The Growing Appeal of the Asian Investment Grade Credit Market

Powerful structural trends are shaping the Asian investment grade credit market.

January 2017

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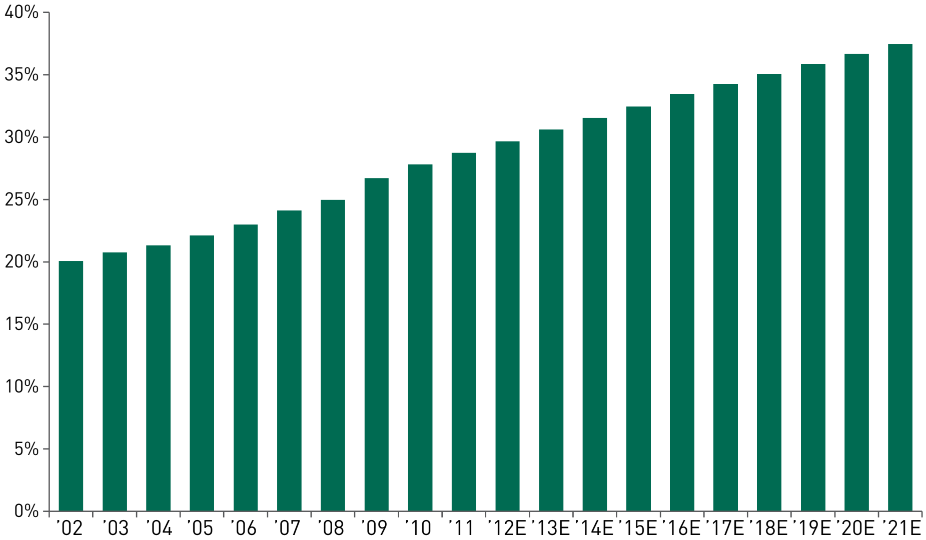
Fixed income markets have clearly been performing well. To some, they have been performing surprisingly well, driven by powerful structural trends that are now more widely acknowledged.

Globally, we think the Asian credit market, particularly its investment grade segment, stands out. This market, which has been noticeably gaining growing investor acceptance, benefits from resilient fundamentals and exceptionally strong technical tailwinds. It also continues to offer better spread levels than some of its developed markets peers. In today's intense hunt for yield, this is a highly attractive feature. As a result of these and other factors, the performance of the Asian credit market, particularly on a risk-adjusted basis, has been strong.

Of course, investors can't disassociate the opportunity of Asian credit from its largest and fastest growing component: China. While some may shy away from investing in the country, we believe that a well understood and analyzed China, which continues its long economic transformation, still offers compelling investment opportunities.

The Major Asia ex Japan Economies Represent Over a Third of Global GDP



* Asia ex Japan includes China, HK, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand.
Source: IMF, PineBridge Investments. As of October 2016.

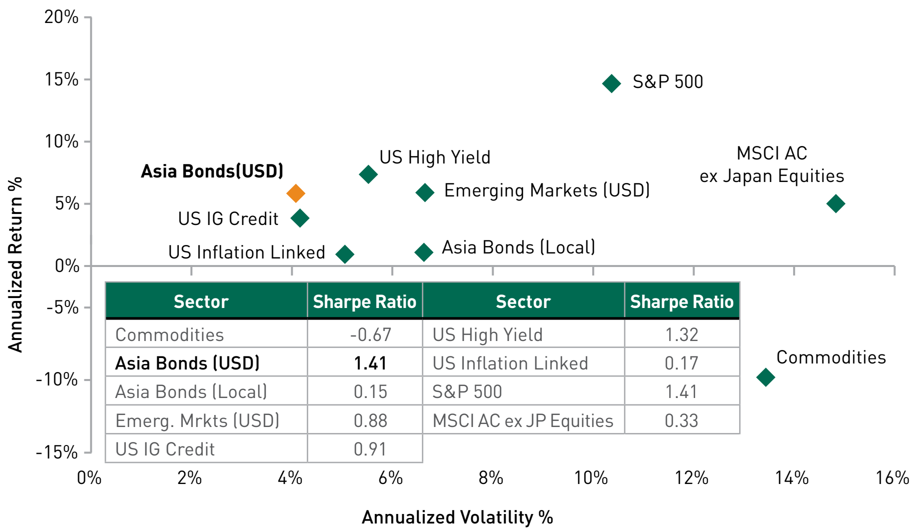
The rise of the Asian credit markets

It is no secret that Asia is an increasingly important part of the global economy. Looking at Asia's share of the world's GDP, the major Asian economies outside of Japan represent more than a third of global GDP. Even with moderating economic growth, Asian economies are expected to continue to drive global growth. Their relative importance is likely to continue to grow in the foreseeable future.

