First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | February 2021

Market review

Investment grade credit spreads in Asia continued to tighten, reflecting encouraging progress with Covid vaccination programs across the region, and news that a new fiscal stimulus program was likely to be approved in the US. The US$1.9 trillion package is expected to support the US economy until conditions normalize, in turn benefiting corporate earnings worldwide.

In spite of the narrowing spreads, total returns from the asset class were negative. The JACI Investment Grade Index returned -1.17% over the month, reflecting unfavourable movements in US Treasury yields. Government bond yields rose sharply worldwide as investors suggested the anticipated rebound in economic growth will result in escalating inflation.

There was a little less economic data released than usual, owing to the Lunar New Year holiday. Anecdotal evidence suggests consumer spending in China was quite solid throughout the holiday period, with online sales maintaining their recent strength. The new issuance calendar was also affected by the holidays, although Chinese e-commerce giant Alibaba did raise US$5 billion in a four-tranche issue. Interestingly, one of the tranches was a sustainability bond; the first ever issued by Alibaba.

Indonesian state-owned oil giant Pertamina returned to the US dollar bond market, raising US$1.9 billion in a two-tranche offering. The 1.4% spread on the shorter-dated of the two securities – a five-year issue – is the lowest among USD-denominated bonds currently on issue in Indonesia, underlining the perceived creditworthiness of this issuer. Indeed, final order books were comfortably oversubscribed, enabling the issue to be completed with spreads significantly below initial guidance.

Performance review

The First Sentier Asian Quality Bond Fund returned -0.65% for the month of February on a net-of-fees basis.

The return was negative largely due to a sharp rise in US treasury yield despite credit spread holding firm. Inflation expectations in the US climbed to the highest since 2014 amid hopes of a strong economic recovery following successful Covid-19 vaccine rollout and a massive fiscal stimulus.

On a relative basis, the fund outperformed the index in February as our short US duration positioning protected the portfolio from rising yields just as it did in January.

- The Fund invests primarily in debt securities of governments and corporate issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

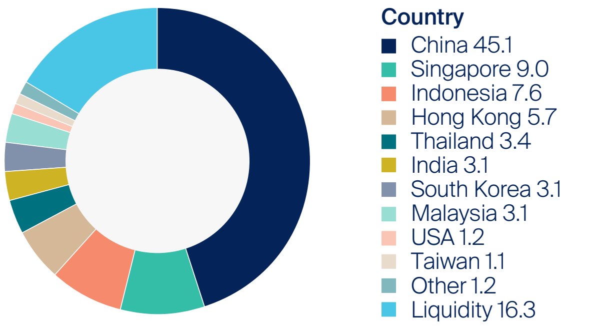
Cumulative performance in USD (%)[1]

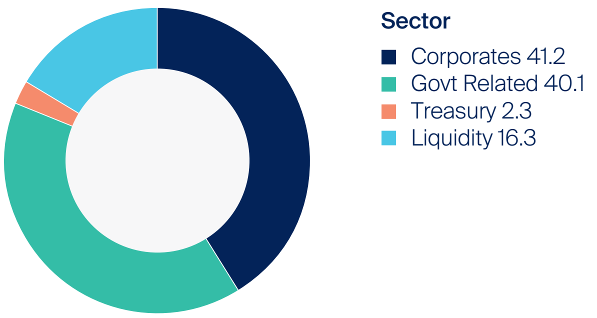
	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	-0.2	-0.6	2.3	16.7	24.0	90.8
Benchmark*	-1.0	-1.2	2.6	19.1	26.5	145.4

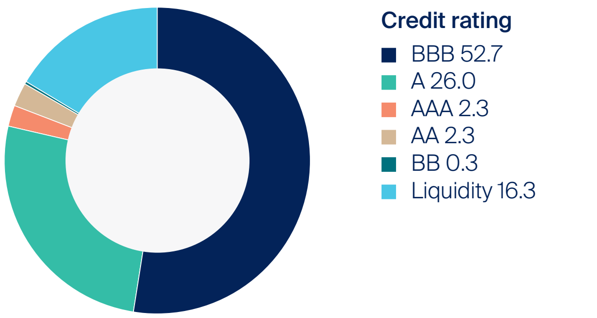
Calendar year performance in USD (%)[1]

	2020	2019	2018	2017	2016
Class I (USD - Acc)	5.9	10.9	-1.3	5.6	3.4
Benchmark*	6.9	11.0	0.0	5.5	4.5

Asset allocation (%)[1]







Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	5.1
Pertamina Persero PT	4.0
China National Chemical Corp Ltd	3.1
China National Offshore Oil Corp	2.9
Country Garden Holdings Co Ltd	2.9
China Huarong	2.5
DBS Group Holdings Ltd	2.3
China Overseas Land & Investment Ltd	2.2
Temasek Holdings (private) Ltd	2.2
Indonesia (Republic of)	2.1

Fund positioning

Activity in the portfolio was relatively light, as we monitored the impact of rising Treasury yields. Credit fundamentals in Asia remain supportive, but Treasury yields will impair total returns if they continue to trend higher.

The Fund participated in the new issuance of 10-year notes from Ping An Insurance and Pertamina. Chinese energy giant CNOOC was also added to the portfolio. The issuer appears on the US' list of sanctioned companies, but we are comfortable with its creditworthiness.

The short duration position in the US Treasury market was maintained, in anticipation of rates continuing to edge higher. This strategy aided relative performance over the month, and helped preserve capital.

