Asian bonds: Coming out of the woods in 2019

Asian bond enthusiasts will find more reason to rejoice in 2019. Looking at historical returns, Asian bonds typically return to positive territory following a year of losses. The asset class may be poised for a recovery this year, after 2018 that saw higher yields, wider credit spreads and a flattening US Treasury yield curve that markets took as signs of an impending recession. Investors previously spooked by rising interest rates can find comfort in anticipating that the US Federal Reserve (Fed) may slow down the pace of interest rate hikes amid US inflation levels and employment data that have reached targets.

Key factors for performance in 2019

- Historical bond resiliency
- US interest rate hikes slowing down; expect up to 2 Fed rate hikes in 2019, down from 4 in 2018
- Headwinds moderating from easing US-China trade tensions

Asian credit market trend

Asian credit markets typically do better following a year of poor returns. For instance, in 2009, the Asian credit market (in US dollars) rallied with a 28.3% return after a negative return of 9.8% in 2008. This was followed by a surge of 8.3% in 2014 after a loss of 1.4% in 2013.

Asian bond returns

Calendar Year	Percentage change in Asian bond benchmark returns (%)
2018	-0.8
2017	5.8
2016	5.8
2015	2.8
2014	8.3
2013	-1.4
2012	14.3
2011	4.1
2010	10.6
2009	28.3
2008	-9.8

Source: Bloomberg, benchmark used is the JP Morgan Asia Credit Index Core, in USD, as of 31 December 2018

Since Asian credit markets declined 0.8% in 2018, returns may turn positive for 2019, should historical standards serve as any indication for performance.

Lower risk

Bonds offer stability, an important feature to preserving capital. Despite the volatility in 2018, default rates on Asian high yield bonds stood between 2.5% to 3.5%, according to Bank of America Merrill Lynch.

Peer comparison: Asian bonds vs Asian equities from 2008 to 2018

Asset	Benchmark	Annualised Volatility	Annualised Return
Asian equities	MSCI Asia ex-Japan	18.4%	10.1%
Asian bonds	JP Morgan Asia Credit Index Total Return Composite	4.8%	7.6%

Source: Bloomberg. Data compiled from 31 December 2008 to 31 December 2018 in USD

In the Asia region, bonds offered decent returns against equities at lower volatility, so it comes as no surprise that the asset class was the darling of investors for the last decade. Up until December 2015 when the Fed raised interest rates for the first time in a decade, bond yields were on a downtrend which meant bond prices were rising throughout the period.

Interest rates and changing tides

When it comes to navigating the bond market, a key question for investors now is whether the Fed may possibly pause interest rate hikes to relieve market turbulence and pressure on a slowing US economy. Furthermore, Fed officials have pivoted their language in guiding markets. The stance on rate increases in January 2019 was described by Fed Chairman Jerome Powell as “patient”, departing from earlier comments in 2018 that looked forward to a “gradual tightening”. As a sign that rates will soften, the 10-year US Treasury yield has fallen to 2.66% (as of end January 2019), down since its 2018 peak of 3.24% in November 2018.

Hence the headwinds from a previously hawkish Fed should fade. As strength in the USD wanes, this should stem outflows from Asian risk assets and produce stronger Asian bond returns. In addition, bond valuations have become more reasonable as issuers pay higher yields to attract investors.

Trade wars

While headlines on trade tensions between the US and China have rattled markets, the conciliatory stances from both sides have encouraged capital inflows into the region. In November 2018 alone, foreign investors turned net buyers of Asian bonds as markets anticipated an optimistic outcome on a truce between US President Trump and China’s President Xi at the G20 meeting. This suggests that any signs of improvement, even if temporary between the two superpowers, will be positive for the Asian bond market.

Opportunities: Investment grade vs high yield

Whilst fundamentals of investment grade credits had stayed healthy with adequate liquidity, the recent rapid rise in US interest rates and credit spread widening pushed overall bond yields higher. This overall yield level presents a good entry level for investors with lower risk profiles to get invested at this time. For us, we like pockets of value within the Asian high yield offering a much higher return and yet minimal impact from any rise to US interest rates. The need for yield remains and we continue to be selective with credit differentiation. Moreover, as credit spreads had already widened out in 2018, we view the current valuation as compelling.

Bond funds

The most prudent way to invest in bonds for the long term is by purchasing units in bond funds. Firstly, bond funds require a capital outlay for as little as S$1,000, while the minimum investment to invest in a bond is S$250,000. A bond fund also provides the benefits of diversification by investing into a multitude of bond holdings from issuers across sectors, companies, geographies or governments.

Bonds are not without risks, such as the borrower’s (bond issuer’s) ability to honour the coupon payment and default risks. It is important to select for bond quality and the coupon which the underlying bond pays. The income stream from bonds provides a way to hedge against the core inflation rate and enables investors the predictability in their portfolio when planning for long term-obligations such as retirement and funding for children’s education.

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