eastspring investments

A member of Prudential plc (UK)

INSIGHTS

May 2013

US high yield bonds continue to deliver attractive returns

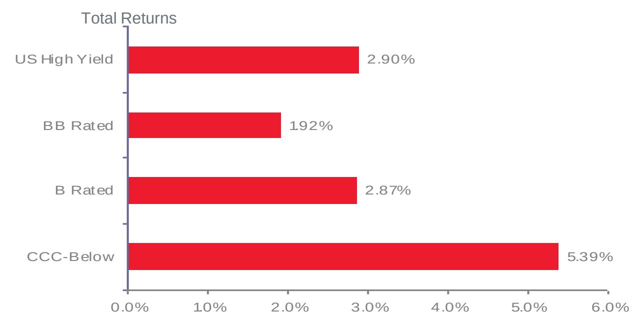
Q1. US high yield bonds have continued to deliver attractive returns in the first quarter of 2013 despite the heightened political risks in Europe. What has underpinned performance thus far?

High yield bonds have benefited from a few key dynamics in 2013, including the absence of "worst-case" outcomes related to the European debt crisis and US fiscal cliff, accommodative monetary policy and a slow-but-supportive level of underlying GDP growth.

The first of these factors – the avoidance of doomsday scenarios – has been made possible in part by the ECB's Open Monetary Transactions Program (OMT) introduced in 2012, which has significantly reduced the risk of financial system contagion, and in turn, allowed high yield bonds and many other risk asset classes to shrug off volatile headlines out of Europe. News during the quarter surrounding Cyprus's "bail-in" as well as other political dysfunction illustrated this point.

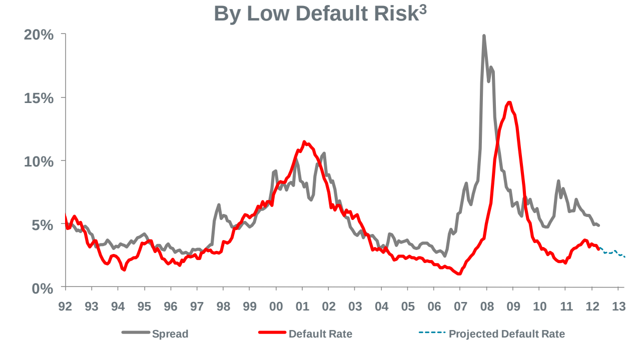
USD high yield bond yields continued to fall during most of the quarter. In fact, triple-C bonds delivered over 5% in total return during the three month period, while single-B and double-B bonds lagged at roughly 3% and 2%, respectively[1].

Chart 1: Triple-C Bonds Outperformed in 1Q2013[1]



Despite falling yields, the asset class has continued to attract flows, largely because it remains attractive from a relative perspective. With the US Fed and other central banks taking actions to hold down rates, investors continue to seek better yields than what is offered by higher quality bonds. Furthermore, the tradeoff between risk and reward has generally remained favorable, as demonstrated by low default rates and expectations. US high yield corporate default rates fell during the quarter from 3.4% to 3.0%, and Moody's expects the default rate to fall further over the next 12 months[2] .

Chart 2: Post- Crisis Tights in Credit Spreads Are Justified By Low Default Risk[3]

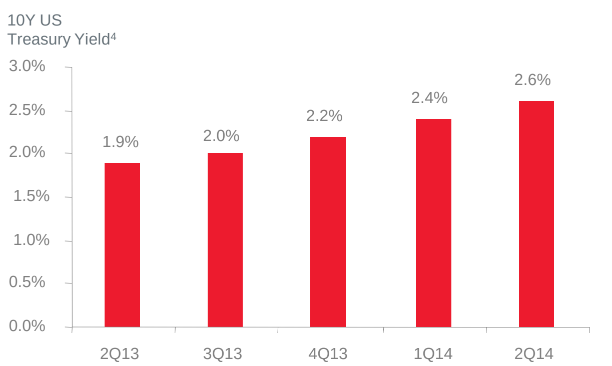


Source: PPM America and Eastspring Investments (Singapore) Limited.

