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High Grade: Searching for Quality

As corporate credit stress comes into focus, do we avoid SGD corporate bonds altogether?

- Despite bouts of volatility, we view bonds as still an effective hedge against equity volatility on the downside and provide a defensive buffer to overall portfolio returns. As we enter into a more turbulent time for the economy and financial markets, we center our focus on the high grade parts of the SGD bond market, particularly financial and non-financial high grade corporate credit as this asset class consists of issuers who (a) have defensible fundamentals (b) acceptable all-in yield and (c) likelier to have better market liquidity versus high yielders as the market starts thawing.
- We avoid names with stretched liquidity (ie: can a company fund its liabilities) who may find refinancing more difficult in this environment as captured in our "COVID-19: Liquidity Situation" special interest commentary.
- Since the escalation of the COVID-19 outbreak and exacerbated by the oil shock, markets have been selling off in a rapid manner. The rates rally and shading of prices on some of these has led to spread widening of 45bps from their one-year average spreads among our top senior bond picks. Spreads on these bonds represent the largest widening in the past five years or since the issue was priced (for bonds issued more recently).
- Our top-picks on average have an all-in-yield of 2.55% (112bps above swaps) and have an average maturity of 5 years. Though, dislocation in markets means that actual prices differ on a case-by-case basis which may improve returns to buyers.
- With the flip flop between risk-on and extreme risk-off, we could very well see days where prices go lower, indicating this may still not be the absolute lowest point to bottom fish.
- However, at OCBC Credit Research, we find it more useful to think about who are the quality issuers within the SGD bond space and to start positioning for that, rather than wait out for a timing that is the absolute bottom (which could be as rare as hitting a unicorn to get right).

Recommendation: Overweight

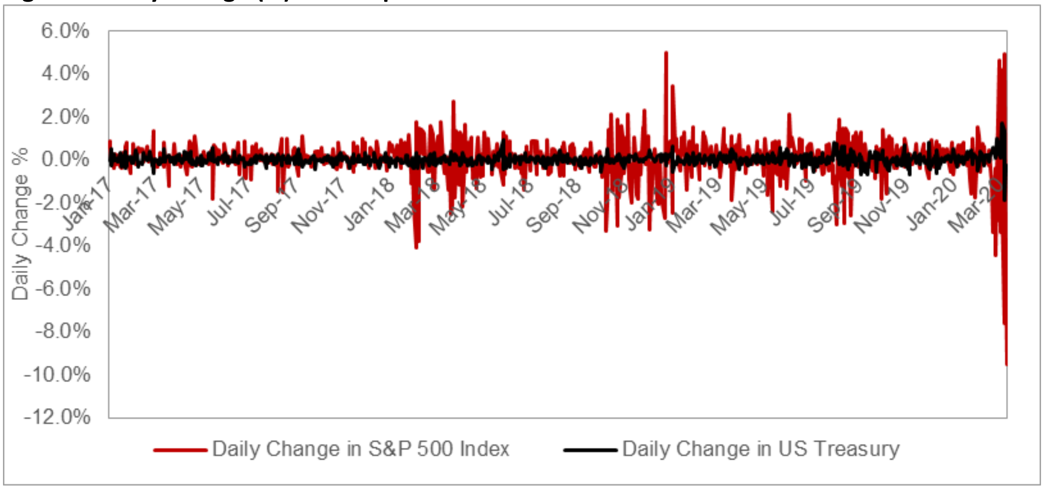
- We advocate moving up the credit curve and are **Overweight high grade bonds of issuers with issuer profiles of Neutral(3) and above**. While we generally consider Neutral (4) issuers to be high grade, at times of extreme stress, this group is more susceptible to downgrades.
- While not the best yielders in the market, high grade issuers pay more than statutory bodies and government bonds and are more defensible versus high yielders who are more susceptible to market illiquidity and heightened refinancing risk at times of market stress. When markets start thawing (which history informs us it eventually would), liquidity is likely to return first to segments and issuers higher on the credit curve.
- For non-financial corporates, we particularly like vanilla bonds. As captured in our special interest commentary "Perpetuals Tetralogy: Step-ups Matter", vanilla bonds provide (1) Fixed maturity date and (2) Fixed coupon. These give investors assurance on the repayment period and expected total returns (if held to maturity). Vanilla bonds avoid the structural deficiencies of perpetuals of call risk and resetting into lower distribution rates in this interest rate environment.
- As mentioned in our Monthly Credit View for March, we are turning cautious on bank capital. This is due to both fundamental reasons (with the severely weakened operating environment for both business and consumer loan exposures and lower interest rates which will pressure earnings through lower net interest margins, weaker credit demand and rising credit costs and non-performing loans) as well as the aforementioned technical reasons with higher call risk for Additional Tier 1 instruments given reset spreads are tighter than prevailing credit spreads. That said, certain banks under our coverage remain sound fundamental issuers in view of their strong business franchises, solid capital positions and their systemic importance which gives rise to an expectation of government support when needed. We tend to look therefore at seniors or Tier 2s of these issuers given they have defined maturity dates.

