



**FUND INSIGHTS**

# 2015 ASIAN BONDS OUTLOOK

EASTSPRING INVESTMENTS – ASIAN BOND FUND  
EASTSPRING INVESTMENTS – ASIAN HIGH YIELD BOND FUND  
JANUARY 2015

## 2014 REVIEW

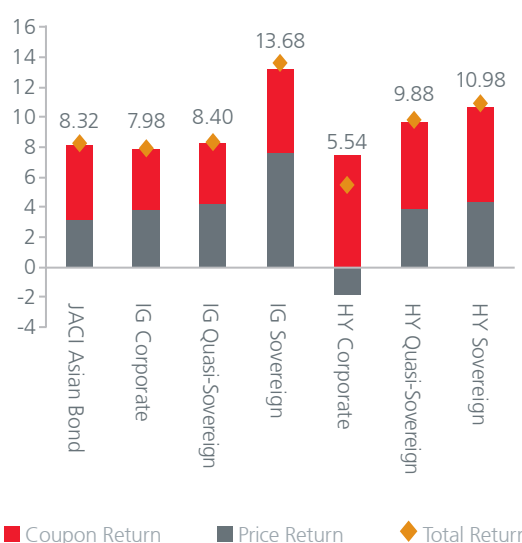
The Asian USD bond market delivered a strong gain of 8.3% in 2014 (as proxied by the JPMorgan Asia Credit Index), surprising market expectations on the upside and outperforming other Emerging Market and US bond indices. The gains in Asian bonds continued to be underpinned by coupon income, while unexpected declines in longer term US interest rates also helped lift performance.

However, the year under review was not without its challenges. While risk appetite in the Asian bond market initially strengthened amid an easing of “taper-tantrum” fears and positive election outcome in India and Indonesia, sentiment subsequently turned as the sharp falls in oil prices triggered concerns over global growth and the impact on oil and gas companies. Additionally, ongoing worries over the slowing Chinese economy and property sector, as well as negative developments in selected Chinese property companies towards the later part of the year, also weighed on sentiment.

Given this mixed backdrop, investors turned more discerning in their credit selection, contributing to a divergence in credit spread trend and performance across sectors. The Asian investment grade sector outperformed as the more resilient investor sentiment contributed to a moderate spread compression. The sector also benefited more from the falls in US interest rates given their longer duration profile.

On the other hand, performance of Asian high yield bond market lagged the broad market, although the sector still ended the year in a positive territory. While Asian high yield sovereigns delivered strong returns, high yield corporate bonds underperformed. The relatively weak investor sentiment resulted in a widening of high yield corporate spreads, which eroded some gains from carry and lower US interest rates. Performance was dragged down by the Chinese high yield property, as well as energy/commodity related names, which were impacted more by the headwinds mentioned earlier.

Fig. 1. JACI 2014 Return Attribution (%)



Source: Bloomberg, JP Morgan, as of 31 December 2014.  
Note: IG = Investment Grade, HY = High Yield.



## WHAT HAS HELPED THE FUNDS' PERFORMANCE OVER THE PAST YEAR?

Despite the market challenges, both the Asian Bond and Asian High Yield Bond Fund fared relatively well, delivering outperformance against the benchmark (gross of management fees). Broadly, both funds benefited from positive credit selection and overweight in the Indonesia and India bond markets, where we viewed to be oversold following the taper tantrum. Our neutral to slight duration overweight stance, on the back of our view of a benign US interest rate environment, was also generally constructive to the funds' performance. Apart from the above, our non-benchmark exposures to selected Asian currencies and local currency bonds (eg. Indonesian Rupiah bonds), as well as positive security selection in markets, such as the Philippines and Hong Kong (more specifically for the Asian Bond Fund), also contributed positively.

## 2015 OUTLOOK

Despite a relatively rough start to the year for the Asian USD bond market, we believe that there remain opportunities for the Asian bond market to deliver decent returns in 2015.

