May 2017

Matthews Asia

## Matthews Asia Perspective

# The Case for Asia Credit Amid Rising Rates and Inflation


Teresa Kong, CFA
Portfolio Manager

Satya Patel
Portfolio Manager


*When it comes to enhancing portfolio yield and diversification, Asia offers compelling opportunities.*

The U.S. Federal Reserve has taken gradual steps toward what is known as policy normalization by raising the target range for its federal funds rate three times since late 2015. Europe—including the U.K.—is a bit behind. Yields remain low in developed markets, yet inflation is rising.

Amid this environment, how should fixed income investors preserve their portfolios and generate attractive income? We believe an allocation to Asia credit can inject yield into a broader fixed income portfolio while enhancing its diversification.

Traditionally, Asian interest rates have been closely correlated with the United States. When the U.S. economy heats up, it generally affects the rest of the world. Asia in recent times, however, has benefited from structural reforms at a time of higher political risk in developed markets.

It is also important to keep in mind that not all Asian markets are the same. Hong Kong is often highly correlated with the United States. Other markets, such as Thailand, are much less correlated and interest rates in frontier markets such as Vietnam, Sri Lanka and Pakistan are more affected by local factors such as inflation and fiscal policy.

### Look East

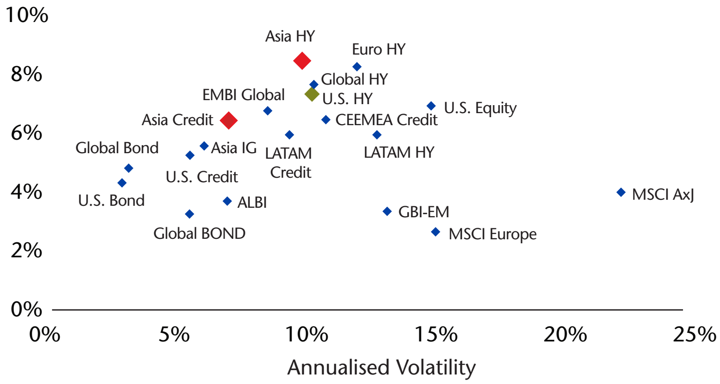
But why look east when rising U.S. rates are bound to result in higher rates in Asia? Well, it depends on the type of Asian bond. As U.S. interest rates rise, local currency bonds will show correlation with interest rates. The biggest influence, however, is the interest-rate differential between the local economy and the U.S. If rates rise substantially slower locally than in the U.S., there may be outflows back to the U.S.—the reverse of what is called the carry trade—and this may lead to depreciation of the local currency.

Asian companies also issue U.S. dollar-denominated debt and the interest-rate component will be linked directly to the U.S. In a thriving economy, as rates increase, credit spreads will tighten. As a result, there is less difference in yields between higher and lower quality bonds. In such an environment, however, the price sensitivity of U.S. dollar-denominated Asian bonds is considerably less affected than that of U.S.-dollar bonds such U.S. Treasuries.

Another reason Asia debt may present an attractive opportunity for investors: Asian companies that issue U.S. dollar-denominated debt tend to have solid fundamentals. Often, they represent blue chip companies within their countries and tend to have lower debt levels and better cash flows than their counterparts in developed markets. As bond valuations are less efficient among the emerging and frontier markets, active managers have more opportunities to generate alpha.

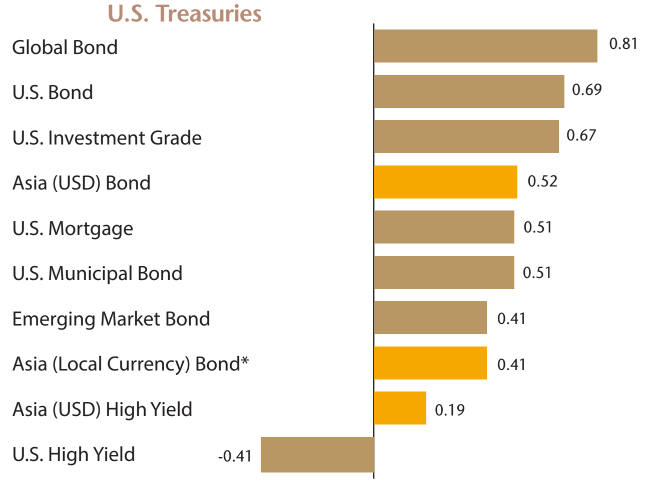
Within the high-yield asset class, Asia offers a superior risk return profile compared with the U.S., Europe and Latin America high yield. In addition, Asian bonds have historically had one of the lowest betas—i.e. price sensitivity—to U.S. Treasuries.

