# SINGAPORE FIXED INCOME REVIEW

## MARKET REVIEW

In December, the Singapore government bond market saw mixed performance across the curve. On the whole, the curve bear-flattened, underperforming moves seen in the US Treasury (UST) curve as a result of liquidity pressure on the front end of the curve. The 3-month SIBOR rate rose to 1.50% from 1.20% and we saw the front end to the belly of the curve rise by 16 basis points (bps) to 42 bps over the course of the month. The long end of the curve continued to be well supported by domestic investors which drove yields lower.

Singapore government securities (SGS) underperformed USTs which also experienced a bear-flattening move over the period. The UST curve saw rates on the front end higher by 10-12 bps in spite of the US Federal Reserve (Fed) rate hike. Meanwhile, long-end UST yields declined by 9 bps as demand for long-end USTs continued to anchor the curve.

The Singapore economy saw growth at its fastest pace since 2014 with 2017 growth coming in at 3.5% year-over-year (YoY), from 2.0% in 2016. 4Q17 GDP growth of 3.1% YoY, and 2.8% quarter-over-quarter (QoQ) on a seasonally adjusted annual rate (saar), marked a slowdown from 3Q17 GDP growth as manufacturing momentum slowed to 6.2% YoY (-11.5% QoQsaar). But, services sectors picked up speed to 3.0% YoY (7.5% QoQsaar) on the back of finance and insurance, wholesale and retail trade, and transportation and storage sectors.

According to the report released by the Ministry of Trade and Industry (MTI), growth in this sector “was supported primarily by robust output expansions in the electronics and precision engineering clusters, which outweighed output declines in the biomedical manufacturing and transport engineering clusters.” Headline inflation accelerated to 0.6% YoY in November (October: 0.4%), in line with expectations, driven by higher costs for services and private road transport. Core inflation, which excludes accommodation and private road transport costs, remained steady at 1.5% YoY for the third consecutive month. Core inflation, remained steady at 1.5% YoY for the third consecutive month.

## OUTLOOK

We expect global growth momentum in 2018 to be supported by still accommodative monetary policy, lower fiscal drag, trade recovery and supportive consumer sentiment. We believe monetary authorities in advanced economies, with the exception of Japan, will be easing monetary accommodation after several years of extraordinary easing prompted by the global financial crisis. The unusually low core inflation levels across both advanced economies and many emerging markets (EM) will keep the pace of the normalization gradual. The challenge will be managing near-term headline inflation pressures from a low base and not stifling the growth momentum needed to resolve more fundamental structural challenges to growth arising from demographic and technological shifts. 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.

The US economy heads into 2018 with strong growth momentum and an unemployment rate already below levels that Fed officials view as sustainable with the economy operating at full capacity. Wage growth is moving toward the 3.00%-3.25% rate, core inflation should also accelerate in 2018 at 1.8% as rising labor costs boost services prices, higher energy prices and a weaker dollar pass-through to the core, and the drag from healthcare policy diminishes. The Federal Open Market Committee (FOMC) raised rates for a third time this year at its December meeting. It also increased the caps on reinvestments to US$10 billion per month, as expected. Despite stronger economic forecasts, the committee’s rate projections were largely unchanged and continued to show a gradual tightening of policy in the years ahead. Median rate projections continued to show three hikes for 2018 and two for 2019. The long-run median dot was also unchanged, although the 2020 dots shifted up slightly. Fed Chair Janet Yellen reiterated that the majority of the FOMC views current weak inflation as likely to be transitory. However, she acknowledged that there has been a "prolonged shortfall" in inflation and that the 2.0% target is "symmetric," so weak inflation remains a risk to policy. While the tax reform package marks a key change in US tax policy and continues to boost positive growth sentiment, the actual pass-through and economic impact remains uncertain; the December Fed meeting minutes suggest that Fed members only see a modest boost to capital spending with the magnitude of its effect uncertain.

