Asian bonds are the quality plays within the broader emerging market bond universe

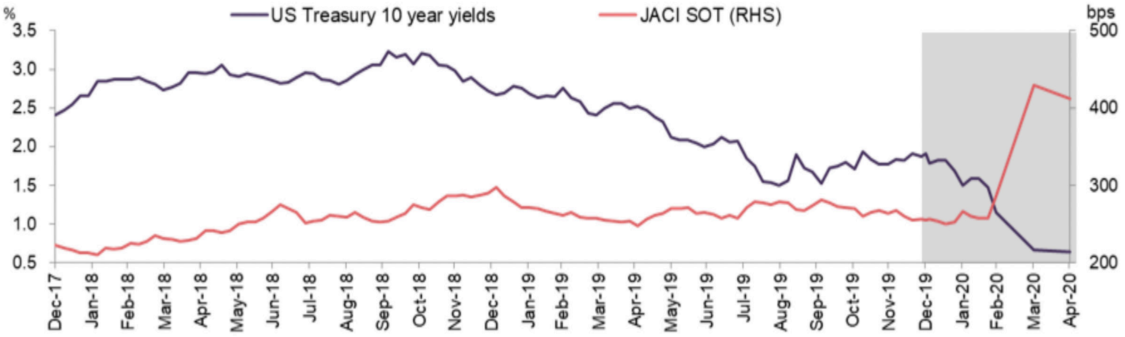
May 2020

Executive summary

- Asian bond markets have generally held up better than their emerging market peers in the recent market downturn, underpinned by their higher asset quality and strong regional support.
- The very low global yield environment – as the major developed market central banks pursue QE-based stimulus – could prove supportive to the overall Asian government bond markets. Unprecedented support from major central banks in extending lending facilities to include investment grade credit and bonds of selective fallen angels, will also lift sentiment towards the broader credit universe.
- Investors should continue to look for quality within the Asian credit segment, focusing on investment grade credits and lightening on high yield exposure.
- Unlike other emerging market blocs, the oil & gas sector within the Asian credit is dominated by highly-rated investment grade quasi-sovereign issuers. Within the metal & mining sector, stay in the safety of the higher quality issuers who possess strong operational track records.
- At the broader level, the services sectors, which have been hit more severely than manufacturing in the face of widespread containment measures, is key for recovery to take hold. Countries that have avoided imposing severe restrictions or effectively contained the virus, appear to be better positioned for an early recovery.

Risk sentiments recovered modestly in April as nations began to roll back on lockdowns. In a sharp reversal from March, credit spreads led by the high yield sector tightened, while US Treasury yields traded in a narrow range, after fluctuating wildly in the prior month. As a reflection of improving market conditions, the US Federal Reserve (Fed) slowed the pace of US Treasury purchases in April to US$10 billion a day, down from US$75 billion in mid to end-March.

Chart 1: Risk sentiments recovered modestly in April, as reflected by tighter credit spreads, led by the high yield sector and range-bound US Treasury moves



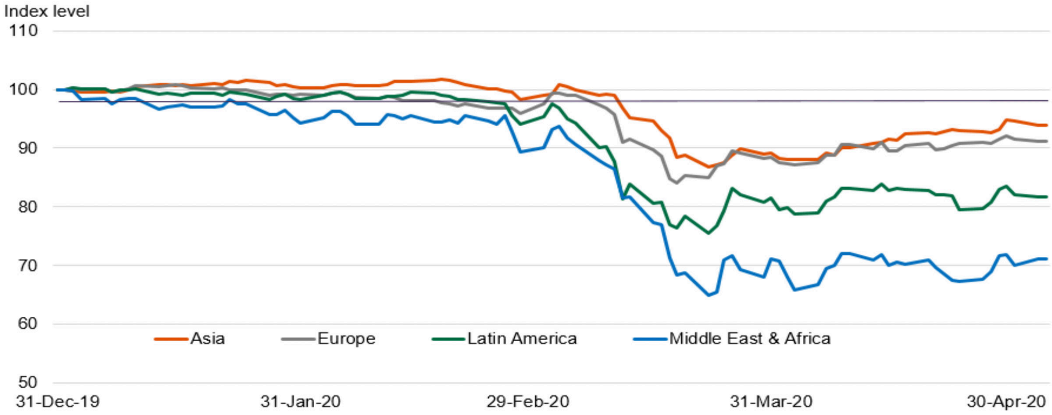
Source: Bloomberg, JACI refers to the JP Morgan Asian Credit Index as of 30 April 2020

