By Koh Liang Choon,
Head of Fixed Income

nikko am
Nikko Asset Management

FROM THE FIXED INCOME DESK

Monthly Outlook

Summary

- USTs weakened further in December, as caution prevailed following the November sell-off. As widely expected, the US Federal Reserve (Fed) raised interest rates by 25 basis points (bps). 10-year UST yields ended the month at 2.44%, about 6 basis points (bps) higher compared to end-November levels.

- South Korean lawmakers voted to impeach President Park Geun-hye following months of uproar over influence-peddling accusations. The next presidential election was originally scheduled for December 2017, but is now likely to be held much earlier.

- China's PPI surged in November, largely on the back of rising commodity prices. Consumer inflation also rose, led by higher food and household goods prices. Meanwhile, the fall in China's foreign exchange reserves accelerated.

- The Indian and Indonesian central banks kept their interest rates on hold, on the back of benign inflation. The Bank of Thailand also maintained its interest rate, citing improvements in exports and consumption as likely to offset softer tourism and private investment.

- The Asian credit market ended December mixed. Asian high-grade declined, underperforming high-yield which gained 0.28% as high yield was less impacted by the increase in US treasury (UST) yields.

- The month saw a lower volume of new deals given the usual lull into year-end. There were 10 new issues – amounting to USD 5.4bn – in the high-grade space. However, primary activity for high-yield remained active with 18 new issues amounting to USD 4.8bn.

- We continue to favour Indian and Indonesian bonds and currency. Carry levels are still attractive for Indian bonds and there remains potential for further rate cuts. Similarly, Indonesian bonds stand to benefit from relatively higher carry amid benign inflationary pressures. Stable external balances, improved fiscal outlooks and political stability have all contributed to the resilience of the IDR and INR. In contrast, we expect Philippine bonds, the KRW and SGD to underperform.

- Volatility is likely to persist, with the US Fed on a tightening path, uncertainty surrounding the policies of the new US administration, and risk events including elections in Europe. Returns for Asian credit are likely to be subdued in 2017. While gross supply is expected to be higher in 2017, net supply is likely to come in lower than in previous years given sizeable bond maturities.

Asian Rates and FX

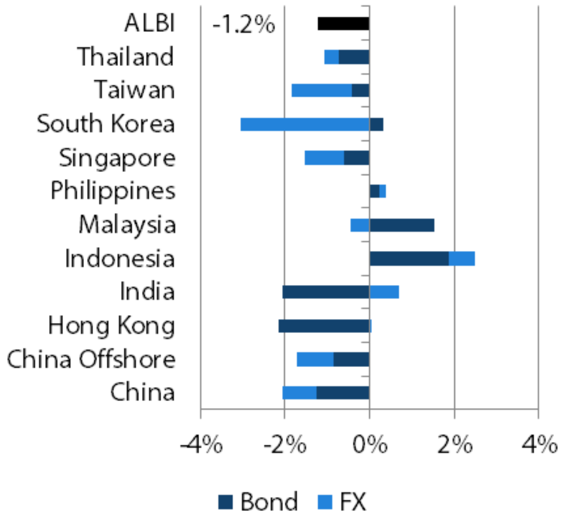
Market Review

- US Treasuries (USTs) ended lower in December

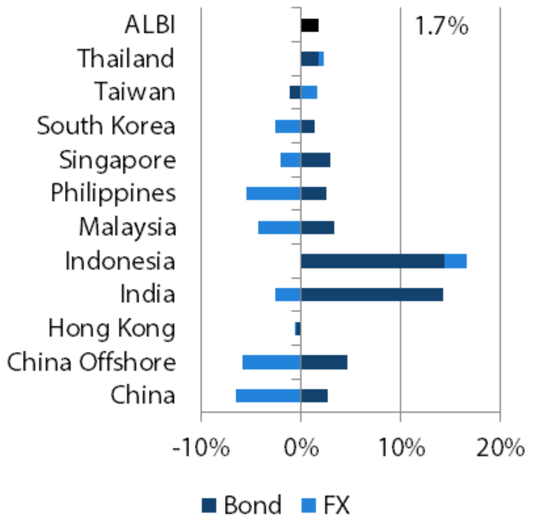
USTs weakened further in December, as cautiousness prevailed following the big sell-off in November. As widely expected, the US Federal Reserve (Fed) raised interest rates by 25 basis points (bps). On top of this, it revised its projection for rate hikes in 2017 to three quarter-point rises from the previous forecast of two. Demand for the USD rose following the perceived "hawkish" Fed signal. Meanwhile, oil prices jumped, after global oil producers agreed to cut their output to reduce oversupply. Overall, 10-year UST yields ended the month at 2.44%, about 6 bps higher compared to end-November levels.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 31 December 2016



