First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook

December 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

Asian credit spreads remained under siege especially investment grade credits as the uncertainty clouding the markets for the past few months does not look like abating anytime soon. US credits' dismal performance in the past two months also weighed heavily on Asian credits. However, the spectacular rally in US treasuries as market priced out rate hike in 2019 more than offset the loss caused by spread widening, allowing the JACI to deliver a positive 1.34% return for the month. This gain brought year to date loss to just -0.77%, a very good performance when compared to all other asset classes which have gone through a significant re-pricing throughout the course of the year. JACI spread widened by 5bps to end the year at 291bps while 10 year treasury rallied by 30bps to end the year at 2.68%. By country, spread returns were largely negative with the exception of China and Mongolia which held up very well, while Sri Lanka recovered from a severely oversold position.

Just when we thought there could be some resolution between the US and China on trade issues, markets were roiled by the arrest of Huawei CFO Meng Wanzhou during a stopover in Vancouver on her way to Mexico. The 46-year-old is accused by the US of guiding a global effort by the Chinese telecom equipment giant to mask violations of sanctions on sales to Iran. This development added more tension to the already edgy relationship between the two nations and it does not look like it will abate anytime soon. This news resulted in a bout of spread widening in Asian credits most notably the China technology names.

Meanwhile in India, the cabinet approved the sale of the Indian government's stake in REC Ltd to Power Finance Corporation Ltd (POWFIN) for INR140 billion in a surprising reversal of the previous plan which was for REC to take over POWFIN. This deal if completed, will likely lead to a downgrade on POWFIN's rating due to significant capital erosion as S&P's current negative outlook on POWFIN does not factor in the possible debt-funded acquisition. As a result of this announcement, POWFIN bonds were brutally sold off, while bonds of REC trading below par were bid up on speculation of a change of control trigger, should government stake falls below 50%. Nevertheless, there are plenty of uncertainty around how this deal will be finance, whether the government will structure the deal in such a way to avoid the change of control trigger and also whether the Reserve Bank of India (RBI) would reject the deal if the total capital adequacy ratio (CAR) of the post-merger POWFIN falls below the minimum threshold of 15%. To compound on the uncertain political sentiment, Urjit Patel resigned as the Reserve Bank of India governor. It was widely suggested that his resignation comes against the backdrop of increasing tensions between the Finance ministry and the Reserve Bank of India.

As widely anticipated, the US Fed raised policy rate by 25bps for the fourth time this year though what is more important is that they have now lowered projections for both interest rates and economic growth in 2019. While Chairman Powell and his team feels that economic activity in the US has been rising at a strong rate, they flagged threats from a softening world economy. The language in their statement has also shifted from "the FOMC expects that further gradual increases would be required" to a more dovish "the FOMC judges that some further gradual increases in rates will likely be needed". The median estimate for the long run neutral rate among Fed officials fell to 2.75% from the previous 3%, further supporting their dovish stance.

Supply slowed to a trickle at only USD 12.3b for the month of December. Issuance continued to be dominated by the Chinese as they rush to utilise their offshore bond quota. Other notable issuance included the USD 3b issue by Indonesia sovereign. For the year, total issuance came in at USD 192b, representing a 29% decline year over year.

Performance Review

The First State Asian Quality Bond Fund returned 1.24% for the month of December on a net of fees basis.

The positive return was largely attributed to the strong rally in US treasury as market continued to price out rate hikes despite credit spreads being under pressure throughout the month. On a relative basis, fund performed in line with benchmark.

For the full year, 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. In Q3, we gave up a big part of the outperformance as our long duration position detracted value amid rising US treasury yields. In Q4, our long duration position recovered strongly as US treasuries staged a strong rally in the last two months of the year as market priced out further rate hikes in 2019. However, our overweight positioning in credit continued to detract value as spreads continued to widen. We also held an average of 3-4% of local currency bonds throughout the year and that detracted value as well as the dollar performed strongly in 2018.

