Western Asset Management

June 2017

SINGAPORE
FIXED INCOME REVIEW

MARKET REVIEW

In June, the Singapore bond market made marginal gains with the belly holding up even as yields moved marginally higher at both the front and back end of the curve. The Asian Local Bond Index (ALBI) Singapore Government Bond Index rose by 0.10%, bringing year-to-date gains to 3.55%.

The US Treasury (UST) curve bear-steepened, with long-end yields rising while the front end was more anchored. Three-month and 1-year yields rose by 4 basis points (bps) and 10 bps, respectively. Five-year USTs widened by 14 bps to 1.89%, while the yield on 10-year USTs also rose by 10 bps at 2.30%.

Singapore government securities (SGS) performed in line with USTs, driven by onshore technical support and local demand. The long end outperformed, with the yields on 3-month bills widening 4 bps to 0.98%, while the 1-year yield was 3 bps higher at 1.08%. The 2-year yield was unchanged at 1.22%, the 5-year yield tightened by 5 bps to 1.51%, while the 10-year widened by 1 bp to 2.09%. At the long end, the 30-year SGS tightened 2 bps to 2.44%.

Low base effects lifted headline inflation in May to +1.4% year-over-year (YoY) from +0.4% in April. Core inflation, on the other hand, moderately eased to 1.6% in May from 1.7% in April. The main reason for the pickup in inflation was the difference in timing of rebates on service and conservancy charges. According to the statement released by the Monetary Authority of Singapore (MAS) and the Ministry of Trade and Industry (MTI), the pickup in fuel and utility costs arising from increases in electricity (6.1% in 2Q17 versus 1Q17) and gas tariffs (2.4% in May-July from previous measure) also contributed to the rise in inflation. They were offered in April this year and in May in 2016, thereby creating an unfavourable base. As a result, accommodation costs declined by a smaller 1.5%, compared with the 6.7% fall in April. Core inflation eased to 1.6%, lower than the 1.7% registered in the preceding month. The decline in services inflation more than offset the pick-up in food and utility costs. Industrial production (IP) rose 5.0% YoY in May and was -3.5% month-over-month (MoM) on a seasonally adjusted basis, led by electronics. This was modestly lower compared with a 6.7% YoY increase in April and the consensus expectation of 7.5% growth. Excluding the biomedical sector, IP growth was stronger, rising by 13.1% YoY (April: 15.6%; March: 13.9%). Semiconductors were again the key driver of IP growth, as output from the sector remained high in May; the semiconductors IP index pulled back modestly in May from the record high levels in April.

Non-oil domestic exports (NODX) growth fell only slightly to -1.2% YoY in May from -0.8% in April, well above expectations (consensus: -5.6%). On a sequential basis, seasonally adjusted NODX rose by 8.1% MoM in May, reversing most of April's 9.0% decline. The jump in NODX was led by electronics, in particular ICs (+16% MoM SA, Apr: +5.6%). However, non-electronics also saw a large technical rebound that erased much of the plunge in April, on jumps in both petrochemicals and volatile pharmaceuticals. External demand remains on track to support growth, though momentum is moderating, the jump in NODX also suggests that Singapore's services sector continued to benefit from the broader rebound in regional trade activity.

OUTLOOK

At its June meeting, the Federal Open Market Committee (FOMC) raised the fed funds rate target by 25 bps to a range of 1.0%-1.25%, as expected. This was the fourth rate hike of the cycle. The FOMC also stated that it intends to begin tapering reinvestments this year, and released an addendum to its policy normalization principles, which laid out a relatively hawkish balance sheet policy—with caps gradually rising to $50 billion per month over the course of the next two years. The committee's economic projections showed lower inflation for 2017, but its outlook continues to point to a rapid recovery to 2.0% beginning next year. US Federal Reserve (Fed) Chair Janet Yellen said that inflation had been held back by "one-off reductions in certain categories like wireless prices and prescription drugs." In her view, these factors will create base effects that are likely to suppress YoY rates of inflation through next March. She remained confident that further improvement in labor markets and the passing of these one-off factors would lead inflation to return to 2.0% by the end of next year. The median dots were unchanged through 2018, suggesting one more hike in 2017 and three hikes in 2018.

