Value Partners
Since 1993

Value Partners
Fixed Income Investment Outlook

Executive Summary

US: Rates to stay restrictive

Despite the overall restrictive monetary tone for most of the year, economic data for the US has remained surprisingly resilient in 3Q23, which bolstered hopes of a soft landing. After pausing in June, the Fed raised rates by 25bps in July, and the market priced in odds of another hike by the year-end. The Fed's hawkish tone is expected to prevail as more time is needed to ensure inflation returns to its target and as it considers the cumulative effect of monetary tightening on the economy.

We believe the Fed's narrative on keeping rates "higher for longer" will stay for the remainder of 2023 – underlying growth appears to remain quite solid, and inflation is still some way far from the target. Although high energy prices are already on the Fed's radar, we are mindful of any Israel-Hamas war-induced upward trend, which may add incremental pressure on headline inflation.

The strong and durable labour demand continues to provide some buffer to household income and private consumption. Nevertheless, with restrictive rates taking a toll on the economy, we continue to expect job and inflation data to soften and show signs of weakness. Some downward pressure on growth may arise, given the potential weakening in payrolls, consumption, and investment sentiment. Overall, moderating growth in the US is a more likely scenario heading into 2024, and we believe the path of a rate cut is still far-fetched.

China: Need more policies to jumpstart the economy

After China's GDP rebounded to 6.3% in 2Q23 YoY due to a low base effect, its economic momentum bottomed out and moderated to 4.9% in 3Q23 YoY due to sluggish property sales and both retail sales and infrastructure investment decelerating on a high base. China has accelerated easing efforts since August, including demand-side measures for the property sector and RRR cuts, as well as speeding up the issuance of special local government bonds. On the property front, we believe these policies help set a nationwide and symbolic guidance in reviving sentiment in high-tier cities. Nevertheless, we believe the sector will take time to heal, and a sustainable sales recovery requires an improvement in expectations of income growth and job security.

The slower growth trajectory shall keep the ongoing path of accommodative measures into 2024, including the expansion of the fiscal budget, which requires more debt issuance to fund infrastructure projects and continued easy monetary policy. Other than boosting growth, these measures may address falling land sales and the tight funding environment for LG/LGFVs, which have warranted attention from the government. The Central Economic Work Conference in December shall give us some clues on the magnitude of fiscal expansion set for next year.

We believe a policy stimulus tilted toward private consumption would be more desirable and effective in rebalancing the growth outlook. On the other hand, interest rate cuts and credit expansion appear to be not as effective, given the overall subdued household and business sentiment. We believe a massive rate cut is unlikely due to the unwanted impacts on capital outflows, currency depreciation, and banks' financial health. Hence, we see challenges remain for the government in addressing the efficacy of fiscal expansion, demographic issues, and ways to achieve more sustainable and high-quality growth in the medium term.

