Fixed Income Outlook 1Q 2022

Value Partners
Investing through discipline

Executive Summary: A step forward in policy fine-tuning

U.S. entering a tightening cycle; volatility remains

Inflation in the U.S. and the pace of Fed's rate hikes will likely create more volatility heading into 2022. Market expectations on U.S. inflation may shift with spending rotation between goods and services, supply chain disruptions and labor market bottlenecks. Covid waves could pivot those expectations from time to time. Given that inflation is now above the 2% target, coupled with the tight labor market and growth moderating (2021: 5.6% YoY real GDP, 2022E: 3.8%, Bloomberg consensus), we view that we are heading towards a path for policy normalization.

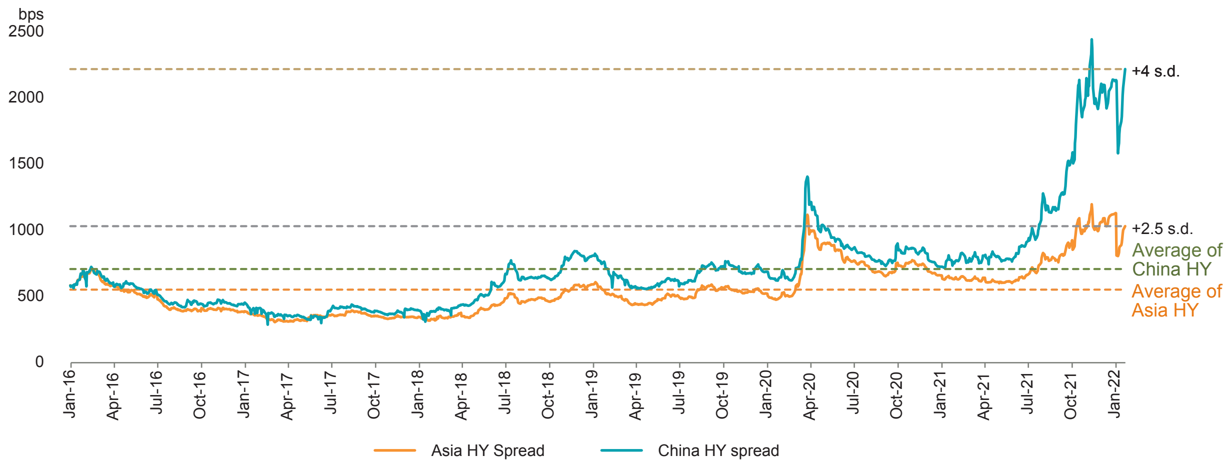
We believe a hawkish Fed tone will remain in 1H22 and market volatility may stay elevated for a sharper normalization path. The market is now pricing in four to five rate hikes by end-2022, with the first one to commence in March along with balance sheet runoff. That said, the market, as always, will react ahead of the Fed and may turn towards a more sanguine policy path as we move through the year. We are mindful of liquidity tightening and growth slowing to coincide in 2H22. As the market runs ahead to price in rate hikes, we expect the 10-year U.S. Treasury yield should march a tad higher from current level (1.9% as we wrote) in 1Q22.

China's policy fine-tuning to support growth and sentiment

Pandemic restrictions have been taking a toll on China's activities. 4Q21 saw depressing retail sales and sluggish property sales. Although exports were strong on global demand recovery, domestic infrastructure investment lagged. The National People's Congress ("NPC") that will commence in early March may set the "above 5%" growth target and policymakers will step up on easing efforts. These may include front-loaded special local government bond issuance, property easing and monetary relaxation. While China's GDP growth is likely to slow sequentially in 1Q22 (2021: 8.1% YoY real GDP, 2022E: 5.2%, Bloomberg consensus), we expect it to bounce back in 2H22 on further consumption rebound and pick up in property sales.

We retain our view that credit contraction has bottomed out and credit demand would improve, but with a lag. Nevertheless, this should support sentiment towards China's credit market. Within the property sector, there were some signs of coordinated policy relaxation, including eased control on mortgage and developers' financing since late last year. Recently, the potential relaxation in restricted presale funds has also given the sector a relief rally. We expect more property easing to come, but will unlikely to be an aggressive stimulus that we saw in the 2015/16 cycle.

