First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | June 2021

Market review

Investment grade spreads ground tighter during the month, following the global trend. Locally, sentiment was boosted by news that US President Biden had signed an order amending the ban on American investment in 59 Chinese companies. The move is expected to help drive further spread compression in bonds issued by State-Owned Enterprises in particular, and saw improved sentiment towards issuers such as ChemChina, China State Construction Group, Sinochem Group, and China Three Gorges.

We also saw some unwinding of recent 'reflation' trades – investors now appear to believe upward pressure on US inflation will be temporary, rather than more persistent. In turn, this saw US Treasury yields fall further, and helped credit spreads tighten. The JACI Investment Grade Index returned 0.95%.

Notable new issues during the month included a US$3 billion, triple-tranche deal from the Republic of Indonesia. Firm demand for these new sovereign bonds enabled the issuer to tighten the final price from initial guidance. Other deals included a US$1.75 billion dual-tranche issue from Indofood – the largest instant noodle producer in Indonesia – and a US$300 million 5-year unsecured bond from Hong Kong and Shanghai dual-listed toll road operator Shenzhen Expressway. The latter offering was more than 20 times over-subscribed, underlining the extent of demand for high quality corporate bonds in the region.

Performance review

The First Sentier Asian Quality Bond Fund returned 0.59% for the month of June on a net-of-fees basis.

The positive return was largely due to a sharp move lower in US Treasuries yield which in turned supported the credit market.

On a relative basis, the fund underperformed the index as our short duration positioning continued to work against us this month. Our local currency bonds exposure also detracted value as the dollar strengthened against most Asian currencies.

- 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.

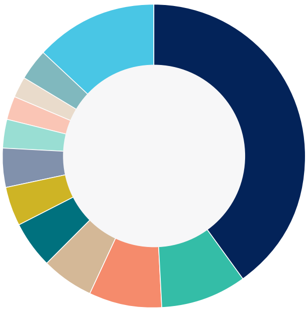
Cumulative performance in USD (%)[1]

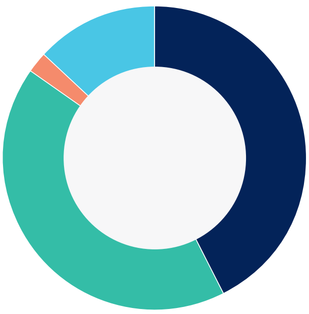
	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	0.1	-0.9	2.6	17.6	18.6	90.2
Benchmark*	1.1	-0.5	2.7	20.2	22.3	147.1

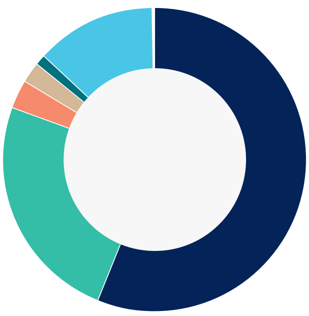
Calendar year performance in USD (%)[1]

	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)	4.8
Pertamina Persero PT	4.1
China National Offshore Oil Corp	3.1
China National Chemical Corp Ltd	3.0
Country Garden Holdings Co Ltd	2.6
Philippines (Republic of)	2.2
Indonesia (Republic of)	2.2
DBS Group Holdings Ltd	2.1
China Overseas Land & Investment Ltd	2.1
Temasek Holdings (private) Ltd	2.0

Fund positioning

The Fund's exposure to China Cinda was reduced significantly, as we believe the ongoing Huarong saga could weigh on sentiment towards the asset management sector more broadly. This move should help mitigate the performance impact of any spread widening in this part of the market.

We have been looking to increase the Fund's diversification across several countries and sectors, again to limit the performance impact of weakness in specific sectors or regions. This process continued in June, with the Fund participating in various new issues. Names added to the portfolio over the month included LG Chem and Mirae Asset Securities in South Korea, Indonesia sukuk, Philippines sovereign, RHB Bank in Malaysia and Aramco in Saudi Arabia.

The existing short duration position in the US Treasury market was maintained. This strategy added meaningful value to the portfolio earlier in the year, but has been a drag on performance over the past three months or so as US government bond yields have drifted lower. Policymakers at the Federal Reserve have started to amend their guidance for US interest rates, however, suggesting that borrowing costs could be raised earlier than was previously anticipated. Against this background, we believe it is unlikely that Treasury yields will revisit their lows from 2020 and that a modest increase from current levels remains most likely in the remainder of this year.

Q3 2021 investment outlook

Overall, we remain cautious on the outlook for Asian credit markets as we head into the second half of the year. Any pronounced sell-off could present some interesting buying opportunities. After more than a year, the world remains in the midst of the Covid pandemic. And despite vaccination rates picking up globally – especially in developed economies – there appears to be no sign of reprieve in the near term. We now have to contend with more contagious variants of the virus, which could delay the anticipated economic recovery. Separately, concerns around debt problems in China – most notably involving Huarong and Evergrande – are likely to continue to weigh on market sentiment, even though they have been largely idiosyncratic in nature thus far.

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 J.P. Morgan JACI Investment Grade Index.
1 Source: Lipper & First Sentier Investors, Nav-Nav (USD total return) as at 30 June 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.

Amid all the uncertainty regarding its economic recovery forecasts, the Federal Reserve has surprisingly turned more hawkish, indicating that US interest rates are likely to be raised before the end of 2023 if inflation continues to rise and if the economy continues to recover as anticipated. This latest guidance is in stark contrast to the previous rhetoric, which suggested policy settings would be unchanged until the end of 2023, at the earliest. We believe this change could be a game changer for credit and currency markets in the second half of this year, particularly if inflation continues to trend higher as this would inevitably put pressure on policymakers to move quicker.

