FUND INSIGHTS

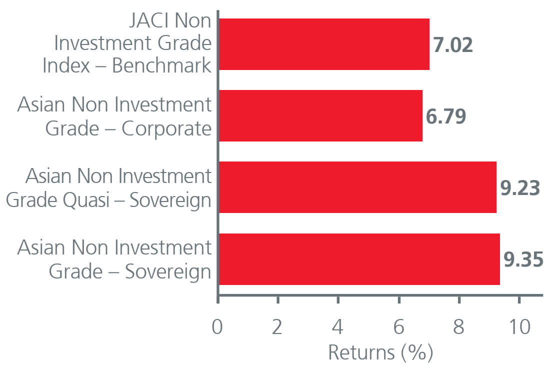
INVESTING IN ASIAN HIGH YIELD BONDS: OPPORTUNITIES AND CHALLENGES

EASTSPRING INVESTMENTS – ASIAN HIGH YIELD BOND FUND
OCTOBER 2014

HOW HAS THE ASIAN HIGH YIELD PERFORMED SO FAR?

Year to date, Asian USD high yield bond market posted a positive return, rising by 7.02%[1]. The overall positive performance of the Asian USD high yield bond market was helped by the declines in longer-dated US Treasury yields and accrual income. Significant declines in US Treasury yields were seen at the start of the year amid a slew of weaker-than-expected US economic data and an Emerging Market currency rout also triggered some flight-to-quality flows into US Treasuries. While the US economy subsequently showed signs of a rebound from the winter drag, the market's generally dovish expectations of the US Federal Reserve monetary policy stance continued to keep a lid on US interest rates.

Fig.1. Year to date[1] Performance Returns (%)



Source: Eastspring Investments, Bloomberg, JP Morgan, as of 30 September 2014. Note: Non IG = Non Investment Grade.

Besides the positive price impact from the declines in US risk-free rates, the Asian USD high yield bonds benefited from improved macroeconomic environment. Although economic data remained generally soft in Asia, investor sentiment improved as concerns over the impact of Quantitative Easing (QE) tapering eased. Supportive policy actions (such as China's "mini-stimulus" program, India's and Indonesia's policy rate hikes in 2013 that helped stem further currency weakness and other administrative measures to rein in imports) and a general stabilisation of macroeconomic environment, particularly in India and Indonesia, where current account balances improved and political uncertainties abated, also bolstered sentiment. This contributed to a tightening of credit spreads within the Asian high yield sovereign/quasi-sovereign sectors, with Sri Lanka and Pakistan sovereigns outperforming strongly.

Returns of Asian high yield corporates were similarly positive but moderately lower compared to sovereign and quasi-sovereign sectors as they were weighed down by the weaker performance of Chinese high yield property and Indonesian coal credits. Credit spreads of Chinese high yield property issues widened moderately amid concerns over problems in the shadow banking sector, as well as a slowdown/consolidation of the Chinese economy and property market. Sentiment towards Indonesia coal names was, on the other hand, impacted by weak coal prices and company-specific issues.

[1]As at 30 September 2014. As represented by the JPMorgan Asian Credit – Non Investment Grade index.

WHAT IS YOUR OUTLOOK FOR THE ASIAN HIGH YIELD BOND MARKET AND HOW IS THE FUND POSITIONED GIVEN THIS OUTLOOK?

We entered into 2014 expecting the year to be a challenging one for the Asian high yield bond market given the potential headwinds from QE tapering in the US, political uncertainties and ongoing structural adjustments in a number of Asian countries. Since then, some of these concerns have abated as QE tapering appears to have been priced in by the market, while the generally stable economic data in Asia, as well as a favourable election outcome in India and Indonesia, has helped stabilise market sentiment.

> Going into the year end, we remain cautiously optimistic on the economic outlook for Asia, which could provide a benign macro backdrop for Asian debt issuers.

A pick-up in global growth is expected to provide some support for Asian economies even as pace of growth remains moderate. The relatively sound fundamentals of Asian governments also provide room for policy support such as stepping up on fiscal spending, recapitalisation of troubled banks, etc. should growth falter. At the same time, re-financing risks for Asian high yield debt issuers remain manageable as many Asian high yield companies have taken advantage of the low interest rate environment in the past years to raise funding and / or to extend their debt maturity profile. This is also helped by the low interest rate environment and abundant global liquidity which are expected to be sustained given the accommodative stance of major central bank (evidenced by the latest monetary easing by European Central Bank).

