First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly review and outlook | December 2020

Market review

As we saw in global equity markets, the rollout of Covid vaccinations was perceived to be an encouraging development for the economic growth outlook and, in turn, corporate profitability. This supported investors' appetite for credit and enabled valuations to improve further, extending the recent rally in the asset class. There was also a focus on discussions over a new financial stimulus package in the US. Eventually a second pandemic relief bill was agreed, worth US$900 billion, following the US$2 trillion CARES Act that was approved nine months ago.

These encouraging developments supported sentiment and saw credit spreads narrow in Asia and elsewhere. Performance was hampered by a modest increase in US Treasury yields, but overall returns from Asian credit markets were positive nonetheless. The JACI Investment Grade Index closed the month up 0.25%, extending returns in the 2020 calendar year as a whole to nearly 7%. Ultimately, despite an uncomfortable pickup in volatility, Asian credit generated pleasing returns for investors that persevered with the asset class during and after the Covid shock.

Despite the generally favourable market conditions during December, investors kept a close watch on geopolitical tensions. In particular, relations between the US and China remained strained after American officials added chipmaker SMIC and oil producer CNOOC to the blacklist of Chinese companies with alleged links to the Chinese military. Investors' caution around this issue appeared to prevent spreads from narrowing further over the month.

On the issuance front, Hong Kong Airport Authority, the operator of Hong Kong International Airport, issued US$1.5 billion of new perpetual bonds, in a two-tranche deal. This was the first new investment grade issue in Hong Kong since October and was met with enthusiastic demand. The offer attracted particularly strong interest from institutional investors, with the final order books nearly 10 times over-subscribed. This followed the recent trend in the Asian credit market and saw spreads tighten by 65bps to 70bps from the initial price guidance.

Performance review

The First Sentier Asian Quality Bond Fund returned 0.32% for the month of December net-of-fees SGD term.

The positive return was largely attributed to spread tightening following the rolling out of the Covid-19 vaccines in several countries along with hopes of more fiscal stimulus in the US. The positive return was achieved despite US yields edging higher on the expectation of more supply in the months ahead.

On a relative basis, the fund outperformed the index in December. This was largely due to our short US duration positioning which added value as rates edged higher during the course of the month.

Annualised performance in SGD (%)[1]

	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	4.8	3.8	N/A	3.1
Class A (SGD - Q Dist) (Inc initial charges)	0.6	2.4	N/A	2.1
Benchmark*	6.7	5.4	N/A	4.4

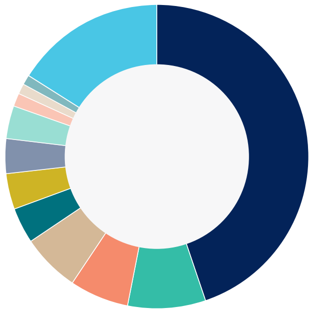
Cumulative performance in SGD (%)[1]

	3 mths	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	1.3	4.8	11.8	N/A	13.6
Class A (SGD - Q Dist) (Inc initial charges)	-2.7	0.6	7.4	N/A	9.1
Benchmark*	1.4	6.7	17.0	N/A	19.6

* The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

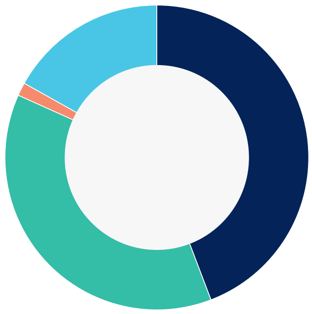
1 Source: Lipper, First Sentier Investors. Single pricing basis with net income reinvested. Data as at 31 December 2020. The First Sentier Asian Quality Bond Fund inception date: 1 November 2016.

Asset allocation (%)[1]



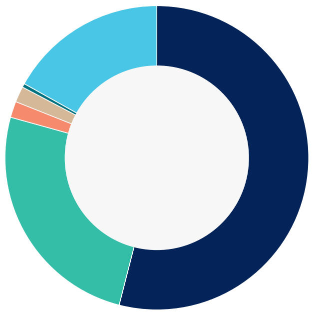
Country

- China 44.1
- Singapore 7.6
- Hong Kong 6.3
- Indonesia 5.8
- Thailand 3.9
- India 3.5
- Malaysia 3.5
- South Korea 3.5
- USA 1.3
- Taiwan 1.2
- Other 1.2
- Liquidity 18.2



Sector

- Corporates 42.8
- Govt Related 36.4
- Treasury 2.6
- Liquidity 18.2



Credit rating

- BBB 52.5
- A 23.8
- AA 2.6
- AAA 2.6
- BB 0.4
- Liquidity 18.2

Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	5.6
China National Chemical Corp	3.5
China Huarong	2.8
Country Garden Holdings Co Ltd	2.7
Pertamina Persero PT	2.6
China Overseas Land & Investment Ltd	2.5
DBS Group Holdings Ltd	2.5
PTT PCL	2.3
Bank of Communications Co Ltd	2.3
United Overseas Bank Ltd	2.0

Fund positioning

The Fund participated in the new issuance from Hong Kong Airport Authority and increased exposure to other high quality names, such as Huanen. We believe these credits will continue to be well supported given the ongoing 'search for yield' thematic.

Investment in selected Chinese property names, such as Country Garden and Shimao, was also increased. Both of these are stable credits and have the potential for ratings upgrades and further spread tightening this year, in our view.

