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IDEA

November 25, 2018 11:00 PM GMT

2019 Asia Credit Outlook | Asia Pacific

Waiting for the Bottom to Be Bullish

We see 2019 as a transition period for Asia credit towards the bottom of the cycle. Valuations don't fully reflect weakness in fundamentals. We stay cautious but lay out three signposts that would make us bullish. Investors should focus on alpha opportunities through single-name credits in 2019.

Transitioning from the peak of the market to the bottom: Among all the asset classes, credit benefited the most from a lower rates and lower volatility environment that had persisted for the past decade. It was the asset class that saw the most inflows due to investors' 'pursuit for yield'. However, we went through a paradigm shift this year, where DM central banks were hiking rates and withdrawing QE due to strong growth and improving inflation numbers. This led to our rolling bear market thesis that all asset classes would not be spared from producing negative returns this year, beginning with EM equities at the start of the year to the last asset class standing – US HY (it had positive returns up to mid-November). Asia credit was no exception, as 2018 clearly marked the end of the 10-year Asia credit bull market (Exhibit 1) due to tightening financial conditions in Asia (especially China), and we expect this to remain the case in 2019. Although valuations have cheapened, we don't think that they fully reflect the fundamental challenges in the asset class, signalling further weakness ahead. Hence, we don't think that we are at the bottom of the cycle yet.

The need for investors to change their mindset: Similarly to when we wrote our 2018 outlook (see All Eyes on Financial Conditions, November 26, 2017), we believe that psychology is an important driver of Asia credit spreads. We believe that investors need to get over the 'buy on the dip' market mindset as this strategy only works in a low rates and low volatility environment. Investors also need to remind themselves that investing in credit against a macro backdrop of higher rates and higher volatility is about navigating the negative skew that exists in credit returns. This basically means that to succeed in credit investing in the long run it is all about being consistent at producing positive returns by avoiding the defaults. How do investors achieve consistency? Eliud Kipchoge, the current marathon world record holder (we would think that, of all the sporting events, marathon is the sport that rewards long periods of consistency) once said "When you bring motivation and discipline (together), then you can be consistent". Hence, we think that, going into 2019, investors should not get demotivated, given the widening in credit this year, but instead see this as an opportunity to take advantage of the current high dispersion. However, this motivation needs to be combined with the discipline of combing through each credit to differentiate them.

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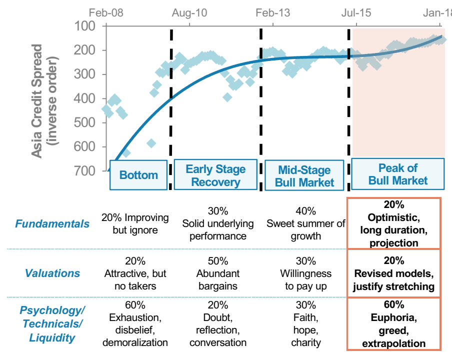
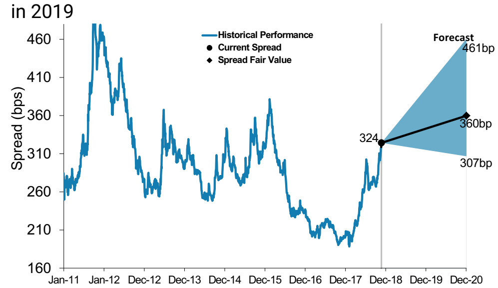
Exhibit 1: Market phases for Asia credit



Source: Adapted from *The Art of Asset Allocation*, Second Edition, by David M. Darst, CFA (McGraw-Hill, 2008), iBoxx, Morgan Stanley Research

Exhibit 2: Our base case is for Asia credit to widen 36bp in 2019



Source: iBoxx, Morgan Stanley Research forecasts

Executive summary: Waiting for the bottom to be bullish

Waiting a little longer to turn bullish: We remain cautious on Asia credit as the asset class transitions from the bull market to the downturn phase of the cycle. Although valuations have cheapened, we don't think that they fully reflect the fundamental challenges for the asset class, signalling further weakness ahead. That said, we are clearly less bearish on Asia credit in 2019 compared to the last two years, and our forecasts reflect this (Exhibit 3). We think there is a good chance that Asia credit finds a bottom somewhere around mid-2019, as our economists are expecting the Fed to pause after the June rate hike, which should ease financial conditions and support growth in the region. There are three key signposts we are waiting for before turning bullish: i) An improvement in onshore credit creation for Chinese corporates; ii) De-escalation in China-US trade tensions; and iii) Valuations pricing in fundamental weakness.

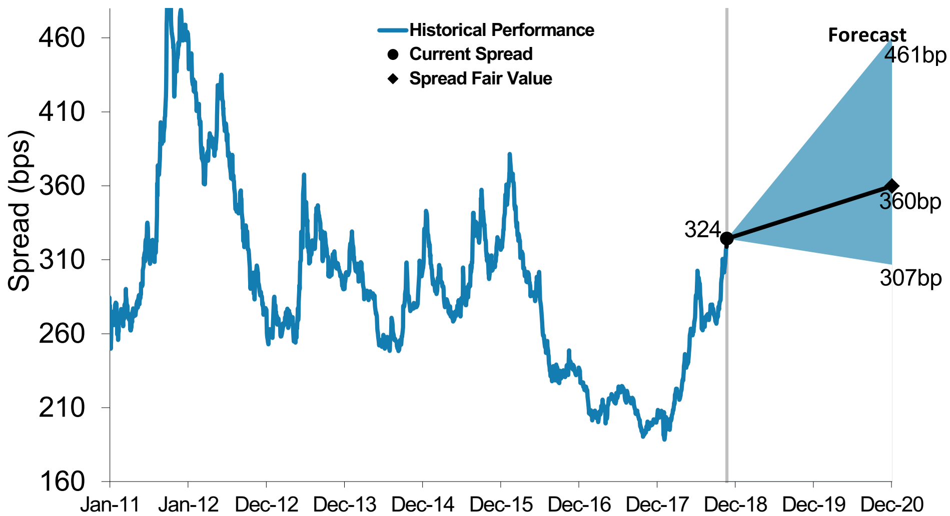
Financial conditions in Asia should remain tight, especially in China: We expect China to continue using fiscal easing in 2019 to cushion the impact of trade tariffs and weak broad credit growth. However, the current easing cycle in China is not credit-driven, unlike the past two easing cycles. Besides China, a sharp drop in loan growth for the rest of the region also shows signs of tightening financial conditions. This implies further dispersion within Asia credit and the potential for higher defaults in 2019. Hence, we believe that investors should expect more downside risks in their portfolio as fundamentals deteriorate further. Technicals should remain weak next year, given lacklustre demand and elevated supply (Exhibit 4), driven by a large debt maturity wall.

Maintaining our preference for IG and taking advantage of high dispersion: We stick to our up-in-quality view, preferring Asia IG over HY and China IG over HY. We also recommend taking advantage of high dispersion in Asia credit by differentiating China IG central SOE sectors by technicals and picking up high-quality credit in the China HY property sector.

Below are our key trade ideas for 2019

1) Up-in-quality trade: Prefer Asia IG over Asia HY, China IG over China HY
2) Staying EW in China IG central SOE but differentiating single-name credits by technicals
3) UW China HY sector: Long select high-quality China property names
4) Increasing duration in Asia IG corporates (3-5Y and 5-7Y)
5) Turning EW from UW on Indonesia sovereign and SOE
6) UW senior financials: China leasing is the sweet spot

Exhibit 3: Our base case is for Asia credit to widen 36bp in 2019



Source: iBoxx, Morgan Stanley Research forecasts

Exhibit 4: We expect gross issuance to increase by 36% but net issuance to be 10% lower in 2019

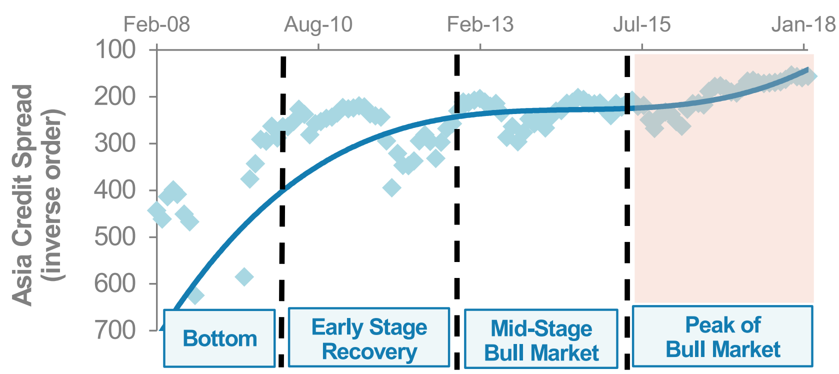
	2019 Supply Forecast (2018 YTD)					
(USD bn)	Total	IG Corp	HY Corp	Banks	Non Banks	Sov
Gross issuance	**198 (145)**	65 (56)	50 (53)	49 (13)	20 (9)	14 (13)
Redemptions	144 (87)	43 (31)	23 (20)	47 (23)	19 (9)	12 (3)
Net issuance	53 (59)	22 (25)	26 (34)	2 (-10)	1 (0)	2 (10)

Source: Bloomberg, EMDB, Morgan Stanley Research forecasts

A review of 2018 – the end of the Asia credit bull market

As the saying goes, "hindsight is 20/20". 2018 clearly marks the end of the 10-year secular bull market in Asia credit. Asia credit spreads were at 13-year tights (the furthest our data could go back to) early this year, marking the "peak of the bull market" phase in David Darst's (author of *The Art of Asset Allocation*) famous asset class cycle framework (Exhibit 5). Since then, we have transitioned slowly towards the bottom phase of this framework but we don't think we are at this phase yet as fundamentals are not improving and valuations, although cheaper, are not pricing in the fundamental weakness. That said, technicals and investors' psychology are matching the characteristics of the bottom of the cycle. Technicals remain weak for Asia credit and most investors we met in the past two to three months told us that they are cautious on Asia credit.

Exhibit 5: The peak of the 10-year Asia credit bull market ended early this year

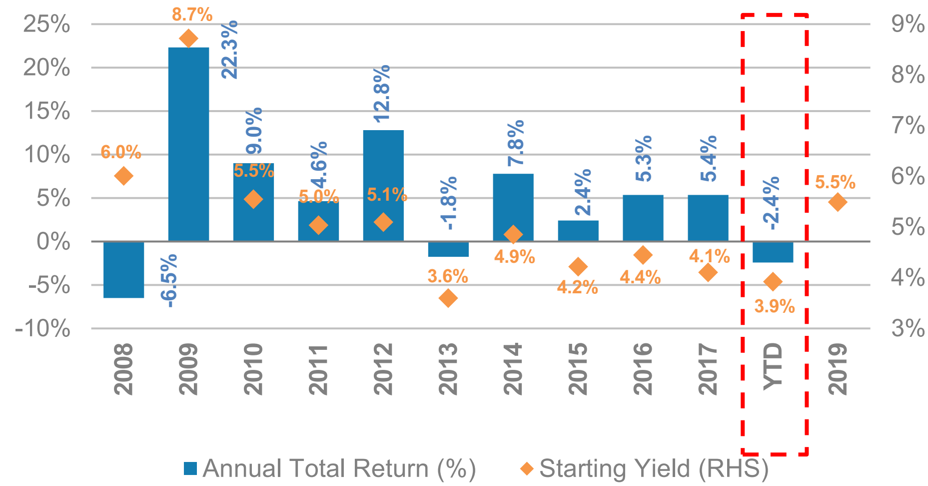


Fundamentals	20% Improving but ignore	30% Solid underlying performance	40% Sweet summer of growth	**20% Optimistic, long duration, projection**
Valuations	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	**20% Revised models, justify stretching**
Psychology/ Technicals/ Liquidity	60% Exhaustion, disbelief, demoralization	20% Doubt, reflection, conversation	30% Faith, hope, charity	**60% Euphoria, greed, extrapolation**

Source: Adapted from The Art of Asset Allocation, Second Edition, by David M. Darst, CFA (McGraw-Hill, 2008), iBoxx, Morgan Stanley Research

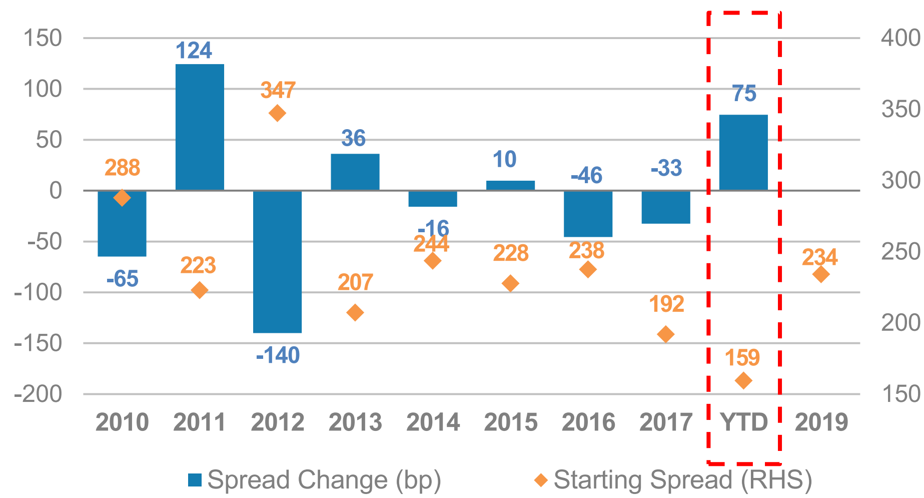
YTD Asia credit total returns have been at the worst level since the 2008 Global Financial Crisis. Between 2009 and 2017, Asia credit had only one year of underperformance – in 2013 – and that underperformance was better than the YTD -2.4% return (Exhibit 6). The story for Asia credit spreads is slightly different; between 2010 and 2017, there were three years of Asia credit spread widening (Exhibit 7). The current YTD spread widening is the largest since 2011. The good news is that Asia credit is probably going to start 2019 at a much higher spread of 234bp, which is similar to the level at the start of year in 2014-16. In terms of yield, the current yield of 5.5% is the highest since 2010. Hence, Asia credit is likely to start 2019 with a much greater buffer compared to 2018, when spreads were the tightest and yields were close to the lowest.

Exhibit 6: This year's Asia credit total return is the worst since the 2008 Global Financial Crisis



Source: iBoxx, Morgan Stanley Research; Note: Pricing as of November 9, 2018.