For the year ending 31 December 2016



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 December 2016

- **South Korean legislators voted to impeach President Park Geun-hye**

Following months of uproar over influence-peddling accusations, South Korean lawmakers voted overwhelmingly to impeach President Park Geun-hye. Prime minister Hwang Kyo-ahn has, effective immediately, become the nation's acting president, while the Constitutional Court decides whether Ms. Park stays in office. The deliberation could take up to six months. The next presidential election was originally scheduled for December 2017, but is now likely to be held much earlier.

- **China's PPI jumped in November; foreign reserves declined anew**

China's PPI surged 3.3% year-on-year (YoY) in November, following a 1.2% rise in October. Much like the previous month, higher prices at the factory gate were prompted mainly by rising commodity prices. Meanwhile, consumer inflation picked up for a third consecutive month, on the back of higher food and household goods prices. In particular, fresh vegetable prices climbed almost 16% YoY. Meanwhile, the fall in China's foreign exchange reserves accelerated in November. Reserves shrank by USD 69.1bn to USD 3.05tr – the largest monthly fall since January. During the month, the People's Bank of China and National Development Reform Commission warned of "irrational investment" in foreign assets such as properties and hotels.

- **Reserve Bank of India (RBI) left interest rates unchanged**

In December, the RBI's monetary policy committee voted unanimously in favour of keeping policy rates unchanged. However, the Indian central bank provided a boost to liquidity by announcing that the 100% incremental cash reserve ratio (CRR) requirement it imposed last month will be withdrawn. Commenting on the demonetisation exercise, the RBI believes that the impact on growth and inflation will only be for a transitory period. It retained its baseline CPI inflation projection for March 2017 at 5%, noting that risks are tilted to the upside. The Fiscal Year 2017 Gross Value Added (GVA) growth projection was, however, sharply lowered from 7.6% to 7.1%.

- **Bank Indonesia maintained interest rates**

Bank Indonesia (BI) left interest rates unchanged in December. The central bank maintained its 2016 GDP growth projection at 5%, and sees end-2016 inflation settling at 3-3.2%. Notably, BI mentioned that "earlier easing moves [are] enough to support GDP", suggesting that the monetary authority is likely to leave rates unchanged for a while. Separately, trade data for November was robust. Exports jumped 21.3% YoY, led by improvement in non-oil & gas exports. Import growth similarly increased sharply. Consequently, the trade surplus narrowed to USD 0.8bn in November, from USD 1.2bn in the previous month.

- **Bank of Thailand kept policy rates unchanged**

In its last policy meeting of 2016, Bank of Thailand voted unanimously to keep its policy rate unchanged at 1.5%. The monetary policy committee highlighted that "the Thai economy would continue to expand at a pace close to the previous assessment, but downside risks have increased." The central bank seems less concerned on the domestic front, citing improvements in exports and consumption as likely to offset softer tourism and private investment. Also, the central bank expects inflation to gradually rise and return to its target band within 1Q 2017. The inflation target for 2017, which was approved by the cabinet on 20 December, is 2.5% with a band of +/-1.5%.

