INSIGHTS

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OPPORTUNITIES IN THE ASIAN HIGH YIELD SPACE

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Investors continue to tussle with the implications of a less supportive monetary policy backdrop, contributing to volatility across equity and bond markets. The largely upbeat economic data in the US supported expectations that QE3 tapering would happen sooner rather than later. While the brighter US economic outlook buoys sentiment towards the US and other developed market risk assets on the whole, emerging market risk assets have little to cheer in the wake of slowing growth prospects. This triggered redemption flows in both hard currency and local currency emerging market bond funds, which added to the selling pressures in the Asian US dollar bond market during the May-June period.

In the shorter term, Asian US dollar credit assets, including Asian high yield bonds, could remain vulnerable to the US Treasury volatility and slowing growth outlook in Asia, especially that of China. Nevertheless, we are not in the China hard landing camp and remain sanguine on the growth outlook for Asia. Against this benign macro backdrop, we remain constructive on the outlook of Asian high yield bonds in the medium term. At current levels, Asian high yield bonds still provide investors with a relatively attractive yield pick-up over US Treasuries. The higher “carry” of credit securities could also help to mitigate the impact of rising risk-free rates.

In addition, the recent widening in Asian credit spreads has improved valuation to some extent. We believe when the market fully discounts the likelihood of tapering in the US Fed’s bond buying program, there could be new pockets of opportunities in the Asian high yield bond space. We continue to reduce our underweight in corporate bonds in view of their higher carry, as we still see carry as a major source of return for Asian high yield bonds this year.

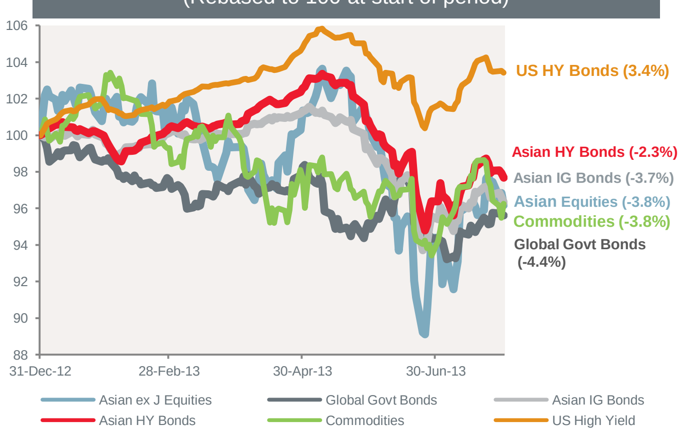
Source: Eastspring Investments (Singapore) Limited

1. How has the Asian high yield market fared thus far?

The performance of Asian high yield bonds was relatively stable until late May when concerns over the US Fed tapering its quantitative easing (QE) program triggered rises in US risk-free rates. These rises were led by the long end of the curve, with 10-year US treasury yields rising by 82 bps to 2.58% (Bloomberg, 31 July 2013).

The volatility in US interest rates, as well as outflow pressures (amid concerns over Asia's growth outlook and a drying-up of liquidity post QE) also contributed to a widening in Asian credit spreads during the May-June period. Asian USD credits took a hit in the rising interest rate and widening spread environment. Asian high yield bonds were not spared amid the negative sentiment in bond market. However, some stability has returned to the market since the sell-off, as investors digested the implications of a QE tapering. In July, the non-investment grade sector led a broad tightening in credit spreads within the Asian USD bond space, with high yield sovereign and corporate spreads compressing 37 bps and 20 bps respectively (Bloomberg, 31 July 2013). The tightening of credit spreads, coupled with coupon income helped the sector turn in a positive performance in July.

YTD PERFORMANCE OF ASIAN HIGH YIELD BONDS VS OTHER ASSET CLASSES
(Rebased to 100 at start of period)



Source: Bloomberg, data as at 31 July 2013, in USD. The graph above is included for illustrative purposes only. Please note that there are limitation to the use of such indices as proxies for the past performance in the respective asset classes. The historical performance is not indicative of the future or likely performance of Eastspring Investments (Singapore) Limited or the Fund.

