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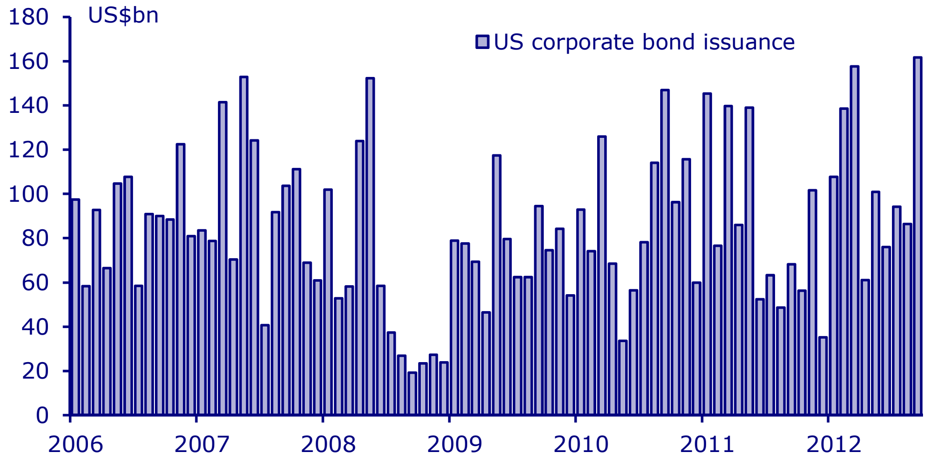
# The ageing allure of the corporate bond

## Seoul

The continuing reality of zero rates, or near zero rates, in so many important markets has led to one by now dramatically self-evident phenomenon. That is an explosion in corporate bond issuance this year, be in in America, Europe or Asia.

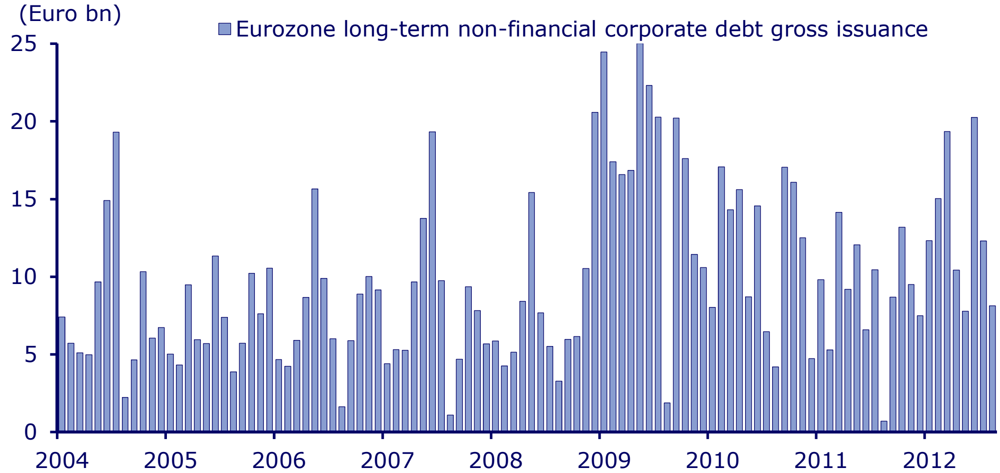
Thus, US corporate bond issuance rose by 20%YoY to US$984bn in the first nine months of this year (see Figure 1), on course to break the record annual issuance of US$1.13tn reached in 2007, according to data from the Securities Industry and Financial Markets Association (SIFMA) and Thomson Reuters. Likewise, Eurozone long-term non-financial corporate debt gross issuance rose by 55%YoY to €105.6bn in the first eight months of this year, according to ECB data (see Figure 2). As for Asia, Dealogic data shows that Asia ex-Japan international bond issuance denominated in US dollar, yen and euro has reached US$110bn so far this year, compared with US$81bn in the whole of 2011 (see Figure 3).

Figure 1
**US corporate bond issuance**




Note: Data up to September 2012. Source: Securities Industry and Financial Markets Association (SIFMA), Thomson Reuters

Figure 2
**Eurozone long-term non-financial corporate debt gross issuance**




Note: Data up to August 2012. Source: ECB

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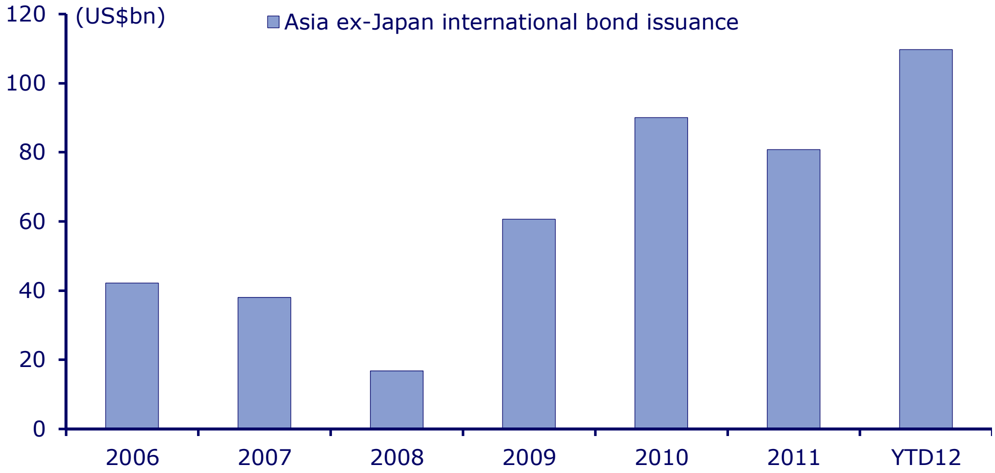
Figure 3
**Asia ex-Japan international bond issuance**

