First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | May 2022

Market review

The Asian investment grade credit returned 0.49% in May, rally in US treasury more than offset credit spread widening, following a broader fall in risky assets. Asia Investment Grade (IG) spreads widened by 8bps to 201bps. A combination of China's weak macro backdrop with its zero-Covid policy and heavy outflows from Emerging Market (EM) bonds kept Asia credit spreads elevated. We believe that Asian credit still offers decent value relative to the broader credit market, though we remain selective in credits that are able to ride through this volatility.

In China, the policy tone developed positively over the month, as the China Securities Regulatory Commission (CSRC) signaled the market to provide reasonable financing support for bond issuances from Chinese developers. The People's Bank of China (PBoC) also cut the five-year loan prime rate by 15bps to 4.45%, lowering home financing costs. This policy easing helped support overall sentiment in the property sector particularly amongst higher quality issuers. Encouragingly, Longfor and Country Garden announced plans to issue RMB500mn (US$74.8mn) of onshore bonds with credit protections features.

China asset management companies (AMCs) witnessed a mix of headlines. Greatwall AMC delayed announcing their 2021 financial results, leading to bouts of sell-off amongst AMCs, a situation similar to what was seen with Huarong in 2021. The news led to a widening spread of Greatwall bonds although later on, the company confirmed that they were operating normally and indicated to release their financial result by 30 June 2022. China Cinda, another government-supported AMC, had its USD bonds downgraded by Moody's to Baa1 on the back of deterioration of profitability, worsening capital adequacy, and rising risks from sizeable property exposure. In contrast, Huarong announced a proposal to issue up to RMB20bn (US$3bn) of additional Tier 1 (AT1) capital and will hold extraordinary shareholders meeting in the middle of June. If successful, it will improve its capital adequacy ratio closer to its peers. The bonds rallied across the curve. We continue to hold our view that these AMCs play an important role to China's economy and governmental support will remain intact. We maintain our overweight bias for Huarong.

In the sovereign space, spreads widened on heavy EM hard currency outflows and poor market sentiment. Asia IG sovereign fundamentals remain intact despite the broader market sell-off in the first half of the month. As rates stabilized, the Indonesian government managed to issue its biggest dual-tranche Sukuk of US$3.25bn at an attractive pricing, which was 3x oversubscribed. We hold a mild positive stance for IG-rated sovereigns such as Indonesia and the Philippines while avoiding frontier markets.

Overall volume in the Asia primary issuance market remained subdued, as the risk-off tone and rate volatility dampened issuers' appetite. Issuance came primarily from IG issuers with high new issuance premiums to attract demand. Notable issuances included a dual-tranche US$3.25bn Indonesia Sukuk, US$500mn China Merchants Port Holdings, US$350mn Exim Bank of Thailand and US$550mn ENN Energy issuances.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned -0.25% in May, underperforming its benchmark by -0.48%.

The negative return was largely due to weakness in credit spreads. Our exposure in China property detracted from performance.

- 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.

	We thought that...	Therefore, we...	And the results...
US Rates	Markets had more than priced in impending rates hikes and US rates would be range bound as growth moderates.	Closed an underweight duration position versus the benchmark and maintain a neutral stance for US rates in the portfolio.	The neutral duration positioning had a negligible impact on performance.
Asian IG	Fundamentals remain sound in Asian investment grade (IG) corporates. Valuations are increasingly attractive on the back of the recent credit spreads widening.	We maintained a cautious approach amid the enormous uncertainly in the investment landscape, focusing on names with strong fundamentals and the wherewithal to survive further market volatility. In the primary market, we added to select primary market names, particularly new issue premium presented attractive valuations.	The fund's allocation to high quality Indonesia quasi-sovereigns such as Pertamina and PLN were additive to performance. The fund's overweight in credit spreads detracted from performance as credit spreads widened.

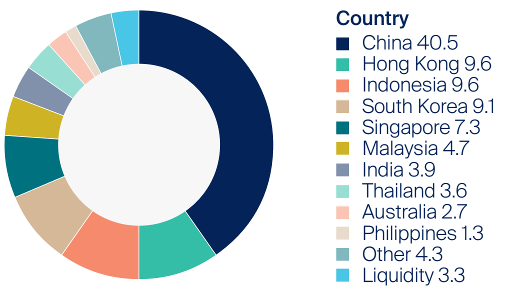
Cumulative performance in USD (%)[1]

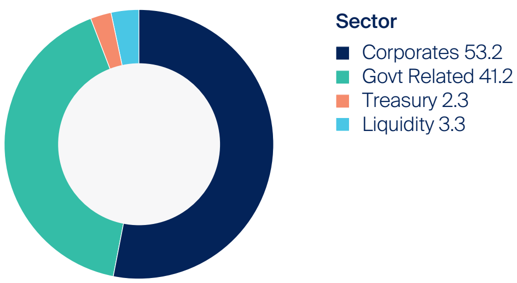
	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	-4.7	-8.8	-9.1	-1.2	5.7	71.8
Benchmark*	-4.1	-7.5	-6.2	3.6	11.6	129.7

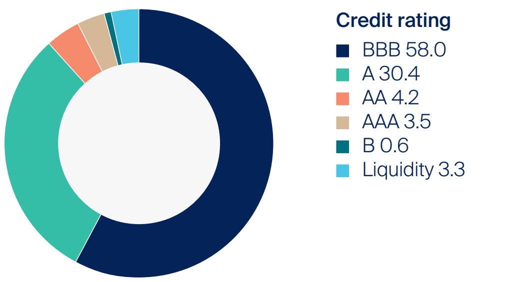
Calendar year performance in USD (%)[1]

	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]







Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	5.1
Indonesia (Republic of)	3.5
China National Offshore Oil Corp	2.8
China Overseas Land & Investment Ltd	2.8
PCCW LTD	2.6
Korea Investment Holdings Co., Ltd.	2.5
Pertamina Persero PT	2.3
Perusahaan Listrik Negara	2.2
China Mengniu Dairy Company Limited	2.2
Alibaba Group Holding Ltd	1.9

Fund positioning

The previously-held short position in US rates has been removed, following a prolonged period of rising yields. As valuations became increasingly attractive in the China property sector, the portfolio added to higher quality, defensive names that we believe have the wherewithal to survive further market volatility, such as Vanke, Country Garden, China Resources Land and China Overseas Land. In the technology sector, we also added Alibaba. We closed our underweight position in Indonesia by purchasing long-dated PLN bonds and Indonesia's Sukuk new issuance.

