Western Asset Management February 2017

ASIA FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) saw gains of 1.41% month-over-month in February, bringing year-to-date (YTD) gains to 2.32%. Gains were driven by a strengthening of US Treasuries (USTs) across the UST curve as well as continued tightening of spreads. The top-performing sector was non-investment-grade sovereigns, which saw gains of 2.91%, while the weakest sector was investment-grade corporates, which saw gains of 1.08%. UST yields tightened marginally, specifically in the long end of the curve, recovering some losses from the last quarter of 2016 even as there were increased expectations of a Federal Reserve (Fed) hike in March.

With rates being a tailwind during the month of February—for example, the 10-year UST, we ended February 8 basis points (bps) tighter than where we began the month—and credit spreads tightening across the board, Asian credit built upon an already decent start to the year over the month. The JACI FINS CORP Index returned 0.8%, bringing the first two months' tally to 1.3%. The JACI IG NONFINS CORP Index had returns of 1.3% in February, resulting in a YTD 2017 return total of 1.9%. On a sector basis and starting with Asian financials, we saw bonds tighten across virtually all geographies and instrument types. Not surprisingly, one of the areas with the least amount of tightening occurred in Korea given its low beta nature with bank seniors 5 to 6 bps tighter at both the 5-year and 10-year tenors. That stated, Korean bank Tier 2 paper outperformed many of its Asian peers with the PUSAN 26s and SHNHAN 26s about 20 bps tighter in the month (while Chinese BCHINA 24s and ICBCAS 25s were 15 bps tighter, for example, while Hong Kong BNKEA 26s and DAHSIN 26s were about 17 bps tighter). With the very significant amount of new supply coming from the Chinese banks in the senior space (roughly one-third of all Asian investment-grade corp/financials new issues came in the form of Chinese bank senior paper on a YTD-2017 basis), Chinese bank senior secondary levels saw some pressure with the likes of SDBC 5/10-year bonds only 2-3 bps tighter on the month. On the other hand, other NBFI Chinese seniors, such as leasing paper and AMCs (despite seeing decent primary supply as well) performed well, with 10-year paper 15 to 20 bps tighter in February. In other geographies, 5-year bank seniors in Malaysia, India and Thailand were about 20 bps, 15 bps and 10 bps tighter, respectively. As for the Asian corporate space, it was similar to its financial peers with really the comparison just being the degree of how much bonds tightened. Chinese state-owned enterprises (SOEs) were about 10 bps tighter across the curve, though we did see higher-beta names such as the MINMET 25s/26s being 30 bps tighter. Chinese tech names (BIDU/TENCNT/JD/BABA) were about 15 bps tighter. Hong Kong and Korean corporate bonds were 5 to 8 bps tighter, while over in India, corporate bonds were about 15 bps tighter at both the 5-year and 10-year tenors, though we did see significant outperformance out of the ADSEZ 22s being 25 bps tighter in the month. Malaysian and Thai corporates were on average 10 bps and 15 bps tighter, respectively. On the new-issue front, we saw a continued surge in issuances in February which resulted in US$26.6 billion of new bonds inked during the first two months of the year; this is the highest tally start to the first two months of any year (last highest was US$22.8 billion during January-February 2015). During February 2017, over 70% of new investment-grade corp/financial new issuances stemmed from China (compared with less than 50% in January 2017).

The Markit Asia Local Bond Index (ALBI) saw gains of 1.21% in February, bringing YTD returns to 3.47%.The continued recovery of Asian currencies, partly on the pullback from speculative long US dollar positions across most markets contributed to returns. Asian rates also saw gains across most markets—India being the only exception—with losses after the Reserve Bank of India signaled a pause in its monetary easing trajectory. Indonesia led the outperformance with positive returns of 1.18%, with increasing expectations of an upgrade to investment-grade by S&P and attractive real yields resulting in outperformance. Asian currencies were mixed

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versus the US dollar with the Korean won leading the outperformers with gains of 2.06% while other higher-beta currencies such as the Taiwan dollar and Singapore dollar seeing similar gains of 1.77% and 0.82%, respectively. The laggard was the Philippine peso with losses of 1%.

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, be they on the fiscal front or repealing 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 March Committee 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 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 said, 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 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 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, 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.

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