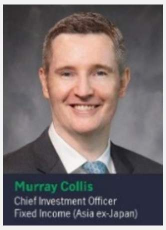
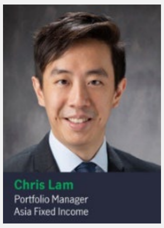
Manulife Investment Management

2024 Outlook Series: Asian Fixed Income

Jan 2024





Further monetary tightening by the US Federal Reserve (Fed) and the ongoing ructions in China's real estate sector again weighed on Asian Fixed Income in 2023. However, a pivot from the Fed in late 2023 and Asia's resiliency led to positive returns and outperformance for the year. As Endre Pedersen, Murray Collis, and the Pan-Asian Fixed Income team argue, a changing global rates environment positions the asset class to accelerate in 2024 with attractive nominal yields and carry opportunities. Credit is slated to continue posting a positive performance amid a diversifying investment universe, with potential upside for selective markets and sectors with strong credit fundamentals.

Accelerating momentum amid a transitioning macro backdrop

Investors entered 2023 with arguably greater certainty than the previous year. The threat of inflation was well known, and it continued to dominate the macroeconomic landscape and monetary policy. Indeed, after the Fed hiked rates by a historic 425-450 basis points (bps) in 2022, the US central bank delivered a further 100 bps of hikes last year, bringing the federal funds rate to 5.25%-5.50% by August 2023. The US central bank subsequently paused from September onwards.

However, uncertainty persisted, as investors wondered when the Fed would halt and whether the US economy could ultimately achieve a 'soft landing'. As a result, US Treasuries experienced significant volatility, particularly longer-duration bonds. The 10-year Treasury, which began the year at 3.88% peaked at around 5%, before receding at the year's end. The MOVE Index, a measure of US Treasury option volatility across maturities, spiked in 2023 to the highest level since 2008.

Against this backdrop and despite heightened volatility, Asian fixed income outperformed global fixed income and the broader emerging market universe (See Chart 1).

Chart 1: Global fixed income performance (2019-2023)[1]

From a credit spread perspective, Asian investment-grade (IG) bonds continued demonstrating resilience, tightening by roughly 32 bps in 2023[2]. This was mainly due to a shorter duration profile and an investment universe containing a greater concentration of state-owned firms in more resilient regional economies. IG's total return grew by 7.4%, driven by solid credit fundamentals and falling US Treasury yields towards the end of 2023[3].

[1] Source Bloomberg, as of 31 December 2023. Asian fixed income= JACICOTR; Emerging Markets fixed income= JGENVUUG; Global fixed income=LEGATRUU. Rebased to 100 as of January 2019.

[2] Source: Bloomberg, as of 31 December 2023. JACIIGBS.
[3] Source: Bloomberg, as of 31 December 2023. JACIIGTR.

Asian high yield (HY) also posted a positive return, albeit at a slower pace of 4.8%, amid the strong performance of regional sectors such as Indian renewables and Macau gaming, offsetting the volatility and adverse sentiment of China's property sector[4].

2024: Yield and carry opportunities remain relatively attractive with a resilient regional economic profile

As we move into 2024, the interest-rate environment is likely to stabilise after the high volatility experienced over the past two years.

Our base case is that the Fed is near or at the end of its current rate hiking cycle. Once this is confirmed, we believe several positive catalysts will emerge to stabilise the macroeconomic environment and benefit Asia.

Indeed, even as the IMF estimates global economic growth to decelerate this year to 2.9%, Asia is projected to be the fastest-growing global region at 4.2% in 2024 due to its diversified growth profile.

China's economic growth lagged market expectations in 2023. Still, we believe that recent signals of strengthening fiscal and monetary policy and more targeted measures to help the property sector, such as recent reports of a list of developers eligible for financing, are constructive.

Equally important, economies, such as India and Indonesia, have developed new sources of growth that can add to the region's resiliency.

India posted the fastest growth in Asia among large economies in 2023 due to robust government investment in infrastructure and successful manufacturing onshoring schemes like the Production Linked Incentives. Meanwhile, Indonesia is developing a domestic supply chain to produce electric vehicle batteries that allow value-added activities pertaining to key minerals, such as bauxite and nickel, to remain onshore.

[4] Source: Bloomberg, as of 31 December 2023. JACINGTR.

In the next section, we will break down our 2024 Asian fixed-income outlook into three areas: credit, rates, and currency.

