Matthews Asia Perspective:
Riding the Credit Cycle—Is it Time to Buy?

In my 20-plus years of investing, one of the toughest things to do is to have the ability to invest exactly when the consensus says to flee. I believe we are standing before one of these rare windows of opportunity, when high yield bond prices trough at the end of a credit cycle. If we define a credit cycle as the expansion and contraction of access to credit, marked by the peaks in credits spreads (or lowest bond prices), credit cycles have typically lasted, about 8–10 years—with the previous peak in credit spreads occurring in November of 2008. If this is a typical credit cycle, we might be close to the end of the cycle, with spreads reaching their peak and prices reaching their nadir.

Figure 1. HIGH YIELD SPREAD HISTORY BY REGION

Contrary to popular belief, in today’s volatile environment, I believe riskier asset classes such as Asia high yield may actually provide more downside protection from the increasing probability of rising U.S. interest rates than some other fixed income asset classes that are traditionally considered to be safer.

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1 A credit cycle is not to be confused with the overall economic cycle. In this piece, I focus exclusively on the credit cycle, as defined by the expansion and contraction of access to credit, marked by the period between peak credit spreads. In contrast to the credit cycle, I believe the U.S. economic cycle still has legs. It is clear from recent U.S. Federal Reserve statements that the recovery has been tepid, and the Fed has just begun to see enough strength in employment and inflation to justify the first interest rate hike. The Asian economic cycle has somewhat decoupled from that of the U.S, largely due to the slowdown in China. Most emerging economies are still slowing, and central banks are still on an easing trajectory. Given this economic backdrop, we believe it makes for an even stronger case for buying at the current level of credit spreads, as the global economy is still on a recovery path from the global financial crisis.

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*JACI HY is the high yield portion of the J.P. Morgan Asia Credit Index

Note: Chart depicts blended spread over the U.S. Treasury curve. It is not possible to invest directly in an index.

Source: Bloomberg
**Rising Interest Rate Risk**

Despite the current, more volatile environment, the probability of the U.S. Central Bank increasing interest rates continues to grow and with it so does the risks investors now face across many of their fixed income investments.

Consider an investor buying a 10-year U.S. Treasury today at a yield of 1.8% and a price of 100. If interest rates rise instantaneously by 1% (100 basis points), the bond price would fall to 91.4, resulting in a loss of 8.6%. Because of the absolutely low level of rates, the sensitivity of bond prices to changes in yield is much higher today than at any time in U.S. history. Likewise, an investor in other low-yielding global government bonds would experience a similar mark-to-market loss in a rising interest rate environment. An investor in the German bund would experience an even greater loss of 9% because the current yield on the German bund is only 0.3% (30 basis points).

Given the riskiness of risk-free securities today, we see Asia High Yield (as represented by the high yield portion of the JACI index) as representing a compelling investment case. The combination of a much higher yield and the lower empirical sensitivity of high yield to interest rate changes makes high yield Asia credit a potentially attractive proposition for an investor looking to diversify the interest rate exposure within their fixed income portfolio.

To sum up, it may seem counterintuitive, but in some respects, investing in high yield at this point in the cycle may potentially have less downside than buying U.S. Treasuries because current spreads capture much of the credit risk. While this may go against conventional wisdom, we are at a unique point in the economic and credit cycle. This window is unique because we are standing before the coincidence of the end of both an interest rate cycle and a credit cycle.

To be sure, it takes a lot of intestinal fortitude to buy when the majority is selling. But at today's downtrodden prices, there is margin for error even if we are wrong about the bottom. Looking to invest at historically wide levels, combined with a medium-holding period of at least two years, has historically generated attractive returns. Indeed, our empirical analysis shows that investing in Asia credit (USD-denominated debt of Asian companies) at current credit spreads (+284 basis points (2.84%) plus or minus 50 basis points (0.50%)) and holding the investment for at least two years, we believe, would result in positive returns.

The story is even more compelling with Asia high yield, especially when one had a long-term investment horizon (Figure 3). The charts below depict the historical returns for entering at today's spreads (plus or minus 50 basis points) over a one, two and three year horizon. If an investor only had a one year horizon, he would have reaped positive returns about 90% of the time. However, about 10% of the time he would have experienced negative returns. If the investor is able to extend his investment horizon from one to two years, the results would have been better. As you can see from the middle chart, the returns are less dispersed and all positive. Finally, the three year return chart shows the most tightly clustered returns and all solidly above zero. We think having at least a three year investment horizon is important because base interest rates are lower today than historical levels. In conclusion, while it is impossible to time entry perfectly at peak spreads, history shows that being able to enter at today's spreads, which are one standard deviation above historical, would experience an even greater loss of 9% because the current yield on the German bund is only 0.3% (30 basis points).

**Figure 3. HISTORICALLY, RETURNS HAVE BEEN COMPELLING IN ASIA HIGH YIELD AT CURRENT LEVELS**

*JACI HY* entry spread vs. 1-, 2- and 3-year returns

These attractive returns result from prices incorporating higher ex-ante expected defaults and recoveries than what is actually realized ex-post. Just as quickly as risk aversion can increase, driving spreads wider, a risk-on rally can also tighten spreads. The key takeaway here is if you buy when spreads are wide and maintain at least a two year holding period, then returns would have been favorable historically.
There are, of course, some caveats to extrapolating this result to today. First, the Asia bond universe is very different today in terms of country and industry allocations than in the past. Just for comparison sake, we take two points in time: 2002 versus 2015. Quantitatively, the Asia U.S. dollar (USD) bond market is about 10 times bigger. In terms of types of issuers, 60% of the borrowers in 2002 were sovereign or quasi-sovereign entities versus only 33% today. In general, corporates have higher default risk than sovereign and quasi-sovereign borrowers and require substantially more due diligence at the company-level, in addition to the analysis of default risk of the underlying sovereign. Finally, today’s universe has much greater exposure to China. 41% of Asia’s USD bond market today is comprised of borrowers from China. In high yield, China has an even higher weighting of 45%.

