Matthews Asia

2018 Fixed Income Outlook:

Asia Bonds Provide Diversification in a Rising Rate Environment

Teresa Kong, CFA
Portfolio Manager
Matthews Asia

In 2017, Asia bonds had three strong tailwinds—attractive credit spreads, currency appreciation and a favorable interest rate environment. In 2018, we expect credit spreads and currency appreciation to continue driving returns in Asia bonds. Local interest rates in Asia could present a slight headwind for bond returns in some countries. In aggregate, however, local interest rates may be a neutral factor across the region. We expect total returns for Asia bonds to be strong in 2018, but lower than in 2017.

The bigger story for Asia bonds in 2018 may be how their performance is poised to compare with U.S. bonds. U.S. interest rates finally started to rise in December 2015 after years of anticipation by market participants. U.S. Federal Reserve Chair Janet Yellen favored gradual action and we expect her successor, Jerome Powell, to adopt a similar approach. Depending on inflationary pressures in the U.S. economy, the Fed's target benchmark rate might increase two to four times over the next 12 to 18 months. Gently tapping the economic brakes at this stage of the economic cycle is a prudent measure to slow a robust U.S. economy.

For current holders of U.S. bonds, rising U.S. interest rates would generate losses in bond portfolios as bond prices fall. Rising rates would particularly affect low spread asset classes like U.S. municipals and investment grade corporate bonds. In our view, investors in these asset classes might consider paring back and reallocating capital to securities with lower U.S. interest-rate risk, which include Asia bonds.

Here's a look at factors that may affect Asia bonds in 2018:

Attractive Credit Spreads

In our view, Asia high yield bonds look reasonably valued, while U.S. and European high yield bonds appear overvalued. Credit spreads for Asia high-yield bonds are near historic averages. In contrast, spreads for U.S. high yield bonds are about 200 basis points (2.0%) below average while spreads for European high yield bonds are 300 basis points (3.0%) below.[1] In simple terms, Asia high yield bonds are compensating investors for taking credit risk, in our view, while U.S. and European high yield bonds are not.

In 2018, we expect to see a bit more volatility in bond prices and credit spreads. At the same time, we expect many Asia bonds to offer a fairly healthy coupon rate, building a strong base with the potential for positive returns. A bond that starts with a 4% coupon and gains a small boost in currency appreciation, for example, could potentially generate attractive returns for investors who may be experiencing falling bond prices at home.

Positive Currency Appreciation

Asian currencies had a banner year in 2017 and most Asian currencies saw strong gains versus the U.S. dollar (USD). We expect smaller currency gains in 2018, but still positive momentum. We believe the key tailwinds behind this outperformance will likely continue next year. They include (1) synchronized growth of the world's three largest economies: U.S., Europe, and China; (2) recovery in world exports, and (3) several Asian currencies being fundamentally undervalued. For 2018, we expect solid mid-single digit returns for many Asian currencies.

Some commentators speculate that U.S. tax reform could result in dollar strength as firms may have more incentives to repatriate the cash offshore back to U.S. I disagree. Large U.S. multinationals are already flushed with cash and have been deploying capital to buy back stock. It's also not clear how much the denomination of that cash changes since cash is an accounting entry. Whether the cash is in local currency vs. USD is dictated more by business needs like working capital than by the U.S. tax code. Overall, we expect positive returns in Asia currencies for 2018 and that the corresponding rising values in Asian currencies will be a tailwind for Asia bonds.

Diverse Drivers for Local Interest Rates

While the global economy is experiencing somewhat synchronized growth, monetary policies can vary widely as different countries grow at different rates. In 2017, interest rates generally did not rise across Asia. Much of Asia maintained a favorable interest-rate environment even as rates were rising in the U.S. Central banks in Asia make monetary policy decisions based on local economic conditions, resulting in a diverse set of interest-rate decisions across Asia.

1 Sources: Bloomberg and Bank of America Merrill Lynch. Historic averages refer to the 20-year time period ending 12/29/17.

Export-driven economies in Asia are starting to see signs of inflation. Most central banks in Asia have stopped cutting rates and are evolving to a tightening stance as their economies heat up. While interest rates were a tailwind for Asia bonds in 2017, they could be a slight headwind in 2018 if rates rise. Our view is that any negative impact generated by rising interest rates in Asia would be fairly modest. Even if interest rates were to rise by 25–50 basis points (0.25%–0.50%) in 2018 across Asia, the cost of capital would still be very low in terms of its historical averages.

Possible Risks

We are most concerned about potential macro issues stemming from the geopolitical unrest in the Middle East and Africa, including Saudi Arabia, Turkey and South Africa. The one Asian country we are watching closely is Pakistan. We think the Pakistani rupee will need to depreciate more from where it is today. It has historically been dependent on Saudi Arabia as a source of foreign capital. With the current political uncertainty there, Pakistan might experience balance of payment issues should there be delays in the capital from China's one belt one road program.

In an increasingly interconnected world, geopolitical tensions affect all investors. However, in our view, most of these risks mentioned are idiosyncratic and are unlikely to cause a major contagion that would undermine the global recovery. The best guidance is to focus on what you can control. Investors can control the quality of portfolios, the duration within portfolios and asset allocation decisions within the fixed-income category, including an allocation to Asia bonds.

Building More Resilient Portfolios

As central banks raise rates, many investors are taking a fresh look at fixed income holdings with an eye toward reducing interest-rate risk. Asia bonds can help to diversify portfolios that currently have heavy exposure to U.S. or European government, investment grade or high yield debt. For global investors, there are often three logical places within a portfolio for implementing an allocation to Asia bonds—emerging market debt, high yield bonds and tactical fixed income products. We believe Asia bonds provide investors with an important tool for building more resilient fixed income portfolios, while meeting a variety of long-term objectives.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Fixed income investments are subject to credit, currency, and interest rate risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to make principal and interest payments. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. Interest rate risk is the possibility that yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise.

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