

Fixed Income Insights

Q2 2024

For professional investors only

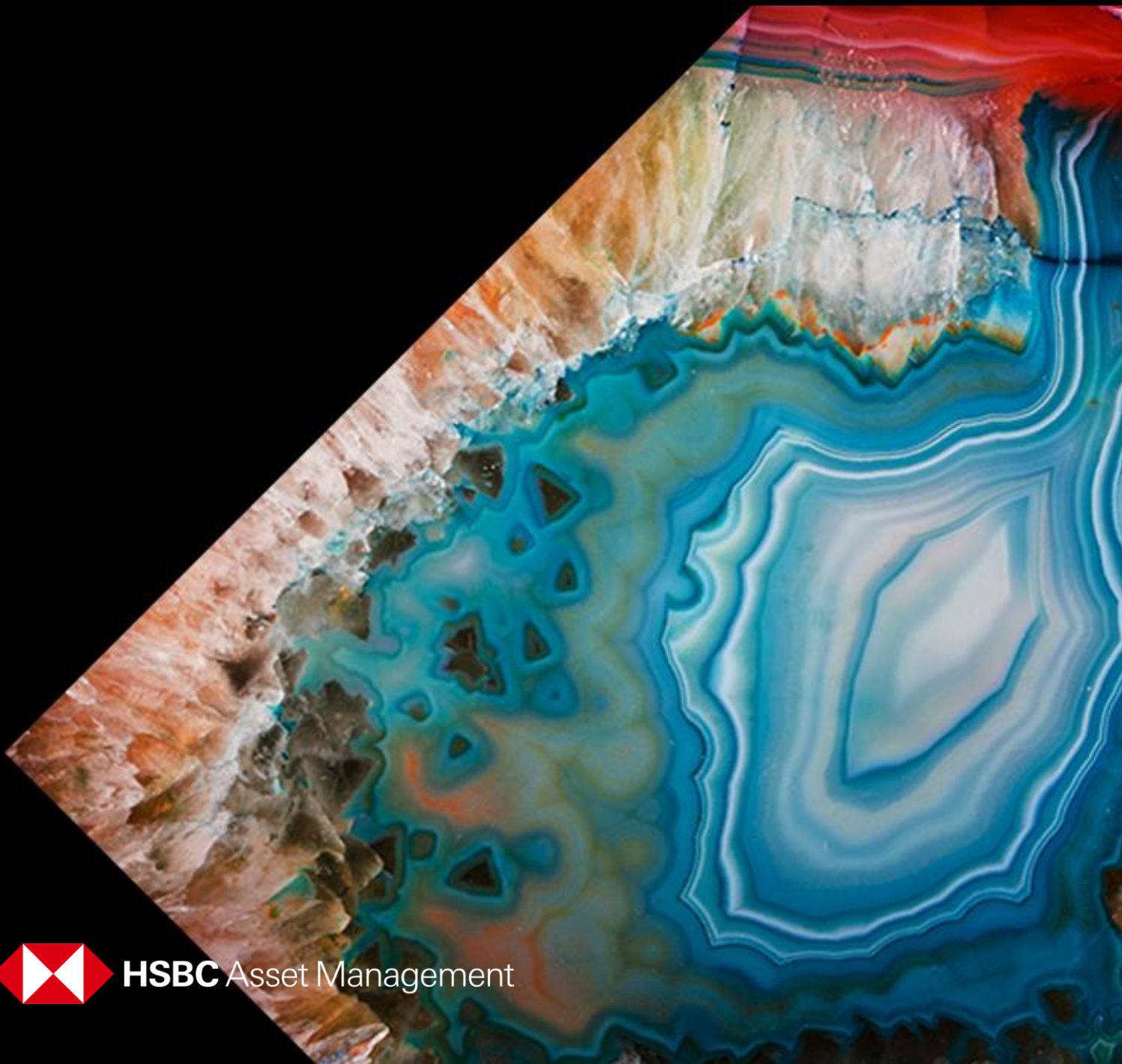


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Foreword



The re-emerging market narrative and pricing of higher-for-longer rates along with the persisting strength in risk asset prices does not seem to us to be a stable equilibrium. Given current valuations, we are moving to a more defensive stance in credit portfolios.

Welcome to the latest edition of our Fixed Income Insights series, where we present the findings of our quarterly Strategic Forum.

We publish this edition as markets digest a series of stronger-than-expected data on US activity and inflation, and comments from some Federal Open Markets Committee members that they would not be cutting rates until they "gained greater confidence" that inflation was on a steady path back to its 2% annual target. This has challenged assumptions that the disinflation battle had already been won and led to a re-evaluation of rate cut expectations that had taken encouragement from earlier public statements by the FOMC Chairman. It's fair to say that there is less confidence now in the immaculate disinflation outlook and a reversion to the 'higher-for-longer' investor narrative that was such a key feature of market action last summer.

Markets pricing higher-for-longer interest rates at the same time as risk assets are priced at their highs and spreads historically tight, does not seem to us to be a stable equilibrium. In credit portfolios, that leads us to be more defensive and to be even more vigilant on sector and corporate fundamentals in our decision-making processes.

This is why, a year after first assessing the risks from a downturn in commercial real estate, we revisit the question in light of further deterioration driven by high interest rates and by what now seems the secular force of hybrid working reinforced by cyclical headwinds of cost control. By extension, it is important to examine whether this downturn could have a material impact on banks. Our analysis shows that direct commercial real estate risks are manageable for major banks. Despite a potential impact on their profitability, they have sufficient buffers to cope with historically large losses on property assets.

