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ASIA HIGH GRADE CREDIT

A Safe Haven within Emerging Market Debt (EMD)

Summary

Asia Credit is significant enough as an asset class to be considered separately, and its high grade segment could be a relative safe haven if EMD flows reverse

The inflows into EMD continue to be strong in 2017, with JP Morgan expecting an additional $20b this year[1] – the majority into hard currency debt. EMD is now valued at historic highs, with spreads on the Corporate Emerging Markets Bond Index (CEMBI) Broad continuing to tighten to their lowest levels since the 2008 financial crisis.

This is despite repeated signals by the US Fed that it will raise interest rates in 2017, political uncertainty over protectionist US trade policies, and the recent slide in oil prices[2]. All of these are typically key vulnerabilities for EMD issuers.

In a bear case scenario for EMD, US rates go up, the USD appreciates and EMD issuers see capital outflow and pressure to meet USD earnings (similar to the 2013 "taper tantrum"). The question is: **What is the best position for investors who still see the long term value in EMD, as a source of growth and excess return over Developed Markets (DM)?**

We believe for long-term EMD investors, Asia Credit is now a significant enough asset class (with $700b in issuance) to warrant a separate allocation, and Investment Grade offers a relative safe haven. Unlike many other EMD regions, there is a large enough local pool of capital to cushion the volatility of "hot money" external flows. More than 75% of Asia Credit is now owned by local investors (see chart 2 below).

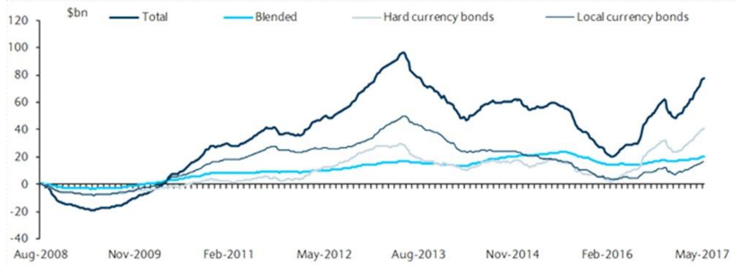
Apart from technical support factors, we also believe that fundamental growth in Asia is more resilient and broader based than many other EM regions, and this is driving greater diversification and higher credit quality in the region. Faster, more diverse growth is also supporting better earnings and net leverage for Asian investment grade issuers.

While we recognize that valuations in Asia Credit – particularly High Yield – are at historic highs, we believe that the external vulnerabilities of Asia Credit – particularly Investment Grade - are less than for other EMD issuers.

Inflows into EMD

The Hunt for Yield Moves South

Chart 1: Flows into Dedicated EMD Bond Funds



Source: EPFR Global, Barclays Research

For DM investors starved for yield, the attraction of EMD is clear. As the chart above shows, the flows particularly into USD denominated EM debt since 2016 have been growing rapidly and the total AUM in EMD is now nearly at the highest levels post-crisis. JP Morgan reports that EM corporate dedicated AUM is now at $81 billion[3].

Demand has also helped drive good total returns - CEMBI Broad has returned 4.2% YTD as of April 2017. In particular, the High Yield segments of other EMD indices, such as Emerging Market Bonds Index Global (EMBIG) and JP Morgan Asia Credit Index (JACI) Sovereign, have seen returns of 6.5% and 6.4% over the same time[4].

