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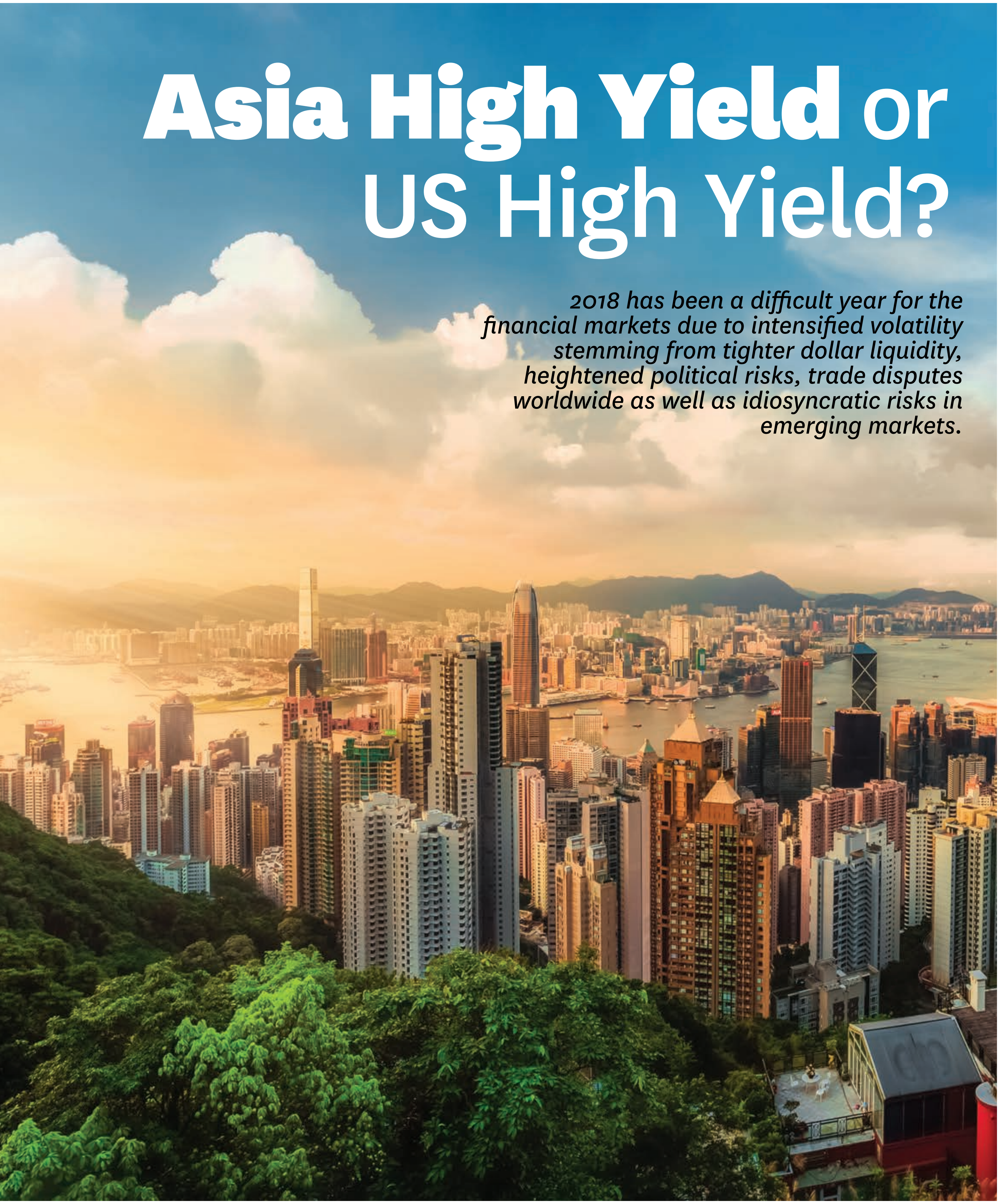
Asia High Yield or US High Yield?

