LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management

September 2017

ASIA FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) closed flat on a month-over-month (MoM) basis in September with losses of -0.01%, bringing year-to-date (YTD) gains to 5.34%. Losses were driven across the US Treasury (UST) curve, in spite of a tightening of spreads. The top-performing sector was non-investment-grade quasi-sovereigns, which saw gains of 0.90%; the weakest sector was investment-grade quasi-sovereigns, which saw losses of 0.22%. UST yields bear-steepened, driven by the long end of the curve.

With rates as a headwind during the month (10-year USTs ended September at 2.33%, while they began the month at 2.17%), we saw a muted performance from Asian credit. September marked the first month this year during which we saw negative monthly returns, as the JACI FINS CORP Index had negative returns of 0.1%, bringing the year-to-date (YTD) 2017 tally to a positive 3.7%. The JACI NONFINS CORP Index saw returns of negative 0.3%, which resulted in YTD 2017 returns of 5.1%. On a sector basis and beginning with Asian financials, for a second month in a row, Korean financials were the clear underperformers (and the only ones where spreads widened) as the geopolitical risks on the Korean Peninsula continued to create an overhang. Korean quasi-sovereign and commercial bank 5-year senior paper were 3-5 basis points (bps) wider with 10-year senior paper about 5 bps wider. On the bank capital front, Korean Tier-2 paper from SHNHAN/KEBHNB/WOORIB were 2-5 bps wider, while Tier-2 paper in other geographies such as HK (BNKEA/DAHSIN) and Singapore (UOBSP/OCBCSP) were 4-6 bps tighter during the month. On the other end of the spectrum, Indian banks had a strong month with regard to spreads tightening. Indian bank ~5-year seniors from EXIMBK/SBIIN/ICICI/CBKIN/AXSBIN were 10-15 bps tighter, while ~10-year seniors from ICICI/RECLIN were 8 bps tighter. Over in China, Big Four bank 5-year seniors were about 5 bps tighter, while their 10-year counterparts (along with quasi-sovereign bank 10-year paper) had outperformed with spreads coming in by nearly 10 bps. There was meaningful spread tightening in the Chinese AMC space, led by the CCAMCL/GRWALL 27s being 15 bps tighter, while the HRAM 27s had underperformed somewhat, being only 5 bps tighter as the market was anticipating a likely jumbo new deal coming from HRAM in the near future. In the Asian corporate space and similar to their financials peers, we again saw Korean paper underperform for a second month in a row – the only region where spreads had widened. For example, we saw the KORGAS 22s and KOROIL 22s 8-10 bps wider during the month, with other 5-year senior paper 3-5 bps wider in general. Chinese high-quality Tier-1 state-owned enterprise (SOE) seniors were about 5 bps tighter during the month with similar moves seen for the Chinese tech space. We did see some outsized moves in the Chinese property space with the LNGFOR 22s tightening 14 bps and the SINOCE 27s tightening almost 30 bps during the month. In India, we saw 5-year PSU seniors (ONGCIN/BPCLIN/NTPCIN) about 7-10 bps tighter, while outperformance came in the form of the RILIN 22s being 13 bps tighter. In South East Asia, spreads were 3-5 bps tighter for most bonds, though the IOIMK/SPSP/CAPLSP 22s tightened 7-9 bps – to be the clear outperformers. Regarding new issuances, we saw the seasonal uptick in September from a traditionally slow August as investment-grade Asian corporates/financials new prints climbed to US$14.8 billion from US$8.1 billion. Chinese issuances accounted for nearly 60% of the new prints, while HK and Korean issuances accounted for 21% and 16%, respectively, of the new prints during the month.

The Markit Asia Local Bond Index (ALBI) saw losses of 0.37% in September, bringing YTD returns to 7.82%. Returns were mixed across markets with higher-yielding markets seeing gains hold up in spite of a late-September selloff, while higher-UST beta markets saw weakness alongside moves in USTs. Indonesia outperformed with gains of 1.67% while on the other hand, Hong Kong underperformed with losses of 0.73% for the month. Asian currencies were mostly weaker on the back of broad-based USD strength and rising UST yields. The Malaysian ringgit outperformed with gains of 1.12% while the Indian rupee underperformed with losses of 2.14%.

