Legg Mason Global Asset Management

ASIA FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) lost 0.17% month-over-month in December, bringing year-to-date (YTD) gains to 5.81%. Losses were primarily due to weakness in US Treasuries (USTs) across the UST curve. The top-performing sector was non-investment-grade sovereigns, which saw gains of 0.42%, while the weakest sector was investment-grade sovereigns, which saw losses of 1.08%.

USTs saw losses across most of the curve on a bear-flattening move following Donald Trump's presidential victory and expectations of a significant fiscal shift that would boost both near-term growth and inflationary expectations, ultimately leading to the Federal Reserve's (Fed's) hike. Five-year USTs widened by 9 basis points (bps) to 1.93%, while the yield on 10-year USTs widened 6 bps to 2.44%. Returns were mixed across the JACI; Pakistan was the top performer with gains of 0.93% while Indonesia performed the worst, with losses of 1.08%.

On the back of the month shortened by the holiday season, and after two challenging months, it was a relatively subdued December in terms of returns. USTs were well settled as, for example, the 10-year UST began December and ended December at very similar levels (albeit with a spike in yields mid-month). The JACI FINS CORP Index was flat during the month of December, bringing the full year returns to 3.4%, while the JACI IG NONFINS CORP Index saw December returns of -0.2%, resulting in full year returns of 4.2%. On a sector basis and beginning with Asian financials, spreads were generally unchanged to tighter across the investment universe. After two months of underperformance, Korean financials (both commercial and quasi-sovereign entities) recouped some of their losses, led by 10-year paper (such as EIBKOR 26/27 and KDB 26), which saw spreads tighten 5-8 bps. Other outperformers included Indian financials, which saw spreads tighten 7-10 bps for quasi-sovereign EXIMBK 21s/26s and a similar amount for the ICICI 20s/26s. In China, bank seniors were mostly unchanged across the curve with bank bullet Tier-2 paper (BCHINA 24s/ICBCAS 25s) seeing about 10 bps of tightening. The other pocket of outperformance in Chinese financials were the asset management companies, with 5-year paper about 5 bps tighter and 10-year paper 10-15 bps tighter. Singaporean, Malaysian and Thai bank seniors and capital instruments were largely unchanged in terms of spreads during December.

As for the Asian corporate space, we would note that with the exception of some pockets of weakness, spreads were generally tighter across the board. The only obvious area of weakness was in some of the Chinese local government financing vehicle, or LGFV, names (which had done well in the previous months), with TRTHK 21s, CQNANA 21s and JNXCCC 21s 3-5 bps wider. On the other hand, Chinese technology names generally performed well with the JD 21s and HUAWEI 26s 10-12 bps tighter in the month. Similar to their financial peers, Indian corporates saw 10-15 bps of tightening at the 10-year part of the curve (NTPCIN 26s and ONGCIN 26s in particular) with 5-8 bps of tightening at the 5-year mark (NTPCIN 21s and IOCLIN 21s in particular). Another area where we saw outperformance was in Malaysia, specifically the oil-related quasi-sovereign PETMK complex with the PEMTK 22s being 5 bps tighter and the PETMK 26s 10 bps tighter. Also performing well were non-oil peers TNBMK 26s and AXIATA 26s—both 10-15 bps tighter.

On the new issue front, not surprisingly, the amount of issuances dropped off in December given the holiday season. There was only a total of US$5.1 billion of investment-grade corporate/financial new prints in December compared with US$10.5 billion in November and US$15.1 billion in October. We would note that the Indonesian sovereign's US$3.5 billion three-tranche deal in early December accounted for the lion's share of the total US$5.1 billion of new prints.

The Markit Asia Local Bond Index (ALBI) saw losses of 1.22% during December, bringing YTD gains to 1.73%. Asian local currency bond markets continued to see losses this month, driven by an increase in yields across most markets alongside the change in tone in USTs. Asian rates broadly sold off across most markets, with Malaysia and Indonesia being the only exceptions, on the back of a selloff in global core rates. Indonesia led the outperformance with positive returns of 1.87%, as the correction in yields resulted in investor interest and a positive growth outlook for 2017. The biggest losses were in South Korea at -2.91%. Asian currencies saw mostly declines versus the US dollar with the Korean won leading the declines, weakening 2.57% versus the US dollar while the Indian rupee saw gains of 0.85%.