Asian bond markets' performances have been underpinned by higher asset quality

In the recent downturn, Asian bond markets have held up better than their emerging market peers, underpinned by their higher asset quality. The Asian local currency bond market is characterised by a 100% investment grade sovereign universe, with the nine major Asian bond markets[1] firmly in investment grade territory. Asian countries have also shored up their macro-fundamentals, reflecting lessons learnt from the previous crises, with most Asian economies supported by current account surpluses and rising FX reserves.

Chart 2: Asian local currency bond markets have outperformed other EM sovereign markets

YTD performance of Asian local currency bonds and the rest of the emerging market sovereign blocs



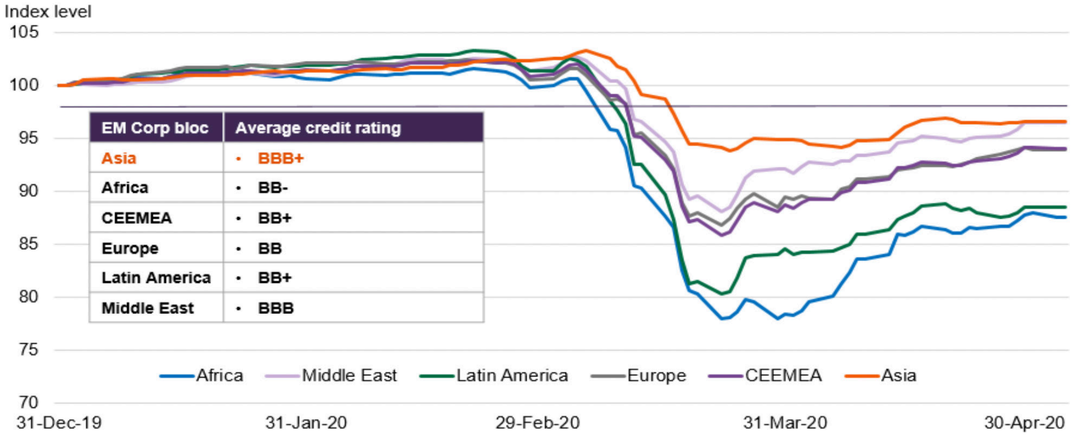
Source: Bloomberg as of 5 May 2020. Indices used are the JP Morgan GBI-EM Global Diversified Unhedged USD indices - specifically Asia (JP Morgan GBI-EM Global Diversified Asia Unhedged USD Index), Europe (JP Morgan GBI-EM Global Diversified Europe Unhedged USD Index), Latin America (JP Morgan GBI-EM Global Diversified Latin America Unhedged USD Index), Middle East & Africa (JP Morgan GBI-EM Global Diversified Middle East & Africa Unhedged USD Index)

[1] based on the Markit iBoxx Asian Local Currency Bond Index as of 30 April 2020. Asian countries include China, Hong Kong, Indonesia, India, South Korea, Malaysia, the Philippines, Singapore and Thailand.

Similarly, Asian credit has also fared better (than most of the other emerging market corporate markets) in recent months, underpinned by its higher asset quality and strong regional support. 78%[2] of the Asian credit universe is of investment grade quality, with an average credit rating quality of BBB+, in contrast to the rest of the emerging market corporate bloc which have a lower average credit quality[3].

