

Fixed Income Insights

Q4 2023

For professional investors only

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Foreword



Higher interest rates and yields have undoubtedly revived the role of bonds in asset allocations. Nonetheless, a rising cost of capital is likely to pose some challenges for the more risky parts of the credit market.

Welcome to the latest edition of our Fixed Income Insights, which summarises the key findings of our quarterly Strategic Forum. As we publish this update, the Fed has just adjusted its economic projections in a market-friendly way. It revised near-term growth upwards, revised inflation expectations downwards in the coming years and continued to predict a limited rise in unemployment. Most importantly, the Fed removed its prior expectation for one further 25bp rate hike this cycle and lowered its end-2024 Fed funds figure by 50bp to 4.60%, implying 75bp of policy easing next year. This improving inflation outlook and change of tone in the Fed's rhetoric means markets are even more convinced of heading toward a soft landing. But the risks remain significant, in our view. And the main risk now is that that a soft-landing outcome is fully priced, implying little room for disappointment on the macroeconomic and corporate profits scenario.

This is why we dedicate this edition to assessing these risks, from both a macro and a fundamental perspective. In the first section, we ask ourselves whether US household and corporate balance sheets are a determining source of vulnerability for the US economy. For now, we do not find that balance sheets are so stretched as to be the cause of a recession in themselves. On the other hand, we know that recessions are most often caused by significant stress in a small part of the economy, and there are pockets of vulnerability among lower-income households and small businesses that may become problematic as the lagged effects of rate rises works fully through the transmission mechanism.

In the second section of this publication, we look at another potential challenge posed by higher interest rates and a rising cost of capital. The most risky parts of the credit bond market could be victims of rising defaults and steeper credit curves, especially those that face a 'maturity wall' resulting from opportunistic funding at low rates during and just after the pandemic. Here again, we do not believe that there will be a widespread problem, but there are likely to be pockets of pressure which may pose risks to certain sections of the market.

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

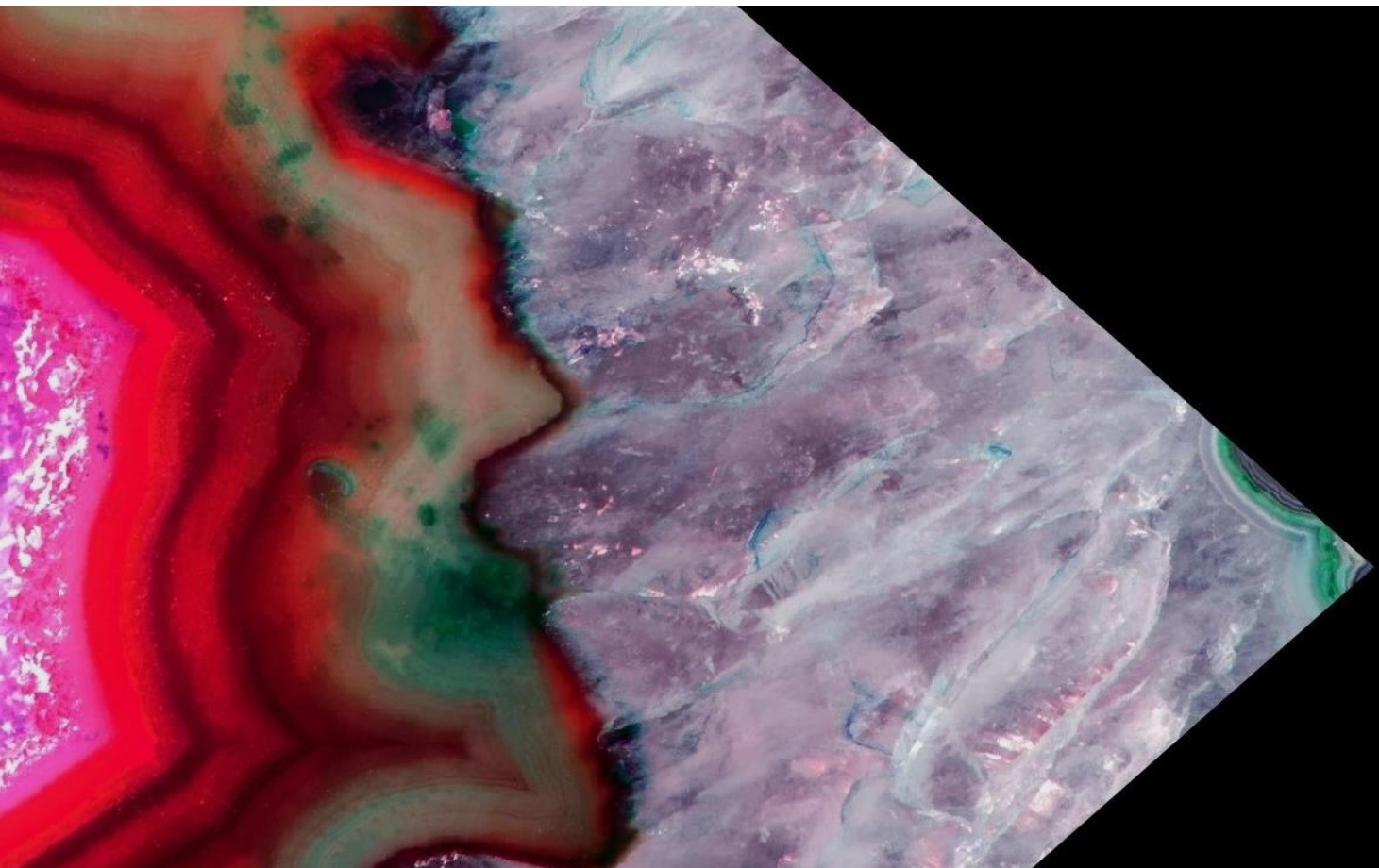
Are US household and corporate balance sheets a determining source of vulnerability for the US economy?

