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When adding risk to portfolios, don’t forget bonds

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With risk appetite looking likely to rise in the coming months, investors will likely be increasingly focused on expressing this via equities. But fixed income will likely remain a sizable share of portfolios, and investors should also look into using their bond allocations to increase their risk exposure. We believe this can be accomplished by both moving down the credit curve, and the capital structure. We also remain Most Preferred on Asian local currency bonds. Indian government bonds in particular are an attractive way to diversify global fixed income exposure.

With stronger US labor market data and renewed signs of policy intent in China bolstering the sentiment on economic growth in the world’s two largest economies, markets have refocused on the prospects on equities. The S&P 500, up almost 42% over the past 12 months, rose as much as 2.8% in the six trading days from 4 October.

While it is true that equities tend to be the favored vehicle for expressing a greater risk appetite, investors should remember that fixed income will still be needed for healthy, balanced, and well-diversified portfolios. Because bonds still account for a sizable share of portfolios, investors might find the suggested options below for how to adapt bond portfolios for a more pro-risk environment.

Move down the credit curve. Investors can inject more risk exposure into their bond portfolios via moving down either the credit curve or the capital structure, or both. Generally, a stronger growth environment, coupled with policy rate easing in the US, tends to result in more forgiving funding conditions, which in turn favors less robust credits. This shifts the risk-reward balance in favor of the yield pickup on offer from the slightly riskier credits.

In terms of going down the credit curve, we would switch from the A or AA segment to the BBB segment for yield enhancement. Within the banking sector, we favor Tier 2 debt over senior notes given the potential for meaningful yield pickup. We favor Thai, Indonesian, and Hong Kong Tier 2 bonds

Add some higher-yielding China credits. Although we do not expect that China's policy stimulus will significantly affect the segment's fundamentals, we do expect that credits from asset managers and leasing companies will be the chief beneficiaries. These credits are trading at spreads wider than the overall Asia IG at the moment, and we think these can perhaps narrow relative to the overall segment, which should translated into a boost in returns.

Remain cautious over Asia High Yield (HY). Notwithstanding the 15% returns year to date from Asian HY, and the potential growth in risk appetite in the coming months, we still believe investors should be highly selective about this segment. Specifically, we think investors should apply a bottom-up approach to sift out segments with fundamental improvement stories, such as Macau gaming. Visitation from mainland China looks set to continue improving, and we would select certain higher-yielding bonds to boost portfolio yields. Elsewhere, select opportunities in commodities might also be worth some portfolio exposure, since both the US soft landing and Chinese stimulus should help keep commodity prices supported in the coming six months. It should be noted though that this commodities play is mainly a tactical one aimed at harvesting currently attractive yields, and should not be seen as a hold-to-maturity.

It should also be noted that we remain Most Preferred on Asian local currency bonds, and Least Preferred on Chinese government bonds (CGBs). Asian local currency bonds are predominantly domestically issued government bonds, which should benefit from appreciating Asian currencies and lower Asian rates. In particular, we believe there is a structural case for diversification into Indian government bonds (IGBs). We believe US Fed rate cuts, foreign inflows to India's debt market, and more balanced growth-inflation dynamics will drive the 10- year IGB yield to 6.25% by September 2025 from the 6.7-6.9% over the past three months. This still offers sizable price upside, making IGBs an attractive way to diversify global fixed income exposure.

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