Manulife Investment Management

2020 Outlook Series: Asian Credits

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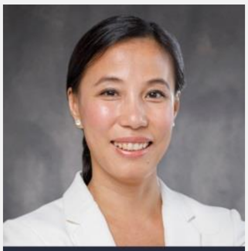

Fiona Cheung
Head of Credit, Asia

Asian credits posted an impressive 2019[i] thanks to a favourable investment backdrop: low yields drove capital flows into the region, issuance was robust, and corporate fundamentals remained solid[ii]. As we enter 2020, we do not expect a significant deterioration of credit profiles, but weaker privately-owned enterprises and less strategically-important state-owned companies may face increased pressure. In this outlook, Fiona Cheung, Head of Credit, Asia, outlines why investors should remain vigilant and selective in 2020.

Accommodative easing and strong investor demand drove 2019 performance

Asian credit markets moved higher in 2019, as credit spreads narrowed on the back of numerous positive macro factors.

- **"Lower for longer" global interest rate landscape:** The Federal Reserve (Fed)'s progressively dovish tone throughout 2019, coupled with the European Central Bank's re-entry into quantitative easing, led to a sharp repricing in bond markets. US Treasuries exhibited significant volatility, with 10-year yields ending the year sharply lower[iii];

- **Increased capital inflows:** Lower (and even negative) yields for some developed countries' bonds[iv] prompted global investors to seek higher returns in emerging markets. Asia was a key beneficiary of increased capital inflows, particularly as credit issuance remained supportive;

- **Stronger monetary accommodation:** Numerous Asian central banks aggressively lowered rates due to declining global yields, receding inflationary pressures and slowing global growth. India, Indonesia, and the Philippines were the most active markets, with the latter two cutting rates and lowering the bank reserve requirement ratio to boost lending levels.

Asian Credits: Strong fundamentals and increased market differentiation will define 2020

In 2020, we believe that economic growth in developed countries will remain subdued, but Asian economic growth should remain relatively strong with muted inflationary pressures[v]. We also think that despite notable monetary loosening last year, some Asian markets, such as Indonesia and India, have additional room for accommodation to boost economic growth. Regional markets may also benefit from shifting supply chains away from China towards other manufacturing bases. Overall, this growth differentiation should continue to support regional credits if Sino-US trade tensions do not materially worsen, which is our base-case scenario.

From a supply perspective, we envisage a marginal increase in issuance with modest redemptions, which will be supportive for the market[vi]. The trend of Asia-based institutional demand for regional credit (especially in the high-yield space)[vii] should continue to deepen in 2020, providing a stable "home base" that is supportive of prices during cases of amplified market volatility. We forecast that the region's default rate, as a lagging indicator of credit quality, will gradually tick upward as a delayed reflection of slowing global growth[viii]. As a result, we believe that security selection and bottom-up research will remain vital, particularly as idiosyncratic risks increase.

Based on these factors, our view is that Asian credit markets are poised for further gains in 2020, with greater differentiation. In Indonesia, we are constructive on high-quality credits in key sectors such as property and coal mining. While in India, we see attractive yield and steady credit standings in areas such as steel and renewables.

China Credits: Opportunities amid amplified risks

The Chinese economy may face ongoing headwinds from trade tensions in 2020, but we still expect it to grow by 5.5%-6%. The Chinese government should continue to provide support through targeted fiscal measures and accommodative monetary policy, but we don't expect full-fledged credit expansion similar to 2008-2009 due to ample market liquidity and building inflationary pressures. With economic challenges and capital outflow pressure, the RMB should remain weaker, above the threshold of 7 RMB to 1 US dollar in 2020.

Looking at the market's overall fundamentals, we do not see a significant deterioration in credit, although more modest performance is likely. We prefer the credits of strategically important state-owned enterprises (SOEs) and Local Government Financing Vehicles (LGFVs), which stand to benefit from continued government support via lending and fiscal stimulus. Examples include toll-road operators, railway operators or companies involved in strategic projects at the national level.

