MARKET INSIGHTS

ASIAN USD BOND 2015
A HALF YEAR REVIEW

JULY 2015

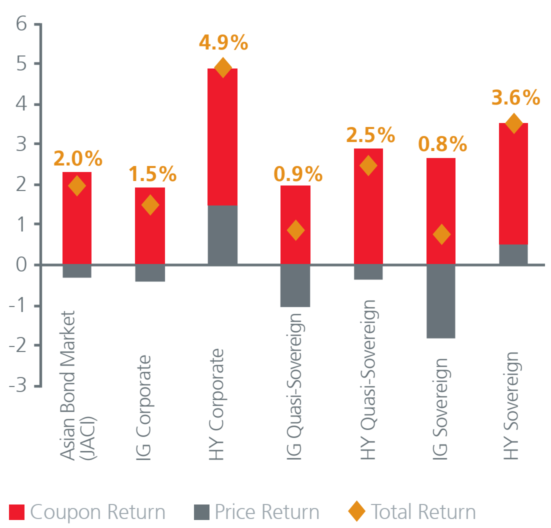
Asian USD-denominated bonds generally delivered a positive return in the first half of 2015, underpinned largely by coupon income. This was in spite of a volatile US interest rate environment and see-sawing investor sentiment. The broad Asian USD bond market rose 2%[1], while outperformance was seen in the high yield sector which gained 4.8%[2].

The relatively strong performance of the Asian high yield sector belied a rocky start when credit spreads spiked amid negative headline news on China; slowing growth concerns, sales suspension of selected property projects and debt woes of a Chinese property developer, Kaisa Group, spooked investors. Falling oil prices and volatility in Asian currency markets also weighed on investor sentiment. The negative impact from spread widening, however, was offset by declines in US interest rates, which were driven by disappointing US economic data and lower global inflationary pressures.

Market sentiment reversed subsequently in the second quarter of 2015. Stabilisation of oil prices and a more optimistic US economic outlook fuelled expectations of an imminent rate hike by the US Federal Reserve (US Fed). A sell-off in the European government bond markets in late April also pressured US interest rates higher, reversing the declines seen early in the year. In contrast, investor appetite for Asian credits improved as the negative newsflow on Chinese property market abated and easing of property restrictions and monetary policy in China bolstered sentiment. The flush liquidity conditions too continued to support demand for yield; this was reflected by the generally well-received new issuances in the Asian credit market.

Against this volatile backdrop, the direction of Asian credit spreads was generally mixed across sectors over the first half of 2015. Spreads were generally tighter in the Asian high yield corporate sector (particularly Chinese high yield property credits) amid a strong rally since February, while modest widening of credit spreads was seen among investment grade corporates. The impact of US interest rate changes was relatively muted, although the moderate rise in long tenor US interest rates weighed on the performance of longer-dated credits such as investment grade sovereigns, which generally have a longer duration profile.

Fig.1. Year-to-date Asian Bond Market Return Attribution (%)



Source: JP Morgan Asia Credit Index, as at 30 June 2015.
Note: IG = Investment Grade, HY = High Yield.

[1,2] Represented by JP Morgan Asia Credit Index as at 30 June 2015.

US RATE HIKE FEARS TRIGGER MARKET TURBULENCE

With the US economic recovery regaining momentum, markets are rife with anticipation over an impending US Fed lift-off. We expect a hike in the third quarter of 2015 which will likely be felt across all asset classes. Investors, however, seem to have priced in a fourth quarter rate hike.

At the same time, the US Fed has also been cautious with its forward language, reasserting that its stance remains dependent on the strength of economic data. Since the start of the year, data releases have been mixed; US inflation and wage prints are weaker than they were at the start of the three most recent Fed tightening cycles. On the other hand, jobs growth is solid, a trend that is expected to continue. This has triggered uncertainty over central bank guidance and turbulence in the financial markets in recent weeks.

