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Asia credit remains in good standing

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As we near the start of US policy easing, and US Treasury yields continue to decline, the door for investors to lock in yields is still open, but won't remain so indefinitely. One option that remains attractive is Asia IG, where we expect strong fundamentals to provide strong returns bolstered by decent carry of around 5%. In particular, we like Indonesia and South Korea IG.

Over the past week, the VIX volatility index has settled in a range of 18.9-23.8, after spiking to a high of 65 in August. This compares to a range of 11.1-19.4 (bar one day) in the three months prior to the tumultuous August. Over this period, the S&P 500 fell as much as 2%. All this highlights the fact that investor portfolios are likely to be buffeted by continued volatility.

Amid the rising uncertainty, we believe investors should protect their portfolios by adding quality into both their equities and fixed income segments. One market segment that we feel might still be underutilized is Asia credit. We think that Asia credit—in particular the investment grade (IG) segment—can help bolster portfolios against elevated risk levels in the coming months. In particular, our preferred sectors include Indonesia and South Korea IG. Investors should actively consider Asian IG credits as a complement to their bond portfolios for the following reasons:

The resilience of Asian credit passed the recent stress test. Amid the spike in risk aversion in the first week of August, the Asia IG segment slightly outperformed most global IG segments as credit spreads across all fixed income segments widened. Asia IG credit spreads widened by 8bps although total returns remained in positive territory as overall yields fell. We attribute this relative resilience to the Asia IG segment's stickier investor base and solid fundamental backdrop; the latter is a key attribute of quality bonds, which we think should be a focus for investors. Asia IG bonds are thus likely to enable the segment to bolster bond portfolios, especially during risk-off periods.

Falling US policy rates can still prompt lower UST yields. We are aligned with the market in expecting the Federal Reserve to cut interest rates by 100bps by the end of the year. We also expect another 50bps of cuts by June 2025. Although US Treasury (UST) yields have fallen sharply over the last month or so, we still see the 10-year yield falling another 15bps to our March 2025 target of 3.50%, and the 5-year UST yield falling another 20bps to 3.25%. We believe IG returns should be supported by decent yield carry of around 4.9%, in addition to some capital gains as yields move lower. We believe the window to lock in yields is still open in the IG space, which would be the mainstay of Asia IG's returns.

Softer USD against Asia FX to add more support. We recently moved the USD to Least Preferred largely on the expectation of falling carry against other key G10 currencies as their central banks ease less aggressively than the Fed. We are also Most Preferred on the EUR, the GBP, the AUD, and the CHF, and expect all four to gain against the USD till June 2025. We also expect Asia's central banks to broadly cut around half the amount that the Fed does: about 25-50bps by year-end, followed by another 25-50bps next year. This should see the USD also weaken against most Asia FX (the CNY being a key exception) through September 2025. This environment is likely to also be supportive for Asia credit on two fronts: Fed easing is likely to boost risk appetite; and it lowers the USD funding and refinancing costs for Asian issuers. The latter should boost the creditworthiness of Asian issuers, whose revenues are often at least partially in local currencies.

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