Chart 3: Asian credit have outperformed most of the other EM corporate markets, underpinned by their higher credit quality and strong regional support

YTD index performance of Asian credit and the rest of the emerging market blocs



EM Corp bloc	Average credit rating
Asia	• BBB+
Africa	• BB-
CEEMEA	• BB+
Europe	• BB
Latin America	• BB+
Middle East	• BBB

Source: Bloomberg as of 5 May 2020. Indices used are the JP Morgan CEMB Broad Diversified indices - specifically Africa (JP Morgan CEMBI-Broad Diversified Africa Index), Asia (JP Morgan CEMBI-Broad Diversified Asia Index), CEEMEA (JP Morgan CEMBI-Broad Diversified CEEMEA Index), Europe (JP Morgan CEMBI-Broad Diversified Europe Index), Latin America (JP Morgan CEMBI-Broad Diversified Latin America Index), Middle East (JP Morgan CEMBI-Broad Diversified Middle East Index)

[2] based on the JP Morgan Asian Credit Index as of 30 April 2020 | [3] based on the JPM CEMBI Broad Diversified Index as of 30 April 2020

Recovery in the services sector will be key to watch; pace of rebound among Asian countries will differ

In response to the COVID-19 pandemic, policy support globally has been forthcoming, with monetary measures acting in unison with fiscal stimulus. Lower policy rates, easier credit conditions, and targeted fiscal stimulus to the sectors most vulnerable to COVID-19 will help to keep credit flowing, mitigate income loss and promote a gradual recovery when lockdown measures are unwound. While such policy actions are unlikely to be timely enough to avert a global recession, they are critical in stablising financial markets and aiding in the eventual recovery.

In a sharp contrast to prior crises, the impact of the COVID-19 driven shock to services will be equal or more than the impact to manufacturing. Thus, the unwinding of containment measures will be a key condition for the recovery to take hold. Countries that have avoided imposing severe restrictions (such as Taiwan and Korea) or effectively contained the virus (such as China), appear to be better positioned for an early recovery. We expect China and, to a lesser extent, parts of North Asia such as Hong Kong, Taiwan and Korea to lead the recovery from COVID-19 with most of the negative economic impact concentrated in 1Q 2020. In contrast, the rest of the major economies – US, Europe, ASEAN, and India will lag, with the adverse growth effects felt most acutely in 2Q 2020 on a sequential growth basis.

Asian local currency bonds: favour duration and curve play, cautiously positioned on the currency front

We expect fiscal measures to play a more prominent role versus monetary policy in the current easing cycle. In Asian economies where increased bond supply is needed to fund the additional fiscal deficits, yield curves should steepen as the front end is anchored by easing rates while duration supply would weigh on the long end. That said, the very low global yield environment – as the major developed market central banks pursue QE-based stimulus – could prove supportive to the overall Asian government bond markets.

Within the Asian local currency bond strategy, our risk budgeting is focused on active duration and curve play, with selective overweight in the more defensive bond markets, such as China, Singapore, Korea, and the Philippines. We are more cautiously positioned in the high yielders such as Indonesia. Within the curve, we favour up to the 10-year tenor as duration easing will support the front end and are sidelining tenors beyond

that, on worries of supply headwinds. We are more cautiously positioned on the currency front, driven in part by periodic flare-ups of US-China trade spats, against the weakening growth backdrop. We prefer to be tactically long in carry currencies such as the Indian rupee, and the Philippines peso. At the same time, we are putting in place hedges in currency markets such as the Indonesia rupiah, which are most exposed to external vulnerabilities.

Asian credit: bias towards the investment grade sector, lightening on risk across high yield segment

Major central banks such as the Federal Reserve, and the European Central Bank have unleashed unprecedented support such as the extension of lending facilities to include investment grade credit and bonds of selective fallen angels. This is viewed favourably by the markets and will lift risk sentiments towards the broader credit universe. Similarly, Asian central banks such as the Bank of Korea, and Bank of Thailand have followed suit and put in place similar corporate bond buying credit facilities. With these in mind, one should not be too underweight in overall credit beta but instead be focused on separating the wheat from the chaff. Weaker economic growth and the possibilities of higher default rates, also suggests investors should favour the investment grade universe and lighten on risk across the high yield segment.

