First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | July 2021

Market review

Spreads on many investment grade credits in Asia widened in July, as unexpected regulatory crackdowns by the Chinese government eroded sentiment towards risk assets in the region. Officials are looking to nationalise the private tuition sector and are also seeking greater control over big tech firms, like Alibaba. These developments did little to cheer investors who were already somewhat cautious. Ongoing concerns associated with China Huarong Asset Management continued to undermine confidence, for example.

In spite of the spread widening, the asset class generated a positive return over the month – the JACI Investment Grade Index returned 0.54%. This reflected a sharp downward movement in Treasury yields. Government bond yields came under downward pressure worldwide, given rising cases of the delta coronavirus variant and the associated risk of new virus-related restrictions being introduced in key regions. Federal Reserve officials also reiterated that they are not currently concerned about rising inflation, and that recent price rises will be temporary. They also hosed down suggestions that the quantitative easing program in the US could be scaled back in the months ahead. This is important, as large-scale asset purchases are helping to keep Treasury yields low. Officials seem willing to continue providing stimulus measures to support the economic recovery, despite the highest inflation rate in a decade. Treasury yields drifted lower as investors digested this latest commentary and pushed back their expected timing of interest rate increases.

Locally, Chinese officials reduced the amount of cash that banks must hold in reserve. This policy shift came in response to slower-than-expected growth in the Chinese economy in the June quarter. Essentially the move frees up around US$150 billion of liquidity, theoretically boosting lending and supporting economic activity levels.

Elsewhere, a new US$750 million, dual-tranche issue from Adani Ports – India's largest private port operator – was not particularly warmly received by investors. All of the new bonds were sold and pricing tightened from initial guidance, but the order book was not as over-subscribed as many others recently. This underlined the current fragility of sentiment, and suggests investors will remain selective in their security selection.

Performance review

The First Sentier Asian Quality Bond Fund returned 0.17% for the month of July on a net-of-fees basis. The positive return was largely due to a sharp move lower in US Treasuries yield despite the spread widening in credits. On a relative basis, the fund underperformed the index as our short duration positioning continued to work against us for yet another month.

- 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.

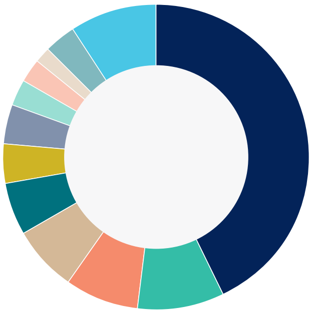
Cumulative performance in USD (%)[1]

	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	0.9	-0.7	0.4	17.1	17.3	90.5
Benchmark*	1.9	0.0	1.1	20.4	21.4	148.4

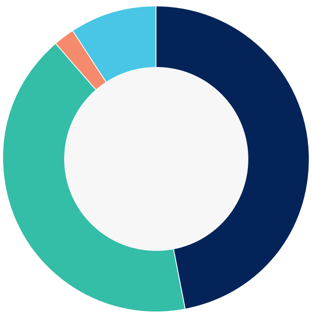
Calendar year performance in USD (%)[1]

	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

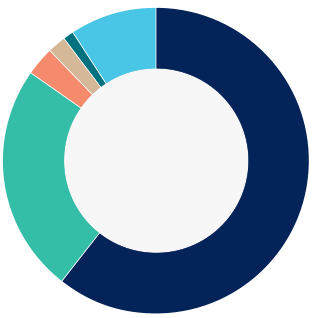
Asset allocation (%)[1]



Country
- China 42.9
- Singapore 9.0
- Indonesia 7.9
- South Korea 7.0
- Hong Kong 5.4
- Malaysia 4.3
- Thailand 4.0
- India 2.9
- Australia 2.6
- Philippines 1.6
- Other 3.2
- Liquidity 9.1



Sector
- Corporates 47.1
- Govt Related 41.6
- Treasury 2.2
- Liquidity 9.1



Credit rating
- BBB 60.5
- A 24.3
- AA 2.9
- AAA 2.1
- BB 1.0
- Liquidity 9.1

Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	4.7
Pertamina Persero PT	4.0
China National Offshore Oil Corp	3.0
China National Chemical Corp Ltd	3.0
Country Garden Holdings Co Ltd	2.5
Korea Investment Holdings Co., Ltd.	2.4
Indonesia (Republic of)	2.2
China Mengniu Dairy Company Limited	2.1
DBS Group Holdings Ltd	2.1
China Overseas Land & Investment Ltd	2.1

Fund positioning

We continued to add selectively to the Fund's investments, participating in new issues from Xiaomi, China Modern Dairy, Korea Investment and Securities, and Haidilao. Adding exposure to these names further increased the existing diversification in the portfolio.

We also increased investment in China Huarong Asset Management, which offers reasonable value in our view after the bonds were affected by delays in the release of financial results. In mid-month, the company announced it will redeem some perpetual bonds on issue despite the securities trading below their par value. This was an encouraging development, and might support sentiment towards the embattled issuer.

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.

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.

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 31 July 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.

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 July 2021