July 2016

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FROM THE FIXED INCOME DESK

Monthly Outlook

Summary

- US Treasury (UST) yields gained in a volatile month across asset classes. The US Federal Reserve (Fed) scaled back projections for raising interest rates, while the UK voted to leave the EU by a 4% margin, surprising markets. 10-year UST yields eventually ended the month at 1.47%, about 38 basis points (bps) lower compared to end-May levels.

- The Reserve Bank of India (RBI) left interest rates unchanged, maintaining its accommodative stance. Meanwhile, RBI governor Raghuram Rajan announced he would leave the central bank after his three-year term ends in September.

- South Korea cut its benchmark rate to a new record low, citing growing risks to the economy. The central bank and government will jointly create a KRW 11tr recapitalization fund to rehabilitate the country's shipping and shipbuilding sectors.

- Asian credits also rose in June, with high-grade outpacing high-yield. Spreads were similarly volatile: the Brexit result sent high-grade spreads wider before tightening sharply into month-end as continued easy monetary policy globally began to be priced in.

- Bank Indonesia (BI) lowered its benchmark interest rate for the fourth time this year, and announced macro-prudential easing measures that are scheduled to take effect from August. Separately, parliament voted in favor of the tax amnesty bill, buoying sentiment towards Indonesia credits.

- The month saw a significantly lower number of new deals, given the volatility. However, new issuance in the high-yield space picked up.

- We expect the impact of Britain's exit from the EU on Asia's economic activity to be relatively muted, as the region has comparatively low trade links with the UK. We upgrade our views on South Korea, Singapore and Thai bonds to neutral, on their relatively high correlation to USTs compared to other regional bonds. Meanwhile, we downgrade Indian bonds from overweight to neutral.

- Recent data continues to suggest a moderation in the pace of growth in China and the recent depreciation trend of the CNY bears monitoring, as this could rekindle concerns over capital outflows from China.

- While a "lower for longer" monetary policy environment should be positive for credits, and the demand backdrop remains broadly supportive, it does not seem that current valuations fully compensate for the increase in macro uncertainty. Against this backdrop, we favour high-grade over high-yield.

Asian Rates and FX

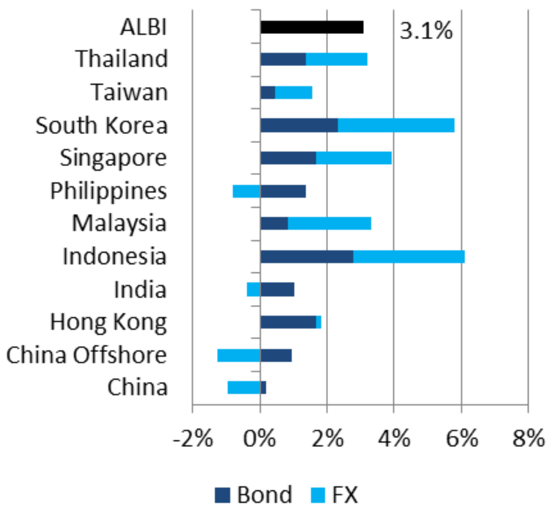
Market Review

- US Treasuries rallied in June

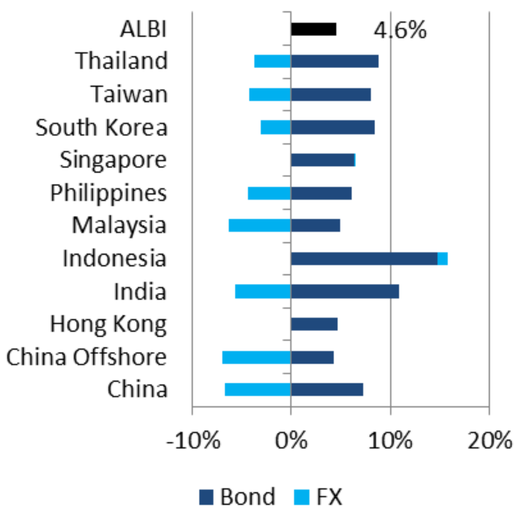
US Treasuries (USTs) registered gains in what was a volatile trading month across asset classes. The initial gradual decline in yields was driven by overall cautiousness in anticipation of the UK referendum. Volatility subsequently picked up after the US Federal Reserve (Fed)'s dovish statement revealed officials scaled back projections for raising interest rates. As UK polls exhibited a resurgence in support for staying in the European Union, yields crept higher as risk assets gained. However, on 24 June, the UK voted to leave the EU by a 4% margin, surprising markets and sending 10-year UST yields to an intra-day low of 1.40% on that day. 10-year yields eventually ended the month at 1.47%, about 38 basis points (bps) lower.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 June 2016



For the year ending 30 June 2016



Note: Bond returns are in local currencies while FX and ALBI returns are in USD. Past performance is not necessarily indicative of future performance. Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 June 2016

- RBI left interest rates unchanged; market awaits announcement of new RBI Governor

The Reserve Bank of India (RBI) left interest rates unchanged. It maintained its accommodative stance, but highlighted that the recent rise in CPI inflation leaves "the future trajectory of inflation somewhat more uncertain". Meanwhile, RBI Governor Raghuram Rajan announced that he will leave the central bank when his three-year term comes to an end in September. The government will reportedly reveal Rajan's successor in July.

