Value Partners
Fixed Income 4Q24 Outlook

Executive Summary

US: A front-loaded pace of monetary easing

The US Fed's larger-than-expected 50bp rate cut in September was a surprise, reflecting the central bank's confidence that its long-term inflation target of 2% can be maintained, and the cooling job market showed no alarm. The Fed guided two more 25bp cuts by end-2024 and another four more 25bp cuts in 2025. US futures market prices for a lower Fed Fund rate than the 3.4% envisioned by Fed by end-2025. Despite the 50bp move, the Fed appears less likely to embark on an aggressive easing path unless the job market gets weaker, with the median dot plot estimate on the long-run Fed Fund rate largely unchanged at around 2.9%.

The market will shift its attention to the US election and fiscal development in the coming months, and volatility will likely rise. A Trump victory would likely lead to expectations of aggressive tariff actions and an inflationary environment. Additionally, a Republican sweep could increase the likelihood of fiscal deficit. Both scenarios could mean a return to a slower rate cut path.

The 2Q24 GDP growth of 3.0% (QoQ) and 3.1% (YoY), driven by consumer spending, exceeded expectations after a mixed 1Q24. Our base case assumption of a slowdown in consumption due to the massive monetary tightening in the past year remains unchanged. This means a deceleration in growth for 2H24, given also a high base in 2H23.

China: Sentiment lift on more stimulus to come

Recently, China introduced another suite of measures to stimulate the property and equity markets. These include cuts on the reserve requirement ratio (RRR) and policy rates, further relaxation on housing policies, and liquidity support for stocks. In a statement, the government pledged to stop the property market's decline and stabilize it, reflecting that it recognizes the strong urge to resolve inventory issues and revive consumer sentiment. However, the impact on growth and the path to reflation will hinge on the speed of execution.

According to media reports, the government may issue ultra-long special sovereign bonds of about RMB2-3 trillion in the coming weeks to boost economic growth further, ease local government stress, and drive consumption. We believe the broader measures may not imminently cure the weak consumption and housing inventory issues. The housing destocking cycle is also a long-drawn process that requires coherent and effective cooperation between local government and banks, as well as sizable financial support to normalize high inventories. So far, the progress on destocking has been slower than expected.

China's real GDP expanded 0.7% (QoQ) and 4.7% (YoY) in 2Q24 – a miss due to the continued property downturn and sluggish consumption. We believe these factors will remain headwinds for growth in 2H24. Separately, a significant US tariff hike on Chinese exports will also be a drag on growth.

Asia: Maintaining resilient growth, cautious on tariff noises

While export expansion remains mild, GDP growth was resilient for most Asian economies in 2Q24. Notably, Indonesia's GDP growth was stable at 5.1% YoY, thanks to increased investment and net exports, and India's growth normalized to 6.7% YoY from 7.8% in the previous quarter amid slower government spending due to parliamentary elections. We expect these markets to exhibit solid growth for rest of year.

We believe a stable macro backdrop shall continue to support the credit quality of Asian bond issuers. Our assumption of a US soft landing should not derail the growth in Asia. Asian countries shall see some room to cut rates (e.g. Indonesia, India) as the US enters a broader easing cycle and benign domestic inflation. The trend of lower funding costs should positively impact credit appetite to fund expansion plans. Corporates shall also benefit from cheaper domestic funding access, which help reduce refinancing risk.

The growth of Asia ex-China countries is closely correlated with exports, and trade dependence on the US is on the rise. We take a cautious stance on those with higher trade-related exposure, including Korea and Taiwan, despite the tech sector's increasing instrumental role globally. We are relatively more constructive on Indonesia and India, given their resilient growth and less exposure to trade risks.

Credit Strategy

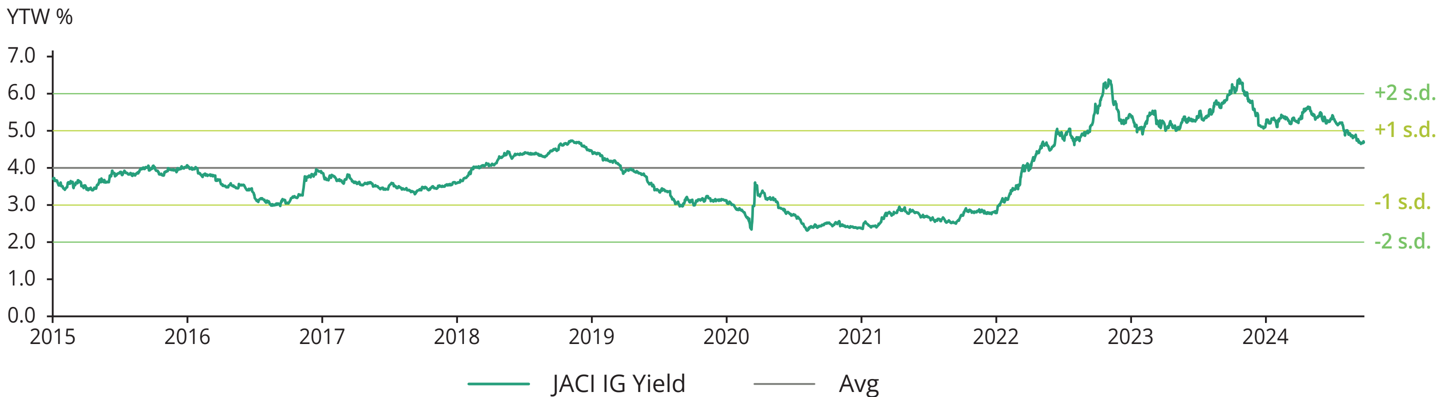
Credit spreads tightened in 1H24 and turned largely flat in 3Q24. The resilient macro backdrop and an overall constructive tone on Asian credits support the spread tightening trend this year. Credit spreads for Asia high yield (Asia HY) bonds compressed by 250bps (source: JACI) in 1H24, with a risk-on sentiment. Asia investment grade (Asia IG) bonds showed a similar trend, with spreads tightening by 20bps in the same period.

