Value Partners
Investing through discipline

Fixed Income Investment Outlook 1Q 2023

Executive Summary:

US: Sticky inflation and slowing growth momentum

Strong US job and PMI data have surprised the market on the upside, with the 10-year US treasury yield moving 50 bps higher from early February (7 bps wider YTD). This has led markets to reassess the peak Fed rate and policy path. While a US soft landing or recession scenario remains difficult to pinpoint due to the mixed bag of data, a growth slowdown in the latter part of this year is inevitable, especially after the massive monetary tightening in 2022.

The above trend inflation lingering against the 2% target will likely make the Fed maintain its tightening tone, anchoring the view on slower for longer increases in the Fed funds rates and the terminal rate marginally shifting higher. Fed fund futures currently imply up to 70-75 bps higher rates in the second-third quarter and peak at around 5.3%. With sticky inflation, albeit waning, and a resilient labor market, we maintain our view that the Fed will not opt for prematurely loosening policy in 2023.

China: Reopening paves the way for normalization; response to policy pivot is key

Most high-frequency data indicate much better economic activities in China after it lifted its Covid-related lockdowns. Chinese New Year-related and overall resumption of activities shall partly buoy GDP growth in the first quarter of this year. Sequential YoY growth should recover more notably in the second quarter on further recovery in consumption, services, and the marginal narrowing declines in property sales, plus a low base effect. Macro policies shall support infrastructure investment, as emphasized in the Central Economic Work Conference (CEWC) late last year, though we note the pace may slow as the financial health of local government levels calls into question lower land sales. Export growth will likely moderate amid the global slowdown.

We expect policies to remain supportive in 2023 as the new administration has put emphasis on stabilizing and boosting growth. Some stimulus from the government may come after the National People’s Congress annual session on 4-5 March 2023. Monetary policies should remain accommodative to maintain a broadly stable liquidity environment. The overall positive growth backdrop in China shall stabilize market sentiment.

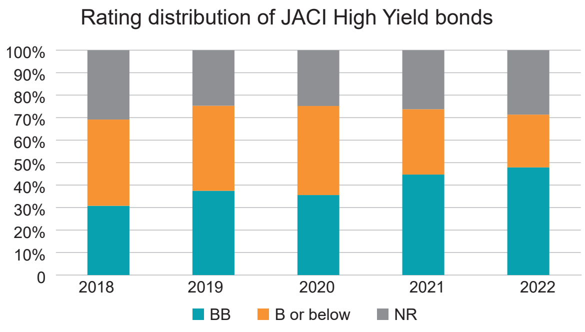
As the reopening theme is largely priced in, we believe the market will gradually shift its focus on further evidence of recovery and, specifically, macroeconomic trends in March and April. We are mindful of policy execution and the pace of property sales recovery as they matter for a fundamental turnaround.

Credit Strategy

Asian US dollar bonds rallied on China's reopening and policy pivot towards the property sector. Asia's overall economic recovery shall remain intact as pandemic threats fade. Reopening in China shall accelerate the recovery in domestic consumption and pent-up demand, which should help boost GDP growth to a more normalized level of around 5.5%, together with an overall supportive tone in both fiscal and monetary policies. The gradual economic rebound in China shall also offset the impact of a potential soft landing in the US.

The fundamentals of Asia and China investment grade (IG) remain on solid footing due to low default and fallen angel risks. The credit quality of Asia high yield (HY) issuers should also stabilize after the correction in the credit and property cycle. Moreover, the Asia HY market is of relatively better credit quality than in prior years, with more constituents in the BB space (accounting for 44% now vs. 30-42% in 2018-21 in Asia HY index bonds, Figure 1).

Figure 1: Proportion of BB rating bucket trended steadily upward in Asia HY index



Source: JP Morgan Asia Credit Index, based on face value; NR bonds included 3.3% of cogard bonds, which has no credit rating at bond issue level.