Asia: Manageable inflation challenges

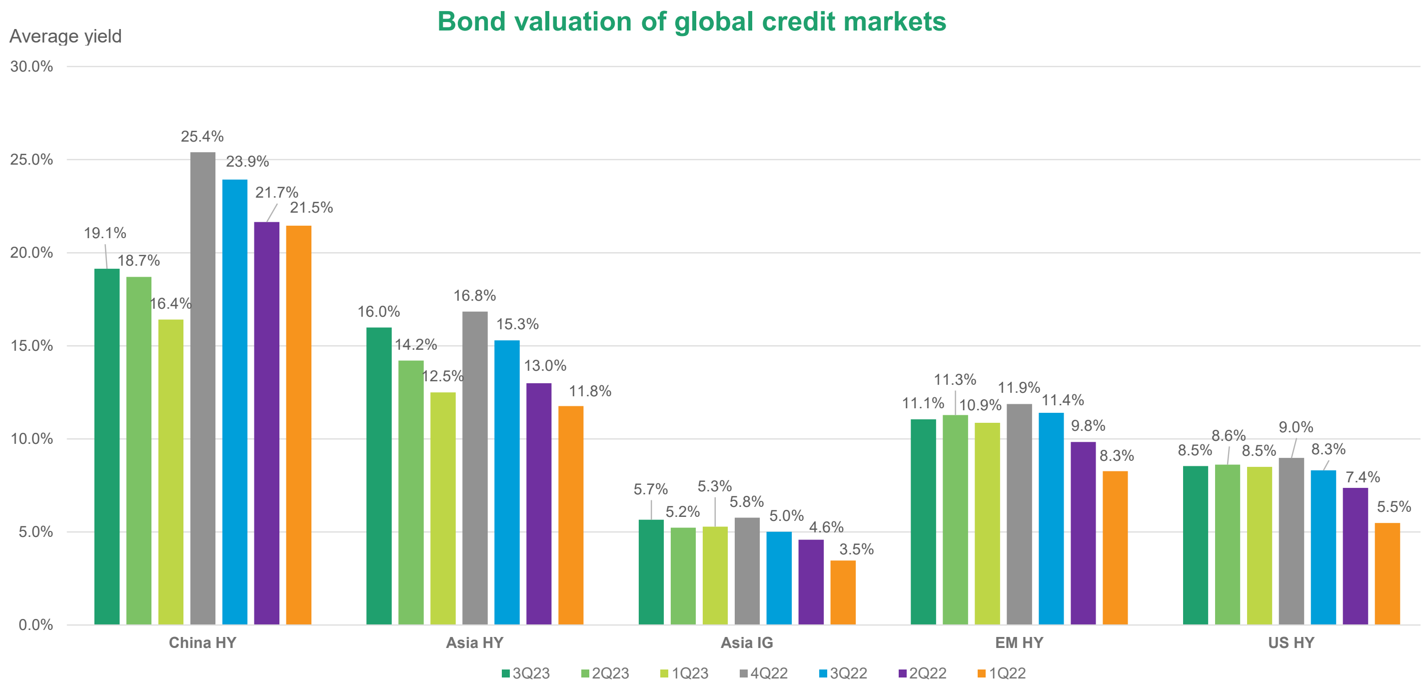
After the pandemic, Asia's growth recovery remains in an improving path, thanks to the region's resilient domestic demand. Although the slowing global and Chinese demand weighed on Asian exports, the impacts should have largely bottomed out. Moreover, inflation challenges have not been as fierce as in the West and are mostly in line with Asian central banks' expectations, such that they were able to pause rate hikes during the ongoing US hike path. As a result, Asian onshore bond yields have not risen as much compared to the US. Overall, we believe there is a high bar for Asian central banks to resume rate hikes, especially when the inflation outlook is benign. That said, the higher for longer US rates outlook will delay Asia's rate cut cycle. Geopolitical tensions and the resulting surge in oil prices warrant caution, as a sustained overshoot may pose inflationary pressure and the resumption of rate hikes, given that most Asian markets are importing nations. Currency weakness could pose risks to Asia USD bond issuers, but peaking US rates and foreign exchange interventions that stabilize domestic currencies should see manageable impact on the asset class.

Credit Strategy

The fundamental outlook of Asia and China investment grade (IG) bond issuers remains solid with low default rate risk, supporting credit spreads. The landscape of Asia high yield (HY) has changed significantly, with fewer constituents from the Chinese property sectors, reflecting an increasingly more stable credit quality in our view. Credit selection and identifying dislocation opportunities remain crucial; the pace and breadth of corporates' earnings and cash flow recovery remain our key focus. Bond buybacks have also become more prevalent, which reduce the refinancing burden for bond issuers and underpin technicals for the select HY segment. Given the stabilizing credit outlook, improved sector diversification, and expectations of lower default rates, we see a better value proposition in Asian HY bonds heading into 2024 (Figure 1). Decent carry also provides downside protection in an overall slowing growth environment.

