First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook

October 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

Despite global economic data remaining soft, sentiment in the Asian Credit market was positive throughout the month led by optimism that the US and China are progressing well towards a trade deal. New issuance market was vibrant too with most issues well received despite little concession given to investors. The JACI delivered a positive 0.52% return for the month as spreads tightened by 6bps to 268bps, more than offsetting the rise in US treasury yields. This brought year-to-date return to 10.66%. Most notably, high yield outperformed investment grade during the month, recovering strongly from previous months' weakness. By country, spread returns were mostly positive with the exception of Philippines. Frontier markets including Mongolia, Pakistan and Sri Lanka emerged the top performers as emerging market bonds were well supported amid major central banks' continued easing stance.

Preliminary GDP growth readings were released in the US, Eurozone and China during the month all of which pointed to slowing growth. Despite the weaker growth outlook, major government bond yields continued to rise amid hopes for a trade resolution between the US and China. US 10-year treasury yields rose 3 bps to 1.69% while the moves in Bunds and JGBs were more pronounced.

As expected, the Federal Funds rate was lowered by 0.25% towards the end of the month; the third cut in three months. The Core PCE, the Federal Reserve's preferred measure of inflation moderated and moved further below the central bank's 2.0% target, giving them the room to further lower policy rates if necessary. That said, market is now starting to believe that fiscal policies will likely be more effective at this stage of the economic cycle.

Supply stayed robust during the month with a total of USD 19.5b worth of issuance. Worth noting is we saw more non-China issuers this month accounting for 46% of the October's supply. Year-to-date supply now stands at USD 242b, a 53% increase year-over-year. Despite the ongoing protests which has now turned violent, household names in Hong Kong came to the market and garnered strong demand for their papers. This include CLP Power's USD 500m perpetual bond and Li & Fung's tap of its USD 400m 5-year issuance launched in September. Three Gorges USD 850m, 5 and 30-year issue and Perusahaan Listrik Negara 10 and 30-year deals were some of the other notable issues.

Performance Review

The First State Asian Quality Bond Fund returned 0.17% for the month of October on a net of fees basis.

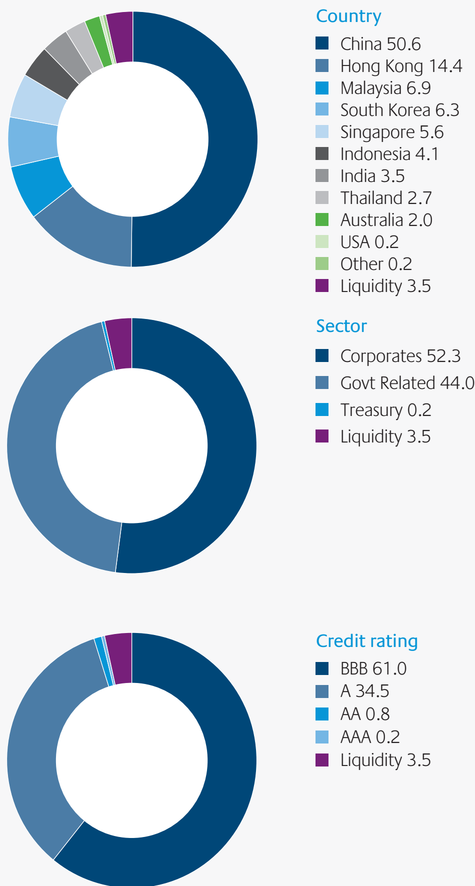
The return was largely attributed to the tightening in credit spreads which more than offset the rise in US treasury yields.

On a relative basis, the fund performed largely in line with the index.

	Cumulative Performance in USD (%) [1]					
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	2.0	10.5	12.2	11.3	20.7	80.5
Benchmark*	2.1	10.4	12.5	13.3	25.2	131.3

	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]



Top 10 Issuers (%) [1]

Issuer Name	%
China Huarong	4.6
Genting Berhad	4.0
Bank of Communications Co Ltd	3.8
Sinochem Hong Kong (Group) Co Ltd	3.6
Hyundai Motor Co	3.5
Industrial and Commercial Bank of China Ltd	3.4
United Overseas Bank Ltd	3.4
Nan Fung International Holdings Ltd	3.3
China National Offshore Oil Corp	3.1
China Overseas Land & Investment Ltd	2.8

On a year-to-date basis, our overweight in credit along with security selection both added value 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. This outperformance was especially significant in the May to August period during which the 10-year US treasury yield rallied by around 100bps. Our underweight in both Indonesia and Philippines spread duration detracted value for a big part of the year. Since September, we have gone neutral on US duration as we believe rates are likely to consolidate in a narrow range. In credit, we remained cautious while selectively participating in new issues. These positioning resulted in our funds performing largely in line with index over the past two months.

