

Bond investing in Asia: Peaking bond yields present unique opportunities

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Peaking bond yields, measured rate hikes in Asia and still healthy credit fundamentals among Asia's higher quality corporates present investors with an attractive entry point to the Asian bond market. As China growth risks recede, we are likely to see flows return to Asian bonds, further supporting prices.

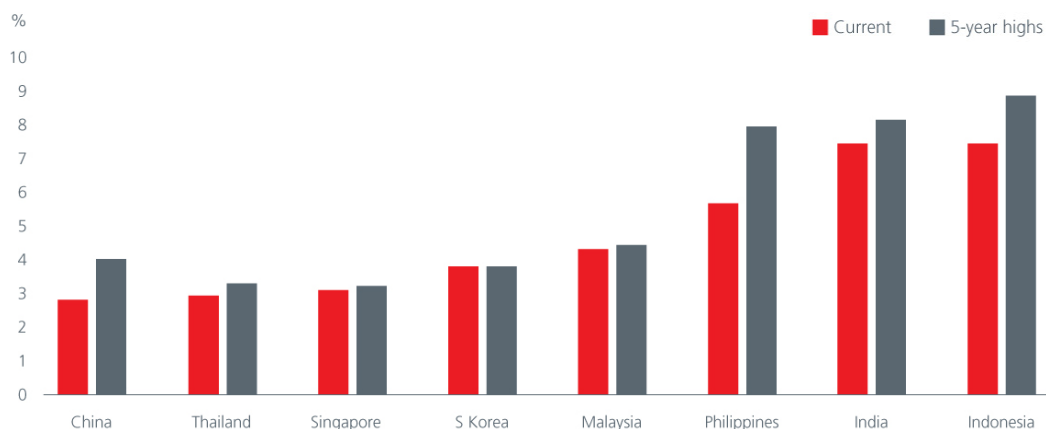
Rising global inflation and interest rate hikes have caused global bond prices to reprice swiftly in 2022. In June, the Federal Reserve undertook its biggest interest-rate hike since 1994. From just 1.5% a year ago, the US 10-year Treasury yield has crossed 3% at the point of writing, the highest in ten years¹. While Asian bonds were affected by the rise in US

yields, China's growth slowdown in the first half of 2022 had further weighed on investor sentiment towards Asian and Emerging Market assets.

We note that most local currency 10-year bond yields are currently close to their five-year highs, and many have exceeded previous highs during the 2018 Fed hiking cycle. Fig. 1. We believe that Asia's higher bond yields today offer investors an attractive opportunity to gain bond exposure.

Meanwhile, the steepness across most Asian yield curves relative to their historical averages suggests that it is viable for investors to add longer duration bonds to their portfolios.

Fig. 1. Asia local currency government bond yields



Source: Eastspring Investments. Bloomberg. As at 20 June 2022.

Source: ¹28 June 2022. Bloomberg.

If market risk sentiment stabilises and improves, which we expect, we would likely see Asian bond returns enhanced by the higher yields and more attractive credit spreads.

WE MAY BE PAST THE WORST FOR THE CHINESE ECONOMY

China's economy needs to stabilise in order for investor sentiment, especially sentiment towards Asian assets, to improve. On this front, Chinese policy makers have announced greater fiscal support in the form of tax cuts. Infrastructure investment will also be an important growth driver. Chinese state-owned policy banks have been asked to set up a RMB 800 billion (USD120 billion) line of credit for infrastructure projects. In terms of monetary easing, the People's Bank of China has cut the reserve requirement ratio, loan prime and mortgage rates. Further easing can come from liquidity injections, targeted credit support and further cuts.

Stabilising the real estate sector, which accounts for 20-25% of China's GDP, is important for the Chinese economy. While contracted property sales continue to register sharp year on year declines in May, higher quality developers saw smaller declines. Sales may pick up as lockdowns ease and consumer confidence returns. The People's Bank of China has also been encouraging high-quality China property developers to acquire property projects owned by the distressed developers. This can help lower the default rate in the sector. We expect more aggressive easing and support measures in the real estate sector in the second half of the year. These are likely to include a relaxation of pre-sales proceeds by local governments, and further easing in mortgage and home purchase restrictions in Tier 1 cities.

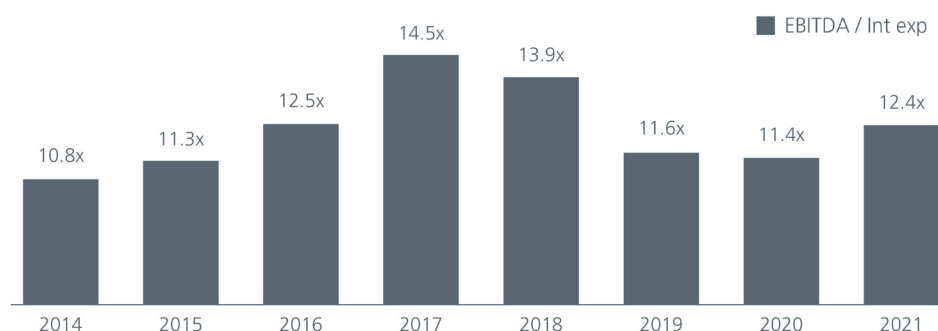
As such, we may have moved past the worst for the Chinese economy in the second quarter of 2022, but it would take time for the counter cyclical measures to be reflected in the real economy. Meanwhile, the Chinese Renminbi should be more stable in the second half of 2022. Consistent with a supportive economic policy, the Chinese authorities are likely to want a stable currency as well. This should in turn help to anchor the region's currencies.