2018 has been a difficult year for the financial markets due to intensified volatility stemming from tighter dollar liquidity, heightened political risks, trade disputes worldwide as well as idiosyncratic risks in emerging markets.



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SINGALLIANCE

ALL MAJOR ASSET CLASSES, from equities to fixed income to commodities, registered negative returns during the year, testing the effectiveness of the diversification argument extolled by the modern portfolio theory. Interestingly, within fixed income, the correlation between its two sub-asset classes, Asia High Yield ("HY") and US High Yield, remained low at 0.25 throughout 2018, after peaking in 2017.

Rolling one-year correlation between Asia high yield and US high yield bonds

A closer inspection of the correlation between Asia and US High Yield shows that it dropped sharply in November 2017 from 0.55 to 0.3, which begs the question: why such a sharp drop? Taking into consideration that this 0.3 is calculated using a rolling window of one-year data from November 2016 to November 2017, it reflects the market's expectations of a tightening cycle by the Federal Reserve in the US. In fact, the upper bound of the Fed Fund Target Rate has risen by 25bps every quarter since December 2016 (except from 3Q17) from 0.5% to its current 2.5%. The repercussions of a tightening Fed have taken their toll on global liquidity, leading to an economic slowdown worldwide as well as a flattening of the US yield curve as the market priced in potential policy mistakes. Contrast this with China, which represents 56% of Asia high yield bonds: it is still on an easing path, with the required reserve ratio for major banks decreasing gradually from 17% to 14.5% after the latest rate cut in January. With double-digit interest rates, there is still ample room for further easing measures, albeit with caution. Furthermore, China has signaled several other stimulus packages, including tax cuts and more infrastructure spending, to bolster economic growth in the face of challenges from the trade tensions with the US. The spillover of these positive effects to the rest of Asia is evident due to close ties of their economies to China.

Aside from the divergence in the monetary policy between the two regions, valuations of Asia HY are cheaper than US HY after the correction last year, demonstrated by an option-adjusted spread over US HY of 130bps; furthermore, the yield to worst for Asia HY at 8.32% is better than US HY at 7.15% and the modified duration of 2.98 is much shorter than 4.16 of US HY. This is evidenced by their performance since January 2015 as depicted in the graph above: while annualized return for Asia HY is marginally higher at 3.71% vs. 3.56% for US HY, the volatility is noticeably lower at 2.99% for Asia HY vs.3.89% for US HY. It's worth noting that Asia HY, often considered as a sub-sector of emerging market bonds, is severely under-represented in global bond indices, especially when taking into consideration the total size of the economy these countries collectively represent. Take Bloomberg Barclays Global Aggregate Total Return Index as an example: Asian HY (with country definition according to the United Nations, which includes Turkey and Middle East) stands for less than 4.5% of the index, whereas the collective GDP accounts for more than a third of the world's economy, with China alone contributing over 15%. Not only does Asia form the largest portion of the global economy, Asian economies, according to the IMF, are estimated to grow at a rate of 6.5% in 2019, outpacing that of advanced economies (1.8%) and the world (3.7%).

