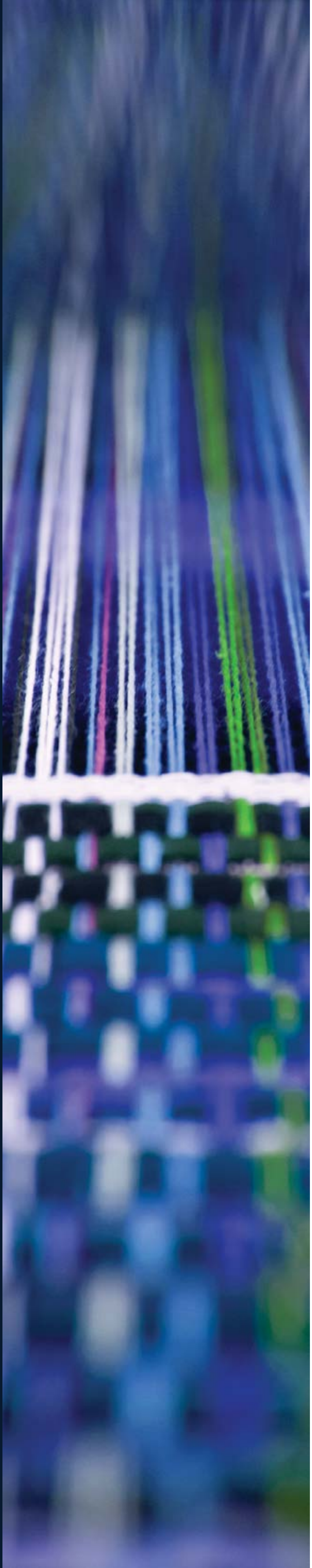

Portfolio insight

Asian credits: capturing the Asian premium

Q2 2019

Manulife Investment Management

Overview

After a tumultuous 2018, the Asian credit market has rebounded this year on the back of an improved cyclical outlook and strong economic fundamentals. The high-yield segment is particularly noteworthy, offering competitive real yields, attractive valuations, and higher yields to maturity—particularly when compared with equivalent assets in the developed markets, a phenomenon known as the Asian premium.

With 10 offices in the region and a team of more than 50 fixed-income professionals on the ground, Manulife Investment Management is well positioned to help investors capture these exceptional opportunities in Asian credits.

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Key highlights

Why Asian credits now?

The Asian credit market has rebounded after a difficult 2018, supported by a number of cyclical factors, including an increasingly dovish U.S. Federal Reserve (Fed) and renewed investor interest, which translated into capital inflows into Asian financial markets.

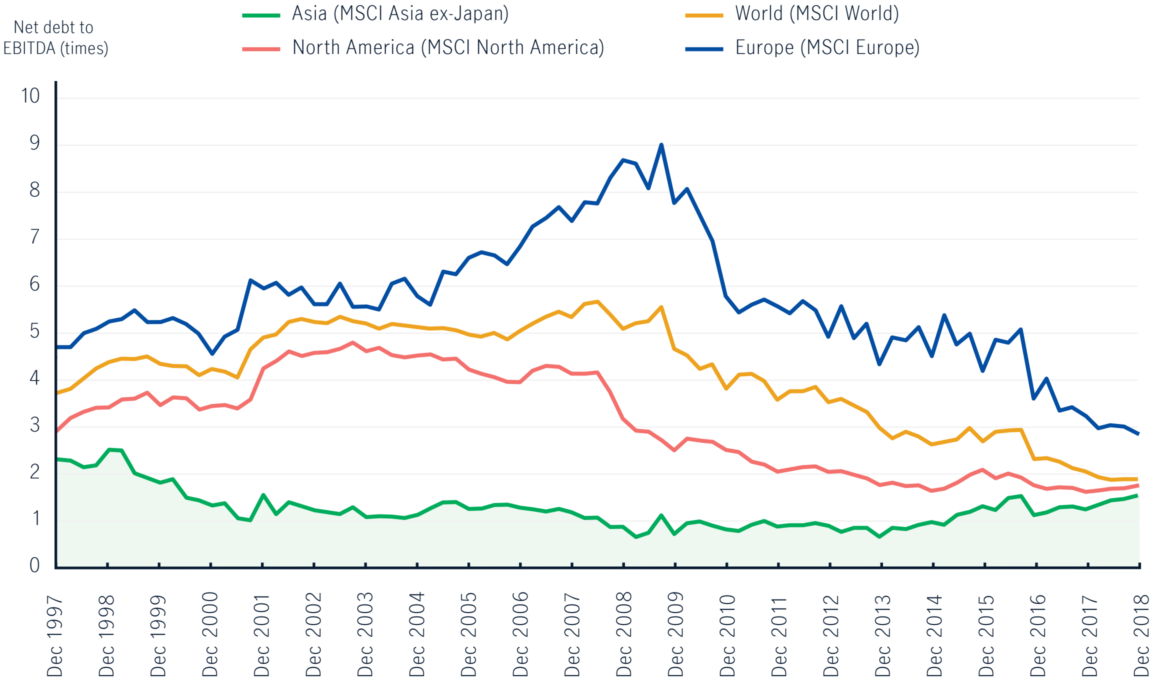
Against this favorable macro backdrop, we believe the Asian credit market, particularly the high-yield (HY) segment, is poised to make further gains. In our view, this will be driven by robust market fundamentals, which include 1) strong corporate balance sheets, 2) low default rates, 3) a strengthened regional investor base, and 4) attractive valuations and higher yields to maturity—the Asia premium.

