Fixed Income Quarterly Investment Outlook

Value Partners
Investing through discipline

January 2021

Entering into vaccine-driven normalization

2020 closed with a diminishing risk premium, as vaccine hopes and expectations of a growth rebound solidify. Massive policy easing in 2020 was much needed in calming markets while coping with the economic shocks brought by COVID-19. Into 2021, the vaccine rollout, accommodative monetary policy and fiscal stimulus should fuel a further growth recovery globally.

Market optimism could wane over time due to the fear of diminishing liquidity support from 2H21 and a slow vaccination rate, eventually resulting in greater market volatility. We believe such an environment presents better investment opportunities as valuations have also shifted higher.

Closer to home, we believe the growth in Asia and China would outstand with a faster recovery. Central banks in Asia are likely to maintain an easing bias under low inflation pressure. The prospects for a better growth outlook in Asia and the sustained strength in CNY should also bode well for the region's dollar bond market and attract fund flows given the ongoing quest for yield.

Key macro themes in 2021

Vaccine outlook matters in reviving growth: A high vaccine efficacy rate should pose upside risks to the global growth recovery. Acceleration in vaccination rate and additional stimulus package could reset the global GDP growth higher. The U.S. real GDP growth is broadly revised upward to c6% from c5% in 2021, post Georgia runoffs. The market may underwhelm on the slower-than-expected vaccination rate and extra rounds of lockdown. That should prove temporary as vaccine distribution is considered a top priority globally. A gradual shift to higher growth expectations will occur in the coming months, with more references to a taper in the later part of 2021.

A steepening yield curve: The Georgia runoffs raises the possibility of additional stimulus after US$900bn announced in December 2020. After crossing the 1% mark, the 10-year U.S. Treasury yield is set to march higher on an additional fiscal stimulus and reflationary pressure in the U.S. That said, from the current level of 1.1%, the pace of increase is likely modest, touching 1.25-1.5% by end-2021. Inflation in 2Q21 will trend higher due to a low base. Unless oil price surprises on the upside, inflation may stay structurally low in the next one year. With the Fed's attempt to overshoot 2% inflation, the possibility of near-term rate hikes is very remote.

Sanctioned China SOEs a risk or an opportunity?: The U.S. imposed sanctions on 31 Chinese state-owned enterprises (SOEs) from November 2020 and three major Chinese telcos were added to the list in December. This has triggered a knee-jerk sell-off in some China SOE bonds (16 entities out of 31 companies have bonds outstanding) given index exclusion risks (JACI, EMBI). These 16 entities accounted for 3.7% of the JACI index. Per our estimates, Chinese tech like Tencent and Alibaba bonds accounted for 2.5% of the JACI index. The recent decision by the US against banning investment in Chinese tech have revived market sentiment. Furthermore, Chinese three oil names are still the under the spotlight of becoming the next target. We estimated those bonds will constitute c2% of the JACI index.

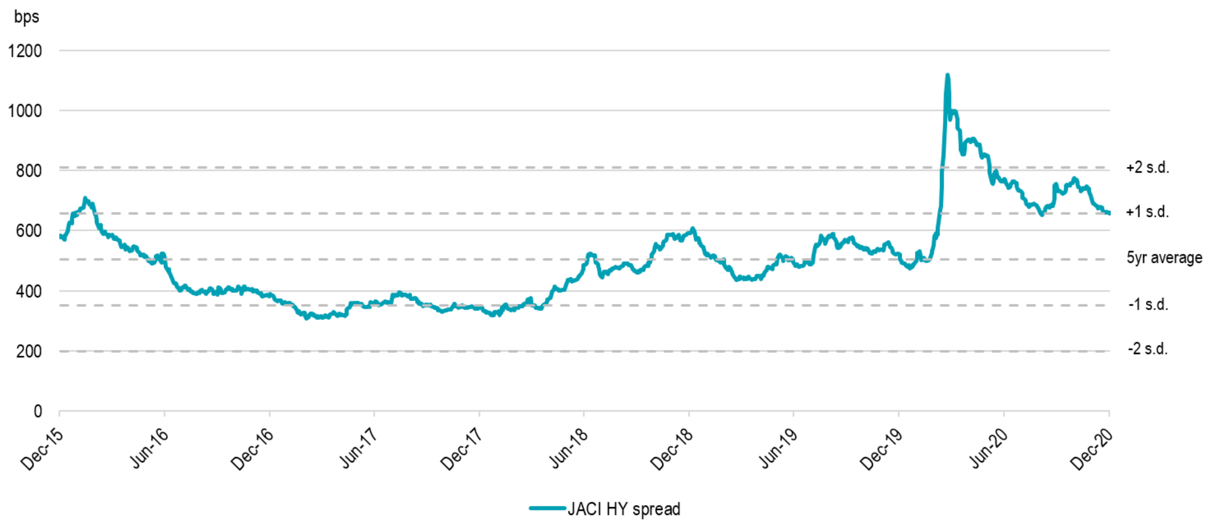
The U.S. investors are permitted until 11 November 2021 to divest the bond holdings of 16 entities, hence technical should remain heavy in the near-term. It could result in bonds changing hands from the U.S. to Chinese-based investors given cheapened valuations and limited impact on fundamentals. Notably, spread widening (c100bp since November 2020, 10yr is yielding at c4.5%) was more severe in the curve of a national chemical company in China, given its higher revenue generation from the U.S. While we do not envisage the U.S. will change its stance on China after Biden takes over the reins, we foresee a more predictable approach to the U.S.-China relations would fade the risk on the overall China USD bond market.

