Fixed Income Outlook 4Q 2021

Value Partners
Investing through discipline

Distorted valuations but be selective

Inflation expectations in the driving seat

The third quarter of 2021 was characterized by further growth normalization as fiscal stimulus and low base effect faded away. Global inflation, however, remains to be the dominating theme in the coming quarters, driven by ongoing supply chain constraints and high energy prices. Rising vaccination rates releasing pent-up demand and potential wage gains in the US could accelerate inflation worries. We expect that the supply chain issue may be resolved in 2022, which may alleviate some of these inflationary pressures. Markets would therefore likely maintain the expectation for a very gradual Fed hiking cycle. There are scopes for the 10-year US Treasury yield, which is c1.5%, to nudge a tad higher by the end of 2021, but we see the magnitude nowhere close to the extreme move in March 2021. Despite tighter financial conditions in the US, ample liquidity and sizable negative yielding bonds (US$ 11.7 trillion) globally would continue to lure demand for yield enhancing assets.

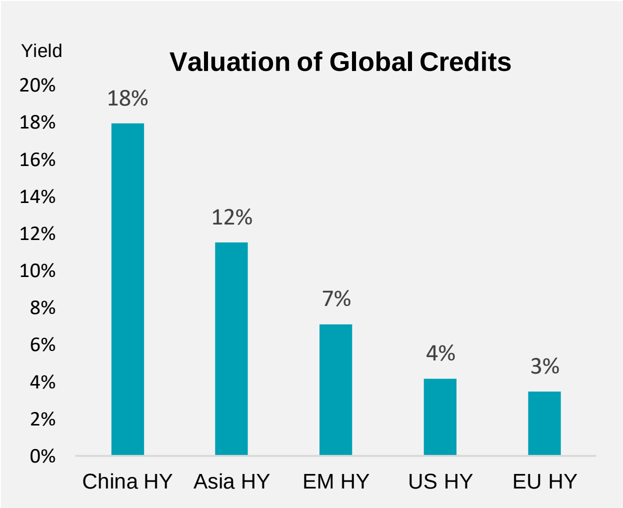
China policies take the spotlight

In China, policy drove much of the volatility in the third quarter, which was in line with expectations in our last quarter outlook. With the government's priority on controlling financial risks and leverage, credit growth would remain subdued. Nonetheless, we expect that credit contraction is bottoming and some marginal rebound should occur in the coming quarters. Slower growth momentum and People's Bank of China's ("PBOC") keen maintenance on liquidity should limit 10-year Chinese government bond ("CGB") yields, currently at 2.9%, to materially rise. Moreover, persistent foreign inflows into onshore bond market and strong trade export should mitigate cyclical headwinds for the renminbi, which should bode well for the Asia dollar bond market.

The recent PBOC narratives downplaying the concerns on inflation and the use of other monetary measures to maintain stable liquidity has diminished hopes for further Required Reserve Ratio ("RRR") cuts. Specifically for the property sector, with more failed land auctions and cooling property sales, the PBOC guided banks to resume giving out mortgages in several cities and provide loans to ensure a healthy state of the sector. On the other hand, the Ministry of Housing and Urban-Rural Development ("MOHURD") is said to be drafting rules to strengthen supervision on developers' presale funds – which could impair their financial flexibility, in our view. The potential launch of nationwide property tax may further affect sentiment. Overall, we believe the government will keep a tight stance with some marginal adjustments to avoid a material spillover effect from the Evergrande fallout and any systemic risks. The market may look up to the next Politburo meeting in early November for any clue on further policy easing.

