December 2016

By Koh Liang Choon,
Head of Fixed Income

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Nikko Asset Management

FROM THE FIXED INCOME DESK

Monthly Outlook

Summary

- UST yields surged in the month as Trump's election victory prompted expectations of a significant fiscal package and possible upside inflation risk under the new administration. 10-year UST yields ended the month at 2.38%, about 56 basis points (bps) higher compared to end-October levels.

- India saw an unexpected crackdown on INR 500 and INR 1000 banknotes, which are estimated to account for more than 80% of currency in circulation by value. These notes will be replaced by fresh ones with better security features.

- In China, foreign reserves contracted for the fourth straight month on the back of depreciating RMB. Meanwhile, key measures of inflation in China rose in October, while the Chinese government continued to tighten onshore financing measures for developers in November.

- Regional central banks kept rates unchanged during the month, citing uncertainty posed by the incoming Trump administration. In general, Bank Indonesia, the Thai central bank and the Bangko Sentral ng Pilipinas noted that current monetary conditions were still accommodative enough to facilitate growth in the respective regions.

- The Asian credit market registered losses in November as UST yields jumped. Following Mr. Trump's surprise win, uncertainty surrounding possible US protectionist trade policies, higher USD and treasury yields prompted an exodus of funds from Emerging Markets (EM). Asian high-grade underperformed Asian high-yield in the month.

- Despite the surge in risk-free rates, the month saw a lower but still elevated number of new issues. There were 20 new issues – amounting to USD 10.5bn – in the high-grade space. Meanwhile, primary activity for high-yield remained active with 14 new issues amounting to USD 4.4bn.

- We continue to favour Indian and Indonesian bonds and currency. Indonesian Rupiah could outperform peers should repatriation flows from its tax amnesty programme increase, while we see the Indian Rupee recovering on expectations of renewed inflows into Indian securities following the demonetisation exercise. In contrast, we expect Philippines bonds, the Peso and Korean Won to underperform.

- Volatility is expected to remain high, driven by events such as the Italian referendum on constitutional reforms followed by the US Federal Open Market Committee (FOMC) meeting. For high-yield China property, tightening onshore funding channels coupled with anticipation of more tightening measures to come is likely to be another source of concern.

