ASIAN RATES AND FX OUTLOOK 2019

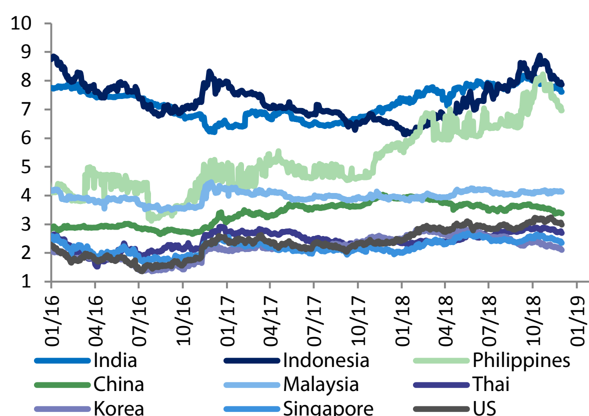
2018 Market Review

2018 turned out to be a year of high volatility for global rates markets, with US Treasury (UST) yields rising about 55-96bps[1] across the curve. The year opened with a steep rise in risk-free rates, prompted by optimism in the global economy, with positive macro news from both developed and Emerging Markets (EM) fueling expectations that global growth could remain well above trend. Subsequent firmer inflation readings triggered heightened expectations that the US Federal Reserve (Fed) could accelerate monetary policy tightening. Fears of swifter global liquidity withdrawal, together with a steep rise in oil prices, triggered outflows from EM assets including Asia. Current account deficit countries such as India and Indonesia felt the brunt of the pressure, prompting Bank Indonesia to raise its policy rates by a total of 175bps[1] to date, as it moved to contain capital outflows amid a significantly weaker rupiah. The Bangko Sentral ng Pilipinas similarly hiked rates by equal measure in the year, although the aggressive move was driven principally by the need to rein in rising inflationary pressures.

US trade policy took center stage in 2018, with the world's largest economy getting embroiled in a tit-for-tat trade battle on several fronts. Notably, US President Trump's hard line stance on trade was most pronounced against China, with the US president at one point threatening to impose tariffs on all Chinese imports. The two countries reached a temporary truce in November, although the longer term outlook remains uncertain. In addition to rising trade tensions between the two countries, there were concerns that China's deleveraging efforts have started to tighten financial conditions onshore and thus further weigh on domestic growth, particularly on the investment and consumption fronts. With the domestic slowdown looking to be worse than expected, Chinese policymakers started rolling out easing measures (both monetary and fiscal). These included cuts to banks' reserve requirement ratios, calls from policymakers to increase credit supply and cut financing costs, a softening in regulations governing the shantytown renovation programme, as well as cash injection by the central bank via its Medium-term Lending Facility (MLF).

Against such a backdrop, Asia's growth moderated across much of the region, primarily due to weakness in the external front, while inflationary pressures, save for the Philippines, remained largely contained. Overall, Asian local government bonds recorded negative returns, with the Markitt iBoxx Asian Local Currency Bond Index (ALBI) registering losses of 1.93%[1] in USD unhedged terms. Meanwhile, the US Dollar enjoyed broad-based strength against most regional currencies, as US growth remained robust in the face of trade tensions taking root. On a total return basis, China outperformed regional peers. Chinese policymakers' firm resolve to abandon the deleveraging campaign and ease financial conditions was the main driver of gains in Chinese Government Bonds (CGBs). In contrast, the Philippines markedly underperformed. Sentiment towards bonds were dampened by the jump in inflationary pressures, while the country's weak current account position suppressed demand for the peso.

Chart 1: 2018 10-year Benchmark Yields, Returns and FX Returns



	iBoxx ALBI Indices	Currencies vs. USD
ALBI Index	**-1.93%**	**-4.78% (ADXY)**
China	7.56%	-6.52%
Hong Kong	-0.02%	-0.14%
India	5.83%	-8.21%
Indonesia	-2.24%	-5.13%
Korea	5.41%	-4.47%
Malaysia	3.44%	-3.29%
Philippines	-6.71%	-4.82%
Singapore	0.18%	-2.50%
Thailand	0.26%	-0.93%

Source: Bloomberg, as of 30 November 2018.

