

ASIAN CREDIT OUTLOOK

2017

Overview

2016 was a year of surprises. The Federal Reserve (Fed) backtracked on its outlook on interest rate hikes, Britain voted to leave the European Union, Donald Trump triumphed over Hillary Clinton to become the 45th US President, and Italian Prime Minister Matteo Renzi resigned after a resounding defeat in the Italian referendum. Commodities rallied on expectations of an acceleration of raw-material demand in China and reflation after Mr. Trump's win. Asian credit spreads tightened against this backdrop, although risk-free rates ended higher vis-à-vis the previous year.

The year opened with a spike in volatility. Concerns over the macro outlook in China and further unconventional monetary policy after the Bank of Japan (BOJ) adopted negative interest rates resulted in a significant widening of credit spreads. This bout of risk-aversion was brief, however, as the European Central Bank (ECB) subsequently announced an upsized quantitative easing (QE) program and the Fed re-priced the path of interest rates lower. Big rallies in global bond markets ensued. As global yields sank lower, capital flowed into Emerging Markets (EM). In June, overall cautiousness pervaded, in anticipation of the UK referendum. Although the knee-jerk reaction to the BREXIT vote was a sell-off in risk assets, sentiment quickly reversed, driven by expectations of further global monetary and fiscal easing. The persistent decline in yields again triggered a massive allocation of funds into EM, including Asia. Indian and Indonesian bonds benefitted immensely from this capital flow, with spread performance reinforced by sustained reform progress in both countries. Leading up to the fourth quarter, Asia credits recorded strong returns. However, on 9 November, Donald Trump's upset win in the US presidential election triggered a myriad of uncertainties. As markets started pricing in upside inflation risk from a Trump administration, risk-free rates surged. Together with the increasing probability of protectionist trade policies by the US going forward and a sharply higher USD, EM witnessed an exodus of funds, erasing a substantial portion of year-to-date (YTD) returns (particularly for Asia investment-grade).

In all, the JACI Composite returned 5.6% YTD. Asian high-grade gained 4.3%, with the spread tightening 27 basis points (bps) from 214bps to 187bps. Asian high-yield delivered 10.8%, with the spread tightening 119 bps from 575bps to 457bps¹.

Economic growth in Asia is expected to remain broadly stable in 2017. While there will be greater external uncertainties as well as country-specific challenges, Asian economies are, on balance, better equipped to deal with external pressures compared to a few years back. Furthermore, structural reforms in China, India, and Indonesia have continued to advance. While monetary easing may be on hold in most countries, the fiscal lever remains available to support domestic demand should the need arise.

The credit profile of Asian investment grade corporate issuers should remain broadly stable as companies have scaled back capital expenditure and mergers & acquisition (M&A) activities. However, high-yield issuers are expected to continue reporting elevated net leverage in 2017, with rising borrowing costs reversing most of the improvement in debt servicing ratio seen in 1H16. The Asia high-yield default rate is likely to worsen a little next year from the extremely low level in 2016, but is expected to remain manageable.

The key downside risks for 2017 include: a faster-than-expected pace of US rate hikes, contagion risks from further weakness in other EMs, worse-than-expected economic slowdown and greater financial system stress in China, and strong protectionist trade policies under the new Trump administration. Returns for Asian high-grade and high-yield are likely to be subdued in 2017, reflecting the challenges for fundamentals, market technicals and current valuation. For Asian high-grade credits, the expectation is that credit spreads will end 2017 at around 211bp or about 25bps wider, bringing spreads closer to the longer-term levels. Bond carry will dominate returns as the expected spread widening from rising UST yields will weigh on total returns. With this, the estimate for the total return for Asian high-grade bonds is around 2%. For Asian high-yield corporates, spreads in sectors with stronger fundamentals, such as Chinese property, are already trading at rich valuations. Asian high-yield spreads could end 2017 50bps wider from the current 465bps. The higher carry from high-yield could mitigate the potential spread widening and rise in risk-free rates. Asian high-yield is expected to return 3.4% in 2017.

¹ J.P.Morgan Asian Credit Indices as at 2 December 2016

Fundamentals

Macro

Economic growth in Asia is expected to remain broadly stable in 2017. However, there will be greater uncertainties emanating from US trade policies under the new Trump administration, risk of capital outflows in a rising US yield environment, as well as country specific challenges.

China – We believe the Chinese authorities will continue to pursue a fine balancing act in managing the economy in 2017. The recent stabilisation of key real activity indicators such as industrial production, retail sales and fixed asset investment provides more space for the authorities to deal with other structural challenges. These include reining in state-owned enterprise (SOE) leverage, reducing overcapacity in select sectors, and containing shadow banking risks. Should the economy weaken during the year, fiscal policy could be used extensively to ensure GDP growth does not drop off too sharply. This is particularly important, considering that the politically significant 19th National Congress of the Communist Party is set to be held in 2H17. Domestic oriented sectors such as consumer and public infrastructure should fare relatively better next year given the uncertainty of trade relations with the US under the new Trump administration. While we expect the Chinese authorities to succeed in managing the economy broadly, there will inevitably be periods of volatility in the year ahead, particularly in the financial sector. Key risk drivers that we are watching closely include capital outflows, the rise in onshore bond yields, increase in bank's non-performing loans (NPLs), and a slowdown in the property sector.

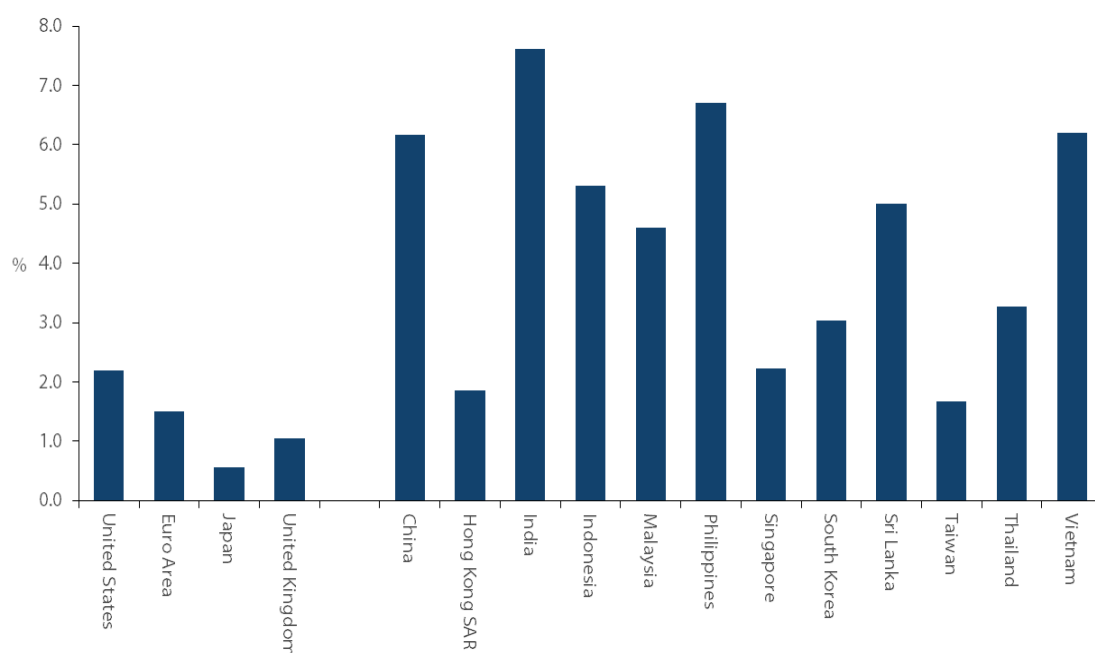
India – The one-off demonetisation policy implemented by the Indian authorities towards the end of 2016 put a speed-bump on what has been a highly successful economic reform story within EMs. While real activity is likely to dampen in the near-term, the medium-term outlook for the Indian economy continues to brighten following a slew of meaningful reform measures that have been passed or implemented in recent years. These measures include the new Goods & Services Tax (GST) bill, bankruptcy law, and the relaxation of restrictions on foreign direct investments (FDIs). The demonetisation measure itself will also reap long-term benefits of reducing tax revenue slippage and increasing fiscal capacity, and the current economic impact is expected to be transitory. Moreover, with inflation remaining subdued, there is room for monetary easing to support the economy near-term. India's economy is also not particularly dependent on net exports. It has a negligible trade surplus against the US, making it less vulnerable to the threat of rising protectionism in the US. Nonetheless, the risk of foreign capital outflows from India's bond and equity markets amidst rising US interest rates and a strengthening USD will be present, but manageable, in our view.

Indonesia – The Indonesian economy is expected to chart a steady path in 2017. The injection of renewed momentum into the reform drive towards the end of 2015 has continued in 2016, highlighted by the appointment of a highly regarded Finance Minister, Sri Mulyani Indrawati. While the pressure to raise fiscal spending will persist in 2017, the new Finance Minister is expected to maintain fiscal discipline and restore much needed credibility to the budgeting process. The improvement in terms of trade, especially in palm oil, rubber and coal should provide some lift to domestic demand, which has been lagging. The pick-up in commodity exports should also help to contain the current account deficit. While Indonesia is a more open economy compared with India, its share of exports to the US is small, and it also runs a negligible trade surplus against the US. The Indonesian sovereign remains a rating upgrade potential. On the negative side, Indonesian local currency and hard currency bonds have been a consensus overweight among EM investors throughout 2016. Hence, any broad-based capital flight from EM will have spill-over impact on Indonesian assets.

Others – In South-East Asia, we expect the Malaysian and Thai economy to remain broadly stable, with the Oil & Gas (O&G) sector benefiting from the lift in crude oil prices. However, politics could be a risk driver, with a general election in Malaysia next year and the political dynamics between the new monarch, the military-led government, and civilian political parties that bear monitoring in Thailand. Politics is also the overriding concern for the Philippines, even as the economy continues to do well. On the other hand, the more open and developed economies of Asia, including South Korea, Hong Kong and Singapore, are likely to face pressures on the external side, if the more protectionist scenarios of US trade policies were to materialise. Amongst the three, South Korea does seem more vulnerable given the concurrence of a top-level political scandal and well-documented difficulties in the shipping, ship-building and construction/heavy machinery sectors. Nevertheless, these countries do have considerable fiscal buffers to support the economy should the need arise.

Asia's positive sovereign rating trajectory is likely to stall in 2017 as the economies have to contend with external and domestic challenges as well as political uncertainties. Following multiple upgrades in recent years, the sovereign ratings of South Korea and the Philippines are likely to stabilise at present levels, and indeed, there is a risk of a negative outlook for both if less benign economic and political outcomes were to materialise. Indonesia remains the only bright spot, with S&P keeping a Positive Outlook on the sovereign's BB+ rating since May 2015, while Fitch went a step further and revised Indonesia's BBB- sovereign rating outlook to Positive in December 2016.

Chart 1: IMF GDP Growth Forecast



Source: IMF Work Economic Outlook, as at October 2016

Table 1: IMF GDP Growth Forecast for 2016, 2017 and 2021

	2016F %	2017F %	2021F %
United States	1.6	2.2	1.6
Euro Area	1.7	1.5	1.5
Japan	0.5	0.6	0.6
United Kingdom	1.8	1.1	1.9
China	6.6	6.2	5.8
Hong Kong SAR	1.4	1.9	2.9
India	7.6	7.6	8.1
Indonesia	4.9	5.3	6.0
Malaysia	4.3	4.6	5.0
Philippines	6.4	6.7	7.0
Singapore	1.7	2.2	2.6
South Korea	2.7	3.0	3.0
Sri Lanka	5.0	5.0	5.0
Taiwan Province of China	1.0	1.7	2.7
Thailand	3.2	3.3	3.0
Vietnam	6.1	6.2	6.2

Source: IMF Work Economic Outlook, as at October 2016

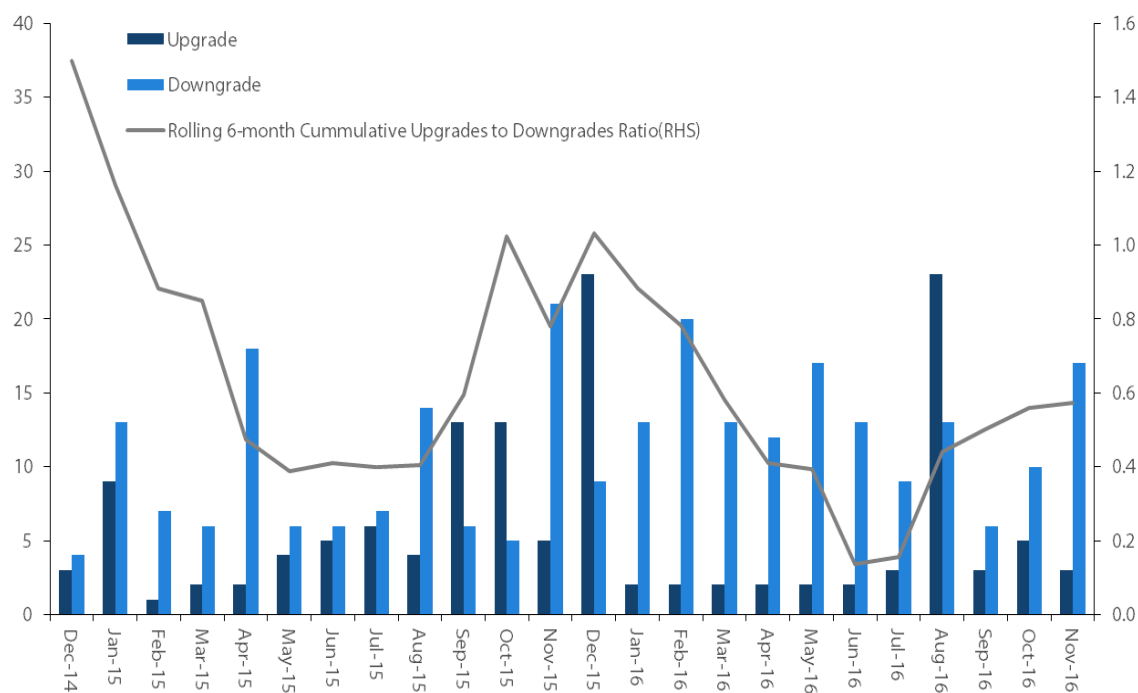
Credit

On the whole, there were more rating downgrades than upgrades for Asian issuers in 2016. However, this masked a divergence in rating trajectories between Asian investment grade and high-yield issuers, which has persisted over the past few years. Asian investment grade continues to see slightly more upgrades than downgrades, with sovereign upgrades benefitting government-related issuers, especially from South Korea. In contrast, rating downgrades have continued to overwhelm upgrades in the Asian high-yield space, with the real estate, metals & mining, and O&G sectors all facing intense pressure earlier this year.

We expect to see this divergence in rating trajectories between Asian investment grade and high-yield to carry on in 2017, albeit to a lesser extent than in 2016. Asian high-yield issuers are expected to continue reporting elevated net leverage in 2017, with rising borrowing costs reversing most of the improvement in debt servicing ratio seen in 1H16. While key commodity prices have rebounded, their sustainability remains in question. In the China high-yield real estate sector, while record contracted sales in 2016 should filter through to earnings and cash flows in 2017, the willingness of issuers to deleverage instead of pursuing aggressive land-banking and inorganic growth remains a concern. That said, a lot of the expected weakness has already been incorporated in the current ratings of Asian high-yield issuers, so we would expect a lower net rating downgrade ratio in 2017. On the other hand, the wave of sovereign-related rating upgrades in the Asian investment grade space is not likely to be repeated in 2017. At the same time, the operating environment will become more challenging, particularly for property companies in Hong Kong and banks across Asia. Although these issuers are backed by strong financial buffers, the balance of risk is downside. Hence, we expect a broadly stable rating upgrade/downgrade ratio for Asian investment grade in 2017. One key uncertainty is the degree of implied sovereign support that is incorporated into the ratings of government-related issuers in China. Any change in the notching applied by major rating agencies could have substantial impact on the final ratings within the China investment grade space.

After a small spike in 2015, the Asian high-yield default rate has climbed down to just 0.9% in 2016, highlighting the resilience of high-yield issuers from this region. The Asian high-yield default rate is likely to worsen marginally in 2017 from this extremely low level, but remains manageable at around 2.0%² in 2017. This is due to low maturities for high-yield next year, coupled with adequate liquidity following heavy pre-funding done this year.

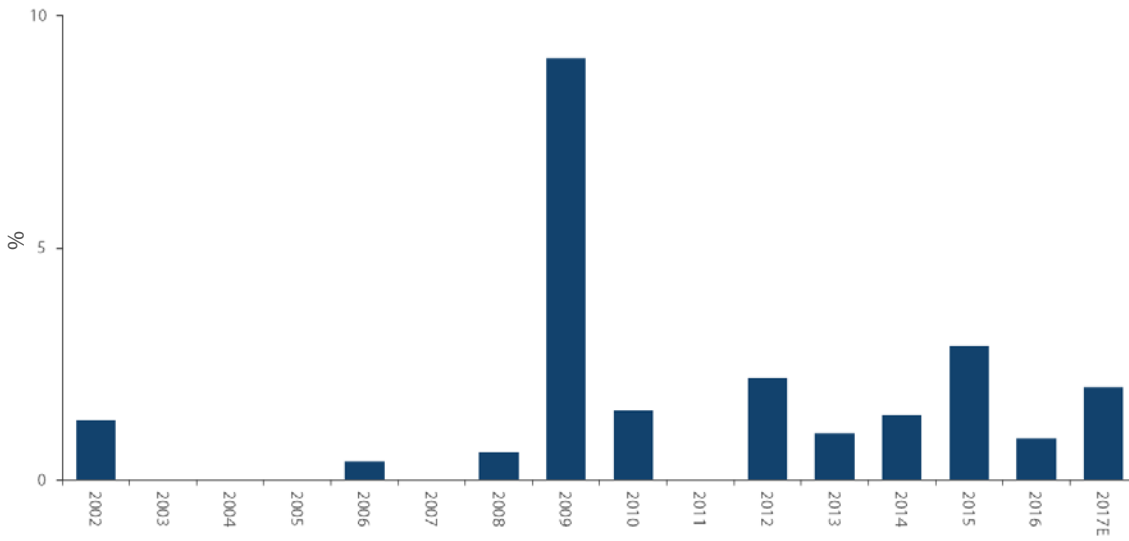
Chart 2: Asia Credit – Upgrades versus Downgrades



Source: J.P. Morgan Asia Credit Analytics, as at 2 December 2016

² J.P. Morgan, Asia Credit Outlook and Strategy for 2017, as at 2 December 2016

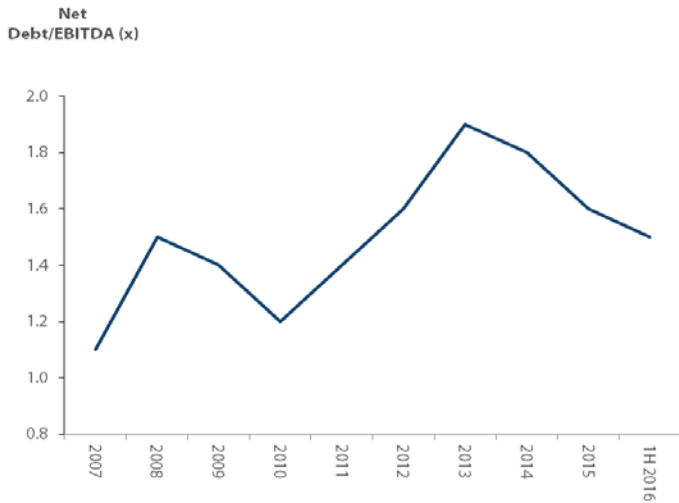
Chart 3: Asia High-Yield Default Rate



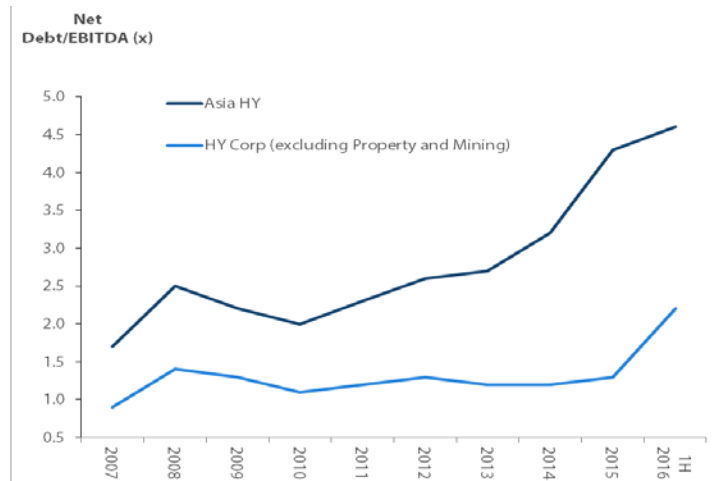
Source: J.P. Morgan Asia Credit Outlook and Strategy for 2017, as at 5 December 2016

