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FUND INSIGHTS

ASIAN HIGH YIELD BOND MARKET UPDATE

EASTSPRING INVESTMENTS – ASIAN HIGH YIELD BOND FUND (THE "FUND")
JULY 2016

HOW HAS THE ASIAN HIGH YIELD BOND MARKET PERFORMED SO FAR?

We entered 2016 with a view that there were pockets of value in the Asian high yield bond market. This view has been proven largely correct as Asian high yield bonds (represented by the JP Morgan Asia Credit – Non Investment Grade Index) reported a strong gain of 7.80% in 1H 2016. Our fund, Eastspring Investments – Asian High Yield Bond Fund (the "Fund"), delivered a significant outperformance of 124 basis points against the benchmark, rising by 9.04% (gross of fees) over the same period.

The strong performance of Asian high yield bonds was driven by a combination of lower US interest rates and a tightening of credit spreads.

US Treasury yields have fallen as global growth concerns and volatile commodity prices drove flight to quality flows into US Treasuries. The mixed economic data in the US, as well as concerns over the impact of UK's decision to leave the European Union (EU), also pushed back expectations of US rate hikes.

Despite the jittery global backdrop, demand for Asian high yield credits remained resilient amid limited new supply. While there were initial worries over sustained commodity price weakness and a rapid slowdown in China, the fears receded in mid-February of 2016 following a strong rebound in oil prices and supportive policy moves in the region. Some signs of stabilisation in China's March-April 2016 economic data also led to the market's cautious optimism.

Across markets/sectors, Indonesian high yield corporates stood out as a clear outperformer. The Indonesian bond market turned in an impressive year-to-date performance, helped by an improving macro picture. Higher public sector spending and stabilising domestic demand were all positive contributors to Indonesia's macro environment. Gaming, energy and commodity-related credits also made a strong comeback following their underperformance last year.

Against this backdrop, the Fund benefitted significantly from its overweight in both Indonesian USD and local currency (off benchmark) bonds. The Fund's overweight position in Sri Lanka, as well as positive credit selection in India and Mongolia, were also contributors to the Fund's outperformance.

Fig.1. Year-to-date returns of Asian high yield corporates (%)

Source: Bloomberg, Bank of America Merrill Lynch Asian dollar high yield corporate index, as at 30 June 2016.

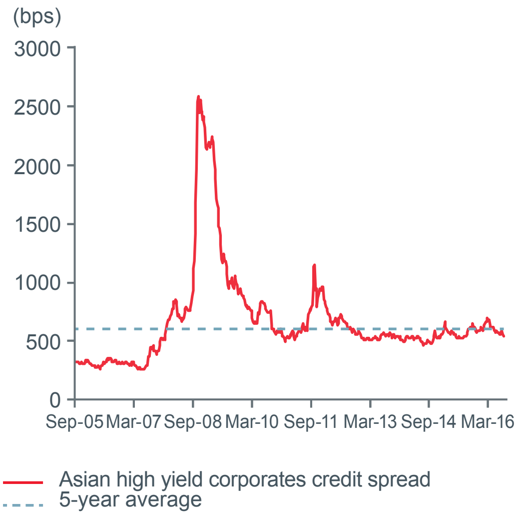
WHAT IS YOUR OUTLOOK FOR THE ASIAN HIGH YIELD BOND MARKET AND HOW IS THE FUND POSITIONED GIVEN THIS OUTLOOK?

Undoubtedly, the intense quest for yield, as well as limited new supply has played a big part in the market's strong performance in 1H 2016.

This strong demand for yield looks likely to be sustained as liquidity continues to be pumped in by central banks, while interest rate expectations are being lowered (to negative level for some!).

Rising participation from local investors also underpins the resilient demand for Asian bonds. Notably, we have seen strong interests from China onshore institutional investors, seeking to enhance yield through USD bonds given their yield advantage over onshore bonds. While all-in yields of Asian high yield bonds have fallen significantly to near 6% currently, the asset class still offers a relatively attractive yield pick-up compared to the investment grade sector, as well as other high yield bond markets (see Fig 3). High yield credit spreads are also trading off their record lows, currently at levels near the 5-year historical average.

Fig.2. Credits spreads of Asian high yield corporate bonds



Source: Eastspring Investments, Bloomberg, as at 1 July 2016. Asian high yield corporates credit spread represented by JP Morgan Asia Credit – Non Investment Grade Index.

That said, it is important to proceed with caution through credit differentiation. Growth in Asia remains weak due to the soft external demand and domestic constraints. This will continue to put pressure on corporate earnings and amplify idiosyncratic weaknesses, as seen from the negative credit migration trend over the past 12 months. Potential headwinds could also arise from Brexit's fallout, sharper-than-expected slowdown in China and renewed volatility in currencies/commodity prices. These uncertainties could still trigger bouts of risk aversion, which may not be fully priced in by the market at current valuations. We are thus adopting a more cautious stance in our Fund for now, in view of the less compelling valuations. We have been taking profit in higher-beta credits, while switching to lower-beta securities, or to new issues that are more attractively priced. We are also paring our investment bets in smaller single B-rated names, which are more likely to tap the USD bond market for funding although the overall supply for the high yield bond market remains limited.

