ASIAN CREDIT OUTLOOK 2019

Summary

The macroeconomic backdrop for Asian countries should remain broadly neutral for credit performance in 2019. GDP growth is expected to moderate across the key economies, although we don't expect any hard landing scenarios to materialize.

We expect fiscal policy to remain supportive of growth in most Asian economies, notably China, and act as a stabilizer to weakness in external and private domestic demand. Given the national elections in India and Indonesia, some fiscal slippage is to be expected, although the broad fiscal consolidation trend in these countries remain intact and is likely to resume in coming years. Last but not least, with inflation remaining subdued, we expect monetary policy to stay neutral to accommodative across most Asian economies.

In 2019, the focus will be more on credit selection across countries and sectors. Credit with a strong management and track record of operating through tough business and funding environments will be preferred. We generally still prefer shorter-dated credit, both in Asia IG and HY. Within China HY, we have a preference for short-dated property bonds over industrial.

2018 Market Review

2018 turned out to be a year of high volatility for Asia credit. A strong rally in January, prompted by optimism on the global economy, proved to be short-lived. Subsequent firmer inflation readings and rising oil prices triggered heightened expectations that the Fed could accelerate monetary policy tightening, leading to a spike in UST yields, as well as an exodus of funds from EM including Asia. US trade policy took center stage soon after, with the US getting embroiled in a tit-for-tat trade battle on several fronts. Notably, US President Trump's hard line stance on trade was most pronounced against China. Uncertainty over the outlook for global trade provided a cap for UST yields. Meanwhile, idiosyncratic concerns in Turkey and Argentina adversely affected investor sentiment for risky assets. The resulting sharp falls in some EM currencies including the Indian Rupee (INR) and Indonesian Rupiah (IDR) added to investor concerns and pushed credit spreads wider. Bank Indonesia (BI) lifted interest rates by a total of 175bps so far in this cycle, largely as a policy response to stabilize the rupiah.

In addition to intensifying trade tensions, there were concerns that China's deleveraging efforts have started to tighten financial conditions onshore and further weigh on domestic growth, particularly on the investment and consumption fronts. With the domestic slowdown looking to be worse than expected, Chinese policymakers started rolling out (both monetary and fiscal) easing measures. The loosening of policies in China provided a lift to sentiment in July and August and reversed some of the spread widening since February 2018. However, the Asia credit market succumbed to a sell-off anew in September and October, as disappointing earnings results from US companies caused a significant correction in global equities, prompting USTs to rally. Toward the end of the year, the market tone turned more constructive on expectations that the Fed is close to ending its cycle of rate hikes, and news that the US and China have re-opened negotiations to ease trade tensions.

Over the year, a shift in supply and demand dynamics provided yet another headwind for Asia credit, particularly for the high-yield space. Tighter liquidity conditions in the onshore Chinese market caused offshore bond supply to remain heavy, but simultaneously moderated demand from onshore investors. Overall, the JACI Composite returned -1.63% year-to-date. Asia high-grade lost -0.95%, with spread widening 48bps to 206bps. Asia high-yield corporates lost 3.92%, underperforming as spreads widened 164bps to 620bps.

Key risks to watch for in Asia credit next year include:

1. **Trade and US-China relationship**: The US and China are in negotiations to resolve the trade conflict, with a tentative deadline of 1 March, 2019, to reach a deal. Failure to come to a compromise, on trade and other strategic issues, will likely be negative for credit spreads and the broader risk environment.

2. **China**: A sharper-than-expected slowdown in China due to weak external demand and tight onshore funding conditions could weaken investor sentiment significantly.

3. **Commodity prices**: While current account deficit countries that are net oil importers would benefit from lower crude oil prices, a sharp and abrupt fall could lead to greater uncertainty and damper investor risk appetite. Lower commodity prices also affect the credit fundamentals of upstream companies in the Oil & Gas and Metals & Mining sectors.

4. **Rise in risk-free rates**: Despite the pervasive dovish sentiment in the US Treasury market at the end of the year, a sharp rebound in UST yields due to higher-than-expected wage and price inflation remains a key risk for 2019.

5. **Supply**: Demand for Asia credit is expected to stay decent despite a more challenging EM hard-currency flow environment. The gross supply of new issues should remain strong, especially if higher onshore funding costs and/or more limited availably of credit onshore causes Asian issuers to turn more toward the USD credit market. However, with sizeable redemptions in 2019, net supply should be manageable.

