First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook

January 2018

- The Fund invests primarily in debt securities of governments and corporate issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

Market Review

Risky assets got off to a flying start with equity markets making new highs while credit rallied towards pre crisis tights. The bullish sentiments were only dampened towards the end of the month as developed market rates edged higher on expectations of more aggressive rate hikes by the Fed along with a normalising of ultra-easy monetary policies by the European Central Bank (ECB). Despite spreads tightening by almost 10bps during the month, JACI returned a negative 0.52% as the loss in US treasuries more than offset the gain coming from spreads tightening. The 10 year US treasury yield increased by 30bps to end the month at 2.71% while JACI blended spread ended the month at 213. Investment grade bonds returned a negative 0.74%, underperforming high yield which delivered a positive 0.25%. This is largely due to the higher interest rate sensitivity of investment grade bonds. Spreads return by country were all positive led by frontier markets including Mongolia, Pakistan and Sri Lanka as sentiments towards emerging markets and frontiers remained highly positive.

The ECB started its asset purchase program tapering this month and minutes from their December meeting (released mid-January) were more hawkish than expected with discussions turning towards the end of the asset purchasing program and potential rate hikes thereafter. In the US, policy rates remained unchanged after the January Federal Open Market Committee (FOMC) meeting but the accompanying statement was interpreted as being slightly more hawkish. The FOMC was more positive on employment, household spending and investment and noted that core inflation is no longer declining with expectations it will stabilise around the 2% objective over the medium term. The Bank of Japan (BOJ) left monetary policy unchanged in the month was expected by markets and offered an upbeat view on inflation. However, some speculation on rate control was introduced at month end when the BOJ increased its monthly bond purchases by JPY30 billion, the first increase since September 2017.

New issuance in Asia remains very strong as we witnessed a total of USD31.7b supply during the month, which is 53% higher year over year. China accounted for 65% of supply while India and Philippines made up another 9%. High yield issuance registered an extremely strong month with USD12b of new issues, considering that total supply for 2017 was only USD75b.

Performance Review

The First State Asian Quality Bond Fund returned -0.48% net of fees for the month of January [1].

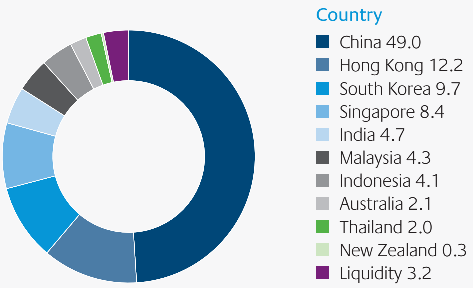
Cumulative Performance in USD (%) [1]						
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	-0.5	-0.5	4.4	8.1	14.1	64.8
Benchmark*	-0.8	-0.7	3.9	9.7	19.3	108.0

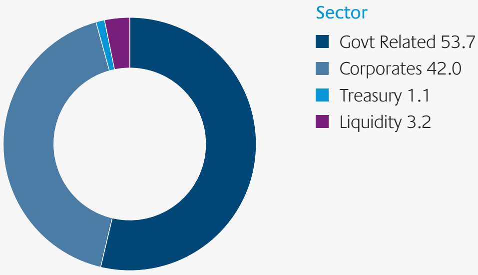
Calendar Year Performance in USD (%) [1]					
	2017	2016	2015	2014	2013
Class I (USD - Acc)	5.6	3.4	0.9	6.8	-3.0
Benchmark*	5.5	4.5	2.2	9.0	-2.6

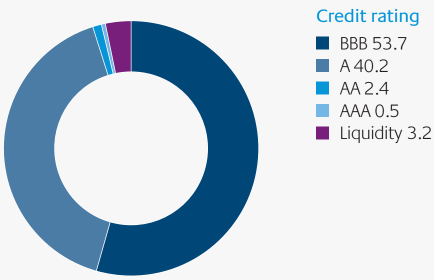
[1] Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 January 2018. Fund since inception date: 14 July 2003. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc) is the non-dividend distributing class of the fund. *The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.

