Western Asset Management April 2018

SINGAPORE FIXED INCOME REVIEW

MARKET REVIEW

In April, the Singapore government bond market saw losses of -0.78%, reversing gains of 0.45% last month, bringing year-to-date returns to -1.96%. The 3-month SIBOR rate rose to 1.51%, up from the previous month's 1.45% level alongside moves in front-end LIBOR rates. The Singapore curve bear-steepened with yields higher by up to 24 basis points (bps) in the long end while the front end saw yields retracing. Singapore government securities (SGS) performed in line with US Treasuries (USTs) on the whole during the month of April. USTs saw yields rising by up to 24 bps in the belly, but front-end yields were almost flat for the month.

With a stronger growth trajectory and firm demand-driven inflation, the Monetary Authority of Singapore (MAS) increased slightly the slope of the S$NEER policy band, from zero percent previously. The width of the policy band and the level at which it is centred were unchanged. This policy stance is consistent with a modest and gradual appreciation path of the S$NEER policy band that will ensure medium-term price stability. This is the first positive slope shift after two years, during which the MAS had committed to a neutral policy (flat slope) for an extended period.

According to the Advance Estimates released by the Ministry of Trade and Industry today, the Singapore economy grew by 1.4% on a quarter-on-quarter seasonally-adjusted annualised basis in 1Q18, a moderation from the 2.1% recorded in 4Q17. In comparison, year-over-year (YoY), GDP rose by an estimated 4.3% in 1Q18, following growth of 3.6% for 2017 as a whole. The MAS expects GDP growth in 2018 to come in slightly above the middle of the forecast range of 1.5%–3.5%. Productivity will continue to contribute to growth this year, even as total employment is projected to expand following a marginal contraction in 2017. Core Inflation, which excludes the costs of private road transport and accommodation, edged up to average 1.6% YoY in January–February 2018, from 1.4% in 4Q17. This was largely due to stronger price increases in services and retail items, which more than offset lower food price inflation. The MAS expects inflation to rise on imports on the back of strengthening global demand while domestic demand-driven inflation is also expected to rise though the extent is expected to be moderate because of relatively subdued retail rents and constraints on firms' pricing power due to market competition. The MAS expects core inflation to rise gradually over the course of this year. For 2018, core inflation should come in within the upper half of the 1%–2% forecast range. The latest quarterly survey for the Singapore Index of Inflation Expectations (SInDEX) showed that "one-year-ahead" headline expectations rose to 3.43% in 1Q18 (4Q17: 2.97%), the highest since 4Q14. Core inflation expectations jumped 0.4 percentage points to 3.3%, the highest since 3Q15. Although the press release cited trade tensions and US monetary tightening as external factors behind the rise, it also noted an improving domestic job market. Rising inflation expectations, including over the longer term, seems to concur with the MPS's assessment that upward pressures on core inflation will persist over the course of this year and beyond.

March non-oil domestic export (NODX) growth of -2.7% YoY disappointed despite improving from -6.0% in February (consensus: 1.2%; Nomura: 0.5%). The improvement in NODX growth was mainly because of the Lunar New Year moving holiday effect. Electronics exports continued its sharp decline (-7.1% YoY in March from -8.0% in January-February combined), dragged by exports of integrated circuits. A decoupling in electronics performance between NODX and industrial production (IP) suggest that Singapore's manufacturing of electronics products is increasingly shifting towards higher-end production design and testing. Non-electronics export growth also dropped sharply to -1.3% YoY from growth of 8.5% in January-February combined, which was boosted by surging exports of non-electric engines and motors, food preparations and measuring instruments in January. IP growth eased to 5.9% YoY in March from 6.7% in February, which was revised down from 8.9%. The main drag was a significant moderation in electronics output growth to 12.4% YoY in March from 23.2% in January-February. This, however, continued to diverge from NODX data by showing a sharp decline in electronics NODX growth.

Headline inflation slowed to 0.2% YoY in March (February: 0.5%; January: 0.0%), which was weaker than expected. The decline in headline inflation was driven in part by lower Certificate of Entitlement (CoE) premiums, which lowered private road transport costs. On a YoY basis, private road transport costs fell 0.6% YoY, from a positive print of 0.6% in February. Core prices were flat on the month, leaving core inflation also a touch softer at 1.5% YoY. Underlying demand-pull inflation pressures remain limited despite the pick-up in GDP growth.

OUTLOOK

March US Federal Open Market Committee (FOMC) minutes reflect a hawkish tilt, reinforcing expectation of a June hike. Committee members were unanimous in their assessment that the economic outlook has strengthened, and all expected inflation to move up in the coming months. Current FOMC members appear to be relatively more convinced of the benefits to real growth from the Tax Cuts and Jobs Act (TCJA) than was the previous group, despite generally seeing the economy as already operating above potential. In this press conference, Federal Reserve Chair Jerome Powell emphasized that he would not prejudge the economic effects of fiscal policy at the same time downplaying the point estimates of the Summary of Economic Projections (SEP). Rather, he is open to seeing what is borne out in the data. During Powell's recent speech at the Economic Club of Chicago, he noted the difficulty in assessing signals from labor measures pointing in different directions and emphasized that the Committee would be guided by "…incoming data across all of these measures." Treasury structural technicals continue to present a challenge to yields; central banks which for the past 10 years have been buying 18% of USTs (40% of total debt bought by foreigners) now have lower demand as a result of weaker global reserve growth. Historically when the US dollar was weak, Asian central banks limited their currency appreciation by buying the US dollar, and the bond purchases indirectly protected the US dollar's downside with US fixed-income purchases. This acted as a "put" to protect the US bond market's downside, when the US dollar was weak. On the supply side, the fiscal deficit continues to rise and with the Fed stepping back the threat of steeper yield curves will increase. The rise in US dollar LIBOR has also changed the calculus of foreign investors buying US fixed-income paper on a hedged basis. In February, Japanese investors sold a record ¥4 trillion ($37 billion) of US bonds, in the fifth straight month of selling. Two thirds of the recent Japanese liquidation of US bonds have been reallocated to European and Australian bonds. For the first time since the crisis, the pickup on a hedged 10-year German bund materially exceeds that of a hedged 10-year UST by 60 bps.

