Audio Transcript: Valuations and Carry Limit Asian Fixed Income November 20, 2023

Katie Klingensmith [00:00:01] Welcome, everybody, to today's conversation, Around the Curve, from Brandywine Global. I'm Katie Klingensmith, and I am joined by my colleague, Carol Lye, who's based in Singapore. She's a senior research analyst and a portfolio manager on many of our global fixed income strategies. It's great to have Carol here because there is so much conversation going on right now around the macro and politics, of the future of Asia. And Carol looks at the world, but certainly has a lot of depth in Asian countries. Carol, I'd love to just get us started, what's going on in China? I mean, just, there's a lot of pessimism around the growth, real estate. What's the overall scenario and is all of this pessimism warranted?

Carol Lye [00:00:49] What we have been seeing in China, really, is that, if you remember, China's growth after they opened up from COVID, that didn't last too long. It only lasted two quarters into this year. And then, you know, the whole issues about housing came back again. And, of course, you know, there was the still, you know, kind of rocky U.S.-China relations. So, they all added up, and it resulted in pretty much weak growth for China. So, I would say that, you know, if we look at the recent data that has been coming out, in fact, growth has been bottoming out. The Chinese officials, the government, is quite firm that they want growth to pick up from here. And so they have started to put policies in place that will help growth going forward. So, for example, one of the latest policies that they have come, and potential policies that they are thinking of coming up with, is what they call the PSL policy. And it is effectively, some would call it like a Chinese QE per se, where they are going to start pumping money into the property sector, perhaps more in terms of renovating certain shanty towns, urban villages. They did that program in 2015, and it worked pretty well, it really helped growth to pick up. Now this time around is a little bit different. We don't expect them to put in as much, to be frank. And also, you know, shanty towns have already been renovated. So, they have to find new projects essentially to work on. But I think the main message is really that the Chinese government gets it. They want to stabilize growth and from here, I think, growth in China has bottomed. It will, kind of, pick up, not in a big way, to be frank, but at least stabilize from here.

Katie Klingensmith [00:02:45] Seems like part of the worry is the global environment. And, well, I'm in San Francisco, and there's been a lot of focus on the recent Biden-Xi APEC meetings. Do you think that the trade tensions or the lack of dialog between the U.S. and China have had and might have a real impact on the near-term economic outlook?

Carol Lye [00:03:07] Certainly. I think, you know, when you, when we kind of speak to people on the ground in China and also when you read, you know, kind of sentiments, the businesses in China are very worried about what is going to happen globally, especially with the kind of relations that they're having with the U.S. And so, businesses' confidence is actually quite weak in that aspect. So, anything that, you know, is going to help, you know, push, you know, expectations or optimism in that direction is really helpful. And so, I think the reason and what's going on today with Biden and Xi is really good because they have decided that, you know, they're going to work on military communications, work on putting some export controls, you know, fentanyl exports as well. So, there's some give and take that this summit is a very high-level summit. And I think there are a lot of positive messages that are coming out of it. It's really going to be quite helpful for both countries and especially for China.

Katie Klingensmith [00:04:17] It seems it's coming from a rather low set of expectations, so that there's really the potential for improvement. Well, let's think about the rest of Asia. Historically, Brandywine Global has had a lot of orientation towards investment opportunities in Asia, but it doesn't seem to really be a focus of ours right now. Why not?

Carol Lye [00:04:38] Right. I would say emerging Asian countries this time around are still, you know, in relatively good shape, if you think about growth and inflation. Well, the issue with Asian countries is just that they never quite hiked monetary policy as much as other countries, for example, in Latin America. And you remember our Brandywine Global process, we--in our environment or sphere of investment--we look across a lot of different emerging markets. And when we compare them, EM Asia valuations are just much tighter as compared to Latin America, even for CEEMEA. Nominal yields are also way below the U.S. So, the carry story is not really there--carry meaning nominal yield story--is not really there for Asia. And so we prefer to be more in Latin America where we can, we are compensated more for the risk rather than be in Asia, where yields are much lower.

