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By The Asian Fixed Income Team

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2018 ASIAN RATES AND FX OUTLOOK

Summary

- The global recovery is expected to continue, albeit at a more moderate pace. Meanwhile, we foresee policy normalisation and an acceleration of inflation in Asia. Political action will move to South Asia in the wake of upcoming elections there.

- We believe that Indonesia and China bonds will provide attractive returns relative to peers. Other Asian government bond yield curves are likely to experience higher steepening bias. Demand for Indonesia and China bonds will get a boost from potential index inclusion in global indices while valuations in China are attractive given the big sell-off this year. Meanwhile, we expect inflationary pressures in Indonesia to be contained and monetary policy to remain accommodative.

- We take a neutral view on the US Dollar (USD), as we see a more balanced picture in terms of demand. Overall, we expect Asia FX to outperform the USD, barring a surprise jump in US inflation, further Federal Reserve (Fed) rate hikes or possible fiscal policy reform. We prefer Malaysian Ringgit (MYR), South Korean Won (KRW), Singapore Dollar (SGD), Thai Baht (THB) and Chinese Yuan (CNY) over the Philippine Peso (PHP), Indian Rupee (INR) and Indonesian Rupiah (IDR).

2017 Market Review

2017 was an encouraging year for growth. While political developments drove market direction for the large part, supportive macroeconomic conditions and benign inflation buoyed investor sentiment. Asia's growth accelerated across much of the region and at a faster pace than the developed economies. This put their inflation rate at slightly higher than in the developed economies, albeit still largely contained.

Overall, Asian local government bonds recorded positive returns, with the Markit iBoxx Asian Local Currency Bond Index (ALBI) registering gains of 9.86%[1] in USD unhedged terms. On a total return basis, Indonesia, Malaysia and Thailand outperformed regional peers while the Philippines underperformed.

Meanwhile, Markit iBoxx ALBI China Onshore underperformed in local currency terms, returning -1.83%[1]. However, Chinese bonds were still positive in USD terms, returning 3.66%[1] on the back of the appreciation of CNY this year.

Asian Fixed Income

Key views

- Global economic recovery to continue

The current US business cycle has entered its ninth year, making it one of the longest ever. Going forward, the key determinant of the strength of US growth would be the pace of progress on fiscal policy, which at this point remains fluid. Congressional elections are due in November 2018, and the possibility of an eventual Democrat-led legislative branch and Republican-led executive branch of government could pose a challenge. The uncertainty in fiscal policy and certain political jockeying in this scenario may weaken corporate and consumer activities as regulatory, healthcare and tax policies remain ambiguous. However, offsetting this politically influenced uncertainty is the expectation that the cyclical global recovery seen in 2017 would continue, albeit at a milder pace as the growth cycle nears maturity.

In Asia, a stronger-than-expected trade recovery has been a pillar of faster GDP growth in 2017. For 2018, the region looks poised for another year of growth. The export growth momentum is likely to taper next year, and the growth cycle should broaden to include recovery in domestic demand as increased employment opportunities support consumption. China will remain a key point of interest in 2018, as policymakers balance near-term growth with the pace of reform.

- Monetary policy tightening not expected to be aggressive

In the US, markets largely expect a Powell-led Fed to indicate continuation of the current monetary policy. As such we expect to see at least two Fed rate hikes in 2018, even if progress on the central bank's inflation mandate remains frustratingly slow. Nonetheless, we anticipate that unwinding of quantitative easing is likely to continue in a very gradual manner, to avoid policy mistakes. We see short-end US Treasury yields rising as the Fed raises its policy rate further. Long-end yields are likely to gradually increase as the year progresses, as mounting signs of higher inflation expectations get priced in. ECB tapering may also induce the UST yield curve to steepen at around mid-year.

In Asia, Bank of Korea is the first central bank in the region to start policy rate normalisation. Further actions are likely to be data dependent, and we expect the monetary authority to wait at least a few more months before hiking rates further. Similarly, we look for rate hikes in the Philippines and Malaysia, and a return to an upward sloping SGDNEER band for

[1] As of 30 November 2017

Singapore. Overall, we think this is unlikely to be an aggressive rate hike cycle, as we believe inflation prints will remain largely benign.

Elsewhere in China, the People's Bank of China's (PBoC) Govenor Zhou Xiaochuan is due for retirement, following 15 years in the position. There is currently no heir-apparent to Mr. Zhou, but the new PBoC governor will undeniably be more powerful. Markets are largely expecting the central bank to be elevated to run the office of the newly created super-regulator Financial Stability and Development Committee (FSDC) which oversees the functions of the PBoC, CBRC and CSRC.