- Higher interest rates have raised questions as to whether household and business debt is sustainable or whether the strength of the asset side of balance sheets can mitigate the impact of higher interest payments.
- Balance sheet resilience is not evenly distributed across either household or business sectors, and it is important to accept that it is likely to be the fate of the marginal business and consumer which will determine whether the US enters recession.
- Our analysis indicates that balance sheets are not unusually stretched and should, therefore, not be the source of significant financial stress, but that the interest rate shock is creating vulnerabilities in some areas.

Will refinancing the 'COVID Maturity Wall' pose a threat to global credit markets?

- Opportunistic funding at low rates during and just after the pandemic was a prudent step at the time, but it has created a 'maturity wall' in 2024 and 2025 which could create refinancing difficulties at the higher rates now prevailing.
- We do not believe that there will be a widespread problem, but there are likely to be pockets of pressure which may pose risks to certain markets.

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Are US household and corporate balance sheets a determining source of vulnerability for the US economy?



Higher interest rates have raised questions as to whether the strength of the asset side of balance sheets can mitigate the impact of higher interest payments. Our analysis indicates that balance sheets are not unusually stretched and should not be the source of significant financial stress, but that the interest rate shock is creating vulnerabilities in some areas.



Dominic James Bryant
Director of Macro Strategy



Ernst Osiander
Head of Global Rates Strategy

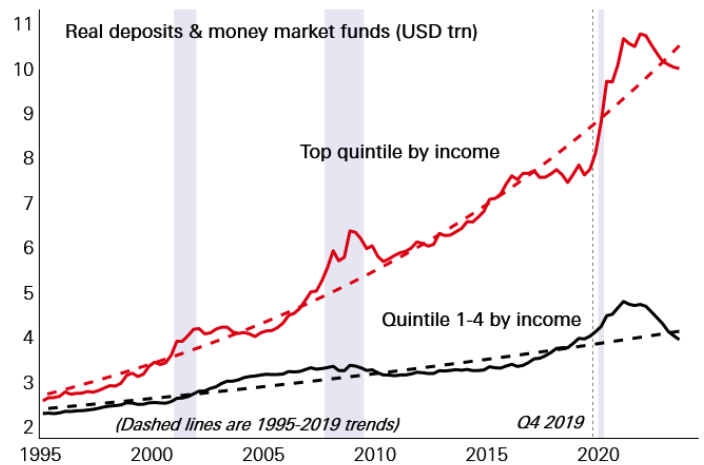
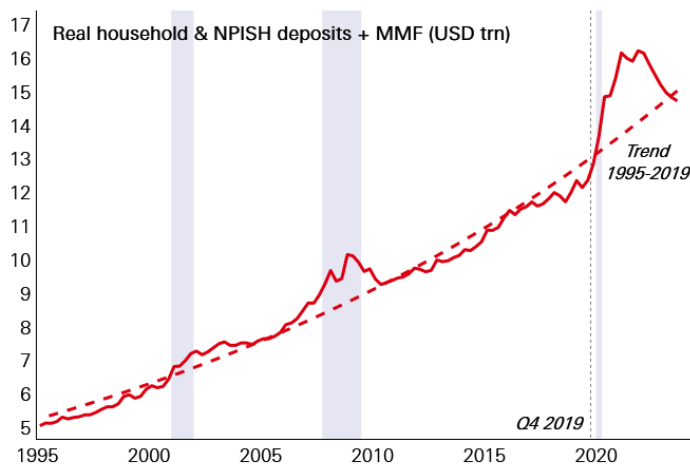
Household net worth is in good shape and this could keep the savings rate low, but some cohorts of consumers now coming under pressure with consumer loan delinquencies rising quickly.

At their peak, households' holdings of deposits plus Money Market Funds jumped by around 20% of disposable income as money was accumulated in the pandemic and post pandemic periods, at the same time that interest rates rose to seductive levels. But holdings are now normalising to trend in real terms, while deposits are significantly skewed towards high-income households, meaning that the positive balance sheet effects are not evenly distributed.

