Asia Fixed Income Investment Outlook Quarterly Update

September 2024

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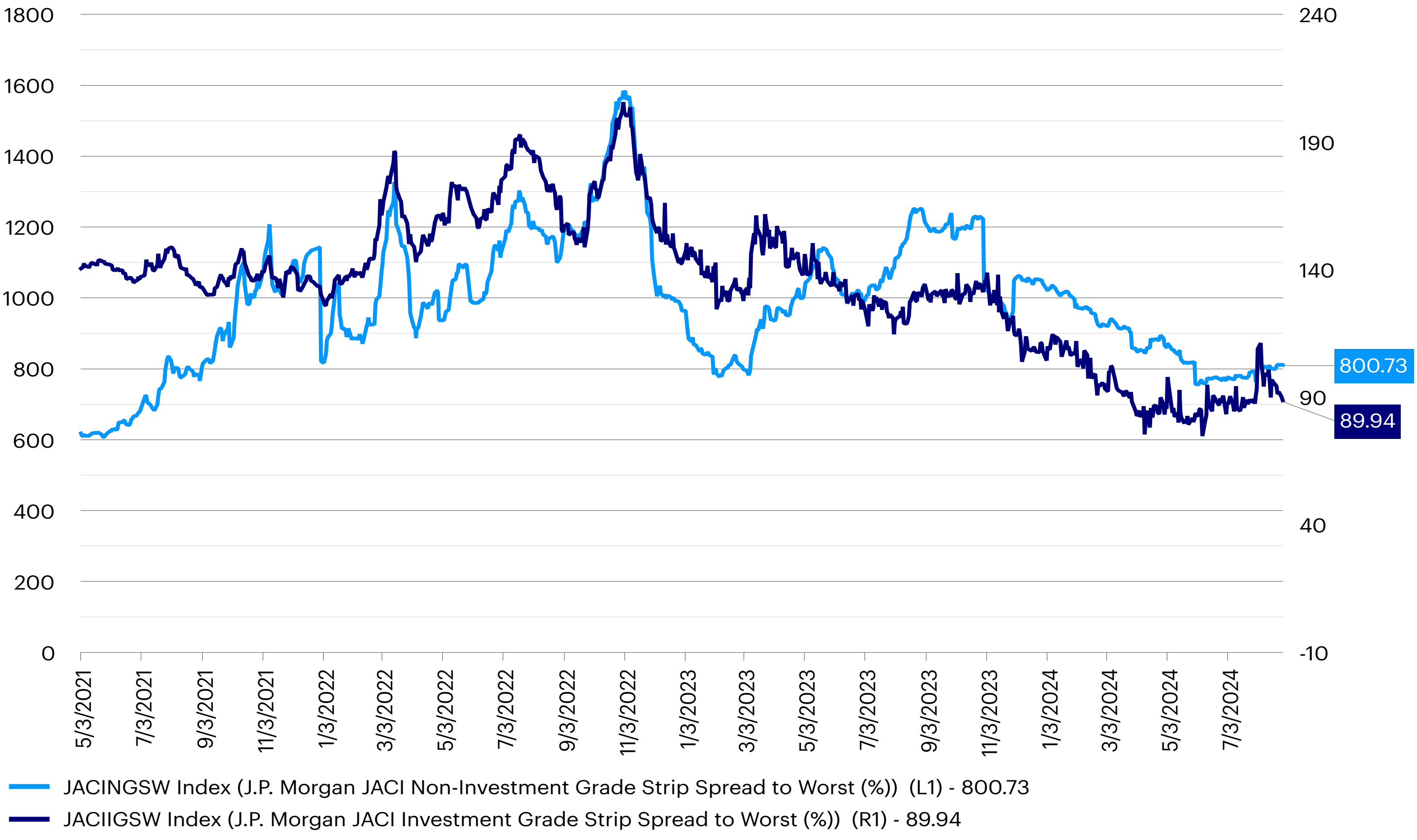
Asia investment grade (IG) outlook for Q4 2024

Global macro activity has taken center stage in recent months. The unwinding of Japanese yen carry trades, rising US political risks and geopolitical risks in the Middle East have triggered a flight to safety and escalated rates volatility. Despite this, Asia investment grade (IG) still recorded a decent return year-to-date led by the US rates rally and spreads compression.

