As of June 26, 2019

Asia Deserves Some Credit

The Potential of Corporate Credit in the World's Fastest-Growing Region

When considering investment in Asia, the first thought is often towards equities, which isn't surprising, given the growth of equity markets in the region. However, there also exists a lesser known, yet massive, Asian corporate credit market.

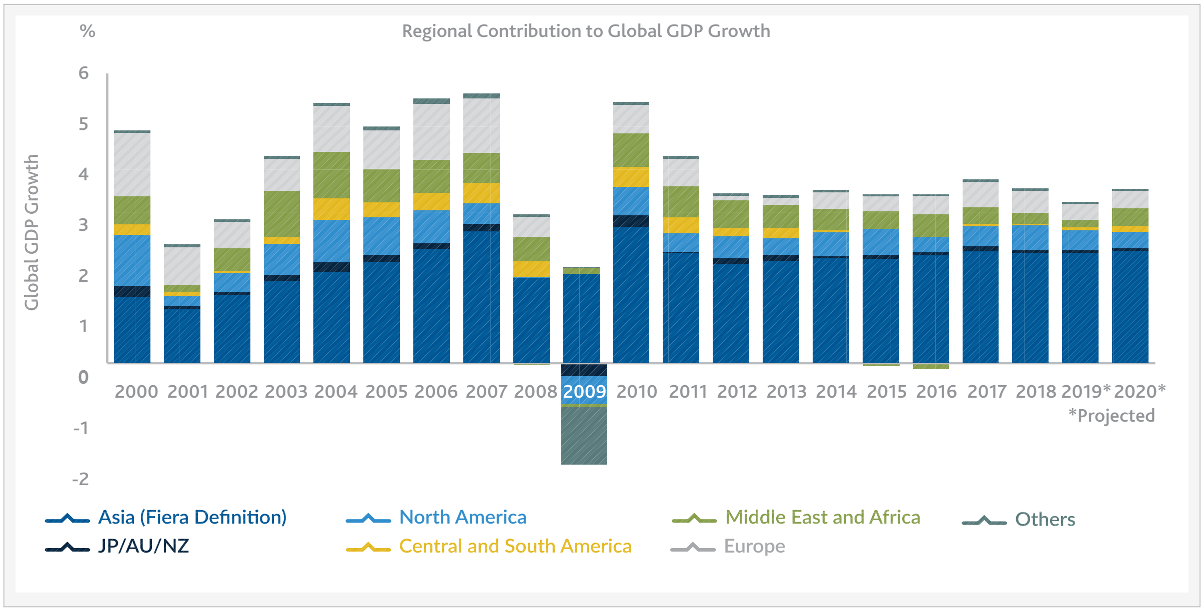
This $50 trillion asset class[1] has the potential to provide significant benefits for those seeking exposure to the geographical engine of world growth, including reduced correlation to traditional equity and credit markets, and higher potential returns. Below, we discuss the supply and demand imbalances that have recently created significant opportunities in this under-the-radar sector of the fixed income market.

The World's Growth Engine

Before diving into Asian corporate credit as an asset class, it's worth exploring the macro view of the region (which, for our purposes, notably excludes Japan[2]). Asia is the fastest growing region in the world and has been for the last few decades, making it the undeniable engine of global GDP growth over the long term. Since 2010, Asia has contributed, on average, about 60% of yearly global growth – that's up from about 43% in the 2000s[3] . Perhaps most importantly, Asia's growth has been resilient during periods of economic weakness. For example, in 2009, world GDP fell by 0.1%, with the U.S. and European economies shrinking by 2.5% and 4.8% respectively. Meanwhile, that same year, Asia's GDP grew by 6.4%[4].