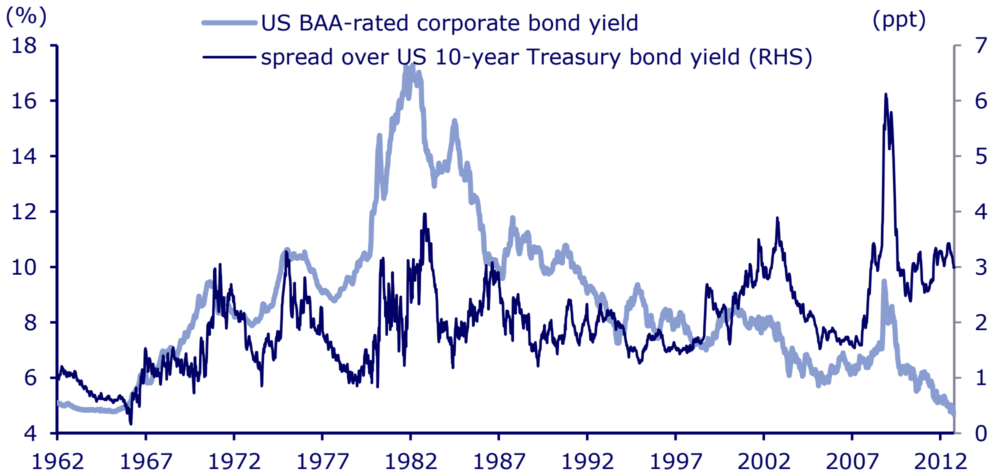



Note: Data up to 5 October 2012. Include bonds denominated in US$, yen and euro. Source: Dealogic

The interesting point about this trend is that it is primarily a response to demand rather than because corporates need to borrow lots of money to fund, say, new investment. Indeed a large part of the issuance seems merely to be a re-financing exercise to take advantage of cheaper long-term funding costs courtesy of the plunge in government bond yields.

But whatever the motivating factor, the demand is coming from investors with capital seeking to generate yield, and often this is being done by taken on lots of gearing. Thus, *GREED & fear* has been hearing from financially well-endowed friends all year that private bankers in Asia have become increasingly aggressive offering gearing on corporate bond purchases to their clients. Thus, loan to value ratios of up to 80% are apparently commonplace on bonds seen as safe. And the willingness to lend money in this manner has grown as confidence has grown, courtesy of the likes of Ben Bernanke, that US short-term interest rates will remain at zero for longer.

Figure 4
**US BAA-rated corporate bond yield spread over US 10-year Treasury bond yield**




Source: Bloomberg, Federal Reserve

The question then has now become how long this new carry trade will persist. For judging by the record level of corporate bond issuance activity has already become quite feverish. True, that does not mean the market is about to implode. The obvious triggers for a rout of leveraged corporate bond investors would be central bank tightening by the likes of the Fed and/or a sharp sell-off in the Treasury bond market. But for now there is no sign of either development. Meanwhile, the private bankers selling the bonds on leverage can continue to argue, as *GREED*

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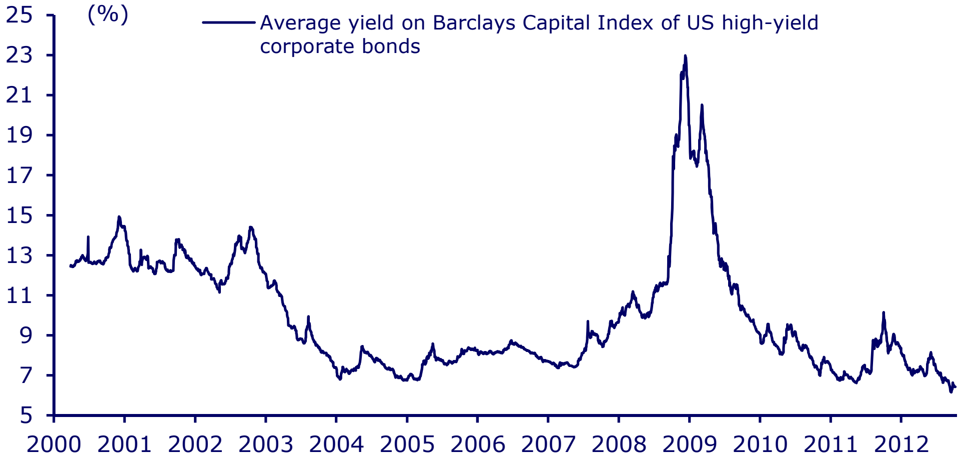
& *fear* assumes they still do, that spreads are not yet at historic lows. This is indeed true even if nominal yields on such bonds are at record lows courtesy of the plunge in government bond yields over the past year globally. Thus, the US BAA-rated corporate bond yield has fallen to a record low of 4.67% at present. But in spread terms it is still 299bp above the 10-year Treasury bond yield, compared with a record low spread of 16bp reached in 1966 (see Figure 4). Likewise, the average yield on the Barclays Capital Index of German corporate bonds declined to a record low of 1.88% last month and is now 1.93% or 103bp above the average yield of the Barclays Capital Index of German government securities. This compares with an all-time low spread of 8bp reached in 1999 (see Figure 5).

Figure 5
**Average yield on Barclays Capital Index of German corporate bonds over German government yields**


Note: Based on Barclays Capital Euro Aggregate Bond Index. Source: Datastream

Figure 6
**Average yield on Barclays Capital Index of US high-yield corporate bonds**




Source: Datastream

If wealthy high net worth individuals in Asia are one source of demand, they clearly are not the only ones desperate for yield. Institutional investors also need yield, most particularly pension funds and insurance companies.

