

Asset Management

Fixed Income Insights

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For professional investors only



HSBC

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Foreword



The shifting global economic landscape has created an environment where market valuations may not fully reflect the potential impact of current stresses in credit markets.

Welcome to the latest edition of House Views, which summarises the key findings of our quarterly Strategic Forum. As we publish this update, the immediate question is whether the US policy rate has reached its peak. The Fed is still balancing concerns over strength in the labour market against already restrictive policy, with the added complication that the recent sharp increase in Treasury yields has effectively further tightened the monetary stance. Similarly, the ECB's September rate hike may be its last, given slowing inflation and sluggish activity.

In this edition, we take a step back from the usual tight focus on inflation and central bank policies. Instead, we discuss US fiscal policies through the lens of US sectoral balances. This perspective is particularly relevant as it sheds light on the unexpected strength of US consumption, as well as on the late-cycle relative strength of corporate balance sheets. From an investment perspective, this implies that policy rates might be kept "higher-for-longer", although we are sceptical of the "higher forever" scenario seemingly reflected in current Treasury yields. Our view remains that US monetary policy is tight and that we are close enough to the point where the economy is set to slow markedly, bring inflation down to target, and allow for cuts in the Fed Funds rate next year. This view, and our cautious stance on risk assets, is reinforced by our assessment that the economic outlook for most of the rest of the world is not strong enough to withstand real interest rates at the level currently implied by the US yield curve.

Credit markets and other risky assets seem to continue to price in a soft landing and do not yet appear to be factoring in meaningful recession concerns. We continue to advocate a cautious approach to portfolio positioning, given the stresses developing in credit markets and our expectation that default rates will continue to rise, with a significant acceleration in Europe and continued stress in the China real estate market. We detail these views in the second section of this publication. We also examine emerging market debt, where improving credit fundamentals present selective opportunities. Sovereign external ratings have an average skew towards a positive outlook for the first time in a decade. Consequently, we see some selective opportunities among emerging markets, amid pockets of better growth, inflation dynamics, and more attractive valuations.

We hope you find this publication to be an interesting and useful resource.



Michael Cross

Global CIO, Fixed Income
HSBC Asset Management

In a nutshell

What are the implications for the treasury market of US balance sheet dynamics?

- US public sector budgets have undoubtedly deteriorated, and this may have increased the term premium and maintained upwards risks, although treasury yields are still probably being driven more forcefully by interest rate expectations.
- In the long term, the deficit is set to continue widening driven by rising outlays rather than dwindling revenues
- One of the drivers of a long-term deterioration in the government deficit could be growing inequality. In addition, external conditions can also push the US government to run a deficit.
- From an investment standpoint, we think that US monetary policy is tight and close enough to the point where the economy is set to slow markedly, bring inflation down to target and allow cuts in the Fed Funds rate next year.

Developing stresses in global credit

- Tighter policy has not yet led to widespread credit stress across global markets, although defaults in Europe and Asia have accelerated, the former as a result of energy prices and the latter due to the China real estate funding crisis.
- Our expectation is for default rates to rise, with a significant acceleration in Europe and continued stress in the China real estate market.
- Meanwhile, emerging market external sovereign bonds are undergoing deleverage and improving credit fundamentals. As a consequence, sovereign external ratings have an average skew towards a positive outlook for the first time in a decade.

What are the implications for the treasury market of US balance sheet dynamics?



Public sector budgets have undoubtedly deteriorated, and potentially driven the increase in the term premium over the summer, but the 15-year high in treasury yields owes much to elevated Fed policy rate expectations.



Dominic James Bryant
Economist and Macro Strategist

Many investors have been surprised by the rise in treasury yields over the summer, with some citing deteriorating debt dynamics and increased treasury issuance as key catalysts.

The deficit has widened substantially since early 2022, but the debt ratio has fallen from its pandemic peak due to high nominal GDP growth

Much of the widening in the ex-interest deficit actually came in Q1 2023, and is almost entirely a result of a sharp drop in receipts from personal current taxes, which were lowered by inflation driving up tax thresholds and various temporary tax reliefs. This in part accounts for the resilience of the economy in the first half of this year, but importantly these factors were not part of a discretionary or pro cyclical fiscal easing.



Ernst Osiander
Head of Global Rates Strategy

Figure 1: High nominal GDP growth has lowered the federal government debt ratio (% of GDP)

