

First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | September 2022

Market review

The Asian credit market returned -3.51% in September, weighed down by higher US Treasury (UST) yields and wider credit spreads. US inflation did not see signs of easing as US Consumer Price Index (CPI) surprised on the upside, and the Fed hiked rates by another 75 basis points (bps) during the September Federal Open Market Committee (FOMC) meeting. Asian credit was not insulated from broader risk sentiments as investment grade (IG) spreads widened by 10bps to 208bps, while Asian High Yield (HY) spreads widened by 150bps to 1163bps. We turned more defensive in credit risk given the negative implications that the materialisation of recession may have on credit returns.

In Asian Investment Grade credit, higher UST yields posed headwinds to spreads despite constructive news on border reopening in Asian economies namely Macau, Hong Kong, Japan, and Taiwan. Macau outperformed the rest of the index. In China, there was a rising concern in China Asset Management Space (AMCs) as they continue to face challenging operating conditions and its large exposure in property sector. Moody's downgraded Great Wall AMC to Baa1 with negative outlook. We believe the AMC sector may witness a series of downward rating revisions to BBB credit rating bucket (from A) over the medium term.

In the sovereign space, bonds traded weaker as recent Emerging Market (EM) bond inflows proved to be short-lived, and was more than offset by even larger outflows in September, driven by market volatility. Spreads weakened amongst both sovereign and quasi-sovereign names. Despite poor market sentiment, Indonesia managed to issue multi-tranche USD bonds totaling USD2.65bn in size that was well absorbed by the market. We continue to

remain comfortable with the fundamentals of investment grade rated economies, with an added tinge of caution in broader sovereign spreads, 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, albeit there are still issuance activity from several high quality issuers such as Indonesia sovereign, Korea Electric Power, and the Export-Import Bank of Korea.

Fund positioning

To reduce the portfolio's underweight in Indonesia, we participated in the Indonesian primary issuance market as new issue premiums looked attractive. However, over the course of the month, an added caution on spreads prompted us to sell down our Indonesia sovereign holdings. We also sold the portfolio's remaining exposure in Haidilao amid China's steadfast zero-Covid policy.

Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -3.83% in September, underperforming its benchmark by -0.75%.

The negative return was largely due to the widening of credit spreads amid volatile market conditions. Exposure to china property detracted from returns, although the portfolio's underweight in Indonesian and Philippine sovereigns helped add to performance.

	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.	Reduced overall US duration to an underweight but maintained an overweight in the long end of the US curve.	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 uncertainty 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 30 September 2022

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