However, we are mindful that bouts of volatility could emerge, especially as the region remains vulnerable to turns in investor sentiment given the region's soft growth prospects and as the region enters into a late stage of credit expansion cycle. Headwinds could arise from potential disappointment in global and/or China's growth momentum, more aggressive increases in US interest rates than initially expected and negative headline news from China (arising from consolidation of the property sector or problems in the shadow banking). Additionally, valuations of Asian high yield bonds, on the whole, are not extremely compelling at current levels, with credit spreads trading below the longer term average.

> That said, we believe that sentiment-driven corrections could throw out pockets of opportunities in the Asian high yield bond market.

We will seek to take advantage of these opportunities, particularly as we continue to hold a sanguine longer-term view on Asia and the high yield bond markets. For example, we have been selectively adding Chinese high yield property companies following their underperformance this year. While challenges such as excess supply and slowing sales momentum in the Chinese property sector will continue to drive consolidation in the industry, we do not expect a collapse in the medium term. This is partly helped by an increasingly differentiated policy approach by Chinese government, as seen by the selected relaxation of property measures in lower tier cities which experience more severe oversupply problems. Meanwhile, urbanisation and rising income levels will continue to drive end user demand for properties. In this environment, credit selection would also be the key as we seek to identify issuers which could weather the cyclical and structural adjustments in Asia.

Additionally, we continue to look for off-benchmark opportunities to enhance the Fund's returns. Currently, we are retaining our off-benchmark positions, in selected Asian currencies and local currency bonds (4.2% of the Fund[2]) where they still offer value following the 2013 sell-off.

[2]As at end August 2014.

HOW DOES PRICING IN THE ASIAN HIGH YIELD BOND MARKET COMPARE WITH OTHER HIGH YIELD MARKETS OR BOND SEGMENTS?

In general, 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 485 basis points[3], which is still higher than the lows of around 156 basis points seen just prior to the Global Financial Crisis.

Compared to US and Euro high yield corporate bond market, the yield pick-up from Asian high yield bond market is significant even as more recently markets witnessed some widening of credit spreads in the US and Euro high yield corporates space due to sell-off and outflows in global high yield funds.

In fact, the yield differential between Asian high yield corporates and similarly-rated US and Euro high yield corporates (as reflected by the respective indices' credit spreads) has widened for the past one and a half 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 and Euro corporate bonds with similar credit ratings.

Fig.2. Asian, US and Euro High Yield Corporate Option-Adjusted Spreads (basis points)

Source: Bloomberg, as at 26 September 2014. *Represented by Bank of America-Merrill Lynch, Asian High Yield (ACHY), US High Yield Index (H0A0) and Euro High Yield (HE00) respectively. The chart above is included for illustrative purposes only. Any projection or forecast is not necessarily indicative of the future or likely performance of the Fund.

Fig.3. Characteristics of Asian High Yield market versus other high yield markets

	Asian Bond	Asian IG Corporate	Asian HY Corporate	US HY Corporate	Euro HY Corporate
Market Cap (US$mn)	518,963	304,048	80,405	1,335,493	365,424
No. of Issues	783	467	185	2,267	547
Effective Yield (%)	4.08	3.30	7.89	6.26	4.13
Effective Duration (years)	5.14	5.06	3.49	4.49	3.44
Credit Spread* (basis points)	236	160	645	440	396

Source: Eastspring Investments, as at 30 September 2014. *Refers to option-adjusted spreads. Note: IG = Investment Grade, HY = High Yield. Past performance is not necessarily indicative of the future performance.

[3]As at 30 September 2014, Bank of America Merrill Lynch Indexes from Bloomberg.

With the effective yield of Asian high yield corporate bonds at around 7.9%[4], we continue to think that income stream from Asian high yield corporate bonds compensates investors reasonably...

As such, the Fund will be focused on picking high yield credits that are likely to benefit from the prevailing economic conditions and are able to weather through potential rises in financing costs.

Furthermore, with the effective yield of Asian high yield corporate bonds at around 7.9%[4], we continue to think that income stream from Asian high yield corporate bonds compensates investors reasonably for the credit risks taken given that default rate in Asia is expected to remain manageable in the coming year.

WHAT IS THE POTENTIAL IMPACT OF HIGHER INTEREST RATES ON ASIAN BONDS AND WHAT ARE THE STRATEGIES IN PLACE TO CUSHION THE IMPACT?

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.

Therefore, performance of high yield bonds could remain supported in an environment where interest rate rises due to stronger global growth momentum.

