Thriving Amid Volatility: Perspectives on Asian Credit

Disruptive Forces in Investing

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Anu Rajakumar: Despite recent volatility across global markets, fixed income within the emerging markets across Asia continue to remain fairly resilient, both before and since the COVID-19 crisis began. What is it about the Asian credit markets that allow the region to thrive? My name is Anu Rajakumar, and to answer that question and more, I'm joined today by Prashant Singh, Managing Director for the Asian Fixed Income team here at Neuberger Berman. Prashant, thank you for joining me.

Prashant Singh: Thank you, Anu. Thanks for having me.

Anu: Now, there's been a lot happening in the Asia fixed income space, but perhaps you can start by just giving me a quick summary of the current environment.

Prashant: Sure, Anu. So obviously, as in other parts of the world, asset markets in Asia have primarily been driven by COVID-19 related developments over the past few months. But what we've also seen is that, given the relatively stronger fundamentals of Asian economies, their asset performance has been far more resilient in this region.

The strong fiscal and monetary stimulus that has been provided across the region's economies has also aided its resilience, which is not only visible in fixed income but also is visible across equities and the currency space. Now, talking specifically on fixed income, Asian hard-currency bonds, for instance, have shown a strong rebound post initial COVID-19 related sell-off. The JPMorgan Asia Credit Index, or JACI as we call it, which is a widely use benchmark for the Asian hard currency segment, it is already showing positive total returns for the year.

The spreads themselves, which had widened out significantly, post the initial COVID scare, have already rebounded and retraced almost half the total widening that we had seen. Similarly, in the local currency space, we have generally seen a very strong performance in bonds across markets. It has primarily been driven by aggressive monetary easing, but given the sovereign, balance sheets being in a fairly robust shape, most markets have also been able to take the widening fiscal deficits in their stride. And the extra supply has been a little bit of an issue. The respective central banks have shown a very strong hand in supporting the local markets; and that has provided a broader resilience to the bond markets, too.

Anu: Now, you spoke about the resilience across the markets that's creating opportunities for investors. You know, other than some of the fiscal and monetary policy, what is it about Asia and the Chinese bond markets in particular that's allowing for those opportunities to be created?

Prashant: Sure. So, there are a few aspects that we can look at. First thing that stands out is the relative valuations. Now, even with the rebound that we have seen, we find the current valuations fairly attractive for the asset class. Once again, let's take the Asian dollar bonds, for instance. We did an analysis internally to understand the potential deterioration of credit fundamentals as a result of this crisis. And as for our numbers, the kind of spread widening that we have seen (which is in excess of 100 basis points YTD) appears quite unwarranted. Now, as per our numbers, the spread widening is purely attributable to risks coming from potential downgrades or potential defaults should not have been more than 20 to 25 basis points. So given this excessive widening that we have seen, we are fairly confident that, as things stabilize, we should see a reasonable spread compression happening over time. Similarly, if you look at some of the relatively high-yielding local bond markets like India and Indonesia, we find that there is excessive term premia priced into these curves at this point of time. With inflation unlikely to be a concern anytime soon, we think this term premia is, again, unwarranted; and it is scope for outperformance of these bonds going forward.

Now, when we talk about this relative valuation being attractive, obviously our thoughts are underpinned by our sanguine view on both sovereign and credit risk in the region. If you look at Asian corporates, for example, their balance sheets were relatively quite strong going into the crisis. This is reflected by JACI's average rating of triple B plus. More than 77 percent of the index is actually rated investment grade. Almost 38 percent is rated single A minus and above.

Prashant: Many of these corporates also draw strong support from their respective sovereigns; and coming to sovereigns, as I briefly mentioned earlier, the sovereign balance sheets have remained quite healthy. The public debt ratios are relatively modest across the region. Most of the Asian economies also run current account surpluses, or at least have a strong balance of payment positions, which reduces the potential external vulnerabilities that the economies in the region might experience.

Onshore markets are also generally quite deep. Their banking systems are pretty well capitalized. All of this, again, reduces the potential for systemic risks in the region. So this was more about fundamentals in evaluations. Now, the other aspect to look at is the management of COVID-19 spread itself; and here, we can find there is, relative differentiation within the region. The North Asian economies like South Korea, China, and Taiwan, these economies witnessed the spread of virus much earlier, but also managed to combat and control the spread much more effectively.