Figure 1: Real-terms deposits well above pre-pandemic levels for top income quintile

Deposits & MMF normalising in real terms

Holdings of deposits skewed towards high-income households



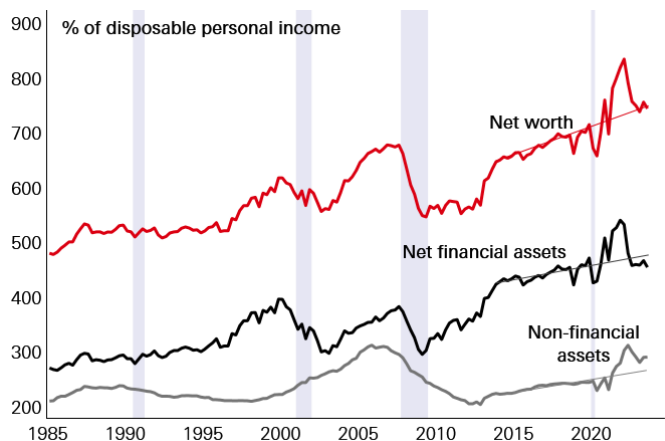
Source: HSBC AM, Macrobond data, December 2023.

In terms of wider household balance sheets, we see that net worth has risen above trend since the pandemic, mainly as a consequence of rising house prices; housing assets make up the vast majority of non-financial assets.

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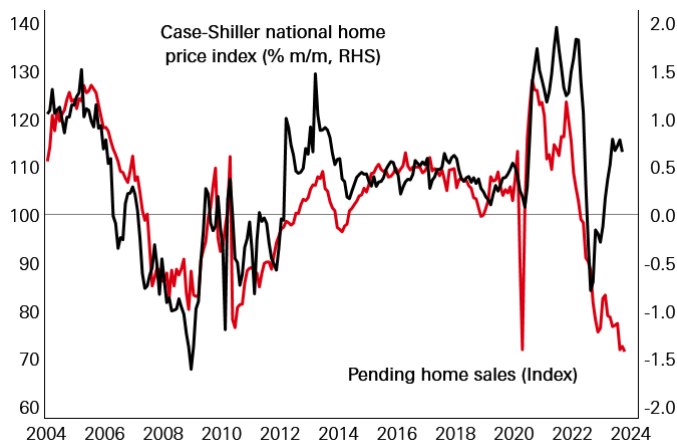
This may explain the low level of the saving rate, which tends to have a negative correlation to household net worth. But it also underlines the vulnerability of household net worth to house prices. If the unemployment rate were to rise markedly next year, it would create downside risk to the housing market by bringing about forced selling at a time when demand is under pressure from high mortgage rates.

Figure 2: Financial assets on trend, non-financial assets above trend



Source: HSBC AM, Macrobond data, December 2023.

Figure 3: Downside risk if unemployment rises markedly

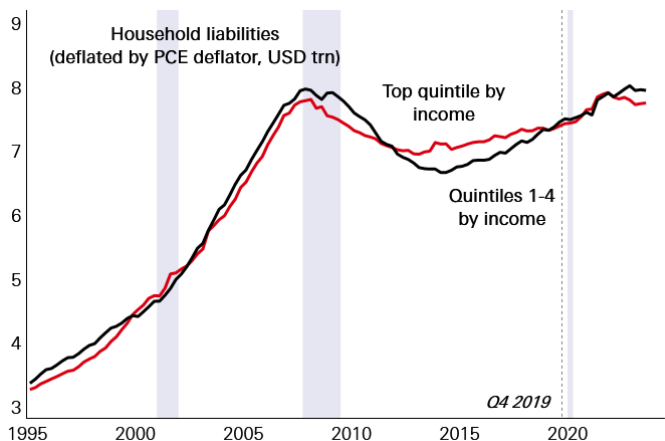


Source: HSBC AM, Macrobond data, December 2023.

Holdings of financial assets such as equities, pension entitlements and mutual funds, although susceptible to the inevitable volatility of markets, are heavily concentrated in the top 20% of earners, so the housing market, where wealth is more evenly distributed, is a key determinant for the outcome for the consumer.

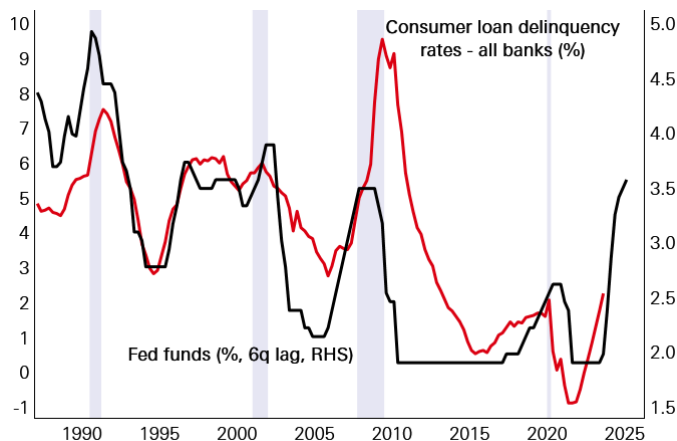
On the other side of the household balance sheet, aggregate debt-to-income does not appear problematic; it is far lower than prior to the GFC, although it is higher than in the 1990s / early 2000s, when we last saw this level of rates on a sustained basis. There is also no significant difference in the overall debt dynamics of top earners compared to the rest. However, consumer credit may be a source of concern, as this form of debt has risen quickly in real terms for middle income households. Indeed, consumer loan delinquencies are already rising sharply, indicating that there are now some cohorts of consumers coming under pressure.

