PARTNER CONTENT

DIVERSITY IN ASIA'S BOND MARKETS

The second Asian Bond Investor Survey sponsored by HSBC and S&P Global Ratings explains why global institutional investors are increasing their allocations to Asian bonds

By ***FinanceAsia*** **Editors**

International bond investors are raising their asset allocations to Asia, increasing their exposure to the region's credits and preparing to augment their portfolios with bank capital issues, green bonds and infrastructure financings. They are also hotly-anticipating the opening up of China's onshore bond market.

Although these investors stress the importance of public credit ratings and independent research on individual securities, some are nevertheless willing to buy unrated bonds in their search for incremental yield and diversification.

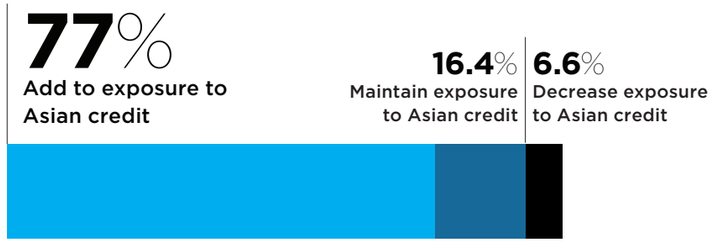
There are still signs of caution. Investors are anxious about heightened geopolitical instability in Europe after the Brexit referendum result. This is leading some to diversify their hard currency exposure, as well as prompting greater focus on growth prospects in Asia, most notably China and India.

These are the key findings of the second HSBC and S&P Global Ratings-sponsored Asian Bond Investor Survey, conducted in late August and early September by East & Partners Asia, a leading specialist market research and consulting firm.

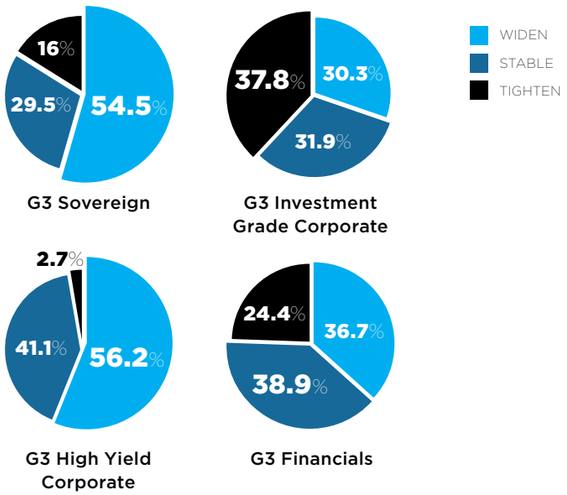
Through extensive one-on-one interviews, the survey revealed that as many as 77% (table 1) of 152 asset managers in Asia-Pacific, Europe and North America, with funds under management averaging US$3.73 billion, intend to add to their holdings of Asian fixed income. This is slightly more than in the inaugural survey six months ago.

"Global and regional investors are clearly raising the weightings given to Asian bonds in their portfolios, reflecting the attractiveness of the asset class," said Alexi Chan, global co-head of debt capital markets at HSBC. "The regional investor base is also shifting, to include

1 From an investment perspective and looking ahead over the next 12 months, do you expect to:



2 What are your expectations for spread movements in 2016?



much greater participation from institutional money managers and insurance companies, alongside banks and private wealth."

Although there are some expectations that yield spreads for sovereign, investment grade and high yield corporates, and financial institutions are likely to widen (table 2) after the recent surge in emerging markets as an asset class, Asian bonds are supported by solid foundations and positive sentiment.

"Asia's capital markets are characterised by abundant liquidity, a growing variety of investment institutions, and appetite for a wide range of credit profiles and instrument types," said Chan.

"Increasing investor comfort with China's economic outlook has helped underpin the positive market dynamic," he added. "In addition, cross-border merger and acquisition activity is vibrant, and net investor flows into commodities are turning positive after a four year reduction."

