July 2017

By Bertram Sarmago, Investment Director, Asian Fixed Income
Jian Wei Loh, Portfolio Manager

nikko am
Nikko Asset Management

ASIA HIGH GRADE CREDIT

The case for a more selective approach to Emerging Market Debt

Key Points

- The rapid development of the Asia Credit markets provides new opportunities to improve the risk and return profile for investors. Asia Credit creates additional fixed income diversification benefits over the US Aggregate Bond (US Agg), or a fixed income allocation already diversified across the US Agg, US High Yield, Global Sovereign and Emerging Market Debt
- While Asia Corporate Debt requires unique credit research skills, we believe that due to major geopolitical and macro risks in emerging markets, investors should take a more selective approach by incorporating Asia Investment Grade issuers as a separate allocation within this universe
- In particular, adding Asia Investment Grade Credit (IG) lowers downside volatility for both US Investment Grade or Emerging Market Debt portfolios, thus providing institutions with an important risk mitigation tool. We believe that there are key fundamental and technical trends that will support this lower volatility and source of quality yield for a long time into the future
- While Asia Investment Grade (IG) has delivered moderate returns (+4.0%) YTD compared to higher beta segments of EMD, it still offers a robust yield vs. US IG, and its downside volatility is far lower than other EM regions, or even US peers
- We believe there are key fundamental and technical trends that support this low volatility, and Asia Credit IG in particular offers US investors a defensive tactical allocation within EMD, while also providing a long-term source of quality yield

Making the Most of Emerging Markets...

Throughout 2016 and 2017, Emerging Markets Debt (EMD) has performed very well for investors. However, this has attracted strong asset inflows, which has compressed yields such that EMD valuations are now at historic highs. At the same time, there remain a number of potential key risk factors for EMD:

1. The US Fed is clearly on a path of raising rates, and while moderate rate rises so far have not impacted EMD, such will likely provide an increasingly competitive source of yield for investors.
2. Similarly, the political risk of the US adopting more protectionist "America First" trade and tax policies also needs to be considered. At present, this risk appears to be muted by the difficulties of the Trump Administration in implementing its agenda, but it remains a potential catalyst for downward revision in EMD.
3. Finally, there is potential for oil prices to fall. Much of hard currency EMD – particularly in the high beta segments – is linked to oil-related issuers, and a drop in oil prices would negatively impact them.

Given these risk factors, it makes sense for US investors in EMD to assess how they are positioned, and consider how they could reallocate to lower beta segments to limit downside volatility without sacrificing too much yield. Indeed, with the growth of the EMD universe, there is now sufficient size and diversity for investors to take selective positions. CEMBI and EMBI make up a combined market size of USD 1.3 trillion with 506 different issuers. Within EMD, Asia Credit IG is now a significant segment in its own right. For instance, the JP Morgan Asia Credit Index Asia (JACI) IG now measures USD 600 billion.

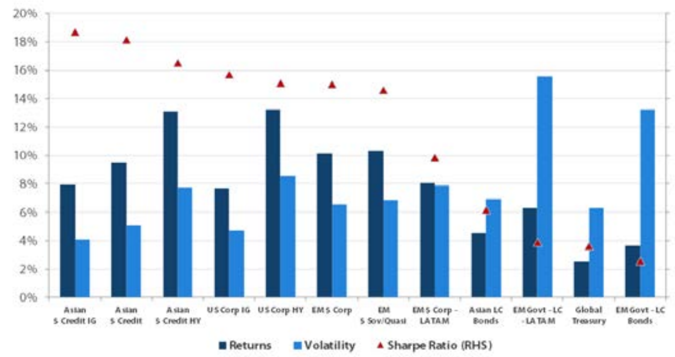
Asia as a Component of EMD

	Market Size (BN)	Number of Issuers
CEMBI + EMBI	1,318.09	506
Asia	401	204
Latin	491	143
Europe	267	84
Middle East	85	41
Africa	75	34

Source: JP Morgan April 2017; Note that JACI has higher market size than CEMBI + EMBI Asia given the lower minimum size requirement for JACI.

