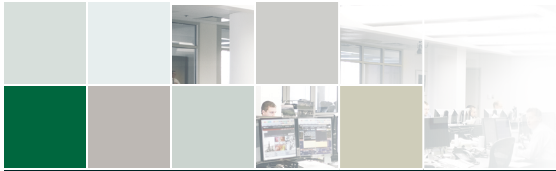


MARKET OUTLOOKS

ASIAN FIXED INCOME

Endre Pedersen, Senior Managing Director, Asian Fixed Income

A pleasant first half but challenges to come

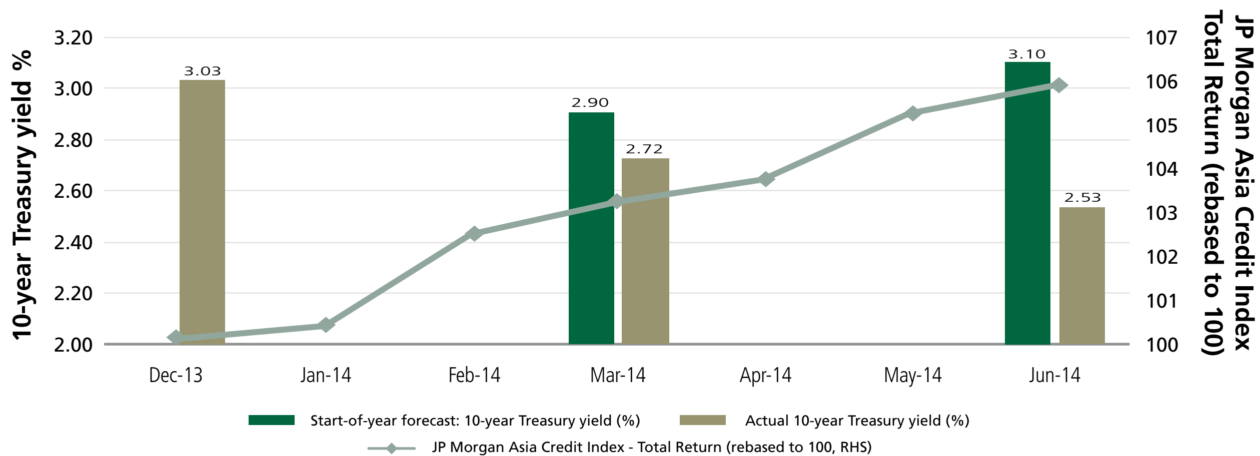
Asian bond markets delivered better-than-expected performance in the first half of 2014 — a pleasant surprise for fixed income investors who expected US Federal Reserve (Fed) Quantitative Easing (QE) tapering and rate hike expectations in the US market to create challenging trading conditions. Instead, investors were rewarded with 5.0% return on local-currency Asian bonds and 5.9% return on hard-currency (i.e., US-dollar-denominated) Asian bonds.

Asian markets shrug off headwinds

Everything seemed lined up against Asian bonds as 2014 dawned. Risk-off sentiment on emerging markets was predominant in the wake of the mid-2013 "taper tantrum" — when investors pulled billions of US dollars' worth of capital from emerging bond markets in anticipation of rapid US interest rate hikes alongside the QE taper — and in the face of uncertainty over the situation in Ukraine.

However, the move to exit Asian fixed income proved to be an overreaction. US Treasury yields actually fell as the QE taper progressed. Meanwhile, a harsh US winter led to GDP contraction in the first quarter of 2014 and the 10-year Treasury yield concurrently declined to the 2.5% level from the 3.0% level and remained generally stable. Lower-than-expected US Treasury yields were kind to Asian bond investors, who reaped capital gains as yields fell in the region and enjoyed attractive carry due to higher-than-global-average coupons thanks to the "Asia premium" that rewards investors for the perception of higher risk in Asian markets.

Actual and expected 10-year Treasury yield and Asian credit return



Source: Bloomberg, 1Q14 SIFMA Government Forecast Survey; June 30, 2014.

Local currencies also rewarded investors in Asian bond markets in the first half of 2014. After having lost significant ground during the taper tantrum, many regained ground — the Korean won recouped 3.8%, the Indian rupee 2.7%, and the Indonesian rupiah 2.5%. The Chinese renminbi (RMB) proved the exception in this case, breaking a long-term appreciation trend and losing 2.4% over the period.

Overweight corporate bonds to limit interest rate risk

That being said, the first half of 2014 was likely a reprieve from interest rate hikes rather than a pardon. Looking ahead, we see the likelihood that US treasuries will sell off, bringing the 10-year back up to the 3.0% level and driving US dollar appreciation. Both will present challenges to Asian bond investors, particularly in local-currency markets. Against this backdrop, we believe a prudent bond investment strategy is to limit interest rate sensitivity by curtailing duration and, in the short term, to minimize foreign exchange risk by overweighting hard-currency bonds.

In our view, the key to limiting interest rate sensitivity is to focus on corporate bonds, which tend to be of shorter duration than sovereign bonds. After a slow start to the year, we saw relatively strong Asian external corporate debt issuance of about US$112 billion in the first half of 2014 and expect this to remain steady into the second half. This presents opportunities for discerning investors with an in-depth credit research capability to generate returns. We are particularly constructive on so-called "cross-over" bonds that straddle the line between investment and non-investment grade. At present we are focusing on BBB-rated bonds and target duration of less than three years.

Managing currency in a strengthening US dollar environment

We believe that managing currency exposure will become increasingly important in the second half of 2014. Asian local currencies surprised to the upside in the first half. Most gained ground versus the US dollar as domestic economic fundamentals improved and foreign investors gingerly began returning to regional markets.

If US Treasury yields begin to climb, however, we see the US dollar strengthening and expect most local currencies to lose at least some ground. This leads us to overwhelmingly favor hard-currency bonds as a means to largely eliminate foreign exchange risk. Exceptions to this include our belief that the RMB will return to a gradual appreciation trend after having depreciated in the first half of 2014. While the Chinese economy was slow for much of the first half, we have recently seen signs of a pick up. The HSBC Flash Manufacturing PMI recovered to positive ground in June, coming in at 50.7 (readings over 50 indicate expansion), and exports were up 7.0% year-on-year as of the end of May.

We are also constructive on the Indonesian rupiah, which was volatile in the first half of 2014 but is expected to appreciate in the second half as domestic fuel subsidies are rolled back further and the country's economic fundamentals continue to improve. The nation's financial markets and currency reacted positively when pro-reform candidate Joko Widodo was declared the winner of Indonesia's presidential election on July 22.

Overall, we continue to see opportunities to generate returns on Asian fixed income if investors position themselves carefully. This means undertaking careful credit research to select the most promising corporate issuances, maintaining a bias to shorter duration, and emphasizing hard currency alongside highly selective exposure to local currencies.

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