# Value Partners
# Fixed Income Investment Outlook

## Executive Summary

### US: More patience for a policy pivot

Softer prints in US inflation and the Fed's dovish tone in 4Q23 have buoyed expectations for a pivot to materialize in 2024. We have likely passed the peak monetary tightening cycle we saw in 2022 and 2023, when the Fed raised rates by 425bps and 100bps, respectively, and paused in the September 2023 meeting, given the moderating inflation trend. However, the inflation print in January 2024 surprised on the upside, making the last mile of disinflation a difficult one. Overall, we believe the Fed will ensure inflation is durable enough to reach its 2% target and stay patient on the rate cut path.

The changing inflation landscape and the Fed's cautious optimism regarding the US economic strength have shifted market expectations of the rate cut magnitude in 2024 – from initial expectations at the start of 2024 of seven rate cuts for the year to just three-five times. Some risks emerge for a June cut if inflation remains surprisingly persistent. This also suggests the volatility of the US Treasury (UST) yield could rise.

The US's real GDP finished strong at 3.1% YoY in 4Q23 (+2.9% YoY in 3Q23), driven by upside in trade, business investment, and consumption. Our base case is a softer economic trend post restrictive monetary policy in the past two years. The lower fiscal stimulus, higher borrowing costs, and a sequential slowdown in consumption could present some headwinds for growth in 2024.

### China: A reactive easing stance to cope with slower growth

China's real GDP in 4Q23 slowed sequentially from 3Q23 but expanded at 5.2% in 4Q23 YoY (+4.9% YoY in 3Q23) due to a low base effect. Infrastructure fixed-asset investment (FAI), exports, and retail sales all accelerated on a YoY basis. However, property sales remained sluggish. The deflationary trend intensified, with CPI falling by 0.8% YoY in January 2024.

China has accelerated easing efforts, though mostly modest in scale and piecemeal. We see limited monetary options, and the ongoing emphasis on accommodative measures would not deviate much. With respect to the property sector, new policies introduced in January 2024 focused more on the property financing side, including "whitelist" projects eligible for funding support and investment property (IP) operating loans. We see these marginally positive. We believe property sales remain instrumental in the sector's turnaround, which requires an improvement in income growth and job security expectations. While the sector may create a lower drag compared to previous years, we also need an overall reflationary policy, potentially with more fiscal stimulus.

We believe challenges remain for the government to address the efficacy of fiscal expansion, demographic issues, and weak demand in the medium term. The National People's Congress (NPC) meeting next month shall give some further clues on growth drivers whereby focusing on high-quality growth should remain a top government priority. Some of the key assumptions being factored in include the setting of the fiscal deficit at 3-4% and government bond issuance to be at a similar scale as last year, more pledged supplementary lending (PSL) to be provided by the PBOC to banks for the infrastructure and property sector, and easier monetary policies like RRR and rate cuts.

### Asia: Disinflation progress supports an easing path

The post-Covid growth recovery in Asia and stable macro backdrop support the credit quality of Asian bond issuers. The broad assumption that a US policy pivot does not coincide with a major growth slowdown would limit the downside risk on growth for most Asian countries. The excessive monetary tightening has not led to widespread asset quality issues for Asian banks, which have maintained steady non-performing loans (NPLs). We expect some Asian countries to start rate cuts in 2024 on a more benign inflation trend, as seen in 4Q23. Lower borrowing costs should have a positive impact on credit appetite to fund expansion plans. This, coupled with resilient domestic demand, should underscore the growth trend. Geopolitical tensions leading to a sharp rise in oil prices could expose some risks to Asia, which is largely a net commodity importer, though we believe this is manageable.

