By Koh Liang Choon,
Head of Fixed Income

nikko am
Nikko Asset Management

ASIAN FIXED INCOME OUTLOOK

January 2018

Summary

- As widely expected, the US Federal Reserve (Fed) raised interest rates by 25bps in December, its third rate hike this year. It also raised its GDP forecast for 2018. Overall, 10-year US Treasury (UST) yields ended the month close to end-November levels, while 2-year UST yields gained.

- Asian credits gained in December as spreads edged tighter. Sentiment was boosted by the lower supply compared to November, as well as a number of sovereign rating upgrades.

- The Thai central bank raised its growth forecast for 2017 and 2018 on the back of continued improvements in merchandise exports and tourism that were driven by a stronger global economic recovery. Meanwhile, South Korea approved an expansionary budget for 2018.

- The People's Bank of China raised the rates it charges commercial banks on seven-day and 28-day loans by 5bps each. In the meantime, Chinese regulators continued their campaign to reduce financial institutions' overall leverage and control risks in the financial system. Elsewhere, Fitch upgraded the sovereign credit ratings of Indonesia and the Philippines.

- The primary market continued to be active, with 25 new issues amounting to USD 13.3bn in the high-grade space. Meanwhile, the high-yield space saw 19 new issues amounting to around USD 6.3bn.

- We continue to believe that Indonesia bonds will provide attractive returns relative to regional peers. Demand is likely to be buoyed by potential index inclusion in widely tracked global indices, manageable inflationary pressures and accommodative monetary policy. On the currency front, we are positive on the Malaysian Ringgit, while maintaining our cautious view on the Philippine Peso.

- The backdrop for Asian economic and corporate credit fundamentals is expected to remain constructive heading into 2018. However, we expect more subdued Asian credit returns compared to 2017, taking into account a continuation of less accommodative US monetary policy.

- For Asian high-grade credits, bond carry will again dominate returns as the expected rise in UST yields will negatively impact total returns. Asian high-yield corporates should outperform high-grade due to their shorter duration and higher carry.

Asian Rates and FX

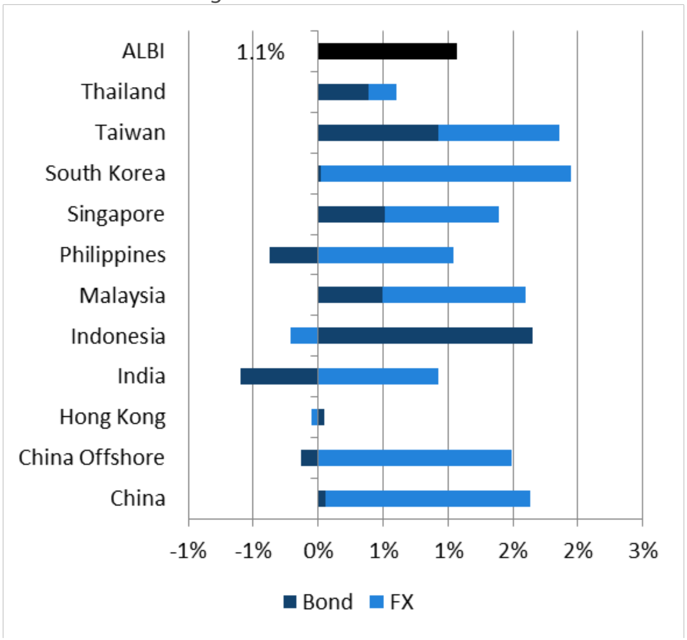
Market Review

- US Federal Reserve (Fed) raised interest rates by 25 basis points (bps) as expected

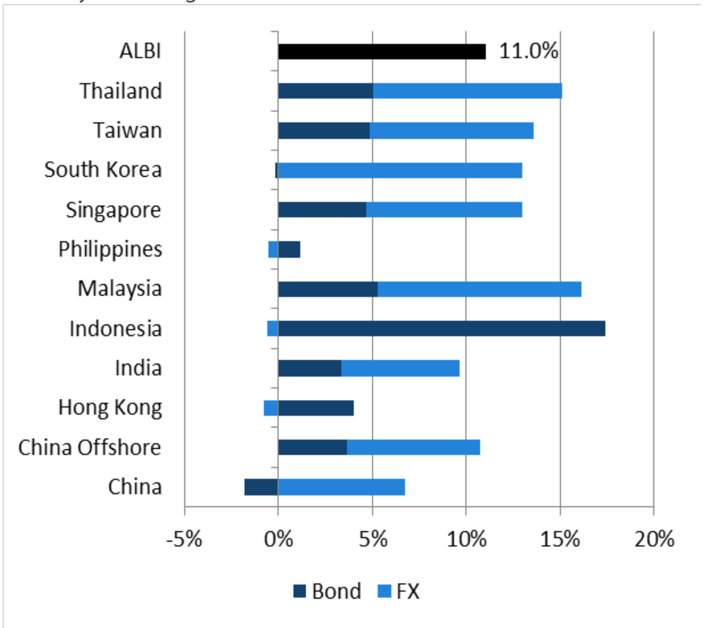
As widely expected, the Fed raised interest rates by 25bps in December, its third rate hike this year. The median dots in the Summary of Economic Projections remained at three rate hikes for 2018 and just over two in 2019, but the 2020 projection edged higher by nearly 1 hike. The GDP forecast for 2018 was upgraded from 2.1% to 2.5% and the unemployment rate to 3.9% from 4.1%. According to Fed Chairwoman Yellen, the Federal Open Market Committee (FOMC) generally identified changes in tax policy as a factor supporting this modestly stronger outlook, although many noted that much uncertainty remains about the macroeconomic effects of the specific measures that may ultimately be implemented. Overall, 10-year US Treasury (UST) yields ended the month close to end-November levels at around 2.41% with the yield curve continuing to flatten. 2-year UST yields ended the month 10bps higher at 1.88%.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 31 December 2017



