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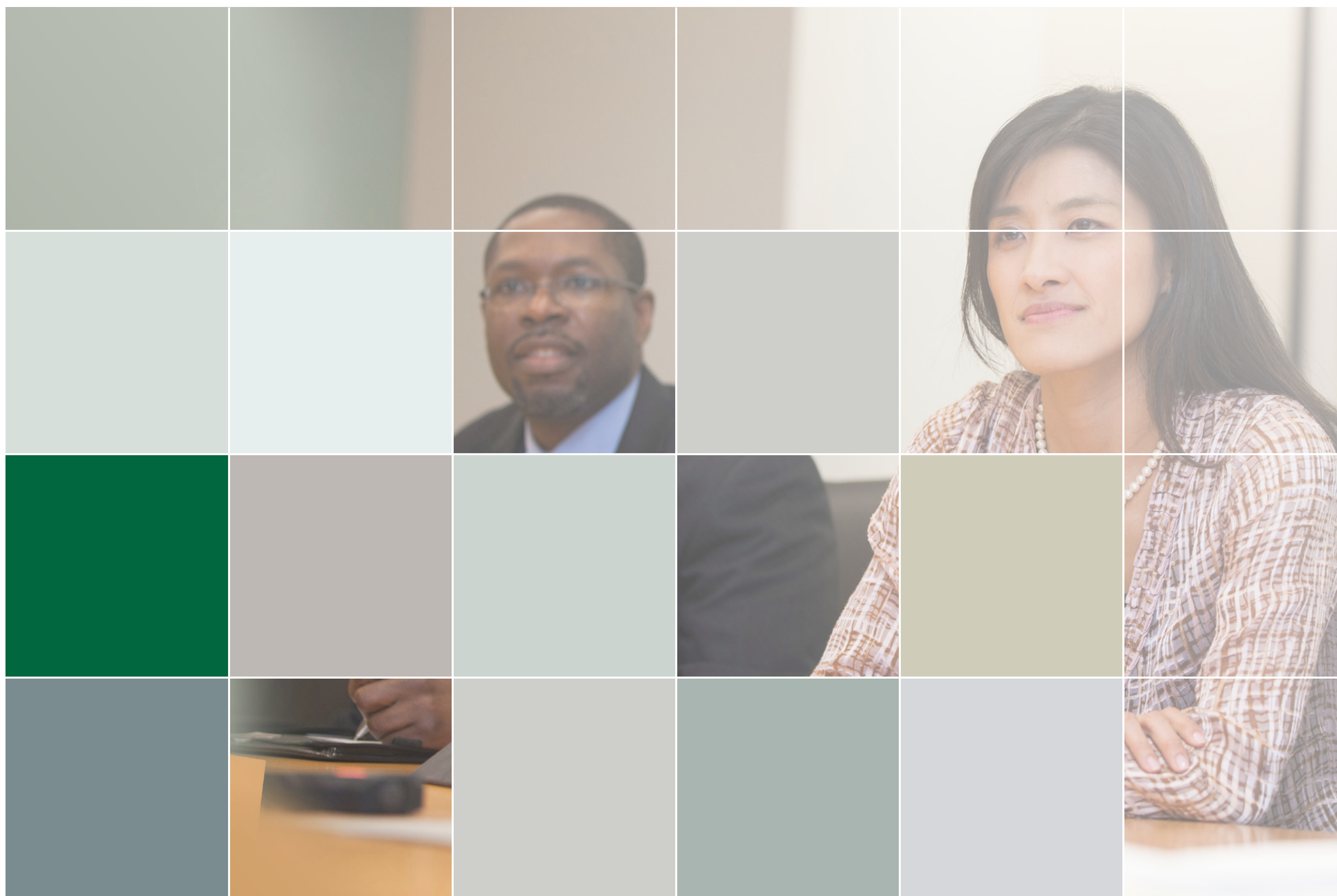

Asian bonds

From tactical to strategic asset allocation

November 2014

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Introduction

The Asian bond[1] asset class has evolved from a short-term tactical play to a strategic long-term investment case for any forward-thinking global asset allocation decision maker. The Asia ex-Japan block shows robust fiscal conditions, with potentially higher growth prospects than developed markets. Strengthened credit worthiness and a large cushion of foreign reserves support the notion that the asset class is worthy of inclusion in an investor's global asset allocation as a long-term investment.