In the longer-term, however, the opportunity cost of not staying invested in the market remains high. The coupon income offered by Asian high yield bonds is still substantial on absolute terms, especially in this low interest rate environment.

The favourable supply-demand dynamics and our expectation of a muddle-through scenario for Asian economies (helped by the policy and fiscal room of Asian governments to stimulate growth) should also limit downside risks.

Furthermore, there are pockets of improving macro and micro stories, which are sometimes overlooked by investors. In India and Indonesia, growth potential remains strong on the back of structural reform progress, relatively low level of private sector debt and robust domestic demand. The recent monetary policy easing in Indonesia, which saw policy rates and loan-to-value ratio being cut, is also viewed to be a positive for property demand. In China, its property sector continues to be a stabilising force, with rising residential property prices and strong sales volume across the country (and not just in the Tier 1 cities). Housing inventories have also been reduced amid the strong sales momentum. Considering these factors, we are maintaining an overweight position in Indonesian corporates and Chinese property credits in our Fund. In India, our positions are more selective, with our overweights driven by bottom-up views. We also have a small non-benchmark exposure to Indian Rupee currency bonds.

THOUGHTS ON BREXIT IMPACT ON THE ASIAN HIGH YIELD BOND MARKET

Asian high yield credit spreads initially widened in reaction to the unexpected Brexit outcome. However, by the end of June 2016, Asian high yield credit spreads recovered and closed the month only 2 basis points higher than the previous month.

While Brexit could weigh on growth in the UK and Eurozone, which in turn has a knock-on impact on Asia's growth, the direct fallout is expected to be manageable.

Asia's trade and financial linkages with the UK and EU have weakened over the past decade. This is also in line with our observation that most Asian corporates have limited direct exposure to UK and Europe.

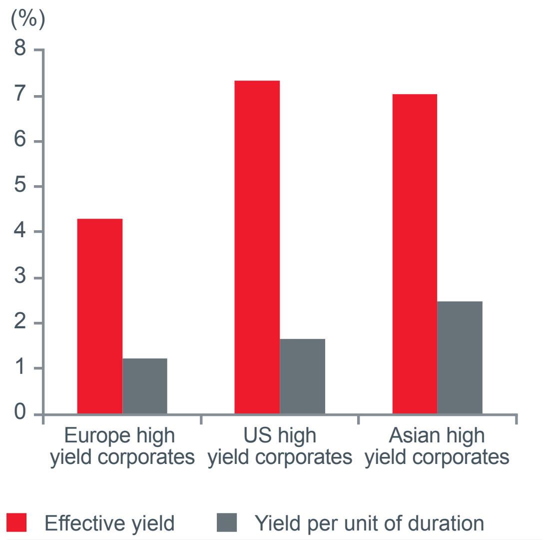
For those that have significant exposures, they are generally large companies with stronger balance sheets.

Nevertheless, there remain formidable political uncertainties ahead and bouts of risk aversion could be triggered by negative developments arising from Brexit. Contagion risks and potential second-order impact due to a slowdown in global growth would also still need to be closely watched. However, our baseline scenario remains that contagion risks would be contained and the probability of a global recession is low. This is in line with our view that the event is primarily a politically-induced one, rather than a credit crisis that has more immediate financial and liquidity ramifications. Major central banks are also better prepared to act and mitigate excessive volatility in financial markets.

HOW DOES PRICING OF THE ASIAN HIGH YIELD BOND MARKET COMPARE TO THAT OF OTHER HIGH YIELD BOND MARKETS?

The yield differential between Asian and US high yield corporate bonds appears to have narrowed over the past year if we compare only the top-line yield of the respective market indices. However, if we adjust for the duration differences in the two markets (as seen from the yield per unit of duration chart), it can be seen that Asian high yield corporate bonds still offer yield pick-up over the US.

Fig.3. Yield per unit of duration



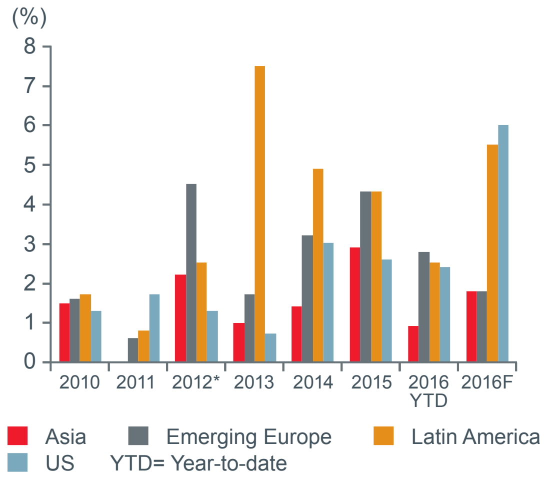
Source: Bloomberg, Eastspring Investments, Bank of America (BofA) Merrill Lynch, as at 30 June 2016. Asian high yield corporate as represented by BofA Merrill Lynch Asian dollar high yield corporates index; US high yield corporates as represented by BofA Merrill Lynch US high yield index, Europe high yield corporates represented by BofA Merrill Lynch Europe high yield index.

