First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

March 2016

- 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:

- A rebound in oil price, stabilisation of the renminbi and a decrease in expectation of the number of rate hikes by the US Fed led to a strong rally in Asian credits.
- Moody's lowered China's Aa3 government bond rating outlook to negative from stable. On the following day, they lowered the outlook of 38 Chinese State-Owned Enterprises.
- 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.
- 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.

Market commentary

A rebound in oil price, stabilisation of the renminbi and a decrease in expectation of the number of rate hikes by the US Fed led to a strong rally in Asian credits, a much welcomed reprieve as credit spreads have largely been under pressure since the start of the year. Spread of the JPMorgan Asia Credit Index (JACI) tightened by 33bps to 287bps, more than offsetting higher US treasuries yield. This led to the JACI delivering a third consecutive month of positive return at 1.92%, while year to date return registered an impressive 3.55%. Total return for both investment grade and high yield were both positive at 1.58% and 3.29% respectively for the month. By countries, spread returns were all positive in March with Mongolia, Indonesia and Pakistan outperforming.

On 2nd March, Moody's lowered China's Aa3 government bond rating outlook to negative from stable. On the following day, they lowered the outlook of 38 Chinese State-Owned Enterprises. Three main reasons were cited. The weakening of fiscal metrics, as reflected by rising government debt and contingent liabilities. A continuing fall in reserve buffers due to capital outflows and uncertainty around the authorities' capacity to implement reforms to address imbalances in the economy. At China's National People's Congress, growth target is lowered to 6.5-7% in 2016 from 7% in 2015 showing their commitment to support growth amid the ongoing rebalancing of the economy. Fiscal deficit is projected to increase to 3% of GDP in 2016 from 2015's target of 2.3% even though the actual number was a higher 3.5%.

During mid-month, European Central Bank (ECB) eased monetary policy further across multiple fronts in response to lower inflation expectations. The rate on the deposit facility was lowered by 10bp to -0.40%. The monthly purchases under the asset purchase programme will be increased from €60bn at present to €80bn. The ECB also decided to include investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area in the list of assets that are eligible for regular purchases under a new corporate sector purchase programme.

A week later and as widely anticipated, the US Fed held the Fed Funds target rate unchanged at 0.25-0.5%. The Fed remained of the view that the economy will expand at a moderate pace though highlighted the risks coming from global economic and financial developments. More importantly, their dot forecasts of where they expect the Fed fund rate to be, is now implying only two rate hikes in 2016, down from the previous expectations of four hikes.

Following the Fed's move, Bank Indonesia (BI) cut rates for the 3rd consecutive month bringing the BI and FasBI rates lower by 25bps to 6.75% and 4.75%, respectively. In the monetary policy statement, BI cited reduced uncertainty in the global financial markets, lower expectations of US rate hikes and negative interest rates in Europe and Japan as reasons behind their move. Its forward guidance suggests that they will be more cautious in deciding on further policy easing.

There were $11bn in USD fixed rate supply last month though year to date supply is down by 32% reflecting the bearish environment we were in for a large part of the quarter. Chinese issuers accounted for 22% of monthly supply, followed by Indonesia at 23%, Korea at 15%, and Hong Kong at 9%.

Performance

In USD term, the First State Asian Quality Bond Fund returned 1.69% in March[1].

Portfolio positioning

We reduced our exposure in Indonesia from overweight to neutral following the sharp rally which saw Indonesia outperforming its peers. We also reduced our short US duration position at the 10 year part of the curve as we believe the weakening global growth and the negative interest rates in Europe and Japan will likely cap further selling off in US rates. Our positioning in local currency bonds remained modest at below 5% of portfolio.

By country, we remained overweight in China and also 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 and downward pressure in oil price. 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 and Yellen sounding more dovish of late, much uncertainty has been removed allowing investors to focus on the fundamentals. Technical backdrop remains favorable for Asian credits amid the high cash balance investors hold. 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 US 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 labor 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 been 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 households 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 anemic growth should the slowdown in China persists. This has 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. Asia's local currency bonds market development over the past decade has led to reduced reliance on USD funding. 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.

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

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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