Nikko Asset Management

From The FIXED INCOME Desk

Monthly Outlook

July 2014

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Summary

- During the Federal Open Market Committee (FOMC) meeting in June, the US Federal Reserve (Fed) announced an additional USD 10bn per month in tapering, while keeping the target rate at 0.25%. 10-year US Treasuries (UST) yields were higher by about 5 basis points (bps) on improving economic data.

- In June, the Philippines central bank hiked its Special Deposit Accounts (SDA) facility rate, while India lowered its Statutory Liquidity Ratio (SLR). Indonesia and Thailand maintained their policy rates.

- The monetary easing policy announcement by the European Central Bank (ECB) as well as the targeted 50bps reduction in the required reserve ratio (RRR) in China and a dovish June FOMC meeting provided support to Asian credits in June.

- Over the month, Asian high-grade credits returned -0.04% while high-yield credits returned 1.65%. Activity in the primary market picked up in June, with total issuance amounting to around USD 13.8bn.

- We expect the central bank of Malaysia to adopt a more hawkish bias in the future, which will likely support the ringgit. We expect Thailand's economic activities to head toward a slow pick-up, while South Korea to remain supported by its strong current account position. We are neutral on Indonesia as the country heads for a tight presidential race.

- The recent muted volatility in risk-free rates should be positive for Asian credit. Asian credit spreads are expected to slowly grind tighter in the coming month as new issuance supply dwindles amidst the summer lull period in an environment of healthy fund inflows. With this backdrop, carry should dominate returns for the coming month barring any severe macro shocks.

ASIAN RATES AND FX

Market Review

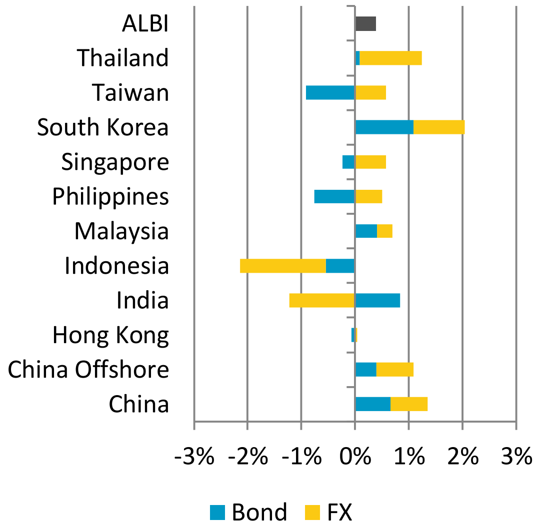
US FED MAINTAINED ITS TARGET RATE AND CUT BOND BUYING PROGRAM BY ANOTHER USD 10BN

Geopolitical risks in Iraq and dovish central banks stance capped rise in UST yields

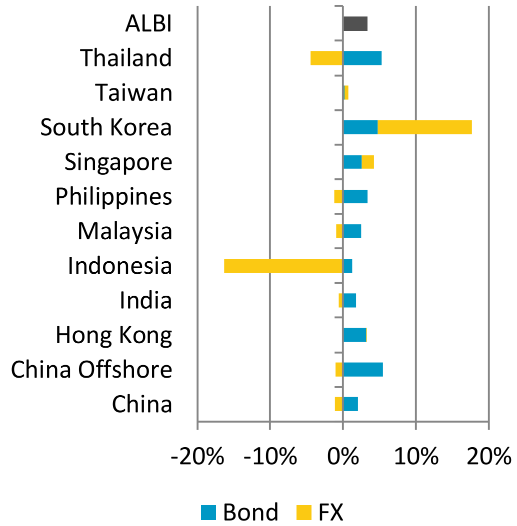
During the FOMC meeting in June, US Fed Chairperson Janet Yellen reiterated that the Fed is still committed to its accommodative policy stance even as the US economy continues to show signs of gradual recovery. As expected, the Fed kept rates unchanged at 0.25% and continued with the quantitative easing tapering by another USD 10bn to USD 35bn per month. Overall, 10-year UST yields were higher by about 5bps in June on improving US economic data. The rise in yields was however capped by the escalating geopolitical risks in Iraq and dovish stance from the US Fed and ECB.

