Asian Credit Strategy

An update of investor base for Asian USD issuance – locals continued to dominate

Emerging Markets

05 June 2019 Corrected

Global Emerging Markets | Corporate Credit Asia

Joyce Liang
Research Analyst
Merrill Lynch (Hong Kong)
+852 3508 3817
joyce.liang@baml.com

Katherine Tai
Research Analyst
Merrill Lynch (Hong Kong)
+852 3508 4439
katherine.tai@baml.com

Ingrid Hsu
Research Analyst
Merrill Lynch (Hong Kong)
+852 3508 2573
ingrid.hsu@baml.com

GEMS Corporate Credit Rsch
BofAS
+1 646 855 4096

Local investors continued to dominate Asian USD issuance

In the past decade, Asia-based investors' dominance of USD bond primary deals has been growing progressively to 79% in the first five months of 2019 – a significant rise from 53% in 2010 and 64% in 2015, while the new order books from both the US and Europe accounts have been shrinking in recent years, partly because more global funds have established their presence in Asia. Note that US demand has been weakening at a faster pace than those from Europe, partly due to the declining share of 144A issuance.

Gradual comeback of banks' participation in 2019

The surge in banks' participation rate from 16-18% in 2010-14 to 27-33% in 2015-16 was mainly due to an influx of demand from Chinese banks. Subsequently, the numbers declined to 27% by 2017 and 23% by 2018, respectively, given the stabilization/ appreciation of the RMB against the dollar. The Sino-US trade conflict, since early 2018, has pushed CNYUSD to the weaker range, with recent exchange rate approaching the psychological 7.0 level. Looking ahead, banks may get more support from a gradual return of China bids as we are seeing a modest pick-up in banks' participation rate to 26% 2019 YTD vs 23% in 2018. By sector, banks have been mostly active in Asian financials' new issuance, while they were least involved in Asian sovereigns over the last few years.

Foreign investors most active in Indon, India & Sovereign

Despite the overall trend of declining foreign participation in Asian USD new issuances, foreign investors remain more involved in deals from Indonesia & India, followed by Philippines and Korea; but largely shunned Chinese deals. By security type, foreign investors have been most active in Asian sovereigns, buying 62% of the new issuances, while they were least involved in Asian financials, subscribing to less than 20% of the new deals in the space.

China: foreign investors prefer Tier-1 SOEs, IG Tech names

For China USD new deals standalone, foreign interests appeared more prominent in the Tier-1 state-owned enterprises/SOEs (eg. CNOOC, Sinopec, China Three Gorges, State Grid, etc.) and IG Tech names (eg. Baidu, Huawei, Lenovo, JD, etc).

Asia credit volatility relatively subdued on a global scale

On a global scale, Asia IG volatility remains the lowest, while Asia HY ranks the second lowest after Euro HY as a majority of Chinese investors adopt the buy-and-hold to maturity strategy. Within Asia, volatilities in both China IG and China HY have been comparatively more subdued, owing to the strong dominance of Chinese investors in Asian dollar new issuances. Meanwhile, both Indonesia and India have witnessed greater volatility in both IG and HY. During an economic downturn, India and Indonesia tend to suffer more than other Asian countries, led by potential capital outflow. By sector, trade war escalation has resulted in a sharp spike in China tech volatility since 2018.

China USD credit still offers attractive risk-adjusted return

In summary, we think China offshore USD credit still offers decent risk-adjusted returns versus its EM peers given the lower volatility. In our view, investors seeking diversification could add risk through India, Indonesia and selected Asian sovereigns.

Refer to important disclosures on page 9 to 11.

