Asian bonds: Building blocks for resilient portfolios

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Against an uneven global economic recovery, Asia appears set to recover faster than the rest of the world. As developed market bond yields stay low, Asian bonds offer investors attractive yields, quality and diversification – the building blocks needed to build resilient portfolios in a post-covid era.

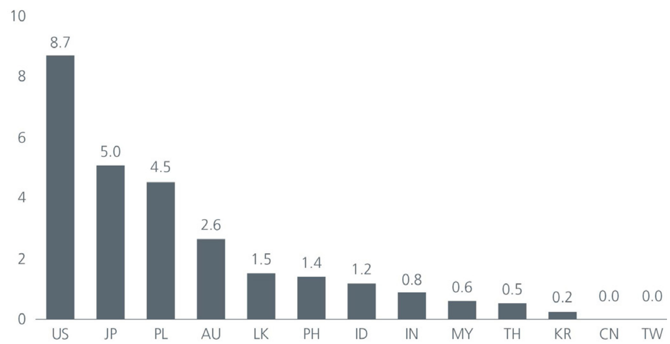
Developed market government bond yields sank to record lows this year as central bankers moved swiftly in March to slash interest rates and launch bond-buying programmes to counter the economic fallout from the pandemic. With global central bankers keen to keep interest rates and bond yields low, investors face the prospects of near-zero or negative returns from the safest debt. The amount of negative yielding debt has reached USD15.5tr[1] globally.

Against this backdrop, investors can cast their nets wider and look to Asian bonds to meet their desired investment outcomes. The diversity in Asia's bond markets means that Asian bonds can offer investors attractive yields, quality and diversification, helping them to build more resilient portfolios that are needed in a post-COVID era.

QUALITY – ON FIRMER GROUND

Compared to developed market peers, Asia entered the pandemic with healthier debt dynamics, although country differences exist. While Asian policymakers have also implemented stimulus measures to counter the adverse economic impact of the pandemic, Emerging Asia's central bank purchases of government securities to date are nowhere near the scale of the developed markets'. See Fig 1.

Fig 1: Central bank purchases of government securities year to date (% of GDP)



Source: CEIC. Haver. Citi Research. August 2020.

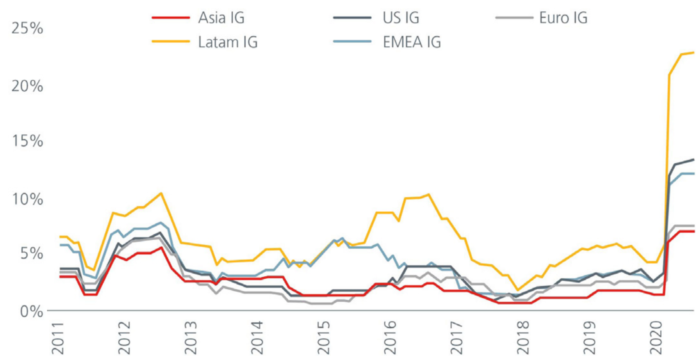
Source: [1]Bloomberg. As of 2 October. Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value.

Given healthier balance sheets and higher yields, it is not surprising that Asian sovereigns such as China Government Bonds enjoyed inflows from foreign investors in the last few months. On the other hand, foreign ownership of Indian and Indonesian sovereigns has fallen on investor concerns over the countries' rising fiscal deficits and increasing new bond supply. The bifurcation in the market clearly highlights the need for active management.

Not only are Asian governments' balance sheets in a relatively better shape, the credit metrics of Asian Investment Grade (IG) corporates also compare favorably against their developed market peers. The net leverage ratio for Emerging Market IG corporates stood at 1.6x in the last 12 months, significantly below their US (2.4x) and European (3.9x) counterparts[2].

When market volatility rose in March as the COVID-19 pandemic unfolded, Asian IG corporates were notably less volatile than their global counterparts. Fig 2. This is partly because state-owned enterprises, which are more likely to receive government support during a downturn, make up a significant portion (~25%) of Asian IG issuers.

