2025 Midyear Investment Outlook – Asia Fixed Income: Emerging Markets

May 2025

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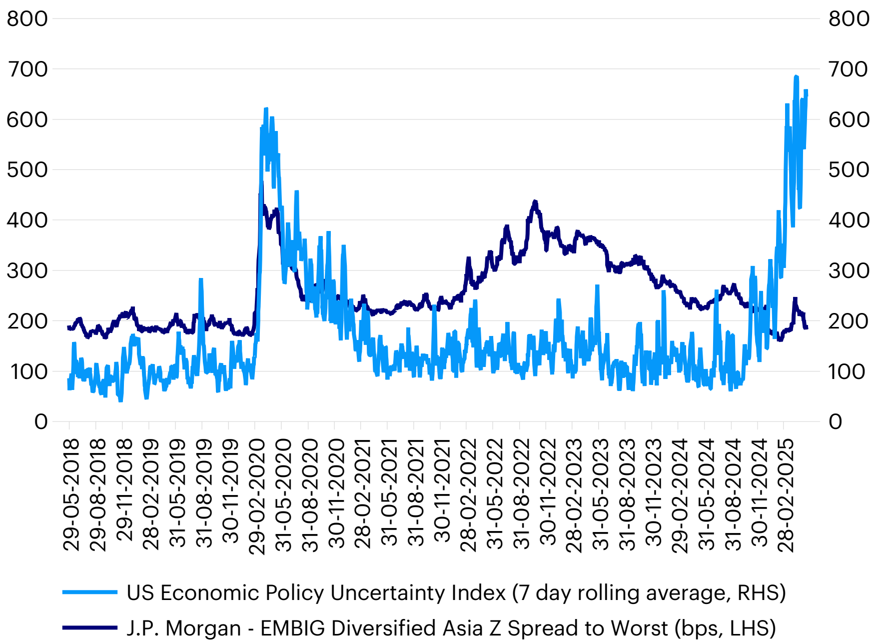
While the market volatility in Asian hard currency and local currency sovereign bonds in April 2025 was significant, the selloff didn't last long, and recovery was swift and strong. By mid-May 2025, Asia hard currency sovereign and quasi-sovereigns saw their spreads return to late March levels, which were close to the tightest seen over the past five years (Figure 1).

There are some merits in the current market pricing of Asia emerging market (EM) credit fundamentals, as the Chinese government among other Asian governments has already rolled out more domestic stimulus policies to pre-empt potential downside shocks from the trade fallout. Local Asian central banks have also not shied away from enacting easing monetary policies. These policy tailwinds along with still robust economic fundamentals in the region provide good justification for the relatively tight credit spreads.

However, we believe that recent geopolitical developments have led to a rise in market risk levels. Although the tariff rates announced on "Liberation Day" have largely been pushed back by another three months, global investment spending has already and will continue to be impacted negatively. We are seeing signs of slower growth in the US and expect the Federal Reserve (Fed) to be stuck between managing lower growth and higher inflation in the coming quarters. We will only get more clarity on how each local Asian economy has been doing after the initial tariff shock wears off and backward-looking data gets released in the coming months. We have a high conviction that the data will be softer.

Figure 1: Asia credit spreads and US economic policy uncertainty index (May 2018 - May 2025)

