Emerging Asia Rates Alert: The Alpha in Asia for AUD-Based Investors

28 January 2009

Author:

Tamara Mast Henderson
Director, FX/Rates Strategy, Asia
Global Markets
+65 6419 7930
Tamara.Henderson@anz.com

Market Outlook

In 2008, rates markets posted the strongest returns in many years, boosting the profile of government bond benchmarked investors over the asset classes of credit and equity. There were significant curve shifts as well, particularly in the wake of the Lehman Brothers bankruptcy, as the market landscape fundamentally changed—breaking the back of inflation expectations in emerging Asia.

Going forward, we remain bullish on rates in emerging Asia over the near-term. For AUD-based investors—both benchmarked real money funds and leveraged (or funded) investors—Asian government bond and interest rate swap markets offer the added attraction of diversification benefits and lower return volatility.

Insight from 2008

The Lehman Brothers bankruptcy in September prompted a sharp U-turn in focus from inflation to growth for the central banks in emerging Asia. Global markets have been in a frenzy ever since, with the exception of a consolidative period in December.

Table I: Total Return - Asian Government Bonds

2008 (%)	Total Return in AUD	Total Return in LCY	Maturity	Coupon
S Korea	69.2	14.9	Sep-17	5.50
India	65.8	22.2	Jul-17	7.99
Thailand	58.5	22.1	Jan-17	5.50
Indonesia	37.4	-0.7	Jul-17	10.00
China	34.8	21.6	Mar-17	3.40
Malaysia	34.8	10.4	Feb-17	3.81
Hong Kong	30.7	11.6	Dec-17	3.52
Singapore	28.7	9.7	Sep-18	4.00
Australia	23.3	23.3	Feb-17	6.00
US	38.7	19.0	Nov-17	4.25

Sources: ANZ, Bloomberg

The spike in risk aversion combined with aggressive rate cuts in late 2008 produced a sharp rally in rates markets across the globe. The ten-year US Treasury generated a total return

Our Vision:

For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

of nearly 40% in AUD terms, but returns in parts of emerging Asia were more spectacular—69% in the ten-year Korean Treasury bond and 66% in the ten-year Indian government bond. Even in Indonesia, where the curve bear flattened over the course of 2008, Australian-based investors earned a total return of 37% in AUD terms (Table I).

Table II: Monetary Policy and Corresponding Curve Adjustments

2008 (bps)	Full Year			Post Lehman		
	Net Chg in CB Policy Rate	Chg in 10Y Govt Yield	Chg in 2s10s Spread	Net Chg in CB Policy Rate	Chg in 10Y Govt Yield	Chg in 2s10s Spread
Hong Kong	-525	-225	-23	-300	-158	20
S Korea	-200	-148	108	-225	-163	65
Singapore*	-142	-63	35	-29	-104	63
Taiwan	-138	-121	-18	-163	-76	1
India	-125	-223	12	-250	-294	-3
Thailand*	-50	-230	-52	-100	-170	-71
Malaysia*	-25	-92	-24	-25	-157	14
China	0	-170	97	-216	-129	53
Philippines	25	n/a	n/a	-50	n/a	n/a
Vietnam	25	111	-90	-550	-561	-83
Indonesia	125	187	-109	0	-128	-86
Australia	-250	-233	178	-275	-169	121
US	-425	-181	47	-200	-151	100

* Generic government yields were sourced from Bloomberg (I347 for China). On the curve, 3s10s is the spread shown for Malaysia, while 2s9s is the spread shown for Thailand. Singapore adjusts monetary policy via its exchange rate; as such, the quoted shift in its "policy rate" is for SGD 3M SIBOR.

On the government curve, there was significant bull steepening in 2s10s in 2008. Within emerging Asia, Korea's curve steepened the most (+108 bps), followed by China (+97 bps), while India's curve steepened the least (+12 bps). Meanwhile, Hong Kong, Malaysia, Taiwan and Thailand all experienced moderate bull flattening—that is, the drop in yields was more pronounced at the back end of the curve. In countries where inflation expectations remained elevated (e.g. Indonesia and Vietnam), the curve bear flattened and the 2s10s spread narrowed by roughly 100 bps over the course of 2008 (Table II).

In addition to evaluating the shifts in yields and curve spreads, we examined correlation coefficients on daily changes, both for the year of 2008 as a whole and for the period following the bankruptcy announcement for Lehman Brothers. Post-Lehman data were examined separately in order to determine whether correlations were affected by the spike in market volatility. In most cases, post-Lehman correlation coefficients were very similar to the coefficients calculated for 2008 as a whole.

