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MANAGER INSIGHT

Asia High Yield Credit: A Distinctive Emerging Markets Story

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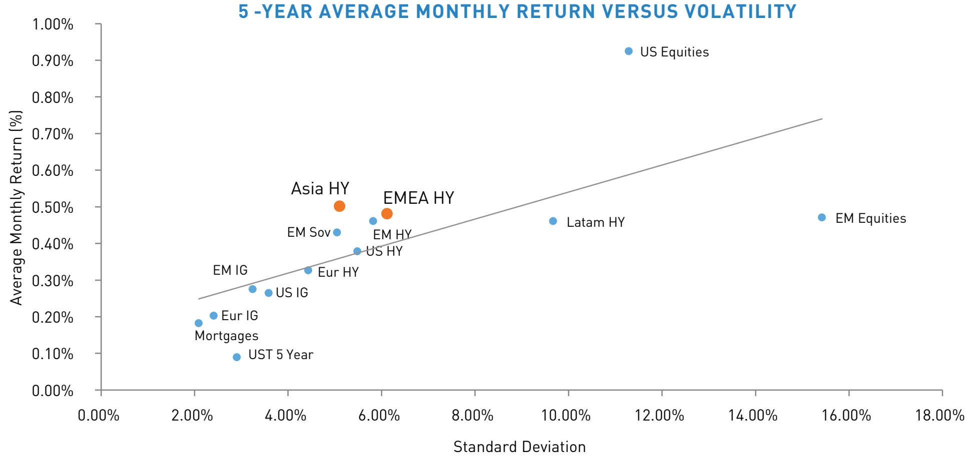
KEY TAKEAWAYS

- Asia high yield credit has one of the highest returns per unit of volatility globally.
- The asset class has been benefiting from strong macro fundamentals, a growing universe and regional market dynamics.
- Adding exposure to EMEA high yield credit can expand the opportunity set without adding to correlated beta.

Investors may view emerging markets (EM) as particularly vulnerable to volatility, since the asset class typically sees outflows during times of market stress. However, EM are not all one and the same.

Hard-currency Asia high yield credit has shown resilience through periods of stress. Over the last five years, Asia high yield credit, as measured by the JP Morgan Asia Credit High Yield Index, has had a lower drawdown and a higher average annualized return than other high yield asset classes.[i] This period covers the commodity price crash in 2016 and the correction in Asia credit in 2018. More broadly, Asia high yield credit stands out among global indices, providing one of the highest five-year risk-adjusted returns globally.

5 -YEAR AVERAGE MONTHLY RETURN VERSUS VOLATILITY



Source: Bloomberg, Loomis Sayles, ICE indices, data as of June 30, 2019. Asia HY =ICE BofAML HY Asia EM Corporate Plus Index. EMEA HY = ICE BofAML High Yield EMEA EM Corporate Plus Index. Latam HY = ICE BofAML HY Latin America EM Corporate Plus Index.

Past performance is no guarantee of future results.

On the following pages, we outline key factors supporting Asia high yield credit's lower drawdown and strong risk/return profile, and identify how to broaden the opportunity set by investing in other EM countries or regions with similar traits.

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Positive Macro Fundamentals

The International Monetary Fund (IMF) estimates that Asia's GDP growth rate in 2018 was 6.4%,[ii] the highest in the world. Rising local purchasing power, technology and infrastructure development and greater regional connectivity should fuel growth further. The IMF projects that Asia's share of global GDP growth will increase from 59% in 2018 to 65% by 2024, which would take its share of global GDP from 33% to 39%, respectively.[iii]

