First Sentier Asian Quality Bond Fund
Monthly review and outlook

Monthly Review and Outlook | September 2020

Market review

Following several months of strong gains since the Covid shock in the March quarter, Asian credit markets paused for breath in September and spreads widened slightly.

There was a substantial focus on commentary from policymakers. In the US, Federal Reserve spokespeople suggested interest rates are unlikely to be raised until 2023 at the earliest. These comments did not have a material impact on Treasury yields; the beneficial impact of a modest 2 bps drop in 10-year yields was insufficient to offset the spread widening. As a result, the JACI Index returned -0.06% over the month.

Robust demand for recent new issues has affected pricing. With most deals comfortably oversubscribed, issuers are completing transactions at valuations that often exceed initial guidance. Companies cannot be blamed for taking advantage of favourable market conditions, but the premiums have meant many new issues have not performed particularly well in secondary trading.

State-owned China National Chemical Corporation (Chemchina) was among issuers in September, selling both USD and EUR-denominated bonds with varying maturities. Chemchina is among the US Pentagon's list of Chinese companies with military links, but that did not deter investors from subscribing for the ~USD3 billion of bonds on offer. Local investors were particularly active in the bidding process, with the new offerings around three times oversubscribed on average.

Taiwan Semiconductor Manufacturing Company also issued USD3 billion of new bonds. Again, the pricing of the deal was above initial guidance.

Performance review

The First Sentier Asian Quality Bond Fund returned -0.39% for the month of September on a net-of-fees basis.

The negative return was largely attributed to spread widening as investors took profit following a strong run in the credit markets since the low in March. The relentless new issue supply further exacerbated the cautious sentiments.

Despite the pullback in September, year-to-date return still look spectacular at close to 5%. This strong performance is largely due to the strong rally in US Treasuries 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.

On a relative basis, the fund lagged the index once again, having previously closed the gap in August. Security selection and an underweight in US duration are the main detractors of performance in the month of September.

- The Fund invests primarily in debt securities of governments and corporate issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

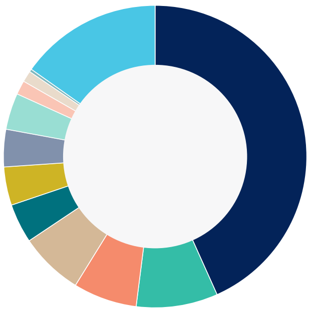
Cumulative performance in USD (%)[1]

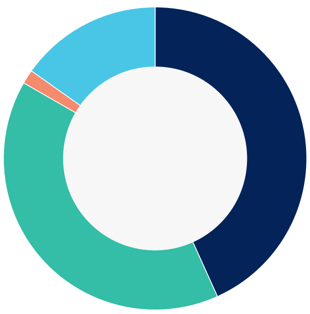
	3 mths	YTD	1 yr	3 yrs	5 yrs	Since inception
Class I (USD - Acc)	2.1	4.4	5.0	14.8	25.9	89.2
Benchmark*	2.0	5.6	6.4	17.5	30.3	145.4

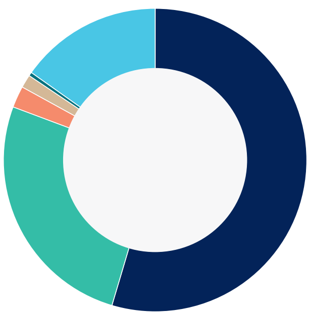
Calendar year performance in USD (%)[1]

	2019	2018	2017	2016	2015
Class I (USD - Acc)	10.9	- 1.3	5.6	3.4	0.9
Benchmark*	11.0	0.0	5.5	4.5	2.2

Asset allocation (%)[1]







Top 10 holdings (%)[1]

Stock Name	%
People's Republic of China (Government)	5.0
China Overseas Land & Investment Ltd	3.5
China Huarong	3.4
Pertamina Persero PT	3.1
DBS Group Holdings Ltd	2.9
Bank of Communications Co Ltd	2.7
Sinochem Hong Kong (Group) Co Ltd	2.6
United Overseas Bank Ltd	2.5
ENN Group International Investment Limited	2.2
Perusahaan Listrik Negara	2.0

Portfolio positioning

Fund activity was primarily focused on deploying excess cash and increasing diversification in the portfolio.

We participated in new issues from Ting Yi, Three Gorges, ENN Energy and Taiwan Semiconductor Manufacturing Company; issuers that are perceived to be high quality, but which do not often come to the market. Otherwise there was limited activity in the portfolio, partly reflecting our overall cautious stance. Protecting gains made in the past few months and holding high quality, liquid names should help the Fund navigate what could be a turbulent end to an extraordinary year.

For now, neutral credit spread positioning and a short interest rate duration bias are held.

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.

Performance is based on First Sentier Asian Quality Bond Fund Class I (USD - Acc) is the non-dividend distributing class of the Fund, the performance quoted are based on USD total return (non-dividend distribution).
This Fund is a sub fund of Ireland domiciled First Sentier Investors Global Umbrella Fund Plc.
* The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.
1 Source: Lipper & First Sentier Investors, Nav-Nav (USD total return) as at 30 September 2020. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%. Fund inception date: 14 July 2003.

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.

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 end of September 2020