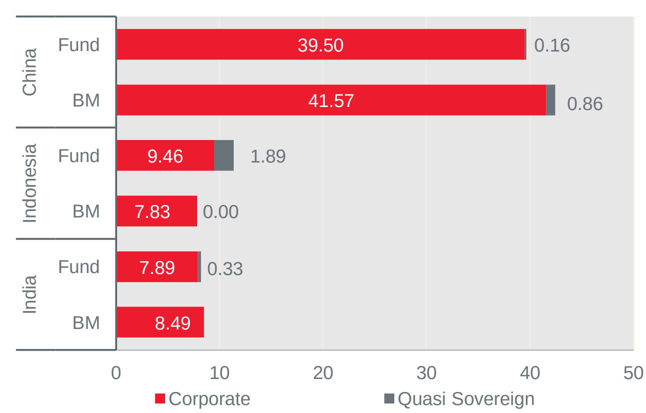
2. Given that yields have been compressed to historic lows, is there still value to be found among Asian high yield bonds?

Indeed, the all-in yields of Asian high yield bonds remain low relative to history due to a combination of downward shifts in the US risk-free rates and credit spread compression over the past years.

However, at current yield level of more than 7% (Bloomberg, JACI High Yield index, 31 July 2013), Asian high yield bonds still offer a relatively attractive income stream. If we look at the credit spreads of Asian high yield bonds, which is the yield premium over risk-free rates, they also remain above the record lows seen before the Lehman Crisis and are at levels, which we view, still compensate investors reasonably for the default risks of investing in these bonds. This is particularly so when viewed in the context of the low default rate expected for Asian high yield bonds this year.

Additionally, the recent uptick in yields has improved the valuation to some extent. We believe when the market fully discounts the likelihood of tapering in the US Fed's bond buying program, new pockets of opportunities will emerge within the Asian high yield bond space.

3. Could you elaborate on the rationale behind the Eastspring Investments – Asian High Yield Bond Fund's top three country allocations?



Source: Eastspring Investments (Singapore) Limited, as at 30 June 2013, unless otherwise stated, based on internal data.

The Asian high yield bond universe is made up of non-investment grade bonds issued by Asian governments, quasi-governments and corporate entities. A large portion of these opportunities tend to be found in the major Asian emerging markets, such as China, Indonesia and India, where more companies are still growing and developing. This is reflected in the significant weights that these three countries have in the benchmark index, JACI High Yield index.

As such, investment in an Asian high yield bond fund would typically involve exposures to these three markets. As of June 2013, we are slightly underweight China and India relative to benchmark weights, and overweight Indonesia. The country allocations are mainly a result of bottom-up credit decisions.

China

While there have been increased concerns over the growth prospects in China, we think that the risk of a hard-landing is mitigated by the government's controls of the country's main financial institutions and its robust fiscal buffers, which could help cushion growth. Thus, our base case remains that a hard-landing scenario can be avoided in China. The ongoing structural reforms (eg. Interest rate liberalisation, reining in shadow banking and property measures), while likely to result in a more moderate pace of growth as compared to the past decade, is ultimately a step in in the right direction to build a more long-term sustainable growth model.

Nevertheless, we remain selective with our credit selection. We prefer to invest in the bigger, better quality, Chinese credit names, which have reasonable funding access and are likely to survive a potential consolidation in their respective industries.

On a sectoral level, we continue to prefer Chinese property companies as compared to industrials. We view that the demand for property is likely to remain underpinned, particularly in the mass market segment, given the continued urbanisation and increasing affluence of the country.

The property measures are targeted more at the speculative/ higher-end property segment in the higher tier cities and hence the impact of the measures are likely to vary across market segments/cities. Additionally, the sector has been dealing with the tightening bias of the regulator for some time now and has learnt to manage the regulatory risks better.

In contrast, earnings of Chinese industrials are less transparent and are more sensitive to cyclical headwinds.

