Fixed Income Quarterly Investment Outlook

Value Partners
Investing through discipline

Q4 2019 Market Review

January 2020

Mixed signals and prolonged discussions of the U.S.-China trade talk continued to take center stage throughout the fourth quarter. As an initial bilateral deal is expected to soon be inked, U.S. equity marked its best yearly return in six years and oil prices staged its strongest rally since 2016. Looking at the tables below, we believe the improving trade situation propelled an increase in treasury yields in the first half of 4Q19, with interest rates being range-bound and moving toward the 2% level subsequent to the announcement of a trade deal. Emerging market corporate and China high yield space, moreover, benefited from a lack of supply and investors' crave for yield. That said, sporadic credit default events among the non-property names in December had undermined the sentiment. We will continue to closely monitor the onshore space development and potential default cases. Social and financial market reform as well as central bank policies are supportive to China's bond market. The initiatives by the government include making rates market-driven system, pledge to relax restrictions relating to *hukou*, or household registration system, as well as central bank's decision to lower reserve requirement ratio.

Major central banks globally have taken dovish tone in their monetary policies, and even introduced negative interest rate, putting pressure on global high-yield assets. Bonds offering yield over 5% currently accounts for merely 5% of the entire public debt market. Compared to the U.S. and other emerging markets, Asian credit market, especially U.S. dollar-denominated China property bonds, carries scarcity value. It is expected that future capital inflows will continue. While it remains an unknown in what forms the bilateral trade conflicts to evolve, inexpensive valuation of Asian credits, especially China, stands out. We favor a strategy that emphasizes strong income generation amid the battle between the two superpowers, which is highly likely to become a new norm.