Looking for diversification options in global asset allocations, we dedicate the second section of this publication to Asian currency bonds. Reasonable growth forecasts for most of emerging Asia and less need for monetary stimulus in these economies leads us to believe that local bonds can continue to provide investors with solid carry opportunities.

I trust you will find our analysis and takeaways interesting and a useful resource.



Michael Cross

Global CIO, Fixed Income
HSBC Asset Management

In a nutshell

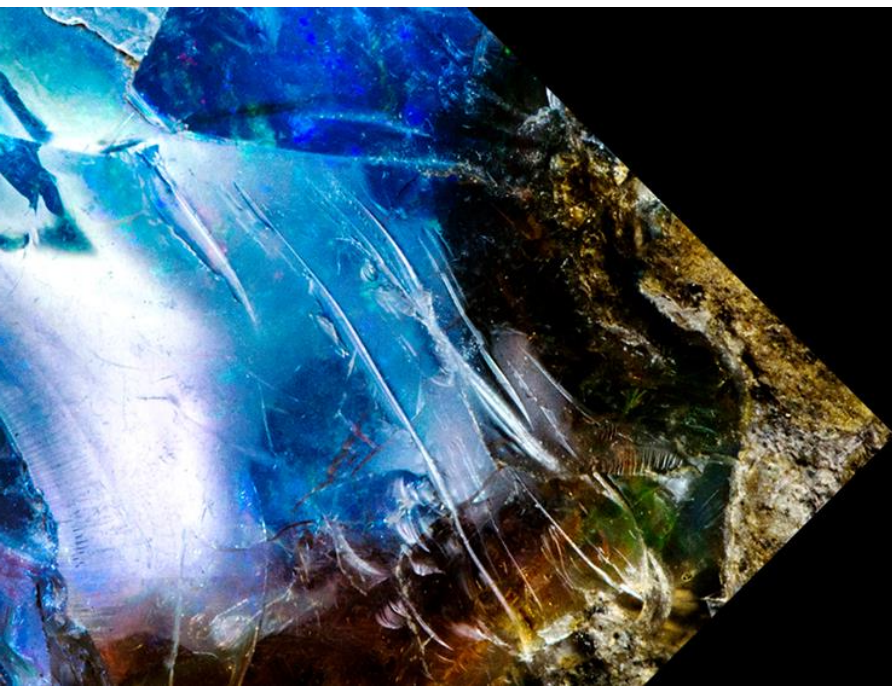
Is the continuing downturn in commercial real estate a risk to bank balance sheets and AT1 bonds?

- Commercial real estate markets across the world are struggling with secular forces of hybrid working reinforced by cyclical headwinds of cost control, in addition to high interest rates.
- In Europe, polarization is continuing with central, flexible, green Grade-A offices remaining in demand, but most outside of these categories facing risk of obsolescence. In the US, the office market is under severe pressure, with national office property prices estimated to be down 20% from peak levels already. In Hong Kong, the commercial real estate market is experiencing all-time high vacancies, with rents declining by 6% year-on-year in 2023.
- This secular downturn in commercial real estate can have a material impact on banks, which are the main lenders to this sector. Nevertheless, direct commercial real estate risks are manageable for major banks, which have sufficient buffers to cope with historically large losses on property assets. Overall, this is more a profitability concern rather than a capital issue.

Why Asian currency bonds are worth a second look

- A strong US dollar and a perception that these markets are difficult to access, made Asian currency bonds out of favour in most global asset allocations.
- While inflation in most of Asia has been lower than in other regions, resulting in shallower hiking cycles post-pandemic, growth forecasts for most of emerging Asia are reasonable without the need for monetary stimulus.
- In addition, Asian central banks may be keen to avoid currency weakness at a point when it may be unnecessarily disruptive to economic prospects.
- While each market has its unique features and frameworks, Asian currency bonds – especially in India and Indonesia – can currently offer solid carry opportunities, supported by sound fundamentals and diversification potential in a global fixed income allocation.

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Is the downturn in commercial real estate a risk to bank balance sheets and AT1 bonds?



The secular downturn in commercial real estate can have a material impact on banks, which are the main lenders to this sector. In the vast majority of cases, this is a profitability rather than a capital issue. This allows us to maintain a relatively constructive – but selective – view on the most subordinate part of the capital structure – contingent capital bank debt.



Céline Berger
Credit Analyst (Europe)

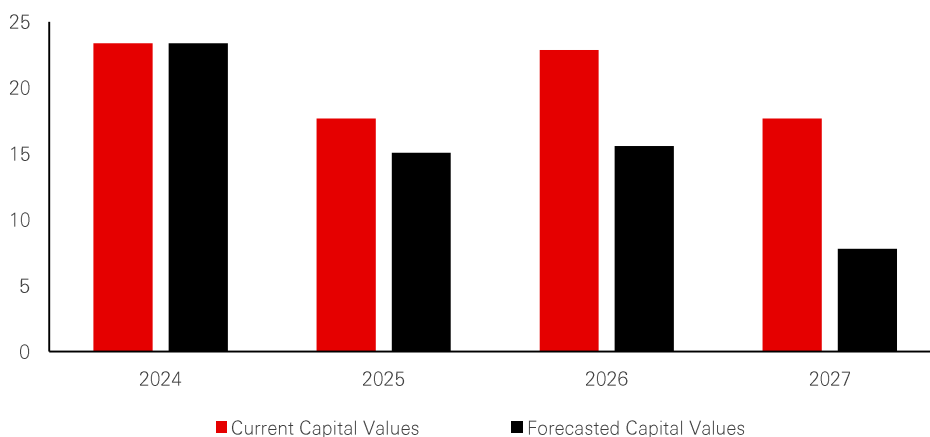
Although there are regional variations, commercial real estate markets across the world are struggling with secular forces of hybrid working reinforced by cyclical headwinds of cost control, in addition to high interest rates.

