First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

June 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:

- Asian credit market was in a cautious mode for a large part of June, awaiting the outcome of United Kingdom's referendum on whether to leave the European Union (EU).
- The uncertainty around the timing of the exit pose the biggest risk and this is widely expected to be a long drawn affair, not boding well for economic prospects and general market sentiments.
- We increased our local currency bonds exposure via India and Indonesia government bonds as we expect US Fed's rate hike expectations to be further pushed back as more uncertainty clouds the global economic outlook.
- We now see little chance of a US Fed hike this year barring a sharp spike up in inflation.
- Heading into the second half of 2016, we remain positive on Asia's longer term fundamentals and its ability to ride through this period of uncertainty.

Market commentary

Asian credit market was in a cautious mode for a large part of June, awaiting the outcome of United Kingdom's referendum on whether to leave the European Union (EU). Against the run of the opinion polls and the betting markets in the final few days before the vote, the people of the United Kingdom (UK) voted to leave the EU (also known as Brexit). This sent shockwaves across major financial markets with credit spreads widening and equity markets falling sharply. Asian credit market was not spared with investment grade spreads widening 10-15 bps and high yield dropping 3-4 points following the result. Nevertheless, the sell-off was short-lived and market recovered strongly with the JACI spread closing the month at the same level where it was a day before the poll. On the back of the strong rally in US treasury throughout the month, the JACI index gained 1.77% bringing year to date return to an impressive 6.54%. Investment grade outperformed high yield with returns of 1.83% versus 1.52%. Spread returns were mixed, with Mongolia leading the pack while Philippines and Bangladesh formed the major laggards.

The official tally of the UK referendum showed the Leave camp received approximately 51.9% of the total votes. Voters' turnout was high at 72%, well above the 66% seen in the 2015 General Election. The process to leave the EU is likely to take at least two years once the UK Parliament invokes Article 50 of the Lisbon Treaty (the Treaty of the European Union). The uncertainty around the timing of the exit pose the biggest risk and this is widely expected to be a long drawn affair, not boding well for economic prospects and general market sentiments. Post Brexit, S&P downgraded the UK's rating by two notches, from AAA to AA while Fitch moved its rating from AA+ to AA.

Over in Asia, central banks remained on an easing mode. The Bank of Korea (BoK) cut its policy rate by 25bp to a record-low of 1.25%, contrary to consensus expectations of a hold (only 1 out of 18 analysts had expected a cut at the June meeting). The rate cut was delivered on the back of the announcement of the government's restructuring plans which is expected to have a negative impact on employment and hence consumption, which has been the main driver of growth in recent quarters. Amid continued acceleration of household debt growth, expectation is that BoK is unlikely to cut further, barring a significant shock to growth.

On June 28, Indonesian passed a new tax amnesty bill. Under the new law, tax rates will range from 2 to 10 %, depending on how quickly an individual declares his assets and whether the assets are repatriated to Indonesia. Currently, personal income tax rates in Indonesia range from 5% to as high as 30%, while businesses are taxed at a rate of up to 25%. The Indonesian government is hoping that the tax amnesty will help raise 165 trillion rupiah, which will increase revenue by 11%. At the moment, only 27 million of Indonesia's 250 million population are registered taxpayers and only around a million people file tax reports. Bank Indonesia and the Ministry of Finance expect the tax amnesty to boost GDP by between 0.4% and 1.3%.

We saw USD 7.7b fixed rate supply in June while year to date supply is 25% lower than the same period last year. This is largely attributed to uncertainty around the Fed rate hike and more recently the UK referendum. Chinese issuance without any surprise dominated once again accounting for 91% of total issuance in June. On a year to date basis, issuance from China is now 59%, significantly higher than the 50% level recorded in the past three years.

Performance

In USD term, the First State Asian Quality Bond Fund returned 1.65% in June[1].

Portfolio positioning

During the earlier part of the month, we increased our exposure to the more defensive names such as Hong Kong Electric, China Nuclear Power and Three Gorges, switching out of the higher beta Bharti. Post Brexit, we increased our local currency bonds exposure via India and Indonesia government bonds as we expect US Fed's rate hike expectations to be further pushed back as more uncertainty clouds the global economic outlook.

By country, we remained overweight in China, Hong Kong and Singapore 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 potential supply and low profits in these companies amid falling oil price in the past year. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

Investment outlook

Moving into the second half of 2016, the uncertainty around growth outlook is set to heighten hot on the heels of the UK BREXIT vote. What is certain now is that there will be more volatility as we move closer to the Italian referendum on constitutional change in October and the US presidential election in November. Donald Trump's rapid rise in popularity is indeed alarming and if he is elected as president, markets are expected to react more negatively than what we witnessed after BREXIT. That said, the silver lining behind the dark clouds could potentially be a concerted effort by the remaining members in the European Union (EU) to agree upon a cohesive response, thereby making the region stronger. Monetary policies around the world are also likely to remain highly accommodative with lower for longer becoming lower forever, boding well for risky assets as the search for yield continues. We now see little chance of a US Fed hike this year barring a sharp spike up in inflation. This potentially means more stability in Asian currencies which have been hampered by expectations of Fed hike. As a result, central banks in Asia can be more accommodative for the remaining of the year. Against the above backdrop, we would adopt a cautious and defensive stance in Asia credits, selectively adding risks as value emerge while turning more bullish on high yielding currencies.

