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ASIAN FIXED INCOME OUTLOOK

July 2017

Summary

- US Treasury (UST) yields were range-bound for the most part of June, before surging in the last few days of the month. The US Federal Reserve (Fed) raised interest rates by 25 basis points (bps), despite soft inflation data. Overall, 10-year UST yields ended the month at 2.30%, about 10 bps higher compared to the previous month.

- The Indian central bank kept its interest rates unchanged in June, but lowered its forecasts for inflation and growth for the fiscal year. Meanwhile, headline CPI inflation declined to a record low of 2.18% year-on-year in May, driven by softer food prices.

- In a landmark step for China's integration into the global financial system, index provider MSCI announced the inclusion of Chinese stocks in its global benchmark equity index.

- Overall, Asian credits registered gains in June. Carry was the key contributor to returns, as US yields climbed. Asian high-grade returned 0.26%, while Asian high-yield corporates returned 0.04%.

- China's banking regulator reportedly stepped up scrutiny of firms which have recently expanded aggressively into overseas markets, dampening sentiment towards Chinese high-yield names.

- The number of new deals jumped in June, with the pick-up concentrated in high-yield. There were 21 new issues worth around USD 10.3bn in the high-grade space, while the high-yield space saw 29 new issues amounting to USD 17.1bn.

- The Fed's inclination to stay on a gradual tightening path should be supportive of high yielders such as Indonesian and Indian bonds. S&P's upgrade of Indonesia reaffirms positive sentiment towards Indonesian bonds and may potentially translate to lower funding costs. Liberalisation in hedging regulations and lower political risk in Malaysia have also resulted in increased flows into the country. Meanwhile, we remain cautious on Philippine bonds. On the currency front, Indonesian Rupiah (IDR) and Indian Rupee (INR) are expected to outperform while the rally in Malaysian Ringgit (MYR) is expected to continue. Conversely, the narrowing current account surplus is likely to drag on the Philippine Peso (PHP).

- Volatility in UST yields has increased, on the back of the hawkish tilt of recent statements made by a number of key central bankers. However, continued regional demand for USD Asian credit and positive flows into emerging market (EM) hard currency bonds should support the market.

Asian Rates and FX

Market Review

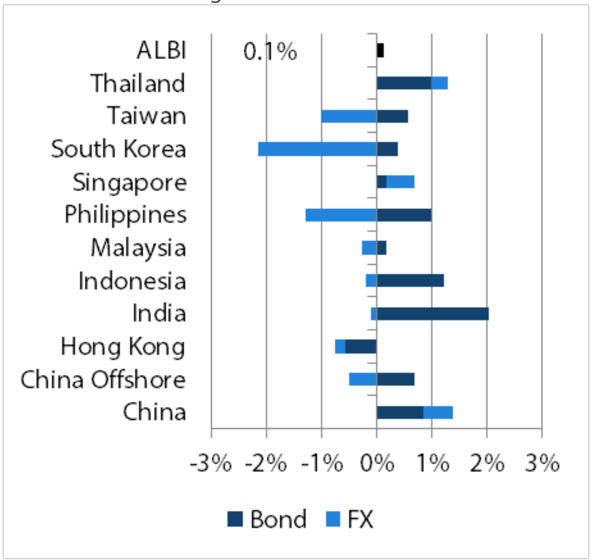
- US Federal Reserve raised interest rates

US Treasury (UST) yields were trading range-bound for the most part of June, before surging in the last few days of the month. Political news in the US and the surprising results of the UK general election at the start of the period had a minor impact on markets. The US Federal Reserve (Fed) subsequently raised interest rates by 25 basis points (bps), despite soft US inflation data. Details of its balance sheet normalisation plan were provided, with Fed Chairperson Janet Yellen saying that the process could start "relatively soon".

