First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook

June 2019

- 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

Even though there was a lack of development on the trade front, sentiment in the market was mildly positive throughout the month as market got a boost from the dovish rhetoric from both the US Fed and the ECB. The widely anticipated G20 meeting took place at the end of the month though just like most previous meetings, it didn't bring about any surprises. As investors in this region continued to put cash to work mostly via new issues, JACI spreads tightened by 6bps to 265bps. Coupled with the strong rally in US treasury as market started pricing in rate cut, the JACI delivered a strong positive return of 1.59%, bringing year to date gain to an impressive 8.04%. Investment grade total return was largely in line with that of high yield for the month of June. By country, spread returns were largely positive with Indonesia, Pakistan and Sri Lanka the top performers as emerging market bonds benefitted from strong inflows amid markets' expectation of lower interest rates in the US.

The US Fed's decision to leave rates unchanged but signaling readiness to cut them if economic outlook doesn't improve proved to be a game changer during the month which subsequently led to sharply lower bond yields, tighter credit spreads and higher equity prices. Fed Chairman Jerome Powell cited the escalation of trade tension as a key concern that could lead to many issues and that they will act promptly if that is appropriate. This all but ended the tightening cycle with the market now pricing in more than 2 rate cuts before the end of the year. Prior to the Fed's meeting, ECB's President Mario Draghi indicated that they would deliberate easing measures in the coming weeks and that additional stimulus would be required in the absence of improvement in economic data. While the precise nature and the scope of the measures are vague, the tone was clearly a very dovish one.

During the highly anticipated G20 meeting, US president Donald Trump met China's premier Xi Jinping and both agreed to resume trade discussion. Trump said that the United States would not impose any new tariffs on Chinese exports while the talks were underway and that China had agreed to resume broad purchases of American farm products and other goods. Trump also backtracked on a ban on sales of American equipment to Huawei, citing that he wanted to help US companies that had complained about the ban. While the G20 did not bring about much positive developments, financial markets heaved a sigh of relief that the tension between the US and China did not get worse.

Amid the positive sentiments, new issuance market was very active. Total fixed rate issuance topped USD 33b, a 76% increase from May. This brought year to date issuance to USD 155b, a 54% increase year over year. Some notable deals included Indonesia's USD 750m 10 year, Sri Lanka printed USD 2b across 5 and 10 year while ChemChina issued USD 2.3b multi tranche across 3, 5, 10 and 30 year.

Performance Review

The First State Asian Quality Bond Fund returned 1.32% for the month of June on a net of fees basis.

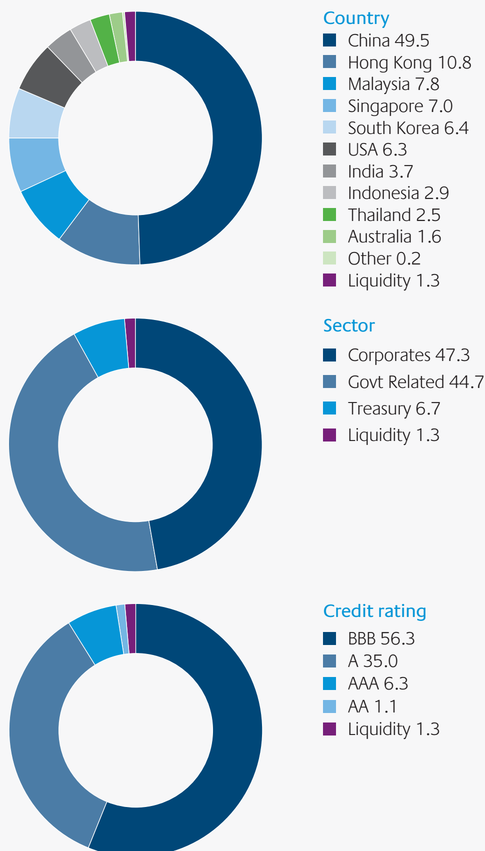
The positive return was largely attributed to both spread tightening and US treasury rally as market aggressively priced in rate cut by the US Fed.

On a relative basis, the fund under-performed the index in June largely due to our underweight in Indonesia and Philippines both of which rallied significantly during the month as emerging market bonds received very strong inflows. On a year to date basis, our overweight in credit along with security selection both added value especially during the January to April period. Our overweight in US interest rate duration which we held since the start of the year also contributed positively to our excess return.

	Cumulative Performance in USD (%) [1]					
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	3.0	7.8	9.0	9.9	19.8	76.2
Benchmark*	3.3	7.5	9.6	11.5	24.6	125.3

	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 49.5
- Hong Kong 10.8
- Malaysia 7.8
- Singapore 7.0
- South Korea 6.4
- USA 6.3
- India 3.7
- Indonesia 2.9
- Thailand 2.5
- Australia 1.6
- Other 0.2
- Liquidity 1.3

Sector
- Corporates 47.3
- Govt Related 44.7
- Treasury 6.7
- Liquidity 1.3

Credit rating
- BBB 56.3
- A 35.0
- AAA 6.3
- AA 1.1
- Liquidity 1.3

Top 10 Issuers (%) [1]

Issuer Name	%
United States Treasury	6.3
China Huarong	4.8
Genting Berhad	4.2
Bank of Communications Co Ltd	4.1
United Overseas Bank Ltd	3.9
Sinochem Hong Kong (Group) Co Ltd	3.9
Hyundai Motor Co	3.8
Nan Fung International Holdings Ltd	3.6
China Construction Bank Corp	3.1
China Overseas Land & Investment Ltd	3.0

Portfolio Positioning

During the month, we partially closed our short credit positioning as we believe the technical backdrop will be stronger in the short term following the Fed and ECB's dovish rhetoric. The benign outcome of the G20 will also boosts near term market sentiments despite us maintaining a cautious outlook on credit and risky assets for the rest of the year. We increased further our long US interest rate duration as we believe US growth will continue to moderate while inflation will stay well below the Fed's 2% target, which means US bond yields have plenty of room to move lower.