US economy's improvement in recent quarters has been underpinned by continued strength in consumer spending as unemployment falls to below 5% and a strong housing market that has benefitted from the ultra-low interest rates. However, business spending and exports have been lethargic at best and following BREXIT they are both likely to turn weaker amidst the uncertainty in Europe. Against this backdrop, it will be hard if not impossible for the US Fed to hike rates as they have repeatedly cited global economic uncertainty as one of the main factor whenever they decided to go on hold. This make their projection of 2 hikes for 2016 look very aggressive in the current environment barring a sudden spike up in inflation. The steady rise in oil price in the past few months has helped stabilize the fragile sentiments in the oil and gas sector which was in distress early this year. Any sharp correction in oil and commodity prices will likely be detriment to US growth outlook for the remaining of the year.

Eurozone's economy has been resilient this year, underpinned by strong domestic demand amid easy monetary policy, low oil and commodity prices and improving labour markets. Nevertheless, UK's vote to leave the EU will have severe ramifications since the country accounts for 13% of all exports from the Eurozone. While it is unclear how much global business confidence, investment and employment are affected at this stage, the risk is clearly an underestimation of the consequences. The 1.5% GDP growth which we had expected since the start of the year is likely to be revised downwards and as such, the output gap will definitely remain wide while disinflationary pressure amplifies. Political landscape in Europe will be put under further scrutiny with the upcoming Italian referendum on reform taking place in October while elections in France and Germany will be held in 2017. Negative rates across Europe will also eventually put stress on the banking and insurance industry, certainly a development that warrants closer scrutiny by the European Central Bank.

Following sluggish growth in the past few quarters and a worse than expected Bank of Japan's (BoJ) tankan survey for business conditions, the government announced a shift towards fiscal easing. It was also confirmed that they would be postponing the April 2017 consumption tax hike to Oct 2019. Prime Minister Abe promised that the government would implement bold economic measures, suggesting that a second supplementary budget will be legislated around September 2016. While the government is committed to support growth amid a bleak outlook, Japan continues to face several downside risks to its economy. This includes rapid deterioration in growth amongst Japan's main trading partners most notably China and further appreciation in the Yen leading to a reduction in Japan's exports competitiveness.

Despite the ongoing reforms and an uncertain outlook, there are positive signs that the Chinese economy is stabilizing. Housing related investment might slow down in the second half of the year, as government is likely to rein in the recent sharp rise in property prices witnessed in top tier cities. Exports might contract further as sentiments turned cautious in Europe following UK decision to leave the EU. Nevertheless, bank lending remains robust and looking at the aggressive municipal bond issuance plans, the government looked determined to support growth and achieve the growth target of 6.5%-7%. In the days following the shocked result in the UK referendum, the People's Bank of China (PBOC) allowed the renminbi to drift weaker, underperforming most Asian currencies. While this move re-ignited fears of more currency devaluation, we see it as more of a preemptive easing amid the uncertain outlook. We also expect the PBOC to ease monetary policies further with a combination of banks' reserve ratio requirement and interest rate cuts and continue to remain supportive of growth.

At the beginning of the year, we were of the view that Asian economies will be stuck in a protracted period of anemic growth as China slows. This will likely be exacerbated by what could be a structural trend of developed economies starting to produce what they used to import, as cost of production falls. This assessment turned out to be spot on as Asian exports especially in countries like Singapore, Malaysia, South Korea and Taiwan experienced sharp declines. With BREXIT dragging down business sentiments in Europe, we are unlikely to see a turnaround in exports anytime soon. The good

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

news is, central banks in Asia can afford to remain accommodative or become more aggressive in easing as the likelihood of the US Fed hiking rate waned substantially amid the uncertainty around BREXIT. That said, continuation of reforms by major Asian economies remains crucial especially those targeting an improvement in productivity, as easy monetary policies while useful in supporting short term growth will inevitably run its course at some stage.

We see Asian credit valuation as fair at this juncture factoring in the narrowing spread premium versus US peers, weakening trend in credit metrics and an uncertainty global growth outlook. Nevertheless, with global growth outlook murky and major central banks expected to keep rates low for longer, if not forever, the search for yield continues and thus providing a favorably technical backdrop for the market. This was evidenced by how quickly the market recovered and rallied post BREXIT. We have also turned positive on Asian rates and currencies especially the higher yielding ones namely Indonesia rupiah and India rupee, as the Fed rate hike looking more distant as the global economy slows down further. As value based investors, we have been using any sell-off as opportunities to re-establish long positions in both credit and local currency bonds and we will continue with this approach as we head into the second half of the year as we remain positive on Asia's longer term fundamentals and its ability to ride through this period of uncertainty.