By Koh Liang Choon,
Head of Fixed Income

nikko am
Nikko Asset Management

ASIAN FIXED INCOME OUTLOOK

October 2017

Summary

- US Treasuries declined in September, prompted by the possibility of a rate hike by the Federal Reserve in December and Trump's tax reform bill being passed by Congress.

- Continued tensions in the Korean peninsula weighed on sentiment. Overall, 10-year UST yields ended the month at 2.33%, about 22 basis points (bps) higher compared to end-August. Asian credits registered a slight loss, despite some tightening in credit spreads.

- Inflationary pressures in the region edged slightly higher in August, with the exception of Indonesia. Bank Indonesia cut its key policy rates by 25bps for a second consecutive month, while other regional monetary authorities left interest rates unchanged.

- Meanwhile in China, the People's Bank of China removed the reserve requirement for FX forwards trading and adjusted the reserve requirement for offshore banks' onshore RMB deposits.

- In addition, S&P lowered China's sovereign rating to 'A+' from 'AA-', changing the outlook to 'stable' from 'negative'. The downgrade is the second by an international ratings company this year.

- Primary market activity picked up in September. The high-grade space had 31 new issues, while the high-yield space saw 23 new issues. Chinese issuers dominated the space, as companies rushed to issue before the Chinese Golden Week holiday in the first week of October.

- The normalization of monetary policy tools and increasing possibility of a US tax reform bill is likely to place further pressure on long duration positions in the markets. With a pick-up in volatility expected, we see Indian, Indonesian and Malaysian bonds outperforming regional peers. Meanwhile, we hold a cautious view on Korean bonds.

- On the currency front, we are likely to see continued support for the Malaysian Ringgit while our preference for the RMB is reinforced by China's strong current account surplus. In contrast, we remain bearish on the PHP and KRW.

- Into the final quarter of 2017, we can expect returns, especially from high-grade, to be driven by the direction of UST yields. That said, credit spreads are likely to be range-bound as catalysts remain limited with valuations remaining expensive. Spreads could remain at the tighter end of the historical range, with fundamentals still sound across most of Asia.