Recent macro data releases have confirmed the renewed disinflationary trend and a much weaker US labor market. The latest Federal Open Market Committee (FOMC) minutes and Jackson Hole summit offer enough evidence to support a Fed rate cutting cycle starting in September. Powell indicated labor market conditions are "less tight" than before and highlighted that "the time has come for policy to adjust". However no potential pace of future rate cuts was specified. In addition, the July FOMC minutes showed that most officials expect a September rate cut as the likely scenario.

Figure 1 - JACI Investment Grade versus JACI High Yield (May 2021 – August 2024)



Source: Bloomberg, data as of August 16, 2024.

Fed fund futures are pricing in a total of 100bps cuts for rest of the year, implying at least one FOMC with a 50bps cut. Another 100bps of cuts has been priced in for 2025. We do not believe that US economic data has deteriorated enough to justify an immediate 50bps cut. The market has clearly shifted from inflation to growth concerns. However, we see lower probability of the US going into a recession, particularly with several stronger than expected US economic data released since August.

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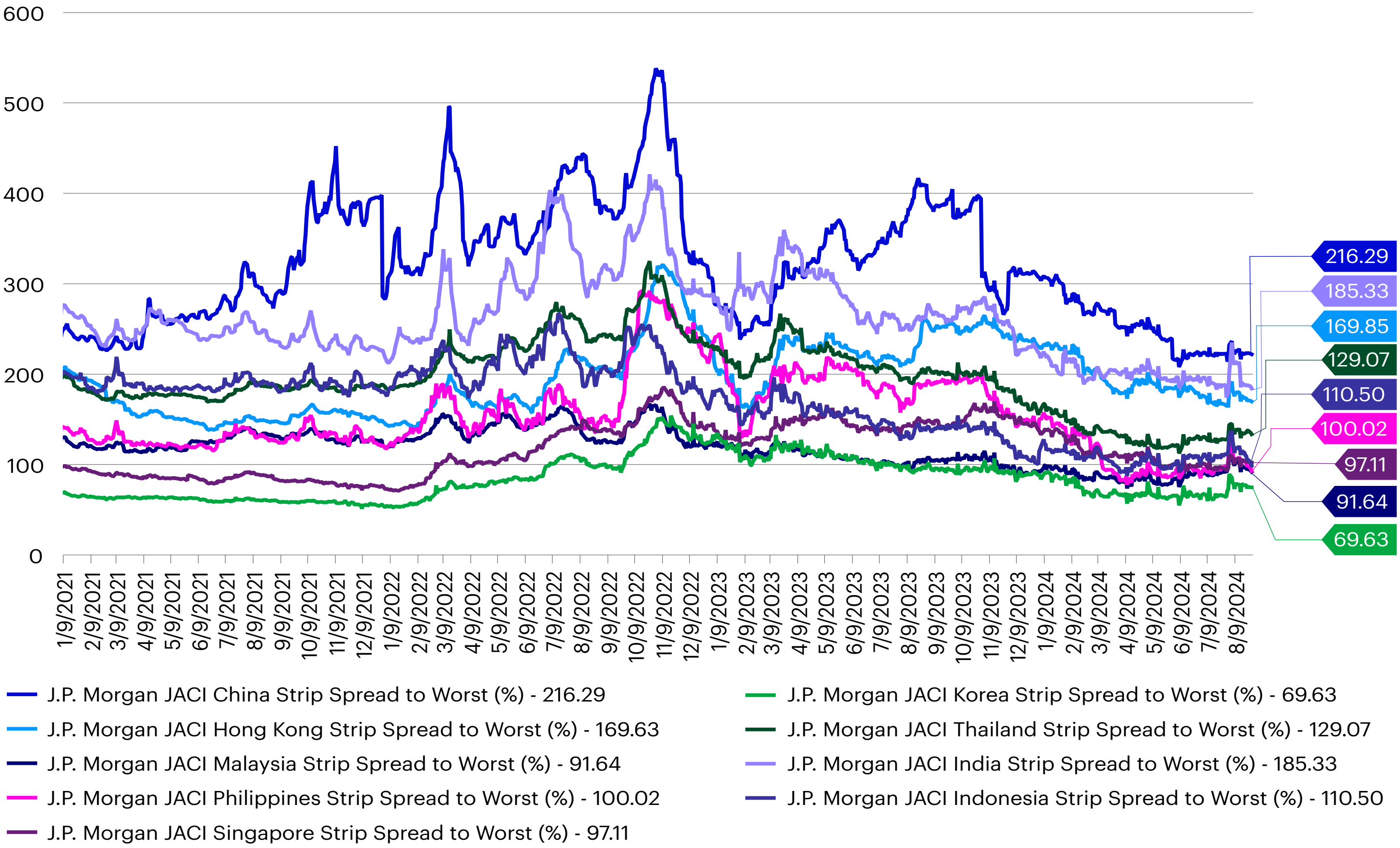
Asia IG spreads widened modestly in Q3 amid the flight to safe-haven assets in early August due to the unwinding of Japanese yen carry trades and recession fears in the US. JP Morgan Asia Credit Index (JACI) IG spreads have widened +17bps to 97 basis points (as of Aug 16, 2024) from +80bps (as of May 20, 2024). Nonetheless, we saw no signs of panic among Asia credit investors despite the sharp increase in equity volatility. Asia credit has since recovered as macro concerns have subsided. Market participants are reluctant to adopt a strong directional view and market technicals appear to be well balanced for the time being.