Bonds as shock absorber

While historical correlation between equity returns and bond returns are not static and correlation of the two asset classes is affected by the underlying macroeconomic environment, bonds are still an effective hedge against equity volatility on the downside and provide a defensive buffer to overall portfolio returns. Even though bonds may not perfectly hedge day-to-day volatility of equities, we find that returns between bonds and equities were low-to-negatively correlated at times of significant equity market stress, which is when the role of bonds as a shock absorber is most useful (1978, 1982, 1987-1989, 2001-2003, 2008-2010, and 2014).

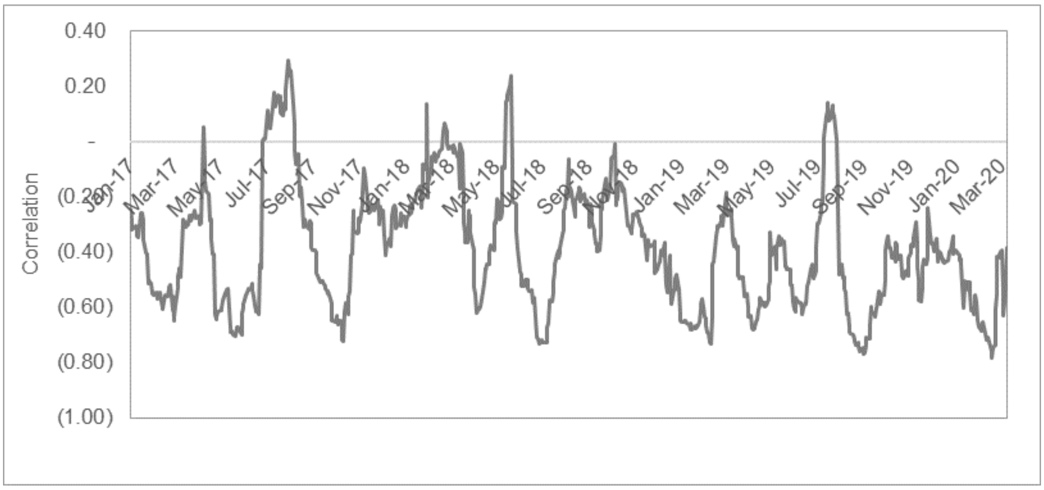
Even in the recent three years where both equities and bonds have had bouts of high volatility, we find this relationship to continue holding. Out of the 806 market days using a data set from 3 January 2017 to 12 March 2019, we find that there were only 116 days where both the S&P 500 Index and the Bloomberg Barclays US Treasury Total Return Index both saw negative daily returns.