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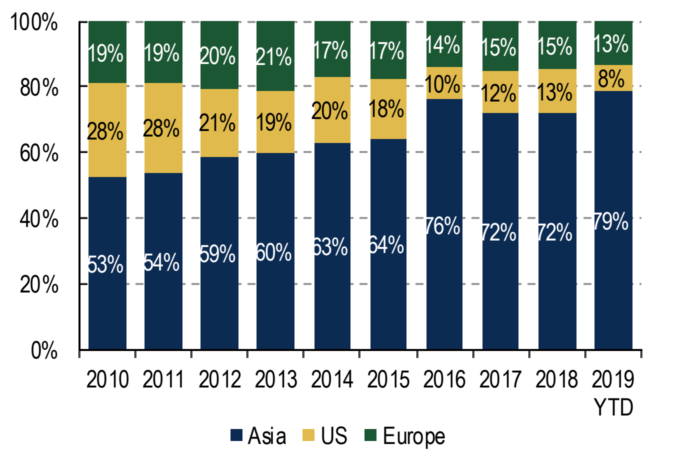
Strong Asian participation caps volatility

Asian investors continue to dominate Asian USD issuance

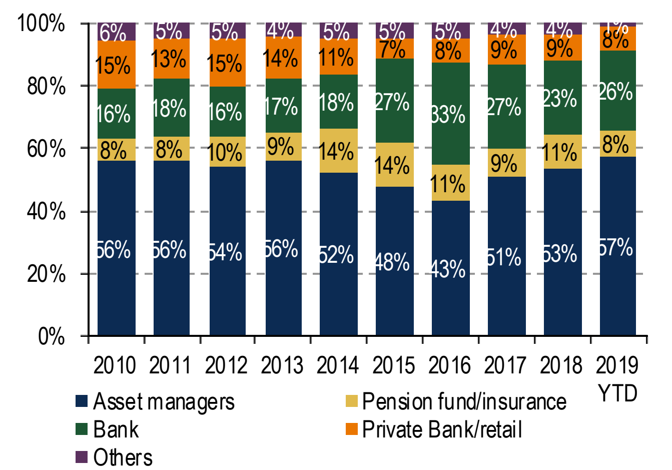
In the past decade, Asian investors' dominance of Asian USD bond primary transactions has been growing progressively to 79% YTD-2019, a significant rise from 53% in 2010 and 64% in 2015 (Chart 1). Among the foreign investors, new order books from both the US and Europe have been consistently shrinking in recent years, though US demand has been weakening at a faster pace than that from Europe, partly attributable to the declining share of 144A issuance. In recent years, more Asian issuers have opted for the Regulation S-only format due to the less stringent regulatory and disclosure rules as well as lower fee consideration. Alternatively, another possible reason could be more global funds have been building or strengthening their presence in the Asian region, so those purchases would be considered as local investor buying.

Chart 1: Asia new issues investor base breakdown by region



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 2: Asian new issues investor base breakdown by investor type



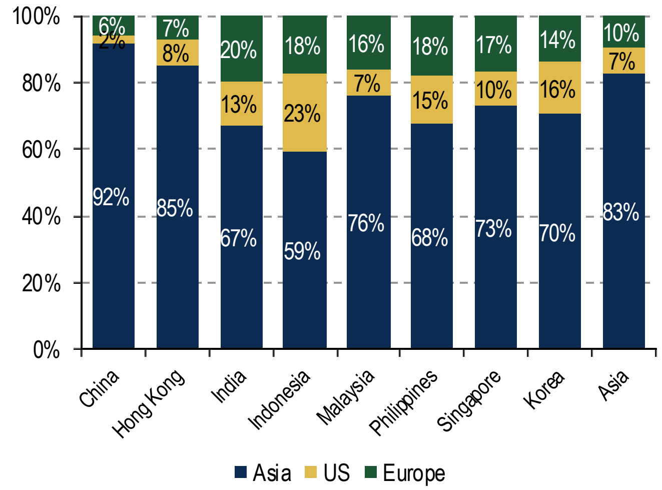
Source: Bloomberg, BofA Merrill Lynch Global Research

Gradual comeback of banks' participation in 2019

Chart 2 shows the Asian new issue distribution by investor type over the past decade. Institutional asset managers (57% YTD-2019) have always been the largest investor group, followed by banks (26%) and pension fund/Insurance (8%) as well as private banking/PB (8%).

