Economics

DBS Flash

Introducing the Asia Rates Valuation Indicator

Group Research

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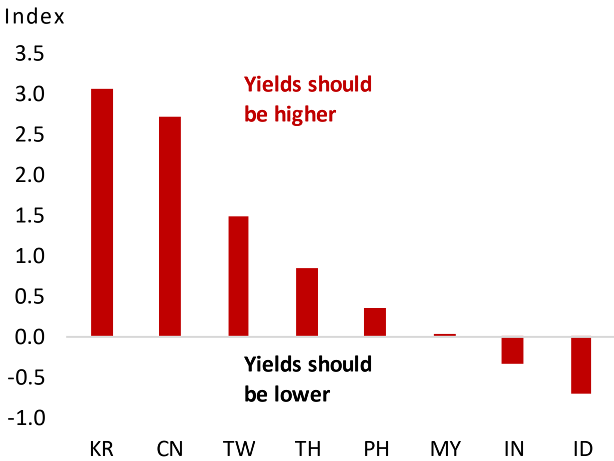
- The Asia rates valuation indicator (ARVI) provides a standardised way to evaluate rates from a macro standpoint
- A divergence between the indicator and where the market is trading at could point to over/undervaluation in rates
- The indicator suggests that Korea and China yields may be too low. On the other end of the spectrum, India and Indonesia yields may be too high
- This indicator is not meant for timing purposes. Technical indicators fare much better
- This indicator should be complemented with deeper analysis into the intricacies of each market

Introducing the ARVI

In this piece, we introduce our Asia rates valuation indicator (ARVI) and have a quick look to see where the market currently stands. **The ARVI is a way to standardize how we view Asia rates relative to USD rates from a macro standpoint.** The construction of this indicator takes into account inputs such as inflation, current account and policy rates (an elaboration of the ARVI is at the back) and compared with the 10Y local yield premium Asia has over the US. Intuitively, we are saying that higher inflation and higher external funding needs in Asia will need to be offset by higher nominal yields. If there is a divergence between the market and fundamentals, the indicator then suggests that bonds may be over/undervalued.

Asia: Gap to Indicator



Source: Bloomberg, DBS transformation

Uses of the indicator

-Provide a standardised and systematic way to assess Asia local currency bonds

-Provide guidance on whether Asia bonds are over/undervalued based on current economic fundamentals. This can be forward looking if macro forecasts are inputted

-In principle, the indicator acts somewhat like the price/earnings ratio for the stock market

Limitations of the indicator

- The indicator only considers the past five years of data. This means that the extremes of the Global financial crisis are not taken into account
- The indicator does not provide cues for market timing. Technical indicators are much better for those. Markets can stay over/undervalued for extended periods
- By construction, the indicator does not consider selected risks such as politics, market sentiment, liquidity conditions and other factors that may explain why Asia rates are where they are

Where do we stand now?

We have applied this indicator to the markets that we cover (Singapore and Hong Kong rates are excluded as they track US rates closely) and find that yields are probably too low in Korea and China and somewhat too high in India and Indonesia.

We broadly agree with what the indicator is suggesting. KTBs have been remarkably resilient despite turbulence in the global bond markets. Foreign investors have taken to KTBs amid a somewhat dovish central bank, contained inflation, favourable basis swaps and easing tensions with North Korea. However, at current levels, KTB yields look somewhat too low. Similarly, China govvies have performed well as the authorities took defensive steps (easing monetary policy) amid the ongoing trade war with China. However, with outflow pressures much more muted this time round despite a weaker RMB, onshore (and offshore) interest rates have stayed low. The inclusion of China onshore bonds to the Bloomberg Barclays Global Aggregate Index (phased in over 20 months starting April 2019) is an additional tailwind. At current levels, most of the good news is probably already reflected in the bond prices.

On the other end of the spectrum, Indonesia and India government bonds look undervalued. Yields in these two economies have risen significantly since the start of the year as the carry environment unwound. In both cases, their respective central banks have already taken active steps (hike rates, take steps to stabilise currency, implement other macro-prudential measures) instil confidence in the market. While the news narrative is still somewhat negative (trade war and EM fears linger), higher real rates will eventually be positive for local currency bonds. With valuations attractive, investors are likely waiting for positive catalysts before re-entering these markets again.

