First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | October 2022

Market review

The Asian credit market returned -3.66% in October, as spreads leaked wider and US Treasury (USTs) yields edged higher. US inflation data gave markets no relief as the Consumer Price Index (CPI) surprised on the upside, though some weakness in economic data helped restrain yields from going higher. Broadly cautious risk sentiments hurt Asian credits; Asian Investment Grade (IG) spreads widened by 10 basis points (bps) to 208bps, while Asian High Yield (HY) spreads widened by 150bps to 1163bps. We maintain a defensive stance in credit risk on heightened recession risk.

In the Asian Investment Grade (IG) space, US-China headlines caused China IG spreads to widen across the board, with China technology names underperforming in particular on news of the US chips exports ban. US' export controls of advanced semiconductor chips to China reignited concerns over the tech cold war between the world's two largest economies. Asian semiconductor behemoth, TSMC, saw bond spreads widening despite its manageable exposure to China and limited exposure to high-end AI and supercomputers. Meanwhile, Haohua (ChemChina) also widened by more than 100bps to trade at 350bps relative to the 10-year bond as the US government added the issuer to its Department of Defence (DOD) list. Coming out of China's 20th party congress, the consolidation of Xi Jinping's leadership exacerbated risk-off sentiments, as did the retirement announcement of Madam Wu, Chairwoman of Longfor Properties, China's largest privately owned property name.

Sovereign bonds traded weaker as emerging market (EM) bond outflows continued in October, albeit at a more moderate pace. Spreads continued to weaken in the sovereign and quasi-sovereign space. On a more positive note, however, the Philippines successfully issued USD1.5B in bonds across two tranches amid volatile markets. While fundamentals of IG-rated sovereigns remain sound, we stay clear of frontier economies while maintaining a cautious stance in case of further downside in broader sovereign spreads.

Overall issuance volume in the Asia's primary market remained subdued, overshadowed by the risk-off tone and ongoing volatility in rates. However, several high quality issuers emerged such as the Industrial Bank of Korea, Syngenta Group, Korean Development Bank as well as the Philippines (sovereign).

Fund positioning

Fund positioning was kept stable for most part of the month. The portfolio purchased Tencent on attractive valuations as well as the issuer's relative underperformance in the Chinese tech sector.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned -3.59% in October, underperforming its benchmark by -0.93%.

The negative return was largely due to the widening of credit spreads amid a weak credit market, with exposure to china property names being the main detractor from returns.

- 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	US rates would potentially rise further in the short to medium term on persistently high inflation and hawkish Fed sentiments. However, the curve could potentially invert further should the recession materialise.	Maintained the portfolio's underweight in US duration.	The underweight in US rates was additive to performance as US rates sold off over the month.
Asian IG	Fundamentals remain sound in Asian Investment Grade (IG) corporates but volatility in credit markets may remain elevated for a sustained period.	We increased caution on credit exposure across portfolios amid the enormous uncertainly in the investment landscape, focusing on names with strong fundamentals and the wherewithal to survive further market volatility.	The fund's exposure to Chinese property names detracted from performance, but this was offset by the underweight versus the benchmark in sovereign names in Indonesia and the Philippines.

Q4 2022 investment outlook

Notwithstanding the ongoing rate hike cycle by the Fed, our expectations of a rally in the long end of US Treasuries did materialise as recessionary fears increased; the 10 year US Treasury yield briefly descended 90bps from its peak in June on heightened recessionary fears. At this juncture, we expect the Fed to stay its course in upcoming meetings, hiking rates to curb inflation on the premise that unemployment rate stays low and economic activities do not contract too sharply. Our recalibrated view is to turn more cautious on US duration though we see any further sell-off as opportunities to accumulate long positions.

Meanwhile, the inflation situation in Europe is much more precarious. Despite oil price correcting more than 20% below its recent peak, Eurozone inflation is likely to remain elevated even as the inflation expectations in the US moderate. With the Eurozone's higher dependence on natural gas, inflationary pressures will continue to rise amid the ongoing Russia-Ukraine war and as insulation heating demands rise in winter. It is getting harder to fathom how Europe can sustain significantly lower interest rates versus the US, amid a much higher inflation that is seeing no reprieve. The continued weakness of the Euro also compounds the inflationary problems currently faced by the region. While the ECB is widely expected to drag its feet in delivering rate hikes, a convergence in monetary policy between the ECB and the Fed cannot be totally ruled out and that could potentially lead to increased volatility for risky assets.

Along with other developed markets, Japan's inflation has been rising as well, albeit at a much slower and a more measured pace, allowing the Bank of Japan (BOJ) to remain highly accommodative with their monetary policy stance. That said, the recent weakness of the JPY where it reached a 25-year low has started to cause alarm across markets. We believe the BOJ will likely intervene if JPY weakness persists. However, if there is no change in monetary policy by the BOJ while the Fed continues to hike, we are unlikely to see an immediate turnaround for JPY.

Sentiments in Asian credit have been dominated by Fed rate hike expectations this year and we expect that to continue for the rest of 2022. In the months ahead, we will be closely watching China's developments particularly around the mid-October 20th Party Congress. A relaxation in China's Zero-Covid policy stance post the congress meeting would boost market sentiments immensely and help China's property sector through improving pre-sale numbers. Recent developments, such as the liquidity fund for distressed developers, have been positive. We believe that the Chinese government will do everything they can to provide access to onshore funding for many of the property developers.

Based on 1H22 earnings, Asian investment grade (IG) credit fundamentals have remained sound. A large majority of Asian companies (ex-China) reported strong revenue and earnings before interest, taxes, depreciation, and amortisation (EBITDA) growth along with margin improvements, resulting in lower gearing and leverage ratios. In line with market expectations, pockets of weakness were observed within China, as property names and China AMCs saw earnings decline amid the country's property market crisis. The Chinese technology sector also experienced decline in revenue and EBITDA margins although credit profiles remain stable. In contrast, oil majors in China and the rest of Asia posted very strong earnings while capex projections remain largely within expectations. We see the strong credit rally in August bringing Asian IG back into fair valued territory, as spreads in the JPM Asia Credit Index (JACI) hover back to its 5-year average. Nonetheless, an all-in yield for JACI IG at close 5% looks highly attractive for longer-term investors.

Amid the Fed's aggressive rate hike cycle, the US dollar has continued to surge higher and has now breached key resistance levels vs other developed market currencies (eg: EUR and JPY). This has in turn led to pronounced weakness in Asian currencies. While the MYR and KRW are now trading at very attractive levels, we prefer to observe the USD strength on the sidelines until signs of a significant shift in policy stance from the ECB and BOJ emerge. In fact, the greenback may even strengthen in the event of a global recession next year. In local currency bonds, bond yields in most markets, with the exception of China, have been edging higher due to higher inflation and rate hike expectations. While Asia's inflation numbers pale in comparison to those in the US and Europe, a global recession could trigger outflows in local currency bonds. We advocate caution in adding exposures to these markets for now.

Source : Company data, First Sentier Investors, as of end of October 2022