Asian Rates and FX

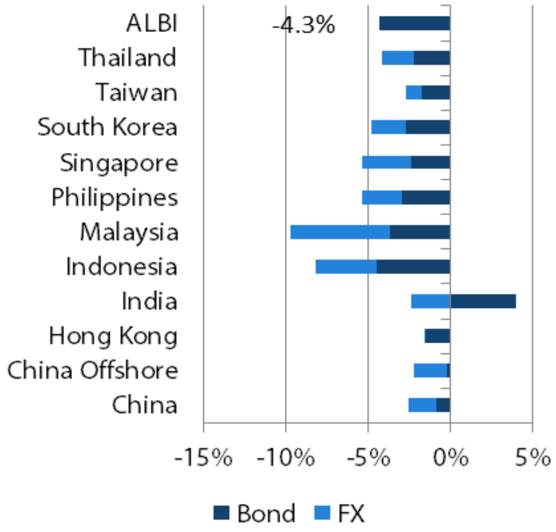
Market Review

- US Treasury (UST) yields jumped in November

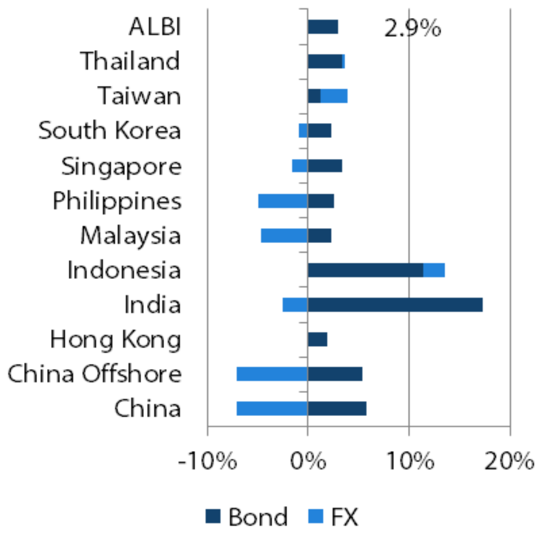
There was an overall decline in risk appetite at the start of the month, prompted by uncertainties leading up to the US presidential election and hawkish undertones from major central banks. On 9 November, Republican presidential nominee Donald Trump won over Hillary Clinton to take office as the 45th President of the United States. Although the upset win spurred an initial flight to safety, sentiment quickly reversed following Mr. Trump's conciliatory victory speech and as markets focused on the possibility of a significant fiscal package under the new administration. However, as the market started pricing in upside inflation risk from a Trump administration, US bond yields surged and the USD rose. Overall, 10-year UST yields ended the month at 2.38%, about 56 basis points (bps) higher compared to end-October levels.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 November 2016



For the year ending 30 November 2016



Note: Bond returns are in local currencies while FX and ALBI returns are in USD. Past performance is not necessarily indicative of future performance. Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 November 2016

- India announced demonetisation of INR 500 and INR 1000 currency notes

In an unexpected major crackdown on the stock of undeclared money, Indian Prime Minister Narendra Modi announced that the government will replace its largest-denomination bank notes with new ones. Current Indian Rupee (INR) 500 and INR 1000 banknotes - estimated to account for more than 80% of currency in circulation by value - ceased being legal tender on 8 November. Meanwhile, fresh notes with better security features were introduced. According to the government, this exercise will eventually extend to other denominations.

- China's FX reserves fell for a fourth straight month; PPI saw a further rise in October

Foreign reserves in China fell USD 46bn in October to USD 3.12tr, contracting more than expected. Reserves have been dropping for four consecutive months, contributing to the downward pressure on the renminbi (RMB). During the month, People's Bank of China (PBoC) Deputy Governor Yi Gang sought to calm markets, assuring that the country has "very adequate" foreign reserves and that the RMB remains strong compared to currencies in its exchange rate basket. Nevertheless, the State Administration of Foreign Exchange (SAFE) was reported to have put on hold its approval of certain pending outbound investments. Meanwhile, key measures of inflation in China rose in October. Headline CPI inflation advanced 2.10% from a year ago, following a 1.90% gain in the previous month, on the back of higher food costs. More significantly, PPI, a gauge of factory-gate prices, strengthened further to 1.2% year-on-year (YoY) in October after it registered 0.10% YoY in September, prompted mainly by rising commodity prices.

- Regional monetary authorities leave interest rates unchanged

Central banks in the region stood pat on rates, with most of them citing uncertainty posed by the incoming US administration as a key reason for the decision to leave rates unchanged. Bank Indonesia added that the cumulative 150bps in rate cuts it has delivered is "sufficient for growth", and sees full-year 2016 GDP printing 5.0%. Elsewhere, the Thai central bank described overall monetary conditions as "accommodative and conducive to economic recovery", while the Bangko Sentral ng Pilipinas noted firmness in domestic economic activity, supported by solid private household consumption and investment.

Market Outlook

- Overweight Indian and Indonesian bonds; cautious on Philippine bonds

The demonetisation exercise in India has led to a surge in banking system liquidity. This has pushed Indian bonds to rally, despite the sell-off in global bonds following the US elections. In spite of these gains, carry levels are still attractive. Meanwhile, the new leadership at the Reserve Bank of India (RBI) has suggested that the RBI rate cut cycle is still ongoing. These factors lead us to believe that there is scope for Indian bonds to outperform on an intra-Asia basis in 2017. Low offshore participation further provides a buffer in the event of overall weakness in global fixed income. Similarly, our preference for Indonesian bonds is grounded on relatively higher carry against a backdrop of still benign inflationary pressures. Meanwhile, we have a cautious view on Philippine bonds. Against a backdrop of strong domestic demand, we believe there is the risk of an acceleration in inflation in 2017. Less favourable base effects from oil prices further heightens this risk. We also expect political noise from President Duterte's rhetoric to continue to weigh on investor sentiment towards Philippine assets.

