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PAiF
ABF Pan Asia Bond Index Fund

Asian Bond Watch

Asian Bonds: Hard or Local Currency?

2018 has so far been a challenging period for both local and US dollar-denominated Asian debt markets. Asian local currency government bonds, as measured by the Markit iBoxx ABF Pan-Asia Unhedged Total Return Index, delivered double-digit returns (10%) in 2017 but lost ground in the six-month period to the end of June this year (-2%)[1]. Similarly, Asian hard currency government bonds, as measured by the J.P. Morgan JACI Sovereigns Total Return Index, returned 9% last year but have underperformed local currency markets in the first half of 2018, recording a negative return of -5%[2].

US economic strength, expectations of a faster rate-hike schedule, rising oil prices and an impending trade war combined to prompt a resurgence in the dollar. Quantitative tightening also has the effect of reducing dollar liquidity. Meanwhile, the European economy had slowed on weaker data and rising political risks, notably in Italy. Debt woes in Argentina and Turkey further undermined investor confidence, further driving investors into safe haven assets such as the dollar.

Higher rate and stronger dollar expectations deter investors

A strengthening US dollar has long been the nemesis for emerging market (EM) debt. From the taper tantrum in 2013 to Trump's election in 2016, the spectre of higher rates and a stronger dollar have deterred investors.

However, with ongoing reforms, Asian economies have taken huge strides towards rebalancing their current account and fiscal positions. Today, the bloc is significantly less vulnerable to macroeconomic shocks as the dollar strengthens and interest rates rise in lockstep.

In broad terms, the primary driver of hard currency bond returns is EM sovereign credit spreads. For non-Asian investors, or those who prefer to base their investments in US dollars, these investments pose no foreign exchange risk.

On the other hand, a key driver of local currency bond returns is foreign exchange (FX). Yields on these bonds will, therefore, reflect FX volatility and currency risk premia, making them ideal for investors that wish to diversify away from the US dollar. More importantly, exposure to an economy's currency, as well as its sovereign credits, offers investors more direct exposure to a country's growth prospects.

Hard vs. local currency bonds

One of the most frequent questions asked by investors is: How should I choose between hard and local currency Asian bonds?

When deciding between differently denominated bonds, investors will need to consider their base currency and existing portfolio composition, in addition to available yields. For example, the euro has a lower correlation to EM currencies versus the US dollar, so euro-based investors might benefit more from local currency investments.

Broadly speaking, for investors who are looking mainly to avoid any currency risk and purely want to focus on the Asian fundamentals, they may look into the hard currency space. For investors who are trying to harness the long-term growth story of Asian economies, they may look for opportunities investing in local currencies in order to enjoy the full benefits of potential bond market returns, plus also the Asian FX returns.

More attractive valuations

Despite short-term macro risks such as dollar strength and the potential for further trade turmoil, we prefer local currency over hard currency EM debt. With Asian currencies about 5-6% undervalued against the dollar, according to State Street's measures of fair value, this represents an opportunity in local currency debt.

Year-to-date underperformance of Asian currencies ran counter to all expectations at the beginning of 2018, but US protectionism, rising rates and a weaker growth in Europe show little signs of abating. These conditions will support dollar strength, and investors need to exercise more caution as these headwinds continue to weigh on local currencies.

However, after the recent decline, current valuations of Asian bonds may present attractive entry points for discerning investors. Hard currency valuations have come down from their year-end tights, while local currency issuance typically offers better risk-adjusted return over hard-currency debt.

Kheng-Siang Ng
Asia Pacific Head of Fixed Income
State Street Global Advisors

[1] Source: Bloomberg. iBoxx ABF Pan-Asia Unhedged Total Return Index covers China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore and Thailand.
[2] Source: Bloomberg. J.P. Morgan JACI Sovereigns Total Return Index covers China, Hong Kong, India, Indonesia, South Korea, Malaysia, Maldives, Mongolia, Pakistan, the Philippines, Sri Lanka and Vietnam.

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