Chart 4: Asian Corporate Metrics Trend

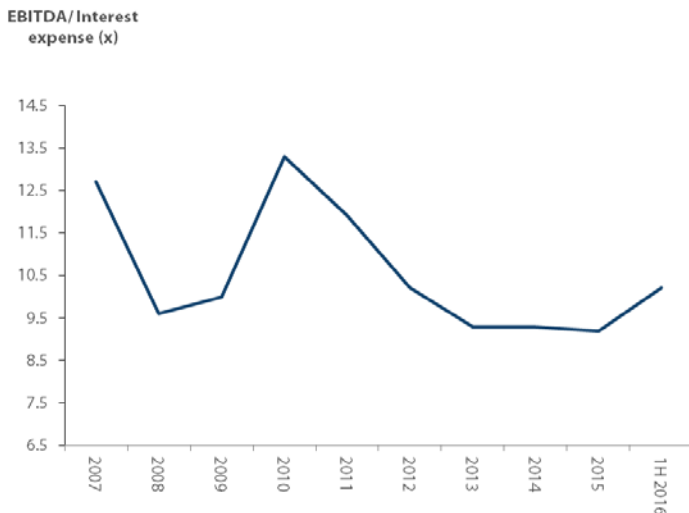
Asian IG – Net leverage has improved slightly



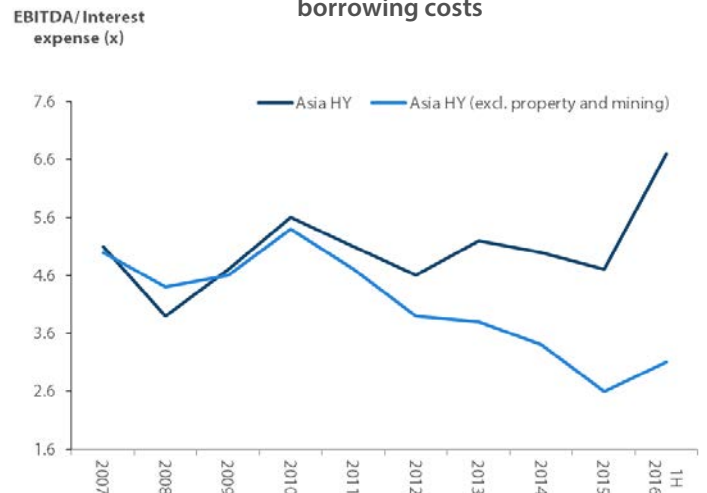
Asia HY – Leverage has deteriorated, led by property and mining



Asian IG – Debt service ratio has improved



Asia HY – Debt service ratio has improved, due to low borrowing costs



Source: J.P. Morgan Asia Credit Outlook and Strategy for 2017, 5 December 2016

Valuations

Asian high-grade and high-yield credit spreads tightened in 2016. High-grade tightened by 29bps to 186bps. High-yield corporate spreads tightened by around 121bps to 464bps. Both high-grade and high-yield spreads are currently below their historical post Global Financial Crisis (GFC) mean levels. However from a historical spread history perspective, spreads are at relatively expensive levels.

Chart 5: Asian High-Grade Spread



Source: J.P. Morgan, Bloomberg, as at 9 December 2016

Chart 6: Asian High-Yield Corporate Spread



Source: J.P. Morgan, Bloomberg, as at 9 December 2016

The relative value between Asian high-grade³ versus high-yield corporate spreads suggests a tilt towards high-grade as the spread ratio of 2.45⁴ is below the approximate mean of 2.66. From a valuation perspective, high-grade is preferred going into 2017. However, as risk-free rates are expected to continue rising, total returns from high-yield with shorter overall duration may still outperform high-grade on a total return basis.

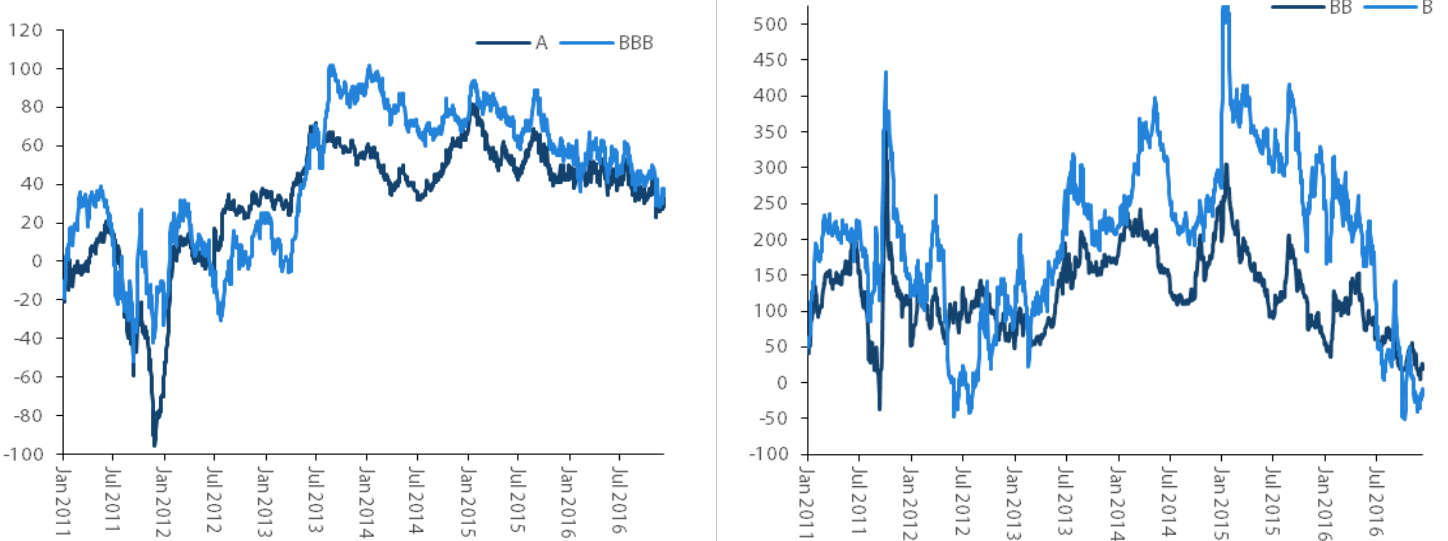
Chart 7: Ratio of Asian High-Yield Corporate to High-Grade Spread



Source: J.P. Morgan, Bloomberg, as at 9 December 2016

In 2016, Asian credit spreads tightened against European comparables. The spread differential between Asian and European A- and BBB-rated corporates tightened by 22bp to 28bp and by 27bp to 34bp respectively. Asian high-yield outperformed by a larger margin in 2016, with the spread differential between Asian and European credits for BB- and B-rated corporates narrowing by 38bps to 19bps and by 262bps to -8bp respectively. The current premium offered by Asian credits is modest for high-grade but on the expensive side for high-yield.

Chart 8: Credit Spreads – Asia versus Europe



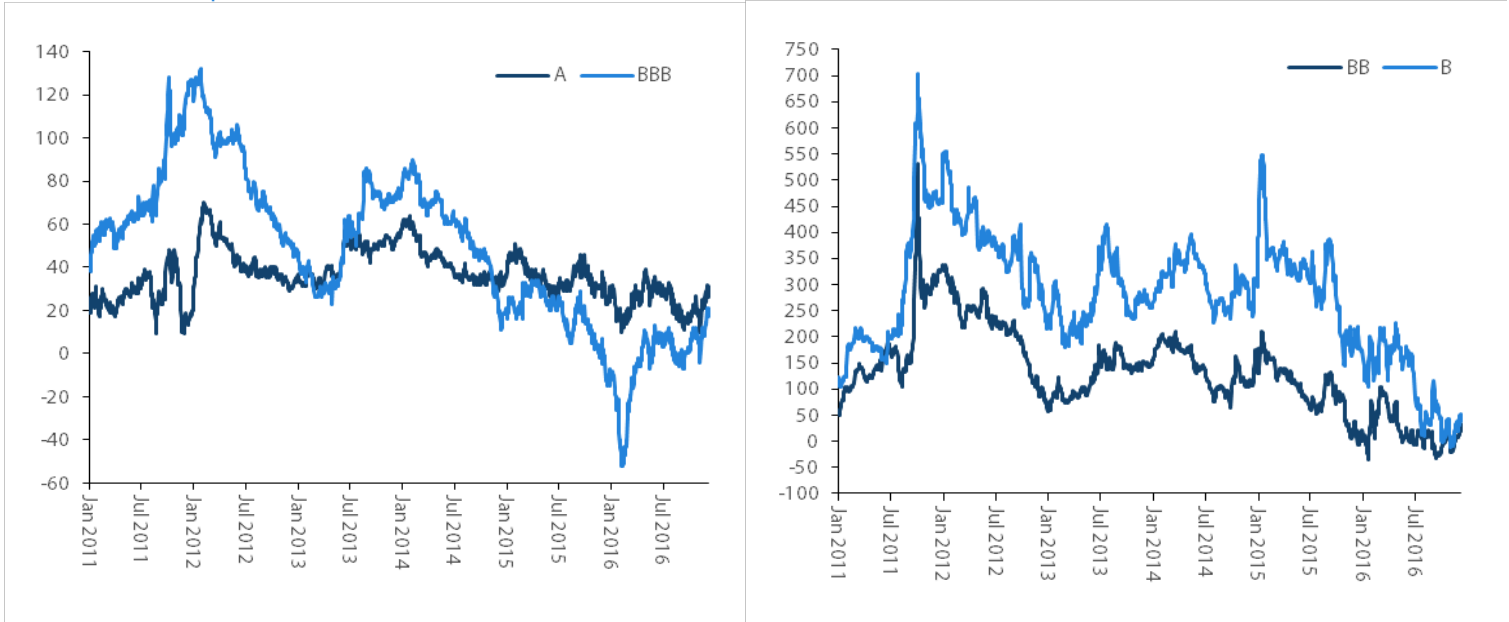
Source: BofA Merrill Lynch Bond Indices, Bloomberg, as at 9 December 2016

³ Refers to the broad JACI high-grade universe

⁴ As at 9 December 2016

Against US credits, Asian credit was mixed. The spread differential between Asian and US A-rated corporates tightened by 5bp to 26bp and BBB-rated corporates widened by 24bp to 17bp. Asian high-yield was also mixed with single-B outperforming. The spread differential between Asian and US BB-rated corporate widened by 11bp to 33bp and B-rated corporates tightened by 123bp to 53bp. From a historical perspective, the relative value offered by Asian credit compared to US credit, especially for high-yield, is not compelling.

Chart 9: Credit Spreads – Asia versus US



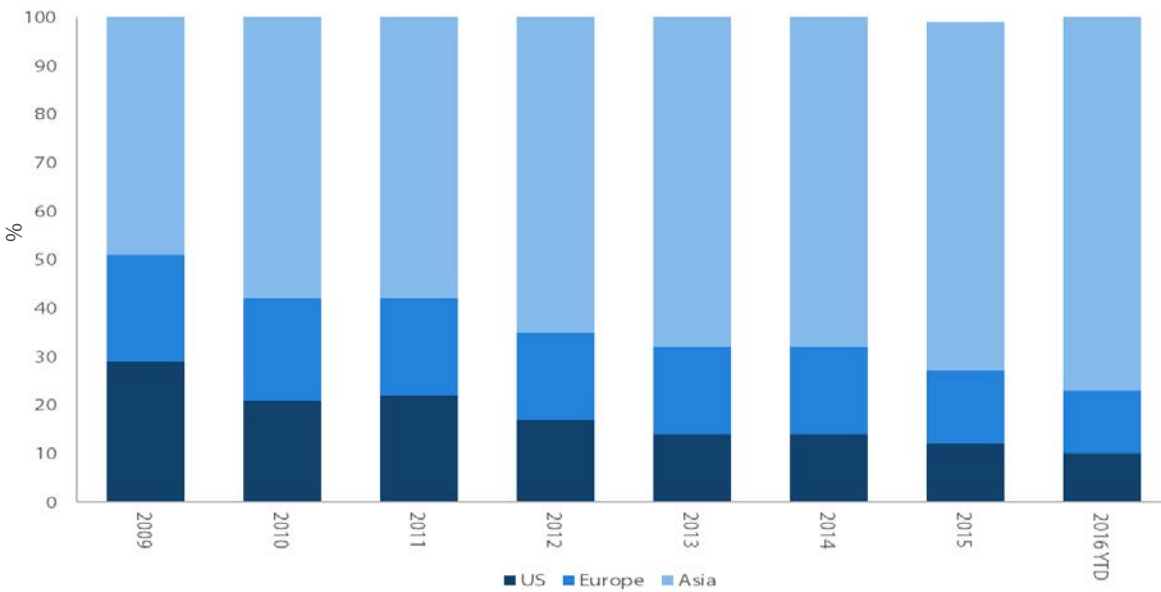
Source: BofA Merrill Lynch Bond Indices, Bloomberg, as at 9 December 2016

Technicals

The technical backdrop for Asia credit is likely to remain neutral. On the demand side, EM fund inflows were positive for most of the year, but reversed after the US election results. These external flows will remain vulnerable to continued concerns over monetary policy direction by major global central banks and macro concerns in the broader EM region, including Asia, in face of higher US interest rates.

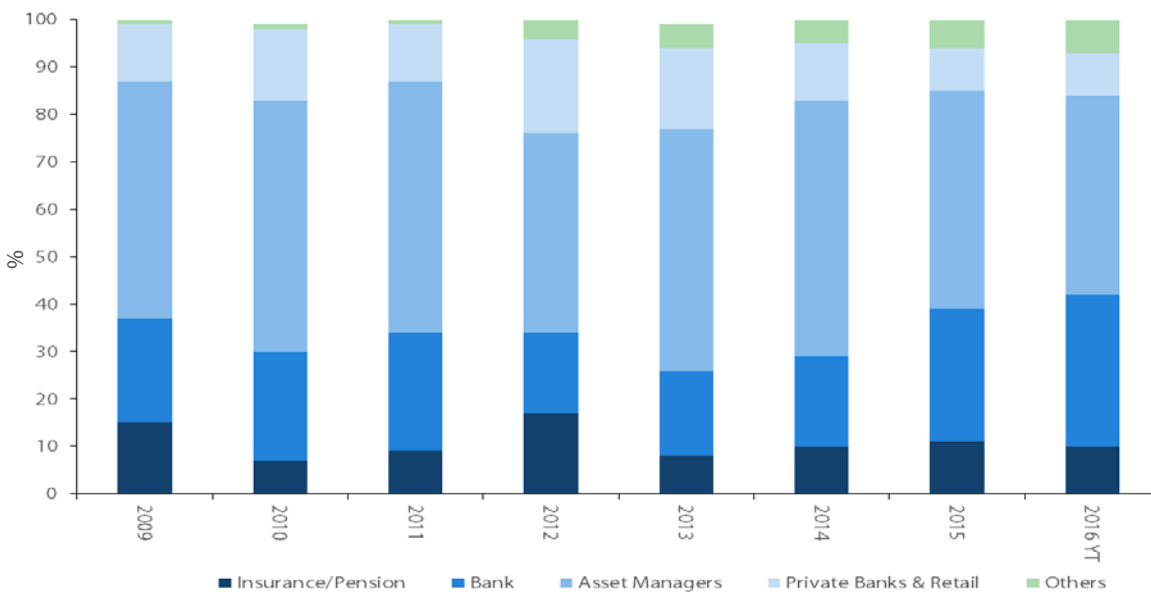
On the other hand, indigenous demand for Asia credit has helped to offset the impact of these external outflows. This is observed from the primary allocation by geography. As shown in Charts 11 and 12, the reliance on foreign sponsorship for new issues has continued to decline to around 23% and this trend is likely to persist into 2017. With the CNY on a weakening trend, the demand for USD Chinese credit from China based investors should remain intact into 2017, barring abrupt moves in onshore rates, credit spreads and CNY.

Chart 10: Primary allocation according to geography



Source: J.P. Morgan Asia Credit Outlook and Strategy for 2017, as at 5 December 2016

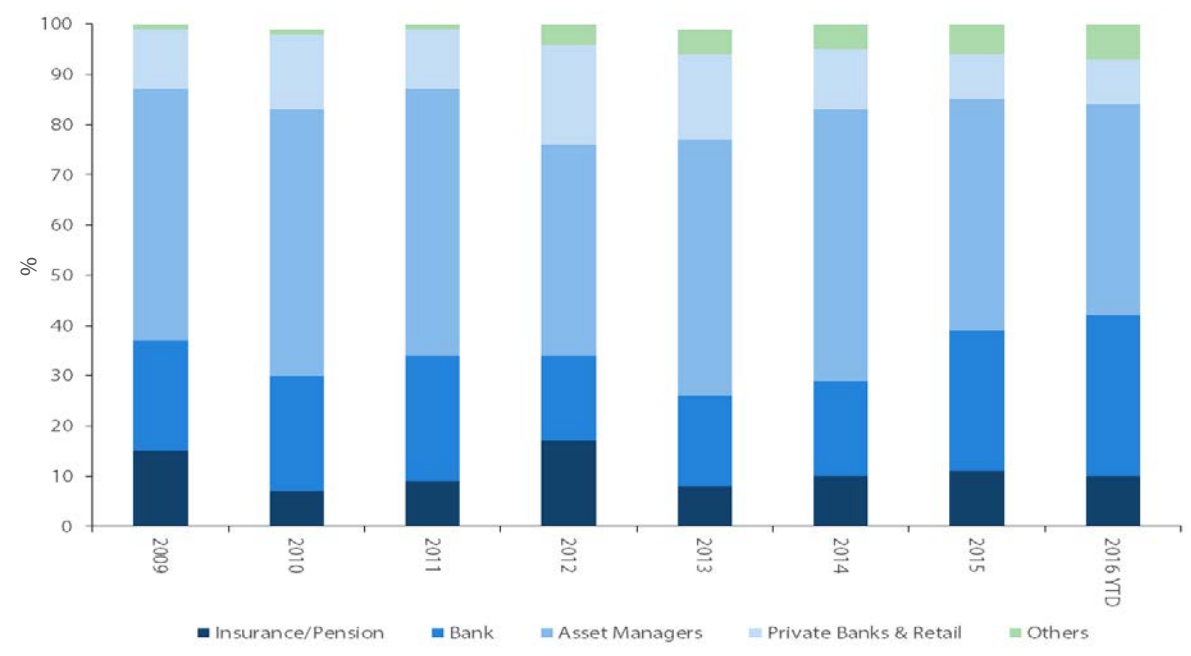
Chart 11: Asian Investor Base



Source: J.P. Morgan Asia Credit Outlook and Strategy for 2017, as at 5 December 2016

In 2016, gross supply was approximately USD 162bn, which was slightly higher than in 2015. For 2017, gross supply is likely to be higher given sizeable refinancing requirements. After factoring USD 156bn of maturities and coupon received, net supply is expected to come in at USD 44bn. While this is likely to be manageable, the number is lower than the approximately USD70bn over the past 2 years⁵.