Despite the yield compression YTD, we believe the absolute yield levels of Asia and China HY credits remain attractive relative to their peers and provide some cushion against adversity (Figure 2). We selectively trimmed some exposure due to their rich valuations and adopted a more cautious view on the speed of a fundamental turnaround. Peak inflation, fading US dollar strength, and limited net financing should support bond technicals.

From a yield perspective, the level of the Asia IG index retreated to about 5.4% from a high of 6.5% yield in November last year, out of which 70% is from the UST yield. This shall help cushion any impact on credit spread widening. Short-end IG bonds remain in a sweet spot on attractive all-in yield and offer decent total returns.

A more apparent improvement in China's physical property market will likely occur in late 2023 and 2024 when developers' funding stress eases and land acquisitions resume. Rounds of supportive measures in November last year on reopening and curbing risks for the property sector are encouraging signs and shall stabilize the credit quality of China issuers in the longer run.

That said, we see challenges ahead on the macro front, including periods of heightened volatility brought about by rates and inflation expectation changes, US soft landing and recession risks, or China's patchy growth recovery. Therefore, we keep our duration neutral and maintain our strategy of diversifying our exposure into India, Indonesia, and Macau. We focus on issuers with manageable refinancing risks throughout our credit selection. Credit spreads may widen under a US slowdown scenario. Nevertheless, value or relative value opportunities may emerge.

In the coming quarters, we believe the market shall also focus on some idiosyncratic events, including the Adani Group fallout in India and binary names in the Chinese property space. That said, we do not see material contagion risks from these events. We are also monitoring some Chinese developers that remain binary when it comes to their upcoming bond repayment. However, most of these risks are factored in.

Asian bond performance

Asia HY was marked with a stellar performance in the fourth quarter of last year on China's policy pivot, including the 20 Covid-related reopening measures and 16 supportive financing policies for the property sector. Credit spreads of the JP Morgan Asia Credit Index High Yield ("Asia HY Index") tightened 284 bps to 994 bps, contributed mainly by China-domiciled bonds in November, while that of JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") was largely flat at around 190 bps. In terms of total returns, the Asia IG Index generated 1.9%, and a notable rebound of 11.3% was seen for the Asia HY Index in the fourth quarter. 2022 closed with a total return of -10%, given the significant move in US rates and -15.1% on the property downturn in China, respectively.

Figure 2: Asia and China HY bond yield attractive compared to peers

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

Sector Views

Onshore China

The 10-year China Government Bond (CGB) yield fluctuated within a narrow range of 30 bps in 2022. It reached the 2022 peak level at 2.95% in early December post-reopening news and finished the fourth quarter at an average of 2.8%. With activities starting to normalize and growth momentum building up, we believe there is room for yields to move higher, or frontloaded, at 3% in the first half of 2023 (more notable YoY impact on GDP in 2Q23 due to low base on Shanghai lockdowns). Nevertheless, we expect the level will likely fluctuate, depending on the speed of economic recovery. The pace of economic growth may start to decelerate in the second half of this year, leading to some moderation in the CGB yield in the same period.

We believe the PBOC will likely exercise caution on policy rate cuts as most central banks stick with a tightening bias at least until the first half of 2023 and given the deprecation pressure on the renminbi. The gradual economic rebound should also reduce the need to cut rates.

For the most part of the second half last year, the 10-year CGB yield was inside that of the US on the Fed's hawkish stance. The CGB yield was 100 bps inside that of the US at the end of 2022 from 115 bps at the year's start. We think it is possible that this yield gap to narrow further, given our base case of a softer growth outlook in the US and hence some retreat in UST yield, plus a potential boost to the CGB yield, as mentioned above.

Asia Investment Grade

Asia IG index credit spreads widened by 50-60 bps in 2022 but tightened 50 bps from the November peak on reopening news. Given the movement YTD (-20 bp), we believe spreads will be sideways or on a slightly widening bias in the first half this year on a weaker-than-expected macro picture. Short-end IG bonds remain in a sweet spot on attractive all-in yield. Asia IG Index generated 1.9% in total returns in the fourth quarter. The key driver of performance in 2023 should mainly come from UST yield consolidation.

