

First State Asian Quality Bond Fund

Monthly Review and Outlook

August 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 was largely in a defensive mode amid rising geopolitical tension with North Korea defiantly launching missiles including one that flew right over Japan. Investors are also seen patiently awaiting development around fiscal reform in the US as the debt ceiling deadline approaches. Despite the heightened uncertainty, markets generally held up well with only modest spread widening seen. JACI delivered yet another month of positive return of 0.94% mainly due to the strong rally in US treasury where we see the 10 year treasury yield falling 18bps to end the month at 2.12%. JACI spreads meanwhile widened by 4 bps to 237bps. Investment grade lagged high yield return at 0.89% vs 1.10%. August's return brings year to date performance to an impressive 5.36%.

There were no major central banks' policy changes during the month though many were left disappointed as talks of tapering and balance sheet reductions were notably absent. Fed Chairman Yellen and European Central Bank (ECB) President Draghi were cautiously optimistic in their speeches but fell short of saying anything hawkish. Economic data announced during the month suggest that economic growth remains strong globally while labor markets in the US continue to see gains. There remains little evidence of an acceleration in wages or inflation data.

Over in Asia, Bank Indonesia (BI) cut its policy rate by 25bps to 4.50% though consensus was expecting a hold. The cut was meant to spur growth amid a disinflationary environment where BI expects inflation to come in at around 4% this year and 3.5% the next. BI also mentioned that external risks have subsided, as the Fed interest rate hikes and balance sheet reduction are now likely smaller and will come later than expected.

Notwithstanding the cautious mood, new issuance supply in August remained robust at a total of USD13.7b. This was dominated largely by high yield and bank seniors paper accounting for almost 73% of issuance. By country, China continues to lead the pack with 46% of issuance, followed by Indonesia at 19% and India at 14%. Year to date supply is now 66% higher than that in 2016 and looks well on its way to yet another record year for new issuance. Most notably, high yield supply has made a strong comeback, a major trend for a big part of this year.

Performance Review

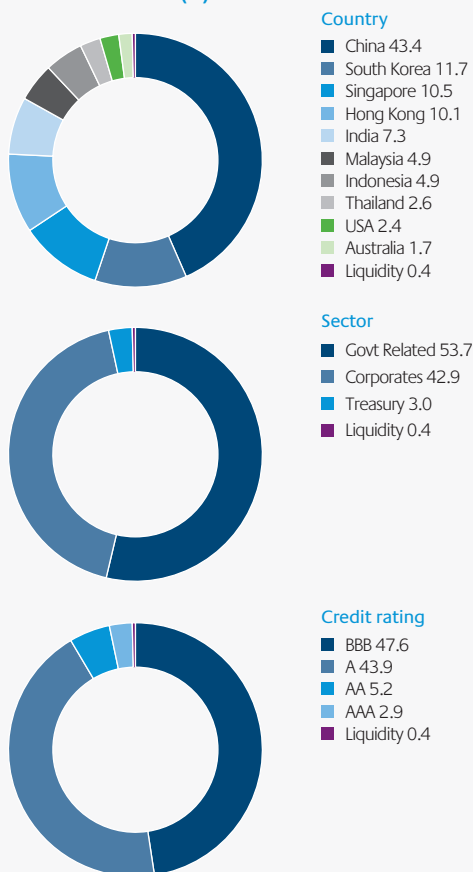
The First State Asian Quality Bond Fund returned 1.0% net of fees for the month of August ¹.

	Cumulative Performance in USD (%) ¹					
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	1.7	5.4	0.9	10.7	16.8	65.3
Benchmark*	1.7	5.3	1.5	13.8	23.0	109.3

	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

¹ Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 August 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.

