First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

February 2018

Market Review

Continued synchronised global growth along with signs of rising inflation led to heightened rates volatility which triggered a sell-off in equity and credit markets. Asian credit market was not spared though the week long Lunar New Year break brought about a much needed reprieve. Corporate bond supply also dipped sharply during the holiday shortened month amid the negative sentiments though we do witness some signs of improvement towards the end of the month. JACI ended the month in negative territory for the second consecutive month as US treasury yields headed higher, dragging spreads wider along with it. The 10-year US treasury yield ended the month 16bps higher at 2.86%, while the JACI blended spread widened by 7bps to 219bps. JACI returned -0.85% during the month leading to a year to date return of -1.37%. Spread returns were mostly negative with the largest losses seen in Indonesia, Sri Lanka and Vietnam, which were ironically the top performers in 2017. The longer dated bonds remained under pressure through the month. This includes BABA 47, PERTIJ 44 and TENCNT 38.

Whilst there were no change in monetary policy during the month, there was certainly an air of positivity around the global economies and strong expectation for further monetary tightening. In the US, markets began fully pricing in the three planned Federal Open Market Committee (FOMC) 2018 rate hikes and even speculating for a fourth. The optimism came on the back of the strong wages and inflation data released in the month. Speculation in the UK turned to the prospect of a rate hike by the Monetary Policy Committee as the Bank of England signaled that an interest rate hike may come as soon as May. Minutes from the European Central Bank's January meeting showed inflation is picking up at a faster pace than predicted which market participants briefly interpreted as potential for monetary stimulus to come to an end sooner than expected. However Draghi's speech at month end remained consistent with the prior rhetoric surrounding ongoing monetary accommodation.

New issuance in Asian credit was significantly lighter especially in the period leading to the Lunar New Year holidays. Total USD fixed supply as USD 12.6b, down 7% year over year and 40% lower than January. China contributed to 55% of the supply. By segment, 42% of issuance was Bank senior papers, while high yield bonds continued its comeback since second half last year accounting for 30% of supply in February.

Performance Review

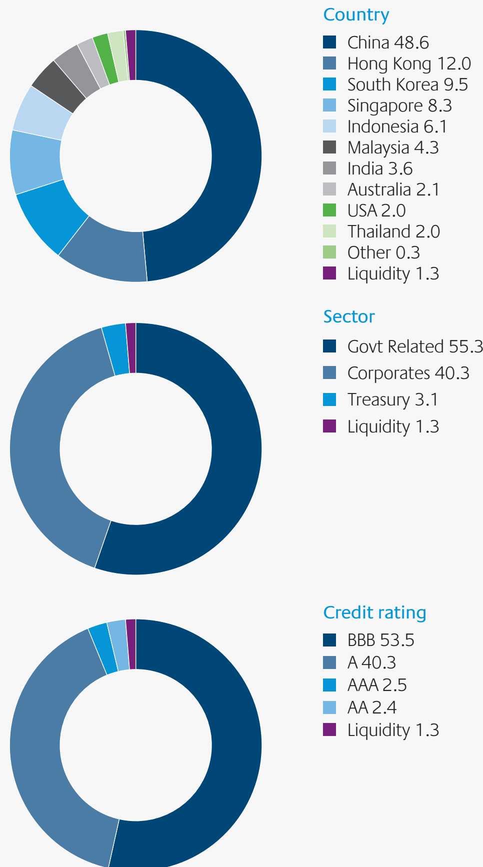
The First State Asian Quality Bond returned -0.9% (excludes initial charges) for the month of February [1].