In Europe, office demand is highly bifurcated, with central, flexible, green Grade-A office most in demand and others facing obsolescence risk. Meanwhile, tenants' focus on cost and footprint rationalisation has weighed on demand. Despite this, rents should remain resilient thanks to indexation and limited supply of Grade-A properties. There is expected to be an €82 billion funding gap for office property over 2024-2027 across Europe as values decline, but with loan-to-value (LTV) ratios lower than before the global financial crisis (GFC), and the prospect of falling interest rates, there should be limited recourse to the banking sector. The German market is perhaps the most stressed with higher-than-average LTVs, particularly weak economic prospects and unfavourable demographics.



Michael T Milby
Credit Analyst (US)

Figure 1: Debt funding gap in Europe over 2024-27 period (offices, in €bn)

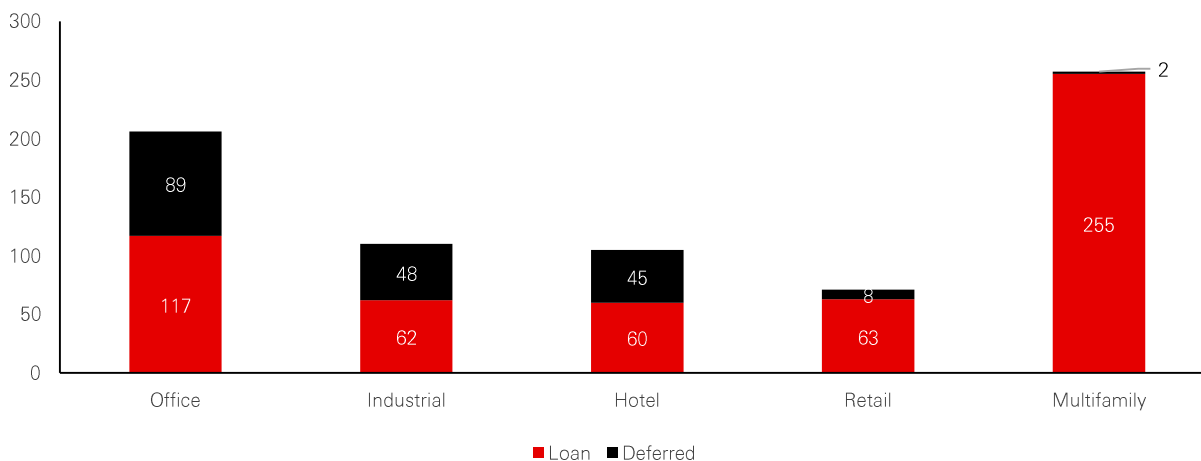


Source: CBRE Research, December 2023.

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In the US, the office property subsector has been under severe pressure. National office property prices are estimated to be down 20% from peak levels already and forecasted to be down 30-40% from peak to trough this cycle. Desk utilization is expected to remain at around 60%, meaning that office space demand is expected to fall by a further 10% over the coming 2-3 years. Office vacancy rates are expected to peak at 19.8% from 18% currently, according to CBRE.

Figure 2: CRE Debt Maturing in 2024 by Property Type (\$bn)



Source: Marcus & Millichap, Q3 2023.

Hong Kong’s commercial real estate market is experiencing all time high vacancies (around 12.8% Grade A and 9.8% central business district) with rents declining by 6% year-on-year in 2023, as well as the prospect of increased supply. This is more of a cyclical phenomenon due to the sluggish economy and malaise in local financial markets, with the trend towards hybrid working less pronounced. Australia is also experiencing the combination of abundant supply and limited demand, while Singapore has relatively more healthy fundamentals but with flat rental growth. Low LTVs (mostly well below 50%) mitigate some of the generally weak environment in Asia.

The Gulf Cooperation Council region represents one of the brighter spots in global commercial real estate with continuing steady demand growth, albeit at a more moderate pace. Demand should continue to be supported by positive economic drivers, combined with government reforms aimed at attracting foreign investors and expat inflow.

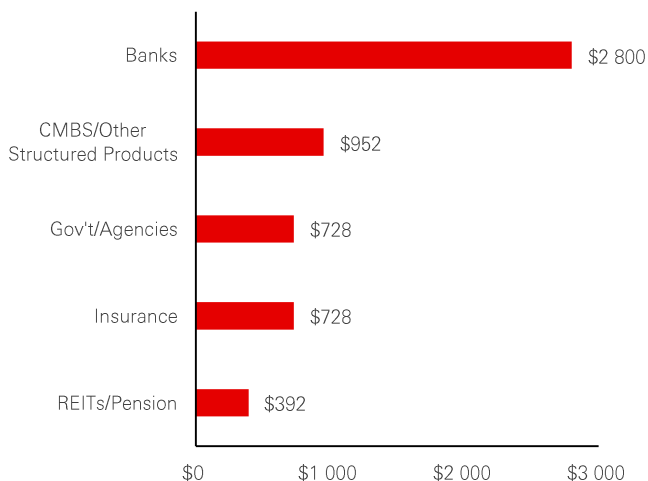
Direct commercial real estate risks are manageable for major banks, which have sufficient buffers to cope with historically large losses on property assets. We see higher risks in US regional banks and German specialized lenders, but conservative LTVs and improved profitability should avoid systemic contagion.