Figure 4: Household debt has risen gradually in real terms



Source: HSBC AM, Macrobond data, December 2023.

Figure 5: Consumer loan delinquencies rising quickly



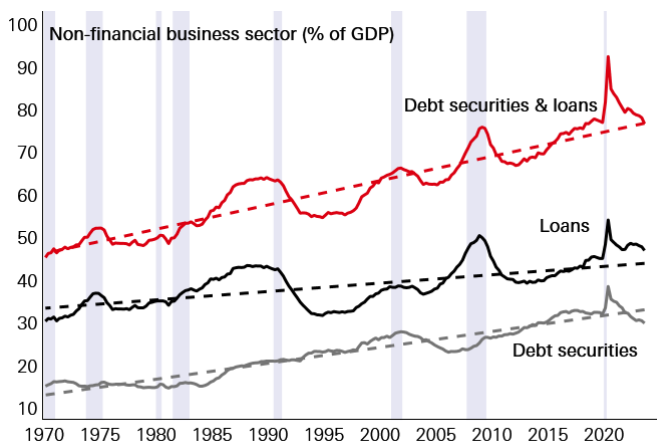
Source: HSBC AM, Macrobond data, December 2023.

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For the business sector, overall debt levels are around trend, but higher than when we last saw borrowing rates at this level. Loans are a potential pressure point, with small businesses already experiencing rising delinquencies, even if – in aggregate – cash holdings are close to all-time highs.

The non-financial business debt-to-GDP ratio is around trend, with loans above trend and debt securities marginally below. However, interest rates are in line with pre-GFC norms when debt ratios were lower. High issuance of bonds during the pandemic has delayed the impact of higher policy rates to an extent, but with some shorter maturity bond issuance now maturing, more companies will begin to pay interest more in line with policy rates.

Figure 6: Loans above trend, debt securities below trend



Source: HSBC AM, Macrobond data, December 2023.

Figure 7: But short-term loans as share of debt is higher than in 2010s

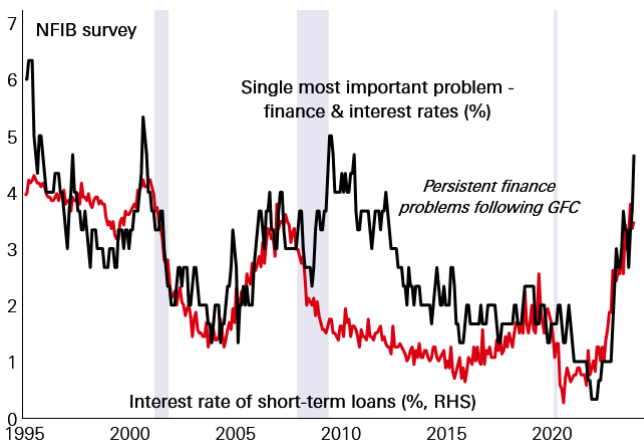


Source: HSBC AM, Macrobond data, December 2023.

Business loans are a potential pressure point, with short-term loans as a share of overall debt having risen steadily and materially from around 2010. Small business interest rates have surged to levels last seen around the turn of the century, but with the level of debt a lot higher as a proportion of GDP.

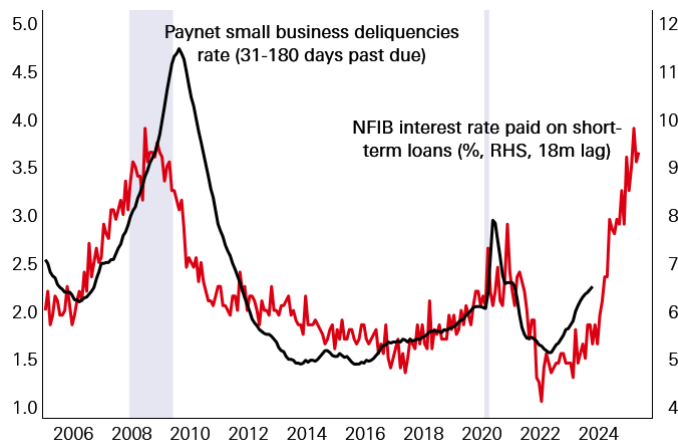
This seems to be a significant concern to the businesses themselves, with the widely watched NFIB (an association of small businesses in the United States) survey indicating that the proportion of small firms viewing financing and interest rates as their number one problem has risen to levels seen prior to recent recessions. Moreover, the small business delinquency rate has already started rising and it tends to track the interest rate paid on short-term loans. This relationship suggests the potential for delinquencies to move substantially higher next year.

Figure 8: Small business financing problems have risen sharply



Source: HSBC AM, Macrobond data, December 2023.

Figure 9: Small business delinquencies are rising



Source: HSBC AM, Macrobond data, December 2023.

