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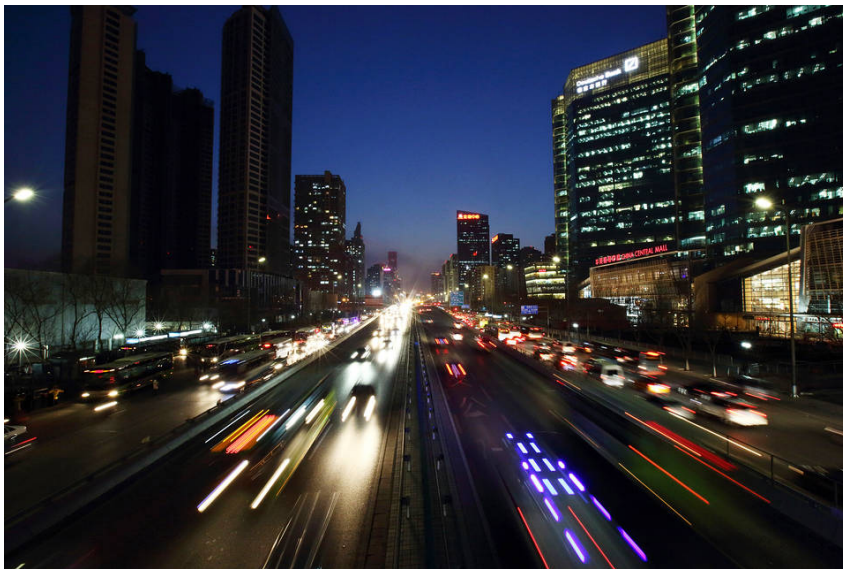
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MARKETS

Fed Move Gives Asian Bonds a Silver Lining in Stormy Year

Bonds in Asia were on track for worst December in years until Fed's dovish tone set off a global rally



Vehicles move along an expressway as towers at Kaisa Plaza, developed by Kaisa Group Holdings Ltd., left, stand near completion in Beijing. Kaisa defaulted on interest payments on its offshore debt this year. *PHOTO: BLOOMBERG NEWS*

By **FIONA LAW**

Dec. 21, 2015 1:14 a.m. ET

The U.S. Federal Reserve's first rate increase in almost a decade gave Asian bond markets an unlikely boost after one of their weakest years amid slower growth, rising

borrowing costs and money flowing out of emerging markets.

Bonds in Asia were on track to have their worst December in five years until the Fed’s dovish tone set off a rally in global markets.

“Investors focused on the [Fed’s] commitment to a gradual cycle and also took comfort in the notion that the central bank will continue to... maintain the size of its balance sheet,” said Russ Koesterich, chief investment strategist at BlackRock.

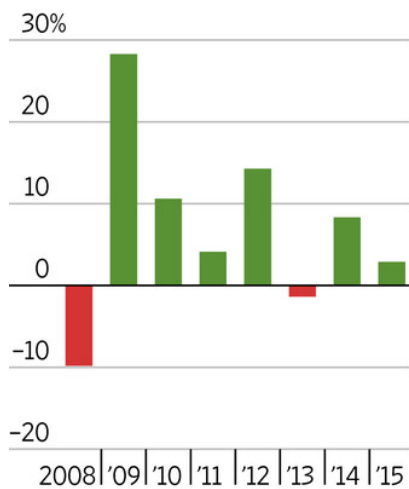
Dollar-denominated bonds in Asia outside of Japan are up 2.9% for the year so far. Except for taper-tantrum scarred 2013 when bonds lost 1.4%, this year is the worst for Asia bonds since the global financial crisis in 2008, according to the J.P. Morgan Asia Credit Index.

The markets had drawn in investors with returns of 14% in 2012 and 8% last year, making them top performers in the low-yielding bond world.

