Opportunities Abound in Asian High Yield Bonds

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As global central banks maintain their dovish bias, the search for yield has become a prevalent theme amongst investors today in a historically low interest rate environment. The Asian high yield (HY) space offers ample opportunities for investors to enhance portfolio yield as valuations start to turn attractive following the sharp sell-off in the 1Q'2020.

In this interview, Geoff Lunt, Director, Asian Fixed Income, HSBC Global Asset Management shares his views on the fixed income market and why he believes Asian HY bonds are in a sweet spot today for investors seeking income certainty and stable returns.

Geoff Lunt
Director, Asian Fixed Income
HSBC Global Asset Management

Q1 COVID-19 has become 2020 black swan event for global markets. How has the fixed income market responded following the outbreak and where are yield levels currently?

Over the past 20 years, the Asia dollar bond market has delivered an annualized return of 6.9% and has outperformed global bonds during this period.

Amidst the uncertainties in 2020, Asia bonds have fared relatively well thus far. Asia dollar investment grade bonds saw a smaller drawdown compared to global investment grade bonds and US investment grade bonds. While Asian bonds were not immune to the negative impact of past market crises, they recovered sharply following periods of downfalls, ultimately leading to a strong rise over the long term.

The Asia dollar high yield bond market is also expected to have a relatively lower default rate in 2020 versus other high yield markets. In local currency bonds, China and India have thus far outperformed emerging markets as a whole.

Asian economies, on average, have been more stable than their counterparts in other parts of the world. This is largely due to the underlying economic robustness as well as strong and coordinated government policy support.

Q2 Did you observe any credit deterioration or increase in defaults rates in the region?

2020 default rates for Asian bonds are expected to be lower than other regions. The default rate of the Asian high yield bond market isexpected to be 4% for 2020, which is lower than other global markets. One of the favourable factors is the lower exposure that Asian credit has to the energy sector. Overall, default risks in Asia high yield remain idiosyncratic. While we might see a record amount of defaults in 2020, given the high growth of the Asian high yield market size over the past few years, defaults as a percentage of the market should remain manageable.

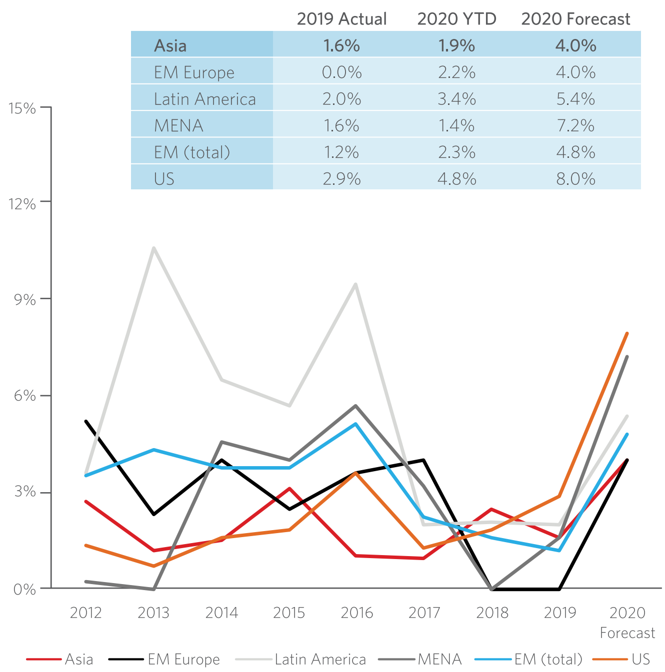
Credit analysis is now more crucial than ever as we expect credit defaults will rise following the economic damage created derived from Covid-19.

From a credit risk perspective, a strong credit selection process is important to avoid bonds with the highest risks in the market and to concentrate on bonds with a combination of attractive yields and likelihood of capital preservation.

Graph 1: Credit Risk Remains Manageable

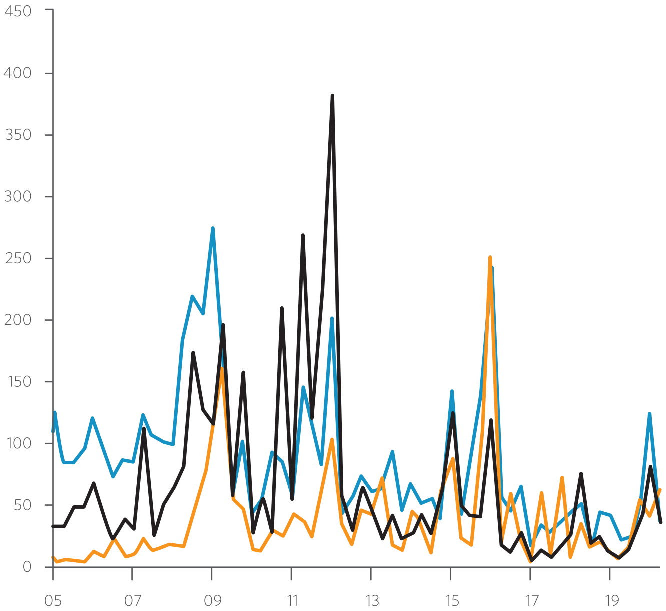
Asia high yield default rates (2012-2020F)

	2019 Actual	2020 YTD	2020 Forecast
Asia	1.6%	1.9%	4.0%
EM Europe	0.0%	2.2%	4.0%
Latin America	2.0%	3.4%	5.4%
MENA	1.6%	1.4%	7.2%
EM (total)	1.2%	2.3%	4.8%
US	2.9%	4.8%	8.0%



Rating reviews - downgrades

Quarterly obs of number of downgrade rating reviews including both IG and HY corporates based on Moody's. Q2' 20 is as of 4th Jun 2020



Source: JPMorgan, Bloomberg, Wind, HSBC Global Asset Management, data as of July 2020

Q3 China which was the first country to be hit with COVID-19 is seeing some signs of recovery as business activities resume. What's your view on China's recovery and the bond market?

