Asian Fixed Income

Fund Manager Interview

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Key points

Aberdeen believes:

- Search for yield continues amid low interest rates worldwide
- India and Indonesia offer attractive yields and improving credit quality
- China is widening investor access to its markets
- There are many encouraging trends in the Asian fixed-income markets at this time

Overview of the asset class

On the horizon: What are major developments currently taking place in the Asian fixed-income markets?

So much has changed in the markets during the three decades we have been investing in Asian fixed income. Lower yields across much of the world have had a very significant impact. In 1986, interest rates in Australia were 21%, and just recently the Reserve Bank of Australia cut rates to 1.75%, which is the lowest level on record. The story is similar across other parts of Asia as well. For example, interest rates in the Philippines have now fallen to 4% from around 10%. Therefore, we continue to search for higher-yielding opportunities that fit our quality assessment by having structurally improving fundamentals. India and Indonesia exemplify a lot of the encouraging trends we currently see in Asian fixed income.

For example, the governments in these two countries have a reform mind-set and are aiming to make their countries run more efficiently. In India, the parliament passed a new bankruptcy law in May, making it easier to wind down a failing company and handle its outstanding debts.

Besides high-profile reforms such as a uniform goods and services tax and improved provision for land acquisition to facilitate infrastructure projects, the Modi administration has made significant strides in empowering the states and facilitating competitive federalism. In Indonesia, President Joko Widodo has succeeded in delivering important reforms such as the removal of fuel subsidies and is in the process of implementing a tax amnesty to encourage the repatriation of capital. Here too, the focus is on infrastructure development.

At the same time, we have also seen improvements in the credibility of the monetary policy. The Reserve Bank of India has adopted an inflation target which provides a robust framework for monetary policy decision-making. Likewise, the Indonesian central bank is working to improve the transmission of monetary policy to ensure its policy stance more effectively influences the lending rates used by banks and other corporations to finance activity.

All of these reform initiatives, including a commitment to fiscal prudence, reinforce continued improvements in the credit quality of the sovereigns.

Aberdeen
Simply asset management.

Impact of market events on the asset class

What are some of the opportunities you're seeing in this space?

India

The Modi government has forged ahead with its proposed reforms. While they may have not been as dramatic as supporters had previously hoped they would be, these reforms represent an important step forward for the country in reducing its bureaucratic inefficiencies, improving its infrastructure and generally reducing the number of bottlenecks in the Indian economy. Most importantly, Modi has made some fairly significant institutional changes. Notably, he has empowered the provinces in India to develop their own growth plans while encouraging innovation and competition among one another for capital. This should go a long way in helping cement the reform mind-set in people's minds, helping it become more pervasive and long-lasting. While change will likely be slower than what was initially expected, it should have a good chance of enduring.

The recent announcement of Raghuram Rajan's resignation as head of the Reserve Bank of India has created considerable uncertainty surrounding future monetary policy objectives.

However, there has still been plenty of progress made in terms of fighting inflation, which has made the country more attractive to foreign investors. We believe that, with Prime Minister Modi's support, these trends will continue once Rajan's successor has taken the reins.

Structurally lower inflation and institutional reform should deliver significant opportunities for bond investors over the medium term. India is in the process of re-rating, and fundamentals are improving, as shown in the charts below.

We have been investing in the Indian bond market for almost 15 years now, and while the Indian bond market is still quite difficult to access, it is not crowded with foreign participants, which we find appealing.

Indonesia

Indonesia has a similar story to India, with its own reformist president focusing on infrastructure development. Policymakers will do anything to avoid a repeat of 1997-1998, when the country was swept up in the Asian crisis, and fiscal discipline has been a major focus of successive administrations. The Indonesian central bank has been keen to demonstrate its own policy credibility and independence, and has recently been focused on improving the transmission of its policy into the real economy.

