FIXED INCOME RESEARCH **24 JUNE 2013**

AEJ Rates portfolio update

Adding to Malysia steepeners; holding India flatteners; exiting outright receive positions in Thailand and India swaps.

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Asian rates curves have continued their steepening on the hawkish signals from the FOMC. We have recommended Malaysian steepeners, Indian flatteners and Thailand receivers in swaps. In line with the hawkish and explicit message from the FOMC on its QE tapering plans (see *FOMC Wrap: Another Policy Shock*, 20 June 2013), we increase the weight of our Malaysia steepener position in our strategy portfolio, continue to hold Indian flatteners and exit our outright receive positions in Thailand and India.

Add to Malaysia 2s5s steepeners

We add a further USD5K DV01 to our 2s5s Malaysia steepeners (Current: 50bp, Carry-Roll: -2.5 bp/3 month), in our strategy portfolio (see *Adding to our 2s5s steepener recommendation*, 22 April 2013). Looking at the market from a positioning perspective, Malaysia has been the primary beneficiary in Asia ex-Japan of liquidity inflows with foreign investors holding as much as 47% of outstanding bonds in the Malaysian market (see *How a US unwind of QE could affect Asia*, 28 May 2013). With Fed tapering getting closer, the market continues to debate the future of capital inflows into emerging markets. As such, in the current environment we note that Malaysia remains the most vulnerable (with Indonesia) Asian rates markets. Along with vulnerability from a bond-outflow perspective, the rise in volatility in the global and Asia rates markets also calls for higher term premium on the yield curve, and hence steeper yield curves. Specifically, on the Malaysia swap curve the stable nature of interbank fixings makes the curve steepen (flatten) when paying (receiving) pressure emerges. From a local dynamics perspective, the Malaysian curve is another candidate for steepening as Bank Negara Malaysia's (BNM) bias is to normalize rates. Though the current growth/inflation dynamics do not call for any immediate normalization of policy rates, our economists judge that such a situation may well develop in Q4 this year, forecasting a rate hike in Q4 2013 (see *Malaysia: On the brink of a trade deficit*, 7 June 2013). On the activity side, domestic demand has held up well, while headline inflation is low, but rising. Pressure points are emerging on the overall macro front, in our view, with the trade surplus narrowing as domestic demand keeps import growth high relative to export growth. The political situation is also not conducive to significant fiscal consolidation and therefore, with time, we expect most of the macro burden to be borne by monetary policy. As such, Malaysian steepeners remain a strong conviction recommendation.

Exit receive THB 5yr outright; look to initiate receive 2yr outright or 2s5s steepeners

We exit our outright THB 5yr swap receive position (see *Thailand: receive THB 5yr IRS*, 29 April 2013). We have a receive bias in Thailand but we think front end is the best way of expressing the view amid dovish bias by Bank of Thailand. The front end appears to be providing decent value, especially the 2yr part of the curve. The 1fwd1y IRS is 2.96% now compared to the past month fixing average of 2.23%. However, in the current markets where US rates remain the primary driver, we would wait for rates markets to stabilize before initiating the positions (see *Thailand: BOT leaves door open for more easing*, 29 May 2013).

Hold India swap flatteners; exit outright positions in India swaps

We holding swap flatteners in India as we believe INR depreciation will further delay the rate cut cycle, which should impact the front-end of swap curve. Also, given the negative carry considerations in front-end swaps, the market's bias will be to revert to a flattening trend once the current momentum in rates wanes. Overall, the combination of tight interbank liquidity, delays in the rate cut cycle and the low-growth environment calls for a flatter INR swap curve (see *India Rates Strategy: The world is flat*, 18 April, 2013). Though we hold the flatteners, we exit our small outright receive 1fwd2y position, given the pressure of rising global rates. We look to re-establish a received position in the belly as and when the opportunity arises (see *India: Awaiting a "durable" fall in inflation*, 17 June 2013).

Bottom-line: We add to our Malaysia steepener position and hold our India flatteners, while exiting outright received positions in Thailand and India. We see value in the front end of the Thailand and the belly of the India swap markets and will look to re-establish receive trades in both markets when the opportunity arises. However, in the current environment, momentum seems to have overtaken carry and value considerations. Please see our full strategy portfolio *here*.

Disclosure Appendix A-1

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