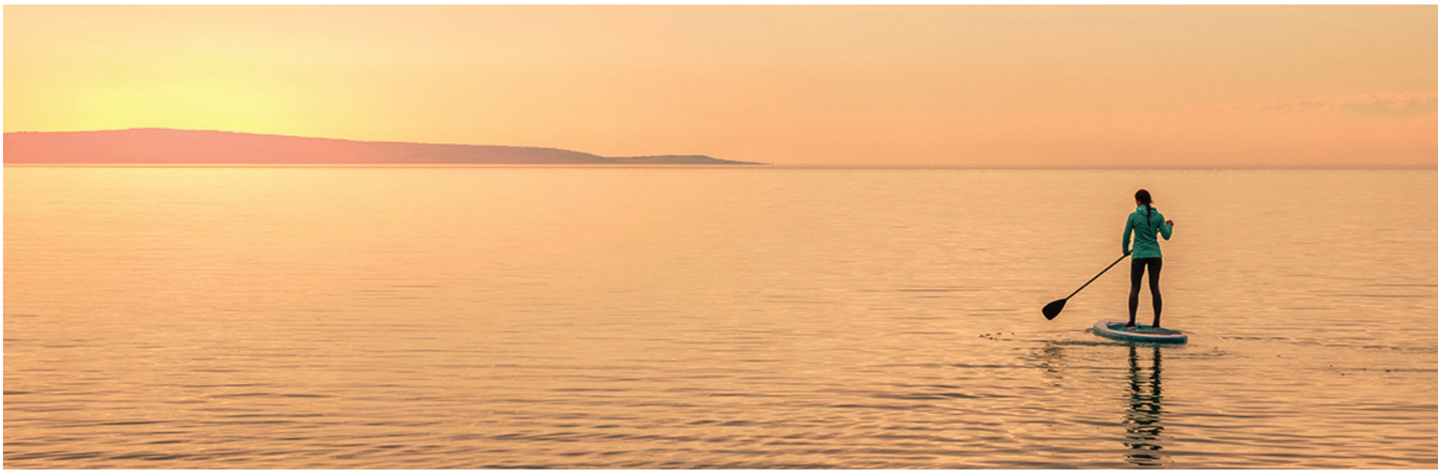

Asian High Yields: Keep calm and carry on

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Uncertainty in the China bond market has weighed on Asian High Yield bonds in 2021, but investors may want to ride through the near-term volatility. With its attractive yields, manageable defaults and shorter duration, we believe that Asian High Yield bonds can benefit from the region's eventual economic rebound and should be one of the first stops for yield seeking investors.

2021 has been a challenging year for the Asian High Yield (AHY) bond market. A default by a Chinese property company in January heightened investor concerns, causing it to underperform its US and European peers to date. Fig. 1. Despite idiosyncratic risks in China, fears over rising defaults and risks of higher interest rates, we believe that there are opportunities within the AHY bond market, and it remains an attractive asset class for yield-seeking investors.

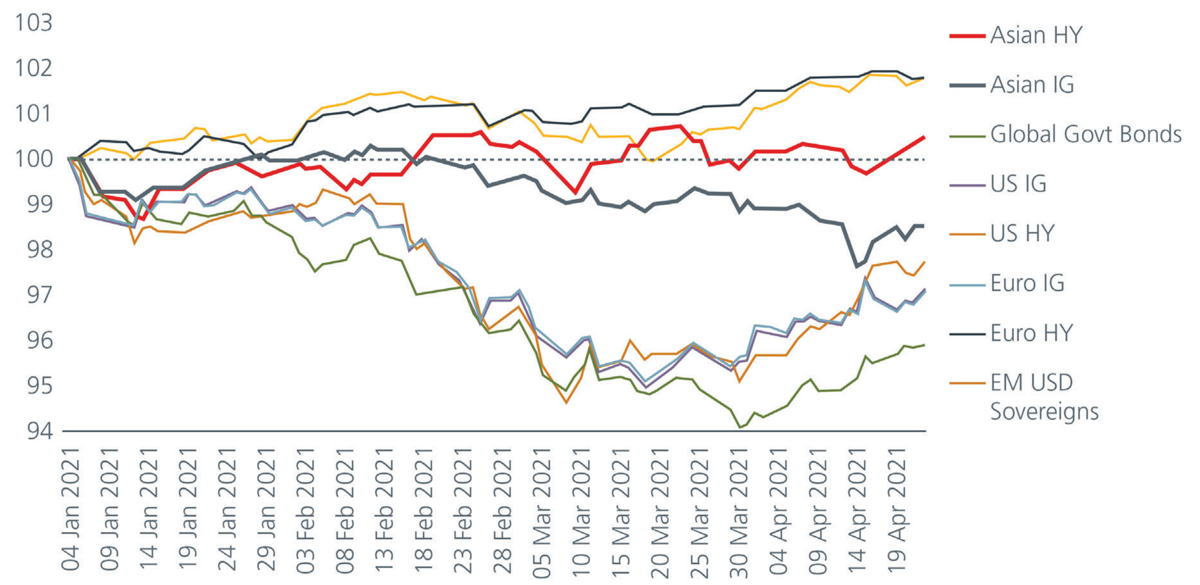
STICKING WITH QUALITY IN CHINA

We are likely to see an uptick in onshore bond defaults in China given the Chinese government's commitment to reforms and desire to reduce net leverage in the system. A number of high-profile defaults in 2020 and the recent developments surrounding China Huarong Asset Management showed investors that the central government will no longer give blanket guarantees even to state-controlled entities.

