

Asian fixed income update

Monthly commentary

August 2015

Economic & market overview

Risk aversion dominated trading in July on the back of continued turbulence in Chinese equities, uncertainty over Greece and a commodity rout. Asian fixed income markets weakened but were more resilient than their equity peers. Local currency bond markets traded within a narrow range, while US-dollar bonds posted marginal gains. China's faltering economy dampened prices of commodities, including gold, iron ore and crude, with most falling to multi-year lows. Outside Asia, Greece agreed to a bailout with onerous terms. Elsewhere, Federal Reserve chairman Yellen reaffirmed monetary policy normalisation this year, as the US economy strengthened. This supported the US dollar, with the Australian dollar, won and baht depreciating the most among Asian currencies.

In China, large intraday swings in equity markets led Beijing to unleash a spate of stop-gap measures to staunch the losses, including cuts in interest rates and banks' reserve ratios. While GDP growth remained steady at 7% in the second quarter, worse-than-expected PMI data deepened economic worries. Short-term bonds retreated but the longer end strengthened, while the yuan closed flat. At the time of writing, China's central bank devalued the yuan, leading to a sharp fall in the offshore Chinese currency. The authorities said the cut in its reference rate by 1.9% was a one-off adjustment and meant to help position the yuan towards more market-driven movements (see Focus section overleaf).

Elsewhere, in India, short-term bonds outperformed their longer-term peers, as the central bank left interest rates unchanged. There was decent demand despite higher-than-expected inflation and monsoon concerns. The rupee closed 0.68% lower against the US dollar.

Thai bonds rallied, led by the mid-term segment, as private consumption and investment contracted, reflecting the economic malaise. Inflation remained benign amid falling energy prices. The baht was among the weakest regional performers. On the policy front, the government named Veerathai Santiprabhob as the next central bank governor, which seemed well-received by the market. Veerathai, only 45, comes with top-notch credentials, including a Harvard economics doctorate as well as stints at the IMF and Siam Commercial Bank. We don't expect significant policy changes upon his term at the helm from Oct 1.

Another solid performer was the Philippine market, underpinned by external factors, such as global sentiment and US Treasury market moves, in the absence of domestic catalysts. The peso fell in line with the broader regional trend. Malaysian bonds closed flat, as the central bank kept monetary policy unchanged amid expectations of moderating growth. The ringgit sank to a 16-year low against the US dollar at one point, reeling from a political storm over state investment company 1MDB. In Hong Kong and Singapore, short-end bonds lagged their longer-term counterparts. This was also the case in Korea and Taiwan, where the long end outperformed.

The key laggard was Indonesia, with long-term bonds leading the decline. While the central bank left policy unchanged for a fifth straight month and indicated further improvements in the current account deficit, it also signalled weaker growth ahead. Inflation accelerated on the back of volatile food prices.

Asian credit markets' resilience was notable, albeit not unexpected, given that the region was benefiting from lower commodity prices. Investment-grade bonds led modest gains, while the high-yield sector also rose marginally over the month. Meanwhile, Chinese investment-grade deals comprised the majority of new issues, which have totalled more than US\$90 billion year-to-date.