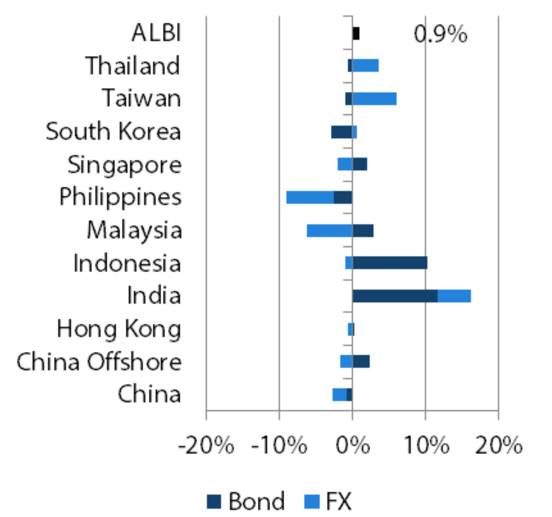
Meanwhile, oil prices fell sharply, as fears of oversupply escalated amid a significant increase in Libya's oil production. Towards the end of the month, yields surged, prompted by comments from European Central Bank (ECB) President Mario Draghi suggesting that the ECB could be ready to reduce its bond-buying programme. Overall, 10-year UST yields ended the month at 2.30%, about 10 bps higher compared to the previous month.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 June 2017



For the year ending 30 June 2017



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 June 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.

- Reserve Bank of India (RBI) revised inflation and growth outlooks lower

The Indian central bank kept interest rates unchanged in June, but lowered its forecasts for inflation and growth prints for the Fiscal Year (FY). The RBI now expects inflation for the first half of FY2018 (which ends in March next year) to register 2.0-3.5%, from an earlier forecast of 4.5%. For the second half of the same FY, it sees inflation printing between 3.5-4.5% (from 5%). It also slightly lowered its expectation of FY2018 gross value added (GVA) growth to 7.3% from 7.4%. The minutes of the RBI meeting revealed that although most members of the monetary policy committee acknowledged the benign inflation outlook, a majority is uncertain of its sustainability. Meanwhile, headline CPI inflation declined to 2.18% year-on-year (YoY) – the lowest on record - in May, with the moderation driven mainly by continued softening in food prices.

- China to sell USD government bonds; MSCI adds A-shares to global benchmark equity index

China's Ministry of Finance announced that it will be selling RMB 14bn worth of CNH bonds and RMB 2bn worth of USD denominated bonds in 2017. Half of the planned Dim Sum bonds will be offered in the first half, with the remainder to be sold in the second half of the year. Issuance of USD denominated bonds – the first since 2004 - will be conducted in the latter half of 2017. Meanwhile, global index provider MSCI announced that it would include Chinese stocks in its global benchmark equity index for the first time – a landmark step for China's integration into the global financial system. MSCI cited improved accessibility of the China A-share market as a result of the stock connect programme, as well as the easing of pre-approval requirements for index-linked investment products, as factors for its decision.

Market Outlook

- Prefer Indian, Indonesian and Malaysian bonds; cautious on Philippine bonds

The Fed's inclination to stay on a gradual tightening path should be supportive of risk assets while capping the pace of increase in UST yields. Positive flows into emerging market bonds are likely to persist, as UST yields remain largely range-bound. Against such a backdrop, we foresee high yielders like Indian and Indonesian bonds outperforming. The upgrade on Indonesia by S&P gives it a full-investment grade rating. This will reaffirm positive sentiment towards Indonesian bonds, and may potentially translate to lower funding costs for the country in the longer run. We are cognizant that positioning is already heavy, but expect supportive macro and global liquidity conditions to continue to sustain demand.

In contrast, offshore investor positioning in Malaysian bonds is very light, following the exodus of funds after the US elections. Of late, there has been a turnaround in the flow picture for Malaysian assets, which we expect to persist for a while. Recent liberalisation in hedging regulations as well as lower political risk in Malaysia will help improve sentiment towards Malaysian bonds. Meanwhile, our cautious view on Philippine bonds remains. Against a backdrop of strong domestic demand, there is a risk of a further acceleration in inflation. This will negatively affect demand for Philippine bonds.

