December 2017

Asia Credit : Close to the peak

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Key risks – ‘the known unknowns’

- US$ strength in a rising US rate environment – implications for EMFX
- Geopolitical risks – North Korea, European terrorism, Syria, Iran, Qatar, Trump policies
- Tax reform and infrastructure spend for the US are going to have a bearing on rates. With 2018 mid-terms to be kept an eye on.
- Likelihood of Central Bank balance sheets contracting
- US Tech sector – any unwind of the sharp bull run seen since beginning of the year has potential to impact other markets
- Life after 19th National Congress of Communist Party in China – focus on reforms may increase the pain
- China – liquidity tightening, rising domestic yields and likelihood of tougher reforms
- Rapid and ongoing pick up in bond issuances

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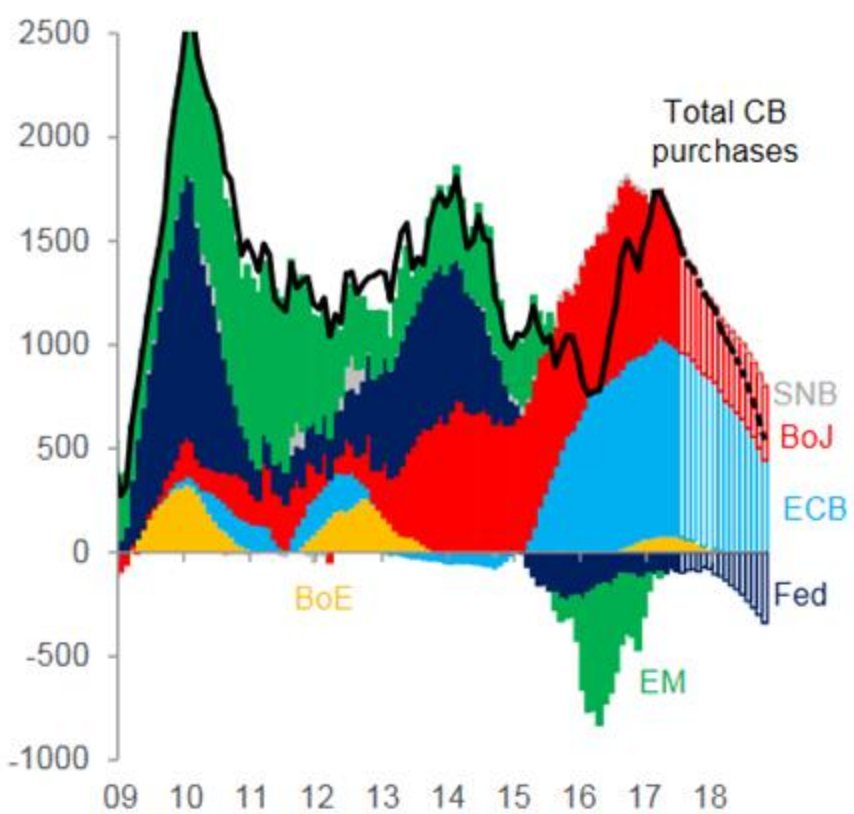
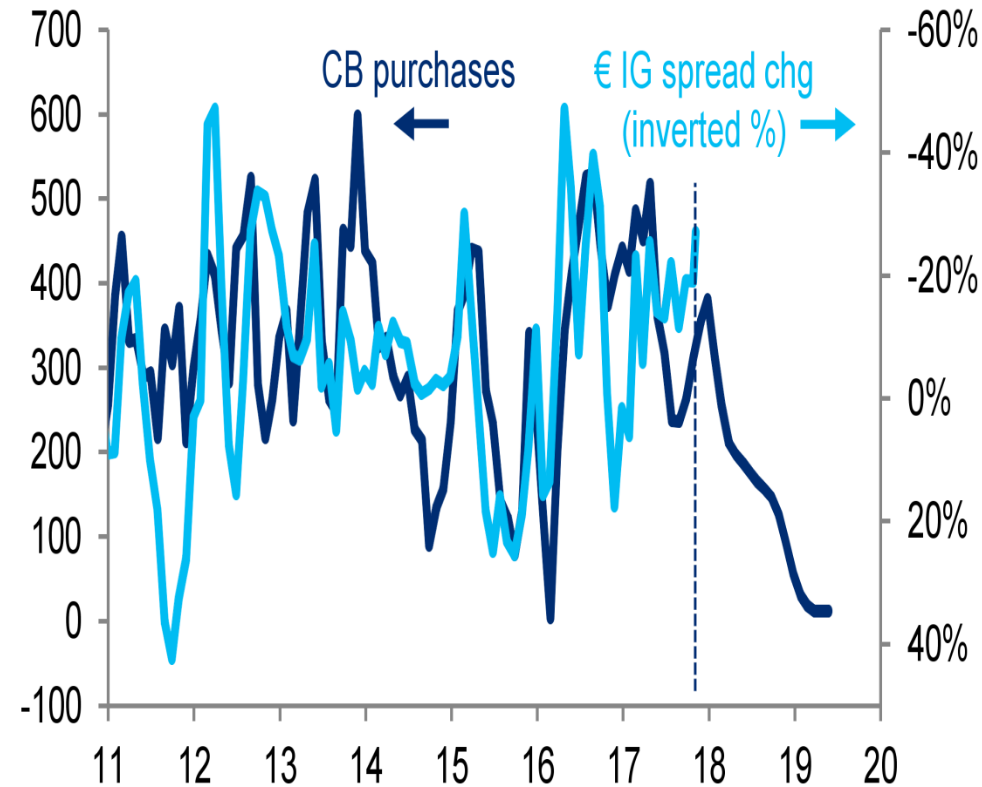
Central Bank Purchases have supported the markets so far – Withdrawal has the potential to be painful

Our favourite market indicator

Securities purchases by global central banks, rolling 12m, $bn





Source: National central banks, Citi Research. EMFX reserve changes are FX-adjusted.

Source: European Credit Derivatives Outlook 2018 - Making the most of limited options , Matt King (https://www.citivelocity.com/t/eppublic/1DLVh)

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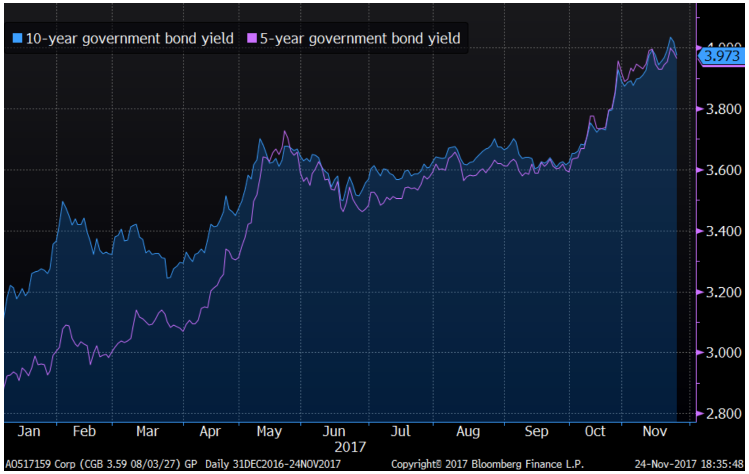
China – Onshore Bond Yield Rose in 2017 Amid Financial De-Leveraging