## Credit Strategy

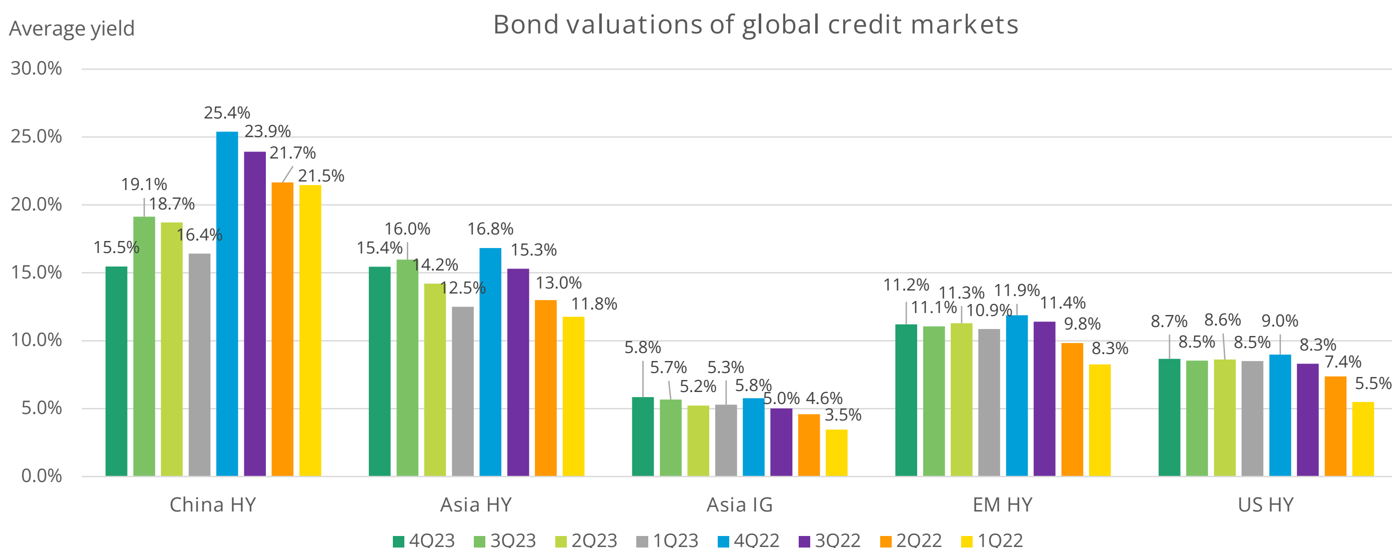
Falling UST yields were the driving force behind the risk rally for the Asian credit market in 4Q23. Credit spreads for Asia high yield (HY) bonds compressed by 60bps (source: JACI) on an average in 4Q23 versus 3Q23, with risk-on sentiment. The trend of spread compression prevailed and another 134bps tightening was observed in Asia HY on a YTD basis. Asia investment grade (IG) bonds showed a similar trend, with spreads tightening by around 30bps YTD. We expect Asian credit spreads to remain well anchored, given limited issuance, particularly defaults stabilizing and improved sector diversification in the high yield segment. Given the credit spread move, returns will be driven by decent carry in the Asia HY space, where a Fed pivot shall post an upside for Asia IG bonds.

We continue to hold the view that the fundamental outlook of Asia IG bond issuers remains solid with a broadly stable macro backdrop and credit conditions. The rising odds of a rate cut later this year, plus disinflationary trends, should provide a constructive backdrop for IG bonds and duration. With the volatility in UST likely to rise, we believe there are some opportunities in the Asia IG space, which remains a decent income choice with a shorter duration than its US peers.

For Asia HY, China's weight has structurally reduced to 23% from 54% in 2020, with a more balanced and diversified portfolio towards other APAC regions. A lot of the sectors do not directly correlate with the Chinese property sector and offer diversification benefits. For instance, decent growth momentum in Macau and a solid macro backdrop in India and Indonesia shall underpin bond issuers' credit quality. We have seen more prevalent bond buybacks by issuers in these regions and shall reduce issuers' refinancing burden accordingly.

Compared with US HY and EMEA HY's 3-4% default rate in 2024 under a US soft landing scenario, Asia HY (excluding China property) should fare much better at 1-2%, thanks to the region's manageable refinancing needs and supportive local capital markets. Given the limited bond choices, we believe rollover risks are more receptive, with issuers offering decent carry and room to improve their credit profiles via earnings growth and deleveraging. Our themes on credit selection stay with those beneficiaries, which will allow us to capture some alpha returns.

**Figure 1: Asia credit markets enter a more stable credit cycle with structural change in key constituents**




Source: JP Morgan Asia Credit Index, Bloomberg Index; as of Dec 2023.
4Q23 total returns were boosted by lower UST yield and risk-on sentiment. JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and High Yield ("Asia HY Index") generated +5.6% and +6.3%, respectively in the quarter versus +7.4% and +4.8% in 2023.

## Sector Views

### Onshore China

The 10-year China Government Bond (CGB) yield headed lower in 4Q23, especially in December, to close at 2.6% due to the ongoing weak growth momentum. The overall yield level dialed back around 30bps on a YoY basis in 2023 as property and consumption activities lacked strength. We see the risk of CGB yields trending upwards is low in 1Q24 as the government signaled more room for monetary easing. The NPC meeting will guide a ramp-up of the fiscal budget to boost growth, which will likely increase the bond supply in 2Q24.

Some rate cuts should remain on the radar during 2024, given slow growth and deflationary pressures, but will unlikely be material in our view, given the negative repercussions on capital outflows, net interest margin (NIM) pressure for banks, and deprecation pressure on the renminbi. Expectations of a gradual economic recovery should also lower the magnitude of further rate cuts. Fund flows into China is pressured by the dollar's strength and high UST yields. This yield gap (currently at 200bps) may narrow more when the US pivot starts to materialize.

