November 2012 Vol. 17 No. 11

Yields to head downward, market quality improving

Category: Global
By Toby Garrod

Demand set to outpace supply, leaving cash-rich issuers in increasingly comfortable position

Institutional investors may soon see higher yielding opportunities start to ebb in the Asian local currency bond markets as relentless demand pushes down yields and as the number of issuers' starts to decline with the dwindling need for external financing due to bulging coffers – tilting the supply demand balance in favour of the issuers. But with a decade of explosive growth behind it (issuance of East Asian local currency bonds grew from US$1.17 trillion in 2002 to $9.93 trillion in 2012, according to the Asian Development Bank), what the markets may start to lack in high issuance and yield, they should compensate for in terms of additional liquidity and depth.

Kenneth Akintewe

"A few years ago, the very interesting thing about the local currency bond markets was that you had this very robust macroeconomic story, but investors were not really appreciating it. Therefore you had yields in the region that were pretty high," says Kenneth Akintewe, portfolio manager, Asia fixed income at Aberdeen Asset Management Asia in Singapore. "Back then we could talk about high yielding markets and stuff like that. The difference now is that everyone is fully aware of the fundamental story in Asia, the improving credits story, with numerous countries undergoing sovereign upgrades, and that has obviously been priced into term structures – so yields have been sustainably moving lower in pretty much every market in the region. It's now difficult to talk about Asia as a high-yield play."

The recent coordinated monetary easing action from central banks across the developed world has served to magnify the issue, much to the dismay of buyers.

"The enormous liquidity created by the fiscal policies of the West is now finding its way into Asia," says Phoon Chiong Tuck, head of fixed income at Lion Global Investors in Singapore. "Particularly in the past 18 months. In terms of momentum in the credit markets, it's much stronger this year. And now the money is finding its way into selected local currency markets. The result of this is that spreads are starting to come in. When we go into primary issues, we see there's been tremendous competition in the past three to four months. We see spreads starting from indicative levels, but finally when they close they're actually 20-30 basis points away from the early indications. Essentially, there's a feeding frenzy going on."

Meanwhile, fiscal policies from within Asia are also having a significant impact on the market, given that the vast majority of Asian local currency bonds are issued by government agencies.

One of the fundamental strengths of the region is that nearly every single government, bar perhaps India, has exercised very good fiscal discipline, he notes, so what you are actually seeing is smaller and smaller deficits and debt to GDP ratios coming down. With this, he says that the size of issuance relative to the size of demand for debt has been too little, which has also forced yields to decline across the region.

Market maturity

So while the allure of these products may be starting to dim in terms of returns, there's a new glow of quality among the products in terms of credit quality. A change in market participants has further bolstered views on the market's maturity.

"Ten years ago, there was a lot of hedge fund activity as it was easier for them to come into the markets, move them around and get out again, whereas now you have these structural 'real money' flows," says Mr. Akintewe. "You have sovereign wealth funds, central banks and global investors looking to allocate more of their money to this region. Furthermore, it's not just about Western ownership of the Asia bond market. People often talk about how foreign ownership of the Malaysian bond market has risen to 40%, how it's risen to 30% in Indonesia, and risen to 80% in Australia. The assumption is that this comes from outside the region, but regional central banks have been investing a lot more of their capital in the region recently."

The more market participants that enter the market, the higher quality the market becomes, he says. “There’s a lot more flow, narrower spreads and a deeper and more liquid market. Both market depth and liquidity have improved dramatically since about 2005. The turnover of the market has at least doubled if not more since then. Meanwhile, the size of the market has grown from around $2.5 trillion in 2004-05 to around $7 trillion now. This all makes it much easier to transact, especially in terms of volume.”

Not for the retail space

The trade off of yield for quality and liquidity may do little to hurt market demand in the local currency space, given the risk profiles of the investors.

Phoon Chiong Tuck

While retail investors prefer to play solely on the credit risk side, sticking to US dollar-denominated debt products, the institutional investment firms play to their strengths in understanding the complexity of the markets, and that means picking up returns on currency gyrations.