Correlations were computed on daily data, which were transformed to correct for serial correlation and time zone differences vis a vis the US market opening. By convention, "low" or "nil" correlation is assigned to coefficients in the 0.0 to 0.3 range; "medium" correlation is assigned to coefficients in the 0.4 to 0.6 range; and "high" correlation assigned to coefficients greater than or equal to 0.7.

Table III: Correlations within Local Rates Markets

2008	Full Year: Govt 2s and Govt 10s	Full Year: GOV 10s and IRS 10s	Post Lehman: Govt 2s and Govt 10s	Post Lehman: GOV 10s and IRS 10s
China	0.7	0.3	0.7	0.4
Hong Kong	0.7	0.7	0.6	0.7
India	0.6	0.5	0.5	0.5
Indonesia	0.4	n/a	0.4	n/a
Malaysia	0.9	0.4	0.9	0.4
Philippines	n/a	n/a	n/a	n/a
Singapore	0.6	0.7	0.5	0.7
S Korea	0.9	0.6	0.9	0.6
Taiwan	0.0	0.7	0.1	0.7
Thailand	0.7	0.6	0.8	0.6
Vietnam	0.5	n/a	0.7	n/a
Australia	0.7	0.4	0.7	0.3
US	0.8	0.9	0.8	0.9

Sources: ANZ, Bloomberg

Looking within individual markets, we found high correlations between the ten-year government bond yield and the corresponding IRS rate in Hong Kong, Singapore, and Taiwan—not as high as in the US, but higher than in Australia. More moderate correlations were found between government bond and IRS markets for India, Korea, and Thailand (Table III).

On the government curve, low to nil correlations were found between two- and ten-year yields in Taiwan. However, a high level of correlation was found for this pair in China, Hong Kong, Malaysia, Korea, and Thailand—similar to correlations in Australia and the US. The implication for investors is clear: one should not blindly extrapolate behaviour from one market to another.

Table IV: Correlations with Australian Rates

2008	Full Year: Govt 10s	Full Year: IRS 10s	Post Lehman: Govt 10s	Post Lehman: IRS 10s
China	-0.1	-0.1	-0.1	-0.2
Hong Kong	0.3	0.1	0.3	0.1
India	0.1	0.2	0.2	0.1
Indonesia	0.1	n/a	0.1	n/a
Malaysia	0.1	0.1	0.2	0.0
Philippines	n/a	0.0	n/a	0.0
Singapore	0.3	0.3	0.2	0.4
S Korea	0.1	0.0	0.1	0.1
Taiwan	0.3	0.2	0.3	0.2
Thailand	0.2	0.3	0.2	0.4
Vietnam	0.0	n/a	0.1	0.0

Sources: ANZ, Bloomberg

Emerging Asian rates markets offer diversification benefits for AUD-based investors as correlations between Australian and emerging Asian rates markets were found to be low to nil in 2008. Correlations were also low in the post-Lehman period—with two exceptions. Post-Lehman, ten-year IRS rates in Singapore and Thailand had a moderate positive correlation (+0.4) with the Australian ten-year IRS rate. However, a correlation coefficient of 0.4 is too low to extrapolate a meaningful day-to-day trading relationship.

Table V: Correlations between Equities & 2Y Govys

2008	Full Year		Post Lehman	
	Local Equities	Australia Equities	Local Equities	Australia Equities
China	-0.1	0.0	-0.2	0.0
Hong Kong	0.1	0.2	0.0	0.1
India	-0.1	0.1	0.0	0.1
Indonesia	-0.3	-0.1	-0.4	-0.1
Malaysia*	-0.1	0.0	0.1	0.1
Philippines*	-0.2	-0.1	-0.2	-0.2
Singapore	0.1	0.1	0.2	0.1
Skorea	0.0	0.1	0.0	0.1
Taiwan	0.0	0.0	0.0	0.0
Thailand	0.0	0.0	-0.1	0.0
Vietnam	0.0	0.0	0.1	0.0

Note: Baseline daily data were sourced from Bloomberg. The 3-year government yield was used for Malaysia, and IRS rates were used for the Philippines.

Surprisingly, correlations between equities and two-year government bond yields were found to be low to nil. Correlations were also low in the post-Lehman period—with one exception. Post-Lehman, Indonesian two-year government yields had a moderate negative correlation (-0.4) with Indonesian equities (Table V).

The *a priori* expectation was that yields and equity prices would be positively correlated, reflecting safe haven flows into bonds when equities weaken (and vice versa). However, the correlation data suggest that Indonesian bonds had a slight tendency to trade more like equities in 2008.

Emerging Asia Rates Outlook

Equity markets will be eager to anticipate the turn in the cycle, but it will take some time for the fiscal and monetary policy responses announced thus far to bear fruit. It will also take time for risk appetite to begin to rebuild. As long as the trough in the downturn remains elusive, rates markets in emerging Asia should remain supported.