Chart 12: USD Asian Credit - Issuance by Sector



Source: BofA Merrill Lynch Global Research, Asia Credit 2017 Year Ahead, as at 23 November 2016

Return Expectations

Returns for Asian high-grade and high-yield are likely to be subdued in 2017 on the back of the likelihood of a less accommodative US monetary policy, potential outflows from EM and current valuation. For Asian high-grade credits, the expectation is that credit spreads will end 2017 at around 211bp or about 25bps wider, bringing spreads closer to the longer-term levels. Bond carry will dominate returns as the expected spread widening with rising UST yields is expected to weigh on total returns. With this, the estimated total return for Asian high-grade bonds is around 2%.

For Asian high-yield corporates, spreads in sectors with stronger fundamentals, such as Chinese property, are already trading at rich valuations. Asian high-yield spreads could end 2017 50bps wider from the current 465bps and the higher carry from high-yield should be able to mitigate the potential spread widening and rise in risk-free rates. Asian high-yield is expected to return 3.4% in 2017.

Risks

The key risk factors that would drive Asia credit returns in 2017 are:

Rising risk-free rates – Asian credit will continue to face headwinds from rising treasury yields as the Fed continues to hike rates. A concern is that the pace of rate hikes, which is still expected to be gradual, could accelerate if economic growth, labour market and inflation outlook in US improve sharply in response to President Trump's reflationary policies.

Contagion from EM weakness – Rising UST yields and a strengthening USD could precipitate outflows from EM funds, and would have a negative spill-over impact on Asian credit technicals, even if Asian fundamentals are more compelling compared to other EM regions.

⁵ Source: J.P. Morgan Asia Credit Outlook and Strategy for 2017, as at 5 December 2016

Growth slow-down in China – While not our base case, a greater-than-expected slowdown in Chinese GDP growth could tighten China credit spreads across sectors. In addition, even with real activity remaining broadly stable as we anticipate, there are key risk drivers that need to be watched closely for tactical positioning, including the pace of capital outflows, the rise in onshore bond yields, increase in bank's NPLs, and slowdown in the property sector.

Protectionist US trade policies – President-elect Trump's protectionist rhetoric is well-documented, even though the actual trade policies under his new administration remain unclear for now. Under a worst-case scenario, open economies in Asia with high exposure to the US, particularly those with high trade surpluses with the country, could be at risk. These countries include China, Hong Kong, South Korea and Vietnam.

Strategy

In 2017, the focus will remain on relative value positioning across countries and sectors. We will begin with a lower than benchmark duration positioning. Risk-free rates will rise as the Fed continues to hike interest rates. Short-dated issues could underperform as bear flattening could lead to an under-weight stance in short-dated ultra high-grade issues e.g. AA- or higher rated issues. In addition, we over-weight IG credits in the 4-to-10 year tenor given the still steep credit curve in a number of sectors. For HY, short-dated callable issues remain attractive on a total return basis especially their lower sensitivity to rising rates.

Within high-grade, we will continue to underweight the very highly rated issues, i.e. those in the AAA or AA category from Korea and Singapore, given tight valuations but with the exception of China related issues. Preference is for credits in low single A to the BBB category that still offer some room for spread compression.

A summary of our assessment of the various market segments is provided in Table 2 below. A more detailed presentation of our views on the different sectors starts on page 13.

Table 2: Market Call Summary

Sector	Call	Rationale
Sovereigns and Quasi-sovereigns		
Sovereigns	Underweight to Marketweight	Neutral positioning in Indonesian sovereigns. While there is renewed momentum in the reform progress and growth outlook is decent, valuation is less attractive after the spread tightening in 2016. Philippine sovereign issues continue to trade at tight spread levels.
Quasi-sovereigns	Underweight to Marketweight	Low-beta Korean quasi-sovereigns remain at historically tight levels. For Indonesia, valuation of quasi-sovereign bonds looks rich versus sovereign bonds, especially shorter-dated issues. For the China quasi-sovereigns, there is still decent pick-up compared to Korean comparables.
Investment Grade Corporates		
Infrastructure	Overweight to Marketweight	Chinese infrastructure sector will continue to benefit from central fiscal policy while insulated from external sector concerns. Well-structured corporate perpetual issues are attractive in this sector.
Oil & Gas	Underweight to Marketweight	Rebound in crude oil prices have largely been priced in. We are overweight the Chinese O&G majors, but underweight the sector in India, Thailand as well as ancillary service providers from China.
Real estate	Marketweight	While facing a more challenging operating environment, the strong financial buffers and bond technicals should shelter the Hong Kong property credits. We are slightly underweight the sector in China.
Technology, Media & Telecoms (TMT)	Underweight to Marketweight	Telecoms sector across Asia is facing rising competitive pressures from new entrants and new technology. Credit selection is paramount.
Utilities	Underweight to Marketweight	While this sector is likely to be defensive, valuations across the higher-rated issues from Korea and Hong Kong are expensive. We are slightly overweight the sector in India.
Financials		
Senior	Underweight	Despite a manageable fundamental backdrop, underweight bank seniors due to tight valuations. Avoid India public sector banks due to weak fundamentals.

Sector	Call	Rationale
Subordinated bank capital securities	Overweight	Overweight bank subordinated securities due to attractive spread pickup over senior debt. Opportunities are present in Singapore Basel III Tier 2 debt due to resilient fundamentals and in short-dated callable bonds that are assessed to have high call probabilities.
Non-Bank Financial Institutions (NBFIs)	Marketweight	NBFIs continue to offer decent carry returns on a total return basis compared with senior bank debt. Opportunities lie in leasing companies given their more resilient asset quality, supported by a fully collateralised lending model. AMC's and insurance companies are more sensitive to capital markets volatility and could look attractive at wider levels.
High-Yield Corporates		
China Property	Marketweight	While the property sector in China is likely to moderate from its cyclical peak in 2016, most Chinese high-yield properties still maintain a decent liquidity buffer. Given the current tight valuation and expected increase in new issuance, we overweight the short callables and underweight the long.
Industrials	Underweight to Marketweight	Overall industrial profit has been recovering along with orders and prices. In addition, fiscal stimulus by governments will drive infrastructure demand. However, certain credits still have higher leveraged balance sheets. We like the heavy machinery, gaming sector but are cautious on exporters.
Resources	Underweight to Marketweight	Despite the rise in oil price, we are cautious on oil services companies as most are heavily indebted. On the other hand, we are neutral on metals given the expectation of supportive government fiscal policies.

Any references to particular securities are for illustrative purposes only and are as at the date of publication of this material. This is not a recommendation in relation to any named securities and no warranty or guarantee is provided.

Sectorial Views

Financials – Cautious on bank senior bonds, Constructive on bank subordinated – In the middle of a moderate and manageable weakening asset quality cycle for Asian banks

Fundamentals

Overall, the fundamental backdrop for Asian banks is moderately weak and is a reflection of the fragile macroeconomic environment. However, we believe that this will be manageable for banks, given that sufficient existing capital buffers and loan loss provisions are in place. Banks are also responding by slowing loan growth and restraining their risk appetite, and these steps are likely to help preserve capital ratios.

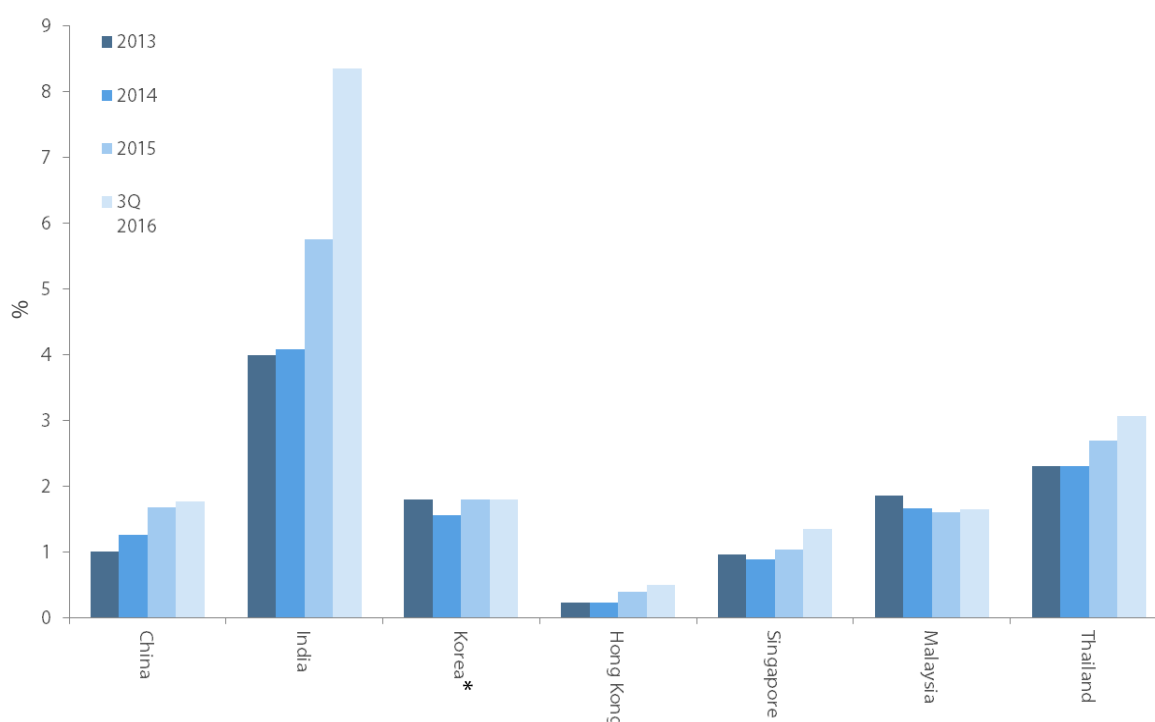
Asset Quality

In 2016, NPL ratios increased in almost all Asian banking systems. The increases were gradual in most systems except for India, which saw large spikes as banks recognised stressed accounts following the Asset Quality Review by the RBI. In 2017, we expect the gradual weakening of asset quality across most banking systems to continue, led by the commodity and industrial sectors which have been hard hit by low commodity prices and slowing growth in China.

In India, we expect that NPL ratios will stabilise around current levels as many stressed accounts have already been recognised by banks. Credit costs will likely remain elevated, however, as banks currently have weak provision coverage.

In China, we expect asset quality to continue weakening and NPL ratios to rise, albeit at a measured pace. Although the country is witnessing a slowdown in growth and a highly leveraged corporate sector, banks have been actively working to restructure debt for borrowers and maintain a high rate of NPL sales and disposals. The rally in many commodity prices has also given relief to many mining and steel companies previously under stress.

Chart 13: Non-Performing Loan Ratios



Sources: Bloomberg, Nikko AM Asia, PBOC, South Korea Financial Supervisory Service, HKMA, Bank Negara, Bank of Thailand, as at 15 December 2016

*Korea latest data as at 2Q 2016

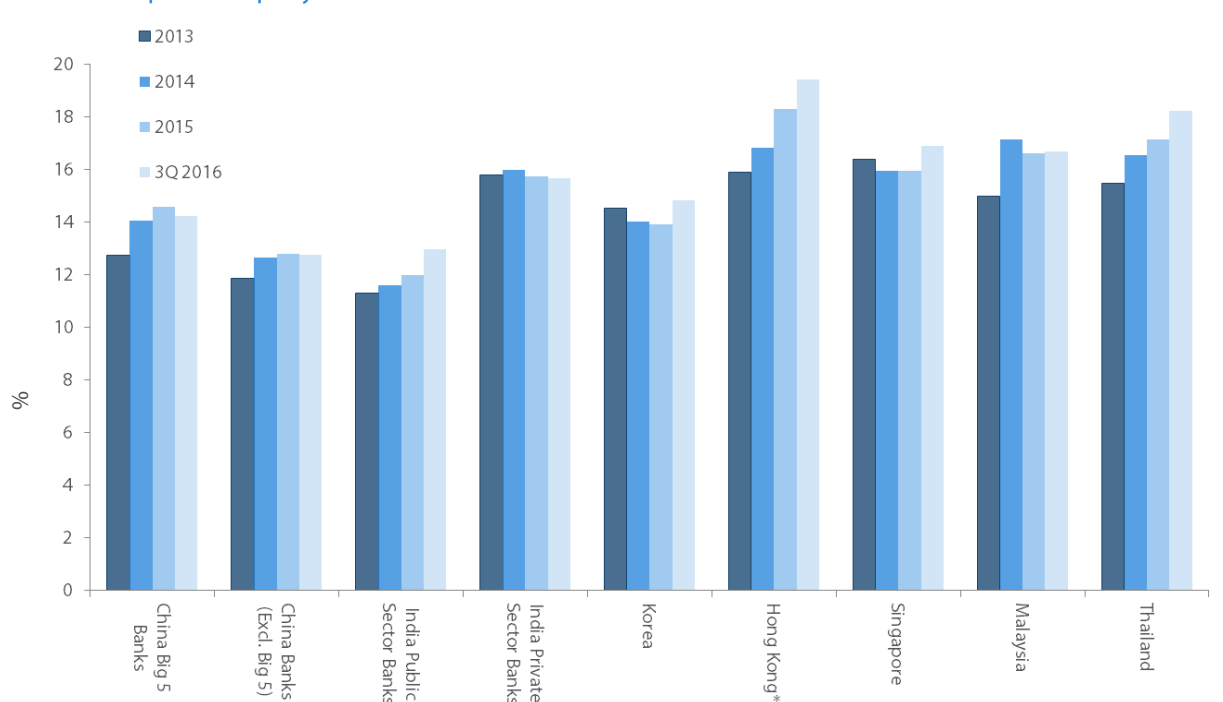
Capital Adequacy

Banks in Asia are generally well capitalised with Capital Adequacy Ratios of most of them above 14%. While weak profitability and asset quality has acted as a drag on capital ratios, this has been more than offset by banks' slowing loan growth and restrained risk appetite. India government banks and China mid-tier banks, however, are inadequately capitalised, and we see the credit profiles of these banks being especially at risk in an economic downturn.

India government banks have seen some capital improvement this year, thanks to large injections from the government budget and a relaxation of some Reserve Bank of India (RBI) regulations. Most banks however still remain very poorly capitalised, with thin buffers above Basel III requirements. In addition, the planned government injections for the next two years are substantially lower than in 2015 and 2016 as the government aims to reduce its fiscal deficits.

China mid-tier banks have continued expanding assets aggressively this year, and this has limited their capitalisation. On the other hand, Chinese financial regulators have implemented various measures to enforce banks' risk management, and this should help improve banking system stability in the long run.

Chart 14: Capital Adequacy Ratios



Sources: Bloomberg, Nikko AM Asia, PBOC, South Korea Financial Supervisory Service, HKMA, Bank Negara, Bank of Thailand, as at 15 December 2016

*Hong Kong latest data as at 2Q 2016

Liquidity

Asian banks are in a strong liquidity position as a result of a large reliance on deposit funding and sufficient liquid assets to cover market funding. With loan growth remaining low, banks should be able to maintain their current liquidity profile and are unlikely to face difficulty meeting Basel III liquidity requirements.

Profitability

Profitability is expected to remain weak for the Asian banks, primarily as credit costs stay elevated in line with the weakening asset quality cycle. On a positive note, we expect net interest margins to improve from current low levels, led by banks in Hong Kong and Singapore where interest rates are closely tied to the Fed decisions.

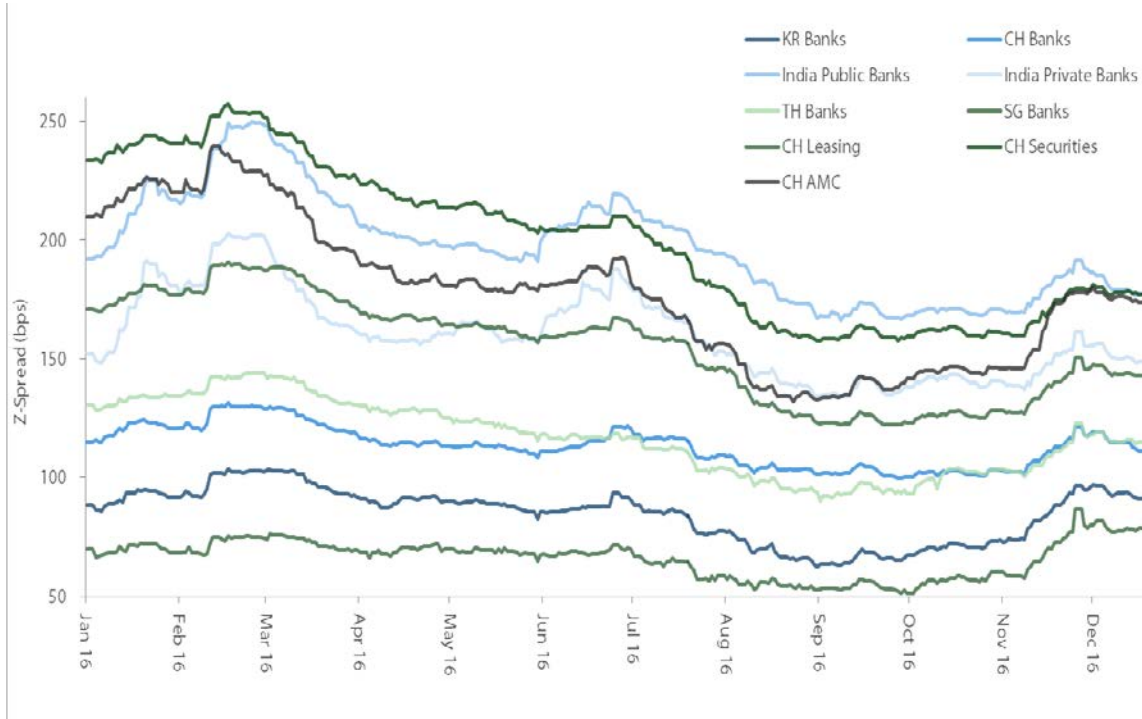
Government Support

Government support in a stress scenario remains very likely for most large Asian banks in order to maintain public confidence and systemic stability. Operational resolution regimes have yet to be adopted, although Hong Kong is moving towards introducing one in the near future, with Singapore following thereafter.

Valuations

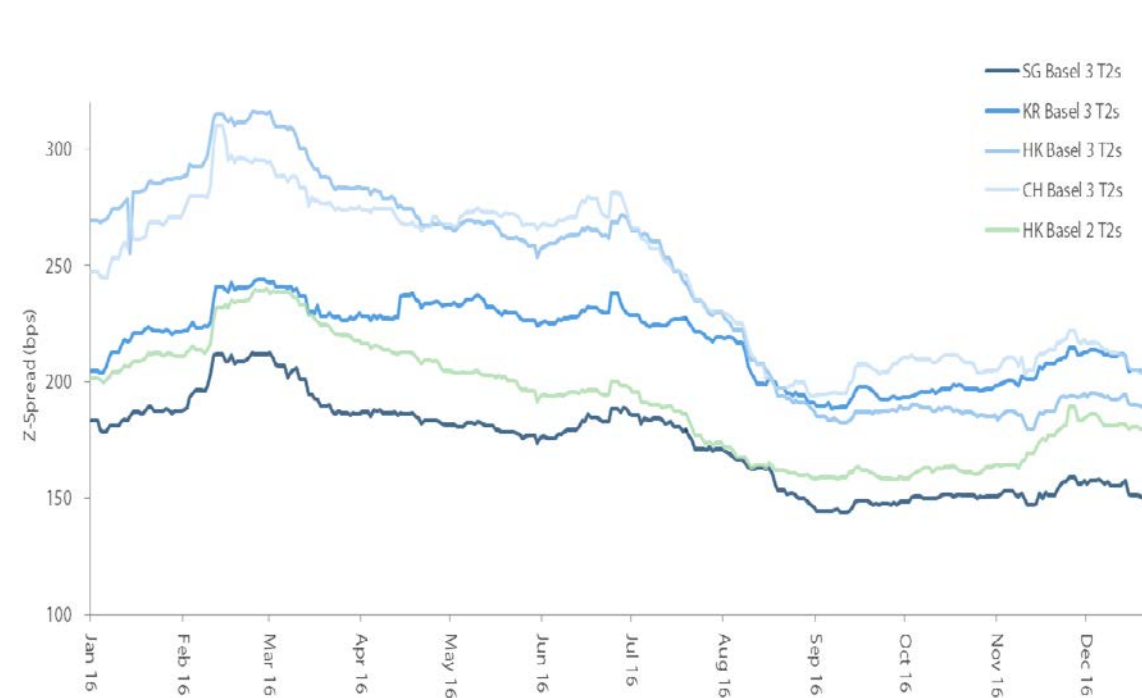
Financials have underperformed the broader JACI index by 39bps, tightening by 21bps YTD. This compares to 34bps of widening and 49bps of tightening in 2015 and 2014 respectively. Spreads started the year volatile, widening 45bps in mid-February to the YTD high of Z+227bps, before tightening substantially to Z+149bps in August. Since then, spreads have gradually widened to Z+161bps.