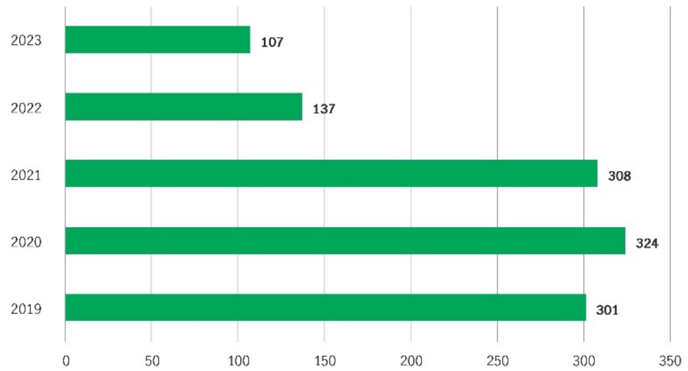
2024 IG: Continued strong credit fundamentals

Asian IG credit posted resilient performance in 2023 despite a volatile global market due to strong credit fundamentals and robust regional economic growth, both are expected to continue in the new year.

Supply-side factors also played a role: Asian credit issuance declined by 22% year-on-year in 2023 (See Chart 2) due to higher yields for US-dollar-denominated bonds, which has led many companies to seek cheaper domestic funding options.

Moving into 2024, although we expect lower yields to incentivize a gradual rise in IG issuance, we don't expect the net supply of bonds to be positive this year (given maturities) unless the Fed embarks on an aggressive rate cuts cycle.

Chart 2: Asia credit total issuance, 2019-2023 (US $bn)[5]



Additionally, although we see some potential spread widening for IG bonds if Treasury yields continue to move lower, the overall total return of the market should still be positive as declining nominal yields outweigh the loss due to widening credit spreads.

Based on this backdrop, we are constructive on selective pockets of regional IG opportunities. As always, bottom-up credit selection remains imperative:

- **Selective privately-owned enterprises (POEs) in China,** primarily with a credit rating of 'BBB'. Although China's economy will likely remain volatile in 2024, we believe that selective POEs

[5] Source: J.P. Morgan, as of 29 December 2023.

with strong fundamentals are poised to outperform and benefit from China's structural consumption growth.

- **Asian regional bank capital bonds** can offer a compelling risk-reward proposition. Indeed, Asian banks have shown resiliency after a raft of US banking failures in March 2023. Overall, the state-owned backing of many Asian banks augurs well, as they are less volatile and more likely to be viewed as systemically important by governments across the region.

  For example, we see opportunities in Indian banks backed by strong economic performance, improving asset quality, and growing demand for corporate and consumer lending. Additionally, we are constructive on the bank capital bonds of more stable and well-capitalized Australian banks, where we see attractive valuations. By moving down the credit curve, we can obtain higher yields while managing risk among internationally renowned financial institutions with robust corporate governance.

  Finally, these instruments also play a key role in portfolio diversification, particularly as overall issuance in the regional IG space has lagged over the past two years.

2024 HY: Evolving opportunities in an expanding credit universe

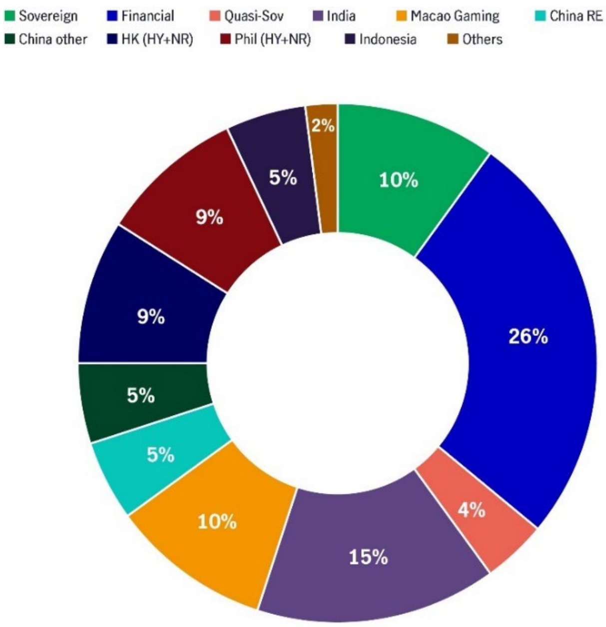
China property continued to weigh on HY performance and investor sentiment in 2023. But as we have previously pointed out, China property is playing a less critical role in the HY investment universe as a significant number of firms have defaulted, with some declaring bankruptcy. Since 2021 when the Chinese property sector slump started, 115 defaults totalling US $144 billion have been registered.