The Federal Reserve has favored extremely accommodative policy settings for more than a year, since the beginning of the Covid pandemic. This has helped support sentiment, but we were always skeptical about policymakers' ability to forecast economic conditions beyond a year, let alone two. Furthermore, unlike any previous economic downturn, a Covid-led recession is highly unpredictable; hence the recovery is likely to be uncertain too. Pent-up demand has been rapidly building during lockdowns, which suggests economic activity levels could surge in the months ahead, likely resulting in even higher inflation. Federal Reserve officials continue to suggest that higher inflation is transitory, but what if their assessments turn out to be wrong? We believe the risk of spiraling inflation as activity levels rebound is what led the Federal Reserve to change its course, turning more hawkish and suggesting two rate hikes are possible before the end of 2023. Discussion around tapering the massive bond purchase program in the US is also underway. A moderation in the current pace could occur later this year, though may not have as much impact on bond and credit markets as interest rate hikes. We take some comfort that the Federal Reserve appears to be pondering the scale of its quantitative easing program, but remain concerned it may be 'too little, too late'. As we have said before, the colossal amount of money printed over the past decade or so has already led to massive asset bubbles.

Asian economies look set to recover strongly this year following the sharp contraction in 2020. Recovery rates are likely to be boosted further by an increase in vaccination rates. Using a vaccination target of 75% – perceived as a prerequisite for keeping the virus under control – China, Singapore and South Korea are on track to get the majority of their populations vaccinated in the next three months. Taiwan and Thailand will likely reach that landmark by the middle of next year, while more populated countries, like Indonesia and Philippines, will probably take almost another two years to get there. While the signs look encouraging and actual vaccination rates may even outpace these expectations, many countries continue to grapple with an even more highly transmissible 'delta' variant of the virus. Recent infections in Taiwan and Vietnam are a timely reminder of the persistent risk of fresh outbreaks, despite previous successful containment. Singapore has recently tightened restrictions to the strictest levels in more than a year given the emergence of a second wave, despite making excellent progress with its vaccination program.

Being the first economy to be hit by Covid and also the first to start recovering from it, there had been suggestions previously that the Chinese would start to tighten monetary policies and liquidity conditions. These concerns seem to have abated, with growth rates remaining uneven as domestic consumption continues to lag. Against this backdrop – along with the ongoing deleveraging of the property sector – the Chinese central bank is likely to leave accommodative policy settings in place for the rest of this year. South Korea is the only country in Asia that has explicitly signaled a potential shift in policy stance, as growth continues to bounce back strongly and as headline inflation has risen above the Bank of Korea's 2% target. Nevertheless, even if rates are raised later this year, we expect any hike would be a move towards policy normalisation, rather than representing the beginning of a tightening cycle.

Following some high profile defaults from Peking University Group and China Fortune Land – both of which have huge amounts of debt outstanding – investors have increasingly scrutinised two other sizeable issuers in recent months; Huarong and Evergrande. This has led to significant spread widening in these two names, as the market has questioned whether they are 'too big to fail'. The market's perception of implicit government support for State-Owned Enterprises also seems to have waned.

We believe Huarong remains systemically important to China's financial system, as it is one of the largest buyers of banks' bad debts. Huarong also has plenty of non-core assets that could be divested, enabling the company to meet its near-term liquidity needs. We therefore believe there is a low probability of default, but some restructuring of the company's heavily indebted non-core assets seems possible.

As for Evergrande, there has been increasing concern about the company's fundamentals since the Chinese government rolled out the 'three red lines' policy, which forces property developers to reduce leverage. Evergrande targets halving its debt to 350 billion yuan by mid-2023, fulfilling the 'red lines' for net debt to equity by mid-2021, cash coverage by end-2021 and liability-asset ratio by end-2022. We are encouraged by the aggressive plan to comply with the new policy, but anticipate some bumps along the way given the sheer size of Evergrande's debt. That said, at current spread levels the market appears to have priced in a lot of bad news already.

The Chinese government seems determined to push ahead with reforms, suggesting we will see other idiosyncratic pockets of stress, like Huarong and Evergrande. While full bailouts are no longer possible amid the reforms, there are many ways the government could lend indirect support to lessen the systemic impact should either of these two companies require restructuring. The Chinese government simply could not afford for the finance and property sectors to come under duress simultaneously.

Asian credit markets delivered lackluster performance in the first half 2021. Indeed, returns from investment grade bonds were negative, largely due to higher US Treasury yields. We think Treasury yields could rise further given heightened inflationary expectations, more fiscal stimulus and suggestions that the Federal Reserve could raise interest rates earlier than previously anticipated. Credit spreads were little changed in the first half, and appear fair considering investors' expectations of improving corporate earnings. With investment grade spreads currently below the five-year average, the scope for meaningful further tightening currently appears limited. A continued backup in US Treasury yields could, however, present an attractive entry point in terms of 'all in' yield for longer-term investors.

Finally, we believe the US dollar could weaken over time, especially with the promise of more fiscal stimulus from President Biden. That said, should the Federal Reserve turn more hawkish and talk up the likelihood of interest rate hikes and bond purchase tapering, we could see the dollar strengthen and some associated short-term weakness in Asian currencies.

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

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