China growth to outshine, fading credit growth should not pose a major threat: We see a stronger rebound in China's GDP growth at c8% in 2021 (2% in 2020, 6% in 2019), led by exports and domestic consumption. A slowdown in China's credit growth will occur concurrently as growth picks up. Nonetheless, the focus on financial stability should keep onshore default rates in check and steady onshore yield to keep refinancing risks under control. Overall, tighter regulations will continue to drive deleveraging and greater credit differentiation for the property sector, which should further stabilize developers' credit profile and underpin their bond performance in the medium term.

Valuations

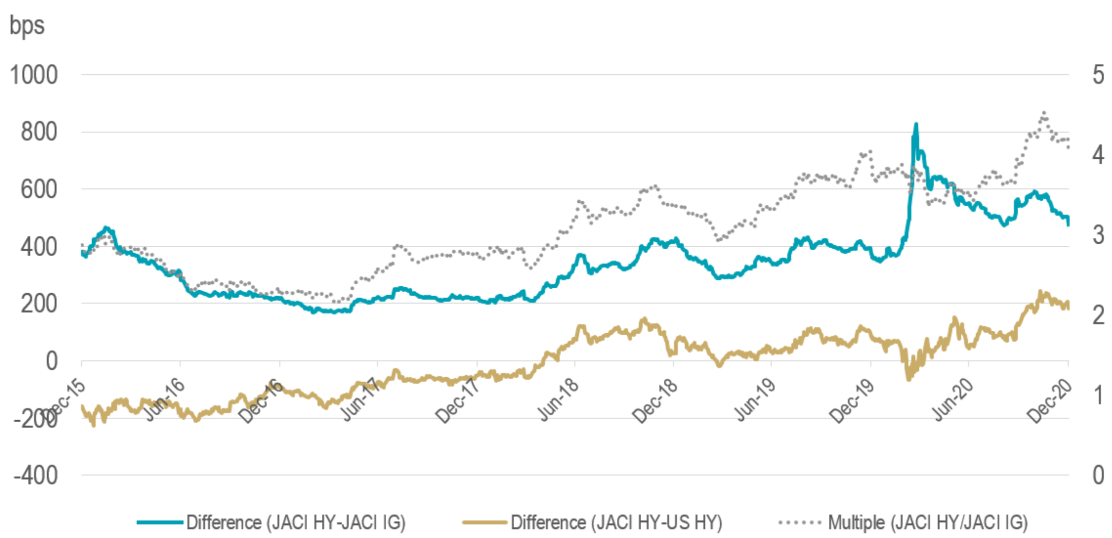
In 2020, the JACI composite returned 6.3%, with JACI Investment Grade (IG) index and JACI High Yield (HY) index growing 6.9% and 4.9%, respectively. **We believe Asia HY offers better relative value over IG in 2021. Asia HY, at c1 s.d. cheap over the last 5 years in terms of credit spread (Fig 1), is preferred from a total return and carry perspective. A premium of 477bp over Asia IG and 184bp over US HY suggests room for compression (Fig 2)**. A possible overshoot in back-end UST yields under more positive vaccine development and further fiscal stimulus should favor Asia HY more than Asia IG, which is 2x longer in duration.

