LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management

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ASIA FIXED INCOME REVIEW

MARKET REVIEW

We took a breather from the recent multi-month run of positive returns as headwinds from higher US rates came back with the US Treasury (UST) 10-year ending September at 3.05% compared with 2.86% at the beginning of the month. The JACI FINS COPR Index saw a -0.1% return, which resulted in a 0.2% return for the first three quarters of 2018, while the JACI NONFINS CORP Index had a tougher time with a return of -0.5%, which resulted in a year-to-date (YTD) performance through September 2018 of -2.0%. On a sector basis and beginning with Asian financials, we saw continued clear outperformance as a whole from Korean financials with 5-year and 10-year senior paper 5 basis points (bps) to 10 bps tighter and Filipino seniors also performing well with the likes of RCBPM 23s, PNBPM 23s and BDOPM 23s being 12 bps, 10 bps and 6 bps tighter, respectively, during September. On the other end of the performance spectrum, Indian bank seniors were negatively impacted by the turmoil in the country's non-bank financial institution space with 5-year and 10-year paper from the likes of ICICI/SBIIN being 5-10 bps wider, but the clear underperformers were the Yes Bank YESIN 23s which widened over 70 bps on the back of the Indian bank regulator curtailing the tenureship of the bank's CEO. Elsewhere, spreads were generally 2-3 bps tighter, but we did see in China the China Huarong AMC 5-year and 10-year paper widen 7-13 bps during the month. On the non-financials front, we are seeing corporate performance largely mirroring their financial peers. For example, Korea remains the clear outperformer geographically as 5-year bonds from both quasi-sovereign and non-government related issuers tightened 5-10 bps in September, while on the other hand, Indian corps saw 5-year paper widen 3-5 bps and 10-year paper widen about 10 bps. Elsewhere, we saw instances of idiosyncratic underperformances on the back of new-issue supply pressure with the likes of Chinese property POLYRE 23s being 17 bps wider and HK property NANFUN 27s being 27 bps wider. Also of note in China, tech JD.com's JD21s/JD26s were 16 bps and 29 bps wider, respectively, as negative news about the founder/CEO being arrested in the US (though subsequently released) weighed on those bonds. New-issues-wise, it was not a surprise that we had a significant pick-up in issuances as investors come back to their desks from the summer lull with the September Asian investment-grade corp/financials tally being $18.7 billion compared with the $9.6 billion monthly average we saw during June, July and August. As a result, we have gained ground versus last year as YTD through September 2018 are now just about 7% behind the YTD September 2017 tally. The geographical split for the September $18.7 billion of new prints was 81% Chinese, 6% Thai, 5% Korean, 3% Indian, 3% Hong Kong and 2% Filipino.

The Markit Asia Local Bond Index (ALBI) saw a -0.60% return in September, bringing YTD returns to -3.82%. Most Asian markets saw losses in the month with the exception of Malaysia, India and China onshore and offshore markets. This was alongside weakness in USTs, which saw yields rising after the US Federal Reserve's (Fed) hike. Emerging market (EM) weakness continued to drive weakness in Asian currencies, specifically in the Indian rupee and Indonesian rupiah with the former seeing losses of 2.38%.

OUTLOOK

Fed officials raised interest rates and cemented expectations for another hike this year as they reaffirmed that a strong US economy will probably warrant further gradual increases well into 2019. The quarter-point move boosted the benchmark fed funds rate to a target range of 2.0% to 2.25%. The policy statement was essentially unchanged, with the exception that the Committee removed references to monetary policy remaining "accommodative." The removal of the term "accommodative" does signal that the neutral rate is on the radar and the Federal Open Market Committee (FOMC) will need to justify restrictive monetary policy in the coming year. The Committee also upgraded median growth expectations for 2018 and 2019, acknowledging stronger-than-anticipated real growth. For the first time, the FOMC published projections for 2021, in which the committee endeavored to project a "soft landing."

The White House announced that it has imposed tariffs on approximately $200 billion worth of imports from China, effective September 24. The tariffs will start at 10% until the end of the year, but in an unexpected twist, are set to rise to 25% on January 1, 2019. This is even worse than what the market had been pricing in, namely a 10% tariff that would apply indefinitely. The White House added that "if China takes retaliatory action against our farmers or other industries, we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports." The administration's decision to leave out key consumer products such as smartphones is some indication of its worry about the negative impact tariffs may have on American consumers. The negative impact on China's export growth may range from -3.4% to -2.0%, while the direct impact on nominal GDP growth is between -0.5% to -0.3%. China announced a retaliatory tariff list of $60 billion US imports with additional tariffs ranging between 5% and 10%, and will likely further increase to 5% to 25% on January 1, 2019 as previously announced. China's total imports from the US amounted to $130 billion in 2017; the announced tariff will cover almost all the US exports to China ($50 billion plus newly announced list of $60 billion). The indirect impact will be a near-term negative, with increased pressure on export unemployment in China, the softening of business confidence and re-alignment of supply chains. In the long term, for as long as the broad economy remains supportive, trade tensions will prompt restructuring in favour of increased mechanization, and moving up the quality curve. Premier Li Keqiang sent a clear message that China would not utilize its currency to offset the potential effects of tariffs but rather, continue to reduce China's reliance on low value-added manufacturing exports.