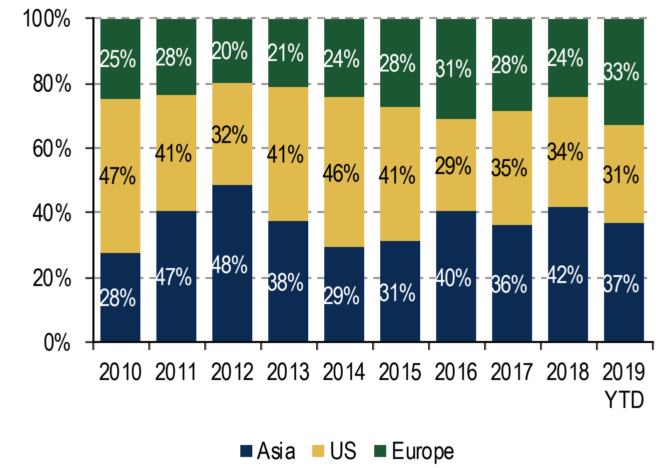
Note that the surge in banks' participation rate from 16-18% in 2010-14 to 27-33% in 2015-16 was mainly driven by an influx of demand from Chinese banks. Subsequently, the number declined to 27% by 2017 and 23% by 2018, respectively, given the stabilization/appreciation of the RMB against the dollar. The Sino-US trade conflict, since early 2018, has pushed CNYUSD to the weaker range with recent exchange rate approaching the psychological 7.0 level. Looking ahead, banks may receive more support from a gradual return of China bids as we are seeing a modest pick-up in banks' participation rate to 26% 2019 YTD vs 23% in 2018. By sector, banks had been mostly active in Asian financials' new issuance, while they were least involved in Asian sovereigns over the last few years.

Chart 3: Asia new issues investor base breakdown by region into individual country (2016-2019 YTD)



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 4: Asian sovereign new issues investor base breakdown by region

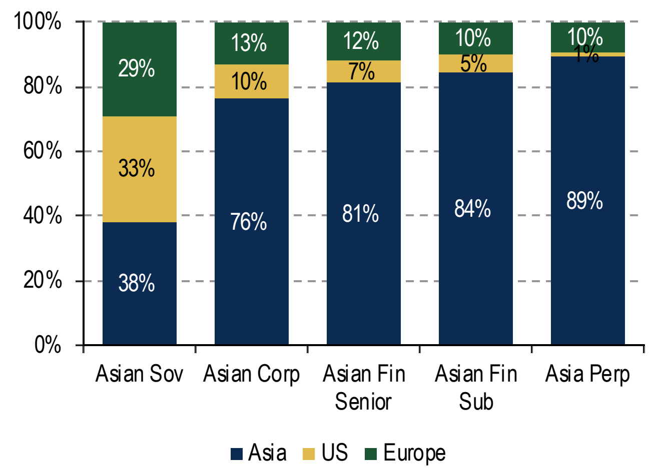


Source: Bloomberg, BofA Merrill Lynch Global Research

Foreign investors most active in Indonesia, India and Sovereign

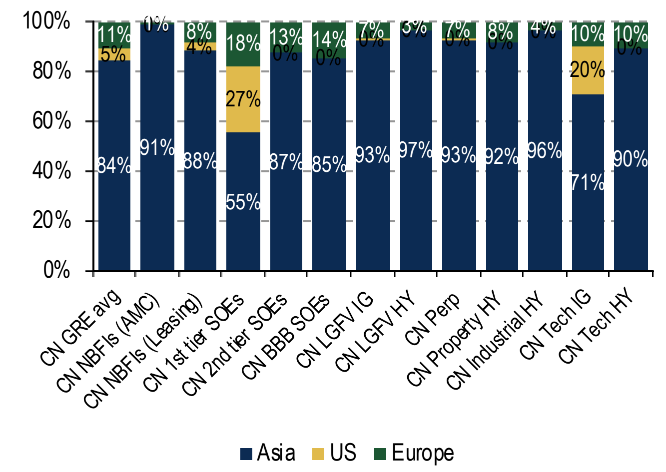
To determine how the investor base varies for individual Asian countries, we used the new issues' buyer distribution data over the period 2016 to 2019 YTD (Chart 3). As expected, China had the highest participation from Asian investors, followed by Hong Kong, while the US and European-based funds have been generally more diversified with a higher allocation to Indonesia and India, followed by the Philippines and Korea. By security type, foreign investors have been most active in Asian sovereigns, buying 62% of the new issues (Chart 4), while they were least involved in Asian financials, subscribing to less than 20% of the new deals in the space (Chart 5).