Fig 1: JACI HY spread



Source: JP Morgan

Fig 2: JACI HY vs JACI IG and US HY



Source: JP Morgan

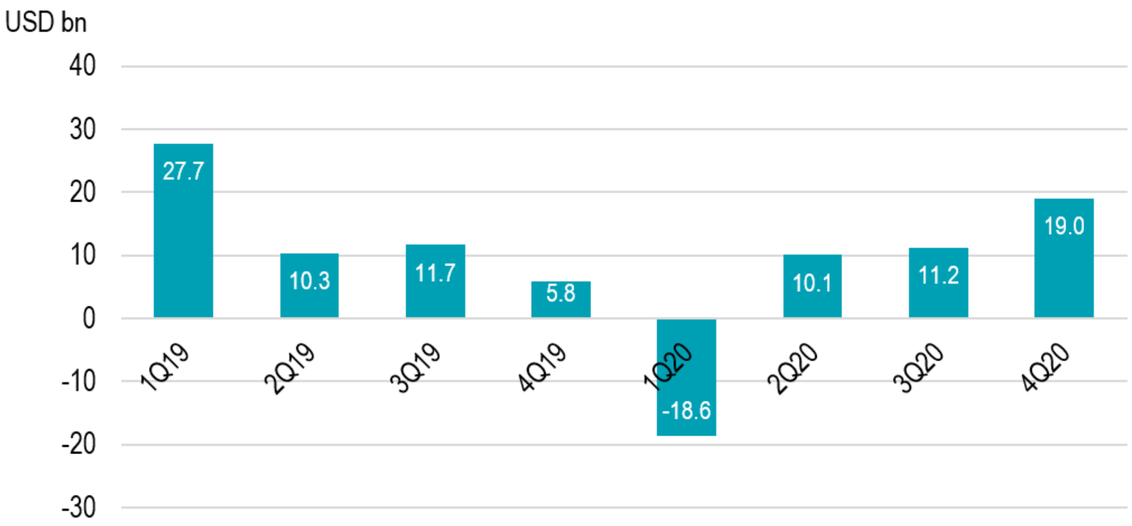
The JACI IG Index closed at a spread of 156bp at end-2020, 60bp wider than US IG. The JACI IG spread is currently trading at its 5-year average, and recouped 46% from its wide in March 2020. Despite demanding valuations relative to HY, we see a pocket of opportunities on sanctioned Chinese SOEs. A downgrade in India sovereign cannot be entirely ruled out, but we see a lower likelihood of expected improvement in growth and consumption, albeit the debt overhang. Asia credits have proven to be resilient and well coped with the challenges of COVID-19. Over 97% of Asia HG retained their investment grade status in 2020, given SOE dominance and strong parental support. This trend shall prevail in 2021. **We believe IG sector is fairly valued and offers little room for error.**

JACI HY Index closed at a spread of 634bp at end-2020. JACI HY spread is still at 81th percentile since 2016, and recouped 43% from its wide in March 2020. Asia's default rate is expected to be kept at c3% in 2021 (2020: 2.7%), and remain at low levels both in global and historical context. Importantly, candidates in Asia more vulnerable to default are priced, in our view. **We see room for spread to tighten in this space with a managed refinancing cycle and our preference for quality and liquid benchmarks.**

Dollar bond issuance to accelerate: Another record year of Asia bond issuance was noted in 2020 (gross: cUSD310 bn, net: cUSD110 bn), with a skew towards IG companies. As the Chinese government has turned less accommodative from 2H20 as growth picks up, a rise in onshore yield over offshore pushed some Chinese issuers to $ bond market. The low yield environment could entice IG issuers to term out bond maturity profile at cheaper costs. Arguably, this also increases IG's sensitivity to the U.S. rate risk, but Asia IG would fare better than its U.S. counterparts on a shorter duration (6 years versus 9 years). Cushioning the issuance trend in 2021 is rising redemption, which should be 2H heavy before reaching a peak in 2022. Hence we expect net supply in 2021 will remain quite flat.

EM Funds flow: Inflows remained steady with US$18.1bn into Emerging Market (EM) Hard Currency bonds over 4Q20 (Fig 3). The cumulative inflows for 2020 into EM hard currency bonds reached US$22bn, lower than the 5-year average inflows of US$38bn. In DM bonds, we have seen strong inflows of US$55.6bn into US IG funds but a more subdued inflow of US$6.1bn into US HY funds.

