Asian Fixed Income

Asian Fixed Income Outlook

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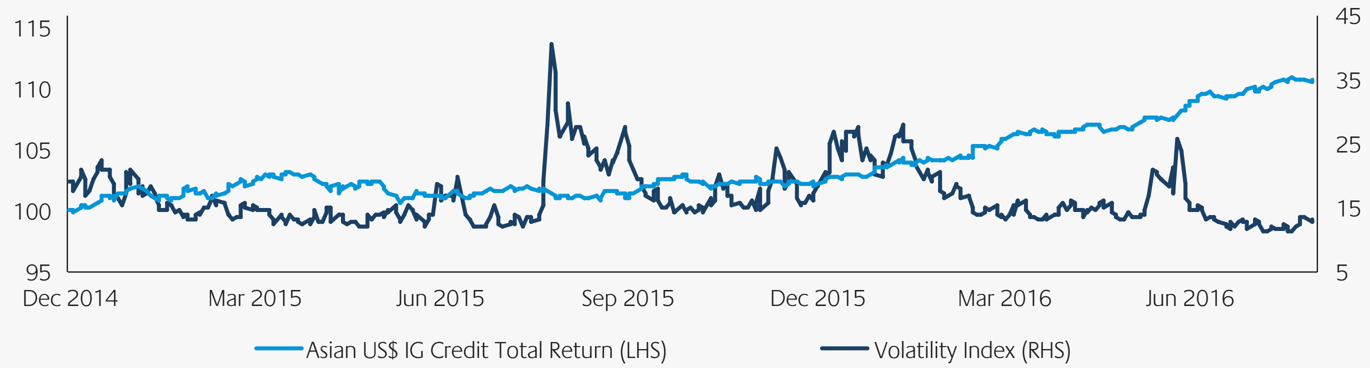
Following several periods of heightened volatility in the first half of 2016, the start of the second half has been comparatively muted, marked by extended periods of depressed market volatility during the northern hemisphere summer. Asian Fixed Income continues to deliver stable positive returns with yields and spreads lower for the year to date, despite challenging and volatile market environment experienced at the beginning and middle of 2016. At the end of June, market uncertainty created by the affirmative Brexit vote saw a sharp sell-off in risk assets. However within only a few days most risk assets had recovered, and have since traded through pre-Brexit levels. Global markets remain flush with liquidity as global central bank activity continues to be its dominant driver, and we expect this factor to persist in the medium term and continue to be supportive of global assets prices.

Chart 1: Asian US$ IG Credit continues to provide stable positive returns during recent periods of volatility

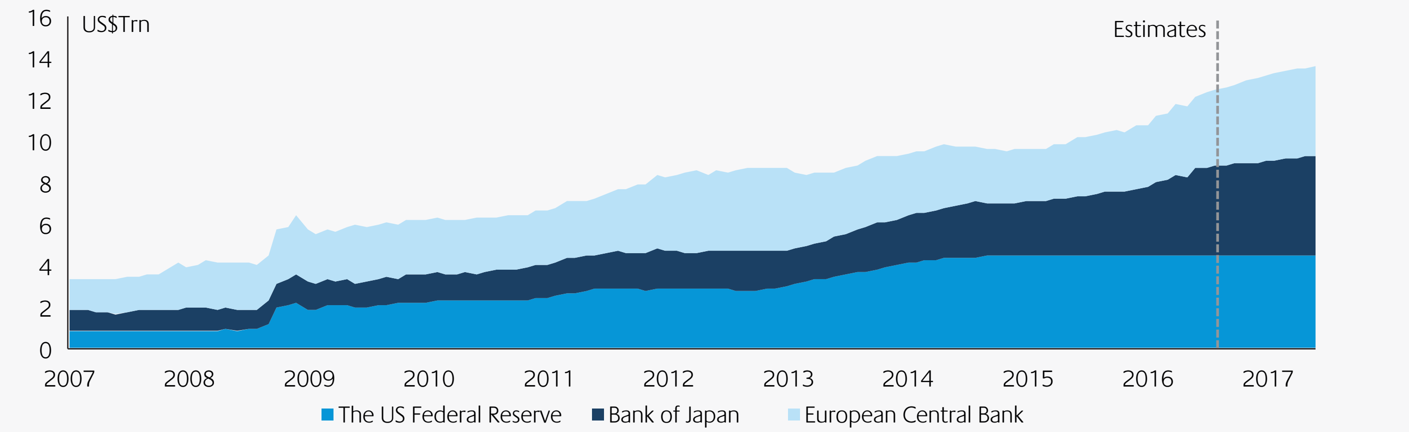


Source: JP Morgan, Chicago Board Options Exchange, as at 31 August 2016.

Looking ahead for the remainder of 2016, we expect returns to remain stable, albeit with intermittent volatility. The driver of fixed income markets at present is not the macro economic outlook, rather the two factors created by central banks intervention namely:

1. The demand from key central banks purchases of government and corporate bonds in Japan, Europe and again now in the UK, remains highly supportive of global fixed income markets.

