Fixed Income Outlook 3Q 2021

Value Partners
Investing through discipline

Executive Summary: Policy to drive sentiment

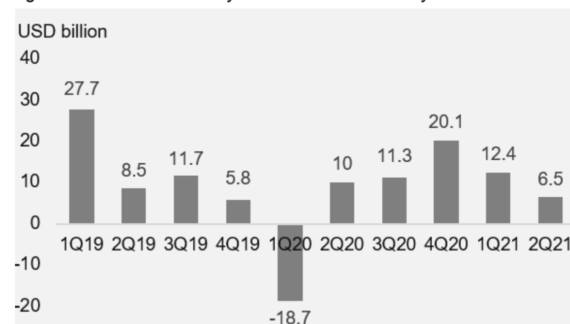
The vaccination rollout and easing of mobility restrictions have reset global growth higher. However, the growth pace in the near-term could be derailed by the delta variant and fading low base effect, but we view that the uptrend in growth should be maintained. With global credit spreads being priced for growth recovery and benign default rates, in the coming quarters, we are cautious about any major shift in the Fed's tone on policy normalization in the US and taper timetable and any change in China's onshore financing environment that has been kept in a tightening mode for most of this year as growth slowly dissipates.

In the US, we expect that the possibility of a rate hike remains low in the near term, as the recent inflation increase in the country is due to pent-up demand and supply chain bottlenecks, and the US labor market is yet to normalize. That said, we view that a sharp turn in the Fed's dovish tone could derail market sentiment in the fixed income markets. We will continue to stay cautious on possible US tapering timetables. After the consolidation in 10-year US Treasury yield in the second quarter of 2021 ("2Q21"), we believe there are scopes to trend higher towards end-2021 despite the growth normalization. The possibility of a US rate hike remains low in the near-term. The market is now pricing in one or two hikes by 2023.

In China, the recent Required Reserve Ratio ("RRR") cut in July underscores People's Bank of China's ("PBOC") intention to support liquidity and preserve lower funding costs. Falling credit impulse would linger to keep financial risks under control. This, and slower growth momentum should keep onshore government bond yields at a lower level – currently at about 3% – after tightening 11bps year-to-date ("YTD").

In addition, the ongoing demand/supply imbalance behind the upcycle in commodities may turn in the second half of 2021 ("2H21"). Nonetheless, we think it is a bit early to expect a material correction in commodity prices when growth is still expanding, albeit at a moderating pace. This, together with a benign US dollar, matters for maintaining a supportive tone for emerging market ("EM") credit markets and fund flows (Figure 1).

Figure 1: EM hard currency bond funds had steady inflows YTD



Source: EPFR data as of 20 July 2021

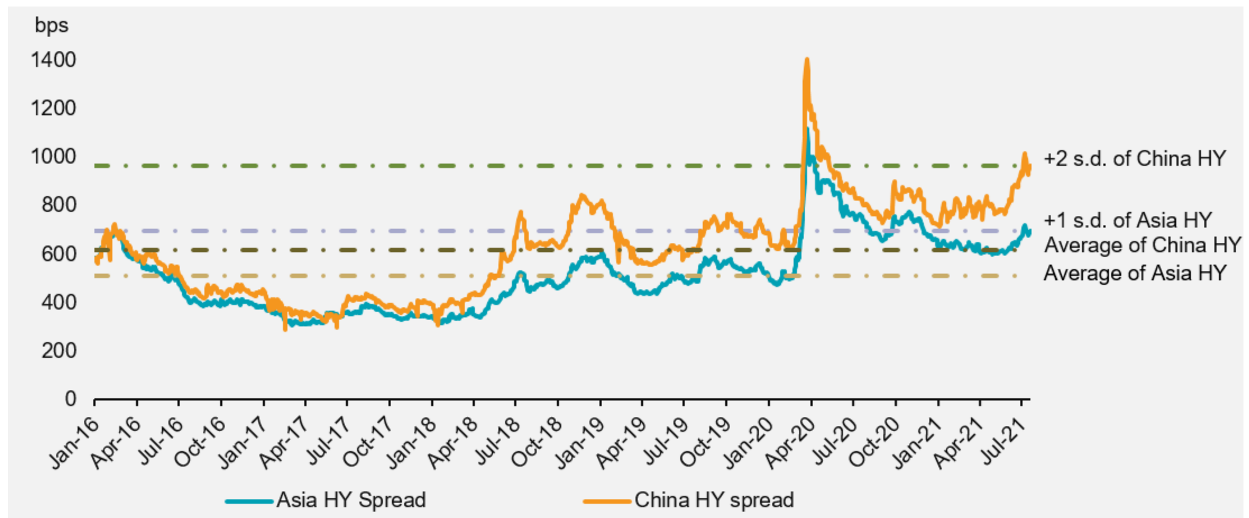
The prospects for growth recovery in Asia and manageable default rates should bode well for the region's dollar bond market. Moreover, the ample level of global liquidity looking for yield enhancement should lure demand for Asian

