VIEWPOINT

January 2015

Prepared for Professional Clients only

ASIAN BONDS: AN OVERLOOKED OPPORTUNITY

Asia is considered a beneficiary of strong demographic and economic fundamentals as well as a stable banking system, broad political stability and improving corporate governance standards. Despite this, bond investors remain underweight in the region[1].

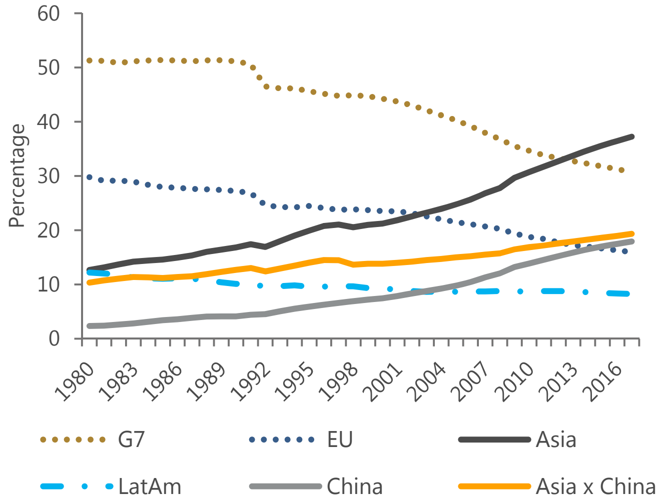
With increasing issuance and exposure to a broad range of geographies, risk profiles and industry sectors, the Asian fixed income universe offers a widening source of diversification, says Sarah Percy-Dove, head of credit strategy, Asian Fixed Income, Standish Asia.

Despite recent concerns about a Chinese slowdown, Asia remains a powerhouse of international growth. The region accounts for more than a third of global GDP and has the highest per-capita GDP growth rates in the world[2]. More startling is a demographics story that looks set to supercharge these numbers in the coming decades. The region has 55% of a world population that is expected to grow from a current 7.16 billion to 9.55 billion by 2050[3]. By then, Asia will account for more than 50% of world GDP, according to the Asian Development Bank.

At the same time, major economies – China foremost among them – are pushing towards consumption rather than export-led economic models and this is expected to drive sustainable growth in the long term, especially as the region's emerging middle class continues to grow in size and economic clout. Globally, this key demographic is expected increase from 1.8 billion people today to 3.2 billion by 2020 and to 4.9 billion by 2030, with almost all of this growth (85%) coming from Asia[4]. The spending power of the demographic is also expected to climb steeply, with demand forecast to grow from US$21 trillion to US$56 trillion by 2030.

Again, over 80% of this growth in demand is expected to come from Asia[5].

SHARE OF WORLD GDP



Source: International Monetary Fund (IMF) Wold Economic Database. 31 April 2014

RISING POWER

Yet, despite these positives for the region it remains something of a back-water for fixed income investors, with Standish Asia's Percy-Dove noting outstanding Asian bonds, excluding Japan, account for just 2.7% of the Barclays Global Aggregate Bond Index. She believes investors neglect the region at their peril and the increasing depth and breadth of Asia's bond market and the diversification opportunities it offers are key advantages that should not be overlooked.

[1] Barclays, Citi & JP Morgan data

[2] Fitch Sovereign Comparator as at September 2014

[3] UN Population Division; World Population Prospects: The 2012 Revision Volume 1: Comprehensive Tables

[4 & 5] OECD Development Centre Working Paper No.285 January 2010.

