First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | February 2023

Market review

The Asian credit market returned -1.33% in February, spreads continued to tighten in investment grade credits while high yield gave up some of their recent months' gain. Meanwhile, US Treasury (USTs) 10-year yields moved higher by 41bps to 3.92% on the back of stronger than expected data and increasing speculation that Federal Reserve may have to hike to a terminal rate beyond 5.25%. For the month, Asian Investment Grade (IG) spreads tightened 14 bps to 169bps, while Asian High Yield (HY) spreads widened by 24 bps to 746bps.

In the Asian Investment Grade (IG) space, the China reopening story remains highly supportive towards market's sentiment. Headline news on Adani relating to allegations of fraud and stock market manipulation affected the bond prices of Adani's entities with little spillover impact to the rest of the market.

During the early part of the month, China High Yield Property bond prices retraced along with weakening global macro sentiment and an absence of further policies from the Chinese government. Country Garden (COGARD), Sino Ocean (SINOCE) fell c. 10pts from January highs. In late February, China Securities Regulatory Commission (CSRC) announced to launch a pilot program for real estate private equity investment funds. The investment scope include residential properties, commercial properties and infrastructure projects. We believe this will help to accelerate developers' contracted sales and cash collection. In addition, contracted sales started seeing signs of recovery, led by tier 2 cities and resales market. Property bonds gradually found some support after falling more than 10pts from highs.

Asian Sovereign bonds also declined as the broader emerging market inflows moderated while higher US Treasury yields also dampened sentiments. Asian frontier markets, Pakistan and Sri Lanka remained at depressed level they continued to struggle in a very challenging economic environment in their respective countries. Fitch further downgraded Pakistan to CCC- from CCC+ as Foreign Exchange (FX) reserves fell to critically low level as it faces upcoming external debt repayments.

Overall issuance volume moderated in February 2023. In the investment grade space we had issuance from Korea Development Bank (KDB), Korea Housing Finance Corp (KHFC), Shanghai Commercial Bank Tier 2, Bank of Communication, Prudential Financial, HDFC Bank. While in High Yield, Dalian Wanda came to the market.

Fund positioning

We continue to invest our excess cash in US T-bills as front end rates remain attractive while we await opportunities. We participated in the Shanghai Commercial Bank T2 in the primary market due to its attractive carry of above 6%. In currencies, we took profit on our CNH and EUR exposure following a strong rally since the end of 2022. We are now largely neutral on currencies with the exception of MYR which we continue to hold. We were also largely neutral on US duration though we now have a positive bias given how much yields have risen in the past month.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned -1.49% in February, underperforming its benchmark by 0.2%.

The negative return was largely due to the sell-off in US treasuries as market started pricing in a higher terminal US Fed policy rate. Even though credit spreads moved tighter for the month, it wasn't enough to offset the US treasuries' loss. On a relative basis, the fund underperformed the benchmark as our overweight in Chinese property bonds gave up some recent gains. Our underweight in Indonesia and Philippines sovereign also detracted value as emerging market debt continued to be well supported throughout the month.

- The Fund invests primarily in debt securities of governments or quasi-government organization in Asia and/or 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 may also expose to RMB currency and conversion risk.
- 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.

	We thought that...	Therefore, we...	And the results...
US rates	The Federal Reserve would be less aggressive in hiking rates, however rate cuts is premature with high prices remains.	Maintained a tactical/neutral stance for US rates in the portfolio.	The Fund's neutral stance in US rates versus the benchmark had a negligible impact on portfolio performance even though US rates moved significantly higher during the month.
Asian IG	Fundamentals remain sound in Asian Investment Grade (IG) corporates but a cautious stance remains warranted following the sharp rally in the past few months.	Tactically traded high quality names in the primary and secondary markets in names that offered attractive issuance premium and still offered value.	The Fund's exposure to Chinese property names detracted value as bond prices retraced following the recent rally. Underweight versus the benchmark in Indonesia and Philippines sovereign also detracted value as spreads contracted amid a more constructive backdrop for emerging markets debt.