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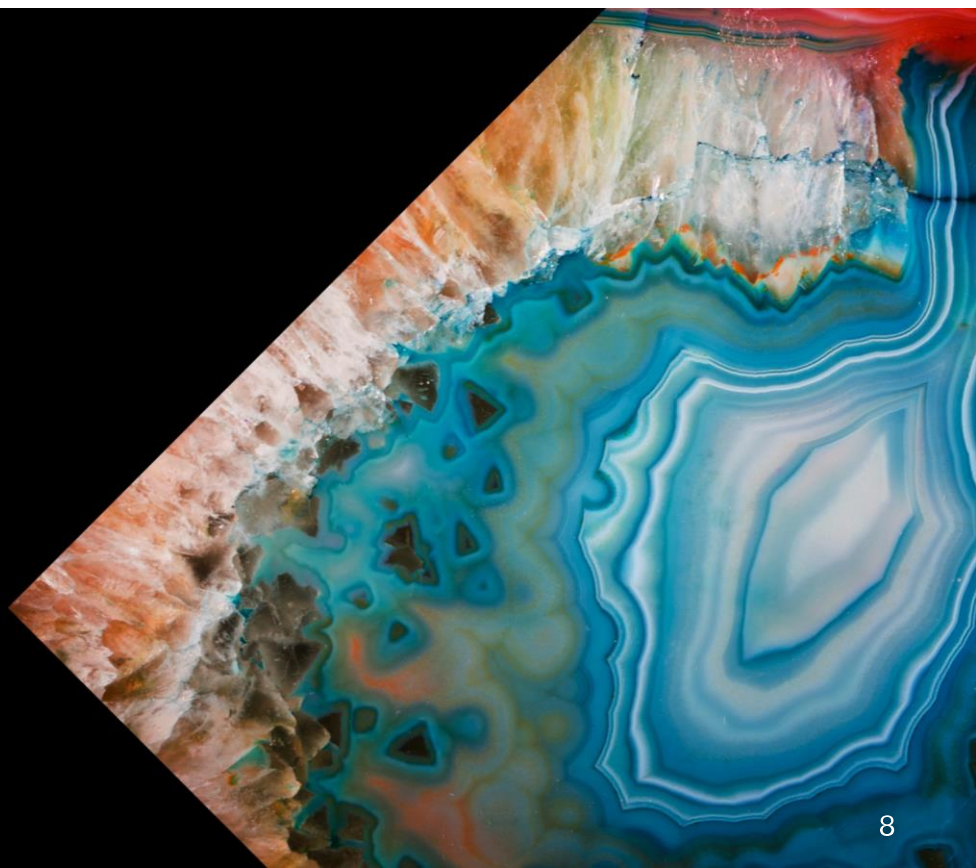
In terms of mitigation from the other side of the balance sheet, companies – and especially corporates – are sitting on a considerable cash pile in aggregate. But this is not evenly distributed, with 20% of companies holding 87% of the cash, and this minority may well be benefiting from high interest rates as a consequence. Meanwhile, the debt is also not evenly distributed, with 20% of companies sitting with 72% of the debt¹. It seems likely to be the case, then, that although a few very large companies are prospering, a large number of smaller companies may be struggling with higher levels of more expensive debt.

In summary, although aggregate household and business balance sheets are in reasonable shape, limiting the scope for a deep recession or widespread financial stress, they are also not so strong that they will be the decisive factor in avoiding a recession.

One of the key features of balance sheets currently is the distribution of assets and liabilities, which is very skewed in a way which favours large businesses and higher earners. Recessions are most often caused by significant stress in a small part of the economy, and current conditions may be conducive to that outcome. On the other hand, we do not find that balance sheets are so grotesquely stretched in any direction as to be the cause of a recession in themselves.

¹ <https://www.thespreadsite.com/the-haves-and-have-nots/>

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Will refinancing the 'COVID Maturity Wall' pose a threat to global credit markets?



Greater utilisation of alternative sources of funding will be part of the solution to the maturity wall for some issuers. This could actually provide technical support for credit markets in 2024, with sparse supply meeting increasing demand for higher yields.



Tim Kroeber
Head of Credit Research US

Opportunistic funding at low rates during and just after the pandemic was a prudent step at the time, but it has created a 'maturity wall' in 2024-2026 which could create refinancing difficulties at the higher rates now prevailing or force deleveraging.

As we can see in Figure 1, although the maturity wall is set to grow everywhere in 2024-25, the situation is not particularly acute in western developed markets, although there may be particular sectors which will feel stress. Among the companies most vulnerable to the higher refinancing cost of short-term debt are those in capital sensitive sectors, lower quality banks, REITS and those in the lower parts of the high yield ratings spectrum.

The Asia maturity wall is steeper, but here is where issuers can most lean on local markets, especially in China and India where financing costs are lower and the market is deep.

Meanwhile, the latest economic expansion has been driven by income, rather than balance sheets, and therefore it is the earning outlook which will be key to how companies address upcoming maturities, which should be manageable in the event of the reasonably benign economic outcome currently discounted.