In line with this impressive economic growth, the US dollar-denominated Asian credit market has been rising steadily. As of December 2016, the market stands at a substantial US$692 billion, essentially more than tripling from around US$200 billion in 2009.

The market's performance is also impressive. Risk-adjusted performance, as measured by its Sharpe ratio on a five-year rolling basis, has been exceptionally strong and stands at 1.41 as of 31 December 2016. On a relative basis, annualized returns of the JP Morgan Asian Credit Index – Investment Grade were 4.76% from December 2011 to December 2016. This compares with 2.64% for the Barclays Global Aggregate Index over the same period.

Asia Bonds Provide Good Risk-Adjusted Returns



Sector	Sharpe Ratio	Sector	Sharpe Ratio
Commodities	-0.67	US High Yield	1.32
Asia Bonds (USD)	**1.41**	US Inflation Linked	0.17
Asia Bonds (Local)	0.15	S&P 500	1.41
Emerg. Mrkts (USD)	0.88	MSCI AC ex JP Equities	0.33
US IG Credit	0.91		

Sources: Bloomberg. Rolling five-year data as of 31 December 2016. Commodities represented by the DJ UBS Commodities index, Asia USD Bonds by the JPM JACI index, Asia Local Bonds by the HSBC Asia Local Bond Index USD unhedged index until 31 Dec 2015 and Markit iBoxx Asia Local Currency Bond unhedged index onwards, Emerging Markets (USD) by the JPM EMBI Global Diversified index, US IG Credit by the Barclays US Credit index, US High Yield by Barclays US High Yield index, US Inflation Linked by Barclays US Inflation Linked index, US Equities by S&P 500 index, and Asia ex Japan Equities by the MSCI MXASJ index. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Past performance is not indicative of future results. Any views represent the opinion of the manager and are subject to change.

What's been driving the strong performance?

Broadly, fundamentals in Asia are relatively stable, with better-than-peers' corporate credit profiles, particularly when it comes to the investment grade segment. Clearly, different markets within Asia are in different credit cycles, but the market as a whole has been exhibiting healthy fundamental trends. For instance, net leverage in Asia declined from 1.9 times in 2015 to 1.8 times in 2016, as opposed to a global average that went up from 1.7 times to 1.9 times during the same period[1]. On the profitability side, although the Asian credit market's EBITDA declined slightly by 4% in 2015, it substantially outperformed that of its global peers, which declined by 19%.[1] Although this ratio has moderated this year, the ratio of credit ratings upgrades to downgrades is still above 1, which essentially means there are still more credit upgrades than downgrades[2].

One of the greatest shifts the market has seen over the past few years is in the domicile of investors. Essentially, Asian buyers are now the dominant buyers of Asian credit. Numbers clearly illustrate that point: In the first quarter of 2010, Asian buyers represented roughly half of the buyers of Asian credit. In the third quarter of 2016, this number went up to an impressive 81%.[1]

This helps explain the lower volatility Asian credit has been experiencing. Asian buyers, investing in their home markets in companies they know and understand, tend to be "stickier" than offshore investors, often dubbed "tourist investors." Asian policymakers also support this shift, after learning the hard way in the 1997 Asian financial crisis that having well developed and functioning markets helps mitigate the effects of financial disintermediation. The investor base is also better diversified by investor type, with asset managers decreasing from 55% in the first quarter of 2010 to about 43% now; private banks and retail flows going up from close to nothing to about 6% as of the past quarter; and banks increasing their share from 21% to 32%.

