eastspring investments

A member of Prudential plc (UK)

INSIGHTS

January 2013

Are bonds in trouble?...We think not.

In recent months, improvements in the Chinese and US economic data coupled with the passage of the fiscal cliff bill on 2 Jan, have triggered wide-spread optimism that the US economy is recovering. The more bullish sentiment has led to rising worries that interest rates would increase significantly in 2013, leading to capital losses on bonds. But we think these concerns are too premature. Read on.

Macro picture looking rosier than a year ago

There is more certainty that China is not heading towards a hard landing. The previously-moribund US housing market is showing signs of recovery while the unemployment rate has been decreasing. A series of policy measures, including the latest bond-buying scheme has alleviated default fears by Eurozone nations.

Yet, many challenges still remain for the global economy; US growth remains sluggish, Eurozone continues to contract, while China is entering a slower growth era as the economy matures and growth drivers rebalance from exports to domestic consumption. Furthermore, upcoming event risks i.e. polls in Germany and Italy and the US debt ceiling are likely to challenge the current bullish sentiment.

Sub-trend US growth suggests rates to remain range-bound in 2013

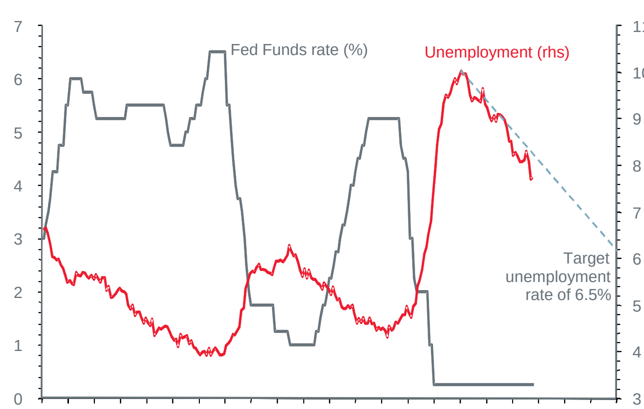
In fact, the effects of the 2008 Global Financial Crisis, branded as the most severe recession since the 1930s Great Depression, still linger. While aggressive policy measures back then helped to prevent a more prolonged downturn, growth has remained sluggish. Today, following three rounds of quantitative easing and other policy measures, US growth remains below-trend and expected to remain so in 2013.

Equally, the US government has chalked up huge amounts of debt through these measures, which has not even begun to be unwound unless the next round of fiscal cliff negotiation in March results in substantial spending cuts by the government.

This fragile state of growth has prompted the US Federal Reserve to guide that short-term rates will remain very low as long as the unemployment rate remains above 6.5% and inflation is projected to be not more than 0.5% above its 2% longer-run goal for the next 1-2 years.

Judging from the still-high level of unemployment rate of 7.7% and the pressing need to bring down government debt levels, the fundamental picture of the US remains soft and the likelihood of aggressive policy rate increases in the next two years remain low. Against this backdrop, we hold the view that US interest rates would remain range-bound in 2013.

Chart 1 : Unemployment rates in US remain elevated



Source : US Federal Reserve Board and the US Bureau of Labor Statistics from DataStream as at 29 Nov 2012. Note that past performance is not an indicator of either present or future performance. Any views expressed above may alter with out notification.

Back to basics : Benefits of investing in bonds

Instead of focusing on the interest rate forecasts (which is inherently difficult to do particularly given the heavy intervention of policy makers in current environment), we should remind ourselves of the characteristics of bonds as a tool to provide investors with a source of steady growth over time.

While bond prices are subject to risks of interest rates rising, volatility from investing in bonds is generally still much lower than equities. It is also important to remember that a rise in rates would ultimately mean higher coupon reinvestment for investors from new bond issues despite suffering short-term losses on existing bonds.

For corporate bonds, the potential capital loss from interest rate increases would at least be offset in part by the higher coupon rates compared to government bonds, as well as potential credit spread tightening as investors feel more confident about the macro environment and corporate profitability.

Asian bonds provide an attractive income option

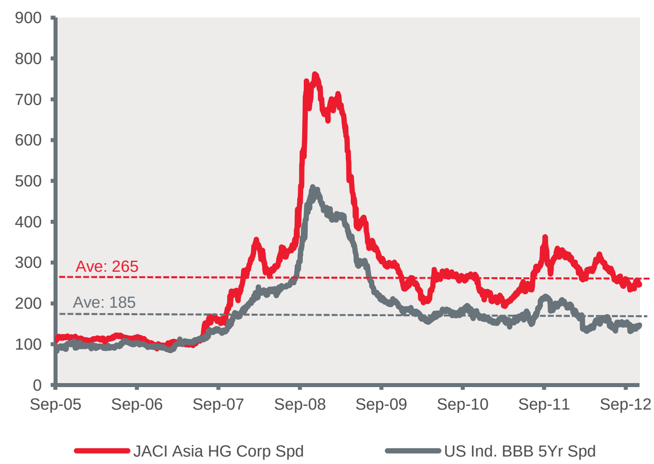
Asian bonds continue to provide investors with more attractive yields compared to developed market bonds, while fundamentals of Asian economies and corporates remain relatively sound.