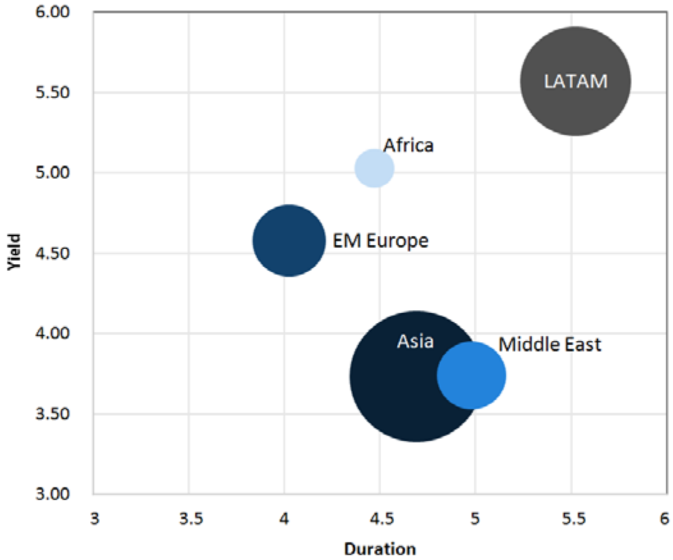
The chart below confirms the superior Sharpe Ratios for USD debt in Asia:

Asia Credit IG Risk Return vs Other Credit Segments



Source: Nikko AM, Bloomberg, Markit, JP Morgan, 31 May 2017

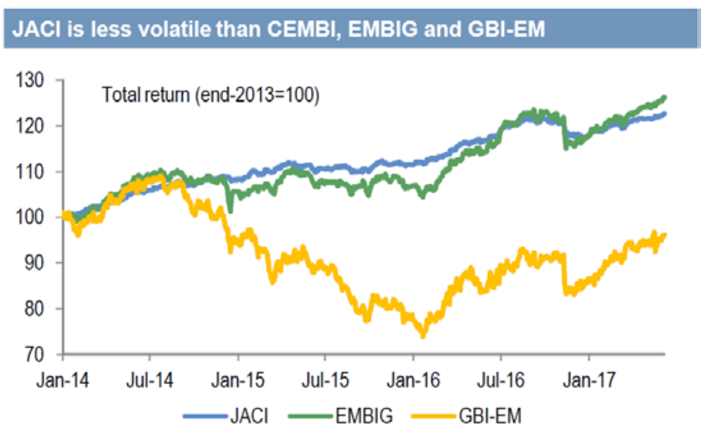
Emerging Market Debt - Regions by Yield vs Duration (CEMBI)



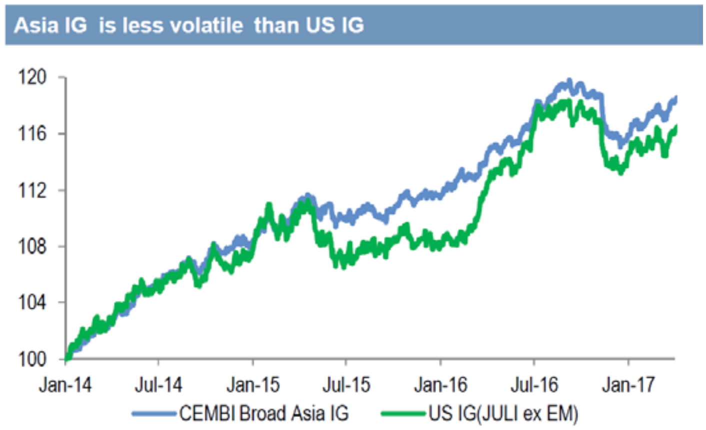
Source: JP Morgan, 28 April 2017

Why is Asia Credit Volatility so Low?

As the charts below show, Asia Credit has not only been less volatile that other high beta Emerging Market regions, but even lower than US IG, and the same is also true comparing Asia Credit High Yield to US High Yield.