By country, we remained underweight in Philippines sovereign on tight valuations. We do not like India banks and corporates as valuation does not reflect the fast weakening fundamentals. We are also underweight in Indonesia as we believe all the good news have been priced in following the spectacular year to date performance in Indonesian spreads. Within China, we are overweight Investment grade property, Banks' leasing companies and Asset Management companies while underweighting core SOEs, banks and LGFVs (local government financing vehicles).

Investment Outlook

Financial markets entered the second half of the year on a sanguine beat following the resumption of trade talks between the US and China, coupled with dovish rhetoric from both the Fed and the ECB. The search for yield in the bond market will likely persist for a while as the lower for longer theme re-emerges following a period of monetary tightening. However, if we look beyond the positive technical backdrop, there is hardly anything to cheer about when it comes to fundamentals as global growth outlook continues to deteriorate. With fixed income markets delivering extraordinary returns year to date; many of which have exceeded double digits by the half year mark, it pays to be cautious as we navigate the murky path for the rest of the year.

When we started the year, market was pricing in two Fed rate hikes for 2019. That expectation has now become two rate cuts between now and the end of the year. While the debate will continue on whether the US goes into a recession and by how much the Fed should cut rates, the trend towards slower growth has become more apparent since the last quarter. We would also reiterate our skepticism towards the effectiveness of the Fed and ECB's ultra-easy monetary policies following a decade long

[1] Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 30 June 2019. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%. Fund 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.

of reckless money printing. We further question the ability of these major central banks to cope with the next crisis as it now has limited options in their toolkit with interest rates so low and monetary conditions already very easy.

While many are relieved that trade talks between the US and China has resumed, we are of the opinion that the damage is already done. Business confidence has taken a hit and that will take time to recover. The disruption to supply chain in the technology sector is highly worrisome and the impact is somehow underestimated by many. Even if the trade war is to stop, the technology war between the US and China looks set to continue as both strive for world dominance. Against the backdrop of slower growth, a lack of inflation and rate cuts from the Fed, we remain very bullish on US treasuries especially when compared to the meagre yields in other developed markets.

Global growth outlook seems to have turned for the worse. Amongst the world's 16 largest economies, 11 now have a PMI reading of under 50, the largest number since April 2011. With the slowdown in exports, countries such as South Korea and Singapore have both lowered growth forecasts. Even economies with a strong domestic story which include Indonesia and Philippines are facing slower growth too. Just like the developed economies, inflation across Asia remains very benign. For instance Indonesia and India, economies that were used to inflation in the 5-6% range are now printing at half or less of that range. This gives Asian central banks the flexibility to cut rates if they need to. In fact Malaysia, India and Philippines have already done so, with South Korea and Indonesia likely to follow suit in the coming months. China has been bearing the brunt of the trade war and inevitably monetary and government policies will continue to ease in order to support growth. At this point, we are of the opinion that fiscal policies will remain targeted as there are still traces of the excesses from the mammoth stimulus rolled out during the last global financial crisis. While China has the levers to prop up their economy and prevent a collapse, we do not share the same hype as other market participants as the quality of growth will be poor. Furthermore, many issues that China is facing right now are mostly external and are beyond their control.

Credit markets have entered into a "buy first, worry later" mode amid the lower for longer theme. However, we believe such reckless behavior will be punished once investors realise whatever the central banks do may not be enough to prevent the next downturn. Following the strong rally this year, risk premium is way too low to compensate for the heightened uncertainty of trade war, technology war and the imminent slower global growth. A key risk for credit market we would like to highlight is that US corporates have accumulated significant amount of debt in the past decade, taking advantage of the low interest rate environment. Total non-financial corporate debt to GDP ratio has now risen to the highest level by record. The multi-fold expansion of the BBB segment of US investment grade bonds makes it very vulnerable should slower growth in the US eventually lead to a slew ratings downgrade in this segment. Any downgrade related forced selling will inevitably put pressure on Asian credit spreads despite our stronger fundamentals.

At the end of June, JACI spread has tightened by almost 30bps year to date despite rising uncertainty and weakening fundamentals. At the same time, 10 year US treasury yield has declined by almost 70bps as market swung from pricing in rate hike to now rate cuts. Total return at above 8% for the JACI is now approaching two times that of the five year index average return. While we are still confident that US treasury will continue its rally thereby boosting total return, we are less certain of the trajectory of credit spreads should a US or global recession materialise. The risk reward certainly does not warrant moving down the credit curve notwithstanding the near term technical backdrop which remains very strong. Against this backdrop, stay with quality and look before you leap!

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