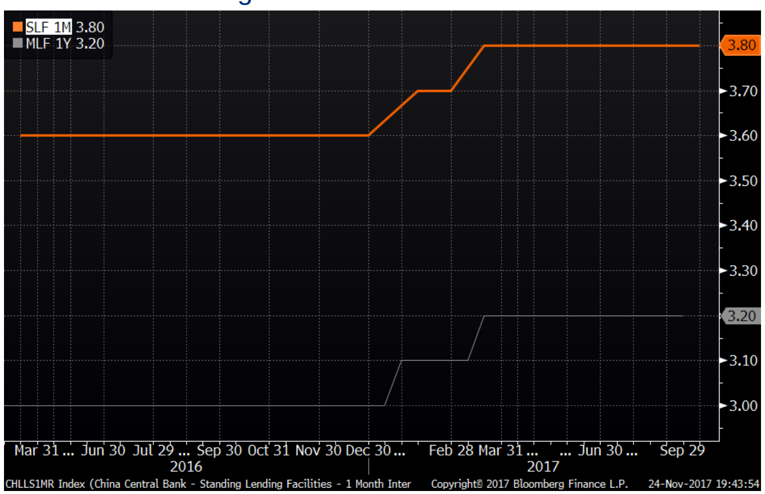
- Chinese authorities have committed to a multi year financial de-leveraging theme
- Onshore bond yields – evident by 5-yr and 10-yr government bond yield – rose in 2017 and surged in recent months. Curve has flattened.
- But no liquidity crisis – PBOC smoothed out fluctuations to avoid excessive volatility as financial stability remains a priority
- Interbank rates' increased in 2017, but volatility remains manageable.
- Increase in corporate bond yields is one of the biggest risks to watch out for – implication for borrowing costs

China 5y and10y government benchmark yield

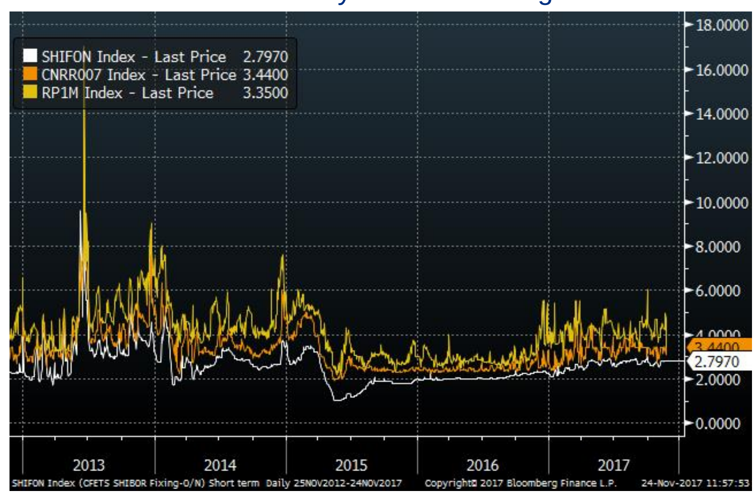


China onshore corp 5y AA yield vs 5yr gov benchmark

PBOC raised its guidance on interbank SLF and MLF rates



Interbank market volatility remains manageable in 2017



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Source: Bloomberg, 11/27/2017

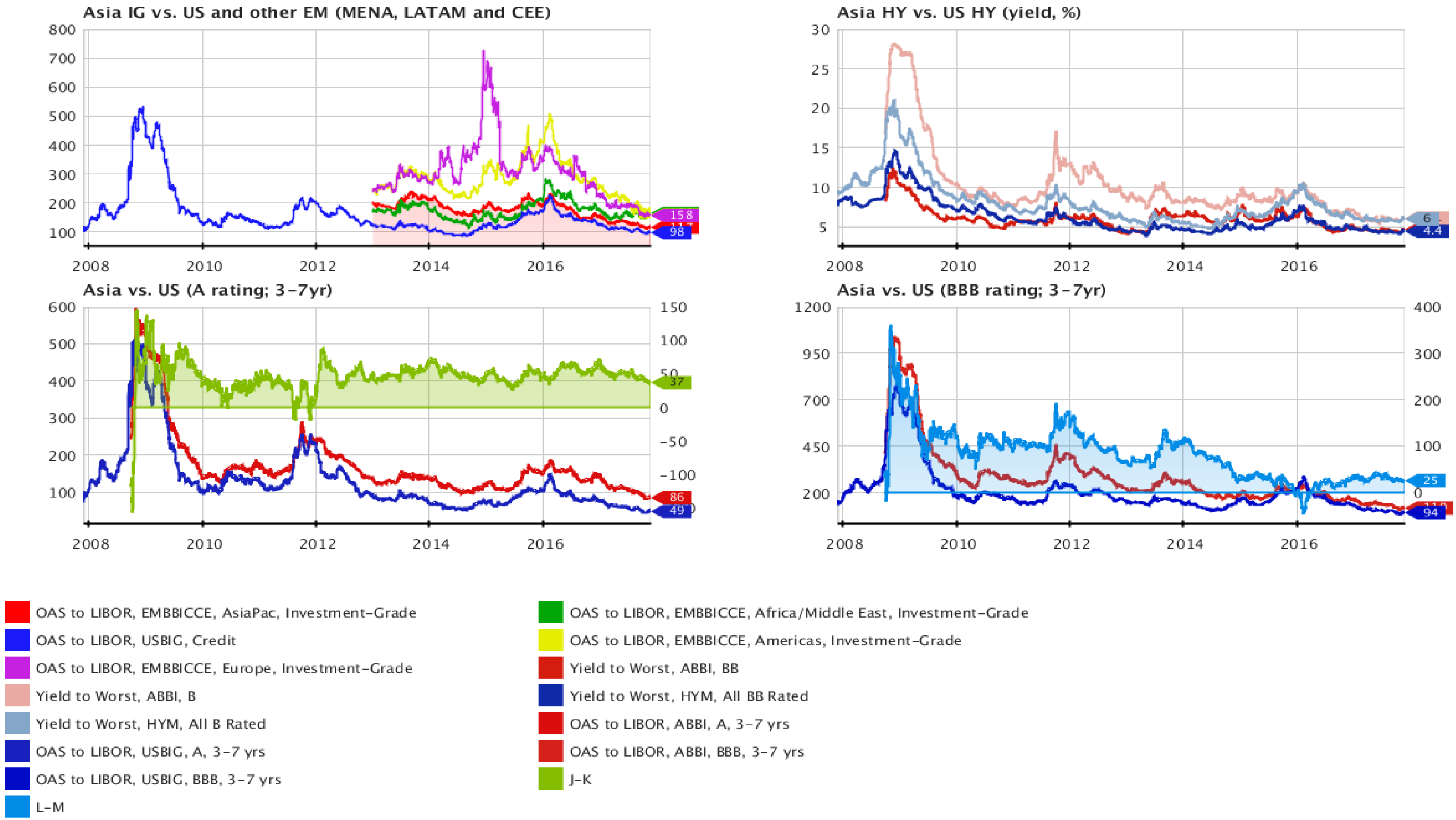
China – Frequent Tightening Measures Focused on Preventing Financial Risks

