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## Invest in emerging markets and Asian bonds for growth and income

- ▶ Demand for emerging markets and Asian bonds is likely to remain strong
- ▶ Economic conditions such as liquidity and interest rates are supportive
- ▶ Yields remain attractive, and these markets may benefit as investors recognise fundamentals and reprice risk

In 2011, markets were beset by a number of concerns, including the potential default of Greece, rising Spanish and Italian bond yields, credit rating downgrades for US sovereign debt and European banks, and rising unrest in the Middle East.

In this challenging environment, most risky assets suffered. Yet 2011 was a positive year for global emerging market bonds ("GEM bonds") which returned 7.2%. This compared favourably with majority of global asset classes.

The superior performance of GEM bonds, including Asian bonds, was the result of strong liquidity, improving credit fundamentals (e.g. continuing upgrades) and better growth prospects. As investors continue to recognise the underlying value of this asset class, GEM bonds are well-placed to outperform.

### Drivers for global emerging market bonds in 2012

- ▶ **Steadily rising demand for global emerging market bonds**  
GEM bonds continued to gain traction with the total net inflows of around USD44.8 billion<sup>1</sup> in 2011. The universe has benefited from the growing participation of domestic investors, particularly from local pension funds and

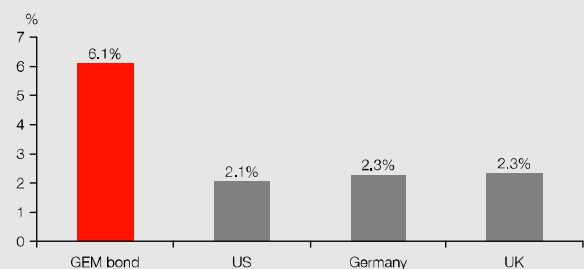
sovereign wealth funds. There has been a fourfold increase in assets under management by emerging market pension funds over the past decade, and this robust growth is expected to continue into 2012 and beyond.

- ▶ **Yields to remain attractive**

In this low interest rate environment, one of the key reasons that investors are attracted to emerging markets is income. Yields for GEM bonds are more than twice of developed market government bonds such as US Treasuries and German Bunds, yet with lower volatility.

In 2012, yields are likely to remain relatively unchanged and are likely to attract investors seeking income amid market volatility and rising credit risk in some of the developed fixed income markets.

Chart 1: Comparison in bond yields between developed and emerging markets



Source: HSBC Global Asset Management, data as at 30 November 2011.

- ▶ **Asian bonds represent very good value**

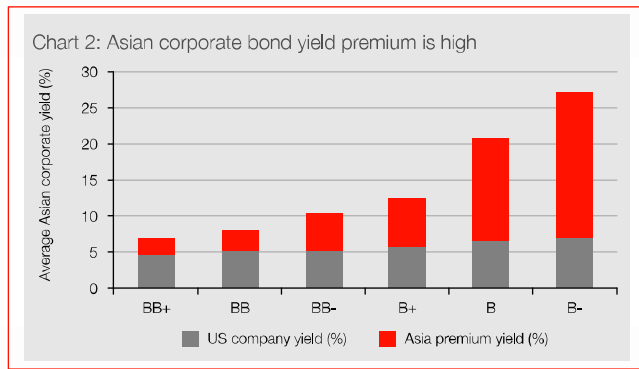
In the third quarter of 2011, Asian credit spreads rose sharply due to increased risk aversion and concerns that the European debt situation was deteriorating. In the fourth quarter, the Asian bond market rebounded as risk sentiment improved.

### What is credit spread?

Credit spread is the difference in yield between bond issues with different credit qualities. The credit spread reflects the additional yield an investor can earn with higher credit risk, usually relative to government bonds such as US Treasury bonds.

However, credit spreads still remain above the levels than they were at the start of the year. As the underlying fundamentals for Asian bonds has actually improved during this period, this indicates that there is plenty of room for credit spreads to come down further, and for Asian bond prices to appreciate.

The relative value of this asset class is also reflected in the yield premium for Asian corporate bonds versus their US counterparts. As corporate default rates are very low in Asia and remain far lower than in the US, this suggests that the premium should not be that steep.



Source: HSBC Global Research, Asian Credit View, January 2012.

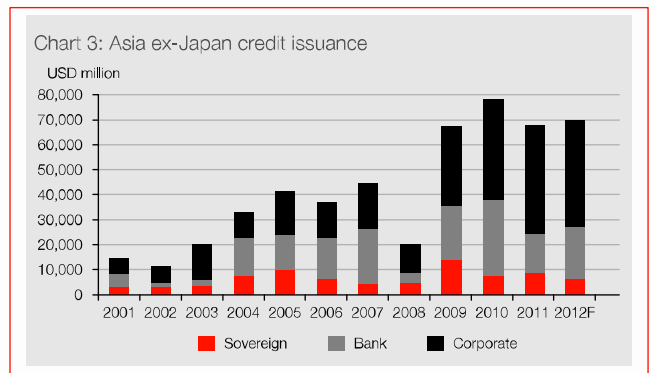
### ► Monetary conditions remain supportive

In response to the headwinds to global growth, emerging market central banks do appear to be on an easing cycle. This is especially true in Asia where falling inflation has empowered Asian policymakers to adopt an easing bias to protect growth.