Katie Klingensmith [00:05:39] So, that's a big answer that valuations are not extremely attractive and that the carry is not as high as some other regions. But in spite of that, are there certain growth stories or certain individual countries that you're really watching?

Carol Lye [00:05:52] Yeah, I think there are potentially just two or three here. The first one is really India, because India's bond market has been very, in terms of its exposure to foreigners, has been very small. So recently, if anyone has been following the fixed income markets quite closely in Asia, India will be included in the GBI-EM indices. So going forward, there's going to be much more of flows that's going to come into India. It works well for India. India's fundamental story is, it is quite good as well. You know, if you look at a couple of the metrics, for example, their reserves to exports, their reserves are still at very high levels. So, I would say that India is a pretty good story, and that's potentially where money can flow into for fixed income. Now, the other story that we are putting a lot focus as well on is on Japan, obviously, because the BOJ is likely to move ahead to normalize their rates a bit more quicker than thought. So, because of the sustained inflation and weak exchange rates, and we have talked about this a couple of times, but we are very focused on looking at Japanese yields and shorting, in fact, more Japanese yields if we can from here.

Katie Klingensmith [00:07:14] I definitely want to get back to the currency conversation. But before we do that, talk to me about what the big macro trends are. I mean, coming out of COVID are very different paths for different countries. Tourism from China plays a big role for the growth of many of the different countries in Southeast Asia. What are the big trends that you're watching?

Carol Lye [00:07:35] Now, I think coming back to, you know, after post-COVID, tourism, like you say, is one of them. Now, Asian countries in general have opened up much later as compared to the Western world. In addition, China only opened up last year. So, we are still seeing a fair bit of demand for travel in this part of the of the world. We continue to track the number of tourists from China to other Asian countries. And it's still quite, you know, it's still ranging somewhere around the levels of 40% for some countries to 80% for other countries as compared to pre-pandemic. So, which means there's a scope for a greater revival in tourism. Now, we don't expect that to, you know, suddenly jump much higher because in China they are just still, you know, restrictions over visas. It's harder to get visas. Flight numbers are still cut, slowly, steadily increasing. So, that number will start to increase. And it's not a one-off jump that's going to happen. Now, so that's the first theme of tourism. The second theme that we are watching very closely is to do with offshoring and increasing FDIs, because the recent trends that we are seeing is that FDIs into China is coming up. It's actually getting in a bit of a, I wouldn't say a bad shape, but, you know, flows have not been going into China as much. So, a lot of these FDI flows, in fact, have been coming into Asia. Companies are rethinking their supply chains. They are keeping operations for China within China while trying to move some of the operations there for more global or Asia in nature out of China. So, we are seeing rising FDIs into Malaysia, Vietnam, Thailand, India, Indonesia. So, these are some of the countries that are going to benefit and are benefiting from that re-jig in supply chains. Now, that said, these countries are still small, you know, in size when you compare them to China. And therefore, they simply cannot replace China operations. So, I would feel that there is going, there is this re-jig in supply chain operations, but not a full cut off or cut away from Chinese operations totally. So, it's like juggling between two different worlds altogether, China and something that's out of China.

Katie Klingensmith [00:10:03] Carol, you mentioned that we see opportunities in the Japanese yen. Can you give us an update on what's going on with the Japanese economy and monetary policy?

Carol Lye [00:10:12] Right. So, with Japan's increasingly, you know, interest getting even more interesting, I think, you know, there are various signs, which are showing us the way that the BOJ is moving much quicker towards normalizing out of negative interest rates. You know, I think most analysts have been putting, you know, removing negative interest rates to like, you know, more towards the end of next year. And in fact, some are saying, you know, 2025. But if you read their recent monetary policy meeting minutes, it's getting very much evidently clear that a lot, I think half of the board members, are getting more comfortable with inflation. They see the side effects of such easy monetary policy, such big effects of negative interest rates. So, what they are starting to swing towards is actually to start removing not just, you know, the entire removal of YCC, or yield curve control, but also to start thinking about removing negative interest rate policy. So, and if that does happen, that is definitely, I would say, the biggest regime change because, you know, you basically have, you know, Japan has been in that negative interest rate policy since I think it was 2015. So, that's like a full seven years that they have been invaded there. And once that moves, it's not just the interest rate that will move, but also the currency. It will really start to move a couple of things. And I really see the signs that they are going to start quickening that pace going forward. I mean, if you look at the yen and where it is now, it's at 151, right? And it's just generating a lot of imported inflation for them. So, eventually we'll have to do something. And I think we're getting closer and closer to something happening on that front.

