Fixed Income
Investment Outlook 3Q 2022

Navigating The Transition To Moderate Growth And High Inflation

Fed pivot remains in debate

The Federal Open Market Committee (FOMC) raised fed fund rates by 225 bps this year. Markets expect another 50-75 bps hike in the next FOMC meeting in September. The FOMC's task is becoming increasingly difficult when considering weakening growth data, labor market resilience, and stubbornly high inflation. The market has ongoing debates between more hawkish hikes due to high inflation and a Fed pause at some point in time (i.e., a Fed pivot). Indeed, there are several indicators at levels consistent with previous Fed pauses, including the falling of new home sales and the ISM Purchasing Managers' Index (PMI), as well as the inverted 2-10-year US Treasury (UST) yield curve, which is at -38 bps now from +78 bps at the start of the year. Nevertheless, we believe it may still be a bit early for a Fed pause scenario. As recession fears are still looming, we expect the 10-year UST yield to stay at current level in 3Q22. This came after some consolidation in later part of 2Q22, when the 10-year UST yield contracted by about 80 bps from the June high of 3.5% to 2.7% to date, which we noted in our outlook earlier. Fed fund futures currently imply up to 120 bps higher rates by the end of 2022 and peak at around 3.6% in 1Q23. In our view, market volatility may escalate as we still have US inflation and non-farm payroll reports before approaching the next FOMC meeting in September.

China's growth to marginally normalize in 2H22

The Covid-related lockdowns, sluggish consumer demand, and slowdown in property sales hit China's economy hard in 2Q22. Furthermore, the mortgage payment suspension in mid-July induces more unease to the Chinese property sector. Local governments and banks are tasked to ensure home completion and protect social welfare. More importantly, this shall help restore buyers' confidence and avoid systemic risks. Separately, the July Politburo meeting seems to de-emphasize the ambitious growth target set in March. Hence, the full-year GDP growth will likely point to the downside, with the Bloomberg consensus at sub-4% for 2022. Though the path to recovery is uncertain alongside the country's zero-case approach, we continue to look for some improvement in China's growth in 2H22 with an overall supportive tone in both fiscal and monetary policies.