In America the so-called high yield or junk bond market has been very strong. Yield, if not spreads, are again near record lows while there have also been big inflows into special high-yield bond funds. Thus, the average yield on the Barclays Capital Index of US high-yield corporate bonds has declined from 23% in late 2008 to 6.43% at present, after falling to a record low of 6.15% in mid-September (see Figure 6). While US high-yield bond funds recorded

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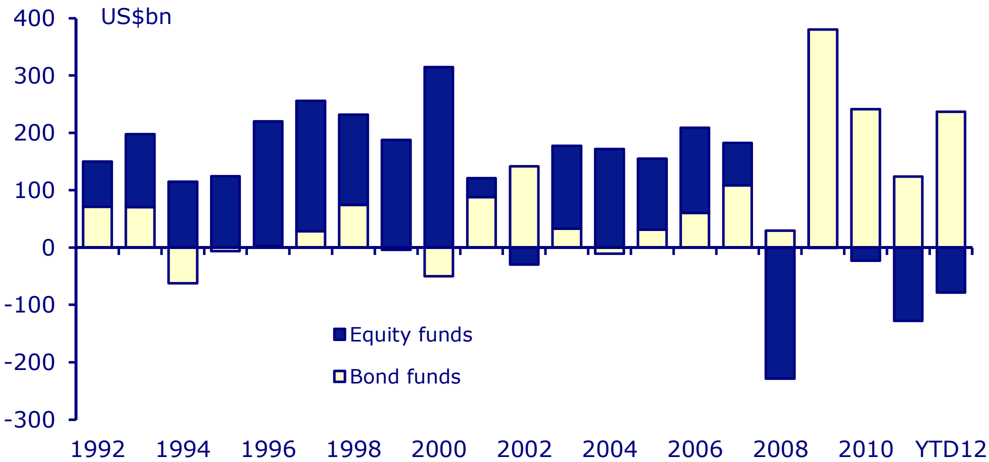
inflows of US$33.7bn in the first three quarters this year, according to Lipper data, compared with just US$1bn of inflows in the first three quarters of 2011.

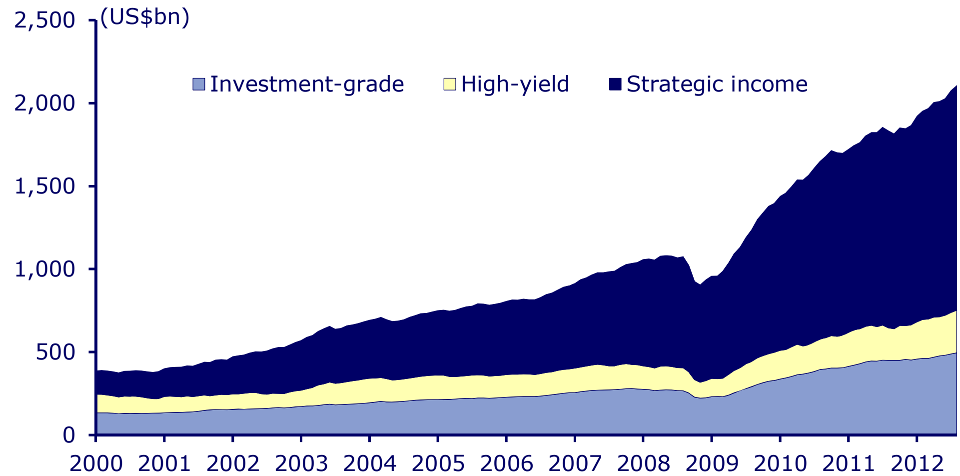
These inflows are on top of the large inflows into US investment-grade corporate bond funds which saw inflows of US$90.5bn in the first three quarters of this year compared with US$51.4bn in the same period in 2011, according to Lipper. Indeed US bond mutual fund inflows have dramatically exceeded the inflows into US equity mutual funds since 2007, according to data released by industry trade group, the Investment Company Institute. Thus, US bond funds have recorded US$237bn of inflows so far in 2012 and US$1.12tn since 2007, while equity funds have recorded outflows of US$78bn year-to-date and US$385bn since 2007. As a result, US corporate bond-related mutual fund assets, including investment-grade, high-yield corporate bond funds and so-called strategic income funds which invest in a mixture of US fixed income securities, have risen from US$905bn in late 2008 to US$2.1tn at the end of August (see Figure 8).

Figure 7
**US bond and equity mutual fund flows**




Note: Data up to September 2012. Source: Investment Company Institute (ICI)

Figure 8
**US corporate bond-related mutual funds' total assets**




Source: Investment Company Institute (ICI), Datastream

Another related phenomenon is the explosion of late in US corporate bond ETFs which now total US$106bn in the investment-grade space and US$32bn in the high-yield space, up from only US14bn and less than US$300m at the beginning of 2008, according to the Investment Company Institute. Clearly, the more money that flows into corporate bond ETFs the more money that has to buy a fixed list of bonds since these ETFs tend to track specific bond indices.

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All of the above is doubtless well known to those active in the world of fixed income. But it is a trend that equity investors should by now be aware of given that the enthusiasm for corporate bonds has now become very extended. It is also the latest example of the search for yield, and related distortions, driven by the easy money policies of the world's major central banks which are in turn driven by the example set by "Open-ended" Billyboy.

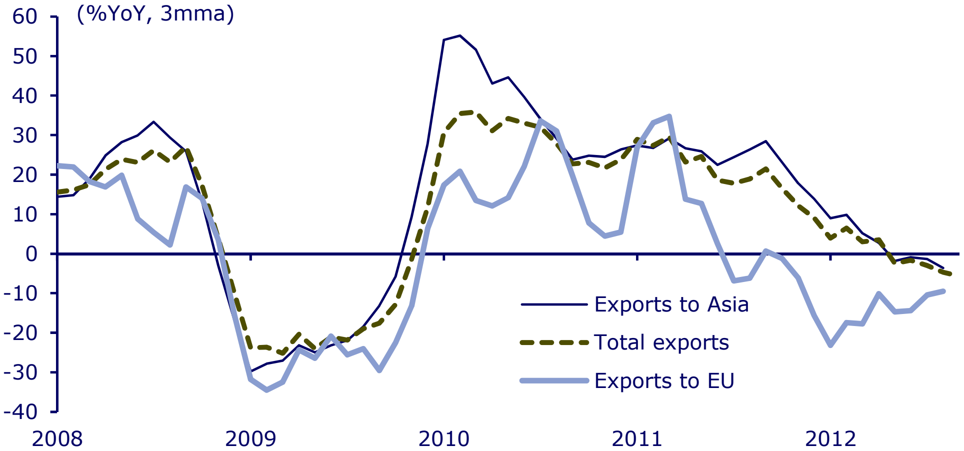
Speaking of Billyboy, an interesting article in the *Wall Street Journal* at the end of last month detailed how the Fed chairman lobbied his fellow governors to gain support for his new "open-ended" policy which is seemingly driven by his social worker-like concerns about the level of unemployment; though in *GREED & fear*'s view the real driver is an ideological faith in the all-curing powers of mechanical monetarism (see *WSJ* article "*How Bernanke Pulled the Fed His Way*" by Jon Hilsenrath, 28 September 2012). Still the Journal article is yet a reminder, if it is needed, that the so-called hawks on the Fed are not hawks.

