Market Review

The key word of the month was "tapering," that is, concerns over when the tapering of quantitative easing (QE) would begin. While easy liquidity was the dominant driving force across all financial assets, the reminder that this will one day end was enough to be a wake-up call for markets. Risk assets corrected on the back of profit-taking, while fixed-income assets retreated on concerns that capital flows would diminish.

Most sectors of the J.P. Morgan Asia Credit Index (JACI) saw negative returns for the month. The overall Index lost 2.12% for the month, resulting in year-to-date (YTD) returns of -0.67%. The best performing sector this month was non-investment-grade corporates, which gained 0.5% in May. The worst performing sector was investment-grade sovereigns, which lost 4.48%, with YTD losses of 1.81%. US Treasuries (UST) generated negative performance for the month, losing 1.53% in May, bringing YTD returns into negative territory at -0.73%. The long end of the curve saw the biggest losses at 6.38%, while the short end of the curve (one to three years) saw the smallest losses, at 0.14%. On the whole, the JACI composite tightened 5 basis points (bps) for the month from 283 bps at the end of April to 278 bps at the end of May. The JACI investment-grade composite narrowed 11 bps, while the non-investment-grade composite widened by 106 bps. The investment-grade composite saw losses of 2.18%, while the non-investment-grade composite saw losses of 2.0% for the month. All countries in the Index generated negative returns, with the exception of Pakistan, which saw gains of 4.11%; Indonesia was the laggard with losses of 4.32%.

During the month of May, the JACI investment-grade non-financial corporates index returned -1.75%, essentially reversing YTD April 2013 gains as the YTD May 2013 returns stood at 0.11%. Meanwhile, the JACI investment-grade financial corporates index returned -0.97% in May, resulting in a YTD return of 1.21%. In what was almost a complete reverse of what happened in April, the sell-off in UST largely accounted for the negative returns as on a spread-over-UST standpoint, the JACI investment-grade non-financial corporates index and JACI investment-grade financial corporates index tightened 11 bps and widened 1 bps during the month, respectively. Not surprisingly, the underperformers in the investment-grade space came mainly from the oil and gas sector (CNOOC, CNPC, SINOPEC, PTTEP, Thai Oil and KORGAS), as that space holds the bulk of the long-dated corporate bonds. This was further compounded by the significant amount of new issuances that we saw from the Chinese SOE names in May, with CNOOC and State Grid of China printing US$4 billion and US$2 billion of new bonds, respectively (these two names alone accounted for almost 50% of the total investment-grade new issuance in May). In financials, the Malaysian bank seniors (Maybank, CIMB, Export-Import Bank of Malaysia, RHB Bank and Hong Leong) still outperformed during the month on a spread basis (on the back of completed Malaysian elections early in the month), despite the significant general credit selloff that we saw toward the end of May. On the other hand, Korean bank seniors (such as KDB, KEXIM and Korean Finance Corp.) were the laggards, especially toward the end of the month on the back of the number of longer-dated bonds in that space. Total investment-grade new issuances totaled nearly US$13 billion during the month of May, bringing the YTD issuance level to almost US$46 billion, or 37% higher than last year's pace.

In May, the JACI non-investment-grade index returned -2.0%, dragging the YTD return down to -0.3%, with the bulk of the underperformance attributed to the non-investment-grade sovereign bonds (down nearly 4.0%). The Philippines, the largest constituent in the non-investment-grade sovereign index in the JACI, was upgraded to investment-grade by S&P in early May, but remained in the index until the end of the month. The market was in risk-off mode in May.