Chart 15: Five-Year Bank and NBF1 Senior Bonds



Source: Bloomberg, Nikko AM Asia as at 21 December 2016

Chart 16: Non-Bank Financial Institution and Bank Tier-2 Bonds



Source: Bloomberg, Nikko AM Asia as at 21 December 2016

Senior Papers

- Overall, bank seniors have underperformed in 2016 as spreads did not rally as much as that of subordinated debt and non-bank financial institutions.
- Even Indian public sector bank seniors and Thailand bank seniors, the best performers within this category, both tightened just 16bps YTD, underperforming the broader Financials and JACI indexes. We see this tightening as being driven primarily by limited new issuance, and see little value in current spread levels. In addition, we remain concerned over weak fundamentals of the Indian public sector banks.
- Korea bank seniors were 2016's worst performers as spreads widened 3bps. We believe the underperformance can be attributed to tight spreads at the start of the year, as well as the political scandal surrounding President Park.

Subordinated Debt

- Hong Kong Basel III Tier 2 instruments were the top performers among Asian financials in 2016, with spreads contracting by an average of 80bps YTD. This was driven in large part by the compression of Point of non-viability (PONV) premiums from 69bps at the start of the year to 12bps currently, following the passing of the Financial Institutions (Resolution) Ordinance that effectively reduced the differentiation between new Basel III Tier 2 instruments and their legacy Basel II counterparts.
- Korean Tier 2 debt instruments were the biggest underperformer in the subordinated debt space for the second year running, with spreads tightening an average of 1bps YTD. Like their senior paper counterparts, we believe the underperformance is due to tight starting spreads and the political headlines this year.
- Currently, we see opportunities in short-dated callable bonds across Singapore, Hong Kong, China, and Thailand. We believe many of these bonds have high call probabilities, and still provide attractive spread pickups over senior debt.

Non-Bank Financial Institutions

- China Asset Management Companies (AMCs) were the best performers among Non-Bank Financials in 2016 which tightened on average approximately 32bps YTD. The 10 year bonds started the year at 278bps and tightened to a mid-low range of 200bps. The leasing companies also tightened close to 25bps and stabilised around 185bps.
- We continue to view each of the four asset management companies as systemically important and a key tool in policymakers' efforts to manage rising NPLs in the financial system.
- We expect China's leasing industry to be stable and growth to remain strong as a result of its diversification of funding sources to support this expansion. Moreover, we take comfort that most of these bank affiliated leasing companies enjoy very strong parental support, which hold strategically important roles in facilitating the businesses of their parent banks. Moreover, the NPL ratio of bank affiliated financial leasing companies was 0.9% in 2015 (versus 1.7% for banks). We expect a resilient asset quality trend for lessors given their fully collateralised lending model (versus approximately 55% secured loans for banks).
- We expect more supply from the AMCs given the growing amount of distressed assets resulting in increased need for more capital. We also expect more leasing companies to come to the market given their natural need for USD funding as they expand overseas.

Technicals & Supply Outlook

In 2017, the forecasts are for approximately USD 90bn of gross issuance by Asian financials, while maturities are estimated to amount to about USD 48bn. In 2016, issuance has been dominated by Chinese financial institutions, which we estimate accounted for approximately 67% of total Asian financial issuance. This trend is likely to continue, as the Chinese financial institutions fund their overseas growth and One Belt One Road projects.

In the senior bonds space, we expect issuance from Asia ex-China banks to be mainly for refinancing needs. Asian banks are slowing their loan growth, a reflection of their recognition of lending risks, as well as slowing demand from companies which have been cutting back on capital expenditures.

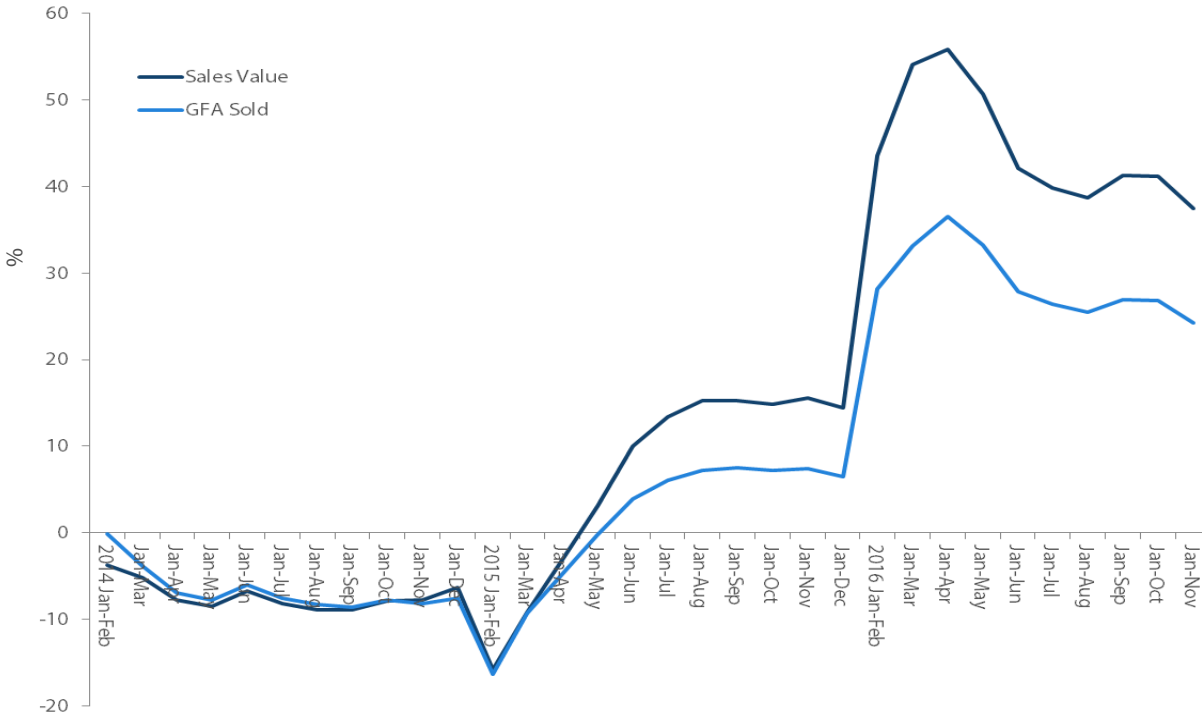
Issuance in the subordinated bonds space meanwhile will be driven by the need to create capital buffers, with capital needs being more prominent in China, India, and select Korean institutions. At the same time, favourable pricing offered by the local currency markets suggest that issuance in domestic markets is likely to continue to dominate, with international markets used more as a means of diversification. Specifically, banks from India and China are likely to tap USD markets to boost their Tier 1 ratios, while Singapore banks are likely to issue Tier 2 bonds to replenish legacy Basel II instruments which are callable in 2017.

China Property Sector – Slightly cautious due to the potential of further policy headwinds

Re-Cap 2016

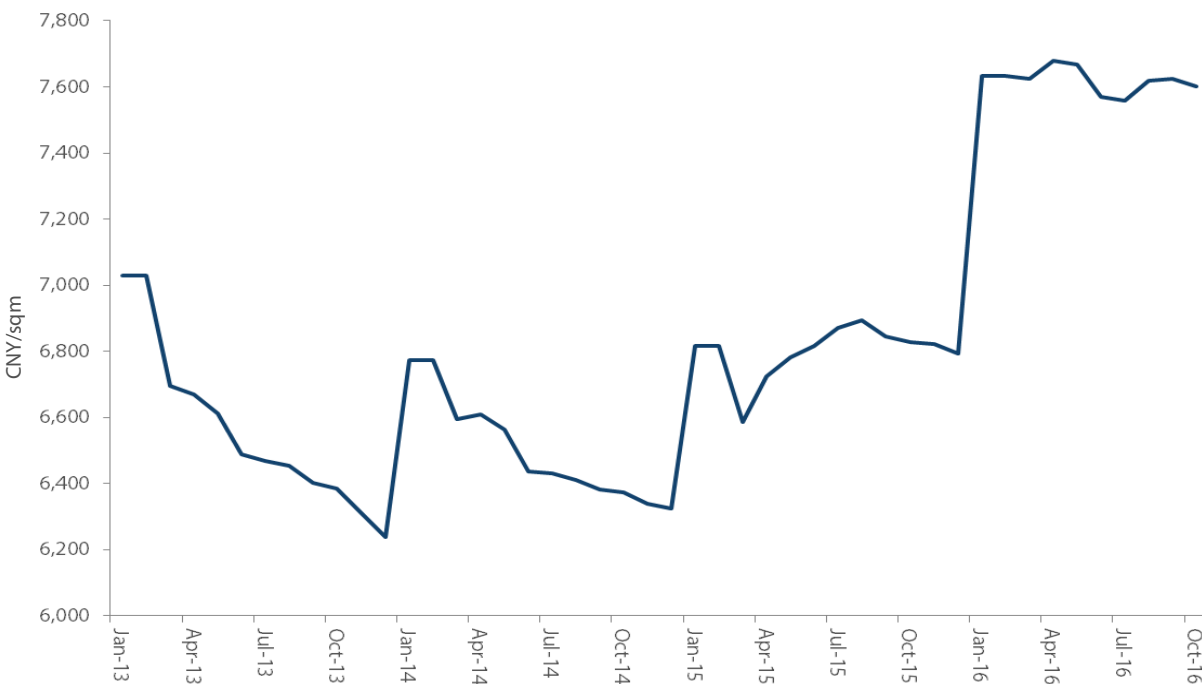
2016 was among the best years for China’s residential market mainly due to favourable policies and credit conditions (shown in the charts below). During the year, growth was initially led by strong sales in Southern and Eastern China, followed by the pick-up in Central and Western China. As shown in Chart 19, prices have also increased by approximately 12% in 9M16 as a result of low inventory in Tier 1 and 2 cities.

Chart 17: National Real Estate Sales and Sales Value Growth



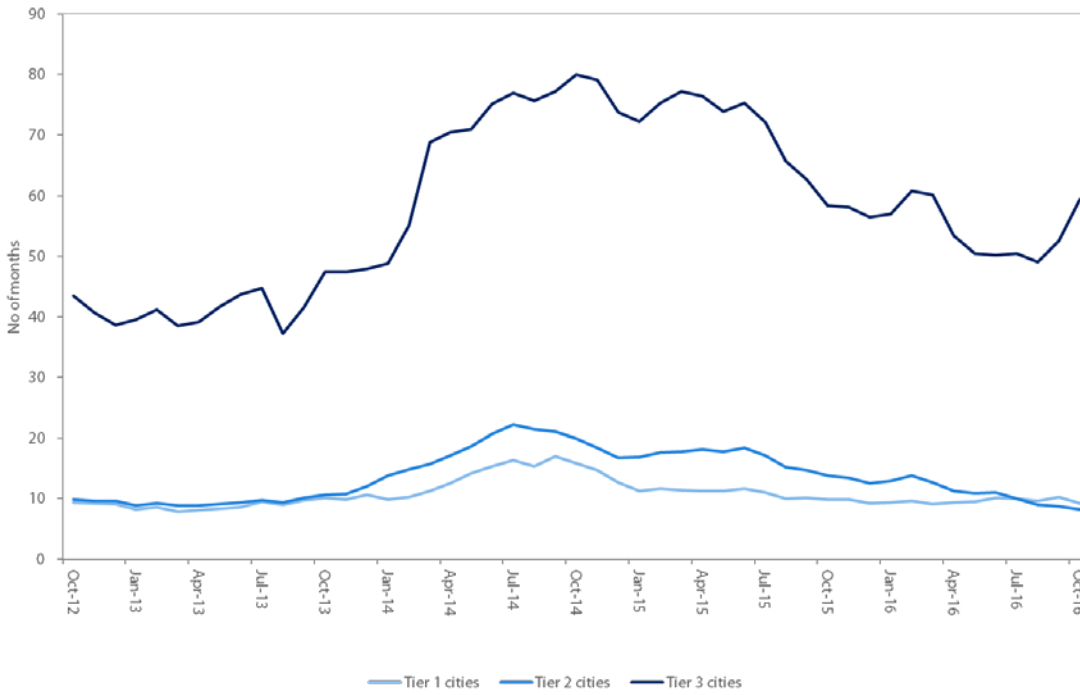
Source: NBS, Nikko AM Asia, as at 13 December 2016

Chart 18: Monthly ASP Trend



Source: Soufun, Nikko AM Asia, as at 8 December 2016

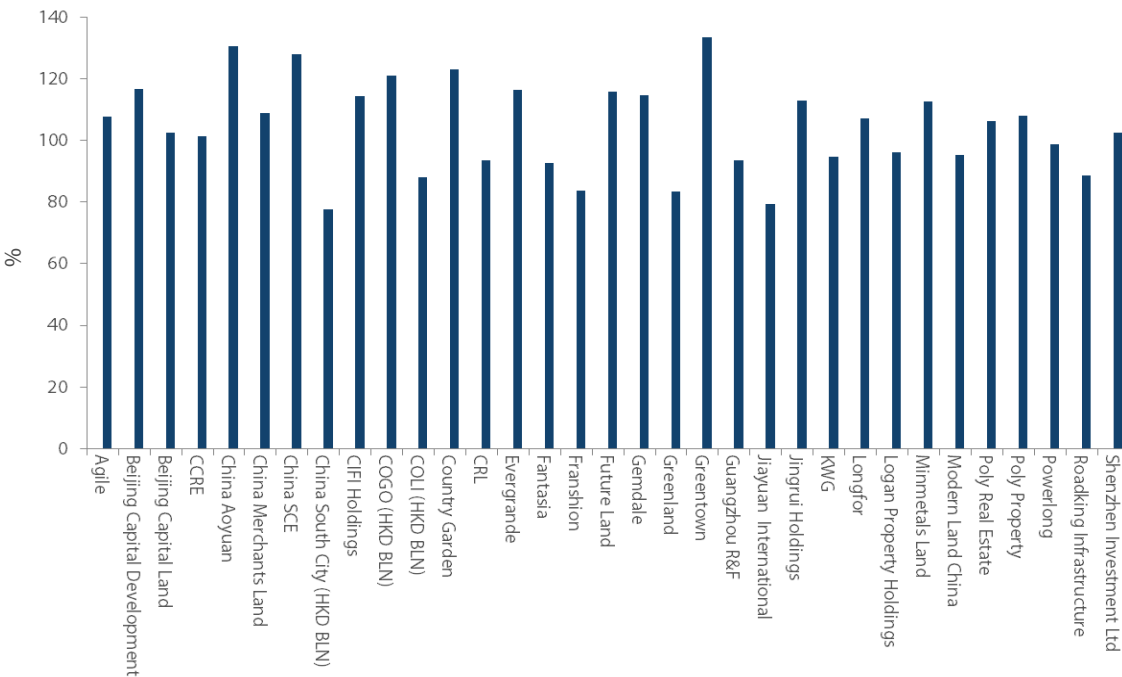
Chart 19: Inventory Level by City Tier



Source: Soufun, Nikko AM Asia as at 8 December 2016

About 62% of developers under our coverage have already exceeded their full year sales target as at end November.

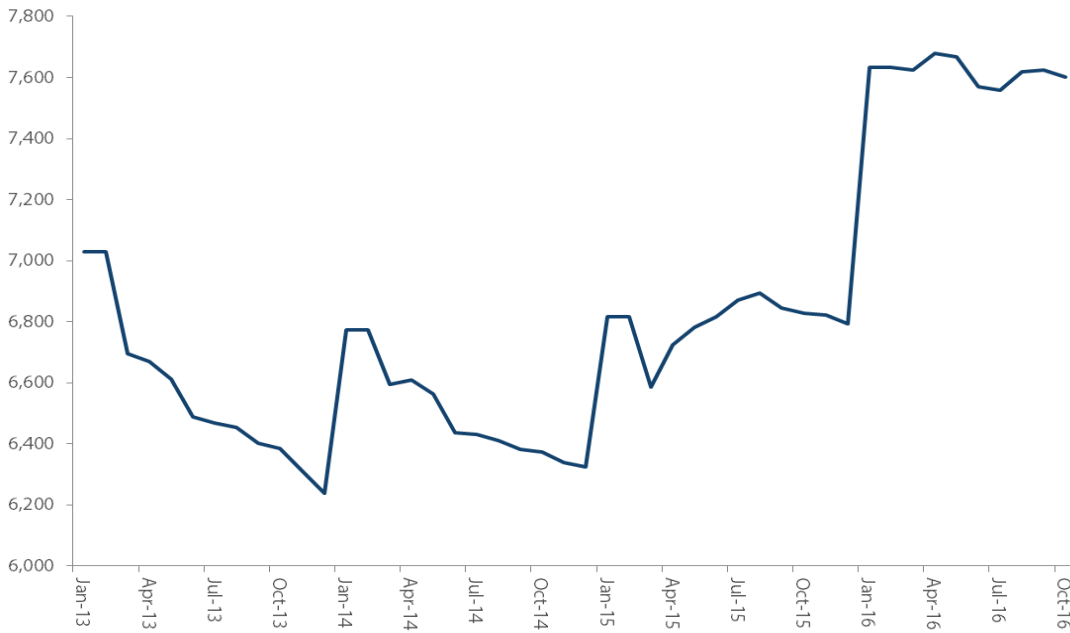
Chart 20: Contracted Sales Completion Rate as at end-November 2016



Source: Companies, Nikko AM Asia as at 19 December 2016

Overall credit conditions for developers were more relaxed in 2016 due to the opening up of the domestic corporate bond market, bank loans and even land-related financing were also quite accessible.

Chart 21: Funding conditions for developers



Source: NBS, Nikko AM Asia as at 13 December 2016

In October, sales performance was more diversified across the country due to the introduction of numerous tightening policies during the Golden Week. Over 20 cities announced new or enhanced tightening measures in late September and early October (as listed in the table below). Since the implementation of further cooling measures, sales volume has tapered as buyers and developers adopted a wait and see approach. This tepid sentiment is likely to continue into 1H17 and we will most likely get a better indicator of both demand and the direction of policies in 2Q17.

