Schroders

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The Case for Asian local currency bonds

January 2021

Schroders as your partner in Asian bonds

At a glance

As interest rates have fallen to historic lows over the past year, we explore which segments of the fixed income market could still offer investors the potential for attractive income and returns. We first review the performance of global fixed income market over the past 15 years and show that Asian bonds have performed well, particularly against other emerging markets. We then analyse some potential drivers for this attractive return risk profile, and argue that Asian local currency bonds could continue to deliver attractive returns for investors going forward.

Asian bonds have historically achieved superior return and risk profile: Asian fixed income has outperformed other emerging market bonds, generating stronger returns with lower volatilities. This more efficient return profile spans across all Asian fixed income sectors, from rates, FX, and credits, and across sovereign, investment grade, and high yield bonds.

Return opportunities: With strong macro fundamentals, compelling valuations, and a favourable FX backdrop, Asian local currency bonds have the potential to deliver returns from both carry and currency appreciation. We view Asian local currency bonds as an attractive alternative to both high quality developed market treasuries as well as a good complement to credits and other emerging market bonds.

Why Schroders? A dedicated team with significant experience and track record investing in Asian bonds, Schroders offers investors an opportunity to take advantage of this growing and attractive region in fixed income.

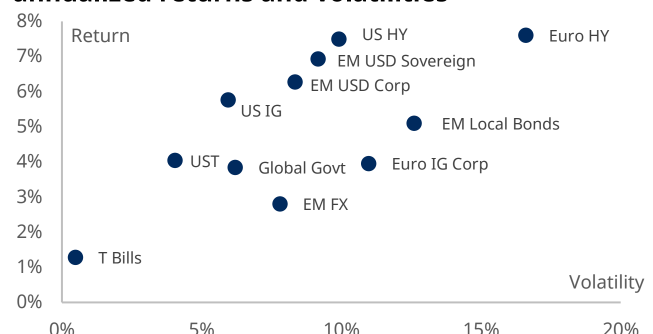
Challenges in a low rate environment for fixed income investors

As global interest rates plunged to historic lows following the pandemic, it has become increasingly challenging for investors to find opportunities in the fixed income market that could still provide an adequate level of income as well as the potential for downside protection. In the past, investors could look across the spectrum of fixed income investments to find value and opportunities, from government bonds to credits, from investment grade to high yield, and from US to other developed and emerging markets. In this paper, we first review how these different sectors of the bond market have performed historically, and argue that on a forward-looking basis, one of the most attractive opportunities may lie in the Asian local currency bond market.

Historical performance of Asian bonds

The past few decades have been very good for fixed income investors, propelled by interest rates falling to historic lows. In Chart 1 we show how different equity and fixed income asset classes have performed over the past 15 years, a period encompassing the housing bubble, the Great Financial Crisis, the subsequent recovery, European debt crisis, Taper Tantrum, China slowdown, Fed hike, the Covid-19 recession, and the historic rebound since:

Chart 1: Global fixed income asset class 15-year annualized returns and volatilities



Source: Schroders, Bloomberg, based on 15 year of monthly USD unhedged returns ending Dec 2020. See appendix A for the different market indices used in the analysis

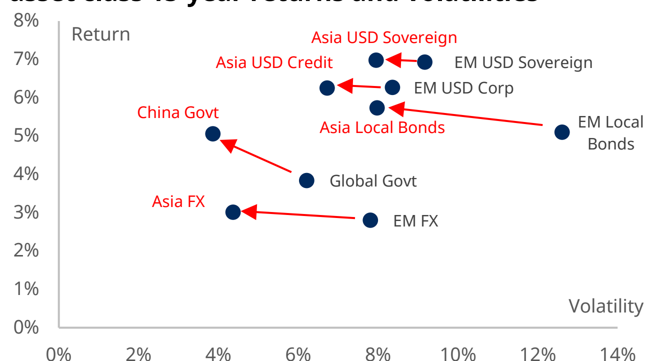
*Schroder International Selection Fund is referred to as SISF throughout this document.

A few observations emerge from the returns and volatilities experienced over the past 15 years:

- USD assets have broadly outperformed global, European, and emerging market fixed income assets
- As one would expect, the riskier segments of the market have delivered higher returns than the safer sectors, but also with higher volatilities. High yield bonds performed the best, followed by emerging market debt, then investment grade debt, then governments, then cash.
- Within EM, local currency assets lagged, with EM local currency bonds not only underperforming hard currency USD bonds, but also exhibiting higher volatilities.