Portfolio Positioning

We remained cautious in our credit positioning during the month while selectively participating in new issues. We maintained a neutral stance on US rates at the long end of the curve as we believed a positive outcome from the trade discussion could push rates higher in the short term. We kept our long duration at the front end as we believe the US Fed will continue to cut rates as the US economy remains on a weakening trajectory. Our country positioning remained unchanged. We are overweight in China and Hong Kong. Within China, we are overweight investment grade property, big four banks' leasing companies and asset Management companies while underweighting core SOEs, banks and LGFVs (Local government financing vehicles). We remained underweight in Philippines and Indonesia on tight valuations. We do not like India banks and corporates as valuation does not reflect the fundamentals, which have continued to weaken in recent months.

Q4 Investment Outlook

As we moved into the last quarter of the year, there are clearer signs that the world is and will continue to be struggling for growth. The Fed has since cut policy rate twice, which now look more reactive rather than preemptive as Chairman Powell had suggested. The ECB has rolled out a fresh round of quantitative easing though we remain skeptical on the impact it has on the real economy after a decade of overdose. The inverted yield curve in the US and signs of stress in the US repo markets further add to the complexity of the tasks on hand for the Fed and these occurrences are not to be taken lightly especially the repo market situation which looks set to emerge again. While many may say "this time it is different" due to the central banks omnipresence, such signs of stress are usually precursors for a crisis. Amid the gloom and doom, there could be some positive surprises for the financial markets in the coming quarter should we get some positive development out of the trade discussion between the US and China. Markets could also cheer any form of fiscal stimulus by the major economies as this now looks imminent should growth continues to weaken despite rate cuts and quantitative easing.

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

While the US Fed and many Asian central banks still has room to cut policy rates, we would question its effectiveness because the normalization process in the past few years did not bring interest rates back to pre-global financial crisis levels. It has become more consensual of late that in order to avert a sharp slowdown as we head into 2020, fiscal stimulus is likely to be the more effective policy tool from here. Let's analyze the fiscal situation across major economies.

Donald Trump's aggressive fiscal stimulus brought US budget deficit to around 4.6% of GDP from the previous years' slightly above 3% level. While aggressive stimulus is not likely to be approved ahead of the election in 2020, current budget deficit level is still a long way off from the 8% level hit during the post crisis period of 2010-2011. Meanwhile Eurozone's budget deficit at 1% level also looks benign and China's deficit is still below 3% despite the targeted stimulus rolled out in the past two years. What this means is while we do not expect fiscal stimulus to be of the same magnitude as 2008-2009, there is ample room for most government to roll out such measures especially when inflation across the globe remain benign or even non-existent. India has recently announced aggressive tax cuts and that is likely a precursor of more to come from other Asian economies. Fiscal stimulus however, is unlikely to be the panacea. Approval process takes time and even upon implementation there could be a delayed impact on the real economy. The uncertainty around the trade war makes it more difficult to determine which sector needs stimulus and as a result, most government are likely to take a more reactive approach thereby risking doing too little too late. Fiscal stimulus may also be less effective in some Asian economies where corruption is rife.

Looking at the performance across major asset classes, it is clear that the US and Europe rates markets have been spot on in identifying the slowing global growth trend as evidenced by the sharp rally in rates over the past year. One can also argue that some segments in the high yield space have started reflecting a weakening economy and rising default rates. Investment grade spreads have remained relatively stable, suggesting its more defensive profile in a downturn. One worrying sign that emerged of late is that the usually resilient US equity market is now showing some concerns about global economic outlook or at least is no longer reacting positively to Fed rate cuts. Should this trend of risky assets continuing to reprice to reflect the deteriorating outlook, a heightened bout of volatility will be imminent especially if growth starts to plunge regardless of what central banks do. Specific to Asian credits, notwithstanding the spectacular rally this year, both IG and HY have underperformed those in the US. Asian investment grade bonds are now trading at around a spread premium of around 30bps above that of the US, which is modestly above that of the five year average suggesting they do offer some value on a relative basis. While we have been and will continue to advocate caution and go for quality, we do see some value emerging in certain segments which include Hong Kong corporates such as New World Development and Hysan following the sell-off amid the protest in Hong Kong. We remain bullish on US interest rates as we believe the Fed will continue to cut policy rates amid slowing growth, which means it should support total return for Asian USD credits. Nevertheless, we do not think it will be a one-way street as there could be short term spikes in yields should we get any positive development around the trade discussion, any surprise stimulus roll out by Trump or a disruption in oil supply.

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