# Clouds Starting to Disperse for Asia Fixed Income

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If 2018 was a perfect storm for Asia fixed income, then 2019 could turn out to be a Goldilocks environment. Growth expectations diverged in 2018 as the U.S. enjoyed a boost from tax cuts, while macro headwinds and negative sentiment weighed heavily on Asian markets. For Asia fixed income, the intensification of the Sino-U.S. trade war and rising oil prices earlier in the year were significant obstacles. Almost anything that could go wrong for Asia bonds in 2018 did. Looking to 2019, key questions for Asia includes, “Will U.S. economic outperformance continue? Or will an easing in U.S. growth expectations make Asian bonds look more favorable in comparison?” We believe slower U.S. growth and the prospect of the rest of the world having hit bottom could pave the way for outperformance in Asia bonds next year.

**Possible Positive Catalysts for 2019**

Toward the end of 2018, we see signs that many of the negatives for Asia (and positives for the U.S.) may be reversing, which makes us cautiously hopeful for 2019. The most dramatic reversal has been in oil prices, which fell more than US$25 in a month after peaking near US$85 per barrel. Lower oil prices tend to benefit oil-importing Asian economies, such as Indonesia and India, as lower prices lead to stronger current accounts and less inflationary pressure, which are positives for local interest rates.

In contrast, for U.S. growth, we now see some headwinds on the horizon. First, boosts from fiscal stimulus should diminish. Second, corporate sentiment has been hurt by trade policy uncertainty, which could impact investment. Finally, the past eight U.S. Federal Reserve rate hikes could weaken more vulnerable parts of the economy. To be clear, while we see signs that U.S. growth sentiment may be coming off a high base, we do not see imminent recession risks.

Much of the U.S. outperformance is based on expectations of better U.S. growth (and better earnings and lower default rates), leaving higher risk assets vulnerable to declines. In contrast, Asian high yield spreads had already widened significantly, pricing in a very negative economic outlook. We believe the level of default rates implied by current credit spreads is higher than what the actual default rates will be. If Asian economic fundamentals stabilize and the default rate stays low, Asian credit spreads should tighten in 2019.

**The Fed in the Spotlight**

Should U.S. growth slow, market expectations for the Fed to raise rates more aggressively may reverse. We expect the Fed to continue to hike rates to remove excess accommodation, but not to tighten monetary conditions. Lower U.S. growth expectations and a less aggressive Fed are typically ingredients for a weaker U.S. dollar. This could help countries in Asia, many of which had been forced to raise rates in 2018 to stabilize their currency. In this scenario, Asian local currency bonds start to look attractive.

In China, where monetary policy has turned from tight to loose in 2018, we could see continued easing in 2019. Chinese policymakers sought to reduce leverage in the riskiest segments of the economy in the first half of 2018 while minimizing spillover to other parts. As the rhetoric around the Sino-U.S. trade dispute heated up in the second half of the year, Chinese policymakers have reversed course by easing fiscal and monetary policies. Looking forward to 2019, we expect increasing stimulus, such as tax cuts, to support healthy economic growth. A stable Chinese economy tends to benefit the rest of Asia as well.

**Long-Term Value Proposition Has Increased**

Across interest rates, currency and credit, Asia's long-term value proposition has increased. On the interest rate front, the pressure for Asia's central banks to increase policy rates may fall with the Fed taking on an increasingly dovish tone. Falling interest rates may again provide a stabilizing tailwind to bonds. Furthermore, the most vulnerable countries, which had to raise rates to defend their currencies, have likely reached high points in the rates cycle and have the potential to reverse. For example, Indonesia and India had to raise interest rates to stem currency outflows at the height of the emerging market turmoil. As Asia's ccentral banks implemented policies that have been effective in stabilizing inflation, sentiment, and investor flows, we see value again in several countries' relatively high nominal and real rates.