Figure 1: China HY credit spreads priced in regulatory risks

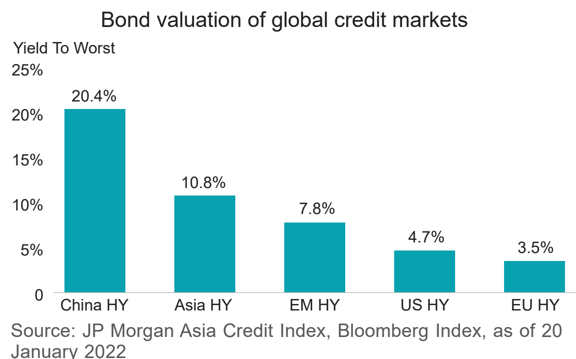


Source: JP Morgan Asia Credit Index, Bloomberg Index, as of 20 January 2022

We are closely monitoring idiosyncratic risks in the China property sector and favor credit quality in 2022, as further constructive policy adjustments are widely expected by the market and credit polarization is likely to stay. In particular, we look for signs of improvement in China's physical property market, property price movements, as well as developers' liquidity situation versus their maturity walls.

We prefer to hide behind shorter duration bonds to fend off rising rates, which will be a pressure point for Asia investment grade ("Asia IG"), especially when credit spreads are tight. Asia high yield ("Asia HY") ex-China credit spreads should remain resilient given the skew on consumers, utilities and commodities. Their bond valuations tend to be on the tight end but should provide diversification benefits. China high yield ("China HY") credit spreads priced in a lot of the policy risks and sector consolidation, and valuations are undemanding (Figures 1 & 2). Through our active management and bottom-up approach, we stick with credit names in the China HY sector with manageable near-term maturities as we remain cautious on idiosyncratic risks.

Figure 2: Value dislocation in China HY bonds



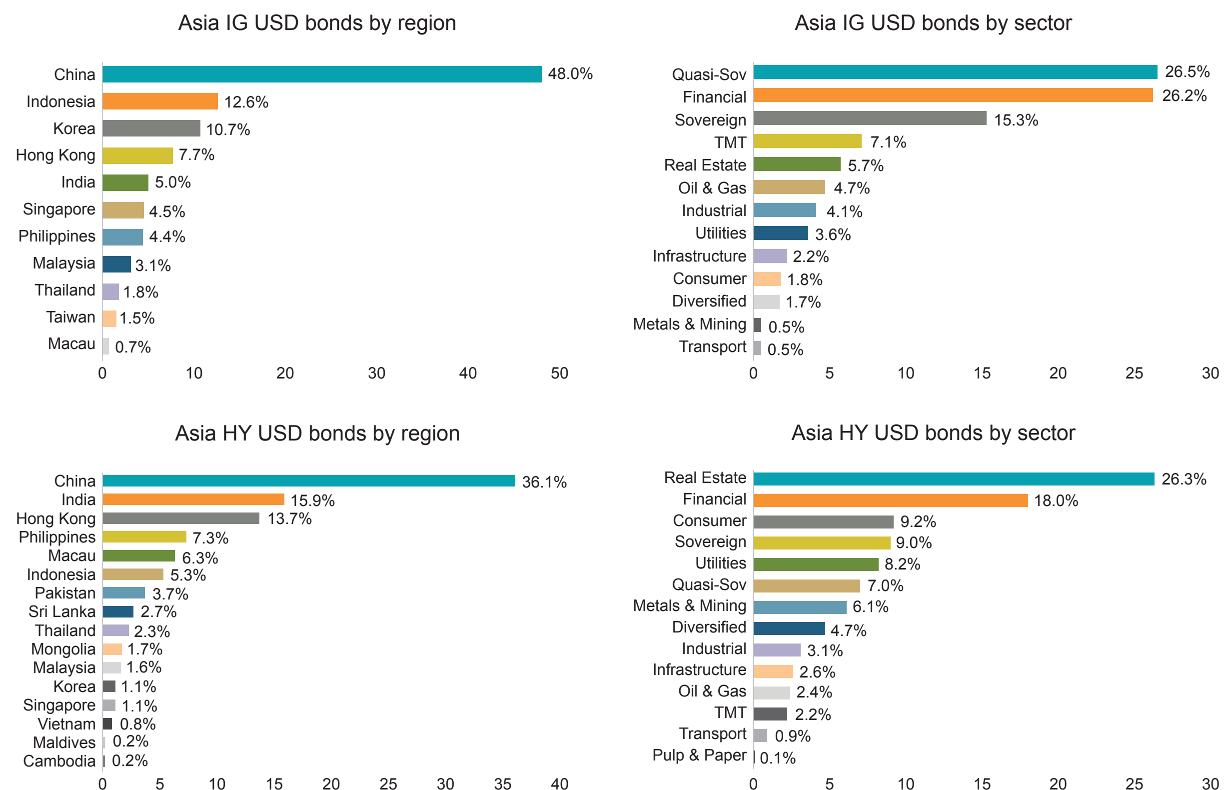
Source: JP Morgan Asia Credit Index, Bloomberg Index, as of 20 January 2022

