Asia Fixed Income Investment Outlook – Quarterly Update

March 2024

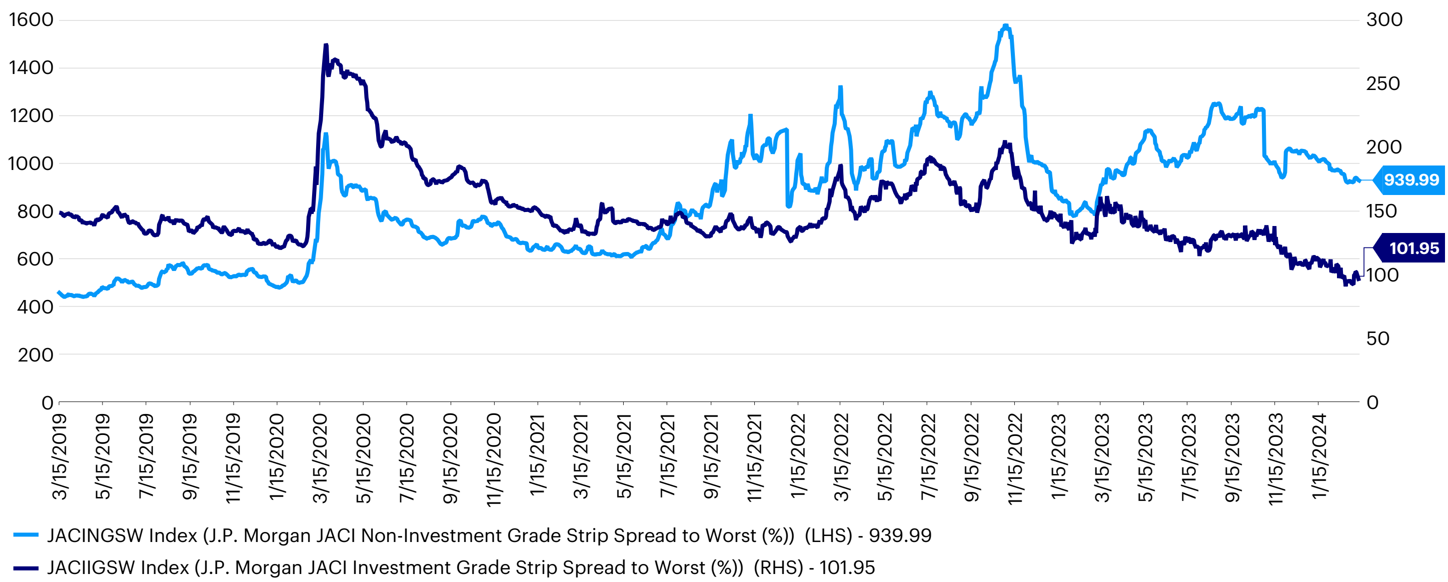
Chris Lau
Senior Portfolio Manager

Asia investment grade (IG) outlook for Q2 2024

Macro factors continue to dominate price action and market sentiment in the Asia investment grade (IG) market. US rates are an important driver of Asian credit investors' total return. US treasuries have rallied since November 2023 till early January of this year, reflecting the expectation that Fed cuts could start as soon as March. However, US macroeconomic data has been more resilient this year. Nonfarm payroll data has been strong and higher-than-expected inflation data suggests the risk of stickiness is rising and that the disinflation path can be bumpy. 10-year treasury yields have been on an upward trajectory since January reaching 4.30% thus far this year due to the unwinding of Fed rate cut expectations.

Asia credit has had a very strong start to the year despite the sell-off in US rates. Asia IG spreads have reached a new historical low year-to-date (Figure 1). JACI IG spreads have tightened by 18bps to 90bps as of 22nd February 2024, which is already lower than the earlier low of 118bps back in January 2018. From a spread perspective, Asia IG outperformed US, spread pick-up vs US IG has declined from 16bps (widest level year-to-date) to 2bps (versus 5Y average of 30bps).

