

# To have and to hold

Fixed income market is expected to continue to provide exciting investment opportunities, but investors should be more selective

BY PETER KOK

**B**OND markets performed very well in 2014 and certainly better than what was expected at the start of the year. Heading into 2015, income generation will still be one of the key objectives for investors. The relatively low interest rate environment and easy monetary policies will continue to motivate investors to look for investment opportunities in bonds. The fixed income market is however expected to face some challenges from the US Fed policy, geopolitics, macroeconomic developments and relative valuation among asset classes.

In my opinion, three themes hold the key to generating higher returns for credit market investors. They are:

- Preference for corporate credit over sovereigns
- Relative value in Emerging Markets (EM) over Developed Markets (DM)
- Credit selection will be key within EM bond markets

## Corporate credit over sovereigns

We are living in an environment of very low interest rates (in absolute terms). This means that even a small increase in the interest rates could lead to capital loss. As corporate credits offer a higher yield than sovereigns, they provide a greater buffer against rising interest rates and are therefore a better alternative to sovereigns.

## Relative value in EM over DM

Emerging Market Investment Grade (IG) corporate bonds offer relatively higher yields compared to developed market corporate bonds of similar credit quality. EM corporates trade at an average spread of approximately 250 basis points (bps) whereas US corporates trade at a lower spread of nearly 150 bps. Hence, in the investment grade credit space we prefer EM credit over DM credit.

Emerging market high yield corporate credit also has a relatively higher premium than developed markets and offers interesting investment opportunities. EM corporates trade at an average spread of approximately 630 bps whereas US corporates trade at a spread of nearly 565 bps. Hence, while there are opportunities in both developed and emerging market high yield credits, being selective is the key to generating higher returns.

Among the emerging markets, we prefer Asia due to its stronger growth compared to other emerging markets, relative stability and additional tailwinds due to lower oil prices.

## Credit selection is key

The recent commodity-linked sell-off in some of the markets such as Russia and



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Brazil and the slowdown in China may have created pockets of opportunity in the EM region. However, when we take into account the risk-reward trade-off, Asian credit still looks good.

A quick look at the Asian IG corporate balance sheets shows that the corporates maintained stable credit fundamentals in 2014.

On the other hand, the fundamentals for High Yield (HY) corporates have selectively deteriorated because of slower economic growth and higher balance sheet leverage.

The Chinese property sector, which is the largest component of the high yield credit universe, still faces challenges of lower property prices and rising inventories. In addition, lower commodity prices could also lead to further pressure on the smaller oil and gas sector and mining companies.

Therefore, in the face of a potential rise in interest rates and a lacklustre corporate fundamental outlook, credit selection becomes even more important. In the search for yield, investors should avoid over-extending themselves, either by compromising on credit quality or on maturity in an effort to generate yield.

## US dollar bond market

The Asian US dollar bond market is large enough to offer investors a wide choice of issuers and capital structures.

In this space, the Chinese property sector offers higher yields, but faces a weaker sectoral outlook and is prone to headline risk. Adding on bonds of IG issuers or relatively larger and stronger BB category rated developers offers better risk/reward.

Investors can also selectively go down the capital structure of high-quality com-

panies. This offers higher yields compared to senior debt of the same issuer for a slight increase in credit risk. For instance, perpetuals from high-quality corporates with bondholder-friendly structures (such as high coupon step-up, shorter call date, etc) offer opportunities to capture higher yield. Similarly for banks, subordinated debt has emerged as a large sub-asset class. Some investors even view subordinated debt issued by Chinese banks as an attractive, less volatile alternative to Chinese high yield corporate debt.

## Local currency bond market

Over the last decade, Asian local currency bond markets have also evolved to supplement the Group of Three (G-3) currency bond markets. Chinese renminbi (CNY) and Indian rupee (INR) bonds stand out as the top picks within the Asian local currency bond universe. Bonds in both local markets offer attractive yields (approximately 3 to 4 per cent for China and 7 to 8 per cent for India) for investment grade credit quality.

China has already begun cutting rates, while India is expected to do so in 2015 which could potentially lead to capital gains in addition to the carry, thereby enhancing total returns. The Singapore dollar corporate bond market is another important investment avenue for investors holding Singapore dollar (SGD) deposits. For all local currency bonds, our preference is for larger and more liquid benchmark bond issuances.

## Income generation

Low interest rates are leading to a lot of first-time issuers accessing the bond markets. This provides fixed income investors an unprecedented array of issuers and capital structures to choose from.

Given the low deposit rates, income generation will remain a key objective for investors. Investment in the credit markets thus offers an opportunity to generate higher returns than cash deposits.

Investors should maintain a well-balanced portfolio of investments. In our view, fixed income forms an integral component of any diversified portfolio of income generating assets.

Regardless of what investors buy, they need to be able to hold the bonds to maturity and should have the ability to stomach some volatility should US interest rates begin to rise in 2015.

On the whole, the fixed income market is expected to continue to provide exciting investment opportunities in 2015, but investors will need to be increasingly selective and opportunistic in their quest for returns. ■

Peter Kok is Regional Head, Asean, Private Banking Clients, Standard Chartered Bank