



## Discerning value in Asian bond markets

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**Low Guan Yi, Head of Fixed Income at Eastspring Investments, explains why rising inflation fears are premature, which Asian bond market segments offer the best value in the current environment and what has contributed to the team's recent awards.**

### **1. WITH INFLATIONARY EXPECTATIONS ON THE RISE, ARE YOU AS CONVINCED AS YOU WERE AT THE START OF 2021 THAT RATES AND YIELDS WOULD BE CAPPED AND HOW ARE YOU POSITIONED TO WITHSTAND VOLATILITY?**

While there is likely to be higher inflation in the first half of 2021 due to base effects and higher food and oil prices, our view remains that this will be largely transitory. Significant output gap remains globally, which will limit the extent and magnitude of price increases for both goods and wages. Beyond the short-term headwinds, structural disinflationary forces, such as aging demographics and technological advances, are also firmly in place.

With the inflationary pressures kept in check, we think rate hikes mostly remain unlikely before 2023. Labour market developments will also be the focal point for policymakers, and current divergences in economic performance—e.g. robust global industrial production contrasting with sluggish retail spending and services recovery—suggest that central banks may prefer to err on the side of caution when it comes to tightening monetary conditions. The US Federal Reserve, for example, has once again reiterated its commitment to keep policy rates through 2023 at the March FOMC meeting, despite acknowledging the improving economic outlook and a turn this year to higher inflation. We believe most Asian central banks will follow the Fed's lead with policy holds.

That said, unfortunately, episodes of sharp and sudden spikes in US real yields are typically negative for Asian fixed income assets and carry trades. Such episodes are usually accompanied by a selloff in the local currencies as well. However, we do not expect the current bout of weakness in Asian fixed income markets to be sustained given our

conviction that inflation is unlikely to get out of hand and talks of taper tantrums are misplaced. In fact, we think that with yields having adjusted so quickly, they provide more attractive entry points for long-term investors. We have thus moderately raised our duration overweight position in our flagship Asian bond funds, where compatible with their investment objectives. This is in line with our expectation of Asian bond markets' outperformance against developed markets on the back of their yield advantage. With global liquidity conditions extremely flush, investor demand for yield in the region will remain intact, especially given the region's stronger fundamentals and economic outperformance versus the rest of the world.

## 2. WHICH SEGMENTS OF THE ASIAN BOND MARKET CURRENTLY OFFER GOOD VALUE?

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Corporate bonds have outperformed government debt thus far in the recent global bond selloff. We expect overall corporate bond returns, especially high quality (not necessarily investment grades) issues in the 3-5-year segment, to remain resilient against the trend of rising rates. Within the government bond sector, 1-3-year bonds have held up well due to flush liquidity system, and expectations that central banks will maintain their accommodative policies through 2021.

In addition, the market has priced in policy rate hikes in most Asian local markets in the coming 12-18 months, which we think is an unlikely event. We thus see value in the short-end of most local government bond curves.

With Asian central banks remaining highly accommodative and supportive, we expect Asian rates to outperform US rates amid the overall rise in yields. Inflows to Asia will persist amid a reflationary market environment and improving risk sentiment. Some of these flows will find their way to Asia's fixed income markets. Structural duration demand from domestic long-term investors, such as pension

funds and insurers, will continue to support the performance of long-dated bonds.

We also think Asian high yield (HY) bonds continue to have the best risk-adjusted prospective returns in comparison with other HY markets like US HY or European HY. The lower expected default rates this year also suggest that while spreads have tightened, they remain sufficient to compensate investors for the risk. In addition, a large segment of Asian HY, the Chinese property developer credits, are now constrained by the three-red-lines reform from leveraging up excessively. This, coupled with improving global growth, should support the fundamentals of Asian borrowers in the near-to-medium term.

The recent rising onshore defaults and tightening onshore liquidity in China may trigger bouts of volatility. But we see such bouts as buying opportunities for long-term investors, bearing in mind that credit selection is key. The ability to differentiate among credits and be selective is important in the current phase of the credit cycle, which will see some companies struggle when the liquidity support provided since 2020 starts to fade.

## 3. EASTSPRING WAS THE FIRST TO LAUNCH AN ASIA FOCUSED ESG FIXED INCOME FUND. HAS THIS HELPED TO CEMENT YOUR ROLE AS AN ESG ACTIVIST TO EFFECT CHANGE WITH ISSUERS?

