Western Asset Management

December 2018

ASIA FIXED INCOME REVIEW

MARKET REVIEW

Similar to last month, spreads largely widened in Asian credit during December. An outsized move in US Treasuries (USTs) helped to keep returns positive, however. For example, 10-year USTs finished the month at 2.68%, having begun the month at 2.97%. The JACI FINS CORP Index saw a return of 0.8%, bringing the full year tally to +1.3%, while the JACI NONFINS CORP Index had a positive return of 1.4%, which helped to lessen the full year 2018 negative return to -0.8%. On a sector basis, as with last month, we continued to see Chinese, Korean and Singaporean bank seniors—+2-3 basis points (bps)—and Chinese, Hong Kong, Korean and Singaporean bank Tier-2 paper—+4-6 bps—outperform the general market. On the other end of the spectrum and also like last month, we saw some significant spread-widening in the Korean insurance space (capital instruments from KYOBOL/HUKLFI/HLINSU/KORREI were about 45 bps wider on average) and also in the Chinese insurance space (capital instruments from CHLIIN 27s widened over 230 bps and PANLIZ 77s widened over 150 bps). Indian financial seniors in the ~10-year tenor bucket were about 20 bps wider, though we did see a significant divergence in performance in two specific names, RECLIN and POWFIN. The RECLIN 27s, for example, were 25 bps tighter during the month, while the POWFIN 27s and POWFIN 28s were 100-125 bps wider during the same period. This move happened on the back of POWFIN's announcement that it intends to buy the Indian government's 53% stake in RECLIN, which caused rating agencies to place POWFIN's Baa3/BBB- ratings on credit watch negative. On the other hand, such a transaction could result in the Change of Control provision being triggered for the RECLIN bonds, given that the Indian government's direct/indirect stake in RECLIN would fall below 50% (POWFIN itself is over 60% owned by the Indian government), thereby resulting in bondholders' ability to put the bonds back to the company at par. Philippine and Indonesian bank seniors underperformed, with spreads widening 20-30 bps. On the non-financials front and similar to their financial peers, we continued to see Korean, Singaporean, Hong Kong and Chinese Tier-1 state-owned enterprise (SOE) seniors perform the best, with spreads generally 3-7 bps wider. Chinese tech saw more pressure with the BABA/BIDU/TENCNT curve widening up to 15 bps, though the HUAWEI curve fared worst, with bonds about 50 bps wider on the back of the arrest of its CFO in Canada. Another area of clear weakness in China was the LGFV space on the back of relentless supply, with 2021 paper widening 30-40 bps on average. Chinese property saw a dispersion of performances with the LNGFOR 23s/28s tightening 5-10 bps, while on the other end, the VNKRLE 23s widening over 35 bps on the back of new supply. In India, corporate bond spreads were 10-20 bps wider. On the new issues front, Asian investment-grade corp/financials issuances amounted to just below US$9 billion, which was understandably down from November's US$16 billion, given the holiday season. This brought the full-year tally to just over US$161 billion, about 14% lower than what we saw in 2017.

The Markit Asia Local Bond Index (ALBI) saw a 1.51% gain in December, bringing the year-to-date (YTD) return to -0.44%. After a strong comeback in November, emerging market (EM) local bonds continued to see a broad-based recovery in December. Asian EM local bonds strengthened, led by both UST gains and Asian currency strength that led to gains across markets. The largest gains were seen in India, Singapore and Hong Kong as the well anticipated Federal Reserve (Fed) hikes resulted in investors adding duration towards the end of the year. Asian currencies gained across the board, led broadly by the strengthening of the Chinese yuan over a pause in escalating trade tensions with the US.

OUTLOOK

At its December 19 meeting, the Fed took the target range for its benchmark funds rate from 2.25% to 2.5%. Central bank officials are now forecasting two hikes next year, down from three rate raises previously projected. The Federal Open Market Committee (FOMC) signaled a slower, but still consistent hiking path. Fed Chair Jerome Powell acknowledged tighter financial conditions over the last month, but noted that one hike fewer next year should help mitigate this. He acknowledged that there was uncertainty about the future pace and path of the policy rate in 2019, stressing the data dependency of future decisions. On the balance sheet normalization process, Powell commented that he did not expect the runoff to create problems and that short-term rates have been pushed up by bill supply and repo rates. Consequently, the median real GDP, unemployment and core Personal Consumption Expenditure forecasts saw only marginal downgrades in the December SEP. The FOMC is concerned about global growth headwinds at this juncture, but still optimistic on the US economy. The European Central Bank (ECB) confirmed that its €2.6 trillion QE programme will end this month, but enhanced forward guidance indicated that reinvestments of maturing debt will continue "for an extended period of time past the date when [policy makers] start raising the key ECB interest rates." Interest rates are expected to remain at their present levels at least through the summer of 2019. ECB President Mario Draghi's tone was upbeat, but the message was cautious. He acknowledged that data had been weaker than expected, mostly though not entirely due to external and temporary factors. He admitted that the Governing Council had debated the extent to which softer activity was temporary.