RISK ON

Equity market volatility, the weight of regulatory burdens, erratic global economic growth and warnings about escalating sovereign and corporate debt have become constant concerns. But rising political risk in Europe has joined these issues as a major theme — and nearly 60% of survey respondents (table 3) expressed anxiety in the wake of the surprising Brexit vote last June.

Changing market dynamics also provide opportunity. An overwhelming 90.8% of survey respondents intend to increase exposure to sterling, compared with 80.1% in April, two months before the UK vote referendum to leave the European Union (table 4). This no doubt reflects the impact of the Bank of England's new corporate bond purchase programme.

The search for extra yield, in the face of low or zero underlying interest rates and other stimulative central bank policies, has led many bond investors to add risk by extending duration and by moving down the credit curve.

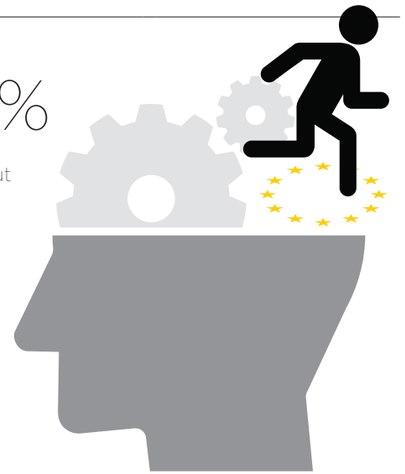
"Risk appetite returned strongly in the third quarter, driving a resurgence in the Asian high yield market, as well as the issuance of perpetual securities. The vast majority of transactions we brought to market received an excellent reception from investors," said Chan.

Issuance of unrated bonds picked up too. As many as 44.1 % of survey respondents intend to increase allocations to public unrated credits (table 5) during the next 12 months, with

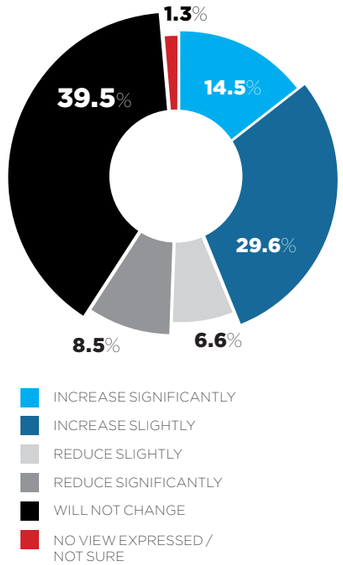
3a "OTHER" MARCO-ECONOMIC CONCERNS NOTED

	% of fixed income investors
Military / political / social tensions in Asia	26.3%
Reducing yields on offer	17.1%
Default risks in emerging markets	15.1%

55.9% of investors are concerned about **Europe: rising political risk (Brexit,etc.)** over the next 12 months



5 In the next 12 months how will your exposure to public unrated bonds in Asia-Pacific change?



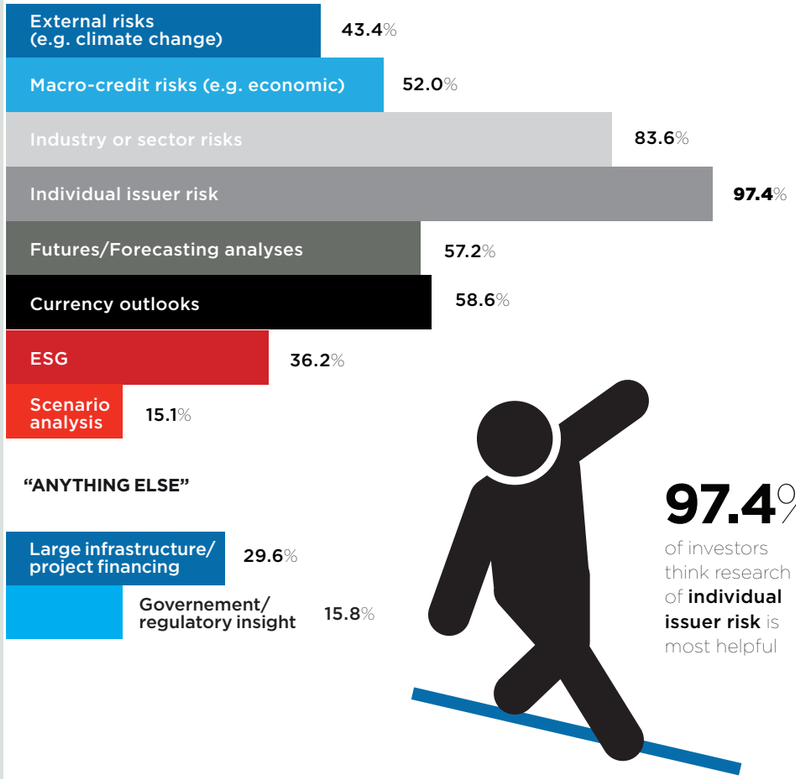
3 WHAT ARE YOUR TOP MACRO-ECONOMIC CONCERNS OVER THE NEXT 12 MONTHS?

