High Quality Diversification Benefits of Asia Credit

Strong fundamentals and powerful tailwinds make this growing asset class one to watch for global investors.

October 2020

KEY INSIGHTS

- Asset class offers an increasingly significant opportunity set, growing above USD $1 trillion in issuance as a vast regional investor base absorbs new supply with resilient spread performance.
- Improved leverage profiles and low historical default rates support Asia credit fundamentals, while direct access to region with high economic and demographic growth provides powerful tailwind.
- Asia credit has delivered diversification benefits and defensive qualities similar to developed credit markets (DM) along with an attractive risk-return profile versus major asset classes.

Samy Muaddi
Portfolio Manager,
Asia Credit Bond Strategy

Sheldon Chan
Associate Portfolio Manager,
Asia Credit Bond Strategy

Asia credit has reaffirmed its case in 2020 as an asset class that could potentially offer both upside and defensive qualities in a year when significant volatility hit nearly every asset class across fixed income, equities and commodities. After recording an 11.8% return in 2019, the asset class has delivered 4.5% so far in 2020, completely recovering earlier losses incurred during the initial market shock caused by the onset of the coronavirus pandemic.[1] With a yield profile of about 3.2%, the asset class also offers income opportunities at a time when nearly a quarter of global bonds have a negative nominal yield.[2]

The strong performance has come in spite of prominent negative headlines regarding heightened U.S.-China tensions, including a contentious trade dispute that continues to simmer despite a preliminary agreement at the start of the year. The uncertain path of the pandemic and its potential impact on the region has also increased scrutiny on whether financial markets in Asia can withstand a slowdown in economic growth. Taken together, this has created an unfounded perception that the asset class carries undue risk.

Investors should certainly remain vigilant in monitoring future developments within the market, but they would also be well served to consider objectively how Asia credit could potentially contribute as a portfolio component. A close examination of the asset class reveals that many of the factors which have contributed to its performance remain intact.

Asset Class Continues to Grow

The Asia credit market grew more than four-fold over the past decade to above USD $1 trillion in outstanding debt as Asian corporations increasingly utilized capital markets to fund growth plans.

[1] J.P. Morgan Credit Index Diversified, data as of August 31, 2020.
[2] J.P. Morgan Credit Index Diversified, yield to worst data as of August 31, 2020; Bloomberg Barclays Global Aggregate Bond Index, data as of September 21, 2020.

> Since 2010, the Asia credit asset class has grown by an average of 15% per year.

The region has accounted for more than 50% of emerging markets (EM) bond issuance each year dating back to 2014.[3]

The J.P. Morgan Asia Credit Index Diversified is a USD-only benchmark that balances exposure across the Asia ex-Japan region to reduce concentration risk in any single market. It includes a cross-section of developed markets, like Hong Kong and Singapore, as well as both EM and frontier markets. Overall, the benchmark has a diversified investment grade profile with 77% of its bonds rated as investment grade (IG) and an average credit rating of BBB+, as of August 31, 2020.

