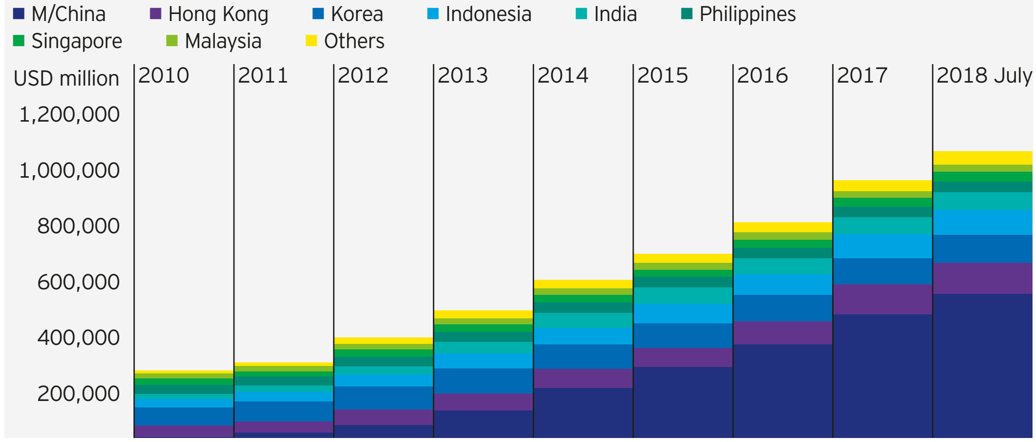
Volatility in Asian US dollar bond market may present opportunities

31 July 2018

The Asian US dollar denominated bond market has grown quickly in recent years, currently exceeding USD1 trillion in size. (Figure 1) This expansion has been fueled by rising gross new issue volumes. As of the end of 2017, new issue volume accounted for around one third of the total market, with a large proportion of both the issuer and buyer base being Chinese institutions. (Figure 2) At the same time, the Chinese authorities have been implementing their policy goals of opening the domestic market, reducing leverage in the financial system and normalizing the credit curve.

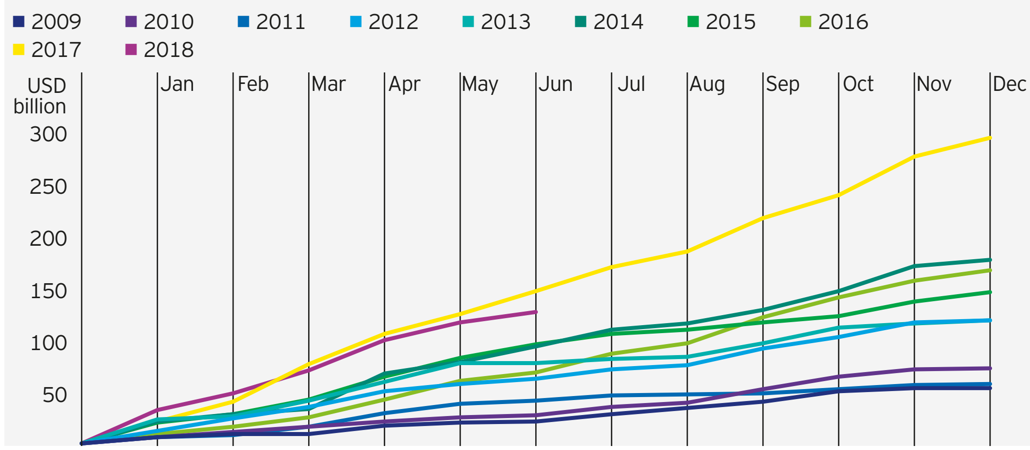
This presents both opportunities and challenges for the asset class. The latest policy announcements (around the weekend of July 21) have eased credit conditions relative to the direction of travel indicated in the April release of new asset management rules - and have been taken very positively by the market.

Figure 1: Growth of the Asian US dollar bond market
(Outstanding Asian US dollar bonds by country of issuance)



Source: HSBC, Bloomberg L.P., Invesco, data from Dec. 31, 2010 to July 18, 2018.
M/China is Mainland China.

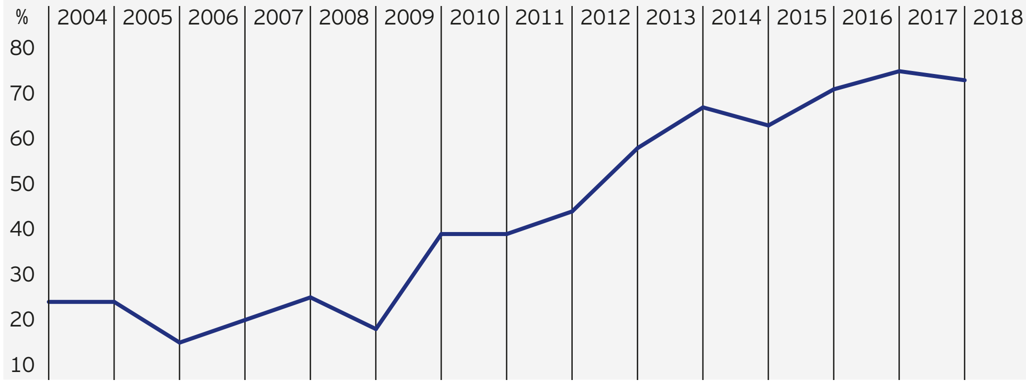
Figure 2: Gross supply of Asian US dollar bonds



Source: Bloomberg L.P., HSBC, data as of May 31, 2018.

