Investing in Asian corporate bonds

An asset class with tactical advantages.

GRACE HUANG
Analyst and portfolio manager with the corporate bonds team of CDP Capital World Markets.

Asian high-grade U.S. dollar corporate bonds represent a good tactical asset class to add excess return and reduce risks for North American institutional investors.

Aggregate credit fundamentals in the Asian high-grade corporate sector are stable and improving, and the imbalance between the supply of and demand for credit constitutes constructive technical support. The imperfect correlation of returns with those of Asia's U.S. counterparts provides diversification benefits, while greater international investor involvement increases the "investibility" of the market for non-Asian investors.

The Outperformance

This asset class outperformed its U.S. counterparts rated in the BBB-to-A universe during the past six years on a cumulative total return basis, representing almost 200 basis points of annual excess returns. This outperformance was achieved despite the relative tight spreads of Asian corporate bonds, except for the crisis years of 1997 to 1998. As the volatility of Asian corporate bonds came down substantially after the crisis, their Sharpe ratios were higher than those of the U.S. counterparts from 1999 to 2002.

One key element behind this impressive performance is the positive credit cycle in East Asia after the 1997-98 financial crisis. The export-promotion development model and the close link between governments, businesses and financial institutions helped create the 1985-90 "Asian Boom," and planted the seeds for the 1997-98 crisis. This crisis was marked by overinvestment and overcapacity, high leverage in both the government and corporate sector, serious debt maturity and currency mismatch, a fragile banking system, and depressed domestic demand.

Key Credit Drivers

Since the crisis, East Asia has been trying hard to harmonize the conflicting policies of restructuring and stimulating economies, with some countries going through difficult reforms. Economic growth (with low inflation), corporate and banking restructuring, improvements in macroeconomic management, improvements in external liquidity positions, and political stability have been the key credit drivers of Asia's high-grade U.S.-dollar-denominated corporate bond market. Regional economic integration, a zero default rate in Asia's high grade corporate sector in the past three years, and corporate de-leveraging further underpin the defensive nature of the asset class. It was a "safe haven" amid the global market volatility caused by the 9/11 terrorist attacks, U.S. corporate scandals and failures, the U.S. economic slowdown and the troubles in Latin America during the past two years.

Another key element is strong technical support. Asia, including Japan, boasts the five largest foreign exchange reserves in the world. The continent also accounts for more than US$1.2 trillion in foreign exchange reserves (56% of global total), and high savings rates (which exceed 30% of gross domestic product), constiting a huge supply of foreign currency liquidity. This, together with the slow loan growth and loose macroeconomic policies, leads to the famous "Asian Bid." However, the Asian U.S. dollar corporate bond market is not a pure Asian play. While Asian investors tend to have a greater proportion of the pie in the secondary market, foreign investors have become prominent players in the primary issuance markets for the big and good names, commanding around 60% of the allocation.

In the long term, Asian economies need to reduce their reliance on exports, deepen and broaden their capital markets (especially a regional bond market), continue to clean up non-performing loans, continue to restructure the corporate sector, improve corporate governance, quicken the pace in institutional building, and focus on the quality rather than just the quantity of growth.

With the strong rally last year and firmer investor confidence in the U.S. corporate bond market, Asian high-grade U.S. dollar corporate bonds might underperform their U.S. counterparts this year. However, changing competitive dynamics and credit trends among countries, sectors and companies could create interesting cherry-picking opportunities. ■