Table 3: Summary of Tightening Policies in 2016

Date (2016)	City & Tier	Home Purchase Restrictions		Downpayment Policies	
		Maximum Units (Locals)	Maximum Units (Non-locals)	First Home	Second Home
25-Mar	Shanghai (Tier 1)	2	1 (with 5 year tax proof from 2 year tax proof)	Remains at 30%	Increase from 30% to 50%; 70% for big or luxury units
27-Mar	Shenzhen (Tier 1)	2	1 (with 3 year tax proof from 1 year tax proof)	Remains at 30%	Increase from 30% to 40% (with first home loan paid off)
1-Jul	Hefei (Tier 2)	2	1 (with 2 year tax proof)	Increases from 20% to 25%	Increase from 30% to 40% if already have property but no outstanding mortgage record; 50% if have property and outstanding mortgage record; 60% if have more than 2 properties but have no outstanding mortgage record
9-Aug	Hefei (Tier 2)	2	1 (with 2 year tax proof)	Remains at 25%	Increase from 30% to 40% if already have property but no outstanding mortgage record; 50% if have property and outstanding mortgage record; no mortgage allowed for those with mortgage record of 2 or more times and those with 2 or more properties
11-Aug	Nanjing (Tier 2)	No Home Purchase Restrictions (HPR)	1	Remains at 25%	Increase to from 30% to 35% with property but no outstanding mortgage record; 45% to 50% if have property and outstanding mortgage record
12-Aug	Suzhou (Tier 2)	2	1	Remains at 20%	30% if property or outstanding mortgage; 40% to 50% if have property and outstanding mortgage record
1-Sep	Wuhan (Tier 2)	2	1	Remains at 25%	Increase from 30% to 40% if have property or outstanding mortgage record
5-Sep	Xiamen (Tier 2)	2	1 (with 2 year tax proof)	Remains at 25%	Remains at 40%
19-Sep	Hangzhou (Tier 2)	No HPR	1	Remains at 20%	Increase from 30% to 50%
26-Sep	Nanjing (Tier 2)	2	1	Increases from 25% to 30%	Increase to 50% if have property or mortgage record; 80% if have property and outstanding mortgage record
28-Sep	Hangzhou (Tier 2)	No HPR	1	Increases from 20% to 30%	Increase from 30% to 50%; increase from 40% to 50% (provident fund)
30-Sep	Beijing (Tier 1)	2	1 (with 5 year tax proof)	Increases from 30% to 35% for mass market; 40% for big or luxury units	50% if have property; 70% for big or luxury units
30-Sep	Kunshan (Tier 3)	No HPR	2 (with 1 year tax proof)	Increases from 20% to 30%	Increase from 30% to 50% with property or mortgage record; Increase from 50% to 80% with property and outstanding mortgage record
1-Oct	Tianjin (Tier 2)	2	1 (with 1 year tax proof)	Increases from 25% to 30% for residents; 40% for non-residents	Increase from 30% to 40%
1-Oct	Chengdu (Tier 2)	1 in specified districts	1	Remains at 30%	Increase from 30% to 40%
1-Oct	Zhengzhou (Tier 2)	2 (< 180sqm)	1	Remains at 20%	Remains at 30%
2-Oct	Hefei (Tier 2)	2	1 (with 2 year tax proof)	Increases from 25% to 30%	Increase from 30% to 40% if already have property but no outstanding mortgage record; 50% if have property and outstanding mortgage record
2-Oct	Wuxi (Tier 2)	No HPR	1	Increases from 20% to 30%	Increase from 30% to 40% if have property
2-Oct	Jinan (Tier 2)	3	1	Increases from 20% to 30%	Increase from 30% to 40% if have property and outstanding mortgage record
3-Oct	Wuhan (Tier 2)	2	1	Increases from 20% to 25%	Increase from 30% to 50%
3-Oct	Zhengzhou (Tier 2)	2 (< 180sqm)	1	Increases from 20% to 30%	Increase from 30% to 40% if have property and outstanding mortgage record
4-Oct	Shenzhen (Tier 1)	2; 1 for Singles	1 (with 5 year tax proof from 3 year tax proof)	Remains at 30%; 50% for those with no existing property but have mortgage record	Increase from 40% to 70% if have property
4-Oct	Guangzhou (Tier 1)	2	1 (with 3 year tax proof)	Remains at 30%	Remains at 70%

Date (2016)	City & Tier	Home Purchase Restrictions		Downpayment Policies	
		Maximum Units (Locals)	Maximum Units (Non-locals)	First Home	Second Home
4-Oct	Suzhou (Tier 3 2)		1 (with 2 year tax proof)	Increases from 20% to 30%	Increase from 30% to 50% if have property or mortgage record; 50% to 80% if have property and outstanding mortgage record
5-Oct	Nanjing (Tier 2)	2; 1 for Singles	1 (with 2 year tax proof)	Increases from 30% to 35%	Increase from 30% to 50% if have property or mortgage record; 80% if have property and outstanding mortgage record
5-Oct	Xiamen (Tier 2 2)		1 (with 2 year tax proof)	Increases from 25% to 30%	Increase from 40% to 60% (if already have property record or outstanding mortgage); 70% for big or luxury units
6-Oct	Zhuhai (Tier 3 2)		1 (with 1 year tax proof)	Increases from 20% to 30%	Increase from 30% to 40%
6-Oct	Changsha (Tier 2)	1 in specified districts (< 90 sqm)	1 (with 1 year tax proof) (< 90 sqm)	Remains at 20%	Remains at 30% if have property or outstanding mortgage record
7-Oct	Foshan (Tier 2 3)		1 (with 1 year tax proof)	Increases from 20% to 30%	Increase from 30% to 40% if have outstanding mortgage record
7-Oct	Fuzhou (Tier 2 2)		1 (with 2 year tax proof)	Increases from 20% to 30% for residents; increases to 40% for non-residents	Increase from 30% to 40% if have property and outstanding mortgage record
7-Oct	Dongguan (Tier 3)	2	1 (with 2 year tax proof)	Increases from 20% to 30%	40% if have property and outstanding mortgage record
8-Oct	Nanchang (Tier 2)	1 in specified districts	1	Increases from 20% to 30%	Increase from 30% to 40% if have property or outstanding mortgage record; 50% if have property and outstanding mortgage record
10-Nov	Hangzhou (Tier 2)	No HPR	1 (with 2 year tax proof)	Remains at 30%	Increase from 50% to 60% (provident fund)
15-Nov	Wuhan (Tier 2 2)		1 (with 2 year tax proof)	Increases from 25% to 30%	50% for mass market units; 70% for big or luxury units
15-Nov	Shenzhen (Tier 1)			Remains at 30%	Increase from 40% to 50% for mass market if already have one property; 70% for big or luxury units
29-Nov	Shanghai (Tier 1)	2	1 (with 5 year tax proof)	Increases from 30% to 35% (with no mortgage or no property record);	50% for mass market if already have one property or have mortgage record; 70% for big or luxury units if already have one property or have mortgage record
29-Nov	Tianjin (Tier 2 2)		1 (with 1 year tax proof)	Remains at 30% for residents; remains at 40% for non-residents	Remains at 40% if have property and outstanding mortgage record
3-Dec	Jiaxing (Tier 3)	1 in specified districts (< 90 sqm)	1	Remains at 20%	Remains at 50%

Source: Various news sources, local government websites, Nikko AM Asia as at 15 December 2016

Challenging but manageable operating environment in 2017

Going forward, developers can expect to see a more challenging operating environment, particularly in 1H17. Credit will be less readily available, the policy environment more uncertain, differential across cities will increase and the land banking process would become more complicated. This is a year to filter out the good developers from the bad as we expect deeper market consolidation (行业深度调整, 行业分化明显). Only developers that can sustain profitability and continue to increase market share will survive.

Following the cyclical peak in 2016, housing demand is expected to soften due to the following factors: 1) potentially negative impact from the newly imposed home purchase restrictions and higher down payment requirements; 2) tightened credit conditions, especially in cities with cooling measures; 3) demand which has been brought forward (预先透支需求) following the relaxation of policies which began in March 2015.

Property prices are also expected to decline, albeit at a lesser extent. Developers, especially larger ones, are better positioned as sufficient financing and strong sales in 2016 boosted cash flow. In addition, current inventory for Tier 1 and 2 cities are low. Therefore, there is less pressure for developers to cut prices.

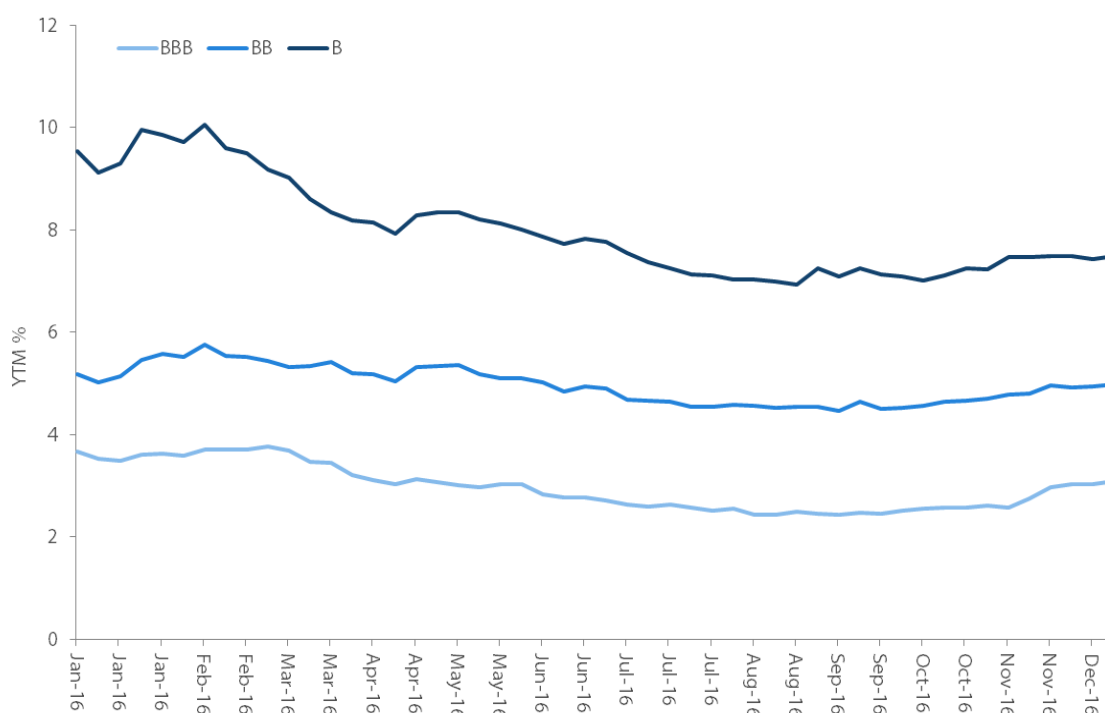
Overall, risk management should be the main focus for developers, especially in 1H17. In this challenging operating environment, execution capability and accessibility to funding channels will further differentiate them.

Valuations

2016 was a rewarding year for the property sector in terms of housing market demand and valuations prior to the tightening measures in October. Going into 2017, the curve is expected to steepen due to rich valuations and, as such, the duration of the current tightening cycle remains unclear.

With on-going headwinds for the industry coupled with tight valuations, we would recommend to underweight the Chinese property sector, especially on the longer dated bonds from developers with higher leverage. We instead prefer bonds from financially strong developers that have high coupon rates and are callable in 2017 and 2018 due to their high call possibility and good carry.

Chart 22: Average Property Bond Yield

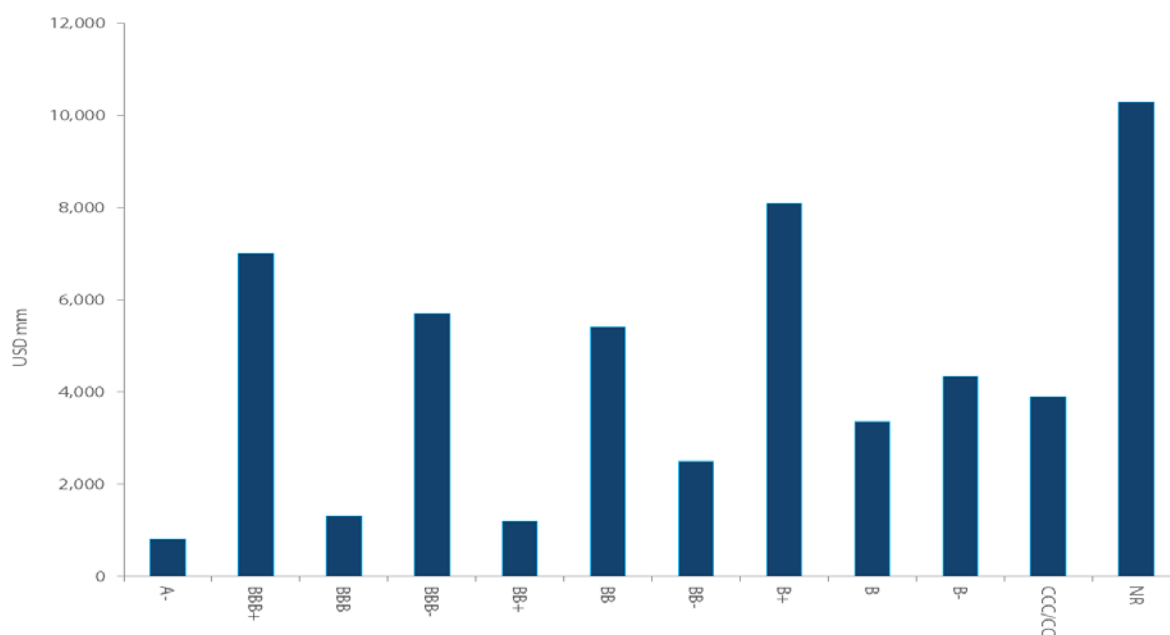


Source: Bloomberg, Nikko AM Asia, as at 14 December 2016

Technicals

The pace of USD issuance by property developers was one of the slowest in 2016 as a result of the opening up of the domestic corporate bond market. The sector printed a total of USD 7.1bn as at 13 December 2016, of which high grade accounted for only USD 720mm and high yield accounted for USD 6.4bn. This was even lower than the USD 9.18bn printed back in 2015, and explains the supportive technical element for the sector in 2016.

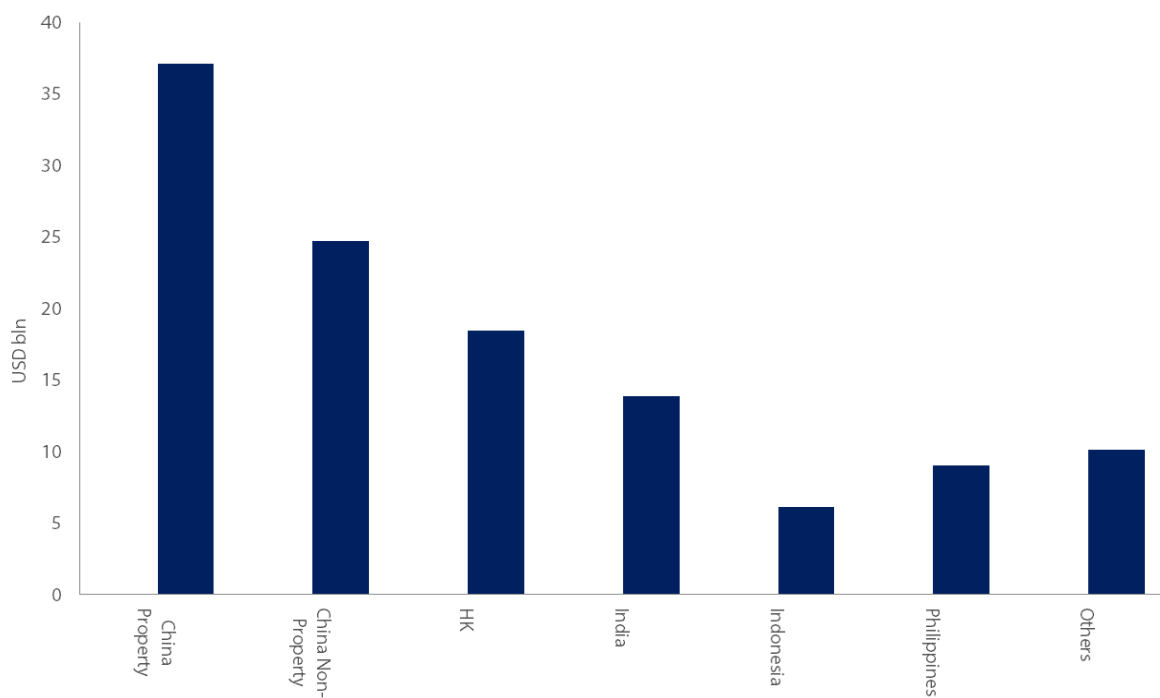
Chart 23: Outstanding China Property Bonds by Rating



Source: Bloomberg, Nikko AM Asia, as at 12 December 2016

Chinese developers continue to be the biggest component in Asian USD high-yield bond space, accounting for over 37% of the total outstanding high-yield bonds (shown in the chart below).

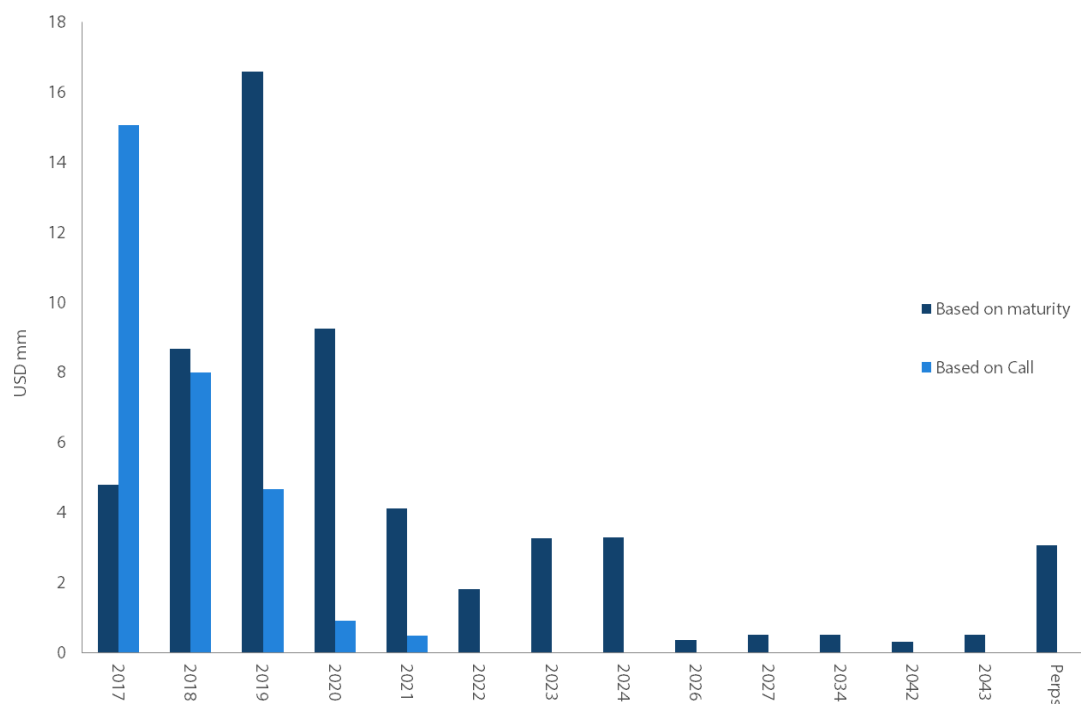
Chart 24: Asia High-Yield Market by Country and Sector (excluding Sovereign and Quasi-Sovereign)



Source: JP Morgan JACI Asia Index as at 12 December 2016

We expect supply to pick up in 2017, particularly for refinancing, as there are approximately USD 4.8bn of bonds maturing and USD 15.1bn of callable bonds. However, we do not expect issuers to fully fund all of these maturities and redemptions through the issuance of new USD bonds. Some issuers could redeem or repay the bonds via alternative funding channels such as loan markets and onshore bonds. Despite the tightening of the onshore financing channels, we believe that the larger developers still have an edge in obtaining funding onshore.

Chart 25: Bond Maturity and Call Schedule (USD mn)



Source: Bloomberg, Nikko AM Asia as at 13 December 2016

Hong Kong Property Sector – Cautious with negative bias towards developers but neutral on landlords

Fundamentals

The Hong Kong Government introduced further tightening measures to cool the overheated residential measures on 4 November 2016. Effective from 5th November 2016, the double stamp duty (DSD) will be revised to a flat rate of 15%, compared to a range of 1.5% to 8.5%, for second-home buyers (shown in the table below). Hong Kong Permanent Residents who currently do not own property are exempt from the new rate and only have to pay a minimum of HKD 100 or a maximum rate of 4.25%. Exemptions are also granted to single property owners who sold their first property within six months of buying a new one. The new rule is set to reduce housing demand from both local investors and non-local buyers, both of whom are thought to be the primary driving forces for the rebound in prices since March 2016.

