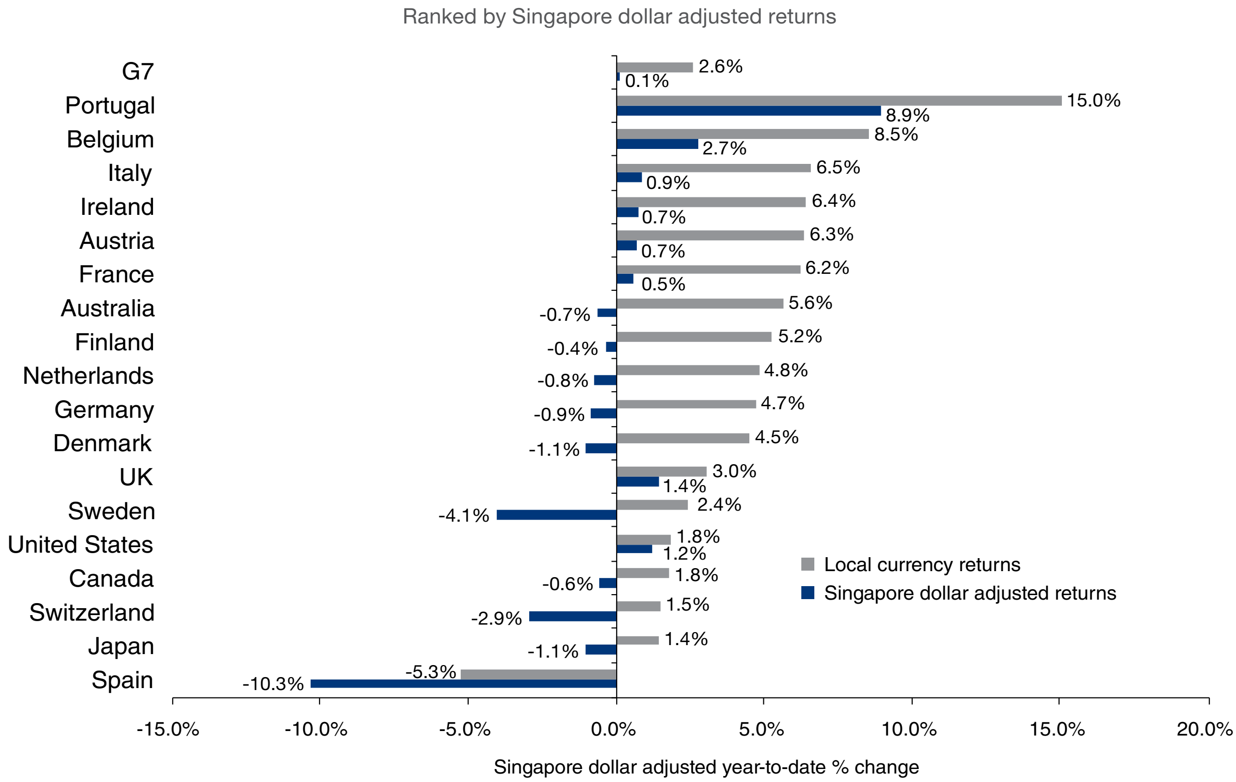
GLOBAL FIXED INCOME STRATEGY

Bond Market Returns



Source: Yield Book, as of 31 May 2012

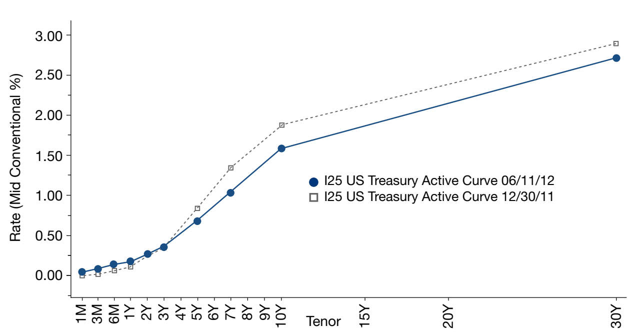
The G7 Bond Index is almost flat year to date, returning 0.1%in Singapore dollar terms. Slower economic data along with the worsening European situation prompted a "flight to quality" towards US treasuries, driving the 10-year yield to an all-time low of 1.45% this May and returning 1.8% in US dollar terms. The "non-trouble" European countries have all had positive returns in local currency terms, but the returns in Singapore dollar terms are much lower due to the appreciation of the Singapore dollar. Spanish government bonds were the worst performer of the group as concerns about Spain's banking system and its survival without external help took centre-stage. Spain eventually succumbed to the market pressure and will apply for a Euro 100 billion bailout from the EU through its Fund for Orderly Bank Restructuring ("FROB").