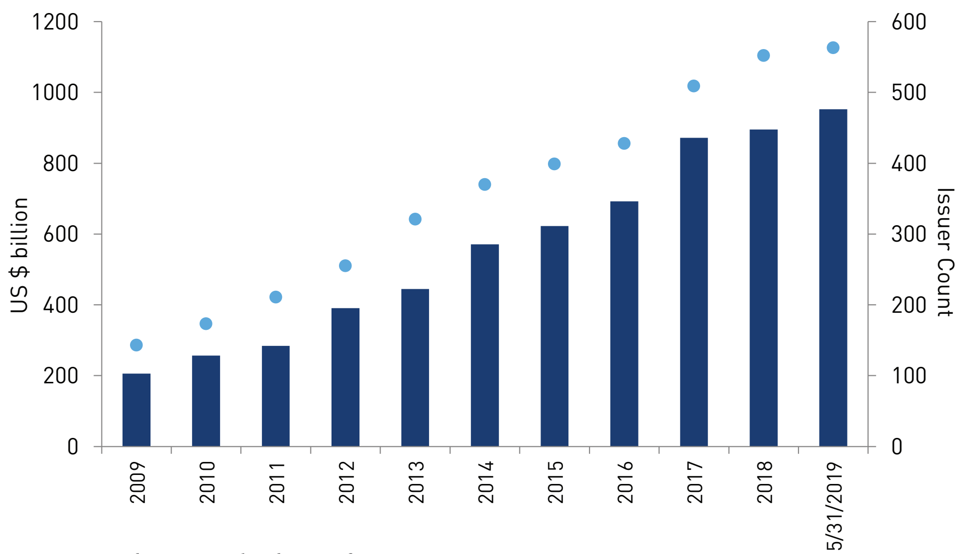
A Growing Universe with Improving Credit Metrics

Sovereign and corporate debt issuance in Asia has expanded notably over the past decade, mirroring the region's strong growth. The market value of the Asian US-dollar credit market, as measured by the JP Morgan Asia Credit Index, has grown four-fold since 2009. The index has a market cap of close to a trillion dollars, now on par with many developed market indices.

The number of issuers in the index has tripled in the same period. In the last five years, Asian issuers, primarily from China, have been the main contributors to gross bond supply in EM.

JP MORGAN ASIA CREDIT INDEX MARKET CAP & ISSUER COUNT

Market Cap (left-hand scale)
# of Issuers (right-hand scale)



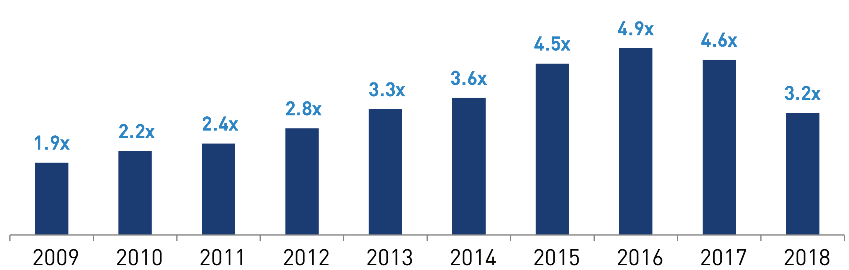
Source: JP Morgan and Loomis Sayles, data as of May 31, 2019.

Corporate issuers in the region have been generating solid earnings growth and reducing debt. Despite trade tensions and global growth concerns, Asian high yield corporate leverage dropped sharply in 2018, revenues currently appear healthy, and rating trends have been stable.

NET DEBT/EBITDA HAS TRENDED DOWN

Asian high yield corporate leverage dropped sharply in 2018

Net debt/EBITDA



Source: JP Morgan Asia Credit Outlook, May 2019.

Asian companies now enjoy greater financial flexibility than in years past. The local debt market has grown since the Asian financial crisis of 1997, giving companies access to domestic funding and reducing dependence on the US debt market. JP Morgan estimates that only 1.2% of the JP Morgan Asia Credit Index (by market cap) has high direct exposure to the US.[iv] Thus, direct impact from the US-China trade war should be limited. Furthermore, according to Moody's, Asian high yield covenants are among the strongest in the world.[v]

