Matthews Asia

Matthews Asia Strategic Income Fund

Choose a Share Class: Investor

Period ended June 30, 2018

For the first half of 2018, the Matthews Asia Strategic Income Fund returned -3.49% (Investor Class) while its benchmark, the Markit iBoxx Asian Local Bond Index, returned -3.33%. For the quarter ending June 30, the Fund returned -5.26% (Investor Class) compared to the benchmark return of -4.31% over the same period.

Market Environment:

The key pillars for Asia's strength were firmly in place as the year began, but some of these pillars looked increasingly fragile in the second quarter. Stability in the first quarter was followed by a notable return of volatility in the second quarter. While U.S. growth remains strong, European economic indicators surprised on the downside in the first quarter. Rising trade tensions between the U.S. and China also led to market swings.

On the interest rate front, volatility in rates markets led to a repricing of risk globally as investors demanded higher risk premiums. Strong economic data in the U.S. has increased rate hike expectations for the remainder of 2018 and 2019. As rates in the U.S. moved higher in the second quarter, interest rates in most Asian countries followed suit. The notable exception was China. The higher bond yields resulting from efforts by Chinese authorities to deleverage the financial system began easing earlier in the year and continued through June.

Asia high yield credit spreads are now significantly wider than historical averages. With the attractive value of Asia high yield relative to its U.S. and European counterparts, demand for Asia bonds may turn positive. It is important to put this mild depreciation in the context of the more severe sell-off in the currencies of emerging market countries such as Turkey, Brazil and South Africa—all of which experienced depreciation of more than 15% relative to the U.S. dollar in the second quarter.

After a stable first quarter, Asia high-yield credit spreads widened by 100 basis points (1.0%) in the second quarter, driven by issuers in China and Indonesia. Dispersion among dollar-denominated bonds increased, presenting an opportunity to identify attractive relative value. In this environment, security selection is paramount and we continued to move our portfolio into low duration, higher quality issuers where we believe we are well-compensated for the risk.

Performance Contributors and Detractors:

In the second quarter, among the biggest contributors to portfolio returns were our holdings in the bonds of Sprint Communications, KWG Property Holding and DFCC Bank in Sri Lanka. Sprint Communications, which is majority-owned by the Japanese firm Softbank, benefited from a renewed effort to merge the company with its rival, T-Mobile. The combined company would likely benefit from increased scale and lower leverage. The bonds of Chinese property developers have been under pressure this year as spreads have widened and credit conditions continued to be tight in onshore China. KWG is a high-quality developer with ample liquidity and solid prospects. DFCC Bank bonds mature in October this year and, given their short remaining life, we earned attractive carry with little price volatility by owning them.

The largest detractors in the second quarter were sub-investment grade Indonesian corporate bonds issued by Lippo Karawaci[1], the convertible bonds of CP Foods, a Thai company, and Indonesian government bonds. Lippo Karawaci is a property developer in Indonesia. Bonds performed poorly in the quarter as high yield spreads widened and the Indonesian central bank raised interest rates to help stabilize the Indonesian rupiah, potentially dampening property purchases in the country. CP Foods' convertible bonds performed poorly as shares of its subsidiary CP All corrected on softer growth. Indonesian government bonds performed poorly as the Indonesian rupiah depreciated versus the dollar and rates moved higher.

Notable Portfolio Changes:

In the second quarter, we started a number of positions in local currency, high yield and convertible bonds. We selectively added to our local currency bond holdings. For instance, we invested in Malaysian government bonds and the dim sum bonds of Franshion, a leading property developer. As high yield spreads widened and expectations for rate hikes from the U.S. Federal Reserve increased, we added shorter duration bonds with mid-single digit yields, which we expect will have potentially limited interest rate sensitivity while earning reasonable returns. These include the bonds of Chinese companies like KWG Property and Tsinghua Unigroup, which we added after they fell in price. We also added the convertible bonds of companies like Zhongsheng Group, a leading Chinese auto-dealership, and China Overseas Land & Investment, a high quality Chinese property developer.

