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As the economy strengthens, GDP growth and inflation have been recovering sharply in Asia. With this as a backdrop, we expect monetary policy in many Asian countries to support the appreciation of local Asian currencies versus the U.S. dollar and other major currencies over the next 3-5 years. This secular currency appreciation will likely play an important role in a broader adjustment of the economic imbalances that have been building between Asia and developed Western nations over the last decade.

This rebalancing process will be facilitated by Asian monetary and political authorities who realize that greater exchange rate flexibility is in their best interest: in a near zero interest rate environment in the developed world, undervalued currencies would expose Asian economies to inflationary pressures and asset bubbles. While we expect this transition towards increased currency flexibility to be a multi-year process, higher volatility in a number of Asian currencies suggests that we are in the early days of that transition period.

In light of this paradigm shift and with the strengthening of Asian economies versus developed markets, we believe Asian bonds are attractive due to:

- The expected appreciation of Asian currencies relative to the U.S. dollar and other major currencies
- Yields on local Asian government bonds appear attractive compared to major developed world government bonds
- Fundamental and technical factors are supportive of Asian corporate bonds

Rebalancing the Imbalances in the Global Economy

In the aftermath of the 1997/1998 Asian financial crisis, monetary policy in most Asian countries was focused on maintaining currencies at depressed levels for several years to support an export led recovery. This monetary policy, along with the region's rapid industrialization, has led to a spectacular surge in current account surpluses.

Reading the Tea Leaves

A current account surplus indicates a country's increase of its stock of net foreign assets, in other words it is a net saver relative to the rest of the world. Across Asia, reserves have risen from US\$446 billion in 1997 to US\$3,343 billion at the end of 2008, implying that the tremendous wealth accumulated by Asian nations was stored in foreign exchange reserves rather than private savings.

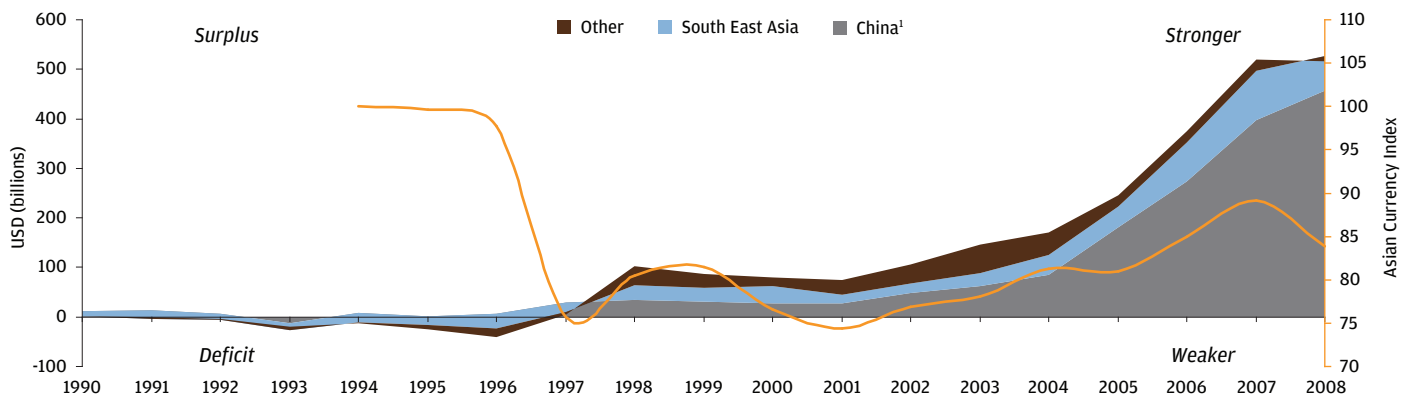
As exhibited by **Exhibit 1**, China accounts for a disproportionately large share of the total surplus given its rapid industrialization over the past 10 years. Most of these reserves and the tremendous wealth accumulation in Asia are suspected to have been reinvested into Western government bonds as this was really the only place for China to park its reserves. This has contributed to low borrowing costs, fueling excessive borrowing in the West.

