3rd October 2022

Do Asian investment grade bonds provide a good opportunity for yield hunting investors?

Over the past three months Asian High Yield (HY) bonds have continued to exhibit a great deal of market volatility. Between mid-July and mid-September, the Markit iBoxx Asian HY index (IBXXAHBI) saw an impressive recovery returning +5.58% in the 2 months between 19th July and 19th September although these gains have almost fully reversed in the past week on account of global market turmoil. Nevertheless, during this period Asian HY bonds have still materially outperformed Asian Investment Grades (IG) markets and indeed in the whole period from 19th July to present (29th September) Asian HY has outperformed Asian IG by 174bps. It is perhaps too early to say Asian HY markets have finally reached a point of stabilisation however clearly its massively cheapened valuation has allowed it to outperform the lower risk asset class despite the ongoing global market crisis.

The longer this continues, the more it is going to leave the markets with an interesting dilemma. As IG bond prices decline and yields naturally improve, we will need to ask the question whether the recent rise in IG yields will eventually justify adding some investment grade exposure to our Asia HY investment strategy? To answer this question it is perhaps best to understand first why IG bonds have been underperforming HY over the past few months and whether it may continue going forward.

With a weighted average duration of 4.88 (vs 2.58 for the High Yield Index), Asian IG bonds are always going to be more sensitive to interest rate moves. The increase in US Treasury yields has accelerated since the end of July after the US Federal reserve signaled a more aggressive than previously forecasted determination to fight persistently elevated inflation. Indeed, the "dots" plot from the September FOMC meeting that predicted a Fed Funds rate of 4.375% by the end of 2022 was certainly not something widely expected by the market two months ago.

Coupled with this has been the corresponding outperformance of the USD. The combination of an aggressive Federal Reserve, a global energy crisis and elevated geopolitical risk out of Russia and China was always going to be a dollar friendly

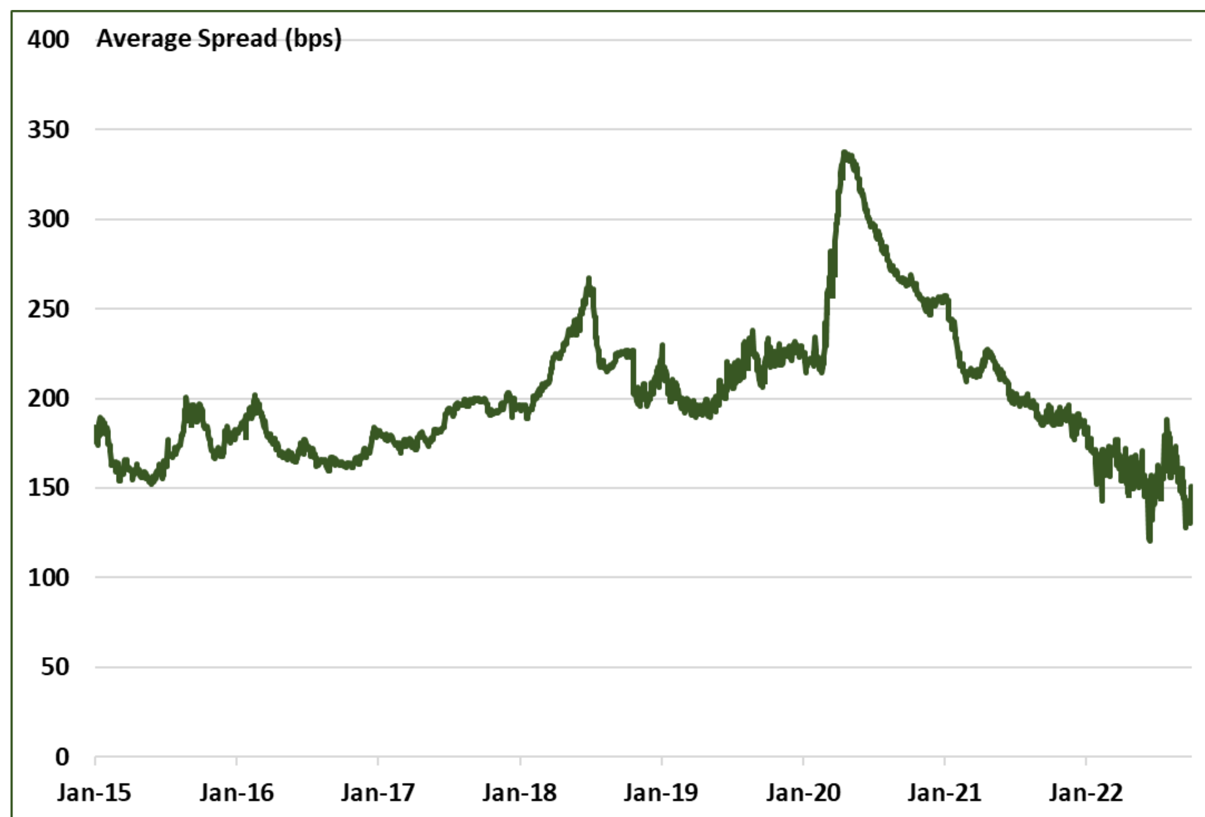
environment. More recent political upheaval in the UK and in Italy has further exacerbated the situation. This is particularly concerning for dollar funded Emerging Markets (EM) sovereigns that remain a material weighting in Asian IG bond indices (particularly the long duration buckets of those indices). For much of the past two years current account deficit countries such as Indonesia and India have managed to limit currency depreciation due to a combination of commodity price hedging (in the case of Indonesia) and economic growth (in the case of India). However, even these markets have found the relentless dollar strength impossible to hold back in recent weeks. A falling Indonesian rupiah, Indian rupee or Chinese yuan for that matter will all put an additional funding burden on Asian IG USD bond issuers that are financing their debt service through local currency receipts. Of course, these are problems that are faced by HY issuers as well as in some ways they should be more exposed to a deteriorating funding environment. However, given the massive fall in valuations led by China property bonds earlier this year the downside impact of the macro environment has had less impact recently.