[1] As at 30 November 2018.

2019 Outlook

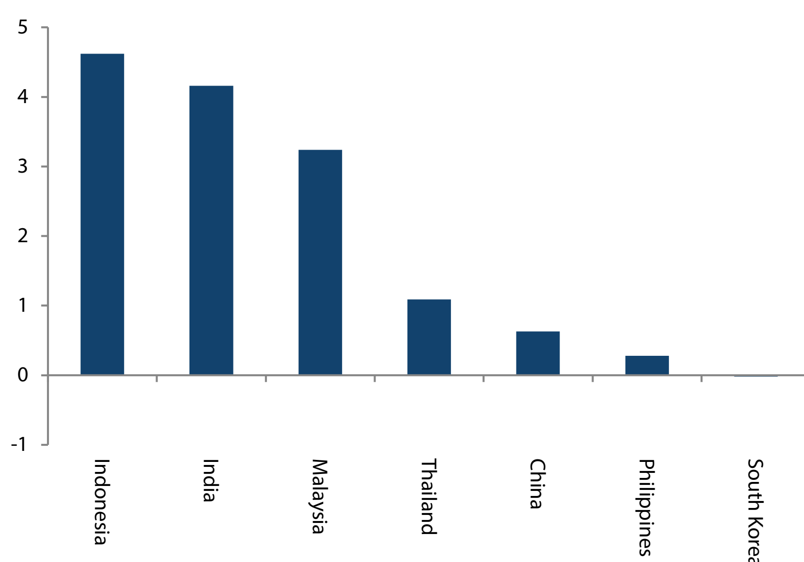
Global growth is expected to grind lower in 2019, with continued monetary policy normalization in developed markets being the key headwind for the world economy. Financial conditions will tighten further as the Fed continues its gradual increase in interest rates, with one more hike this December, followed by one to two hikes next year. This, in our view, should move rates to a 'neutral' setting. Meanwhile, the European Central Bank (ECB) is also expected to end its asset purchase programme in December 2018.

In Asia, next to rising funding costs, ongoing trade tension between US and China pose the biggest downside risk to regional growth. That said, we believe that the 90-day truce called by Trump and Xi at the recent Buenos Aires G20 meeting is positive for both sides reaching further agreements, thereby reducing chances of further escalation in trade tensions. However, we are mindful that key issues such as intellectual property protection, cyber theft and forced technology transfer, continue to weigh on the dynamics. Consequently, we foresee difficult negotiations ahead, and the uncertain longer term outlook will continue to impact on trade and investment decisions. Within Asia ex-China, protectionist trade policies will continue to be a primary drag on growth for open economies such as South Korea, Singapore and Hong Kong. Positively, concerns over hard-landing for Chinese growth could subside, as authorities are increasingly aware of the extent of onshore pessimism and are responding more firmly via fiscal and liquidity support.

We expect Fed expectations to remain the primary driver of UST moves in 2019. Given our Fed forecast, we anticipate some downward pressure on the short-end of the UST yield curve. Meanwhile, continued unwinding of the Fed's balance sheet will also put a floor on long-end yields. We forecast 10-year UST yields to trade between 2.8-3.2% in the first quarter of 2019. Overall, we expect inflationary pressures in the US to subside, as wage pressures ebb and commodity prices are capped by a soft-landing of the Chinese economy. Within Asia, we hold constructive views on Chinese, India and Indonesia government bonds going into 2019, and have a less sanguine view on South Korea government bonds. We expect demand for Chinese bonds to be sustained by the gradual deceleration in Chinese growth. Potential inclusion into the Bloomberg Barclays Global Aggregate Index and/or FTSE Russell indices should provide another tail wind for Chinese bonds. Meanwhile, demand for India and Indonesia bonds is likely to get a boost as market focus turns to the attractive real yields offered in the space. In contrast, expensive relative valuations of South Korea bonds will drag on sentiment. On currencies, we maintain that broad USD strength will remain, at least in the first quarter of 2019, driven by lingering Sino-US trade uncertainties and Fed policy normalization. Among Asian currencies, we anticipate regional FX markets to focus on the possibility of the RMB breaching past 7 against the USD. Our preference is for currencies backed by sustained current surplus such as the Thai Baht and Singapore Dollar.