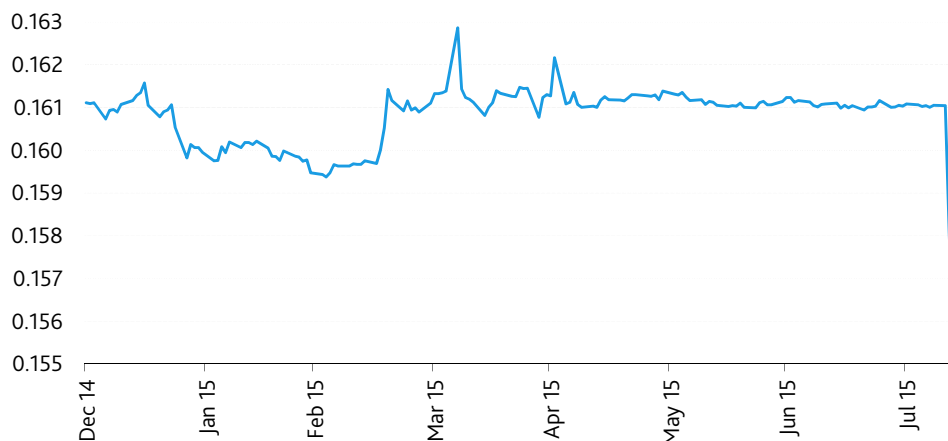
Outlook

China's yuan adjustment is obscuring developments in Europe and the US for now, triggering further volatility across commodities, currencies and financial markets. Given that Beijing has been inclined to use monetary policy easing and government spending to support growth, investors interpret its latest move to mean that the economy is in much worse shape than thought. Another concern is a potentially damaging wave of competitive devaluations breaking across the emerging world. Already, Vietnam's central bank has widened the dong's trading band. Elsewhere in Asia, concerns on the political landscape related to the 1MDB scandal resulted in greater volatility with respect to Malaysian bonds and the ringgit. Indonesian markets reflect growing disenchantment with the Jokowi administration in implementing reforms and managing the economy. Outside Asia, key sentiment drivers include the expected normalisation of monetary policy by the US Federal Reserve later this year, although Greece and its creditors have agreed to a provisional bailout.

We expect central banks to continue to ease policy across Asia, given that economic data remain lacklustre for the most part. Cheaper oil prices are providing some inflation relief. This may support local currency bond markets. Following the yuan adjustment, we expect further short-term weakness in other regional currencies amid continued US-dollar strength. In the Asian credit segment, it is worth monitoring mainland companies that hold US dollar debt, as many have increased dollar borrowings over the past few years because of the then low US interest rates and hopes that the yuan will appreciate against the dollar. A sharp depreciation in the Chinese currency would leave many of these companies, especially those that have not hedged the US-dollar loan exposures, susceptible to currency mismatch risk, given that their revenues are still denominated in yuan.

Focus – A step in the right direction

Yuan - US dollar cross rate



Source: Bloomberg, 12 August 2015

We view China's yuan adjustment as a move towards currency liberalisation rather than a competitive devaluation. The timing may appear convenient, but the move would have had to happen at some point, given that it is part of Chinese policymakers' overall long-term plan to internationalise the yuan. The adjustment has also swiftly addressed some of the IMF's reservations about including the currency in its special drawing rights basket – a key step towards attaining global reserve currency status – if only symbolically. So, for Beijing, why not "seize the day", especially given weak exports and persistent concerns over the faltering economy?

The adjustment means that the yuan's fixing and spot rates should converge. Ultimately, it is a positive step towards reform and a larger role for the yuan in the global economy. With the move, the currency will be more flexible but also more volatile, as demand and supply forces play a bigger role. Nonetheless, we would caution against interpreting the adjustment as a bold attempt by the central bank to engineer currency weakness above and beyond what the fundamentals dictate. Across our portfolios, we have moved from an overweight to a neutral position in the yuan. Given that other regional currencies may come under depreciation pressure, we remain underweight the likes of the won, ringgit and Singapore dollar.

Index performance table

| Benchmark returns in US\$ | Value | 1M | 3M | YTD |
|---|--------|---------|---------|---------|
| JPM Asian Currency Index (ADXY) | 110.29 | -1.20% | -2.36% | -2.23% |
| HSBC Asian Local Bond Index (ALBI) | 251.87 | -1.63% | -3.91% | -2.07% |
| JPM Asian Credit Comp Index (JACI) | 190.98 | 0.34% | -0.51% | 2.35% |
| MSCI Asia Pacific ex Japan Equity Index | 450.98 | -5.26% | -12.17% | -3.48% |
| US Treasury 10-Year (bps) | 2.18% | -17 | +15 | +1 |
| Oil (US\$) | 47.12 | -20.77% | -20.98% | -11.54% |

Source: Bloomberg, 31 July 2015

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Bloomberg data are for illustrative purposes only. No assumptions regarding future performance should be made.

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