Figure 4. ASIA CREDIT BY COUNTRY

Given China is the single biggest issuer and risk to Asia credit markets, let us revisit the state of the Chinese economy and its implications for the rest of the markets.

We believe the biggest critical uncertainty with respect to China is the recent capital outflows. Following our research, we have come to the conclusion that the motivation behind capital flows in China is, in fact, similar to everywhere else in the world—they are driven by investors seeking higher risk-adjusted returns. Consider the dilemma of a typical saver in China. He has the choice of putting his money in the bank in either renminbi (RMB), or exchanging some portion (up to 50,000 RMB) into USD and keeping the USD in an account either onshore or offshore. A one-year certificate of deposit (CD) in China would have yielded 3% in 2014. Today, that rate is just 1.5%. More important is not the absolute rate, but the relative deposit rates in RMB versus the USD. As Chinese rates have trended down, U.S. rates have trended up over the last couple of years. As you can see from the chart below, the relative differential between the yield on a one-year CD in U.S. and China has converged to the same level.

The CFETS (China Foreign Exchange Trade System) RMB Index measures the yuan’s performance against a basket of 13 currencies, published by CFETS. The renminbi was tightly managed to a steady appreciation path relative to the dollar from 2005–2013. Since 2013, the Chinese government has explicitly changed the way they manage the renminbi from a managed float to the dollar to a managed float relative to a trade-weighted basket of its largest trading partners.

The other part of this return equation is the outlook for the renminbi versus the U.S. dollar. The renminbi was tightly managed to a steady appreciation path relative to the dollar from 2005–2013. Since 2013, the Chinese government has explicitly changed the way they manage the renminbi from a managed float to the dollar to a managed float relative to a trade-weighted basket of its largest trading partners. Given the rise in currency volatility, low onshore deposit rates, and the recent weaker performance of the Chinese renminbi relative to the USD, it’s no wonder that many Chinese are seeking ways to earn better risk-adjusted returns overseas. We are not seeing signs of depositors making a run on the banks, or an imminent crisis of confidence in the political system. On the contrary, we are seeing the Chinese following the capitalist motto, looking for attractive risk-adjusted returns just like everyone else in the world.
The final question that needs to be addressed is why, specifically, is Asia high yield attractive? If high yield in general is attractive at the moment, then why not invest in U.S. high yield or high yield in other regions like Latin America? The answer lies in the superior risk-adjusted returns of Asia high yield over that of high yield from other regions. Below is the risk return profile of various high-yield markets since the inception of the Asia credit Index (as represented by the J.P. Morgan Asia Credit Index) in 1999:

**Past performance is no guarantee of future results.** Fixed income investments are subject to credit, interest rate and currency risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to make principal and interest payments. Interest rate risk is the possibility that yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. U.S. Treasuries are guaranteed by the full faith and credit of the U.S. Government as to the timely payment of principal and interest. U.S. Treasuries are subject to market and interest rate risk and may be worth less than their original cost upon redemption prior to maturity. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. The views and information discussed in this report are as of the date of publication, are subject to change and may not reflect the writer’s current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. It should not be assumed that any investment will be profitable or will equal the performance of any securities or any sectors mentioned herein.

But surely this is an unusual period, you might say, as it captures the period just coming out of the Asian financial crisis of 1997–1998. In fact, the risk-return characteristics are very attractive for the last 5- and 10-year periods. Over a 5- and 10-year period, Asia high yield has generated higher risk-adjusted returns than both U.S. and European high yield. Just to drive home our point: for the same level of risk in U.S. high yield, one would have had more than 2% more in total return over this period.

In summary, we are entering a rare opportunity, one that typically appears only once per decade, for investing in Asia credit. As an asset class, Asia high yield offers risk-adjusted returns superior to high yield of all other regions, including U.S. high yield. At current valuations, we believe Asia high yield offers a return potential sufficient to offset losses from expected defaults over the cycle. The other conclusion is that just as credit spreads widen quickly, they also tighten quickly. It is almost certainly going to be a better investment than traditional fixed income asset classes such as government bonds, which have more downside than upside. Getting in at historically wide levels of today and having a long-term investment horizon historically has resulted in attractive returns.

**Figure 6. SINCE INCEPTION ANNUAL RISK AND RETURN**

Data shown from 1999 (or since inception) through December 2015 for Asia Credit (J.P. Morgan Asia Credit Index—JACI), Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofA Merrill Lynch High Yield Master II Index), Euro High Yield (Barclays Pan-European High Yield Index), LATAM High Yield (J.P. Morgan CEMBI-Broad Latin American High Yield Index), Global High Yield (BofA Merrill Lynch Global High Yield Index), J.S. Credit (BofA Merrill Lynch U.S. Corporate Master Index), CEEMEA Credit (J.P. Morgan Corporate Broad EMBI CEEMEA Index), Asia Bond (HSBC Asian Local Bond Index—ALBI), LATAM Credit (J.P. Morgan Corporate Broad EMBI Latin America Index), Emerging Markets (EM) Bond (P Morgan Emerging Markets Bond Index Global) U.S. Aggregate (Barclays U.S. Aggregate Bond Index), Euro Aggregate (Barclays European Aggregate Bond Index), Global Aggregate (Barclays Global Aggregate Bond Index), U.S. Equity (S&P 500 Index), MSCI Europe Index and MSCI All Country Asia ex Japan Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Volatility is the standard deviation of returns. Source: Bloomberg; data period 1999 to December 2015; 10/00 to December 2015; *2002 to December 2015.

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