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Schroder ISF* China Local Currency Bond

Fund Manager: Julia Ho | Fund update: February 2023

Market recap

- Data surprises for China have been the main driver of markets, as PMI showed broad-based recovery and housing transactions recorded its first positive annual growth. In February, 10Y Chinese government bond yield fell and ended the month at 2.9%, while RMB was down -2.4%.
- The Fund (CNH C Acc, net) posted +0.3% for the month, outperforming the benchmark, Markit iBoxx ALBI China Onshore index.

Drivers of fund performance

- Rates strategies detracted, predominantly dragged by off-benchmark exposure to US duration.
- For spread strategies, the China Real Estate sector pulled down the performance as homebuyers continue to stay cautious despite the country reopening and government's policy to ease its leverage limits to stir growth in the property sector.

Outlook and positioning

- Strong policy support since November has led to an improving sentiment in the property sector. This, coupled with the acceleration in consumption and production activities indicated the post-COVID recovery in China is well on track.
- The recent NPC highlighted key economic targets such as 5% GDP growth, 3% budget deficit and CNY3.8 trillion local-government special bond quota. Given the modest growth target, the need for big monetary and fiscal policy is likely reduced. While there are tentative signs of stabilization, credit stresses would likely to continue to emerge. Furthermore, uncertainties still remain around the shape of property sector recovery, particularly the restructuring of defaulted developers debt. As such, we believe the PBoC will ease credit policies and step up stimulus to retore home buyers' confidence and ensure the completion of housing projects.
- Foreign bond inflows will likely return once the USD-RMB rate differential stabilizes, especially as Chinese onshore bonds are increasingly seen as a portfolio diversifier and supported by the tailwind of ongoing inclusion of Chinese government bonds into the FTSE World Government Bond Index (WGBI), as well as the longer-term trend for global central banks and SWFs to diversify away from USD assets. In fact, IMF has lifted the weighting of RMB in the SDR currency basket, which bodes well for the internationalization of RMB and increase the attractiveness of RMB assets over the secular horizon.
- Given the economic tailwinds, monetary policy in China is likely to be less accommodative and CGB yields are likely to be range-bound. RMB may experience near term pressure after the recent rally as a more meaningful China reopening should be negative for China's current account, both on domestic demand recovery and capital leakage through the travel route.
- In terms of portfolio positioning, we reduced our underweight duration stance in China after considering the rally of Chinese rates since July and risks of more supply as Beijing bring forward the issuance of local government bond supply to stabilize the economy.
- With the base case outlook that systemic financial risks in the Chinese economy remains very low, we have kept our overweight in policy banks, which provide yield pickup over Chinese government bonds.
- China property spreads are still amongst the highest in Asia IG and HY. We expect the rebound of property sales to take a long path. As such, investors are likely to be keenly watching any incremental measures announced and policy execution. We therefore remain highly selective in corporate credits and will need to see more significant improvement of risk sentiment on Chinese credits before dialling up the allocation. On balance, we prefer a more defensive allocation to spread products with the anticipation that market volatilities will stay.

*Schroder International Selection Fund is referred to as Schroder ISF throughout

Calendar year performance (%)

Year	Fund[1]	Index[2]
2022	1.1	3.5
2021	4.9	6.1
2020	2.0	2.5
2019	4.2	4.4
2018	7.6	8.5
2017*	0.4	1.7
2016*	2.8	4.1
2015*	2.3	2.2
2014*	3.0	2.6
2013*	2.2	2.5

Source: Schroders as at 31 December 2022, based on Schroder ISF China Local Currency Bond C Acc CNH share class, net of fees, bid to bid.

[1] The fund was renamed Schroder ISF China Local Currency Bond Fund from Schroder ISF RMB Fixed Income Fund effective 1 July 2019. There was no change made to the investment objectives or strategy.

[2] With effect from 1 May 2019, Markit iBoxx China Onshore index began to include Chinese policy bank bonds.

*The fund changed investment strategy focus from China offshore investment grade bonds to China onshore bonds, effective 1 June 2017.

Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get the amount originally invested.

Risk considerations

The capital is not guaranteed.

In order to access restricted markets, the fund may invest in structured products. Should the counterparty default, the value of these structured products may be nil.

Non-investment grade securities will generally pay higher yields than more highly rated securities but will be subject to greater market, credit and default risk.

A security issuer may not be able to meet its obligations to make timely payments of interest and principal. This will affect the credit rating of those securities.

Investments in money market instruments and deposits with financial institutions may be subject to price fluctuation or default by the issuer. Some of the amounts deposited may not be returned to the fund.

Currency derivative instruments are subject to the default risk of the counterparty. The unrealised gain and some of the desired market exposure may be lost.

Investments denominated in a currency other than that of the share-class may not be hedged. The market movements between those currencies will impact the share-class.

Investment in bonds and other debt instruments including related derivatives is subject to interest rate risk. The value of the fund may go down if interest rate rise and vice versa.

Emerging markets will generally be subject to greater political, legal, counterparty and operational risk.

Emerging equity markets may be more volatile than equity markets of well established economies. Investments into foreign currencies entail exchange risks.

The fund may hold indirect short exposure in anticipation of a decline of prices of these exposures or increase of interest rate.

The fund may be leveraged, which may increase its volatility. The fund enters into financial derivative transactions. If the counterparty were to default, the unrealised profit on the transaction and the market exposure may be lost.

Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.