Figure 1: Bond Indices generated double-digit return

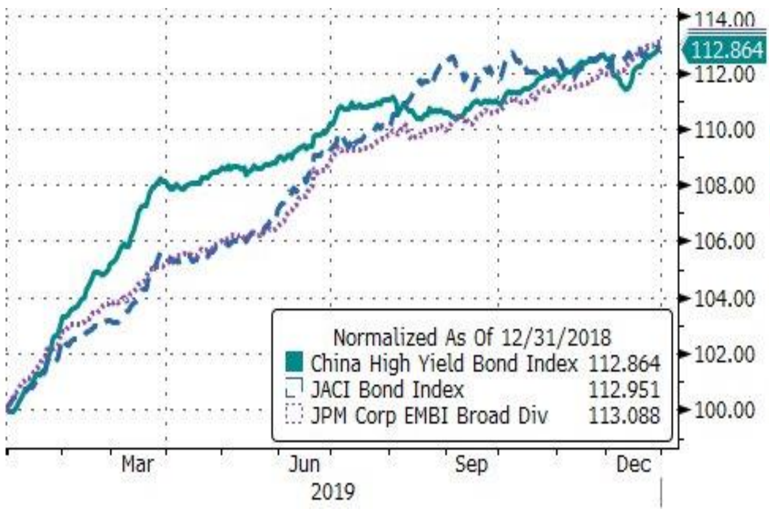


Figure 2: U.S. Treasury Yields are bottoming out

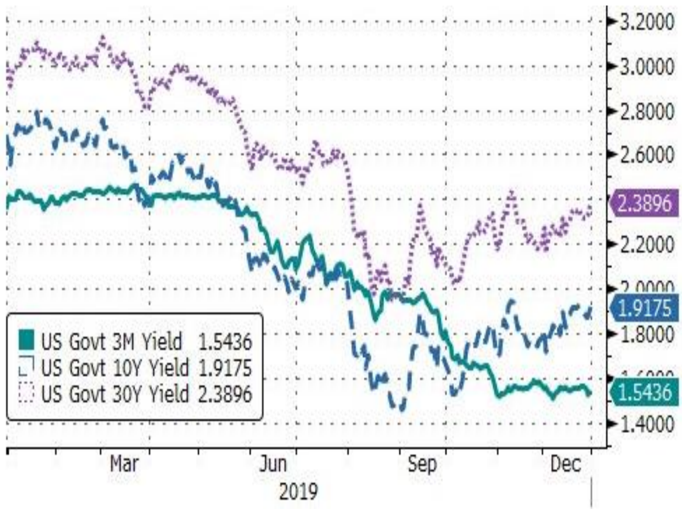
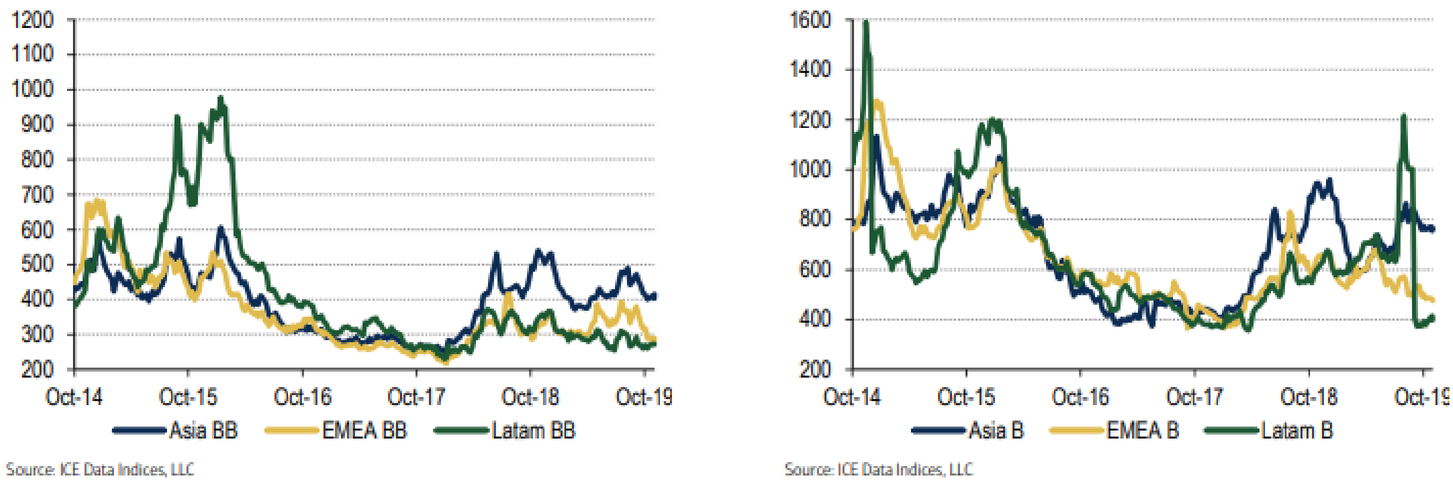


Figure 3: BB and B Spreads by Region



** Source of data/charts: ICE/BAML, Bloomberg and Value Partners, 31 December 2019*

The Caixin-Markit Purchasing Managers' Index (PMI), a proxy of China's manufacturing activities, hit 51.8, marking the steepest acceleration since December 2016. We observe a similar improvement in manufacturing and service sectors in the U.S., which in turn encouraged new business flows. Also, a slower contraction in the manufacturing sector in Germany, an export-dependent economy, paints a slightly more optimistic picture for the time being. During this period, the mutual agreement on trade between the U.S. and China has also led copper and oil prices to bottom out.

