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DIVERSIFYING IN A RISING-RATE ENVIRONMENT

As Rates Rise, Asia Bonds May Help Advisors Diversify Portfolios

By Teresa Kong, CFA®, and Satya Patel

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As the U.S. Federal Reserve contemplates additional rate increases, advisors are taking a fresh look at fixed income holdings with an eye toward improving diversification and long-term returns. Asia bonds can help diversify portfolios that have heavy exposure to U.S. or European government and corporate debt. In particular, Asia high yield bonds historically have had especially low correlations to U.S. Treasuries and corporate bonds. U.S. investors may find logical places to implement an allocation to Asia bonds by rebalancing away from existing allocations for global bond strategies, U.S. or European high yield bond holdings, or tactical fixed income products.

A logical first step toward investing in Asia bonds is getting to know the marketplace for Asia bonds. The market is broad and diverse, ranging from China on the larger end of the issuance scale to Thailand and the Philippines on the smaller end. These countries tend to have fast-growing economies, backed by high levels of personal savings. This combination makes many fixed income markets in Asia attractive to global investors seeking to generate yield and total return while diversifying portfolios.

Asia's bond markets have relatively low correlations with equity and fixed income asset classes around the world. For portfolios with allocations to high yield, emerging market, or high-quality U.S. or European fixed income, an allocation to Asia's local currency or dollar-denominated bond markets can bring significant diversification benefits. Figure 1 shows that popular broad-market bond indexes historically have had high correlations to U.S. Treasuries, but Asia bonds and Asia high yield as asset classes have had very low correlations.

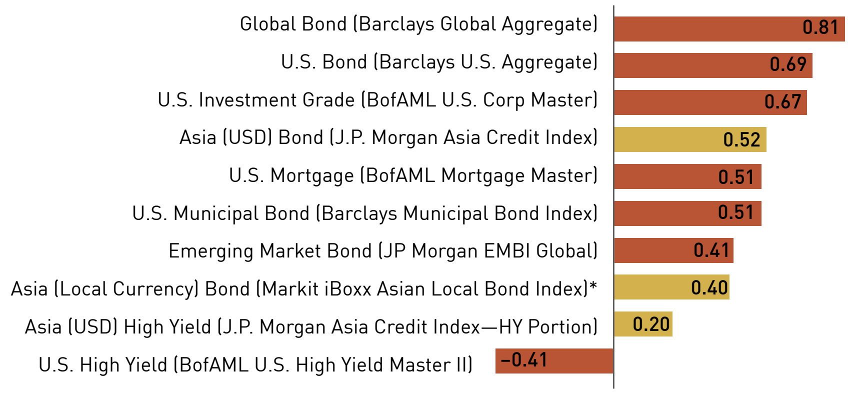
Asia bonds pose their share of risks, of course, including issuers with different accounting standards, nascent bankruptcy codes, and corporate governance practices. For these reasons, we believe in an active approach to investing in the region. Seemingly basic accounting

KEY POINTS

- In today's rising-rate environment, Asia high yield bonds offer low correlation to U.S. Treasuries and attractive diversification benefits.
- Global equity and fixed income markets are volatile, so investors should have a time horizon of three years or longer before considering Asia high yield.
- Widening credit spreads among Asia high yield present an attractive entry point for investors, who historically have been rewarded over the long term for investing at this point in the cycle.

Figure 1

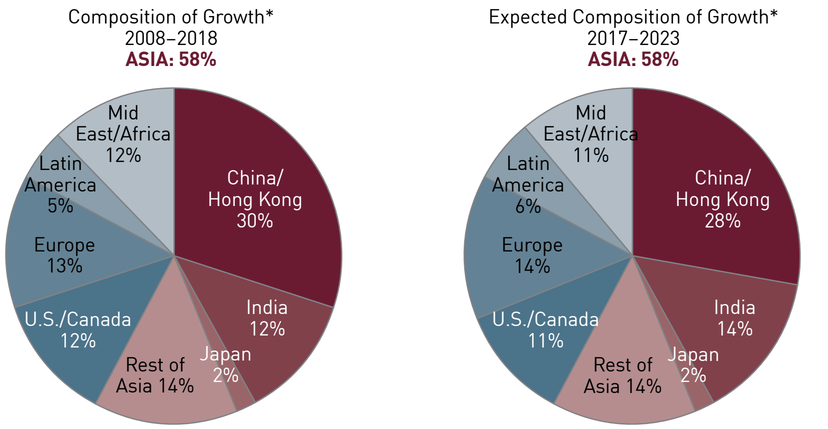
BETA OF ASSET CLASS TO FIVE-YEAR U.S. TREASURY INDEX, DECEMBER 31, 1998–DECEMBER 31, 2017