Figure 1: Daily Change (%) of US Equities and Bond Returns



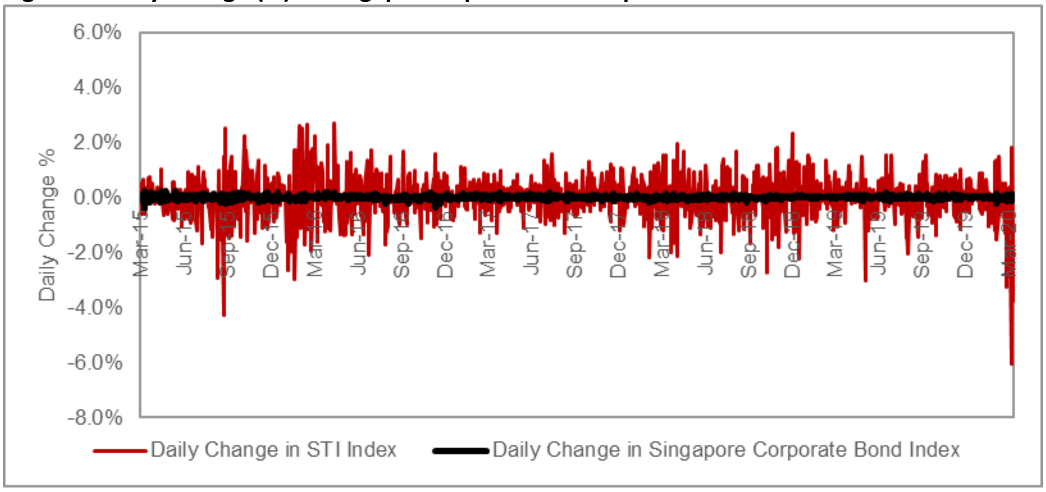
Source: Bloomberg (S&P500 Index and the Bloomberg Barclays US Treasury Total Return Index), OCBC Credit Research

Figure 2: US Equities-Bond Returns Correlations – Correlation changes in US Treasury versus S&P 500



Source: Bloomberg (S&P500 Index and the Bloomberg Barclays US Treasury Total Return Index), OCBC Credit Research
Note: (1) 30-day refers to market days
(2) Correlation of daily returns over a rolling 30-market day period

Figure 3: Daily Change (%) of Singapore Equities and Corporate Bond Returns



Source: Bloomberg (STI Index and the S&P Singapore Corporate Bond Total Return Index), OCBC Credit Research

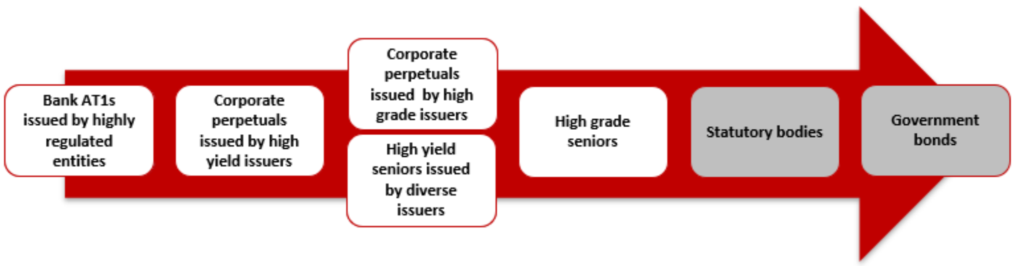
Search for quality

The SGD bond market is smaller and less diversified versus the deep and broad US bond market. At OCBC Credit Research we define the main buckets as follows:

- Government bonds (Singapore Government Securities, MAS bills)
- Statutory bodies (Housing Development Board, Land Transport Authority, Public Utilities Board)
- Corporates
  (a) Financial Institutions (Senior bonds and bank capital instruments)
  (b) Non-Financial Institutions (Corporate bonds and corporate perpetuals)

Bonds issued by statutory bodies generally trade slightly wider than government bonds and often bought on a relative value basis and where rate considerations are important. Within the corporate sector, the universe can be split further into financial institutions that tend to issue bank capital instruments (Additional Tier 1 and Tier 2) in the SGD bond market. Non-financial institutions corporate issuers include those whom we consider as high-grade issuers (our issuer profile of Neutral (4)) and above and higher yielding issuers (our issuer profile of Neutral (5)) and below. Predominant issue types include (1) Senior unsecured papers and (2) Subordinated perpetuals. Perpetuals issued by high yield issuers exist though are typically issued when the credit environment is loose.

