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Fixed Income Investment Outlook

Executive Summary

US: Retaining a tightening bias post rate skip in June

The US Fed paused its interest rate hikes in June, ending a series of 10 consecutive rate increases since March 2022. This should allow the central bank to consider the cumulative effect of monetary tightening on the economy. However, a slowing but still elevated inflation will unlikely derail the Fed's tightening tone and does not preclude the Fed from resuming rate hikes later.

While US job and inflation data remain stubbornly high, we are mindful that they have started showing some signs of weakness. This may mean the path and timing of near-term rate hikes would be more unpredictable. In any case, we believe the massive monetary tightening, tighter credit conditions, and a softening labor market will weigh on the US economy and its growth outlook. Against this backdrop, we expect the US treasury yield to trend lower in the medium term.

China: Refocusing on policy fine-tuning after a transitory rebound faded

While the removal of Covid-related lockdowns and pent-up demand supported GDP growth in the first quarter of this year, economic momentum has moderated, and the property market remains sluggish. In addition, the financial health of local governments has attracted the attention of investors, given the sizeable year-on-year contraction in land sales, which is the biggest revenue source for many local governments. Deflation risks may heighten if economic activities and confidence fail to pick up. The slower growth trajectory has raised the possibility of further policy easing before and during the July Politburo meeting.

We expect the policy tone to remain supportive, but will be more targeted toward consumption. Monetary policies should stay accommodative to maintain a broadly stable liquidity environment. Other than the deposit rate cut and LPR cut in June, there could be further RRR and policy rate cuts. While the breadth and magnitude of rate cuts are developing, the government must balance their unwanted impacts on capital outflows, currency depreciation and banks' financial health. Policy banks may also be called upon to support infrastructure investment and local governments. On the property front, further mobilization of the existing policies is likely, including the relaxation of home purchase restrictions and down payments or fine-tuning of financing rules introduced in late 2022. These might boost sentiment in the short term, but a major massive shift in the current economic and property policy remains unlikely.

Credit Strategy

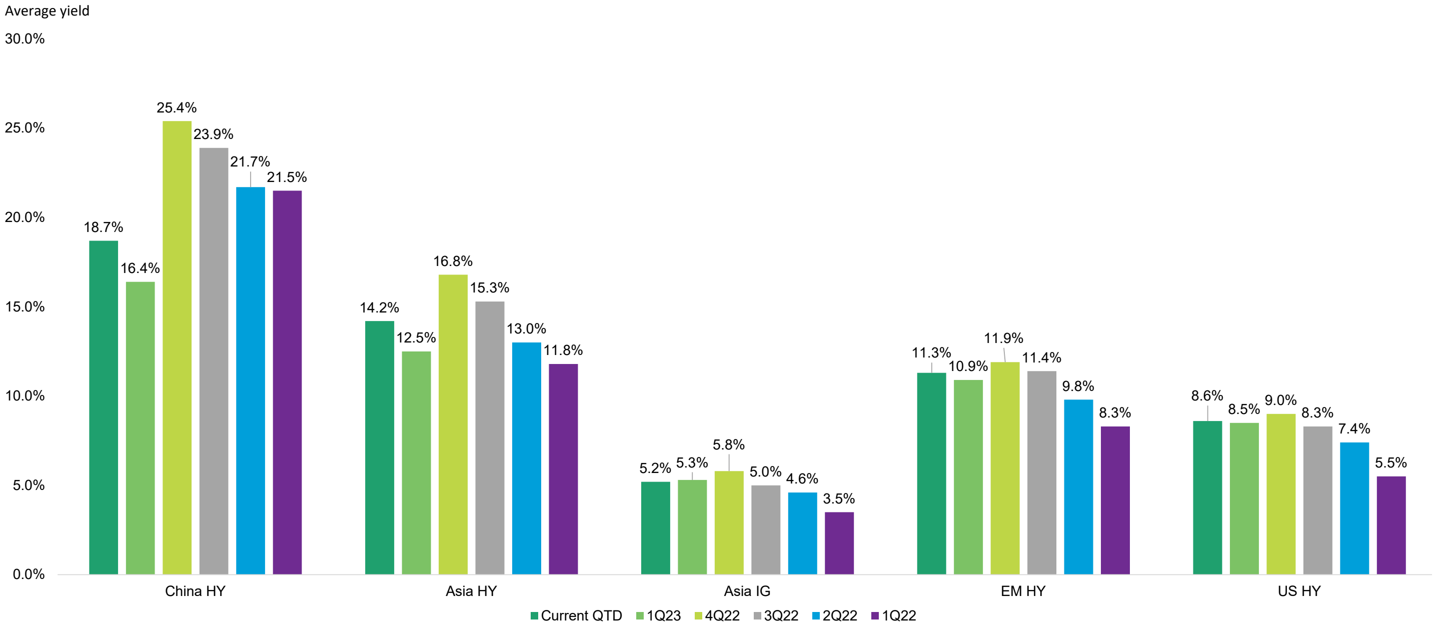
We remain cautious given ongoing challenges on the macro front, including periods of volatility, US recession risks, tightening liquidity, continuing geopolitical concerns, and China's patchy growth recovery.

