Manulife Investment Management

2020 mid-year outlook: Asian Fixed Income

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In the current uncertain market environment, Asia's economies and credits are uniquely positioned to weather the challenges compared to peers. In this mid-year outlook, the Asian Fixed Income team and Asia Credit Research team, led by Endre Pedersen (Chief Investment Officer, Asia ex-Japan) and Fiona Cheung (Head of Credit, Asia), examines the region's economic outlook, the major trends they see that will shape the Asian fixed income landscape and the robust fundamentals that should drive attractive opportunities in Asian bond markets.

Asia's fundamentals shine in uncertain times

This year has unfolded like no one forecast. Markets were initially filled with optimism after the United States and China signed a first-phase trade deal in mid-January. However, the global spread of COVID-19 and oil price shock roiled global asset markets, leading to significant volatility and dramatic drawdowns. Unprecedented fiscal and monetary stimulus, coupled with seemingly successful virus containment measures, have stabilised markets, but many investors are still asking: what is the outlook for Asian fixed income markets in this highly uncertain environment?

Our base case is that the initial "sugar rush" of central bank and government support should lead to a sharp economic rebound in the second half of 2020. That said, the effect will eventually dissipate in developed markets toward late 2020 and the early stages of 2021. In fact, we expect that even when the global economy returns to "normal", it will only be at roughly 70-80% capacity compared to pre-COVID-19 levels.

Looking ahead: three major trends

With that base case in mind, we see three major trends unfolding globally over the short-term with implications for fixed income investors.

- **Credit conditions in developed markets are expected to deteriorate further** due to slower growth and elevated levels of debt and unemployment. Governments should possess fewer policy tools to address their sluggish economies, particularly in a prolonged downturn. As a result, Moody's forecasts a significant rise in the rate of global credit defaults in 2020[1], while Fitch has already observed a noticeable increase in "fallen angels" in developed markets[2]. According to credit rating agencies, however, the default rate is expected to be lower in Asia-Pacific, and we believe the fallen angel risk is comparatively more manageable in this region[3].

- **Localisation or regionalisation will accelerate** over the medium to long term due to COVID-led supply chain disruption. More governments will be directly involved in sensitive and essential industries to ensure stable supply of goods and reduce reliance on imports. Strategic sectors such as technology, semi-conductors, high-value added manufacturing and healthcare will receive increased government support. In addition, companies that previously relied on foreign funding could seek to return to domestic capital markets in order to minimise the potential issues in offshore funding channels due to rising geopolitical risks.

[1] Source: Moody's, 29 April 2020. The global default rate is forecast to reach 11.6% by the end of 2020.

[2] Source: Fitch Webinar, 12 May 2020. "Fallen Angels in the US and Europe", May 2020. There have already been over 20 fallen angels recorded in March 2020 in the US and EMEA. This is compared to roughly 50 fallen angels recorded in Asian credit markets over the past 12 years.

[3] Source: Moody's, 29 April 2020. The default rate in Asia-Pacific is forecast to reach 6.4% by the end of 2020.

- **The divergence in regional credit markets should continue.** We observed that a number of Chinese high-yield industrial names have recently failed to finance their US dollar bonds, leaving the high-yield market skewed more towards Chinese property issuers. In addition, the uncertain macro environment could favour state-owned companies over private ones, as we can see from 2019/20, when defaults in China were largely concentrated in private companies[4].

Opportunities in Asian fixed income

In this rapidly changing global environment, we believe that the fundamentals of Asian fixed income should come to the forefront. Indeed, the region still boasts a relatively attractive economic growth outlook[5], diversified and well-managed economies, sustainable sovereign and corporate debt levels, and higher yields that should make it attractive to global fixed-income investors.

We are positive on interest rate and credit opportunities for the second half of 2020.

Indonesia attractive from rates perspective

Although many central banks in Asia have aggressively cut rates, several markets still have room to introduce further supportive measures. In particular, we remain constructive on Indonesia for a number of reasons. It has responded well to the COVID-19 outbreak, and its government has already started to re-open the country, albeit gradually. Also, Indonesia's macroeconomic fundamentals largely remain intact, and the country's central bank has exercised prudence cutting rates, supporting the rupiah's stabilization amid the country's lowest inflation rate in almost two decades [6]. While the government has notably increased spending to boost economic growth in the current downturn, the fiscal deficit still remains at an acceptable level, especially compared to other emerging markets[7].