- Prefer IDR and INR; underweight KRW and PHP

We note that a potential rise in repatriation flows from the tax amnesty programme will provide some buffer for the Indonesian Rupiah (IDR) to outperform vis-à-vis regional peers. Meanwhile, we see the INR recovering on expectations of renewed inflows into Indian securities. In contrast, we are cautious on the Philippine Peso (PHP) and the Korean Won (KRW) as we see it underperforming regional currencies, prompted in part by greater political uncertainty in the respective countries. Moreover, we believe that the KRW will be highly vulnerable to fears of possible protectionist trade policies by the new US administration.

Asian Credits

Market Review

- A sell-off in Asian credits

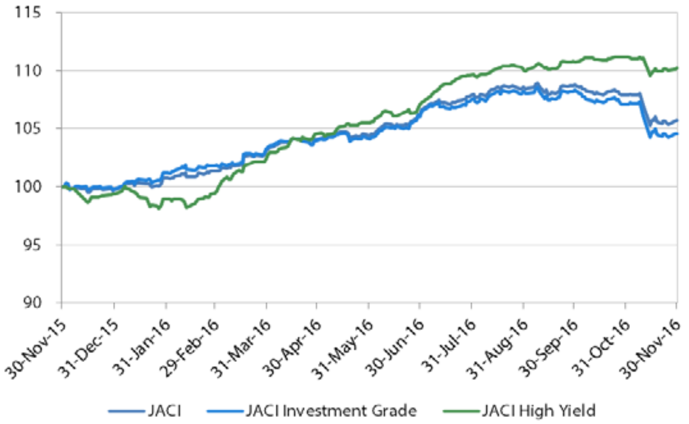
The Asian credit market registered losses in November. Weakness was driven by a surge in US Treasury (UST) yields as overall credit spreads tightened by about 6 basis points (bps) in the month. Asian high-grade lost 2.38%, underperforming Asian high-yield which weakened 0.64%, as risk-free rates gapped higher. Following Mr. Trump's surprise win, uncertainty about possible protectionist trade policies by the US going forward, sharply higher USD and treasury yields prompted an exodus of funds from Emerging Markets (EM).

- China further tightens onshore financing for developers

The Chinese government continued to introduce measures to tighten onshore financing for developers. According to Caixin, the National Development and Reform Commission (NDRC) has restricted property developers from issuing enterprise bonds for commercial property development, although it noted that bond issuances for social housing purposes in low-inventory cities continued to be permitted. This dampened sentiment towards China property credits, although price movement was limited.

JP Morgan Asia Credit Index (JACI)

Daily returns for the period from 30 November 2015 to 30 November 2016



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 30 November 2016

- Slower primary market activity within investment grade space

Despite the surge in risk-free rates, the month saw a lower but still high number of new deals of investment-grade credits. There were a total of 20 (compared to 27 last month) new issues – amounting to USD 10.5bn – in the high-grade space. Meanwhile, primary activity for high-yield remained active with 14 new issues amounting to USD 4.4bn in the month.

Market Outlook

- Rates volatility expected to remain high with key risk events in December

Rates volatility, which is expected to remain high, is likely to drive the market in the near-term. This will be influenced by the Italian referendum on constitutional reforms in early December followed by the US Federal Open Market Committee (FOMC) meeting on 13th and 14th December. The FOMC is expected to raise rates. For high-yield China property, tightening onshore funding channels coupled with anticipation of more tightening measures to come is likely to be another source of concern. Spreads have remained relatively resilient and remain on the expensive side from a historical context. Given this, we maintain a more defensive stance overall.

- Supply to taper into year-end but fund flows bears monitoring

The supply of new issues should taper into year-end but is expected to pick-up strongly in January. While in-region demand for Asian credit seems to remain intact, the external fund flows into EM hard currency debt bears monitoring given the recent outflows seen after the US presidential results.

Important Information