INSIGHTS

December 2013

OPPORTUNITIES IN THE ASIAN HIGH YIELD SPACE

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2013 marked a challenging year for Asian USD-denominated high yield bond market as QE tapering fears resulted in a sharp rise in US interest rates and triggered redemption flows from Emerging and Asian bond markets. The weaker growth prospects of Asia relative to the developed markets and increased structural challenges in Asia also weighed on investor sentiment. Nonetheless, the Asian high yield bond market managed to outperform the other Asian bond sectors over the year, helped by the higher carry and a relatively more resilient investor demand for high yield corporates.

Going into 2014, markets conditions could remain choppy as uncertainties on QE tapering remains an overhang. More precarious economic conditions in Asia and political risks arising from upcoming elections could also trigger bouts of volatility. However, we do not believe it is all doom-and-gloom for Asia. A moderately strengthening global growth, led by the US, will lend some support to Asian economies, while structural reforms are being initiated to help selected Asian economies be better positioned for the longer term. At the same time, US interest rates should normalise at a gradual pace and monetary policy remains accommodative as the US economy remains at a fledging stage of recovery.

Against this mixed macro backdrop in Asia and modestly rising US interest rates, we think that positive carry from Asian high yield bonds could continue to drive performance and deliver a moderate return for investors. However, credit selection has become more important in this environment as idiosyncratic risks could rise given the more challenging economic backdrop for Asia.

Source: Eastspring Investments (Singapore) Limited

1. How has the Asian high yield market fared in 2013?

After a stellar double-digit return in 2012, Asian high yield bond market experienced a more challenging year in 2013. As at 27 November, the JPMorgan Asian Credit – Non Investment Grade index registered a modest total return of 1.16% in USD terms.

Asian high yield bonds started the year on a relatively stable footing until May this year, when the US Fed's comments on potential QE tapering triggered sharp rises in US interest rates during the May-Aug period. Over the same period, performance of Asian high yield bonds was also negatively impacted by a widening of credit spreads, in tandem with the rest of the Asian credit market. Selling pressures rose in the Asian credit market as investors were worried about the risk of higher US interest rates and potential capital outflows from Asia should the liquidity tap be turned off. The perceived weaker economic fundamentals in selected Asian countries also exacerbated investor sentiment. While these concerns were eased subsequently, following the surprise decision by the US Fed to not begin QE tapering in September, the spectre of QE tapering continued to cast a shadow on Asian credit market going into year-end

Nevertheless, Asian high yield bond market continued to outperform the other Asian credit sectors during the year, helped by the resilient performance of Asian high yield corporate bonds. While macro concerns in Asia resulted in negative returns of high yield sovereigns, this was offset by gains in Asian high yield corporate bonds year-to-date. The higher coupon income of high yield corporates provided a buffer against the rise in US interest rates, while credit spreads of corporate bonds remained relatively stable over the year, supported by continued demand for yield and relatively stable credit backdrop.

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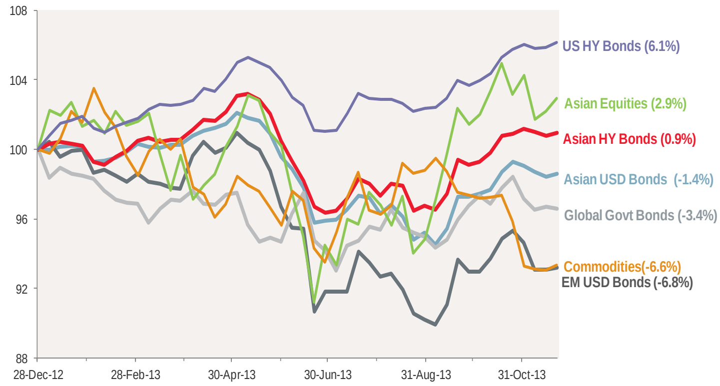


Note: The following indices are used as the proxy for the respective asset class: (1) Commodities: Thomson Reuters/Jefferies CRB Index; (2) Asian Equities: MSCI AC Asia ex Japan; (3) Asian High Yield Bond: JP Morgan Asia Credit – Non Investment Grade Index (4) Global High Yield Bonds: Bank of America-Merrill Lynch Global High Yield Index (5) US High Yield: Bank of America-Merrill Lynch US High Yield Master index II (6) Asian USD Bond: JP Morgan Asia Credit Index (JACI) and (7)EM USD Bonds: JP Morgan Emerging Market Bond Index All indices are in USD.

