

First State Asian Quality Bond Fund

Monthly Review and Outlook

July 2017



- 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.

Market Review

Asian credit market continued its recent lackluster trend with spreads trading in a tight range throughout the month while investors remained more focused in the new issuance market. Amidst the low volatility with the exception of a few idiosyncratic high yield names, JACI managed to eke out a small gain of 0.55% largely attributed to coupon return. Spread return by countries were mixed. Indonesia, Mongolia and Sri Lanka turned in yet another month of impressive gains having led the pack since the start of the year, while Macau, Pakistan and Thailand detracted value during the month.

Amid ongoing discussion around reduction of balance sheet, the US Federal Open Market Committee (FOMC) left rates unchanged at 1.0-1.25% as widely expected. The Fed's statement noted improvements in the labor market but stressed that they are monitoring inflation developments closely. A more detailed discussion of how the reduction in asset purchases will work was also outlined, increasing expectations that during the September meeting we will see the start of a reduction in the balance sheet, while interest rate will likely remain unchanged until December.

Rhetoric from the European Central Bank (ECB) remains on the hawkish side, but seemingly watered down from the initial aggressive interpretation of ECB President Draghi's speech in late June. Nonetheless, it needs to be noted that the European situation contrasts with the US in that the rate of increase in the

balance sheet will need to be reduced before it is able to fall. The Bank of England is in a similar situation of having turned more hawkish of late, with an increasing number of dissenting votes supporting a rate hike coming to light. The looming Brexit negotiations remains a risk for decision makers.

During the month, rumors were rife that Chinese regulator has blocked Chinese banks from lending to the Dalian Wanda Group as the group's recent foreign acquisitions were seen to be overly aggressive and at odds with the government's capital restriction. This created some nervousness in the high yield segment of the credit market where we witnessed Dalian Wanda bonds at one stage dropping more than 10 points. Subsequent, Wanda announced on the 19 July 2017 that it plans to sell 77 hotels in China to Guangzhou R&F Properties Co. Ltd. and a 91% stake in 13 tourism projects to Sunac. This development all but allayed the fears that the government's move will force Dalian Wanda to go into financial distress, much to the relief of the market.

Issuance for July totaled USD 20.6b, almost equally split between investment grade and high yield. China accounted for 48% of total issuance in July, followed by Korea at 15%, Indonesia at 13% and India at 10%. Year to date supply is now at 68% versus the same period last year. A noteworthy point is that high yield corporate issuance is up by almost 408% year over year following a barren spell in the past two years.

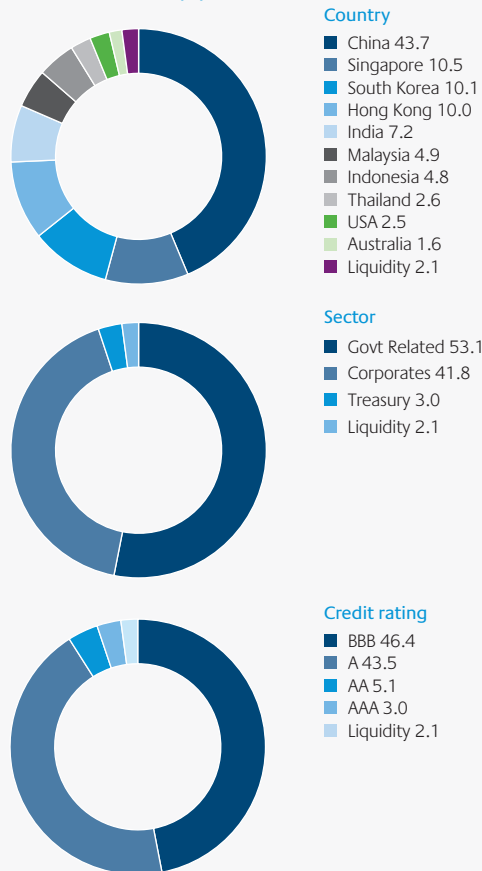
Performance Review

The First State Asian Quality Bond Fund returned 0.31% net of fees for the month of July ¹.

Cumulative Performance in USD (%) ¹						
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	1.6	4.4	0.8	10.6	16.5	63.7
Benchmark*	1.5	4.4	1.4	14.1	22.4	107.4

Calendar Year Performance in USD (%) ¹					
	2016	2015	2014	2013	2012
Class I (USD - Acc)	3.4	0.9	6.8	-3.0	9.1
Benchmark*	4.5	2.2	9.0	-2.6	11.3

Asset Allocation (%) ¹



Top 10 Issuers (%) ¹

Issuer Name	%
CNOOC Ltd	4.7
China Huarong	4.4
Sinochem Hong Kong (Group) Co Ltd	4.1
China Overseas Land & Investment Ltd	3.9
Pertamina Persero PT	3.6
Overseas Chinese Bk Corp	3.3
Beijing Infrastructure Investment Co Ltd	2.8
Bank of Communications Co Ltd	2.6
Hyundai Motor Co	2.6
United States Treasury	2.5

Portfolio Positioning

We closed our short US duration strategy as inflation in the US looked to have peaked and is now trending lower. The beginning of balance sheet tapering also means that the Fed will not be too aggressive in their subsequent rate hike and hence long end yields should stay range bound. We also moved our overall credit strategy from neutral to a modest overweight amid signs that weakening credit metrics over the past few quarters are bottoming out while demand and supply technical factors remain highly favorable for Asian credits. We stayed defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. Within China, we are overweight the investment grade property and technology while underweighting the banks and LGFVs (Local government financing vehicles) on supply concerns. We further reduced some of our Alibaba exposure as it has done remarkably well for the past few quarters. We are underweight India banks on tight valuations offset by an overweight in Indian corporates. We kept our local currency bond exposure at well below 5% mainly in CNH and MYR.