Overall, we expect Indonesia will continue to boast attractive real yields and further room for interest rate cuts in 2020.

China, state-owned enterprises and quasi-sovereigns lead credit outlook

We believe that the most significant short-term opportunities lie in credit selection. Overall, Asia will not be immune from the general trend of credit deterioration; rating downgrades and defaults should gradually rise over the next two years[8], with a present, but more subdued risk of fallen angels compared to other regions[9].

However, the region should be better positioned than its global peers – not only because Asian credit quality is high, with a sizable majority (roughly 77%) of the issues in the J.P. Morgan Asian Credit Index (JACI) rated as investment grade – but also because corporates benefit from a broad array of diversified funding channels, ranging from local banks to bond markets.

Investors should be constructive on the following credit segments:

- **China** has arguably led the world on the path to economic recovery, and the People's Bank of China should remain supportive amid escalating geopolitical tensions and continuing economic challenges. Investors should be notably positive on the state-owned enterprise (SOE) and real-estate sectors. These segments are crucial for a prolonged economic revival and should receive robust government support. While we are generally sceptical of local government

[4] Source: Goldman Sachs, China Default Watch.
[5] Source: International Monetary Fund, June 2020: Forecast economic growth in 2020 for advanced economies is -8.0%, while for emerging and developing Asia it is -0.8%.
[6] Source: Jakarta Globe, 19 June 2020. Bank Indonesia projects the country's gross domestic product (GDP) growth to range from 0.9% to 1.9% in 2020, but growth is expected to rebound to 5%-6% next year.
[7] Source: Bloomberg, 1 April 2020. In the wake of the 1997 Asian financial crisis, Indonesia adopted a statutory 3% (as a percentage of GDP) annual fiscal deficit ceiling in 2003. In April 2020, the Indonesian government scrapped the fiscal ceiling until 2023 to boost the country's fiscal response. Currently, the Indonesian government projects a 5.07% fiscal deficit in 2020.
[8] Source: Source: Moody's, 29 April 2020. Moody's forecasts an increase in Asia's high yield default rate from 1.1% in 2019 to 6.4% in 2020.
[9] Source: Bloomberg. Only roughly 8% of firms in JACI are rated "BBB-", and 65% of those firms are government-related entities with greater support than traditional corporates.

financing vehicles (LGFVs), as many are linked to municipal or provincial authorities that may not receive expected support, there are a select few tied to strategic economic projects that should be attractive to investors.

- **State-owned enterprises and quasi-sovereign entities** compose roughly 40% of the JACI index. We feel that this segment in ASEAN is poised to weather the macro challenges, as many firms are national champions and enjoy access to diversified funding streams. They also have very resilient credit profiles and should benefit from continued monetary easing in the region.

Within Asia, we are more cautious on India.

- Due to concerns over **India's** significantly slower growth and already heavy and still rising fiscal deficit, we believe it has relatively limited headroom to cushion further downturns. Having said that, the country also boasts several positives, such as comparatively low reliance on external funding (external liabilities account for just 6% of central government debt)[10] and a forecast narrowing current account deficit this year due to improving terms of trade on lower oil prices[11].

  Depending on how successful the Indian government is in meeting the growth and debt targets metrics set by the credit rating agencies, as well as the stance of the rating agencies (whether they take a pro-cyclical or looking through the cycle approach), the India sovereign and quasi-sovereign ratings could be exposed to fallen angel risk — given India's latest borderline investment-grade rating (Baa3/BBB)[12]. The team will continue to monitor this situation closely.

Asian fixed income set to shine

Overall, we think that the global economy is likely to enter a rough patch over the next two years. Amid subpar growth, security selection will become critical as credit rating downgrades and defaults proliferate. However, we believe that Asia's economic and corporate fundamentals, as well as attractive yields, should allow it to shine for investors in these uncertain times.

[10] Source: Fitch, 18 June 2020.
[11] Source: Standard and Poor's, 10 June 2020.
[12] On 1 June 2020, Moody's Investor Service downgraded the Government of India's foreign-currency and local-currency long-term issuer ratings to "Baa3." On 10 June 2020, S&P Global Ratings affirmed its "BBB-" long-term and "A-3" short-term unsolicited foreign and local currency sovereign credit ratings on India.

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