

Aberdeen Asian Fixed Income – New Opportunities for Investors



- Health of Asian economies reflects strong GDP growth and fiscal prudence
- Asian local bonds have emerged as a unique asset class, developing in both size and sophistication
- Diversity of Asian bond markets provides investment choice as well as low correlation with developed markets
- Asian currencies appear attractive on fundamental basis

Greece's troubled finances have cast a timely spotlight on the credit worthiness of developed economies. The need to implement significant fiscal austerity measures to reduce widening budget deficits and the need to roll over substantial quantities of maturing sovereign debt have pushed up the cost of sovereign and corporate funding. Spreads between Germany and countries such as Greece, Portugal and Spain are now wider. Greece's sovereign debt rating has now fallen to below investment grade, while Spain has recently been downgraded by several ratings groups. Global investors remain wary of the impact that any further deterioration will have not only on Europe's highly inter-linked banking sector but also on the prospects for the region's growth.

Recent developments in Europe have certainly taken much of the attention away from the fiscal and regulatory challenges facing the United States. These are challenges that will need to be addressed soon in order to ensure a longer term path towards sustainable economic recovery

Asia seems a world away from these dramatic developments. The relative health of its economies reflects strong GDP growth and a prolonged period of fiscal prudence. Behind this is a larger shift in global power, with Asia now the principal creditor of the West.

A growing number of investors are beginning to consider how they can take advantage of these developments. At Aberdeen we believe that Asian fixed income represents one strategy, and, given the huge number of opportunities in the region, the interest in this asset class is now justifiably growing.