We added to the Fund's position in Thai Oil, which we believe will benefit from the recent increase in the oil price. WTI Crude prices have risen 35% in the past two months alone and are now back to levels from February, before the Covid shock began to dominate attention globally. This should provide a tailwind for revenue growth, and help support sentiment towards this and other energy producers. Thai Oil has also laggard the broader market rally over the past six months or so, providing scope for some catch-up.

In rates, we increased the scale of the Fund's short duration position in US Treasuries. We believe Covid vaccines, which have already started to be rolled out in nine countries, will materially improve the growth outlook. The new stimulus package might also exert some upward pressure on US rates.

Finally, we maintained hedges over the Fund's Chinese yuan and Singapore dollar exposures. The recent rally in Asian currencies has been a little too quick and too strong, in our view.

Q1 2021 investment outlook

As we move into 2021, the economic outlook seems a lot brighter than it was just three months ago. Vaccines against the Covid-19 virus are now being rolled out; more than four million doses have been administered, across nine countries. There will undoubtedly be distribution and logistical challenges in developing regions, but we are reassured by the pace at which the vaccine is being rolled out in countries including the US and Singapore. Hopefully these nations can provide support for others, for collective benefit. We are also encouraged by the high efficacy rate of the approved vaccines and the potential implications for economic activity levels. China, the first country to be hit by Covid-19 – and also the first to have it under control, even before the vaccines – has seen a strong recovery in consumer spending and retail activities. This positive trend may emerge elsewhere if the virus is contained. Many consumers are showing signs of lockdown and work-from-home fatigue, suggesting spending could pick up quite strongly as restrictions are eased.

On the political front, the new Biden administration in the US is expected to be more collaborative with major global trading partners. Some of the inward-looking policies introduced by President Trump might even be unwound during 2021, perhaps helping to rebuild damaged relations with China. A much reduced focus on Trump's social media activity should be a further welcome development, as his random outbursts over the past four years have often spooked investors and resulted in an uptick in market volatility. In Europe, the UK has now left the European

[1] Source: Lipper, First Sentier Investors. Single pricing basis with net income reinvested. Data as at 31 December 2020. The First Sentier Asian Quality Bond Fund inception date: 1 November 2016.

Union, following more than four years of negotiation that has dominated policymakers' agenda. December's trade agreement appears to have greatly reduced uncertainty in the region, which has weighed on sentiment since 2016.

While geopolitical uncertainty appears to be easing, we will continue to closely monitor US sanctions against companies on the list of alleged military-backed entities. The list includes several high profile State Owned Enterprises in China – Three Gorges, SinoChem, China National Chemical Corporation and China General Nuclear Power Group, for example – which are frequent issuers of US$-denominated bonds. The inability to sell bonds to US investors will inevitably affect the liquidity of these securities. We would also be concerned if US banks were prohibited from trading in these names, as such a move would further affect liquidity. The aforementioned names are among the highest quality credits in the Asian universe and any negative developments relating to these issuers could therefore limit spread tightening in the broader market.

Major central banks appear likely to keep monetary policies accommodative to help economies rebound from the Covid shock. We have questioned the effectiveness of monetary policies in dealing with what is a health crisis rather than a cyclical economic slowdown, and are relieved that US officials are starting to voice concerns about the unintended consequences of quantitative easing measures. There remains scope for financial instability worldwide if large-scale asset purchase programs are kept in place for too long. That said, we are not expecting tighter monetary conditions any time soon; it will take time for the current ultra-easy monetary policy settings to be reversed. Policymakers have indicated that policy settings will remain accommodative until there is "significant progress in economy recovery".

At some stage in 2021, we expect Federal Reserve officials to provide clearer forward guidance on the interest rate front. For now, the risk with maintaining such vague guidance is that longer-dated US government bonds could sell off sharply if economic growth and unemployment rebound strongly, particularly if inflation in the US breaches the Federal Reserve's 2% target. Such a move would affect risk assets worldwide, including corporate credit.

The Federal Reserve will likely tolerate a gradual rise in Treasury yields, in our view, particularly as 10-year yields of around 0.9% remain well below the previous low of around 1.4% in 2016. US policymakers' commitment to keep interest rates close to zero until the end of 2023 should support the 'search for yield' theme in global markets. At the same, spreads for both investment grade and high yield credit in Asia remain well above the tights seen in 2017-18, and remain attractive compared to US peers. Fundamentally, credit metrics should further improve as the availability of Covid vaccines boosts consumer and business confidence.

Persistent economic headwinds still suggest default rates in Asia will rise, but a default rate of between 3% and 4% now appears most likely; much lower than forecasts from a few months ago. Stress is most likely to be seen in idiosyncratic names, with minimal spill over anticipated in the broader market. Demand for Asian credit is therefore expected to hold up strongly and any sell-off in the market is likely to be shallow, unless confidence craters and liquidity freezes up as it did in March 2020. The sheer weight of money ready to be deployed into yielding investments is significant. The demand/supply dynamic should therefore remain a powerful technical factor driving spreads tighter in early 2021, and should be supportive of a continued rally in the Asian credit market.

While current spreads look attractive against this backdrop, the sharp drop in US Treasury yields in 2020 means the all-in yield of the JACI Investment Grade index is now close to historical lows. Indeed, we are mindful that returns could be adversely affected by a quicker-than-expected steepening in the Treasury curve. With that in mind, portfolio positioning remains cautious, with higher quality names continuing to be favoured. We will look to further diversify exposures as opportunities are identified in the new issuance market.

A further spike in Covid cases – including the spread of variants of the virus similar to what we have seen recently in the UK – remains the biggest risk to the overall encouraging outlook.

Source : Company data, First Sentier Investors, as of 31 December 2020