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ABF Pan Asia Bond Index Fund

Asian Bond Watch

Will rising rates mean a start of a major bond bear market?

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As inflation has risen, the US Federal Reserve (Fed) and several other central banks around the world have begun to tighten their monetary policies. In its June meeting, the US Fed announced to raise the federal funds rate by 25 basis points to between 1.75% and 2%. It was the seventh rate hikes since it began the tightening cycle in 2015, and Fed officials expected to raise rates two more times this year for a total of four hikes.

While we think the US rate hikes will continue to be gradual and largely dependent on economic data, around the world we may come to an end of easing. For instance, the European Central Bank (ECB) and the Bank of Japan have signalled an intention to follow the Fed's footsteps and end the ultra-accommodative monetary policies soon.

Asian fixed income in a rising rate environment

So will it be a start of a major bond bear market? The prospect of further Fed monetary tightening could damp investor enthusiasm for fixed-income assets, but we should also bear in mind that inflation across the region remains relatively subdued, so the prospect of rate hikes in the region is likely to be gradual.

It is also interesting to note that by 'locking-in' low, long-term interest rates, issuers have lengthened the average maturity of their borrowing, which has consequently increased the average duration of investors' portfolios.

Asian local currency government bonds, as measured by the Markit iBoxx ABF Pan-Asia Index, recorded a total return of close to 10% last year. In 2018, the positive trend has continued, though to a lesser extent with smaller gains in Asian currencies against the US dollar.

Asian local currency bond returns tend to be driven by Asian currency performance. Against a backdrop of rising US interest rates, the US dollar is likely to strengthen. While many Asian economies are now less dependent on dollar financing, it is still a significant funding source. If the dollar appreciates, this could weaken emerging-market currencies, including those in Asia.

Positive fundamentals support long-term prospects

Nevertheless, US interest rates and the dollar are not the only factors affecting Asian currencies and hence the performance of Asian local currency bonds. The attractiveness of the region's bond markets is also due to ongoing improvements in the underlying markets including strengthening economic growth, low inflation and healthy fiscal balances. In addition, authorities have taken the necessary steps to strengthen their respective economies. Measures include tighter regulation, a recapitalising of banking systems, and improvements in corporate governance. Various policy actions have bolstered fiscal and current-account positions which have resulted in credit rating upgrades in some Asian countries.

These positive fundamentals will continue to support Asian bond prices. Structural trade surpluses and growth differentials between Asian economies and developed countries will also exert upward pressure on currencies over the medium to long term that will ultimately be beneficial to Asian local currency bond markets.

Other factors include relatively higher yields compared to the developed bond markets, good diversification benefits given the low correlation of Asian local currency bonds with other developed bond markets, and attractive returns with moderate volatility.

Widened opportunity set

Many investors gain their exposure to Asian fixed income indirectly, via global or emerging-markets funds and mandates. However, with the Asian debt markets rapidly expanding, the opportunity set has widened.

One fast-growing segment of the market is bonds issued in local currencies. Indeed, the Asian local-currency government bond market has grown significantly in recent years and now amounts to more than US$12 trillion in total issues outstanding as of December 2017; this compares to US$304 million in 1998.

We have witnessed over time that investors' inflows into Asia have been constantly increasing at a steady pace. Moreover, April 2019 will see Chinese yuan-denominated government bonds and policy bank financial bonds begin their phased entry into the Bloomberg Barclays Global Aggregate Index. Other leading market benchmarks are likely to follow suit, further supporting capital inflows.

In the long run, the rise of the Asian economies, as well as the Asian bond markets, will feature as part of the core allocation of the global investors.

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