We believe the sector will stabilise over the long term amid the continued supportive measures by the government; however, it will not return to the days when it contributed roughly 25-30% of the country's GDP.

Indeed, we envisage the sector continuing to contract and undergo significant consolidation. The path to this inevitable outcome will likely see continued volatility, that said, the number of defaults is expected to gradually decrease over time.

Perhaps more important for investors, with China property only currently accounting for roughly 5% of the J.P. Morgan Asia Credit Index (JACI) HY (approximately 40% at its peak), we expect there are evolving opportunities in a diversifying credit universe. Thus, further volatility in the sector should have less influence on market performance than larger corporate segments such as Indian renewable energy and Macao gaming (See Chart 3).

Chart 3: JACI HY composition by sector[6]

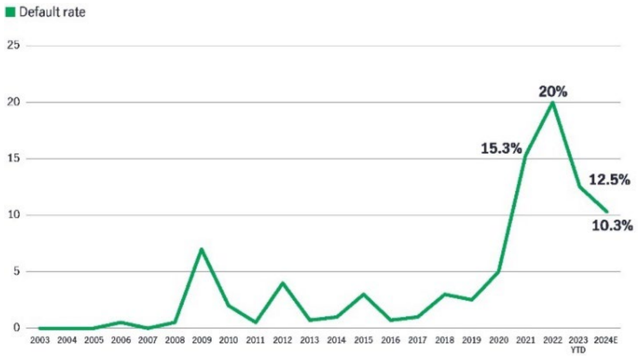


Furthermore, entering 2024, the credit fundamentals of the overall Asian HY space are expected to improve further. While defaults remain elevated at 12.5% (estimated) in 2023, far above the historical average, they are forecast to notably decelerate to 10.3% in 2024[7] (See Chart 4).

[6] Source: J.P. Morgan, as of 15 November 2023.

[7] Source: Goldman Sachs, November 24.

Chart 4: Asian HY historical default rates, 2003-2024E[8]



Overall, we are constructive on the following HY segments for 2024:

- **Indian infrastructure** names are attractive, with a strong macro story and robust government support. India's economy is arguably the strongest in the region, and the Indian government has earmarked US$120 billion for infrastructure investment in the upcoming fiscal year. This has led to an improving credit profile: roughly 29% of credit upgrades in India during the first six months of 2023 were related to infrastructure – the most of any sector.

- **Macao casinos** have resilient credit fundamentals post-China's reopening in early 2023. Although China's economic growth has been slower than expected, Macao's recovery continued with an uptick in tourists during Golden Week, which led to some credit upgrades. We also see attractively valued opportunities in the sector within the Asian HY space.

  Overall, the landscape of the Asian high yield market has changed dramatically over the past three years to become more diversified from a geographic and sector basis.

- **China's property sector** currently constitutes a significantly smaller proportion of the HY universe (roughly 5%) than before. The government has expanded support beyond the supply side (developers) to include the demand side (consumers), in addition to the deep discounts presented in the market. Overall, we are cautiously optimistic and are highly selective on issuers during this K-shaped consolidation process.

2024 Rates: Selective opportunities in high-yielding markets

As the Fed is near or at the end of its tightening cycle, we envisage a constructive environment for Asian rates in 2024.

Overall, Asian central banks have varied in their responses to a hiking Fed in 2023: Amid a more benign inflationary environment, some regional central banks, such as those in India and Indonesia, did not match the Fed's pace with continued rate hikes.

With the Fed and other global central banks likely on pause and receding regional inflationary pressures in 2024, we believe some Asian central banks have room for potential rate cuts.

As Asian local-currency rates markets have largely outperformed US Treasuries due to a more measured approach to inflation[9], we remain constructive on three high-yielding markets in 2024.

- **Indonesia** offers an attractive nominal yield, with the 10-year government bond roughly at 6.50%[10]. Further, we believe that Bank Indonesia has potential room to cut rates after hiking its policy rate to 6% in October, primarily to protect the currency. Inflation has steadily fallen and remained within the central bank's target of 4%[11]. Finally, the country's fiscal situation is seeing improvement, with projected fiscal deficits for 2023 and 2024, respectively, both estimated to be lower than the 2.35% posted in 2022.

