2021 Asian Fixed Income and FX Outlook: A sweet spot for Asian bonds

January 2021

By the Asian Fixed Income Team

A review of 2020

The year 2020 truly surprised the markets, with the COVID-19 pandemic at one point bringing global economic activity to a virtual standstill as economies shut down in rapid succession. As a result, financial markets across all asset classes, including safe-haven assets, exhibited extreme volatility. With significant disruptions to global markets, policymakers across the world raced to introduce measures to restore calm. While initially feeble and disjointed, monetary and fiscal authorities across the globe grew more coordinated and forceful by the end of the first quarter, finally succeeding in stabilising key segments of the global fixed income market. Global risk assets went on to stage a strong recovery, with US equity markets hitting record highs towards year-end.

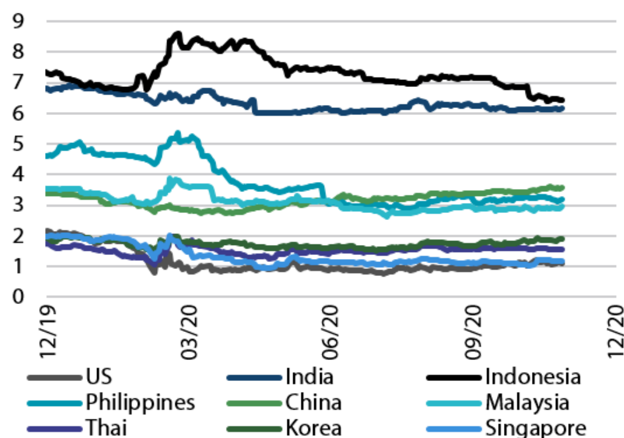
Against such a backdrop, US Treasury (UST) yields plunged 82–147 basis points (bps) across the curve. Low inflation, aggressive and broad-based policy support from central banks and concerns around the resurgence of COVID-19 infections in major economies anchored yields at low levels. In August, US Federal Reserve (Fed) Chair Jerome Powell announced a major shift in the central bank's approach to achieve maximum employment and its inflation goal, as it formally adopted a flexible average inflation targeting policy. Consequently, expectations of rising inflation caused longer-term rates to ratchet higher, although they were still at relatively low levels. The UST curve steepened after the US elections as the markets positioned for a reflation trend. A slew of positive COVID-19 vaccine trial results provided further impetus for long-end yields to rise.

In Asia, several economies experienced technical recessions on the back of the pandemic, with the ongoing recovery being uneven and partial. The decisive and unprecedented policy response from governments and central banks—both in swiftness and scale—headed off a more devastating outcome. Within the region, growth in North Asia proved to be relatively more resilient. With demand tepid, inflationary pressures fell, and annual headline consumer inflation rates in Malaysia, Singapore, and Thailand all turned negative at one point.

Overall, Asian local government bonds recorded positive total returns, with the Markit iBoxx Asian Local Currency Bond Index (ALBI) registering gains of 7.66%[1] in US dollar (USD) unhedged terms. Meanwhile, the USD weakened against most regional currencies amid the positive risk tone. On a total return basis, Indonesian and Philippine bonds outperformed regional peers, with demand bolstered by aggressive monetary easing by their respective central banks. Indonesian bonds also benefited from Bank Indonesia's (BI) liquidity support and the return of offshore capital. In contrast, Thailand markedly underperformed, as lingering political tension and a lack of tourism receipts weighed on sentiment towards Thai assets in general.

[1] As at 30 November 2020

Chart 1: 2020 10-year benchmark yields, returns and FX returns



	iBoxx ALBI Indices	Currencies vs. USD
ALBI Index	**7.66%**	**2.79% (ADXY)**
China	1.85%	5.84%
Hong Kong	7.06%	0.52%
India	11.93%	-3.59%
Indonesia	12.61%	-1.80%
Korea	1.51%	4.51%
Malaysia	5.80%	0.42%
Philippines	9.72%	5.35%
Singapore	7.68%	0.32%
Thailand	1.69%	-0.97%

Source: Bloomberg, as of 30 November 2020.