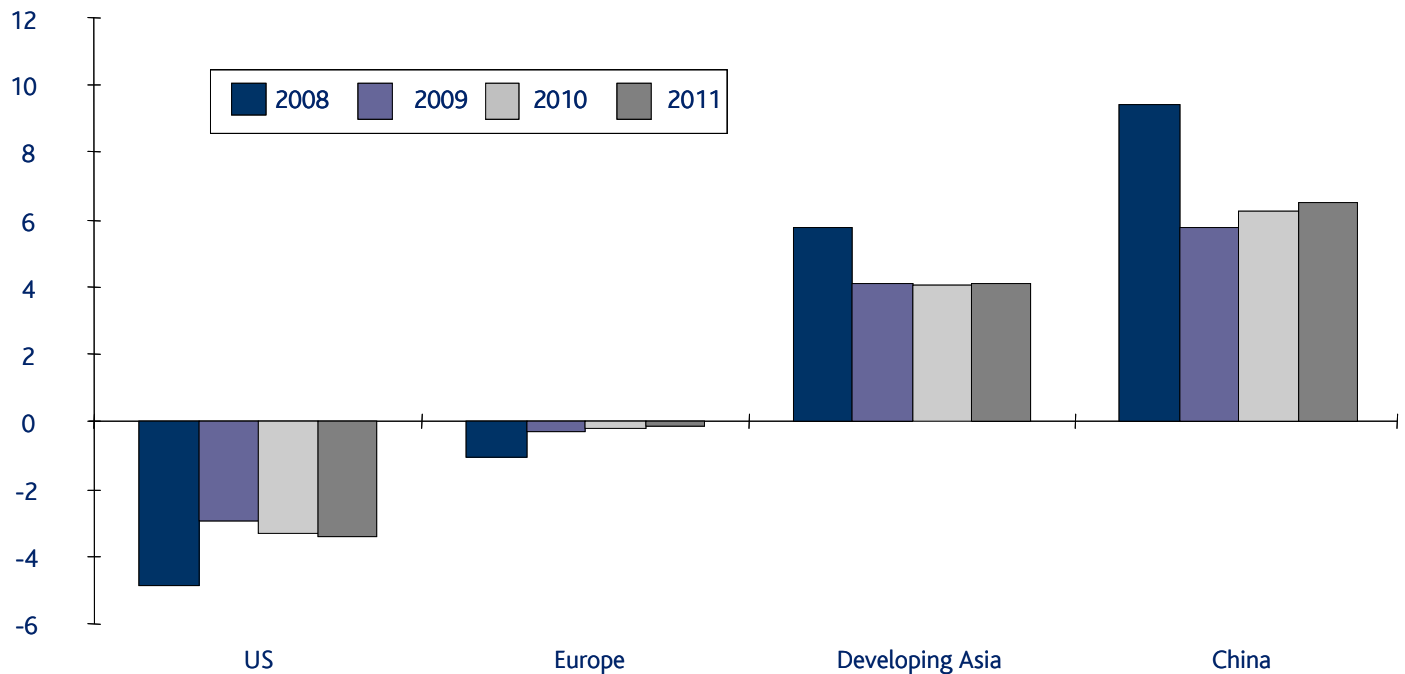
Global imbalances persist

The pressing question for the West is how it should deleverage without causing a relapse in growth or, conversely, a renewed asset bubble. Imbalances have been building through at least the past decade. The US and Europe have been consistently running budget deficits and increasing government debt. In sharp contrast, Asia emerged from its own crisis in 1997/98 with a renewed focus on fiscal sustainability, strong growth, and reduced reliance on offshore capital for domestic growth. Mounting current account surpluses were just the icing on the cake.

China and India continue to lead, as they take advantage of government stimulus and the rebound in both regional and global economic activity. With their large internal markets they are best placed to accelerate a catch-up in living standards with the developed world. Yet high levels of debt and sluggish consumer demand persist in the West. Structurally high unemployment and politically difficult spending cuts there could also jeopardise recovery. It is a valid fear, then, that export-dependent Asian economies will be unable to avoid any renewed serious slowdown. But improving intra-Asian trade and rising domestic consumption will help to offset that, as will efforts to expand new markets among other developing economies.

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Current account balance (% GDP)



