Western Asset Management January 2017

SINGAPORE FIXED INCOME REVIEW

MARKET REVIEW

In January, the Singapore bond market reversed its losses; the United Overseas Bank Singapore Government Bond All Index rose by 0.98%.

The US Treasury (UST) curve saw marginal shifts—the long end of the curve underperformed. Five-year USTs tightened by 1 basis point (bp) to 1.91%, while the yield on 10-year USTs widened 1 bp to 2.45%.

Singapore government securities (SGS) outperformed USTs, driven by onshore technical support. The front end outperformed, with the yields on 3-month bills tightening 21 bps, to 0.85%, while the 1-year yield was tighter by 8 bps. The 2-year yield tightened 2 bps, to 1.29%; the 5-year yield tightened by 12 bps to 1.73%, while the 10-year tightened 17 bps, to 2.30%. At the long end, the 30-year SGS tightened 1 bp, to 2.70%.

December industrial production was up 21.3% year-over-year (YoY) beating expectations of 10.4% by a large margin. Notably, there was a big jump in electronics sector (semiconductors in particular), and December non-oil domestic exports numbers released earlier also beat expectations. The headline consumer price index rose 0.2% on a YoY basis in December, pushing higher from the marginal increase of 0.02% in November. The higher inflation print in December was largely due to higher private road transport costs. Petrol prices were raised a further 2% in December, and have risen 11.6% since February 2016, the lowest point of the year. On a YoY basis, petrol prices have started to add to headline inflation, with an increase of 4.2% in December, compared with a decline of 0.2% in November. Core inflation, which excludes accommodation and private road transportation, was stable at 1.2% in December. Services inflation edged up to 1.6% YoY from 1.5% in November, according to the Monetary Authority of Singapore report. Core inflation averaged 0.9% for the full-year 2016.

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 "[its] access to those islands is not going to be allowed." This was a departure from the 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 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

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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 political landscape will 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 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, 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.

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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.

Singapore continues to be anchored by its fundamental strength, with an estimate of sovereign foreign net assets by Fitch at around 90% of GDP as of the end of 2016. With its balanced fiscal policy mandate and its high current account surplus, projected at 19% of GDP for 2016, or an average of 18% for the past five years, structural underpinning remains firm. Demographics remain a key challenge and growth in the next decade will likely be closer to the 2% level with current-account surplus and fiscal surplus narrowing as a result of lower savings and higher social expenditures related to an aging population.

Having dodged a technical recession in 4Q16, Singapore has continued to demonstrate its cyclical linkages to the broader region, which is clear given the significance of trade to its economy. Even as the government attempts to diversify the drivers of economic growth and improve productivity, policymakers remain constrained by limits of socially acceptable immigration growth rates and the slow nature of structural policy shifts towards higher productivity. This is evident in rising labour costs, weak corporate profitability, declining export share and competitiveness. Policymakers are cognisant of the tradeoffs and appear willing to give up higher growth for more politically palatable inclusive growth. This is perhaps necessary to preempt the rising tide of anti-globalisation seen in the developed world as a result of unbalanced growth. While we remain comfortable with a quality bias in the Singapore corporate bond market, we are cautious of the rapid expansion of the Singapore credit market and the relatively low level of risk premium the market is pricing into bonds issued by new entrants. We remain highly selective and will place a strong emphasis on sound credit fundamentals as a key premise. We believe our long-term approach will allow us to ride out any volatility in the next few months and we will seek to minimize our risk exposure.

In terms of strategy, we continue to adopt a tactical approach to positioning across the SGS curve in view of global growth headwinds and monetary policy divergence amongst central banks. We will seek to bolster carry-through exposure in high-quality corporate and bank credits.

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