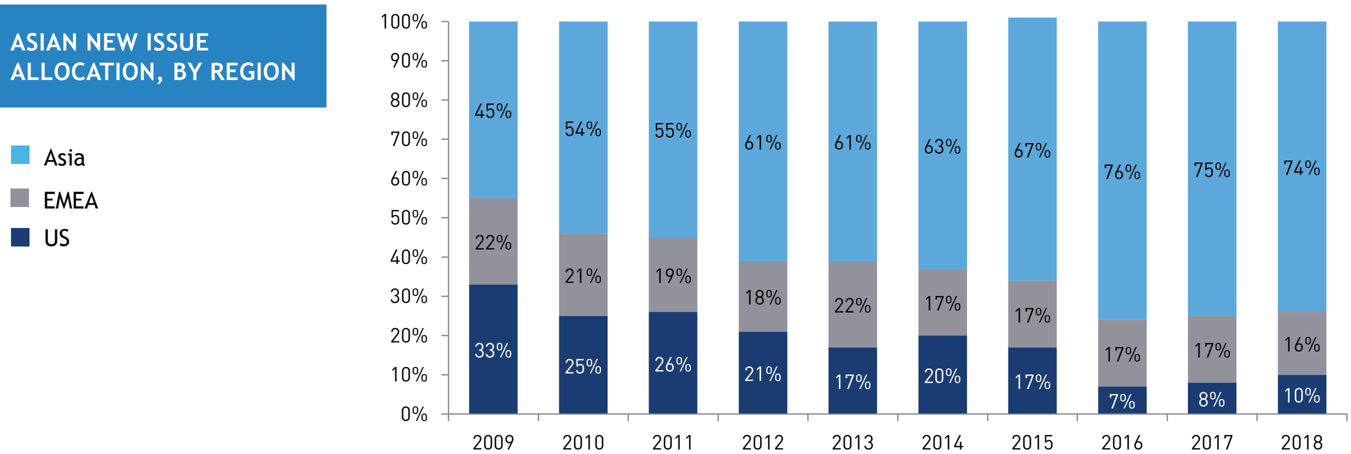
Despite its growing bond universe and solid corporate fundamentals, Asia's representation in major global bond indices remains low. We believe this lack of inclusion represents opportunity for investors dedicated to understanding and investing in the region.

Regional Investor Base Helps Anchor the Asset Class

Asia is positioned to be the fastest-growing asset management market in the world, with total client assets under management estimated to reach US $29.6 trillion by 2025, accounting for almost a fifth of the global total.[vi] PwC estimates the growth rate of insurance premiums in Asia is more than three times the world average. Mobile and digital technology are propelling financial inclusion in Asia. We believe the asset management market can sustain high growth rates as technological penetration continues to increase.

This investment capital has driven strong regional demand for Asian credit. Since 2016, close to 80% of Asian corporate primary deals have been allocated to Asian investors.[vii] This regional investor base anchors hard-currency Asia credit. Both bullish and bearish sentiment can drive local demand for the asset class. In good times, the investor base typically buys familiar "name brands" and established investment themes. Additionally, issuing in hard currency is a natural quality filter because, generally, only higher-quality, larger companies are able to fulfill the requirements to issue offshore. In uncertain times, the US dollar and US Treasurys tend to outperform local currencies, and the investor base tends to flock to hard-currency assets.

ASIAN NEW ISSUE ALLOCATION, BY REGION



Source: JP Morgan, EM Corporate Strategy Presentation, data as of May 31, 2019.

Many investors are also drawn to the countercyclical features of Chinese property, the largest sector in the Asian high yield credit space. Property plays a critical role in China's economy; Moody's estimates the property and construction sectors account for about 25%-30% of GDP.[viii] Property is a source of income for the government, and it is generally the primary investment for Chinese citizens. Chinese authorities have implemented a number of macroprudential measures to guard against excesses in the sector, but have shown a tendency to relax these restrictions in the event of a downturn.

Expanding the Opportunity Set with Plus Regions

The EM opportunity does not end with hard-currency Asia high yield credit. We also see opportunity in high yield credit from "plus" regions, defined as emerging Europe, the Middle East and Africa (EMEA). We view EMEA high yield credit as an extension of what we like about Asia high yield credit, but with added diversification and demographic benefits.