Q2 2023 investment outlook

Risky assets started the year in euphoria as a moderation in US inflation led the US Fed to switch to a more gradual path of rate hikes. A complete relaxation in China's zero Covid policy further boosted market's sentiment up to a point valuations in credit markets is no longer pricing in any risk of a global recession. While uncertainty around global growth remains, the high all in yield for Asian Credit is an attractive proposition for us to stay constructive in this asset class.

US economy appears resilient of late and labor market remains tight as jobs creation surprised on the upside. Corporate earnings remain decent though outlook is looking increasingly cautious. We are of the view that the stronger than expected headline figures, especially that of the labor market is likely to have veiled the underlying weakness in the US economy. This weakness may have already started during Q4 2022, during which major US technology firms started laying off workers, a clear indication the outlook is not looking too rosy. US imports have also slowed down significantly in recent months, a trend that is highly evident as we simultaneously witnessed sharp decline in Asian exports. With interest rate now at elevated levels, we are starting to see stress in the housing market as many Americans struggle with the high mortgage rate. With consumer prices moving significantly higher, real disposable income has inevitably declined and this will significantly impact consumption going forward even if inflation is to moderate. We believe the US Fed will continue hiking policy rate at 25bps per meeting so long as unemployment rate stays low and economy continues to expand. We also believe it is inconceivable for the Fed to continue tightening without bringing about a recession. In other words, we believe a recession is imminent. The only question is when it will happen and how deep it gets.

Similar to the US, Eurozone economy held up well despite the numerous challenges it faces which include the Russian-Ukraine war. Inflation though remains a serious problem and looks to be much worse than that in the US at this juncture. This means the European Central Bank (ECB) will likely remain hawkish and play catch-up on policy tightening with the US Fed. Nevertheless, we do take some comfort that the region is now better prepared for further energy shocks as inventory level is high as the region adjusts to a prolonged Russian-Ukraine war. This should help alleviate concerns around a further spike in inflation figures should the war take a turn for the worse.

Meanwhile in Japan, border re-opening since last October didn't quite help bring about a strong recovery in economic activities. In fact growth momentum is showing signs of slowing as exports declined amid weakening global demand especially those from US and Europe. We are skeptical that China re-opening could give Japan a much needed lift. Despite being stuck in a deflationary spiral over the past three decades, Japan did not welcome the current strong inflationary environment as it is costs led rather than demand driven. The weakening yen has further exacerbated the problem to the point it is affecting consumption. While Bank of Japan (BOJ) recently maintained that they will not tweak monetary policy due to supply side issues, we do think a further widening of the yield curve control could not be totally ruled out. We believe BOJ will continue to curb excessive weakness in the Yen while adopting a gradual change to monetary policy if needed.

Asian credit market continued its strong rally towards the end of 2022 on the back an expectation of a more gradual rate hike by the US Fed coupled with positive sentiment around China's re-opening. Valuation for investment grade bonds are now tighter than historical average. Nevertheless, we remain positive on the credit fundamentals of Asian IG and we expect little credit rating changes from here. Supply is also likely to remain soft and hence supportive for bond's demand and supply technical. Should the Fed continue to bring terminal rate higher, the high all in yield of close to 6% would make Asian Investment Grade bonds too attractive to ignore. In other words despite of a cautious global economic outlook, we remain constructive on Asian IG. Asian High Yield led by Chinese properties bonds have done very well of late and is likely to take a pause. We do believe the worse could be over for this sector though we do need to see pre-sales figures improving significantly before bond prices can move higher from here. Following a strong run in the past few months, Asian currencies retraced some of its gain as the dollar regained some ground as market started pricing in a higher terminal Fed fund rate. We do believe this trend may continue a little longer though any further weakness could provide investors a more attractive entry point into Asian currencies. We also expect most Asian central banks to be on hold as inflation figures look relatively benign when compared to developed market peers.

Source : Company data, First Sentier Investors, as of end of February 2023

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