First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

As at December 2015

- First State Asian Quality Bond Fund invests in debt securities of issuers organised, headquartered or having their primary business operations in Asia.
- The Fund invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. The Fund may invest in below investment grade and unrated debt securities. This exposes the Fund to greater liquidity risk, default risk and price changes due to change in the issuer's creditworthiness. The Fund invests in fixed income securities which may be impacted by movement in interest rates. It is possible that the entire value of your investment could be lost.
- For the monthly distributing Shares Class, any fees and expenses relating to this Share Class may be paid out of capital resulting in an increase in distributable income. At times the dividend may be paid out of capital. This amounts to a partial return of an investor's original investment, or from any capital gains attributable to that original investment, and may result in an immediate decrease of the Net Asset Value per share.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

Key highlights:

- Asian credit market started the last month of the year on a cautious note as investors await the first rate hike in almost a decade by the US Federal Reserve.
- On the 17th December, Yellen delivered the 25bps hike as widely anticipated without causing much market reaction. On the 17th December, Yellen delivered the 25bps hike as widely anticipated without causing much market reaction.
- We maintained our modest overweight position in credits against a still supportive monetary policies backdrop globally, that will lead to the continued search for yield.
- Challenging times are ahead for Asia though we see some bright spots. Reforms in China, India and Singapore are long-term positive despite the near term growth uncertainty.

Market Commentary

Asian credit market started the last month of the year on a cautious note as investors await the first rate hike in almost a decade by the US Federal Reserve (Fed). Throughout the month, oil & gas and other commodity names especially in the high yield space came under pressure as crude oil continued to make new lows. On the 17th December, Yellen delivered the 25bps hike as widely anticipated without causing much market reaction. Asian bonds subsequently went into hibernation mode as liquidity dried to a trickle heading into year end. Spread of the JPMorgan Asia Credit Index (JACI) widened by 5 bps to close the month at 283 bps while 10-year US treasury yield rose 6 bps to 2.27%. Top performers in terms of spread returns albeit modest were Pakistan and South Korea, while India and Sri Lanka experienced more substantial weakness. For the year, JACI returned 2.80%, JACI IG 2.16% and JACI High Yield 5.20%

The Federal Open Market Committee (FOMC) of the Fed has finally and unanimously started the monetary policy normalisation process by announcing a 25bp increase in the Fed Funds target range from 0%-0.25% to 0.25%-0.5%. The statement accompanying the policy decision highlighted the improvement in the US economy, noting that there has been considerable improvement in labour market conditions this year. Also, the Fed notes that economic activity has been expanding at a moderate pace, with household and business investment increasing at solid rates, housing improving further, while net exports remained soft. The Fed statement also reinforced the data-dependent nature of the policy outlook, stating that the actual path of the Federal Funds rate will depend on the economic outlook as informed by incoming data.

On the 11th December, the China Foreign Exchange Trade System (CFETS) published a CFETS exchange rate index for RMB. At the same time, the People's Bank of China (PBoC) issued an article on its website about this index stating that the purpose of this index is to help guide market participants to shift their focus from the bilateral RMB/USD exchange rate to the effective exchange rate, which is based on a basket of currencies. This aim to maintain the RMB exchange rate stable at an adaptive and equilibrium level.

New bond supply for the month came in at US$ 9.7b, largely from Indonesia sovereign (US$ 3.5b) and Chinese banks. For the full year, total issuance was at US$ 174b, a 14% decline year over year. Chinese issuers accounted for 55% of the total, up from the 52% in 2014, a strong testament of the increasing dominance of the second largest economy of the world. By sector, only sovereigns saw an increase of 15% year over year. Banks decreased by 7%, investment grade

corporates was down 21% while high yield contracted sharply by 25%.

Performance

In USD terms, the **First State Asian Quality Bond Fund** fell 0.5% in December[1].

Fund Positioning

We maintained our modest overweight position in credits against a still supportive monetary policies backdrop globally, that will lead to the continued search for yield. Demand from China onshore investors remain high providing strong technical support for the market especially the Chinese issuers. We believe rate hike by the US Fed in 2016 will be gradual barring a sudden spike up in inflation. We maintained our short US duration position at the front end of the curve. Our positioning in local currency bonds remained modest at around 5% of portfolio.

By country, we remained overweight in China, Hong Kong partly offset by a short in Philippines. We continue to overweight in high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the oil and gas sector which includes names like CNOOC, CNPC and SINOPEC due to large supply from this sector. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

Investment Outlook

As we move into 2016, market sentiments will continue to be dictated by a slowing global growth along with the policy divergence between the US Fed and other major central banks. Corporate credit fundamentals have been weakening in the past few quarters adding to the already murky outlook. Nevertheless, the weakening trend has not reach a level that is a cause for concern, with the exception of several high yield names in the oil & gas and commodity sector. On a brighter note, with the first rate hike by the Fed behind us, much uncertainty has been removed allowing investors to focus on the fundamentals. The technical backdrop remains favorable for Asian credits while on the currency front, we can potentially see Asian currencies doing well in the second half of the year should the dollar strength wanes or even reverse. At this juncture, we see the biggest risks for the market in 2016 to be another leg down in oil price, leading to a wave of defaults or US inflation overshooting market's expectations leading to an unorderly sell-off in the longer dated US treasuries.