It is also the case should the American economy continue to disappoint Bernanke that, beyond increasing his asset buying programme, the Fed chairman could also move one day to a nominal GDP target as endorsed by Professor Michael Woodford of Columbia University in his Jackson Hole study presented at the end of August ("*Methods of Policy Accommodation at the Interest-Rate Lower Bound*", 31 August 2012). Thus, Woodford, a mate of Billyboy's, argued in his paper that "An example of a suitable target criterion would be a commitment to return nominal GDP to the trend path that it had been on up until the fall of 2008." On this point, the Fed chairman certainly did not disassociate himself from the idea of nominal GDP targeting when asked about Woodford's study at his press conference on 13 September. Thus, Bernanke said: "Woodford is my former colleague and co-author and friend, so I know him quite well, and I know his works quite well."

All this is why investors should assume that the experiment in unorthodox monetary policy will continue so long as Bernanke is in tenure.

*GREED & fear* has been in Seoul this week for the first time in a year. Unsurprisingly, there is growing focus on weakening domestic demand as a result of the external slowdown. Thus, the Bank of Korea today cut its real GDP growth forecast for this year to 2.4%, down from 3.5% in April, and so more in line with consensus forecasts of 2.6%. Bank loan growth is also forecast by CLSA's Seoul office to be running at only 3% by the end of this year.

Figure 9
**Korea export growth**




Source: CEIC Data

The reduced forecast reflect, first, the sharp decline in exports and, second, the growing evidence that this is feeding into weaker consumption, a trend confirmed by companies visited

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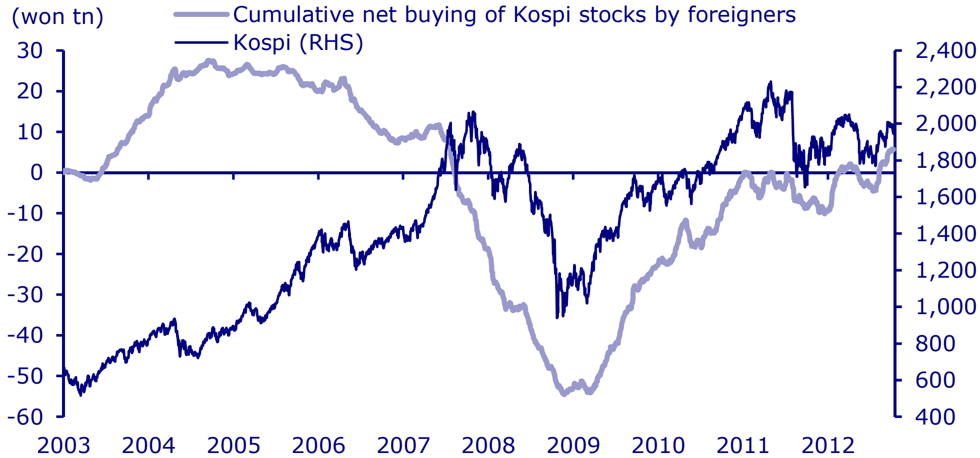
this week. Thus, exports declined by 5.6%YoY in 3Q12 (see Figure 9) while retail sales declined by 1%YoY in August, the first annualised decline in 40 months (see Figure 10).

Figure 10
**Korea retail sales growth**


Source: CEIC Data

Figure 11
**Cumulative foreign net buying of Kospi stocks**




Source: Bloomberg, CLSA Asia-Pacific Markets

Yet before its recent turn down the Korean stock market had provided a good example of the role of liquidity in reviving world stock markets last quarter in spite of deteriorating fundamentals, helped by renewed foreign buying. Thus, foreigners bought a net 8.9tn won of Kospi stocks last quarter, after selling a net 5tn won in 2Q12 (see Figure 11). Yet IBES consensus 2012 earnings for the MSCI Korea Index were revised down by 4.5% in 3Q12. Similarly, the net profit margin for listed stocks was only 4% based on the most recent quarterly earnings. Despite the above the market managed to rally last quarter, resulting in a multiple rerating.

Still penetrating down, the bulk of the performance continued to be driven by Korea's star multinational exporters, namely Samsung Electronics and the auto sector. For example, the Kospi rose by 7.7% last quarter while Samsung Electronics, Hyundai Motor and Hyundai Mobis rose by 12.1%, 8.4% and 13.1% respectively, accounting for 27%, 5% and 4% of the increase in Kospi. This re-confirms *GREED & fear*'s longstanding view that the Korean stock market is less a top down story than it is a play on the country's leading multinationals, which are primarily Samsung in the electronics/mobile telecom sphere and the Hyundai Group in autos.

