

# Asian Fixed Income

## Monthly Commentary

December 2011

### Indices Performance Table

	30/11/2011	1M (US\$)	3M (US\$)	YTD (US\$)
JPM Asian Currency Index (ADXY)	115.84	-1.08%	-3.18%	-0.53%
HSBC Asian Local Bond Index (ALBI)	238.15	-2.42%	-4.02%	4.21%
JPM Asian Credit Comp Index (JACI)	151.49	-0.83%	-1.41%	3.20%
MSCI Asia Pacific ex Japan Equity Index	392.97	-8.13%	-10.37%	-17.94%
US Treasury 10-Year (bps)	2.07	5	-16	-123
Oil	100.36	7.69%	13.01%	9.83%

Source: Bloomberg

### Economic & Market Overview

Asian currency markets weakened in November, as the deepening European debt crisis further challenged sentiment, while Asian equity markets sold off by almost 5%. However, in general, volatility was more notable in the non-Asian emerging market currencies. In Europe, Italian 10-year yields rose above 7%, while a weak German bond auction and sovereign debt downgrades for Belgium, Hungary and Portugal compounded contagion worries. Across the Atlantic, US politicians failed to agree on spending cuts. Elsewhere in Asia, the focus continued to shift from inflation to growth risks and the potential for monetary easing. At the month-end, major central banks coordinated efforts to enhance their capacity to provide liquidity to the global financial system.

Third-quarter Asian growth numbers were mixed, with exports reflecting weaker external demand but consumption resilient though with downside risks. China's growth moderated to 9.1% year-on-year in the third quarter from 9.5% in the previous three months. Industrial output and new orders declined in November, reflecting domestic weakness even as export orders continued to grow. India also saw growth slacken as industrial production cooled, although the services sector outperformed.

Singapore's non-oil domestic exports posted the sharpest decline in more than two years in October, as slowing external demand hurt electronics shipments. The government expects economic growth to decelerate to 1%-3% next year from 5% this year. Similarly, Philippine exports fell by a greater-than-expected 27% in September, leading to weaker-than-anticipated third-quarter GDP growth. There was also softer-than-expected growth in Thailand, compounded by the recent floods, with October's production contracting by 36%. In contrast, continued steady growth in

Indonesia and Malaysia underscored the strength of their domestically oriented economies.

Meanwhile, the pace of monetary easing accelerated as central banks in Indonesia and Thailand cut interest rates by 50 bps and 25 bps respectively. Significantly, China's 50 bps cut in the reserve requirement ratio at the month-end signalled the end of the tightening stance, as inflation eased to 5.5% in October from 6.1% in September. Elsewhere, however, the Bank of Korea maintained a tightening bias, though it softened its tone. Wholesale price inflation stayed elevated in India, driven by food and fuel costs, but there was evidence of an easing of pricing pressures.

#### **Asia Dollar Credit**

Asian credit markets were similarly challenged in November, with the JP Morgan Asia Credit Index falling by 0.83% as most of the widening in spreads occurred in the first week of the month. In the cash market, liquidity remained thin and the performance of bonds was volatile. Some selling from non-Asian accounts persisted, given the uncertainty in the European political outlook. Investment-grade bonds outperformed high-yield bonds, with high-yield corporates underperforming the most. Sector-wise, industrials as well as financials and oil and gas lagged, while at the country level, China, India and Sri Lanka were the worst performers. Despite the fragile sentiment, there were five new issues totalling US\$3.85 billion, comprising three investment-grade bonds by Bank of China, Korea Finance Corporation and Doosan, and two high-yield bonds by the Indonesian government and Indonesian state-owned utility PLN.

#### **Currencies**

Asian currencies remained under pressure, given continued external uncertainty and the sell-off in regional equity markets. The rupee's weaker fundamentals drove its underperformance.

It fell to an all-time low of 52.73 before recovering to end the month 6.7% weaker against the dollar. The ringgit, rupiah and won also lagged. In contrast, the yuan and baht were more stable owing to support from policymakers. Asian currencies saw better performance against the euro, given its 3% sell-off against the US dollar.