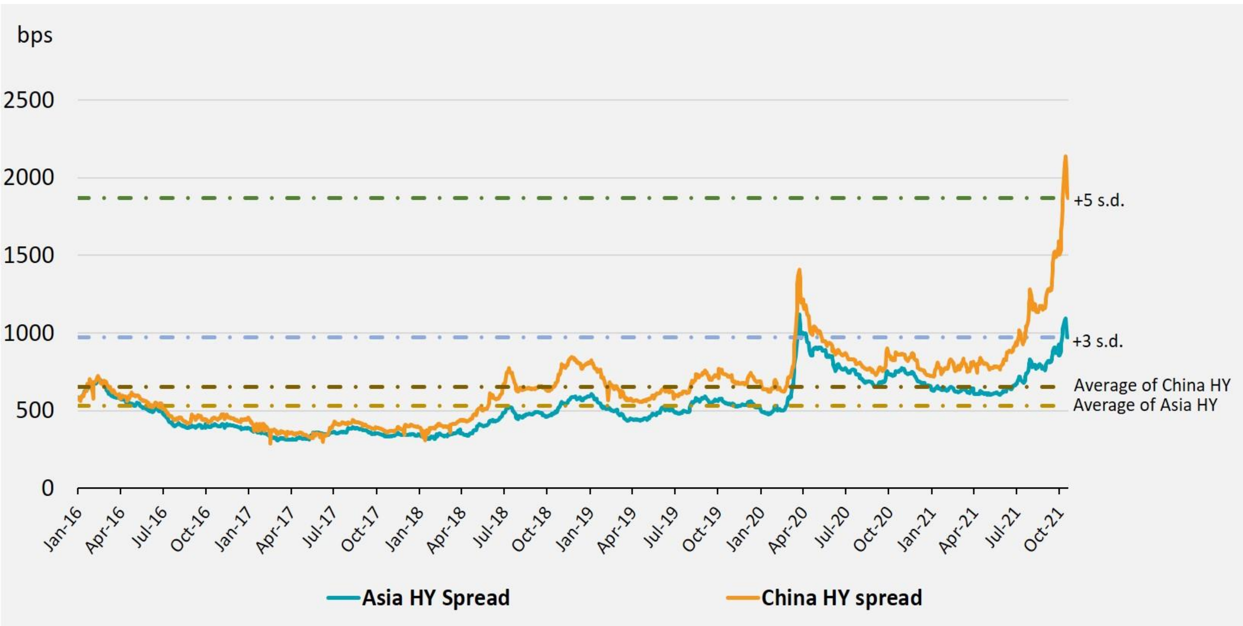
As policy and idiosyncratic risks are likely to stay on the horizon, we remain focused on credit quality for the rest of 2021. Asia's economic recovery remains intact as pandemic threats are abating. As rising US Treasury rates remain a pressure point for Asia investment grade ("Asia IG"), especially when credit spreads are tight, shorter duration is preferred. China high yield ("China HY") credit spreads stood at 5 standard deviation (s.d.) cheap over the last five years (Figure 1), indicating that a lot of the policy risks and sector consolidation have been priced in. Through our active management and bottom-up approach, we focus on searching for candidates that are long-term "survivors" but dislocated in terms of valuations (Figure 2). We believe they offer compelling value within the emerging markets space. As the Chinese property sector is undergoing consolidation with leverage control, this should anchor their credit profiles in the longer run.

Figure 2: Value dislocation in China HY bonds



Source: Bloomberg Index as of 18 October 2021

Figure 1: China HY credit spreads at 5 s.d. cheap over the last 5 years



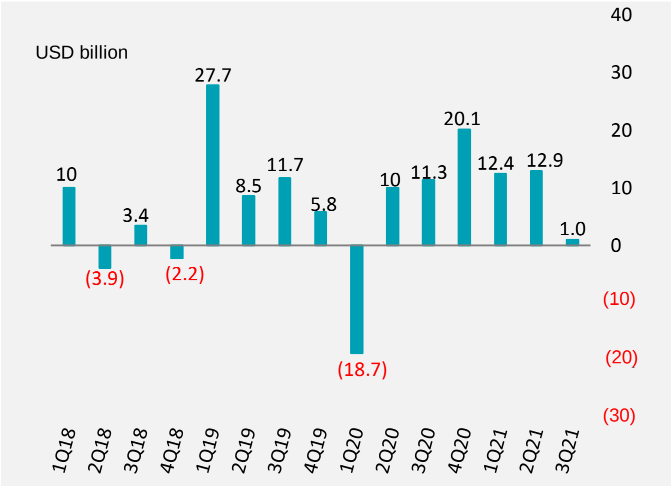
Source: JP Morgan Asia Credit Index, Bloomberg Index as of 18 October 2021