For example, China had experienced monetary tightening in 2011, as the People's Bank of China had sought to bring inflation under control. Since July 2011, headline inflation has been steadily easing, from 6.5% year-on-year in July to 4.2% in November. To support growth, policymakers have announced a cut in the reserve ratio requirement for banks, and further policy easing is expected in 2012.

### Bond issuance indicates health

On the back of strong demand, issuance in Asian bond markets is likely to remain healthy. In 2011, gross issuance was around USD67.7 billion. In 2012, HSBC Global Research is looking for a gross issuance in the range of USD65-72 billion. This indicates that demand for Asian bonds is strong, and that investors will continue to buy and hold these bonds into the future.



Source: HSBC Global Research, Asian Credit View, January 2012.

### ► Positive long term outlook for Asian currencies

Many Asian currency valuations look cheap on real purchasing power measures with relatively higher interest rate than the developed world, where yields are likely to remain very low. The currencies that stand out include those of China, Indonesia, Korea, Malaysia and Singapore. Many of these currencies depreciated in nominal terms in 2011.

Over the longer-term, Asian currency appreciation should be a key component of investment returns for equity and local currency bonds. Undervaluation of Asian currencies provides an important reason to consider Asian exposure more generally.

### Active management can add value in emerging and Asian bond markets

Over the past two years, Asian bonds shined out from the crowd and offered investors a better risk-return profile than their global peers – Asian high yield and global high yield bonds returned 18.8% and 16.9% respectively, with a volatility of 10.3% and 10.5% respectively<sup>2</sup>.

Volatility can also be minimised through careful credit selection and risk management. The diversity of this universe means that skilled managers can exploit existing discrepancies in yield, spreads, duration, liquidity, currency movements to generate excess returns. This is particularly applicable to Asian bond markets that are still in the initial high growth phase, and where information inefficiency still exists and bond experts with a proven track record can add value.

#### Sources:

1. JP Morgan Emerging Markets Research, data as at 5 January 2012.
2. Bloomberg, data as at 31 December 2011. Asian high yield: JACI Non Investment Grade Total Return; Global high yield: BofaML Global High Yield.

## O u t l o o k

## United States



The outlook for the US economy remains tough, particularly as unemployment is stubbornly high at about 9%, with consumer spending a key driver of growth. However, the US does appear to be seeing stronger growth than other developed economies. This may provide some support to 2012 corporate earnings, at least compared with other developed markets, especially if economic stimulus measures are extended into 2012. Although valuations are somewhat higher for other developed markets, with a 2012 forecast price/earnings ratio of 10.9 times, we consider this a fair premium given the stronger economic momentum and lower tail risks compared with Europe.

## Europe

Prospects for continental Europe remain dominated by the Eurozone debt crisis and the ability of politicians to arrive at a permanent resolution to the problem. Standard and Poor's recognised that the policy initiatives that have been taken by European policymakers in recent months may be insufficient to fully address the ongoing systemic stresses in the Eurozone. As a result they cut the ratings of nine countries in the Eurozone. European equities trade on a low multiple of 8.8 times forward earnings, implying the asset class offers significant value should a solution be found.



## Bonds

Countries with high debt and/or budget deficit ratios witnessed their funding cost surging to all-time highs since the Euro was launched. Even core economies which were supposed to be immune against peripheral contagion saw their government bond yields rising well above corresponding German benchmark yields. Notwithstanding Federal Reserve actions which are currently supporting Treasury prices, the positive surprise seen in economic data can continue and should the Eurozone reach agreement on a lasting solution to its sovereign debt crisis, the safe haven premium currently embedded in US Treasury prices may start to evaporate, forcing yields to rise to levels more reflective of the current economic and fiscal backdrop.



## Asia ex-Japan



The slowdown in global economic activity has had an impact on Asia ex Japan, given its relatively high levels of exports to developed countries. However, we still view the economic backdrop favourably, with its economies offering stronger growth than the developed world. Inflation is showing signs of moderating and we could see loosening monetary policies in 2012, which we would regard as positive for the region's economies and equity markets. Within Asia ex Japan, Chinese equities' valuations are low, with the market trading on about 8.2 times 2012 earnings, significantly below the market's 10-year average of about 12.5 times.

## Japan



Japanese equities frequently traded in a disconnected manner from other markets in 2011. Like other equity markets, valuations remain attractive, particularly if Japanese companies can boost their levels of return on equity, although this is likely to be a longer-term development. For 2012, Japanese equities are likely to be affected by the slowdown in global growth, while the appreciation in the yen is also likely to dampen corporate performance.

## Currencies

Many currency markets have been driven by similar factors as those driving equity and bond markets, for example the Swiss franc which has seen significant appreciation. We would see a resolution of the Eurozone sovereign debt crisis being positive for the Euro and negative for the Swiss franc, and possibly the US dollar and Japanese yen should such a resolution be accompanied by a wider increase in risk appetite. Longer term we see the emerging market currencies as well placed to appreciate, reflecting their long term structural advantages, albeit policy actions may be used to prevent currencies appreciating.