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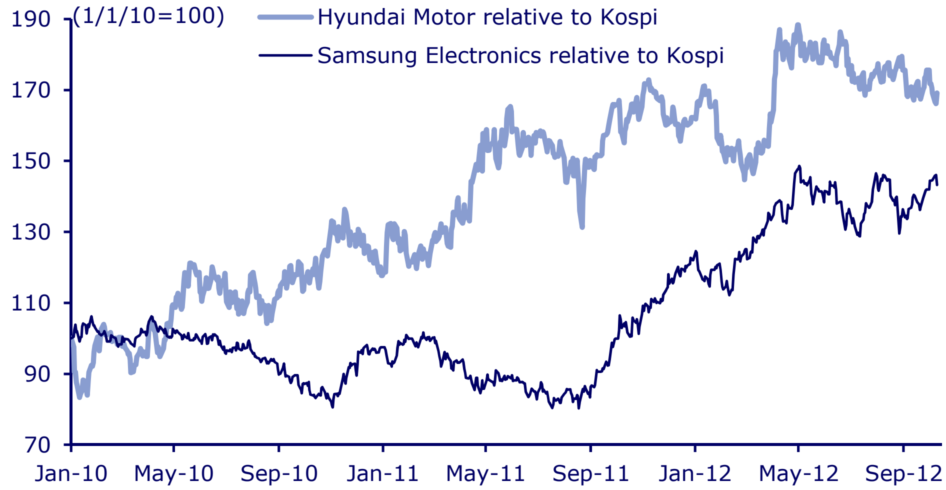
Figure 12

**Samsung Electronics and Hyundai Motor relative to Kospi**




Source: Datastream

Discussions with colleagues this week confirmed the view that it is right to maintain a 5% weighting in Samsung Electronics in *GREED & fear*'s Asia ex-Japan long-only portfolio (see Figure 22). One point for the non-specialist to note is the potential for the company to profit, at Intel's expense, from the move to the ARM-based PC processor market, a technology currently used in the mobile chip space. This is a topic of a just published CLSA report (*US semiconductors - Processor wars: Intel versus the ARM army*, 8 October 2012 by US tech analysts Srini Pajjuri and Mark Heller). Thus, the PC processor market has previously been the domain of only Intel and AMD, but with the release of Windows RT on 26 October Samsung will be in the game along with other ARM-based chip designers.

Otherwise, *GREED & fear* is struck by the view of many in Seoul that Apple's decision to source its components from elsewhere could prove in the longer run to be a bigger problem for Apple than for Samsung. This is because of the limited options available to source advanced components on reasonable terms from other manufacturers. To cite one example, the March launch of the latest iPad would apparently have been delayed by several months without Samsung's LCD panels, as the other suppliers were unable to deliver on time.

While *GREED & fear* makes no claim to tech expertise, it is obvious that Samsung has a phenomenal record for execution and in the hot mobile telecom area has built a commanding presence with well-designed products and smart marketing and branding, helped doubtless by the recent decision to sponsor the world's most famous football team for another three years. This is why *GREED & fear* should perhaps have had the stock in the portfolio since the portfolio's inception at the end of 3Q02 since when it has appreciated by 389% in US dollar terms compared with a 198% gain in the MSCI AC Asia ex-Japan Index. This is certainly highly impressive for such a large cap stock even if it is not as good as the 683% gain of the long-only portfolio since inception.

As it is, Samsung has been in the portfolio since 11 September 2008, since when it has appreciated by 146% compared with a 28% gain in the MSCI Asia ex-Japan and the portfolio's 62% gain over the same period (see Figure 13). Yet it is still trading at 8.1x this year's forecast earnings and 7.2x next year's earnings, assuming earnings growth of 71% this year and 14% in 2013 based on the forecasts of CLSA's Seoul-based tech analyst Matt Evans. Note the company reported last week a preliminary operating profit estimate for 3Q12 of 8.1tn won, compared with consensus estimates of 7.6tn won. Evans believes that about 3tn won of the third quarter's record 8.1tn won in operating profit was generated from the sale of a single product, the Galaxy S3 smartphone.

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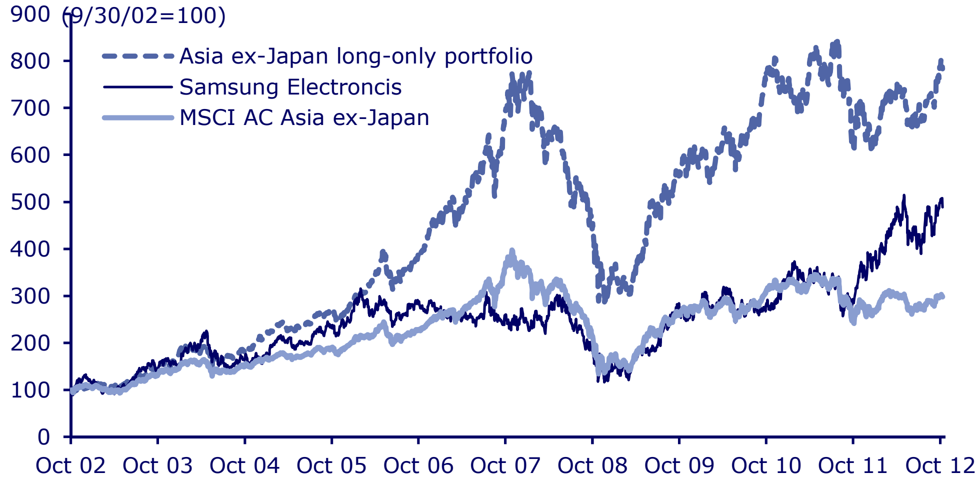
Figure 13

**Samsung Electronics performance relative to MSCI Asia ex-Japan and long-only portfolio**




Source: Datastream, CLSA Asia-Pacific Markets

The other Korean stock *GREED & fear* has in the portfolio is NHN, which has actually been in the portfolio since 3 November 2005 when *GREED & fear* first visited the company. The original rational to have NHN in the portfolio was simply that, as Korea's dominant search engine, it represented a good domestic demand play in a country which was obviously in love with everything "online". For the same reason China's dominant search engine, Baidu, has been in the portfolio since 17 January 2008.

*GREED & fear* made a second ever visit to NHN this week, as a result of which *GREED & fear* is happy to maintain the stock in the portfolio. The company remains the dominant search engine with a 70% market share in search in Korea with the current challenge, as with Baidu and Google, how to navigate the move from a world where ecommerce will be conducted less on personal computers and more on mobile devices. This will doubtless create teething problems as payment systems are developed. One problem with advertising on hand-held devices is, obviously, that the screen is smaller. But the potential upside is that an advertiser may prove willing to pay more for a prominent position on that smaller screen.