Outlook for 2021

We expect global growth to grind higher in 2021, but the pace of recovery will likely be uneven among economies. In the US, renewed upticks in COVID-19 infections heading into the winter season may lead to the re-imposition of restrictions. This poses a significant headwind for growth in the fourth quarter of 2020 and the first quarter of 2021. That said, increased spending by the Biden administration is likely to mitigate some of the downside risk to economic activity. Global growth is then expected to pick up modestly as vaccine access expands.

Within Asia, we expect North Asia to continue to lead the recovery (at least in the first half of 2021). But we also expect the growth divergence between North Asia and the rest of the region to narrow. Unprecedented fiscal support from governments have been pivotal to the ongoing recovery. We expect fiscal action to continue in 2021 but anticipate renewed private sector confidence as the vaccine becomes broadly available and provides a powerful tailwind to regional growth.

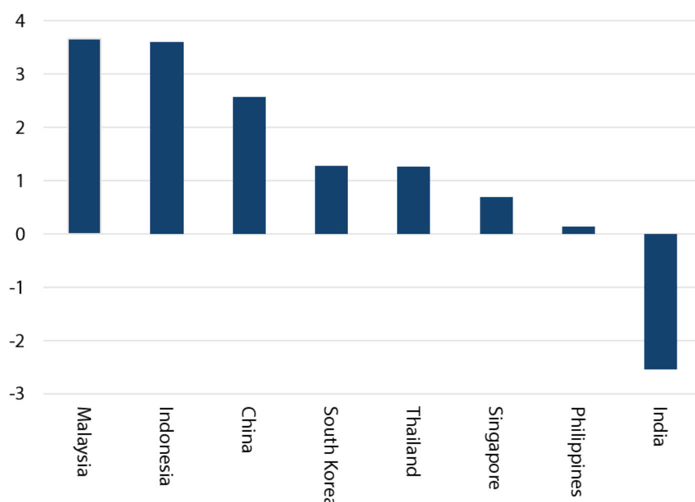
Meanwhile, inflation will likely rise from current low levels and remain manageable as the negative output gap is expected to persist. The Fed has embraced a flexible average inflation targeting strategy. Given our view that the US economy still has some distance to go before attaining full employment, we do not expect an interest rate hike from the Fed in 2021. These factors accord regional central banks room to further loosen monetary policy, if needed. In our view, economies which have trailed in COVID-19 containment such as Indonesia, Malaysia and the Philippines would need more support. Hence, we expect their respective central banks to announce further rate cuts in the near-term.

We anticipate the combination of growth recovery supported by vaccine availability, fiscal support and a still dovish Fed to push UST yields higher in 2021. Against a backdrop of positive risk tone, we believe Emerging Market (EM) inflows into local markets will continue to improve. We favour countries with high carry such as Indonesia, where

flows have begun to return. We prefer to be patient on Indian bonds at this point, waiting for inflationary pressures to moderate. We expect Asian currencies to appreciate against the USD, with the Chinese yuan, South Korean won and Singapore dollar—being relatively more trade-sensitive—outperforming. Lingering political risk will be key headwinds for the Malaysian ringgit and Thai baht, which may cause these currencies to lag their peers.

The key downside risks to our investment thesis include a delay in vaccine developments, escalating geopolitical tensions between major countries and a faster-than-expected acceleration in inflationary pressures prompted by an upside surprise to growth.

Chart 2: Asian real rates (%) - 5-year yields vs CPI



Source: Bloomberg, as of 30 November 2020.

Individual country outlooks

China

Chinese economic growth has bounced back from initial weakness in the first quarter. The Communist Party's Central Committee recently unveiled its broad goals for the 14th five-year plan; self-reliance was a key theme and technical innovation was emphasised as vital to the country's development. Overall, few factors threaten growth at this moment, and Chinese bonds may remain weak in the near-term as the Chinese central bank does not have much reason to ease monetary policy. Until we see a more decisive turn in growth numbers, perhaps in the first quarter of 2021, bond yields are likely to continue rising gradually.