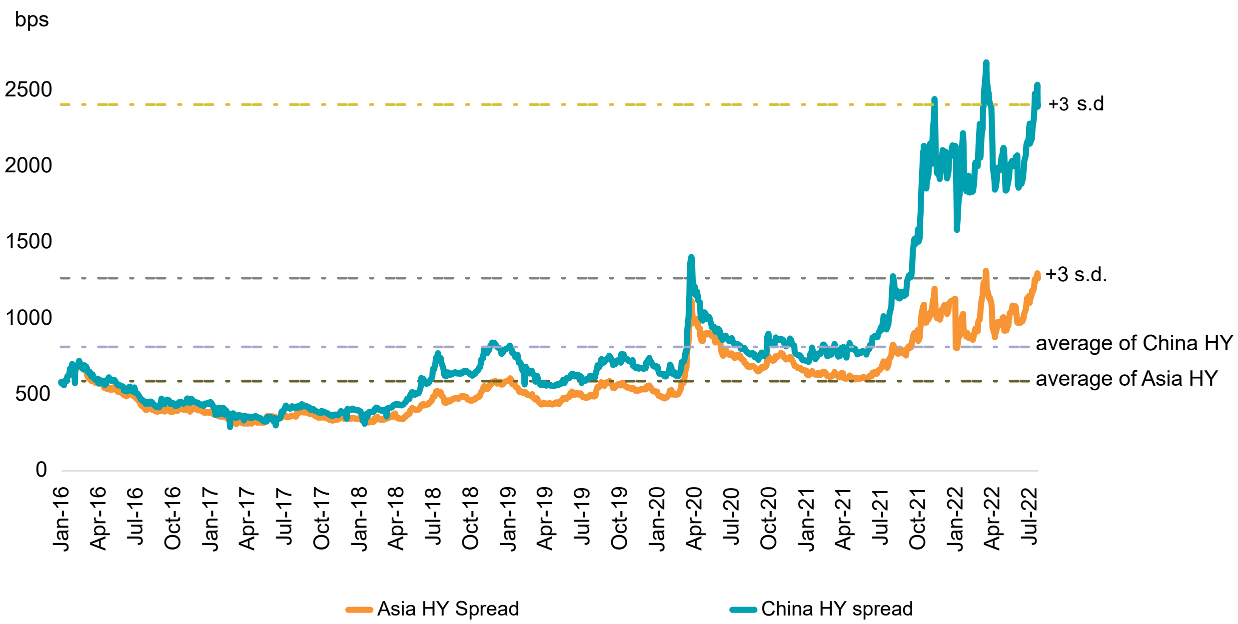
Credit strategy

Our strategy in Asia and China high yield (HY) bonds remains with bottom-up credit selection and sector diversification. We remain cautious about China high yield spreads but believe they have already priced in the property cycle and sector consolidation. Since late last year, many fine-tuning measures, such as relaxation on mortgages and home purchase restrictions, were already implemented in 1H22. We believe it is pivotal for a prompt government response to resume construction for those unfinished projects and deliver to homebuyers. Though this is unlikely to be a quick fix, this is key in supporting a recovery in property sales for the rest of the year and beyond. We took the opportunity of the market weakness to further diversify into other markets, including India, Indonesia, and Macau.

On the other hand, credit spreads for Asia and China investment grade (IG) bonds should remain resilient on low fallen angel risks and local demand. However, we do not think Asia IG spreads are attractive enough on a relative value basis, despite the waning supply that should support bond technicals in this space. We continue to prefer those with short-end, highly rated IG papers that offer a decent all-in yield.

