JK Capital Management Ltd.

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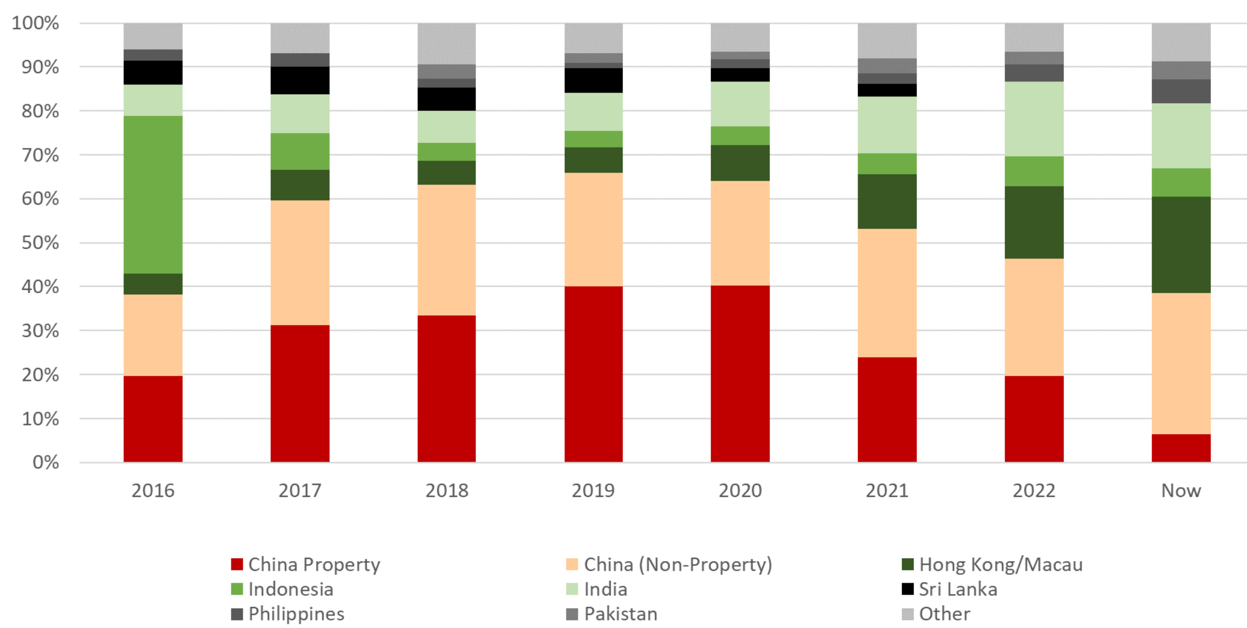
The Asian High Yield bond market is no longer hostage to China property

The Asian USD High Yield (HY) bond market has certainly seen some extreme volatility in the past few years. Since its origin ten years ago when the market became large enough to be considered a standalone asset class, the DNA of this sector has changed dramatically. In recent years the performance of Asian HY bonds has been tainted by a China real estate crisis to such an extent it would be easy to imagine China property is the only component of the market. However today this could not be further from the truth.

China property bonds currently only account for a mid-single digit weighting of the market and while it wasn't always the case, going forward the return outlook for the market will be driven by a range of diversified factors which are well removed from the PRC real estate policy. Below we look at how the market has evolved in recent years and what the real Asian HY market looks like today in terms of weightings and sector sensitivities.

