Principal Asset Management Company (Asia) Limited

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Principal Asset Class Series – Asian Credit

May 2022

What is the current macro backdrop?

- Skyrocketing food and energy prices pushed United States CPI inflation to 8.5% y/y in March, another 40-year high. Inflation pressures have forced the Fed to tighten policies more aggressive, with the potential of a total of 100 bps hike in the second quarter alone. The Fed is also going to start to roll off its balance sheet in June, at a pace of $95 billion a month eventually.

- After one of the worst quarters for fixed income, the selloff in developed market sovereign bonds continued into the second quarter. U.S. 10-year Treasury yields hit above 3%, its highest level since late 2018. Real yields have also risen extensively and briefly turned positive for the first time since March 2020. Outside of the U.S., 10-year German bund yields are at +1% - the highest level since 2014.

- With a deteriorating global growth outlook and tightening financial conditions, fixed income returns are becoming more challenging. Considering a more attractive carry, cheaper valuations and greater flexibility in policy stimulus amid more controlled inflation within the region, Asian credit may be a more appropriate place to be relative to developed market fixed income while volatility persists.

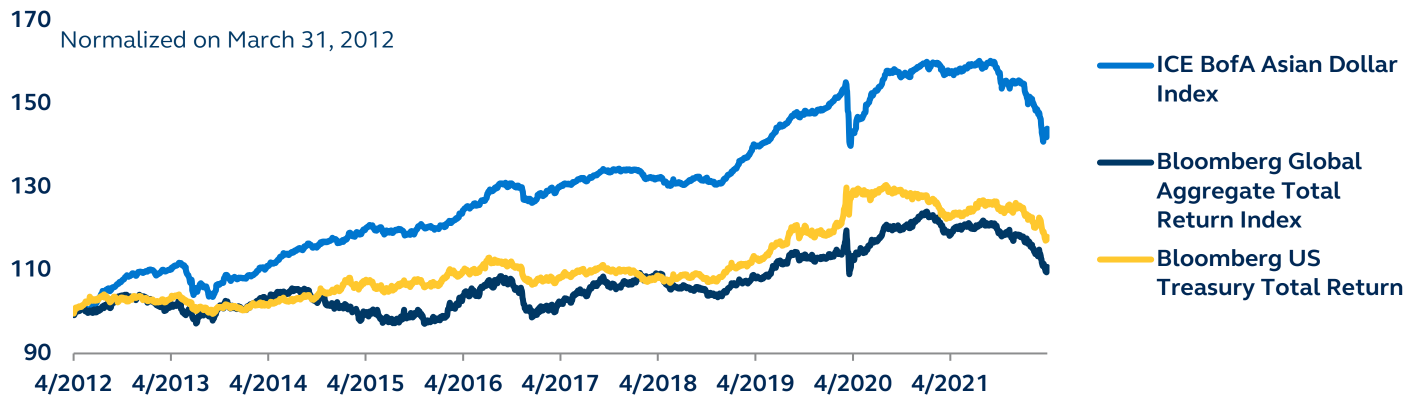
Why may Asian credit outperform?

1. Low yields, yet rising

- Looking back at the last two interest rate hike cycles, Asian bonds outperformed to a large extent after the Fed's first hike from both a one- and two-year cumulative return respective. The ICE BofA Asia Dollar Index returned an average of 8.3% a year after the Fed's first rate hike in 2004 and 2015, outperforming global investment grade bonds (as represented by the Bloomberg Global Aggregate Total Return Index) and U.S. Treasuries (represented by the Bloomberg U.S. Treasury Total Return Index) by approximately 3.4% and 4.5% respectively.

Figure 1: Performance during Fed rate hikes[1]