	% of all fixed income Investors	% of Asia Based Investors (No: 104)	% of RoW Investors (No: 48)
Europe: Rising Political Risk (Brexit, etc.)	55.9	44.2	83.3
Equity market: Continues correcting with high price volatility	42.1	43.3	39.6
Political and regulatory imposts	39.5	41.3	35.4
Commodities: Prices continue falling	32.2	28.8	39.6
China: GDP growth below expectations	28.9	32.7	20.8
U.S. Faltering economy	27.0	26.0	29.2
Reversal of easy monetary conditions (e.g. Fed's rate rise)	23.7	24.0	22.9
Property: Correction in several markets	16.4	13.5	22.9

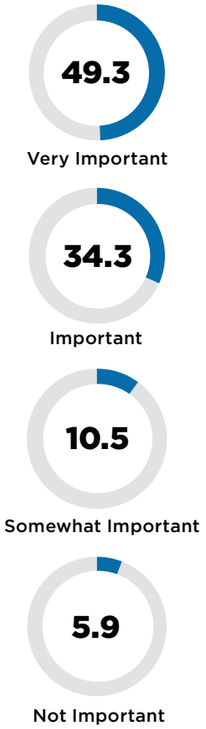
4 FROM AN INVESTMENT PERSPECTIVE AND LOOKING AHEAD IN WHICH CURRENCY MARKETS WILL YOU INCREASE OR DECREASE EXPOSURE?

	% of fixed income investors		
	Increase exposure	**Decrease exposure**	**No change / No view / NA**
GBP	90.8	2.0	7.2
USD	78.3	3.9	17.8
YEN	69.7	2.6	27.6
AUD	61.2	0.7	38.2
EUR	55.3	19.1	25.7
CNH	44.1	0.7	55.3
SGD	34.9	1.3	63.8
MYR	17.8	3.3	78.9

6 How would you prioritise the following in terms of research that can be provided to help you?



7 How important is it for an issuer and/or a bond issue to have a public credit rating?



94% of them citing yield enhancement as their main motivation.

This is despite the fact that more than 30% of respondents expect Asian default rates to increase, especially in the property sector where the preponderant bond issuers are based in Mainland China.

RESEARCH RATED

In this precarious environment, it is unsurprising that there is strong demand for independent research and the reassurance of individual bond ratings by global credit agencies.

"Bond default levels have risen and markets are vulnerable to event-shocks, but the overwhelming demand for yield will continue to win the day," said Matt Bosrock, managing director, global head of developing markets at S&P Global Ratings. "Access to independent credit analysis is a critical tool to ensure dispassionate risk assessment."

According to the survey, timely and accurate research into individual bond issuers is the priority with almost 98% of investors (table 6), followed by sector risk (83.6%) and, increasingly, currency analysis (58.6% compared with 51.7% six months ago).