The Asian bond market (ex-Japan) has grown rapidly since 1997 to about US$8.5 trillion as of 30 June 2014, delivering a better risk-adjusted return than most other asset classes over the past decade while maintaining indications of potential continued growth and strong returns[2]. While the asset class is diversified and most Asian countries and territories are of investment grade quality, it remains under-represented in global bond indices. Asian bonds notably offer investors direct access to the booming Chinese bond market.

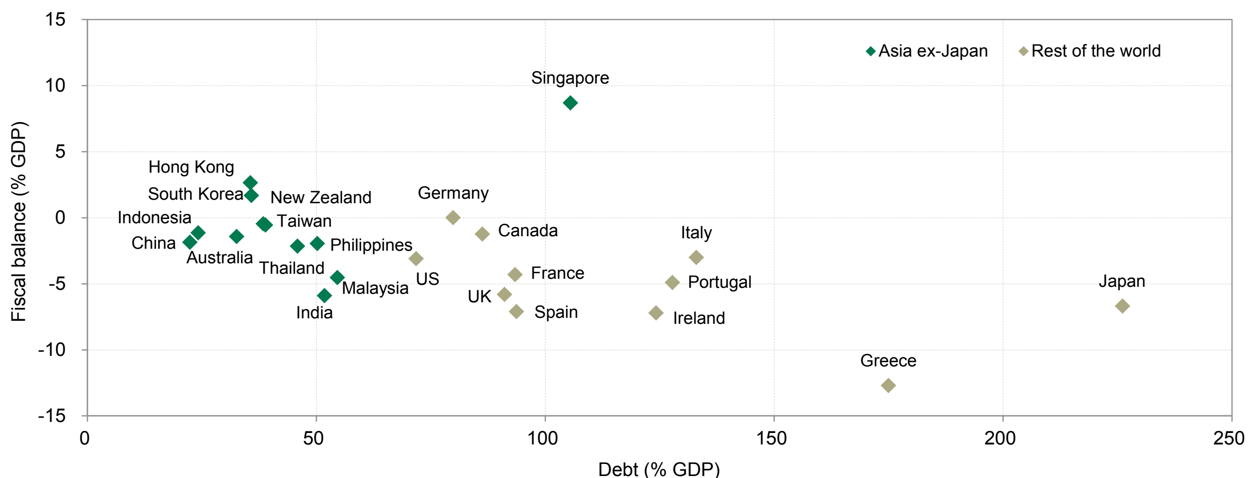
Why Asia? Why now?

In the wake of the global financial crisis, developed markets have been volatile and challenged notably due to lack of growth, declining competitiveness and abyssal fiscal deficits. We have entered a two-speed world where emerging economies have become a solid alternative to developed economies. While rating agencies have been punishing fiscally weak countries, with the United States and European countries being downgraded, emerging economies, especially in Asia, have been on an upward ratings trajectory, offering a new investment avenue for global investors.

Strong economic fundamentals and solid credit worthiness

GDP growth rates in Asia have demonstrated remarkable resilience and we believe the region will remain a bright spot in the global economy, with growth forecast to be at least two times higher than in developed and other emerging markets. Also, Asian economies show stronger balance sheets than most developed economies. They generally enjoy low debt-to-GDP ratios and low fiscal burdens (figures 1 and 2).

