

Asian Fixed Income

Busting key myths

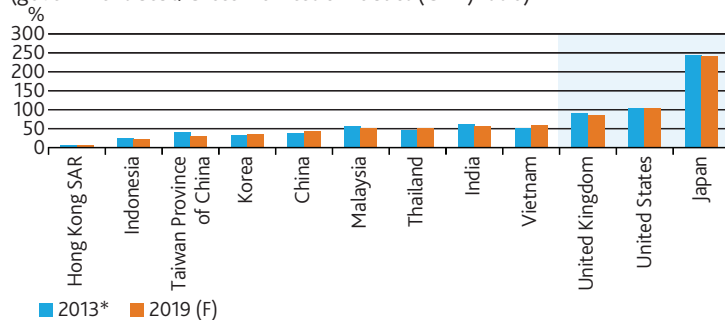
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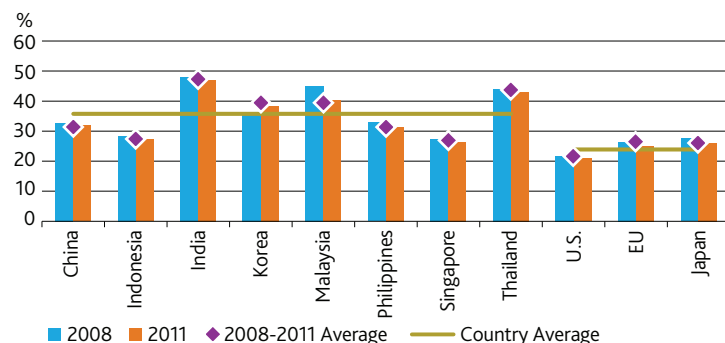
Since quantitative easing began in Europe, bond prices have rallied. A quarter of government bonds have negative yields. This squeeze on yields has led investors to look at riskier bonds in the hunt for positive returns, resulting in robust demand for high-yield bonds on the continent. Alternatives also lie abroad. Asian fixed income offers investors good yields, backed by solid fundamentals and sustainable growth. But the asset class is much misunderstood. Here, we dispel some common myths of Asian fixed income.

Investing in Asia's long-term potential

Asia's leverage is much lower than key developed markets (government debt/Gross Domestic Product (GDP) ratio)



Asia is at a much earlier stage of growth (gross value added of industry as a percentage of GDP)



Source: International Monetary Fund, World Economic Outlook Database, October 2014; Aberdeen Asset Management, CEIC, World Bank, 2013

* 2013 are IMF forecast figures for the following countries: Taiwan, Hong Kong, Korea and Japan For illustrative purposes only. Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

Myth: Weak Asian currencies are a cause for concern

Reality: While most Asian currencies have fallen against the US dollar since the start of 2015, this short-term weakness masks the structural strengths of Asian economies, which underpin the region's long-term potential.

Unlike in Europe, Asian policymakers have flexibility to cut interest rates or pump-prime to support growth. This is because most countries have sizeable current account surpluses and foreign exchange reserves as well as low debt levels. Central banks have grown in credibility and independence.

Some countries have bucked the trend of a strong dollar. In India, for example, strong foreign inflows have pushed up the rupee, as investors bet on reforms there. The Thai baht has been resilient, buoyed by a large trade surplus. In the Philippines, steady foreign worker remittances and outsourcing revenues are buttressing the peso.

On a broader level, Asia is still the world's fastest-growing region, with most countries still at a much earlier stage of growth compared to Japan, the US or the European Union. Our view is that the robust fundamentals will continue to support the appreciation bias of Asian currencies against the euro, yen as well as other G10 currencies over the longer run.