Figure 14

**NHN Corp share price**


Source: Datastream

At 24x forecast 2012 earnings and 19x 2013 earnings NHN is no longer cheap with the multiple boosted of late by the success of its so-called LINE messenger service in Japan, where it already has 31m users accounting for 47% of the 65m users globally. This smartphone app

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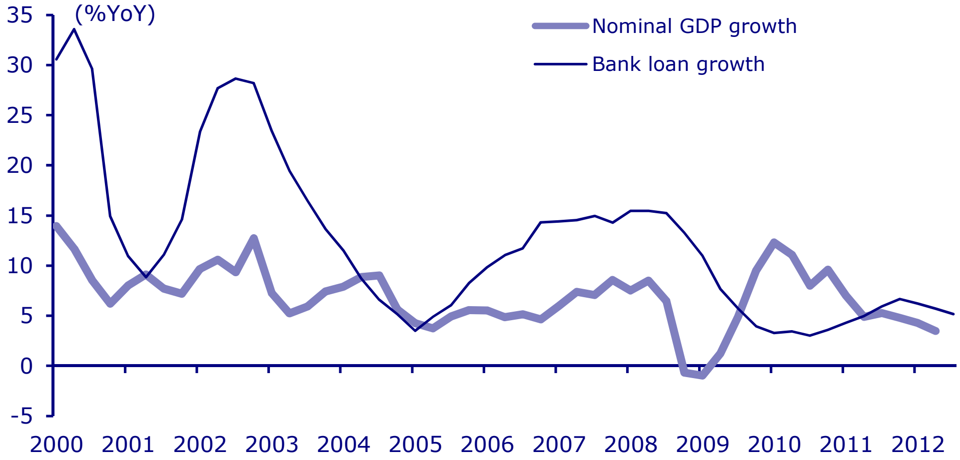
allows free messages between users enhanced with cutesy animated characters, which clearly appeals to the Japanese psyche. Still given that the stock is up 304% in US dollar terms since its inclusion in the portfolio in November 2005, *GREED & fear* is prepared to give the company the benefit of the doubt. The critical point for *GREED & fear* is that NHN's status as Korea's dominant search engine remains intact. As *GREED & fear* personally never uses the internet either on a PC or on a hand held device, it may be odd that any form of opinion is advanced at all in this area. But the view here remains extremely simple; namely that, as with Google, the dominant search engine provides a critical utility function in a world where most people, especially younger people, do use the internet for a growing number of functions. The search engine is certainly a far more critical function that the so-called "social media" function of the grotesque "Facebook" which, so far at least as *GREED & fear* can tell, is primarily driven by adolescent peer pressure.

Figure 15
**Korea bank loan growth and nominal GDP growth**




Source: CEIC Data, Bank of Korea

Moving away from tech, the banking story in Korea remains as relatively dull as ever even if it remains a macroeconomic positive that Korean banks no longer indulge in boom bust lending cycles. Thus, bank loan growth ran below nominal GDP growth in the period between 4Q09 and 2Q11 and has since run only slightly above nominal GDP growth (see Figure 15). Still CLSA's Korean head of research and a banking specialist, Shaun Cochran, is now concerned about a potential NPL cycle. He notes that the Bank of Korea's credit risk perception index, which is a quarterly survey of senior loan officers, usually leads a credit cycle by three to four quarters and has started to reflect growing caution on the part of lenders. Thus, the index has risen from a low of 6 in 1Q11 to 38 in 4Q12, the highest level since 1Q09 (see Figure 16). There is certainly scope for deterioration in asset quality since the NPL ratio for the banking system is currently only 1.5%. Still any pick up in NPLs should be relatively moderate in a banking sector which is hardly trading at euphoric valuations. Thus, Korea's most highly rated bank, Shinhan Financial, is trading at 0.8x book. *GREED & fear* would certainly rather own Shinhan than any major European bank. Still a problem for all Korean financials, including Shinhan, is that Korean regulators have a rather eccentric obsession about limiting dividend payout ratios. Thus, Shinhan's forecast payout ratio is only 16% this year.

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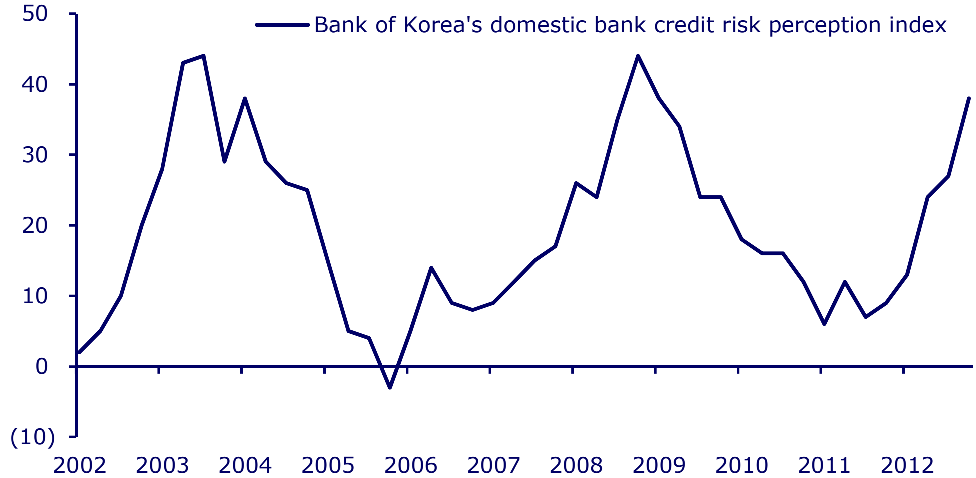
Figure 16

**Bank of Korea's domestic bank credit risk perception index**




Source: Bank of Korea - Survey on Lending Practices

Figure 17

**Korea 10-year government bond yield less overnight call rate**


Source: Bloomberg, CLSA Asia-Pacific Markets

Meanwhile, given growing evidence of the externally driven slowdown impacting the domestic economy, the Bank of Korea has until today been extremely cautious in terms of a lack of easing in this cycle. Thus, prior to today's 25bp cut to 2.75%, the central bank had only cut interest rate once in this cycle by 25bp in July. Today's cut certainly does not surprise given an inverted yield curve (see Figure 17) and given that the latest inflation figure was still below the central bank's inflation target band of 2-4% with CPI inflation running at 2.0%YoY in September after slowing to 1.2%YoY in August, the lowest inflation rate since May 2000 (see Figure 18). Core CPI inflation, which excludes agricultural and petroleum products, also remained low at 1.4%YoY in September. Meanwhile, the Bank of Korea has now reset its inflation target range for 2013-2015 at 2.5-3.5%.