Past performance is no guarantee of future results. Figure 1 shows beta of each asset class to the BofAML U.S. Treasury current 5-Year Index, based on monthly returns. Data for the December 31, 1998–December 31, 2017 time period. Indexes are unmanaged and it is not possible to invest directly in an index.
**Asia (Local Currency) Bond (Markit iBoxx Asian Local Bond Index), beta since inception 2001*
Sources: Bloomberg, Matthews Asia, Merrill Lynch, Pierce, Fenner & Smith Incorporated (BofAML), used with permission. .

Figure 2

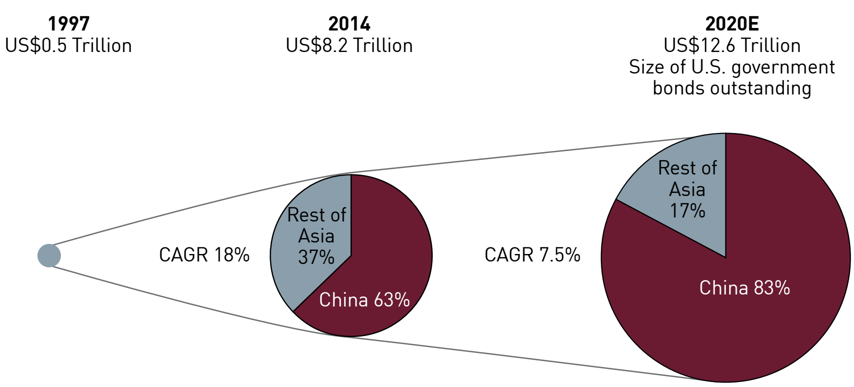
ASIA CONTINUES TO LEAD GLOBAL GROWTH



**Based on GDP on Purchasing Power Parity (PPP) basis. There is no guarantee any estimates or projections will be realized.*
Source: International Monetary Fund; World Economic Outlook Database, April 2018, http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx

Figure 3

ASIA BONDS OUTSTANDING—THE MARKETPLACE FOR ASIA BONDS IS GROWING



Market size in 2020 is an estimate. There is no guarantee any estimates or projections will be realized.
CAGR: Compound Annual Growth Rate
Sources: Asian Bonds Online, International Monetary Fund, Matthews Asia estimates

rules such as those that apply to revenue recognition or cash amounts can vary from one country to the next in Asia, and understanding the different accounting standards is critical for analyzing the strength of a company's balance sheet and the quality of its cash flows.

We believe fundamental analysis is key to gaining exposure to the most desirable investment characteristics of the region and avoiding the most significant risks. A passive approach employed by an index or exchange-traded fund could result in allocations to companies, sectors, and countries with poor fundamentals, governance, and future prospects.

INCORPORATING ASIA BONDS INTO U.S. AND GLOBAL PORTFOLIOS

A traditional fixed income tool kit for advisors may include municipal bonds, investment-grade corporate bonds, global bond strategies, high yield bonds, and tactical fixed income products. For U.S. investment professionals, Asia bonds can help with these final three categories—global bonds, high yield bonds, and tactical fixed income products.

As interest rates rise, it's a natural time for advisors to re-examine their overall mix of investments within the bond portion of portfolios. Global bond strategies tend to have a high correlation to U.S. Treasuries (see figure 1), meaning they have a high level of interest-rate risk in a rising-rate environment. Trimming international or global bond allocations significantly and rebalancing with Asia bonds can reduce correlations to U.S. Treasuries and dial down exposure to interest-rate risk.

Rebalancing toward Asia bonds also increases exposure to the fastest-growing parts of the global economy. Over the past decade, Asia made up more than 50 percent of global growth (see figure 2), yet many investors remain underallocated to Asia, especially within the fixed income portion of portfolios. For fixed income investors, Asia bonds offer an attractive creditworthiness, because Asian borrowers and households tend to have low debt and high savings, along with high gross domestic product (GDP) growth underpinning Asia's credit markets.

