Cherry-pick amid volatility

Fullerton Fund Management's Patrick Yeo shares insights on the Asian bond asset class

ASIAN bonds weathered volatility in 2015, but are still widely seen as a preferred asset given private clients' appetite for yield and income. Patrick Yeo, Head of Fixed Income from Fullerton Fund Management, shares some perspectives on the asset class in 2016.

Q: The Federal Reserve is widely expected to embark on a series of rate hikes in 2016, following the first hike in December. How do you expect this to impact the Asian bond asset class, both in terms of US dollar and local currency debt?

We expect the trajectory of global and regional interest rates to be flat or mildly rising in 2016. The Fed will continue to take into account the global economic conditions in its rate decisions, given the expected challenging global outlook and the firm US dollar (USD).

Hence, a sharp correction in the Asian credit market is unlikely, based purely on interest rate moves. That said, we are cognisant that tail risks, such as a weakening in economic and corporate fundamentals in Asia, continue to persist. We therefore expect phases of volatility with spreads widening, which may be amplified by market illiquidity.

Q: There remains a strong appetite for bonds among Asian investors, who see the asset as a means to cushion volatility and earn income in the process. What opportunities do you see in Asian fixed income and high yield in 2016; which sectors of issuers do you like and which might you avoid?

We see opportunities around the five-year sector in the USD Asian bond market, given the expected slow pace of rate increases this year. Bonds in this maturity bucket carry reasonable yield without too much interest rate risks. For Singapore dollar (SGD) investors, having a portfolio of USD hedged back to SGD also makes sense, as investors will receive currency hedging gains with the current interest rate dynamics.

At Fullerton, we believe in having a diversified portfolio with careful selection of individual bonds, based on the respective bonds' credit fundamentals and valuation metrics to determine the weighting in the portfolio. Even a sector that has faced or is facing many challenges can offer opportunities, with bonds that can be trading at distressed levels.

In general, investors can consider investing in USD share classes, should they expect the USD to further strengthen this year. We also encourage investors to allocate to shorter duration portfolios, which should offer more protection in this rising rate environment.

Q: There is still a lot of concern about credit quality particularly among Chinese issuers. Given the economic cycle in Asia, what do you see in terms of default rates and related risks to corporate earnings? Please share your approach towards mitigating risk.

Fundamentally, we think that most Asian investment grade issuers are well placed with strong balance sheets to withstand the expected earnings weakness in 2016. Nonetheless, idiosyncratic risks will continue to persist, particularly among Asian high yield issuers in sectors such as commodities and industrials. Therefore, credit selectivity will be a key theme in 2016.

We do not foresee a huge risk of rising interest rates affecting the portfolio through duration risk. We favour short-dated bonds as these will be better shielded from spread widening. We believe credit selectivity is the most important in an environment of uncertainty and slowing growth, both of which will impact corporate earnings that will in turn affect credit metrics. Having a diversified portfolio is also key to mitigating idiosyncratic risks in the credit market.

Q: Please share with us your guidance for investors' expectations for Asian fixed income yields and returns in 2016.

We anticipate that the US 10-year Treasury yield will possibly trade in a range of 2.3 per cent to 2.8 per cent in 2016. Therefore, we are underweight duration in our fixed income portfolios and are underweight sectors (for example sovereigns and quasi sovereigns) that are more correlated to benchmark rate moves. Conversely, we are overweight selected high yield bonds that we believe are better shielded from rising interest rates. We expect returns of about 3 per cent for USD Asian fixed income.

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