With regards to US-China tensions, we believe that Joe Biden's US election victory will not materially change Washington's rhetoric on China. However, the Biden administration is likely to engage China through proper diplomatic channels, which will reduce volatility and uncertainties in bilateral relations. This will in turn somewhat reduce risk premium in the markets.

The yuan has continued to appreciate against the USD after the US election. In October, Chinese policymakers relaxed the yuan pricing mechanism and lowered the risk reserve ratio for FX forward transactions, signalling that Chinese policymakers may tone down sizable moves from here. That said, China's growth outperformance, strong current account surplus and structural drivers of continued Reminbi (RMB) internationalisation will likely support the yuan's outperformance against its regional counterparts in the near to medium term.

South Korea

Gross domestic product (GDP) growth in South Korea has been relatively resilient relative to its peers, underpinned largely by a strong recovery in exports. In the third quarter of 2020, the economy expanded 1.9% quarter-on-quarter (QoQ), its first positive reading in 2020, as work- and study-from-home amidst the pandemic significantly boosted demand for memory chips and electronics. For the whole of 2020, Bank of Korea (BOK) expects GDP to decline 1.1%, before increasing by 3% in 2021. On expectations that US president-elect Biden will adopt a more predictable

economic policy, especially in trade, business investment is likely to increase globally, which could boost growth in Korea's exports.

South Korean bonds are expected to trade in line with USTs. The BOK does not have much room to cut rates further, and concerns around financial risks, such as elevated outstanding household loan growth, will likely prompt the central bank to stand pat at the next policy-setting meeting. The BOK has, however, reiterated that it stands ready to act if necessary, and the markets have been alerted to hints of a ramp-up in bond purchases by the central bank.

Meanwhile, like China, South Korea's growth outperformance and widening current account surplus will be supportive of further won appreciation against the dollar. The increasing emphasis on 5G and the global adoption of this technology will be supportive of the tech cycle, which should support South Korean equities and thus the currency. That said, we note that rhetoric from South Korean policymakers have since turned hawkish, which suggests heightening wariness of further big swings by the currency.

Malaysia

The protracted political uncertainty is the main risk to Malaysia's recovery, with the ruling coalition having but a slim and frail majority in parliament. A general election is likely which may disrupt medium-term recovery efforts. We note that the COVID-19 resurgence has prompted re-introduction of containment measures, although they are less strict and more selectively applied in localised areas. Hence, the drag to growth will not be as severe as that in the second quarter of 2020. For 2021, the central bank expects growth between 6.5% and 7.5%, driven by a rebound in global demand and domestic investment activity. Should actual growth falter, we note Bank Negara Malaysia still has room to further ease monetary policy. The latter should provide support for faltering local bond demand from pension withdrawals.

Separately, we expect the ringgit to underperform its regional peers in the first half of 2021, as commodity price stagnation and political uncertainty, coupled with possible easing by the central bank, weigh on sentiment. The stable current account surplus should still provide a back-stop on the downside.

Singapore

The Singapore economy turned around in the third quarter of 2020, following an unprecedented decline in the April to June period. Extreme weakness on the domestic side was slightly offset by strength in exports, particularly the electronics sector. For 2020, the Monetary Authority of Singapore expects the country's GDP to contract between 6.5% and 6.0% and post above-trend growth in 2021 due to a low base. Policymakers have been pushing to re-open the borders in a gradual and safe manner. We believe that the availability of a vaccine in 2021 could slowly revive the country's position as a global travel hub.

Singaporean bonds are likely to continue outperforming USTs on the back of ample domestic liquidity and the attractiveness of the Singapore dollar (SGD). Meanwhile, we see the SGD getting a boost from a continued rebound in international trade as well as a nascent second-half recovery in air travel.