Emerging market (EM) Asia economic growth could slow but is currently growing at a healthy pace, consistent with a US soft landing scenario. Core inflation has turned softer, giving room for EM Asia economies to ease. While Asia IG corporates' credit profiles have deteriorated marginally as their profit margins and interest coverage have been under pressure, overall credit fundamentals remain largely stable with sufficient liquidity.

Market technicals are becoming more neutral and less supportive as the negative net supply situation is gradually improving. G3 Asia ex-Japan bond issuance has surged from countries including China and India. We believe new bond issuances present some attractive investment opportunities.

Despite the sell-off in credit spreads in early August, overall, Asia IG credit spreads remain at levels close to the tight end by historical standards. We find compelling valuations with attractive credit spreads for some selected longer dated Asia IG including China and Indonesia IG corporates. We expect China IG will continue to enjoy strong technicals driven by onshore interest. We believe Indonesia IG corporates will continue to benefit from negative net supply and be less impacted than government bonds by the possible deterioration in Indonesia's budget. We expect Asian IG credit spreads broadly to remain range-bound for the rest of the year. Given the importance of maintaining overall yield carry, Asia IG yield offers at 5 to 5.20% low volatility returns appears very attractive.

Figure 2 – Asia credit spreads by country over the past five years (July 2021 – August 2024)



Source: Bloomberg, data as of August 16, 2024.

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The upcoming macro drivers will likely set the tone for global assets in the months ahead. Investors remain cautious about any surprises. Investor focus on risk management and sentiment could swing quickly upon the upcoming US election result and policies to be implemented as well as any developments in the Middle East. In the medium term, we believe resilient growth, benign inflation and the start of an easing cycle in the US will continue to create a favorable backdrop for risk. We think Asia IG credit will continue to be supported by stable fundamentals and technicals and that yield carry looks attractive on an all-in perspective. Receding rates volatility in the latter part of this year should gradually attract fund flows into Asia IG. 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 rest of 2024. Most of the return from Asia IG will come from yield carry and US treasury yields will be the single largest variable for total returns.