The key downside risks to our investment thesis are: worse-than expected Chinese economic slowdown and greater stress in its financial system, contagion risks from weakness in other emerging markets, and a faster-than-expected pace of US rate hikes.

Chart 2: Asian Real Rates (%) - 5-Year yields vs. CPI



Source: Bloomberg, as of 30 November 2018.

Individual Country Outlooks

China

Chinese economic growth is poised to slow further in 2019, prompted largely by the lagged effect of credit tightening. However, we hold the view that the economy will avert a hard landing, as authorities have begun to recognize the degree of pessimism within the real economy and the onshore financial markets. In the meantime, the trade ceasefire with the US agreed during the G20 summit, has reduced the urgency for China to introduce large scale fiscal measures. Nonetheless, the Politburo's recent declaration of the need for timely measures to counter growing downward economic pressure, signals that the government stands ready to roll out significant fiscal and liquidity support for the economy. Meanwhile, monetary policy has clearly shifted towards an easing bias.

We expect the recent rebound in inflation to be temporary and expect overall inflationary pressures to remain manageable in 2019, on the back of our expected moderation in growth. This, together with supportive monetary policy from the PBoC, should put a cap on interbank rates and limit the rise in government bond yields that may result from an increase in the fiscal deficit. Potential inclusion into the Bloomberg Barclays Global Aggregate Index and/or FTSE Russell indices should provide another tail wind for Chinese bonds. On the other hand, keeping onshore rates low in the face of continued US rate hikes could intensify the depreciation bias on the Renminbi (RMB). Moroever, markets are likely to use the RMB as the proxy for success or failure of trade negotiations between China and the US, suggesting that the USDCNY pair could "test" the 7.0 level should talks fail.

South Korea

We see a significant risk of a moderation in South Korea's GDP growth in 2019. The economy is highly dependent on trade with both the US and China. Consequently, increased trade uncertainty puts downward pressure on South Korea's economic growth. Another risk to GDP growth next year stems from the possible end of the semiconductor industry 'super-cycle', amid growing concern over memory chip oversupply. The housing market will continue to slow down, as the government's focus on curbing rising house prices should continue to discourage home-building. Meanwhile, the labour market continues to be weak, with recent jobs data coming in extremely soft. The latter has since prompted President Moon to replace the finance minister and policy chief for failing to deliver on the growth agenda of creating jobs and improving income inequality. However, these twin objectives are inherently conflicting in an economic downturn, shifting the burden to the Bank of Korea, where the governor and Monetary Policy Committee (MPC) members have started to dither on their views regarding further policy normalization.

In November, the Bank of Korea raised its policy rate by 25bps, as it prioritized narrowing the gap between its seven-day repo policy rate and the Fed funds rate, despite mounting downside pressure on the economy. We expect the central bank to stay on hold for a prolonged period following this move.

Given Korea's high economic dependencies on both the US and China, it is more vulnerable - vis-à-vis regional peers - to a further escalation of the US-China trade war. Moreover, moderation in geopolitical risks on the Korean Peninsula has largely been priced in by markets. These factors tempers support to the Korean Won. Hence, we enter 2019 taking a cautious view on the currency, as we see considerable risk of it underperforming regional peers. Similarly, we have a neutral call on Korean bonds, on the back of relatively expensive valuations.

