Asia Fixed Income Investment Outlook for Q4 2023

September 2023

Chris Lau and Norbert Ling from Invesco's Fixed Income team share their investment outlook for Asia investment grade and Asia high yield for Q4 2023.

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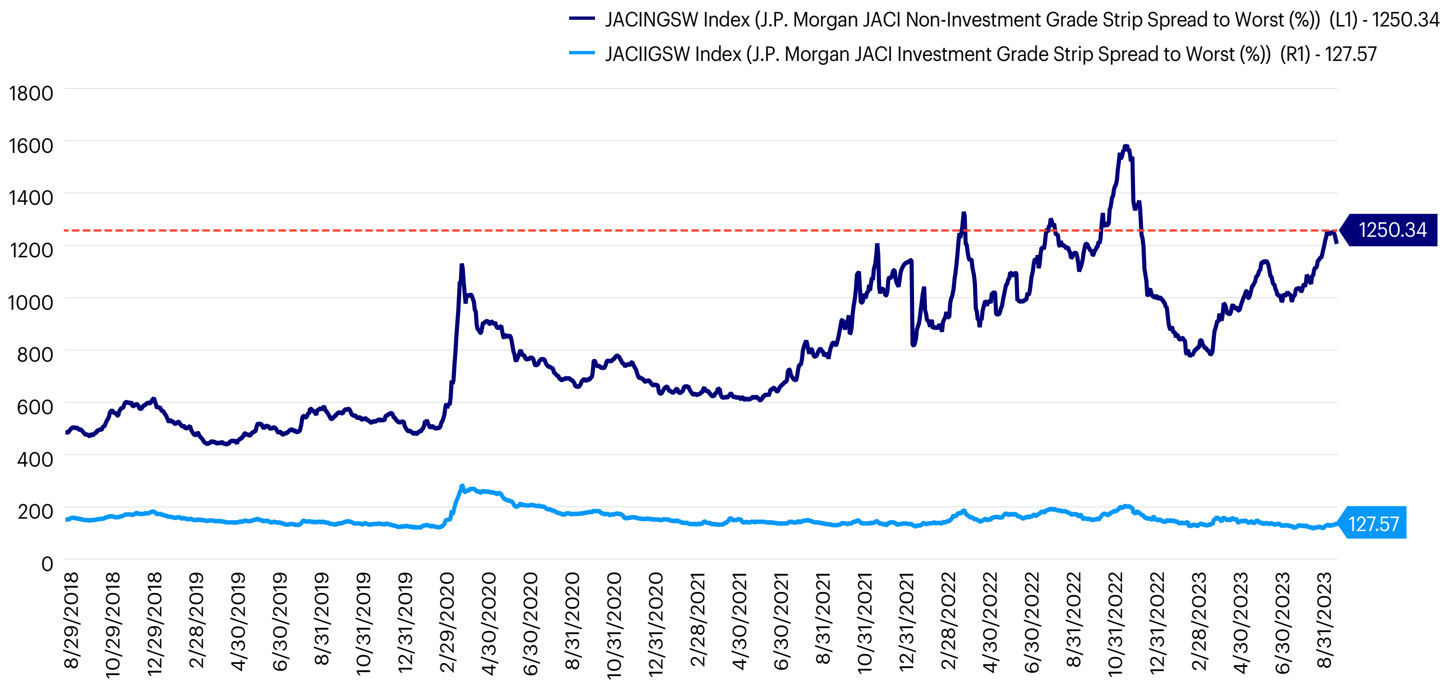
Asia investment grade (IG) outlook