We are taking advantage of bouts of relief rally, as we have seen in April, to rotate out of credits our analysts have identified as having weakening fundamentals. On a similar note, we are also taking advantage of the revival in the primary issuance market, which has been dominated by investment grade issuers, to build duration and capitalise on the higher yield premium today versus a few months ago.

At the country level, we favour China, which is leading the global recovery against COVID-19, as well as Hong Kong and Korea. Armed with strong fiscal firepower and less aggressive social distancing measures, we expect them to benefit as activities in China normalise and the supply shock abates. At the sector level, we favour TMT, utilities and Chinese property (for the high yield allocation). We like TMT and utilities for their resilient fundamentals. The Chinese property sector is a key beneficiary of easier credit conditions in China. Policy measures at the local and central government level have also been supportive while the latest contracted sales data have also surprised on the upside. Most of the property developers we are in touch with continue to guide for a positive year-on-year growth for FY2020. That said, within the high yield segment and beyond the Chinese property sector, we would stay in the safety of the BB rated bloc.

Oil supply and demand dynamics will potentially normalise

US oil prices collapsed into negative territory for the first time in April, as the rising costs of increasingly scarce storage, coupled with a sharp retraction in global demand, pushed producers to pay buyers to take the product off their hands. This was further exacerbated by the rolling over of sizable oil future contracts (which were expiring) by US-based oil ETFs. That said, oil prices have since ticked higher and are back firmly in positive territory. Looking ahead, we believe oil prices at current low levels are unsustainable and will normalise as economic activities gradually pick up. Supply dynamics will also adjust potentially, although this will take time, as low-cost producers rein in production to maintain profitability. We are beginning to see this playing out in some of the higher frequency data we monitor, including a smaller rise in stock piles at key US storage hubs.

Asia has been a beneficiary of lower oil prices in the past

Nevertheless, we expect disinflationary pressures to build, on a combination of low oil prices and the COVID-19 driven demand shock, which in turn creates slack in the goods and labour markets. On a more positive note, some Asian countries such as India will be a key beneficiary of lower inflation headwinds, which in turn, will open up more room for the central bank to ease. We expect the Reserve Bank of India to ease by another 75 bps over the next 12 months. The country's current account balances could also shift towards a small surplus this year and in turn, provide more fiscal flexibility to support its domestic currency. Looking back in history, lower oil prices have worked favourably for Asia as the region, being a net oil importer, uses oil as an input factor to power its growth engines.

Unique to the Asian credit market, the oil and gas sector, unlike other emerging market blocs, is dominated by highly-rated investment grade quasi-sovereign issuers and tend to be long duration, and thus exhibit higher correlation with US Treasuries rather than oil prices (as seen in Chart 4). Conversely, the metals & mining sector which accounts for less than 2%[4] of the Asian credit market, trades with a higher sensitivity to commodity and oil prices. Within this sector, we are staying in the safety of the higher quality issuers who have demonstrated strong operational execution track records or those with sufficient refinancing flexibilities to ride through this downturn.

Chart 4: Asian oil and gas sector exhibited higher historical correlation with US Treasuries than with Brent Oil

Sector	US Treasury 5 Year Yield	US Treasury 10 Year Yield	Brent Oil
JACI Infrastructure	(0.4)	(0.5)	(0.0)
JACI Financials	(0.5)	(0.6)	0.1
JACI Industrial	(0.0)	(0.1)	0.1
JACI Investment Grade	(0.4)	(0.6)	0.1
JACI TMT	(0.4)	(0.6)	0.1
JACI Oil and Gas	**(0.4)**	**(0.6)**	**0.2**
JACI Utilities	(0.3)	(0.4)	0.2
JACI Composite	(0.3)	(0.4)	0.2
JACI Real Estate	0.0	(0.2)	0.2
JACI Non-Investment	0.2	(0.0)	0.3
JACI Consumer	0.1	(0.1)	0.3
JACI Metals & Mining	**0.2**	**0.0**	**0.4**

Source: Fullerton, Bloomberg, based on weekly data over the last 5 years to 23 April 2020. JACI refers to the JP Morgan Asian Credit Index.

[4] Based on the JP Morgan Asian Credit Index as of 30 April 2020.

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