Southeast Asia stands firm

Southeast Asia is becoming an important part of an investor's portfolio, writes **Betty Kotevski.**

Despite some volatility, Asian emerging markets fixed income is standing firm, with desire for diversification, access to the China growth story, and improved governance practices such as borrowing in local currencies rather than the US dollar driving investor confidence. With expectations that currencies in the region will appreciate over the long term on the basis of economic growth and strong fundamentals, Southeast Asia is likely to become an increasingly important part of investor portfolios.

S&P Dow Jones Indices' Associate Director of Fixed Income Indices Michele Leung says despite global investor sentiment turning negative during the May/June sell-off, and the fear of a liquidity squeeze and deleveraging in China, Asian fixed interest markets recovered most of the losses in July. "Investors continue to want exposure in both Chinese currency and credit. We see the offshore market remaining a favourite for the yield factor."

Emerging Southeast Asia

Local currency bond markets in emerging Southeast Asia, which includes China, Thailand, Indonesia and the Philippines, have grown at an annual average rate of 16.5% since 2001, according to a 2013 Asian Development Bank (ADB) working paper. Quarter-on-quarter growth rate for the local currency bond market in the first quarter of 2013 was 2.9%, as the region's bond market reached $6.7trn in size. At end of March 2012, emerging Asia accounted for nearly 10% of the global debt market, up from 2.4% in 1996. The most rapidly growing markets in the first quarter 2013 were Vietnam (20.8% for the quarter), Indonesia (5.9% for the quarter, 13.9% for the year), and Singapore (5.1%).

Asian emerging fixed interest markets have also considerably boosted liquidity in the past few years, with each country's local currency fixed interest markets bigger in size than the US-dollar denominated markets.

Total local currency bonds outstanding in Indonesia reached IDR1,154.8trn ($119bn), in the first quarter 2013, according to the Asia Bond Monitor. In Indonesia, corporate bond issues for the first quarter were dominated by banking and financial institutions. For the Philippines, where the corporate bond market expanded by 19.8% for the year to the first quarter 2013, total LCY bonds outstanding reached PHP4.1trn ($99bn). In Thailand, total LCY bonds outstanding reached THB8.6trn (or $294bn). The share of foreign holdings of Thai LCY government bonds rose from 12.2% in March 2012, to 17.6% a year later.

Why the volatility?

The ADB says that while emerging Asia's debt markets are becoming more robust, volatility is on the rise. A sell-off in Asian emerging economies' fixed income markets followed the US Federal Reserve's stimulus tapering comments in May/June this year, but losses were largely recovered in July, indicating resilience in these markets following both macro and micro level restructuring in their debt markets and economies.


Endre Pedersen

Manulife Asset Management's Managing Director of Fixed Income Endre Pedersen believes the volatility seen in May/June was not actually about Asian economies' fundamentals. "Large global bond investors dipping their toes into emerging markets, dipping their toes into Asia more or less for the first time – they are very, very quick to pull out because this is not a risk they are familiar with," he says.

Pedersen said the sell-off was basically a beta sell-off which followed over three years of a beta rally "where pretty much everything you were touching was increasing in value."

The response of investors to the volatility and uncertainty in interest rates has been to shorten the length of their bond investments. Kheng-Siang Ng, Asia Pacific Head of Fixed Income at State Street Global Advisers (SSgA), says at this point, investors generally remain light on duration, meaning they are short on duration in general. "We feel in the near term, Asian bonds will remain on the negative side, though the weakness in Asian bonds will be less than the US."

S&P Dow Jones Indices' Vice President of Fixed Income Indices James Rieger says a "great deal" of money has moved from fixed rate bonds to floating rate, as a response to the volatility. "Volatility has got to increase a bit because of the uncertainty of where interest rates will go or when interest rates will rise. And that has got investors on the edge of their seats, when you're talking about owning long term fixed rate debt and securities."

Another driver on the fixed income markets is the impact of the Basel III regulations on banks. "It has to play some role in how banks are exposing themselves to certain credit," Rieger adds.

