Rally driven by technical factors

Asian USD bonds have exceeded all expectations by producing a total return of 9% in the first eight months of the year, driven by the search for yield, reasonable macro environment and supportive technical factors. At this stage, the bond yields for both investment-grade and high-yield bonds are approaching the tightest levels in the last five years. However, Asian bonds still offer a higher yield than the US domestic bonds.

As concerns over China's growth have abated to some extent and India's growth has picked up, Asia's growth is forecast to exceed that of other regions and to stay stable for the next three years. Yet, concerns are rising over the increased leverage on corporate balance sheets and the excess of rating downgrades over upgrades. Looking ahead, technical factors are likely to continue to support Asian bonds. They will continue to present an attractive opportunity to global investors, particularly against the preponderance of negative interest rates elsewhere.

Asian dollar bonds have smashed expectations this year

Asian bonds denominated in USD have smashed the expectations for the year by generating a return of 9% in the first eight months, according to the JP Morgan Asia Credit Index. This has far exceeded our own forecasts for the year, as well as those of even the most bullish analysts in the market.

Unsurprisingly, high-yield bonds have done better than investment-grade bonds, but not by a large margin.

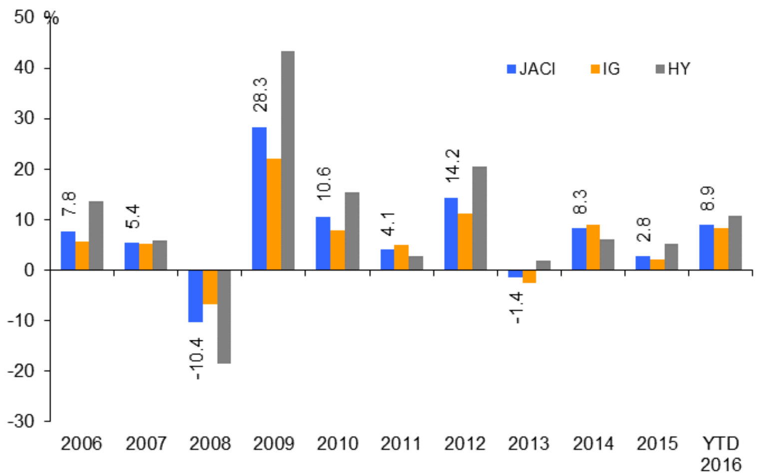
Total returns from Asian dollar bonds

Asian USD bonds	**Total return Jan-Aug 2016**
Investment grade	8.4%
High yield	10.7%
Overall	8.9%

(Source: JACI)

Viewed against historical returns for the market, the Asian dollar bond returns this year have reinforced the attractions of this assets class (see chart below).

Historical returns from Asian dollar bonds

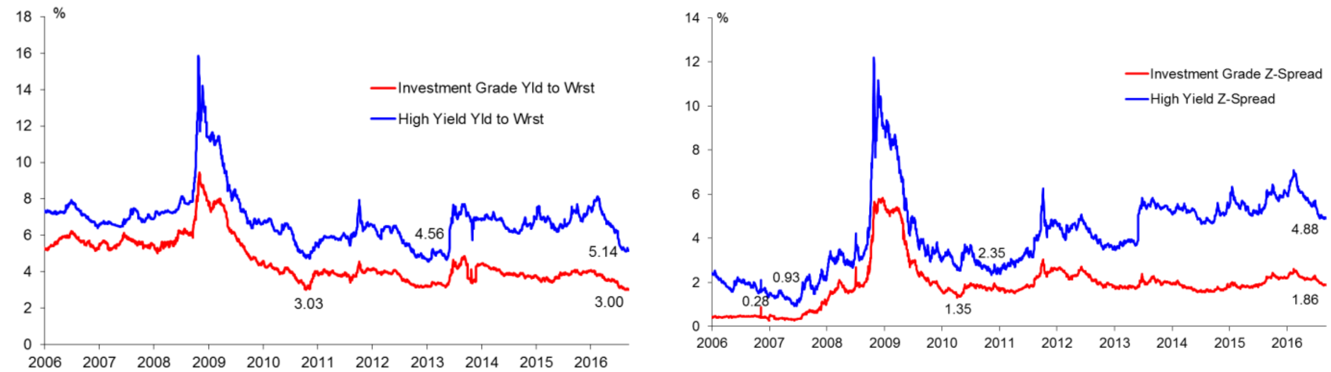


(Source: JACI)

Where are the valuations now?

