Making Sense of Coronavirus for Asia Credit Investing

June 2020

KEY INSIGHTS

- Asia credit has proved resilient amid the coronavirus pandemic, supported by success containing initial outbreaks along with regional buyer base and low exposure to commodities sector
- Default rate expectations may increase but should still remain in line with historical levels given recent refinancing activity and policy support
- Medium- and long-term outlook for Asia credit remains positive, with BB-rating space and China property sector appearing most compelling.

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Asia credit has rallied following sharp volatility in March when the coronavirus outbreak became a global pandemic. What is driving the resilience in the asset class and how does it compare globally?

The past three months have been extremely volatile in financial markets, and the Asia credit market did not escape that. The downside in U.S. dollar-denominated Asia credit has been more contained versus broader Emerging Markets (EM), however, showcasing the role that the asset class can play as a more defensive component of EM debt.

In terms of investment grade (IG), Asia credit has held up very well compared with Europe and U.S., which is a continuation of a 15-year trend. Since Asia IG also often trades at a discount relative to other regions, its resilience during periods of market stress supports the case that it can provide useful diversification benefits and act as a building block for asset allocation.[1]

The recent recovery in the asset class has been driven in part by tailwinds unique to Asia Pacific. First, key economies across the region, namely China and South Korea, have managed to contain coronavirus outbreaks and resume business activity while other parts of the world have lagged. Also, this region has relatively less exposure to the commodity sector and has avoided the drag caused by the recent oil price collapse. Lastly, there is a strong buyer base within Asia Pacific that creates a structural demand for issuances in the region.

How would you rate liquidity conditions in Asia credit since the initial market shock? Do you see any improvement yet in the primary market?

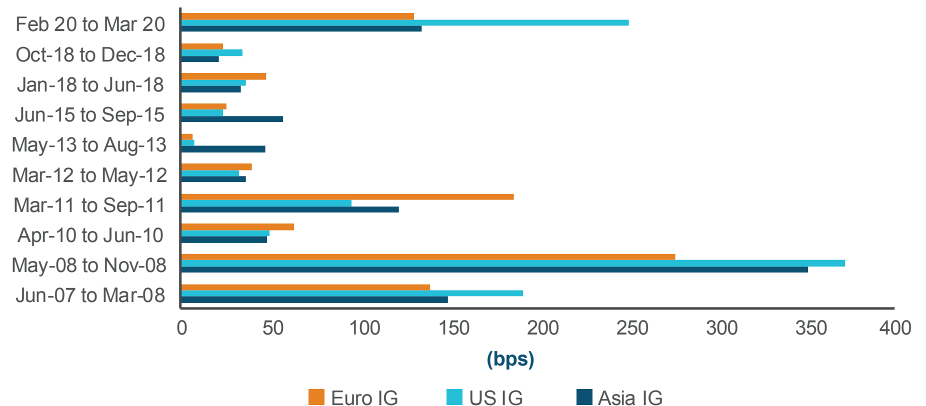
Like the rest of the world, secondary market liquidity was very limited as you would expect during a sell-off. The unique operational challenge of investors and market makers working remotely and in isolated fashion during much of the intervening period has

[1] For more information, please see our recent whitepaper "High Quality Diversification Benefits of Asia Credit"

> Asia credit continues to be the main driver of overall EM corporate issuance, much like the past few years.

Spread Changes during Sell-offs

(Fig. 1)



In periods of drawdown, Asia IG spreads have remained as defensive as global DM IG spreads.
Exceptions: Taper tantrum, China RMB devaluation
Asia IG: JP 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.

also made it difficult at times to execute investment decisions. This resulted in elevated bid-offer spreads, especially for Asia high yield (HY).

Primary market issuance started the year well above historical averages before falling sharply in March. It has since shown signs of improvement, with the majority of issuance coming from IG. More broadly, Asia credit continues to be the main driver of overall EM corporate issuance, much like the past few years. Going forward, we expect corporates in this region will continue to tap capital markets to seek refinancing or stretch out their debt profiles.

Historic levels of fiscal and monetary stimulus could bolster corporate fundamentals amid the pandemic. Do you expect that default rates in Asia Pacific will remain low in this environment?

