

Market Review

December was a good month for Asian bond markets as investors sought to position themselves in anticipation of a better year ahead, with some reprieve from the headwinds in global markets seen during the past year. The month ended with positive returns for both hard- and local-currency Asian bonds. While eurozone worries continued to cloud the horizon, the hope of concerted, targeted action on the part of policymakers to address growth concerns boosted investor sentiment for the month.

Almost all sectors of the J.P. Morgan Asia Credit Index (JACI) generated positive returns. The overall Index rose by 0.89% for the month, bringing the year-to-date (YTD) gain to 4.12%. The best-performing sector was high-yield corporates, which rose 1.91% in December after falling 3.4% in November. All but two of the 12 country sub-indices generated positive returns. Indonesia was the top gainer, with a total return of 2.31%. Pakistan was the worst-performing country, down 0.99%.

Similarly, all but one of the 10 onshore bond markets within the HSBC Asian Local Bond Index (ALBI) generated positive returns. The top performer in onshore bond markets was Indonesia, with monthly returns of 4.4%, while the only market in which there were negative returns was Hong Kong at -0.06%. Asian currencies saw a mixed performance for the month. The biggest gainer was the Chinese renminbi (+1.32%), while the Thai baht depreciated the most, ending the month weaker by 2.2%. The overall ALBI rose 0.76% in December, bringing the YTD return to 5%.

Central banks in Asia have demonstrated a clear resistance to aggressive monetary easing despite hopes for strong action to boost growth in Asian economies. Central bankers have made it clear that while inflationary pressures are abating, they remain a concern, especially imported inflation resulting from energy costs. The trigger for aggressive policy action will be the deterioration of global market conditions, either from a demand perspective or a conflagration in the eurozone crisis. Bank of Korea (BoK) kept its policy rate unchanged at 3.25% in light of the inflation figures, which came in at 4.2% year-over-year (YoY), unchanged from November. The rate-hike cycle has clearly ended, and central bankers have shifted their emphasis to a moderation in policies that is accommodative for growth.

Economic activity showed signs of optimism in the two largest Asian economies, China and India. China's purchasing managers index (PMI) for December came in at 50.3, moving into expansionary territory from the 47.1 reading in November. In India, the PMI rose to 54.2 in December from 51.0 the

prior month. However, in the more export-oriented economies, such as South Korea, Singapore and Taiwan, economic indicators showed signs of weak external demand from Europe and the US. South Korea's industrial production (IP) grew 5.6% YoY, lower than the previous month, due to a sharper-than-expected drop in automotive production. In Taiwan, IP fell 3.6% YoY, reversing the previous month's gain of 1.4% YoY, driven by declines in semiconductors, chemicals and metals output.

Inflation across Asia has become more manageable as a result of slowing demand. Inflation has shifted from being less demand-pull to being more cost-push. China's CPI fell to 4.2% YoY, the lowest reading since September 2010. The PPI decelerated sharply to 2.7% YoY — the lowest level since December 2009 — clearly indicating continued softening in global commodity prices. In India, wholesale price inflation came in at 9.11% YoY, lower than October's 16% YoY, as a result of a softening in food prices. In South Korea, import prices eased to 11.8% YoY, compared with October's 16% YoY. However, because inflation in Asia is highly sensitive to the price of oil and gas (most Asian countries are net importers), policymakers will keep a keen eye on geopolitical risks on the horizon. The other key risk to inflation will be food-price spikes due to adverse weather events. Intervention therefore is expected in Asian currencies, as a stronger currency will help in mitigating the effects of cost-push imported inflation.

Asian credits tightened in the period relative to the month of November. Corporate spreads tightened on top of strengthening US Treasuries (UST). The JACI composite spread tightened from 383 points (bps) at the end of November to 374 bps at the end of December. The tightening was led by high-yield corporates — the leaders being Chinese property firms on investors' hopes that the Chinese government will relax some of the property-tightening measures in light of a weakening residential property market. The tightening was also attributed to Fitch's upgrade of Indonesia to BBB- (investment-grade) from the previous BB+ (non-investment-grade).

Outlook

Concerns about the eurozone debt-overhang continue to cast a shadow over the global economy. A weak US economy, which has not shown a clear pickup in growth trajectory, has contributed to the negative drag on global sentiment. The interconnected nature of global trade and capital flows implies that Asia will not be immune from any fallout as a result of either the eurozone crisis or slowing global growth.

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Export data out of Asian economies have been reflecting a slowdown in exports to the US and Europe, with export growth out of China slowing to its weakest pace since 2009.

However, there is a silver lining. An uptick in China's and India's manufacturing activity, as well as resilience in South Korean exports (buoyed by demand from China), provide an early indication of the resilience of Asian economic momentum despite the cloudy global outlook for 2012. A continuing moderation of inflationary pressures in Asia, evident in moderating CPI numbers across the region, will also allow policymakers to shift their focus to growth in the year ahead. The UN Food and Agriculture Organisation's (FAO) Food Price Index in December continued to reflect a fall in global food prices; it was 11.3% off its peak in February 2011. Slowing global demand, bumper crops and a reversal of export restriction policies have all contributed to a slowdown in food inflation. The wild card, though, remains unexpected adverse weather events that could cause a spike in food prices. Otherwise, reduced pressures of food prices will be positive for Asian economies such as China, India, Thailand and the Philippines, which are highly sensitive to food-price-driven inflation.

The keyword in Asia is policy flexibility. Moderating inflation allows for monetary policy flexibility, while favorable fiscal positions allow for fiscal policy flexibility. While global economic headwinds will persist given the continued uncertainty from the eurozone debt crisis, Asian governments are in a very favorable position to employ expansionary fiscal or monetary policies in the event of continued global malaise or to inject significant liquidity into markets in the event of an adverse financial shock. Asian governments have also shown increasing maturity in using targeted tools to address issues at hand while mitigating undesired adverse effects. More importantly, most Asian governments have taken long-term steps in the aftermath of the Asian financial crisis (AFC) to address structural flaws in their economic and banking systems and so are in a better position to manage future crises.

A case in point would be Indonesia, whose long-term foreign-currency and local-currency ratings were upgraded to investment-grade by Fitch in December. The upgrade was sooner than expected and was seen as a significant milestone for a country that lost its investment-grade rating almost 14 years ago in 1997. The ratings agency stated that Indonesia was upgraded on the grounds of its "resilient economic growth, low and declining public ratios, increased external liquidity and prudent macroeconomic framework." Indonesia now has foreign reserves totaling more than twice its short-term debt. Its total government debt is at 25% of its GDP, while the annual gross financing requirement is at 3% of GDP. This is a complete turnaround from Indonesia's external position in 1997, when it had to turn to the International Monetary Fund (IMF) for assistance as foreign capital pulled out of the nation at the height of the AFC.

Our long-term strategies have not changed from prior months, given our confidence in the underlying fundamentals. The strength of government balance sheets, current-account surpluses and declining inflationary pressures will provide support to government yields in most Asian countries. The rate-hike cycle appears to have come to an end for most Asian countries, and a shift to accommodative monetary policies in the near term will provide upside potential to government bonds. We expect to maintain our overweightings in countries with strong fundamentals and to add interest rate exposure in line with our view of a shift in policymakers' focus from inflation to growth. Preferred currencies in portfolios include the South Korean won, Singapore dollar, Malaysian ringgit, Indonesian rupiah, Chinese yuan and Philippine peso. Preferred countries include Singapore, the Philippines, Indonesia, Malaysia and South Korea.

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