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10 questions on strategy: Asian High Yield

After a strong start for fixed income in 2019, we sat down with **Hayden Briscoe**, Head of Asia Pacific Fixed Income, and his team to talk about their Asian High Yield (HY) strategies and explore the opportunities for investors in 2019.

What themes defined the Asia high yield market in 2018?

Market sell-offs made 2018 a tough year for credit both in Asia and across the world. Economic uncertainty and deleveraging pressured yields in China, which is a core part of the Asia HY space.

Globally, US Fed tightening pushed up US yields, impacted global credit, strengthened the USD and put Asian hard currency debt under a lot of pressure.

Toward the end of 2018, investor sentiment improved after the Fed turned dovish and yields became attractive.

How have your strategies performed in the past 6 – 12 months?

Our Asian and China HY strategies performed strongly both in absolute terms and relative to competitors.

That's partly because we avoided defaults because of our credit selection process, i.e. doing detailed on-the-ground and bottom-up research on companies in China, avoiding small companies pressured by deleveraging, and focusing on quality companies with good access to capital.

Importantly, we avoided local government financing vehicles (LGFVs), companies owned by local governments in China. We believe LGFVs are a highly risky asset class to invest in because they are linked to non-transparent and undisciplined lending practices at the local level in China.

China real estate is a large part of our strategies and we took advantage of sector repricing during the past 18 months.

What is your outlook for 2019 and where do you see opportunities?

We expect a reverse of 2018 in the Asia HY space and we believe China HY valuations look very attractive indeed.

With a less hawkish Fed, and China moving into easing mode, we believe now is a good time to position for potential capital appreciation through 2019 and attractive yield opportunities.

Bloomberg data show the China HY space started the year with yields of 10%+[1], and we believe that there's potential for returns of 12%+ through the year.

[1] Bloomberg, January 31, 2019

What is the investor case for Asian HY vs. other HY markets in 2019?

We believe yield differentials are compelling with Asia HY at about 8%, compared with around 6.8% in the US HY space[2]; and that policy easing in China will benefit Asia HY.

Fundamentally, however, growth prospects look stronger in Asia than other markets with 5.7% GDP growth forecast in 2019, compared with 3.5% GDP growth forecast for the world economy in 2019 [3].

You seem to believe credit fundamentals are sound in Asia. Why?

We see less credit pressure on Asian countries and corporates in 2019.

Many countries in the region saw currency pressure in 2018 as the dollar strengthened. As a result, many countries raised interest rates, and by more than the Fed hiked, which caused credit stress.

Now the Fed has turned dovish, Asian countries are cutting their rates and reversing course on their 2018 tightening stance, for example in India, so there's less credit pressure in the markets.

Moving beyond the country level, we feel Asia corporate credit has stronger fundamentals than those in the US and EMEA.

That's because, firstly, net leverage levels in the investment grade and high yield categories are lower and, secondly, cash-to-total debt levels are higher in Asia compared with the US, Latin America, and EMEA [4].

That said, we remain highly selective in the companies we invest in.

China is a dominant theme in your strategies, but the IMF is predicting slower growth – isn't that a risk?

Not in our view.

That's firstly because official data from China's statistics ministry and the IMF show that China's growth rate has been trending down for years, and that's consistent with the rebalancing process in the economy that is seeing consumer demand and industrial upgrading take over from fixed asset investment and exports as the main drivers of the economy.

We believe this means slower, but more sustainable, long-term growth for China - which is exactly what investors want to see.

Secondly, and more importantly, we're expecting China's economy to stabilize in H2 2019.

The government has applied explicit policy support and that will likely take six-to-nine months to show up in the official government figures.

That's a reality many market participants don't currently recognize, and why we believe it is time to be positioned now.

We're expecting China's economy to stabilize in H2 2019. The government has applied explicit policy support and that will likely take 6 – 9 months to show up in the official figures.

What has the Chinese government actually done to support the economy?

Tax cuts for businesses and consumers, targeted support from monetary policy, and a commitment to invest in infrastructure projects are just some of the policy initiatives enacted recently.

Looking specifically at credit markets, China's National Development and Reform Council (NDRC) has let high-quality privately-owned enterprises (POEs) issue enterprise bonds.

This is a significant change because it opens up a new funding channel in addition to corporate bonds and medium-term notes (MTNs).

Additionally, the People's Bank of China (PBoC) has increased relending and rediscounting quotas by CNY

[2] Bloomberg and JP Morgan, January 31, 2019
[3] Bloomberg, January 31, 2019
[4] Bank of America Merrill Lynch. January 31, 2019

100bn and introduced targeted medium-term lending facilities (TMLFs) for small-and-medium-sized enterprises and private companies to increase longer-term funding and cut banks' funding costs.

What countries/sectors are you over/underweight in your Asia HY strategy??

At the country level, we are overweight China, Indonesia, while underweight India, Sri Lanka, the Philippines, and Malaysia.

At a sector/industry level, we are overweight China real estate, Indonesia corporates and financials.

We are underweight to China state-owned enterprises, as well as corporates in the Philippines and India[5].

You are overweight in China real estate, isn't that risky now that the market is slowing?

From an aggregate national perspective, official data from the Chinese government show that sales momentum is clearly slowing. Based on anecdotal evidence we have seen on research trips, conversations with company managements and due to weaker macro backdrop, we expect sales to continue to slow.
Looking into 2019, we wouldn't be surprised to see a slight drop in overall national sales, but we don't see that as a reason to turn cautious on China's real estate sector.

From a credit perspective, we believe three factors define the outlook for China's real estate developers.
Firstly, Chinese real estate developers are in a very different state now compared to the past cycles.
Many of the companies we favor have grown their market share, scaled up their operations and have improved their funding channels.

Real estate companies used to have local focus but have now widened their footprints nationally. This has helped them diversify geographical risk associated with localized property cycles and policies. Consequently, the leading developers are in a much better position to navigate market trends and cycles.

Secondly, inventory levels in this cycle look healthier compared to last property market cycle of 2014/2015.
Considerably lower level of land supply and brisk property sales during the upturn in 2016/2017 has helped the developers in clearing inventory backlogs.
Developers have also been more conservative about adding to their land reserves over the past six-to-nine months.

Finally, policy towards the property sector has remained restrictive and has sufficient room to readjust for supporting the sector, when the need arises.
We are already seeing some targeted policy support measures at the local levels in China.
Given the importance of property sector towards economic growth and local government finances, we expect the pace of policy relaxation may accelerate if there is any material weakening in the sector.

Looking into 2019, we wouldn't be surprised to see a slight drop in overall national sales, but we don't see that as a reason to turn cautious on China's real estate sector.

What events should we look out for in 2019?

As we said above, we believe investors need to look for stabilization in China's economy in H2 2019.

We don't feel market participants currently appreciate this and most commentary is focused on trade issues and softening numbers. On a related note, we're expecting de-escalation of the US/China trade war.

We believe that both sides are looking for reconciliation and we note that China has already made definite steps, such as opening up sectors to outside investment and improving intellectual property protection, to address many of the US government's key concerns.

Looking specifically at fixed income, the inclusion of onshore China bonds in the Bloomberg global bond aggregate from April 2019 should be a historic change for both Chinese and global markets because we believe it is likely to spark strong capital inflows, increase liquidity onshore, and force investors to pay attention to China's onshore fixed income space.

[5] Weightings are correct as of January 31st, 2019

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