Inflationary risks in Asia are under control, and most central banks may strive to avoid "overtightening". Ultimately, higher dollar funding costs should have a manageable impact on Asia IG corporates as they can tap local markets where rates are adjusting higher in a more controlled manner. This, together with low fallen angel risks and limited bond supply, should bode well for the sector to remain resilient in 2023. Credit profiles of China SOEs and China TMT will remain strong, though bond valuations or credit spreads appear modestly rich. That said, SOEs are better positioned to enjoy ongoing funding access and low funding costs, given their strategic importance and policy functions.

Asia IG index credit spreads were 1.39x against the US, compressed from the 1.55x peak in December. We turned neutral after the compression. The risk of a US recession, which may see US IG spreads widen 50-70 bps, the renewed concerns on rising US-China trade tension, and China's tightening regulations will remain key pressure points in this space.

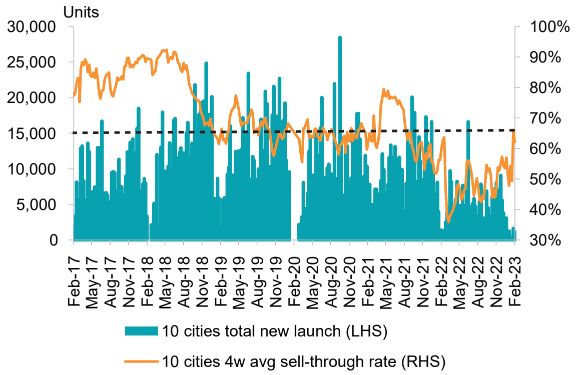
China Property

Asia's real estate sector returned 28.7% in the fourth quarter last year, thanks to a major policy shift in China that drove the outperformance of Chinese property bonds. After the policy shift in November, the property sector in China exhibited some early signals of improvement, including higher sell-through rates (Figure 3) and sales office visitations. The sector had been impacted by tighter policy on developers' financing under the "three red lines" introduced in 2018 and sluggish property sales due to lockdowns. The PBOC and CBIRC's announcement on the 16 financing measures in November set the regulatory tone in facilitating the financing side for developers under the market-based approach. Other financing measures include the CBIC-backed or NAFMII-backed bond financing program, which generally requires collateral from developers. The CEWC also emphasized stability in the sector, while the MOHURD (Ministry of Housing and Urban-Rural Development) has promoted additional measures, such as cutting down-payment ratios and mortgage rates for first-time homebuyers.

The recovery trajectory of the sector will depend on the effectiveness of these measures and the pace of recovery post-relaxation of Covid restrictions. We believe there is still an urgency for the government to ease policies further to revive buyers' confidence and restore developers' financing access in a broader manner.

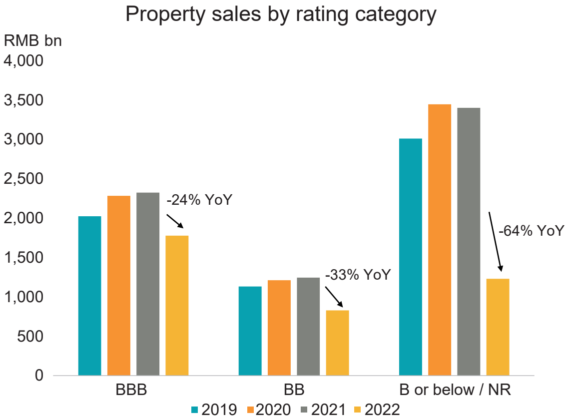
Nationwide property sales declined by 27% YoY to RMB13.3 trillion in 2022 (please also refer to Figure 4 on sales by rating category), mainly driven by a slowdown in GFA sold (-24% YoY) on weak demand, and to a less extent on ASP (Average Selling Price, -3% YoY). This trend should prevail to reflect the retreat of property sales, with a lower new supply in 2023. Nevertheless, the decline YoY should gradually narrow in 2023, given a low base effect and response to supportive policies. New starts shall fall further on constrained land acquisitions. We expect the overall POE business scale will shrink further (32% of national property sales in 2022, from 39-40% in 2019-20) on subdued land acquisitions in 2022, while SOEs will gain more market share, given their continued access to funding and strong support from the government.

