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

Monthly Review and Outlook | June 2023

## Market review

Asian Investment Grade (IG) credit returned -0.16% over the month despite spreads tightening 11 basis points (bps) to 173bps. Higher US Treasuries eroded the positive effect from narrower spreads, resulting in the negative performance of the sector. Although the US Federal Reserve announced a pause in rate hikes, a hawkish poise led market participants to believe that more rate hikes might still be in the works for the rest of the year, leading to an upward pressure in yields.

The month began on a good note as US debt ceiling negotiations found a resolution, averting a possible technical default. Asian investment grade credit spreads grinded tighter over the month despite softer economic data out of China. Alibaba Group Holding Ltd's (BABA) business overhaul progressed with the announcement of leadership changes, which saw two lieutenants of Jack Ma taking on the split roles of longtime chairman and CEO Daniel Zhang. Prices of BABA's USD bonds remained largely stable over the month. At yields that are relatively high by historical standards, we believe that Asian investment grade credit still offers decent value, though we remain selective in credits that are able to weather a downturn better than the broader market.

Asian IG sovereign and quasi-sovereign bonds saw spreads continuing to edge tighter against a tight liquidity backdrop in the market. In frontier markets, Pakistan secured initial approval for a USD3bil IMF loan at the end of the month, narrowly averting a sovereign default as the country struggles to service its external debt. The IMF approval came with stringent requirements that included demands for the sovereign to increase interest rates, cut budget spending further and raise taxes in an economy that was heading into elections. Prices of Pakistan bonds rallied spectacularly by over 12 points, outperforming the rest of Asian sovereigns.

In continuation of the weak year-to-date trend in primary issuance, the market saw the lowest monthly volume in year-to-date issuance. South Korea remained the only source of steadfast primary market supply, with investment grade corporates such as SK Broadband, Hyundai Capital America and Korea Expressway Corporation coming to the market with USD issuances.

## Fund positioning

The long duration of the Fund was maintained, though some longer dated positions were pared to keep the Fund's duration tolerance within limits. In what was a largely sideway moving secondary market, the Fund tactically switched Chinese technology names where spreads looked rich into BBB-rated names where the team felt there was room for further spread tightening. The Fund also closed an underweight in South Korea by participating in Korean corporate issuances.

## Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -1.05% in June, underperforming its benchmark by -0.79%.

On a relative basis, the Fund underperformed its benchmark as overweights in Chinese property detracted from performance. This was partially offset by the Fund's exposure in high quality quasi-sovereigns and longer dated credits where spreads tightened over the month. Exposure in local currency bonds and the Japanese yen also detracted from performance.

| | We thought that... | Therefore, we... | And the results... |
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| **US rates** | The Federal Reserve would be closer to the end of its rate hike cycle and be less aggressive in hiking rates. However, prices will remain high and the likelihood or rate cuts remains low | Maintained an overweight stance for US rates in the portfolio | The Fund's overweight in US rates versus the benchmark detracted from returns as US rates moved higher 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 were largely stable. However, the Fund's exposure to Chinese property names detracted from performance as spreads widened. This is offset by an overweight in Indonesian-quasi sovereigns |

## Q3 2023 investment outlook

2023 has thus far been a more upbeat year than 2022 for Asian Fixed Income, with positive returns year-to-date driven in part by the anticipated slowdown in the Federal Reserve's pace of rate hikes, as well as China's border re-opening. This performance looks even more commendable against the backdrop of market uncertainties brought on by the collapse of Silicon Valley Bank and Credit Suisse Bank. In supply technicals, the significant slowdown in primary market issuance for Asian Credit slowed additional price support for credits, as evidenced by the resilience in credit spreads during periods of market stress, such as the US regional banking crisis.

We expect the second half of the year to be constructive for Asian credit markets. It is difficult to fathom 10 consecutive rate hikes amounting to more than 500bps not having any effect on the economy. Despite headline growth data still coming in above expectations, particularly in terms of consumption data, we attribute a large part of this to a sharp increase in household debt in the form of credit card and home equity loans, rather than a robust job market and strong wage growth. In other words, we do not believe a debt-fueled economy is sustainable if interest rates stay elevated. While the US regional bank crisis appears to be contained for the time being, the root trigger of the crisis - risk-free T-bills still yielding higher than deposit rates – remains, leading many to ponder what else remains beneath the seeming calm. The more obvious path to us is that further tightening of credit conditions will restrict economic growth for the foreseeable future.

Debate abounds the US Federal Reserve's next move. We believe we are close to the end of the current rate hike cycle. With core inflation now below the Fed fund rate, it does give the Fed an opportunity to take a pause, assess the impact of the past year of rate hikes before deciding on their next step. With unemployment rate still near historical lows, we do not believe the Fed will be cutting policy rates this year. Barring a sharp deterioration in economic growth, the dollar may stay strong in the coming quarter as long as it maintains a favorable interest rate differential against the EUR and JPY. 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.

The euphoria following China's lifting of its zero-COVID policy has proven to be short-lived amid faltering economic momentum in recent weeks. Nevertheless, tailwinds from China's re-opening should continue to benefit the Asian region. The path to recovery will be a winding and bumpy, but coming off a low base, achieving the 5% growth rate for 2023 should be feasible. We believe the probability of large-scale stimulus to be low, but should China's growth falter, the central Chinese government could implement targeted policy measures to support the country's economy.

Inflation in Asia is relatively benign when compared to developed markets, giving Asian central banks more flexibility to cut rates to spur growth should the need arise. In fact, many Asian central banks have paused their rate hikes in recent weeks as inflation moderated further. 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.

We remain constructive in Asian IG credit while staying selective in Asian High Yield. Despite signs of slowing earnings and weaker economic activity in the region, fundamentals of Asian Investment Grade (IG) corporates remain sound. Considering the mounting macro uncertainty, valuations are starting to look rich, despite modest weakening in Asian IG credit metrics within still solid territory. Nevertheless, high all-in yields well above 5% does makes this asset class attractive from an income carry perspective. Our bias is to look for idiosyncratic and relative value opportunities. In Asian High Yield (HY), survivors in the Chinese high yield property sector may provide short-term trading opportunities. Significant upside returns potentially reside among distressed names who survive the debt restructuring process, and these names could benefit from improvement in pre-sales figures.

Source : Company data, First Sentier Investors, as of 30 June 2023