By the Asian Fixed Income Team

ASIAN CREDIT OUTLOOK

2018

Summary

- We expect the economic backdrop for Asian credits to remain constructive in 2018, but remain cognizant of several risks including rising interest rates, robust supply, unexpected weakness in China, geopolitical developments and cross-asset volatility.

- From a fundamental standpoint, we expect GDP and export growth in Asia to remain firm though expansion could moderate. Valuations wise, high-grade and high-yield spreads remain at relatively expensive levels from a historical perspective. We also expect the technical backdrop for Asia credit is likely to remain neutral and returns are likely to be subdued in 2018, reflecting a continuation of less accommodative US monetary policy and current valuation.

- The focus in 2018 will likely remain on relative value positioning across countries and sectors. For duration positioning, the tilt is lower than benchmark. From a spread pick-up perspective, IG credits in the 7-to-10 year tenor from some countries such as China are attractive. For high-yield, short-dated callable issues remain attractive.

2017 Market Review

2017 saw signs of a firming recovery in the global economy. In particular, China remained a primary investor focus as authorities continued to pursue a fine balancing act between near-term growth objectives and long-term structural challenges. While developments in China evolved pretty much as expected, political tensions in the Korean peninsula became an unexpected source of turbulence for Asia credit, especially for South Korean credits.

Overall, demand for higher-yielding assets such as Emerging Market (EM) credits remained strong despite the start of monetary policy normalisation in the developed economies. EM bond funds, including Asia credit, received stronger than expected inflows from global and regional-based investors. This helped to absorb the strong gross issuance, led by Chinese issuers, resulting in broad-based spread tightening across Asia credit. Overall, JACI Composite returned +5.61% year-to-date. Asia IG gained 5.30%, with spread tightening 22 basis points (bps) from 185bps to 163bps. Asia high-yield delivered 6.70%, with spread tightening 17bps from 454bps to 437bps[1].

As the backdrop for Asian economic and corporate credit fundamentals is expected to remain constructive in 2018, we could experience an extended credit cycle, with credit spreads well supported. However, tight spread valuation and a more neutral demand-supply dynamics could hinder significant spread tightening from current levels.

Key risks to watch for in Asia credit next year include:

1. **Rise in risk-free rates:** Credit spread is tight historically, and any sudden uptick in risk-free rates, both globally and in Asia local markets, could result in a reassessment of risk by investors, leading to an outflow of funds. Risk-free rates could rise if, for example, wage and price inflation were to begin surprising on the upside globally.

2. **Supply:** While demand for Asia credit is expected to stay robust, the gross supply of new issues should be equally strong, especially if higher onshore funding costs and/or more limited availably of credit onshore causes Asian issuers to turn more towards the USD credit market.

3. **China:** A sharper-than-expected slowdown in China resulting from the deleveraging and reform policies could weaken investor sentiment significantly.

4. **Korea tension:** While our base case is that there will be no all-out military conflict, a re-escalation of the tensions in 2018 cannot be ruled out. However with North Korea continuing to advance in its weapons program, a re-escalation of tension in the Korean peninsula is possible.

5. **Cross-asset volatility:** We have seen extremely low volatility across asset classes in 2017, which may not be sustainable. Given where valuations are for many asset classes, materialisation of one or more risk factors could trigger a rise in cross-asset volatility globally.

[1] J.P Morgan Asian Credit Indices, as at 4 December 2017

2018 Asian Credit Outlook

Fundamentals

Macro

We expect the economic backdrop for Asian countries to remain constructive in 2018, which would lend support to corporate credit fundamentals. This is despite expected moderation in GDP growth for some countries, notably China, from the above potential growth rate achieved in 2017. Export growth for most Asian economies should also remain solid in 2018, albeit with some moderation from 2017 levels. Domestic demand is also likely to stay robust, particularly private consumption, while investment growth could vary by country. One key downside risk to watch is rising inflation and consequent tightening of monetary policies and financial conditions. Surprise upside in inflation readings leading to more hawkish central banks and higher domestic yields could dampen the prospect for domestic demand.

