There is life in Asian high-yield bonds yet

Investors should keep favouring them over investment-grade bonds

By **DILIP PARAMESWARAN**

ASIAN high-yield bonds have had a tremendous run since the global financial crisis. In the four years from 2009 to 2012, they have produced annual returns of 43 per cent, 16 per cent, 3 per cent and 21 per cent, respectively (see chart).

This is by any means a handsome return for those who dared to take the plunge after the 2008 crisis.

During this period, the yields on the high-yield bonds have also fallen significantly. As a result, the better-quality high-yield bonds yield barely 5-6 per cent for a five-year maturity. This raises the question whether there is any attraction left in the high-yield bonds.

We believe that, when it comes to choosing their fixed-income investments, investors should continue to favour high-yield bonds over investment-grade.

To understand why, we must first discuss the interest rate environment. After reaching multi-decade lows, it is difficult for dollar interest rates to decline any further.

On the contrary, they may well start rising once the market starts pricing in expectations of revival in the economic growth, even ahead of the official increase by the US Federal Reserve.

Accordingly, many market participants are expecting an increase in 10-year US yields of 25-50 basis points by the end of this year. If that happens, high-yield bonds, with their higher yields, will have more room to tighten in terms of yields and counter the impact of rising US Treasury rates.

The financial markets have been awash with liquidity for the last three years, thanks to central bank actions in the United States and Europe.

We expect the comfortable liquidity situation to last well into 2014, which means that high-yield issuers will be able to refinance their maturing debt without much problem.

Low interest rates and the ease of refinancing are expected to keep the high-yield default rates low.

Moody's predicts that the Asia-Pacific (excluding Japan) high-yield default rates would be only 2 per cent in 2013, a very low level even if higher than the 0.7 per cent achieved in 2012.

While we have been arguing in favour of investing in Asian high-yield, a few words of caution are also in order. With this supportive outlook for high-yield bonds, the flow of new issues is likely to be strong through the year.

But not every bond issue might be worth buying. For example, investors have burnt their hands already by subscribing to some perpetual bonds recently.

Investors would also do well to be careful in their selection of bonds. Earlier this year, due to the flood of liquidity, even highly risky bonds with very low credit ratings (such as the "CCC"-rated issues from Glorious Property, Powerlong, Hopson Development and Greentown, all of them Chinese property developers) have found buyers.

But their ability to withstand unexpected market downturns or tighter financial market conditions is weaker than that of other issuers. It is important not to invest just based on yields, but to look closely at the fundamental credit quality of the issuer.

High-yield bonds are also likely to face greater volatility than investment-grade bonds. But those with the patience to ride through the volatility will ultimately do well this year.

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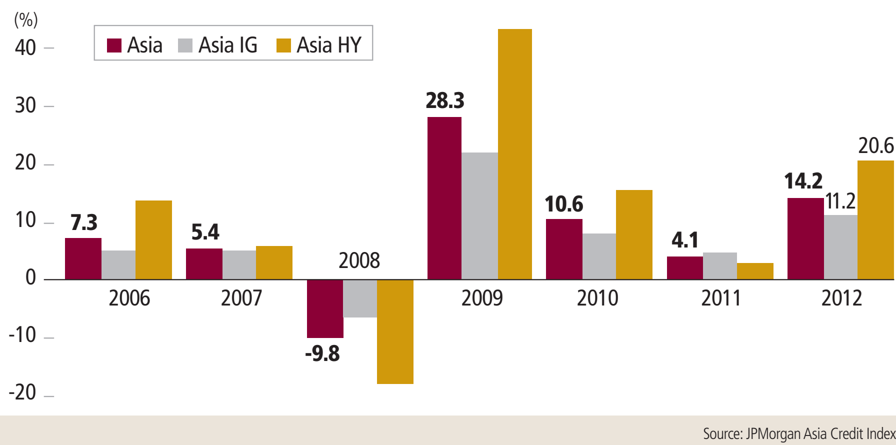

Barclays warns of risk to leveraged investors

Bond holders may be forced to sell if interest rates rise

[SINGAPORE] Wealthy Asian investors who have borrowed against their houses to buy bonds may find themselves among forced sellers if interest rates rise, spurring a price slump in vulnerable securities, according to Barclays plc.

US dollar-denominated notes sold by more than 20 companies including Olam International and Henderson Land Development are some of those most exposed if private bank clients move money out of the fixed-income market, Barclays said in a research note dated March 14.

Private banks hold 15-20 per cent of total corporate bonds in Asia and as much as 30 per cent of high-yield, or junk, notes.

Low borrowing costs have been one of the main factors driving the strong demand for Asia credit, and many high-net-worth investors went further into debt to buy the securities, according to the report.

In the past six months, equities have generated solid returns while credit has lagged, creating a risk that fund flows will rotate out of bonds in a quest for higher returns and compound the price slump.

"US rates are already beginning to rise, albeit gradually, and leveraged lending could be scaled back if risk committees begin to focus on the quality of such lending," wrote the Barclay analysts, who were led by Krishna Hegde, Singapore-based head of Asia credit research.

Furthermore, any sharp or sustained sell-off in Treasuries would impact bond prices and raise borrowing costs. Considering that most private bank investors do not hedge rates, "this is an important risk factor", they wrote.

Ten-year Treasury yields have risen 20 basis points this year to 1.95 per cent as at March 19. Asian stocks have returned 4.04 per cent since Dec 31 versus 0.83 per cent for US dollar bonds in the region, Bank of America Merrill Lynch indexes show. "Based on our discussions with various private banks, we think some private accounts could face margin calls if US Treasuries sold off by 1.5 per cent to 2 per cent," Mr Hegde wrote.

In such an event, credit committees may turn conservative and scale back on loan-to-value ratios, which could result in margin calls for highly leveraged portfolios, according to the report.

Bonnie Ngan, a Hong Kong-based spokeswoman at Henderson Land, declined to comment on the report when contacted yesterday. Chow Hung Hoeng, a Singapore-based spokeswoman at Olam, also declined to comment.

Other bonds flagged in the report as being potentially vulnerable include Cosco Pacific Ltd's US$300 million of 4.375 per cent notes due in January 2023; the US$350 million of 6.375 per cent September 2017 bonds sold by Sun Hung Kai & Co; and Soho China Ltd's securities in US currency. "A potential slowdown could affect segments such as Reg S only issues from Hong Kong companies that are unrated or BBB-," the analysts wrote.

High-yield bonds currently priced below issuance levels with a concentrated buyer base and corporate hybrids that have weak structures could also be hurt, he said. Bonds sold under Regulation S may not be offered or sold to investors in the US. – *Bloomberg*

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