- Chinese authorities issued frequent new regulations in November:
  - Asset management product consultation draft
  - Regulation over online cash-lending business
  - Scrutiny into public-private partnership projects
  - Regulatory guidance over policy banks
  - Restriction on specific insurance companies with non-compliant products
- We expect these measures to prove positive for fixed income investors over the longer term:
  - Create standardized regulation
  - Reduce shadow banking risks and improve transparency
  - Place constraints on non-standardized credit assets
  - Remove layering and channel businesses
  - Break implicit guarantees on off-balance sheet products
- But liquidity will likely remain tight and could spark selective defaults
  - Banks and FIs' off-balance sheet products' attractiveness will be reduced
  - Smaller banks' and NBFIs' liquidity could be pressured because of product unwinds
  - Unwinding will be more evident in low-quality corporate bonds and LGFV notes with limited turnovers

Technicals and Valuations

Asian valuations – limited room to go further

- YTD, Asia IG is tighter 49 bps while Asia HY BB is tighter 31 bps. Spreads close to all time tights.
- Asia HY is almost flat to US HY. Asia vs US IG though still provides some pickup



Source: Citi Asia Credit, CitiVelocity. As of 11/27/2017

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Asian returns – solid YTD performance across the board

- Asia IG returns have been stable and much less volatile vs. HY.
- Indonesia had yet another blockbuster year and so did HY sovs. China provided steady returns despite high level of supply
- Last months' selloff was most vividly felt for the HY space while IG remained stable

Country	Weekly	Monthly	YTD	2016
Eastern Europe				
Turkey	-0.3%	-1.0%	7.6%	3.5%
Russia	0.2%	0.6%	5.6%	12.9%
Kazakhstan	0.4%	0.8%	10.3%	12.3%
Azerbaijan	0.4%	-0.2%	4.4%	21.5%
Africa/Middle-East				
Qatar	0.1%	-0.1%	3.2%	3.5%
UAE	0.2%	-0.1%	5.2%	4.9%
South Africa	0.3%	-0.3%	9.3%	13.0%
Asia				
China	0.1%	0.0%	5.2%	5.5%
India	0.4%	0.1%	6.4%	8.8%
Indonesia	0.5%	-0.1%	11.9%	14.3%
Malaysia	0.0%	0.3%	6.1%	2.1%
South Korea	0.0%	0.2%	3.2%	2.0%
Latin America				
Mexico	0.6%	0.4%	10.4%	8.3%
Brazil	0.7%	0.2%	13.1%	25.6%
Colombia	0.5%	0.3%	10.2%	16.1%
Peru	0.2%	0.1%	7.5%	10.8%
Chile	0.2%	0.1%	8.2%	8.7%
Sectors				
Financials	0.2%	-0.1%	5.9%	7.3%
Energy	0.3%	0.3%	9.0%	11.8%
Consumer	0.3%	0.4%	6.6%	10.8%
Metals/Mining	0.7%	0.4%	12.2%	24.7%
Property	0.4%	0.1%	7.0%	7.9%
Telecom	0.1%	0.0%	7.8%	5.2%
Utilities	0.2%	0.0%	7.2%	5.2%

	YTD returns
Asia credit	5.75%
IG corporate	4.80%
HY corporate	6.10%
IG Sovereign	8.10%
HY sovereign	11.30%

Source: Citi Asia Credit, CitiVelocity. As of 11/27/2017

While the localization of investor base has supported these valuations

- From 49% of the issues being Reg S/144a as recent as 2014, such issues are merely 26% of the total issuance this year given the development of the local investor base
- Almost 62% of the gross issuance YTD 2017 is from China and almost 75% of the new issuances are being allocated to Asia, a large part of that being to China investor base
- **Any reversal in flows is to be watched closely for definitive sign of turns for risk**

Period	$Bond Issuance ($ bn)	Reg S Only (%)	Reg S and 144A; SEC registered etc.
FY14	174.9	51.1%	48.9%
FY15	142.7	53.4%	46.6%
FY16	164.5	70.4%	29.6%
FY17 YTD	262	73.1%	26.9%

