Manulife Investment Management

2020 Outlook Series: Asian Fixed Income

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Asian fixed income delivered strong returns in 2019, with gains in both the investment-grade and high-yield credit segments. In this 2020 outlook, Endre Pedersen, Chief Investment Officer, Fixed Income (Asia ex-Japan) outlines the opportunities he sees in the interest rates, credits and currency segment of the Asian fixed income market.

A strong 2019 due to favourable macro factors

At the start of 2019, our annual outlook identified two key macro drivers for the asset class: 1) Federal Reserve monetary policy; 2) Sino-US trade negotiations.

1) **Federal Reserve policy:** US Treasury yields took a volatile ride in 2019, with 10-year yields at one point declining by more than 130 basis points, compared with the start of the year,[1] as the US Federal Reserve (the Fed) shifted from monetary tightening to easing. In Asia, we saw accommodative monetary policy that was in lockstep with the Fed. Investors' search for yield, coupled with an increasing amount of negative-yielding bonds in developed markets, boosted regional capital inflows.

2) **Sino-US trade relations:** See-saw Sino-US trade talks continued to impact investor sentiment and global growth prospects in 2019. We are carefully watching their progress into 2020, and believe this factor is likely to have less impact on high-quality Asian credits than equities. We believe that consumption-driven economies, such as Indonesia and India, should outperform export-reliant economies.

Overall, Asian fixed income posted strong gains in 2019 in this environment, with both the investment-grade and high-yield credit segments moving higher[2].

Continued robust fundamentals would drive outperformance amid uncertainty in 2020

Moving into 2020, we expect the fundamentals of Asia to remain intact. Asia is still forecast to have the fastest GDP growth of developed and emerging markets over the next few years, despite protracted global trade tensions[3]. Equally important, Asia is one of the few regions that still boast the capacity for monetary and fiscal stimulus. Interest rates in Asian markets are generally higher than developed markets, which provide room for further and effective monetary-policy easing before a handoff to fiscal policy.

Overall, we believe Asian Fixed Income will continue to be a relative beneficiary of a favourable macro backdrop in 2020; however, a sluggish global economy means that investors should pay increased attention to risk. We will outline the opportunities we see for Asian fixed income in three categories: 1) interest rates, 2) credits, and 3) currencies.

[1] US Department of the Treasury, as of 2 December 2019. 10-year Treasury yielded 2.79% on 18 Jan 2019 versus 1.47% on 28 August 2019.

[2] JACI investment grade posted a 10.73% gain, while JACI high-yield posted a 11.58% gain up to 6 December 2019.

[3] International Monetary Fund World Economic Outlook, October 2019: Projected annual real GDP growth for **Emerging and Developing Asia**: 2020 (6%), 2024 (6%); **Advanced Economies**: 2020 (1.7%), 2020 (1.6%); **Emerging and Developing Europe**: 2020 (2.5%) and 2024 (2.5%); **Latin America and the Caribbean**: 2020 (1.8%), 2024 (2.7%).

Interest rates: Continued global and regional monetary easing

We believe that the global monetary easing observed in 2019 may continue into 2020. The Fed's monetary policy is likely to head in a stable-to-easing direction, while US Treasury yields may stay at low levels against a benign monetary policy backdrop. In general, we have a long bias (compared with 2019) in terms of portfolio duration (sensitivity to interest rates) to capture the potential benefits from a further softening of Treasury yields.

