Fixed Income
Investment Outlook 2Q 2022

Executive Summary: Marco headwinds persisting

Be prepared for (more) U.S. rate hikes

1Q22 was marked by heightened market volatility due to the military tensions between Ukraine and Russia and expectations of a faster pace in U.S. policy normalization on inflation overshoots. The Fed's March dot plot, which shows the median policy rate projection, indicated a more aggressive rate hike path for 2022 before reaching a peak rate of 2.5-2.8% in late 2023. A sharp rate hike could put pressure on U.S. growth, also fueled by lingering Covid cases, supply chain disruption, and demand hit by high commodity prices. We believe the Fed will likely maintain a hawkish tone with the key goal of curbing inflation. The 10-year United States Treasury ("UST") quickly approached c3% (+147bp YTD). Some consolidation cannot be ruled out, depending on upcoming inflation data and if the narrative of slower growth gradually becomes dominant. With quantitative tightening underway and the next FOMC meeting in May and June, market volatility will unlikely abate. Fed fund futures currently imply up to 250bp higher rates by the end of 2022.

Downward shift in China's GDP growth prompts more timely policy easing

In March, the National People's Congress meeting set a GDP growth target of around 5.5% for 2022 (8.1% actual for 2021), with front-loaded infrastructure spending, higher tax cuts, monetary, and property easing. More monetary easing, which may include policy rate cuts or RRR cuts, should occur in ensuring abundant liquidity and supporting credit growth. We think more aggressive policy easing is still much needed as Covid outbreaks pose renewed downside risks to growth. In addition, higher oil prices, geopolitical conflicts, and easing global demand could narrow China's trade surplus contribution to GDP. Overall, while China's growth is expected to slow sequentially in 1H22 on covid-induced lockdowns, we expect it to bounce back in 2H22 on consumption rebound and some recovery in property sales. We believe the property sector to stabilize in the coming quarters, given signs of coordinated policy relaxation and bottoming out of credit contraction.