	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	-1.4	-0.9	-1.4	-1.5	0.2
Fund (Inc initial charges)	-5.4	-4.8	-5.3	-5.4	-3.8
Benchmark*	-1.8	-1.0	-1.6	-1.7	0.5

The negative return was largely attributed to the widening in spreads amid a higher US treasury yields, as markets continue to price in further tightening in monetary policies in both the US and Europe. On a relative basis, the fund has performed well relative to the JACI IG index. This was largely attributed to our short US interest rate duration strategy which we implemented in January. Our local currency bonds holdings also added value as USD continue to weakened.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 28 February 2018. Fund since inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

Asset Allocation (%) [2]



Top 10 Issuers (%) [2]

Issuer Name	%
CNOOC Ltd	4.9
Hyundai Motor Co	4.5
Sinochem Hong Kong (Group) Co Ltd	4.3
China Huarong	4.3
Citic Ltd	3.8
China Overseas Land & Investment Ltd	3.6
China Petrochemical Corp	3.6
Pertamina Persero PT	3.4
United Overseas Bank Ltd	3.1
China People's Republic of (Government)	3.1

Portfolio Positioning

During the month, we took profit on our short US duration position as we believed the upward move in US treasury yield is overdone while positioning for short is getting crowded, making the market vulnerable to a sharp reversal. We also reduced our long position in credit to neutral as we expect credit spreads will be vulnerable as markets continue to adjust to a higher rates environment. Nevertheless, we started to see value in shorter dated corporate bonds especially from an all in yield basis after the significant upward move in short term US interest rates. We have been adding short dated bonds including CHJMAO 22 and BCOMFL 22. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting the higher beta Indonesia and Philippines sovereign on tight valuations. Within China, we are overweight the investment grade property, neutral on technology while underweighting the banks and LGFVs (Local government financing vehicles). We are underweight India banks on tight valuations offset by an overweight in Corporates. We maintained our local currency bonds exposure at around 3% of portfolio.

Investment Outlook

Market and economic conditions look a lot more favorable as we start 2018 versus a year ago when it was clouded with uncertainties. We now have a synchronised global growth that looks set to continue at least in the first quarter along with Fed rate hikes that has been well communicated and thus bringing no surprises. There is also optimism around US tax reforms and China's ability to rebalance its economy without derailing its growth. Amid this positive backdrop, the more plausible risks that we see derailing the risky assets rally would be limited to a more hawkish than expected ECB as it winds down its QE and a sudden spike up in inflation in the developed economy forcing the Fed and ECB to move quicker. 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 becoming a structural development that bodes well for the market. In short, we are bullish in Asian fixed income for Q1 barring significant changes to the above mentioned factors.

As we correctly anticipated, the US economy progressed well enough throughout the year to allow the US Fed to continue normalising monetary policies. To put some numbers into perspective, the US economy has created nearly 10 million jobs since Janet Yellen took charge in February 2014. Unemployment rate has declined from 6.7% to 4.1% while GDP growth has averaged a healthy though unspectacular 2.1% post the global financial crisis from 2010 to present. If such trends continue or are at least maintained, we do expect the Fed to continue hiking policy rate albeit at a slower rate than what they had projected. Yellen's successor Jerome Powell is also unlikely to bring about any material change to the rate hike trajectory. Just like December 2016 post the US presidential elections, there has been huge optimism from the markets amid the imminent passing of tax cuts and possibility of tax reforms in 2018. Consensus is projecting tax cuts to add around 0.3% to 2018 growth while an increase in fiscal spending in defense and infrastructure to add another 0.2%. While I believe Trump will deliver some of his agenda, his path will unlikely be smooth as the prospects of a widening budget deficit is unlikely to be popular amongst both House Republican and Congressional Democrats. The boost to economic growth is also likely to be short-termed. Drastic and effective structural reforms are what we need to see in order to lift the US economy above its trend growth, which we believe is in the 2-2.5% range. Low productivity growth and poor demographics, something we mentioned repeatedly in the past remain the key issues faced by the US as well as other developed economies.