"There is a tremendous demand for authoritative and timely research on industrial sectors as well as individual bonds," said Ritesh Maheshwari, managing director, head of market and franchise development, Asia Pacific at S&P Global Ratings. "The survey reaffirms our own feedback from investors, whose current risk-on attitude means independent reassurance is especially important."

Indeed, nearly half (49.3%) of respondents believe a credit rating is very important for public bonds, and only 5.9% think it is unimportant (table 7).

"In fact, it is a little perplexing why some companies don't apply for bond ratings, because the cost is low compared to the fees they pay to their bankers," said Maheshwari. "Perhaps, they want to avoid too much independent scrutiny."

S&P Global Ratings has a negative rating bias in Asia-Pacific spanning the primary, secondary and tertiary sectors, and has particular concerns about small-sized Chinese property developers, often due to their weak liquidity positions and unsustainable leverage levels, as well as the oil and gas sector across the region — most notably Singapore following the Swiber default in the summer — due to depressed commodity prices and

Alexi Chan, global co-head of debt capital markets at HSBC

sluggish trade hurting revenues.

But investors appear much less bearish, at least judging by their allocation choices.

A variety of products have come to market, including bonds with less restrictive covenants and unrated quasi-private placements, as well as innovative structures such as 'fixed-for-life' perpetuals.

In China — where, along with India, investors believe they have the best opportunities for healthy returns, with 44.7% planning to raise exposure to the former and 36.8% to the latter (table 8) — the expected level of government support is a major consideration for determining the credit-worthiness of bond issues, according to Bosrock.

"Analysts need to weigh up a company's importance for the national or local economy and the strategic significance of the sector in which it operates," he said. "For example, state-owned banks have a central role and are unlikely to be allowed to fail."

Moreover, ignoring China or the rest of Asia-Pacific is not a viable option for investors.

"Investors have little alternative but to seek opportunities in emerging markets to earn incremental yield. Asian bonds are one of the best options, because market structures and regulatory environments are more evolved than in most other developing jurisdictions," said Bosrock.

BOND VARIETY

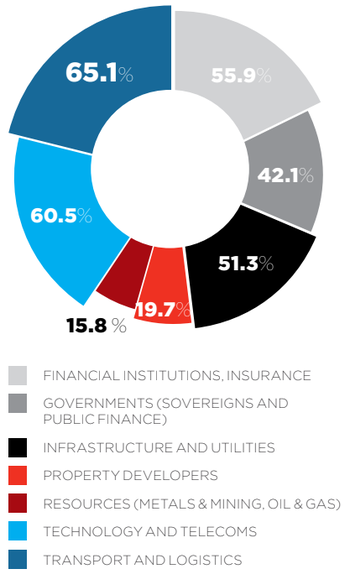
Asia-Pacific's fixed income markets, already rich in territorial and sectoral diversity, are continuing to develop rapidly. Local currency markets are opening up to foreign investors and nascent bond structures are meeting the demands of asset managers, issuers, regulators and the wider, non-financial community.

Investors are keen to participate in a raft of new loss-absorbing bank capital hybrid bonds (55.9%) that are expected to come to market. From a corporate sector perspective, transport and logistics (65.1% compared with 58.9% in

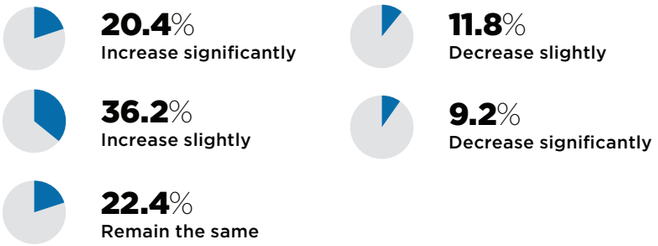
8 FROM AN INVESTMENT PERSPECTIVE AND LOOKING AHEAD, IN WHICH CURRENCY MARKETS WILL YOU INCREASE OR DECREASE EXPOSURE?

