June 2016

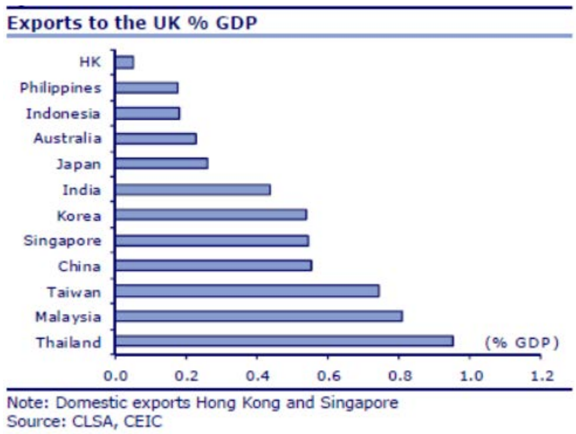
BREXIT - ASIAN FIXED INCOME UPDATE

The immediate fallout from the Brexit win has been a strong flight to safety. US Treasuries rallied with the UST 10-year yield down to 1.44%, lower by 31 basis points (bps) on 27 June 2016. Asian currencies also weakened with broad US dollar strength (the Korean won was the weakest with a decline of -2.70%)[1]. Most Asian local currency bonds strengthened in line with US Treasury movements, except for high beta countries like Indonesia. In Asia high grade credit, a modest widening in spreads was offset by a sharp decline in US Treasury yields. Asian high yield credit was impacted more than high grade, but the overall impact was still muted when compared to the sell-off in equities and currencies.

1) Asia Macro

UK impact on Asia - As the exit process would take two years, growth outlook uncertainty in the UK and the Eurozone could impact Asian economies as well. The economic impact would depend on how exposed the country is to the UK and to the Eurozone. Asian export exposure to the UK is low, so the direct impact of weaker UK growth would be low as well. Thailand has the highest UK export exposure in Asia, yet its exports to the UK account for less than 1% of GDP, as shown in Chart 1. From an export competitiveness perspective, Asian exports are different from the UK, so a weaker GBP would not significantly impact Asia's export competitiveness.

Chart 1: Asia's export exposure to the UK



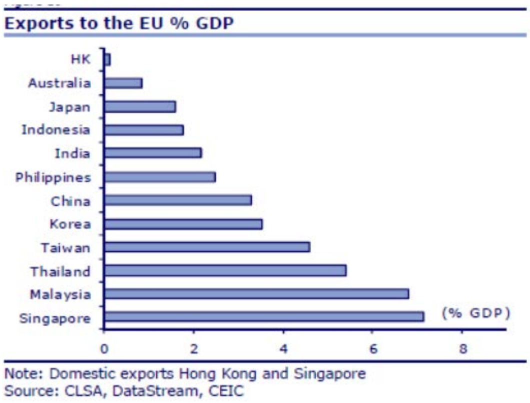
Source: CLSA, 24 June 2016

Eurozone impact on Asia - On the other hand, the exit of the UK would have an impact on the Eurozone. As Asian trade is higher with Europe, Asian exports could be impacted by weaker EU economy and also by a weaker Euro. The most exposed economies include Taiwan, Thailand, Malaysia and Singapore.

[1] Source: Bloomberg, June 2016.

Uncertainties in political developments in the region could lead to further market volatility with concerns about other EU countries calling for an exit from the Eurozone, as well as possible calls for independence within the UK (e.g. Scotland). Uncertainties surrounding when the UK will start the exit process and during the exit negotiations could also lead to market volatility / risk aversion episodes, impacting Asian markets as well. This volatility could dampen consumer sentiment and subsequently impact Asian growth. But from an asset allocation perspective, Asian credit may viewed as a safe haven within the Emerging Markets credit universe.

Chart 2: Asia's export exposure to the EU



Source: CLSA, 24 June 2016

Asia monetary policy - Also, with the US Fed policy rates lower for longer, the potential for further rate cuts from regional central banks increases. Countries like China, South Korea, India, Indonesia, Malaysia, and Thailand may cut rates further to support the economy from the potential impact from Brexit.

2) Asian Local Currency Markets

Asian government bonds ended mostly higher, following the lead of US Treasuries. The sell-off in regional equities following UK's vote to leave the EU benefited bonds in general. The market's defensive positioning led higher beta bonds such as Indonesia to underperform, amid relatively light trading. Increased supply as a result of a scheduled auction also affected Indonesian bonds. The flight to safety also meant a strong US dollar. Asian currencies weakened with broad US dollar strength.

Table 1: Market Performance between June 24 to 27 – Asian Local Currency Bonds and FX

	iBoxx ALBI Local Indices	Currencies vs. USD
China	0.04%	-1.00%
Hong Kong	0.62%	-0.05%
India	0.29%	-1.02%
Indonesia	-0.90%	-0.77%
Korea	0.89%	-2.70%
Malaysia	0.07%	-2.02%
Philippines	0.42%	-1.40%
Singapore	0.70%	-1.87%
Thailand	0.60%	-0.62%

Source: Markit iBoxx, Bloomberg, 27 June 2016

The direct impact to Asian markets has been mainly from a risk aversion perspective. With the upcoming uncertainty, we expect the US Fed to further delay its rate normalization cycle. Similarly, Asian rates in the region will be supported with country-specific factors dominating further in terms of direction for interest rates. The low-for-longer rates has provided room for Asian central banks to ease monetary policy and should be positive for bonds. On the other hand, US dollar strength has led to weakness in Asian FX and could be exacerbated by further capital outflows leading to currency weakness. Currency weakness could be mitigated by the slower US Fed hiking cycle. The impact on the Chinese bond and currency markets were in line with the impact in other Asian countries – bonds were well supported while the currency weakened.

3) Asia Credit Markets

The overall market reaction in Asian credits was modest from a spread movement perspective. Spread widening in Asia credits was more than offset by the rally in risk-free rates with Asia Investment Grade managing positive returns. Asia Investment Grade credit spreads were generally wider by around 5 to 20bps following the Brexit vote. As shown in the table below, benchmark IG spread widened about +14bps but yields still declined by 9bps between June 24 and 27, 2016. Total return performance during the same period was 0.63%.

Table 2: Market Performance between June 24 to 27 – Asian Credit

	Returns (%)	Yield to Maturity change	Spread (SOT) change	Yield to Maturity (Jun 27, 2016)	Spread (SOT) (Jun 27, 2016)
Asia Credit – IG	**0.63%**	**-12 bps**	**+14.1 bps**	**3.61%**	**227 bps**
Asia Credit – Non-IG	**-0.27%**	**-1 bp**	**+25.3 bps**	**6.91%**	**564 bps**

Source: Bloomberg, JPMorgan & Nikko AM, as at 27 June 2016.

The direct impact to Asian credit, with the exception of a small number of corporates, is likely to be limited. Even for corporates in this category, any rating pressure is unlikely to be immediate. The potential indirect impact is likely to be from general risk aversion, USD strength with weaker Asian currencies and lower commodity prices, and weaker growth over the medium-term.

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