INCOME PARTNERS

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CIO LETTER

MACRO VIEW

US and G7

Inflation is back in a big way, yet so far financial markets have not really responded significantly to the high inflation numbers, at least up till now. Why is that? Does the market still think that inflation is transitory?

Well, at least the Fed and other central banks already started to change their tune. It is getting more challenging to argue that inflation will drop off significant in 2022. I do not think markets believe that inflation is only transitory, at least fewer and fewer people remain in that camp, ourselves included.

Financial markets care less about the actual inflation and economic numbers. Rather, they care more about government and central bank policies. So far a flattening yield curve and strengthening dollar are pointing to a tightening Fed policy. The million-dollar question for 2022 becomes- to what extend policy makers will change their policies on the expectation of higher inflation? I think monetary policy will be a more important factor to watch than fiscal policy during 2022. Fiscal policy takes time to show effects and requires Congress/Parliament approval, etc. whereas monetary policy is more immediate, doesn't require government approval and has instant impact on financial assets.

I am in the camp that the Fed will raise rates as long as it does not burst the equity, credit and real estate and other asset bubbles which might result in a major negative wealth effect and hence recession. They would rather choose to have higher inflation than the collapse of the markets and therefore potential recession. In fact, I further believe and argue that they prefer a 4-5 % inflation range for the next decade in order to resolve the sovereign debt problem.

Higher inflation is a solution to the sovereign debt problem of most G-7 economies given their high debt to GDP ratio in the range of 100%-250%. Of course, they will never admit that is the case. What about the bond markets? Will they revolt? They certainly should, but I am not sure they will and can. Why? It is TINA. There is no alternative. They might have no choice and are forced by regulations to buy government bonds, i.e. financial repression. They have been forced to buy zero to negatively yielding bonds for a few years, so why not higher rate with coupons. I would not be surprised to see that the governments might impose some forms of capital control if large amount of capital is moving out of their countries.

Here is how I see the fed rate hike cycle will playout in 2022 -

- Phase 1: October 2021 to March 2022

  The Fed turns hawkish verbally, resulting in stronger dollar and flattening yield curve. US 10-year treasury might test 2.0 % and inflation numbers start to plateau during Q1 2022.

- Phase 2: April to September 2022

  Expect two to three rates hikes, provided that US HY CDS spread is less than 500 bp, IG CDS less than 150bp and US equity correction no more than 20%.

- Phase 3: October 2022 to early Q1 2023

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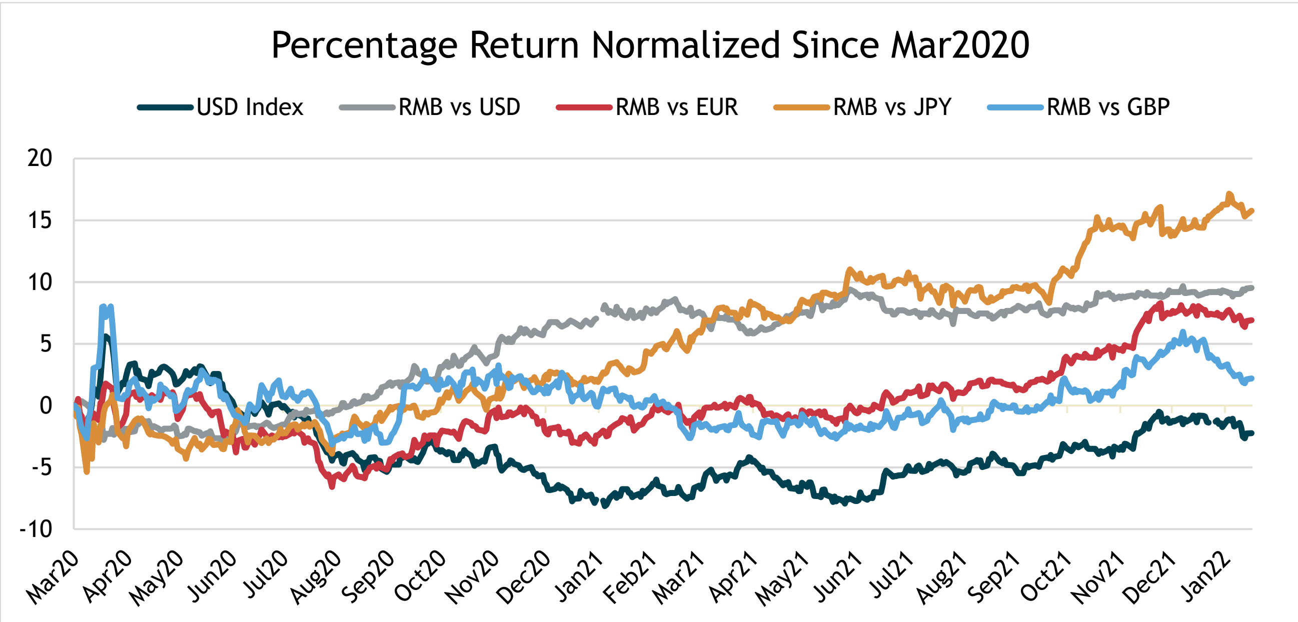
The Fed tones down hawkish comments with inflation number starting to print 4-5% year-on-year basis as the higher base effect kicks in. This will give the Fed sufficient ammunition to slow down the rate hikes and even reverse if the financial markets go into a tailspin. What can go wrong with this view? My view is based on less government spending, fewer government transfer and less consumer spending plus tighter monetary policy hence a slower economy. However, if you look at the US consumer in aggregate balance sheet is almost $35tn , 1.5x of US GDP and what if there is no slowdown in spending and actually pick up due to pend up post pandemic demand . In this scenario, the US yield curve will most likely steepen and might test 2.5% to 3.0%. In this scenario, all asset classes will experience major sell off and the Fed will have no choice but to reverse tightening policy. Structurally, with the high debt level across G7 economies, the interest rate will need to come down. Yes, the rate will eventually come back down but it will cost a lot of damage to portfolio if the US consumer spending didn't drop this year. This is the key area that I will be focusing at in the cycle.