We also closed a handful of positions in the quarter. Notably, we decreased both our local currency exposure and duration in Indonesia and India. Both countries have relatively high beta currencies and saw rates move higher in the second quarter, and we proactively reduced risk in each. We also exercised our put on the convertible bonds of Saratoga Investama, an Indonesian holding company with stakes in leading Indonesian companies, as we saw limited upside in continuing to hold the bonds.

Outlook:

While we anticipate that Asia's fixed income markets may remain volatile through the second half of 2018, we do believe that current prices have corrected to account for much of the uncertainty in the global environment. We expect U.S. rates to set the tone for local rates in Asia's developed countries as the U.S. economic cycle gathers momentum and starts to create mild inflation. Recent Federal Reserve commentary has led to somewhat higher expectations for rate hikes in 2018 and 2019. We expect inflation to remain subdued in emerging economies such as India and Indonesia, offering insulation from the rising rate environment globally. The wild card is for tariffs, which can create inflation in the U.S.

We expect Asian currencies to rebound in the second half of the year as the U.S. dollar loses the strong momentum it displayed in the second quarter. One significant driver of dollar strength has been euro weakness. Some measures of Eurozone economic sentiment hit lows experienced during the Global Financial Crisis and Greek Crisis, so we think the euro is more likely to strengthen than weaken given the amount of negativity priced in.

Finally, Asia high yield spreads are now significantly wider than historical averages, with room to fall given default rates of less than 2%. With the attractive value of Asia high yield relative to its U.S. and European counterparts, we expect greater demand for Asia bonds. On the supply side, the move by Chinese regulators to limit offshore issuance to just refinancing of existing issues might create scarcity value. The relative value of Asia combined with little net new supply should drive spreads lower. Here, too, there is potential downside in the negative headlines associated with the inevitable rise of defaults in China. While we have consistently highlighted the need for more defaults to drive a more appropriate credit risk premia onshore, some investors might conflate the Chinese onshore corporate market, which we believe is expensive, with that of the Chinese offshore market, which already has experienced a substantial correction. In sum, we see value in U.S. dollar-denominated debt of Asia corporates because the valuation can be grounded in intrinsic value. As long as we maintain a long-term investment horizon of greater than three years, and experience no defaults, the total return potential for U.S. dollar bonds offers compelling investment opportunity at current levels.

As of 6/30/2018, the securities mentioned comprised the Matthews Asia Strategic Income Fund in the following percentages: Franshion Brilliant, Ltd., 5.200%, 03/08/2021, 0.9%; Sprint Communications, Inc., 6.000%, 11/15/2022, 1.6%; DFCC Bank PLC, 9.625%, 10/31/2018, 2.3%; SoftBank Group Corp., 6.000%, 07/19/2049, 2.4%; (Lippo Karawaci) Theta Capital Pte, Ltd., 6.750%, 10/31/2026, 2.1%; (Lippo Karawaci) Theta Capital Pte, Ltd., 7.000%, 04/11/2022, 0.8%; CP Foods Holdings, Ltd., Cnv., 0.500%, 09/22/2021, 2.5%; Tsinghua Unic, Ltd., 4.750%, 01/31/2021, 2.4%; Zhongsheng Group Holdings, Ltd., Cnv., 0.000%, 05/23/2023, 0.8%; KWG Property Holding, Ltd., 6.000%, 09/15/2022, 3.6%. The Fund held no positions in T-Mobile, Inc. and (Saratoga Investama) Delta Investment Horizon International, Ltd. Current and future portfolio holdings are subject to risk.

[1] Lippo Karawaci is listed as Theta Capital Pte, Ltd.