After the rally in Asian US dollar bonds during the first quarter following China's reopening and policy pivot towards the property sector, sentiment waned due to weakening economic data in China. That said, looking beyond the second quarter, we expect Asia's overall economic recovery to remain on an improving path, given the region's resilient domestic demand. China's recovery trajectory should be on track, led by consumption, despite the short-to-medium-term economic uncertainties. Moreover, inflation in Asia continues to ease, which is an encouraging sign and may create room for policy easing in certain markets, such as Korea and India. On the other hand, we remain mindful of various risks, including the global economic slowdown, which could pose headwinds to the region's export outlook, as well as China's lagging growth – especially in the property sector – which may take some time to recover.

The fundamentals of Asia and China investment grade (IG) bond issuers are on solid footing. Their net bond issuance have remained at a lower level, given the high US interest rates, and they have low default risks. On the Asia high yield (HY) front, the credit quality of bond issuers has stabilized following the correction in the credit and property cycle. The pace and breadth of earnings and cash flow recovery remain our key focus. Those with better credit quality are turning to domestic banks and bond markets for refinancing needs.

Peaking inflation and US rates and the limited bond supply shall underpin bond technicals in the Asia bond market. Asia IG bonds are yielding around 5% and mostly reflect US treasury yields. That should help cushion any impact on credit spread widening. Short-end Asia IG bonds remain in a sweet spot, given their attractive all-in yield and stable total returns. Meanwhile, Asia and China HY bond yields surged in the second quarter due to China's weak economic data. A surge in yield for the second quarter put Asia and China HY valuations reasonably compelling relative to their peers (Figure 1). On the Chinese property front, which accounts for 10% of Asia HY, we note that the physical property market in the country will take time to heal, given sluggish land sales and confidence trap. We expect some signs of improvement to occur gradually in 2024. For Chinese non-property sectors, we believe select issuers remain beneficiaries when consumer demand restores.

Figure 1: Asia HY bond yield trended higher on slower growth in China



Source: JP Morgan Asia Credit Index, Bloomberg Index; as of June 2023

Overall, bottom-up selection and sector diversification remain crucial, given the patchy growth in China and the divergence of credit quality. We continue to adopt a more cautious view of the speed of a fundamental turnaround in China and maintain our strategy of diversifying our exposure into India, Indonesia, Hong Kong and Macau. We also prefer light-duration positioning, given the Fed's expected hawkish tone due to the persistently strong inflation/job data. That said, we see some room to gradually add duration in the medium term as US interest rates peak. In terms of total returns, the JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and High Yield ("Asia HY Index") generated 3.5% and 2.2%, respectively, up to mid-June.

Sector Views

Onshore China

The 10-year China Government Bond (CGB) yield dropped by 30 bps to 2.6% since March (as of mid-June, -18bps since the beginning of 2023) due to the country's weaker growth momentum. Meanwhile, the 25% decline in local government land sales since the start of the year suggests stress has been building up. Local government financing vehicle (LGFV) debt roughly accounted for 13% of Chinese banks' total assets as of Dec'22. However, we believe this should not pose systemic risks to banks as the central government will likely channel more support, though some loan restructuring cannot be ruled out with the banks' non-performing loan (NPL) risks to be spread out in future years. Property and consumption activities also lack strength. Given this backdrop, we expect CGB yields will moderate and maintain at current levels. The yield level may move higher towards the fourth quarter, but that is also a function of reaction to policies and a sustainable demand recovery.

The lowered deposit rates and the policy rate cut in June suggested the government is concerned about an economic slowdown and deflationary pressures. Further easing will likely push the local currency weaker. For most of the first half this year, yields of the 5-year CGB (-68 to -166 bps) or the 10-year CGB (-44 to -118 bps) were inside that of US treasury yield, given the Fed's hawkish stance. Depending on China's policy response, a further rate cut may see the possibility of the 10-year CGB yield testing the 2020 lows at 2.4%. This could prolong the trend of a wider yield gap against the US.

Asia Investment Grade

Asia IG index credit spreads were mostly stable (as of mid-June, -5bps to 174bps since the beginning of 2023). We believe spreads will be sideways or on a slightly widening bias in the second half of the year due to macro headwinds. Nonetheless, Asia IG bonds should offer defensiveness, especially for short-end bonds, which remain in a sweet spot with an attractive all-in yield. The Asia IG Index generated 3.5% in total returns up to mid-June. Consolidation in US treasury yield stands as the main driver of performance in 2023 and beyond, as we believe credit spreads will stay flat.