Source: Eastspring Investments, Bloomberg, 22 November 2013, in USD. The graph above is included for illustrative purposes only. Please note that there are limitations 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.

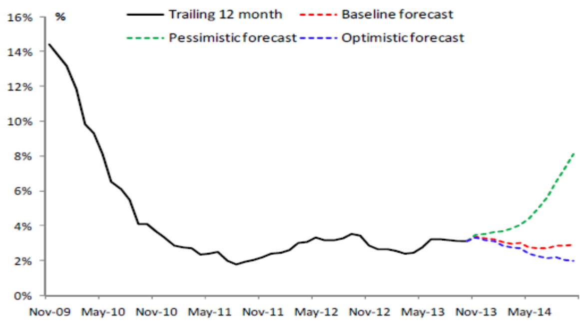
2. What is your outlook for the Asian high yield bond market for 2014 and how is the Fund positioned given this outlook?

2014 is likely to be another challenging year. Bouts of volatility in the Asian bond market could still persist until there is more clarity on QE tapering. Until then, the mixed US economic data and conflicting messages from Fed governors would continue to trigger swings in interest rate and QE expectations that will have a fall-on impact on the Asian asset markets.

Within Asia, political risks in the more fragile countries, such as the upcoming elections in Indonesia and India, could also add to the volatility. Additionally, with private sector leverage having climbed aggressively over the past few years, credit cycle is likely to turn less favourable for Asia. Credit expansion is likely to be replaced by some extent of de-leveraging, or moderation of credit growth. This will support a slower pace of growth in Asia, while non-performing loans and defaults among corporates could tick up as earnings slow and funding conditions tighten in Asia.

Having said that, the downside risks for Asia are likely to be balanced by a stronger global growth environment in 2014, led by the US. While Asia's growth is less attuned to the fortunes of the G3 economies than before, economic linkages remain significant. This is partly why we continue to expect a benign default environment in Asia, in keeping with the global default expectations.

MOODY'S GLOBAL HIGH YIELD DEFAULT RATES



Source: Moody's, November 2013

On the other hand, the poor quality of employment growth in the US, low inflation rate, coupled with a still expansionary monetary policy (ie. tapering does not equal tightening), should still keep US rate rises modest in 2014. This is especially so when US Treasuries have, to certain extent, priced in a less accommodative interest rate environment, with 10-year US Treasuries having climbed higher by around 100 bps year-to-date[1].

Overall, the macro picture that we expect to emerge is one of a slowly normalizing interest rate environment while Asian economies continue to muddle along. In this environment, we continue to think carry is likely to drive returns, rather than credit spread tightening. The relatively high coupon income from high yield bonds can still potentially deliver moderate returns to investors, after offsetting negative price impact due to rises in risk-free rates. Credit selection will play an even more important role as idiosyncratic risks among high yield names could rise in tandem with a less supportive credit environment.

In this environment, we seek to enhance portfolio yield through selective higher-yielding names, while avoiding names with high default risks. We have thus pared our exposures to the Philippines corporate bonds, where yields have been trading tight relative to their risk, and increased our exposures to selected Indonesian and Chinese names which offer better value. We believe that pockets of value opportunities could still emerge during the coming year as swings in sentiment could result in credits being oversold or mis-priced relative to fundamentals. We will seek to exploit these opportunities, including off-benchmark positions, such as our current exposures in selected Asian currencies or Asian local currency bonds, where we think still offer value following the 2013 sell-off.