Thailand

Thailand's GDP growth bounced by a strong 6.5% QoQ in the third quarter of 2020, due partly to easing of the virus containment measures and increased government spending. The strong showing could suggest the worst is over. That said, recovery will likely be slow going forward, given the Thai economy's heavy reliance on international tourism, as governments proceed cautiously in re-opening borders. In addition, persistent anti-government protests will further weigh on the already weak growth outlook.

More rate cuts from the Bank of Thailand are possible, given the weak growth outlook, but we note that with the policy rate currently at 0.50%, it has little room to further lower rates. The potential for rate cuts would support bond demand especially as domestic liquidity is flush. On a relative value perspective, offshore investors are likely to prefer bonds which provide better risk-reward.

We also expect the baht to underperform its regional counterparts in the medium term, as lingering political tension and lack of tourism receipts weigh on the currency. The relatively large and persistent current account surplus would, however, provide it with some downside support.

India

India's economy was hit relatively badly by the COVID-19 pandemic. India's industrial growth turned positive in September, following six consecutive months of contraction, as lockdown measures eased. Other high-frequency data also suggests that recovery is picking up. On top of this, the government recently announced fresh policy

measures to support the economy. Barring another surge in COVID-19 infections, the economic recovery may well surprise on the upside from here, which could reduce the urgency to further ease policy rates.

Meanwhile, the Reserve Bank of India's unconventional tools and bond-supportive measures have provided strong support for Indian bonds in recent months. Although the space provides attractive carry and would benefit from the resumption of inflows into EM, we deem it prudent to wait for a sustained moderation in inflationary pressures before turning more bullish on Indian bonds.

Indonesia

As with the rest of the region, third quarter Indonesian growth saw an improvement reflecting the impact of businesses re-opening in big cities. Government consumption growth grew significantly, consistent with improved execution of the government's support packages. The path to recovery remains fragile and uncertain. While domestic COVID-19 infection rates remain stable, they are still at high levels, prompting households and corporates to remain cautious on spending. We do expect the government to accelerate disbursements of fiscal expenditures, which should continue to be the main driver of growth in the next few months. A more meaningful recovery may only happen in mid to late 2021, when vaccines could be rolled out widely. Hence, we expect inflation to remain fairly anchored at low levels in 2021. Meanwhile, with FX stability ostensibly achieved, BI has resumed monetary policy easing after keeping rates unchanged for three consecutive meetings. Going forward, we expect further rate cuts by the central bank as focus has clearly shifted to supporting growth.

We go into 2021 with an overweight view on Indonesian bonds. As mentioned, a modest recovery in GDP growth against a low inflationary environment leads us to believe that BI will stay accommodative for at least the first quarter of 2021. Our expectation of an outperformance of Indonesian bonds on an intra-Asia basis is further supported by the higher yields offered in the space. We believe Indonesian bonds and the rupiah will also benefit from what we expect will be an increase in foreign flows into the EM debt space.

Philippines

Growth momentum in the Philippines has lagged peers. Public sector spending remains weak while the private sector's lack of confidence has led to the collapse of private spending. To shore up the economy, the Bangko Sentral ng Pilipinas has lowered its key policy rate to a record low of 2%[2].

Going forward, we foresee a much weaker pace of recovery for the Philippines vis-à-vis regional peers, in the absence of sizeable fiscal support measures. Fresh government fiscal support would in large part rely on the tax cuts via the Corporate Recovery and Tax Incentives for Enterprises (CREATE) Bill which is expected to be signed into law in 2021. Economic activity may also take time to bounce back despite the availability of a vaccine given low existing immunisation rates. Hence, we expect inflation to remain subdued for some time. Against such a backdrop, the central bank is likely to ease monetary policy further. Despite supportive monetary policy, we expect a gradual rise in Philippine bond yields in 2021 from its current historic low levels, as the markets price in recovery from the slump due to the pandemic.

Meanwhile, the collapse in imports in 2020 has supported the strong performance of the peso. As economic activity and infrastructure spending resumes, the trade deficit should widen anew, albeit at a modest pace. We hold a neutral view on the peso.

[2] As at 30 November 2020

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