Source: Citi Asia Credit, Bloomberg, As of 11/27/2017
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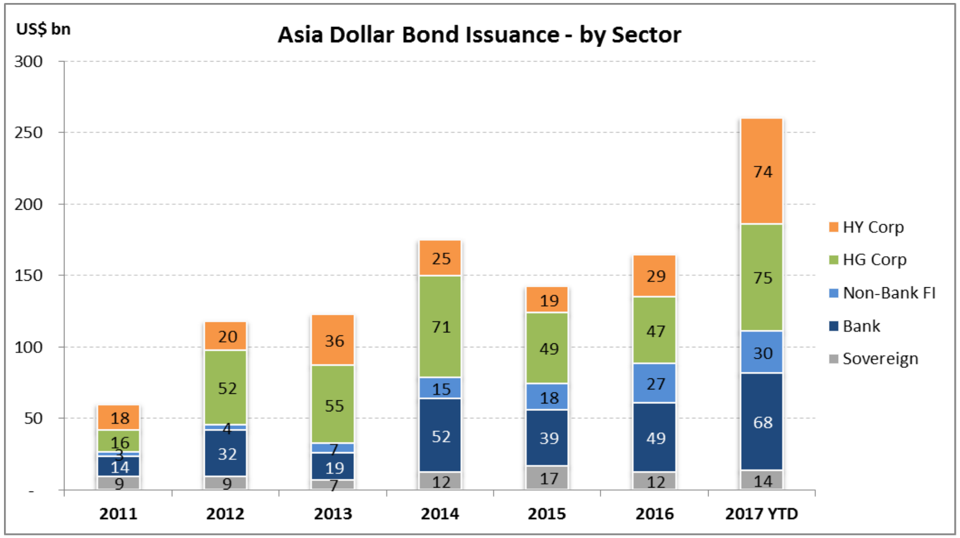
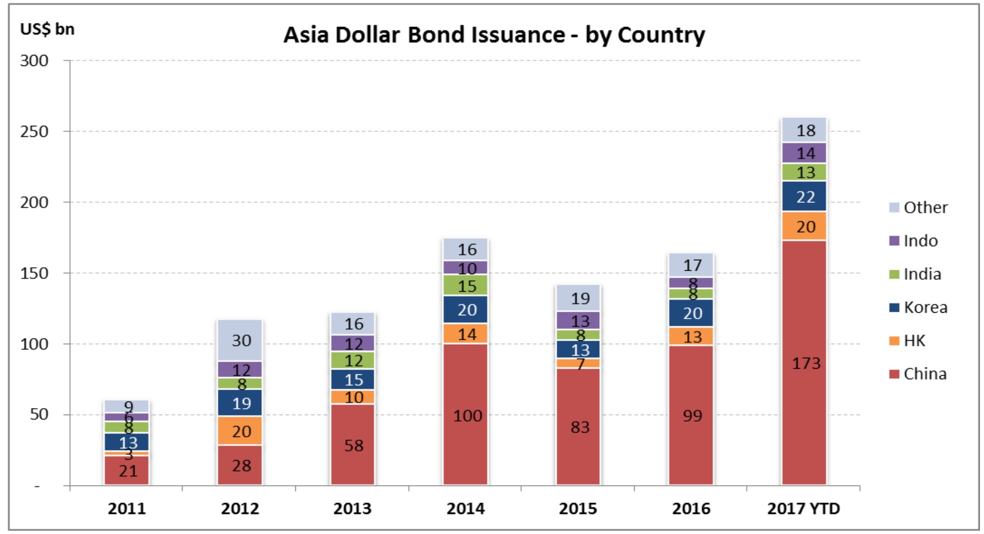
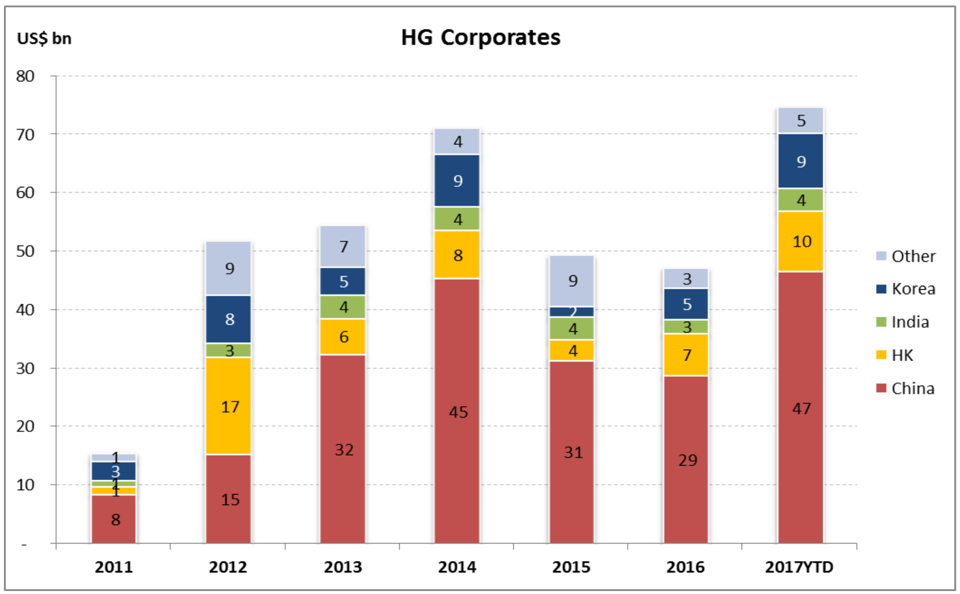
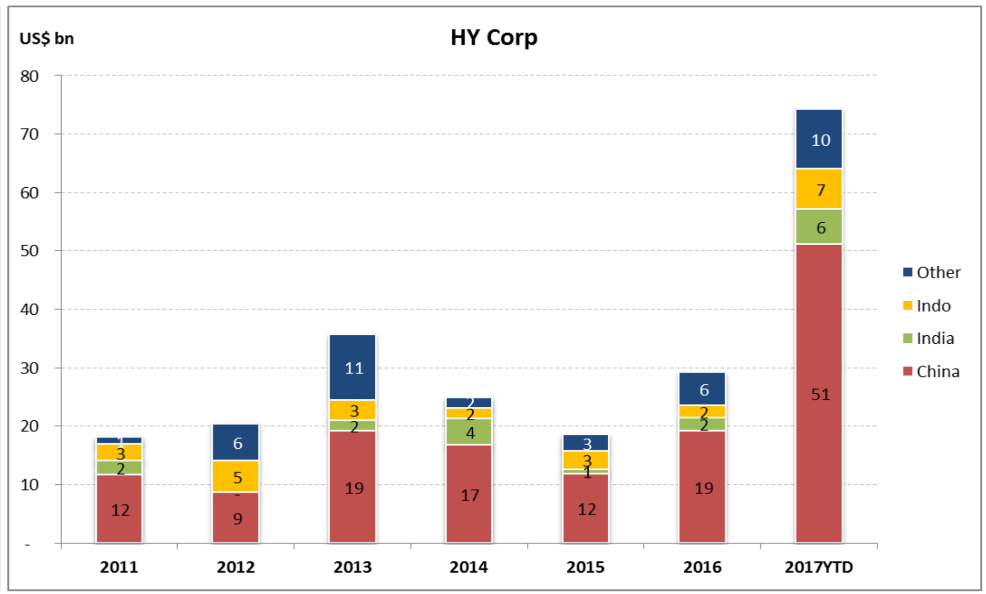
2017 Issuance – all about China. HY issuance to be watched









Source: Citi Asia Credit, Bloomberg. As of 11/27/2017

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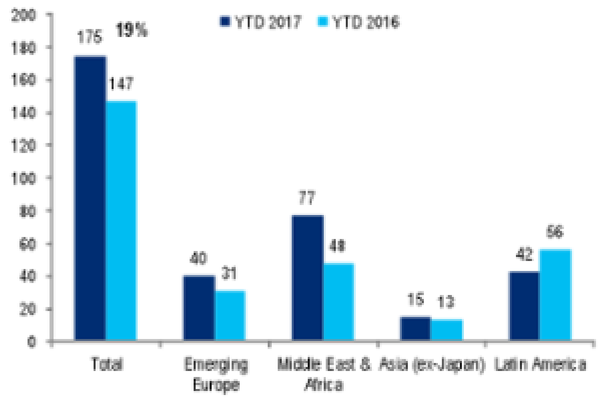
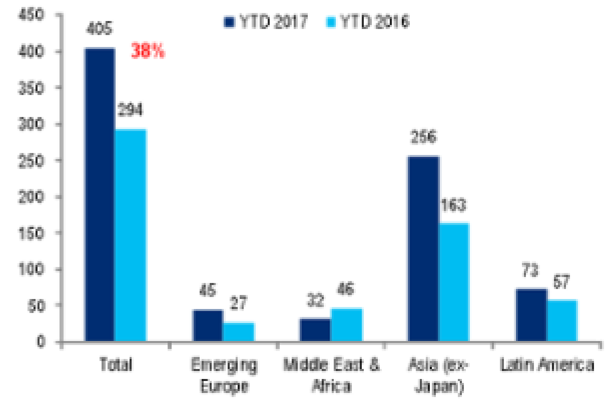
2017 Issuance – net issuance of more than US$200 bn

Figure 17. Sovereign: Gross Issuance – Regional Breakdown (USD bn)



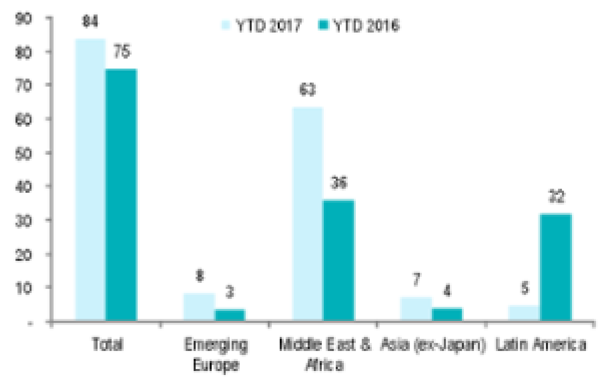
Source: Citi Research, Bloomberg

Figure 18. Corporate: Gross Issuance – Regional Breakdown (USD bn)



Source: Citi Research, Bloomberg

Figure 19. Sovereign: Net Issuance – Regional Breakdown (USD bn)



