Off the beaten path

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Investors looking to diversify their portfolios could consider non-traditional fixed income

By Carman Wong

LAST year was an eventful year for the Emerging Market (EM) corporate bond market with total positive returns at 4.14 per cent, despite the fact that credit spreads had widened by 70 basis points (bps) against the previous year. 2015 started with another challenging environment and the overall market corrected significantly due to the escalation of the Russian crisis and plunging oil prices. All in all, emerging markets hard currency fixed income still posted a positive return.

For the second half of 2015, diversification in investors' asset allocation remains one of the key strategies towards good performance. Corporate credits selection is expected to feature more importantly than it did in 2014, and investors should expect a broader spectrum of returns with increased volatility in these credits.

Emerging economies fundamentals: mixed picture

Emerging Markets (EMs) span Asia, Latin America and Europe, and include countries such as Brazil, Russia, India and China. In the EMs, economic growth forecast may continue its downward trend, especially in Latin America and Emerging Europe. We have lowered our growth forecasts for Latin America from 2.4 per cent to 0.3 per cent, and Emerging Europe from 1.8 per cent to -0.9 per cent.

In Latin America, with three of the region's seven largest economies (Brazil, Argentina and Venezuela) in recession, regional growth is likely to fall to a new low this year. As a result of weak economic conditions, most of these countries may have limited scope for budgetary and monetary stimulus measures. Lower oil prices and weak commodity prices are also a significant headwind for some countries, making it difficult to generate any significant growth.

In Emerging Europe, ABN Amro's April 2015 round of economic data suggests that Russia's recession is deepening. While the Russian central bank's changed FX (forex) policy will help to bolster the tentative stabilisation in Russia's FX reserves, there remains a risk of ongoing capital flight.

Turning to Asia, most Asian sovereigns have seen upgrades in their ratings over the last six months. For instance, the Philippines has been upgraded to Baa2 by Moody's. The outlook for the economies of many other Asian sovereigns, such as Indonesia, South Korea and India is also positive.

In China, the economic slowdown is apparent, as seen from ABN Amro's growth forecasts of 7 per cent in 2015, compared to the 7.4 per cent growth rate in 2014. This may not necessarily be adverse, as it can partly be attributed to the Chinese leadership's measures to mitigate the potential housing sector bubble. The Chinese government is also implementing financial sector reforms to reduce barriers to entry and liberalise markets, as well as reforms to weed out corruption on the political front.

We predict the Chinese authorities will continue to add stimulus to keep economic growth close to their 7 per cent target. Our data indicates that regional growth has slowed in the first quarter of 2015. General factors underlying the regional slowdown relate to the weakening of domestic demand in several countries, and declining global growth affecting export demand from Japan and China.

Nevertheless, we believe Asian growth will remain resilient this year, outperforming other regions by a wide margin. Hence, our overall expectation for Asian EM countries is that they will have a strong showing as most of these countries are net energy importers. They may benefit from the current oil price decline and the resulting lower inflation. Central banks in this region are also likely to stick to their loose monetary policies.

Emerging corporate bond opportunities

EM sovereign bonds tend to closely follow ratings rather than fundamentals. For example, the highest-rated sovereign credits are expected to have the tightest spreads versus lower-rated sovereigns which have correspondingly wider spreads. With the possibility of further economic weakness for most EM countries, it is important to note the vulnerability of some of the EM bonds in the current economic environment. In addition, EMs could be under further stress if the Fed starts its expected rate hike as most EM sovereign debt is based in US dollars, and therefore, EM sovereign debt demonstrates a higher correlation with the movement of the US bond markets.

However, global growth has also been coming down significantly in recent years, falling from around 5.5 per cent in 2010 to around 3.5 per cent last year. Assuming our view on (slowing) globalisation is correct, EM bonds could then outperform the more risky EM assets. In addition, EMs could become more of a local oriented investors' market. Earnings growth in Asia has been relatively strong. Asia has also benefitted greatly from a decline in oil and commodity prices.

For tactical asset allocation in a bond portfolio context, we do not favour EM sovereign bonds. We see risks in Latin America with their tremendous growth readjustment process, while countries such as Turkey and South Africa are both running large current account deficits. In particular, we do not recommend Russian and Brazilian sovereign bonds due to their continued weak fundamental and political uncertainties.

ABN Amro has chosen to focus more on opportunistic Asia corporates than other regions due to its yield premium over US Treasuries. Also, the huge infrastructure push by China will support the region in the coming years positively. We also recommend Asian corporates due to their relative short tenor (three to five years), additional yield premium over US Treasuries for new issuance, supportive monetary authorities in the region, and last but not least, the huge effort and commitment by the Chinese authorities to develop the regional bond market. In a recent report, Standard & Poor's noted that in the next five years, 30 per cent of global issuance will be coming from China.

In Asia, we remain positive about most Asian investment grade corporate bonds to the extent that these bonds are strongly supported by local investors and a stable local investor base. These corporate bonds may be more likely to weather any potential external shocks.

In addition, our view is that Asian countries are likely to continue to demonstrate stable macroeconomic fundamentals, and we see that the potential for their GDP (gross domestic product) growth is generally stronger than that of developed markets. We believe some Asian countries may also benefit from lower energy and commodity prices, as compared to the Latin American or Eastern European countries.

Active investors looking for investment ideas may wish to include Asian corporate bonds such as the China state-owned enterprises with strong credit metrics and the four state-owned asset management companies. We believe that they carry decent yields as compared to other similarly-rated developed market bonds.

Investors may also wish to consider strong A-rated technology names as part of their portfolio's defensive play. In Hong Kong, selected credits with robust recurring income and strong balance sheets may also be an option, although most of them are unrated.

For Indian corporates, the BBB-rated corporates appear fair at credit spreads in the range of 260 to 270 bps. In comparison, the credit spreads of China corporates are at 310 bps and Hong Kong corporates at 260 bps. From a macro perspective, we predict that India will still enjoy positive momentum with its continuing gradual reforms. Moreover, if the proposed offshore Indian rupee bond materialises, the reduction in external commercial borrowings will offer interesting yield opportunities in US dollar Indian credits.

On the other hand, we are less keen on Indonesian corporates as credit metrics are deteriorating owing to a slowing Indonesian economy and rich bond valuation. Another possible investment idea would be high investment grade South Korean bonds that could continue to serve as low beta safe haven credits in Asia.

For Asian high yield bond investments, name-specific headline makers, particularly from Chinese or Indonesian high beta companies, will likely remain volatile. We expect their credit fundamentals to deteriorate to reflect weaker earnings, and thus valuations may be unattractive from the risk/reward perspective. In addition, the tight valuations of these corporates have not priced in potential investigation risks or weak financial metrics. We, therefore, prefer to stay away from lower quality high-yield Asian corporates that may face potential corporate governance concerns and limited corporate disclosure.

In our view, EM corporates have generally been offering better value over comparable EM sovereigns or Developed Market corporates. However, investors must be cognisant of the risks and carefully select the relative merits of a company's debt offering.

Market risks should also be considered. In particular, when markets move into "risk off" (risk averse) mode, investors seek perceived safe havens such as US Treasuries, instead of investments in EMs. It is then that EMs may be sold off. It is also noteworthy that one of the biggest risks for EM corporates is likely to arise from certain accounting and corporate governance standards in EMs that lag those of developed markets. Hence, comprehensive research into each corporate bond and the market in which it operates is therefore required. W

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