In addition to the massive increase in public reserves in the Asian economies (see **Exhibit 1**), the imbalances between the developed and emerging economies continues in the private sector. The double whammy of the 2007-2008 credit crisis followed by the 2010 European fiscal crisis has become the day of reckoning for Western economies with the pace of borrowing unsustainable.

Exhibit 2 illustrates the borrowing differences in the private sector: home mortgages typically account for less than 30% of GDP in most Asian nations versus more than 80% in the West.

As consumers and the banking system de-lever and cap the overall growth prospects of Western markets, we expect growth in Asian economies to outpace the developed world.

EXHIBIT 1: CURRENT ACCOUNT POSITION

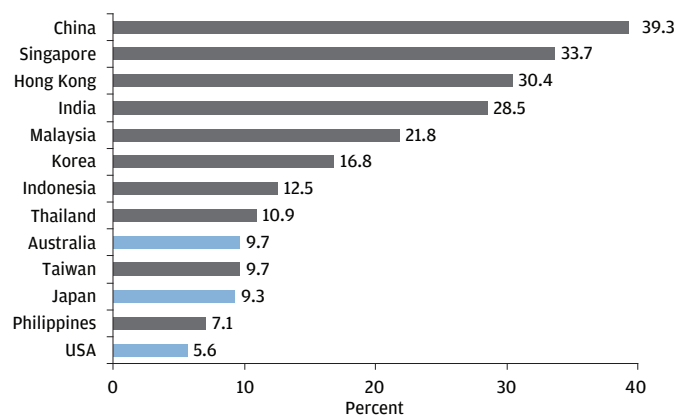


Source: Asian Development Bank.

¹ China includes Hong Kong, South East Asia includes Singapore, Thailand, Philippines, Malaysia and Indonesia, Other are Korea, India and Taiwan; Asian Currency Index is the Bloomberg-JPMorgan Asian Dollar Index base 100 in December 1994.

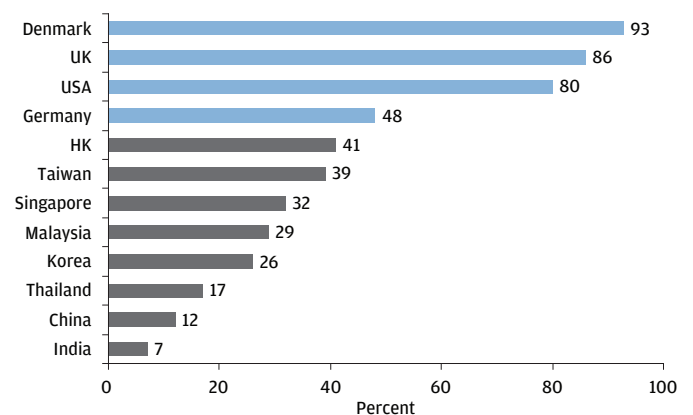
EXHIBIT 2: TOO MUCH BORROWING IN THE WEST, PLENTY OF SAVINGS IN THE EAST

2A: SAVING RATE



Source: Euromonitor from trade sources/national statistics, ©2010 Euromonitor International, May 2010

2B: MORTGAGES AS A PERCENTAGE OF GDP



Source: European Mortgage Federation, Asian Development Bank, HDFC, April 21, 2010

In fact, we expect emerging economies, the Asian economies in particular, to be the major contributors to global growth in the years ahead.

Low global bond yields and faster Asian growth will likely keep capital flowing into the Eastern countries as investors search for higher returns. Of course, this search for return might cause a variety of asset bubbles in Asia with limited capacity to absorb such inflows. The strategy for countries facing such a dilemma has often been to accumulate FX reserves, creating insurance to protect against bursting bubbles and to curb any significant currency volatility. These heavy currency interventions, however, force Asian economies to adopt the accommodative monetary policy prevailing today in the West. But this ultra accommodative monetary policy is clearly inappropriate for a burgeoning Asia and exposes the region to excessive domestic liquidity creation that could escalate the creation of asset bubbles. Breaking this link to Western monetary policies by allowing their currencies to float more freely is in the best interest of Asian nations over the next few years.

Today is an opportune time for Asian authorities to start implementing this transition given how divergent credit and macroeconomic cycles are in the West and Asia. This secular currency appreciation will likely play an important role in the broader adjustment of economic imbalances between Asia and the western economies over the last decade and sets the stage for tremendous opportunity in the Asian bond markets.