Figure 4: Major economies PMI bottomed out

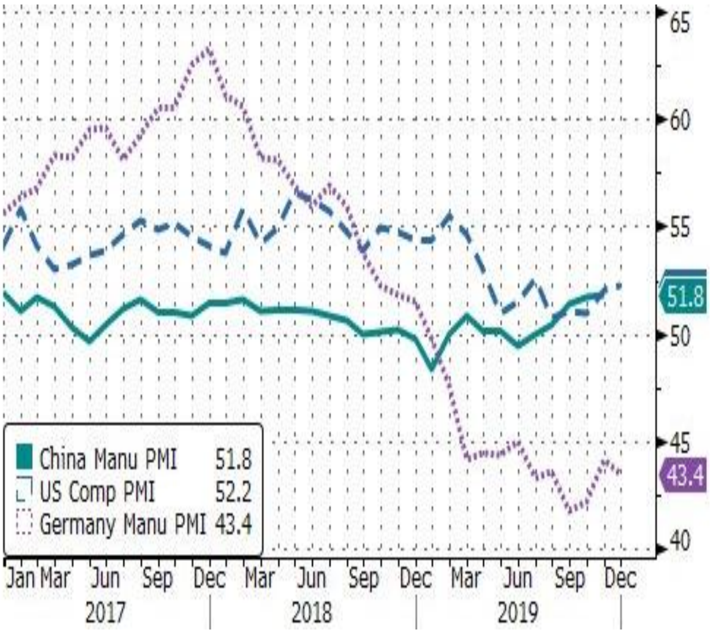
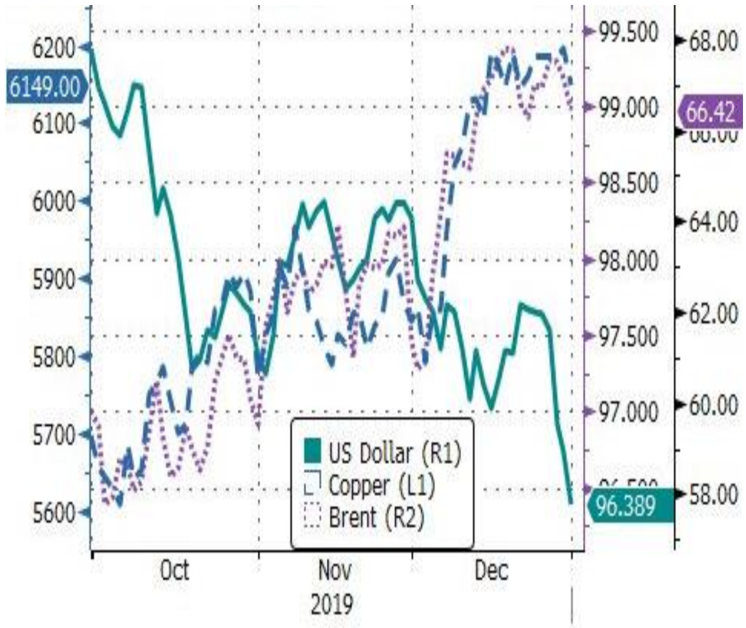


Figure 5: Copper and oil bottomed out



Although the latest U.S. economic data fell short of market expectation and stirred concern about the inverted yield curve, we do not see a recession is about to happen. The current status perpetuates an investment theme of weakening U.S. dollar, supported by policymakers' tendency to shift from monetary stimulus to fiscal easing. In 4Q19, the U.S. Dollar Index (DXY) dipped to 96.4 from 99.4, one reason for that is the greenback was pressured by a strong British sterling and euro. The pound rallied subsequent to the victory of Boris Johnson and the Conservative Party in the U.K. general election, a milestone of the Brexit journey. As President Trump's stance in anti-globalization remains, we expect the dollar to come under pressure in 2020, due to less contribution to the global demand growth. In particular, the European economy and exporters should benefit if trade tensions subside.

In terms of interest rate, we hold our previous view that the 10-year U.S. Treasury yield is expected to move towards 2.1% from 1.92% level at the end of 2019. It represents an increase from as low as 1.45% in August. We expect rates to scale back leading up to the end of 2020. The dot plot suggests to us slightly higher rates in 2021 and 2022. However, the December round of the Federal Open Market Committee meeting, the Fed's chair Jerome Powell said the hurdle for raising rates is quite high, as it requires significant and persistent increase in inflation. In addition to rate movement, potential uncertainties stemming from the U.S. presidential election may trigger another round of U.S. treasury rally.

Asia credits (JACI) return was up 1% in 4Q19 as positive developments on the U.S.-China trade deal fueled a market rally. In India, systemic cleanup of the financial sector, gradually ironing out the goods and services tax and amendments to the Insolvency and Bankruptcy Code are poised to lead a gradual recovery. Meanwhile, Indonesia is also committed to improve investment landscape through various tax reforms under the new Omnibus Law. Outside of Asia, advancement in the ratification of the U.S.-Mexico-Canada free trade agreement brought Mexican assets and oil prices a rally. Larger cut in supply committed by the OPEC+ was also supportive for oil-exporting EM countries.