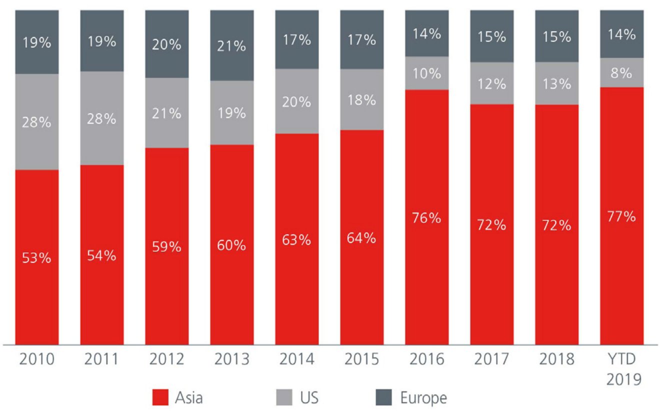
Fig. 2: Excess return volatility for Asian IG credits vs other regions



Source: ICE Data Indices LLC, BofA Global Research.

At the same time, the growing domestic investor base for Asian bonds over the last ten years has provided greater stability for the market. Asia-based investors, largely made up of local pension funds, insurance companies and mutual funds, now account for more than 75% of new USD issue supply, up from 53% in 2010. Fig. 3. These investors help provide a cushion against capital flight from investors outside the region during periods of risk aversion.

Fig. 3: Asian bond market new USD issuance – investor distribution by geography



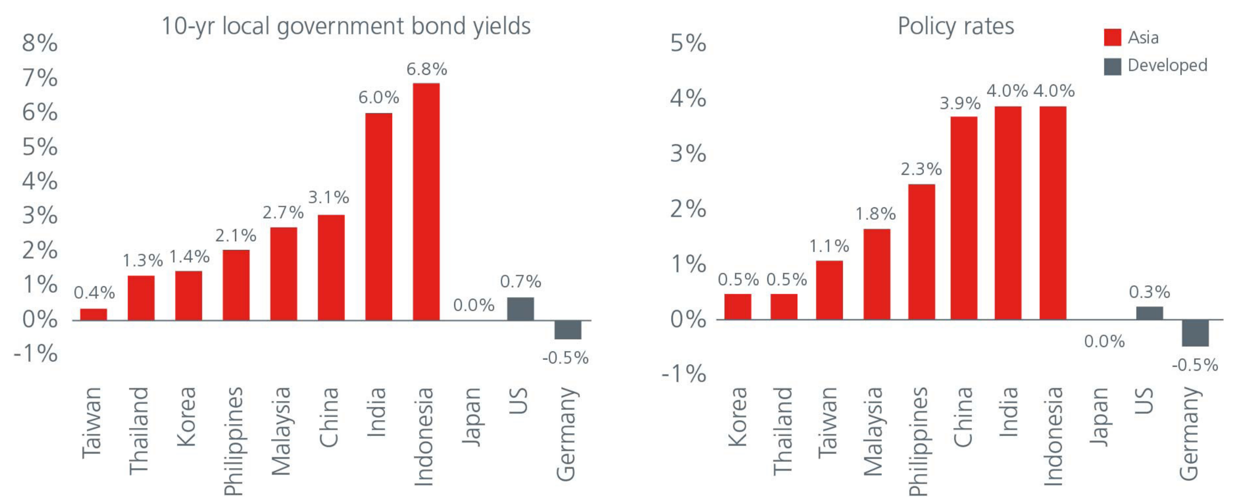
Source: Dealogic, BofA Merrill Lynch Global Research (2019 as of July data).

YIELDS – ATTRACTIVE

Asian government bond yields are currently yielding more than their developed market counterparts. Fig. 4. At the same time, although many Asian central bankers have cut interest rates as the coronavirus pandemic unfolded, policy rates are still higher compared to the developed markets Fig. 5. This suggests that Asian central banks have further room to ease if required, which can help underpin their bond markets. That said, we expect most Asian central banks to keep their powder dry for now and focus their efforts at ensuring that financial conditions remain conducive for the private sector.

Source: [2]JP Morgan, Bloomberg. Last 12 months incorporate partial 1Q20 earnings. For EM, utilising an evolving set of external bond issuers with debt outstanding and excluding 100% quasis, financials, real estate and defaulted companies.