In common with most of the rest of the world, the largest US banks are well positioned to absorb commercial real estate and office loan losses. In the words of Treasury Secretary Janet Yellen, “The exposure of the largest banks is quite low, but there may be smaller banks that are stressed by these developments”. Our stress tests, which modelled a 10% loss on banks’ commercial real estate books, indicate that there would be just one failure of a regional, commercial focused bank amongst the thirty largest banks in the US by total assets. Offices typically represent less than one quarter of total commercial real estate loans at the medium rated bank, so even a significant loss in the office sector should not materially impair the capital of all but the very exposed.

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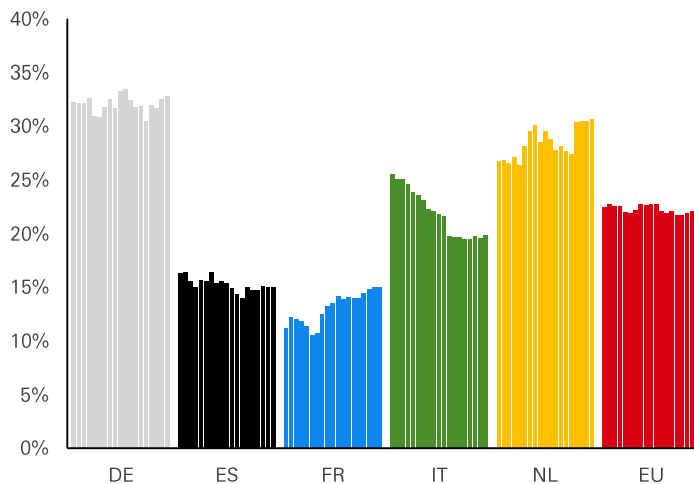
The structure of the German banking system and economy has translated into larger and more concentrated exposure to commercial real estate companies. There are more specialist lenders to the commercial real estate sector, while the collaboration of Savingsbanks and Landesbanks (a model not replicated in other countries) tends to concentrate the landesbanks' focus on commercial banking. Compared to the period before the GFC, however, these institutions have less leverage and far less exposure to structured credit, while their part ownership by the states and recently increased profitability give them an extra layer of protection.

Figure 3: Holders of CRE mortgages (\$bn)



Source: Federal Reserve, Goldman Sachs, December 2023.

Figure 4: Loans to CRE within loans to NFC (Q1 2019 to Q3 2023)



Source: EBA Risk Dashboard, HSBC AM, December 2023.

A vast majority of the commercial real estate threat to bank balance sheets falls out of the scope of the bond markets and the AT1 sector, with limited issuance from the most vulnerable institutions. Larger banks which are frequent issuers in relevant benchmarks have relatively lower exposure to CRE. In general, we would only consider AT1 investments in fundamentally sound institutions given the significant downside risks, but remain cautiously and selectively optimistic even at the tighter spreads now available.

We have seen strong compression of credit spreads within the capital structure in the US, Europe, Asia and Emerging Markets, with the spread differential between senior and the most subordinated bank bonds narrowing sharply. The retracement since the wide levels seen after the Credit Suisse writedown and the Silicon Valley Bank collapse has taken spreads of AT1 to around their one-year tightest levels, but even so, USD AT1s trade around the same level as single B high yield corporates, even though most is investment grade rated. We see better value in USD AT1 against their European peers. USD bonds trade at a tighter spread, but the relative historical average implies better prospects for tighter spreads in the USD market, while the EUR market has an average lower credit quality.

Over the long term, USD AT1 is trading wider against corporate bonds than the six-year average, and we still see the all-in yield of 8.2% as interesting. We also see value in European AT1 with headline yields close to 8% (note that Euro rates are lower than USD rates), although in relation to corporate bonds, spreads are relatively tight compared to both short-term and long-term historical averages.

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Figure 5: AT1 versus high yield bonds and bank cap stack in Europe

EUR Financials RV Across Cap-Stack	Current Spread	Yield (%)	Spread 1Y %ile	Spread 1Y Min	Spread 1Y Max	Spread 1Y Avg	Spread 6Y Avg
Banks Senior IG	125	3.72	6%	119	216	168	134
Banks SP IG	111	3.63	6%	107	181	147	111
Banks SNP IG	132	3.77	7%	125	232	179	148
Banks T2 IG	194	4.46	6%	184	339	262	212
Banks T2B IG	166	4.17	7%	158	272	203	188
Banks T2C IG	209	4.62	5%	199	384	299	233
AT1	480	7.42	1%	476	1115	735	607
Nonfins Corps IG	115	3.59	3%	113	160	139	132
Nonfins Hybrids IG	243	4.92	6%	234	398	329	305
HY	395	6.61	8%	378	591	497	475
HY BB	272	5.28	3%	265	482	395	380
HY B	489	7.53	14%	462	653	568	617

Spreads Relationships							
SNP-SP	21	0.14	9%	18	51	32	37
T2C-SNP	77	0.85	4%	74	152	120	85
T2B-SNP	34	0.40	80%	9	40	24	40
T2C - T2B	43	0.46	2%	41	122	96	45
AT1 - T2C	271	2.80	1%	268	735	436	374
AT1 - HY	85	0.81	0%	83	535	238	132
AT1 - HY BB	208	2.14	0%	207	644	340	228
AT1 - HY B	-9	-0.11	1%	-16	473	167	-9
AT1- HYBRIDS IG	237	2.50	0%	237	725	406	303
SEN BNKS - NONFINS IG	10	0.13	10%	5	56	29	2

