Value Partners
Fixed Income Mid-Year Outlook

Executive Summary

US: Moderating inflation paving a rate cut path, but the last mile remains bumpy

The upside surprise on inflation and job market prints in 2024 anchored the trend of higher US treasury (UST) yields, with the 10-year UST climbing to this year's high at 4.7% in late-April before settling at about 4.4%. Market expectations for a pivot to materialize this year remain unchanged, though the timeline is being pushed back to 4Q24. The last mile of disinflation could be bumpy, given ongoing resilience in both US growth and its labor market. Markets now price in for a 39bp rate cut in 2024 versus 28bps in late-April.

Ultimately, we think the Fed's view is predicated on inflation being durable enough to reach the 2% target, and obstacles are unfolding that may imply a more gradual rate cut path, not an aggressive one. For instance, the US' fiscal position and the geopolitical tension-led energy inflation are developing events.

An additional rate hike would have negative implications on risky assets. We believe the chance of that scenario is low ahead of the US election, together with a moderating inflation trend and 2.1% real rates, which means the bar back to monetary tightening is high. Given the moderating inflation trend, we envisage one or two rate cuts in 2H24.

1Q24 GDP delivered a mixed picture, with the economy expanding slower on a quarter-on-quarter trend, whereas inflation data topped consensus estimates. We stick with our base case of a soft-landing post-restrictive monetary policy in the past two years. A slowdown in consumption could see a modest deceleration in growth for 2H24.

China: Push for inventory clearance to revive property sector but requires patience on effectiveness

The easing measures on the property sector announced in May have modestly revived sentiment. Major measures include the lowering of down payment and financial aid from the People's Bank of China (PBOC) to support local governments in purchasing unsold but completed projects of up to RMB500 billion (mainly funded by the PBOC's re-lending facility of RMB300 billion).

We acknowledge the size of financial support may not fully and immediately cure the inventory problem, but the package highlights regulatory efforts and a sense of urgency in accelerating a destocking cycle to tame systemic risks. We believe the policy is heading in the right direction with the shift of emphasis towards clearance of inventory, which we think is a more effective way to stabilize housing prices and household confidence, in addition to timely delivery of properties.

However, this is expected to be a long process, given uncertainties associated with incentives and the speed with which local government and banks execute tasks. In our view, the sector may create a lower drag than in previous years but we also need an overall reflationary policy, potentially with more fiscal stimulus.

China's real GDP expanded 5.3% in 1Q24 year-on-year due to a low base effect. We expect a similar year-on-year trend in sequential quarters under the baseline assumption of the property sector being stabilized. Exports and manufacturing capex to upgrade supply chains remain to be the key growth drivers.

Asia: India's surprising election results should have a manageable impact on credits

The export recovery in Asia has continued, with markets more closely aligned with the global technology supply chain, such as South Korea and Taiwan, benefiting the most. The overall stable macro backdrop supports the credit quality for Asian bond issuers. The broad assumption that a US policy pivot does not coincide with a hard landing would cap 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 nonperforming loans (NPLs). That said, Asian countries should see a shallow rate cut cycle, and most would look upon Fed's rates decision. The developing trend of lower funding costs should have a positive impact on credit appetite to fund expansion plans. This, coupled with resilient domestic demand, should underscore the region's growth trend.

Meanwhile, India's election results came with a surprise, with the incumbent ruling party, the Bharatiya Janta Party (BJP), losing its parliamentary majority. While this implies greater reform challenges in a coalition government, we do not see the election results completely derail India's policy continuity and growth path. Hence, we expect a limited impact on Indian bond issuers.