Fig 3: EM Hard Currency funds flow



Source: J.P. Morgan

Positioning for 1Q21

Stabilization of the U.S.-China relations, accommodative central bank policy and managed default rate in Asia should continue to drive inflow into Asia credits. We adopt a barbell strategy in seeking value via 1) cheapened BBB bonds e.g. Chinese sanctioned names, 2) solid single B property names with strong fundamental and reasonable spread pick-up over BB and 3) higher-beta single B property with improving credit metrics or re-rating potential. A stabilization of US-China relations and foreign portfolio inflows should add to RMB strength. We believe that 1Q21 offers a better window to build up RMB bond position.

Asia sectoral view

China onshore bond market

Despite the COVID19 disruption, China became the first to contain the pandemic and achieve rapid economic recovery. Onshore credit yield fell in 1Q20 while steepened significantly from April 2020 and continued its upward trend in 4Q20. As the expectation of RMB appreciation was growing, we noted a significant inflow into the onshore bond market during 2020. Global investors hold more than 9.7% of China government bonds (CGB) at end-2020 compared to 8.5% at end-2019.

Onshore default trend remains highly relevant for offshore bond market as $ bond issuers tap both markets for funding. The unexpected default of a Chinese coal mining company in November 2020 led to material sell-off and onshore credit spreads widened. Sentiments for both onshore and offshore bonds of weak SOEs/LGFVs and related credits were negatively impacted. However, we do not believe these events would have any material impact on good quality credits in the long-run.

We believe China's trade surplus, further portfolio inflows on more index inclusion and high interest rate differential (200bp over US) are all supportive factors for the RMB. FTSE Russell will add Chinese government bonds into World Government Bond Index (WGBI) in October 2021. While the index inclusion of government bonds already happened, we shall pay attention to the interest of foreign capital in the allocation of credit bonds. **Overall, we expect onshore monetary policy is likely to remain neutral or loose in the near term. We believe that 1Q21 offers a better window to build up RMB bond position.**

Lastly, we estimate that the total amount of maturing credit bonds will increase modestly in 2021 before tapering off. SOEs and LGFVs account for the majority of the total maturity. The onshore credit market is recovering, though the aftershocks from SOE default have not been fully eliminated. Some better quality credits were also affected during the sell-off, and we believe these represent some buying opportunities.

Asia IG

In China IG space, we monitor the investment restrictions from the U.S. and their potential impacts on the segment. On 12 November, 2020 President Trump issued an Executive Order prohibiting transactions by any U.S. persons in publicly traded securities or their derivatives that are issued by any "Communist Chinese military companies". This restriction shall be effective from 11 January, 2021. Concerns over index eligibility and potential restrictions on U.S. persons buying securities of selected Chinese corporates triggered a sell-off of Chinese SOEs. The bond spread issued by one of the largest national oil companies in China widened 8-57bp (widened 21bp on an average) and that of the Chinese chemical company mentioned earlier widened 13-90bp (widened 62bp on an average) during 4Q20. Near-term technicals might continue to remain heavy. We continue to monitor this space as it could be a potential alpha in 2021.

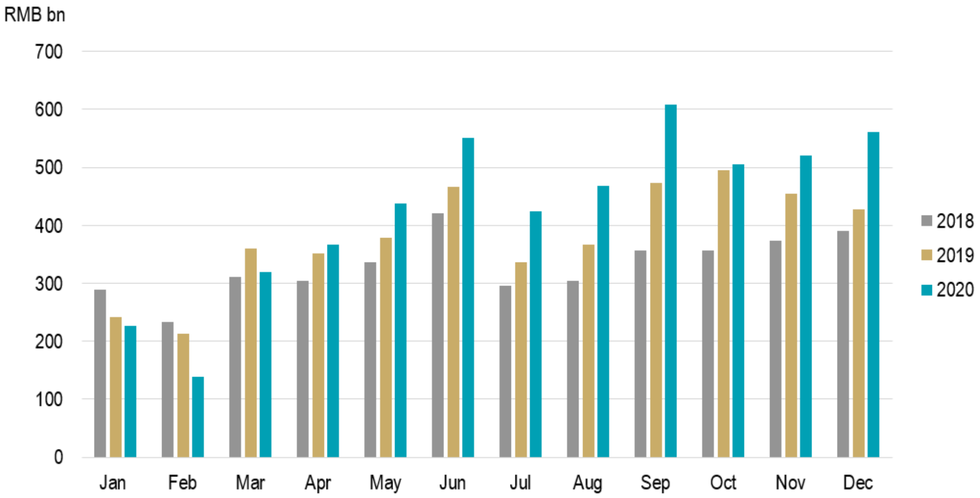
Indonesia and India IG were major alpha for 4Q20 as spreads tightened on an average of 52bp and 80bp. Technicals remain strong with low net supply and investors look for opportunities outside China with the sanction risks. However, post rally in 4Q20, India IG SOE turned expensive especially given the potential fallen angel risk of sovereign.