After the strong performance this year, Asian USD bond yields are at or near all-time lows. But much of the fall in yields has come from a corresponding fall in the U.S. Treasury yields. If we eliminate that factor, Asian spreads are still reasonable. See charts below for yields and spreads.

Historical yields and spreads



(Source: JACI)

At this stage, Asian bonds still offer a premium over the US domestic bonds, as the following comparison shows.

Asia dollar bonds: Yield premium over US bonds

Rating	Asia		US		Asia yield premium
	Yield to worst (%)	Maturity to worst (Years)	Yield (%)	Maturity (Years)	(%)
A	2.90	5.9	2.05	6.0	0.85
BBB	3.45	8.2	2.98	8.0	0.47
BB	4.14	3.3	3.51	3.0	0.63
B	6.40	3.7	5.08	4.0	1.32

(Source: JACI, Bloomberg)

Three drivers

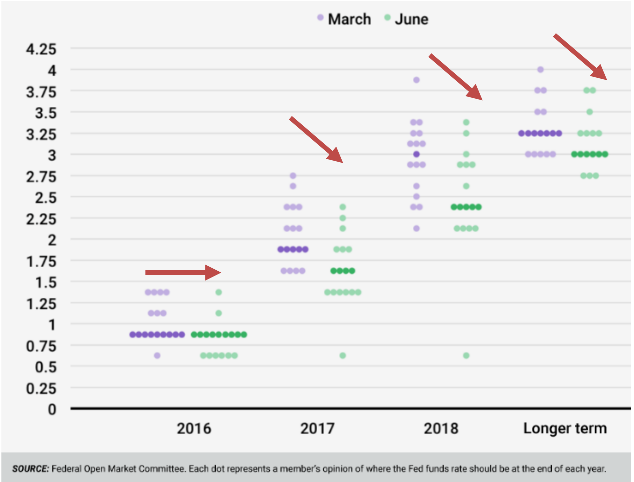
There are three main drivers for this strong performance:

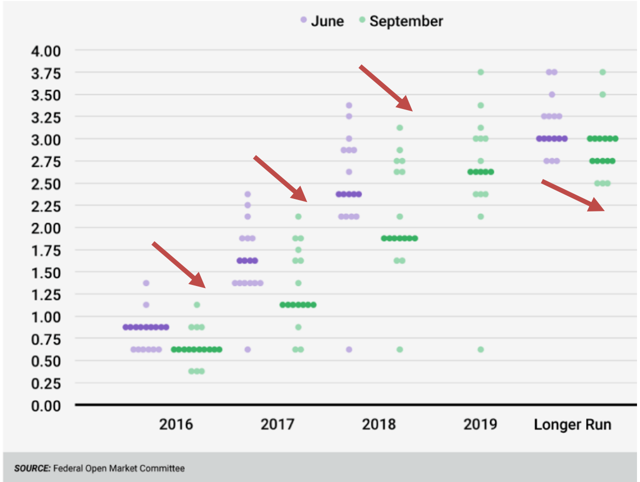
1. Search for yield
2. Reasonable macro environment
3. Supportive technical factors

Search for yield

The ongoing search for yield has intensified this year. One of the underlying factors is the lower expectations of rate increases by Fed. After one rate increase in Dec 2015, there have been incresed doubts about whether the Fed would be able to raise rates aggressively this year. The recent Jackson Hole conference has boosted expectations – yet again; but the employment numbers have disappointed subsequently. Even now, while it is possible that the Fed would raise the rates once this year, it is not certain if they will be able to raise more aggressively. Fed's own dot plots, indicating the members' expectations of rates over the medium term have been revised twice down during the year, as the following chart shows. In fact, the Fed members have revised down even the longer-term "steady state" rate projections.