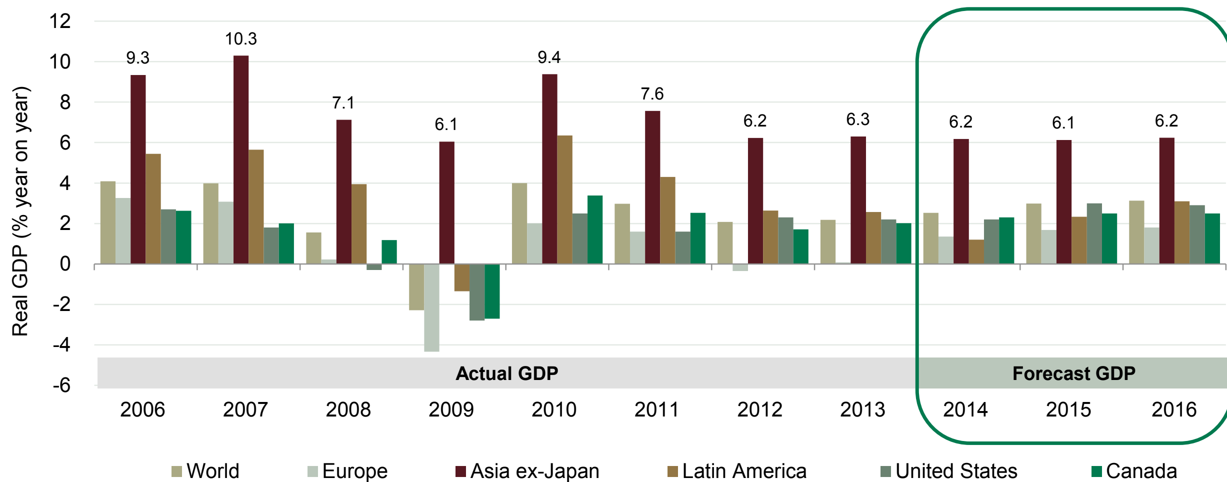
Figure 1: Fiscal balances and debt to GDP ratios of Asian economies versus developed economies



Source: Bloomberg, 30 September 2014. Manulife Asset Management

[1] "Asian bonds" refers to "Asian bonds (ex-Japan)" throughout this text.
[2] Asian Development Bank, JP Morgan indices, Manulife Asset Management. Past performance is not indicative of future results.

Figure 2: Real GDP growth of Asia ex-Japan versus other regions



Source: Bloomberg, Economic survey, 30 September 2014.

Since the global financial crisis, Asian sovereign credit ratings have remained stable and even improved in some cases. Most recently, Standard & Poor's raised the Philippines' credit rating to BBB in May 2014, one year after the upgrade to investment grade status. Similarly, Moody's upgraded Vietnam's credit rating by one notch to B1 in July 2014 on back of improving economic fundamentals (Figure 3).

Historically, liquidity has been a major concern holding investors back from investing in Asian corporate bonds. This is changing, however, as US and European banks scale back their lending operations in Asia due to capital constraints and Asian corporates increasingly look to bond markets to meet their funding needs. In fact, issuance has already hit a record high so far in 2014. Year-to-date Asia ex-Japan hard-currency (US dollar) bond issuance has topped US$147 billion as of 30 September 2014[3].

Figure 3: Asian sovereign credit ratings

Country/Rating	Moody's	S&P	Fitch
Singapore	Aaa	AAA	AAA
Hong Kong	Aa1	AAA	AA+
China	Aa3	AA-	A+
Taiwan	Aa3	AA-	AA-
South Korea	Aa3	AA-	AA
Malaysia	A3	A	A
Thailand	Baa1	A-	A-
India	Baa3	BBB-	BBB-
Philippines	Baa3	BBB	BBB
Indonesia	Baa3	BB+	BBB-
Vietnam	B1	BB-	B+

Investment grade   Non-investment grade

Source: Bloomberg, 30 September 2014.

[3] Bloomberg, 30 September 2014.

Favourable monetary policies and large foreign reserves

There are other structural economic supports for the continued development of a vibrant and deep corporate bond market in Asia, which is seen as essential for the region in the coming years.

Thanks to prudent interest rate hikes in 2009 and 2010, Asian central banks now have much more room than their developed market counterparts to cut interest rates and stimulate their economies should the situation warrant. Over a longer horizon, a structural fall in interest rates is evident in a few Asian countries as they are implementing economic reforms and experiencing rapid development. The 10-year Indonesia government bond rate, for example, has fallen from 20% to the current 8.0% level during the past decade3. Although we can make the argument that the road ahead could be less enjoyable, the Asian block offers the benefit of being heterogeneous, spanning from less developed markets to AAA-rated markets such as Hong Kong and Singapore. This disparity offers numerous cross-market trading opportunities for well-resourced active investment managers.