1 Fiera Capital/Clearwater estimates as of November 2018, analysis based on latest available data from various sources including PBOC, RBI, SEBI, RBA,RBNZ, BOK, ADB, FSB,C Bond, Asia Bonds Online, HKMA, MAS & Bloomberg. Asia Offshore comprises syndicated loans, convertible bonds and offshore bonds. Our estimates for this analysis include the following countries: China; Hong Kong; Indonesia; South Korea; Malaysia; Philippines; Singapore; Thailand; Vietnam; India; Taiwan.
2 For this paper, unless otherwise noted, the following countries are included in our definition of Asia, in order to best match the data behind the indices utilized: Bangladesh; Bhutan; Cambodia; China; Hong Kong; India; Indonesia; South Korea; Laos; Macao; Malaysia; Mongolia; Myanmar; Nepal; Pakistan; Papua New Guinea; Philippines; Singapore; Sri Lanka; Taiwan; Thailand; Vietnam.
3 Source: Fiera Capital; International Monetary Fund, World Economic Outlook (April 2019). Country GDP growth and share of world GDP retrieved from the IMF DataMapper, as of April 2019.
4 Ibid.

Asia – The Engine Of World Growth



Source: Fiera Capital; International Monetary Fund, World Economic Outlook (April 2019). Country GDP growth and share of world GDP retrieved from the IMF DataMapper, as of April 2019. List of countries in "Asia (Fiera Definition)" is in Footnote 2 of this paper.

The incredible growth of the region over the years has helped diversify Asia from what was once a resource- and manufacturing-heavy economy into one which is increasingly consumer- and services-focused (though manufacturing and core industries still play an important role in the regional economy). The result is that Asian businesses, ranging from global banks and manufacturing to major tech firms, have matured and taken their place among the largest in the world. Thus, investors now have the ability to invest in companies outside of traditional developed markets and which have underlying fundamentals that are increasingly comparable to more well-known Western counterparts. For example, as of 2018, the largest four banks in the world by assets are all based in China, and the largest, The Industrial and Commercial Bank of China, has more assets than Wells Fargo and Citigroup combined[5].

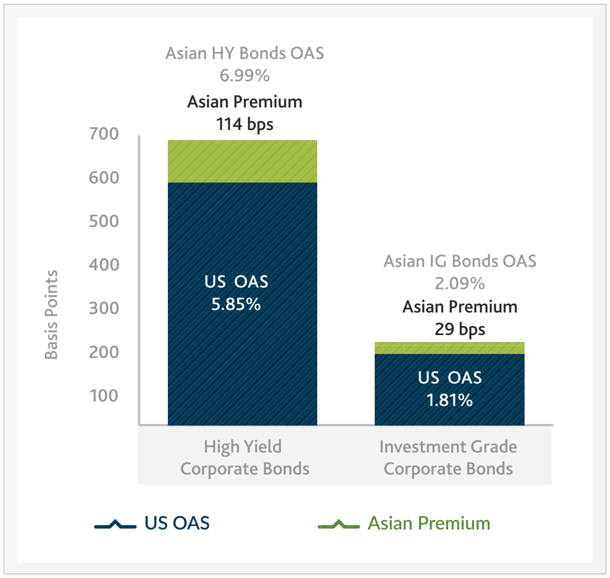
Admittedly, Emerging Markets, particularly Asian equity and credit markets, had unimpressive performance in 2018, as geopolitics, trade war and growth fears drove many investors out of the region. Specifically, in the Chinese credit markets, the combination of a conscious tightening of credit by the regulators and the maturing bond market's first major defaults brought about a widening of spreads and lower prices across onshore (i.e., bonds traded in mainland China in CNY) and offshore (i.e. bonds traded in CNH outside of mainland China) debt. However, looking at the longer-term picture, it's easy to see the region's potential, given its ongoing growth and strong government balance sheets. Yet despite these strong fundamentals, the bonds issued by many Asian corporations have historically offered higher yields than their peers in the developed world, a phenomenon known as the "Asian Premium".

Don't Discount The Asian Premium

The "Asian Premium" – that is, the additional yield commanded by Asian corporate debt over developed Western world debt – has averaged anywhere from 100 to 300 basis points over the last ten years, depending on the credit rating of the bonds. For example, the option-adjusted spread (OAS) on U.S. Dollar-denominated Asian high yield bonds has averaged 6.99% since 2007, more than the 5.85% OAS of similar-rated U.S. high yield debt. Meanwhile, Asian investment grade corporate bonds, with an OAS of 2.09%, have commanded a more modest premium over investment grade U.S. corporate bonds, whose OAS averaged 1.81%.