- BoK cut interest rates by 25bps; government announced details of bank recapitalisation plans

The South Korean central bank lowered the benchmark interest rate to a new record low of 1.25%. The unanimous decision was prompted by growing risks to the economy, and followed an announcement that the Bank of Korea (BoK) and the South Korean government will jointly create a KRW 11tr recapitalization fund to help policy banks rehabilitate the country's shipping and shipbuilding sectors. To be launched in July 2016, the fund is scheduled to run through the end of 2017.

Market Outlook

- Upgrade South Korea, Singapore and Thai bonds to neutral

We expect the impact of Britain's exit from the EU on Asia's economic activity to be relatively muted, as the latter has comparatively low trade links with the UK. Another Brexit implication is a prolonged period of slow global economic growth, which prompts us to expect the US Federal Reserve to leave interest rates lower for longer, while other monetary authorities may gravitate towards further rate cuts to spur domestic economic growth. Nonetheless, the vote has undeniably highlighted the risk of further disintegration of the EU over the longer term. Consequently, we upgrade our views on South Korean, Singapore and Thai bonds to neutral, on their relatively high correlation to USTs vis-à-vis other regional bonds. Meanwhile, we downgrade Indian bonds from overweight to neutral. Recent elevated inflation readings have lowered the chances of further rate cuts by the RBI. Furthermore, the uncertainty surrounding the next central bank governor is likely to dampen sentiment towards Indian bonds for now.

Asian Credits

Market Review

- Asian credits registered gains in a volatile month

Asian credits ended higher in a volatile trading month across asset classes. US Treasuries (USTs) drove performance of credits, leading high-grade to outperform high-yield in June. Asian high-grade returned 1.83% and Asian high-yield returned 1.5%. Asian high-grade spreads initially widened to 225bps from 208bps but retraced to 213bps before the referendum as a "remain" vote in the UK referendum began to be priced in. The surprise "leave" result subsequently sent spreads wider to 232bps before tightening sharply into month end at 216bps as continued easy monetary policy globally began to be priced in. Asian high-yield spreads were also similarly volatile.

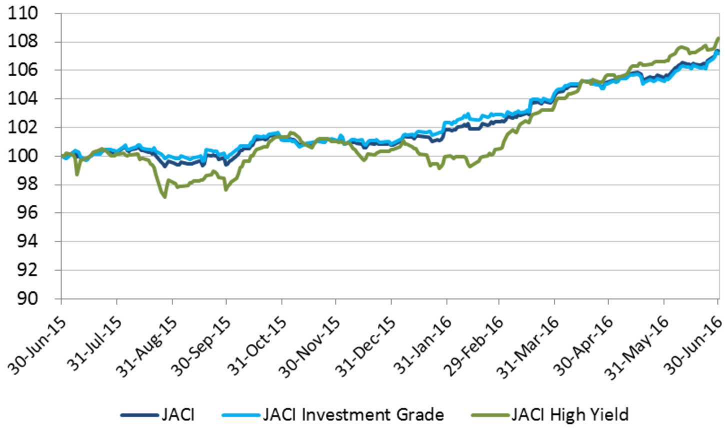
- Indonesian central bank cut rates; parliament approved tax amnesty bill

Bank Indonesia (BI) lowered its benchmark interest rate for the fourth time this year. The central bank also announced macro-prudential easing measures that are scheduled to take effect from August. Among other things, it relaxed the loan-to-value requirements on housing loans, and raised the minimum loan-to-funding ratio to encourage credit growth. Towards the end of the month, the Indonesian parliament voted in favor of the tax amnesty bill. The sentiment towards Indonesia credits was supported by these measures. Notably, Indonesian high-yield property credits rallied on the relaxation of the loan-to-value requirements.

- Slower primary market activity

The month saw a significantly lower number of new deals, given the volatility. However, new issuance in the high-yield space picked up. There were a total of only nine new issues – amounting to USD 4.95bn - in the high-grade space, while the high-yield space saw eight new issues amounting to USD 2.48bn.

JP Morgan Asia Credit Index (JACI)



Daily returns for the period from 30 June 2015 to 30 June 2016
Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 31 May 2016

Market Outlook

- Macro risks increasingly elevated

On Brexit, the direct exposure to UK/EU for most Asian issuers is limited with only a small handful of names which could be impacted. Even so, any fundamental impact is unlikely to be immediate. However, the impact to Asian credit is likely to be mainly indirect, from potentially weaker global growth and heightened political uncertainty from Europe over the medium-term. In Asia, recent data continues to suggest a moderation in the pace of growth in China and the recent depreciation trend of the CNY bears monitoring, as this could rekindle concerns over capital outflows from China. Over the medium-term horizon, macro risk has become elevated.

- Technicals broadly still supportive, but valuations less so

A "lower for longer" monetary policy environment should be supportive of credits. The demand backdrop for Asian credit remains broadly supportive. However, given the sharp tightening seen in credit spreads post the referendum results, it does not seem that current valuations fully compensate for the increase in macro uncertainty. We favour high-grade over high-yield given macro uncertainties from BREXIT on top of an already weakening growth backdrop in Asia.

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