Matthews Asia

Matthews Asia Perspective
Asia Credit Spreads Look Rewarding

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We recently sat down with Matthews Asia Portfolio Managers Teresa Kong and Satya Patel to discuss the appeal of Asia corporate bonds for bond investors seeking global diversification.

Asia credit spreads are wide, while U.S. credit spreads are narrow. What accounts for this difference?

In response to the global financial crisis of 2008, the U.S. Federal Reserve and European Central Bank launched massive quantitative easing (QE) that has lasted for the better part of a decade. This artificially inflated money supply continues to distort credit spreads for U.S. and European high yield debt, making it harder for investors to earn attractive returns in these asset classes. In contrast, Asia's central banks largely avoided QE, allowing credit spreads to be shaped by market forces. Across Asia today, credit spreads for corporate bonds look rewarding for long-term investors.

What factors contribute to the stability of Asia's credit markets?

Asia's credit markets benefit from several layers of stability at the country level that are often lacking in other parts of emerging markets. Macroeconomic factors providing a tail-wind for Asian corporate bonds include political stability, economic strength, reasonably balanced current accounts, low debt-to-GDP ratios, strong FX reserves and central bank independence. Macroeconomic risks remain, of course, and market conditions can change quickly, particularly in emerging markets. As active managers, we seek to identify and manage these macro risks through our fundamental, proprietary research process.

Figure 1.
Annual Risk and Return (In Home Currency)
Period From 1999 To December 2018

Asia high yield's long-term risk-adjusted returns have been very attractive

	Asia HY	Euro HY	Global HY	LATAM HY*	US HY	EM Bonds
Annual Return	9.30%	6.73%	6.42%	8.25%	8.97%	9.16%
Annual Volatility	8.91%	11.06%	8.94%	11.93%	8.88%	8.90%
Sharpe Ratio	1.04	0.61	0.72	0.69	1.01	1.03

*2002 to December 2018

Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index.

Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofAML High Yield Master II Index), Euro High Yield (Barclays Pan-European High Yield Index), LATAM High Yield (Latin America High Yield portion of the J.P. Morgan CEMBI Broad Index), Global High Yield (BofAML Global High Yield Index). EM Bonds (JP Morgan Emerging Markets Bond Index Global).

Source: Bloomberg data; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission.

Why consider Asia corporate bonds as an alternative to EM debt or U.S. and European high yield?

For investors looking for diversification, Asia corporate bonds offer three key advantages: higher return potential, lower historic volatility and access to highly creditworthy issuers within emerging markets. Since the inception of the J.P. Morgan Asia Credit Index in 1999, Asia high yield bonds, represented by the high-yield portion of that benchmark, have consistently outperformed U.S. high yield and European high yield for investors with a time horizon of three years or longer, with lower volatility. (See Figure 1).

What do wide credit spreads in Asia suggest about investing at this point in the cycle?

Wide credit spreads make this an attractive time to invest in Asia high yield (see Figure 2). Investors have historically been rewarded over the long term for investing at this point in the cycle. Looking at the 20-year period ending December 31, 2018, when entering Asia high yield at the spread levels we see today, investors have historically achieved a positive return over any two- to three-year holding period. Even with a one-year holding period, 90% of the cases showed a positive return.[1] Though the past does not always spell the future, it does make us more optimistic about future Asia high yield returns.

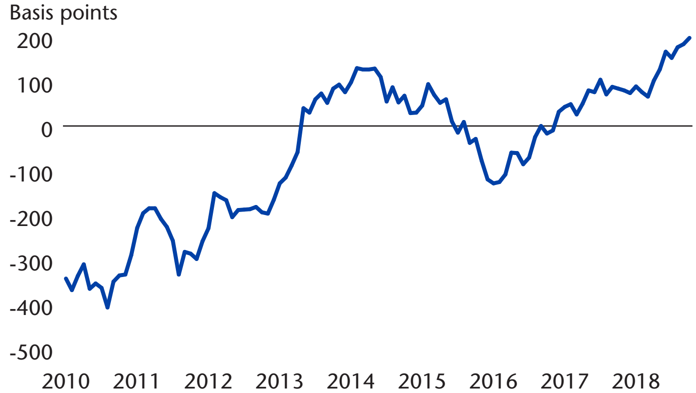
How do you evaluate and manage credit risk among Asia corporate bonds?

When it comes to understanding and managing credit risks, we believe an active approach to security selection is key. That's why we take a forensic approach to reading financial statements of the companies we invest in to ensure a clear understanding of the risks of potential defaults in our portfolios. By seeking to minimize the risk of default in our portfolios, we believe we can better capture the attractive long-term return potential of Asia corporate bonds.

1 Returns based on spreads for the JACI High Yield Index, which is the high yield portion of J.P. Morgan Asia Credit Index.

Figure 2. Asia High Yield Spreads Minus U.S. High Yield Spreads

The divergence between Asia high yield and U.S. high yield spreads is near record highs



Source: Bloomberg; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. Asia High Yield (JACI High Yield Index, which is the high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofAML High Yield Master II Index). Spreads are represented by option adjusted spreads.

Looking ahead, what opportunities do you see on the horizon?

Over the next decade, we expect companies in frontier markets within Asia to expand their bond issuance globally. Countries such as Sri Lanka, Vietnam, Pakistan, Mongolia and Cambodia currently have just a trickle of corporate bonds available to global investors, but we expect these markets to mature and deepen over time. At Matthews Asia, we understand these markets very well, creating opportunities for us to find high-quality companies in relatively untapped new places, driving the potential for attractive long-term returns for our clients.

Index Definitions

Bank of America Merrill Lynch High Yield Master II Index is a market-capitalization-weighted index that includes sub-investment grade sovereign and corporate issuers included in the J.P. Morgan Asia Credit Index.

Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Barclays Pan-European High Yield Index tracks fixed-rate, investment-grade securities issued in the following European currencies: Euro, British pounds, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Slovakian koruna.

J.P. Morgan Asia Credit Index (JACI) tracks the total return performance of the Asia fixed-rate dollar bond market. JACI is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and is partitioned by country, sector and credit rating. JACI includes bonds from the following countries: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Thailand and Singapore. Index is for comparative purposes only it is not possible to invest directly in an index. Source: BNY Mellon Investment Servicing (US) Inc., Index data from J.P. Morgan.

J.P. Morgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets and includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The EMBI Global defines emerging markets countries with a combination of World Bank-defined per capita income brackets and each country's debt-restructuring history.

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