Exhibit 7: Asia credit saw the largest widening in spreads this year since 2011



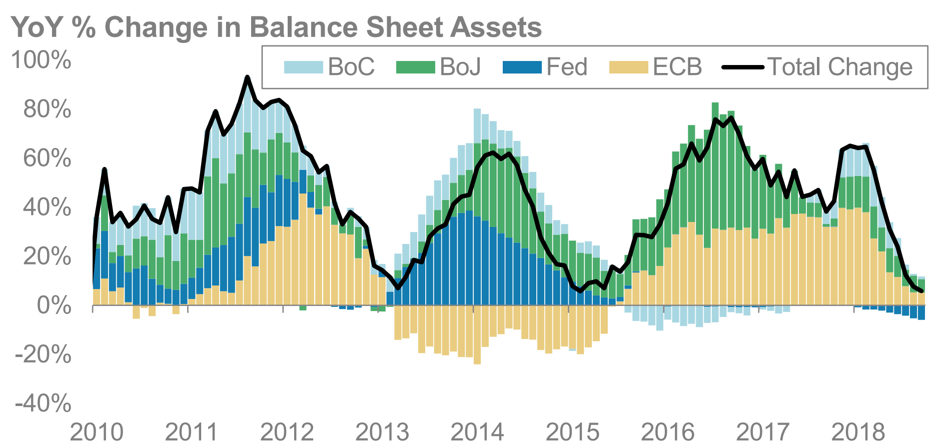
Source: iBoxx, Morgan Stanley Research; Note: Pricing as of November 9, 2018

Three key Asia credit themes going into 2019

1) Further tightening of global financial conditions and higher volatility…

Going into 2019, global financial conditions should remain tight as we expect G3 central banks to remain on their tightening monetary policy path. We expect the Federal Reserve to hike three times (December 2018, March 2019 and June 2019), and the hikes to end in 1H19. We expect the Fed to pause after that before it resumes hiking in 2020. The ECB will be playing catch-up to the Fed, as our economists expect the ECB's first hike to be in October 2019 followed by two more rate hikes in 2020 (1Q20 and 3Q20). Lastly, for the BoJ we expect it to adjust the NIRP in 2Q19 by raising the policy rate by 10bp to 0%. In addition, we have a backdrop of DM central banks unwinding their balance sheets (Exhibit 8). The Fed started last year and will continue to do so until 2H19, while we expect the ECB to end QE by the end of this year. In short, we believe that financial conditions will only get tighter in 2019, especially in 1H.

Exhibit 8: DM central banks had been reducing their balance sheets in 2018

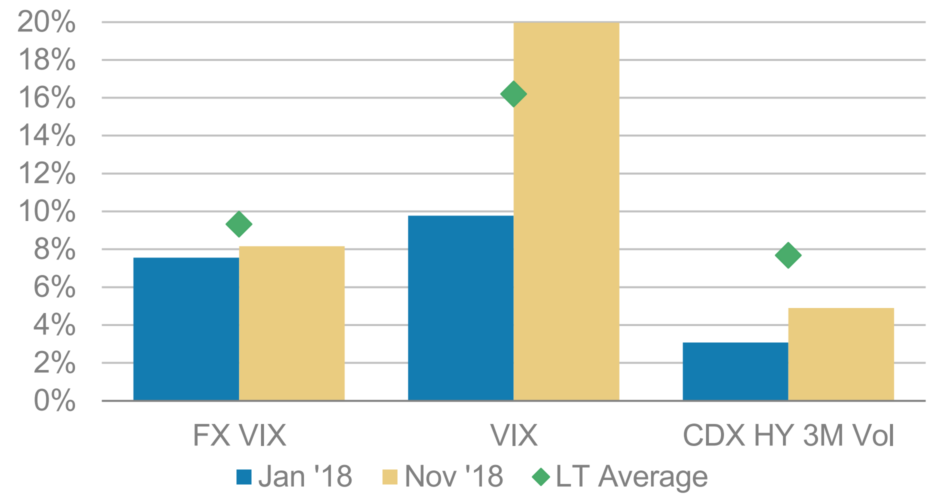


Source: Bloomberg, Morgan Stanley Research

One of the biggest impacts of the aforementioned DM central banks' move to tighten financial conditions is a potential pick-up in risk asset volatility. Central banks were clearly the main volatility dampener for global risk assets in this cycle, where volatility for most asset classes hit historical lows. For example, the VIX hit a 28-year historical low in 3Q17. Not surprisingly, with the Fed withdrawing its balance sheet and hiking four quarters in a row since December 2017, we are starting to see risk asset volatility pick up (Exhibit 9).

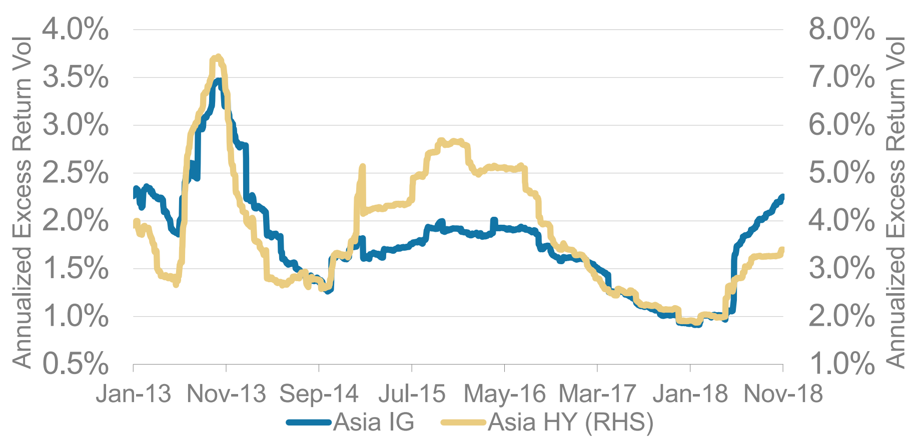
We would argue that credits benefit the most from a low rate and low vol macro backdrop, especially if one thinks of credit as shorting a put option. As volatility starts picking up, the credit risk premium would need to reprice higher (i.e., higher credit spreads). Not surprisingly, given the widening in Asia credit spreads, volatility also started to pick up (Exhibit 10). Although there has been a significant increase in Asia credit vol for both Asia IG and Asia HY, we are only back to the average vol in the past five years and **we see room for volatility to pick up, especially for Asia HY, which would put pressure on spreads to widen.**

Exhibit 9: Volatility is picking up throughout various asset classes



Source: Bloomberg, Morgan Stanley Research

Exhibit 10: Asia credit volatility has picked up significantly since the middle of the year



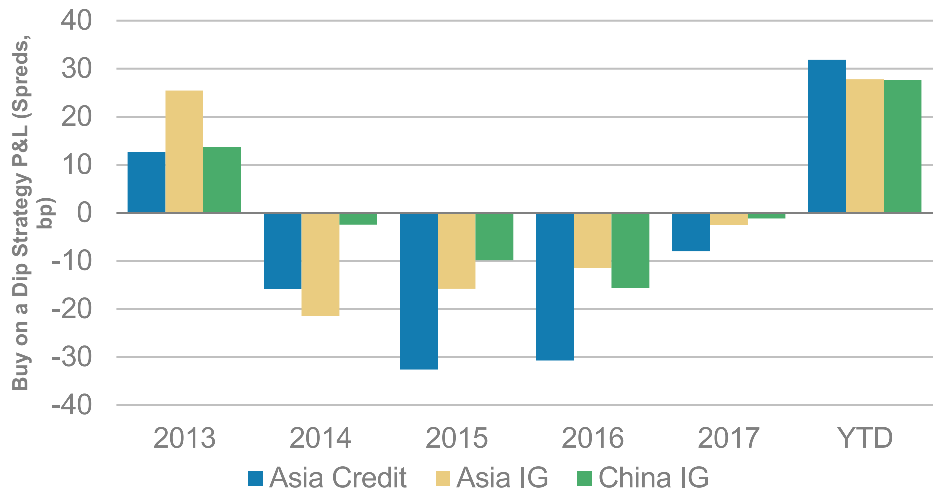
Source: iBoxx, Yieldbook, Bloomberg, Morgan Stanley Research

…mean that Asia credit is no longer a 'buy on the dip' market

Exiting a lower rates and lower volatility environment means that investors would need to change their 'buy on the dip' mindset, which worked so well in this cycle. We believe that this strategy only works in a low rate and low volatility environment where investors are forced to search for yield and where there is massive spread compression. We set up a very simple ' buy on the dip' strategy for Asia credit, where for every month of negative performance in Asia credit, the strategy would buy the following month. The strategy would do nothing the following month if the return is positive.

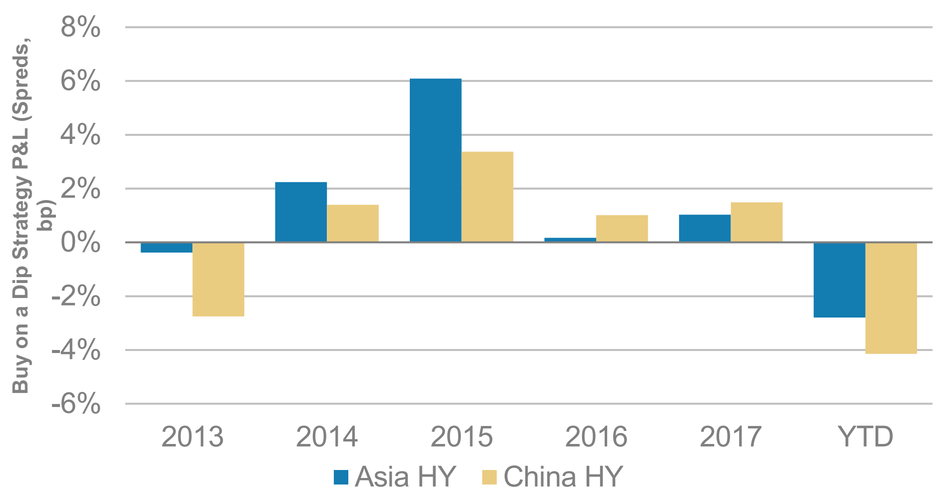
With this strategy, an investor would be able to produce a positive return (spread tightening) in four out of the past five years, between 2013 and 2017 (Exhibit 11). The story is the same for Asia IG and China IG but with a slightly different magnitude. The 'buy on the dip' strategy didn't work in 2013 due to the taper tantrum, which is the same macro backdrop we are moving into now. If we apply the same strategy in HY (Exhibit 12), and look at total returns, the strategy only produced one negative return between 2013 and 2017. However, if we look at the YTD performance of this strategy, it has had the worst performance so far since 2013. For example, the current -4.15% return in China HY more than offset the gains in 2016 and 2017. **Hence, we think that investors need to be wary of 'buying on the dip' as it is less likely to produce a positive return, given that we expect a further increase in volatility and tighter financial conditions.**

Exhibit 11: 'Buy on the dip' strategy no longer works for Asia credit and Asia IG



Source: iBoxx, Morgan Stanley Research; The performance data provided is a hypothetical illustration of mathematical principles; it does not predict or project the performance of an investment or investment strategy. Past performance is no guarantee of future results.

Exhibit 12: 'Buy on the dip' strategy no longer works for Asia HY



Source: iBoxx, Morgan Stanley Research

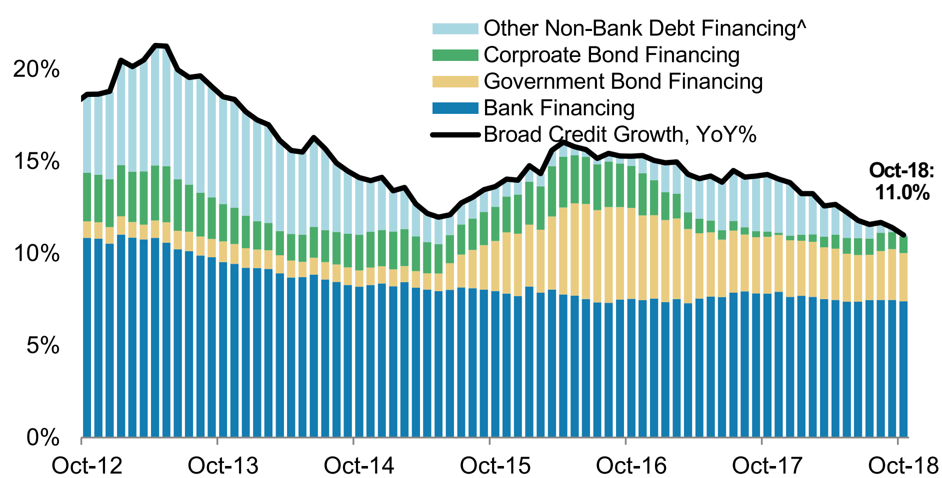
2) Tight financial conditions in Asia, especially China, drive credit dispersion further…

As mentioned in Screening the China HY Property Sector for Alpha, October 19, 2018, we continue to expect credit dispersion to pick up in Asia. We also continue to expect financial conditions to be tight in 2019 for China. We don't subscribe to the view that China is in a credit easing cycle, like it was in 2010-11 and 2012-13. We believe that China is using fiscal easing measures to try to offset the impact from US trade tariffs and is also slowing broad credit growth (Exhibit 13). The recent broad credit growth number in October slowed further by 40bp versus September, and half of the slower growth was driven by shrinking shadow banking credit (see Weaker Credit Growth amid Sluggish Business Lending, November 13, 2018).

As pointed out by our China bank analyst, Richard Xu, October's weak TSF shows that 'automatic' tightening from proper financial regulations remains in place (see When price tag is clear, choices become harder, November 14, 2018). We agree with him that a more transparent financial system makes the price tag for supporting economic and credit growth much clearer. Despite periodic credit support from government bonds, we think that a major credit impulse from China is unlikely. **Hence, despite some investors preferring to call the recent measures (such as RRR cuts, policies supporting private enterprise, etc.) by Chinese policy-makers as 'outright easing', we prefer to think of them as 'offsetting automatic tightening'. Hence, we still think the net result is that financial conditions will remain tight in China.**

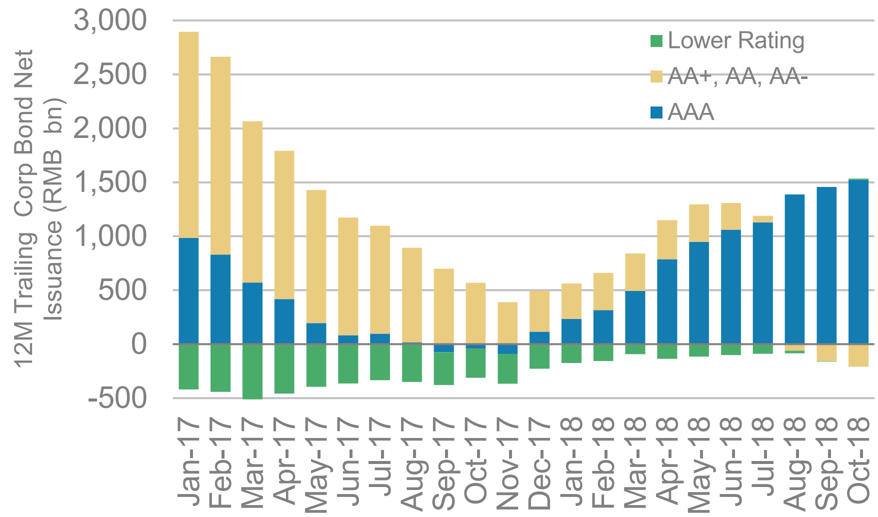
Two key data points we are monitoring closely on credit creation for Chinese corporates are: i) AA corporate bond net issuance; and ii) Banks' medium-to-long-term loan growth. Unfortunately, both are showing signs of weak credit creation. AA corporates' net issuance remained negative, while banks' medium-to-long-term loan growth is on a decline. After a weak September net issuance for AA corporates, we saw an improvement in October, but it remained negative during the month. On a 12-month trailing basis, AA corporate net issuance turned more negative in October (Exhibit 14). The October bank loan number was lower than we had expected and medium-to-long-term loan growth did not increase (Exhibit 15). Hence, it is unclear whether corporates (especially small- and medium-sized corporates) are benefiting incrementally from the higher overall bank loan growth that we have witnessed. There seemed to be a lag for bank loan growth to translate into medium-to-long-term loans and the lag increased in every cycle since 2011. The lag clearly increased as banks seemed to turn more cautious with every easing cycle.

