First State Investments

CAN ASIAN FIXED INCOME CONTINUE TO PERFORM WELL IN 2020?

Asian Fixed Income

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Persistent trade-related uncertainty and unrest in Hong Kong clouded the outlook for Asian growth in 2019. Bond yields were under downward pressure for much of the year and, in turn, fixed income markets in the region performed well.

With the macroeconomic and geopolitical environment showing signs of improvement, we ask Senior Portfolio Manager Nigel Foo whether government and corporate bonds in Asia can perform well again in 2020.

The lower Federal Funds rate in the US pushed bond yields down globally last year – is that likely to persist in 2020?

The change in policy stance was extraordinary – after all, only a year ago investors assumed US interest rates would continue to be increased. The three cuts we saw in 2019 were therefore quite surprising to some people. It's not clear whether or not there will be further cuts this year, particularly as the signing of the 'phase one' trade deal between the US and China has improved the outlook for global growth. Recent economic data releases have also been a little more encouraging, both within Asia and globally. Consequently, further interest rate cuts may not be required in the US or in other key regions. This suggests monetary policy will be less of a tailwind to bond markets in the year ahead.

That said, President Trump is expected to continue to laud the benefits of a weaker US dollar and lower interest rates ahead of the election in November. Trump is also talking up the possibility of fiscal stimulus measures. With that in mind, it's plausible that US bond yields could drift a little higher in the year ahead, or at least remain range-bound if economic growth stabilises around current levels.

There have been suggestions that monetary policy is increasingly ineffective in stimulating growth – would you agree with that?

That certainly appears to have been the case in this cycle. Interest rates have been at zero for a long period of time in both Europe and Japan, for example, without any meaningful improvement in growth. In fact, for some time now we've been suggesting that fiscal stimulus is a more effective policy tool.

It seems policymakers might be thinking the same. Japan has announced a massive fiscal stimulus program, worth around US$160 billion, aiming to support economic activity beyond the Tokyo Summer Olympics in July and August. Indonesia is also expected to boost infrastructure spending in President Jokowi's second term.

Asian central banks do still have room to lower interest rates to support growth if required, but we are expecting to see more fiscal stimulus packages like these to provide targeted economic assistance.

So, will an improvement in economic activity levels support Asian credit?

Hopefully, but aside from the economic outlook it's worth noting that regional credit fundamentals remain quite supportive. Many corporates have been deleveraging in recent years and improving their balance sheets. As a result, in our opinion corporate default rates in Asia are expected to remain under control this year – probably around the 2% to 2.5% range.

Rising defaults in China have been well documented in the past year or two. We are comforted though that defaults on both onshore and offshore Chinese debt in 2019 did not increase materially from 2018, despite the trade-related slowdown in activity levels. Interestingly, recent defaults by the Tewoo Group and the turmoil around the Peking University Founder Group provide a reminder that credit risk among State Owned Enterprises in China is increasing. There's reduced implicit support from the Government and we expect that trend to continue. As a result, we're watchful of valuations in this part of the market.

How are Asian credit valuations looking following the rally in 2019?

Well, they're certainly less attractive than they were 12 months ago. Investment grade credit spreads[1] tightened by around 40 bps in 2019 and high yield spreads closed the year around 100 bps lower. Following these moves, valuations are hovering close to the five-year average.

One of the key reasons behind the strong performance in 2019 was the return of onshore Chinese investors – they had been largely absent the year before. Their continued participation would provide a useful boost for the market. New supply is also expected to moderate following a record year of issuance in 2019. Again, this should provide some support assuming inflows into the asset class remain positive.

Overall, the global macroeconomic backdrop appears to have stabilised, which augurs well for risk assets including credit. Nevertheless, following stellar performance last year – where both investment grade and high yield Asian credit markets registered double digit gains – some caution is warranted. We'll be waiting for a pullback in valuations before substantially increasing risk exposure in our Asian credit portfolios.

1 Spreads are the difference in yield between corporate bonds and comparable high quality government bonds. The spread reflects the higher risk profile of corporate debt compared to government debt.