Figure 1 - JACI Investment Grade versus JACI High Yield (13 March 2019 – 11 March 2024)



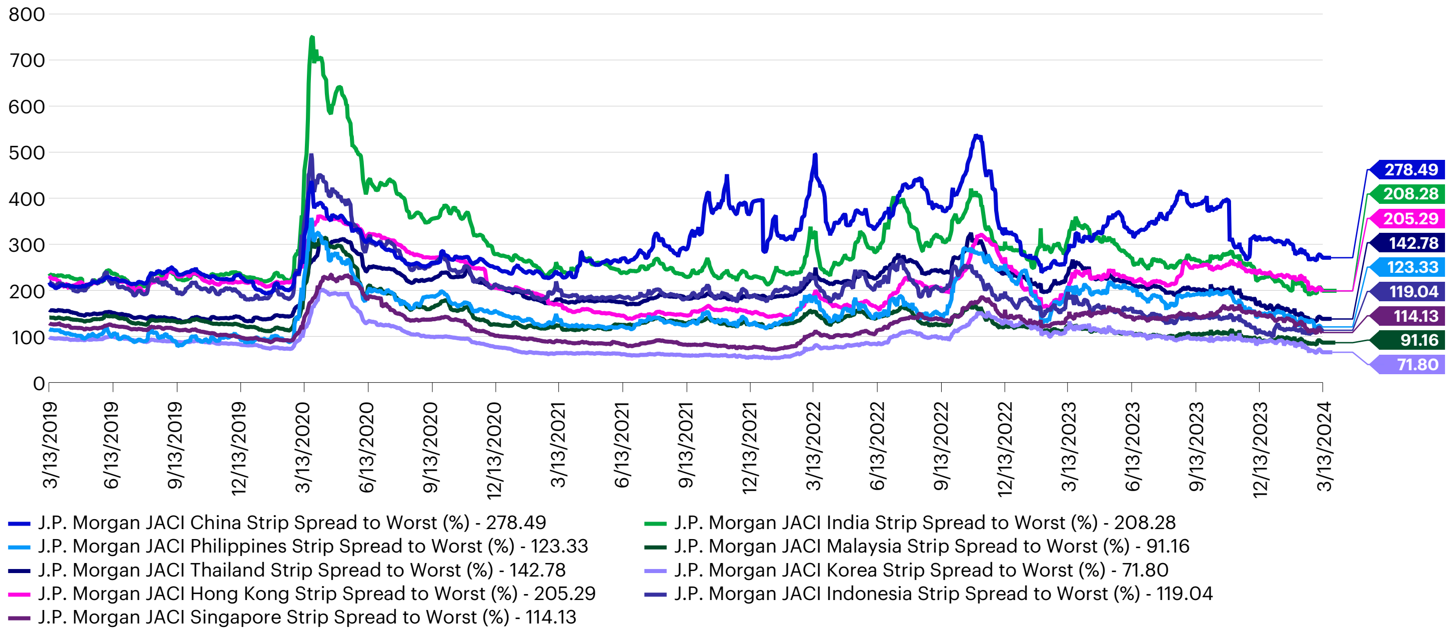
Source: Bloomberg, data as of 11 March 2024.

Fed Chair Jerome Powell told the market the Fed was "not far" from being able to cut rates. However, Fed officials will probably want a bit more evidence that inflation is moving toward their target. The "higher for longer" narrative remains a major risk factor at least for the first half of 2024 given the resilience in US growth and sticky inflation. The market is currently pricing in between three to four rate cuts this year, which we believe is about right. Current data suggests a delayed and cautious cutting cycle. We expect the first rate cut to happen in June.

In the medium term, resilient growth, disinflation and a start of the easing cycle would be a favorable environment for risk-taking. Despite the tight credit spreads, Asia credit remain attractive from an all-in yield perspective after the recent US rates sell-off. We believe Asia IG bonds should continue to perform well in Q2 enjoying stable fundamentals and strong technicals. Receding rate volatility should support fund flows in 2H 2024, favoring high quality IG bonds due to attractive all-in yields.

The People's Bank of China (PBoC) announced a 50bps cut in the reserve requirement ratio (RRR) and 25bps cut in 5Y loan prime rate. Policymakers signaled they will use interest rates to promote consumption and investment and to lower finance costs in the real economy. The PBoC noted the gap between the current inflation and its target. We expect monetary policy to remain accommodative and provide sufficient liquidity onshore. The "lower-for-longer" narrative for China onshore rates is expected to continue, which has prompted onshore investors to invest aboard. The government has set policy goals for the property sector including treating state-owned enterprises (SOEs) and private companies equally in term of financing, increasing public housing, and a further lifting of property restrictions. However, extremely weak contract sales remain a drag for the China property sector. We expect weak operating cash flow from contract sales and anticipate refinancing channels for both private developers and SOE developers to remain challenging.