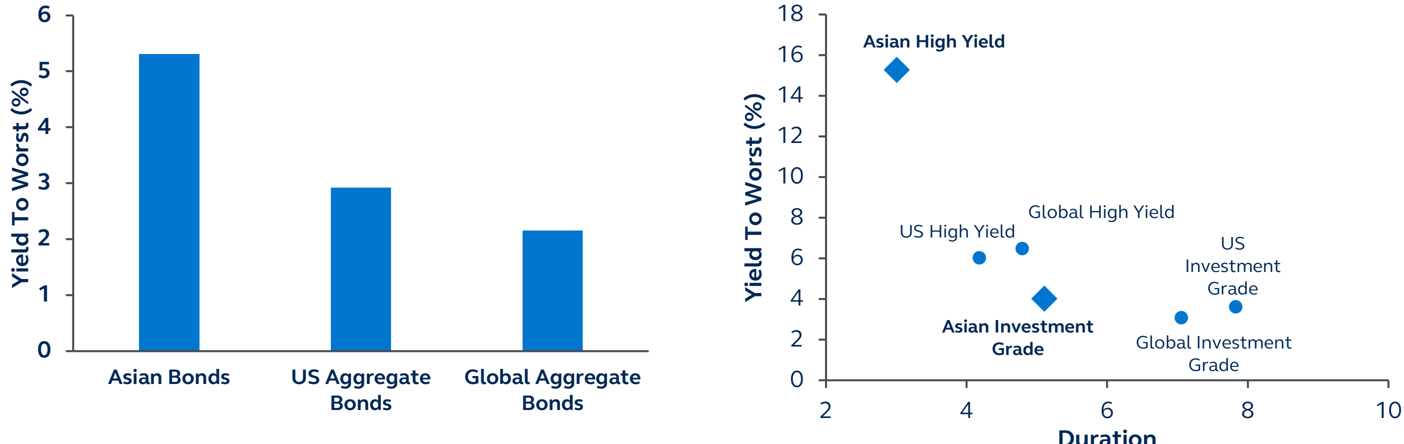
Cumulative Return Subsequent to Fed Rate Hike since June 30, 2004	3-Month	1-Year	2-Year
ICE BofA Asian Dollar Index	**4.9%**	**10.8%**	**12.5%**
Bloomberg Global-Aggregate Total Return Index	3.4%	7.5%	7.8%
Bloomberg US Treasury Total Return Index	3.3%	7.1%	5.3%
Cumulative Return Subsequent to Fed Rate Hike since Dec 16, 2015	**3-Month**	**1-Year**	**2-Year**
ICE BofA Asian Dollar	**2.4%**	**5.9%**	**11.9%**
Bloomberg Global-Aggregate Total Return Index	3.9%	2.4%	9.1%
Bloomberg US Treasury Total Return Index	2.0%	0.5%	3.6%



2. Potential yield advantages

➢ While interest rates in developed markets are on the rise, Asia still possesses potential yield advantages. The yield to worst for Asian bonds was 5.3% as of March, compared with 2.9% and 2.2% for U.S. and global composite bonds. Benefiting from higher yields and relatively short durations means that both Asian investment grade and high yield bonds have yield/duration ratios that are higher than their global counterparts. This may cushion the impacts of rising interest rates.

Figure 2: Asian Credit may exhibit yield and shorter duration advantages[2]



3. More attractive valuations after 1Q selloff

➢ Similar to the global picture, Asia credit spreads have generally widened in the first quarter. Geopolitical tensions, the worsening growth/inflation mix arising from the spike in commodity prices, unclear direction of China's policy actions and tightening Fed policy have all been weighing on financial markets. The spread-to-worst level of Asian credit was almost one standard deviation higher than its 3-year average, which could be tighter when rates stabilize.

Figure 3: Asian credits have moved towards the cheaper end[3]

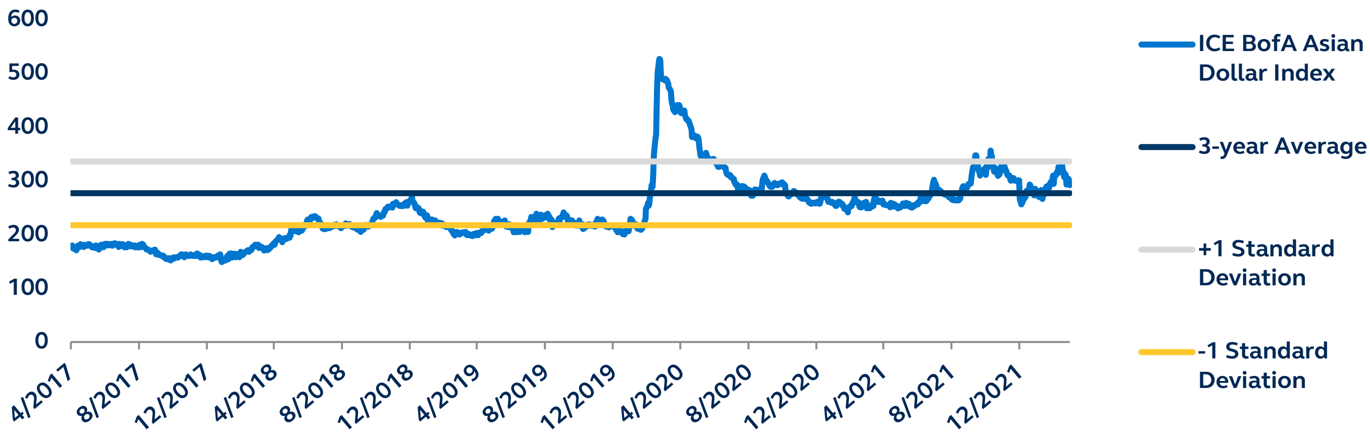
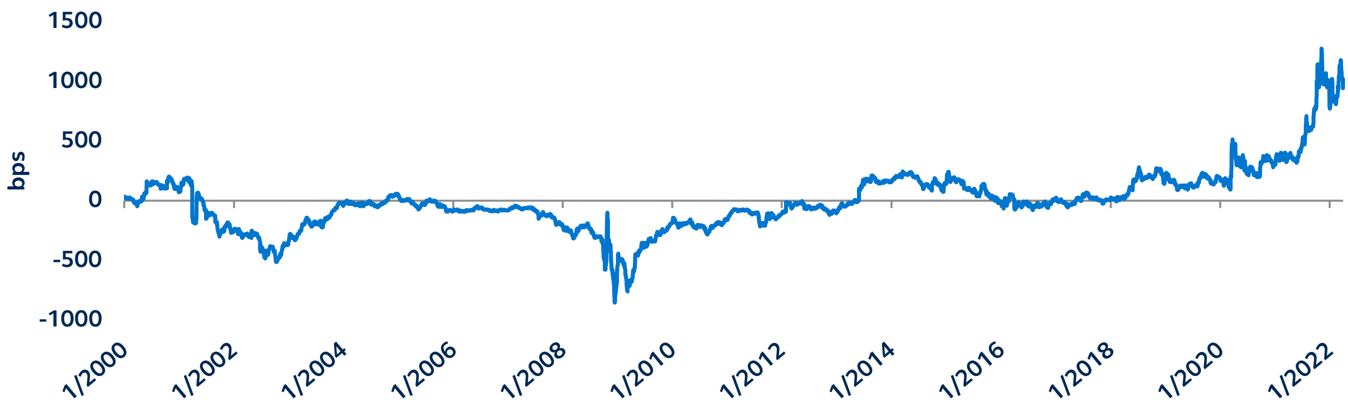