Exhibit 13: China's broad credit growth continued its year-to-date decline in October



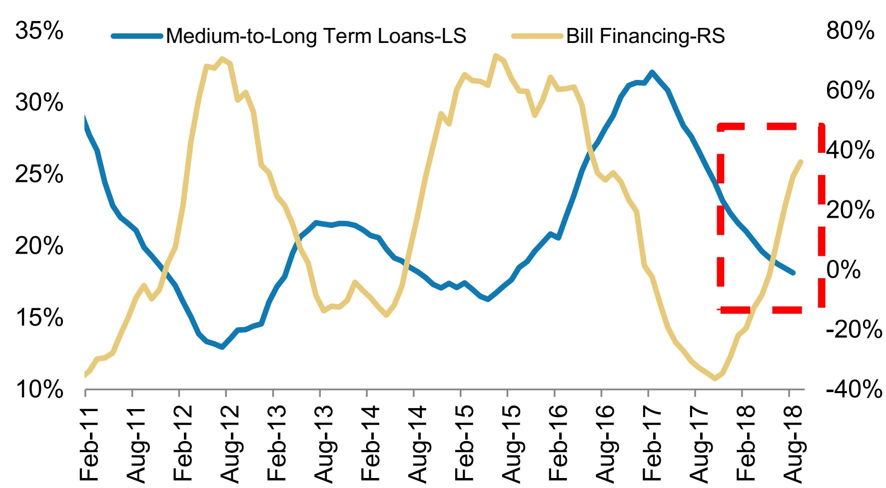
Source: CEIC, Morgan Stanley Research; ^Including entrusted loans, trust loans, bank acceptance, corporate bonds, asset-backed securities (ABS) of depository institutions and loan write-offs.

Exhibit 14: 12-month trailing net issuance has been negative since this August



Source: WIND, Morgan Stanley Research

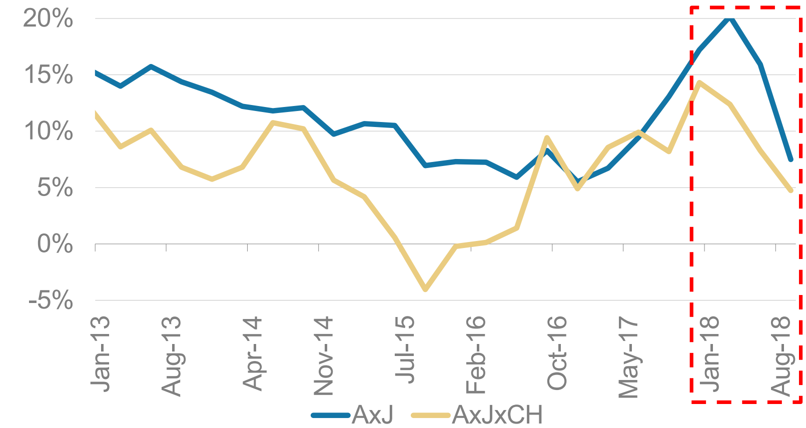
Exhibit 15: Chinese banks' medium-to-long-term lending growth had been falling since early 2017 while bill financing growth had picked up substantially



Source: CEIC, Morgan Stanley Research

Although there is a lot of focus on financial conditions in China, it is also important to note that it is not only China that is experiencing tighter financial conditions. The rest of region is also experiencing tighter financial conditions as loan growth for Asia ex China and Japan banks is currently on a downward trend; after peaking at the end of last year at 12%Y, it has declined to 5%Y this September. Given that 66% of the credit to Asia corporates and households is given by banks, we think that credit conditions will remain tight for Asia corporates if loan growth continues its downward trend. India is a good example of tighter financial conditions being experienced. In September, IL&FS, an infrastructure financing company, defaulted on its obligations, resulting in an increase in the cost of funding for non-bank financials (see It's All About Confidence, September 23, 2018). This is on top of the backdrop of rising rates in India. All these point towards tighter financial conditions in India.

Exhibit 16: Asia ex Japan banks loan growth is on a downward trend since the start of the year

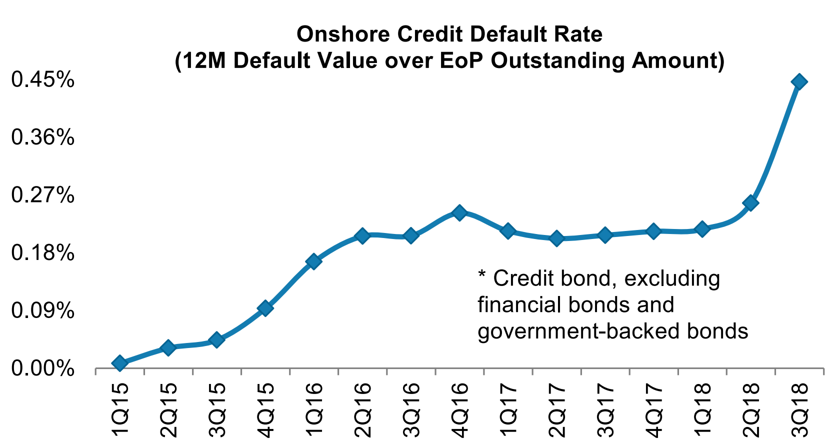


Source: CEIC, Morgan Stanley Research

…as we expect defaults to start picking up further in 2019

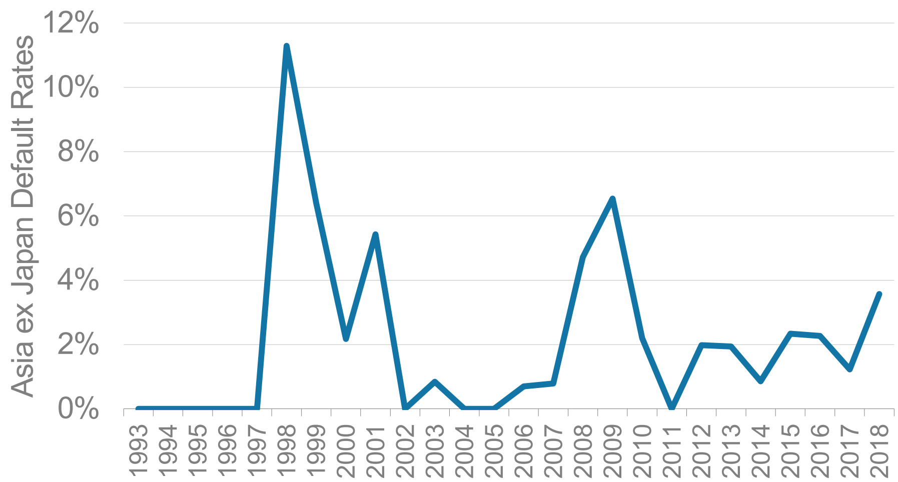
Hence, given the currently tight credit conditions, we are not surprised to see a pick-up in defaults in both the China onshore corporate bond market (Exhibit 17) and the offshore USD Asia credit market (Exhibit 18). These defaults clearly highlight the importance of credit differentiation, especially for Asia HY/China HY corporates as they are disproportionately affected by tighter financial conditions compared to their IG corporate counterparts. A case in point is the weak period following the Mid-Autumn Festival, where Qinghai Provincial Investment (QHINVG) managed to avoid an offshore USD bond default, thanks to bank funding. At the same time, there were 4-5 defaults in the onshore corporate bond market the same week. This shows that lenders themselves are being selective in who they are providing loans to. Given our expectation of tighter financial conditions in 2019, we see room for defaults to pick up for both the onshore corporate bond market and offshore USD bond market. **Based on the past three default cycles (the 1998/99 Asia Financial Crisis, the 2001 internet bubble and the 2008/09 Global Financial Crisis) in Asia credit, the average default rate is 6.9% and the Asia default cycle usually lasts for two years. Hence, we think that the default cycle that started in 2018 will continue into 2019 and is likely to surpass levels we have seen this year.**

Exhibit 17: Onshore corporate bond defaults picked up further in 3Q18



Source: WIND, Morgan Stanley Research

Exhibit 18: YTD Asia HY default rate is 3.6%*, the highest since the Global Financial Crisis in 2009

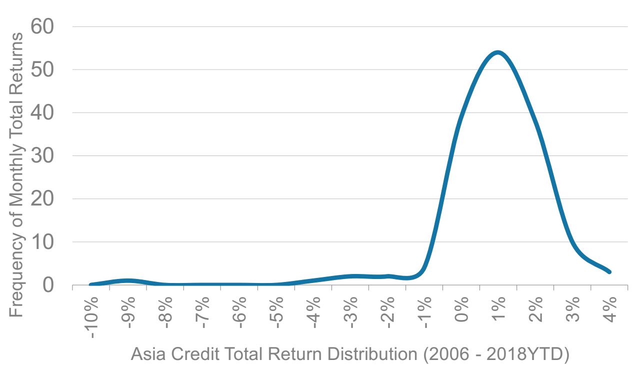


Source: S&P, Morgan Stanley Research estimates; *YTD number is an Morgan Stanley Research estimate; the rest are S&P data.

3) Downside risk matters more for Asia credit in this transition period

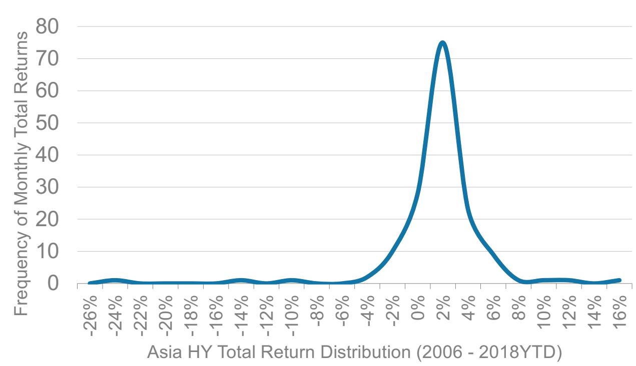
As mentioned above, we are going through a transition phase, to the bottom of the Asia credit cycle from the peak of the bull market phase, which is why we think that it is important for Asia credit investors to focus on the downside risks. If you look at Asia credit returns in a long cycle (2006-18 YTD), you notice that most of the time returns are centred on 0-2% of monthly returns, but there are large negative tail returns that are as high as 9%, which gives it a negative skew (Exhibit 19). The story is similar with Asia HY, except due to its higher carry, most of its returns are centred on 0-4%, with a negative skew that is as high as -25%. Hence, credit as an asset class tends to have a negative skew.

Exhibit 19: In a long cycle, Asia credit returns have a strong negative skew



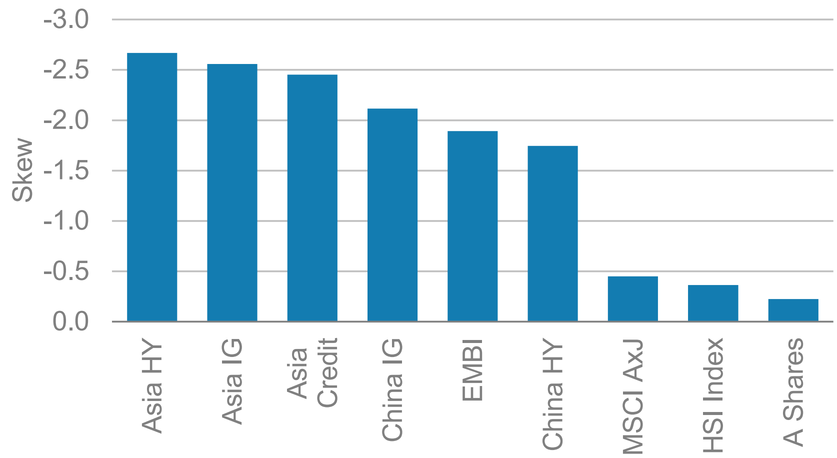
Source: iBoxx, Morgan Stanley Research

Exhibit 20: Asia HY has the highest negative skew among Asia credit sectors



Source: iBoxx, Morgan Stanley Research

Exhibit 21: Credit has a much more negative skew than equities



Source: .Bloomberg, iBoxx, Morgan Stanley Research

You cannot invest in credit in the same way that you invest in equities

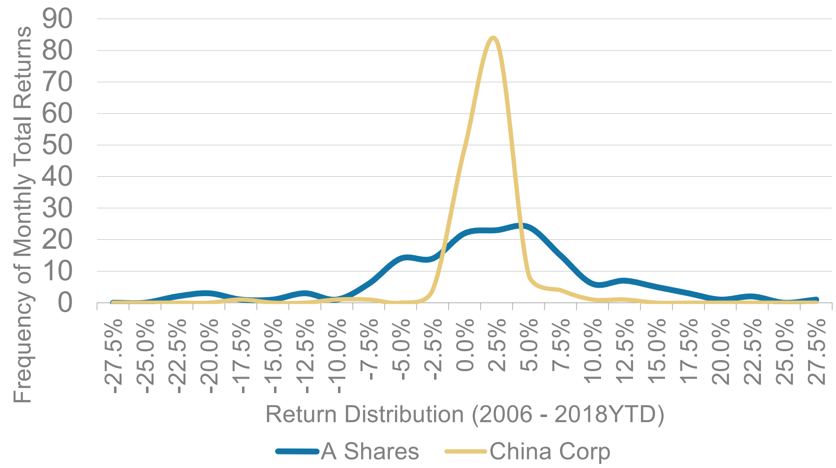
If one compares the skew of credit versus equity, one would notice that credit is substantially more negatively skewed than equity (Exhibit 21). We can understand why by comparing Chinese corporate credit returns with A-share returns (Exhibit 22). Chinese credit clearly has a high number of monthly returns that is around the mean and a negatively skewed tail. At the same time, A-share return frequency distribution is more even across the return bucket (both positive and negative), which explains why A-shares have a much lower negative skew than China credit.

Borrowing Howard Marks' tennis analogy, we believe that we can better explain the difference in strategy needed to invest in credit versus equity:

"To be above average, an athlete has to separate from the pack. To win at high-level tennis, a player has to hit 'winners' – shots his opponents can't return. They're hit so hard, so close to the lines or so low over the net that they have the potential to end up as 'unforced errors'. In the absence of skill, they're unlikely to be executed successfully, meaning it's unwise to try them. But people who possess the requisite skill are right in attempting them in order to 'play the winner's game'".