Figure 1. Asia Bond Looks Attractive Over the Long Run (Last 5 Years)




***Past performance is no guarantee of future results.*** It is not possible to invest directly in an index. Volatility is the standard deviation of returns.
Data shown from 2011 through December 2016 for Asia Credit (J.P. Morgan Asia Credit Index–JACI), 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 (J.P. Morgan CEMBI Broad Latin American High Yield Index), Global High Yield (BofAML Global High Yield Index), U.S. Investment Grade (BofAML U.S. Corporate Master Index), CEEMEA Credit (J.P. Morgan Corporate Broad EMBI CEEMEA Index), Asia Bond (Markit iBoxx Asian Local Bond Index (ALBI), LATAM Credit (J.P. Morgan Corporate Broad EMBI Latin America Index), EMBI Global (JP Morgan Emerging Markets Bond Index Global), GBI-EM (JP Morgan GBI-EM Global Composite), U.S. Aggregate (Barclays U.S. Aggregate Bond Index), Euro Aggregate (Barclays Euro Aggregate Bond Index), Global Aggregate (Barclays Global Aggregate Bond Index) U.S. Equity (S&P 500 Index), MSCI Europe Index and MSCI All Country Asia ex Japan Index .
Sources: Bloomberg; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. See Disclosures for full disclaimer.

Figure 2. Asia Bonds Have Among the Lowest Beta to U.S. Treasuries




***Past performance is no guarantee of future results.*** It is not possible to invest directly in an index. Data shown from 31 December 1998 to 31 December 2016; Chart shows beta of each asset class to the BofAML U.S. Treasury Current 5 Year Index, based on monthly returns.

Global Bond (Barclays Global Aggregate Bond Index),U.S. Bond (Barclays U.S. Aggregate Bond Index), U.S. Investment Grade (BofA Merrill Lynch U.S. Corporate Master Index), U.S. Mortgage (The Bank of America Merrill Lynch Mortgage Master Index), U.S. Municipal Bond (the Barclays Municipal Bond Index), Asia Bond (HSBC Asian Local Bond Index – ALBI), Emerging Markets (EM) Bond (JP Morgan Emerging Markets Bond Index Global), *Asia (Local Currency) Bond (Markit iBoxx Asian Local Bond Index), beta since inception 2001. Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index).

Sources: Bloomberg, Matthews Asia Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. See Disclosures for full disclaimer.

## Monitoring Default Rates

A key determinant of how and where spreads will move is market default rates. Over the past cycle, most Asia credit defaults have been within commodities, such as oil or coal companies, as a result of falling prices. Prices have now stabilized and they need only remain at a level where the least-efficient producer can produce their goods at a profit in order to avoid default. As a result, we believe default rates have stabilized and might even fall.

Cultural influences also should be considered. Asia has many types of bankruptcy laws that do not have as many precedents as the U.S. bankruptcy code. This can make the outcome of defaults less certain, as U.S. and U.K. law are based on precedent, whereas Asian ones tend to follow the letter of the legislation.

While there is no matrix for default outcomes, we have made a close study of Chinese defaults. China's recovery rate has been very close to that of the U.S.—around 45 cents on the dollar. The average offers less comfort, however, as it tends to be all or nothing, and it depends on the structure of the default. One way to mitigate such risks is to consider using an active manager.

## Our Process

At Matthews Asia, our strategy is based on careful credit analysis and a long-term approach for making investment decisions. We look for the persistence of the structural components of the data and if consistent over quarters—or even years—investors can take advantage of the market fluctuations that can be sparked by the noise of the daily news cycle.

As the search for yield continues and low but rising interest rates could possibly erode investors' bond portfolios, our view is that Asia credit presents investors with a compelling investment opportunity.