG Credit Par with Negative Yield for European Investors




Source: Morgan Stanley Research, Bloomberg, FTSE Russell Indices LLC. Yields are subject to change and can vary over time.
Past performance is not a guarantee of future results.

### Table 1 Dovish pivots from central banks globally

| | |
|---|---|
| **Fed** | • Three 25bp cuts in July, September and October |
| **ECB** | • Deposit facility rate cut further into negative territory by 10bps to -0.50%<br>• Targeted Long-Term Refinancing Operations (TLTRO) extended to three years<br>• Resumed QE at EUR 20 billion per month in November with no explicit end-date |
| **BOJ** | • In October, the BOJ removed the timeframe of "at least through spring 2020" for forward guidance and introduced the possibility of further lowering short-term rates |
| **EM Asia** | • Philippines, China, Hong Kong, Indonesia, Vietnam, Thailand, South Korea, Malaysia and Sri Lanka found space to cut rates |

[1] Source: JP Morgan 2020 US High Grade issuance forecast. 15 November 2019.

firms account for an estimated EUR 7 trillion[2] (~USD 8 trillion) and EUR 12 trillion[3] (~USD 13 trillion) of assets, respectively. An estimated 40-50%[4] of their assets are invested in fixed income, accounting for ~EUR 8-9 trillion of demand from this investor base. It is worth noting that the Euro IG credit universe is just ~EUR 2.4 trillion (~USD 2.7 trillion), 20% of which is negative-yielding.

Japanese pension funds and insurance firms account for ~USD 3 trillion and ~USD 3.5 trillion of assets, respectively and this is set to rise in the coming years. The USD 1.5 trillion Government Pension Fund of Japan (GPIF) in October 2019 began to classify fully-hedged foreign bonds as domestic bonds in what we believe is a precursor to further increasing foreign bond allocations.

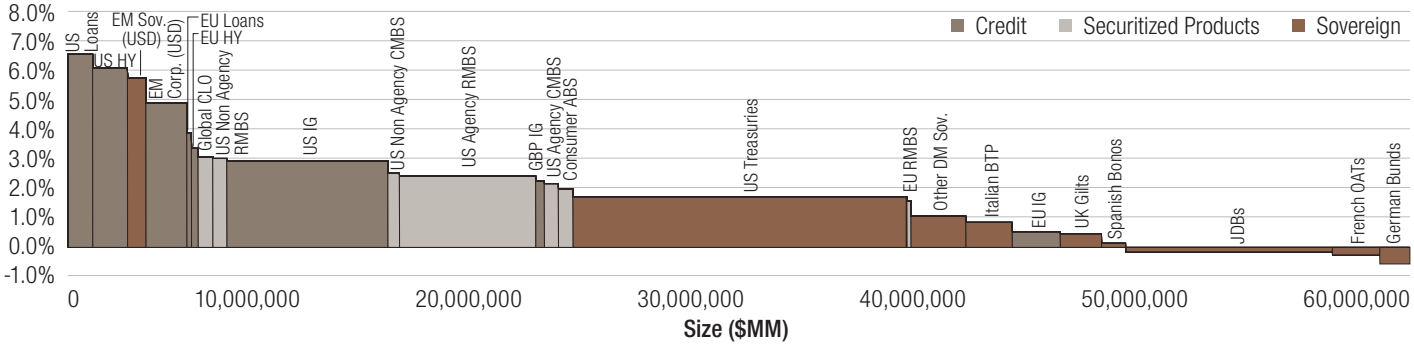
**These flows could seek a home in emerging and Asian IG USD debt, given the lack of attractiveness of US IG on an absolute basis.** Whilst emerging and Asian IG USD debt always provided a spread pick-up versus developed market peers, most investors in the past ignored its relative valuation advantage as US IG provided sufficient value or yield on an absolute level. However, we believe the lack of attractiveness of the US IG market on an absolute basis will now cause investors to tilt marginal allocations towards emerging and Asian IG, rather than the relative value advantage which was always present.

**However, investors will be entering a market that is relatively small compared to US IG,** and also faces constrained net supply. The entire emerging USD credit market (non-sovereign) is USD 2.4 trillion in size, of which only slightly more than half is IG-rated. If hundreds of billions of flows need to find a home in the coming years, the effect on spread compression in EM and Asia will be amplified.

**The declining growth of EM credit market size is exacerbating the problem.** Over the last decade, EM credit markets (non-sovereign) grew from approximately USD 800 million to USD 2.4 trillion, an over 10% annualised growth rate. However, various sub-segments of the EM credit markets have not only witnessed growth slowdowns in recent years, but have started to shrink (LatAm and EM European markets). The principal remaining growth driver has been Asia, and to a lesser extent growth the Middle East and North Africa (MENA) region as it attempts to move away from long-term dependency on petroleum revenues.

In 2019, the entire gross new issuance of the EM USD credit market stood at USD 489 billion, with Asia contributing to 60-70% of the incremental gross supply and almost all of the net supply within the asset class. However, net new issuance was only USD 88 billion, which is less than 4% growth of the EM credit (non-sovereign) USD market. In the next section, we discuss how we believe the supply in Asia too will remain relatively constrained in 2020 going forward. Taken together, we expect spreads to tighten to accommodate these new flows that are expected in 2020-2021.

**Figure 2 – Yield versus market size across fixed income** (EM markets are still relatively small)




Source: Morgan Stanley. Yields as at 7 October 2019. Past performance is not a guarantee of future results. Yields are subject to change and can vary over time.

## Table 2 Asia and MENA the only regions with positive net new supply

### EM credit (non-sovereign) USD issuance in 2019 by region

| 2019 | ASIA | EM EUROPE | LATAM | MENA | GLOBAL EM |
|---|---|---|---|---|---|
| **Gross Issuance** | 316 | 38 | 74 | 61 | 489 |
| **Net Issuance** | 92 | -9 | -13 | 18 | 88 |

Source: JP Morgan EM Corporate Technicals. 3 December 2019. Amounts in billions.

[2] OECD – "Pension Markets in Focus 2019."

[3] EIOPA statistics.

[4] Pension Europe and EIOPA data.

## 2. ASIAN CREDIT TECHNICALS TO STRENGTH FURTHER AMID LOWER NEW SUPPLY AND NEW INVESTOR GROUPS

Net new supply of Asian bonds in 2019 stood at USD 108 billion, which was 30% lower than the 2017 peak. This drop can be primarily attributed to three factors: a) the fall in domestic market rates in Asia made it more attractive for companies to issue onshore than in the international USD markets, b) slow capital expenditure needs from corporates given the global growth slowdown, and c) Chinese government restrictions on firms growing globally amid US-China trade tensions and domestic financial reform.

As such, the relative share of IG issuances continued to get squeezed, with HY issuance forming 41% of the total. This year, we expect net supply to be even lower – at USD 30-50 billion. For context, this represents less than 4% of the Asian ex-Japan USD bond market.