Chart 2: Central banks balance sheets continue to grow

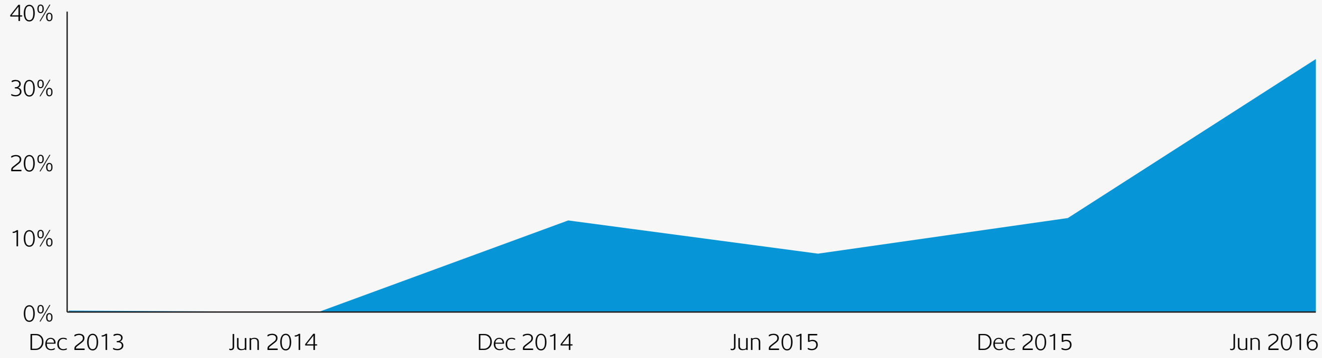


Source: European Central Bank, Bank of Japan, The US Federal Reserve, as at 30 June 2016.

2. The result of this demand (approximately US$13 trillion) is negative yielding bonds across a significant proportion of global government bond universe, which in itself further enhances global demand for Asian fixed income, as investors shift their attention to regions where positive yields still remain.

We expect the above technical drivers to remain in place for the foreseeable future, thereby continuing to support fixed income returns. Both spreads and yields are likely to remain relatively stable for the remainder of 2016, thereby consolidating full year returns.

Chart 3: Proportion of developed market government bonds* with negative yields

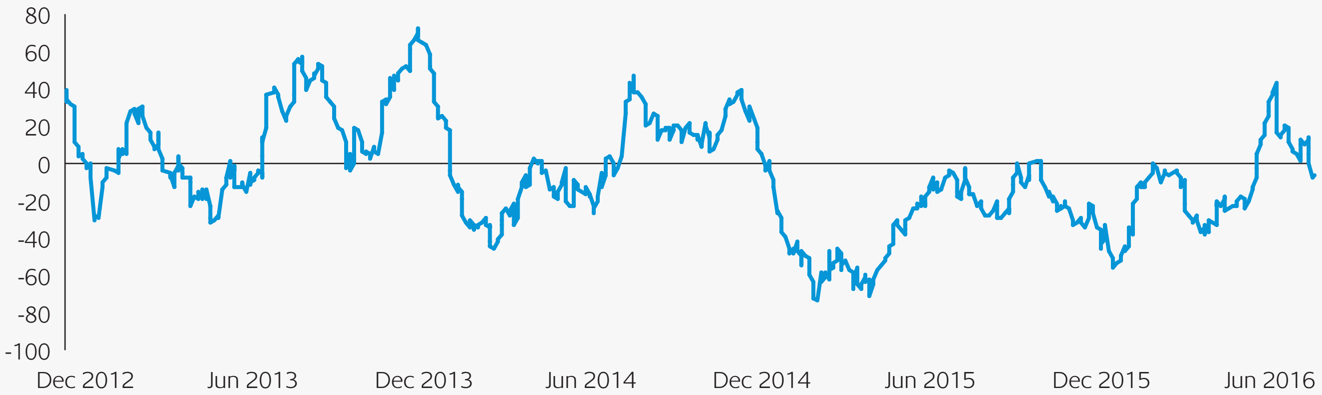


Source: Citi, as at 30 June 2016. * Using the Citi World Government Bond Index as a proxy.

In terms of risks to our constructive outlook, a potential source of volatility is from political uncertainty or a sudden decline in global growth. Political uncertainty in Europe is widespread from German public discontent with the government's refugee policy, Spain's inability to form government and the Italian referendum on constitutional change in October. The upcoming US Presidential election also has the potential to create further market instability if the Republican candidate is successful.

On the economic growth front, the US economy's improvement in recent quarters has been underpinned by continued strength in the labour market, consumer spending and a strong housing sector. However, business spending and export growth has been less convincing and following Brexit they are both likely to face further headwinds amidst the ongoing uncertainty in Europe. Against this backdrop, the US Federal Reserve's ('the Fed') path of tightening monetary policy will need to be measured and of a gradual pace. Therefore, whilst uncertainty over the pace of the Fed tightening was one of the key drivers of volatility at the beginning of the year, this risk has now significantly abated.

Chart 4: Citi Economic Surprise Index for the US continues to show mixed signals for economic momentum



Source: Citi, as at 31 August 2016.

Across the Atlantic, the Eurozone economy had been resilient this year, recording its 13th consecutive quarter of positive GDP growth. This has been underpinned by solid domestic demand amid easy monetary policy, low oil and commodity prices and improving labour markets. Despite this, we retain a cautious outlook for the remainder of the year for the monetary union. The UK's vote to leave the European Union will likely have medium term ramifications as the country accounts for 13% of all exports from the Eurozone. While it is unclear how much global business confidence, investment and employment are affected at this early stage, there is a risk of an underestimation of the consequences. In the longer term, this may result in further policy easing by the European Central Bank to continue to promote growth in the region.

Looking to Asia, specifically China, we see reasons to anticipate that the Chinese economy is stabilising. Chinese monetary conditions have eased significantly since the end of 2015. Our analysis suggests that there has historically been a lag of approximately six months between monetary conditions and GDP. Given the recent easing of monetary conditions and the ongoing focus of government reforms to support growth, we see reasons to expect continued stabilisation in Chinese's economic data in the second half of 2016.

Chart 5: Improving Chinese monetary conditions should help stabilise economic growth

Source: Bloomberg, as at 31 August 2016.