Asia's sovereign rating outlook is stable in 2018. Following the upgrade of Indonesia's sovereign rating to BBB- by S&P and Moody's earlier-than-expected upgrade of India's sovereign rating to Baa2 this year, we see little scope for further upward movements in Asia's sovereign ratings. At the same time, having downgraded China's sovereign rating by one-notch in 2017, we expect no further changes from the major rating agencies in 2018. The major risk remains an escalation of military tension in the Korean peninsula.

Credit

We expect Asian corporate credit fundamentals to remain broadly stable. The banking system across Asia is likely to see improved profitability if rates begin rising and the yield curve steepens, while asset quality concerns are beginning to ease across Singapore, Hong Kong and India. The string of regulatory tightening measures introduced in China will likely be credit positive for major Chinese banks even if it leads to tighter liquidity and narrower profit margins in the near-term.

The investment grade (IG) corporate sector in Asia has shown improvements in leverage and debt servicing ratios over the last few years. We believe the deleveraging trend among Asia IG corporates will continue into 2018 given expectations of broadly stable earnings, continued discipline on capital expenditure and still subdued appetite for merger and acquisitions (M&A), apart from a few large strategic acquisitions by Chinese state-owned enterprises (SOEs). The Chinese authorities have put the spotlight on overseas acquisitions by Chinese companies, both public and private, hence the magnitude of overseas M&A by Chinese companies should moderate as well in 2018. On the other hand, with global policy rates starting to rise and Asian central banks following suit, we could see higher funding costs and therefore stable to slightly weaker debt servicing metrics in 2018, after several years of consistent improvement.

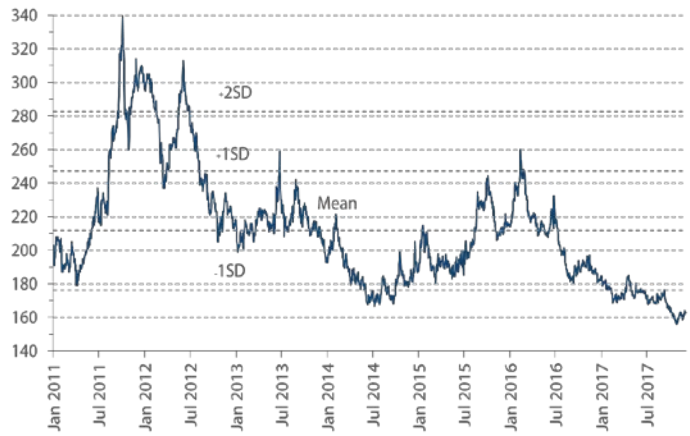
On the high-yield (HY) side, the worsening trend in leverage may continue albeit at a slower pace given the strong contracted sales recorded by the Chinese property developers in 2017, and the expectation of stable commodity prices which should support the earnings of the HY metals and mining sector. However, rising funding costs may see further deterioration in debt servicing metrics.

That said, with many HY companies having refinanced their near-term debt maturities over the last two years, we believe refinancing risk is manageable overall, and the Asia HY default rate is likely to fall back to the 1% to 1.5% range following a small increase in 2017 due to several idiosyncratic distress debt exchange/default.

Valuations

Both high-grade and high-yield spreads remain below their historical post global financial crisis (GFC) mean levels at relatively expensive levels from a historical perspective.

