eastspring investments

A member of Prudential plc (UK)

Fixed Income Outlook: Navigating the challenges from the COVID-19

Low Guan Yi, Chief Investment Officer, Fixed Income, Eastspring Investments, Singapore

Low Guan Yi, Chief Investment Officer, Fixed Income, shares her team's strategy in the aftermath of the COVID-19 outbreak and explains why they are overweight Chinese property developers within Asian credits.

Q. How has your outlook for the global economy changed since the start of 2020?

The global economy was looking to be in a better shape going into 2020. The signing of the Phase 1 trade deal between the US and China in mid-January had boosted business and investor sentiment. Leading global Purchasing Managers' Index (PMI) and manufacturing data, as well as the tech cycle were showing signs of a recovery. Unfortunately, the outbreak of the coronavirus in Wuhan (now named "COVID-19") has now cast a cloud over the global growth outlook. Economic data for the first quarter of the year is likely to be poor, especially in China and selected Asian economies such as Singapore, Hong Kong and Thailand, which have strong linkages to the Chinese economy.

While China has locked down several cities and restricted travel, which may help to curb the spread of the virus, these unprecedented measures are likely to be highly disruptive and could significantly impact the China economy and the rest of the world.

Q. Many investors have pointed to the sharp rebound of the Chinese and Asian economies after the SARS epidemic in 2003 as a reason to look through the near-term weakness. What are your thoughts?

While we can look back to 2003 for some guidance, we must be cognizant that the China today is very different from the China then. For one, the service sector accounts for a much larger share (54% in 2019) of the Chinese economy (See Fig. 1) and policy support is more constrained with debt to GDP at 275% of GDP. These, together with China's structural slowdown, suggest that the economic recovery could be more sluggish compared to the SARS period. As a result of the outbreak, China's growth is forecasted to slow to 4.8% in the first quarter of 2020 and the full year growth target of 6% appears elusive.

Meanwhile, the impact on the rest of the world could be larger. Afterall, China's share of global oil demand has since doubled since 2003 while its share of global tourism spend has increased almost seven-fold. See Fig. 2. With China being a key player in the global supply chain, there have already been reports of component shortfalls in the auto industry and the risk of factory closures in Korea and Europe.

Q. Does that mean we should be braced for a sharp slowdown in the Chinese economy?

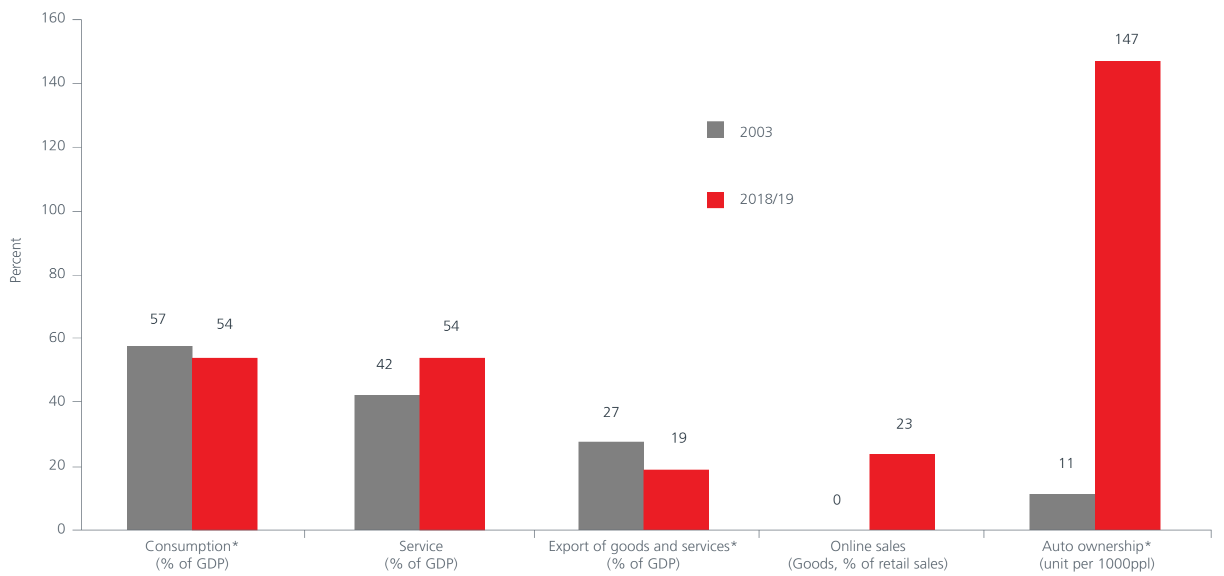
While we are watchful, there are some mitigating factors. In 2003, SARS hit Beijing and Guangdong provinces the hardest, two important economic power houses in China, with a combined GDP share of 14.5%. The COVID-19, on the other hand, is concentrated in Wuhan, and to a larger extent the Hubei province, whose provincial GDP share is only 4.5% of the national total.