Chart 5: Asia new issues investor base breakdown by security type by region (2016-2019 YTD)



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 6: China new issues investor base breakdown by sector by region (2016-2019 YTD)



Source: Bloomberg, BofA Merrill Lynch Global Research

China: foreign investors favor Tier-1 SOEs, IG Tech names

For China USD new deals standalone, foreign interests appeared more prominent in the Tier-1 state-owned enterprises/SOEs (eg. CNOOC, Sinopec, China Three Gorges, State Grids, etc.) and IG Tech names (eg. Baidu, Huawei, Lenovo, JD, etc) (Chart 6).

Volatility

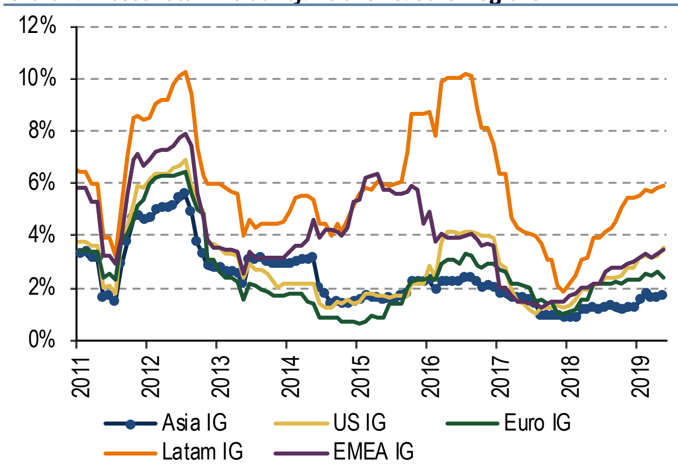
India & Indonesia credits more volatile than China

On a global scale, Asia IG volatility has been hovering at a low level vs other regions and the divergent trend has grown more evident since 2018 (Chart 7). During 2012-13, Asia HY used to exhibit much greater volatility but has become relatively more stable in recent years (Chart 8). It is interesting to note that the regional HY volatility has been moving quite consistently in the same direction since 2017. In the face of an increasingly synchronized global growth slowdown and trade war escalation, global HY has seen volatility ratcheting up fast since early 2018.

Within Asia, volatilities in both China IG and China HY have been more subdued, thanks to the continual increasing participation from Chinese investors in the Asian dollar bond market in recent years. Note that a majority of Chinese investors adopt the buy-and-hold to maturity strategy, instead of a high-frequency trading style which is more often seen with global institutional accounts.

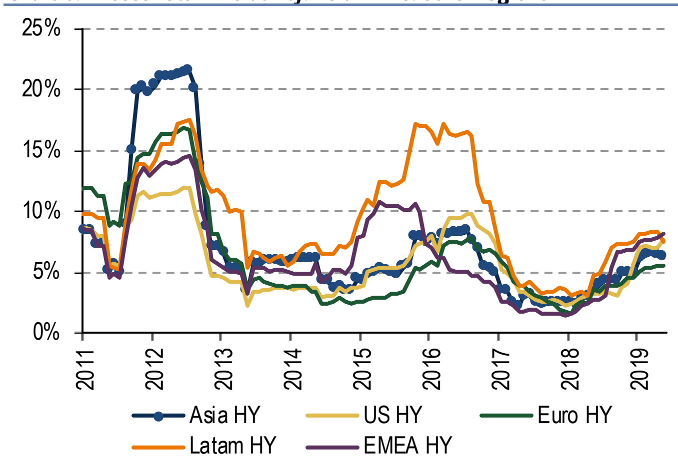
Given the stronger involvement from foreign investors (shown in primary deal statistics in earlier section and EPFR country allocation (Charts 11-12), both Indonesia and India have witnessed greater volatility for both IG and HY (Charts 9-10). During an economic downturn, India and Indonesia tend to suffer more than other Asian countries, led by abrupt capital net outflow.