Source: JP Morgan, Asia Credit Outlook and Strategy June 2017



Source: JP Morgan, Asia Credit Outlook and Strategy June 2017

There are four key reasons why the volatility for Asian Investment Grade Credit in particular has been so low compared to other segments of EMD:

1. **Fundamental Growth** – higher rates of growth and a more rapidly diversifying economic base

2. **Technical factors** – local capital formation and the rise of the “local bid” – Asia owns >75% of its own debt

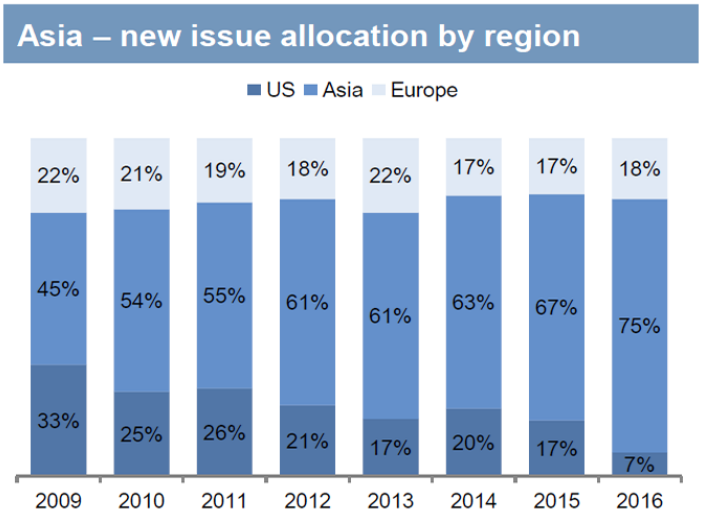
3. **Credit Quality** – the average credit rating for Asia is 1-3 notches above that other EM regions

4. **Credit Metrics** – net leverage for Asia IG firms has declined, whereas other EM regions are more stretched

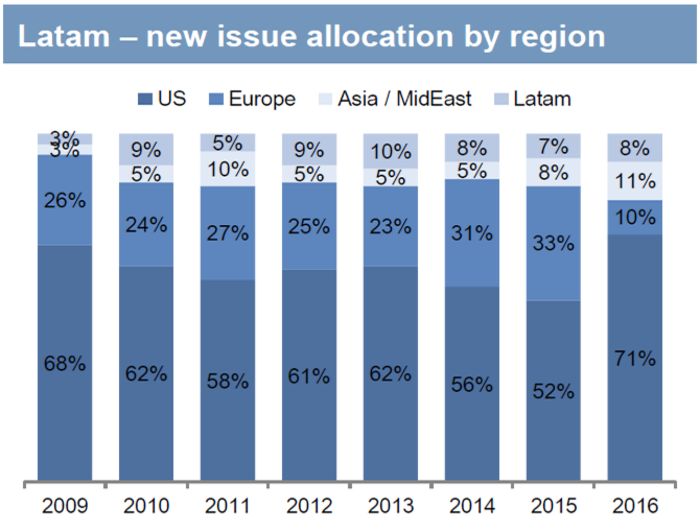
Fundamental Growth – Asia is the fastest growing region in the globe (IMF forecasts growth of 5.5% in 2017 vs 4.5% for EM total[1]). Asia also is home to the world’s second largest economy and greatest growth engine: China. China is both a key source of issuance and a key source of local capital for the region (especially given its high savings rate). Like Japan before it, the rise of China is having a “flying geese” effect – driving growth in other regional markets.

Technical Factors – Unlike Latin America, which only own 11% or its own debt issuance, or the Mideast, which owns 37%, Asia investors own 75% of their own debt, which has helped dampen volatility in the market significantly. Much of this investment (42%) in new issuance is coming from Chinese banks, but other countries are also key investors (Malaysia 27%, Hong Kong 20%).