Structural Demand for Asia Credit

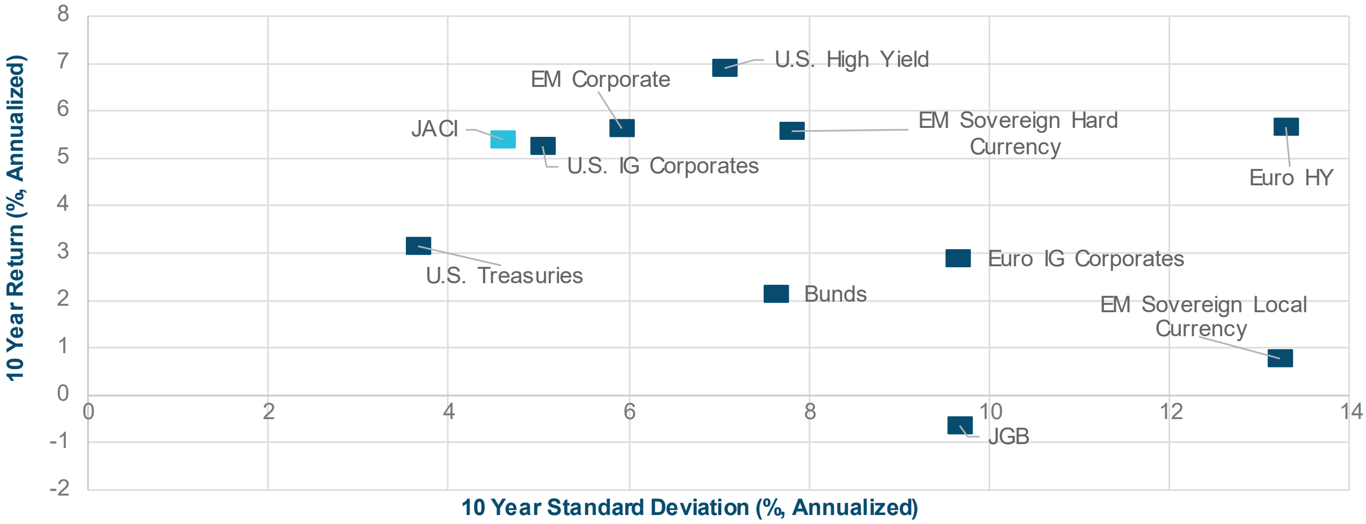
In terms of demand, we believe the appetite for new issuances should remain buoyant in a normal market environment given relatively attractive valuations combined with higher-yielding opportunities. Moreover, the high savings rate in Asia versus other regions creates a powerful structural demand from within the region for income-generating investments, reducing Asian companies' reliance on external capital. Local investors account for a strong buyer base of corporate debt in Asia Pacific, unlike EM more broadly where foreign investors have a larger share, which can potentially lessen volatility during periods of market stress.

Since 2010, the Asia credit asset class has grown by an average of 15% per year, unlike the stable-to-shrinking U.S. high yield and EM sovereign debt markets.[4] Primary market issuance started 2020 well above historical averages before falling sharply in March during the global market shock. It has since shown signs of improvement as Asia credit continues to act as the main driver of overall EM corporate issuance. Going forward, we expect corporates in this region will continue to tap capital markets to seek refinancing or stretch out their debt profiles.[5]

Delivering Strong and Steady Returns

Asia credit compared favorably over a 10-year period

As of August 31, 2020



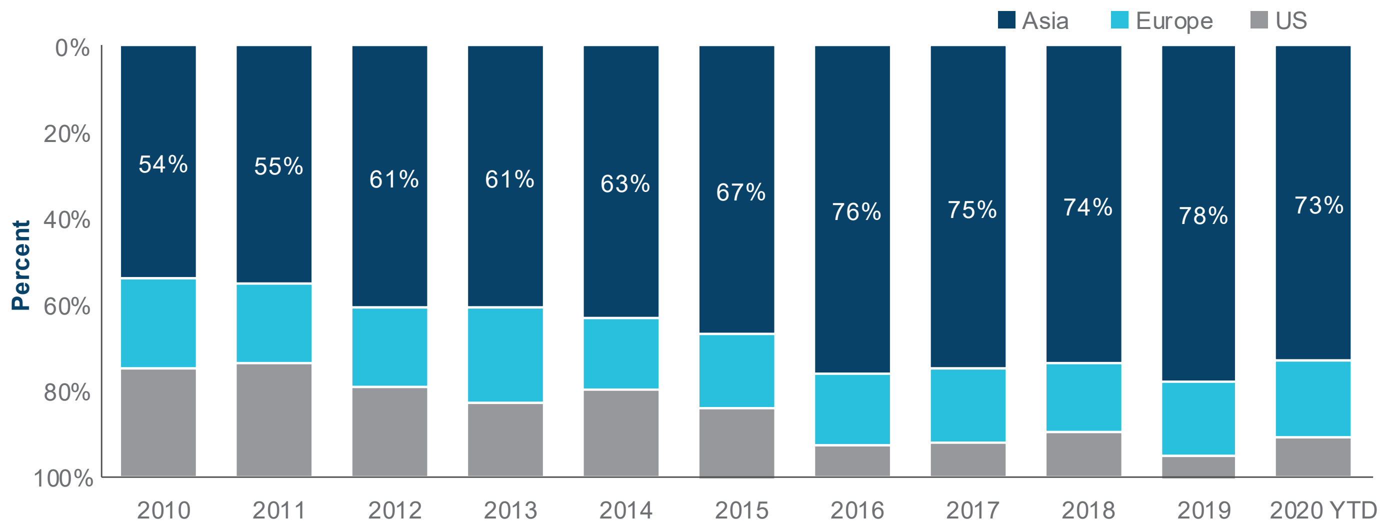
Past performance is not a reliable indicator of future performance.