Figure 4: Conceptual Look at Credit Risk in the SGD Bond Space (In terms of descending risk):



Source: OCBC Credit Research
Notes:
(1) The devil lies in the details for corporate bonds where the structure of a specific instrument (eg: seniority, security, issuing entity, tenor and other terms and conditions) ultimately determine the credit risk at an issue-level
(2) Due to the diversity of issuers within the SGD bond market, the credit risk of certain perpetual issues and AT1s may be lower than senior issues issued by high yield issuers

As we enter March 2020, volatility in global markets took a sharp turn in both the equity and the bond markets. While the SGD corporate bond market was shaky, we did not see similar levels of volatility (courtesy of Singapore investors' holding power we think), prices of bonds have shaded down despite the rates rally which reflects investors and dealers alike adopting a much more defensive stance. From a technical consideration, we focus our attention on subsets of the SGD bond market where spreads have widened to interesting levels and where we are not holding unnecessary credit risk amidst a possible bumpy ride from economic headwinds.

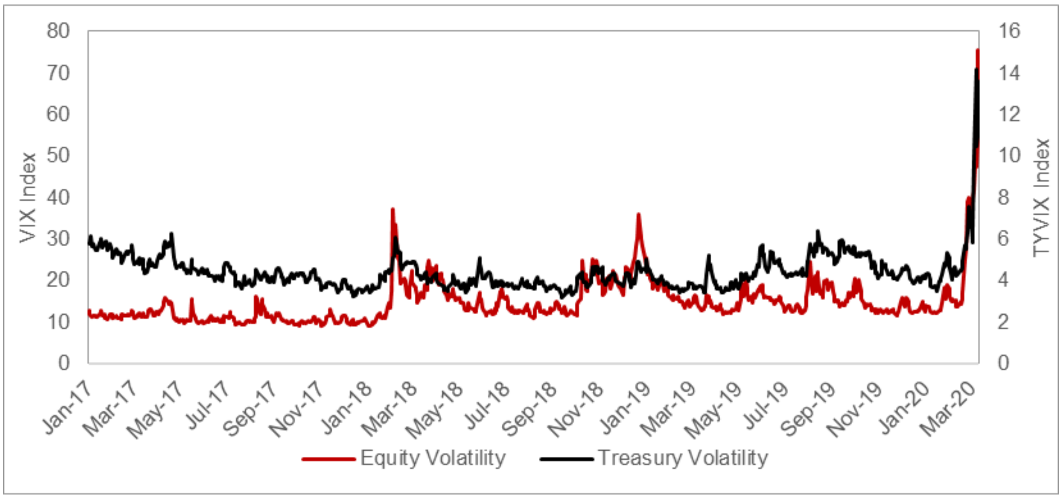
We ignore the statutory body and government sector for the purpose of this piece as this sector does not fit our all-in-yield criteria (ie: statutory body and government bonds pay less than the interest rate which we pay our mortgages, to say the least) which we believe is not interesting enough for our readers.

We also look for an acceptable level of all-in-yields which ultimately translates into cash returns for investors. Outside short dated high yield bonds with good/stable market liquidity and where ability for the issuer to repay is clear, we have adopted a defensive stance on high yield. We have observed that in times of extreme stress, high yield tends to face the highest illiquidity penalty.

At the beginning of the year, we had a neutral-to-overweight call on large parts of the perpetual market, although we have since revised our view to reflect the interest rate environment which have changed swiftly in the past two weeks. While there are a handful of perpetual issues which we still like, we have turned Underweight on this asset class as we think issuers would likely treat perpetuals as more equity-like in today's uncertain environment as an equity buffer. Rates rallying also means more perpetuals may reset into lower distribution rates at time of first call, making it uneconomical to call and refinance with another perpetual (especially if credit spreads stay at this elevated level). On Wednesday, we saw Deutsche Bank AG announcing that it would not be calling its USD1.25bn DB 6.25% PERPc20s Additional Tier 1 notes on 30 April.

With these considerations in mind, we set out to search for these issuers whose fundamentals are able to withstand economic and sector headwinds in the next 12 months with an unlikely change to their current issuer profiles which we have assigned to them. We then pick out parts of the curve we like on relative valuation basis. The issuers which we have picked are sector leaders in their respective industry sectors and geographies. While leverage levels have inched up along with the broad corporate sector, access to financing markets remain considerable for these issuers while their credit metrics remain manageable for their issuer profile levels.