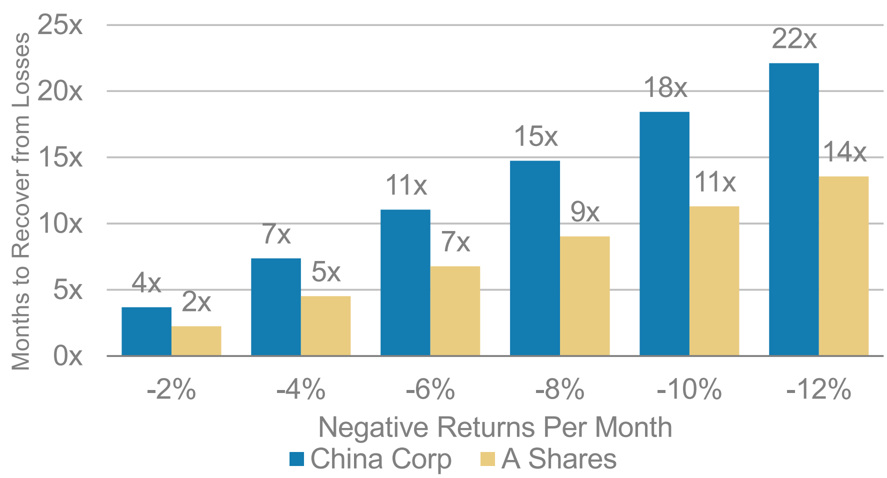
Hence, equity investors should focus on hitting 'winners' because equities have a much higher probability of hitting winners (i.e., higher expected return). In contrast, credit investors should focus on not committing 'unforced errors' since they have a lower probability of hitting winners (i.e., lower expected returns). Not surprisingly, given the difference in the return profile of credit versus equity, it is much harder for credit investors to recoup their losses compared to equity investors, and the disparity increases as the losses stack up (Exhibit 26). Using A-shares and offshore USD China corporate bond index expected returns, we can see that for a -2% return, credit would require two more months than equity to recover, and for a -8% return, credit would need half a year more to make up for the losses. Hence, for credit investors, the key is not hitting 'winners' but to avoid 'unforced errors' that lead to bond defaults. Given that we are expecting default rates to pick up and the part of the cycle we are in, we feel that credit investors need to be extremely mindful of their downside risk.

Exhibit 22: China credit versus equity returns distribution comparison



Source: iBoxx, Bloomberg, Morgan Stanley Research

Exhibit 23: Equity needs fewer months than credit to recover from losses



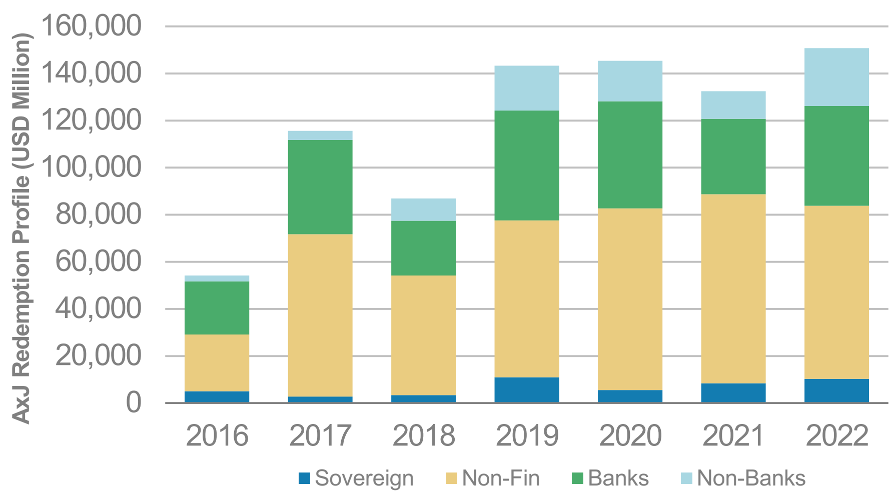
Source: iBoxx, Bloomberg, Morgan Stanley Research

Technicals to remain weak for Asia credit in 2019

Lower net issuance due to a higher redemption schedule

In terms of the supply-side story for Asia credit, we are currently entering a high redemption wall phase from 2019 (Exhibit 24). This year, the total redemption was only US$87 billion, versus 2019's total redemption of US$143 billion, or a 64%Y increase in 2019. Hence, Asia corporates will be facing increased refinancing risk in 2019 and the hurdle is much higher for 2019 net issuance to surpass this year's number. That said, we do note that the refinancing risk is moderated by the fact that close to 63% of the total redemption next year is by banks and Asia IG corporates, which we don't think will have issues in refinancing.

Exhibit 24: Wall of redemption is high from 2019 onwards



Source: Bloomberg, EMDB, Morgan Stanley Research

Exhibit 25: We expect gross issuance to increase by 36% but net issuance to be 10% lower in 2019

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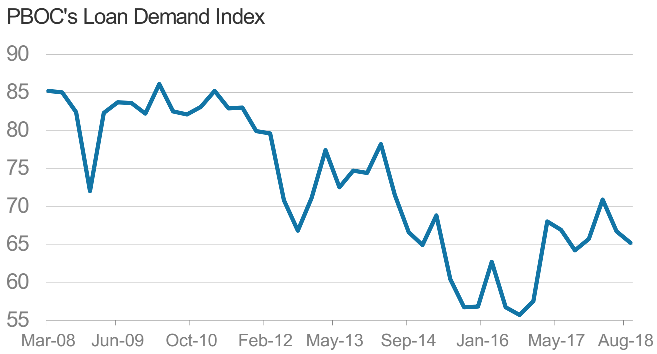
Net issuance	53 (59)	22 (25)	26 (34)	2 (-10)	1 (0)	2 (10)

Source: Bloomberg, EMDB, Morgan Stanley Research forecasts

Hence, we are forecasting net issuance to decrease by 10% in 2019 but, not surprisingly, we are expecting gross issuance to increase by 36%. Most of the positive move in net issuance will be driven by Asia corporates, both Asia IG and HY (Exhibit 25). We expect demand from Chinese corporates to remain strong (Exhibit 26), given weak credit creation in China. We also see room for capex (Exhibit 27) to continue to pick up or at least remain steady from here as we expect growth for the region to moderate a little in 2019. Unfortunately, we don't expect the rest of the sectors to have more than US$2 billion net issuance.

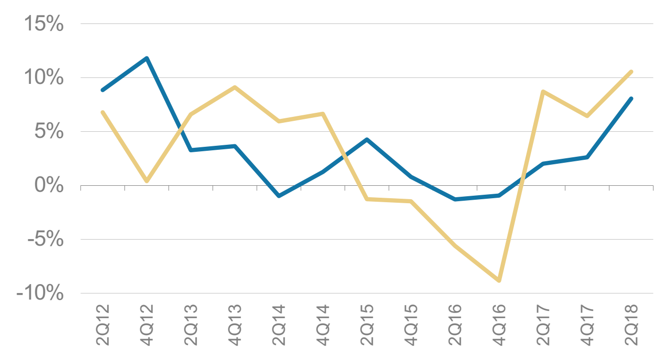
After a disappointing net issuance of -US$10 billion for Asia banks this year, we expect net issuance to turn flat next year. We think that one key driver of this low net issuance will be the lower investment needs in the Belt and Road Initiative, which took a back seat this year due to the US and China trade tension. We don't expect this to change too much in 2019 and are forecasting only US$2 billion of net issuance. We think that the story will be same for the non-banks sector as it goes through a deleveraging phase from the financial clean-up policies. We expect that most of the gross issuance will be for refinancing purposes. Lastly, sovereign issuance has been rather consistent. The past five years' average is US$14 billion, and this is what we base our gross issuance forecast on for Asia sovereigns.

Exhibit 26: Demand for credit by Chinese corporates remained strong despite moderating growth



Source: CEIC, Morgan Stanley Research

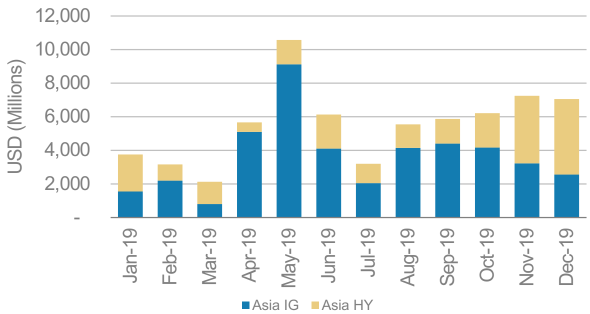
Exhibit 27: Asia corporates' capex trend has been picking up since 2017



Source: Bloomberg, Morgan Stanley Research

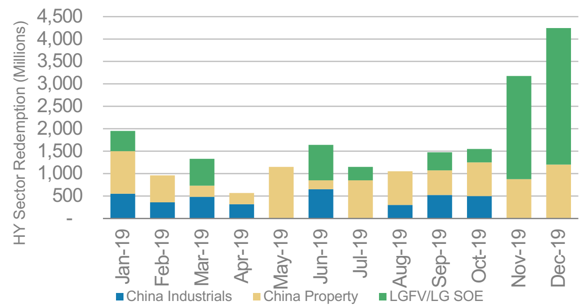
Lastly, we want to take a quick look at the refinancing risk for Asia corporates in 2019. May 2019 will be a big redemption hump, but most bonds are issued by Asia IG so we don't think that there will be high refinancing risk there (Exhibit 28). We think that the focus on refinancing risk should be on Asia HY, which is mainly Chinese HY. The good news is that the refinancing needs are more evenly spread out, at least for the first ten months of the year. In addition, the increase in refinancing needs for Asia HY is not high at US$3 billion. Between January and October next year, the average redemption for China HY corporates is US$1-2 billion. The refinancing risk really kicks in in the last two months of 2019 where close to US$5.4 billion of LGFV bonds come due. That said, LGFV is not the sector with the highest amount of refinancing needs. The China property sector beats the LGFV sector narrowly by US$200 million. China industrials is a distant third with US$3.7 billion of bonds coming due. **Hence, the refinancing risk in Asia HY is really in the LGFV and China property sectors.**

Exhibit 28: May 2019 is where we see the highest redemptions for Asia corporates



Source: EMDB, Bloomberg, Morgan Stanley Research

Exhibit 29: Redemption profile for China HY is quite evenly distributed, except for the last two months of the year



Source: EMDB, Bloomberg, Morgan Stanley Research

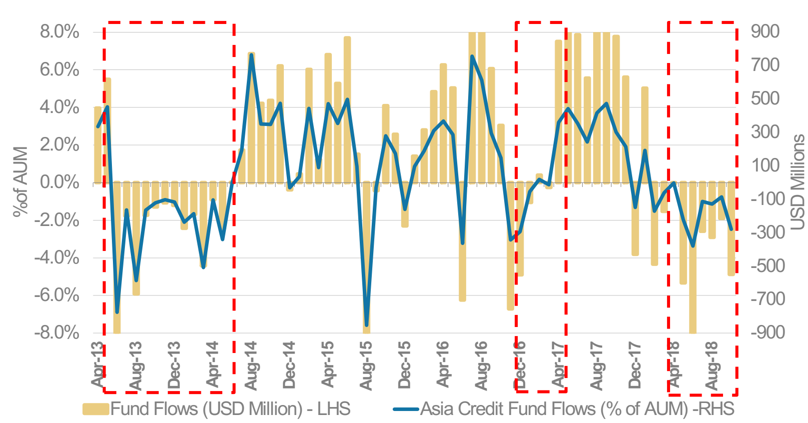
No sign of demand picking up for Asia credit

Demand for Asia credit this year is the weakest we have witnessed so far since the taper tantrum. Among the three key investor types that make up close to 90% of the buyer base of Asia credit, they are not showing any signs of a demand pick-up this year, and we expect this to continue in 2019. We find it hard to expect demand to pick up if we are expecting spreads to widen and rates to go higher (i.e., higher hedging costs).

Asset managers staying defensive due to outflow pressure

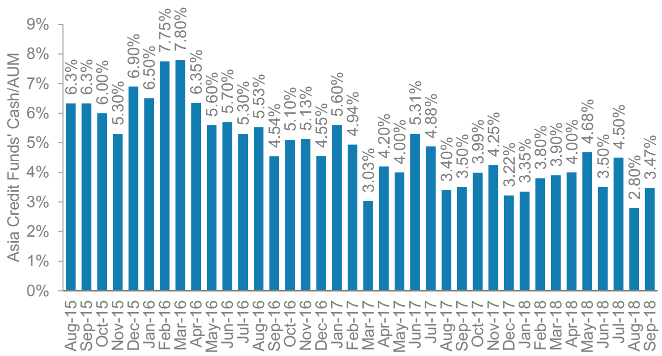
The investor base that saw the sharpest drop in demand for Asia credit this year was clearly Asia credit funds. Our proprietary Asia fund flows tracker shows that, since February, Asia credit funds had nine consecutive months of outflows (Exhibit 30). This means that Asia credit funds lost close to 12.8% of AUM in the past nine months, the longest consecutive months of outflows since 2013. In 2013, credit funds experienced 12 consecutive months of outflows, and the outflows amounted to 30% of AUM. Hence, we see room for outflows to continue unless we start seeing Asia credit posting some monthly positive returns. Not surprisingly, Asia credit funds have been positioned rather defensively. Asia credit funds' duration remains the lowest since we started tracking these funds (Exhibit 32), and their cash levels also increased in September (Exhibit 31).

Exhibit 30: Asia credit funds have seen saw consecutive monthly outflows since this February



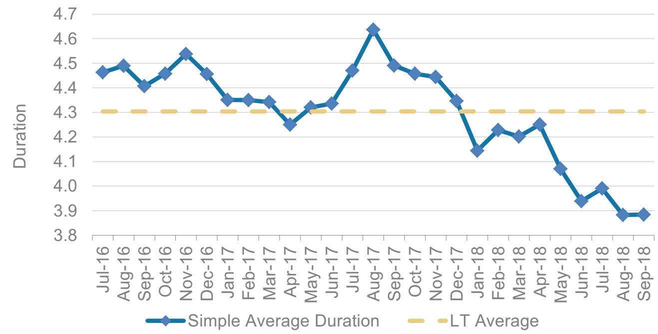
Source: Bloomberg, Morgan Stanley Research

Exhibit 31: Cash level for Asia credit funds picked up in September



Source: Fund fact sheets, Morgan Stanley Research

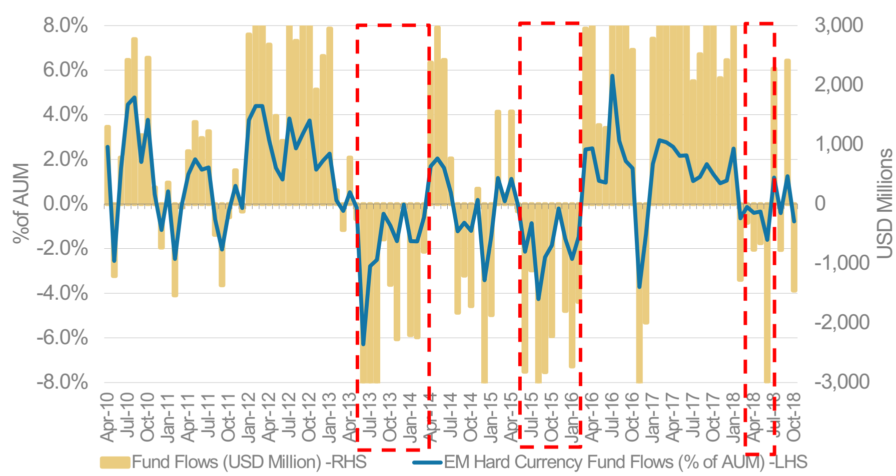
Exhibit 32: Asia credit funds' duration is at a historical low



Source: Fund fact sheets, Morgan Stanley Research

EM hard currency funds seemed to fare a bit better than Asia credit funds as they managed to get three strong months of inflows in January (+US$6 billion), July (+US$2.3 billion) and September (+US$2.4 billion). That said, they still had seven months of outflows through October this year. In order for us to see inflows from EM hard currency funds to Asia credit, it would need to begin looking cheap versus the rest of EM, which has been starting to happen in the past 1-2 months.

