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Asian Credit Remains Firmly Investment Grade

Given the global economic slowdown that has accompanied the fight against COVID-19, one would expect downward revisions to credit ratings, and widening credit spreads as markets price in the risks of loss of demand and disruption to business activity. This is largely how the past few months have unfolded in credit markets globally. In particular, the risks of default and of downgrades from investment grade to "fallen angel" high-yield credit ratings have been in focus, as these outcomes can lead to relatively high potential losses.

Asia credit is no exception. Even after the recent rally, credit spreads for the JP Morgan Asia Credit Index (JACI) were wider by over 100 basis points for the year as of June 16. The key question for investors is whether or not that spread widening is a reasonable reflection of the true downgrade and default risks in the market. We present our thoughts below.

To answer this question, we set out what we view as a reasonable assessment of the risks of rating downgrades and defaults due to a deterioration in credit fundamentals, and extrapolated the potential impact of those risks on valuations. We show the results for each ratings bucket of the JACI in figure 1.

Overall, we would observe that rating agencies generally would consider the balance sheets of Asian issuers to be in good shape coming into the COVID-19 crisis. The JACI's average rating of BBB+, with over 77% issuers in the index rated investment grade and close to 38% rated A- or higher. The Index is well diversified and has limited exposure to commodity and other highly cyclical risks. Outside of India, the capital ratios of Asian banks have generally improved by two or three percentage points in the past decade, as they have raised capital and liquidity following the adoption of Basel 3 standards and other regulatory measures, and this should increase their capacity to support corporates and households. Finally, many Asian economies, and particularly China, South

Korea, Taiwan and Singapore, are ahead of the curve in terms of controlling the spread of COVID-19 and being able to re-open their economies.

Putting all of that together, based upon our internal valuation calculations we estimate that, for the Composite Index, the increased risks of rating downgrades and defaults from COVID-19 should only have caused the Asia credit index spreads to widen by around 23 basis points.

FIGURE 1. HAS SPREAD-WIDENING GONE BEYOND WHAT IS FUNDAMENTALLY JUSTIFIED?

Actual spread-widening in Asia credit and our own estimates for downgrades and defaults and their implied spread-widening

	A	BBB	HY	JACI Composite
Index Weight (1)	31%	39%	17%	100%
Current Index Spread (1)	203bp	316bp	770bp	364bp
YTD Spread-Widening (1)	61bp	106bp	236bp	109bp
Downward Rating Migration Rate (2)	2%	8%	20%	7%
Default rate (2)	0%	0%	3.6%	0.6%
Impact on Index Spread (2)	1.2	16	98	23

(1) JP Morgan Asia Credit Index (JACI) as of 16 June 2020
(2) NB estimates based on estimates of downgrade and default risks, and the impact of those risks on credit spreads
Source: Neuberger Berman, JPMorgan. Actual credit spread data as of June 16, 2020.

In our view, observed spread-widening, in excess of 100 basis points, is in large part due to dislocations caused by stresses in the financial markets rather than actual credit risks. With significant liquidity injections and provisions of credit facilities by the central banks around the world, we believe that such stresses will dissipate. If our view is correct, then spreads on Asian credits appear exceedingly attractive, especially given the low volatility characteristics usually associated with the asset class.

Now let's set out our rationale for the results above, going through each ratings bucket.

AAA/AA/A: Strong Credits, Very Little Risk of Downgrade to High Yield

The AAA/AA/A bucket constitutes 38% of the JACI. Standalone fundamentals in this rating bucket are very strong in our view and the issuers tend to have additional support from highly rated sovereigns. We believe that ratings downgrade risks are low, as is reflected in the fact that fewer than 1% are on watch negative among the rating agencies. Our focus here is on the A rated bucket, since AAA/AA has too small a weight and too little volatility to have a significant impact on overall index spread. Even here, however, spread-widening risks are low since the impact of a ratings transition from A to high BBB, which is still investment grade, has tended not to be high.

BBB: Few Fallen Angels, and Most Are Likely to Trade as Crossover Rather Than High Yield

The risks in the BBB bucket are relatively high, with 5% of issuers on watch negative and 16% on negative outlook among the rating agencies. Given the wide spread differentials between the investment grade and high yield segments of the market, we believe that "fallen angel" risk is substantial here, and downgrades to Indian and Indonesian corporates are the major risks in this bucket due to the relative weakness of their sovereigns' credit ratings.

Still, we estimate that only 2% of the investment grade bonds in the index is at risk of being downgraded to high yield, and we also expect most fallen angels to trade more as "crossover" than high yield credits, given their links to stronger sovereigns: overall sovereign debt in emerging Asia stands below 60% of GDP, versus more than 100% for the developed world, and its external debt ratio is less than half that of other emerging regions, according to IMF data. Moreover, less than 25% of the BBB bucket (which is less than 5% of the Composite Index) has the lowest rating of BBB-. The rest have a one- or two-notch buffer from becoming fallen angels.

Despite all this, the widening of BBB spreads this year has priced for around half of the BBB index to become full fallen angels—that is, trading more like high yield than crossover credit. We would put that proportion at more like 4%.

High Yield: Our Estimated Default Rate Below 4% Remains Modest

Given the leveraged nature of high yield credit, 10% of this rating bucket is on watch negative among the rating agencies. Downgrade risks are high, but our default risk estimate is well contained, at 3.6% of the Asian high yield bucket, which is modest compared with global high yield and its own history.

We think Asian high yield issuers in general will be relatively resilient in this cycle because few are in the at-risk commodity sectors. Most are now seasoned market participants with diversified funding channels and large operating scale in their home markets, and many spent last year extending their debt maturity profile and building up cash. Indeed, our default expectations for this segment have actually declined from 4.2% since March, as a number of stressed credits have improved their liquidity position via corporate actions and capital-raising. Their actions in the face of adversity demonstrate a strong willingness to pay and notable financial flexibility. As such we think the current spreads in Asian high yield more than compensate for default risk.

Risks to Our View

There are, of course, a few risks to our views.

First, a few south and south-east Asian economies, such as India and Indonesia, and some of the frontier markets, are still struggling to contain the pandemic. The resumption of activity in these countries will take longer and will be attended by higher risks, which calls for selective and more nuanced positioning in portfolios.

Further, with China having a large weight in the index and the Chinese economy having significant linkages to most of the other economies in the region, the asset class does remain quite exposed to China-specific risks, such as a rise in U.S.-China tensions or renewed concerns around a second wave of COVID-19.

With those caveats in mind, however, we believe that the spread-widening that has met the COVID-19 crisis is understandable, but overstates the downgrade and default risks in the Asian credit markets, and represents an attractive value opportunity for long-term investors.

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