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ASIAN FIXED INCOME OUTLOOK

July 2018

Summary

- In June, the US Treasury (UST) curve flattened. The US Federal Reserve (Fed)'s 25 basis points (bps) rate hike was accompanied by a more hawkish tone, supporting higher short-term rates. The European Central Bank (ECB) laid out plans to wind down its bond-buying programme by end of the year. Sino-US trade tensions escalated at month-end.

- Overall, 2-year and 10-year yields ended at 2.53% and 2.86% respectively, about 10bps higher and 0.2bps lower compared to end-May.

- As for Asian credit, overall performance was negative as weak market sentiment pushed credit spreads wider. Asian high-grade returned -0.21% and Asian high-yield returned -1.38%.

- Within the region, inflationary pressures printed mostly higher in May. Monetary policies in India, Indonesia and the Philippines raised policy rates, while the People's Bank of China (PBoC) announced a targeted Reserve Requirement Ratio (RRR) cut.

- In China, business activity slowed down in May. There was a moderation in year-on-year growth rates of industrial production, investment and retail sales.

- Meanwhile, the primary market activity moderated in June, particularly within the high-yield space given weak market sentiment. There were 18 new issues worth around USD 8.15bn in the high-grade space, while the high-yield space saw a total of just 10 new issues worth about USD 1.95bn.

- On local currency bonds, we prefer China, Singapore and Malaysia bonds. Chinese policymakers' shift to monetary easing, Singapore's 'safe haven' status vis-à-vis regional peers and the relatively attractive real yields of Malaysian bonds are reasons that support our view.

- On the currency front, we prefer the Malaysian Ringgit (MYR) over the Singapore Dollar (SGD) and Korean Won (KRW). South Korea and Singapore are relatively more vulnerable to supply chain disruptions from further trade friction. Meanwhile, Malaysia's currency account position has been improving, and economic activity remains robust. Higher oil prices are likely to provide additional support to the MYR.

- Asian credit continues to be confronted by a number of issues. Monetary policy tightening, especially in the US, is expected to continue in 2H2018. Trade tensions are also unlikely to abate in the near term.

- In China, tightening onshore liquidity, rising onshore defaults and rising refinancing concerns for smaller issuers have weakened sentiment particularly towards China high-yield issues. Meanwhile, the reduction in new issuance is more reflective of a lacklustre demand than a slower pipeline of issues. All-in yields are also beginning to look more attractive.

Asian Rates and FX

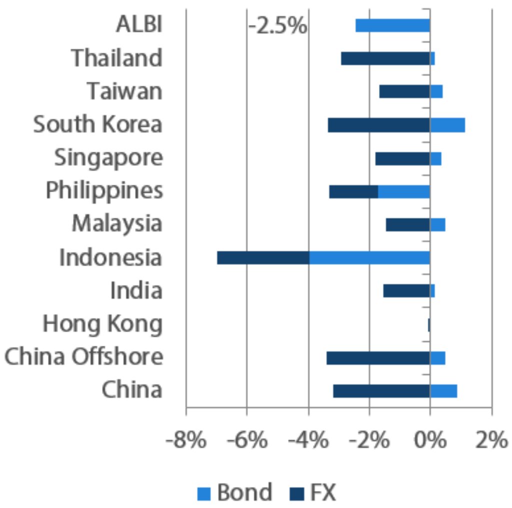
Market Review

The US Fed raised short term interest rates by another 25bps

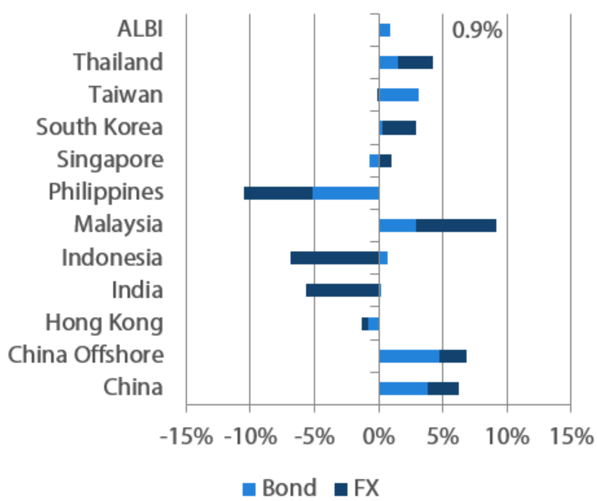
The UST yield curve flattened in June. Yields initially traded higher ahead of policy meetings scheduled for the three major central banks. Mid-month, the US Fed delivered the widely anticipated second 25bps hike for the year. The rate rise was accompanied by a more hawkish tone, supporting higher short-term rates. Over in Europe, although the ECB laid out plans to wind down its bond-buying programme by end of the year, it declared that interest rates will remain unchanged "at least through the summer of 2019." This dovish guidance spurred buying of long-dated bonds. Meanwhile, the Bank of Japan acknowledged that more work is needed to achieve its inflation target. Towards month-end, renewed escalation in Sino-US trade tensions further anchored long-end yields lower. Overall, 2-year and 10-year yields ended at 2.53% and 2.86% respectively, about 10bps higher and 0.2bps lower compared to end-May.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 June 2018



