FUNDAMENTAL FLASH

2022 Fixed Income Outlook | Bracing for Policy Shifts

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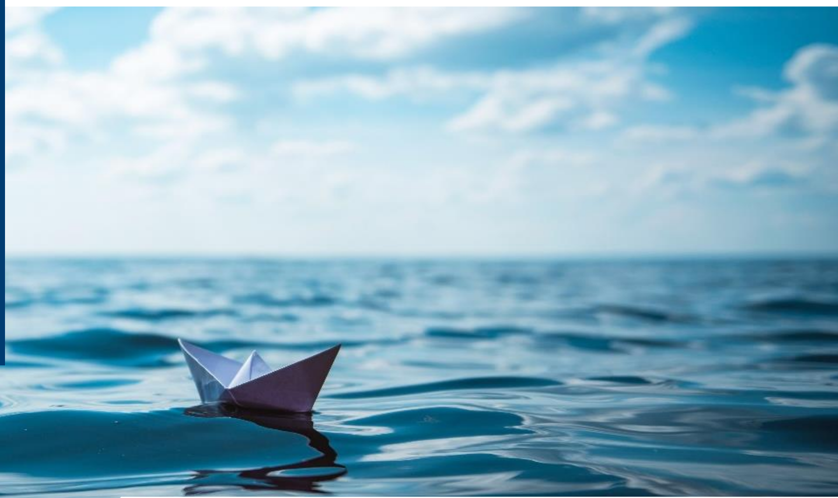

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Policy tightening and inflation will be key watchwords for fixed income investors in 2022 as the prospects of higher interest rates could cast a pall over bond markets. However, pockets of value are also emerging especially in China which is looking to add fiscal stimulus.

Esther Teo, Senior Director of Fixed Income shares her views on the outlook for bond markets as well as how the team is positioning for the year ahead.

Flashpoints

- Expecting softer growth on the macro-front amidst an uneven recovery in 2022 as COVID continues to linger.
- US-China tensions will persist as both countries head into elections years in 2022.
- Opportunities emerging in China due to an indiscriminate sell-off in the property sector. However, there is a need to be selective.
- Taking a defensive stance with a preference for shorter-dated bonds with headwinds stemming from monetary policy tightening.

<u>Questions</u>

1. 2022 has been described as a 'transitionary' year for markets as growth rates normalise and monetary policy tightens. What is your assessment of the global macro backdrop for 2022 and the downside risks to growth?

We expect recovery to be patchy and uneven as uncertainty surrounding COVID-19 continues to linger into 2022. Developed markets (DMs) are expected to outperform emerging markets (EMs), as DMs adopted a more aggressive stimulative stance to combat downward pressure arising from the pandemic in the form of rate cuts and handouts such as unemployment benefits, etc.

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In addition, central banks in EMs are embarking on its tightening policy cycle to tamp down inflation which is piercing new highs. This is especially in Brazil and Mexico where strong inflation has fuelled pressure for rate hikes.

Throughout 2021, EMs were challenged on the back of a strong US dollar environment, weak domestic growth, and rising rates. We expect this theme to continue into the 1H'22 mainly driven by growth divergence. However, inflation should start trending downwards by mid-2022 as commodity prices peak and the supply chain crunch eases.

Inflation remains one of the key risks to market. If inflation proves to be stickier especially on the higher side globally, central banks will be pressured to raise rates further. This poses a challenge to the current low interest rate regime and needs to be reassessed by global policymakers and investors.

Other notable events in 2022 include election years in both the US and China respectively. While Republicans are widely expected to make gains in the mid-term elections in November 2022, this will not help US-China relations as there is still bipartisan support to act against China. As such, relations between both countries are expected to remain strained in 2022.

Overall, we taking a cautious stance going into 2022 due to uncertainties stemming from growth and inflationary outlook. However, an economic recession isn't within the base-case, though growth is expected to be relatively soft.

2. Following blockbuster stimulus in 2021, global central banks like the Fed are now set to withdraw liquidity and hike interest rates next year to tamp down inflation. How will Asian bonds be impacted?

As signalled by the US Federal Reserve at its policy meeting in December, the Fed has guided to markets that it plans to speed up its tapering of bond purchases which would pave the way for 3 rate hikes in 2022.

Liquidity withdrawals and a rising rate environment will be headwinds for fixed income assets that could lead to a widening of credit spreads. Investment Grade (IG) credit spreads are close to historical tight levels.

We see opportunity in the High-Yield (HY) space especially in China's property sector which is trading at attractive levels due to an ongoing sector crisis where default rates have climbed up significantly. Due to the bond price distortion, certain bond issuances have sold-off indiscriminately.

However, we are taking a very selective approach as some developers might not be able to survive the crisis.

3. It's been a volatile year for China's bond market as the Evergrande debt saga unravels in the property sector. With policymakers now looking to provide fiscal stimulus to support growth, is a recovery in sight? What's the outlook for China bonds in 2022?

As alluded, Beijing has shifted its policy focus to now supporting growth where policymakers have repeatedly emphasised its priority for economic stability. As such, we do not expect a sharp contraction in growth.

However, any impact would be gradual as the government is mindful to not over-stimulate the economy as well which leads to financial instability. As such, recovery is expected towards the 2H'22.

For offshore bonds, we see opportunity in select quality names that are trading at distorted levels as mentioned above.

In the onshore market, we continue to like this space too as Chinese government bonds are trading at a premium versus peers. For example, the 10-Year CGB is trading at 2.8% which is 140bps higher than US Treasury. The sector could benefit further from a gradual opening of capital markets and its inclusion into any major bond indices.

4. How are you positioning our fixed income portfolios? Are there any segments of the bond market you see value in?

In light of headwinds stemming from a rising rate environment and tapering of liquidity, we are taking a cautious and defensive approach. We prefer shorter-tenure bonds to reduce duration and inflation risk.

We see pockets of value in China bonds following the indiscriminate sell-off in the property sector. We also favour Malaysia corporate bonds for its carry as domestic bond yields have risen.

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