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Nikko Asset Management

# From The FIXED INCOME Desk

Monthly Outlook

## August 2014


Koh Liang Choon
Head of Fixed Income
Nikko AM Asia Limited


## Summary


- Improving US economic fundamentals have marginally offset the heightened geopolitical concerns in Russia/Ukraine and Israel/Gaza, leading to the sell-off in risk-free assets in July.

- The US Federal Reserve (Fed) chairperson Janet Yellen has affirmed that the current monetary accommodation remains appropriate during her semi-annual senate testimony. 10-year US Treasury (UST) yields were up by 3 basis points (bps) in July.

- The market saw a growing foreign demand for Asian bonds recently, particularly in Thailand, Indonesia and India.

- In July, Malaysia hiked its overnight policy rate and Philippines raised its reverse repo rate. Elsewhere, the South Korean government has introduced a stimulus plan to bolster its economy.

- China property bonds continued to trade well as some Chinese cities loosened their home purchase restrictions. Elsewhere, Indonesian sovereign and quasi-sovereign credits were bolstered by the positive presidential election results.

- Over the month, Asian high-grade credits returned 0.61% while high-yield credits returned 1.11%. Activity in the primary market picked up strongly in July, with total issuance amounting to around USD 16.8bn.

- We are positive on both Indonesian bonds and currency following the positive presidential election result. Also, we maintained our overweight stance in Malaysia, while being overweight on KRW and neutral on Korean bonds. In addition, while we remained underweight on Philippines bonds, we have now moved to neutral on PHP.

- Asian credits are expected to fare better than credits from other regions as fundamentals in Asia appear to be on firmer footing. Meanwhile, the recent outflows from US high-yield funds and widening high-yield spreads could have a potential knock-on impact on Asian high-yield credit. In addition, we expect the positive sentiment in China to continue and the government to implement more reforms to boost the ailing property sector.

# ASIAN RATES AND FX

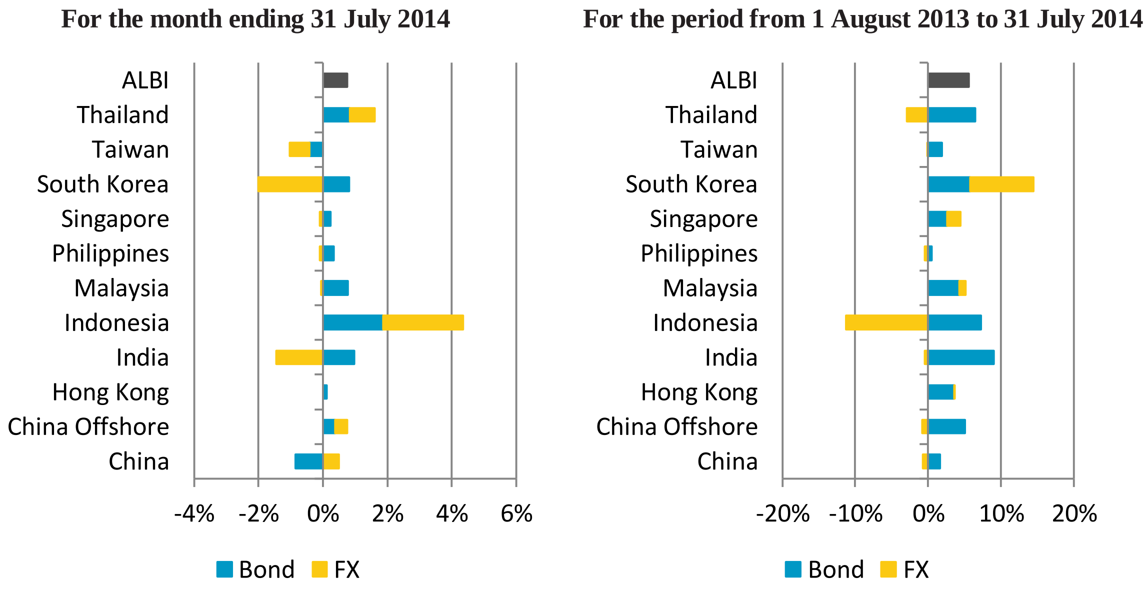
## Market Review

THE US FED CONTINUES TO STIMULATE THE ECONOMY BY KEEPING INTEREST RATES LOW

*UST sold-off on improving fundamentals*

Improved US economic fundamentals had marginally offset the heightened geopolitical concerns in Russia/Ukraine and Israel/Gaza, leading to the sell-off in risk-free assets in July. Although most recent data pointed towards a resumption of the US economic recovery, Fed Chairperson Yellen has maintained a dovish bias during her semi-annual senate testimony in mid-July. Yellen is in the view of seeing a more sustained and broad-based improvement in the labour market conditions before hiking interest rates. Meanwhile, during the July Federal Open Market Committee meeting, the US Fed acknowledged the recent improvements seen in the US economy and labour market as well as the firming inflation. Overall, 10-year UST yields were higher by about 3bps in July.