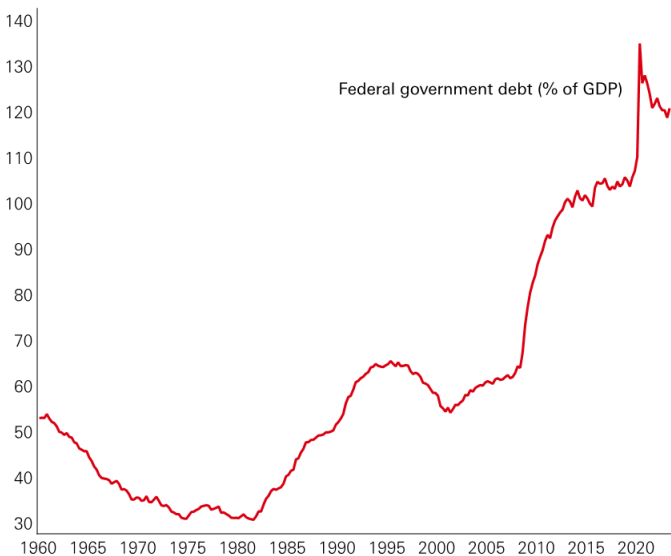
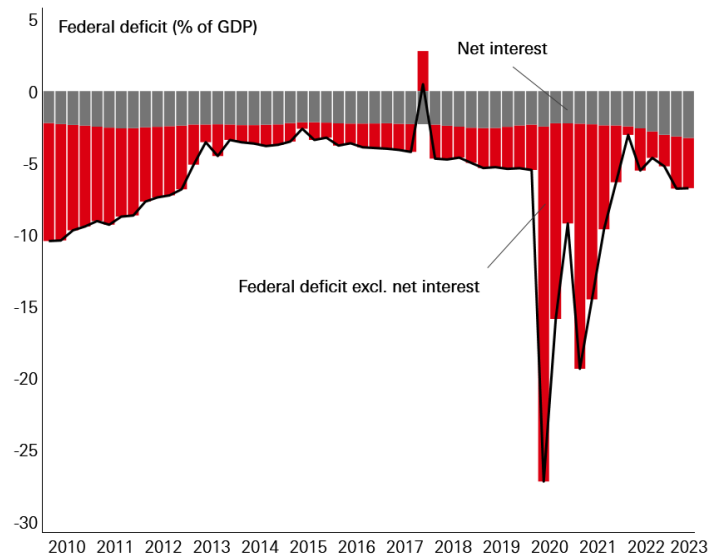


Figure 2: Ex-interest deficit widened markedly in Q1 2023



Source: HSBC AM, Macrobond data, October 2023

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The impact of high-profile policy measures and secular adjustments to parts of the economy should be limited in terms of both the deficit and aggregate growth

The CHIPS and Science Act, which provides USD 280bn of new funding for the research and manufacture of semiconductors in the United States, will only result in a very marginal fiscal easing, while the Inflation Reduction act is expected to produce a modest narrowing of the deficit. While these policies, and the drive to onshore production following disruption to supply chains in the pandemic should support some forms of investment, they are unlikely to sustain the record pace of investment growth in these areas. The impact on overall economic growth should therefore moderate in the medium term.

In the long term, the deficit is set to continue widening, driven by rising outlays rather than dwindling revenues

Mandatory spending will be the key factor in the widening of the deficit in the coming years, continuing a strong trend which has been in place since the 1990s and crowding out discretionary spending. Net interest payments are also projected to rise following the end of the period of exceptionally low interest rates post the GFC. Medicaid and Medicare, along with other entitlements, will be the major components of the rise in outlays, highlighting the long-term fiscal challenges faced by many mature economies.

Figure 3: Discretionary spending squeezed out

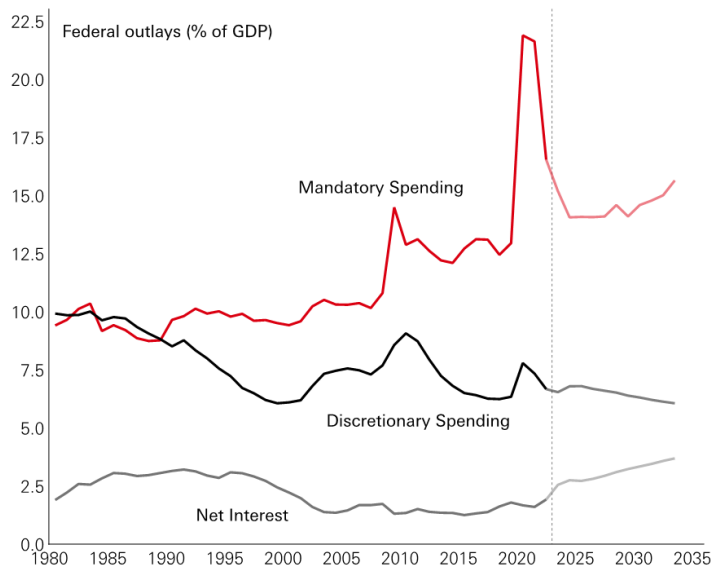
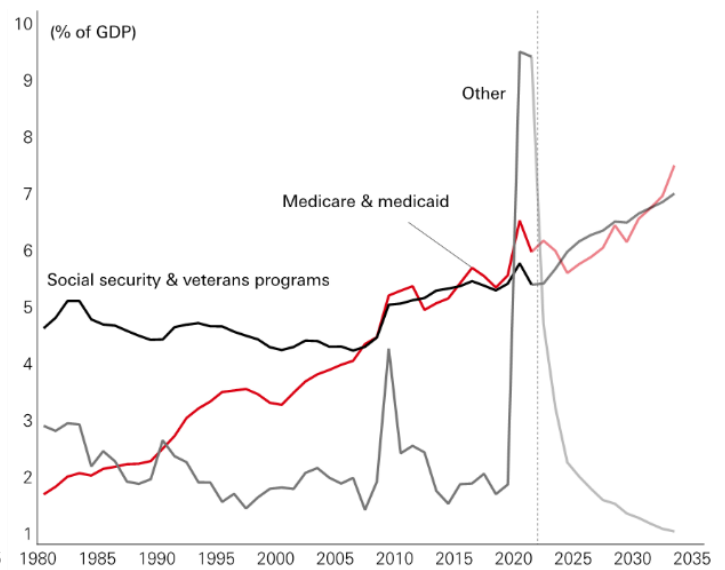