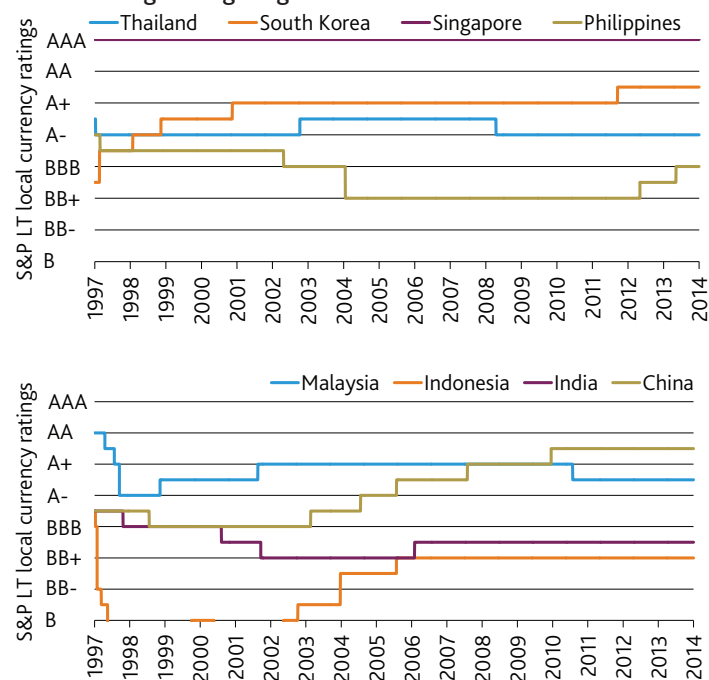
Myth: The only economy that matters in Asia is China

Reality: China is slowing, to the detriment of the global economy. Within Asia, commodity exporters are most exposed. But Asia is more than China. India's large, relatively insulated economy is now growing faster than China's. With a population of over 1.2 billion, it is set to become the third-largest economy by 2030. Indonesia is also large, being the world's fourth-most populous country. Rich in resources and consumers, the country could be one of the world's five largest economies by 2030.

Another positive for Asia is the bloc of the Association of Southeast Asian Countries (ASEAN), whose 10 member countries boasted a combined GDP of US\$2.4 trillion in 2013. Home to more than 600 million people, ASEAN has a labour force whose size is surpassed by only China and India. Trade and investment are also growing and deepening within the bloc. With a burgeoning middle class, future demand for goods and services is immense.



Asian sovereign ratings migration



Source: S&P, Bloomberg, December 2014 For illustrative purposes only. Standard & Poor's credit ratings are expressed as letter grades that range from "AAA" to "D" to communicate the agency's opinion of relative level of credit risk. Ratings from "AA" to "CCC" may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories. The investment grade category is a rating from AAA to BBB-.

Myth: Political risk is high in Asia

Reality: Asian countries are at different stages of economic and political development. Policy capacity, flexibility and independence also vary. Sovereign ratings reflect this diversity and risk.

For example, Singapore has maintained a sovereign rating of AAA for years, with the same party in power since independence in 1965. It is an open economy, backed by sound economic policies and high corporate governance standards.

In other countries, a general commitment to economic policy orthodoxy has led to upgrades in sovereign ratings, particularly in Indonesia, South Korea and the Philippines. Last year, the election of reformers in key economies further enhanced the region's rating profile. In addition, Asian leaders recognise that it pays economically to foster good relations and trade ties, despite the occasional territorial spat.

Contrast all that with the deterioration seen in other parts of the world, particularly among emerging markets. Russia's rating was cut to "junk", as the energy exporter felt the brunt of a sharp drop in oil prices, rouble volatility and Western sanctions. Ukraine and Greece both suffered downgrades by Moody's and Fitch respectively. In Brazil, a sickly economy and a corruption scandal engulfing state-owned Petrobras have put its investment grade rating at risk.

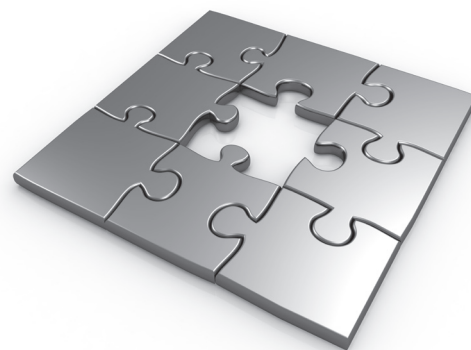
Myth: When we buy into global fixed income or emerging market debt, we buy into Asia

Reality: We beg to differ. Global fixed or emerging market debt benchmarks, which typically influence allocations, have minimal exposure to Asia.