Against this backdrop, we believe Asian credit technicals will continue to strengthen for four reasons:

**a.** Net new supply in 2020 will remain low

**b.** Increased participation from US investors could further shrink Asian RegS supply

**c.** Partial diversion of Asian USD issuance into EUR-denominated bonds will further decrease supply in Asian USD RegS market

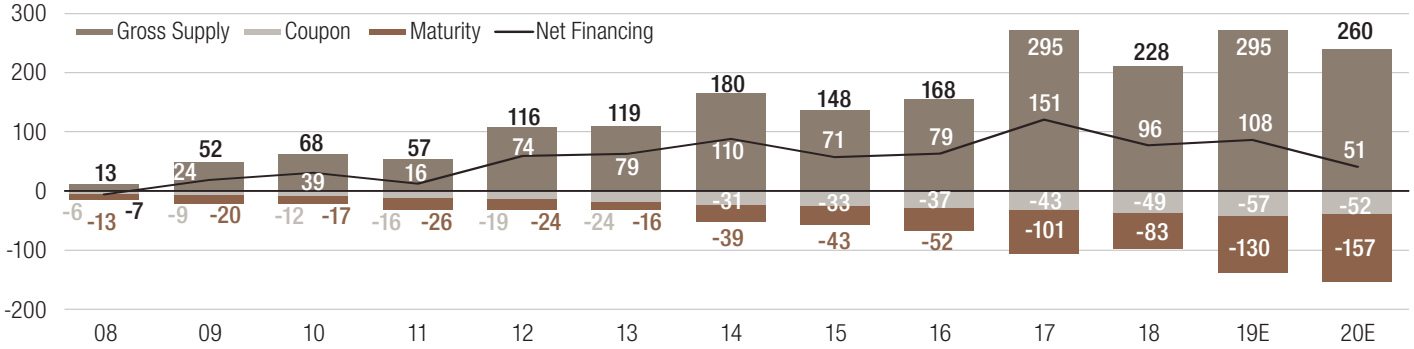
**d.** Growth of fixed maturity products in Asia, which thin market liquidity in the mid-duration segment

We elaborate on each below.

**a. Net new supply in 2020 will remain low.** We expect 2020 gross supply to moderate slightly to USD 240-260 billion, on the back of the few factors: 1) prefunding of some 2020 debt maturities in 2019; 2) lower capex and M&A funding needs, 3) more stringent regulations of China offshore bond issuance; 4) recovery of the respective domestic bond/banking markets. Most of the issuance will be for refinancing purposes. Netting out ~USD 157 billion of maturing debt in 2020 and ~USD 52 billion in coupon payments back to investors, we expect overall net supply would be significantly lower at only USD 30-50 billion. **This would make 2020 the lowest year of net issuance since 2011.**

### Figure 3 – Record year of refinancing lowers net supply

Estimated net financing (USD in billion), JP Morgan estimates




Source: JP Morgan. Data as at 29 November 2019.

### Table 3 Key supply trends for 2020

#### Key pockets of supply reduction

| | |
|---|---|
| **China SOEs** | • China state-owned enterprise (SOE) issuance to soften as overseas acquisition activities are curbed by intensifying global trade protectionism and improved access to onshore bond markets |
| **Chinese bank AT1 bonds** | • While there are USD 5.5 billion of Chinese AT1 callables slated for 2020, we expect these to be refinanced onshore given the lower funding cost |
| **China HY property** | • Since mid-2019, the Chinese authorities have been more stringent in giving out offshore bond issuance quotas to developers in an attempt to clamp down on runaway real-estate prices<br>• In addition, onshore liquidity conditions have also eased, and various large-cap developers have now regained access to the onshore public bond market offering much lower rates |
| **Indonesian HY** | • As Indonesian HY spreads remain at the wider-end of the spectrum, most issuance will likely center around refinancing. In particular, we expect several developers to refinance their 2020-2022 bonds not only by bond refinancing, but via partial use of bank loan funding as well |

## Table 3 Key supply trends for 2020 (cont'd)

### Key areas of supply increase

| | |
|---|---|
| **China local SOEs, LGFVs** | • Selected local SOEs and LGFVs (local government financing vehicles) may opportunistically tap the market to finance the government infrastructure drive amid the slowing economy |
| **China leasing companies** | • Leasing companies with genuine USD funding needs will also continue to raise USD bonds |
| **Hong Kong banks Tier 2** | • Potential pick up in Tier 2 bonds as Hong Kong banks seek to refinance the legacy Tier 2 bonds issued in 2010 |
| **India NBFCs and renewable energy bonds** | • Faced with difficult credit conditions in local markets, more NBFCs (non-bank financial companies) might look to tap the offshore markets<br>• This would include gold-based lenders and consumer finance firms |
| **India renewable energy bonds** | • Growth in India's renewable power generation will need to be funded, and a majority of that will likely be funded by USD funding as local institutions have adequate exposure to the power sector |
| **Indonesian quasi-sovereign issuance** | • Indonesian quasi-sovereign issuance may pick up as the new administration seeks funding for its ongoing infrastructure push. Some new SOEs may venture offshore to diversify their funding |
| **Frontier debut issuance** | • Vietnamese and Mongolian issuers may be able to issue if supportive conditions prevail |

Source: Lombard Odier, J.P. Morgan, Merrill Lynch.

b. **Increased participation from US investors could further shrink Asian RegS supply.** While the 144A markets[5] have taken a backseat as the Asian bond investor base has expanded, we understand that an increasing number of companies are considering these formats in order to sell to US institutional investors. This is partly because issuers are concerned that the Chinese bid driving many of the RegS deals is becoming over-concentrated and issuers would like to diversify their investor base.

   Data from Dealogic (from October 2019) shows a 40% rise in the number of deals sold with the 144A format in 2019. In October 2019, HY Chinese developer Kaisa Group Holdings[6] sold its first 144A/Reg S bond in six years, enticing US investors with a 12.25% yield. US investors took 19% of the initial issue, and 11% of the re-opening later that month, both higher than demand for typical Chinese property bond issuance.

   In our view, an increase in 144A issuance would certainly raise transparency, and bring back more US investors to the Asian market. This would in turn deepen the liquidity of the Asian market, particularly for Chinese bonds, providing a counterweight to a somewhat one-direction market. However, this could also mean lower Asian USD RegS bond supply.

c. **Partial diversion of Asian USD issuance into EUR-denominated bonds will further decrease supply in the Asian USD RegS market.** Historically, the EUR funding market has represented a small proportion of total Asian supply. Based on our estimates, Asian supply of EUR bonds has been broadly stable at around EUR 20 billion annually in the past few years, rising from zero in 2012. Most of the issuance came from IG sovereigns, policy banks and corporates with genuine EUR funding needs.

   With the ECB's revival of its quantitative easing program keeping a lid on benchmark rates, EUR issuance has suddenly become much more attractive for borrowers globally, sometimes even on a currency-hedged basis. The difference has already encouraged various companies across North America to raise financing in EUR to bring down their overall funding costs. According to Dealogic, US IG companies sold USD 129 billion of EUR bonds equivalent so far this year, more than double the USD56 billion in 2018. So far, interest from Asian borrowers has not grown dramatically due to a lack of familiarity.

