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INSIGHTS

Asian Bond Opportunities in 2013

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Asian credit markets posted impressive returns in 2012. Spread tightening, coupled with yield compression were the main performance drivers. With valuations no longer as compelling, will Asian bonds continue to outperform in 2013?

Our take is that Asian bonds continue to provide investors with more attractive yields compared to developed market bonds, while fundamentals of Asian economies and corporates remain relatively sound. Although bond valuations of Asian USD-denominated bonds are not considered cheap at current juncture, the pickup in yields over the risk-free rate accounts for a significant percentage of total returns, and amply compensates for the expected level of default risks.

Similarly for the Asian local currency bond markets, local government bonds still offer higher yield opportunities than that of developed government bonds. Unlike the developed markets, there remain Asian markets where real interest rates are positive. The theme of Asian currency appreciation vis-a-vis the US dollar could also continue to play out given Asia's strong economic fundamentals. Moreover, as the profile of the various Asian currencies differ, an Asian multi local currency fund approach can harness value. Currency is one of the three drivers of returns in a local currency bond fund. For instance, the Indonesian rupiah depreciated 7% in 2012[1], but Indonesian bonds had a capital gain of 13% in local currency terms[1], so the bond gains more than offset the currency losses. Investing in a multi-currency bond fund also allows for risk diversification. The fund manager can be overweight on safer currencies such as the Hong Kong Dollar and the Singapore Dollar in times of market uncertainty, and be overweight on higher beta currencies such as the Korean Won and the Malaysian Ringgit when risk appetite is supportive.

All said, the benefits of investing in bonds are best achieved over the longer-run rather than attempting to time the market. Both investment grades and high yields offer diversification within a broader investment portfolio, which is an important attribute in any given market cycle.

Source: 1 Bloomberg, January 2013

1. We all know that the Fed will eventually reverse its easy money policy. Do you think it will be in 2013 or 2014?

Chairman Bernanke commented recently that it could taper down its bond purchase program at one of its "next few meetings" if the economic data continues to improve. The timing of the actual tapering down of the QE3, however, remains highly uncertain as it is dependent on the Fed's assessment of whether there is real and sustainable progress in the labor-market outlook. The outlook of the latter, while showing signs of positive trend, is still susceptible to potential drags from the ongoing fiscal consolidation and a still-nascent economic recovery.

Even in the event that the tapering of QE3 does happen within the year , the longer term implications on the US interest rate markets may also not be so straight forward. For one, growth rate in the US remains tepid. There remains some way to go before the unemployment rate falls to the Fed's threshold of 6.5%[2] and inflation expectations are still well below 2.5%[2]. This tepid economic environment is likely to help the Fed hold on to its guidance to keep its policy rates at ultra low levels and keep the interest rates anchored at the short end of the curve at least for this year.

2. Given that the team view is for rates to remain low, what are the specific attractions for each segment?

David : Asian USD credits could continue to deliver decent returns given the relatively stable macroeconomic backdrop and low default rates. In 2012, returns were mainly driven by lower US interest rates and tightening of credit spreads.

This year, spread compression will likely be moderate given the less compelling valuation following 2012's sharp rally.

I therefore see "carry" as a major source of return for Asian USD credits this year and will look for yield enhancement to the portfolio, but in a defensive way. Although there has been some selling pressure on Asian USD credits due to recent volatility in the US interest rates, we think that the carry theme would continue to play out once investors look beyond the short-term "noise".

We see value in Greater China names over the more tightly priced Korean counterparts in the investment grade space, and favour Chinese property issues over industrial credits in view of their better risk-reward profile.

Guan Yi : Asian local currency bonds fared well in 2012, bolstered by the lower interest rate environment in Asia. Returns were also boosted by the sovereign rating upgrades of Indonesia and South Korea.

In 2013, the scope for further policy cuts by Asian central banks seems limited given Asia's moderate growth outlook and the recent stabilization in economic indicators in the US and China. But there remain opportunities in selected local bond markets. In India, further policy rate cuts are expected and it may also avert a rating downgrade if the reforms are pushed through. The Philippine local bond market could continue to hold up well despite the strong rally year-to-date on the back of flush domestic liquidity. Sentiment in the market is also likely to be underpinned by the sovereign rating upgrade by S&P and Fitch.

The recent volatility in currency markets not withstanding, we still expect to benefit modestly from Asian currency appreciation against the US dollar this year, especially for markets which enjoy strong current account flows.

Source: 2 Monetary Policy Releases, May 2013

Finally, I would like to add that the demand outlook continues to favour Asian local currency bonds in the longer term. The higher yields offered by the higher quality Asian government bonds compared to the developed markets continue to attract strong inflows. There is a growing demand for Asian bonds from institutional investors, such as insurance, central banks and sovereign wealth funds, as they diversify away from the lower-yielding fixed income holdings into Asian bonds. Within Asia, the structural demand for long-dated bonds is increasing as Asian insurance/pension funds grow and have greater need for such bonds to fulfill their capital requirements.

Danny : 2012 was a good year for Singapore dollar bonds. A combination of spread compression between corporate and government bonds and the yield pick up from corporate credits provided the fillip for Singapore bonds.

In 2013, Singapore credits should continue to hold up well, although there now is lesser room for further spread tightening.

Nevertheless, I still expect Singapore dollar bonds to perform largely in line with the market's longer-term historical growth trend of around 3%[3], an attractive rate compared to the interest offered on fixed deposits. Moreover, issuers in the Singapore dollar corporate bond space are highly recognizable names to investors as they are likely to be listed companies or well known multinationals operating in Asia Pacific.

3. As yields fall, it becomes more attractive for companies to raise capital. Do you think that the better 2013 returns will be achieved via yield strategies or "playing" new issues?

David : Within the Asian USD credit space, we expect to see strong issuance in 2013 as companies continue to take advantage of the low interest rate environment to build up the war chest for future growth or to refinance more expensive debt, although overall issuance is expected to be slightly lower than that of 2012. We do expect the hefty issuance pipeline to present some opportunities, but patience and selectiveness are the keys. Investors should look for meaningful pricing concession at issuance or wait for weakness in price actions after launch amid the glut of new supply.

Guan Yi :Corporate bond issuance in local currencies has picked up in recent years. Singapore dollar corporate bond market was the leader in 2012 with issuance growing by more than 30% over the previous year[4]. Besides Singapore, other markets are also picking up, such as Malaysia, Indonesia and the Philippines. I think this will offer investors more opportunities to derive value in the corporate bond space.

Danny : 2012 was a record year for new issuance in the Singapore dollar bond segment. The market witnessed robust participation by both new and existing issuers. Foreign issuers also boosted the volume as many now consider the Singapore dollar as an attractive funding option due to favourable government initiatives to boost the bond market.

Given last year's hive of activity, we are unlikely to achieve similar volumes in 2013. The pipeline does not appear as strong as last year, as most companies have met their financing needs and continue to be well served by loan markets.

Nonetheless I expect there to be a number of new issues over the year, due to issuers' refinancing requirements.

3 Bloomberg, Eastspring Investments (Singapore) Limited, based on annualised 10 –year return of HSBC Singapore Bond Index
4 Asianbondsonline, in USD, March 2013

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