COMMENT

Steering through the storm in Asian credit

Risks are rising along on the way, but Asian bonds could still deliver a positive return for this year, says **DILIP PARAMESWARAN***.

ASIAN BONDS POSTED a splendid return of 8.3% in 2014, far above anyone's wildest dreams. As we move into 2015, can they repeat their performance?

The first challenge facing Asian credit is the global economic backdrop. The most important hurdle this year is the impending rise in US interest rates and its impact on asset markets. Although the consensus is for rates to finally start rising in the third quarter, the potential pace of that increase is unclear, particularly in the face of the stubbornly low inflation.

In Europe, growth is stalling even for countries with strong balance sheets, and the economy is inching closer to deflation. Greece's sudden elections may trigger renegotiations with other eurozone countries and raise the spectre of a currency breakup. Japan remains an experiment in progress, with the success of Abenomics far from assured in the face of faltering growth and sluggish exports.

By contrast, the economic picture in Asia is much brighter. Although various indicators have repeatedly shown that the Chinese economy is slowing, there is enough room for fiscal and monetary relaxation to maintain a growth rate close to 7% for 2015. India's new government faces a rare confluence of positive factors. Lower oil prices will bring the current account closer to balance and reduce inflation, enabling interest rates to be cut and fuelling a pick-up in growth. The new government in Indonesia has also begun to take difficult decisions to cut fuel subsidies and devote more funds to infrastructure development.

Overall, the International Monetary Fund forecasts Asia ex-Japan to maintain its growth steady at 6.3% for 2015.

ACCORDING TO THE JP Morgan Asia Credit Index, Asian spreads ended 2014 exactly where they started: 262bp.

At the current levels, Asian spreads are still much wider than before the 2008 global financial crisis: investment-grade spreads are more than double (188bp versus 83bp) and non-investment-grade spreads are more than thrice the pre-crisis levels (534bp versus 167bp).

In comparison to US spreads, Asian investment-grade corporate bonds provide a yield pick-up on average of 120bp, and Asian non-investment-grade corporate bonds pay 190bp more at the same rating and maturity. While some of this may be attributed to poorer liquidity, more complex legal systems and macroeconomic vulnerabilities, it still indicates the premium that Asia can provide.

Although the year has begun with a potential bond default by China's Kaisa Group, a multitude of defaults through the year is unlikely.

International bond issues from Asia hit a record of US$210bn last year, and there should be no problem in finding buyers for another year of heavy supply. One positive development in the last five years has been the superior ability of Asian investors to absorb Asian bonds, taking 57%–58% of last year's new issues, up from 40%–45% of a much smaller volume pre-crisis.

That brings us to the question of what will happen when interest rates start rising. Based upon previous rate cycles, there is no evidence to support an automatic widening or narrowing of credit spreads; rather, spreads depend on the prevailing macro and credit environment.

GIVEN THE REASONABLE economic growth, subdued default rate, higher spreads in Asia and the growing investor base, our base case is that Asian spreads would contract by about 20bp this year, delivering a total return of about 3% assuming five-year Treasury yields rise about 70bp. While this is lower than last year's total return, it must be remembered that about 60% of last year's return came from falling Treasury yields, a supporting factor unlikely to be repeated this year.

However, our forecast is not meant to rule out high volatility or idiosyncratic risks during the year. If oil and commodity prices continue to decline, or if the Russian situation gets worse, emerging markets in general could suffer and a contagion effect could reach Asia as well. While it stands to reason that Asia would be a net beneficiary of lower oil prices, and investors should be able to differentiate Asia from other emerging markets, volatility may still affect valuations in the interim.

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Europe still has the potential to emerge as a significant source of volatility. Closer to home, China could roil the markets, too, if it struggles to rev up its economy.

The consolation in these cases is that the Fed might be pushed to slow the pace of rate increases, and equity markets may perform worse than expected, again prompting higher allocations to fixed income.

Within Asian credit, volatility in high-yield is likely to be much higher this year and one or two mistakes could wipe out the returns from a high-yield portfolio. Individual risks have risen in Chinese property, and some lower-rated issuers may find it difficult to refinance their maturing bonds. Issuers from the resources sector from Indonesia and China are at risk of a further slide in commodity prices. Subordinated debt issues from banks are also pressuring higher-rated high-yield bonds. Our preferred strategy is to overweight investment-grade, while maintaining an exposure to high-quality high-yield names.

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