December 2017

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ASIAN FIXED INCOME OUTLOOK

December 2017

Summary

- US Treasury (UST) yields declined during the month. The nomination of Jerome Powell as the next US Federal Reserve (Fed) chairman overshadowed stronger US economic data, but was subsequently offset by increased geopolitical risks in the Middle East and a setback to US tax reform.

- Conversely, Asian credits suffered losses in November. Overall credit spreads edged wider, as a confluence of factors ranging from rising geopolitical risk in the Middle East, deleveraging concerns in China, and heavy new supply prompted investors to switch into capital preservation mode.

- Regional economies registered robust growth for the quarter, led yet again by the Philippines on the back of robust performance in the services and industry sectors. Elsewhere, South Korea's central bank hiked rates, signaling the start of the policy rate normalisation cycle. Meanwhile, Bank Negara Malaysia opted to leave its policy rate unchanged.

- Chinese policymakers tightened rules on the asset management industry. Furthermore, the Ministry of Finance increased control on Public-Private Partnership (PPP) projects, lifting entry barriers to these projects and imposing a limit on PPP investment. In India, Moody's Investors Service upgraded its sovereign rating to 'Baa2' from 'Baa3'.

- Activity in the primary market picked-up significantly in November, with 50 new issues amounting to USD 27.9bn in the high-grade space. Meanwhile, the high-yield space saw 29 new issues amounting to around USD 10.4bn.

- 2018 is likely to be a year of lower returns and higher volatility for Asian local currency bonds. A combination of robust economic growth and the possibility of inflationary pressures rising may lead regional central banks to be more hawkish. Against this backdrop, we anticipate Indonesian bonds to outperform regional peers while hold a cautious view on Philippine bonds.

- On the currency front, we favour the RMB and are also fairly positive on the Malaysian Ringgit. In contrast, we remain bearish on the Philippine Peso.

- Spreads are already at tight levels from a historical basis, and the heavy new issue supply pipeline across high-grade and high-yield could pressure secondary spreads. That said, the Asian economic growth backdrop is still decent and thus significant spread decompression does not appear likely in the near-term.

Asian Rates and FX

Market Review

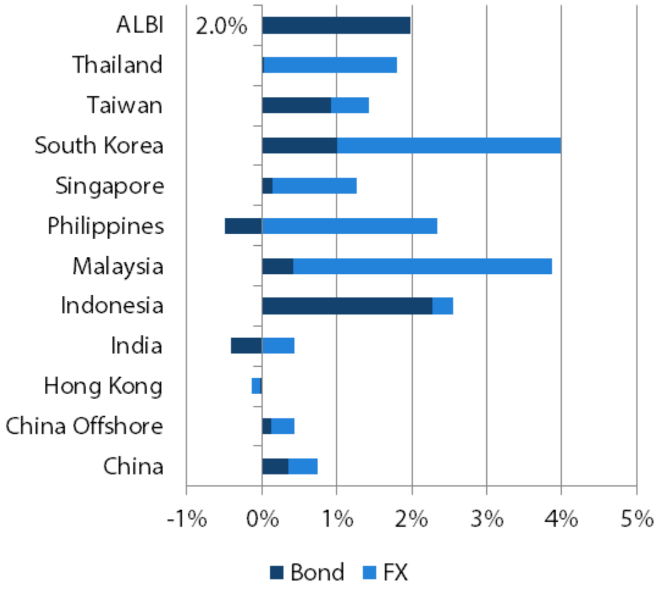
- US Treasuries (USTs) yields ended lower in November

Earlier in the month, the nomination of Jerome Powell as the next US Federal Reserve (Fed) chairman overshadowed stronger US economic data. Markets took the nomination news positively, pushing yields lower, on expectations that Mr. Powell will continue the Fed's current approach to monetary policy. Investors largely ignored the further drop in the US unemployment rate, as well as the acceleration in year-on-year PPI.

