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INSIGHTS

December 2013

Asian Fixed Income 2014 Outlook

Braced For Another Challenging Year

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Asian Fixed Income

2013 was challenging! While my global expectations – moderate growth and low inflation - largely panned out, the US Federal Reserve Board's ambiguous communication on QE tapering threw a curve ball. Post Mr. Bernanke's tapering comments in May, Asian domestic bonds and currencies fell to levels not seen since their 2009 lows. Asian US dollar credits also fell as US interest rates spiked higher and credit spreads widened.

Despite this challenging environment, my nimble-footed, tactical stance for 2013 delivered as hoped. Our funds generally fared well. A late year fall in Asia's currencies did drag on some of our funds, but the falls were a salutary reminder that if we ignore currency movements, it will cost.

May's market gyrations, when investors first got cold feet on US tapering, provide a good example of the tactics we deployed over the year. As markets fell, we reduced portfolio durations. When yields rose to, what I felt were, unjustifiably high levels (bearing in mind that tapering does not necessarily equate to monetary tightening), we reversed our positions and increased our duration overweights. This "trade" helped our portfolios lock in higher yield levels and positioned us well for the subsequent bond rally.

I like to think that it was not only good tactics that contributed to our 2013 results; good security selection also played its part. Overweighting corporate credits worked well. And in the Philippines, Thailand and Korea, overweight durations helped returns given the outperformances of those markets.

The one area I would revisit and readapt my positioning is that of the US dollar and Asian currencies, as I have already hinted. 2013's currency calls were extremely difficult owing to tapering fears that led to US dollar strengthening against Asian currencies. On hindsight, I should have been less aggressive in our Asian currency overweights, particularly India's Rupee given the country's twin deficit problems.

Going into 2014, I suspect the global macro picture will not change significantly.

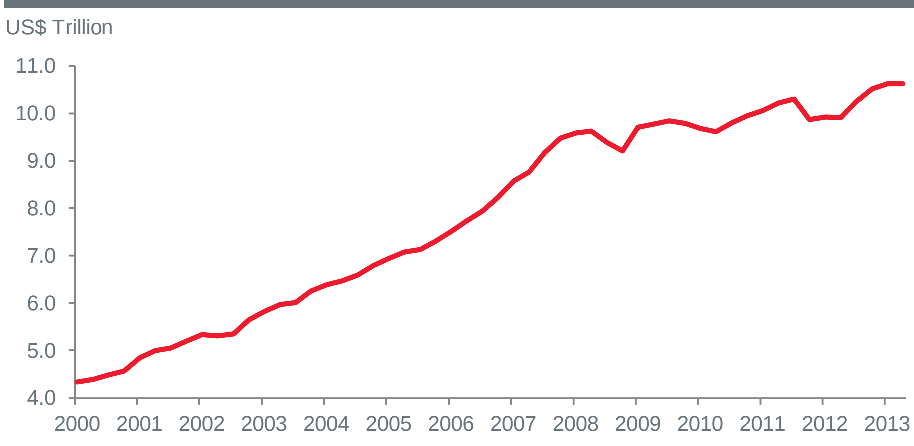
Yes, the US economy may strengthen as the fiscal-drag effect wanes and consumption is boosted by the wealth effects resulting from improving housing and financial markets. I would be surprised, however, if growth exceeds the 3% "escape velocity" threshold needed to generate a stronger self-sustaining recovery. The low labour participation rate and high underemployment remain concerns for the Fed.

The other G3 economies, Europe and Japan, are confronting structural challenges; the Eurozone's recent upbeat economic data, for example, masks a wide disparity between the core and peripheral economies. Ongoing deleveraging (in both private and public sectors), has still to run its course. Over in Japan, it remains to be seen whether Abenomics will be successful in reviving growth beyond the translation effect of a weak yen. In Asia, I expect a continuance of moderate growth trajectory, assuming China's growth stabilizes around 7.0 to 7.5% and developed economies continue their moderate recovery.

The "Great Rotation" from bonds into equities is still some way away.

This all suggests that global monetary policy will remain accommodative albeit less supportive. I expect interest rates to "normalize" only slowly. To drive the point home, I expect the first US policy rate hike to take place in early 2015, at the earliest! And that on the assumption that 2014 will see robust job additions. Given the low interest rate backdrop and the increasing structural demand for bonds, I suspect that "The Great Rotation" from bonds into equities is still some way away.

Chart 1 : Corporate credit holdings continue to rise, underpinned by structural demand from insurance and mutual funds



Source : Federal Reserve statistical release of "Flow of Funds Accounts of the United States", as of 2Q13. Data is a summation of holdings of banks, pension funds, insurance, mutual funds, households, rest of the world and others

Against this background, I will maintain 2013's tactical, nimble-footed, approach when managing duration. Markets will likely remain volatile, so a consistent duration underweight position is not necessarily the best strategy; "carry and roll down" strategies from overweight duration positions can potentially more than offset the impact of modest rises in interest rates. Shifts in policy expectation too could bring about price movements that throw up buying opportunities.

Having said that, I think the market has partially discounted a start to tapering. A sell-off in US Treasuries to the same extent as 2013 seems unlikely, I suspect. A repeat of the 2013's sell off in Asian bond markets is also less likely.

Security selection is critical given that tapering fears will induce volatility.

But, uncertainties surrounding the timing and pace of tapering will induce bouts of volatility, more so in economies with large external vulnerabilities or growth imbalances. China, India and Indonesia, for example, have recognized the structural weaknesses that 2013's selling exposed. All have stepped up efforts to address these areas. But meaningful structural adjustments will take time. Markets perceived as not doing enough, fast enough, could still be "punished".

While security selection is always critical, I think it will be more critical this year given that I am braced for wide divergences between market performances. Today, for example, in our Asian local bond fund, I am overweight duration in both Singapore and Thailand where domestic factors and valuations remain supportive.

Overall, I expect most Asian interest rates to trade either within a broad range or moderately higher. This should provide selective tactical opportunities when markets move to extreme levels (as in 2013, when Asia's bond sell-offs brought valuations to attractive levels). The late 2013 rebound has not entirely reversed the year's earlier losses, suggesting room for Asia to play "catch-up" in 2014.

Corporate credits offer attractive yields over government bonds.

I aim to enhance portfolio yields through higher-yielding corporate credits (both local currency and US dollar). It seems that the additional yield pick-up over government bonds will continue to be an important driver of returns in an environment in which capital gains from interest rate declines and credit spread tightening are more limited or uneven. Additionally, some level of timing is important as the credit cycle for Asian companies has turned less benign given the increase in leverage levels over the recent years.

Adopt a "carry play" strategy for Asian credits.

Chart 2 : Asian bonds offer significant yield pick up over US counterparts

Source: Barclays Capital and JP Morgan from Thomson Reuters Datastream as at 28 November, 2013. All data are in USDs

On currencies, I think there is room for Asian currencies to appreciate over the medium term (assuming that individual economies are not headed into balance of payment crises). I am overweight India's rupee and the Philippine's peso. Both currencies underperformed in 2013 and have the potential to rebound. But overall, 2014 currency selection will be no less difficult than in 2013, I fear.

In a nutshell.

In short, I expect 2014 to be as challenging as 2013. Nonetheless, opportunities exist for investors who are prepared to do their investment homework and strategize effectively.

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