BONDS IN MOTION: U.S. FISCAL SHIFTS AND ASIA'S CREDIT LANDSCAPE

2025 Q3 FIXED INCOME OUTLOOK

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Highlights:

- **The sustained elevated U.S. fiscal deficit enables the Treasury to issue more short-term debt, helping to restrain sharp upward movements in long-term bond yields**
- **Asian investment-grade dollar bonds demonstrate resilient fundamentals, low leverage, and attractive yields, with a preference for issuers in China and South Korea**
- **Limited supply and relatively low default rates underpin the appeal of Asian high-yield dollar bonds, particularly in China, India, and Macau**

High U.S. budget deficit drives increased short-term debt issuance to contain long-term yield pressures; Limited supply and strong fundamentals support Asian dollar bonds

TThe recent increase in the U.S. debt ceiling, designed to underwrite President Trump's tax cuts and expansionary fiscal policy, has heightened concerns about rising budget deficits and the resulting surge in Treasury issuance. This has prompted investors to reassess the risk-return profile of U.S. Treasuries, contributing to greater volatility in global bond markets. We believe the U.S. Treasury retains capacity to expand short-term debt issuance throughout the remainder of this year and into the first half of next year, a move that should ease upward pressure on long-term yields. Concurrently, Moody's downgrade of the U.S. credit rating has diminished the status of the dollar and dollar-denominated assets as safe havens, leading some capital to shift toward non-dollar assets.

While U.S. long-term Treasuries remain important to monitor, we advise caution amid ongoing uncertainties. Close scrutiny of macroeconomic trends and policy shifts is essential, with flexible portfolio positioning and diversification into non-U.S. bonds—such as European sovereign debt and Asian corporate bonds—advised. Currently, attractive investment opportunities exist in Asian investment-grade dollar bonds from China and South Korea, as well as high-yield dollar bonds in China, India, and Macau.

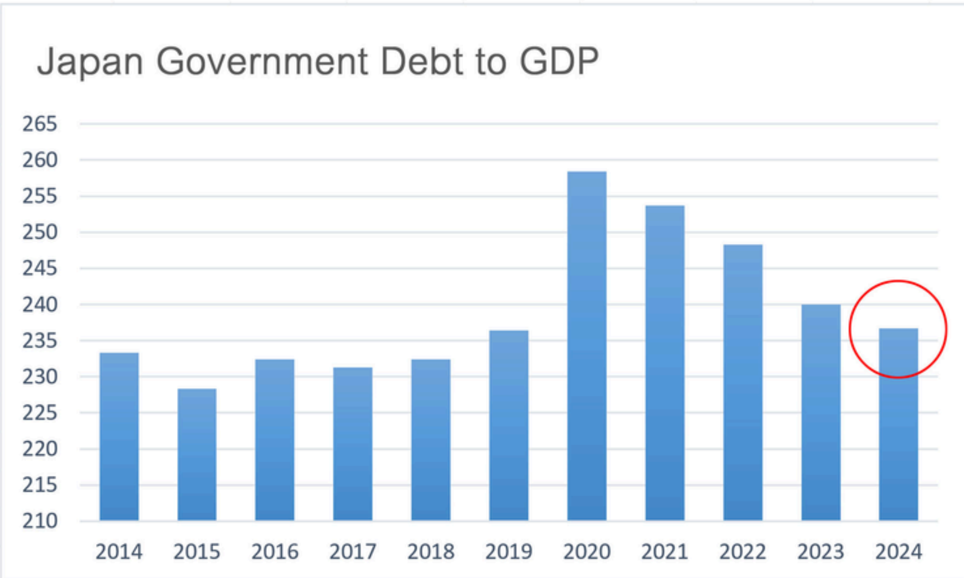
Investment-grade bonds

The enactment of the debt ceiling increase—referred to as the “Big, Beautiful Bill”—has amplified market concerns regarding fiscal risks. The legislation includes phased reductions in certain energy tax incentives, cuts to Medicaid spending, and increased tariff revenues. While some provisions offset revenue losses from extended tax cuts, the fiscal deficit is projected to remain elevated, potentially exceeding 6% of GDP in 2025 and 2026. Market apprehension persists that a substantial issuance of long-dated bonds could cause oversupply and further steepen the yield curve. Although long-term bond valuations remain pressured, accelerated issuance of short-term debt is expected to curb sharp rises in long-term yields.

Furthermore, core inflation in the U.S. has decelerated for three consecutive months, unemployment claims have risen moderately, and manufacturing activity remains weak—factors fuelling market expectations of two Federal Reserve rate cuts later this year. The 10-year Treasury yield has rebounded from June lows, potentially signalling a buying opportunity. Given ongoing market uncertainties, investors should maintain vigilance regarding macroeconomic and policy developments and adopt flexible strategies.

Global debt landscape and Asian corporate bonds

Apart from the U.S., other major developed economies such as Japan and the U.K. are grappling with rising debt burdens. Japan's debt-to-GDP ratio is approximately 236.7% for 2024, while the U.K.'s public debt stood at 95.5% as of late April. These mounting debt levels, alongside the impact of U.S. tariffs, have prompted investors to reassess sovereign bond allocations. Elevated budget deficits contribute to continued volatility in yields. In addition to U.S. Treasuries, certain European sovereign bonds still offer attractive opportunities, albeit requiring selective exposure. Persistent uncertainty around the Bank of Japan's monetary policy motivates a cautious stance on Japanese government bonds.



