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Asia credit: IG segment offers shelter from the storms

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Although the macroeconomic environment has favored risk assets this year, as serious risks remain, it would be prudent to buffer portfolios against them. Asia IG offers an attractive risk-reward balance given that all-in yields remain elevated while fundamentals are healthy. In particular, we favor Indonesia and South Korea IG as both boast strong fundamentals and should be able to withstand the threat from tariffs.

Risk assets have outperformed bonds year-to-date as macroeconomic conditions turned out to be more benign than earlier feared, and the Federal Reserve began easing as expected in September. The MSCI ACWI has risen 20% while MSCI Asia ex-Japan (MXASJ) has climbed 14%. In the Asia credit space, high yield (HY) credit has returned 15.5% compared to Asia Investment Grade's (IG) 6.1%. With the S&P 500 equity market volatility index (VIX) down from above 23 at end-October to 13-14 currently, global economic growth expected to remain robust in 2025, and the Fed expected to continue cutting rates through 2025, investors may be tempted to skew their portfolios toward more risk. The contained reaction of South Korean equities (down less than 3%) to the domestic political tumult is only likely to further encourage this viewpoint.

However, the idiosyncratic episode in South Korea highlights the uncertainty that lies beneath the surface. Aside from these unknown "unknowns", there are the well-identified "unknowns" in the form of the looming tariff threats, and the still-simmering geopolitical hot spots in Ukraine and the Middle East. Policy error also remains a background risk that might materialize in the event of tariff-driven supply chain disruptions.

As these risks remain, investors would do well to buffer their portfolios against the negative side of the risk-reward tradeoff, especially when the positives have dominated of late. We recently addressed a range of investor concerns about the Asia credit space, and summarize the key points below.

Asia IG still presents most attractive risk-reward balance. Asia investment grade (IG) credit's 5.2% yield provides investors with an attractive level of compensation relative to the risk incurred. Its strong fundamentals are the main bulwark: net leverage has been declining since its 2020 peak at 2.9x to 2.3x in 2023, and interest coverage remains at a healthy 7.8x despite some deterioration recently. We expect these fundamentals to remain healthy over the coming 12-18 months as Fed easing continues, reducing the segment's interest expense burden. Consensus forecasts are for healthy earnings growth through 2025, and we see leverage remaining contained amid an absence of significant planned capex.

Market fundamentals are also supportive: net supply is likely to be negative in 2024 and flat in 2025. The USD 182bn of maturities this year should keep Asia IG net supply constrained, and 2025's likely healthy macroeconomic environment should ensure issuance needs are comfortably met. On tariffs, China will likely face the brunt of Trump's protectionist policies again, but we believe sound credit fundamentals will be sufficient for most Asian issuers.

Favor Indonesia and South Korea IG. Spreads in the Asia IG space are tight but can remain so for an extended period of time. Across the Asia credit space, we favor the short-to-medium tenors (averaging out to 5 years). In terms of regions, we favor Indonesian and South Korean IG credits. The macro-economic backdrop for Indonesia is positive, and its domestically-driven economy helps to cushion potential tariff risks. Credit fundamentals are healthy, and the commodity-linked credits should remain supported by buoyant prices in the coming months. We favor strategically-important quasi-sovereign issuers with improving credit quality.

South Korean IG is one of the highest quality segments in Asia IG, with the majority of credits in the AA or A rating bucket. We see these credits as a good carry play, with all-in yields of about 5%. We believe the current domestic political turmoil will not lead to a sustained spread widening in the Korea IG space, and see little impact on fundamentals. Any widening will make all-in yields look even more attractive and that should bring back demand. Any spread widening is likely to be transitory and would thus be a good opportunity to add exposure. Valuations are attractive given their AA/A ratings; select South Korean bank Tier 2 bonds offer 60-80bp yield pick-up over their senior bonds.

Asia HY fundamentals still a problem for the segment. The fundamental picture is less rosy for HY credit; the low-7% representative yield of the segment is inadequate relative to the risks, in our view. Asia HY issuers' poor net cash ratio (-20%) and relatively high 4.7x at end-2023 more than negate the recent marginal improvement in earnings. Consensus earnings expectations for 2025 are for slower growth than for Asia IG although limited planned expansion should allow overall metrics to stay stable in 2025. Nevertheless, the segment remains susceptible to issuer idiosyncrasies, and investors need to carefully evaluate each issuer individually. We advocate an opportunistic and bottom-up approach to investing in this segment and see relative value in the Macau gaming and commodity sectors.

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