FULLERTON INSIGHTS

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What's Next for Asian Fixed Income Markets?

Asian bond markets have done well in the first eight months of the year on the back of stable global growth, benign inflation, and technical support. Positively, better growth prospects in the US and the Eurozone, coupled with sustained growth momentum in Asia, have provided tailwinds to the global recovery. Less certain is the timing and pace of the unwinding of quantitative easing by major developed market central banks, which could pose headwinds for the recovery and risk assets in general.

In the US, consumer and business sentiment have improved, while manufacturing indicators remain generally strong. Labour market conditions are robust, with the economy near full employment. Coupled with a healthy housing market, fundamentals for the US consumer appear positive. Inflation indicators that are closely monitored by the Federal Reserve (Fed) remain below the target inflation rate of 2.0%, suggesting that the Fed may continue to move gradually on rate hikes. That said, the minutes of the July FOMC meeting suggested that the Fed is likely to move ahead with a reduction of its balance sheet, possibly in September this year. Meanwhile, US financial conditions have eased despite the Fed rate hikes over the past three quarters, suggesting further room for policy normalisation. Less positively, political tensions in Washington have cast further doubt on the ability of the Trump administration to deliver on its pro-growth agenda.

Elsewhere, Eurozone recovery has grown more robust and broad-based. GDP growth is running at 2-2.5% pace, supported by healthy domestic demand. While the European Central Bank (ECB) had indicated that it is deliberating on a decision to scale back its Quantitative Easing (QE) programme in response to a stronger economic recovery in the Eurozone, inflationary pressures remain subdued. Furthermore, the timing and pace of the QE taper remains uncertain – the minutes of the ECB meeting in July shed little light on how soon the central bank intends to unwind its massive stimulus programme.

In Asia, the growth momentum remains strong. Asian exporters have largely benefitted from the upturn in global demand, although the export growth momentum moderated in 2Q17 on the back of softer electronics exports, while the base effects of commodity prices wore off. That said, Asian purchasing managers' indices have remained buoyant, in line with improving developed market business sentiment.

Asian Credit Markets – Supportive Technicals, Valuations Remain Tight

Asian credits, as represented by the JACI Composite Index, have returned 5.36% year to date (as at end August), supported by spread tightening and Treasury gains. US Treasury (UST) returns had accounted for nearly half of total returns, as the UST curve flattened on the long end. Short end yields ended higher with the 2-year note at 1.33% while the 10-year note ended August at 2.12%. By segment, both the JACI Investment Grade (IG) and High Yield (HY) Indices have chalked up strong returns of 5.30% and 5.60%, respectively.

The flip side of the strong performance in Asian credit markets is that valuations remain tight, with spreads hovering near historical lows dating back to 2010. As at end August, the JACI yield-to-maturity was 37bps below the historical average of 4.76%, while on a spread basis, the JACI was close to 39bps below its historical average. Within the sub-segments, IG corporates provide more upside compared to HY corporates, on a spread-to-historical basis. IG corporates are currently trading at around 10bps above historical lows while HY corporates are already trading below the historical lows. Spread decompression has also been more pronounced at the lower end of the credit spectrum, as the spread differential between 'BB' and 'B' credit buckets remains very tight compared to historical levels.

Credit fundamentals for IG corporates are stronger compared to that for HY corporates, as IG corporates have stable EBITDA and better earnings profiles. Furthermore, IG corporates have been improving and deleveraging balance sheets over 12-18 months, scaling back capex, while softer commodity prices have also helped.

On the supply side, primary issuance continues to be very strong. New bond issuance has added up to US$180 billion YTD as of mid-August. Much of the new issuance has been from China issuers, particularly Chinese HY issuers. Indeed, HY corporate supply has already set a new record this year of total issuance close to US$55 billion supply,

which is already ahead of the supply of US$36 billion chalked up in 2013. In comparison, bond issuances from countries such as India and Indonesia, which we have a more favourable outlook on, have been far more subdued this year.

That said, the technical picture for Asian credit markets has remained supportive due to robust inflows. Indeed, Emerging Market (EM) bonds have seen an inflow of US$64 billion for the first half of 2017. Within Asia, strong demand for new issues from domestic Asian investors – particularly Chinese onshore investors – had also provided the technical support for the Asian credit market. That said, going forward, we believe investors may turn more discerning towards specific segments of issuers, given that new issue supply is likely to remain heavy for the rest of the year.

