First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

July 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:

- Moving well into the second half of 2016, the uncertainty around growth outlook is set to heighten hot on the heels of the UK BREXIT vote.
- 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.
- 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.
- We remain positive on Asia's longer-term fundamentals and its ability to ride through this period of uncertainty.

Market commentary

Asian credit market continued its relentless rally amid the ongoing search for yield as market now believe that major central banks will get even more aggressive in their ultra-easy monetary policies as growth outlook weakens post BREXIT. We witnessed a spike up in issuance activity during the month, many of which were many times over-subscribed and performed well. The JACI index gained 1.44% bringing year to date return to 8.08%. Spreads return across markets were all positive with the frontier markets Mongolia, Pakistan and Sri Lanka the top performers.

Following David Cameron's resignation last month, which was triggered by UK's referendum vote to leave the European Union (EU), Theresa May took over the helm becoming Britain's second female prime minister after Margaret Thatcher, who held office from 1979 to 1990. Her immediate challenge which looks like an uphill task is to negotiate the terms of BREXIT with the EU and at the same time preventing the economy slipping into recession amid sharply declining PMIs and investors' confidence, both of which will delay investment and spending decisions.

Several central banks in Asia met during the month with different outcomes. Bank Negara Malaysia surprised the market with a 25bps cut in OPR to 3%, citing weak exports outlook amidst external uncertainties post Brexit. The 2016 inflation forecast was also cut by 0.5% to 2-3%, though they expect prices to remain stable thereafter. Meanwhile in South Korea, the Bank of Korea (BoK) left policy rate unchanged at 1.25% following the unexpected cut in June as the BoK adopts a wait and see approach for the coming months. At the same time, 2016 growth forecast is lowered from 2.8% to 2.7% while inflation forecast is lowered from 1.2% to 1.1%. This was despite BoK having a view that domestic economy will sustain modest growth on the back of expansionary macroeconomic policies, namely the recent rate cut in June and the extra fiscal stimulus planned for second half of this year. Bank Indonesia also left policy rate unchanged leaving the 7 day reverse repo rate at 5.25%, BI rate at 6.50% and Fasbi rate at 4.50%, though this was against consensus, which was for a 25bps cut. From the policy statement which sounded fairly neutral, it does look like BI is allowing time to assess the impact of previous cuts which amount to 100bps in total.

As widely expected, the US Federal Reserve Open Market Committee (FOMC) decided to leave the official Fed Funds target rate unchanged at 0.25%-0.5%.In detailing the policy decision, the Fed has taken a slightly more positive tone, noting that near-term risks to the economic outlook have diminished. The Fed's statement also noted that data since the June meeting showed that the labour market had strengthened and that economic activity has been expanding at a moderate rate. Over in Japan, Prime Minister Abe announced a ¥28 trillion supplementary budget which is much larger than the ¥10 trillion that was being reported in the past few months. Following this announcement, Bank of Japan (BoJ) eased monetary policy further albeit modestly, much to the disappointment of the market. The latest easing includes an increase in the ETF purchase program from an annual pace of ¥3.3 trillion to ¥6 trillion and an increase in the BoJ's

USD lending program to Japanese firm to $US24bn, from the previous $US12bn. Significantly, all other monetary policy measures under the "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate" (QQE-NIR) program were left unchanged.

There were US$18.3bn in USD fixed rate supply in the month of July noticeably one of the busiest July in recent years. Supply momentum picked up significantly post Brexit and we saw more diversity in issuer countries. Nonetheless, supply is still running around 16% behind to the first seven months of 2015 given the uncertain environment we were in over the past few months.

Performance

In USD term, the First State Asian Quality Bond Fund returned 1.31% in July[1].

Portfolio positioning

We made several changes to our strategies during the month amid a relentless search for yield. We moved from neutral to overweight in India while in South Korea we moved from short to neutral. We also increased our exposure in Indian government bond as this is a market that still provides attractive carry. At the same time, we took profit on our long Indonesian government bond position. Lastly, following a retracement in yield, we squared up our short position at the front end of US treasury curve.

By country, we are now overweight in China, Hong Kong, Singapore and India and 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 well 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 stabilise 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 detrimental 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 stabilising. 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

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

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 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.

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