

First State Asian Quality Bond Fund

Monthly Review and Outlook

November 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 weakened in November as investors turned cautious amid tight valuations and expectations of upcoming supply. JACI returned a negative 0.18% largely due to spreads widening and higher US treasury yields. Investment grade outperformed high yield though both delivered negative returns at -0.16% and -0.27% respectively. By countries, spread returns were mixed. Mongolia and Bangladesh stood out as the top positive contributors, while Indonesia, Pakistan and China were the worst performers.

In the US, the President's nomination for the incoming Chairman of the US Federal Reserve (Fed) was confirmed as Jerome Powell. During Powell's confirmation hearing, he reiterated Yellen's rhetoric of being on track for a rate hike in December and an overall gradual upward path for interest rates. Markets took the announcement in their stride and saw the appointment as a continuation of the Fed's current approach.

After having kept policy rates on hold since mid-2016, Bank of Korea (BoK) became the first Asian central bank to tighten monetary policy by hiking policy rate by 25bps to 1.5%. This was in line expectations if one recalls that BoK highlighted in their last statement that conditions are getting ripe to adjust monetary easing even though growth and inflation conditions will still need to be monitored. That said, the rate hike decision was not unanimous with 1 board member calling for policy rate to be on hold. On growth, BoK's Governor Lee thinks this year's growth will come in at 3.1-3.2%, slightly higher than its October forecast. He expects another year of above potential growth in 2018 at around 3%, modestly higher than previous forecast of 2.9%. On inflation, he believes CPI will stay at 1% level in the near term and gradually approach the target rate of 2% over time.

Other newsworthy events in the month include the rising oil price which moved close to US\$60 a barrel, the highest level since June 2015. This was boosted by speculation that OPEC will extend production cuts, which was confirmed later in the month. Also helping the rise was the arrest of a number of ministers, royals and military officials as part of an anti-corruption campaign in Saudi Arabia. Geopolitical risk was further increased when North Korea launched another missile after a notable hiatus around the time of the Chinese Congress. Whilst the missile was significantly bigger than prior ones, market was somewhat unresponsive to the event and again demonstrated a resilience to ongoing geopolitical risks, for now.

Despite the cautious sentiments, we witnessed USD 36.2b worth of supply which is the busiest month this year. This brings year to date supply to 56% from the same period last year. Alibaba's 5 tranches USD 7b supply stood out and was well received by US investors who previously shunned Alibaba's inaugural issue 3 years ago. This issuance is significant as it potentially has the impact of leading the way for Asian corporates to build a benchmark curve, which will help deepen our markets.

We maintained neutral in US duration throughout the month as US treasury yields remained stuck in a tight trading range despite optimism around the tax reforms. We believe 10 year US treasury yields will remain in our previously identified 2-2.5% range. We further increase our overweight in credit via several new issues in Chinese SOEs. In other countries, we remained overweight in the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. Our local currency bonds exposure remains at below 5%.

Performance Review

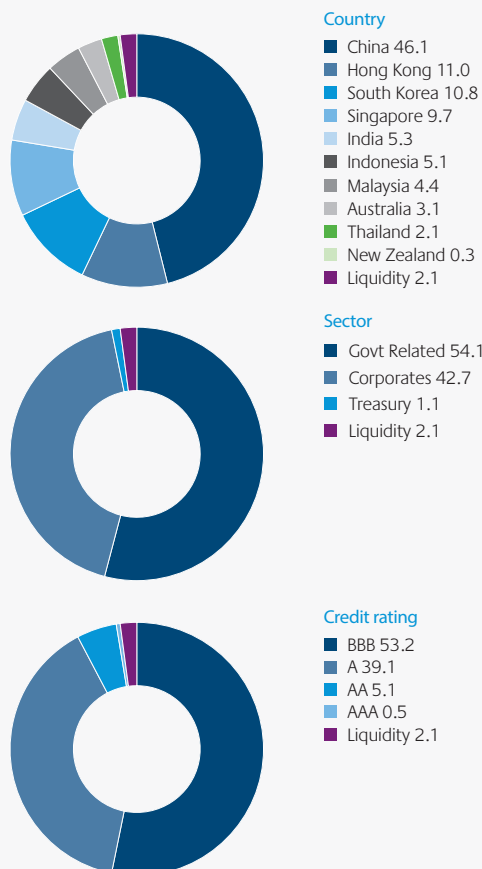
The First State Asian Quality Bond Fund returned -0.12% net of fees for the month of November ¹.

Cumulative Performance in USD (%) ¹						
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	0.1	5.5	5.1	9.7	14.2	65.4
Benchmark*	0.0	5.3	5.0	12.4	19.6	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

The fund has delivered strong returns this year largely due to the spread tightening in Asian credits. US treasuries yields which are still below where we started the year also contributed to the returns despite losing some ground in recent weeks. In terms of excess return, we maintained an overweight in credit for a big part of the year and that has done well. Securities selection has been the largest component of excess returns this year. Names we held overweight positions include Alibaba, China Overseas Land, OCBC and Pertamina. Local currency bonds that we opportunistically added to the fund over the past few years also made a significant contribution to excess return this year from both a currency and rates perspective. Our holdings in local bonds are mainly in CNH, IDR, INR and SGD. We recently added some AUD corporates to the fund.