Asian bond performance

During the third quarter, credit spreads of the JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") was subdued on flat US rates move, while the JP Morgan Asia Credit Index High Yield ("Asia HY Index") widened 180bps on general risk-off and idiosyncratic events. Accordingly, the Asia HY Index (-5.7%) underperformed IG (+0.4%) in terms of total returns in the third quarter. Segment-wise, commodity and high yield sovereigns 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 Index"), underperformed (-2.7% year-to-date, 48.1% weight) on higher regulatory risks, followed by Indonesia (-0.7% year-to-date, 10.8% weight), which was modestly affected by US rates move with a skew towards longer dated bonds. On the flipside, India (+2.9% year-to-date, 6.7% weight) advanced thanks to the commodity rally. Demand for Asia bonds had been supportive for the most part of the year (Figure 3) due to fund inflows despite higher volatility and redemption pressure.

Figure 3: Emerging market hard currency bond inflow for most part of 2021



Source: EPFR data as of 30 September 2021

Sector views

Onshore China bond

The RRR cut in early July aggravated market concerns on China's economic downturn in the second half. The 10-year CGB yield flattened 21bps to 2.8% in the third quarter. Regulations on real estate and local government financing vehicles have not been relaxed. We view that there are obstacles for PBOC to pursue more RRR cuts in the fourth quarter, and monetary policy may only focus on marginal easing. That said, we cannot entirely rule out a cut amid the moderating economic outlook.

Rising US Treasury yields are becoming constraints for the China bond market. However, we view that this affects sentiment more than actual flows. Foreign funds participation into China bond market should remain robust, despite the narrower US-China yield differential at 130bps, versus over 200bps at start of 2021. More government related bonds are expected to be issued in the fourth quarter, but that should be met with better liquidity. Hence, this factor alone should place limited upward pressure on bond yields.

Onshore corporate credit bond issuance was flat year-on-year ("YoY"), while financial bonds dropped sharply due to the new Asset Management rule implemented in April 2018. The rule requires all wealth management products to be valued at fair market value instead of amortized cost, which affects demand. This trend should prevail until year-end for financial bonds. Onshore corporate yield curves should remain steady.

Asia investment grade bond

Asia IG returned 0.4% in the third quarter (-0.5% in 1H21) on flat US rates move and tight credit spreads, reflecting low fallen angel risks. China IG spreads bottomed out in the second quarter, aided by the bailout of Huarong. The planned capital injection of RMB 50 billion by a consortium of state-owned enterprises and the asset disposal of RMB 50 billion should provide some reprieve. Outside of China, Indonesia's macro-environment is underpinned by the acceleration of credit growth, while the commodity rally provides a tailwind and narrows the country's current account deficit. These should support Rupiah despite a hawkish Fed. India is also another bright spot on reduced sovereign downgrade risks.

