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Asia Bonds: Tactical Value for a Long-Term Opportunity

This will be an Asian century—and especially an emerging-Asia century.

Asia ex-Japan already accounts for more than half of the world's population. It generates a third of the world's merchandise trade volume, attracts more than a quarter of global foreign direct investment and makes 65% of worldwide patent applications. It has been growing GDP per capita and expanding its middle class at a much faster rate than other emerging regions over the past 30 years. By 2050, if estimates from the Centennial Group International and the McKinsey Global Institute prove correct, the region will be producing more than half of the world's GDP.

For the past 20 years, this growth has been sustained with very modest fiscal risk. The region is a net creditor to the rest of the world and its aggregate government debt burden, at 55% of GDP, is little more than half that of the developed economies. Most mainstream emerging Asian economies run a current account surplus, with the aggregate surplus for the entire region at 2%.

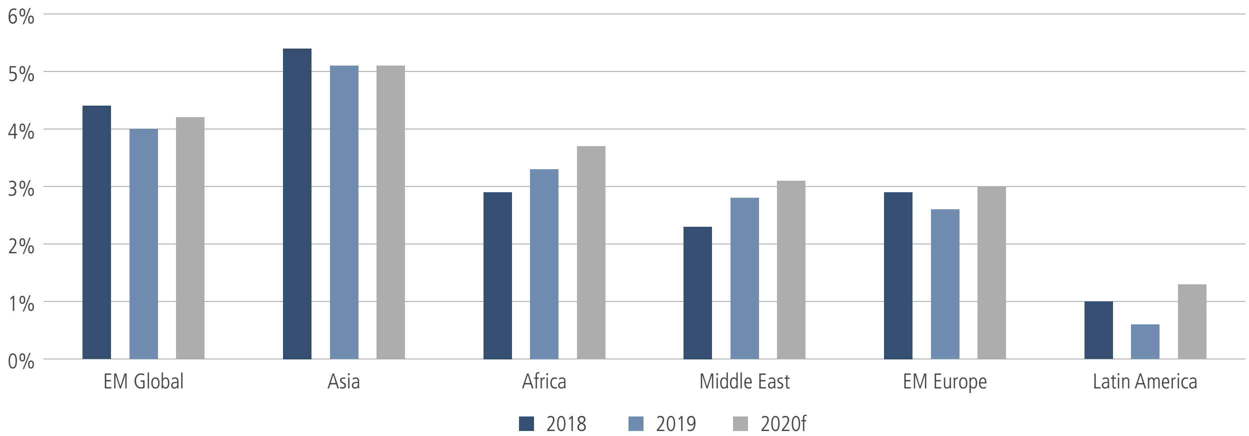
We believe this mix of impressive growth, fiscal conservatism and two decades of macroeconomic stability with relatively attractive valuations makes Asian debt a particularly interesting investment opportunity.

Risk-Adjusted Performance

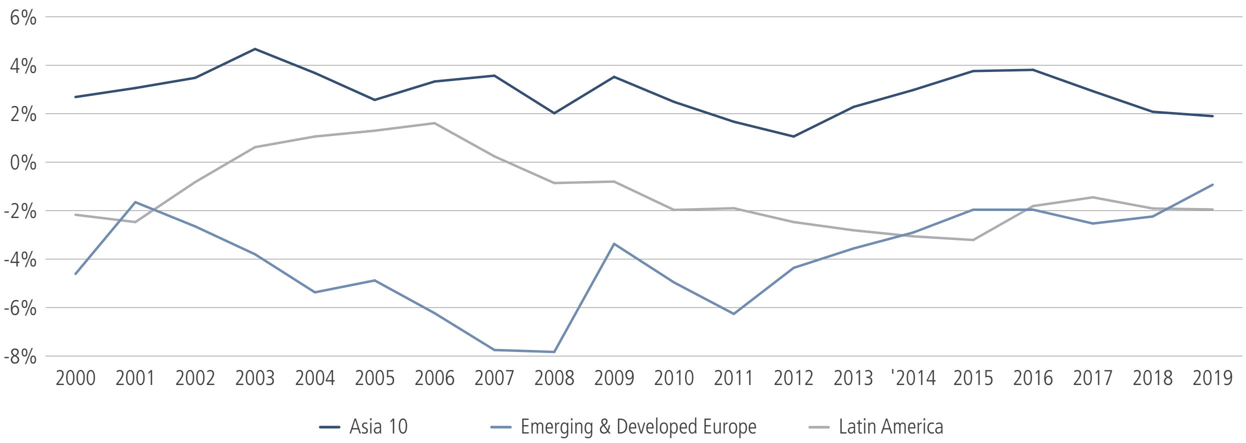
As figure 1 shows, the risk-adjusted performance of Asian debt over the past 15 years compares favorably with many other emerging markets debt asset classes. Local currency Asia debt has proven particularly resilient even during periods of weakness across emerging markets due to the support that the region's current account surpluses provide for its currencies.