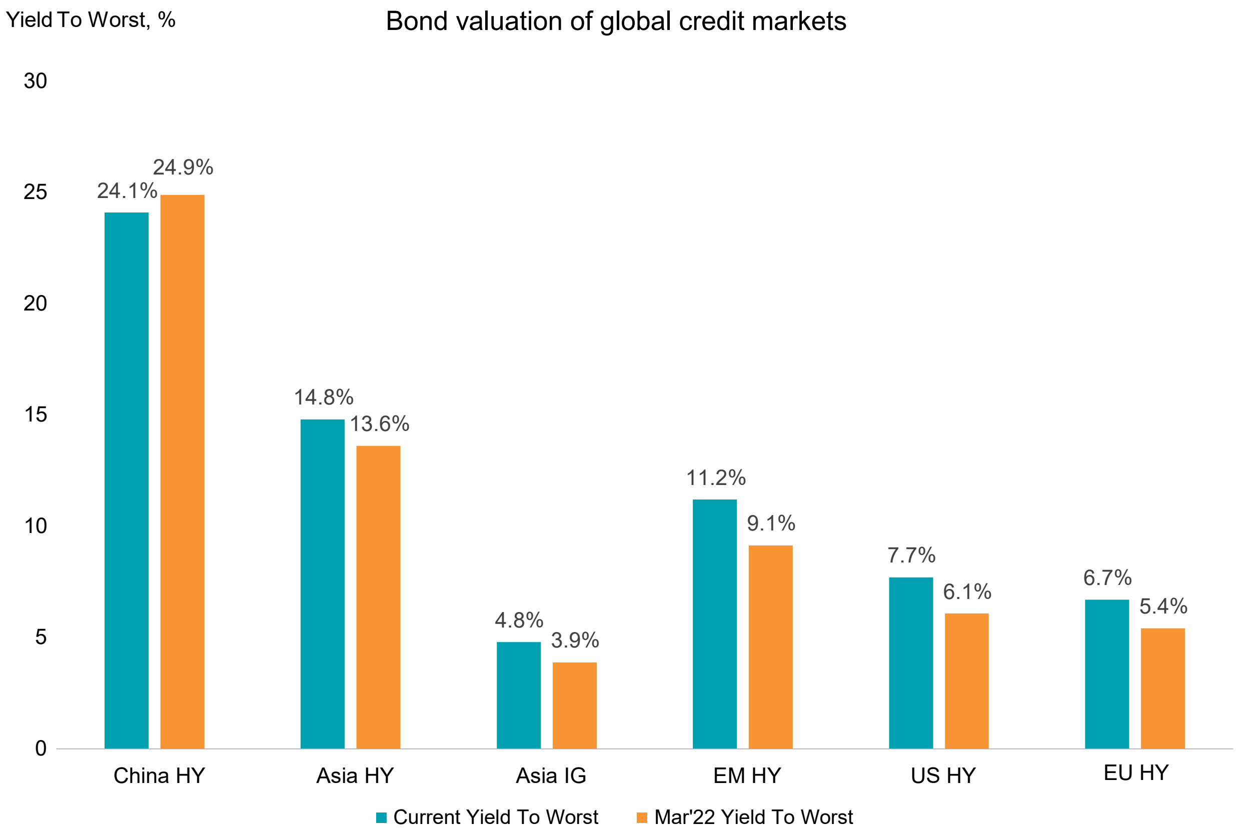
Asia Bond Performance

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



Source: JP Morgan Asia Credit Index, Bloomberg Index; as of July 2022

Figure 2: Value dislocation in China HY bonds

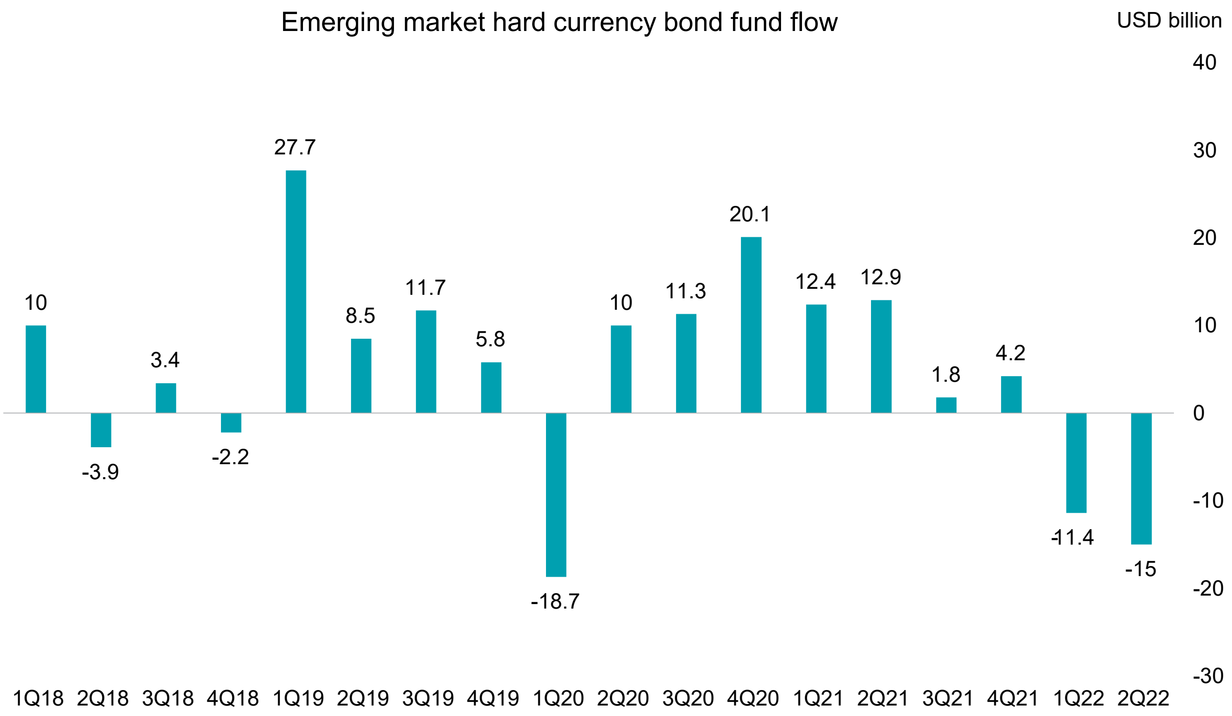


Source: JP Morgan Asia Credit Index, Bloomberg Index; as of July 2022

Similar to 1Q22, the heightened market volatility and the general risk-off sentiment impacted global credit markets in 2Q22. In 2Q22, credit spreads of the JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and Asia Credit Index High Yield ("Asia HY Index") widened from 22 bps and 165 bps to 179 bps and 1,103 bps, respectively. In terms of total returns, the Asia IG Index generated -3.8%/-9% in 1Q22/1H22, a large part of which was attributable to the higher UST yield. The lockdown in Shanghai had negatively impacted property sales and a weakening in sentiment for Asia HY, which posted -9.6%/-18.8% total returns in 2Q22/1H22.

Within the JP Morgan Asia Credit Index or "JACI Composite Index", Macau, Indonesia, and India underperformed China (-3.7%/-10.4% in 2Q22/1H22, 44.4% weighting at end-June) amid fund outflows and recession concerns in June (Figure 3). Specifically, Indonesia (-8.4%/-14% in 2Q22/1H22, 11.4% weighting) underperformed more than India (-6.0%/-10.1% in 2Q22/1H22, 6.9% weighting) on a higher proportion of longer-dated bonds, which were negatively impacted by the US rates move.