OUTLOOK

The Fed raised interest rates 25 bps in its December meeting, as widely expected. Three hikes rather than two were featured in the dot plot of expectations for the appropriate rate of fed funds in 2017, after some participants incorporated potential fiscal policy shifts. The statement noted that inflation expectations had moved up "considerably" but were still low. Risks to the outlook were described as "roughly balanced," unchanged from November. Fed Chair Janet Yellen noted that there may be some degree of labor market slack, but fiscal policy was not needed when the unemployment rate was 4.6%—already a "modest undershoot" of the Fed's long-run estimates. Minutes from the December Federal Open Market Committee (FOMC) meeting indicated that the Board staff and "about half" of FOMC participants incorporated preliminary assumptions about fiscal easing into their projections. Growth forecasts by FOMC participants were also boosted by expectations of prospective fiscal stimulus. However, it is worth nothing that officials "emphasized their considerable uncertainty about the timing, size, and composition of any future fiscal and other economic policy initiatives as well as about how those polices might affect aggregate demand and supply." The actual policies that will be implemented remain to be seen, specifically those on tax reform and infrastructure spending.

Markets appear to be taking two divergent narratives, with equities pricing in higher growth on the back of Trumponomics while fixed-income markets are pricing in the impact of inflation and a change in trajectory for the Fed and rates. Labour market tightening in the US should boost reflationary expectations. Additional infrastructure spending will put more upward pressure on construction worker wages, which could also be affected by Trump's immigration policies. The limits on growth will be felt as rates move higher and there may be a resulting dampening effect on mortgages on top of already tightening lending standards. Many changes will depend largely upon which of Trump's policies eventually get approved by Congress.

Policy divergence will increase going into 2017, highlighting the difference in social-political and economic trajectories, globally. National politics and policymaking are likely to become increasingly insular as politicians seek to appease the electorate ahead of the next election. In Asia, we have been seeing it unfold with the rise of Narendra Modi in India, Joko Widodo in Indonesia and Rodrigo Duterte in the Philippines. These are political outsiders who rode mass support to power with an agenda that promised growth and prosperity with gains accruing to the middle class. 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. In a report on the impact of rising populism on sovereign creditworthiness, Fitch notes that "There are two potential sovereign credit consequences. The populist appeal of more accommodative fiscal policies in countries with high government debt levels could put pressure on ratings. Secondly, increased nationalism, specifically related to trade policy and immigration, may ultimately lead to lower economic growth, weaker export earnings and the emergence of balance of payments and external debt repayment challenges."

The global trade outlook remains negative, with major global trade agreements now in limbo. Expectations will likely increase for further slowdown as a result of uncertainty and that could translate to more risk-averse behavior by corporations and consumers across the developed world. That said, a protracted global trade war is not likely, because even as one country seeks to put up barriers to imports, the retaliation in terms of barriers to their own exports both in terms of goods and services should curb the magnitude of trade restrictions. The US consumers' sway on the economy and the potential spike in prices reduces Trump's ability to pursue a trade war, just as previous attempts by President Bill Clinton to tax high-end Japanese automobiles were shelved because of lobbying by US dealers of Japanese cars. Similarly, Chinese firms that assemble iPhones would be less affected if Apple shifted assembly onshore due to the rise in iPhone prices. What is clear, however, is that the global supply chain is likely to dis-intermediate and regional supply chains will emerge in its wake. This has been driven by technological advancements in production technology, shorter product lifecycles and shifts in consumer behavior. The shift in political landscape will hasten the breaking up of extended global supply chains. One can expect to see increasing regionalization and re-rationalization of production chains by corporates, hastened by political shifts by made possible by new technology and further driven by cost optimization. There is a stoic confidence that whatever policies the US imposes on China and by extension the region, Asia and China have enough means to respond and emerge stronger. 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.

In today's environment of increasing fragmentation, of economic boundaries and of less cooperation it will perhaps be wise for investors to seek to reduce misalignments, such as those of asset-liability duration, currency and risk, in order to seek to protect against unnecessary risks with asymmetric returns, specifically on the downside. This would imply a home bias, to insulate against currency risks, and this could mean that in seeking diversification it would make sense for an investor to not look too far outside their immediate region, given the alignment of currency risks. 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 that measured 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 South East 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.

That said, risks (clearly emanating from China) remain from a debt overhang and capital misallocation, mispricing and its associated effects on property prices and the banking system; however, risks remain endogenous to both the country and its domestic political economy. 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 enterprise 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, specifically Xi Jinping, so that he has the political clout and capital to replace members in the Politburo and PSC with his preferred candidates. 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, result in a loss of confidence and trigger more outflows.

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 such as India, Indonesia and the Philippines. Positioning becomes another key factor, not just whether positioning is heavy or light but the source of the positioning also matters. 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 aspect, Asia markets that have significant regional or home bias will see yields supported by such technicals. 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 (US29.4 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. While 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. Trump's anti-TPP stance could hamper President Tsai Ing-wen's agenda to diversify export markets beyond China. In the case of the Philippines, its less clear cut as President Duterte appears to have extended an olive branch to President-elect Trump, the significant linkages to US in the form of trade, remittances and business process outsourcing, or BPO, poses vulnerability in the event of a shift in foreign and economic relationship between the Philippines and the US. India should continue to outperform, with currency reform on the back of its taxation reform buttressing the case for an improved growth outlook and more room for monetary easing.

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