LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management

June 2018

ASIA FIXED INCOME REVIEW

MARKET REVIEW

After posting strong performance in May, Asian credit reversed course in June despite a relatively stable environment for US rates. The yield on the 10-year US Treasury (UST) bond ended June at 2.86% after having begun the month at 2.90%, which was more than negated by credit spreads widening. The JACI FINS CORP Index saw flat returns in June which culminated in a 1H18 performance of -0.4%, while the JACI NONFINS CORP Index registered a negative return of -0.2% in June which resulted in a 1H18 performance of -2.3%. On a sector basis and beginning with Asian financials, we saw similar themes as we did in the past few months with underperformance stemming primarily from India and to a lesser extent the Philippines in June. In India, ~5-year tenor bonds such as the EXIMBK 23s and YESIN 23s were 5-10 basis points (bps) wider, while ~10-year tenor bonds saw some significant moves with RECLIN 27s/RECLIN 28s/POWFIN 27s widening 30-35 bps, though the EXIMBK 28s did outperform on a relative basis—out only 6 bps. In the Philippines, the PNBPM 23s/RCBPM 23s were about 10-15 bps wider during the month. Like last month, the insurance space in Korea and China continued to underperform with capital instruments such as the Korean HLINSU 48nc23s, KYOBOL 47nc22s, HUKLFI 47nc22s and Chinese CHILOV 27nc22s widening 30-35 bps, while the Chinese PANLIZ 77nc22s widened nearly 60 bps. Still in China, on the back of new deals being announced, Chinese AMC HRAM 27s and Chinese leasing FRESHK 23s both widened about 18 bps in June. Elsewhere, Chinese, Korean, Singaporean, Malaysian and Thai bank seniors were generally 3-5 bps wider. On the non-financials front, again in terms of across-the-board underperformance from a single geography like last month, we need to turn to India where ~5-year tenor paper widened anywhere from 10 bps (IOCLIN 23s/ONGCIN 23s) to 25 bps (OINLIN 24s). ~10-year Indian senior paper sold off 10 bps (NTPCIN 28s) to as much as 55 bps (ADTIN 26s). We also saw some outsized moves in Malaysia with the GENTMK 27s being nearly 30 bps wider in June. Turning our attention to China, top tier state-owned enterprises (SOEs) (CHGRID and oil majors) saw 5-year and 10-year paper widen 5 bps and 10bps, respectively, while lower tier LGFVs continued to struggle (on average 100-150 bps wider to as much as nearly 240 bps wider for underperformers such as the YUNAEN 22s). Chinese tech saw ~10-year paper such as the BIDU 28s/TENCNT 28s move 15-20 bps wider and still in China, property bonds seeing significant underperformance from RSMACA 22s (+240 bps) on the back of a downgrade to junk by S&P and the likes of CHIOLI 23s/LNGFOR 23s/POLYRE 23s/YUEXIU 23s being 10-15 bps wider. Korean, Thai, Hong Kong and Singaporean corporate bonds outperformed on a relative basis with paper 3-5 bps wider during the month. On the new-issue front, we had just $6.9 billion of Asian investment-grade corporate/financials issuances in June, down 46% year-over-year (YoY).This brought the 1H18 tally to just under US$82 billion, which is a 12% decline compared with 1H17. Nearly 80% of the new bonds printed in June originated from China (all of which are financials related), while 10% each originated from Korea and from Singapore

The Markit Asia Local Bond Index (ALBI) saw losses of 2.45% in June, bringing year-to-date (YTD) returns to -3.33%. Returns were mixed across all markets with most markets posting gains in local currency terms with losses in Indonesia and the Philippines. Asian currency weakness was again the key driver of losses as most Asian currencies weakened by as much as 3.4%, led by the Chinese yuan offshore as the People's Bank of China (PBoC) stood by allowing broad US dollar strength to drive markets.