5 S&P Global Intelligence, https://platform.mi.spglobal.com/web/client?auth=inherit#news/article?id=44027195&cdid=A-44027195-11060

The Asian Premium Since 2007



Source: Fiera Capital. Index data: Asian High Yield Bonds, ICE BofAML Asian Dollar High Yield Corporate Index; US High Yield Bonds, ICE BofAML US High Yield Index; Asian Investment Grade Bonds, ICE BofAML Asian Dollar Investment Grade Corporate Index; US Investment Grade Bonds, ICE BofAML US Corporate Index. Weekly data from Jan. 2007 to March 2019.

With a similar credit rating and no foreign currency exposure, what explains the premium being demanded by the market for USD-denominated Asian credit? While there can be no single, formal explanation behind the Asian Premium, perception undoubtedly plays a role, as the relative unfamiliarity of Western investors to the Asian credit market results in higher perceived risk and therefore a risk premium. Corporate governance is also a factor, as the region has historically been perceived as less focused on investor protection than developed Western nations (more on that later).

Finally, institutional demand and supply issued by Asian corporate borrowers play a major role. Most Asian institutions such as pension plans and insurers have Asian currency-denominated liabilities, and thus they tend to favor debt in local currency in order to match their liabilities. As such, there aren't many local, natural buyers of USD-denominated Asian debt in the region. Yet there is demand for funding in U.S. Dollars by Asian corporations, as they often have USD-denominated revenues and/or liabilities and can typically get funding with longer maturities if the debt is issued in U.S. Dollars.

YTM vs OAS

Yield-to-Maturity (YTM)

The Yield-to-Maturity represents the annualized expected total return on a bond assuming the bond is held until its maturity. Thus, the YTM is well-suited for analyzing bonds that are not callable by the issuer.

Option-Adjusted Spread (OAS)

The Option-Adjusted Spread is an interest rate spread above a reference rate (e.g. a U.S. Treasury rate). It represents the annualized expected total return above the risk-free rate, taking into account options embedded within a bond; that is, it considers the issuer's right to call (i.e., immediately repay) the bond should interest rates fall. Unlike investment grade bonds, high yield bonds often have embedded options, making OAS a more accurate pricing model than YTM in their case.

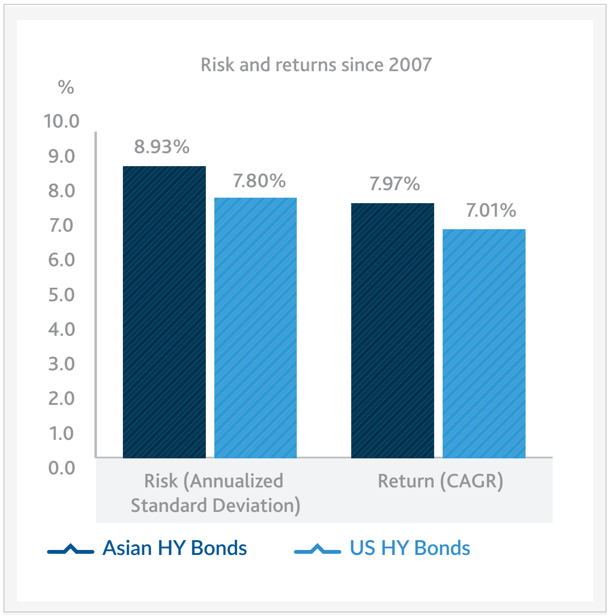
However, banks have traditionally preferred to channel credit to large, state-owned enterprises in Asia, leaving private companies and Small and Medium Enterprises (SMEs) with poor access to bank credit. Indeed, a World Bank study found that 58% of SMEs in South and East Asia were either un-served (i.e., they need but have no access to credit) or underserved (have access to some credit but not as much as needed)[6]. These factors result in a funding gap for local corporations looking to borrow in USD, inducing such SMEs to pay higher rates to attract creditors. They have also resulted in a large and growing non-bank lending industry in the region, as many borrowers are now turning to private lenders who are capable of offering attractive borrowing as well as partnering with the borrower to improve their financial position over the longer-term.