Returns and volatility calculated based on 10 years of monthly returns from August 2010 to August 2020. Non-USD indices are unhedged in USD. Sources: JP Morgan, Bloomberg, FTSE. Indices: J.P. Morgan Asia Credit, J.P. Morgan EMBI Global, J.P. Morgan GBI–EM Global Diversified, J.P. Morgan CEMBI Broad Diversified, Bloomberg Barclays Euro Aggregate Corporate, Bloomberg Barclays European High Yield, Bloomberg Barclays U.S. High Yield, Bloomberg Barclays U.S. Corporate Investment Grade, Bloomberg Barclays U.S. Aggregate–U.S. Treasury, FTSE German GBI, FTSE Japanese GBI.

[3] J.P. Morgan, Bond Radar, data analysis by T. Rowe Price, data as of August 31, 2020.
[4] J.P. Morgan Credit Index, data as of August 31, 2020.
[5] J.P. Morgan research

Asia Credit Asset Class is Likely to Continue to Grow

Allocation of new bond issues by region
As of July 31, 2020



Sources: JP Morgan, Bond Radar, data analysis by T. Rowe Price.

Strong Top Down Fundamentals

Robust economic growth in Asia ex-Japan has provided a powerful tailwind for the region's corporates to capitalize on new markets both at home and abroad.

In the span of just a decade, China eclipsed Japan as the world's second-largest economy and is now more than double its size. The entire region accounts for 27% of the global economy, up from 10% in 2000. Robust growth has also sparked a rising tide of wealth across emerging and developing Asian countries with per capita income projected to top USD $6,000 in 2020. The rise has been due in part to the region's immense population - it accounts for 2 out of every 5 people in the world - and young demographic profile in the case of countries like India, Indonesia, Bangladesh and the Philippines.[6]

We believe policymakers have taken appropriate steps to ensure continued expansion by striving to reduce reliance on export-led growth and improve openness and competitiveness of their respective financial markets. A commitment in most economies following the Asian Financial Crisis to increase foreign exchange reserves and lower inflation also bodes well. The trend of positive country rating migration seen across key regional economies reflects meaningful progress.

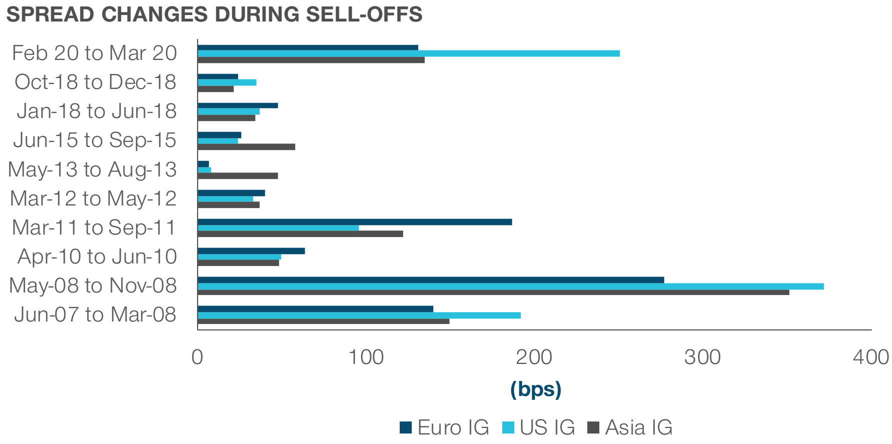
Asian corporates have demonstrated improved fundamentals in recent years. When viewed in the context of EM more broadly, Asian high yield (HY) issuers have consistently lower default rates dating back to 2002.[7] More broadly, Asian corporates have also displayed an improving leverage profile. This has not come at the expense of profitability either, as key markets like China and South Korea are expected to record positive earnings growth in 2020 having contained initial coronavirus outbreaks, while the region as a whole is forecast to deliver a double-digit earnings recovery in 2021.[8] Taken together, these indicators send a positive signal to fixed income investors that Asian corporates are able to grow while still improving their capacity to service outstanding debt.