Recap of Q3

Asia investment grade spreads grinded tighter in Q3, both in absolute and relative terms. Elevated US treasury yields, a better macro picture in Asia versus the developed world, and shrinking new issuance supply, led to further Asia IG spread compression. While the Federal Reserve slowed down the pace of rate hikes, it indicated more possible hikes to come. Major central banks around the world also shared a similar hawkish tone due to sticky inflation. While rate volatility persisted, Asia IG spreads continued to perform well in Q3 as Asia bonds are now pricing in a "goldilocks" scenario, enjoying stable fundamentals and strong technicals. Fund flows are also supportive, favoring high quality IG bonds due to attractive all-in yield. The JPMorgan Asia Credit Index (JACI) IG spread traded at all-time tight since 2011 at +115bps on Aug 1. However, we have seen divergence between Asia IG and high yield (HY). Credit spread of Asia HY was wide +1253 year-to-date on August 21, primarily due to the sell-off in China HY properties (Figure 1).

Figure 1 - JACI Investment Grade versus JACI High Yield (Aug 2018 – Aug 2023)



Source: Bloomberg, data as of Aug 25, 2023

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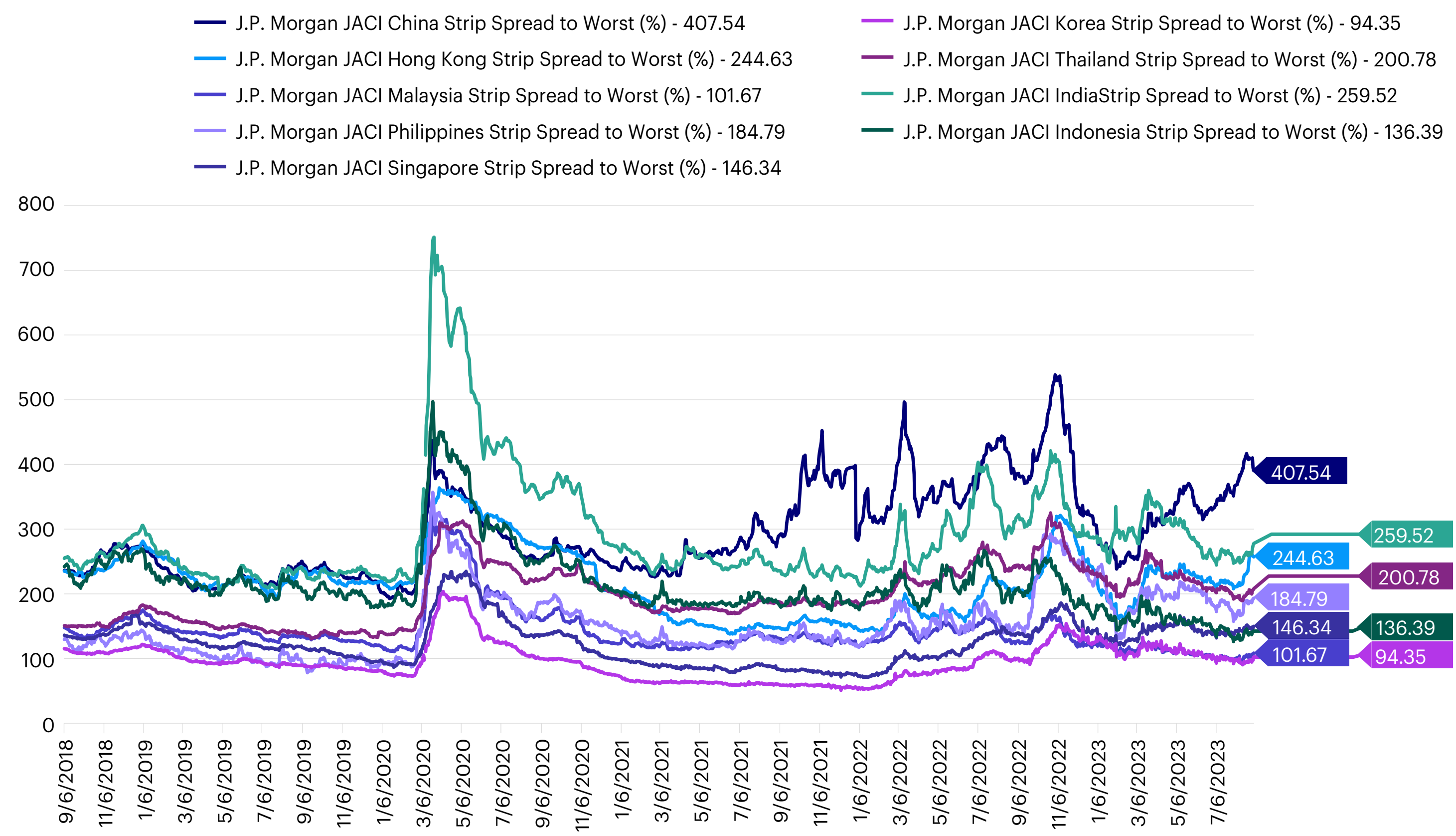
We continued to see huge divergence in credit spread performance among different Asia countries (Figure 2). Credit spread from Asia ex-China outperformed China as China continued to suffer from macro concerns and deepening HY property woes. Southeast Asian countries like Indonesia, the Philippines and Malaysia, have returned to their tightest spread levels from pre-Covid, benefitting from the relatively stable economic momentum, and investors' need for diversification away from China. Sovereign fundamentals remain strong due to moderate debt levels and fiscal discipline.