Hedges over the Fund's exposures to the Chinese yuan and Singapore dollar were removed. We believe both countries are better placed than most others to contain the spread of Covid-19, which should help support their currencies on foreign exchange markets.

Q1 2021 investment outlook

As we move into 2021, the economic outlook seems a lot brighter than it was just three months ago. Vaccines against the Covid-19 virus are now being rolled out; more than four million doses have been administered, across nine countries. There will undoubtedly be distribution and logistical challenges in developing regions, but we are reassured by the pace at which the vaccine is being rolled out in countries including the US and Singapore. Hopefully these nations can provide support for others, for collective benefit. We are also encouraged by the high efficacy rate of the approved vaccines and the potential implications for economic activity levels. China, the first country to be hit by Covid-19 – and also the first to have it under control, even before the vaccines – has seen a strong recovery in consumer spending and retail activities. This positive trend may emerge elsewhere if the virus is contained. Many consumers are showing signs of lockdown and work-from-home fatigue, suggesting spending could pick up quite strongly as restrictions are eased.

Performance is based on First Sentier Asian Quality Bond Fund Class I (USD - Acc) is the non-dividend distributing class of the Fund, the performance quoted are based on USD total return (non-dividend distribution).
This Fund is a sub fund of Ireland domiciled First Sentier Investors Global Umbrella Fund Plc.
* The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.
1 Source: Lipper & First Sentier Investors, Nav-Nav (USD total return) as at 28 February 2021. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%. Fund inception date: 14 July 2003.

On the political front, the new Biden administration in the US is expected to be more collaborative with major global trading partners. Some of the inward-looking policies introduced by President Trump might even be unwound during 2021, perhaps helping to rebuild damaged relations with China. A much reduced focus on Trump's social media activity should be a further welcome development, as his random outbursts over the past four years have often spooked investors and resulted in an uptick in market volatility. In Europe, the UK has now left the European Union, following more than four years of negotiation that has dominated policymakers' agenda. December's trade agreement appears to have greatly reduced uncertainty in the region, which has weighed on sentiment since 2016.

While geopolitical uncertainty appears to be easing, we will continue to closely monitor US sanctions against companies on the list of alleged military-backed entities. The list includes several high profile State Owned Enterprises in China – Three Gorges, SinoChem, China National Chemical Corporation and China General Nuclear Power Group, for example – which are frequent issuers of US$-denominated bonds. The inability to sell bonds to US investors will inevitably affect the liquidity of these securities. We would also be concerned if US banks were prohibited from trading in these names, as such a move would further affect liquidity. The aforementioned names are among the highest quality credits in the Asian universe and any negative developments relating to these issuers could therefore limit spread tightening in the broader market.

Major central banks appear likely to keep monetary policies accommodative to help economies rebound from the Covid shock. We have questioned the effectiveness of monetary policies in dealing with what is a health crisis rather than a cyclical economic slowdown, and are relieved that US officials are starting to voice concerns about the unintended consequences of quantitative easing measures. There remains scope for financial instability worldwide if large-scale asset purchase programs are kept in place for too long. That said, we are not expecting tighter monetary conditions any time soon; it will take time for the current ultra-easy monetary policy settings to be reversed. Policymakers have indicated that policy settings will remain accommodative until there is "significant progress in economy recovery".

At some stage in 2021, we expect Federal Reserve officials to provide clearer forward guidance on the interest rate front. For now, the risk with maintaining such vague guidance is that longer-dated US government bonds could sell off sharply if economic growth and unemployment rebound strongly, particularly if inflation in the US breaches the Federal Reserve's 2% target. Such a move would affect risk assets worldwide, including corporate credit.

The Federal Reserve will likely tolerate a gradual rise in Treasury yields, in our view, particularly as 10-year yields of around 0.9% remain well below the previous low of around 1.4% in 2016. US policymakers' commitment to keep interest rates close to zero until the end of 2023 should support the 'search for yield' theme in global markets. At the same, spreads for both investment grade and high yield credit in Asia remain well above the tights seen in 2017-18, and remain attractive compared to US peers. Fundamentally, credit metrics should further improve as the availability of Covid vaccines boosts consumer and business confidence.

Persistent economic headwinds still suggest default rates in Asia will rise, but a default rate of between 3% and 4% now appears most likely; much lower than forecasts from a few months ago. Stress is most likely to be seen in idiosyncratic names, with minimal spill over anticipated in the broader market. Demand for Asian credit is therefore expected to hold up strongly and any sell-off in the market is likely to be shallow, unless confidence craters and liquidity freezes up as it did in March 2020. The sheer weight of money ready to be deployed into yielding investments is significant. The demand/supply dynamic should therefore remain a powerful technical factor driving spreads tighter in early 2021, and should be supportive of a continued rally in the Asian credit market.

While current spreads look attractive against this backdrop, the sharp drop in US Treasury yields in 2020 means the all-in yield of the JACI Investment Grade index is now close to historical lows. Indeed, we are mindful that returns could be adversely affected by a quicker-than-expected steepening in the Treasury curve. With that in mind, portfolio positioning remains cautious, with higher quality names continuing to be favoured. We will look to further diversify exposures as opportunities are identified in the new issuance market.

A further spike in Covid cases – including the spread of variants of the virus similar to what we have seen recently in the UK – remains the biggest risk to the overall encouraging outlook.

Source : Company data, First Sentier Investors, as of end of February 2021