Figure 5: Volatility in Equity and Bonds



Source: Bloomberg VIX Index and TVIX Index, OCBC Credit Research

What happens to high grade bonds if interest rates fall to zero

As of writing, 10Y UST yields were at 0.85%, though on 9 March 2020, the 10Y UST hit an end of day low of 0.33% and it is no longer inconceivable for 10Y UST to touch zero. SDSW10 is now at 1.25% though hit an end of day low of 0.87% on 9 March 2020. While we are still somewhat away from SDSW10 hitting zero, it is not outside the realms of possibility for certain parts of the swap curve to do so.

Conventional thinking would suggest that when rates fall, high grade corporate bond prices should increase to reflect that existing bonds were issued when rates were higher (and vice versa). However, in a situation of a zero-rate brought upon by heightened fear of recession risks, we think SGD corporate bond prices would not increase as investors start pulling out of risk asset markets alike. This means that we expect credit spreads to widen further in a further rate rally.

However, should a zero-rate environment (and subsequently negative rates) becomes a structural issue more akin to Europe and Japan, we expect the conventional case of bond prices increasing to eventually kick in and only to break at time of market stress. However, zero-rates as a structural phenomenon for the US market is not a mainstream view for now.

Figure 6: Illustration of High Grade Corporate Bond vs. Zero-to-Negative 10 Year Yield

Source: Bloomberg (WMT 4.875% '29s denominated in EUR, Euro 10 Year Yield), OCBC Credit Research

Issuer	OCBC Credit Research Commentary
Mapletree Commercial Trust ("MCT") **Issuer Profile:** Neutral (3) **Issues:** **MCTSP 3.11% '26** Price: 102.75 YTW : 2.64% Spread: 152bps **MCTSP 3.045% '27** Price: 101.94 YTW : 2.76% Spread: 157bps **Technical considerations:** The medium to long end of the MCTSP curve looks relatively more attractive. We also expect MCT's credit profile to hold up well in the midst of the COVID-19 situation.	• Singapore focused with five office and retail assets, namely VivoCity, Mapletree Business City, Bank of America Merrill Lynch Harbourfront, PSA office building (40-storey office block and Alexandra retail Centre) and Mapletree Anson. Total valuation was SGD8.9bn as at 31 August 2019. • Aggregate leverage stood at 33.4% as at 31 Dec 2019, with 75.3% of its borrowings in fixed rate. Given MCT has completed the acquisition of Mapletree Business City 2 on 1 Nov 2019, we see the likelihood of MCT leveraging up to acquire assets as very low in the next six months. • While MCT has SGD265.1mn of short term debt, against SGD68.8mn cash, we think it is manageable as all of MCT's assets are unencumbered. • As COVID-19 becomes more widespread globally, we view MCT's 100% exposure to Singapore as an advantage. We are also not overly concerned about MCT's exposure to the retail i.e. VivoCity because no retail lease was expiring for the remaining financial year ending 31 March 2020 ("FY2020") as at 31 Dec 2019 and only 9.7% of total gross rental revenue will be expiring in the financial year starting 1 April 2020("FY2021"). • MCT is 32.9% owned by Temasek Holdings Pte Ltd through Mapletree Investments.
CapitaLand Commercial Trust ("CCT") **Issuer Profile:** Neutral (3) **Issues:** **CCTSP 3.17% '24** Price: 102.47 YTW: 2.51% Spread: 151bps **CCTSP 3.327% '25** Price: 103.40 YTW: 2.60% Spread: 154bps **Technical considerations:** Given we think the merger of CCT and CMT is very likely to happen, and CCTSP is trading wider than CAPITA, we think some of the CCT bonds could look interesting.	• CCT has a portfolio of eight Grade A office assets in Singapore Central Business District and two office buildings in Frankfurt, Germany (portfolio valuation: SGD11.1bn). CCT also owns 10.9% of MRCB-Quill REIT, a commercial REIT listed in Malaysia. • The proposed combination of CMT and CCT to form "CapitaLand Integrated Commercial Trust" ("CICT") will be the third largest REIT in Asia Pacific and the largest REIT in Singapore with a combined market capitalisation of SGD16.8bn. • While CICT is estimated to see aggregate leverage at 38.3%, higher than CCT's aggregate leverage of 35.1% as at 31 December 2019 due to debt taken up to fund the acquisition, we think the merged entity has much to benefit from the firepower it will have in terms of debt headroom and property development headroom, and the wider opportunities that CICT will be "eligible for". • Also, given where aggregate leverage has historically been for the separate REITs, we think CICT would be keen to explore ways to deleverage and also to generate further headroom to pursue opportunities via debt in the future. Some more direct ways to do are via the issuance of perpetual bond and secondary equity fund raising. • CCT is 29.37% owned by CapitaLand Ltd ("CAPL").
CapitaLand Ltd ("CAPL") **Issuer Profile:** Neutral (3) **Issues:** **CAPLSP 3.8% '24** Price: 105.22 YTW: 2.55% Spread: 158bps **CALSP 3.08% '27** Price: 102.10 YTW: 2.77% Spread: 164bps **CAPLSP 3.15% '29** Price: 101.80 YTW: 2.93% Spread: 175bps **Technical considerations:** CAPLSP curve looks interesting offering wide spreads while its diversified business profile should cushion against impact arising from COVID-19.	• CapitaLand Ltd, the largest listed property play on the Singapore Stock Exchange, is well-diversified across property types and geography with a total asset of SGD82.3bn. • Over 70% of SGD3.22bn FY2019 operating EBIT was recurring income sources including retail (39.6%), Commercial (17.3%), Lodging (10.8%) and Business Park, Industrial & Logistics (6.1%). • CapitaLand Ltd owns 8 listed REITs which upstream over SGD500mn dividends p.a. including CapitaLand Mall Trust, CapitaLand Commercial Trust, Ascendas REIT and Ascott REIT. • CapitaLand Ltd is 51.5%-owned by Temasek Holdings Pte Ltd. • Net gearing is manageable at 63%.

