Impact of the U.S. downgrade on Asian Fixed Income Markets

Regarding the U.S. downgrade by Standard & Poors (S&P):

- The downgrade has been well telegraphed by all three rating agencies and we believe the market impact will be fairly muted in the coming months.
- The downgrade highlights the fiscal imbalance in the U.S. as well as the need for investors to focus more on sovereign risks, even in the heavily indebted developed economies.
- Many global central banks have been diversifying away from USD denominated debt in recent years. The downgrade may speed up the gradual diversification of the central banks' foreign currency reserves away from USD to other remaining AAA countries debts.

The downgrade's impact on U.S. rates:

- The downgrade, alone, will have a muted impact on U.S. rates. While the higher credit risk of the U.S. sovereign may push up the U.S. government's borrowing cost, we believe that the factors which will influence the U.S. interest rates will continue to be its economic fundamentals and the market's general risk aversion.
- The bond market has been pricing in a much higher probability of a second recession in the U.S. Notwithstanding near-term earnings remain fairly constructive, and risky assets are under selling pressure on fears of a sharp slowdown in global economies. Fiscal consolidation means a much lower probability of fiscal stimulus going forward. Coupled with the rolling European sovereign debt crisis, the U.S. Treasury market continues to remain a safe haven for global investors.
- The Federal Open Market Committee (FOMC) this week will shed more light on the Federal Reserve's next move, which will have a greater impact on the rates market.
- The U.S. Treasury market will continue to be the largest, deepest and most liquid bond market in the world. For global central banks, the USD will continue to be the global reserve currency and the Treasury market the best alternative for holding reserves.

Our Asia Fixed Income team believes:

- The downgrade further highlights our long held belief that global investors should consider Asian bond markets as a viable diversification opportunity. In particular, the countries that still have an AAA rating status will attract capital inflows e.g. Australia, Singapore in Asia Pacific. The newly developing CNH market, particularly the highly rated issuers, should also benefit from a global search for alternative currencies and bond markets.
- We generally do not invest in the U.S. Treasury market. We believe the Asian sovereign bond markets and Asian currencies will continue to benefit from any flow out of the U.S. looking for relative safety and better yield opportunities. The countries we like in Asia Pacific are China, Korea, Singapore, Australia, Indonesia and Malaysia.
- We continue to believe that it does not pay to hold U.S. Treasury bonds at the current low yield, notwithstanding the downgrade, and that high quality corporate bonds present a better alternative for fixed income investors. The downgrade of the U.S. will underscore the relative safety of the highest quality corporate issuers.
- We believe the markets' fear about a 'hard landing' in China is overdone. The global uncertainty induced by the sovereign risks and economic slowdown from the developed economies should work to ease inflationary pressures on Asian economies. The downgrade and other risk factors should give the Asian central banks a reason to ease up on their tightening measures.

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