2024 Mid-Year Investment Outlook – Asia Fixed Income: Emerging Markets

May 2024

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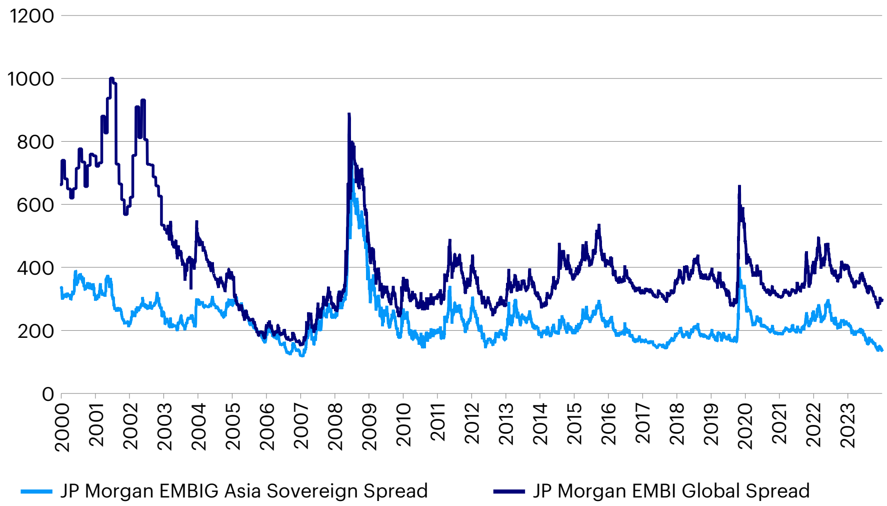
Emerging market (EM) Asia hard currency sovereign bonds continued to trade tighter in 1H 2024. This asset class has been trading at the tightest absolute levels since the Global Financial Crisis (GFC) (Figure 1). The overall universe of EM hard currency sovereign bonds has also been trading tighter. However, the current Emerging Markets Bond Index Global Core (EMBIG) spread is quite some distance away from its post GFC tight.

Figure 1: J.P. Morgan EMBIG Asia sovereign spread vs EMBIG spread (bps)



Source: Bloomberg, Invesco. Data as of 22 May 2024.

EM Asia sovereign issuers' credit fundamentals have been improving in recent years. However, the relative value between Asia and rest of EM has become less favorable. We have observed balanced technicals in EM Asia hard currency sovereign bonds, as capital outflow pressures and net redemptions have largely offset each other. Yet on the demand side, global capital has been flowing into developed markets (DM) bonds instead of EM and Asia in particular, largely due to valuation concerns.

Local investors across Asia, on the other hand, are keen to buy USD bonds issued by their own governments. As local governments in the region have either seen improved fiscal conditions in recent years, or are facing cheaper funding options domestically, the issuance volume of hard currency sovereign bonds has been low in Asia compared to the other EM markets.

The current global macro backdrop seems to be in a steady state. Market consensus is that DM are likely to go towards the soft-landing scenario while the EM macro-outlook also does not give much cause for concern. With this base case, we expect the rest of EM to outperform EM Asia hard currency sovereign bonds as risk assets are likely to benefit from the stable macro environment. In the unlikely scenario where the market sells off, we believe strong local demand will help EM Asia sovereign bonds to outperform other regions.

Rather than hard currency, we are more positive on Asian local currency bonds. Asian local government bond yields have been trading at relatively high levels given the wide US Treasury and other DM government bond yield curves. These high absolute yield levels are attractive for local investors looking for risk-free returns. Most Asian countries have raised interest rates in recent years as global inflation has become rampant and major central banks like the Federal Reserve (Fed) have kept rates high.

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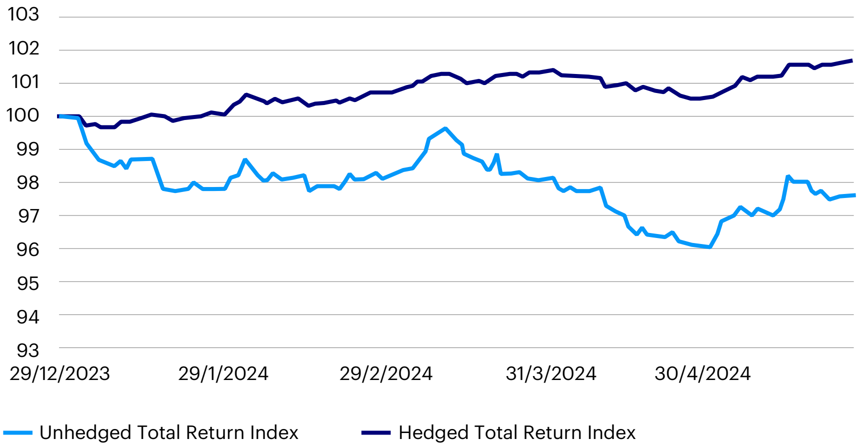
For domestic investors, Asian local government bonds offer attractive yields relative to historical standards. In general, Asian governments have been doing well in recent years in terms of delivering on their macro and fiscal targets. Another factor that is propelling demand is demographics. Most Asian markets are witnessing a rapid growth in middle-income households, driving record investment demand. As Asian local government bonds are risk-free for domestic investors, these are logical investment targets for this new crop of investors.

At the same time, we admit that the relative yield pickup of this asset class against US Treasuries has not been as attractive, with the Fed staying put on interest rates amid domestic inflationary pressures. We expect international investors to find Asian local rates attractive once the Fed and other DM central banks start to cut. Nevertheless, we believe the recent USD rally will fade before year end as the market has re-priced the Fed cutting cycle for the remainder of the year. The recent underperformance in local currency EM Asia government bonds has largely come from exchange rates. Once the USD rally fades, we expect to see positive performance potential from Asian local currency government bonds in USD terms.

Figure 2: The strong USD has brought about an underperformance in Asian local currency rates markets

iBoxx Asian Local Bond Index, re-based to 100 as of end 2023



Source: Bloomberg, Invesco. Data as of May 2024.

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