Early Signs of Greater Asian Currency Flexibility

In the aftermath of the recent credit crisis, Asian monetary and political authorities have been focused on the prevention of future asset bubbles in the region. The pursuit of that objective has led to changes in economic policies with a focus on the property and foreign exchange markets.

China's central government has been seeking to discourage investment demand for property while increasing the supply of low-cost housing. For instance last April, rules raising the down payment for second homes and increasing mortgage rates on second properties have been introduced. Credit control through the state owned banking sector has been a more indirect means to control the booming real estate market. Beside China, Hong Kong and Singapore have adopted similar policies in the real estate market.

While measures aimed at containing speculation in the property market have been broadly reported, the shift in foreign exchange policy is more subtle and should be implemented more gradually. Increased currency flexibility is a multi-year process and we are today in the early days of that transition period. Recent market developments, including the higher volatility in a number of Asian currencies; however, suggest that Asian Central Banks are starting to allow their exchange rates to float more freely.

In the wake of the recent credit crisis, Asian Central Banks have resisted the temptation of constraining their currencies at very competitive levels. While that adds a hurdle for exports in a challenging global environment, the primary objective of preventing excessive credit creation prevailed. In contrast to the Asian crisis, monetary authorities in the region have allowed their currencies to swiftly recover from distressed valuations after the recent credit crisis. **Exhibit 3** illustrates that point by showing the appreciation/depreciation of regional currencies versus the U.S. dollar throughout the recent crisis:

- **June 2007 to July 2010**

Since the start of the “subprime crisis” in July 2007, when the first signs of stress in credit markets emerged, most regional currencies have, on balance, appreciated versus the U.S. dollar with the notable exception of the Korean won and the Indian rupee.

- **5th of March 2009 to July 2010**

As the subprime crisis reached a climax in early 2009, with the S&P 500 index hitting a trough on March 5, 2009, all currencies in the region have appreciated markedly.

EXHIBIT 3: APPRECIATION/DEPRECIATION OF ASIAN CURRENCIES VERSUS THE USD

Currency	June 2007 to July 2010 (%)	March 5, 2009 to July 2010 (%)
CNY	12.3	0.9
HKD	0.6	-0.1
INR	-12.0	11.8
IDR	1.3	35.7
KRW	-21.6	32.6
MYR	9.0	17.1
PHP	1.8	6.8
SGD	12.9	14.0
THB	-1.4	12.0
TWD	2.5	9.0