Asian bond performance

In 4Q21, credit spreads of the JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") tightened 6bps to 179bps, while the Asia Credit Index High Yield ("Asia HY Index") widened 270bps to 910bps on more idiosyncratic events. The Asia HY Index performed -6.8% of total returns during the quarter, underperforming the Asia IG Index's 0.1% performance. Within Asia HY, perpetual bonds, commodities and utilities outperformed real estate on China's tightening and a rising default trend.

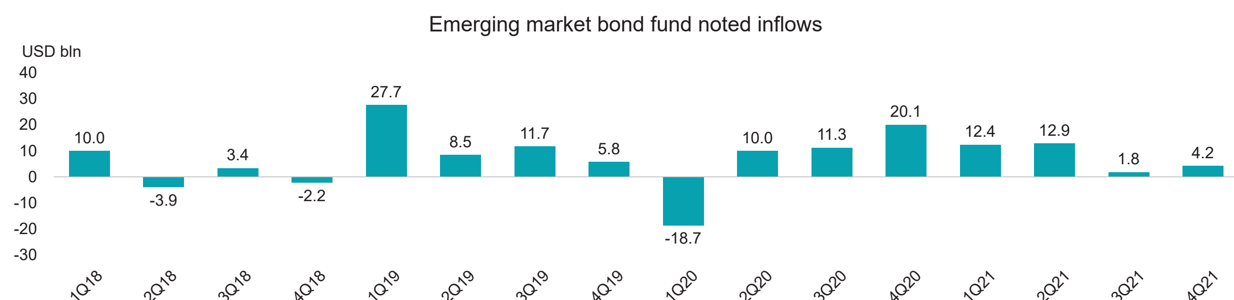
On the country level, China (in the JP Morgan Asia Credit Index or "JACI Composite Index"), underperformed (-3.1%/-5.8% in 4Q21/2021, 46.2% weighting) on higher regulatory risks and weakness in the property sector. Indonesia fared better (+1.3%/+0.6% in 4Q21/2021, 11.3% weighting) than India (+0.7%/+3.6% in 4Q21/2021, 7% weighting) in 4Q21, but lagged for the full-year 2021 due to a higher proportion of longer-dated bonds negatively impacted by the U.S. rates move. Cheapened bond valuations, the need for diversification (Figure 3) and expectations of a modest recovery in China's property sector should lure fund flows to Asia credits, in our view. Demand for Asia bonds remained intact in 2021 (Figure 4) due to fund inflows despite higher volatility and redemption pressure in the China property space.

Figure 3: Diversification of Asia bond market



Source: JP Morgan Asia Credit Index, as of 18 January 2022

Figure 4: Steady fund flows within the emerging market bond market



Source: EPFR data, as of December 2021

Sector views

Onshore china bond

The 10-year China Government Bond ("CGB") yield flattened 40bps to 2.8% at end-2021 on rising concerns about growth moderating, especially in the second half when the low base effect from 2020 faded away, coupled with the power crunch and sluggish property sales. The rising yield from end-September to mid-October reflected worries on domestic inflation and rising U.S. yields. However, a series of signals released since mid-October indicates the government's pledge to stabilize growth, which drove the yield level lower until now. Net-net, the 10-year CGB yield further flattened 9bps in 4Q21. In 2021, People's Bank of China ("PBOC") also cut the RRR twice – in July and December – each by 50bps. We expect China to proactively pursue an accommodative monetary policy that is conducive to economic stability.