We prefer a barbell strategy to balance risk reward in a likely challenging 2024 with restrictive US rates and China's patchy growth recovery. On the one hand, Asia IG bonds, yielding 5-6%, provide a decent income choice with a shorter duration than its US peers. We see some opportunities to rotate into longer-term bonds to reduce the re-investment risk when there is a clearer picture of the path for a Fed pivot. The Asian HY space also offers pockets of opportunities for issuers with decent-quality assets and access to onshore capital markets that facilitate their ability to refinance. Our themes on credit selection stay with those beneficiaries from a consumption-led recovery or deleveraging trend. We monitor the speed of a fundamental turnaround in China and maintain our strategy of diversifying our exposure into India, Indonesia, Hong Kong, and Macau.

Figure 1: Compelling Asia bond valuations versus peers, with improved sector diversification and default rates stabilizing



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

3Q23 total returns were hurt by a surge in US yield and risk-off sentiment. JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and High Yield ("Asia HY Index") generated -1.3% and -3.4%, respectively in the quarter versus 1.7% and -1.4% upto 9M23.

Sector Views

Onshore China

The 10-year China Government Bond (CGB) yield had a V-shape move during 3Q23 (2.7% at the end of September), with a weaker economic outlook accompanied by a 20bp spike since August lows. With property and consumption activities lacking sustainable strength, the risk of a further uptick in CGB yields is controllable unless there is a rising likelihood of a ramp-up on the fiscal budget, which increases bond supply.

The People's Bank of China will likely exercise caution on policy rate cuts, given their impact on capital outflows, net interest margin (NIM) pressure for banks, and deprecation pressure on the renminbi. The gradual economic rebound should also reduce the need to cut rates. The dollar strength and higher for longer US rates lead us to believe the yield gap between US and China government bonds will stay wide in 4Q23 (currently at 220bps).

Asia Investment Grade

Not much has changed with the Asia IG index credit spreads in 3Q23, despite the sharp selloff in US rates, reflecting largely solid credit fundamentals. The sector should offer defensiveness with an attractive all-in yield and favorable technicals. However, we see limited room for further spread compression, based on its historical average and versus US peers. Yet, a material widening in the credit spread is not our base case, as US credit spreads shall avoid a recession-style selloff. Some consolidation in the US treasury yield will be a key driver for performance in 2024.

The slower and uneven growth in China, as well as high US rates, will take centre stage for Asian credits in 2024. Asia IG should remain broadly stable, with high-rated credits being the most resilient due to their strong balance sheets and market positions, as well as access to funding. The weight of Asia IG and high-rated credits within the index also increased, such that A/AA credits constituted around 44% of the JACI Composite Index, followed by BBB at 41%. This, together with low fallen angel risks and limited bond supply, should bode well for Asia IG to remain resilient in 2024.

China Property

The various easing measures for the sector are yet to provide a game changer on broad-based confidence and demand weakness. Property sales exhibited a marginal rebound in September despite rounds of measures introduced in August that focused on the recovery of higher-tier cities, indicating the need for more easing measures. We expect sales growth to bottom in 2023-24 as concerns over job security and income growth remain key hurdles for housing demand, which take time to recover. This view is also predicated on our expectations that the government will maintain a supportive, non-aggressive tone in reviving the sector and a slowing urbanization rate.

The divergence trend for SOE and POE developers will likely be sustained, with the former benefiting from policies supporting higher-tier markets and access to funding. We have a cautious view on a POE sales turnaround, given limited land acquisitions on tight funding, lower new supply, and restrictive property sales escrow accounts that prioritize project delivery.

Overall, we expect nationwide property sales value to fall by 10% in 2023, narrowing from 2022 (-28% YoY), and maintain a soft trend in 2024 (-5 to -10% YoY). New starts will likely decline on a similar scale due to constrained land acquisitions, low sell-through rates, and more resources devoted to project completion. These will drag real estate investment (REI) growth. Separately, the government has been promoting the renewal of old urban villages in high-tier cities to revive REI. However, the scale, pace of property price recovery, and funding sources will likely differ from the shanty town redevelopment scheme, which was primarily funded by policy bank loans that resulted in a sector upcycle.