Figure 3: US recession fears drove outflows in 2Q22



Source: JPM/EPFR data, as of July 2022

Sector views

Onshore China

The 10-year China Government Bond (CGB) yield was range-bound at 2.75-2.85% in 2Q22, in line with our expectations in our last quarterly outlook. During 2Q22, the yield curve steepened modestly due to the very loose liquidity environment. The weak growth momentum due to lockdowns also lured strong safe-haven demand for rates bonds by financial institutions. This partially offset the impact of higher rates bond issuance and foreign outflows. To further inject liquidity, a 25 bps reserve requirement ratio (RRR) cut took place in April.

For 3Q22, we believe overall liquidity conditions will stay loose to support growth recovery. The People's Bank of China (PBOC) stressed a few measures in late June, including 1) maintaining sufficient liquidity, 2) lowering financing costs, and 3) stabilizing credit growth. A turning point to watch is if credit growth accelerates in 3Q22, which PBOC typically reduces liquidity injection. China's GDP is expected to modestly improve in 3Q22 versus 2Q22 on a lower base. The inflation trend is also worth watching, as it could push the yield higher. Overall, a potentially less loosening trend, higher inflation print, and modest improvement in growth underline our assumption that the CGB yield would increase towards the year-end.

The 10-year CGB yield was inside US by 19 bps at June end, from 127 bps at the start of 2022. This trend turned flattish now after UST yield adjusted lower on recession fears. We think a sustainable yield advantage trend is more important in stabilizing the RMB and capping additional pressure on foreign outflows. This may be put to the test given the expectation of a higher 10-year UST yield towards the year-end, which is at 3.2-3.3%, against the current 2.7%.

Asia Investment Grade

Asia IG bonds returned -3.8% in 2Q22, as they were negatively impacted by the UST rates move and spread widening. Both Asia and China IG spreads widened by 15 bps in 2Q22 (+27 bps in 1Q22). China IG spreads have narrowed from levels seen in mid-March, negatively impacted by the regulatory crackdown in the technology sector and concerns over an economic slowdown. While the tensions between Russia and Ukraine have muted direct impact on Asian IG credits, slower growth, weaker external demand for Asia, and higher input costs have dampened sentiment in 2Q22. With inflationary risks largely reining for Asia, most central banks may strive to avoid “overtightening”. Hence, we believe higher funding costs should have a manageable impact for Asia IG corporates as they can tap local markets where rates are adjusting higher in a more controlled manner. In addition, Asia faces more manageable macro headwinds than its western developed market counterparts. This, together with low fallen angel risks, should bode well for the sector to remain resilient in 3Q22 or 2H22.

As the 10-year UST yield already fell 80 bps since mid-Jun, we prefer to take profit or at least keep duration more neutral. Valuation-wise, Asian IG spreads compressed against the US for most of 1H22, and now stand at 1.15x. We do not think Asia IG spreads are attractive enough on a relative value basis, despite waning supply should support bond technicals in this space. We prefer short-end highly rated IG papers that offer decent all-in yield.