2019 Asian Credit Outlook

Fundamentals

Macro

The macroeconomic backdrop for Asian countries should remain broadly neutral for credit performance in 2019. GDP growth is expected to moderate across the key economies, although we don't expect any hard landing scenarios to materialize. Export growth is likely to slow as the impact of existing tariffs began to be felt more forcefully. However, import growth is likewise expected to moderate, especially if commodity prices remain broadly stable to moderately lower on global growth concerns. The contribution of net exports to GDP growth is therefore expected to be only slightly less supportive relative to 2018. Countries with large current account deficits will continue to be the focus for credit investors and remain vulnerable to spikes in the USD, US interest rates and crude oil prices.

We expect fiscal policy to remain supportive of growth in most Asian economies, notably China, and act as a stabilizer to weakness in external and private domestic demand. Given the national elections in India and Indonesia, some fiscal slippage is to be expected, although the broad fiscal consolidation trend in these countries remain intact and is likely to resume in coming years. Last but not least, with inflation remaining subdued, we expect monetary policy to stay neutral to accommodative across most Asian economies. This is particularly relevant in China where the tightening in onshore financing conditions had exerted negative pressure on the performance of both onshore and offshore USD credit in 2018. With the recent policy focus on ensuring adequate financing to the private sector and provincial public infrastructure projects, we expect credit conditions in China to improve next year.

With 2019 expected to be a year of moderation for GDP growth and other sovereign credit metrics, we anticipate little change in Asia's sovereign rating outlook.

Credit

We expect Asian corporate credit fundamentals to remain broadly stable. We expect broadly stable credit profile for Asian banks, underpinned by still solid economic condition, strong capitalization, and stable asset quality. The ability and willingness of banks to extend credit remain firm. In China, efforts continue to strengthen the regulatory framework governing the major banks, which helps to mitigate systemic risk in the overall financial system despite tighter liquidity and rise in onshore corporate defaults from low levels.

The investment grade (IG) corporate sector in Asia has shown improvements in leverage and debt servicing ratios over the last few years. While the deleveraging trend is not likely to stretch much further with the neutral macro backdrop resulting in slower earnings growth and higher funding cost, we expect no significant deterioration in the credit profile of Asia IG corporates. Ratings bias is therefore expected to be broadly stable through 2019.

On the high-yield (HY) side, there will likely be greater differentiation, both between and within sectors. The China property sector will likely see slower growth in 2019. However, strong contracted sales achieved in 2018, lower land-banking activities, and less acute onshore funding conditions should help to mitigate the risks. Larger developers will undoubtedly fare better than smaller ones given their better access to financing and greater array of saleable resources. Credit metric trends for China HY industrials will be more credit specific, although still tough onshore financing conditions will exert pressure across the sector. The Asia HY metals and mining sector could see some pressure given the expectation of weaker commodity prices from 2018 average.

We believe refinancing risk remains manageable overall, although the Asia HY default rate is likely to remain elevated, relative to its history, in the 2% to 3% range due to tough operating environment and still tight credit availability affecting select issuers with tight liquidity.

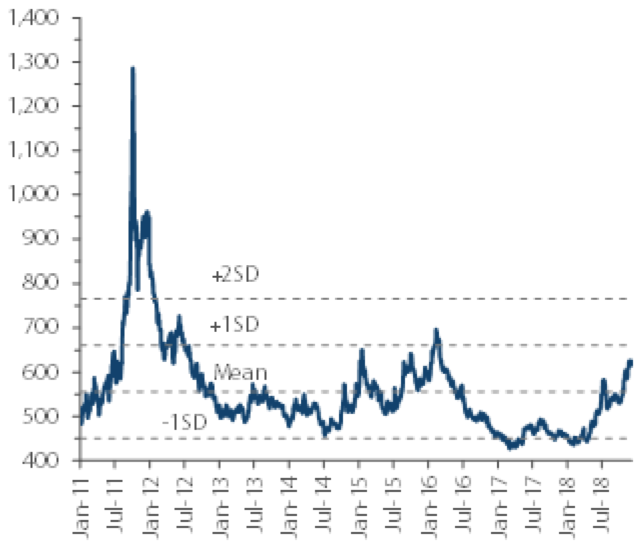
Valuations

Both high-grade and high-yield spreads have cheapened over the course of 2018. High-grade spreads at 206bp are near the historical post global financial crisis (GFC) mean level. With the high-yield underperformance in 2018, high-yield corporate spreads at 620bp have cheapened to a level last seen in 2016. With the sell-off in UST yields, high-grade yields have risen to a more attractive level of 4.9%; a level last seen during the taper-tantrum in 2013. Similarly, the high-yield corporate yield has risen to 9.05% -- a level last seen in 2012 after the European crisis.