Figure 4: Relative spread: Asia-US high yield[4]



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4. An Asian reopening story, led by China

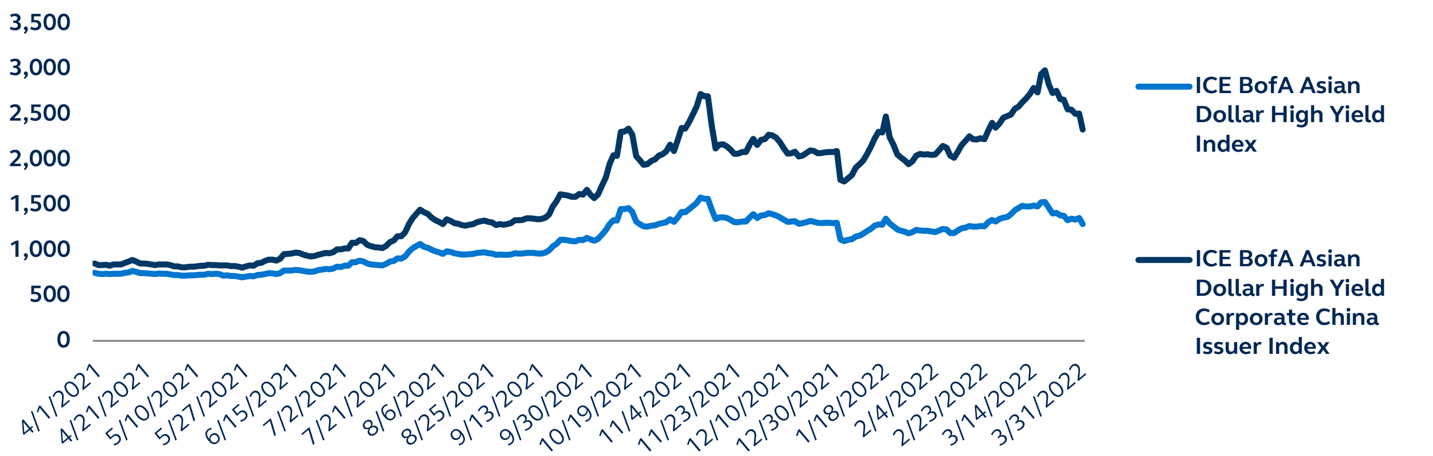
- The Asian economy is expected to maintain relatively strong recovery momentum, leading the global economy to continue to expand in 2022. Compared with the developed world, inflation pressures are relatively subdued in Asia and there are less urgent needs for monetary policy tightening.

- China's GDP growth exceeded expectations in the first quarter, up 4.8% year-on-year, but it slowed on a quarterly basis. The seasonally adjusted quarterly growth slowed from 1.6% in the fourth quarter to 1.3% in the first quarter. The economic growth rate in the second quarter may be even weaker, dragged by the resurgence of COVID cases and lockdowns in different cities.

- It may be more difficult to achieve the annual economic growth target of 5.5%, and measures to stabilize the economy may become more important. On the fiscal front, besides increasing infrastructure investment, expanding tax cuts and fee reductions, a further relaxation of the real estate policies may be crucial.

