Matthews Asia

Matthews Asia Strategic Income Fund

Period Ended 30 June 2018

For the first half of 2018, the Matthews Asia Strategic Income Fund returned -2.97% while its benchmark, the Markit iBoxx Asian Local Bond Index, returned -3.33%. For the quarter ending 30 June, the Fund returned -5.29% compared to the benchmark return of -4.31% over the same period.

Market Environment:

The key pillars for Asia's strength were firmly in place as the year began, but some of these pillars looked increasingly fragile in the second quarter. Stability in the first quarter was followed by a notable return of volatility in the second quarter. While U.S. growth remains strong, European economic indicators surprised on the downside in the first quarter. Rising trade tensions between the U.S. and China also led to market swings.

On the interest rate front, volatility in rates markets led to a repricing of risk globally as investors demanded higher risk premiums. Strong economic data in the U.S. has increased rate hike expectations for the remainder of 2018 and 2019. As rates in the U.S. moved higher in the second quarter, interest rates in most Asian countries followed suit. The notable exception was China. The higher bond yields resulting from efforts by Chinese authorities to deleverage the financial system began easing earlier in the year and continued through June.

Asia high yield credit spreads are now significantly wider than historical averages. With the attractive value of Asia high yield relative to its U.S. and European counterparts, demand for Asia bonds may turn positive. It is important to put this mild depreciation in the context of the more severe sell-off in the currencies of emerging market countries such as Turkey, Brazil and South Africa—all of which experienced depreciation of more than 15% relative to the U.S. dollar in the second quarter.

After a stable first quarter, Asia high-yield credit spreads widened by 100 basis points (1.0%) in the second quarter, driven by issuers in China and Indonesia. Dispersion among dollar-denominated bonds increased, presenting an opportunity to identify attractive relative value. In this environment, security selection is paramount and we continued to move our portfolio into low duration, higher quality issuers where we believe we are well-compensated for the risk.

Performance Contributors and Detractors:

In the second quarter, among the biggest contributors to portfolio returns were our holdings in the bonds of Sprint Communications, KWG Property Holding and DFCC Bank in Sri Lanka. Sprint Communications, which is majority-owned by the Japanese firm Softbank, benefited from a renewed effort to merge the company with its rival, T-Mobile. The combined company would likely benefit from increased scale and lower leverage. The bonds of Chinese property developers have been under pressure this year as spreads have widened and credit conditions continued to be tight in onshore China. KWG is a high-quality developer with ample liquidity and solid prospects. DFCC Bank bonds mature in October this year and, given their short remaining life, we earned attractive carry with little price volatility by owning them.

The largest detractors in the second quarter were sub-investment grade Indonesian corporate bonds issued by Lippo Karawaci[1], the convertible bonds of CP Foods, a Thai company, and Indonesian government bonds. Lippo Karawaci is a property developer in Indonesia. Bonds performed poorly in the quarter as high yield spreads widened and the Indonesian central bank raised interest rates to help stabilize the Indonesian rupiah, potentially dampening property purchases in the country. CP Foods' convertible bonds performed poorly as shares of its subsidiary CP All corrected on softer growth. Indonesian government bonds performed poorly as the Indonesian rupiah depreciated versus the dollar and rates moved higher.

Notable Portfolio Changes:

In the second quarter, we started a number of positions in local currency, high yield and convertible bonds. We selectively added to our local currency bond holdings. For instance, we invested in Malaysian government bonds and the dim sum bonds of Franshion, a leading property developer. As high yield spreads widened and expectations for rate hikes from the U.S. Federal Reserve increased, we added shorter duration bonds with mid-single digit yields, which we expect will have potentially limited interest rate sensitivity while earning reasonable returns. These include the bonds of Chinese companies like KWG Property and Tsinghua Unigroup, which we added after they fell in price. We also added the convertible bonds of companies like Zhongsheng Group, a leading Chinese auto-dealership, and China Overseas Land & Investment, a high quality Chinese property developer.

We also closed a handful of positions in the quarter. Notably, we decreased both our local currency exposure and duration in Indonesia and India. Both countries have relatively high beta currencies and saw rates move higher in the second quarter, and we proactively reduced risk in each. We also exercised our put on the convertible bonds of Saratoga Investama, an Indonesian holding company with stakes in leading Indonesian companies, as we saw limited upside in continuing to hold the bonds.

Outlook:

While we anticipate that Asia's fixed income markets may remain volatile through the second half of 2018, we do believe that current prices have corrected to account for much of the uncertainty in the global environment. We expect U.S. rates to set the tone for local rates in Asia's developed countries as the U.S. economic cycle gathers momentum and starts to create mild inflation. Recent Federal Reserve commentary has led to somewhat higher expectations for rate hikes in 2018 and 2019. We expect inflation to remain subdued in emerging economies such as India and Indonesia, offering insulation from the rising rate environment globally. The wild card is for tariffs, which can create inflation in the U.S.

We expect Asian currencies to rebound in the second half of the year as the U.S. dollar loses the strong momentum it displayed in the second quarter. One significant driver of dollar strength has been euro weakness. Some measures of Eurozone economic sentiment hit lows experienced during the Global Financial Crisis and Greek Crisis, so we think the euro is more likely to strengthen than weaken given the amount of negativity priced in.

Finally, Asia high yield spreads are now significantly wider than historical averages, with room to fall given default rates of less than 2%. With the attractive value of Asia high yield relative to its U.S. and European counterparts, we expect greater demand for Asia bonds. On the supply side, the move by Chinese regulators to limit offshore issuance to just refinancing of existing issues might create scarcity value. The relative value of Asia combined with little net new supply should drive spreads lower. Here, too, there is potential downside in the negative headlines associated with the inevitable rise of defaults in China. While we have consistently highlighted the need for more defaults to drive a more appropriate credit risk premia onshore, some investors might conflate the Chinese onshore corporate market, which we believe is expensive, with that of the Chinese offshore market, which already has experienced a substantial correction. In sum, we see value in U.S. dollar-denominated debt of Asia corporates because the valuation can be grounded in intrinsic value. As long as we maintain a long-term investment horizon of greater than three years, and experience no defaults, the total return potential for U.S. dollar bonds offers compelling investment opportunity at current levels.

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

Rolling 12 Month Returns for the period ended 31 December 2017

Matthews Asia Strategic Income Fund	2017	2016	2015	2014	2013
I (Acc) (USD)	9.06%	8.83%	-1.03%	n.a.	n.a.

Matthews Asia Strategic Income Fund	2017	2016	2015	2014	2013
Markit iBoxx Asian Local Bond Index (USD)	11.04%	1.73%	-2.88%	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 Accumulation 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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Investors should not invest in the Fund solely based on the information in this material alone. Please refer to the Prospectus for further details of the risk factors.

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

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