- Inflation pickup expected but not a major concern

An unexpected swifter pick-up in inflation is a key risk as it could prompt markets to re-think the Fed's rate hike trajectory and in turn, push global rates higher. We expect the trade-off between unemployment and inflation, known as the Phillips curve, to finally show signs of life in 2018 as the US economy moves deeper into full employement. Low and middle wage industries are already exhibiting signs of higher wage inflation, and we expect this momentum to continue and to spread to other economic sectors. Moreover, we expect higher commodity prices being sustained, triggered in part by extension of OPEC's commitment to stem oil supply.

In Asia, inflation will accelerate in 2018, but we do not foresee it being a major source of concern. Demand-side inflationary pressures in South Korea are unlikely to rise considerably given tightening in the housing sector. In Indonesia, headline CPI is likely to remain fairly anchored, supported in large part by the government's effort to improve food supply management across the country. The Singapore government has suggested that an upward adjustment in taxes is possible, which we foresee could lead to higher inflationary expectations in the country. Meanwhile, the upside risks to inflation in the Philippines is high, prompted by strong domestic demand and credit growth.

- Politics in South Asia to take centre stage

Meanwhile, it is difficult to anticipate the extent geopolitical risk would factor into markets in 2018. The political conflict in the Middle East, the North Korea nuclear issue, and political uncertainty in key Eurozone countries remains in the background, and an escalation would likely place downward pressure on yields.

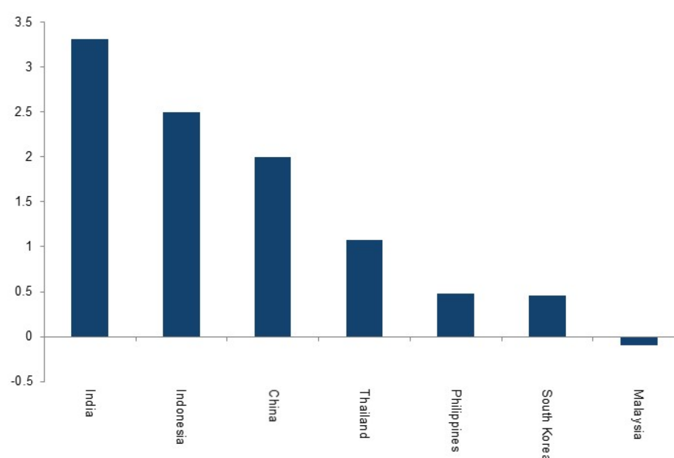
In 2018 and 2019, political action will move to South Asia. Malaysia and Thailand are expected to hold legislative elections in 2018, and India, Indonesia and Philippines are scheduled to hold national elections the year after. Although we do expect increased fiscal support ahead of these elections, the quantums are likely to be minimal, and we expect no dramatic widening in their fiscal deficits. Our base case is that markets are unlikely to price-in higher political risk premia heading towards these events as current governments continue to enjoy relatively high approval ratings. Meanwhile, China's politics should remain in focus until next March when the composition of the politburo would be further reshuffled and changes made to the top posts at the various government agencies, notably the central bank.

2018 Asian Fixed Income Outlook

- More favourable on Indonesia and China bonds

2018 is likely to be a bumpy year for Asian local government bonds, on the combination of higher inflation and monetary policy normalisation in US, Europe and Asia. Asian government bond yield curves are likely to experience higher steepening bias. Nonetheless, we believe that Indonesia and China bonds will provide attractive returns vis-à-vis regional peers. Demand for both spaces will get a boost from potential index inclusion in widely tracked global indices. The big sell-off in Chinese bonds so far in 2017 has left valuations very attractive. Although market confidence remains weak due to deleveraging, we believe that the worst could be behind us. Meanwhile, inflationary pressures in Indonesia are likely to remain fairly anchored, and we expect monetary policy to remain accommodative.

Chart 2: Asian Real Rates (%) - 5-Year yields vs. CPI



Source: Bloomberg, as of 30 November 2017.

- Asia FX expected to outperform the USD

For 2018, we take a neutral view on the USD, as we see a more balanced picture in terms of demand. The main risk to this view is an unexpected swifter pick-up in inflation. Other factors that would support USD strength include further Fed rate hikes and expectations of fiscal policy reform.