For the year ending 31 December 2017



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 31 December 2017

Note: Bond returns refer to ALBI indices quoted in local currencies while FX refers to local currency movement against USD. Returns are based on historical prices. Past performance is not necessarily indicative of future performance.

- **Bank of Thailand raised growth forecast to 3.9%**

The Bank of Thailand unanimously voted during the December Monetary Policy Committee (MPC) meeting to keep its policy rate unchanged at 1.50%. According to the central bank, the Thai economy as a whole was projected to achieve higher growth than previously assessed on account of continued improvements in merchandise exports and tourism that were driven by a stronger global economic recovery. Subsequently, the GDP forecasts for both 2017 and 2018 were upgraded to 3.9% from 3.8%.

- **South Korean policymakers approved an expansionary 2018 budget**

South Korea's National Assembly approved an overall fiscal deficit of 1.6% of GDP (KRW 28.5tr) for the Fiscal Year (FY) 2018, from a 1.7% deficit in FY2017. Fiscal spending is projected to increase by 4.6%, which will be offset by a 5.7% expected rise in revenues. Notably, policymakers raised the allocation to economic projects by 0.4% to 17.4%, reducing the allotment towards social welfare to 33.7% (from 34.1% in the initial proposal). Meanwhile, the statutory maximum corporate tax rate was raised to 25% (from 22%), while the maximum personal income tax rate was increased by 2% to 42%.

- **Philippine lawmakers passed tax reform bill**

Lawmakers in the Philippines approved a tax reform measure that is expected to yield around PHP 130bn in net revenue during its first year of implementation. The bill is one of the five tax packages Philippine president Rodrigo Duterte is pushing, in a bid to increase state revenues to help fund his massive "Build, Build, Build" infrastructure programme. Among other things, the bill expands the value added tax base, raises taxes on petroleum products, automobiles and sugar-sweetened beverages, while lowering personal income taxes.

Market Outlook

- **Positive on Indonesia bonds**

We continue to believe that Indonesia bonds will provide attractive returns relative to regional peers. Demand will get a boost from potential index inclusion in widely tracked global indices. Inflationary pressures are likely to remain fairly anchored, supported largely by the government's effort to improve food supply management across the country. We expect monetary policy to remain accommodative as policymakers continue to focus on fueling domestic growth ahead of provincial elections next year. Political noise may rise towards the second half of 2018, although we think this will be fleeting as opinion polls continue to suggest support for President Jokowi.

- **Prefer Malaysian Ringgit over the Philippine Peso**

Going into 2018, our preference for the Malaysian Ringgit over the Philippine Peso remains. Robust growth in Malaysia and a hawkish Bank Negara support our positive view on the MYR. Sustained higher oil prices will further lift Malaysia's fiscal and current account balances, providing another tailwind for the currency. In contrast, we anticipate the Philippine Peso to continue to weaken in 2018, as concerns surrounding the country's deteriorating current account balance re-emerge due to the infrastructure build-out.

Asian Credits

Market Review

- Asian credits ended 2017 on a firm note

Asian credits registered gains in December. Asian high-grade returned 0.13% and Asian high-yield corporates returned 0.28% as high-grade and high-yield spreads edged tighter over the month. While the supply of new issues remained robust, the lower amount of supply compared to November was supportive of technicals. Sentiment was also buoyed by a number of sovereign upgrades in November and December. The Fed's rate hike caused front-end US Treasury (UST) yields to shift higher. The passage of the "Tax Cuts and Jobs Act" also caused longer-dated UST yields to shift higher before retracing towards the end of the month. For 2017, Asian credits delivered a strong performance despite a record supply of new issuance. Asian high-grade and high-yield corporates returned 5.46% and 6.15% respectively in 2017.

