Nikko Asset Management

# From The FIXED INCOME Desk

Monthly Outlook

## October 2014

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## Summary

- In its September Federal Open Market Committee (FOMC) statement, the US Federal Reserve (Fed) renewed its pledge to keep interest rates near zero for a considerable time after its quantitative easing (QE) program ends in October. However, the US Fed indicated it could raise borrowing costs faster than expected when it starts moving.

- For the month, the 10-year US Treasuries (UST) yield rose sharply by about 15 basis points (bps) to 2.49% after reaching an intra-month high of 2.62%.

- Malaysia maintained its benchmark overnight policy rate in September, while Philippines raised both its policy rate and special deposit accounts (SDA) rate to curb inflation.

- Volatility returned to Asian credits arising from sharp movements in the risk-free rates and credit spreads in the month. Asian credit spreads came under pressure from a series of exogenous and endogenous developments.

- Over the month, Asian high-grade credits returned -0.81% while high-yield credits returned -0.89%. Activity in the primary market picked up in September with total issuance amounting to around USD 13.6bn.

- Thai and Malaysian bonds are expected to be well-supported, while Indonesian bonds are likely to be well sought-after as concerns over the bond supply have eased in the country. We underweight Singapore and Hong Kong bonds on expectations of a rising UST yield. We continue to underweight Philippines bonds due to the sticky inflation and ongoing monetary tightening cycle.

- The development of the pro-democracy protests in Hong Kong, political progression in Indonesia and the USD strength are expected to drive the performance of Asian credits. Meanwhile, the pipeline for new issues continues to build. While near-term volatility could temper the amount of new issuance, expectations of a heavy pipeline is likely to cap any spread compression in the coming month.

ASIAN RATES
AND FX

## Market Review

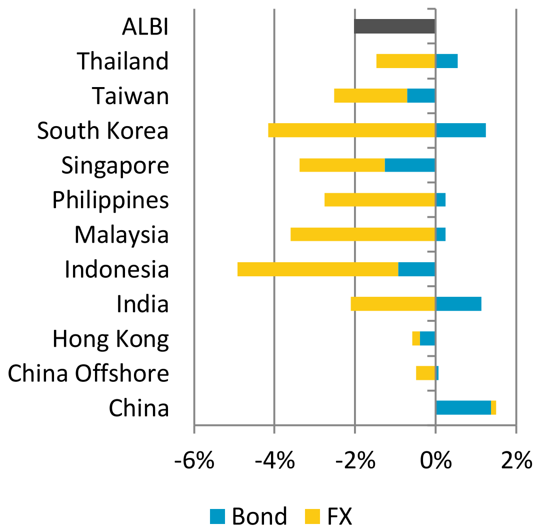
THE US FED KEPT ITS INTEREST RATE GUIDANCE INTACT

*Few changes in September FOMC statement but more hawkish interest rate projection*

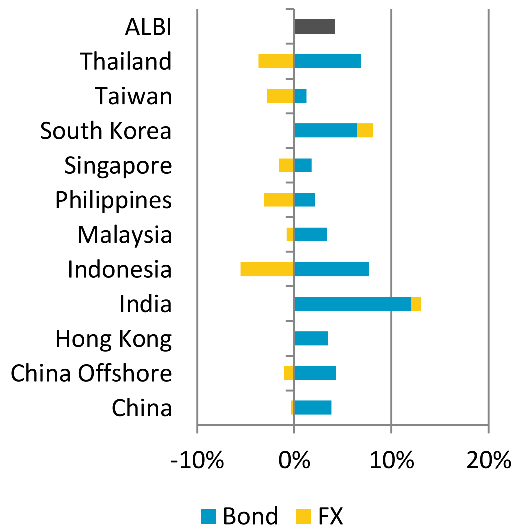
Contrary to market expectations, the US Fed maintained its guidance in the September FOMC statement that short-term interest rates will remain near zero for a "considerable time" after the end of its QE program and reiterated that there remains “significant underutilisation” of labour resources. However, despite maintaining the dovish tone in the statement, interest rate projections by FOMC members pointed to a faster pace of rate increases. The FOMC now expects a rate of 1.25% to 1.5% as at end-2015 and an interest rate of 2.75% to 3% by the end of 2016. The US Fed also revised down both its growth and unemployment rate forecasts. Specifically, GDP forecast for 2014 was reduced from 2.2% to 2.1%. Similarly, growth for 2015 is forecasted at 2.8% instead of 3.1%. For unemployment, it now expects a little below 6% by the end 2014 and 5.5% for 2015.

