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Asian Fixed Income: What future in a rising rates environment?

Asia Investment Advisors Limited

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Executive Summary

- After 5.8% in 2016 and 2.3% so far in 2017, Asian dollar bonds are likely to continue to deliver a positive return of about 3% for 2017, despite the potential rise in US interest rates
- Base case: 10y Treasury yields to rise to about 3%. Asian IG spreads likely to end up within +/- 20bp of current levels and HY spreads are likely to widen by 5-75bp.
- Reasons: Seach for yield; Reasonable macro environment; strong economic growth in Asia (better than other EMs); rising institutional investment in Asia; low default outlook
- Key risks: Very tight valuations; macroeconomic imbalances in China; faster-than-expected slowing of China; unexpected pickup in US rates; rising idiosyncratic risks in Asian bonds

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Outlook for 2017: The Macro and Market Factors

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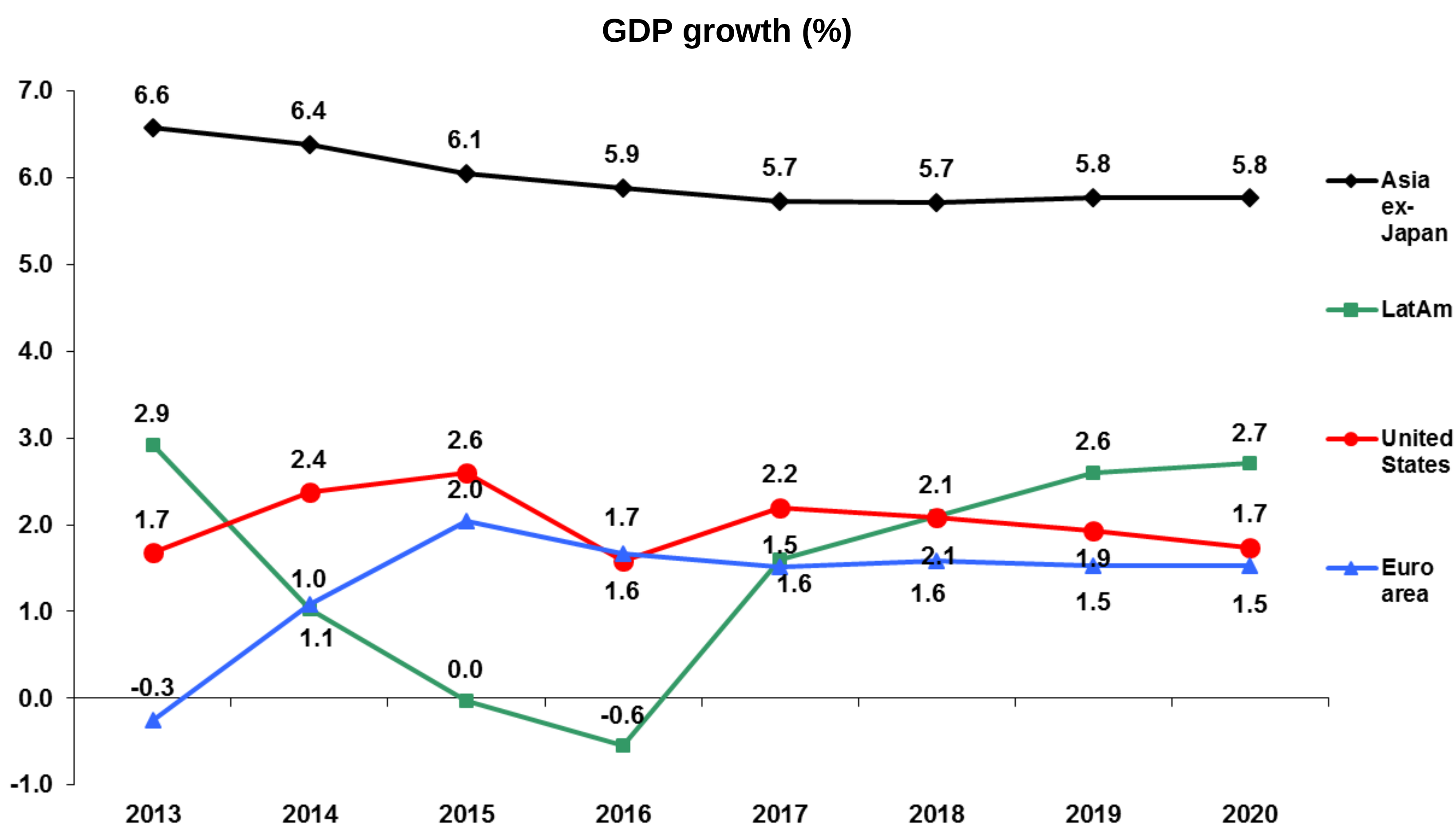
Asia: Still growing strongly