Lastly, Asian countries and territories (ex-Japan) hold over US$6.0 trillion in foreign currency reserves, with China alone accounting for around US$3.9 trillion3. We believe that this offers an attractive cushion to foreign investors who want to invest in Asian assets, relative to other emerging markets around the world.

To sum up, global markets have been extremely volatile since the onset of the global financial crisis and the subsequent turmoil in the eurozone. Risk appetite has declined sharply as investors have flocked to safe assets amid fear of a global economic recession. Against this backdrop, 10-year US Treasury bond yields at one point dropped below 2%, German 10-year Bunds fell below 1% while some other high-quality sovereign bonds are also seeing unprecedented low rates3. As policy responses from global central banks indicate that any increase in interest rates will be gradual, investors around the globe are now asking the same question: where to invest next?

We believe that one attractive solution is to invest in Asian bonds.

Why Asia for bonds?

The past six years following the global financial crisis marked both a turning point and a testing point for Asian markets for three major reasons:

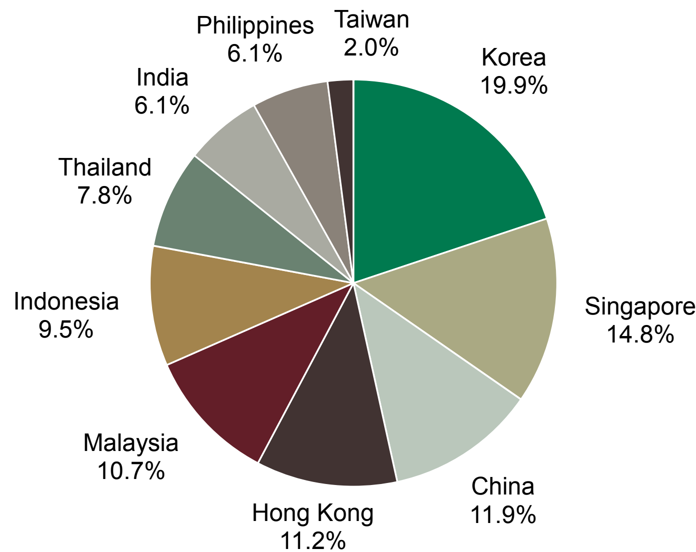
- Foreign investors increased their allocation to local fixed income markets to unprecedented levels;
- Credit risks associated with Asian issuers declined while developed sovereign issuers were downgraded or put on negative watch;
- The Chinese yuan or renminbi (RMB) continued to emerge, notably through the rapid growth of the "offshore RMB" (aka "CNH" or "dim sum") bond market in Hong Kong.

The inexorable rise of Asian bonds

Asian bond markets have gone from being virtually nothing at the time of the 1997 Asian financial crisis to becoming among the fastest growing fixed income markets in the world. The local-currency Asia ex-Japan bond market is diversified across 10 main bond issuing economies in the region (Figure 4). The index average yield is about 4.1% for an average duration of 5.7 years[4]. The credit quality of the majority of constituent countries and territories is high, with two AAA-rated: Singapore and Hong Kong.

[4] HSBC Asian Local Bond Index, 30 September 2014.

Figure 4: Asia (ex-Japan) local bond universe[5]



Source: HSBC Asian Local Bond Index composition, 30 September 2014.