Source: Citi Research

Figure 20. Corporate: Net Issuance – Regional Breakdown (USD bn)

Source: Citi Research

Source: EM Credit Barometer Weekly - Slowing inflows over Thanksgiving , Luis Costa (11/24//2017, https://www.citivelocity.com/t/eppublic/1DI3J)

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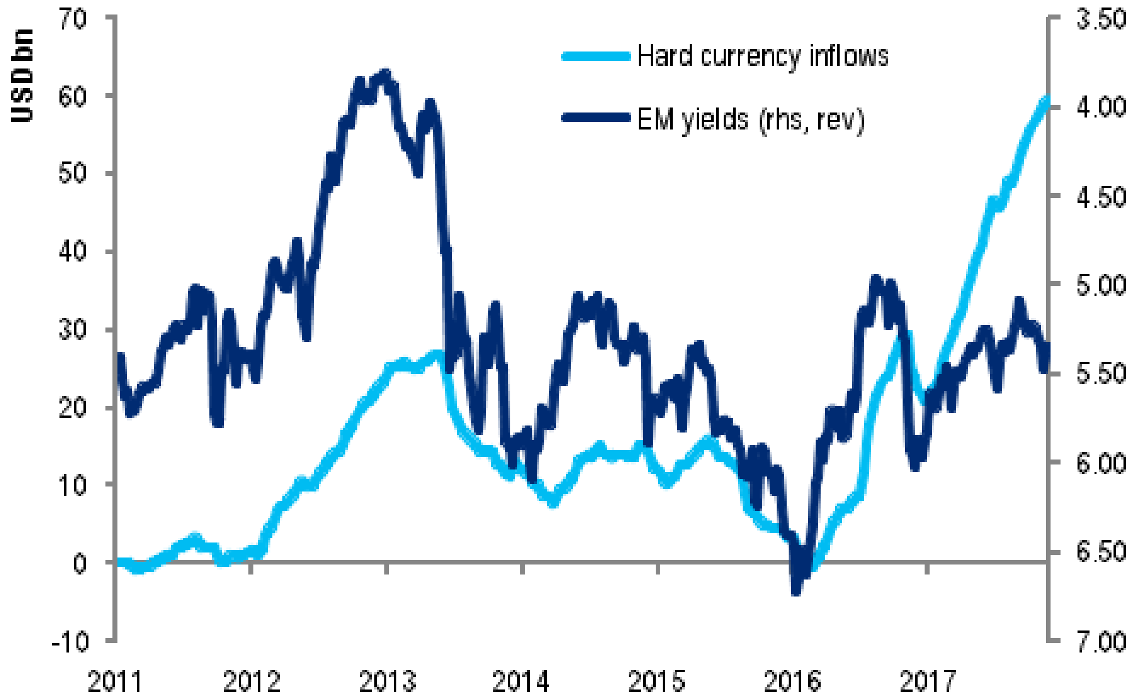
EM bond fund flow has been strong

Institutional flows have held up so far while 'China bid' continues to play a strong part

- Technicals for EM flows remain strong
- Blended EM funds have now seen 16 week straight inflows



Source: EM Credit Barometer Weekly - Slowing inflows over Thanksgiving , Luis Costa (11/24//2017, https://www.citivelocity.com/t/eppublic/1DI3J)

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China bid – Differentiating and looking through the noise

China IG in a better spot to benefit vs. China HY. Differentiating the impact of China bid on different segments of China credit markets is important.

- China IG spreads will likely continue to be well supported by bank treasuries' bids amidst price weakness. Profit-taking can be sporadic when yields are low, but real demand for yields and duration will continue to overwhelm.
- Spread compression between good quality BBBs and single-As will continue, driven by demand in absolute yields from both SOE banks and joint-stock banks.
- NDRC's approvals of China IG new issues have been healthy in both issuer quality (SOE focused) and issuing pace so far. This is constructive to secondary performance as well. Expect NDRC to keep prioritizing SOE and high-quality issuance in the next quarter.
- Domestic noise around certain issuers is (and will) impacting some investors, but asset managers, prop desks, bank treasuries likely to continue favoring companies that 1) have sound credit profiles 2) are socially important 3) have key-man associated favorably with the government and 4) have close relationships/large scale with the banking system.
- Small (US$100-300 mm) HY issuances, from first time issuers, largely privately placed are at risk of worsening technicals
- Structured flows related to Chinese wealth management products (most notably Chinese Bank AT1 leveraged CLNs) are likely to have a meaningful impact on underlying AT1s, especially small 2nd/3rd tier issuers
- Given tapered pressure on RMB weakness and volatility, expect no further drastic capital control measures from the Chinese regulators. The rapid realization of north-bound Bond Connect signifies that the regulators will not cut further into the south-bound routes (QDII AMs and wealth management products, bank treasuries). But do not expect rapid easing of overseas investments either.

Source: Citi Asia Credit

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Maturity/Call* profile – large maturities/call over next 3 years. Issuance trend to remain strong in 2018

China (Financials, IG Corps and HY Corporates), Korean IG/Corps and Indian Financials will see big maturities/call

Row Labels	2017	2018	2019	2020	2021
⊟IG Corp	**15,716**	**30,813**	**47,791**	**32,550**	**28,049**
CN	5,366	18,815	29,231	22,050	15,399
HK	5,700	3,495	6,600	4,050	5,000
IN	300	1,100	1,750	1,650	1,500
KR	2,700	5,480	3,160	3,250	3,750
MY		50	3,000	1,550	
SG	700	400	2,750		1,100
TH		323	1,300		700
TW	950	1,150			600

Row Labels	2017	2018	2019	2020	2021
⊟Financials	**19,897**	**30,057**	**67,559**	**65,735**	**42,565**
CN	6,497	14,250	44,390	39,310	25,965
HK	500	1,000	4,099	5,675	2,250
ID	-	300			
IN	2,850	5,407	4,800	6,000	1,800
KR	5,550	4,900	7,600	10,550	9,300
MO			320		
MY	1,650		1,500	1,450	1,500
SG	1,750	2,300	3,050	1,750	1,450
TH	1,100	1,900	1,800	800	300
TW				200	

Row Labels	2017	2018	2019	2020	2021
⊟HY Corp	**10,016**	**29,331**	**27,588**	**22,602**	**17,664**
BD		300			
CN	5,748	22,296	19,917	13,278	5,663
HK	453	1,134	2,565	3,192	2,662
ID	579	1,744	985	2,160	2,700
IN	732		1,625	1,500	3,100
KR				300	
LK	-	1,350	250		
MO	825	850	350		
PH	1,179	1,302	1,120	1,022	2,234
SG	500	355	775	1,150	1,305

Row Labels	2017	2018	2019	2020	2021
⊟Sov	**-**	**3,400**	**10,417**	**6,222**	**8,057**
CN					
FJ				200	
HK			1,000	1,000	
ID	-	2,900	3,500	2,000	3,250
KR			1,500		
LK			1,675	1,000	1,000
MN	-	500		500	500
MY					1,550
PH	-		2,742	776	1,757
VN				745	

Source: Citi Asia Credit, Bloomberg. As of 6/30/2017 * Bonds are categorized as callable in a certain year based on Bloomberg pricing and current trading norms

