2024 Mid-Year Investment Outlook – Asia Fixed Income: Investment Grade

June 2024

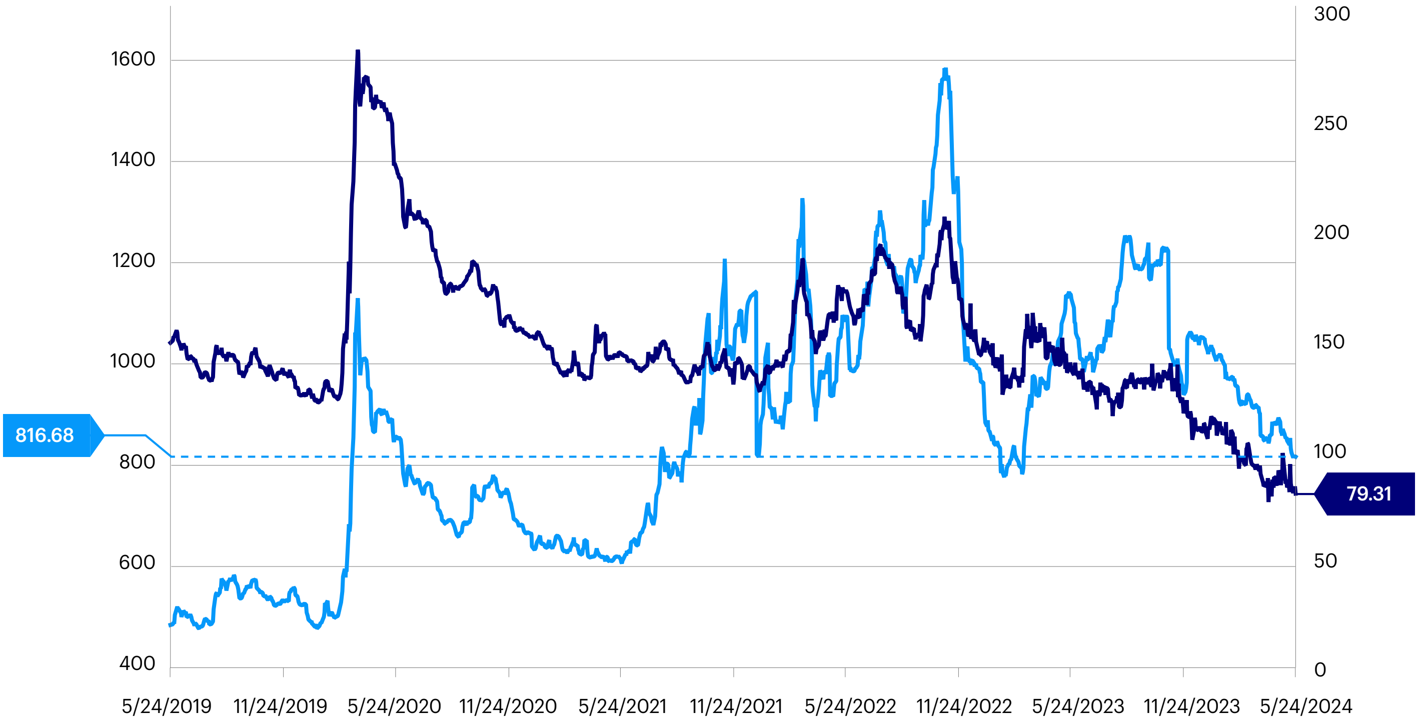
Chris Lau
Senior Portfolio Manager
Invesco Fixed Income

Asia investment grade (IG) credits held up relative well in 1H. In our view, solid fundamentals, strong technicals and the fact that all-in yields look attractive from a historical perspective will continue to support credit markets into 2H.

