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| First State Investments - Asian Fixed Income |
| Asian Fixed Income |
| **November 2018** |
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**The Outlook for Asia**

The market outlook for Asia and the bond market demand remains positive according to our analysis. Growth outlook remains constructive, inflation contained, and Asia’s central bank rates are higher than in developed markets and thus leave bullets in the case of growth decline. On the negative side, there is a growing demographic pressure that will require the need to develop sustainable pension systems. We think about this in the context of a very strong size growth of the Asian USD credit market and looking forward we believe the demand dynamic for Asian Investment Grade credit should remain robust.

**Outlook for Economic Growth in Asia**

Asia stable and robust economic growth in the past decades has increased the region significance in Global GDP context. Asia share of GDP has risen from 31% in 2000 to 45% in 2018, taking account of almost half of Global GDP. This is a positive trend for Asia while an opposite trend is observed in other regions. US and China trade tensions may impact global growth especially Asia, nonetheless it is still projected to be the fastest growing region globally.

Bloomberg survey estimates Asia growth to come in at 6.1% in 2018, and moderating to 5.8% in 2019.

%



Source: Bloomberg as of 31 October 2018.

Along with this projected economic growth, GDP per capita’s are projected to rise significantly, supporting the development of a middle class in Asia that is significant in terms of population.

**Outlook for Demographics in Asia and Potential Implications for Pension demand**

Source: Bottom graph ICI Global and US Census “Globalisation and the Global Growth of LT Mutual Funds” as at March 2014

Number of Retirees per 100 workers

* Many of Asia’s retirement systems are ill prepared for the rapid population ageing
* The demographic change to fewer babies and longer life expectancy took a century in Europe and North America
* In Asia this transition is happening in a generation. Asia’s ageing will be at its peak between 2010 and 2030 according to the OECD
* Compared to OECD averages the percentage of those who contribute to pensions is low
* Pension reforms are on the agenda of Asian countries. Models in Singapore and Hong Kong are often used as guides
* A broader agenda exists now in recognition of the benefits a domestic pension system brings to the stability of demand for domestic bond markets

**Outlook for the Development of Pensions Industry in Asia**

The Hong Kong and Singapore’s Pension systems are the most developed in the region. Using their growth as a guide for potential growth of new pension systems, a rapid development of pensions across the region presents significant opportunity.

1. HK’s MPF – today approximately US$80bn – actuarial Society of Hong Kong paper 2015 predict this to be US$335bn - US$413bn by 2035 (over 300% growth)
2. SG’s CPF – today US$195bn – last 15 years has averaged a growth in size of 8%. The actuarial assumptions predict growth to between US$900bn and US$1.1trn by 2035 (over 300% growth)!

Other major economies in the region are coming off a lower base in terms of the pension system development. Arguably the pace of growth and development could or should be greater for said economies. The Asian Development Bank in a 2015 publication forecast that over the following 15 years, 500 million adults in Asia will begin a pension savings plan for the first time. This should be supportive of demand for Asia fixed income. Furthermore, this will further complete the positive household savings rates that exist throughout China. Something absent from many developed markets.

**Regulatory Reform / Harmonisation in Asia**

A challenge for Asia’s financial markets has been harmonisation of financial markets. Lead regulators in the region collaborate and where feasible enact policy consistent with other regulators in the region. However there is much more than can be done to reform regulation and harmonise financial markets. An interesting recent development has been the announcement that the International Organisation of Securities Commissions (IOSCO), the world’s leading body of capital market regulators that oversees markets worth over US$140tril, launched its first-ever Asia-Pacific hub in Malaysia. It will play a major role in developing capital markets, on a collaborative basis, which will help the capital markets grow even further. The hub is also expected to strengthen regulatory capabilities in the region.

**China Onshore**

A recent development that directly impacts the Asian bond market is the ongoing opening of the China onshore bond market. Whilst access is available within certain daily limits, the longer term objective is to support two way flows of capital, specifically between onshore China and Hong Kong. Initially the development is aimed at attracting international investors to its vast onshore markets (the world’s third largest). By broadening the investor pool it should improve the quality of its onshore debt markets and ultimately stem outgoing capital flows. The next step would be larger two way flows that should be supportive of Asian bond markets.

**Summary View**

Asia remains the region with better economic growth and contained inflation. The demographics are deteriorating and requires focus from governments on pensions and savings which is being done so in countries such as Singapore and Hong Kong, but needs further action in many others. Pension growth should underpin support for Asia USD Investment Grade in the coming years. The announcement of IOSCO’s first hub in Asia (we believe) is a significant step towards the promotion of more harmonisation across the countries in Asia. Additionally, Asian Credit valuation has become more attractive following months of spread widening, especially for all in yield investors such as the pension funds and insurance companies.