Chart 1: Asian High-Grade Spread

Source: J.P. Morgan, Bloomberg, as of 6 December 2018

Chart 2: Asian High-Yield Corporate Spread



Source: J.P. Morgan, Bloomberg, as of 6 December 2018

In 2018, against US credit, Asian credit broadly underperformed despite some late retracement in spread differentials in late 2018. Lower rated credit underperformed more than those in the higher rated segment. In 2018, the spread differential between Asian and US A-rated ended 3bp tighter, despite underperforming for most of 2018. BBB-rated differential widened by 18bp to 72bp. Asian HY underperformed with BB-rated and B-rated widening by 122bp to 156bp and by 238bp to 240bp. At this point, there is more value in the BBB- category for high-grade and in the high-yield segment where the spread differential is at the wider end of the recent historical range.

Technicals

The technical backdrop for Asia credit is likely to remain lacklustre into 2019. The external flows into EM funds should remain muted given on-going macro concerns and tighter monetary policy environment. Indigenous demand for Asia credit should also remain intact as seen from the take-up in primary issuance despite the weak backdrop for most of the year. However, with onshore liquidity still tight, in particular for Chinese high-yield issuers, USD issuance is likely to weight on secondary spreads.

Gross supply is likely be around USD226bn, as seen in 2018. This should be manageable, with a sizeable amount due to redemptions of existing issues of around USD149bn.

Return Expectations

Asian credit returns are likely to be subdued in 2019, reflecting a continuation of a tighter US monetary policy, heightened macro-headwinds from the China-US trade tensions, while acknowledging that valuations, in particular for high-yield, have improved. Risk-free rates are expected to continue rising, albeit at a slower rate than that in 2018. For Asian IG credit, the expectation is that credit spreads will end 2019 with a small widening on the back of the various macro risk factors, offset by spreads that have cheapened and higher starting all-in yields. Bond carry will again be the main driver of returns as the continued rise in UST yields will continue to negatively impact returns. We expect modest positive returns for Asian IG bonds in the low single-digit range.

Asian high-yield spreads could end 2019 marginally wider from the current 620bp. In 2019, Asian HY is expected to outperform IG due to the shorter duration and higher carry. Comparing IG corporates to HY corporates, the spread ratio of 2.81 higher than the mean of around 2.50, also suggests a tilt towards HY corporates.

Strategy

In 2019, the focus will be more on credit selection across countries and sectors. Credit with a strong management and track record of operating through tough business and funding environments will be preferred. We generally still prefer shorter-dated credit, both in Asia IG and HY, where valuation has been become dislocated relative to fundamentals for some credit due to the broad market weakness, especially towards end-2018. Within China HY, we have a preference for short-dated property bonds over industrial.

In terms of yield curve positioning, we remain underweight duration relative to benchmarks given the risk of widening credit spreads in the longer-end of the curve, as well as the risk of UST yields rebounding from end-2018 levels.

We remain overweight financial subordinated debt in countries with strong banking systems such as Singapore and Hong Kong. We continue to like China infrastructure and the stronger segments of China quasi-sovereign, while remaining wary of technology due to sector headline risks. We remain underweight Philippines sovereign and South Korea credit on valuation. We are neutral Indonesia in IG, but are overweight the sovereign sector versus quasi-sovereign and other sectors.

Country & Sector Outlooks

Countries

China

Chinese economic growth is poised to slow further in 2019, prompted largely by the lag effect of credit tightening. However, the economy will avert a hard landing, as authorities have begun to recognize the degree of pessimism within the real economy and onshore financial markets. The trade ceasefire with the US has reduced the urgency for China to introduce large scale fiscal measures. Nonetheless, the Politburo’s recent declaration of the need for timely measures to counter growing downward economic pressure, signals that the government stands ready to roll out significant fiscal and liquidity support for the economy. Meanwhile, monetary policy has clearly shifted toward an easing bias.

We expect the recent rebound in inflation to be temporary and expect overall inflationary pressure to remain manageable in 2019, on the back of our expected moderation in growth. This, together with supportive monetary policy from the PBoC, should put a cap on interbank rates and limit the rise in government bond yields that may result from an increase in the fiscal deficit.

