



Asia Pacific's bond market – challenging perceptions on East/West decoupling

Endre Pedersen, Executive Director Asia Fixed Income, debunks a decoupling myth and assesses the impact this has on Asia's bond markets as the global economy emerges from recession.

In any 'ordinary' recovery, commentators would be looking to the Asia Pacific region for signs of growth on the economic horizon.

The region's markets are often seen as a particularly sensitive bellwether of export demand from Europe and the US and so as those larger economies pull out of their malaise and begin ordering again, the belief is that markets in Asia should be among the first to bask in recovery sunshine.

On the flip side, many commentators have also been dissecting the possibility of a decoupling between western economies and Asia Pacific. The theory being that as the latter's nations develop strong domestic demand, their reliance on American and European consumers decreases.

Decoupling – but not as we know it

Whilst there is certainly evidence that Asia as a region is becoming less reliant on the US and Europe, we believe there is actually a far more important decoupling story going on – one which affects how we as fixed income investors on the ground in the region invest our money.

That is a decoupling *within* Asia, with two distant types of economies emerging. Those – like Singapore, Japan and South Korea – that continue to rely on trade with the US and Europe and those – such as Australia, Indonesia and Hong Kong – that are becoming increasingly reliant on either domestic consumption and/or demand from China.

Put simply, as Western economies continue to show only very tentative signs of recovery, the difference between the two groups of Asian nations is becoming ever more pronounced. Could a two speed Asia be emerging from the global turmoil? And, if so, what does this mean for fixed income investors?

Emerging opportunities

The simple answer is that both types of Asian economies offer opportunities for savvy fixed income investors – particularly those who have access to quality, on-the-ground local research that can seek out the individual opportunities that are emerging in Asia.

Let's take the Korean currency as an example. The won is currently cheap compared to other export currencies. Pummeled for much of 2008, the Korean won suffered as foreign investors pulled out their investments and concerns weighed about the reliance of Korean corporates on USD short term borrowing and their reliance on exports.

Since then, pressures to stay competitive in the export market have meant that the won has not been allowed to appreciate much for fear that it will make Korea's LCD TVs expensive and uncompetitive for foreign shoppers, even at a time when demand is supposedly due for an uptick. This suggests that the Koreans have yet to be convinced about the strength of any global recovery.

Similarly, the Korean central bank cannot hike interest rates until it is certain that the recovery is sustained. This presents a chance for those investors that believe that too much positive news has already been priced into the comparatively high five year rates – currently running at 5.0%. Given that the current cash rate is 2%¹, the central bank would have to raise rates aggressively to reach that weighted 5.0% target.

Those investors who don't buy into the European recovery story can therefore benefit by buying Korean bonds – banking on the fact that if 5 year rates have to come down, bond prices will head north.

Australia – a new bull from China's shop?

In some respects, Australia bridges the divide between the two types of Asia Pacific economies. It is one of the new group of breakaway nations that is decreasing its reliance on the US and Europe as it increasingly benefits from China shopping for its resources.

However, it still exports a significant proportion of its commodities to Western economies. Moreover, its traditionally hawkish central bank tends to like to keep interest rates high. So, as with Korea, Australia's bonds prices are likely to increase if longer term interest rates come under pressure to drop.

Indonesia - powering ahead

Indonesia is a good example of an Asian country that is driving growth for itself. With

a population of a quarter of a billion people, it has strong domestic consumption and does not need to rely on exports to drive its economic growth. Its increasing political stability and careful interest rate cutting seems to have positioned it well to emerge strongly from the global turmoil.

This was recently recognized by the credit ratings' agency, Moody's, who upgraded Indonesia's sovereign debt from Ba3 to Ba2 in September.

According to Moody's, the country's relatively strong resilience to the global recession as well as its healthy medium-term growth prospects prompted the rating upgrade.

Certainly Indonesia has fared better than many Asian nations during the recent recession and with an exuberant domestic economy, there is little pressure to keep the Indonesian Rupiah weak in order to remain competitive.

We think the Indonesia currency presents some really interesting opportunities for investors in the medium to long term as we expect to see currency appreciation thanks to increased foreign investor confidence and improving domestic fundamentals.

As far as Indonesia interest rates are concerned, we believe there is some room for interest rates to fall further. Although we expect to see the return to inflation – possibly up to the 4% year-on-year level by the end of the year from its current level¹ of 2.6% year-on-year – inflationary expectations are already priced into the market.

Conclusion

The fallout from the global market turmoil has led many commentators to see Asia as the world's next economic 'knight in shining armour', leading the charge with a quiver full of fiscal stimulus cash, resource riches and domestic consumption.

For investors, this decoupling from the West suggests that the region may be the growth story of the future but, delve deeper and the picture is far more complicated than a simple East/West decoupling.

If Asia is expected to ride to the economic rescue, investors should be prepared for the intra-regional decoupling story to make for more than a simple one horse race. As fixed income investors in the region, we are in little doubt that this decoupling story will be a defining characteristic for how different Asian economies fare in the future.

Going forward, more than ever, detailed local analysis of individual markets' dynamics will be required if investors are to back the right horse.

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All dates are 2009 unless otherwise specified. ¹ As at end of October 2009.

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