   However, the recent EUR 4 billion issue from the Chinese government for the first time in 15 years might be a harbinger of change. Once a benchmark China sovereign curve has been established in EUR, Chinese companies, particularly the major state-owned enterprises, could be encouraged to follow suit with EUR issues. In late 2019, Chinese HY conglomerate, Fosun International's EUR 400 million 3.5 year offering came at a low yield of 4.35% and received more than EUR 2.3 billion of orders, with 71% of buyers coming from Continental Europe and UK. These successes might tempt Asian issuers to raise financing in EUR to bring down their overall cost of borrowing. The potential growth of the EUR funding market could, therefore, further limit the net issuance of USD bonds going forward.

d. **Growth of fixed maturity products (FMP) in Asia which thin market liquidity in the mid-duration segment.** FMPs represent a relatively new product class in Asia that has grown to in excess of USD 10 billion in AUM with exposure to EM/Asia. These funds tend have an explicit maturity date (mostly 3 to 5 years), and hold a portfolio of bonds with maturity close to funds' maturity dates. They tend to adopt a hold-to-maturity strategy to maintain stable cash flows for fund investors throughout the fund life. These products have gained a large following among Asian retail and private banking investors as a defensive play with stable expected cash flows. For example last year we witnessed a single FMP fund in Asia raise more than USD 1.9 billion in one month. This has now created client demand that was absent in the past, and is now sapping offer-side liquidity from the front-end and mid-duration areas of the market.

[5] 144A documentation to the deal is required to get full access to the US investor base.

[6] 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. The case studies provided in this document are for illustrative purposes only and do not purport to be recommendation of an investment.

## 3. CHINA PROPERTY: INDUSTRY CONSOLIDATION AND BUSINESS TRANSFORMATION TO DOMINATE IN 2020

**Chinese property is now one of the largest asset classes in the world, with an estimated market value of USD 43 trillion, compared to USD 44 trillion and USD 34 trillion for US fixed income and equities respectively.[7] The value represents three times China's GDP, and the asset class contributes ~8% of GDP directly and between 28-32% of GDP including indirect contributions.**

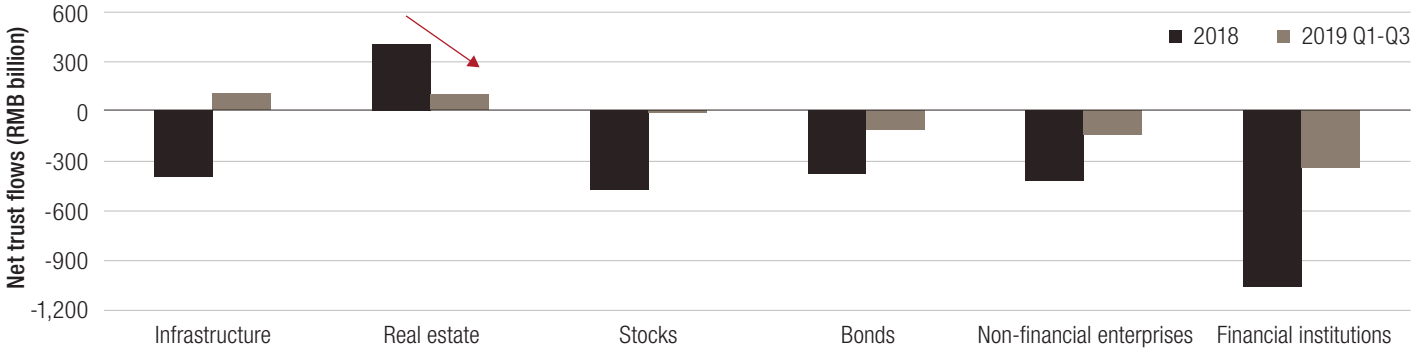
**After 20 years of rapid development, China's residential property market has consolidated since 2014.** The fast growth prompted authorities' concerns, and they consequently instituted tighter regulations to slow the pace of price appreciation. However, the sector is extremely important from a social perspective, therefore balancing stability and downside protection will be equally important for the government in 2020.

**The government has now embarked on an easing bias in the overall economy, and as such, we believe it can afford to maintain tighter financing conditions in the property sector.** Monetary policy has become more supportive of the overall fiscal expansion, as evidenced by People's Bank of China's (PBOC) 50bps reserve requirement ratio (RRR) cut effective 6th January, which is expected to release RMB 800 billion of long-term liquidity into the market. Nonetheless, authorities are clearly focussed on tighter controls on the property sector as announced in June 2019.

New rules on bank lending rates introduced in August 2019 are designed to lower lending costs to the real economy, and crucially exclude interest rates on mortgages, thereby keeping pressure on the property sector. **Indeed, real estate financing has been tightened across all channels, including mortgage, trust financing as well as domestic and offshore bonds.** *Net trust lending turned negative in every month between July and October 2019, reflecting tighter regulatory scrutiny of trust loans since July and the pass-through channel business since August.*

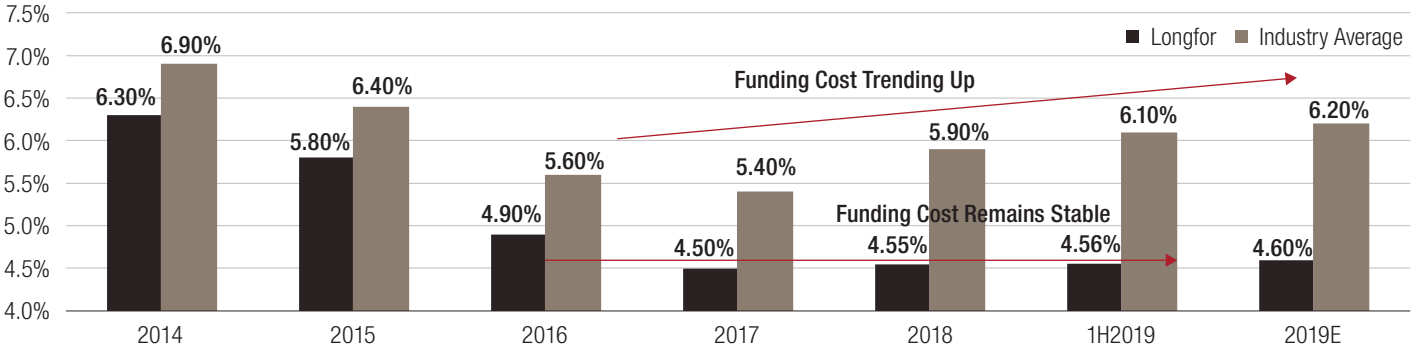
**This tightening is expected to impact the smaller HY issuers more since IG and larger developers have always benefited from easier access to bank credit and low-cost funding.** There is a clear divergence in funding costs for developers with better balance sheets and financing access. For example, Longfor (Baa3/BBB/BBB),8 a leading property developer, maintained its average

### Figure 4 – Decline in trust funding (i.e. 'shadow' channels) for property developers




Source: Moody's Investors Service and China Trustee Association.

### Figure 5 – Industry leaders are disproportionately benefiting with lower funding cost




Source: Citi, Moody's, Lombard Odier. For illustrative purposes only. Past performance is not a guarantee of future results. Yields are subject to change.

[7] Source: Goldman Sachs. US fixed income market size includes the US Treasury market.

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funding cost at 4.56% as at June 2019, essentially unchanged from 4.55% in 2018. Larger developers with considerable land bank on their books also benefit from the ability to be more flexible on land acquisition while smaller developers with fast-churn models are more hampered by tighter funding controls.

As such, we expect the market to continue consolidating, and oligopoly leaders to take shape. The market share of top 10 developers has risen from 5.4% in 2006 to 34% in 2019, and we expect this to reach 45% by 2022. Based on our conversations with leading real estate firms and banks in China, we believe the market will evolve as follows (see Table 4).