Spreads tightened during the month but that is not enough to offset the higher US treasury yields as market continue to price in further rate hike and less easy monetary policies by both the US Fed and the ECB. On a relative basis, the fund has performed well relative to the JACI IG index. This was largely attributed to our short US interest rate duration strategy which we implemented around mid-month. Our local currency bond holdings also added value as USD continue to weaken.

Asset Allocation (%) [2]







Top 10 Issuers (%) [2]

Issuer Name	%
CNOOC Ltd	5.1
Hyundai Motor Co	4.7
China Huarong	4.4
Sinochem Hong Kong (Group) Co Ltd	4.4
Citic Ltd	3.8
China Overseas Land & Investment Ltd	3.7
China Petrochemical Corp	3.6
Pertamina Persero PT	3.6
United Overseas Bank Ltd	3.2
HongKong JHC Co Ltd	3.1

Portfolio Positioning

During the month, we reduced our US duration from a neutral position as we believe the current synchronised growth in global economies and continued economic improvement in developed countries give the US Fed and the ECB the opportunity to step up the pace of monetary policies normalisation, exerting upward pressure in rates. Supply of US treasuries resulting from fiscal stimulus is likely to exacerbate the situation in the short term. We also reduced our credit exposure albeit maintaining a modest overweight stance, locking in some decent profits following months of relentless rally. As the yield curve in the US has flattened significantly in recent months, we started adding them to our portfolios as we believe they are starting to look more attractive. We remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting the higher beta Indonesia and Philippines sovereign on tight valuations. Within China, we are overweight the investment grade property, neutral on technology while underweighting the banks and LGFVs (Local government financing vehicles). We are underweight India banks on tight valuations offset by an overweight in Corporates. Following a strong run in Asian currencies, we reduce our local currency bonds exposure to around 3% of portfolio, down from the previous 5%.

Investment Outlook

Market and economic conditions look a lot more favorable as we start 2018 versus a year ago when it was clouded with uncertainties. We now have a synchronised global growth that looks set to continue at least in the first quarter along with Fed rate hikes that has been well communicated and thus bringing no surprises. There is also optimism around US tax reforms and China's ability to rebalance its economy without derailing its growth. Amid this positive backdrop, the more plausible risks that we see derailing the risky assets rally would be limited to a more hawkish than expected ECB as it winds down its QE and a sudden spike up in inflation in the developed economy forcing the Fed and ECB to move quicker. Supply and demand technical in the Asian credit market remains extremely favorable as we believe the current situation of too much cash chasing after a limited pool of assets is likely to persist. The onshore Chinese investors' bid is becoming a structural development that bodes well for the market. In short, we are bullish in Asian fixed income for Q1 barring significant changes to the above mentioned factors.

As we correctly anticipated, the US economy progressed well enough throughout the year to allow the US Fed to continue normalising monetary policies. To put some numbers into perspective, the US economy has created nearly 10 million jobs since Janet Yellen took charge in February 2014. Unemployment rate has declined from 6.7% to 4.1% while GDP growth has averaged a healthy though unspectacular 2.1% post the global financial crisis from 2010 to present. If such trends continue or are at least maintained, we do expect the Fed to continue hiking policy rate albeit at a slower rate than what they had projected. Yellen's successor Jerome Powell is also unlikely to bring about any material change to the rate hike trajectory. Just like December 2016 post the US presidential elections, there has been huge optimism from the markets amid the imminent passing of tax cuts and possibility of tax reforms in 2018. Consensus is projecting tax cuts to add around 0.3% to 2018 growth while an increase in fiscal spending in defense and infrastructure to add another 0.2%. While I believe Trump will deliver some of his agenda, his path will unlikely be smooth as the prospects of a widening budget deficit is unlikely to be popular amongst both House Republican and Congressional Democrats. The boost to economic growth is also likely to be short-termed. Drastic and effective structural

[2] Source: First State Investments as at 31 January 2018.

reforms are what we need to see in order to lift the US economy above its trend growth, which we believe is in the 2-2.5% range. Low productivity growth and poor demographics, something we mentioned repeatedly in the past remain the key issues faced by the US as well as other developed economies.