Exhibit 33: EM hard currency funds had outflows in seven of the ten months of this year

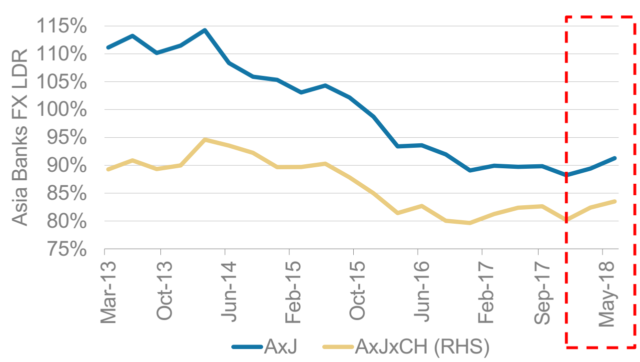


Source: EFPR, Morgan Stanley Research

Asia banks' demand continues to decline; the end of the 'onshore China bid'

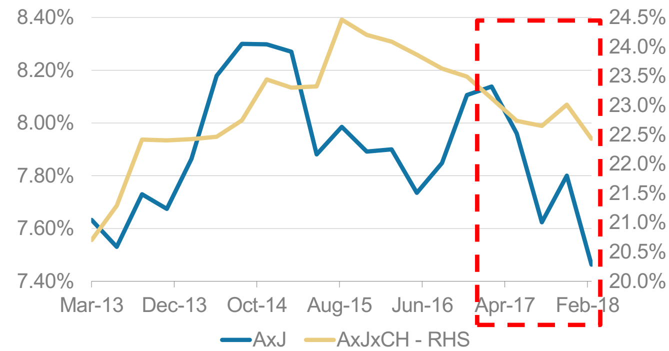
Asia banks are an important buyer base for Asia credit as they make up close to 30% of the primary allocation demand. Unfortunately, their demand for Asia credit is on the decline due to their rising FX LDR since the start of the year (Exhibit 34). This is true even if you exclude China banks' numbers. A higher FX LDR means that banks are growing their FX loans much faster than their FX deposits, which translates to less excess liquidity that needs to be invested (i.e., buying fewer Asia credit bonds). The opposite is true when the FX LDR is decreasing, which was the case from early 2014 to the end of 2017 (when the FX LDR troughed and explains why banks were active buyers of Asia credit). In addition, the dollarisation in Asia banks continued to decline, showing signs that FX deposit growth remains weak. We think it is unlikely that Asia banks' FX LDR will decrease significantly in the near term as FX loan growth is likely to continue to outpace FX deposit growth, given the tight financial conditions in Asia, and our FX team expects USD to weaken by 10% in 2019.

Exhibit 34: Asia banks' FX LDR has picked up since the start of this year



Source: CEIC, Morgan Stanley Research

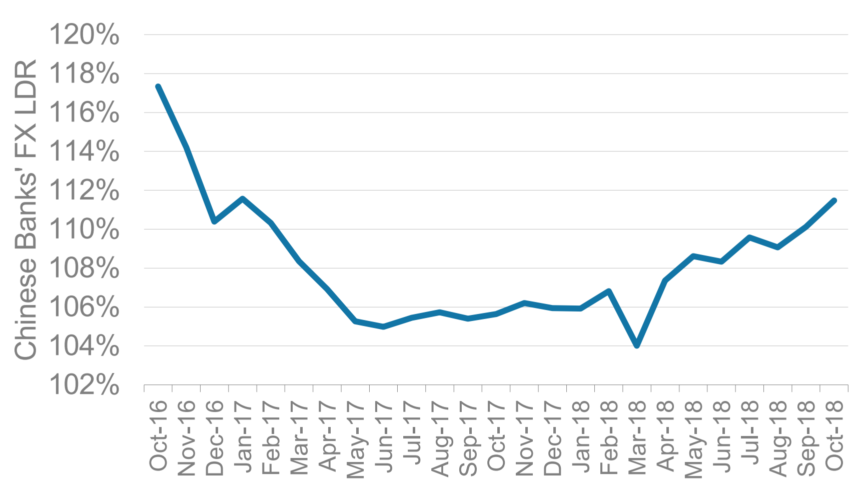
Exhibit 35: Asia banks' dollarisation is hitting a five-year low



Source: CEIC, Morgan Stanley Research

Another key demand driver in Asia credit in the past five years was the 'China onshore bid' that we first wrote about in 2015 (see Positioning for the Onshore Bid, August 25, 2015). We have always used Chinese banks' FX LDR as a proxy for 'China onshore bid' demand due to Chinese banks being an important driver of this demand. Unfortunately, we don't think that the demand will come back for now as the FX LDR for Chinese banks has been rising steadily since this March (Exhibit 36). Given the tight credit conditions for Chinese corporates, we think that FX loan growth will continue to outpace FX deposit growth (this wasn't the case in the past five years due to a strong dollar discouraging FX loan growth borrowing). Hence, we think that it is hard to see Chinese banks' demand for Asia credit improving in the near term, unless we start to see some easing in China financial conditions and a strong USD (which is not our base case).

Exhibit 36: China onshore banks' FX LDR has been on the rise since this March

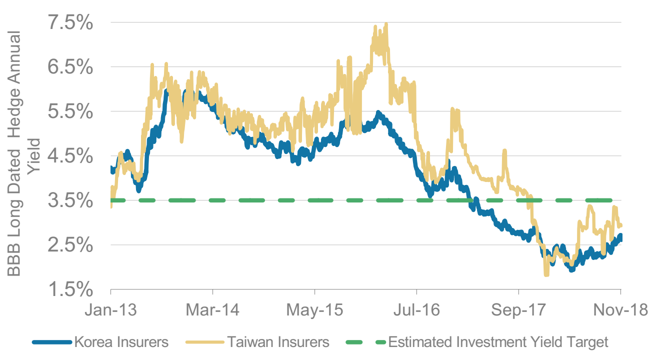


Source: CEIC, Morgan Stanley Research.

Hedging costs remain a key headwind for insurers

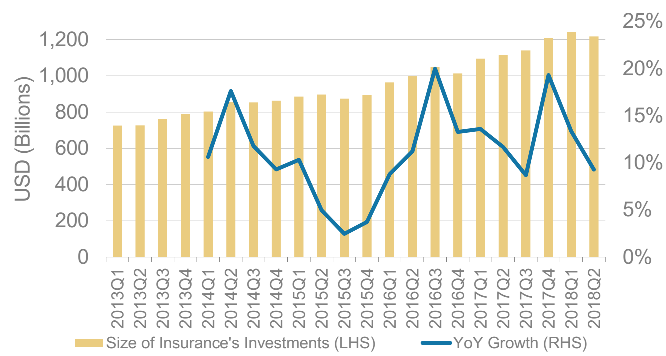
Asia insurers are the key buyers of the long-end Asia credit universe, making up close to 11% of the total Asia credit buyer base. Unfortunately, Asia-based insurance companies' demand for Asia credit has been rather weak in the past 12 months due to rising hedging costs. With the adoption of IFRS 9 last year, it is very costly for Asia insurers to run an FX mismatch. If we take the current yield of a long-dated BBB Asia IG corp and cross-currency swap the bond yield back to KRW and TWD, we find that the annual carry of the yield is less than 3%. This is really low, as our understanding is that Korean and Taiwanese insurers need a yield of at least 3.5%. Thus, we are not surprised to see demand from these insurers decline this year. This is also consistent with what our US credit team observed. Per Fed data, in 1Q18, US credit saw net selling from non-US investors for the first time since 2012 (see Foreign Flows: Rough Around the Hedges, September 14, 2018). In addition, we are not seeing growth in the investment book of the key 12 largest Asia insurers that we track. The investment book for these insurers grew from US$800 billion to US$1.2 trillion by the end of last year, or a CAGR of 10%. However, the Asia insurers' investment book has been relatively unchanged since the start of the year. This means that they don't have substantial incremental demand to invest and Asia credit is less attractive from an allocation perspective than from a hedge perspective.

Exhibit 37: Hedged long-dated Asia BBB corp yield is below Taiwan and Korea insurers' investment yield target



Source: iBoxx, Bloomberg, Morgan Stanley Research

Exhibit 38: Asia insurers' investment books have been relatively unchanged this year

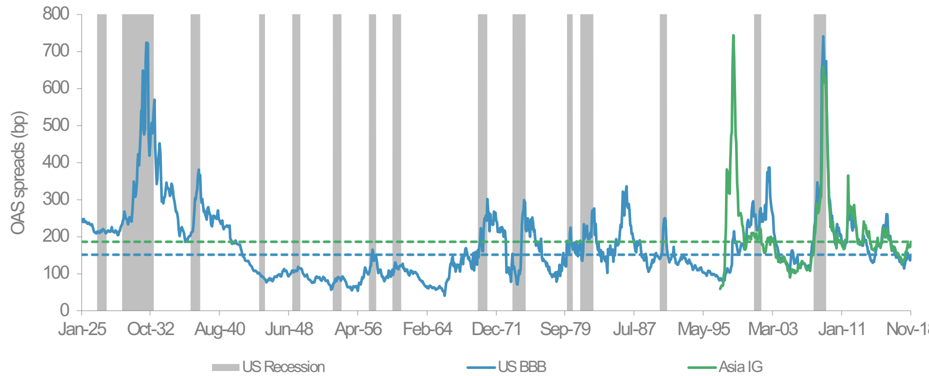


Source: SNL, Morgan Stanley Research

Valuations for Asia credit are cheaper but are not pricing in fundamental risk

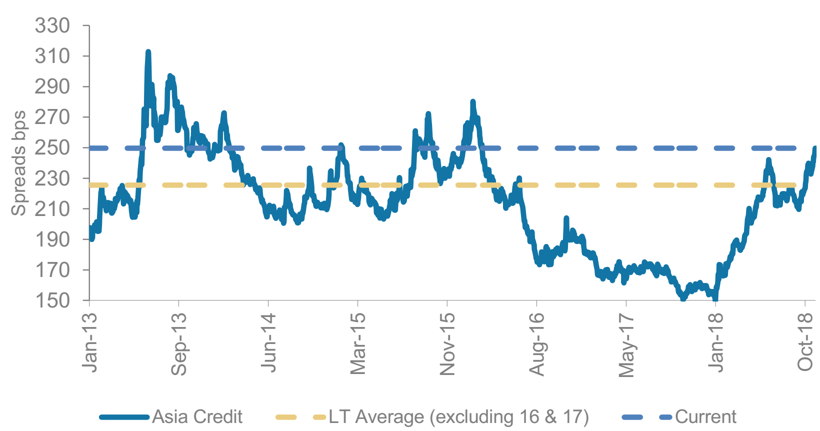
Valuations were largely ignored by investors in the past two years, but are now finally getting the attention they deserve. We believe that valuations should be a key investor focus in 2019. If we take a very long-term view of Asia IG credit, going back as far as the 1990s, Asia credit looks fair at best. The long-term historical average spread for Asia credit (since 1997) is 211bp versus the current level of 186bp. Hence, we still don't think that the current valuation is cheap enough, at least from a long-term perspective.

Exhibit 39: Asia credit is still close to long-term historical tights



Source: Moody's, Yield Book, NBER, Bloomberg, iBoxx, Morgan Stanley Research; Shaded areas indicate recession.

Exhibit 40: Asia credit is cheaper, but is only back to pre-2016 levels

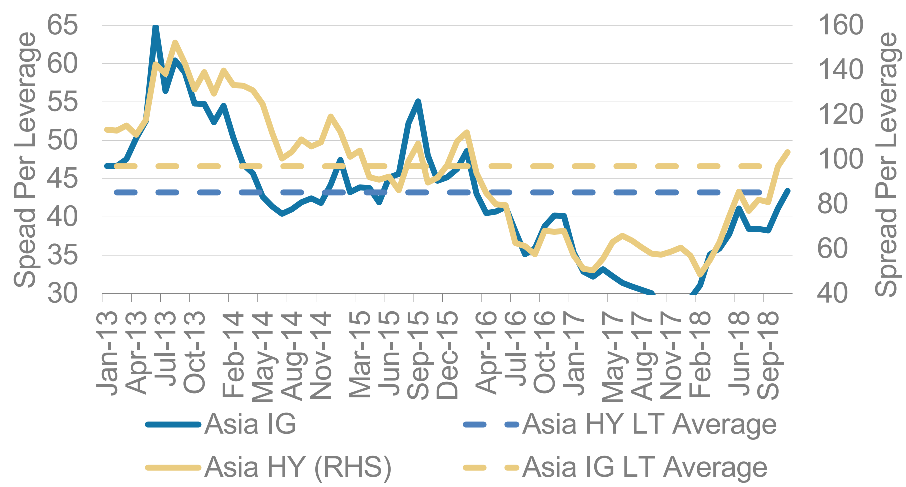


Source: .iBoxx, Morgan Stanley Research

From a medium-term point of view, we are taking 2013 as the starting point. We would argue that 2013 is a good starting point as this is when we started to see a pick-up in Chinese corporates' issuance and onshore Chinese participation in our offshore USD Asia credit market. Asia credit looks slightly cheaper now versus its historical average but again not significant enough that we think that the risk/reward is attractive (Exhibit 40). We had excluded 2016 and 2017 in our long-term average calculation as we were confident that we would be back to the spread level at that time as spreads were driven more by quantitative easing.

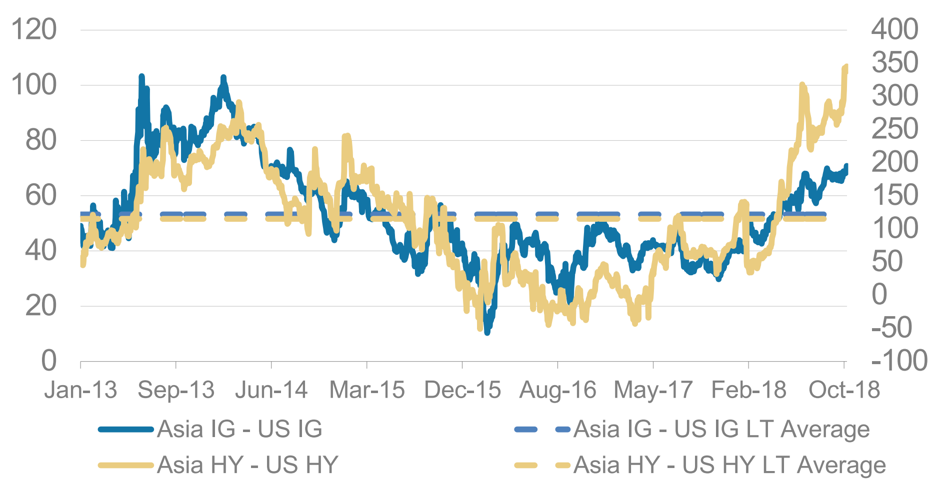
The best valuation metric we have to make our point that the weak fundamentals in Asia corporates are not priced in is our SPL metric. Exhibit 41 shows that from a SPL perspective both Asia IG and Asia HY SPL are close to the historical average range. This means that valuations remain fair as spreads have not increased enough to compensate for the high leverage of these Asia corporates. Lastly, we want to push back on the argument that we should be buying Asia credit because it looks cheap versus US HY (Exhibit 42). We don't think that this is the case – we believe that Asia credit looks cheap relative to US credit because US credit valuations are currently rich.

