Fixed Income 2H’2021 Outlook: Finding Yield in an Uneven Recovery

Prepared by: Affin Hwang Asset Management

Against an uneven economic recovery backdrop, bond investors in search for yield have to navigate a new normal environment and interest rate cycle. We spoke to the Fixed Income Investment team at Affin Hwang AM who share their views and opportunities they see in bond markets.

Macro Environment

Esther Teo
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It’s been a strong 2021 so far in terms of economic growth as countries reboot their manufacturing activities and consumption returns. Do you see this continuing for the rest of 2021?

For 2H’2021, we expect the pace of economic recovery to normalise from the hyper-growth rates which we saw in 1H’2021. China’s 1Q GDP grew by 18% in the 1Q’2021 while US registered 6.4%, a very sharp recovery as it was from a low base.

However, we are now likely to have reached the peak of economic activities as signalled by various manufacturing gauges and economic surprise indicators. A fall in credit impulse data across different economies also suggest that lower credit creation flows could lead to slower growth. While economic growth will remain positive, the pace of growth will slow down for the rest of the year.

A key risk to monitor is the Delta variant which is posing a new threat to economic reopening with a resurgence of new COVID-19 cases. However, hospitalisation and mortality rates have remained relatively low especially in UK and Europe, where more than 50% of the population have been vaccinated. This is a positive sign showing the efficacy of vaccines so that economies can continue to gradually reopen. However, emerging economies with low vaccination rates and in lockdown will see a delay in their economic recovery. We expect developed markets (DM) to outperform emerging markets (EM) in 2H’2021.

Inflationary fear has been on the mind of every investor as economies bounce back from COVID-19. Should investors be concerned?

We share the same view as the Fed who believes that current inflation is more transitory in nature as opposed to structural. Various factors contributed to a spike in inflation including a low base effect as well as supply-demand imbalances in the commodity space.

There seems to be a mismatch of information in the US where the unemployment rate remained high, but companies are finding it difficult to hire workers. This is partly due to the unemployment benefits offered by the US government as part of its fiscal stimulus plan to aid blue-collar industries. Under the programme, there may be little incentive for workers to return to work as they earn more from government handouts. However, we expect this program to be rolled back gradually before ending entirely in September. This distortion caused companies to raise wages to attract workers which also contributed to higher inflation.

Where do you see the current interest rate cycle and when the US Federal Reserve (Fed) could start raising rates? How will bond markets react then?

The Fed is taking a patient approach towards rate tightening with the first rate hike only expected to take place in 2023. As mentioned, the Fed believes the recent high inflation print is transitory. The Fed also wants to see US unemployment rate falling below 4% to ensure the recovery is sustained.

However, the Fed could look at tapering its quantitative programme (QE) by early 2022. This may lead to higher volatility in markets. However, the Fed has been much more cautious now in telegraphing its monetary policy intentions to investors to prevent a similar taper tantrum episode as seen in May 2013. We believe the market may be more prepared this time given we have gone through a previous QE tapering. We expect the Fed to start communicating their QE tapering plan in Sept 2021 which is likely to be very similar to its previous tapering program.

With the Fed maintaining an accommodative monetary policy stance, we expect this to be supportive of the bond market. We have likely seen the peak of US bond yields in the 1Q'2021. For the remainder of the year, bond yields will likely trade in a range and by the end of 2021, it could start to rise again as bond investors price-in the risk of tapering by the Fed as well as rate hikes.

Asia Fixed Income

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Fixed Income

It's been a great year so far for Asian bonds. Do you think it will continue to be in favour in the 2H'2021? Or are there factors that have diminished your outlook?

We believe that economic growth is on a recovery trend, though it remains uneven. Key central bankers around the world believe that the economy is growing, albeit not as strong as it could be. As such, monetary policy will likely remain accommodative for the rest of the year, and this is supportive of the bond markets.

Because we are still in a low yielding environment, investors' need for higher returns will continue to drive the search for yield theme. Currently, the amount of negative yielding assets (i.e. bonds that are not paying any interest) issued by developed markets amounted to over US$ 13 trillion. Thus, many pension funds or insurance companies are scouting around EMs looking for better yielding assets.

We continue to see Asian credits, be it investment-grade (IG) or high-yield (HY), to outperform US corporate bonds from a carry perspective. As such, Asian bonds continue to offer investors attractive yield and diversification benefits in their portfolios.

In terms of credit health of issuers, have they improved in tandem with the current pandemic environment?

In 2020, we did see default rates rising following the unprecedented economic shutdown caused by the pandemic. In Asia, we saw over 20 corporate bond defaults last year which amounted to about US$ 13 billion (US-dollar denominated bonds). Companies with weak balance sheets and cashflow were more susceptible to defaults.

Since then, we have seen global defaults rates come down significantly. Default rates in 2020 ranged between 8%-9%. This year the default rate is estimated to hover around 2%. The credit environment has seen improvements and there is less downgrade pressure for lower-rated corporates. We expect defaults will remain contained in 2021 as recovery takes hold and we are confident that Asia will weather through this pandemic crisis smoothly.