Chart 1: Asian High-Grade Spread



Source: J.P. Morgan, Bloomberg, as of 4 December 2017

Chart 2: Asian High-Yield Corporate Spread

Source: J.P. Morgan, Bloomberg, as of 4 December 2017

In 2017, against European comparables, the spread differential between Asian and European A-rated and BBB-rated corporates did not change materially, at around 31bp and 39bp respectively. Asian HY was mixed, with the spread differential between Asian and European credits for BB-rated widening by 32bp to 63bp but B-rated corporates narrowing by 16bp to a tight of 3bp. Against US credits, Asian credit was mixed. The spread differential between Asian and US A-rated and BBB-rated corporates tightened by 5bp to 28bp and by 14bp to 14bp respectively. Asian HY underperformed with BB-rated and B-rated corporates widening by 16bp to 53bp and by 19bp to 72bp. There is less value in the BBB- category and while the high-yield spread differential has increased, it is still at the lower end of the historical range[2].

Technicals

The technical backdrop for Asia credit is likely to remain neutral. The robust external flows into EM funds should continue into 2018 barring any major deterioration in EM fundamentals. Indigenous demand for Asia credit should also remain decent in 2018. However, with the CNY strengthening in 2017, the rise in onshore bond yields and credit spreads, the demand for USD Chinese credit from China based investors might moderate in a year where gross supply is likely be around, if not higher, than the record high of USD 287bn[3] seen in 2017.

Return Expectations

Asian credit returns are likely to be subdued in 2018 reflecting a continuation of less accommodative US monetary policy and current valuation. For Asian IG credits, the expectation is that credit spreads will end 2018 with some small tightening on the back of a sound Asian fundamental backdrop albeit with valuations on the expensive side from a historical context. Bond carry will again dominate returns as the expected rise in UST yields will negatively impact total returns. With this, we expect modest positive returns for Asian IG bonds.

For Asian HY corporates, spreads from some countries and sectors with stronger fundamentals are trading at rich valuations. Asian high-yield spreads could end 2018 about 20bp tighter from the current 456bp. In 2018, Asian HY is expected to outperform IG due to the shorter duration and higher carry with risk-free rates expected to continue rising. Comparing IG corporates to HY corporates, the spread ratio of 2.53, around the mean of 2.50, also suggests a tilt towards HY corporates.

Strategy

In 2018, the focus will remain on relative value positioning across countries and sectors. For duration positioning, the tilt is lower than benchmark. While short-dated issues will be impacted by the Fed rate hikes as the yield curve flattens, the long-end could underperform should inflation shows signs of picking-up given the significantly flattening of the yield curve. From a spread pick-up perspective, IG credits in the 7-to-10 year tenor from some countries such as China are attractive. For high-yield, short-dated callable issues remain attractive.

Some key sector calls are as follows:

Sovereigns. For Indonesia, sovereign issues up to the 10-year point are more attractive relative to quasi-sovereign issues where the spread differential are generally close to multi-year tights. For Philippines, remain underweight as valuation of sovereign issues remain at tight levels.

Quasi-sovereigns. In Korea, prefer quasi-sovereign entities over commercial entities especially those up to 5-years given the flat credit curve. In China, 10-year quasi-sovereign entities look attractive from a spread pick-up standpoint.

Financials. We continue to like the financial subordinated debt over senior debt in China, Hong Kong and Singapore given attractive spread pick-up. We are also positive on the China asset management companies' (AMCs) 10-year and senior perpetual bonds given the steep spread pick-up over shorter-dated bonds, supported by their still significant strategic role.

Infrastructure. China's infrastructure sector will likely experience a slowdown in the earlier part of the year, which should help stabilise leverage metrics after the strong growth pace in 2017. The strategic importance of issuers in this sector to the Chinese government's policy agenda will, however, remain high. Well-structured corporate perpetual issues remain attractive in this sector.

Metals & Mining. While we expect there to be some moderation in commodity prices, the overall price levels will still be favourable for upstream metals & mining companies. We expect the sector's profitability and credit fundamentals to be supported, and the moderate deleveraging trend to continue. We have a favourable fundamental view towards Asia HY metals & mining issuers, although the current low yield and volatility make it a tough call to have a strong Overweight in this sector.