### HSBC Asian Local Bond Index (ALBI)

**For the month ending 30 September 2014**




**For the period from 1 October 2013 to 30 September 2014**




Note: Bond returns are in local currencies while FX and ALBI returns are in USD. Past performance is not necessarily indicative of the future performance.
Source: HSBC Asian Local Currency Bond Indices, Bloomberg, 30 September 2014

*Bank Negara Malaysia (BNM) pauses on monetary tightening*

At the September Monetary Policy Committee (MPC) meeting, BNM left its benchmark overnight policy rate unchanged at 3.25%, after raising rates in July. While its policy statement was more dovish on growth and inflation than previously, the central bank continued to leave the prospect of further tightening open. According to the concluding paragraph in the policy statement "further adjustment to the degree of monetary accommodation may be taken depending on how new information will affect the assessment on the balance of risks". It was indicated that the MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth, inflation and financial imbalances.

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■ *Bangko Sentral ng Pilipinas (BSP) tightens policy to curb inflation pressures*

In September, the BSP raised its policy rate (reverse-repo rate), repo-rate and SDA rate by 25bps in September to 4.0%, 6.0% and 2.5% respectively, while leaving the reserve requirement rates unchanged at 20%. The central bank also increased its 2014 inflation forecast from 4.3% to 4.5% and 2015 inflation from 3.74% to 3.8%. The BSP highlighted that the balance of risks to the inflation outlook continues to lean toward the upside, with price pressures emanating from the possible further increases in food prices as a result of tight domestic supply conditions, as well as from pending petitions for adjustments in utility rates and potential power shortages. The Monetary Board believes that the continued favourable prospects for domestic demand, as evidenced by the stronger GDP growth in the second quarter, allow some scope for a further adjustment in policy rates.

■ *Thailand announces 2015 financing plans*

Thailand's Public Debt Management Office (PDMO) has announced the government's fund raising plan for the FY2015 (October 2014 to September 2015). The PDMO intends to raise THB 705bn in FY2015 with THB 445bn via issuance of loan bonds, inflation linked bonds and amortising and THB 260bn via loans, savings bonds and promissory notes. Given the total maturities of THB 279bn in FY2015, net issuance is lowered by 14% at THB 166bn compared to THB 194bn for FY2014. With the objective of enhancing liquidity of the benchmark bonds, the PDMO will be re-issuing bonds instead of creating new benchmark series in FY2015.

## Market Outlook

INDONESIAN BONDS OFFER ATTRACTIVE YIELDS TO INVESTORS

■ *Positive on Thailand, Indonesia and Malaysia bonds*

We remain broadly positive on ASEAN bonds, expecting them to be resilient even in the event of US Fed's tightening. Meanwhile, we expect Thailand bonds to be well supported as growth in Thailand remains anaemic and an accommodative monetary stance is required. Elsewhere, the recent sell-off in Indonesia bonds due to political concerns had pushed yields higher, and is now offering attractive yields to investors. Given that bond supply concerns have eased, we expect Indonesia bonds to be well sought-after going forward. In Malaysia, long-term fiscal consolidation plans and implementation of the Goods and Services Tax in 2015 will bode well for Malaysia bonds. We do not expect BNM to embark on aggressive tightening and monetary policies will likely be data-dependent going forward.

■ *Remain underweight in Singapore, Hong Kong and Philippines*

Given that Singapore and Hong Kong bonds are highly correlated to USTs, we remain underweight in Singapore and Hong Kong bonds on expectations that the UST yields is likely to rise. We are also underweight in Philippines bonds on the back of sticky inflation and ongoing monetary tightening cycle.