Rising FX costs which naturally increases credit risk should be reflected in a widening credit spread for Asian issuers although the actual moves in spreads have been a lot more mixed than one would expect. For long duration Asian bonds, spreads are wider than they were a year ago and the tightening in CDS spreads seen over the summer has reversed sharply in the past week with the iTraxx Asia 5yr CDS Index now at its highest level since 2012. However, given the level of overall yields in the market, the recent spread widening appears inadequate to compensate investors for the additional macro risks, in our view. Credit spreads are typically correlated with risk free yields but the spread widening for global IG bonds so far in 2022 has remained quite modest. Furthermore, a study of China IG cash bond spreads shows the average differential between corporate credit bond yields and US risk free rates at the short end of the curve (i.e. 2-year maturity) is actually well below the long term trend (see Chart).

In other words, at a time when the USD 2-year risk free rate can provide a yield of 4.15%, the additional compensation for holding China IG credit exposure is only 145bps. We do not think this is sufficient or sustainable. We expect many investors would prefer to hold USD money market instruments rather than short dated Asian IG bonds at these pricing levels. This would suggest that investments in short dated Asian IG paper is not attractive at present when compared to HY paper.

However, that does not mean there is no value in short dated Asian investment grade bonds at all. It just means that one has to be more selective. As with all markets there are a spectrum of opportunities in the IG asset class, and we have seen that the underperformance of selected BBB rated names in Asia could provide exciting investment prospects. Several IG issuers had their yields rise to >10% over the past month and given our consistent strategy to maximize diversification and to find lower risk investment returns away from the distressed China real estate asset class, these issuers can provide a good enhancement to the overall portfolio. Of course, rising global FX volatility must be carefully monitored for all our positions as it continues to form an essential component of our single name due diligence.

Chart 1: Yield differential (spread) between 2year Chinese Investment Grade corporate bonds and 2 year US Treasuries



Source: Bloomberg / JKCM

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