In this environment, we also expect property developers that are proactively shifting to a more sustainable recurring income business model to benefit in 2020-2021. Over the years, more and more developers have diversified their business model to incorporate a growing portion of recurring revenues, reflecting a dual growth plan, which will help improve their debt servicing ability.

**We believe the combination of a) formation of oligopolistic conditions, b) diversification being adopted by industry leaders and c) controlled industry growth stemming from regulatory checks by the authorities, will drive the sector yields in the USD market tighter. We believe this will be an alpha opportunity for investors in 2020, especially amongst the industry leading credits.** A key part of this thesis is that we expect lower net supply of HY property bonds in USD in 2020-2021. *Based on recent regulation that will be in place from 2020 onwards, the NDRC (National Development and Reform Commission) will only permit developers to pre-fund one-year maturities ahead in the USD market and no funding for growth purposes will be allowed.*

As such, JP Morgan expects Chinese HY property bond supply to moderate from USD 60 billion in 2019 to just ~USD 40 billion in 2020. This would roughly cover the USD 23 billion maturing in 2020 and half of 2021's maturities of USD 32 billion. Besides lower supply, the gradual reopening of the onshore bond markets for Chinese developers – at lower yield levels than in the offshore USD market – will render existing USD bonds cheap on a relative value basis to investors.

With this supportive backdrop, China HY property at 8.6% YTW (yield to worst) offers strong value to global investors versus Asia HY (7.1% YTW) or US HY (5.9% YTW) at end-2019 figures. We believe this could entice some global investors to migrate marginal capital to China HY this year.

### Table 4 Roadmap for national residential and commercial developers

| PERIOD | MARKET PHASE | INDUSTRY CHARACTERISTICS |
|---|---|---|
| **2000 – 2012** | High growth period | • High fragmentation between developers<br>• Broad-based high growth with less product differentiation |
| **2012 – 2016** | Growth spurt of physical market | • Last high growth stage of physical market<br>• Growth of speculative demand in the market<br>• Growth in financial leverage of developers, weakening credit metrics |
| **2016 – 2019** | Consolidation of developers | • Speculative demand gradually phased out<br>• Rise in market consolidation between real estate developers |
| **2020E – 2030E** | Formation of oligopoly | • Moderate market share increases<br>• Barriers to entry increases<br>• Smaller players could see profit margins shrink due to lack of scale, high cost of funding and cost of landbank replenishment |
| **2025E – beyond** | Oligopoly leaders to focus on inventory property | • As China's urbanisation process becomes saturated, oligopoly leaders will start to diversify their businesses and build recurring property revenues in areas such as leasing and inventory ownership |

### Table 5 Select property developers with more sustainable business models

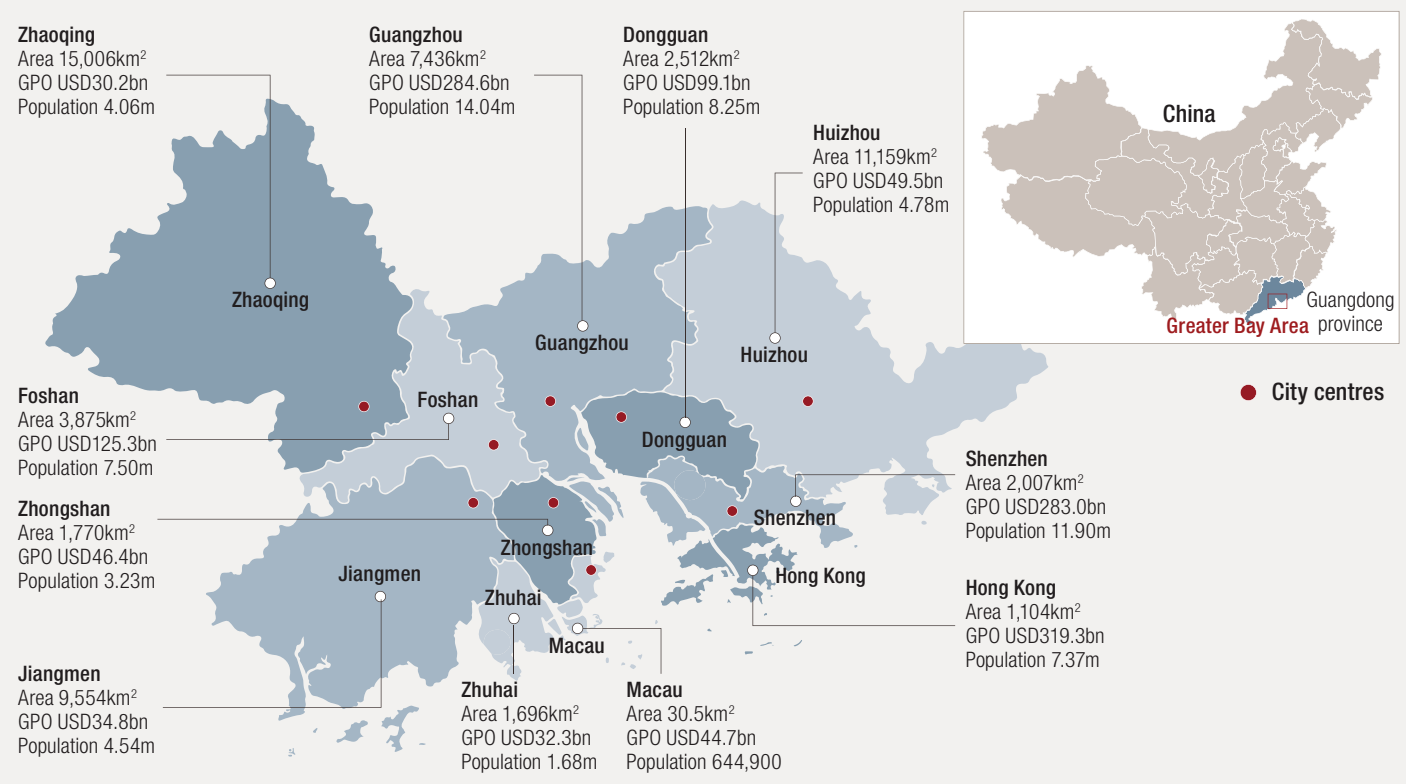
| | |
|---|---|
| **Longfor** | • Leading property developer with nationwide focus<br>• Growing portfolio of investment properties including shopping malls which has mitigated some of the volatility in its property development business |
| **Future Land** | • Developer from Yangtze River Delta region<br>• Also focusing on both recurring income and property sales |
| **Powerlong** | • Despite its smaller developing scale, has developed its non-development revenue – rental income, property management fees and hotel income |

## 4. CHINA'S GREATER BAY AREA TO PROVIDE INCREASING QUALITY INVESTMENT OPPORTUNITIES

In February 2019, Chinese policymakers released the blueprint for the development of Guangdong-Hong Kong-Macau Greater Bay Area (the GBA Outline Development Plan). The GBA has already received plenty of attention for its ambition to transform nine mainland cities and two special administrative regions into a new Silicon Valley-type technology and innovation hub. **GBA is designed to be the most promising region for social and economic development in the coming 10 to 15 years.**

With the two-way integration between HK/Macau and the mainland cities, the region is set to lead China's economic upgrade and transformation. China's GBA Outline Development Plan establishes the basic framework for the region to become a world-class bay area with an efficient flow of capital, people and goods by 2022 and count amongst the world's leading business hubs by 2035. This includes efforts to build out the transportation system with a goal of creating a "one-hour living circle" within major GBA cities via high speed rail, inter-city railway and highway investment. GBA will require more harmonized policies and regulations so that goods, services, capital and people can move more freely within the region – including currency use, immigration rules, and corporate tax rates.