We experienced broad-based selling of Asia cash bonds, triggered by a combination of factors, e.g., slower than expected Chinese manufacturing data and concerns over the US government's tapering of its QE program. The selling pressure was most pronounced for liquid and recent outperformers, with newly issued long-dated bonds most impacted. The Chinese property space was off by as many as 4 points, with the underperformers skewed toward the long-dated and single-B space. The Longfor bond complex was down 3 to 4 points overall. Adaro 19s were down 2 points and the Indika bond complex was off by 2 to 4 points on profit-taking due to persistently weak thermal coal prices, especially after the announcement of China's import ban on low-calorific coal. Profit-taking also spilled over to the newly issued Indonesian corporate bonds, e.g., Gajah Tunggal 18, Japfa 18 and Bhakti Investama 18. Alam Sutera's bonds were down 3 to 4 points. Philippine corporate bonds were also weak throughout the month due to the weakness in Philippine sovereign bonds. Despite the overall risk-off mode, we noticed that the outperformers for the month were skewed entirely to high-beta credits, e.g., Hidili, Bakrie Telecom, Bumi Resources, China Fishery, CIFI Holdings, Renhe and Xinyuan Real Estate. The new-issue pipeline was relatively robust, although the pace of issuance slowed noticeably in May. There were US$4.5 billion of high-yield corporate bond issues last month, with Vedanta Resources being the largest issuer with its US$1.7 billion dual-tranche issue followed by Citic Pacific's US$1 billion perpetual note. Non-investment-grade Chinese property issuers raised slightly over US$1 billion.

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Of the 10 onshore bond markets within the HSBC Asia Local Bond Index, all but three markets generated negative returns for the month of May. The top performing local market was India, with gains of 2.23% for the month, bringing its YTD returns to 4.89%. India continued to benefit from positive momentum generated by steps taken by the government to encourage capital inflows as well as expectations of further easing by the Reserve Bank of India. Most Asian local bond markets were weaker for the month on the back of UST yields spiking over concerns that the tapering of QE would result in outflows from emerging markets (EM). Local investors did not show strong support for the market, as they too wanted to position themselves for a general steepening of yield curves, preferring to sit on the sidelines and wait for better entry levels.

On a YTD basis, the top-performing market continued to be the Philippines, with gains of 7.00%. Philippine government bonds saw continued profit-taking as investors saw lesser value at current yield levels and the low likelihood of any easing of the policy rate given strong domestic demand and robust economic activity. Indonesian government bonds continued to underperform the region, as concerns over the current account deficit continued amid rising uncertainty over the government's ability to carry out fuel pricing reforms. For the month of May, Indonesian government bonds lost 2.38%, resulting in YTD losses of 2.18%.

Asian currencies were mostly weaker for the month of May, with only the Chinese yuan seeing a gain. The offshore deliverable Chinese yuan saw gains of 0.26%, largely driven by persistently strong fixings by the People's Bank of China (PBoC) of the Chinese yuan mid-rate. The onshore Chinese yuan saw gains of 0.49% for the month, resulting in YTD appreciation of 1.61%, or 3.85% on an annualized basis. The continued strength of the yuan despite broad Asian currency weakness reflects continued onshore appetite for the onshore Chinese yuan, and Chinese policymakers' desire to shift the Chinese economy's driver of growth toward domestic consumption. Chinese policymakers have also expressed their intent to widen the trading band of the Chinese yuan to increase volatility, and to better reflect actual market supply and demand for the Chinese yuan. This is in line with the broader aim of taking small steps toward greater use of the Chinese yuan in trade and ultimately internationalization of the Chinese yuan. The Indian rupiah saw the biggest decline for the month, at -5.57%, with the demand for US dollars onshore offsetting capital inflows. The Thai baht also saw losses of 3.83% for the month on the back of worries over potential capital control measures after the Ministry of Finance expressed concerns over speculative inflows that were causing the baht to appreciate beyond fundamentals. Apart from local factors, broad US dollar strength on the back of a rise in UST yields as well as the long-term potential of shale gas and its ramifications for US energy independence were the key driving factors in the declines seen in Asian currencies.

Outlook

The latest trade data suggest that global trade remained weak in the first quarter with a modest quarterly gain of only 0.6%, or a year-over-year gain of 1.6%, well below the long-term average of 5.0%. The silver lining, though, is Japan's attempt to step up. This should have some positive impact on regional exports and output growth. Modest signs of recovery in Japanese exports were seen, driven by yen depreciation, though overall EM exports remain weak due to soft developed-markets demand. Weakness in developed-market demand continues to be the main headwind for Asian economies. Weakness in investment activity from China has also resulted in high inventory positions for manufacturers, weighing down any potential pickup in output activity.