In recent months, the Federal Reserve (Fed) has been on hold given the strong labor market and stickier than expected inflation in the US. As such, the interest rate trajectory has not panned out as the market anticipated. We believe the Fed will find it very difficult to cut rates until the persistent inflation trend reverses and is set to keep its policy rate higher for longer. The latest hawkish FOMC minutes boosted US treasury yields and the US Dollar Index. Various FOMC members have questioned if policy rates are restrictive enough and have expressed a willingness to tighten policy further if warranted. However, we believe the chances of a rate hike are extremely slim. In our base case scenario, we still expect 1 to 2 rates cuts this year, with the first cut occurring in November 2024. In our view, the macro backdrop is still favorable for risky assets, but the pullback in expected Fed rate cuts could be a headwind for risky asset performance in the coming months.

Asia IG spreads continued to tighten in 1H, despite doing so at a much more moderate pace, and have reached a new historical tight year-to-date. The JP Morgan Asia Credit Index (JACI) IG spreads have tightened to 80 basis points (as of May 20, 2024), the tightest level since the Global Financial Crisis (GFC). From a spread perspective, Asia IG outperformed US IG on a relative value basis. Spreads between Asia IG relative to US IG have declined to -6 basis points while historical average spreads were in the range of +20 to +30 basis points.

Figure 1 - JACI Investment Grade versus JACI High Yield (May 2019 – May 2024)



JACINGSW Index (J.P. Morgan JACI Non-Investment Grade Strip Spread to Worst (%)) (L1) - 816.68
JACIIGSW Index (J.P. Morgan JACI Investment Grade Strip Spread to Worst (%)) (R1) - 79.31

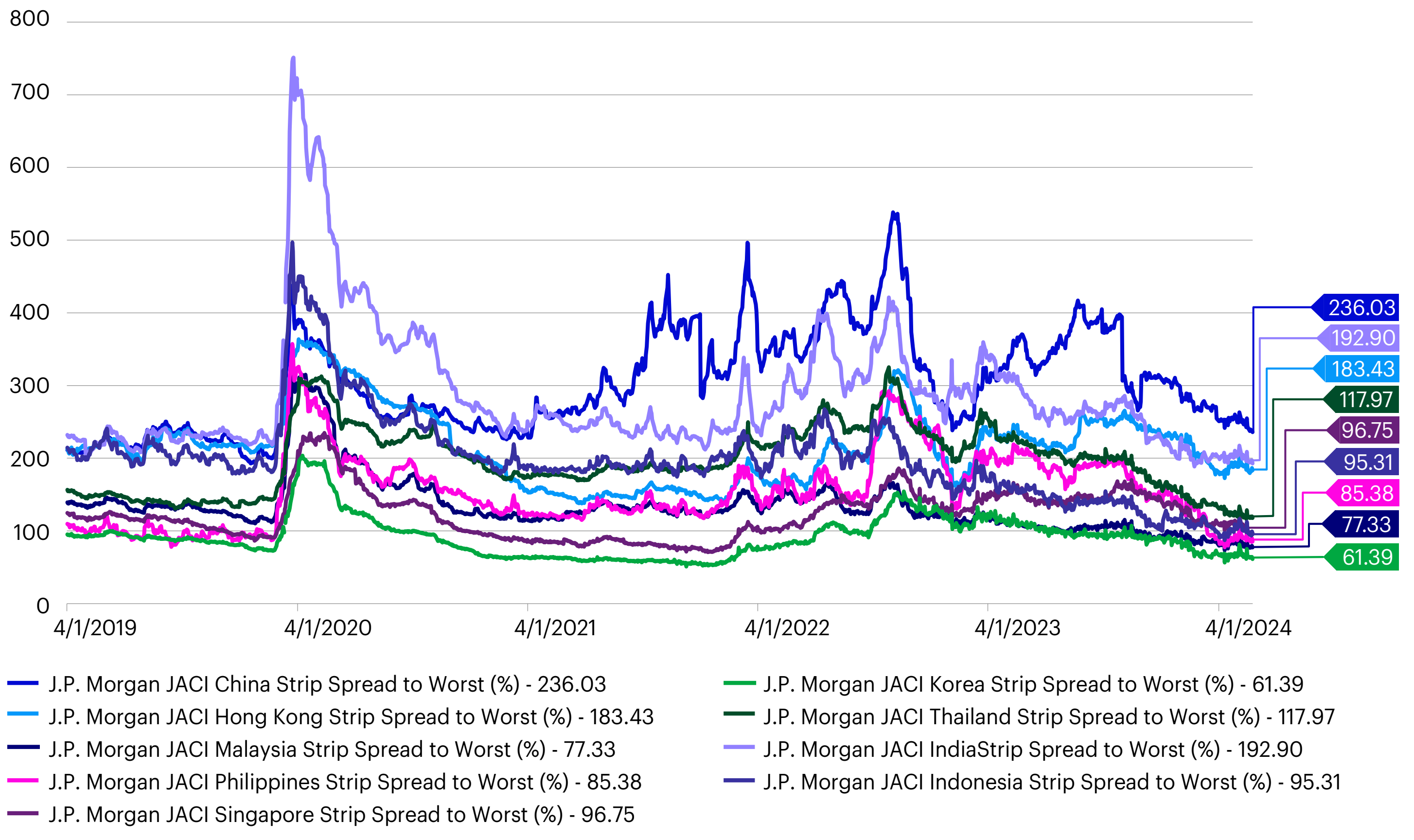
Source: Bloomberg, data as of May 24, 2024.

