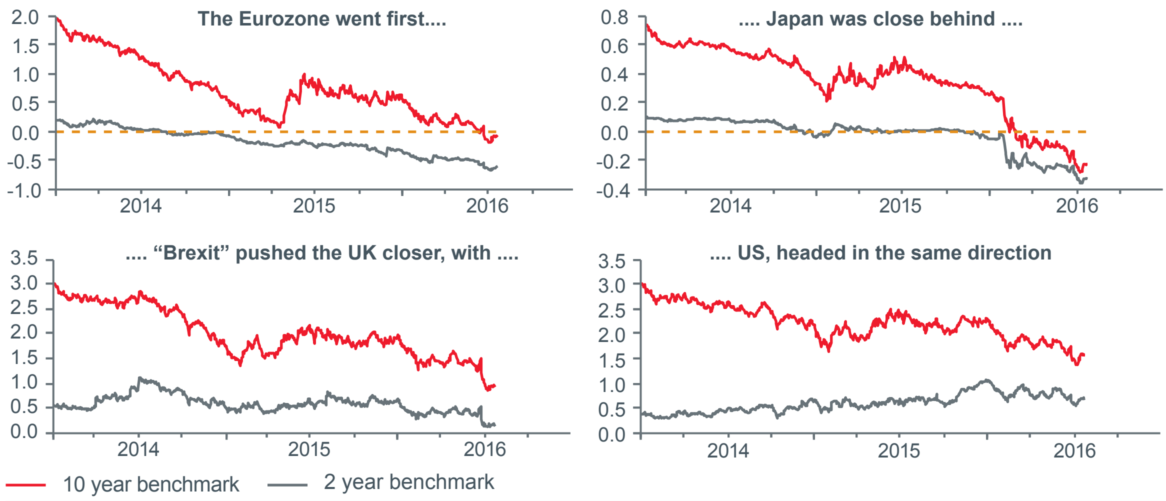
MARKET INSIGHTS

ASIAN BONDS. SET TO SOAR?

A WALL OF MONEY DRIVING YIELDS NEGATIVE MAKES ASIAN BONDS LOOK BETTER AND BETTER

AUGUST 2016

Fig.1. Global liquidity could push Asian bond yields lower... much lower



Source: Sovereign benchmark redemption yields as calculated by Thomson Reuters on Datastream as at 25 July 2016.

BOND RALLIES WILL SPLASH INTO ASIA

Aggressive easy monetary policies being implemented by both the European and Japanese central banks have been instrumental in pushing their respective bond yields into negative territory.

The Bank of England could also step harder on the money accelerator, further depressing gilt yields, owing to the uncertainties facing the UK economy following the "Brexit" vote.

Suddenly, US Treasuries look relatively attractive, particularly as investors seek and appreciate the relative safety of US government debt.

Will this yield momentum ripple into the Asian bond market? Good grounds exist for believing it will!

AWASH IN LIQUIDITY; THERE'S MORE TO COME

Major central banks are poised to inject even more money into their systems despite their record balance sheet sizes to date.

The BOJ, in addition to its earlier pledge to double its purchases of Japanese ETFs, (yesterday) released details of its plan to fiscally revive its economy via cash payouts and infrastructure projects.

Tomorrow, the BOE meets to deliberate rates, which are expected to be trimmed as the country attempts to fend off Brexit concerns and revive an anemic domestic economy. In addition, the ECB looks poised to ease its quantitative easing policy further through more injections and its existing QE programs.

In short, the sea of money already sloshing around the system will only grow. That money must flow somewhere. But where?

Asia? Asian bonds?

THE PATH TO ASIA AND ASIAN BONDS

How Asian Bonds could be swept up in the rush for yield becomes clear when looking at the path bonds have followed in response to easy money policies:

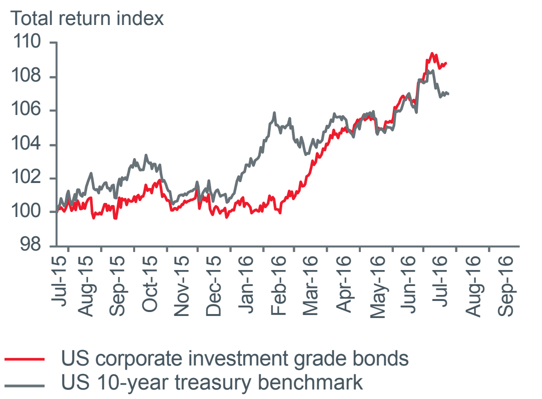
Take the Eurozone, for example:

- Short dated European sovereign bond yields fell below zero as the ECB encouraged both bond buying and corporate lending with its various easing programs (LTRO, TLTRO and OMT[1]).
- Investors chasing yield had little option but to buy longer dated sovereigns driving their yields down in these maturities.
- The search for yield push investors increasingly into credits, which involves taking on more risk.

In the hunt for yield, investors are being pressured into moving out the yield curve (i.e. extend duration) and going down the credit spectrum (i.e. higher credit risk bonds). The same process is in play in Japanese government bonds and UK gilts. It is feeding both US Treasuries and their proxies; US corporate investment grade bond yields are falling fast.