Figure 2 – Asia credit spreads by country over the past five years



Source: Bloomberg, data as of 25 Aug 2023.

While in China, July activity data continued to show a broad-based slowdown. Big downside surprises in retail sales, fixed asset investment, and industrial production (IP) confirm weakening demand amid deepening property woes and subdued consumption. Since the start of 2H23, China property developers have continued to struggle with sluggish contracted sales. China Real Estate Information Corporation's preliminary July monthly sales data showed that attributable sales of top 100 developers in July fell 36% YoY (-28% YoY in June), turning 7M23 aggregate sales growth to -5% YoY compared with slight positive YoY growth of 0.2% in 1H23. We are closely monitoring the potential for negative contagion from the credit events of two major property developers as broader risks for the property sector highlight the continued challenging environment faced by developers. We expect event risks in the sector to remain elevated for issuers with front-loaded debt stacks.

On the macro front, at the Politburo meeting on July 24, top leadership recognized the downside risks facing the economy and are pivoting toward a pro-growth stance. The PBoC cut its policy rates afterward, but other meaningful follow-through has been limited. The PBoC's rates cut came earlier and was larger than the market expected, signaling the central bank recognizes the urgency to support the economy. The outlook has deteriorated, with the property slump triggering financial stress. The surprise action raises the hope that the PBoC will play a more active role in supporting growth under the leadership of the new governor, Pan Gongsheng. We expect this to ease policy rates further, lowering rates, and the reserve requirement in the months ahead.

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Outlook
With lingering growth concerns and elevated rates volatility, we expect investors to remain relatively conservative in their positioning until we see more clarity. US inflation pressures are easing, which could give policymakers room to keep interest rates at or near current levels for the time being. Still, we believe price gains will remain above the Fed's 2% target, making policymakers hesitant to declare victory. The Fed is close to the end of their tightening cycle, the debate now is shifting from how high interest rates could go to how long they will stay elevated. High frequency indicators suggest a further moderation of China's economic momentum in Q3 that could well extend to Q4. The market focus has shifted toward easing measures from China policymakers to – what policies will be introduced, when will they take effect, and what impact will they bring. We are expecting to see a step-up in policy stimulus and more frequent announcements will be rolled out, but still anticipate targeted policy responses instead of a "bazooka" from the government.

We remain relative cautious toward Asia investment grade in the short term as investors are still focused on the downside risks on China's property sector and potential spillover risks. Part of the reason to be cautious is due to high US treasury yields, if US growth continue to surprise to the upside and if inflation proves stickier than expected, the recent move is US treasury yields could well be sustained as yields reset to a higher range around current levels. That said, we expect rate volatility to reduce toward end of the year. In our view, lower rate volatility plus attractive carry should maintain technical support for Asia credit in the medium term. While we do not see scope for material spread compression in Asia IG, we believe the relatively high all-in yields should be supportive for the space in Q4.