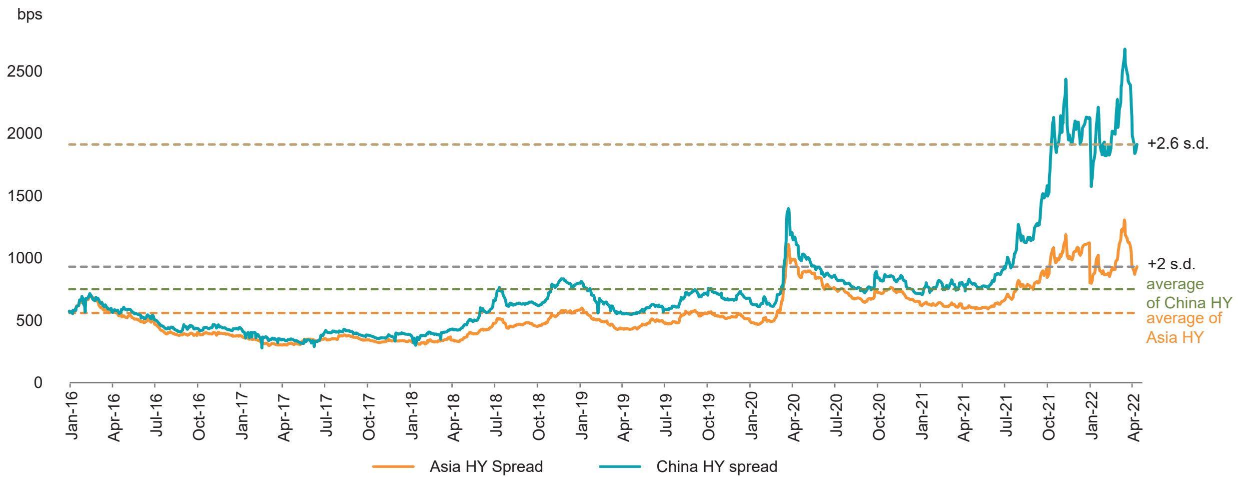
Credit strategy

With a major correction seen in Asia high yield ("Asia HY") bonds during the past few quarters, we should not be too far off from the bottom of the credit and property cycle in China. The supportive tone from regulators and government officials in mid-March on curbing risks for the property sector (c.16% weight in JACI HY Index at end-March) are encouraging signs that will stabilize the sector outlook. We look for further signs of improvement in China's physical property market, which is likely to emerge in 2H as 1H will be negatively affected by lockdowns. More fine-tuning measures, such as the relaxation on mortgages and home purchase restrictions in selective cities, shall continue to forge ahead. We emphasize credit quality in our bond selection, as credit polarization is likely to stay.

Higher UST yield had been a drag on bond performance for Asia investment grade (IG) bonds YTD. Shorter duration is preferred, and tight credit spreads provide less cushion to offset the rates risks. Credit spreads for Asia IG bonds should remain resilient on low fallen angel risks. Specifically, China high yield ("China HY") spreads have already priced in property cycle and sector consolidation (Figure 1 & 2). We stick with credit names with access to funding and manageable near-term maturities as we remain cautious about idiosyncratic risks.

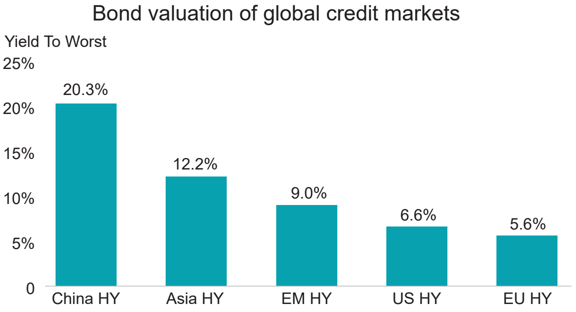
Asia bond performance

Figure 1: China HY credit spreads priced in bottoming of credit and property cycle



Source: JP Morgan Asia Credit Index, Bloomberg Index, as of 11 April 2022

Figure 2: Value dislocation in China HY bonds

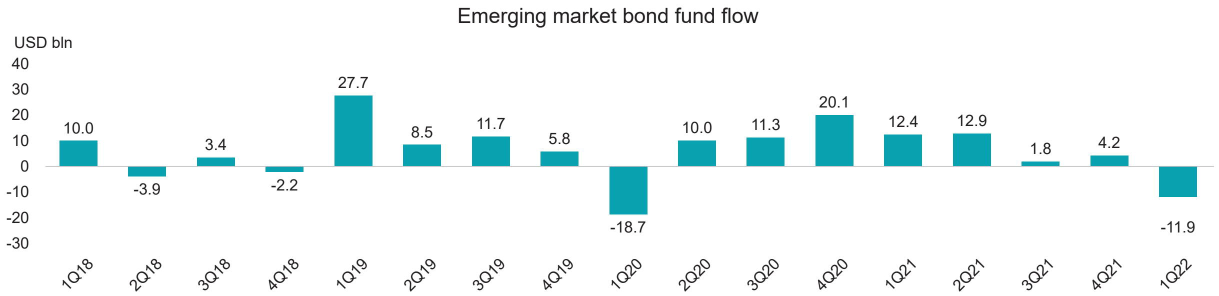


Source: JP Morgan Asia Credit Index, Bloomberg Index, as of 11 April 2022

In 1Q22, both credit spreads of the JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and Asia Credit Index High Yield ("Asia HY Index") widened 28bps and 144bps to 161bps and 950bps, respectively. Asia IG Index generated -5.4% total returns in 1Q22, of which 4% was attributable to the higher UST yield. The universe was also impacted by geopolitical tensions and regulatory crackdown on China's technology sector. A risk-off mode was also seen in the Asia HY Index, with -10.1% of total returns amid defaults and concerns on audit issues for FY21 financial statements within the China property sector.