Europe's growth has consistently surprised us on the upside in the past year, led by robust growth in the Germany and France coinciding with a period of synchronised global growth. Leading indicators also point to a continuation of this strong momentum as we head into 2018. That said, we believe this bout of strong economic performance is largely cyclical and exaggerated by consumer and business sentiments recovering from a low base. We do not share the same optimism as many investors do, as we believe Europe as a region has not implemented any meaningful structural reforms that will boost its longer term growth prospects. Also, the continued strength of the Euro will start to weigh on exports. ECB has signaled its intention to taper its QE program by reducing their monthly purchase starting January 2018. It will not be until the middle of 2018 before they announce whether QE will be extended beyond September. In the absence of inflation, policy rate rise will not happen until 2019. This means monetary policies will remain highly accommodative.

Japan's economy has also been delivering good performance amid strong exports growth. Prime Minister Abe winning another strong mandate at the snap elections in October also ensures continuity of Abenomics and its three arrows of easy monetary policy, fiscal stimulus and structural reforms. This was evidenced in the adoption of a JPY2 trillion fiscal package on the 8 December. Similar to Europe, inflation has fallen short of central banks' target and hence interest rates in Japan are expected to stay low. While much attention is on the continued rate hike by the US Fed, the bigger risks to the market is actually an earlier than expected exit from the easy monetary policies by the ECB or BoJ should the strong economic performance continues. This is because while the US rates have started normalising, Bunds and JGBs are still stuck near zero, making them more vulnerable to a rise in yields.

Despite all the skepticism from the developed nations around China especially in 2016 when the renminbi depreciated sharply, China did a remarkable job in delivering strong growth while undergoing economic reforms. It successfully rebalanced its economy away from investments into consumption, while exporters structurally shifted up the value chain and have become more competitive. We have been bullish on China and remain positive as we believe Premier Xi JinPing will continue to drive reforms after he consolidated his authority at the 19th Party Congress. High level of debt remains a problem in China though the pace of credit growth has been slowing. We are not overly concerned as the bulk of the debt is domestic and hence any blowup can be more easily contained. In other words, any crisis from China will pale in comparison to the global financial crisis in 2008 or the European crisis in 2011. A key development we are closing watching in 2018 is the opening up of the China onshore interbank bond market. This is something that investors cannot ignore as this market will eventually form a significant portion of the major global bond indices. The recent spike up in onshore yields brought the 10 year Chinese government bond yield close to 4% which is an attractive level especially when compared against the meagre developed market yields. We believe the renminbi will remain stable though the movement will be dictated by the broad US dollar trend rather than China's macroeconomic performance. PBOC's recent rate hike following on the heels of the US Fed's hike is a clear indication of its determination to keep the renminbi stable.

Amid the synchronised global growth, Asia as a region has benefitted from strong exports growth though that is likely to wane in the second half of 2018 as the developed economies reach the mature state of the current cycle. Countries that are relatively more export oriented including the likes of Singapore, Malaysia and Thailand will be vulnerable to a turn in the global trend, while those with a stronger domestic demand story such as Indonesia and Philippines will likely prove to be more resilient. Accommodative monetary policies have pretty much run its course and most central banks are likely to move towards a tighter stance albeit a very gradual one, with the intention of normalising policy rates and at the same time stabilising their currencies. The most hawkish of the lot is likely to be the Banko Sentral ng Pilipinas (BSP), where we expect at least two 25bps hikes especially should the US Fed continues tightening. BSP historically has been by far the most aligned to the US and with its current account deficit widening putting pressure on the peso, rate hikes look imminent in 2018. With inflation largely subdued and likely to remain so for most part of this region, expectations of rate hike by central banks in Indonesia, Thailand and Malaysia range from only 1-2 hikes. As monetary policies take a back seat, development around fiscal policies will be in focus especially in countries where we are expecting elections namely Indonesia and Malaysia. In order for fiscal stimulus to be effective, it needs to bring about along lasting impact on the structural aspects of an economy. Singapore's push to improving workers' skills and productivity are examples of such reforms and if the rest of the region could follow suit, the longer term prospects of Asia will inevitably look even brighter.