Manulife Investment Management

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Investment Note

Neal Capecci
Portfolio Manager

Rising uncertainty related to the ongoing US-China trade war has sparked a rush into developed government bonds as investors sought refuge from the ensuing market volatility, which sent yields for the asset class further into negative territory[1]. Does this suggest that traditional safe havens and negative-yielding assets are the only places where investors can find shelter? Neal Capecci, our portfolio manager who specialises in pan-Asian bonds, takes a closer look.

The importance of positive yield: why Asian fixed income makes sense in the face of rising uncertainty

Staying positive

Call it the calm before the storm. As recently as 31 July, markets had been expecting the US-China trade war to progress in a constructive manner. But everything changed a day later, when the Trump administration said it would impose fresh tariffs on Chinese imports from September. Things rapidly took a turn for the worse. In the days that followed, the Chinese renminbi (RMB) fell below a psychologically important level, the US Treasury declared China a currency manipulator, and China responded by hiking tariffs on US$75 billion of US products. One thing's clear: The potential for a near-term agreement between both countries is now greatly reduced.

Unsurprisingly, uncertainty spiked and markets got whipsawed—stocks plunged and bond yields took a significant leg down as the risk-off mentality took hold. By mid-August, global negative-yielding debt crossed the US$15 trillion mark (Chart 1).[1] Suddenly, the US Federal Reserve's (Fed's) 25 basis points (bps) interest-rate cut on 31 July appeared modest relative to market pricing.

Central bank action and stimulus hopes

There can be little doubt that we're firmly back in the "lower for longer" environment. The Fed had already trimmed rates in July—before the latest trade row erupted—and we expect G10 central banks to maintain an easing bias for the foreseeable future. Central banks in Asia have also been cutting rates—the second week of August was particularly memorable as four central banks announced significant rate cuts within a day of each other. We believe there'll be more rate cuts to come because the region's policy makers aren't constrained by inflation, which remains benign. Importantly, they have more room to maneuver since interest rates in many emerging Asian economies remain relatively high. These policy actions, in our view, will be supportive of the asset class, particularly high-quality local currency bonds.

The prospect of government stimulus as a response to the expected economic downturn is also likely to provide further support for risk assets. In fact, we've already seen some developments on this front: Thailand recently unveiled plans for a US$10 billion package, while Indonesia's latest budget shows that the government is seeking to boost fiscal spending significantly to counter slowing growth. Separately, there's also growing speculation that the Singapore government could introduce a stimulus program should things take a turn for the worse. To top it off, China, which has already implemented numerous measures to support its economy since the trade war started, could also announce further initiatives.

[1] Bloomberg, as of 7 August, 2019.

While the expected wave of central bank action and government stimulus might provide some support to the global economy, how the US-China trade war will unfold and the specific ways in which it'll hurt growth remains anyone's guess. One question that investors are grappling with is whether the RMB will weaken substantially as the trade dispute escalates and what that could mean for regional economies in Asia. This is why markets were unnerved by the Chinese authorities' decision to allow the RMB to weaken below the seven-to-one US dollar level on 5 August.

Currency risks—it's complicated

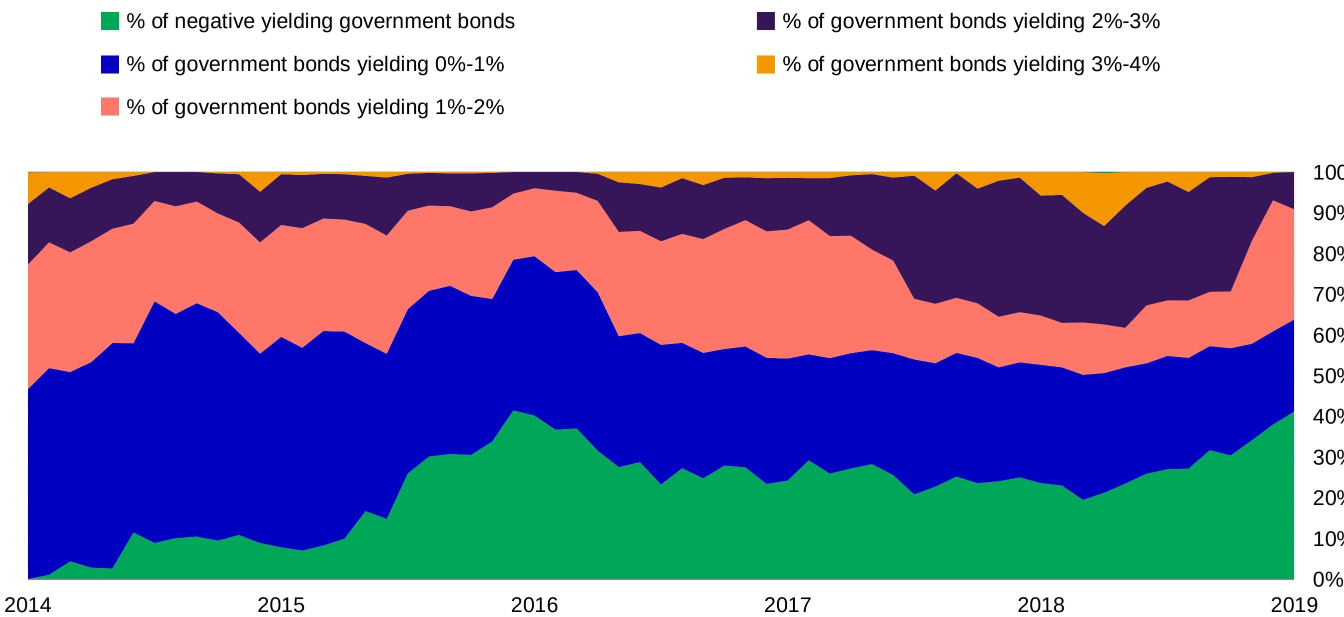
Without a doubt, this is an issue that we, as investors in Asia, are following very closely. However, it's important to note that the People's Bank of China has kept the RMB-US dollar exchange rate relatively stable since then, and we expect it to continue doing so. A disruptive depreciation of the currency isn't likely because an overly aggressive weakening could lead to capital outflows and undo a lot of the good work that China has done to modernise its economy. Amid the current geopolitical uncertainty, we believe it makes sense to have a balanced approach to currencies at this juncture and favour neither US dollar-denominated issues or local currency bonds.

The pursuit of meaningful, positive returns

In our view, the appeal of Asian fixed-income remains undimmed despite the fragile global environment. Our conviction can be traced back to the region's strong economic fundamentals and a key characteristic of the asset class—its ability to offer diversification benefits in a global portfolio. Crucially, Asian bonds continue to offer positive yields, a factor that's highly significant as developed- market government bonds move further into negative territory. The combination of increasingly accommodative monetary policy and the promise of additional stimulus should also create a highly supportive backdrop for the asset class. The global macroeconomic environment may be fragile, but it doesn't mean that the pursuit of meaningful, positive returns needs to come to an end. Rather, we believe it's even more important to stay positive.

Chart 1: Global government bond yields: share of negative-yielding government bonds rises

Bond yields as a % of the ICE BofaML Global Government Index



Source: Bloomberg, as of 15 August, 2019.

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Manulife Investment Management

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