Figure 4: Entitlement spending is the (well-known) problem



Source: HSBC AM, Macrobond, Congressional Budget Office data, October 2023

Higher levels of inequality can create a vicious circle for the deficit

One of the drivers of a long-term deterioration in the government deficit could be growing inequality. Unequal distribution of income means that wealthier households can save a higher proportion of their income. Ultimately, this tends to lead to lower aggregate spending, with weaker household consumption lowering the attraction of domestic investment relative to investing in other countries. As a consequence, the government has to plug the consumption gap with deficit spending.

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Figure 5: Inequality on a long-term deteriorating trend in the US

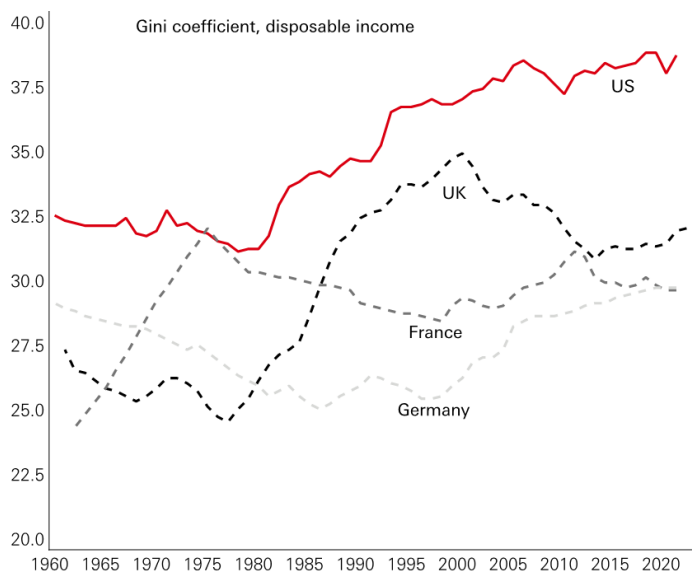
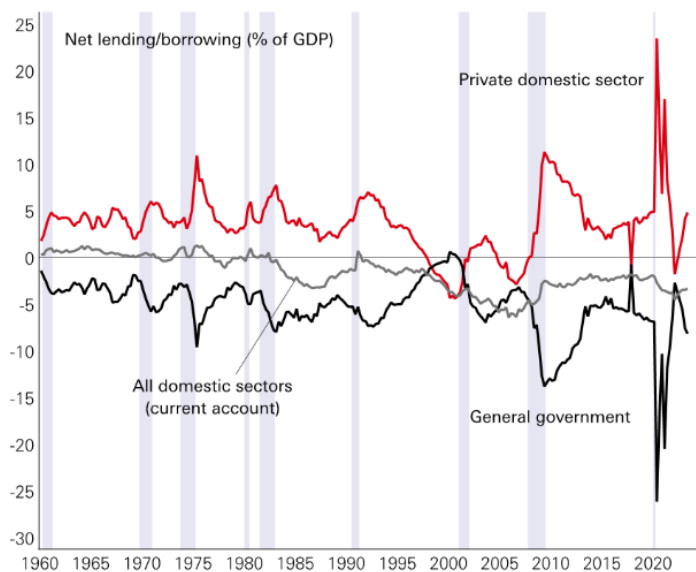


Figure 6: Private sector surplus offsets large part of public sector deficit



Source: HSBC AM, Macrobond data, September 2023

External conditions can also push the US government to run a deficit

By virtue of issuing the global reserve currency, the USD, the US economy needs to run a current account deficit in order to supply USD to the rest of the world. Given the private sector typically runs a surplus, the result is that the US government is almost duty-bound to run a budget deficit. The size of the US current account deficit, and the government deficit, is influenced by savings behaviour inside and outside the US.