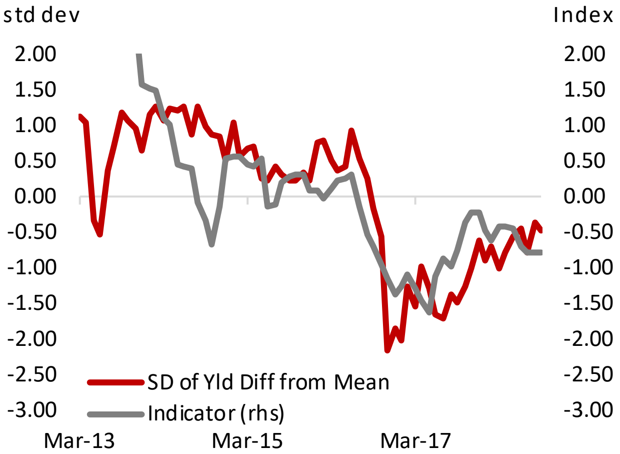
Methodology

-calculate and normalise the real 10Y yield differential with the US

-calculate and normalise the CPI (YoY) differential with the US less current account (as a % of GDP)

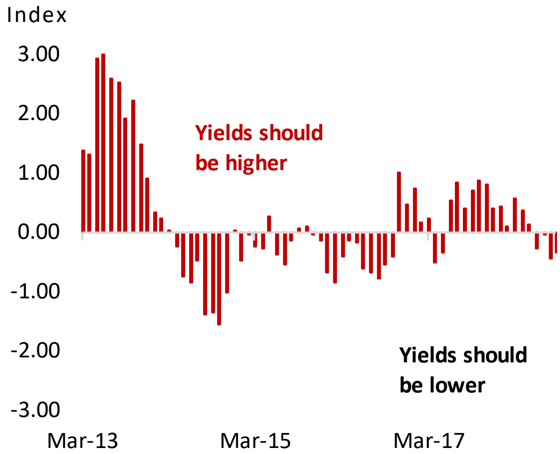
-The Gap to indicator is calculated as the difference in standard deviation between the above two steps

