



ASIAN FIXED INCOME OUTLOOK

September 2017

Summary

- The US Treasury (UST) market grinded higher in August. Rising tensions in the Korean peninsula and a lack of direction from the US Federal Reserve and the European Central Bank on the outlook for monetary policy put pressure on US Treasury yields.
- Overall, 10-year UST yields ended the month at 2.13%, about 17 basis points (bps) lower compared to the previous month. Asian credits gained in August along with US Treasuries, despite some widening in credit spreads.
- Inflationary pressures within the region remained largely benign in July. India bucked the trend with a consumer price increase of 2.4%, though this was due largely to the unwinding of a favourable base effect. The central banks in India and Indonesia each cut interest rates by 25bps, citing low headline inflation.
- South Korea unveiled its budget for FY18, in which it plans to increase fiscal stimulus to bolster economic growth by creating jobs and stoking domestic consumption.
- China saw a moderation in fixed asset investment growth and housing sales growth. Industrial production was weaker than expected, mainly due to slower output in the mining sector.
- Primary market activity slowed in the Asia credit space. The high-grade space had 15 new issues worth USD 8.25bn in August. Meanwhile, the high-yield space saw 22 new issues amounting to USD 6.51bn.
- The US central bank is expected to announce the timing of its balance sheet reduction in September. While volatility could pick up towards the end of the year, we expect Asian bonds, particularly the high yielders, to remain supported. We continue to favour Indonesia, India and Malaysia bonds.
- On the currency front, we believe that improvement in India's basic balance will continue to be supportive of the INR, while robust economic activity in Malaysia should be positive for the MYR. Conversely, our bearish view on the PHP is anchored on continued current account deterioration.
- While tensions over North Korea are likely to persist, Asian credit spreads are not expected to widen significantly as a military conflict remains unlikely. However, the near-term outlook for Asia credit could be tested by a pick-up in primary activity in the month ahead.