In addition, ecommerce was just starting to emerge in 2003 as many in China still did not have internet access. These days, online sales account for 20% of total retail sales in China. As such, the disruption to China's retail and wholesale businesses could be smaller.

The Chinese government is likely to roll out more accommodative monetary policies. We see room for additional policy rate cuts in the first half of this year. There is also scope for further cuts to the Reserve Requirement Ratio as well as for Medium-term Lending Facility (MLF) and Open Market Operations (OMO) in the coming weeks to inject both short and long-term liquidity into the banking system. At this stage, the People's Bank of China (PBoC) is likely to prioritise financial stability and growth over inflationary concerns.

Besides easier monetary policies, the government may also roll out more expansionary fiscal policies such as accelerating infrastructure spending, subsidising interest costs, as well as lowering or waiving taxes for affected entities. Industries that supply medical instruments may also receive targeted policy support.

Fig. 1. China: Some notable differences; 2003 and now[1]



Q. Has the bond market priced in the impact of the COVID-19 outbreak?

Using the SARS episode as a guide and considering the potentially larger economic impact of the current outbreak, it appears that the bond market has only partially priced in the impact of the COVID-19 outbreak.

During the SARS episode in 2003, the MSCI Asia ex Japan Index fell by around 15% from peak to trough, while spreads of Asian credits widened by around 30 basis points, before recovering rapidly.

In the recent COVID-19 outbreak, the MSCI Asia ex Japan Index has fallen by only 8% from peak to trough, while Asian credit spreads have widened by around 17 basis points. See Fig. 3. The performance of Asian USD credits has also been relatively resilient. While credits in selected industries which are directly impacted by the virus (e.g. gaming, retail and tourism) and other higher beta credits experienced some initial softness, the correction has been moderate, and some credits have since rebounded.

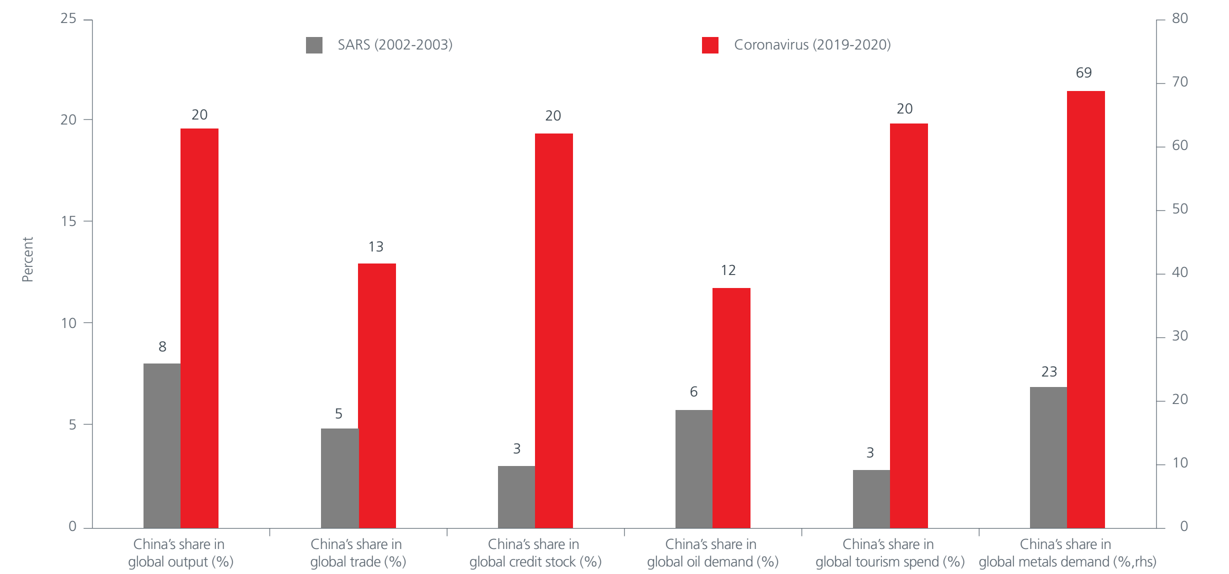
Q. How are you and your team navigating these challenging times?

We may still experience more volatility ahead, which could be potentially triggered by disappointing economic data and/or concerns over the effectiveness of the efforts made to contain the virus. We thus hold an overweight duration position across our portfolios as we expect monetary policy to be accommodative in Asia to counter the adverse economic impact. This also serves as a hedge to our credit exposure, which may experience come under pressure should risk aversion re-emerges.

