Western Asset Management

ASIA

FIXED INCOME REVIEW

MARKET REVIEW

The J.P. Morgan Asia Credit Index (JACI) lost 0.79% month-over-month in October, bringing year-to-date (YTD) gains to 8.24%. Returns were muted due both to weakness in US Treasuries (USTs), specifically in the long end of the UST curve, and weakness in Asian credit spreads, which saw some widening. The top-performing sector was non-investment-grade quasi-sovereigns, which saw gains of 0.50%, while the weakest sector was investment-grade sovereigns, which saw losses of 2.28%. USTs saw losses on the long end of the curve on a bear-steepening move, as the Federal Reserve (Fed) continued to edge towards a hike later in the year. Five-year USTs widened by 16 basis points (bps) to 1.31%, while the yield on 10-year USTs widened 23 bps to 1.83%.

Returns were mixed across the JACI, with Pakistan seeing the biggest gains at 2.51% while the Philippines saw the biggest loses of 1.91%.

For the first time this year, Asian credit returns turned negative on a monthly basis, not helped by the significant selloff in USTs during the course of October (for example, the 10-year UST rose to a yield of 1.83% at the end of October compared with a yield of just over 1.60% at the beginning of the month). The JACI FINS CORP Index returned -0.5% in October, resulting in YTD returns of 5.0%. The JACI IG NONFINS CORP Index saw performance of -1.0% during the month, with returns of 6.9% for the first 10 months of the year. On a sector basis and beginning with Asian financials, spreads were generally tighter with the exception of two geographies—Korea and Thailand. Korean quasi-sovereign banks such as EIBKOR/KDB saw their 5- and 10-year seniors widen 4-5 basis points (bps), while over in Thailand 5-year seniors from BBLTB, KBANK and TMBTB were 5-7 bps wider, with the underperformance likely as a result of the recent passing of the Thai king. Elsewhere, Indian bank seniors tightened 3-5 bps on average. Over in China, financial senior paper was 2-3 bps tighter, but we did see some pockets of outperformance from Tier-2 paper such as the BCHINA 24s/ICBCAS 25s, which were about 15 bps tighter.

With regards to the Asian corporate space and starting with China, the clear winners in general were the local government financing vehicle (LGFV) bonds as we saw the likes of CQNANA and XANCON tighten 10-12 bps. That being said, there was a particular name that significantly outperformed, tightening over 50 bps—the CNBG complex—on rumours that the company ChemChina would be merged with fellow Chinese state-owned enterprise Sinochem, which is a stronger/higher-rated entity. Similar to their financials counterparts, Korean quasi-sovereign corporates also underperformed with spreads widening 5-10 bps, led by the KORGAS 21s and KOROIL 21s. The same could be said of Thai corporates, with spreads widening 3-5 bps, largely mirroring their financial counterparts. Meanwhile, Indian corporates had a good month with spreads 8-12 bps tighter in the likes of BHARTI 25s, ONGCIN 26s and RILIN 25s.

On the new issue front, the pace of issuances in October followed that of September with US$15.1 billion of investment-grade corporate/financial issuances in October (versus September’s US$15.6 billion). On a YTD basis, new investment-grade corporate/financial issuances were now 5% above last year’s pace, compared with being 8% behind last year’s pace during the first nine months of this year. About 40% of the new deals in October were of Chinese origin, while Korean issuers accounted for nearly 30% of the deal flow.

The Markit Asia Local Bond Index (ALBI) saw losses of 2.04% during October, bringing YTD gains to 7.56%. Asian local currency bond markets reversed gains this month, driven by a shift higher in yields across most markets alongside expectations of a Fed rate hike. Asian rates broadly sold off across most markets, with India being the only exception on the back of a selloff in global core rates. Reserve Bank of India’s continued dovishness following its rate cut led to its outperformance. China onshore and India led outperformance with positive
returns of 1.21% and 0.81%, respectively, and displayed characteristics of domestically-oriented markets, anchored by domestic monetary policy. The biggest losses were seen in South Korea, which returned -5.4% while the Philippines saw losses of 2.87%. The larger than average losses were driven by domestic bond market technicals. Asian currencies saw broad declines versus the US dollar with the Korean won leading the declines, weakening 4.20% versus the US dollar.

