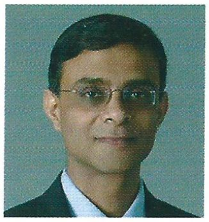
Is there a bubble in Asian fixed income?



DILIP PARAMESWARAN asks whether Asian bonds are due a sudden correction.

OVER THE LAST three years, yields and spreads on Asian bonds have steadily declined to the point that "high yield" has become an oxymoron. The JP Morgan Asia Credit Index (JACI) has produced a total return of 7.8% so far this year, and many people are asking the question: Is there a bubble in Asian fixed income?

The "B" word has become an amorphous concept – one that everyone talks about all the time, but no one knows precisely what it means. Let us try to keep the dreaded word in perspective for our discussion. One definition of a bubble is when the prices are far in excess of the fundamental value of the assets. Another way to look at a bubble is as an unsustainable and rapid rise in prices. Either way, a bubble carries the potential to hurt investors when it eventually bursts.

Keeping this in mind, let us examine the evidence in the Asian US dollar bond markets. The first piece of evidence for the existence of a bubble is the contraction in both yields and spreads. It is true that the current yield to maturity of 4.6% for JACI seems too tight, particularly when compared with the high of 11% during the global financial crisis. But if we disregard the spike in yields during the crisis and the period when the interest rates were slashed in its aftermath, average yields have moved in a narrower range of 4.2%–5.5% in the last four years, and the current yield is near the middle of this range.

Similarly, the current average spread of 243bp over US Treasuries appears tight when compared with the high of over 800bp at the peak of the crisis. But in the last four years, Asian credit spreads have ranged between 214bp and 450bp; and if we disregard the mini-spike during the European sovereign crisis, they have moved between 214bp and 320bp. Compared to this range, the current spreads do not appear so alarming. In fact, they are still more than double the tight levels of 109bp reached in 2007.

ASIAN SPREADS STILL offer value, compared to US domestic bonds. Asian investment-grade corporate bonds, for example, trade at 180bp over Treasuries, while US industrial bonds with equivalent credit quality and maturity trade at spreads of 100bp.

When we consider the fundamentals, another key factor is the default rate for bonds. According to Moody's, the global high-yield default rate stood at 2.1% in July 2014, well below the historical average of 4.7%. In Asia-Pacific, Moody's predicts a default rate of 3.3%.

Such low default rates are one of the main supports for the current tight spreads, but we must remember that low default rates are themselves partly the result of loose liquidity conditions and easy monetary policy. That brings us to one of the key reasons to question whether the Asian bond market might collapse in a bubble-like fashion when rates start rising and liquidity begins to ebb.

It is doubtless true that bond valuations have benefited from falling rates. In 2014 so far, of the 7.8% return generated by Asian bonds, 3.6% has come from a fall in Treasury yields and the rest from tightening spreads.

THIS COMFORTABLE ENVIRONMENT would change as the Fed starts raising rates in the second half of 2015. Not only will longer-duration bonds face capital losses, but weaker companies would also find it more challenging to roll over maturing debt – in turn leading to higher default rates.

It is based on such fears that some predicted a "great rotation" of funds from fixed income to equity. But so far, in the Asian bond markets, there has been scant evidence of such a shift. New issue volumes are touching record levels, with US$120bn sold so far this year, up 35% over the same period in 2013. Although private banks have taken up only 9.7% of new issues this year, down from 16.2% and 13.9% in the last two years, institutional funds have more than filled the gap.

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At a very fundamental level, Asian economic growth is holding up reasonably well, although all eyes are on growth rates in China and India. For the Asian bond market, China's economy is a key variable, especially as it pertains to the Chinese property sector.

So, finally, is there a bubble or not in Asian bonds? Although valuations are stretched at the moment, they are not entirely divorced from fundamental factors. Some of the supporting factors such as low rates and high liquidity will diminish over the next two years, but I believe the correction will be orderly and not a sudden collapse. Asian bond valuations may be tight, but they are not a bubble.

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ASIAN BOND SPREADS (BP)

	Current	Pre-crisis tight	Mid-crisis wide	4-year tight	4-year wide	Notes
JACI	246	109	813	214	460	The 4-year wide level was reached in 2011 in the midst of the European sovereign crisis. Otherwise, the range has been 214-320bp.
JACI - IG	178	75	661	179	339	
JACI - HY	472	150	1,222	235	625	

Source: Asia Investment Advisors