HSBC Asian Local Bond Index (ALBI)

For the month ending 30 June 2014



For the period from 1 July 2013 to 30 June 2014



Note: Bond returns are in local currencies while FX and ALBI returns are in USD. Past performance is not necessarily indicative of the future performance.
Source: HSBC Asian Local Currency Bond Indices, Bloomberg, 30 June 2014

Philippines hiked SDA rate by 25bps

Bangko Sentral ng Pilipinas (BSP) kept reverse repo rate unchanged but increased the SDA rate by 25bps to 2.25%, a moderate tightening policy after increasing its RRR earlier. However, the central bank kept its policy rate on hold at 3.50%, reflecting the BSP's reluctance to tweak their official policy rates. The decision to raise SDA rates reflects the BSP's upwardly revised inflation forecasts; BSP has increased its average inflation outlook to 4.4% for 2014 (from 4.3%) and its 2015 forecast to 3.7% (from 3.4%).

Bank Indonesia (BI) kept rates unchanged; budget revision finalised

As per market expectations, BI maintained its policy rate in June. Meanwhile, the 2014 budget deficit has been finalised to 2.4% of GDP from the initial proposal of 2.5%. The Indonesian government will finance the budget deficit by increasing the bond sales by IDR 59.9tn instead of the initial proposal of IDR 69tn.

Bank of Thailand (BoT) kept rates unchanged as economic and political outlook stabilises

BoT voted unanimously in June to keep the policy rate at 2% in view that the current rate remains sufficiently accommodative. Also, the central bank expects the economic outlook to improve, given the significant reduction in political uncertainties. In addition, Thailand's consumer confidence index improved to 70.7 in May compared with 67.8 in April. Furthermore, both investment activity and private consumption were up strongly in May on a month-on-month basis. Meanwhile, Thailand's political situation has started to show signs of stabilising after the military government took control in May and street protest has waned significantly since then. The fiscal budget for 2015 has been approved, which is expected to help kick-start the much needed government spending projects to lift the ailing economy.

India reduced SLR by 50bps

During the Monetary Policy Committee meetings in June, the Reserve Bank of India (RBI) kept its key policy rates unchanged, as per market expectation. However, RBI reduced the SLR, the amount that banks have to keep in government bonds, by 50bps to 22.5% of deposits. RBI stated that it may ease rates if inflation cools faster than expected, less hawkish than previous comments.

China expanded targeted monetary easing measures

Market sentiment in China was lifted following the announcements of increased targeted liquidity and credit easing by the People's Bank of China. Specifically, the State Council unveiled a targeted 50bps reduction in the RRR for financial institutions with sizeable loans to the agricultural sector and small- and medium-sized enterprises, effective from 16 June 2014. This, together with the RRR cut for county-level rural banks in April, may release about CNY 200bn liquidity in the banking system, compared with CNY 540bn from a 50bps system-wide RRR cut.

Market Outlook

EXPECT THAILAND'S ECONOMIC ACTIVITIES TO PICK-UP IN THE MONTHS AHEAD

Positive on Malaysia, Thailand and South Korea

Given the gradual rise in inflation and modest growth in Malaysia, we expect Bank Negara Malaysia to adopt a more hawkish bias in the future which will likely support the ringgit. In addition, given that Malaysia is a net oil exporting country, we expect the nation to be less vulnerable to the rise in oil price caused by the current crisis in Iraq. Elsewhere, the economic and political situation in Thailand has stabilised following the military coup in May. After several months of political stalemate and economic deterioration, we expect economic activities to bottom out and head toward a slow pick-up in the months ahead. Against this backdrop, we are mildly positive on Thailand while being mindful of the country's political developments. Meanwhile, we expect South Korea to remain well supported by its strong current account position. Of note, South Korea's current account reached a USD 9.3bn surplus in May, resulting in a total of USD 31.5bn cumulative surplus from January 2014 to May 2014.

Neutral on Indonesia

Given the tight presidential race, we prefer to stay neutral on Indonesia for the time being. So far, the market has favoured and expected Jokowi to win the presidential election. However, recent polls have shown that the margin between the two candidates, Jokowi and Prabowo, have narrowed significantly. On the economic front, we are mindful that the recent trade deficits were largely due to seasonal factors and expect some improvements in the external balances post-Ramadan period. Lastly, we expect BI to keep its key rates unchanged for the rest of the year as inflationary pressures remain manageable.

