Look East

Asia bonds are still a good carry play for credit investors

By Henry Wong

IN the Emerging Market (EM) space, the collapse in commodity prices since the middle of last year has continued to disturb EM. However, expectations of a delay in Fed rate hike, lower UST (US Treasury) yields and the stabilisation of commodities have been supportive to EM credits since mid-March.

The Asia bond market has been the least volatile in the EM credit space as Asia is a net importer of oil and has enjoyed the benefit of a lower oil price. Asia also has not been subject to similar geopolitical problems that central Europe and LATAM (Latin America) have been experiencing.

The Asia market achieved decent performance in Q1 2015 of which UST contributed +1.6 per cent out of a total return of 2.2 per cent, whereas Asia spread return was +0.6 per cent. The Asia region marginally underperformed JPM CEMBI Broad (+2.4 per cent) which may be due to a tight valuation of Asia credits as well as high coupon income in other EM space. The Asia credit market remains buoyant upon further quantitative easing in Japan and market reforms, together with the relaxation in monetary policies and reserve ratio requirement in mainland China.

Asia IG (Investment Grade) credits continued to outperform HY (High Yield) in Q1 2015. Asia IG credits, which have a relatively decent fundamental, enjoyed support from global investors. Asia HY credits suffered a bad experience from the Kaisa incident in late December. Kaisa is a Chinese property company focusing mainly in South China. The exodus of the whole Kaisa management triggered a big sell-off in Asia HY in January. However, the Chinese authorities realised in time the seriousness of not helping out the property sector – the IPO bond (offshore) market for the Chinese property sector was shut down for almost two months. As a result, the Chinese authorities relaxed housing policies regarding second-house buying and mortgages in late February.

Expectation of a delay in Fed action and massive stimulation policies rolled out by the Chinese government have resulted in a strong rally in the China equity market. Market sentiment on Chinese HY space has improved. Sales volume and the price per square metre of properties in major cities have shown signs of bottoming out this April.

Economic reforms in China and India, the establishment of the Asian Infrastructure Investment Bank, and China's application of SDR (Special Drawing Rights) membership have set a positive tone for Asia credits. An aggressive cut in interest rates and bank reserve ratio requirement, in addition to the possible outright purchase of banks' assets and local government debts in mainland China are providing ample liquidity, not just favourable for investment in the domestic market, but also for the Asia region in general.

All these positive factors have outweighed the negative macro picture in China despite the macro scenarios – falling GDP (gross domestic product) growth and below projected inflation – being a concern to Asia and EM investors.

Asia HYs, and China HYs in particular, have been catching up in performance with IG credits since March this year. This liquidity will continue to drive the market as China is just at the beginning of wide-scale policy easing and stimulation of various economic sectors. Nevertheless, for HY space, bottom-up picking of the right investment is always key in the market.

With the macro economy in the region cooling, the default forecast for Asia HY is naturally up marginally, but the downside risks are largely factored in. With global government yields lingering at low level or even at negative level for some countries over a long period of time, Asia credits, HYs in particular, continue to be a good carry-play for credit investors.

Low default rates

Though Asia credits have been trading tighter than other EM regions, these valuations are justifiable given a better macro environment, together with a further loosening in monetary policies in the region. Moreover, even in the HY space, Asia continues to have the lowest default rate.

Besides, it is expected that the region will continue to have below-average inflation and this will enable Asian central banks to be proactive on monetary policy so as to remain competitive in exports and to support growth. This is important to the Asia region as global economic momentum remains sluggish.

Demand-supply dynamics for new bond issuances remain supportive. Asia has seen the heaviest new issuances among EM regions. Thus far, new issues, especially IG, have been well received by an expanding regional investor base, and there is a noticeable pick-up in participation by foreign investors, especially funds and mandates focusing on EM investment.

Supply will continue to pick up, especially in the second quarter – which is usually the busiest quarter for Asia issuers as Asia corporates are ready to issue 144A bonds after announcing earnings results. As risk appetite returns, new issuance in Asia HY may pick up quickly in the second quarter.

To conclude, China's policy easing and stable oil prices will continue to benefit both HY and IG credits. It has made sovereigns and quasi-sovereigns less attractive for this year. Of course, with a higher supply of Asia credits this year, the risk will then be a supply glut from time to time. Altogether, Asia credits remain good for carry and yield enhancement with lower volatility versus other EM.

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