Manulife Investment Management

2019 mid-year outlook — Asian fixed income

July 2019

Endre Pedersen
Chief Investment Officer
Fixed Income, Asia ex-Japan

Asian fixed income posted strong performance in the first half of 2019[1], as Asian bond yields (local currency and US dollar) edged lower. Some regional currencies, particularly those in emerging Asia that struggled in 2018, appreciated against the US dollar[2].

Against a backdrop of shifting Fed policy and the potential easing of Sino-US trade tensions, Asian bonds appear to be well-positioned. However, the situation remains fluid, and the evolving and complex interplay between these macro factors should continue to influence our investment approach – when volatility increases opportunity often knocks.

Spotting opportunity in volatility

In our 2019 full-year outlook, we stated that our investment strategy had shifted from a defensive position to an offensive one. We felt that global bond markets were overly optimistic about the health of the US and the global economy, which meant that interest rates were more likely to pause than go higher.

Moving into the second half of the year, we remain on the offensive but have become nimbler when searching for opportunities given the rapidly evolving market conditions. In particular, we believe that Asian bond markets will continue to be shaped by the development of two macro issues identified in our annual outlook:

- **Federal Reserve (Fed) policy:** After raising interest rates at its December 2018 meeting, the Fed made a significant policy shift in January, declaring a pause in the interest-rate-hike cycle. As the US and the global economy showed signs of lost momentum and increased uncertainty over Sino-US trade frictions, bond markets responded, and the 10-year Treasury yield dropped by over 70 basis points (bps)[3]. Will bond yields fall further, move sideways, or recover?

Sino-US trade tensions: Although Sino-US trade tensions appeared to ease during the first quarter of 2019, they escalated in May after US President Donald Trump threatened then ultimately raised tariffs on Chinese imports. The US also placed a prominent Chinese electronics manufacturer on a trade blacklist[4]. We view the re-engagement in trade talks and negotiations between after the G20 meetings as a positive development. Also, the US agreeing to partially remove restrictions against a leading Chinese telecommunications equipment maker[5] indicates that slightly cooler heads are starting to prevail. In our view, the two countries will eventually reach an agreement in the second half of 2019 to avoid further economic damage and reduce the risk of a recession, particularly as we face the upcoming 2020 US presidential election. Nevertheless, long-term tensions could remain after any agreement as the complex Sino-US diplomatic relationship continues to evolve. What's more, has the market fully priced in the prospect of ongoing Sino-US tensions even after an agreement has been reached?

[1] The JACI Investment-Grade Corporate Index (JACIIGTR) rose by 6.63%; the Markit iBoxx Asia Local Bond Index (IBXXALBI) rose by 4.74%. Bloomberg, as of 21 June 2019.
[2] Bloomberg, as of 21 June 2019. The Indonesian rupiah, Philippine peso, and Indian rupee strengthened against the US dollar year-to date after weakening against it in 2018.

[3] From the start of the year, the 10-year Treasury yield peaked at 2.8% and temporarily fell below 2.0% during intraday trading. Bloomberg, as of 21 June 2019.
[4] Source: South China Morning Post, 30 May 2019.
[5] Source: "Remarks by President Trump in press conference", the White House Office of the Press Secretary, 29 June 2019. President mentioned letting US companies resume sales to China's largest telecommunications equipment maker. China and US will be talking about taking the maker off the Commerce Department entity list.

The answers to these questions will undoubtedly unfold during the rest of the year. However, we believe Asian bonds are well positioned due to the region's strong fundamentals and the capacity for monetary policy easing, which should provide ample opportunities in the areas of rates, credit, and currency.

Rates: Dry powder for Asian central banks

The Fed's monetary-policy direction and moderate inflation conditions in Asia provide policy room for the region's central banks. The Fed's future interest-rate path is dependent on the evolution of the Sino-US trade-war, and we see room for two rate cuts in 2019. Whether these occur will depend on the progression of Sino-US trade tensions and the subsequent impact these have on US economic growth. As noted above, the prospect of Fed rate cuts are already priced into markets – which are reflected in Fed fund futures – leading to developed market bond yields overshooting on the downside.

This global backdrop can provide opportunities for Asian bond markets. Asian economies that raised interest rates in 2018[6] now have enough dry powder to adopt accommodative monetary policies, a favourable environment for local-currency bonds. Furthermore, the widened interest-rate differential between Asian and developed bond markets increases the appeal of Asian bonds, especially high-yielding bond markets. As a result, we are constructive on the following markets:

- **Malaysia's** bond market, which boasts a high credit rating[7], can provide relatively attractive real yields. Malaysian government bond with longer term maturities yields currently hover between 3.60% to 3.80%. Meanwhile, inflation levels were negative in early 2019, increasing to marginally positive territory in March – the lowest level in Asia[8]. We believe that Malaysia also has room for further rate cuts after the central bank lowered the policy rate by 25 bps in May.

- **Indonesia's** bond market has gradually recovered in 2019. This followed amplified market volatility and six interest rate hikes by Bank Indonesia in 2018. Indonesian government bond yields are currently trending lower, and the rupiah is trading in a more stable band. After President Joko Widodo's convincing electoral victory in April, coupled with S&P's credit-rating upgrade in May, we believe that foreign inflows into the country's bond market should accelerate. With more supportive market dynamics, Indonesia bonds are positioned to perform, given the potential for rate cuts in the second half of 2019.