Positive on local interest rate markets in China, Malaysia, and Indonesia

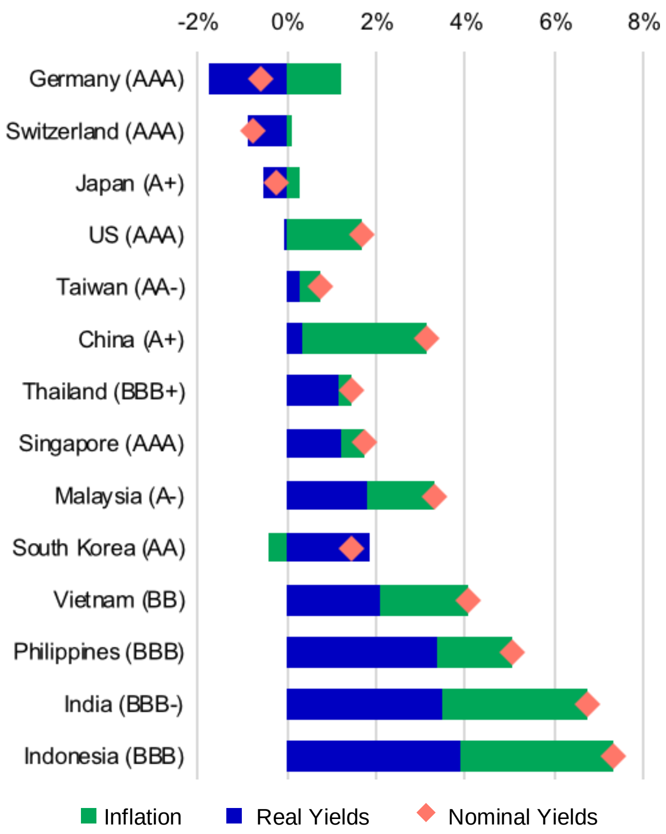
The economic diversity of Asian economies, from exporters to domestic-driven demand, should provide robust investment opportunities for bond investors.

- The trajectory of **China's** economy will be watched closely in 2020. Our base case is for economic growth to stabilise and inflationary pressure (largely driven by food prices) to be temporary. The government is likely to implement targeted fiscal and monetary stimulus policies; however, as the country "onshores" its supply chain[4], the stimulus is more likely to support domestic growth than regional economies. From a longer-term perspective, we see 2020 as another potential milestone year for the development of China's bond market. After the inclusion of Chinese bonds in the Bloomberg and J.P. Morgan indices in 2019, more global indices may consider their inclusion in 2020, which will lead to greater inflows.

That said, investors will also be able to tap into a diverse array of economies outside China, particularly in Southeast Asia. We believe Asian local-currency bond markets of domestically driven economies stand out given their sound fundamentals and compelling real yields.

- We continue to remain constructive on fixed-income opportunities in **Indonesia**, because of its compelling yields (10-year government bonds yields c. 7% level, rated "BBB" by international rating agencies) in a global context. Bond investors have already benefitted from the re-election of President Widodo and his ambitious reform agenda and Bank Indonesia (BI) cutting interest rates four times in 2019. We believe that BI has further room for monetary easing in 2020 on the back of accommodative Federal Reserve monetary policy and moderate inflationary pressures.
- **Malaysia** is another market that we prefer in 2020. Malaysia was one of the less active regional markets in 2019, cutting interest rates only once earlier in the year. A combination of domestically driven growth and one of the lowest inflation levels in the region should translate into competitive real yields for investors. We also estimate the market has room to cut interest rates further in 2020.

Chart 1: Nominal and real sovereign yields of 10-year bonds in Asian and developed markets[5]



[4] Import substitution is the policy of substituting domestic suppliers for foreign importers to localize the supply chain.

[5] Source: Manulife Investment Management, Bloomberg. Sovereign ratings based on the median rating between S&P, Moody's and Fitch, as of 30 September 2019. Inflation rate is represented by year-on-year change of consumer price index.

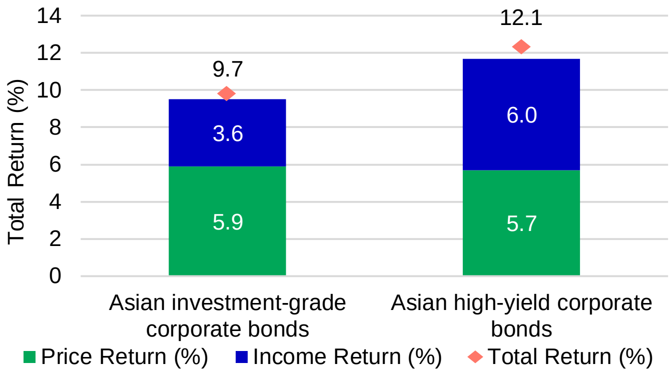
Credits: opportunities in the Asian bond market

Due to the accommodative global macro environment, we expect demand for high-quality Asian credits to remain buoyant in 2020. Furthermore, we do not expect refinancing issues in the Asian investment-grade space, which could support a tighter credit spreads trend in 2020. Despite the negative sentiment surrounding the US-China trade tariffs, Chinese investment-grade credit spreads did not significantly widen in 2019, as the country's state-owned enterprises (e.g. infrastructure and utility companies) and quasi-sovereign issuers (e.g. policy banks) are less-sensitive to trade negotiations. Overall, we prefer the credits of strategically important state-owned enterprises (SOEs) and select local government financing vehicles (LGFVs), which stand to benefit from continued government support via lending and fiscal stimulus. Examples include toll-road operators, railway operators, or companies involved in strategic projects at the national level.