The Citi World Government Bond Index has less than 1% Asian representation, and only Malaysia and Singapore at that. Among emerging market debt indices, big markets China and India as well as higher-rated sovereigns Korea and Hong Kong are excluded for technical reasons.

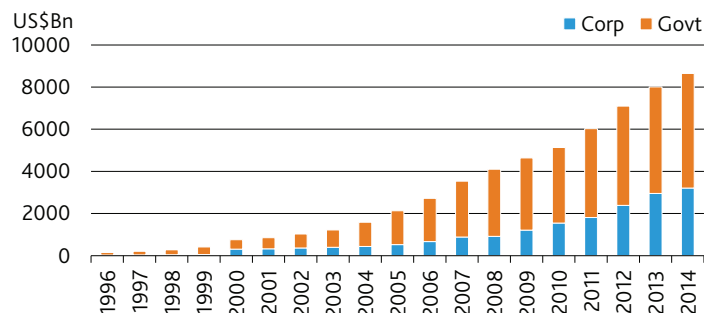
As a result, many investors of global fixed and emerging market debt have very limited exposure to Asia, and what little they have is generally concentrated in only one to two Asian markets. Many just miss out on the diverse opportunities across the entire region.

This is a travesty. India, for instance, has a big and liquid bond market offering yields of close to 8%.¹ Across Asia, we see a virtuous circle. As regulators seek to grow and deepen financial markets, demand from issuers and investors is rising. This broadens fund-raising options and lowers the cost of capital for corporates and creates investment alternatives for individuals and institutions. As a result, the investor base deepens and liquidity improves, enhancing the access, structure and resilience of the markets. This has been evident in how Asian fixed income markets have developed over the past 10 years.

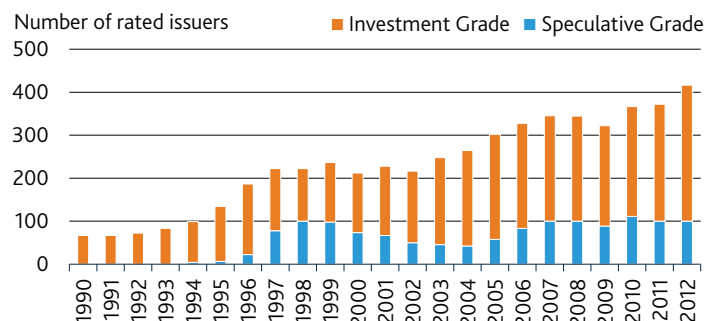


Asian fixed income universe is investible

Local currency bond market² growth



Moody's-rated issuers in Asia Pacific³ (ex-Japan)



Source: Asian Development Bank, BIS Quarterly Review, December 2014; Moody's Investor Service, April 30, 2013.

Myth: Asia's US-dollar bond market is too small and niche

Reality: Asia's US-dollar bond market has grown rapidly over the past decade. At US\$591 billion, it is now as large as the sterling corporate, emerging market sovereign or European high-yield markets. By 2017, the market is set to grow to US\$1 trillion, supported by issuance of US\$150-US\$200 billion a year.

The asset class also covers a wide spectrum of countries, sectors and ratings. Of the 15 Asian countries, China accounts for the lion's share at 35.5%. Ratings of credit issues range from AAA to C, while sectors are split into corporates, financials, sovereigns and quasi sovereigns.

Other market metrics are encouraging. Asians are buying Asian corporate debt. They account for two-thirds of the buyers of new issues. This makes the market less susceptible to swings in global risk appetite, improving its resilience. Corporate default rates are low, in line with those in the US and Europe.

¹ Source: Bloomberg, Asia Bond Monitor 2015, Asian Development Bank, May 2015.

² Includes Indian local currency government bond issuance

³ Bond and loan markets

Myth: Asian fixed income is riskier and more volatile than emerging market debt

Reality: Asian local currency bonds have generated slightly lower returns than their emerging market debt peers but with much less volatility on average over the past 10 years.⁴

Asian corporate bonds are similarly less volatile and better-rated than their emerging market debt equivalents.⁵

The fundamentals of investment-grade bonds have stabilised in recent years. Corporate leverage levels have been stable because of muted M&A activity and lower capital expenditure. Lower funding costs have lightened debt servicing loads.

