

## Anticipating a strong year for bonds

Unlike the US and Europe, Asian central banks are maintaining accommodative monetary policy, offering macro support for Asian bonds

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In a world where the global interest rate environment is posing greater risks, Asia ex-Japan's inefficient fixed-income markets offer opportunity for flexible investors. Although interest rates are slowly rising in the US, Asian bond spreads remain attractive.

In contrast to the tightening monetary policy in the US and a lower pace of quantitative easing in the European Union, Asian central banks are currently maintaining accommodative monetary policy. From a macro perspective, this is supporting Asian bond markets.

In 2017, Asia's yield premium attracted global investors in fixed income. Asian bonds remain appealing in 2018, supported by the continuing yield premium, improving corporate health, the progress of frontier markets and strong Asian FX. However, it will be important to be more discriminating this year than in 2017. Inflation risks are building

across the world as food and energy prices climb. In Asia, inflation appears to be still manageable, but even here risks are rising.

Against this stable backdrop, Asian fixed income offers potentially rich opportunities.

### Attractive yield premium

Asian sovereign bond valuations, as well as their underlying fundamentals, remain attractive relative to core developed market fixed-income securities. Specifically, the benign inflation outlook supports long-duration bonds, for example in Indonesia.

There is also a case for Asian investment-grade bond spreads to compress further against US investment-grade bonds (despite historically tight levels), especially as corporate fundamentals in the US are weakening. Asia's spread



## Ups and downs: currencies in Asia were strong against a vulnerable US dollar

per unit of leverage is more attractive than developed market investment-grade corporate bonds, indicating the region's much higher risk-reward ratio. Recent maturity extension exercises have also reduced refinancing risks in a rising US interest rates environment.

Frontier markets' government bonds offer an even higher yield premium. From an economic perspective a number of them are making good progress. For example, Sri Lanka is adhering to IMF guidelines, Mongolia is benefiting from the recovery in commodity prices and Pakistan is gaining from subsiding political risk.

### Healthy corporates

Turning to corporate health, many Asian companies posted strong earnings growth in 2017 and are likely to do so again this year. Robust domestic demand, higher export volumes, effective use of ecommerce to increase sales and reduce costs, and the logistical support provided by infrastructure development are all driving profitability. Improvements to corporate health should be

sustained by further balance sheet deleveraging, enhancing interest coverage and liquidity profiles.

Asian high-yield corporate bonds are generally in good shape, although the fundamentals are strongest outside the property and mining sectors, which are nevertheless improving due to higher contracted sales among the former and stronger commodity prices that will boost the latter.

The default rate is 2% compared with the emerging market average of 2.4%, and Asia high yield remains comparatively cheap with a lower duration risk in a global context.

### FX buttress

Foreign exchange performance will still be a major determinant of Asian domestic bond market performance. Last year, many regional central banks adopted accommodative monetary policies in response to subdued inflation: currencies were strong against a vulnerable US dollar and were further supported by healthy external balances. This year the situation is likely to be more nuanced. Investors are

likely to focus on the local bond markets of countries with low inflation outlooks and higher real interest rates relative to regional peers, substantial foreign exchange reserves to buttress currency volatility, and sustainable economic growth reinforced by stable political systems. More generally, rapid GDP growth in almost all Asian countries is likely to support currencies.

Beyond the intrinsic attractions of Asian bonds, the increasing wealth of Asia's regional investors is reinforcing bond markets. Expanding wealth management firms and regional insurance companies have become major participants. Consequently, new issue subscriptions and secondary market performance are far less reliant on US- and European-based asset managers than a few years ago.

2018 looks likely to be a good year for Asia ex-Japan fixed income. Yet generating positive and consistent investment returns will take a flexible and diversified approach. This will allow investors to benefit from alpha across the economic cycle.

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