high yield dollar bonds, which has scope to mean reverse as China's tightening cycle is being priced in.

Overall, we view that Asia high yield ("Asia HY") continues to provide attractive value over Asia investment grade ("Asia IG") and US high yield ("US HY") (Figure 2 and 3).

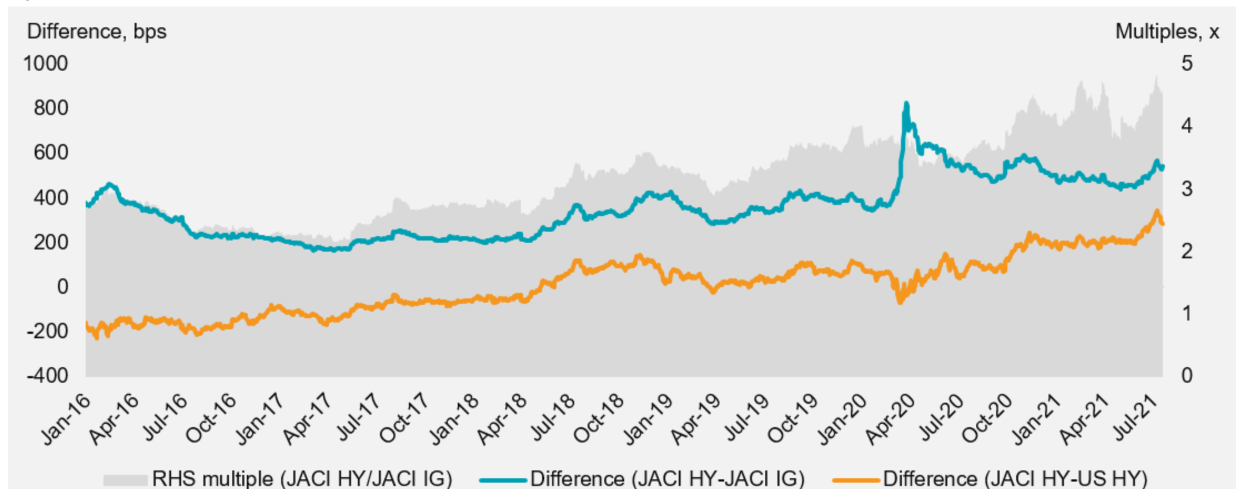
During the first half, credit spreads of the JP Morgan Asia Credit Index Investment Grade ("JACI IG") tightened 22bps, while that of JP Morgan Asia Credit Index High yield ("JACI HY") widened 42bps. The Asia HY index fared better at 1.3% during the same period, mainly driven by carry, versus the muted returns of Asia IG (-0.5%), driven by the falling 10-year US Treasury yields in the second quarter. Segment-wise, consumer and sovereigns continued to outperform against real estate being affected by onshore tightening.

