Matthews Asia

Matthews Asia Strategic Income Fund

Period ended March 31, 2018

Download PDF

For the quarter ending March 31, 2018, the Matthews Asia Strategic Income Fund returned 1.87% (Investor Class), outperforming its benchmark, the Markit iBoxx Asian Local Bond Index, which returned 1.03%.

Market Environment:

The year began on the heels of a strong market in January, followed by a notable return of volatility in February and March. Volatility in rates markets led to a repricing of risk globally as investors gave second thoughts to the risk premiums in valuations. Rising trade tensions between the U.S. and China also led to market swings as investors handicapped the latest headlines and assessed the likelihood of a destructive trade war.

On the interest rate front, strong economic data and hawkish comments from the new U.S. Federal Reserve Chairman Jerome Powell led to a repricing of rate hikes from three to four increases this year. As rates in the U.S. moved higher, rates in most Asian countries followed suit. One notable exception was China. Over the past few quarters, Chinese authorities pushed yields higher in an effort to drive deleveraging in the financial system, and this began to ease in the first quarter.

Asian currencies were mixed in the quarter, with greater dispersion than in 2017. Countries such as Malaysia, Thailand and China all saw currency appreciation of about 4% in the quarter, while Pakistan, the Philippines and India experienced mild depreciation of 2% to 4%.

Credit spreads were relatively stable throughout the quarter, with high yield Asian spreads closing basically unchanged. Dispersion among credit remained low, driven by continued demand for yield among global investors. In a low dispersion environment, security selection is paramount and we continue to migrate our portfolio to higher quality credits as the lowest credit quality part of our universe offers little premium for additional risk.

Performance Contributors and Detractors:

The biggest contributors to returns in the first quarter were our holdings in ringgit-denominated bonds issued by the Malaysian government, followed by the convertible bonds of CP Foods and Bangkok Dusit Medical Services. Malaysian government bonds performed well on the combination of interest income and currency appreciation, with the ringgit appreciating 4.7% in the quarter. CP Foods convertible bonds performed well as the underlying equity rallied nearly 15% on an improving growth and profitability outlook, driving the bond's price higher. Bangkok Dusit Medical convertible bonds performed well as the underlying equity rallied on stronger margins and stability in the Thai health care sector. The bonds are also denominated in Thai baht and benefited from currency appreciation during the quarter.

The biggest detractors to returns in the first quarter were our holdings in rupiah-denominated bonds issued by the Indonesian government, along with our holdings in corporate bonds of Softbank and HSBC. Indonesian bonds performed poorly in the quarter as the rupiah depreciated mildly, and Indonesian interest rates moved slightly higher. Softbank bonds performed poorly in the quarter on a lack of funding clarity for corporate initiatives such as the US$100 billion Vision Fund (the largest

Average Annual Total Returns - Investor Class (3/31/2018)

1-year 8.82%
3-year 6.20%
5-year 3.81%
10-year n.a.
Inception (11/30/11) 5.35%

Gross Expense Ratio [1]
1.33%

After fee waiver and expense reimbursement: 1.15% [2]

[1] Matthews Asia Funds' 12b-1 Plan (the "Plan") is inactive. Although the Plan currently is not active, it is reviewed by the Board annually in case the Board decides to re-activate the Plan. The Plan would not be re-activated without prior notice to shareholders and any amounts payable under the Plan would be subject to applicable operating expense limitations. If the Plan were reactivated, the fee would be up to 0.25% for each of the Investor Class and Institutional Class, respectively.

[2] 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

venture capital fund in history) and its potential investment in Swiss Re insurance. HSBC performed poorly due to the combination of rising interest rates and wider credit spreads, driven by soft quarterly results and expectations for charges as the bank exits a number of countries around the world.