[6] World Bank and IMF data, data analysis by T. Rowe Price.
[7] J.P. Morgan, data analysis by T. Rowe Price.
[8] HSBC earnings review and preview. As of August 31, 2020.

Providing Support for the Portfolio

Asia IG performed like developed markets during sell-offs

As of August 31, 2020



Asia IG: J.P. Morgan Asia Credit Index Diversified Investment Grade, z spread
US IG: Bloomberg Barclays U.S. Aggregate Corporate Investment Grade Index, OAS
Euro IG: Bloomberg Barclays Euro-Aggregate Index, OAS
Sources: J.P. Morgan Chase & Co. and Bloomberg Index Services Ltd.

The onset of the coronavirus pandemic clearly means that default expectations need to increase as pullbacks in economic activity will negatively impact corporate earnings. Even so, we expect the Asia HY default rate in 2020 is likely to remain in line with historical levels. Looking at China specifically, policymakers have announced several liquidity-boosting measures so far this year, while continued access to onshore bond markets could reduce the refinancing risk for HY corporates with outstanding USD-denominated issuances. Furthermore, the Asia HY corporate universe has relatively low exposure in industries such as energy, travel, and aviation, which are facing more challenged and uncertain outlooks due to the pandemic.

More broadly, several countries within the region have contained initial coronavirus outbreaks and resumed business activity on a sustained basis while other parts of the world have lagged. This has driven a recovery in manufacturing and domestic consumption activity, which supports asset prices. Notably, the IMF expects China will be the only major economy to record positive growth in 2020 followed by a robust 8.2% expansion forecast for 2021. After a sharp decline this year, India's economy is also tabbed for rapid growth in 2021 with a projected 8.8% expansion versus a 5.2% global average.

High Quality Diversification

The unique characteristics of Asian corporates have contributed to Asia credit's diversification benefits, particularly for investors with large positions in core fixed income. We believe this characteristic is likely to become more permanent if the asset class continues to grow in size and scale as expected. Meanwhile, Asia credit has a relatively high correlation with Asia ex-Japan equities but a more stable return profile, allowing investors to access the region's economic development and growing markets with a lower risk profile.

While investors may turn to Asia credit in search of higher yields, a position in the asset class could also provide defensive qualities. Earlier in 2020, Asia credit proved resilient during the period of extreme market volatility at the onset of the coronavirus pandemic, showcasing its defensive qualities within the EM debt space. This is a pattern that we have observed repeatedly in the past 15 years, where Asia IG maintains similar defensive properties to U.S. IG and Europe IG in periods of meaningful global spread widening. There have been a few instances where Asia spreads widened relatively more, however, such as during the "taper tantrum" in 2013 when global investors pulled money out of the region in anticipation of tighter global monetary conditions. The sell-off was short-lived though as the market took stock of the region's improved top-down fundamentals.

Positive performance in Asia credit is not just a recent occurrence either. It has demonstrated an attractive risk-return profile over an extended period versus other major asset classes. It is also worth noting that Asia IG has a relatively lower duration risk than U.S. IG and Europe IG, offering higher yield on shorter-dated issuances.

In our view, the outlook for Asia credit over the medium- and long term remains positive. Even after a strong recovery in asset prices, yields and credit spreads are still attractive relative to historical levels, particularly against a backdrop of accommodative global central bank policy. In this environment, strategic investors have the opportunity to capitalize on price dislocations within the market through informed security selection as we expect the asset class will continue to grow in depth and breadth.

WHAT WE'RE WATCHING NEXT

In our view, robust economic growth throughout the region and supportive financial conditions could provide a tailwind for risk assets and Asia credit spreads. Increased uncertainty regarding the path of the pandemic and heightened U.S.-China tensions could weigh on the asset class in the near term, however.

Over time, we expect the opportunity set within the asset class will continue to grow in both depth and breadth, favoring strategic investors who can capitalize on price dislocations within the market through informed security selection.

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