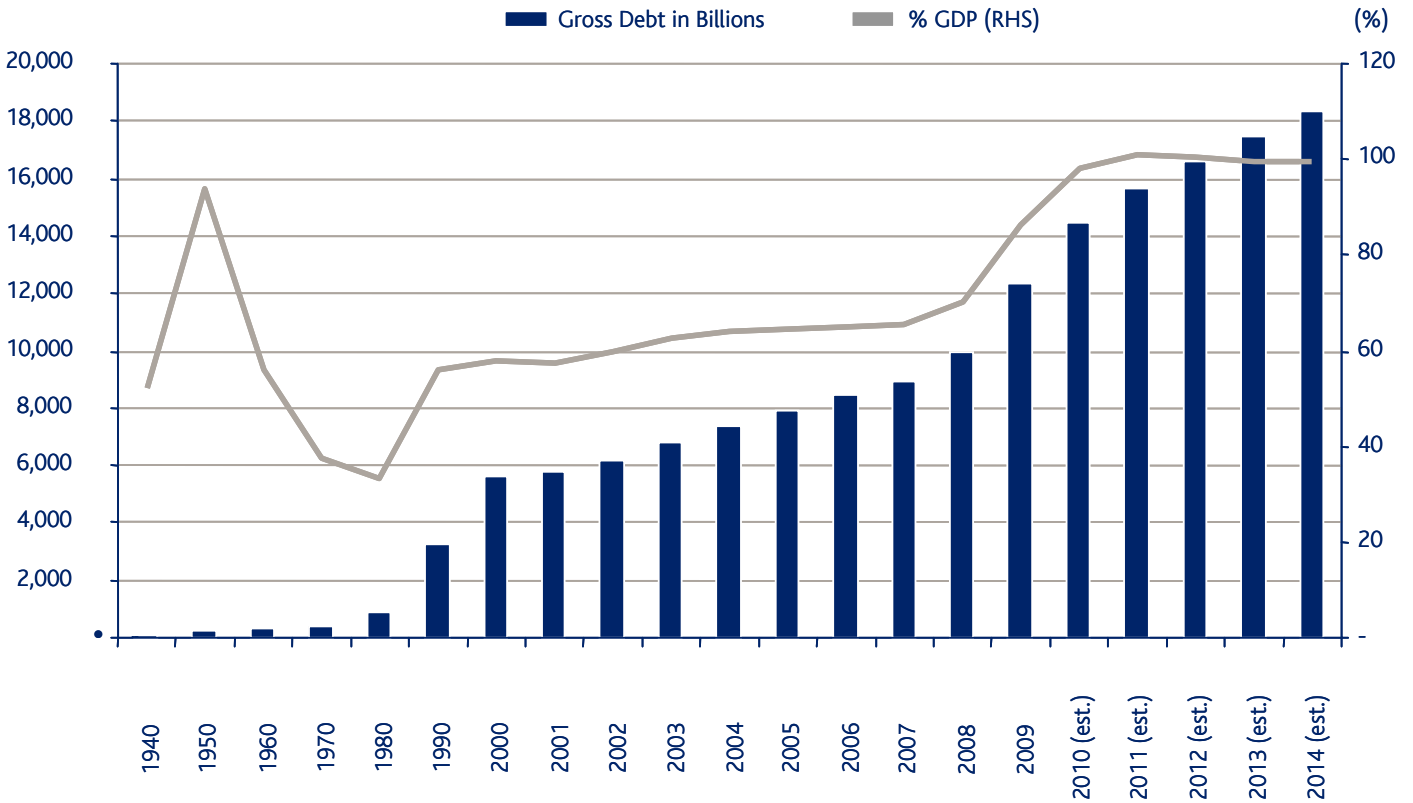
Source: IMF, WEO Database, Apr 2010

US Government Debt and the IMF

To put the current economic situation into some perspective, during the Asian financial crisis in 1997-98, the IMF provided \$36 billion to support reform programmes in the three worst-hit countries, namely Indonesia, Korea and Thailand. This formed part of an international support package totalling around \$100 billion. (Adjusted for inflation, the figures for the Asian bailout today would of course be much higher). More recently, the IMF committed up to \$300bn as part of a stabilisation fund for the euro area, a sum that if fully activated would exceed the combined size of the ten biggest loans it has ever made. Meanwhile, the budget deficit that will require external financing by the US government this year will be around \$1.5 trillion dollars, while total US debt is now forecast to rise to \$18 trillion by 2014.

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Local currency bond market in Asia ex-Japan (USDbn)



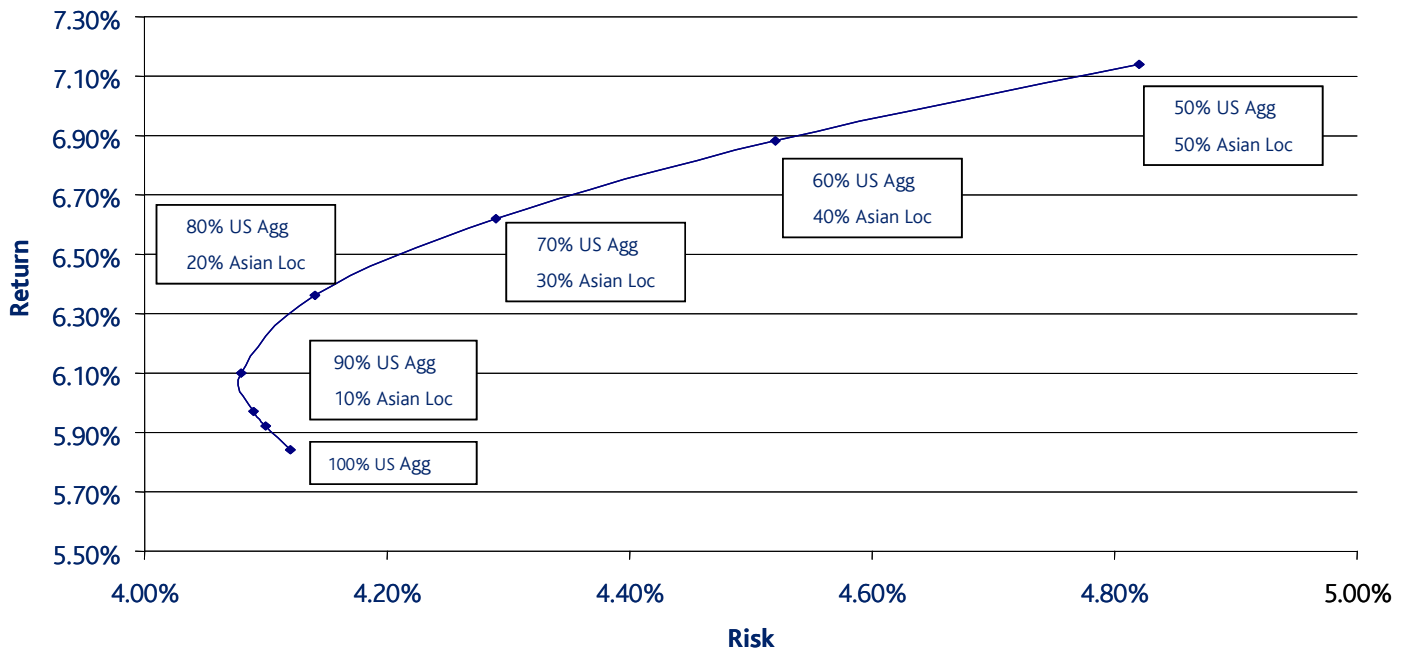
Source: Budget of the US Government 2010