Property. We are cautious on the sector given the tightening policy bias, and are generally staying away from longer-dated property bonds and smallish aggressive developers. We still like the shorter-dated bonds of selected credits in the Chinese high-yield property space.

Technology. We are positive on technology companies' credit profiles as we expect cash flow generation to remain strong and surpass investment requirements. However, given the tight valuation to the quasi-sovereign issues, particularly at the shorter-end of the curve, we adopt a more neutral positioning for now.

[2] JP Morgan, Bloomberg, as at 4 December 2017
[3] Nikko AM, as at 4 December 2017

Country & Sector Outlooks

Countries

China

We expect a slight moderation in China's GDP growth in 2018. At the 19th National Congress of the Communist Party, President Xi has called for a shift in the policy focus from a pure emphasis on headline GDP growth towards greater quality of growth and sustainability. This likely means the ongoing policies of reining in excessive leverage and overcapacity in the industrial sector, and containing potentially systemic risks in the financial sector will be pursued further. The drive to reform the state-owned enterprises (SOEs) to enhance their productivity and competitiveness will also continue. Tighter financial conditions and ongoing policy-driven structural changes in the industrial sectors will likely see fixed investment growth facing downward pressures in the earlier part of the year. However, if there are signs of a severe slowdown in growth, we believe the authorities will allow some easing of liquidity, increase targeted fiscal spending, or loosen some property sector restrictions towards the second half of the year. This would allow fixed asset investment to roughly maintain its contribution to GDP growth for the year as a whole. We also expect similarly robust contribution from private consumption, while the contribution from net exports could moderate slightly.

India

After some setback in 2017 due to disruptions caused by the demonetisation initiative in late 2016, and the implementation of the Goods and Services Tax (GST) this year, the Indian economy appears to have stabilised and have shown early signs of recovery, which we expect to continue and strengthen into 2018. Pent-up demand should lead to higher private consumption and investment growth, and fiscal support is likely to be forthcoming in view of the upcoming General Elections in 2019. The ongoing resolution of non-performing assets (NPAs) in the banking system and recently announced bank recapitalisation program for state-owned banks should help to put the banks in a better position to provide fresh credit to support the recovery. Overall, despite the near-term setback, the longer-term outlook for India remains bright, as the demonetisation initiative, GST implementation, improvement of the Insolvency and Bankruptcy Code and other structural reforms are all likely to improve the country's long-run growth potential.

Indonesia

Having had a relatively decent year in 2017, we expect Indonesia's GDP growth to moderate slightly in 2018 mainly due to a slowdown in export growth which benefited substantially from the rebound in commodity prices this year. Domestic demand is expected to remain broadly stable.

Sectors

Financials

We see a stable fundamental backdrop and macroeconomic environment for Asian banks, support by banks' adequate capital buffers, manageable asset quality, as well as Asian government measures to address financial system risks. In China, the authorities have taken concrete steps in this regard, including tightening controls on shadow banking activities and banks' reliance on short-term funding. In Hong Kong, capitalisation remains strong, and banks are sufficiently buffered from a potential property market downturn. Singapore banks maintain robust credit profiles, with improving fee income and healthy capital levels.

Given the stable fundamental outlook, we are Overweight China, Hong Kong and Singapore financial subordinated debt versus senior debt. Subordinated debt valuation continues to be attractive against senior debt, even after spreads have tightened considerably in 2017. In addition, we expect that issuance of financial subordinated debt will be relatively limited, while supply for financial senior debt will likely remain elevated.

We are positive on China asset management companies' (AMCs) 10 year and senior perpetual bonds, given wide spread pickup over their shorter dated bonds. These state-owned AMCs play a strategic role in China's economic rebalancing and help maintain financial system stability. We expect that their credit profiles are likely to be supported by planned common and preferred share issuances. The AMCs may also slow expansion in non-core businesses, following guidance from the regulators to revert their focus to their primary business of distressed asset management.