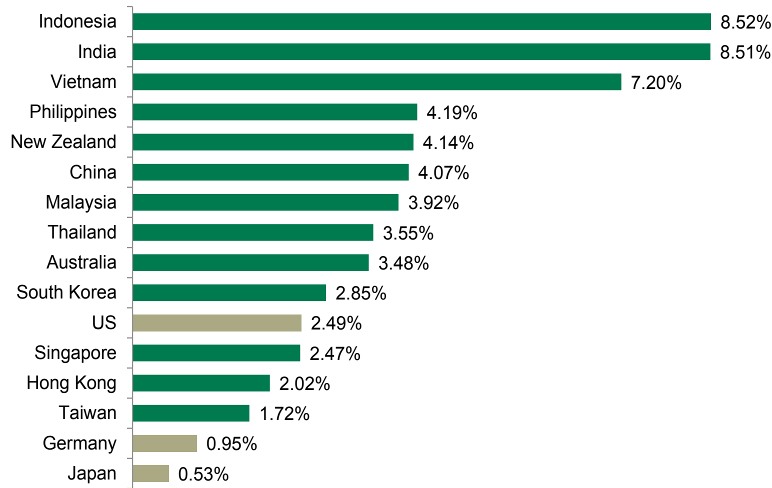
Despite the strong growth potential for Asian bonds, local government bonds continue to trade at relatively attractive valuations compared to the US Treasury bonds (Figure 5). In the current low-yield environment, this yield pickup is attractive. The story on the credit side is similar as there are still gaps between the US and Asian corporate bonds.

The Citi World Government Bond Index shows that Asian government bonds account for a minute 2% of the global index[6]. However, the region contributes a significant portion of the world's GDP. One can obviously draw an incorrect conclusion that Asian government bonds account for a disproportionate share of the global investment universe. However, the reason behind this anomaly is that almost all bond indices are market-cap weighted. This means the more a country borrows, the bigger the slice it represents in the index. Fiscally responsible sovereigns that have less debt outstanding end up having much smaller weights in the index. We recommend investors be aware of this bias when making investment decisions involving Asian bonds. Looking forward, this anomaly is expected to be corrected as Asian countries and territories will eventually play a larger role that is commensurate with their levels of economic activity on the global stage. This in turn points to the likelihood of better valuation and liquidity for Asian bonds.

[5] The market capitalisation of the HSBC Asian Local Bond Index is US$1.7 trillion as of 30 September, 2014. The index tracks the total return performance of liquid bonds, denominated in local currencies, in China, Hong Kong, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. The market weightings are constructed to provide a bond portfolio that defines the market of developing Asian local currency bonds available to international investors. Weightings are determined by the total size of each domestic bond market, liquidity of the secondary market, accessibility to foreign investors and the development of infrastructure to facilitate fixed income investments and trading.

[6] Citi Yield Book, 30 September 2014.

Figure 5: Asian10-year government yields



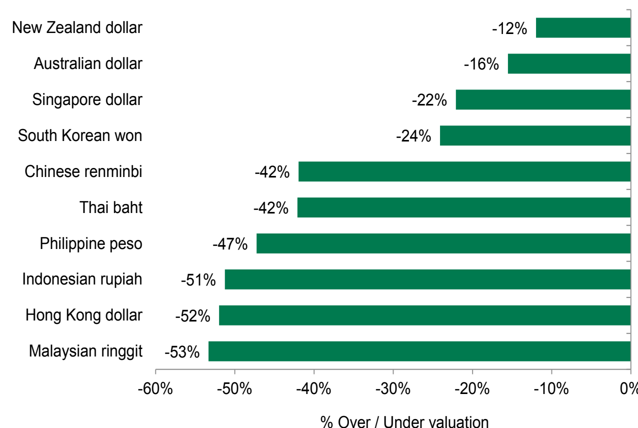
Source: Bloomberg, 30 September 2014.

Potential currency tailwind

Two distinct bond markets can be found in Asia—namely local currency and hard currency (US dollar) bonds. The local currency market offers potential currency appreciation benefits and tends to be more volatile in risk-off market environments. The hard currency market, which is the smaller of the two, is usually more resilient when risky assets sell off. We believe that, when taken together, these two markets help investors benefit from upside market potential in risk-on environments and limit performance draw-down in risk-off environments. An interesting point is that Asian local-currency bonds tend to display higher correlations to equity markets than to US dollar bonds. This means that Asian local-currency bonds would potentially benefit from a hypothetical sustained global equity bull market scenario.