We are constructive on Indian credit from a fundamental perspective, but believe it is less attractive from a valuation point of view. India's economy progressively slowed in 2019, but inflation was generally contained for most of the year for the Reserve Bank of India to cut interest rate aggressively. However, a string of defaults in the non-banking financial companies' sector has not only roiled credit markets but affected liquidity conditions despite accommodative monetary policy. Despite these challenges, we are encouraged by a recent Supreme Court ruling that confirmed that the claims of secured creditors are superior to that of unsecured creditors, a positive development for international investors[6]. For 2020, we may wait for more attractive entry points for Indian credit from a valuation perspective.

We remain constructive on the regional high-yield space in 2020, particularly with a short-dated bias. Indeed, high yield should continue to present yield opportunities for investors but with marginally higher risks compared with 2019. These risks include a large proportion of high-yield issues coming due in 2020, as well as a potential marginal uptick in defaults, particularly for small-to-mid-size privately owned enterprises in China. Risks for marginal companies in China have arguably worsened, as the government undertakes a more targeted stimulus and liquidity conditions tightened for smaller financial institutions. As a result, robust credit research selection should ensure that investors are compensated with attractive risk-adjusted returns. For more details on our outlook for Asian Credit, please refer to the piece contributed by our Asian Credit Team.

Chart 2: 2019 Year-to-date Asia Credit total return breakdown (%)[7]



Currencies

In 2020, we are closely monitoring exogenous factors, such as ongoing Sino-US trade negotiations, US elections and signs of global economic recovery that may drive Asian currency markets in binary directions. Hence, we are opting to maintain broad Asian bond exposures balanced between US-dollar Asian bonds and local-currency bonds in order to diversify currency risk. We suspect currencies of export-driven economies to have a more volatile profile, as most of the exogenous factors have binary outcomes on their economic growth and subsequently their currency. We are somewhat cautious on the Chinese renminbi versus the US dollar, given the prospect of trade-war-related rhetoric. We favour markets that offer attractive real yields and rely on strong domestic economic fundamentals. Whichever way exogenous events play out, fundamentals would support a more stable economic growth trajectory and currency. From that standpoint, we believe Indonesia's rupiah would stand out relative to its regional peers.

[6] Euromoney: "India reverses course on Essar Steel decision", 15 November 2019.

[7] JP Morgan, Bloomberg as of 29 November 2019. Past performance is not an indicative of future performance.

Prepared for the era of sustainable and flexible Asian bond investing

Manulife Investment Management is well-equipped with one of the largest credit research teams in Asia. Apart from the traditional research and financial analysis on every single issuer, our credit analysts work closely with our dedicated Environment, Social and Governance (ESG) research team to review ESG factors. In addition, a dedicated ESG taskforce for our Asian Fixed Income portfolios has been set up to track the progress of ESG integration. As such, our Asian bond strategies are ESG aware and consider ESG factors with a strengthened process to manage screening and quantify downside risks.

Arguably, the Asian fixed income space is getting more diverse and complex, expanding to 17 markets and 14 sectors[8]. This means that an established team with local on-the-ground support is even more relevant than ever before. Manulife Investment Management is supported by more than 50 fixed income investment professionals located in 10 offices across Asia[9]. We also adopt a "go-anywhere" approach that invests flexibly from across the entire US$18 trillion Asian fixed income spectrum[10]. This "blended" Strategy allows us to capture the triumvirate benefits of mitigating event risk, diversification and maximum flexibility.

[8] JP Morgan Asia Credit Index, September 2019.
[9] Manulife Investment Management, as of 30 June 2019.
[10] Asia Development Bank, Manulife Investment Management, June 2019.

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Manulife Investment Management

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