Chart 7: Excess return volatility: Asia IG vs. other regions



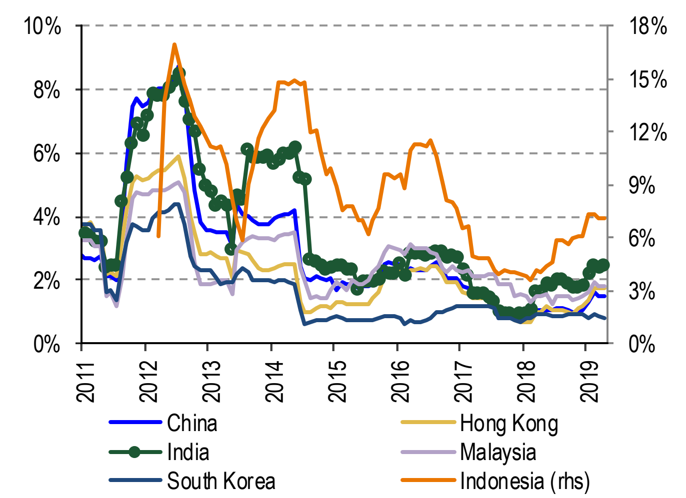
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 8: Excess return volatility: Asia HY vs. other regions



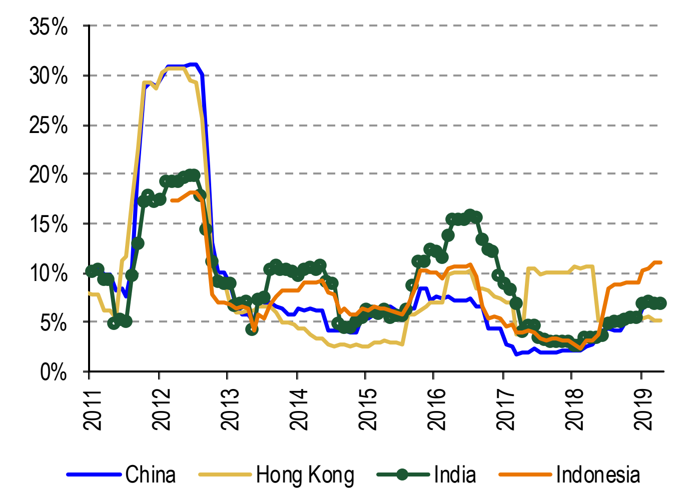
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 9: Excess return volatility for Asian IG credits by country (Note: Indonesia RHS; others LHS)



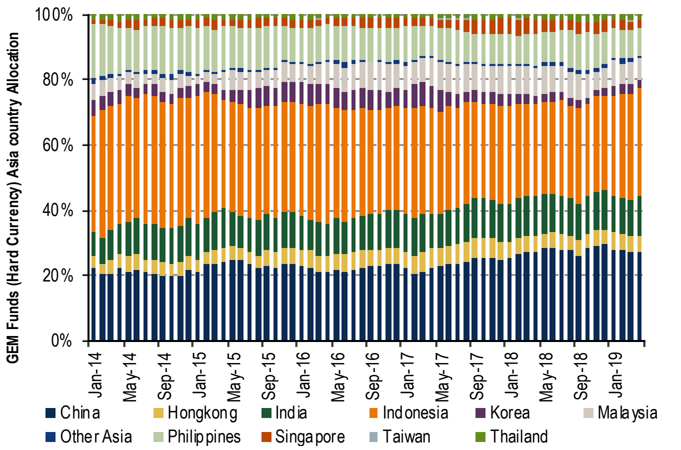
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 10: Excess return volatility for Asian HY credits by country



