First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | June 2022

Market review

The Asian credit market returned -2.28% in June, weighed down both by widening in spreads and higher US Treasury yields. This has brought losses in the calendar year to date to -10.7%. Rising inflation in developed countries and fear of recession further brought risk-off sentiments while China's zero-Covid policy continued to cloud the economic outlook in Asia. As a result, Asia Investment Grade (IG) spreads widened by 3bps to 206bps. We continue to be selective in credits that are able to ride through this volatility.

In Asian IG, some positive headlines were seen in the China Technology sector as China's National Press and Publication Administration approved 60 new gaming titles for the second time this year. Regulators also set out plans to allow Didi back onto China Apple's app store, after about one year since it was removed. While a more benign stance from Chinese authorities supported the spreads of tech names (despite denials of the rumour of the revival of Ant Group IPO), a rally failed to take off. We are watchful of tech performance as we have gradually added exposure to China Tech names over the past months as spreads became increasingly attractive. In the Asset Management Company (AMC) space, China Huarong's announcement of sale of its bank subsidiary was credit positive, with S&P later stating its comfort in the company. The company also exercised its redemption rights to redeem its onshore bonds. We maintain our overweight bias for Huarong.

Fundamentals remained intact with IG sovereigns, with rating agencies raising its outlook on a few countries. S&P affirmed Malaysia's sovereign rating at A-, revising its outlook from negative to stable on the back of strong external and economic recovery. Fitch also affirmed India's BBB- rating and raised its outlook to stable from negative. We maintain a mild positive stance for IG-rated sovereigns while avoiding frontier markets.

Asia's primary issuance volumes remained subdued, as the risk-off tone and rate volatility dampened primary market appetite. Issuance came primarily from IG issuers at high new issuance premiums to attract demand. Notable issuances for the month included China Railway Group, Nonghyup Bank, Kyobo Life Insurance, and Hanwha Energy.

Fund positioning

Positions were largely maintained over the month. The portfolio added to positions in Country Garden, a name that we believe will survive through China's property market upheaval. We also established an overweight in US Treasuries as a risk-off ballast should recessionary concerns materialise.

Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund -1.93% in June, underperforming its benchmark by -0.37%.

The negative return was largely due to weakness in credit spreads. Our exposure in China property detracted from performance, as did positions in Indonesian credits.

	We thought that...	Therefore, we...	And the results...
US Rates	Should recessionary fears be realised in the market, the long end of the US curve would rally.	Established an overweight position in the long end of the US curve towards the end of the month.	The overweight in the long end US positioning had a negligible impact on performance.
Asian IG	Fundamentals remain sound in Asian investment grade (IG) corporates but volatility in credit markets may remain elevated for a sustained period.	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. The fund reduced credit risk and sold down on sovereign positions in the Philippines and Indonesia.	The fund's underweight in sovereign names in Indonesia and the Philippines versus the benchmark was additive to returns, as did the underweight in gaming names such as Sands China Ltd. However, the fund's position in Indonesian quasi-sovereigns detracted from performance.

Q3 2022 investment outlook

Concerns over the rapidly tightening financial conditions by the Fed, followed by the ECB, amid record high inflation have led to the dismal performance across major asset classes during the first half of 2022. Further speculation even abound that the Bank of Japan (BOJ) may have to eventually abandon its yield curve control policy should inflation in Japan continue to rise. To put the numbers in perspective, inflation in the US and Europe at around 8% is at a 40 year record high. The Fed had little choice but to deliver a total of 150bps of rate hikes to date, with increasing possibility of another two 75bps hikes in the next two meetings. As a result, the market is now pricing in a terminal policy rate of around 3.5% to be attained by mid-2023. Meanwhile in Europe, the ECB is now widely expected to deliver its first rate hike of 25bps in July, followed by 50bps in September and 25bps thereafter in each of the subsequent meetings till March 2023, totaling 175bps of rate hikes in quick succession. While the foreseeable terminal policy rates are still well below inflation rates in the respective regions, a significant amount of rate hikes has been priced in by the market over a very short period of time. What this means is that should we see some moderation in inflation prints as we move into Q3, long end rates in both the US and Europe could see a rally, reversing part of the heightened rate hike expectations.