We are also looking closely at opportunities in other regional markets:

- **The Philippines** is on our radar due to an attractive rates outlook. The central bank was one of the most aggressive in Asia last year, raising interest rates by 175 bps when it fell behind the curve on inflation. As headline inflationary pressures have since receded, the central bank has already cut rates by 25 bps in 2019, with talk of more to come. Having said that, the peso remains highly volatile, largely due to a structural current account deficit. We would need to see greater currency stability and a narrowing current account deficit before turning meaningfully constructive on this market.

Credit: Attractive yields with careful credit selection

Despite notable volatility in global fixed income markets, Asian credit spreads were generally well behaved in the first half of 2019. Investment-grade credits remained in a more stable range of 200 to 230 bps, while high-yield credits were between 510 to 635 bps[9]. Although there were periods of sell off in the Asian high-yield segment, driven by the heightened global uncertainty, we are still positive on this segment for its attractive carry (which could offset further potential credit-spread widening) for the second half of the year. With careful credit selection, and by avoiding defaults, we believe that investors can earn an attractive yield in this space.

[6] Those markets include India, Indonesia, Korea and the Philippines.
[7] The country boasts an "A-"credit rating by all three rating agencies.
[8] Bloomberg, as of 18 June 2019.

[9] Bloomberg, as of 22 June 2019.

We think that Chinese government support [10] designed to counter the impact of trade tensions is one of the main reasons behind the stability of Chinese and broader Asian credit spreads. With China accounting for a significant proportion of new issuance in the region[11], the shift by the People's Bank of China to an accommodative monetary stance has reduced liquidity pressures. At the same time, the Chinese government has implemented key targeted fiscal measures to support the economy [12]. This liquidity flow is the equivalent of quasi-easing measures by the central bank, and that's why we see investment grade and fundamentally sound high-yield credit spreads behaving well.

Overall, we like state-owned enterprise (SOE) credits due to government support and continued economic consolidation as the economy faces external and internal challenges. For example, we think that SOEs that are closely linked to government policies or have systematic importance should be primary beneficiaries, as the government rolls out plans to support local enterprises with infrastructure and related government spending. Indeed, we have seen an uptick in onshore issuance by SOEs with lower funding rates as liquidity conditions have improved. The onshore default rates of SOEs have also remained low, as most defaults this year are from privately owned enterprises. We are less favourable on the industrials space and those marginal names seeking financing.

By sector, we are still constructive on the Chinese property sector, particularly developers with projects in Tier-1 and Tier-2 cities. As the government continues to roll out stimulus, firms in the property sector with this footprint should prosper, while those with projects in Tier-3 and Tier-4 cities may face difficulties. In recent months, we have seen policy easing in selective cities in the sector, which has led to a recovery in developers' contracted sales [13]. Refinancing risks for China developers have been reduced, as many have pre-funded their maturing debt through new bond issuances in the first four months of 2019.

Currency: A supportive backdrop

The potential negative economic repercussions from trade tariffs on the US economy and the lower US yield environment reduce the scope for broad US-dollar strength. This should create opportunities for Asian currencies to strengthen in the second half of 2019. The trade-weighted US dollar has gained by as much as 2%[14] over the year to date, driven by safe-haven flows, but gave back much of these gains in June.

Given their sound fundamentals, Asian currencies have been relatively resilient. The Bloomberg JP Morgan Asia Dollar Index has lost only -0.2% over the year to date[15]. For the second half of 2019, the renminbi should trade in a less volatile band, providing a supportive backdrop for other Asian regional currencies to perform. In particular, we are constructive on the Indonesian rupiah and Korean won. The Indonesian rupiah, which posted positive performance in the first half of 2019, should benefit from a narrowing current-account deficit and potential capital inflows due to its high-yielding nature. In contrast, the Korean won was the worst performing currency of the first half of 2019 [16]. However, it should be helped from any positive developments in Sino-US trade talks and a more stable Chinese yuan.

Compelling opportunities

Shifting Fed policy and the potential easing of Sino-US trade tensions, coupled with room for further monetary easing, present a positive backdrop for Asian bonds. Despite macro challenges, we believe their combination of strong fundamentals and

[10] These policies include injecting liquidity and a lower reserve requirement ratio. People's Bank of China, as of June 2019. Throughout the first six months, PBoC has increased liquidity support for small and medium-sized banks, conducted targeted medium-term lending facility (TMLF) and lowered the required reserve ratio.
[11] Source: JP Morgan, May 2019. China issuers have raised US$70n from the market in 2019YTD, accounting for 62% of total supply.
[12] Bloomberg, as of 11 June 2019. Those policies include: lowering the value-added tax (VAT) tax rate in March and relaxing restrictions on how the proceeds of special bond offerings are used in June

[13] South China Morning Post: "New home prices rise in almost all Chinese cities as lower mortgage rates, lighter restrictions spur demand", 16 May 2019.
[14] Bloomberg, as of 21 June 2019.
[15] Bloomberg, as of 24 June 2019. The Bloomberg JP Morgan Asia Dollar Index reflects performance of a basket of Asian currencies against the US dollar.
[16] Bloomberg, as of 21 June 2019.

resilience make them well positioned in the current market environment. As we move into the second half of 2019, we believe investors could consider Asian bonds for compelling opportunities.