The US economic data started slowing this quarter after ending 2011 with a surge in growth and adding jobs at a solid pace in January and February. Though the recent weakness in payrolls is partly due to seasonality, there is also a broad-based deceleration in the economy. This further strengthens our expectations of another round of quantitative easing ("QE") to take place by August this year. The downward revisions to the Q1 GDP growth suggest that the US economy is still fragile and vulnerable to any external shocks.

The US government faces a critical fiscal situation at year-end after the November elections when many tough budget decisions are due including pending tax increases, expiring programs and spending cuts. The uncertainty generated by the fiscal cliff may start slowing growth in the later part of the year as households and businesses may start postponing decisions as they approach the election month. Though the 5-year breakeven rates are currently higher than their four year average, they are still not above the Fed's comfort zone. Hence, we don't think inflation would hold back a potential QE if the economy deteriorates from here, bringing economic justification. The Fed has maintained its dovish tone in the last FOMC meeting, mentioning the recovery in the housing market as still being vulnerable. Our expectation for QE 3 is for an outright expansion of balance sheet with buying in the Mortgage Backed Securities and Treasuries sector.

The US Treasury market still faces a risk from a Greece exit from the Euro zone and hence is likely to stay low until the uncertainty is removed. We expect the 10-year treasury yields to rise to the 2% level and remain range-bound between 1.6 and 2.2% once there is more clarity on the Euro zone situation. We expect the curve to remain flat as markets turn to the "risk off" mode unless we see significant positive surprises from the US economy. Our exposure to US treasuries is neutral in terms of assets, duration and currency, as compared to the benchmark.

US Treasury yield curve



Source: Bloomberg, as of 11 June 2012

In Europe, the support for the peripheral markets from the ECB's LTRO has started to fade, and the revisions to Spain's deficit targets triggered fresh volatility in the markets. Adding to the market fear was the indecisive Greek elections, in which none of the parties were able to form a coalition government resulting in a re-election due on 17 June. This certainly raised the odds of Greece's exit from the Euro zone, even though there are signs that the New Democratic Party should be able to succeed in forming a government. We do not foresee a disorderly exit by Greece but the scenario should continue to muddle through in the next few months. Spain agreed to a bailout for its banks to a maximum of EUR100 billion to be channelled through Spain's FROB, though this still represents a liability of the Spanish sovereign.

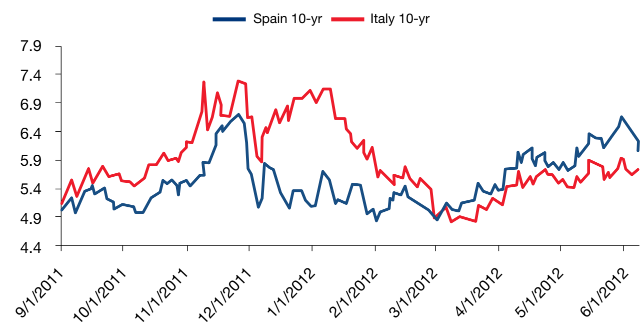
Given the continued volatility in the peripherals, German Bunds continued to be the safe haven of the Euro zone, bringing the yields to all-time low levels. The decoupling from the rest of Euro zone and record low level of unemployment mean that inflation could rise due to wage pressures. In recent months, we have also seen the growing size of the euro area's national banks' claims and liabilities to the TARGET2 payment system. The German Bundesbank has substantial claims while central banks in the peripherals have substantial liabilities. The imbalance poses potential credit risk towards core Europe, especially to Germany, in the event of a disorderly exit as the claims and liabilities of the national central banks are with the ECB, not with other central banks. Hence, any ECB losses from refinancing operations with banks in the departing country would have to be shared by the remaining members of the Euro system. For the time being, we expect bund yields to stay low as the safety/liquidity premium from lingering market tensions is capping the yields. Domestic buying from the Euro zone should also continue to be strong due to shrinking investment grade sovereigns. However, the key risks towards German credit quality may develop if there is a flight from the Euro zone altogether or if the ECB faces substantial consequences in case Greece exits the Euro zone.