	% of fixed income Investors	
	Increase Exposure	Decrease Exposure
China	44.7	0.7
India	36.8	-
Australia	30.3	1.3
Japan	27.6	2.6
Whole region / no specific country targeted	17.8	1.3
Indonesia	17.1	-
Hong Kong	16.4	-
South Korea	14.5	1.3
Malaysia	9.9	2.0
Singapore	9.2	-

9 What sectors within Asian fixed income do you think will be most attractive in 2016?

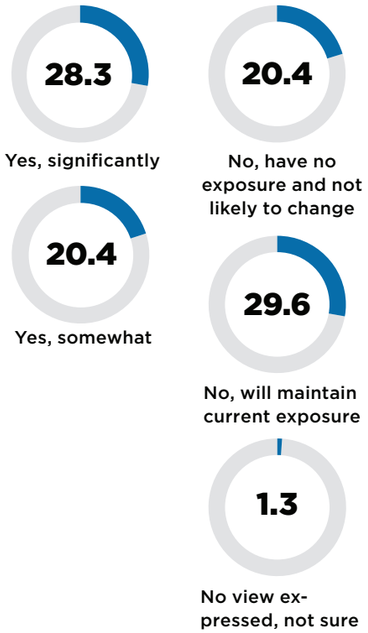


10 Do you expect to decrease or increase your exposure to bank capital (AT1, T2 or TLAC)?



11 Do you expect to increase your fixed income exposure to the infrastructure sector in the next 12 months?

%



12 If you answered yes, are you likely to participate in the Belt and Road Initiative?

April) has overtaken technology and telecoms (60.5% versus 63.6%) as the most attractive sector (table 9).

"The Brexit vote was followed by an acceleration in capital issuance from financial institutions in Asia-Pacific, as expectations that underlying rates would stay 'lower for longer' led to a major rally in the asset class," said Chan. "Most interestingly, Asian banks were able to achieve significantly tighter pricing levels on AT1 securities than their European peers, reflecting the different perceptions of risk."

The survey revealed continuing positive sentiment towards bank capital issues with some 56.6% of respondents planning to increase their holdings, and only 21% intending to reduce exposure to the sector (table 10), mainly for fund weighting and credit quality reasons.

"All bank capitalisation bonds have been rated so far, but each needs to be analysed and assessed separately," said Maheshwari.

Meanwhile, nearly half (48.7%) of survey respondents intend to increase their fixed income exposure to the infrastructure sector (table 11), up 7% from six months ago. Countries throughout the region, for example India, Indonesia and the Philippines, have ambitions to improve their country's infrastructure, including power capacities and transportation networks, and are likely to tap into Asian fixed income liquidity and investors' demand for higher yields and longer maturities.

The potential of the infrastructure sector has been further accentuated by China's Belt and Road Initiative , although the strategy remains at an early stage in respect of detail about how it will be implemented. More than half (51.4%) of investors said they will get involved (table 12), with 32.4% still undecided — presumably because they are waiting for substantive schemes.

GOING GREEN

New bond structures are already evolving both as mechanisms for financing energy requirements efficiently and to address concerns about climate change and the impact of rapid regional industrialisation on the environment.

One of the most exciting initiatives is the growth of so-called green bonds — and they have clearly caught the imagination of fixed income investors.

"In many meetings we hold with investors, ESG [environment, social and corporate governance] and green bonds are on their agenda," said Bosrock.

Although only 14.5% of survey respondents so far have an allocation to green bonds, two thirds are now familiar with the nascent sector (table 13). Also, almost half (47.4%) plan to increase their holdings (table 16, see page 63).

"The development of the green bond market is a really important focus for regulators, the investment community and issuers in the region at the current time," said Chan.

"Asia-based investors are at an earlier stage in their involvement in the sustainable financing agenda than some of their European peers. But with regulators in China and elsewhere moving this subject to the top of the agenda, the potential for rapid growth in the market is clear," he added.

In fact, China is the world's largest green bond issuing nation in so far in 2016 (up to September 22), accounting for 44% of global volume with US$20.9 billion raised from 23 deals, compared to just US$1.3 billion from three deals in full year 2015, according to Dealogic.