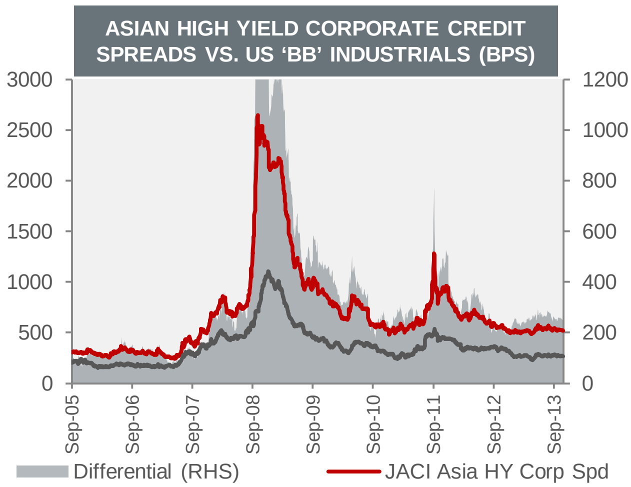
3. How does pricing in the Asian high yield bond market compare to that of in other high yield or bond segment?

While not extremely cheap, we consider valuations of Asian high yield bond market to be still reasonable; Asian high yield corporates offer a significant yield pick-up over Asian investment grade corporates of around 300 bps , which is significantly higher than the lows of around 140 bps[2] seen just prior to the Global Financial Crisis.

Compared to US high yield corporate bond market, the yield pick-up is similarly significant. In fact, the yield differential between Asian high yield corporates and similarly-rated US high yield corporates (as reflected by the respective indices' credit spreads) has widened this year, following the outperformance of the US high yield corporates. This means investors are compensated more in terms of coupon income for holding onto Asian high yield corporates as compared to US corporate bonds with similar credit ratings.

Furthermore, with the current yield levels of Asian high yield bonds at around 7%[3], we continue to think that income stream from Asian high yield bonds compensates investors reasonably for the credit risks taken given that default rate in Asia is expected to remain manageable in the coming year.

Source: *1,3* Bloomberg, 29 November 2013. *2* Bloomberg, Eastspring Investments (Singapore) Limited, Credit spread differential between JACI Investment Grade Corporate Index and JACI High Yield Corporate Index, as at 27 November 2013



Source: Bloomberg, 26 November 2013. The charts above are included for illustrative purposes only. Any projection or forecast is not necessarily indicative of the future or likely performance of the Fund.

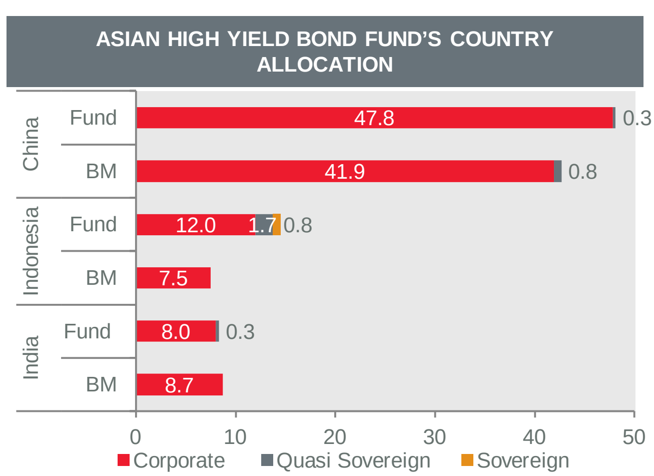
4. Could you elaborate on the rationale behind the Eastspring Investments – Asian High Yield Bond Fund's top three country allocations?

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

While structural imbalances persist in China, India and Indonesia, we do not expect growths to fall off the cliff or the emergence of systemic crises. The countries' GDP growths are likely to moderate over the coming years as they undergo longer-term structural adjustments but their pace of growth is still expected to be higher than developed markets. There remain favourable structural trends that help push growths forward;

Continued urbanization, young workforce (in India and Indonesia) and rising Foreign Direct Investments are structural themes that are still playing out in a number of Asian economies, including China, India and Indonesia. Additionally, economic fundamentals in these countries are still arguably stronger than before the Asian Financial Crisis (eg. Build-up of FX reserves, external debt exposures, etc.), which should help the countries weather through volatility in capital flows.

