First Sentier Asian Quality Bond Fund Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | May 2023

Market review

The Asian credit market returned -0.82% in May. Asian Investment Grade (IG) spreads remained almost flat, tightening only by 2 basis points (bps) to 184bps, but overall index returns were dragged down by widening spreads in the high yield space and higher US Treasury yields. Asian High Yield (HY) bonds, dominated by the Chinese Property sector, experienced strong pricing pressure on idiosyncratic company news. In rates, the Federal Reserve hiked interest rates by 25bps in early May, and US Treasury (UST) 10-year yields increased by 25bps, ending the month at 3.67%.

Investment Grade Asian credit began the month on a weak note as markets returned from holiday in the month of April. IG credit spreads saw its share of volatility as spreads widened at one point to above 200bps, but the sector overall displayed resilience despite market jitters from the potential US debt ceiling impasse as well as renewed concerns from the US regional banking crisis.

Spreads of Asian investment grade sovereign and quasi-sovereign bonds remained stable with only marginal tightening over the month. Ratings agencies Fitch revised the outlook for the Philippines to stable, reflecting the rating agency's confidence that the country is returning to strong medium-term growth after the Covid-19 pandemic. In Asian frontier markets, prices of Sri Lankan bonds recovered positively as the Asian Development Bank (ADB) approved a special policy-based loan, adding budget support during a time when the country's Balance of Payments (BOP) is showing improvements from tourism receipts and inward remittances. Pakistan, on the other hand, remains in discussion with the IMF to arrange a board meeting to help unlock more funds ahead of a financing program that would expire in June. Prices of Sri Lankan and Pakistan government bonds rose by up to 4 points over the month.

The slump in primary market issuances continued as Asian USD issuance volumes ended slightly lower than April. Malaysia's sovereign wealth fund, Khazanah Nasional launched its first rated USD issuance. The largest issuance of the month came from the Export-Import Bank of China, who issued a 3-year 1.5bil USD bond. Investors also saw other high quality names such as the Hong Kong SAR and the Export-Import Bank of Korea coming to the market with USD issuances.

Fund positioning

The Fund made secondary market transactions where it took profit on names where prices have rallied. In the primary market, the Fund participated in a Malaysian Quasi-sovereign issuance.

Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -1.37 in May, underperforming its benchmark by -0.84%.

On a relative basis, the Fund underperformed its benchmark as overweights in Chinese property detracted from performance. This was partially offset by the Fund's exposure in Indonesian quasi-sovereigns where spreads tightened over the month. Exposure in local currency bonds detracted from performance.

	We thought that...	Therefore, we...	And the results...
US rates	The Federal Reserve would be closer to the end of its rate hike cycle and be less aggressive in hiking rates. 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 on concerns of a US debt default
Asian IG	Although valuations started to look rich, fundamentals remain sound in Asian Investment Grade (IG) corporates. We maintained a cautious stance should spread leak wider	Remained focused on high quality names that are deemed more resilient through risk-off market conditions	Overall investment grade spreads were largely stable. However, the Fund's exposure to Chinese property names detracted from performance as spreads widened. This is offset by an overweight in Indonesian-quasi sovereigns

Q3 2023 investment outlook

2023 has thus far been a more upbeat year than 2022 for Asian Fixed Income, with positive returns year-to-date driven in part by the anticipated slowdown in the Federal Reserve's pace of rate hikes, as well as China's border re-opening. This performance looks even more commendable against the backdrop of market uncertainties brought on by the collapse of Silicon Valley Bank and Credit Suisse Bank. In supply technicals, the significant slowdown in primary market issuance for Asian Credit slowed additional price support for credits, as evidenced by the resilience in credit spreads during periods of market stress, such as the US regional banking crisis.

We expect the second half of the year to be constructive for Asian credit markets. It is difficult to fathom 10 consecutive rate hikes amounting to more than 500bps not having any effect on the economy. Despite headline growth data still coming in above expectations, particularly in terms of consumption data, we attribute a large part of this 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 other words, we do not believe a debt-fueled economy is sustainable if interest rates stay elevated. While the US regional bank crisis appears to be contained for the time being, the root trigger of the crisis - risk-free T-bills still yielding higher than deposit rates – remains, leading many to ponder what else remains beneath the seeming calm. The more obvious path to us is that further tightening of credit conditions will restrict economic growth for the foreseeable future.

Debate abounds the US Federal Reserve's next move. We believe we are close to the end of the current rate hike cycle. With core inflation now below the Fed fund rate, it does give the Fed an opportunity to take a pause, assess the impact of the past year of rate hikes before deciding on their next step. With unemployment rate still near historical lows, we do not believe the Fed will be cutting policy rates this year. Barring a sharp deterioration in economic growth, the 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 their Yield Curve Control policy will have significant implications for the course the dollar's strength.

The euphoria following China's lifting of its zero-COVID policy has proven to be short-lived amid faltering economic momentum in recent weeks. Nevertheless, tailwinds from China's re-opening should continue to benefit the Asian region. The path to recovery will be a winding and bumpy, but coming off a low base, achieving the 5% growth rate for 2023 should be feasible. We believe the probability of large-scale stimulus to be low, but should China's growth falter, the central Chinese government could implement targeted policy measures to support the country's economy.

Inflation in Asia is relatively benign when compared to developed markets, giving Asian central banks more flexibility to cut rates to spur growth should the need arise. In fact, many Asian central banks have paused their rate hikes in recent weeks as inflation moderated further. 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 remain constructive in Asian IG credit while staying selective in Asian High Yield. Despite signs of slowing earnings and weaker economic activity in the region, fundamentals of Asian Investment Grade (IG) corporates remain sound. 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 31 May 2023