We expect overall Asia FX to outperform USD, barring a surprise jump in US inflation. We prefer MYR, KRW, SGD, THB and CNY over PHP, INR, and IDR. Malaysia is expected to be supported by robust growth, a hawkish Bank Negara and sustained higher oil prices. Improving bilateral relations with China could boost South Korea's current account surplus while the central bank's policy rate normalisation should sustain demand for the KRW. We do highlight, however, that the North Korea risk remains in the background. We see the MAS shifting to a stronger currency policy, while China's strong current account surplus and the incremental demand expected from the potential inclusion of Chinese rates into global bond indices should bode well for the RMB. In contrast, we anticipate the PHP to weaken anew in 2018 on a further deteriorating current account. Meanwhile, we hold a neutral view on the INR, but believe that there is risk of the currency weakening if higher oil prices are sustained.

Individual Country Outlooks

China

Going into 2018, we hold the view that the main challenge confronting China would be balancing near-term growth with the pace of reform. Deleveraging efforts will continue, although we expect more subdued market reaction to the announcement of new measures compared to 2017. Among other factors, the targeted RRR cut announced by the PBoC in September 2017 will provide an extra liquidty cushion to the market. We expect the economy to moderately decelerate in 2018, and believe that this has, by now, been largely priced in by markets. President Xi Jinping has, at the Party Congress, reinforced his preference for growth that is of higher quality and sustainable. The Central Economic Work Conference will be held before 2017 ends, and will be closely watched as policymakers reveal signs of the likely policy stance in the year ahead.

We are more positive on Chinese bonds. The big sell-off seen in 2017 has left valuations of Chinese bonds very attractive. Although market sentiment remains weak, we believe that the worst is probably behind us. Bond technicals are also likely to turn positive in 2018, as onshore bonds may be included into the global bond benchmarks (as well as for EM bond benchmarks), and this could lead to positive flows for the onshore bond markets, particularly for China government bonds. The government continues to support the internationalisation of the CNY and have expedited licensing process for global investors to enter the market, supporting our positive view on the CNY.

One of the key events for China's financial markets in 2018 is the appointment of the PBoC governor. The People's Bank of China Govenor Zhou Xiaochuan has hinted he is retiring soon, following 15 years in the position. There is currently no heir-apparent to Mr. Zhou, and markets are definitely eager to find out who will take the reins, as the new PBoC governor will undeniably be more powerful, with the central bank being largely expected to be elevated to run the office for the newly set up Financial Stability and Development Committee (FSDC). A new FSDC head is also likely to be named as the current head, Ma Kai, the vice premier in charge of economy, is due for retirement in March.

Korea

The South Korean economy will likely see slower growth in 2018. Specifically, business investment growth is expected to moderate significantly, considering that major capex projects, especially in the semiconductor sector, have been completed this year. Moreover, we anticipate a slowdown in the housing market as the government continues to roll-out measures tightening the housing sector and mortgage loans. Offsetting these would be a modest improvement in consumption as the government seeks to increase minimum wages and social spending, and an anticipated boost in inbound tourism following the political 'reconciliation' with China.

Bank of Korea hiked its benchmark interest rate by 25bps in November, being the first central bank to initiate monetary policy normalisation in the region. The commitment to an accommodative stance did not come as a surprise in view of the absence of demand-led inflationary pressures. Having said that, we believe that the rate hike is unlikely to be one-off, reinforcing our bearish stance for Korea bonds and a steeper curve bias. However, we do expect the central bank to wait at least a few months before delivering another rate hike. Going forward, inflation will remain subdued, as demand-side inflationary pressures are not likely to show a considerable rise given the tightening in the housing sector.

The Korean Won is likely to outperform regional currencies, given that the BoK is likely to tighten further. However, we do note that geopolitics on the Korean Peninsula is a fat tail risk that warrants close monitoring. While tensions have lately somewhat abated, the situation has not been resolved. Absent an obvious peaceful solution, a spike in tensions can readily happen, which will in turn dampen sentiment towards the Korean Won. That said, we maintain the view that an all-out military confrontation is very unlikely.

India

In 2017, the government announced an expansion of plans to recapitalise its public-sector banks over the next two years, and committed to announce additional banking reforms over the next quarter. Public sector banks will receive about USD 32bn in funds, which the government hopes will loosen credit conditions, and boost investment and growth. This recapitalisation plan should have positive implicatons for growth in the medium-term, although near-term effects are unclear given that the specifics of the bonds have yet to be disclosed. Meanwhile, rising oil prices could hurt India's macro picture via the trade deficit and inflation channels.

