First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | October 2020

Market review

Investment grade credit spreads tightened early in the month, partly reflecting optimism among investors that a new stimulus program would be approved in the US. Sentiment deteriorated later, as a downturn in equity markets and uncertainty associated with the US presidential election dominated attention. There was also a meaningful uptick in Covid cases in the US and Europe towards month end, requiring new lockdown measures to be introduced in some areas. Again, this eroded sentiment towards credit markets and other risk assets.

US Treasury yields rose quite sharply over the month – particularly on longer-dated securities – as investors repositioned ahead of the election. This acted as a drag on credit markets, offsetting most of the beneficial spread movement. The JACI Investment Grade Index returned 0.02% over the month.

Asian companies remained active in issuing new bonds. Collectively, these deals attracted good levels of interest among investors. On average, the books were around three times oversubscribed – an encouraging indicator, though demand has eased a little from earlier in the year. Similarly, the pricing of new deals has moderated a little; recent new issues have typically been offered at a modest discount to help entice investors.

Chinese e-commerce giant Meituan was among firms to issue sizeable volumes of new debt. The company issued USD2 billion of new 5- and 10-year securities, its inaugural offerings in the USD-denominated market. The deal was more than seven times oversubscribed and pricing was marked tighter as a result. The positive momentum continued in the secondary market after the issuance process was complete.

It was a busy month for sovereign issuance too, with the People's Republic of China issuing USD6 billion of new paper in a multi-tranche deal. This was the first time the Chinese Ministry of Finance had issued USD-denominated bonds in the '144A/RegS' format, which allowed US onshore investors to access the bonds. A mix of tenors were issued, between 3 and 30 years. US demand focused on the longer-dated securities, with American investors buying more than 20% of the 10-year bonds and nearly half of the 30-year issue. Despite the large size, the deal was very well supported – final order books were more than five times covered as income-oriented investors chased the healthy yields on offer.

Performance review

The First Sentier Asian Quality Bond Fund returned 0.31% for the month of October net-of-fees SGD term.

The rise is US Treasury yields offset most of the beneficial spread movement. The positive return in this fund was mainly attributed to SGD strengthening against USD.

Despite the pullback in September and now a flat October, year-to-date return for investment grade bonds still look very respectable at well above 5%. This strong performance is largely due to the strong rally in US Treasuries during January to March period as the Fed slashed policy rates and are committed to keep them low for the new three years.

While credit spreads have recovered strongly from the March low, they are still trading wider than where they started the year reflecting the uncertainty around Covid-19 and rising ratings downgrade risks. However with Biden declared winner in the US election and the positive news around a vaccine which is expected at the end of the year, credit market will likely to remain well supported between now to year end.

Annualised performance in SGD (%)[1]

	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	3.7	3.3	N/A	2.9
Class A (SGD - Q Dist) (Inc initial charges)	-0.5	1.9	N/A	1.9
Benchmark*	5.9	4.9	N/A	4.3

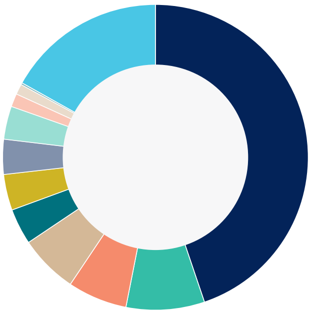
Cumulative performance in SGD (%)[1]

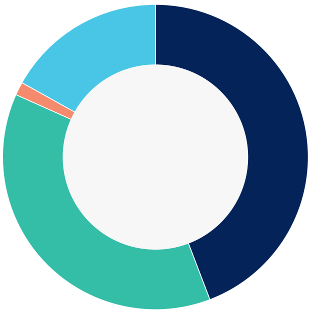
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	-0.2	3.7	10.2	N/A	12.2
Class A (SGD - Q Dist) (Inc initial charges)	-4.2	-0.5	5.8	N/A	7.7
Benchmark*	0.0	5.9	15.5	N/A	18.2

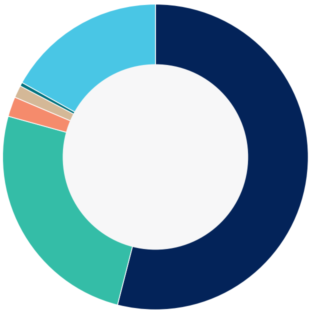
* The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

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

Asset allocation (%)[1]







Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	4.7
China Overseas Land & Investment Ltd	3.2
China Huarong	3.1
Pertamina Persero PT	2.8
DBS Group Holdings Ltd	2.7
Country Garden Holdings Co Ltd	2.6
Bank of Communications Co Ltd	2.5
Sinochem Hong Kong (Group) Co Ltd	2.4
United Overseas Bank Ltd	2.2
ENN Group International Investment Limited	2.2

Portfolio positioning

Cautious portfolio positioning was maintained, given the potential widening in spreads. The Fund only participated in selected new issues over the month, including Chinese property developer Country Garden. The Fund also participated in the Meituan issue, which added meaningful value. We also bought some short-dated, high quality China Central SOE bonds, deploying some of the excess cash in the portfolio.

At the same time, the previous short duration position in the US Treasury market was neutralized, at least until after the presidential election on 3 November. Exposures to the Chinese yuan and Singaporean dollar were also hedged, to protect the portfolio from any unexpected currency volatility around and immediately after the US election.