Figure 2 – Asia credit spreads by country over the past five years (13 March 2019 – 11 March 2024)



Source: Bloomberg, data as of 11 March 2024.

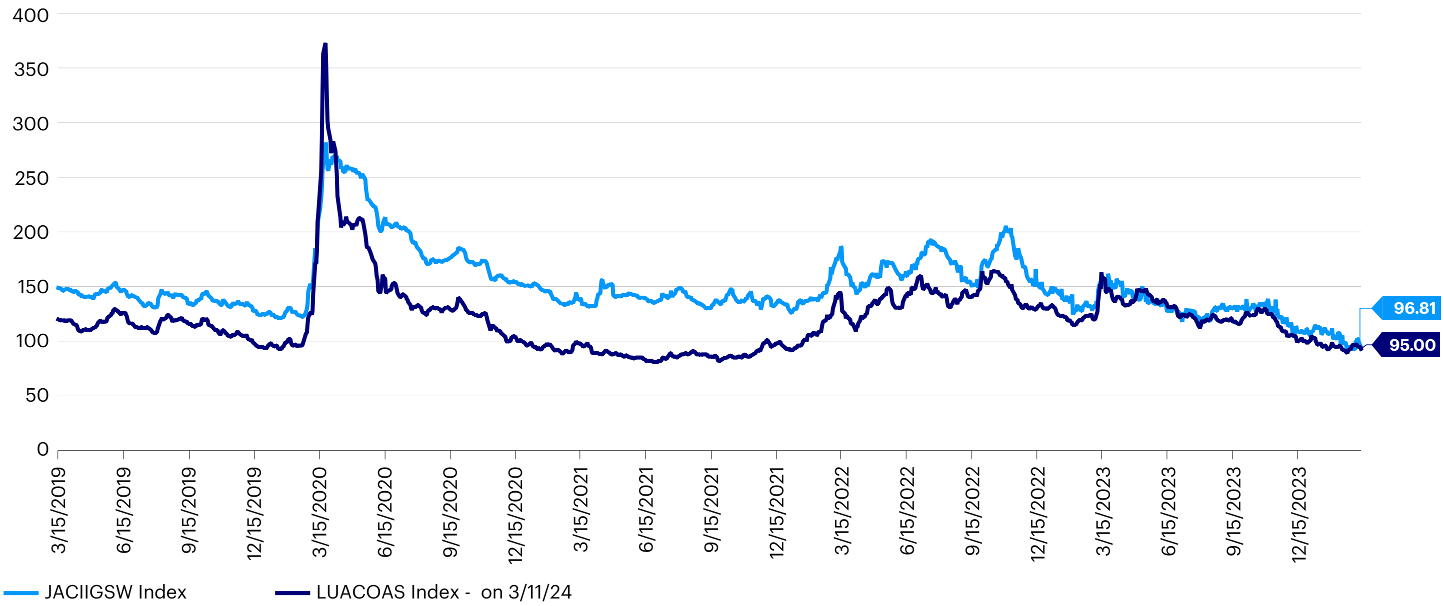
We continue to see divergence in credit spread performance between different Asian countries and China. Technical support for China IG has become very strong in Q1 2024, as onshore investors increase their allocation to offshore USD bonds, particularly SOE bonds. Credit spreads from China outperformed Asia ex-China despite the slower economy and continued property market weakness. Asia ex-China credit spreads widened toward the end of the quarter, tracking the sell-off in US IG. We remain constructive on credit spreads of Southeast Asian countries such as Indonesia, the Philippines, and India. We believe these markets will continue to benefit from stable economic momentum, benign inflation and increases in global fund flows. Exporting countries will benefit this year from surging tech-related export growth and inventory re-stocking. Asia sovereign fundamentals largely remain solid due to moderate debt levels and fiscal discipline. Inflation has peaked in most Asian countries, which provides room for these markets to keep their monetary policy accommodative.

We believe Asia corporate fundamentals should improve gradually in 2024, supported by decent economic growth prospects and access to local funding channels. However, the Chinese property sector will likely be a drag to corporate credit performance, and we expect credit risk in the Hong Kong property sector to rise. Credit fundamentals outside of Hong Kong and China appear robust, having benefited from an improved operating environment and good access to local funding.