IN: Normalised 10Y yield differential vs US & Indicator



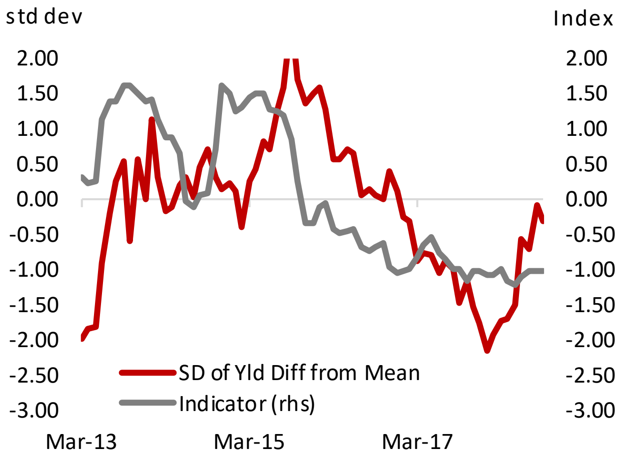
Source: Bloomberg, DBS transformation

IN: Std Dev Gap between Yld differential & Indicator



Source: Bloomberg, DBS transformation

ID: Normalised 10Y yield differential vs US & Indicator



Source: Bloomberg, DBS transformation

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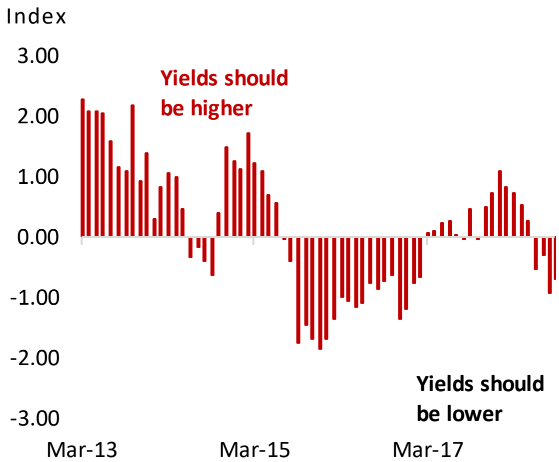
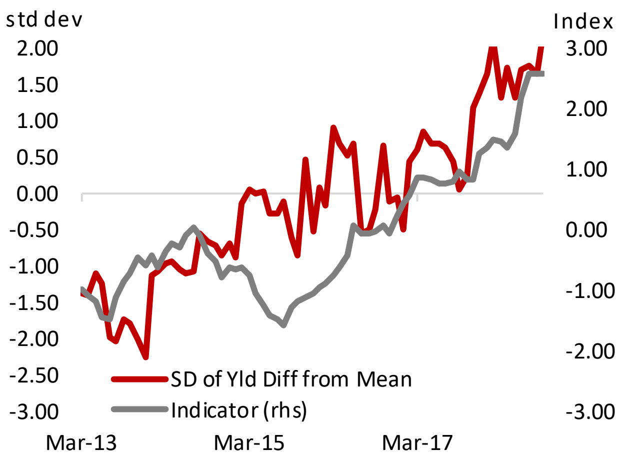