6 IFC Enterprise Finance Gap Database, The World Bank. Data updated November 6, 2013. https://finances.worldbank.org/Other/IFC-Enterprise-Finance-Gap-Database-Summary-Data/b4d6-42j9

Potential portfolio benefits

It should be noted that at least part of the Asian Premium likely exists due to the more volatile nature of the region's debt; that is, it is compensation for moving up the trading risk spectrum. Since 2007, Asian high yield debt has had an average annualized volatility – as measured by standard deviation – of 8.93%. This is above the 7.80% volatility exhibited by U.S. high yield bonds. However, the increase in risk also came with increased returns; Asian HY bonds returned 7.97% annually vs 7.01% annually for U.S. HY bonds, a difference of nearly 1% per year. That said, volatility matters less to investors who are targeting the asset class with a long-term view as opposed to trading through short-term noise. Moreover, for those who choose to invest through private channels (for example, via a non-bank lender or private credit manager), managers who engage in deep credit analysis and invest higher in the capital structure tend to have a less volatile profile.

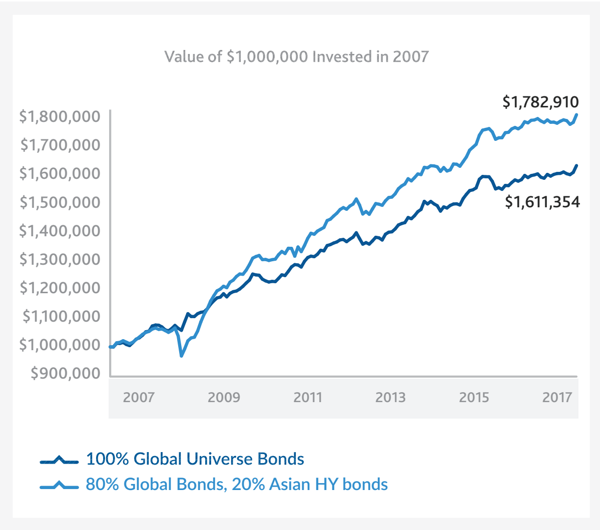
Asian HY bonds are more volatile, but have returned more



Source: Fiera Capital. Indices: Asian High Yield Bonds, ICE BofAML Asian Dollar High Yield Corporate Index; US High Yield Bonds, ICE BofAML US High Yield Index. Risk and returns calculated using weekly total return data from Jan. 2007 to March 2019.

This pickup in return has had major benefits for those investors who have allocated to Asian credit. For example, an investor who had invested $1 million in global bonds at the beginning of 2007 would have seen this amount grow to $1.611 million at the end of 2018. With a 20% allocation to Asian high yield bonds, however, that portfolio would have grown to $1.783 million – a pickup in returns of $172,000.

Asian high yield bonds can add value to bond portfolios



Fiera Capital, Multi Asset Class Solutions. Index data: Global Universe Bonds, Barclays Universe Global USD Hedged; Asian High Yield Bonds, ICE BofAML Asian Dollar High Yield Corporate Index. Monthly data from Jan. 2007 to Dec. 2018. Please see important disclosures regarding hypothetical returns at the end of this document.

Equity investors may also benefit from Asian credit's reduced correlation to global equity indices relative to U.S. high yield bonds. Asian HY bonds have demonstrated a lower correlation to U.S., EAFE and even to Emerging Asian indices than did U.S. HY bonds.

CORRELATION - EQUITY INDICES AND US/ASIAN HY BONDS SINCE 2007

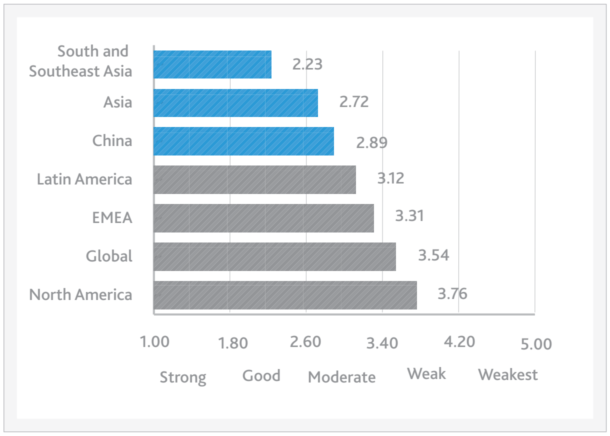
	US Equities	EAFE Equities	Emerging Asian Equities	Asian HY
Asian HY	0.34	0.44	0.49	
US HY	0.62	0.66	0.58	0.64

Source: Fiera Capital. Index data: Asian High Yield Bonds, ICE BofAML Asian Dollar High Yield Corporate Index; US High Yield Bonds, ICE BofAML US High Yield Index; US Equities, MSCI USA Net TR USD Index; EAFE Equities, MSCI EAFE Net TR USD Index; Emerging Asian Equities, MSCI Emerging Asia Net TR USD Index. Weekly data from Jan. 2007 to March 2019.