We continue to be constructive for Asia IG bonds, given their attractive all-in yield and the Fed's rate cut cycle. Despite the recent consolidation in the US treasury yield, Asia IG bonds' yield of 4.9% at the index level remains high on a historical basis. Also, they remain a good choice for both income and diversification in the portfolio, with low underlying credit risks. Typically, IG bonds generated strong returns after US rates peaked. They help mitigate downside risks and generally preserve capital in periods of crisis or high market volatility.

Timing for adding IG bond duration is pivotal, given that the current US treasury yield has priced in multiple rate cuts down the road. A Trump victory or a Republican sweep scenario could increase the likelihood of fiscal deficits and alter the expectations of rate cuts. We prefer to stay in the "belly" part of the curve for duration, given the bias on the Fed's front-loaded cuts and US election uncertainty. 10-year UST yield remains range-bound at 3.6-3.9%. Credit spreads-wise, we expect them to go sideways, given the current level of 150bps, which is 20bps below the historical average. Asia IG's solid credit profile is backed by corporates' strong balance sheets and cashflows, as well as good access to funding. They are also well-positioned to navigate any economic turbulence. An expanded APAC bond market in the IG space, including Japan and Australia, offers even more country diversification benefits, and tends to exhibit a more stable credit profile. We like Asian financials, Japanese lifers, and Indonesian quasi issuers.

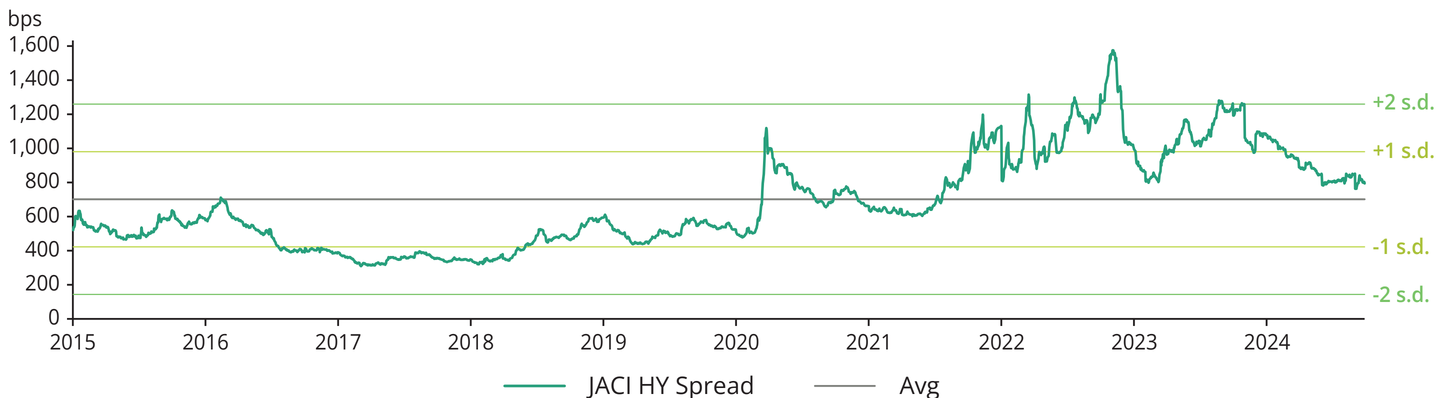
The shift of monetary policies from being a headwind to a tailwind supports risky assets. Asian HY corporates will benefit from lower funding costs and easier onshore and offshore refinancing options, which should strengthen their credit profiles. Hence, we see room for current Asia HY credit spreads at 790bps (JACI HY Index level) to tighten relative to the long-term average of 650bps. With a stabilizing credit outlook, improved sector diversification, and expectations of lower default rates, we see a good value proposition in Asian HY bonds heading into 2025. Attractive carry and spread compression shall keep total returns at decent levels (YTD at 15% for JACI HY). Our themes on credit selection remain with those issuers demonstrating their ability to improve their credit profiles via earnings growth and deleveraging. We are constructive on selective issuers in Hong Kong, Indonesian, and India, and neutral on Macau gaming.