Figure 2: China HY credit spreads at 2 s.d. cheap over the last 5 years



Source: JACI Asia HY Index, Barclays China HY Index; Bloomberg as of 20 July 2021

Figure 3: Asia HY index offers attractive value over Asia IG index and US HY index



Source: JACI Asia HY Index, Barclays China HY Index; Bloomberg as of 20 July 2021

Watch out for idiosyncratic events

Besides policy changes, idiosyncratic events, particularly in the high yield space, should also be the market's focus in the second half. We stick to our bottom-up approach on bond selection and move up the credit quality spectrum as we expect markets would likely stay jittery. These events, that we shall monitor include:

1) Whether or not Huarong will publish its upcoming fiscal year 2020 ("FY20") results by the due date at end- August 2021 to avoid an event of default; if the government will bail out these state-owned enterprises ("SOE") to keep reputational risks under control; and if there is a concrete plan on addressing its offshore bond maturity.

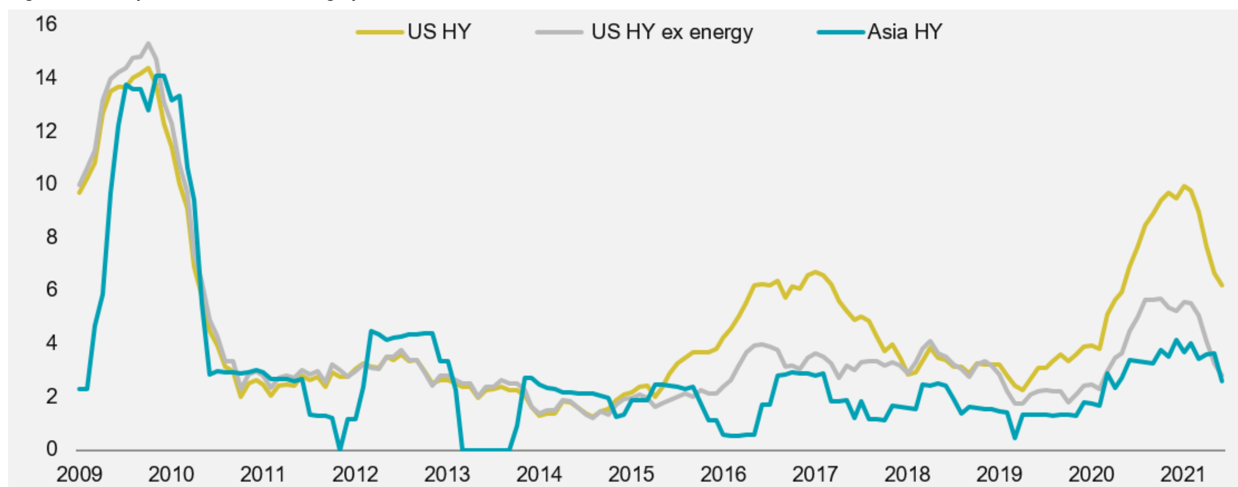
2) Whether Evergrande's sizable payable issue will drag on and if will there be any form of debt restructuring.

Contagion risks have been under control as better names with decent fundamentals could still issue bonds. That said, market volatility will not abate until there is a clearer picture of those events. Some spillover effects could occur but these events should not result in an acceleration of systemic defaults in the offshore bond market (Figure 4). From an index weight perspective, Huarong accounts for 1% of the JACI composite, while Evergrande accounts for 3.9% of the JACI HY (0.9% in the JACI composite).

Hence, any impact should be manageable given bond valuations have also moved. Fallen angel risks in Asia IG bonds are also low. Strong property presales YTD, cashflow preservation and the decelerating Chinese property's offshore bond refinancing needs in 2H21 (US$17 billion, US$23 million in the first half) should keep their credit profiles in check.

In our view, China's policy target to balance growth and risk controls should provide a healthier credit landscape in the longer run. To neutralize risk exposure in Chinese property, we diversify into commodities- and consumption-related credits as defensive plays.

Figure 4: Steady default rate of Asia high yield bonds



Source: BAML research, as of 30 June 2021; Default rate = Last 12 months ("LTM") count of defaulted issuers/total number of issuers at period start

Sector views

Onshore China bond

China onshore yield was kept over 3.1% for most of the year, except recently when the curve flattened to 2.9% post-RRR cut on 9 July. The falling yield level is in line with our expectations in our 2Q21 outlook. The RRR cut reiterated PBOC's prudent monetary policy to boost long-term funding for banks, not the overall liquidity. Aggressive fiscal stimulus is unlikely in the short term on expanding GDP growth. Another RRR cut cannot be ruled out for the rest of the year, together with rising uncertainty on exports and slower investment. The rising expectations of more accommodative policy and more normalized economic growth should continue to flatten the onshore yield curve in 2H21.