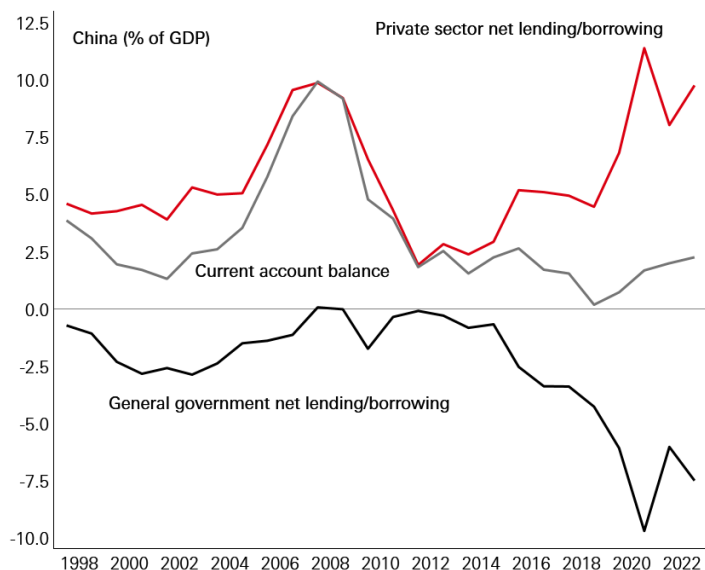
The most obvious example of this was in the years running up to the GFC. China's huge private sector surplus and minimal government deficit ensured it ran large current account surplus, which needed to be offset by current account deficits in Western economies. In the case of the US, its current account deficit reflected borrowing by the government and private sector – in the case of the latter, excessive borrowing amid low interest rates and lax financial sector regulations.

We now see another build-up of private sector savings in China, but this time it is being mirrored by a commensurate level of Chinese public sector borrowing, resulting in a far lower Chinese current account surplus. It is important to remember, then, that although the US has a wide budget deficit and rising debt, in this cycle so does China.

Overall, the dynamics of the US public sector finances reflect a complex range of potentially interrelated factors, some of which are beyond the control of the US government itself.

Nonetheless, the worsening of the public finances in recent years represents an upside risk to US Treasury yields over the medium term.

Figure 7: Private sector savings glut has re-emerged



Source: HSBC AM, Macrobond, International Monetary Fund data, October 2023

Most estimates of the US Treasury term premium have risen significantly in Q3 2023 in a bear steepening curve move

Term premium is the compensation an investor demands for holding longer-dated bonds beyond expectations of the level of interest rates, and although not directly observable, it has long been extrapolated from models. In the past quarter, these models have tended to indicate that the term premium for 10-year US treasuries has risen by around 50bp, implying that the reasons for the rise in treasury yields have been more than just higher interest rate expectations.

Commonly cited reasons have been the likely continued increase in issuance of treasury market risk (including size, coupon and duration), the Fitch downgrade of the US sovereign and the spill over of the Bank of Japan's loosening of Yield Curve Control (YCC).

It is difficult to infer the impact of increased supply on yields from historical study, but current circumstances in the US imply upside risks

Although it is intuitive to conclude that a material increase in supply will drive the term premium upwards, and that a reduction will send it in the opposite direction, the correlation has been difficult to identify in the past. Indeed, there have been times when exceptional circumstances in the funding situation do not appear to have made much – or even any – difference, for instance in the period 1999-2001 when the US ran a huge surplus, but the impact on the term premium appears to be muted at most.

But it is certainly the case that in extreme circumstances where governments have been seen to have lost control of fiscal policy either deliberately or through a gradual build-up of pressure, that yields can respond dramatically to the prospect of increased issuance and force politicians and policy makers to act. Examples include the Eurozone debt crisis in the post GFC years and the UK mini-budget shock of 2022.

By no means would we suggest that there is a similar crisis brewing in the US, but some features of the funding outlook at the moment might nevertheless point to an upside risk to the term premium. First and most simply, supply is certainly rising and auction sizes may have to increase further.

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Figure 8: Treasury issuance for August quarterly refunding (monthly auctions)

Supply (\$bn)	FRN	2y	3y	5y	7y	10y	20y	30y	5y TIPS	10y TIPS	30y TIPS	UST	FRN	TIPS	Total
May-23	22	42	40	43	35	35	15	21		15		231	22	15	268
Jun-23	22	42	40	43	35	32	12	18	19			222	22	19	263
Jul-23	24	42	40	43	35	32	12	18		17		222	24	17	263
Aug-23	24	45	42	46	36	38	16	23			8	246	24	8	278
Sep-23	24	48	44	49	37	35	13	20	22	15		246	24	15	285
Oct-23	26	51	46	52	38	35	13	20				255	26	22	303

Source: US Treasury, BNP Paribas, HSBC AM, September 2023

Second, the study of past events may only have limited use given that these were taken at times of far lower deficits as a percentage of the size of the economy, and not at a time when the market is going through Quantitative Tightening. Finally, the high cost of servicing short dated Treasury Bills in a significantly inverted yield curve adds to the overall pressure.

An estimate from Goldman Sachs implies that a 1% of GDP increase in the stock of debt translates to roughly a 2-4bp increase in 10 year yields.

On that basis, the Central Budget Office's projections for a roughly 20% increase in the debt-to-GDP ratio over the next 10 years should take yields to a level 40-80bp higher, all else being equal.

However, it is important to note that information regarding the likely future deterioration of funding metrics is broadly known to market participants, so may already be discounted, while the pace of any repricing is uncertain.