1 Stronger corporate balance sheets

The earnings picture in Asia has been very positive, bolstered by stable GDP growth in the region. Asian economies have been expanding at a pace that's significantly higher than the global average,[1] helping the region's companies to maintain a healthy profit level despite a deceleration in global economic activity.

The typical Asian investment-grade (IG) company is well positioned to service, and to ultimately pay back, its debt obligations. In addition, the level of leverage among Asian firms remains lower than their peers in the United States and Europe.

Global corporate leverage levels



Source: Bloomberg, MSCI, as of December 31, 2018.

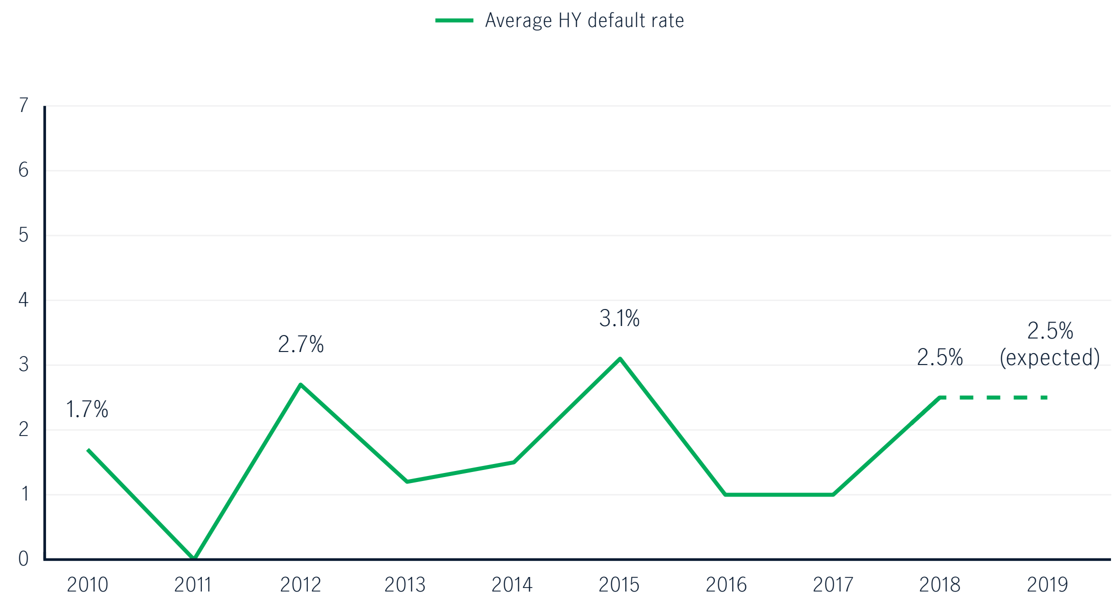
2 Lower default rates

Deleveraging efforts in China led to a higher number of defaults within the Asian HY segment in 2018. The expected default rate for Asian HY companies in 2019 is 2.5%, which is similar to the level recorded in 2018 and, crucially, below emerging Europe (3.5%) and Latin America (3.4%).[2]