For the onshore credit market, the default amount remains fairly high but the number of defaulters is trending downwards. In particular, the amount of SOEs defaults accelerated, but that of private-owned enterprises ("POE") reduced. This trend will likely persist as China has been shifting towards capital efficiency from growth and has become more tolerant of defaults. That said, we envisage that government support will remain in place for the majority of to avoid widespread defaults. We seek investment opportunities on those names affected by market sentiment but with better fundamentals, and avoid more commercialized local government financing vehicles ("LGFV") owned by weaker governments due to higher refinancing risks.

Asia investment grade bond

The segment underperformed in 1Q21 and recovered in 2Q21 on the US rates move. In total, the asset class returned -0.5% during the first half. Credit spreads were overall tight, reflecting low fallen angel risks, despite the ongoing overhang of China's anti-competition issue and potential China-US tension. The rising COVID cases and low vaccination rate in Indonesia will pose downside risks on growth recovery, and put on hold fiscal consolidation along with pushing policy normalization to 2022. There is some pressure on EM currencies from moderating global trade growth and Fed tightening concerns.

The Indonesian rupiah could be on the back foot into year-end, which usually keeps Bank Indonesia from cutting rates. A cut in policy rates is therefore unlikely. Moody's and Fitch have kept their negative outlook on India sovereigns since June 2020. Subdued growth and downside risks to the financial system are key drivers for a downgrade. We believe agencies will be patient as lockdowns eased, but growth uncertainty will likely force the Reserve Bank of India to remain dovish even if inflation is uncomfortably high.

In this space, pre-refinancing may bring the supply pipeline forward on expectations of higher US Treasury yields in 2H and onwards. Overall, we see little room for spread compression and stay underweight the segment on a potential rise in the US Treasury yield.

Figure 5: YTD contracted sales on track with target

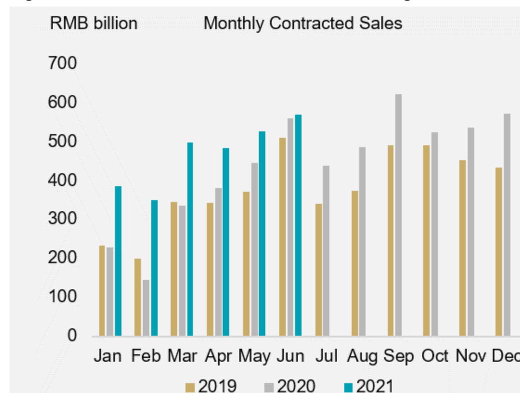
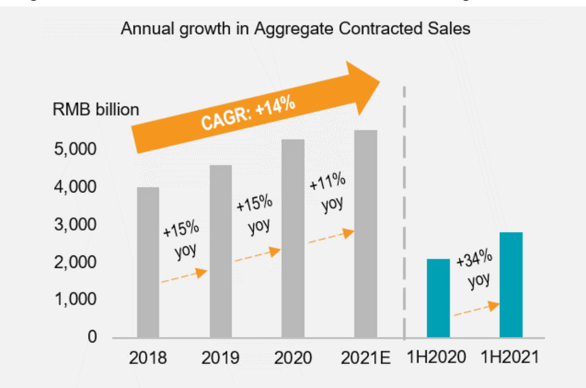


Figure 6: 1H 2021 contracted sales noted decent YoY growth



Source: Company data from 28 listed Chinese developers, as of June 2021

China property bond

Among the 28 listed Chinese developers that we track, contracted sales growth in 1H21 was maintained at a healthy level of 34% YoY (73% YoY in 1Q21 due to a low base). Overall inventory months were kept at a healthy level when compared to the last downturn (Figure 7). Developers generally met 50% of the FY21 full-year presales target, and this is key in cashflow generation. The trend of slower revenue growth and compression in profit margins, however, will persist in 2021. This is attributable to higher land prices and slower land acquisitions - the result of concentrated land sale policy and overall tight financing under "three red lines" policies – as well as the increasing amount of non-consolidated joint venture/associates' projects. Those developers with a competitive edge on Greater Bay Area and urban redevelopment projects are better protected on margin.