OUTLOOK

The Federal Open Market Committee (FOMC) left the fed funds rate target range unchanged and announced that balance sheet runoff will begin in October, as widely expected. The median dots in the Summary of Economic Projections continued to show a third rate hike this year and three hikes in 2018. The FOMC affirmed its stance of its well-telegraphed balance sheet adjustment in line with its “Policy Normalization Principles and Plans,” which was introduced at its June meeting. “The Committee now judges that it is appropriate to begin implementing its balance sheet normalization program.” The committee said that the economy continues to expand at a modest pace, led by household spending and business investment. Bonds remain supported, quite the contrary of what markets were expecting, anchored by a macroeconomic environment of low inflationary pressure, moderate growth, low UST yields and a lack of any urgent sense of hawkishness out of major central banks. In Asia, late-September’s selloff in risk was reminiscent of last year’s selloff after Donald Trump’s election, with the tax reform proposal and an extension of the debt ceiling driving UST yields and the USD higher. That stated, we remain comfortable with the broader structural backdrop in terms of low inflationary pressure and benign structural global growth. Asian markets’ vulnerability remains low, driven by stronger fundamentals compared to previous episodes. The latest export and manufacturing Purchasing Managers’ Indices (PMIs) continue to point towards resilience across most of Asia, with growth momentum sustaining into 4Q17. The Asian Development Bank (ADB) has upgraded growth forecasts for developing Asia to 5.9% in 2017 and 5.8% in 2018.

As an economy that contributes to one-third of global GDP growth, China will remain a stabilizing force in Asia in the last quarter of the year heading into 2018. Following the 19th Party congress, Chinese leadership will be inclined to continue to maintain a stable macroeconomic environment to enable the pursuit of structural reforms including financial regulation, state-owned enterprises (SOEs) and property sector reforms. The longest ruling party in the world since 1949, the China communist party has defied expectations only because it has continuously adopted reforms and successfully achieved economic development over the decades in power. Debt overhang and structural inefficiencies remain a longer-term concern. However, China’s economy remains well supported by secondary industry growth, robust consumption and strong service-sector demand. In a State Council meeting chaired by Premier Li Keqiang, the government decided to increase support to small-medium sized enterprises (SMEs) by lowering their tax burden and cutting the reserve requirement ratio (RRR) for commercial banks whose credit to SMEs exceeds certain thresholds. Following the State Council decision, the People’s Bank of China (PBoC) announced two-tier RRR cuts for commercial banks that meet the “inclusive finance” (lending to SMEs, agriculture, poverty reduction projects and innovative activity) criteria. Earlier in the month, PBoC removed the 20% reserve requirement on foreign exchange forwards (banks were required to hold the equivalent of 20% of their clients’ foreign exchange (FX) forwards positions in dollar reserves since Sept. 1, 2015, a measure to increase the forward trading cost and slow the pace of CNY depreciation). This was after continued strengthening of the Chinese yuan and August FX reserve data pointing to a slower pace of capital outflows. FX reserves rose for the seventh consecutive month to US$3,091.5 billion in August. The strength in the Chinese yuan has been driven by a confluence of both domestic and external factors. Domestic holders of US dollar have started to unwind dollar holdings, regaining confidence in PBoC’s ability to anchor the Chinese yuan. If Chinese exporters continue to remove their long USD/CNY hedges and convert more of their export proceeds back to CNY onshore, CNY could be poised to strengthen further. In view of this, and a broad weakness of the US dollar externally, PBoC has not been tempering the move by buying dollars like it did in the 10 years leading up to 2015. In view of broad US dollar weakness, supported by either current account surplus or capital inflows, Asian central banks have demonstrated an increasing reluctance to aggressively intervene beyond daily smoothing of volatility. This has resulted in most Asian currencies seeing strong gains year-to-date.