Chart 1: Evolution of the Asian High Yield market (*) sector breakdown



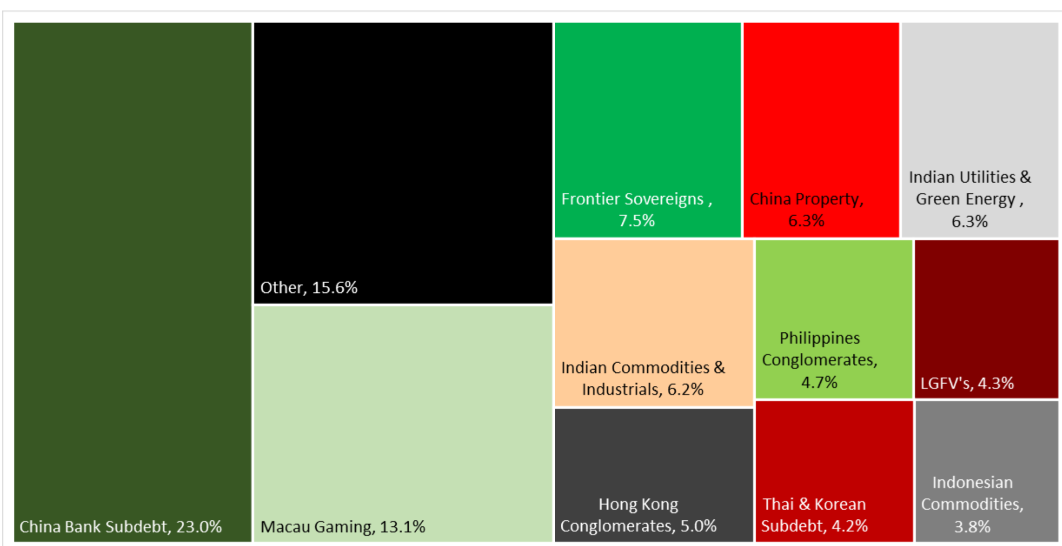
* Breakdown of Iboxx AHBI Index

Source: Bloomberg, Markit

Initiated in January 2013, the AHBI index, launched by HSBC and later taken over by iBoxx Markit, turned 10 years old this year. Chart 1 shows the geographical breakdown of this Index since Markit took over its management in mid-2016. Originally the Asian HY market was dominated by Indonesia when the government and quasi sovereign bonds were still rated BB+. However, after Indonesia was upgraded to investment grade in 2017, the make-up of the high yield market changed rapidly and China emerged as the most important component, driven in a large part by the emergence of the real estate sector. China property issuance superseded all other sectors and by the start of this decade the sector alone accounted for 40% of the index. In fact, taking into account the fact that many China property bonds were of very short maturity (< 1 year) and therefore excluded from the index, the real weighting of China property in the Asian HY market was close to 50% in 2020.

This situation proved unsustainable. The China property crash that began in 2021 and that continued over the past three years has seen the weighting of China property collapse. As per index rules any issuer which defaults has its bonds immediately stripped from the index. Combined with the massive price drop of issuers that have so far avoided default, we have seen the weighting of China property fall to just 6% today. Offsetting this has been a corresponding growth in other segments of the market, particularly non-property China, Hong Kong/Macau and India.

Chart 2: Mapping the key sector exposures of Asian High Yield bonds (*) today



*Breakdown of Iboxx AHBI Index

Source: Bloomberg, Markit

Chart 2 shows a breakdown of what are the most important sectors that dominate the Asian HY market today and the results may be surprising to many who still see Asia as a China property driven asset class. By far the largest segment today is China Bank Sub-debt which is predominantly AT1 (Additional Tier 1) bonds issued by state owned banks and which accounts for almost one quarter of the index. This includes the largest HY bond in the region, the USD6.2bn ICBC AT1 Perpetual. Another sector that has grown in significance in recent years has been Macau Gaming which saw a sharp increase of issuance on the back of a massive expansion of investment in the sector in the past five years following government relaxation on licenses. Global casino operators including MGM China, Wynn Macau, Melco and Studio City together account for 13% of the Asian HY market.

One sector which didn't exist at all when the index was launched 10 years ago was offshore China Local Government Financing Vehicle (LGFV) bonds. These issuers which have been a key conduit for China's regional government infrastructure investments in recent years have grown in both the Investment Grade and High Yield markets and today account for 4% of the High Yield Index. Frontier Sovereigns has always had a presence in the Asian HY market although their components continue to evolve. Sri Lanka at its peak was 8% of the HY index in 2017 but was stripped out in 2022 after the country defaulted. On the other hand, Pakistan was only added to the Index in 2018, and today it has a 4% weighting. Finally, India is a market that has grown in importance in recent years as it has become the fastest growing major economy in the region. Key sectors for India HY include commodity, industrial and green energy issuers. In total India accounts for 15% of the Asian HY Index.

In summary Asia HY is an asset class that should no longer be viewed as "China property plus others". Today it probably exhibits the best sector and regional diversity it has ever seen. In addition, as the high dollar interest rate environment pushed the yields of lower rated investment grade and crossover rated Asian credits to a higher level, the ability to hold an attractively yielding diversified portfolio of Asian dollar bonds has improved dramatically. At the very least the days where Asian market performance was only a reflection of the fortunes of China's real estate sector are, in our view, very much in the past.