Surprisingly strong investor protection

When it comes to investing in Asia, skepticism often arises due to the perception surrounding the region's historical lack of transparency and investor protections; this interpretation has discouraged more than one foreign investor from investing capital there. The reality, though, is that the 1997 Asian financial crisis marked a turning point for the region. Since then, a much stricter banking regulatory system and the rise of alternative credit lenders have led to a healthier financial ecosystem. While the elite Asian companies continue to issue debt in U.S. Dollars in Western jurisdictions (and thus must comply with developed country regulations) global investor interest in the region has nonetheless helped the market mature to a point where, from a regulatory standpoint, it's flirting with developed market standards. In fact, the situation for holders of U.S. Dollar offshore bonds shows that, by some standards, Asian credit is even more favorable than elsewhere in the world in terms of investor protection. Moody's average covenant quality score from January 2011 through December 2018 was much stronger for Asia as a whole – including China and South and Southeast Asia – than for all other regions of the world over the same timeframe.

Covenant packages for Asian HY bonds are stronger than those in other regions



Source: Reproduced with permission from Moody's Investors Service, High Yield Covenant Database. Note: Excludes high-yield lite bonds. Average scores reflect scores from 1 January 2011 through 31 December 2018.

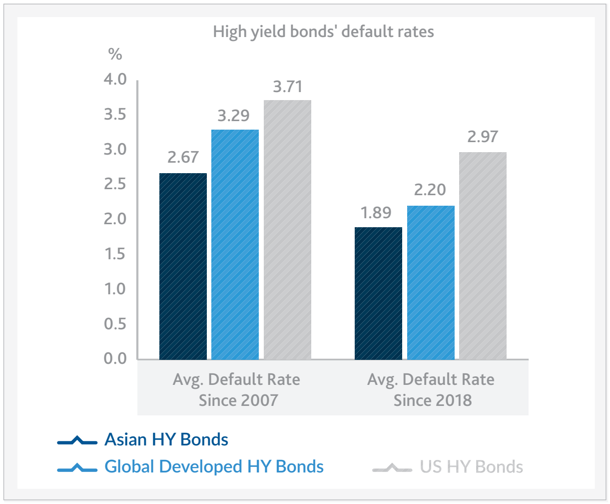
Where we stand now

The Asian Premium has already persisted over a long period of time, yet for anyone considering this asset class now, it's important to understand where yields stand now. Due to some headline-grabbing stories of bankruptcies in the Chinese onshore market, in late 2018 spreads on Asian high yield bonds over U.S. high yield hit their highest since early 2015. This created significant entry opportunities for Asian credit investors in both the public and private credit markets. While spreads have narrowed since then, there remains a longer-term story of liquidity tightening in Asia which is helping drive the market.

History of Asian HY Spreads over U.S.

Source: Fiera Capital. Indexes used: Asian HY Bonds, ICE BofAML Asian Dollar High Yield Corporate Index. US High Yield Bonds: ICE BofAML US High Yield Index. Premium is calculated using the Option-Adjusted Spread for each index using weekly data from Jan. 2007 to Mar. 2019.