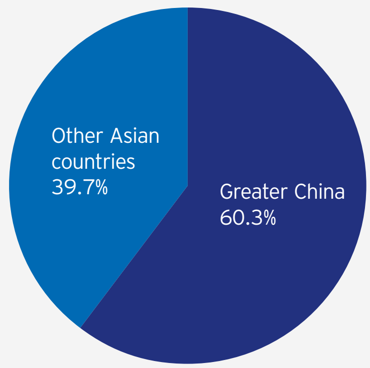
Chinese bond issuers accounted for more than 70% of the gross issuance volume in 2017. (Figure 3) In stock terms, China now accounts for more than 60% of the Asian US dollar bond market. (Figure 4).

Figure 3: Greater China as a percent of total gross issuance of Asian US dollar bonds



Source: HSBC, data as of May 31, 2018.

Figure 4: Issuer share of Asian US dollar bond market

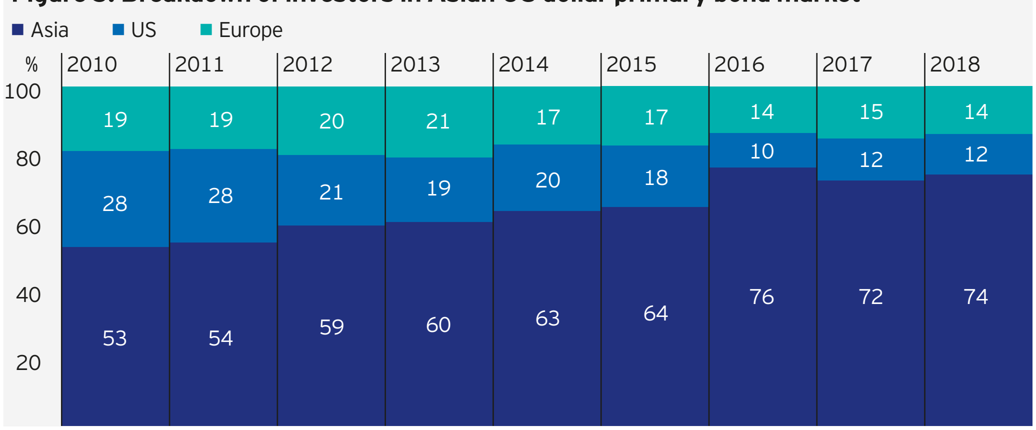


Source: Bloomberg L.P., JP Morgan, Invesco, data as of May 31, 2018. Other Asian countries include: Korea, Indonesia, Mongolia, India, Philippines, Malaysia, Singapore, Thailand, Sri Lanka, Pakistan, Vietnam, Maldives, Bangladesh.

Chinese demand has also grown steadily

Most new issues of Asian US dollar bonds have been purchased by Asian investors. (Figure 5) Of these, Chinese investors have dominated the primary market as they continue to diversify into international bond markets.

Figure 5: Breakdown of investors in Asian US dollar primary bond market

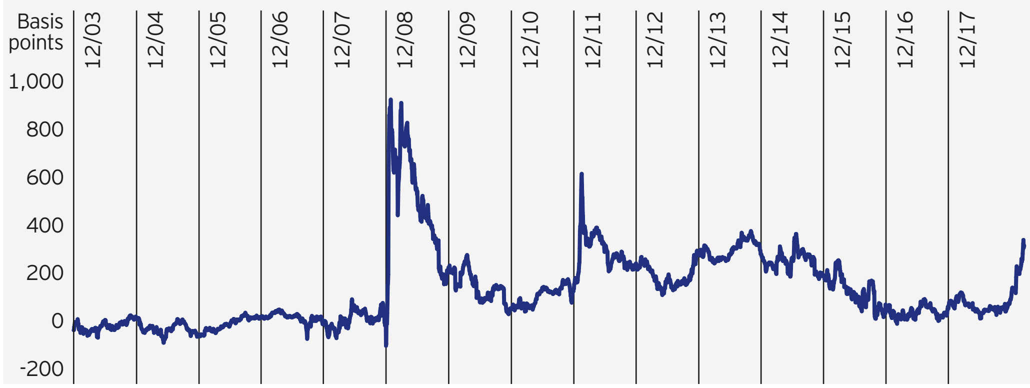


Source: BoA Merrill Lynch, Bloomberg L.P., data from Dec. 31, 2010 to June 30, 2018.

Recent developments have pressured the Asian US dollar bond market
Positive Chinese supply and demand dynamics have supported the rapid growth of the Asian US dollar bond market in recent years and as such, credit spreads were generally tight relative to US corporate bonds until the first quarter of 2018. (Figures 6 and 7) This positive impact was seen more clearly in Asian US dollar high yield bonds versus investment grade.