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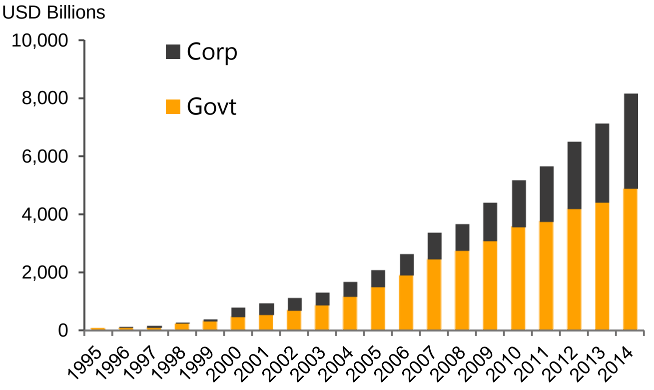
BNY MELLON

ASIAN LOCAL CURRENCY MARKET CAP

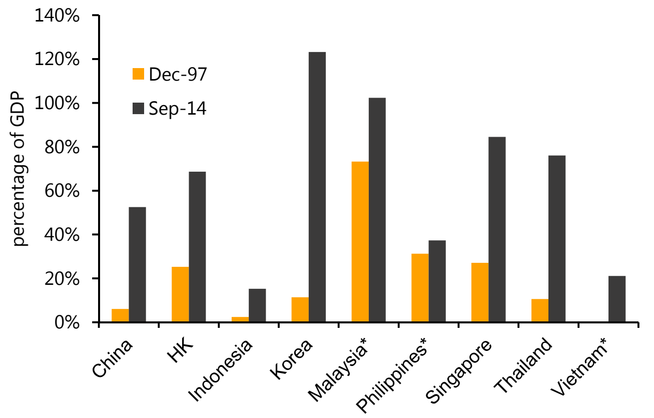


Source: Asian Development Bank. 31 December 2014.

RISING ISSUANCE

Since the Asian financial crisis of 1997, Asian bond issuance has increased dramatically, particularly in local currencies. In 1995, the local currency market capitalisation of the Asian bond market – both corporate and government bonds combined – stood at just US$126bn. As of September 2014, that figure had risen to over US$8 trillion, an increase of over 6,000%[6].

ASIAN LOCAL CURRENCY MARKET AS % GDP



Source: Asian Development Bank. 31 December 2013.
* From 2000

The greatest gains were in Korea, Hong Kong, Thailand, China, Vietnam and Singapore – a remarkable rise reflecting the growing size and importance of these economies on the world stage. Incredibly, this market growth has occurred in an environment of notably lower leverage for both the government and corporate sectors.

[6] Source: Asian Development Bank, December 2013

The Asian US dollar bond market, as represented by the JP Morgan Asia Credit Index (JACI), is also growing steadily. The index comprises 366 Issuers and 872 securities from 16 countries and 14 broad sectors. It is growing at around 15% annually, with US$180bn in new issuance in 2014 alone.[7] That still pales into relative insignificance compared with US credit markets, but, stresses Percy-Dove, this growth in Asian fixed income means that investors now have a far greater range of opportunities to which they can gain exposure, whether by sector, geography or risk profile.

“Asian economies do not move in tandem and offer a wide range of macro environments, so opportunities abound,” she says. “This diversity is one of Asia’s strengths. In terms of geography alone, the universe runs the gamut of AAA-rated countries right through to those rated triple-C. Each is in different stages of the economic and monetary cycle, offering additional diversification for investors.”

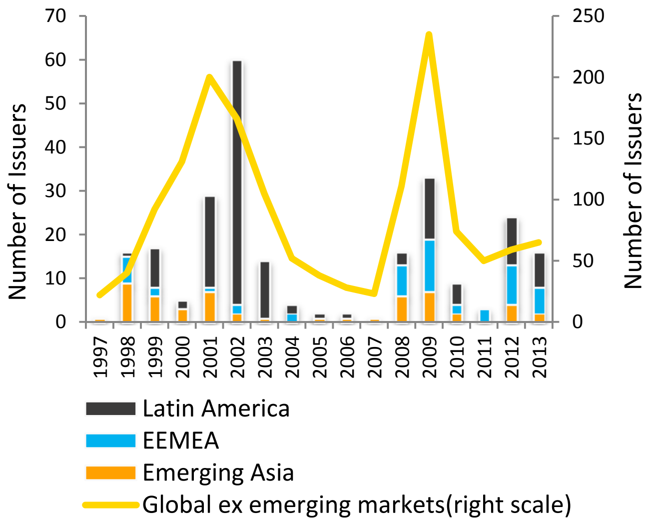
She notes emerging economies like Sri Lanka and Vietnam can be volatile in terms of pricing and yields, as can Indonesia because of its relative size on global emerging market indices. Korea and Philippines, conversely, tend to be lower beta markets and show a greater stability in prices and yields.