When considering these factors, the demand point to a strengthening bias. This is why when we meet investors yet to allocate to Asia USD Investment Grade our suggestion is to consider it as a core holding going forward. **Why Asian Fixed Income**

We believe we stand at a juncture where Asia Fixed Income (specifically USD credit) should be considered a strategic allocation instead of tactical. The market is maturing and consistently produces risk adjusted returns that compare well across other asset classes. Demand continues to grow for Asia Fixed Income yet globally, the asset class remains under allocated. The previous long held concerns about allocating to Asia Fixed Income have diminishing. Historically the primary concerns with Asia Fixed Income are:

* Lack of Diversification
* Low Credit Quality
* Excessive Volatility
* Inadequate Returns

We believe that the growth and development of the Asia Fixed Income market in recent years will continue diminishing even further the concerns above.

**Lack of Diversification**

Asia Fixed Income markets have experienced significant growth since 2008. By way of example, we consider the growth in a widely used Asian Fixed Income Benchmark, JP Morgan Asia Credit Index (“JACI”). Since 2008, JACI has quadrupled its market capitalization (Chart 1 below). Within that, the number of issuers in the benchmark has almost tripled. When considering the number of issuers and that Asian Fixed Income issuers (eligible for benchmark inclusion) originate from 17 different countries, this facilitates the construction of portfolios far more diversified than ever before. Today China issuers are the largest constituent of Asia Fixed Income, followed by Indonesia, South Korea, Hong Kong, and India.

**Chart 1: JP Morgan Asia Credit Index**

**Expanding Investment Universe**

 

**KEY STATS:**

* Size of Index (RHS) has increased from $257bn in 2010 to $871bn in Oct 2018.
* Number of eligible issuers (LHS) in the index has increased from 208 issuers in 2010 to 537 in Oct 2018.

Source: First State Investments and JP Morgan. Data as of 31 October 2018

**Low Credit Quality**

The growth in issuance in Asian USD credit in general has been dominated by Investment Grade Corporates. In 2015 approximately 80% of the new issuance that came to market came from Investment Grade Corporates (Chart 2).

**Chart 2: JP Morgan Asia Credit Index**

**Ratings Diversification dominated by Investment Grade**



Source: First State Investments and JP Morgan. Data as of 31 October 2018

**Excessive Volatility**

Asia Fixed Income had historically endured volatility greater than other investment grade markets. With the growth in the market creating a deeper and more diversified universe, Asia volatility has begun to recede. However our research has pointed to an additional point that may contribute to the decreased volatility. Chart 3 compares annualized 12 month rolling volatility of Asian Investment Grade to US Investment Grade, overlaid with the total market capitalisation (RHS) of Asia Investment Grade. From 2009 (i.e post crisis) Asia Investment Grade has exhibited more volatility than US Investment Grade. Interestingly though from the end of 2014 until today, Asia Fixed Income volatility has largely mirrored that of US Investment Grade.

**Chart 3: Annualised volatility of total returns**



Source: First State Investments, JP Morgan, and Bloomberg Barclays. Data as of 31 October 2018

A recent study by KPMG looked at where the Asia Fixed Income Assets reside. Over the last five years the percentage of Fixed Income assets held within Asia has continued to grow, rather than being held in the US or Europe (Chart 4). We believe that this is a contributing factor to the reduction in volatility as Asian investors would be far more aware of the issues with respect Asian issuers, than foreigners.

 **Chart 4: New issue investor allocation by region**



Source: First State Investments and BoAML. Data as of 31 October 2018

As discussed we attribute this to market growth and greater participation by Asian based investors.

**Inadequate Returns**

Asia Fixed Income has delivered consistent returns year on year. Since inception (Chart 5) the JACI IG has provided consistent yearly positive returns except in 2008 (in line with most asset classes) and 2013 (as a result of taper tantrum). Additionally a common misconception is that Asia Fixed Income will underperform in a rate rising environment in the US. The JACI index was launched in September 2005, in the middle of the Federal Reserve’s last rate rising cycle that lasted through to the middle of 2006. That cycle was quite aggressive yet Asia Fixed Income still generated positive returns. In 2018, Asia credit market ytd return was negative, the first time since taper tantrum. While the resilience of Asia credit returns against Fed rate hike cycle were evident throughout 2015 to 2017, Fed hiking cycle in 2018 is concurrent with escalating US China trade tensions, Turkey fallout, falling Asia exchange rates and thus general risk-off sentiments has impacted returns.