There is nothing too remarkable about Fitch's downgrade of the US, with credit ratings a relative assessment

April's downgrade by Fitch seems to bring the US's sovereign rating broadly in line with those countries with similar long term debt fundamentals, and it is important to note that challenging debt dynamics are common across global economies. Despite talks of 'buyers' strikes' and politically motivated shunning of US treasuries by other governments, it is difficult to see viable and better alternatives offering the same level of quality and liquidity.

Figure 9: The dynamics of the economy and its reserve currency status afford the US more leniency than other issuers

Country	2023 deficit as % of GDP	General government net debt as % of GDP	Revenue as % of GDP	Expenses as % of revenue	Debt affordability ratio	S&P		Moody's		Fitch	
						Rating	Outlook	Rating	Outlook	Rating	Outlook
Norway	25.3	-68.4	65.7	0.62	-2.63	AAA	Stable	Aaa	Stable	AAAu	Stable
Sweden	0.0	7.1	46.9	1.00	0.82	AAAu	Stable	Aaa	Stable	AAAu	Stable
Netherlands	-1.9	39.5	43.1	1.04	0.53	AAAu	Stable	Aaa	Stable	AAAu	Stable
Germany	-3.7	46.7	47.0	1.08	1.17	AAAu	Stable	Aaa	Stable	AAAu	Stable
Denmark	1.4	5.0	50.8	0.97	-0.79	AAAu	Stable	Aaa	Stable	AAA	Stable
Australia	-3.1	35.9	36.0	1.08	2.80	AAAu	Stable	Aaa	Stable	AAAu	Stable
United States	-6.3	95.5	31.9	1.20	6.57	AA+u	Stable	Aaa	Stable	AA+u	Stable
Finland	-2.5	34.5	52.1	1.05	-0.16	AA+	Stable	Aa1	Stable	AA+	Stable
Austria	-2.7	56.4	49.7	1.05	1.31	AA+	Stable	Aa1	Stable	AA+u	Neg
France	-5.3	99.4	52.7	1.10	3.49	AAu	Neg	Aa2u	Stable	AA-u	Stable
Belgium	-5.2	93.2	50.8	1.10	2.53	AAu	Stable	Aa3	Stable	AA-u	Neg
Britain	-5.8	95.1	39.2	1.15	8.99	AAu	Stable	Aa3u	Neg	AA-u	Neg
Japan	-6.4	161.0	35.7	1.18	0.97	A+u	Stable	A1	Stable	Au	Stable

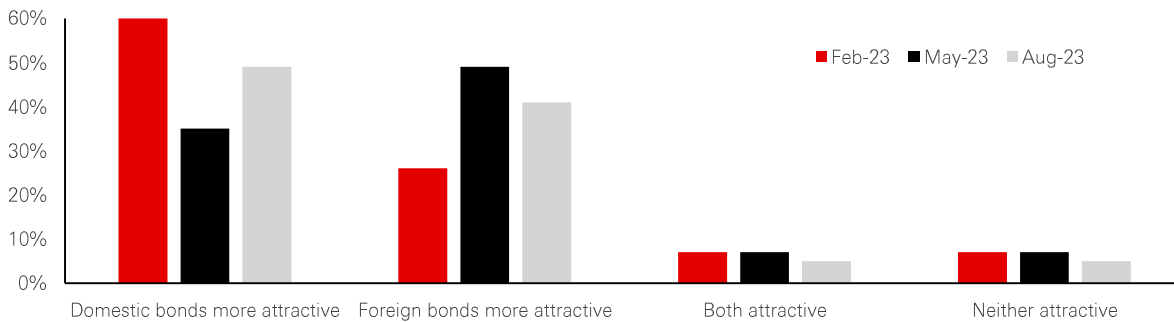
Source: Bloomberg, JP Morgan, HSBC AM, September 2023.

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The changes to Yield Curve Control are unlikely to change demand for foreign bonds from Japan in a meaningful way

Selling of foreign bonds by Japanese investors has been caused by a number of factors including the global duration sell-off and the deterioration of hedged yields. But foreign bonds continue to be viewed in a reasonably favourable light by the Japanese investor community despite the domestic monetary policy shift, while perceptions that the Federal Reserve is approaching the end of its tightening cycle is potentially offering an entry point for reinvestment into US treasuries. JGBs yields still need to move substantially higher to eliminate the yield advantage which unhedged Japanese investors continue to enjoy on their foreign bond holdings.

Figure 10: Japanese investors' perception of the relative attractiveness of domestic and foreign bonds



Source: MoF, Barclays Research and NatWest Markets, September 2023.

While supply and demand concerns likely contributed to the recent sell-off in US Treasuries, rate expectations have also moved considerably upwards since the beginning of August and this probably provided a greater impulse. Together, these factors are a more likely explanation of market movements than a large change in the real neutral rate of interest.

Some commentators have put forward the hypothesis that the real neutral rate of interest (often referred to as r^*), the long-term rate at which the economy is in equilibrium, has risen significantly and this has been a reason for much higher interest rates and treasury yields. This would suggest that monetary policy is not especially tight and that a smooth landing for the economy can be achieved.