Technicals remain very strong due to negative net supply in Asia's credit space. Early redemptions of outstanding USD bonds with bank loans or the local currency bond market have further shrunk the investment universe. We expect supply to remain muted in 2024 given the rates volatility and cheaper funding costs in the local currency market.

We expect stable fundamentals and strong technicals to continue to support Asia IG credit. We think yield carry looks attractive from all-in yield carry perspective. While we do not see scope for material spread compression in Asia IG from current levels, we believe the relatively high all-in yields should be supportive for the space in 2024. Our expectations for estimated total return is high for Asia IG when considering 2024 as a whole. In our view, most of the return from Asia IG may come from treasury moves.

Figure 3 - JACI Investment Grade versus US IG (14 March 2019 – 11 March 2024)



Source: Bloomberg, data as of 11 March 2024.

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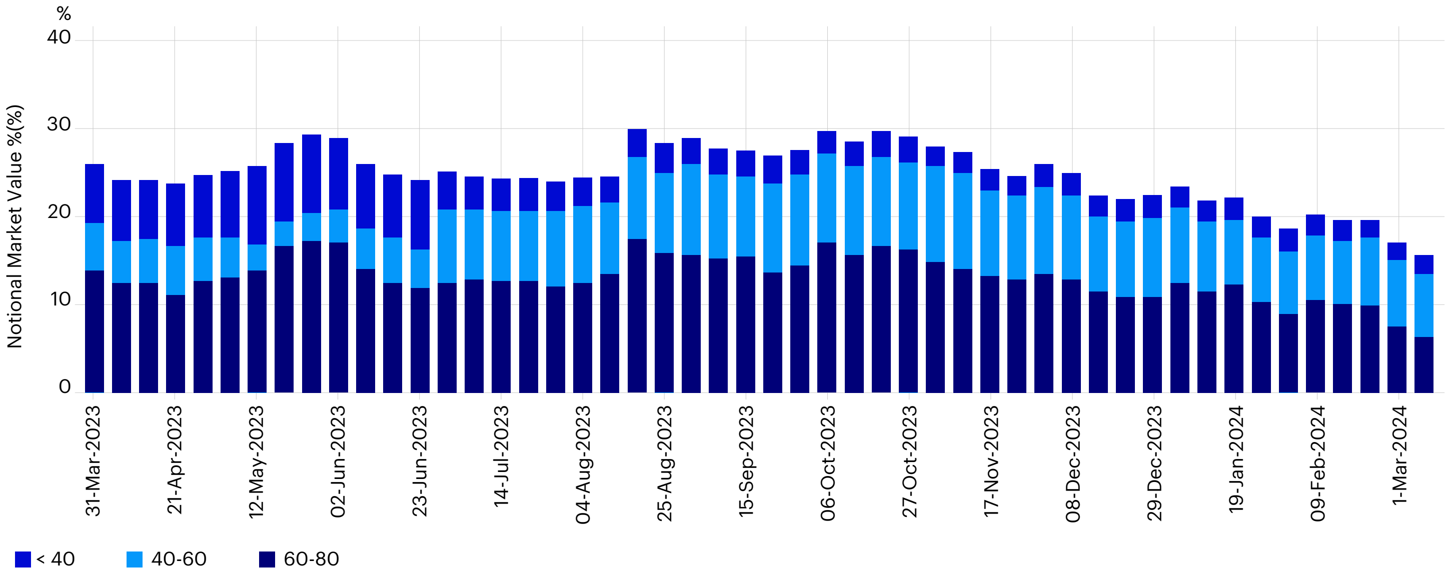
Norbert Ling
ESG Credit Portfolio Manager

Asia high yield (HY) outlook for Q2 2024

The Asia HY asset class has got off to a strong start in 2024, and the total return of the JPMorgan Asia Credit Index (JACI) HY amounted to 5.6% as of 8th March 2024. The asset class has outpaced both European HY and US HY in terms of total return, in large part due to excess returns contribution within the CCC and B rating categories. The proportion of bonds with a cash price of 80 cents or below decreased from 30% in Oct 2023 to 15% as of 8th March 2024 (Figure 4). Lastly, income only accounted for one fifth of the asset class return as of 8th March 2024.

Figure 4 - Proportion of JACI HY with cash price of 80 cents or below

Notional Market Value % / Price



Source: Bloomberg, data as of 8th March 2024.

As we go into Q2, we highlight three themes that we believe will be key for investors looking at the Asia HY asset class.