Asian HY Bonds Have Historically Had Lower Default Rates Than U.S. And Other Developed Markets

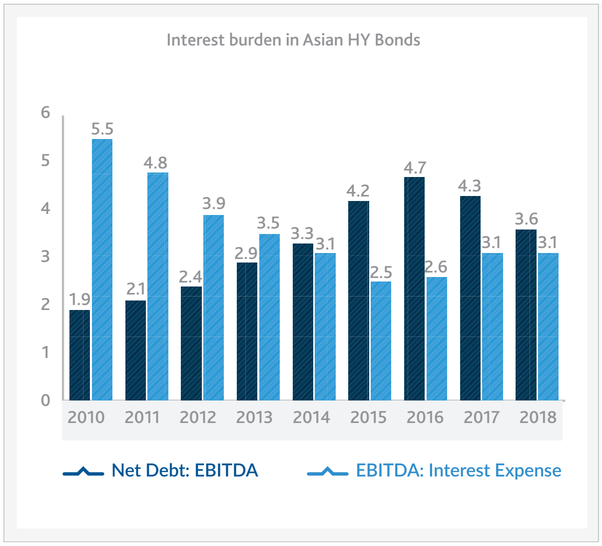


Source: Fiera Capital. Index data: Asian High Yield Bonds, ICE BofAML Emerging Markets Corporate Plus Index, filtered for all Asia-Pac Emerging Market countries; US High Yield Bonds and Global Developed High Yield bonds, ICE BofAML Global High Yield Index, filtered for US or developed market only, respectively. Monthly data from Jan. 2007 to March 2019.

The industry consolidation and bank balance sheet reduction that took place in Europe and the U.S. directly after the Global Financial Crisis is still an ongoing phenomenon in Asia. As mentioned, this is leaving many strong companies without access to sufficient capital from traditional venues such as banks, and hence investors in this space are well-positioned to continue enjoying the benefits of the Asian Premium over the long-term.

Moreover, it seems that the premium to hold Asian versus developed market credit does not necessarily coincide with the underlying bonds' fundamentals. The major risk inherent in any bond is the default risk, and in this respect, Asian credit has been outperforming. In the last decade and specifically in 2018, Asian high yield bonds have demonstrated lower default rates than similar U.S. and global developed market bonds. In addition, after a period of deterioration, credit metrics among Asian HY issuers have been improving over the last few years. Specifically, Net Debt:EBITDA levels have been falling since 2016, while at the same time, interest coverage ratios have improved.

Credit metrics are improving among Asian HY corporate bonds



Source: "Asia USD Credit Market - A Statistical Chart Book 2018" from JP Morgan. Reproduced with permission from JP Morgan.

How can we reconcile the fact that spreads increased throughout 2018 despite lower default rates and improved credit metrics? This actually isn't an anomaly – research has demonstrated that in the corporate credit market, monthly spread changes are principally driven by local supply/demand shocks, rather than by the likelihood of default of the underlying companies[7]. Thus, there will inevitably be times when credit supply and demand imbalances – which are part of the reason behind the Asian Premium, as described earlier – drive rates upward despite a lower likelihood of default. For investors with a long-term view, this becomes essentially a period of having your cake and eating it too.

Bottom Line: The Asian Premium Offers Significant Potential

For those with a willingness to invest for the long-term, opportunities in the Asian high yield credit space have existed for years, and the events of 2018 have created an interesting entry point for those who have not yet invested in this asset class. As demonstrated, the Asian Premium rewards investors holding bonds in this asset class without assuming additional risk, on average, over equivalent developed market bonds. Moreover, the region is significantly more diversified than two decades ago, offering investors a wealth of options with exposure to some of the fastest growing economies in the world. As bank deleveraging in the region continues and demand for private capital grows, investors seeking higher yields with an impressive portfolio diversifying effect would be wise to consider this large and growing asset class.

7 Collin-Dufresne, Pierre, Robert Goldstein, and J. Spencer Martin. 2001. "The Determinants of Credit Spread Changes." Journal of Finance 56 (6): 2177–207.

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MSCI Emerging Markets Asia Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Asian emerging markets.

ICE BofAML Asian Dollar High Yield Corporate Index tracks the performance of sub-investment grade US dollar denominated securities issued by Asian corporate issuers in the US domestic and Eurobond markets

ICE BofAML US High Yield Index tracks the performance of below investment grade, but not in default, US dollar- denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.

ICE BofAML Asian Dollar Investment Grade Corporate Index tracks the performance of investment grade US dollar denominated securities issued by Asian corporate issuers in the US domestic and Eurobond markets

ICE BofAML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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Barclays Universe Global USD Hedged Index contains investment grade and high yield credit securities from the Multiverse represented in US Dollars on a hedged basis, (Multiverse is the merger of two groups: the Global Aggregate and the Global High Yield).

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