Look to the future

First State Investments' Jamie Grant gives his take on Asian fixed income

VOLATILITY and uncertainty have soared since the Brexit vote. Jamie Grant, Head of Asia Fixed Income, First State Investments, shares his perspective on the Asian fixed income outlook.

Q: Given the uncertainties and the pall cast over global growth, what do you see as the positive (or negative) underpinnings for fixed income assets, and Asian fixed income in particular?

Asian fixed income, specifically USD-denominated corporate credit, posted positive returns in the first half of 2016. Despite outperforming US investment grade and US high yield for much of the last year, Asian credit remains largely under-allocated globally due to antiquated views.

Long-held reservations about Asian credit are driven by concerns that we think are becoming a thing of the past. Since 2008, the Asian credit market has undergone dramatic changes that have slowly dissipated concerns about the lack of diversification, poor credit quality and liquidity. Looking at the more commonly used Asian credit benchmarks alone, we can see that the number of corporate bond issuers since 2008 has increased by more than three times resulting in greater diversification and liquidity. Today, we are able to build portfolios with much better diversification thanks to a greater number of issuers available.

Strides in credit quality have been the most important development. When analysing Asia credit investment grade benchmarks against US investment grade benchmarks, we found that the average ratings have equalised over recent years, proving that the traditional perception of Asian issuers as being poorer in overall credit quality is no longer valid. This improvement in average credit quality has been driven by the rapid growth in new investment grade issuers.

Yet, there are other interesting developments that are providing stable footing for Asian credit returns, particularly in terms of where the ownership of the assets resides. Today, over 60 per cent of the universe is held by investors who reside in Asia. The growth is significant when we compare this to historical ownership trends. We believe it is a contributing factor to the stability of returns as Asia-based investors are far better equipped to understand the risks and opportunities presented by this asset class.

Looking ahead for the rest of 2016 we see several factors that will pose challenges for returns. Until recently monetary policy divergence was likely the dominant factor. Asia sits between the US Federal Reserve and their desire to raise rates and the stimulus boosting policies of the Bank of Japan and the European Central Bank. This will result in a continuation of the theme that we have seen for some time – increased volatility. However, the recent UK vote to leave the European Union ("Brexit") has reduced expectations for rate rises.

We think political uncertainty in Europe and the US in the second half of 2106 will drive volatility. Yet, Asian fixed income continues to weather such volatility well by providing consistent returns. Year-to-date, Asia credit has posted better returns than Emerging Markets corporates, US investment grade and US high yield. While spreads have widened, returns have been supported by the rally in underlying Treasury yields. The upside is that the widening of spreads now sees them above long-term average. However, when considered in the context of the credit fundamentals of Asian issuers against their US peers, the credit fundamentals for Asian issuers remain more stable.

Q: The US dollar (USD) has been on a strengthening trend over the past three years. What impacts do you anticipate for corporate issuers and how are they mitigating these?

The strength of the USD recently presents challenges for Asia corporates. For Asian issuers in general, the USD market offers access, liquidity and the ability to raise larger amounts than possible domestically. As the USD rises, so does the value of debt which can create challenges for corporates. However, this does not mean that investors should shy away from companies issuing USD-denominated bonds as it is likewise common for many Asian corporates to generate revenues and cashflows in USD, which acts as a natural offset.

When considering corporates in South-east Asia, understanding the structure of cashflows is a significant benefit. South-east Asian corporates typically do not hedge their USD exposure leaving them exposed to currency fluctuations. In 2015, several South-east Asian currencies experienced significant weakness against the USD.

As a result, some companies from the developing countries were unable to refinance their debts given the lack of depth in their domestic bond markets. In China, some companies, particularly property companies, have started to refinance their foreign currency bonds domestically in an effort to mitigate the impact of a strengthening USD.

Q: Please share with us your investment discipline – how do you select credits and what drives a buy or sell decision?

At First State Investments, we build our portfolios using a combined top-down and bottom-up process. For key decisions, such as whether to overweight credit, we employ a factor-based approach, which breaks down the main drivers of credit markets, namely: the macroeconomic environment; the political environment including government/central bank policies; valuations and risk premium; technical including the supply and demand backdrop; and finally sentiment.

These factors are scored and weighted before a decision on credit positioning is taken. Once agreed, we must choose which countries to overweight and underweight.

We are currently overweight China, Hong Kong and India where we feel that valuations are adequately compensating investors for the risks undertaken and additionally for Hong Kong, we expect limited issuer supply. We are underweight the Philippines and South Korea predominantly on the view that valuations are looking expensive relative to other countries.

Finally, we then look to build – from bottom up – the portfolios by adding securities that we have shortlisted through a proprietary credit analysis process. Further embedded in our approach is an Environmental, Social and Governance (ESG) assessment, which seeks to highlight those non-financial risks that have the potential to become financial.

Q: Worries over a credit bubble in China have weighed on the asset class. How justified are these concerns?

Global financial markets have agonised over China and the risk of a "hard landing" for some time. Reports in Western print media appear to suggest that China is set to implode at any moment. However, the reality is that China is slowing and rebalancing at a time when they are gradually opening the economy. Worrying about whether China will grow at 6.5 or 6.8 per cent has not been our concern. Rather, we have looked at signs that show growth will stabilise. With that we have focused specifically on monetary conditions and their lag on GDP (gross domestic product) growth.

Monetary conditions, which have continued to tighten into the end of 2015 due to rate cuts, banks' RRR (reserve requirement ratio) cuts and a weakening economy, have now begun to ease. While still tight relative to history and other economies, monetary conditions have started to improve. This gives us the confidence that the economy will stabilise towards the middle of the year. This is the key reason why China and Chinese credits remain a key overweight in our funds along with Hong Kong and India. W

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