### Figure 6 – Greater Bay Area – 11 cities encompassing 70 million people




Source: Prospects – Asia Real Estate Intelligence.

**GBA cities are benefitting from continuous population inflows.** Annual population inflow to Shenzhen and Guangzhou stands at about 500k, while smaller cities like Foshan attracted about 250k of population inflows. In the past 10 years, Guangdong's population has grown 16% (Guangzhou: 41%; Shenzhen: 37%), outpacing China's average growth of 5%. These are being supported by various talent plans being announced by the regional governments, and we expect this trend to continue in 2020 and beyond.

**Early investments tend to benefit infrastructure, construction and real estate sectors,** as seen in other regional development plans in China. Property developers with this regional focus (starting with Shenzhen and Guangzhou) will continue to benefit from supportive policy, strong demand (population inflow) and more growth opportunities.

**Urban Redevelopment Projects (URPs) in particular will lead the property market in the GBA.** URPs refer to the transformation of the old city (in part or entirely) so as to suit the new developments of the city and improve the living environment of residents. As urbanization rates continue to increase, there is limited new land supply in the major GBA cities. The government plans to coordinate development of cities and small towns to accommodate 100 million new urban residents by 2020. This will require the transformation of old idle factories into new residential areas, and the conversion of old low-rise residential houses with low plot ratio into high rise apartments with higher plot ratio. With very supportive top-down policy and the heavy redevelopment needs in GBA, we expect URPs to accelerate in the coming few years.

## Table 6 Selected investments opportunities amongst GBA players

| | |
|---|---|
| **Logan** | • Started off as a regional real estate developer, entered Shenzhen market in 2003 and has been focusing in the GBA ever since with an emphasis on mass-market residential property<br>• 80% of its land bank is concentrated in this region<br>• Has a solid track record in URPs, providing a competitive advantage over its peers |
| **Aoyuan** | • Strong branding and established presence in Guangdong Province, particularly in Guangzhou City<br>• Benefitting from early strategic planning initiatives and will likely continue to benefit from the affluent economy and growing population in its home market (Guangdong Province) |
| **Kaisa** | • Over 20-years operating history in higher-tier cities in the GBA, especially in Shenzhen<br>• Also has high exposure to the regional URPs, with large and high quality salable resources |
| **China State Construction International** | • State-linked, vertically-integrated construction and investment conglomerate mainly engaged in infrastructure investment, construction projects as well as building-related operations |

## 5. ASIA'S EVOLVING ENERGY TRANSITION TO COME INTO FOCUS

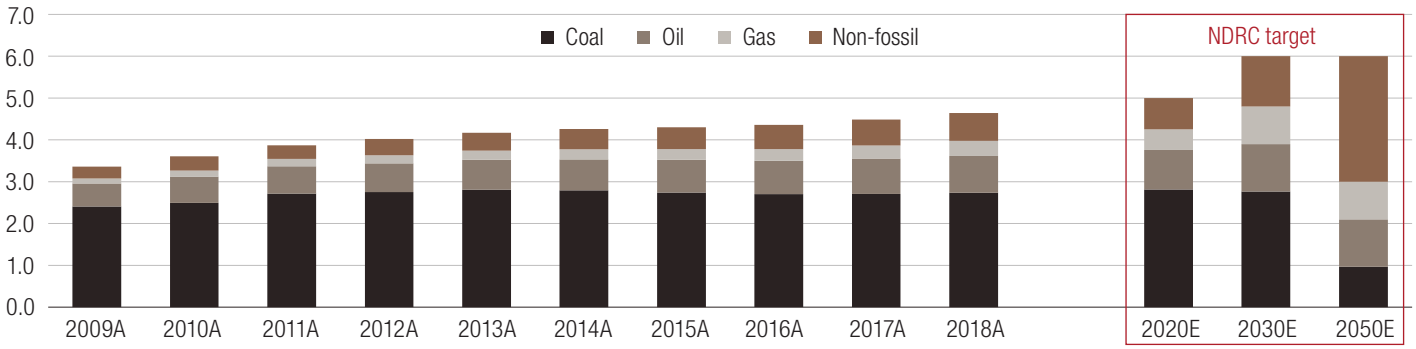
Asia remains the world's fastest growing region with India, China and Indonesia among the fastest growing countries globally. From accounting for about a third of global GDP (purchasing power parity terms) in 2000, Asia is expected to lead the world economy with ~50% share of global GDP by 2040.[9] **This in turn is likely mean developing Asia will account for two-thirds of the increase in the world's energy demand by 2040.**[10]

At the moment, Asian countries remain heavily reliant on coal as a primary source of fuel, accounting for ~50% of their energy mix. With most western economies reducing their reliance on coal-fired power, Asia now accounts for ~75% of global coal consumption.[11] However, there has been tremendous effort made by both China and India (which account for the bulk of coal consumption within Asia) **to increase their reliance on non-coal based energy sources**. Governments in both countries have set out ambitious targets to achieve over the next 10-30 years, and so far, Asia-Pacific already generates more electricity from renewable sources than Europe on an absolute level.

**In Indonesia, the energy transition is likely to take longer given unique challenges that the country faces.** The country has historically been dependant on its significant available reserves of coal - these reserves that are easy to extract and transport with existing infrastructure. Unlike other countries, Indonesia lacks the ability to harness several non-fossil fuel based sources of power. For example, being prone to earthquakes, nuclear energy is simply not an option for Indonesia. Similarly, hydropower has very limited scope given the geology. Still, the Indonesian government has rolled out a detailed roadmap for increasing the contribution of non-coal sources to its energy mix over the next 20-30 years.[12] The government targets to achieve non-coal sources of 75% by 2050 despite the exponential energy growth requirement of 175.2 MTOE in 2017 to estimated 1000 MTOE in 2050.[13]

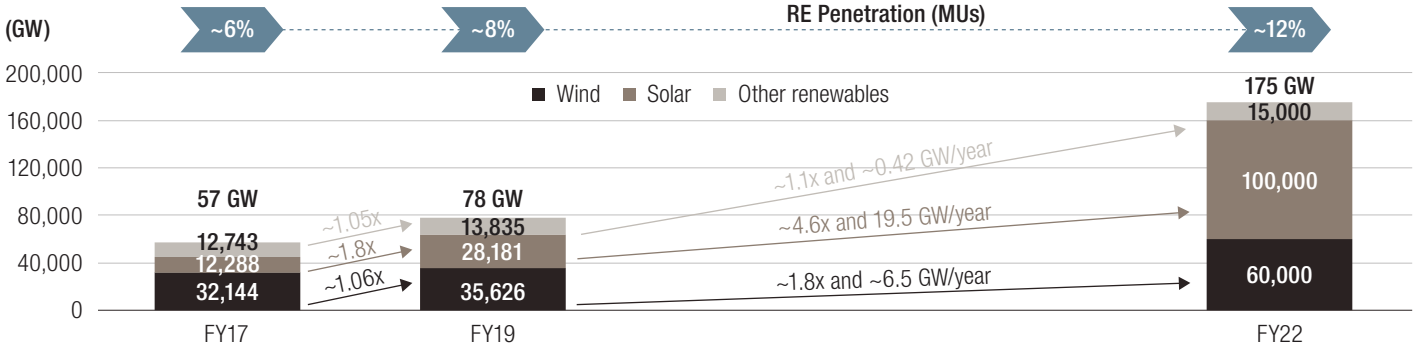
**Ambitious plans by EM countries have resulted in rapid growth in the renewable energy space. China, India and other Asia account for almost half of the growth in global renewable power generation.**[14] In India, solar and wind power has become the cheapest form of power generation driven by rapidly declining module costs, increased funding access, and significant interest from domestic and foreign developers to participate in this high-growth