Nevertheless, we are not ignoring the unique structural challenges that are confronting each country and we agree that policy reforms need to continue. Asian governments, too, appear to be cognisant of these challenges and have initiated measures in the right direction in our opinion. As such, while we believe that the road to reform remains long, our base case scenario remains that of orderly structural adjustments taking place in these countries over time. However, we remain mindful of the impact of a more challenging macro environment, which may lead to higher defaults among weaker companies or sectors. We will thus be cautious in our credit selection as we seek to identify better quality names which can survive a less favourable macro environment. For example in India, we are underweight smaller private banks which may not receive any state support in times of crisis. We are also cautious the weaker corporate in India as they may not have the financial flexibility to deal with a depreciating rupee.



Source: Eastspring Investments (Singapore) Limited, as at 31 October 2013, unless otherwise stated, based on internal data.

5. Chinese property developers continue to dominate the Asian high yield bond markets. What's our view on the Chinese property developers?

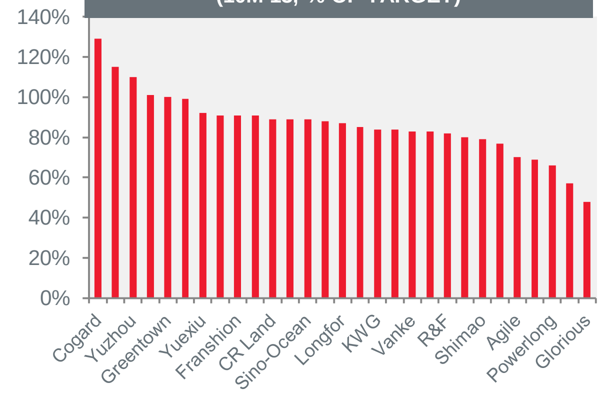
We retain a stable outlook for Chinese property market going into 2014. Demand for housing is expected to remain resilient, supported by the country's continued urbanization and income growth. However, after the strong property sales and price growth (19% in top-tier cities and 7-9% in tier 2-4 cities)[4] in 2013, we expect property sales and prices to moderate in 2014.

The more moderate growth in the sector is likely to be driven by tighter liquidity conditions and slower household income growth. Liquidity conditions in China is tightening, with domestic repo rate and bond yields moving higher as the government aims to manage inflation pressures and credit growth, particularly through the shadow banking channel .

On the policy front, however, we expect impact of the new reforms measures announced to be manageable. The 3rd plenary session of 18th CPC Central Committee and the subsequent 60-point reform plan outlined the comprehensive measures targeting, administrative, financial, fiscal, land and resource reforms over the next 5-10 years. Property tax was mentioned as one of these measures and will likely be rolled out gradually over the country starting next year. While it may impact property demand in the near term, the longer term impact from an extension of the property tax is not expected to be significant as seen from the property tax trial schemes in Shanghai and Chongqing. In these two cities, property prices continued to rise despite the implementation of property tax of 0.42% to 1.2%[5]. Other structural reforms, such as relaxation of one-child policy , Hukou system could also boost demand for housing and speed up urbanisation of lower tier cities that can potentially benefit developers focusing on lower tier cities.

We also remain sanguine on the sector as financial profiles of Chinese property developers are expected to be largely stable. Contracted sales this year has been robust, with most companies reporting numbers that are in line with targets.