Asian Rates and FX

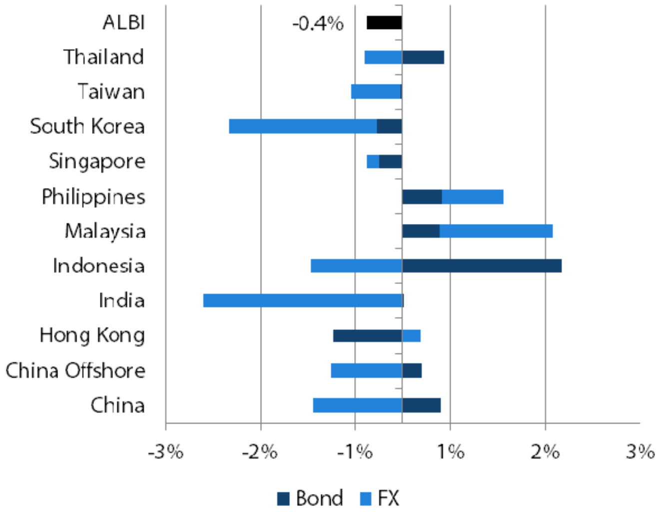
Market Review

- US Treasury (USTs) yields rose in September

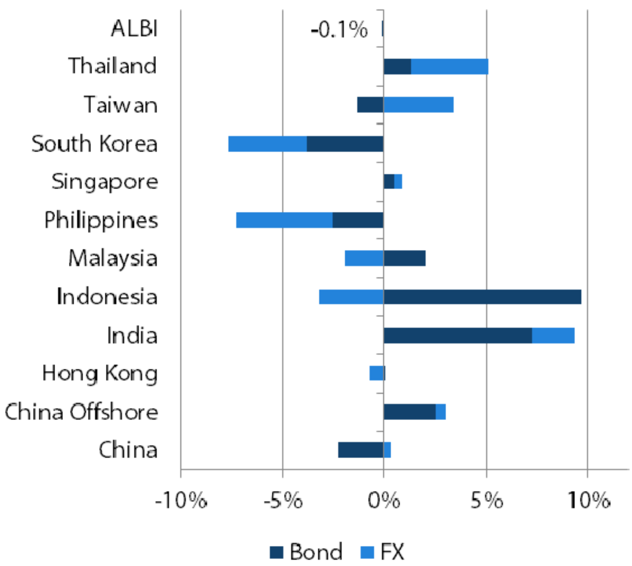
Following initial concerns over tensions in the Korean peninsula, markets quickly shifted focus to macroeconomic data, prompted by a stronger-than-expected US August core inflation reading. The latter, coupled with anticipation of the Federal Open Market Committee (FOMC) meeting, pushed a steady rise in UST yields. The US Federal Reserve (Fed) left interest rates unchanged and confirmed it would begin shrinking its bond portfolio in October. More importantly, it left open the possibility of raising short-term interest rates again in December, with Fed Chairperson Janet Yellen declaring the US economic recovery to be "on a strong track." Towards the end of the month, the sell-off in USTs picked up pace. Political developments pointed to an increasing possibility of US President Trump's latest tax reform bill being passed by Congress, prompting expectations of higher economic growth and inflationary pressures. Overall, 10-year UST yields ended the month at 2.33%, about 22 basis points (bps) higher compared to end-August.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 September 2017



For the year ending 30 September 2017



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 September 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 edged higher in August

Inflationary pressures in the region edged slightly higher in August. The rise in headline CPI in Malaysia was prompted mainly by a faster pace of increase in transport and food costs. In the Philippines, the rise in food, utilities and transport inflation was also the driver of the higher headline CPI reading in August. Thailand's annual headline consumer prices rose for a second straight month, albeit still remaining way below the central bank's 1-4% target range. Meanwhile, India's headline CPI continued its uptick for the second straight month, on the back of a jump in vegetable prices. In contrast to the rest of the region, Indonesia's headline inflation reading in August eased somewhat. Food inflation was stable, while the pick-up in transport inflation was offset by lower housing, clothing and healthcare inflation.

- Bank Indonesia (BI) cut rates anew; other regional monetary authorities leave interest rates unchanged

The Indonesian central bank eased again in September, cutting its key policy rates by 25bps for a second consecutive month. BI cited that inflation has surprised to the downside, and said that it expects the recent rate cuts to "improve the recovery in the domestic economy". Meanwhile, other regional central banks left interest rates unchanged. The Bangko Sentral ng Pilipinas sees current policy settings as "appropriate", and said that domestic demand remains "firm". It maintained its 3.2% inflation forecasts for both 2017 and 2018. In Malaysia, the central bank remained on hold, albeit saying that it expects 2017 GDP growth to likely be stronger than it had earlier expected. Bank Negara Malaysia noted that the strong export sector could boost domestic demand. Despite this, it sees core inflation being contained.

- China removed reserve requirement for FX forwards trading

Effective 11 September, financial institutions were no longer required to put aside reserves when buying dollars for clients through currency forwards. The rule, imposed in October 2015, was introduced to stem depreciation pressure in the currency. In addition to this, the People's Bank of China (PBoC) also adjusted the reserve requirement for offshore banks' onshore RMB deposits, allowing the latter greater flexibility to move their RMB funding between on- and offshore markets. These policy refinements, announced ahead of the 19th Party Congress in October, prompted markets to expect a potential acceleration of FX reforms in China, working eventually towards a free-float.

Market Outlook

- Prefer India, Indonesia and Malaysia bonds over Korean bonds

We expect volatility to pick up towards the end of the year, prompted by a rise in financial markets' sensitivity to well-flagged market events (such as the US Fed rate hike and balance sheet reduction, and European Central Bank's (ECB's) tapering of its quantitative easing (QE) programme). We expect the Fed to conduct another 25bps hike, and foresee the ECB communicating plans with regard to QE tapering in the remaining months of 2017. Going forward, the intention of central banks to normalise monetary policy tools, despite lingering debate about the 'transitory' nature of recent soft inflation prints, could weigh on already stretched bond price valuations. In addition, the increasing possibility of a US tax reform bill being passed in the fourth quarter is likely to place further pressure on long duration positions in the markets, as expectations for stronger growth and inflation escalate. Under such a backdrop, we see Indian, Indonesian and Malaysian bonds outperforming regional peers, given their historically lower correlation to US Treasuries. Meanwhile, we hold a cautious view on Korean bonds, as persistent geopolitical risk is likely to further dampen sentiment towards the space.