### Figure 7 – China's targets to shift away from coal to non-fossil fuel (billion tce)




Source: NBS, NDRC, Goldman Sachs Global Investment Research. As at 31 August 2019.

### Figure 8 – India's aggressive renewable energy targets




Source: Renew Power offering circular (2019).

[9] Mckinsey – Asia's future is now (Jul 2019).

[10] BP Energy outlook (2019).

[11] BP Statistical Review of World Energy 2019.

[12] National Energy Policy (NEP), Govt of Indonesia (2014).

[13] PwC – Power in Indonesia, 2018.

[14] BP Energy outlook (2019).

market. **India is looking to increase power generation capacity from renewable energy sources to 175GW by 2022-23 and further to 450GW by 2030.[15] For China,** the combination of falling costs and China's drive to increase renewables as a percentage of primary energy is driving growth in solar and wind power.

**Renewable energy project finance bonds issued by Indian corporates is one of our favoured sectors in 2020.** These bonds generally follow issuance under a Restricted Group (RG) structure, which, through bond covenants, significantly or completely ring fence bond holders from the holding company. Key features of these bonds include:

- With the RG structure, bond investors benefit from first lien or security on the renewable energy assets
- Assets have contracted long-term, 25-30 year, fixed-tariff PPAs, with grid priority for dispatch and no volume risks. Renewable energy projects are currently awarded through competitive bidding from both central and state governments
- Bondholders face almost project financing-equivalent risks with first lien charge on assets and strong covenant packages in bond documentation that restrict increase in debt and dividend payouts. For example, recent bond issuance from Renew Power and Adani Green included cash flow waterfall mechanisms, notional amortization, debt-service coverage ratio (DSCR) linked dividend restriction and pool protection events
- Despite an average gross leverage of seven times across the RG bonds, they are rated within the BB bracket on account of utility-like features and strong covenant quality with low subordination risks. This leverage reduces over time as cashflow from renewable projects piles up

**The high growth offered by the sector combined with a utility-like business model has attracted many global investors to this sector as equity owners** – This includes sovereign wealth funds (GIC of Singapore and ADIA of Abu Dhabi), pension funds (CPPIB and CDPQ of Canada), multi-lateral agencies (IFC) and other strategic investors (JERA). The ownership structure has helped allay bond holders' corporate governance concerns, which can be significant in many of the family-owned businesses in the emerging market universe.

**We have already seen increasing issuance to reflect these structural trends.** The first ever issue in this space came from Greenko Energy, one of India's largest renewable energy players via an inaugural USD 550 million bond (which was called by the company in 2017). In 2019, ~USD 2.8 billion was issued in this asset class.

Outstanding USD bonds from Indian renewable energy sector corporates stand at about USD 5.3 billion, accounting for 25% of the Indian HY corporate bond universe, which is ~USD 20 billion. A non-comprehensive summary of Indian renewable energy restricted group (bond issuing vehicles) bonds issued in 2019 includes:

## Table 7 2019 issuance by Indian renewable energy companies

| BOND ISSUE | ISSUE DATE | COMMENTS |
|---|---|---|
| **Renew Power**<br>USD 525 million 6.67% 2024<br>(BB-/NR/BB) | Mar-2019 | India's largest renewable energy company backed by Goldman Sachs (49%), CPPIB (16%), ADIA (16%). The new 2024 bonds were **a debut, direct issuance by the operating company secured by 636MW of solar/wind energy projects**. |
| **Adani Green Energy**<br>USD 500 million 6.25% 2024<br>(BB+/NR/BB+) | Jun-2019 | India's 4th largest renewable energy company. The bonds were **secured by 930MW of solar energy projects with very strong covenants**. |
| **Greenko Energy**<br>USD 500 million 5.55% 2025<br>USD 535 million 5.95% 2026<br>(NR/Ba1/BB) | Jul-2019 | India's 2nd largest renewable energy company. The bonds were **secured by 950MW of renewable energy projects along with a guarantee from the holding company – Greenko Energy (65% owned by GIC)**. |
| **Azure Power**<br>USD 350 million 5.65% 2024<br>(NR/Ba2/BB) | Sep-2019 | India's 8th largest renewable energy company. The bonds were **secured by 650MW of solar energy projects with very strong covenants**. |
| **Adani Green Energy**<br>USD 362 million<br>4.625% 2039<br>(BBB-/Baa3/BBB-) | Oct-2019 | India's 4th largest renewable energy company. The bonds were the **first from Indian infrastructure space with an amortizing feature (weighted average life of 13.5 years). Because of the very strong renewable energy project portfolio as well as tight covenants**, bonds were the first from Indian renewable energy space to be awarded IG ratings. |

[15] Announced by Indian Prime Minister, Narendra Modi at the UN Climate Action Summit in September 2019.

## 6. INDONESIA HY CONTINUES TO OFFER VALUE

**Average Indonesian HY yields have returned to 2019 wides.** Indonesian HY bonds had a strong start in H1 2019, benefiting greatly from global EM inflows, supportive election results, as well as a shock-and-awe rights issue from real estate to hospital conglomerate Lippo Karawaci which took bond prices up 30 points. However, yields widened suddenly in H2 2019 after a series of unexpected idiosyncratic credit events[16] led to a complete reassessment of the corporate governance and refinancing risks in Indonesian HY. Amid these concerns, rating agencies also took a tougher stance, with several Indonesian credits suffering multiple downgrades.