Asian Rates and FX

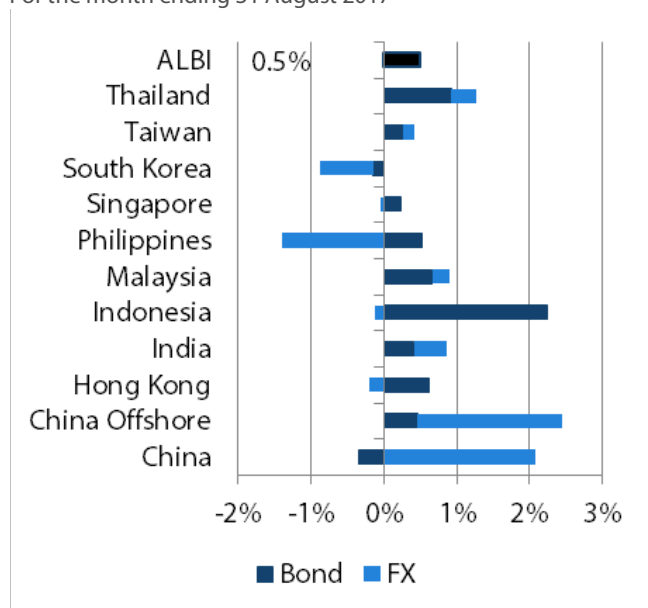
Market Review

US Treasuries rallied in August

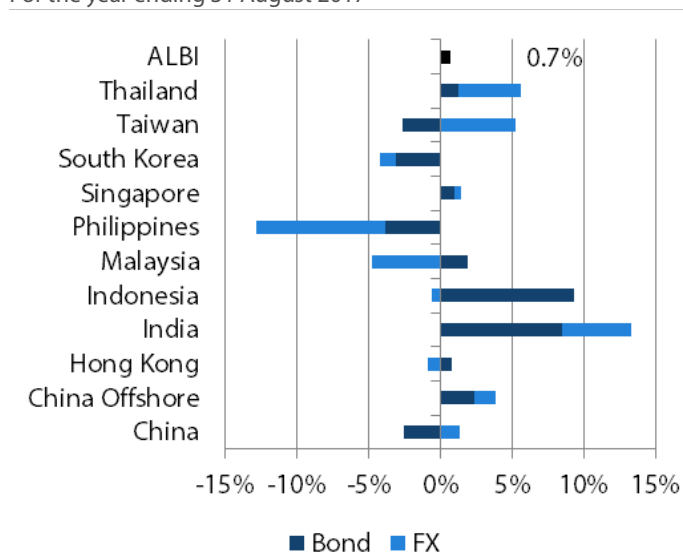
The US Treasury (UST) market grinded higher in the month. The ascent in USTs in the first half of the period was supported largely by rising tensions in the Korean peninsula and a low US inflation print. Investors' flight to quality was briefly interrupted after the US and North Korea mutually scaled down their rhetoric. Markets subsequently remained broadly calm amid debate on the US debt ceiling and tax reform. Towards the end of the month, the focus turned to the annual meeting of central bankers in Jackson Hole, where US Federal Reserve (Fed) Chairperson Janet Yellen and European Central Bank (ECB) President Mario Draghi disappointed markets, as they refrained from providing direction on the outlook for monetary policy. There was a further push lower in yields at month-end, triggered by another missile test by North Korea. Overall, 10-year UST yields ended the month at 2.13%, about 17 basis points (bps) lower compared to the previous month.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 31 August 2017



For the year ending 31 August 2017



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 31 August 2017

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

Inflationary pressures remained benign in July

Regional headline inflationary pressures remained benign in July. PPI inflation in China was unchanged for the third consecutive month, whereas headline CPI dipped, on the back of a lower rate of increase in the prices of nonfood items. Headline CPI in Malaysia fell further, prompted mainly by a decline in the transport component, reflecting lower fuel prices, whereas a significant easing of food inflation was the main driver of the moderation in Indonesia’s annual inflation rate. In Singapore, CPI rose slightly to 0.6% in July, as higher water

tariffs kicked in and prices of clothing and household goods increased. Growth in consumer prices in the Philippines rose, on the back of an increase in transport costs, which was offset in part by a moderation in food inflation. Elsewhere, Thailand’s annual headline inflation picked up slightly, printing 0.17%, but remaining way below the 1-4% target range of the central bank. Meanwhile, consumer prices in India saw a considerable jump to 2.4% in July, although much of the rise in prices was due to the unwinding of a favourable base effect.

Chinese real activity weakened

Following extraordinarily strong performance in June, real activity in China weakened across the board in July. The moderation in fixed asset investment growth was due largely to a deceleration in both manufacturing and property investment. Housing sales growth printed 2.0% year-on-year (YoY) in July, a significant slowdown from the 21.4% YoY growth in the previous month. The softness in the property market similarly affected property related sales and weighed on retail sales growth. Meanwhile, weakness in industrial production was due mainly to slower output in the mining sector.

South Korea unveiled its Fiscal Year (FY) 2018 budget

South Korea’s Ministry of Strategy and Finance unveiled the FY 2018 budget, which sees fiscal revenue and spending rising by 5.7% and 4.6% respectively over the FY 2017 supplementary budget. President Moon’s government is stepping up fiscal stimulus to bolster overall economic growth by creating jobs and stoking domestic consumption. Details of the budget reveal welfare outlays rising by the most on record, while spending for infrastructure, culture and sports have been reduced. Overall, the government estimates the fiscal deficit to register around 2%, with the government debt-to-GDP ratio remaining unchanged at close to 40%.

Market Outlook

Prefer India, Indonesia and Malaysia bonds

The US central bank is expected to announce the timing of its balance sheet reduction in September. Given soft inflation prints, we expect major central banks to normalise monetary policies in a gradual manner, prompting rates to be range-bound. However, we expect volatility to pick up towards the end of the year, on market scepticism of a December rate hike. In the meantime, we expect Asian bonds, particularly the high-yielders, to remain supported. Foreign interest in Indonesian bonds has returned following the correction in early July. Real yields remain attractive compared to regional peers, and monetary policy and inflation are supportive. Moreover, we reiterate that the wider pool of investor interest, as a result of S&P’s upgrade, may potentially translate to lower funding costs for Indonesia in the longer run. We expect demand for Indian bonds to remain supported in the near term, also due to the relatively higher carry. Meanwhile, offshore investor positioning in Malaysian bonds continues to be light relative to historical standards. Inflation appears to have peaked, which could provide further support for the space.