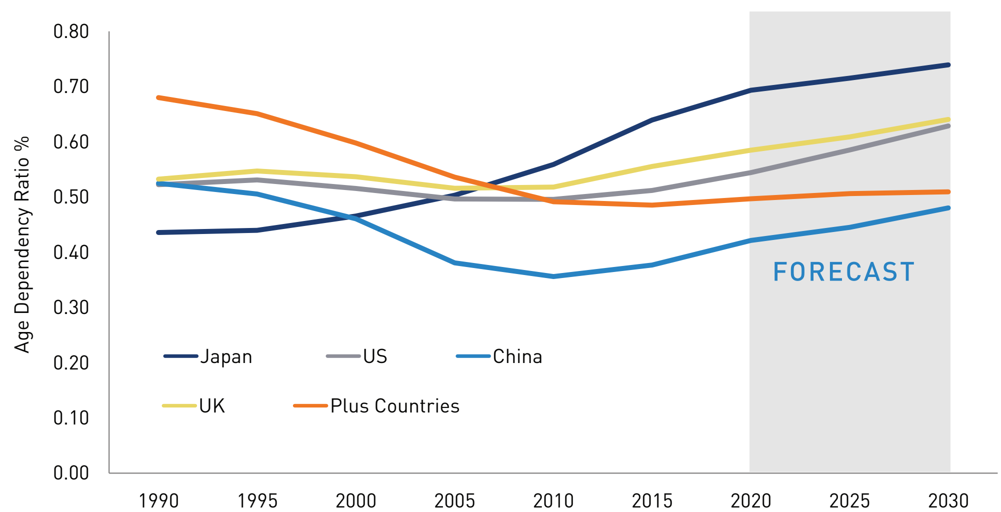
VARIABLES THAT CAN SHAPE THE OPPORTUNITY		
POSITIVE MACRO FUNDAMENTALS	A GROWING UNIVERSE	REGIONAL INVESTOR BASE
Growth in EMEA should support a stable contribution to GDP growth over the next five years, while advanced economies and Latin America are expected to decline. Together, EMEA and Asia can capture about 75% of global growth.[ix]	As of June 30, 2019, EMEA represents only 2% of global bond indices, with a growing issuer universe.[x]	The Middle East has a strong local investor base, enhancing local demand and providing added stability to the local market.

The Asia high yield credit universe is concentrated, with limited diversification opportunities. Adding exposure to plus regions or countries can expand the opportunity set without adding to correlated beta, and can give exposure to some complementary factors. Of course, it's important to be mindful of the many risks, including credit, market, sovereign, governance, and liquidity. The importance of fundamental credit research in these regions cannot be overstated.

FAVORABLE DEMOGRAPHIC TRENDS

The EMEA region has favorable demographic trends. For example, it has a lower age dependency ratio, indicating more workers available for growth—an important driver for EM assets. This tailwind of young people entering the work force can help offset China's aging work force.

DEMOGRAPHIC TREND IN THE "PLUS" COUNTRIES CAN DRIVE GROWTH



Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). Data points from 2020 forward are probabilistic population projections based on the World Population Prospects 2019: http://population.un.org/wpp/

GREATER CONNECTIVITY

China's infrastructure growth is expected to expand throughout Asia and adjacent regions as China looks to increase interconnectivity with its Belt and Road Initiative, a major global infrastructure development plan. This effort has already begun, with some projects yielding real productivity enhancements that could ultimately support growth. For example, the Standard Gauge Railroad in Kenya reduced travel time between the Port of Mombasa and Nairobi from over 15 hours to 4.5 hours. As China continues to move forward with its Belt and Road Initiative, infrastructure development in the EMEA region has the potential to enhance trade within these regions, increase growth, and widen the opportunity set.[xi]

Pick Your Spots in Emerging Markets

Asia high yield credit and EMEA high yield credit write a distinctive EM story. This universe is positioned to potentially benefit from long-term structural growth, an expanding investment universe, and positive regional market dynamics. We believe this combined opportunity set can offer favorable risk-adjusted returns with lower volatility than the broader EM asset class. However, investors must be aware of the risks and do their homework, carefully judging the merits of each issuer's debt offering relative to the political and financial risks associated with its home country.