We believe that the PBOC will pursue another round of RRR cuts and maintain a loosening liquidity environment in 1H22. The 10-year CGB yield (2.7% as we wrote) may bottom in 1Q22 as growth improves from 2Q22, with credit contraction bottoming. These should drive yields higher towards the year-end. Risks to this view could be that growth stabilization is harder to accomplish amid Covid disruptions and regulatory changes. The pledge for growth stability and the latest easing by China, as opposed to the tightening path that the U.S. is embarking on, has seen the U.S.-China yield differential to converge further at 80bps currently, versus over 200bps at the start of 2021. Having said that, we believe foreign funds participation in China's bond market should remain robust.

The onshore corporate bond market continued to witness credit differentiation. The government reiterated the tone on curbing implicit debt of local governments and local government financing vehicles ("LGFVs") faced more constraints on refinancing. Hence, we believe default risks are accelerating for weaker LGFV names with sizable debt maturity.

Asia investment grade bond

Asia IG returned +0.1% in the 4Q21 and flat for the full-year 2021. Spread compression (-35bps for 2021) and coupon returns were largely offset by the United States Treasury ("UST") rates move. China IG spreads were widest in 2Q21 due to heightened concerns on Huarong and regulatory changes on historically defensive Technology, Media & Telecommunication ("TMT") and energy sectors. Spreads closed tighter by end-2021 post-bailout of Huarong, Haohua' rating upgrade and manageable fallen angel risks. Outside of China, India became under the spotlight as Moody's changed its sovereign rating to stable from negative, on the back of the country's strong recovery and limited impact on the financial system from the two pandemic waves.

Overall, rising UST yields would remain key pressure points for Asian IG bonds. Although fundamentals of most Asian IG corporates should remain resilient and we expect fewer "policy shocks" in China when compared to 2021, we do not find valuations appealing given the tight credit spreads. We stay underweight duration in this space.

China property bond

We believe 1Q/1H22 will remain a challenging period for the sector given a potential decline in contracted sales growth in 1Q/1H22 (flat in FY21, Figure 5), weaker earnings in FY21, the lower gross profit margin driven by the cut in property prices, as well as the sizable maturity wall. We expect more constructive policy fine-tuning to happen after the NPC meeting in March. Given these factors, we believe credit quality remains key in our bond selection.

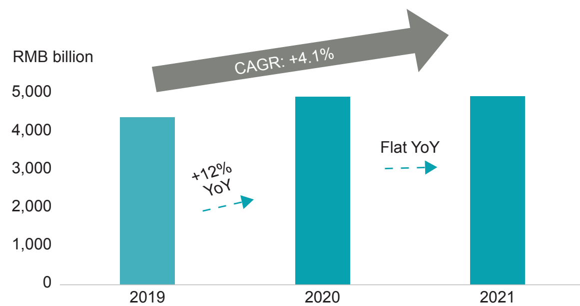
In our view, a sluggish set of FY21 results should be priced in bond valuations, given the fall in earnings, weaker profitability and reduced cash levels. Market volatility will, however, stay high on much weaker-than-expected contracted sales going forward (slowdown was apparent in 2H21, Figure 6), negative surprises on audit-related issues for FY21 results and more debt exchanges. The implementation of property tax may occur in 2022 and that may impact buyers' sentiment.

Notably, the sector reacted positively to a top-level policy tone shift during the Politburo meeting in December, followed by some easing measures, including the relaxation of mortgage approvals and the encouragement of project-level M&A loans by state-owned or high-quality developers (which are also to be excluded from the "three red lines" calculation).

Further measures that the market expects include the potential relaxation of restricted funds under escrow presale accounts. We believe any such relaxation will tend to differ by region (those with tighter rules will be subject to some moderation), and the focus on timely project delivery, especially in lower-tiered cities, will remain a top priority after the collapse of Evergrande. Overall, since it takes time to execute easing measures, it may take three to six months to have some positive impact on the physical property market. In the longer run, we expect that developers that will manage to survive should benefit from taking in more market share on further shrinkage in the sector.