- Prefer MYR and RMB over KRW and PHP

Malaysia's growth has been surprising on the upside. Moreover, the country has been attracting greater foreign direct investment, which, together with the liberalisation in hedging regulations, are likely to continue to support positive sentiment towards the Malaysian Ringgit (MYR). Our preference for the RMB is reinforced by China's strong current account surplus. Moreover, the potential inclusion of Chinese rates into global bond indices should sustain demand for the currency. In contrast, although there have been signs of improvement in the Philippines' current account and trade numbers of late, we maintain that the outlook for the country's current account position continues to be weak, on the back of massive medium term infrastructure spending plans. Meanwhile, the ongoing tension in the Korean peninsula is likely to prompt further weakness in the South Korean Won (KRW) on outflows from the country's securities markets.

Asian Credits

Market Review

- Asian credits ended lower

In September, overall Asian credits registered a slight loss, as a 7bps tightening in credit spreads was not enough to buffer the rise in UST yields. Expectations of tax reform in US and monetary tightening by the Fed prompted a sell-off in USTs. Asian high-grade returned -0.16%, while Asian high-yield corporates returned 0.51%.

- Standard & Poor's (S&P) downgrades China's credit rating

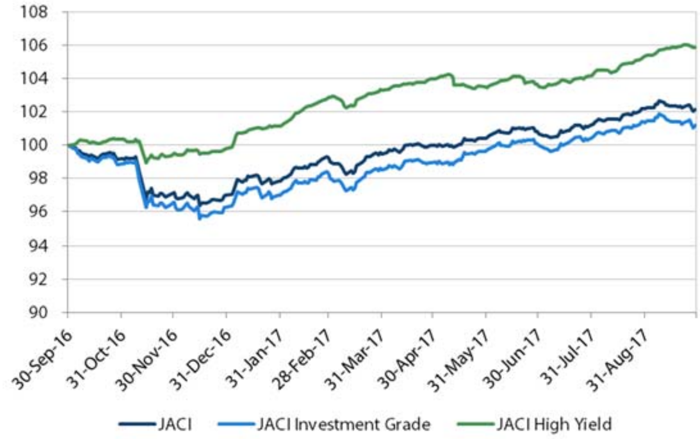
S&P lowered China's sovereign rating to 'A+' from 'AA-', changing the outlook to 'stable' from 'negative'. The downgrade is the second by an international ratings company this year. Moody's had cut China's debt rating one notch lower in May. S&P said that the move reflected increased economic and financial risks in China, following a "prolonged period of strong credit growth". Consequently, it also made adjustments to ratings and/or outlooks of a number of Chinese issuers. However, the impact of the rating downgrade on credit spreads was muted.

- A pick-up in primary market activity

Primary market activity picked up in September. The high-grade space had 31 new issues worth USD 15.8bn, while the high-yield space saw 23 new issues amounting to USD 15.6bn including the massive USD 7.25bn issue from Postal Savings Bank of China. Chinese issuers dominated the space, as companies rushed to issue before the Chinese Golden Week holiday in the first week of October.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 September 2016



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

Market Outlook

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

Asian credit spreads continued to tighten in face of a more hawkish US Fed, uptick in UST yields, tensions over North Korea, and a heavy issuance pipeline. Into the final quarter of 2017, returns, especially from high-grade, are likely to be driven by the direction of UST yields. While data has shown limited signs of inflation picking up, a swifter progress for US President Trump's tax reform bill and a more hawkish Fed could test the "lower-for-longer" view. Credit spreads are likely to be range-bound as catalysts to drive spreads significantly tighter remain limited with valuations remaining expensive. However, spreads could remain at the tighter end of the historical range with fundamentals still sound across most of Asia.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.