The stronger relative performance of the US markets versus global and EM has been well analysed so would not be a focus here. But investors might not be aware that if we took a closer look at just within the EM asset classes and compared the Asian market returns, we now could see an interesting pattern:

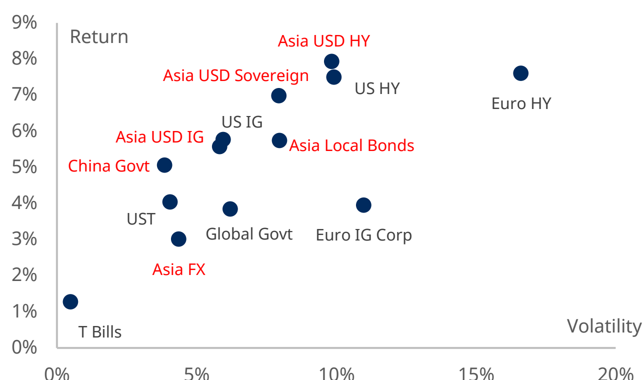
Chart 2: Asian and emerging market fixed income asset class 15-year returns and volatilities



Source: Schroders, Bloomberg, based on 15 year of monthly USD unhedged returns ending Dec 2020. See appendix A for the different market indices used in the analysis

It is very interesting that in every instance when we move from the broader emerging markets to just Asian emerging markets, the return profiles become much more efficient, with improvements in both the historical returns and a reduction in volatilities. Now, if we redraw Chart 1 showing only the Asian EM and the global and US bond markets, we see that the Asian EM fixed income sectors have been very competitive, delivering returns even in excess of US bond market returns:

Chart 3: Asian and global fixed income market 15-year returns and volatilities



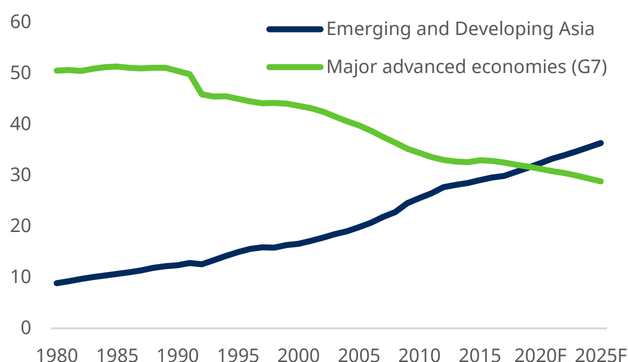
Source: Schroders, Bloomberg, based on 15 year of monthly USD unhedged returns ending Dec 2020. See appendix A for the different market indices used in the analysis

Investors might be surprised to learn that historically EM Asian asset class performance has been this strong, even surpassing the US fixed income market returns. So what is happening here? And more importantly, can investors expect this phenomenon to continue? Below we take a closer look at Asian local currency sovereign bonds and discuss some of the reasons that we believe will lead to continued favourable risk return characteristics for Asian sovereign bonds going forward.

Asian economies have strong fundamentals

We believe the first reason for Asian bond markets to perform well is due to the stronger fundamentals of Asian economies relative to the global developed and other emerging market economies. Over the past couple of decades, emerging Asian economies have grown significantly faster than the rest of the world, having overtaken the G7 countries in their share of global GDP, and now contribute more than half of all global GDP growth:

Chart 4: Share of global GDP between EM Asia and G7 economies

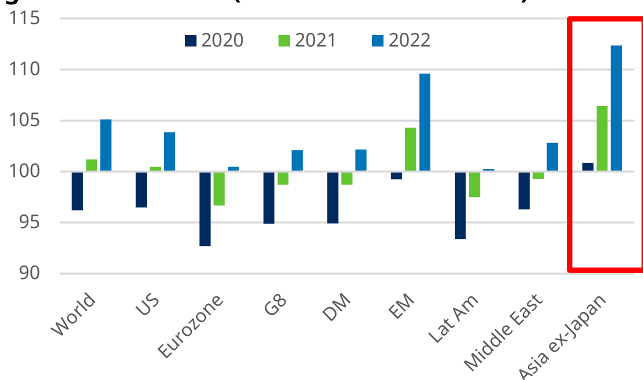


Source: IMF, as of October 2020

Additionally, the growth differentials between Asian and other global economies have only widened over the past year. Due to cultural reasons and stronger government actions, Asian economies, led by China, are the first ones to enter the global pandemic and the first ones out. Chart 5 below shows the GDP

trajectories of global economic regions from 2020-2022, indexed to 100 at the end of 2019. Asia ex-Japan is the only region with 2020 GDP exceeding 2019 level, and far outpacing other regions in developed markets or other emerging markets. Europe and Latin America have been particularly impacted by the pandemic with their GDP levels expected to barely get back to 2019 levels only at the end of 2022.