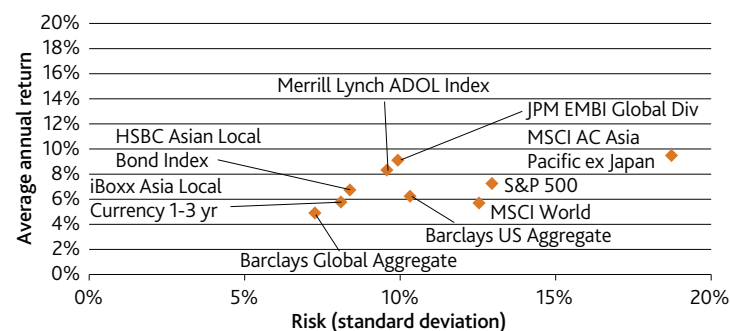
For high-yield bonds, we have some concerns. The Chinese property sector, comprising a big chunk of the market, is straining under an oversupply of new homes and weakening prices. In particular, Shenzhen developer Kaisa is facing a potential default after missing two bond payments, which caused recent market volatility. We, however, view the risk as being more company-specific, with minimal systemic impact.

Taken together, both the local currency and credit markets provide investors with a broad opportunity set in rates, currency and credit with the breadth and flexibility to meet different return expectations.

The diversity that Asia brings to global portfolios is supported by what we see as reasonably attractive valuations, given positive real yields and still-cheap currencies across many markets. Importantly, policymakers with an eye on reform are rebalancing growth towards domestic demand. This is acting as a tailwind for unlocking valuation opportunities.

Risk and return

Average 10-year annual EUR returns versus standard deviation of annual EUR returns, unhedged



Source: Bloomberg, Aberdeen Asset Management, December 31, 2014
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS

Index definitions

The BofA Merrill Lynch Asian Dollar Index tracks the performance of U.S. dollar denominated sovereign, quasigovernment, corporate, securitized and collateralized debt publicly issued in the U.S. domestic and eurobond markets by Asian issuers.

The Barclays Global Aggregate Bond Index is a broad-based index that measures the global investment grade fixed-rate debt markets inclusive of three major components: U.S. Aggregate Bond Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index.

The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS.

HSBC Asian Local Bond Index (ALBI) is a market capitalization-weighted index that tracks the total return performance of liquid bonds, denominated in local currencies of China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand.

The JP Morgan EMBI Global Diversified index is a uniquely-weighted version of the J.P. Morgan EMBI Global Index. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding.

The JP Morgan GBI Emerging Markets Global Diversified Index is a comprehensive global local emerging markets index comprising liquid, fixed-rate, domestic currency government bonds.

The JP Morgan US Liquid Index (JULI), provides performance comparisons and valuation metrics across investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their ratings and maturities.

The MSCI AC Asia Pacific ex Japan Index is a free float-adjusted, market capitalization-weighted index that captures large and mid-cap representation in the Asia Pacific region excluding Japan. The MSCI AC Asia Pacific ex Japan Index consists of the following developed markets countries: Australia, Hong Kong, New Zealand and Singapore; and the following emerging markets countries: China, India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand.

The MSCI World Index is a collection of stocks of all developed markets in the world, as defined by MSCI.

The Markit iBoxx Asia Local Currency Index covers local currency sovereign and quasi-sovereign debt from 10 Asian markets.

The S&P 500® Index is a market capitalization-weighted index that includes 500 leading companies in leading industries of the U.S. economy. Focusing on the large-cap segment of the market, the S&P 500® Index covers approximately 80% of available U.S. market capitalization.

⁴ Source: Based on analysis of HSBC Asian Local Bond Index and JPMorgan EMBI Global Diversified Index, Bloomberg, Aberdeen Asset Management, December 31, 2014.

⁵ Source: BofA Merrill Lynch, Asia Credit 360, May 15, 2015.

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Aberdeen Asset Management Inc.
1735 Market Street, 32nd Floor
Philadelphia, PA 19103
Telephone: (800) 485-2294
aberdeen-asset.us

Aberdeen Asset Management Inc.
161 Bay Street, 44th Floor
Toronto, Ontario M5J 2S1
Tel: (416) 777 5570
aberdeen-asset.ca