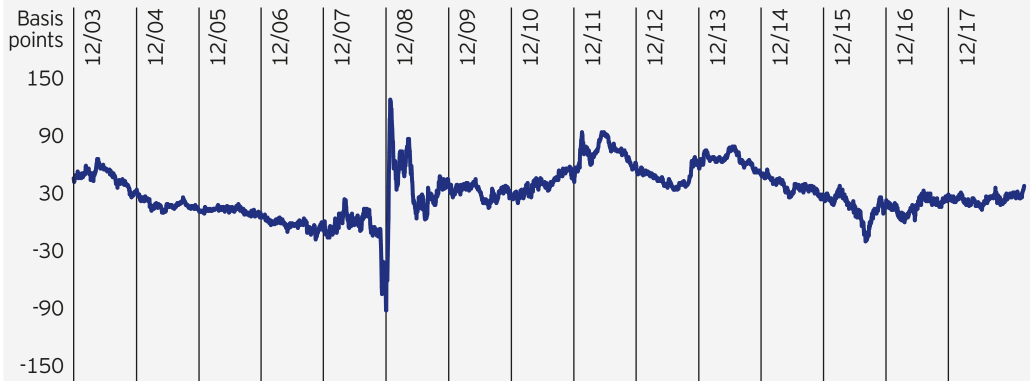
In late April, the Chinese authorities announced new regulations on wealth management products which comprise a major segment of Chinese shadow banking activities. Wealth management products are an important source of funding for most non-state-owned enterprises in China. The total volume of non-guaranteed wealth management products in China was estimated at CNY22.2 trillion (around USD3.4 trillion) at the end of 2017.[1] Although the launch of new regulations was widely anticipated by the market and Chinese financial institutions, some details of the new regulations were not addressed. While waiting for further guidance from regulators, some Chinese financial institutions paused or significantly scaled back their wealth management product business. The total size of non-guaranteed wealth management products rapidly shrank by 5.3% to CNY21trillion (USD3.1 trillion) as of the end of June.[1] This caused a "credit crunch scenario" for many non-state-owned enterprises in China. It significantly raised the market's perception of refinancing risks related to Chinese US dollar high yield bond issuers, leading to rapid credit spread widening in the offshore market. The widening of Chinese US dollar high yield spreads rippled across the Asian US dollar high yield bond market in June. (Figures 6 and 7).

Figure 6: High yield US dollar corporate bond spread differential (Asia minus US)
(OAS spread difference)



Source: Bank of America Merrill Lynch's ICE Bond Indices page in Bloomberg L.P., Bloomberg L.P., Invesco, "ACCY", ICE BofA Merrill Asian Dollar High Yield Corporate Constrained Index; average credit rating= Ba3; average duration= 2.96 as of July 13, 2018. "H0A0", ICE BofA Merrill US High Yield Index; average credit rating= B1; average duration= 4.12 as of July 13, 2018. Past performance is not a guarantee of future results; current performance may be higher or lower than performance quoted.

Figure 7: Investment grade US dollar corporate bond spread differential (Asia minus US)
(OAS spread difference)



Source: Bank of America Merrill Lynch's ICE Bond Indices page in Bloomberg L.P., Bloomberg L.P., Invesco, "ACIG", ICE BofA Merrill Lynch Asian Dollar Investment Grade Corporate Index; average credit rating= A3; average duration= 4.92 as of July 13, 2018. "C0AC", ICE BofA Merrill US Corporate Constrained Index; average credit rating= A3; average duration= 7.03 as of July 13, 2018. Past performance is not a guarantee of future results; current performance may be higher or lower than performance quoted.

New policy measures may support Asian US dollar bonds

Around the weekend of July 21, the Chinese authorities announced more detailed guidance on the new wealth management product regulations. Although the new regulations will likely lead to further tightening of shadow banking activities in China, they will also likely reactivate the healthier parts of the wealth management product segment of the banking system. Therefore, we expect the market's perception of refinancing risk as it relates to Chinese US dollar denominated high yield bonds to improve, potentially leading to a tightening of credit spreads of selected Asian high yield bonds.

In addition, the PBoC outlined a plan on July 18 for a medium-term lending facility (MLF), which is expected to incentivize Chinese banks to buy lower-rated onshore corporate debt.[2] Although this new measure may not immediately significantly improve the refinancing risk faced by Chinese high yield bond issuers, we believe it provides a positive signal to the market that the Chinese authorities may want to avoid an unnecessary credit crunch on the path to a reduction in leverage and more normalized credit curve. Based on these recent constructive policy moves, we see value in selected Chinese and Asian US dollar denominated bonds, high yield issuers in particular.

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1 Source: China Banking Regulatory Commission, July 20, 2018.
2 Source: Bloomberg L.P., "China Flirts with Easier Monetary Policy Amid Slowing Growth", July 18, 2018.

Important Information

All data as of July 31, 2018 unless otherwise stated. All data is USD, unless otherwise stated.

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