In Indonesia, polling by the Centre for Strategic and International Studies (CSIS) in late August shows that approval ratings for President Joko Widodo (Jokowi) remained steady at 68%, similar to 69% in the SMRC poll in May 2017 and 67% in the last CSIS poll in August 2016. This suggests the opposition’s victory in the Jakarta gubernatorial election this year did not reflect a broader deterioration in Mr. Widodo’s popularity. With an eye on the 2019 presidential election, Jokowi continues to figure strongly. This would bode well for economic continuity and the ability to avoid political machinations leading to the elections that would derail economic reforms. Consumption demand that boosted Asia exports in the early 2000s doesn’t look set to return given the shift in demographics and accompanying consumption shifts. Asia, however, has already been adapting to this shift since post 2008, with export volume growth below 5% (this versus the 15% Asia was used to before 2008). Asia’s strength remains its heterogeneous 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, while 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. 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 a 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.

In the Asian fixed-income space, market differentiation remains key. 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 with 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, even as supply and diversity of issuers continue to grow. 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. Regulatory changes involving margining requirements for non-deliverable forwards (NDFs), and subsequently all other currencies, will result in a reduction in liquidity for both hedging and speculative positioning by investors. This will structurally impact behavior of FX currency pairs, resulting in underlying currency fundamentals, portfolio and investment flow to have more significant bearing on currency valuations. Hence, we will take these factors into consideration when managing FX exposure and risks within the portfolio.

Brandywine Global
Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
RARE Infrastructure
Royce & Associates
Western Asset Management

Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long term, actively managed investment strategies.

- Over US$754 billion* in assets invested worldwide in a broad mix of equities, fixed income, alternatives and cash strategies
- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

* As of 30 September 2017.w

IMPORTANT INFORMATION

Source: Western Asset Management. This document is issued by Legg Mason Asset Management Singapore Pte. Limited (Registration Number (UEN): 200007942R), in Singapore and by Legg Mason Asset Management Hong Kong Limited in Hong Kong and Macau ("**Legg Mason**"). This document is for information only and does not constitute an offer or invitation to the public to purchase any shares in any fund in Singapore, Hong Kong or Macau.

If this document is distributed in Macau, this may not be used other than by the Distributors.

This document is for information only and is not intended to provide investment advice. All data, opinions, estimates and other information are provided as of the date of this document and may be subject to change without notice. Where past performance is quoted, such figures are not indicative of future performance. Investors intending to subscribe for any units or shares of a fund should refer to the Fund's most current offering document. **INVESTMENT INVOLVES RISKS**. Please refer to the offering documents for further details, including the risk factors. Although information has been obtained from sources that Legg Mason believes to be reliable, no guarantee can be given as to its accuracy and such information may be incomplete or condensed and may be subject to change at any time without notice.

Any views expressed are opinions of the respective investment affiliates as of the date of this document and are subject to change based on market and other conditions without notice and may differ from other investment affiliates or of the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. The mention of any individual securities/ funds should neither constitute nor be construed as a recommendation to purchase or sell securities, and the information provided regarding such individual securities/ funds is not a sufficient basis upon which to make an investment decision. Portfolio allocations, holdings and characteristics are subject to change at any time. Legg Mason, its affiliates, officers or directors, may have an interest in the acquisition or disposal of the securities mentioned herein. Distribution of this document may be restricted in jurisdictions, other than Hong Kong, Macau and Singapore. Any person coming into possession of this document should seek advice for details of, and observe such restrictions (if any).

Neither Legg Mason nor any officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this document or its contents. The information in this document is confidential and proprietary and may not be used other than by the intended user. This document may not be reproduced, distributed or published without prior written permission from Legg Mason.

Issuer in Hong Kong and Macau:
Legg Mason Asset Management Hong Kong Limited.

This document has not been reviewed by the Securities and Futures Commission in Hong Kong or Monetary Authority of Macao in Macau.

Issuer in Singapore:
This material has not been reviewed by the Monetary Authority of Singapore in Singapore.

FOR PUBLIC IN SINGAPORE AND HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY.

w