First Sentier Asian Quality Bond Fund Monthly review and outlook

Monthly Review and Outlook | September 2023

Market review

Asian credit posted negative returns for a second consecutive month. The JACI Index returned -0.96% in September. In Investment Grade (IG) Asian credit, spreads tightened by 4bps but the investment grade index returned -1.24% over the month. Performance was weighed down by an increase in US rates, which offset the marginal tightening of overall credit spreads on increasing Fed rhetoric and market confidence that the US economy could achieve a soft-landing post aggressive rate hikes, 10-year US Treasuries moved an aggressive 46bps higher, ending the month at 4.57%.

In IG Asian credit, spreads were largely supported by technicals and idiosyncratic news drove bond price movement across the month. In the technology sector, China scored a point in its rivalry against US technology when Huawei utilized a China-made 7nm chip technology for its latest smartphone, showing progress in its attempts to build its own domestic chip ecosystem. However, this win also dragged semiconductor producer SK Hynix into the spotlight for suspicion on supplying China with restricted technology by the US, allegations that SK Hynix has denied and is now investigating. Elsewhere, in the Chinese AMC space – China Great Wall AMC (GRWALL) was downgraded by Fitch to BBB+ with negative watch at the start of the month, citing its failure to produce 2022 financials within its stipulated grace period. Moody's also placed Huarong's issuer rating at Baa3 (HRINTH USD bond rating at Ba1) under review for downgrade. In spite of negative headlines, AMC bonds ended the month with tighter spread on news the Huarong's bond repurchase, which help boost sentiments in the IG space.

Spreads in quasi-sovereign names in Indonesia widened marginally over the month as high US rates weighed heavily on long-dated bonds. Meanwhile, high yield sovereign bonds in markets such as Sri Lanka and Pakistan continued to hold steady on the lack of major headlines.

Primary market activity was fair. Investment grade names, particularly South Korean issuers, took the bulk of the issuances for the month. The largest issuances came from Korea Export-Import Bank (EXIM) and Hyundai Capital America with an issuance size of USD 2bil each. ESG related bonds were also seen from LG Energy Solution and Korea Land & Housing Corporation.

Fund positioning

After reducing credit risk in the previous month, the Fund kept positioning stable and participated in a new Korean issuance.

Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -2.49% in September, underperforming its benchmark by -1.11%.

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 as investment grade quasi-sovereign spreads widened. Exposure in Malaysian Government bonds and the Japanese yen also detracted from performance on the strength of the US Dollar.

	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 stance for US rates in the portfolio	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, sovereign and quasi-sovereign spreads leaked wider. An overweight in long-dated Indonesian quasi-sovereigns further eroded performance

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 30 September 2023