The US economy, as we had expected, expanded at a healthy pace prompting the Fed to deliver its first hike in almost a decade in December 2015. We are looking for a continuation of this positive albeit modest growth momentum, underpin by decent expansion in consumer spending despite business investment remaining largely subdued. With the world slowing, the US economy has done well up to this point, though we expect it to remain entrenched in the 2-2.5% growth trajectory with risk to the downside should global growth worsen. Inflation expectation has been low in the US on the back of extremely low oil and commodity prices amid a strong dollar. We expect this trend to continue at least for Q1 2016 and thus the path for rate hike will be extremely gradual.

Eurozone has performed reasonably well in the past year on the back of an improving labour market and an increased in consumer spending, as household are able to spend more due to savings from a lower oil price. The region has also benefitted from both the European Central Bank (ECB) massive Quantitative Easing (QE) program and a lenient European Commission that has reduced the pressure of austerity. Despite achieving close to 1.5% growth in 2015, we are not overly excited about Europe as business investment remains very weak and the easy fiscal conditions that have be supportive towards growth may not persist. Even if the region is to maintain growth at around 1.5%, it will not be enough to close the output gap. Against this backdrop, we expect inflation to remain low for a considerable time and monetary policy to remain easy for a big part of 2016. Similar to the Eurozone, we expect monetary conditions in Japan to remain easy as inflation continue to significantly lag Bank of Japan's (BoJ) target of 2%. Nevertheless, we do not expect the BoJ to further expand the scale of its already massive asset purchases barring a nasty external shock. Japan's growth outlook for 2016 in fact is starting to look more optimistic, underpinned by strong consumption as household expenditure got a boost from a broad based wage growth which is expected to continue for the 3rd consecutive year. Fiscal policy also looks supportive for the household sector following the recent announcement by the government to provide subsidy for 12.5 million low income household as part of the JPY 3.5 trillion budget.

The ongoing rebalancing of the Chinese economy from an investment-driven model to a consumption-led one has inevitably weighed on growth. Coupled with the decline in trade numbers, aggressive monetary and fiscal policies need to be implemented should the government want to achieve its growth target of at least 6.5%. We expect at least 2 rate cuts and banks' reserve ratio cut of up to 400 bps for 2016. Currency is also expected to weaken gradually though with the intention of having it move more in line with other major currencies instead of using its weakness to spur exports. Fiscal policies will likely continue to be supportive of growth. However, similar to what we have witnessed in the past year, they are likely to be more targeted. The magnitude will also be far from the size delivered during the 2008 global financial crisis as China is still reeling from excess capacity in many segments of the economy.

In 2015, we highlighted our concerns that Asian economies could potentially be stuck in a protracted period of anaemic growth should the slowdown in China persists. This has

[1]The Fund's calendar year performance: 0.9% (2015); 6.8% (2014); -3.0% (2013); 9.1% (2012); 2.5% (2011).

materialised and is likely to continue. Furthermore, the recovery in the west, notably the US and Europe has not lifted Asian exports the way it used to as many of these developed economies started producing what they used to import as cost of production decreases. China's shift to a more consumption-driven model also mean that demand for import from other Asian economies will continue to stay weak. Most Asian central banks still have room to cut policy rates should growth continue to surprise on the downside. Nonetheless, with the Fed having started a hiking cycle, we do expect them to tread more cautiously as a divergence in monetary policy from the US could lead to outflows which is very destabilising for the economy. Countries including Indonesia, Malaysia and Sri Lanka are likely to be the most vulnerable in such a scenario. Key to watch in 2016 will be the reforms that will be rolled out especially those measures that target an improvement in productivity. Despite facing an uncertain outlook, we do not see the current situation culminating into a financial crisis. Asian's local currency bonds market's development over the past decade has led to reduced reliance on USD funding. The FX regime is now more flexible in Asia unlike in the 1990s when many of them have some form of a peg to the USD. On top of a higher FX reserves, many central banks now have multi-lateral and bilateral currency swaps agreements which serve as a useful liquidity tool in times of stress.

Challenging times are ahead for Asia though we see some bright spots. Reforms in China, India and Singapore are long-term positive despite the near-term growth uncertainty. Credit valuations do not look stretched especially against the backdrop of very strong technical factors including the demand from China onshore investors and the overwhelming demand for high quality Asian issues. After more than a year of brutal sell-off, Asian currencies are looking significantly oversold, bringing them to levels that do not reflect fundamentals. Longer-term growth prospects in Asia remain intact and return from local currency bonds especially the high yield Indonesia and India will likely outperform those of developed market if investors are able to take a longer-term view and ride out the current volatility.

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