CHINESE PROPERTY CONTRACTED SALES (10M 13, % OF TARGET)



Source: Eastspring Investments (Singapore) Limited, Company sources, November 2013

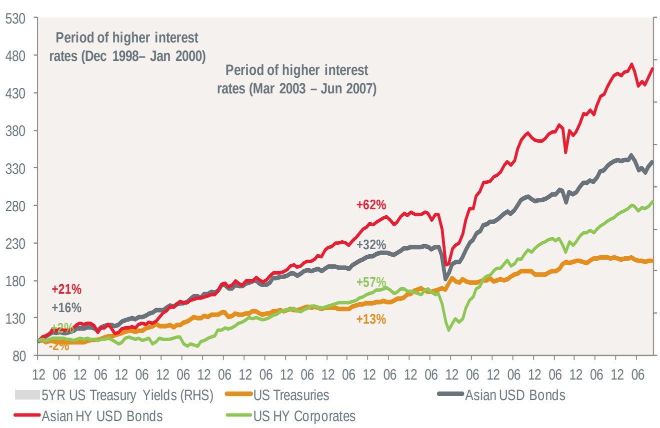
Chinese property developers have also bolstered their cash holdings, partly through debt offerings. The higher cash holdings (and extension of companies' debt profile in some) will enhance the companies' ability to weather through periods of funding squeeze such as when onshore money market rate rates spiked in late June or when a surge in risk aversion resulted in offshore debt markets to be shut. At the same time, earnings of Chinese property developers are expected to remain resilient this year, helped by the robust contracted sales reported in first half 2013 that were generally in line with the companies' forward guidance . The overall level of leverage of "BB"-rated Chinese property names also remain reasonable. Nevertheless, given that financial conditions of each company differs, it is important that to be selective and invest in companies which we think will survive a potential slowdown in growth and consolidation in the sector.

6. What will the "future" of Asian high yield debt be like if interest rates were to increase next year or the year after?

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, could potentially tighten, thereby supporting prices. Furthermore the "carry" of credit securities would help to partly absorb the impact of rising risk-free rates.

Source:*4* Nomura, 26 November 2013, 5 Bloomberg News, January 2011.

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 remain moderate, driven more by carry than spread tightening.



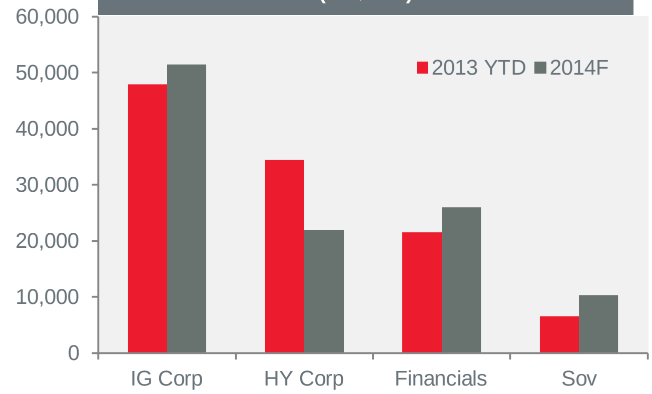
Source: Bloomberg, 31 October 2013; Asian USD Bonds represented by JPMorgan Asia Credit Index, Asian HY USD Bonds represented by JPMorgan Asia Non-investment grade index, US Treasuries represented by Citigroup US Treasuries/Agencies Index, US HY Corporates represented by BofA-Merrill Lynch US High Yield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

7. How will new issuances impact the Asian high yield market in 2014?

After the record issuance in Asian high yield market this year (more than US$35 bn, led by Chinese property developers)[6], we expect issuance to remain robust in 2014. Early re-financing by corporates in anticipation of higher interest rates in the coming years, tighter bank lending conditions and other funding needs are likely to drive corporates to tap the debt market for funds. However, high yield issuance may moderate in 2014 as re-financing requirements from maturing high yield debt in 2014 remains undemanding. Chinese property companies have also raised substantial cash holdings in the past year, reducing the need for them to tap the debt market as actively as this year.

As such, we expect high yield bond supply to be manageable in 2014, particularly as demand from an increased pool of Asian investors should remain largely resilient.

ASIAN CREDIT ISSUANCE BY ISSUER TYPE (US$ MN)



Source: JP Morgan, November 2013

Source: 6 JPMorgan, November 2013.

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