As expected, Francois Hollande emerged as a winner in the French elections. According to his campaign's focus on introduction of pro-growth policies, his first measures are likely to be on revisions of pension reforms, which could start widening the pension deficit and raise doubts with the rating agencies. Hence, the policy moves by the new president bears close watch, as any downgrade by another rating agency would take away its average AAA rating, posing a risk on yields. Any extension of deficit targets could also cause a decline in investor confidence, bringing the country to the forefront. Though it remains to be seen how the change in policies evolves in France, we do not expect any major negotiations to be held on the EU pact.

A formal request for the bailout was made by Spain before the Greek elections, but the actual funding will be rolled out in the second half of the year, as the ESM facility will officially start only in July. We expect the loans to come from the ESM (not EFSF) as it offers an extra layer of protection via its seniority, which the core EU countries are likely to demand. On the other hand, the previously made EFSF loans to Greece, Ireland and Portugal were ranked pari passu with their existing debt. The subordination of the Spanish government bonds may further put pressure on their yields, spreading the crisis beyond to the financial sector.

Before the bailout request, Spain's PM unveiled the awaited banking reforms in May but was not able to calm the market's apprehensions. The plan lacked a few key elements, including a back stop mechanism for the losses in the banking sector. Though the country has now hired the "big four" accounting firms to carry out individual audits of the banking system, Bankia (the bank formed by integration of seven cajas in 2010) had announced financing needs of €19 billion-four times that of initial estimates. The announcement signalled that the Spanish banking system may be facing more losses than estimated. The EU is also considering extending Spain's deadline to hit 3% deficit target to 2014 from 2013. Italy, on the other hand, is also facing dwindling commitment from the political parties supporting the current technocratic government to follow a strict consolidation course. Hence, PM Mont's ambitious plan (including labour market reforms) may fade away in negotiations and compromises.

10-year yields: Italy and Spain



Source: Bloomberg, as of 11 June 2012

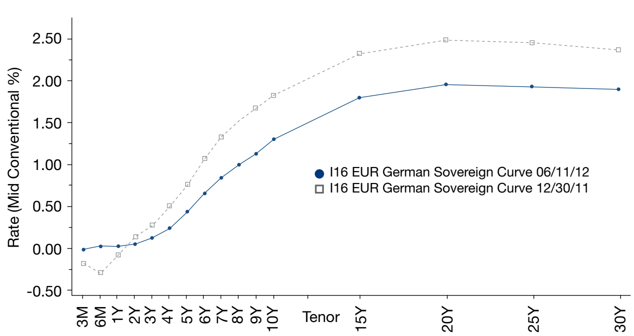
Overall, the Euro zone continues to struggle with the ongoing debt crisis, with the risks of Greece's disorderly exit still being on the forefront. Greece's default will affect the ECB and the official sector, which have holdings of Greek government bonds and other collateral. For Spain, the success of the rescue plan will depend on its execution and should be used to write down the hidden losses. It is also crucial for the country to achieve its fiscal targets to limit the requirement of the bailout to the financial sector.

On the other hand, an important step towards EU bank consolidation is currently under discussion. This proposes a common support for the banking system of all EU countries, which would spread the costs of any future bank rescues and a centralized institution leading the entire banking system. Though we consider the proposal to be a step in the right direction which will spell out an insolvency regime for banks, the plan will need to be first approved by all EU countries and the European parliament and may not take effect any time soon.