Zoe Chuang
Credit Analyst (Asia)

Figure 1: A growing maturity wall

Sector	Market size (USD billion)	2024 Maturities	2025 Maturities	2024-2025	Notes
US Investment Grade	8062	745	888	20%	Driven by Autos, Banks and post-Covid issuance from select sectors
Europe Investment Grade	3361	319	380	21%	Autos, Retail and Capital Goods
Asia Investment Grade	836	144	147	35%	China Financials and State Owned companies, Korean Financials and Coporates
US High Yield	1350	34	99	10%	BB-tilted but overall amount is elevated (2016-2022 average is around 5%)
US Leverage Loans	1340	22	107	10%	B3 and lower accounts for a high portion of refinancing needs
Asia High Yield	120	28	24	43%	China Property, Indian Corporates
Europe High Yield	403	48	61	26%	BB tilted

Source: HSBC AM, Bloomberg data, November 2023.

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The US maturity wall is set to increase over the next 2 years and we believe that the vast majority of investment grade issuers are prepared to absorb higher financing costs. While refinancing is a growing risk in high yield, many issuers took advantage of improved financial conditions during 2023 to address near-term maturities.

The US Investment Grade maturity wall is set to increase by 21% year-on-year in 2024 (\$136 billion). Approximately half of that increase is being driven by the banking sector due to increased regulations and Basel III. Within the non-financial sector, increased maturities are being driven by the outsized Covid-related issuance the market saw in 2020 and the following year.

The macro backdrop and market volatility will play a significant role in ultimate issuance in 2024, but refinancing risk should be manageable for most investment grade issuers. Pockets of vulnerability include regional banks, REITs, and select industrial issuers. In high yield, we expect default rates to continue to increase but feel the risks are fairly concentrated in select industries such as Media and Healthcare. In addition, the maturity wall is skewed towards higher quality BB issuers who should be more resilient to higher borrowing costs.

The pace and scope of market stress in 2024 and beyond will be driven more by the earnings backdrop versus changes in funding costs. Our base view is that US credit markets will likely benefit from a relatively strong technical picture next year, especially if a deep recession is avoided.

Figure 2: US investment grade maturities (USD billion)

Sector	2024	2025	% of '24-25 Maturity Wall	Variation 24/25
Banking	317	354	41%	12%
Consumer Non-Cyclical	74	93	10%	26%
Consumer Cyclical	70	94	10%	34%
Technology	52	64	7%	23%
Electric	35	39	5%	11%
Insurance	35	35	4%	0%
Capital Goods	34	42	5%	24%
Energy	30	45	5%	50%
Communications	24	37	4%	54%
Finance Companies	19	16	2%	-16%
Basic Industry	14	19	2%	36%
REITs	13	15	2%	15%
Transportation	12	15	2%	25%
Brokerage AM Exchanges	9	14	1%	56%
Financials	395	434	51%	10%
Non-financials	350	454	49%	30%
Total	745	888	-	19%

Source: HSBC AM, Bloomberg data, November 2023.

Figure 3: US high yield maturities (USD billion)

Sector	2024	2025	Total	% of Total
Financials	7.1	13.4	20.5	15%
Energy	1.4	15.9	17.4	13%
Travel	3.4	9.1	12.5	9%
Gaming	2.5	8.5	11.0	8%
Healthcare	1.0	8.2	9.2	7%
Transportation	3.1	6.1	9.1	7%
Technology	0.4	7.3	7.7	6%
Capital Goods	0.7	5.9	6.5	5%
Retail	2.4	3.8	6.2	5%
Services	2.0	3.8	5.8	4%
Autos	1.4	3.5	4.9	4%
Cable	3.4	0.7	4.1	3%
Utilities	1.3	2.2	3.5	3%
Packaging/Paper	0.7	2.7	3.4	3%
Media	0.4	2.6	3.0	2%
Chemicals	1.4	1.2	2.5	2%
Real Estate	0.5	1.6	2.1	2%
Telecoms	1.5	0.3	1.7	1%
Food Producers	0.0	1.4	1.4	1%
Metals	0.3	0.7	1.0	1%
BB	22.6	45.0	67.6	51%
B	7.3	37.9	45.1	34%
CCC	4.7	16.0	20.8	16%
Total	34.6	98.9	133.5	100%

Source: HSBC AM, Bloomberg data, November 2023.

Maturity walls in European investment grade and high yield markets look manageable, but certain sectors in high yield such as automotive, chemicals, retail and real estate might experience more stress.

After record issuance in 2020 and 2021 driven by the low-rate environment and the ECB Corporate Sector Purchase Programme, supply was soft in 2022, recovered somewhat this year and we expect that to continue in 2024. Both investment grade and high yield companies have sound liquidity positions and committed credit lines, although some deterioration in credit metrics is expected from a position of strength – notably on coverage ratios. Besides, it would be important to watch the identified sectors such as Auto or Healthcare with maturities over 2024 and 2025 more than doubling.

European investment grade credit metrics are at peak quality with low leverage, elevated cash balances and margins at record levels – a strong starting point that should limit the volume of fallen angels next year. High Yield credits have recovered post-Covid thanks to deleveraging and earnings growth, but weaker economies might weigh again on company fundamentals. While weakest credits remain in a fragile position in a rising rate environment, high-cash balances should sustain an increasing but moderate default rate. Particular stress is ongoing in REITs, where asset sales and search for alternative refinancing remain at the top of the agenda for most players.