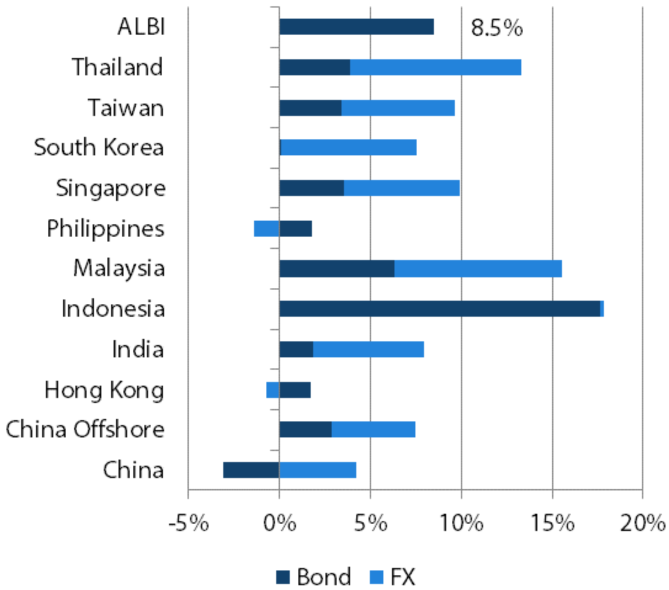
Subsequently, increased geopolitical risks in the Middle East sapped market sentiments. A setback in US tax reform led markets to adjust their expectations for stronger growth, capping yields at the long-end. Overall, 10-year UST yields ended the month at 2.41%, about 3 basis points (bps) lower compared to end-October.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 November 2017



For the year ending 30 November 2017



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 November 2017

Note: Bond returns refer to ALBI indices quoted in local currencies while FX refers to local currency movement against USD. Returns are based on historical prices. Past performance is not necessarily indicative of future performance.

- Regional economies registered robust growth in the third quarter

The Philippine economy expanded at 6.9% year-on-year (YoY) in the third quarter of 2017, leading regional growth once again. The services and industry sectors were the main sources of strength, which more than offset slower agricultural production. Similarly, expansion in Malaysia was robust, with third quarter GDP accelerating to 6.2% in the same period, from 5.8% in the second quarter. The improvement in growth was broad-based, led by fixed investment and private consumption. In Thailand, economic expansion in the third quarter printed 4.3% YoY, exceeding expectations, while second quarter growth was upwardly revised to 3.8%. Expansion was supported mainly by external demand. Elsewhere, Indonesia's economy grew at a slightly faster pace in the July to September period, as government consumption and investment spending rose faster, while private consumption growth held relatively stable.

- Bank of Korea (BoK) raised its policy rate by 25bps; Bank Negara Malaysia turned more hawkish

South Korea's central bank hiked rates by 25bps to 1.5%, signaling the start of the policy rate normalisation cycle. The BoK sounded positive on domestic growth, and expects the semiconductor upcycle to continue for now. Going forward, it anticipates headline CPI to be in the mid-1% range "for some time and then gradually approach the target level." Meanwhile, although Bank Negara Malaysia opted to leave its policy rate unchanged, its monetary policy committee (MPC) statement noted that "given the strength of the global and domestic macroeconomic conditions, the Monetary Policy Committee may consider reviewing the current degree of monetary accommodation", signalling the possibility of a rate increase in 2018.

- Moody's upgraded India's sovereign rating

Moody's Investors Service upgraded India's sovereign rating to 'Baa2' from 'Baa3', changing the outlook to 'stable' from 'positive'. The credit rating agency said that the move – its first since January 2004 - was prompted by the "expectation that continued progress on economic and institutional reforms will, over time, enhance India's high growth potential." It acknowledged that the general government debt burden remains significantly higher relative to similarly-rated peers. However, Moody's believes ample private domestic savings are available to finance the government deficit, which somewhat mitigates the impact of the higher debt levels.

Market Outlook

- Positive on Indonesia bonds; cautious on Philippine bonds

2018 is likely to be a year of lower returns and higher volatility for Asian local currency bonds. We note that a number of factors remain fluid and warrant further observation. For one, it remains to be seen whether the recent rise in oil prices is sustainable, and the potential impact this would have on inflation and thereby, rates. At this point, we maintain the view that the Fed would continue on a gradual hiking path, but note that a new Fed Chairperson and the departure of Fed Vice-Chairman Stanley Fischer and Federal Reserve Bank of New York President Bill Dudley reduces the visibility on the policy outlook for next year.

In Asia, a combination of robust economic growth and the possibility of inflationary pressures rising may lead regional central banks to be more hawkish. Against this backdrop, we anticipate Indonesian bonds to outperform regional peers.

Inflationary pressures are likely to remain fairly anchored, helped in a large part by the government's effort to improve food supply management across the country. We do not expect Bank Indonesia to cut interest rates further, but see monetary policy remaining accommodative as policymakers continue to focus on boosting domestic growth. Near-term bond technicals are supportive of the space. The government has cancelled the remaining bond auctions for the year, and demand could get a significant boost in the event that Indonesia gets included in the Bloomberg Barclays Global Aggregate Index. Meanwhile, we hold a cautious view on Philippine bonds, as the risks to inflation in the Philippines is high.