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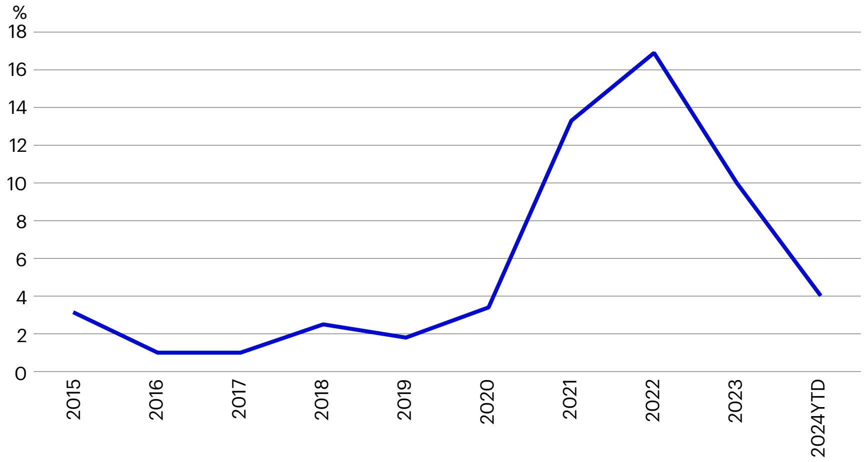
Asia high yield (HY) outlook for Q4 2024

In Q3, the JP Morgan Asia Credit Non-Investment Grade Index continues to build on its positive total return with the index up by 1.5% (as of 15 August) and 12% year-to-date. Income remains the primary driver of return and we continue to favor short dated high yield bonds given the low default rate backdrop.

Default rates continue to moderate in Asia, with the Asia high yield (HY) default rate at 4.1% year-to-date, the lowest level since 2020 (Figure 1). Outside of the real estate sector, only one issuer has defaulted thus far this year, and it was classified as a default due to a distressed exchange rather than a missing coupon payment, principal repayment or restructuring.

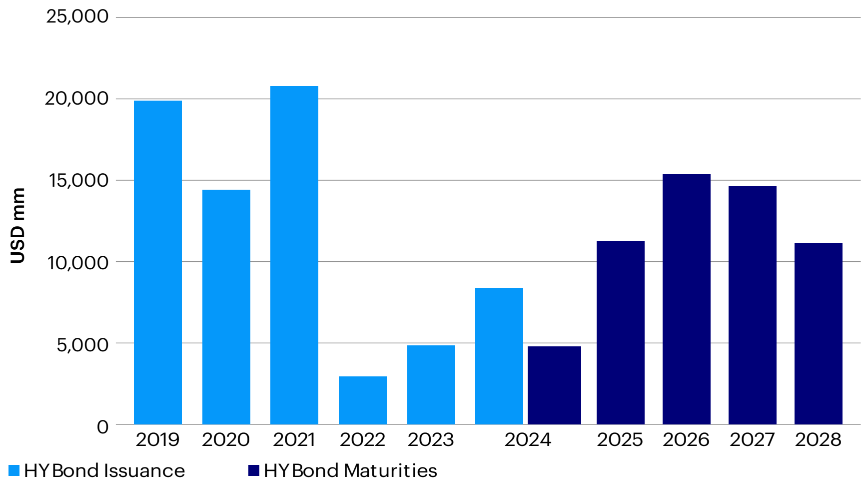
Figure 1 – Asia HY default rate continues to moderate



Source: JP Morgan, data as of August 16, 2024.

Looking ahead to the rest of the year, we expect default rates to remain low. We do not believe the maturity wall within the Asia HY asset class is a concern as issuers are able to access financing via primary markets and continued cash flow generation (Figure 2). For non-defaulted HY bonds maturing within the next 12 months [1], almost all are trading at over 80 cash price (except sovereigns undergoing debt restructuring), and therefore do not show signs of significant financial distress.