Concerns over the US Federal Reserve's quantitative easing tapering spurred foreign capital outflow and increased volatility in Asian currencies during 2013. The volatility and dislocation of currencies created pockets of opportunities in Asia, as the fundamentals of most Asian economies are sound and supportive of structural currency appreciation.

Figure 6: Purchasing power parity—Asian currencies versus the US dollar



Source: Bloomberg, Big Mac Index Purchasing Power Parity of Asia Pacific (ex-Japan) countries, 30 September 2014.

Though recent Japanese yen depreciation has had a negative effect on export-led currencies such as the Korean won, over a longer horizon, there is strong evidence that Asian currencies are still undervalued relative to the US dollar. When valued under purchasing power parity, the currencies of China, Indonesia, Malaysia and the Philippines are undervalued by an average of more than 40% (Figure 6). We believe the combination of robust fiscal positions, large foreign reserves and high growth prospects make a very solid argument for a structural appreciation of many Asian currencies. Based on our analysis, we expect Asian local currencies, as a basket, to appreciate by an average of 1–2% per annum against the US dollar over the next few years.

What about liquidity risk?

The classic argument of Asian bond skeptics has been the market's lack of depth and liquidity versus developed markets. Although the argument is fair, liquidity has been improving as the market has grown and bond maturities have extended. That said, there is some disparity between Asian markets with South Korea at one end of the spectrum as the most liquid bond market in the region and lower-rated economies at the other end showing relatively wider bid-offer spreads given their limited bond market depth.

Other common hurdles to cross-border investments and settlements include foreign investor quotas, registration limitations, currency exchange controls, taxes and legal framework. However, these barriers should become less of a concern as local authorities embrace the globalisation process. We expect a number of factors such as aging populations, rising incomes and increasing pension fund demand to inevitably contribute to a more open and deeper Asian debt market in the years ahead.

As is also the case for more mature bond markets, liquidity issues are faced by lower-rated (and even unrated) credit names, smaller-size market segments and under-researched issuers. In order to reduce liquidity risk and get the best trading execution conditions, we believe it is essential to understand local bond market particularities and dedicate appropriate on-the-ground resources to covering Asian debt markets.

How do Asian bonds fit the asset allocation mix?

Investing in Asia might concern some investors who believe it constitutes a risky proposition. Although Asian stock markets are notoriously volatile, this is not necessarily the case with Asian bond markets. Indeed, Asian bonds have delivered better risk-adjusted returns than most other major asset classes over the past ten years (figures 7 and 8)[7].

Risk-efficient historical performance which we believe will remain attractive

Asian bonds have delivered an average of 6.5% total returns per annum[8] over the past ten years, providing a steady income stream to investors.

While the appreciation of Asian currencies has certainly contributed to the asset class returns, it has not been the only driver, contrary to what some investors may think. Indeed, overall returns have been balanced, with steady recurring coupons and capital appreciation also driving performance.

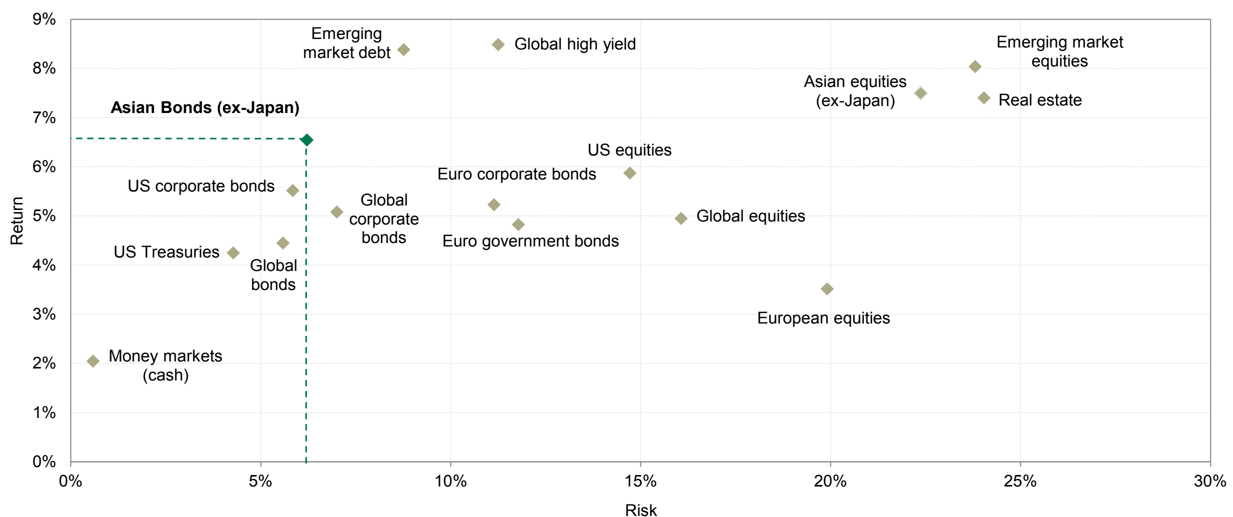
Going forward, we expect returns on Asian bonds to remain higher than returns in other regional bond markets. Given current running yield levels and the potential for continued gradual appreciation of regional currencies, total returns in US dollar terms are expected to average 6% per annum[9].