Source: J.P.Morgan Asset Management

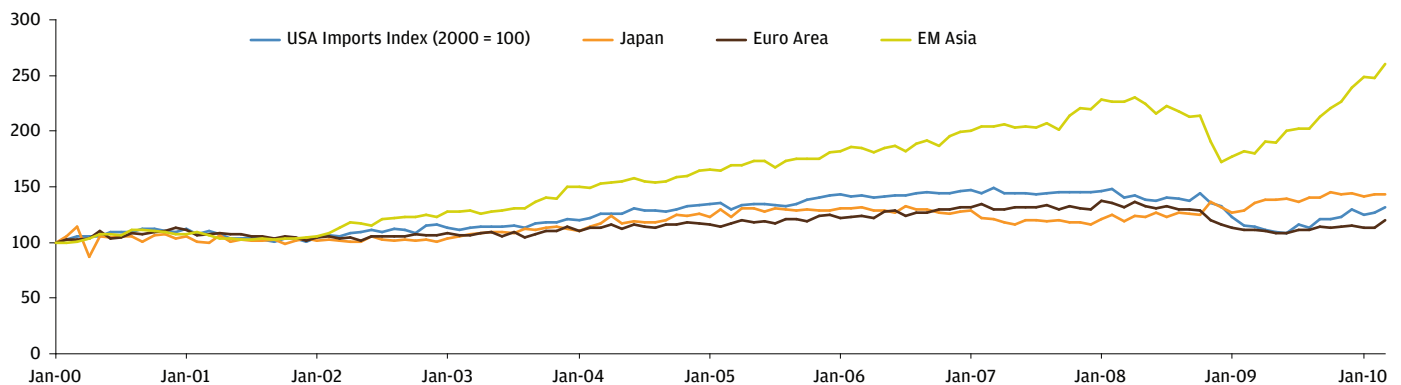
Reading the Tea Leaves

Over the last decade, growth in pan-Asian trade has outpaced trading with the rest of the world by a wide margin (**Exhibit 4**). This reflects the reality that Asian nations have established a specialization in different aspects of the manufacturing production chain. For every manufactured good exported to the U.S. from China, a number of regional transactions might take place. For instance, a car assembled in China might incorporate semiconductors made in Singapore, car parts manufactured in Taiwan and raw material from Indonesia and Malaysia. This faster pan-Asian trade growth also reflects faster expansion in Asian consumption and investment.

Because of its sheer size and cheap, efficient work force, China is usually involved in the manufacturing of Asian goods for export. The Chinese economy's openness and close integration

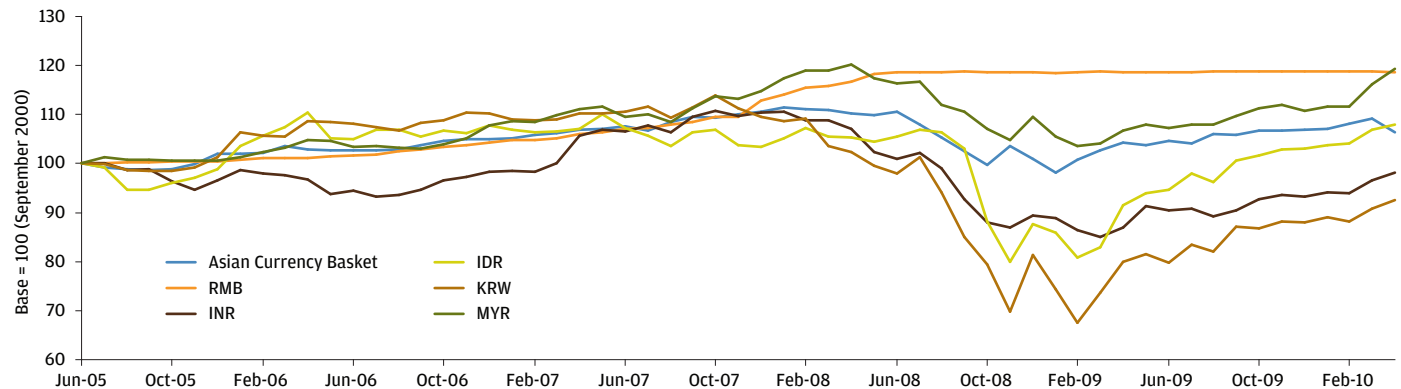
in regional and global trade implies that its foreign exchange policy matters a great deal to its neighbors and the rest of the world. As a result, China's announcement on June 19, 2010 that it would allow the renminbi to start fluctuating again reinforces the case for other regional currencies to also appreciate. From that perspective, the 2005 to 2008 experience when China first allowed its currency to gradually appreciate relative to the U.S. dollar is instructive. **Exhibit 5** shows that the correlation between the renminbi and other major emerging Asian currencies was significantly positive with regional currencies appreciating markedly over that period of time given their greater flexibility versus the renminbi. The renminbi's renewed appreciation could therefore open the door for a broader revaluation of regional currencies. It is also noteworthy that

EXHIBIT 4: GROWTH IN PAN-ASIAN TRADE (BASE 100 IN 2000)



Source: HSBC Bank as of June 20, 2010.

EXHIBIT 5: RENMINBI APPRECIATION AND OTHER ASIAN CURRENCIES—THE 2005-2008 EXPERIENCE



Source: Bloomberg, ADXY for Asian currency basket, base 100 on June 30, 2005.

over the last five years Asian currencies have depreciated significantly relative to the renminbi: the Korean won has depreciated by 26% relative to the renminbi over that period of time while the Indian rupee has depreciated by over 20% and the Indonesian rupiah by close to 11%. That leaves significant appreciation potential for the broader basket of Asian currencies in an environment where the renminbi will be allowed to resume its gradual appreciation.