Figure 5: Muted growth in 2021 contracted sales

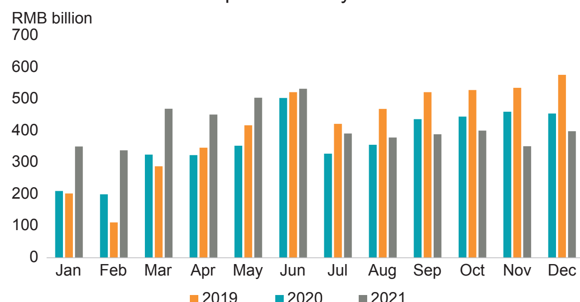
Chinese developers' contracted sales flattish in 2021



Source: Company data from 30 listed Chinese developers, as of December 2021

Figure 6: Monthly contracted sales

Chinese developers' monthly contracted sales

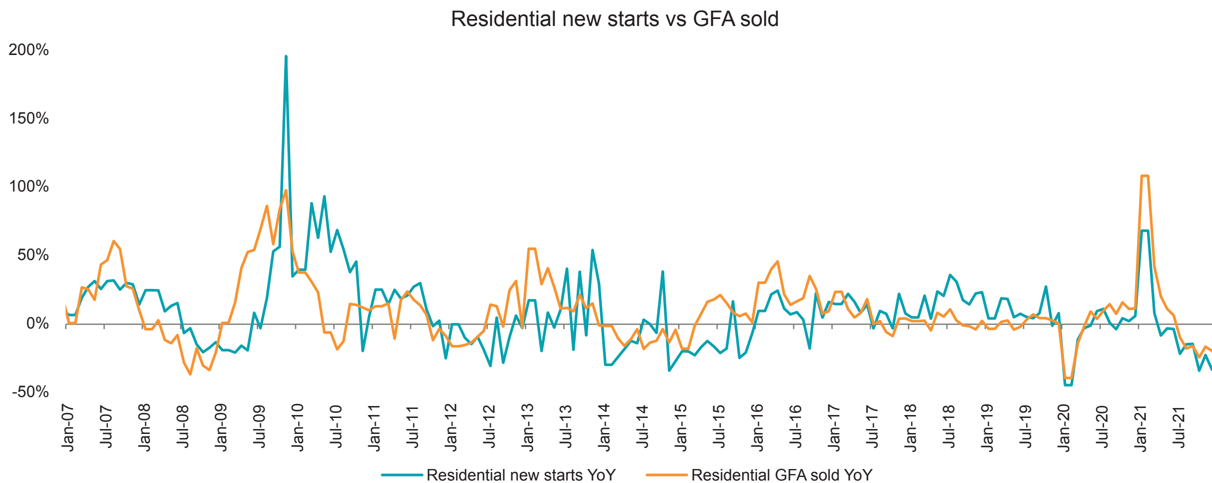


Source: Company data from 30 listed Chinese developers, as of December 2021

The high yield real estate sector returned -18.3% in 4Q21 (-32% for the full-year 2021) on policy and higher default risks. We believe the sector has priced in a lot of the downside risks with no policy easing. As credit differentiation continues to play out, we have a preference for developers that have lower near-term refinancing needs and a relatively better landbank life as land acquisitions tend to slow in coming quarters. For the 20 key developers that we closely monitor, we estimate that they will have peak onshore and offshore bond/ loan refinancing needs in March and April this year, of the amount of USD5.6 billion and USD6.3 billion, respectively, before fading to USD1.9 billion and USD2.8 billion in May and June. The level will accelerate in July through August, hence, refinancing pressure remains heavy. We underweight those off-benchmark developers with heavy reliance on the offshore bond market and short landbank life.

