Matthews Asia

Matthews Asia Strategic Income Fund

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Period Ended 31 March 2018

For the quarter ending 31 March 2018, the Matthews Asia Strategic Income Fund returned 2.45%, outperforming its benchmark, the Markit iBoxx Asian Local Bond Index, which returned 1.03%.

Market Environment:

The year began on the heels of a strong market in January, followed by a notable return of volatility in February and March. Volatility in rates markets led to a repricing of risk globally as investors gave second thoughts to the risk premiums in their 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.

On the interest rate front, strong economic data and hawkish comments from the new U.S. Federal Reserve Chairman Jerome Powell led to a repricing of rate hikes from three to four increases this year. As rates in the U.S. moved higher, rates in most Asian countries followed suit. One notable exception was China. Over the past few quarters, Chinese authorities pushed yields higher in an effort to drive deleveraging in the financial system, and this began to ease in the first quarter.

Asian currencies were mixed in the quarter, with greater dispersion than in 2017. Countries such as Malaysia, Thailand and China all saw currency appreciation of about 4% in the quarter, while Pakistan, the Philippines and India experienced mild depreciation of 2% to 4%.

Credit spreads were relatively stable throughout the quarter, with high yield Asian spreads closing basically unchanged. Dispersion among credit remained low, driven by continued demand for yield among global investors. In a low dispersion environment, security selection is paramount and we continue to migrate our portfolio to higher quality credits as the lowest credit quality part of our universe offers little premium for additional risk.

Performance Contributors and Detractors:

The biggest contributors to returns in the first quarter were our holdings in ringgit-denominated bonds issued by the Malaysian government, followed by the convertible bonds of CP Foods and the bonds of State Grid Corp. of China. Malaysian government bonds performed well on the combination of interest income and currency appreciation, with the ringgit appreciating 4.7% in the quarter. 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. State Grid Corp. of China, an onshore Chinese bond denominated in renminbi (RMB), performed well as credit risk premiums in the onshore Chinese bond market fell and the currency appreciated versus the dollar.

The biggest detractors to returns in the first quarter were our holdings in rupiah-denominated bonds issued by the Indonesian government, along with our holdings in corporate bonds of Softbank and Modernland Realty (Modernland Overseas). Indonesian bonds performed poorly in the quarter as the rupiah depreciated mildly, and Indonesian interest rates moved slightly higher. Softbank bonds performed poorly in the quarter on a lack of funding clarity for corporate initiatives such as the US$100 billion Vision Fund (the largest venture capital fund in history) and its potential investment in Swiss Re insurance. Modernland Realty bonds performed poorly on the back of a soft macro environment in Indonesia and weakness in the property sector.

Notable Portfolio Changes:

In the first quarter, we actively managed our local currency exposures, selectively reducing exposure in currencies such as the Indian rupee and Indonesian rupiah. While we generally favor local currencies at the moment, we selectively added the U.S. dollar-denominated bonds of corporate issuers such as Lippo Karawaci, Modernland Realty and Vipshop. Lippo Karawaci and Modernland are Indonesian real estate developers whose bonds offered attractive entry points in the quarter. The convertible bonds of Vipshop offer potential upside, particularly after the company took a strategic investment from Tencent and JD.com.

We trimmed our exposure to the Indian rupee as we saw risk increasing. Bond yields have moved higher in recent months as investment appetite from banks waned and foreign investors reached the government's investment limit. At the same time, businesses are still adjusting to the recently implemented Goods and Services Tax (GST). We reduced our weighting in the Indonesian rupiah on softness in the macroeconomic environment and our expectation that the new governor of the Indonesian central bank will move toward pro-growth policies that drive inflation higher.

Outlook:

We expect Asia's fixed income markets to continue to be attractive in 2018, although rising volatility could lead to a bumpier ride across markets. Credit spreads and currency appreciation will likely be tailwinds that drive returns, while interest rates could present a slight headwind in some countries.

We expect U.S. rates to set the tone for local rates in the developed countries of Asia as the U.S. economic cycle gathers momentum and finally starts to create mild inflation. U.S. Federal Reserve Chairman Powell surprised markets with his openness to four rate hikes this year, leading to repricing in equity and fixed income asset classes globally. Nevertheless, the gentle tapping of the economic brakes at this stage of the economic cycle is a prudent measure to slow a robust U.S. economy and should not disrupt the current synchronous growth story. We expect inflation to remain subdued in emerging Asia economies such as India and Indonesia, offering insulation from the rising-rate environment globally.

The factors behind the strong Asian currency performance for the past several quarters will likely continue. They include synchronized global growth, a recovery in world exports and a relative undervaluation of several Asian currencies. We expect currencies of countries with growing current accounts to disproportionately benefit from synchronized global growth. The country most at risk for currency depreciation has been Pakistan. In the first quarter, the Pakistani rupee depreciated over 4% relative to the U.S. dollar. As we continue to see signs of pressure, we hold no exposure to the country either in U.S. dollars or local currency.

Finally, we expect credit spreads to remain at current levels or even tighten in 2018, offsetting any headwinds from rising rates. Asia high yield spreads are still hovering around historical averages, with room to fall more at this stage of the economic cycle. Given default rates of less than 2%, and the attractive relative value of Asia high yield relative to its U.S. and European counterparts, we expect more inflows into Asia, which should also drive spreads lower.

Rolling 12 Month Returns for the period ended 31 March 2018

Matthews Asia Strategic Income Fund	**2018**	**2017**	**2016**	**2015**	**2014**
I (Acc) (USD)	9.03%	8.05%	1.84%	n.a.	n.a.
Markit iBoxx Asian Local Bond Index (USD)	7.28%	0.02%	2.72%	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