Volatility has abated from the unprecedented levels reached in the wake of the Lehman Brothers bankruptcy last year. Nevertheless, volatility remains elevated and this continues to support risk aversion trades.

The ultimate safe haven of the US Treasury market has become quite expensive in both absolute and relative terms, which will induce investors to look elsewhere. Also, worries about supply have begun to weigh on the long end of the Treasury curve.

Central banks in much of emerging Asia have already cut policy rates aggressively, but unlike the US Federal Reserve, many Asian central banks still have ample monetary “space” to ease further. The countries with the most scope to ease monetary policy are Indonesia, Vietnam, India, the Philippines and China—all with over 500 bps of potential ammunition.

Government balance sheets in much of emerging Asia are sufficiently strong to absorb announced fiscal stimulus programmes (see *Emerging Asia 2009: The Year of the Bootstrap*, 22 January 2009). In Hong Kong and Singapore, the fiscal balance has been in surplus since at least 2006. Meanwhile, Indonesia has surplus financing from 2008 to cover much of the 2009 budget.

As such, local rates markets should be less vulnerable to worries about supply, unlike US Treasuries. Indeed, the much needed boost to liquidity should be supportive of trading in the secondary markets of emerging Asian bonds.

Although monetary policy is less effective in the current environment in which banks are hoarding cash, those countries with limited fiscal space (such as India and the Philippines) will have no choice but to rely more on monetary policy to support domestic demand. Also, those countries with more command-driven, as opposed to market-driven, economies (e.g. China and Vietnam) are able to enhance the effectiveness of monetary (and fiscal) policy.

All in all, this should translate into further compression in local government bond yields and swap rates in emerging Asia. In contrast, the forward market is priced (Bloomberg indicative rates) for *higher* two-year IRS rates in six months' time—presenting attractive return potential in a number of markets, especially Indonesia given its favourable financing position this year (Table VI).

Table VI: Outlook for 2009

	CB Policy Rate		2Y IRS			2s10s
	Current	Projected (July '09)	Current	Projected (July '09)	Forwards (July '09)	Curve View (bps)
China	5.31	4.50	1.05	0.8	1.2	+20
Hong Kong	0.50	0.25	1.33	1.2	1.6	Neutral
India	5.50	4.00	4.15	3.0	4.3	Neutral
Indonesia	8.75	6.00	11.80	9.5	12.1	+120
Malaysia	2.50	1.50	2.24	0.7	2.3	Neutral
Philippines	5.50	4.00	3.70	2.3	3.5	Neutral
Singapore*	0.69	0.55	1.36	1.2	1.5	+20
S Korea	2.50	1.00	2.83	1.6	2.9	+20
Taiwan	1.50	1.00	0.86	0.5	1.0	Neutral
Thailand	2.00	0.50	1.90	0.7	2.0	+50
Vietnam	7.00	5.00	n/a	n/a	n/a	+80

Sources: ANZ, Bloomberg. (*) Singapore adjusts monetary policy via its exchange rate; as such, the quoted "policy rate" is for SGD 3M SIBOR. Data as of 27 Jan.

On the curve, we take a neutral view on the 2s10s government spread in Hong Kong, India, Malaysia, the Philippines and Taiwan. This position is largely based on the experience of the past year, when there was limited response in curve spreads amid the sharp rally in rates markets.

Elsewhere, we anticipate further steepening in the curve, but caution that we are likely approaching the end of this trend in China, Singapore, and Korea. The Indonesian government curve is where we see the greatest potential for widening in the 2s10s spread over the next six months given that Bank Indonesia has only just started to ease monetary policy.

Emerging Asia Rates Strategy

Real Money Funds: There are three key issues for AUD-based real money investors: 1/ portfolio weighting, 2/ area of the curve, and 3/ whether to hedge currency exposure. For those investors which have emerging Asia in their benchmark, we suggest increasing the weight for Asia. For those investors that do not have emerging Asia in their benchmark, we suggest adding or increasing existing off index allocations to emerging Asia.

In terms of duration and positioning on the curve, benchmarked or relative return investors who have allocations in emerging Asian local rates should extend duration to long from neutral in Indonesia as knock-on effects from the global slowdown penetrate more deeply into the local economy, prompting more aggressive rate cuts. A curve steepening view can be expressed without going short, by over-weighting the short end of the curve at the expense of the long-end.

AUD-based investors in emerging Asian rates reaped stellar returns in 2008, mostly from currency exposure. On a risk-reward basis alone, currency hedges for exposures to Asian emerging bonds would be prudent.