On average, Indonesian HY has now corrected back to the early-2019 levels with a YTW of about 8.5%. **This makes Indonesian HY one of the widest HY sector in EM (adjusted for duration and ratings), and now offers a healthy pick up compared to global names, in our opinion.**

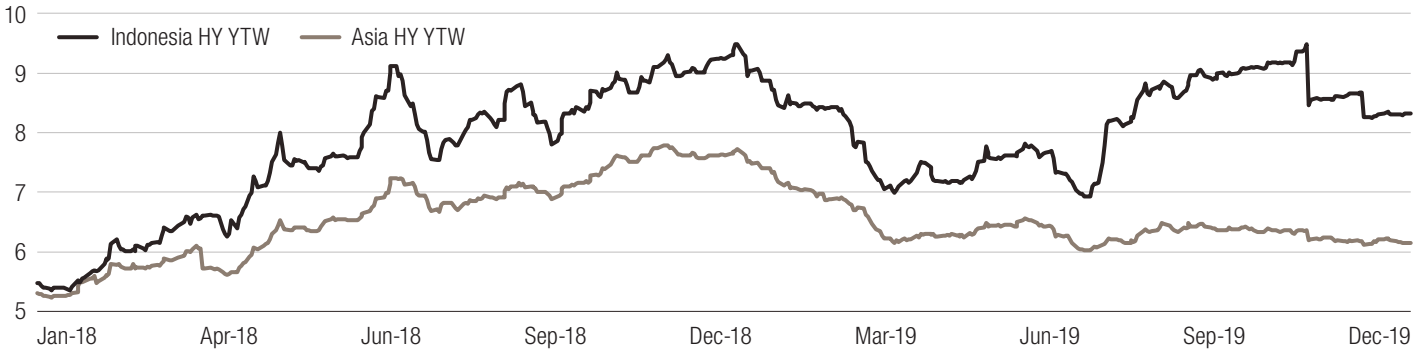
**With close inspection, we do not believe that the large spread differential that has developed between the BB and B segment in Indonesia is warranted.** As we delve deeper into the breakdown of Indonesian HY, there is a bifurcation between the relatively large-cap and established BB names which trade at richer levels, and the weaker single-B names which are at high single-digits or even distressed levels. We believe that some of these B names may be unjustifiably penalized for their: 1) small bond issue size which discourages global investors from looking at them; 2) limited management's experience in selling their credit story to global investors, and; 3) spill over concerns from idiosyncratic events suffered by domestic peers. While downward pressure on fundamentals may persist into 2020, we believe that picking idiosyncratic single names that can outperform will be the key in 2020.

### Table 7 Indonesian HY bonds provide attractive pick up versus other EM HY bonds

| | AVERAGE RATING (S&P/MOODY'S) | AVERAGE LIFE TO WORST | AVERAGE YIELD |
|---|---|---|---|
| **Indonesia HY** | B+/B1 | 4.05 | **8.31** |
| **China HY** | B+/B1 | 4.17 | 7.74 |
| **India HY** | BB-/Ba3 | 4.37 | 5.69 |
| **Brazil HY** | BB-/Ba3 | 9.38 | 5.24 |
| **Asia HY** | BB-/Ba3 | 4.07 | 6.15 |
| **CEEMEA HY** | B+/Ba3 | 4.27 | 6.05 |
| **LATAM HY** | BB-/Ba3 | 5.32 | 7.34 |
| **Middle East HY** | BB-/Ba3 | 5.08 | 5.61 |
| **CEMBI+ HY Index** | BB-/Ba3 | 4.56 | 6.52 |

Source: Lombard Odier, J.P. Morgan (based on CEMBI+ HY Index). Data as at 20 December 2019. Yields are subject to change and can vary over time. Past performance is not a guarantee of future results.

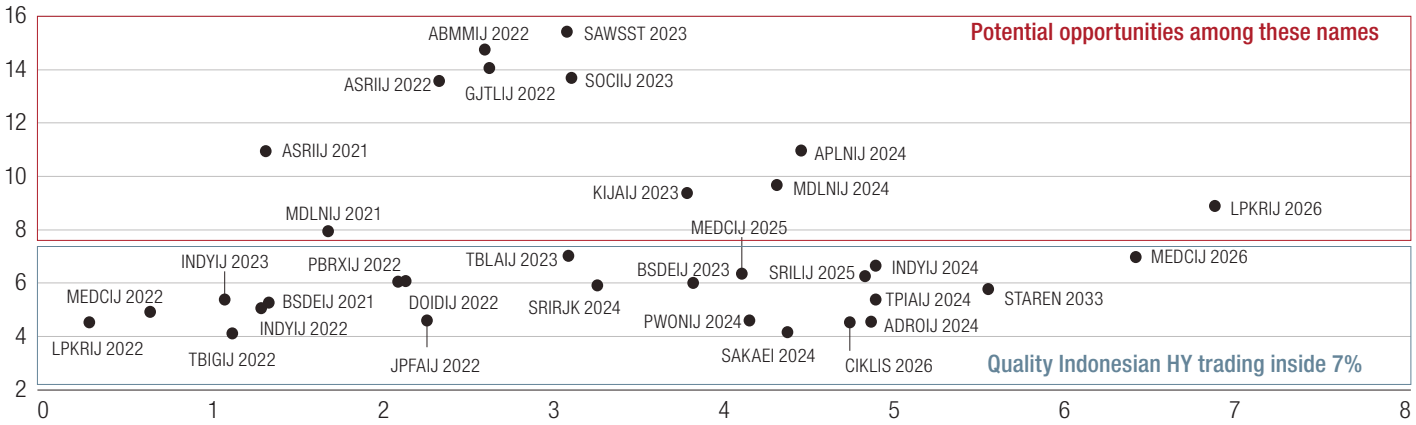
### Figure 9 – Indonesian HY bonds diverged sharply in H2 2019




Source: Lombard Odier, J.P. Morgan (based on CEMBI+ HY Index). Data as at 20 December 2019.

[16] 1) Duniatex attempting to restructure before its first coupon payment; 2) One of Agung Podomoro's lenders pulled out of the loan syndicate ahead of the debt refinancing due to head-office issues; 3) Jababeka suffered a shareholder dispute with its promoter threatening a potential Change of Control event; 4) Surprising weak H1 2019 results from Sawit Sumbermas.

## Figure 10 – Wide dispersion in the Indonesia HY markets




Source: Lombard Odier, Bloomberg. Data as at 23 December 2019. Yields are subject to change and can vary over time.
Past performance is not a guarantee of future results.

**Within the HY universe, we believe the Indonesian residential property (physical market) could finally find a bottom in 2020.** After facing years of dwindling demand for Indonesian property, we believe residential real estate marketing sales may finally see a stronger recovery in 2020 on the back of the following factors:

1. Supportive government policies, including tax incentives and loan-to-value (LTV) relaxation.
2. Banks starting to pass through lower benchmark interest rates into mortgage rates.
3. Concerns about political instability easing after the presidential inauguration and cabinet appointments.
4. Lower interest rates globally boosting investment demand.

Indeed, marketing sales have started to rebound in Q3 2019 after the presidential elections, underpinned by the stable end-user demand and recovering interest from investors/upgraders. According to a Bank of Indonesia survey, sales of new homes were up 13.95% y/y in the July-September period, after a 16% y/y contraction in the previous quarter. That said, not every segment stands to benefit equally from this recovery. In our view, lower-to-middle mass market segments would be the key beneficiaries due to the pent-up demand from the growing middle class.

**Among Indonesian developers with outstanding USD Bonds, we favour those focussed on the low-mid segment.** There are more projects being launched at the sub-IDR 2 billion range. Besides Lippo Karawaci's massive Meikarta project in the capital city of Jakarta which often grabs headlines, developers such as Agung Podomoro and Alam Sutera[17] have been launching more "affordable" products that were fairly well-received. We believe this trend is likely to accelerate into 2020.

**Furthermore, the relaxation of policies governing mortgage disbursement could benefit these property developers when the market turns, in our opinion.** Policies governing mortgage disbursement have been relaxed since 2018, allowing developers to have earlier cash disbursements from mortgage sales. Ceteris paribus, this would indirectly translate to lower net gearings for developers. While such positive impact has yet to dramatically impact developers' ratios due to weak marketing sales in the past two years, we believe that the impact could be more meaningful should marketing sales recover in 2020. Developers with larger contributions from mortgage financing would be the larger beneficiaries.