We have been witnessing an unprecedented quantity of economic stimulus from developed market policymakers, with the Federal Reserve providing a direct backstop for U.S. corporate bonds being one notable example. Here in Asia, several countries have also announced their own versions of fiscal and monetary stimulus, while trying to strike a balance between providing an appropriate level of support based on their respective debt capacities as well as managing the healthcare situation but also facilitating a return to business activity. Against this backdrop, there have been divergent trends across the region.

Entering the year, we held a sanguine outlook on the Asia HY default rate following considerable refinancing activity. The onset of the coronavirus pandemic clearly means that default expectations now need to increase from that low level as pullbacks in economic activity will negatively impact corporate earnings.

Even so, we believe the Asia HY default rate will still 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.

We feel that problems in the current environment may be most likely to occur in the commodities sector, where Asia HY has relatively low exposure versus other regions. Ongoing uncertainty is likely to weigh on demand and result in lower proceeds for energy producers, in particular.

What is your outlook for Asia credit? Is now a potentially attractive entry point to the asset class?

We remain positive on the outlook for Asia credit over the medium- and long-term. Represented by the J.P. Morgan Asia Credit Index, it is an asset class that has increased four-fold over the past decade beyond US$1 trillion and provides direct access to a region with robust economic and demographic growth.

The BB-rating space is most compelling at the moment, in our view. This segment offers a sweet spot where it is possible to participate in the spread compression story without taking excessive levels of risk. In terms of specific sectors, we remain positive on China property, where the largest developers recently recorded higher contracted sales volume in a positive sign for the market.

In terms of valuations, we feel that there is still space for spreads to tighten further even after Asia credit's recent rally. Moreover, we have observed a pattern dating back to 2007 where market dislocations have led to double-digit returns in the asset class within 12 months of their occurrence. In this current cycle, we hit a bottom in mid-March and believe that the asset class is now on track to deliver attractive risk-adjusted returns.

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What are some of the key risk events that you will be watching over the next 3-6 months?

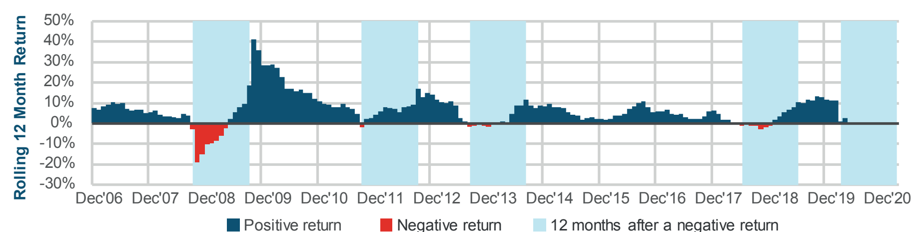
The increase in default risk is certainly something that we are closely monitoring. In this environment, it is imperative to focus on bottom-up, fundamentals to identify which corporates are best equipped to avoid defaults and can withstand sudden volatility.

Another key trend to watch is the path of the coronavirus pandemic. Already, we have seen a divergence across Asia Pacific where there have been varying levels of success in containing initial outbreaks and countries have announced a range of stimulus recovery plans in accordance with their individual fiscal situations and external vulnerabilities. Investors should stay abreast of the latest developments regarding the pandemic since recovery rallies are likely to proceed differently across countries.

Lastly, U.S.-China tensions have surfaced again, having been a bit under the radar for a few months following a contentious trade dispute last year. We expect that negative headlines could remain high for the foreseeable future ahead of the U.S. presidential election in November.

Level of Returns after the Sell-offs

(Fig. 2) Last 12 Month Returns: Jaci Diversified Index



JACI Diversified Index		
Start of Negative 12-Month Trailing Return Period	Max Drawdown	Returns after T+12 Month*
Sep-2008	-19.1%	18.4%
Sep-2011	-2.0%	16.9%
Aug-2013	-1.6%	11.8%
Jun-2018	-2.5%	10.5%

As of 30 April 2020

Past performance is not a reliable indicator of future performance.

Max Drawdown is the lowest cumulative 12-month return reached during this period. Chart refers to the J.P. Morgan Asia Credit Diversified Index

Source: Bloomberg, J.P. Morgan

*Total Cumulative Return is the cumulative return over the period lasting the number of months provided in the third column beginning with the month given in the first column. .

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