** Source of data/charts: Bloomberg and Value Partners, 31 December 2019*

Chinese Onshore Bond Market

In this quarter, China's onshore bond market sustained its trend from the prior quarter. Interest rate again experienced a slight upward shock, mainly due to the uptrend in the Consumer Price Index driven by the surging pork prices, the bilateral trade agreement with the U.S., and consistent monetary policy in China.

From September to October, China's bond yields rose on the back of short-term expectation in a half in easing, inflation and risk appetite recovery. The 10-year treasury yield reached 3.31% (4Q19 peak), an increase of 17bps from the end of Q4. Since November, interest-rate bonds have strengthened, largely due to the overall deviation of economic and financial data, central bank marginal interest rate cut, and decline in risk appetite. As of 31 December, 10-year government bond rate slid to 3.14%, down 17bps from the quarter peak.

Throughout 2019, credit bonds outperformed interest rate bonds, but yield is currently at the historical low. The issuance of credit bonds continued the rebound trend from Q418 onwards. Both the issuance scale and net financing scale significantly increased compared to 2018, and bond yield demonstrated a downward trend. The capital return for sinking ratings is higher than the return for longer duration. However, the risk of default is still gradually expanding. As of end of December 2019, onshore credit bond default amounts to 201, 39 of which are entities reporting their first-ever default.

In 1Q20, taking various factors into consideration, we believe the possibility of further monetary policy easing is still high. The downward pressure on the real economy will further encourage the central bank to reduce social financing costs. Meanwhile, unblocking the monetary transmission mechanism will remain the top priority in 2020. From the credit perspective, high-yield bond strategy enjoys the opportunities from the process of credit quality differentiation. In terms of specific sectors: short-term financing environment for LGFV continues to be favorable; housing and enterprise policies are moderately loose, and consolidation within each sector is generally accelerating; private enterprise financing continues to be under pressure and special opportunities will be in focus.

Figure 6: CGB and CDB Bonds

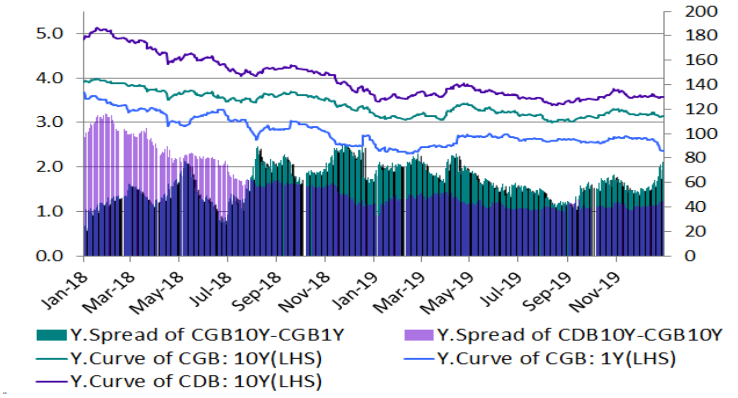
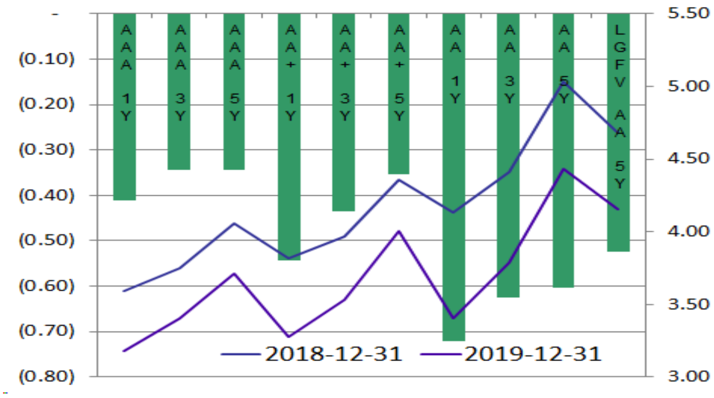