On the country level, China (in the JP Morgan Asia Credit Index or "JACI Composite Index"), underperformed (-7% in 1Q22, 45.5% weighting at end-March) on weakness in the property sector. Indonesia (-6.2% in 1Q22, 11.3% weighting) underperformed more than India (-4.4% in 1Q22, 7.0% weighting) on a higher proportion of longer-dated bonds, which were negatively impacted by the U.S. rates move.

Figure 3: Marco risks drove outflows within the emerging market bond market



Source: EPFR data, as of March 2022

Sector views

Onshore China bond

The 10-year CGB ("China Government Bond") yield was flat at 2.77% at end-March with a mixed movement in 1Q22. During the quarter, the yield peaked at 2.85% in February due to further policy easing in the property sector and strong credit data. It subsequently declined amid the weaker economic outlook and sluggish new loan addition. We view that the current level has already priced in some expectations of policy rate cuts or RRR cuts in 2Q22, and expect the level to be range-bound.

With the pandemic disruptions, we believe China will proactively pursue an accommodative monetary policy to reduce downward pressure on growth. We believe growth to recover from 3Q22 onwards, with credit contraction bottoming and additional policy stimulus. We reiterate our view that the CGB yield should march higher towards the year-end (-37bps in 2021). Risks to this view could be that growth stabilization is harder to accomplish amid Covid disruptions and regulatory changes.

The 10-year US-China yield differential compressed to 45bps at the end of March and close to par now, versus 127bps at the start of 2022. The huge compression reflected the tightening path that the US is embarking on, which contrasts with the expectation of more easing in China on the pledge for growth stability. With the UST yield pricing in the Fed's rapid rate hikes and may consolidate, there is a lower likelihood that the US-China yield differential to compress further. Foreign inflows into the onshore bond market may decelerate faster if the yield differential inverted or the CNY currency depreciates more sharply. This, however, is not our base case scenario. Most onshore rates bonds are owned by long-term investors, including foreign central banks and funds that track global bond indices, so we believe they will keep their CNY bond allocations along with the development of the RMB internationalization process.

Asia investment grade bond

Asia IG bonds returned -5.4% in 1Q22, mainly due to the UST rates move. Asia IG Credit spreads widened 20bps whereas China IG spreads widened 50-60bps amid regulatory crackdown in the technology sector and concerns over an economic slowdown. Higher geopolitical tensions in Russia-Ukraine have a little direct impact on Asian credits, but the second-order effects like the drags on growth, a slowdown in global trade, and higher commodity prices have dampened the overall sentiment. India, as a commodity importing country, could feel the inflationary pressure, with its current account deficit widening. Under this backdrop, there is a high likelihood of the RBI raising rates earlier in June (vs. August) if inflation overshoots.

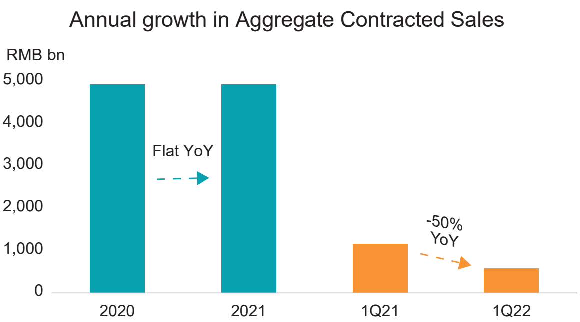
We like to stay in short duration in 2Q22, as we have preferred to underweight duration in 1Q22. We believe much of the UST impacts are front-loaded and may wane towards the year-end as growth slows. Still, both credit spreads and the UST could both widen in 2Q22. Fundamentals of most Asian IG corporates should remain solid, and there should be fewer "policy shocks" in China compared to 2021. We look for more spread widening in China IG as an opportunity to offset the UST yield move.

