eastspring investments

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2020 MARKET OUTLOOK

AN INTERVIEW WITH LOW GUAN YI

Low Guan Yi, Chief Investment Officer of Fixed Income at Eastspring Investments, Singapore, shares her views on bond bubble talks whilst being constructive on government bonds in Asia, especially in countries where central banks have more room to cut rates.

1 2019 has been a stellar year for bonds, prompting talks of a bond bubble. Do you agree and what are the key risks for bond investors going in 2020?

2019's strong performance in global bond and credit markets was driven by declines in government bond yields. Further compression in credit spreads, which occurred largely in the first half of the year, also boosted returns of credit markets. The Asian USD bond market has posted a double-digit gain year-to-date, while the Asian local bond market also posted a decent return despite experiencing some weakness in Asian currencies[1].

While it is unlikely for global bond markets to repeat 2019's returns in the coming year, we view talks of a bond bubble to be premature. Firstly, the US Federal Reserve has just emerged from a rate hike cycle with the last hike occurring in December 2018. US Treasury yields, despite having declined sharply this year, are still above post-crisis lows. Further, low global bond yields are symptomatic of the structurally benign inflation environment, perhaps not quite to Japan's extent, but along similar lines. With inflation consistently undershooting central bank inflation targets, exacerbated by weak growth momentum, inflation expectations are being de-anchored, thus fuelling central banks' inclination to ease further.

Nevertheless, given that significant policy easing has either been implemented or priced in by the markets, we see a key risk for bond investors to be policy disappointment. A less-than-expected dovish monetary policy stance, due to central banks falling behind the curve, or upside surprises in growth data, could potentially push bond yields higher. In negative-yielding markets, such as the Eurozone and Japan, the perceived narrowing of room for policy manoeuvre could also threaten the stability of bond markets. At the same time, the occurrence of a global recession or hard-landing of major economies, such as China, could lead to heightened risk aversion which may trigger a rout in risk markets, including global credits.

2 Do you see the possibility of more rate cuts by the US Fed? What impact will this have on your positionings?

On the back of 3 to 4 Fed rate cuts likely to be seen in 2019, we expect the Fed to potentially ease at least one more time going into 1Q 2020. US economic exceptionalism is likely to fade; the fiscal tailwinds from 2018 have started to taper off, while the on and off trade negotiations between US and China have also taken a toll on investments and continue to be a growth drag. Even if the "mini" trade deal materialises in the months ahead, it is not expected to lift the policy uncertainty given that the gap in expectations between the two countries on contentious issues, such as intellectual property protection, technology transfers, and industrial subsidies, remains very wide and is unlikely to be addressed in the phase one deal. Further increases in trade tariffs are expected to be suspended as part of the phase one deal but earlier tariffs would continue to weigh on trade flows.

That said, the strength of the US consumption economy cannot be underestimated, underpinned by a strong labour market. The US economy should also continue to enjoy support from easy financial conditions and buoyant asset markets. We expect the Fed to be on a data-watch mode, rather than engage in an outright, aggressive, easing cycle. However, growth headwinds remain significant, in our view, and the US economy is likely to get worse before stabilising, contingent on the US-China trade negotiation outcome.

We are therefore biased towards a duration overweight position but are mindful that the growth and interest rate environment will remain very fluid given elevated policy and geopolitical uncertainties globally. As such, we prefer to stay nimble and adjust our duration position actively should yields hit the upper or lower end of our expected range.

3 Given that rates look set to be low-for-longer, where can bond investors find the most value in 2020?

The long duration bias in Asian rates and bonds is still very much intact, based on our view that Asian central banks are generally willing and able to cut rates to support growth. We are therefore generally constructive on government bonds in Asia, especially in countries where central banks have more room to cut rates. This would include Indonesia, Philippines and to some extent India.

As US economic exceptionalism fades, the USD, which has held up strongly this year despite lower US yields, is likely to weaken. This sets the stage for Asian currency carry trades to do well, particularly in the high yielders – the Indian Rupee and Indonesian Rupiah. With the local currencies poised to register gains, this strengthens the case for buying into higher yielding Asian local currency bonds.

However, the weak growth environment and fragile investor sentiment should continue to see a rise in idiosyncratic risks, both at sovereign as well as corporate level. As such, while the broad interest rate environment as well as liquidity conditions should remain supportive, idiosyncratic factors could still result in divergence in performance as we have observed this year.