Default levels in China are widely expected to stabilize as the People's Bank of China shifts to a monetary easing bias in 2019. This should lower onshore borrowing costs for Chinese firms, which could have a positive effect on China's offshore corporate bond market.

Having said that, a thorough and effective credit assessment process remains crucial when investing in this asset class. In our view, a bottom-up approach to credit selection is key to identifying investment opportunities in the segment, helping to strike a balance between quality and attractive valuation.

Historical Asian HY default rate

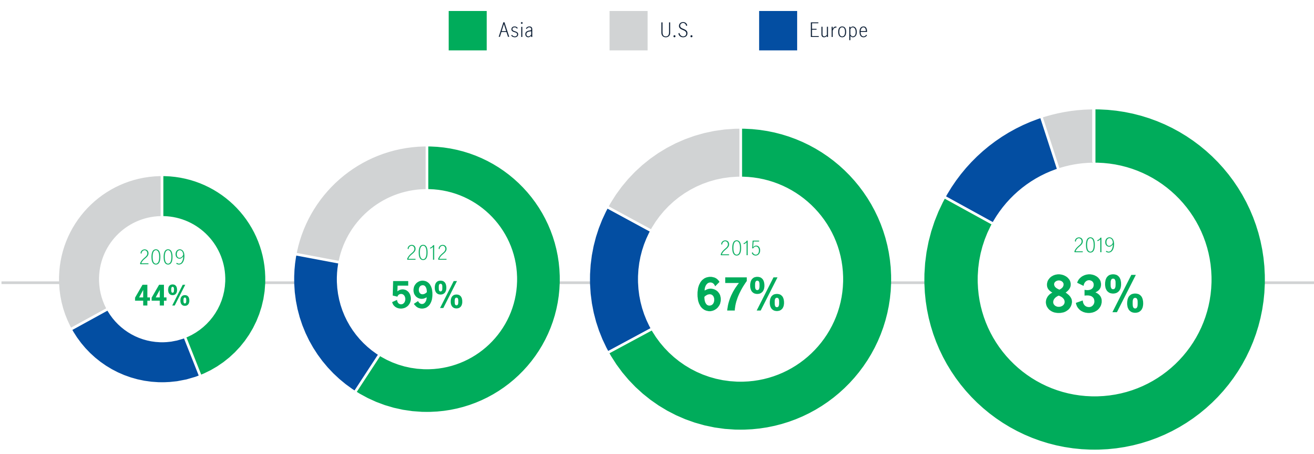


Source: J.P. Morgan, Bloomberg, January 2019.

3 A strengthened regional investor base

The investor base for Asian credit has evolved. Over the years, we've observed a growing investor base within Asia. Their allocated share of new U.S. dollar-denominated bond issues has nearly doubled in the last decade. This group of investors is more likely to be committed to the region and less influenced by short-term market movements. The strengthened Asian investor base therefore offers more stability to the asset class, particularly in times of increased volatility.

Allocated share of new U.S. dollar-denominated bond issues to Asian investors is growing



Source: Manulife Investment Management, J.P. Morgan, March 2019.

4 Attractive valuations and higher yields to maturity

Rising U.S. interest rates and potential emerging-market (EM) contagion stemming from country-specific idiosyncratic events in 2018 had led to a widening of HY and IG spreads, with much of the adjustment in Asian credit markets rather than U.S. markets.

Market repricing in these credit segments has created interesting opportunities for investors in 2019. For instance, Asian HY bonds, on average, offer a yield to maturity of around 7.6%, which is considerably higher than its U.S. peers.[3] Supported by a thorough credit selection process, we believe that investors can find attractive opportunities within this space.