Fed's Dot Plot: Interest rate projects down, and down again



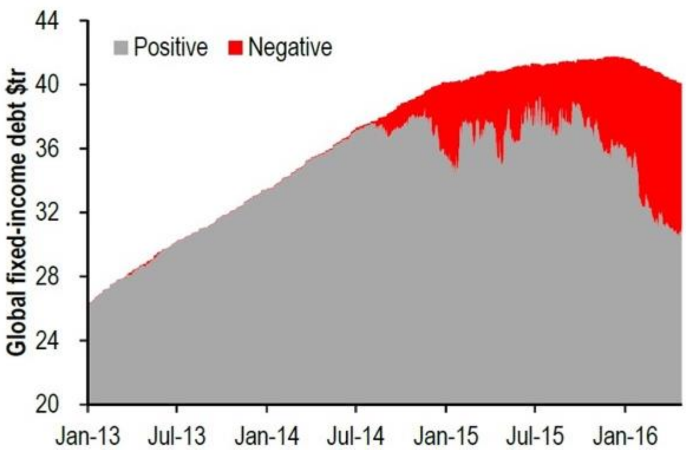


(Source: Business Insider)

The second factor for the search for yield is the continuing quantitative easing (QE) by the ECB and Japan. In March 2016, the ECB expanded its QE from EUR60bn to EUR80bn per month; cut deposit rates to minus 40bp; and offered 4-year loans to banks at minus 40bp. In Japan, QE is continuing at JPY80trn per year; Japan also charges minus 10bp on excess reserves of banks.

This level of QE has pushed the yields on a large range of government and even corporate instruments to negative. European corporates are now issuing bonds at negative yields (Sanofi, Henkel recently issued bonds at yields of minus 5bp); in the secondary market, according to some estimates, 30% of European investment-grade corporate bonds are trading at negative yields. The following chart shows the increasing share of negative yields in the market.

Global percentage of bonds with negative yields



(Source: BAML)

A third underlying factor for the search for yield is that fact that U.S. Treasury yields have crashed to all-time lows – yet again – this year. This indicates several issues: the lack of faith in the Fed's ability to raise rates consistently; continuing tepid growth in the US; persistently low inflation; and global negative yields. The following chart shows the 10-year Treasury yields.

10-year U.S. Treasury yields

(Source: Quandl)

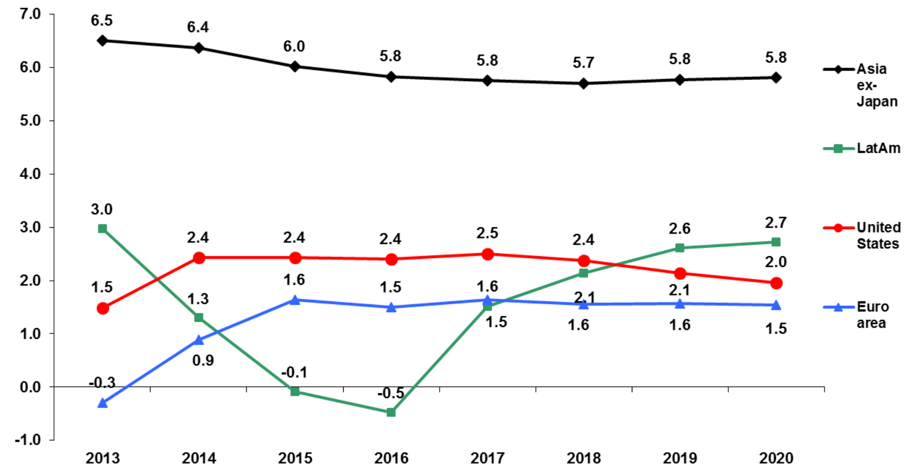
Reasonable macro environment for Asia

However, Asia has benefited from a reasonable macro environment during the year. In particular, concerns that China may face a hard landing have abated. IMF expects China to slow to 6.5% in 2016 and further to 6.2% in 2017 and 6% thereafter. The government is succeeding currently in stabilizing the economy: there are signs of stabilization in GDP, industrial production, and retail consumption; the property sector has been doing well and is likely to continue in 2H2016. However, concerns continue that that further increase in credit and investment may not boost the economy, but may lead to non-performing loans in the future.

