Western Asset Management

June 2018

SINGAPORE FIXED INCOME REVIEW

MARKET REVIEW

In June, the Singapore government bond market saw gains of 0.32%, bringing year-to-date returns to -1.51%. The 3-month SIBOR rate was marginally higher at 1.52%. The Singapore curve bear-flattened with yields higher by up to 13 basis points (bps) in the front end of the curve while the long end saw yields lower by up to 7 bps. Singapore government securities (SGS) underperformed US Treasuries (USTs) on the whole during the month of May. USTs saw yields higher by up to 10 bps in the belly while long end yields were broadly unchanged.

May industrial production printed at 11.1% year-over-year (YoY), a large increase against April's YoY figure of 9.1%. However, this was mainly due to low base effects. Nevertheless, most major sectors showed improvement led by electronics, which was up 17.1% YoY and biomedical production, which was up 17.7% YoY. The May Consumer Price Index (CPI) rose 0.4% YoY, in line with expectations and slightly higher than the previous month's print of 0.1% YoY. Core CPI was a tad higher than expectations, coming in at 1.5% YoY.

Headline inflation slipped to 0.1% YoY in April (March: 0.2%; February: 0.5%), which was weaker than expected. The decline was driven in part by lower Certificate of Entitlement (CoE) premiums YoY, which offset rising petrol prices. In addition, even with the 2.8% increase in electricity tariffs effective from April, Consumer Price Index (CPI) for fuel and utilities moderated from 8.1% YoY to 6.3% in April. The Monetary Authority of Singapore (MAS) core inflation, which excludes accommodation and private road transport costs, retreated further to 1.3% YoY from 1.5% in March. The breakdown showed that services inflation edged lower to 1.3% in April from 1.4% in March, reflecting larger declines in telecommunication services fees and smaller increases in recreational costs, which offset higher holiday expenses.

OUTLOOK

The US Federal Reserve (Fed) hiked the fed funds rate by 25 bps in its June Federal Open Market Committee meeting, taking the upper bound 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 is that this is "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 emerging markets (EM) debt and equity markets, the largest monthly outflow since November 2016. Yet despite talk of a generalized crisis, both USD and local currency-denominated EM debt have returned year-to-date losses of only -4%. 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 and 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 between 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 in the by-elections for 12 vacant seats in the National Assembly. Out of 17 major metropolitan and provincial government elections, the ruling party won in 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 People's Bank of China 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. Compared 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 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.

A broad-based synchronous global economic recovery continues to benefit Singapore, traditionally a high-beta economy. The cyclical uptick provided a much-needed boost to consumer confidence as well as corporate bullishness, evidenced in property developers' aggressive bidding for en-bloc residential sale sites. The medium-term growth outlook remains moderate as demographic headwinds and a continued low tolerance for a rise in immigration points to a structural slowdown of traditional human capital employment-driven growth. The service sector remains a key pillar supporting employment, at 80% of total employment, picking up the decline in the manufacturing sector. Singapore continues to be anchored by its fundamental strength, with an estimate of sovereign foreign net assets at around 90% of GDP as of year-end 2016, according to Fitch.

We are cautious of the rapid expansion of the Singapore credit market and the relatively low level of risk premium the market is pricing into bonds issued by new entrants. We remain highly selective and will place a strong emphasis on sound credit fundamentals as a key premise. We believe our long-term approach will allow us to ride out any volatility in the next few months and we will seek to minimize our risk exposure. In terms of strategy, we continue to adopt a tactical approach to positioning across the SGS curve in view of global growth headwinds and monetary policy divergence among central banks. We will seek to bolster carry-through exposure in high-quality corporate and bank credits.

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