Nevertheless, we are maintaining our overweight in Asian USD credits, particularly high yield credits, as we see demand for carry to remain underpinned in the longer term with interest rates likely to stay low. We note also that the sectors that could be directly impacted by the COVID-19 virus probably accounts for only 1.4% of the Asian USD credit market (JP Morgan Asia Credit Index).

Within Asian credits, we are overweight high yield Chinese property developers. We believe that pent up demand should drive sales once the

Fig. 2. China's increased importance to the global economy[2]



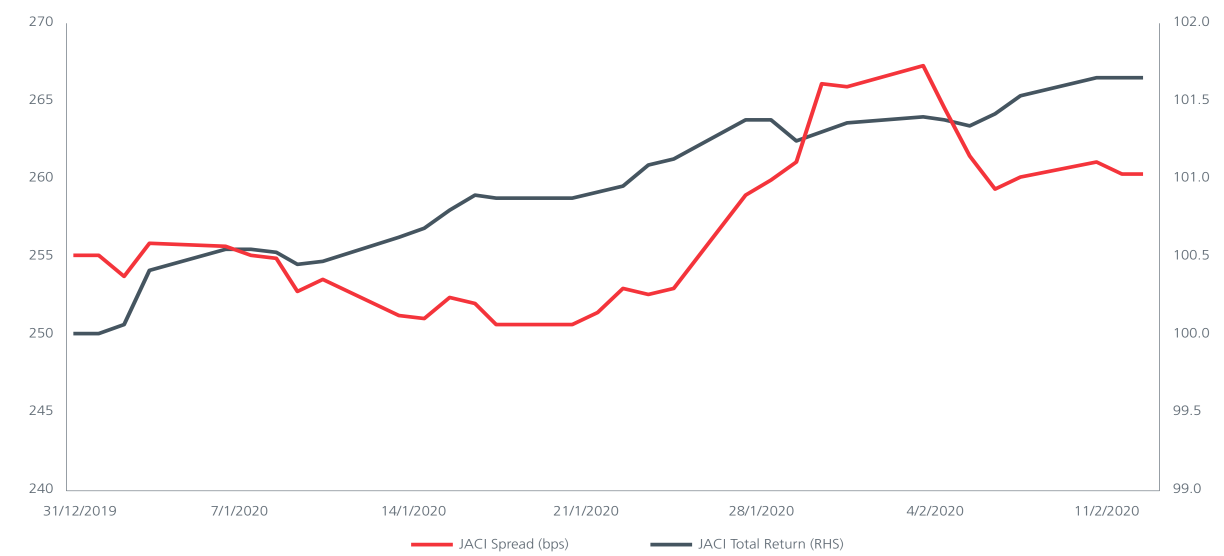
situation stabilises in the second half of the year. Many developers have also switched to alternative online sales channels as they shut down sales offices. Furthermore, most developers have a diversified landbank, with the Hubei province (including Wuhan city) accounting for only an average of 4-5% of their total landbank (in terms of Gross Floor Area). Given the robust bond issuance at the start of the new year which took advantage of the easier regulatory measures and strong market demand, many developers have already pre-funded their offshore financing needs. This should help to mitigate liquidity concerns. Meanwhile, the government has many policy levers that can be used to ease financing conditions for developers.

We are watchful for buying opportunities in sectors whose credit spreads may widen due to the direct and/or secondary impact of the COVID-19 virus. These include Macau Gaming, Retail/ Leisure and Hotels, Airlines, Hong Kong property developers, Conglomerates as well as Chinese car distributors. We will look to trim selected weaker industrial issuers that are less likely to receive state support as the government prioritises the more critical sectors.

Interestingly, bond issuance, which has been robust before the Lunar New Year holidays, seems to be resuming despite no clear containment of the virus. Meanwhile, although inflows into Emerging Market (EM) bonds slowed towards late January and the local currency bond market experienced outflows in the first week of February, the inflows into EM hard currency bonds have been relatively resilient.

Nevertheless, we continue to monitor any developments, including high frequency economic data that will shed light on the regional and global impact of the outbreak, which could change our current baseline assumptions.

Fig. 3. Year to date Asian USD Credit performance and spreads[3]



Sources: [1] CEIC, UBS estimates, Note: * data as of 2018 [2] Top Left: BIS, IMF DOTS, IFS, Haver, Bloomberg, UBS; Note: China's GDP share is PPP-adjusted share in world total [3] Eastspring Investments, Bloomberg, February 2020

eastspring investments

A member of Prudential plc (UK)