Source: HSBC AM, Iboxx indices, 25 March 2024

Figure 6: AT1 versus high yield bonds and bank cap stack in the US

USD Financials RV Across Cap-Stack	Current Spread	Yield (%)	Spread 1Y %ile	Spread 1Y Min	Spread 1Y Max	Spread 1Y Avg	Spread 6Y Avg
Banks Senior IG	100	5.45	3%	98	178	139	124
Banks SP IG	82	5.44	0%	82	152	113	98
Banks SNP IG	102	5.46	3%	100	182	142	129
Banks T2 IG	146	5.93	1%	145	247	198	176
AT1	352	8.04	1%	346	879	534	437
Nonfins Corps IG	101	5.56	2%	100	156	127	143
HY	336	7.85	3%	330	502	410	423
HY BB	228	6.71	4%	222	365	291	310
HY B	355	8.02	3%	348	551	442	478

Spreads Relationships							
SNP-SP	20	0.02	22%	12	47	29	32
T2-SNP	44	0.46	7%	42	66	56	46
AT1 - T2	206	2.11	1%	201	632	336	261
AT1 - HY	16	0.19	0%	16	381	124	14
AT1 - HY BB	124	1.33	0%	123	516	243	127
AT1 - HY B	-3	0.02	1%	-5	328	92	-41
SEN BNKS - NONFINS IG	-1	-0.11	7%	-3	25	11	-19

In Asia, retracements are close to their one-year tight and look rich against high yield corporates (note that Asia high yield corporate spreads are much wider than in the US or in Europe). Gulf state AT1s trade very tight given strong sovereign support, while the Latam complex trades on issuer specificities as few names have AT1 outstanding – although pickups are material. Banks continue to retire AT1 on its first call date, while Asian banks have ready access to the local currency markets to issue capital instruments. Japanese Banks have now started to issue \$AT1, and this has been very well subscribed by the market.

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Why Asian currency bonds are worth a second look



Most Asian currency bonds have not gained great favour among global investors in recent years given the strong US dollar and a perception that these markets are difficult to access. Yet, low correlation with other currencies, interesting real yields and favourable macro trends could change asset allocators' mind.



Alfred Mui
Head of Asian Fixed Income

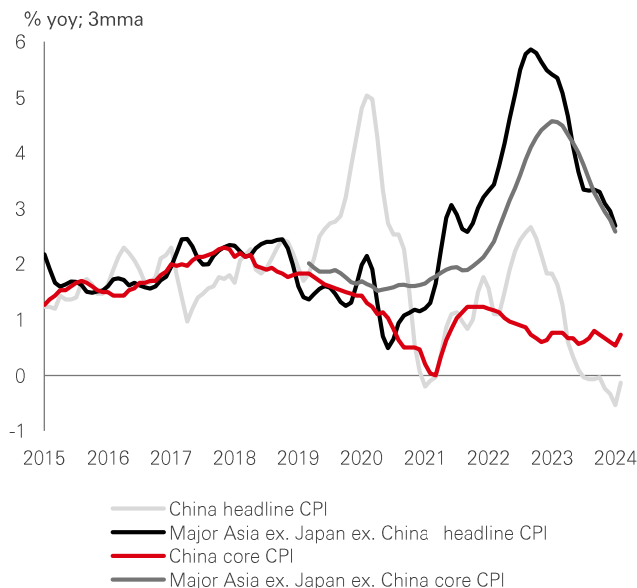
Inflation in most of Asia has been consistently lower than in other regions, resulting in shallower hiking cycles post pandemic than in some LatAm and CEEMEA economies. The coming easing cycle will likely also be more measured and synchronised with the US Fed, given satisfactory growth prospects and a reluctance to risk currency instability.

Outside China, emerging Asia experienced a marked post pandemic inflationary cycle, but never suffered the same extraordinary pressures as the United States, Eurozone or some other emerging markets. Policy rates, therefore, could be set at levels which were not severely disruptive to economies, and now that we are seeing inflation falling back to central bank targets, markets are discounting interest cuts in the coming months.



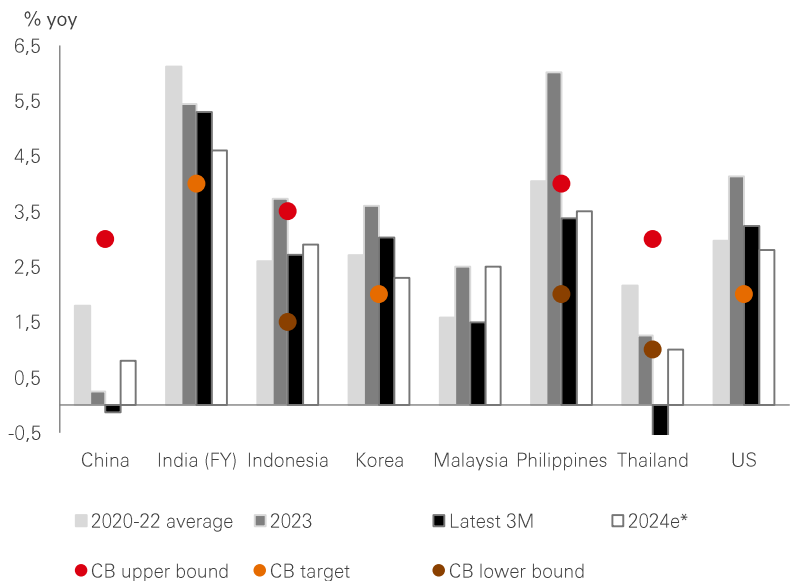
Renee Chen
Investment Strategist

Figure 1: Deflation fears in China and welcome disinflation in the rest of emerging Asia



Source: CEIC, HSBC AM, Bloomberg data, March 2024.

Figure 2: Inflation has gradually eased back within central bank targets



*Bloomberg consensus forecast as of 8 March 2024
Source: HSBC AM, Bloomberg data, November 2023.