Looking ahead, we expect the Asia IG bond supply to be high in 1Q21 and we remained cautious on the long end due to rates volatility.

Chinese Properties

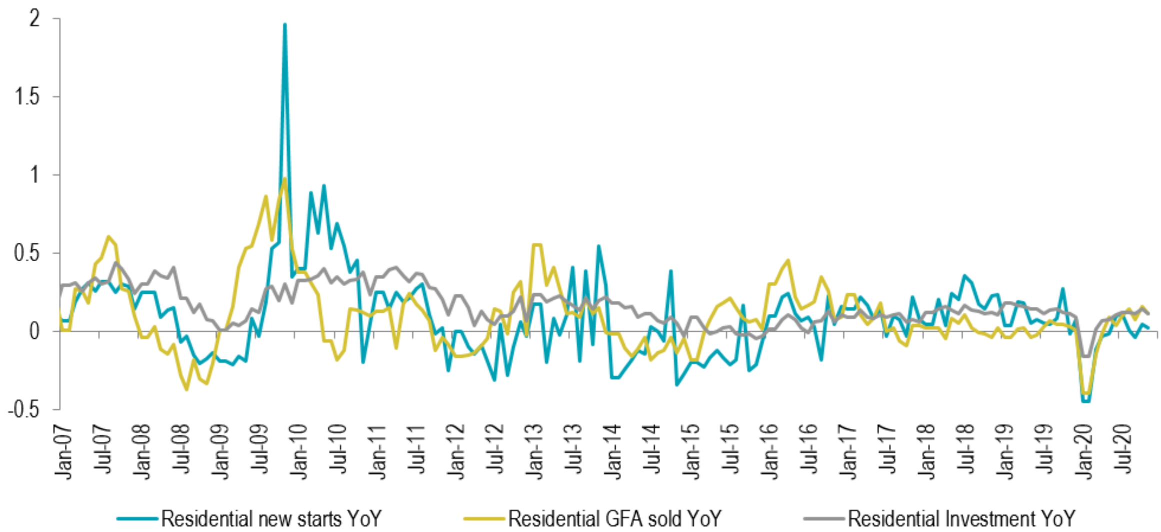
Fundamental trend: Among the 29 listed Chinese developer credits we track, contracted sales rebounded strongly since 2Q20 and advanced 15% YoY in 4Q20 (26% YoY in 3Q20, 13% YoY in 2Q20). Contracted sales for full-year 2020 advanced 12% YoY (15% in 2019), helped by easier credit and release of the pent-up demand. Developers in the bond universe continued to outperform the nationwide. Up to November 2020, the nationwide residential sales jumped 2% YoY while new starts contracted 3% YoY as COVID19 disrupted construction activities. Inventory months have quickly normalized from March 2020 as developers demonstrated their ability to accelerate sales and improve sell-through rate in 2H20.

