LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management December 2017

ASIA FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) saw month-over-month (MoM) gains in December with a return of 0.17%, bringing year-to-date (YTD) gains to 5.78%. Gains were seen across the US Treasury (UST) curve and spreads tightened for the month. The top-performing sector was investment-grade sovereigns, which saw gains of 0.17%; the weakest sector was investment-grade quasi-sovereigns, which saw gains of 0.07%. UST yields bull-flattened, driven by the long end of the curve.

With rates largely range-bound for a second month in a row in December (10-year USTs ended December at 2.40%, while it began the month at 2.36%) and spreads having an unchanged bias overall, monthly returns were relatively muted. The JACI FINS CORP Index saw flat returns which resulted in full-year 2017 returns of 3.8%, while the JACI NONFINS CORP Index returned 0.1% in December—taking us to a full-year return of 5.6%. On a sector basis and beginning with Asian financials, given the holiday season and muted trading liquidity, we saw bonds mostly unchanged across the board with at best 1-2 basis points (bps) of widening or 1-2 bps of tightening in terms of volatility. That stated, we do note the 6 bps of widening in the Chinese leasing BCOMFL 27s during the month of December, while outperformance came in the form of Filipino bank BDOPM 23s and UBPPM 22s tightening 9 bps and 13 bps, respectively. On the non-financials front and similar to their financial peers, spreads were largely unchanged throughout Asia, though we would highlight some outperformers—Chinese VNKRLE 27s and HAOHUA 22s/27s were all 5 bps tighter along with Malaysian GENTMK 27s also 5 bps tighter. On the other hand, we saw Hong Kong's NWDVEL 22s widen 8 bps as an outlier on the underperformance end. On the new-issue front, we saw a robust primary calendar, despite the holiday season, as December 2017 monthly issuance in Asian investment-grade corporate/financials totaled US$13.2 billion, which is a significant tally given the average monthly December issuances over the past three years (2014-2016) only came up to just over US$4 billion. Of the US$13.2 billion of new issuance this December, 60% came from China and 30% came from Indonesia (courtesy of a US$4 billion sovereign print).

The Markit Asia Local Bond Index (ALBI) saw gains of 1.07% in December, bringing YTD returns to 11.04%. Returns were strong across most markets with higher-quality markets seeing gains driven by corresponding moves in USTs. Indonesia led outperformance with gains of 2.85% as positive year-end supply technicals, an upgrade by Fitch and expectations of index inclusion drove outperformance. The Philippines underperformed with losses of 0.84% even though onshore liquidity conditions remained firm. Asian currencies were mostly stronger, driven by a weaker US dollar across the board. The Korean won outperformed with gains of 1.77%, while the Indonesia rupiah underperformed with losses of 0.35% as Bank Indonesia continued to build foreign exchange (FX) reserves while keeping the rupiah on a stable footing.

OUTLOOK

Global growth momentum in 2018 will be supported by still accommodative monetary policy, lower fiscal drag, trade recovery and supportive consumer sentiment. Monetary authorities in advanced economies, with the exception of Japan, will be easing monetary accommodation after several years of extraordinary easing prompted by the global financial crisis. The unusually low core inflation levels across both advanced economies and many emerging markets (EM) will keep the pace of the normalization gradual. The challenge will be managing near-term headline inflation pressures from a low base and not stifling the growth momentum needed to resolve more fundamental structural challenges to growth arising from demographic and technological shifts. The high debt levels in advanced economies, unfavorable demographics and still slow structural growth rates also suggest limited upside for rates given debt overhang risks and the attendant feedback loop into consumer confidence.

The US economy heads into 2018 with strong growth momentum and an unemployment rate already below levels that Fed officials view as sustainable, and with the economy operating at full capacity. Wage growth is moving towards the 3.00%-3.25% rate, core inflation should also accelerate in 2018 at 1.8% as rising labor costs boost services prices, higher energy prices and a weaker dollar pass-through to the core, and as the drag from healthcare policy diminishes. The Federal Open Market Committee (FOMC) raised rates for a third time this year at its December meeting. It also increased the caps on reinvestments to US$10 billion per month, as expected. Despite stronger economic forecasts, the committee's rate projections were largely unchanged and continue to show a gradual tightening of policy in the years ahead. Median rate projections continued to show three hikes for 2018 and two for 2019. The long-run median dot was also unchanged, although the 2020 dots shifted up slightly. Chair Janet Yellen reiterated that the majority of the FOMC views current weak inflation as likely to be transitory. However, she acknowledged that there has been a "prolonged shortfall" in inflation and that the 2.0% target is "symmetric," so weak inflation remains a risk to current policy. While the tax reform package marks a key change in US tax policy and continues to boost positive growth sentiment, the actual pass-through and economic impact remains uncertain; the December Fed meeting minutes suggest that Fed members only see a modest boost to capital spending with the magnitude of its effect uncertain.