[7] Past performance is no guarantee of future results.
[8] Blend (50% HSBC Asian Local Bond Index + 50% HSBC Asian Dollar Bond Index), from 30 September 2004 to 30 September 2014.
[9] Manulife Asset Management, 30 September 2014.

Portfolio diversification benefits

Asian bonds display a low historical performance correlation to non-fixed income asset classes. This suggests they offer an attractive diversification benefit within a multi-asset portfolio. More interestingly, Asian bonds show a relatively higher correlation to emerging market debt (0.91)[10], meaning that there is potentially less risk for bond investors who are already invested in global emerging market debt portfolios to switch their allocations from global emerging market bonds into stand-alone Asian bonds as bond returns tend to be highly correlated (Figure 8). We believe that adding Asian bonds to a diversified multi-asset mix can improve the overall risk/return profile of an efficient portfolio[11].

Figure 7: Risk-adjusted returns of key asset classes over the past 10 years[12]



Note: See Figure 8 for data sources and range.

Chinese bonds to provide an additional diversification avenue going forward

Last but not least, the booming market of offshore RMB bonds which started in 2010 via Hong Kong's financial hub, cannot be ignored. The so called "dim sum" bond market is celebrating its fourth anniversary and has grown rapidly to reach a size of around US$120 billion[13]. It is expected to grow further in the years to come as China is opening its capital account and is internationalising its currency. These bonds will likely play an increasing role in Asian bond portfolios in the years ahead.

CNH bonds offer investors direct access to potential appreciation of the Chinese yuan as well as broader scope for yield pick-up and diversification benefits versus traditional bond markets.

[10] Manulife Asset Management, Bloomberg, 30 September 2014.
[11] No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.
[12] Risk refers to the annualised standard deviation of index monthly returns, in US dollar terms.
[13] Manulife Asset Management, Bloomberg, 30 September 2014.

The dim sum bond market has shifted from being a seller's market to become a buyer's market with better yield-on-offer and credit differentiation. In the early days, investors attracted by the CNH market wanted to make a quick buck by betting on rapid yuan appreciation against the US dollar and other major currencies. Subsequently, relatively low-quality issuers tried to get their funding done through this new bond market. In late 2011, Chinese macro data started to surprise investors to the downside, inflation came off, and the markets started to price a potential depreciation of the yuan, pushing CNH bond yields upwards. As the demand and supply for CNH bonds became broader, with further institutional investors and high quality global issuers experimenting with this market, the CNH market became more balanced, more liquid and more stable. In our view, investors can now expect attractive yields of around 4.2%[14] as well as moderately positive currency appreciation.

One currency, many applications...

RMB	Renminbi: official name of the Chinese currency, derived from ren min bi, or "The People's Money".
CNY	Yuan: the base unit of the Chinese currency. Also represents the currency code used in financial markets.
CNH	Currency code used to represent the exchange rate of RMB that trades in Hong Kong.

