Asian bond yields `lag growth'

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Yields on long-term local currency bonds have failed to adjust to the booming economic growth in Asia that will ultimately bring rising inflation and interest rates in its train, Deutsche Bank's Charles Feng warned.

Once this oversight was corrected, Feng said, the receding bull market for Asian bonds would finally come to an end as investors began selling bonds and yields were driven higher to compensate investors.

``The sell-off we have seen in US fixed-income has not taken place to the same degree in Asian bonds,'' Feng told the Asian Bond Market Forum being held at the University of Hong Kong yesterday.

Feng, director of fixed-income research (Asia) for Deutsche Bank, referred by way of example to India, where money supply was growing at around 15 per cent, the economy was expanding at almost 7.0 per cent, and inflation was running at 5 per cent.

``But the yield on a 10-year Indian government bond is barely above 5 per cent,'' he said. ``That means that unless inflation in India falls dramatically - unlikely since it is already at historical lows - investors will earn negative real returns on their bonds.''

The same could be said for many local currency bonds issued since the financial crisis of 1997/98 in order to finance deficits and recapitalise banking sectors which had led to a liquidity-driven rally in the market.

From 1 per cent of GDP before the crisis, fiscal deficits had ballooned to 3.9 per cent in 2002, and allied to government moves to encourage recourse to debt markets and reduce reliance on bank lending, the need to finance these deficits had led to a 55 per cent expansion in local bond issues since 1996 and a doubling of the share held by Asian paper in the global market, to 4.2 per cent.

Further complicating the fair value of bonds in the present environment was the fact that corporate paper in particular was thinly-traded and ``marking to market'' was not very well enforced in the region.

``There is a lot of discretion on how a bond manager can mark to market [or book the market value of his portfolio],'' he said. ``For example, in Taiwan, bond funds prefer to hold corporate bonds because there is no trading in them, and they can mark whatever they want.''

Lack of liquidity [or trading turnover], added fellow-panelist Paul Lejot, honorary fellow of the Asia Institute of International Financial Law at the University of Hong Kong, was partly the result of comparatively small individual issues.

``In East Asia as a whole - which is 10 economies including India - in 2003 to date, there have been about 1,400 local currency medium-term public issues totalling US$66 billion [HK$514.8 billion], of which half have come from Korea.

``Regarding liquidity and how it evaporates, the average size of deals across the board is the local currency equivalent of US$48 million. In Korea the average size was US$56 billion, and in Hong Kong it was just US$24 million - you can't get much liquidity there,''

Lejot said.

Feng warned also that low demand for loans meant that around the region banks had invested heavily in government bonds and appeared ``complacent'' about the risk associated with falling prices.

This complacency, he said, might have been encouraged by the assumption of central bank support for the market. But there were signs that regional banks were reaching the end of their ability to continue sterilising strong capital inflows by issuing debt paper, he said.

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