- People's Bank of China (PBoC) raised borrowing costs; policymakers issued new rules to enhance liquidity risk management in banks

The PBoC raised the rates it charges commercial banks on seven-day and 28-day loans by 5bps each. The move came just hours after the Fed raised the Fed Funds rate by 25bps. The Chinese central bank also raised rates for a medium-term liquidity instrument, but left the benchmark policy rates unchanged. Meanwhile, regulators continued the campaign to reduce financial institutions' overall leverage and control risks in the financial system, with the China Banking Regulatory Commission (CBRC) publishing draft revisions of liquidity risk regulations for lenders. According to the CBRC, the aim of the new regulations is to "strengthen the liquidity risk management at banks and ensure the safe, stable and sound operation of the banking system." It said that the final version of the rules will be effective 1 March 2018.

- Fitch upgraded the sovereign ratings of the Philippines and Indonesia

Fitch raised the Philippines' sovereign rating to 'BBB' with a 'stable' outlook. According to the credit rating agency, "strong and consistent macroeconomic performance has continued, underpinned by sound policies that are supporting high and sustainable growth rates." It added that "investor sentiment has also remained strong, which is evident from solid domestic demand and inflows of foreign direct investment." The agency also sounded positive on the country's fiscal outlook, citing the government's tax reform initiative. Fitch expects the fiscal deficit to remain under 3% of GDP for both 2018 and 2019. On monetary policy, it noted that the appointment of Bangko Sentral ng Pilipinas Governor Nestor Espenilla provides continuity and supports monetary policy credibility.

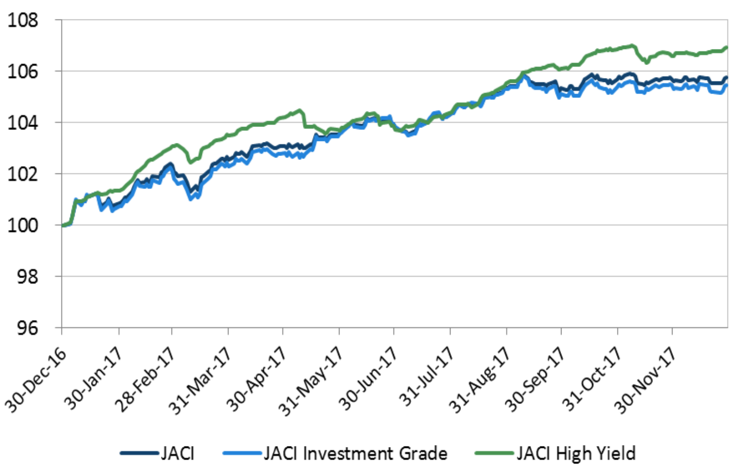
The ratings agency also raised Indonesia's sovereign credit rating from 'BBB-' to 'BBB', with a stable outlook. Fitch highlighted two key drivers that support the decision. First, Indonesia's resilience to external shocks has strengthened as macroeconomic policy has consistently been geared towards maintaining stability. A more flexible exchange-rate policy has helped the country build a buffer of foreign exchange (FX) reserves. Second, the government's concerted structural reform drive is improving the business environment as reflected in a sharp improvement in Indonesia's position in the World Bank's Ease of Doing Business ranking. The reforms also seem to be contributing to a strengthening of the external finances, as foreign direct investment (FDI) has picked up to such an extent that Fitch expects net FDI to cover the current account deficit over the next few years.

- Active primary market into year-end

The primary market continued to be active, with new supply mainly from Chinese issuers. For the month, there were 25 new issues amounting to USD 13.3bn in the high-grade space. Meanwhile, the high-yield space saw 19 new issues amounting to around USD 6.3bn. For the full year, gross supply reached a record of around USD 300bn.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 December 2016



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 31 December 2017

Market Outlook

- Asian economic and corporate credit fundamentals supportive but valuations appear expensive

As the backdrop for Asian economic and corporate credit fundamentals is expected to remain constructive heading into 2018, an extended credit cycle with credit spreads well supported could continue for some time. However, tight spread valuation and more neutral demand-supply dynamics could hinder significant spread tightening from current levels. Compared to 2017, we expect more subdued Asian credit returns in 2018, taking into account a continuation of less accommodative US monetary policy. For Asian high-grade credits, bond carry will again dominate returns as the expected rise in UST yields will negatively impact total returns. Asian high-yield corporates should outperform high-grade due to their shorter duration and higher carry, with risk-free rates expected to continue rising.

- Supply to pick up in January; expectation of higher risk-free rates to entice issuance

Primary activity is likely to restart in January with heavy supply expected into Chinese New Year in February. Current spread levels and expectation for risk-free rates to trend higher is likely to entice issuers. With the flatter yield curve, the preference could lean towards longer-dated issuances.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.