Western Asset Management February 2017

SINGAPORE FIXED INCOME REVIEW

MARKET REVIEW

In February, the Singapore bond market made gains alongside a flattening of the yield curve; the United Overseas Bank Singapore Government Bond All Index rose by 1.17%, bringing year-to-date gains to 2.15%.

The US Treasury (UST) curve saw weakness heading into expectations of a US Federal Reserve (Fed) rate hike in March—the long end of the curve outperformed. Five-year USTs widened by 2 basis points (bps) to 1.93%, while the yield on 10-year USTs tightened 6 bps to 2.39%.

Singapore government securities (SGS) outperformed USTs, driven by onshore technical support and local demand. The front end outperformed, with the yields on 3-month bills tightening 5 bps to 0.80%, while the 1-year yield was tighter by 5 bps. The 2-year yield tightened 7 bps to 1.23%; the 5-year yield tightened by 14 bps to 1.59%, while the 10-year widened marginally by 1 bp to 2.31%. At the long end, the 30-year SGS tightened 25 bps, to 2.44%.

January industrial production (IP) rose 2.2% year-over-year (YoY), down sharply from a 22.1% YoY increase in December, and below expectations. The slower YoY IP growth was due partly to effects related to the timing of the Lunar New Year holiday (January 2017 compared with February 2016). This high base was exacerbated by a sharp rise in pharmaceutical output in January 2016—+31.2% month-over-month (MoM) on a seasonally adjusted annual rate (SAAR). On a MoM SA basis, IP fell 6.0%, possibly due to production shutdowns ahead of the holiday period. The January headline Consumer Price Index (CPI) accelerated to 0.6% YoY (December: 0.2%) on energy and services. This was in line with market consensus, though core CPI rose by 0.1% more than expected, to 1.5% YoY (December: 1.2%). The rise in headline CPI was led by a 5.9% YoY jump in oil-related items (December: -0.1%), reflecting rises in electricity tariffs and stronger pickup in petrol prices, with the latter contributing to the acceleration of private transport CPI, alongside a smaller decline in car prices. Services rose as higher airfares (likely on higher fuel costs) and telecom fees more than offset lower public transport CPI. Food CPI edged down. Accommodation costs remained weak and edged down 0.1% amid ongoing softness in the rental market.

Singapore's final 4Q16 GDP was revised significantly higher to 2.9% YoY from 1.8% YoY. This was higher than consensus of 2.5%. For the full year, GDP was upgraded to 2% from the advance print of 1.8%. This makes 2016 in line with 2015's growth but still at a low since 2009. By sector basis, manufacturing provided the main delta for the upward revision. Advance print for manufacturing was +6.5%. This was revised higher to 11.5% YoY. Construction contracted 2.8% YoY (no change from advance) and services were revised slightly higher to 1% from 0.6% YoY. The government is keeping its 2017 growth forecast at 1%-3%. Non-oil domestic exports rose 8.6% YoY in January, sustaining the strong performance of the previous two months (December: 9.1%; November: 15.6%). On a MoM SA basis, non-oil domestic exports (NODX) rose 5.0%, while 3Mo3M SAAR growth surged to 83.5%. Similar to the November report, the YoY improvement in the December NODX was broad-based, led by petrochemicals, electronics and other machineries.

OUTLOOK

US President Donald Trump's ability to pass legislation remains uncertain, with the judiciary having stopped his travel ban in its tracks. It remains to be seen whether his support in Congress will enable him to push through other aspects of his agenda, whether on the fiscal front or regarding the repeal of Obamacare. With the uncertainty surrounding policy direction out of the executive and legislative branches of government, the Fed remains the only source of clarity for now. Fed Chair Janet Yellen indicated a readiness to raise the fed funds rate at the Federal Open Market Committee (FOMC) March 14-15 meeting in fairly explicit language. She said that as long as "employment and inflation are continuing to evolve in line with" officials' expectations, "a further adjustment of the federal funds rate would likely be appropriate." As a

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result, markets now see a hike at the March meeting as close to a done deal. On quantitative easing, Yellen has repeatedly said the Fed will not start to unwind its bond holdings until interest rate hikes are "well under way." The risks, though, are a shift towards a more aggressive monetary tightening stance.