Europe's growth has consistently surprised us on the upside in the past year, led by robust growth in the Germany and France coinciding with a period of synchronised global growth. Leading indicators also point to a continuation of this strong momentum as we head into 2018. That said, we believe this bout of strong economic performance is largely cyclical and exaggerated by

[2] Source: First State Investments as at 28 February 2018.

consumer and business sentiments recovering from a low base. We do not share the same optimism as many investors do, as we believe Europe as a region has not implemented any meaningful structural reforms that will boost its longer term growth prospects. Also, the continued strength of the Euro will start to weigh on exports. ECB has signaled its intention to taper its QE program by reducing their monthly purchase starting January 2018. It will not be until the middle of 2018 before they announce whether QE will be extended beyond September. In the absence of inflation, policy rate rise will not happen until 2019. This means monetary policies will remain highly accommodative.

Japan's economy has also been delivering good performance amid strong exports growth. Prime Minister Abe winning another strong mandate at the snap elections in October also ensures continuity of Abenomics and its three arrows of easy monetary policy, fiscal stimulus and structural reforms. This was evidenced in the adoption of a JPY2 trillion fiscal package on the 8 December. Similar to Europe, inflation has fallen short of central banks' target and hence interest rates in Japan are expected to stay low. While much attention is on the continued rate hike by the US Fed, the bigger risks to the market is actually an earlier than expected exit from the easy monetary policies by the ECB or BoJ should the strong economic performance continues. This is because while the US rates have started normalising, Bunds and JGBs are still stuck near zero, making them more vulnerable to a rise in yields.

Despite all the skepticism from the developed nations around China especially in 2016 when the renminbi depreciated sharply, China did a remarkable job in delivering strong growth while undergoing economic reforms. It successfully rebalanced its economy away from investments into consumption, while exporters structurally shifted up the value chain and have become more competitive. We have been bullish on China and remain positive as we believe Premier Xi JinPing will continue to drive reforms after he consolidated his authority at the 19th Party Congress. High level of debt remains a problem in China though the pace of credit growth has been slowing. We are not overly concerned as the bulk of the debt is domestic and hence any blowup can be more easily contained. In other words, any crisis from China will pale in comparison to the global financial crisis in 2008 or the European crisis in 2011. A key development we are closing watching in 2018 is the opening up of the China onshore interbank bond market. This is something that investors cannot ignore as this market will eventually form a significant portion of the major global bond indices. The recent spike up in onshore yields brought the 10 year Chinese government bond yield close to 4% which is an attractive level especially when compared against the meagre developed market yields. We believe the renminbi will remain stable though the movement will be dictated by the broad US dollar trend rather than China's macroeconomic performance. PBOC's recent rate hike following on the heels of the US Fed's hike is a clear indication of its determination to keep the renminbi stable.

Amid the synchronised global growth, Asia as a region has benefitted from strong exports growth though that is likely to wane in the second half of 2018 as the developed economies reach the mature state of the current cycle. Countries that are relatively more export oriented including the likes of Singapore, Malaysia and Thailand will be vulnerable to a turn in the global trend, while those with a stronger domestic demand story such as Indonesia and Philippines will likely prove to be more resilient. Accommodative monetary policies have pretty much run its course and most central banks are likely to move towards a tighter stance albeit a very gradual one, with the intention of normalising policy rates and at the same time stabilising their currencies. The most hawkish of the lot is likely to be the Banko Sentral ng Pilipinas (BSP), where we expect at least two 25bps hikes especially should the US Fed continues tightening. BSP historically has been by far the most aligned to the US and with its current account deficit widening putting pressure on the peso, rate hikes look imminent in 2018. With inflation largely subdued and likely to remain so for most part of this region, expectations of rate hike by central banks in Indonesia, Thailand and Malaysia range from only 1-2 hikes. As monetary policies take a back seat, development around fiscal policies will be in focus especially in countries where we are expecting elections namely Indonesia and Malaysia. In order for fiscal stimulus to be effective, it needs to bring about along lasting impact on the structural aspects of an economy. Singapore's push to improving workers' skills and productivity are examples of such reforms and if the rest of the region could follow suit, the longer term prospects of Asia will inevitably look even brighter.

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