ASIAN CREDITS, HOWEVER, LARGELY HELD STEADY

In fact, Asian credits have outperformed its US and European counterparts year-to-date despite the continued sell-off in US Treasuries and European sovereigns. Demand has also remained solid for new issues despite ongoing heavy issuance and a robust supply pipeline. We maintain our positive view on Asian credits and do not expect rate hikes to adversely affect the performance of the asset class to a significant extent over the longer term. Our convictions stem from the following reasons:

1. Asian credits have historically shown resilience in a rising rate environment.

Rate hikes generally occur during an economic up-cycle and credit spreads, or credit risk premium, usually narrow to partially offset the rising rates. At the same time, the "carry", or higher coupon income, of Asian credits would help to partly absorb the impact of rising rates.

On top of this, the yield premium offered by Asian USD credits remains wide despite the gradual maturation of Asian bond markets; Asian investment grade corporates currently offer an estimated yield pick-up of 20 - 50 bps over similarly rated US corporates, while the pick-up of Asian high yield corporates averages around 100 - 200 bps.

We believe that this will underpin Asian credit outperformance against US credits going forward, especially as we do not expect a sustained increase in Asia's risk premium in the longer run.

2. Asian corporate funding costs are more aligned to Asian rate cycles than the US.

The onshore market remains the main funding avenue for Asian corporates. This means that funding costs for Asian corporates are impacted more by changes in the local interest rates, rather than the US. While the global rate cycle was highly synchronised before 2008, it is important to note that US and Asian economies are now on different growth and monetary policy trajectories. The tightening bias of the US Fed contrasts with Asia where central banks have generally eased policy this year. As such, we expect funding costs for Asian corporates to remain largely manageable given still-accommodative local interest rate environment in Asia.

3. Broader and deeper captive investor base in Asia.

One of the often-cited concerns for risk assets is the sizeable foreign ownership and the subsequent risk of capital outflows. However, most Asian USD bonds are increasingly placed and held in Asia. Versus other emerging markets, Asian corporate bonds have a deeper local investor base where most of the debt is bought and traded by investors who are somewhat captive to the segment.

BUT AN INDISCRIMINATE SELL-OFF COULD STILL OCCUR WHEN THE US FED FINALLY HIKES RATES

While the fundamentals imply potential resilience of Asian credits against higher US rates, heightened investor nervousness over the uncertainty of US Fed's actions and other factors at play may result in temporary dislocations for the asset class. New developments, for example, continue to unfold in Greece. A disorderly outcome of the debt negotiations could still trigger spikes in risk aversion which could result in volatility in Asian bond markets. A more aggressive than expected hike from the US Fed would also lead to market turmoil.

SUCH DISLOCATIONS, HOWEVER, ARE LIKELY TO BE SHORT-LIVED IN OUR VIEW

As Asia is a net importer of oil, the fall in crude oil prices this year has reduced inflationary pressures and boosted growth prospects for most of the region. Asian policy makers have also taken this opportunity to strengthen their fiscal position through subsidy reductions and tax collection improvement. In addition, positive structural reforms have helped the region continue on a stable or positive rating migration trend, while economic growth in Asia, albeit facing some headwinds, also remains significantly higher than the rest of the world. Furthermore, we believe China is able to step up its monetary easing policies and fiscal stimulus programs to help achieve stable growth, and the rest of the region would benefit from this.

Nevertheless, default rates of Asian credits are expected to pick up moderately and specifically in China, as authorities appear more comfortable in allowing failing issuers to default. We do not view this negatively but instead believe that this would instill greater market discipline and allow authorities to reallocate capital more effectively within the economy. As such, our overarching theme for differentiation remains. Security selection is key in driving excess returns, and we maintain our focus on companies or countries that are deemed better equipped for a slowdown.

OUR STRATEGY AND POSITIONING

We are more constructive on longer-dated investment grade corporates where the credit spread curve remains steep despite robust credit metrics. Nevertheless, we are mindful of their sensitivity to US Treasury yield volatility and may hedge out the interest rate risk if needed. While credit fundamentals are weakening in the high yield corporate space as a whole, there are still pockets of value opportunities. We favour credits which have decent credit profile but, due to headwinds against their respective sectors, lag behind the market or trade at wider credit spreads than similarly rated credits in general. This includes credits in the Chinese property sub-sectors and oil-related names.

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