Q4 2020 investment outlook

Following our last quarterly update, we continued to be mired in a Covid world, alternating between a relaxation of lockdowns and a spike in new cases. Credit markets remained strong, however, as policymakers' commitment to keeping cash rates low increased the appeal of higher yielding alternatives. In fact, during September in the US, Federal Reserve officials announced interest rates will not be increased until 2023 at the earliest. They are also committed to continue supporting the economy, lowering unemployment and pushing up inflation, even allowing it to overshoot their 2% target.

When European Central Bank President Mario Draghi said in 2012 he will do "whatever it takes" to save the euro during the Eurozone sovereign crisis, it was deemed to be bold and decisive. The same cannot be said now of what the Federal Reserve has been doing since the onset of Covid-19. The Global Financial Crisis in 2009 and the Eurozone Crisis in 2012 were both systemic in nature, warranting swift action by the central banks. The coronavirus pandemic, however, is a health crisis which cannot be resolved with zero interest rates or quantitative easing programs. Ultimately, accommodative monetary policy settings will do little for the real economy if the virus continues to prevent people from going back to work and stops people from leading normal lives.

To reiterate what we have cautioned previously, these reckless acts by central banks may actually do more harm than good in the longer term. Their actions will inevitably further inflate asset price bubbles they have created in the past decade; when these bubbles burst, there could be catastrophic consequences. To put some numbers into perspective, the US Federal Reserve's balance sheet is expected to hit USD10 trillion by the end of 2020. Before the financial crisis in 2008-9, the size was well below USD2 trillion. Global quantitative easing programs are expected to cost around USD6 trillion this year alone. That is more than half the cumulative total rolled out during the 2009-2018 period.

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

Some central banks in Asia have also jumped on the bandwagon, with Indonesia and Philippines both rolling out quantitative easing programs. Bank Indonesia (BI) has started buying bonds from both the primary and secondary markets in a bid to cap interest rates. The liquidity injection of close to USD 20 billion has, however, failed to spur much credit growth. In fact the bond buying has had an adverse impact, with foreign investors exiting the government bond market amid fears of depreciation in the rupiah following BI's quantitative easing. Historically, whenever BI has increased money supply the rupiah has weakened significantly. The Indonesian government has also pledged to do more on the fiscal front, which means supply of USD sovereign bonds will almost certainly rise. The lack of medical facilities in the country is even more worrying and there is a high likelihood that the actual number of Covid cases is being under reported. Test kits are not readily available in the country and even if they were, they would likely be unaffordable for many people. With the heightened uncertainty, we have turned more cautious on the outlook for Indonesian sovereign spreads.

In the coming weeks, markets might have to contend with some volatility brought about by campaigning for the US Presidential election, which will be contested on 5 November. Speculation around whether Republican Donald Trump or Democrat Joe Biden will win will intensify in the days and weeks ahead and investors will debate the potential impacts for markets. The world has become more politically and socially polarized in recent years and investors should be mindful about the unpredictability of voters; Trump's election victory in 2016 and Brexit did not happen by accident. Amid the Covid-19 pandemic, many voters could opt to cast a ballot by mail, which could potentially delay the election results and open up allegations of fraud. The risk of a contentious outcome is real. There has been some speculation that either candidate could dispute the election outcome, but this risk currently appears to be under-appreciated by markets. In short, if the situation turns ugly, it could bring about broader social unrest and protests. Markets could therefore face a period of intense volatility in the last quarter of the year, regardless of who wins the election.

On a brighter note, there are currently more than 160 coronavirus vaccines being developed by researchers around the world. No fewer than 26 are currently in clinical trials. Of these, 12 have reached Phase II trials, while another six are in the final Phase III of large-scale efficacy and safety tests. To put these figures into perspective, it took decades for hepatitis B drugs to reach the developmental milestones achieved by Covid-19 researchers in just nine months. We may be edging closer to an effective vaccine more quickly than many people think.

Asian credit markets staged a remarkable 'V shaped' recovery from their lows in March, partly reflecting aggressive interest cuts, quantitative easing measures and fiscal stimulus programs in the US. Returns for the JACI Investment Grade index are now well above 5% in the calendar year to date, an extraordinary return given the extent of the Covid sell-off in February and March. While spreads remain well above the post-GFC average, 'all in' yields are now close to record lows given the fall in Treasury yields. Many high quality credits are currently yielding a meagre <1%.

The Federal Reserve's purchases of investment grade corporate bonds in the US is generally supportive for Asian credits, but the low yield and high dollar price may prove to be a strong psychological barrier for the market to continue to break higher. Further, investors should not underestimate the risk that fiscal stimulus around the world fail to have their desired effect due to the Covid situation persisting or worsening. The market value of 'fallen angels' – investment grade issuers that are downgraded into the high yield category – in Asia is widely estimated to be around USD16 billion, or ~3% of the universe, is not significant at this stage, but the number could rise further. We are not anticipating a downgrade to India's sovereign credit rating, but this could lead to another ~USD40 billion worth of downgrades; this could have a ripple effect across other markets in the region. India has been among the worst hit countries, with Covid-19 putting tremendous strain on the public healthcare system.

On the issuance front, the deal calendar remains busy and most issues are currently being many times covered. Consequently, aggressive final price tightening from initial guidance has meant many issues have not performed particularly well in secondary trading. This was especially evident towards the end of the quarter.

Against this background, we are cautious heading into Q4. Protecting gains and holding high quality and liquid issues should allow us to ride through what could be a turbulent end to an extraordinary year.

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