We believe that the neutral rate may have drifted higher, but only rising modestly from the abnormally low level witnessed after the GFC. This is confirmed by most models and market based projections. It reinforces our view that US monetary policy is tight and close enough to the point where the economy is set to slow markedly, bring inflation down to target and allow cuts in the Fed Funds rate in 2024.

Developing stresses in global credit



Tighter policy has not yet led to widespread credit stress across global markets, although we expected a more pronounced acceleration of defaults in Europe and Asia. Meanwhile, emerging market external sovereign bonds are undergoing deleverage and improving credit fundamentals.

Fallen angel risk seems extremely well contained in developed markets, although ratings drift has entered negative territory.

Our forecast is for a global fallen angel rate (percentage of issuers downgraded from investment grade to high yield) of 1.2% over the next 12 months. This adds up to just 28 issuers out of the 2,268 we cover globally. The negative trend is much more pronounced in emerging market corporates (2.1%) than in the US (0.3%) and in Eurozone (0.6), where we believe that the Covid and the energy crisis have already triggered the downgrade of the most vulnerable issuers. Likewise, corporates who were able to weather those crisis are better anchored in the Investment grade space.

The number of issuers we expect to be downgraded from single-A to the BBB category is even fewer – just 24. However, these are bigger issuers, namely banks and utilities in the US, Asian banks and developed market capital goods companies.

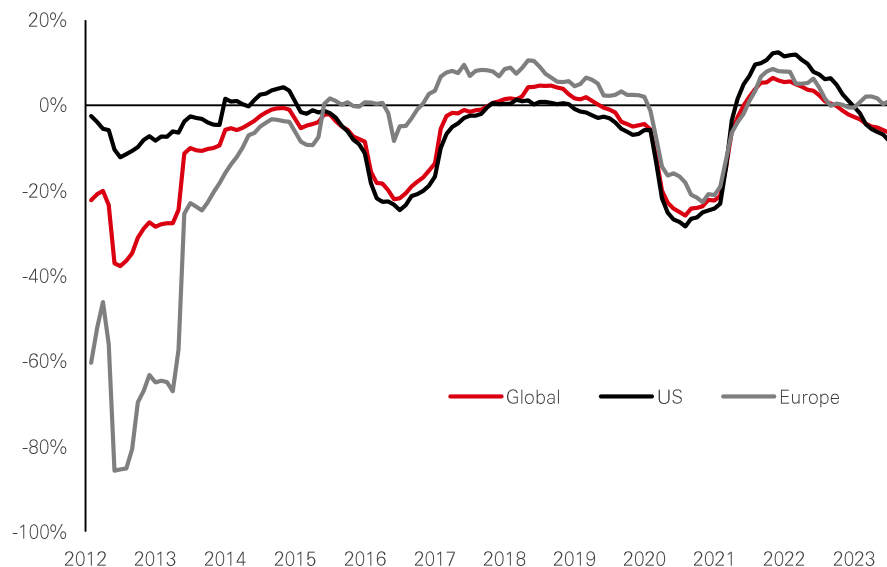


Tim Yip
Credit Analyst (Asia)



Ricky Liu
Senior Portfolio Manager

Figure 1: Rating drift = (notches upgrades – notches downgrades) / rated issuers



Source: Moody's, HSBC AM, September 2023

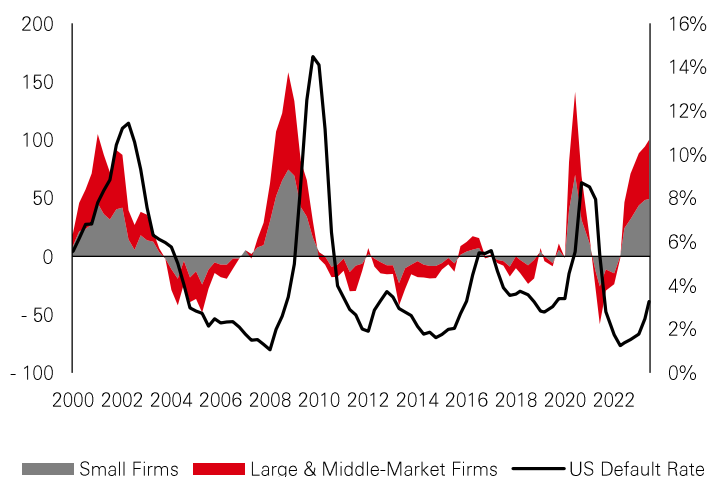
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Our expectation is for default rates to rise, with a significant acceleration in Europe and continued stress in the China real estate market

Lending standards in Europe and the US tightened further in the second quarter of 2023 and are expected to continue to do so as illustrated by Central banks’ lending surveys, reflecting the negative impact of a weaker and less certain economic environment on banks’ risk tolerance.

Sectorally, we expect defaults to be more evenly spread in the US, with transportation, media, services and healthcare experiencing the highest default rates by number of issuers, although no sector should experience more than 10% of its issuers defaulting. In the Eurozone, on the other hand, real estate and retail will be by far the biggest hit sectors with possible default rates of around 20% and 14% respectively, including some repeated defaulters. Not surprisingly, statistics for emerging markets are dominated by the China real estate sector, which will continue to experience further stress, although interestingly the default rate for China outside real estate is expected to be low, with just 2.3% of issuers defaulting.