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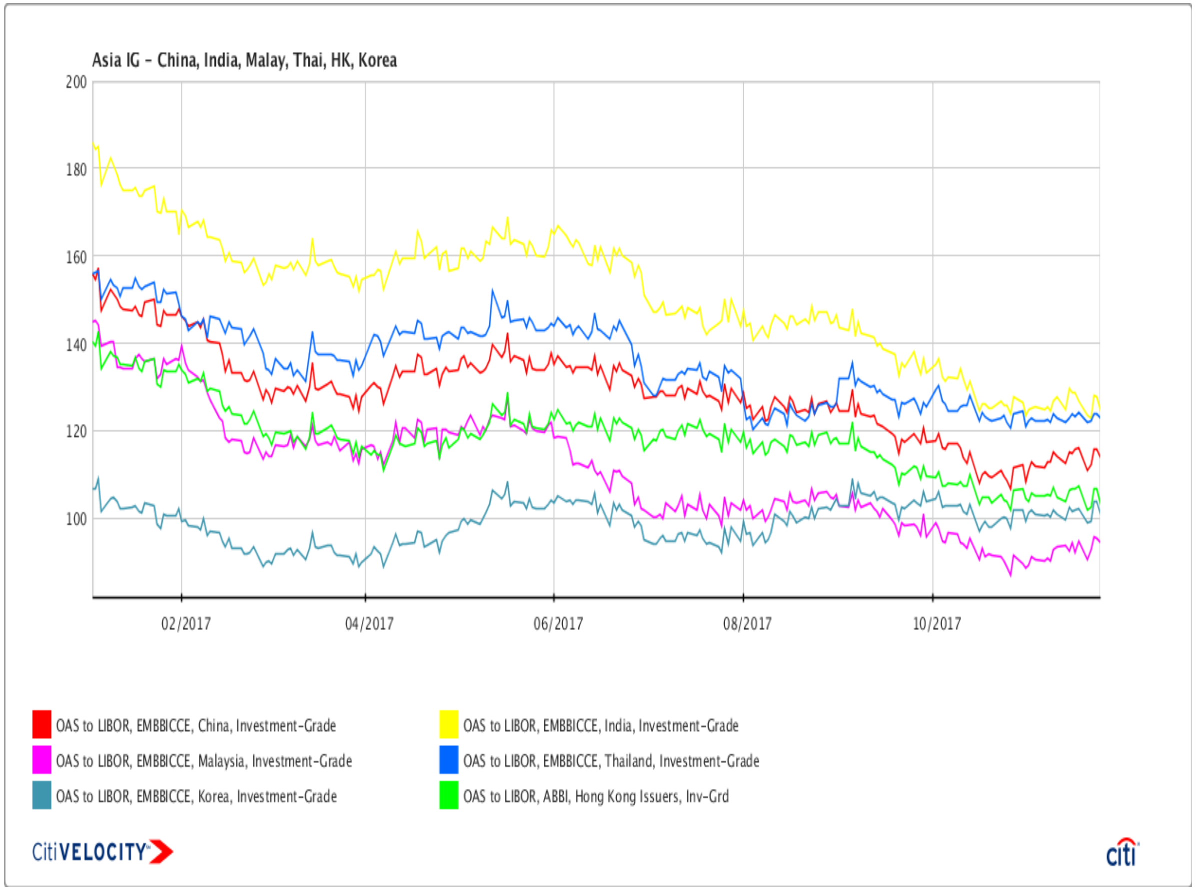
Sector Strategy – IG & Financials

IG Strategy

Prefer IG to HY in general.

Tightly priced Korea has underperformed and ratings adjusted, is the most attractive in the region.



- We would **expect carry to be the main driver of returns for IG in 2018 once again**. Expect spreads to be supported initially at the beginning of the year on the back of solid technicals. Central bank unwind and rising UST will be the key risk as we head further into the year.
- **Macro and political factors will be the key drivers for spreads once again** – specially for China, Korea, India and Malaysia.
- **Short dated part of the curve has been very tight, but technicals solid. We prefer 5-10 years duration**. But constructive on longer dated 30yr risk as well given lack of paper and good technicals.
- Rates curve has flattened and longer dated paper less attractive for yield based buyers.
- We **again expect IG technicals to hold up better vs. HY**, specially for China. This is one of the main reasons for our overall preference for IG vs. HY (where idiosyncratic risks are much higher).

Source: CitiVelocity. As of 11/27/2017

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China IG Overall Thoughts

Key preferences and themes

Overall view

- **Investment needs from Chinese bank treasury desks underpin the stable spread performance of China IG; spreads likely to remain stable if not drifting wider**
- **Most alpha/compression trades have been realized during 1H; we prefer high-quality papers to weak BBB in view of the insignificant differences in yields/spreads; quasi-sovs look more attractive in this sense**
- **Comfortable with E&P, TMT and Utilities sectors but most names are just carry plays**
- **Cautious on the LGFV space given potential onshore credit events as well as pickup in supply**
- **Cautious on the chemicals names mainly due to supply risk**
- **Perps are in general looking tight; we like only a few high step-up perps for carry**

Source: Citi Asia Credit, Bloomberg. As of 11/27/2017

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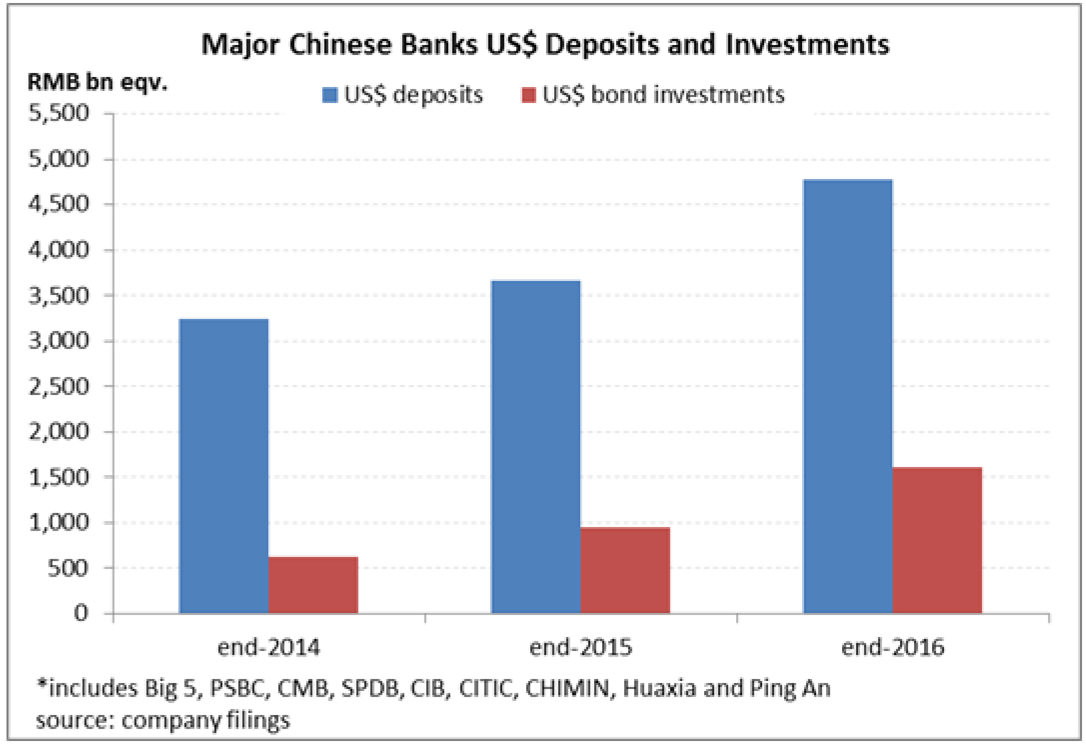
China IG – underpinned by bank treasury books

Capital controls have remained tight YTD; while banks continue to expand their US$ treasury books

Chinese banks continue to see increases in dollar deposits.

