First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

April 2018

Market Review

April was another dismal month for the Asian credit market bringing year to date loss above the 2% mark. While concerns over trade wars waned, the renewed focus on tighter monetary policies and heightened inflation expectations in the US led to sharply higher US treasury yields and hence the negative return. Losses in high yield corporates became more pronounced during the month, underperforming investment grade on both a spread and total return basis. JACI returned -0.66% in April even though blended spread was almost unchanged at +233 bps. Spread returns by country were mixed. Mongolia was the biggest loser at -0.34% while Pakistan rode against the tide of a broad emerging market weakness, delivering a positive 1.16% spread return.

During the month, Moody's upgraded the Government of Indonesia's long-term issuer and senior unsecured ratings to Baa2 from Baa3 and changed its outlook to stable from positive. According to Moody's, the upgrade was underpinned by an increasingly credible and effective policy framework that is conducive to maintaining macroeconomic stability. A build-up of financial buffers, prudent fiscal and monetary policy strengthens Moody's confidence that Indonesia's resilience and capacity to respond to shocks has improved. As a result, they believe Indonesia's credit metrics are now more comparable to sovereigns at the Baa2 level.

Meanwhile, the political uncertainty in Sri Lanka remains dire. President Maithripala Sirisena suspended parliament until next month in a shock move amid a deepening power struggle between him and his unity government's prime minister. The move, scheduled to last until May 8, came hours after at least 16 Sirisena loyalists, including six cabinet ministers, said they would leave the troubled coalition. Relations between the rival groups in the unity government have soured after both suffered losses in February's local council elections. The suspension of the parliament also came just two days after Sri Lanka's USD 2.5b 5 and 10 year bond issuance, much to the dismay of investors who participated in the deal.

Supply continued to come relentlessly during the month amounting to a total of USD 24.2b. Nevertheless, year to date issuance remains at 5% below the same period in 2017. China continues to dominate accounting for 65% of issuance this month including those from heavyweights such as CNOOC, State Grid and China Overseas Land. What is noteworthy is that supply were largely in the 5 and 10 year tenor with the 30 year issue conspicuously absent, unsurprising as the flatness of the yield curve makes longer dated bonds less attractive. High yield issuance continues to pick up as onshore liquidity remains tight. Year to date high yield issuance is now 68% higher than that in 2017. Though with yields sharply higher in the past month, pace of issuance will likely moderate from here.

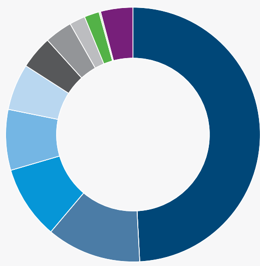
Performance Review

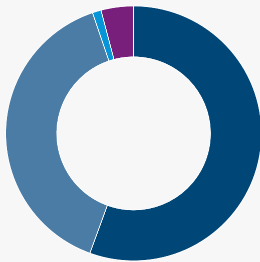
The First State Asian Quality Bond returned -1.0% for the month of April (excludes initial charges)[1]. The negative return was largely attributed to the rise in US treasury yields. On a relative basis, the fund underperformed relative to the JACI IG index mainly due securities selection and local currency bond holdings.

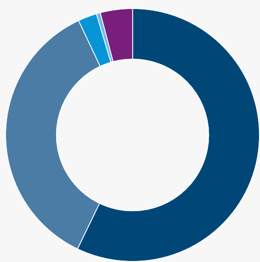
	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	-2.4	-1.0	-1.9	-2.6	-0.9
Fund (Inc initial charges)	-6.3	-4.9	-5.8	-6.5	-4.8
Benchmark*	-2.3	-0.7	-1.5	-2.4	-0.1

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 April 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	%
China Huarong	4.9
Hyundai Motor Co	4.5
China National Chemical Corp	4.4
Citic Ltd	3.7
China Overseas Land & Investment Ltd	3.6
China Petrochemical Corp	3.5
Sinochem Hong Kong (Group) Co Ltd	3.4
Pertamina Persero PT	3.3
Peking University Founder Group Co Ltd	3.2
United Overseas Bank Ltd	3.0