We take some comfort that 1) presales target was on track YTD and cash collection rate would be maintained at around 70-80%; 2) developers exhibited an overall disciplined land banking strategy in the first half to preserve liquidity (land acquisition costs accounted for 40% of presales), and this trend should prevail in 2H21 due to a tighter funding environment; 3) developers' bond refinancing needs to decelerate in 2H21 versus 1H21 (offshore at US$17 billion in 2H21 versus a total of US$40 million in FY21, onshore at US$20 billion in 2H21 versus a total of US$50 billion in FY21). Developers might resort to asset disposal if the onshore bond channel is shut for refinancing purposes.

The sector returned -2.3% in 1H21 given its close tie with policy tightening in China. Yields of single B and BB widened 6-7% since Jun'21, from 3% at year start. Sentiment waned after the defaults of China Fortune Land and Sichuan Languang, Yuzhou's surprised earnings miss. etc.

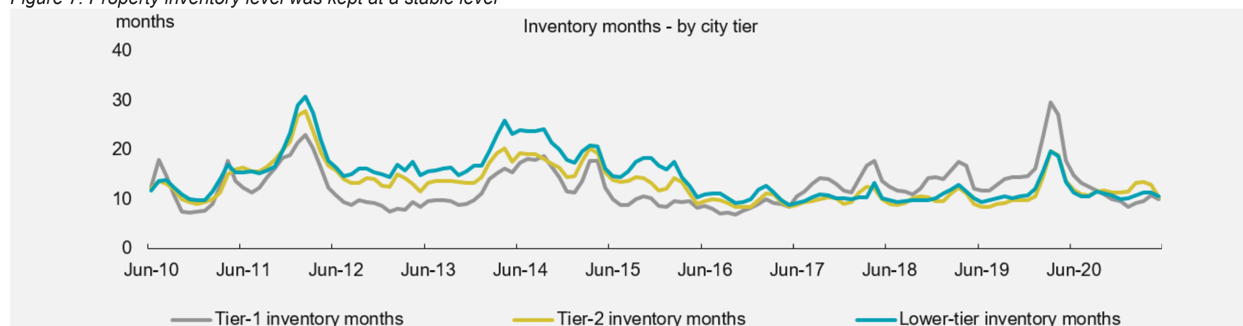
We see value in selective B and high beta B credits on their compelling valuations (Figure 8). China's growth will normalize in 2H21 and a tightening tone bias on the property sector remains. That said, developers with decent landbank quality and prudent financial management shall survive in this cycle. We believe yield compression could come from the muddling through on the Evergrande saga without a major restructuring event and an improvement in China's onshore financing environment.

We are more focused on assessing developers' landbank quality given their falling profitability and are mindful of issuers who have low contracted liabilities to revenue coverage. We favor developers that maintain their access to onshore funding channels, prioritize financial discipline and liquidity management over growth, have the ability to execute sales and maintain healthy cash collection rate, and are less exposed to heavy off-balance sheet liabilities.

China industrials bond

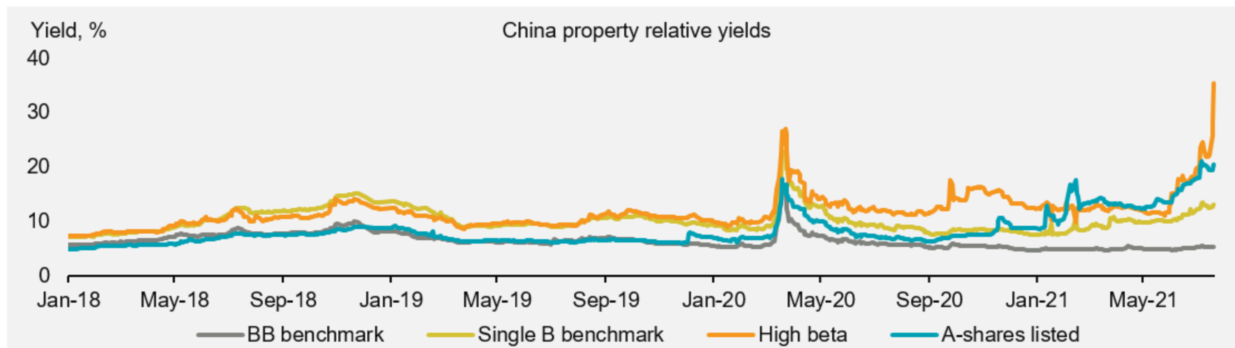
The sector performed in line with the index in the first half. Bond technicals were strong on diversification needs from the property sector,