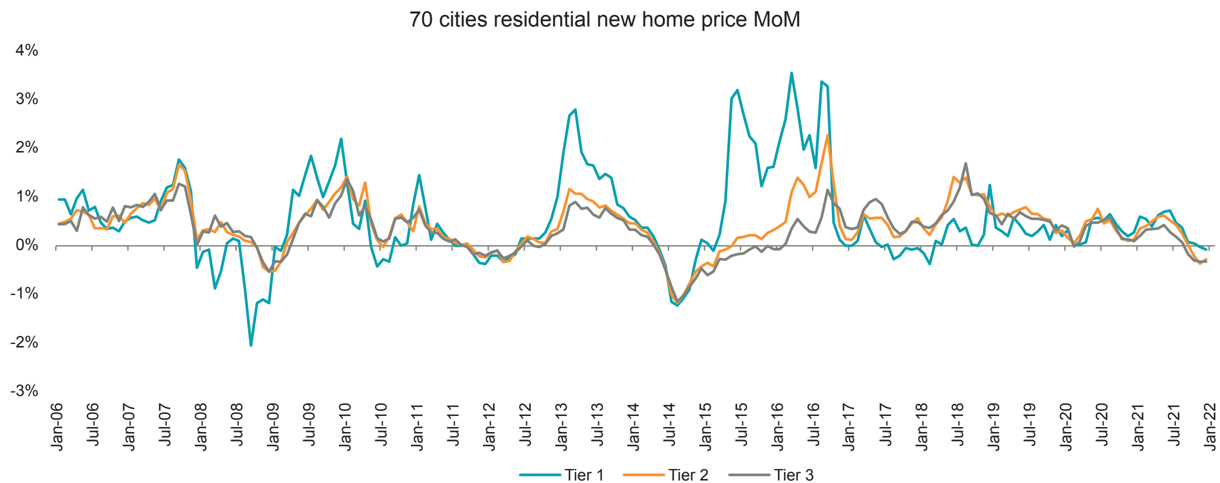
The value of new home sales reached its peak in 2021 (Figure 7) and we expect the level to drop c10-15% YoY in 2022. The drop in sales would likely be more notable at 20-30% YoY in 1H22 due to high base, current weak sales run-rate and fewer new project launches amidst falling new starts in 2H21-1H22. Stabilization of sales should start to emerge in 2H22, with a low base and the impact of policy easing starts to kick in. Given developers' liquidity pressure remains and more pricing incentives are needed, we expect national property price to drop further in 2022, taking reference from last downturn in 2014/15 (Figure 8). More failed land auctions will also imply new starts to decline in 1H22 and the drop will narrow marginally in 2H22 on pick-up in property sales.

Figure 7: Residential sales reached peak level in 2021



Source: UBS research, as of 26 January 2022

Figure 8: Property prices declined since 2H21



Source: UBS research, as of 26 January 2022

Macau gaming bond

Macau gaming bonds returned -2.0% in 4Q21 (-2.8% for the full-year 2021). The sector underperformed on the government's clampdown on junket operators and broader weakness across China high yield sector. For 2021, gross gaming revenue stood at 30% of the pre-Covid level.

The regulatory overhang, however, has reduced after the release of the proposed gaming law revisions in mid-January 2022. The government proposes a maximum of six gaming licenses with and license duration of 10 years (plus a maximum extension of three years). The recent clarifications on no change in tax rate and no requirement of government representatives on the board of casino operators are also taken positively by the market. The next event to watch will be the public re-tendering of concessions. This process may take longer than the concession expiry date in June 2022. Nonetheless, we expect there could be a short period of license extension to current operators until the public bidding completes.

Heading into 2022, we believe the opening of Macau's borders will remain the key catalyst for gaming bonds as the risk of concession non-renewal is considered low. Despite most operators having maintained sufficient liquidity buffer in the next 12-18 months, the border situation is critical for operators' earnings recovery and maintaining their current credit rating. The sector is a diversification play within China HY sector. We see some opportunities in the new issuance window as we expect some gaming operators are required to raise funds for capex. Risks to this will be prolonged restrictions on the border crossing and increasing government intervention.

Commodities bond

The metal and mining high yield sector had a decent total return of +1.1% in 4Q21 (+10.8% for the full-year 2021). We see some diversification benefits in this space given commodity prices will stay in 2022. Slower growth in China and property sales may drag on demand in commodities but we believe recent policy easing should support commodity prices in the medium term. Supply concerns are also key in upholding the commodity cycle.

Data sources are attributed to Bloomberg unless specified.

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