In Europe, consumer inflation has staged a rebound in 2017, and aggregate real wage growth has also been picking up, driven by some combination of accelerating employment growth and accelerating nominal wage increases. In the German labor market, the signs of tightness are increasingly clear. In September, the unemployment rate fell to 3.6%, the lowest since reunification. While headline unemployment remains higher in other parts of the eurozone such as in France at 9.7%, cyclical improvement continues to support wages. Structural employment issues remain but in the near-term, wages and inflation pressures will rise. The European Central Bank (ECB) will seek to avoid a sharp increase in long-term rates which will threaten the stability of still highly indebted sovereigns and households. However, the ECB will likely signal a quantitative easing (QE) exit by the middle of 2018. The Bank of Japan (BoJ) would also have to manage the risks to its balance sheet judiciously; given its size, any abrupt change in monetary policy would have a significant destabilizing effect on global core yields. While the BoJ has been specific about maintaining accommodation as long as inflation remains below 2%, the economy is already at full employment with asset prices rising and a labor shortage. Japanese companies facing their worst labour shortage in 40 years have improved benefits and shifted contract workers to permanent roles in a reversal of the trend towards part-time and contract work over the last decade. The impact of an abrupt rise in yields on the BoJ's balance sheet as well as fiscal risks to the government is significant. While it takes about four years for the Fed to wind down QE by holding securities to maturity to avoid realizing capital losses, it would take the BoJ 20 years to do the same as estimated by the International Monetary Fund (IMF).

Significant global risks would be largely in the geopolitical realm. On the Korean peninsula, the political calculus in view of the regime's need to stay in power would imply that even as tensions will rise from time to time, the risks of escalation remain low. In the Middle East, though, the risks of strategic miscalculation remain high, as still low oil prices continue to result in significant deficits in countries such as Saudi Arabia. Any domestic instability out of Saudi Arabia might result in a nasty shock to oil prices given Saudi Arabia's significant role in global oil production. As for economy-specific idiosyncratic risks, they would largely be from asset price bubbles that have emerged in the aftermath of extraordinary accommodative monetary policy over the past decade.

BoJ and ECB bond-buying will exceed new issuances in the next five years; two-thirds of the US$1.5 trillion of debt issued by advanced economies since 2010 have been bought by official institutions. The IMF's analysis suggests a crowding out of private investors has been the result of the reduction of available stock of fixed-income instruments. In equity markets, given the slowdown in IPOs as private markets become more attractive, de-listings and stock buybacks have created a technical crowding out even as passive index trackers continue to pile into a smaller pool of large caps. Even as supply of high-quality bonds is constrained, demand remains strong, anchored by two structural drivers, ageing populations and regulatory requirements. In another three decades, 17% of the world's population will be over 65 years of age, from 8.5% in 2015. European insurance regulations have made it prohibitive for equity allocations given the amount of capital required to be set aside.

The Chinese economy looks set to continue to be a stabilizing force on global growth, with regained confidence in its currency management, social-political stability and still sizeable fiscal and administrative economic policy control anchoring growth. The Central Economic Work Conference (CEWC) was held in Beijing on 18-20