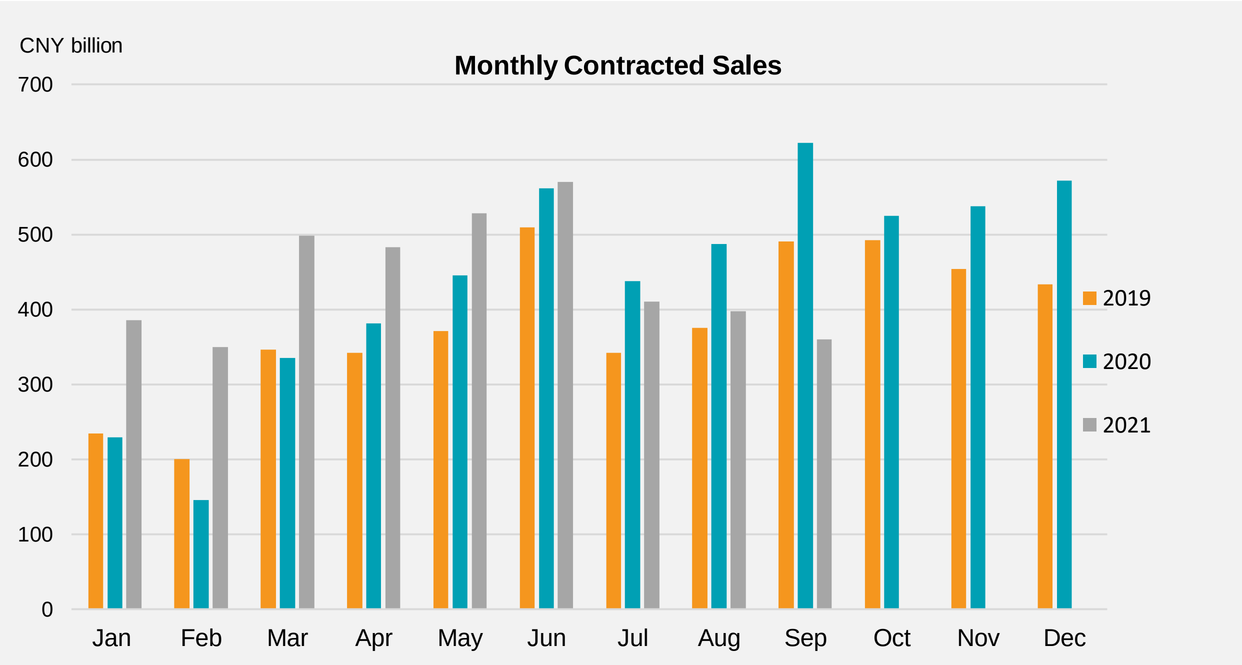
Overall, rising US Treasury yields and the renewed US-China trade tension would remain key pressure points. Pre-refinancing may bring additional issuance but this should be well absorbed by markets. We view that Asia IG credit spreads may start to widen in the midst of rates volatility and Emerging market outflows. We stay underweight the segment and prefer short duration.

China property bond

The tighter policy on developers' financing under the "three red lines" and high land prices from concentrated land sales resulted in more failed land auctions. Weaker overall property sales and sluggish prices in lower-tier cities may persist in the fourth quarter. All these may prompt some marginal easing, although we do not expect this to be broad-based. Nevertheless, we believe rigid demand will support sales growth for those cities with increasing populations in the long run.

Among the 28 listed Chinese developers that we track, contracted sales growth in the third quarter declined by around 20% YoY (9M21: +9% YoY, Figure 4 and 5) amidst an overall tight policy, fewer property launches and weaker sentiment due to Evergrande. Most developers have achieved about 70% of their full-year targets and more launches are expected in the fourth quarter. We believe those targets are achievable on marginal mortgage relaxations and sufficient saleable resources to support sell-through, which is vital for cashflow generation.

Figure 4: Monthly contracted sales



Source: Company data from 28 listed Chinese developers as of September 2021

The HY property bonds had a total return -15% in the third quarter (-17% year-to-date) on rising event risks. In addition to Evergrande saga, Fantasia's default in early October has induced collateral damage to market sentiment. This raises concerns on more defaults, especially for smaller developers or developers' that rely on the offshore bond market. Some developers might opt for the debt exchange route if bond markets remain shut for refinancing purposes or opt for offshore asset disposal to raise capital. We believe the sector has priced in a lot of the downside risks and no policy easing.