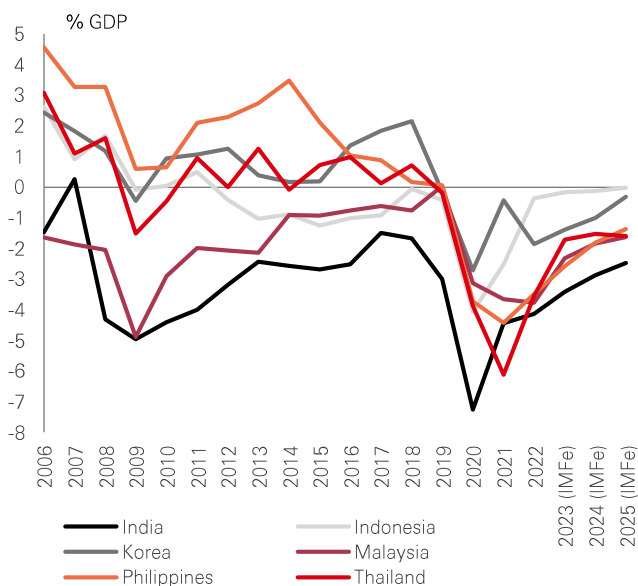
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With inflation on a downwards path and a global environment of monetary easing expectation, it might be reasonable to question whether Asian central banks should already be cutting rates. However, there are two key reasons why it is likely that policymakers will wait to follow or synchronise with the US.

The first is that growth prospects for most of emerging Asia are reasonable without the need for monetary stimulus. A gradual export recovery has been especially beneficial to economies like Korea and Taiwan which have high exposure to the global semiconductor rebound, while India and Indonesia are enjoying the economic tailwinds of secular policy measures implemented in past years. In addition, although obviously an important partner for the ASEAN region, a recalibrating Chinese economy is not as dominant a force in the Asian complex as may sometimes be assumed. Although there are pockets of high exposure, such as exports from Indonesia and foreign direct investment (FDI) to Thailand, other region and intra region ties are just as, if not more, important. Moreover, the economic ties between India and China are slight, with India positioning itself as an alternative option to China in many global offshoring ventures. Meanwhile, as already implied, rates never had to go as high in emerging Asia in the first place and therefore are not at significantly restrictive levels.

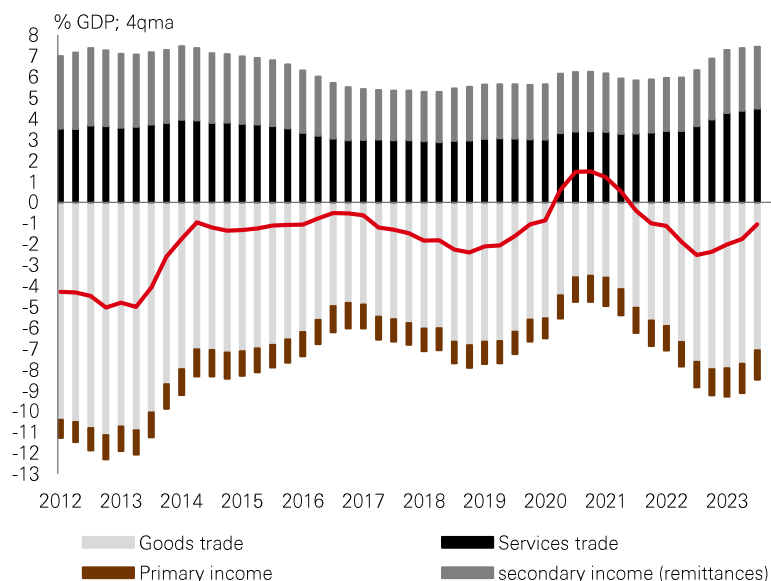
The second reason is that Asian central banks may be keen to avoid currency weakness at a point when it may be unnecessarily disruptive to economic prospects. The experiences of economies such as China and Chile, which were amongst the first central banks to cut rates and have some of the weakest currencies in the past two years, may be cautionary to those where depreciation has been damaging in the past. Some Asian economies can no longer rely on rock solid current account fundamentals as domestic demand grows stronger, while interest rate differentials are not as favourable to Asian currencies as has been the case in previous cycles. The notable exceptions to these drivers are India and Indonesia, where better export performance and inflows have improved current accounts and basic balances, while interest rates are still high by global standards. Generally, Asian currency fundamentals remain sound, with prudent fiscal consolidation providing macro stability at the same time that FDI is recovering, especially in greenfield development and manufacturing. There seems little benefit, though, in risking hard won stability and credibility by easing too quickly.

Figure 3: Government primary deficit (gradual fiscal consolidation)



Source: IMF (World Economic Outlook, October 2023) CEIC, HSBC AM, March 2024.

Figure 4: India current account balance (robust services exports and remittances help offset large goods deficit)