Market speculation of a debt restructuring and even a potential default by China Huarong Asset Management had caused its bonds to sell off and created a negative spillover impact to dollar-denominated debt issued by China's other State-Owned Entities (SOEs). We believe that the Chinese government would review its support to SOEs on a case by case basis and would wish to avoid any financial systemic risks.

Amid the noise, it is important to remember that the Chinese property sector dominates the AHY bond market and is a key driver of returns. The sector's interconnectedness with China's GDP motivates the government to ensure that the appreciation in property prices is relatively stable. Further, the transparency in Chinese property companies is high, with sales and pre-sales numbers reported on a monthly basis, a fact that may be underappreciated by some investors.

Fig 1: Bond market index performance year-to-date (rebased to 100)



Source: Eastspring Investments, Bloomberg, JPMorgan, ICE BAML, FTSE indices, 22 April 2021, daily data, rebased to 100.

Investors may also fail to appreciate that the Chinese property market is probably one of the most regulated in the world following the government's move in 2020 to introduce caps for debt-to-cash, debt-to-assets and debt-to-equity ratios – dubbed the 'three red lines'. We believe that better capitalised developers are likely to outperform going forward given potential industry consolidation as well as the knock-on effect on developers following greater scrutiny of mortgages to homebuyers.

For now, we remain comfortable with our exposure in the Chinese property sector. We also prefer the provincial-level and key tier-2 city SOEs or Local Government Financing Vehicles (LGFVs) that have strategic importance.

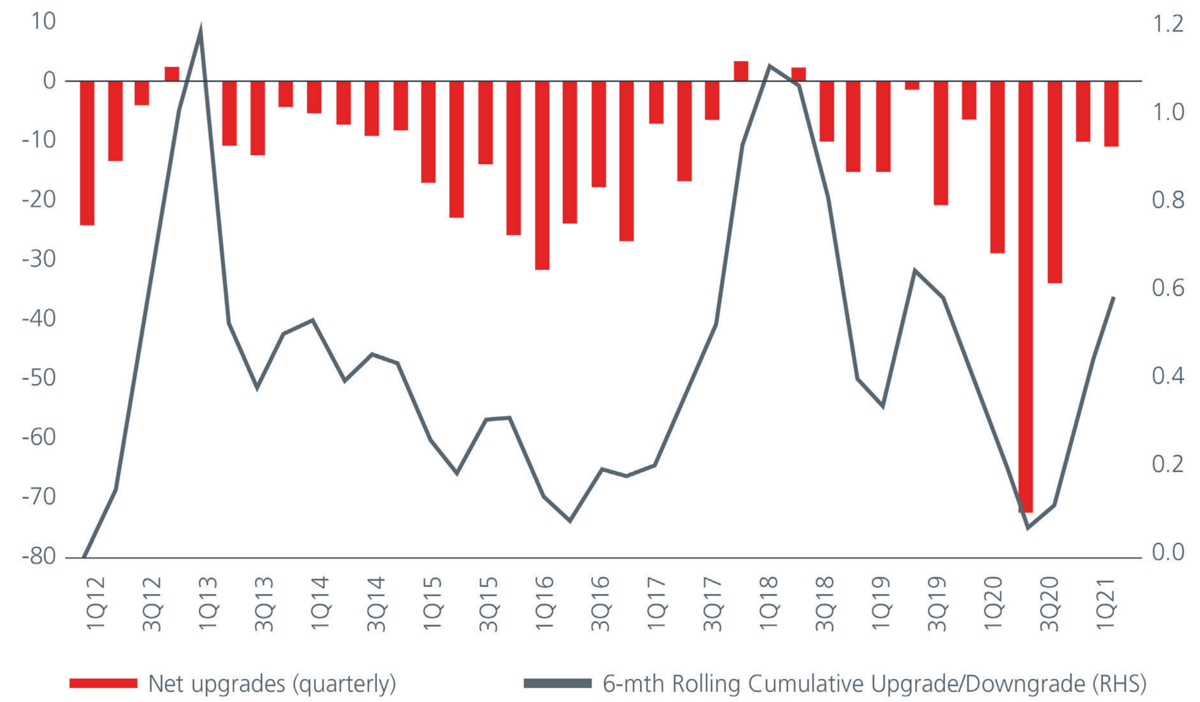
NAVIGATING THE DEFAULT JOURNEY IN ASIA

Default rates across Asia are likely to rise as governments pare back their stimulus measures, but defaults should still be manageable. We expect AHY's average default rate to range between 2 to 4% in 2021. While idiosyncratic risks have inevitably risen, the negative migration trend of 2020 appears to have bottomed. Fig. 2. In addition, a significant number of AHY bond issuers are linked to commodities, which offer scope for optimism. The size and diversity of the AHY bond market should also help to temper default rates.

