IP VIEWPOINT

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ASIA HIGH YIELD UPDATE: Q&A WITH INCOME PARTNERS

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Income Partners believes the Asian High Yield Market currently offers an attractive opportunity going into 2019. The market yield has surpassed 9% for the first time since 2009, with bond prices having dropped close to 5-20 points in 2018 with many trading at 70 or 80 cents on the dollar. Implied default probabilities exceed historical and expected default rates.

Importantly, the three primary factors weighing on the markets in 2018 are beginning to clear or are largely priced in:

- *Rising US interest rates*: We believe the Fed has almost completed its hiking cycle and has acknowledged rates are close to neutral.
- *China Deleveraging*: Since mid-2018 Chinese authorities have been loosening policy and encouraging lending to private enterprises. We expect more of the same in 2019 with additional fiscal support.
- *US-China trade tensions*: While uncertainties remain, there are positive signs including the decision to suspend tariff increases.

After underperforming many markets in 2018, we believe Asian High Yield is in a position to perform strongly in 2019.

In this IP Viewpoint, we sit down with Income Partners Chairman, CIO and CEO Emil Nguy, as well as co-CIOs Raymond Gui and Suvir Mukhi, to address some of the key questions on investors' minds as they assess the opportunities and risks in the Asia High Yield asset class today.

Q: What have been the key drivers behind the significant spread widening in Asian High Yield this year?

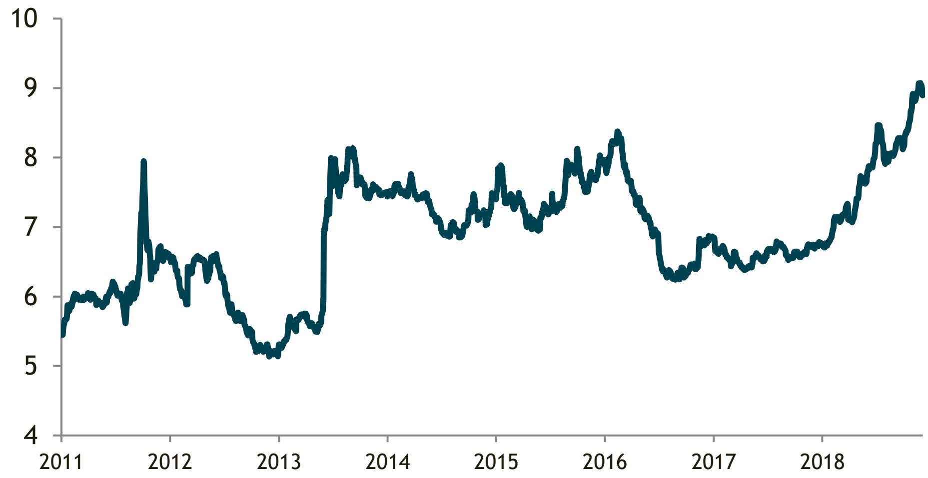
Emil: Unlike previous Asia credit market sell-offs which have typically been driven by one dominant factor, this year's sell-off has been drawn out and driven by multiple factors: Fed rate hikes, EM outflows, China onshore de-leveraging, significant new issuance and U.S.-China trade tensions. Among these factors, we believe China's deleveraging policy has been the most significant driver of spread widening this year.

Together, these factors have led the JP Morgan Asian Non-Investment Grade Blended Index to decline by 4.6% through November 30, pushing the index yield level from 6.5% to above 9%.

Q: How do yields look today relative to historical sell-offs?

Emil: The JP Morgan Asia Non-Investment Grade Blended Index is currently offering yields above 9%, levels we have not seen since 2009 during the Global Financial Crisis. As shown in the chart below, there have been three instances in recent years where yields have reached 8%: the European Debt Crisis (2011), Taper Tantrum (2013) and the CNY Depreciation (2015-16). In each of these cases, attractive yield levels quickly brought buyers back to the market, providing attractive post sell-off total returns.