Source: IMF

Economic backdrop: China and India

China

- IMF expects China to slow to 6.2% in 2017, and then to 6% in 2018 and 2019: “Soft landing”
- Economic growth propped up by credit infusion; total credit close to 300% of GDP
- Challenge of rising capital outflows
- Property construction has been a key support, but property prices unsustainably high and regulatory action has begun to control them
- Government still has fiscal leeway
- Potential trade tensions have quietened

India

- Key beneficiary of lower oil prices: lower inflation and current-account deficit
- Responsible budget for FY2018
- Lower interest rates paused, but may continue in 2H
- Growth to stay in a range of 7.6-8.0% (IMF)
- Key constraint: Health of the banking system

Economic backdrop: Asia vs. EM

Asia

- Asia ex-Japan to maintain growth at 5.7% (IMF)
- Asia is a key beneficiary of moderate oil prices
- Asian growth to outshine other EM

EM

- IMF expects LatAm to recover from -0.6% to +1.6%, but that depends on commodity prices and its ability to manage USD borrowings against a rising USD
- EE steady at 3%, Russia uncertain

Asian bonds: Market factors (1)

Asian ratings

- Sovereign ratings stable; coming to the end of the upgrade cycle
- Indonesia upgrade to IG by S&P not likely soon due to EM risks
- Corporate ratings are peaking, although not likely to see a raft of downgrades

Balance sheets

- Asian corporate leverage has risen
- Significant improvement in Chinese property sector fundamentals, but regulatory action to curtail prices likely; but China's economic slowdown likely to affect other sectors
- Commodity recovery has supported some corporate balance sheets

Defaults

- Global HY defaults to pick up modestly. Moody's forecast: 3% by end-2017. Energy sector default concerns have waned
- Asian defaults likely to inch up but not proliferate

Asian bonds: Market factors (2)

New issues

- New issue volumes have remained strong in 1Q2017. Likely to continue strong in 1H, but volumes in 2H depend on interest rates and macro risks
- Asian support for new issues solid. Chinese banks help support Chinese issuers.

Asset allocation

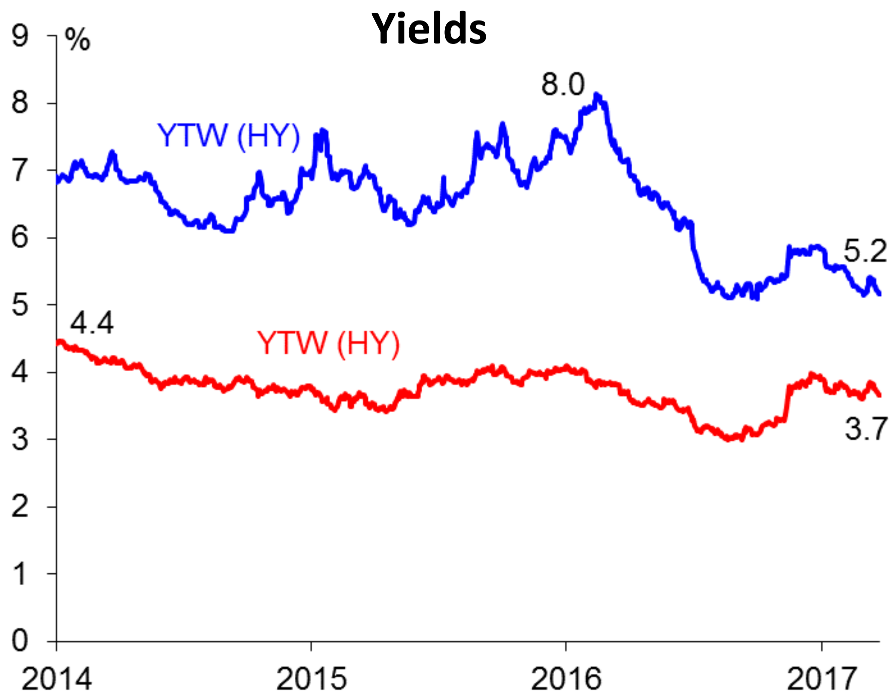
- Private-wealth investors have already started reducing their participation; may continue to do so in 2017
- But institutional funds in Asia are taking up more of Asian issues

