First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | May 2024

Market review

The Fed held policy rates steady at 5.25%- 5.5% during its meeting at the start of the month and markets cheered on the subsequent non-farm payroll numbers that came in weaker than expected. Strong purchasing managers' index (PMI) prints suggesting a possible reacceleration of US growth pushed the 10-year benchmark Treasury yields from 4.3% levels back up to 4.6%, but personal consumption expenditures (PCE) numbers that came in line with forecasts reignited hopes that the first rate cuts could be seen before the end of the year. Overall, benchmark US Treasuries moved 18bps lower over the month, ending just shy of 4.50%. Against a backdrop of firm fundamentals and strong supply-demand technicals, the Asian credit market shrugged off effects of the oscillations seen in rates; Asia Investment Grade (IG) spreads remained almost unchanged versus the previous month at 121bps, and J.P. Morgan Asia Credit Index (JACI) IG total returns stood at 1.08% for the month.

Economic tensions between the US and China ratcheted up a notch as election rhetoric increased in momentum. President Biden announced sweeping tariffs on Chinese electric vehicles (EV) imports that will quadruple tariffs to 102.5% from 27.5%, a move that came in tandem with the nearly $ 81 billion from the EU and the US in semiconductor spending. Likewise, there were reports of China's government telling technology firms including Alibaba (BABA), Baidu (BIDU), Tencent (TCEHY) and TikTok's parent ByteDance to cut back on their purchase of foreign made AI chips from Nvidia (NVDA) and other companies in favor of purchasing more domestically made chips. Chinese TMT issuers – Baba, JD.com and Lenovo came to the market with convertible bonds, with some proceeds going to equity buy-backs. Outside of China, S&P revised India's sovereign rating to positive (from stable) with expectations that pro-growth policies, infrastructure investment and commitment to fiscal consolidation would continue. Price action was relatively quiet but trended towards better buying sentiments in the market.

The USD Asian IG Quasi-sovereign market performed on par with the rest of the USD Asian investment grade credit space, with spreads tightening by 2bps over the month. IG Sovereigns proved to be the slightly better performer for the month, although it still lagged behind the performance of Quasi-sovereign names that have experienced better spread tightening year to date.

Asia's primary issuance market was active during the first half of the month. Besides the usual Chinese and Korean issuers, Southeast Asian issuers – Singapore's OCBC Bank and Thailand's Export-Import Bank tapped the USD investment grade credit space. The Republic of Philippines also came to the market with a USD 2billion issuance.

Fund positioning

After having gradually reduced the overweight in credit exposure over the last few months, the Fund kept credit risk exposure levels mostly unchanged over the month. Riding on tailwinds of decent spread tightening seen year-to-date, the Fund trimmed its positions in Chinese state-owned enterprises (SOEs), and also took profit in Australian banks where valuation has gotten richer. Where primary issuances offered attractive carry, the Fund added quality names to the portfolio to maintain yield levels.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned 1.49% in May, outperforming its benchmark by 0.40%.

- 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	At current levels of interest rates, even with US economic data still holding up well, a slowdown is still on the cards. Barring a reacceleration in inflation, the likelihood of rate cuts would increase as the year progresses.	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 added to returns.
Asian IG	Fundamentals remain sound in Asian Investment Grade (IG) corporates, but spreads have reached extremely tight levels.	Remained focused on high quality names that are deemed more resilient should the market enter a risk-off mode.	An underweight in sovereigns in Indonesia and the Philippines detracted from returns. This was offset by the overweight in Indonesian quasi-sovereigns as well as positioning in high quality credits.

The Fund's overweight in duration was positive for performance as Treasury yields moved lower over the month. An underweight in sovereigns in Indonesia and the Philippines detracted from returns. This was offset by the overweight in Indonesian quasi-sovereigns as well as positioning in high quality credits. Exposure in local currency bonds and currencies also added positively to returns as the USD was weaker over the month.

Q2 2024 investment outlook

Like how a storyline needs some twists to maintain an interesting narrative, the current market cycle is giving its fair share of suspense as the anticipated easing in the US economy did not materialize over the first quarter of 2024. Recent economic data portrayed US growth to be stronger than expected, with consumption, labor and growth all pointing to resilient broad-based strength in spite of a relatively high interest environment, and inflation still holding up above the Fed's 2% target.

However, despite the ongoing uncertainty, we do think that the outcome would be largely within expectations, with a slowdown still on the cards. Also, as political noise ramps up in a US election year, we believe that the likelihood of future rate hikes by the Fed is an extremely low probability, even as the timing of rate cuts remains an open question. The path to lower inflation has been noted to be bumpy and we expect global growth, in aggregate, to be slower than in 2023. Given how year-end data can be volatile due to the holiday season, it would be arguably early to conclude that the US is poised to completely avoid a recession. We have witnessed uncertainties and cracks appearing over the past year, and markets can deteriorate very quickly should a downturn emerge. The risk of a stagflation scenario too cannot be totally ruled out and we would rate its probability as higher when compared to the last quarter. Further increases in US treasury issuance, a US debt crisis and a re-acceleration in inflation are possible risks that could challenge the team's long US duration positioning. Should any of these scenarios pan out, the sanguine outlook that markets have priced in for credit spreads could also be at risk.

In Europe, inflation has mellowed in line with lower energy prices, but growth remains subdued, weighed down by economic heavyweights Germany and France, as well as an overall with pessimism in consumer confidence that has shrouded the region. There is a possibility that the ECB could cut rates earlier than the Fed. We expect the ECB risks not cutting rates soon enough to cushion the effects of the slowdown in growth in the EU.

China's policies have been turning highly accommodative even though they stop short of a massive stimulus like the one in 2008-2009. In undertaking an ambitious growth target of 5% for 2024, allowing a continued budget deficit of 3%, and issuing special treasury bonds, China is sending a strong signal in committing to growth. However, 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 consumer confidence and pre-sales numbers 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 export-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.

The Bank of Japan's (BoJ) exit from its NIRP and YCC policy has not come easy after 17 years in a negative interest rate environment. We expect monetary conditions to remain very accommodative in Japan as the BoJ monitors the long anticipated virtuous cycle – for higher wages to translate into higher spending, for the economy's ability to sustain inflation at its 2% target. In the meantime, the course of the dollar's strength remains largely driven by the Fed's monetary policy. When the first rate cuts are implemented, Asian local currency bonds may perform well, and this will likely lead to further dollar weakness versus Asian currencies, further boosting Asian local bond returns.

While Asian Credit fundamentals have remained stable, demand-supply technicals was the bigger driver of year-to-date performance. In line with broad expectations, the scarcity in bond supply has also rendered new issuance premium to be increasingly small. At this juncture, we remain constructive in Asian IG credit as high all-in yields well above 5% does makes this asset class attractive from an income carry perspective. That said, a risk-off scenario could occur very swiftly at current valuation levels. Our bias is for higher quality names and to ensure sufficient diversification in portfolios as the market rides this rally in credit spreads, with a focus on issuers 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 May 2024