Malaysia

2019 is likely to be a year of fiscal repair and moderating growth for Malaysia. Although private consumption should be supported by higher minimum wages, investment will be subdued. The new government's decision to rationalise spending, and in turn suspend and/or cancel several large infrastructure projects will cut public investments next year. Softer growth would also be partly due to the lacklustre performance of commodity markets, especially for crude palm oil. These could be somewhat offset by increased private business spending resulting from the return of about MYR 37bn in tax refunds to businesses over 2 fiscal years. Meanwhile, some upward pressure on inflation could arise from factors including the return to more market-based fuel pricing, the higher taxes on sweetened beverages and a low base effect. Nonetheless, overall inflation pressures are still likely to remain benign, due to the anticipated growth slowdown. We currently see the current growth-inflation balance to be stable and expect Bank Negara Malaysia to remain on hold in the first half of 2019.

We enter 2019 with a neutral view on Malaysian rates and the ringgit. Although slower growth and relatively attractive real rates (on much lower recent inflation) should be supportive of bonds, there are risks to the government's fiscal position in the form of off balance sheet liabilities that have only recently been fully accounted for. The recently announced Budget 2019 under the new administration raises concerns about potentially higher deficit and hence bond supply next year as the government attempts a soft landing. Likewise, the ringgit's outperformance against regional peers has mostly reversed on concerns over the tighter deficit/debt headroom. Much depends on the new administration maintaining the confidence of consumers and investors on medium term sustainability, a tough balancing act.

Singapore

The Monetary Authority of Singapore's (MAS) latest macroeconomic assessment was cautiously optimistic notwithstanding rising US protectionist trade policies identified as the primary risk to Singapore's 2019 growth outlook. The longer term outlook remains uncertain despite the 90-day truce called by Trump and Xi at the recent Buenos Aires G20 meeting. Domestically, growth has broadened beyond the 2016 export-driven spike. Greater growth is expected from modern services and the digital/tech sectors which bodes well for long term sustainability. Core inflation should stay robust in the near term after edging close to the 2% level in recent months. Inflationary pressures will be supported by continued strength of the labour market as well as hikes in administered prices. However, an expected slowdown in economic growth and moderation in global energy prices could limit upside of the core index in the coming year, whereas policymakers' efforts to curb speculation in the property market could also weigh on the headline number.

We head into 2019 looking to be more opportunistic in our positioning, targeting specific value points on the curve while avoiding large over- or underweights. The next main shift in policy expectations has begun with a more tentative Fed moving long end yields lower. We do still expect Singapore Government Securities (SGS) yields to continue to track UST yields, especially on the short-end. The long-end of the curve could continue to sell off less than the equivalent UST due to strong domestic growth and flush liquidity. As core inflation prints remain elevated, the MAS is likely to tighten its FX policy further, allowing the Singapore Dollar to continue being attractive against its regional peers. We do not expect significant outperformance, however, as the worsening external outlook will firmly temper any upside for the region. This is in spite of the temporary truce in the US-China trade dispute, which postpones a wider ranging and more permanent agreement.

Thailand

Similar to other regional economies, GDP growth in Thailand is likely to moderate in 2019. Growth in exports is already projected to fall from 2018's blistering pace. Nonetheless, domestic growth could be supported by upbeat consumer sentiment and the public infrastructure development programme. The military government's focus on infrastructure upgrades within the Eastern Economic Corridor (EEC) special economic zone has attracted interest from both domestic and foreign investors.

The implementation of sustainable, long-term development spending is highly dependent on elections that Thai junta leader and Prime Minister General Prayuth expects to be held by February 2019, or May 2019 "at the latest". The conduct and outcome of the elections are the largest uncertainty for 2019 but we believe that a clean election, and consequently, a genuine return to democracy, would be positive for sentiment and the economy. However, we highlight that the absence of a specific poll date means that there remains significant risk of a delay, as election timelines have been announced thrice before and eventually pushed back.

Inflation is likely to stay below the central bank's target range, as growth moderates. The Bank of Thailand has been forthright about the need to build up policy space and to reduce financial stability risks brought about by the prolonged period of low interest rates, leading us to believe that a rate hike may be imminent (probably as early as December 2018). However, given subdued growth prospects, the central bank will likely be on a prolonged pause after that.