The rest of G7 central banks will have similar playbook. During 2021, US Dollar strengthened against Euro, Yen and almost all other currencies with only one outlier being Chinese RMB. The Chinese RMB is the only currency (and bond market) that has positive real yield and is uncorrelated with the US and G7 markets. Please see below.

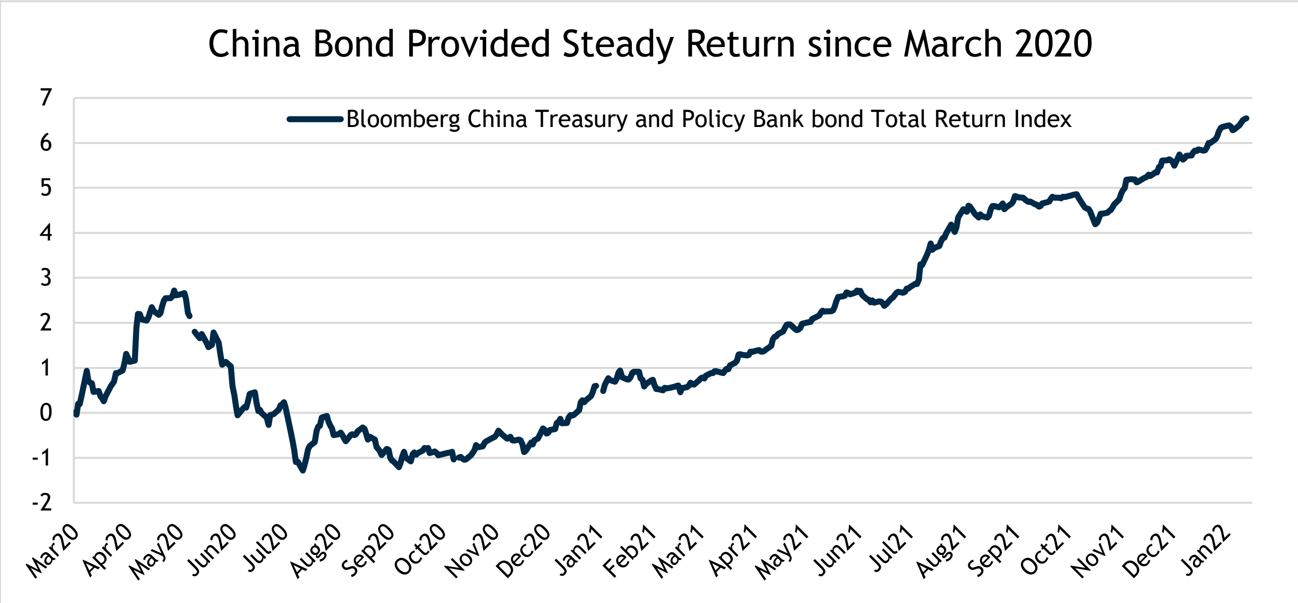
China

RMB has outperformed major currencies since the beginning of the pandemic. Factors such as proactive prudent monetary policies, strong exports helped by integrated and resilient supply chains, and steady foreign inflow into onshore RMB assets boosted by global bond indices inclusions, all contributed to the strengthening of RMB. The divergence in US and China's monetary policies shall narrow the yield differential as the Fed starts to hike in 1H 2022, and potentially may put some pressure over RMB. I believe the aforementioned factors will continue to support RMB in the medium to long run. In addition, RMB rates bonds, i.e. sovereign and quasi-sovereign bonds, have proved to be a good asset class that generates steady return in the past two years and may benefit more as China tackles its structural issues and continues to ease.