China property bond

1Q22 property sales were sluggish (-45-50% YoY, Figure 4-5) due to weak home buyers' sentiment, limited project launches, and Covid restrictions. Falling contracted sales will pose ongoing concerns for the sector heading into 2Q22 as lockdown looms. We continue to expect a more noticeable drop in sales in 1H22. In our view, these negatives are priced in the bond valuations. That said, we expect some improvement in sales from 3Q22 onwards, due also to a low base YoY (weak 2H21) and the ongoing fine-tuning of policy measures.

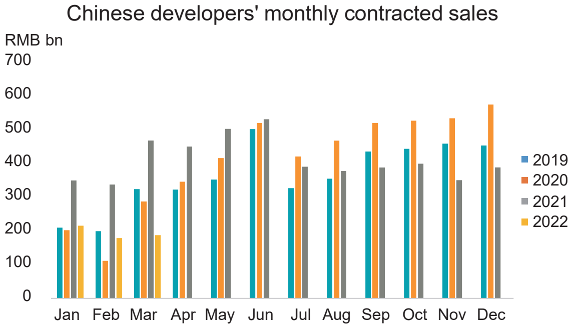
The NPC meeting in March maintained a similar tone from the Politburo in December last year on policy continuity. Policy focuses on fulfilling reasonable housing demand with city-specific policies and more emphasis on rental housing. More cities, such as Zhengzhou, Fuzhou, and others, have started to fine-tune their home purchase restrictions and are seeing more favorable mortgage costs or down-payment terms. We reiterate our view that the government would not aggressively relax the sector, but more supportive measures should be unveiled given the covid-led downside risk on growth.

Figure 4: Contracted sales take time to recover



Source: Company data from 30 listed Chinese developer, as of March 2022

Figure 5: Weak property sales in 1Q22



Source: Company data from 30 listed Chinese developers, as of March 2022

The high yield real estate sector returned -24% in 1Q22 on more distressed credit events and concerns on audited issues for FY21. For 2Q22, other than physical market recovery, we also monitor closely on the potential relaxation of restricted funds under escrow presale accounts. This, however, is not our near-term base case assumption as timely project delivery remains a top priority. On the financing front, some developers were able to raise funds from onshore (medium-term notes) and offshore markets (convertible bonds, SBLC bonds, etc). We believe credit differentiation remains the key trend.

Refinancing pressure remains heavy for the rest of 2022. To maintain ample cash liquidity to survive through the cycle is pivotal. We analyzed 25 developers in our universe based on their "three red lines" compliance and noted that the coverage of cash to short-term debt ratio has declined. This is in line with market expectations, given a decline in sales and rigid debt repayment. Therefore, we prefer developers that have lower near-term refinancing needs, decent buffer in the cash-to-short-term debt ratio, and a relatively better landbank life as land acquisitions tend to slow in coming quarters.

Macau Gaming bond

Macau gaming bonds returned -7.89% in 1Q22. The sector was affected by surging Covid cases, which dimmed gross gaming revenue (GGR) recovery outlook, and the broad weakness across China high yield bonds.

Macau's GGR in 1Q22 was at low a 20% of the 2019 pre-Covid level, owing to the recent Omicron outbreaks in the adjacent Shenzhen/Guangdong region and further tightening of border policies. While we believe most operators have maintained sufficient liquidity runway even in the case of zero GGR scenario, the travel demand to Macau may take time to recover given the evolving Covid situation in mainland China and the restrictive border measures.

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. The border situation is critical for operators' earnings recovery and maintaining their current credit rating. The sector remains a diversification and "re-opening" play within the China high yield sector. Risks to this will be prolonged restrictions on the border crossing and increasing government intervention.

Commodities bond

The metal and mining high yield sector recorded a -1.3% return in 1Q22 on broad weakness in the China high yield space. We continue to prefer this sector, which offers diversification benefits and robust commodity prices. We see that a huge loosening of supply/demand imbalance is unlikely to happen in the near term, given ongoing geopolitical tensions, or unless the slowdown in China lasts much longer than expected. This shall underpin commodity prices in the medium term.