On the currency front, our models indicate potential for Asian currencies to appreciate over the next year. These include the higher yielding currencies such as those of India and Indonesia, which depreciated along with their twin-deficit peers (those with current account and fiscal accounts) in emerging markets. Lower yielding currencies, such as the Korean won, Thai baht, and the Singaporean dollar also have potential to appreciate should the Sino-U.S. trade tariff dispute ebb. Tensions created by this trade dispute have disproportionately affected the currencies of these small open economies. When we analyze the various outcomes of the trade dispute, we see further tariffs being increasingly harmful to both sides.

In credit, we believe Asia high yield valuations look very attractive and if any of the risk factors of 2018 diminish, securities prices may be poised to rebound. In terms of valuation, U.S. high yield bonds appear overvalued relative to Asia high yield, while Asia high yield appears undervalued. U.S. high yield spreads are about 200 basis points below their historical average, while credit spreads for Asia high yield bonds are more than 75 basis points above average. This is a big divergence that is near historic highs (see Figure 1). Much of the downside has been already priced in, and we've noted opportunities for a recovery in security prices above.

Widening credit spreads among Asia high yield present an attractive entry point for investors, who historically have been rewarded over the long term for investing at this point in the cycle. Looking at the 20-year period ending September 30, 2018, when entering Asia high yield at the spread levels we see today, investors have historically achieved a positive return over any two to three year holding period. Even with a one-year holding period, 90% of the cases showed a positive return[1]. Though the past does not always spell the future, it does make us more optimistic about future Asia high yield returns.

As the Fed continues its quantitative tightening measures, volatility in the prices of higher risk assets has increased. We believe Asia fixed income, however, could be a relatively better asset class to weather volatility over the long term. Historically, since 1999, Asia high yield has offered better volatility-adjusted return than U.S. and global high yield, as well as emerging markets bonds (see Figure 2). Current valuation levels make this a compelling time to consider adding Asia high yield as a long-term diversifier for any portfolio.

### Sino-U.S. Trade War: The Case for Active Management

Looking beyond historic returns, the trade dispute between the U.S. and China represents the biggest challenge for Asian markets, and potentially, a disruption to the past 30-plus years of globalization. As trade issues remain unsettled, we expect to see additional volatility ahead as investors struggle with uncertainty around the impacts of tariffs.

However, the trade war also represents opportunities for many Asian economies and industries. Corporations in Vietnam and Malaysia, for example, tell us they have received increased interest from foreign companies looking to diversify their supply chain. In such paradigm shifts, it is often the biggest historic winners (who are often the largest index constituents) that are hurt the most. As such, we believe active management in Asia fixed income allows us to reduce exposure to risks facing some of the biggest issuers and index constituents, by allowing us to pick securities representing smaller or more idiosyncratic issuers and themes.

### Cautiously Optimistic

Looking ahead, Asia fixed income could benefit from lower oil prices, moderating U.S. growth expectations and an incremental boost from Chinese policymakers to support growth. Faster rate increases from the Fed and any potential escalations in the trade war represent risks. Since many of the negatives are already reflected in the valuations of Asia bonds, this gives us some comfort and leads us to turn cautiously optimistic about 2019.

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[1]Returns based on spreads for the JACI High Yield Index, which is the high yield portion of J.P. Morgan Asia Credit Index.

Index definitions

Bank of America Merrill Lynch High Yield Master II Index is a market-capitalization-weighted index that includes sub-investment grade sovereign and corporate issuers included in the J.P. Morgan Asia Credit Index.

Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Barclays Pan-European High Yield Index tracks fixed-rate, investment-grade securities issued in the following European currencies: Euro, British pounds, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Slovakian koruna.

J.P. Morgan Asia Credit Index (JACI) tracks the total return performance of the Asia fixed-rate dollar bond market. JACI is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and is partitioned by country, sector and credit rating. JACI includes bonds from the following countries: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Thailand and Singapore. Index is for comparative purposes only it is not possible to invest directly in an index. Source: BNY Mellon Investment Servicing (US) Inc., Index data from J.P. Morgan.

J.P. Morgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets and includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The EMBI Global defines emerging markets countries with a combination of World Bank-defined per capita income brackets and each country's debt-restructuring history.

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