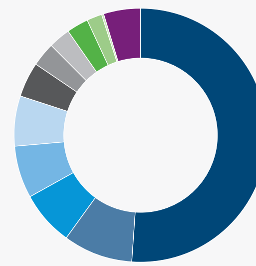
Cumulative Performance in USD (%) [1]

	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	0.7	-1.3	-1.3	7.7	16.1	63.4
Benchmark*	1.2	0.0	0.0	10.2	22.7	109.5

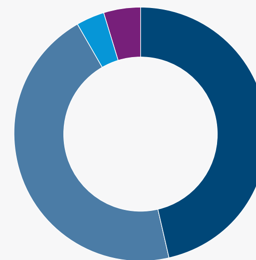
Calendar Year Performance in USD (%) [1]

	2018	2017	2016	2015	2014
Class I (USD - Acc)	-1.3	5.6	3.4	0.9	6.8
Benchmark*	0.0	5.5	4.5	2.2	9.0

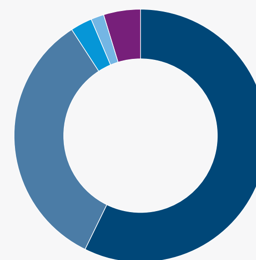
Asset Allocation (%) [1]



Country
- China 51.3
- Hong Kong 8.9
- South Korea 7.0
- Singapore 6.6
- Malaysia 6.5
- India 4.5
- USA 2.9
- Indonesia 2.9
- Thailand 2.8
- Australia 1.8
- Other 0.2
- Liquidity 4.7



Sector
- Corporates 46.6
- Govt Related 45.3
- Treasury 3.4
- Liquidity 4.7



Credit rating
- BBB 57.4
- A 33.5
- AAA 2.9
- AA 1.6
- Liquidity 4.7

Top 10 Issuers (%) [1]

Issuer Name	%
United Overseas Bank Ltd	4.4
Hyundai Motor Co	4.3
China Vanke Co Ltd	3.9
Nan Fung International Holdings Ltd	3.9
China Huarong	3.7
China Overseas Land & Investment Ltd	3.3
Sinochem Hong Kong (Group) Co Ltd	3.2
Ping An Insurance Group Co of China Ltd	3.1
United States Treasury	2.9
Pertamina Persero PT	2.9

Portfolio Positioning

There were no change in our strategy during the month. We maintained our overweight positioning in both IG and HY as valuation has become more attractive following months of spread widening. We also kept our moderate long position in US interest rate duration as signs of economic slowdown became more apparent in recent months amid the ongoing trade war and a waning fiscal stimulus. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting Philippines sovereign on tight valuations. We are also underweight in Indonesia as sentiments around emerging market is expected to remain tentative at best. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government

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

financing vehicles). We reduced our exposure in India mainly in Power Finance and REC amid the uncertainty and a potential ratings downgrade upon the completion of the deal. We maintained our underweight India banks amid rising NPLs.

Investment Outlook

As we begin the New Year in 2019, worries that have hampered market sentiment look set to persist or even intensify. Consensus is suggesting growth in the US will slow, as effects of fiscal stimulus wane. It is also widely inferred that the inverting yield curve always precede a recession. On top of that, many believe after close to 10 years of economic expansion, the probability of the US economy slowing has increased significantly. With Europe and Japan already slowing significantly in the past few months and the rest of the world starting to feel the pain of the ongoing trade war between the US and China, it is indeed hard for one to be optimistic in the current environment.

The US economy has been leading global growth for a large part of 2018, more notably in the second half of the year. Hence how the economy performs in 2019 and the subsequent impact on the Fed's rate hike trajectory will come under even more scrutiny as it will have a material impact on asset prices for Q1 2019. Many forecasts by economists and even those by the US Fed are pointing to slower growth ahead. Key reasons include the waning of fiscal stimulus, an economy that is already at full employment and the lagged impact of previous rate hikes. Recent trade data also suggests that US exports to China has been declining sharply, as a result of the tariffs imposed by China, providing a further drag on growth. While it is hard to argue against the above reasons and in fact we do think the US economy will eventually slow, we feel the market is a tad too early and too pessimistic in pricing in a recession and pricing out further rate hikes. This is because we believe being in the late cycle of a decade long economic expansion does not necessarily means growth will screech to an abrupt halt. Following the 4th rate hike in 2018, the Fed turned dovish as they are now more cautious of the global growth outlook even though they believe US economy remains strong. They now see only 2 hikes for 2019 which suggest one hike in March and another in June should the economic momentum continues. We agree with the Fed this time as projecting 2 hikes is appropriate at the moment as we expect to see slowdown to start looking more pronounced only in the second half of the year. We also expect the US treasury curve to fully flatten to around the 2.8% handle by the end of Q1. We currently see value in the short end 2-5 year part of the curve. While all attention has been on the trade war leading to an obvious slowdown in growth, we reiterate that a key risk market is not currently prepared for is a tariffs led inflation. If the US and China fail to come to a compromise at the end of the current 90 day trade truce, it could potentially lead to a breakdown in global supply chain and as a result, higher imported prices. This will force market to reassess their inflation expectations, which is currently very benign.