Leveraged Funds: For leveraged or funded investors, curve steepeners can be adopted by taking receiver positions at the short-end and/or payer positions at the long-end. Look for segments of the curve which are inverted in order to reap the added benefit of positive carry. Alternatively, opt for pairings in regions of the curve that are relatively flat in order to minimize negative carry.

Contacts

ANZ Economics & Markets Research

Saul Eslake	Chief Economist	+61 3 9273 6251	Saul.Eslake@anz.com
Fiona Allen	Business Manager	+61 3 9273 6224	Fiona.Allen@anz.com

Industry and Strategic Research

Julie Toth	Senior Economist	+61 3 9273 6252	Julie.Toth@anz.com
Paul Deane	Rural and Regional Economist	+61 3 9273 6295	Paul.Deane@anz.com

Australian Economics and Interest Rates Research

Warren Hogan	Head of Australian Economics and Interest Rates Research	+61 2 9227 1562	Warren.Hogan@anz.com
Katie Dean	Senior Economist	+61 3 9273 1381	Katie.Dean@anz.com
Riki Polygenis	Economist	+61 3 9273 4060	Riki.Polygenis@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com

Global Markets Credit Research

Jason Hill	Global Markets Credit Analyst	0434 312 356	Jason.Hill@anz.com

Commodities Research

Mark Pervan	Head of Commodities Research	+61 3 9273 3716	Mark.Pervan@anz.com
Doug Whitehead	Soft Commodity Strategist	+61 3 9273 6684	Doug.Whitehead@anz.com
Natalie Robertson	Graduate Analyst	+61 3 9273 3415	Natalie.Robertson@anz.com

Property and Financial System Research

Paul Braddick	Head of Property and Financial System Research	+61 3 9273 5987	Paul.Braddick@anz.com
Ange Montalti	Senior Economist	+61 3 9273 6288	Ange.Montalti@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Stephanie Wayne	Research Analyst	+61 3 9273 4075	Stephanie.Wayne@anz.com

Foreign Exchange and International Economics Research

Amy Auster	Head of Foreign Exchange and International Economics Research	+61 3 9273 5417	Amy.Auster@anz.com
Tony Morriss	Senior Currency Strategist	+61 2 9226 6757	Tony.Morriss@anz.com
Amber Rabinov	Economist	+61 3 9273 4853	Amber.Rabinov@anz.com

Foreign Exchange and Interest Rates Research (London)

Tim Riddell	Currency and Interest Rate Strategist		Tim.Riddell@anz.com

Asian Economics Research (Singapore)

Paul Gruenwald	Chief Economist, Asia	+65 6419 7902	Paul.Gruenwald@anz.com
Tamara Henderson	Director, Currency and Rates Strategy, Asia	+65 6419 7930	Tamara.Henderson@anz.com
Chang Wei Liang	Analyst, Economic Research	+65 6216 1838	WeiLiang.Chang@anz.com

New Zealand Economics Research (Wellington)

Cameron Bagrie	Chief Economist, New Zealand	+64 4 802 2212	Cameron.Bagrie@anz.com
Khoon Goh	Senior Economist	+64 4 802 2357	Khoon.Goh@anz.com
Philip Borkin	Economist	+64 4 802 2199	Philip.Borkin@anz.com
Steve Edwards	Economist	+64 4 802 2217	Steve.Edwards@anz.com
Kevin Wilson	Rural Economist	+64 4 802 2361	wilsonk1@anz.com
David Croy	Interest Rate Strategist	+64 4 802 2286	David.Croy@anz.com

Research and Information Services

Marilla Rough	Senior Information Officer	+61 3 9273 6263	Marilla.Rough@anz.com
Manesha Jayasuriya	Publications Coordinator	+61 3 9273 4121	Manesha.Jayasuriya@anz.com

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

14th Floor 100 Queen Street, Melbourne, Victoria, 3000, Australia

Telephone +61 3 9273 6224   Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121   Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of FINRA and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160   Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

This document ("document") is distributed to you in Australia and the United Kingdom by Australia and New Zealand Banking Group Limited ABN 11 005 357 522 ("ANZ") and in New Zealand by ANZ National Bank Limited ("ANZ NZ"). ANZ holds an Australian Financial Services licence no. 234527 and is authorised in the UK by the Financial Services Authority ("FSA").

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of ANZ), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any securities referred to herein should contact ANZ S, not its affiliates.

This document is being distributed in the United Kingdom by ANZ for the information of its market counterparties and intermediate customers only. It is not intended for and must not be distributed to private customers. In the UK, ANZ is regulated by the FSA. Nothing here excludes or restricts any duty or liability to a customer which ANZ may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZ, ANZ NZ, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZ, ANZ NZ, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will directly or indirectly relate to specific recommendations or views expressed about any securities or issuers in this document. ANZ, ANZ NZ, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.