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Endnotes

[i] *Rolling five-year drawdown. Source: Monthly return data from Bloomberg, ICE, JP Morgan, as of June 30, 2019. Asia HY = JP Morgan JACI High Yield Index. EMEA HY = ICE BofAML High Yield EMEA EM Corporate Plus Index. Latam HY= ICE BofAML High Yield Latin America EM Corporate Plus Index. US HY = Bloomberg Barclays US High Yield Index. Euro HY = Bloomberg Barclays Pan European High Yield Corporate Index.*

	ROLLING 5-YEAR DATA, AS OF JUNE 30, 2019		
	ANNUALIZED RETURN	DRAWDOWN	RETURN/VOLATILITY
ASIA HY	5.9%	-4.8%	1.37
EMEA HY	5.6%	-11.4%	0.92
LATAM HY	3.8%	-16.7%	0.40
US HY	4.7%	-9.7%	0.85
EURO HY	4.1%	-5.3%	0.87

Past performance is no guarantee of future results.

[ii] *International Monetary Fund Data Mapper, Emerging and Developed Asia, as of April 2019.*

[iii] *International Monetary Fund Data Mapper, Emerging and Developed Asia, as of April 2019.*

[iv] *JP Morgan Asia Credit Outlook and Strategy, June 2019.*

[v] *Moody's Investors Service, Sector In-Depth, Covenants — Asia, July 2019.*

[vi] *PwC, Asset & Wealth Management Revolution: Embracing Exponential Change, 2017, and Asset & Wealth Management 2025, The Asian Awakening, January 2019.*

[vii] *JP Morgan Asia Credit Outlook and Strategy, June 2019.*

[viii] *Moody's Investors Service, May 25, 2018.*

[ix] *International Monetary Fund Data Mapper, as of April 2019.*

[x] *Bloomberg Barclays Global Aggregate Index, as of June 30, 2019.*

[xi] *Even if the Belt and Road Initiative were to stall out now, completed infrastructure projects should see long-term growth as the new infrastructure encourages economic development and enhances trade.*

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***ICE BofAML High Yield Asia EM Corporate Plus Index** - The index is a subset of ICE BofAML Emerging Markets Corporate Plus Index including all securities rated sub-investment grade based on the average of Moody's, S&P and Fitch, and with a country of risk associated with the geographical region of Asia.*

***ICE BofAML High Yield EMEA EM Corporate Plus Index** - The index is a subset of the ICE BofAML Emerging Markets Corporate Plus Index including all securities rated sub-investment grade based on the average of Moody's, S&P and Fitch, and with a country of risk associated with the geographical region of EMEA.*

***ICE BofAML High Yield Latin America EM Corporate Plus Index** - The index is a subset of the ICE BofAML Emerging Markets Corporate Plus Index including all securities rated sub-investment grade based on the average of Moody's, S&P and Fitch, and with a country of risk associated with the geographical region of Latin America.*

***JP Morgan Asia Credit High Yield Index** -The index tracks the total returns of high yield US dollar-denominated debt instruments issued by corporate entities in emerging markets countries in Asia.*

***JP Morgan Asia Credit Index** - The index tracks the total returns of US-dollar-denominated debt instruments issued by corporate entities in emerging markets countries in Asia.*

***Bloomberg Barclays US High Yield Index** - The index measures the US-dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.*

***Bloomberg Barclays Pan European High Yield Corporate Index** - The index measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer.*

***Bloomberg Barclays Global Aggregate Index** provides a broad-based measure of the global investment grade fixed income markets. The three major components of this Index are the US Aggregate, the Pan-European Aggregate and the Asian-Pacific Aggregate Indices. The Index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities. Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.*

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***Belt and Road Initiative (BRI) Risks**: BRI will have an unclear and indirect impact on the development of BRI economies and some geopolitical risks could escalate threatening the trade corridor. Policy and political risks are viewed as two of the greatest barriers to the BRI. Legal framework, financing and the government sector have been identified as being the largest potential obstacles to development. BRI is a developmental strategy proposed by China focusing on connectivity and co-operation. Funding is expected to yield monetary returns but there will be economic consequences if projects fail to deliver on their expected returns. Challenges include the scale of the initiative, operational issues, sources of funding and geopolitics.*

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