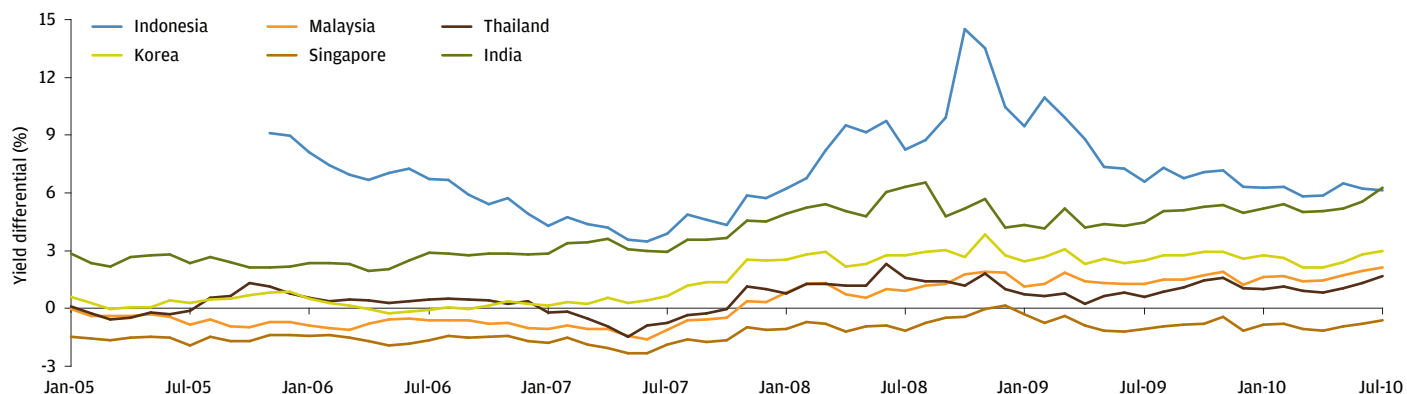
Attractive Yields in Asian Local Currency Bonds

Beside the medium term appreciation potential of Asian currencies, local government bonds offer attractive yields compared to developed market government bonds. In particular, while historically global investors had to give up a significant amount of yield to access Asian local currency bonds, the current global low yield environment makes them look relatively attractive from a yield perspective. For example, on August 30, 2010, yields on 10-Year U.S. Treasury were 2.47% versus equivalent maturity Korean and Indonesian bonds offering yields of 4.38% and 8.35%, respectively. **Exhibit 6** illustrates this point by showing the difference in yield between short dated Asian local currency bonds and U.S. Treasuries with similar maturities. Until the recent credit crisis of 2007-2008, U.S. Treasuries were offering yields similar or higher to those available in Asian currencies. Indonesia was the only market to offer significantly higher yield. As Central Banks around

Asia have started to tighten their monetary policy while the U.S. Fed maintains a very accommodative policy, yields in most Asian markets exceed those in U.S. Treasuries by a significant margin.

Furthermore, as the regulatory environment and liquidity of Asian markets improve, more investors may become attracted to investing in the region. In addition, as an increasing number of Asian nations are upgraded to investment grade status, an increasing number of investors can invest in the region. This broader investor base combined with their potential need for greater currency diversification is likely to benefit Asian currency bonds. While, for many investors, currency diversification effectively meant reallocating assets away from the U.S. dollar towards the euro, the recent European fiscal crisis has led investors to look for new currency diversification opportunities. In particular, anecdotal evidence shows that Central Banks are increasingly diversifying their foreign reserve allocation towards selected Asian currencies. In particular, Bloomberg reported on August 18, 2010 that China had doubled its allocation to Korean won government bonds since the beginning of the year. This is likely to be a broader trend as the Japanese government, for instance, reported that China had bought a record US\$20.3 billion of Japanese government bonds. While China is grabbing the headlines due to its scale, other Central Banks face a similar situation.

EXHIBIT 6: YIELD DIFFERENTIAL BETWEEN SHORT-END ASIAN LOCAL BONDS AND U.S. TREASURIES



Source: J.P. Morgan Asset Management based on 3-5 year JPM GBI index data.

Asian Corporate Bonds Offer Opportunity

The market for Asian currency bonds remains dominated by government bonds. Hong Kong and Singapore are the only two countries in the region with relatively liquid corporate bond markets. While in the long run the market for local currency corporate bonds will probably grow, U.S. dollar denominated Asian corporate bonds is today the best way to gain exposure to the non-government sector in the region.