ASIAN CREDITS

Market Review

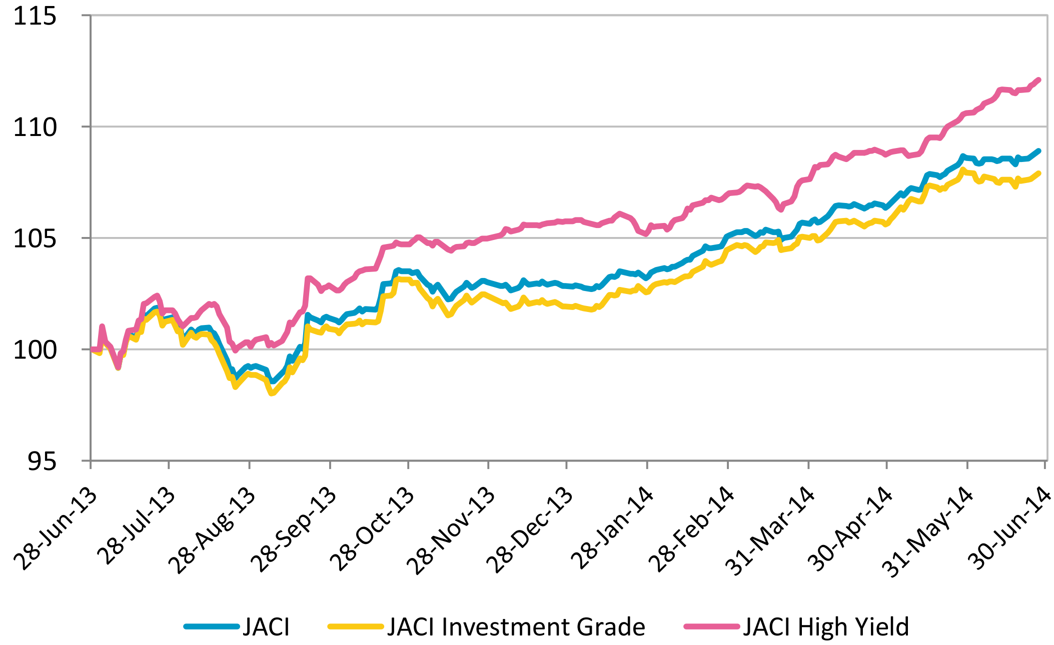
ASIAN HIGH-GRADE RETURNED -0.04%, WHILE HIGH-YIELD RETURNED 1.65% IN JUNE

Asian credits rallied

In June, while Asian credit spreads tightened, weaker UST led to marginally negative returns for Asian high-grade. During the month, the ECB delivered the highly anticipated comprehensive set of easing policies. This, together with the 50bps targeted RRR cut in China, and a dovish FOMC meeting in June provided support to Asian credits. During the month, the 10-year UST yield rose to 2.53% from 2.48%. On a total-return basis, Asian high-grade returned -0.04% while high-yield returned 1.65%. High-grade spreads tightened by 6bps to around 174bps by the end of the month. High-yield corporate spreads ended the month 38bps tighter.

JP Morgan Asia Credit Index (JACI)

Daily Returns for the period from 1 July 2013 to 30 June 2014



Note: Returns in USD. Past performance is not necessarily indicative of the future performance.
Source: JP Morgan, 30 June 2014

China property bonds remained supported; weak sentiment in Indonesia

Despite signs of slowdown in the Chinese property sector, the Chinese property bonds traded well on growing expectations of some relaxation in home purchase restrictions. With more signs of stabilising economic growth and the Chinese authorities embarking on more targeted easing measures, Chinese credits in other sectors also remained supported during the month. Meanwhile, Indonesian sovereign and quasi-sovereign credits underperformed as jitters about the upcoming presidential election triggered some selling after recent polls indicated a closer contest between the two candidates.

■ *Pace of new issuance picked up in June*

Activity in the primary market picked up in June. During the month, total issuance amounted to around USD 13.8bn, up from around USD 11.4bn in May. There was around USD 12bn of high-grade issuance coming from 23 issues and around USD 1.8bn of high-yield issuance from 6 issues.

Market Outlook

ASIAN CREDIT SPREADS TO SLOWLY GRIND TIGHTER IN THE COMING MONTH

■ *Low interest rate volatility should benefit Asian credit*

The muted volatility in risk-free rates recently engendered by the accommodative policy tone from the ECB and the US Fed should be positive for spread products such as Asian credit. Asian credit spreads are also expected to slowly grind tighter in the coming month as new issuance supply dwindles amidst the summer lull period in an environment of healthy fund inflows. With this backdrop, carry should dominate returns for the coming month barring any severe macro shocks. While Asian credit spreads have reached close to their post-crisis tights at some point in June, it does not seem that the rally is likely to derail anytime soon. Despite our positive view of Asian credit, we remain watchful for a more positive trend in economic data that could portend a more rapid than anticipated change in monetary policy stance which will likely upset the current benign market backdrop.

■ *Indonesian Elections a focal point in July*

A key focal point is the Indonesia presidential elections in early July. The election outcome is likely to have a more immediate impact to the Indonesian sovereign and quasi-sovereign credits with a Jokowi win being the market preferred outcome. The impact to high-yield Indonesian credits is likely to be more muted, at least in the near-term.