First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook
July 2018

- The Fund invests primarily in debt securities of governments and corporate issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

Market Review

The first week of July was pretty much a continuation of the weakness we witnessed during the first half of the year, though sentiments turned positive following China's loosening of liquidity conditions onshore, in a bid to offset the negative impact on the economy arising from deleveraging as well as the intensifying trade war with the US. New issue activities also roared back to life with many issues being priced at fairly attractive levels, luring investors out of the hibernation mode they have been in for the past few months. For the month, JACI returned a positive 0.78% as the spread tightening of 16bps more than offset the higher US treasury yields. By country, spread returns were all positive led by Indonesia, Pakistan and Sri Lanka, markets which bore the brunt of the sell-off during the first half of the year.

In light of the prospects of slower growth amid the trade war with the US and the ongoing deleveraging which has been in place for the past two years, China policy makers stepped up their efforts to prop up growth with a series of easing measures during July which included the China Banking and Insurance Regulatory Commission asking commercial banks to increase loan supply to private companies and SMEs. The party leaders also agreed at a politburo meeting to adjusted the official monetary policy stance from "prudent and neutral" to merely "prudent", a clear move towards loosening. Nevertheless, Premier Li Keqiang downplayed the impression that the government is returning to heavy handed stimulus by describing the shift towards easing as fine tuning.

The rise in global yields in the second half of July was largely due to Bank of Japan (BoJ) statement that they were considering a change in policy settings. While official rates were left unchanged, BoJ Governor Kuroda detailed that they would increase the range of fluctuation for the 10 year JGB yield from 10bps to 20bps around the current target yield of 0%. While some viewed this as the first step in BOJ seeking to permit JGB yields to drift higher over time and hence a tighter monetary policy, many believe the BOJ is nowhere close to hiking interest rate having recently pushed inflation target out to 2020.

Amid the more bullish sentiment, new USD issuance picked up hitting USD 10.3b during the month. This was more than twice the amount the month before though year to date issuance at USD 110b still lagged by 28% when compared to the same period last year. China continued to dominate supply in July accounting for more than half of the issuance. Some notable deals included China Merchant Port's USD600m 10 year issue, which was 7.5x oversubscribed. Two well-known but infrequent issuers POSCO and Temasek Holdings also issued bonds. POSCO's USD 500m 5-year deal was met with an overwhelming response with orders at 5.6x while Temasek's USD 1.35b 10-year deal had orders at 3.5x oversubscribed.

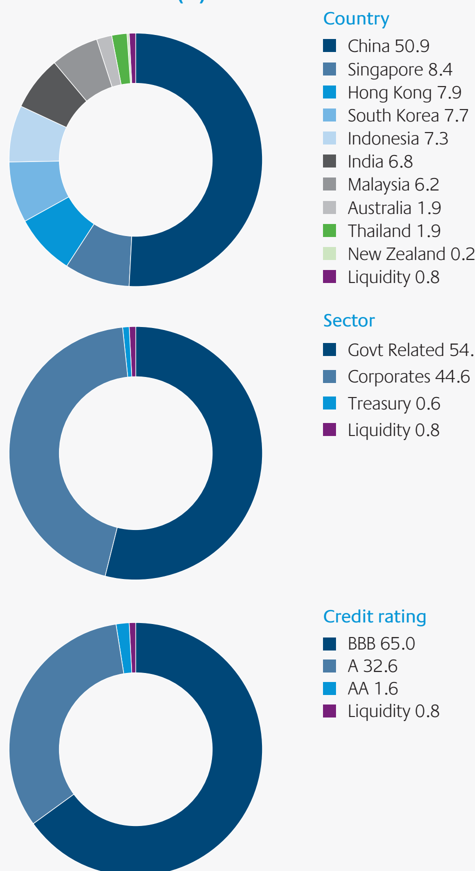
Performance Review

The First State Asian Quality Bond Fund returned 0.56% for the month of July on a net of fees basis. The positive return was largely attributed to spread tightening across all markets which more than offset the rise in US treasury yields. On a relative to benchmark basis, our overweight in China added value which more than offset what was detracted by our short in Philippines. Our local currency bond holdings continued to lose ground as the USD continued its strong rally as the trade war intensified during the month. On a year to date basis, our short US interest rate duration during Q1 along with our shorts in Indonesia and Philippines we held for a large part of 1st half of the year added value enabling the fund to deliver good year to date excess returns versus the benchmark.

	Cumulative Performance in USD (%) [1]					
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	0.3	-1.8	-0.7	7.3	16.2	62.6
Benchmark*	0.6	-1.5	-0.5	9.1	22.2	106.4

	Calendar Year Performance in USD (%) [1]				
	2017	2016	2015	2014	2013
Class I (USD - Acc)	5.6	3.4	0.9	6.8	-3.0
Benchmark*	5.5	4.5	2.2	9.0	-2.6

Asset Allocation (%) [1]



Top 10 Issuers (%) [1]

Issuer Name	%
United Overseas Bank Ltd	4.6
Hyundai Motor Co	4.4
China National Chemical Corp	4.4
Indonesia (Republic of)	4.2
China Huarong	3.7
China Overseas Land & Investment Ltd	3.4
China Vanke Co Ltd	3.4
Sinochem Hong Kong (Group) Co Ltd	3.3
Pertamina Persero PT	3.2
ICBC Financial Leasing Co Ltd	2.9

Portfolio Positioning

We made several strategy changes in the month of July. We moved our neutral positioning in both US interest rate duration and Asia credit spread duration to overweight during the month as valuations have become more attractive following months of weakness. We reduced slightly our overweight in high yield following very strong rally during the month, while keeping our local currency bonds exposure in the 3-4% range. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting Philippines sovereign on tight valuations. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We remained underweight India banks though we added our exposure in Indian corporates during the month in both investment grade and high yield as spreads were trading at the widest levels in recent years.