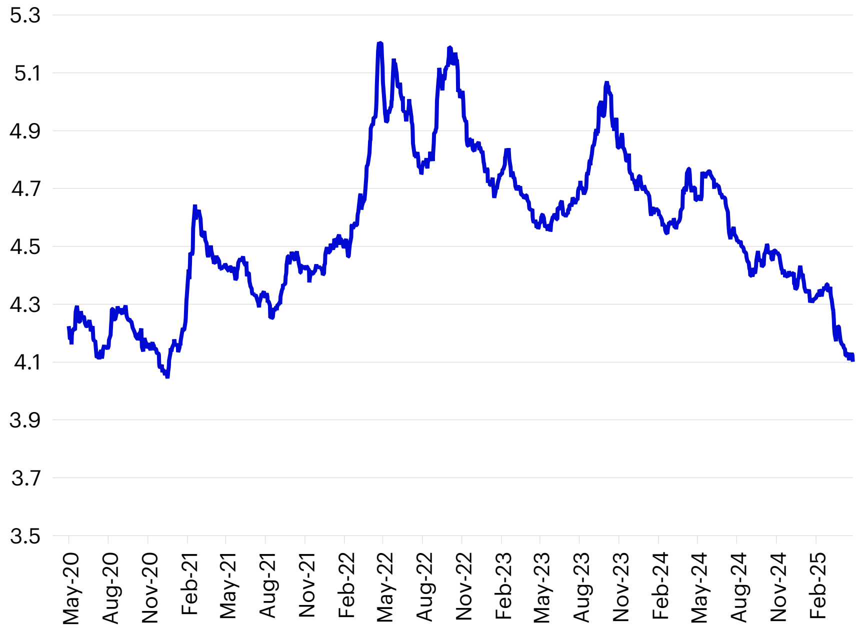


Source: Bloomberg, Invesco. Data as of 19 May 2025.
Note: EMBIG refers to Emerging Markets Bond Index Global.

We remain cautious given the current divergence between Asia credit spreads and US policy uncertainty (Figure 1) and are therefore more risk averse when considering Asia hard currency sovereign and quasi-sovereign bonds.

Valuations in Asia local currency government bonds have been tight, and we have observed lower nominal yield levels in recent years. The J.P. Morgan GBI-EM Broad Diversified Asia Yield to Maturity has reached the tightest levels since Q1 2021 (Figure 2). Considering the index included Indian government bonds that are in general yielding higher than most other constituent countries in 2024, the like for like comparison may show even tighter valuations.

Figure 2: J.P.Morgan GBI-EM Broad Diversified Asia Yield to Maturity (% p.a.) (May 2020 – May 2025)



Source: Bloomberg. Data as of 19 May 2025. Note: GBI-EM refers to Government Bond Index – Emerging Markets.

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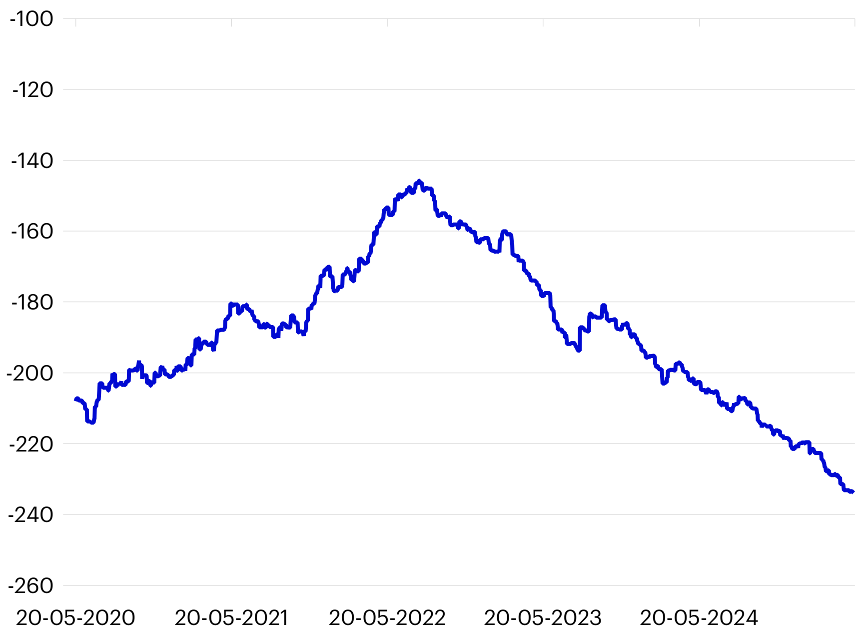
We are positive on Asia local currency bonds despite the lower yield levels as we believe other fundamental and technical factors continue to support the performance of these bonds, both in terms of bond prices as well as foreign exchange rates.

We have observed lower inflation in several major Asia EM countries (Figure 3). While the higher tariff rates impose inflationary pressures on the US, they will work to push down inflation numbers in export-oriented countries.

As inflation is anticipated to be less of a risk for Asian markets, we expect that local central banks will not have significant concerns with keeping monetary policy loose so long as the country's economic growth faces headwinds.