The Asian premium is a key attraction of Asian bonds, as debt issued in Asia offers a higher yield than the bond equivalent in developed markets, despite sharing an identical credit rating. The spread differential between the two represents the Asian premium; in other words, investors owning Asian debt can enjoy a higher income return relative to a similarly rated U.S. corporate bond without taking on additional risk, theoretically speaking.

Historically, the spread between Asian IG bonds and their similarly rated U.S. counterparts is around 75 basis points (bps); a similar premium is observed between Asian HY and U.S. HY. Interestingly, the yield differential between Asian HY and U.S. HY widened recently, to roughly 107bps.[4]

Asian premium in HY over the past decade

1 **2010**

Asian HY outperformed (spreads tightened) amid investor expectations of further quantitative easing policies by the Fed (QE2).

2 **2013**

Asian HY sold off (spreads widened) as a result of the taper tantrum. Asian HY underperformed U.S. HY, as EMs typically underperforms developing markets in a risk-off environment.

3 **2015/2016**

U.S. HY underperformed due to lower energy prices, as energy producers represent a relatively large component of the segment.

4 **2018**

Asian HY came under pressure due to concerns over Fed tightening, U.S.-China trade tensions, and negative investor sentiment.

Source: Manulife Investment Management, J.P. Morgan, April 30, 2019. LHS refers to left-hand side, RHS refers to right-hand side.

Risks in Asian credits

Corporate governance

Although significant progress has been made in the last decade, corporate governance standards in some parts of Asia remain lower than their counterparts in developed markets. This is a factor that investors should take into account when investing in this asset class. That said, there's been important improvements in the area of accounting transparency and minority shareholder rights in many markets throughout the region.

Liquidity risk

The Asian U.S. dollar bond market has historically been particularly susceptible to liquidity risk, as the market's also home to debt issued by little-known companies that are traded among a relatively narrow base of investors. However, the breadth and depth of the market is changing—many larger and better-known issuers have entered the arena in the last few years, and we've seen an increase in regional Asian institutional investors who view Asian credit as a strategic long-term investment. This creates a more stable ownership base for the asset class, thereby helping to reduce liquidity risk.

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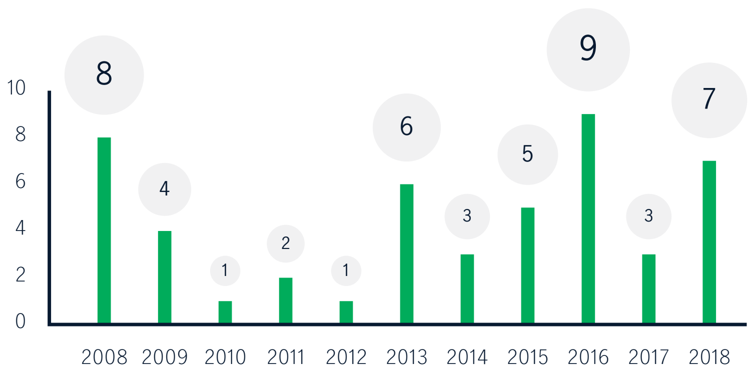
Tapping into our core strength: credit selection

Credit selection is critical to investment success within this segment—it's as much about identifying opportunities as it is about knowing which propositions to avoid.

We believe our track record speaks for itself. Over the past 10 years, we haven't recorded a single default in our regional pan-Asia fixed-income portfolio holdings. There have been 49 "fallen angels"—bonds whose investment rating had been cut from IG to non-IG status—within the Asian credit space (excluding Japan) during that period, and we've avoided them all. In our view, this reflects not just our expertise in the area of credit selection, but also our commitment—as active managers—to safeguard investors from potential capital loss and credit write-offs.

Number of fallen angels in Asia (ex-Japan) fixed income



Source: Manulife Investment Management, Standard & Poor's, Moody's, J.P. Morgan Asia Credit Index (JACI), December 2018. Please note that the definition of investment-grade bonds might differ for each bond mandate, depending on the relevant investment guidelines.

There have been

49

fallen angels
from 2008 to 2018 in Asia (ex-Japan). Our investment team did not invest in any of them.