### HSBC Asian Local Bond Index (ALBI)




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, 31 July 2014

*Growing foreign demand for Asian bonds*

The market saw growing foreign demand for Asian bonds recently, especially in Thailand, Indonesia and India. In particular, Thailand received over USD 4bn bond inflows for the month of July. This was largely on the back of improved political situation in Thailand where most emerging market managers were previously underweight in Thai bonds due to the political tensions since last November. Elsewhere, increased foreign demand for Indonesian bonds was largely due to the positive presidential election euphoria. In India, the increased foreign institutional investors (FII) quota buoyed bond investor sentiment, leading to a deluge of foreign bond inflows into the country.

*Positive sentiments lifted Indonesia bonds and currency*

In Indonesia, market sentiment was boosted by the falling inflation and the presidential election results. With easing inflation, Bank Indonesia opted to keep its key policy rate unchanged at 7.50% and assured to look into ways to improve the current account position. On the political front, the market's favourite Jokowi won the presidential election with 53.15% of the votes. However, his rival candidate Prabowo did not concede defeat and contested the election results legally. The constitutional court will announce the ruling results by 24 August 2014.

### Reserve Bank of India (RBI) increased FII limit

Indian bonds rallied on news of increased FII limit. On 23 July 2014, the RBI announced the raise of sub-limit for FII investments in Indian government bonds by USD 5bn to USD 25bn. Correspondingly, the sub-limit for FII investments available to insurance and pension funds will be reduced to USD 5bn from the previous limit of USD 10bn. Overall, the FII quota in Indian government bonds remained unchanged at USD 30bn. Although lock-in period is not required, the incremental USD 5bn has to be invested in Indian government bonds with a minimum residual maturity of 3 years.

### Malaysia and Philippines hiked policy rates

Bank Negara Malaysia (BNM) delivered the highly anticipated overnight policy rate hike by 25bps to 3.25%, the first rate hike in 3 years. The accompanying policy statement sounded broadly neutral but BNM did not dismiss the likelihood of more monetary policy tightening measures in the future. BNM also maintains its broadly optimistic view on Malaysia's growth momentum and considers the inflationary pressures to remain manageable. That said, June headline inflation was 3.3% year-on-year (YoY), in-line with market expectations. Elsewhere, Bangko sentral ng Pilipinas (BSP) raised its reverse repo rate by 25bps to 3.75%. At the same time, BSP left the Special Deposit Account rate unchanged at 2.25% following a 25bps hike in the previous month. Meanwhile, BSP has increased its inflation forecast for 2014 to 4.4%.

### South Korea unveiled stimulus package

South Korea economy expanded 3.6% YoY in the second quarter which was below market expectation. On a quarter-on-quarter seasonally adjusted annualised basis, 2Q 2014 GDP grew 0.6%, weaker than the 0.9% growth in the previous quarter. The softer growth was largely due to weaker domestic demand following the Sewol ferry tragedy in April. The country's 2014 GDP growth forecast was also reduced to 3.7% from a previous print of 3.9%. To spur economic growth, the government unveiled a stimulus package of an additional KRW 11.7trn in planned fiscal expenditure and additional KRW 31trn in loan programs. Meanwhile, Bank of Korea kept its key policy rates unchanged as per market expectation, despite the non-unanimous decision in which one member opposed to the rate freeze.

## Market Outlook

MALAYSIA'S CENTRAL BANK IS THE FIRST IN SOUTHEAST ASIA TO TIGHTEN POLICY IN 2014

### Positive on Indonesia and Malaysia

We are turning positive on Indonesia following the reform-minded Jokowi's victory in the July presidential election. We expect positive political dynamics to continue post-election, which would bode well for both Indonesian bonds and currency. Meanwhile, we remained overweight in Malaysia on improvements in economic fundamentals and amid the central bank's hawkish tone. With the 25bps rate hike in July, BNM has become the first central bank in ASEAN to raise policy rate this year.

### Overweight Korean won; Neutral on bonds

We continue to remain overweight on Korean won given its stabilising economic fundamentals. On the other hand, we are neutral on Korean bonds due to rich valuations despite growing expectations of rate cut to be delivered in the next monetary meeting.

### Underweight Philippines bonds; Neutral on currency

We continue to remain underweight on Philippines bonds due to lingering concerns over rich valuations and rate hike expectations. However, given growing expectations of rate hike and improving economic fundamentals, we have moved from underweight on PHP to neutral.