While recent April inflation data showed a renewed disinflationary trend, the Fed will need to wait for more evidence to justify rate cuts. Current data suggests a delayed and cautious cutting cycle. In the medium term, we believe resilient growth, disinflation and the start of easing cycle would be a favorable environment for risk taking. Despite the tight credit spreads, Asia credit remains attractive from an all-in yield perspective after the recent US rates sell-off. We expect Asia IG bonds to continue to perform well in 2H benefiting from stable fundamentals and strong technicals. Receding rate volatility in the latter part of this year should support fund flows in 2H 2024, favoring high quality IG bonds due to attractive all-in yields.

In general, we believe most market participants are aware that current valuations are not cheap, however are still willing to hold on to their positions and would be keen to buy on dips. We think improving Asian economies and stable fundamentals among Asian corporates justify the current tight valuations. We expect that Asian IG credit spreads could be range-bound at +/- 10 basis points for the next half year. Our biggest concern is still on the rates side should ten-year US treasury yields trend toward 5%, and rates stay higher for longer.

Economic activities showed resilience in ex-China Asian economies and most Asian IG issuers have stable fundamentals. Headline and core inflation has continued to moderate across Asian economies so far this year. However, Asian local currencies have shown weakness year-to-date due to the unwinding of - Fed rate cut expectations and broad US dollar strength. The risk of delayed policy easing is rising, and Indonesia and Taiwan have already surprised the market with rate hikes this year. US dollar strength could force Asian central banks to maintain more restrictive policies to defend their currencies.