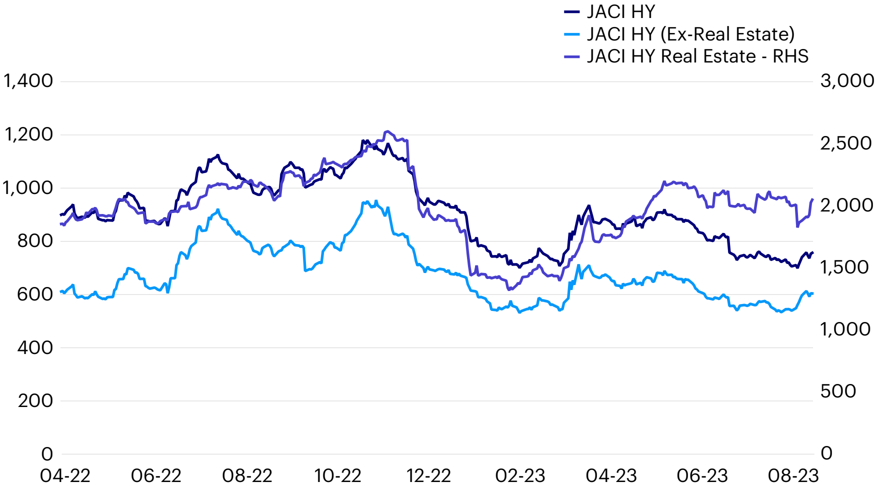
Despite the strong technicals, Asia valuations are not attractive now compared to global IG. Asia IG credit spreads traded even slightly more expensive than US IG during May to July. Meanwhile, macro uncertainties and volatility in the China property sector is expected remain a key concern for the market. With the ongoing uncertainties and gradual increase of new supply, we think Asia IG credit spreads, especially China IG, will remain volatile in Q4, and we think the spread at the index level is likely to drift wider from the August level before any meaningful stimulus is announced. It is important to stay up in quality when looking at China credit. Credit differentiation is even more important.

Asia high yield (HY) outlook

Recap of Q3
In Q3, the JPMorgan High Yield Index (JACI HY) posted negative total returns of -4.64%, which was largely due to the real estate sector specific credit issues. Excluding real estate, the JACI High Yield Index would have delivered positive total returns. This masks positive contributions from other resilient sectors such as Indian renewables as well as Macau gaming and financials.

JACI HY spreads were relatively resilient in Q3 with spreads close to pre-banking crisis levels in February. This has been a function of stable credit fundamentals (outside of real estate) and there has not yet been a default within the JACI High Yield index ex-China in 2023.

Figure 3 - Spread to Worst of Asia High Yield Index



Source: JPMorgan, Aladdin, data as of August 2023.

