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Nikko Asset Management

ASIAN FIXED INCOME OUTLOOK

May 2018

Summary

- US Treasuries (USTs) experienced a sharp sell-off in April as yields rose about 10 to 24 basis points (bps) across the curve. Trade war fears between US and China receded, with Chinese President Xi Jinping's commitment to further open up the economy to foreign businesses. Firm inflation readings, rising oil prices and growing government debt pushed UST yields higher.

- Overall, 2-year yields ended at 2.49%, about 22bps higher, while 10-year yields, which broke above 3% towards month-end before pulling back, ended at 2.95%, about 21bps higher compared to end-March.

- As for Asian credits, it was another month of negative returns, prompted mainly by the sharp rise in UST yields. Asian high-grade returned -0.63%, with spreads tightening about 2bps. High-yield corporates underperformed, returning -0.89%, as high-yield corporates saw a marked pick-up in primary market supply which in turn caused spreads to widen about 12bps.

- In April, market news was also focused on the two Koreas, where both leaders agreed to pursue a peace agreement. Elsewhere, the Monetary Authority of Singapore (MAS) increased the FX policy slope. Moody's upgraded Indonesia's credit rating while Standard & Poor's upgraded its outlook on the Philippines.

- Chinese real GDP growth registered 6.8% year-on-year (YoY) in the first quarter of 2018, matching the previous quarter's rate. China also cut banks' reserve requirement ratio (RRR) by one percentage point.

- Meanwhile, activity in the primary market stayed robust especially in the high-yield space. There were 27 new issues amounting to USD 16.9bn within high-grade, and 27 new issues amounting to USD 11.6bn within high-yield.

- We are positive on Indonesian and Chinese bonds. Manageable inflation and inclusion of bonds into the global index are positive factors for Indonesia, while China's focus on growth over deleveraging suggests that more targeted easing could be forthcoming.

- On the currency front, we prefer the Renminbi (RMB) and the Thai Baht (THB), and have also moved to a more neutral (from negative) view on the Philippine Peso (PHP), on expectations that the Philippine central bank will hike domestic interest rates soon.

- For Asian credits, this space continues to be pressured by a number of risk factors, which include the sharp rise in UST yields, the risk of an escalation in trade tensions, and the US Federal Reserve (Fed) on a tightening path. Technicals has also been eroded by the heavy pipeline of new issues, which is likely to continue into May, especially for high-yield issuance from China.

Asian Rates and FX

Market Review

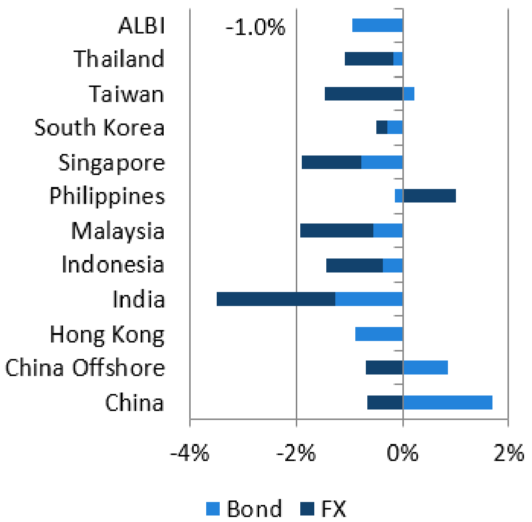
The UST yield curve shifted higher in April

USTs experienced a sharp sell-off in April, as yields rose about 10 to 24bps across the curve. Major tariff threat announcements between US and China at the start of the month overshadowed a relatively weak March US employment report. Fears of a trade war subsequently receded with Chinese President Xi Jinping's commitment at the Boao Forum to further open up the economy to foreign businesses, allowing markets to re-focus on macro data. Subsequent firm inflation readings, combined with rising oil prices, triggered concerns the Fed could accelerate monetary policy tightening, pushing UST yields higher. The leg-up in yields was further supported by concerns on growing government debt. Overall, 2-year yields ended at 2.49%, about 22bps higher, while 10-year yields, which broke above 3%

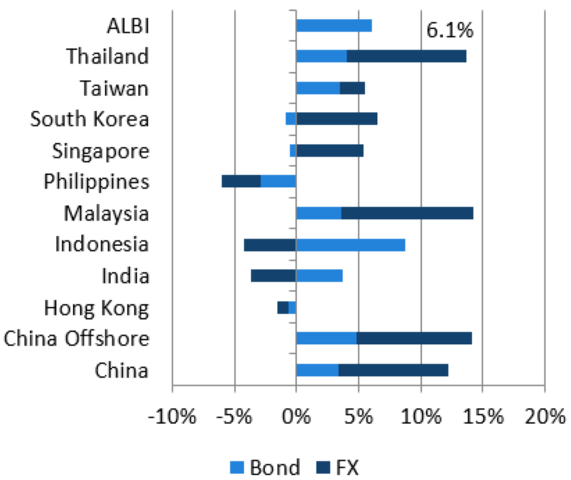
towards month-end before pulling back, ended at 2.95%, about 21bps higher compared to end-March.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 30 April 2018



For the year ending 30 April 2018



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 30 April 2018

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.

Two Koreas agreed to pursue peace agreement

Towards the end of the month, the leaders of North and South Korea held a historic summit, and agreed to pursue signing a peace treaty that would formally declare a resolution to the seven-decade war between the countries. In addition, the statement following the meeting said that the two sides "confirmed the common goal of realising, through complete denuclearisation, a nuclear-free Korean Peninsula." Military talks seeking for a "phased disarmament" has been scheduled in May.