QIC's Managing Director of Global Fixed Interest Susan Buckley says volatility has increased because investment banks now play a lesser role in 'warehousing' risk post-GFC, as their balance sheets have shrunk with deleveraging. "We've had big flows into credit, and when they take fright – whether it's ETFs or other investments – when they swing back the other way, who is the buyer of that risk? Investment banks used to play that role. So, it lurches from one side of the ship back to the other." QIC points to US Federal Reserve data showing that primary dealer holdings of corporate debt of more than 12 months duration have shrunk dramatically from 2008.

Strong fundamentals

But the volatility the markets are dealing with now is coming on the back of some considerable growth post-GFC. According to the ADB, the region's financial markets were considered a safe haven by investors and saw large capital inflows, expanding sharply during the first half of


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2009 following a significant decline in the fourth quarter of 2008 amid the global financial crisis.

Significant macro-economic fiscal reforms at a country level, as well as restructuring of much corporate and government debt into local currency debt has also helped the economies become more resilient, especially compared to the Asian crisis of 1997. The fundamentals are there to retain global flows, experts believe.

Vijay Chander, Executive Director of Fixed Income at Asia Securities Industry and Financial Markets Association (ASIFMA) points out the 'big 5' countries in ASEAN, including Indonesia and the Philippines, are now all investment grade, which has lessened the volatility in their fixed income markets. "Most of the sell-off has been caused by the widening in treasuries rather than a perceived deterioration in the credit profile of any of the countries of the region.

"To that extent, I would say markets have taken the sell-off in stride. Now of course, in price terms, if you're an investor in a bond and you're priced off treasuries, which is typically how most Asian bonds are priced, the spread widening per se has been muted, but the treasuries themselves have moved, so that would cause the bond price to fall and that's what we have largely seen."

Chander says many Southeast Asian economies have generally adopted more sensible government policies, and have built up substantial foreign currency reserves. This has made their fixed income markets more resilient. "The Philippines, in particular," Chander says, "termed out their foreign currency borrowings and they managed to have much more of a match between currency inflows and outflows, generally speaking. So, there's been a much greater focus on matching the duration of assets and liabilities, particularly in foreign currency, to make sure that you're not suddenly caught short in a liquidity crunch."

Investors are definitely distinguishing between countries in the Southeast Asian region, Chander adds. Indonesia, for instance, has been slower to attract inflows. But with duration mismatches being eliminated and corporates borrowing more in local currency, and matching the currency of their projects to the currency of their borrowings, the market infrastructure has improved.

Local currency borrowings

A key feature that has helped the economies stand firm in the face of the latest sell-off has been borrowing in local currencies rather than the US dollar, a lesson learned from the Asian crisis. Many corporates in 1997 had borrowed in US dollars but their revenues were in local currency, taking 'false comfort' that prior to the crisis most currencies were pegged to the dollar. "From that, there was a concentration of minds and corporates decided that they'd be better served borrowing in their respective local currencies," Chander says.

According to the ADB, issuance in local currency bond markets by both government and companies surged in the wake of the Lehman collapse in September 2008, "supporting massive official stimulus programmes to pump-prime affected economies."

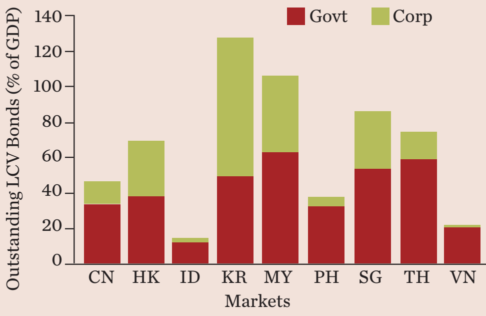
However, the currencies' strength is also due in part to their attraction to global investors looking to diversify. The share of foreign holdings of the region's local currency government bonds continued to rise in the first quarter of 2013, except in Korea and Japan. The share of foreign holdings of government bonds in Indonesia remained the highest in the region (32.6%).