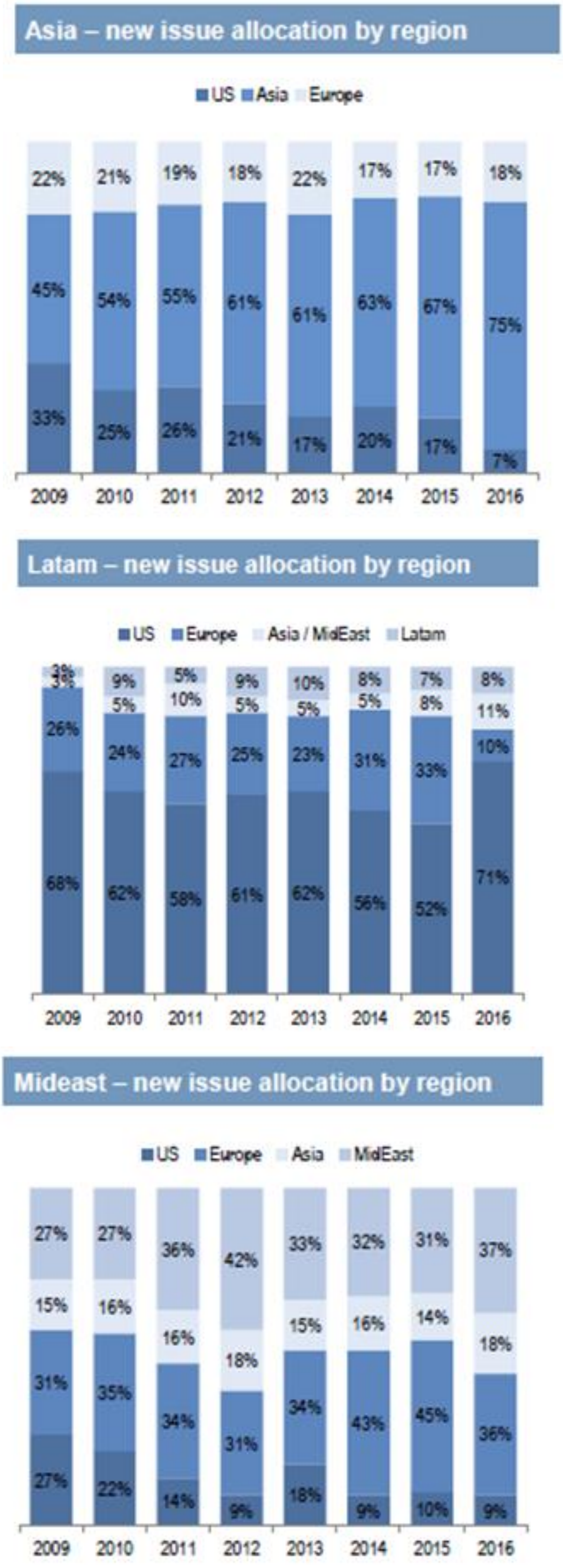
However, spreads have now tightened to a point where there is concern over the sustainability of such returns (CEMBI Broad is close to a post-crisis tight of 260bps)[5]. Given the potential negative catalysts (US trade/tax policy, interest rates, oil price uncertainty) it is important for long-term investors to examine the vulnerabilities of the market and assess how best to position within it.

1. Source JPM: Smooth Sailing So Far, But Beware Of Uncharted Waters, February 2017, p. 20
2. Source: The Week: Oil Price Rally Stalls Amid Supply Doubts 17 May 2017
3. JPM: Smooth Sailing So Far, But Beware Of Uncharted Waters, February 2017, p. 49
4. JPM: Asia Credit Analytics, April 2017, p. 3
5. JPM: Smooth Sailing So Far, But Beware Of Uncharted Waters, February 2017, p. 2

Technical Support for EMD Regions

The local bid in Asia damps down volatility

Chart 2: Divergence in ownership of debt by EM Region



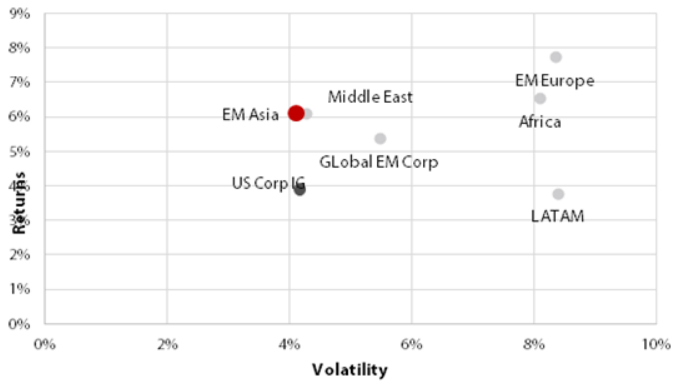
Source: Bond Radar, JPM Feb 2017

One of the key characteristics of the Asia Credit market has been the rise of the local bid. In comparison to other EM regions, local Asian investors now dominate new corporate issuance allocation, at 75% - whereas in Latin American only 8% of external bonds are held locally, and for the Middle-East 37%.

As BAML noted in March 2017, the increasing participation by local investors in particular has driven down volatility in Asia Credit, with the implication that investors could "*diversify away EM risks through Chinese bonds as a defensive play given their much lower volatility*"[6].

We believe that the rise of the local bid in Asia for hard currency bonds is a long term structural trend, related to both the fundamental growth patterns (greater integration into global supply chains), higher savings rates, and the increasing interdependence and sophistication of regional financial institutions (as with Chinese banks).

Chart 3: EM Corporate Bond Indices



Source: As of April 28, 2017. JP Morgan, Bloomberg Barclays indices, Nikko AM calculations

In a replay of the 2013 taper tantrum, where DM investors can generate better returns out of US fixed income markets, the vulnerability of EM to external flows will be a key factor in the downside impact.

For Chinese investors, a key driver of flows into Asia Credit is the depreciation of the CNY vs USD, and an increase in USD rates is unlikely to dampen that demand.

As Chart 3 shows, EM Asia Corporate has delivered better overall performance than Global CEMBI on a five year basis, with significantly lower volatilities.