China GDP growth registered 6.8% in the first quarter; China cut banks' RRR

Chinese real GDP growth in the first quarter came in at 6.8% YoY, matching the previous quarter's rate. Economic activity was supported by strong exports in the first two months of the year, and resilient domestic consumption and factory output. Towards the end of the month, Xinhua News reported that China will strive hard to achieve this year's economic targets, citing a politburo meeting chaired by President Xi Jinping. The country's top-decision making body added that domestic demand will be boosted to ensure the stability of the economy, and that supply-side structural reforms and overcapacity cuts will be deepened. Meanwhile, the People's Bank of China (PBoC) cut the amount of cash that most banks are required to hold in reserve by one percentage point. The cut became effective 25 April and applied to most banks, with the exception of policy lenders. According to the PBoC, it will require financial institutions to use the extra freed-up funds (about RMB 400bn after accounting for RMB 900bn MLF repayments) to lend to small and micro companies, adding that this will be an added requirement in its macro-prudential assessment for banks.

MAS increased the FX policy slope

The MAS announced that it would increase the slope of the SGDNEER policy band "slightly", and will keep the width of the policy band and the level at which it is centred, unchanged. The statement that accompanied the decision sounded largely positive, with the monetary authority noting the broadening of growth in the local economy. In addition, it shared that it now sees core and headline inflation rising gradually into the "upper half" of its forecast ranges. Nonetheless, MAS did highlight that an escalation of global trade tensions is a source of downside risk.

Moody's upgraded Indonesia's credit rating; Standard & Poor's upgraded its outlook on the Philippines

Indonesia won a credit rating upgrade from Moody's in April. The rating agency cited a credible policy framework and prudent fiscal and monetary stance as reasons for the move, and noted the improvement in the sovereign's resilience and capacity to respond to shocks. The impact of the upgrade on Indonesian government bonds was muted. Meanwhile, Standard & Poor's raised its outlook on the Philippines' credit rating from 'stable' to 'positive', citing "policy-making settings could support a track record of more sustainable public finances and balanced growth over the next 24 months." The move signals that an upgrade to the country's current 'BBB' rating could happen within the next 2 years.

Market Outlook

Positive on Indonesia and Chinese bonds

The recent re-pricing of Asia bonds have made Indonesian bonds attractive to us as real yields have expanded. We continue to expect inflation to remain within the Bank Indonesia's target range. Upcoming elections are likely to prompt the government to keep inflation in check. Meanwhile, passive flows into the space should increase as we get close to inclusion of Indonesian bonds to the Bloomberg Barclays Global

Aggregate Index in June. Meanwhile, Chinese policymakers' recent rhetoric which focused on growth over deleveraging suggests that more targeted easing could be forthcoming. This, together with our expected moderation in growth, should be supportive of demand for bonds.

Prefer RMB and THB

Thailand's income terms of trade continues to be boosted by rising tourism income, supporting our positive view on the THB. Meanwhile, Chinese policymakers have said that further opening up of the financial sector may be realised as early as end-June. Continued reforms are likely to be supportive of the RMB. Moreover, increased demand for the currency is anticipated as Chinese shares get added to the MSCI equity benchmarks on 1 June. We move to a more neutral (from negative) view on the PHP, on expectations that the Bangko Sentral ng Pilipinas will hike domestic interest rates soon.

Asian Credits

Market Review

A sell-off in Asian credits

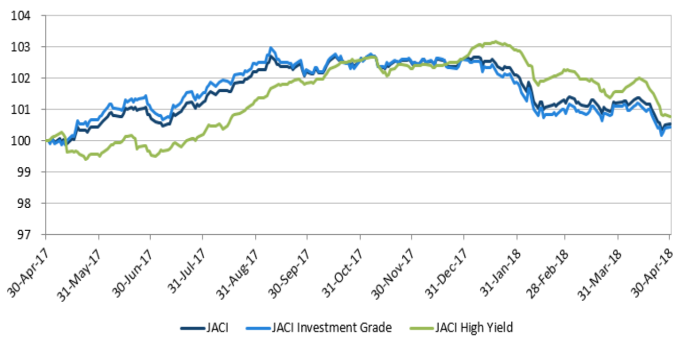
Asian credits registered another month of negative returns in April, prompted mainly by a sharp rise in UST yields. Asian high-grade returned -0.63%, with spreads tightening about 2 bps. High-yield corporates underperformed, returning -0.89%, as high-yield corporates saw a marked pick-up in primary market supply which in turn caused spreads to widen about 12bps. The sharp rise in UST yields accompanied by weakening local currencies, accentuated the sell-off in Emerging Market (EM) bonds including issues from Indonesian and Philippines.

A further pick-up in primary market activity

Activity in the primary market stayed robust especially in the high-yield space. There were 27 new issues amounting to USD 16.9bn within high-grade, including a USD 1bn sovereign issue from Indonesia. Meanwhile, the high-yield space saw 27 new issues amounting to around USD 11.6bn, including the USD 2.5bn sovereign issue from Sri Lanka.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 30 April 2017



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 30 April 2018

Market Outlook

Increasingly number of risk factors with new issuance activity a headwind

Asian credit continues to be confronted by a number of headwinds. The sharp rise in UST yields, the risk of an escalation in trade tensions between China and the US, and the US Fed on the tightening path, are headwinds for credit. Sentiment is also dampened by weakening local currency and bonds in recent weeks. Without some stability in UST yields and the sharp upswing in USD abating, spreads of EM hard currency bonds is unlikely to rally. Technicals is also eroded by the heavy pipeline of new issues. The heavy pipeline of primary activity seen in April is likely to continue into May, especially for high-yield issuance from China. This should continue to dampen secondary activity and spreads in the near-term.

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