Q2 2022 investment outlook

Such a meaningful repricing in the US Treasury market was unsurprising given the strength and persistence of inflation. Headline CPI in the US remained stubbornly high throughout the quarter, with escalating geopolitical tensions adding to already disrupted supply chains. Specifically, the Russia-Ukraine war pushed up oil, commodity and food prices and fed through to heightened inflationary expectations going forward.

Many market participants are likening the current interest rate outlook in the US to the rate hiking cycle in 1994. It is important to note, however, that inflation at that time was lower than it is now, and that the Federal Reserve was not as far behind the curve as it appears to be today. Moreover, we have not seen a stagflationary environment since the 1970s; few investors have experienced conditions like we are seeing now in their careers. The ongoing Covid situation and the Russia-Ukraine conflict are adding to the complexity in analysing and navigating markets.

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 May 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.

The military conflict in Eastern Europe is now into its second month and could have meaningful implications for Asia if it persists. The war has already disrupted oil and commodity supplies, resulting in a sharp increase in prices. This will likely act as a pressure point for external balances; with the exception of Malaysia, most Asian economies are net commodity importers. India and Philippines appear most at risk. While Indonesia will end up having a higher energy import bill, this should be partially offset by its higher exports of other commodities including palm oil, coal and base metals. We have witnessed some weakening of the Indian rupee and Indonesian rupiah and the central banks might have to intervene with more aggressive rate hikes if the weakness persists. The more open economies in Asia – including South Korea, Singapore and Taiwan – all started their monetary policy normalisation path in Q3 last year and are set to continue. Indonesia and Malaysia are expected to raise rates in Q2, while the Philippines and Thailand will likely follow suit later in the year. All are expected to normalise policy settings gradually, but the probability of them having to move more quickly than expected has undoubtedly increased.

In the US, the Biden administration seems determined to reduce the budget deficit, unwinding several years of excesses during the Trump Presidency. This means monetary and fiscal policies are both becoming more restrictive at a time when the world is grappling with the uncertainties of the Covid-19 pandemic and the Ukraine conflict. The likelihood of stagflation in the US has therefore increased, as suggested by the Treasury yield curve. The curve inverted briefly in March, with yields on 2-year notes rising above those on comparable 10-year securities. We are seeing similar inflationary pressure in Europe, suggesting the European Central Bank will have to bring forward its own rate hiking cycle. Elsewhere, while inflation in Japan remains below the central bank's 2% target, the recent rise in Japanese Government Bond yields could be a warning signal for financial markets that the Bank of Japan will also eventually act, following many years of ultra-easy monetary policy.

On a more positive note, the recently concluded China National People's Congress meeting confirmed a commitment by the Government to target GDP growth of 5.5%. This appears optimistic, in our view, given the ongoing contraction in the property sector, which is estimated to account for at least 20% of GDP. The high likelihood of further large-scale lockdowns owing to China's 'zero tolerance' approach to Covid-19 also suggests Government policy will be pro-growth in the months ahead. Support will likely come in the form of targeted fiscal stimulus, while monetary policy will likely remain accommodative. We are also comforted by an easing in policy stance, following months of downturn in the property sector. A relaxation in local policy settings seems likely and overall financing conditions for property firms should improve in the months ahead. Debt restructuring in Kaisa and Evergrande (expected in the second half of the year) could provide more clarity for the path ahead for other developers, thereby boosting sentiment towards the distressed sector.

Sentiment towards Chinese credits has been hampered by slowing GDP growth. We have also seen increased regulation across several sectors including property, education and technology. The possible delisting of Chinese technology stocks listed in the US and concerns around US sanctions should China invade Taiwan are also eroding investors' confidence. While many of these concerns are warranted, some of the associated spread widening appears to have been overdone. Accordingly, we are seeing some value emerging, especially in the technology space and in selected State Owned Enterprises.

Asian investment grade spreads closed the quarter at +192bps, close to the five-year average. Current valuations therefore seem fair given the prevailing uncertain environment globally. That said, following the recent increase in US Treasury yields, the 'all in' yield for Asian investment grade credit is above 4%. This presents an appealing potential return, particularly for long-term investors.

Valuations in the Asian high yield sector remain at depressed levels, hampered by the Chinese high yield property sector. We continue to look for further signs of stabilisation in this space, which will include a return to the new issuance market for certain developers alongside debt restructuring plans for Evergrande and Kaisa. A rebound in the Chinese high yield property sector could have a positive spillover impact for the broader Asian investment grade market.

As for Asian currencies, we are maintaining a cautious stance given the imminent rate hiking cycles in the US and Europe. The US dollar is likely to remain strong relative to Asian currencies against a background of quantitative tightening by the Federal Reserve, which is expected to start soon. We also see some potential upside in Asian rates in the coming quarter, as markets do not appear to have adequately priced in more aggressive rate hiking scenarios from various Asian central banks.

Source : Company data, First Sentier Investors, as of end of May 2022

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