We expect Chinese bank treasury books to keep expanding their US$ bond investment portfolio on the back of this trend.



Source: the financial reports of corresponding banks, As of 7/7/2017

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Regional Financials

NC5 B3T2s exhibit attractive risk-reward; select names offer RV vs. corporates;

- **AT1s: non-call risk increasingly in focus as we approach 2019; avoid bonds with weaker credit profiles + relatively low ret margins; we take a cautious stance given supply**
- **B3T2s: bullet T2s appear tight; NC5 B3T2s in general look decent based on undemanding sub-senior ratios**
- **AMCs: performance capped by supply, few pickings**
- **Leasing and insurance: some RV vs. corporates but avoid headline names**
- **Limited value in bank seniors across countries but Chinese Big 4 bank seniors have some small RV vs. China quasi-sov corporates**
- **HY Fins: extremely tight in our view, some bonds even mispriced**

Source: Citi Asia Credit. As of 11/27/2017

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Indian IG Corporates – tight, but stable

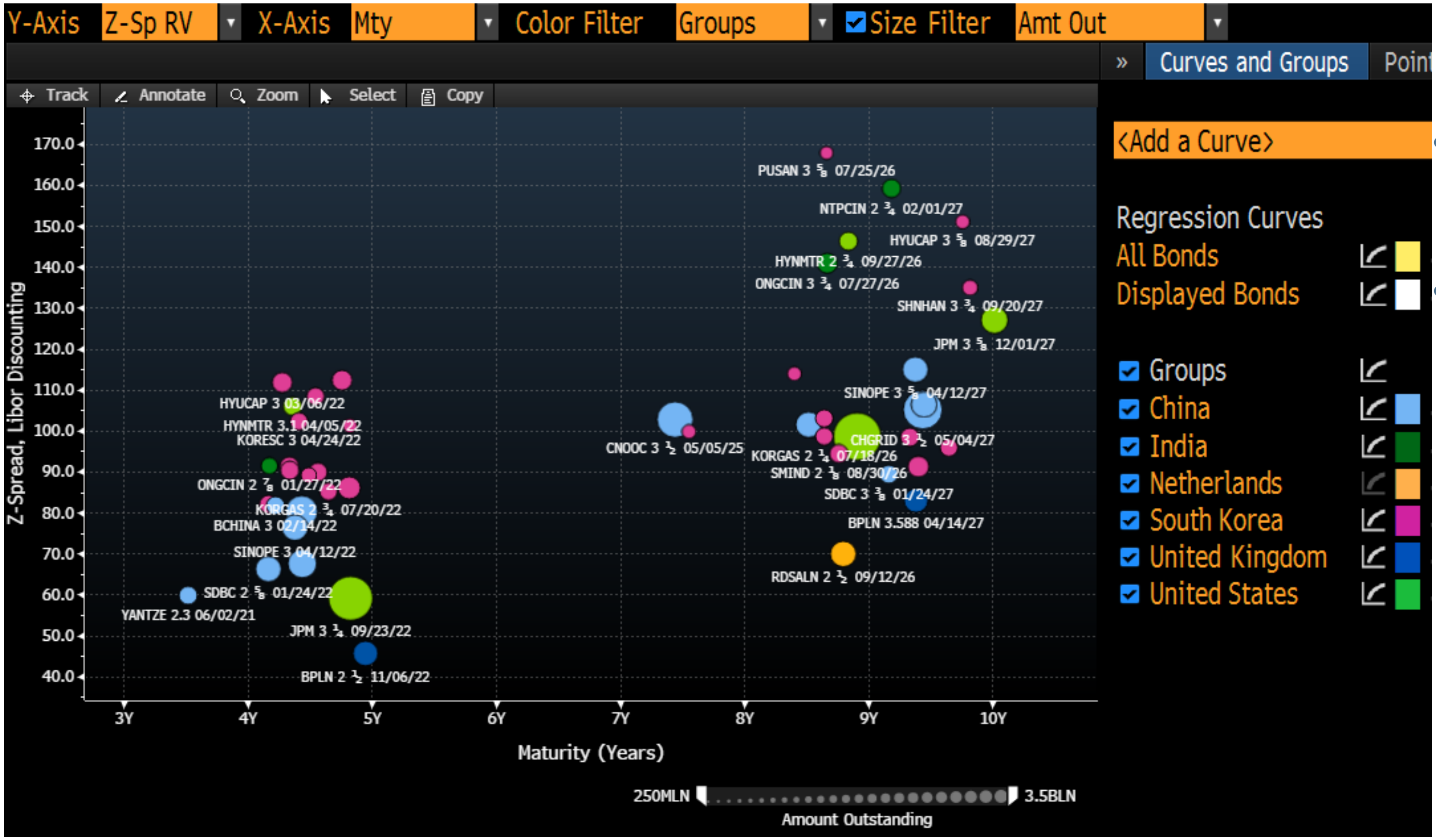
Structural reforms continue to support valuations and investor inflow. Ratings adjusted, this is one of the tightest EM sectors globally. But likely to stay resilient given stable underlying macro

- Rating upgrade of the sovereign to Baa2 by Moody’s, but S&P holds the ground as of now
- Valuations largely already reflect the macro improvement
- Assets have been chased and supply has been manageable so far – but we expect that to pick up
- Indian banks and corps vs. Chinese banks and corps has shrunk to just ~30 bps now for 5 notch rating differential. Indian quasi corps and banks now trade flat to inside of AA- rated Korean quasi corps and banks

Source: Citi Asia Credit

Korean corporates – prefer short end

Improving macro environment while North Korea noise will remain. Flat curve and some pickup to DM



- 5 yr Korea corporates trade flat to wide off Chinese corporates and in some cases Indian corporates as well
- 5 yr Korean quasi corps provide about 40 bps pickup to US benchmark names, for better ratings relatively
- Non- quasi 5 yr corps provide good pickup to quasi sov as well as China corps.

