Western Asset Management

August 2017

ASIA
FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) saw gains of 0.94% month-over-month (MoM) in August, bringing year-to-date (YTD) gains to 5.36%. Gains were driven across the US Treasury (UST) curve, in spite of marginal widening spreads. The top-performing sector was non-investment-grade sovereigns, which saw gains of 1.43%; the weakest sector was investment-grade corporates, which saw gains of 0.83%. UST yields bull-flattened, driven by the long end of the curve.

It was another strong performance month for Asian credit on the back of significant tailwinds coming from the UST markets (the 10-year UST rate ended August at 2.12%, while it began the month at 2.25%). The JACI FINS CORP Index had a return of 0.6% in August, which resulted in a YTD 2017 return of 3.7%, while the JACI NONFINS CORP Index had a banner month with returns of 1.1% in August and as such, YTD 2017 returns of 5.4%. On a sector basis and beginning with Asian financials, the geography that clearly underperformed was Korea which is not surprising given the increased geopolitical risks on the Korean Peninsula. Korean quasi-sovereign bank and commercial bank 5-year paper were about 3 basis points (bps) wider, while higher beta HYUCAP 22s were 8 bps wider. There was more underperformance out of the 10-year space with the likes of EIBKOR 27s being 6 bps wider. We also saw some underperformance out of the Indian financials space—much more so for 10-year paper as the EXIMBK 26s and RECLIN 27s were 6-7 bps wider during the month, while Indian financial 5-year paper spreads were largely unchanged. Over in China, bank seniors—both 5- and 10-year paper—finished the month 3-5 bps tighter across the board, while we did see spreads move wider in the Chinese leasing and AMC space. Chinese leasing 5-year paper was 2-3 bps wider (such as ICBCIL 22s and BCOMFL 22s), while on the AMC front, the CCAMCL 22s were 4 bps wider, but the HRAM 22s (and HRAM complex in general) had seen significant pressure with spreads 12 bps wider in the month on the back of market anticipation of a new deal. Spreads in South East Asian financials were marginally tighter, though we did see some Thai banks outperform, such as the BBLTB 22s being 6 bps tighter in August. In the Asian corporate space and similar to their financials peers, we saw weakness out of Korea. Korean 5-year quasi-sovereigns (such as KOHNPW 22s, KORGAS 22s) were 3-5 bps wider with non-government linked entities such as GSCCOR 22s being 6 bps wider. There was more pressure for 10-year Korean quasi-sovereigns as KORGAS 27s and KOROIL 27s were both nearly 10 bps wider during the month. The bulk of spread moves in other Asian geographies were generally 3-5 bps tighter, though we would highlight some significant outperformance from high quality Tier-1 Chinese state-owned enterprises (SOEs). For example, the CHGRID 22s and SDIC 22s were 8-9 bps tighter in August, while the CHGRID 27s and SDIC 27s were about 15 bps tighter. On the new-issue front, we saw a well-expected seasonal slowdown in new issuances as the amount of investment-grade Asian corporate/financials new prints in August totaled US$8.1 billion, which is about half of July's tally. In terms of the geographical split, August was relatively well balanced with Chinese, Indonesian, Korean and Indian issuers accounting for 27%, 25%, 19% and 16%, respectively, of the new investment-grade Asian corporate/financials prints. That stated, we think as the new-issuance calendar comes out of the seasonally slow summer in September, Chinese issuers should once again start to account for north of 50% of the issuance pie.

The Markit Asia Local Bond Index (ALBI) saw gains of 0.49% in August, bringing YTD returns to 8.23%. Returns were positive across all markets with the exception of China onshore and South Korea, with Indonesia leading gains at 2.24%. Asian currencies were mostly stronger on the back of broad-based USD weakness. The Chinese yuan outperformed with gains of 1.92% onshore and 1.97% offshore.