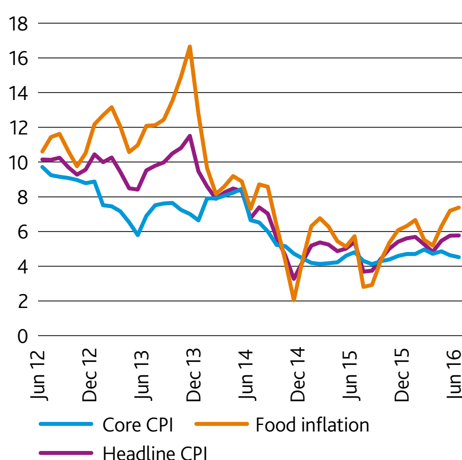
We expect that it is only a matter of time before Indonesian debt is upgraded by Standard & Poor's to investment grade – the last of the three major rating agencies to do so – although we don't expect it to happen this year.

Indonesia has been quite focused on attracting foreign capital. The infrastructure and coordinating departments have improved the experience for foreign investors and delivered tangible results in terms of foreign direct investment (FDI) inflows.

On the other hand, Indonesia is quite a diverse country with a highly political environment that's often polarised. But after the presidential election, Joko Widodo has been able to bring the opposition parties in line with him, focusing on some fairly hard-hitting reforms such as the implementation of a tax amnesty that will see a repatriation of assets sitting offshore. The recent re-appointment of Sri Mulyani Indrawati as the Finance Minister after a stint at the World Bank reinforces the credibility of the policy-making institutions.

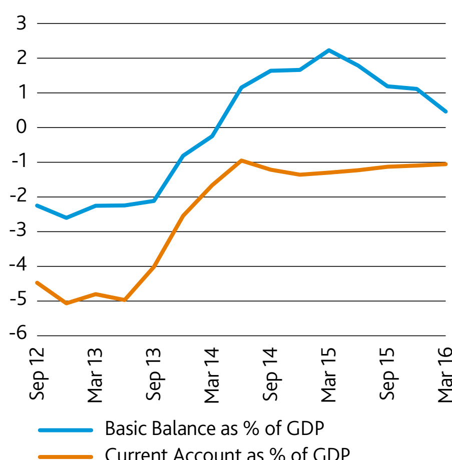
The only concern is that from time to time there is a lurch towards economic nationalism, which is what we experienced in the early days of the Jokowi presidency. However, we have seen a much more pragmatic approach recently. Overall, the future looks bright for Indonesia.

Chart 1: Inflationary pressures (% yoy)



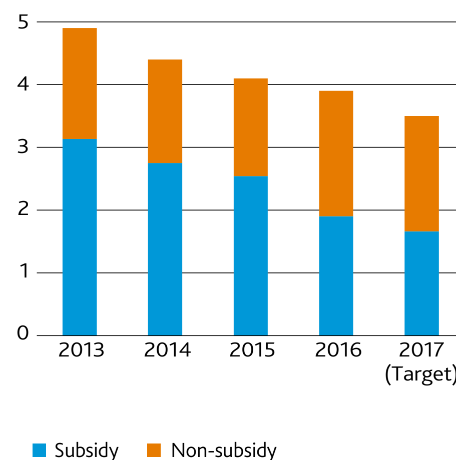
Source: CEIC, June 2016. For illustrative purposes only.

Chart 2: External balances (% GDP)



Source: CEIC, June 2016. For illustrative purposes only.

Chart 3: India, Fiscal Deficit (% of GDP)



Source: CEIC, June 2016. For illustrative purposes only.

China

The big story that we think will be worth commenting on within the next six to 12 months is around the Chinese opening of the capital markets, particularly the bond market. Back in February, we saw the authorities move away from the quota-based access for foreign bond investors to give more free access and somewhat unlimited access to the local bond market. Still, some of the terms and conditions for this event were only finalised weeks ago. So it really hasn't ramped up in terms of the full opening at this point, but we can be certain that based on what we are seeing so far, there will be a lot more interest in accessing the Chinese bond market with the eventual inclusion of China in a number of the bond indices.

The Chinese bond market used to be pretty difficult to access, because first you needed to apply for a quota, which had to be approved by the regulators. We have had a quota that we received in 2009, but they have announced that in February access will be more freely available to foreign investors, so it would be similar to access in a market such as Korea.

The really interesting aspect will come when indices begin to include China because it means that the global investors who have long ignored China will need to start forming some sort of strategy.