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. Increasingly, global trade will shift towards increased regionalization, a structural change away from global supply chains to regional supply chains. This has been driven by technological advancements in production technology, shorter product lifecycles and shifts in consumer behavior. One can expect to see increasing regionalization and re-rationalization of production chains by corporates, hastened by political shifts 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 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.

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. This augurs 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 populations in certain economies offset by large and emerging young populations in others. As a share of global trade, Asia now stands at 25% or more than twice that of the US at 11%. Interestingly, whilst 15% of Asian exports go to the US, 21% of US exports go to Asia. More importantly, intra-region trade is now the predominant driver of exports, with intra-region trade at around 50%, an all-time high as the region becomes more interdependent. That stated, there are risks to the imposition of a border adjustment tax by the Trump administration. Specifically, the more vulnerable economies are Vietnam, Taiwan, Korea and Malaysia due to the large share of exports to the US and the higher price elasticity of their export product mix.

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 those 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.

China's National People's Congress saw the presentation of the government work report spelling out economic policy targets for 2017. This should entail the maintaining of steady growth while containing risks in property and financial systems. In his government work report, the Chinese Premier Li Keqiang pointed out that the government's overall work objective in 2017 was to maintain economic stability and improve policy coordination across lines to stabilize GDP growth, secure job opportunities, control risks, ensure financial safety lines, guarantee people their livelihoods and protect the environment. 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 enterprises (SOE) 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. The People's Bank of China (PBoC) will have to maintain capital controls to

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help China break away from the Sino-US monetary policy union, as the Fed tightens. The current foreign exchange (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, resulting in a loss of confidence and triggering more outflows. On the renminbi exchange rate, Yi Gang, Deputy Governor of The PBoC has stated that using FX reserves to maintain renminbi stability has more benefits than downside and maintaining renminbi stability respects market principles, and a steady currency is a good thing for the Chinese economy.

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, with an increasing divergence from US monetary policy compared to a decade ago when Asian central banks were more inclined to alignment. 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. As 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. India should continue to outperform, with currency reform on the back of its taxation reform buttressing the case for an improved growth outlook. With monetary easing in India and Indonesia being put on hold, this should provide support for the rupee and the rupiah.

Singapore continues on its path of restructuring in view of the shifting competitive landscape and domestic demographic challenges. There remains an urgent need to position the economy as well as the labour force higher up the value chain given the constraints of labour implied by tighter immigration policy. The recent report by the government's Committee on the Future Economy concluded that growth is likely to average 2% to 3% per year over the next decade, down from a previous expectation of 3% to 5%. With little political room to manoeuvre in terms of immigration, growth will have to come from productivity, which remains dismal at 0.6% per year for the past decade. The government has downshifted its productivity growth forecast to 1% to 2% over the next decade, instead of the previous aim of 2% to 3%. The most recent budget continues on the government's effort to reshape the labour force, with funding for self-directed re-skilling and learning as well as wage-supplement for displaced workers seeking to re-tool for vastly different career paths. Public sector infrastructure projects will be brought forward to start in FY2017 and FY2018 to help mitigate the slowdown in private sector construction.

Rising healthcare and social costs given an aging population as well as infrastructure costs of building new rail lines, doubling the capacity of the international airport as well as a redevelopment of its seaport (even as revenue streams remain highly vulnerable to cyclical downshifts) all continue to be key challenges. The overall budget maintains an expansionary tilt while sticking to the government's prudent approach to budgeting and seeking to maintain a balanced budget over its term of government. The government projects an overall budget surplus of 0.4% of GDP in the fiscal year starting April 2017 (FY17), down from 1.3% in FY16. The projected surplus, in part, reflects expectations for further substantial returns on government investments—reflected by the net investment returns contribution without which the basic budget comes in at a projected deficit of 1.9% of GDP, from 1.4% in FY16.

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 year-end 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. Household debt remains constrained by high mortgage levels, at 75.3% as of end 2016, from 73.8% in year-end 2015, with mortgages at 56.8% of GDP. This and a more hawkish Fed monetary policy stance provide little room for monetary policy easing by the monetary authority of Singapore (MAS). The burden of growth support will continue to be on the fiscal and administrative side of the house. We expect the MAS to hold its neutral SGD nominal effective exchange rate (NEER) bands in April amid a modestly improved outlook for global growth and inflation.

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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