India

In 2019, the economy is likely to continue to register robust growth, helped in part by increased expenditure by the central government ahead of the general elections in April/May, and an improving investment climate. Meanwhile, we think inflation has peaked in India, as food price inflation is likely to moderate/remain stable. Nonetheless, we anticipate the headline number to remain close to 4% on a year-on-year basis. Hence, in the absence of a seasonal shock to food prices, we expect the RBI to maintain its monetary policy unchanged. On the general elections due in April/May 2019, we expect the current ruling party to remain in power, albeit possibly with a slimmer majority.

Indonesia

For 2019, GDP growth is likely to moderate, as BI’s cumulative 175bps rate hikes this year filter through the broader economy. Moreover, the postponement/cancellation of some investment projects point to domestic investment likely being sluggish in the coming year. Despite these factors, we expect growth to remain firm. Government policies to keep inflation stable and provide targeted assistance to households, together with election-related spending ahead of the April presidential elections, are likely to support private consumption.

We expect inflation to remain fairly anchored next year, given the pre-emptive hikes taken by BI. Improvement in the government's efforts to enhance food supply management across the country will also ensure that inflation remains manageable in the coming year. Against such a backdrop, our base case is for the Indonesian central bank to leave interest rates unchanged in 2019, barring a further sell-off in EM currencies.

Politics have started to take the spotlight, as campaigning for the presidential elections in April 2019 has gone full swing. We expect the elections to be relatively uneventful, with President Joko Widodo being re-elected for a second term.

Sectors

Financials

We expect broadly stable credit profiles for Asian banks, underpinned by still solid economic conditions, strong capitalization, and stable asset quality. In China, the regulators have made progress in reducing systematic financial risk by curbing shadow banking and interbank lending activities. We expect larger Chinese banks to be in a better position to tide over the challenging macro conditions. In Hong Kong, we believe banks have sufficient capital buffer to withstand a potential property market correction. In South Korea and Singapore, we see stable operating environments boding well for capitalization, profitability and asset quality.

Therefore, we are overweight subordinated debt from China, South Korea, Hong Kong and Singapore. We believe capital instruments from these countries still offer attractive valuation compared to their senior papers, although supply is likely to pick up next year given that subordinated debt issued by Chinese banks back in 2014 will likely be called and refinanced.

We are positive on China Leasing companies senior debt with the leasing to bank senior pickup widen to ~40bps from the tights of ~25bps. These bank affiliated leasing companies are expected to receive timely support if required from their parent banks with explicit liquidity/capital support under the articles of association of leasing companies. China asset management companies' (AMCs) saw regulators introducing rules to encourage them to refocus on their traditional distressed assets business and to deleverage. We view AMC's shift back to core business of traditional asset management as credit positive. With China's slower economic growth in the coming years, their systemic importance will increase. Therefore, we continue to like the AMCs from a medium story perspective.

Oil & Gas

Oil prices declined significantly in 4Q 2018. Brent was down 30% after hitting its peak of $86 per barrel in October. It is currently hovering around $60 per barrel. Despite the sharp decline, Brent has averaged around $70 per barrel in 2018, which is still 25% higher than the year before. Upstream oil companies are still expected to report a significant full-year growth in earnings for 2018. Downstream companies will benefit from lower oil prices due to lower feedstock costs. Working capital needs will also be lower and margins will improve as a result. In the near term, downstream companies are likely to report some inventory losses due to the large swings in oil prices. These will largely be one-off impacts that do not alter the long-term credit fundamentals of these companies.

Looking toward 2019, the oil futures market indicates expectation for prices to remain range-bound at the current level of $60 per barrel. Saudi Arabia and Russia recently agreed in the G20 meetings to extend cooperation towards production cuts into 2019. This will help to stem further declines in prices.

At current price levels, we expect Asian oil & gas companies to have a stable credit profiles with little to no impact to their credit ratings. Oil majors in Asia are mainly represented by national oil companies that enjoy strong support from their respective governments. Therefore, despite the lower profitability from lower oil price, we expect the credit fundamentals for these companies to remain strong and resilient.