Firstly, we expect US interest rate increases to be moderate and led by shorter-term rates. While the US Federal Reserve will commence rate normalisation in 2015, we view that the scope for aggressive rate hikes to be limited as the positive growth momentum in the US is balanced by persistent structural slack in the US job market (as reflected by the low labour participation rate and wage growth). Inflation rate also remains contained and well below the Fed's 2% target, helped by the sharp falls in oil prices.

Additionally, global liquidity will remain abundant in the wake of further monetary easing in Europe and Japan. The accommodative monetary policies in these major economies, coupled with the pick-up in US economy, could provide a boost to the global growth which could lift earnings of Asian corporates.

Having said that, there remain potential headwinds, both globally and within the region, that could heighten volatility in the Asian credit market; from the global macro perspective, changes in US rate hike expectations, renewed political uncertainties in Greece and still-fragile economic conditions in the Eurozone and Japan could result in growth disappointment. While falling oil prices lowers global inflationary pressures and are beneficial to global growth on the whole, further falls in oil prices could pose considerable downside risk to some economies and dampen risk sentiment. Asia is also slowing after years of build-up in leverage, which has led to pockets of excess capacity. Investor focus, in particular, will be on China's ability to strike a balance between growth and structural adjustments, as well as reform progress in countries like India, Indonesia and Malaysia.

On balance, nevertheless, we view that the confluence of global factors and Asia's relatively strong fundamentals should still support a benign macro picture and moderate compression of Asian credit spreads.

Much has been said about risks in China and the Chinese property market but we retain our view of an orderly slowdown that is supported by the ample resources of the Chinese government and its strong influence in the real economy. There is also room for further monetary policy easing if growth falters significantly from here, particularly as inflation rates have fallen off significantly.

However, we recognise that idiosyncratic risks in Asia have also risen as we enter into a slower growth phase, while bank lending is tightening after the strong growth seen in the past years. Default rate of high yield companies is thus expected to pick up, although it should remain low compared to historical levels in view of generally stable credit metrics and manageable refinancing requirements in 2015.



Fig.2. Key Risks and Opportunities

Key Risks	Opportunities
Sharp rise in US Treasury yields and/or a faster-than-expected tightening of monetary policy by the US Fed.	Base case scenario: A moderate global and Asia growth scenario; Room for Asia to implement reforms and manage an orderly slowdown; US interest rates to rise in a very measured and gradual manner in the longer term.
Disappointment with China growth, sharp slowdown in the property sector or industries with excess capacities.	Given the above, seek to take advantage of pockets of value opportunities which may emerge due to swings in investor sentiment.
Escalation of geopolitical tensions in Emerging Market countries, e.g. Russia-Ukraine, or political instability within the Eurozone.	Current strategy: <ul style="list-style-type: none"> <li>▶ Credit selection remains key to deliver performance over time</li> <li>▶ Overweight long-dated investment grade corporates and high yield corporates</li> <li>▶ Overweight Indonesia and Philippine corporates</li> <li>▶ Selective opportunities in India, Chinese high yield property, energy names and local currency bonds</li> </ul>
Continued sharp falls in oil prices resulting in significant deterioration of fundamentals in oil-exporting countries or energy companies	

Source: Eastspring Investments (Singapore) Limited.