OUTLOOK

The Federal Open Market Committee (FOMC) has become increasingly concerned about the decline in inflation even though much of the committee views the recent declines as transitory. The FOMC minutes also include discussion of the potential flattening of the Phillips curve, but “most” believed the framework remained “valid.” Economic activity was characterized as “rising moderately” with a continued expansion in both household spending and investment. Participants saw labor market conditions strengthening further since the last meeting, noting that job gains “picked up substantially” and that the unemployment rate remains low by historical standards. The July FOMC minutes suggested changes were afoot to the US Federal Reserve’s (Fed’s) balance sheet reinvestment policy at the upcoming 20 September meeting—with only “significant adverse developments” that could stand in its way. Weak labour force productivity growth continues to be the key driver of slower growth and wage inflation, lower productivity growth implies that the US economy will need more workers to achieve the same rate of output growth.

With global trade picking up on a cyclical basis and major economies moving into a growth sweet spot, financial assets continue to benefit from a slow monetary normalization path and a low-inflation, moderate-growth environment. Global growth remains supported and broad based across both developed and emerging economies. The rise of the informal sector, the sharing economy, has resulted in a greater share of jobs going to part-time employment. Entrants to the labour market are moving into the gig economy, into low-skill, on-demand employment. This has resulted in persistently low wage growth which in turn alongside range-bound oil prices continues to anchor inflationary pressures. Challenging demographics, slowing labour force growth and the difficulty in driving productivity growth will also continue to be a dominant anchor of inflationary pressures.

Tensions on the Korea Peninsula, stoked by an aggressive North Korean leader, have increased in Asia. The sixth nuclear test was claimed to be a hydrogen bomb loaded into an ICBM. North Korea’s latest claim follows the July ICBM tests that brought Kim Jong-un’s regime a step closer to achieving its aim of being able to deploy a nuclear warhead over the continental US. Yet as much as tensions have elevated, they remain contained as there appears no way out in terms of either a military response or diplomatic overtures. Bank Indonesia (BI) lowered the policy rate (7D reverse repo rate) by 25 bps to 4.50%, against the market consensus for a hold. This marks the first rate cut since October 2016 (after BI lowered the rates six times in 2016). BI cited low/manageable inflation, low risk from US rates normalisation, and importantly the need to support domestic growth, as the key reasons behind the rate cut. This is likely a one-off opportunistic cut with an overall neutral stance as evidenced in its accompanying monetary policy statement. BI continues to be focused on pursuing stability and building resilience to external risks. The move is a sense of how growth pressure is building up in the Jokowi administration though BI appears to have acted relatively prudently by easing when the conditions are in its favour.

In China, China Unicom has become the first major centrally owned SOE to announce a mixed ownership plan. 10 strategic investors took part in this private share placement program, and their investment share ratio could have reached 35.2%, compared to the shareholding of 53% by the state. The share of private investors in this mixed ownership reform amounts to 18.85%, while the investment from Tencent (5.18%), Baidu (3.3%), JD (2.36%) and Alibaba (2.04%) is largest. Chinalife, a major state-owned insurer, invested RMB 21.7 billion, accounting for 10.22% of the total share, and became the largest strategic investor in this round of private share placement. Furthermore, the employees of China Unicom hold around 2.7% of Unicom shares, in addition to the existing public stockholders of 25.4%. According to the announcement, China Unicom’s (CU) parent company China United Network Communications would raise CNY61.7 billion from the deal. This amount would then be injected—either via a new share placement or a loan of favourable terms. If this is via a new share placement, it should help to effectively lower CU’s net gearing in FY17 to ~20%, from ~51%. Given the unsustainable trajectory of SOE debt (SOE debt is about 103.4% of GDP or 65% of the total corporate debt) and leverage, privatization via mixed ownership reform is crucial in lowering debt levels. This also paves the way for debt to be used for equity swaps in other SOEs. From an operational perspective, strategic partnership with the private sector would be positive for increasing efficiency. The People’s Bank of China (PBoC) continues on its uphill task to manage liquidity growth and regulatory arbitrage and in its latest move it has restricted banks from issuing non-convertible debentures (NCDs) more than one year from 1 Sep, the NCD market being a fast-growing market with an outstanding size of around CNY 8.4 trillion. While the market impact is limited given that short-dated NCDs form only less than 2% of total issuance, the PBoC continues to tighten the noose around related regulations at managing liquidity growth.

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.

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