## ASIAN CREDITS

### Market Review

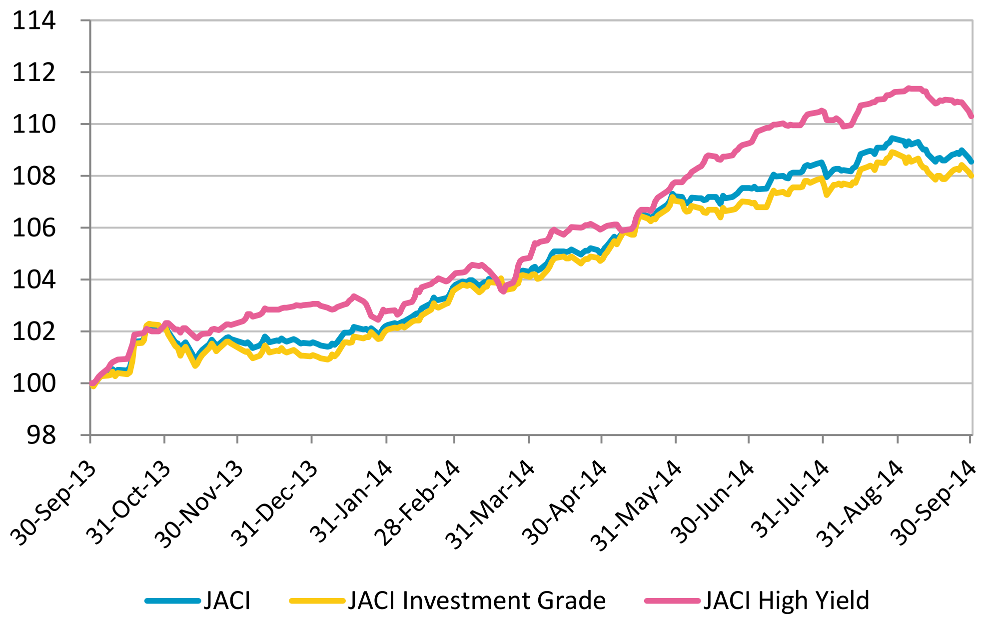
RETURNS FROM ASIAN CREDITS WERE NEGATIVE IN SEPTEMBER

*Volatile month for Asian credits*

Volatility returned to Asian credits arising from sharp movements in the risk-free rates and credit spreads. For the month, the 10-year UST yield rose sharply by about 15bps to 2.49% after reaching an intra-month high of 2.62% due to heightened concerns that the US Fed may turn more hawkish at the September FOMC meeting. Asian credit spreads also came under pressure from a series of exogenous and endogenous developments, including the pro-democracy protests in Hong Kong. On a total-return basis, Asian high-grade credits returned -0.81% while high-yield credits returned -0.89%. High-grade spreads widened by 3bps to around 180bps by end- September after tightening by about 10bps earlier.

### JP Morgan Asia Credit Index (JACI)

**Daily Returns for the period from 1 October 2013 to 30 September 2014**




Note: Returns in USD. Past performance is not necessarily indicative of the future performance.
Source: JP Morgan, 30 September 2014

*Spreads under pressure from an array of pressure points*

During the month, market sentiment was weighed down by external pressure points, including weakness in the broader emerging market space (particularly in Latin America) and continued tensions between the West and Russia. Sentiment was also held down by concerns over the weakness in the US credit markets, especially high-yield, which may result in some spillover to Asia credits. Within Asia, there were renewed concerns that the economic growth in China may once again be losing momentum. In late-September, news that the People's Bank of China will be working with banks to lower mortgage rates for first home buyers lent some support to Chinese property credits. Elsewhere, news that Indonesia's parliament passed a controversial law scrapping direct local elections, which is seen as undermining the democratic process, dampened sentiment towards Indonesia sovereign and quasi-sovereign credits. Meanwhile, the Occupy Central pro-democracy protests in Hong Kong in late-September pulled down market sentiment further, although spreads for Hong Kong credits widened only marginally thus far.

*Pace of new issuance picked up but was lower-than-expected*

While activity in the primary market picked up, it was lower-than-expected as volatility rose. In September, total issuance amounted to around USD 13.6bn, up sharply from around USD 5.4bn during the lull in August. Of these, there was around USD 11.2bn of high-grade issuance coming from 20 issues and around USD 2.4bn of high-yield issuance from 10 issues.

## Market Outlook

*Developments in Hong Kong, Indonesian elections and USD strength bears monitoring*

The development of the standoff between the authorities and protesters in Hong Kong is likely to drive the direction of Chinese and Hong Kong credits in the near-term. In addition, continued signs of slowing economic growth in China and softness in the property sector will likely exert some pressure on Chinese credits. Meanwhile, the Indonesian sovereign and quasi-sovereign complex is expected to be driven by political developments and posturing by the different political parties as Joko Widodo prepares to be sworn in as President on 20 October 2014. While the economic footings of Asian economies have improved since mid-2013, the recent sharp depreciation of many Asian currencies against the USD may again heighten concerns over the current account and fiscal deficits of some countries.

MEDIUM-TERM OUTLOOK FOR ASIAN CREDITS REMAINS DECENT

*Supply likely to put a lid on significant spread tightening but medium-term fundamentals intact*

The pipeline for new issues continues to build. While near-term volatility could temper the amount of new issuance, expectations of a heavy pipeline is likely to cap any spread compression in the coming month. With significant bank subordinated debt issued recently and a heavy pipeline expected from Chinese banks, returns from this sector is likely to remain lackluster in the near-term. While Asian credit is confronted by near-term challenges, the medium-term outlook remains decent with economic growth unlikely to slow sharply and default rates expected to remain low.