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Doug Hodge Discusses Asian Investment Trends and Strategies



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Mr. Hodge oversees all aspects of PIMCO's business across the Asia Pacific region. Located in Tokyo, Mr. Hodge has senior management responsibility for PIMCO's four Asia Pacific offices, in Tokyo, Hong Kong, Singapore and Sydney. Mr. Hodge also served on the PIMCO Executive Committee, responsible for setting firm-wide business strategy and policy. Previously, Mr. Hodge was a senior account manager responsible for client relationships worldwide and a global product manager. Mr. Hodge joined PIMCO in 1989, formerly having been associated with Salomon Brothers where he was a global fixed income trader. He has twenty-two years of investment experience, and holds a bachelor's degree in economics from Dartmouth and an MBA from the Harvard Business School.

PIMCO Managing Director Doug Hodge oversees all aspects of the firm's business across the Asia Pacific region. In the interview below, Mr. Hodge discusses the possible impact on Asian economies from a slowdown in the U.S. and how it affects investors in the region.

Q: Since you last spoke to us in September, global financial markets have faced a contagion from the U.S. subprime mortgage problem. How has the economic outlook changed in Asia?

Hodge: One large question now is whether the global economy can continue on its course of decoupling from the faltering U.S. economy. There are some signs of "re-coupling," with financial market linkages causing equity markets around the globe to tumble. With the U.S. economy looking increasingly recessionary, we must ask ourselves how it will impact Asia. Will aggregate demand in Asia be large enough to compensate for a drop in U.S. consumption?

So far, the answer is mixed. Consumption in Asia has grown over recent years, along with the region's double-digit economic expansion, in what we believe is a long-term secular trend. But since the U.S. represents roughly 25% of global consumption, shrinking U.S. demand will inevitably impact Asia. But it may take time before this impact is felt at a macroeconomic level.

Recent statistics illustrate the lag between the U.S. weakness and its effect on Asia. The U.S. has run a current account deficit for more than 20 years. This means that Americans consume more than they produce and borrow money abroad to finance those purchases. If you look exclusively at trade data, you will see that the U.S. net export contribution to real GDP has turned positive in the second half of 2006, suggesting the U.S. is no longer a net consumer but a net exporter. But despite the world's biggest consumer becoming a net exporter, Asian exports haven't slowed. This suggests that the impact is not yet being felt in Asian economies. This is in contrast to the situation in 2001, when Asian export growth dropped suddenly and sharply shortly after the U.S. economy weakened.

While some impact on Asia from slower U.S. consumption seems inevitable eventually, we expect it to be smaller than it was a decade ago. Asian states have changed drastically since the IMF salvaged them ten years ago from a region-wide financial crisis. They have moved from deficits to surpluses, and contribute

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significantly to overall consumption and capital in local and global markets. Based on purchasing power parity, Asian economies have grown 200% since 1997. The tables have turned, which leads us to expect more resilience to a U.S. slowdown and could also explain the delayed reaction in statistical data.

Q: What can Asian countries do to limit the impact from the slowing U.S. economy?

Hodge: There are three tools Asian policymakers will use to help mitigate the effects of a slowing U.S. economy: currency adjustments, monetary stimulus and fiscal stimulus.

Currency adjustments are already in use. In Asia, we are seeing greater flexibility and currency appreciation, though the pace is still largely dictated by China and, to a lesser extent, the oil-producing Gulf states. There will be continued pressure, especially on China, to allow an accelerated pace of currency appreciation.

As for the other tools, we haven't seen much yet in the way of interest rate cuts or fiscal stimulus in Asia, mostly because Asian economies haven't slowed very much. However, there is scope for fiscal policy to have a significant effect because most Asian governments, with the exception of Japan, have healthy fiscal positions which give them a range of fiscal policy options.

Q: How is the current economic environment affecting bond markets in Asia?

Hodge: With the U.S. already in a significant economic slowdown, we are starting to see a turning point in the Asian region's cycle as well, led by Japan. In the U.S., slowing growth, monetary easing, and interest rate cuts have all spurred bond price appreciation. Now we're starting to witness the same phenomenon in Japan. Growth expectations have been revised downward, short-term interest rates have fallen, and the yield curve has steepened. These trends lead to potential capital gains in properly positioned bond portfolios.

