Matthews Asia™

# Matthews Asia Strategic Income Fund

Choose a Share Class: Investor ▼

## Period ended December 31, 2018

For the year ending December 31, 2018, the Matthews Asia Strategic Income Fund returned -4.05% (Investor Class) while its benchmark, the Markit iBoxx Asian Local Bond Index, returned -0.44%. For the fourth quarter, the Fund was flat at 0.0% (Investor and Institutional Classes) versus 3.51% for the Index.

### Market Environment:

Asia's fixed income markets faced challenges in 2018. Starting in the second quarter, volatility was persistent across Asian credit, currencies and interest rates. This was driven by factors such as trade, stress in emerging markets, policy normalization from the U.S. Federal Reserve and an environment that transitioned from synchronized global growth to one in which U.S. growth remained robust while other regions slowed.

The yield on the 10-year U.S. Treasury peaked in early November at 3.24%, up 83 basis points (0.83%) in the year. Late in 2018, as the threat of a disruptive trade war waned and commentary from the Fed became more dovish, U.S. rates moved lower. The shift led to a supportive environment for Asia's currencies, which outperformed the U.S. dollar into year end.

As we move into 2019, some big risks facing Asian economies have begun to fade. In the second half of 2018, consensus views of the U.S.—China trade dispute shifted toward an escalated and protracted conflict encompassing trade, investment, technology transfer and national security. A turning point was the G20 meetings in Buenos Aires in November as market volatility motivated both sides to talk. This paradigm shift was reflected in currency markets across the region, which depreciated versus the dollar in the first 10 months of the year, before rebounding as trade tensions dissipated. For instance, in the first 10 months of the year, high beta currencies such as the Indian rupee (-13.6%) and the Indonesian rupiah (-10.8%) depreciated significantly against the U.S. dollar. As trade tensions dissipated late in the year, both the rupee and the rupiah rebounded, with the rupee gaining 6.0% and the rupiah gaining 5.7%.

Returns in Asia credit were negative for the first time in five years, with spreads across investment grade and high yield issuers widening on the year amid the challenging macro environment. In general, performance was a function of credit quality, with issuers from the more highly rated countries of South Korea and Taiwan outperforming while issuers from Sri Lanka and Indonesia underperformed.

Stress in emerging market countries, such as Argentina and Turkey, also weighed on investor sentiment. While market sell-offs in Argentina and Turkey did not directly spread to Asia, high beta markets such as India and Indonesia, nevertheless, struggled in the third quarter. We believe this is unlikely to be repeated in 2019.

### Performance Contributors and Detractors:

For the full year, among the biggest contributors to portfolio returns were bonds denominated in Thai baht, Malaysian ringgit and Chinese renminbi (RMB). Our Thai baht performance was driven by the convertible bonds of Bangkok Dusit Medical Services, a Thai hospital company, which performed well on the strength of the underlying equity. Our Malaysian ringgit bonds were driven by government bonds, which provided attractive carry with minimal impact from currency depreciation. Our gains in Chinese RMB-denominated bonds was driven by a combination of RMB-denominated convertible bonds of China Railway Construction, and our allocation for much of the year to the high-quality onshore bonds of Chinese issuers.

Among the largest detractors to Fund performance in 2018 were our holdings in U.S. dollar-denominated credits, as well as Indian rupee (INR)- and Indonesian rupiah (IDR)-denominated bonds. Asian credit spreads widened throughout the year, with issuers across the region coming under pressure. The Fund's holdings in companies such as Lippo Karawaci and Modernland in Indonesia, and Ctrip and Tsinghua Unigroup in China, detracted from performance. Our holdings in INR-denominated corporate bonds and IDR-denominated government bonds also performed poorly on a combination of currency depreciation and rising local interest rates.

## Notable Portfolio Changes:

In the fourth quarter, we made a number of portfolio changes aimed at increasing our allocation to local currencies. We increased our currency exposure to countries across the region, including South Korea, Singapore, Thailand and Indonesia. South Korea, Singapore and Thailand are low-yielding countries, with interest rates lower than those in many developed countries. With little short-term upside to rates, we increased our exposure through currency forwards. In Indonesia, interest rates were significantly higher in 2018 as the central bank raised rates to defend the currency, and foreigners sold bonds and exited the market. We see room for interest rates to fall in Indonesia, and chose to add duration as well as currency exposure in the country.

In the fourth quarter, we exited a handful of positions as we reshaped the portfolio. We sold the U.S. dollar-denominated high yield bonds of Lippo Karawaci, as well as the convertible bonds of Vipshop and China Overseas Land & Investment. We also significantly decreased our exposure to the RMB. We sold our holdings of onshore bonds issued by state-linked entities after rates and credit spreads came down. We also sold the dim sum bond of China Jinmao (Franshion Brilliant), a high-quality property developer.

## Outlook:

After significant repricing in 2018, we see the elements for strong performance across Asian credit, currencies and interest rates.

Since the Fed hiked rates four times in 2018 and stayed the course on balance sheet reduction, we expect no more rate hikes by the Fed in 2019. This would give Asia's policymakers the ability to slow their pace of rate hikes as well, and given that inflation remains low across the region, we see a broader drop in Asian interest rates.

Our outlook for Asian currencies is also positive. With U.S. growth still positive but decelerating and the Fed appearing to be on hold, we expect Asia's currencies to outperform. The significant drop in oil prices in the fourth quarter of 2018 also helped shore up oil-importing countries across Asia, providing a boost to foreign exchange reserves, current accounts and fiscal balances.

Finally, Asia high yield spreads offer attractive values for the long-term investor. With 12-month trailing default rates at 1.03% and spreads hovering around 6% at the end of 2018, the market has priced in substantially higher expected future defaults than the current run rate. We believe the major risks to the region, including a further slowdown in global growth, any escalation in trade shocks or further outflows stemming from policy normalization in the U.S., are priced in at these levels. Furthermore, based on our solvency and liquidity analysis, we do not expect any of the securities in the portfolio to default. As such, the relatively attractive yields in Asia offer a strong base for positive returns.

In sum, we see value in U.S. dollar-denominated debt of corporations in Asia 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 Asia credit offers a compelling investment opportunity at current levels.

As of 12/31/2018, the securities mentioned comprised the Matthews Asia Strategic Income Fund in the following percentages: Modernland Overseas Pte, Ltd., 6.950%, 04/13/2024 1.6%; and Ctrip.com International, Ltd., Cnv., 1.250%, 09/15/2022 5.3%. The Fund held no positions in Bangkok Dusit Medical Services Public Co., Ltd.; China Railway Construction Corp., Ltd.; (Lippo Karawaci) Theta Capital Pte, Ltd.; Vipshop Holdings, Ltd.; China Jinmao (Franshion Brilliant, Ltd.); or Tsinghua Unigroup Co. Ltd. Current and future portfolio holdings are subject to risk.

## Average Annual Total Returns - Investor Class (12/31/2018)

1-year -4.05%
3-year 4.54%
5-year 3.10%
10-year n.a.
Inception (11/30/11) 3.89%

## Gross Expense Ratio

1.19%

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.

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***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 12/31/2018

30-day Yield: 5.29%

30-day Yield Excluding Expense Waiver: 5.19%

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 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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