First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | December 2023

Market review

The strong bond market performance from November displayed healthy momentum into the end of the year as dovish comments from some Fed officials gave the rally further room to run. The Asian credit market returned 2.69% in December, bringing total returns for the year to 7.02%. JACI Asian Investment Grade (IG) credit spreads tightened by 7 basis points (bps).

Fears of policy risks were reignited when the National Press and Publication Administration in China (NPPAC) announced draft rules to quell excessive consumer spending on domestic online games. Aided by strong market technicals and robust fundamentals, bond prices of Tencent remained stable even as equity prices sold off. Concerns abated to some extent when NPPAC announced that they would further revise the draft articles after taking into consideration stakeholder views. Moody's changed the outlook for China sovereign to Negative from Stable, citing that "China's usage of fiscal stimulus to support local governments and its spiraling property downturn is posing risks to the nation's economy". Moody's also lowered the rating outlook on Hong Kong and Macau, 33 China SOEs, 22 LGFVs and 3 China POEs including BABA and Tencent as well as 8 Chinese banks to Negative following the sovereign rating action. However, after the initial small widening of sov CDS, the credit market remained calm after the rating actions.

Investment grade sovereign bonds performed well in December, with returns contributed largely by the rally in US Treasuries. Indonesian sovereign bonds was an outperformer among Asian countries.

The primary market for Asian US Dollar bonds was quiet into year-end, with China being the only market with investment grade issuances.

Fund positioning

The Fund increased its duration positioning relative to benchmark as the rally in US Treasuries continued into December. Some T-bills were deployed into Chinese credits with good upside potential and long dated local currency bonds.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned 3.89% in December, outperforming its benchmark by 1.20%.

The Fund's overweight in duration was positive for performance as bonds rallied on the back of lower US Treasury yields. An underweight in sovereign bonds from Indonesia and the Philippines detracted from performance, but this was compensated by an overweight in Indonesian quasi-sovereigns and security selection. Exposure in local currency bonds and the Japanese yen added to performance as the US Dollar weakened.

- The Fund invests primarily in debt securities of governments or quasi-government organization in Asia and/ or 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	The US economy would start showing signs of weakening and US rates would start to show signs of peaking. However, prices will remain high and the likelihood or rate cuts remains low	Maintained an overweight bias for US rates in the portfolio, with a tactical approach in light of the recent volatility in rates	The Fund's overweight in US rates versus the benchmark contributed to returns as US rates moved lower during the month
Asian IG	Amid rich valuations, fundamentals remain sound in Asian Investment Grade (IG) corporates	Remained focused on high quality names that are deemed more resilient should the market enter a risk-off mode	Overall investment grade spreads continued to tighten, contributing to the Fund's overweight in credit. An underweight in sovereigns in Indonesia and the Philippines detracted from performance as spreads narrowed, though this was offset by the overweight in Indonesian quasi-sovereigns

Q1 2024 investment outlook

2023 has not been for the faint-hearted. The euphoric mood from China's post-Covid reopening that highlighted the start of 2023 revealed its alter ego as the year progressed with a slew of turbulent events, such as the regional banking crisis and Israel Hamas war. Adding to that, Asian Credit was dealt a challenging hand – the persistent increase in US rates, a struggling Chinese property sector as well as China's economic slowdown. Thankfully, the resilience of the Asian Credit market came through, with the index as a whole still chalking almost 5% in total returns year-to-date.

Entering 2024, we expect global growth, in aggregate, to be slower than in 2023. Our earlier views that US economic conditions were bleaker than hard data suggested was arguably early, but as Covid-era savings run dry, jobless claims rise and retail sales weaken, we are beginning to see the sobering reality of an economy under strain due to the prolonged high interest rate, high inflation environment. We now expect the Federal Reserve (Fed) to adopt a wait-and-see approach over the next few months before deciding on their next move. Barring a re-acceleration of inflation in 2024, we believe the Fed has reached the end of the current rate hike cycle.

In Europe, sustained high prices continue to depress economic growth. Even as headline inflation trends lower, stronger European countries such as Germany are grappling with faltering growth as manufacturing and services activity continue to contract. Unless inflation cools off significantly enough to meet the European Central Bank (ECB's) 2% target, we expect the ECB risks not cutting rates soon enough to cushion the effects of the slowdown in growth in the EU. We believe that growth in Europe in 2024 would be subdued, at best.

China's policies have been turning highly accommodative even though they stop short of a massive stimulus like the one in 2008-2009. By allowing budget deficit to widen to above 3%, it is a very strong indication of China's commitment to prop up growth. However, despite the political commitment to stabilise growth in China, the multilayered problems causing China's slowdown means that we don't expect a quick recovery. The property sector and weak consumer sentiment will remain weak links that need to be addressed. In other words, we still need actual gross domestic product (GDP) numbers and pre-sales in the property sector to pick up on a sustained basis before market confidence can be restored. Nevertheless, we are of the belief that the Chinese economy will emerge much stronger from this consolidation process and maintain a positive long-term outlook for the economy.

Asian economies have been resilient thus far, but effects from China's slowdown are not negligible. The growth outlook in Asia is showing signs of weakness especially for exports oriented countries including Singapore, South Korea and Taiwan, caused not only by China's slowdown, but also reflective of the lackluster demand from developed economies. We believe that this trend is likely to stay. Within the Asian region, countries with a stronger domestic story, such as India and Indonesia, are likely to fare better. Against this weakening external backdrop, most Asian central banks have paused rate hikes as inflation moderated and shifted attention to supporting growth. We remain constructive on the region's longer-term growth prospects as Asian economies continue to move up the value chain in the global economy.

Thus far, the rising inflation in Japan has been insufficient to convince Japanese regulators to normalise monetary policy. However, the Bank of Japan's next move should be closely watched as any signs of change to their Yield Curve Control policy will have significant implications for the course the dollar's strength. We see higher certainty of the Euro and other Asian currencies continuing its appreciation against the US dollar, a trend that is largely driven by the Fed's move. Asian local currency bonds may perform well should the Fed cut interest rates in 2024, as this will likely lead to further dollar weakness versus Asian currencies, further boosting Asian local bond returns.

We remain constructive in Asian IG credit. Fundamentals are now mixed but technicals will likely remain a tailwind during the early part of 2024. Even as credit spreads are almost at post-GFC tights, high all-in yields well above 5% does makes this asset class attractive from an income carry perspective. Our bias is to focus on higher quality names that have the liquidity and resilience to withstand a hard global landing, should such a scenario emerge.

Source : Company data, First Sentier Investors, as of end of December 2023