As the "envelope is pushed along", this process could ultimately fuel strong rallies in Asian bonds. As yields of US Treasury and investment grade bonds reach historic lows, the flow of funds into Asian bonds should be closely monitored to spot the " big wave".

Fig.2. US yield seeking investors move up the risk curve to investment grade credits



Source: Barclays Capital from Datastream as at 25 July 2016. [1]Both series have a duration of circa 7 years. Credit outperformance illustrates the risk effect having all but eliminated duration.

ASIAN INVESTMENT GRADE CREDITS ARE KEY

The transmission vehicle into Asia could well be via Asian investment grade USD credits; these offer higher yields of circa 3½% against 2¾% plus of their US counterparts for comparable credit quality[2].

Fig.3. Investors can gain an extra 70 basis points by investing in Asian USD credits

Source: Barclays Capital and JP Morgan Asian bond indices from Datastream as at 25 July 2016. †The difference in yields between corporate investment grade bonds for the US and Asia (USD credits).

The case for switching is strong. But, is it strong enough? With hand on heart, the answer is "Not yet".

[1]LTRO = Long Term Refinancing Operation, TLTRO = Targeted Long Term Refinancing Operation, OMT = Outright Monetary Transactions. [2]Redemption yields on USD investment grade credits as measured by the Barclays Capital investment grade credit index and the JP Morgan Asia index for investment grade credits from Datastream as at 25 July 2016. [3]As reported in the Financial Times, 26 July 2016.

IT REALLY IS DIFFERENT THIS TIME

Investors may argue, "We have seen Asian credits offer higher yields before, but this was insufficient to trigger an aggressive switch into Asian investment grade credits. Why should it be different this time?

The answer? As the global liquidity pump keeps up, the transmission mechanism highlighted could well push near record low US credit yields even lower.

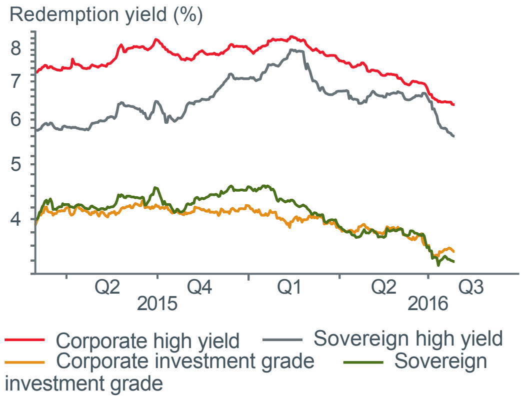
Full impact of negative yields has yet to be felt.

Pension funds/insurance companies have little option but to increase both portfolio duration and credit risk to achieve the yields needed to fund their commitments. In Japan, the yield on 40-year bench-mark bonds recently fell to ¼%. Japanese investors are already moving offshore; July saw the largest one-week purchase of foreign bonds ever at ¥2.5tr.[3]

THE ASIAN IMPACT IS ALREADY EVIDENT

The impact on Asian bonds, sovereign and credit, investment grade and high yield, is already being felt. The balancing act between longer duration and higher risk is tantalizingly apparent in the sharp fall in Asian sovereign non-investment grade bond yields.

Fig.4. Investors rush to Asian sovereign bonds as the first stepping stone to yield



Source: JP Morgan Asian bond indices from Datastream as at 25 July 2016.

It takes only a little stretch of the imagination to envisage a case whereby an investor, driven by the need to buy good yielding assets. Funds will be channelled into higher yielding bonds which are balanced with a measured risk trade-off. Such choices naturally settle on higher yielding Asian sovereign-issued bonds.

But equally, the steady fall in corporate yields suggest investors acknowledge that corporate yields are attractive in relation to the extra risk.

THE MONEY WAVE RIPPLES INTO ALL ASIAN BOND CLASSES

The same forces at play in the developed bond markets can be seen at play rippling out into Asian bonds. When observing the interplay between Asian bonds and their US counterparts, it seems as if an investment shift is already underway.

DO NOT FORGET ASIAN MONETARY POLICY

The dynamics discussed above relate purely to global macro fund flows, which seem firmly in the driver's seat.

One should not overlook Asia's fundamentals. Several Asian central banks (India, Indonesia, Korea and China) have room for monetary easing. Keep in mind, also, the noted reform progress in China, India and Indonesia. It is also worth pointing out that growth in Asia (exc. Japan) remains among the world's highest.

The case for a sustained Asian bond rally looks strong.

IN A NUTSHELL

- Negative yields in developed bond markets seem set to stay as both the BoJ and ECB are poised to further open their monetary faucets.
- Yield-seeking investors are being forced to trade off longer duration and higher risk.
- The positive yield gap between US and Asian investment grade bonds could attract an attention not evident in the past.
- The interplay between Asian bonds, both sovereign and credit, and investment grade and high yield, suggest a move is already underway.
- Domestic Asian bond conditions could still see various Asian central banks cut rates. Asia's reform and growth fundamentals are superior.

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