The US economy continues to improve, led by a strong private sector, though fiscal tightening appears to be holding back growth. The longer-term outlook for the US appears intact on the back of a slow housing recovery and increasing likelihood of energy independence. A recovery in developed markets will no doubt be beneficial for Asian markets via the exports channel and the reduction of tail risks in Europe. Monetary policy continues to be anchored by the G3, US, EU and Japan, with central banks clearly determined to support recovery, offsetting the drag from fiscal tightening. The US looks set to be the leader again, though this time around in shifting gears on monetary policy, with the Federal Reserve (Fed) pointing toward a third quarter of tapering if the economic recovery continues on its current path. The tapering of QE seeks to ensure financial market stability in the long run, and more importantly, it reflects the decreasing effectiveness of QE in driving economic activity. The risks now are that unexpected monetary policy shifts will introduce volatility across all asset classes, from safe haven government bonds to property markets. The latest signaling by the Fed again is an attempt to provide early warning for markets to respond over a longer period, and is ultimately consistent with Chairman Ben Bernanke's philosophy of forward communication.

There has been heightened concern over China's growth trajectory, and increasingly so regarding potential bubbles in its financial markets. We remain comfortable with a slower pace of growth in China, as this allows room for policymakers to focus their efforts on liberalizing and reforming the economy for more inclusive, balanced and sustainable growth. With regard to China's financial markets, the rapid buildup of leverage in the Chinese economy is a valid concern, but we take comfort in the view that authorities are cognizant of the risks at hand

and are moving quickly to tackle the problems. The trade-off, however, is clear: slower growth and quality instead of quantity. This has been clearly communicated by Chinese leaders; there is no need to pursue growth for the sake of growth. In the broader scheme of things, this is healthy and supportive of longer-term dynamics and the sustainability of growth for China, and by extension, Asia.

Inflation continues to moderate across most of Asia, while the growth/inflation balance appears to be at a comfortable spot for policymakers. Weakness in global commodity prices has been offsetting the effects of strong domestic demand and tight labour markets. While the easing cycle appears to have come to an end, Asian central banks are in a good position to react should exogenous headwinds arise. There also remains sufficient policy space for fiscal support across Asia to respond when necessary. The easing in global liquidity from an impending QE-tapering should also ease capital inflow pressures and the risks of asset-price bubbles. With unemployment still at low levels and domestic demand strong, we do not foresee aggressive policy assertion in either the monetary or fiscal space for the rest of the year. The key trigger for any easing would likely be if there is significant risk of a rise in unemployment, or if risk factors from global geopolitics or the eurozone arise.

Yield-seeking inflows will continue to be a driver of fixed-income returns in Asia, with a greater preference for local currency debt, the shorter end of curves and corporate bonds. Improving fundamentals, the positive steps taken toward reforms and a supportive macro backdrop will also be helpful factors. Portfolio inflows continue to be supportive, with relatively strong regional growth, improving margins, and better earnings prospects. Intra-region demand for fixed-income is not expected to decline with rising pension assets and increasing insurance coverage as incomes rise. Prudential measures to regulate risk-taking behavior will also imply that insurance and pension assets will maintain or increase their allocations to fixed-income assets. Out-of-the-region demand is also strong, largely from a diversification perspective. This is especially the case in terms of reserve managers seeking to diversify out of G3 government bonds.

As in prior months, our long-term strategies have not changed given our confidence in the underlying fundamentals. The strength of government balance sheets, current account surpluses and declining inflationary pressures will provide support to government yields in most Asian countries. While the exogenous risks have increased, we believe that a long-term approach will allow us to ride out the volatility in the medium-term. Structural flows and favorable supply-demand dynamics continue to provide upside potential to government bonds. Consequently, we will maintain our overweight in Asia, but with a bias to be nimble so as to make appropriate adjustments in response to short-term shifts in market technicals.

In terms of currency, all Asian central banks continue to maintain managed-float regimes, allowing markets to determine exchange rates. Still, central banks will not shy away from intervening to smooth out volatility. There will be intervention when central banks feel there is market dysfunction or when there are significant misalignments. While the pace of appreciation has slowed, we continue to maintain a fundamental overweight in Asian currencies. Preferred currencies in our portfolios include the Singapore dollar, the Chinese yuan and the Philippine peso. From a duration perspective, preferred countries include Philippines, India and South Korea.

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IMPORTANT INFORMATION

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