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Schroder ISF* China Local Currency Bond

Fund Manager: Julia Ho | Fund update: March 2024

Market recap

- High-frequency data continue to show an uneven recovery between supply and demand side indicators. All four China PMIs exceeded 50, entering expansionary territory.
- Yet, credit growth disappointed, with Total Social Financing growth slowing to 9% y/y in February, reflecting subdued demand from the private sector amid a prolonged housing slump and weak consumption.
- Concurrently, CPI rose by 0.1% y/y in March, while PPI inflation fell for the 18th month in a row to a weaker-than-expected -2.8%, primarily due to decrease in raw material prices.
- China's two sessions came and went without much surprises. In line with expectations, a 5% economic growth target and 3% budget deficit was set at the National People's Congress (NPC) with no bazooka stimulus announced. A massive restructuring plan was unveiled, aimed at boosting technological innovation, reducing risks to financial stability, and enhancing financial support for key sectors.
- At the end of March, RMB had declined by 0.27% against USD, while the 10Y CGB yield fell to 2.30%.
- The Fund (CNH C Acc, net) posted 0.30% for the month, trailing its benchmark, Markit iBoxx ALBI China Onshore index which posted 0.42%.

Drivers of fund performance

- The portfolio's residual long US duration exposure contributed to returns.
- Our underweight front-end, and long-end of the China curve posted negative returns.
- Allocations in the Real Estate and Utilities sectors contributed, even though the underweight to policy banks dampened overall spread returns.

Outlook and positioning

- We believe the decline in China's CPI and PPI may have reached its lowest point. However, we anticipate the persistence of lowflation (near-zero GDP deflator) as the nation shifts towards a consumption-led growth model. This is due to structural challenges such as the faltering property market, high youth employment, and a deteriorating demographic trend.
- Though seemingly rather tepid economic conditions, growth remains on steady grounds through the transition away from excessive imbalanced growth. With Q1 GDP growth beating expectations, coming in at 5.3% y/y, policymakers lack the impetus needed to employ bazooka-like stimulus measures that could risk tipping the scale against their objective of sustainable quality growth. That said, authorities will defend any downside deviation from their 5% growth target.
- Aggressive easing may not be in the PBOC's pipeline but the central bank would continue its accommodative stance to support the economy - a positive for CGBs. With the current CGB trading range-bound, we continue to maintain a modest overweight duration stance.
- Given our base case outlook that systemic financial risks in the Chinese economy remain very low, we have maintained our exposures to policy banks. This approach offers a modest yield pickup over CGBs.
- In terms of credit, China's growth weakness should be limited to well-demarcated weak spots such as China property. As such, we stay highly selective and focus on segments expected to be well-supported domestically such as Utilities, Industrial and Financials.
- The strengthening USD is likely to continue to exert downward pressure on the RMB, with the backing of the widening rates differential between the US and China. That said, stability of the RMB remains as authorities' priority. While cognizant that the USD is unlikely to relinquish its strength in the near term, Chinese authorities would however, be tolerable to some weakness in their currency. Over the medium term, however, the dollar is likely to weaken due to its rich valuations and the challenges posed by the twin deficits in the US.
- Over the secular horizon, tailwinds for Chinese onshore bonds remain intact. Foreign bond inflows are likely to return once the USD-RMB rate differential stabilizes or reverses, 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) to an eventual weighting of roughly 5.25% of the index. The longer-term trend of

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

RMBinternationalization and de-dollarization would also be supportive of its currency.

Calendar year performance (%)

Year	Fund[1]	Index[2]
2023	5.6	4.6
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

Source: Schroders as at 31 December 2023, 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.