StarHub Ltd ("STHSP") **Issuer Profile:** Neutral (3) **Issues:** **STHSP 3.08% '22** Price: 101.52 YTW: 2.45% Spread: 161bps **STHSP 3.55% '26** Price: 103.30 YTW: 2.97% Spread: 188bps **Technical considerations:** Relative to Singapore Telecommunications Ltd, we think StarHub Ltd provides a good pickup while offering exposure to the defensive telco sector which should weather the current downturn.	• Amidst the outbreak of COVID-19, we think STHSP offers an oasis in a desert as its core businesses should not be directly impacted. • While competition remains intense, mobile price erosion appears to have stabilized. • Credit metrics remain healthy with reported net debt to EBITDA of 1.51x with reported EBITDA of SGD617.1mn more than sufficient to cover SGD38.3mn of interest expense and SGD407.6mn of near-term debt.
Ascendas Real Estate Investment Trust ("AREIT") **Issuer Profile:** Neutral (3) **Issues:** **AREIT 2.655% '21s** Price: 100.83 YTW: 1.87% Spread: 128bps **AREIT 3.2% '22s** Price: 102.48 YTW: 2.05% Spread: 132bps **Technical considerations:** Both the AREIT short dated seniors are trading 100bps wider versus short dated statutory body bonds. Historically AREIT short dated only traded 50bps wider.	• Focusing on business parks, science parks and other industrial properties, AREIT has a portfolio of 198 properties with a total valuation of SGD12.8bn in end-2019. SGD9.2bn of AREIT's portfolio are located in Singapore. • In the quarter ended 31 December 2019, EBITDA/Interest coverage was 4.1x. • In a worst-case scenario where leases coming due in 2020 do not get extended and assuming EBITDA takes a 20% hit, this still indicates a manageable interest coverage ratio of 3.3x. Reported aggregate leverage was 35.1% and manageable. • While the REIT maintains very little cash balance, 91.8% of its investment portfolio (~SGD11.8bn in value) remains unencumbered which should help the REIT obtain secured financing if need be. AREIT maintains considerable access to equity markets. • AREIT is ~19% owned by CapitaLand Ltd.
Ascott Residence Trust ("ART") **Issuer Profile:** Neutral (3) **Issues:** **ARTSP 3.523% '23s** Price: 103.44 YTW: 2.53% Spread: 164bps **Technical considerations:** Within the senior part of ARTSP's curve, this senior bond provides a 16bps spread-pick up against the ARTSP 4.205% '22s which in our view more than compensates for its one year longer maturity. While ARTSP is in a hard hit sector, a sizeable portion of its gross profit comes from Master Leases.	• ART owns 87 properties with a total asset of SGD7.4bn in end-2019 (including those combined from Ascendas Hospitality Trust ("ASCHTS") • ART's assets are mainly located in Japan, Singapore, Australia and New York City. Other important geographies include China, France and the UK. • While the hospitality sector would be hard hit in the COVID-19 outbreak, 25% of ART's standalone gross profit come from properties under Master Leases in 4Q2019. We estimate that EBITDA from Master Leases alone could have covered overall interest in 4Q2019 by 1.2x. 50% of ASCHTS' net property income (gross profit equivalent) in its most recent available quarterly financials ended September 2019 was also from Master Leases. • As at 31 December 2019, ART's short term debt (excluding lease liabilities) was SGD337.1mn against ART cash balance of SGD275.5mn and we see refinancing risk as manageable. • ART is ~40% owned by CAPL.