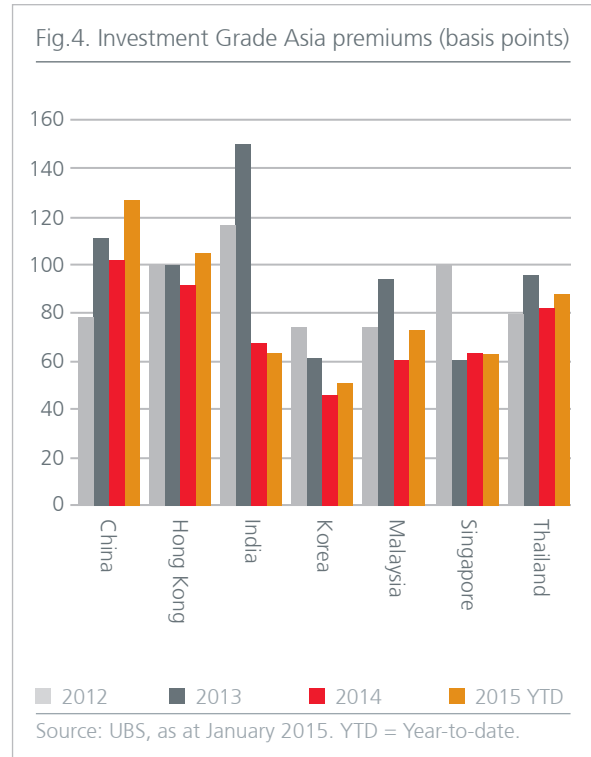
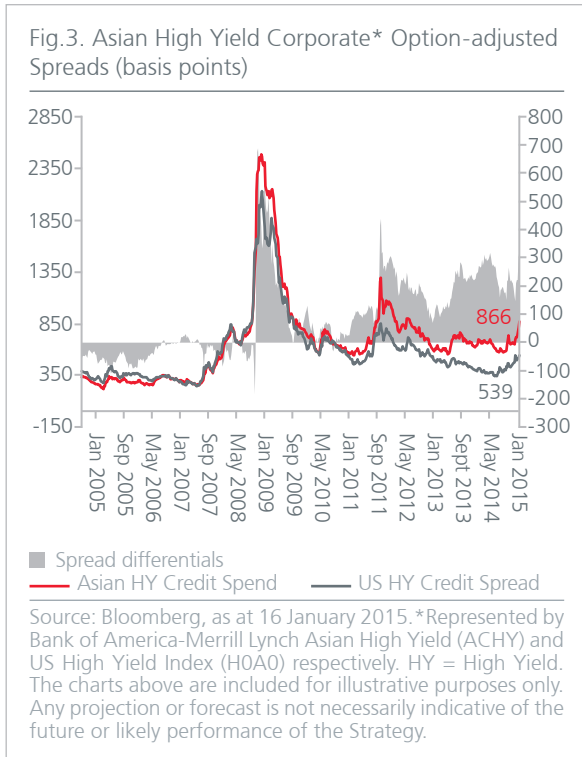
As such, credit selection will continue to be important in 2015 amid an overall cautious risk sentiment and we are thus selective in our investments.

In our view, Asian investment grade credit spreads still offer value, especially in the long-end, where the credit curve is relatively steep.

The recent sell-off in Asian high yield bond market, and commodity-related and Chinese property names in particular, has improved valuation and could present selective opportunities, as some credits with reasonably sound profile suffer from indiscriminate sector-wide sell-off.

## HOW DOES PRICING IN THE ASIAN BOND MARKET COMPARE TO OTHER REGIONS?

Following the sell-off in the Asian bond market during the December 2014 - January 2015 period, valuations have generally improved relative to other regions. In particular, the yield differential between Asian high yield corporates and similarly-rated US high yield corporates, has widened significantly to levels above long-term average. While there remain uncertainties in the Chinese high yield property and energy sector at current juncture, we think that the sell-off has made valuations more attractive and, given our sanguine outlook for the market in the longer term, we will look to cautiously add exposures in selected names which we think have been oversold relative to fundamentals.



Furthermore, with the effective yield of Asian high yield corporate bonds at around 9.10% (as of 23 January 2014), we continue to think that income stream from Asian high yield corporate bonds compensates investors attractively for the relatively low default risk in Asia expected in the coming year.

Yield differential for the investment grade sector, on the other hand, has narrowed somewhat due to underperformance of the US investment grade energy sector relative to Asia. However, there remain selected value opportunities within the Asian investment grade sector.