JACI Non-Investment Grade Index: Yield Level (%)

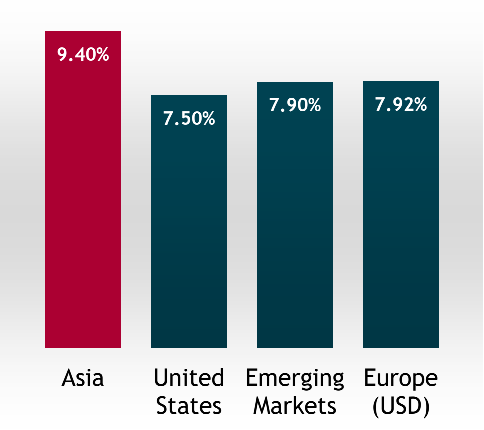


Source: Bloomberg, December 2018

Q: How has Asia fared relative to other Global High Yield markets?

Suvir: Asia, and particularly China, has led global credit markets in this sell-off, largely due to the role of onshore China deleveraging and the U.S.-China trade war rhetoric. As a result, the Asia High Yield spread premium over similar-rated credits in the U.S. and Europe has widened significantly. Today, Asia BB-rated credits offer a 2% yield premium versus equivalent rating U.S. credits, and the yield premium is 3.5% with B-rated credits, as shown in the chart below.

Global High Yield Markets YTM (%)



Source: JP Morgan, 30 November 2018

Q: With China at the centre of the market volatility this year, how have other parts of the offshore Asian High Yield market performed?

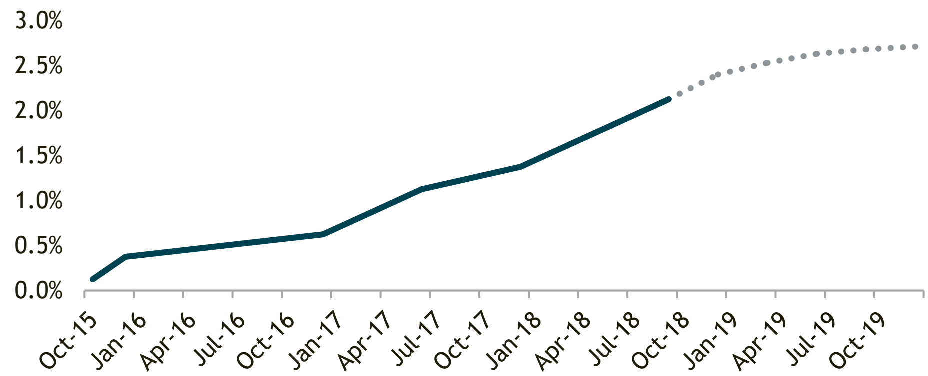
Suvir: While Chinese credits were the first to correct in early 2018, we quickly saw spread widening encompass High Yield credits from other Asian countries, particularly India and Indonesia which are the largest Asian markets outside China. The rally in the oil price through the third quarter of 2018 also contributed to this, given both countries' reliance on oil imports.

Q: What has changed today?

Emil: In our view, the three key risk factors that drove 2018 volatility, namely the Fed rate hiking cycle, China deleveraging and the U.S.-China trade war rhetoric, are either abating or have been fully priced into current valuations. Let's address each of these in turn.

Suvir: The Fed rate hiking cycle has, as in previous cycles, strengthened the U.S. dollar and produced weak Emerging Market credit and equity performance. The U.S. economy is now showing signs of slowing and we've already seen Treasury yields decline and the yield curve flatten. The Fed has indicated it is already close to neutral, and Fed Fund Futures are now pricing in only 1-2 remaining hikes, as shown in the chart below. We expect this to relieve pressure on Emerging Market assets.

