# First Sentier Asian Quality Bond Fund
# Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | August 2021

## Market review

August saw some encouraging developments with China Huarong Asset Management. Concerns about the financial position of this issuer had weighed on sentiment over the past few months, but the announcement of state-led support for the beleaguered firm was perceived to be an important milestone.

The company announced that state-owned investors including CITIC Group, China Insurance Investment and China Life Asset Management will replenish its capital levels. The size of these strategic investments has not yet been disclosed, but press reports indicated the inflows amounted to around RMB50 billion (or more than US$7 billion). The capital injection alleviated concerns about a potential debt restructure. It now appears the company will have sufficient capital to remain solvent and that state support will be forthcoming, if required. With the new backing confirmed, the company will likely focus on divesting non-core subsidiaries to further boost capital levels.

The strong recovery in Huarong bonds and relief among investors helped support sentiment towards credit in the region more broadly. The JACI Investment Grade Index rose 0.80%. This positive return came in spite of a modest increase in Treasury yields, which acted as a drag on total returns.

In other news, Chinese authorities continued to consider regulatory changes in various areas of the economy. Following new anti-monopoly and data security rules in the technology sector and a clampdown on tutoring companies, regulators are now targeting “unfair competition activities”. This unforeseen development hampered issuers like Alibaba and Tencent, but did not deter investors entirely – internet search engine operator Baidu was able to complete the issuance of a new sustainable bond.

In other new issuance activity, Singapore Exchange raised US$250 million. With the order book more than nine times over-subscribed, pricing of the new 5-year bonds tightened from initial guidance. Again, this underlined the strong demand for high quality paper from stable issuers in the region.

## Performance review

The First Sentier Asian Quality Bond Fund (Singapore Unit Trust) returned 1.27% for the month of August on a net-of-fees SGD term.

The positive return was largely due to tightening in credits spreads following the positive development with China Huarong Asset Management, which more than offset the rise in US Treasury yields.

On a relative basis, the fund outperformed the index largely due to our overweight in Huarong bonds. Our short US duration positioning also added value.

**Annualised performance in SGD (%)[1]**

| | 1 yr | 3 yrs | 5 yrs | Since inception |
|---|---|---|---|---|
| Class A (SGD - Q Dist) (Ex initial charges) | 1.3 | 4.7 | N/A | 2.8 |
| Class A (SGD - Q Dist) (Inc initial charges) | -2.8 | 3.3 | N/A | 1.9 |
| Benchmark* | 2.1 | 6.1 | N/A | 4.0 |

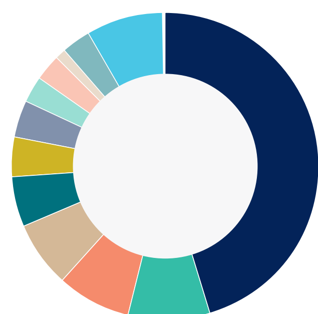
**Cumulative performance in SGD (%)[1]**

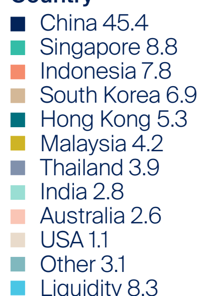
| | 3 mths | 1 yr | 3 yrs | 5 yrs | Since inception |
|---|---|---|---|---|---|
| Class A (SGD - Q Dist) (Ex initial charges) | 2.0 | 1.3 | 14.8 | N/A | 14.1 |
| Class A (SGD - Q Dist) (Inc initial charges) | -2.1 | -2.8 | 10.2 | N/A | 9.6 |
| Benchmark* | 2.3 | 2.1 | 19.5 | N/A | 20.6 |

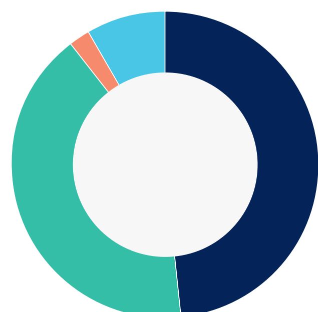
* The benchmark displayed is the J.P Morgan JACI Investment Grade Index (SGD Index) (Hedged to SGD).

