Matthews Asia

Matthews Asia Credit Opportunities Fund

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Period ended 31 March 2018

For the quarter ending 31 March 2018, the Matthews Asia Credit Opportunities Fund returned 0.69% while its benchmark, the J.P. Morgan Asia Credit Index, returned -1.37% over the same period.

Market Environment:

The first quarter of the year was notable for the return of volatility, which had been largely absent from markets for several years. Volatility in U.S. interest rates led to a repricing of risk globally as investors gave second thought to the risk premiums in valuations. Rising trade tensions between the U.S. and China also led to market swings as investors handicapped the latest headlines and assessed the likelihood of a destructive trade war.

The U.S. Treasury yield curve rose 25 to 40 basis points across the curve in the first quarter. This was driven by robust economic data and comments from new U.S. Federal Reserve Chairman Jerome Powell, indicating that economic conditions may warrant four increases this year—a greater number than had been anticipated. Despite the move in interest rate markets, Asia high yield credit spreads were relatively stable throughout the quarter. High yield new issuance topped US$10 billion for the quarter, a healthy amount for a stable and growing market.

Performance Contributors and Detractors:

In the first quarter, among the biggest contributors to portfolio returns were our holdings in the convertible bonds issued by CP Foods and Bangkok Dusit Medical Services, as well as renminbi-denominated bonds issued by China National Petroleum. CP Foods convertible bonds performed well as the underlying equity rallied nearly 15% on an improving growth and profitability outlook, driving the bond's price higher. Bangkok Dusit Medical convertible bonds performed well as the underlying equity rallied on stronger margins and stability in the Thai health care sector. The bonds are also denominated in Thai baht and benefited from currency appreciation in the quarter. China National Petroleum, an onshore Chinese bond, performed well as credit risk premiums in the country's onshore bond market fell and the currency appreciated versus the dollar.

Among the largest detractors in the first quarter were sub-investment grade Indonesian corporate bonds issued by Lippo Karawaci[1], Jababeka and Cikarang Listrindo. Lippo Karawaci bonds performed poorly as higher interest rates in the U.S. led to maturity extension in the bonds (whereby the bonds went from pricing in an early redemption to being priced to maturity). Jababeka bonds performed poorly as the company disclosed that Perusahaan Listrik Negara (PLN), the Indonesian government's electricity distribution monopoly, curtailed generation at Jababeka's gas-fired power plant because of its high cost and the oversupply environment in Indonesia. Cikarang Listrindo, which is also an Indonesian power generation company, lost value on rising U.S. interest rates and uncertainty in the Indonesian power market driven by PLN.

Notable Portfolio Changes:

In the first quarter, we started new positions, including in the convertible bond of Qingdao Haier and the RMB-denominated bond of China National Petroleum Corp, and added to a number of existing positions. Qingdao Haier[2] is one of the largest Chinese manufacturers of air conditioners and home appliances. We invested in the company's convertible bonds as we believed its shares were trading cheap relative to international peers and that the bonds had limited downside risk. Qingdao Haier might even potentially benefit from U.S. tariffs on foreign washing machines as it bought the General Electric (GE) appliance division back in 2016. As policymakers in China work to deleverage the financial system, China National Petroleum Corp bonds offered an attractive yield relative to the fundamental risk of the company. Amid market volatility in the quarter, we opportunistically added to existing investments in companies such as Lippo Karawaci and Debt and Asset Trading Corp in Vietnam.

Outlook:

In our view, Asia high yield bonds look reasonably valued, while U.S. and European high yield bonds appear overvalued. Credit spreads for Asia high yield bonds are near historic averages. In contrast, spreads for U.S. high yield bonds are about 200 basis points (2.0%) below average while spreads for European high yield bonds are 300 basis points (3.0%) below average. In simple terms, Asia high yield bonds are compensating investors for taking credit risk, in our view, while U.S. and European high yield bonds are not.

Over the course of 2018, we expect to see more volatility in bond prices and credit spreads. At the same time, the relatively attractive yields in Asia offer a strong base for positive returns. A bond that starts with a 5% yield and has 25 basis points (0.25%) of credit spread compression, for example, could potentially generate attractive returns for investors over the course of the year.

In terms of risks, we expect some headwinds from regions such as the Middle East to potentially affect investor appetite for emerging markets. Recent political unrest in Saudi Arabia and Iran will remain at the front of our minds. We see most of these risks as idiosyncratic, however, and unlikely to spread to Asia.

[1] Lippo Karawaci is listed as Theta Capital Pte, Ltd.

[2] Harvest International Co. is a subsidiary of Qingdao Haier.

Rolling 12 Month Returns for the period ended 31 March 2018

Matthews Asia Credit Opportunities Fund	2018	2017	2016	2015	2014
I (Dist) (USD)	6.09%	9.66%	n.a.	n.a.	n.a.
J.P. Morgan Asia Credit Index (USD)	1.73%	4.80%	n.a.	n.a.	n.a.
I (Dist) (GBP)	-5.90%	26.41%	n.a.	n.a.	n.a.
J.P. Morgan Asia Credit Index (GBP)	-9.32%	20.46%	n.a.	n.a.	n.a.

Risk Considerations

The value of an investment in the Fund can go down as well as up and possible loss of principal is a risk of investing. Investments in international and emerging market securities may involve risks such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. The Fund may invest in the following: derivatives which can be volatile and affect Fund performance; high yield bonds (junk bonds) which can subject the Fund to substantial risk of loss; and structured investments which can change the risk or return, or replicate the risk or return of an underlying asset. The Fund invests in holdings denominated in foreign currencies, and is exposed to the risk that the value of the foreign currency will increase or decrease. These and other risks associated with investing in the Fund can be found in the Prospectus.

Performance figures discussed in the Fund Manager Commentary above reflect that of the Institutional Distribution Class Shares and has been calculated in USD. Performance details provided for the Fund are based on a NAV-to-NAV basis, with any dividends reinvested, and are net of management fees and other expenses. Past performance information is not indicative of future performance. Investors may not get back the full amount invested.

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Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg

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