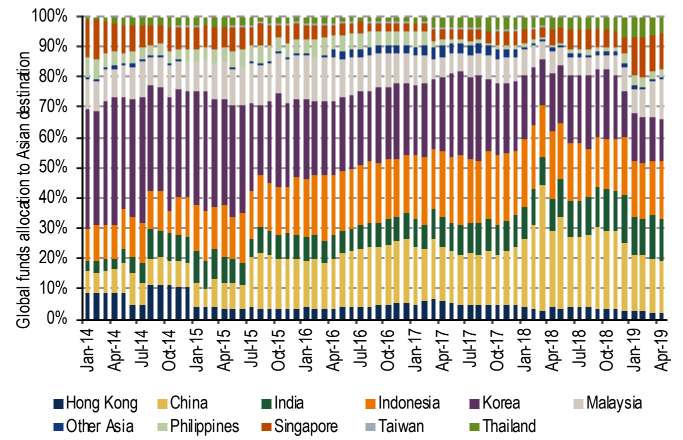
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 11: GEM fund (hard currency) Asia country allocation



Source: EPFR

Chart 12: Global fund (hard currency) Asia country allocation

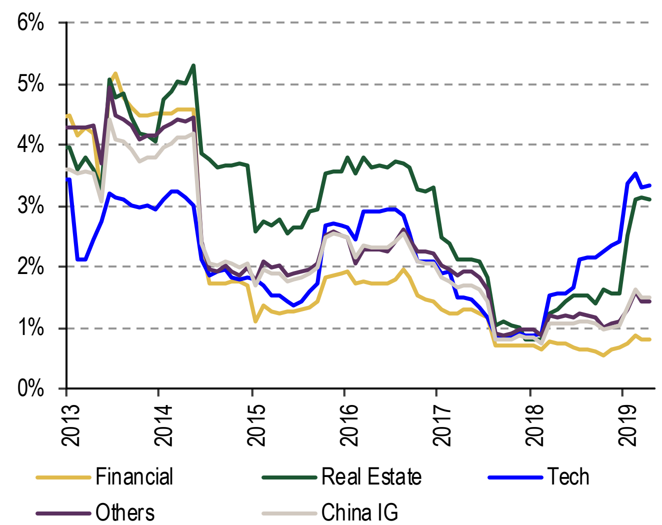


Source: EPFR

Sharp spike in China Tech vol on trade war escalation

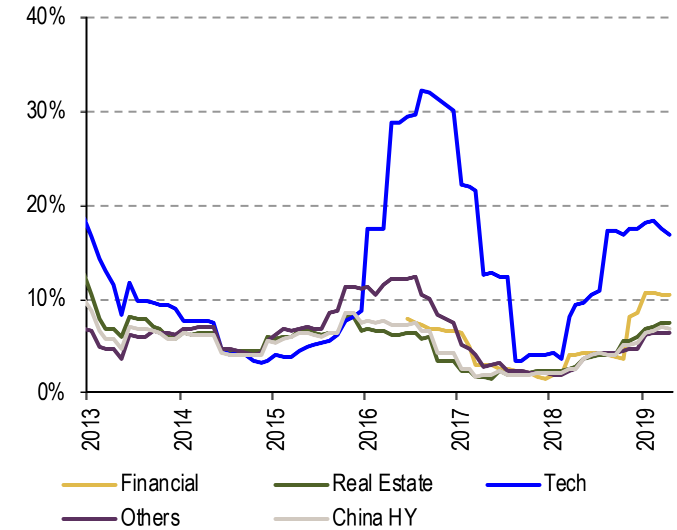
The two charts below single out China IG and HY volatility breakdown by major sectors. Since President Trump fired the first bullet by imposing a 25% tariff on steel and 10% on aluminum and restricting foreign investment in key technology industry in March last year, China Tech names have been hit hard with spreads narrowing more on the long-end than short-end. On an aggregate level, BAT (Baidu, Alibaba and Tencent) saw spreads widen by nearly 80bp in 2018 before stabilizing in the first four months of this year on receding trade tensions but has resumed widening again in May on trade talks impasse.