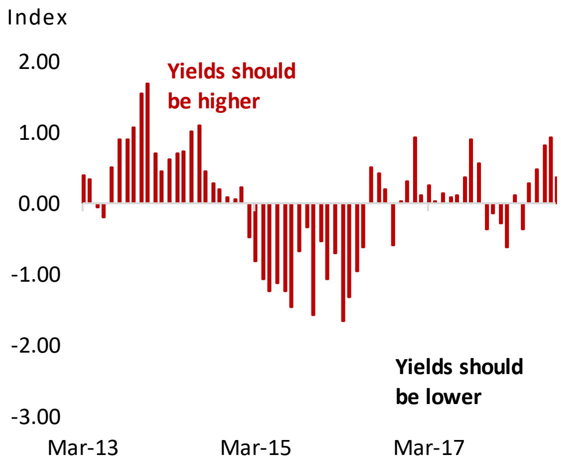
Source: Bloomberg, DBS transformation

PH: Normalised 10Y yield differential vs US & Indicator



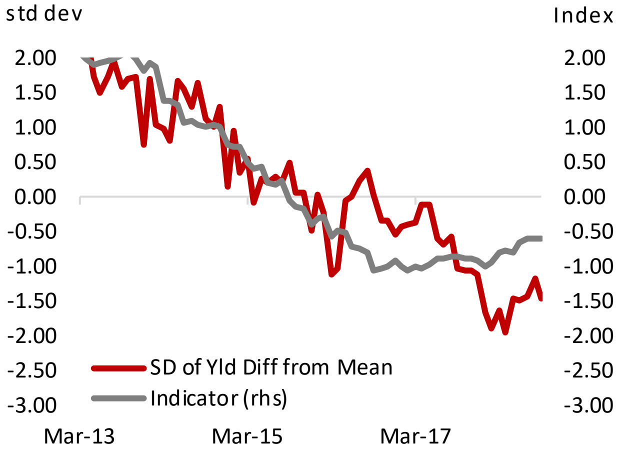
Source: Bloomberg, DBS transformation

PH: Std Dev Gap between Yld differential & Indicator



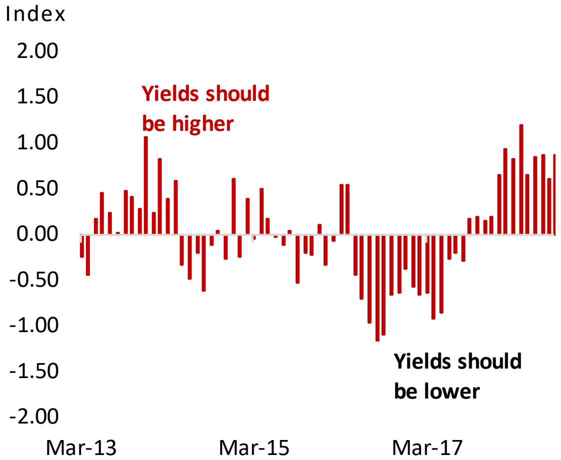
Source: Bloomberg, DBS transformation

TH: Normalised 10Y yield differential vs US & Indicator



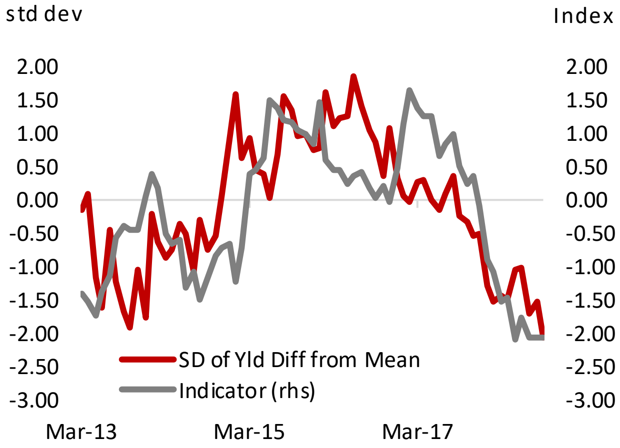
Source: Bloomberg, DBS transformation

TH: Std Dev Gap between Yld differential & Indicator



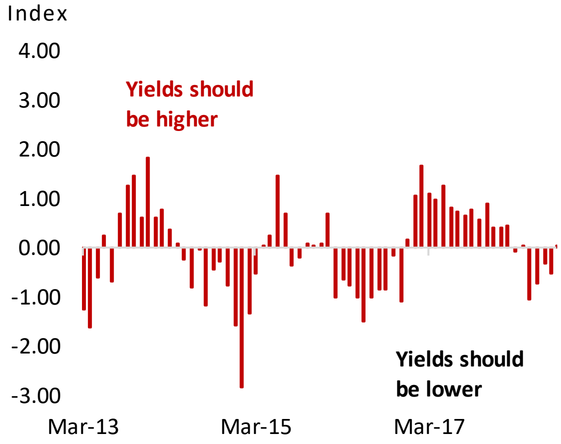
Source: Bloomberg, DBS transformation

MY: Normalised 10Y yield differential vs US & Indicator



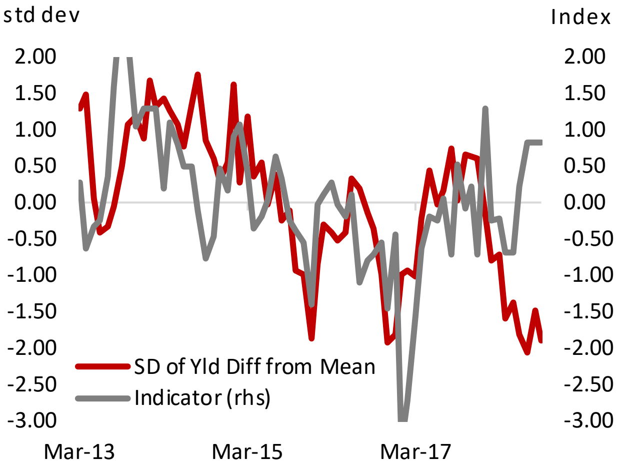
Source: Bloomberg, DBS transformation

MY: Std Dev Gap between Yld differential & Indicator



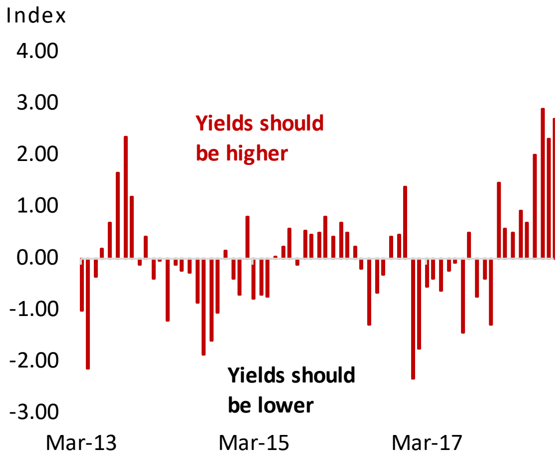