We hold a neutral view on Thai bonds going into 2019 despite BoT's normalisation push. Bond supply dynamics are positive, as net supply is expected to decline in Fiscal Year 2019, largely due to higher redemptions. However, real rates are still relatively less attractive versus peers after many years of BoT accommodation. Meanwhile, with elections still a key unknown, we head into 2019 with a neutral view on the Baht. Beyond that, we are constructive on the prospects of the Baht, due to Thailand's large and stable current account surplus which has plumped up the country's sizable FX reserves.

India

In 2019, the economy is likely to continue to register robust growth, helped in part by increased expenditure by the central government ahead of the general elections in April/May, and an improving investment climate. Meanwhile, we think inflation has peaked in India, as food price inflation is likely to moderate/remain stable. Nonetheless, we anticipate the headline number to remain close to 4% on a year-on-year basis. Hence, in the absence of a seasonal shock to food prices, we expect the Reserve Bank of India to maintain its monetary policy unchanged.

We enter 2019 with a constructive view on Indian bonds. With the central bank likely to stay on hold, market focus will turn to the attractive real yields offered in the space. Meanwhile, the Indian Rupee will continue to be sensitive to big moves in oil prices and equity flows, and could see a pick–up in volatility on heading towards the general elections due in April/May 2019. On the latter, we expect the current ruling party to remain in power, albeit possibly with a slimmer majority.

Indonesia

For 2019, GDP growth is likely to moderate, as Bank Indonesia's (BI) cumulative 175bps rate hikes this year filters through the broader economy. Moreover, the postponement/cancellation of some investment projects point to domestic investment likely being sluggish in the coming year. Despite these factors, we expect growth to remain firm. Government policies to keep inflation stable and provide targeted assistance to households, together with election-related spending ahead of the April presidential elections, are likely to support private consumption.

We expect inflation to remain fairly anchored next year, given the pre-emptive hikes taken by BI. Improvement in the government's efforts to enhance food supply management across the country will also ensure that inflation remains manageable in the coming year. Against such a backdrop, our base case is for the Indonesian central bank to leave interest rates unchanged in 2019, barring a further sell-off in Emerging Market currencies.

Politics have started to take the spotlight as campaigning for the presidential elections in April 2019 has gone full swing. We expect the elections to be relatively uneventful, with President Joko Widodo being re-elected for a second term.

We hold a constructive view on Indonesian bonds going into 2019. Relatively stable inflationary pressures, coupled with a central bank likely to stay on hold, will boost demand for Indonesian bonds as markets' focus turns to the attractive real yields offered in the space. Meanwhile, we expect the rupiah to stabilise, as introduction of the domestic non-deliverable forward (DNDF) market, together with adjustments made to control import goods consumption, are poised to take external pressure off the currency, barring renewed pressure on EM assets.

Philippines

Growth momentum in the Philippines is expected to stay strong, with public investment in infrastructure poised to accelerate. Thus we expect the current account to continue to post deficits on the back of rising imports of capital goods. Although this points to domestic investment needs continuing to outstrip savings in the next few years (the Duterte administration's 'Build, Build, Build' progamme and Development Plan spans 2017-2022), the country anticipates realizing revenue streams from these investments in the future, which should be positive for real GDP growth in the medium term. Separately, private consumption may soften in 2019 due to recent buildup of inflationary pressures. However, we expect election-related spending (mid-term elections are due in May 2019) to offset part of this.

On inflation, we see scope for moderation (especially in the second half) next year, largely due to positive base effects, given the significant rise in inflationary pressures in 2018. That said, the BSP still forecasts inflation to remain above target next year. Indeed, domestic demand continues to be firm and this, coupled with a weak peso, points to risks to the inflation outlook leaning on the upside. However, our base case is that the central bank will refrain from further aggressive tightening next year, and believe that it is likely at or near the end of its hiking cycle, unless an external shock triggers further rise in inflationary pressures.

We hold a neutral view on bonds going into 2019. Although we see inflation expectations adjusting lower in the coming months, this will likely be offset by higher supply risk to finance the ongoing fiscal spending. Meanwhile, we anticipate the Philippine Peso to weaken anew in 2019, as risk of continued deterioration in the current account persists on the back of the infrastructure build-out.

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