Figure 4: EUR investment grade maturities (USD billion)

Sector	2023	2024	2025	% of total bonds	Variation 23/25
Autos	34	26	24	37%	-29%
Basic industry	13	15	19	26%	45%
Capital Goods	16	16	20	29%	25%
Consumer goods	15	21	23	24%	55%
Energy	12	13	13	25%	17%
Healthcare	16	15	18	20%	15%
Media	5	3	4	20%	-5%
Real Estate	11	12	20	19%	76%
Retail	6	9	8	28%	37%
Services	4	6	3	31%	-4%
Technology	8	5	10	25%	31%
Telecoms	15	14	15	21%	4%
Transportation	12	12	13	17%	10%
Utilities	19	23	33	20%	70%
Non-financial senior	190	200	228	23%	20%
Non-financial hybrid	9	10	12	14%	34%
A	70	65	75	21%	7%
BBB	109	120	139	25%	27%

Source: HSBC AM, Macrobond data, November 2023.

Figure 5: EUR high yield maturities (USD billion)

Sector	2023	2024	2025	% of Total	Variation 23/25
Autos	3,8	7,5	7,2	39%	87%
Basic industry	2,5	4,0	4,8	34%	94%
Capital Goods	3,8		3,5	17%	-7%
Consumer goods	2,2	4,7	0,8	66%	-63%
Energy	1,4	1,5	2,4	40%	73%
Healthcare	0,6	1,0	4,9	22%	721%
Leisure	2,6	1,3	1,4	21%	-44%
Media		0,5	1,7	29%	
Real Estate	1,1	2,4	3,3	35%	216%
Retail	1,6	3,1	1,6	33%	2%
Services	1,2	3,0	4,3	28%	260%
Technology		1,5	2,5	23%	
Telecoms	3,1	4,5	6,1	26%	102%
Transportation	2,3	2,2	3,6	47%	60%
Utilities	0,3	1,5	0,9	37%	163%
Non-financial senior	26,4	38,7	49,1		86%
Financial senior	3,3	9,5	11,7		261%
Non-financial hybrid	4,8	10,7	10,6	36%	120%
Financial Subordinated	3,6	8,6	6,2	61%	71%
BB	21,6	33,3	38,8	45%	80%
B	4,8	11,7	17,8	30%	272%
CCC & below	3,2	3,2	4,2	33%	30%

Source: HSBC AM, Macrobond data, November 2023.

Access to lower cost onshore debt is a key theme for USD Asian credits facing the most challenging maturity wall, which in an elevated US dollar rate environment is likely to lead to a further contraction in the size of the market in 2024.

High US interest rates and investor risk aversion to China high yield has made alternative sources of funding more attractive options for many issuers in the Asia USD bond market. In 2023 we have seen bonds in several sectors refinanced through bank loans, asset sales, internal cash as well as local bond issuance. Geographically, Korea has been an outlier with higher levels of issuance, driven by higher domestic funding costs than in USD when swapped back into KRW.

We see overall manageable refinancing risk for Asian investment grade sectors, where we would expect the China investment grade corporate complex to shrink further with the availability of relatively cheap onshore financing in a deep and liquid domestic bond market. Meanwhile, we expect financials activity to remain brisk, with Chinese and Korean banks and bank lessors likely to remain more active.

In Asia High Yield, we also expect China issuance to be tepid and for challenges to be confined mainly to individual companies where refinancing difficulties are well known.

Figure 6: USD Asia investment grade maturities (USD billion)

Sector	2024	2025	% of 2025 maturity wall	Variation 24/25
China - Banking senior	24	27	18%	10%
China - SOE	17	18	12%	3%
China - Local gvt fin. vehicle	11	12	8%	11%
China - Bank leasing	8	5	3%	-45%
China - Property	5	2	1%	-59%
China - Asset management cics	5	6	4%	20%
China Industrials	2	2	1%	-10%
HK - Corporate and property	6	4	3%	-36%
Korea - Banks and financials	10	15	11%	51%
Korea - Private corporate	3	3	2%	-8%
Korea - Quasi	3	6	4%	97%
India - Banks & Financials	4	0	0%	0%
India - Corporates	2	1	1%	-53%
SEA - Banks	5	2	1%	-60%
Macau	0	2	1%	0%
AT1	0	1	1%	-
T2	10	6	4%	-37%
TMT	6	10	7%	59
Oil & gas	8	11	7%	30%
Sovereigns	11	10	7%	-13%
Other	3	6	4%	135%
Total	144	147		
Financials and sovereigns	77.7	71.4	48%	
Non-financials	66.6	76	52%	

Source: HSBC AM, Macrobond data, November 2023.