The inflation problem facing the western world is a sticky one. Having been adamant that inflation is transitory, the Fed now has an unenviable task of taming inflation to uphold their credibility while at the same time endeavoring to achieve a soft landing for the US economy. The Fed's biggest challenge is its inability to control the factors contributing to inflation. Commodity and food prices arising from the Russia-Ukraine war will remain elevated until a ceasefire is reached. The reprieve we see from the resumption of normalcy as the global supply chain recovers post Covid-19, though its effect will only be at a gradual pace.

Worries over a potential recession in the US has been gathering momentum, with signs suggesting a slowdown coming sooner rather than later. High inflation in the form of higher petrol and food prices have inevitably put a dent in consumer confidence. Business confidence also appears to be weakening as companies turn cautious as cost pressures mount. Rising interest rates are impacting the housing market and coupled with the recent decline in the stock market, there will be some strain on individual consumers' wealth and hence consumption patterns.

Credit markets have largely adopted a cautious tone since the start of the year as investors grappled with Fed rate hikes, the Russia-Ukraine war and China's policies induced slowdown. US IG has widened by around 60bps at the mid-year mark amid significant outflows and is currently implying a 40% chance of the US going into recession. In contrast, Asian IG outperformed, widening only 25bps during the same period owing largely to a more favorable technical backdrop. Should investors price in a US or global recession scenario more aggressively, credit spreads in general should continue their widening paths. That said, Asian IG is looking very attractive from an all-in yield perspective. Recovery in the Chinese economy and further easing of policies and regulatory crackdowns on the technology sector may offer further support this asset class. We also believe fundamentals will remain stable for most Asian IG issuers.

Following months of sell-off, news flows relating to Chinese property developers continue to dominate headlines. This is despite trading volume on many of these names dwindling to a trickle; many traditional asset managers either have divested their holdings or are staying on the sidelines. This decline in trading activity has led to exaggerated bond price movements even on news that usually would not have material price impact. While there will be a series of Chinese developers' bonds maturing in the coming months which potentially may lead to more volatility for the sector, we believe the worst is behind us. Since late 2021, policies have become more supportive and this accommodative stance will likely continue to increase. Downside risks remains with China's zero-Covid policy stance impeding a recovery for the sector, which explains why bank lending to the real estate sector remains conservative despite policy easing measures. Many do not anticipate a strong pick up in pre-sales figures as long as the country remains in lock-down mode. Nevertheless, we do expect the Covid situation to ease in the second half of the year, boosting pre-sales. Clarity around the debt-restructuring plan for Evergrande and Kaisa would likely boost sentiments further.

Against the backdrop of more aggressive rate hikes by the Fed and quantitative tapering, the US dollar has strengthen significantly since June 2021. We now see the trajectory for the USD closely linked to ECB's course of monetary policy in the months ahead. Unlike the Fed's relatively steady course of monetary policy normalisation in 1H 2022, the ECB's path forward is less straightforward and fraught with risks. Lackluster growth, weak consumer demand, ongoing uncertainty from the Russian-Ukraine war as well as concerns on peripheral European nations' ability to withstand higher rates suggest to us that the ECB is unlikely to move as aggressively as the market expects. The implementation of ECB's normalisation of monetary policy is contingent not only on economic data, but also on its successful navigation of EU political dynamics with the added complexity of energy-related inflation, supply shock and the war. Should the environment worsen, the possibility of further fiscal support even at the European level is something we do not rule out.

Asian economies have witnessed a broad based rise in inflation versus their respective central bank targets, though nowhere near levels seen in the US and EU. The tone of monetary policy in the region has been relatively accommodative due to a confluence of factors, namely benign inflation, post-Covid economic re-openings, and recovering consumer demand. In the absence of differentiating catalysts, the current weakness in Asian currencies will likely remain status quo in the near term. We will look to signs of a pause in Fed rate hikes and a recovery in China's economy before turning bullish on Asian currencies again. On the interest rates front, we believe there will be more rate hikes to come from most central banks, China being the exception, to curtail inflation as prices continue to edge higher. Hence, we would wait for more attractive valuation levels before accumulating positions in the local currency bonds market.

Source : Company data, First Sentier Investors, as of 30 June 2022