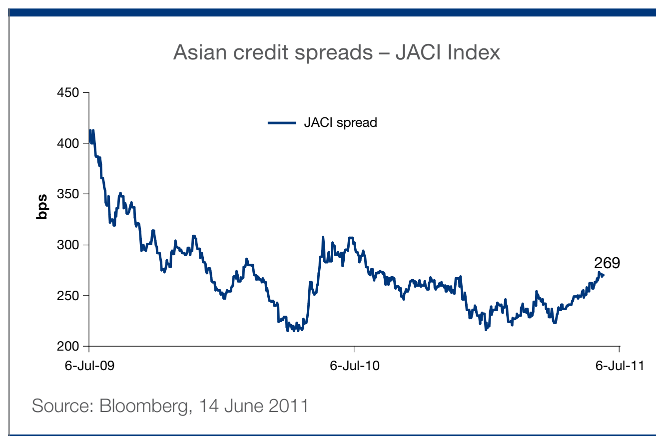
ASIA FIXED INCOME

Outlook and Strategy

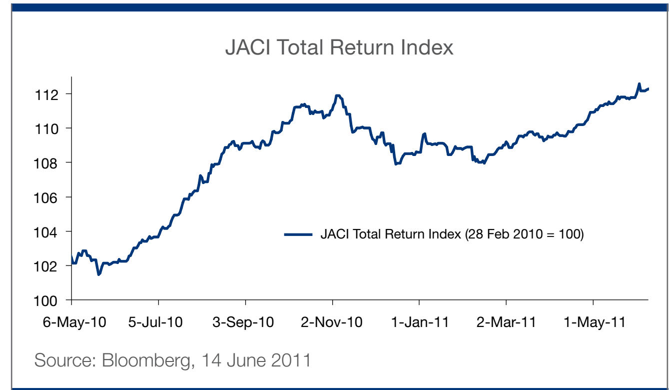
The Asia credit market weakened in second quarter of 2011, with spreads widening 33 basis points to 269 basis points as at 14 June 2011 after having tightened 5 basis points in first quarter of 2011.

However, with UST rallying hard (10-year UST yield fell 37 basis points to 3.10% in second quarter), the JACI total return index (including accrued interest and in USD terms) rose 2.3% in second quarter of 2011 from 0.83% in first quarter of 2011. This takes the year-to-date total return to 3.2% in USD terms.

At a spread of 269 basis points at 14 June 2011, the Asian credit market is pricing in real GDP growth of around 7.1% for Asia. We think that the Asian credit spread is trading at slightly expensive valuation. We think that fair value spread for Asian credits should be around 300 basis points as we think that Asia is likely to grow at around 6.7% on average in 2011.



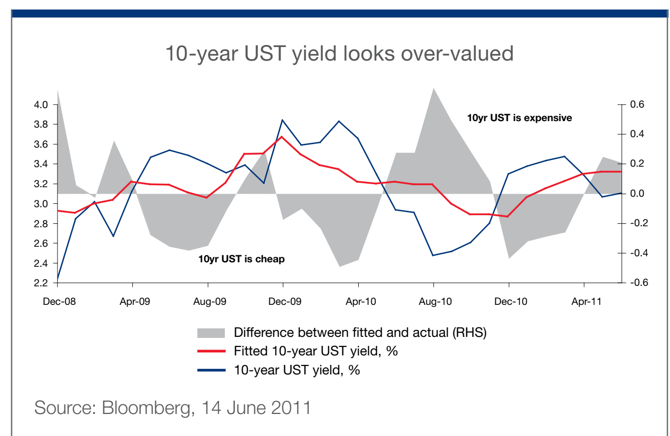
Source: Bloomberg, 14 June 2011



Source: Bloomberg, 14 June 2011

We expect Asia credit spreads to widen by a further 20 to 30 basis points in third quarter of 2011 to around 290 to 300 basis points on the back of weakening global growth, the high food and energy prices, supply disruptions from the Japan earthquake and the end of QE2 in the US.

