First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

October 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:

- After 9 straight months of positive return, Asian credit market finally gave up some of its impressive year to date gains in October.
- We maintained our moderate overweight positions in both credit and duration as we expect the relentless search for yield to continue for the rest of the year.
- We are likely to be stuck in a low growth, low inflation environment for a foreseeable future. What this mean is returns across various asset classes will also be tapered and the income generating feature of an asset class will become more important for investors.
- We have been using any sell-off as opportunities to add risk in both credit and local currency bonds and will continue with this approach as we head into the end of the year.

Market commentary

After 9 straight months of positive return, Asian credit market finally gave up some of its impressive year to date gains in October. This was largely due to rising US treasuries yield despite spreads ending the month tighter. US treasury yields were moving in tandem with the surge in oil price and the move higher was exacerbated by increased uncertainty around possible tapering of the ineffective the quantitative easing by both the Bank of Japan (BoJ) and the European Central Bank (ECB). During the month, we witnessed a flurry of new issuance that delivered mixed performance though demand was generally strong. There was also a broad-based USD strength leading to weak performance in many Asian currencies. JACI returned -0.79%, with investment grade underperforming high yield with return of -1.08% and 0.38% respectively. Spreads return were positive across all markets with the frontier Mongolia, Pakistan and Vietnam leading the pack.

If Singapore's growth outlook is deem to be an accurate barometer for regional growth, the path ahead looks treacherous. Weakness in the republic's Q3 growth estimates came in much weaker than expected, contracting by 4.1% on a quarter on quarter on a seasonally adjusted basis, while year-on-year growth is only 0.6%. What is more worrying is that the slowdown is broad-based with manufacturing and trades leading the contraction. Against this backdrop, MAS maintained a neutral stance for the S$NEER policy band, with no change to the width or the level at which it is centered. However, they assessed that the neutral policy stance will be needed for an extended period to ensure medium-term price stability, though market is now expecting more easing to come when they have their next meeting in April 2017.

Over in India, the newly constituted Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) unanimously decides to cut repo rate by 25bps to 6.25% in its first meeting. While this cut was delivered amid falling inflation, it is also seen as a pre-emptive move in view of the slowing global economy, uncertainty around the US election and expectation of a Fed rate hike in December. Not to be outdone, Bank Indonesia (BI) cut the 7 day reverse repo rate by 25bps to 4.75% during the second half of the month. While we believe the motivation was similar to that of the RBI, BI has previously taken a view that economic growth in the third quarter was not as strong as they had expected, citing the downward adjustment in government spending and weakness in external demand as the main reasons behind this decline.

New issuance market remained vibrant with USD19.3bn of fixed rate supply last month, well above the average of USD14bn over the past four years. Bank senior dominated, accounting for 36% of total supply. Year-to-date supply is now 15% ahead of the same period in 2015. China maintained its pole position accounting for 57% of total issuance, this is followed by South Korea at 14% and Hong Kong at 9%.

Performance

In USD terms, the First State Asian Quality Bond Fund returned -0.92% in October[1].

Portfolio positioning

We maintained our moderate overweight positions in both credit and duration as we expect the relentless search for yield to continue for the rest of the year. We are now overweight in China, Hong Kong, India and Singapore, while maintaining a short position in Philippines as valuations are still tight. The US treasuries remains attractive relative to its developed market peers whereby around a third are still trading at negative yield. In addition to providing additional carry, a long duration provides a buffer for the portfolio in the event of credit spread widening should the market get hit by a risk event with the next one being the US election in November.

By country, we are now overweight in China, Hong Kong, Singapore and India and short in Philippines. We continue to overweight high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the Chinese banks and asset management companies due to potential supply and weakening fundamentals. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

Investment outlook

We started the year on a tumultuous note during which markets were crippled by the rapid deterioration in the oil & gas and commodity sector. The poor sentiments were further exacerbated by the heightened uncertain over the extent of China's slowdown. Nevertheless, markets have recovered strongly from the lows and exhibited resilience especially since brushing aside the shocking BREXIT outcome and we expect that trajectory to continue as we move into year end. There are major risk events coming up, which include the US Election, the Italian referendum and of course the Dec FOMC meeting, though we do not expect them to be as disruptive as those factors that have moved the market in the earlier part of the year. Global growth is likely to remain sluggish especially in most developed countries with central banks expected to continue missing their inflation targets. Monetary policies are expected to stay highly accommodative though its effectiveness on the real economy has clearly waned if not dissipated. With productivity remaining low in many countries, fiscal measures will now come under increased scrutiny as countries look for ways to lift their economies. As fiscal policies brings about positive changes only over the mid to long term, we are likely to be stuck in a low growth, low inflation environment for a foreseeable future. What this mean is returns across various asset classes will also be tapered and the income generating feature of an asset class will become more important for investors.