Of course the US will not require IMF support, so long as the dollar is the world’s default currency. But perhaps global fixed income investors, who principally hold US dollar-denominated assets, ought to wonder at the projected level of debt issuance. With sub-par growth in store, this might be an opportune moment to consider diversifying. At the very least, in the medium to long term, the US surely faces the risk of rising bond yields and a depreciating currency relative to Asia.

Our analysis suggests that, based upon returns from the Asian and US fixed income markets during the period 2001 to May 2010, investors would have benefited from diversifying their portfolios into Asia.

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Adding Asian bonds to portfolio of US bonds (Jan 01-May 10)



Source: Aberdeen, May 2010

Local Asian bond market as a distinct asset class

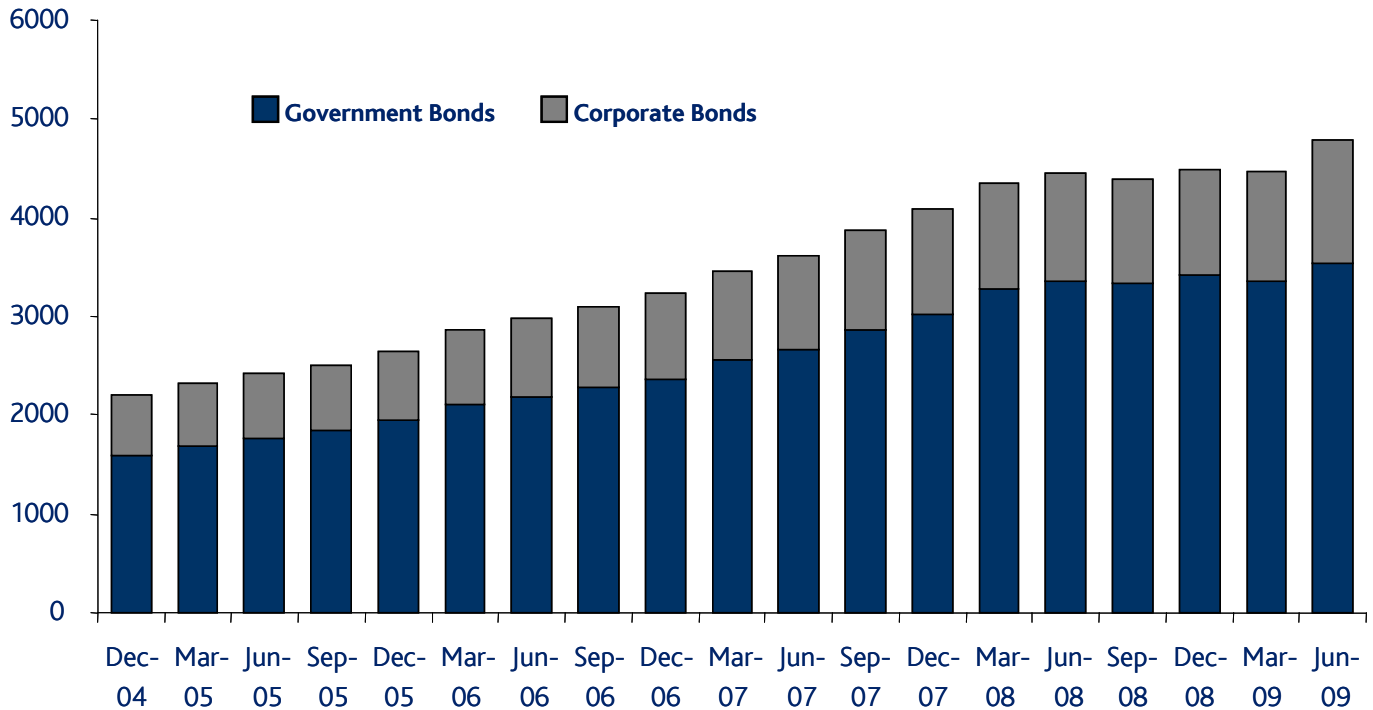
One of the outcomes of the Asian crisis was the development of the local bond markets. Until then most borrowing had been via commercial banks. In addressing this deficiency, governments recognised the need to provide some protection to the financial sector, encouraging more debt issuance through the capital markets. As a result, regional issuers have been able to tap Asia's vast pool of savings and provide fixed income investors with attractive investment opportunities. The local bond markets have developed rapidly and are now worth about \$5trn – far larger than the established Asian US dollar bond market. The Asian local bond market comprises around 75% government bonds and 25% in corporates.