OUTLOOK

The Fed hiked the fed funds rate by 25 bps in its June Federal Open Market Committee meeting, taking the upper bound of the fed funds rate range to 2%. Meanwhile, the interest rate on excess reserves (IOER) was only raised by 20 bps. The statement acknowledged that US economic activity is "solid" while projecting more positive numbers for GDP growth, unemployment and inflation. The upbeat description of the economy and removal of the “low inflation” rhetoric led to a hawkish market tone and a risk-on, bear-flattening move. The European Central Bank (ECB) was very dovish despite announcing the likely end of its asset purchase programme, from £30 billion a month to £15 billion after September. The ECB stated explicitly that it will stop net asset purchases by the end of the year. The opt-out clause describes this as “subject to incoming data confirming the Governing Council’s medium-term inflation outlook”. The ECB issued unusually explicit and time-specific forward guidance on interest rates, pledging to keep its key benchmark rate at its present (negative) level “at least through the summer of 2019”. This took place as data show softening in growth momentum and political risk rising within the bloc. Even as core inflation continues to see upward pressure, the ECB appears to be keen to maintain its current monetary policy stance given limited fiscal room even as political frictions rise.

Data from the Institute of International Finance show that in May foreign investors pulled US$12.3 billion out of EM debt and equity markets, the largest monthly outflow since November 2016. Yet, despite talk of a generalized crisis, both US dollar and local currency-denominated EM debt have returned losses of only -4% YTD. That’s similar to investment-grade US corporate bonds and not much worse than the -2% loss on UST. Turkey and Argentina have been handicapped. In Turkey, policymaking has lacked credibility; Argentina lacks the luxury of a sticky investor base. The silver lining to their troubles is that lately policymakers have responded to the retreat of foreign capital with relative orthodoxy. Both have hiked interest rates, and Argentina has taken steps to bolster its foreign reserves as it benefits from low inflation, relatively strong current account positions and a reduced dependence on external financing, especially at the sovereign level. These limit contagion risks across markets and protect the asset class as a whole against a generalized EM economic crisis. Asian markets stand out here, as their funding markets are far more localized, even for US dollar debt. More than three-quarters of Asian US dollar debt issued last year was bought by investors based in the region. This has allowed policymakers to show greater flexibility in allowing local currencies to act as shock absorbers.

On the Korean Peninsula, the relationship between South Korean President Moon Jae-in and North Korean leader Kim Jong-un continues to show improvement. North Korea clearly wants to draw closer to the US and create a multilateral relationship with South Korea and the US rather than being forced into a corner with its sole bilateral Chinese relationship as its only anchor economically. However, the 27 April North-South Korea summit was far more crucial for a shift in the peninsula’s geopolitics, when the leaders agreed to a permanent peace treaty, the “complete denuclearization” of the Korean Peninsula and economic integration. Closer economic integration could also bring long-term benefits to both economies. The “new economic map” initiative proposed by South Korean President Moon is a blueprint for unification, job creation and higher growth through inter-Korean economic cooperation. Moon sees inter-Korean trade and investment links as the best guarantee for a peaceful and stable Korean Peninsula. His rationale is that this would necessarily change Pyongyang’s strategic calculus as the economies of South and North Korea become intertwined. Moon met with Kim for a second time only three days after US President Donald Trump initially cancelled his summit with the North Korean leader. This sent the message that inter-Korean rapprochement will continue irrespective of the state of U.S.-North Korea relations, a policy that has the support of many South Korean people who do not want their country’s North Korean policy to be dictated from Washington or Beijing. There is no appetite for a return to maximum pressure against the North, in South Korea. China and Russia also are making their own moves to benefit from any economic opening up that North Korea could be about to undergo. Russia has invited Kim to visit in September, and China already has eased restrictions on the flow of goods and people across the Sino-North Korean border.