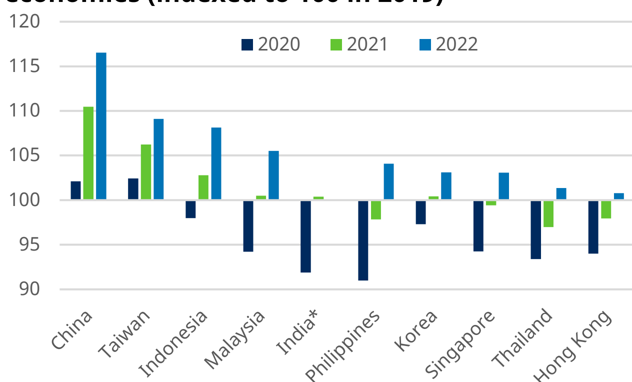
Chart 5: Annual forecasted real GDP levels of global economies (indexed to 100 in 2019)



Source: Schroders, Bloomberg Economic Forecast based on contributor composites, as at 19 January 2020

When we focus just on Asia ex-Japan as shown in Chart 6, we can see that China was the only major world economy with a positive GDP growth in 2020, followed by expected continued sharp rebound in 2021. The rest of the Asian economies are benefiting from this positive dynamic from China, as it is the largest trading partner in the region. Taiwan is the other economy that grew in 2020, thanks to its strong semiconductor sector that benefited from the work-from-home technology boom as well as its outstanding pandemic containment. Overall, as shown in Chart 5, the Asia ex-Japan region is expected to grow more than 12% from 2019 to 2022, far exceeding the 5% globally and 2% in developed markets.

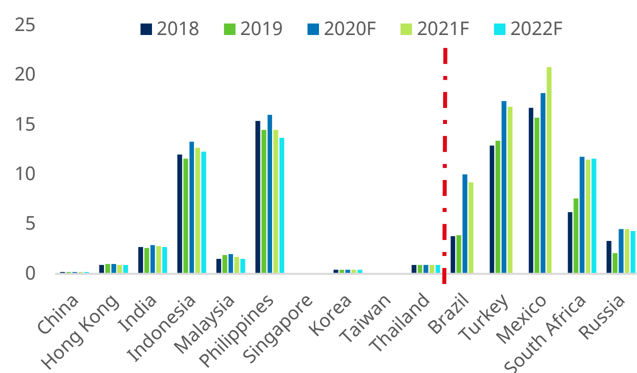
Chart 6: Annual forecasted real GDP levels of Asian economies (indexed to 100 in 2019)



Source: Schroders, Bloomberg Economic Forecast based on contributor composites, as at 19 January 2020. India 2020 and 2021 projections based on fiscal year 2021 and 2022

If we look at Asian sovereign debt profile, we also notice a significant difference relative to other emerging market countries. While total debt to GDP ratios have risen globally over the past year as governments expanded fiscal spending to stimulate growth, chart 7 below shows how Asian economies' external government debt to GDP levels have remained very low and stable, with many countries near zero.

Chart 7: External government debt to GDP of Asian and select emerging market countries (%)



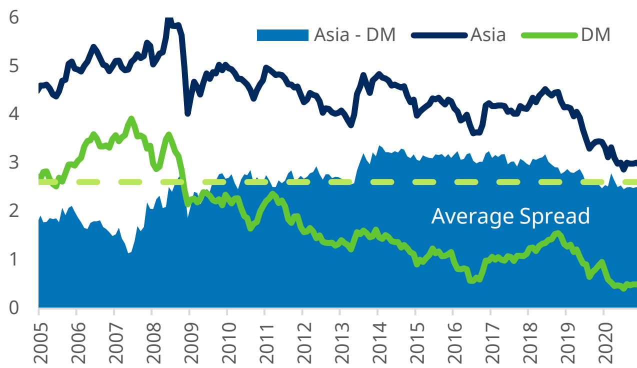
Source: Deutsche Bank Research, as at January 2021

Compared to other EM countries that are more reliant on external funding sources, Asian economies are less vulnerable to the volatility of global capital flows and can tap into the large domestic savings pools to manage their debt dynamics more effectively. This more robust debt structure is one reason that has helped Asian countries avoid defaults since the Asian financial crisis when Korea, Thailand, and Indonesia faced rising foreign debt pressures amidst rapidly depreciating currencies in 1997. Over the last two decades as countries in Latin America, Middle East, and CEEMEA experienced defaults or pressures from energy price volatility, the robustness of Asian economic growth and the lower reliance on external debt have proven to be a resilient feature for investors in Asian fixed income.