Fig 4: Monthly contracted sales for 29 China property developers



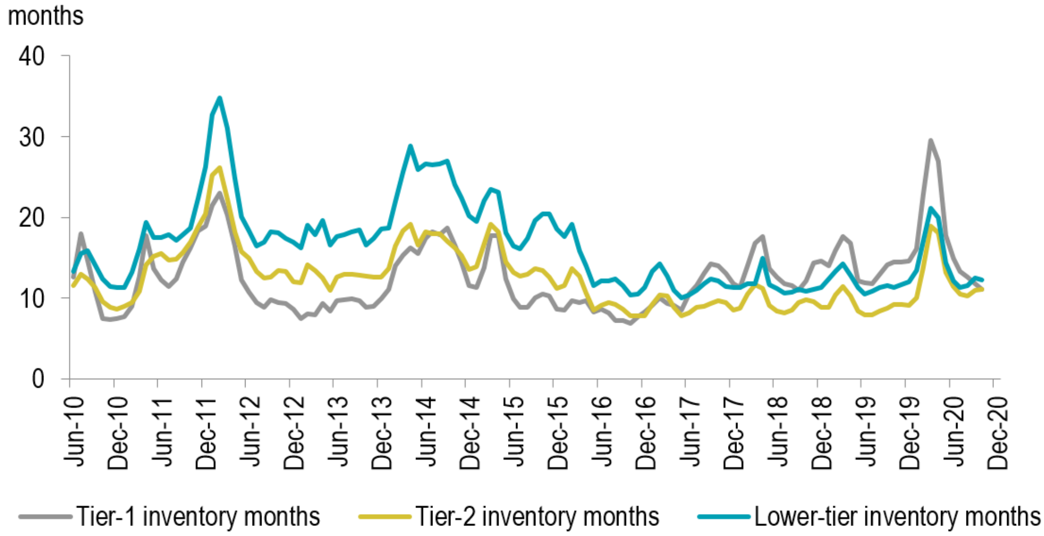
Source: Company data

Fig 5: Residential new starts vs GFA sold



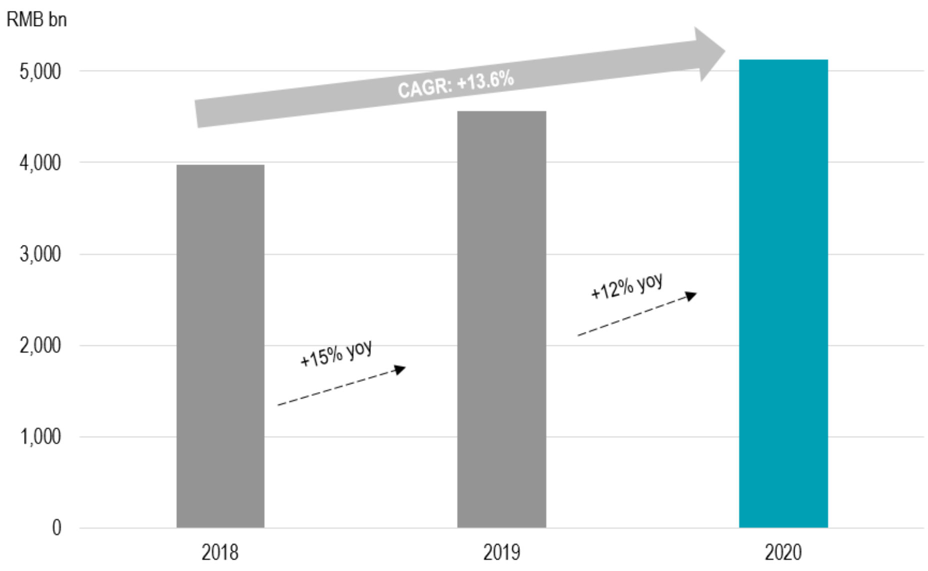
Source: UBS

Fig 6: Inventory months - by city tier



Source: UBS

Fig 7: Annual contracted sales for 29 China property developers



Source: Company data

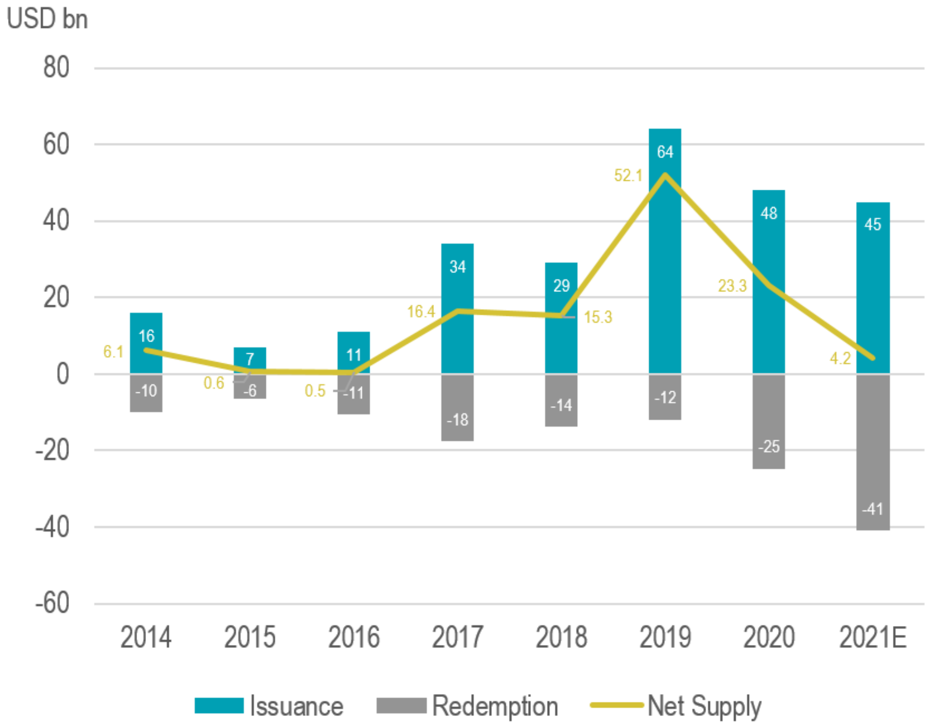
Policy: A few messages related to the sector were highlighted in Central Economic Work Conference held in December 2020: 1) housing is for living, but not for speculation; 2) The "three red lines" rules on capping debt growth at 0-10% will facilitate deleveraging for developers; but this should not translate into systemic risk for the sector with low government's tolerance; and 3) it will increase land supply and strengthen regulation for the rental property market.

