ASIAN BOND MARKETS DEEPENING

The inaugural FinanceAsia Bond Investor Survey sponsored by HSBC and S&P Global Ratings reveals the growing scale and confidence of the region’s credit markets and investors

By Jackie Horne
We live in an increasingly globalised world where Asia and, particularly, China play an ever-growing role. Nonetheless, the inaugural biannual Asian Bond Investor Survey sponsored by HSBC and S&P Global Ratings shows striking regional differences of investor opinion towards a number of issues affecting Asian debt markets.

During March, East & Partners (a FinanceAsia joint venture) conducted a series of telephone interviews with 151 of the world’s top chief investment officers and heads of fixed income. The fixed income assets under management at these funds average out at more than $3.7 billion.

Some 74% of the fund managers contacted are based in Asia, reflecting the growing pool of capital being generated in the region and the increased on-the-ground presence of global institutional investors. Of the remaining, 15% are in the US and Canada and 11% in Europe.

**CREDIT CONSIDERATIONS**

The most positive message, which showed up time and again in the survey, is a belief in Asia’s importance and in the long-term future of China’s domestic bond market. And over the short-term, an overwhelming 74.8% of respondents said they planned to increase their Asian exposure within the next 12 months.

Only 6% of respondents said they planned to reduce their holdings.

Perhaps unsurprisingly, most of those planning to increase their exposure are based in Asia, while a majority of respondents planning to maintain exposure at current levels are from elsewhere in the world.

“This ties in with what we see,” Alexi Chan, global co-head of debt capital markets at HSBC, said. “Asia’s debt
Capital markets have been making strong progress in recent years. "Issuance volumes have been growing, supported by an increasingly diversified investor base, including notable demand from insurance companies. We’re seeing strong participation by a broad range of investors from across Asia, bringing greater depth and duration to the markets," he added.

Despite the expected increase in Asian allocations, investors were not positive about the outlook for regional spreads. Most of those surveyed said they believed that the spreads on Asian G3 sovereign and high-yield corporate debt would likely widen over corresponding risk free rates over the next 12-months.

“Our ratings reflect this finding,” said Ritesh Maheshwari, head of Asia Pacific market and franchise development at S&P Global Ratings. “We rate 21 sovereigns in the region and there’s a net bias towards downgrades. China, Hong Kong, Sri Lanka and Papua New Guinea are all on negative outlook.”

Likewise, S&P Global Ratings’ second quarter Credit Conditions report also highlights elevated negative bias in Asia Pacific, indicating rising credit risks. This is led by metals and mining, where the bias has risen from 11% to 38% from this time last year, followed by property, up from 22% to 24% over the same time frame.

Investor sentiment is more split in the case of Asian G3 financials and investment grade corporates, the Asian Bond Survey showed. Where the former is concerned, 30.4% of respondents thought spreads would widen, while 43.5% thought they would be stable and 26.1% thought they would tighten.

In the case of G3 investment grade corporates, 33.9% expected spreads to widen, 30.5% to remain stable and 35.6% to tighten.

G3 debt refers to bonds denominated in US dollars, yen, or euros – the currencies of the world’s three largest economic blocs, China aside.

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**Impact of USD movements on investment decisions**

- **Add Exposure:** 74.8%
- **Maintain Exposure:** 19.2%
- **Decrease Exposure:** 6.0%

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**Spread movement expectations**

- **G3 Sovereign:**
  - Tighten: 20.5%
  - Stable: 35.8%
  - Widen: 43.7%

- **G3 Investment Grade Corporate:**
  - Tighten: 15.7%
  - Stable: 35.6%
  - Widen: 43.3%

- **G3 High Yield Corporate:**
  - Tighten: 4.3%
  - Stable: 33.3%
  - Widen: 62.3%

- **G3 Financials:**
  - Tighten: 26.1%
  - Stable: 30.4%
  - Widen: 43.5%
Sectors that will contribute most to performance in 2016

- Financial Institutions, Insurance: 57.6%
- Governments: 39.7%
- Infrastructure & Utilities: 49.7%
- Property Developers: 21.2%
- Transport & Logistics: 58.9%
- Technology & Telecoms: 63.6%

Expected change in exposure by country - next 12 months

“We’re seeing strong participation by a broad range of investors from across Asia, bringing greater depth and duration to the markets”

— Alexi Chan, HSBC
CREDIT CONCERNS

Respondents to the Asian sentiment survey singled out property as the sector most likely to see defaults. Two-thirds of them expect real estate debt spreads to climb and 85.7% believe defaults generally are likely to emanate from China.