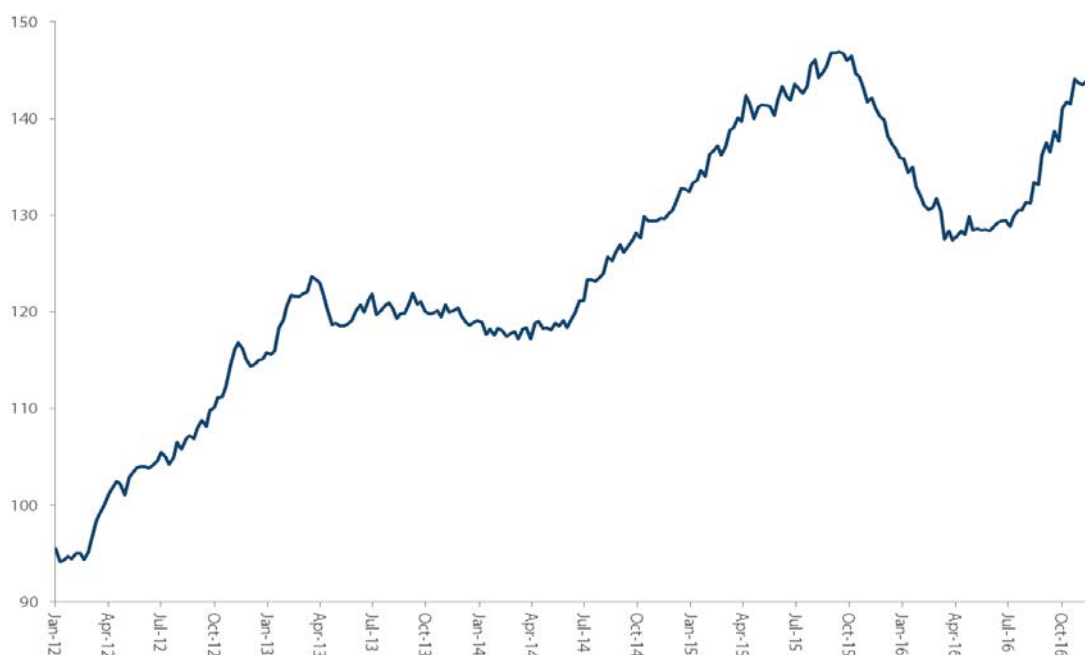
Table 4: Double Stamp Duty (DSD)

Residential Price		Rate	Rate
Exceeds (HKD)	Does not exceed (HKD)	(Previous)	(Effective 5th November)
	2,000,000	1.5%	15.0%
2,000,000	2,176,470	HKD30,000 + 20% of excess over HKD2,000,000	15.0%
2,176,470	3,000,000	3.0%	15.0%
3,000,000	3,290,320	HKD90,000 + 20% of excess over HKD3,000,000	15.0%
3,290,320	4,000,000	4.5%	15.0%
4,000,000	4,428,570	HKD180,000 + 20% of excess over HKD4,000,000	15.0%
4,428,570	6,000,000	6.0%	15.0%
6,000,000	6,720,000	HKD360,000 + 20% of excess over HKD6,000,000	15.0%
6,720,000	20,000,000	7.5%	15.0%
20,000,000	21,739,120	HKD1,500,000 + 20% of excess over HKD20,000,000	15.0%
21,739,120		8.5%	15.0%

Source: Inland Revenue Department, Nikko AM Asia as at 15 December 2016

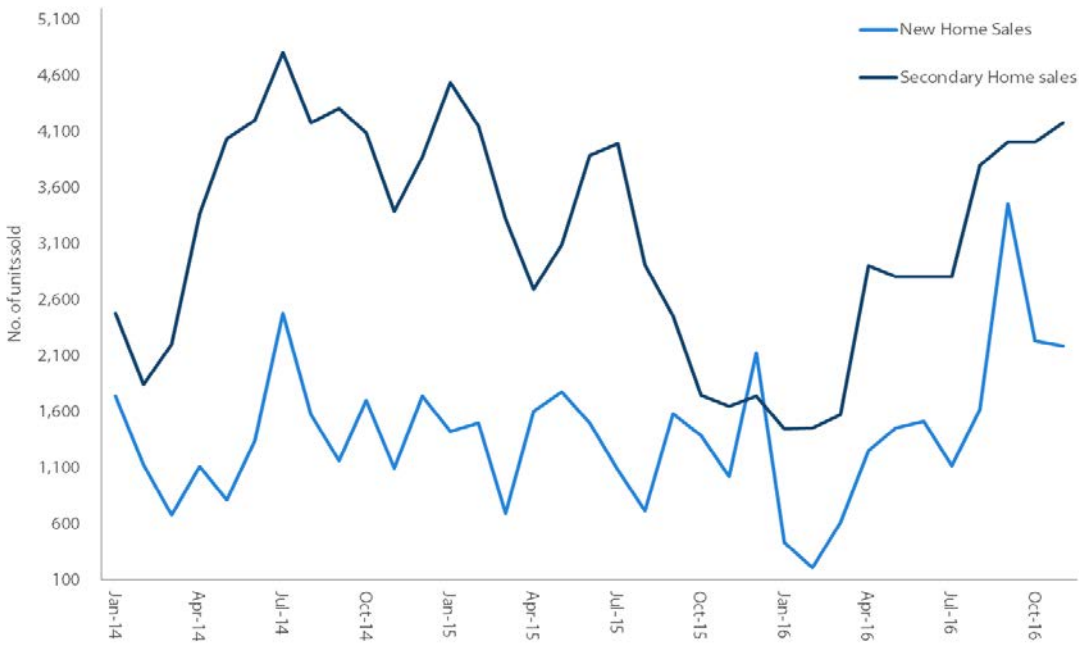
According to Centaline property index, property prices rose by approximately 5.8% YTD as at 30th October 2016 (almost hitting peak levels seen in September 2015) before the Double Stamp Duty (DSD) was implemented. Home prices are likely to see downward pressure in 2017 as homebuyers wave goodbye to negative real interest rates after the Hong Kong Monetary Authority raised the base rate by 25bps to 1%, the first rise since December last year.

Chart 26: Centaline Centa-City Leading Index



Source: Centaline, Nikko AM Asia, as at 15 December 2016

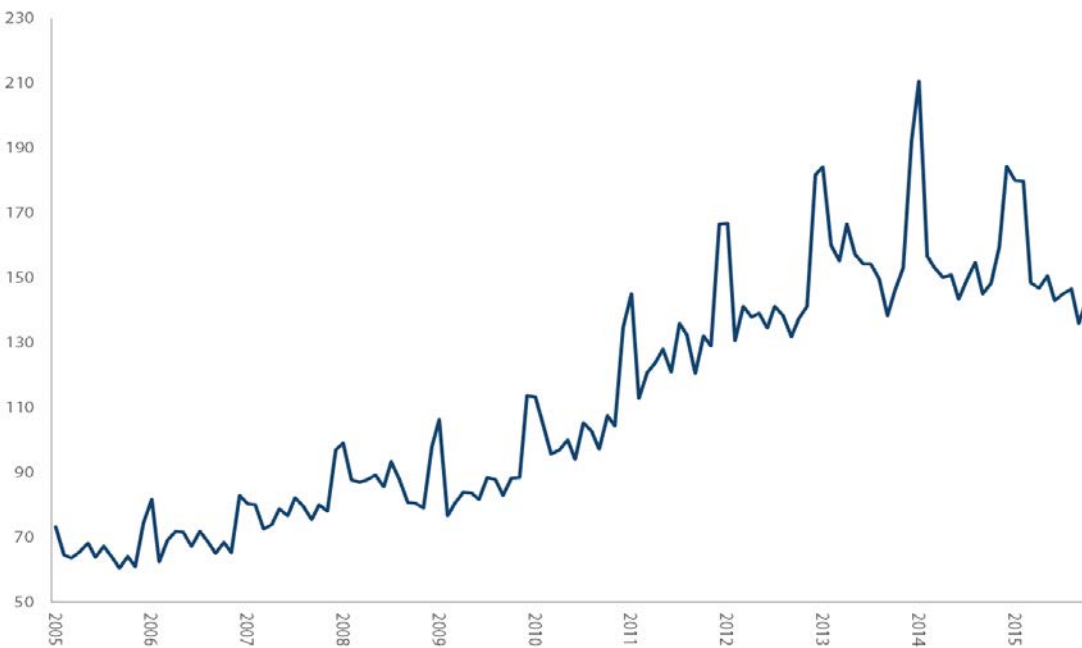
Chart 27: Monthly Property Transaction Volume



Source: Centaline, Nikko AM Asia, as at 15 December 2016

Hong Kong retail sales have fallen for 20 consecutive months, as shown in chart 29. However the decline has been decelerating, as seen in October where retail sales fell 2.9% year-on-year (YoY) compared to the 4% YoY decline in September. According to the Hong Kong Census and Statistics Department, tourist arrivals also recovered in October, declining 2% YoY versus the 3% YoY decline in the previous month. Similarly, the decline in tourist to Mainland China also moderated, decreasing 3.5% YoY in October from a 5% YoY drop in September. We anticipate that rentals for street level retail may bottom out soon while shopping malls could face mild downward pressure. Street level retail rentals have fallen approximately 34% from its peak as street shop landlords continue to cut rents so as to retain tenants. Shopping malls rents, which had been more resilient, started seeing marginal declines as major mall operators increased their F&B tenant mix in 2016.

Chart 28: Hong Kong Retail Sales Index



Source: Census and Statistics Department, Nikko AM Asia, as at 15 December 2016

Hong Kong office rental rates continue to be buoyed by the positive momentum in 3Q16, mainly attributable to tight vacancy rates in Central. In 2017, rental continues to be under pressure for non-core districts as vacancy rates are expected to rise on the back of oversupply. Supply is estimated to be 2.6 million square feet, of which 70% will be concentrated in Kowloon East⁶. Core and fringe CBD districts will continue to see support from mainland financial institutions, though this is likely to happen at a smaller scale in 2017.

Table 5: Key Figures for JLL Grade A Office (3Q16)

3Q16	Average rental (HKD/sqft)	QoQ % Change	YTD % Change	Vacancy
Overall Office	68.6	1.2%	3.5%	4.2%
Central Office	109.8	2.2%	7.2%	1.5%
Wanchai/CWB Office	63	1.1%	4.1%	2.7%
TST Office	48.7	-1.3%	0.5%	2.6%
HK East Office	47.7	0.2%	1.6%	2.7%
Kowloon East Office	33.8	-0.3%	-1.4%	7.2%

Source: Jones Lang LaSalle as at 15 December 2016

Valuations

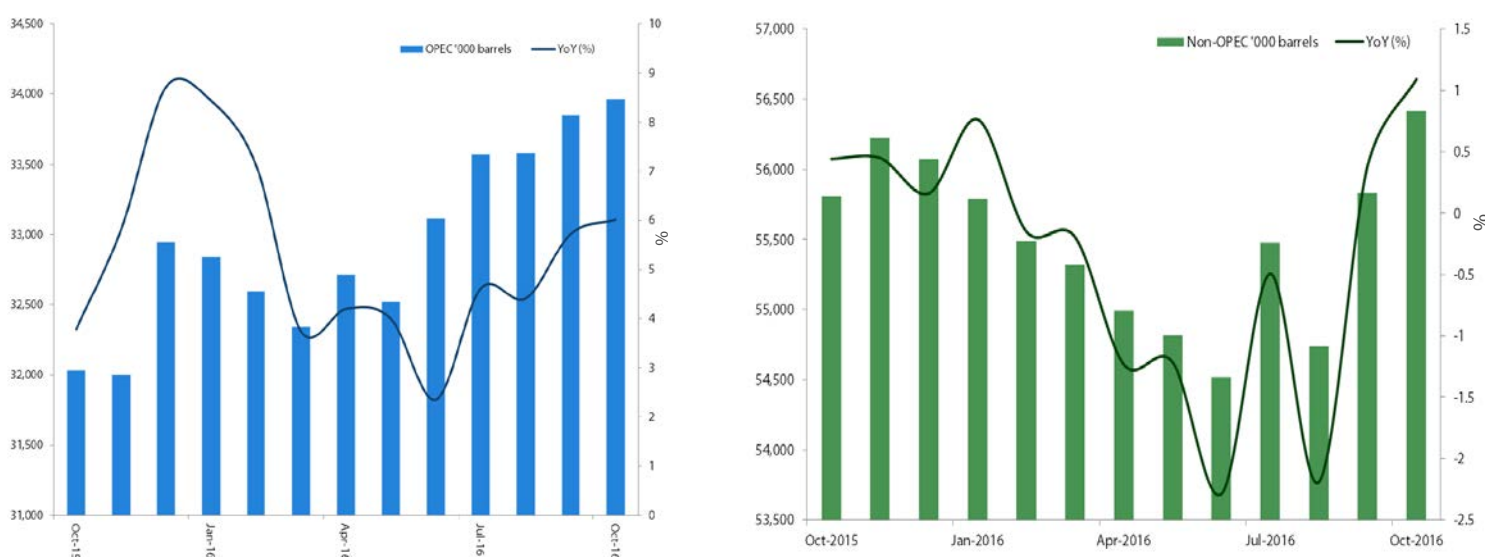
We continue to see value in selected unrated Hong Kong property names, given the premium over its rated peers. We also prefer office landlords (especially those that have core CBD office portfolios and are willing to dispose of non-core assets) over developers due to demand from Chinese corporates.

Oil and Gas Sector – Normalisation of industry is well under way

Oil prices began the year on a downward spiral, hitting a low of USD 26 per barrel in February. This set the stage for a strong recovery for the rest of the year as the market had been too pessimistic with the demand supply dynamics of the industry. Oil prices gradually recovered, rising almost 100% from the lows. Prices reached USD 50 per barrel by May and have been range bound since. At current levels, prices remain well below the USD 100 per barrel price range during the heydays.

Internal rife within the OPEC cartel created further volatility in oil price throughout the year. After many rounds of negotiations, the cartel was finally able to arrive at an agreement towards production cuts in late November. This helped to provide a floor to the oil price. Saudi Arabia, which earlier prioritised regaining market share at the expense of lower oil price, is now willing to make the necessary concessions in order to support the oil market.

Chart 29: OPEC and Non-OPEC Production

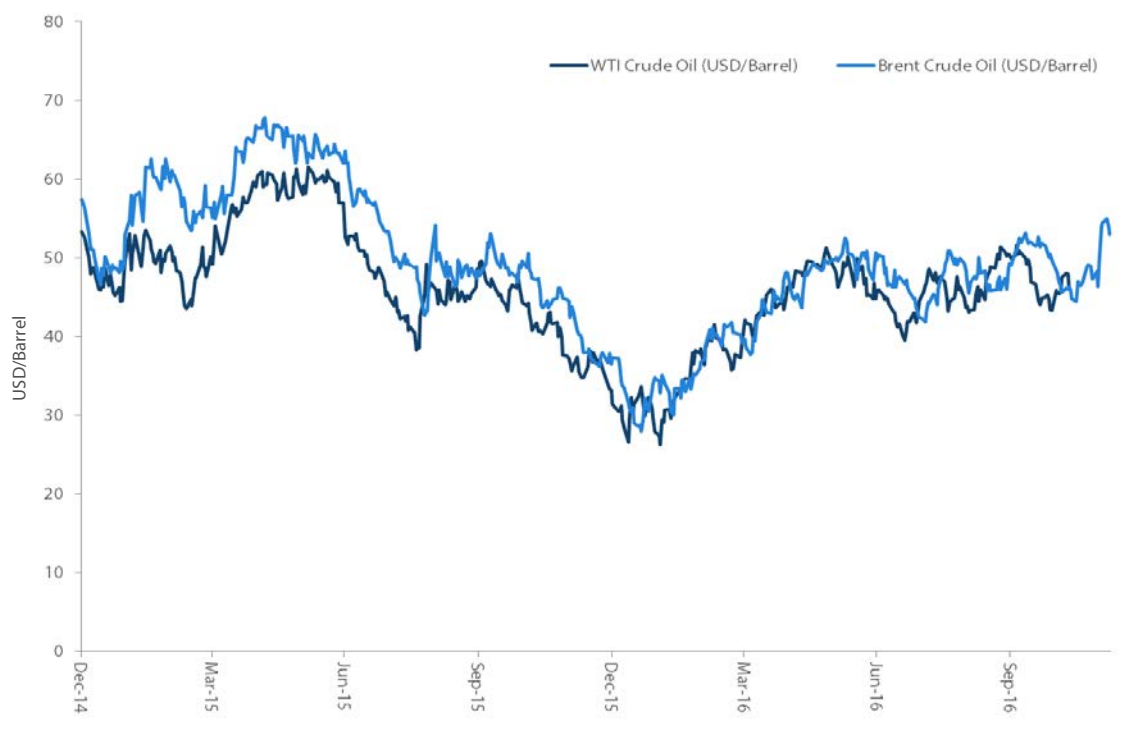


Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

⁶ Rating and Valuation Department, Real Estate Intelligence Services – Jones Lang LaSalle 2016

Investments in upstream activities have been curtailed significantly across the industry. The normalisation of the oil industry is well under way. A slow gradual recovery in oil price is to be expected. The demand outlook for oil remains healthy and the excess supply gap is expected to come to balance by 2017. This is however hinged on the successful execution of OPEC's production cuts with its member countries abiding to the agreed production levels. Oil price averaged about USD 43 per barrel in 2016. It is expected to rise to above USD 55 in 2017.

Chart 30: WTI and Brent Crude Oil Prices



Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

Exploration and Production Companies - Neutral

Upstream oil and gas companies in Asia have largely weathered the low oil price environment well. Companies have curtailed capital expenditure to conserve liquidity and maintained strong credit profiles. While profitability has weakened, cost cutting measures and a reduction in capital expenditure spending have helped to minimise the credit deterioration. CNOOC was downgraded by a notch to A+ by S&P. However, other major oil companies in the region such as CNPC, Petronas, PTT, Pertamina, and ONGC were able to retain their ratings. The ratings for these oil majors are expected to be stable over the course of the next year.

Refining and Chemicals Companies - Neutral

Refining and chemicals companies have been able to reap the benefits of low oil prices. Due to the lower value of inventories, working capital requirements have now been reduced. Gross refining margins within the region have also improved as new refining capacities have been well absorbed by the robust economic activity in the Asian region. Gross refining margins are expected to range around USD 6 – 7 per barrel, which is a healthy range for the sector. The relaxation of import restriction of crude oil by the Chinese government allowed the rise of teapot refiners in China this year. The added capacity from these teapot refiners caused an overcapacity situation in the Chinese domestic market. However, the excess production has been well absorbed by the overseas export market. Capital expenditure within this midstream sector is expected to be high as this area remains one of the bright spots of the oil and gas value chain. The credit ratings for companies such as Sinopec, Thai Oil and Indian Oil were unchanged. The rating is expected to be stable in the next year.

Oil Services Companies - Cautious

Oil services companies were the worst hit within the O&G industry. Curtailment in investments and operating expenditure has drastically shrunk the availability of new tender contracts for services companies. The lack of services jobs is forcing the companies within this sector to downsize their operations to conserve liquidity, leading to impairment of assets. For companies that are heavily indebted, financial restructuring may be necessary.

