Western Asset Management

October 2018

SINGAPORE FIXED INCOME REVIEW

MARKET REVIEW

In September, the Singapore government bond market saw losses of -0.16%, bringing year-to-date returns to -1.18%. The 3-month SIBOR rate was largely unchanged at 1.64%. The Singapore curve bear-flattened with yields higher by up to 11 basis points (bps) in the front end of the curve while the long end saw moves of up to 10 bps higher. Singapore government securities (SGS) outperformed US Treasuries (USTs) on the whole during the month. USTs saw yields higher by up to 19 bps in the long end of the curve while front-end yields were higher by 13 bps.

The Monetary Authority of Singapore (MAS) increased slightly the slope of the Singapore dollar nominal effective exchange rate policy band. The centre and width of the policy band were left unchanged. The MAS expected core inflation to experience modest but continuing pressure and narrowed its 2018 core inflation forecast range to 1.5%-2.0% from previously, stating that it would average in the upper half of the 1%-2% range. Its 2019 core inflation forecast range was also higher at 1.5%-2.5%. Meanwhile, the central bank noted that ongoing trade friction could pose uncertainty and weigh on economic activity in 2019. Barring that, the MAS expected the economy to remain on a steady expansion path in the quarters ahead, keeping output slightly above potential.

The Singapore economy expanded 2.6% year-over-year (YoY) and 4.7% quarter-over-quarter (QoQ) on a seasonally adjusted annual rate (saar), which was higher than the market consensus forecast of 2.4% YoY and 5.0% QoQsaar. The key contributor was manufacturing which moderated from double-digit growth in 1H18 to 4.5% YoY and 7.6% QoQsaar, albeit this was on the back of a high base of 19.1% YoY and 34.9% QoQsaar in 3Q17. Electronics, biomedical manufacturing and transport engineering clusters provided the main support to the manufacturing sector. Services also maintained momentum at 2.9% YoY and 6.3% QoQsaar, buoyed by finance and insurance, business services and wholesale and retail trade industries. MAS provided a benign growth outlook, highlighting that the "Singapore economy is likely to remain on its steady expansion path in the quarters ahead, keeping output slightly above potential." Growth would be driven by the "ICT, financial and business services sectors" while the contribution from manufacturing "will moderate." On global growth, the MAS noted that it has been "relatively resilient thus far," though there is "uncertainty" (as expected) around "trade frictions" that "could weigh more discernibly on global economic activity." The MAS also saw growth in the upper half of the official 2.5%-3.5% forecast range in 2018, before "moderating slightly in 2019." MAS expected the "small, positive output gap" to persist in 2019, "imparting modest inflationary pressures".

OUTLOOK

Early October saw USTs breaking key levels, driven by a couple of strong data releases. The Institute of Supply Management services Purchasing Managers' Index (PMI) posted its second strongest reading since the index began in 1997. Wage growth was in the spotlight after Amazon increased its hourly minimum wage to US$15. Core Consumer Price Index (CPI) inflation has risen from 1.7% YoY in November to 2.4% YoY in July, though it slowed to 2.2% YoY in August. Similarly, core Personal Consumption Expenditures (PCE) inflation rose from 1.4% YoY in August 2017 to 2.0% YoY in August 2018. As for wages, average hourly earnings growth rose from 2.7% YoY in July to 2.9% YoY in August, the highest level since May 2009. US dollar strength looks likely to persist on the combination of fiscal easing and monetary tightening. In the medium term, US dollar liquidity will continue to be a challenge with rising US yields and a rising budget deficit leading to a rise in UST issuance. The continued rise in US equities was driven by buybacks which hit a record of US$194 billion for 1Q18 and 2Q18 might face a challenge if corporate spreads start rising, given that US non-financial corporate debt to GDP is already above 45%, the same level seen before recessions in 2008 and 1997.

The International Monetary Fund (IMF) downgraded its 2019 growth forecast for emerging markets as a group to 4.7% from 5.1%, highlighting concerns of the risks arising from capital outflows. This tail-risk scenario would likely have a severe impact on economic performance in emerging markets, especially for sovereign and corporate borrowers that are dependent on external financing," the IMF's report said. "The estimated outflows under this scenario are much higher than, for example, in the fourth quarter of 2011, at the height of the European sovereign debt crisis. Political unity of the eurozone has come into question after German Chancellor Angela Merkel's decision to step down. Eurozone GDP growth decelerated to 1.7% YoY in 3Q18, below 2% for the first time since 3Q16.