- Prefer INR, IDR and MYR; cautious on PHP

We maintain that high carry currencies such as the IDR and INR will continue to outperform among Asian currencies. Both countries have attracted greater foreign direct investment, resulting in marked improvement in their basic balances. Moreover, monetary authorities in both countries have built back their reserves, and are in a better position to manage currency volatility. The MYR in particular has rallied strongly, and we see it continuing to play catch-up to earlier gains in Asian FX. As mentioned, political risk in Malaysia has fallen. This, together with strong economic activity, should further support demand for the currency. Meanwhile, the narrowing current account surplus is likely to drag on the PHP.

Asian Credits

Market Review

- Asian credits ended higher in June

Overall, Asian credits registered another positive month in June. Carry was the key contributor to returns, as US Treasury (UST) yields climbed. Asian high-grade returned 0.26%, while Asian high-yield corporates returned 0.04%. The underperformance of Asian high-yield was prompted by weaker commodity prices, continued concerns about the implications of China's financial deleveraging, and heavy supply within the space.

- CBRC stepped up scrutiny of select companies; South Korea announced a KRW 11tn supplementary budget

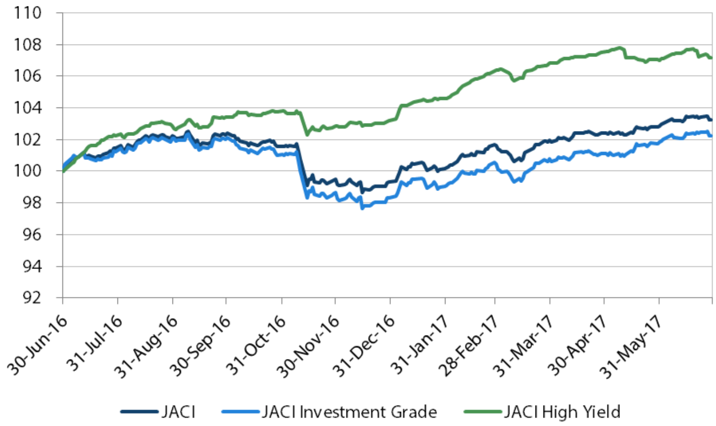
The China Banking Regulatory Commission (CBRC) reportedly increased its scrutiny of Chinese firms which have aggressively expanded into overseas markets in recent years. According to reports, policymakers requested that some banks provide details of overseas loans made to companies including Dalian Wanda Group, Anbang Insurance Group, and Fosun International. The news dampened sentiment towards Chinese high-yield names, causing spreads to significantly widen. Meanwhile, South Korean President Moon Jae-in proposed a KRW 11tr supplementary budget. Notably, the bulk of the package is allocated to increasing employment within the public and social services sectors, as the president tries to deliver on his key election promise of creating more than 800,000 public sector jobs.

- A jump in primary market activity

The month saw a jump in the number of new deals, with the pick-up concentrated within high-yield. There were 21 new issues worth around USD 10.3bn in the high-grade space. Meanwhile, the high-yield space saw 29 new issues amounting to USD 17.1bn. This included large multi-tranche issues from Chinese property companies China Evergrande and Kaisa Group Holdings. Evergrande raised USD 6.62bn (with USD 3.8bn for refinancing) and Kaisa raised USD 3.5bn (with USD 2.7bn for refinancing).

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 June 2016



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

Market Outlook

- Focus on China deleveraging and treasury volatility to dictate returns

Volatility in UST yields has increased, on the back of the hawkish tilt of recent statements made by a number of key central bankers. This could potentially lead to some market volatility. In addition, with the deleveraging process ongoing in China, the rise in onshore yields has made offshore USD China credit yields less compelling than before. This, along with the recent appreciation in the RMB, could also dampen some demand for USD credits if expectations for continued RMB depreciation are tempered.

- Demand for Asia credit to remain supportive but supply could weigh on technicals

However, continued regional demand for USD Asian credit and positive flows into emerging market (EM) hard currency bonds should support the market. For high-yield, in particular China property, after the heavy issuance from Evergrande and Kaisa, it may take some time before technicals in this space stabilise.

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