China's lead in the green bond market comes just over a year after the product made its debut in the country in July 2015, when Xinjiang Goldwind Science & Technology priced a US$300 million offshore deal. Shanghai Pudong Development Bank's ¥20 billion (US$3 billion) onshore green bond, priced in January 2016, is the largest Chinese green bond priced to date.

"However, there is insufficient benchmark data and no clear consensus about what constitutes a green bond and nor are the principles fully-agreed and immutable," said Bosrock.

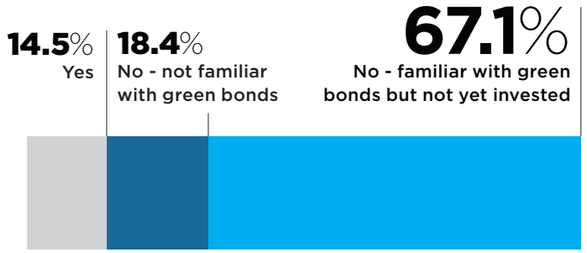
Rating agencies can help create standardised, meaningful benchmarks which should expedite the growth of the 'green' sector. Recently a division of S&P Global, S&P Dow Jones Indices, took a controlling stake in Trucost, a leading environmental data provider and index compiler.

The growth of the green bond sector is part of a more general adoption of ESG factors in investment decision-making and their inclusion in asset managers' mandates.

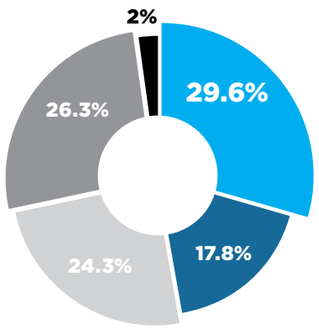
Nearly 30% of survey respondents

Matt Bosrock, managing director, global head of developing markets at S&P Global Ratings

13 Are you invested in Green Bonds?

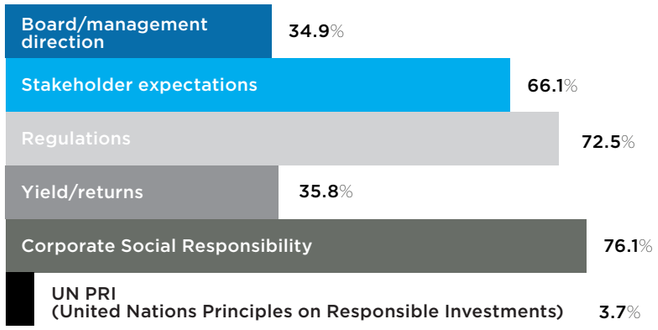


14 How likely is it that ESG (Environmental, Social & governance) factors will impact your future credit investment decisions?



- ALREADY FACTORED IN
- LIKELY - IN THE NEXT 12 MONTHS
- LIKELY - IN THE NEXT 12-24 MONTHS
- LIKELY - BEYOND 24 MONTHS
- NOT LIKELY AT ALL

15 If you already factor in or answered "Likely" to question 14, what will drive this change?



are already focused on ESG and about 69% intend to incorporate ESG in their bond selection process (table 14). Stakeholder expectations, regulatory insistence and simply a sense of corporate social responsibility are driving this trend (table 15).

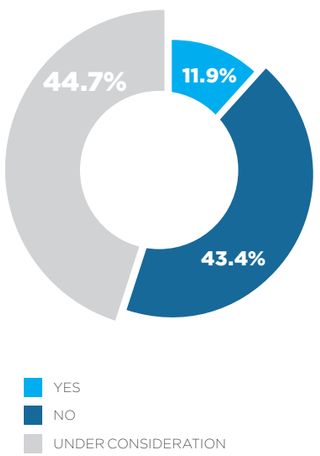
CHINA OPENING

Another major development is taking place in China's capital markets. The so-called Panda bond market (renminbi-denominated bonds issued in the Mainland by foreign borrowers) has established itself well this year, with nearly 30% of investors planning to increase their exposure (table 16). Investors see great potential in China's vast onshore bond market.