FIGURE 1. SUPERIOR GROWTH, FUNDAMENTALS AND RISK-ADJUSTED RETURNS

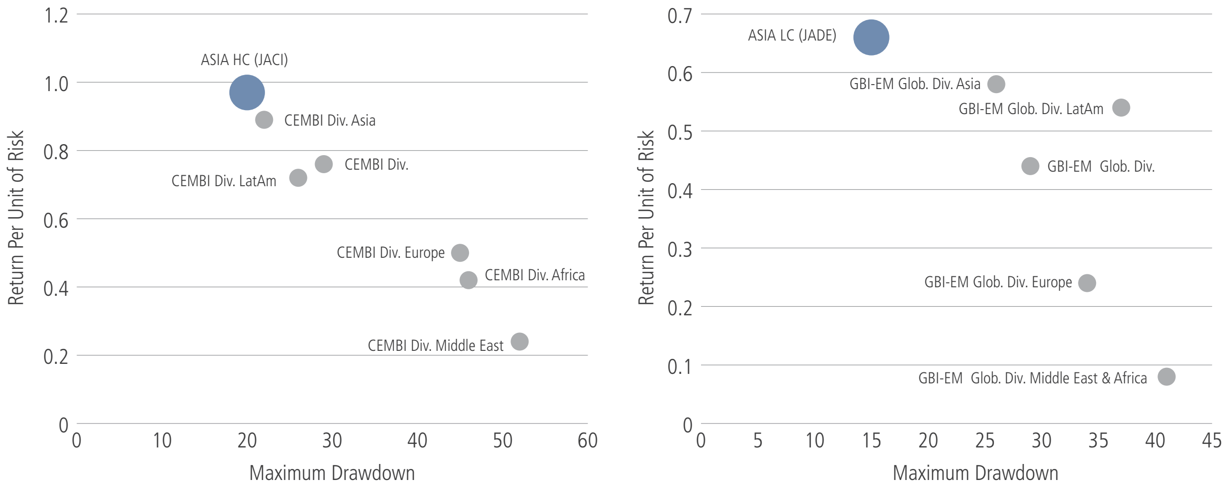
Real GDP per capita growth, year-on-year



Current account balance (% of GDP)



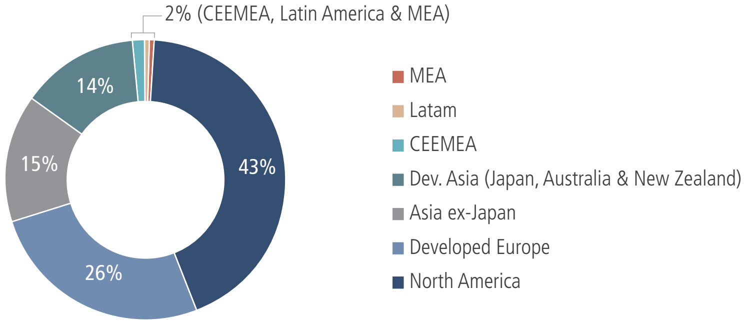
Risk-return ratio and drawdown for a range of emerging markets debt asset classes, 2005 – 2019



Source: IMF, Bloomberg, Neuberger Berman. GDP and current account data as of October 15, 2019. The Asia 10 are: Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand and Vietnam. Asset class performance between December 31, 2004 and October 31, 2019. Sharpe ratios calculated with a risk-free rate of 1.75%. Indices used: JPMorgan JADE Broad; JPMorgan JACI Composite Total; JPMorgan EMBI Global Diversified and Global Diversified regional indices; JPMorgan CEMBI Diversified and Diversified regional indices.