Figure 7: Chinese Onshore Credit Bonds



Chinese Offshore Property Sector Recorded Strong Returns

Property sales in 4Q19 were resilient. Full-year sales among the listed names we track totaled c.20% year-on-year, according to third-party agencies. National sales in 11M19 growth was at 7.3% YoY (10M: 7.3%), suggesting FY19E sales to hit RMB 16trn. Thanks to the aggressive sales campaign in 4Q19, the listed developers recorded an average of 37% quarter-on-quarter growth versus 3Q19, or 29% yoy growth versus 4Q18. For 2020, we expect sales figure to remain relatively stable, with mid-sized developers outperforming. We believe sales sentiment to be supportive in tier 1/2 cities upon resilient demand and supply in control, whereas tier 3/4 cities to remain under pressure after short-lived policy-driven revival because of weaker price expectation and higher inventory.

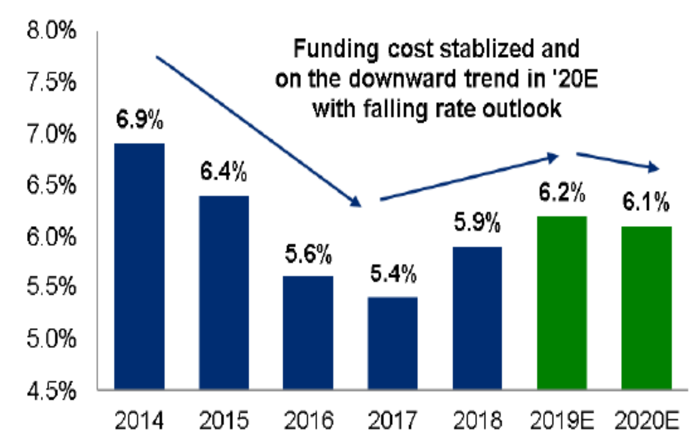
In reversal to the strict tightening stance since 2Q19, we see clear policy direction shifting to downside protection since 4Q19 and would expect it to carry forward to 2020, providing that there was no mention of the property sector at the politburo meeting in December. In the latest Central Economic Working Conference, the authority applied a softer tone with the focus on stabilizing property market including "stable land price, property price and expectation" and the need of full implementation of city-specific housing policies. Under a rather mild top-down policy guidance, we see more fine-tuning in local policy, including loosened provident-fund mortgage, home purchase restrictions in selected areas or districts in several tier 2/3 cities (Foshan, Qingdao, Chengdu Tianfu, Guangzhou, Qingyuan, etc.) under the *hukou* scheme. Overall, we expect policy to remain city-specific and adaptive, which would mitigate the downside risks and support the market in 2020.

** Source of charts: Bloomberg, Chinabond.com.cn and Value Partners, 31 December 2019*

2019 is a strong year for China HY property bonds, posting a year-to-date return of 15%. At the current valuation, the sector is trading at 222bps spread pick-up over USHY, and 206bps over the CEMBI HY. The spread for JACI CN Property B versus JACI CN Property BB was standing around 169bps as of the end of 2019, which is at a reasonable level versus the historical average since 2016.

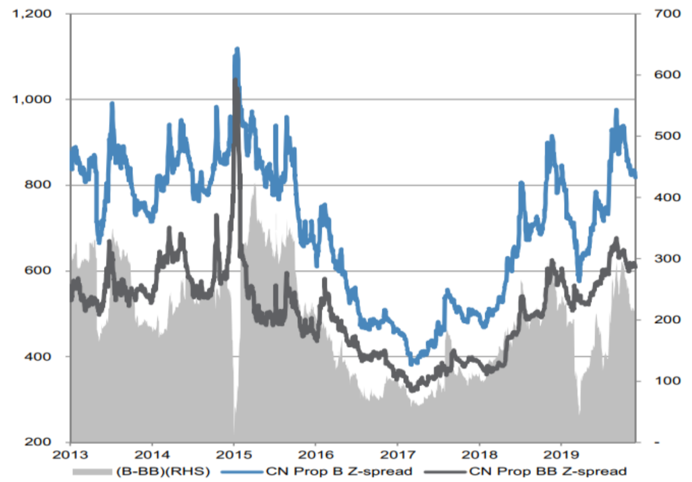
We see net supply of the USD-denominated bonds from the sector to decline notably in 2020 due to the rule changes by the National Development and Reform Commission, giving issuance quota approval to refinance bonds with original maturity longer than one year. The combined effect of a resilient market, more supportive policy stands and strong market technical foster our expectation of the credit spread further tightening in 1Q20. Besides, we continue to see B-rated names to offer better relative value, and the spread between the JACI CN Property B versus the JACI CN Property BB to compress in 1Q20.

