SGD bond market rises to challenges in 2021

In a near zero rate environment, yield-starved investors are pushed further into the risk spectrum. Is there a better way out?

By Andrew Wong, Ezien Hoo, Wong Hong Wei and Seow Zhi Qi

OUR concerns in early 2020 were trivial compared to what actually unfolded during the year. The outbreak of Covid-19 brought immense challenges to public health, livelihoods and economies globally. The impact will linger in 2021, with growth in the first half likely to remain dampened. We expect normalcy to return only in the second half, on the back of positive economic developments and deployment of vaccines.

For yield-seeking investors, the window of opportunity was tight given the quick rebound in prices. The stunted growth of the SGD corporate bond market in 2020 further complicated efforts to deploy capital.

Total new issuances (excluding government issues) fell 25.8 per cent year on year to S$17.9 billion. By sector, there was a significant fall in issuance from statutory boards and the government-linked sector (-51 per cent yoy to S$3.2 billion) while issuance in the financial and real estate sectors also saw a decline.

We think this was driven by a worsened business environment, weaker corporate fundamentals as well as the uncertain outlook connected with the pandemic.

Conversely, the rapid decline in cost of funding, especially for bigger real estate investment trusts (Reits), contributed significantly to the surge in Reits' debt issuance to S$2.1 billion, almost double that in 2019.

Apart from dwindling choices, it is no longer straightforward to go down the capital structure to hunt for yield. The risk of issuers not calling perpetuals at first call dates (evidenced by Ascott Residence Trust's ARTSP 3.07 per cent perp and Wing Tai Properties Ltd's WINGTP 4.35 per cent perp) and risk that the distribution payments of perpetuals will be deferred (evidenced by Lippo Malls Indonesia Retail Trust's LMRTSP 6.6 per cent perp) highlight the inherent structural risks of this higher yielding instrument.

Near-zero rate environment pushes investors to take risk but at what expense?

No two crises are the same. During the 2008-2009 global financial crisis, the 5Y Treasuries rose by more than 100 basis points due to an increase in inflation expectations, after the Fed first deployed the quantitative easing programme. However, this time, the 5Y Treasuries remained flat after the Fed pumped in around US$3 trillion into the economy through various support programmes beginning in March 2020.

While inflation expectations for the real economy have been on the rise, there has yet to be a consensus on the timing and mechanism which will trigger inflation. Meanwhile, interest rates and yields plummeted to record lows in 2020 for many major markets.

Against such a backdrop, many investing challenges, such as a lack of yield to cover future income needs and the threat of rates rising in the future, have appeared. Looking ahead, we expect investors to be pushed further out along the risk spectrum, with an accelerated shift towards riskier assets (ie equities, private equity, venture capital and infrastructure assets etc) in 2021.

On technicals, we expect a higher probability of a bear steepening on rising economic recovery in the first half of 2021. For high-grade bond investors, particularly investors who are only allowed to invest in very highly rated credits, the market environment may remain challenging given very low all-in yields. As such, we may see high grade funds underperform on a net return basis when fees are factored in for developed market focused funds.

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Under the Fed's guidance, short-end rates are likely to remain until employment and inflation reach desired levels over the longer run. Our macroeconomic research colleagues expect US inflation to remain below the target rate of 2 per cent through 2022, and short-end rates are likely to stay constant until the first half of 2023 at the earliest.

Since a negative rate environment with simultaneously rising short-end rates is not our base case, we think it is advantageous for bond investors to stay invested and focus on the shorter-to-belly part of the curve and consider select bonds with higher credit spreads to compensate for the elevated risk that an interest rate increase will lead to a fall in price bond prices.

For very high-grade bonds, a small increase in rates (eg 25 basis points) will quite easily result in a decline in bond price, wiping out the gains in yield pick-up by stretching the duration. The belly of the curve though is steeper versus a year ago and is the most interesting part of the curve in our view.

In the past, an extended low-rate environment encouraged excessive leverage and indiscriminate bond buying. This is a lose-lose strategy, and we favour a more considered approach. To generate yields of more than 3 per cent, bond investors would need to take on higher credit risk and/or subordination risk. Within the SGD bond market, this means "crossover" credits which straddle between high grade and high yield, bank capital and selected corporate perpetuals that generate structurally higher yields.

A synthetic "crossover" diversified portfolio can also be created via a mix of high grade and true high yield bonds. However, this strategy entails investors taking on a higher level of idiosyncratic risk. They need to closely monitor their portfolio and have a good understanding of each issue.

Worst may be over for SGD corporate bonds but risk remains

Aside from travel and hospitality related issuers, we think the worst of the credit crunch in the SGD corporate credit market is behind us. But system-wide credit risk in Singapore is still elevated, particularly among households and small-to-medium enterprises. As buffers from debt moratoriums have not expired, it remains uncertain what the actual default levels would be when such buffers are removed.

Higher risk aversion from system-wide credit risk could mean limited appetite among market participants for true high yield (with knock-on impact on secondary market liquidity). As such, we do not advocate a solely true high yield SGD bond investment position.

Overall, we enter 2021 with high optimism in risk markets as investors bake in a low-for-much-longer short-term rate environment and brush aside the fact that the number of virus cases is still escalating. In the real economy, a rapid "start-and-stop" reopening – currently practiced by many countries – may lead to inaction as businesses are unable to plan ahead, curtailing their growth strategies. The prospect of an uneven and tepid economic recovery and a mix of past, present and future risks present a complex picture for credit in 2021.

Investors should also consider major trends shifting the broader landscape, including the impact from a K-shaped recovery, expiring government stimulus, accelerated digital shift and rising prominence of environmental, social and governance factors.

Barring new unknowns, we expect credit risk for bulk of SGD corporate bonds in the first half of 2021 to be more manageable versus Q1 2020. At this stage of the pandemic, we have a lot more information on which issuers would be more resilient versus those that might not be, versus Q1 2020. Combined with solid market liquidity, the environment is broadly supportive of credit.

Andrew Wong; Ezien Hoo, CFA; Wong Hong Wei, CFA; and Seow Zhi Qi, CFA are credit research analysts at OCBC Bank's Global Treasury Research & Strategy.

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