We believe that upside risks to inflation are high, on the back of 1) possible relaxation of the fiscal deficit target and 2) rising oil prices. The inflation trajectory will make it difficult for the Reserve Bank of India to justify further easing. Consequently, we enter 2018 with a neutral view on Indian bonds, as the risk of higher inflation is offset somewhat by higher real yields offered by the space. We hold a neutral view on the INR.

Political noise will rise in 2018, as 10 state governments will hold elections in the year, and general election is due to be held by May 2019. For markets, the main concern is whether the government turns towards populist policies and relax its fiscal consolidation plan amid the election schedule.

Singapore

2017 saw a pick-up in GDP growth, helped by robust semiconductor production. Going forward, we anticipate a pick-up in services sector activity to shift the mix of growth towards domestic-oriented sectors and away from exports. The recovery in households' net asset position in recent years will further support our expected improvement in private consumption. We also see a possible expansion of private investment, supported by a revival in the residential property cycle.

Headline inflation will likely accelerate in 2018, albeit moderately. The property market has rebounded, and there is less slack in the labour market. The cyclical recovery in commodity is a further catalyst to a rise in inflationary pressures. Prime Minister Lee Hsien Loong announced at the

annual convention of the ruling PAP party, that higher taxes are “not a matter of whether, but when”, as spending on investments and social services grows. This has prompted markets to expect a Goods and Services Tax (GST) hike proposal, perhaps as early as the 2018 budget announcement. Although the implementation of a GST hike is unlikely to happen immediately, and is expected to be offset by a fiscal package from the government, this will still put upward pressure on inflationary expectations.

In terms of monetary policy, MAS has paved the way for a return to an upward sloping SGDNEER band in 2018, after downplaying significance of the “extended period” language in its October policy statement. Improvement in labour market and signs of dissipating slack leads us to believe that there is now an increased likelihood of an FX policy adjustment in April. Overall, we expect the SGDNEER to remain at the upper end of the band in the year. Given the currency’s high beta to the USD, USD trend is a key factor worth watching. Our bias towards outperformance of the SGD remains, on the back of our lukewarm and more balanced view on the USD.

We head into 2018 looking to opportunistically position for curve steepening on the rates side, given the current flat yield curve and our view that markets are underpricing global inflationary risks. Higher frequency of auction issuance in 2018, with more long end issuance spread out throughout the year compared to 2017 should keep some pressure for yield curve steepening to take place. As front-end US rates rise as a result of further Fed rate hikes, we expect SOR rates to move higher and put pressure on front end Singapore Government Securities (SGS) as well.

Thailand

Growth in 2018 is likely to remain relatively subdued vis-à-vis regional peers, although there may be upside risk from a possible acceleration in government infrastructure projects and welfare reforms before the general election. External factors were the main growth drivers in the past year, as domestic demand has remained mostly stagnant - one of the main reasons why inflationary pressures continue to print below the central bank’s target range of 1-4%. Being a net energy importer, Thailand is more sensitive to oil price movements vis-à-vis regional peers. Thus, if oil prices continue to rise, inflationary pressures in Thailand are likely to increase. However, persistently weak domestic demand is likely to limit any increase in core inflation. Our base case is for Bank of Thailand to leave interest rates unchanged in 2018.

We hold a neutral view on Thai bonds going into 2018. Although real rates remain attractive vis-à-vis peers, a sharp rise in net government bond supply in the year is likely to dampen demand. We are more positive on the prospects of the Thai Baht, even as the currency has rallied strongly last year, supported by our view that the strong current account surplus will be maintained.

Politics would be a key risk for Thailand in 2018. Prime Minister Prayut Chan-o-cha declared that elections would take place in November, with an exact date due to be announced in June. This would be Thailand’s first general election since 2011. Given that election timelines have been announced twice before and eventually pushed back on both occasions, we believe that plans could still change, and anticipate markets to price in increased political premium by the second half of 2018.

Malaysia

GDP growth in Malaysia experienced a robust acceleration in 2017, underpinned by strong private sector expenditure. Going forward, we expect a slight moderation on the back of a slowdown in exports (as the tech cycle fades). Nonetheless, higher oil prices, should it persist, would provide a boost to growth as Malaysia is a net oil exporter. The government has stuck to its fiscal consolidation pledge, targeting a fiscal deficit of 2.8% in 2018. We note though that the conservative oil price assumption (USD 50/bbl) provides leeway for the government to increase fiscal spending to support growth, if needed.