6. Bank of America Merrill Lynch Breakdown of Investor Base for Asian Dollar Bonds March 8, 2017

Fundamental growth in Asia

Asia's growth is maturing and diversifying

The "China plus one" approach being adopted by many global manufacturers is relocating export capacity and growth in ASEAN countries, reflected in greater dollar issuance by these countries. At the same time, economic development within large Asian markets is seeing issuance from new sectors, such as technology firms. Finally, regional initiatives, such as China's "one belt, one road" are also driving greater interdependence within the region, diversifying sources of external demand[7].

Chart 4: Global Growth Rates – Asia leads pack

Latest Economic Growth Projections
(percent of GDP change)

		Projections	
	2016	2017	2018
World Output	**3.1**	**3.5**	**3.6**
Asia Output	**5.3**	**5.5**	**5.4**
Emerging Asia	6.4	6.4	6.4
Industrial Asia	1.3	1.6	1.1
East Asia	6.1	6.0	5.7
South Asia	6.7	7.1	7.5
ASEAN	4.8	4.9	5.1
Small States	3.4	3.4	3.8
Advanced Economies	**1.7**	**2.0**	**2.0**
United States	1.6	2.3	2.5
Euro Area	1.7	1.7	1.6
United Kingdom	1.8	2.0	1.5
Canada	1.4	1.9	2.0
Other Advanced Economies	2.2	2.3	2.4
Emerging Market and Developing Economies	**4.1**	**4.5**	**4.8**
Low-Income Developing Countries	**3.6**	**4.7**	**5.3**

Source: IMF, April 2017 *World Economic Outlook*.

This does not mean that Asian growth has "decoupled" from developed markets. Indeed, if anything integration into global supply chains has increased its sensitivity.

However, the same is true for other EMD issuers – if the 2013 taper tantrum showed investors anything, it is that "decoupling" in a global economy is almost impossible for any growing economy.

At the same time, in other EMD regions, much of hard currency issuance has a far greater exposure to commodities, and especially Oil and Gas prices, than in Asia.

Around 26% of EMD hard currency corporate bonds are by issuers whose main USD earnings are from Oil and Gas (21%) or Metals and Mining (5%). Further, with the recovery in Oil and Gas prices in 2016, gross leverage within this sector has increased, particularly for Latin America – where it is now at 4.9x compared to 4.4x in 2015[8].

Along with USD interest rates then, another key vulnerability for EMD is if Oil and Gas prices were to weaken further in 2017.

As Investment Grade issuance has grown in Asia (from $116bn in 2006 to $541bn in 2016), the number of issuers has also exploded – from 90 to 251 over the same period. The spread of growth across the region is reflected in country investment grade issuance – in 2006 only seven countries qualified, in 2016 there were 11 countries issuing investment grade dollar debt[9].

While investors may have concerns about the growth of China and its dominance within Asia Credit (it now accounts for 41% of JACI), there is diversification within China – as well as a broader range of Asian countries issuing investment grade debt, as with the recent upgrade of Indonesia.

China is also a good example of how sector issuance in maturing EM economies is diversifying. In 2006, its investment grade issuance was limited to Sovereign, Quasi-sovereign and Financials. In 2016, Oil and Gas, TMT, Real Estate and Infrastructure were also key issuers. While some of those sectors may be of concern (such as High Yield Real Estate) the broad scope of China issuance helps limit its risk.

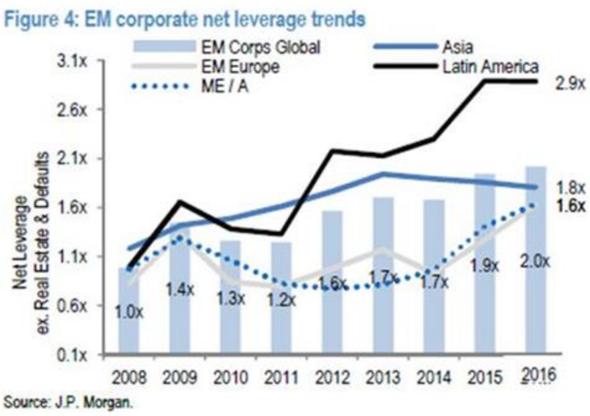
For a specialist active manager, this growth and diversification creates more opportunities to generate alpha. Importantly, for longer-term EMD investors, Asia's higher growth rates mean that its issuers can continue to provide a yield pick-up to DM issuers, but without the vulnerabilities that many EM regions face in sustaining growth.

7. McKinsey, China's One Belt One Road: Will it Reshape Global Trade,
8. JPM: Smooth Sailing So Far, But Beware Of Uncharted Waters, February 2017, p. 44
9. JP Morgan Dec 2016

Credit Metrics - Asia High Grade v EMD

Strong Asia High Grade earnings moderate net leverage, despite increasing issuance

Chart 5: Gross and Net Leverage in Emerging Market Debt by Region



As the charts above show, while gross leverage across EM regions has increased (with the exception of Latin America, which seems to have peaked in 2015), net leverage has been moderating in Asia Corporates since 2013, which coincides with declines in capital expenditure. Average EBITDA margins for Asia Corporates improved to 16.8% in 2016, up from 14.0% in 2013.

