COMMENT

Sense and stability in Asian fixed income

Asian bonds are yet again likely to generate positive returns this year and can provide a measure of stability to investors' portolios, says DILIP PARAMESWARAN*

THE YEAR HAS not exactly started well for many asset classes. Oil has sunk to prices not seen in the last 12 years. With another sudden downward lurch in its currency, China has injected more concerns into the market about its economy, dragging other commodities further down. Equity markets have taken fright, with the Dow already down 9% since the start of 2016.

Against this background, there is one question on the mind of every investor: "With the Fed poised to raise again this year, what does the future hold for fixed-income investments?" In our assessment, the answer is not as negative as you might think: US dollar bonds from Asia can generate a total return of 2%–4%, without leverage.

Last year, Asian bonds generated a total return of 2.8%, split into 2.2% for investment-grade and 5.2% for high-yield bonds, according to JACI index data. This year's returns are likely to be on a par with those.

The first point to appreciate is that Asia is still an attractive growth story. China's economic slowdown being partly compensated by India's pickup, Asia ex-Japan is still set to grow at 5.8% this year and next, according to the IMF's forecasts. This stands in stark contrast to the outlook for other emerging markets, which are suffering from a mix of problems, including low commodity prices.

This year's expected total return from bonds depends on many moving parts. The first is, of course, the likely increase in the Fed funds rate and the medium-term Treasury yields. Economists hold different views on how much the Fed would raise the target rate. Some point to the persistently low inflation, others talk about falling unemployment, and some highlight the potential for global issues (including China) to slow the pace of rate increase. But overall, the Fed funds futures are currently pricing in a Fed funds rate of 0.6% for the year-end. That indicates the potential for medium-term Treasury yields to rise less than expected, perhaps by 50bp.

The second key element is the credit spreads. According to the JACI data, the average Asian bond at the end of 2015 traded at 293bp over swaps, broken down into 222bp for investment-grade and 596bp for non-investment-grade. These spreads are eight times the pre-crisis levels for investment-grade and over six times for non-investment-grade. Although one may argue that the pre-crisis levels reflected unjustified and unsustainable exuberance, the current levels are still higher than the post-2009 average spreads by about 25bp for investment-grade and 140bp for non-investment-grade.

Compared to the US credit markets too, Asian bond yields are still higher, by about 90bp for investment-grade and 50bp for high-yield.

In our view, the current spreads reflect neither a significant overvaluation, nor undervaluation. Consequently, they indicate the potential for the spreads at the year-end to stay close to their current levels, perhaps within 20bp.

The third determinant of returns is defaults. At a global level, high-yield default rates are likely to pick up: Moody's expects the global high-yield default rate to reach 3.7% by November 2016, a level that is higher than the 3% for last year, but still lower than the longer-term average of 4.2%. In Asia, most of the defaults have been triggered by the crash in commodity prices and the economic slowdown in China. These factors are likely to keep Asia's default rates elevated, but should not lead to a spike.

THE TECHNICAL FACTORS for Asian bonds are likely to be supportive this year. Already, many major issuers have turned to Chinese domestic bonds instead of US dollars, as it offers them cheaper funding and reduces their currency risk. This year's supply of new bonds is also likely to be restrained by the same trends, particularly in the China high-yield sector.

At the same time, the demand for bonds has remained strong, in particular from the institutional investors in the region, who picked up 63% of new issues in 2015, up from 58% in each of the three years prior to that. For most investors, Asian bonds have become a mainstream asset class, rather than a frontier asset class; and they are likely to maintain their presence in Asian bond markets in the medium- to long-term.

Asian bonds have become a mainstream asset class, rather than a frontier asset class.

Based on these factors, we expect Asian bonds to generate total returns of 2%-4% if five-year Treasury yields rise by 50bp. Even if the five-year rates rise by 75bp, which seems aggressive given the uncertainties surrounding further rate increases, Asian bonds can still generate positive returns in the range of 0.7%-3%.

Given the higher yields and lower duration, high-yield bonds on the whole are likely to generate higher returns than investment-grade bonds by about 200bp in the base case. However, the challenge for investors is likely to be one of avoiding the potential defaulters. That is no easy task, since the defaults are triggered not only by economic, but sometimes by political factors as well.

In an environment of so many uncertainties – including those around the Chinese economy, commodity prices and geopolitical risks – we believe investors should maintain a reasonable allocation to fixed income to provide stability to their portfolio returns.

**Dilip Parameswaran is founder and head of Asia Investment Advisors, an advisory firm specialising in Asian fixed income.*