In recent years, local bond markets have deepened following the issuance of longer dated paper, with most now having maturities extending to 20 years. This has been achieved via government debt diversification to ensure stability of long term yields, and the introduction and expansion of new debt instruments. On the demand side local investors such as pension and insurance companies have looked to match liabilities as sales of their financial products have grown rapidly. It is true liquidity can be lower than in developed markets. However an increase in the number of foreign investors is helping to improve trading volumes.

Taken together, more diversified bond markets and a wider investor base have added greater sophistication to the Asian bond markets to the point where they now occupy a unique position within the fixed income universe as a discrete, fully investable asset class.

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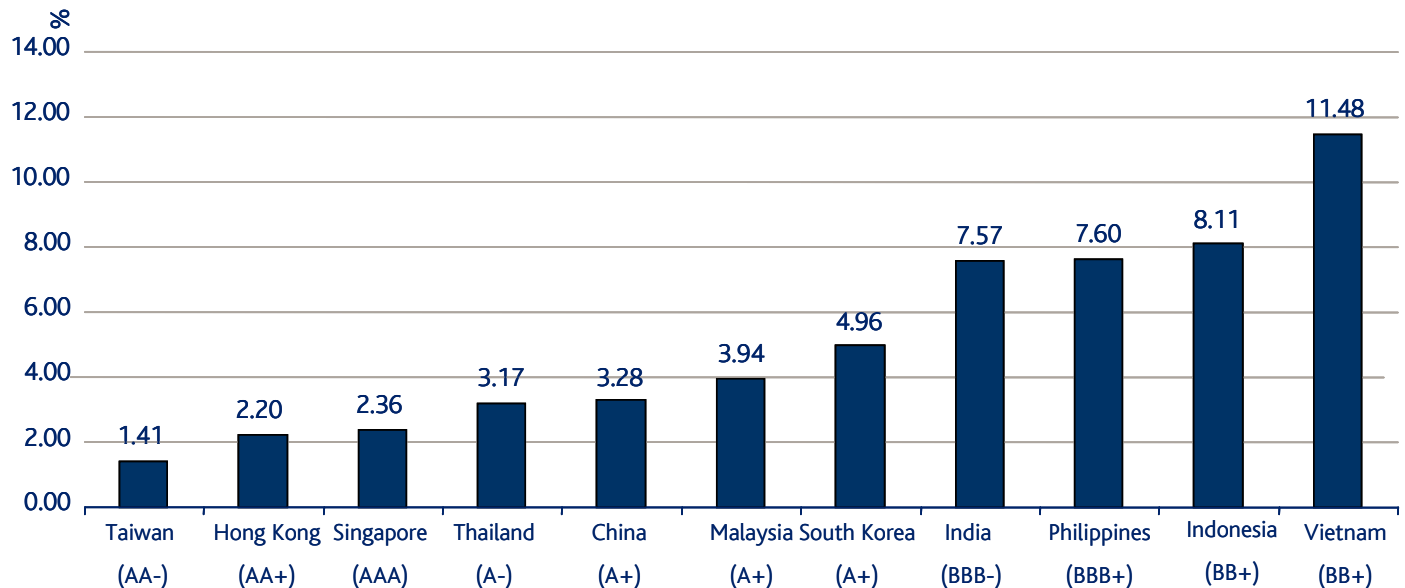
Source: HSBC, Asia Bond Monitor, Jan 2010