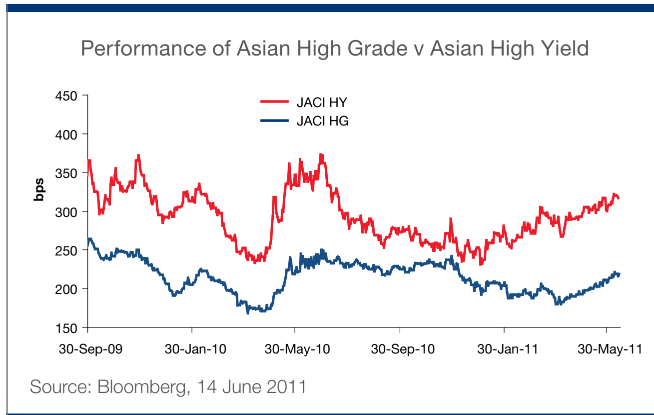
Having rallied hard in second quarter of 2011, we think that the 10-year UST yield at 3.10% looks over-valued especially given that QE2 will be ending at end June 2011. Our internal model indicates that fair value for 10-year UST should be around 3.3%, which means that 10-year UST is currently around 20 basis points over-valued.



Source: Bloomberg, 14 June 2011

We think that UST is now vulnerable to a sell-off in third quarter of 2011 especially with US inflation now rising steadily and QE2 ending in June 2011. We expect 10-year UST yield to rise to 3.5% in third quarter of 2011 and possibly past 3.75% by end 2011.

Performance of Asian High Grade v Asian High Yield



Source: Bloomberg, 14 June 2011

We continue to position our portfolio in third quarter of 2011 to minimise the negative impact from any further rise in interest rate in second half of 2011. Hence, we continue to slightly over-weight non-investment grade credits and underweight investment grade credits. Investment grade credits have higher duration due to their lower coupon and hence are more badly affected than high yield credit from rising interest rates. High yield credits are generally less sensitive to higher interest rates due to their larger spreads over UST. We will maintain our interest rate hedges against rising interest rate in third quarter of 2011.

In **High Grade**, we are overweighting China, Hong Kong, Singapore and Australia High Grade corporates. These credits include **New World Development, Henderson Land, PCCW, China Overseas, Singapore Power, China National Petroleum, National Wealth Management, ENN Energy and Kerry Properties**. These companies offer decent yield pick-up over similarly rated credits and duration without a compromise in credit quality.

In **High Yield**, we prefer good quality corporate bonds like **MIE Holdings**, **Bumi Resources**, **Yanlord**, **Franshion** and **Cogard** that have strong balance sheets and solid business models. We also like **Shui On** 6.875% 2013 and Shui On 7.625% 2015, which are both denominated in RMB (Renminbi) and offers a good yield pick-up over other RMB credits.