DBS Group Holdings Ltd ("DBS") **Issuer Profile:** Positive (2) **Issues:** **DBSSP 2.78% '21** Price: 101.00 Yield: 1.56% Spread: 88bps **DBSSP 3.80% '28c23 (Tier 2)** Price: 103.40 Yield: 2.55% (YTC) Spread: 165bps **Technical considerations:** These issues are usually well held. Considering DBS' strong fundamentals, we suggest investors pick up these instruments that have a defined maturity date.	• Primarily operates in Singapore (70.2% of FY2019 profit before tax ("PBT")) and Hong Kong (22.7%) and is a leading financial services group in Asia with a regional network of more than 280 branches across 18 markets. • Recent record results with PBT up 14% y/y for FY2019 to SGD7.58bn provides a solid buffer for 2020 and indicates DBS' strong underlying fundamentals and earnings generation capacity. • Fundamentals anchored by established Consumer Banking/Wealth Management franchise (covers individuals) which contributed 36.6% of FY2019 PBT. This is complimented by the Institutional Banking segment (covers institutional clients, large corporates and small and medium sized businesses) which contributed 49.2% of FY2019 PBT. Treasury Markets' (structuring, market-making and trading of treasury products) contributed 4.3% of FY2019 PBT. • Balance sheet quality remains solid with a low non-performing loan ratio while capital levels are well above minimum requirements (CET1 ratio of 14.1% as at 31 Dec 2019 is above minimum CET1 requirement of 9.3%). • Liquidity ratios remain strong and both over 100% (average all currency liquidity ratio of 136% and net stable funding ratio of 110% as at 31 Dec 2019. • 30% indirectly owned by the Singapore government through Temasek Holdings
Australian & New Zealand Banking Group Ltd ("ANZ") **Issuer Profile:** Positive (2) **Issues:** **ANZ 4.00% '25** Price: 102.40 Yield: 3.43% Spread: 238bps **ANZ 3.75% '27c22s** Price: 102.68 Yield: 2.38% (YTC) Spread: 156bps **Technical considerations:** While not immune to general industry pressures, we think ANZ offers better fundamental exposure given solid execution and lack of known regulatory issues	• ANZ is one of Australia's big 4 banks and the largest bank in New Zealand. It is ranked in the top 25 globally by market capitalization with operations in 33 markets. • Prior period restructuring has improved underlying fundamentals and refocused earnings on key markets (Australia and New Zealand). Australia Retail and Commercial continues to be the main segment contributor from a cash profit basis at 49.4% of total for FY2019 although declined from 55.9% in FY2018. In contrast, contribution from ANZ's institutional segment rose to 28.3% in FY2019 from 22.8% in FY2018, overtaking New Zealand as the second largest contributor. • Restructuring has also solidified its capital position with ANZ's APRA compliant CET1 at 10.9% as at 31 Dec 2019. Including divestments, the CET1 ratio improves to around 11.1%. • Its liquidity position is robust with a liquidity coverage ratio of 140% and net stable funding ratio of 116.4% as at 30 September 2019 which includes the impact of the Reserve Bank of Australia's Committed Liquidity Facility ("CLF") • CLF and pro-active regulation by the Australian Prudential Regulation Authority indicate a supportive and strong operating environment.

Source: Bloomberg indicative prices as at 13 March 2020, actual prices may differ. Please approach your OCBC representative, OCBC Credit Research

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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