Indonesia and India

The medium term growth potential of the two countries is expected to remain solid, driven by their vast domestic demand, a young workforce and growing affluence. While there have been concerns over the countries' twin deficits, i.e. the growing current account and fiscal deficits, Indonesia and India are expected to still grow by 6.0% and 5.9% respectively in 2013, and 6.2% and 6.6% respectively in 2014 (Consensus Economics, July 2013). These forecasts far exceed the modest growth rates we continue to see in the developed markets. Additionally, the governments appear to be serious in tackling the structural issues, such as the raising of fuel prices, spending on infrastructure, opening up to Foreign Direct Investments for selected sectors in India, etc.

Having said that, we are mindful that there are structural and cyclical headwinds that could hamper the full growth potential and put pressure on selected industries or companies. In Indonesia, we are overweight in the consumer-related names but have turned more cautious on coal names given the lacklustre coal demand and refinancing issues with selected coal companies.

In India, we are overweight in selected oil & gas and utilities names but underweight selected Indian banks which have weaker fundamentals and are subject to higher domestic macro risks.

4. What is the outlook for Asian high yields amid concerns on rising interest rates?

Traditionally, credit assets would not fare too badly in a rising interest rate environment as this generally happens during the uptick of the economic cycle with improving credit fundamentals. Credit spreads, provided they are not too tight to start with, would generally tighten, thereby underpinning prices. Furthermore the "carry" of credit securities would help to partly absorb the impact of rising risk-free rates.

Assuming this relationship holds, Asian high yield bonds are expected to fare better than other bond segments in an improving economic environment given their higher sensitivity to cyclical factors. The higher carry of high yield bonds as compared to investment grade bonds also puts this asset class in a better stead to weather a rising interest rate environment. Nonetheless, with the sharp compression in credit spreads over the past five years, room for further spread tightening is more limited. We expect returns to moderate significantly from last year's double-digit growth.

Performance of Asian and US Bonds over recent interest rate cycle

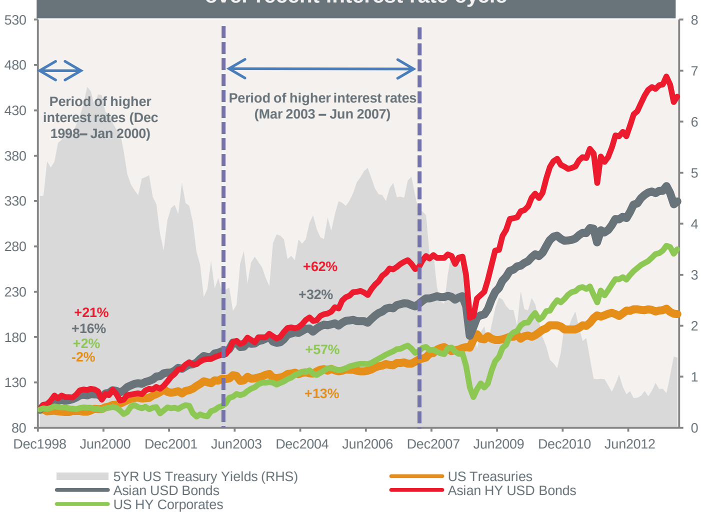


Chart Source: Bloomberg, 31 July 2013; Asian USD Bonds represented by JPMorgan Asia Credit Index, Asian HY USD Bonds represented by JPMorgan Asia Non-investment grade index, US Treasuries represented by Citigroup US Treasuries/Agencies Index, US HY Corporates represented by BofA-Merrill Lynch US High Yield Index.

Nevertheless, Asian credits, while not exactly cheap, are not seriously overpriced either, in our view, and the recent market dislocation has improved their valuations moderately. Therefore, we believe when the capitulation is done, Asian credits, especially high yield corporates, should still have their appeal in a possibly rising interest rate environment.

We have thus taken advantage of the recent market corrections to add to our corporate exposures, as we still see carry as a major source of return for Asian high yield bonds this year.

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