From a historical perspective, yields are extremely low in pretty much all major fixed income markets. The Asian market is no exception. However, Asia investment grade still offers some spread differential when compared with that in other markets. This matters even more so in this intense search-for-yield environment. While it is fair to say that this spread might continue given the US market is deeper and more developed than the Asian market, it is important to mention that technical factors tend to be stronger in Asia than in other markets.

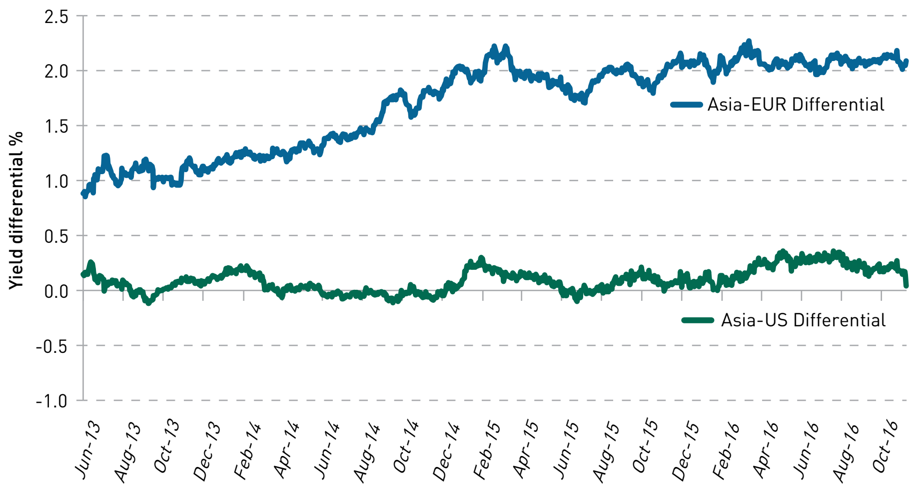
[1] Source: JP Morgan as of September 2016.

[2] Source: S&P ratings for the Asia ex Japan Investment Grade segment per Bloomberg, as of October 2016.

For instance, although the Asian credit market continues to grow, it is doing so at a slower pace. Net debt issuance in 2016 was US$83.3 billion compared with US$75.2 billion in 2015. We expect net issuance in 2017 would be much lower than in past years, mainly due to bonds maturing and being called. This more limited supply, along with a large number of the major and regional central banks having an accommodative stance, is met by strong demand from investors hungry for yield and looking to invest in the increasing Asian money pool.

Finally, another attractive feature of the Asian investment grade space is its shorter duration profile. This makes it less vulnerable to interest rate risk, should rates adjust higher.

Spread Differentials Are Attractive



Source: BAML, PineBridge Investments estimates. As of 30 October 2016.

Don't fear the dragon

The elephant – or, more appropriately, the dragon – in the room when it comes to investing in Asia is, of course, China. Chinese issuers represent about 43% of the Asian investment grade credit universe[3] and constituted more than 50% of issuance in 2015 and 2016 year to date. In a nutshell, one cannot disassociate investing in the Asian fixed income markets from investing in China.

While market participants' views on China tend to be polarized, we think they're often overly simplistic. The reality is that China is a large, complex economy that continues to present compelling investment opportunities. The key to unlocking the country's potential as an investment, in our view, is holistic and thorough analysis that focuses on the direction policy is taking.

So, will China's economy experience a "hard landing?" We think it's highly unlikely: China has enough counter-cyclical tools at its disposal to avoid a severe economic growth slowdown. More importantly, investors with a deep understanding of the dynamics in China can build stronger Asia credit portfolios.

[3] As of 31 August 2016, as represented in the JACI IG index.

Should we worry about Chinese leverage?

Chinese leverage has been, rightly so, the focus of a large number of investors' attention as it has increased over the past few years. However, upon further analysis, three things stand out:

- Chinese leverage is concentrated predominantly in the corporate sector, which grew from 92% of GDP in 2008 to 122% in 2015. The sovereign sector is still relatively low at 30% of GDP, and household debt is also low at 40% of GDP.
- Within corporate sector leverage, the majority of lending went to sectors such as manufacturing, transportation, property, construction, and mining – many of the "old economy" segments. As some of these segments face overcapacity, it is reasonable to expect a gradual deleveraging of some sort to occur.
- China's external debt is limited to about 7% of GDP, allowing China substantial flexibility to deal with leverage on its own terms, given its introverted financial markets.