In other words, for each unit of duration risk, we are getting a higher yield from Asian high yield corporate bonds.

This yield pick-up also remains attractive relative to the default rate expectation for the Asian region this year. Despite the challenging operating environment, high yield default in the region is expected to remain low, helped by low refinancing needs and availability of alternative funding avenues for high yield corporates. For example, Chinese property developers have turned increasingly to onshore debt market for funding to mitigate currency risks and lower funding costs. This has also resulted in a number of offshore USD bonds being called or redeemed this year. Furthermore, unlike in the US, where the energy sector has contributed to an increase in high yield default rate to 2.4% year-to-date, the sector represents a much smaller part of the Asian high yield universe.

This has kept the overall high yield default rate in Asia at around 0.9% in 1H 2016, with moderate increases expected for the rest of the year.

Fig.4. High yield corporate default rates for 2010-2016F



Source: JP Morgan, as at July 2016. Note: F = Forecast. Default rates are par weighted and based on high yield debt stock at prior year-end, excluding defaulted bonds; inclusive of distressed exchanges. * Excludes USD5.2 billion in BTAS recovery notes issued in 2010 restructuring. Any projection or forecast is not necessarily indicative of the future or likely performance.

CHINA, ESPECIALLY THE CHINESE PROPERTY SECTOR, REPRESENTS A LARGE PART OF THE ASIAN HIGH YIELD BOND MARKET. WHAT IS YOUR OUTLOOK FOR CHINA AND THE CHINESE PROPERTY SECTOR?

Growth outlook in China remains soft as a combination of factors such as, elevated leverage, challenging external growth condition and ongoing structural reforms, could continue to weigh on growth. For 2016, the government growth's forecast was also lowered to a range of 6.5 % - 7%, down from the above 7% growth pace in the recent years.

We view that the government remains focused on supporting growth and preventing it from falling off the cliff.

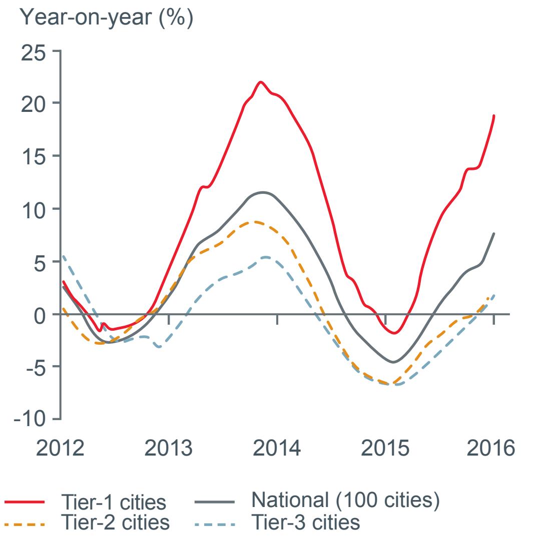
This is reflected by the easing measures implemented by the People's Bank of China and the policies announced over the past year. Reserve requirement ratios and policy rates have been lowered, while liquidity continues to be injected through various monetary policy tools. At the same time, infrastructure projects have been sped up and public spending has risen.

Nevertheless, with the government's continued ongoing structural reforms, including efforts to reduce overcapacity in the manufacturing sector and tighter controls over non-traditional financing channels, the outlook for different sectors is likely to be uneven. Material/industrial companies are likely to be under continued pressure as private investments slow and global demand remains soft.

The broad outlook for the property sector, on the other hand, is expected to remain stable. Although property sales and prices could moderate in 2H 2016 after the strong performance over the past year, we note that the contracted sales targets of major property developers are not overly aggressive to begin with. Many of them have also outperformed their sales targets in 1H 2016. This is likely to provide a buffer against earnings disappointment. The overall policy bias will also remain supportive even as selective tightening is seen in Tier 1 cities to prevent a build-up of asset bubbles.

Given this stable outlook, we continue to hold an overweight in the Chinese high yield property sector. While valuations have become more expensive after their performance last year, the sector still provides a stable source of carry, with yield currently at around 5 – 6%.

Fig.5. House price inflation in China



Source: CRIES, CEIC, J.P. Morgan Economic Research, as at June 2016.

Broad trends apart, the importance of credit differentiation cannot be emphasised enough in this environment. Within the property sector, despite our broad overweight in the sector, we are mindful of potential deterioration in the credit fundamentals of selected developers, which have been more aggressive in land acquisition. Outside of the property sector, on the other hand, we may hold credits which could potentially benefit from a bottoming out of negative sectoral trend, or where the companies are making positive steps to weather through the challenging operating environment, such as through a reduction of capital expenditure or sales of assets.

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