Where do you see opportunities in Asian bonds for the rest of the year?

The sweet spot will be Asia because of the good carry that we are seeing. There are two things that we like in Asia. First are the corporate perpetuals, where issuers have solid balance sheets and bonds offer compelling yields on a risk-adjusted return basis.

Secondly, we like the HY corporates of which we remain selective on, despite the riskier credit metrics. This is because of the widening spreads that we have seen of late. Some of these HY companies are showing very good returns, specifically "BB" rated bonds. We also look for rising stars (i.e. improving companies) which have potential to see rating upgrades in the mid to long-term.

Being first the country to rebound post-pandemic, China is seeing strong growth and consumption appetite. What's your outlook for its bond market and its growing size?

China's bond market has grown rapidly over the past few years to become the second largest bond market in the world. Its inclusion into global indices such as the JP Morgan Government Bond Index – Emerging Markets, Bloomberg Barclays Global-Aggregate Index and recently FTSE Russell's World Government Bond Index has also created more awareness. Global bond investors benchmarked against these indices, will have to allocate their money into China Government Bonds (CGBs) to match the index levels. In that sense we have seen strong inflows into the market. Additionally, the broadening of investor base would improve market liquidity as well.

China bonds also stand out as a diversification opportunity. The CGBs has been resilient during the first quarter this year, mitigating the negative impact from the rising US Treasury yields. From a valuation standpoint, China's sovereign rating is rated A1 and its 10Y CGB gives a yield of close to 3%. The China 10Y real yield is approximately 1.8% which compare favourably to the US 10Y real yield of -3%, after considering rating differential.

Malaysia Fixed Income

Ahmad Raziq
Senior Portfolio Manager
Fixed Income

Moving closer to home, Malaysia's economic growth has been revised downwards amidst a resurgence of COVID-19 cases. What's your forecast for growth this year and impact to the local bond market?

GDP growth forecasts for 2021 is expected to be revised lower with estimates ranging from 4.0%- 4.5%. This is much higher compared to 2020 where the country's GDP shrank by 5.6% in a pandemic year. However, the estimates still remains below potential if you refer to the 6.0%-7.5% GDP growth as forecasted by Bank Negara Malaysia (BNM).

Since the start of the pandemic, the government has announced a slew of fiscal measures. In total, 7 fiscal stimulus measures were announced by the government amounting to RM530 billion. Out of this figure, RM83 billion was a direct fiscal injection.

As such, there will be some implications to the country's fiscal deficit which is expected to rise from 6% guided earlier. The new range is expected to range between 6.5%-7.5%. In terms of the statutory debt ceiling, it is expected to be raised from 60% to 65%. This could put some downward pressure to the country's sovereign ratings. We could also see a bit more volatility in the local bond market because of the additional bond supply.

Moving forward, we will continue to monitor the latest developments in terms of the economy as well as the country's vaccination rollout progress. It is important to see more parts of the economy reopening because that will support the general outlook for the economy. We will also get more clarity on any additional fiscal measures that could be announced moving forward by the government.

Malaysia's equity market has been quite unloved by foreigners with large outflows. What about local bonds? Is there still strong demand from foreigners?

We are seeing a gradual recovery in the local bond market post sell-off in the 1Q'2021. We saw yields spiked up by over 100 bps during the peak of the sell off after US Treasury yields increased in a similar manner. Currently, we are seeing better demand from local and foreign investors in general. At the moment, the relatively stable and range-bound movement in the US Treasury is positive for the local bond market.

In terms of foreign flows, we actually saw positive foreign inflows for the past 13 months straight. On a YTD basis foreign inflows amounted to around RM25 billion. The share of foreign holdings in MGS had gradually increased to about 41%. We expect this trend to continue at least in the near-term. But there could be some downside risk posed by a potential tapering by the Fed.

In terms of the relative yield, Malaysian government bonds provide a relatively higher pick-up compared to bonds issued by DMs. From a volatility perspective, it's actually quite stable as well.

On a currency basis, the Ringgit is also quite attractive to foreigners because it is trading quite low in terms of valuations on a historical basis. But inherently, the Ringgit does have some potential to strengthen especially in this current environment where Malaysia's exports are growing by double-digits. Commodity as well as electrical and electronic (E&E) exports have been stronger compared to previous years. This could lend support to the Ringgit and potential for strengthening in the medium-term.

Do you see any more room for another overnight policy rate (OPR) rate cut by Bank Negara Malaysia (BNM)?

BNM will likely maintain the OPR at 1.75% for the rest of the year despite concerns over the growth of the economy. We believe BNM is looking at other factors such as the progress of the vaccination rollout, the stronger than expected exports and also the fact that the current lockdowns is less punitive to the economy.

As such, BNM is cautiously optimistic in terms of the growth outlook for Malaysia. The government has also announced various fiscal stimulus measures to aid recovery and that should support growth, while waiting for further parts of the economy to reopen.

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