- **The Indian market** arguably boasts the strongest fundamentals regionally and offers an attractive 10-year government bond yield of around 7.20%[12]. Growth remains robust with third-quarter GDP at 7.6% (year-on-year), which is the strongest in the region, while inflation has receded and the trade and current account deficits have stabilised.

  In addition, the market may benefit from potential further inclusion in global indices: the J.P.

[8] Source: Goldman Sachs, November 2023.
[9] Bloomberg, as of 31 December 2023.
[10] Bloomberg, as of 31 December 2023.
[11] Bank of Indonesia web site.
[12] Bloomberg, as of 31 December 2023.

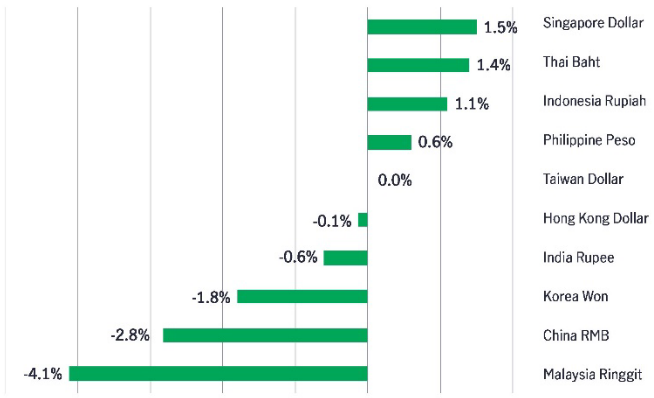
Morgan GBI-EM suite of indices will include Indian government bonds starting in June this year, with Bloomberg Barclays and FTSE also considering the country for inclusion in 2024.

- **Finally, the Philippines** offers relatively attractive valuation opportunities, given its higher volatility profile. The country's rate environment has displayed historically high beta with the Fed; thus, it could benefit more than other regional markets when the Fed pauses its current rate hiking cycle.

2024 Currency: Rupiah and Won forecast as bright spots

The US dollar had a volatile 2023, with the DXY initially strengthening on the back of higher rate differentials, only to end the year roughly flat. Asian currencies posted a mixed performance, with several markets enjoying gains against the greenback in 2023 (See Chart 5).

Chart 5: Asian currency performance versus US dollar[13]



We believe that once the Fed signals it has stopped its rate hiking cycle, this will be broadly supportive of Asian currencies in 2024. We are particularly constructive on two currencies:

- **Indonesia's rupiah** is poised for greater stability and performance in 2024 due to an improved global rates environment and potential increases in portfolio and foreign direct investment. Foreign investors currently hold less than 15% of outstanding government bonds, while this was close to 40% before the outbreak of COVID-19 in 2020. This proportion could potentially increase with higher yields and a more stable currency. Foreign direct investment is also accelerating as the country builds a domestic ecosystem to produce electric vehicle batteries and other high-tech products.

- **Korea's won** is also slated to perform after a late-year rebound in 2023. Exports posted positive year-on-year performance in October for the first time in 13 months after the trough in semiconductor demand passed. With demand for semiconductors and artificial intelligence-related products expected to rise over the near term, Korea's exports will likely remain upbeat and contribute to a positive current account in the new year.

Conclusion

After 18 months of Fed interest rate hikes and further consolidation in the Chinese property sector, Asian fixed income rebounded into positive territory in 2023 and shows signs of green shoots for 2024.

This momentum can continue in 2024 on the back of a more accommodative Fed, strong regional and corporate economic performance, and resilient credit fundamentals. We believe Asian bond markets have the potential to significantly outperform globally, as we move closer to an ending of the Fed's monetary tightening cycle and bottoming of the Chinese property sector.

However, markets are likely to remain volatile in the interim. In addition to the potential risks over evolving inflation and monetary policy, Asia will experience key elections this year in India, Indonesia, Taiwan, and South Korea- not to mention significant elections outside the region in the United States.

Bottom-up credit analysis remains imperative as credit is expected to remain challenging as higher rates may lead to slowing economic activity. Selective rate markets and currencies could also contribute based on solid fundamentals.

[13] Source: Bloomberg, as of 31 December 2023.