ASIA FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) held on to month-over-month (MoM) gains in October with a return of 0.43%, bringing year-to-date (YTD) gains to 5.79%. Losses were driven across the US Treasury (UST) curve, while spread tightening drove gains. The top-performing sector was non-investment-grade quasi-sovereigns, which saw gains of 0.83%; the weakest sector was investment-grade sovereigns, which saw gains of 0.28%. UST yields bear-flattened, driven by the front end of the curve.

With rates largely range-bound during the month of October (10-year USTs ended October at 2.38%, while they began the month at 2.34%), the credit-spread-tightening environment in Asia resulted in a rebound of performance. The JACI FINS CORP Index had returns of 0.3% during the month which brings the YTD performance to nearly +4.0%, while the JACI NONFINS CORP Index returned 0.4% resulting in returns of 5.5% on a YTD basis. On a sector basis and beginning with Asian financials, we saw a tightening of spreads in Korea—the first time after two consecutive months of spread widening. Korean quasi-sovereign and commercial bank 5-year paper tightened 5-7 bps with clear outperformance stemming from NBFI HYUCAP 22s and HYUCAP 27s where spreads tightened around 20 bps in October. We also saw the SHNHAN Tier2 2027 bullets outperform as well—ending the month nearly 30 bps tighter—compared with other Asian Tier-2 paper where spreads tightened roughly 15 bps (BNKEA 26s, UOBSP 27s, BCHINA 24s and ICBCAS 25s). Over in China, quasi-sovereign banks such as EXIMCH/SDBC saw their 10-year bonds about 12-15 bps tighter, while commercial bank 10-year paper (BCHINA 27s) tightened nearly 20 bps. Chinese NBFIs also performed well with leasing entities BCOMFL 22s/27s being 17 bps/24 bps tighter and AMCs (CCAMCL/GRWALL/HRAM) 22s/27s being 20 bps/30 bps tighter. We think the strong performance out of China is related to the anticipated tight pricing of the rare Chinese sovereign USD 5/10-year bonds which ultimately priced at T5+15 bps and T10+25 bps, respectively. Indian cross-over rated banks clearly benefitted from the Indian government's INR2.1 trillion bank recapitalization plan announced late in the month with the likes of BOIIN 20s/20s being 13-14 bps tighter, while stronger non-PSU banks such as ICICI/AXSBIN saw their bonds only tighten 2-3 bps. In the Asian corporate space and similar to their financial peers, we saw a turnaround with Korean corporate paper as quasi-sovereign 5-year paper was about 5-7 bps tighter and 10-year paper was roughly 10 bps tighter. Also similar to their financial peers, Chinese quasi-sovereigns (such as CHGRID/SINOPE, etc.) 5- and 10-year paper tightened as well—to the tune of 10 bps and 15 bps, respectively. Still in China and outside of the immediate quasi-sovereign space, we saw outsized performance from Chinese property developer SINOCE, whose 2027 bonds tightened 30 bps in October. Indian corporate bonds also performed well with the ADSEZ/NTPCIN/ONGCIN 22s being 12-15 bps, though the clear outperformers were the BHARTI complex with the 24s/25s about 25 bps tighter during the month. On the flip side, we did see underperformance out of select HK names with the CKHH 22s/27s unchanged in the month and we also saw the same performance out of the NANFUN 27s. On the new-issuance front, the total October investment-grade Asian corporate/financials new print came in at US$12.5 billion with Chinese issuers accounting for just under 60% (which is in-line with the YTD averages) and Korean issuers accounting for about 30%.

The Markit Asia Local Bond Index (ALBI) saw losses of 0.09% in October, bringing YTD returns to 7.73%. Returns were mixed across markets with higher-quality markets seeing gains while higher-emerging market (EM) beta markets saw weakness alongside moves in risk assets. Indonesia underperformed with losses of 1.38%, while on the other hand China offshore outperformed with gains of 0.18% for the month. Asian currencies were mostly stronger in spite of the risk-off theme in EM on the back of rising UST yields. The Korean won outperformed with gains of 2.29% while the Philippine peso underperformed with losses of 1.36%.

OUTLOOK

Prospects for global growth in the near term remain sound, with the global recovery strengthening across both advanced economies and EMs. The International Monetary Fund (IMF) revised up slightly its global growth forecasts for the second time to 3.6% for 2017 and changed its view of the balance of risks for growth to “broadly balanced” in the near term, from “slightly tilted to the downside” back in April. Such a growth backdrop would imply a low chance for further easing amongst developed economy central banks due to a fear of adverse side effects, financial stability considerations, a lack of need for further stimulus and concerns about upside risks to inflation in the future. The IMF highlighted the risk of rising household debt globally as a key risk to financial stability. The key finding from the IMF’s Global Financial Stability Report October 2017, published ahead of its annual meeting, is that there is a trade-off between a short-term boost to growth from higher household debt and its medium-term costs to macroeconomic and financial stability, which may result in lower growth, consumption and employment. The median household debt-to-GDP ratio in emerging economies has increased to 21% in 2016 from 15% in 2008, while in developed economies it is 63% from 52% in 2008. Mortgage debt accounts for half of household debt in developed economies; in emerging economies it captures about one-third or less. In its report, it also highlighted that countries with flexible exchange rates and better financial regulation and supervision are better placed to mitigate the risks. 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.

President Xi Jinping delivered his three-and-a-half-hour speech, from his 13-chapter comprehensive Party Work Report at the recently concluded China Communist Party Congress. The macro policy priorities and development strategies discussed in the report were largely in line with expectations. Going ahead, the focus should be on supply-side structural reforms, pushing for upgrade in quality and efficiency of growth, with higher total factor productivity growth. Governor Zhou Xiaochuan made a reform appeal in a recent interview, as he defined a “troika” of three drivers of China’s opening up: trade and investment opening, exchange rate reform, and relaxation of capital control. He said China should continue to open up its economy, despite the difficulties and challenges. At the G50 Finance Ministers and Central Bank Governors’ Meeting On 12-13 October, highlighted that economic growth in China has been strengthening, as indicated by recent data. GDP grew by 6.9% in the first half of the year, and the momentum is expected to continue in the second half. Imports and exports grew strongly, with the current account surplus expected to shrink further. Fiscal revenues continued to grow, and prices remained stable. He warned that Chinese companies have taken on too much debt, and argued for less financial leverage as well as fiscal reforms to constrain local government borrowing. Macroeconomic indicators, though, continue to be strong, with real GDP growth on track to hit 6.9% for the full year and equity markets pulling ahead with strong domestic confidence in both the political dynamism in place and the structural economic trajectory.

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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