The US Trade Representative (USTR) identified the proposed list of products that benefit China's industrial policies (e.g., Made in China 2025) but with the lowest impact on US consumers. The list mainly includes home appliances, machinery, electrical equipment, instruments, vehicles, aluminium and steel, pharmaceutical, etc. China delivered a clear message that any US trade action against China will be retaliated on equal scale and intensity. 106 US product categories will see an additional 25% tariff imposed, while the actual effective date depends on the US administration's final decision on its trade actions on China. China's proposed list is largely proportional to US trade actions, covering US exports to China with a value of over $48 billion (>30% of total US exports to China). The top products on the list include soybeans ($14 billion), autos ($13 billion), aircrafts ($10 billion), plastics and chemicals ($6 billion), liquid gas ($2 billion), cotton ($1 billion), and other agricultural products (e.g., corn, beef, tobacco). In a press conference held following the announcement, Vice Minister of Finance (Mr. Zhu Guangyao) and Vice Minister of Commerce (Mr. Wang Shouwen) emphasized the recent party lines that China is not interested in a trade war, although it is not afraid of fighting one either. The ministers also indicated that China is open to negotiations with the US. Implementation of US tariffs, if any, will take effect around September at the earliest. Public consultations will last for two months, after which it could take up to three months before a final decision by the USTR on actual implementation. Judging from recent US trade negotiations including NAFTA, it is not inconceivable that the final version ends up being highly diluted from the initial proposal, particularly given the strong resistance from US industrial, agriculture and other lobby groups. China's Commerce Ministry held a press conference responding to President Donald Trump's threat of an additional $100 billion in tariffs. Officials called US action both wrong and misjudged, adding China is ready and will not hesitate to respond. China said it doesn't rule out any options and has detailed retaliatory measures ready, adding it will take immediate retaliation if the US releases a new list of products to target with tariffs. In 2017, the US exported $155.2 billion to China vs. China's $433.1 billion to the US. If China decides to match dollar for dollar, it will likely have to essentially target all goods imported from the US. It is in the services trade where China will have more leverage, given that in 2016 the US exported $54.2 billion services to China versus China's $16.1 billion of exports to the US.

The speech given by President Jinping Xi at the Bo'ao Forum was conciliatory on trade, reiterated China's intention to open the financial sector, strengthen IP protection, join the Government Procurement Agreement (GPA) of the WTO, promote imports and revise the negative list for foreign investment (by June 2018). While President Xi did not directly address the recent escalation of the China-US trade dispute, he called for "peace and cooperation (through dialogue)", while cautioning against "Cold War mentality and zero-sum game thinking." People's Bank of China (PBoC) governor Yi Gang gave a keynote speech at the Boao Forum, and emphasized that China will not use renminbi devaluation as a tool to confront trade tensions — Yi attributed the US-China trade imbalance to structural and macroeconomic reasons. The declining saving rate in the US will make it difficult to reduce its trade deficit. He also noted that China's service deficit against the US has been enlarging rapidly. Furthermore, China will firmly push forward the convertibility of the renminbi capital account, and the renminbi policy reform will be coordinated with the financial market opening.

Emerging markets (EM) resilience continues to drive outperformance, with EM equities outperforming developed market (DM) and EM local bond markets holding up despite the rise in LIBOR and the Fed's expected rate hike. This has largely been driven by benign domestic inflationary pressures, limited pass-through from supply side pressures amid modest domestic pricing power anchor core inflation even as headline inflation will move up modestly on higher commodity prices. From a monetary policy perspective, central banks in Asia continue to maintain a neutral to dovish stance, balancing excess domestic liquidity while allowing currencies to strengthen in view of protectionist risks arising out of the US. While the latest version of the semi-annual Treasury report (released on the 13th of April) stopped short of naming any country as a currency manipulator, Korea remains on the list even as Taiwan was removed and India was added. The synchronous global recovery has anchored risk sentiment and Asia continues to be favoured on the back of more stable social-political environments and positive growth demographics. Capital flows to EM funds have grown by over three times than that to DM funds in 1Q18. The Asian local bond market received its 14th straight month of inflows. Excess inventories of oil have shrunk to the lowest level in three years, a surplus of just 43 million barrels, based on the five-year average. Two years ago, the storage surplus hit 400 million barrels. This is partly a consequence of a concerted effort by Saudi Arabia, its OPEC colleagues, and Russia, to throttle back output to bolster prices and cause a pickup in global demand. Tensions in Venezuela and Syria have also weighed on supply. Higher oil prices should not have the same impact on Asia low yielders, relative to the rest of the world, as currency appreciation can dampen import price pressures.

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.

PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

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