First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook

December 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:

- Markets felt a lot calmer in December with credit spreads largely range bound amid a continued concern over higher US rates and a stronger dollar.
- The outlook for Asian economies looks challenging for 2017. The region is facing heightened external uncertainties which include potentially a faster than expected Fed rate hike.
- Asian central banks have room to cut policy rates to spur growth, though we believe many will at least wait for their currencies to stabilize before contemplating their next move.

Market commentary

Following the brutal rates sell-off in November, markets felt a lot calmer in December with credit spreads largely range bound amid a continued concern over higher US rates and a stronger dollar. Major central banks didn't surprise with their policies and rhetoric though some investors interpreted European Central Bank and the US Fed to be a tad less dovish as before. J.P. Morgan Asia Credit Index (JACI) returned -0.17%, largely due to higher US treasury yields with the 10 year yield rising by 6bps to end the year at 2.44%. Higher US Treasury yield also led to investment grade bonds underperforming high yield with returns of -0.30% and +0.30% respectively. Spread returns were mostly positive with the exception of Indonesia, Sri Lanka and Vietnam while frontier markets such as Mongolia, Pakistan and Bangladesh were the top performers.

The European Central Bank (ECB) during the early part of the month announced a longer than expected extension of its asset-purchase/ quantitative easing (QE) program out to December 2017, well beyond the previous projected timeframe of March 2017. However, the QE program will from April 2017 onwards be reduced to a monthly pace of €60bn from the current €80bn/month which some investors interpreted as less dovish. In addition, the ECB made changes to the operations of its QE program that will allow it to continue to purchase assets for a longer period if that should prove necessary. All official interest rates were held unchanged, with the Deposit Facility rate remaining at -0.4%.

A week later, the US Federal Reserve (the Fed) Open Market Committee (FOMC) raised its Fed Funds target rate by 25bp to a new range of 0.5%-0.75%. This decision was widely expected by the market and follows the first rate hike in this cycle in December 2015. However, this is only the second rate hike from the Fed in the past decade. The Fed's policy decision was unanimous. The surprise in the decision today was a slight upward drift in the FOMC's median projection for the Fed Funds rate in the years ahead, i.e. the 'dots', with three rate hikes now expected for 2017 as opposed to two and a small increase in the long-run 'dot' to 3.0% from 2.9% previously. These moves came despite only very modest changes to the key economic forecasts. In her press conference, however, the Fed Chair Yellen went out of her way to emphasize that the changes to the 'dots' were really only very minor and only involved a few FOMC members upgrading their views. In her press conference, the Fed Chairman also made the point that the raising of interest rates was a sign of the confidence the Fed has in the economy and should therefore be taken as a positive by financial markets and the community in general.

Italy's referendum saw Prime Minister Renzi's constitutional reform rejected along with his leadership, as the 60/40 vote against the referendum led to his resignation. Whilst a no vote was anticipated, the strength of the vote surprised markets with banking stocks particularly impacted as concerns heightened on their non-performing loans issues. Nevertheless, major markets including Asian credit exhibited resilience and looked immune to event driven risks.

Despite a slowdown in issuance, this December still registered a robust USD10.8b worth of new issues. On a full year basis, new issues increased by 15% over 2015, coming in at USD 205b. Chinese

issuers accounted for 60% of the total, up from the 55% last year. At a distant second is South Korea at 12% while Hong Kong came in at 9%.

Performance

In USD terms, the First State Asian Quality Bond Fund returned -0.3% for the month of December. [1]

Portfolio positioning

Post FOMC, we moved our US duration strategy from moderate long to neutral as we have concerns over a potential overshooting in market's positioning for an inflationary environment amidst Donald Trump's expansionary fiscal policies, though we maintain that it would take time for these policies to change the US economy structurally especially on the inflation front. Asian credit market has exhibited strong resilience throughout the period of rates sell-off post Trump's victory and we continue to believe spreads will hold up well as technical backdrop in Asia remains very strong. We are still overweight in China, Hong Kong, India and Singapore, while maintaining a short position in Philippines as valuations are still tight. We have around 5% exposure to local currency bonds which we have accumulated over the past few years as we still believe in the fundamentals of Asian economies in the long term.

Investment outlook

If you think last year was tumultuous, 2017 is unlikely to be any smoother as we face continued uncertainty around global growth and several political headwinds. We have the French and German elections coming up, BREXIT negotiations will soon start and what is now on every investors' mind Donald Trump's protectionism and fiscal policies. Fiscal stimulus from the US if implemented on a large scale could provide immediate boost to both consumers' and markets' confidence, which is good for risky assets. However, if this leads to higher inflation and more US treasuries issuance, bond market might come under further pressure. There are also some clear signs that inflation in the US is edging higher, this is likely to be exacerbated by the low base effect of crude oil as prices continue to recover from 2016 lows, not great news for bond investors.

