Generating Alpha in the Expanding Universe of Asian Fixed Income

Dhiraj Bajaj, Head of Asian fixed income at Lombard Odier considers Asian credit as a new asset class within the global fixed income market. He explained to delegates at the Hubbis Independent Wealth Management Forum how selectivity is essential and why adopting the correct, long-term strategies are essential to achieve the appropriate balance between risk and reward.

BAJAJ OPENED THE PROCEEDINGS WITH AN INTRODUCTION TO SWISS PRIVATE BANK LOMBARD ODIER, and its asset management business. "As at 30 June 2019, total client assets for the Group stood at CHF287 billion, and assets under management for Lombard Odier Investment Managers represents about CHF50 billion of that. The asset management business is a full-service offering, covering fixed income, convertibles, equities, multi-asset and alternatives. Our mission today is to look at the universe of Asia credit, which has grown exponentially - just over a decade ago Asia credit was little over USD250 billion in size, while today it stands at USD1.3 trillion."

He highlighted how, within the credit markets, there are a few key trends. Asia's growth has been steady fast, rising at more than 5% - 5.5% on autopilot a year, with inflation of only 3% and a relatively stable sovereign economic picture of the major countries, for example China, India, Korea, Indonesia, all of which are proper investment grade.

Asia rising

"But if you look at other emerging markets that were actually bigger than Asian credit 10 to 15 years back, for example, Latin America, Russia, Turkey, and others, these markets have now

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actually stopped growing, or have witnessed sovereign downgrades. Meanwhile, not only have the markets grown dramatically in Asia, but the quality has also remained quite constant or improved. And there is greater diversification, more issuers."

On the demand side, he continued, the external vulnerability has significantly reduced in Asia. For example, China is a net creditor to the world, which means that the bulk of the stock of debt in China is owned by the Chinese themselves. And the savings rate in North Asia is extremely high, while demographics are shifting towards older people, especially in North Asia, with a median age in China now being 41.

Domestic investment booming

"The result of all these factors coming together," Bajaj reported, "is that we now have a lot more money in Asia than we actually envisaged in the past, as more and more Asians are now buying Asian debt more than ever before and displacing the foreigners. Ten years ago, if we look at new supply in the market, Asians were buying less than 50% of the debt; in a much bigger market today they are more than 80% of the market. All in all, we now have a picture of supply which is a far, far bigger market, greater diversity and a picture of demand which is very healthy from a structural perspective. And all that means the external vulnerability for Asian debt markets to have a systemic crisis is very low."

He then reviewed the global economic and financial trends of recent decades, concluding that the structural trend shows clearly that growth has already been low for the last 10 years, and will continue to stay low and with that, inflation is also going to stay low.

"QE in the last 10 years has allowed us to prolong this cycle, but now it can't sustain the cycle any longer," Bajaj reported. "The 30-year Treasury yield at 2.25% tells us clearly that the market expectation for long term inflation is very low. So, we believe the fixed income market structure will change, in an unprecedented manner, and we are going to see negative interest rates and negative term premium in the US persist for much longer."

The result is the ongoing flight to safety in global fixed income markets this year, including a huge shift in capital from EM equities to EM debt in 2019, with floods of money chasing investment-grade (IG) and global high-grade debt. "Meanwhile, we have seen a widening of corporate spreads at the lower rating levels."

Asia high yield relatively undervalued

The net result is that Bajaj and colleagues believe that

the IG market is going to be well anchored in the years to come. "Meanwhile," he noted, "from a valuation perspective, we see Asia high yield having underperformed other emerging markets, as well as the US high yield market, opening the door to opportunity."

He pointed to the valuation of Asia high yield of BB rating at roughly 100 basis points wider than Lat-Am, and B rated paper wider by about 265 basis points. "Against US high yield, BB in Asia is wider by 167bp and B grade paper wider by 300 or more basis points. This is a great opportunity, and if we also factor in the reducing supply of high yield paper in Asia, the story is even more compelling."

The strategy Lombard Odier's team propose is, therefore, to use any backup in US treasury yields and Asia EM IG spreads to increase allocations to fixed income. "We are very much focussed on long-dated paper investment grade in US Dollars, and we would like to capture these allocations with high yield, opportunistically," he reported. "And that is what we are doing through the flagship fund we manage in Asia, our Asia Value Bond Fund, which is about two billion dollars in size now and has averaged 6.8% in net returns over the last seven years."

Extend and focus

Bajaj then delved into considerably more detail, maintaining that investors should focus on extending duration within the Dollar credit spectrum. "We could very easily be in a scenario where five-year treasury yields are less than 1% in one to three years from today, with 10-year treasury yields back towards below 1.5%. That is why we are buying higher quality, longer-dated credit duration papers, basically 10-year, 20-year, 30-year papers, where you are getting to 3.5% to 4%, or even 4.5%."

Asia Value Bond – the doorway to return

He offered more detail on their Asia Value Bond Fund, which he reported today (October 22nd, 2019) offered a yield of 5.8% versus the index, which was less than 4%. "The duration is significantly longer than the index," he added, "and from a country allocation perspective we are quite balanced in terms of exposure to the top three countries in Asia, including China, India and Indonesia, but we also have some other markets in investment-grade where we think the investment-grade spreads are relatively cheap, like the Middle East and others."

He concluded by stating that the fund and allocations accordingly ideally reflect their global macro view. "We are therefore urging investors to shift their portfolios to high-end quality and with interest rate duration exposure, and credit spreads exposure that all come with long-dated bonds, as high-quality credit should benefit optimally in the disinflationary environment ahead."

The fascinating presentation ended with a lively Q&A session with the delegates, who left with a clear impression of Lombard Odier's views on the world of fixed income and of the potential they must grasp those opportunities through the firm's Asia Value Bond Fund. ■