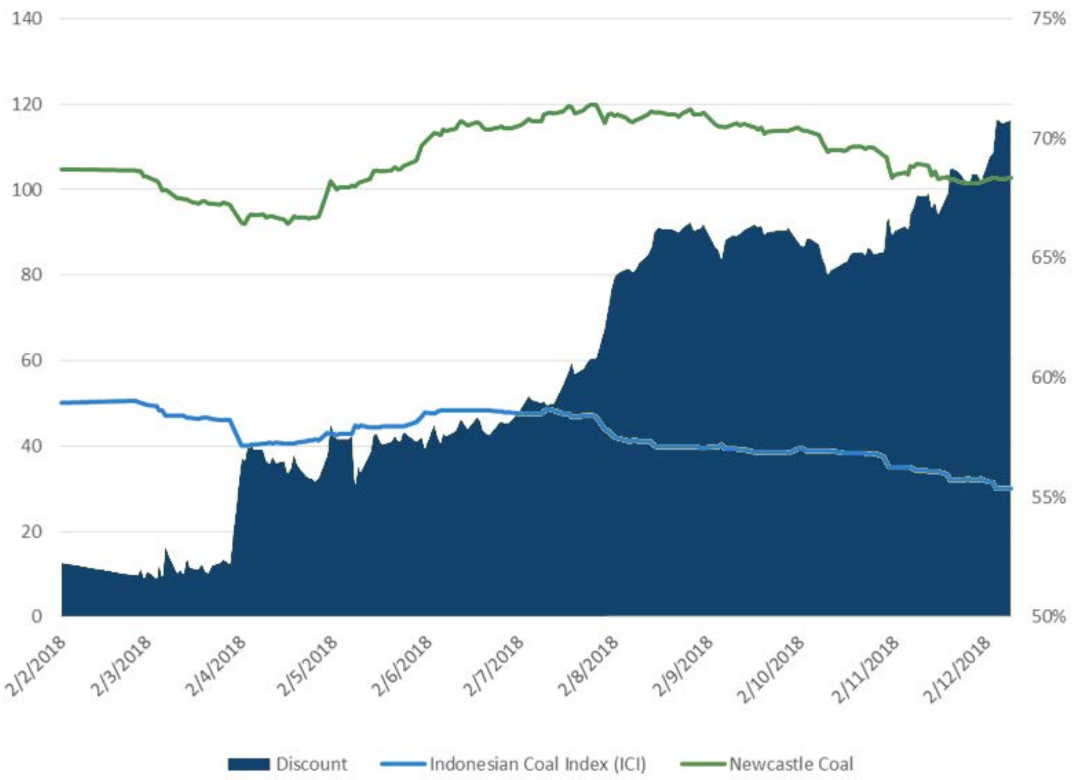
Coal & Mining Services

China's economic growth is expected to slow in 2019. Lower economic activity will drive down energy demand, and impact coal prices. In mid-November, China's NDRC imposed port restrictions on both metallurgical and thermal coal. As a result, seaborne coal prices have been under intense price pressure.

The impact of the import restriction is most pronounced on low-grade coal, which mainly originates from Indonesia. This is seen in the diverging price trends between the Newcastle coal index and the Indonesian Coal Index. While Newcastle coal price remains above $100 per tonne, Indonesia's 4200kcal ICI index has fallen almost 40% from its July peak and is trading near $30 per tonne. Should low-grade coal prices persist at these levels, some of the smaller Indonesian coal miners are likely to come under pressure. As for contract mining services companies, we expect a marginal deterioration of their credit profiles. They have better earnings visibility with less correlation toward coal prices, compared with upstream mining companies.

Overall, we expect credit profiles for companies in this sector to weaken in 2019, driven mainly by weaker coal prices. However, the deterioration will be buffered by the improved capitalisation, following two years lofty coal prices. Refinancing risks will be minimal as well, as there are no notable bond maturities over the next twelve months.