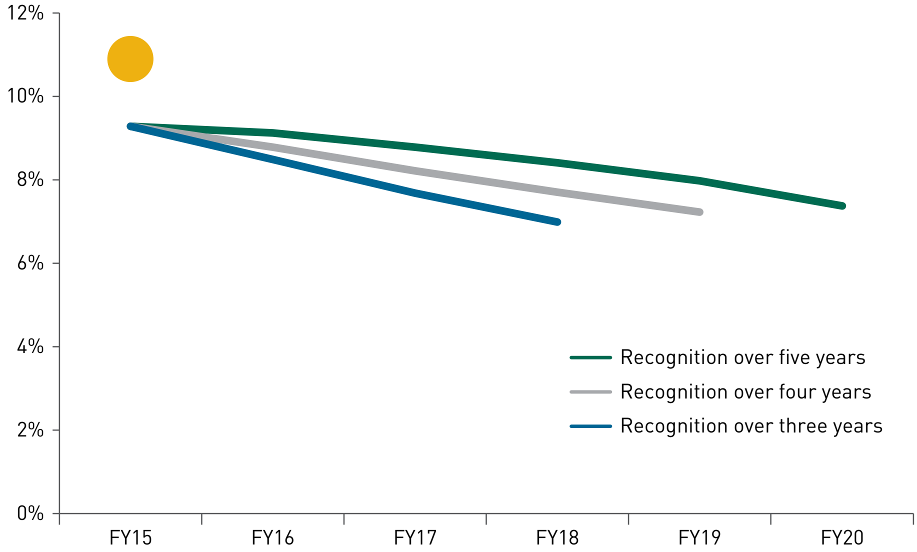
In short, there are some pockets of excess leverage in China, but one cannot characterize the whole system, or the whole corporate segment, as excessively leveraged. These realizations can guide one's investment in China with a sector selection process calibrated to avoid highly leveraged, and potentially problematic, segments.

A health check of the financial system

Speculation abounds about the ability of the Chinese financial system to withstand shocks. To measure this ability, we took current nonperforming loan (NPL) figures and stressed them to an excessively punitive 15%. We also assume that all of those NPLs will be confirmed as such within the relatively short time frame of three years. We found that the capitalization ratio of the banking system would go from approximately 11% currently to about 6%. A capitalization ratio of 6% might be suboptimal, but it does clearly indicate that China's banking system can potentially withstand substantial shocks without being insolvent.

This point can also be made for other banking jurisdictions in the region, which we believe are reasonably well capitalized, with regulators taking steps to further buffer any asset quality deterioration.

China's Banking System Could Withstand Substantial Shocks
(Capitalization Ratios at NPL of 15% Stress Scenario)



Note: CET1 – Common equity tier 1. NPL – Nonperforming loans.
Sources: China Banking Regulatory Commission (CBRC), CEIC, SNL, Deutsche Bank, PineBridge Investments estimates; As of June 2016.

The whole picture

Although China is a large segment of Asian credit, it is by no means the entire market, which includes developed economies such as Singapore, Hong Kong, and Korea, as well as developing economies such as India, Indonesia, and the Philippines, not to exclude upper middle income countries such as Malaysia and Thailand.

An interesting feature of this market is that it is one of the very few that witnessed positive credit ratings momentum in the past five years. The Philippines, for instance, went from below investment grade five years ago to investment grade by all three major rating agencies today. Indonesia, which has been undertaking some promising reforms, also witnessed a substantial credit rating improvement, with two of the major agencies rating it at investment grade.

In short, we expect the US dollar-denominated Asian investment grade market to continue to gain growing investor acceptance given its relatively stable fundamentals and strong technical factors.

About PineBridge Investments

PineBridge Investments is a global asset manager with experience in emerging and developed markets, and investment capabilities in multi-asset, fixed income, equities and alternatives. Our firm is differentiated by the integration of on-the-ground investment teams of more than 210 professionals, providing investors with the combined benefits of global fundamental perspectives and analytical insights. We manage over US$82 billion as of 30 September 2016 for a global client base that includes institutions, insurance companies, and intermediaries.

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