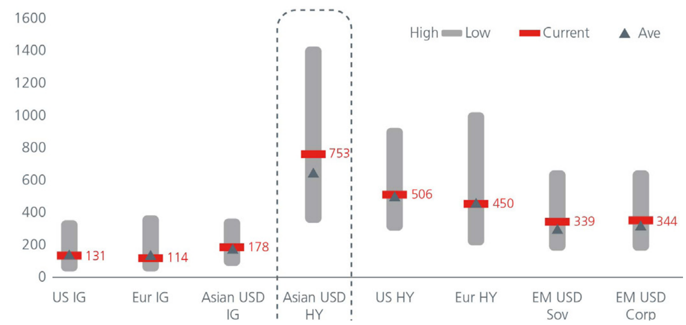
Fig. 4 and 5.



Source: Bloomberg. September 2020.

The higher yields from Asia's high yield (HY) corporate bond market have attracted increasing investor interest over the years. Asian HY bonds returned 7.3% p.a. over the last 10 years, surpassing the returns from US (6.7% p.a.) and European (5.7% p.a.) HY bonds. Although the yield differential between Asian and US HY bonds has narrowed following the rally in March, Asian HY bonds still provide attractive carry. At the point of writing, Asian HY spreads are averaging 753bp, more than the 505p spread offered by US HY bonds. More importantly, these spreads are still above their 10-year average, suggesting that there is still room for Asian HY spreads to narrow further. Fig. 6. Historically, investors entering the Asian HY bond market at yields between 7% to 8% have enjoyed a median return of 7.1% over a rolling 3-year period.

Fig. 6: Spread to worst (bps) over the last 10 years

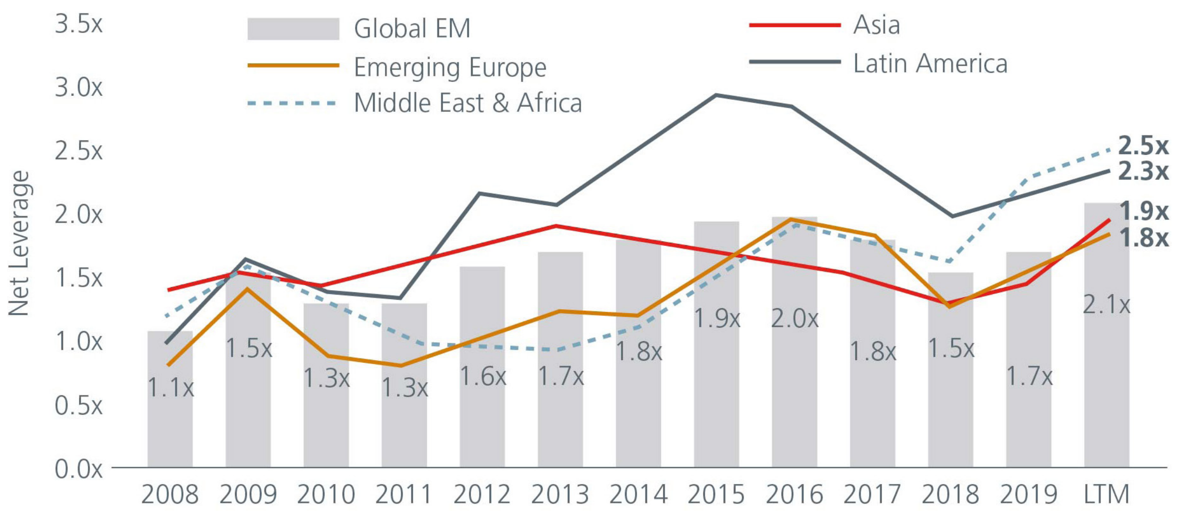


Source: Eastspring Investments, Bloomberg, as at 31 August 2020. US, EUR and Asian USD Investment Grade and High Yield corporates represented by ICE BofA US Corporate Index, US High Yield Index, Euro Corporate Index, Euro High Yield Index, Asian Dollar Investment Grade index, Asian Dollar High Yield index respectively. EM USD Sovereign and Corporates are represented by JPMorgan Emerging Markets Bond Index Global and JPMorgan Corporate Emerging Markets Bond Index respectively.