For the year ending 30 June 2018



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 June 2018

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.

Monetary authorities in India, Indonesia and the Philippines raised policy rates

The Reserve Bank of India's Monetary Policy Committee voted unanimously in favour of hiking policy rates by 25bps. However, the central bank refrained from signalling a shift to a tightening cycle, and instead, retained its 'neutral' monetary policy stance. Similarly, the Bangko Sentral ng Pilipinas (BSP) raised its benchmark interest rate by another 25bps in June. This follows a similar quarter-point hike last month. While the monetary authority lowered its headline Consumer Price Index (CPI) forecasts for this year and next, it noted that inflation risks remain titled to the upside. The BSP left the door open for more rate hikes, stating that it stands ready to take further policy actions as needed. Meanwhile, Bank Indonesia (BI) raised its policy rate for the third time in six weeks by a larger than expected 50bps, as it attempts to halt the deepening slide in the rupiah. The central bank also relaxed the loan-to-value ratio for property loans and financing-to-value ratio for property financing – a move it hopes will stimulate the property sector and maintain the momentum of domestic economic recovery and stability of the financial system.

Inflationary pressures print mostly higher in May

Headline CPI inflation in India, the Philippines, Malaysia, Singapore and Thailand all printed higher in May. The acceleration in inflationary pressures in the five countries was prompted in part by higher transport inflation. Notably, Thailand's annual headline inflation rate registered within the central bank's target range for the second straight month. Meanwhile, inflationary pressures in Indonesia and South Korea eased during the same month, prompted by a moderation in food inflation. Elsewhere, headline CPI in China remained unchanged.

Chinese activity data registered weak

Business activity in China slowed in May. There was a moderation in year-on-year growth rates of industrial production, investment and retail sales. The slowdown in industrial production stemmed mainly from the manufacturing sector, while a moderation in sales of construction and decoration materials, and automobile sales prompted the drop in retail sales growth. The continued focus on financial deleveraging also led to a marked contraction in shadow banking activity. Notably, aggregate financing halved in May from April. The disappointing data could have prompted the Chinese central bank to maintain its 7-day OMO reverse repo rate and other quasi policy rates, moving away from its previous practice of following US Fed hikes.

Market Outlook

Prefer China, Singapore and Malaysia bonds

We acknowledge a now-heightened risk of prolonged trade tensions between the US and China. Continued deterioration of trade relations could further sour investor sentiment on riskier assets, and hit global growth. Markets' risk aversion and expectation of slower growth will be supportive of bonds. Within Asian local government bonds, we prefer China, Singapore and Malaysia bonds. Chinese policymakers' shift to monetary easing should be supportive of bond prices. Malaysia bonds offer relatively attractive real yields, and unlike other central banks in the region, Bank Negara Malaysia is expected to stay on the side-lines. Meanwhile, Singapore's 'safe-haven' status vis-à-vis regional peers would benefit Singapore Government Securities in the near-term.

Prefer MYR over SGD and KRW

We expect the US Dollar (USD) rally to continue, amidst lingering global trade tensions and further policy tightening from the US Fed. Within the region, South Korea and Singapore are relatively more vulnerable to supply chain disruptions from further trade friction, given their highly export-dependent economy. Meanwhile, Malaysia's current account position has been improving, and economic activity remains robust. Consequently, we see the ringgit being less vulnerable to a risk aversion this round, with higher oil prices providing additional support.