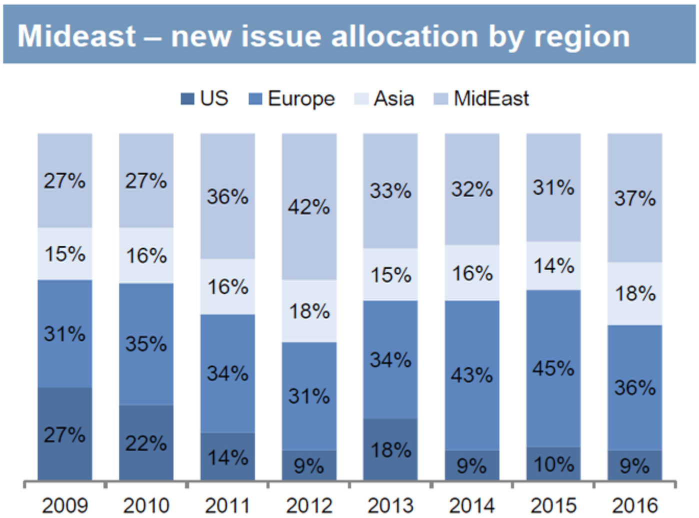
Allocation in to EMD by Region



Source: JP Morgan, February 2017



Source: JP Morgan, February 2017



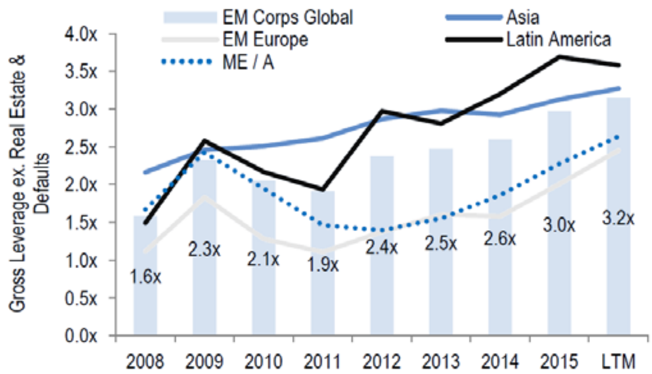
Source: JP Morgan, February 2017

Credit Quality – Linked to the fundamental growth story and market diversification is the emergence of many new investment grade issuers in Asia. In 2006, only 90 issuers could access Investment Grade markets on the JACI index, while in 2016 there were 251. As the recent upgrade of Indonesia to investment grade shows, the integration of more Asian countries in global supply chains has allowed them to increase their credit quality.

Credit Metrics - Relative to other Emerging Market regions, such as LATAM, EM Europe and the Middle East, net leverage for Asian Investment Grade debt has declined since 2013 as investment grade companies have built up their liquidity buffers. Coupled with a lower reliance on external demand, the lower net leverage means that Asian IG Credits are better protected against a downward correction in EMD.

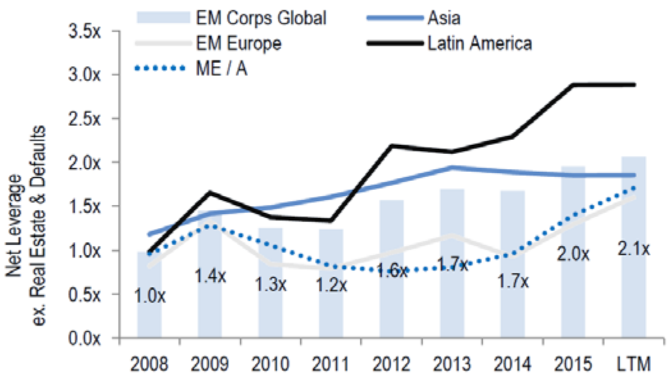
Credit Metrics for EMD Issuers by Region

EM Corporate gross leverage trends



Source: JPMorgan: Smooth Sailing So Far, But Beware of Uncharted Waters, February 2017

EM Corporate net leverage trends



Source: JPMorgan: Smooth Sailing So Far, But Beware of Uncharted Waters, February 2017

What is the Trade-Off for US Investors?

There are two clear costs to re-allocating defensively from higher beta segments of Emerging Market Debt, and making a separate allocation to an Asia Credit Investment Grade fund:

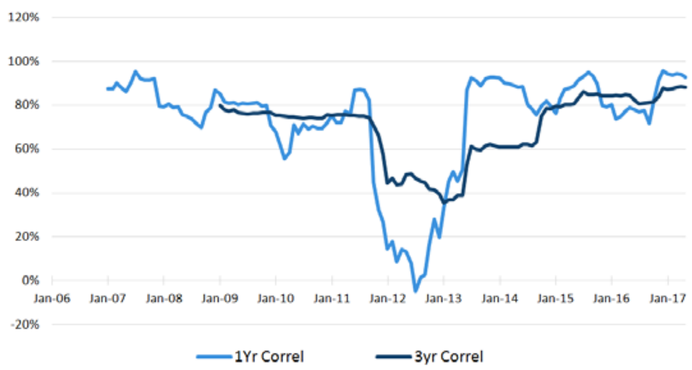
More moderate returns – JACI Investment Grade has returned 4.0% YTD 2017 which is below EMBIG at 7.1% and CEMBI Investment Grade at 4.4%. If we break down the CEMBI index, EM Debt from LATAM Investment Grade has returned 6.5% and EM Europe Investment Grade has produced 4.9% while CEMBI Asia IG has only returned 3.6%. However, over the same period the US Agg has only delivered 2.27% YTD June 2017.

