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Could the Tide be Turning for Asia Credit?

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Following a difficult and challenging 2022, will 2023's Year of the Rabbit characteristics of thoughtfulness and calm be reflected in the performance of Asia credit? Portfolio Manager Mel Siew discusses his outlook.

How do you see the prospects for economic growth in the Asian Pacific region compared to other parts of the world?

In US and Europe, there are headwinds to growth, with some of the more bearish forecasts showing recessions in those areas. In Asia Pacific however, the outlook is positive due to the reopening of China, which has taken people by surprise over how quickly it has happened and how strong the momentum has been. Even outside China, the broader region has a more robust outlook for 2023. The consensus growth forecast for India is 6-7% and 5% for Indonesia, with a similar range for Malaysia, Philippines and Thailand¹, not only because they are beneficiaries of the China re-opening, but also because they already have strong domestic economic foundations.

Following a tumultuous 2022, what is your view on the current situation within the Asia credit market?

Last year was difficult for all financial markets, and Asia credit was no exception. Yet there were some idiosyncratic reasons for its performance, such as turmoil in the Chinese property sector which suffered from regulatory pressures resulting in a lot of stress and elevated defaults. There were also US/China tensions, China's strict Zero Covid Policy (ZCP), and adverse regulations in the technology sector.

As we move into 2023, a lot of those headwinds have fallen away. China has reversed its ZCP and the crackdown on technology seems to be coming to an end. We entered the year with yields that we haven't seen since before the Great Financial Crisis in 2008. Investment grade yields are close to 6%, up from around 2% in 2020/2021, offering investors the chance to access solid, high-quality credits while benefiting from very high yields². The ICE BofA Asian Dollar Index (ADOL) comprises 90% investment grade and 10% high yield, yet still has an average yield of 6%³.

The pace of China's re-opening and the market's reaction has taken many people by surprise. Is this sustainable?

We've seen an extremely strong start and I think the momentum will continue. We also saw the concept of 'revenge buying' in other parts of the world, where people with pent up savings have been eager to do things they have been unable to for a long time, such as travelling, eating out, shopping, etc.

This has been happening a lot in China; for example, we saw a huge surge in domestic travel for Chinese New Year. Airline flights reached just over 70% of pre-Covid numbers and highway traffic was up 114%⁴, resulting from a reluctance to use public transport. We expect this recovery to continue given how the Covid situation seems to be progressing and the trend in re-opening.

What does this mean for the market? From November 2022 we saw a huge rally, arguably fueled, not just a by China's ZCP pivot, but also by expectations of a potential US Federal Reserve pivot in terms of when interest rates were expected to peak. What we have seen more recently is potentially some doubts and revisions to that outlook, given strong US economic data and that has likely led to some pull back in the market.

Sources:

¹ Bloomberg consensus forecasts as of 6th March 2023

² ICE Data Platform, BofA ADOL Index, as of 8th February 2023

³ IBID

⁴ Dragon Trail International, Chinese Traveler Sentiment Report, January 2023



In January the Asian credit market returned 3%⁵, which is not sustainable for the whole year. Some people see 2023 as a coupon clipping year, where they will get the carry (total yield) to compensate for the uncertain macroeconomic backdrop. As a prediction for 2023, this is a fair one, but things could change further down the line.

Generally, in our view, global accounts have been underweight Asia, particularly China over the past few years, and especially in recent months. Investors were likely caught out by the sharp reversal of China's ZCP and its quick reopening. As investors address this underweight, there may well be another tailwind as exposure is increased in a rising market as investors chase strong returns.

A second order impact to consider with China's reopening is Chinese tourists staying within the region, which will boost regional economies. However, this is not expected until later in the year due to a lack of holidays and a population that remains reluctant to travel due to Covid. Countries and sectors likely to benefit from the Chinese tourism revival are gaming corporates in regions like Macao, Malaysia and Singapore, and the banking sector in Thailand which would have significant dealings with companies that rely on tourism.

What about Japan and Australia?

As investors seek China alternatives, they are looking more at off-benchmark countries such as Japan and Australia, which have a large stock of dollar debt. We think there is value in some of the Japanese financials versus Chinese financials, when comparing regulatory regimes and looking at how tight Chinese financials have traditionally traded.

Most of the Asian market uses the J.P. Morgan Asia Credit Index (JACI) as their index provider. Currently out for comment is an enhancement to the index that would expand the geographical coverage to include Japan, Australia, New Zealand and Papua New Guinea. Japan and Australia would enter as the 2nd and 3rd largest index weights and reduce China's weighting⁶. This gives investors an option to lower the weighting of China in their reference index and increase the breadth of their investment universe, which we have seen reduced because of the low levels of issuance. Within our portfolios however, we are able to go off benchmark, and already have some exposure to these regions.

Away from China, where else do you see opportunities?

Last year, natural beneficiaries from investors' China avoidance trade were the other large countries with stocks of US dollar debt such as India, Indonesia and Korea. We were no exception, and our portfolios diversified into India which offers a long-term story in relation to its ambitious plans for a renewable energy rollout (solar and wind). That sector is expected to grow significantly. We believe this investment theme will likely remain a focus with the growth of environmental, social and governance factors and green bond funds, as there is a natural buyer base. Interestingly, those bonds are 144A and REGS registered, making them eligible at issue to be sold into the US. Therefore, there should also be a supportive US buyer base for Indian renewable bonds.

Indonesia is another strong growth story. The high yield market has shrunk slightly, but the local banks are lending to companies which, ironically, has meant the US dollar market no longer looks attractive to issuers. From an issuance perspective this is not good, but from a corporate funding channel perspective, they are able to access alternative sources of funding, thus effectively reducing re-financing risk.

We have seen this theme across Asia, where support from local banks is making re-financing much easier despite the high interest rate environment. The other side of that coin however is that we do not expect issuance to be very strong this year, with forecasts of zero, or even negative net issuance. That can quickly change if investors feel rates have topped out and flows return to Asia credit. If credit spreads start to compress, we may see issuers develop the confidence to return to market. But we don't think we are close to that scenario at the moment.

Overall, given the growth forecasts for Asia, including the strong reopening story we're seeing in China, we are relatively bullish on the Asia credit market for this year. However, risk remains, and we would therefore advocate a focus on active management and credit quality in our portfolios.

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⁵ ICE Data Platform, ICE BofA Asia Dollar Index (ADOL), as of 31st January 2023

⁶ Exclusive: JPMorgan proposes new Asia credit index with lower China weighting -sources, Reuters, as of 28th February 2023

Index description

ADOL - The ICE BofA Asian Dollar Index tracks the performance of U.S. dollar denominated sovereign, quasi-government, corporate, securitized and collateralized debt publicly issued in the U.S. domestic and eurobond markets by Asian issuers.

JACI - The JP Morgan Asia Credit Index (JACI) Non-Investment Grade Corporate Index which provides exposure to USD-denominated high yield debt securities issued by companies in Asia.

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