Source: Bloomberg, Citi Asia Credit. Product availability is subject to current market conditions. All pricings and information are indicative and purely for illustration and discussion purpose and not a recommendation to buy or sell into any specific transaction. For further details, please contact your sales representative. As of 11/27/2017

Sector Strategy – HY Corporates

HY Strategy – All about staying clear of the minefields

Barbell strategy preferred – carry from good quality names and reaching for yield for distressed names

- **We prefer better quality, low noise HY names and not look to chase optically more yieldy names.**
- **China HY Property – We expect leverage to increase**
- **China HY Industrials – We expect rising idiosyncratic risks in 2018**
- **Indo HY – We prefer Indo HY to India HY.**
- **India HY – Tight sector, some carry but mostly pans for us.**
- **Other HY – We see some opportunities in commodities, expect gaming to be stable.**

Source: Bloomberg, Citi YieldBook. Product availability is subject to current market conditions. All pricings and information are indicative and purely for illustration and discussion purpose and not a recommendation to buy or sell into any specific transaction. For further details, please contact your sales representative. As of 7/7/2017

China HY – sector outlook

Higher risks expected

- We expect Chinese property underlying to remain status-quo in late 2017 and early 2018. (1) Do not expect policy relaxation, certain cities may have fine-tuning (either more strict or less strict as case by case, (2) borrowing cost should go up, onshore-bond market may selective open to a few issuers but not all.
- We expect leverage of most property companies to go higher as most want to grow their scale. Scale really matters in China in terms of recognition and access to funding. Sales growth and margin improvement will help offset the negative impact of leverage, on the other hand.
- Environmental protection and over capacity reduction is again emphasized in 19th Party Congress. Citi expects negative impact on coal price, while positive impact on coke and aluminum.
- We expect idiosyncratic risks to go up in 2018.
- Higher onshore yields, tighter onshore funding will have more impact on Chinese HY in 2018.

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China HY– higher onshore yields, tighter onshore funding will have more impact in 2018.

Supply to be closely watched

Performance

- Issuers are willing to pay higher premium to get deal gone. IPTs are more attractive and new issue premium are better in Nov compared to transactions in 1Q17 and 3Q17, yet secondary performance of many new issues in Nov are poor.
- Talks of supply and struggling new issue performance led secondary bonds widened in Nov. Even some benchmark credit long-end bonds dropped 4pt in a few days (eg. LOGPH, YUZHOU).
- The 364 deals were actually performing better than 3yr deals even though most 364s are issued by weak single-B issuers, given (1) the pricing is very close to or even higher than 3yr bond, (2) some investors especially Chinese prefer short-dated paper, the shorter the better, (3) these bonds are usually well anchored.

Expectation on market

- We expect overall spread in China HY may continue to go wider into year end and into the new year, especially weak single-Bs of both industrials and properties, given (1) supply concentration, (2) less credit familiarity in general, (3) less strong hand real money involvement (ie. bank treasury, international funds, etc)
- We expect refinancing concerns and potential default risk to increase in 2018 given maturities in China HY, among these were 364s issued this year. Access to new NDRC quota and market appetite for 364s then are uncertain currently, in our view.

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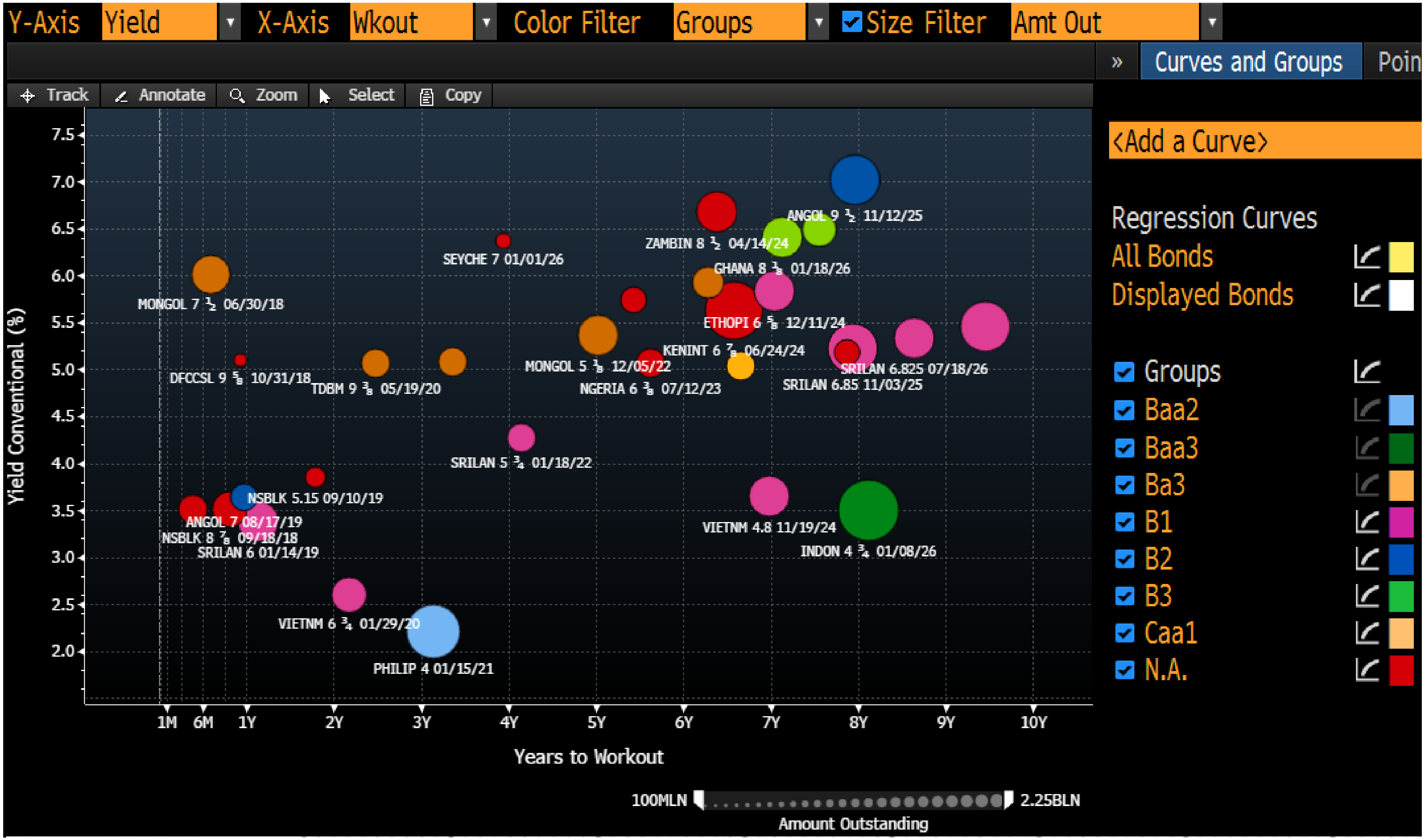
Non-China HY – credit profiles remain well supported

- **For Indo property, after worsening till end 2016, sales and credit parameters have started to turn for the positive for sector names. We don't expect a U shaped sales recovery, but expect sector to remain resilient for credits. Refi or liquidity concerns are low**
- **Credit improvement for Indo industrials is less noticeable vs. property. Name specific credit peculiarities exist**
  - We prefer some resource based names in this space
- **For Indian HY: Concerns on valuations and credit quality. Some carry opportunities and better technicals than Indo**
- **Commodity HY names: attractive in pockets**

HY sovereigns – stabilizing stories

- **Asia Frontier names have performed in line with African sovs. Our pick MONGOL has been among the main outperformer in this period.**



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Conclusion

- Valuations tight, technicals still supported
- 2018 likely to be a year of subdued returns
- Pickup in volatility likely more pronounced towards the later part of the year
- Prefer IG to HY in general
- Within HY, prefer a barbell strategy
- Not much value in extending duration

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