Asia's economic growth is accompanied by a growing marketplace for fixed income securities. By 2020, the marketplace for Asia bonds is expected to grow to US$12.6 trillion, with China representing the largest portion within the region (see figure 3).

Next, let's look at U.S. high yield bonds. Asia high yield bonds also can help enhance a high yield position. Since inception more than two decades ago, the J.P. Morgan Asia Credit High Yield Bond Index has returned about 9.5 percent per annum (see figure 4). This means it outperformed both global and U.S. high yield markets in terms of both return and volatility risk. In addition, U.S. high yield bonds look overvalued in our view and Asia high yield looks reasonably valued. Credit spreads for U.S. high yield bonds are about 200 basis points below their historical average and spreads for Asia high yield bonds are around 80 basis points above their historical average.

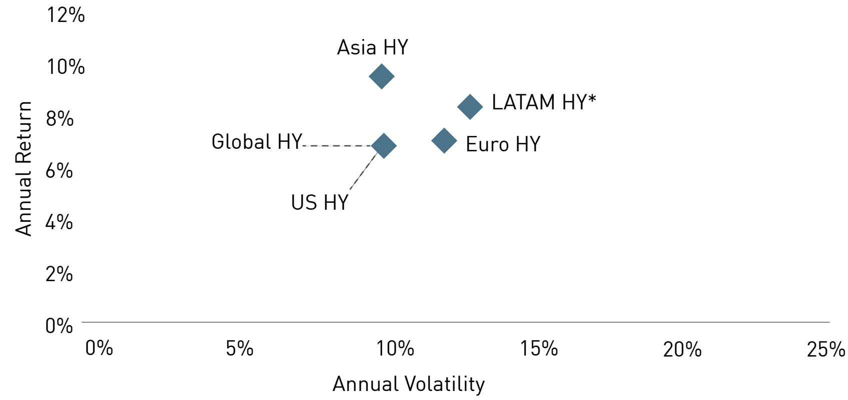
Historically when investors have entered Asia high yield at the wider-than-average spread levels that we see today, long-term returns have been attractive (see figure 5). Historical data indicates that an investor with a two- or three-year holding period historically has generated positive returns when investing in Asia high yield where spreads are today. Even with just a one-year holding period, investors entering Asia high yield where spreads are today have made money around 90 percent of the time. Given that we are nearly a decade into the current business cycle, a medium-term holding period is important because we can expect to see volatility and default rates increase around the world. Working with an active manager can help reduce default risk, but most Asia high yield portfolios are likely to experience volatility in the near term. For active managers, volatility is a buying opportunity, because investors in Asia high yield historically have been rewarded for their patience over the long term.

Finally, let's consider tactical fixed income products. If you expect U.S. interest rates to continue rising for the next two to three years, then Asia bonds potentially could help to reduce some of the interest-rate risk associated with U.S. Treasuries or investment-grade bonds. "Tactical" can mean different things to different investors, ranging from a very short-term outlook to a more medium-term outlook. If you're considering Asia fixed income for a tactical portfolio holding, our view would be taking a medium-term outlook, which we define as the next several years, as opposed to weeks, months, or quarters.

Figure 4

ANNUAL RISK AND RETURN (IN HOME CURRENCY)

PERIOD FROM 1999 TO SEPTEMBER 2018

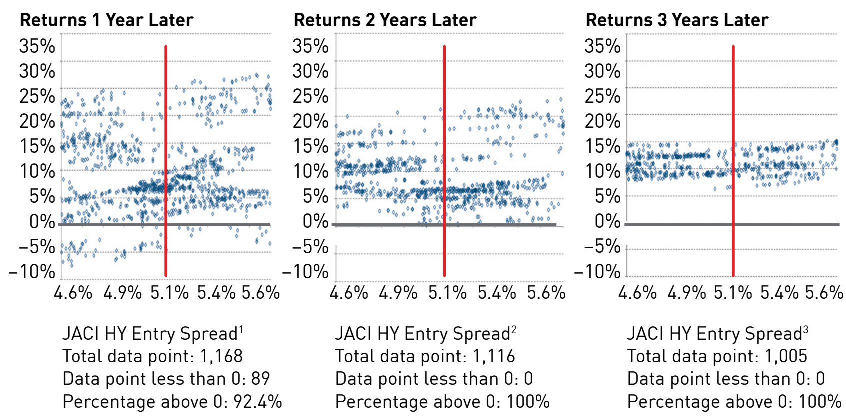


**2002 to September 2018*
Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index. Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofAML High Yield Master II Index), Euro High Yield (Barclays Pan-European High Yield Index), LATAM High Yield (Latin America High Yield portion of the J.P. Morgan CEMBI Broad Index), Global High Yield (BofAML Global High Yield Index).
Source: Bloomberg data