Figure 3: HSBC Pan-Asia Inflation Surprise Index (May 2020 – May 2025)



Source: Bloomberg, HSBC research. Data as of 19 May 2025. Note: This index tracks the degree to which inflation data in Asia has been coming in higher or lower than expectations. The indices cumulate standardized surprises in scheduled inflation data releases. A positive trend to the index indicates that inflation data has been coming in, on average, higher than expected. A negative trend in the index indicates that inflation data has been coming in lower than expected. Data is included from the following countries/regions: Hong Kong, China, Taiwan, South Korea, Malaysia, Singapore, Philippines, Thailand, India, Indonesia.

Apart from fundamental factors such as lower rates and lower inflation supporting Asian local government bonds, technical factors may benefit this asset class as well. We continue to see local buyers looking to add exposure since government bonds are seen as risk-free securities in the local markets. The growth of middle-class households in Asia markets also continues to foster investment demand.

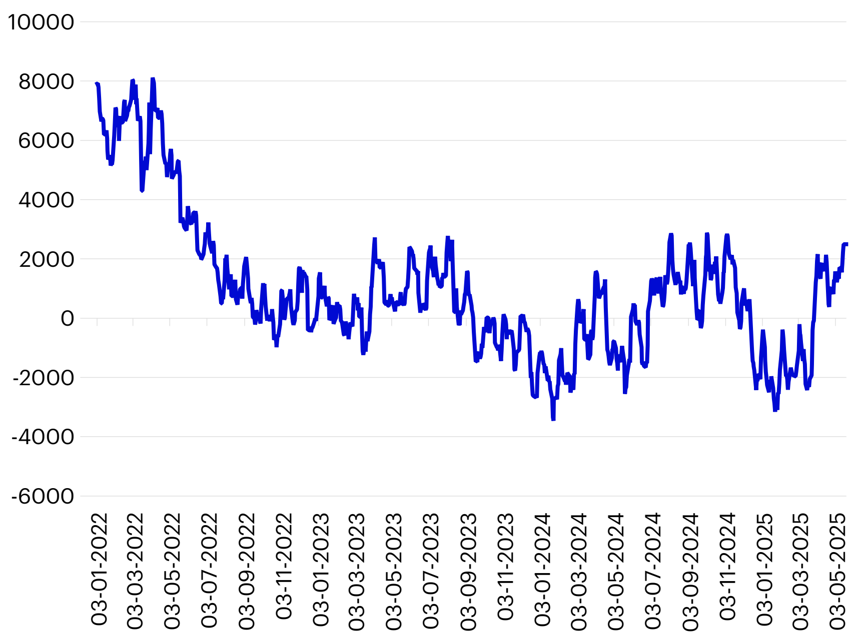
On the currency front, we have seen US dollar strength fading in Q1 2025 and we believe the dollar index will continue to come under pressure. With policy uncertainty and potential recession risks in the US, we expect the de-dollarization trend to benefit some Asia local currency bond markets as well.

Combining our optimistic outlook on both bond prices and exchange rates, we are more positive on Asia EM local currency bonds over hard currency. One example is the Indian rupee denominated bond market. The Reserve Bank of India (RBI) has started cutting its policy rate since February 2025 and will likely continue in 2H 2025 as low inflation is expected to keep real interest rates at high levels.

The RBI conducted open market operations in recent months when interbank liquidity was tight to ensure a liquidity surplus so that the eased monetary policies could translate into the real economy (Figure 4). On the exchange rate, we believe the weaker US dollar will provide room for the Indian rupee to perform well along with other Asian currencies.

Among Asia EM, we think India will be one of the least impacted countries from the potential tariff headwinds. Although the Markit iBoxx ALBI India Index has already returned around 6% YTD till mid-May 2025,[1] we continue to be bullish on the asset class and expect positive performance going forward.

Figure 4: Net liquidity surplus or deficit (INR bn) (January 2022- May 2025)



Source: JPM, Bloomberg. Data as of 20 May 2025.

1. Source: Bloomberg, data as of May 2025. For illustrative purposes only. An investment cannot be made directly into an index.

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