1. Focus on income and preference for short-dated high yield paper
2. Historical performance of Asia HY versus Asia IG
3. Relative value between Asia HY and Asia IG

Focus on income and preference for short dated high yield paper

As highlighted in our 2024 investment outlook, we believe that fundamental security selection remains key in order to identify business models that are resilient enough to operate in a higher rate environment. Against this backdrop, we favor HY-rated businesses that generate free cash flow in excess of their short-term debt maturities and argue that short-dated HY paper from these issuers represent attractive risk-adjusted returns for income-focused investors.

Within the short-dated HY bond space, we see opportunities to be invested in Asia national champion banks across the capital structure that are well capitalized and provisioned, as well as in the Macau gaming sector where issuers remain in deleveraging mode as earnings recovery continues apace.

Historical performance of Asia HY versus Asia IG

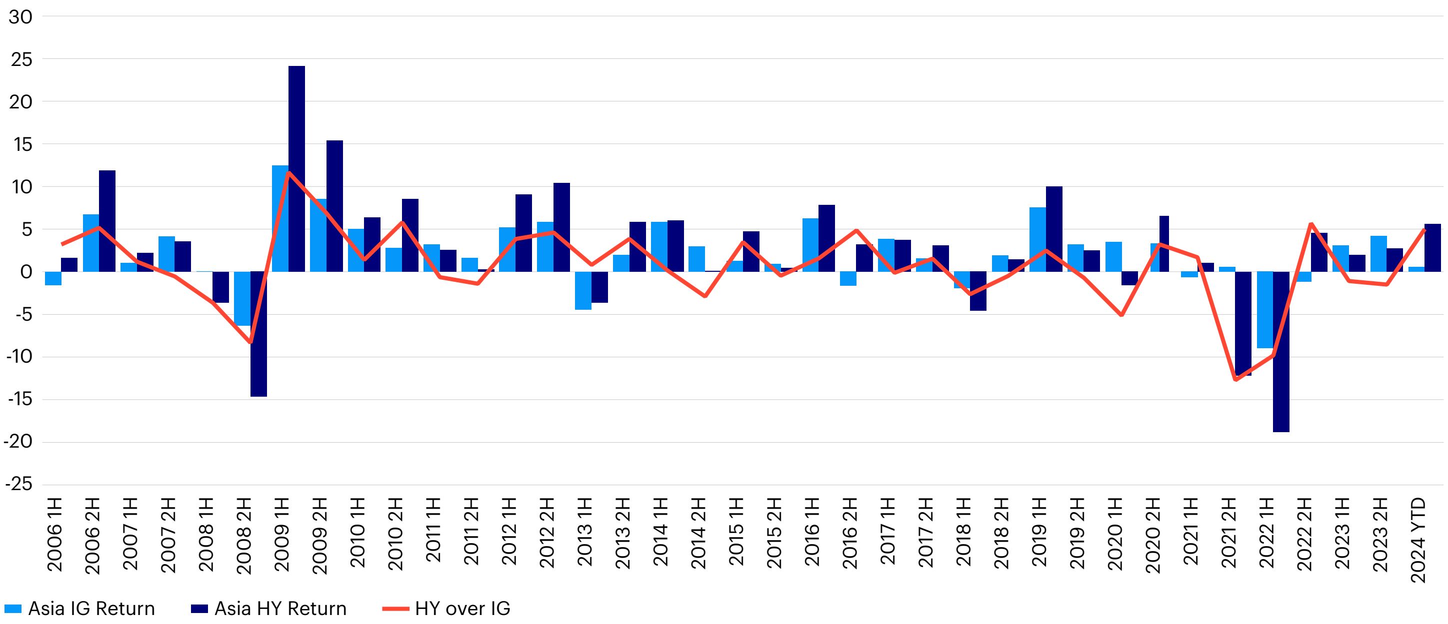
So far this year Asia HY outperformed Asia IG by nearly 5% as of 8th March 2024.[1] An outperformance to this extent has been quite rare for the Asia fixed income space over a longer time horizon (Figure 5). Since 2006, there have only been five occasions out of 36 semi-annual periods where the Asia HY bond market has outperformed the Asia IG market by more than 5%.

1. Source: Bloomberg, Invesco. Note: Proxy for Asia HY is JACI Non-Investment Grade and for Asia IG is JACI Investment Grade.

