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Why short duration Asian bonds could be a flexible and well-timed play on market uncertainty?

Jim Veneau, Head of Asian Fixed Income

Aidan Yao, Senior Economist & Asian Fixed Income Investment Specialist

- **The ultra-low interest rate environment is driving yield-hunting investors to look east at Asian credit**
- **A short duration approach can potentially provide, a natural buffer against rising inflationary expectations, and long-term interest rate risks**
- **By re-allocating interest rate risk budget and placing a strong focus on credit risk selection, Asian Short Duration strategy can help to provide relative insulation from potential macro shocks**

Low interest rates send yield hunters east

The COVID-19 pandemic has exacerbated the many structural challenges facing fixed income investors.

For one, global interest rates had fallen to near zero even before the latest crisis, limiting central banks' options for more monetary support. The room for conventional policies in most developed countries had been exhausted during the global financial crisis, with successive rounds of quantitative easing (QE) further suppressing bond market term premiums, making it difficult to sustain returns.

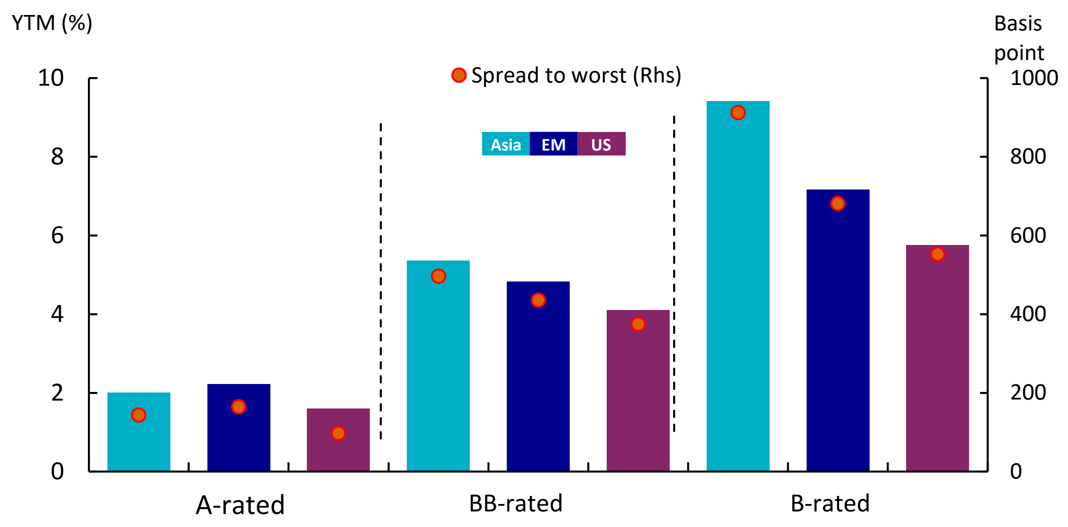
Some central banks, in the euro area and Japan for example, have even gone a step further into negative interest rates, giving rise to the peculiar asset class of "negative-yielding" bonds – a sector which has grown to almost $15 trillion in size[1]. In today's zero-rate environment where finding yield

[1] https://www.bloomberg.com/news/articles/2019-08-06/negative-yielding-debt-hits-record-15-trillion-on-trade-woes Aug 6, 2019

has become increasingly challenging, it's inevitable for global bond investors to venture out of their comfort zones into markets with higher credit risks, in a bid to find higher yields.

Right now, Asia's credit market is attracting growing attention from global investors. The local currency universe has seen over 400% growth over the 10 years up to 2019, while over the same time period, the hard currency universe has experienced over 500% growth almost US$1.6 trillion.[2] Greater potential growth in the region has historically sustained higher nominal interest rates, while Asian credit has both higher ratings - with corresponding lower defaults - and spreads than their US and European peers, meaning they are offering potentially better rewards to investors. (Exhibit 1)

Exhibit 1:



Source: JACI, CEMBI BD, ICE BofA US Corp and HY, as of July 31 2020

Benefiting from this yield enhancement, our Asian Short Duration strategy's yield-to-maturity (YTM) has averaged around 5% this year, with a monthly dividend distribution ratio of more than 5%[3] – a competitive level in an Asian and emerging markets' context, and markedly higher than those prevailing in developed markets.