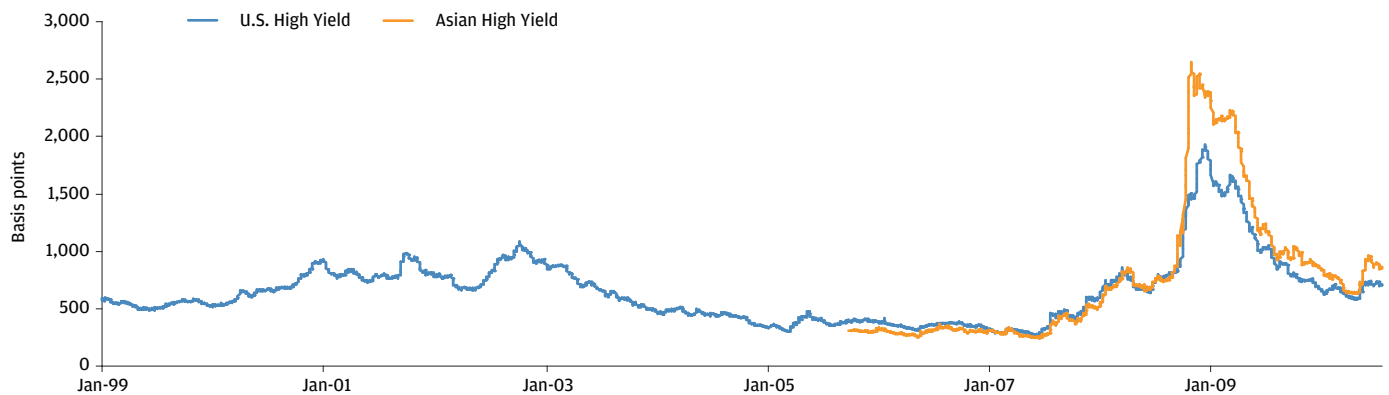
We expect the sector to continue to perform well in the current near zero yield environment. In our opinion, while corporate bonds, globally, should perform well, Asian corporate bonds are particularly attractive relative to other regions from a valuation standpoint. Specifically, despite the region's stronger growth and healthier banking sector, credit spreads on Asian corporate bonds still offer a premium over U.S. corporate bonds carrying a similar rating. **Exhibit 7** illustrates that despite the premium narrowing since the fourth quarter of 2008 it remains significant for both investment grade and

high yield corporate bonds. We remain positive on global corporate bonds but believe that given current fundamentals and relative valuations investors would achieve greater return investing in Asian credits rather than U.S. corporate bonds.

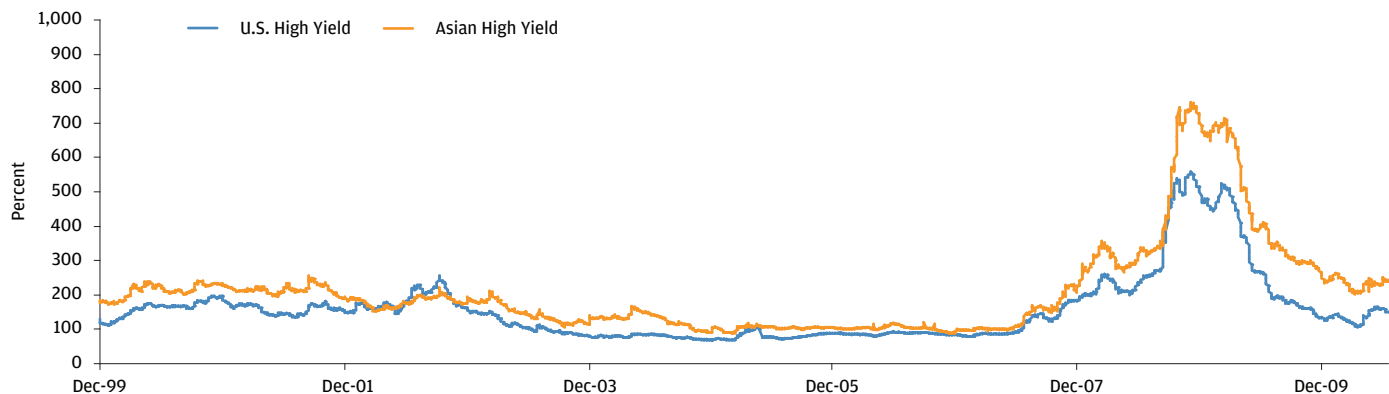
We also note that technicals are supportive of Asian credit markets for the year ahead. The buoyant credit market of 2009 has allowed Asian investors to raise significantly more capital from the market than they needed to refinance maturing bonds. Specifically, **Exhibit 8** (on the opposite page) shows 2009 issuance by Asian corporations far exceeded the amount returned to investors in the form of maturing bonds and coupon payment. Hence, having been able to front load their financing needs in 2009, Asian companies will be under less pressure to issue new bonds going forward, limiting the amount of new supply. Furthermore, Asian corporations are expected to return about US\$33 billion of cash to investors in the form of maturing bonds and coupon payments in 2010. This should support investor demand for Asian credit as portfolio managers will have to reinvest this cash into the market.