Asian bond valuation is attractive

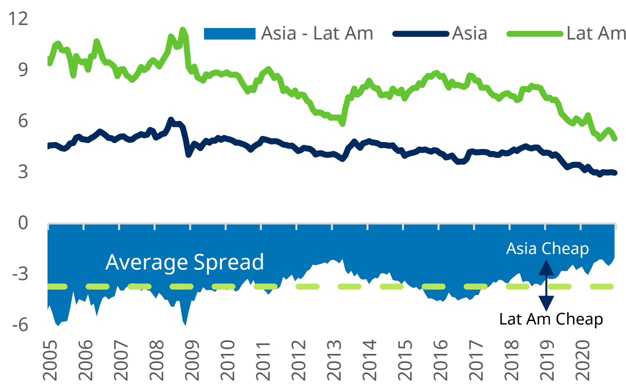
Despite stronger fundamentals, Asian bonds are trading near the historic average or cheaper side of valuation levels versus global fixed income markets. Charts 8 and 9 show the yields and spreads of EM Asia local currency sovereign debt vs. global DM Treasury yields and EM Latin America yields.

Chart 8: Yields and spread of EM Asian local currency sovereign bonds vs. global developed market Treasuries (%)



Source: Bloomberg, as represented by the JPMorgan Asia Diversified Index Broad Diversified and Bloomberg Barclays Global Treasury Index, as at 31 December 2020

Chart 9: Yields and spread of EM Asian local currency sovereign bonds vs. Latin American sovereign bonds (%)



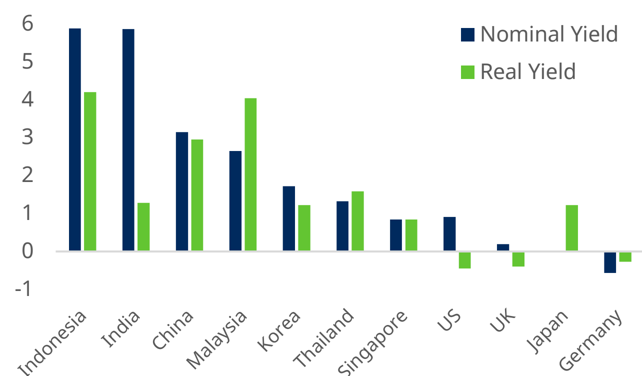
Source: Bloomberg, as represented by the JPMorgan Asia Diversified Index Broad Diversified and GBI-EM Broad Latin America indices as at 31 December 2020

While Asian sovereign bond valuation is around historic average versus global developed market bonds at 2.5%, with the global DM bond yields barely above zero, the extra spread offered by Asian bonds is particularly valuable. Compared to Latin American sovereigns, Asian bonds are actually trading at the cheapest level at -2.0% vs. historical average of -3.7%. This valuation is compelling as Asian bonds are rated 3 notches higher at A/A2 vs. Latin American sovereigns at BBB/Baa2 for the two indices shown in the chart, and with much more favourable historical risk reward profiles.

As China is the largest country in Asia, a key factor for the attractive valuation of the Asian local currency sovereign bonds is the yield pickup of Chinese government bonds versus global sovereign bonds. As the Chinese economy has continued to rebound, the People's Bank of China has already begun to normalize its monetary policy. While other global central banks have cut rates to zero and implemented quantitative easing and other unconventional monetary policies in a broad stroke to stimulate their economies, the PBOC has used a more measured and targeted approach to provide relief to small and medium enterprises, mitigate the problem of non-performing loans to ensure rising defaults do not lead to systemic financial risk, and contain leverage in the property sector to manage gradual debt deleveraging. As a result, Chinese rates actually rose last year to reflect the stronger economic outlook and less easy policies compared to other countries. However, with still muted inflationary pressure and areas of the economy still needing policy support, we do not expect the PBOC to shift to a hawkish stance any time soon, and the current rate levels provide an attractive entry point for investors to capture high quality yields that could provide both income and diversification relative to global sovereign yields.