We believe most central banks in Asia will strive to avoid "overtightening" in taming inflation. The higher dollar funding costs should have a manageable impact on Asia IG corporates. These corporates can tap alternative funding from onshore markets where bond yields have fallen. This, together with low fallen angel risks and limited bond supply, should bode well for Asia IG to remain resilient in 2023.

Overall, the rising odds of a US recession plus disinflationary trends should provide a more constructive backdrop for IG bonds and duration. The Asia IG index's credit spreads were nonetheless tight at 1.2x against the US, leading us to take a neutral view. The potential US spread widening, ongoing US-China trade tensions, and China's tightening industry regulations in the TMT space will remain key pressure points for Asia IG bonds' credit spreads.

China Property

The China high yield property sector posted negative returns up to mid-June due to sluggish property sales and weak demand. The sector exhibited some early signals of improvement in the first quarter but faded in April due to the broad-based confidence weakness. This backdrop prompts higher expectations of more policy easing, which is expected to involve releasing home purchase restrictions in higher-tier cities, reducing down payments, and others. In our view, the government will likely maintain a supportive tone rather than aggressively stimulate the sector. As home delivery and social security remain the government's top priority, we believe demand-side easing is more imminent as expectations of income growth and job security are prerequisites for a sustainable sales recovery.

Nationwide property sales value improved 12% YoY to RMB4.5 trillion during the first five months of 2023, but the trend of polarization between SOE and POE developers persists, with the latter posting a 24% YoY decline. We remain cautious about a POE sales turnaround, given limited land acquisitions on tight funding, lower new supply, and subdued demand. During the same period, new starts continued to fall by 23% YoY on constrained land acquisitions, lower sell-through rate, and more resources devoted to project completion (+20% YoY). For the second half of this year, we expect POE developers' business scale and balance sheets to shrink on low land capex with a focus on debt retirement. SOEs are expected to gain more market share as they continue to have access to funding and strong financing support.

We believe select POE developers should survive the downturn after rounds of de-capacity and deleveraging. In addition, they would be key beneficiaries of the potential demand recovery and remain our preference. Nevertheless, we exert cautiousness in this space and require ongoing evidence on a more sustained recovery for both property sales and developers' financing capability.

Macau Gaming

Macau gaming bonds provided steady returns of 3.8% during the first five months of 2023. Gaming operators benefitted from China's reopening, resulting in a strong recovery in gross gaming revenue (GGR). Overall GGR was at MOP35 billion for the first quarter, or 45% of 2019 levels, and further improved to 52% as of the end of May. In particular, mass GGR recovered strongly to about 70% of 2019 levels during the first quarter, exceeding most expectations, and further improved to 85% as of the end of May. This shall underpin operators' credit profiles in terms of EBITDA growth (as most of their operating expenses are fixed in nature) and cash flow generation, which supports deleveraging and improves their credit outlook in the medium term.

Heading into the second half of this year, while we expect Macau visitations and GGR to moderate, the trend should point to a recovery path, given more hotel supply and better seasonality. In addition, the National Immigration Administration of China announced in May that it would further optimize immigration policies. The move should support group travel, which exhibited a slower pace, versus the Mainland's individual visit scheme (IVS), which allows travelers from Mainland China to visit Hong Kong and Macau.

We believe that while current market valuations have priced in a fundamental recovery, the sector remains to have good carry and a diversification play. The overall low supply of China-related HY bonds also supports the sector's technicals.

Indian and Indonesian corporates

Bond valuations for Indian corporates are on the rich side relative to US HY. The fundamental profile of Indian renewables shall remain stable, taking into account their large and diversified portfolios, strong sponsors, improving receivable days, and ongoing access to onshore funding. Nonetheless, they may be exposed to risks of credit spread widening, considering US recession risks and ongoing rates volatility. We believe there are opportunities in this space if credit spreads widen.

Indonesian bond performance was largely stable, with manageable refinancing risks and diversification benefits. The macro picture is improving, with a fiscal surplus and manageable inflation. Bank of Indonesia's emphasis on currency stability should avoid a volatile move in IDR. Property developers shall benefit from launches, which are back-loaded into the second half of 2023, and friendly mortgage rates. Commodity players remain defensive with low-cost positions, strong liquidity, and limited bond refinancing risks. We are closely monitoring the weaker demand from China that is weighing on commodity prices. Given the resilient macro backdrop, we expect Indonesia HY bonds to be well supported into 2023.

Data sources are attributed to Bloomberg unless specified.

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