Asia Insight

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Why Invest in Asia Bonds?

With 10-year U.S. government bonds hovering at approximately 2%, it's no wonder that yields are among the concerns that consistently emerge as we speak with investors. The other concerns they cite are worries over inflation and volatility. Given these issues, we believe that one attractive solution to consider is diversification into Asia's bonds.

Consider for a moment that the total return of a U.S. Treasury Bond to a U.S. investor comes primarily from the coupon and a rise or fall in interest rates. International bonds, on the other hand, are driven not just by yield, but by three distinct return drivers: credit, currency and interest rates. If we consider each of these three primary drivers of returns, we can see why the total return potential for Asia bonds might be comparatively attractive.

Credit

Asia's fixed income markets are attractive from both a fundamental and valuation perspective. The growth of Asia's bond markets is one of the region's most important and remarkable economic developments of the last decade. This growth has been fueled by a combination of domestic wealth generation and foreign investment. In addition to enhanced credit quality, Asia's bond markets have also experienced improvements in liquidity, transparency and diversification.

Following significant structural economic reforms that have taken place in the past decade, the sovereign credit ratings of many Asian countries, especially emerging Asian countries within the Association of Southeast Asian Nations (ASEAN), are generally improving. For example, in December, Fitch Ratings upgraded Indonesia's sovereign credit rating to investment grade for the first time in more than a decade. The country's rise as an important emerging market continued when it won its second credit rating upgrade from Moody's Investors Service, which returned the country to investment grade in January. It is also worth noting that overall, debt-to-GDP is lower for Asia ex-Japan than it is for the United States. Using just about any measure of credit, Asia ex-Japan stacks up favorably, considering the current global environment.

This is not to say that Asia's bond markets are risk-free. In fact, even as Indonesia rises it still struggles with many issues, including corporate governance, a lack of infrastructure, and a relatively nascent democracy. If one defines risk as price volatility, Asia's bonds are riskier than those of their U.S. counterparts as they tend to have higher historical price volatility. And since Asia's bonds are also relatively less liquid than their U.S. counterparts, investors should be compensated for this. These risks arguably warrant a higher risk premium to foreign investors, but may also indicate higher potential yield.

Currencies

The second primary driver of returns stems from the potential for currency appreciation. The region has two distinct bond markets—local currency and U.S. dollar bonds. The local currency bond market, as proxied by the HSBC Asia Local Bond Index, is about US$1.24 trillion (larger than the U.S. high yield bond market) and offers currency diversification. The U.S. dollar bond market in Asia is about US$295 billion, and offers attractive yields over their U.S. counterparts. These two markets together provide compelling investment opportunities across credit, currencies and interest rates. As U.S. dollar-based investors, we benefit from the appreciation of a foreign currency relative to the U.S. dollar when we buy a bond that is denominated in that foreign currency. While the valuation of currencies can be a difficult exercise over a short horizon, we believe that over the long run there is a strong structural argument for the appreciation of many Asian currencies relative to the U.S. dollar.

Interest Rates

Besides currency and credit, our third primary driver is interest rates. While most economies are affected by global supply-demand factors such as aggregate growth and oil prices, they are also subject to local factors such as employment, monetary policy, and fiscal spending that make each economy unique. As such, countries' economic cycles are not synchronous and being exposed to different interest rate cycles can provide a source of diversification and return. For a few of the emerging Asian economies like the Philippines and Indonesia, in

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addition to diversification, one might also participate in price appreciation from the long term structural fall in their interest rates. The argument could be made that we "missed the boat" since interest rates have fallen from above 15% a decade ago to the current 6% level for both countries. But this might just be the fifth inning of a multi-decade fall in interest rates in such emerging nations. During the mid-1990s, some predicted the end of the U.S. bond bull market (when U.S. interest rates were at 6%), and likewise, it might be too early now to say the same for countries like Indonesia and the Philippines. This is especially the case if political stability continues, and inflation stays range-bound in these countries.