Figure 8: Funding cost back on downward trend in ‘20E



Source: Companies, Citi Research

Figure 9: JACI CN Prop B vs JACI CN Prop BB



Source: J.P. Morgan. Data as of Nov 29, 2019.

<u>China Offshore Industrial Bonds Continue to See Credit Events, We See Value in Selective Bonds</u>

China offshore corporate-bond default cases amount to $2.47bn in 2019, data compiled by Bloomberg shows. This batch include seven dollar bonds, one offshore yuan bond and one Hong Kong dollar note. China’s industrial space continued to see credit events in 4Q, and the default trend spread from private-owned enterprises (POE) to state-owned enterprises (SOE). The names include Tewoo Group (TEWOOG) and PK Founder Group (PKFOUN). Late November, TEWOOG, a Tianjin Sasac wholly-controlled SOE, threw a debt-restructuring plan covering four of its offshore dollar bonds totaling USD 1.25bn, in which it proposed to either tender the bonds at discount or to restructure them into new debt securities issued by another local SOE in Tianjin. The plan offers recovery value to investors, in a range between 36% and 67% depending on the tenor of the original bonds. Despite a certain haircut, offshore investors were treated better than those in onshore in this case. In another case, PKFOUN failed to repay one of its onshore short-term commercial paper on time by 2 December, but managed to avoid an official default as onshore bondholders agreed an extension of settlement of the already defaulted onshore CNY 2bn short-term notes to as late as 21 February. PKFOUN has a total principle of USD 1.8bn in outstanding dollar bonds. Its subsidiary, Peking University Resources (FOUIHK) also has an outstanding debt of USD 1.15bn. PKFOUN is controlled by Peking University and has always been considered as a SOE despite the ongoing shareholder dispute between Peking University and minority private shareholder. The potential default news of PKFOUN came as a surprise to the market and we saw some extent of spillover effect to other weak SOEs. In the POE space, Shandong-based companies continued to hit the headlines after Yuhuang being unable to repay its onshore corporate bond on time, triggering cross-default in offshore dollar bonds. Shandong Ruyi, on the other hand, successfully repaid its bonds due 2019, and stimulate market sentiment recovery.

We stay cautious on China’s industrial space in general, as we see continuous tightening on onshore funding for POEs and potentially some weak SOEs. However, we saw trading opportunities coming out from the weak market sentiment and exaggerated volatility. For example, some university bonds were hit, first dipping 30pt and then recovering roughly 20pt in December due to the newsflow of PKFOUN default. Some bonds by Shandong issuers were also down around 10pt in December and rose about 4ppt afterwards. We are selective, seeking only those with solid fundamentals and/or strong shareholders, and less affected by the wider tightening onshore credit market.

** Source of data/charts: Bloomberg, JPMM.com, Citi, Companies, and Value Partners, 31 December 2019*

Credit Default Swap Index

Credit default swap index is a credit derivative used to hedge against credit risk or to take a position of a basket of credit entities, similar to the concept of buying an insurance contract that provide the buyer with a protection against specific risks, such as default, bankruptcy and credit rating downgrade. Unlike its most basic form - credit default swap (CDS), which is an over-the-counter credit derivative, a CDS index is entirely standardized in terms of credit security. It may thus be more liquid and trade at a smaller bid-offer spread. That means it can be cheaper to hedge a portfolio of CDS or bonds with a CDS index than it would be to buy many single-name CDS to achieve a similar outcome. Currently, there are two main families of corporate CDS indices: CDX and iTraxx. CDX indices consist of North American and emerging market companies and are administered by a CDS Index Company, CDSIndexCo and marketed by Markit Group Limited, and iTraxx indices contain companies from the rest of the world and are managed by the International Index Company (IIC), also owned by Markit.

