First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | October 2023

Market review

Geopolitical tensions in the Middle East dominated headlines early in the month as Israel launched into a war against Hamas, the militant group responsible for a surprise attack on Israel, but any risk-off sentiments was overshadowed by the higher-for-longer rhetoric led by the Federal Reserve. The Asian credit market returned -0.65% in October, driven by negative returns both in Investment Grade (IG) and High Yield (HY) credit. Credit spreads in Investment Grade (IG) Asian credit remained in tight territory and compressed further by 3bps, but this was offset by the rise in US treasuries across the curve, resulting in overall negative returns of -0.67%.

Most IG Chinese credits benefited from solid technicals and news of further stimulus being announced in China. Chinese technology names in particular responded positively as credit spreads tightened across the curve. Among asset management companies, Huarong bonds rallied across curve on the back of company's continued bond buybacks. On the other hand, IG rated developers including Vanke and Longfor saw prices falling due to lackluster national sales recovery and contagion from liquidity issues coming from Gemdale's, another high-quality developer, liquidity issues. In other bond market events, PTTGC, Thailand's flagship petrochemical company, announced plans to repurchase bonds as part of its bid to reduce gross debt. This move came on the back of Moody's negative rating action in August 2023, and signaled to the market the company's adequate finances.

Longer-dated Indonesian investment grade sovereign and quasi-sovereign bonds saw spreads continuing to edge tighter. However, positive returns were nullified by the sharp spike in US Treasury yields in early October. There was some reprieve in the middle of the month but volatility and the sustained rise in US Treasury yields that returned at the end of October meant that returns in investment grade sovereigns continued to remain challenged.

Month on month, primary issuance fell both in terms of total issuer volume as well as issuance size. Issuance activities for USD credit resided with only Chinese and South Korean issuers, namely from financials such as ICBC and Korea Development Bank. By quantum, Green bonds comprised approximately 25% of these new issuances.

Fund positioning

The Fund opportunistically adjusted duration positioning when US Treasuries rates spiked higher in the early part of the month. An overweight in Chinese rates was reduced to neutral. In credit names, spread exposure was further trimmed as a defensive move. The Fund increased its exposure in Malaysian Government securities marginally on the back of the weakened Malaysian ringgit.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned -1.15% in October, underperforming its benchmark by -0.48%.

An underweight in sovereign bonds from Indonesia and the Philippines was additive for performance. However, the Fund's exposure in high quality quasi-sovereigns detracted from performance even though investment grade quasi-sovereign spreads tightened due to the sustained rise in US rates. Exposure in Malaysian Government bonds and the Japanese yen also detracted from performance on the continued strength of the US Dollar.

- The Fund invests primarily in debt securities of governments or quasi-government organization in Asia and/or 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	The US economy would start showing signs of weakening and US rates would start to show signs of peaking. However, prices will remain high and the likelihood or rate cuts remains low	Maintained an overweight bias for US rates in the portfolio, but have in light of the increased volatility	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 tightened marginally. However, the increase in rates eroded returns. An underweight in sovereigns in Indonesia and the Philippines added to performance, though this was offset by the overweight in Indonesian quasi-sovereigns

Q4 2023 investment outlook

The upbeat tone that underscored most of the first half of 2023 faced some challenges as we entered the second half of 2023. Even as prices remained high across developing economies, headline inflation numbers dampened as compared to the previous year. However, growth in Europe showed signs of faltering, and China's slowdown loomed like a dark cloud over the horizon even as the US economy printed strong numbers that portrayed strong consumption, wage growth and still low unemployment numbers. We saw more downgrades than upgrades in the overall Asian credit space, although fundamentals have remained mostly intact amongst high quality credits. In supply technicals, the primary market issuance for Asian Credit remains extremely slow, providing additional price support for credits as tightening spreads helped offset the rise in interest rates.

We expect the second half of the year to be more revealing of actual economic conditions as the effects from policy transmission surface with more clarity. It is difficult to fathom rate hikes amounting to more than 500bps not having any effect on the US economy. We attribute a large part of stronger than expected headline growth 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 an already debt-fueled economy, more restrictive credit conditions will also further restrict growth as interest rates stay elevated for the near future.

In the US, we believe we are close to the end of the current rate hike cycle. Cooling signs in core inflation numbers offer the Fed an opportunity to take a pause and assess the impact of the past year of rate hikes before deciding on their next step. However, the historically low unemployment rate also lead us to believe that Fed will unlikely cut policy rates this year. Barring a sharp deterioration in US economic growth, the US 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 its Yield Curve Control policy will have significant implications for the course the dollar's strength. Within the region, we have turned cautious on Asian currencies as they are now vulnerable to a US, China or global recession scenario as risks and uncertainties continue to mount.

China's slowdown has led to ripple effects across Asian economies. The growth outlook in Asia is showing signs of weakness especially for exports oriented countries including Singapore, South Korea and Taiwan. This also suggests that global demand including those from developed economies have been weak and are likely to stay lackluster. Barring a major stimulus from China, headwinds from China's slowdown would inevitably mean a prolonged period of weak exports numbers from Asian economies. Countries with a stronger domestic story, such as India and Indonesia, are likely to fare better.

The fall of industry stalwarts in China's property space has been alarming, to say the least. Until Chinese regulators come through with stimulus significant enough to inject optimism to the property market and increase property sales, default risk remains high among private and mixed ownership developers. With continued weakening of technicals and deteriorating fundamentals, we see a low probability of strengthening in the property sector in the short term. While the default of Country Garden hasn't been our base case scenario, the market bloodshed could turn uglier and imply the intent of Beijing to let natural selection run its course. On the upside, albeit painful, this would also mean an acceleration of the consolidation of China's property sector in the longer run.

Inflation in Asia has thus far been fairly under control when compared to developed markets, giving Asian central banks more flexibility to pause rate hikes and potentially cut rates to spur growth should the need arise. There are clear signs that inflation in most Asian countries are likely to continue trending lower, unless food and energy inflation rear its ugly head and cause a spike in headline inflation. 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 adopt a cautious tone in Asian IG credit and remain selective in Asian High Yield. With signs of slowing earnings and weaker economic activity in the region, fundamentals of Asian Investment Grade (IG) corporates remain sound. However, 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 end of October 2023