In May, China allowed international investors to buy onshore bonds through an agent bank appointed by the government rather than having to gain approval within a Qualified Foreign Institutional Investor quota. There are about 20 agent banks, including HSBC.

So far, 11.8% of survey respondents are invested in onshore Chinese bonds, but 44.7% are planning to take advantage of further measures to open access (table 17).

17 Are you currently invested in China's onshore bond markets?



Ritesh Maheshwari, managing director, head of market and franchise development, Asia Pacific at S&P Global Ratings

Outstanding onshore bonds are worth US$7.5 trillion, making China the world's third biggest bond market behind the US and Japan. Yields on 10-year issues were around 2.68% on October 27, compared with 1.816% for US Treasuries, 0.128% for German bonds and the negative yields offered by Japanese government bonds. That in itself will help attract global investors, but the increasing inclusion of Chinese bonds in global indices will also drive demand.

"The opening up China's onshore bond market to overseas issuers and investors represents an enormous opportunity," said Chan. "The current gradual approach to capital market liberalisation by Chinese regulators will be given further impetus by the recent inclusion of the renminbi in the IMF's special drawing rights basket."

Access to new markets, the development of innovative and diverse fixed income products, the deepening of the regional investor base and, perhaps most of all, Asia-Pacific's global importance means that the trends identified in this latest survey will continue. Asia-Pacific's fixed income markets are likely to attract and also benefit from increasing allocation weightings by international investors. ■

For more on the survey, with insights and analysis on Asia Pacific's bond markets, please visit our microsite at www.financeasia.com/

16 DO YOU EXPECT TO INCREASE/DECREASE YOUR EXPOSURE TO THE FOLLOWING INSTRUMENTS?

% of fixed income Investors

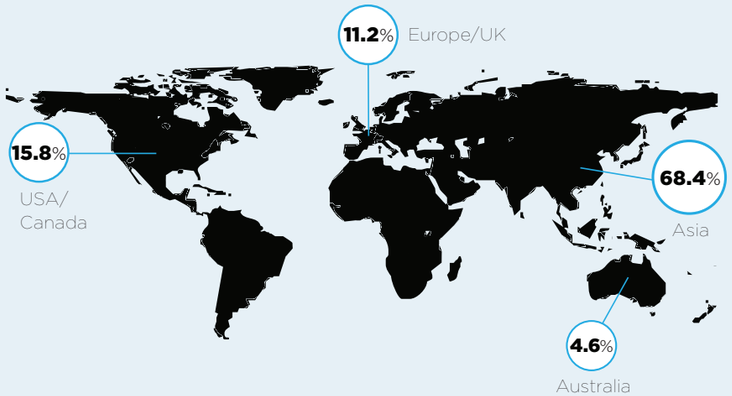
	Significant Increase	Moderate Increase	Hold Position	Moderate Decrease	Significant Decrease	Total Invested
Floating rate notes	25.0	28.9	34.2	8.6	3.3	100.0
Green bonds	19.1	28.3	51.3	0.7	0.7	100.0
Panda bonds	10.5	19.1	50.7	-	-	80.3
Formosa bonds	1.3	2.6	1.3	-	-	5.3
Masala bonds	0.7	2.0	0.7	-	-	3.3

DEMOGRAPHICS

Between August 15th and September 5th 2016, East & Partners Asia conducted a series of telephone interviews with 152 of the world's top chief investment officers and heads of fixed income from Asia-Pacific, Europe and North America.

A breakdown of the geographical split of the interviewees and their job titles is highlighted below. The fixed income assets under management at these funds average out at more than US$3.73 billion.

COUNTRY DISTRIBUTION



SURVEY RESPONDENTS BY JOB DESCRIPTION

Head of fixed income	36.8%
CIO fixed income	33.6%
Head of credit	13.8%
Senior fixed income portfolio head	13.2%
Head of emerging market debt	2.6%
TOTAL	**100%**