Impact of Recent Rise in US Mortgage Delinquencies on Asia

14 March 2007

What Happened?

The US yesterday released a report showing that sub-prime mortgage delinquencies rose to a four-year high. As a result, markets fell across the region.

Impact on Asian Financial Markets

At present, with low and stable unemployment rate, the risks of material credit deterioration appears limited to the sub-prime mortgage sector. However, as the US economy is already in a soft patch after 3 quarters of sub-trend growth, any further deterioration in the US sub-prime mortgage segment may spread to the broader housing market and to the overall economy. These uncertainties, along with possible policy measures in cooling the overheated markets (such as China equities), and further risks relating to the JPY carry trade unwinding, all weigh heavily in the sentiments of financial markets. With rising risk aversion, financial markets are thus sensitive to any potential weak US growth data and negative newsflow from the sub-prime mortgage market.

Strategy on Asian Equity Funds

We view this market fall as a continuation of what we saw towards the end of February. There has been no change to the long-term fundamentals of Asian economies and companies, given the improved corporate governance and capital management as well as expected continued strong long-term growth in the region. On a cautious note however, we have been looking more closely at some of the financial institutions that may be exposed to the lower quality CDOs.

Strategy on Schroder Asian Bond Fund

We maintain a defensive strategy. We believe that with a diversified exposure, which has always been the cornerstone of our strategy, the Fund should be able to ride the current market volatility well.

Specifically, we believe that our long duration strategy (attributed mainly via German Bunds and selective Asian local bonds) will benefit our Fund from the “flight-to-quality” and weak economic data. As the US economy is currently exhibiting signs of another “soft patch”, we expect broader USD weakness to still surface at some point. Hence, the Fund will hold on to its substantial non-USD exposures. The Fund has no exposure to USD High Yield sovereign bonds in light of their expensive valuation, which are vulnerable to market corrections. We remain constructive in Asia High Yield corporate due to their attractive relative value, sound fundamental (default rate remains low) and limited supply in the market. With a well diversified portfolio of more than 40 corporate issuers, we will maintain exposure in the corporate sector. The Fund currently does not have exposure to credit holdings that have key business activities in the US sub-prime mortgage markets.

Strategy on Schroder Asian Premium Bond Fund

We maintain a defensive strategy. We believe that our long duration strategy (mainly via investment grade USD exposures, JGB and German Bunds) will benefit our Fund from the “flight-to-quality” and weak economic data. As the US economy is currently exhibiting signs of another “soft patch”, we expect broader USD weakness to still surface at some point. Hence, the Fund will hold on the JPY and Euro positions. In credits, our strategy focuses on investment grade corporates and banks which are reasonably defensive with strong credit fundamentals and limited supply in the market. The Fund currently does not have exposure to credit holdings that have key business activities in the US sub-prime mortgage markets.

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