STILL HEALTHY CREDIT FUNDAMENTALS FOR HIGH GRADE CORPORATES

Trade volume growth was already softening even before the US Federal Reserve started to hike interest rates. With the decline in COVID restrictions globally, consumption is likely to continue to shift from goods to services. Against this backdrop, Asian economies with large domestic populations are expected to fare quite well relative to the more trade-dependent Asian economies. The ASEAN economies should continue to benefit from their delayed reopening: this should be especially positive for Thailand whose economy is highly reliant on tourism. Commodity exporters like Malaysia and Indonesia should also see strong GDP growth in 2022.

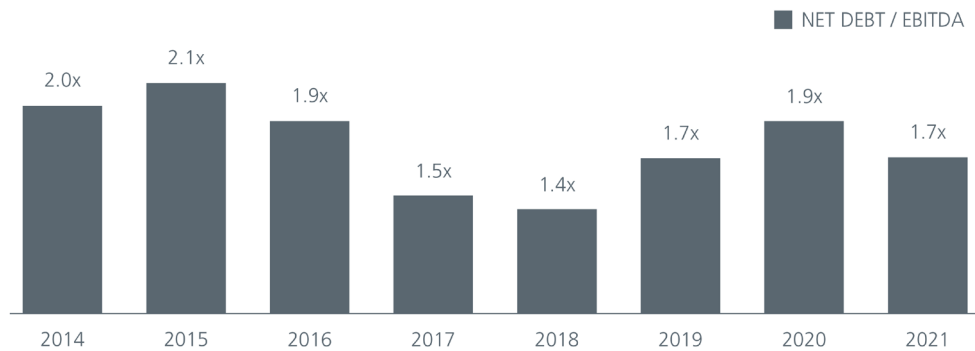
We note that corporate fundamentals, particularly among Asia's higher quality companies, have remained healthy. In fact, leverage and interest coverage ratios are largely back to pre-COVID levels for Asian Investment Grade corporates. Interest coverage has improved on the back of lower borrowing costs. See Fig. 2. Net debt/EBITDA has also fallen, implying that Asian corporates are requiring less time to pay off their debt. See Fig. 3.

Fig. 2. Interest rate coverage has improved



Source: Bloomberg Finance L.P. J.P. Morgan. April 2022.

Fig. 3. Asian high-grade corporates paying off debt quicker



Source: Bloomberg Finance L.P. J.P. Morgan. April 2022.

Given still healthy corporate balance sheets coupled with wider spreads following the Asia bond market's sell off year to date, the risk return profile for Asia investment grade credits is improving.

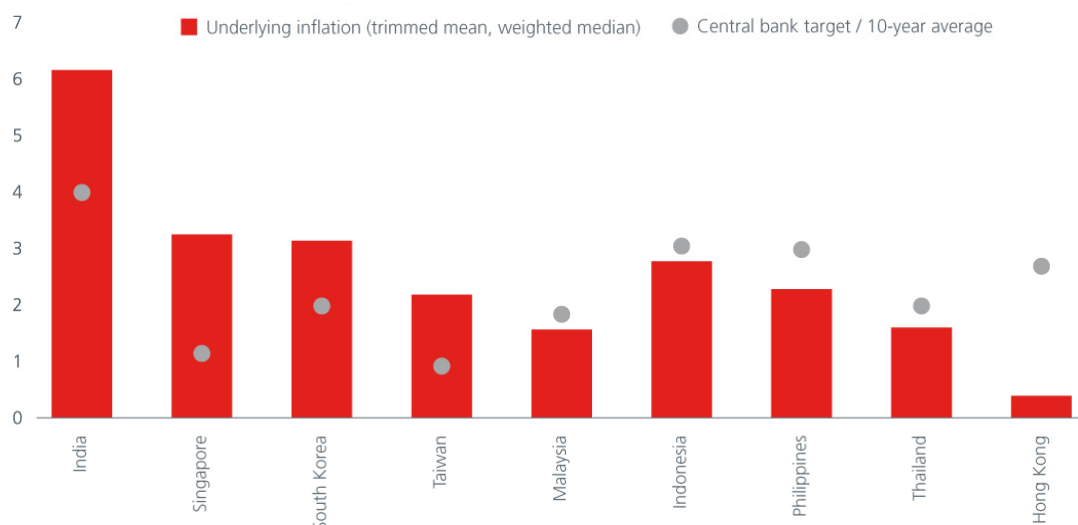
RATE HIKES IN ASIA ARE LIKELY TO BE MORE MEASURED

Higher commodity prices from supply chain disruptions, rising energy prices and reopening pressures have lifted inflation across Asia. Inflation is above central bank targets

in Singapore, South Korea and Taiwan – higher income economies which have mostly managed the COVID outbreak better and have brought economic activity back to or above potential. Fig. 4. Accordingly, the central banks in these economies have also been among the first in the region to have tightened their monetary policies.