#### **Local Currency Government Bonds**

Local currency bond markets were well supported as sentiment shifted from inflation and policy normalisation, to a focus on growth risks and potential policy easing. Chinese bonds outperformed the rest of the region with 2-year yields falling 40 bps and the 2-year to 10-year curve steepening by 25 bps. The Korean curve performed well, shifting about 10 bps lower, with the short end outperforming slightly as the market began to anticipate an easier central bank policy stance. Philippine bonds were somewhat wedged between elevated inflation, with the consumer price index breaching the central bank's 3-5% target range early in the month, and slowing growth, as 10-year yields ended the month 3 bps lower.

The Indian market found some stability as policymakers made available additional bond quotas to foreign investors. Ten-year yields ended the month 15 bps lower, with the 2-year to 10-year curve flattening by 6 bps. Meanwhile, 10-year yields in Singapore and Hong Kong fell by 7 bps and 17 bps respectively, moving in line with US 10-year Treasuries, which declined by 5 bps to 2.07%.

On the other hand, Indonesian bonds underperformed as 2-year and 10-year yields rose by 10 bps and 39 bps respectively. This was despite intervention by policymakers amid fragile sentiment. Bank Indonesia cut its policy rate by a larger-than-expected 50 basis points to 6%. Following the strong rally in end-October, Thai bonds also gave up some of their gains, as 10-year yields ended 10 bps higher in November.

## Outlook

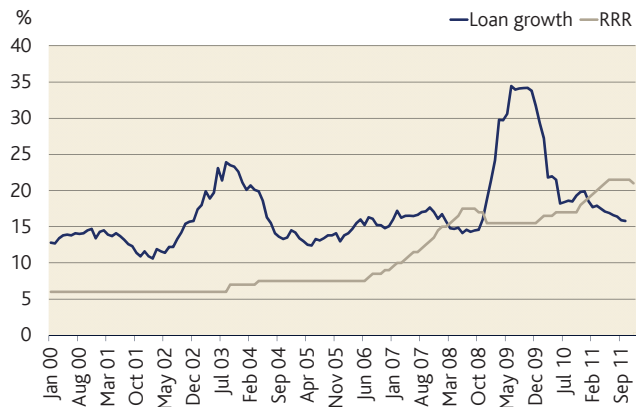
A resolution of peripheral European sovereign debt issues appears unlikely in the short term. With ever more disparate Eurozone efforts to rescue the monetary union from collapse, we expect continued volatility in global markets over the next few quarters.

The economic outlook is also a concern, with the global recovery likely to remain subdued over the next year and Europe possibly facing a recession in the first half of 2012. In Asia, economic growth has continued to slow, in line with the broader global trend. However, easing inflation and healthier fiscal fundamentals afford policymakers more room for manoeuvre. While we do not foresee a hard landing for China, we expect growth to moderate further with policymakers more generally moving to provide some support to their economies. Longer-term challenges in rebalancing the economy towards more sustainable, consumer-led growth also persist.

Given the current environment, we retain our cautious stance with an eye on capitalising on relative value opportunities in the local bond markets. We remain positive on Asian currencies over the medium term, although the European turmoil is likely to provide temporary support to the US dollar in the near term.

The Asian credit market is likely to remain volatile amid thin trading. Nevertheless, due to concerns over the lingering European sovereign debt crisis and the tight US dollar funding environment, we expect companies to continue to tap the primary market for funds.

## Focus: End of China's credit tightening



Source: CEIC and Deutsche Bank

As inflation eases and growth slows, China's central bank has begun to relax its tight credit policy. It cut the reserve requirement ratio (RRR) by 50 bps at the end of November. This was before the release of the purchasing managers' index for November, which marked the first contraction since March 2009. Weeks prior to this move, the central bank had announced adjustments in macro-prudential policies such as expanding the definition of broad money supply (M2) to include various deposit substitutes and reducing the RRR for 20 small rural credit cooperatives in order to ease domestic tight lending conditions for small to medium-sized enterprises. Looking ahead, we see further RRR cuts so as to boost the domestic banks' excess reserves ratio, currently at a historic low of around 1%, back to the historic average of around 3%. But we think it unlikely that interest rate cuts would be implemented given negative real yields. For now, we expect monetary policy to be on hold for an extended period.

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