First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Market review

Despite some volatility in spreads during the month, investment grade credit in Asia was little changed in December as a whole. The JACI Investment Grade Index returned -0.07%. In fact, it was a similar story in the 2021 calendar year – spreads fluctuated during the year as sentiment ebbed and flowed, but the market was almost flat in the year as a whole (-0.01%).

December started with 'risk-off' tone, following detection of the latest Covid-19 variant, Omicron. Sentiment improved slightly after the People's Bank of China lowered reserve ratio requirements by another 50 bps; the second move by the central bank in 2021 to support economic growth. Nonetheless, valuations remained affected by various unsettling headlines and developments in the Chinese high yield property sector.

Shimao, a large Chinese developer, was stripped of its investment grade rating as Fitch and S&P both downgraded the firm's debt – to BB and B+, respectively. The bond price had already fallen sharply earlier in the month, following rumors over non-repayment of debt and possible trust loan extensions. Later in the month, there were some more encouraging developments as the company committed to improve its cash flow and working capital position. Management announced the company will sell US$367 million of Hong Kong property and loans, which helped the bonds partially recover earlier losses.

The new issuance calendar was relatively quiet approaching the year-end holiday season. That said, State Power Investment Corporation – one of the major electricity generation companies owned by the Chinese Government – raised US$1.2 billion through the issuance of new preference shares. Demand for the offer, which was rated A2 by Moody's, A- by S&P, and A by Fitch, was quite firm, with the order book nearly 2x oversubscribed.

Away from China, we saw a rebound in spreads among Asian sovereigns. Demand for longer-dated bonds improved after spreads had initially widened following the Omicron news. Securities issued by Indonesia and the Philippines performed relatively well, for example.

Performance review

The First Sentier Asian Quality Bond Fund returned -0.39% for the month of December on a net-of-fees basis.

The negative return was largely due to sharp decline in Shimao bond prices following rumors of possible trust loan extension. The decline was exacerbated by Shimao's rating downgrade by both Fitch and S&P.

On a relative basis, the fund underperformed the index largely due to our overweight in Shimao.

- 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 may also expose to RMB currency and conversion risk.
- 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.

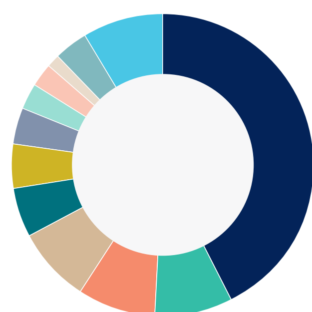
Cumulative performance in USD (%)[1]

	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	-1.4	-1.8	-1.8	15.3	20.2	88.5
Benchmark*	0.1	0.0	0.0	18.6	25.0	148.4

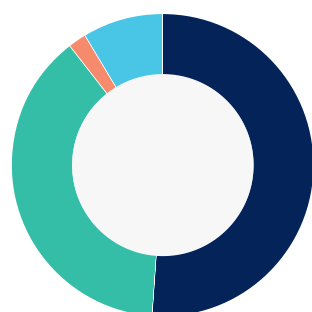
Calendar year performance in USD (%)[1]

	2021	2020	2019	2018	2017
Class I (USD - Acc)	-1.8	5.9	10.9	-1.3	5.6
Benchmark*	0.0	6.9	11.0	0.0	5.5

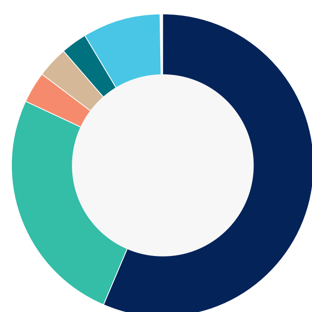
Asset allocation (%)[1]



Country
- China 42.7
- Singapore 8.4
- South Korea 8.3
- Indonesia 7.9
- Hong Kong 5.3
- Malaysia 4.7
- Thailand 3.9
- India 2.8
- Australia 2.5
- Philippines 1.4
- Other 3.8
- Liquidity 8.4



Sector
- Corporates 51.3
- Govt Related 38.2
- Treasury 2.1
- Liquidity 8.4



Credit rating
- BBB 56.6
- A 25.6
- BB 3.4
- AAA 3.3
- AA 2.8
- Liquidity 8.4

Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	4.8
China National Offshore Oil Corp	3.0
Indonesia (Republic of)	2.8
China National Chemical Corp Ltd	2.4
China Huarong	2.4
Korea Investment Holdings Co., Ltd.	2.3
Shimao Group Holdings Limited	2.3
China Mengniu Dairy Company Limited	2.0
China Overseas Land & Investment Ltd	2.0
Temasek Holdings (private) Ltd	2.0

Fund positioning

Not too many changes to portfolio positioning were made over the month, although exposure to the Chinese property sector was reduced via sales in Shimao and Country Garden.

The short position in US interest rate duration was maintained, in anticipation of a further increase in Treasury yields. Bond yields rose during December as the market continued to focus on escalating inflation, which provided a modest tailwind to performance.

Q1 2022 investment outlook

Despite the ongoing concerns around the COVID Omicron variant dominating the headline news, we believe the key driver of markets as we head into 2022 will be monetary policies normalisation led by the US Fed, followed by the ECB. After all, Fed Chairman Jerome Powell has all but turned hawkish, dropping the "transitory" stance on inflation, which has remained stubbornly at elevated levels. While we do not expect the Fed to move too aggressively in terms of rate hikes, the risk is for them to finally admit they have been behind the curve, should inflation prints stay high over the course of the New Year. Given the lofty valuations of the US equity market along with tight credit spreads especially in US investment grade bonds, we maintain our cautious stance towards risky assets as we move away from ultra-easy monetary conditions. We would also keep a close eye on Chinese government's policies on the property and technology sectors as these would affect sentiments in the Asian credit markets.