Lower for longer? Short duration can help investors tackle rising inflation and long-term interest rate risks

Rising interest rates pose a significant challenge to any fixed income portfolio, and even a threat of large drawdowns in value, particularly to those with longer duration. While no major central banks are in the position to lift policy rates while COVID-19 remains uncontained, long-term bond yields bear little resistance should inflation rebound, and bond supply concerns rise. US 10-year Treasury yields rose 20 basis points in August 2020, while the breakeven inflation rate – a measure of market

[2] Source: AXA IM, Asian Development Bank, Asian Bond Monitor March 2020. Mar 2019 data for Local Currency and September 2018 for Foreign Currency (last complete set of data).
[3] Source: AXA IM, as of August 31, 2020

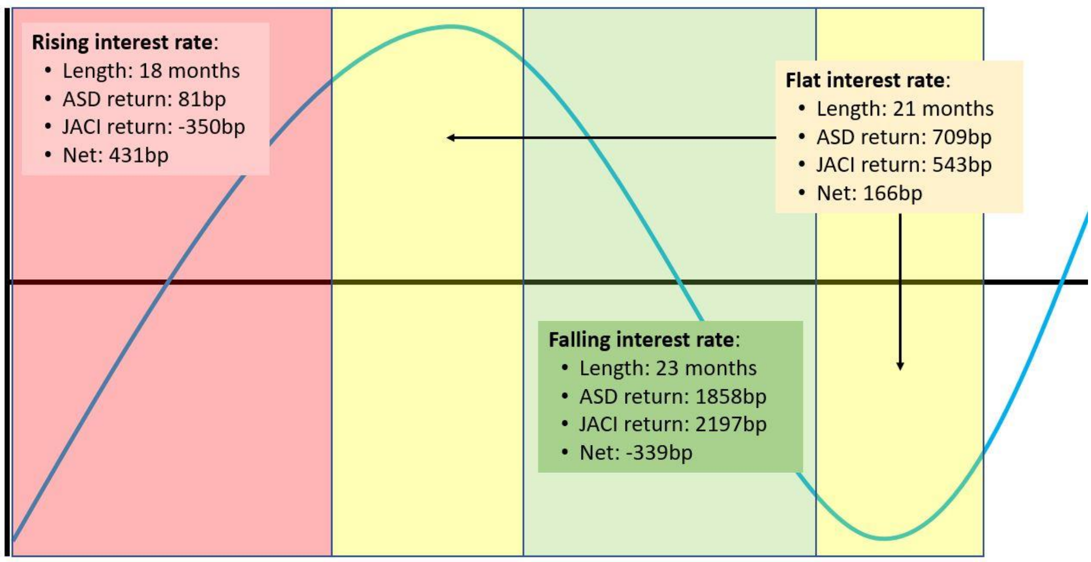
inflation expectations – surged to 1.75% from a low of 0.6% at the height of the COVID crisis in March 2020.[4]

If the Federal Reserve was successful in stoking inflation with its latest change in mandate to keep policy rates lower for longer, even as inflation returns to the economy, a further rise in inflation expectations could push nominal bond yields even higher. This in turn could cement a turning point in the global interest rate cycle.

A short duration strategy can provide a natural shield against higher inflation and interest rates. Contrary to any tactical moves to position for rising or falling rates, our Asian Short Duration strategy lies in its systematic approach to manage duration, structurally limiting it to under three years. Such a design feature is not motivated by our cyclical view of the interest rate cycle but is more of a strategic choice. It reflects our preference for focusing on yield and return from credit exposure over extended duration.

This investment approach has proven effective in the Asian credit context, manifested in our strong total return and outstanding risk-adjusted performance relative to the full duration JP Morgan Asia Credit Index (JACI) despite an overall falling interest rates environment throughout the past five years. Exhibit 2 shows that Asian Short Duration strategy has achieved this by outperforming the JACI on both flat and upside of an interest rate cycle, with these gains more than offsetting its underperformance on the downside.

Exhibit 2: Asian Short Duration performance across interest rate cycle



Source: AXA IM, Bloomberg, Fund Galaxy, data as of end of June 2020. Inception date of 13/04/2015 and is used for calculation. JACI = JPMorgan Asian Credit Index. Past performance is not an indicator of future performance.

With global interest rates already at the zero-lower bound, the chance of a continued fall is less than that of flat or even rising interest rates. In our view, where we are currently in the interest rate cycle is playing in favour of a short duration fixed income strategy.

