February 2017

By Koh Liang Choon,
Head of Fixed Income

nikko am
Nikko Asset Management

FROM THE FIXED INCOME DESK

Monthly Outlook

Summary

- US Treasury (UST) yields ended higher in January as weaker-than-expected payroll data led markets to moderate their forecasts for Federal Reserve (Fed) rate hikes in 2017. Overall, 2-year and 10-year UST yields rose about 2 and 1 basis points (bps) respectively in the month.

- The Korean central bank left its policy rate unchanged at 1.25%, but trimmed full-year 2017 GDP forecast to 2.5% from 2.8% citing a slowdown in domestic economic growth. Meanwhile, CPI inflation is expected to rise to the 2% target level by the middle of 2017, owing mainly to an increase in oil prices.

- China's GDP expanded 6.7%, in line with the official growth target. Headline CPI moderated slightly to 2.1% year-on-year (YoY) while PPT rose 5.5% YoY in December, attributed mainly to rising commodity prices. In Singapore, NODX and IP registered strong readings in December.

- Asian credits registered gains in January, as credit spreads tightened. Despite heavy primary supply and higher risk-free rates, Asian high-grade returned 0.76% and Asian high-yield corporates returned 1.32%.

- Meanwhile, the Chinese central bank introduced a temporary 28-day liquidity facility to several large commercial banks and the People's Bank of China (PBoC) increased the six-month and one-year Medium-term Lending Facility (MLF) rates.

- Activity in the primary market picked-up significantly in January following a December lull. For the month, there were 39 new issues amounting to about USD 20.7bn - USD 14.2bn in the high-grade space, and 18 issues amounting to around USD 6.5bn in the high-yield segment.

- We expect Indian and Indonesian bonds and currencies to outperform. Indonesia is supported by attractive carry, improved fiscal outlook and political stability, while a possible credit rating upgrade by Standard & Poor's and higher yields offered by Indian bonds will sustain demand for the space. We are cautious on Philippine bonds, Korean Won (KRW) and Singapore Dollar (SGD). Korea and Singapore will be vulnerable to protectionist trade policies by the Trump administration, given the open and export-oriented nature of their economies.

- Volatility is likely to remain, with the US Fed on a tightening path, uncertainty injected by policies of the new US administration, and risk events including elections in Europe. These factors have driven the direction of UST yields and, with spreads at the tight end of the historical range, we remain cautious. Meanwhile, the supply of new issues is expected to remain heavy in the coming month, although demand for Asian credit appears to be intact.

