First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | July 2022

Market review

The Asian credit market returned 0.25% in July, with the widening in credit spreads more than compensated by lower US Treasury (UST) yields. Rising inflation in developed countries and fears of recession intensified risk-off sentiments, and China's zero-Covid policy continued to cloud economic outlook in Asia. In its quest to rein in inflation, the Federal Reserve (Fed) increased Fed fund rates by another 75bps. This came against a weaker growth backdrop as US GDP data printed negative growth for the second consecutive quarter. UST yields ended the month lower as market focus shifted from the aggressive rate hike cycle to the possibility of recession. Asian Investment Grade (IG) spreads widened by 27bps to 233bps. We continue to be selective in credits that are able to ride through this market volatility.

In Asian Investment Grade (IG), China credits underperformed with the Chinese property sector being the biggest laggard. Reported news on rising mortgage payment suspensions due to the delayed delivery of pre-sold property project exacerbated existing concerns faced by the property sector, and Chinese banks were not spared from scrutiny on its asset quality due to its exposure to the sector. The recovery of the Chinese property sector will hinge on how quickly regulators act to help defaulted developers.

Sovereign bonds traded weaker amid continuing EM bond outflows and souring risk sentiments. The rally in US Treasury rally during the final days of the month restored some stability to IG sovereigns as spreads tightened. We hold a mild positive stance for IG-rated sovereigns while avoiding frontier markets.

Overall volume in the Asia primary issuance market remained subdued, as the risk-off tone and rate volatility dampened issuers' appetite. Issuance came primarily from IG issuers such as Lenovo, TSMC, and Posco.

Fund positioning

We reduced credit positions at the start of the month as a risk-off move. The portfolio sold Republic of Philippines and Haohua early in the month. As spreads widened towards the end of the month, we switched from names such as Singapore Airlines, and Aramco to add positions in Power Finance, Lenovo, Pertamina, and Indofood.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned 0.54% in July, underperforming its benchmark by -0.22%.

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

- The Fund invests primarily in debt securities of governments and corporate 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	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 of the US curve had a positive 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 and tactical 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 early in the month by selling sovereign positions in the Philippines, before picking up select credits as spreads got attractive.	The fund's underweight in sovereign names in Indonesia and the Philippines versus the benchmark detracted from performance, as did the fund's positions in Chinese property names.

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 end of July 2022

Important information

Investment involves risks, past performance is not a guide to future performance. Refer to the offering documents of the respective funds for details, including risk factors. The information contained within this material has been obtained from sources that First Sentier Investors ("FSI") believes to be reliable and accurate at the time of issue but no representation or warranty, expressed or implied, is made as to the fairness, accuracy or completeness of the information. To the extent permitted by law, neither FSI, nor any of its associates, nor any director, officer or employee accepts any liability whatsoever for any loss arising directly or indirectly from any use of this. It does not constitute investment advice and should not be used as the basis of any investment decision, nor should it be treated as a recommendation for any investment. The information in this material may not be edited and/or reproduced in whole or in part without the prior consent of FSI.

This material is issued by First Sentier Investors (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong. First Sentier Investors is a business name of First Sentier Investors (Hong Kong) Limited.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. All securities mentioned herein may or may not form part of the holdings of First Sentier Investors' portfolios at a certain point in time, and the holdings may change over time.

First Sentier Investors (Hong Kong) Limited is part of the investment management business of First Sentier Investors, which is ultimately owned by Mitsubishi UFJ Financial Group, Inc. ("MUFG"), a global financial group. First Sentier Investors includes a number of entities in different jurisdictions.

To the extent permitted by law, MUFG and its subsidiaries are not responsible for any statement or information contained in this material. Neither MUFG nor any of its subsidiaries guarantee the performance of any investment or entity referred to in this material or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk, including loss of income and capital invested.