However, the improvement in credit metrics has certainly been led by the Investment Grade Corporates. Higher EBITDA has allowed firms to build up stronger cash balances – with cash to total debt increasing from 26.3% to 31.9% over the same period. As a result, Net Debt to EBITDA is down from 1.8x to 1.4x.

Asian High Yield Corporates on the other hand have seen their credit fundamentals weaken, as they have expanded debt to fund growth – with Net Debt to EBITDA expanding from 2.7x to 4.1x.

It should be noted that defaults within the Asian Corporates have been low at around 1.0% for 2016, whereas this was 3.6% for EM Europe, 9.2% for Latin America and 5.7% for Middle East and Africa. Even US High Yield default rates were at 4.1% for last year.

Along with more diversified earnings growth, the improving EBITDA margins for Asia Investment Grade Corporates is feeding stronger cash balances and provides a better buffer against earnings pressure should markets turn negative for EM Corporates.

Unlike the EM High Yield, and EM Commodities in other regions where leverage is much higher and external vulnerabilities far greater, we believe the ability of Asia Investment Grade Corporate to ride out another taper tantrum and provide a long-term source of quality yield is much higher.

Chart 6: Credit Metrics for Asian High Yield

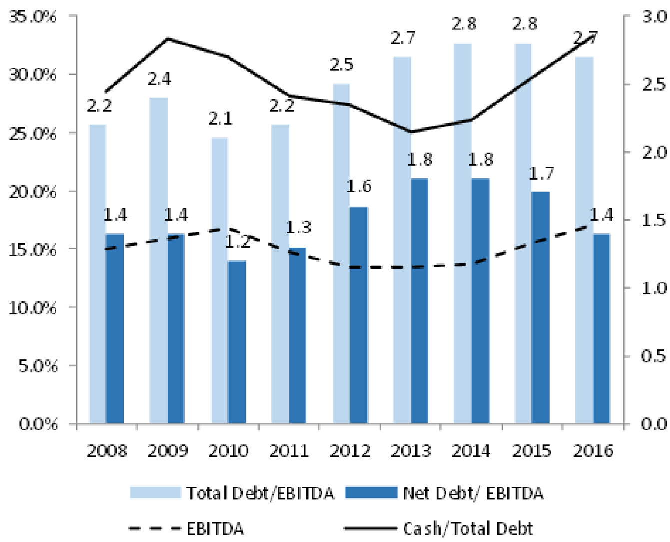
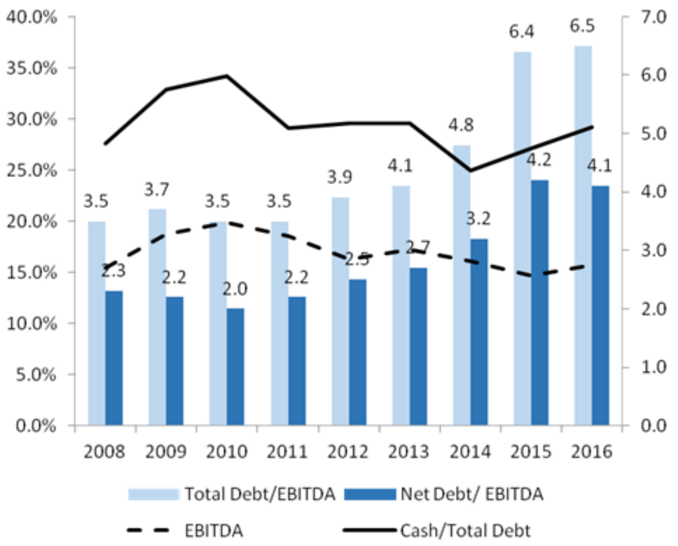


Chart 7: Credit Metrics for Asian Investment Grade Credits



Source: JPM Asia Credit Analytics April 2017 p 52

Conclusion

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

– **Asia High Grade still offers some relative upside,** as spreads have not tightened as far as High Yield, or some other EMD segments.

– **On limiting the downside – Asia High Grade is far better positioned as a safe haven than other segments of EMD.** Local investors cushion the volatility of external flows, fundamental growth is faster and less vulnerable to commodities, and net leverage for Investment Grade Corporates has declined as cash balances have improved.

– **Over the long-term, given the rapid growth in size and scope of the Asia Credit market (particularly Investment Grade) we believe this asset class deserves separate consideration / allocation** from any committed EMD investor. It represents a good source of quality yield pick-up over other Emerging and Developed Market alternatives.

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