The cyclical turning point seen in the U.S. and now Japan hasn't been felt strongly yet in other Asian markets, but we expect it will become more prominent over time. As Asian currencies appreciate, inflationary pressures through much of Asia should be alleviated. Combined with somewhat weaker growth in Asia as a result of the U.S. slowdown, the scenario should allow interest rates to fall. This should be supportive for bonds.

Q: Are Asian investors positioning themselves to benefit from lower rates in Asia?

Hodge: We haven't necessarily seen investors repositioning like we do in the U.S. and Europe. This is mostly the result of an overall lack of a bond investment culture in Asia.

When economic conditions sour and market volatility increases, investors typically flock to safe havens like bond markets. But traditionally the Asian investor simply moves back and forth between cash and equities. While there is typically broad participation in equity rallies, Asian investors tend to pull out completely when risks in the market increase.

In many Asian countries, there is little incentive in terms of yield premium over cash to stick a toe in the water and go for bonds instead of cash. A U.S. investor, for example, would typically demand a yield differential of 100 to 200 basis points,

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depending on the risk, to switch from cash into bonds. Many Asian bond markets do not offer such premiums. Cash rates are generally high across Asia but term premiums are not because Asian yield curves are relatively flat. For example, in India, while the bank rate is at 6%, the repo rate is 7.75% and the 10-year rate is roughly 8%. In Australia, we have an inverted yield curve with the policy cash rate at 7.25% and the 10-year yield below that rate, just over 6%. A notable exception is Japan, which, along with the U.S., currently has one of the world's steepest yield curves.

In an environment like this, there is little incentive for local Asian investors to invest in bonds, but this could gradually change. The economic slowdown across the world will likely encourage central banks to start cutting interest rates, leading to lower cash rates while currencies appreciate and put downward pressure on inflation. At the same time, investors in Asia might realize that equities aren't going to rise by 20% to 100% annually like they have in the past. Investors might then find that bonds can offer relatively attractive returns and also offer attractive returns versus cash.

Q: Are some Asian investors more likely than others to discover the potential of bonds?

Hodge: The first place we'll see that development of a more bond-oriented culture will probably be in Japan. From past experience, Japanese investors are relatively quick to give up on equities when markets sour. Japan also offers attractive yield premiums since the yield curve in Japan is one of the steepest in the world. So at this point, there is more of an incentive for Japanese than for other Asian investors.

In addition, there is psychology at work that would point to Japan being a frontrunner in the region. Investors in many high-growth Asian countries see the looming slowdown only as a temporary pause in the extraordinary secular growth cycle. Japan doesn't have that view as its growth has already stabilized.

Apart from local demand for bonds, we should also look at supply. The Asian growth cycle may slow a bit, but there will still be demand for capital as growth continues, even if it is at a slower pace. The Asian economies, by all probabilities, will not fall into recession, but equity market conditions are likely to weaken. If the equity markets prove to be a difficult source of capital, Asian companies will increasingly turn to the debt markets as they mature. Historically, Asian companies have been borrowing from banks and they still do. But we've been seeing more and more companies that come to the debt markets as they become more familiar and comfortable with issuing bonds. I expect this trend to continue.

Q: With the potential for more local demand and supply, do you also see continued foreign demand for Asian bonds denominated in local currencies?

Hodge: Foreign demand for Asian bonds is definitely there. As the world woke up to the fact that the U.S. dollar is falling and that Asian currencies are appreciating, Asian local currency investments are becoming more appealing. At the same time the Asian growth outlook appears more stable going forward than that of the U.S. or Europe. U.S. growth is likely to trend around 2-3%, whereas the trend line growth in Asian and emerging countries is likely to be around 8-10%. Foreign investors will probably prefer those Asian countries that have more solid growth foundations and more stable political structure because they are less risky.

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All things being equal, Asian bonds are likely to offer a higher real rate of return compared to developed markets such as the U.S., while Asian currencies are going to appreciate. These are convincing arguments for holding Asian bonds as they will likely be better returning investments than developed country alternatives.

Q: Thank you, Doug.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed.

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