In Europe, consumer inflation staged a rebound in 2017; aggregate real wage growth has also been picking up, driven by a combination of accelerating employment growth and accelerating nominal wage increases. In the German labor market, the signs of tightness are increasingly clear. In September, the unemployment rate fell to 3.6%, the lowest since reunification. While headline unemployment remains higher in other parts of the eurozone such as in France at 9.7%, cyclical improvement continues to support wages. Structural employment issues remain, but in the near-term, wages and inflation pressures will rise. The European Central Bank (ECB) will seek to avoid a sharp increase in long-term rates which would threaten the stability of still highly indebted sovereigns and households. However, the ECB will likely signal a quantitative easing (QE) exit by the middle of 2018. The Bank of Japan (BoJ) would also have to manage the risks to its balance sheet judiciously, given its size; any abrupt change in monetary policy would have significant destabilizing effect on global core yields. While the BoJ has been specific about maintaining accommodation as long as inflation remains below 2%, the economy is already at full employment with asset prices rising and a labor shortage. Japanese companies, facing their worst labour shortage in 40 years, have improved benefits and shifted contract workers to permanent roles in a reversal of the trend towards part-time and contract work over the last decade. The impact of an abrupt rise in yields on the BoJ's balance sheet as well as fiscal risks to the government are significant. While it takes about four years for the Fed to wind down QE by holding securities to maturity to avoid realizing capital losses, it would take the BoJ 20 years to do the same, as estimated by the International Monetary Fund (IMF).

Significant global risks would be largely in the geopolitical realm. On the Korean Peninsula, the political calculus in view of the regime's need to stay in power would imply that even as tensions will rise from time to time, the risks of escalation remain low. In the Middle East, though, the risks of strategic miscalculation remain high, as still-low oil prices continue to result in significant deficits in countries such as Saudi Arabia. Any domestic instability out of Saudi Arabia might result in a nasty shock to oil prices given Saudi Arabia's significant role in global oil production. As for economy-specific idiosyncratic risks, they would largely be from asset price bubbles that have emerged in the aftermath of extraordinary accommodative monetary policy over the past decade.

BoJ and ECB bond buying will exceed new issuances in the next five years. Two-thirds of the US$1.5 trillion of debt issued by advanced economies since 2010 have been bought by official institutions. The IMF's analysis suggests a crowding out of private investors has been the result of the reduction of available stock of fixed-income instruments. In equity markets, the slowdown in IPOs as private markets become more attractive, de-listings and stock buybacks have created a technical crowding out even as passive index trackers continue to pile into a smaller pool of large caps. Even as the supply of high-quality bonds is constrained, demand remains strong, anchored by two structural drivers, ageing populations and regulatory requirements. In another three decades, 17% of the world's population will be over 65 years of age, from 8.5% in 2015. European insurance regulations have made it prohibitive for equity allocations given the amount of capital required to be set aside.

Asia looks set for a strong cyclical uplift in 2018, with major economies delivering stronger growth supported by positive regional trade outlook, domestic political stability and endogenous growth. The global electronics purchasing managers' index (PMI) is at its highest level in seven years, with a positive consumer electronics cycle benefiting trade-sensitive North Asia economies. 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, projected at 3.5% for 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% some 20 years ago to less than 10%. A positive working-age population and productivity growth remain the structural underpinning. Private investment and a government spending pickup will anchor domestic growth, though along with this, spare capacity will further narrow and Asian central banks will see less room for continued monetary accommodation. However, even cost-push inflationary pressures from rising commodity prices will remain offset by weak demand-pull inflation forces, driven by significant manufacturing slack as well as labour market dynamics. In the Asian local currency fixed-income space, market differentiation remains key. 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.

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.

A more-hawkish Fed monetary policy stance provides little room for monetary policy easing by the Monetary Authority of Singapore (MAS). Electricity tariffs will rise 6.3% MoM in January, raising 2018 headline and core inflation by 0.1%. Policymakers have been hinting at the need to raise taxes to ensure fiscal sustainability. The upcoming Budget 2018 that will be announced on February 19 will also provide greater clarity on any changes to the Goods and Services Tax (GST), with the GST to raise headline inflation by 0.7% for every 1% increase in the tax rate. MAS could tweak its current neutral monetary policy stance to a slight appreciation bias this year though it is clear that given the shift in long-term growth potential, a moderate slope for the SGD nominal effective exchange rate (NEER) would be appropriate amidst a modestly improved outlook for global growth and headline inflation. The burden of growth support will continue to be on the fiscal and administrative side, with a focus on the latter as policymakers attempt to anchor long-term drivers of growth on productivity gains and labour force quality improvements.

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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* As of 31 December 2017.