The US dollar had weakened sharply on retail sales and Consumer Price Index (CPI) figures before the FOMC meeting but recovered ground versus G10 currencies after the meeting. This was not the case with US rates, which went down (CT10 reached a 2.10% low at some point overnight) and stayed down. The fact that long-end yields have stayed low suggests that either the demand for bonds continues to anchor yields or that inflation and growth expectations remain low. The market continues to accept in its stride any well-telegraphed plan for both Fed rate trajectory and balance sheet normalization. Avoiding another taper tantrum appears to anchor the Fed's communication protocol for its policy direction and expected action path. There have also been structural shifts in FX markets in Asia, specifically in the non-deliverable forward (NDF) space driven by regulatory shifts, varying margin requirements and the significantly less active role of speculative investors. This has resulted in Asia FX being driven more by current account flows in the medium term, and in the short term by capital account flows. With Asian growth still on a sustainable and increasingly endogenously oriented path, this provides both sustainability in terms of current account flows and support from capital account flows for Asian currencies. Asia's draw is not just that of yield but of resilience in a changing global trade environment and sustainable economic growth.

Asia is in much better shape now than in 2013, hence a repeat of the taper tantrum is unlikely even as the Fed begins unwinding its balance sheet (most likely later this year). Despite the recent rally, real rates are higher, FX reserves have been built up, current accounts have adjusted and overall macro vulnerability is lower. However, a rise in US rates along with being at this stage of the hiking cycle calls for a very selective and concentrated approach with a focus on where there are clearly growth/valuation fundamentals and when carry/volatility is optimized from a technical perspective. For example, in the case of Indonesia we continue to see it as a positive carry story even if the currency gain has been limited to 1% this year. This is largely due to the central bank's accumulation of reserves of over $20 billion in the past year or a 20% increase in total reserves. This would provide further buffer against FX liabilities and will likely help to dampen both volatility and vulnerability for the rest of the year. In the short term, the risk in Asia would be that of an accelerated narrowing of output gap, which we see as unlikely with the exception of Malaysia and the Philippines, or a turnaround in what is currently benign inflation from either food or oil price shocks. We remain watchful of these risks and as such have been careful about maintaining adequately liquid positions and appropriately sized diversified allocations across markets.

In the Asian 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. Positioning becomes another key factor. Foreign ownership will have to be differentiated between speculative investors and longer-term investors, and the intent of ownership should also be taken into consideration. In this respect, Asian markets that have significant regional or home bias will see yields supported. This is particularly evident in the US dollar Asian credit market. What will be crucial in navigating the US dollar Asian credit space will continue to be the fundamental understanding of each credit and the deep appreciation of primary-market support and secondary-market technicals, even as supply and diversity of issuers continue to grow. The downside risk to growth and uncertainty could prompt lower consumption and greater savings, and this should support demand in most markets.

While we expect FX volatility in Asia to increase, we also expect to see greater differentiation. Countries with lower reliance on US demand will likely benefit, specifically India and Indonesia. Hong Kong, Singapore, Taiwan, South Korea and Vietnam are most vulnerable given their export-orientation and vulnerability to slower global trade and investment growth. Korea is at risk of being labeled a currency manipulator given its large surplus with the US (US$29.4 billion), and its free trade agreement with the US also remains at risk. India should continue to outperform, with currency reform on the back of its taxation reform buttressing the case for an improved growth outlook. With monetary easing in India and Indonesia put on hold, the rupee and the rupiah should be supported. Regulatory changes involving margining requirements for NDFs, and subsequently all other currencies, will result in a reduction in liquidity for both hedging and speculative positioning by investors. This will structurally impact behavior of FX currency pairs, resulting in underlying currency fundamentals, portfolio and investment flow to have more significant bearing on currency valuations.

Singapore continues on its path of restructuring in view of the shifting competitive landscape and domestic demographic challenges. There remains an urgent need to position the economy as well as the labour force higher up the value chain given the constraints of labour implied by tighter immigration policy. The recent report by the government's Committee on the Future Economy concluded that growth is likely to average 2%-3% per year over the next decade, down from a previous expectation of 3%-5%. With little political room to maneuver in terms of immigration, growth will have to come from productivity, which remains dismal at 0.6% per year for the past decade. The government has downshifted its productivity growth forecast to 1%-2% over the next decade, instead of the previous aim of 2%-3%. Public sector infrastructure projects will be brought forward to start in FY2017 and FY2018 to help mitigate the slowdown in private-sector construction.

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. With its balanced fiscal policy mandate and its high current account surplus—projected at 19% of GDP for 2016, or an average of 18% for the past five years—structural underpinning remains firm. Household debt remains constrained by high mortgage levels—at 75.3% as of year-end 2016, up from 73.8% at year-end 2015—with mortgages at 56.8% of GDP. This and a more-hawkish Fed monetary policy stance provide little room for monetary policy easing by the MAS. The burden of growth support will continue to be on the fiscal and administrative side of the house. We expect the MAS to hold its neutral SGD nominal effective exchange rate (NEER) bands amidst a modestly improved outlook for global growth and inflation.

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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