Diversification benefits - As the chart below shows, there are some diversification benefits from Asia IG for a US investor, but the correlation is not as low as for CEMBI (52% on 5Y basis). There are two key reasons for this:

- at a fundamental level, the integration of Asia into global supply chains means it is more closely tied to the US
- as Asia Credit within JACI is USD denominated and benchmarked off of US Treasuries – these also drive closer correlations (82% on 5Y basis)

However, as the rolling correlations chart below shows, there are clearly different drivers to the Asia Credit market from the US (as the period from mid 2011 to mid-2013 shows). As regional sources of demand continue to diversify we would expect the correlation with the US Agg also to decline. Both through trade and domestic diversification, China is shifting from export led growth to domestic consumption and now accounts for nearly 20% of regional exports[2]. The growth in commercial services trade within the region – particularly in areas such as tourism, healthcare and education – should also drive diversification away from commodities and manufacturing.

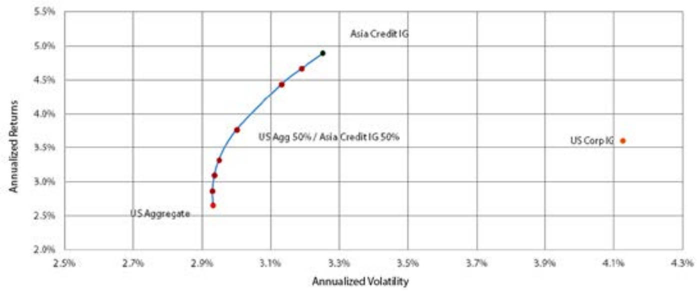
Downside Correlation of JACI Investment Grade and US Aggregate



Source: Nikko AM, Bloomberg, 28 April 2017

Even with more moderate returns and higher correlations than Global EMD indices, the low volatility and higher returns of Asia Credit Investment Grade does deliver a more efficient investment frontier for US investors. As the scenario chart below shows, using a 50/50 weight of Asia Credit Investment Grade and US Agg, based on historical 3-year returns and volatility, a US investor would see a yield pick-up of 111 bps (from 2.66% to 3.77%), while volatility would only increase by 3bps (from 2.97% to 3.00%). By comparison, if the investor were to simply allocate 100% to US Investment Grade, he or she should expect a marginally lower return 3.61% at a much higher cost in terms of volatility, at 4.13%. Hence, as a defensive repositioning, it makes more sense for a US investor to make a separate allocation to Asia Credit Investment Grade than to divest from EMD completely and re-allocate to US Investment Grade.

Efficient Frontier of US Aggregate and Asia Credit – based on 3Y return / risk



Source: Nikko AM, Bloomberg, as of April 2017

Conclusions

The benefits of a separate allocation to Asia High Grade within EMD include:

- As with the broader Emerging Market universe, the dynamics of the Asia Credit universe are also very diverse. As economies within the region mature, unique country factors play a greater role in determining returns and US investors can expect greater divergence in business cycles and increased diversification.

- A selective allocation to Asia IG offers US investors a good defensive position within the EMD universe. There is some trade-off in terms of returns and diversification against a broad EMD exposure, but it significantly reduces the downside volatility exposure that comes with high beta EMD regions.

- From a long-term perspective, the fundamentals of Asia Investment Grade support "quality yield" pick-up, while ongoing development will continue to drive growth and diversification of USD denominated IG debt within the region.

1 Source: IMF Forecasts April 2017
2 Source: World Bank Group: Diversification, Growth and Volatility in Asia-Pacific, July 2015

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our websitewww.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration
thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.