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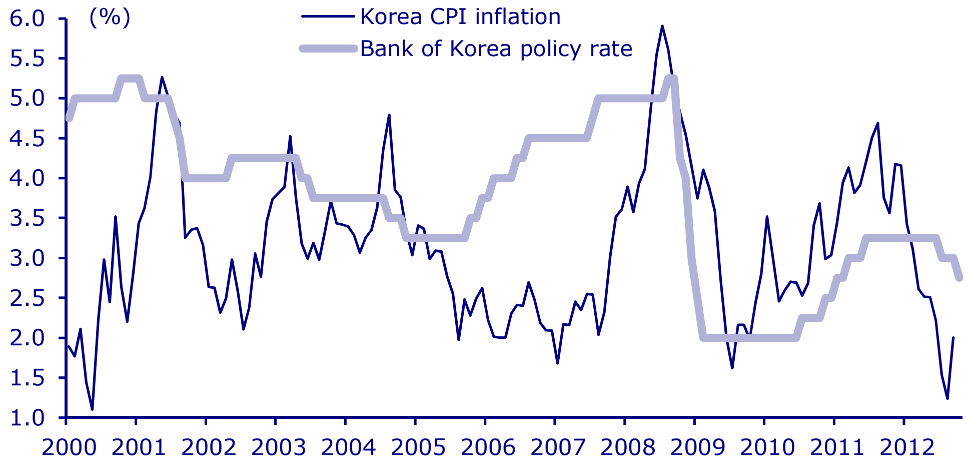
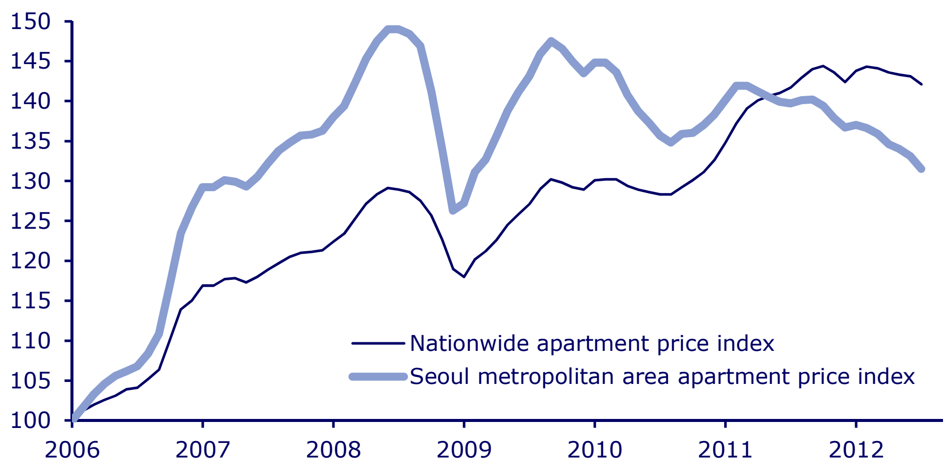
Figure 18
**Korea CPI inflation**




Source: CEIC Data, Bank of Korea, CLSA Asia-Pacific Markets

One reason for the central bank's relative conservatism appears to be continuing concerns about high household debt which currently totals 84% of GDP and 155% of household disposable income, the highest level in Asia. There are also the perennial concerns in Korea about setting off renewed speculation in the residential property market. Still, the reality is that the combination of ongoing anti-speculation measures, which have continued to be applied in recent years even under the present conservative government of Lee Myung-bak, excess supply and deteriorating demographics means that the residential property market has been essentially trading sideways in recent years. Thus, the Seoul metropolitan area transaction-based apartment price index has declined by an annualised 0.1% over the past five years, while the formerly hot residential area of Gangnam in Seoul has seen prices in some apartments decline by nearly 30% from peak levels. Meanwhile, the lack of overheating in the residential property market is also shown by the fact that the average loan to value ratio of Shinhan's mortgage book is only 49%.

Figure 19
**Nationwide and Seoul metropolitan area transaction-based apartment sales price index**




Source: Korea Real Estate Information Center, Ministry of Land, Transport and Maritime Affairs (MLTM)

This is a presidential election year in Korea with the election due to be held on 19 December. The political atmosphere is heating up, most particularly as the past quarter saw an interesting development with 50-year old software entrepreneur Ahn Cheol-soo confirming he will run for the presidency as an independent candidate on a reform chaebol ticket under the currently trendy slogan of 'economic democratisation'. This announcement led to a surge in his popularity in the polls which means the right-wing candidate for the ruling Saenuri Party, Park Geun-hye,