SSgA's Ng says Asian local currency bonds have been one of the areas a lot of market participants and fund managers have been paying attention to, which has included fund launches. Ng also believes there will be a lot more activity in the next few months in the RMB, now that it's got the investors' group participation from Hong Kong institutions, and the widening of that group to include London and Singapore who have applied for a quota to invest in the interbank bond markets in China.

And there's a lot of support for the view that the currencies in the region are only going to get stronger. Manulife's Pedersen believes the currencies will strengthen over the next 10 years, on the basis of economic growth and strong fundamentals. "Whether you're looking at it from a growth angle or a fiscal angle, relative to the rest of the world, Asia stands out on a fundamental basis, and that is combined with pretty attractive fundamentals or valuations when it comes to the rates side — when you're still being paid on the rates — or whether you're looking for undervalued currencies, or you're looking just from a credit spread where you're combined to the corporate bond market."

Manulife has scaled back in areas like corporate high yield, Pedersen says, and is now buying back particularly on the currency side. "If we're looking at interest rates, currency, and corporates in Asia, we think that currencies look

Size of LCY Bond Market in % of GDP



CN: ChinaBond.
HK: Hong Kong Monetary Authority.
ID: Indonesia Stock Exchange.
JP: Japan Securities Dealers Association.
KR: KoreaBondWeb.
MY: Bank Negara Malaysia.
PH: Bureau of the Treasury; Bloomberg, LP.
SG: Monetary Authority of Singapore (Government bonds and annual Corporate bonds); Bloomberg, LP (Starting from 2007, quarterly data for Corporate bonds are estimated).
TH: Bank of Thailand.
VN: Bloomberg, LP.

the part that has cheapened up the most."

Investors globally are looking for diversification away from the dollar, more so in the context of the tapering which has seen treasury spreads widen, according to ASIFMA's Chander. Hence, there is a lot of interest in diversifying into local currency. He says Southeast Asian bond markets were among the best performing markets in the early part of the year before the May/June sell-off, and the Thai Baht also gave a substantial contribution in terms of total returns, appreciating to its best levels since the Asian crisis.

Corporate bond markets

Asian emerging economies' corporate bond markets have also seen solid growth. According to the ADB, large companies tapped local bond markets during the GFC to raise funds as banks turned cautious. Though corporate bond spreads widened, they remained below prime lending rates in many markets, allowing firms to continue raising funds.

"The corporate bond markets do not have a great deal of liquidity," Chander says, "especially when you're talking about say, a Thai Baht issue of a corporate or a Malaysian ringgit issue. Some of them are more liquid than others, so a well-known, quasi-sovereign name like Petronas or Cagamas in Malaysia might be quite a bit more liquid than a lesser known corporate. So the liquidity there is really dependent on name recognition."

SSgA's Ng says there has been some corporate issuance but volumes are not as heavy as at the beginning of the year, and investors are still wary of taking on too much risk. "Investors obviously are a bit concerned right now especially if there are any issuances coming from the high yield sector. Most of the issues that would be well received are at least of the investment grade side; the issues we have seen from that May/June period: most are from the investment grade side."

Manulife's Pedersen says issuers are definitely holding off but more issuers are expected to come forward as markets settle down from the May/June sell-off. "We are seeing issuers coming back to the market, slowly, and we are anticipating that will continue. I think we've seen just under $100bn so far this year in terms of overall corporate issuance in US dollars in Asia and we're expecting to see more issuance coming back into the market. People weren't willing to buy anything in June given the volatility, and given that, people were looking to reduce exposure. There was enough paper on the street to pick up whatever you wanted. During that period you didn't see any new allocations into Asia." He says things have now calmed down and flows are expected.

And, consistent with many other fixed income markets: loan terms and yields are very much dependent on the issuer. "You had some auto companies (recently) going direct to the US," Pedersen says. "The terms were good for the borrower, but not particularly for the lenders. They're trying to price it to US autos, and were not showing it to the Asian lenders." ■