From another perspective, a widening of spreads due to any unfounded fears over potential defaults offer opportunities for experienced investors to add alpha. That said, we are cautious on the Southeast Asian banks as non-performing loans are likely to rise, although this should not be confused with a banking crisis.

Asia may also witness so-called 'fallen angels', as higher rated bonds get downgraded to high yield status because the issuer has fallen into financial trouble. Indeed, some pockets of risk exist in the region – such as in India – stemming from the

Fig 2: A decelerating downgrade trend in Asian High Yield



Source: JP Morgan, April 2021.

ongoing impact of the pandemic on the Indian economy. A downgrade to India's sovereign rating would have a knock-on effect on the ratings of other Indian corporate and quasi-sovereign issuers. If this materialises, the additional supply of bonds into the AHY bond market may cause renewed volatility, although this is currently not our base case.

STAYING LESS VULNERABLE TO RISING RATES

In 2021, global bond markets in general have been buffeted by fears of rising interest rates on the back of higher inflation expectations.

Even though the macro backdrop in the US has improved, we believe that the market's expectations of rate hikes seem a little premature. The Federal Reserve's (Fed) average inflation targeting framework suggests that the US central bank can remain patient for some time. As such, the yield pick-up from AHY bonds remain attractive in a still lower-for-longer rate environment. Even if rates were to rise, AHY bonds have the benefit of having the shortest duration among other bond sectors, making them less vulnerable to rising interest rates – another fact that may be underappreciated by investors. Fig. 3.

POISED FOR THE EVENTUAL REBOUND

A resurgence in COVID-19 cases in Asia in the second quarter of 2021 has highlighted the danger of looking too far ahead for the time being. The gradual removal of various policy-led stimulus measures further heightens the need for closer scrutiny on the creditworthiness and longer-term sustainability of individual companies across Asia. Meanwhile, the Chinese government's desire to reduce moral hazard in its bond market is creating some uncertainty. Credit selection remains key.

Fig 3: Asian High Yield's yield advantage and short duration profile

	AVERAGE YIELD (%)	DURATION (yrs)	AVERAGE CREDIT QUALITY
Asian HY Corp	7.6	**2.5**	**B+**
50% EM Corp + 50% EM Sovereign (Hard Currency)	4.9	6.4	BBB-
US HY Corp	4.3	4.1	B+
Asian USD Bonds	3.4	5.2	BBB+
Asian Local Bonds	3.3	6.6	A
EUR HY Corp	2.6	3.5	BB-
Asian IG Corp	2.4	5.3	A-
US IG Corp	2.3	8.1	A-
Developed Gov Bonds	1.0	8.2	AA
EUR IG Corp	0.4	5.4	A-

Source: Bloomberg, Eastspring Investments, BofAML, Citigroup, Markit iBoxx as at 31 March 2021. Asian HY Corp as represented by BofA Merrill Lynch Asian Dollar High Yield Corp Index. Asian IG Corp as represented by BofA Merrill Lynch Asian Dollar Investment Grade Corp Index. US IG Corp and US HY Corp as represented by BofA Merrill Lynch US Corp and High Yield Indices respectively, Asian Local Bonds as represented by the Markit iBoxx Asian Local Bond Index, Asian USD Bonds as represented by BofA Merrill Lynch Asian Dollar Index, Developed Govt bonds represented by JP Morgan Government Bond Index – Broad. EUR HY Corp and EUR IG Corp represented by BofA Merrill Lynch Euro High Yield and Euro Corporate Indices respectively. 50% EM Corp + 50% EM Sov (Hard currency) as represented by JP Morgan EMBI Global Diversified Index + JP Morgan CEMBI Broad Diversified Index. HY= High Yield, IG = Investment Grade. Average yield for corporate bonds are based on yield to worst.

While the lingering impact of the pandemic has dampened the region's economic outlook in the short term, its fundamentals remain solid. This bodes well for a rebound in growth once cases come under control again. Trade in Asia in 2021 is expected to exceed its previous peak in October 2018. Stronger growth in the US is also expected to have positive spill over impact on Asia in terms of exports and investments. Given AHY bonds' attractive valuations, higher yields and shorter duration, we believe that the sector is poised to benefit from the region's eventual economic rebound. Investors may want to ride out the near-term volatility.

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