Credit Strategy

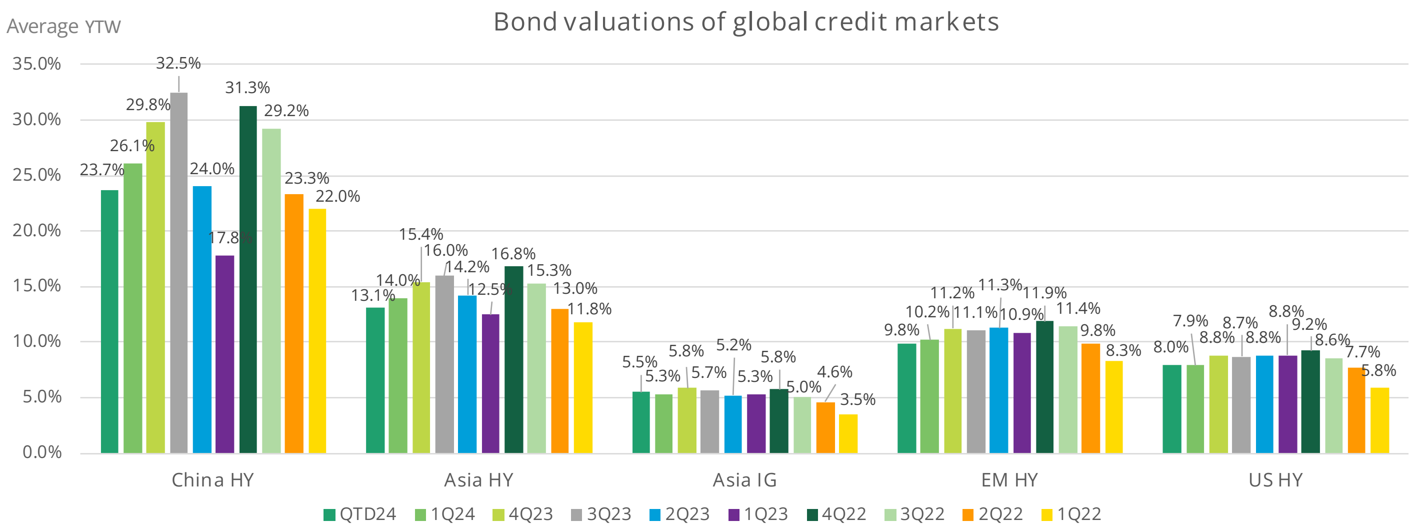
The resilient macro backdrop and an overall constructive tone on Asian credits support the spread tightening trend this year. Credit spreads for Asia high yield (Asia HY) bonds compressed by 180bps (source: JACI) in 1Q24, with a risk-on sentiment. Asia investment grade (Asia IG) bonds showed a similar trend, with spreads tightened by 28bps in the same period. So far in 2Q24, the spread compression trend in Asia HY continues (-95bps from the end of March 2024), while that for Asia IG is sideways. We expect Asian credit spreads to remain well-anchored, given limited issuance, stabilized default trend, and improved sector diversification outside of China. As credit spreads move, returns will be driven by decent carry in the Asia HY space, while a Fed pivot poses a modest upside for Asia IG bonds.

A potential rate cut this year plus disinflationary trends should provide a constructive backdrop for IG bonds and duration, despite spreads being on the tight end. A decent all-in yield and negative net issuance should support technicals for Asia IG bonds.

We remain constructive on Asia HY credits with a decent spread pick-up over IG and its US HY peers. The impact of China's property downturn is likely behind us, though a fundamental recovery for the remaining privately-owned enterprise (POE) developers will take time. Elsewhere, the growth momentum in India and Indonesia shall support onshore financing conditions, which provide alternative means of refinancing for offshore bond issuers. Issuers that tendered and bought back bonds also help reduce refinancing burdens and lower default probabilities. The total return in 1Q24 (+6.8%) was diversified, driven by real estate and metal & mining segments, as well as frontier sovereigns.

Compared with US HY and EMEA HY's 3-4% default rate in 2024 under a US soft landing scenario, Asia HY should fare much better at 1-2%, with manageable refinancing needs and supportive local capital markets. Given the limited bond choices, we focus on 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 that allow us to capture some alpha returns.

Figure 1: Asia credit spreads compressed on a constructive tone and strong technicals



Source: JP Morgan Asia Credit Index, Bloomberg Index; as of June 2024.
1Q24 total returns were boosted by risk-on sentiment. JP Morgan Asia Credit Index Investment Grade ("Asia IG Index") and High Yield ("Asia HY Index") generated +0.6% and +6.8% in the quarter, respectively, versus +5.6% and +6.3% in 4Q23 and +7.4% and +4.8% in 2023.

Sector Views

Onshore China

The 10-year China Government Bond (CGB) yield (currently at 2.3%) headed lower notably in 1Q24 and turned sideways in April-May, reflecting further monetary policy easing and low expectations of domestic growth or reflation. We continue to expect the risk of CGB yields trending upwards to be low in the coming quarters due to deflation fears and the ongoing property or LGFV deleveraging trend. China's domestic rates would likely drift lower. It also appears that the market has not priced in the impact of potential supply shocks, driven by a ramp-up on the fiscal budget to boost growth. So far, CGB issuance reached 25% of the full-year quota versus 15% on average in 2022-23.

The possibility of a rate cut remains high in 2024, given slow growth and deflationary pressures, but unlikely to 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. The expectation of a gradual economic recovery should also lower the magnitude of further rate cuts. Fund flows into China are also 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 1Q24, as the higher UST yields offset the tighter credit spreads. We continue to think spreads are on the tight side. However, the sector should offer defensiveness with an attractive all-in yield and favorable technicals. We see little room for spread compression on a spread pick up of 30-40bps over its US peers, which we believe is fair. Yet, a material widening in the credit spread is not our base case, as the US will likely avoid a recession-style selloff. Some consolidation in the US treasury yield should be the key driver for returns in 2H24. We focus our strategy on belly part of the curve for opportunities in high rating buckets.

