

INSIGHTS

June 2013

QE¹ Tapering Fears Overdone

While the recent talk of the US Federal Reserve (Fed) winding down its quantitative easing (QE) programme has negatively affected credit markets, we do not believe that the economy has recovered sufficiently to warrant a tapering anytime soon. Nonetheless we expect bouts of volatility throughout the year as market participants react to Fed's announcements.

US economy remains in a fragile growth state

The latest first quarter growth figure of 2.4% came in lower than the 2.5% forecast. A drop in government spending, a result of the Federal budget cuts that kicked in early March, had a greater fiscal drag on the US economy than expected.

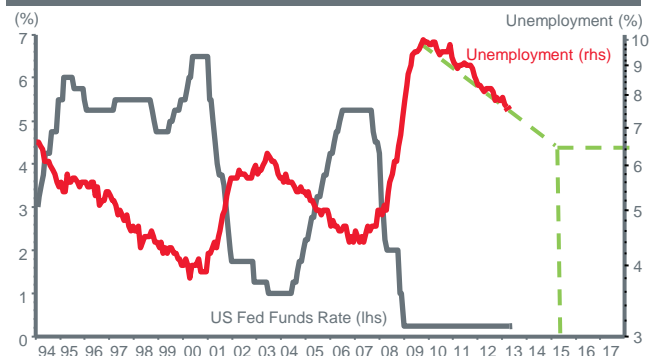
The recent data reinforces our view that the US economy is susceptible to potential drags from the ongoing fiscal consolidation. Although the extent of harm to the economy remains unclear, the budget cuts pose a headwind to growth.

Furthermore, the broader global growth environment remains relatively soft. Recessionary pressures are still prevalent in the Eurozone, while growth data in the emerging countries have disappointed of late. These factors could continue to constrain the pace of recovery in the US.

Until the US economy experiences a sustained period of positive data releases, the Fed is likely to remain patient in their decision to put an end to quantitative easing. We believe there will need to be compelling evidence of a sustained recovery as opposed to a few strong months for the Fed to end their easing.

Our colleagues at PPM America are of the view that quantitative easing remains tied to a 6.5% unemployment threshold. A sustainable growth environment should go hand-in-hand with an improved labor market and reaching the 6.5% target.

Chart 1 : US unemployment rates still way behind 6.5% target



Source : US Federal Reserve Board and the US Bureau of Labor Statistics from DataStream as at 27 May 2013. Note that past performance is not an indicator of either present or future performance.

As such, a more plausible scenario for early tapering would be if there were consistent 3% GDP gains and a sufficiently improved labor market as evidenced by solid payroll numbers. This scenario has yet to be achieved.

Even if QE were to end within the next 3-6 months, rates will likely rise sharply initially but would not last long. We do not believe that the economy is on sound enough footing to handle rates that are too high.

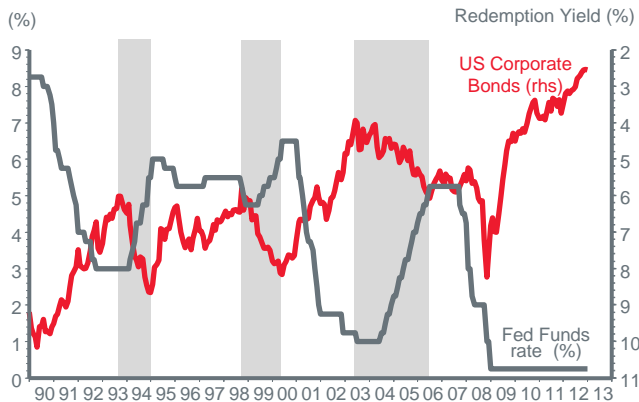
Implications of a QE wind down

a) US credit markets

While we think that the Fed will unlikely turn off the liquidity tap soon, it is understandable why investors remain jittery over this issue.

Bond yields are at historic lows and are poised to rise once the Fed reverses its easy monetary policy (refer to Chart 2). When that will occur remains unclear.

Chart 2 : Bonds have sold off each time the Fed raised rates



Source : US Federal Reserve Board, Barclays Capital and Standard and Poors from Datastream as at January 17, 2013. Note that past performance is no indicator of either present or future performance.

Since the timing of an end to QE remains uncertain, our US bond fund managers are currently maintaining a relatively neutral stance on duration. However, they are managing the potential for a rate rise at the margin. In the **US Investment Grade portfolios**, the portfolio managers have a slight short position to interest rate futures. In the **US High Yield Bond Fund**, the fund manager has an under-weight to the double-B portion of the market and is investing in lower duration bonds and securities down the capital structure such as bank preferred stock.

PPM America maintains their focus on credit selection and will continue to rely on their robust credit analysis to generate out-performance during periods of market turmoil.

b) Asian credit markets

The gradual removal of cheap funding and the accompanying strength in the US dollar may exacerbate capital outflows from Asian markets, although this may to some extent be mitigated by the ongoing QE programs and accommodative monetary policy stance in countries like Japan and Europe.

Local interest rates will likely rise in tandem. But the fact that the correlation between Asian and US interest rates varies from country to country as does the level of foreign holdings of domestic bonds (which may affect the extent of market sensitivity to capital outflows), the result could be a more nuanced impact across Asia's local interest rate markets.

Furthermore, unlike in the US, the soft economic and inflation prints in Asia have provided scope for some central banks (India and Thailand) to cut rates further. In the foreign exchange markets, currencies with bigger current account deficits may also be more vulnerable to capital outflows (e.g. India and Indonesia) than those with positive trade balances (e.g. Korea and Singapore).

However, the volatile backdrop necessitates a tactical and differentiated investment approach across the individual Asian interest rate and foreign exchange markets. In the **Asian Local Bond Fund**, interest rate positions were partially hedged towards the end of May through the selling of US Treasury futures, while duration overweight positions were maintained in selected markets such as India and Thailand.

For **Asian Bond and Asian High Yield Bond Funds** (investing primarily in USD-denominated bonds), the key performance driver is credit selection. With the fundamental story largely intact for Asian bonds and carry expected to be an important source of return this year, we continue to look for opportunities to enhance yield. Higher yielding securities are also expected to fare better than higher-rated ones in the near term as they should be less sensitive to the volatility in US Treasuries owing to their higher "carry".

We thus view periods of market correction as opportune times to invest in attractively priced securities.

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