First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | January 2024

Market review

As the pace picked up in January, markets initially saw some retracements in the global bond rally during the end of 2023 as expectations of an earlier rate cut from the Fed faded due to still resilient economic data. However, as quarterly earnings from banks revealed a daunting possibility that many Commercial Real Estate (CRE) loans could fail to repay principals, US Treasury rates dipped again to sub 4% levels, ending the month at 3.91%. Spreads in the Asian credit market, however, remained tight, reflecting the strong supply demand technicals that had been anticipated for the start of the year. JACI Asian Investment Grade (IG) credit spreads widened slightly by 2 basis points (bps), resulting in -0.12% in total returns for the month.

It was largely a firm month for Asian Investment Grade corporates. Thai banks reported improving net margins for the 4th quarter of 2023. China's annual Central Economic Work Conference emphasized "stability" as the keyword for 2024, with the market expecting regulators to continue its support in seeing China through its trough of economic and property sector weakness. News of China's three asset management companies (AMCs) - Cinda, Orient, and Great Wall being incorporated into China Investment Corporation prompted a 10-20bps tightening across the AMCs curves. In the technology space, Baidu and Lenovo saw equity prices slumping on accusation of connections with China's military and/or electronic espionage, but bond prices remained well supported on the back of healthy sector techncials and attractive all-in yields. On the flipside, negative news was observed in some areas of investment grade credit - China's big four asset management companies (AMCs) experienced downgrades by Fitch and Moody's, a decision that was made in view of the weakened governmental support that these institutions had amid their substantial property exposures. Huarong, in particular, was downgraded to high yield by Moody's.

Investment grade sovereign bonds held up well in January. S&P upgraded Indonesia's 3 largest state-owned banks, Mandiri, Rakyat and Negara to BBB from BBB-, mainly due to higher likelihood of extraordinary government support. Meanwhile, quasi-sovereigns also witnessed further spread tightening, with several Indonesian quasi-sovereigns gearing up to implement renewable energy projects in line with Indonesia's ambitious green energy transition plans.

The primary market for Asian US Dollar corporate bonds began the year with a decent start, with more than half of new investment grade issuances coming from South Korea. Sovereign issuances, however, came in weaker, resulting in a combined fall in YoY total issuance numbers. By quantum, ESG bonds comprised approximately one-fifth of investment grade USD new issuances.

Fund positioning

The Fund increased its duration positioning relative to benchmark as the rally in US Treasuries continued into December. Some T-bills were deployed into Chinese credits with good upside potential and long dated local currency bonds.

Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -0.83% in January, underperforming its benchmark by -0.56%.

The Fund's overweight in duration was positive for performance as bonds rallied on the back of lower US Treasury yields. An underweight in sovereign bonds from Indonesia and the Philippines detracted from performance, but this was compensated by an overweight in Indonesian quasi-sovereigns and security selection. Exposure in local currency bonds and the Japanese yen added to performance as the US Dollar weakened.

	We thought that...	Therefore, we...	And the results...
US rates	With the Fed having communicated its pivot, the US rates have peaked. The likelihood of rate cuts would increase as the US economy starts to show signs of weakening in the months ahead	Maintained an overweight bias for US rates in the portfolio, with a tactical approach in light of the recent volatility in rates	The Fund's overweight in US rates versus the benchmark detracted from returns as US rates edged higher during the month as economic data pointed towards a resilient US economy
Asian IG	Fundamentals remain sound in Asian Investment Grade (IG) corporates, but spreads have reached extremely tight levels	Remained focused on high quality names that are deemed more resilient should the market enter a risk-off mode	Overall investment grade spreads leaked wider, detracting marginally from the Fund's performance

Q1 2024 investment outlook

2023 has not been for the faint-hearted. The euphoric mood from China's post-Covid reopening that highlighted the start of 2023 revealed its alter ego as the year progressed with a slew of turbulent events, such as the regional banking crisis and Israel Hamas war. Adding to that, Asian Credit was dealt a challenging hand – the persistent increase in US rates, a struggling Chinese property sector as well as China's economic slowdown. Thankfully, the resilience of the Asian Credit market came through, with the index as a whole still chalking almost 5% in total returns year-to-date.

Entering 2024, we expect global growth, in aggregate, to be slower than in 2023. Our earlier views that US economic conditions were bleaker than hard data suggested was arguably early, but as Covid-era savings run dry, jobless claims rise and retail sales weaken, we are beginning to see the sobering reality of an economy under strain due to the prolonged high interest rate, high inflation environment. We now expect the Federal Reserve (Fed) to adopt a wait-and-see approach over the next few months before deciding on their next move. Barring a re-acceleration of inflation in 2024, we believe the Fed has reached the end of the current rate hike cycle.

In Europe, sustained high prices continue to depress economic growth. Even as headline inflation trends lower, stronger European countries such as Germany are grappling with faltering growth as manufacturing and services activity continue to contract. Unless inflation cools off significantly enough to meet the European Central Bank (ECB's) 2% target, we expect the ECB risks not cutting rates soon enough to cushion the effects of the slowdown in growth in the EU. We believe that growth in Europe in 2024 would be subdued, at best.

China's policies have been turning highly accommodative even though they stop short of a massive stimulus like the one in 2008-2009. By allowing budget deficit to widen to above 3%, it is a very strong indication of China's commitment to prop up growth. However, despite the political commitment to stabilise growth in China, the multilayered problems causing China's slowdown means that we don't expect a quick recovery. The property sector and weak consumer sentiment will remain weak links that need to be addressed. In other words, we still need actual gross domestic product (GDP) numbers and pre-sales in the property sector to pick up on a sustained basis before market confidence can be restored. Nevertheless, we are of the belief that the Chinese economy will emerge much stronger from this consolidation process and maintain a positive long-term outlook for the economy.

Asian economies have been resilient thus far, but effects from China's slowdown are not negligible. The growth outlook in Asia is showing signs of weakness especially for exports oriented countries including Singapore, South Korea and Taiwan, caused not only by China's slowdown, but also reflective of the lackluster demand from developed economies. We believe that this trend is likely to stay. Within the Asian region, countries with a stronger domestic story, such as India and Indonesia, are likely to fare better. Against this weakening external backdrop, most Asian central banks have paused rate hikes as inflation moderated and shifted attention to supporting growth. 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.

Thus far, the rising inflation in Japan has been insufficient to convince Japanese regulators to normalise monetary policy. However, the Bank of Japan's next move should be closely watched as any signs of change to their Yield Curve Control policy will have significant implications for the course the dollar's strength. We see higher certainty of the Euro and other Asian currencies continuing its appreciation against the US dollar, a trend that is largely driven by the Fed's move. Asian local currency bonds may perform well should the Fed cut interest rates in 2024, as this will likely lead to further dollar weakness versus Asian currencies, further boosting Asian local bond returns.

We remain constructive in Asian IG credit. Fundamentals are now mixed but technicals will likely remain a tailwind during the early part of 2024. Even as credit spreads are almost at post-GFC tights, high all-in yields well above 5% does makes this asset class attractive from an income carry perspective. Our bias is to focus on higher quality names that have the liquidity and resilience to withstand a hard global landing, should such a scenario emerge.

Source : Company data, First Sentier Investors, as of 31 January 2024