Katie Klingensmith [00:12:20] Just to follow up, Carol, and we've talked about how there is a lot of economic momentum in Japan. You just noted that the Bank of Japan is moving more quickly than even we anticipated. Why is the yen weaker and weaker?

Carol Lye [00:12:33] The main thing is really to do with the U.S. side, where rates have just been at a higher level compared to Japan. And you know, it's just not helping the yen. But, like I said, going forward what is really needed to move the yen are just two things, right? Basically, it will just be U.S. policy, interest rate policy. And if Japan's starts to really move out of the negative interest rate policy and thereby reinforcing some expectations of higher interest rates going forward in Japan. And of course, if we continue to see growth picking up more strongly for Japan, that will really help the yen going forward.

Unfortunately, you know, this year has not been a year for the yen. Perhaps it might be next year.

Katie Klingensmith [00:13:17] You highlighted that there could be opportunities in the currency front in Japan, but that generally speaking, Asian bonds are less attractive right now. What are the other big trends driving Asian currency markets?

Carol Lye [00:13:32] Basically, just, you know, currencies are just really about interest rate differentials and growth differentials. So, interest rate differentials this year have just been more about the U.S. And the latest, you know, CPI print out of the U.S., obviously, in addition to higher unemployment rate, simply starting to point us in the direction that hikes are at peak. So, there is a case for a weaker U.S. dollar going forward from here on growth differentials. Now, China's growth has been, you know, as we talked about earlier, it has been disappointing over the past two quarters. But with the fiscal stimulus and potential inventory restocking, there is the evidence that points to some stabilization from here. So, that helps to really put a bottom into some of the weak, into weak rest of the world currencies. Now within Asia, because currencies are, again, lower yielding, we are much more focused on a selected few currencies. So, Australian dollar is one which has, you know, typically benefits from China stabilization. It has also decoupled from yield differentials. So, that's one of the currencies that we find attractive. The other two currencies that are attractive and really speaks to what we are talking about in terms of the macro theme of the rejigging of FDIs is really the Malaysian dollar and Korean won. These are currencies that have value. It benefits from China's stabilization, medium term there's the reshoring of FDIs that help. And in the near-term as well, there's a bottoming out in the Asian electronics cycle. So, that really helps those currencies.

Katie Klingensmith [00:15:12] Alright, so, it sounds like there's some select opportunities, both on the bond side, but maybe even more upcoming in the currency side. What do you think are the big risks for the region?

Carol Lye [00:15:22] Well, really just two risks. I think that the two risks ahead for China, the first is that if we get a rerun again with U.S. exceptionalism, where, you know, U.S. growth is stellar. It continues to pound ahead. Now, this is going to cause a problem for lower-yielding countries and currencies in Asia, because if you rewind back to about two months, three months ago, a lot of these Asian currencies, or sorry, countries, they were forced to either hold on to their rates or even hike rate, for example, in Indonesia and Philippines. So, if we get exceptional growth again because of their yield differentials, so these countries will, you know, currencies will not perform as well. Now the second biggest risk is to do with China's growth. If it doesn't stabilize and in fact, it continues to weaken, that will definitely put a dent to global growth and global commodities. And just being China's neighbors, it's just not going to help our growth fundamentals as well. So, those are the two biggest risks.

Katie Klingensmith [00:16:28] Well, it still seems that a lot of the individual stories rest on what happens in China and in the U.S., so alas. We covered a lot of ground. I really appreciate that overview of much of what's going on in Asia. Thank you, Carol Lye, for being part of the Around the Curve conversation at Brandywine Global.