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Remain selective in the credit space

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While we believe that equities have become more attractive in a portfolio context, we would caution against shifting from investment grade to high yield. With the spreads of both segments very tight at the moment, we find the more resilient IG segment offers the more attractive risk-reward balance and urge investors to deploy idle cash to lock in the attractive IG yields. Investors in Asia credit meanwhile can inject more risk exposure into their IG bond portfolios by either moving down either the credit curve or the capital structure, or both.

As the outlook for the US and global economy shifts from "soft landing" to "no landing" (benign growth with inflation close to the Federal Reserve's target and growth at/above trend), risk appetite is likely to grow. Indeed, we have shifted our view on equities to Attractive, and expect this to gain more traction in the markets in the coming months. This growth in risk appetite could well tempt investors to consider adding more risk to their global bond allocations and shift from Investment Grade (IG) toward High Yield (HY).

While this might be understandable, we continue to like IG corporate credit and recommend that investors shift excess cash into quality fixed income as the global rate-cutting cycle advances. Although all-in yields remain elevated compared to history, we believe quality IG bonds should deliver attractive total returns from both carry and price gains over the next 12 months. Meanwhile, we keep HY at Neutral as we see limited scope for significant spread compression from already-narrow levels. Below, we explain our view, as well as how investors in Asia credit can inject risk exposure into the IG segment in the region.

IG fundamentals remain resilient and yields elevated. With the outright level of yields currently still appealing, we believe investors with excess cash holdings should look to lock them in. The segment's fundamentals appear robust.

Absent a deep recession, we believe the near-term risk of increasing rating downgrades and significant upward pressure on spreads appear limited. While our outlook of range-bound credit spreads (over US Treasuries) could be threatened by a meaningful economic slowdown or an outright recession, we believe spread widening would likely be largely offset by falling interest rates in this scenario.

Looking ahead, we continue to see IG returns (1-10-year maturities) in the high-single-digit range over the coming 12 months, supported primarily by elevated carry, low spread-volatility, and price gains on falling government bond yields. Investors can also consider diversified fixed income strategies—including selective exposure to higher-yielding parts of the asset class—as a way of further enhancing portfolio income.

Narrow HY yield spreads. Resilient economic growth and prospects of easier monetary policy have supported a narrowing in HY credit spreads. Currently, they are close to historical lows. This indicates the market seems to have priced in expectations of low credit losses, and a below-average credit risk premium; As such, we see limited scope for significant spread compression from here. We believe the segment would be more vulnerable compared to higher-quality investment grade corporate credit should growth concerns resurface, as the more leveraged, lower-rated companies have higher sensitivity to adverse economic outcomes and hence have greater default risk. Therefore, we remain tactically Neutral on HY credit at this stage. We believe total returns are still set to remain respectable in our base case, given the elevated level of outright yields and expected low credit losses.

Injecting risk into Asia IG. Investors in Asia credit, meanwhile, can inject more risk exposure into their IG bond portfolios by either moving down either the credit curve or the capital structure, or both. Improving investor risk appetite shifts the risk-reward balance in favor of the yield pickup on offer from the slightly riskier credits. In terms of going down the credit curve, we would switch from the A or AA segments to the BBB segment for yield enhancement. In the banking sector, we favor Tier 2 debt over senior notes given the potential for a meaningful yield pickup. We favor Thai, Indonesian, and Hong Kong Tier 2 bonds.

Investors can also consider adding some higher-yielding mainland China credits. Although we do not expect China's policy stimulus to affect the fundamentals of the segment very much, we do expect credits from asset managers and leasing companies to be the chief beneficiaries. These credits are trading at spreads wider than Asia IG currently, and we think these can perhaps narrow relative to the overall segment, which should translate into a boost in returns.

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