Outside of China, we also see other EM Asian sovereign markets with the potential to generate attractive returns. In the other high-quality fixed income markets such as Korea and Singapore, rates are likely to stay low as monetary policies remain accommodative while economic activities are starting to resume due to more effective management of the pandemic spread. In Indonesia, the new Omnibus law could lead to a more favourable growth outlook while inflation rate remains low. Similarly, in Malaysia, attractive real rates are providing support to valuation. In Thailand, rates are also likely to stay anchored until global tourism resumes to pre-pandemic normal levels after the rollout of vaccines reaches critical mass and people feel comfortable traveling again. Finally, in India where food inflation has remained elevated, nominal yields have also stabilized in the last few months, reflecting the expectation for an easing of pricing pressures. Overall, as shown in Chart 10 below, Asian sovereign rates mostly offer attractive carry to investors based on both nominal and real yields. The attractive real yields are particularly compelling as most global DM real yields are negative.

Chart 10: 10-year Asian and global sovereign nominal and real yields based on headline CPI (%)



Source: Bloomberg, as at 31 December 2020

Asian local currency bonds offer a diverse set of market opportunities in both rates and currencies

In addition to offering attractive valuation, we also show below in Table 1 that the different countries within Asia have also historically offered investors a diverse set of investment opportunities with varying dynamics and correlations to global stock and bond markets. We broadly categorize the Asian countries into advanced, middle income, and emerging economies. We show data for both the currency unhedged and hedged returns in USD to better illustrate the correlations including currency effects and from interest rates only (plus hedging costs). While on an unhedged basis Asian local bonds have generally exhibited higher correlations, we can see there is divergence among the three groups of countries, especially in the local interest rate markets (i.e. hedged basis):

Table 1: Asian local currency bond correlations with global sovereign bonds and global equities

Economy Type	Economy	Credit Rating	FX Unhedged		FX hedged	
			DM Sov Bonds	Global Equities	DM Sov Bonds	Global Equities
Index	**Asia Local Bond Index**	**A**	**0.65**	**0.54**	**0.56**	**0.19**
Advanced	Singapore	AAA	0.75	0.45	0.63	0.07
Advanced	Hong Kong	AA+	0.58	-0.09	0.58	-0.13
Advanced	South Korea	AA	0.61	0.31	0.34	-0.18
Advanced	Taiwan	AA-	0.57	0.37	0.39	-0.06
Middle Income	China	A+	0.25	0.33	0.07	-0.05
Middle Income	Malaysia	A-	0.53	0.48	0.47	0.26
Middle Income	Thailand	BBB+	0.56	0.46	0.50	0.17
Emerging	Philippines	BBB+	0.36	0.41	0.33	0.32
Emerging	Indonesia	BBB	0.37	0.54	0.36	0.41
Emerging	India	BBB-	0.22	0.26	0.01	-0.12

Source: Bloomberg, based on monthly Markit iBoxx ALBI USD unhedged and hedged returns vs. the Bloomberg Barclays Global Treasury Index and MSCI All-Country World Index from 2013 to 2020, as at 31 December 2020

- For the advanced Asian economies, the bond markets tend to have lower yields and behave more similarly to developed market treasuries, with local bonds showing negative correlations to equities and serving the role as high-quality risk hedging assets in a multi-asset portfolio.
- The middle-income countries led by China tend to have lower correlations to other asset classes as their economies are driven primarily by the growth of the domestic middle class. As China is now focused on "internal circulation" as its growth model, we expect lower correlations to persist with global markets.
- The emerging economy bonds are high yielders whose markets are more sensitive to global growth, leading to lower correlations with DM bonds and higher correlations with risk assets and typically stronger returns during economic recovery periods. The exception is India where limits on foreign ownership have led to less foreign investor participation and thus low correlations with global assets.
- Although not shown here, frontier markets such as Vietnam (another country that generated positive GDP in 2020) and Sri Lanka also exhibit different dynamics from the other Asian countries, providing additional opportunities as these markets develop over time.

We believe this rich set of countries and different market dynamics not only provide investors with investment opportunities and diversification benefits, but also offer fund managers with significant alpha potentials. Furthermore, investors can separate investment decisions on interest rates and currencies to more surgically express market views. For example, if an investor expects Thai rates to stay low due to accommodative monetary policy while the currency demand to weaken from the decline in tourism, she can express a bullish view on Thai bonds using cash bonds or interest rate swaps and a bearish view on Thai baht with FX forwards. One could also broaden the investment scope to quasi-sovereign and corporate bonds in local or hard currencies as additional sources of alpha. An experienced manager with deep local knowledge and resources across the Asian region could potentially uncover market inefficiencies and deliver superior investment returns to investors.