**Meanwhile, we also turn more positive on industrial property demand amid continued foreign investment and infrastructure spending.** With a "stronger" government, the new administration could finally introduce initiatives to increase Indonesia's appeal as a manufacturing hub and increase its foreign direct investments (FDI) inflows. These include: 1) passing the Omnibus Law, which would allow for labour reform; 2) easing of corporate income tax rates, and; 3) simplification of regulatory process. In addition to the reforms, we believe the government will continue to provide investment incentives via tax holidays, etc. Based on our understanding from several industrial estate players, enquiries for industrial land have already picked up since the elections and could further improve should government initiatives are successfully implemented. We continue to like property developers with exposure to this segment into 2020.

[17] 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. The case studies provided in this document are for illustrative purposes only and do not purport to be recommendation of an investment.

## 7. THE MIDDLE EAST'S GROWING HIGH GRADE UNIVERSE OFFERS SPREAD AND DIVERSIFICATION OPPORTUNITIES

High-grade USD issuance from the Middle East has increased significantly in the past few years. The market of sovereign and corporate USD credit from the GCC (Gulf Cooperation Council countries) has risen by more than 300% in the past 10 years to USD 405 billion currently. This now represents 10% of the global EM hard currency of sovereigns and corporates.

An interesting aspect of GCC issuance is the dominance of sovereigns – including Saudi Arabia, UAE and Qatar, which account for ~50% of the GCC hard currency bond universe. Another 25% of issuance comes from various government-owned entities, and the remainder mainly from the large-cap private sector. As such, the GCC market provides exposure to strong quality sovereigns and corporates.

**GCC hard currency bonds have slowly been included in the emerging market indices.** The Middle East weight in the JP Morgan EMBI Global Diversified, which only includes sovereigns and 100% sovereign owned credits, is nearly 15% now. They also account for ~17% of the CEMBI Broad Diversified index. Corporates are still not in the popular JPMorgan Asian credit indices. Despite the sizeable weights, **we believe large asset managers have been slow to embrace the *GCC corporate market and it has lagged peers from other regions***. Combined with strong quality and a rising awareness from benchmark-indexed funds, we believe GCC corporate bonds provide a strong relative value opportunity for active investors.

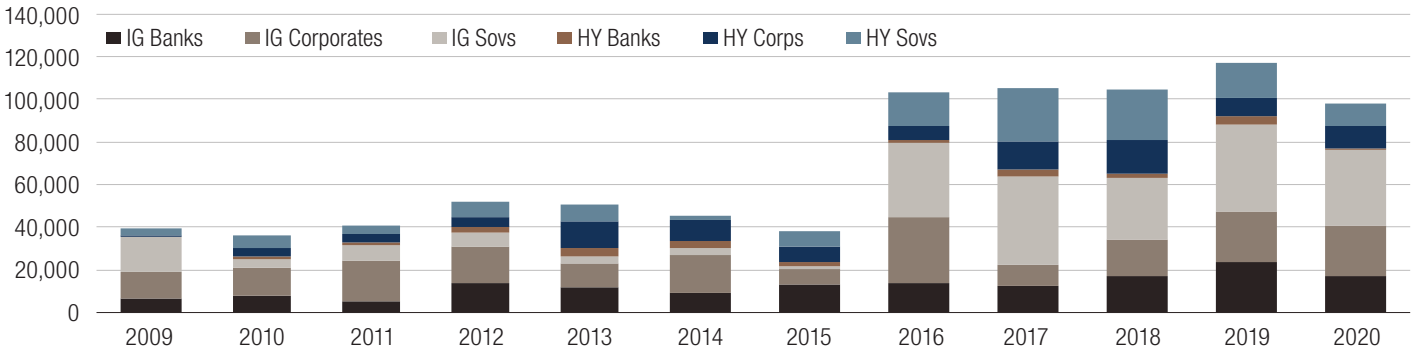
**A key consideration for our growing favour is renewed fiscal discipline in the region after the recent years of high government spending.** Over the past few years, governments had refocused their policy choices towards increased public spending amid rising geopolitical tensions and slowing global growth. Almost all the GCC countries had awarded wage bill increases which had put pressure on their fiscal balances, leading to increased issuance.

However, faced with lower long-term petroleum revenues, governments are now beginning to respond with more conservative 2020 budgets. Saudi Arabia's 2020 budget pencils in a reduction in government spending, and introduces a downward revision in the medium-term fiscal projections for the first time after three upward revisions. Qatar and Kuwait expect to continue running fiscal surpluses into 2020 while UAE hopes to keep the deficit contained at ~3% of GDP.

Against a backdrop of extremely strong external positions for these countries, we are becoming more comfortable with the region as a longer-term diversification play to our core Asian credit exposures. From a valuation standpoint, these high-grade issuers still trade at a discount to Asian sovereigns and corporates, and we expect a further convergence of these spreads under a supportive macro backdrop.

This trend is reflected in the financials space as well, with Kuwaiti, Qatar and UAE Financials trading above the emerging market spread versus rating curves. We are cognisant that profitability pressures might increase slightly given the dovish outlook from the Fed, and we note NIMs (net interest margins) are already quite high compared to global peers. The sector also enjoys a strong capital position and high loan loss reserves which should be sufficient to weather the ongoing weakness in real estate prices in the region.

**Figure 11 – Gross issuance from the Middle East (USD billion)**




Source: JP Morgan as at 3 December 2019.

## Table 9 Recent new areas of diversification offered by GCC universe to Asian credit portfolios

| | |
|---|---|
| **Green bonds** | • Debut issuance of green bonds from the region<br>• In 2019, GCC mall owner and lessor MAF Holdings issued its inaugural green bond with use of proceeds to make its malls and facilities more environmentally friendly |
| **Bank AT1** | • Increased AT1 issuance in 2019 from UAE, Qatar and Kuwait<br>• GCC AT1s benefit from creditor-friendly regimes where point-of-non-viability determinations are much more conservative than that of European or even certain Asian jurisdictions<br>• Banks in various GCC countries benefit from very stable deposit funding as the state guarantees depositors a high or full amount of banked deposits in case of bank failure<br>• Significant AT1 issuing banks are state-owned or backed |
| **Defensive sectors** | • Inaugural issuance from defensive sectors such as mall operators, commercial property lessors, hospital operators, schools and universities occurred in 2018-2019<br>• In 2019, GEMS Education which is a leading private-sector education services firm, issued inaugural HY bonds. The firm operates more than 250 schools in 13 countries in the region, with a global network made up of some 170,000 students<br>• In late 2018, NMC healthcare, a leading operator of private sector hospitals, issued inaugural bonds, as did Tabreed, a district cooling utility |
| **Long-duration non-sovereign paper** | • Greater amounts of high-quality AA and A rated long-end bonds have been issued by GCC based entities. These tend to be reasonably liquid and offer Asian portfolios the benefit of building duration<br>• Aramco in 2019 issued its first bond offering worth USD 12 billion outstanding in 2019, including in tranches dated 10, 20 and 30-years. Other high quality entities such as Abu Dhabi's state investment holding company Mubadala (AA-rated) issued 30-year paper |