China remains the key engine of growth in Asia; however, the region is also supported by a number of dynamic, well run economies throughout North and Southeast Asia. The combination of a well- educated, motivated workforce, sensible economic policy, low external debt and generally decent infrastructure has created a formula of stable economic growth for the region. North Asia, furthermore, enjoys a "first in – first out" position.

Overall the default rate in the China onshore bond market is very low and is expected to stay in range. The Chinese government has been focused on achieving growth stability and implementing not only comprehensive monetary and fiscal measures, but also emergency loan programs to alleviate funding stress. All of these measures should continue to keep systemic default risks off the table.

Q4 In a lower-for-longer interest rate environment, where can investors find higher yield? Is it a good time for investors to look at the Asian HY space following the sharp correction?

After the substantial adjustment in Asian dollar bonds earlier in the year, Asian high yield bonds have become more attractive, with the average yields at around 7.5% as of July 2020. This creates good investment opportunities in the Asian high yield bond market. On a relative basis, Asia dollar bonds continue to offer a yield premium versus bonds in the US and Europe.

This is where picking the right bonds can make all the difference. With lower prices, investors have the opportunity to purchase assets at a significantly lower price. If they are able to avoid the bonds that might default, they will be rewarded with attractive potential returns later when the market recovers. And the recovery is underway.

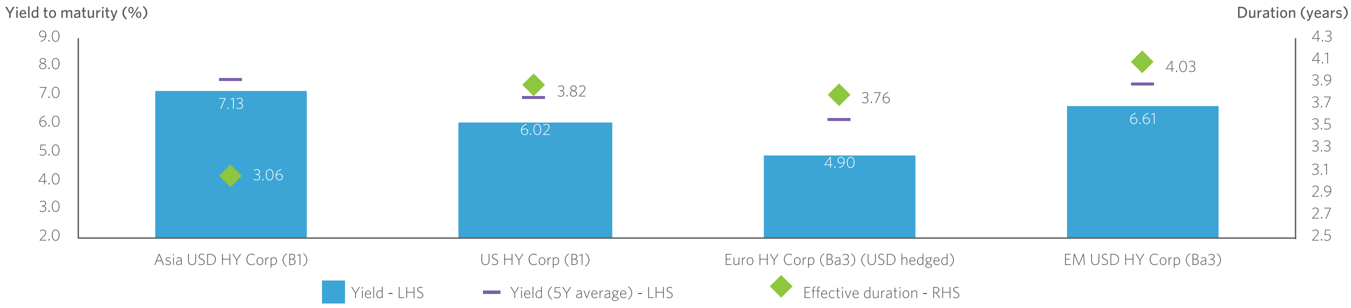
However, there are pitfalls to look out for. A common issue facing bond markets is liquidity - the ability to buy and sell securities at will without excessive bid offer spreads. Bonds are generally not traded on exchanges and are transacted bilaterally between independent counterparties.

So when the market has more people intending to sell with very few investors wanting to buy, it is difficult to match up buyers and sellers to ensure a good two-way flow. This means that valuation prices can get marked down viciously as the clearing price in the market can be much lower than the fundamental value of the security.

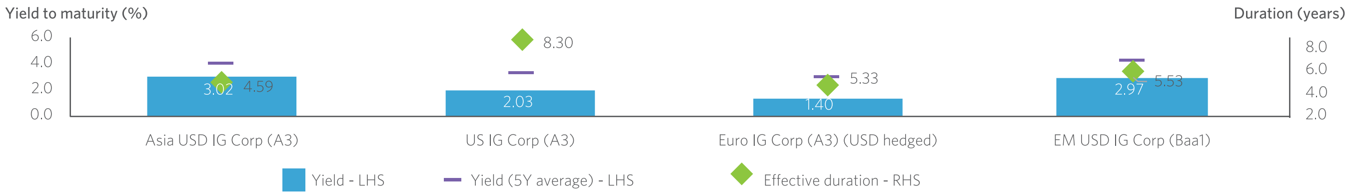
For investors searching for pockets of stronger certainty, the Asian credit market is proving to be more resilient than other markets and asset classes, particularly in the high yield space.

Graph 2: Asia high yield bonds trade at attractive valuations with shorter duration

Asia high yield: Attractive yields compared to other markets, with lower duration



Investment grade markets



Source: JP Morgan, BAML, as of 14 August 2020
US IG Corporate – ICE BofA US Corporate Index; US HY Corporate – ICE Bofa US High Yield Index; Euro IG Corporate – ICE BofA Euro Corporate Index; Euro HY Corporate – ICE BofA Euro High Yield Index; Asia IG Corporate – JP Morgan Asia Credit Corporate Index Investment Grade; Asia HY Corporate – JP Morgan Asia Credit Corporate Index Noninvestment Grade; EM IG Corporate – JP Morgan Corporate Emerging Markets Bond Broad Diversified Index Investment Grade; EM HY Corporate – JP Morgan Corporate Emerging Markets Bond Broad Diversified Index Noninvestment Grade