Western Asset Management

January 2017

# ASIA FIXED INCOME REVIEW

## MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) saw gains of 0.89% month-over-month in January. Gains were driven by a strengthening of US Treasuries (USTs) across the UST curve. The top-performing sector was non-investment-grade sovereigns, which saw gains of 1.90%, while the weakest sector was investment-grade corporates, which saw gains of 0.56%. UST yields tightened marginally, specifically in the belly of the curve, recovering some losses from the last quarter of 2016 as expectations of fiscal easing were up in light of increased policy uncertainty from the Trump administration.

With rates relatively stable (for example, the 10-year UST ended January essentially where it began the year), Asian credit had a decent start to the year. The JACI FINS CORP Index returned 0.5%, while the JACI IG NONFINS CORP Index saw January returns of 0.5%. On a sector basis and starting with Asian financials, spreads were generally 1-2 basis points (bps) tighter. That being said, we did see marked underperformance coming from the Chinese asset management company segment, led by the HRAM complex. HRAM 26s were 7 bps wider during the month as investors struggled to digest the volume of recent HRAM new prints that continued to weigh on technicals (HRAM printed US$5.6 billion of bonds between mid-November 2016 and mid-January 2017, and this US$5.6 billion quantum represented nearly 25% of all investment-grade corporate/financial bonds printed during that period). On the other end of the ledger, Indian banks ICICI and IDBI outperformed, with bonds 10-15 bps tighter during the month. As for the Asian corporate space, we would note that the general performance mirrored their financial counterparts with spreads 1-2 bps tighter, though there were pockets of divergence. On the underperformance side, we continued to see Chinese LGFV names leak wider (now for two months in a row) with the likes of CHDXCH 21s, CSPLIN 19s and CQNANA 26s 5-7 bps wider in January. On the other hand, Chinese tech names such as BIDU/TENCNT saw their bonds 5-8 bps tighter during the month. Indian PSU IOCLIN and BPCLIN bonds also did well—around 10 bps tighter—while the non-public sector undertaking BHARTI 23s/24s/25s were 10-15 bps wider on the back of renewed concerns regarding the competitive landscape in the Indian telecommunications space. On the new issue front and unsurprisingly given a quiet December, January issuances spiked and we saw nearly US$14 billion of investment-grade corporate/financial new prints. There was a much better balance in terms of the origin of the new prints, with China accounting for 46%, Korea 20%, the Philippines 14% and India 7%.

The Markit Asia Local Bond Index (ALBI) saw gains of 2.24% in January, recovering its losses in the month of December. A large part of returns came from a recovery of Asian currencies, partly on the pullback from speculative long US dollar positions across most markets. Asian rates also saw gains across all markets, with China being the only exception. South Korea led the outperformance with positive returns of 3.88%, a pullback from significant losses in the previous quarter on the back of benign economic data. China saw losses in both the onshore and offshore markets as expectations of monetary tightening resulted in a rise in bond yields across the curves. Asian currencies saw mostly gains versus the US dollar with the Korean won leading the outperformers with gains of 4.53%, while other higher beta currencies such as the Taiwan dollar and Singapore dollar saw similar gains of 3.68% and 2.51%, respectively. The laggard was the Indian rupee with gains of 0.68%.

## OUTLOOK

Rex Tillerson, Mr. Trump's nominee for US Secretary of State, likened China's island-building programme to Russia's illegal annexation of Crimea and said that the Trump administration intended to send a clear signal to Beijing that "your access to those islands is not going to be allowed." This was a departure from an earlier US position that it was concerned solely about freedom of navigation. On the eurozone, Trump appears to be for European disintegration, speaking against German

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chancellor Angela Merkel while blaming European woes on immigration. Trans-Atlantic economic and security policies, specifically that of the US' stance on Russia and NATO, remain uncertain and it seems that nothing can be taken for granted under the Trump administration. While his actual economic policies remain to be seen, both in terms of the positive impact from fiscal expansion as well as the negative effects of trade protectionism, what is clear is that Trump's election marks an era of policy uncertainty. The February Federal Open Market Committee (FOMC) meeting was uneventful. The committee unanimously voted to hold rates steady and kept its statement largely unchanged. The FOMC updated its statement to reflect current conditions but did not change the language around expectations for future policy or risks. The policy statement acknowledged the improvement in consumer and business sentiment since the November election but gave no guidance to the timing of the next rate hike. The Federal Reserve (Fed) remains watchful against inflation risks, and there could be implications for the Fed's next move if the core personal consumption expenditure measure hits the FOMC target of 2%.

Policy divergence will likely increase in 2017, highlighting the difference in social-political and economic trajectory globally. National politics and policymaking are likely to become more insular as politicians face increasingly dissatisfied populations. This trend is likely to persist, and this means that economic policies will be focused on short-term job gains and income growth, rather than longer-term issues of fiscal sustainability or global economic cooperation. There is likely to be greater uncertainty in financial markets as there are fewer ideological or even theoretical frameworks upon which economic policy decisions can be based. The global trade outlook remains poor, with major global trade agreements now in limbo. Expectations will likely increase for further slowdown as a result of uncertainty and that could translate to more risk-averse behavior by corporations and consumers across the developed world. That said, a protracted global trade war is not likely, because even as one country seeks to put up barriers to imports, the retaliation in terms of barriers to their own exports both in terms of goods and services should curb the magnitude of trade restrictions. What is clear, however, is that the global supply chain is likely to dis-intermediate and regional supply chains will emerge in its wake. This has been driven by technological advancements in production technology, shorter product lifecycles and shifts in consumer behavior. The shift in the political landscape will likely hasten the breaking up of extended global supply chains. One can expect to see increasing regionalization and re-rationalization of production chains by corporates, hastened by political shifts by made possible by new technology and further driven by cost optimization. The actual demand for onshoring might not necessarily lead to more jobs, as companies will tend to seek to optimise costs while appeasing politicians' demands. This coupled with readily available robotic technology might lead to increased capital investment in automation and greater job losses eventually.