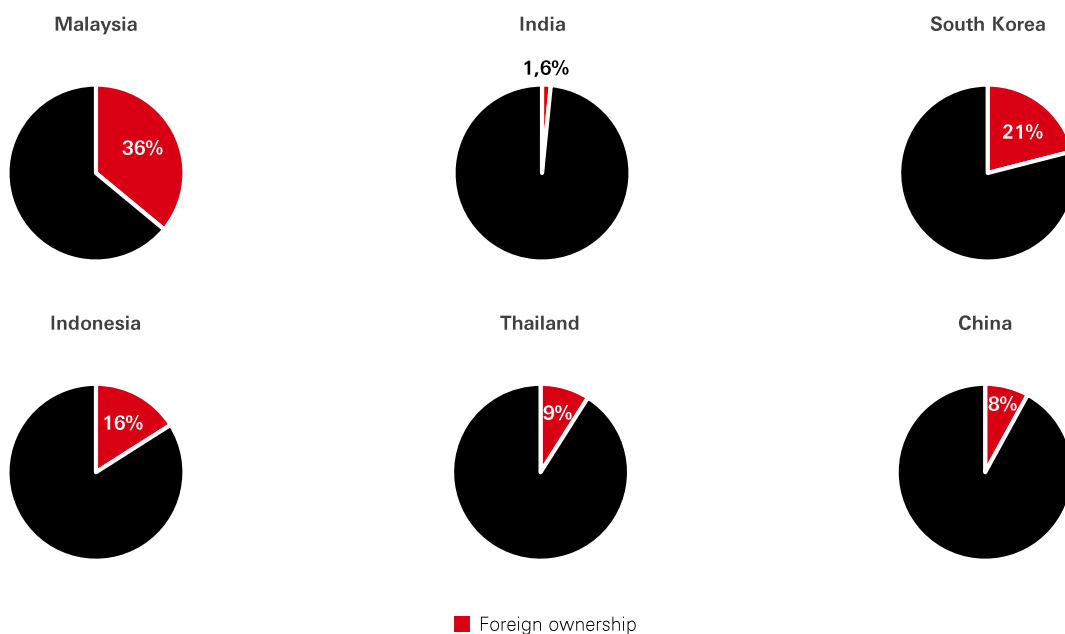


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While each market has its unique features and frameworks, Asian currency bonds enjoy sound fundamentals and attractive characteristics which make them suitable candidates for inclusion in global fixed income strategies, especially given their diversification potential.

China is by far the largest bond market in Asia (ex Japan), with a capitalisation of around \$15 trillion equivalent (depending on how we exactly define 'bond'). Korea and India are the next largest, at around \$2.5 trillion, featuring a combination of sovereign, quasi sovereign, local government and corporate bonds. There is a significant dispersion in the extent of foreign ownership across Asian local bond markets, with Malaysia having the largest share of foreign participation at over one third and, at the other end of the spectrum, India with a notably low figure of 1.6%. These numbers broadly correlate with a combination of the ease of accessing the market and the size of it. Malaysia is a relatively small economy and market, but its authorities have long pursued an open access policy attractive to global investors. India's market is relatively large, but was only made available to global investors under any circumstances around 15 years ago, and although the market has opened up significantly over the intervening period, there remain some restrictions.

Figure 5: Foreign bond ownership



Source: Treasury International Capital, Bloomberg data, December 2023.

High foreign investment share is something of a double-edged sword. There is an obvious benefit in terms of investor diversity lowering the cost of funding, but also vulnerability in times of global risk aversion when investors tend to withdraw from peripheral markets and thereby exacerbate financial stress. Overall, though, foreign investment share in Asia's domestic bond markets is way below the economic footprint of the Asia ex-Japan region, which makes up around 38% of global GDP.

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But it is the diversification quality of some of the key Asian markets which is perhaps the strongest argument for inclusion in a strategic asset allocation. China, India and Indonesia markets in particular exhibit a lack of correlation, which should be beneficial to long-term risk-adjusted returns. These markets tend to follow domestic interest rate cycles and local supply and demand conditions, while having enough critical mass to be less driven by the global risk cycle. They also have relatively low volatility both on a hedged and unhedged basis.

Figure 6: Correlation of returns between Asia, US and global bonds (5-y period of Asian local currency bonds hedged in USD versus US, global and emerging market bonds hedged in USD)

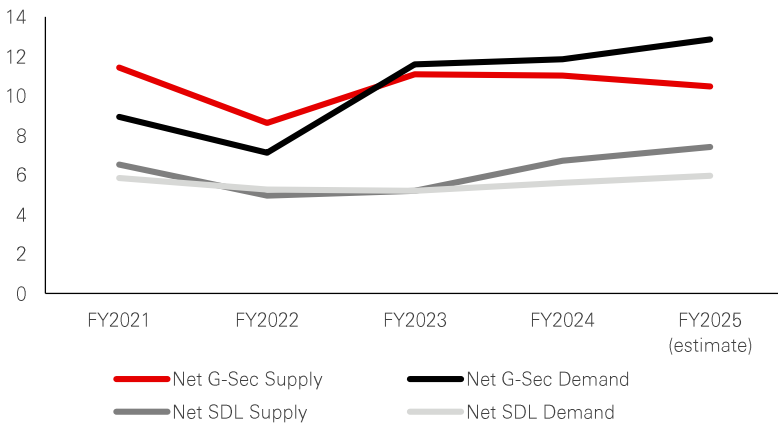
	USD bonds	US Treasuries	Global bonds	Asia	China onshore	China offshore	India	Indonesia	Thailand	Malaysia	Philippines	Korea	Singapore	EM
USD bonds	1.00													
US Treasuries	0.93	1.00												
Global bonds	0.96	0.91	1.00											
Asia	0.68	0.62	0.71	1.00										
China onshore	0.11	0.11	0.12	0.29	1.00									
China offshore	0.11	0.08	0.13	0.23	0.21	1.00								
India	0.30	0.27	0.32	0.43	0.13	0.11	1.00							
Indonesia	0.18	0.11	0.19	0.53	0.02	0.08	0.16	1.00						
Thailand	0.52	0.45	0.53	0.75	0.21	0.19	0.31	0.32	1.00					
Malaysia	0.47	0.35	0.47	0.68	0.13	0.18	0.20	0.39	0.54	1.00				
Philippines	0.34	0.29	0.35	0.57	0.12	0.17	0.18	0.30	0.37	0.41	1.00			
Korea	0.58	0.55	0.63	0.73	0.11	0.08	0.24	0.10	0.46	0.36	0.27	1.00		
Singapore	0.61	0.61	0.64	0.78	0.16	0.16	0.26	0.23	0.53	0.47	0.36	0.57	1.00	
Emerging market	0.55	0.41	0.55	0.63	0.13	0.16	0.32	0.48	0.53	0.50	0.34	0.37	0.40	1.00

Source: HSBC AM, Bloomberg, Markit, FTSE, JPMorgan, 13 March 2024.