Average Annual Total Returns - Investor Class (6/30/2018)

1-year -0.09%
3-year 4.41%
5-year 3.83%
10-year n.a.
Inception (11/30/11) 4.28%

Gross Expense Ratio

1.29%

After fee waiver and expense reimbursement: 1.15% [1]

[1] Matthews has contractually agreed (i) to waive fees and reimburse expenses to the extent needed to limit Total Annual Fund Operating Expenses (excluding Rule 12b-1 fees, taxes, interest, brokerage commissions, short sale dividend expenses, expenses incurred in connection with any merger or reorganization or extraordinary expenses such as litigation) of the Institutional Class to 0.90% first by waiving class specific expenses (i.e., shareholder service fees specific to a particular class) of the Institutional Class and then, to the extent necessary, by waiving non-class specific expenses of the Institutional Class, and (ii) if any Fund-wide expenses (i.e., expenses that apply to both the Institutional Class and the Investor Class) are waived for the Institutional Class to maintain the 0.90% expense limitation, to waive an equal amount (in annual percentage terms) of those same expenses for the Investor Class. The Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement for the Investor Class may vary from year to year and will in some years exceed 0.90%. If the operating expenses fall below the expense limitation in a year within three years after Matthews has made a waiver or reimbursement, the Fund may reimburse Matthews up to an amount that does not cause the expenses for that year to exceed the lesser of (i) the expense limitation applicable at the time of that fee waiver and/or expense reimbursement or (ii) the expense limitation in effect at the time of recoupment. This agreement will remain in place until April 30, 2019 and may be terminated at any time by the Board of Trustees on behalf of the Fund on 60 days' written notice to Matthews. Matthews may decline to renew this agreement by written notice to the Trust at least 30 days before its annual expiration date.

All performance quoted is past performance and is no guarantee of future results. *Investment return and principal value will fluctuate with changing market conditions so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the return figures quoted. Returns would have been lower if certain of the Fund's fees and expenses had not been waived. Please see the Fund's most recent month-end performance.*

Yield as of 6/30/2018

30-day Yield: 4.15%

30-day Yield Excluding Expense Waiver: 4.06%

The 30-Day Yield represents net investment income earned by the Fund over the 30-day period ended 9/30/17, expressed as an annual percentage rate based on the Fund’s share price at the end of the 30-day period. The 30-Day Yield should be regarded as an estimate of the Fund's rate of investment income, and it may not equal the Fund's actual income distribution rate. Source: BNY Mellon Investment Servicing (US) Inc.

Fixed income investments are subject to risks, including, but not limited to, interest rate, credit and inflation risks. Investing in emerging markets involves different and greater risks, as these countries are substantially smaller, less liquid and more volatile than securities markets in more developed markets. Visit our Glossary of Terms page for definitions and additional information.

The views and opinions in this commentary were as of the report date, subject to change and may not reflect current views. They are not guarantees of performance or investment results and should not be taken as investment advice. Investment decisions reflect a variety of factors, and the managers reserve the right to change their views about individual stocks, sectors, and the markets at any time. As a result, the views expressed should not be relied upon as a forecast of the Fund's future investment intent. It should not be assumed that any investment will be profitable or will equal the performance of any securities or any sectors mentioned herein. The information does not constitute a recommendation to buy or sell any securities mentioned.

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You should consider the investment objectives, risks, charges and expenses of the Matthews Asia Funds carefully before making an investment decision. This and other information about the Funds is contained in the prospectus or summary prospectus, which may also be obtained by calling 800-789-ASIA (2742). Please read the prospectus carefully before you invest or send money as it explains the risks associated with investing in international and emerging markets. These include risks related to social and political instability, market illiquidity and currency volatility. Investing in foreign securities may involve certain additional risks, exchange rate fluctuations, less liquidity, greater volatility and less regulation. Fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. Single-country and sector funds may be subject to a higher degree of market risk than diversified funds because of a concentration in a specific sector or geographic region. Investing in small companies is more risky and more volatile than investing in large companies.

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