eastspring investments

A member of Prudential plc (UK)

INSIGHTS

May 2013

What's in store for US Corporate Bonds in 2013?

Q1. What is the outlook for US corporate bonds in 2013?

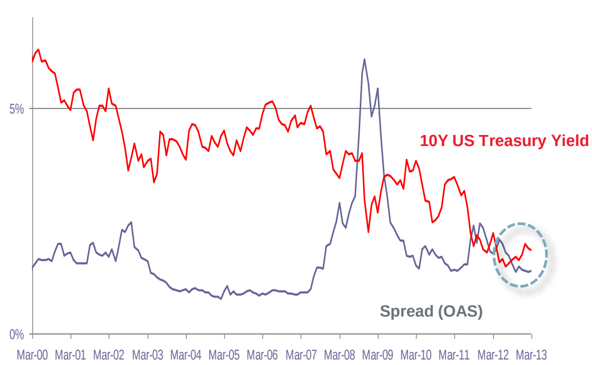
The fund manager holds a constructive – albeit realistic – view on USD corporate bonds, which calls for relatively modest total return for the remainder of the year.

Low interest rates and tight credit spreads limit above-coupon return potential; however, market dynamics remain generally supportive. Although leverage is increasing, company fundamentals remain healthy; and while slow, economic growth is of a particularly bond-friendly nature, remaining high enough to prevent broad-based credit deterioration and low enough to prevent a sharp uptick in interest rates.

Low growth is particularly critical to this outlook, as it continues to coincide with accommodative monetary policy, which in turn has helped keep interest rates low and demand strong. If the economy were to accelerate sharply, interest rates would likely follow suit, challenging our outlook for only limited downside.

However, like the consensus, the fund manager believes that a gradual rise in rates is a more likely outcome. The fund manager also recognizes that interest rate forecasting is fraught with uncertainty, which is why he concentrates primarily on credit selection as well as sector allocation as a means to generate out-performance.

Low interest rates and tight credit spreads limit the above-coupon return potential[1]



While perhaps seemingly unexciting, the fund manager thinks our outlook for both limited upside and downside is by no means unattractive, for a few main reasons.

First, low yields are a reality across global high quality assets. Opportunities for greater yield with similar risk are limited to non-existent.

Second, the macro-political environment remains highly volatile and will likely continue to cause bouts of volatility. It is during these periods that the lower volatility afforded by the asset class will be most appreciated.

Third, the benefits of holding USD corporate bonds, including low volatility and regular income, accrue best over the long-run, irrespective of market cycles.

Source: PPM America and Eastspring Investments (Singapore) Limited.1 Barclays and Thompson Reuters Datastream as of 31 March 2013. "Spread" is the option adjusted spread of the Barclays US IG Corporate Index.

Q2. Will US credit markets benefit from Bank of Japan's quantitative easing programme?

In April, the Bank of Japan (BOJ) announced its plans to spend 60 trillion yen in each of the next two years buying bonds and other assets. While the fund manager does not know the extent to which flows will be directed specifically to USD corporate bonds, many investors speculate that Japanese institutions will necessarily buy more foreign bonds, given lower domestic yields and the lower level of Japanese Government Bond's (JGB) that will be available. Being relatively high quality within the spectrum of risky global fixed income asset classes, USD corporate bonds would be a natural recipient of such flows. Greater demand from Japanese investors would in turn be positive for USD corporate credit spreads, all else held equal. Irrespective of Japan, strong technical underpinnings have been a source of support for the USD corporate market for the last few years. Demand across retail and institutional investors has generally been robust, whereas supply of non-Treasury USD bonds has generally declined. A large additional source of demand would only strengthen this trend further.

While the expectation for greater flows from Japanese investors is certainly a logical one, its fruition remains to be seen. Some investors question whether JGB rates will rise or fall. Although the BOJ intends to first drive down yields in order to induce banks and other large bond investors to invest elsewhere, their ultimate goal is to increase inflation. Increased inflation typically comes with a similar rise in interest rates. The extent to which Japanese investors will deploy assets abroad depends greatly on their expectations for future rates at home; and it is not clear that such expectations are decidedly and uniformly lower.

Q3. The Eastspring Investments - US Corporate Bond Fund has a large weighting in the Banking sector. Why so?

US banks continue to offer good relative value within the USD corporate bond universe. Fundamentals, as measured by metrics such as asset quality and capital ratios, continue to improve; and relevant macroeconomic conditions, such as recovery in the US housing market and greater Eurozone financial stability, have also trended favorably. While credit spreads have tightened considerably in recent months, many banks continue to trade wide relative to historic levels and what's warranted by underlying fundamentals. As such, the fund manager added to over-weights in banks during the first quarter, including to positions in Bank of America, Citigroup and Wells Fargo.

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

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