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Asia's exceptionally high-yielding bond markets

The region's bonds stand out in a world of low and negative yields, but investors need to be picky.

There was a time when negative yields were a rare and unlikely curiosity. No longer: in late 2019, as much as US$16 trillion of bonds worldwide carried a negative yield,[1] although a more positive economic growth outlook means this number has since shrunk. Even so, plenty of debt still offers a meaninglessly low return.

Even places once considered frontier do not deliver in this environment. According to Morgan Stanley, around 30% of the universe of euro-denominated emerging market debt recently traded with a negative yield, including many corporate issuers.[2]

So where to go?

Investors can still find yield in emerging Asia, notably India and Indonesia. According to AsianBondsOnline, the debt market portal backed by the Asian Development Bank, Indonesian local-currency 10-year government bonds yield 7.08%.[3] Through much of 2019, Indian 10-year government paper offered between 4 and 5% over comparable US Treasuries, and Indonesia between 5 and 6%. China offers a deep and liquid high yield market.

International investors have been positioning for this opportunity for some time. According to AsianBondsOnline,[4] just under 40% of Indonesian local currency debt was held by foreigners at the end of June 2019, around 23% of Malaysian ringgit, and just over 15% of Thai baht.

Diverging markets

But it is not a free ride, and it would be an error to think of Asian debt as a homogenous block.

Even here, the plunge to lower yields seemed inexorable until recently. Sovereign bond yields in most Asian nations were expected to drift downwards, as central banks cut interest rates in order to spur economic growth, partly a consequence of the US-China trade war.

Consequently, yield curves inverted (meaning short-term yields are higher than long-term) in Singapore,

Thailand and Hong Kong, generally seen as a precursor of a recession. Yields fell everywhere in 2019, from China to the Philippines. A Reuters survey of over 40 fixed income strategists and economists in September showed that most expected yields to fall further for all countries bar Thailand; if the yield on China's 10-year sovereign debt had fallen to 3% at the end of the year, as the survey expected, it would have been the lowest level in three years. (In the event, it finished 2019 a little over 3%.)

But what's happening appears to be a bifurcation, not an outright pan-regional trend. Yields have been declining on paper from the region's most highly-rated nations: Hong Kong, South Korea and Singapore. They have also been declining in mid-ranked nations, including Malaysia and China. But they have stayed high in higher-yielding markets such as India and Indonesia.

The message that comes through consistently is that Asia is a place to pick and choose opportunity. So, for example, Chinese property dominates Asian high yield; a decisive call on that asset class is essential. With defaults rising as China has sought to deleverage at the same time as facing down a trade war, there are arguments that the sector is risky, yet careful credit selection can find very attractive investments.

A view on the currency is important too, with each under different pressures. The Chinese yuan was until recently depreciating amid a trade war and a slowing economy, for example, while the Indonesian rupiah is stable following the reelection of President Jokowi and a S&P Global sovereign credit rating upgrade.

No shortage of opportunities

Regional analysts from private banks have been quoted as expecting a 3% total return from Asian investment-grade debt over the next 12 months, and 6% from Asian high yield.[5] They judge short duration credits to be better, given the flatness of the yield curve, while a portfolio blending Asian investment grade and high yield should return over 4% in the next 12 months.

Better still, the risk involved is not as extreme as one might think: Bloomberg notes that the Sharpe ratio on Asian bonds, a measure of volatility-adjusted returns, is robust at 1.59 over the past five years. That is thanks to a strong regional investor base familiar with the asset class, as well as low corporate gearing ratios in the region.

And there is certainly no shortage of supply. Borrowers know they are not going to see opportunities like this every day, which is why dollar bond issuance in ex-Japan Asia hit an all-time record of over US$79 billion in the third quarter, according to Bloomberg data.[6]

There is plenty to look at, and good risk-adjusted yield can be found. But buyers need to be picky.

Sources:

1. Negative yielding debt hits record $16 trillion on curve fright, Bloomberg, 15 August 2019.
2. Negative yields leave EM investors with nowhere to hide, Financial Times, 11 September 2019.
3. https://asianbondsonline.adb.org/, 09 January 2020.
4. AsianBondsOnline, Asia Bond Monitor, November 2019, data as of end of September 2019.
5. Retaining the shine, The Business Times, 1 October, 2019.
6. Asia dollar bond sales hit record as issuers lock in cash, Bloomberg, 30 September 2019.

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