Manulife Asset Management

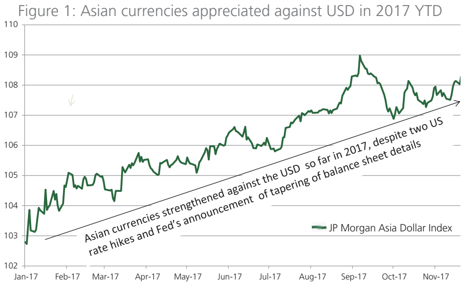
2018 Q1

2018 Outlook: Asian Bonds

Endre Pedersen
Chief Investment Officer, Fixed Income, Asia (ex-Japan)

Despite the US Fed continuing to normalize monetary policy, the flattening of the US yield curve contributed to a weaker US dollar which helped Asian currencies perform strongly in 2017 (Figure 1). In contrast, for 2018, we expect US rate normalization to proceed at a faster pace that should see Treasury yields gradually move higher combined with a stronger US dollar.

Figure 1: Asian currencies appreciated against USD in 2017 YTD



Source : Bloomberg, 22 November 2017

In particular, we see three macro trends shaping Asian fixed income markets in 2018:

Recovering global growth and stable inflation:

- As global growth continues to pick-up, Asian economies are benefitting from a recovery in exports, which in turn helps boost domestic demand. Continued growth will likely maintain investors' positioning in Asian markets.
- In Asia, inflation remains below trend in most countries giving central banks the option to keep interest rates on hold or even cut rates further in some cases. A stable inflation environment is supportive for Asian bonds.

Government policies and reforms:

China's government is expected to continue with deleveraging policies in 2018 while growth is targeted to be maintained at a reasonable level. The deleveraging process should help the Chinese state-owned enterprises (SOE) sector in particular and reduce overall financial risks for investors. India is also proceeding with reforms including the recapitalization of its banking sector to support its economy.

Credit environment:

Investors have been encouraged by the tentative progress made with China deleveraging and the associated improvement to credit fundamentals. Asian corporate credit profiles are also seeing some improvement. As reference, Moody's forecast 2017 default rate for Asian non-financial high-yield corporates at 2.9%, which is lower than their US peers[1].

Our position going into 2018

We believe these factors will offer opportunities to add value to the Asian Total Return Bond Strategy in the following areas:

01 Interest rates

%

We continue to favor the higher-yielding bond markets of India and Indonesia that offer attractive coupon yield. We also see value in Australian government bonds which offer an attractive yield compared to US Treasuries.

02 Credit

While Asian credit spreads have tightened significantly, we believe credit will still be attractive in terms of income potential. We are seeing better value, on a risk-adjusted basis, in selective high-yield corporates compared with investment grade due to their shorter-duration. The Chinese SOE sector is also appealing with the government expected to pursue further deleveraging policies.

03 Currency

$

We have positioned for a potentially stronger US dollar in 2018. While we expect the Indonesian rupiah to be broadly stable, supported by its strong foreign exchange reserves, we have reduced our exposure to the Indian rupee due to the emergence of some headwinds to the Indian economy.

Conclusion:

In 2018, an improving global economy and policy reforms, led by China deleveraging, are expected to dominate opportunities in Asian fixed income. These factors bode well for Asian bond fundamentals, and we will look to leverage these opportunities thoughtfully to deliver consistent returns for investors.

[1] Moody's Investors Service, 11 August 2017: forecast year-end 2017 default rate for Asia non-financial high-yield to be 2.9% (lower than the forecast 2017 US high-yield default rate of 3.2%).