“It’s a little bit harder for retail investors to get their minds around local currency products,” says Low Guan Yi, director of fixed income at Eastspring Investments in Singapore. “Firstly, they are mostly government bonds and secondly, they understandably find the concept of currency volatility harder to manage. It definitely appeals more to institutional investors, such as sovereign wealth funds, central banks, or even corporate treasury type investors, who are uncomfortable with credit risk. They prefer the stability of the government bonds with the currency element. The nature of their activities means they are already used to currency volatility issues.”

Given current global currency market conditions, those in the know should to make some tidy gains in the forex game.

“If we look at the current account and balance of payment surpluses of countries across Asia, we can conclude that the currency theme is going to be very strong over the medium and longer term,” says David Tan, head of investments AllianzGI Singapore and CIO of pan-regional Asian bond mandates. “The region currently has a whopping US$5.3 trillion in foreign exchange reserves, which is greater than 60% of the world’s reserves. This bodes very well for the longer term currency appreciation story. Near term, there will be a little volatility, but longer term the impact is quite certain. In addition, based on purchasing power parity, Asian currencies remain very much undervalued in comparison to developed world counterparts.”

Meanwhile, the currency stories elsewhere are uninspiring.

“If you look at the quantitative easing in the US, why do you want to have it in the first place?” says Mr. Tan. “Technically, it is being carried out to create just enough inflation. Inflation erodes away the value of the debt and, through time, and this also implies a weaker US dollar.”

Yield there, risk hungry

For those managers that are still looking for pepped up returns on their local currency debt, the corporates may yet come to their rescue. While this segment of the market is very much nascent, there is certainly growth in issuance.

“The new developments in the Asian local currency bond markets are happening in the corporate bonds space,” says Ms. Low. “Last year, in 2011, domestic issuance among corporate displayed growth of 17%, but I think this year we are going to surpass that. Just in Singapore dollars alone, issuance has been nearly $28 billion year to date. For full year 2011, the figure was $21 billion. So we’ve seen 33% growth there.”

News markets are also developing in Indonesia and the Philippines, she notes.

“The two markets used to be government bonds only. No-one would touch corporate bonds. But in the last three years we’ve seen very significant growth. Year to date, Indonesia has issues 51 trillion Indonesian rupiahs in corporate bonds (about US$5 billion), while in the Philippines there’s been about 145 billion pesos (about US$4 billion) worth of issuance.”

The local currency corporate issuance from these countries started with vanilla products from the blue chip names, such as San Miguel, but more interesting structures are emerging.

“San Miguel came with a preference share issue, so they are really building the curve, says Ms. Low. “We are also seeing subordinated debt issues. Meanwhile, in Indonesia it has traditionally been that banks that have issued, but now we are suddenly seeing various finance companies come to the market.”

Despite such corporate issuance growth, trends over the long-term here may well go the same way as the government issuance.