Figure 8: Correlation and risk-adjusted returns of Asian bonds over the past 10 years[15]

Asset class	Annualised return	Risk	Return / Risk	Correlation of Asian bonds to other asset classes
Asian bonds (ex-Japan)	6.54%	6.22%	1.05	1.00
Emerging market debt	8.38%	8.76%	0.96	0.91
Global corporate bonds	5.08%	7.01%	0.73	0.82
US corporate bonds	5.51%	5.84%	0.94	0.76
Asian equities (ex-Japan)	7.49%	22.38%	0.33	0.73
Euro corporate bonds	4.82%	11.78%	0.41	0.72
Global bonds	4.45%	5.59%	0.80	0.72
Global high yield	8.48%	11.25%	0.75	0.72
Emerging market equities	8.04%	23.81%	0.34	0.70
Euro government bonds	5.23%	11.14%	0.47	0.67
Global equities	4.95%	16.07%	0.31	0.64
European equities	3.51%	19.91%	0.18	0.64
Real estate	7.40%	24.04%	0.31	0.64
US equities	5.87%	14.72%	0.40	0.58
US Treasuries	4.25%	4.28%	0.99	0.29
Money markets (cash)	2.05%	0.59%	3.49	-0.01

Source: Bloomberg, data based on index monthly returns from 30 September 2004 to 30 September 2014 in US dollar terms unless otherwise noted. Asian bonds (ex-Japan) = 50% HSBC Asian Local Bond Index + 50% HSBC Asian Dollar Bond Index; Emerging market debt = JPMorgan EMBI Global Total Return Index; Euro government bonds = Bank of America Merrill Lynch Euro Government Index; Euro corporate bonds = BofA Merrill Lynch Euro Corporate Index; US Treasuries = BofA Merrill Lynch US Treasury Index ; US corporate bonds = BofA Merrill Lynch US Corporate Index; Global bonds = BofA Merrill Lynch Global Broad Market Index; Global corporate bonds = BofA Merrill Lynch Global Corporate Index; Global high yield = BofA Merrill Lynch Global High Yield Index; Global equities = MSCI World; US equities = S&P 500 Index; European equities = MSCI Europe Index; Asian equities (ex-Japan) = MSCI AC Asia Pacific ex Japan Index; Emerging market equities = MSCI Emerging Markets Index; Real estate = Dow Jones Composite REIT Total Return Index; Money markets = BofA Merrill Lynch US Dollar 3-Month Deposit Offered Rate Average Index. It is not possible to directly invest in an index.

[14] HSBC Offshore Renminbi Bond Overall Index, 30 September 2014.
[15] Risk refers to the annualised standard deviation of index monthly returns, in US dollar terms.

Conclusion

Strong fundamentals have helped Asia become the bright spot of the global economy. We believe that Asia and China in particular will continue to drive global growth in the decade ahead. As Asian debt markets have grown rapidly in recent years and, we believe, will continue to mature due to structural reasons and increased demand from both Asian and non-Asian investors, further opportunities will arise for investors around the globe to benefit from the superior risk-adjusted total returns and stable income the asset class has on offer.

Against this backdrop, any forward-thinking global investor may consider Asian bonds as a potential part of a long-term strategic asset allocation decision rather than a short-term tactical play.

Local knowledge pays off

Risk cannot be avoided in Asian credit markets. However, we advocate that investors manage risk carefully to ensure that they are paid for it rather than avoiding it. We are firm believers that careful research by on-the-ground investment professionals is the key to managing risk and seeking to achieve positive investment returns in Asian fixed income.

Manulife Asset Management has one of the largest research footprints in Asia, with more than 55 fixed income professionals – including 23 dedicated credit analysts covering over 500 Asian issuers – located on the ground at the heart of 10 markets in the region. This includes 22 dedicated Greater China bond market specialists located in Beijing, Shanghai, Hong Kong and Taiwan. These professionals undertake careful analysis of every potential corporate credit investment and assign an in-house credit rating to guide the investment decision.

While investors must also be prudent about diversifying holdings and capping exposure to genuinely illiquid securities, we see no alternative to careful research as a guiding principle for generating vinvestment returns in the region.

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Manulife Asset Management

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