The fiscal impact of higher oil looks more significant in Indonesia, though mitigated by revenue outperformance and room to cut other spending. Jokowi remains well ahead in the polls for now, with a poll conducted in early September putting Jokowi's support at 57.7%, compared with only 32.3% for his opponent Prabowo Subianto. The President remains popular because his policies have improved ordinary people's lives by providing cheaper access to basic healthcare and education. Jokowi has also presided over an aggregate 51% increase in the minimum wage during his four years as president. The government's prioritization of a credible fiscal policy, along with other measures implemented in coordination with Bank Indonesia (BI), will help to ease pressures on the current account deficit. Finance Minister Sri Mulyani announced that the fiscal deficit reached IDR200.2 trillion as of September (1.4% of GDP on a 12-month rolling sum basis), on track for a full-year 2018 fiscal deficit forecast of IDR289.2 trillion (1.9% of GDP). The Ministry of Finance's (MoF) guidance for the full-year fuel subsidy bill is IDR163.5 trillion (1% of GDP), versus the original budget of IDR94.5 trillion, which reflects the impact of higher crude oil prices. The IDR69 trillion increase of the subsidy allocation will be covered substantially by an oil-related fiscal revenue increase of ~IDR45 trillion, every USD10/bbl increase in crude oil prices boosts revenues by about IDR20 trillion. The MoF's proposed 2019 budget projects a lower deficit at 1.84% of GDP.

In China, the People's Bank of China (PBoC) announced that starting October 15 it will cut the reserve requirement ratio for banks by 100 bps. After cuts of 100 bps in April and 50 bps in June, this will reduce the reserve ratio requirement (RRR) for big state-owned banks to 14.5%, and to 12.5% for smaller institutions. From a domestic perspective, the move is largely liquidity-neutral as the liquidity injection will release a total of 1.2 trillion yuan ($175 billion), of which 450 billion yuan is to be used to repay existing medium-term funding facilities (RMB450 billion) which are maturing, while the remaining RMB750 billion will help smooth liquidity during month-end tax payment. The RRR cut is also motivated by the need to support corporate lending. Despite easier interbank liquidity and marginal relaxation of Wealth Management Product (WMP) regulations, broad credit growth is still sluggish. Total Social Financial growth slowed to 10.1% in August 2018, down from an average of 13.2% in 2017. The RRR cut suggests that China's policy framework has been switching from a focus on financial deleveraging towards a bigger fiscal policy boost and a more aggressive monetary policy easing in order to confront an economic slowdown led by a protracted trade war with the US. Over the last six to nine months, the combination of RRR cuts, lower interbank rates, and accelerated local government bond issuance and bank lending have helped to stabilize total credit growth at 11% YoY. In the statement that follows the announcement, the PBoC also addressed the potential influence of the RRR cut on the currency. The central bank believes the impact on the currency is limited given that monetary condition is still neutral. Market yields are stable while broad money supply and total social financing growth are in line with nominal GDP growth. Instead, the PBoC believes these targeted RRRs would help to guide liquidity to small and medium enterprises (SMEs), private sector and innovative industries, and hence would help to rebalance economic structure and lift growth quality. These in return would help support the currency. The central bank reiterates that the renminbi will be basically stable at its equilibrium levels, warranted by China's competitive exports and industrial capacities. The PBoC also suggests that it would continue to take necessary measures to ensure stability in the local currency market.

On the Reserve Bank of India's (RBI) side, the Monetary Policy Committee (MPC) voted 5-1 in favour of leaving the policy repo rate unchanged, against consensus expectations for a hike of 25 bps. The MPC's decision signals that the monetary policy anchor firmly remains headline inflation, and it is not a tool to manage currency. The RBI's policy stance was changed from "neutral" to "calibrated tightening." The governor explained that this means rate cuts are off the table and the next move will either be a hike or no change. The RBI retained its forecast for GDP growth to strengthen to 7.4% YoY in FY19 (year-ending March 2019) from 6.6% in FY18, while paring down its 1Q18 FY20 projection to 7.4% (from 7.5%), as it sees the risks as evenly balanced. Meanwhile, the RBI has significantly revised its CPI inflation trajectory downwards: 4.0% in 2Q18 FY19 (from 4.6% earlier), to 3.9%-4.5% in H2 (from 4.8%), and to 4.8% in 1Q18 FY20 (from 5.0%), with risks "somewhat to the upside."

The growth outlook is clouded by the deterioration in US-China trade relations, though Singapore is in a favorable position to mitigate against the risks, and capitalize on the opportunities from the corresponding trade diversion, as well as the reshuffling of supply chains by global companies in the medium term. The longer-term growth outlook remains moderate as demographic headwinds and a continued low tolerance for a rise in immigration point 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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* As of 30 September 2018.