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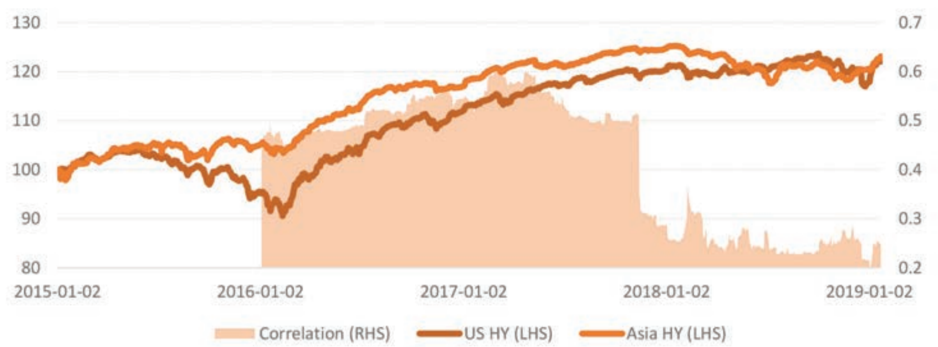
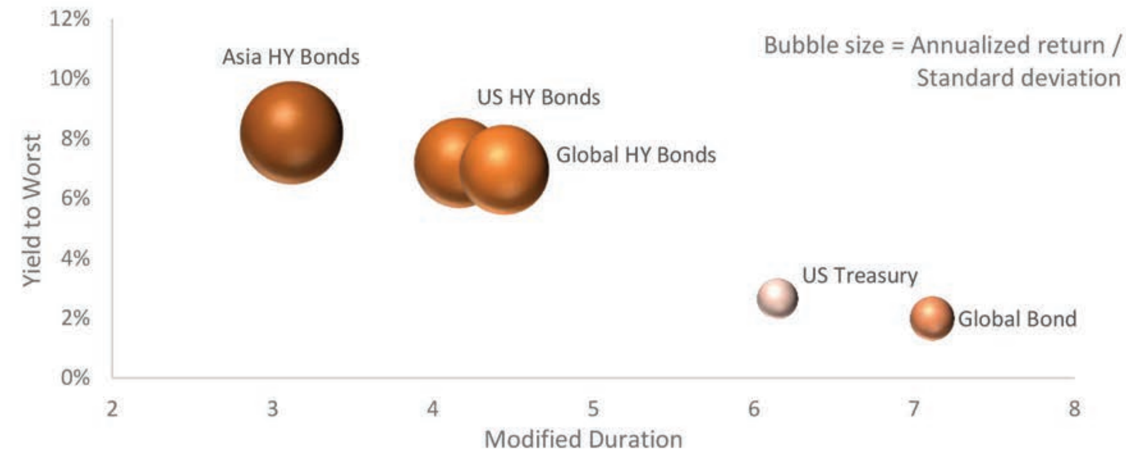


Source: Bloomberg
Data for Asia high yield bonds is proxied by Bloomberg Barclays Asia USD High Yield Total Return Index and US high yield bonds by Bloomberg Barclays US Corporate High Yield Total Return Index. Data range from January 2015 to January 2019.
RHS means right-hand side and LHS left-hand side.



Source: Bloomberg
Data for Asia high yield bonds is proxied by Bloomberg Barclays Asia USD High Yield Total Return Index, US high yield bonds by Bloomberg Barclays US Corporate High Yield Total Return Index, Global high yield bonds by Bloomberg Barclays Global High Yield Total Return Index, Global bonds by Bloomberg Barclays Global Aggregate Total Return Index and US Treasury by Bloomberg Barclays U.S. Treasury Total Return Index. Data range from January 2015 to January 2019.

Yield to Worst vs. Modified Duration vs. Risk Rewards

Of course, it's not all rosy for Asia HY. In its latest report, Moody's expects the credit quality of Asia HY issuers to deteriorate in 2019 due to weaker liquidity positions amid tighter credit conditions, evidenced by rising funding costs: average coupon is expected to rise to 8.4% vs. 6.6% in 2017 and the average maturity to fall to 3.1 years vs. 4.6 years in 2017. However, the overall refinancing risks will remain manageable, in the absence of any exogenous shock, with the expected issue volume to decline by 30% from a high base in 2017. Nonetheless, default rate for Asian HY issuers remains moderate at 2.8%, considerably lower than 4.2% for US HY issuers. The fundamentals for Asian corporates remain stable with balance sheets ~30% less leveraged than their peers in the US.

Whilst it is notoriously difficult to predict the direction of global asset markets, what we know for 2019 is volatility is likely to stay elevated. Diversification is key in a mature cycle and an uncertain market. With relatively attractive valuations, decent yield with short duration, low correlation to other asset classes and a growing economy brought forth by more accommodating monetary policy, Asia HY will likely be a bright star in 2019. ■