UK has also started succumbing to weak external demand, especially from the Euro area counterparts. The recent manufacturing PMI number slumped below the 50 level to reflect contraction and further weakens the growth expectations for the country. On the other hand, the UK labour market data has been surprisingly resilient given the anaemic trend in GDP statistics. One explanation for the strong number is the significant rise in part-time employment. Decline in inflation in the recent months towards the Bank of England (BOE)'s long-term target is reflecting the unwinding of indirect tax hikes. In addition, falls in oil and commodity prices should provide disinflationary impetus in the coming months. BOE has halted its QE at 325 billion pounds, but given the continuing weak momentum in the economy along with receding inflation, we expect the QE to restart later in the year.

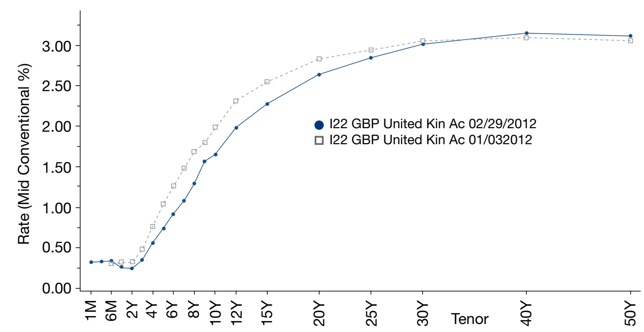
For the Euro zone, we are neutral on Italy and underweight Germany and France. In terms of duration, we are neutral on France and Italy, while short on Germany. Given the slow growth along with falling inflation levels, we are overweight in UK Gilts and long on duration. In terms of currency we are underweight in both GBP and Euro.

German Sovereign Curve



Source: Bloomberg; as of 11 June 2012

UK Sovereign Curve



Source: Bloomberg; as of 11 June 2012

The Japanese economy registered growth of 1.2% quarter-on-quarter for the first quarter of 2012, driven by private consumption and public investments. Supporting the drivers were subsidies on energy-efficient cars, reconstruction demand and restocking of inventories. The trade balance was negative as imports remain elevated from increasing needs for fuels to run thermal power plants as all the nuclear power plants were turned off by May this year. Exports to the European Union countries are declining as these countries are experiencing slower growth.

Domestic demand in Japan is holding up growth and assuming no big shock to the global financial system, it is expected to be supportive of the Japanese economic activities. The labour market has been relatively stable with unemployment hovering around 4.5% for the past few months. Jobs in the quake affected area Tohoku region picked up. There is a modest but improving trend in employment and small firms seem to be responsible for the recovery in job numbers. The pace of improvement may be modest as firms are still cautious amid rising costs, a strong Japanese yen and uncertainty about global economic growth. Loan demand improved across firms and households for the first quarter of 2012, but the bank outlook suggests that there may a slide in the next quarter. Industrial production was still rising but fell short of production target and this is reflected in a weaker realization ratio. The outlook for industrial production is still weak judging from the MITI outlook survey. Overall conditions in manufacturing are tough as costs of production are rising and squeezing profits.

Nationwide consumer price stayed above zero and averaged 0.3% in the first quarter, and was at 0.5% in March. With nuclear power supply unlikely to return in the near future with so much resistance on the ground, electricity charges are poised to increase. The extent is unclear but this posed an upward bias to the CPI.

Banks are big holders of Japanese government bonds (JGBs) financed with high deposits, a consequence of sluggishness in growth and household portfolios are biased to hold low-risk domestic assets such as deposits. These deposits are channelled into JGBs via the banking system. Gross debt to GDP ratio is high and fiscal consolidation has not made any progress.

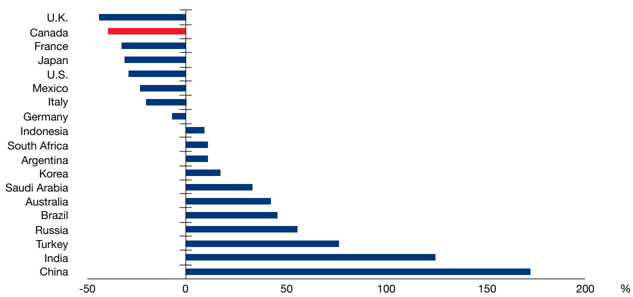
Japan managed to stay away from deflation in the last few months and this gave some respite to the central bank to take more aggressive loosening measures. This is probably one of the reasons for the support for the Japanese yen. Considering the demographics and fiscal challenges, we are underweight JGBs and neutral on Japanese yen.