U.S. Fed Funds Rate (%)

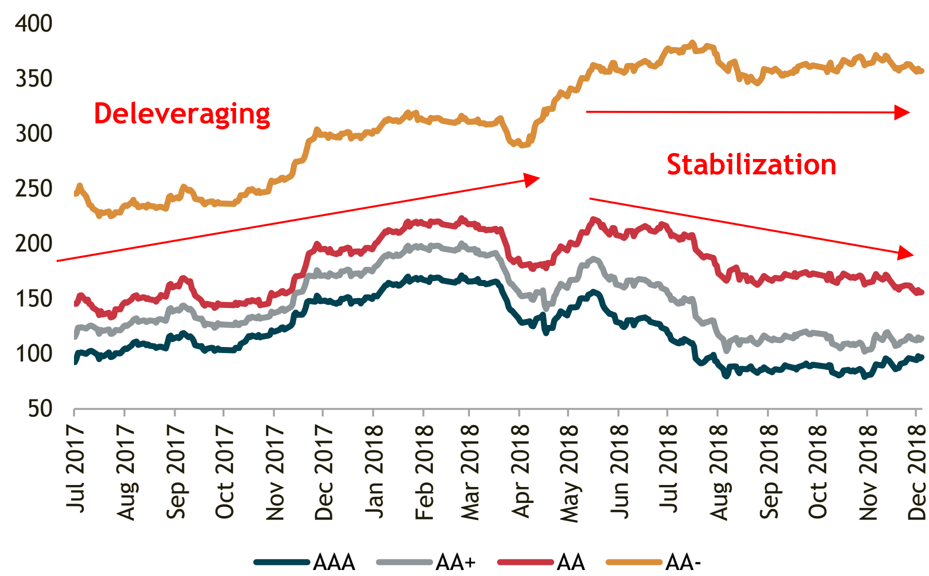


Source: Bloomberg, December 2018 (Future rates are based on the forward curve)

Raymond: China's deleveraging was a self-engineered policy to stabilize debt levels that has weighed on growth and sentiment towards Chinese issuers. Beginning in July, we saw Chinese monetary and fiscal policies become more supportive of growth, and we expect these to continue into 2019. The IP Viewpoint from November 2018 titled "*Policy Easing in China Brings Opportunity for High Yield*" provides specific details on these measures.

A significant impact of these measures has been an increase in liquidity in the onshore China corporate bond market as well as a tightening of onshore credit spreads, particularly for higher quality credits, as indicated in the chart below. This is positive for Chinese issuers in the offshore market, many of which have access to both onshore and offshore markets.

Onshore China corporate bond credit spread (basis points)



Source: WIND, December 2018

Emil: The third factor, U.S.-China trade rhetoric, we believe has morphed into a geopolitical risk, and while it remains a key source of volatility, we believe the recent agreement at the G20 to postpone the escalation of tariffs is a significant step in the right direction, and that current valuations reflect excessive pessimism about the potential for a resolution.

Q: Why has the response to fiscal and monetary stimulus policies in China had a limited impact on asset prices so far?

Raymond: Unlike in previous cycles, Chinese policymakers have adopted a cautious approach to stabilizing the economy and markets this time, as they are keen to avoid a return to high credit growth seen in previous rounds of stimulus, particularly post the Global Financial Crisis.

We expect Chinese policymakers to continue to announce incremental monetary easing and fiscal stimulus measures to stabilize the economy in 2019, adopting a gradual approach to normalizing the onshore credit market and further easing the refinancing risk for Chinese credits, while at the same time striking a balance between growth and stability.

Q: What is the trend in default rates in Asia and is this something investors should be concerned about?