Exhibit 41: Asia IG corp and Asia HY corp's current SPL are below the long-term average



Source: iBoxx, Bloomberg, Morgan Stanley Research

Exhibit 42: US credit's rich valuation makes Asia credit looks cheap



Source: iBoxx, Yield Book, Morgan Stanley Research

How much default rate is priced in in Asia HY?

Another way to look at valuation is by asking the question, how much default rate is priced in in Asia HY spreads? Before we start with our implied default rate calculation, we probably cannot assume that only credit risk is priced into Asia HY spreads. Other risks such as liquidity risk, structure risk and uncertainty in the bankruptcy laws should also be priced in. It is hard to calculate how much is embedded in Asia HY spreads but we can use the historical rating-adjusted spread between Asia HY and US HY (since 2011 but excluding 2016 and 2017) as a proxy for all these risks. The current Asia HY credit spread is 692bp and the historical Asia HY versus US HY rating-adjusted spread is 169bp. This gives us a pure credit risk spread of 523bp. In order to get the implied default rate, we divide 523bp by (1-RR), where RR is equal to the recovery rate.

Exhibit 43: Select recovery prices of historical defaults in Asia credit

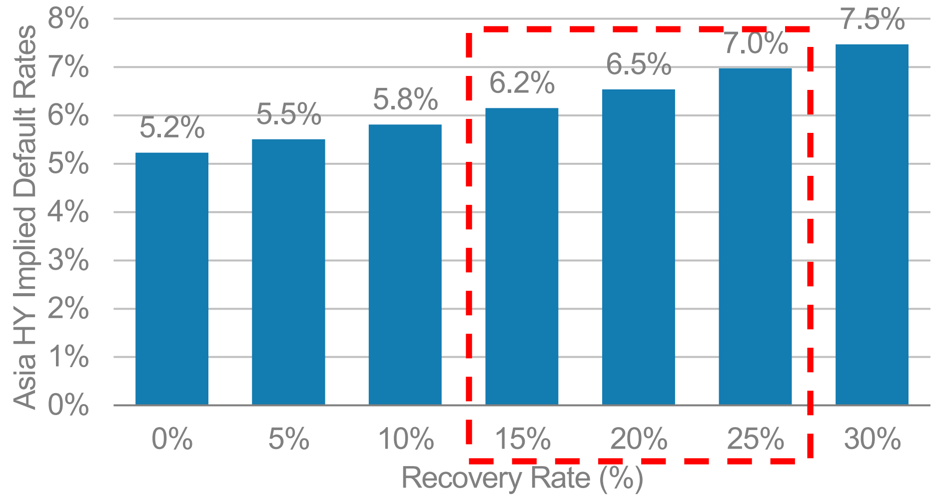
Issuer Default Year	Country	Company	Average Recovery Price
1998	Indonesia	FSW International Finance Company B.V.	20.0
1998	Indonesia	Polytama International Finance B.V.	28.0
2001	China	APP China Group Limited	12.5
2001	Indonesia	APP International Finance Company B.V.	20.0
2001	Indonesia	Indah Kiat International Finance Company B.V.	27.5
2001	Indonesia	Tjiwi Kimia International Finance Company BV	14.0
2009	China	Asia Aluminum Holdings Limited	7.0
2009	Indonesia	Davomas Abadi Tbk (P.T.)	17.0
2009	Thailand	G Steel Public Company Limited	23.0
2010	China	Titan Petrochemicals Group Ltd.	44.0
2010	Indonesia	Arpeni Pratama Ocean Line, Tbk (P.T.)	51.1
2012	China	Sino-Forest Corporation	27.5
2012	China	Sino-Forest Corporation	27.5
2012	Indonesia	Berlian Laju Tanker Tbk (P.T.)	26.3
2013	Indonesia	Bakrie Telecom Tbk P.T.	14.5
2014	China	China Forestry Holdings Co Ltd	32.0
2014	Indonesia	Bumi Resources Tbk (P.T.)	23.0
2015	China	Winsway Enterprises Holdings Limited	28.5
2016	Mongolia	Mongolian Mining Corporation	22.5

Source: Moody's, Morgan Stanley Research.

This tricky part is figuring out what recovery rate should be used to calculate the implied default rate. Exhibit 43 shows the historical recovery rates of bond defaults that either went through a liquidation or a restructuring process. We have excluded bond buybacks at a low dollar price, as we don't think that this strictly constitutes a default, although by credit rating agencies' definition it is considered a default. In fact, we would argue that a company in distress would not have the cash to buy back bonds even at a low dollar price. Based on our understanding, we believe that the general rule of thumb is that if bonds are going through a liquidation the recovery rate will be as low as 10-15%, while if they are going through a restructuring process the recovery rate will be around 20-25%.

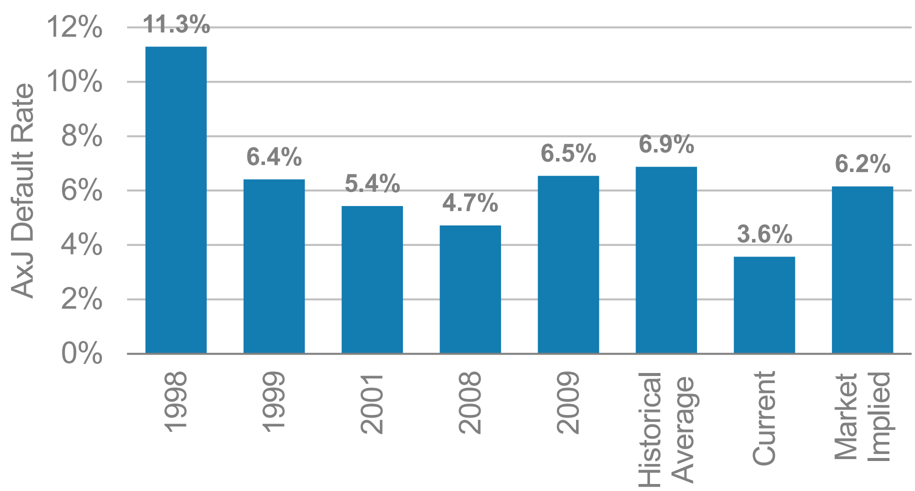
Exhibit 44 shows the implied default rates for the current level of Asia HY. Using the recovery rate range we mentioned above of 15-25%, we can conclude that Asia HY is pricing around 6.2% to 7.0% for default rates. To put this default rate into perspective, we can compare it versus the past three default cycles in Asia credit (Exhibit 45). The average default rate for the past three cycles is 6.9%, which is slightly higher than the current average default rate range we calculated for Asia HY. **Hence, we believe that Asia HY is currently fair at best and it is clearly not pricing in significant default risk versus historical default rates.**

Exhibit 44: Asia HY-implied default rates given various recovery rates



Source: iBoxx, Morgan Stanley Research.

Exhibit 45: Past three Asia default cycles, current and historical average default rates



Source: S&P, Morgan Stanley Research.

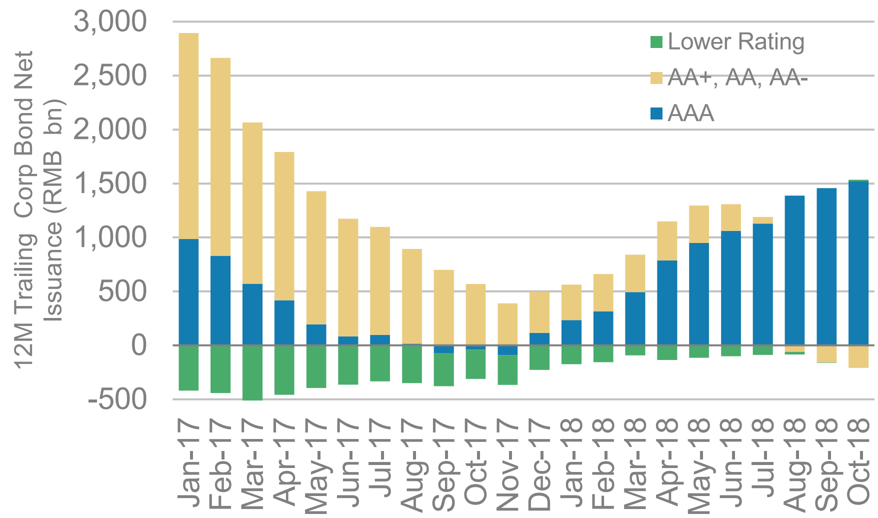
Three signposts we are watching that would make us consider turning bullish

Given that we are in a transition period moving to the bottom of the cycle of Asia credit, we think it makes sense to have signposts that would indicate that we should consider turning bullish. Below are three key signposts that we are monitoring closely:

#1. An improvement in onshore credit creation for Chinese corporates

Given that China credit is 50% of overall Asia credit risk, credit creation for Chinese corporates will be a driver of Asia credit spreads. **In our view, we would need to see AA rated corporate net issuance remain positive for one or two months (looking at 12-month trailing AA corporate net issuance) to be bullish; it has been negative since August (Exhibit 46).** Why has net issuance been weak in the past six months? We think that risk appetite for lower-rated credit remains low due to the recent pick-up in defaults. Note that the China onshore corporate bond market has not experienced a default cycle until recently. Hence, it will take some time for onshore credit investors to start adapting to a more market-driven pricing for credit risk. **In addition, we also need to at least see some stabilisation in China's broad credit growth, which would show that the financial clean-up on the shadow banking side is stabilising.** Lastly, we also hope to see a pick-up in Chinese banks' medium-to-long-term loans (Exhibit 15), which would show that corporates are benefiting directly from the higher Chinese banks' loan growth.

Exhibit 46: 12-month trailing net issuance for AA rated corporates has been negative since August



Source: WIND, Morgan Stanley Research

#2. De-escalation in China-US trade tensions

The current China-US trade tensions remain a key uncertainty to Asia credit investors, especially China onshore investors. During our last marketing trip to Shanghai in October, clients mentioned that the uncertainty surrounding China-US trade is the key reason why they have a more cautious view and want to stay defensive for now. **Hence, for risk sentiment to improve for Asia credit we would need to see a de-escalation in China-US trade tensions.**

Unfortunately, our US public policy strategist Michael Zezas, expects trade tensions to escalate before a de-escalatory endgame becomes plausible (see US-China Trade: Navigating the G20 Noise, November 15, 2018), despite the recent rising possibilities of a constructive US-China statement or a tariff pause post the G20 meeting (both are not reflected in our base case). Our base case for trade is that tensions would escalate until either a clear market or economic weakness causes either China or the US to take a more constructive tone. This appears to us to be what's happened over the past few weeks. The Trump/Xi phone call on November 1 and news that the US is signing off on waivers for Iran oil sanctions both broke following the S&P dropping close to 10% below its year-to-date highs (Exhibit 47).

That said, there is no evidence that a meaningful negotiation breakthrough has occurred. In particular, the US appears to be continuing its demands about intellectual property protections; joint ventures; SOEs; and industrial policy in general. For Asia credit investors, the key point to focus on in the negotiation would be China SOEs' "competitive neutrality". This term was first used by the PBOC governor in a speech at the IMF meeting on October 15. To us, this means there is a risk that China SOEs' easy access to cheap financing might change. **There is also a risk that the amount perceived as government support to SOE might be reduced and that it would lead to a downgrade of Chinese SOE credit ratings as they currently mostly incorporate strong sovereign support.** Hence, this is one reason why we have tried to avoid BBB- names in our China IG central SOE screen and continue to monitor developments here closely.

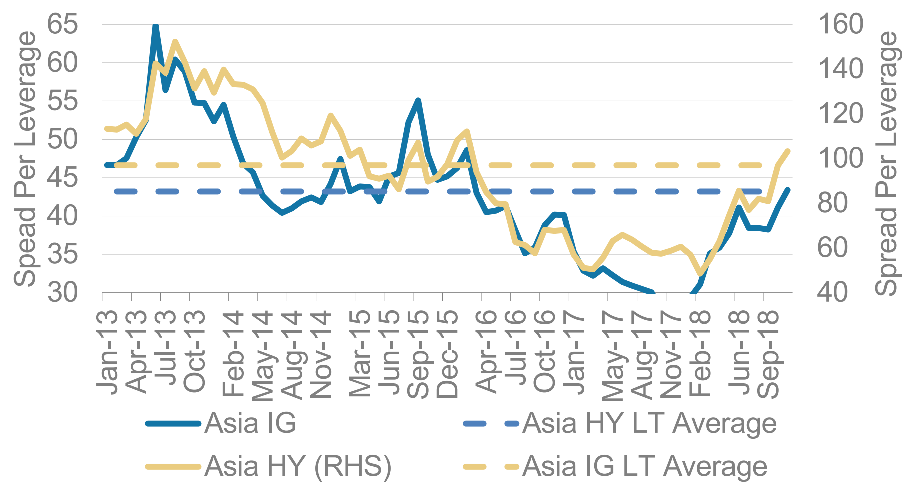
Exhibit 47: Conciliatory measures were made after market weakness

Source: Bloomberg, Morgan Stanley Research

#3. Valuations pricing in fundamental weakness

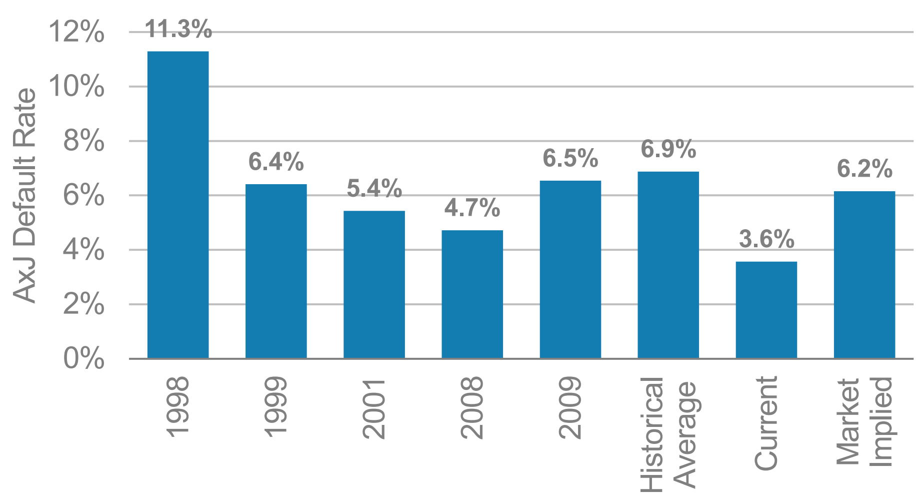
Our last signpost is more a valuation point. As mentioned above, we believe that the current valuation is not pricing in the fundamental weakness. We use two key indicators to guide us in terms of valuations. First, our spread per leverage (SPL) would need to show that Asia credit is cheap. Currently the SPL for Asia credit (both Asia IG and Asia HY) only looks fair at best (Exhibit 48). Second, before we can turn bullish on Asia HY, we think that it would need to price in higher default rates than the historical average (Exhibit 49), which it currently isn't.