Source: Bloomberg, 17 January 2022

	USD Index	RMB vs USD	RMB vs EUR	RMB vs JPY	RMB vs GBP
Cumulative Return (%) Since Mar2020	(2.23)	9.53	6.90	15.76	2.18
Annualized Vol	6.60	2.35	5.35	5.90	3.68
			EUR	JPY	GBP
Annualized Vol vs USD			6.48	5.77	4.82



Source: Bloomberg, 17 January 2022

There are two major driving forces for strong Chinese RMB

1) When the major G7 economies are experiencing negative real rates, the Chinese RMB is the only outlier which offers positive real rates hence a strong RMB. Despite a rising USD rate in 2022, the real yield for US will still be negative in the foreseeable future as articulated earlier. The RMB will remain strong in 2022 with a slightly higher trading range.
2) However, the more significant force is China's determination to de-dollarize its economy. Many countries had tried and failed so will China succeed? Well! I think they have a good shot because, when all other G7 economies are debasing their currencies, it will not be too difficult for China to attract capital inflow. In the land of the blind, the one-eyed man is king. China is the one eyed man in the currency and bond world. The main policy goal of China is not to pump up GDP, in a de-dollarized world, they need a strong RMB and structurally stronger than US dollar. They are biting the bullet and practically bursting all the bubbles, from tech, education to property etc. in 2021 to achieve this goal.

We have been advocating an allocation to RMB and Chinese government bonds for the past few years and continue to recommend the same for 2022. On the credit space, The Asian IG bond market will be steady and mainly tracking the overall US treasury market. I don't see credit events such as Huarong in 2021 happening this year. The excitement and opportunities is in the Asian high yield space, and China property sector in particular. For contrarian investors, buying distressed/stressed

Chinese property bonds is the play for 2022. Here are the reasons and risks/ rewards on this opportunity.

CHINA REAL ESTATE SECTOR HIGH YIELD

The Chinese real estate HY bonds have been among the worst performing assets globally in 2021, falling 37.2%, as a result of tight sector policies hence liquidity constraint. It has been a painful experience for investors in the sector, ourselves included. Amid all the gloom and doom, I find reasons for optimism upon reflecting on my past 30 years experiences during the Asian Financial Crisis (1997) and the Global Financial Crisis (2008). Of course, they are different events but one similarity is the price action of the bonds, they are all in the 20-50 price range. I believe, in the next 12-18 months, most names will provide 2x to 3x return.

I will recap and compare and contrast the three events and outline how I see the Chinese property sector will play out in the next 12-18 months.

Asian financial crisis 1997

Cause: It was a liquidity crisis triggered by both currency and maturity funding mismatch resulting in major currency devaluation and sovereign defaults among most of the Asian economies. I recalled Korean sovereign bank KDB (AA rated) downgraded to Single B within days and price drop from par to 30. Bangkok Bank and similar Asian banks were all traded in the 30. Market consensus was that all the banks will default but in the end no bank defaulted on their debt.

Trigger for Recovery: IMF came in and provided emergency loan and eventually Asia fully recovered

Global financial crisis 2008

Cause: US subprime issue resulting in global banking crisis and all bonds including Chinese property bonds were at similar level as today- 20-50 range.

Trigger for recovery: Global coordinated rate cut and government rescue plan and China's massive RMB 4 trillion stimulus. Within 12 months, most bonds fully recovered to par.

China property high yield crisis 2021

Cause: This is a sector crisis engineered by the Chinese government. The cause is very different from the previous two crises. It is a self-engineered deleveraging exercise and much smaller in scope and breadth.

Trigger for Recovery: First, there will not be a direct bailout of the sector or specific companies because it is against the objective of the self-engineered deleveraging exercise. The end game for the sector is a consolidation of the top 50 private property developers to 20-30 when it is all said and done. The property sector will emerge as a much slower growth and less leveraged sector going forward. With this end game in mind, here are my views of how it will play out in the next 12-18 months.

Phase 1: Price destruction. The price destruction has already happened with most bonds dropping to 20-50.

Phase 2: There will be no direct bail out, but the government already sets in place the framework for recovery. The following five factors will provide clues on the timing of recovery

1) Price level: already at 20-50 level, further downside is limited.
2) Government policy: monetary policy – we have already seen a series of RRR and rate cut and expect more if needed. Fiscal policy - relaxation of mortgages and most significantly, the M&A financial policy support advocated by the government. Why? M&A means consolidation. This is the objective of the whole self-engineered deleveraging exercise.
3) Opening of onshore capital market for developers: first sign of green shoot in Dec 2021 and early 2022
4) Opening of offshore refinancing market: this will come last but will happen very soon as onshore market has already started to reopen
5) M&A: this is the main event of the whole deleveraging exercise and the first one China South City acquired by Shenzhen government occurred in Dec 2021. More recently, Shanghai Pudong Development Bank plans to sell RMB 30 billion (USD 4.7 billion) 3-year bond to fund property asset acquisition loans. I expect the pace will pick up very quickly in 2022.

In short, in my opinion, this is the bottom and the recovery will be fast and swift because the market is relatively small vs the potential pool of capital that is waiting to come in which will drive up the bond prices very rapidly.

Yours sincerely,

Emil Nguy

Chairman, CIO and CEO

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