

Local currency bonds and liquidity are shaping Asia's fixed income future

Lucas Cacioli

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With yields elevated, currencies stabilising and liquidity improving, Asian local currency bonds are drawing greater attention as investors diversify away from dollar assets.



Asian local currency bonds are emerging as an increasingly important segment of global fixed income portfolios, as attractive yields, managed FX volatility and improving market access persuade investors to look beyond dollar-denominated assets.

While challenges remain around liquidity and regulatory infrastructure, managers believe the asset class is moving from a niche allocation to a strategic role.



Rong Ren Goh,
Eastspring Investments

"An Asian currency basket is roughly half as volatile as the USD index," said Rong Ren Goh, portfolio manager for fixed income at Eastspring Investments.

"Many Asian central banks actively manage volatility to support macro and financial market stability. This helps investors achieve better risk-adjusted returns."

CURRENCY CASE

Currency dynamics remain central to the appeal of local bonds, according to Marvin Kwong, portfolio manager for Asian fixed income at M&G Investments.

Asian currencies have weakened by about 20% against the dollar since 2011, even as the region posted stronger growth and healthier external balances, Kwong said.

“With fading US exceptionalism and the Fed expected to cut rates, there is considerable room for Asian currencies to catch up,” he said.



*Marvin Kwong,
M&G Investments*

The narrowing interest rate differentials favour Asia, according to Carol Lye, portfolio manager at Brandywine Global.



*Carol Lye,
Brandywine*

“Global interest rate differentials are likely to move in favour of Asia and emerging markets if the US moves towards cutting their interest rates,” she said. “This will drive the outperformance of Asian currencies and local currency bonds.”

Clifford Lau, portfolio manager at William Blair, said active strategies are key to balancing currency upside and volatility.

“We usually manage our volatility by setting up FX trades in pairs,” Lau said. “With the USD still looking on the rich side, and both nominal and real rates in Asia expected to become more attractive, we think there is good upside in Asia FX with volatility at the same time contained.”

Many local markets also offer compelling yield opportunities, according to the asset managers.

Indonesia and India represent some of these opportunities, where government bonds yield above 6% while currencies remain relatively stable due to proactive FX management, according to Goh at Eastspring.

“Combined with improving growth fundamentals, moderating inflation and stronger policy credibility, the investment case has become increasingly compelling,” he said.



*Clifford Lau,
William Blair*

SCALING ACCESS

Liquidity is often cited as a barrier to scaling allocations, but the managers say conditions are improving.

Local currency bond markets are expanding alongside economic growth and rising national wealth, Goh said.

“Policymakers have been steadily opening access to foreign investors, which over time improves liquidity and market depth,” he said. “Instead of waiting for these markets to fully mature, larger asset managers should build positions progressively and develop capabilities now.”

M&G's Kwong estimated that Asia's local currency government bond market stands at around \$20 trillion, with an additional \$1 trillion in USD credits.

"We consider access and liquidity of these markets to be generally good, especially for higher-rated ones," he said. However, Kwong added that investors need to be mindful of differences in market size, trading volumes, and index inclusion across the region.

Meanwhile, Lye cautioned that smaller Asian markets can still be difficult for large asset managers to access meaningfully.

"Liquidity is always a concern for large asset managers in terms of scaling allocations," she said. "Smaller Asian markets tend to have lower liquidity even in their sovereign bonds."

Diversification can also help address liquidity gaps, according to Lau at William Blair.

"We invest in local markets via supranationals and frontier markets as a source of diversification," he said. "We consider that some of these markets are more liquid than generally expected."

POLICY SHIFTS

Regulatory developments are also shaping the outlook for local currency debt, according to Gordon Ip, chief investment officer for fixed income at Value Partners, who said Chinese authorities have taken steps to expand offshore access.



Gordon Ip,
Value Partners

"Chinese regulators have become more open to expanding offshore investment quotas, and the recent relaxation of the Southbound Bond Connect is a notable example," he said.

Ip added that the CNH market is attracting more interest as investors seek diversification.

"More attention should be placed on making offshore RMB funding more efficient, boosting secondary market activity, and developing hedging instruments," he said. "This can be achieved through enhancements to the offshore repo market and broader risk management tools."

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