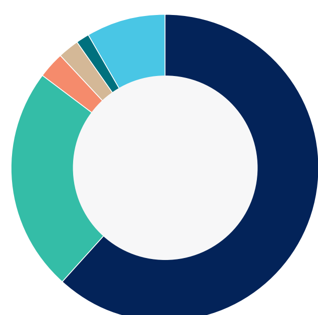
[1] Source: Lipper, First Sentier Investors. Single pricing basis with net income reinvested. Data as at 31 August 2021. The First Sentier Asian Quality Bond Fund inception date: 1 November 2016.

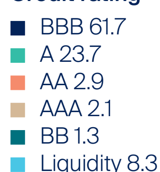
### Asset allocation (%)[1]










### Top 10 holdings (%)[1]

| Stock Name | % |
|---|---|
| People's Republic of China (Government) | 4.6 |
| Indonesia (Republic of) | 3.9 |
| China National Offshore Oil Corp | 3.0 |
| China National Chemical Corp Ltd | 3.0 |
| Shimao Group Holdings Limited | 2.9 |
| China Huarong | 2.8 |
| Country Garden Holdings Co Ltd | 2.5 |
| Korea Investment Holdings Co., Ltd. | 2.3 |
| Pertamina Persero PT | 2.1 |
| China Mengniu Dairy Company Limited | 2.0 |

## Fund positioning

There was limited activity in the portfolio over the month, with most existing exposures maintained.

Property developer Shimao Group was added to the portfolio. The valuation had become more attractive following some selling in the name, amid rumors of concerns over the company's off balance sheet liabilities. Elsewhere, profits were taken on a spread compression trade that had been implemented between Indonesian sovereign bonds and securities issued by state-owned energy company PT Pertamina.

## Q3 2021 investment outlook

Overall, we remain cautious on the outlook for Asian credit markets as we head into the second half of the year. Any pronounced sell-off could present some interesting buying opportunities. After more than a year, the world remains in the midst of the Covid pandemic. And despite vaccination rates picking up globally – especially in developed economies – there appears to be no sign of reprieve in the near term. We now have to contend with more contagious variants of the virus, which could delay the anticipated economic recovery. Separately, concerns around debt problems in China – most notably involving Huarong and Evergrande – are likely to continue to weigh on market sentiment, even though they have been largely idiosyncratic in nature thus far.

Amid all the uncertainty regarding its economic recovery forecasts, the Federal Reserve has surprisingly turned more hawkish, indicating that US interest rates are likely to be raised before the end of 2023 if inflation continues to rise and if the economy continues to recover as anticipated. This latest guidance is in stark contrast to the previous rhetoric, which suggested policy settings would be unchanged until the end of 2023, at the earliest. We believe this change could be a game changer for credit and currency markets in the second half of this year, particularly if inflation continues to trend higher as this would inevitably put pressure on policymakers to move quicker.

The Federal Reserve has favored extremely accommodative policy settings for more than a year, since the beginning of the Covid pandemic. This has helped support sentiment, but we were always skeptical about policymakers' ability to forecast economic conditions beyond a year, let alone two. Furthermore, unlike any previous economic downturn, a Covid-led recession is highly unpredictable; hence the recovery is likely to be uncertain too. Pent-up demand has been rapidly building during lockdowns, which suggests economic activity levels could surge in the months ahead, likely resulting in even higher inflation. Federal Reserve officials continue to suggest that higher inflation is transitory, but what if their assessments turn out to be wrong? We believe the risk of spiraling inflation as activity levels rebound is what led the Federal Reserve to change its course, turning more hawkish and suggesting two rate hikes are possible before the end of 2023. Discussion around tapering the massive bond purchase program in the US is also underway. A moderation in the current pace could occur later this year, though may not have as much impact on bond and credit markets as interest rate hikes. We take some comfort that the Federal Reserve appears

1 Source: Lipper, First Sentier Investors. Single pricing basis with net income reinvested. Data as at 31 August 2021. The First Sentier Asian Quality Bond Fund inception date: 1 November 2016.

to be pondering the scale of its quantitative easing program, but remain concerned it may be 'too little, too late'. As we have said before, the colossal amount of money printed over the past decade or so has already led to massive asset bubbles.

