



Investment Note



22 March 2018

Implications of US rate hike on Asian fixed income and Asian equities

On 21 March 2018, the US Federal Reserve (Fed) continued its monetary policy normalisation process, by announcing its sixth 25 basis points rate hike since December 2015, with a target range of 1.5% to 1.75%. There was also an upward shift in the “dot plot” (a chart having estimates of what the federal funds rate is expected to be), showing that most FOMC members were more hawkish about the Fed’s rate path beyond 2018.¹

In this investment note, **Endre Pedersen**, Chief Investment Officer, Fixed Income Asia (ex-Japan), and **Ronald CC Chan**, Chief Investment Officer, Equities, Asia (ex-Japan) discuss the implications of interest rate hike on Asian fixed income and Asian equities.

In addition to the anticipated interest rate increase, the Fed’s latest dot plot is more hawkish: it suggests three rate hikes are forecast for 2019 and a further two for 2020 (both revised up from the December 2017 meeting). The US Treasury yield curve has experienced a temporary steepness this year (see Chart 1), and soon after the Fed announced the rate hike decision on Wednesday, the 10-year Treasury yield softened after touching 2.9%, while the US dollar experienced its biggest drop in 2 months.²

Asian countries better positioned to cope with higher US rates

Endre Pedersen, Chief Investment Officer, Fixed Income Asia (ex-Japan) thinks that in the current rate hike cycle, the Fed’s monetary policy normalisation process has been well communicated and implemented at a cautious pace. As a result, Pedersen believes Asia fixed income markets have already priced in a fair amount of the interest rate hike impact. If the Fed adopts a more aggressive stance, it may result in a negative market reaction, but the magnitude will be less than that experienced in 2013 (Taper Tantrum).³

In Pedersen’s view, Asian countries are now generally better positioned to cope with higher US rates than they were in prior periods of rising yields, thanks to higher average sovereign credit quality, greater levels of foreign reserves, and broadly healthier current account positions.⁴ On the credit side, Pedersen expects default rates to remain low, though we may see some stress in speculative issuers in the coming months, due to China’s deleveraging process.

While a steeper curve with an accompanying stronger dollar could potentially lead to wider Asia credit spreads, there are few indicators suggesting it is poised to steepen in a meaningful way in the near term.

¹ Federal Reserve; Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, 21 March 2018.

² Bloomberg, 22 March 2018.

³ The 2013 surge in U.S. Treasury yields (from May to September by 136 basis points) resulted from the Federal Reserve’s use of tapering to gradually reduce the amount of liquidity.

⁴ Bloomberg, Economic Survey, 31 December 2017.