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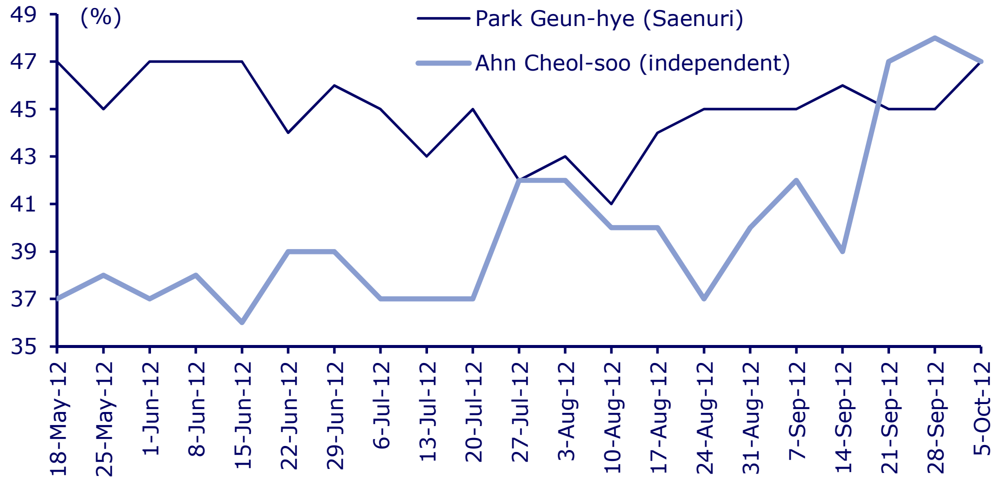
the 60-year-old daughter of former strong man ruler for 18 years, Park Chung-hee, and a five-term member of Congress, is no longer a sure winner. A weekly Gallup poll conducted last week showed that in a two-way race between Ahn and Park, both Ahn and Park received 47% support, compared with 48% and 45% in the previous week (see Figure 20). While in a three-way contest, Park was still ahead with 40% support followed by Ahn with 26%.

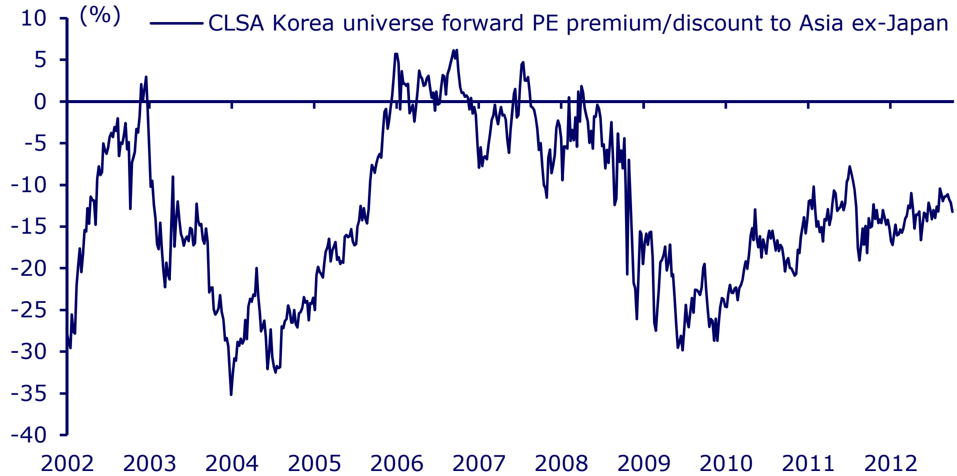
Figure 20
**Gallup Korea poll (two-way race between Park and Ahn)**




Source: Gallup Korea

The issue now is whether Ahn will form an alliance with Moon Jae-in, the candidate for the left-wing Democratic United Party since otherwise Park is likely to win as the more left-orientated vote will be split between two candidates. The challenge for Ahn is that while he offers novelty value and comparative youth, he does not have the political machine of Moon nor does he have the experience in government. Moon was a senior figure in the administration of Roh Moo-hyun, the former left-wing president who ended up committing suicide in May 2009.

Figure 21
**CLSA Korea universe forward PE premium/discount to Asia ex-Japan**




Source: CLSA evalu@tor

Whatever the outcome of the vote, the interesting point is that all three candidates are competing for the middle ground with even Miss Park seeking to depict herself as in favour of *chaebol* reform. Still the reality is that, despite all the talk of "economic democratisation", there remains a lack of concrete proposals about how exactly to reform the chaebol. One possible approach could be a reform of the chaebol's circular ownership structures, which could just turn out to be to the benefit of minority shareholders depending on the details of how such a reform

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is implemented. Among other things such a change might lead to higher payout ratios and, with it, potentially the end of Korea's fabled discount. On this point Korea continues to have by far the lowest dividend payout ratio of all the markets covered by CLSA in Asia. Thus, CLSA's Korea universe of 89 companies under coverage has a forecast dividend payout ratio this year of only 13%, compared with 40% for the Asia Pacific ex-Japan universe.

For the above reason alone investors should not ignore the politics in Korea completely. Still, as noted at the beginning, the critical issue for the Korean market remains whether the likes of Samsung Electronics and Hyundai Motor continue to execute. In this respect, the current noise over "economic democratisation" is fundamentally a problem caused by the remarkable success of the leading chaebol. The example of NHN also shows that it is possible for companies to emerge outside of the chaebol umbrella.

Figure 22

**Asia ex-Japan thematic equity portfolio for long-only absolute-return investors**

| | | |
|---|---|---|
| Regional consumer | 4% | Samsonite |
| Australia gold mining | 10% | Newcrest Mining |
| China internet search engine | 6% | Baidu |
| China internet company | 4% | Tencent |
| India consumer | 8% | Titan Industries (3%), Godrej Consumer (5%) |
| India banks | 4% | HDFC Bank |
| India housing finance | 4% | HDFC |
| India infrastructure finance | 4% | IDFC |
| India infrastructure | 3% | Bharat Heavy Electricals (BHEL) |
| India internet play | 4% | Info Edge |
| Indonesia autos | 4% | Astra International |
| Indonesia cement | 4% | Indocement |
| Indonesia fuel distribution | 3% | AKR Corporindo |
| Korea electronics | 5% | Samsung Electronics |
| Korea internet search portal | 3% | NHN Corp |
| Philippines banks | 5% | Security Bank |
| Philippines consumer | 5% | Universal Robina |
| Singapore dividend plays | 10% | StarHub (5%), SATS (5%) |
| Thailand banks | 4% | Krung Thai Bank |
| Thailand consumer | 6% | CP All |

Note: Readers should refer to the relevant CLSA research reports for detailed analysis & disclosures. Source: CLSA Asia-Pacific Markets