Western Asset Management

March 2018

ASIA FIXED INCOME REVIEW

MARKET REVIEW

We did see some respite on the US Treasuries (UST) front in March as the 10-year UST began March at 2.81%, but ended the month at 2.74%. While spreads did widen, we finished the month with positive returns, for example, with the JACI FINS CORP Index seeing +0.2% of returns in March—pushing 1Q18 total returns to -0.57%. On a sector basis and beginning with Asian financials, we saw two months in a row of continued underperformance primarily out of the Indian banking system. Indian 5-year seniors were anywhere from 20 basis points (bps) wider (YESIN 23s) to over 30 bps wider (EXIMBK 23s), while 10-year seniors such as RECLIN 27s and POWFIN 27s were as much as 30 bps wider during the month. Korean, Thai, Malaysian and Big Four Chinese 5-year bank seniors were about 10 bps wider, though Chinese NBFIs such as AMC and leasing 5-year paper were about 15 bps wider with their 10-year paper about 20 bps wider. On the bank capital Tier 2 front, Korean PUSAN 26s and SHNHAN 27s were both about 30 bps wider, while HK Tier 2s (BNKEA 26s/DAHSIN 26s) were 5-10 bps wider with Singaporean Tier 2 (UOBSP 27s) being the outperformers—just 4 bps wider. On the non-financials front and similar to their financials peers, Indian corps had a tough month with 5-year paper (such as IOCLIN 23s/ONGCIN 23s) about 20 bps wider and 10-year paper (such as BPCLIN 27s/OINLIN 27s) almost 30 bps wider. We also saw in China higher quality state-owned enterprise (SOE) 5-year paper (SINOPE 23s/CNOOC 23s) being nearly 20 bps wider, while their 10-year paper saw similar spread moves. Chinese tech paper at the 5-year tenor was about 15 bps wider, though the LENOVO 22s were about 40 bps wider during the month. We also saw spread pressure in Chinese property with the VNKRLE 27s/LNGFOR 28s being 30 bps wider and LNGFOR 23s/CHJMAO 22s being about 15 bps wider. The clear outperformers were Hong Kong-based and Singapore-based credits with bonds about 5 bps wider both at the 5-year and 10-year tenor part of the curve. New-issues wise, there was an uptick in Asian investment-grade corporate/financials issuance to US$16.5 billion for March from US$10.3 billion in February with the Lunar New Year holidays now behind us and the year-to-date (YTD) 2018 issuances at US$45.1 billion is largely flat versus the same period last year. About 75% of the March issuances came from China and 13% from South Korea with the rest coming from a sprinkling of Thai, Hong Kong and Singaporean issuers.

The Markit Asia Local Bond Index (ALBI) saw gains of 1.26% in March bringing YTD returns to -1.03%. Returns were positive across all markets with the exception of the Philippines, alongside gains in USTs. India led with gains of 2.6% as onshore investors drove a rally after a reduced supply pipeline announcement. Other markets performed mostly in line with bull-flattening moves in the UST curve driven by the long end as markets calmly digested the well-anticipated US Federal Reserve (Fed) rate hike. The underperformer was the Philippines which saw losses of 0.65% as expectations of a more hawkish Bangko Sentral ng Pilipinas (BSP) drove yields higher. Asian currencies were mostly stronger across the board with outperformance driven by high-beta markets such as the Korea won, with gains of 1.98%, the Malaysian ringgit and the Chinese renminbi. The exception was the Philippine peso which saw losses of 0.21% and the Indonesian rupiah which lagged the regional rally to end the month almost flat.

OUTLOOK

The Federal Open Market Committee (FOMC) raised the fed funds rate by 25 bps at its March meeting, as expected. The committee as a whole became more hawkish, raising its growth and inflation forecasts and lowering its unemployment projections, leading it to revise up its projected rate path expectations. The committee lifted its forecasts for 2018 and 2019 growth, by 0.2 percentage points (pp) to 2.7% and 0.3 pp to 2.4%, respectively. It left its 2020 and longer-run estimates unchanged at 2.0% and 1.8%, respectively. Along with raising its growth forecasts, the committee lowered its unemployment rate forecasts, doing so by 0.1 pp for 2018, to 3.8%, 0.3 pp for 2019, to 3.6%, and 0.4 pp for 2020, to 3.6%. It also lowered its longer-run estimate of equilibrium unemployment by 0.1 pp to 4.5%.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.