India, too, has picked up its pace. It is a key beneficiary of lower oil prices, which will help reduce inflation and eliminate current-account deficit. Inflation has been coming under control (but has risen for the last three months), enabling rate cuts. India's growth is expected to pick up to 7.5% - 7.7% until 2020, according to IMF. India's key constraint, however, is the health of the banking system, which has been saddled with a high level of non-performing loans.

Overall, IMF expects Asia ex-Japan to maintain growth at 5.8% (IMF). As a region, Asia is a key beneficiary of lower oil prices. In particular, Asian growth is set to outshine that of other emerging markets (Latin America, Eastern Europe and Russia). See the chart below for IMF's forecast growth rates.

Asia: Outperforming

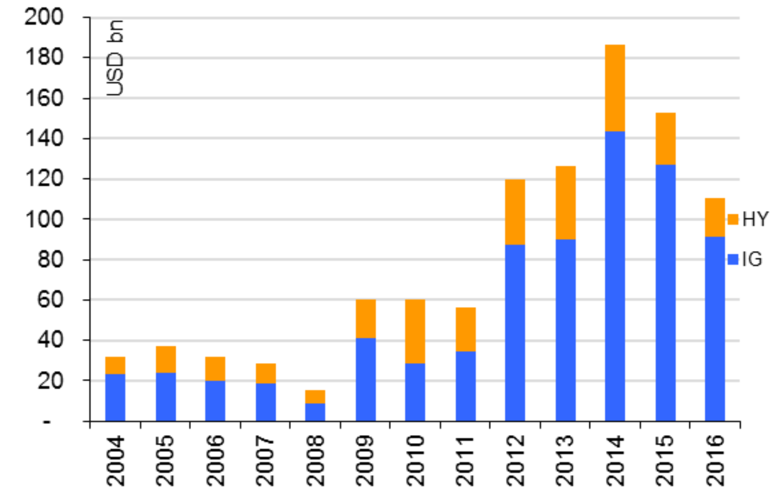


(Source: IMF)

Supportive technical factors

There are many supportive technical factors in the market for Asian USD bonds. One of the main factors is the lower supply as a result of many Chinese companies turning to onshore domestic bond markets rather than issuing USD bonds. As a result, the supply of new bonds has declined this year by about 6% yoy, according to our estimates (see chart below).

Asian dollar bond supply: Lower



(Source: AIA)

Demand for Asian USD bonds, however, has remained stable, particularly from international fund managers who have maintained their allocations to this asset class. In addition, a larger share of Asia's USD bonds is getting placed within Asia, reflecting the pool of savings available in Asia. In the last three years, the share of bonds placed within Asia has increased substantially: 58% in 2014, 63% in 2015 and 73% so far this year.

Concerns rising too

Despite the abundance of good performance and supportive technical factors, some of the fundamental concerns raise concerns. In terms of sovereign ratings, the upgrade cycle is coming to an end, with only one potential rating upgrade: that of Indonesia to investment grade by S&P. The corporate rating downgrades have started to exceed upgrades, as well. This is partly due to the fact that the corporate leverage has risen.

In addition, any potential slowing of China or a renewed weakness in commodity prices will also pressurize corporate credit quality in a variety of sectors.

Outlook

Technical factors are likely to continue to support Asian bonds. In a world of negative interest rates, Asian bonds still offer a premium over US bonds and continue to present an attractive investment opportunity, particularly for European investors. This is despite the fact that the valuations are tight when viewed in the historical context.

However, we believe investment-grade Asian bonds present a better risk/return balance over high-yield bonds at the moment.

While the potential for Treasury yields to rise exists, we believe that the increase cannot be aggressive over the medium term. In particular with some careful hedging of the U.S. Treasury yields, we believe that it is possible to find attractive returns in Asian bonds.

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