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Asian interest rates and USD interest rates and yields

Summary

We expect that the US Fed will not hike in 2016, not just because of the poor labor data but primarily because the global reaction in the rest of 2016 to a hike will harm US assets and the US economy which, in any case, is not performing well. Movements in short and long-term USD rates do not influence local Asian rates except in Hong Kong. Asian forex rates have not moved in any systematic way versus the USD to raise concerns that the current falling trend in Asian short rates will be reversed. A hike will affect USD Asian bonds, but that is a different story. Local short-term rates and yields will stay on a falling trend but concerns over China's credit market may impact sentiment aided by Asian corporate downgrades.

Investment Conclusions

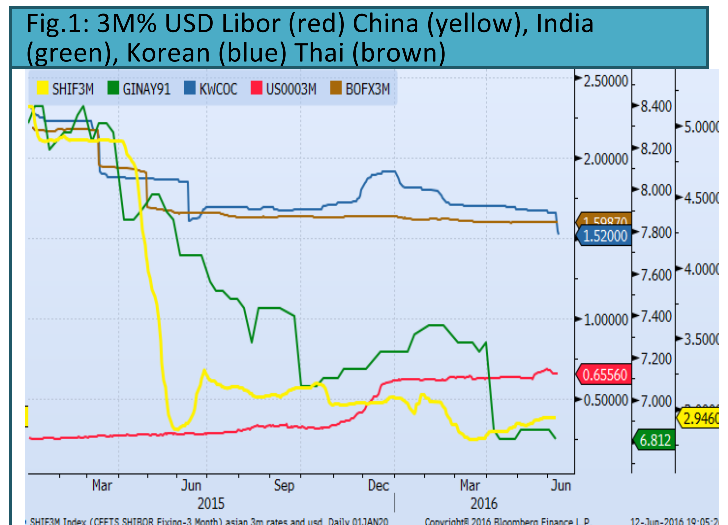
All Asian central banks have in the last 12 months either cut or kept their rates steady. Asian short rates did not react to the Fed's first hike in December 2015. (Fig. 1) Similarly, Asian longer term bond yields (here govies to represent Asian IG bonds) did not move with UST and will unlikely to do so in 2016.However the markets are obsessed with concerns over a credit crisis in China and of the deceleration in growth in some Asian economies. This fear is quantified in the relative rise in downgrades of Asian corporates. The local Asian yield curves could steepen as Asian short-term rates fall, but focus should remain on local currency IG shorter term paper.

USD and local Asian rates: Nice not to know you !

At the risk of pointing the totally obvious, a country with a relatively open economy, few or no capital controls and a fairly flexible exchange rate, will have interest rates which reflect primarily domestic considerations, such as expected inflation, cyclical phases etc. If the interest rates are low (high) versus some other rates, then exchange rate movements will even out the comparative (dis)advantage. If the exchange rates are not allowed to move, then the domestic credit system and economy will need to adjust, including moves in interest rates. Most Asian economies do have these outlined characteristics and, hence, as long as their exchange rates move, their interest rates have no reason to follow the ups and downs of USD interest rates. The exceptions here are HK with its USD peg which means that HKD rates are linked to USD rates, and China with a quasi-pegged exchange rate and capital controls supporting relatively inflexible interest rates.

Back, or rather forward, to the Fed now. If the Fed hikes, the USD may strengthen and if Asian central banks do not like that, they may have to hike rates as well. But what they actually do, tells us exactly the opposite. In the period since October 2014 when the Fed ended QE, Asian central banks have been actively cutting rates, not increasing them. Clearly any subsequent or consequent Asian exchange rate movements were not of importance. Different Asian economies are on different phases of their cycles. China has cut rates because it wished to arrest the deceleration of its economy, India because inflation fell, while S.Korea combined looser monetary with fiscal policy to support its industrial and export sectors badly hit by the G3 slowdown. As Fig.1 shows, after the Fed hiked in Dec.2015 (see the red USD Libor jump), Asian 3M rates shown here either stayed flat or fell, but none of them changed trajectory to a consistent rise.