Dedicated professionals behind our proprietary credit assessment process

The credit assessment process plays a critical role in fixed-income investing. Our investment decisions are guided by our comprehensive in-house credit rating resources, led by the Manulife Asia Credit Committee (MACC), under the guidance of our Head of Asian Credit Research Fiona Cheung.

A dedicated committee of senior fixed-income professionals across Asia, MACC has been set up to ensure that each credit is rigorously analyzed. It's supported by a team of 21 credit analysts on the ground, each contributing local insight to the credit analysis process. All credit issues are debated before being added to the investment team's eligible credit coverage universe.

The committee holds weekly meetings to decide whether newly issued bonds will be placed on a master list of approved names. Once approved, portfolio managers will then be able to assess if a new issue is appropriate for inclusion in their respective portfolios.

Asian credit universe

Head of Asia credit research
- Sole discretion on internal risk rating
- Authority to decide eligibility to approved list

Lead credit analyst
- Presents credit thesis, which includes investment rationale and proposed internal risk rating, to the head of Asia credit research and other participants
- Credit team determines the investment universe

Approved names

Portfolio managers
- Decide which approved credit issues are appropriate for their respective portfolios

Source: Manulife Investment Management, May 2019. For illustrative purposes only.

Once selected, a rating will be assigned to the issue, based on our proprietary internal risk rating (IRR) credit monitoring system, which is similar to the commercial credit assessment services offered by ratings agencies such as Standard & Poor's, Fitch, and Moody's.

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How we add value

- Our internal team covers over 90% of the J.P. Morgan Asian Credit Index (JACI) fixed-income universe. Of the 82 names that are nonrated in the JACI, Manulife Investment Management's credit team has reviewed every single name, while 32% of them are actively covered.
- Our credit research team covers 500 Asian credit names. Of those, 180 are issued by Chinese companies, 30% of which are unrated by external credit agencies.[5]

We believe that our proprietary IRR credit monitoring system allows us to make more informed investment decisions, leading to better outcomes.

Objectivity

The IRR system allows for an independent, transparent, and objective assessment of credit opportunities. Many of our local analysts have previously worked in established credit agencies, providing the team with invaluable insight into how these credit agencies operate—insight that's invaluable to our research and investment process.

Speed

The IRR system creates a consistent investment framework across the region and allows for the speedy integration of relevant information into actionable ratings. Our extensive footprint in the region enables us to carry out our work in an effective timely manner.

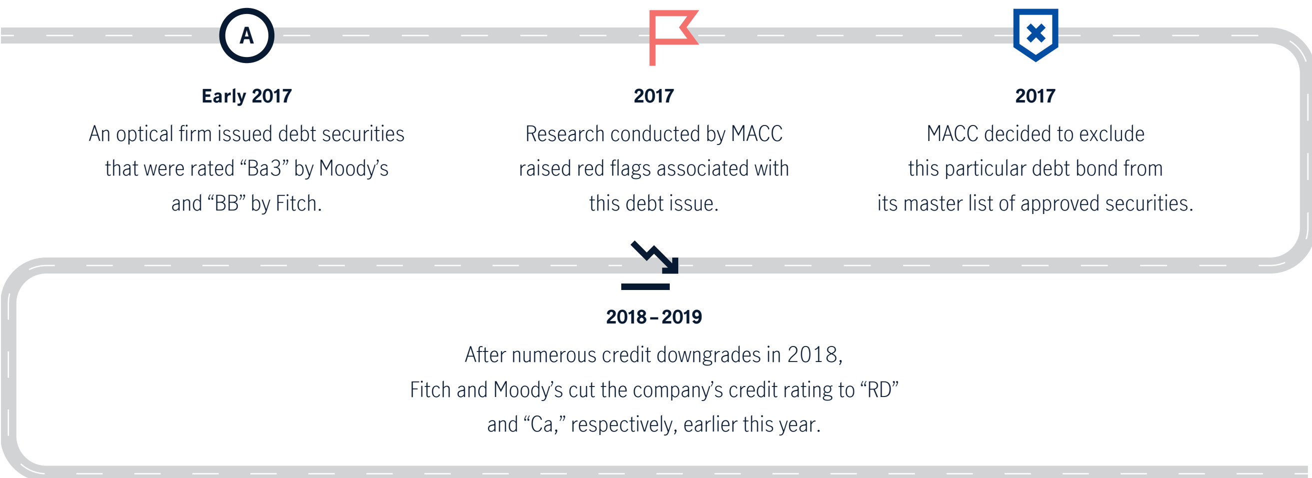
Case studies
The power of proprietary credit research