Macau Gaming

Strong momentum for Macau gaming continued, with revenue exceeding consensus expectations in 1Q24. Market-wide mass GGR grew 6% quarter-on-quarter in 1Q24, which was at the stronger end of historical performance due to improved visitations. We continue to expect mass-driven EBITDA growth at 20-25% YoY in 2024, which should underpin operators' deleveraging efforts.

The Chinese government announced some relaxation measures at the end of April, which should be mildly positive. These measures

include the addition of 10 individual visit scheme (IVS)-eligible cities, lengthening of business visas to Macau/HK, Hengqin-Macau entry visas for packaged tours, etc. The addition of IVS-eligible cities could potentially broaden Macau's addressable market, in addition to the expected ramp-up in mass demand, backed by more new hotel rooms and improving labor issues.

Though bond valuations for Macau gaming bonds are demanding, improving fundamental trends and limited bond supply shall keep the sector a good carry and diversification play within Asia HY. Year-to-date, the sector kept its resilient performance.

Indian Corporates

India's economic growth remained buoyant at 7.8% year-on-year in the March 2024 quarter versus an average growth of 8.3% year-on-year in the previous three quarters. Growth may moderate in FY2025 to 7% (ending March 2025), given the slowdown in capex during election year. Inflation continued its deceleration trend, but vigilance remains towards the 4% target. A rate cut is more likely to commence in 2025. The election outcome, albeit surprising, should support broad policy continuity, including prioritizing infrastructure capex and gradual fiscal consolidation.

India HY performed in line with the rest of Asia HY year-to-date. We consider bond valuations (spanning across renewables, commodities, and utilities) largely fair. Corporate fundamentals are broadly on solid footing with supportive onshore financing conditions. Any consolidation in this space would present some investment opportunities.

Indonesian Corporates

Indonesia's real GDP expanded at a similar pace and grew 5.1% year-on-year in 1Q24, driven by government spending and consumption, offsetting a drag on net exports and weaker investment growth. This trend is expected to be sustained in the coming quarters. The country's prudent fiscal stance, pro-currency stability, and manageable inflation help support a resilient macro picture. Inflation was steady at 2.8% and trended towards the Bank of Indonesia's target, which signals more flexibility for policy easing. The surprise policy rate hike in April was mainly to attract capital inflows and stabilize the Indonesian rupiah.

Indonesian HY bond performance (spanning across property, mining, and industrials) outperformed, thanks to a stable macro backdrop, ongoing bank support for corporates, and scarcity value. We stay constructive on the sector. Corporates have leveraged bank loan access to fund bond buybacks/tenders, which helps avoid defaults or debt restructuring. We expect property sales to mildly slow in 2024, which is not untypical in the election year. Despite a pullback on commodity (thermal coal) prices, the credit profile of mining companies has not materially weakened, given their low operating cost position and disciplined financial policy.

China Property

We believe the latest round of policy measures heads in the right direction and sends a strong signal to the market that policymakers are aware of the potential systemic risks. We remain cautious that the policy measures may not immediately trickle to the fundamental profiles of individual property developers as sales recovery remains crucial. Nonetheless, negative sales growth shall gradually narrow in 2024-25, mostly likely driven by higher-tier cities.

Several aspects that we monitor going forward: 1) any potential upsizing of re-lending support, 2) credit demand in response to the re-lending facility as banks may have little incentive to lend, given the difficulty of finding commercially viable projects and potential low rental yield or NPL formation, and 3) the pace of underlying sales recovery.

Fueled by supportive policies in higher-tier regions and access to funding, SOE market share on property sales jumped to 67% in May 2024 (52% in 2022 and 65% in 2023). We believe the fundamental turnaround for POE's property sales remains difficult due to restrictive property sales escrow accounts that prioritize project delivery and a short land bank life. Those developers with available and unpledged investment property assets could benefit from obtaining alternative funding for debt repayment.

China HY property bonds outperformed the rest of Asia HY, thanks to the supportive policy package and destocking push to stabilize property price expectations. We believe current bond valuations priced in much of the policy initiatives and turned neutral on the survivors.

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Value Partners Hong Kong Limited
43rd Floor, The Center, 99 Queen's Road Central, Hong Kong
T +852 2143 0688
F +852 2564 8487
E vpl@vp.com.hk

Value Partners Asset Management Singapore Pte. Ltd.
9 Raffles Place, #13-04 Republic Plaza, Singapore 048619
T +65 6718 0380
E vpams@valuepartners.com.sg

Value Partners (UK) Limited
City Tower, 40 Basinghall Street, London EC2V 5DE,
United Kingdom
T +44 20 3907 3870
E vpuk-sales@valuepartners-group.com

Value Partners Fund Management (Shanghai) Limited
701A, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

Value Partners Investment Management (Shanghai) Limited
702, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

www.valuepartners-group.com