Asset Allocation (%)²



Top 10 Issuers (%)²

Issuer Name	%
CNOOC Ltd	4.9
China Huarong	4.5
Hyundai Motor Co	4.2
Sinochem Hong Kong (Group) Co Ltd	4.2
China Overseas Land & Investment Ltd	4.0
Pertamina Persero PT	3.7
Overseas Chinese Bk Corp	3.4
Beijing Infrastructure Investment Co Ltd	2.8
Bank of Communications Co Ltd	2.6
United States Treasury	2.4

Portfolio Positioning

We remained neutral in US duration as we believe there are various drivers in the near term that could lead to Treasury yields heading either way. We maintained our modest overweight credit strategy while remaining in the more defensive names, 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 on supply concerns and LGFVs (Local government financing vehicles) because of the poor underlying credit quality. We are underweight India banks on tight valuations offset by an overweight in Indian corporates. We continued to take profit on our local currency bond exposure during the month especially in

CNH bonds as the renminbi continued its relentless rally. Our local currency bonds exposure now stands at below 2% and is largely in CNH and MYR.

Investment Outlook

Some of the key event risks we highlighted at the beginning of the year including Fed rate hikes and French elections has come and gone without derailing the strong rally in the risky assets. In fact volatility has taken a dive as market priced out Donald Trump’s potentially expansionary fiscal policies which was a main theme not too long ago. Even the unexpected geopolitical tensions arising from North Korea ballistic firing of missiles across Japan failed to have any material impact on market sentiments. We attribute this bout of optimism or perhaps complacency to the synchronized growth in major economies witnessed of late and the choreographed moves by Fed, ECB and BoJ, both of which are likely to be challenged in the near future. As valuations across markets get richer, it calls for caution. This is especially so when payoff can be asymmetric should we get a miscalculated move from any of the major central banks as they start the tapering of QE, or heightened geopolitical tension from the Korean Peninsula.

While we are cognizant about the tapering of QE by the Fed and ECB potentially bringing about some short term volatility, we are of the opinion that major central banks are unlikely to move too quickly as they face many structural issues in their economy. In this instance let’s focus on the US. Despite years of zero interest rate policy and quantitative easing, US growth never get to the heights of 4% 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 around low 4% is well below what many would define as full employment, underemployment as measured by U6 is still at elevated level of 8.6%. 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 normalising 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. Hence we certainly do not think the Fed is able to hike rates at the pace which they projected for the next 2 years.

China’s growth continues to be strong and has provided a lift for exports in many Asian and emerging market economies. An encouraging trend is that domestic 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

² Source: First State Investments as at 31 August 2017.

keep growth elevated. Old economies such as imports & exports and agriculture has also seen decent growth, giving the Chinese government the much needed room to maneuver and rebalance its economy. This is evidenced by the country's focus on industrial upgrading, environmental protection, urbanization and further growth of services sectors such as medical and education.

It is widely expected that come the 19th National congress party meeting slated in October, Xi Jinping will further consolidate his power, boding well for the continued reform initiatives in China. With the stabilization or in fact appreciation of the renminbi along with the roll out of Bond Connect, we expect to see further liberalization of the country's capital account. While China continues to tackle issues such as excess capacity and high leverage, their 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 as mentioned above. 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. Current account balance for most Asian economies look healthy unlikely during the 2013 taper tantrums where Indonesian rupiah and Indian rupee were badly hit. With a relatively benign Fed rate hike trajectory, the risks of outflows from this region has subsided significantly and thus provide a constructive backdrop for Asian economies.

Asian credit market has been highly resilient and supply up to the mid-year mark has already surpassed total issuance in 2016. 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. Even though credit metrics do suggest we are in the bottoming out phase especially for many IG corporates adding more supporting to the bullish sentiments, we have turned cautious as we enter a period where we expect to see even more supply, tapering of QE from the Fed and ECB and a threat from a totally unpredictable North Korea. Rich valuations and a strong year to date performance together make our market more vulnerable to tail risks events. Asian currencies and local bonds have done very well year to date and we have also 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.

What will the remaining of 2017 bring? 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 normalise monetary policies, which could potentially lead to repricing of risk premium across asset classes. While we have been cautious for months now, a return of volatility is long-awaited as it will likely to bring about more opportunities for investors in an otherwise range-bound market.

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