THE HUNT FOR YIELD BEGINS (AGAIN)

With average yields of almost 9% and credit spreads near their widest since 2013, Asian high yields are receiving greater interest from investors. Eastspring Investments see opportunities emerging within the Chinese property sector, although robust credit selection remains key.

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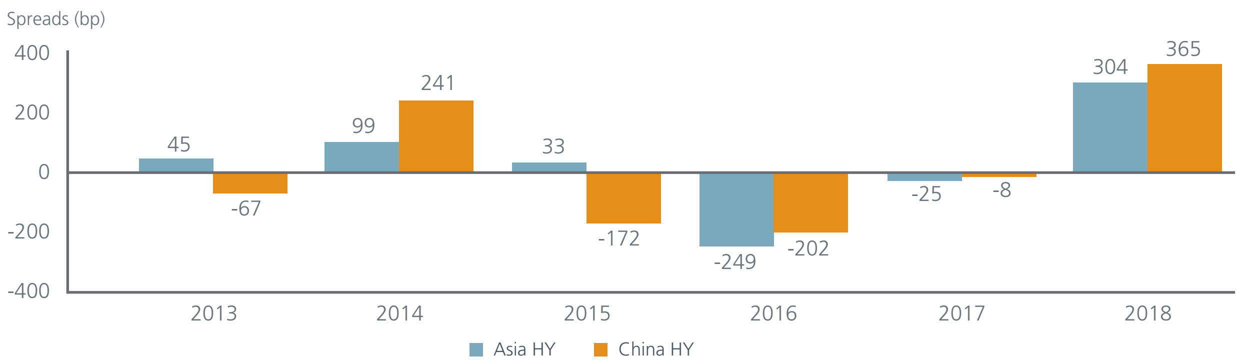
The US Federal Reserve (Fed) signalled in January that it is on hold for the foreseeable future and will be flexible with its balance sheet. The Fed's pause opens the door for other global central banks to likewise halt or even cut rates, against a slower growth backdrop.

Given limited rate hikes in the horizon and little signs of inflation, investors are back on the hunt for yield. With yields averaging almost 9%[1], Asian high yields are receiving greater attention from investors. Meanwhile, as credit spreads for Asian and Chinese high yields have widened the most since 2013, opportunities are emerging for discerning investors. See Fig.1.

Fig.1: Asian and Chinese high yield spread widening the largest since 2013[2]



In a recent survey[3], 56% of institutional investors indicated that they felt high yield spreads were wide, up from 50% a month ago. At current levels, Asian high yields are trading wider than their US, Latin America and Emerging European counterparts, as well as above their 5-year absolute average. On the supply front, new issuance in Asian high yield is expected to fall from 2018's level, which should also be positive for credit spreads.

THE CHINESE ELEPHANT IN THE ROOM

However, with China/Hong Kong accounting for more than 60% of the high yield bond market and the Chinese property sector making up 32% of the high yield benchmark, it is imperative that we address the elephant in the room.

The slowdown of the Chinese economy in 2018, largely on the back of the Chinese government's deleveraging policy had weighed on Chinese assets, including the bonds of Chinese property developers. Several defaults by Chinese bond issuers in 2018, as a result of a more difficult refinancing environment, had also hurt investor sentiment.

On this front, it is encouraging to note the Chinese government has taken steps to make both monetary and fiscal policies more supportive. In 2018, the People's Bank of China (PBoC) cut the Reserve Requirement Ratio (RRR), the share of deposits which commercial banks must hold in reserve, four times. The PBoC announced another RRR cut in January this year, releasing an estimated USD117 billion into the Chinese banking system.

Besides the RRR cuts, the Chinese authorities have also injected cash through the Medium-Term Lending Facility, accelerated infrastructure spending and approved cuts to personal income tax, all designed to help stabilise China's slowing economy.