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2020 was a remarkable year for ESG investment flows, with JP Morgan reporting in January that total ESG assets rose to USD 7.2 trillion, more than double 2019's USD 3 trillion estimated universe. The issuance of sustainable debt—including green, social, and sustainability bonds—continues to grow rapidly, amid strong demand from ESG-conscious investors.

As to our role in the global transition to socially responsible investing, there are important differences regarding issuer engagement between fixed income

and equity investing, such as debt investors not having voting rights. However, this is not to say we cannot play our part in influencing corporate behaviour. Some of our regular efforts include identifying material ESG risks during our analysis, highlighting those risks to the issuers, and holding them to certain expectations in addressing those concerns.

Our team leverages on our well-resourced credit research members to undertake active engagement of issuers within our investible universe. For instance, our twelve-member strong research team conducts over 500 meetings a year, identifies room for improvement, takes every opportunity to communicate our ESG concerns and effect meaningful changes in issuer behaviour. Even prior to the launch of our Sustainable Bond strategy, the evaluation of governance risks had been a key part of our research process. This process is now formalised within an ESG framework, which provides us with a more structured approach to address these issues, with further inputs provided by external ESG data providers such as MSCI and Sustainalytics.

#### **4. WITH CHINA AIMING TO BE CARBON NEUTRAL BY 2060, ESG CREDIT OPPORTUNITIES ARE EXPECTED TO GROW SIGNIFICANTLY. WHAT IS YOUR COMPETITIVE EDGE IN THIS SPACE?**

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Eastspring's Fixed Income team has a strong Asian credit franchise. Our flagship Asian credit strategy has half of its benchmark index comprising of Chinese issuers, thus the team is well acquainted with Chinese credits. Understanding ESG risks and opportunities in China comes from deep insights into the country's underlying credit markets. Our close connectedness to this part of the market is therefore our biggest strength.

This goes back to our well-resourced credit research team, which allows us to cover the entire

investment opportunity set within Asia. Credit analysts covering specific sectors and issuers are also responsible for assessing their ESG risks. Our in-depth understanding of company and industry dynamics helps us identify ESG issues and seek out opportunities arising from emerging ESG trends. A case in point is the recent acceleration of policy trends towards climate action, and the attendant increased investment interest in the renewable energy and electric vehicle sectors. We believe climate transition is a long-term theme, as more governments back the urgency and science behind limiting carbon emissions. With China pledging to achieve carbon neutrality by 2060, Chinese issuers will rally behind the government's ambitious targets and include green initiatives in their business plans.

Additionally, the green infrastructure push in Asia should continue to gain pace. The Asian Development Bank estimated that Asia's infrastructure needs from 2016 to 2030 would exceed USD 26 trillion, including USD 14.7 trillion in the energy sector and USD 8.4 trillion in transportation. Financials and real estate are the other major sectors that are likely to propel green financing innovation.

#### **5. THE MOST RECENT HOUSE AWARD WINS ARE A TESTAMENT OF THE TEAM'S EXPERTISE. TO WHAT DO YOU ATTRIBUTE THESE ACHIEVEMENTS?**

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The team has contributed to these wins by consistently applying a multi-factorial investment approach, focussing on fundamentals, valuations and the technical analysis of the markets we cover. The accolades and growth in our assets under management is thus a recognition that we are a steady pair of hands with a proven track record of navigating the ups and downs of the Asian bond markets.

Having said that, we are by no means resting on our laurels or fixed in our ways; we constantly ask

ourselves if we are capturing the prevailing risks and opportunities adequately, whilst remaining open to fine-tuning our investment process. For example, during the Trump presidency, geopolitical risks and their impact on global financial markets rose significantly. We dialled up our analysis of these risks, engaging in discussions with sell-side analysts and third-party advisory firms to analyse potential risk scenarios from different angles.

The growing emphasis on sustainable investing, and its consequent impact on investors' funding behaviour, has also inspired us to adopt a more structured framework in assessing ESG risks of bond issuers. This dovetails with our view that ESG risks will increasingly drive price differentiation as Asian bond markets mature.

Within the team, we have deliberately sought to enhance diversity with the aim of widening the team's collective perspective; the team is made up of 21 investment professionals with good representation across demographics, nationalities and gender. We have team members of different nationalities, which help expand the language and cultural understanding of the team. In addition, 30% of the team members are women with a number of them occupying senior roles in the team.

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