Considering Inflation

Even when inflation might not be an imminent risk, it is a long-term concern for investors. Economic theory predicts (and much empirical research shows) that an increase in the growth rate of the money supply ultimately leads to an increase in the inflation rate. Some economists point to the rounds of quantitative easing carried out by the U.S. Federal Reserve as necessary to accelerate growth, but they are risky as they could stoke inflation.

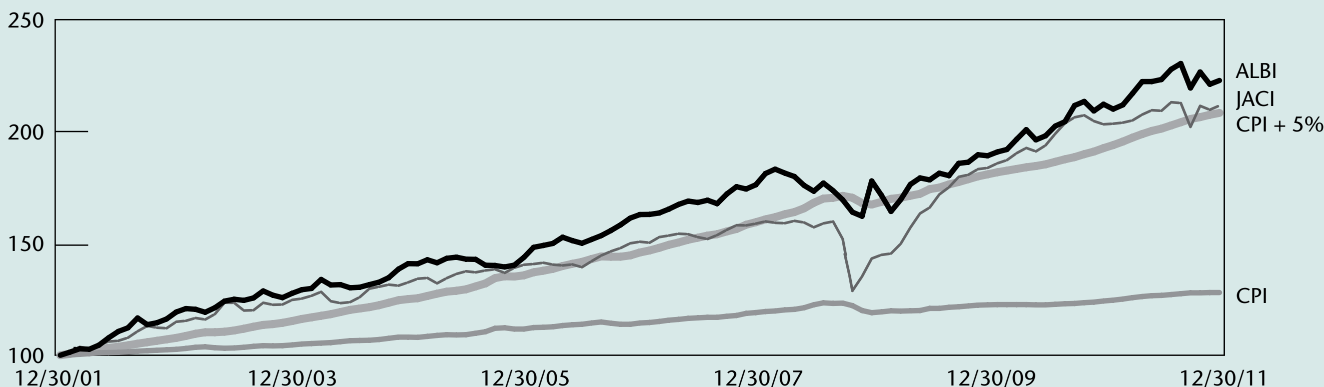
Historically, Asia bonds have provided a rate of return higher than that of U.S. inflation. Investors who had held portfolios that included bonds by Asia issuers—that were either U.S. dollar-denominated or Asian currency-denominated—would have beaten the U.S. consumer price index by more than 5% over the last decade.

Holding a portfolio of bonds that are denominated in Asian currencies not only makes sense from a return perspective, but might also make sense from an asset-liability framework. If one were to think of investments as a way to generate income to cover expenses over the long term, having a proportion of income denominated in the same currency as future expenses might act as a currency hedge. Given that Asia accounts for an increasingly larger portion of U.S. imports, having an income stream derived from underlying instruments denominated in Asian currencies might be prudent.

Perspectives on Volatility

Finally, many investors have reeled from the volatility created by the recent global financial crisis. And prompted by spending needs or just risk aversion, many redeemed their investments. Over the last decade, Asia bonds have had volatility of approximately 6% to 7%, roughly double that of U.S. fixed income. Relative to the U.S. fixed income market, Asia bonds present a higher volatility asset class. However, Asia bonds have only about half the volatility of U.S. equities and about one-third the volatility of Asia ex-Japan equities, making it one of the least volatile international asset classes. Another benefit is diversification.

HISTORICAL RETURNS OF ASIA BONDS (AS REPRESENTED BY INDEX RETURNS) VERSUS THE U.S. CONSUMER PRICE INDEX



The HSBC Asian Local Bond Index (ALBI) tracks the total return performance of a bond portfolio consisting of local-currency denominated, high quality and liquid bonds in Asia ex-Japan. The ALBI includes bonds from the following countries: Korea, Hong Kong, India, Singapore, Taiwan, Malaysia, Thailand, Philippines, Indonesia and China.