Market Outlook

- Overweight Indian and Indonesian bonds; cautious on Philippine bonds

The demonetisation exercise in India has led to a surge in banking system liquidity. This has pushed Indian bonds to rally, despite the sell-off in global bonds following the US elections. In spite of these gains, carry levels remain attractive. We believe there is scope for Indian bonds to outperform on an intra-Asia basis in 2017, as we think there is still room for the RBI to cut rates if needed given benign inflation. Similarly, our preference for Indonesian bonds is grounded on relatively higher carry against a backdrop of a more credible fiscal outlook and still benign inflationary pressures. Meanwhile, we have a cautious view on Philippine bonds, which could underperform against a backdrop of strong growth and rising inflation. Also, we 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 the Indonesian Rupiah (IDR) and Indian Rupee (INR) will continue to outperform their Asian counterparts. Stable external balances, improved fiscal outlooks and political stability have 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. Also, we expect business sentiment in Korea to be plagued by ongoing political uncertainty.

Asian Credits

Market Review

- A sell-off in Asian credits

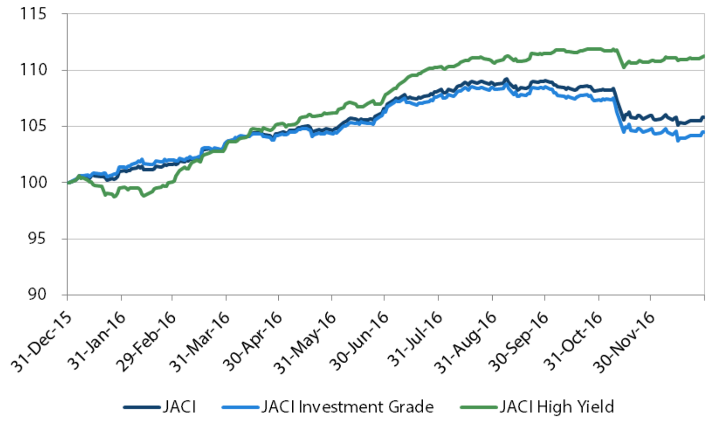
The Asia credit market provided mixed returns in December. Asian high-grade lost 0.3% underperforming high-yield which gained 0.28% as high-yield was less impacted by the increase in US treasury (UST) yields. While spreads remained range-bound for the month, UST yields continued rising. UST yields rose after the European Central Bank (ECB) surprised the markets by announcing that it will reduce asset purchases from Euro 80bn to Euro 60bn a month starting in April 2017, although the programme will be extended to December 2017. USTs further sold off after the US Federal Reserve (Fed) announced its second rate hike in two years during its December meeting, and surprised markets with 3 rate hikes projected for 2017.

- China to focus on stability in 2017

After its three-day Central Economic Work Conference, the Chinese government announced that it would prioritise stability in 2017 while continuing with supply-side structural reform with proactive fiscal and prudent monetary policies. It warned of continued overcapacity issues and the build-up of financial risk including sharply rising property prices.

JP Morgan Asia Credit Index (JACI)

Daily returns for the period from 31 December 2015 to 31 December 2016



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 31 December 2016

- Slower primary market activity within investment grade space

The month saw a lower volume of new deals given the usual lull into year-end. There were a total of 10 (compared to 16 last month) new issues – amounting to USD 5.4bn – in the high-grade space. This includes the USD 3.5bn 3 tranche Indonesian sovereign issuance. However, primary activity for high-yield remained active with 18 new issues amounting to USD 4.8bn in the month.

Market Outlook

- Rates volatility to continue but total returns for the year likely to be positive

Volatility is likely to remain, with the US Fed on a tightening path, uncertainty surrounding the policies of the new US administration, and risk events including elections in Europe. Returns for Asian high-grade and high-yield are likely to be subdued in 2017 reflecting the likelihood of less accommodative US monetary policy, potential outflows from emerging markets and current valuations which appear relatively expensive from a historical standpoint. For Asian high-grade credits, bond carry will dominate returns as some spread widening with rising UST yields will weigh on total returns. For Asian high-yield corporates, the higher carry from high-yield should mitigate the potential spread widening and rise in risk-free rates. Both Asian high-grade and high-yield corporates are expected to provide low single-digit returns in 2017.

- Supply to pick up in 2017

The supply of new issues is expected to remain heavy in the coming month as issuers attempt to issue before the Chinese New Year holidays, especially if they expect risk-free rates to move higher in the near term. Overall, while gross supply is expected to be higher in 2017, net supply is likely to come in lower than in previous years given sizeable bond maturities.

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.

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

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.

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).