US inflation has been hovering around levels not seen before for the past three decades. The US Fed has for months maintained that high inflation is transitory, as they believed supply chain disruption has been the main cause for higher prices and they expect the bottleneck to ease as economy return to normalcy. It is unfathomable that they have been oblivious to the impact of higher wages and a strong domestic demand, both of which have and will likely continue to exert upward pressure on prices. As real interest rates are now deeply negative, the US Fed now has little choice but to hike rates in 2022 in order to uphold their credibility. Expectation is for them to hike 3-4 times in the New Year, which will bring the Fed fund rate to around 1%, a relatively benign hiking pace when put into context with the terminal rate of around 2.25-2.5% achieved during the previous hiking cycle. Interestingly, we observed that despite the high inflation print and a heightened rate hike expectations, the 10-year Treasury yield has remained below 1.5%. We believe while the Omicron variant could have kept yields low in recent weeks, the market looking beyond the current high inflation and pricing in slower growth after the rate hike is another explanation for the low treasury yields as the yield curve continues to flatten. While not our base

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 December 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.

case, US economy heading into stagflation, something which has not happened for decades, cannot be totally ruled out.

While Bank of Korea has started hiking policy rate and Monetary Authority of Singapore has moved to a tightening stance, central banks over in Asia are not pressured to move too quickly as inflation remains benign as the region did not see as strong a rebound in domestic demand when compared to the advanced economies. Countries like India and Indonesia, both of which suffered from previous episodes of Fed's tightening and taper are now in much better shape. India has recovered strongly from a dire COVID hit spell and look set to maintain its investment grade rating, while Indonesia has also benefitted strongly amid higher commodity prices which has helped improved its balance of payment fundamentals as it is a major exporter of coal and crude palm oil. EMD as an asset class will remain volatile amid a Fed rate hike cycle and hence spreads for Indonesia and Philippines sovereign and quasi bonds may face some volatility. Nevertheless, we do see any prolonged weakness as a buying opportunity as these two countries are low beta within the EMD space.

While a Fed rate hike cycle is usually accompanied by a period of continued USD strength and hence Asian currencies weakness, that trend could be quickly reversed should the ECB start to tighten its monetary conditions amid rising inflation in Eurozone, reaching levels not seen for decades. Furthermore, should expectations of slower growth gain momentum, bullish dollar positioning could further be pared down. Rate hikes by Asian central banks may also help to ease some depreciating pressure on their currencies. The Asian dollar index has gained more than 3% in 2021. Barring the Fed entering into an aggressive hiking cycle, further upside for the dollar is likely to be more gradual.

Despite facing numerous challenges throughout 2021, which include the Huarong saga, clampdown on China's technology sector and the ongoing liquidity crisis in the property sector, Asian credits' valuation (excluding property) are currently trading at close to historical tight. This leaves us with little buffer to cushion against the imminent rate hike by the US Fed and hence total return's expectation for 2022 needs to be tapered.

While we do not expect a U-turn in the Chinese government's policies around the tightening of regulations for the technology sector and deleveraging of the property sectors, any softening in tone or steps to support growth should be closely watched as this will likely bring about a change in sentiments which has clouded the market for many months. We maintain that the Chinese property market is currently facing a liquidity crisis, not a solvency crisis. The key question is how much longer can China tolerate the pain? After all, the property sector accounts for at least 20% of GDP growth and has indirect impact on other sectors such as steel and cement. More importantly, the prospect of significant job losses and social unrest as a result of a collapse in property market can never be underestimated. Based on current valuation, the property sector is pricing in a default rate of close to 40%, which suggests the market is trading on fear rather than on fundamentals. Nevertheless, with numerous bond maturities coming up in the first quarter 2022, the sector can remain under pressure in the months ahead.

While the concerns over China remains, there are some bright spots within Asian credits. India's economy has recovered strongly after being ravaged for months by COVID. This led to Moody's changing the sovereign's outlook from negative to stable. This has all but removed the downgrade risk to high yield for many India investment grade credits. Similarly, Indonesia has recovered strongly from the pandemic and has been benefitting from the high commodity prices, being a major commodity exporter. The stronger balance of payment positions, a benign inflation and with foreign investors holding of the local currency government bond at historical low means that Indonesia will likely weather the upcoming Fed rate hike much better than the previous episodes.

The supply picture looks highly favorable for Asian credits in 2022 with gross supply likely to remain little change from 2021. In fact, we believe some of next year's maturities could already been pre-funded to take advantage of the current low rates in anticipation of the Fed rate hikes. India and Indonesia corporates are likely to benefit from the continued improvement in onshore funding and hence have lesser need for USD issuance. Chinese high yield sector remains shut amid the high double-digit yields many issuers are trading at. Overall, we believe demand will continue to dwarf supply especially should we get a boost from a change in sentiments towards China.

In conclusion, we do not expect the Omicron or any subsequent variant to derail economic recovery in the 1st half of 2022. The determination by many countries to "live with COVID" remains strong after almost two years of fighting the pandemic. Monetary policies by the Fed and the ECB taking over COVID as the key market driver are likely as we head into 2022. China's policies will also have an important bearing on Asian credits' performance. Against the above mentioned backdrop, we bring along a cautious stance as we move into the new year, while patiently await for opportunities to emerge.

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

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