- Positive on MYR and RMB; cautious on the PHP

We hold a fairly positive view on the MYR. Malaysia's economy has continued to surprise on the upside. As a net oil exporter, the rise in oil prices, should it be sustained, would be positive for the country. Meanwhile, Bank Negara Malaysia has clearly struck a more hawkish tone at its last policy meeting, suggesting that a rate hike is imminent. We view these factors to be supportive of the MYR. Our preference for the RMB is reinforced by China's strong current account surplus. Moreover, the potential inclusion of Chinese rates into global bond indices should sustain demand for the currency. In contrast, we maintain our bearish view on the Philippine Peso, on the back of current account weakness. Nonetheless, we are cognizant that seasonally strong inflows during the Christmas season could provide some support for the currency in the near-term.

Asian Credits

Market Review

- Asian credits ended lower in November

Asian credits suffered losses in November. Asian high-grade returned -0.16%, outperforming Asian high-yield corporates which returned -0.27%. Overall credit spreads edged wider, as a confluence of factors ranging from rising geopolitical risk in the Middle East, deleveraging concerns in China, and heavy new supply prompted investors to switch into capital preservation mode. During the month, increased approvals for China corporates to raise USD bonds contributed to market fatigue for new issues. Over in the US, additional challenges to US tax reform legislation emerged, as variance between versions of the House and the Senate expands. Consequently, markets started pricing in the possibility that the eventual tax plan could take longer to pass. This, together with the Federal Open Market Committee (FOMC) statement suggesting that members were less confident about inflation returning to target in the medium term capped the move higher of long-end US Treasury (UST) yields.

- China announced tighter regulations for asset management business and Public-Private Partnerships (PPP)

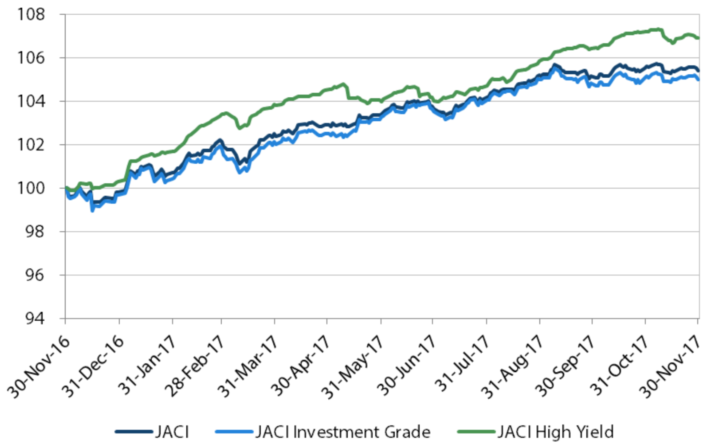
Chinese policymakers stepped up efforts to fend off systemic risks in the country's shadow banking sector, tightening rules on the asset management business. Among other things, the draft regulations require financial institutions to set aside reserves for issuing asset-management products, and restrict the separation of select financial products into different tranches (a common practice that allows funds raised from selling wealth management products to be channelled into stock and bond investments). Similarly, controls on PPP projects were tightened, with regulators announcing that it would review, identify and remove "unqualified" projects from the official PPP registration system. Notably, subway and expressway projects in Inner Mongolia were scrapped suspended amid financing concerns.

- A significant pick-up in primary market activity

Activity in the primary market picked-up significantly in November, with new supply emanating mainly from Chinese issuers. For the month, there were 50 new issues amounting to USD 27.9bn in the high-grade space. Meanwhile, the high-yield space saw 29 new issues amounting to around USD 10.4bn.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 November 2016



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 30 November 2017

Market Outlook

- Direction of UST yields to dictate returns; credit spreads likely range-bound

With the Fed widely expected to hike rates during the December FOMC meeting, economic data and progress of the tax reform deal are likely to drive the direction of UST yields and shape of the UST curve which has flattened considerably. With spreads already at tight levels from a historical basis, the catalysts that could drive spreads appreciably tighter remain elusive, especially if the pipeline of new issuance picks up significantly. However, with the Asian economic growth backdrop still decent and some economies surprising to the upside, significant spread decompression does not appear likely in the near-term.

- Supply of new issues to dampen secondary performance

Focus has been on the heavy new issue supply pipeline across high-grade and high-yield. The pipeline is expected to remain heavy into December which could pressure secondary spreads. In China, with the deleveraging process on-going onshore, rising onshore bond yields and credit spreads could impact sentiment towards offshore USD credits. The heavy issuance from China is also a dampener to spread tightening although China credit spreads do appear to offer better value compared to those from other countries.

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