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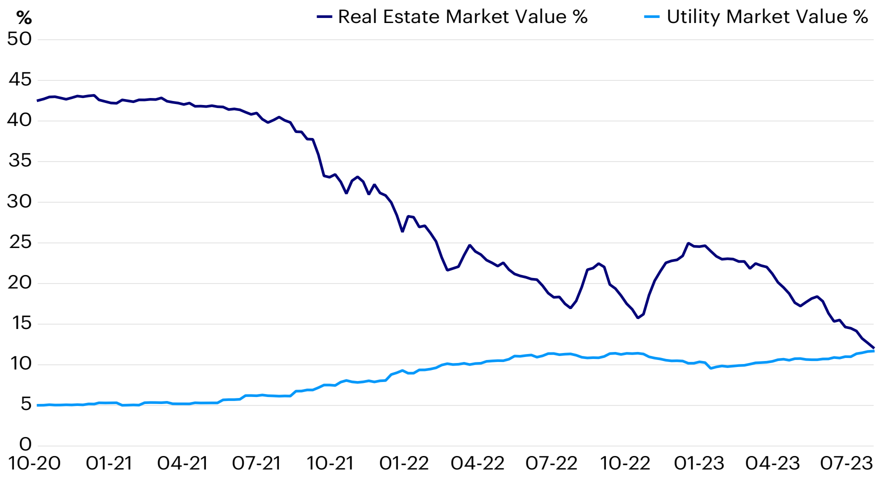
Real estate now comprises a similar proportion of the JACI HY Index as the utility sector
With credit events occurring within the China HY real estate space, there has been a fundamental sector mix shift within the Asia HY index. In 2020, real estate accounted for over 40% of the index market value and today it represents just 12% of the index. The utility sector has a similar weight in the index and this has increased over the past three years on the back of further ramping up of clean energy capacity, continued access to funding markets (both onshore and offshore) and the stable regulatory outlook for the Indian renewables space (Figure 2). We remain cautious on the China HY real estate sector as surviving companies are still facing liquidity and refinancing challenges in a weakening physical home sales market.

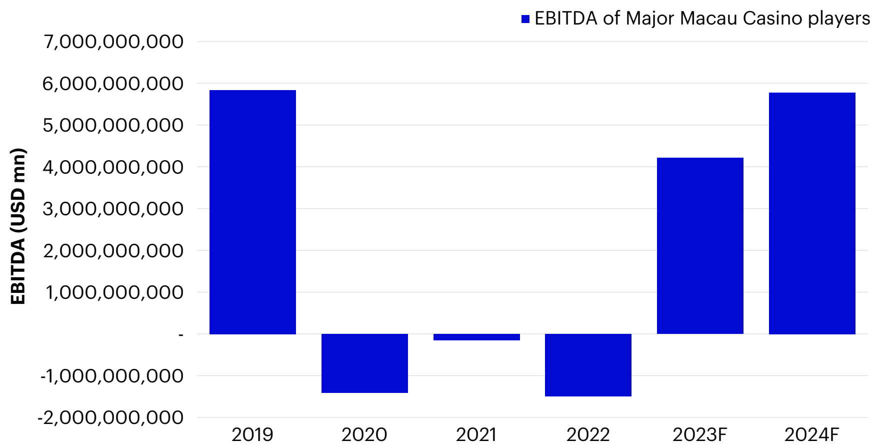
Figure 4 - Changing sector composition of JACI HY Index



Source: JPMorgan, Aladdin, data as of July 2023.

Outlook
Going into Q4, we see income as the main contributor of total return for Asia high yield which has been yielding 12%, with credit differentiation via security selection and sector allocation being a key factor. The index is also now increasingly higher quality with Single-B and Triple-C names accounting for just 23% of index weight and 12% of the index holding at least one investment grade rating. That said, given that valuations are at the tight end of the range, any upside from excess returns are likely to be limited. There are fundamental bright spots within the Asia high yield markets such as Indian renewables, Macau gaming and oil and gas issuers with resilient fundamentals. For Macau gaming, the EBITDA is forecast to return to 2019 levels in 2024 while by the end of 2023 it is expected to reach around 72% of this figure. Issuer fundamentals are expected to improve on top-line, bottom-line and credit metrics for Macau gaming issuers. We also see improved prospects for Asia frontier HY sovereigns with further International Monetary Fund support and debt restructuring progress. Lastly, we expect selective primary activities to pick up again in the Asia HY markets as issuers opportunistically refinance upcoming maturities via new issuances or exchanges.

Figure 5 - Macau gaming sector on track to recover to 2019 levels



Source: JPMorgan, Aladdin, data as of August 2023. Forward-looking statements are not guarantees of future results. There can be no assurance that actual results will not differ materially from expectations.

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Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

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