Figure 3: Property sell-through rates trended upwards YTD



Source: 4 Tier-1 cities: Beijing, Shanghai, Shenzhen, Guangzhou; 6 Tier-2 cities: Chengdu, Chongqing, Hangzhou, Nanjing, Tianjin, Wuhan, Citi equity research

Figure 4: Differentiation in the slowdown of property sales



Source: Company data from 36 Chinese developers

Given the policy directives so far, we believe select POE developers should survive the downturn after rounds of de-capacity and deleveraging. We need to see these financing measures prove to be effective and timely in helping developers meet their upcoming bond maturities (both onshore and offshore). In the meantime, supportive measures for the demand side and better macro expectations shall lift property sales, though this will take time. Nevertheless, we believe select POE developers would remain key beneficiaries of future easing policies and remain our preference. Some marginal players will still run the risk of debt exchange as sales recovery remains challenging and financial flexibility remains stretched.

Macau Gaming

Macau gaming bonds returned 20.5% in the fourth quarter on the successful renewal of 10-year gaming licenses for six incumbents and China's reopening news. These operators include MGM China, Galaxy Entertainment, Sands China, Melco Resorts, Wynn Macau, and SJM. The tender result was in line with our base case, as highlighted in our last quarter's outlook. China also announced in November the "20 measures" and "new 10 measures" to substantially relax domestic anti-pandemic policies. China's swift shift was much ahead of market expectations on rising economic pressure. As a result, market sentiment was boosted, especially for Macau gaming bonds, on expectations of rapid earnings recovery. Furthermore, on border relaxation, Macau cancelled most of its travel restrictions in early January 2023.

Monthly gross gaming revenue (GGR) was reported at MOP11.6bn (+83% YoY) for January, strongly beating market estimates given the Chinese New Year's impact. We closely monitor March and May, which shall augment a more sustainable recovery trend. Macau reported GGR at MOP42.2bn in 2022 or 14% of the 2019 pre-Covid level. Looking ahead, we expect Macau visitations and GGR to recover on the back of Chinese packaged tours resumption from February this year and the cancellation of PCR tests for travelers crossing between Hong Kong and China.

We view that the current market valuations are relatively rich, with the fundamental recovery priced in. We have modestly underweighted the sector and are looking for opportunities in potential new bond issuances, which should be limited. The sector shall be supported by a recovery path on reopening, the overall low supply of China-related HY bonds and a diversification play.

Indian High Yield

Indian bonds stand as the second largest sector in the Asia HY index, following China and Hong Kong combined. We are underweight as valuations do not look compelling relative to US HY and are subject to risks of credit spread widening and higher rates volatility. The development of the Adani fallout may have some repercussions on near-term sentiments for the sector, but we believe they should have limited contagion risks. The credit quality of key sizable renewables companies is backed by their large and diversified portfolios, strong sponsors, and ongoing access to onshore funding. The government's supportive stance towards renewable investment and development should form ongoing tailwinds for the sector. Risks included aggressive debt-funded growth and delay in receivables, which we closely monitor.

In the case of Adani, most of the issues highlighted in the short-seller report are well-flagged and monitored by rating agencies and third-party sponsors/investor communities. In addition, most Adani bonds are embedded with some protection covenants, such as cashflow waterfall, distribution restrictions, and limits on secured debt to avoid subordination risks for bondholders. We take some comfort in 1) the bond structure offering some downside protection, 2) most underlying assets like renewable energy and ports are of decent quality, and 3) the participation of external shareholders/ sponsors and reputable auditors shall provide surveillance on corporate governance. Hence, we prefer bonds at operating levels and investment grade levels as we see the complex offers dislocation opportunities.

Data sources are attributed to Bloomberg unless specified.

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