Chart 13: Excess return volatility for China IG credits by sector



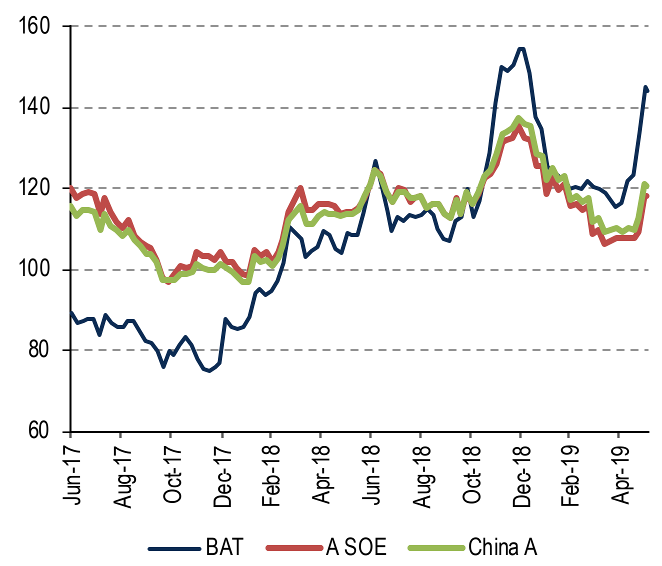
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 14: Excess return volatility for China HY credits by sector



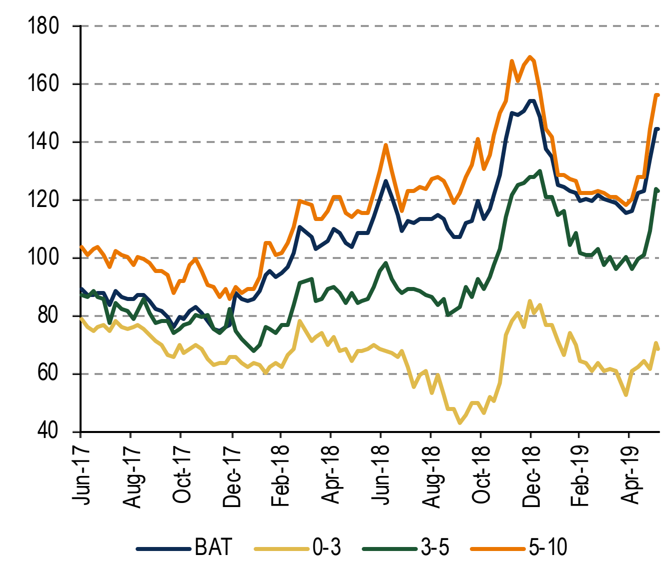
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 15: BAT spread vs China A and A SOE



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 16: BAT (Baidu, Alibaba and Tencent) spread by duration