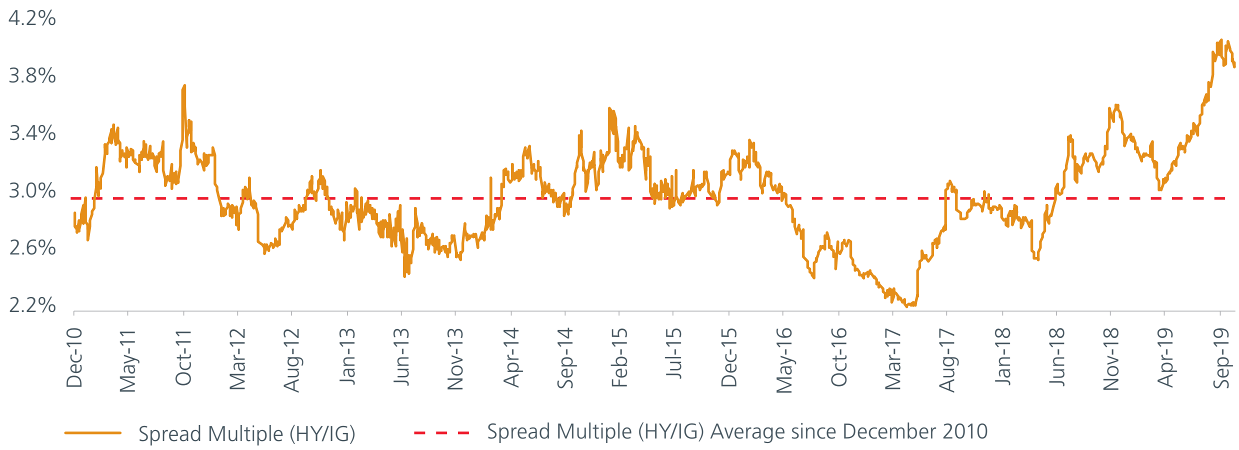
4 The quality of the US Investment Grade index has deteriorated significantly since 2008, yet yields have continued to decline, compensating investors less for much higher risk. Does the same hold true for Asian corporates?

In the Asia USD corporate bond market, all-in yields have similarly compressed in tandem with the declines in US interest rates. Further, Asian corporate earnings, as well as the credit rating migration trend, have also weakened amid the lower growth environment.

However, we still see the deterioration in credit migration trend to be at a manageable pace. Asian USD credits are entering this phase of weaker growth with generally stronger credit fundamentals as compared to the 2015-2016 period (net debt/ EBITDA is 2.2x in June 2019 versus 2.5x in December 2016), which should provide some buffer for Asian companies to weather the more challenging backdrop. In addition, the cautious investor sentiment since 2H 2019 has led to credit spread widening in the high yield sector, while spreads in the investment grade sector remain broadly stable. This has kept Asian credit spreads generally within historical ranges, while spreads of high yield corporates have gone back to levels near end of 2018 when risk aversion spiked. (See Fig 1).

Given the above, we do not see valuations, or the risk premium, to be extremely tight at the current juncture. We are, however, cognisant that refinancing needs of Asian issuers, especially China issuers, are expected to remain high in the coming year, with around USD 120 bn of China USD bonds expected to come due in 2020. We view that the market should still be able to absorb the resultant bond supply, given that over the past 3 years, Asian issuers have been able to print an average of

Fig 1: Widening spreads of Asian high yields (HY) versus investment grades (IG) is an attractive carry story[2]



USD231 bn of new issuances each year. However, the potential supply issuances could also cap potential spread tightening from here.

5 High yields bonds have been a key beneficiary of the global hunt for yield. Is there room for more upside?

Based on our take of the macro backdrop, we believe that a judicious pick-up of bond carry through high yield bonds could still add to portfolio returns. While global growth is expected to remain lacklustre, a global recession is still not our base case scenario considering the likely policy support and varied strands of domestic resilience. And given that interest rate and liquidity conditions are likely to remain supportive, bond carry should still underpin bond returns.

However, the vacillation in recessionary fears and idiosyncratic pressures could still contribute to higher volatility and defaults in the market. This warrants a selective approach, by avoiding credits that are likely to be significantly impacted by the slowing growth momentum and face more funding challenges.

Sources: [1]JP Morgan JACI Indices, Bloomberg, October 2019. [2]Bloomberg, JPMorgan; based on JPMorgan Asian Credit Index (JACI) composite and sub-indices as of 1 November 2019. Please refer to www.eastspring.com/reference-index-list for more details on the indices.