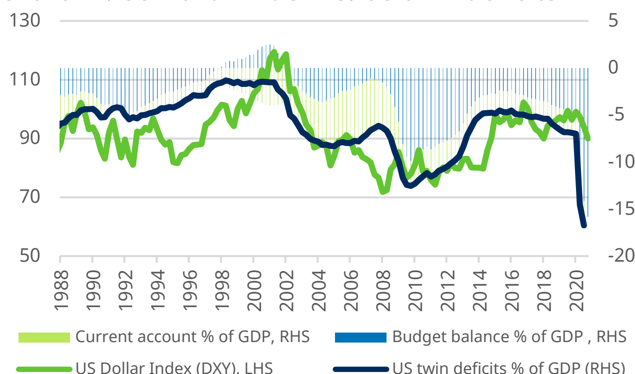
Asian currencies have the potential for appreciation

By now we have highlighted the strong fundamentals of Asian sovereigns, the attractiveness of Asian rate, and a diverse opportunity set. Lastly, we argue that investors in Asian local bonds have the potential for additional gains from currency appreciation.

We believe the USD is in a secular downward trend, thanks to the ballooning twin deficits, record rounds of fiscal stimulus programs, zero interest rate policy, and unlimited quantitative easing by the Fed. As shown in Chart 11, historically the US twin deficits of current account and budget balance have moved in tandem with the broad trends of the dollar index. Since reaching a cycle high last March during the

pandemic flight-to-quality melt up, the USD has declined by more than 10% into a bearish trend, benefitting foreign currencies, including emerging Asian currencies. Concurrently, the US twin deficits have ballooned to unprecedented levels due to the pandemic. We believe the continued accommodative monetary policy as well as additional fiscal support programs under the Biden administration will likely put further pressure on the USD.

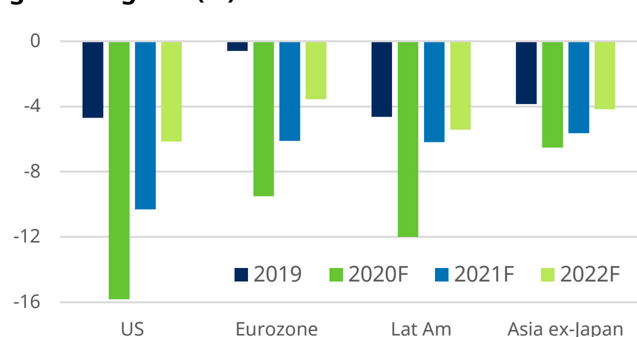
Chart 11: US Dollar Index vs. US twin deficits



Source: Schroders, Bloomberg, quarterly data as at 3Q 2020 for the twin deficits (US Budget Balance + US Current Account Balance) and 4Q 2020 for DXY

However, the US twin deficits are only one side of a coin. As each currency is a cross against another currency, it is the relative dynamics between the US and another country that determines the performance of the currency pair. Now if we compare the budget and current account balances across different regions in Charts 12 and 13, we see that again Asian economies are more structurally sound compared to the US, developed markets, and other emerging markets. While governments globally have expanded deficits to mitigate the pandemic impact, we can see that Asian EM governments are more fiscally restrained in spending, partly due to more effective containment of the virus in the region, as well as less vulnerability to commodity price volatility as is the case for some Latin American countries.

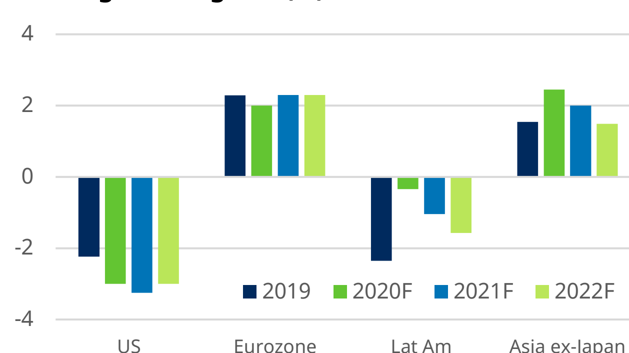
Chart 12: Budget balance as % of GDP across global regions (%)



Source: Bloomberg Economic Forecast based on contributor composites, as at 31 December 2020

In terms of current accounts, Asian economies have maintained a positive balance throughout the pandemic. In fact, current account balance increased in 2020, driven by declines in services imports from fewer Asian tourists traveling overseas due to the global lockdown. So while the US and other EM regions suffer from twin deficits, Asian economies have much more stable fiscal and external balance profiles, relatively benefiting their currencies.