**WHAT ARE YOUR VIEWS ON THE CHINESE PROPERTY AND HOW ARE YOU POSITIONED IN LIGHT OF THE RECENT VOLATILITY?**

In the past weeks, volatility of the Asian credit market has surged, particularly among Chinese high yield property bonds. Markets were unnerved by a series of developments surrounding Kaisa Group, a large Chinese property company, which saw pre-sales registration for

three of its projects being blocked by the Shenzhen local land authority. This was followed by news on the departures of key management personnel and creditors demanding repayment of the outstanding liabilities. Additionally, separate newsflow on more apartments by other developers being blocked in Shenzhen, further weighed on investor sentiment.

With the Kaisa episode still unfolding and questions remain on the reasons behind Shenzhen authority's actions, the weak market sentiment is likely to linger as investors worry over "who's next" to be targeted by the authorities. Nevertheless, while the recent moves appear to be linked to the government's investigations on corruption practices, we do not think that they would be pursued to such extent that would threaten the sustainability of the entire sector. Recent easing of property measures continues to point to the government's willingness to support the sector and we believe the government is mindful of the filter-down impact on the rest of the economy in the event of a collapse in the property sector. It is also important to



separate market noises from meaningful news; The Shenzhen government has clarified that its blockages of affordable housing units developed by companies, such as China Overseas Land and Investment, are due to administrative procedures and not because of non-compliant activities. Fantasia also clarified that the freezing of its apartments involved units that have already been sold and are not targeted at the company.

On a fundamental level, the credit profile for the broad Chinese high yield property sector remains largely stable; Offshore bond issuers (which tend to be the larger property companies in China) continue to report growth in contracted sales in 2014 (average 10% YoY), while shortfalls from their sales targets remain relatively small. Less aggressive land acquisitions during the year, and signs of slowing property price declines, are also expected to help stabilize or improve debt ratios of property companies. Furthermore, with credit spreads of Chinese high yield property bonds widening by more than 300 bps as a result of the recent sell-off, we view that current valuations have improved and are compensating investors more attractively for the risks involved.

All in all, we believe that the risk surrounding the Chinese high yield property sector is largely still an idiosyncratic one and we retain our base case scenario of an orderly industry consolidation in the medium term. While we are mindful that regulatory actions on individual companies are extremely difficult to predict, we have been managing downside risks by staying well diversified across the sector. We are also monitoring the markets closely and seek to be nimble in mitigating downside risks, where market conditions allow.

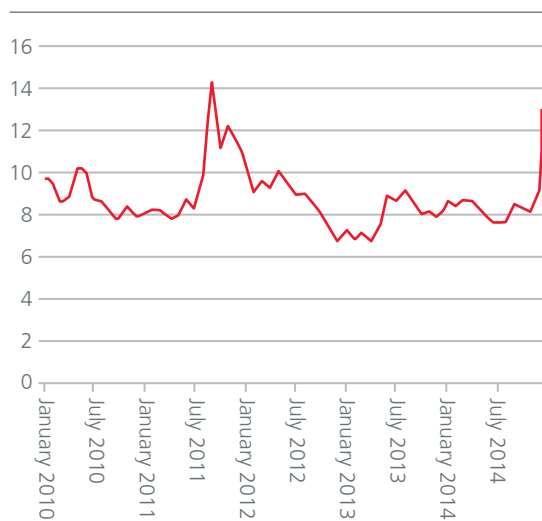
### WHAT IS THE POTENTIAL IMPACT OF HIGHER INTEREST RATES ON ASIAN BONDS AND WHAT ARE THE STRATEGIES IN PLACE TO CUSHION THE IMPACT?

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 Asian bonds could remain supported in an environment where interest rate rises due to stronger global growth momentum. High yield bonds, in particular, 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.

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 funds’ duration position where we view that interest rates have overshoot on the downside. The funds will also be focused on picking credits that are likely to benefit from the prevailing economic conditions and are able to weather through potential rises in financing costs.

Fig.5. Chinese property High Yield – average Yield-to-worst (%)



Source: Bank of America Merrill Lynch Global Research as at January 2015.



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



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