The government has tightened property policies from 2H20, a trend that is likely to continue in 2021. The shift towards more credit tightening measures will likely slow presales growth and modestly reduce developers' buffer to meet funding needs. Despite the concern of policy tightening, we see it more targeted towards some over-heated markets and aiming to strengthen the long-term development of the industry. With the reasonable timeline set by the PBOC for the developers and banks to meet the respective requirements, we believe the developers will exercise financial discipline and focus on enhancing operating efficiency as well as improving debt structure in the near term.

In the longer run, these measures should help anchor credit quality amidst slower growth. Overall, developers with better credit quality should be well-positioned to weather through the cycle given their leading market position and proactive liability management. Developers will likely focus on city-tier positioning, given the core trend of high land prices and modest margin contraction.

Issuance/refinancing: Taking advantage of lower yield, Chinese developers issued cUS$7 bn of bonds in the first week of 2021 alone, notably with 7-8x oversubscription rate as search for yield continues. Moreover, developers have managed to extend bond maturity, especially for better quality and higher-rated credits. This has further lengthened developers' debt maturity and reduced funding costs. We estimate that the sector has cUS$40bn of redemption in each of 2021 and 2022, respectively. Given the "three red lines" requirement, we expect developers to prioritize financial discipline and cashflow/liability management over growth. A modest sales growth, steady onshore yield and lower offshore yield in 2021 should help relieve the sector's refinancing pressures. "Refinancing only" rule guided by the NDRC will likely keep net supply lower than that in 2020.

Fig 8: CH prop issuance net supply to moderate

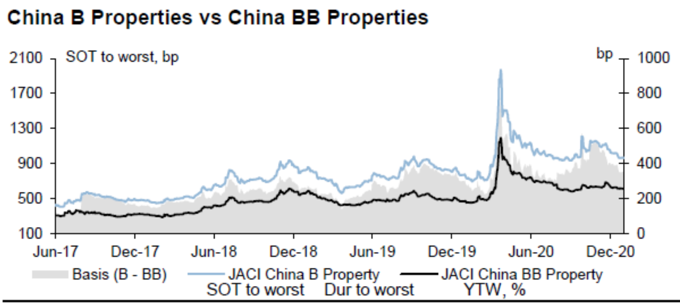


Source: UBS

Valuation: China Property (CH prop) USD HY bonds had a roller-coaster year in 2020 with a decent total return of 9.3%. Despite the big volatilities in March, the sector recovered sharply in 2Q20 and ended 1H20 with a positive return of 2.3%. It then shrugged off the corrections driven by Evergrande saga at Sep-end and the sell-off of a publicly-listed property developer in China and a Shanghai-headquartered developer in November 2020. The sector advanced further in December 2020, which drove the 4Q20 return alone at 5.1%. CH prop USD HY bond performance has been leading among Asia HY credits (excl. financial), and also ahead of global peers, i.e. CEMBI Broad HY (6.6%) and US HY (7.1%).

After the strong performance in 2020, JACI CH prop HY YTW stood at 8.5%, with CH prop B yielding at 9.3% and CH Prop BB at 7.8%, respectively. The spread differential of CH prop B over CH prop BB stood at 351bp as of Dec 31 2020, which is still at the higher end since the bottom in 2017 or early 2020s. Meanwhile, CH prop USD HY bonds still offer 323bp of spread pick-up vs. CEMBI Broad HY at 5.9%. With the attractive valuation, we expect the strong demand would continue from global investors as well as private banking clients under this low yield environment.