Fig.1: 3M% USD Libor (red) China (yellow), India (green), Korean (blue) Thai (brown)



Source: Bloomberg

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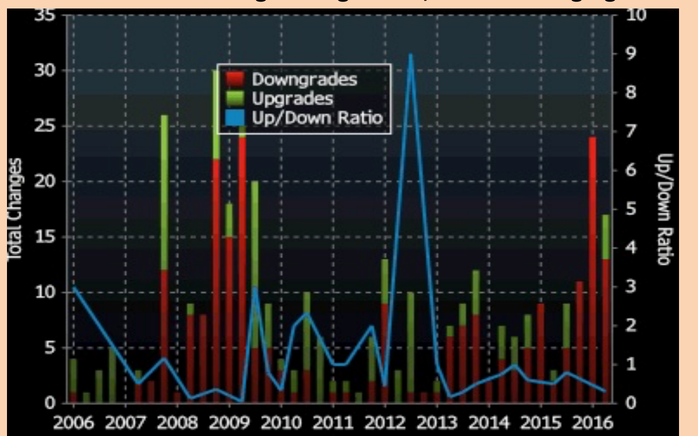
The long end of the curve and the risks therein

The volatility in the 10Y UST during 2015 to date, is not reflected in the yields of the developed and developing Asian govies (Fig.2.)The trend of longer terms IG yields in Asia as represented by these four classes of bonds, is flat to declining.Inflation is not a major issue in most, if not all, Asian economies and oil and some commodity prices have seen to it that it is unlikley to be so for the rest of 2016 and into 2017.Fiscal policies in all Asian economies are mostly supportive, especially in S.Korea and,for a spell, in China but this is within the generally conservative fiscal enviroment in Asia.China's steep rise of corporate credit has been of obsessive concern.It is always forgotten that the major four banks in China, which may be exposed, are majority state owned, the small fiscal deficit (about 3.0% of GDP) is domestically financed and the shrinking, but still enormous, forex reserves of USD 3.2 trillion will imply that a banking crisis

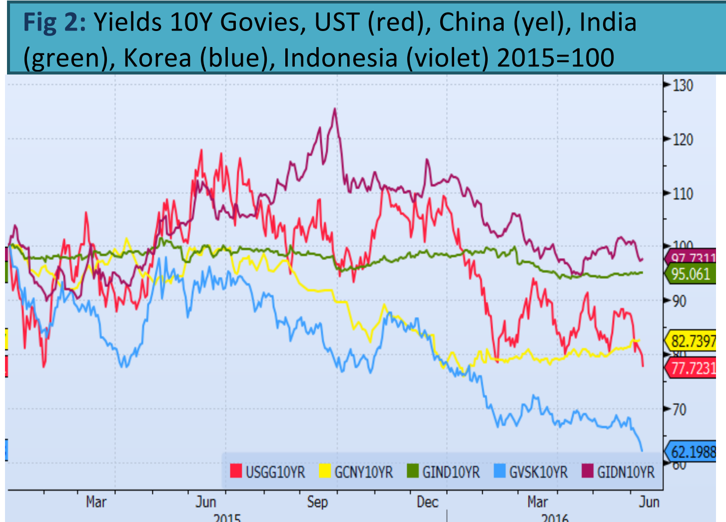
FACT BOX: Asian Ratings changes YTD, not encouraging!



Source: Bloomberg.

will not be an external crisis, as China is a net global lender, but would be a fiscal issue as the banks involved belong to the government. Individual corporates and smaller privately owned banks may come to grief, but this is unlikely to lead to a systemic crisis. More important, however, is the picture in Asia with the Fact Box showing S&P's YTD corporate up and downgrades. The trend in Asia is negative with 4 up and 37 downgrades, hence the U/D blue line is falling to 0.10, with Asia comparing poorly to Japan where there have been 3 up and 5 downgrades (U/D at 0.60). The US comes with a U/D of 0.39 (192 up and 486 downgrades) and Western Europe tops with 0.81 (76 up and 93 downgrades). If ratings are any indication, there are possibly cyclical warnings in Asia, and credit news from China will not be helping sentiment either.

Fig 2: Yields 10Y Govies, UST (red), China (yel), India (green), Korea (blue), Indonesia (violet) 2015=100



Source : Bloomberg

And now for the investment conclusions.....

Official Asian interest rates have been mostly declining or flat during a period that the Fed made repeated statements about, and finally hiked, rates in December 2015. There was no reaction at all in local Asian interest rates and neither have there been any significant moves in the 10Y Asian govies, however imperfeclty these might be representing Asian IG bonds in general.

We do not believe that the Fed will hike in 2016 and, hence, there will be even less reasons for Asian short term rates to reverse their trends. The link between the USD and Asian forex rates (except for Hong Kong and progressively less so for China) is too tenuous and unsystematic to influence the trajectory of local Asian rates.We expect that Asian central banks will mostly keep rates flat till yearend 2016 and, if there is any move, this would be to cut notwithstanding Fed's posturing or even action.It would now follow that Asian longer term yields will stay on a falling or flat trend. However,the worsening outlook in terms of Asian corporate downgrades should keep investors focused on high quality paper. But this would be the outcome of sectoral and microecocomic reasons and not because USD rates may rise again!

Andrew Freris (writing completed 12/6/2016)