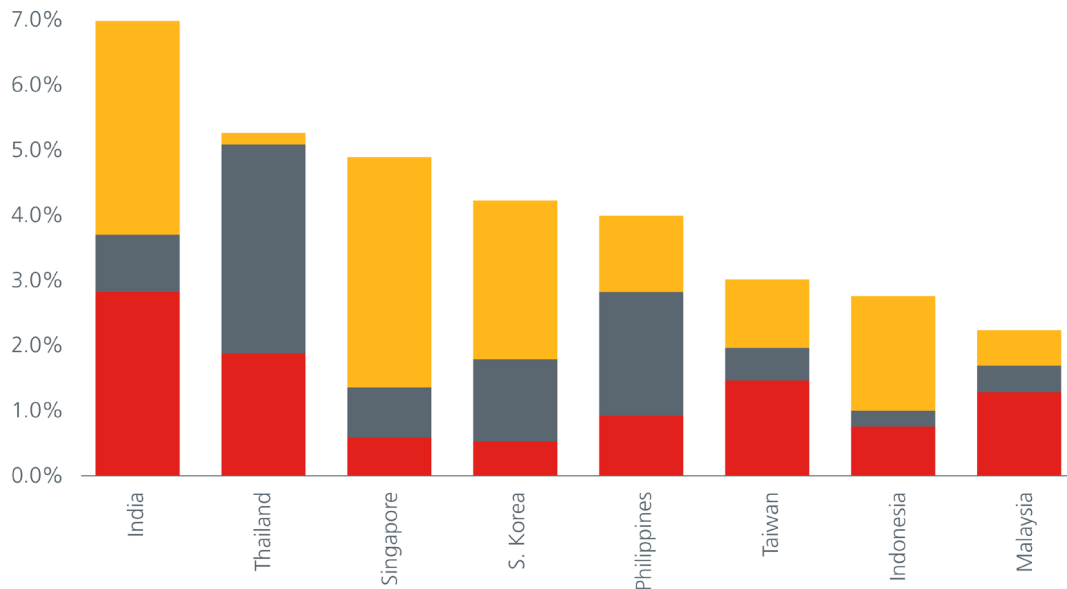
India, Indonesia, Malaysia, Philippines and Thailand were previously struggling with the Delta variant but now, with higher immunity levels and declining social distancing restrictions, policymakers are refocusing on inflation. While

Fig. 4. Inflation versus central bank targets



Source: CEIC and Nomura Global Economics. May 2022.

Fig. 5. Contribution to headline inflation, last 3-month average



Source: Deutsche Bank, CEIC. May 2022.

the pace of rate hikes is picking up in Asia, Asian central banks are likely to be less aggressive than the Fed. The weight of food in the inflation basket in the region is 3-4x larger than for fuel. See Fig. 5. With supply disruptions responsible for the rise in food prices, higher interest rates are unlikely to be effective in bringing prices lower. Therefore, Asian central banks are likely to respond to supply-driven food inflation with non-monetary measures such as subsidies. Nevertheless, the rise in food prices and the impact on inflation bears monitoring.

Meanwhile, inflationary pressures in the US may peak as US growth momentum slows. Although a 2023 US recession is currently not our base case, we note that the Citi U.S. Economic Surprise Index declined in May as key economic data came in below consensus. The market may eventually moderate its expectations on the magnitude of future Fed rate hikes.

Inflationary pressures from supply chain disruptions could also ease in the US, as consumption shifts from goods to services as economies re-open. Energy prices could be tempered by weaker demand as well as by an increase in US shale output. Finally, one of the key drivers of inflation in the

US – used car prices – is moderating as auto production rises. A peak in inflationary pressures will cap US and in turn Asian bond yields.

A UNIQUE OPPORTUNITY FOR BOND INVESTORS

Peaking bond yields, measured rate hikes in Asia and still healthy credit fundamentals among Asia's higher quality corporates present investors with the potential for more attractive returns and diversification. As China growth risks recede, we are likely to see flows into Asian bonds, further supporting prices. The divergence in the macro, inflation and currency outlook within Asia also presents active investors opportunities to enhance returns through duration management, credit selection and currency bets.

This is the last in our series of eight articles which examines the different investment strategies investors can adopt to tap on the opportunities that are emerging in Asia.

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