Source: https://tradingeconomics.com as of 13 June, 2025

In Asia, China's accommodative monetary policies and fiscal stimulus measures foster a supportive environment for corporate issuers. Signs of easing U.S.-China tensions, positive trade discussions in London, and active corporate credit developments—such as early dollar bond redemptions by logistics firms—signal improving credit fundamentals. Supply shortages further enhance technical support, especially in technology, media, and telecommunications sectors, buoyed by rapid AI advancements and positive Q1 earnings among internet companies.

Following the June presidential election in South Korea, political uncertainties diminished, allowing bond prices—previously pressured by tariff concerns—to recover. Many new Korean bond issuances are priced at discounts, offering incremental returns. Although credit spreads on some South Korean corporate bonds have tightened, valuations remain attractive. Progress in U.S.-South Korea trade negotiations could further bolster market sentiment.

Summary

The U.S. fiscal deficit and tariff tensions will continue to influence the U.S. bond market and, by extension, the broader investment-grade dollar bond space. Investment-grade bonds play a defensive role and, when combined with a diversified approach, can help investors navigate volatility.

High-yield bonds

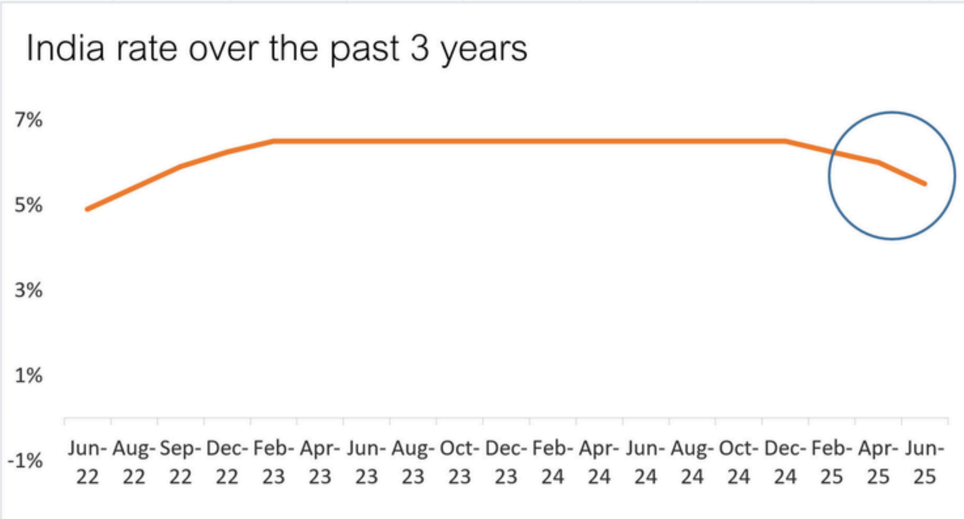
Asian high-yield dollar bonds demonstrated resilience in Q2, quickly rebounding from tariff-related pressures. This sector is less sensitive to U.S. interest rate fluctuations, though short-term volatility persists. Ongoing trade negotiation progress with key partners like India and China may improve sentiment. The expected default rate for 2025 is approximately 2.3%, a multi-year low. Persistent supply shortages provide strong technical support, particularly favouring markets in China, India, and Macau.

China's monetary policy supports high-yield dollar bonds; Focus on Industrial, Property, and LGFV bonds

In early May, China implemented comprehensive monetary easing measures to reinvigorate the economy, including a 50 basis-point cut to the reserve requirement ratio (RRR), a 10 basis-point reduction in policy rates, and lower mortgage rates. The market anticipates additional policy actions, though their likelihood in the summer appears limited. Benefiting from these supportive policies and improving economic fundamentals, Local Government Financing Vehicles (LGFV), select industrial, and property bonds merit close attention. Mainland China recorded healthy contracted property sales in May, with state-owned developers continuing to outperform private counterparts. Furthermore, credit fundamentals are showing encouraging signs; notably, a government-backed private developer secured a fifth loan from a major shareholder to meet debt obligations. Such developments improve the short-term refinancing outlook for businesses. Recent reports indicate Chinese authorities have instructed approximately 20 state-owned developers to avoid defaults on publicly issued debt. While default risk remains low for these entities, this directive is expected to facilitate easier access to domestic financing.

Rate cuts boost Indian dollar bonds; Macau casino closures under watch

India's high-yield bond market has surged, buoyed by easing geopolitical tensions, improved macroeconomic sentiment, robust fundamentals, and credit upgrades. A 50 basis-point rate cut in early June enhances corporate borrowing conditions and may shift financing preferences toward local currency instruments over dollar issuance, maintaining tight dollar supply and technical support. Infrastructure, construction, and non-bank financial sectors are key areas to watch.



Source: Investing.com, data from June 2022 to June 2025

In Macau, despite June traditionally being the slowest gambling season, gaming revenue rose 19% year-over-year, driven by growth in premium segments and new hotel openings. The recent closure of nine satellite casinos—operated under licenses from licensed casino operators—introduces some near-term uncertainties for incumbents. While closures may temporarily reduce revenue and increase acquisition costs, converting satellite casino players into higher-value direct customers could improve long-term profitability.

Conclusion

Despite ongoing uncertainties related to the U.S. fiscal deficit and trade tensions, Asian dollar bonds remain attractive, supported by solid fundamentals and limited supply. Investors should continue to monitor macroeconomic and policy developments carefully and maintain flexible strategies to adapt to evolving market conditions