Asian Rates and FX

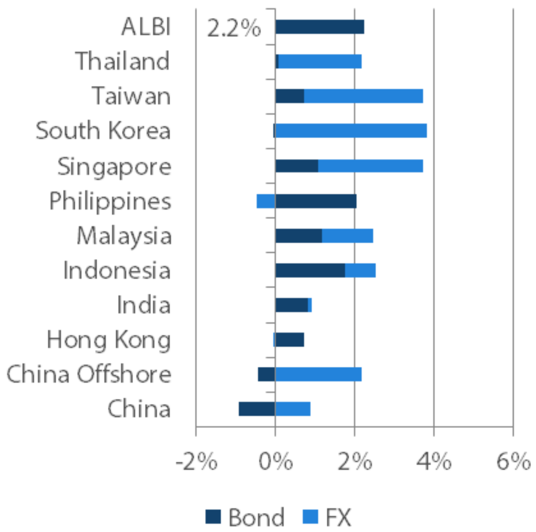
Market Review

- UST yields ended higher in January

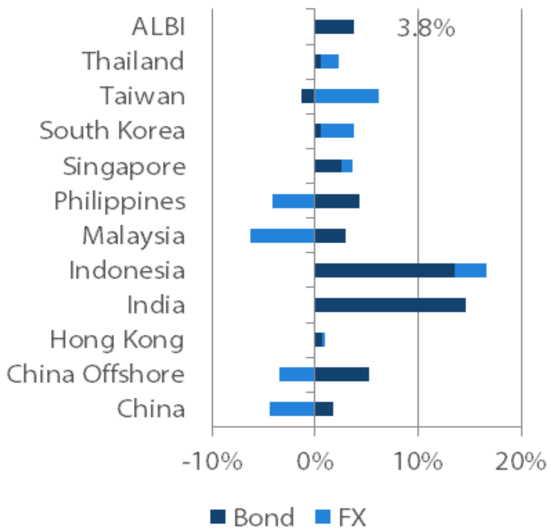
Weaker-than-expected payroll data in early January led markets to moderate their forecasts for Fed rate hikes in 2017. This exerted downward pressure on UST yields as well as the US Dollar (USD). However, yields bottomed mid-month, after Fed Chairperson Janet Yellen commented that "allowing the economy to run markedly and persistently hot would be risky and unwise." Notably, politics took a prominent role in driving market action. US President Donald Trump's view on the USD was echoed by US Treasury Secretary nominee Steven Mnuchin, who said that an "excessively strong dollar" could have a negative short-term effect on the economy. These comments negatively affected demand for the USD and treasuries. Over in Europe, British Prime Minister Theresa May outlined her plan for a definitive break from the European Union, but the Supreme Court ruled that a Parliament approval is needed to trigger Article 50 of the Lisbon Treaty. Overall, 2-year and 10-year UST yields rose about 2 and 1 basis points (bps) respectively in the month.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 31 January 2017



For the year ending 31 January 2017



Note: Bond returns are in local currencies while FX and ALBI returns are in USD. Past performance is not necessarily indicative of future performance. Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 31 January 2017

- Bank of Korea (BoK) trimmed its 2017 GDP growth forecast

The Korean central bank left its policy rate unchanged at 1.25%, but trimmed its full-year 2017 GDP forecast to 2.5% (from 2.8%). The BoK noted that while the slump in exports "has eased", it "judges the pace of domestic economic growth to have slowed somewhat", citing a weaker recovery in domestic demand activities. Nonetheless, the monetary authority expects CPI inflation to gradually rise close to its 2% target level by the middle of the year, owing mainly to an increase in oil prices. For 2017, it projects CPI inflation to register 1.8% (down from 1.9%).

- A further jump in Chinese PPI; Chinese economy grows 6.7% in 2016

In China, headline CPI moderated slightly to 2.1% year-on-year (YoY) in December. Food price inflation came in weaker than the historical average, although non-food price inflation picked up. In contrast, prices at the factory gate surged anew, with PPI rising 5.5% YoY in December, from 3.3% in the previous month. Once again, the jump in PPI was attributed to rising commodity prices. For the whole year 2016, the Chinese economy expanded 6.7% – the lowest since 1990, albeit in line with the official growth target of 6.5-7.0%. Investment was the main drag on the economy, while consumption provided support to overall growth.

- Singapore Non-oil Domestic Exports (NODX) and Industrial Production (IP) readings register strong

Singapore NODX registered another strong reading in December. Exports surged 9.4% YoY – its second consecutive month registering above forecasts. Notably, shipments of petrochemicals surged 28.5%. By destination, exports to China increased by 40%, while those to the US dropped 17%. Similarly, manufacturing output in December surged ahead of expectations, jumping 21.3% YoY. Even after excluding the contribution from biomedical manufacturing – which tends to be volatile – output still recorded a robust 16.1% growth, backed by an almost 50% increase in output from the key electronics cluster.

Market Outlook

- Overweight Indian and Indonesian bonds; cautious on Philippine bonds

2017 is likely to be a year of lower returns and higher volatility for Asian local government bonds. Uncertainties surrounding US policies and concerns about the European Central Bank and Bank of Japan tapering will discourage foreign flows into the region, removing a strong technical support that pushed bond yields lower in the previous year. Inflation is expected to pick up (albeit remaining benign) on account of unfavourable base effects and as China escapes PPI deflation. This makes the case for rate cuts weaker, further limiting the potential upside for bonds.

Within the region, we expect Indian and Indonesian bonds to outperform. The attractive carry offered by Indonesian bonds, and an improved fiscal outlook and firm political stability for Indonesia should be supportive of our view. We also see upside risk to bond prices in the event that a credit rating upgrade by Standard & Poor's materialises. Similarly, higher yields offered by Indian bonds will sustain demand for the space. Meanwhile, we maintain our cautious view on Philippine bonds. Against a backdrop of strong growth and rising inflation, we expect Philippines bonds to underperform. Less favourable base effects from oil prices further heighten inflation risk. We also expect political noise from President Duterte's rhetoric to continue to weigh on investor sentiment towards Philippine assets.