Figure 7: Property inventory level was kept at a stable level



Source: CREIS; Sales to inventory ratio = current inventory/average sales in the past six months. Up to June 2021

Figure 8: Bond valuations



leading to tight valuations. Most credits have already captured the market window to issue bonds for refinancing purposes and led to an upward adjustment on credit ratings.

Fundamentally, corporates should continue to benefit from earnings recovery and a favorable commodity price trend. We are overweight on some consumption-related and commodity names to take advantage of the ongoing recovery of the economy.

Macau bond

Gaming bonds outperformed in the first half and returned 2.2%. The sector benefited from partial relaxation of cross-border travel restrictions from Mainland China to Macau. More importantly, casino bond issuers exhibited some liquidity cushion against cash burn and have taken steps to lengthen bond maturity extension.

In the coming quarters, the more widespread vaccination rollout in Mainland China, Macau and Hong Kong could increase chances for further border relaxation to boost up the sector's gross gaming revenue at some point in 2H21. Another key event to watch out for is the gaming concession renewal as all operators' licenses expire in June 2022. The Macau government has not yet even announced the public consultation timetable nor any renewal plan.

Hence, we expect the entire renewal process, commencing from consultation, law revision to bidding, may take one-two years. Temporary license extension could be an interim resolution.

Commodities bond

The metal & mining sector had a decent return of 7.2% during the first half. The upcycle has been supported by demand recovery and capital underinvestment, and inflation hedging. We shall watch for signs of correction if the supply/demand imbalance were to loosen in 2H21.

Possible headwinds include much slower demand from China in terms of infrastructure and property activities, as well as slower demand globally as restocking ends. Elevated commodity prices should facilitate improvement in earnings and deleveraging for issuers. Similar to Chinese industrials, we prefer to stay invested in this space, which offers diversity in risk exposure.

Sovereign high yield bond

The sector outperformed with a 10% return in 1H21, mainly driven by Sri Lanka sovereigns. The country managed to get US$792 million of Special Draw Rights ("SDR") allocation from the IMF and various swap facilities from PBOC, Reserve Bank of India ("RBI") and Bangladesh. Looking ahead, we believe the credit story remains binary, and will be monitoring the sovereign's ability to manage their short-term debt over the next 18 months, which they have US$2.5 billion of dollar bond maturities falling due and any intention to turn to International Monetary Fund ("IMF") for financing support.

Data sources are attributed to Bloomberg unless specified.

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Follow us

Value Partners Hong Kong Limited

43rd Floor, The Center,
99 Queen’s Road Central, Hong Kong

T +852 2143 0688
E investservices@vp.com.hk

Value Partners Asset Management Singapore Pte. Ltd.

9 Raffles Place, #13-04,
Republic Plaza,
Singapore 048619

Value Partners Asset Management Malaysia Sdn Bhd

Level 28, Integra Tower The Intermark,
348 Jalan Tun Razak,
50400 Kuala Lumpur,
Malaysia

Value Partners Fund Management (Shanghai) Limited

1505C, Taiping Finance Tower,
488 Yincheng Road Middle, Pudong New District,
Shanghai
200120, China

Value Partners Investment Management (Shanghai) Limited

1505A, Taiping Finance Tower,
488 Yincheng Road Middle, Pudong New District,
Shanghai
200120, China

Value Partners (UK) Limited

16 Berkeley Street,
London W1J 8DZ,
United Kingdom