Corporate Credits

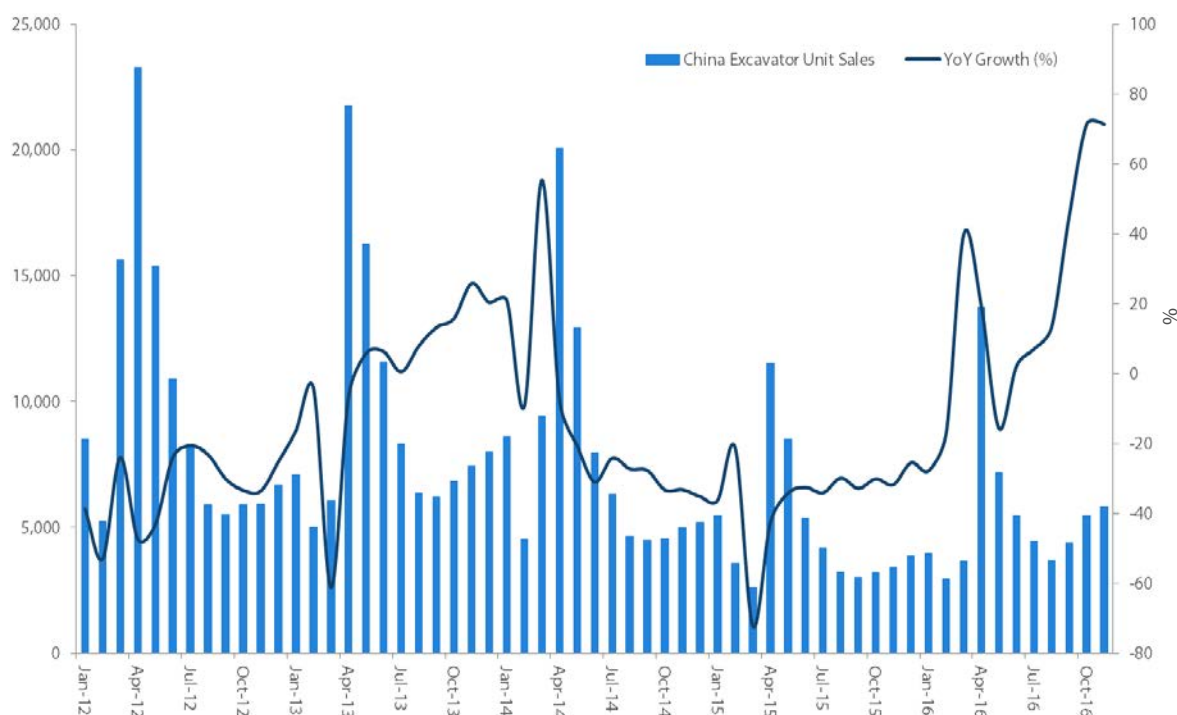
China Infrastructure Construction – Neutral, construction activity to remain strong at expense of credit quality

Infrastructure construction activity in China has been strong. In 2016, the government maintained a strong pace of infrastructure investment, committing to plow resources into transport infrastructure. The government has budgeted CNY 4.7trn on 300 transport infrastructure projects over the next three years. The high amount of government spending will roll into 2017 as it is a key contributing pillar to the country's GDP growth. The establishment of Public-Private Partnership (PPP) projects is gaining traction and helping the government to tap and mobilise private sector resources to fund infrastructure projects across the country. Private sector investors are drawn by the potential attractive and stable returns of these long term infrastructure projects. As a result, construction companies have been kept busy with a flurry of available projects from the government. Order-book backlogs have swelled in 2016. These will keep construction companies busy in the coming year. Despite the favourable environment, we expect some deterioration in credit quality for companies in this sector. The increased number of projects is likely to result in higher working capital requirements, and hence more borrowings.

China Heavy machinery and equipment – Constructive, infrastructure spending to drive sales

Following a period of downturn in the industry that lasted over two years, manufacturing activity in heavy machinery and equipment started to pick up in June 2016. Strong activity in infrastructure construction spurred construction companies to expand and replenish their aging heavy machinery equipment. While overall utilisation of manufacturing factories remain low, sale of heavy equipment such as cranes and excavators have increased almost 90% YoY due to the low base effect. The rising sales are expected to continue into 2017 as infrastructure spending will continue to be supported by the government. Despite the rosier outlook, companies within this sector will remain cautious and focus on strengthening their balance sheets. We expect some improvement in credit quality in this sector.

Chart 31: China Excavator Unit Sales and Growth

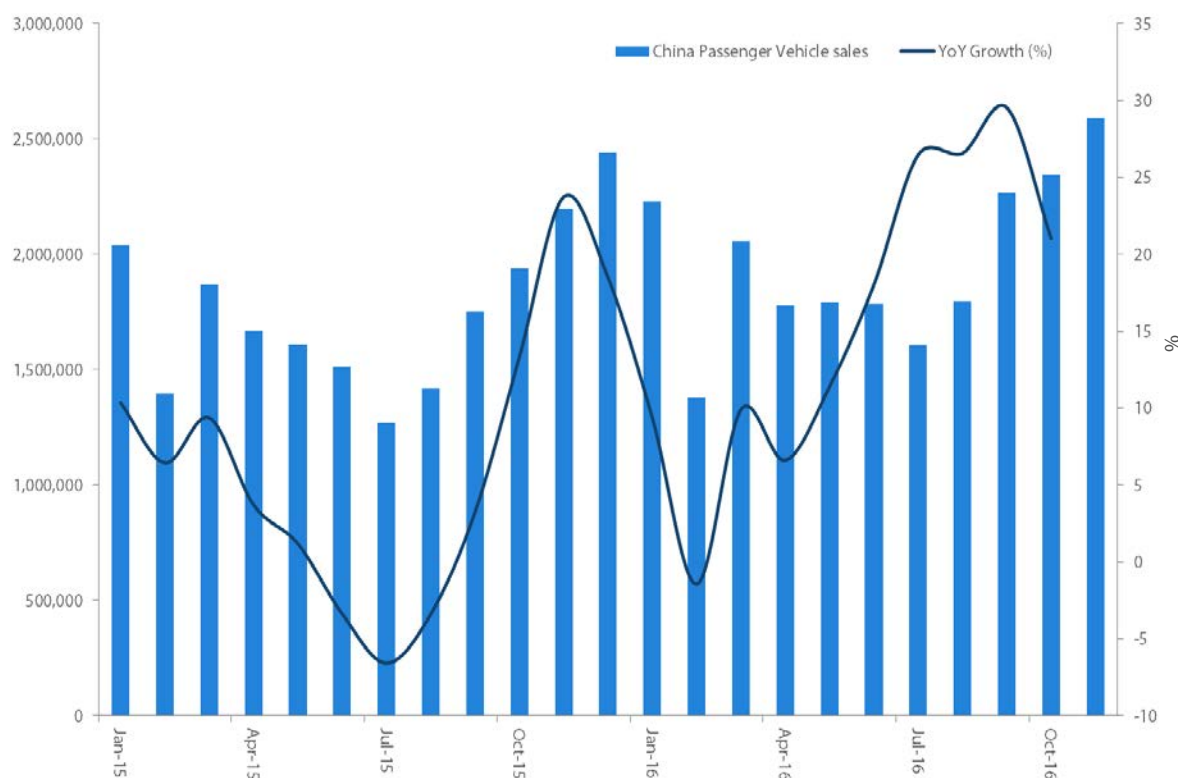


Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

Automobile – Neutral, strong sales growth expected to slow

Passenger vehicle sales were strong in 2016, growing almost 20% YoY. Car sales in domestic China were buoyed by favourable subsidies which supported the mass-market. The reliance on government subsidies is a double edged sword, however, as discretionary car purchases will be heavily influenced by government policy decisions. Expectations are for the government to extend the car purchase subsidy into 2017 in order to support domestic consumption. An unexpected retraction of the subsidy is likely to weigh heavily on automobile manufacturers and auto dealers. Barring any unexpected policy actions, we expect credit quality in this sector to be stable over the next year.

Chart 32: China Passenger Vehicle Sales Volume and Growth

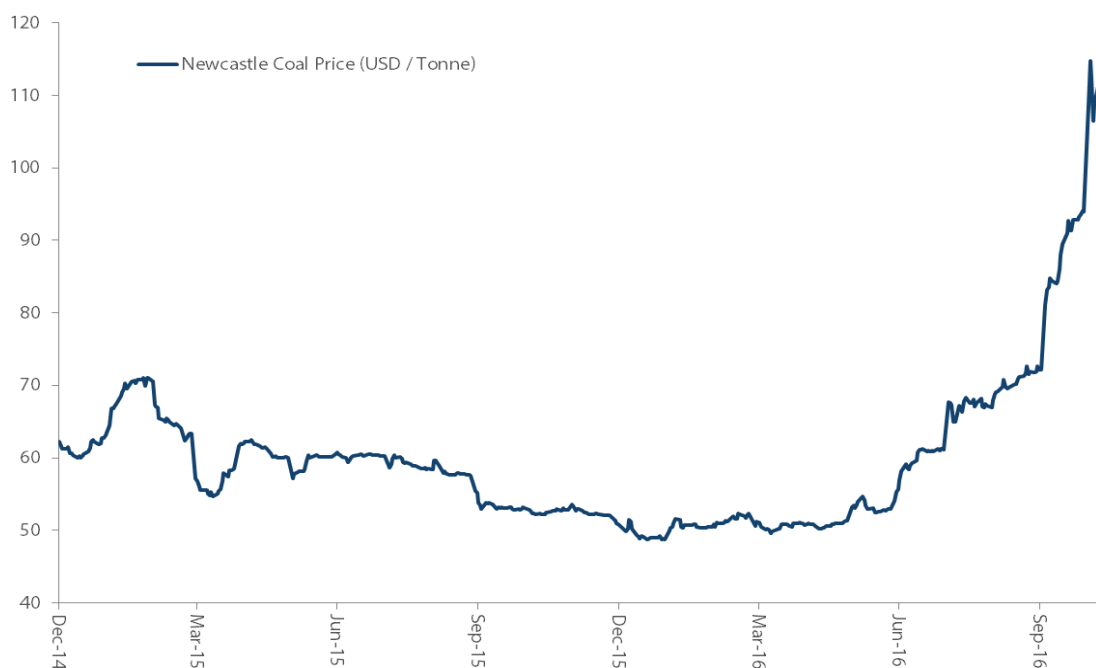


Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

As for the logistics related vehicle market, the implementation of higher emissions standards and stringent rules on vehicle overburden caused an acute supply shortage of logistics vehicles in China. Sales of trucks rose significantly as a result, especially in the heavy duty segment. Sales of heavy duty trucks increased 30% YoY. This bottleneck will take some time to normalise. Industry experts expect sales to be elevated for 12-18 months as logistics companies upgrade and expand their fleets to meet new regulatory requirements. Given this improvement in industry outlook, we expect the credit quality of companies within this sector to improve.

Metals and Mining – Neutral, government interventions to support sector

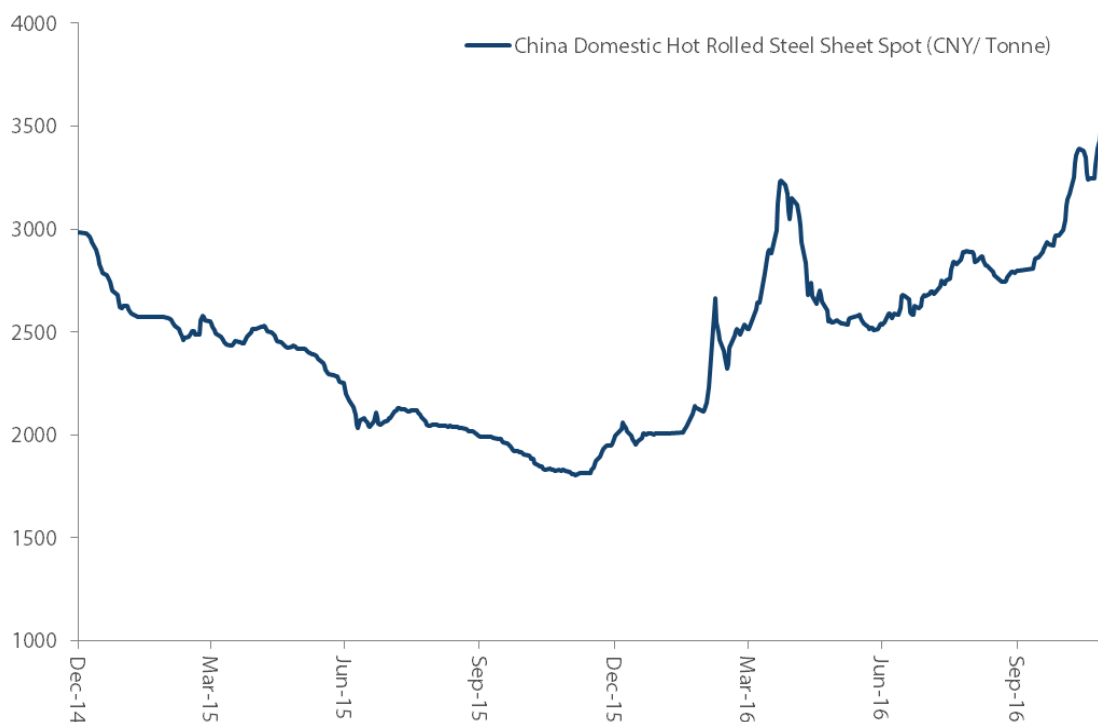
Chart 33: Newcastle Coal Price



Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

Commodity prices were at multi-year lows for most of 2016, hurting profitability of mining companies and stretching their liquidity situation. Firms were forced to shut unprofitable mines and curtail spending. In China, the government pushed through its reform agenda for inefficient SOEs to solve overcapacity issues. Progress has generally been slow. But the initiative did score some success during the year. This was most evident in the coal mining sector, where stringent application of mining bans across the industry helped to curb the oversupply situation.

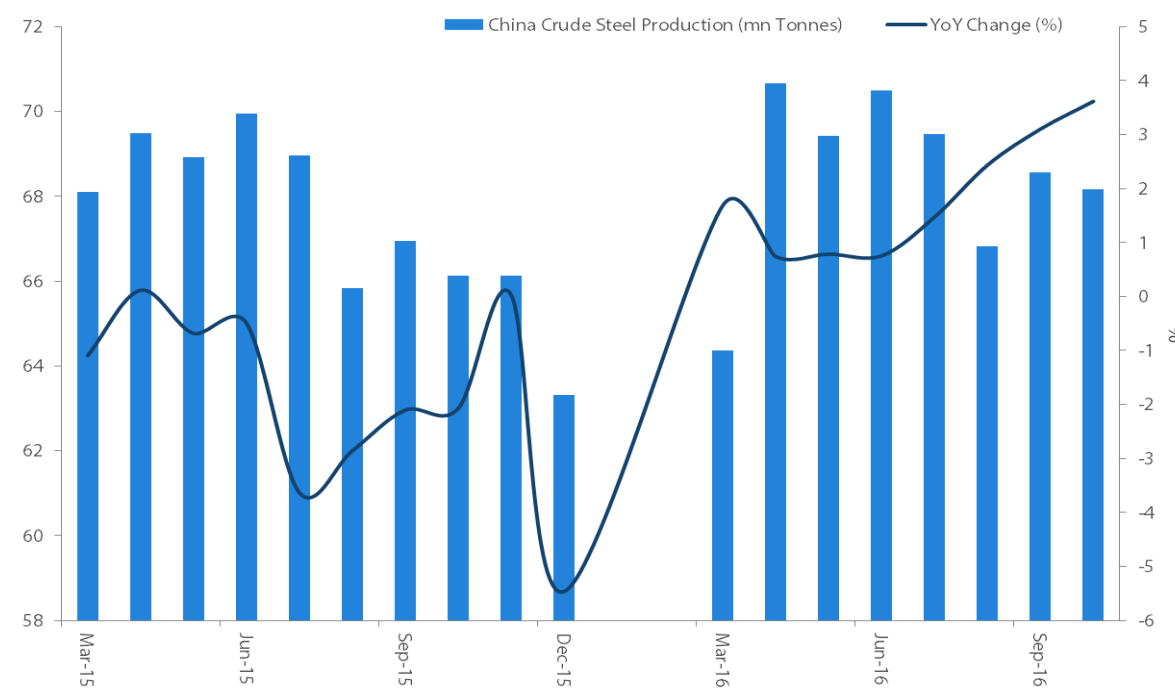
Chart 34: China Domestic Hot Rolled Steel Sheet Spot



Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

As a result, coal prices recovered strongly in 2H16, giving much relief to cash strapped coal miners within the country. The benefits were also felt abroad as seaborne coal prices rallied. The success in the coal sector is likely to bring new vigour to reform efforts in other sectors as well. The steel industry remains fraught with excess capacity, and the central government has been actively managing the gradual closure of inefficient state-owned steel plants and directing the consolidation of steel manufacturers through mergers.

Chart 35: China Crude Steel Production and Growth



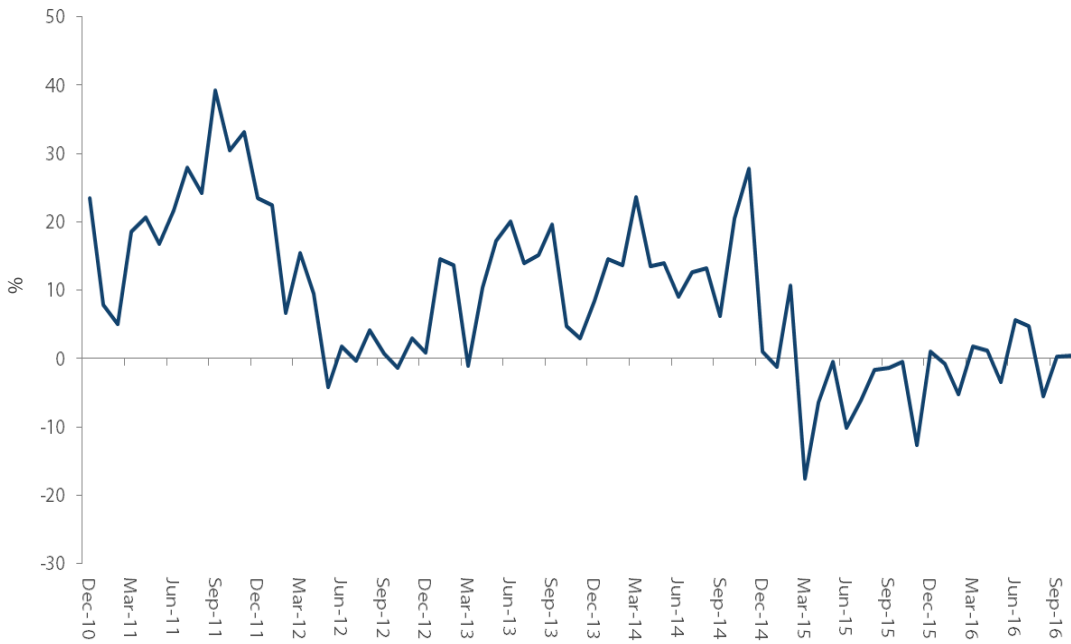
Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

In India, the government imposed a minimum import price on steel products in a bid to support domestic steel producers. This was in response to cheap imports that were depressing profits of local producers. Domestic steel players such as Tata Steel and JSW Steel were direct beneficiaries of the Indian government's intervention and profits of steel producers recovered as a result. Although steel prices have gradually recovered during the year, Indian steel producers continue to lobby for the extension of the minimum import price. We expect the Indian government to continue to be supportive of its domestic industries. Looking ahead in 2017, we expect the credit profile of Indian steel companies to be stable.

Gaming and Entertainment – Constructive, industry downturn has bottomed

Gaming activity was in the doldrums in 1H16 as a decline in visitors from the mainland weighed heavily on the Macau gaming industry. The reduction in visitations coincided with the completion of several large casino resort projects. The opening of Wynn Palace and Sand Parisian during the year exacerbated the situation as the increase in new gaming tables cannibalised business from existing casinos. Nevertheless, the industry saw some improvement in 2H16 as foreign visitations showed signs of bottoming. The overall credit quality of companies within this sector is expected to be stable with marginal improvements.