- The structural elements of policy support – lower mortgage rates, lowered down payment ratios, faster credit disbursal are already in place and might benefit the better-quality developers when the lockdowns ease. They may perform well in sales and have ongoing access to onshore credit channels. Furthermore, the valuation of China high-yield property bonds has become more attractive relative to other high-yield sectors (Figure 5).

Figure 5: China high yield property bonds has become more attractive after the sell-off[5]



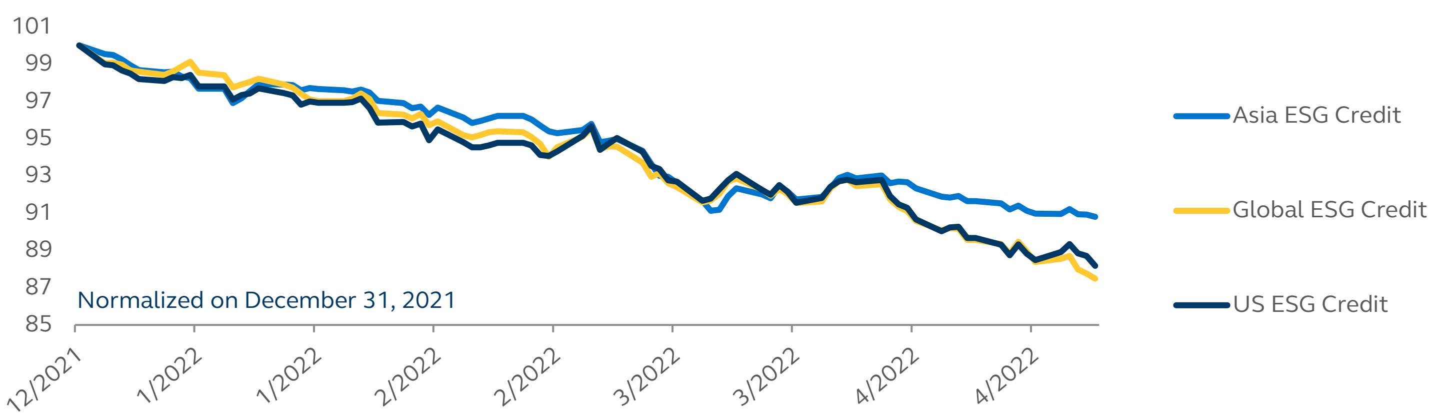
5. Improving Asian ESG credit profile

- Investors are increasingly considering ESG issues to help manage investment risks. ESG performance may reflect a company's efforts to mitigate risks and generate sustainable long-term financial returns.

- ESG factors have historically demonstrated a sizeable impact on Asian fixed income, in areas such as credit quality, defaults, and spreads. Companies with better ESG profiles are likely to have lower financing costs than others.

- Incorporating ESG factors into credit strategies may help investors drive potential positive changes and help achieve attractive risk adjusted return potential over time.

Figure 6: Asian ESG credits have historically achieved less drawdowns than global and US counterparts since the beginning of the year[6]



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[1] As of 31 March 2022. Source: Bloomberg.
[2] As of 31 March 2022. Source: Bloomberg. ICE BofA Asian Dollar Index, Bloomberg US Aggregate Total Return Value Unhedged USD, Bloomberg Global Aggregate Total Return Index Value Unhedged USD, ICE BofA Asian Dollar High Yield index, ICE BofA Asian Dollar Investment Grade Corporate Index, ICE BofA US High Yield Index, ICE BofA US Corporate Index, Bloomberg Global Agg Corporate Total Return and Bloomberg Global High Yield Total Return Index represent Asian Bonds, US Aggregate Bonds, Global Aggregate Bonds, Asian High Yield, Asian Investment Grade, US High Yield, US Investment Grade, Global Investment Grade and Global High Yield, respectively. Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.
[3] As of 31 March 2022. Source: Bloomberg.
[4] As of 31 March 2022. Source: Bloomberg. Spreads are based on ICE BofA indices and represents the difference between effective yield in bps. ICE BofA Asian Dollar Investment Grade Corporate Index, ICE BofA US Corporate Index, ICE BofA Asian Dollar High Yield Index and ICE BofA US High Yield Index represent Asia Investment Grade Corporate, US Investment Grade Corporate, Asia High Yield and US High Yield, respectively.
[5] As of 31 March 2022. Source: Bloomberg.
[6] As of 30 April 2022. Source: Bloomberg. Bloomberg MSCI EM Asia Credit ESG Weighted, Bloomberg MSCI Global Corporate ESG Weighted Index and Bloomberg MSCI US Credit ESG Weighted Total Return Index represent Asia ESG Credit, Global ESG Credit and US ESG Credit, respectively.

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