Market Update Note – Asia Fixed Income Team

Asian Fixed Income

Overview

- The current environment is squeezing the world's borrowers - those who need liquidity. Asia is in a commanding position as the major supplier of liquidity to the global financial markets - viz large current account balances and FX reserves of Asian central banks.
- Asia benefits from the longer term structural stability/support from still strong balance of payments, while the increasing focus on domestic demand with initiatives such as development of domestic bond markets, recycling of FX reserves into Asia, and easier monetary policy (with structurally lower inflationary trajectories) are positive developments for Asian Fixed Income and currency markets.

We have seen considerable nervousness return to global markets in early 2008.

In this Market Update, we present the views of the Asian Fixed Income team, explaining the current market background and their outlook.

As financial market participants contemplate the likelihood of a slowing US economy and the emergence of recession fears, investors have rapidly sought to scale back risk in their portfolios.

Major equity market indices around the world are down 10-20% in the first three weeks of 2008 reflecting a reassessment of the outlook for corporate profitability as US household look certain to scale back consumption. The financial sector continues to be haunted by the string of write-downs to risky assets on the balance sheets. Asian equity markets, too, have moved lower in recent weeks, as participants questioned the validity of the long held "decoupling" theory. In other words, equity investors, in particular, have come to appreciate that Asian economic performance is likely to withstand a slowing of US economic growth, however, in the event that the US enters a recession the risks to Asian economic fortunes are increasing.

US Treasury bond yields have fallen as the market begins to contemplate a more aggressive interest rate response from the Federal Reserve. Federal Reserve Chairman Bernanke recently highlighted that the downside risks to economic growth overshadowed the risks of lingering inflationary pressure. As the market anticipated easier monetary policy, yields on 5 year US treasuries fell to below approximately 2.86% on last Friday (18th January), 0.58% lower than the end of year and 1.35% lower than on 31st September 2007). The yield curve steepened sharply as more aggressive rate cuts were priced.

The Asian fixed income markets have performed resiliently despite the volatility experienced in the regional equity markets. In line with movements in US Treasuries, interest rates in all Asian currencies have fallen sharply, albeit at a less aggressive pace. Asian local interest rates markets have rallied as the moderation in global economic conditions will likely alleviate inflationary pressures within the region, while the central banks appear more likely to pursue an easier monetary policy stance as a means of promoting domestic activity.

Asian currencies have remained resilient during the recent period. Although the Asian currencies have weakened modestly in recent days, they are still trading stronger (against the US dollar) than at the beginning of the year. Despite the slowing global economic conditions, the structural support for Asian currencies remains as current account balances are structurally large. Furthermore, as holders of significant foreign exchange reserve positions, the Asian policy makers are able to provide stability to the currency markets in times of strain. These policy makers have also shown a willingness to use the exchange rate as means to address imported price inflation, while in China, the continued appreciation in their currency progresses as they continue to struggle with their policy challenges. Additionally with the US as the epicenter of financial market turmoil there is some evidence to suggest that investors are seeking an alternative to US dollar denominated assets. As the major supplier of liquidity to the global financial markets (viz injections of capital originating from Asia into the major financial institutions), Asia is in an attractive position.

Globally, credit spreads are wider as investors prefer the safety of less risky assets. Asian credit markets, too, have underperformed treasuries on the flight to quality. Some of the issues that were drivers and now plaguing global credit markets, such as leverage and structuring, were less evident in the Asian credit markets. Nevertheless, the correlation between credit markets globally cannot be denied and this has resulted in foreign selling of Asian credits. Asian investment grade spreads are wider by about 60bps, while high yield corporate spreads are wider by more than 150bps. The Asian financial sector is in a much stronger position that that which prevailed in 1997 (during the Asian financial crisis) – in fact it is the complete opposite to 1997. The banks are very well capitalised and have implemented much improved risk management and lending practices. The domestic asset quality of most Asian banks remains sound, but some will have exposure to the US subprime mortgage and related sectors and have made provisions for losses, but not to the same scale as those in US or European banks.

The Federal Reserve's willingness to respond aggressively to the developing economic implications of the tightening financial market liquidity, by cutting rates by 75bps provided some respite to regional equity markets on 23rd January, while Asian currencies recovered the previous day's losses. The Philippines peso and Indonesian rupiah are up 0.8%, Singapore dollar up 0.7%, Taiwan dollar and Malaysian ringit up approx 0.25%. Interest rate markets rallied aggressively following the 30bps rally in (5yr) US Treasuries, overnight with yields in all Asian markets down approximately 10-30bps as the markets contemplated easier monetary by the local authorities.

Against this backdrop, the fixed income team would recommend a highly vigilant approach and has adopted the following strategy:

- A reduction in US duration as the market has priced in aggressive Federal Reserve action.

- Further currency and interest rate diversification, with exposure to markets such as Vietnam favoured on expectations that the central bank will continue to allow a gradual appreciation in the currency as a means to alleviate some capital account pressures.

- A reduction in exposure to currencies such as the Indian rupiah in anticipation of an elevated risk to foreign equity investor outflows in response to a reassessment of risk.

- A cautious approach to the credit markets with exposure retained to those Asian companies with sound fundamentals. In some instances, the market response has been indiscriminant and the opportunity now exists to identify attractive valuations particularly in some higher quality companies.

Summary

- The current environment is squeezing the world's borrowers - those who need liquidity. Asia is in a commanding position as the major supplier of liquidity to the global financial markets - viz large current account balances and FX reserves of Asian central banks.

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CH/E/200801