Matthews Asia

Matthews Asia Total Return Bond Fund

I (Acc)

Commentary

Period ended 31 March 2022

For the quarter ending 31 March 2022, the Matthews Asia Total Return Bond Fund returned -7.18% (I Acc) and -7.32% (I Dist), while its benchmark, the 50% Markit iBoxx Asian Local Bond/ 50% J.P. Morgan Asia Credit Index returned -4.45%.

Market Environment:

Market sentiment deteriorated significantly in the first quarter of the year with the average spread for high yield 124 basis points (1.24%) wider on the quarter, driven mostly by changes in China high yield real estate. On interest rate and currency, the key themes for the first quarter were inflation and expectations of U.S. rate hikes. Inflation expectations were further exacerbated by the unexpected conflict between Russia and Ukraine which further pushed up energy prices. The latest inflation developments have caused the U.S. Federal Reserve to quicken its path of rate hikes. Higher U.S. interest rates also provided strength to the U.S. dollar, which appreciated against most Asian currencies in the first quarter. Expectations of higher U.S. interest rates and higher domestic inflation in most of Asian countries has also meant higher local interest rates.

The deterioration in China high yield real estate sector is mainly driven by continued defaults of weaker players in the sector and the lack of substantial improvement in contracted sales. While we have seen macro policies on real estate to continue to ease, the recovery is hampered by sporadic COVID-19 outbreaks in key cities such as Shenzhen and Shanghai. Sentiment deteriorated further until China's Financial Stability and Development Committee made a public announcement reassuring the market that further policies will be implemented to stabilize the sector. Market sentiment has seen a partial recovery on the announcement while cautiously waiting for further specific policy implementation.

Performance Contributors and Detractors:

The Fund's Chinese corporate bonds, including Logan Group, KWG Group and Times China underperformed the benchmark due to an overweight in China real estate and selection effect. All three are China real estate developers impacted by the overall China real estate tight funding conditions. On the other hand, by currency, South Korea, Philippines and Indonesia outperformed on the back of both selection and underweight relative to the benchmark. Within the corporate bond portion of the portfolio, Baozun, iQiyi and HSBC Bank were among the top contributors. Baozun is a Chinese e-commerce solution provider and iQiyi is a Chinese video platform. Baozun bonds are puttable in May, and because the company has sufficient cash and liquidity to repurchase the bonds, they've accreted towards par. iQIYI announced a US $285 million fundraising from a consortium of investors, demonstrating shareholder support and access to liquidity. We added HSBC Bank's bonds in the quarter and they were a small contributor to performance.

Notable Portfolio Changes:

During the quarter, we exited positions that reached our price targets or had asymmetric risks to the downside. For example, we exited China pharmaceutical positions such as Hansoh Pharmaceutical and Pharmaron Beijing as regulatory risks no longer justify the risks associated with these positions. We also adjusted the portfolio's currency exposure be more overweight U.S. dollar and underweight Asia local currencies. We believe the recent uncertainties around inflation and geopolitical risk will continue to support a strong U.S. dollar view. Lastly, we added five bond positions outside of China: Australian accounting software company Xero Investments, Thai commercial bank Bangkok Bank, Thai state-owned bank Krung Thai Bank, India-based HDFC Bank and UK multinational bank HSBC Holdings.

Outlook:

The unexpected conflict between Russia and Ukraine, higher prices across energy, soft and hard commodities have put further pressure on inflation. The U.S. Federal Reserve will likely err on the side of faster rate hikes and interest rates in the U.S. will be under further pressure to rise in the medium term. We believe higher U.S. rates will put pressure on Asian central banks to raise interest rates or face more currency depreciation pressures. We do not believe the next few quarters to be favorable to Asian local rates or currencies and have taken steps to reduce the portfolio's local rates and currency exposures.

With China policy turning definitively more positive at a faster pace, we are seeing the turning point in China's policy cycle. With the country's policy cycles leading economic cycles, we expect the current environment to provide good opportunities to add risk. However, the full effectiveness of easing policies are being muted by China's dynamic zero-COVID policy, which has led to periodic lockdowns of major urban areas. Recent COVID outbreaks in key cities such as Shenzhen and Shanghai have put China's annual growth target of 5.5% at risk. To reach this growth target, we expect more proactive fiscal and monetary policy to emerge in the second quarter in support of growth. That said, we expect the weak market sentiment to continue and anticipate higher-than-usual short-term price volatility in markets.

The biggest risks in our portfolio remain the China property companies. With China property bonds across sub-investment grade trading at distressed levels, the market is already pricing in high probabilities of restructuring. While the offshore U.S. dollar-denominated market continues to be shut to most sub-investment grade property developers, there are signs that Chinese banks might be stepping in to provide liquidity. For example, Country Garden—a property development company based in Guangdong—was able to secure a facility of 40 billion renminbi (~US$ 6 billion) from the Agricultural Bank of China as part of a strategic partnership. We are optimistic that more Chinese banks will see the opportunity to step in to be lenders of last resort to bridge the financing gap for the sector.

Rolling 12 Month Returns For the period ended 31/03/2022 - I (Acc)

Name	2022	2021	2020	2019	2018	Inception Date
Matthews Asia Total Return Bond Fund (USD)	-8.14%	17.11%	-6.73%	-1.02%	9.03%	29/08/2014
50% Markit iBoxx Asian Local Bond Index, 50% J.P. Morgan Asia Credit Index (USD)	-4.33%	8.79%	2.05%	3.57%	4.48%	

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

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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