Investment Outlook

Despite starting the year with heightened uncertainty, markets actually remain very resilient with volatility declining significantly. Fed rate hikes, Trump's policies, French elections and terrorist attacks in the UK all seem to have muted effect on markets leading us to ponder what could possibly derail the rally as we move into the second half of the year. While fundamentals have been stable, rich valuations would call for caution especially when markets have slipped into a complacent mode.

Despite years of zero interest rate policy and quantitative easing, US growth never get to the heights of 4% growth in the period preceding the GFC in 2008-9. One explanation is that the high growth rate that was previously achieved was driven by excessive leverage by both consumer and corporates, both of whom have been rather cautious in the past 8 years and they look likely to stay this way. While unemployment rate at 4.3% is well below what many would define as full employment, underemployment as measure by U6 is still at elevated level of 8.4%. This means that while the economy has recovered, there is still plenty of slack as many workers are still underemployed, something Yellen has been stressing upon as she pushed back on normalizing interest rates over the past few years. Many who lost their jobs during the financial crisis were unable to gain employment in the same capacity as many lost finance positions were not being replaced. Technological advancement in recent years has also led to many workers being replaced by machineries. This forces the displaced workers to seek out less automated, lower skill, lower wage jobs, thereby creating a downward spiral in wages. As a result, inflation has stayed benign for so many years despite the impressive economic recovery and we expect it to stay low for many years to come. The job market has also gone through structural changes. There has been a noticeable emergence of pay by tasks jobs over the past few years, such as UBER, Deliveroo. Many also take on freelance web-based jobs amid the internet boom. As such jobs lack stability, they are likely to decrease disposable income as compared to regular salaried jobs. As a consequence, consumer

¹ Source: Lipper & FSI, Nav-Nav (USD total return) as at 31 July 2017. Fund since inception date: 14 July 2003. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc) is the non-dividend distributing class of the fund. *The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.

patterns are likely to shift towards a more cautious one and hence putting further downward pressure on inflation.

Easy monetary policies also look to have run its course in the US as well as Europe and Japan. We now have to look to Donald Trump's fiscal stimulus for the US economy to have a chance of lifting its trend growth higher than the current range which I believe to be around 2-2.5%. Talks of the Fed reducing its balance sheet as well as the ECB tapering its purchase will be key drivers for markets for the next few months. This may also bring about some volatility in the markets which has gone missing since the start of the year. While markets may overshoot while positioning for changes in central banks' rhetoric likely action, we believe both the Fed and the ECB will be very gradual in their approach to lighten their balance sheets.

China continues to defy all odds, delivering strong economic performance in a run that looked to have started since Q316. Consensus expectation of a renminbi devaluation now look like a farce as the Chinese currency remained stable amid further liberalization of the country's capital account. Consumption has become an important contributor to growth as income level rises and consumers' confidence gained strength. We also witnessed robust foreign direct investment into the high-end segments of both the services and manufacturing industries which helped keep growth elevated. Old economies such as imports & exports and agriculture has also seen stable and modest growth, giving the Chinese government the much needed room to maneuver and rebalance its economy.

While China continues to tackle issues such as excess capacity and high leverage, we are cautiously optimistic in its longer term economic development as there are several domestic growth drivers that can continue to underpin China's economic growth. This includes industrial upgrading, environmental protection, urbanization and further growth of services sectors such as medical and education. China's effort and ability to carry out supply-side reforms while engineering slower credit expansion has been commendable and we believe they will continue with a targeted approach in boosting economic growth while maintaining stability in both liquidity management and monetary policies.

Asian economies have largely benefitted from an increase in external demand amid a synchronized growth in the developed economies. China's stable and impressive growth has also been an important factor too. Thus the near term outlook for Asian economies will be highly dependent on the continuation of these two trends. That said, many Asian countries are not resting on their laurels. Philippines and Indonesia stands out as economies with strong structural stories. Singapore, which has been export-oriented has moved its focus to increasing productivity in recent years as it strive to rebalance its economy. Its close neighbor Malaysia has also improved ties with China through numerous infrastructure initiatives.

Asian credit market has been highly resilient and supply up to the mid-year mark has already surpassed total issuance in 2016. Valuation is looking rich as spreads are now trading near the post crisis tightness though credit metrics do suggest we are in the bottoming out phase especially for many IG corporates while idiosyncratic risks in the high yield space remains. Supply and demand technical remains extremely favorable as we believe the current situation of too much cash chasing after a limited pool of assets is likely to persist. The onshore Chinese investors' bid is also unlikely to wane providing further support for the market. Asian currencies and local bonds have done very well year to date and we have turned cautious. While the high yielders such as Indonesia and India will continue to be in favor should the low yielding environment persists, we would await for a pull-back before re-entering these markets. The period of easing monetary policies is also likely to be behind us. While we are not expecting rapid rate hikes, certain central banks such as Bangko Sentral ng Pilipinas BSP and Bank Indonesia are very close to normalizing rates amid strong economic performance.

Will 2017 be a tale of two halves? Stable fundamentals bodes well for markets. However, tight valuation calls for caution especially when central banks, led by the Fed are taking advantage of good economic data to normalize monetary policies, which could potentially lead to repricing of risk premium across asset classes. A return of volatility in the months ahead is getting likely but more importantly it opens up more opportunities.

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