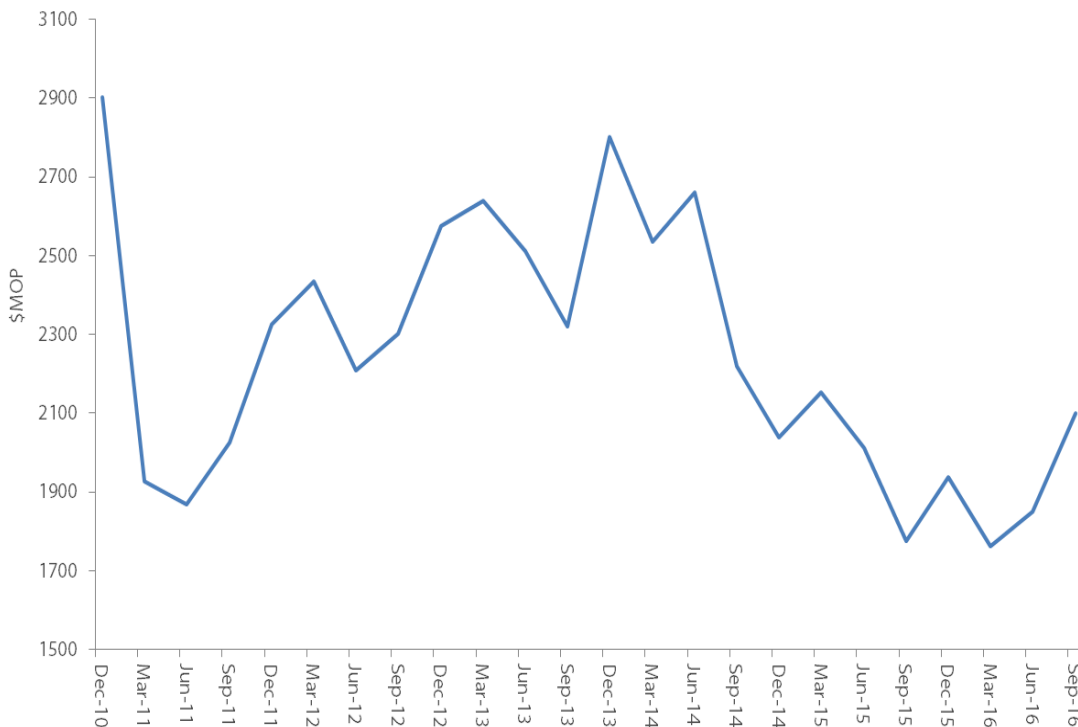
Chart 36: Growth Rate of Chinese Tourists Visiting Macau



Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

Regionally, competition in the gaming sector is set to increase in the years ahead. The Japanese government passed a crucial bill in December to lift a ban on casinos, paving the way for the country's first integrated gaming resort in the next few years. The Philippines' gaming scene is also gaining traction, as the country seeks to draw visitors from China and the region.

Chart 37: Spend Per Capita of Chinese Visitors in Macau

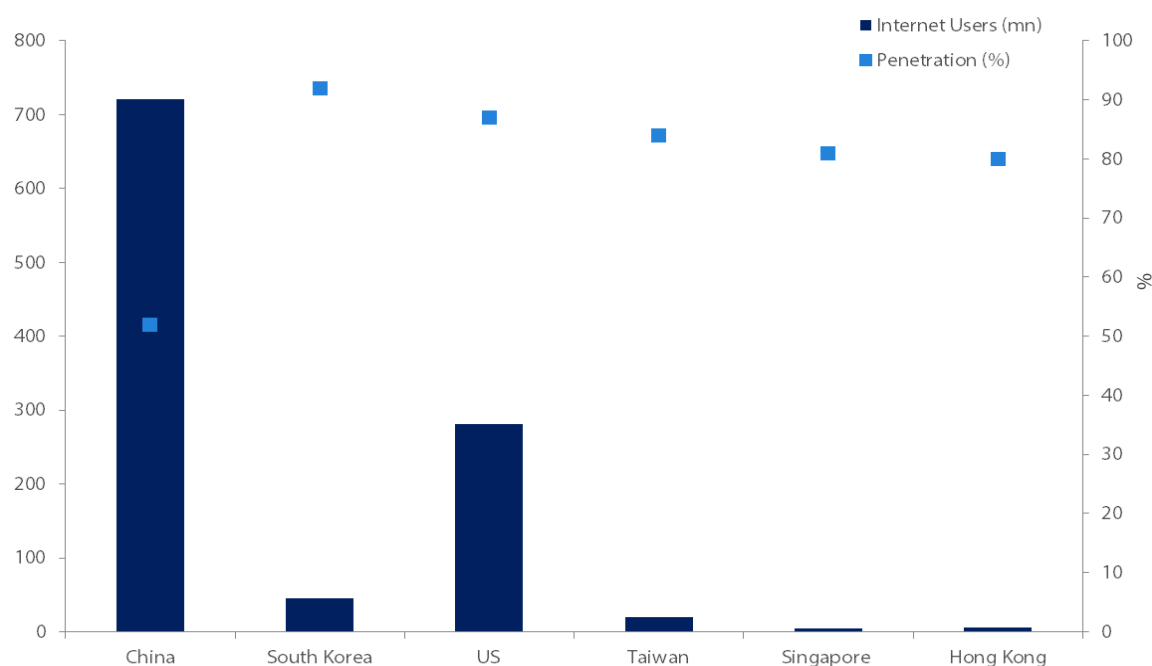


Source: Bloomberg, Nikko AM Asia, as at 16 December 2016

Technology - Constructive outlook given favourable fundamentals and market trend

The online consumption story continues. Chinese internet companies are expected to see further strength in fundamentals on the back of the on-going offline-to-online shift in retail and double digit growth potential. The penetration rate of China's internet user base is relatively low at 52%, well behind other more developed markets such as South Korea (92%), the US (87%), and Taiwan (84%). This percentage is expected to increase, driven by urbanisation, improving network infrastructure as well as richer internet content. These trends are favourable for China internet companies, and should underpin robust revenue growth.

Chart 38: Penetration Rate of China's Internet User Base



Source: Bloomberg, Nikko AM Asia, as at 14 December 2016

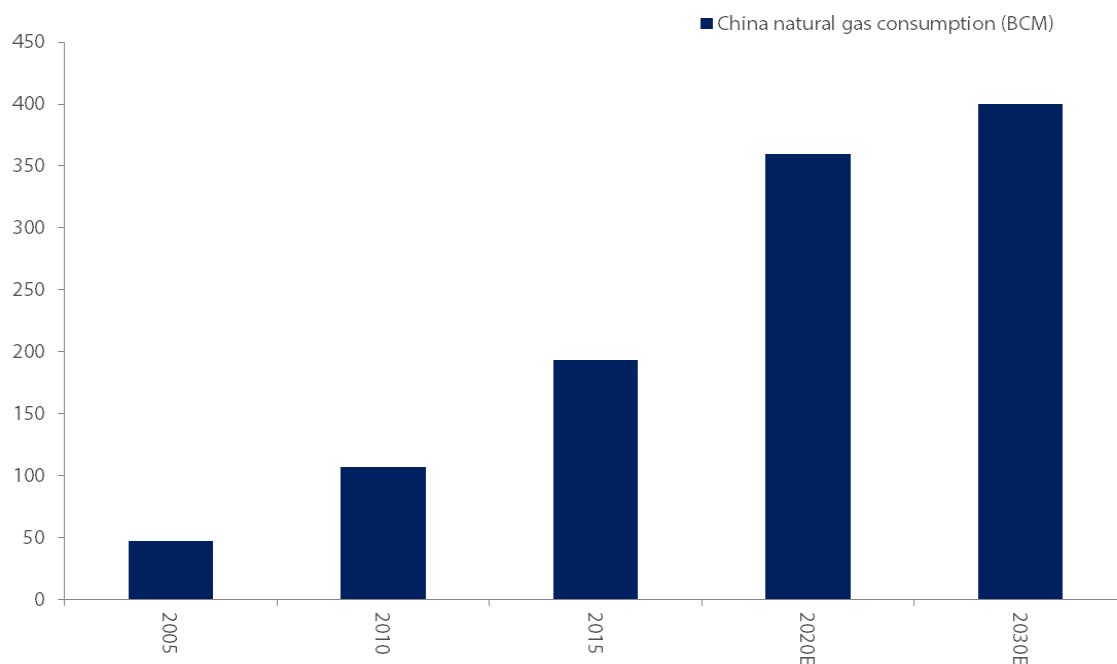
We expect Chinese internet companies to maintain good liquidity, despite increasing M&A activities due to intensifying competition. They tend to explore new business initiatives aggressively as a result of the margin pressure they face, which is coming from heavy spending on content acquisition, and aggressive subsidies to ramp up their user bases and level of user loyalty. Although we expect some margin compression next year, we draw comfort from their strong top line growth and high EBITDA margins, well ahead of US peers.

Alibaba, Tencent and Baidu have a total of USD 2.55bn bonds maturing in 2017 (Baidu: USD 750m/ Alibaba: USD 1.3bn/ Tencent: USD 500m) which will be expected to be refinanced via the capital markets. We also expect Lenovo to tap the USD bond market despite having USD 2.4bn cash on hand. This is due to the USD 1.5bn deferred consideration for the acquisition of Motorola Mobility from Google due in October 2017, as well as its M&A strategy to expand its share in the PC market.

Utilities – Neutral outlook with a constructive bias

Asian utilities have remained stable over the past year thanks to their overall defensive qualities amid concerns about a global economic slowdown and subdued fuel costs. While fuel costs are reversing their downtrend trend, we do not expect prices to reach previous highs. In 2017, we intend to focus on gas and power names that will benefit from a better demand growth outlook, better cost control and management qualities.

Chart 39: China's Natural Gas Consumption Target



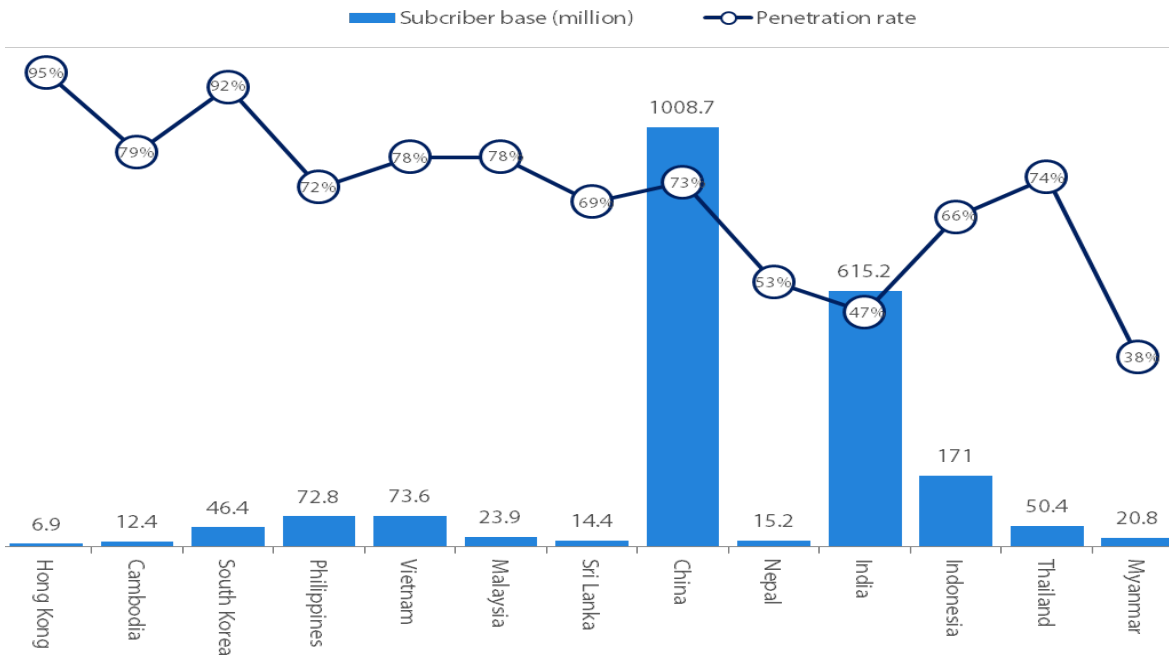
Source: Bloomberg, Nikko AM Asia, as at 14 December 2016

Within the Chinese utilities sector, we prefer the gas and power names which have high recurring income and cash flow visibility for the long term. Moreover, this sector offers some 'shelter' for investors looking for non-commodity related exposure given its relatively clearer earnings visibility leading to a stronger balance sheet. The several reforms being implemented by the government are mostly positive for the sector as they are likely to bring further stability and visibility in the pricing mechanism which currently is approved at each price change. We are also positive on the Indian utilities space, which remains a bright spot thanks to high regulatory certainty, stable cash flows and low non-discretionary capital expenditure.

Telecommunication – Neutral outlook with a slight negative bias

Similar to their global peers, Asian telecom operators should continue to experience rapid growth in data consumption in 2017. This means faster transition from voice to data, accelerating 4G migration, some initial development of 5G, increased smartphone penetration, and more demand for media content. In developing markets such as India, Myanmar, and Philippines, 4G network rollout remains the most important investment. In developed Asian markets such as Singapore, Korea, Hong Kong, the media business is becoming more important to telecom operators as a differentiation factor and driver for data consumption growth. To adjust to the convergence of the telecommunication and media sectors, regulatory bodies in countries including Singapore, Korea, and Australia have formed a single regulator to oversee the two sectors. In 2017, telecom operators in these markets are likely to continue to focus investments on over-the-top (OTT) video services, media contents, IoT, and 5G.

Chart 40: Subscriber and penetration rate by country (2015)

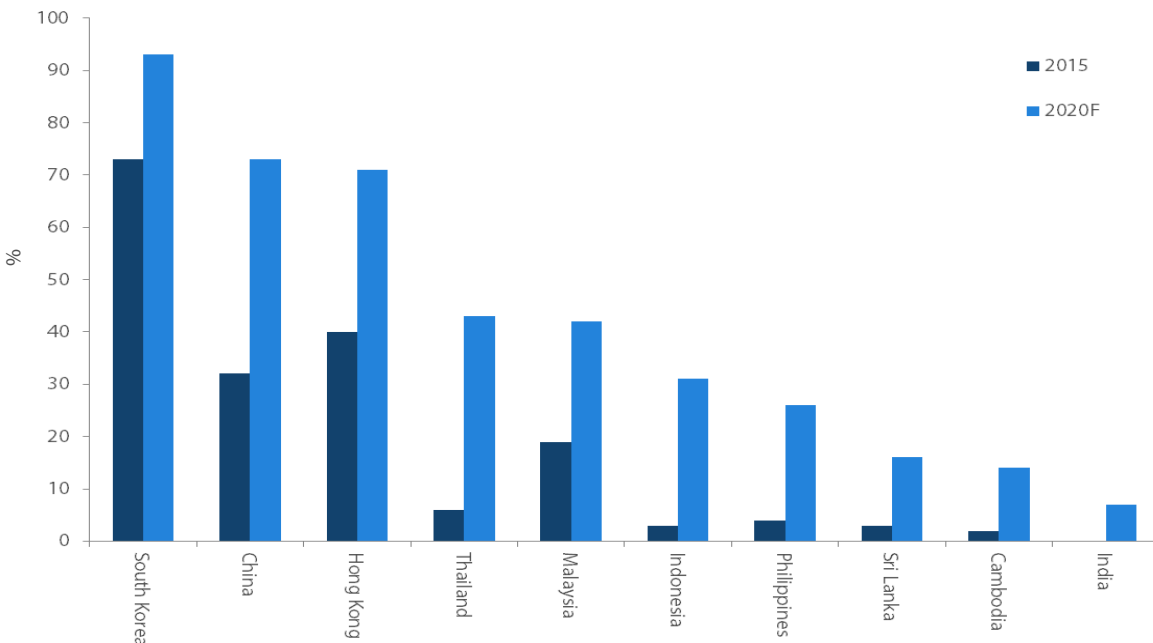


Source: GSMA Intelligence 2016

Overall, credit metrics of Asia-Pacific telecom operators remain largely stable with a slight negative bias, driven by healthy GDP growth and continued expansion of the subscriber base. The negative bias is due to lower operating margin in most markets as a result of the transition from voice to data, high needs for network investment/M&A activities, and rising competition in some markets such as India, Philippines, Singapore and Malaysia. However, major telco players in the region have stable operating cash flow and sufficient financial flexibility to manage their financial leverage. We expect these operators to remain committed to maintaining healthy balance sheets.

Tower operators could continue to benefit from the structural shift from voice to data and the further roll out of 3G/4G networks in Asia. Currently, more than 20% of the Asian population is not covered by a 3G or 4G network. Given the cash generative nature of the tower leasing business, credit metrics of tower operators should be largely stable in 2017. We expect tower operators to fund any tower acquisitions with both debt and equity in order to maintain balance sheet strength.

Chart 41: 4G Coverage by Country

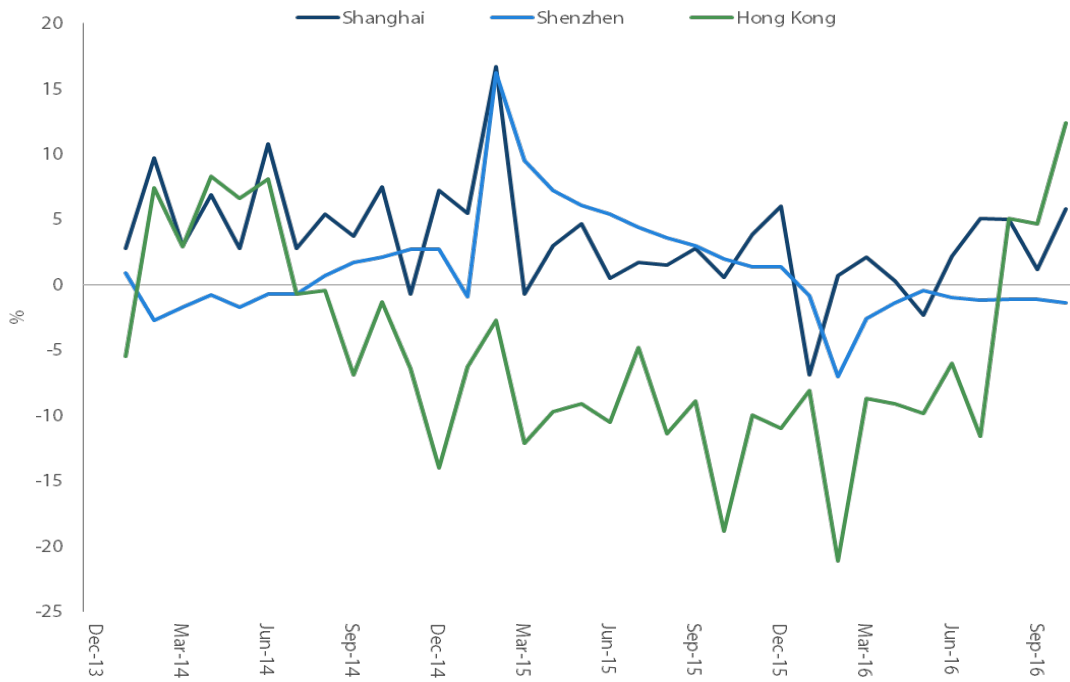


Source: GSMA Intelligence 2016

Transport - Neutral

There have been some early signs of improvement in throughput volume and freight index in 4Q16. Possible drivers for this could be China’s better trade data, integration of major M&A such as CMA-CGM and NOL, restructuring of China Shipping Group and COSCO Group, and reduced supply pressure after the bankruptcy of Hanjin Shipping. However, following Donald Trump’s victory in the US elections, trade protectionism policies could potentially be implemented, and have negative implications for global trade, especially for China and the emerging markets. Overall, we expect moderate revenue growth for port operators as improved trade flows could be moderated by US political risk. Credit metrics should be stable as we expect port operators to further enhance operating efficiency, and reduce capital expenditure. We have a stable view on state-owned infrastructure operators as these credits are more policy-influenced and less affected by economic cycles.

Chart 42: Growth in Container Throughput



Source: Bloomberg, Nikko AM, as at 16 December 2016

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