- Prefer IDR and INR; underweight KRW and SGD

We think high carry currencies such as Indonesian Rupiah (IDR) and India Rupee (INR) will continue to outperform amongst Asian currencies. Stable external balances, improved fiscal outlook and political stability had all contributed to the resilience of the IDR and INR. In contrast, we are cautious on the Korean Won (KRW) and Singapore dollar (SGD) as we believe these countries will be vulnerable to any potential protectionist trade policies by the new US administration given the open and export-oriented nature of these economies. Additionally, we expect business sentiments in Korea to be plagued by ongoing political uncertainty.

Asian Credits

Market Review

- A positive start for Asian credits

Asian credits registered gains in January, as credit spreads tightened. Asian high-grade returned 0.76% and Asian high-yield corporates returned 1.32% - decent gains considering heavy primary supply and higher risk-free rates. Meanwhile, growth in headline CPI in the US and Eurozone, and the jump in Chinese PPI, highlighted the emerging upside risks to inflation, supporting the rise in UST yields.

- PBoC introduced a Temporary Liquidity Facility (TLF); raised 6-month and 1-year MLF rates

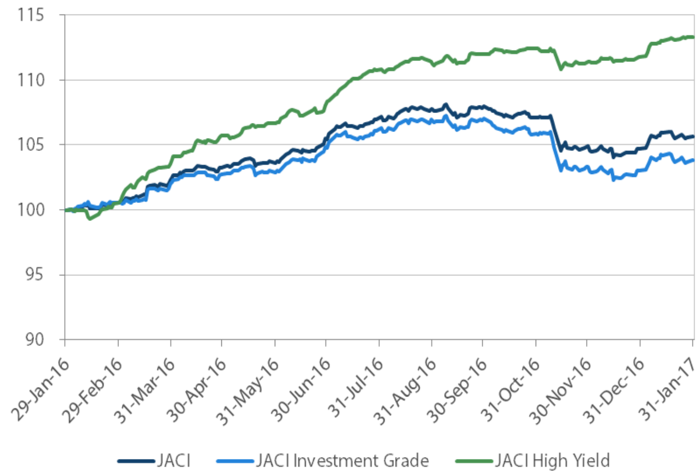
Towards the end of the month, the Chinese central bank introduced a temporary 28-day liquidity facility to several large commercial banks considered to be primary liquidity providers on the interbank market. This was in anticipation of tighter liquidity ahead of the Chinese New Year holidays. A few days later, the PBoC increased the six-month and one-year MLF rates by 10bps each to 3.1% and 2.95% respectively, signaling its intent to keep a tight rein on leverage in the financial system.

- Flurry of primary activity in Asian credits

Activity in the primary market picked-up significantly in January after the December lull. For the month, there were 39 new issues amounting to about USD 20.7bn - USD 14.2bn in the high-grade space, and 18 issues amounting to around USD 6.5bn in the high-yield segment. Overall, there were two sovereign issues - USD 2bn issued by the Philippines and USD 1bn from South Korea. Notably, financial companies such as China Development Bank, Export-Import Bank of Korea and China Huarong International Holdings were some of the heavy issuers in January.

JP Morgan Asia Credit Index (JACI)

Daily returns for the period from 31 January 2016 to 31 January 2017



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 31 January 2017

Market Outlook

- Uncertainty and market volatility expected to pick-up; spreads at tighter end suggest caution

Volatility is likely to remain, with the US Fed on a tightening path, uncertainty injected by policies of the new US administration, and risk events including elections in Europe. The myriad of factors, some conflicting, that have driven the direction of UST yields are expected to remain. These include potentially higher yields due to reflationary policies from the new Trump administration to potentially lower yields from lower growth stemming from protectionist policies. In addition, with spreads at the tight end of the historical range, we remain cautious.

- Supply to pick-up in February after Chinese New Year lull, demand remains intact

The supply of new issues is expected to remain heavy in the coming month, following the Chinese New Year lull in early February. Although the supply of new issues was fairly high in January, the demand backdrop for Asian credit appears to be intact as spreads have broadly tightened. In addition, inflows into emerging market hard currency bonds have started the year on a positive note.

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