Canada grew slower than the previous quarter in the first quarter of 2012. Real GDP was 1.8% yoy in the first quarter of 2012 compared to 2.2% yoy achieved in the fourth quarter of 2011. The growth was driven by business and housing investments. Consumption contributed to GDP growth but at a slower pace while net exports subtracted from growth. Considering the more moderate pace of expansion in the most recent quarter, it is no surprise that the central bank maintained the accommodative monetary policy.

The Bank of Canada (BOC) monetary policy meeting in June ended with the central bank keeping the overnight rate unchanged at 1%, a rate that it has maintained since September 2010. The tone of the central bank has softened from that at the prior meeting, sounding less hawkish than before. In the press release following the decision on the policy rate, the central bank mentioned that outlook for the global economic outlook has weakened in recent weeks and some of the risks surrounding the European crisis are materializing and skewing risks to the downside. The highlight of its domestic economy was that growth in the first quarter of 2012 was slower than expected and the composition of growth was less balanced with housing activity stronger than expected and households adding to their debt burden in an environment of modest income growth. BOC expects contribution from government spending to be modest and recovery in net exports to be weak in light of the ongoing challenges. Inflationary pressure is also expected to be modest.

Contributing to the slower expansion are deepening external challenges and domestic factors such as the strength of its currency and diminishing productivity growth. The rise in investment spending in the first quarter of 2012 is a reflection that there is little slack in the economy and Canadian's firms efforts in expansion and upgrading of their capacity. Canada's market share of world exports has declined by a fair amount as shown in the chart below and more needs to be done to improve the competitiveness of its products. For now, it still enjoys the benefit of proximity and trade links to the United States, which is still in a better shape than the European continent. We are neutral on Canadian government bonds and Canadian dollar.

Percentage change in share of world exports, 2000 to 2010



Source: International Monetary Fund

In recent months, Australia has eased its monetary policy but put fiscal position on a consolidation path.

The Reserve Bank of Australia (RBA) concluded the Monetary Policy Meeting in May with a bigger than expected cut in the cash rate by 50 bps to 3.75%. The decision was based on weaker-than-expected economic conditions and moderating inflation. RBA delivered the bigger than expected 50 bps cut after having left the policy rate unchanged since November last year when they cut it by 25 bps. The central bank typically moves in 25 bps steps except under conditions such as the Great Financial Crisis, when aggressive cuts of 100 bps or 75 bps were delivered. Rate cuts continued in the June meeting by another 25 bps and the driver seems to be deterioration of financial market sentiment. The central bank noted that Europe would remain a potential source of adverse shocks with prospects crowded by weakening growth, heightened political uncertainty and concerns about the strength of some banks.

RBA discussed Australia's growth trend and expected inflation. The domestic outgrowth growth was somewhat below trend for the past year, affected by both temporary factors and the persistently high exchange rate. Structural changes are occurring and the labour conditions softened during 2011, though the rate of unemployment remained low. Both households and businesses continue to exhibit caution.

Underlying inflation has declined and was a little over 2% over the latest four quarters. Headline inflation also declined from about 3.5% last year to about 1% for the first quarter of 2012. Over the coming one to two years, subtracting the effects of carbon price, inflation will probably be lower than expected and still in the 2 – 3% range. This gives RBA the flexibility to reduce the policy rate should economic conditions call for it. As reflected in the Federal Budget for 2012-2013, the government intends to return the budget balance to surplus in 2012/2013. This leaves RBA to do the weight-lifting using monetary policy tools should the economy slow down.

The Australian economy is sensitive to global activities through its trade links especially in its exports of commodities, and the currency is highly sensible to risk sentiments and trade activities. There are signs that terms of trade have peaked and increasing talks of whether the commodity super cycle has come to an end. While mining capital expenditure is still increasing, there are pullbacks in capital expenditure under consideration. This could be due to pauses in further commitments as risk of a slowdown is being assessed.

The government bonds have rallied significantly and priced in further cuts ahead. In view of the above discussed, we are neutral on the Australian government bonds and underweight Australian dollar.