High yield bonds, including Asian high yields are usually more sensitive to cyclical factors, instead of changes in government bond yields or risk-free rates. The higher carry of high yield bonds also helps to mitigate the negative impact of rising interest rates.

However, an uneven growth path in Asia, as well as ongoing structural adjustments, would also mean that selective credit picking to identify bonds with stronger fundamentals or have lower risk of default is required to navigate through the current economic cycle in Asia. Additionally, we will also be mindful of impact due to potential turns in market sentiment as a result of concerns over earlier-than-expected or more aggressive-than-expected rises in interest rates.

At the same time, while we expect interest rates are likely to rise in a gradual and measured manner over the medium term, we have flexibility to reduce the Fund's duration position where we view that interest rates have overshot on the downside.

WHAT IS OUR INVESTMENT CASE FOR THE LARGE EXPOSURE TO CHINESE PROPERTY DEVELOPERS AND WHAT IS THE OUTLOOK FOR THIS SECTOR?

In the near term, the Chinese property sector could experience increased volatility; Sales momentum of Chinese property will likely continue to slow as the clampdown on corruption, tighter liquidity conditions and sluggish economic growth weigh on property demand. More defaults are also expected among smaller onshore property developers as the industry continues to consolidate.

However, we retain our base case scenario of an orderly industry consolidation in the medium term driven by the following factors (refer to Fig.4.).

[4]As at end September 2014.

Fig.4. We retain our base case scenario of an orderly industry consolidation in the medium term driven by the following factors:

Factors supporting the industry consolidation	Comments
Low default risk for USD bond issuers	Chinese developers which have issued USD bonds are all listed, much larger in size and have diversified sources of funding. These bigger developers are also likely to benefit from industry consolidation as they gain market share at the expense of the smaller players, a process which has been ongoing for a while now.
Credit quality of developers have weakened but liquidity is adequate	The property developers had taken advantage of the favourable market conditions in 2013 to tap the bond market to lengthen their debt maturity profile. Liquidity has improved on the back of these fund raising activities.
Selective policy easing	The government's proactive moves in the past few years will help ensure more sustainable growth of the property sector over the long run as the sector remains a key pillar of the economy. To address concerns of a collapse of the sector, the government has adopted a differentiated policy approach by allowing some cities which face oversupply problems to selectively relax the measures. While we do not expect blanket reduction in interest rates or reserve requirement ratios (RRR) this year, the Chinese central bank appears to be keen in avoiding severe liquidity and funding squeeze by injecting liquidity in money market, targeted RRR cuts and allowing more diversified funding channels.
Supportive structural factors	Continued urbanisation and benign housing affordability level should underpin housing demand.
Differentiated property supply-demand dynamics across China	While property sales and prices are experiencing more severe downward pressure in lower tier cities, property demand in the Tier 1 and 2 cities is expected to be more resilient.

Therefore, we remain sanguine about the longer-term outlook of Chinese property sector and retain a preference for the sector over Chinese industrials.

We believe that the Chinese property companies are backed by physical assets which are valuable, ie. landbank, and which make them more viable as acquisition targets should they fall into distress. On the other hand, there would be less market interest in acquiring distressed Chinese industrials say in steel or cement given the problem of excess capacity in these sectors.

We will also remain selective in the Chinese property sector. We will focus on larger developers with strong established brand name and proven track record of accessing offshore funding channels. We also look for developers with certain strengths, such as quality landbank or property developers who are able to sell developments in the fringe of Tier 1 cities which are still seeing good demand from migrant workers/graduates who are first time home buyers.

Disclaimer

This document is issued in:

Singapore by Eastspring Investments (Singapore) Limited (UEN: 199407631H). Eastspring Investments (Singapore) Limited is the appointed Singapore Representative and agent for service of process in Singapore.

Hong Kong by Eastspring Investments (Hong Kong) Limited.

United Arab Emirates by Eastspring Investments Limited which has its office at Precinct Building 5, Level 6, Unit 5, Dubai International Financial Center, Dubai, United Arab Emirates. Eastspring Investments Limited is duly licensed and regulated by the Dubai Financial Services Authority (DFSA). This information is directed at Professional Clients as defined by the Conduct of Business rulebook of the DFSA and no other person should act on it.

Luxembourg by Eastspring Investments (Luxembourg) S.A., Grand-Duchy of Luxembourg.