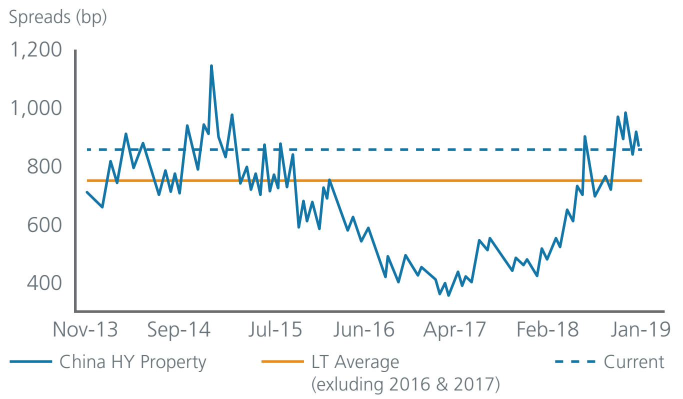
The overall default rate for Asian high yields in 2018 was 2.5%[4], up from 1.0% the year before. While we cannot rule out more defaults by Chinese high yield issuers as financing conditions remain challenging, we do not foresee a systemic wave of defaults among the Chinese issuers. The more systematically important companies will likely continue to have access to financing with defaults mostly limited to smaller fringe players in selected sectors.

Meanwhile, with the market largely expecting the default rate in Chinese high yield bonds to rise, it should not trigger an overly adverse market reaction should this scenario materialise. The incidences of defaults do emphasise, however, the importance of robust credit selection within the Asian high yield space.

POSITIVE ON CHINESE PROPERTY

We are positive on the outlook for the Chinese property sector although January's contracted sales of major developers fell 13% over the same period last year. The decline is partly due to a high base and developers with a focus on Tier 1-2 cities performed better. Home buyer sentiment has improved marginally following signs of policy easing as mortgage rates were lowered. Further signs of policy relaxation including a potential delay in imposing property taxes can help to stabilise sentiment further. On balance, with the Chinese property cycle highly dependent on China's domestic policies, the sector should be supported by the government's efforts to bolster the economy. Despite the rally in December, the valuations of China high yield property bonds still look cheap with spreads above their long-term average. See Fig.2.

Fig.2: Valuations of Chinese high yield property bonds look attractive[5]



Although USD35 billion[6] of Chinese property bonds is expected to mature over 2019-2020, we believe that a large percentage of the Chinese property issuers in the Asian high yield universe will have favourable access to financing, particularly those that are rated single B offshore but AAA onshore. By virtue of their businesses, these issuers have sizable tangible assets such as landbank, development projects or investment properties which can be pledged as collateral for loans. That said, we note that the overall tighter financing conditions had impacted the Chinese property sector positively – selected companies have exercised greater discipline and scaled back their land bank purchases.

PICKS AND RISKS

The wide spreads in Asian/Chinese high yields suggest that a lot of bad news has already been discounted in the price, but further volatility cannot be ruled out if US-China trade tensions escalate. We remain nimble and can move to a more defensive positioning, as we had done at the start of 2018, if required.

For now, China real estate remains a key overweight. Within the China high yield universe, we expect the Chinese property sector to fare better than their industrial counterparts, given their relatively superior access to financing.

Outside of China, we favour Indonesian high yield credits, with a focus on specific Indonesia metals and real estate names. Selected credits in the metals sector were sold off in 2018 given concerns over the weak Indonesian Rupiah. This is despite their borrowings and revenues being largely denominated in US dollars. We also see opportunities in the real estate sector as contrary to market expectations, we believe that some of the companies would be able to successfully meet their refinancing funds through asset sales.

For investors looking for income, the combination of high yields, potential capital and currency appreciation can drive attractive total returns for Asian high yields going forward.

Source: [1]Bloomberg, Eastspring Investments, BofAML, Citigroup, Markit iBoxx as at 31 January 2019. Asian high yields represented by BofA Merrill Lynch Asian Dollar High Yield Corp Index. [2]iBoxx, Morgan Stanley Research. [3]Bank of America Merrill Lynch. Asian Credit Survey. 31 January 2019. [4]JP Morgan, 3 January 2019. [5]iBoxx. Morgan Stanley Research. 13 January 2019. [6]BofA Merrill Lynch Global Research, Bloomberg

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