ICE Merrill Lynch Option Volatility Estimate (MOVE)

The MOVE Index is a well-recognized metrics of the U.S. interest rate volatility that tracks the movement in U.S. Treasury yield implied volatility reflected by the current prices of one-month over-the-counter options on two-year, five-year, 10-year and 30-year Treasuries. According to various research, the MOVE Index has historically provided strong signals inferring the Fed's monetary policy path. Historically, insurance cuts (i.e. rate reductions in 1995 and 1998) the MOVE peaked right before or shortly after the initial Fed action and then trending lower—indicating that the cut had delivered the desired calming effect. In contrast, the MOVE remained elevated for an extended period after the first rate reduction in an easing cycle that led into a recession, such as in 2001 and 2007.

Figure 10: MOVE Index & Fed Fund Rate

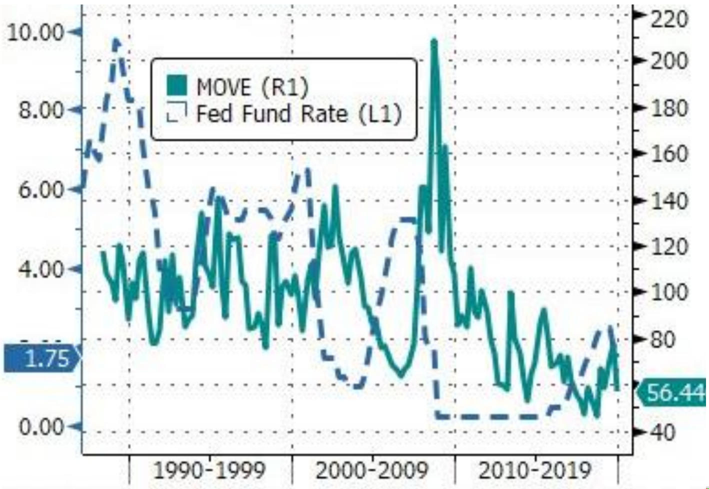
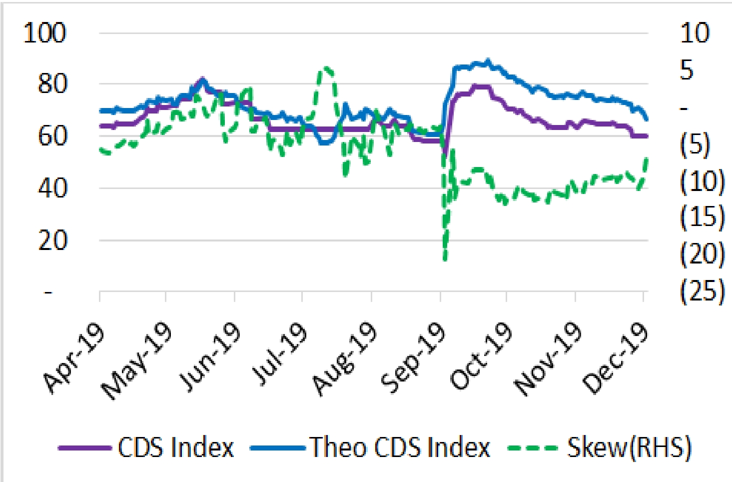


Figure 11: Illustrated CDS Index and its Skew



Skew of CDS Indices

While the skew of the CDS index is often discussed in the context of skew trading, we would like to bring up here both the dynamics behind skew trading and skew from a forward looking perspective. Skew is the differentials between a CDS index and the intrinsic value of the index based on underlying constituents. Skew arbitrageurs exist and bet on the relative illiquidity in some of the underlying individual names compared to the CDS index as well as the different end-users and thus resulting in different dynamics. Indices are widely used as macro hedges and for taking directional positions, often by institutions that do not trade single names. Strong liquidity makes index an attractive tool for the activity. Market participants sometimes believe that high demand in CDS indices would result in negative skew (See Figure 11) which implies an anticipation in widening credit spread. Back in the beginning of 2017, skew of the Markit iTraxx Europe turned positive after staying in the negative territory for most of 2015 and 2016. And subsequently, we saw the iTraxx Europe tightened from 70bps to as low as 43bps.