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



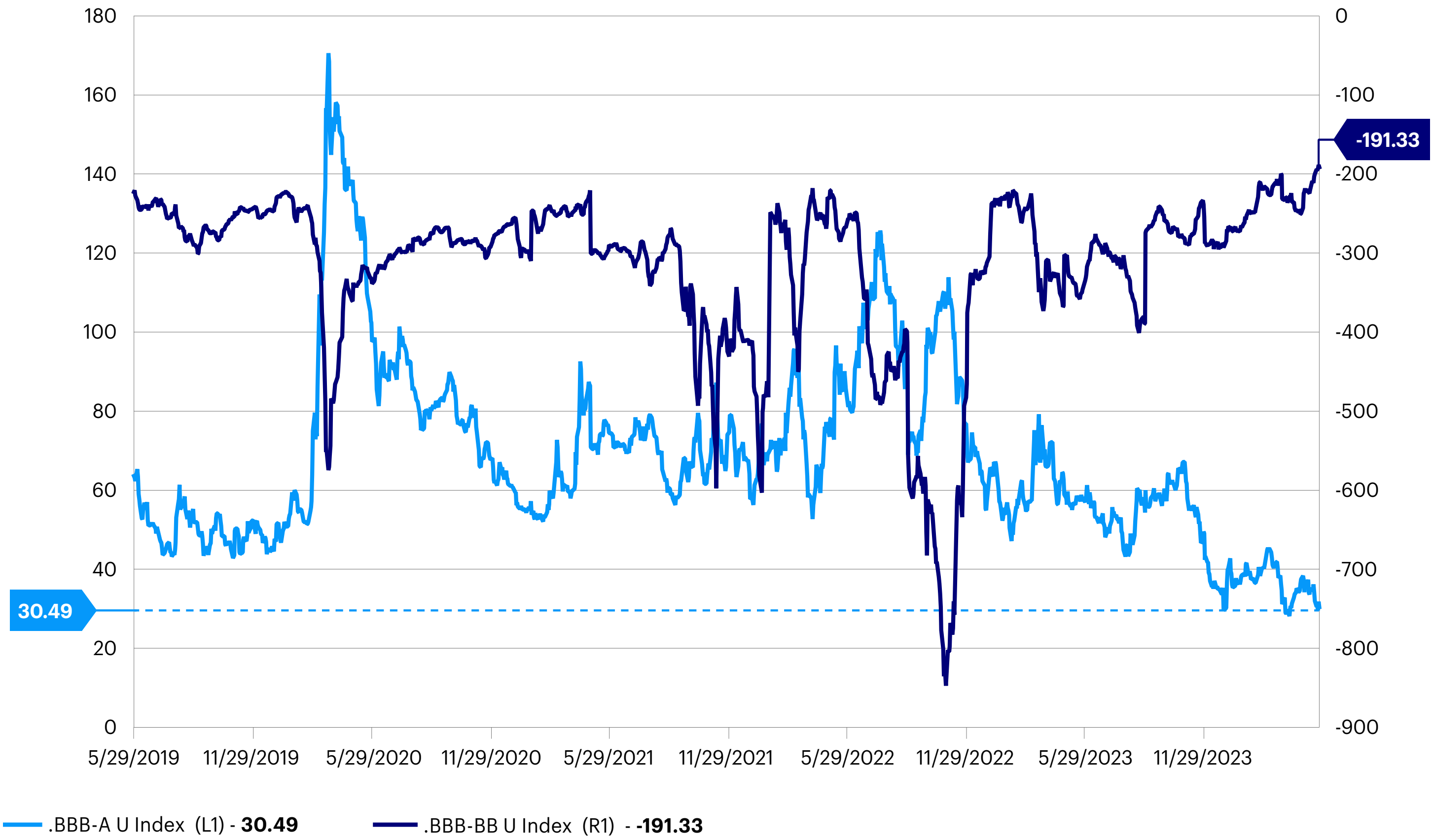
Source: Bloomberg, data as of May 24, 2024.

Following the notable spread compression in the last few months, many BBB corporate credits are at multi-year tights. The broad market no longer offers decent risk-reward potential in our view. BBB corporate credits have tightened significantly year-to-date due to relative value buying interests and generally improving fundamentals. We recommend switching from BBB corporates to higher-quality names or BBB financials. Despite overall tight valuations, there are still pockets of value available in selected new issues including Korea, Japan, and Australian banks Tier-2. We also see attractive relative value in Hong Kong corporates and financials with cheap valuations. While Hong Kong credits had been underperforming the rest of Asia, the outlook for this market is stabilizing following the removal of extra stamp duties in the property sector. We believe refinancing may also benefit from improving local liquidity.

Technicals remains strong in Asia's credit space due to negative net supply. We expect Asia IG primary supply to remain limited in most countries, particularly for corporates. Elevated US dollar funding costs will prompt Asian companies to use internal cash or turn to onshore funding channels for cheaper funding costs. This should further shrink the investment universe. We expect to see a divergence in credit spread performance between different Asian countries and China. Technical support for China onshore IG credits should remain strong given the government's accommodative policy stance. Yield differentials and limited new supply in the offshore market are also prompting onshore investors to increase their allocations to China offshore USD bonds, particularly state-owned enterprise bonds.

Asia IG credit should continue to be supported by stable fundamentals and strong technicals and we think yield carry looks attractive on an all-in 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 continue to be supportive for the space in 2024. Most of the return from Asia IG will come from income carry.

Figure 3 - Credit spread differences between BBB vs A & BBB vs BB (May 2019 – May 2024)



Source: Bloomberg, data as of May 27, 2024.

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