*Judy Leong, CFA - Head of Fixed Income - Credit*

**REVIEW FY2013 & OUTLOOK FY2014:**

- The Asian USD credit market had a disappointing year in 2013 after posting strong performance in prior years. Credit spreads ended the year wider by about 25bps as new supply overwhelmed demand. Not surprisingly, issuers were trying to lock in historic low medium/long-term interest costs. The supply-demand imbalance was further exacerbated when QE tapering chatter hit the markets in May and investors started to redeem from Asia. Macro fundamentals in Asia were secondary concerns.
- For FY2013, the JP Morgan Asia Credit Index "JACI" returned -1.42%. JACI Investment Grade Index underperformed versus JACI Non-Investment Grade Index, delivering -2.60% versus +1.90%.
- For FY2014, we do not a strong reversal to positive returns. The negative return for FY2013 was due primarily to rising US Treasury yields. US 5 year government bond yield rose from 0.65% in May 2013 to 1.72% in Dec 2013. The Bloomberg US Treasury Index declined by -3.29% for FY2013. With the QE tapering starting in Jan 2014, we expect US Treasury yields to continue their climb in FY2014. Our base case is for US treasury 10 year to rise by 40-60bps to around 3.5% with risk of overshooting as markets may over react. Credit is expected to do better as credit spreads may widen by a more moderate 10-30 basis points.
- Overall, AxJ credit is expected to generate positive return but this could be offset by a decline in the underlying treasury hence we expect JACI to deliver flat to low single digit returns for FY2014. It is still a respectable return when considering short term dollar rates at near zero given Fed's guidance to keep policy rate low into 2015.

**Source JP Morgan as of 26th Dec 2013**

| | |
|---|---|
| **JACI Yield** | **5.30** |
| **JACI weighted duration** | **5.17** |

**Expected Total Return for JACI FY2014**

| | Credit spread rises by | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| US Treasury rises by | -20 | -10 | 0 | 10 | 20 | 30 | 40 | 50 |
| 10 | 5.82 | 5.30 | 4.78 | 4.27 | 3.75 | 3.23 | 2.72 | 2.20 |
| 20 | 5.30 | 4.78 | 4.27 | 3.75 | 3.23 | 2.72 | 2.20 | 1.68 |
| 30 | 4.78 | 4.27 | 3.75 | 3.23 | 2.72 | 2.20 | 1.68 | 1.16 |
| 40 | 4.27 | 3.75 | 3.23 | 2.72 | 2.20 | 1.68 | 1.16 | 0.65 |
| 50 | 3.75 | 3.23 | 2.72 | 2.20 | 1.68 | 1.16 | 0.65 | 0.13 |
| 60 | 3.23 | 2.72 | 2.20 | 1.68 | 1.16 | 0.65 | 0.13 | -0.39 |
| 70 | 2.72 | 2.20 | 1.68 | 1.16 | 0.65 | 0.13 | -0.39 | -0.90 |
| 80 | 2.20 | 1.68 | 1.16 | 0.65 | 0.13 | -0.39 | -0.90 | -1.42 |
| 90 | 1.68 | 1.16 | 0.65 | 0.13 | -0.39 | -0.90 | -1.42 | -1.94 |
| 100 | 1.16 | 0.65 | 0.13 | -0.39 | -0.90 | -1.42 | -1.94 | -2.46 |

**THEMES FY2014:**

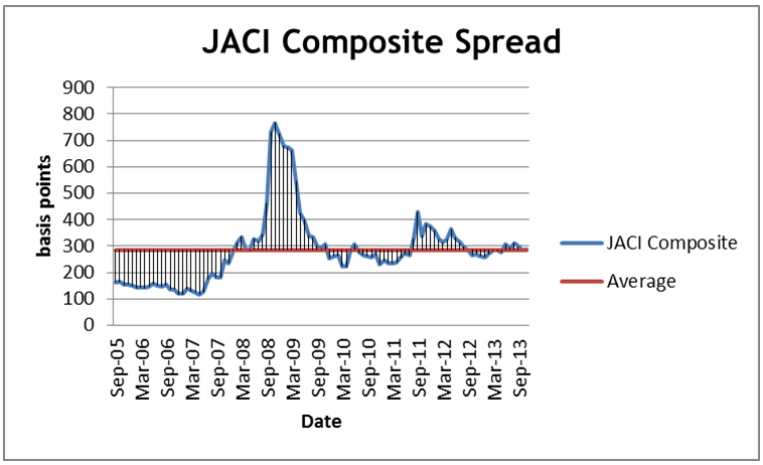
- **QE taper:** Commencing in Jan 2014, QE tapering will keep interest rates under pressure. Domestic bond markets may test new highs given low liquidity and continuing funds outflow from EM Bonds. However with the QE uncertainty out of the way, investors will again focus on macro fundamentals, which in our opinion, is improving.
- **Improving growth, easing inflation**: We expect 2014 to be a better year for Asia primarily due to improving growth from US and Europe. However we expect divergence in performance across the region depending on the country's exposure to developed market demand, its vulnerability to volatile capital flows/higher rates, and its determination to push through domestic policy reforms. Overall we favor North Asia over South Asia as we are more optimistic about countries with high export exposure and those on a reform trajectory. Inflation should be under control with softer commodity prices and continued monetary policy actions.
-

- **Elections & reforms:** China's 3rd plenum reforms are positive for a sustainable growth. Elections in Thailand, India and Indonesia may cause some volatility in the 1H2014 but markets will stabilize and improve from 2H2014 as the governments revert their focus back to reforms and growth.
- **Funds Flow:** Asia bond funds have been experiencing net outflows since May 2013 and will continue to be a concern in FY2014. We expect investors to start to invest in Asia again when the US tapering is about halfway through and Asia delivers stronger growth numbers.

**STRATEGIES FY2014: YEAR OF CARRY**

As mentioned earlier, we expect JACI to deliver flat to small positive returns for FY2014. The current JACI credit spread at the historic average is neither cheap nor expensive. However, at 5.30% yield, it offers good carry to offset the potential loss from rising interest rates. We list out our key positions below based on our views and outlook:

- **Duration:** Underweight with a bear steepener i.e. favor shorter maturity vs. longer maturities.
- **Credits:** Overweight credits versus sovereign/quasi-sovereigns. Overweight non-investment grade corporates versus Investment grade corporates. Sweet spot in BB rated corporates.
- **Sector/Country:** Prefer old-style Basel II bank capital bonds and Chinese property for carry. Cautious on Korea, Chinese SOEs due to supply and Indian financials on the sovereign downgrade risk.



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