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ASIAN BONDS: Expectations for 2015

Summary	Investment Conclusions
Asian USD bonds have YTD outperformed all bonds, EMK and developed (Chart 1, yellow, red) Given that the pursuit of yield is still in place, risky Asian High Yielders (HY, green) did well in 2H.14 but slipped in October versus Investment Grade (IG, blue) Asians. However Asian bonds in local currency (LCY) continued to be some of the best global performers with the extra return over USD bonds reflecting their forex risk. Rather than repeat the platitudes of the expected higher volatility in the bond markets in 2015, we stick with the belief that yield seeking will continue in 2015 and Asian bonds (risk adjusted for those in LCY) will still outperform the rest.	Even if the Fed starts hiking in 2015, the yield differentials of Asians over the UST will likely be maintained because of the sound macros of the former. We do not expect that local Asian rates will follow lockstep USD rates. Hence LCY Asians may lose some of their relative attractiveness especially if the their forex risk rises. A way of reducing the risk of Asian bonds in a "global" portfolio would be to increase the share of IG Asians, despite their relative recent underperformance versus their Asian HY counterparts, but given the inherent greater risk of HY (see ratings discussion)

Asian bonds, the Fed and local central banks

Asian bonds whether in USD or LCY terms have, in general, outperformed in 2014 bonds of developed economies in hard currencies. It is likely that this outperformance will continue in 2015. Consider:

Asian central banks, for a very long time now, run their monetary policies on the basis of domestic considerations and not on some putative link to UST yields. **Higher USD yields will not necessarily mean lower LCY Asian bond price**s. Consider that **China** last cut rates in July 2012, **Taiwan** has not changed official rates since it hiked them in June 2011,**India** last hiked in January 2014,**Indonesia** in September 2013, while **S.Korea** last cut rates in October 2014 as did **Thailand** in March 2014. Both **Philippines and Malaysia** hiked rates in September and in July 2014 respectively. **Hong Kong's** rates will follow those of the Fed because of the HKD peg while **Singapore** has no official rates but a guided forex policy instead. In sum, in the last the 2-3 years while the Fed was following a very loose policy, and since May 2013 a policy with a tightening bias, Asian central banks, raised, cut or left rates unchanged. **The impact of higher UST yields may also have a differentiated impact on Asian USD bonds.** Although it is true that all USD bonds are priced off the UST yield curve, it is equally true that not all Asian economies have the same risk premia.Higher UST yields in 2015 will not necessarily impact all Asian USD bonds equally. Of the outstanding Asian USD issuance of USD 611 bl (2Q.14), China acounted for USD 154 bl, S.Korea 122 bl and Hong Kong USD 85 bl. Hence the USD Asian issuance is dominated by three economies with no major domestic or external economic issues,and with two economies with inflexible forex rates, China and HK.

Chart 1: USD Bonds, All (red),Asian (yellow), Asian IG (blue), Asian HY (green),2013=100

Source: Bloomberg

Balancing the risks

The chart in the Factbox illustrates the historic and recent trend of ratings. In the course of 2014 downgrades tended to dominate upgrades with the majority of the downgrades being concentrated in HY bonds. There is considerable concern over the leverage of Asian corporates and the likely impact on their balance sheets of the higher USD rates in the course of 2015.There is even more concern over the level of debt in China with alarmist stories circulating of an impending crash triggered by the property sector. We have addressed all these issues in previous Econotes and suffice here to recap briefly that China may suffer from corporate and even sectoral bubble bursts, but it is nearly impossible to envisage a systemic crisis. An economy with enormous external surpluses and a global net lender position, with a supposedly undervalued CNY, a small fiscal deficit all domestically financed and with a state-owned banking system which is relatively underexposed to the property sector, plus capital controls, just will not become overnight the US in 2008-9, let alone Argentina or Greece. Bottom line is that Asian bonds will be hit by real and imaginary threats once UST yields rise, but their impact will be cushioned by their wide differences of exposure to USD interest rates. The issue of Asian bonds in LCY is different because of the impact of a stronger USD on Asian forex rates, leaving always aside China,and its quasi-pegged exchange rate, and the HKD peg. But even here current market performance points to some of these issues being of less importance to investors.

FACTBOX: Asian rating trends 2004-2014 (S&P)

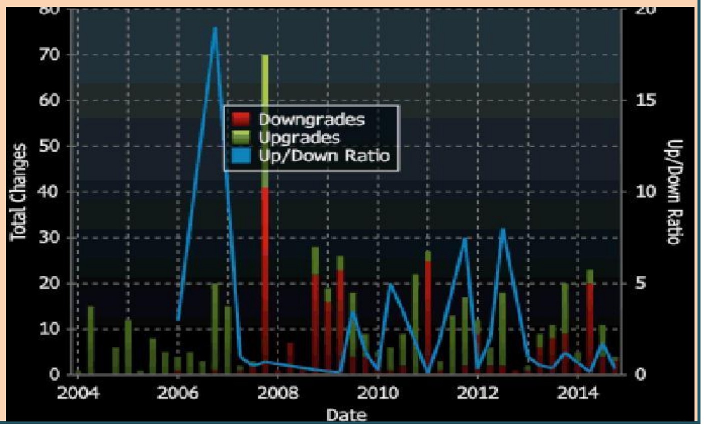

Chart 2: Asian IG CDS, 2014

Source: Bloomberg

Where does this all lead ?

All USD bonds will feel, in different degrees, the impact of higher UST yields. Asian USD bonds start with a strong position of outperformance in 2014 going to 2015.Some market indices are pointing to caution, such as the rating trends. Chart 2 shows that the CDS for IG Asian bonds having spiked during the October mini-crisis are now coming down but not yet to the pre-crisis levels. The pursuit for yield is likely to continue during most of 2015, even if 2Y UST go from a present 0.52% to a consensus forecast of 1.66% at yearend 2015 while 10Y UST rise more modestly from a current 2.33% to an expected 3.37%. HY bonds may perform better than Asian IG bonds in 2015 propelled by the impetus of their post-October recovery. We do suggest, however, to add IG Asians to a portfolio which contains HY Asians in order to maintain some of the yield but reduce the risk.Same caution should be exercised towards LCY Asian bonds, at least till after 1H.14, given the possibility of further Asian forex weakness as the markets adjust to the stronger USD.

Andrew Freris

(writing completed on 6/11/2014)