December, with a clear emphasis on the quality of growth instead of the quantity of growth. Three policy priorities in 2018-2020 were reiterated as being financial deleveraging, poverty reduction and environmental protection. Risks in ever rising property prices have also become a political priority, as pointedly emphasized by President Xi Jinping's remarks that "housing should be for living in, not speculation"; the shift in China's housing cycle will see a moderation in GDP over the next few years. 6% economic growth in China has a similar impact on global growth as 3% growth in the US. Even with a focus on managing financing and systemic risks from building up that will result in a slower pace of debt growth from 14% to 10% over the next few years, growth can still be maintained at 6% on the back of exports, domestic consumption anchored growth and structural reforms that support enterprise growth and labour markets. New urban job creation remains strong at 13 million jobs created annually since 2013 even as real GDP growth slowed from 7.8% in 2013 to 6.8% in 2017 above national targets of 10 million. This has been driven by rapid growth in the services sector (1.7x), which are traditionally more labour intensive, offsetting concerns of rising manufacturing costs and increasing optimization and their effect on employment. E-commerce and mobile payments now anchor a consumption and logistics eco-system that is years ahead of any other developed economy. China's e-commerce payments now account for 40% of global transaction volume, up from 1% a decade ago. Demographic shifts mean that annual new participants in China's labour force have started shrinking since 2008 (20 million) to around 15 million as of year-end 2016. In spite of longer-term demographic challenges, room remains for labour market growth as urbanization grows; agriculture still accounts for 20% of employment in 2016 versus less than 5% in other advanced economies. An insulated capital market and capital controls would continue to keep savings captive. China's high household and national savings rate will provide the space for deleveraging over time. At 20%, China's household savings rate is still double the global average while national savings still stand at around 45% of GDP. Near-term volatility is expected as policymakers seem determined to manage risks in both the financial sector and the property market. Policymakers have a significant challenge on their hands at times of contrasting priorities and opposing interests. For example in the power sector, the need to move towards cleaner sources of energy given pressing environmental concerns that have blanketed cities in smog is at conflict with the massive overcapacity in coal power generation, one billion kilowatts in size. The power generation sector is the country's most indebted, with 7.8 trillion yuan in outstanding debts.

Asia looks set for a strong cyclical uplift in 2018, with major economies delivering stronger growth supported by positive regional trade outlook, domestic political stability and endogenous growth. The global electronics Purchasing Managers' Index (PMI) is at its highest level in seven years, with a positive consumer electronics cycle benefiting trade-sensitive North Asia economies. EM assets will also continue to benefit from stable global growth while positive cyclicals and stronger fundamentals would see Asia as a beneficiary of a search for quality yield. Asia will contribute more than 60% of total global growth of a projected 3.5% in 2018 and looks set to continue to do so in the near term. The US in comparison has seen its contribution to global real GDP decrease from 25% some 20 years ago to less than 10%. A positive working age population and productivity growth remain the structural underpinning. Private investment and a government spending pickup will anchor domestic growth, though along with this, spare capacity will further narrow and Asian central banks will see less room for continued monetary accommodation. However, even cost-push inflationary pressures from rising commodity prices will remain offset by weak demand-pull inflation forces, driven by significant manufacturing slack as well as labour market dynamics. In the Asian local currency 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. In this respect, Asian markets that have significant regional or home bias will see yields supported.

The regional anchor of demand remains strong, a sign of the fundamental current account surplus the region runs. This is very clearly seen in the US dollar funding space, specifically from Chinese issuers, with non-Asian investors falling to less than 10% of issuance from more than 60% as recent as six years ago. In the USD-denominated Asian bonds space, we continue to favor higher quality investment-grade credits, while being cognizant of greater idiosyncratic risks in the high-yield space. Fundamentals wise, we note that the Asian investment-grade corporate credit universe has been on an improving trend with leverage trending down (for example net leverage at FYE14, FYE15 and FYE16 were 1.8x, 1.7x and 1.5x, respectively) and liquidity improving (for example, cash as a percentage of total debt at FYE14, FYE15 and FYE16 were 26%, 30% and 33%, respectively). Furthermore, a significant number of entities that have issued USD investment-grade bonds are government-related entities (GREs), which is closely linked to the financial health of Asian sovereigns where we believe they remain in good stead with the will and wallet to provide support for the GREs, if needed. On the valuations front, Asian investment-grade credit still offers value against, for example, US investment-grade where the current spread pickup of nearly 60 basis points (bps) on a ratings like-for-like basis is largely in-line with recent historical mean. On the other hand, the Asian high-yield credit universe's spread pickup against their US peers at under 100 bps is still below recent historical averages.

Greater exchange rate flexibility than was available during past recoveries will allow some EM central banks to tailor monetary policy to their specific needs, instead of moving their policy rates in lockstep with those of advanced economies. China will be a key anchor in the camp of maintaining its monetary policy stance with policy focused on regulatory and administrative measures to address financial and market risks, rather than higher policy rates. Overall "external beta" of EM FX—the mean impact of all the key external drivers—has declined sharply and is well below the long-term average. The World Bank estimates that unlike in 2000 when 50% of outstanding EM debt was denominated in local currencies, the number now stands at 90%, reducing the dependence on US dollar financing, which was the original sin of Latin America and Asia two decades ago. Asia FX remains fundamentally supported by current account dynamics, as well as by portfolio inflows (specifically by equity inflows over the past year). Asian equity markets have also been driven by earnings growth and there remains room for catchup flows in the equity space. This will structurally impact behavior of FX currency pairs, resulting in underlying currency fundamentals, portfolio and investment flows 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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