First Sentier Asian Fixed Income Investment outlook

First Sentier Investors

Investment outlook | September 2024

Q4 2024 Outlook

Global/US

US economic data prints from the last couple of months have affirmed our bearish view of the US economy. In the days leading up to the Fed's recent policy action, markets grew increasingly divided in views of how aggressive the Fed would be in its policy trajectory, and sentiments seemed a bit more skewed towards a more bearish outcome in the real economy.

At this juncture, after recovering from early August's risk-off drawdown, the seeming calmness in markets is getting somewhat unsettling. A noteworthy observation is that that the US treasury curve has reversed from its inversion. During the course of September, the yield spread between 2- and 10- year Treasury bonds has turned positive for the first time since 2006. While the Fed's attention has been increasingly focused on labor market weakness, other economic indicators that we have been following are suggestive that the economy is running low on growth momentum. Even with the Fed aspiring to achieve a soft landing, possibly via its higher than consensus 50bps rate cut, we cannot rule out the occurrence of a hard landing.

Europe

In Europe, the European Central Bank (ECB) implemented its first rate cuts in July, but the remaining path for future rate cuts remain unclear. With the manufacturing economies in Europe struggling to emerge from its doldrums against a sticky services inflation backdrop, the growth story in Europe does seem to be in a bleaker shape compared to the US. In Germany, weak domestic consumption and investments, as well as structural issues in its automobile sector would likely mean that the export-reliant giant's recovery will not come easy. The better progress in balance sheet reduction does give the ECB some time and flexibility to adopt a gradual approach to cutting rates, but we are also cognizant that the central bank is treading a fine balance between doing too little to help the economy, versus failing to stamp out the embers of inflation should policy rates be reduced too fast.

Asia

China's policies have been highly accommodative with continuous policy measures aimed at stimulating consumer sentiment and destocking excessive property inventory. In undertaking an ambitious growth target of 5% for 2024, allowing a continued budget deficit of 3%, and issuing special treasury bonds, China is sending a strong signal in committing to growth. However, the multilayered problems causing China's slowdown means that we don't expect a quick recovery. The property sector and weak consumer sentiment will remain to be addressed. In other words, we still need actual consumer confidence and pre-sales numbers in the property sector to pick up on a sustained basis before market confidence can be restored. Nevertheless, we are of the belief that the Chinese economy will emerge much stronger from this consolidation process and maintain a positive long-term outlook for the economy.

Asian economies have been resilient thus far. Some have benefitted from the tech upcycle, but effects from China's slowdown are not negligible. The growth outlook in Asia is showing signs of weakness especially for export-oriented countries including Singapore, South Korea and Taiwan, not only due to China's slowdown, but also the lackluster demand from other regions. We believe that this trend is likely to continue. Within the Asian region, countries with a stronger domestic story, such as India, are likely to fare better. Against this weakening external backdrop, we see policy divergence

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- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks. The Fund may also expose to RMB currency and conversion risk.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
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emerging among Asian central banks as some remain on pause while others begin to cut rates along with the Fed's easing cycle. The moderating inflationary backdrop and healthy fundamentals remain favorable tailwinds for Asian economies and currencies. We remain constructive on the region's longer-term growth prospects as Asian economies continue to move up the value chain in the global economy.

The Bank of Japan's (BoJ) exit from its negative interest rate policy (NIRP) and yield-curve control (YCC) policy has not come easy after 17 years in a negative interest rate environment. There has been encouraging increases in real wages that hint promisingly to a stronger domestic growth environment – the yearned after 'virtuous cycle'. As the BOJ normalises interest rates, the yen's strength has seen signs of revival, not only on the back of the Fed's rate cuts, but also potentially as a safe haven currency in the event markets end up with a hard landing scenario. Asian local currency bonds have regained some footing on first signs of the Fed's pivot, and the changing tides in fund flows favoring Asian markets could further boost Asian local bond returns.

Our strategy - credit

While Asian Credit fundamentals have remained stable, demand-supply technicals has been, and will still be, the bigger driver of credit performance in the near term. Primary market supply has been picking up even as spreads come off the year's lows. Investors keen to lock-in income are still digesting the supply with good appetite while yields still remain at the higher end of the historical levels. The recent retracement in credit spreads from June's record tights has been largely within expectations, and the recovery from August's market sell-off demonstrating Asian Fixed Income as a resilient asset class. That said, with the weakness we anticipate in the global economy, a risk-off scenario could occur very swiftly at current valuation levels. Our bias is for higher quality names and to ensure sufficient diversification in portfolios. We prefer issuers with the liquidity and resilience to withstand a hard global landing, should such a scenario emerge.

Our strategy - rates

Given that we are only at the start of the rate cut cycle, we maintain our long bias in US interest rate duration that has been implemented in our strategies. If we were to compare current market rate cut expectations of around 250bps against historical magnitudes that have averaged between 300bps to 400bps, markets have yet to excessively price in future cuts from the Fed. Volatility could play out more visibly from the US election and geopolitical events, both of which would warrant a dynamic approach to managing our duration and currency exposures.

Source : Company data, First Sentier Investors, as of end of September 2024