The diversity of the local Asian bond markets

We can refer to Asian bond markets as a single idea. Yet their underlying diversity presents investors with an opportunity to implement a range of strategic and tactical portfolio ideas across government, credit and currency markets. These opportunities are due, in part, to economies that are at differing stages of development, rated from investment grade through to sub-investment grade. Consequently, a broad range of sovereign yield levels are available from anywhere between 2-12%. The sheer diversity gives portfolio managers the ability to implement a range of active yield curve and interest rate strategies as well as relative value trades both within and outside of Asian markets.

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Asian 10-year government bond yield (%)



Source: Bloomberg, 22 Apr 2010

Attractive returns with low correlation

From a risk return perspective, Asian bond markets have performed comparatively well, generating a similar return to US high yield but with much less volatility. In addition they have shown relatively low long-term correlation with developed world bond markets. Granted, at the peak of the financial crisis all asset classes fell in unison. But if we assume a return to more “normal” market conditions now, there are diversification benefits that support an allocation away from traditional fixed income asset classes and into Asian fixed income – be it local currency (ALBI) or dollar denominated (ADBI) bonds.

Returns, volatility and correlation matrix for fixed income and equity indices (Mar 2005-2010)

	Avg ann return (%)	Vol (ann %)	Global Agg	US Agg	MLGB	MLHY	HSBC Asian Local Bond Index	HSBC Asian Dollar Bond Index	EMBI	MSCI Asia-ex Japan	MSCI World	S&P500
Global Aggregate USD	5.49	3.80	1									
U.S. Aggregate Bond	5.44	3.69	1.00	1								
ML Glob Govt	4.84	7.20	0.71	0.72	1							
ML US High Yield Master II	7.67	13.30	0.28	0.29	-0.03	1						
HSBC Asian Dollar Bond Index	6.90	7.21	0.49	0.51	0.47	0.53	1					
HSBC Asian Local Bond Index	7.72	8.64	0.72	0.71	0.30	0.72	0.55	1				
EMBI GI Div	9.12	10.40	0.64	0.64	0.21	0.81	0.59	0.95	1			
MSCI Asia ex Japan	13.73	26.90	0.22	0.23	0.02	0.73	0.63	0.59	0.69	1		
MSCI World	4.48	18.60	0.24	0.25	0.02	0.80	0.59	0.62	0.73	0.92	1	
S&P 500	1.92	16.31	0.22	0.22	-0.03	0.76	0.55	0.58	0.68	0.82	0.96	1