Credit Selection is Key, Preference for IG Names over HY

In terms of credit strategy, we remain selective within our credit portfolios. We continue to broadly prefer IG names over HY, as the low spread differential between HY and IG corporates does not adequately compensate investors for taking additional risks. Furthermore, IG corporate fundamentals remain strong, and companies have stable credit profiles. We would hold shorter dated IG names for carry and participate selectively in longer-dated IG deals, keeping in mind political noise and potential interest rate hikes going forward.

We are cautious on HY sector valuations, and remain selective when investing in the sector. To that end, we remain nimble in managing our high yield exposures and will selectively add to our HY positions for carry.

Favourable Growth and Inflation Mix for Asian Local Currency Bonds

Asian local currency bond markets have similarly performed well in the first eight months of 2017 on a goldilocks combination of stable global growth and low inflation. The iBOXX ALBI posted a strong return of 8.23% in USD terms as at end August. In local currency terms, bond markets in Indonesia, Hong Kong and India posted the strongest returns.

The inflation backdrop in Asia has been relatively benign, despite the stronger growth momentum so far this year. A sharp decline in food inflation has capped headline consumer price inflation while softer core inflation has indicated a lack of demand-pull inflationary pressures. With inflation staying contained, Asian central banks have the leeway to maintain an accommodative monetary policy stance for longer. Similarly, fiscal policy also remains generally supportive across the region. Nonetheless, we are cognizant that the unwinding of QE in the developed world could create more volatility in the fixed income markets, as a result of rising term premiums in developed market interest rates, which had previously been suppressed by QE. That said, developed market central banks are likely to normalise monetary policy at a gradual pace, which should help to mitigate market volatility.

Defensive on Duration in Asian Local Currency Bond Portfolios

On the flip side, the strong rally in Asian local bond markets so far this year means that valuations are less attractive. Within the region, yield curves in Indonesia, Hong Kong and China have historically been sensitive to UST 10-year term premium, which renders them more vulnerable to US-led yield curve steepening. Furthermore, rising risk premia and interest rate volatility from the tapering of QE by the Fed and the ECB, could lead to more volatility within the Asian local currency bond markets. Lastly, global inflation surprise indices have fallen substantially in 2017 and bond markets have not priced in much inflation upside risk. Normalisation of food inflation across the region would reduce policy space of inflation-targeting central banks to remain accommodative.

Over in China, the authorities remained focused on financial deleveraging, but the pace of which is likely to stay gradual and controlled. President Xi Jinping will continue to prioritise economic growth and stability ahead of the all-important 19th National People's Congress, as he seeks to consolidate his leadership within the party. The continued focus on financial deleveraging, coupled with significant net government bond issuance for the rest of the year, could place upward pressure on onshore bond yields.

Against this backdrop, we believe it is prudent to retain a defensive stance on duration in our local currency portfolios. We are overweight short-dated IDR, INR, and USD credit bonds for carry returns; conversely, we are underweight duration in low-yielding markets sensitive to UST yields, such as the KRW, HKD and SGD. Similarly in China, we retain an underweight bias in duration, but would look to fade extreme market moves. In terms of market/FX

allocation, we have a modest overweight in high-yielding markets (including IDR, INR and MYR) but would remain invested in short-end bonds, to reduce duration exposure.

On credits, we have a moderate overweight on credit versus government bonds. Within that, we are overweight USD and SGD credits, while staying underweight in HKD. On currencies, we expect Asian currencies to stay range bound versus the USD. USD weakness has also turned more pronounced, as the political gridlock in the US has weighed on expectations of US reflationary policies, while monetary expectations in the rest of the developed world have turned less dovish.

Active Management is Key

The investment backdrop remains challenging in the second half of 2017 despite more favourable growth and inflation dynamics for Asian bond markets. Risk events in the market could surface, given the i) uncertainties surrounding the Trump administration, ii) geopolitical tensions in the Korean peninsula; as well as iii) rising risk premia and interest rate volatility from the tapering of QE by the Fed and the ECB. Hence, we expect volatility to spike periodically, especially during periods of risk-off sentiment in the markets.

In this environment, we believe active management is key to delivering returns across our portfolios. Our portfolios are thus actively managed to mitigate risk and achieve total returns. Managing through periods of volatility will be a key consideration and our portfolios managers are vigilant in managing downside risks, even as they focus on optimising returns while maintaining sufficient liquidity in the portfolios.

Please do not hesitate to contact us if you require further clarification.

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