Macau Gaming

Gaming operators have benefitted from a strong recovery in gross gaming revenue (GGR). Market-wide mass GGR in 3Q23 has already improved to around 90% of 2019 levels. We believe this mass-driven growth trend will support improvement in operators' credit profiles in terms of EBITDA growth and free cash flow generation on a YoY basis. Industry EBITDA would land in the range of US$6-7 billion in 2023, which more than covers interest costs and capex amounting to US$3-4 billion. This shall facilitate deleveraging and prompt more rating upgrade actions. We note that while China's softer growth outlook may impact mass market recovery, the operators' credit profile shall remain stable in the medium term.

We view that there is some room for mass demand to ramp up, given more new hotel rooms and improving labour issues. This, coupled with steadily rising margins from operating leverage, should boost EBITDA in 2024. Further outperformance for the sector may drive mass demand to reach 110-120% of 2019 levels. However, this could be a challenging task on expectations of slower growth in China.

Overall yield and credit spreads have widened in September due to the selloff in US Treasures. With non-demanding bond valuations after the correction, limited new supply, and improving fundamental trends, we believe the sector will continue to provide good carry opportunities and diversification benefits within Asia HY.

Indian Corporates

India remains one of the growth engines within emerging markets, thanks to its resilient domestic demand and substantial government capex that has boosted investment. Despite expectations of a high fiscal deficit to continue, the government's limited external debt position moderates currency and capital flight risk. This should anchor macro stability, and the overall picture should not deviate much with the upcoming general elections in 2Q24.

While Indian HY corporates' fundamentals are broadly on solid footing with supportive onshore market financing conditions, bond valuations (spanning across renewables, commodities, and utilities) appear rich relative to its US peers. That said, the sector should remain well-anchored, given the favourable macro backdrop and the lack of bond supply. We adhere to our view on potential credit spread widening in the space on a US hard landing scenario, the impact of sustained high oil prices, and the monsoon season's sequential upside risks to inflation. Any consolidation in this space would provide investment opportunities. We expect the Reserve Bank of India to keep rates unchanged for the rest of FY24 (ending March).

Indonesian Corporates

Indonesia's quick consolidation of its fiscal deficit was supported by the surge in commodity prices and improved domestic economic conditions. On the other hand, slower global and China growth should cool down the country's export and commodity outlook. Nevertheless, Indonesia's prudent fiscal stance and manageable inflation help support a resilient macro picture. The country's focus on higher value chain manufacturing and the electric vehicles ecosystem could attract foreign inflows and provide growth alternatives in the long run. Bank of Indonesia's emphasis on currency stability should avoid a volatile move in the Indonesian rupiah. Overall, we do not anticipate major policy changes post-election in February 2024. Indonesian HY bond performance (spanning across property, mining, and industrials) was largely stable, with manageable refinancing risks and diversification benefits. We closely monitor if the weaker demand from China filters through to commodity prices.

Value Partners Hong Kong Limited
43rd Floor, The Center, 99 Queen's Road Central, Hong Kong
T +852 2143 0688
F +852 2564 8487
E vpl@vp.com.hk

Value Partners Fund Management (Shanghai) Limited
701, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

Value Partners Asset Management Singapore Pte. Ltd.
9 Raffles Place, #13-04 Republic Plaza, Singapore 048619
T +65 6718 0380
E vpams@valuepartners.com.sg

Value Partners Investment Management (Shanghai) Limited
702, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

Value Partners Asset Management Malaysia Sdn Bhd
Level 28, Integra Tower The Intermark, 348 Jalan Tun Razak,
50400 Kuala Lumpur, Malaysia
T +60 3 2775 7688
E vpmy-enquiry@valuepartners-group.com

Value Partners (UK) Limited
City Tower, 40 Basinghall Street, London EC2V 5DE,
United Kingdom
T +44 20 3907 3870
E vpuk-sales@valuepartners-group.com

www.valuepartners-group.com