Figure 5

HISTORICALLY, RETURNS HAVE BEEN COMPELLING IN ASIA HIGH YIELD AT CURRENT SPREADS

JACI HY* ENTRY SPREAD VS. ONE-, TWO, AND THREE-YEAR RETURNS



Past performance is no guarantee of future results. For illustrative purposes only. Indexes are unmanaged and it is not possible to invest directly in an index.

1. Spreads are for the period December 31, 1998–September 28, 2017.
2. Spreads are for the period December 31, 1998–September 28, 2016.
3. Spreads are for the period December 31, 1998–September 28, 2015.

**JACI HY (high yield portion of J.P. Morgan Asia Credit Index) Spread as of September 28, 2018 = 511 bps*
Each data point on the charts represents the return of the JACI HY on a specific day either one, two, or three years later, after entering the market at the noted spread in each respective chart. Spread range is 460–560. Days with spreads that did not fall within this range are not included. Returns in USD.
Source: Bloomberg

SUMMARY: LOOKING EAST FOR DIVERSIFICATION

In a rising-rate environment, it can be helpful to remember why Asia bonds have the potential to provide diversification benefits relative to U.S. and European government and corporate debt. Asia bonds derive their returns from three primary drivers—local credit, currency, and interest rates. Each of these factors offers diversification from U.S. and European interest rates. U.S. investors purchasing Asia

CHINA'S BOND MARKETS

China exemplifies many of the positive trends we see in Asia's bond market. China has a deep and growing market that increasingly is open to global investors, fueled by highly creditworthy bond issuers.

China's onshore bond market is roughly the same size as the market for Japanese government bonds, around US$9 trillion.[1,2] For additional context, the market for U.S. Treasuries is around US$14.5 trillion.[3] Many Chinese corporate bonds trade on the Shanghai and Shenzhen stock exchanges, but Chinese government bonds and policy bank bonds trade on the larger and more liquid China Interbank Bond Market or CIBM. Another Chinese bond market, known as the "dim sum" market, trades offshore and is where international bond investors can buy bonds that clear through international clearing houses. Since the dim sum market issued its first bond in 2007, it has grown considerably.

The dim sum market is readily accessible and does not require local accounts or additional local registration.

Access to China's onshore bond market traditionally has been granted through the country's Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor programs. Since 2016, international investors have been able to directly register with the People's Bank of China in order to access the China Interbank Bond Market or CIBM. In July 2017, the Chinese government announced the latest program, the China-Hong Kong Bond Market Connect, which promises to further streamline this process. As China continues to liberalize its financial markets, mainstream benchmarks used by global investors gradually will include onshore Chinese debt into indexes. Although index inclusion provides investors with exposure to China interest-rate and currency exposures, it does not provide any credit exposure. We believe a dedicated allocation to Asia bonds through an active manager might be the best way to capture the diversification benefits of credit, currency, and interest rates.

As China continues to liberalize its financial markets, mainstream benchmarks used by global investors gradually will include onshore Chinese debt into indexes.

bonds may benefit from several layers of diversification.

As with any investment decision, an investment in Asia bonds should begin with an investor's goals. If diversification and reducing exposure to U.S. interest-rate risk are among the goals of the clients you serve as an advisor, then a dedicated allocation to Asia bonds with an active manager may make sense.

As Asia's growth engine continues to purr, we expect that global investors naturally and organically will begin to direct larger allocations of their fixed income assets to the region. In our view, Asia bonds provide advisors with an important tool for helping their clients diversify portfolios and meeting a variety of long-term objectives. As markets continue to evolve, diversification can be a timely—and timeless—success strategy for advisors.

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ENDNOTES

1. *Asia Bond Monitor*, September 2018, https://www.adb.org/sites/default/files/publication/453321/abm-sep-2018.pdf.
2. SIFMA, December 2017, https://www.sifma.org/resources/research/bond-chart/.
3. *Wall Street Journal*, October 2018, https://www.wsj.com/articles/how-9-trillion-bond-market-adds-up-to-zero-for-japanese-traders-1521982809.

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