China Property

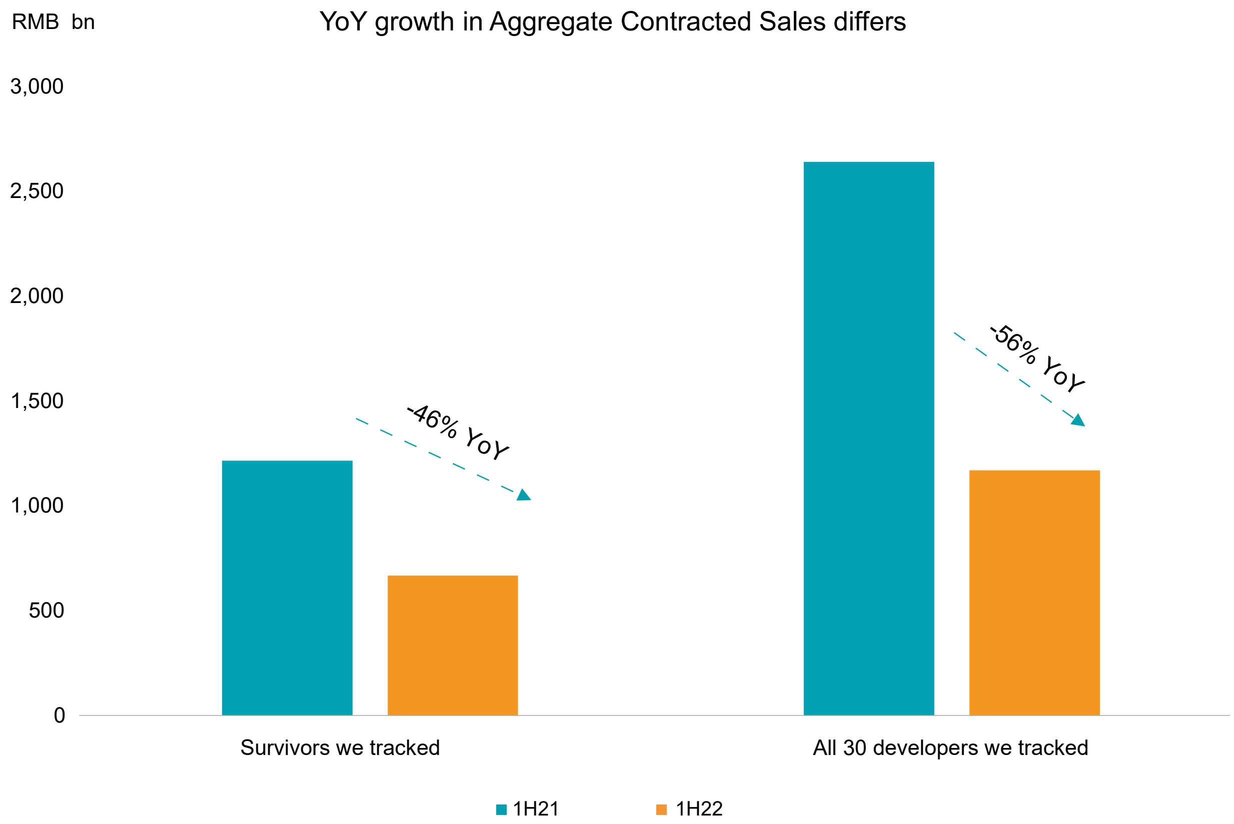
The high yield real estate sector returned -17.6% in 2Q22 amid more distressed credit events and delays in property sales recovery due to lockdowns. In mid-July, news of mortgage payment suspension in China had further dampened sentiment. The suspension was concentrated in lower-tier cities and related to those projects built by defaulted developers like Evergrande.

We do not believe this event will result in systemic risks in China, but there is an urgency for the government to implement measures to restore buyers’ confidence. Most big Chinese banks have already publicly disclosed their related exposure, and overall risks are manageable relative to their loan books and asset quality. To put things into perspective, according to Citi equity research, the total mortgage outstanding amount in China stood at RMB38.3tn, out of which RMB561bn (under a worst-case scenario) or 1.5% of loan books could be impacted. Non-Performing Loan (NPL) risk should, however, fare higher for those smaller regional banks instead of the bigger ones.

For developers, banks will likely exert even tighter control on presale escrow accounts. Banks will also turn more cautious and selective on new mortgage applications, which could slow down cash collection for developers. We expect POE (Privately Owned Enterprises) developers will continue to look for 1) asset disposal to address near-term funding/refinancing needs and 2) debt exchange to deal with their upcoming maturities. SOE (State Owned Enterprises) developers may manage the risks much better given their stronger balance sheet and continued access to funding. Under this backdrop, we continue to prefer developers that have lower near-term refinancing needs and are likely to survive through market consolidation.

