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# Asian Bonds Review And Outlook 2013

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## OVERVIEW

Lion Global Investors shares its views regarding its Asian bonds outlook for 2013

**Market Review**

In 2012, one of the key themes driving global interest rates was the direction of Central Bank policy. The European Central Bank (ECB) announced its Long Term Refinancing Operations (LTRO) while the US Federal Reserve (the Fed) said that it would keep rates low for the foreseeable future. Such policies anchored short-term rates, boosting 'search-for-yield' flows in the fixed income space.

Another theme was the reduction of market fears over a Eurozone break-up. In Europe, Mario Draghi, President of the European Central Bank (ECB) followed-up on his comments that the ECB would do "all that it takes" to protect the Euro with a commitment in September of unlimited bond purchases under its Outright Monetary Transactions (OMT) programme. This substantially removed the tail risk of a Eurozone breakup. Funds that had flowed into the core bond markets seeking safe havens reversed. As a result, bond yields rose from historic lows in the core markets while bond yields in the peripheral countries came down. September also saw the Fed deliver a third round of Quantitative Easing (QE3). All these actions improved the risk sentiment towards the end of 2012.

2012 ended on a positive note, with a rally in major risk assets as markets were buoyed by optimism that a deal would be concluded allowing the US to avert a "fiscal cliff" situation from occurring in 2013; the positive market sentiment was vindicated by the last minute agreement that was reached on the last day of 2012.

With respect to developments in the fixed income market, global credit outperformed, with market technicals rather than fundamentals being the biggest driver of performance. The search for yield was the dominant theme for investors, with markets buoyed by monetary easing by central banks worldwide. The consequent steady flow of funds helped the credit market to enjoy significant spread tightening during the year. Asian credit, as measured by the JP Morgan Asian Credit Index (JACI), gained 14.3% in USD terms, (7.7% in SGD terms) on a total return basis, the best year for the market since 2009.

By contrast, core government bonds underperformed relative to 2011, reflective of investors' more positive risk sentiment. The returns of 10-Year government bonds in the US, UK and Japan were 2.2%, 2.6% and 1.8% respectively, in USD terms for 2012 [1] – modest returns when compared to the double-digit returns seen in 2011. Locally, Singapore Government Securities (SGS) returned 3.9% [2] in SGD terms in 2012.

[1] *Source: JPMorgan's Global Asset Allocation report, as of 4 January 2013*
[2] *Source: UOB SGS Index, as of 31 December 2012*

**Market Outlook**

Looking forward into 2013, the global growth outlook remains uncertain. Growth in the developed countries is expected to be slow. The current easy monetary policy that is in place for most major economies is expected to remain accommodative until there is strength in the pace of growth.

In terms of regions, the outlook for the US appears more positive compared to the other major economies. The deal on tax cuts agreed by the US Congress averted a sharp drag on growth in 2013. While a recession was avoided, fiscal tightening will lead to a modest pace of growth in the US. Further, the unresolved issues of the debt ceiling and longer term fiscal deficit will mean hard negotiations and volatility in the markets in the months ahead. US Treasury rates, therefore, are likely to remain volatile, within a 1.5% - 2.1% range.

In Europe, the ECB's OMT programme has significantly reduced the risk of the Eurozone breaking up but, it has not solved the fundamental issue of sustainability of the present Eurozone structure. This will require further changes in existing arrangements and will have to be agreed in the coming months. The present sense of relief could be interrupted by any number of events, such as the general elections to be held in Italy and Germany during the year. Any rise in the political uncertainty could result in bond yields spiking up for financially precarious Eurozone countries such as Greece and Spain. Talk of a referendum in the UK on the nature of its membership in the EU will also be a source of concern.

In Asia, barring a slowdown in global growth, the region is likely to experience a moderately stronger growth in 2013 compared to 2012, as domestic demand is expected to increase while external demand is expected to recover from the weak levels seen in 2012. Given the extent of rate cuts that Asian countries had in 2012, there is limited room for further rate cuts, with inflation expected to be sticky around current levels as well.

Looking across fixed income asset classes, we expect returns to be more homogeneous in 2013. This is in contrast to 2012, when Asian Credit was the outstanding performer. Much of 2012's return in Asian credit was due to the compression of credit spreads, and this is unlikely to occur again. Returns in 2013 will come significantly from yield accrual; this is likely to lead to returns of 4-4.5% (USD terms).

In the Asian Local Currency space, bond yields are likely to stay around current levels. In addition, we expect Asian currencies to generally do well relative to most developed nations' currencies giving expected returns of approximately 4% (in USD terms) across the broad Asian Local Currency space. Given that short-term interest rates are expected to remain low, FX changes are expected to be a key driver of returns in this space. That said, some countries with higher yields will still see yield accruals contribute to a significant part of returns, given that the country bond yield levels are not uniform across Asia. Judicious country allocation will enhance returns.

Locally, Singapore bond yields have been kept low by the strong inflows and flush liquidity in the local market. This is likely to continue, with major central banks maintaining their easy monetary policy into 2013. In the event that global rates turn higher as global growth turns stronger, we expect the Singapore Dollar (SGD) to track higher as well. There has been a large portion of inflows into SGS, as part of central banks' reserve diversification policy. These flows tend to be less volatile and will mitigate some of the impact should there be a rise in rates.

In Singapore's low interest rate environment, yield return comes mainly from corporate bonds. Flows from various private investors will continue to flow into these securities as long as yields do not spike up.

In terms of currencies, the US Dollar is expected to outperform the other major currencies as the growth outlook for the US continues to improve. Asian currencies are likely to stay resilient as well on the back of a positive growth outlook for China. While growth in the Eurozone remains stagnant, the Euro is likely to remain weak.

**Conclusion**

The uncertainty of the global outlook in 2013 means that shorter term rates are not expected to rise anytime soon. However, given that yields and credit spreads have already declined in 2011/2012, they are unlikely to decline significantly from this point. In such an environment, returns for bonds are more likely to come from yield accruals rather than from capital gains. Returns for the various fixed asset classes are also likely to be homogenous in 2013.

With the low-rate and low-growth environment continuing to be supportive of credit markets, we remain positive on the Asian Credit space. Fund flows are also expected to be more balanced between Asian Credit and Asian Local Currency markets, with the latter expected to see returns enhanced by the appreciation of Asian currencies. In Singapore, with SGS likely to trade in a range, we favour corporate bonds for the yield carry.

Risks to our views include the continuing negotiations over the US debt ceiling and fiscal deficit, the potential sharp weakening of the Japanese Yen and Japanese Government Bonds (JGB), and the Eurozone's recovery being derailed in 2013.

**About Lion Global Investors**

Lion Global Investors, a member of the Oversea-Chinese Banking Corporation Limited (OCBC) Group, is one of the largest asset management companies in Southeast Asia, with total assets under management of S$31.2 billion (US$25.5 billion) as at 31 December 2012. Established as an Asian asset specialist since 1986, Lion Global Investors' core competencies are in managing Asian equities and fixed income strategies and funds to both institutional and retail investors. It has one of the largest and most experienced investment teams dedicated to regional and global equities and fixed income markets, with 45 investment professionals averaging 15 years of relevant investment experience.

Lion Global Investors' network of regional offices outside of Singapore includes Malaysia, Brunei and China (Shanghai). For more information about Lion Global Investors, please visit www.lionglobalinvestors.com.

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