United Kingdom by Eastspring Investments (Luxembourg) S.A. – UK Branch, 125 Old Broad Street, London EC2N 1AR.

This document has not been reviewed by the regulators of the above entities such as Securities and Futures Commission, Hong Kong, Monetary Authority of Singapore, Dubai Financial Services Authority etc.

The Fund is a sub-fund of Eastspring Investments ("the SICAV"), an open-ended investment company with variable capital (Société d'Investissement à Capital Variable) registered in the Grand Duchy of Luxembourg, which qualifies as Undertaking for Collective in Transferable Securities ("UCITS") under relevant EU legislation.

All transactions into the Fund should be based on the latest available prospectus, Key Investor Information Document (KIID), and any applicable Fund or share class offering document of the SICAV. Hong Kong investors should refer to the Hong Kong Summary Prospectus and Product Key Fact Statements ("KFS"). Singapore investors should refer to the Singapore Prospectus and Product Highlights Sheet ("PHS"). Such documents, together with the annual and semi-annual financial reports and the articles of incorporation of the SICAV, may be obtained free of charge from Eastspring Investments (Luxembourg) S.A. at 26, Boulevard Royal, L-2449 Luxembourg, Grand-Duchy of Luxembourg, or at relevant Eastspring Investments business units/ website and their distribution partners.

This document is solely for information and does not have any regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments.

Please refer to the offering documents for details on fees and charges, dealing and redemption, product features, risk factors and seek professional advice before making any investment decision. An investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. The value of shares in the Fund and the income accruing to the shares, if any, may fall or rise. Where an investment is denominated in a currency other than your base currency exchange rates may have an adverse effect on the value price or income of that investment. You should not make any investment decision solely based on this document. Investors may wish to seek advice from a financial adviser before purchasing units of the Fund. In the event that he chooses not to seek advice from a financial adviser, he should consider carefully whether the Fund in question is suitable for him.

Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments. There are limitations to the use of indices as proxies for the past performance in the respective asset classes/sector.

The Fund may use derivative instruments for efficient portfolio management and hedging purposes.

The Fund may, at its discretion, pay dividends out of capital or gross income while charging all or part of its fees and expenses to its capital, resulting in higher distributable income. Thus, the Fund may effectively pay dividends out of capital. Payment of dividends out of capital (effective or not) amounts to a return or withdrawal of part of an investor's original investment or from any capital gains attributable to that original investment, which may result in an immediate reduction of the net asset value per share/unit. The distributions, including amounts and frequency, are not guaranteed and are subject to the discretion of the Fund. Past dividends declared are not a forecast or projection of future distributions.

The preceding paragraph is only applicable if the Fund intends to pay dividends / distributions.

Eastspring Investments companies (excluding JV companies) are ultimately wholly-owned / indirect subsidiaries / associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America.

United Kingdom
For the purpose of UK law, the SICAV fund, which information is hereby disclosed, is a recognized scheme under section 264 of the Financial Services and Markets Act 2000. Please note that the protections provided by the UK regulatory system, especially for retail clients, do not apply to offshore investments. Compensation under the UK Financial Services Compensation Scheme will not be available and UK cancellation rights do not apply. Relevant information on the SICAV is also available at Eastspring Investments (Luxembourg) S.A. – UK Branch, 125 Old Broad Street, London EC2N 1AR and on www.eastspring.co.uk.

Norway
The fund has been notified and registered with the Norwegian Financial Supervisory Authority (Finanstilsynet) in accordance with UCITS Directive 2009/65/EC.

Sweden
The SICAV is a UCITS which has been passported into Sweden for marketing and sale to the public for the purpose of the Swedish Investment Funds Act (Sw. lag (2004:46) ominvesteringsfonder) and has therefore been registered by the Swedish Financial Supervisory Authority (Sw. Finansinspektionen) pursuant to the Swedish Investment Funds Act. This marketing material only refers to sub-fund(s) and share classes of the SICAV which have been passported for marketing and sale into Sweden under the Swedish Investment Funds Act.

Switzerland
In Switzerland, the documents referred to above may also be obtained free of charge from (i) First Independent Fund Services Ltd, having its registered office at Klausstrasse 33, CH-8008 Zurich, who is acting as Swiss Representative Agent of the SICAV and (ii) NPB – New Private Bank Ltd, having its registered office at Limmatquai 1/am Bellevue, CH-8022 Zurich, who is acting as Swiss Paying Agent of the SICAV.

For more information contact content@eastspring.com | Tel: (65) 6349 9100