Q2 High yields are certainly benefiting from the current low interest rate environment. But should rates start to rise, what will be the impact on this asset class?

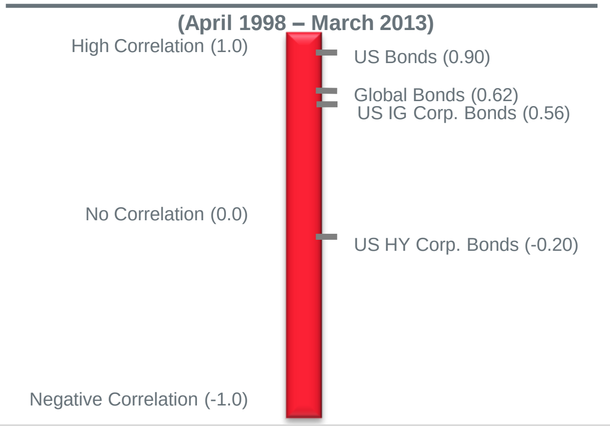
2013 has demonstrated that the outlook for rates remains very uncertain and that an imminent sharp rise is by no means a foregone conclusion. In the beginning of the year, market participants were focused on higher rates, largely because numerous tail risks had been removed through strong ECB financial support measures and US monetary and fiscal policy clarification. While 5Y and 10Y US Treasury rates did indeed trend higher in January amid improved sentiment, they reversed course in mid-February, ending the quarter largely unchanged. Consensus expectations currently call for interest rates to rise at a relatively gradual pace over the next year.

Chart 3: Interest rates forecast to rise gradually



Regardless of forecasts, high yields offer an attractive fixed income investment option for a rising interest rate environment. High yield performance has historically been much less impacted by interest rate movements than higher quality bonds; in fact, over the long-term, the asset class has a negative correlation to US Treasuries, being instead more vulnerable to credit risk.

Chart 4: High yields have a negative correlation to US Treasuries[5]



Q3 What is your outlook for US high yields for the rest of the year and how are you positioning your Fund (Eastspring Investments – US High Yield Bond Fund)?

The fund manager continues to expect high yields to produce a positive, albeit more modest, total return in 2013. Even though the asset class has reached record low yields, sound company fundamentals, a low default environment and supportive growth conditions limit downside risk. On the other hand, capital appreciation is considerably constrained at current valuations.

Given tight spread levels, the fund manager is taking a more cautious stance on portfolio risk. The Fund benefited from having a constructive tilt towards beta at the beginning of the year (with an over-weight to triple-C securities), which the fund manager has since paired down to reflect richer valuations and a tenuous global-macro environment. The Fund is currently maintaining a relatively neutral risk position from a top-down perspective, while concentrating on driving out-performance through individual bond selection.

Source : PPM America and Eastspring Investments (Singapore) Limited.

Source :

1 *BofA Merrill Lynch. Indicates the performance for each quality bucket listed within the BofA Merrill Lynch US High Yield Master II Index.*

2 *Moody's Monthly Default Report, March 2013.*

3 *BofA Merrill Lynch and Moody's as of 31 March 2013. "Spread" is the option adjusted spread of the BofA Merrill Lynch US High Yield Master II Index. "Default Rate" is Moody's weighted U.S. speculative grade default rate.*

4 *Bloomberg as of 10 May 2013, based on the weighted average forecast for the 10-year treasury rate and its implied yield as of the end of each of the quarters illustrated above.*

5 *Not drawn to scale. For illustrative purposes only. "US Treasuries" as measured by the Barclays US Treasury Index, "US Bonds" as measured by the Barclays US Aggregate Bond Index, "US IG Corp. Bonds" as measured by the Barclays US IG Corporate Bond Index, "US HY Corp. Bonds as measured by the BofA Merrill Lynch US HY Master II Index. "Global Bonds" as measured by the BofA Merrill Lynch Global Broad Market Index. Correlation results provided by Morningstar Direct using USD returns. Past performance does not guarantee future results. Please see the disclosure section at the end of this presentation for index descriptions.*

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