Investment Outlook

Trade wars, tighter monetary conditions, emerging markets outflows and the list goes on. Conditions that hampered the markets in the first half of the year look set to continue or even intensify. The only constant seems to be uncertainty. The easy way out is to take cover, especially if you had not already done so. But as we all know, following the crowd might not always lead to the best outcome, particularly when the shelter is overly crowded. As the market has been bearish for such a long time, we believe pockets of value are emerging and that presents opportunities as we enter the second half of the year.

In our outlook for Q2, we correctly anticipated a continuation of global synchronized growth, which allowed the Fed to continue hiking interest rate and the ECB to taper its QE program. We also anticipated global growth to slow in the second half of the year and there are some signs of that already happening. While US growth is still being propped up by the ongoing fiscal stimulus, exports growth in Europe has slowed significantly. Taiwan's semiconductor exports also look to have peaked, a strong indication that the days of strong global trade are behind us. The recent dollar strength is more likely due to the divergence of growth momentum between US and Europe, rather than the ongoing trade wars between US and its trading partners. Inflation in US and Europe have been trending higher towards the respective central banks targets. However, we do not think that trend is sustainable especially in Europe where

[1] Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 July 2018. 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.

inflation numbers have been driven by a weaker euro and higher oil prices both of which are cyclical in nature. In terms of monetary policies, the still decent growth, low unemployment and a gradually rising inflation will allow the US Fed to continue raising policy rate at the pace of one 25bps hike per quarter for the remaining of this year. However, we are less certain of whether they can continue hiking at the same pace through 2019 as the risk to growth is clearly on the downside. As for the ECB, Draghi sounded rather dovish recently signaling that the first rate hike will not come until the summer of 2019, right before he steps down. While the recent softening in growth supports the dovishness, it remain questionable whether the Eurozone still need such ultra-easy policies after so many years. Germany's Jens Weimann, the early favorite to succeed Draghi, has taken a hard line against loose monetary policy. If appointed he could bring about a radical change in monetary policies that the market is not prepared for.

While Asian growth is still expected to look decent and inflation staying benign for the full year, trade wars, stronger USD and months of relentless outflows have pressured Asian central banks to react, albeit in different manner and we expect them to stay highly vigilant. China's central bank People's Bank of China (PBOC) shifted to an easing bias, prioritizing growth and liquidity in spite of the government's ongoing efforts to enforce tighter regulations on shadow banking and deleverage specific sectors. We now expect the PBOC to stop hiking rates in tandem with the US Fed and deliver more Banks' Reserve Ratio Requirement RRR cuts. Indian and Indonesia have been victims of the stronger dollar as we witnessed acute weakness in both the rupee and the rupiah. Both the Reserve Bank of India (RBI) and the Bank Indonesia (BI) reacted by hiking policy rates. This was despite inflation remaining contained and current account deficits staying within manageable ranges. More notably in the case of BI, we witnessed 3 hikes amounting to a total of 100bps over just 6 weeks, a strong willingness to stay ahead of the curve. That said, Indonesia remains vulnerable to risk and flow sentiments. Foreign holdings of Indonesia government bonds fell from the peak of 40% to 38% leading to the rupiah weakness. Should we get a similar or larger magnitude of decline in the months ahead, any BI actions will be in vain.

The same can be said for Malaysia, which has an equally high foreign holdings in their Malaysian Government Securities (MGS). In short, while fundamentals remain sound in Asia, external factors are more likely to drive local markets FX and rates performance in the coming quarters.

Asian credit market sentiments have been weighed down by a wide range of negative factors and uncertainty, most notably the ongoing credit crunch and rising defaults in China. The negative sentiments were further exacerbated by the trade wars between China and the US which is likely to last for a while. While we expect fears around trade war to eventually dissipate as Trump shift his focus to the mid-term elections, development around the credit conditions in onshore China should be closely watched as further meltdown will effectively erase any hope of a rebound in Asian Credit in the second half of the year. That said, we are not feeling too nervous about the current situation in China. After all, the deleveraging process is voluntary and self-imposed, which means the government will have the ability to slow down or even reverse some of the deleveraging should conditions become too acute. Furthermore, allowing the weaker names to default actually promotes a healthy development of the debt market in the long run. In fact we believe credit differentiation is long overdue in China. Asian Credit valuation has become more attractive following months of spread widening. As at the end of the 1st half, JACI IG spread has widened around 42bps to 190, bringing it very close to its 5 year average. The high yield sell-off has been more pronounced with spreads widening by 124bps since the start of the year till 30th June, bringing it to almost 61bps above its 5 year average. Adding in the upward move in US treasury yield, Asian credits' all in yield to maturity is now just 20bps shy of the peak we reached during the 2013 taper tantrums, whereas fundamentals are much stronger now than before. This makes Asian credit highly attractive especially for the long term, all in yield investors such as the pension funds and insurance companies. Anecdotally, real money investors are holding high single digit cash levels, which will inevitably help to limit the downside from an already oversold position. In short, market could be setting ourselves up for a period of strong performance in the second half of the year.

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