Asset Allocation (%) ²



Top 10 Issuers (%) ²

Issuer Name	%
CNOOC Ltd	5.3
China Huarong	4.9
Hyundai Motor Co	4.9
China Petrochemical Corp	4.6
Sinochem Hong Kong (Group) Co Ltd	4.6
China Overseas Land & Investment Ltd	3.9
Pertamina Persero PT	3.7
Citic Ltd	3.4
Reliance Industries Ltd	2.9
United Overseas Bank Ltd	2.8

Portfolio Positioning

We maintained neutral in US duration throughout the month as US treasury yields remained stuck in a tight trading range despite optimism around the tax reforms. We believe 10 year US treasury yields will remain in our previously identified 2-2.5% range. We further increase our overweight in credit via several new issues in Chinese SOEs. In other countries, we remained overweight in the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. Our local currency bonds exposure remains at below 5%.

Investment Outlook

After months of relentless rally during which we witnessed risky assets brushing aside Fed rate hikes, geo-political tension in the Korean peninsula and China's rating downgrade, we finally witnessed a month of weakness in November though we see it more as a healthy correction. The Fed looks set to continue hiking interest rate and have since announced the start of their balance sheet unwind, while ECB is set to follow suit with a reduction in their own bond purchase program once the current one ends in December. Conventional wisdom suggests these actions could put upward pressure on interest rates, though recent episodes of US taper and interest rate hikes have actually led to the opposite outcome. As major central banks rhetoric has been for a long time "easy and gradual", we see little room for surprises. Investors in the short term will likely focus instead on the upcoming US debt ceiling negotiation and tax reforms. The appointment of Jerome Powell as Janet Yellen's successor as the Fed Chairman all but ensure continuity for gradual normalization process. Amid the synchronized global growth as evidenced by many developed and emerging economies posting positive figures in manufacturing PMIs, risk appetite should remain well supported. Nevertheless, we remain defensive as tight valuations make markets more vulnerable to unexpected shocks, which can include fraud and war. The biggest risks we see at the moment for bond markets especially, would be a more hawkish than expected ECB and a sudden spike up in inflation in both the US and the Eurozone.

US economy maintains its positive momentum amid a strong rebound in business investment spending, which increased by 7% in the first half and looks set to continue. Consumers' sentiment has also been strong, staying well above pre-crisis level throughout the whole of this year. With unemployment close to low 4% and non-farm payroll averaging close to 180k in

² Source: First State Investments as at 30 November 2017.

the past few quarters, the Fed looks set to continue normalizing its monetary policies with both rate hikes and a reduction in their balance sheet. Nevertheless, we believe the current strong momentum in the US economy could be more cyclical in nature and the 2-2.5% GDP growth is possibly as good as it gets. With inflation likely to be stuck well below the Fed's target of 2%, we believe the Fed's projection of 1 more hike in December, 3 in 2018 and a few more in 2019 is overly optimistic. Economic fundamentals certainly point to a continuation of a low growth, low interest rate environment for years to come. That said, there are several upcoming events that could lead to investors positioning for higher rates. These include positive development around fiscal policies and tax reforms and a larger than expected inflation print that will spook the market as expectations for inflation have been very low for a long time.

Eurozone growth continues to surprise us on the upside in the past few quarters as PMIs across many countries remain strong and household spending stays robust. This strong growth is especially impressive if we factor in the weaker exports which were dragged down by a strong Euro currency. Full year growth for 2017 is likely to move above 2% having been stuck at around 1.5% for the past few years. Despite the recent optimism, we are of the opinion that Eurozone trend growth remains stuck at around the 1.5% level as the region still faces structural issues including an elevated unemployment rate and a lack of fiscal union amongst the members. The possibility of Catalonia declaring independence from Spain is a timely reminder that nationalistic mindset is still highly prevalent in Europe and is highly destabilizing for the region at a time when collaboration is much desired in order for the region to move forward with reforms that will improve Europe structurally. On monetary policies, ECB announced they will extend their QE for another nine months when it ends in December, albeit at a reduced amount of purchase and without an end date. Rate hike however is unlikely as inflation in the Eurozone remains very low at close to only 1% amid high unemployment rate and low wage growth.

In the past few quarters, Asian economies have largely benefitted from strong global trade and China's continued growth. While China's growth is expected to remain respectable, the risk to Asia is that the global trade cycle might have peaked. Exports

figures are showing signs of softening and Taiwan's ex-China exports, which is a leading indicator for regional exports looks to have turned. Despite an outlook of slower growth as well as some central banks lamenting about the lack of growth, Asian economies are still by far expanding at a much higher level than other regions. Indonesia at above 5% and India at above 6% are more than double that of many emerging market countries. While low inflation has allowed Bank Indonesia and Reserve Bank of India to cut rates to spur economic activities, we do feel these moves are driven more by politics instead of economics.

China's excessive debt issue has been well documented and is something they will continue to tackle. However, what many had not focus on is the resurgence of China's exports after taking a back seat post the GFC during which consumption and infrastructure investments took over as major drivers of growth. What is encouraging is that China exports have structurally shifted up the value chain and have become more competitive. The high tech goods such as Huawei telecom equipment is now getting international recognition amid the private sector's shifting its focus on information technology and industrial automation. This trend if continued, will likely underpin China's ambitious goal to double its GDP by 2020. Post the 19th Party Congress, Premier Xi Jinping further consolidated his power, which will allow his party to continue with reforms that will include reducing leverage in SOEs and making them more efficient, promoting quality economic development with focus on green investment and tougher environmental regulations. We are also likely to see some easing of entry barriers, tax cuts and other measures aimed at providing a more favorable backdrop for the private sector to further develop which will likely be announced in the upcoming months.

Supply and demand technical in the Asian credit market 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. Nevertheless, we maintain a cautious stance as rich valuations and a strong year to date performance make our market more vulnerable to unexpected events.

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