Although bond valuations of Asian USD-denominated bonds are not considered cheap at current juncture, credit spreads (i.e. the risk premium relative to government bonds) are still above their lows, reflecting room for potential spread compression, which could support bond prices and mitigate the impact from the potential modest increases in US risk-free rates.

Similarly for the Asian local currency bond markets, local government bonds still offer higher yield opportunities than that of developed government bonds. Unlike the developed markets, there remain markets where real interest rates are positive, notably in countries like, Malaysia and the Philippines.

The theme of Asian currency appreciation vis-a-vis the US dollar could also continue to play out given Asia's strong economic fundamentals; 2013 economic growth in Asia is forecast to be 6.6% versus the 1.9% in the US[1].

Chart 2 : Asian Investment Grade Corp Credit Spreads (bps)



Source: Bloomberg, 30 November 2012 ; The chart above is included for illustrative purposes only. Any projection or forecast is not necessarily indicative of the future or likely performance.

Asian bonds underpinned by strong inflows in recent years

The attractiveness of the Asian bonds, we believe, are also continuing to find ground among investors as reflected by the strong inflows into the Asian bond markets in the past years.

Looking into 2013, we expect continued technical support for Asian bonds given the persistently strong demand by institutional investors, such as insurance, central banks and sovereign wealth funds, as they diversify away from the lower-yielding fixed income holdings.

Structural shift of retail investors towards emerging and Asian bond markets could also continue given their current low allocation to this region and the on-going need to enhance yields for their fixed income portfolio in today's low interest rate environment.

Source : [1]Consensus Economics, Dec 2012

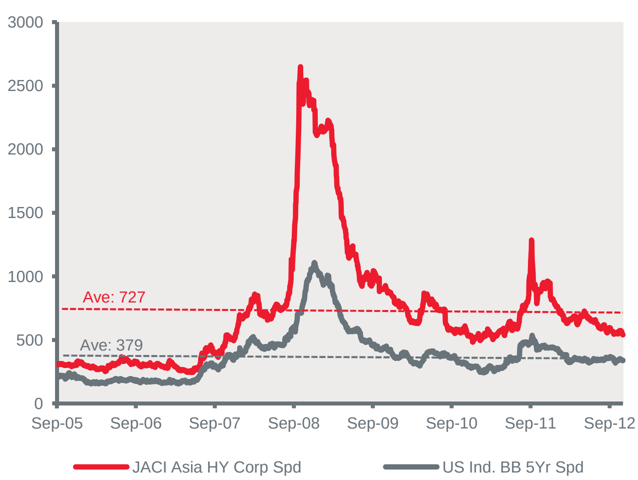
High yield bond investors are still being compensated reasonably

Interest rate movements have less of an impact on this asset class than investment grade credit since investors are compensated more for taking on additional credit risk.

While yields are at record low levels, they are a function of record low treasury yields. Spreads, however, are still near long-term average, while default rates remain low. One of the largest risk for high yields arises from refinancing risk which can trigger defaults.

But both in Asia and the US there is little need for high yield companies to refinance in 2013 given manageable maturity schedules and the amount of refinancing that has been done since the 2008 financial crisis. High yield companies have shored up their balance sheets and fundamentals remain intact.

Chart 3 : Asian High Yield Corporate Credit Spreads (bps)



Source: Bloomberg, 30 November 2012 ; The chart above is included for illustrative purposes only. Any projection or forecast is not necessarily indicative of the future or likely performance.

Bonds should be part of an investment portfolio

All said, we do acknowledge that interest rates globally have declined significantly over the past 3-5 years and that room for further capital appreciation could be more limited going forward. However, investors should keep in mind that as the global economy faces an extended period of fiscal consolidation and structural rebalancing, business cycles are in a "new normal" of lower average growth.

Therefore we believe that bonds should remain a part of a diversified investment portfolio. Not only does it provide a steady income source, the volatility from investing in bonds is much lower than equities.

The benefits of investing in bonds are best achieved over the longer-run rather than attempting to time the market. Both investment grades and high yields offer diversification within a broader investment portfolio, which is an important attribute in any given market cycle.

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