SECTOR	CREDIT OUTLOOK
Banks	• Banks continue to post healthy profits, reflecting the health of the economy(s) in which they operate. Given the robust economic growth in most of Asia Pacific last year, it is of little surprise the banks generated reasonable returns from their businesses. • Indian and Malaysian banks were among the most profitable on an ROE basis. Smaller Hong Kong and Thai banks were among the least profitable. Smaller Hong Kong banks are finding their modest scale a challenge in an ever increasing competitive environment. Meanwhile, government-owned Indian banks suffered a drag on earnings related to increased pension costs for retired employees and higher provisions on seasoning of loans. • Overweight Tier 1 capital debt such as ICICI 7.25% 49 (callable 2016) – cheapest amongst the Tier 1 capital debts. Financials of ICICI has strengthened post balance sheet repair in the last two financial years. • Overweight UT2 sub-debt Chinatrust 5.625% 49 (callable 2015) for attractive carry over JACI Benchmark. Chinatrust is the largest non-state controlled bank and sixth largest bank in Taiwan. The bank has reported healthy credit metrics ending March 2011 with robust asset quality, improve profitability and adequate capitalisation. • While India sector is attractive structurally given its strong macro performance and low private credit/GDP profile, there are some concerns on the pace of credit growth and potential asset quality deterioration among Indian banks. Earnings are also expected to be volatile over the next two years as interest rates increase and asset quality pressure emerges. Coupled with significant supply pipeline, we continue to underweight the sector.
Industrials	• We are turning cautious on the Chinese HY industrial sector as a large supply in recent months has weighed on performance of this sector. Primary issuance has slowed down in recent weeks but more issuers are expected to tap the market in the third quarter. • Chinese corporates have taken advantage of the RMB appreciation story to issue both CNH and USD bonds to lock in lower absolute interest yields. Also, due to tightening of monetary policy, Chinese corporates are unable to obtain funding onshore. • The Chinese HY industrials are currently going through a revaluation with average yields widening 1 to 1.5% on supply technicals. Overall backdrop is still cloudy and we await stabilisation before forming a firmer view on this space. • We like corporates that have strong balance sheets and sound business models. But we are also starting to pay close attention to corporate governance with the Sino-Forest incident. As such, we like corporates with relatively longer operating histories and linkages to the municipal or central governments either through business dealings or ownership. • We continue to like corporates in the resource and energy sector for the continued strong demand for raw materials coming from India and China.
Property	• We remain cautious on the Chinese property sector as policy and supply risks for the sector continue to weight down on the overall sector. • Weaker sentiment in the overall Chinese HY segment continues to weight on existing Chinese property names, although the sector has seen a correction in valuation levels since first quarter of 2011. • We have seen primary issue supply dramatically slowing down after the first four months of 2011. • While the series of measures in 2010 and again in the first half of 2011 have dampened sentiment for the sector, we expect the long term demand for residential property will continue to be strong given rapid urbanisation and rising income levels. However, we remain cautious on the policy front in the near term. • With the headwinds coming from policy and sales execution, we would prefer to overweight in the larger and well-established issuers as well as niche developers, with established execution and management track record. • We also prefer to stay invested in the unrated Hong Kong developers which provide premiums over similarly rated issuers.
Oil & Gas	• Oil prices are steadily rising again since taking a big dip in early May from this year's high in April. • We like this sector for the continued increase in demand and prices for oil and gas driven by growing Asian economies. • Hence we are overweight in this sector.
Utilities	• We like this sector for its defensive and stable qualities. However with the rising oil and coal price environment, gencos that are not able to readily pass on the higher cost of production will see margin squeeze. • Revenue and earnings have been stable while balance sheet and credit metrics remains healthy thus far. We see higher risk of debt-funded M&A transactions in the near to mid term as gencos aim for vertical integration via acquisitions of stakes in energy sources/companies. Thus potential supply risk as companies take advantage of current low rates to issue bonds. • We also remain positive on the Korean utilities, and would participate in new issuances with attractive valuations. We continue to believe that the fuel pass-through mechanism will be implemented in July 2011 as guided by the Korean Ministry of Knowledge Economy.
Consumer	• We are neutral on this sector as fundamentals will remain supported by resilient consumer spending. • However, the lack of superior risk-reward opportunities will limit our participation in this sector.
Telecommunication	• We view telecos in more developed markets as a defensive and stable play, while those in developing markets riding the growth story. • Regardless, we expect to see continued subscriber growth and also increased average revenue per user, driven by the roll-out of new services, increasing use of smartphones/mobile devices, as well as mobile and broadband network expansion in most countries. • However, capital expenditures and operating costs could surge as telcos invest to build up their network and related service capabilities. We do not rule out the possibility of telcos tapping the market for debt – funded acquisitions/expansion plans. • We note that the National Broadband Network projects in Singapore and Australia could change the industry dynamics when it is up and running. • Despite its defensive qualities, valuations remain expensive in general; hence, we are neutral on this sector.

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