Despite this conservative debt profile, Asia's capital markets have consistently grown in both depth and breadth, to the extent that Asia-ex Japan is now the third largest regional bond market in the world (figure 2). China alone is the second-biggest single-country bond market after the U.S. The growth and development of the region's bond markets is likely to be further aided by the opening up of China's onshore bonds to foreign investors. As we have written elsewhere, that market is 10 times larger than the China offshore markets; it includes more corporate issuers from a wider diversity of sectors, and therefore offers more exposure to the dynamics of domestic China with much lower correlations to international markets; and it offers higher credit quality-adjusted yields and shorter duration.[1]

FIGURE 2. EMERGING ASIA IS NOW THE WORLD'S THIRD-LARGEST BOND MARKET



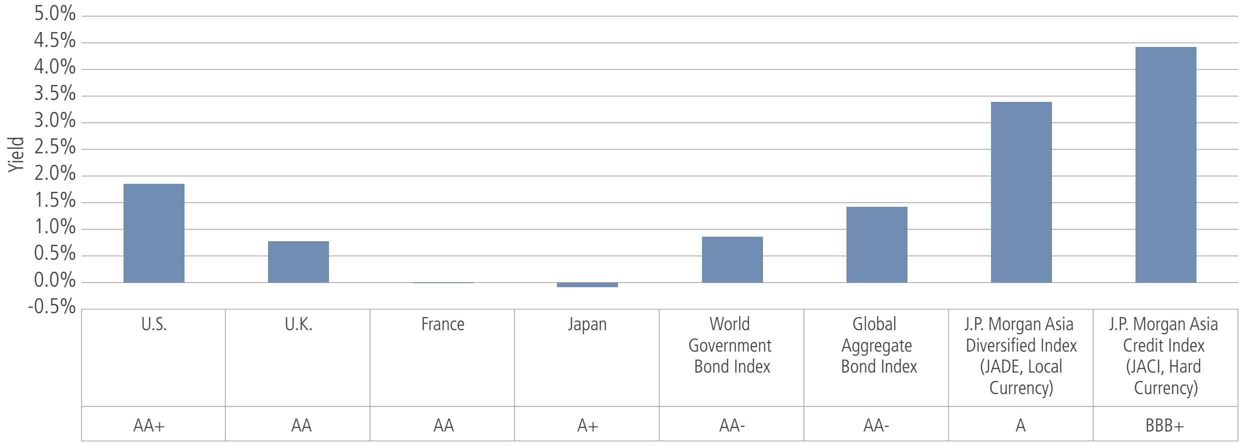
Source: Bank of International Settlements. As of September 22, 2019.

While this is no one's idea of a niche market, then, Asia ex-Japan bonds are still under-represented in the major benchmark indices. The situation is changing fast, especially with the recent inclusion of China onshore bonds in widely used global indices. Nonetheless, Asia ex-Japan still accounts for just 7.8% of the Bloomberg Barclays Global Aggregate Index and 2.3% of the Citigroup World Government Bond Index.

These markets present investors with literally thousands of corporate issuers across more than a dozen countries at different stages of development. This is why we believe an experienced, local presence is so important. Our own Asia team, based out of Singapore and Shanghai, has long experience across all fixed income asset classes in both emerging and frontier markets, including onshore China bonds. Neuberger Berman was one of the first asset managers to receive a license to set up a Wholly Foreign-Owned Enterprise (WFOE) in China.

The under-representation in major benchmarks and the general lack of local analytical expertise is one reason why Asian bond markets, both hard and local currency, generally trade with attractive yields relative to their credit ratings, as shown in figure 3.

FIGURE 3. ASIA BONDS PROVIDE ATTRACTIVE YIELD RELATIVE TO THEIR RATINGS



Source: Bloomberg. The four country yields are for 10-year government bonds. Data as of November 6, 2019.

[1] Peter Ru, "Welcome to the Real China Bond Market" (April 2018), at https://www.nb.com/global/insights/welcome-to-the-real-china-bond-market.

An Attractive Entry Point

These yields follow 12 months of strong performance for the asset class, but still offer an attractive entry point for what we believe could be a promising environment for the region.

Some cooling off in U.S.-China trade tensions is likely to be positive news for Asian currencies. We believe that economic growth is bottoming out in the region, which could support demand for assets geared more toward longer-term economic outperformance, such as local currency bonds. Overall, we expect Asia to be the driving force of the global economy for next several years, which augurs well for business activity, corporate profitability, and the further development and integration of capital markets in the region.

Markets such as Indonesia stand out, in our view. Here, a lengthening track record of macroeconomic stability and fiscal discipline, together with ongoing structural reforms, is beginning to show up in improving economic data. A strong level of reserves and conservative debt ratios would provide some resilience in the event of rising global interest rates. India, China and Malaysia would also be among our favored markets.

In summary, we believe the fundamental Asia story is a very strong one over the medium and the long term, but we also consider current valuations, which prevail mainly due to the recent uncertainties over global trade and the general worldwide economic slowdown, to be an attractive entry point into that story. We believe there is opportunity in both hard and local currency rates, and that, like emerging market currencies in general, most Asian currencies trade at attractive valuations after falling out of favor for much of the past six years.

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