OUTLOOK

Fed Vice Chair Stanley Fischer wasn’t the only G4 central banker lamenting that low rates are not simply due to the actions of central banks—the Bank of England’s (BoE’s) Deputy Governor Ben Broadbent also noted in comments that the BoE is “simply the last link in the chain, not the cause of low interest rates.” Below-trend global growth rates and a weak corporate earnings outlook may hamper the upside for risk assets. November’s Federal Open Market Committee meeting was largely uneventful but continued to point towards an expected December hike. Fed statements continued to lean in a hawkish direction, expressing confidence in the economy and noting that “the case for an increase in the federal funds rate has continued to strengthen.” The committee downgraded the pace of household spending to “rising moderately” from “growing strongly.” This is not a surprise given the release of the advance estimate of 3Q16 GDP, which showed private consumption rising 2.1% quarter-over-quarter on a seasonally adjusted annualized rate versus 4.3% in 2Q16. The global backdrop remains one of subdued growth vulnerable to geopolitical risks and of low inflationary pressure driven by structural and cyclical factors; this should keep central banks on a broadly accommodative policy path. Surplus savings and demographic shifts underpin structural demand for yield. In such an environment, where economic upside is limited and uncertainty remains high, the search for high-quality yield will continue to underpin yields even if the Fed does move ahead with its next hike in December.

On China, the International Monetary Fund (IMF) sounded an alarm with its estimate indicating that the debt-at-risk had increased to 14% of the total corporate loan portfolio in 2015 from under 4% in 2010. This could generate potential losses of around 7% of GDP if one were to apply a 60% loss ratio on these loans. In the shadow banking sector, risks remain high; according to the IMF’s estimate, Chinese listed banks’ holdings of shadow products increased 58% year-over-year in 2015, equivalent to 92% of capital buffers. The 19th National Congress of the Communist Party of China to be held in autumn 2017 will be an important political event given that five of the seven Politburo Standing Committee members will likely be retiring. Sustaining growth momentum will continue to be a key driver of policy at the expense of structural reforms given the need for political capital consolidation. In the near term, the risks of China being a source of instability are low and worries of a sharp Chinese yuan devaluation have subsided.

Asian growth continues to improve, supported largely by emerging Asia on the back of accommodative monetary policy, domestic consumption and a pickup in fiscal expenditures. Headline inflation will likely also see some upward bias, as base effects should drive energy inflation up towards the end of the year. Inflationary pressures, however, remain low in Asia, with large output gaps, high inventory levels and low wage pressures. Unlike in the developed markets, Asian economies have not reached the limits of monetary policy even though they are clearly aware of the limited effectiveness of aggressive monetary policy. Asian economies also have more room to maneuver when it comes to fiscal policy, with Japan likely to take the lead with fiscal stimulus after pushing the limits of its monetary policy.

In developed Asia, for economies such as Hong Kong, Korea, Taiwan and Singapore, policymakers will continue to face the challenge of a dislocation between economic growth and income growth as the wage share of GDP continues to decline. Weak job markets and slow nominal wage growth will continue to exert deflationary pressures on these economies. Even as nominal growth continues at a moderate pace, accommodative policy and supportive structural economic policies might cause a decoupling of productivity growth and employment growth as job creation slows in developed economies. This coupled with rising social costs due to aging demographics will make fiscal sustainability an increasing challenge for policymakers. This is not a problem unique to developed Asia, as the number of degree-level-qualified youths below the age of 34 in the Organisation for Economic Cooperation and Development and the G20 has grown nearly 45% between 2005 and 2013. Policymakers will have to focus on supply-side reforms, including improving infrastructure, increasing the size of the labour force and raising productivity.

For Asian local-currency bonds, there will be increasing differentiation arising from divergent domestic growth trajectories, current account dynamics and local banking macro-prudential concerns. While we expect most local government yield curves to bear-flatten in the near term,
low inflation and strong fiscal positions should keep the belly of most government curves well-anchored. Local buyers are becoming increasingly crucial marginal buyers of local sovereign bonds, encouraged by regulations such as Singapore’s liquidity coverage ratio requirement and Indonesia’s banking regulator requirements, both of which call for banks to hold more bonds. We will judiciously consider local technical factors in light of potential periods of liquidity strain; local markets with less depth will have less capacity to withstand a shift in offshore interest. We expect overall local government bond supply to be lower than in previous years as governments benefit from reduced subsidy expenditures and benign commodity prices.
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