The J.P. Morgan Asia Credit Index (JACI) tracks the total return performance of the Asia fixed-rate dollar bond market. JACI is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and is partitioned by country, sector and credit rating. JACI includes bonds from the following countries: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Thailand and Singapore.

The Consumer Price Index is the U.S. CPI Urban Consumers Month-on-Month Index.

Past performance is not indicative of future results. It is not possible to directly invest in an index and performance shown is not representative of any particular investment. As with any investment there is always potential for gains as well as the possibility of losses.

Sources: Bureau of Labor Statistics, HSBC Asian Local Bond Index and JP Morgan Asia Credit Index

"The diversification benefits of Asia bonds include higher return, a hedge against inflation and lower volatility…"

ASIA BOND CAN ADD DIVERSIFICATION AND RETURN (2002–2011)

Asset Class	Index	Annual Return	Volatility	Sharpe Ratio	ALBI	JACI	US Aggregate	Global Aggregate	EMBI Global Diversified	BAML High Yield	S&P 500	MSCI AC ex Japan
Asia Bonds (Local)	ALBI	8.3%	6.5%	1.28	1							
Asia Bonds (USD)	JACI	8.0%	7.3%	1.10	0.55	1						
U.S. Fixed Income	US Aggregate	6.1%	3.7%	1.62	0.42	0.66	1					
Global Fixed Income	Global Aggregate	6.8%	6.2%	1.08	0.67	0.59	0.72	1				
EM Bonds	EMBI Global Diversified	10.3%	9.1%	1.14	0.57	0.86	0.53	0.51	1			
U.S. High Yield	BAML High Yield	7.8%	11.1%	0.70	0.46	0.63	0.19	0.27	0.74	1		
U.S. Equities	S&P 500	-1.4%	16.1%	-0.09	0.41	0.35	-0.09	0.15	0.53	0.67	1	
Asia ex Japan Equities	MSCI AC ex Japan	7.1%	23.8%	0.30	0.53	0.47	-0.01	0.23	0.58	0.69	0.78	1

Source: Bloomberg

Diversification does not ensure a profit or guarantee against a loss.

The Sharpe ratio is a risk-adjusted measure calculated by using standard deviation and excess return to determine reward per unit of risk.

Volatility is the standard deviation of returns. All data covers 10-year period from 2002-2011.

Because Asia bonds are not perfectly correlated to those of other major asset classes, they provide some diversification benefit. The chart above shows that Asia bonds have a correlation coefficient of 0.3 to 0.8 to major asset classes—the lower the correlation, the higher the diversification benefit.

While we believe the diversification benefits of Asia bonds include higher return, a hedge against inflation and lower volatility, investors should maintain long investment horizons of five years or longer to fully reap the benefits. Just as credit, currency, and interest rates might generate higher return, they also have the potential to generate higher volatility. In light of this, we believe the most effective method of managing volatility is to have a long-term investment horizon that enables one to have the staying power to ride through credit or interest rate cycles, and minimize short-term fluctuations.

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The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The U.S. Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt. The U.S. Aggregate Index was created in 1986, with index history backfilled to January 1, 1976. It is not possible to invest directly in an index.

The Global Aggregate Index (GAI) provides a broad-based measure of the global investment grade fixed-rate debt markets. The GAI contains three major components: The U.S. Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. In addition to securities from these three benchmarks (94% of the overall Global Aggregate market value as of December 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar, Euro-Yen, Canadian and Investment Grade 144A index-eligible securities not already in the three regional aggregate indices. It is not possible to invest directly in an index.

The J.P. Morgan EMBI Global Diversified is a uniquely weighted index that tracks total returns for U.S. dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities. It is not possible to invest directly in an index.

The Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. It is not possible to invest directly in an index.

The S&P 500 Index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. It is not possible to invest directly in an index.

The MSCI All Country Asia ex Japan Index is a free float–adjusted market capitalization–weighted index of the stock markets of China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand. It is not possible to invest directly in an index.

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