[4] Source: Bloomberg

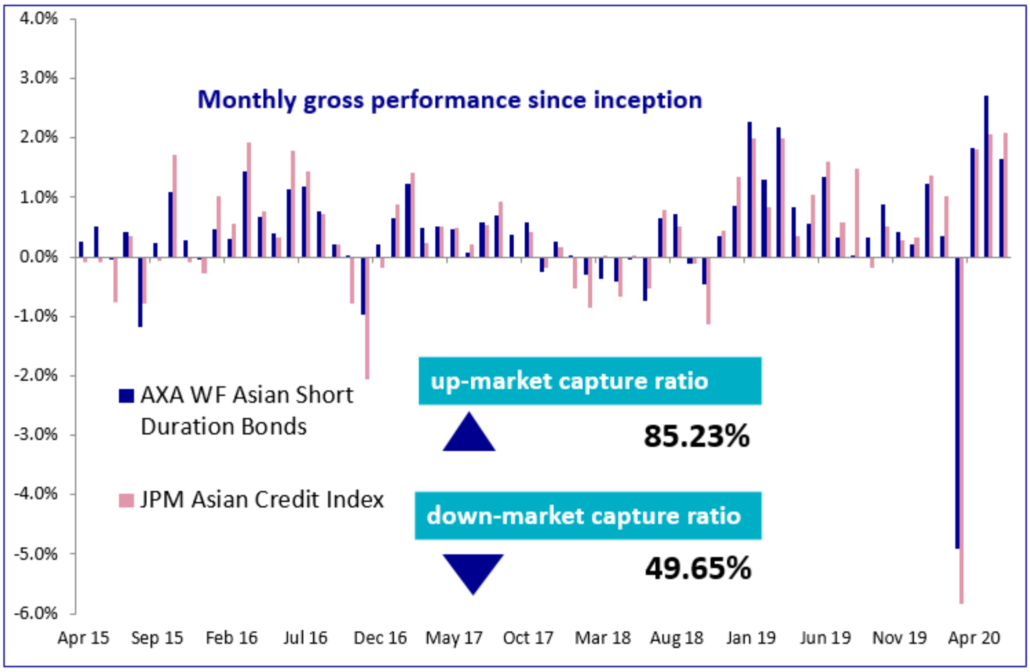
Strong credit focus can provide relative insulation from macro uncertainties

It's important for investors to be aware that we are facing a series of elevated, and likely protracted, macroeconomic uncertainties. The pandemic, which has already had an historically negative impact on the global economy, has also further increased tensions between China and US. Clearly US election politics are not helping to cool the rhetoric with China. The uncertainties with such a consequential presidential election, between two drastically distinctive candidates with starkly different policy preferences, will also have global markets repositioning as Election Day draws closer.

As such, over the near and medium terms, geopolitical uncertainty is likely to challenge investors' risk management by either increasing volatility over anticipation of negative events or creating further price shocks from actual negative events, as witnessed in March 2020. We believe an active Asian credit strategy such as Asian Short Duration is potentially well suited for these challenges.

Even with the COVID-19 impact and persistently ominous headlines throughout much of 2020, it is important to reflect that the direct impact on much of the Asian credit universe has been well contained and that the previously impacted sectors in the market have rallied and substantially recovered most losses. Going forward, we believe that with a strong emphasis on active credit research, focused credit selection can help effectively mitigate many of the ongoing macro uncertainties facing investors and continue to generate stable investment returns.

Exhibit 3: Asian Short Duration has demonstrated superior ability to mitigate downside risk and provide capital preservation



Source: Blomberg, AXA IM as of 31/07/2020. Past performance is not a guide to future performance. All data is for the I USD share class since strategy inception on 13 April 2015. Performance is displayed gross of management fees but net of admin fees. An investor's return will be reduced by the management fees and other expenses. JPM Asian Credit Index is not the fund's benchmark and is provided for illustration performance purposes only.

From a risk standpoint, our Asian Short Duration strategy does not strive to achieve higher yields at the expense of lower credit quality. As a credit fund, Asian Short Duration has maintained an investment grade focus attaining an average "BBB-" credit rating. Meanwhile, by effectively redeploying lowered interest rate risk into high conviction credit exposures, our Asian Short Duration strategy has delivered a consistently highly ranked performance track record – rated top quantile by Morningstar – in managing total return volatility and protecting capital against large market drawdowns. Exhibit 3 shows that ASD has achieved, on average, over 85% of up-market capture, while dropping less than a half of the market during an average sell-off. Such a favourably asymmetric payoff structure, along with a proven tendency to mitigate broader market volatility, adds to Asian Short Duration's appeal in a highly uncertain and fragile macro environment.

Looking ahead

There's no doubt that recent developments in a constantly evolving global environment have presented some formidable challenges for fixed income investors. Zero interest rates and threats of inflation are undermining returns, while a long list of geopolitical tensions, particularly between China and the US, are adding to an uncertain environment for financial markets globally. A portfolio that can generate stable yield, while managing volatility and risks, particularly against those of rising interest rates, could provide an effective solution.

By applying a unique strategy to investing in Asian credits, the Asian Short Duration strategy has demonstrated an ability to convert an attractive yield into stable income, through much reduced volatility and drawdowns than the broader benchmark and full duration peers. The strategy has also proven effective at mitigating capital loss against rising interest rates, which makes it a useful buffer against any negative repercussions coming from the current abundance of monetary stimulus accumulating in the global financial system.

Designed to tap a large, diverse and rapidly growing bond market, supported by Asia's vibrant economies and prudent policies, we believe the considerable merits of an Asian Short Duration strategy are especially appealing in today's complex, uncertain and fast-changing world.

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