While short term outlook for fixed income looks challenging, we are still mired in a long term sluggish global growth environment amidst low productivity and deteriorating demographics in both the US and other developed economies, all of which are structural in nature. This means that interest rates globally is likely to remain much lower when compared to historical levels even if policy rates in the US is to normalize further. Also, China looks to be doing a good job in maneuvering its growth lower without causing much disruption to its economy. A China growing slower but on a firmer footing would certainly bode well for Asian economies as this will likely underpin a case for more robust intra-Asia trades.

Positioning for USD strength and higher US rates has been heavy and is likely to persist barring Trump overpromising and under-delivering. Nevertheless, European Central Bank and Bank of Japan staying accommodative means that the global search for yield will likely continue. Asian credit market has been resilient, surviving the past few risk driven events including Brexit and Trump relatively unscathed. While valuation appears rich, demand and supply technical backdrop has been extremely strong which means any sell-off will likely be brief. Asian currencies have been oversold since last November and we are likely to start seeing some intervention from Asian central banks should this depreciating trend continues. On the other hand, should development in the US fall short of market's optimistic expectations, we could see a quick reversal in the unrelenting dollar strength.

Economic growth in the US has been stable in the past few quarters bringing the US Fed closer to achieving its dual mandate of full employment and price stability. Unemployment rate is now below 5% while core PCE has been hovering around the 1.7% level with strong signs of edging towards the Fed's target of 2%. Growth trajectory for 2017 will hinge heavily on how much Trump delivers on his pre-election promises, which include significant tax cuts, increase in fiscal stimulus and lesser regulations. Trump's policies will certainly have some impact on the Fed's assessment on the US economy though subsequent rate hikes are still expected to be gradual for now. What is certain though is that expectations for a boost to the economy led by Trump's policies are very high, which lends itself to some disappointment should Trump under delivers.

Despite exhibiting some strong growth momentum with PMI in Q4 hitting a 2016 high at 54.4, growth within the big four economies in the Eurozone remains mixed with Germany and Spain showing positive development while France and Italy lagged. Growth outlook for the New Year is one that would be slow and steady, likely in the 1-1.5% range though that would be lower than the 1.9% in 2015 and 1.6% projected for 2016. Against this backdrop, we see little price pressure in Eurozone especially with wage growth remaining subdued as productivity remains low just like that in the US. Political uncertainty would once again be of focus with the France and Germany elections expected to take place this year. Thus it would be hard to get excited over Europe's growth prospects and the slow but steady growth in the 1% handle looks to be the best outcome one can expect over the next few years.

Over in Japan, it looks to be another year of more stimulus from Abenomics though as we have mentioned in the past few years things hasn't really changed structurally for the land of the rising sun. A weaker yen in 2017 will likely give a further boost to exports, which surprisingly held up very well for a big part of 2016. Unemployment in Japan continues to move lower hitting a mid-1990s low at around 3%. However, that hasn't translated into higher inflation which BOJ has been targeting for years without success and it is something we doubt they will ever achieve. Against this moderately positive economic backdrop, BOJ should have some breathing space and has lesser urgency for further monetary easing in the near term.

The outlook for Asian economies looks challenging for 2017. The region is facing heightened external uncertainties which include potentially a faster than expected Fed rate hike, US trade policies which for now look unfavorable if Donald Trump executes his pre-election promises and a China that is willing to accept slower growth in the next five years. Trump's US trade policies will likely keep Asian exports subdued despite recent Asian currencies' weakness which is expected to boost volume. Asian central banks have room to cut policy rates to spur growth, though we believe many will at least wait for their currencies to stabilize before contemplating their next move. Against this backdrop, we expect export oriented economies like Singapore, South Korea and Taiwan to be more vulnerable, while countries that have a favorable domestic story including Indonesia, Philippines and Vietnam to fare better. On a brighter note, the Chinese economy looks to be on a firmer footing despite the slower growth. This has been largely driven by targeted infrastructure spending and a robust property market. Going into the New Year, we expect to see some property cooling measures in the top tier cities, continued reforms on the SOE front and some infrastructure spending in specific areas such as public housing and rails. China also

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

has to do more in terms of corporate deleveraging and preventing capital outflows amid a depreciating currency. Nevertheless, we believe the government still has the levers to guide growth towards their target of around 6.5% before the China National People's Congress.

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