Metals & Mining

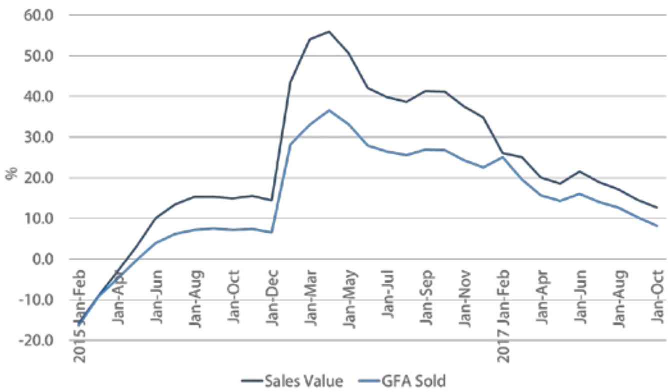
Following a recovery in 2017, commodities are expected to continue delivering a strong year in 2018. Commodity prices will be supported by high underlying demand as global economic activity remains robust. Projections from IMF and the World Bank point towards improving economic growth prospects globally. Strong consumption demand from electronics to infrastructure investments will be key supporting factors underpinning prices of commodities such as aluminium, copper, steel, zinc, etc. Furthermore, we see supply reforms in China to continue consolidating overcapacity sectors and shutting down inefficient plants, hence supporting the demand-supply dynamics of the industry as well.

While we expect there to be some moderation in commodity prices, the overall price levels will still be favourable for upstream mining companies, thus supporting the sector's profitability and credit fundamentals. We generally see improving cash generation ability for the companies benefiting from the high prices. We also expect to see moderate deleveraging across the sector as expansionary capital expenditure have been disciplined. Rating agencies have acknowledged the improving fundamentals of the sector and begun to gradually upgrade credit ratings for companies in this sector. We believe the positive trend will be more pronounced for high yield companies related to metals and mining. For the reasons above, we are favourable towards the sector outlook for 2018 and recommend an Overweight in the Asia high yield, metals and mining space.

Property

The Chinese property sector is unlikely to see loosening measures, be it regulatory or monetary policies, in 2018 unless the broader economy experiences a greater than expected slowdown. This will benefit the top 30 developers as sector consolidation to continue accelerating and they continue to gain market share. China property market is expect to slow down in 2018 but still remain healthy. Both sales value and gross floor area (GFA) sold growth is expected to moderate in 2018 from the current 12.6% and 8.2% respectively as seen in chart below. However, earnings are expected to remain good for FY2017 and 1H2018 due to good sales momentum back in 2016. Gearing on the other hand is likely to creep up but at a manageable level as developers place more importance on liquidity in the midst of a difficult environment. As the National Development and Reform Commission (NDRC) approves more offshore issuance quota, supply risk increases for FY2018 as there is about USD 19.6bn of refinancing needs comprising of USD 12.4bn maturing bonds and USD 7.2bn callable bonds up for refinancing plus new fundraising for business expansions[4]. We are cautious on the sector going into 2H2018 due to the policy environment. We are Underweight on the longer dated property bonds and smallish aggressive developers.

Chart 3: GFA and Property Sales Value trends in China



Source: Nikko AM, October 2017

Technology

We expect the Asia technology sector to continue experiencing strong revenue and EBITDA growth in 2018, on the back of healthy consumption growth, burgeoning offline-to-online commerce trend, and improved monetisation of mobile applications. Growth rates and EBITDA margins might moderate due to increased investments in new business initiatives, contents, customer acquisition and customer retention. We expect these companies to continue to be active in mergers and acquisitions, and to invest in new businesses in order to find new pillars of growth, or to form ecosystems for sustainable growth. Nevertheless, we are positive on technology companies' credit profiles, as we expect cash flow generation to remain strong and surpass investment requirements. Issuance supply is expected to pick up over the next twelve months. Therefore, we believe that we should wait for better entry given the tight valuation of the sector currently.

[4] Nikko AM, as at October 2017

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