Schroders

2010: A year in Asian bonds

How Phuang Goh, Head of Asia (ex Japan) Fixed Income, looks ahead to 2010

- Global governments and central banks took unprecedented measures to avert a meltdown in the financial system and evidence now suggests that an economic recovery is underway in Asia
- However, since the global economic recovery is unlikely to be smooth, we believe that Asian bonds, in particular credit, and currencies will encounter increasing levels of volatility during 2010
- With limited refinancing pressures and solid banking sectors in Asia, the scale of the next correction in risk assets should be relatively modest, and should present opportunities to add to credit, particularly in high yield.

Concerns over the underlying health of the global recovery (subdued G3 final demand, global excess capacities, western deleveraging, unsustainable Chinese credit expansion and infrastructure spending) abated throughout 2009 as economic growth proved more resilient. This was mainly due to the unprecedented levels of fiscal stimulus, injections of liquidity and loose monetary policy implemented by governments and central banks worldwide.

Against this background risk assets rebounded from lows experienced in early 2009 as liquidity-driven rallies fuelled by global zero-interest-rate policies led to huge global portfolio rebalancing in favour of emerging market currencies, including Asia. This helped to lift Asian currencies (the ADXY Index, measuring a basket of Asian currencies, rose 2.2% during January to October 2009).

In terms of commenting on the outlook for Asian bonds during 2010, it is necessary to look at three separate areas – currencies, interest rates and credit.

Currencies

We expect the US dollar to remain driven by general risk appetite and, looking further ahead, by an envisaged policy divergence between different central banks – we believe several Asian central banks such as Korea, India and possibly even China may start to nudge local rates up slightly sometime during the first half of 2010. While the US dollar has longer-term structural concerns, such as its diminishing role as the world's reserve currency and structural fiscal deficits, there is no risk of a confidence crisis in the near term, judging by continued healthy foreign participations in US treasury auctions.

In the near term, with 'risk appetite' at 'euphoric' levels and risk assets lingering at 2009 highs, the consensus is already very bearish on the US dollar. In our view, this has increased the probability of a US dollar bounce, most likely in tandem with an eventual risk asset correction. The giant US dollar-carry trade has benefitted emerging market (including Asian) currencies. However the risks of such crowded trades should not be underestimated in coming months as global 'exit' strategies are phased in, the impact of fiscal stimulus gradually rolls over, and the industrial cycle peaks at a time when expectations about economic growth and corporate earnings in 2010 have become increasingly bullish.

Longer-term, we remain positive on the outlook for mild Asian currency appreciation relative to the US dollar. Mild because Asian central banks will, as usual, be actively intervening in the market to prevent excessive appreciation since Asian economies will need time to undergo a smooth transition away from their historically export-dependent model. The Taiwan dollar is a clear example where there has been persistent central

Schroders

"Asia's solid banking sectors and limited refinancing pressures provide a sound fundamental backdrop for Asian credits."

"With further credit spread tightening expected to be limited, selective high yield corporates offer the best risk-adjusted return opportunities in the prevailing low interest rate environment."

"Despite structural US dollar concerns, extreme levels of optimism and increased positioning risks warrant caution in the near-term."

"Longer-term, the prospects for Asian currency appreciation remain positive."

bank intervention and we would aim to avoid exposure should this continue. The expected re-commencement of Chinese yuan strength, sometime in the first half of 2010, should not differ too much from the 5 to 7% per annum pace of appreciation which was seen prior to the 2008 credit crisis.

Other Asian currencies can generally be viewed as either 'risk plays' or dependent on the US dollar outlook. Both the Korean won and Indian rupee would fall into the first category as they are largely influenced by global risk appetite. The Korean won has a high equity correlation while the Indian rupee is impacted by portfolio flows. The Indonesian rupiah and Philippine peso are also sensitive to risk appetite, but they are less liquid and exhibit high hedging costs in times of risk aversion. We would, therefore, be cautious of holding these currencies in the event of a correction in risk assets. The Thai baht is weighed down by political risks and relatively lower liquidity. The Singapore dollar and Malaysian ringgit fall in the second category since the central banks in these countries have a 'neutral' currency policy bias and are fundamentally backed by foreign reserves and sizable currency account surpluses. Hence our positioning there would depend more on the general US dollar outlook.

Interest Rates

High unemployment and historically low capacity utilisation in developed economies should keep global inflation pressures low and short rates near zero for an extended period of time. Furthermore, a negative macroeconomic environment, historically steep yield curves and signs of continued foreign support in US treasury auctions, as well as increasing demand from banks, should help offset supply pressures to provide a broad range-trading environment for global government bonds.

We believe Asian central banks may be more dovish than the market expects, as aggressive rate hikes are at odds with their policies of stemming FX appreciation. Hence, we see value in short-rates for markets which have priced in aggressive rate hikes such as Korea, India and Thailand, and tactical opportunities for long rates in markets such as Singapore, Malaysia and Korea given the curve steepness. On the other hand, we dislike long bonds in India and Indonesia due to negative bond technicals and expensive valuations respectively.

Credit

Significant credit spread tightening since March 2009 has driven absolute Asian credit yield levels to fresh all-time lows, even relative to the pre-crisis period of 2006-2007. Further credit spread compression could be limited and any further spread movements in the near term are likely to be driven by a broader evolution of risk appetite. While credit fundamentals remain constructive, reflecting limited refinancing pressures and solid banking sectors in Asia, we trimmed exposure in selective credit positions during recent weeks as their expensive valuation no longer offers attractive risk-reward for investors. As companies take advantage of the low yielding and benign market environment to opportunistically tap capital markets, we expect a large supply pipeline in 2010. This will offer opportunities in better valued and good yielding investment grade and high yield corporate credits which will offer attractive rewards in an ultra-low interest rate environment. In contrast, expensive valuations in the Asian high yield sovereign sector (especially the Philippines) no longer offer attractive risk-reward for investors, except for tactical beta management given their better trading liquidity.

Markets likely to remain volatile as uncertainties remain

So where does this leave the markets? We believe that Asian stockmarkets are likely to remain volatile over 2010 as uncertainties remain. While we do not necessarily anticipate a sharp market correction, earnings expectations have been significantly revised up.

How Phuang Goh,
Head of Asia (ex Japan)
Fixed Income

How was appointed Head of Asia (ex Japan) Fixed Income in July 2001 and is currently responsible for investment strategy for Asian fixed income markets and day-to-day management of Asia (ex Japan) fixed income portfolios. He began his investment career in December 1989 and is a Chartered Financial Analyst.

"We see opportunities in markets where aggressive rate hikes have been priced in as global demand remains uncertain."

This could prove to be disappointing given that the aforementioned global imbalances that have plagued the markets have yet to be resolved, which will likely act as a headwind to economic growth further out, hampering regional earnings growth. So with the outlook for the global economy still far from equivocal, combined with the excellent performance of Asian stock markets in 2009, we would not be surprised to see profit taking, with long-term investors switching into companies with strong fundamental support.

This sits well with our approach to investing, with our portfolios currently defensively positioned. Moreover, with the markets now 'normalising', we would expect to see more differentiation at both the sector and company level, and in turn, a market conducive for stock pickers in 2010. Areas of particular interest to us are in the Asian consumer space, insurance, property, infrastructure-related, as well as yield-focused companies, where we are finding valuation merit, and which should do well in this environment. Not only do they offer some downside protection should markets stumble, but they should also benefit from their exposure to Asia's increasingly important consumption and investment trends. On the other hand, we remain cautious on those stocks most sensitive to the global demand outlook, where we feel that valuations and market expectations are too high.