EXHIBIT 7: U.S. VERSUS ASIAN CREDIT SPREADS

7A: HIGH YIELD SPREADS

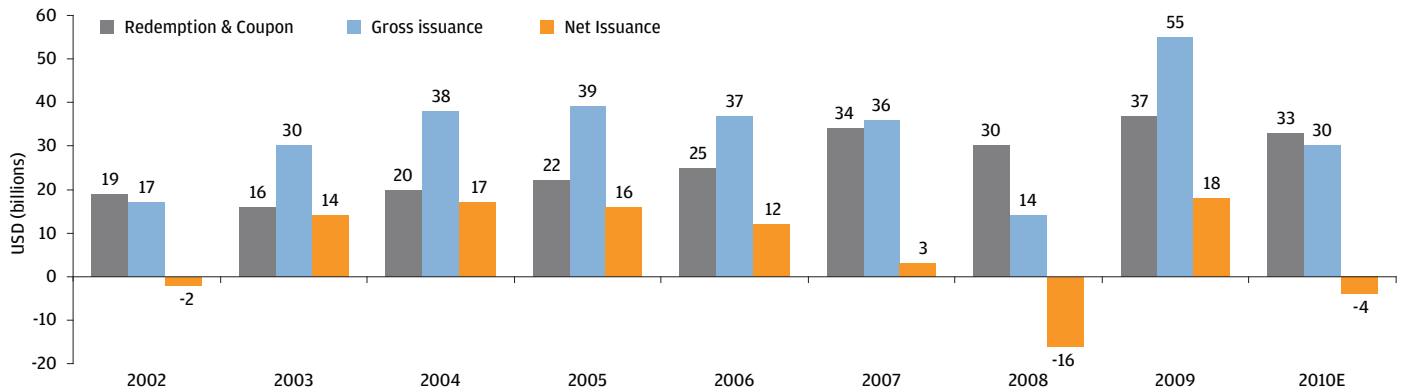


7B: HIGH GRADE SPREADS



Source: JPMorgan JACI corporate for Asia, JPMorgan U.S. High Yield and JULI for the U.S. as of July 21, 2010.

EXHIBIT 8: ASIA EX-JAPAN USD ISSUANCE AND REDEMPTION



Source: Dealogic, Bloomberg, UBS as of July 9, 2010.

Summary

We expect Asian currencies to appreciate relative to the U.S. dollar and other major currencies in the coming years. This trend will play a critical role in a broader secular adjustment of the global imbalances that have been building over the past decade. This rebalancing process will likely be facilitated by Asian monetary and political authorities who realize that greater exchange rate flexibility is in their best interest. We are in the early days of that adjustment process that we expect to be gradual—an evolution rather than a revolution.

Asian currency bonds are therefore a natural home for investors looking to diversify their currency exposures away from their U.S. dollar and euro focused portfolios. Furthermore, in a near zero interest rate environment globally, Asian currency government bonds offer some yield advantage relative to U.S. Treasuries. Finally, fundamental and technical factors are supportive of Asian corporate bonds which can complement Asian government bonds to provide attractive risk adjusted returns.

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