Chart 13: Current account balance as % of GDP across global regions (%)

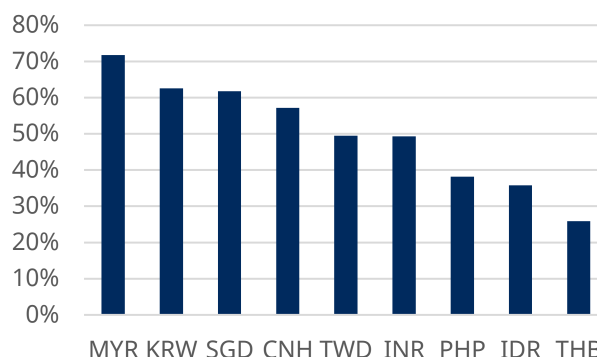


Source: Bloomberg Economic Forecast based on contributor composites, as at 31 December 2020

Additionally, as shown previously in Chart 5, we believe the widening growth deferential due to better control of the pandemic in the Asian economies will result in broader trade and capital flows into Asia from Europe and the US, leading to appreciation of Asian FX. The recently signed Regional Comprehensive Economic Partnership (RCEP) trade agreements could also further promote intra-Asia regional trade and Asian currency strength.

Lastly, as global economies continue to rebound with the vaccine rollout, Asian economies will also benefit from the improvement in manufacturing activities as well as increased trade. Chart 14 below shows the positive correlations of Asian FX performance with global manufacturing index over the past 3 years.

Chart 14: Correlations of Asian currencies to JP Morgan Global Manufacturing Purchasing Manager Index



Source: Bloomberg, based on quarterly data from 1Q 2017 to 4Q 2020

In summary, we expect the USD to continue its secular bearish trend over the intermediate time horizon. We expect the widening growth gap, fiscal and external balance differential, and the post-pandemic economic recovery of manufacturing and tourism activities to be much more beneficial to the Asian economies, leading to appreciation of Asian currencies vs. the USD and other developed market currencies.

Summary

In this paper, we highlight the historical attractive risk return profile of Asian bonds and discuss some reasons that we believe may lead to continued strong performance and lower volatilities than other emerging market or global bond sectors. Asian bonds benefit from strong fundamentals, attractive valuation, structural advantages, favourable currency environment, and an expanding opportunity set. For investors who favour high-quality sovereign bonds and share our positive outlook on Asian FX, Asian local currency bonds offer both a compelling alternative to developed market sovereigns and an attractive complement to credit and other emerging market bond sectors. As the share and importance of Asian economies and capital markets continue to rise in the coming years, Asian local currency bonds may be a segment of the fixed income market that still has the potential to deliver attractive returns in the low yielding environment today.

Investing with Schroders in Asian local currency bonds

1. Our history and capabilities

Schroders is one of the earliest investors in Asia fixed income with more than 20 years of investment experience. In 1998 we launched our Pan-Asian Bond Fund to invest in Asian credits after the Asian financial crisis. As the Asian local markets grew, we launched our SISF Asian Local Currency Bond Fund in 2008 to tap into the increasingly attractive investment opportunities across Asia. Over the years as China gradually opened up its capital markets, we launched the CNH-denominated offshore RMB Bond Fund in 2010 followed by the CNY-denominated Schroders Onshore China Fixed Income Fund in 2014. As the Chinese bond market continued to develop, in 2017 we repurposed the RMB Bond Fund to our current flagship SISF China Local Currency Bond Fund. We have also launched various Asian income and credit focused strategies over the years to capture investment opportunities in this expanding and exciting market space.

Schroders has one of the most well-resourced Asian fixed income teams in the region with 30 individuals based in key financial areas of Singapore, Hong Kong, Shanghai, Jakarta and Taipei. As at 30 September 2020, the team is responsible for managing over US$12.4 billion in AUM across dedicated Pan Asian and single country strategies. We have committed significant investments and resources to Asian and Chinese fixed income, as the region is a strategic growth area for the firm. We have built a deep bench of portfolio managers and research analysts with expertise across rates, currencies, and credits. Our long and successful track record throughout various credit cycles and crisis markets also demonstrate our strong capabilities in Asia.