While market remains fixated on the development of the US-China trade war, cheering any reprieve in trade tensions between the two nations, we believe the ongoing spat between the number one and two economy will persist as the US will pull out all the stops to prevent or at least slow down the ascend of China. In other words, market volatility will remain heighten as asset prices continues to react to these political noise. Trade war will never be positive for anyone. That said, export data from recent months seem to suggest that China has coped much better than the US. This was largely attributed to China's nimbleness in diversifying its export markets away from the US, policy support for exporters in the form of export tax rebates, as well as a favorable exchange rate as the renminbi continues to weaken against the dollar. We expect China to continue pushing forward reforms despite a slowing economy and continue boosting liquidity as it has done in 2018. Amid slower growth and challenges arising from the trade war, we expect the Chinese government to increase the budget deficit to 3.0% of GDP in 2019 from 2.6% in 2018, providing policy support in targeted area, not the broad based stimulus many are hoping for. We also expect the People's Bank of China (PBoC) to continue cutting the reserve requirement ratio (RRR) by another 200bps next year to keep an easing bias in the monetary policy. In summary, we are positive that China still has plenty of levers to rebalance and prop up the economy to above the 6% handle despite the challenges they are facing at the moment.

Away from China, the rest of Asia ex Japan is still expecting to deliver a decent growth of well above 5%, albeit at a slower rate when compared to previous years. The more open and trade focused economies including Singapore, South Korea and Taiwan will be more vulnerable in the current environment especially if the trade tension between the US and China is to intensify. Thus growth rates in these economies are likely to surprise on the downside. Philippines stood out throughout the whole of 2018 delivering exceptional growth and this strong momentum is set to continue into 2019 as the government continues to roll over infrastructure projects. This strong growth came at a price as it brought about an inflation problem amid an overheating economy even though inflation looked to have peaked. Apart from the Philippines, inflation across Asia remains very benign. In 2018, many Asian central banks hiked policy rates for varied reasons. Bangko Sentral ng Pilipinas hiked to combat inflation, Bank Indonesia and Reserve Bank of India hiked to stem currency weakness, while Bank of Thailand and Bank of Korea hiked as part of the monetary policy normalisation process. While there could still one or two hikes left namely in Thailand and South Korea, we believe the tightening cycle in Asia is largely behind us. We expect central banks to be more reactive instead of preemptive in their next move. In fact we would not be surprised if some even cut rates should growth deteriorates sharply. Key events to look out for includes election in both Indonesia and India around April, which may bring about some volatility.

In 2018, focusing on credit fundamentals and relative value opportunities was key in delivering good performance as we begin to see divergence in spreads across sectors and issuers. We would expect this to be more important in the New Year as we are at the late part of the economic cycle. Across the investment grade universe, we continue to get comfort that key measures such as EBITDA and net income margins have improved over the last three years. Debt ratios have also come off while liquidity remains ample with the average cash level at more than 30% of

total debt. In the high yield space, the above mentioned metrics have also started to improve since 2017, following several years of deterioration. Earnings growth for Asian corporates as a whole is also expected to perform strongly in 2019 despite a slowdown in Korea, Taiwan and specifically the technology and telecommunication sectors. At the point of writing, the JACI IG spread at above 200bps is approximately 50bps wider than the recent tights. We view this level as fair, considering the strong credit fundamentals though the uncertain macro environment calls for caution. Within China, value is already emerging in the IG property space with spreads well above 200bps. Technology names including Tencent and Alibaba have also weakened to an attractive level though they are still vulnerable to headline news concerning US and China. We have turned cautious on Indian corporates amid the political uncertainty in the country. Indonesian sovereign and quasi's performance will very much be dependent on whether emerging market as an asset class bounce back from a dismay year of performance in 2018. The biggest risks for Asian IG at the moment would be a continued weakness in US IG, which has shown more pronounced weakness in the recent months, having held up very well for a big part of 2018. Any further weakness in US IG will inevitably have a spillover impact on Asian credits notwithstanding our stronger fundamentals. Nevertheless, further spread widening should provide investors with opportunities to accumulate exposures in high quality names at an attractive price. So be patient as we await opportunities in what we think would be a tumultuous year for risky assets.

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