**Chart 5: JP Morgan Asia Investment Grade Credit Index**

**Annual Total Returns**



Source: First State Investments, JP Morgan, and Bond Radar. Data as of 31 October 2018.

In the context of volatility (i.e. risk adjusted returns or Sharpe Ratio), We compare Asia Fixed Income to major asset classes (Chart 6). Asian Investment Grade Sharpe Ratio when compared to other asset classes for the period from 2009 (Post GFC) to October 2018 remains favourable.

We see increasing probability of more investors allocating to Asia Fixed Income in the coming years. As Central Banks crowd out Fixed Income investors globally, Asian Fixed Income will grow in importance. With higher returns than US Investment Grade and Europe Investment Grade, and annualized volatility akin to US Investment Grade, we believe this makes it an attractive asset class.

**Chart 6: Asset class risk adjusted returns for the period since post GFC to 2018**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **5-year US Treasury** | **Asian USD IG** | **Asian USD HY** | **US IG** | **US HY** | **Euro IG** | **Euro HY** | **EM USD Sovereign** | **EM USD Corporate** | **Global Equities** | **US Equities** | **EM Equities** | **Asia Ex-JP Equities** |
| Annualised Return | 2.2% | 4.5% | 7.2% | 3.0% | 7.3% | 4.5% | 8.9% | 6.0% | 5.7% | 8.4% | 12.9% | 2.4% | 4.9% |
| Annualised Volatility | 2.8% | 3.6% | 6.4% | 2.8% | 5.8% | 3.4% | 7.0% | 6.3% | 4.8% | 13.1% | 12.0% | 17.3% | 16.5% |
|  |   |   |   |   |   |   |   |   |   |   |   |   |   |
| Sharpe Ratio | 0.6  | 1.1  | 1.0  | 0.9  | 1.2  | 1.2  | 1.2  | 0.9  | 1.1  | 0.6  | 1.0  | 0.1  | 0.3  |

Source: Bloomberg, First State Investments, JP Morgan, Barclays, and MSCI as of for the period of since post GFC (2009) to 31 October 2018

**Outlook 4Q 2018 for Asian Credit Market**

As the US Fed continues to normalize interest rate, financing conditions globally will continue to tighten as it did in the past few quarters. Moreover, the ongoing trade war between the US and China will slow down global growth and dampen investors’ confidence. While it is difficult to predict how the trade war will pan out or whether the Fed will hike interest rates more aggressively, focusing on Asian corporates’ fundamentals does provide some optimism that many will be able to weather the storm. Across the investment grade universe, key measures such as EBITDA and net income margins have improved over the last three years. Debt ratios have also come off while liquidity remains ample with the average cash level at more than 30% of total debt. In the high yield space, the above mentioned metrics have also started to improve since 2017, following several years of deterioration. Hence barring a complete meltdown on the trade war front and Asian currency depreciation spiraling out of control, Asia as a region is still expected to grow at a decent rate that is well above its peers. This will likely provide strong support for the improving credit trends and translate into positive rating actions.

The rally in credit we anticipated in our Q2 outlook did materialized. JACI IG spread as at end of 3rd quarter was about 10bps tighter than the wide this year. While it is still around 30bps tighter than the post crisis average, the all in yield is now at a post crisis high following the recent run up in treasury yield. This should increase demand for Asian bonds amongst the long term investors and lifers. Asian IG bonds also offer a yield pickup of up to 50bps vs US peers, further supporting its attractiveness. Asian high yield spread has also tightened in Q3 by approximately 50bps from an oversold territory. While the spread pickup vs US HY has increased, bringing it closer to historical average, we are mindful of the idiosyncratic risks that is omnipresent amid the tightening of financial conditions. Spike in oil price will also likely bring about another bout of volatility. Despite expectations of a pickup in supply post China’s Golden week in October, we do think deal size and pricing will be favorable for investors against the current backdrop of an uncertain economic outlook. Hence we believe total supply for the year will come in lower than previous year’s level, providing market with a balanced technical backdrop.

Uncertainty remains, caution warranted. Stick to quality and fundamentals is still the way to ride through any storms. We would look to add more US treasuries is sell-off continues, be selective and hold a diversified portfolio of credits with strong fundamentals and avoid local currency bonds as we expect more volatility ahead.

Source: JP Morgan, Bloomberg as of 31 October 2018

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