With an economy as large as China and with as much outstanding debt as the Chinese have, it will be a very large component of major bond indices. Other than for dedicated Asian indices, the first inclusion is likely to be in the JP Morgan Emerging Market Bond indices, and it will be included at the maximum weight. Then you will have the Citibank World Government Bond Index, which is used by a lot of Japanese passive funds. It will have a very significant allocation, and that will mean billions of dollars moving into China or indeed a welldefined strategy for avoiding the market. We think it's something that will have a definite impact on the Chinese bond and currency market.

The Chinese market is currently going through an adjustment. Policymakers are focusing on the need for credit risks to be understood by investors and appropriately priced. At the moment there's a mispricing because of the moral hazard from the implied government guarantee on a lot of the corporate debt. They are trying to remove this in order to have a more market-based pricing of risk.

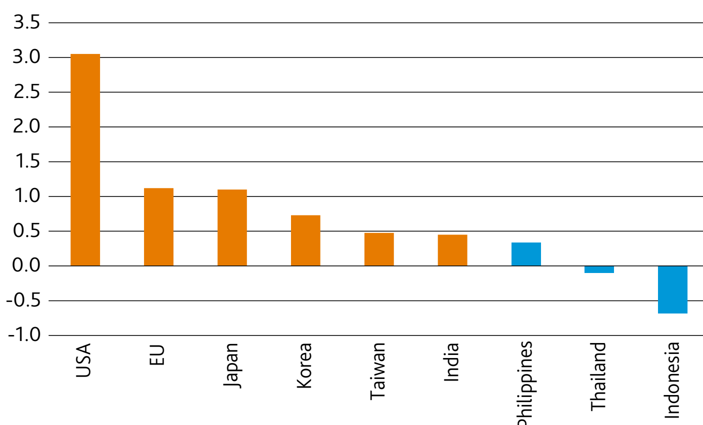
Elsewhere in Asia, in places like Korea and Thailand, rates are fairly low with bond yields at 1% to 2%. Both countries have aging populations, which supports demand for longer-dated bonds and keeps yield curves flat. Also, inflation is non-existent at this point, so policymakers are following their own needs and keeping monetary policy easy for the time being. And, as shown in Chart 4, they still have room to cut rates if necessary.

Our outlook

We believe that investors still need to be patient in this period of heightened uncertainty and volatility. While commodity prices have stabilised somewhat from record low levels, there isn't enough evidence of a global recovery to warrant a rally in prices. Global monetary policy should stay accommodative in the face of weak growth, and we believe the US Federal Reserve (Fed) will continue to put further rate increases on hold amid the uncertainty in the current environment, as shown in Chart 5. China still has some challenges to work through, but we feel that investors are more receptive than they have been due to improvements in the economic and political backdrop.

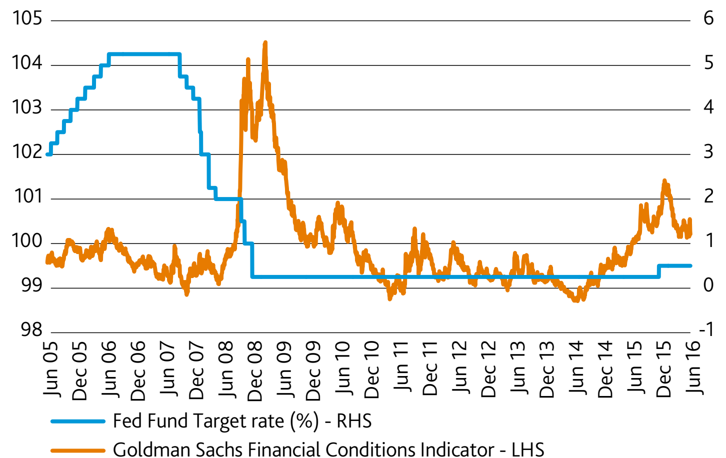
In terms of risks, we are monitoring the Chinese economy to see whether or not any issues may rematerialise, as speculation in commodities continues and the number of corporate defaults are on the rise. Nevertheless, we believe that any spike in volatility and swings in valuations may present us with attractive buying opportunities. We remain cautious but optimistic about Asian fixed income.

Chart 4: Asia still has room to cut rates (Real policy rates %)



Source: Bloomberg, June 30, 2016. For illustrative purposes only.

Chart 5: Goldman Sachs Financial Conditions Indicator vs. US federal funds target rate



Source: Bloomberg, June 30, 2016. For illustrative purposes only.

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