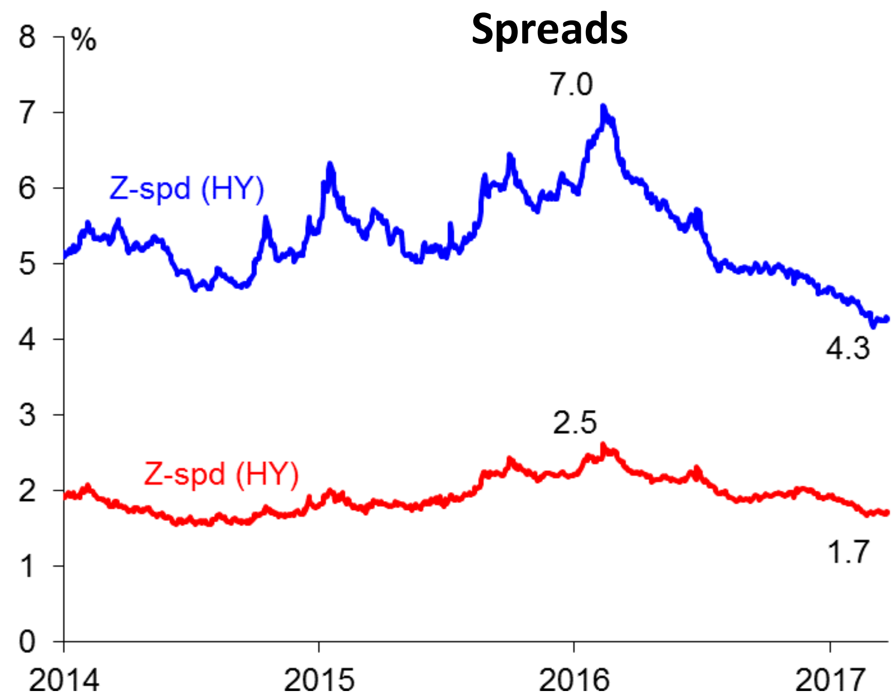
Multiple risks ahead

Oil and commo-dities	▪ Range-bound oil prices positive for Asian economies ▪ Stable commodity prices good for Asian corporate issuers
Europe	▪ European growth limping back higher ▪ Brexit impact has yet to materialise
Geo-political	▪ ISIS ▪ US political, trade issues
China	▪ China maintaining growth at the cost of higher macro imbalances ▪ Geopolitical and trade developments matter
Asian credits	▪ Default rate likely to inch up; idiosyncratic issuer risks rising; although overall defaults may not proliferate, individual bonds could lose significant value

Asian yields and spreads: Compression since 2014

- Asian yields and spreads have both declined since 2014, but the compression in HY is significantly higher