Figure 1: Appealing Asia IG bond yield with the US heading towards a clear rate cut cycle



SOURCE: JACI IG Index, YTW

Figure 2: The current rate cut cycle shall lower funding costs for Asia HY issuers and provides room for spread compression



SOURCE: JACI HY Index, spread to worst

Sector views

China

The latest round of policy measures were more aggressive than expected. PBOC's collective monetary measure announcements surprised the market to the upside. These included a 50bp cut to the RRR, a 20bp policy rate cut, 50bps of mortgage rate cuts for existing borrowers, and a lowering of the minimum down-payment ratio for second-home buyers to 15% from 25%. Moreover, the PBOC has introduced two new tools to boost the capital market by setting up a RMB500 billion swap facility for non-bank financial institutions and a RMB300 billion relending program to support A-share market. We believe these forceful monetary measures should help boost sentiment in the short term. Still, a significant fiscal easing is more urgently needed to deal with the broad-based confidence and demand weakness. Execution remains the key. A rebound in property sales and stable property prices remain instrumental in the sector's turnaround, which also requires an improvement in income growth and job security expectations.

Overall, the easing stimulus might not be a direct game changer for the economy, but the combined forceful monetary and fiscal policies may help avoid further growth downside. The possibility of a rate cut remains high in 2024, given slow growth and deflationary pressures. With the US Fed's pivot, we believe the PBOC could ease monetary policy further but there may be an upside on the 10-year CGB yield given the rising needs for fiscal stimulus in the medium term. The general low rate set up should benefit Chinese investment grade corporates by allowing them to obtain cheaper onshore financing, but their offshore credit spreads are on the tight side given the limited dollar bond supply.

Japan and Australia

Australia has very robust institutional and policy frameworks, which mitigate potential economic and financial stability risks. Key banks' CET1 ratios are 200-300bps over the regulatory requirement of 10.25%, leaving plenty of buffer to withstand any stress.

In Japan, the BOJ's normalization of monetary policies should be positive for banks' profitability, on top of their strong asset quality and stable capital. Megabanks have limited exposure to US commercial real estate and have a strong buffer against regulatory minimums. The offshore refinancing needs, driven by the roll-off of TLAC debt, asset-liability mismatch (part of megabanks' earnings is in foreign currency), and capital needs under Basel III implementation shall add to the demand for dollar bond funding. For insurance firms, the capital needs arising from ESR (economic value-based solvency ratio) regulation commencing in April 2025, and offshore M&A also drive demand for dollar bonds.

Japan and Australia investment grade bonds help expand the Asia bond universe. Diversification benefits and their solid fundamentals support technicals. We selectively add exposure in this space.

Macau

Macau gaming operators maintained good earnings performance in 2Q24 despite weaker seasonality. Overall gross gaming revenue (GGR) in 2Q24 and 1H24 were MOP56 billion and MOP114 billion, respectively, or 77% and 76% of 2019 levels. Although GGR growth slowed in 2Q24 QoQ due to seasonal factors and the crackdown on money exchange activities, we expect a market rebound in 2H24 due to higher visitor arrivals and tourism activities, and the impact of the money flow crackdown should have limited implications. At the operators' level, most have recorded positive free cashflows as capex has stabilized, which should facilitate further deleveraging.

We view bond valuations for Macau gaming bonds are demanding. Given the sector's skew towards the US investor base, it may be more sensitive to a hard landing scenario, though this is not our base case assumption. Nevertheless, the improving fundamental trends and limited bond supply make the sector a good carry and diversification play within Asia HY.

India

Strong economic growth and a stable macro backdrop create a goldilocks phase for India. Broad policy continuity and a softening of oil prices are tailwinds. An increasing number of non-bank finance companies (NBFCs) have recently tapped the dollar bond market as a way to diversify their funding channels. Although their overall funding costs are modestly rising, the robust credit demand, will support the sector's profitability and loan growth. NBFCs will continue to play an instrumental role in fulfilling the credit needs in India. The larger NBFCs' credit profiles are expected to remain solid and backed by improved asset quality on strong economic conditions and capitalization.

We are largely neutral on India HY, given their fair valuations and potential more bond supply. Any consolidation in this space would present some investment opportunities.

Indonesia

Bank of Indonesia surprised the market by cutting its policy rate by 25bps to 6% in mid-September. The decision to ease was attributable to a lower inflation outlook, the need to boost economic growth, and the strengthening of the local currency, supported by foreign inflows. Indonesia's consumption growth maintains its positive momentum. The country continues to promote loan growth, which is expected to reach 10-12% for the full year of 2024. We believe this creates a positive backdrop for dollar bond issuers as they can benefit from lower onshore funding costs and have alternative funding channels for refinancing. Indonesia's central bank is likely to step up its pace of easing if the Fed's rate cuts turn more aggressive.

We stay constructive on Indonesian HY bonds, given strong onshore bank support, good carry, and scarcity value.

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