



# The Spoils of War

Forecasts in early 2018 for a return of volatility after two years of near-somnolent developed markets seem to prove more prescient with every passing month, with significant implications for emerging-market assets.

As we saw, yields in core markets finally began taking off early in the year. In the US, wage growth, improving employment and expectations of Fed rate rise propelled 10-year Treasuries to multi-year high. The rate increase duly came and bolstered yields further, while President Trump's trade hostilities and the subsequent Chinese responses drove money into traditional safe havens, with 10-year Treasury yields hovering around 3 per cent. Although with strong signs that the US is on an upswing, anxieties over geopolitics and trade continue to simmer and infect Asian markets.

After such a prolonged period of stagnation during which global capital had poured into Asian assets in search of yield, local debts were inevitably seen as vulnerable in this environment.

Outflows from Asian debts began in April and have not abated since. Spreads on emerging-market bonds are hovering near a two-year high over Treasuries, propelled by trade fears, a higher dollar and tighter liquidity. Rising oil prices are threatening to swell the current account deficits of major importers like Indonesia, India and the Philippines. Asian currencies have been in decline – notably Indonesia rupiah, Philippines peso and South Korean won – and the region's stock markets hit a collective nine-year low in early July as the first round of US tariffs loomed.

## Asian debts continue to hold up well

It's not all gloom for government debts, however. For one thing, the global economy is doing quite well, and the flight from emerging markets has not been as bad as portrayed.

Asian debt holdings are still equal to the long-term average, which may indicate a resilient demand, and though local-currency bonds have lost value, they are still higher than they were a year ago.

Much of the focus fuelling volatility has been on the potential damage of a US-led trade war, but the prospect of Asian markets is becoming less dependent on the US may buoy sentiment in the long term. Trade growth in Asia is the fastest in the world, and a trade war could accelerate a shift in trade corridors for the benefit of some Asian economies.

Indeed, Chinese government debts have been a beneficiary of the trade conflict, even as stock markets and the currency tumbled. Foreigners bought Chinese sovereign bonds at the fastest rate in almost two years in June, and the yield on the 10-year note reached a 14-month low of 3.47 per cent in early July. Any escalation of the trade war could lure risk-averse foreign capital into bonds at an even faster rate, and with the Chinese government committed to supporting the currency, the danger of the yuan tumbling further is relatively limited.

## Where from here?

After a stellar run in 2017, Asian local-currency debts are facing several headwinds as many of the conditions that enabled that run have started to weaken.

Nevertheless, while investors will need to be a lot more cautious, the outlook remains positive. Yields are still in a reasonable range, with credit spreads having moved up as much as 60 basis points this year. EM local currency debts still provide investors with a healthy spread over US Treasuries, and with a lower US interest-rate risk than hard-currency bonds.

Many EMs now issue debts in their local currency as opposed to hard currency, much of which is held by domestic investors, making it less subject to the vagaries of international flows and less sensitive to dollar moves.

With weak capital flows and political uncertainty in Europe unlikely to abate soon, the dollar is likely to continue to strengthen during the rest of the year. Despite short-term macro risks such as dollar strength and the potential for further trade turmoil, we prefer local currency over hard currency EM debts. With Asian currencies about 5-6 per cent undervalued against the dollar, according to State Street's measures of fair value, this represents an opportunity in local debts. Since much Asian debts are held by local investors, this makes it less vulnerable to international flows, and with account balances generally healthier than before the global financial crisis, the risk of contagion from troubles in Turkey or Brazil is lower than before.



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