Exhibit 48: Asia IG corp and Asia HY corp's current SPL are below the long-term average



Source: iBoxx, Bloomberg, Morgan Stanley Research

Exhibit 49: Current and historical average default rates over the past three Asia default cycles



Source: S&P, Morgan Stanley Research

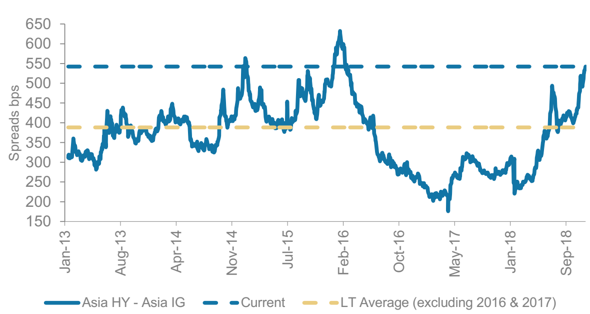
Key trades for Asia credit in 2019

1) Up-in-quality trade: Prefer Asia IG over Asia HY, China IG over China HY

Although valuations are now cheaper in both Asia HY (Exhibit 50) and China HY (Exhibit 51) versus their IG counterparts, we still think that risk/reward favours IG credit. We don't think that the current HY valuation reflects the weak fundamentals, which we think indicates that we are at the bottom of the cycle. Given the tight financial conditions we expect in 2019, we still think that this hurts HY corporates' funding disproportionately more than that of IG corporates, which increases HY default rates. As mentioned above, the current implied Asia HY default rate is still lower than the historical average (in the past three major default cycles since 1998) default rate of 6.9% (Exhibit 52). Lastly, from an SPL perspective, Asia HY only looks fair. Hence, we are sticking to our up-in-quality trade for now.

The risk to this trade would be if we start seeing financial conditions in Asia/China ease significantly or the Fed stops hiking rates much earlier than we expect.

Exhibit 50: Asia HY is cheaper versus Asia IG this year

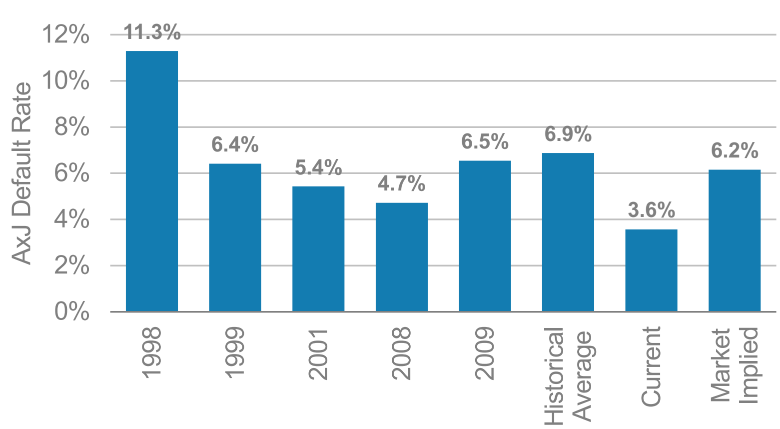


Source: iBoxx, Morgan Stanley Research; Pricing as of November 21, 2018.

Exhibit 51: China HY is cheaper versus China IG this year

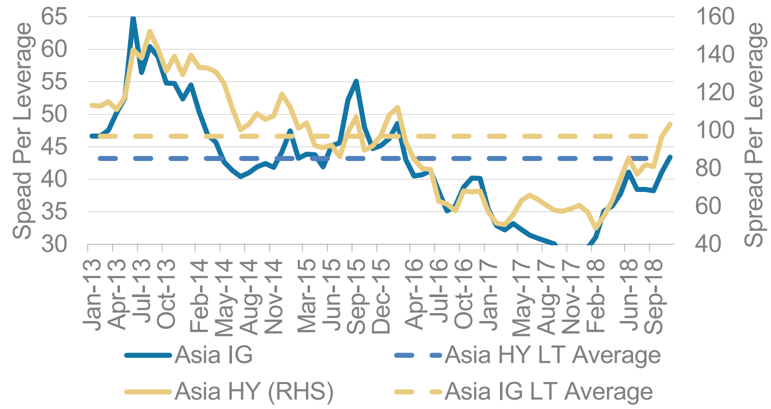
Source: iBoxx, Morgan Stanley Research; Pricing as of November 21, 2018.

Exhibit 52: Historical, current and market-implied Asia HY default rates



Source: iBoxx, Morgan Stanley Research.

Exhibit 53: Asia IG corp and Asia HY corp's current SPL are below the long-term average



Source: iBoxx, Bloomberg, Morgan Stanley Research

2) Staying EW in China IG central SOE but differentiating single-name credits by technicals

Although valuations remain tight, we are keeping our EW position on the China IG central SOE sector because we like its defensive nature. SOE reform forced these firms to reduce leverage and focus on increasing efficiency through mixed ownership reforms. We believe that the current tighter spreads are a reflection of the current SOE reform progress, albeit this process will take time. We are also sticking to our preference for China central over LG SOE/LGFV despite the recent months of cheapening in LG SOE/LGFV sector spreads. We continue to believe that tight financial conditions in China will remain challenging for the LG SOE/LGFV sector, which justifies the currently high credit risk premium applied to the sector (Exhibit 58).

Compared to the US and Europe, we believe that Asia is at a much more advanced stage of the credit cycle, which is not surprising since China started its financial clean-up as early as 2013. If you look at our excess return forecasts, we expect negative excess returns for IG and HY for both US and European credit, and some positive returns in Asia. Hence, we think that it makes sense to differentiate central SOE credits by the geography of the investors that are buying their bonds. **The higher the percentage of Asia ownership, the more defensive the credit will be in the face of a sell-off in the US or Europe, in our view.**

With this in mind, we believe that we can screen single A and BBB credits to buy or to avoid based on whether the bond buyer is mainly from Asia and whether it has a cheap or rich valuation. Using primary allocation data, we can know roughly what percentage of the buyer base is Asia investors. In terms of valuation, we can compare the bond spreads versus the average spread of the average rating for the sector. We benchmark the five-year bonds for each credit or whichever bond is closest to five years to try our best to limit the impact of duration on our valuation metrics. Exhibit 59 and Exhibit 60 show the results of our screen for both rating buckets of China IG central SOE.

In the single A rated China IG SOE space, we see three names (**SHENGY 25, CSSCCO 21, RLCONS 23**) that we would consider buying, given their high percentage of ownership by Asia investors (equal to or above 70%) and cheap valuation (above zero). All three are industrial SOEs in sectors such as energy, railway and transportation (Exhibit 54).

Exhibit 54: A rated China IG SOE that we like based on our screen

No.	ISIN	Company Name	Bond Ticker	Lowest Rating	Asia	Z-Spread	Yield to Maturity	Valuations versus Rating Peers
1	XS1165128585	China Shenhua Energy Co Ltd	SHENGY 25	A	93%	127	4.33%	25
2	XS1882614008	China State Shipbuilding Corp	CSSCCO 21	A+	93%	119	4.22%	17
3	XS0928126340	China Railway Construction Cor	RLCONS 23	A-	81%	116	4.19%	14

Source: Bloomberg, EMDB, Morgan Stanley Research

We also screen for names that we would avoid. These are names (**CNOOC 23, SINOPE 23, CHIRES 22, CNPCCH 23, CHGRID 23**) with a low percentage of Asia buyer base (less than 70%) and rich valuation (less than zero). Not surprisingly, the names that have a low percentage of Asia ownership tend to be names with good fundamentals (Exhibit 55) and in sectors that are really crucial to China such as utilities and oil & gas. These are names that non-Asia investors are more comfortable investing in the China IG central SOE space.

Exhibit 55: A rated China IG SOE that we would avoid based on our screen

No.	ISIN	Company Name	Bond Ticker	Lowest Rating	Asia	Z_SPRD_ASK	YLD_YTM_ASK	Valuations
1	US12634MAD20	CNOOC Ltd	CNOOC 23	A+	31%	98	4.02%	-4
2	USG82016AA75	China Petrochemical Corp	SINOPE 23	A+	47%	96	4.00%	-6
3	USG2113BAA64	China Resources Gas Group Ltd	CHIRES 22	A-	51%	100	4.03%	-2
4	USG22004AE89	China National Petroleum Corp	CNPCCH 23	A	55%	93	3.97%	-9
5	USG8450LAN40	State Grid Corp of China	CHGRID 23	A+	59%	79	3.82%	-23

Source: Bloomberg, EMDB, Morgan Stanley Research

Unlike the single A rated China IG SOE space, all the BBB rated names tend to have a much stronger Asia investor base, so we only screen for names we like in this space. Exhibit 56 shows names (**CHMI 25. COSL 25, CHITRA 24, MINMET 25**) that have a strong Asia investor base (above 85%) and cheap valuation (above zero). We also exclude names that are rated BBB- given our more defensive nature, as we would want to avoid the volatility of downgrade risk.

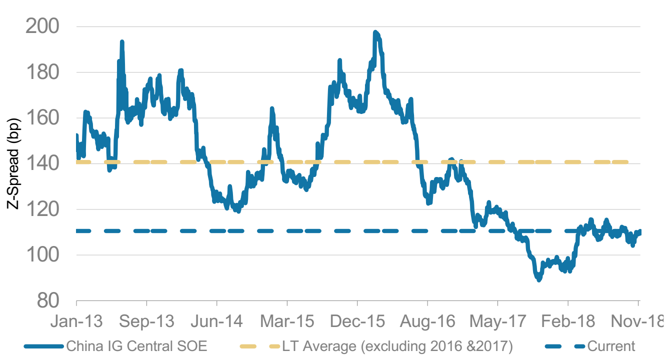
Exhibit 56: BBB rated China IG SOE that we like based on our screen

No.	ISIN	Company Name	Bond Ticker	Lowest Rating	Asia	Z_SPRD_ASK	YLD_YTM_ASK	Valuations
11	XS1269724826	China Merchants Port Holdings	CMHI 25	BBB	95%	163	4.69%	10
18	XS1267602305	China Oilfield Services Ltd	COSL 25	BBB	94%	171	4.77%	19
8	XS1125272143	China National Travel Service	CHITRA 24	BBB+	90%	160	4.65%	8
23	XS1265180643	China Minmetals Corp	MINMET 25	BBB+	87%	170	4.76%	18

Source: Bloomberg, EMDB, Morgan Stanley Research

The risk to this trade would be if we see a significant pick-up in leverage in China SOEs and if Asia credit underperforms both US and European credit.

Exhibit 57: China IG central SOE spreads looks tight

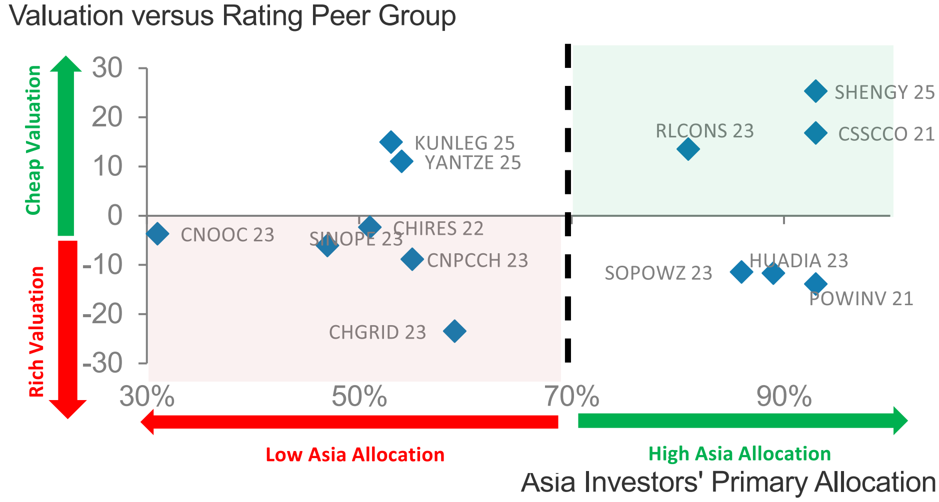


Source: iBoxx, Morgan Stanley Research

Exhibit 58: China IG local government (LG) SOE has been underperforming China IG central SOE

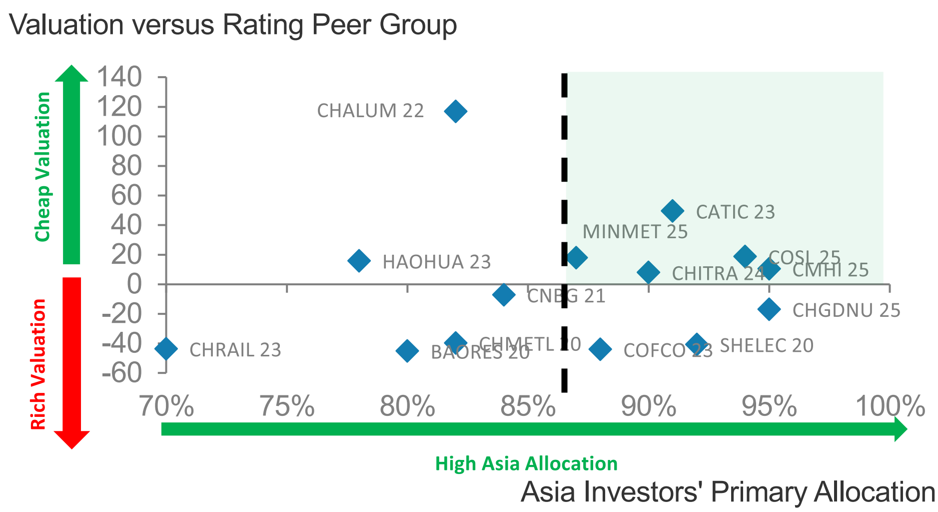
Source: iBoxx, Morgan Stanley Research

Exhibit 59: Screening China A rated single names based on technicals and valuation



Source: EMDB, Bloomberg, Morgan Stanley Research

Exhibit 60: Screening China BBB rated central SOE credit based on technicals and valuation



Source: EMDB, Bloomberg, Morgan Stanley Research

3) UW China HY sector: Long select high-quality China property names

As mentioned above, given our expectation of tight financial conditions in China and for credit creation in China to remain selective, dispersion for China HY should continue to rise. Although we remain cautious on China HY, we do believe that the China HY property sector offers good alpha opportunities to take advantage of in this dispersion. Using three factors from our PCA analysis and land bank concentration, we screen for defensive China HY property credit (see Screening the China HY Property Sector for Alpha, October 19, 2018).

Below are the steps that we have set up to screen for defensive single names in the China property sector:

Step 1: We screen for China HY property issuers that are rated B+ and above (we use the lowest rating among S&P/Moody's/Fitch).

Step 2: We screen out China HY property issuers that don't have at least one bond that is equal to or below three years' maturity.

Step 3: We screen out China HY property issuers' bonds that are illiquid.

Step 4: We screen out China HY property issuers that have less than 30% of their land bank in Tier 1 and Tier 2 cities.

Based on the screen above, we arrive at a list of four issuers (**SHIMAO 21, CIFIHG 21, KWGPRO 21, YUZHOU 21**) in the China HY property sector (Exhibit 61). We think that it is important to have HY property credit with high tier 1 and tier 2 concentration as it would be more resilient to a potential fall in property prices in the physical market, where we started to see some weakness in October (Exhibit 62). In terms of fundamentals, these names are defensive versus the sector. The average cash/short-term debt of the four is 2.31x, versus the overall China HY property sector average of 1.2x. If we look at leverage in terms of net gearing (net debt/equity), the average net gearing for the four is 73%, which is significantly lower than the sector average of 126%.

