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Viewpoint

Asia Credit – Bounding into the Year of the Tiger

February 2022

The recent relaxation of Chinese property sector regulations, a lack of inflationary pressure, stronger external positions vs. the 2013 Taper Tantrum, and a focus on renewables, contribute to potential opportunities for investors within Asia credit.

Asia credit markets suffered a turbulent year in 2021, mainly driven by restrictive Chinese policy measures affecting many sectors including tech, education services, gaming, and finally, the property sector.

Chinese policymakers announced two policy priorities at the December Central Economic Work Conference (CEWC): stabilizing the property sector and stimulating economic growth.

They also highlighted little appetite for any growth hampering policies. Consequently, we think restrictive policy measures are peaking, and for the property sector, easing. We believe that more property market friendly policies in China have led to a recent turning point for investor confidence in the Chinese property sector.

Furthermore, in our view, the comparatively muted effects of global inflation on Asian markets, and renewable energy from India also warrant a closer look at the asset class.

As we move into the Year of the Tiger, which symbolizes strength, we believe Asian credit could offer investors an interesting opportunity in an asset class that is underpinned by largely strong credit ratings.

Christina Bastin

Portfolio Manager

Christina joined Muzinich in 2013 and is an experienced fund manager with a distinguished career in corporate credit spanning 27 years. Prior to joining Muzinich, Christina held various credit/trading roles at Deutsche Bank including managing portfolios of bank risk. Before that she was a Credit Analyst at Schroders Investment Management and Commerzbank. Christina also worked for Fitch Ratings (1995-2000) where she was responsible for rating Korean banks during the Asian crisis in 1996 - and Japanese banks during their banking crisis. Christina holds a BA from the University of Oxford and an MA from the University of London. She was also awarded the Yamamuro Trust Foundation Scholarship for a 1yr International Politics programme at Keio University, Tokyo. Christina is fluent in five languages.

1 Muzinich & Co. views and opinions as of February 2022, and subject to change without notice.

Property Sector Policies in China Are Easing

We are currently at an important turning point for confidence in the Chinese property sector, which we believe will have far reaching effects on the rest of the Asian credit market. With China focused on stabilizing the property sector and stimulating economic growth in 2022, we believe policy shocks, such as those as we saw in 2021, have peaked.

China's property sector has been one of the driving forces of the country's economic growth for some time, with housing activity accounting for c. 29% of GDP.[1]

Over the last several years, the government has been increasing policy restrictions; tightening liquidity and curbing demand to prevent price bubbles and to protect end-buyers.

Policies to limit banks' exposure were implemented to "de-risk" the system and to prevent the sector from overheating. However, these credit restrictions only further eroded confidence in the sector, which had already suffered some high-profile failures.

With a bid to address a loss of confidence in the property sector, the People's Bank of China (PBOC) eased the reserve requirement ratio twice in H2 2021. Furthermore, in January 2022, the PBOC cut the 5-year lending rate—the rate used as a benchmark for mortgages.

The bar for the PBOC to cut interest rates is generally high; the signaling effect from this cut cannot be denied. In January and February 2022, policymakers also announced they were lifting restrictions on usage of cash locked up in escrow accounts, further releasing liquidity into the cash-strapped sector.

As major cities across China start to cut mortgage rates, it should support and work in tandem with the escrow account review.

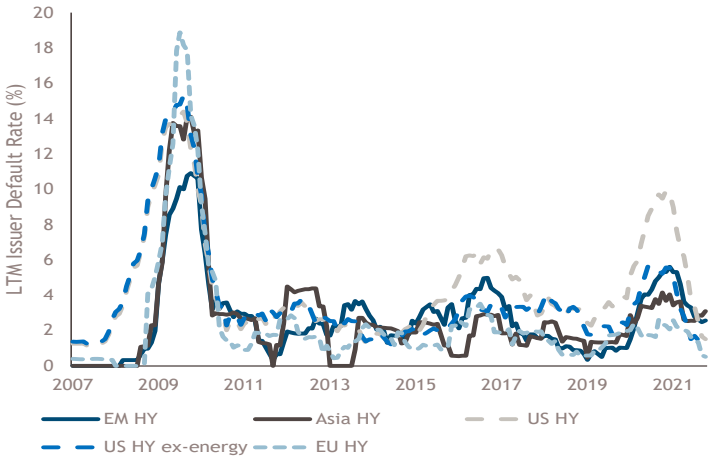
After five years of a policy focused on reducing macro leverage, regulators believe they have achieved their goal and believe it is now a good time to ease monetary policy and stabilize the housing sector.

What about default risk? We do not expect the same high level of defaults (Fig. 1) this year as we saw in 2021 (c. US$60bn)[2], although we are likely to see defaults from small marginal players and from a few medium-sized issuers that were already fairly stretched.

From an investment perspective, we believe property bonds have largely discounted the negative news and now appear at an attractive entry point. We also believe we have reached the bottom of the policy restrictions and it is unlikely we will see further pressure on the sector.

1. "The Size of China's Real Estate Sector", Kenneth Rogoff and Yuanchen Yang, Harvard, December 21st, 2021
2. Standard Chartered Global Research report 'Looking into the Eye of the Tiger' published January 4th, 2022.