2. Our product offering

We offer a Luxemburg-based fund for clients who wish to access the Asian local currency fixed income market. The SISF Asian Local Currency Bond Fund is a benchmark relative Asian rates and FX strategy that aims to capture attractive yields and mispricing opportunities primarily from the Asian local sovereign markets. The following table provides some key statistics of the fund:

	SISF Asian Local Currency Bond Fund
Primary investments	Asian local currency sovereigns
Benchmark	Markit iBoxx Asian Local Bond Index
Inception	May 2008
Yield	3.2%
Duration	7.8 years
Average Credit Rating	A-
Fund Size	USD 411MM
Morningstar Rating	4 Stars
1 Yr Return / Peer Rank	11.0% / 1st quartile
3 Yr Return / Peer Rank	5.8% / 1st quartile
5 Yr Return / Peer Rank	6.2% / 1st quartile
10 Yr Return / Peer Rank	3.4% / 1st quartile

Source: Schroders, Morningstar, based on A Acc share class net returns annualized, as at 31 December 2020

Appendix A

Indices used in the analysis in Charts 1-3:

Asia FX	J.P. Morgan ELMI Plus Asia
Asia Local Bonds	J.P. Morgan JADE Broad unhedged USD
Asia USD Credit	J.P. Morgan JACI Composite
Asia USD HY	J.P. Morgan JACI Non-Investment Grade
Asia USD IG	J.P. Morgan JACI Investment Grade
Asia USD Sovereign	J.P. Morgan EMBI Global Diversified Asia
China Govt	Bloomberg Barclays China Treasury Unhedged USD
EM FX	J.P. Morgan ELMI Plus Composite
EM Local Bonds	J.P. Morgan GBI-EM Global Diversified Unhedged USD
EM USD Corp	J.P. Morgan Corporate EMBI Broad Diversified
EM USD Sovereign	J.P. Morgan EMBI Global Diversified
Euro HY	Bloomberg Barclays Pan-European High Yield Unhedged USD
Euro IG Corp	Bloomberg Barclays Euro Aggregate Corporate Unhedged USD
T Bills	ICE BofA US Treasury Bill Index
US HY	Bloomberg Barclays US Corporate High Yield
US IG	Bloomberg Barclays US Corporate
UST	Bloomberg Barclays US Treasury

Risk considerations

The capital is not guaranteed.

In order to access restricted markets, the fund may invest in structured products. Should the counterparty default, the value of these structured products may be nil.

Non-investment grade securities will generally pay higher yields than more highly rated securities but will be subject to greater market, credit and default risk.

A security issuer may not be able to meet its obligations to make timely payments of interest and principal. This will affect the credit rating of those securities.

Investments in money market instruments and deposits with financial institutions may be subject to price fluctuation or default by the issuer. Some of the amounts deposited may not be returned to the fund.

Currency derivative instruments are subject to the default risk of the counterparty. The unrealised gain and some of the desired market exposure may be lost.

Investments denominated in a currency other than that of the share-class may not be hedged. The market movements between those currencies will impact the share-class.

Investment in bonds and other debt instruments including related derivatives is subject to interest rate risk. The value of the fund may go down if interest rate rise and vice versa.

Emerging markets will generally be subject to greater political, legal, counterparty and operational risk.

Emerging equity markets may be more volatile than equity markets of well established economies. Investments into foreign currencies entail exchange risks.

The fund may hold indirect short exposure in anticipation of a decline of prices of these exposures or increase of interest rate.

The fund may be leveraged, which may increase its volatility. The fund enters into financial derivative transactions. If the counterparty were to default, the unrealised profit on the transaction and the market exposure may be lost.

Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.

Definition of Firm

The Firm is defined as all accounts managed by Schroder Investment Management in the US, UK, Switzerland, Singapore, Hong Kong, Japan and Australia by wholly owned subsidiaries of Schroders PLC. Accounts managed by Schroders Adveq are excluded, Schroders Adveq claims compliance separately. Assets managed against a liability driven mandate or invested in direct property are excluded from the GIPS Firm. Advisory portfolios signed to Schroders Investment Management Hong Kong (SIMHK) are also excluded from the GIPS Firm.

Firm Merger

On 1 January 2017 the Schroders Investment Management GIPS Firm ('the Firm") was formed following the merger of independent regional Schroders Investment Management (SIM) GIPS Firms defined based predominantly on location of the investment desk and held out to clients or prospective clients as the following distinct firms: combined London/New York/Zurich (SIMUK/US & SIMSAG respectively), Singapore (SIMSL), Hong Kong (SIMHK), Australia (SIMAL) and Japan (SIMJP). These Firms were merged as a result of the increasingly global nature of the business, details of previous firm mergers are available upon request.

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