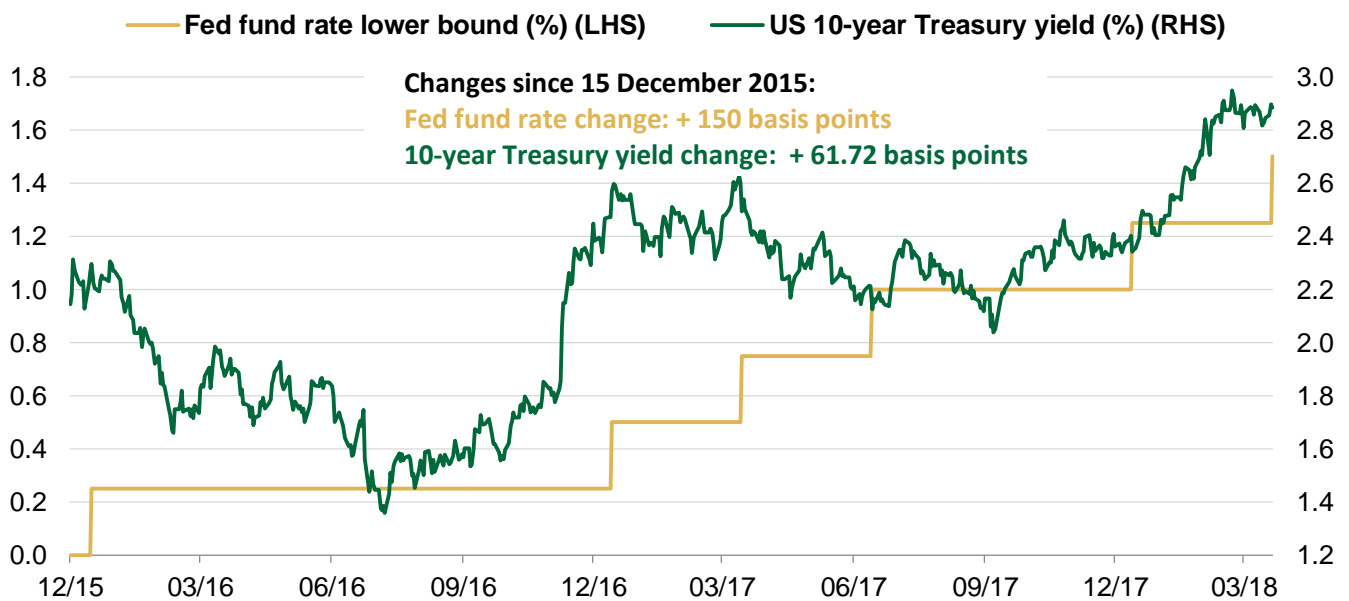
22 March 2018

That said, Pedersen believes the development of a large local investor base will result in Asia credit outperforming other global markets over the medium term.

On the currency front, Pedersen thinks Asian currencies of countries with large trade surpluses have performed well in this environment; however, risks of increased protectionism and the prospect of trade wars could see these currencies come under pressure.

The Indonesian rupiah is among the worst-performing currencies this year due to heightened market volatility. Pedersen expects the coming inclusion of Indonesia in global bond indices to serve as a natural offset to the recent foreign outflows; Bank Indonesia (the central bank) can also utilise their foreign reserves to dampen further rupiah weakness. Volatility of financial markets contributed to weakness in the Indian rupee and Philippines peso. Pedersen remains cautious on these two currencies in the near-term.

Chart 1: US Fed fund rate and 10-year Treasury yield movement since first rate hike in December 2015⁵



South Korea, Philippines and Thailand have their rate hike this year

Ronald CC Chan, Chief Investment Officer, Equities, Asia (ex-Japan) believes the Fed’s March rate hike of 25 basis points is well flagged and expected by market. However, Chan does not expect Asia central banks will follow suit: many Asian economies have abundant domestic liquidity with current account deficits that have halved over the past few years, even in countries with historically persistent deficits such as India and Indonesia.

That said, Chan does expect South Korea, Philippines and Thailand to have one rate hike this year driven by a better domestic growth scenario, as opposed to being led by a US rate hike.

⁵ Bloomberg, 22 March 2018.

Asia well positioned in this new normalized economy

Chan believes Asia has arrived at an inflection point where we transition from operating in a post-Global Financial Crisis (GFC) economy to an environment within which normalized economic activity is the order of the day, underpinned by stronger economic activity that has led to higher inflation and rising interest rates.

Asia is well positioned both structurally and cyclically in this new normalised economy. Structurally, reforms in countries such as Indonesia and India have led to greater macroeconomic stabilisation. This is important, as the difficult reforms implemented during the post-GFC period now allow these countries to enjoy the benefits of normalised economic growth. Indonesia has continued fiscal consolidation efforts and streamlined foreign investor procedures, resulting in increased foreign direct investment (FDI) levels.⁶ Moreover, large regional initiatives such as “One Belt, One Road” from China and local government-funded infrastructure projects are remaking both the economic and physical landscape in Southeast Asia.

Asia should continue to benefit from the broad-based global growth environment, limited inflation pressures, and a weak US dollar. On the other hand, the main risks are escalation of trade friction and a higher-than-expected rate hike trajectory in the US (relative to our base case scenario).

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⁶ Nasdaq, 30 January 2018. [Indonesia says it attracted more foreign direct investment in 2017.](#)