

Schroder ISF* China Local Currency Bond

Fund Manager: Julia Ho | Fund update: July 2024

Market Overview

- China's July activity data suggested a subdued start to Q3. Fixed asset investment and exports fell short of expectations, the property sector remained soft, while industrial production and retail sales picked up moderately. Notably, industrial production increased by 5.1% y/y, and retail sales grew by 2.7% y/y.
- In July, the PBOC announced a 10bp cut in the 7-day reverse repo rate, as well as in the 1-year and 5-year loan prime rates, reflecting a counter-cyclical policy action in response to the slowing Chinese economy. The State Council also announced a 20-step action plan, including improvements to restaurants and tourist facilities, aimed at supporting consumption.
- In July, the RMB gained 1.04%, while the 10-year CGB yield fell to 2.14%.
- The Fund (CNH C Acc, net of fees) was up 0.55%, outperforming its benchmark, Markit iBoxx ALBI China Onshore Index, which posted 0.40%.

Drivers of Fund Performance

- The Fund's performance was driven mainly by rates strategies, while spreads strategies saw a small downtick.
- Our residual long US duration exposure posted gains, which were partially offset by the curve positioning, particularly the underweight in the short-end (2-3Y) and the ultra-long-end (>40Y) of the CGB curve.
- Positive returns from the Fund's allocation to Real Estate sector were mitigated by exposure to the Industrial sector.

Outlook and Positioning

- China's export sector should remain the primary growth driver for the economy amid ongoing drag in the housing sector and sluggish domestic consumption. China's increasingly diverse exports destination base, particularly to low-income countries in emerging markets, could also minimise the impact from tariffs.
- While authorities projected a stronger voice in ensuring their 5% growth target is met at all costs, a deafening response in return when it comes to implementation, is unlikely. Instead, a calibrated policy response and an accommodative bias are likely to remain the prevailing theme.
- We expect the PBoC's plan to short CGBs to focus on long-dated bonds, particularly the 10-year and 30-year, with the aim of tightening liquidity or moving the whole yield

curve upward, thereby nudging far-end yield upwards. This could result in a steeper CGB yield curve, and a positive-sloping yield curve could attract foreign bond flows, supporting the RMB. Furthermore, a narrower US-China bond yield spread when the Fed begins cutting rates may increase the attractiveness of Chinese onshore bonds.

- Looking ahead, we maintain an overweight duration stance, with the view that although PBoC is unlikely to implement large-scale easing such as quantitative easing, its overall monetary policy stance will stay accommodative.
- Given our base case outlook that systemic financial risks in the Chinese economy remain very low, we have maintained our exposures to policy banks, which offer a modest yield pickup over CGBs.
- While downside pressure on the RMB has eased a touch on the back of stumbling USD strength, sustained strength of the RMB is unlikely given the still wide US-China yield differential and China's relatively weaker growth. Authorities are expected to limit the extent of appreciation by keeping the fixings broadly stable, allowing them to ease monetary policy further without putting pressure on the currency. Over the medium term, however, the dollar has scope to soften due to its rich valuations.
- Over the secular horizon, the 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. This diversification is demonstrated by their outperformance against US Treasury over the past five years, and these bond are still under-allocated in international investors' portfolios. Additionally, the longer-term trend of RMB internationalization and de-dollarization should continue to support the currency.
- For Chinese credit, any weakness should be limited to well-demarcated areas, such as the property sector. We stay highly selective, focusing on segments that are expected to be well-supported domestically, including Financials, Industrials, and Transport.

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.

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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.