Source: Bloomberg, DBS transformation

CN: Normalised 10Y yield differential vs US & Indicator



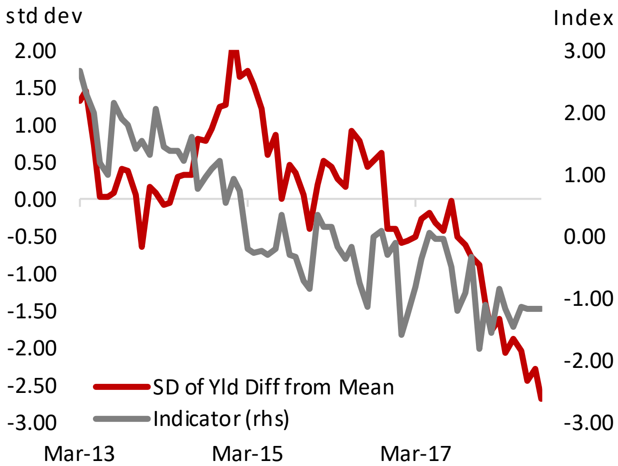
Source: Bloomberg, DBS transformation

CN: Std Dev Gap between Yld differential & Indicator



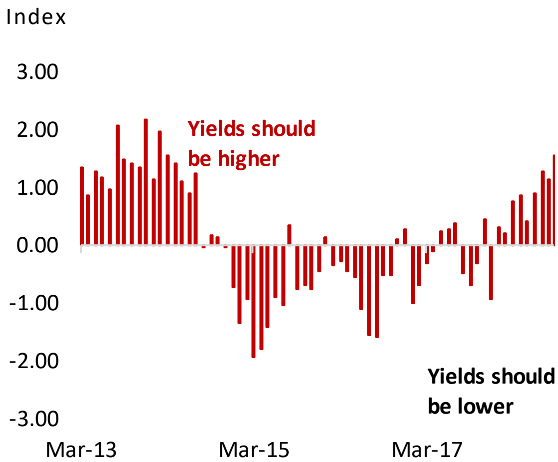
Source: Bloomberg, DBS transformation

TW: Normalised 10Y yield differential vs US & Indicator



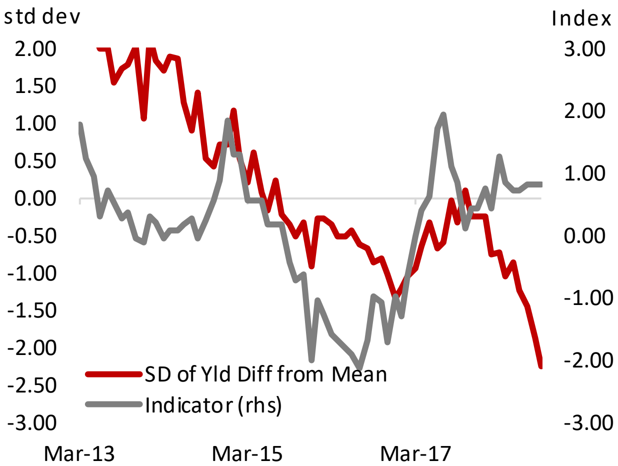
Source: Bloomberg, DBS transformation

TW: Std Dev Gap between Yld differential & Indicator



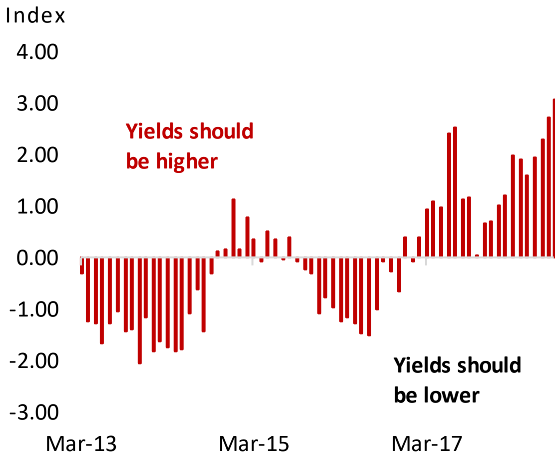
Source: Bloomberg, DBS transformation

KR: Normalised 10Y yield differential vs US & Indicator



Source: Bloomberg, DBS transformation

KR: Std Dev Gap between Yld differential & Indicator



Source: Bloomberg, DBS transformation

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).