### Asia Investment Grade

Asia IG index credit spreads were sideways in 4Q23, and the sharp rise in US treasuries was the key driver of the 5.6% return for the sector. While spreads err on the tight side, the sector should offer defensiveness with an attractive all-in yield and favorable technicals. The room for further spread compression is quite limited, given the fair spread pick-up of 40-50bps over its US peers. Yet, a material widening in the credit spread is not our base case, as the US shall avoid a recession-style selloff. Some consolidation in the US treasury yield will be a key driver for performance in 2024, and we focus our strategy on long duration opportunities in high rating buckets in the likes of China state-owned enterprises (SOEs) and Japanese banks or life insurance companies.

### Macau Gaming

Gaming operators' strong recovery extended in 4Q23, with the market-wide mass gross gaming revenue (GGR) and EBITDA improving to close to 100% and 120% of 2019 levels, respectively. Visitations continued to surprise to the upside. The mass-driven EBITDA growth

at 20-30% YoY in 2024 should underpin operators' deleveraging efforts and prompt more rating upgrade actions. We believe the ramp-up in mass demand, backed by more new hotel rooms and improving labour issues, shall help sustain mass market recovery despite China's overall patchy growth.

Macau gaming bonds kept its resilient performance in 4Q23. Although bond valuations have become demanding, improving fundamental trends and limited bond supply shall keep the sector a good carry and diversification play within Asia HY.

## Indian Corporates

India's economic growth has been holding up well, with real GDP growing at 7.6% YoY in the December quarter (+7.8% YoY in 2Q23). Growth may moderate in FY 2024-2025 on a YoY basis (ending March 2025), given the slowdown in capex ahead of the election. Inflation decelerated in January 2024, but there remains vigilance for inflation to trend towards the 4% target and is subject to food price volatility. Expectations of a high fiscal deficit to come should not materially increase currency and capital flight risks, given the government's limited external debt position. This should anchor a stable macro outlook, and the overall picture should not deviate much with the upcoming general elections in 2Q24. A sharp increase in oil prices, which is not our base case on slower global growth, may pose a risk to macro stability. Market optimism on the Reserve Bank of India cutting rates from June 2024 will require more evidence of non-sticky inflation.

India HY rallied in line with the rest of Asia HY in 4Q23. Bond valuations (spanning across renewables, commodities, and utilities) are on the tight end relative to their US peers, while corporates' fundamentals are broadly on solid footing with supportive onshore financing conditions. Renewables shall benefit from improving receivables issues, and a major commodity player successfully completed its liability management, supporting the overall sentiment in the space. Any consolidation in this space would provide investment opportunities.

## Indonesian Corporates

A stable growth trend supported investment sentiment in Indonesia. Real GDP jumped 5% YoY in 4Q23 (+4.9% in 3Q23). A pullback on commodity prices keeps the current account on a cautious trajectory. Nevertheless, positive portfolio inflows are encouraging, thanks to attractive domestic yield. Also, the country's prudent fiscal stance, pro-currency stability, and manageable inflation help support a resilient macro picture. Inflation was steady and trended towards Bank Indonesia's target, which signals more flexibility for policy easing.

Indonesian HY bond performance (spanning across property, mining, and industrials) outperformed in 4Q23, thanks to a stable macro backdrop. Coal mining companies have been prudent in managing their cash flow and debt profile, supporting a decent set of credit metrics. We expect property sales to slow in 2024, which is not untypical in the election year, and access to onshore bank loans should help accomplish the liability management of some bond issuers.

## China Property

The government has spent efforts in reviving sentiment through a series of policy measures, but broad-based confidence and demand weakness remain key obstacles to developers' sales recovery. Many of the recently introduced policies focus on property financing support, including "project whitelist" and investment property (IP) operating loans. The former highlights projects that are eligible for funding support, which reduces buyers' concerns over delivery risks. IP loans provide some financial flexibility for selective developers to raise alternative funding for debt repayment at the group level. We see these measures as marginally positive. Sales growth shall bottom in the next few years after job security and income growth, key hurdles for housing demand, to recover. Further policies will likely be non-aggressive ones, though the tone will be supportive.

SOE market share on property sales jumped to 65% in recent years, benefiting from policies supporting higher-tier markets and access to funding. Privately owned enterprise (POE) sales turnaround remains difficult on restrictive property sales escrow accounts that prioritize project delivery and a short land bank life. Nationwide residential property sales value fell 6% in 2023 to RMB10 trillion, narrowing from 2022 (-33% YoY), and maintaining a soft trend in 2024 (-5 to -10% YoY). New starts should decline more on constrained land acquisitions, low sell-through rates, and more resources devoted to project completion.

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