Asian Credit

Market Review

Asian credit drifted lower in June

Overall Asian credit registered losses in June, as weak market sentiment pushed credit spreads wider. Asian high-grade returned -0.21% and Asian high-yield returned -1.38%. The significant drop in several Emerging Market (EM) currencies jolted investor sentiment toward EM assets, triggering outflows from EM bond funds. For 1H2018, Asia high-grade returned -1.93%, pressured by rising treasury yields and widening credit spreads. Asian high-yield corporates underperformed, returning -4.26% as credit spreads widened by 91bps.

China announced a targeted RRR cut; monetary authorities in Indonesia, India and the Philippines hiked rates

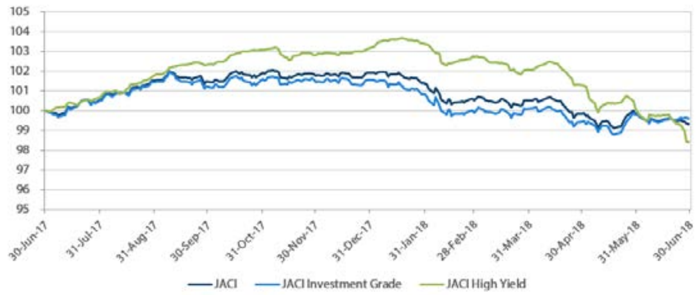
The Chinese central bank announced it will free up funds for targeted banks by reducing the amount of cash they are required to hold in reserve by 50bps. The cut will be effective 5 July, and is expected to unlock about RMB 700bn of liquidity into the system. The move followed a cabinet meeting that announced China's intention to use monetary policy tools to boost credit support to small and micro enterprises, and help reduce the funding cost of the real economy. During the month, the People's Bank of China (PBoC) also set its fixing for the Renminbi (RMB) to the weakest level against the USD since December 2017. The move triggered widespread concern that China may use its currency as a trade retaliation tool against the US. In contrast to the PBoC's easing of monetary policy, central banks in Indonesia, India and the Philippines raised their respective policy rates. Monetary authorities in India and the Philippines hiked rates by 25bps each, whereas Bank Indonesia (BI)'s move was more aggressive, as it lifted rates by 50bps. Notably, BI has now raised its policy rates by a total of 100bps within just six weeks, as it attempts to stabilise the rupiah. For China property issuers, the National Development and Reform Commission (NDRC)'s announcement that offshore bond issuance can only be used for refinancing and not for financing local property projects or working capital also weakened sentiment towards the sector amid rising concerns over refinancing risk as onshore liquidity remains tight.

A moderation in primary market activity

There was a marked moderation in primary supply in June, particularly within the high-yield space given weak market sentiment. Total issuance amounted to about USD 10.1bn. There were 18 new issues worth around USD 8.15bn in the high-grade space, including USD 1.1bn from Huarong Finance and USD 1.5bn issuance from China Construction Bank. Within high-yield, the space saw a total of just 10 new issues, amounting to about USD 1.95bn.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 June 2017



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 30 June 2018

Market Outlook

Asian credit confronted by a number of issues

Entering into 2H2018, monetary policy tightening, especially in the US, looks set to continue. This should remain a headwind for fixed income assets including Asian credit. The ratcheting up of tensions over trade is unlikely to abate in the near term. Asian risk assets including credit are likely to remain under pressure as seen from sharp declines in equities, local currencies and widening credit spreads. Also in China, deleveraging efforts have continued to tighten onshore liquidity with notable declines in shadow banking activities. This coupled with rising onshore defaults and rising refinancing concerns for smaller issuers have weakened sentiment particularly towards China high-yield issues. For a number of other countries, higher oil prices have also fueled concerns about rising current account and fiscal deficits for oil importing countries such as India and Indonesia with their fuel subsidies.

Reduction in new issuance more a function of lacklustre demand, all-in yields beginning to look more attractive

While the supply of new issuances have reduced in the past month, this is more reflective of lacklustre demand than a slower pipeline from issuers. This is likely to continue into July as sentiment remains tepid. While high-grade and high-yield spreads do not look particularly cheap on a historical basis after the widening in 1H2018, all-in yields are now looking more attractive. All-in yields, at 4.71% and 8.30% for high-grade and high-yield corporates respectively, have risen sharply with the rise in UST yields and are now above historical averages seen over the last five years.

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