However, those respondents who are worried about the property sector are almost exclusively located outside of Asia (96.4% of this category). Overall, most respondents feel default rates across Asia will remain stable (68%), with less than a third expecting them to rise (28%).

The key economic concern for the largely Asian investor pool surveyed by East & Partners was rising political risk in Europe. This worried 55% of respondents, followed by volatile equity markets on 41.1% and falling commodity prices 36.4%.

Fears of a China slowdown, on the other hand, did not appear to worry respondents as much, attracting a third of the votes.

What do these conflicting answers mean? HSBC’s Chan commented that market participants’ understanding of China sometimes diminishes in proportion to their geographical distance and that HSBC sees a particular responsibility to provide global investors with as much insight into China as possible.

Perhaps that same analogy can be applied to Asian respondents who have been absorbing the constant flow of negative news headlines emanating from Europe, as they accounted for 80% of respondents concerned about rising political risk.
with markets and opportunities they’re not deeply familiar with. That’s why they need ratings as consistent standards so they can make comparisons across geographies and sectors.”

Both Bosrock and Maheshwari said S&P Global Ratings’ global analysis points to higher risks in other areas rather than rising political risk.

“We have four elevated risk factors,” Maheshwari noted. “The three concerning credit market volatility, tightening liquidity, and slowing global growth are all rising. The one risk factor remaining stable is geopolitical risk.”

**CREDIT LOCALISING**

The results revealed that while China and India are the two countries that investors expect to increase their exposure most significantly (43% and 34.4%, respectively), their focus is on G3 currency bonds.

Singapore and Malaysia received the lowest share of votes, with 9.3% voting for the former and 12.6% for the latter.

Only 10.6% of the investors surveyed are currently invested in China’s onshore market and they are all Chinese. That is not very surprising, but could change in future surveys, given the government only scrapped foreign institutional quotas in February.

Some 43% said they are considering entering but of this number, 89% are Asian.

“The search for yield means investors are having to turn over more rocks and venture further afield”

–Matt Bosrock, S&P Global Ratings
A further half of respondents said they would not be increasing their exposure to panda bonds (onshore renminbi-denominated bonds issued by foreign entities) in the next 12 months. In contrast, 23.2% said they had not developed a view as yet.

Where Masala bonds are concerned (offshore rupee-denominated debt), a lack of issuance shows the product has not yet flashed up on the radar screens of many investors. Some 48% of respondents said they have still to develop a view.

HSBC’s Chan said the results “support the fact that this is an exciting moment for the opening up of China’s onshore capital markets. A lot of educational work now needs to be done to enable international issuers and investors to understand the dynamics of a market, which is evolving very quickly.”

“We’re at a point in history where the cross-border flows are only just beginning,” he said.

**CREDIT WITH CONSCIENCE**

Some of the most interesting data to emerge from the survey points to a growing awareness and appetite for green bonds and credits with strong environ-
mental, social and governance credentials – or ESG.

Only 20% of respondents said they were still unfamiliar with green bonds, while 55% said they were likely or very likely to invest in them over the next 12 months.

In terms of ESG, 29.1% of respondents said ESG is already factored into their credit considerations. Here, investors from outside of Asia led the way, with 64% of these respondents already making ESG judgement calls.

But Asia does not appear to be very far behind. Almost 40% of overall respondents said they are likely to start taking ESG into consideration within the next one to two years and a further 28.5% some time after that.

The key reason why they are doing this is because of a sense of social responsibility (78% agreed), followed by regulations (75%) and stakeholder expectations (69%).

S&P Global Ratings’ Bosrock said ESG is a growing factor in investors’ decision-making processes.