Figure 7: USD Asia high yield maturities (USD billion)

Total	2024	2025	% of 2024 maturity wall	% of 2025 maturity wall	Variation 24/25
China - Property	7.6	7.4	27%	30%	-2%
India - Corporates	6.5	5	23%	21%	-23%
Sovereigns	2.6	0.5	9%	2%	-81%
China Industrials	2.1	1	7%	4%	-53%
India - Corporates	2	1.6	7%	6%	-23%
AT1	2	4.2	7%	17%	113%
Other	1.5		5%	0%	
Macau	1.3	2	5%	8%	48%
China - SOE	0.8		3%	0%	
Financials	0.7	0.4	3%	2%	-46%
Banks senior	0.7		2%	0%	
LGFV	0.5	1.1	2%	5%	120%
T2		0.3	0%	1%	
China - AMCs		0.3	0%	1%	
Hong Kong Corporates		0.6	0%	2%	
Total	28.4	24.3			
Financials + Sovs	6	5.1	21%	21%	
Non-financials	22.3	19.2	79%	79%	

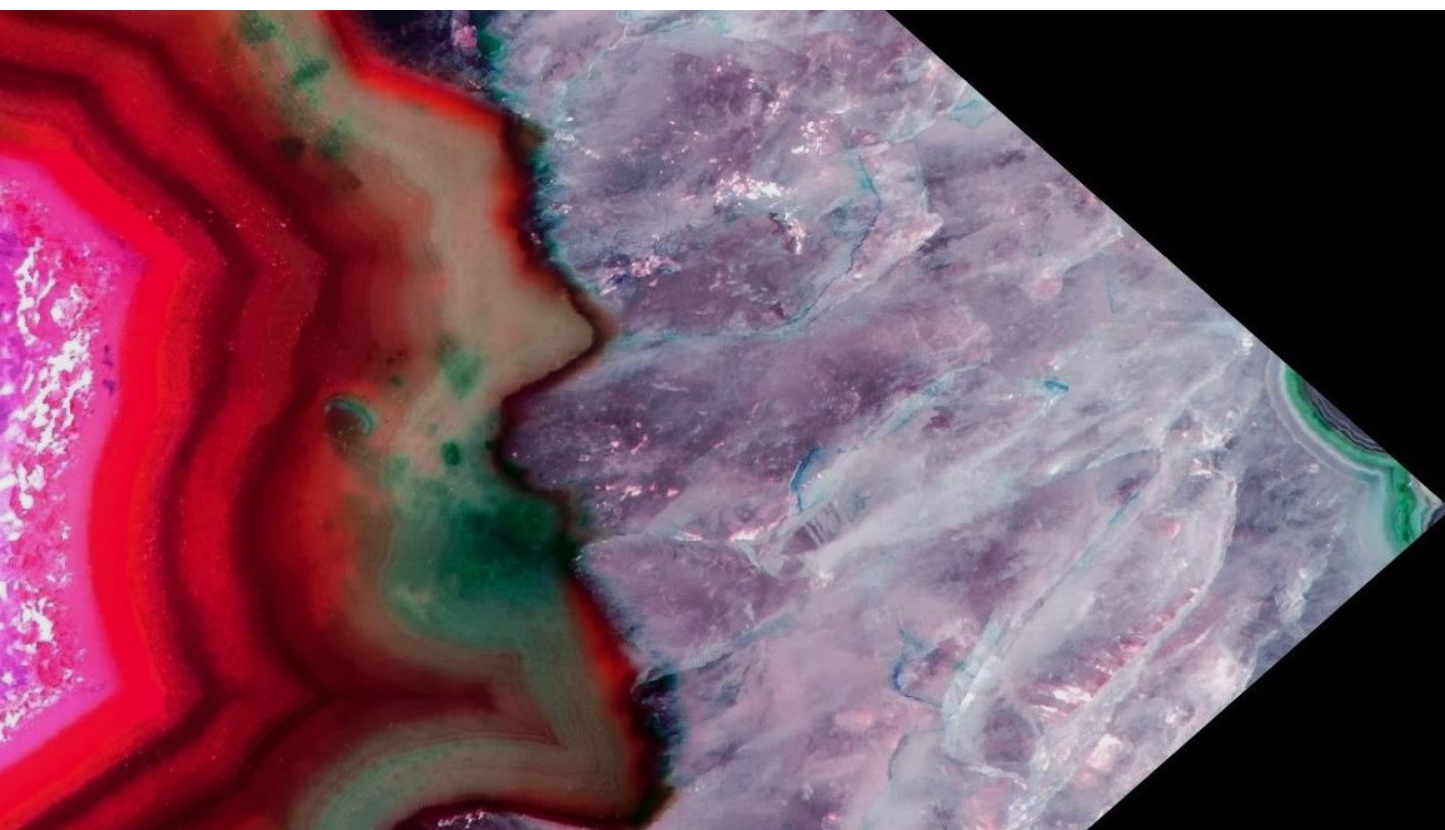
Source: HSBC AM, Macrobond data, November 2023.

The rest of the emerging market debt market is showing a similar pattern. Albeit the issuance over 2023 is up by 55% compared to 2022 when the primary market was quite subdued, and net supply stayed negative.

All regions saw higher issuance, but ME&A was the most active region and we expect this scenario to repeat over 2024 with dominance of IG issuers. On the other hand, CEE will stay negative for the third year. LatAm issuance remains quite low reflecting the still challenging conditions in international markets (similar to Asia) as well as the significant liability management many issuers took in previous years. Although we expected it to pick up next year, the region should remain in net negative territory, which would be the seventh year in a row of negative net issuance.

Overall, with the net negative issuance for emerging markets, technical factors should be positive for the asset class in 2024, notwithstanding important idiosyncratic risks.

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