- **Prefer INR and MYR over PHP**

Our preference for the Indian Rupee (INR) and Malaysian Ringgit (MYR) remains. Improvement in India's basic balance will continue to be supportive of the INR, while robust economic activity in Malaysia should be positive for the MYR. Meanwhile, our bearish view on the Philippine Peso (PHP) is anchored on continued current account deterioration. We anticipate the Philippines' trade deficit to be further pressured by import intensive investment and infrastructure growth.

Asian Credits

Market Review

- **Asian credits registered gains**

Overall Asian credits registered another positive month in August, despite some widening in credit spreads, as US Treasuries (UST) grinded higher. Over the month, rising tensions in the Korean peninsula and a lack of direction from the US Federal Reserve and the European Central Bank on the outlook for monetary policy put pressure on US Treasury yields.

- **Monetary authorities in India and Indonesia cut interest rates by 25 bps**

In August, the Reserve Bank of India's monetary policy committee (MPC) lowered its repurchase rate by 25bps, but maintained a neutral stance, suggesting that decision-making remains data-dependent. The central bank cited recent low headline inflation, the moderation in core inflation, a normal monsoon, and the smooth roll-out of the Goods and Services Tax as factors which opened the space for a rate cut. Nonetheless, it maintained its commitment to the 4% inflation target, and expects to inch closer to this by fiscal year end.

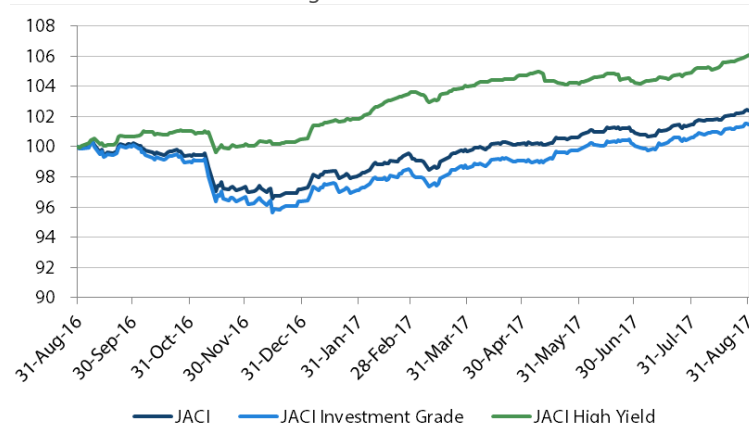
Similarly, in an effort to boost growth, Bank Indonesia (BI) cut its benchmark interest rate by 25bps. According to the central bank, a confluence of favourable factors (including "smaller and later Fed rate hikes", lower than expected inflation and a manageable current account deficit) aligned to support this decision. Notably, BI presented a 2018 inflation target of 2.5-4.5%, lower than the 3-5% in 2017.

- **Primary market activity quieted down**

The primary market remained open, although the pace of issuance moderated from last month. The high-grade space had 15 new issues worth USD 8.25bn in August. Meanwhile, the high-yield space saw 22 new issues (from 18 in July), amounting to USD 6.51bn.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 31 August 2016



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

Market Outlook

- **Upcoming ECB and FOMC meeting keenly watched, outlook for Asia credit could be tested by increased supply**

Key central bank meetings including the upcoming ECB meeting in early September and the US Federal Open Market Committee (FOMC) meeting in mid-September will be keenly watched, with the Fed expected to announce the commencement of its balance sheet reduction programme.

While tensions over North Korea are unlikely to abate anytime soon, Asian credit spreads are not expected to widen significantly as a military conflict remains highly unlikely. However, the near-term technical outlook is clouded by a pick-up in primary activity in the month ahead as more companies exit their earnings reporting black-out period. This could test the demand technicals from continued regional demand for USD Asian credit and positive flows into emerging market (EM) hard currency bonds. Within China, where most of the issuance is expected, higher onshore bond yields and the RMB appreciation over the course of the year could erode some onshore interest in offshore USD Chinese credits.

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