After the first round of tariffs announced by the Trump Administration on steel and aluminium exports, Minister Zhong Shan of the Ministry of Commerce responded at a press conference that China did not want a trade war with the US, and there was still ongoing dialogue between China and the US. Steel and aluminum exports to the US are not significant to China; steel and aluminium account for only 3% of China's total exports and 0.6% of its GDP, only a small fraction of which gets exported to the US. For example, only 1.6% of China's steel exports (1.2 million tonnes) were exported to the US in 2017. Chinese authorities recognise the need to reduce reliance on heavy industry, and are guiding producers through a sharp cut (20% by 2020) in production capacity. Indeed, steel prices bottomed out long before the 2016 US elections as China began targeting capacity reduction and global demand strengthened. There are other sectors that are more sensitive to US trade policies, for example machinery and electronics, and furniture and toys, which account for 48% and 16.5% of American imports from China, respectively. There was further escalation with the introduction of tariffs under USTR Section 301 by President Donald Trump. The section 301 investigation found that China's intellectual property practices caused US$50 billion of harm per year to the US economy. To compensate for this damage, the US intends to impose a 25% tariff on certain imports from China, including airplanes and parts, computers, cell phones, and various electronic products and parts. China will engage in tit-for-tat retaliations with a view to escalate the tension enough without resorting to a trade war with unconventional, targeted measures. Trade-related conflicts will intensify over the next few months before the two sides are willing to reach a compromise and it is in both US and China's interests to avoid an all-out trade war.

A significant amount of spare capacity in Asian economies should therefore continue to anchor inflation, despite the sharp pickup in growth. Monetary policy will not be driven purely by considerations of inflation alone, either; policymakers in Asia are acutely aware of rising protectionist tendencies and the potential for hostile trade policy. This will drive a preference for stability on the rates front. The Philippines, for example, faces the most significant inflation pressures in Asia, in spite of which BSP has not signaled any intention to tighten monetary policy. Emerging market (EM) Asia fundamentals remain well anchored on strong current account balances, lower external financing requirements and strong fiscal discipline. Asian macroeconomic fundamentals remain stable and in spite of the volatility in macro and market conditions, resilience should remain the base case scenario even if in the short term, thin liquidity and bouts of selling can persist. Asia looks set for a strong cyclical uplift in 2018, with major economies delivering stronger growth supported by a positive regional trade outlook, domestic political stability and endogenous growth. 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% twenty years ago to less than 10%. The structural underpinning remains the positive working-age population and productivity growth. Private investment and a government spending pickup will anchor domestic growth though that spare capacity will further narrow and Asian central banks will see less room for continued monetary accommodation. EM Asia's divergence from the US growth cycle is a key anchor of Asian rates, as Asia's recovery has lagged that of the US. 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.

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. Overall "external beta" of EM foreign exchange (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 where 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. The renminbi becomes an ever more important anchor currency in the volatility of macro markets we are witnessing. In an article published by State Administration of Foreign Exchange (SAFE), Mr. Pan Gongsheng, head of SAFE and Vice Governor of the PBoC indicated a shift towards an easing of restrictive capital controls introduced since 2015 as policymakers become increasingly comfortable with the improvement in domestic fundamentals. The renminbi remains supported by corporates' large holding of US dollars, a high onshore yield differential and increasing inflows from offshore investors into the onshore China bond market. The marginal easing of capital controls is also in line with China's long-term target of capital account liberalisation and renminbi internationalization. So while there will be increased two-way volatility in the renminbi, the base case remains one of anchored strength while allowing for two-way movements to prevent one-sided expectations from building up. Asia FX remains supported fundamentally by current account dynamics as well as portfolio inflows, specifically over the past year by equity inflows. 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 the behavior of FX currency pairs, resulting in underlying currency fundamentals, portfolio and investment flows having more significant bearing on currency valuations. Hence, we will take these factors into consideration when managing FX exposure and risks within the portfolio.

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 (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 amount of entities that have issued USD-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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