As for the costs of integration, as the risk of destabilization decreases, South Korea can direct more of its US$40 billion military budget towards financing the costs of economic cooperation. Estimated CAPEX costs for reunification are around US$50 to US$80 billion per year. Further economic unification would likely postpone South Korea’s structural growth slowdown and provide a lift to the two Koreas’ GDP growth by 0.75%-2.0%, until measures kicked in to rein in rising public debt. In the June 13 elections in South Korea, the ruling Minjoo (democratic) party dominantly won the local government election as well as the by-elections for 12 vacant seats in the National Assembly. Out of 17 major metropolitan and provincial government elections, the ruling party won 14 posts, which was the highest winning record for the democratic faction. Also in the by-elections for the lawmakers, the ruling party won 11 seats to ramp up their parliamentary seat share to 43% from 41%. The landslide victory in local/by-elections should be a tailwind for President Moon’s economic policy agenda to boost jobs, reduce income inequality, improve corporate governance and promote innovation. This should boost consumer and corporate economic sentiment while reducing domestic political uncertainty and geopolitical risks on the Korean Peninsula further.

In China, a rise in bond defaults remains idiosyncratic in nature and systemic financial risk is unlikely, considering the small size relative to the overall financial system, stable interbank interest rates and more resilient economic fundamentals than in previous stretched periods in 2014-2016. A total of 13 issuers have defaulted on a combined 20.2 billion yuan (US$3.1 billion) worth of corporate bonds in China's domestic market in 2018, up 41% from the same period last year, when 11 issuers had defaulted. Tightening macro conditions are leading to higher defaults and credit spreads are widening. As a result, AA rated credits are now yielding about 225 bps more than AAA rated ones at the three-year part of the curve. Policymakers could fine-tune to ensure a milder pace of credit tightening. The PBoC reported May 2018 total social financing (TSF) of RMB761 billion, notably lower than market expectations (RMB1.3 trillion) and TSF in May 2017 (RMB1.1 trillion). Adjusted system credit growth (including municipal bonds) slowed to 11.8% YoY, a record low in the last decade. Slower credit growth can be attributed to a shadow banking crackdown and rising bond defaults. Shadow banking credit and bond financing shrunk in balance this month, while loan growth stayed resilient. China's balance sheet anchor remains its high saving rates amongst its households and corporates. Middle-class households have 59% of total assets in property, cash and deposits which still accounts for more than half of their non-property assets, and their average debt-to-asset ratio (mostly mortgages) is at a healthy level of 7%, up slightly from 5.3% in 2013. Average saving rates remain high at 35% in 2017, versus 44% and 21% of disposable income spent on consumption and debt payment, respectively. Compare that with US families whose saving rate had fallen to 2.8% in April 2018. Borrowings by Chinese households have grown rapidly in recent years, largely due to the mortgage-backed home sales rally across almost all Chinese cities. Statistics from the Bank for International Settlements (BIS) show that the household debt-to-GDP ratio in China has risen to 48% in 3Q17 from 27.7% in 4Q11.

While trade tensions continue to simmer, there appears to be no relief in sight given the likelihood of hawkish positioning in view of mid-term elections at the end of the year for the US. The direct impact of the Trump Administration's 25% tariff on Chinese goods will actually be somewhat limited, but the risk of subsequent tit-for-tat retaliation rises. Foreign holdings in China's government bond market could reach US$900 billion over the next five years (from around US$150 billion currently), implying potentially US$750 billion of inflows between now and the end of 2022, while overall allocation to Asia might rise, there could be more rotation from within Asia towards China. Marginal markets like Thailand, Malaysia, Singapore and South Korea will be affected.

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 US dollar-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 trajectory with leverage trending down (e.g., net leverage at FYE14, FYE15 and FYE16 was 1.8x, 1.7x and 1.5x, respectively) and liquidity improving (e.g., cash as a percentage of total debt in FYE14, FYE15 and FYE16 was 26%, 30% and 33%, respectively). Furthermore, we would point out that a significant number of entities that have issued US dollar-denominated investment-grade bonds are government-related entities (GREs), which are 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 credit where the current spread pickup of nearly 60 bps on a ratings like-for-like basis is largely in-line with the 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.

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