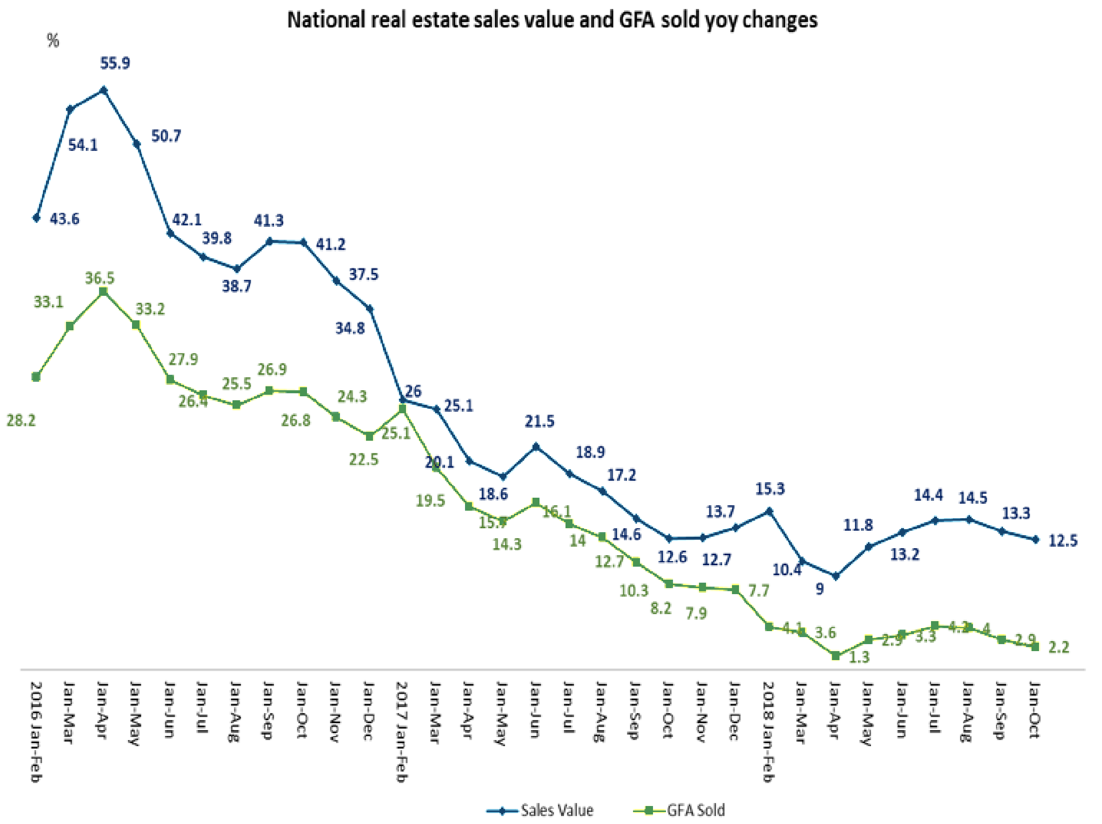
Chart 3:



Property

2019 should be a year of stabilisation after approximately two years of continuous tight government policies. Fine tuning of policies has begun in certain cities and more will follow suit if market sentiment worsens further. The consolidation pace for the sector to pick up as credit policy toward the sector remains tight. 2018 has been one of the best years for property developers with the national residential sales amounting close to CNY 12trn. However, we expect the national residential sales to decline moderately as volume decreases, while prices remain stable in 2019. The volume decline will come mainly from Tier 3 and lower cities, as shanty town redevelopment slows after the successful inventory de-stocking efforts. Talks about the implementation of a real estate tax have been ongoing for the past few years. The probability of implementation in 2019 is unlikely, but more likely a 2020-2021 event. However, the impact from the real estate tax is likely to be minimal if one takes reference from the Shanghai and Chongqing trials, as we await further details from the central government. As the NDRC imposes restrictions on the usage of bond issuance, that of property developers should also be lower in 2019. The total refinancing need for 2019 is approximately USD 25.5bn, comprising USD 14.7bn of maturing bonds and USD 10.8bn of callable bonds. We are cautiously optimistic on the sector as we enter 2019. We prefer the short-dated bonds from quality developers who have demonstrated financial prudence over the various cycles, while staying away from highly leveraged smaller issuers.

Chart 4:



Technology

We expect the Chinese Internet companies to have healthy revenue growth in 2019, but at a slower pace versus last year. Profit margins will continue to moderate due to increased investments in new business initiatives, and higher spending on contents, customer acquisition and customer retention. On the fundamental front, we expect credit profiles of Internet companies to be stable due to their strong cash balance, and their investment activities to be within cashflow generation capability. On the valuation front, the Chinese Internet sector looks increasingly attractive versus similarly-rated Chinese SOEs, and US technology companies. On the technical front, sentiment for the sector is very weak given heightened key executive risks, regulatory clampdown, and continued US-China trade tension, which could take a long time to resolve.

On the fundamental front, we think US-China trade tension to have less direct impacts on the operating performance of China Internet companies, and more impacts on the hardware tech companies. Valuation of hardware tech companies is now very attractive comparing to historical levels and peers, but this could stay for sometimes until the US-China trade tension eases. Hence, we have underweight recommendations for both the Internet and hardware technology sectors.

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