Seeking pockets of value

Facing a worsening outlook, investors could look for opportunities within the Asian high yield bond market

By Manpreet Singh Gill

RARELY has it been so difficult to find attractive opportunities in Asian US dollar (USD) high yield bonds. After offering an average yield of about 7.7 per cent over 2010-2015, Asian high yield (HY) bonds today offer a yield of just over 5 per cent following strong bond price gains this year. Coming against a worsening fundamental backdrop, we believe this is a time for investors to sharpen their focus, protect their capital by not over-reaching for yield and focus on very specific opportunities, both within high yield and other asset classes that offer comparable yields.

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Why we should still look for opportunities

We continue to believe the "search-for yield" environment will largely stay in place. Higher short-term Fed rates notwithstanding, policy efforts in the US and elsewhere are likely to continue to be directed towards capping bond yields in an effort to support reflation. This means, short-term pullbacks notwithstanding, higher yielding asset classes are likely to continue to be supported to some extent.

The Asian HY bond market also remains supported by positive demand-supply dynamics. On the supply side, while new bond issuance has begun to rebound from very low levels, a continued search-for-yield means demand remains very strong. This is a second support for the asset class.

However, while there is a case for maintaining exposure to higher-yielding bonds, these positive factors have to be balanced by the fact that many fundamental factors have begun to deteriorate recently. An active approach to avoiding minefields is appropriate, and our view is that this means becoming far more selective about where yield is obtained.

Why we should be careful

Specifically, there are a few trends in the Asian HY bond market that worry us:

- Absolute debt levels among Asian HY-rated corporate are rising. Net debt/Ebitda (earnings before interest, taxes, depreciation and amortisation) rose to 4.6x in H1 2016, compared with the prior peak of just 2.5x in 2008.
- Credit quality is deteriorating. Credit rating downgrades have outpaced upgrades over the past year, and there has been a rise in the number of lower-rated companies issuing new debt in the market.
- The Chinese property sector, which is a significant portion of the Asian HY asset class, may face tighter policy in many cities following strong house price gains this year.
- Valuations are expensive. The yield premium on offer over Treasury yields is now approaching post-2009 lows.

How these negative factors balance out against what is likely to be still-strong demand for higher-yielding asset classes will be key to how the asset class performs over the next year, and whether it is likely to be punctuated by bouts of weakness along the way.

We believe the best approach is to maintain some exposure to Asian HY bonds, but to be far more selective in finding pockets of value; and look for opportunities in the broader Emerging Market or local currency bond universe.

So where should investors look?

We believe there are three areas worth focusing on more closely for higher yielding opportunities within Asia and the broader Emerging Market bond universe.

First, within Asian HY bonds, we favour a tilt towards the highest quality sector (that is, BB-rated) to minimise downside risk in the event of a pullback. A shorter maturity profile, especially on non-Chinese HY bonds, would also help reduce risk.

While these come at the expense of slightly lower yields, we believe this opportunity cost is more than justified. In our view, this is not the time to be either adding long-maturity HY bonds or adding lower-quality bonds in an effort to stretch for yield.

Second, we believe it is worth adding exposure to a diversified basket of USD bonds of Emerging Market governments. This represents a particularly interesting opportunity because the yields on offer are very similar to that in Asian HY (approximately 5.3 per cent), despite the asset class having about an equal weight towards both high yield and investment grade-rated governments. In other words, this represents an opportunity to raise credit quality while maintaining a similar level of yield.

Third, it may be worth selectively exploring opportunities within higher-yielding local currency government bond markets. Our most preferred area is Indonesian rupiah-denominated local currency bonds. This involves adding rupiah currency risk in order to access the 6 to 8 per cent yield on offer, but this is a risk we believe is worth taking, albeit within limits in a diversified investment allocation.

Diversified investment allocation

One of our broader investment themes is the need for a balanced investment allocation. In our view, we remain caught in a "tug of war" between the continued search for yield, on one hand, and rising risks in asset classes such as Asian HY bonds on the other hand. We believe stepping back and viewing Asian HY exposure through this broader lens remains one of the best ways to maintain exposure while managing the risk.

We see the continued demand for yield as a good reason to maintain some exposure to Asian HY bonds and some of the possible alternatives discussed. However, we equally believe that balancing this with asset classes such as gold or multi-asset macro strategies offers some protection against the rising risk of a pullback. This, we believe, remains key to navigating both the risks and opportunities on offer in Asian HY and comparable bond asset classes. W

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