The oil rally in response to the OPEC output cut on November 7 was shallow; a further slide of ~10% from pre-OPEC cut level suggests that OPEC cuts have now lost their significance. The 1.2 million barrels per day cut by OPEC is struggling to make an impact, especially compared to the times when an OPEC cut would be a resounding bullish trigger for oil. The lack of impact is due to the marginal crude output shifting outside of the OPEC and most notably by way of US shale oil production, which has been the dominant influence in growing non-OPEC supply. The decline in oil prices has benefited the primary energy importers in Asia. In Indonesia, the President remains more than 20 percentage points ahead in the opinion polls with the latest poll conducted in mid-November, putting Jokowi's support at 53.2%, compared with only 31.2% for his opponent, the former general Prabowo Subianto. The upcoming election in April will be the first time the parliamentary and presidential elections are held on the same day. This should favor the incumbent as parliamentary candidates from the opposition will focus on getting themselves elected rather than campaigning against Jokowi, given his popularity. Jokowi's popularity is underpinned by the 63% increase in minimum wage in the past four years as well as the rise in government social welfare spending while maintaining a tight overall fiscal stance.

At 49.4, China's official manufacturing Purchasing Manager's Index (PMI) dropped below the neutral mark of 50 in December for the first time since July 2016. Monthly industrial profits also saw negative growth for the first time in three years. The current growth slowdown is predominantly driven by the government's stringent deleveraging policies between late-2016 and mid-2018. This, coupled with uncertainty arising from trade tensions with the US continue to weigh on growth. The government still appears to be comfortable with the short-term pain being inflicted on growth for as long as unemployment remains manageable and surplus manufacturing labour is absorbed by the still growing service sector. While the PMI sub-index of unemployment has worsened quite substantially since August, the registered unemployment rate remains comfortably "within 4.5%". The government pledged to create over 11 million new urban jobs in 2018. As of October, about 12 million new jobs have already been generated, up 0.76% YoY with the full-year rate on track to reach 13.6 million new jobs in 2018 versus 13.5 million in 2017. Considering the shifting demographics having hit peak working-age population in 2014 and a decreasing demographic dividend, the number of new jobs required will decrease from 11 million in 2017 and 9 million in 2018 to 8.5 million in 2019. Signs are that local government debt in certain areas has already reached a level that would limit the government's ability to significantly boost infrastructure investment after years of rapid growth. Fiscal expansion will rely more on tax cuts for both household and corporate sectors in the future. People's Bank of China (PBoC) set up a new policy instrument called TMLF (targeted medium-term lending facility) to provide financing support to small and micro companies and private companies. Large commercial banks with potential to increase lending to small and micro companies and private companies and that comply with macro-prudential requirements with relatively adequate capital and healthy assets can apply the TMLF. The purpose of the move is to effectively lower banks' funding costs in order to boost credit growth and lower funding costs in the real economy. And at the same time the PBoC would like to have smaller negative impact on FX (versus outright MLF rate cuts), given policy concerns on capital outflow and renminbi depreciation.

In his first media briefing as the Reserve Bank of India's (RBI) new governor, Shaktikanta Das stressed his priority of upholding the autonomy, independence and credibility of the central bank. The importance of retaining the autonomy and credibility of the RBI found repeated mentions in his briefing, though accountability was also cited as a key criterion. While addressing questions on growth, he pointed to the RBI Act, which reads targeting inflation "keeping in mind the objective of growth". The Governor stated that inflation is evolving as per target and the outlook remains benign, though he remains watchful of developments. He refrained from commenting on its implications for interest rates, as that will be decided by the monetary policy committee at its next meeting in February. The Monetary Board of Bangko Sentral ng Pilipinas decided to keep its key policy rates on hold at its meeting on November 13, leaving the overnight borrowing rate, the overnight lending rate and the overnight deposit rate unchanged at 5.25%, 4.75% and 4.25%, respectively. This was the first pause after a cumulative 175 bps of policy rate hikes at five consecutive meetings since May. The central bank revised its 2018/19/20 inflation forecasts modestly lower to 5.2%/3.2%/3.0%, from 5.3%/3.5%/3.3% earlier, on the impact of lower oil prices and steadying inflation expectations. For the first time this year, policymakers also changed the characterization of risks to the inflation outlook from being to the upside, to being "more evenly balanced for 2019" and leaning "toward the downside for 2020". The Bank of Thailand (BOT) raised its policy rate by 25 bps to 1.75%, its first hike since 2011, with a 5-2 vote (from a 3-4 vote at the November meeting), in a bid to curb financial-stability risks and build policy space. Two Monetary Policy Committee (MPC) members voted to leave the policy rate unchanged, as they believe that heightened external risks "could affect Thailand's economic growth in the period ahead" and that the macroprudential measures announced in November "had addressed certain risks" regarding financial stability. The tone of the policy statement was broadly similar to the November meeting. The MPC judged that the economy "continued to gain traction" and added that it was "consistent with its potential". However, the BOT trimmed its 2018 GDP growth forecast to 4.2% from 4.4% and 2019 forecast to 4.0% from 4.2%.

Asia is expected to continue to lead EM growth at 4.4% for 2019 (down from 4.8% in 2018) led by China (6.1%) and India (7.2%), bringing regional growth to 5.6%. This even as developed markets will see growth decline from 2.3% to 2.1%. Tightening in financial conditions, however, affects individual economies unevenly; growth in Indonesia, India and the Philippines are arguably less sensitive to changes in financial conditions. Debt service ratios for the non-financial private sector in Indonesia (4.8%), India (7%) and Thailand (9.8%) are far lower than those elsewhere, reflecting lower overall debt. A given rise in funding costs, therefore, exerts less of a drag on overall demand. Lower oil prices could help counteract the recent tightening in financial conditions across the region. Inflation pressures, already remarkably subdued in most of Asia, are likely to ease further. With lower price pressures, central banks have less need to further hike interest rates.

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