Source: Lipper, Mar 10

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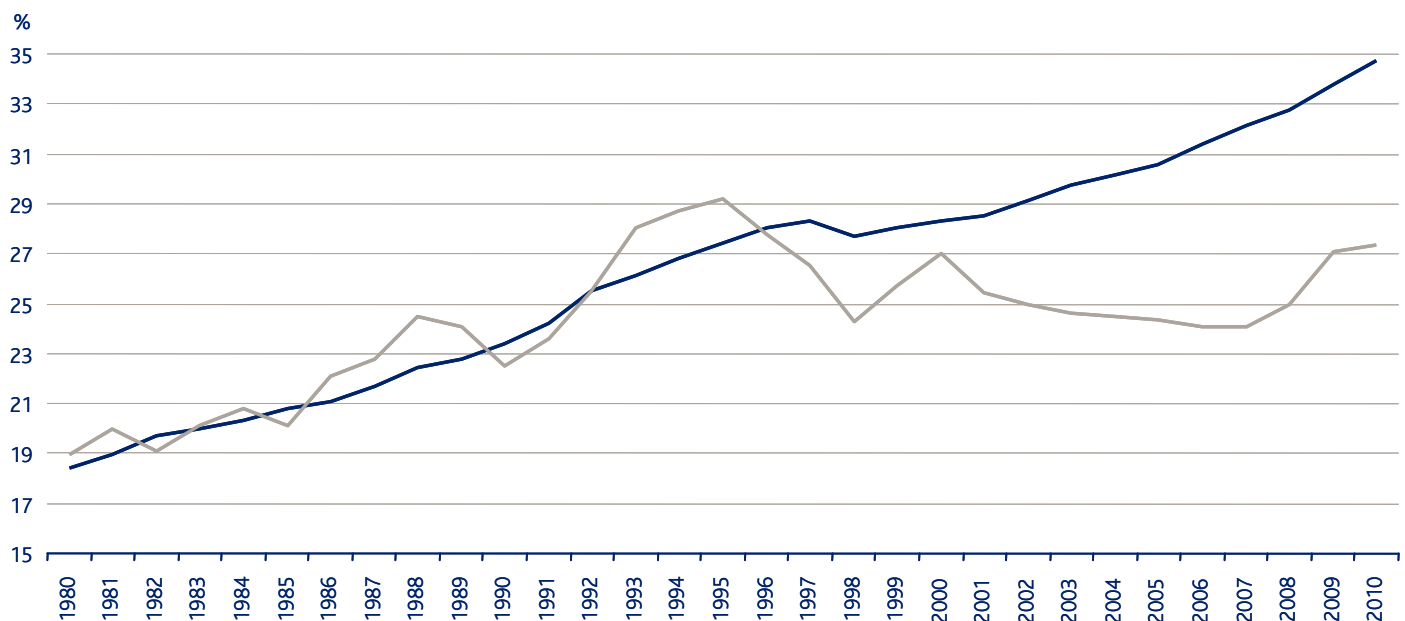
Appreciating currencies

Another factor making Asian bonds worth investigating is the range of currencies covering different FX regimes such as pegged, managed and free-floating currencies. While these add a layer of complexity to Asia's bond markets, they add potential upside too. Research suggests that the gap between PPP-based and market exchange rate-based GDP leaves Asian currencies significantly undervalued. During the past decade this has been an important competitive advantage for the region's export-dependent economies. However, a combination of external political pressure and an acceptance that economies need to be rebalanced towards stimulating domestic consumption will most likely result in Asian currency appreciation.

How soon will that happen? In view of their fast growth and lack of fiscal debt or structural debt-related constraints in the banking sector, Asian governments are able to tighten policy. Indeed with prices rising, some already have. So far they have preferred targeted measures over interest rates. If there is hesitation, it is that in the short term higher interest rates will boost the attraction of local asset markets to foreign investors, thus adding further pressure on currencies. On the other hand stronger currencies will dampen import costs and boost domestic demand.

China will continue to dominate developments. On June 19 it announced the removal of its peg to the US dollar. While this headed off US charges of currency manipulation for the time being, the more important development is the gradual resumption of appreciation of the Renminbi. This may help nudge other countries in the same direction. Moreover, while US monetary policy remains on hold, Asian tightening will support the natural upward trajectory of local currencies.

Asia's share of world GDP (%)



Source: IMF, The Economist, 26 Feb 10

The next great divergence

Economic history tells us that all great economies go through periods of growth and decline. The "Great Divergence" that occurred between the East and Europe during the 18th century marked the moment when China's contribution to global GDP started to decline. The Asian economies today are now charting a very different course. As large net creditors to debt-laden countries in the West, their economic importance has never been greater or more valued. The region's bond markets are starting to gain increasing attention from international investors looking to gain exposure to the opportunities now available in local Asian fixed income assets. For the majority of investors who are typically underweight Asia and overweight US dollar assets, we believe taking such an allocation decision is only due recognition for larger shifts taking place in the global economy.

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