** Source of data/charts: Bloomberg and Value Partners, 31 December 2019*

GDP Forecast	19	20	21
Argentina	-2.8	-1.7	1.5
Australia	1.8	2.2	2.5
Brazil	1.0	2.2	2.5
China	6.1	5.9	5.8
India	5.5	5.1	6.2
Indonesia	5.0	5.0	5.3
Japan	0.9	0.3	0.8
Malaysia	4.5	4.3	4.5
Mexico	0.0	1.1	1.8
Russia	1.2	1.7	1.9
South Africa	0.4	1.1	1.4
South Korea	1.9	2.2	2.3
Thailand	2.5	3.0	3.3
Turkey	0.2	2.6	3.1

Bond Indices	Latest	QTD	YTD
China Corp HY	1,375	1.7%	12.8%
JPM JACI Core	243	0.9%	13.0%
JPM EMBI	945	1.8%	15.0%
JPM CEMBI	351	2.2%	13.1%

Commodities	Latest	QTD	YTD
Gold ($/Oz)	1,517	3.1%	18.3%
Silver ($/Oz)	18	5.1%	15.3%
Platinum ($/Oz)	966	9.4%	21.4%
Copper ($)	6,196	8.8%	4.2%
Aluminum ($)	1,800	5.8%	-3.4%
Iron Ore 62% Fe	90	-1.8%	27.9%
China Coking Coal	2,130	-4.5%	-15.8%
DOE Met Coal	149	4.7%	17.9%
Qinhuangdao Coal	550	-5.5%	-5.2%
Newcastle Coal	65	-2.8%	-36.0%
Brent	66	14.7%	19.0%
HenryHub Nat Gas	2.1	2.0%	-35.7%
Zinc	2,312	-4.8%	-8.2%
Nickel	14,237	-17.3%	34.3%
M'sian Palm Oil	3,016	50.0%	54.4%
Malaysian Rubber	593	9.9%	13.4%
Sugar (cts/lb)	2,930	-5.2%	-1.0%
Argentina Corn	175	12.9%	1.7%
Colombian Coffee	7,797	14.4%	34.7%

5Y CDS	Latest	QTD	YTD
Argentina	3,316	-747	2512
Australia	16	-5	-9
Brazil	99	-41	-111
China	31	-17	-35
Indonesia	63	-29	-75
India	63	-8	-45
Malaysia	35	-18	-75
Mexico	79	-39	-77
Russia	55	-31	-98
South Africa	163	-30	-60
Thailand	24	-7	-22
Turkey	282	-76	-79

Equity Indices	Latest	QTD	YTD
Shanghai Index	3,050	5.0%	25.3%
Hang Seng Index	28,190	8.4%	13.0%
MSCI Ex-Japan	691	12.1%	18.7%
MSCI Emerging	1,118	12.1%	19.0%

FX	Latest	QTD	YTD
USDCNY	6.96	-2.6%	1.3%
USDHKD	7.79	-0.6%	-0.5%
USDJPY	109	0.5%	-0.9%
USDKRW	1,156	3.6%	3.6%
USDAUD	1.43	-3.7%	0.5%
USDINR	71.4	0.7%	2.3%
USDIDR	13,866	-2.3%	-3.6%
USDTHB	30.0	-7.9%	-7.9%
USDTRY	5.95	5.3%	12.5%
USDBRL	4.03	-3.0%	4.0%
USDMXN	18.9	-4.0%	-3.6%
USDARS	59.9	4.0%	58.9%

Interest Rates	Latest	QTD	YTD
UST 3M	1.91%	-0.18%	-0.90%
UST 2Y	1.57%	-0.05%	-0.92%
UST 10Y	1.92%	0.25%	-0.77%
UST 30Y	2.39%	0.28%	-0.62%
CHINA 3M	2.41%	0.08%	-0.42%
CHINA 2Y	2.63%	-0.05%	-0.13%
CHINA 10Y	3.14%	0.00%	-0.17%
CHINA 30Y	3.71%	0.00%	-0.13%

** Source of data/charts: Bloomberg and Value Partners, 31 December 2019*