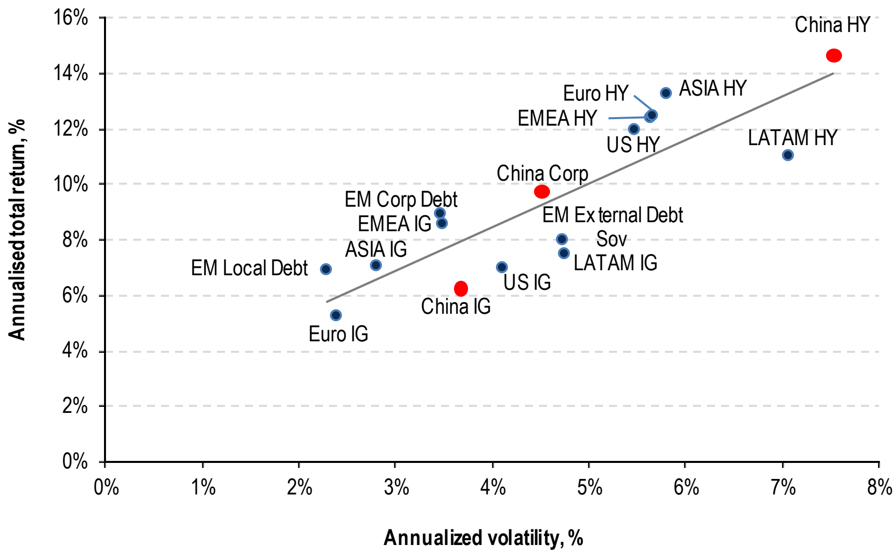
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Risk-adjusted return

China HY still attractive from a risk-reward perspective

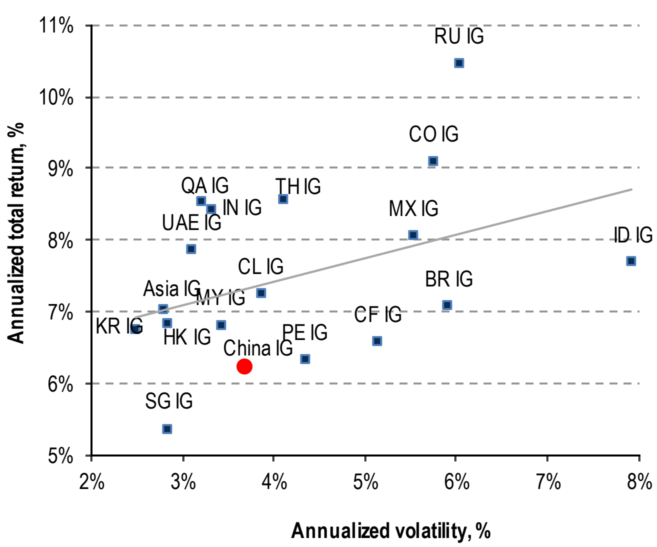
The charts below show the past 10 years' relationship between the annualized total return and annualized volatility by region and by country for IG and HY, respectively. With IG, China has customarily been trading at a richer valuation versus its EM peers as a majority of the Chinese IG issuers are SOEs. However, the dynamics are quite different when it comes to the HY space. Versus its EM peers, China HY has been offering attractive risk-adjusted returns.

Chart 17: Annualized total returns vs annualized volatility by region (2009-YTD 2019)



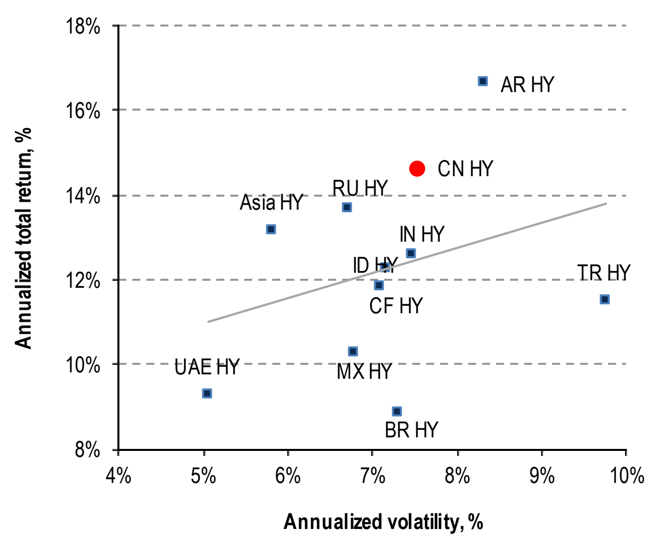
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC
Note: Annual data from weekly data over 2009 to 24 May 2019.

Chart 18: Annualized total returns vs annualized volatility – IG



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 19: Annualized total returns vs annualized volatility – HY



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

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