Fig. 1 - Lower Default Rate

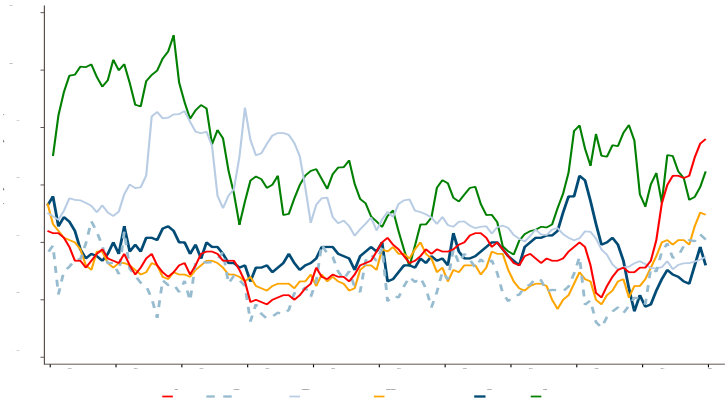


Source: Bank of America Merrill Lynch, Monthly Emerging Market Corporate Chart Book. Data as of December 31st, 2021. For illustrative purposes only.

Inflation Less of a Concern

Developed markets are currently struggling with increasing inflationary pressure but we are not seeing similar large inflation overshoots across Asia - it appears the US inflation is being domestically fueled (Fig. 2). We believe there is a limited risk of a repeat of the 2013 Taper Tantrum.

Fig. 2 - Inflation



Source: Macrobond, as of January 17th, 2022. For illustrative purposes only. Data based on Consumer Price Indices, YOY

While we expect Asian central banks to be hiking with the Fed—this is, in our view, driven by a desire to maintain credibility (i.e., keep currencies stable), rather than a need to combat inflation. The only region diverging from the Fed is China, which is easing.

However, the PBOC have stated that they are looking to be creative with their entire monetary policy toolkit and we expect to see easing through other forms (e.g., escrow account loosening which releases liquidity into the system without cutting interest rates).

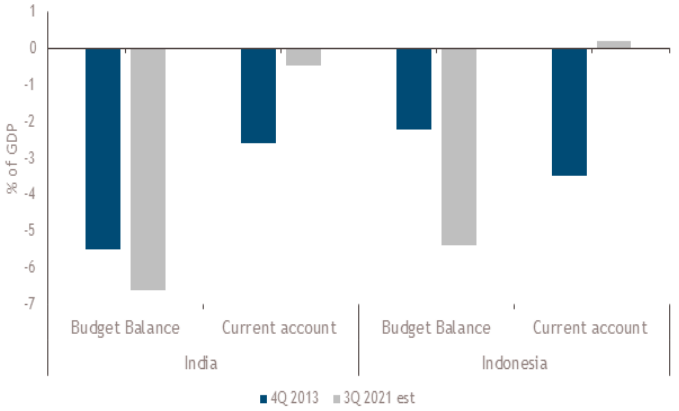
Thailand is on hold at the time of the writing of this paper and South Korea had already moved ahead of the Fed for financial stability reasons.

The most watched countries currently are India and Indonesia, whose external positions have significantly strengthened vs. 2013 with higher foreign exchange reserves and much smaller current account deficits.

In our view, Asian credit markets are driven more by unexpected macro shocks or an unexpected pace of Fed hiking. Furthermore, we see most interest rate hikes already priced into the market. We believe Asian sovereign balance sheets are in much better shape than they have been for some time.

External positions are much stronger, despite governments having had to use their budgets for support during the COVID-19 pandemic. Reserves and current accounts are healthier (Fig. 3), and there are stricter rules around dollar borrowing.

Fig.3 - Current Accounts are Improving



Source: Bloomberg, as of September 30th, 2021. Most recent data available used. For illustrative purposes only

While we are witnessing a gradual tightening of financial conditions across Asia, inflation is within expectations, reducing the risk of a sell-off as occurred with the Taper Tantrum of 2013.

Opportunities in Indian Renewables

Among the many sectors and countries to choose from in Asia, we see interesting opportunities in Indian credit markets. In 2020/2021 India faced a potential sovereign downgrade and the prospect of losing its investment grade rating, which hung ominously over its head.

However, the country managed the incredible challenge of vaccinating an enormous population and acted fast to stimulate the economy, so it is now enjoying a robust recovery and the prospect of a downgrade has faded.

This backdrop is also benefiting corporates where we are seeing very strong earnings.

Despite the flight-to-quality price action as investors fled China and sought India as an alternative, sending prices higher, we believe India continues to offer diversification benefits and we still see undervalued opportunities that have positive growth catalysts. Refinancing pressure is also limited. We believe short dated high yield credit, especially in the renewable energy sector (which has a strong ESG bid) is the “sweet spot” for carry.

The Indian renewable energy sector is growing, and due to aggressive government targets to decrease the country’s reliance on fossil fuels, is likely to benefit from significant growth and development over the next decade.

Risk: Diversification does not assure a profit or protect against loss.

A Strong Outlook

While the global pandemic is far from over, we have already seen a strong rebound in many Asian economies. Countries with huge populations, such as India, have dealt remarkably well with their vaccination programs.

While many still have a long way to go in terms of vaccinating their populations, overall, we believe Asian economies are recovering well from the pandemic and this is likely to continue. At the same time, Asian credit spreads are wide relative to other markets and follow a narrative that remains somewhat uncorrelated with developed market inflationary concerns; we believe countries in Asia are therefore unlikely to undertake aggressive rate hikes to cool overheated economies.

There is also value to be found in certain segments of the market, such as Chinese property, where we believe there are many strong, stable credits that have been hurt by contagion but whose underlying fundamentals remain solid and are likely to benefit from policy changes. Meanwhile, some sectors and countries are benefiting from larger global trends such as concerns around climate change, which is likely to drive up investment in renewable energy.

While risks such as COVID-19 variants and geopolitical tensions warrant monitoring, our outlook for Asian credit markets is in keeping with the strength symbolized by the Year of the Tiger.

Index Descriptions

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.

ADHY - ICE BofA Asian Dollar High Yield Index tracks the performance of sub-investment grade 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.

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