Source: JACI,

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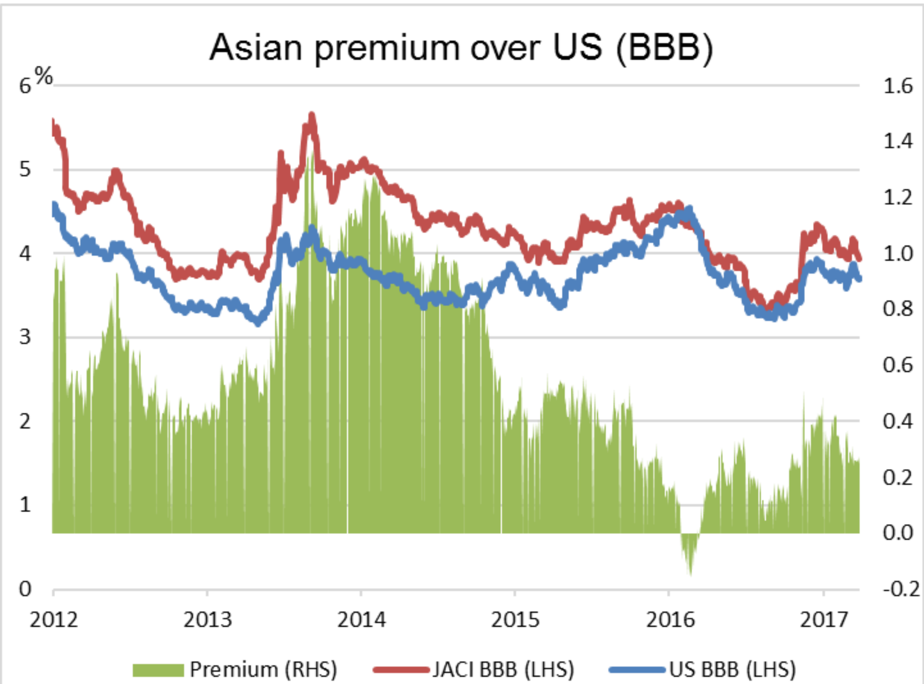
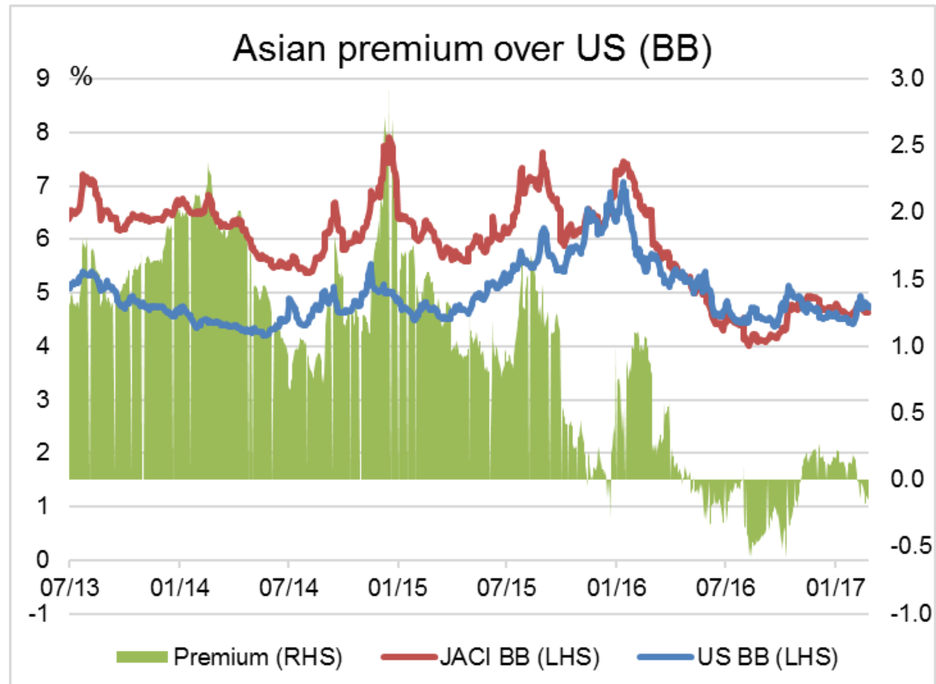
Asia vs. US: Reaching tight levels for HY

- Asian premium over US has declined to very low levels for both IG and HY
- The premium does not support aggressive investment in HY in particular





Source: JACI, Merrill Lynch Indices

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Putting it all together

Positives

- Positive economic picture in Asia:
  - Still reasonable GDP growth
  - Asian growth >> EM growth
  - Beneficiary of stable oil prices
- Peaking of sovereign rating and corporate rating cycles
- High but stabilizing corporate leverage
- Institutional investor support from Asian funds

Concerns

- Extremely tight valuation
- Global political and trade issues
- China imbalances
- Unexpected pick-up in US rates
- Higher default rates and idiosyncratic risks in Asian bonds

The punchline: Technicals outweigh the fundamentals

Spreads and returns

- Asian IG spreads likely to end up within +/- 20bp of current levels, but HY spreads could rise 50-75bp from here
- If 10y Treasury yields rise 50bp in 2017, Asian bond returns could be 2-4% for the year, or about 1% for the rest of the year

Positio-ning

- Despite the higher HY spreads, IG to outperform HY due to rising risks
- Stay wary of lower-quality HY: Refinancing likely to get more difficult
- Strategy: Overweight IG and higher-quality HY

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