Current valuations indicate that long-term real yields are relatively attractive, with inflation under control and around central bank targets. This implies not only that investors can enjoy good levels of real carry, but also that over time rates can be cut with a cushion of comfort that conditions will not become overly accommodative, potentially lowering nominal yields and creating capital gain.

The supply and demand conditions in the India bond market are particularly auspicious at the moment, given that the inclusion of Indian sovereign bonds in the JPMorgan GBI-EM should drive around \$25 billion of flows over the ten months from June 2024, with further index inclusion announcements likely over the course of this year. On the supply side, India’s fiscal consolidation, driven by strong growth and prudent policy, should also ensure continued downwards pressure on yields.

Figure 7: Net demand and supply of India government bonds (INR trillion, ex. RBI)

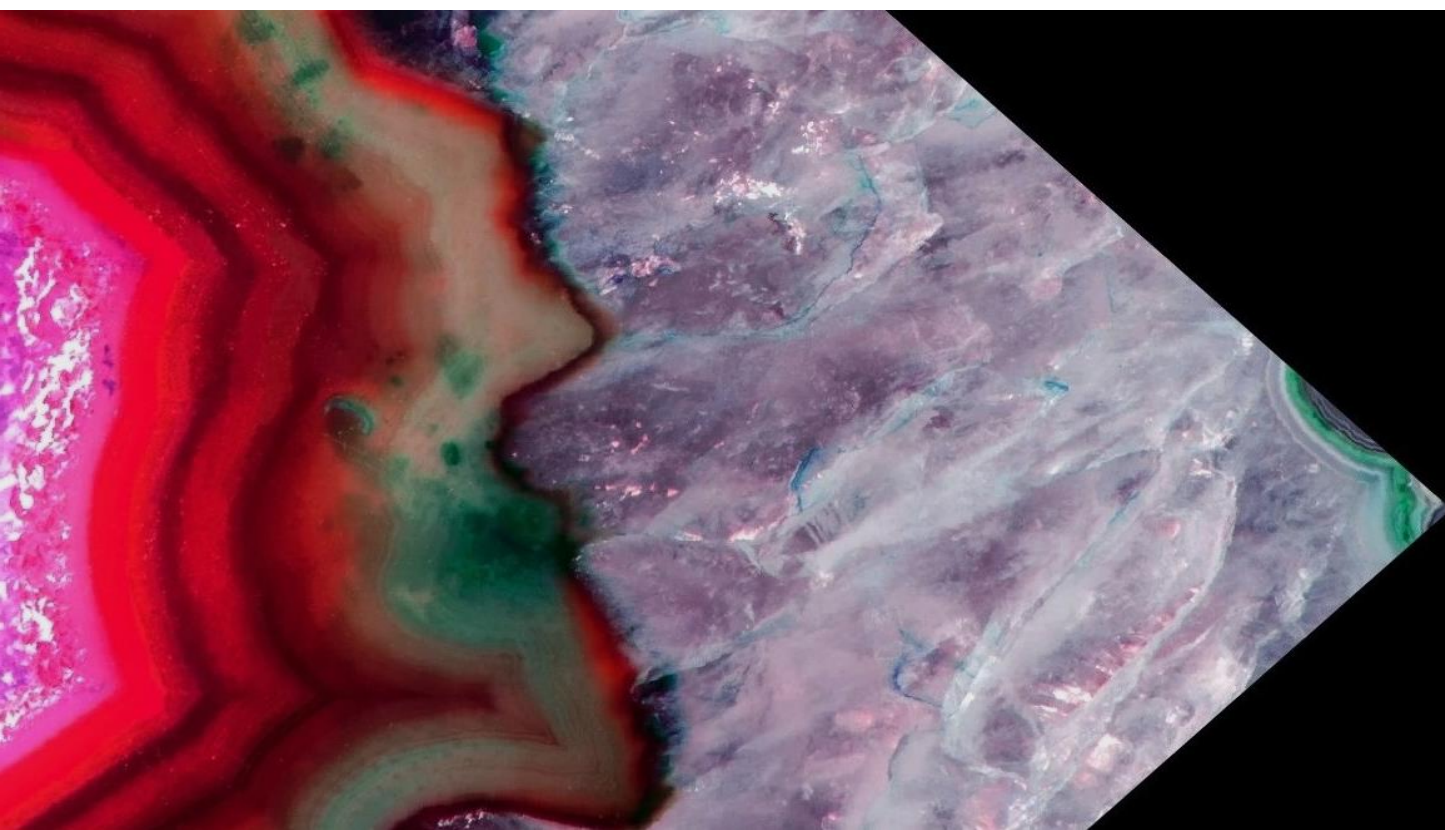


Note: G-Secs (Government securities) are issued by the central government and State Development Loans (SDL) are issued by the state government of India. Source: Reserve Bank of India, February 2024. FY 2025 is HSBC Estimate, Bloomberg, March 2024.

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Our current preference across both Asian and Emerging market portfolios, therefore, is to have an overweight exposure to India with its high carry, positive growth fundamentals and modest inflation. We favour the intermediate to longer end of the curve to take advantage of declining yields from the index inclusion. We are also constructive on Indonesian longer bonds for similar reasons as well as its swing into a positive current account position. In other Asian bond markets, we prefer the shorter end to capture the rate cut opportunity more exactly on relatively flat yield curves.

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