CONFOUNDING EXPECTATIONS?

On the question of yields, Percy-Dove notes that investors have traditionally been concerned about default risk in Asian markets, especially in emerging economies and this has resulted in a yield premium. “Global investors have struggled with a lack of familiarity with the region and there has been a perceived weakness in governance standards, which has carried through to heighten fears of default,” says Percy-Dove. This is despite the Asian high yield market having considerably stronger covenant quality than other regions[8]. “For US dollar-denominated investment grade bonds, for example, this has resulted in a premium of between 50-100 basis points versus equivalent US instruments.” For European investors the premium is even more compelling, with US dollar Asian yields currently four times that of similar EUR corporate bonds[9].

[7] JACI, JP Morgan, December 2014
[8] Moody’s, January 2015
[9] JACI and BoA Merrill Lynch Euro Corporate Index

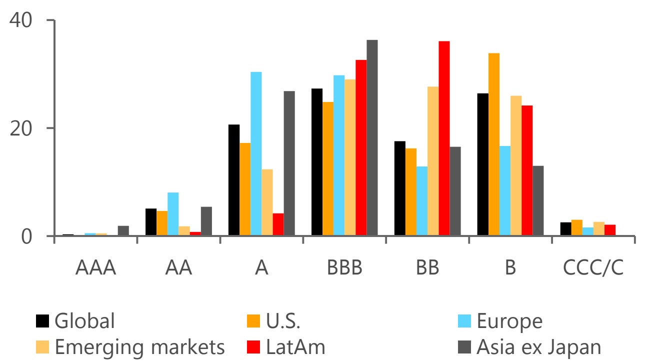
ANNUAL CORPORATE DEFAULTS BY NUMBER OF ISSUERS



Source: Standard & Poor's 2013. Emerging Markets Corporate Default Study and Rating Transitions

She stresses, however, these perceptions are not supported by data. Default rates for Asian corporate bonds are lower than in developed markets, while loss given default (LGD) levels are comparable to global peers. At the same time, average ratings for Asian bonds are actually equivalent or higher than in developed markets, she adds, pointing out at the high-yield end of the spectrum Asian bonds have an average rating of BB-, the same as in euro markets but higher than in the US where the average quality is B+.

RATINGS DISTRIBUTION BY REGION



Source: Standard and Poor's 2012 Annual Asia-Pacific Corporate Default Study and Rating Transitions

Another factor heightening perceived risk is the high proportion of Asian issuers that have come to the market for the first time in recent years. As the tail of first-time issuers shortens and as the market matures, this effect should diminish, says Percy-Dove.

This is not to say the Asian fixed income universe is free from flaws. Corporate governance, while improving, is still a concern. But, says Percy-Dove, developed markets have their own numerous examples of governance breaking down, so a comparison is less informative than might be expected. "The best response here is that Asian markets are different. In part, this is due to the higher proportion of family-controlled companies, coupled with a significantly deeper overlap between the government and corporate world than in other regions. While these aspects strengthen support mechanisms in many respects, they do create opacity, which may increase investors' level of discomfort."

Nonetheless, she points out Asian companies are maturing in their approach to public information and professionalism and this is cause for optimism.