While the current economic environment remains challenging, it is encouraging to note that the net leverage ratio of Asian HY bonds stands at 1.9x, lower than other regions within the Emerging Markets. See Fig. 7. We are likely past the worst in terms of rating downgrades within the Asian HY bond market. That said, still-poor liquidity conditions within the Chinese industrials and selected Indonesian property issuers suggest that investors need to remain highly selective in order to avoid the potential flashpoints in the market. The default rate in the Asian HY bond market stands at 2.2% to date[3] and may reach a mid-single digit level by the end of the year. This compares favourably against

Source: [3]Eastspring Investments. As of end August 2020 and calculated as a percentage of total bond outstanding amount.

Fig. 7: Net leverage of HY bond sectors – Asia vs other Emerging market regions



Source: JPMorgan, Bloomberg, Capital Q. For EM, utilising an evolving set of external bond issuers with debt outstanding and excluding 100% quasis, financials, real estate and defaulted companies. LTM includes partial 2Q 20 results.

Asian HY's default rate of 9% in 2009 and is also lower than the US HY sector's expected year-end default rate of 8%.

DIVERSIFICATION – LOW CORRELATION EXPOSURES

The diversity of Asian economies, currencies and domestic drivers within the Asian bond market implies that Asian bonds can offer global investors significant diversification benefits. This is especially so in the current environment where the low bond yields from developed markets may only provide investors limited diversification in their multi asset portfolios.

China is one of the few large economies that has not carried out quantitative easing this year. As such, investors can enjoy attractive carry from **China bonds** and enhance returns by exploiting its yield curve. Even global bond investors can enjoy added diversification benefits from Chinese bonds. China currently accounts for only 6% of the Bloomberg Barclays Global Aggregate Bond Index. In contrast, US, Japanese and European bonds jointly make up more than 70% of the Index. There is clearly room for foreign ownership of China government bonds to rise above its current level of less than 3%, especially if global central banks seek to diversify their USD holdings over the longer term.

Meanwhile, with the Federal Reserve (Fed) keeping a lid on the level of the US Treasury yield through its bond purchase programme, the USD has become the pressure valve for investors to express their concerns over the US' rising twin deficits. The USD has also lost its yield advantage with the Fed keeping interest rates low. The Asian Dollar Index has gained 5%[4] since its trough in March. Further USD weakness would be positive for Asian currencies, giving active bond managers an opportunity to generate additional returns. If the RMB continues to stabilise, this would help to anchor Asian currencies going forward.

Source: [4]Bloomberg. As of 2 October 2020.

ESG – RISING IMPORTANCE

Beyond the desire for income, quality and diversification from their bond holdings, **ESG considerations** are also becoming increasingly important for investors. In a series of COVID-19 seminars organised by the United Nations Principles of Responsible Investment (UN PRI), 92% of participants indicated that sustainability discussions are a "must" when fixed income investors engage with issuers.

We believe that ESG evaluation can potentially improve long term portfolio performance through identifying and managing the downside risks associated with material ESG risk exposures that issuers face. The availability of data to perform meaningful ESG analysis remains a key challenge, but this is not a challenge unique to Asia. The silver lining is that Asian issuers are aware of the increased emphasis investors have placed on ESG metrics and are responding to increased demand for ESG-related performance data.

That said, even with greater information disclosures, the need to interpret ESG data means that active managers have an important role to play. This is especially so for social and governance issues that may be more difficult to quantify. Our large credit research team undertakes extensive ESG analysis using our **proprietary ESG evaluation framework.**

BUILDING BLOCKS FOR GREATER RESILIENCE

We are probably past the troughs of the economic downturn caused by the pandemic but the global recovery going forward will be uneven. Asia is likely to return to its pre-covid level of activity earlier than the rest of the world. China, Taiwan and Vietnam are already standouts, helped by how well their governments have managed the outbreak to date.

We believe that Asian bonds offer investors a compelling value proposition. For investors looking for quality, Asian investment grade bonds offer healthy credit fundamentals and relative stability. Yield seeking investors on the other hand can enjoy Asian HY's attractive yields but with historically lower volatility compared to its peers. Meanwhile the prospects of a weaker USD suggest that Asia's local currency bonds can offer additional returns and greater diversification. However, the bifurcation in the market suggests that investors would need to actively manage their duration, sector and currency exposures.

We think institutional investors are in the early days of increasing their allocation to fixed income, akin to the risk-reduction exercise we saw post the Global Financial Crisis in 2008. We expect the Asian bond market to benefit from this shift.

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