So as a result, these economies are already pretty advanced in their efforts towards a full resumption of activities. On the other hand, some South and Southeast Asian economies like India, Indonesia, some of the frontier markets--these are behind the curve right now. They haven't yet seen a peak in the number of cases. Now, what that means is that the resumption of activities in these economies will likely take longer, and they will have more risk associated with their reopening of their economies. So these differences obviously warrant a much more nuanced analysis on our own part, but also, at the same time, throw up very interesting themes that we can play within the region.

And lastly, there are a couple of other factors that we can focus on as well. One, the Chinese onshore markets: These bonds, these broad variety of instruments, they show a remarkably low correlation to most of their asset classes, including other emerging-market bonds. So, what this does is that, this provides the investors with a very deep and broad market, which has opportunities across the credit spectrum, but provides additional diversification benefits in their broader portfolios. Some of the biggest bond markets in the region are on their way to be included in global bond indices. So Chinese bonds are already in the process of being included in bond indices like JPMorgan GBI-EM, and Bloomberg Barclay's Global AT. There is a strong likelihood that Indian bonds will also be included in these indices over next 12 to 18 months. So both these markets will stand to benefit a lot from potential capital inflows that will come through following the index inclusion, and that should provide strong technical support to these markets, at least for a period of time.

Anu: Great. Thank you. That's very interesting, and an important point that you made about the focus on active management in some of these markets, given the wide dispersion. Now, just out of curiosity, Prashant, I was wondering if you could touch upon the market recovery in the Asian credit markets this year compared to after the Global Financial Crisis, maybe just compare and contrast these two key periods.

Prashant: Sure, Anu. So, as I touched upon earlier, the market recovery has been reasonably strong, within the asset class. But we must not lose sight of the fact that, market recovery is a function of the economic recovery; and when we compare this to GFC, this time around, I think it is fair to say that the economic shock is much bigger. And that largely emanates from the fact that various regions saw public-health scares; and there was a complete halt in economic activity in different regions for varying lengths of time. This was not witnessed within GFC. Now, this has resulted in significant shocks from both the supply as well as demand perspectives, and the recovery from this will not be that straightforward. The lack of an effective vaccine and concerns on potential second waves, these will also make the process even trickier.

Now, that said, I think the most important policy focus should be on ensuring that medium and small enterprises survive these lockdowns that we are seeing, and that the supply chain remains relatively unscathed. So to the extent that the policies in different economies are able to ensure the survivability of the medium and small enterprises, who are probably the biggest employers in, a lot of these economies, to the extent that, portion of the economy survives; and to the extent that supply chains are relatively intact; I think economic recovery will be quicker, and markets will start to price that in more effectively going forward.

Anu: Sure. You mentioned the supply chain there, which, as we all know, is a huge part of the greater Asian economy. Prashant, what do you think the impact is on the future of supply-chain manufacturing throughout Asia, as a result of this whole pandemic situation?

Prashant: Yeah, that's an interesting question. When we look at the supply chains within the region, and also Asia as a rule in the broader global supply chains, I think it's clear that the process of supply-chain reorientation was already underway prior to the pandemic. There were different reasons for it. First, given the geopolitical risks, the process of re-onshoring or setting up of additional production facilities in other locations was already happening for the likes of Taiwan and Japan. So, there was a clear need for that they should be able to supply some of the production facilities out of China.

Prashant: Second, with China looking to move up the value curve, the low-cost manufacturing was already shifting away to other lower-cost destinations, so, like Vietnam, like Bangladesh, for example. So, now with this COVID-19 likely acting as a catalyst and speeding up this process, we expect to see more manufacturing to be moved out of China; or at the very least, fewer new facilities being set up within China. Manufacturing will potentially be redistributed across many other Asian countries. So who stands to be a beneficiary of this? Clearly Vietnam and Bangladesh will be obvious beneficiaries. They stand out. But we think that likes of Malaysia, Thailand, even, Indonesia, they can also stand to gain from this process of redistribution of supply chains.

Very interestingly, this could also open up a significant opportunity for a country like India if they can push some of their reforms through. So there has been a lot of talk regarding land reforms, labor reforms--that Indian policymakers have been discussing, and if that can be pushed through, then in terms of demographics and wages, India, is ideally placed to pick up the slack in this space. So that should be interesting space to watch out for.

Anu: Perfect. Well, on that note, I think we'll wrap up there. Prashant, really appreciate your time today to discuss the Asian fixed-income market. Thank you for being here.

Prashant: Thank you, Anu. It was a pleasure.

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