Headline inflation has accelerated, and higher oil prices puts risks to inflation on the upside. In the last monetary policy statement, Bank Negara Malaysia has clearly telegraphed its hawkish intent. However, we believe that any tightening is likely to be mild. A hawkish central bank, steady foreign direct investment (particularly from China), and strong growth are factors that support our positive view on the Malaysian Ringgit. However, these reasons are also why we are holding a neutral to underweight call on Malaysian bonds going forward. We further add a point of concern for bond investors in 2018 is the reduction of Malaysia’s weight in the JP Morgan Government Bond Index, upon the inclusion of China in the index.

Lastly, general elections have to be held on or before 24 August 2018. Deputy Prime Minister Ahmad Zahid Hamid recently suggested that the elections could be called by mid-May.Our view is that markets are unlikely to attach a sharply higher risk premia as the opposition coalition remains weak.

Indonesia

We anticipate growth to be fairly stable, if not slightly picking up, in 2018. The finance ministry expects policy easing to start filtering through the broader economy by the first half of 2018. Should this materialise, domestic demand, which has been relatively subdued, should rise along with credit growth. This notwithstanding, government spending is likely to remain subdued. Policymakers’ 2.19% fiscal deficit target for 2018 seems ambitious in our view, and could weigh down a major acceleration in investments or government spending in the absence of additional revenue sources.

Indonesian bonds had another remarkable run in 2017, buoyed by low inflation, interest rate cuts by Bank Indonesia and the upgrade by Standard & Poor’s. We continue to hold a constructive view on Indonesian bonds going into 2018. Inflationary pressures are likely to remain fairly anchored, supported in large part 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. Meanwhile, near-term bond technicals could get a significant boost in the event that Indonesia is included in the Bloomberg Barclays Global Aggregate Index.

We expect the Indonesian Rupiah to stay relatively stable in 2018. The Indonesian central bank continued to build its reserves from last year, and the country has seen significant improvement in its balance of payment (BoP), with its third quarter BoP recording largest since September 2016. Indonesia jumped 19 places in the World Bank's Ease of Doing Business index, which bodes well for continued FDI inflows.

Politics will take the spotlight by second quarter of the year, as campaigning for regional elections (scheduled in June 2018) get into full swing. Post this, President Joko Widodo will announce his chosen vice presidential running mate in August, with the seven-month campaign period for the presidential elections commencing in September. We do not expect a material rise in political risk for Indonesia given that the president continues to enjoy a relatively high electability rating to date.

Philippines

The growth momentum in the Philippines is significant, and we expect the Philippine economy to continue to outperform regional peers, supported in large part by the government's aggressive spending programme. We expect a sizeable impact on net revenue from the passage of tax reforms, helping the government secure funding for its ambitious infrastructure programme. The substantial personal income tax cuts should also boost disposable income, albeit the increase will be moderated by the rise in excise and fuel tax. Meanwhile, President Rodrigo Duterte has taken a stance friendlier to China, relative to his predecessor. This has seen the Chinese government committing to USD 9bn in government loans and USD 15bn in direct investments. We note the projects expected to be funded by Chinese loans are mostly still undergoing feasibility study, and thus, have largely not been imputed into markets' growth forecasts.

Against a backdrop of strong domestic demand and rising oil prices, we believe the risk of an acceleration in inflation is high. Our base case is for headline inflation to stay within the central bank's 2-4% target for most of the year, but believe that a breach of the upper bound could take place towards the latter half of 2018, as inflationary impact of the tax reform is likely to be more back-loaded. Consequently, we expect the Bangko Sentral ng Pilipinas (BSP) to raise policy rates only in the second half of the year.

We hold a neutral view on bonds. Although the risk of monetary tightening is bearish on the outlook for the space, the successful passing of the tax reform alleviates some of the fiscal stress that may come from the government's infrastructure push. Moreover, the central bank's focus on restructuring the RPGB yield curve towards benchmark tenors is a positive for the space, which, coupled with developments in the repo market set-up, will lead to increased trading activity for local currency Philippine bonds. Meanwhile, we anticipate the Philippine Peso to weaken anew in 2018, as concerns about the country's deteriorating current account trend re-emerge on the back of the infrastructure build-out.

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