First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | July 2024

Market review

In the US, rising labor market risks continued to overshadow concerns of persistent inflation that gripped markets earlier in the year. Even after attributing part of the surprising jump in initial jobless claims to external events (Hurricane Beryl and the annual auto retooling shutdown), the unemployment rate for June also edged upwards to 4.1%. Consumer Price Index (CPI) numbers too came in weaker than consensus, reflecting moderating inflation. PMI data showed a mixed picture; services Purchasing Manager's Index (PMI) rose to a 28-month high of 56, while manufacturing PMI fell to a 7-month low back into contractionary territory (49.5). Global Domestic Product (GDP) numbers came in stronger than expected, but suggested consumer spending was skewed towards necessities, such as healthcare, housing and utilities, as excess savings decline. By the end of the month, the economic picture added credence to the viability of the Fed implementing its first rate cuts in September.

The onset of the US election campaigns added to market volatility. US benchmark interest rates declined on anticipation of rate cuts for most of the first half of the month, before market speculation of a potential Trumpbp presidency saw the Treasury curve steepening, partially erasing its early month rally. Towards the end of the month, the escalating Middle East conflict and a dovish FOMC meeting added momentum to the rates rally - US benchmark rates decreased 37 basis points (bps) on the month, ending at 4.03%. In US Treasury curve 2s -10s, the bull steepener saw front end rates in 2-year USTs lower by up to 47bps, reducing the 2s -10s inversion to -23bps.

Asia credit remained resilient. Investment Grade (IG) USD Asian bonds' spreads ended at 134bps, 3bps wider than the previous month. However, with the positive contribution from the interest rate rally, monthly total returns stood at 1.30% in July. The JACI composite clocked 1.32% in positive returns

Weighed down by risk-off sentiments, Asia IG spreads widened over the month. China's third plenum yielded no policy surprises. Besides reiterating its commitment to its 5% growth target, regulators emphasized the need for high quality development as a top priority in building a modern socialist country. In addition, earnings announcements suggested a weaker economic backdrop. Cinda Asset Management Company (AMC) announced a profit alert with expectations of a 40-50% fall in net profit y/y. AMCs spread widened up to 10bps with the weak earnings and supply. Outside of China, challenges in electric vehicle (EV) segments were highlighted by several auto makers, and battery supplier LG Energy revised its annual revenue guidance to -20% y/y from +5% y/y. LG Energy bonds saw spreads widening by more than 10bps.

Indonesian quasi-sovereign bonds saw some spread widening against a rally in rates, but total returns remained positive due to the larger decline in interest rates. Marking a milestone since Sri Lanka's bond default, the sovereign reached an agreement with creditors on the terms of its $12B sovereign bond restructuring. This entailed a deal framework that linked its notes to the country's economic performance, as well as a governance-linked structure for its plain vanilla instruments. With much of the positive news already priced in, Sri Lankan international bonds shed a few points due to the looming election uncertainty in September.

The primary market was quieter than the previous month. But order books for new issues remained strong in spite of the softer economic data coming out of China and the US.

- 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 was positive for 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.

Fund positioning

The Fund increased its overweight in duration on the back of a weakening US economy and the heightened likelihood of aggressive rate cuts from the Fed later in the year. Besides participating in new issues that offered attractive premiums, the Fund sold Chinese credits where market pricing was fair, reducing the Fund's credit exposure relative to the benchmark. A long position in the Japanese Yen was added on expectations of a hawkish stance from the BOJ.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned 1.51% in July, outperforming its benchmark by 0.21%.

The Fund's overweight in duration was positive for performance amid the volatility in Treasury yields over the month. Credit positioning was positive for performance as high-quality credits and an overweight in Indonesian quasi-sovereigns remained resilient amid a small spread widening, with returns boosted by the rally in rates. An underweight in sovereigns in Indonesia and the Philippines detracted from returns. Exposure in local currency bonds and currencies added to returns as the USD was weaker over the month.

Q3 2024 investment outlook

As history has it, the mechanics of monetary policy transmissions can be opaque and accompanied by varying degrees of time lags. Last year, we underestimated the time it would take for Covid-era financial stimulus to unwind and were arguably early in our views of a slowdown in the US economy. This last mile of disinflation has indeed been bumpy, but our bearish views of a weakening US economy are of late finding resonance in the latest economic data releases. While we may not see inflation fall below 2%, the Fed has lowered the bar required to shifts gears to rate cuts, particularly if other economic data do not throw hawkish surprises to the downward economic momentum.

We maintain our long bias in US interest rate duration with a higher conviction that we have seen the peak in US policy rates. With uncertainties and cracks in economic indicators getting more pronounced over the past year, there is a good possibility that the first cuts could commence by September. Downside risks to our base case include further increases in US treasury issuance, a US debt crisis, and a re-acceleration in inflation, any of which 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. That said, the building election rhetoric and geopolitical events remain wildcards that would warrant a dynamic approach to managing our duration exposures.

The European Central Bank (ECB)'s rate cut was largely within expectations, and the European economy's outlook is looking less depressed despite subdued growth, with manufacturing coming off its lows and inflation broadly trending lower from lower energy prices. It remains to be seen if the ECB can afford to stagger its cuts in policy rates should consumption falter and inflation remain sticky in the services sector. Added complexities from the global trade war and geopolitics may further hinder EU's fiscal consolidation plans.

China's policies have been highly accommodative and recent policy measures aimed at destocking excessive property inventory have seemed to gain positive traction. 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, 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 negative interest rate policy (NIRP) and yield-curve control (YCC) policy has not come easy after 7 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 has been, and will still be, the bigger driver of credit performance in the near term. 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, with spread levels at record tights, 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. We prefer issuers with 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 July 2024