China is promoting intellectual property (IP) rights, as part of the strategy, to promote innovation and higher value-added industrialization. History shows that the US tariff may be effective to push factories out of China, but only those serving the US market. In 2015, when US imposed anti-dumping duties against washing machines in China, China's exports of washers to the US collapsed, but exports to other countries and domestic demand continued to grow. The size of the Chinese market is a key factor that helps China to retain supply chains. 50 million units of washers were sold in China in 2017, compared with 10 million in the US and 29 million in Europe. Since July Beijing has approved three big foreign-invested projects: the US$5 billion Giga factory by Tesla in Shanghai (10 July), the US$10 billion chemical plant by BASF in Guangdong province (9 July), and the US$10 billion petrochemical plant by Exxon Mobil in Guangdong province (5 September). Besides the enormous scale, the most important feature of these projects is that they are all fully owned by foreign firms and in relatively sensitive industries where foreign investments were always previously required to be under the joint-venture structure. No joint venture arrangement in these plants suggests little risk of forced technology transfer, a long-held concern for multinationals operating in China.

China's largest province by GDP, Guangdong, unveiled 10 measures to lower the costs of manufacturing companies to mitigate 25% tariff levies from the US. These measures covered a wide range of corporate operating costs in areas of taxation, financing, land use, electricity charge, pension contribution, logistics and transportation. The Chinese authorities have long ignored private firms' complaints about high costs resulting from taxes, social insurance burdens and the lack of access to finance. Ironically, the external pressure put out by President Donald Trump appears to be helping their cause. In the past 17 years, high tech industrial output in Guangdong alone has risen from 17% to 44%. China's legislature passed the Individual Income Tax (IIT) revision bill in August, and aims to partially enforce the new code from October. The key revisions include a consolidated tax on selected sources of income, an increase in the basic deduction to CNY 5,000 from CNY 3,500, an adjustment in tax brackets favouring lower-income groups, and the introduction of special supplementary deductions. The new law is expected to reduce the tax burden on individual taxpayers, especially low- and middle-income groups, and improve income distribution. This reform is in line with the administration's more expansionary fiscal policy and could increase consumption by 0.26% of GDP. While there were earlier talks of adjusting Social Security contributions, the latest state council meeting appears to have put this on the backburner in view of trade tensions. In the longer term, the structural shift in China's current account will remove the structural underpinning for renminbi appreciation. Over the last five years, the current account surplus averaged $211 billion, while the capital account averaged $600 million. Unless capital inflows increase significantly, the shift to a balanced or deficit position on the current account will drive China's balance of payments, raising currency volatility. The moves this year in the renminbi were driven primarily by divergent cycles in the US economy and monetary policy setting with that of China, which is experiencing slower growth driven by deleveraging, de-risking and the negative effects of trade tensions. A lack of policy transparency and uncertainty over the inherent dilemma China policymakers face in managing the tradeoffs of deleveraging while avoiding a rapid tightening of credit conditions. This coupled with investor concerns about the effectiveness of official measures to address the sharp stock market correction and manage greater exchange rate flexibility exacerbated volatility in the currency. This is primarily driven by a decline in savings brought about by an ageing population and corresponding shrinking working age population. Chinese authorities will continue to develop policy tools such as those that other countries use to manage more freely floating and, at times, volatile currencies.

In spite of potential talks and still some political incentive for Trump to strike a deal with China, the chance of any deal is small with the underlying ideological intent on using trade to address China's economic and technological rise and dominance. In the longer run, US efforts to close off its markets and stem the flow of its technology will increase the incentives for Chinese firms to become more competitive by intensifying their own technology investments. The immediate impact though is continued pressure on EM, and continued market momentum riding on the divergence of economic cycles between the US and the rest of the world. Continuing trade tensions will undoubtedly weigh on global growth momentum, even as underlying growth remains supported by CAPEX and productivity growth. The key risk though will be rising wage levels, with G3 wage growth now at 2.3% year-over-year, the highest in 10 years, having risen from an average of 1.6% the past five years. While this has not translated directly to inflation as corporate profits cushion and technology factors dampen the effect of wage growth on inflation. For instance, in the case of the US, while unit labour costs did rise from an average of 1.8% in 2005 to 4.5% in 1Q07, core Person Consumption Expenditures (PCE) rose from an average 2.1% to 2.3% over the same time horizon. Corporates though will face a challenging environment of trade uncertainty, rising unit labour costs and higher real interest rates in this part of a late economic cycle with central banks continuing their countercyclical removal of monetary policy support.

Both Bank Indonesia (BI) and the Bangko Sentral ng PIlipinas (BSP) delivered rate hikes of 25 bps to 5.75% and 50 bps to 4.50%, respectively, in their policy meetings. BI continued to cite the decision was consistent with keeping the domestic financial market attractive (i.e., keeping real rates high to encourage capital inflows) and keeping the current account deficit manageable, similar to the previous meeting in August. Indonesia's fiscal policy has tightened in the first eight months of the year with revenue growth outpacing expenditure growth. The YTD fiscal deficit stood at 1.6% of GDP on a seasonally adjusted basis as of August 2018, 1 percentage point lower than the same time last year. The 2019 budget outlines a further decline in the budget deficit to 1.8% of GDP. For BSP, it said "a further tightening of monetary policy was warranted by persistent signs of sustained and broadening price pressures." It added that risks to the inflation outlook emanate from factors such as "exchange rate volatility," which we noted was an added policy justification for BSP's previous 50-bp hike in August. While most EM countries are expected to raise rates in a countercyclical fashion, China is pursuing defensive easing as a response to the ongoing trade tensions. EM economies facing currency depreciation pressure would also be under pressure to keep rates elevated for longer.

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