"Meanwhile, although the Asian fixed income universe is diverse, it is still dominated by just a few core nations. China accounts for some 34% of the JP Morgan Asian Credit Index, followed by Korea at 14% and Hong Kong at 13%. India accounts for 9%, as it is much harder for Indian companies to borrow offshore due to government regulations[10]. It is also interesting to note that the market has continued to broaden, with Bangladesh being added in 2014 and potential maiden issues from the likes of Cambodia or Laos in the foreseeable future."

OUTLOOK

Looking forward, Percy-Dove points out that with its positive long-term fundamentals – and even in the event of a Chinese slowdown – Asia remains a cornerstone of future world growth. Increasing bond issuance and a broadening range of exposures across sectors, geographies and risk profiles make for intriguing investment opportunities. It remains an overlooked market but one, perhaps, whose time has come.

[10] JACI, JP Morgan, December 2014

COMPARING REGIONS

European Investment Grade	07-Jan-15
Yield To Worst (%)	0.94
OAS (TSY) (basis points)	75.45
Duration (yrs)	4.85
Coupon (%)	3.48
Average Quality	A-
Members	1,784
Market Capitalisation (bn)	1,583
Total Return (%, 1 Yr)	8.01

European High Yield	07-Jan-15
Yield To Worst (%)	4.12
OAS (TSY) (basis points)	398.4
Duration (yrs)	3.49
Coupon (%)	5.75
Average Quality	BB-
Members	466
Market Capitalisation (bn)	258
Total Return (%, 1yr)	5.03

US Investment Grade	07-Jan-15
Yield To Worst (%)	2.99
OAS (TSY) (basis points)	141.86
Duration (yrs)	7.29
Coupon (%)	4.46
Average Quality	A-
Members	5,190
Market Capitalisation (bn)	4,170
Total Return (%, 1 Yr)	8.35

US High Yield	07-Jan-15
Yield To Worst (%)	7.19
OAS (TSY) (basis points)	580.72
Duration (yrs)	4.34
Coupon (%)	6.86
Average Quality	B+
Members	2,210
Market Capitalisation (bn)	1,394
Total Return (%, 1yr)	0.38

Asia Investment Grade	07-Jan-15
Yield To Worst (%)	3.67
Spread Over Treasuries (basis points)	195.9
Duration (yrs)	5.58
Coupon (%)	4.54
Average Quality	A-
Members	592
Market Capitalisation (bn)	445.2
Total Return (USD) %, 1 yr	9.57
Total Return (EUR) %, 1 yr	8.89

Asia High Yield	07-Jan-15
Yield To Worst (%)	7.38
Spread Over Treasuries basis points)	583.6
Duration (yrs)	4.14
Coupon (%)	6.94
Average Quality	BB-
Members	280
Market Capitalisation (bn)	124.9
Total Return (USD) %, 1 yr	4.5
Total Return (EUR) %, 1yr	5.65

Source: Bloomberg, JP Morgan, 7 January 2015

AT A GLANCE:
BNY MELLON ASIAN BOND FUND

As at 31 December 2014

Fund launch date:
25 July 2014

Assets under management: US$32.46m

Investment objective:
A total return comprised of income and capital growth by investing in a portfolio of bonds & similar debt investments and derivatives predominately in Asia

Philosophy & process:
- Seeks to deliver superior excess return from a portfolio predominantly of bonds and currencies or their derivatives from Asian markets
- Conversion of active risk into alpha by active portfolio management
- An actively managed fund implementing alpha strategies across credit, rates and currencies
- Unconstrained by credit quality or maturity
- Uses both quantitative and fundamental methods to identify value in both macro and idiosyncratic positions.

Investment manager:

STANDISH

- Dedicated fixed income and credit manager, founded in 1933
- Deep and experienced in-house research team
- Standish manages the wide spectrum of Global Sovereign, Global Aggregate and Emerging Market Bonds
- Experienced investment team with expertise in Asian Sovereign, Quasi-Sovereign, Corporate Bonds, and FX
- 131 investment professionals in US, UK, & Singapore