Figure 2: US NET tightening lending standards (Senior loan officer opinion survey)



Source: Board of Governors of the Federal Reserve System and Moody’s as of 2Q 2023.

Figure 3: HSBC AM expectations by market

Index	Market	DP # issuers 30.06.2023
H0A0	USD HY	4.5%
HE00	EUR HY	3.8%
JACI HY	Asia HY	10.0%
CEMBI HY	Emerging HY	6.7%

Sources: ICE BofA ML, JP Morgan indexes, Moody’s as of 30.06.23, HSBC AM estimates.

Emerging market (ex-China) sovereign debt trends have diverged from those of developed countries. Emerging market countries ran lower fiscal deficits during the pandemic and have been able to consolidate more quickly.

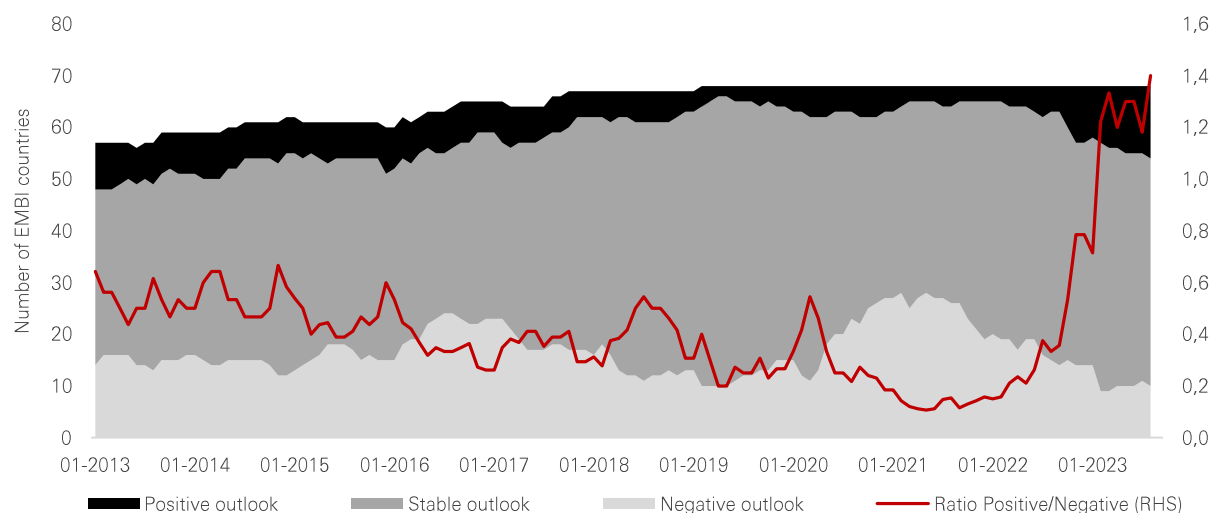
Unlike developed markets, which routinely ran deficits of over 7% in 2020-2021, emerging markets made fewer commitments, to an extent because they had fewer degrees of freedom. The International Monetary Fund (IMF) provided a key preemptive lifeline during this period, with funding doubling from 2020, replacing some of the need for market borrowing.

General government external debt of emerging market bond index countries peaked in 2020 and should continue to come down over the next 12-18 months at least, likely creating a favourable technical tailwind for emerging market hard currency bonds. This is happening because of fiscal consolidation, with most countries keeping expenditure flat, together with greater issuance of local currency debt and a limited supply from quasi sovereigns, which are pursuing alternative funding avenues, including local debt and government support.

As a consequence, sovereign external ratings have an average skew towards a positive outlook for the first time in a decade.

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Figure 4: emerging market bond index ratings outlook skew



Source: HSBC AM, Moody's, S&P, September 2023. For illustrative purposes only.

Sovereign default rates probably peaked in 2022, with a high number of countries hit by mainly idiosyncratic issues, and three forced into default for the sole reason of the Russia-Ukraine conflict. Emerging markets' overall trend of having raised interest rates preemptively to fight inflation and defend currencies post pandemic has now put them in a strong position to ease interest rates over the coming quarters. This should alleviate some of the funding pressures and limit default risk. We continue to see longer timeframes for default resolution, extending the trend of recent years, given a generally more complex composition of creditors. But a more lenient IMF has supported recovery rates near historical averages, offsetting the weight of high global rates. Nevertheless, we acknowledge the risk that higher rates and non-credible restructuring can hit some of the peripheral players and lead to another wave of defaults.