ASIAN CREDITS

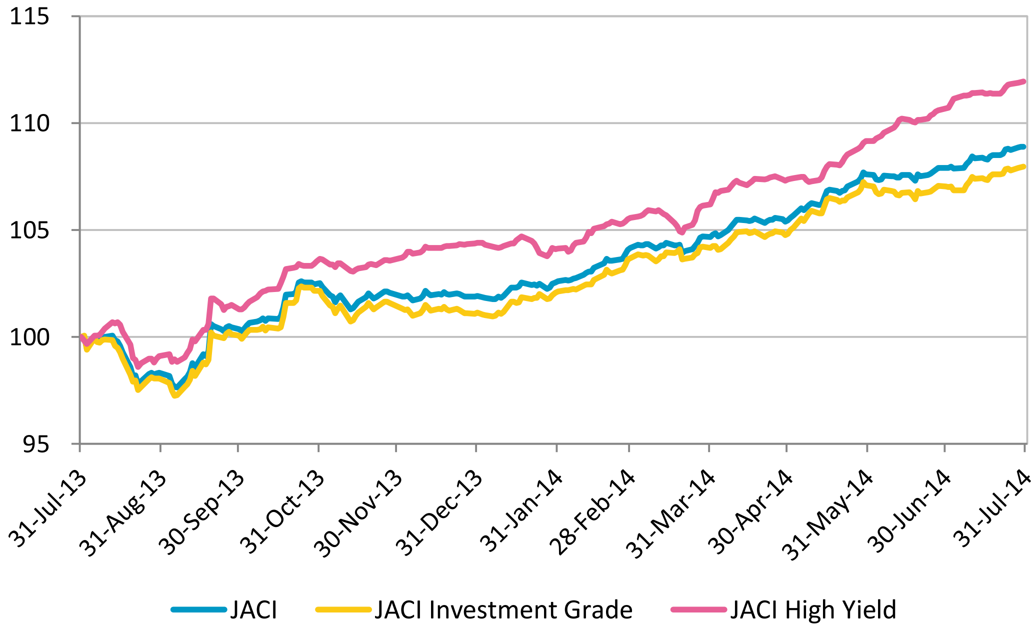
## Market Review

*Asian credits rallied*

In July, Asian credit spreads tightened despite the challenging geopolitical backdrop and a heavy supply of new issues. Improving US economic fundamentals marginally offset heightened geopolitical concerns in Russia/Ukraine and Israel/Gaza, leading to some volatility in risk-free assets during the month. On a total-return basis, Asian high-grade returned 0.61% while high-yield returned 1.11%. High-grade spreads tightened by 5bps to around 169bps by the end of the month.

## JP Morgan Asia Credit Index (JACI)

**Daily Returns for the period from 1 August 2013 to 31 July 2014**




Note: Returns in USD. Past performance is not necessarily indicative of the future performance.
Source: JP Morgan, 31 July 2014

CHINA AVERTED A SECOND DEFAULT IN ITS ONSHORE CORPORATE BOND MARKET

*China property bonds remained supported; post-election rally in Indonesia*

Despite a slowing China property sales growth, China property bonds continued to trade well as 36 out of 46 Chinese cities have loosened home purchase restrictions to spur property sales. Furthermore, the government continued to implement the reform momentum in July. In particular, the key structural reform on urban registration system 'hukou' was announced in July. The hukou reform removes the distinction between urban and rural hukou classification, which would eventually promote urbanisation and boost consumption. In addition, People's Bank of China has provided a 3-year loan of CNY 1trn to the China Development Bank for shanty town redevelopment projects under a new policy scheme called pledged supplementary lending, which is a collateralised loan at medium-term interest rate. At the same time, sentiment on China was lifted following the release of economic data showing modest improvements in China's underlying fundamentals. Meanwhile, the construction company, Huatong Road & Bridge Co, was bailed out from a potential default, thus eliminating a source of potential stress for Chinese credits. Elsewhere, Indonesian sovereign and quasi-sovereign credits were bolstered by Jokowi's victory in the presidential election.

*Deluge of new issuance*

Activity in the primary market picked-up strongly on improved sentiment. In July, total issuance amounted to around USD 16.8bn, up from around USD 13.8bn in June. There was around USD 11.9bn of high-grade issuance coming from 18 issues and around USD 4.9bn of high-yield issuance from 15 issues. The heavy supply of new issues was relatively well-absorbed.

## Market Outlook

ASIAN CREDITS TO FARE BETTER THAN CREDITS FROM OTHER REGIONS

*Geopolitical developments to drive markets in the near-term*

With the increasing number of hotpots, the direction of risk-assets, including Asian credits, will be driven by these geopolitical developments. However, Asian credits should fare better than credits from other regions, such as Eastern Europe, as fundamentals in Asia appear to be on firmer footing. Political risks in Asia have receded with the end of the elections in India and Indonesia. Also, the targeted stimulus measures in China appear to be successful in altering the economic growth trajectory, although bouts of stress are likely to reappear as reforms continue. Technically, Asian credits could also benefit from reallocation from other regions facing greater geopolitical stress premised on continued inflows into emerging market debt funds.

*Outflows from US high-yield bears monitoring*

Recent outflows from US high-yield funds and widening US high-yield spreads could have a potential knock-on impact on Asian high-yield credit. While the sell-off observed is healthy given the significant rally which brought valuations to expensive levels, a sharp and significant widening in US high-yield spreads from sizeable redemption flows could have an impact on Asian high-yield bond prices.

*Expect the Chinese government to implement more reforms to boost the ailing property sector*

In our view, while the execution of the hukou reform will take a couple of years to roll out completely, it bodes well for the overall Chinese economy and is positive for credits. Overall, we expect the positive sentiment in China to continue and the government to implement more reforms to boost the ailing property sector. As such, we have turned to marketweight to slight overweight call on China property sector. Meanwhile, we prefer quality developers with established track record and those that demonstrated prudence with their balance sheets and growth during this challenging period.

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