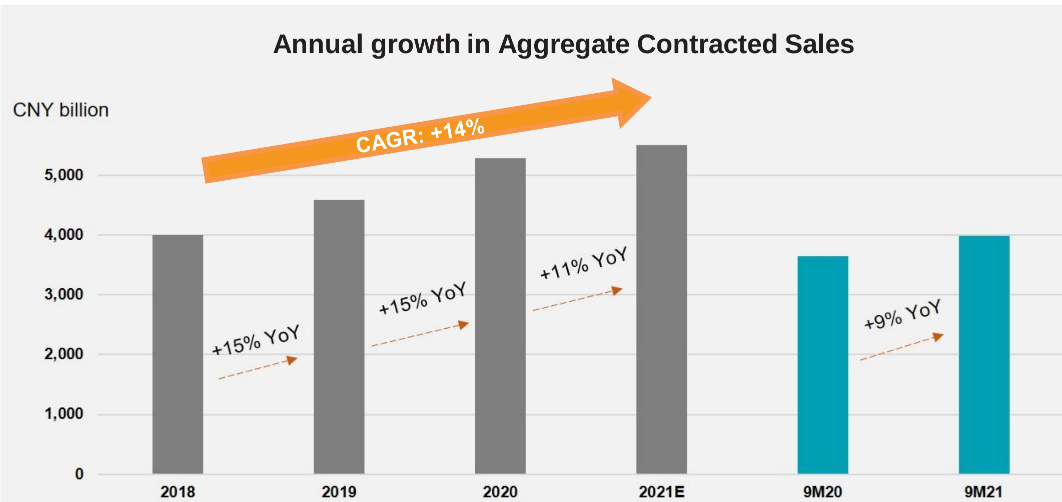
As credit differentiation continues to play out, we focus on searching for candidates that are long-term "survivors" but dislocated in terms of valuations. We also have a preference for developers that have lower near-term refinancing needs until the year-end. We estimate that developers in our universe will have dollar bond refinancing needs of US$5 billion in the fourth quarter and US$9 billion in the first quarter next year, and RMB bond of US$7 billion and US$8 billion, respectively. Refinancing pressure remains heavy. In the medium term, we are more focused on picking developers with better landbank quality and strong sales execution abilities, healthy cash collection rate, and are less exposed to off-balance sheet liabilities. We underweight those developers with heavy reliance on the offshore bond market and short landbank life as most developers slowed down their land acquisitions in recent months.

Macau gaming bond

Macau gaming bonds had a total return of -3% in the third quarter (-0.9% year-to-date), mainly affected by weaker sentiment in China high yield, slower than expected recovery and regulatory overhang. The degree of government intervention will also form another overlay on sector outlook in the longer run, despite the risk of concession non-renewal being low. Most operators have maintained sufficient liquidity buffer, which should avoid a major correction in bond prices and credit ratings. We avoid the sector as bond performance will likely be capped in the near-term, especially without good visibility on recovery of gross gaming revenue, which sits at 30% of the pre-Covid level.

In the middle of September, the Macau government announced it would undergo a 45-day public consultation period until the end of October. On top of license renewal, proposals under consideration include the appointment of a government representative to the boards, increasing local ownership, and approving dividend payments. It will take another two-three months for the government to finalize the draft paper before submitting it to the Legislative Council.

Figure 5: 9M21 contracted sales noted 9% YoY growth



Source: Company data from 28 listed Chinese developers as of September 2021

Commodities bond

The metal and mining high yield sector had a decent total return of +2.3% in the third quarter and outperformed JACI HY index year-to-date (+9.6%). Global demand for commodities will stay robust heading into 2022. The stimulus package in the US and Europe and the push for infrastructure investment from China in the fourth quarter should fuel demand. This should improve EBITDA generation and build up liquidity cushion for commodity players. We see that a huge loosening of supply/demand imbalance is unlikely to happen in the near term, unless the slowdown in China, in terms of infrastructure and property activities, lasts longer than expected. We stay invested in this space with the benefits of risk diversification.

Sovereign high yield bond

The sector returned -1.5% in the third quarter (+8.2% year-to-date), mainly driven by Sri Lanka and Pakistan sovereigns. There are uncertainties on International Monetary Fund ("IMF") discussions and criteria on taxation and power tariffs for Pakistan to unlock US$1 billion of IMF funds. Investors are also concerned about the steep decline in foreign exchange reserves in Sri Lanka. Recently, there was news that the sovereign is approaching Oman and Qatar for US$3.6 billion and US$1 billion of oil credit facility, respectively. For Sri Lanka, we believe the credit story remains binary, and the country's ability to manage its short-term debt over the next 18 months remains questionable.

Data sources are attributed to Bloomberg unless specified.

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