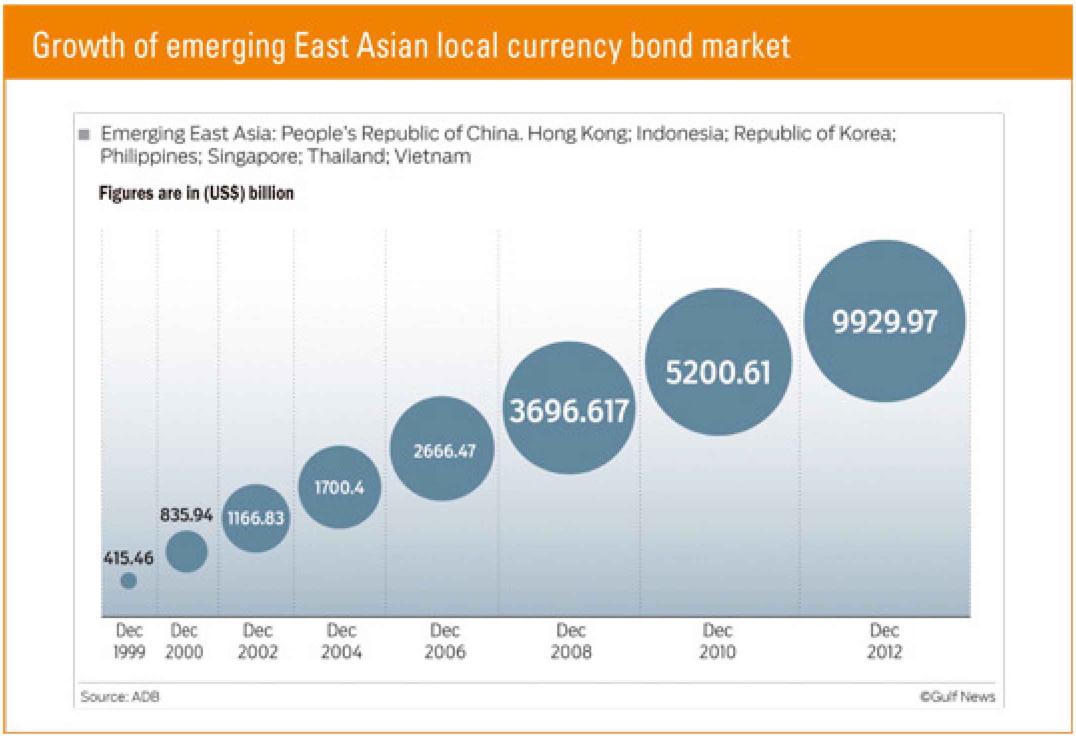
“Although people are thinking about reducing external debts both at the sovereign and corporate level, which implies the local currency bond markets certainly have scope to grow, says Mr. Akintewe. “But the fact that companies in Asia are displaying high profitability means they may not need to issue a lot of debt over the longer term.”

Given the size of the corporate local currency markets, however, that may not prove too much of a headache for the institutional investor.

“If you’re managing a reasonable amount of money just in local currency, then the government bond markets are the more obvious choice,” says Mr. Akintewe. “Our local currency assets stand at about $3.3 billion, which in the context of Asia, for an active manager, is already a fairly sizeable amount of money if you’re implementing trades across a portfolio. And if you’re implementing trades across portfolios then a 1% trade would be a little too sizeable for most corporate bond markets, let alone local currency corporate bonds.”

On the government side, the chance of issuance drying up is very low. No matter how hefty government surpluses become, the fact remains that many countries in Asia need to develop their bond markets. Financial centres like Singapore and Hong Kong aim to raise the credibility of their operations with bond markets that display liquidity, suites of products, and a spectrum of tenures. Meanwhile, one of the key sectors of growth in Asia is pension and insurance companies, and these need bonds markets to operate efficiently.

“If you consider the growing middle class that is emerging in Asia, you can see there’s going to be a lot of need for pensions in the future. There is going to be demand for bonds and supply will also increase” says Mr. Tan.



Recognising risk

“While such strong demand for bonds has brought a much greater variety of issuers,” says Mr. Phoon, “we are also perhaps seeing an increase in names that are not so desirable. Obviously the buyer needs to do due diligence. But also, buyers are often under pressure to get involved in these markets, particularly if they are short from a normal position.”

He continues: “For people who are not so familiar with the Asian markets, or don’t know some of the new names coming to the market, the credit rating agencies play an important role in terms of guiding where a local issuer may stand in relation to other international issuers.”

Further concerns are raised by the fact that many Asian domestic markets have long suffered excess liquidity problems.

“For any country or region, the current flood of global liquidity forces the question, What is the absorption capacity? For Singapore, it is very open, but also they have developed mechanisms to recycle any excess liquidity that is coming in so that any negative impacts are mitigated. But if you look at the house prices there, most people will tell you that there are still effects. Meanwhile, countries that are less open have put up various measures, making it less interesting for international investors to get into their markets,” says Mr. Phoon.

He concludes: “From a policy standpoint, I think certain countries are doing well in managing their situations. Some need to improve, but overall they’re not doing badly at all. On the regulatory side, things tend to be slow moving, and must be co-ordinated with what others are doing around the world. I think certainly, markets have been slowly liberalising, which obviously is an improvement.”