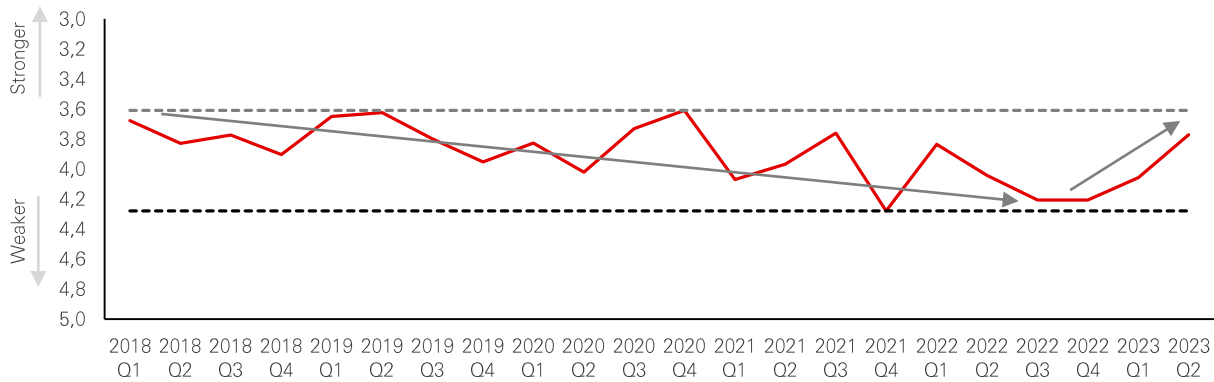
Latest developments in restructuring processes and market conditions are generally negative for recovery values

In the US, we are seeing more issuers who have engaged in distressed exchange subsequently filing for reorganization within two years, suggesting that the initial restructuring merely delayed the inevitable rather than fixing underlying problems, and resulting in lower recovery values. 2023 was particularly weak, with a few very large companies filing with very low recovery. A recent phenomenon is for more aggressive default management from specialist distressed managers, who can push the boundaries of the law in an attempt to disenfranchise other creditors and position lender groups against each other.

A new EU directive implemented into national laws in July 2021 aims to ensure 'a minimal and harmonized preventative restructuring framework within the European Union to enable debtors in financial distress to solve their problems at an early stage and avoid formal insolvency proceedings and promote their efficiency by placing the creditors as leaders within the adoption of the restructuring plans.' There is probably not a large enough observation set at this point to identify a new trend as a consequence of the directive, but 2023 shows a steep decline in recoveries, especially for senior unsecured bond holders, which may be indicative of a more significant differentiation in the treatment of different classes of bond holders in the future. We believe that it is likely that distressed exchanges will become more common as the default cycle turns and as a consequence of the new restructuring framework. Meanwhile, past loose covenants are also likely to negatively impact recovery values, even if more recently covenants have strengthened as market conditions have become more challenging for high yield issuers.

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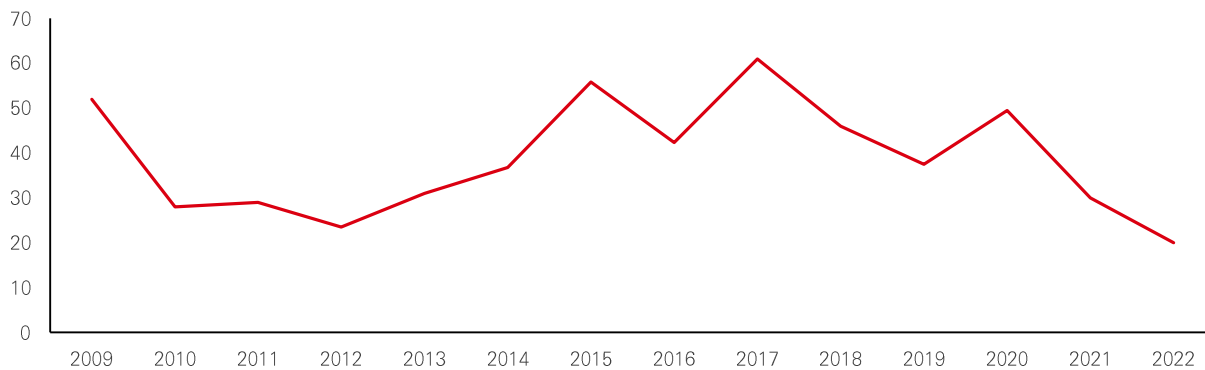
Figure 5: Covenant quality (EU)



Source: Moody's, HSBC AM, September 2023. For illustrative purposes only.

Despite developments in local bankruptcy laws, a high majority of default cases in Asia are resolved via out-of-court restructuring. Mainland China, Indonesia and Hong Kong SAR have the weakest observed recoveries, while other developed Asia appears higher, although cases are few and highly idiosyncratic. Overall, market expectations of recovery rates are declining, probably driven by pessimism around the Chinese economy and the distress in the China real estate sector.

Figure 6: Recovery rates (bond price 1 month after default)



Source: BoA, HSBC Asset Management, World Bank. Recovery rates are based on the average bond price observed 1 month after default from 2009 up to August 2022 for bonds issued by Asia ex-Japan issuers

There are a number of reasons which could explain lower recovery rates in Asia. Complex capital structures, structural subordination and a lack of enforceable covenants in a cross-border situation can all make recovery challenging for the bond holder. Subordination can also occur when offshore bond holders are governed by English or New York law, while onshore holders receive better treatment from local courts.

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