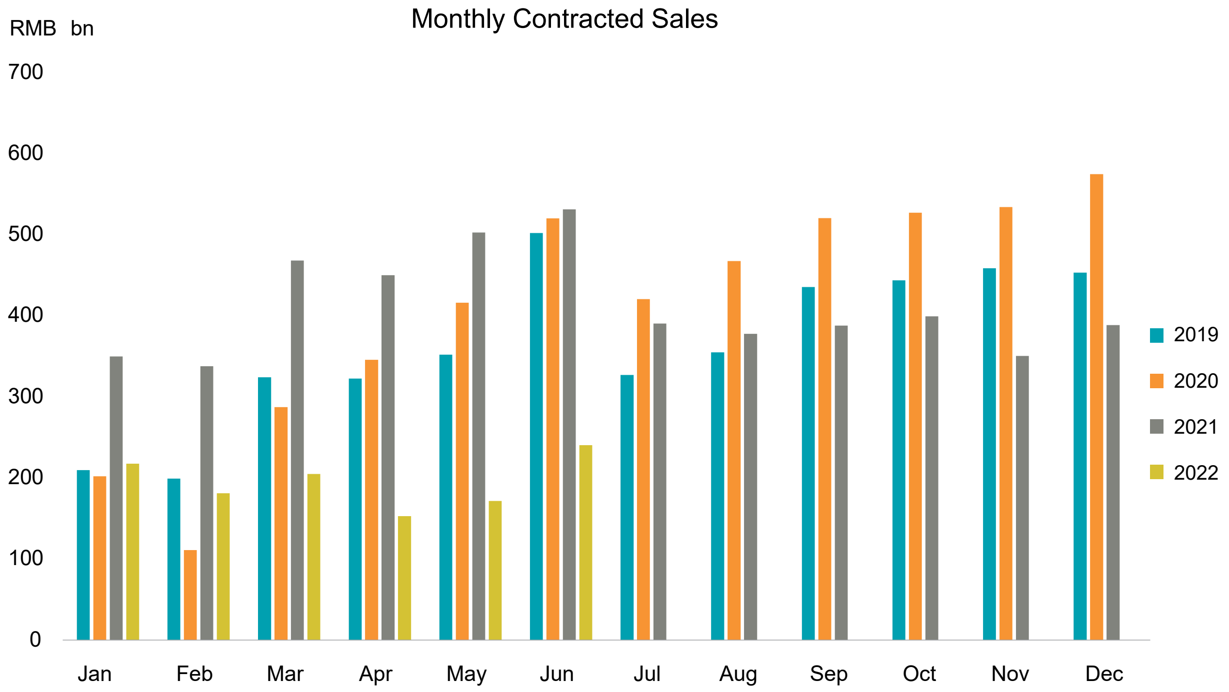
According to news reports, the State Council approved a plan in late July for establishing a stability fund to support 12 developers in completing the stalled property projects. The fund secured RMB50bn from China Construction Bank and a RMB30bn relending facility from the PBOC. The fund can be further upsized to RMB200-300bn (USD30-44bn). If this plan materializes, this should provide some reprieve to sentiment. Nevertheless, we believe the recovery in property sales may take some time, and the narrowing of sales (month-on-month) declines should continue in the coming quarters. Indeed, property sales in China already exhibited marginal recovery on a month-on-month trend in June (Figure 5). The recent Politburo meeting maintained a similar tone on prioritizing home delivery to stabilize the property market, indicating the government remains committed to mending the mortgage suspension situation.

Figure 4: Developers' contracted sales take time to recover when market consolidates



Source: Company data from listed Chinese developers; as of June 2022

Figure 5: Property sales in June exhibited marginal recovery on a month-on-month basis



Source: Company data from 30 listed Chinese developers; as of June 2022

Macau Gaming

Macau gaming bonds returned -20.2% in 2Q22, dragged by the lockdowns in China and broader weakness in credit markets. Macau reported gross gaming revenue (GGR) at MOP8.5bn/MOP26.3bn in 2Q22/1H22, which was 12%/18% of the 2019 pre-Covid level. Most operators we tracked have maintained sufficient liquidity runway under a zero GGR scenario, and multiple operators received shareholder loans or issued equity to boost their overall liquidity. Nevertheless, we believe travel demand to Macau may take time to recover, given the evolving Covid situation in mainland China and the restrictive border measures. The re-opening of its international border, like what has been mulled in Hong Kong, may help revive sentiment.

On license renewal, Macau's government announced that a public tender has been opened and bidding can be submitted until Sep 14. We expect the new license awardees to be announced before the year-end, and it is our base case that all current six operators will have no difficulty in renewal. We took the opportunity to add the sector exposure amid market weakness as we believe the negative impact of the Covid outbreak and stricter border measures were mostly priced in. Meanwhile, we continue to monitor Macau's border situation, which remains critical for GGR recovery and operators' 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

The high yield metal and mining sector recorded a -8.5% return in 2Q22, and the sell-off that was mostly concentrated in June was in response to rising fears of a hard landing in the US and fund redemptions risks. The sector modestly rebounded in July. Geopolitical risks and extreme weather conditions are going to increase dislocation heading into 3Q22. This happens at times when demand also slows. Additionally, commodity prices of some industrial metals have been adjusted lower toward the marginal cost of new supply, which is typical in a recession. We are mindful of risks like supply responses (e.g. oil), and growth headwinds, and prefer to position cautiously.

Source: Value Partners and Bloomberg, data as end of July as stated above, unless stated otherwise.

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