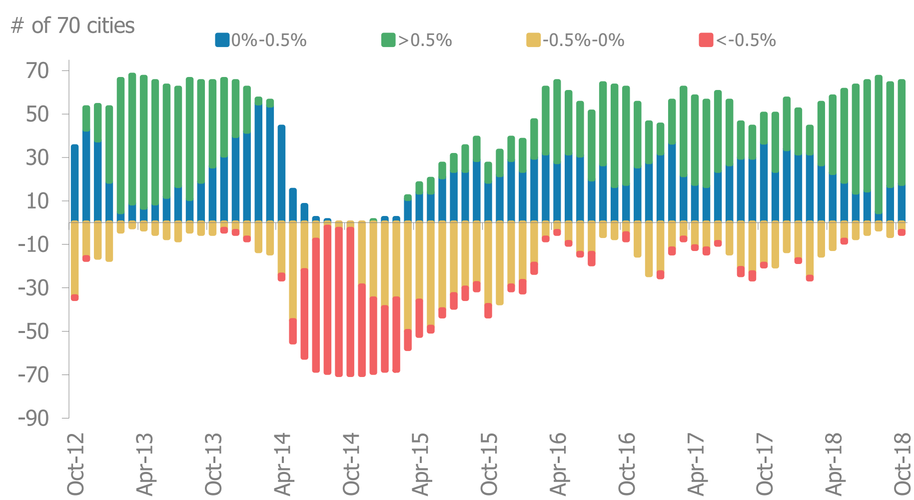
Risks include a large fall in physical property prices in Tier 1 and Tier 2 cities in China, triggering low contracted sales, or credit conditions in China tightening significantly from here, which would increase the liquidity risk of the China HY property sector.

Exhibit 61: Screening for defensive China HY property names

No.	ISIN	Company Name	Bond Ticker	Ratings	Years to Maturity	Tier 1 & Tier 2 Exposure	Yield to Maturity
1	XS1891434604	Shimao Property Holdings Ltd	SHIMAO 21	BB-	2.90	61%	7.12%
2	XS1801151371	CIFI Holdings Group Co Ltd	CIFIHG 21	B+	2.42	76%	10.56%
3	XS1811206066	KWG Group Holdings Ltd	KWGPRO 21	B+	2.71	88%	10.06%
4	XS1819960136	Yuzhou Properties Co Ltd	YUZHOU 21	B+	2.47	62%	10.66%

Source: Company data, Bloomberg, Morgan Stanley Research

Exhibit 62: We started to see some weakness in China property prices in October this year



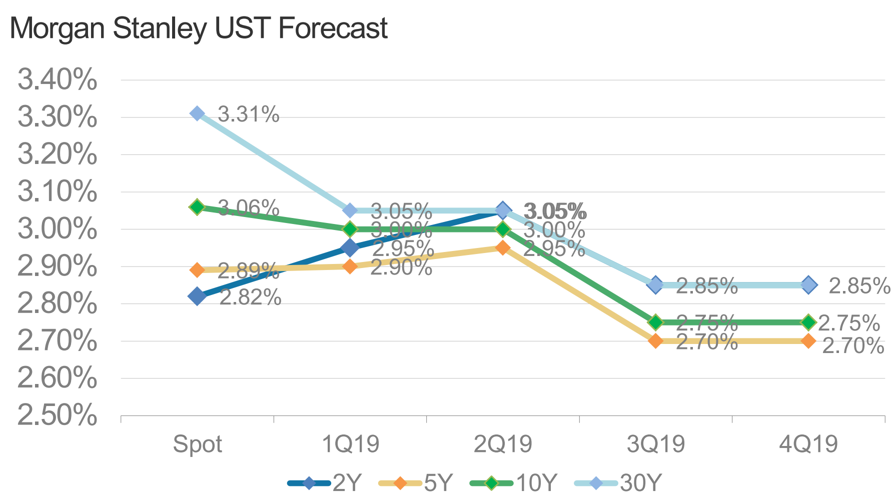
Source: CEIC, Morgan Stanley Research

4) Increasing duration in Asia IG corporates (3-5Y and 5-7Y)

Our US rates team is forecasting a flat yield curve (2s10s) by the end of the year as it expects the Fed to hike rates twice in the first half of the year and pause for the rest of the year as US growth slows down. Hence, we think that it makes sense for investors to increase the duration of their Asia IG corporate portfolio. In order to determine which duration buckets of the Asia IG corporates look attractive, we look at the carry and roll-down of a credit-neutral Asia IG duration curve (Exhibit 63). We think that it is crucial to keep it credit-neutral so it purely reflects duration risk. In addition, we only include names that have bonds in each duration bucket. **For the overall Asia IG corporates universe, we think that the sweet spot is the 5-7-year bucket, but for some investors who want a shorter duration, we think that the 3-5-year bucket is also attractive.** The story is very similar for China IG corporates (Exhibit 65) and A+ rated China IG central SOE (Exhibit 66).

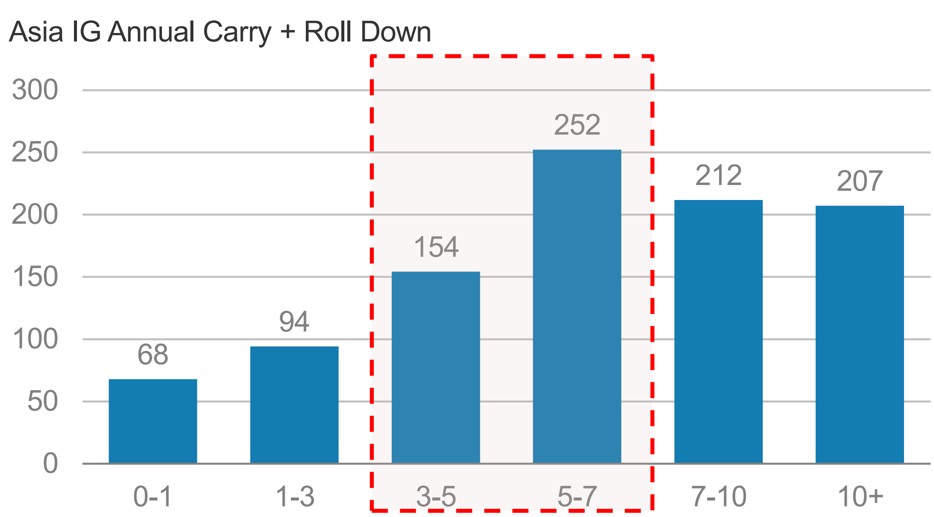
The risk to this trade is significant widening in Asia credit spreads, higher UST yields and the yield curve steepening.

Exhibit 63: Our rates team expects US rates to be lower next year



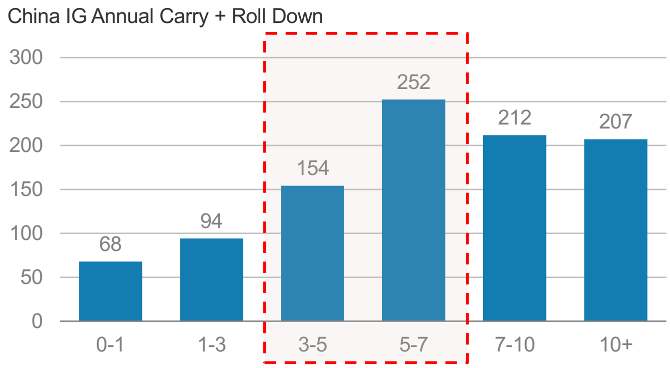
Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 64: We think that the sweet spot for Asia IG is the 3-5 and 5-7-year buckets



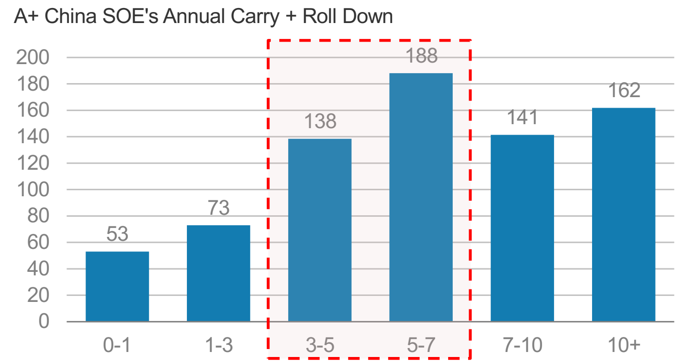
Source: iBoxx, Morgan Stanley Research; Based on our criteria mentioned, Asia IG includes CHGRID, CNOOC, CNPCCH, SINOPE, CHIOLI, HAOHUA, BABA, TENCNT, CCAMCL, HRAM, KORGAS and CKHH.

Exhibit 65: China IG corporate sweet spot is 3-5Y and 5-7Y



Source: iBoxx, Morgan Stanley Research; Based on our criteria mentioned, China IG includes CHGRID, CNOOC, CNPCCH, SINOPE, CHIOLI, HAOHUA, BABA, TENCNT, CCAMCL and HRAM,

Exhibit 66: China A+ rated corporate sweet spot is 3-5Y and 5-7Y



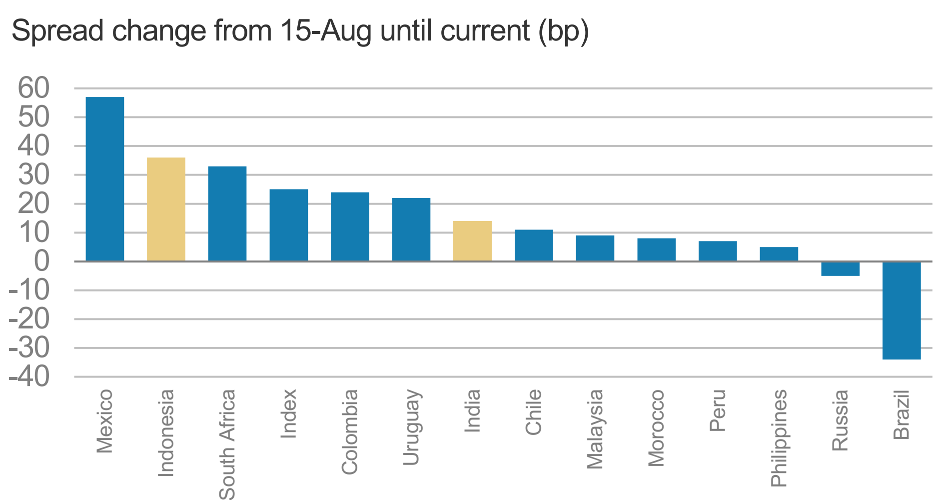
Source: iBoxx, Morgan Stanley Research; Basd on our criteria mentioned, A+ rated China SOE includes CHGRID, CNOOC, CNPCCH and SINOPE.

5) Turning EW from UW on Indonesia sovereign and SOE

We had always been relatively comfortable with Indonesia's macro fundamentals and what drove our UW call was more valuation and technical factors. We change our UW call on Indonesia following the change in view by our Asia sovereign analyst Jaiparan Khurana (see Will We Rally into Year-End? October 29, 2018) due to a cheaper valuation that is already pricing in supply concerns. Since mid-August Indonesia has underperformed EMBI by 11bp, and most of the BBB rated peers in Asia and globally (Exhibit 67). Our key concern remains supply risk from the sovereign, but we feel that this is already a 'known known' and is more or less reflected in the spread, given the underperformance in the past few months.

The risks to this trade are a further sell-off in EM or that concerns about political risk in Indonesia increase in 2019.

Exhibit 67: Indonesia has underperformed the EMBI and most of its BBB rated EM peers since mid-August



Source: iBoxx, Morgan Stanley Research

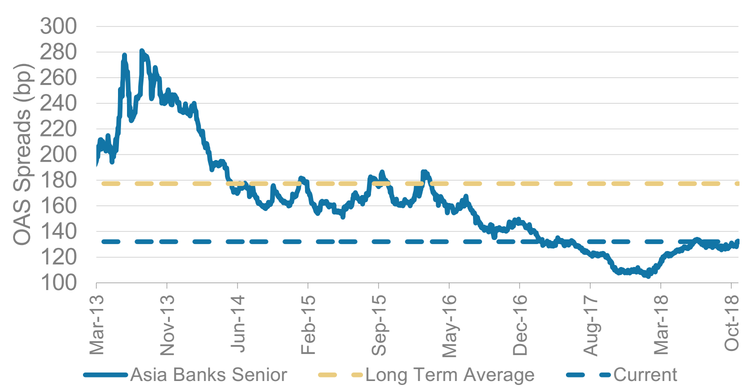
6) UW senior financials: China leasing is the sweet spot

Despite widening by 24bp year-to-date, Asia senior banks spreads are still rich from a five-year historical average perspective (Exhibit 68). Hence, we are keeping our UW position on Asia senior financials. That said, we believe that, within senior financials, the value lies in the Chinese non-bank sector. Exhibit 69 shows that Chinese banks leasing pick-up over Chinese banks seniors is close to a three-year wide, making the sector look cheap. In contrast, China AMC valuation looks fair as its spread pick-up over Chinese banks is trading close to the historical average. Hence, we think that the sweet spot in the Chinese non-bank space is in the China leasing sector.

We break down the China leasing sector into three buckets of tenors: 1-3Y, 3-5Y and +5 years (Exhibit 70). We feel that 1-3Y is the most attractive tenor given the limited pick-up in spreads for investors as they increase duration (only +5bp extension to 3-5Y and +12bp to +5Y). **In the 1-3Y bucket, we find CDBLFU 19, CDBFLU 20, ICBCIL 2.5 21, BKCOML 21 and CCBL 21 attractive.**

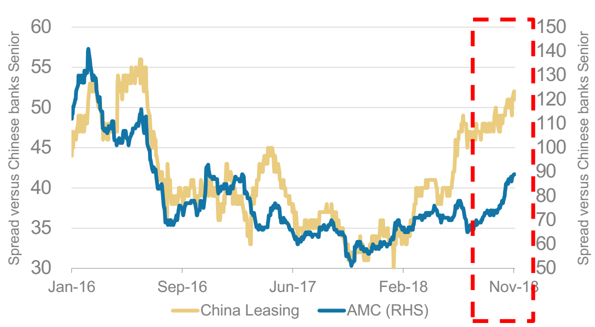
The risk to this trade is that China goes through a hard landing and a sharp drop in GDP growth.

Exhibit 68: Asia bank senior is off the historical lows but still looks tight versus the historical average



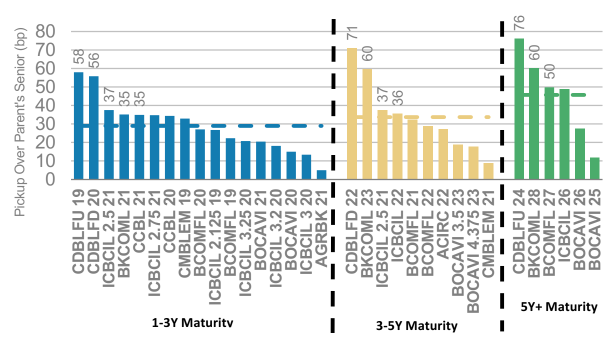
Source: iBoxx, Morgan Stanley Research

Exhibit 69: China leasing spread pick-up over Chinese senior banks is now back to the level of 2015/16



Source: Bloomberg, Morgan Stanley Research

Exhibit 70: China leasing bonds pick-up over duration matches Chinese senior banks



Source: Bloomberg, Morgan Stanley Research

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