We are also constructive on the property sector, which accounts for significant issuance in the high-yield market and a high proportion of GDP, as well as the banking sector. Reported banks' problem loans are improving and the capital-adequacy ratio remains healthy[ix], we do not anticipate a substantial deterioration in bank credits. Banks' NPL ratios are improving and the capital-adequacy ratio remains high, we do not anticipate a substantial deterioration in bank credits. We are less positive on more economically cyclical industries, such as industrials, which have a significant amount of debt set to mature in 2020. Having said that, we are also on the lookout for potential high-quality names in this category that may have been oversold in 2019.

Finally, defaults in China's credit markets remain a hot topic among investors. While defaults in China have largely been concentrated in the private sector, we did see a notable change in the attitude of the Chinese government towards handling financial distress of SOEs, particularly in the banking and LGFV sectors[x]. We believe that the Chinese government will increasingly allow systemically unimportant commercial actors to fail as a means to increase discipline and reduce moral hazard among onshore credit investors.

Environment, Social & Governance (ESG) factors will continue to rise in importance

Although the topic of ESG is not new one, its importance is gaining ground in Asia. Our credit team has taken numerous steps to build our ESG capabilities, having recently become a signatory to the UN Principles for Responsible Investment (PRI).

We have now formally incorporated a robust ESG perspective into our investment analysis and decision-making processes. Apart from the traditional research and financial analysis on every issuer, our credit analysts work closely with our dedicated ESG research team to review ESG factors. In addition, a dedicated ESG taskforce for our Asian Fixed Income portfolios has been established to track the progress of our ESG integration. As we have strong local footprints in Asia, with a team of over 20 credit analysts, this differentiates us from other competitors who are traditionally focused on Europe.

Finally, our unique on-the ground presence in over 10 Asian markets gives a competitive advantage in understanding the three discrete elements of ESG. Often, the true risks of ESG can only be seen through robust on-the ground research coupled with a quantifiable measurement process. This approach allows us to "notch" ratings up and down based on a long-term view of risk.

Besides our corporate framework, we are ready to launch a new structure for sovereign credits in early 2020. This should give us a superior advantage when measuring Asian corporates and sovereigns, particularly on the "Governance" issue. We expect the "G" factor to become increasingly prominent when evaluating Asia's corporates due to concentrated ownership.

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[i] JACI Investment grade rose by 10.85%, with spreads narrowing by 28.6 bps. JACI HY rose by 11.61% with spreads narrowing by 38.9 bps. Data as of 5 December 2019.

[ii] YTD new issuance amounted to US$265 billion, second highest since 2007. JP Morgan, as of November 2019.

[iii] The 10-year US Treasury yield was at 1.77% as of 11/29/2019- while it was 2.69% as of 12/31/2019.

[iv] The total of negative interest rate bonds was roughly US $11.5 trillion or 20% of all bond issuance. Financial Times, as of 19 November 2019.

[v] International Monetary Fund Global Outlook, as of October 2019.

[vi] Issuance for 2019 was $265 billion in 2019 (YTD through 31 October 2019): $152 billion were investment grade, while $109 billion were high-yield. JP Morgan, as of November 2019. Redemptions were around US$ 190 billion; there will be a similar level of redemptions due next year. Source: Barclays, as of October 2019.

[vii] By investor type, insurance/pension represents an average 65% of allocation of high-yield new issues in 2019, versus 48% in 2018; November 2019, JP Morgan.

[viii] According to Moody's, Asia's trailing 12-month (TTM) non-financial high-yield corporate default rate was 1.8% at the end of July 2019, lower than the 2.9% at end-2018. Moody's expects the TTM default rate to bottom out at 0.8% in January 2020 and gradually increase to hit 1.6% in June 2020.

[ix] Manulife Investment Management, November 2019.

[x] Both Baoshang Bank and Bank of Jinzhou were effectively allowed to fail without government bailouts. In November, the defacto default of Tewoo Group represented the first onshore defacto default in 20 years. Peking University Founder Group, a company perceived to benefit from strong government support, failed to repay onshore creditors in December.

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