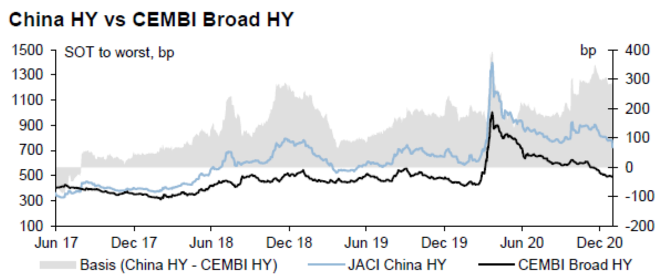
Fig 9 : JACI CN Prop B vs JACI CN Prop BB



	SOT to worst	Dur to worst	YTW, %	
JACI CN B Prop.	963	1.7	9.3	
JACI CN BB Prop.	612	2.0	7.8	
Current Spreads	351			
Historical range	LTM	Date as of	Since 30-Dec-16	Date as of
Avg	380		256	
High	774	23-Mar-20	774	23-Mar-20
Low	223	14-Feb-20	56	8-Feb-17

Source: J.P. Morgan. 31 December 2020

Fig 10: JACI China HY Corp vs CEMBI Broad HY



	SOT to worst	Dur to worst	YTW, %	
JACI CN HY	726	1.9	7.7	
CEMBI Broad HY	488	3.4	5.9	
Current Spreads	238			
Historical range	LTM	Date as of	Since 30-Dec-16	Date as of
Avg	220		127	
High	393	23-Mar-20	393	23-Mar-20
Low	132	12-May-20	-89	20-Jun-17

Note: Current prices & spreads as of December 31, 2020. Source: J.P. Morgan

Meanwhile, we expect the offshore market will continue to be supported by lower net issuance (due to the NDRC rule) and strong inflows from global investors. Therefore, we see better value in 1) solid single B names with strong fundamental and reasonable spread pick-up vs BB-rated names; and 2) higher-beta single B names with improving credit metrics or re-rating potential.

Chinese industrials

China non-property HY space rallied in late 4Q20, driven by overall bullish sentiment on vaccine and reflation story. Commodity names sold off in the earlier part of the year but rebounded the most in 4Q20. Macau gaming space was first sold off in October 2020 as visitation and gross gaming revenue numbers disappointed but rallied sequentially in line with the market in 4Q20. A Shandong-based petrochemical company completed its bond restructuring and offered offshore bondholders a 63 cents buyout using proceeds from asset sales. It is a rare example where offshore bondholders were treated better than onshore creditors as the $ bond provides holders with some advantage over the sale of the company's assets in the U.S.

We keep our cautious stance on the sector, given a tightening tone on onshore financing.

Indonesian HY credits

Indonesia credits was demanded in 4Q20 as investors search for yield and diversification. Commodities names outperformed at the back of a rebound in oil and coal prices. Against the COVID headwind, the default rate was relatively low for the Indonesia HY $ bond space (1 default during 2020), with most issuers managed to take advantage of the strong 1Q20 to extend their debt maturity profile.

During 4Q20, we also noted a few HY issuers completed liabilities management exercise, including 1) an Indonesian integrated property developer's exchange offer of its 2021 and 2022 $ notes into new 2024 and 2025 $ notes; and 2) an Indonesia-based shipping company cash tendered for US$123m of its 2023 $ notes.

We expect Indonesia HY bonds will be well supported into 2021 under the weak USD backdrop and limited supply. The rollout of vaccination and strong coal price environment should also gradually translate to improving fundamentals for Indonesia HY issuers.

Indian HY credits

India HY credits space was largely stable in 4Q20. Dominating the sector is renewable energy corporates, which by nature was less impacted by COVID19 and most of them benefit from strong sponsors. On steel names, producers benefit from an improvement in domestic demand. The sector is protected by the anti-dumping duty charged by the government on steel imports. On non-bank finance corporates (NBFCs), the sector has stabilized post RBI's liquidity infusion and strong foreign investment by well-known private equity investors e.g. Apollo and Oaktree invested in India's second largest housing finance company.

This leaves us with a major oil and zinc producer with more than US$4bn bonds outstanding. The related complex was extremely volatile and was downgraded by Moody's to Caa1 in December 2020 due to the uncertainties in refinancing its short term maturities. Buoyed by the strong momentum in oil, aluminum and zinc prices, the issuer was able to issue new bonds in December 2020 to tender most of its dollar bonds due in June 2021.

Looking forward into 2021, we are slightly cautious on India HY due to the long duration of the universe i.e. it is subject to higher U.S. rate risk.

Data sources are attributed to Bloomberg unless specified.