There is increasing comfort that whatever policies the US imposes on China and by extension the region, Asia and China have enough means to respond and emerge stronger. Worries that a retreat from globalisation will result in lower global growth are valid, but the fact is that global growth is a composite, a result of the growth of each country and region. Such an environment will be one in which local factors regain prominence and the regions and economies that have strong endogenous growth engines will move ahead faster on a relative basis, even in a slowing global economy. Shifting global supply chains are moving towards near-shoring, made possible by manufacturing technological advances as well as distribution shifts that affect consumption patterns. With the US taking the lead in retreating from multilateral free trade integration, countries will increasingly move towards greater regionalization. This augers well for Asia, a region that is heterogeneous in nature with a diversity of both high-income and emerging economies, with technological and developmental stage diversity and, on the whole, positive demographics, with declining working-age population in certain economies offset by large and emerging young populations in others.

In financial markets, Asia has been resilient to a liquidity squeeze this time around, buffered by strong accumulation of foreign exchange reserves on the back of current account surpluses. Portfolio headline outflows, specifically that measure from retail funds, mask the underlying strength of a shift in foreign investor base to less US and more European, intra-Asian investors. We think that Asia remains in a relative sweet spot, with diversified drivers of growth anchored by China, India and Southeast Asia. It is a region that should continue to dominate global growth, tending to benefit from the upside while being insulated against significant downside. India, Indonesia and the Philippines remain well poised within the easy-growth category on the back of large, young and lower-income populations.

That said, risks remain, clearly emanating from China, from a debt overhang and capital misallocation,

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mispricing and its associated effects on property prices and the banking system; however, risks remain endogenous to both the country and its domestic political economy. The top priority for Chinese leadership is the 19th Party Congress, which will be held in autumn 2017. We expect the current leadership to consolidate its power at the 2017 Party Congress, where most members of the Politburo and the Politburo Standing Committee (PSC)—China's top decision-making bodies—will be replaced. This could allow China's president Xi Jinping to push ahead more boldly with his reform agenda, particularly structural reforms such as improving state-owned enterprise efficiency and promoting urbanization. Hence, for now, there is an implicit need to maintain sufficient economic momentum to ensure social-political stability, which implies the need to maintain sufficient job growth, maintain property prices (the bulk of Chinese wealth outside of cash savings) and broad approval levels for the top leadership, specifically Xi Jinping, so that he has the political clout and capital to replace members in the Politburo and PSC with his preferred candidates. The People's Bank of China will have to maintain capital controls to help China break away from the Sino-US monetary policy union, as the Fed tightens. The current FX regime, after a tumultuous beginning on 10 August 2015 will have to be maintained for fear of unleashing outflows triggered by a loss of confidence. A sharp depreciation may in fact strengthen expectations of further depreciation, result in a loss of confidence and trigger more outflows.

In the Asia fixed-income space, market differentiation remains the key to navigating such an environment. In local currency bond markets, it becomes important to differentiate between high UST beta markets such as South Korea and Singapore. In the medium term, domestic monetary conditions and the direction for monetary policy will anchor markets such as India, Indonesia and the Philippines. Positioning becomes another key factor, foreign ownership will have to be differentiated between speculative investors and longer-term investors and the intent of ownership should also be taken into consideration. In this respect, Asian markets that have significant regional or home bias will see yields supported. This is particularly evident in the US dollar Asian credit market. What will be crucial in navigating the US dollar Asian credit space will continue to be the fundamental understanding of each credit and the deep appreciation of primary market support and secondary market technicals. The downside risk to growth and uncertainty could prompt lower consumption and greater savings, and this should support demand in most markets.

While we expect FX volatility in Asia to increase, we also expect to see greater differentiation. Countries with lower reliance on US demand will likely benefit, specifically India and Indonesia. Hong Kong, Singapore, Taiwan, South Korea and Vietnam are most vulnerable given their export-orientation and vulnerability to slower global trade and investment growth. Korea is at risk of being labeled a currency manipulator given its large surplus with the US (US$29.4 billion), and its free trade agreement with the US also remains at risk. Singapore was specifically mentioned in Trump's campaign speeches as one of the countries that had taken jobs away from the US. While Taiwan is less exposed to the US, there should be less direct pressure on the Taiwan dollar. Indirectly, Taiwan exports will continue to be hurt as a result of rising protectionism. Trump's anti-TPP stance could hamper President Tsai Ing-wen's agenda to diversify export markets beyond China. In the case of the Philippines, it's less clear cut as President Duterte appears to have extended an olive branch to President Trump, the significant linkages to US in the form of trade, remittances and business process outsourcing, or BPO, poses vulnerability in the event of a shift in foreign and economic relationship between the Philippines and the US. India should continue to outperform, with currency reform on the back of its taxation reform buttressing the case for an improved growth outlook and more room for monetary easing.

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