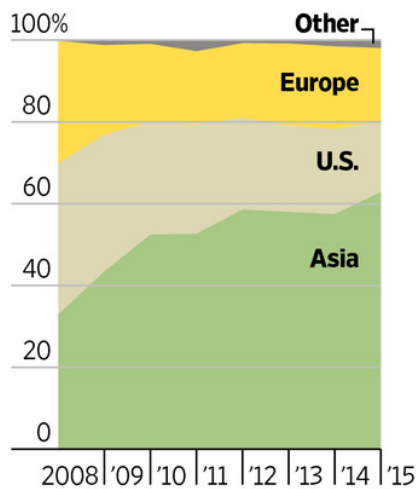
Weak Year

Asia bonds are set to have one of the worst years since the 2008 global financial crisis.

Asia bonds annual returns
(J.P. Morgan Asia Credit Index)



Who bought Asian bonds?



Sources: Thomson Reuters (returns), Asia Investment Advisors (buying)
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The lukewarm bond performance in the region also comes as the selloff in U.S. high-yield bonds heightened concerns about emerging-market debt, which is deemed to be the next most-vulnerable area.

“The volatility in U.S. junk bonds is a wake-up call [for investors] to go back to the fundamentals and check whether their yield compensations are sufficient to cover the credit risks,” said Maurice Meijers, fixed income senior vice president at

Robeco.

Mr. Meijers believes Asia bonds, in particular high-yield debt issued by Chinese real-estate companies, are overvalued. “They have strong tactical support from local investors... but their fundamentals don’t really support the value,” he said. So unlike

Latin American issuers, such as those from Brazil, that experienced significant corrections, Asian debt hasn't really been "repriced" and remains unattractive, said Mr. Meijers.

High-yield bonds in the region fared better than their investment-grade peers, registering a total return of 5.5%, after a combined 15% return over the previous two years.

The success of high-yield bonds is something of a surprise since Chinese property developers account for the bulk of the sector. The companies have been hurt by China's weak property market but were helped by six interest rate cuts and a bond rally at home that let them tap the domestic bond market.

"China's loosening monetary cycle has a bigger impact on Chinese debt than the U.S. rate increase," said Hao Hong, managing director at Bank of Communications Co.

THE FED'S RATE INCREASE

The
low

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returns in the bond market reflects the weakening fundamentals in Asia. Defaults are rising, with companies such as Kaisa Group Holdings and China Shanshui Cement Group Ltd. missing their debt obligations earlier this year. And the higher interest rates being charged to some companies could further slow growth.

“We think the credit cycle in the near term has peaked, mainly due to the moderating economic environment in the region coupled with continuing weak global demand,” said Arthur Lau, co-head of emerging markets fixed income at PineBridge Investments.

He expects Asia bond yields, which move inversely to prices, to rise somewhat in the near term.

Over the past five years, Asian countries and companies have borrowed heavily in U.S. dollars, raising \$723.6 billion debt according to Dealogic—nearly triple from 2006-2010, thanks to low interest rates and the debt-fueled growth model in the region. Now, the companies have to refinance up to \$477.4 billion in the next five years, at a time when funding costs are climbing and profits are weakening.

The good news is any direct impact from the U.S. junk bond selloff might be contained. The portion of Asia bonds sold to American investors has been shrinking over the past few years due mainly to an expansion in homegrown buyers in Asia.



U.S. Federal Reserve Chairwoman Janet Yellen earlier in December. PHOTO: REUTERS

So far in 2015, an average of 17% of new Asian debt was sold to U.S. investors, down from 21% last year. That compared with the recent peak of 37% in 2008, according to **Asia Investment Advisors Ltd.**, which tracks Asia bond sales. At the same time, Asia-based buyers pocketed almost two-thirds of

new dollar bonds in the region this year, up from a third seven years ago, the consulting firm said. Local investors, who might know the companies better, are more likely to stick around during volatile periods than foreigners.

But foreign investors can still hurt Asian markets because of spillover effects from selloffs overseas. **“The worry is whether the whole high-yield space will go through a correction. Then Asia won’t completely escape the effect,”** said Dilip Parameswaran, **chief executive of Asia Investment Advisors Ltd.** “U.S. fund managers who face

redemption needs may pull money from some of our bonds here.”

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