Going into Q2, we expect valuations of Asia HY to be relatively more expensive than Asia IG, as such the potential for excess returns to drive total returns will not be as strong a driver as in Q1.

The tightening of Asia HY spreads has lowered all-in financing costs for Asia HY corporates. This is likely to draw out more HY issuance and offer Asia HY investors new investing opportunities, but may dampen overall market technicals.

Figure 5 - Asia IG versus Asia HY total return



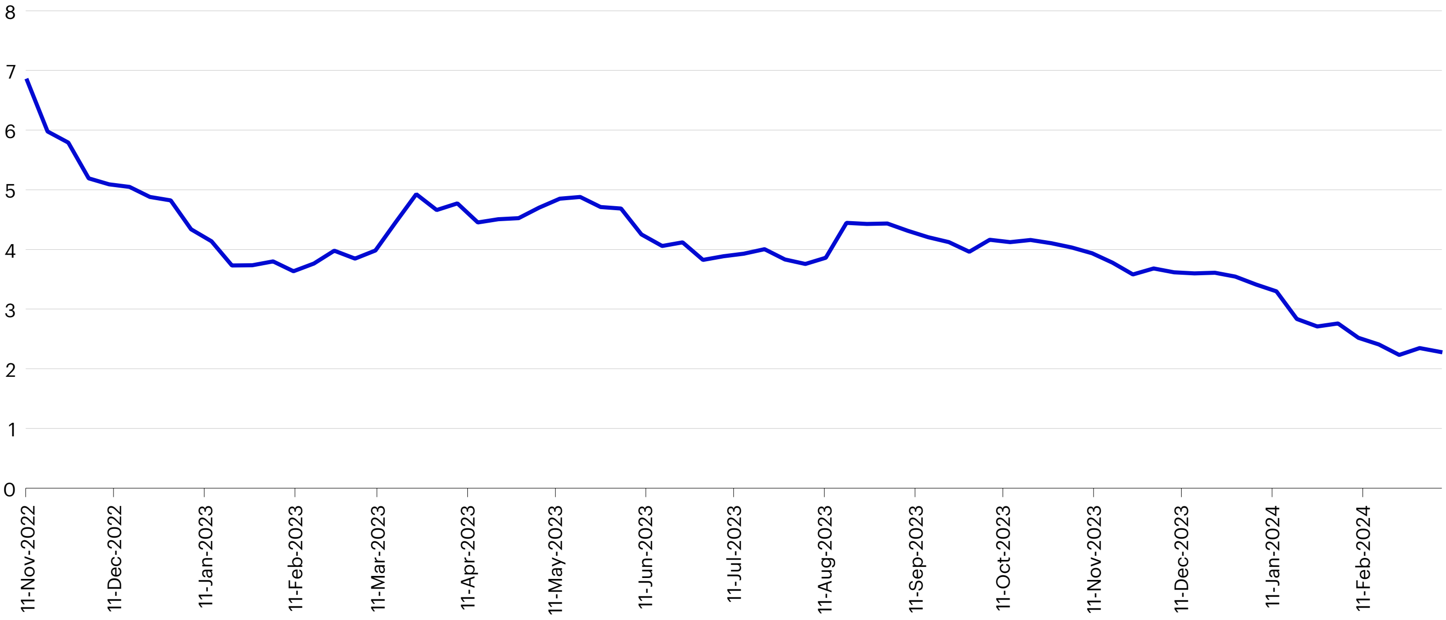
Source: Bloomberg, Invesco, data as of 8th March 2024. Note: Proxy for Asia HY is JACI Non-Investment Grade and for Asia IG is JACI Investment Grade. **Past performance is not a guarantee of future results.** An investment cannot be made in an index.

Relative value between Asia HY and Asia IG

When we look at the relative value between Asia HY and Asia IG (ex-real estate issuers), we note that yield pick-up in HY has continued to drop from 3.5% at the end of 2023 to just 2.2% as of 8th March 2024. As such, the additional yield pick-up to be in the HY asset class has become relatively less attractive. That said, the Asia HY asset class still offers differentiated sector and country exposures that are not available within the Asia IG asset class, and the higher yield and lower duration are supportive in periods of interest rate volatility.

From our perspective, having the ability to have a flexible allocation between IG and HY will be a key source of alpha, allowing the manager to select the best risk-adjusted credit ideas across all ratings categories and sectors.

Figure 6 - Asia HY (ex-real estate) yield pick-up versus Asia IG (ex-real estate)



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