Figure 2 – Asia HY maturity wall is not a concern given a rebound in Asia HY supply

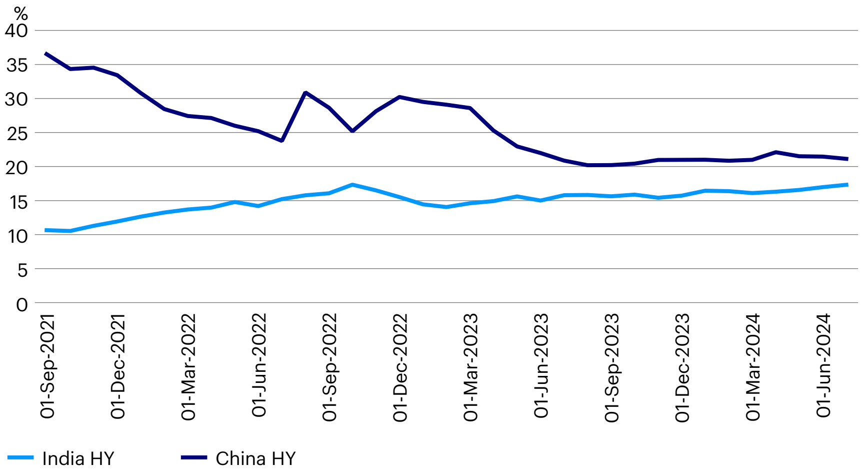


Source: Bloomberg, data as of August 16, 2024.

1. With maturity dates before August 2025

The continuous growth of India HY within the Asia HY asset class is also noteworthy, increasing from around 10% of the JP Morgan Asia Credit Non-Investment Grade Index in 2021 to 17% year-to-date (Figure 3). The proportion of China HY has declined from over 35% to 21% during the same period. One of the reasons for the decline in the size of the China HY market is the low absolute cost of onshore funding in China at the moment, causing the Asia high yield market to look expensive. That said, we believe the diversification of countries and sector mix arising from this development is supportive from a portfolio construction standpoint.

Figure 3 – Asia HY is not just about China, India's weight is growing

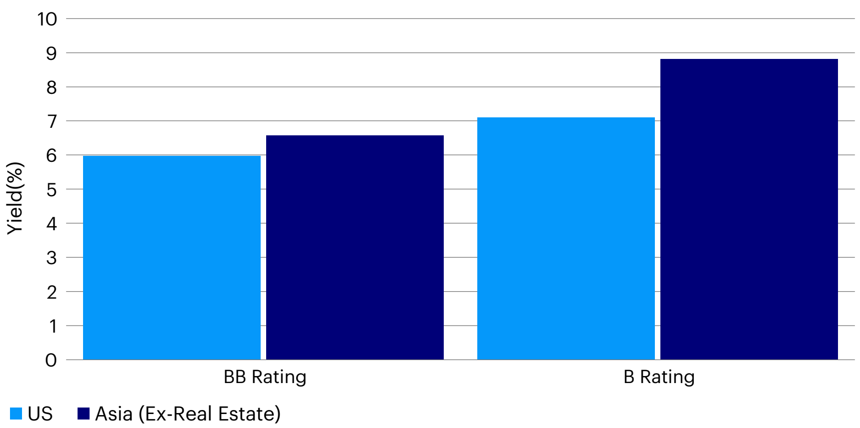


Source: JP Morgan, data as of July 31, 2024. Note: Data shows proportion of notional market value in the JP Morgan Asia Credit Non-Investment Grade Index.

We argue that Asia HY valuations (ex-real estate) remain attractive versus US HY, with a yield pick-up opportunity in both BB and B rating categories that boast lower default rates and diversified issuer selection. Recent new issue vintages have higher coupons of over 7% which offer price appreciation potential in a rate cutting cycle.

Sectors within Asia HY that we favor include Macau gaming, renewables, subordinated financials, infrastructure and consumer companies. We believe that disciplined credit analysis is important in the investment process to generate and deliver on optimal alpha ideas and protect against drawdown risks. We favour companies in the HY space that have positive operating free cash flows to allow them to organically pay down their debt.

Figure 4 – Asia HY remains attractive versus other HY asset classes



Source: Bloomberg, Aladdin, data as of 6 September, 2024.

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