Notable Portfolio Changes:

In the first quarter, we actively managed our local currency exposures, adding to currencies such as the Chinese renminbi and the Thai baht, while reducing exposure in currencies such as the Indian rupee and Korean won. We continue to see onshore Chinese bond issues by high quality companies as having attractive relative value. With the potential to generate returns across credit, currencies and interest rates, we added bonds such as China National Petroleum Corp. and Huaneng Power International. We continue to be constructive on the Thai baht and added exposure in the quarter by buying the convertible bonds of Bangkok Dusit Medical Services.

We trimmed our exposure to the Indian rupee as we saw risk increasing. Bond yields have moved higher in recent months as investment appetite from banks waned and foreign investors reached the government's investment limit. At the same time, businesses are still adjusting to the recently implemented Goods and Services Tax (GST). We reduced our weighting in the Korean won amid market volatility and rising trade tensions in the quarter. The won is a high beta currency and could suffer if meaningful tariffs are enacted by the Trump administration.

Outlook:

We expect Asia's fixed income markets to continue to be attractive in 2018, although rising volatility could lead to a bumpier ride across markets. Credit spreads and currency appreciation will likely be tailwinds that drive returns, while interest rates could present a slight headwind in some countries.

We expect U.S. rates to set the tone for local rates in the developed countries of Asia as the U.S. economic cycle gathers momentum and finally starts to create mild inflation. U.S. Federal Reserve Chairman Powell surprised markets with his openness to four rate hikes this year, leading to repricing in equity and fixed income asset classes globally. Nevertheless, the gentle tapping of the economic brakes at this stage of the economic cycle is a prudent measure to slow a robust U.S. economy and should not disrupt the current synchronous growth story. We expect inflation to remain subdued in emerging Asia economies such as India and Indonesia, offering insulation from the rising-rate environment globally.

The factors behind the strong Asian currency performance for the past several quarters will likely continue. They include synchronized global growth, a recovery in world exports and a relative undervaluation of several Asian currencies. We expect currencies of countries with growing current accounts to disproportionately benefit from synchronized global growth. The country most at risk for currency depreciation has been Pakistan. In the first quarter, the Pakistani rupee depreciated over 4% relative to the U.S. dollar. As we continue to see signs of pressure, we hold no exposure to the country either in U.S. dollars or local currency.

Finally, we expect credit spreads to remain at current levels or even tighten in 2018, offsetting any headwinds from rising rates. Asia high yield spreads are still hovering around historical averages, with room to fall more at this stage of the economic cycle. Given default rates of less than 2%, and the attractive relative value of Asia high yield relative to its U.S. and European counterparts, we expect more inflows into Asia, which should also drive spreads lower.

As of 3/31/2018, the securities mentioned comprised the Matthews Asia Strategic Income Fund in the following percentages: CP Foods Holdings, Ltd., Cnv., 0.500%, 09/22/2021 3.0%; Bangkok Dusit Medical Services Public Co., Ltd., Cnv., 0.000%, 09/18/2019 2.5%; SoftBank Group Corp., 6.000%, 07/19/2049 2.6%; and HSBC Holdings PLC, 6.375%, 12/29/2049 2.2%; China National Petroleum

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, 2018 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

Corp., 4.690%, 01/11/2022 1.4%; and Huaneng Power International, Inc., 3.480%, 06/13/2021 1.3%. The Fund held no positions in Swiss Re and Vision Fund. Current and future portfolio holdings are subject to risk.

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.

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.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Neither the funds nor the Investment Advisor accept any liability for losses either direct or consequential caused by the use of this information.

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 3/31/2018
30-day Yield: 4.17%

30-day Yield Excluding Expense Waiver: 4.12%

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.

Use of this site signifies that you accept our Terms and Conditions

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.

Matthews Asia is the brand for Matthews International Capital Management, LLC and its direct and indirect subsidiaries.

Matthews Asia Funds are distributed in the United States by Foreside Funds Distributors LLC, Berwyn, PA

Matthews Asia Funds are distributed in Latin America by HMC Partners
© 2018 Matthews International Capital Management, LLC