Manulife Investment Management's continued commitment to proprietary credit research has led to interesting opportunities, including occasions where we identified material issues even before established credit rating agencies.

Case study 1
The value of credit analysis: an optical firm

In early 2017, an optical firm issued a bond, which was rated "Ba3" by Moody's and "BB" by Fitch. However, MACC decided against adding the firm to its master list of approved issues because our research revealed a few serious red flags—among them, the high level of related-party transactions, opaque customer relationships, and the share-pledge arrangement between the firm and its parent company. The committee was also highly skeptical of the company's unusually high margins and cash balance, particularly when it didn't seem to possess a compelling edge in a highly competitive industry.

Outcome: Moody's and Fitch downgraded the company several times in 2018. Issues cited included questions about the firm's share-pledge arrangement with its major shareholders. The company also failed to repay a domestic bond due in January 2019. Moody's and Fitch eventually downgraded the company to "Ca" and "RD", respectively.



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Case study 2
The value of our IRR credit monitoring system: a food and beverage producer

In January 2017, our investment team invested in a bond issued by a Chinese food and beverage producer. It was initially rated "B1" by Moody's and "B+" by Fitch. Our credit research team assigned the credit a HY rating, meaning that investment teams managing high beta HY portfolios could consider holding the issue for short-term tactical purposes.

Tracking the company's financials closely, our credit research team noticed the quality of the company's disclosures had deteriorated after issuance. Access to sufficient company financial information became increasingly difficult, and the firm stopped releasing sales revenue breakdown. An examination of the issue revealed discrepancies between data released by the company and corresponding information that was publicly available.

The investment team exited the position after attempts to engage with the management didn't yield a satisfactory explanation. The company was also removed from our master list of approved issues in mid-2017.

Outcome: The company defaulted on an onshore note due in December 2018, which subsequently triggered a cross-default on its 2020 U.S. dollar bonds. Moody's downgraded the issue from "B1" to "Ca" and ultimately withdrew its rating.

January 2017
After conducting a detailed assessment, MACC assigned an HY rating to the debt instrument.

January 2017
The investment team took a position in the issue, which was rated "B1" by Moody's and "B+" by Fitch.

Early to mid-2017
MACC tracked the company's performance closely and noted a deterioration in the quality of the firm's disclosures.

Mid-2017
The investment team sold its position at near par, and the issue was removed from MACC's master list of approved issues.

December 2018
Moody's downgraded the bond from "B1" to "Ca" and subsequently withdrew its rating on the firm.

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Conclusion

We believe the credit space in Asia is a compelling proposition for global investors, and Manulife Investment Management is well positioned to help investors tap into this opportunity. The economic cycle is supportive of the asset class, and fundamentals within the segment remain strong. Asian credit also appeals, from a valuation perspective, given historically low default rates and the fact that corporate leverage in the region remains lower than the global average. With our extensive Asian footprint and our commitment to proprietary credit research, we're well placed to help investors navigate their way through the Asian credit space, enabling them to access the Asian premium.

1 "World Economic Outlook," IMF, as of January 7, 2019. **2** J.P. Morgan, Bloomberg, January 2019. **3** Bloomberg, JACI Non-Investment Grade Total Return Index, April 2019. **4** Bloomberg, as of February 28, 2019. **5** Manulife Investment Management, April 30, 2019.

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A rise in interest rates typically causes bond prices to fall. The longer the average maturity of the bonds held, the more sensitive a portfolio is likely to be to interest-rate changes. The yield earned by a portfolio will vary with changes in interest rates.

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