# First Sentier
# Asian Quality Bond Fund
# Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | April 2024

## Market review

Rising geopolitical concerns over the month bumped inflation from its top headline spot as markets got increasingly skittish on news of the evolving Middle East conflict, US elections, Ukraine war, and the continuing US-China tensions. What dominated market prices, however, was the Fed's reticence to cut rates, with a 'higher-for-longer' stance lingering on as inflation numbers still stayed on its strong trend. US Treasury benchmark yields moved precariously 11bps higher over the month, a magnitude that more than offset the 9bps in credit spread compression in Investment Grade (IG) USD Asian bonds, producing -1.26% of negative returns for the asset class. As a whole, the JP Morgan Asian Credit Index racked up negative returns of -1.17% for the month.

Following Moody's downgrade in sovereign outlook to negative (from positive), China experienced another downgrade in outlook, this time by Fitch. Spreads in Chinese credits remained stable, largely due to strong technicals, despite economic concerns related to China's languishing property sector. In the technology, media, and telecom (TMT) sector, platform companies still enjoyed stable revenue growth though some companies saw net profits eroded by investment losses. Hardware companies such as Lenovo and Xiaomi generally saw some business recovery. More Chinese investors chased TMT bonds for its yield pickup over State Owned Entity (SOE) bonds. Overall, strong technicals caused credit spreads to continue grinding tighter across the board. Thailand's PTTGC announced an all-cash tender for three out of four of its outstanding USD bonds, taking approximately USD750mil of its bonds off the market.

Spreads in Asian IG sovereign bonds remained mostly stable but prices fell across the board due to higher interest rates. In high yield (HY) sovereigns, Sri Lankan bonds returned some of its prior months' rally as the government's bond restructuring talks had yet to yield an outcome. Meanwhile, in preparation for the sovereign's upcoming external financing requirements in 2025, the International Monetary Fund (IMF) and Pakistan discussed a potential follow-up loan programme to its $3bn stand-by arrangement.

The USD Asian investment grade space saw issuances from Chinese local government financing vehicle (LGFVs), Hong Kong issuers such as CK Hutchison Holdings and South Korean issuers such as LG Electronics, Kookmin Bank and KEB Hana.

## Fund positioning

At tight spread levels, the Fund traded selectively with an emphasis on valuations, such as switching from issues that have enjoyed a good rally into new issues that experienced some spread widening on the back of market volatility. The Fund also participated in the primary issuance market where valuations were attractive.

## Performance review

On a net-of-fees basis (SGD terms), the First Sentier Asian Quality Bond Fund returned -2.16% in April, underperforming its benchmark by -0.74%.

The Fund's overweight in duration detracted from performance as Treasury yields moved higher over the month. An underweight in sovereign bonds from Indonesia and the Philippines shielded the Fund partially from the rise in interest rates, but the Fund's overweight in Indonesian quasi-sovereigns eroded performance. Exposure in local currency bonds and currencies also shaved off from positive returns as the USD appreciated against the broad swath of currencies.

| | We thought that... | Therefore, we... | And the results... |
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| **US rates** | With the Fed having communicated its pivot, 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. |
| **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. | An underweight in sovereigns in Indonesia and the Philippines added to returns, but the overweight to Indonesian quasi-sovereigns vs the benchmark detracted from the Fund's performance. |

## Q2 2024 investment outlook

Like how a storyline needs some twists to maintain an interesting narrative, the current market cycle is giving its fair share of suspense as the anticipated easing in the US economy did not materialize over the first quarter of 2024. Recent economic data portrayed US growth to be stronger than expected, with consumption, labor and growth all pointing to resilient broad-based strength in spite of a relatively high interest environment, and inflation still holding up above the Fed's 2% target.

However, despite the ongoing uncertainty, we do think that the outcome would be largely within expectations, with a slowdown still on the cards. Also, as political noise ramps up in a US election year, we believe that the likelihood of future rate hikes by the Fed is an extremely low probability, even as the timing of rate cuts remains an open question. The path to lower inflation has been noted to be bumpy and we expect global growth, in aggregate, to be slower than in 2023. Given how year-end data can be volatile due to the holiday season, it would be arguably early to conclude that the US is poised to completely avoid a recession. We have witnessed uncertainties and cracks appearing over the past year, and markets can deteriorate very quickly should a downturn emerge. The risk of a stagflation scenario too cannot be totally ruled out and we would rate its probability as higher when compared to the last quarter. Further increases in US treasury issuance, a US debt crisis and a re-acceleration in inflation are possible risks that could challenge the team's long US duration positioning. Should any of these scenarios pan out, the sanguine outlook that markets have priced in for credit spreads could also be at risk.

In Europe, inflation has mellowed in line with lower energy prices, but growth remains subdued, weighed down by economic heavyweights Germany and France, as well as an overall with pessimism in consumer confidence that has shrouded the region. There is a possibility that the ECB could cut rates earlier than the Fed. We expect the ECB risks not cutting rates soon enough to cushion the effects of the slowdown in growth in the EU.

China's policies have been turning highly accommodative even though they stop short of a massive stimulus like the one in 2008-2009. In undertaking an ambitious growth target of 5% for 2024, allowing a continued budget deficit of 3%, and issuing special treasury bonds, China is sending a strong signal in committing to growth. However, 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 consumer confidence and pre-sales numbers 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 export-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.

The Bank of Japan's (BoJ) exit from its NIRP and YCC policy has not come easy after 17 years in a negative interest rate environment. We expect monetary conditions to remain very accommodative in Japan as the BoJ monitors the long anticipated virtuous cycle – for higher wages to translate into higher spending, for the economy's ability to sustain inflation at its 2% target. In the meantime, the course of the dollar's strength remains largely driven by the Fed's monetary policy. When the first rate cuts are implemented, Asian local currency bonds may perform well, and this will likely lead to further dollar weakness versus Asian currencies, further boosting Asian local bond returns.

While Asian Credit fundamentals have remained stable, demand-supply technicals was the bigger driver of year-to-date performance. In line with broad expectations, the scarcity in bond supply has also rendered new issuance premium to be increasingly small. At this juncture, we remain constructive in Asian IG credit as high all-in yields well above 5% does makes this asset class attractive from an income carry perspective. That said, a risk-off scenario could occur very swiftly at current valuation levels. Our bias is for higher quality names and to ensure sufficient diversification in portfolios as the market rides this rally in credit spreads, with a focus on issuers 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 30 April 2024