“We’re working towards developing ESG-related products to help investors make more informed decisions,” he said.

“The Europeans, Australians and Canadians are ahead of the curve in this respect. I recently met a big European pension fund where the ESG head sat right next to the global CIO.”

HSBC’s Chan also flagged an interesting juxtaposition between the expected growth of green bond issuance in China and the accessibility of the onshore China market to international investors.

“China is very focused on developing a green bond market to support its environmental goals and is rapidly becoming a world leader in this area,” he said. “Finding effective ways to connect this supply to international demand will open up major opportunities for green bond investor portfolios globally.”

CREDIT SECTORS

The survey also highlighted a marked difference in opinion between different regions where sectors were concerned. Asia’s significant infrastructure financing needs and a steady stream of headlines about China’s Belt and Road policy appear to have hit the mark with regional investors.

A total of 41.7% of overall respondents said they are likely or highly likely to increase their exposure to the infrastructure sector over the coming 12 months. Of this figure, 88.8% hailed from Asia. A lesser 34.5% also said they are likely or highly likely to participate in issues relating to China’s grand Belt and Road blueprint.

When it comes to sector performance, 63.6% of respondents think technology and telecom credits will do well, followed by transport and logistics on 58.9%.

Historically, Taiwanese hardware manufacturers have dominated the Asian technology sector but have not been frequent debt issuers of long-term debt because of the cyclical nature of their cash flows. However, the growth and popularity of e-commerce giants such as China’s BAT troika (Baidu, Alibaba and Tencent) shows how this has been changing in recent years.

Another strong theme to emerge from the survey is Asia’s ongoing appetite for bank capital instruments. Some 26.5% of survey respondents plan to significantly increase their exposure and 35.1%
to slightly increase their exposure. A further 24.5% expect to maintain their exposure.

As HSBC’s Chan reflected, “the region has long been a source of demand for various types of global hybrid capital products. We are now seeing a growing range of Asian accounts, which can invest in such instruments, even as regulations have tightened.”

“Moreover Asian investors have been the key drivers of bank capital transactions, not just from within the region, but at times also from other regions, particularly Europe,” he said.

S&P Global Ratings’ Maheshwari is a banking sector analyst by background and said the planned increase did not surprise him at all. “It’s very heartening because bank capital issuance by Asian credits is now expected to increase quite markedly, particularly in the AT1 space,” he said.

Additional tier-1, or AT1 securities, are instruments that contain the ability to defer coupons as well as triggers that provide for a conversion into equity or a write-off, thereby bolstering a bank’s core capital position in times of serious financial duress. The instruments allow banks to optimise their capital structure under the Basel 3 banking regulatory framework.

In order to differentiate between different credits, investors underlined how important a credit rating is to them. When asked about research that would help them make more informed investment decisions, an overwhelming 97.4% ticked individual issuer risk as well as industry or sector risk (80.8%).

A further 81% said a public rating was either important or very important to them. However, 42% of respondents (mostly from within Asia) also said they planned to increase their holdings of unrated public bonds.

S&P Global Ratings’ Maheshwari and Bosrock believe the answer to this seeming contradiction lies in the history of low default rates in the region since
the Asian Financial crisis. However, they note this is about to change.

“Until recently there were no defaults in China’s public bond market,” Bosrock said. “Since the first default in 2014 (Chaori Solar), we’ve seen defaults accelerate.

“In the first four months of 2016, there have been 10 defaults already, higher than the total number in 2015,” he added. “It’s therefore not surprising to see stronger demand for quality credit ratings and research in China.”

While the survey shows that investors can often have a markedly different view of the world depending on where they are based, their desire for wider and deeper knowledge appears to be a given.

“Historically trade and capital flows have been north-south, usually between developed and developing markets,” S&P’s Bosrock concluded. “But in the last decade, we’ve seen this transitioning to south-south. I was recently in Brazil and the number of questions I fielded about China was immense.”

For more on the survey, with insights and analysis on Asia’s bond markets, please visit our microsite at www.financeasia.com/bondinvestorsurvey.