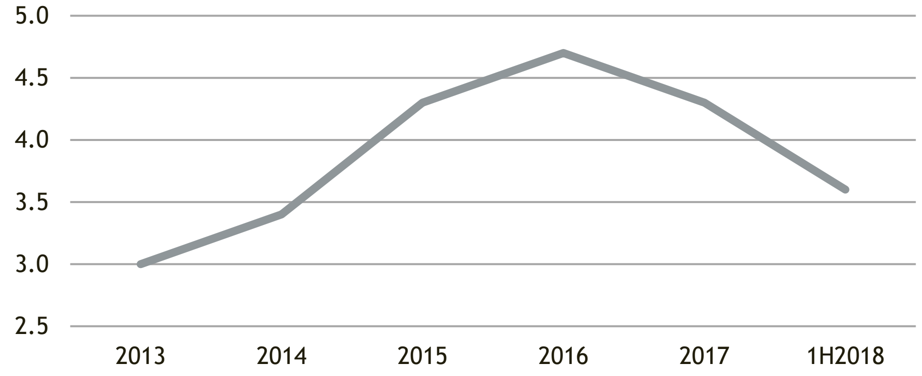
Suvir: Historically, average default rates in the Asia High Yield market have been consistently lower than other Emerging Market and Developed Market economies, as shown in the table below. While Asia default rates have increased modestly in 2018, according to Goldman Sachs analysis, current valuations imply a default rate of 6% for BB-rated credits and 11% for B-rated credits. We believe that default levels are highly unlikely to reach these levels, particularly in light of the fact that Asian High Yield corporates have significantly delevered their balance sheets from a net debt / EBITDA level of over 4.5x in 2016 to around 3.5x today, as shown in the chart below.

High Yield Default Rates

	2017	2007-2017 Average	2018 YTD[1]	2019F[2]
Asia USD	0.9%	2.0%	2.5%	2.5%
Latin America	1.5%	4.6%	0.3%	3.4%
Eastern Europe	2.7%	3.8%	0.0%	3.5%
United States	1.3%	3.2%	1.9%[3]	1.5%

Source: JP Morgan
[1]data as of Oct-2018; [2]JP Morgan forecast; [3]data as of Nov-2018

Asian HY Leverage Trends (net debt / EBITDA)



Source: JP Morgan, December 2018

Q: What do you remain concerned about, and what should investors be watching out for?

Raymond: While we are currently positive on the opportunity for Asia High Yield, in our view the key driver behind the pace of recovery emanates from the pace and scale of China's monetary and fiscal policy easing.

The recent measures will bring greater benefits to higher quality issuers, while for lower quality credits, the improvement in the funding environment may take a longer period of time to deliver benefits. As a result, prudent credit selection remains critical in this market environment.

Q: The China Real Estate sector is a significant part of the overall Asian High Yield market. Are you worried about this sector?

Raymond: It is true that China Real Estate now represents approximately one third of the total outstanding issuance in the offshore USD Asian High Yield market. We agree with the view that there remains risks for investors in this sector, including declining sales volumes and prices and excessive leverage.

At the same time, we think it is dangerous to paint the entire Chinese Real Estate sector with the same brush. The issuers that have access to the offshore bond market are generally larger, of higher quality, and many are industry consolidators. In fact, sales volumes for companies with offshore bonds continue to be stable.

Having said that, we remain cautious about exposures within the China Real Estate sector, generally preferring larger names with sufficient liquidity and quality land banks in Tier 1 & Tier 2 cities. Before adding them to portfolios, we stress test credits in terms of sales volume, price realization and currency fluctuation, and are comfortable with the names we hold based on these measures.

Q: How is Income Partners positioning portfolios to take advantage of the current opportunities?

For 25 years, Income Partners' sole focus has been helping clients successfully navigate the Asian credit markets. Our strength and expertise lie in rigorous, disciplined credit analysis and bottom-up credit selection, with an intense focus on downside protection. Our unique access and network in the region allows us to locate, pin-point and capitalize on fundamental value. We are fortunate that our largest investors have weathered multiple economic cycles with us, including the Asian Financial Crisis, SARS and the Global Financial Crisis.

Our portfolios today are positioned for a rebound, and we have been gradually and prudently adding risk in light of highly attractive valuations. At the same time, we remain highly conscious of outstanding risks in the market, and prefer higher quality high yield credits in the BB-range, while generally avoiding single B and below and unrated or highly illiquid issues.