The US economy recovered from the doldrums in the oil and gas sector earlier this year as evidenced by an improvement in energy mining investments in the 2nd and 3rd quarter. We continue to see an improvement in the labor market though momentum has clearly slowed down with average monthly job gains falling to 182,000 in the first eight months of this year as compared to 219,000 in 2015. The unemployment rate fell from 5.7% in January 2015 to 4.9% in January 2016, but has since stalled. Meanwhile, core PCE price inflation has been stable at close to 1.6% though still below the US Fed's 2.0% target rate. Against this backdrop, we believe the Fed has enough reasons to further normalize interest rate though with uncertainty around the US election outcome, we would not be surprised if they choose to once again push back on hiking. The US election appears to be increasingly competitive. Just like the "unthinkable" BREXIT, a Trump victory cannot be ruled out despite the polls showing Hillary Clinton still having a comfortable lead. A Trump win is perceived to be good for growth, leading to higher inflation notwithstanding the increased political uncertainty which is bad for markets in general. Nevertheless, with the check and balance mechanism put in place in the form of the Congress, it is unlikely many of Trump's promises will be legislated even if he is elected. In the short term, we believe a Trump victory is negative for the fixed income market. However the trajectory of bond yields will eventually be decided by economic fundamentals.

Eurozone growth remains resilient largely underpinned by strong domestic consumption despite the shocking result of the UK referendum to leave the European Union. Nevertheless, there is a risk that the impact on businesses and household spending has been simply delayed until the UK invokes Article 50 next year. On the inflation front, price pressure remains very low with core inflation stuck at below 1%, which is the average pace it has been running at since 2013. This means the European Central Bank's inflation target is unlikely to be met and thus we expect them to extend the time horizon for its asset purchase program to late 2017. Political landscape in Europe poses another risk to the stability of the region with the upcoming Italian referendum on reform taking place in October while elections in France and Germany will be held in 2017. Even though growth has been stable, many challenges remain.

Abenomics is starting to look like a distant memory despite government's efforts to launch more economic stimulus to prop up the economy. Japan continues to struggle with poor domestic demand and a loss in exporters' competitiveness amid a strong yen. The strong currency has also been a major driver of low inflation, as Bank of Japan (BoJ) struggles to achieve their inflation target of 2%. BoJ's altering of the policy framework which includes a specific targeting of the 10-year JGB yield, suggests that they are now concerned about how a flat yield curve is hurting the financial positions of pension funds and life insurance firms. This is a concern we shared not just in Japan but also in Europe. To top it all, rapid deterioration in growth amongst Japan's main trading partners most notably China add another risk to the numerous challenges the country is already facing.

While it has been gloomy and murky in the developed world, we could find some bright spots in Asia. Signs of stabilization in the Chinese economy were further affirmed by data observed over the 3rd quarter. Growth has been supported by the strong momentum in the property market along with boosts to infrastructure spending amidst aggressive municipal bond issuance plans. Exports also got a lift following the renminbi's depreciation over the past year while moderation in wage growth helped in bringing down the costs of production. Against this backdrop, the government is en route to achieve the growth target of 6.5%-7% for this year. China's stability is a much needed boost to other Asian economies, which have been struggling with anemic growth. Trade numbers have been lackluster, and this is evidenced in the poor showing of the exports oriented countries including Singapore, Malaysia, South Korea and Taiwan. Though central banks in Asia have more room to cut rates as compared to their developed market counterparts, the emphasis on reforms remains crucial. Countries targeting an improvement in productivity such as Singapore will come out top over the longer term, as easy monetary policies while useful in supporting short term growth will inevitably run its course at some stage.

We are cautiously optimistic at this juncture though we see Asian credit valuation as tight factoring in the narrowing spread premium versus US peers, weakening trend in credit metrics and an uncertainty

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

global growth outlook. Nevertheless, with lower for longer looking more like lower forever, technical backdrop remains very favorable for the market as investors continue their relentless search for yield. We remained positive on Asian rates and currencies especially the higher yielding ones namely Indonesia rupiah and India rupee, with the Fed rate hike looking more looking more like a yearly event. Following a strong year to date performance of high single digit gains for Asian bonds, we are now defensive in our positioning though as value based investors, we have been using any sell-off as opportunities to add risk in both credit and local currency bonds and will continue with this approach as we head into the end of the year.

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