Bubble trouble for fixed-income assets?

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Fixed income was the hot asset of 2012, producing equity-like returns for debt-like risks. Within it, Asian bonds issued in US dollars produced stellar returns for investors. While Asian US dollar bonds produced a total return of 14 per cent, the high-yield sector within it outperformed it with eye-popping gains of 19 per cent.

Little surprise, then, that the new issue volumes also reached record levels in Asia. Asian investors emerged as the largest group in 2012, subscribing to 59 per cent of the total amount on offer.

But what does the future hold for fixed-income investments? Let's consider some of the forces likely to drive fixed-income investments in 2013. First, the interest rates still hover around multi-generational lows. This reflects the depth of the global financial crisis. The low rates also reflect the extraordinary actions taken by the US Federal Reserve, the European Central Bank, and other monetary authorities, in flooding the economies and markets with liquidity.

This automatically raises the concern that bonds are in bubble territory, and a sudden spike could kill investors in general and fixed-income investors in particular. This underlying fear is logically correct, but it is unlikely to happen in 2013. For one, the US economy is barely limping back to normalcy.

The Federal Reserve must keep interest rates low for a while longer. Unemployment remains at a high 7.7 per cent. The US inflation rate shows no sign of spiking, with inflation staying subdued at 1.8 per cent. The Fed has promised to keep the rates low until unemployment falls to 6.5 per cent and the inflation outlook picks up to 2.5 per cent.

The other risk concerns non-investment-grade bonds. Many investors have been attracted by the high yields on offer. The Hong Kong Monetary Authority recently sent questionnaires to several private banks asking them about their sale of high-yield bonds, worried that investors did not appreciate the risks.

Warren Buffett once remarked, "You never know who's swimming naked until the tide goes out." The tide of liquidity is keeping all the high-yield companies floating, but not all of them will manage to raise finances when the liquidity starts draining. Investors must choose their bonds carefully, as weaker issuers could falter should liquidity start drying up.

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