Asian economies look set to recover strongly this year following the sharp contraction in 2020. Recovery rates are likely to be boosted further by an increase in vaccination rates. Using a vaccination target of 75% – perceived as a prerequisite for keeping the virus under control – China, Singapore and South Korea are on track to get the majority of their populations vaccinated in the next three months. Taiwan and Thailand will likely reach that landmark by the middle of next year, while more populated countries, like Indonesia and Philippines, will probably take almost another two years to get there. While the signs look encouraging and actual vaccination rates may even outpace these expectations, many countries continue to grapple with an even more highly transmissible 'delta' variant of the virus. Recent infections in Taiwan and Vietnam are a timely reminder of the persistent risk of fresh outbreaks, despite previous successful containment. Singapore has recently tightened restrictions to the strictest levels in more than a year given the emergence of a second wave, despite making excellent progress with its vaccination program.

Being the first economy to be hit by Covid and also the first to start recovering from it, there had been suggestions previously that the Chinese would start to tighten monetary policies and liquidity conditions. These concerns seem to have abated, with growth rates remaining uneven as domestic consumption continues to lag. Against this backdrop – along with the ongoing deleveraging of the property sector – the Chinese central bank is likely to leave accommodative policy settings in place for the rest of this year. South Korea is the only country in Asia that has explicitly signaled a potential shift in policy stance, as growth continues to bounce back strongly and as headline inflation has risen above the Bank of Korea's 2% target. Nevertheless, even if rates are raised later this year, we expect any hike would be a move towards policy normalisation, rather than representing the beginning of a tightening cycle.

Following some high profile defaults from Peking University Group and China Fortune Land – both of which have huge amounts of debt outstanding – investors have increasingly scrutinised two other sizeable issuers in recent months; Huarong and Evergrande. This has led to significant spread widening in these two names, as the market has questioned whether they are 'too big to fail'. The market's perception of implicit government support for State-Owned Enterprises also seems to have waned.

We believe Huarong remains systemically important to China's financial system, as it is one of the largest buyers of banks' bad debts. Huarong also has plenty of non-core assets that could be divested, enabling the company to meet its near-term liquidity needs. We therefore believe there is a low probability of default, but some restructuring of the company's heavily indebted non-core assets seems possible.

As for Evergrande, there has been increasing concern about the company's fundamentals since the Chinese government rolled out the 'three red lines' policy, which forces property developers to reduce leverage. Evergrande targets halving its debt to 350 billion yuan by mid-2023, fulfilling the 'red lines' for net debt to equity by mid-2021, cash coverage by end-2021 and liability-asset ratio by end-2022. We are encouraged by the aggressive plan to comply with the new policy, but anticipate some bumps along the way given the sheer size of Evergrande's debt. That said, at current spread levels the market appears to have priced in a lot of bad news already.

The Chinese government seems determined to push ahead with reforms, suggesting we will see other idiosyncratic pockets of stress, like Huarong and Evergrande. While full bailouts are no longer possible amid the reforms, there are many ways the government could lend indirect support to lessen the systemic impact should either of these two companies require restructuring. The Chinese government simply could not afford for the finance and property sectors to come under duress simultaneously.

Asian credit markets delivered lackluster performance in the first half 2021. Indeed, returns from investment grade bonds were negative, largely due to higher US Treasury yields. We think Treasury yields could rise further given heightened inflationary expectations, more fiscal stimulus and suggestions that the Federal Reserve could raise interest rates earlier than previously anticipated. Credit spreads were little changed in the first half, and appear fair considering investors' expectations of improving corporate earnings. With investment grade spreads currently below the five-year average, the scope for meaningful further tightening currently appears limited. A continued backup in US Treasury yields could, however, present an attractive entry point in terms of 'all in' yield for longer-term investors.

Finally, we believe the US dollar could weaken over time, especially with the promise of more fiscal stimulus from President Biden. That said, should the Federal Reserve turn more hawkish and talk up the likelihood of interest rate hikes and bond purchase tapering, we could see the dollar strengthen and some associated short-term weakness in Asian currencies.

Source : Company data, First Sentier Investors, as of 31 August 2021

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