First Sentier
Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | February 2022

Market review

Weakness in Asian credit persisted in February, as Russia's invasion of Ukraine eroded risk appetite globally. The JACI Investment Grade Index declined by 1.70%, with spreads widening in most parts of the market. Investors generally favored the perceived stability of higher quality issuers, which saw Financials names outperform.

Further upward pressure on US Treasury yields also acted as a headwind. Consumer prices in the US are now 7.5% above levels from a year ago, ratcheting up pressure on officials to tighten monetary policy settings. By month end, investors were anticipating as many as six interest rate hikes in the US this year. Money market pricing suggests the Federal Funds rate will start to be raised during March. An initial 0.25% increase seems most likely, although some observers are still anticipating a more aggressive, 0.50% hike. All of this continued to exert upward pressure on Treasury yields.

Although sentiment was dominated by the outlook for interest rates and rising geopolitical tensions, some local factors added to market volatility. In the Chinese property sector, for example, we saw more supportive measures (e.g. lower mortgage rates and banks selling bonds to raise capital to lend), but these were negated somewhat by less encouraging developments (e.g. Zhenro sought consent for a debt exchange in order to avoid formal default).

Issuers in Hong Kong tended to perform poorly, as rising Covid-19 infections in the city led to the introduction of stricter measures. Officials are planning a widespread Covid testing program in March. Anybody testing positive for the virus will be sent to a government isolation facility. This threat saw mobility plummet in the city, and could feed through to lower activity levels and weaker GDP growth in the near term. Spreads also widened in the Philippines and Indonesia, owing to speculation about the probability of interest rate hikes.

In other news, Chinese regulators issued new guidelines asking food delivery platforms to lower fees for restaurants and offering preferential fees to restaurants in regions most adversely affected by Covid-19. Meituan was among the casualties of the new requirements, with spreads widening quite sharply. On the positive side, Fitch upgraded China Huarong Asset Management by one notch, to BBB+. Fitch cited the likelihood of extraordinary support following completion of the company's recapitalisation in December.

The primary market was fairly quiet given the uptick in volatility and the requirement for issuers to offer attractive new-issue premiums to attract demand. Some firms appeared to postpone new issuance and will wait for conditions to stabilise before coming to the market. With interest rates expected to increase sharply, investors are favoring shorter-dated issues and asking for high new-issue premiums for longer-dated deals. For now, supply remains skewed towards investment grade names, primarily in China and Korea. Notable new issues in February included Citic – one of China's largest conglomerates – which completed a multi-tranche, US$1 billion deal. CDB Leasing and aluminum company Chalum also completed sizeable deals, raising US$950 million and US$600 million, respectively. Both offers attracted reasonable demand. In Korea, Kia Motors, Korean Development Bank, and Kookmin Bank all successfully raised fresh capital.

Performance review

The First Sentier Asian Quality Bond Fund returned -2.29% for the month of February on a net-of-fees basis.

The negative return was largely due to weakness in spread and higher US Treasury yield movements.

- 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.

On a relative basis, the fund underperformed the index largely due to our overweight in Shimao. However, our underweight in Indonesia and underweight US rates helped to offset some of the underperformance.

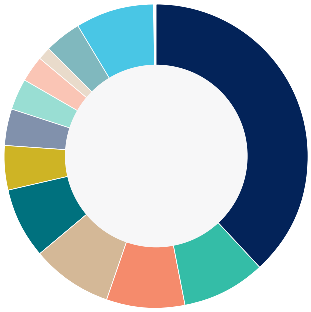
Cumulative performance in USD (%)[1]

	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	-4.7	-4.3	-5.5	7.5	12.7	80.3
Benchmark*	-3.6	-3.6	-2.4	11.8	18.1	139.6

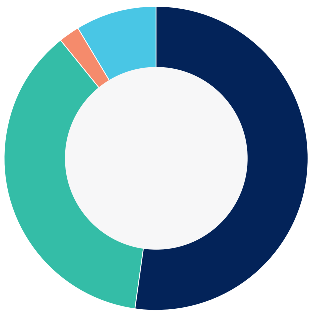
Calendar year performance in USD (%)[1]

	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

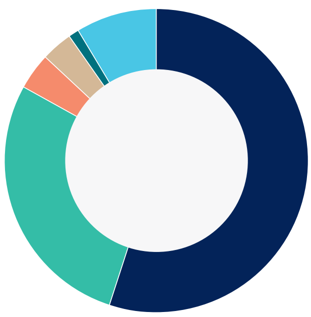
Asset allocation (%)[1]



Country
- China 38.2
- Hong Kong 8.9
- South Korea 8.5
- Singapore 8.4
- Indonesia 7.6
- Malaysia 4.7
- Thailand 3.9
- India 3.4
- Australia 2.8
- Philippines 1.3
- Other 3.9
- Liquidity 8.5



Sector
- Corporates 52.4
- Govt Related 36.8
- Treasury 2.2
- Liquidity 8.5



Credit rating
- BBB 55.2
- A 27.9
- AA 3.9
- AAA 3.4
- B 1.1
- Liquidity 8.5

Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	4.9
China National Offshore Oil Corp	3.0
Indonesia (Republic of)	2.7
PCCW LTD	2.6
Korea Investment Holdings Co., Ltd.	2.4
China Mengniu Dairy Company Limited	2.1
China Overseas Land & Investment Ltd	2.0
Temasek Holdings (private) Ltd	2.0
Bank of Communications Co Ltd	1.8
DBS Group Holdings Ltd	1.7

Fund positioning

Credit risk in the portfolio was reduced, following the sale of some higher beta names. We sold Haohua, Xiaomi, Citic, Huarong, and also liquidated the Fund's investment in Orient Asset Management.

Separately, the Fund's short duration bias was maintained. In spite of the uptick in geopolitical tensions, inflationary pressures remain a genuine concern and will see the Federal Reserve respond quite aggressively with interest rate hikes, in our view. This is expected to feed through to higher Treasury yields.

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

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 28 February 2022. 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.

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 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 February 2022