Portfolio Positioning

Despite maintaining our positive bias on investment grade credit, we were very cautious in adding risks as recent new issues performance has been disappointing and huge supply is still expected in May. High yield valuation is starting to look more attractive following the recent sell-off but we remain neutral as we do not expect any positive catalyst in the near term for sentiments to turn around. We also maintained a neutral positioning on interest rate duration despite the recent sell-off in rates as we believe the continued normalisation of interest rate by the US Fed will keep rates anchored at least for the first half of the year. Our local currency bonds positions were also largely unchanged at around 3-4% of our portfolios. 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, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We are underweight both India banks and corporates on tight valuations deteriorating fundamentals.

Investment Outlook

As we start the 2nd quarter on the back of a dismal Q1 fixed income performance, one can't help but feel nervous as the uncertain factors clouding the market do not look like dissipating anytime soon. While our optimism at the start of the year now looks misplaced, the positive trend of synchronised global growth and still accommodative central banks policies we identified remain intact. Though the ongoing trade war between the US and China looks set to intensify, the actual economic impact does not look too significant despite the damage it has done to market sentiments. As credit valuations are now looking more attractive after the sell-off despite solid fundamentals, staying the course, looking through the noises while identifying idiosyncratic relative value opportunities would be our key theme to extract value for this quarter.

There is no doubt the trade war between the US and China spooks the financial markets. However, it is too early to ascertain the true economic impact on the two nations given the retaliatory nature and also the interconnectivity of the world now. Trade wars are not new and if history is of any guide, there are very few winners, which leads to our belief that Trump is unlikely to take this too far especially when lawmakers from his own party are against him doing it. On the March 8 when Trump signed a presidential proclamation on adjusting imports of steel in the United States, he was surrounded by a carefully arranged group of factory workers. The very people who helped him get elected. This suggests that Trump's recent moves could be part of his ploy to show his supporters he has been delivering on his promises ahead of the mid-term election later this year, without the real intention of letting it escalate into a full blown trade war with China.

The US-China spat is likely to have mixed effects on various Asian economies though overall economic impact effect on this region is likely to remain manageable. This is because overall trade trajectory is ultimately drive by global demand conditions, which up till now remain strong and is less likely to be derailed by trade wars. Should the trade war between US and China escalates from here, Taiwan, Singapore and South Korea will be the most exposed. However, these countries would also stand to benefit if US or China diversify to other import sources as a result of the higher tariffs. If trade war persists for the longer term, higher tariffs will lead to diversification into alternative production bases, which means countries with favorable demographics and lower manufacturing costs such as Vietnam, Indonesia and the Philippines will benefit. What we are more worried in Asia, is that should this trade war drags on, sentiments will be affected leading to tighter financial conditions, deferred domestic demand and ultimately slower economic growth.

[2] Source: First State Investments as at 30 April 2018.

On a more positive note, there were some encouraging development following the China's National People's Congress that concluded recently on March 20. While 2018 growth target was maintained at 6.5%, emphasis has shifted to improving the quality of growth through moving up the value chain and implementing supply side reform. Budget deficit target is set at 2.6% of GDP, which is lower than the 2.9% in 2017, a clear sign of improving financial discipline. There is also an increase focus on the effectiveness of fiscal stimulus and policy mix. Amid the deleveraging exercise in the past 2 years, M2 growth has fallen from the previous double digits territory to 8.2% in 2017. While double digit M2 growth was excessive, the 8% handle will lend good support to the economy if is maintained. Inflation target is left unchanged at 3%, which supports recently appointed People's Bank of China's governor Yi Gang's commitment to keep monetary policies prudent and neutral. We do think the People's Bank of China will guide the renminbi to move in line with the basket of currency used to manage its foreign exchange regime. We do not think currency will be used as a retaliation tool in the trade wars with the US as China would want a stable currency at a time they are accelerating reforms to its capital accounts and opening up its financial service sector.

Our previous assessment of key economic trends in major economies remain unchanged. We expect the current synchronised growth in global economies to continue at least for the current quarter, which means the Fed will continue to hike interest rate while the ECB will continue tapering its QE program. However, as we approach the late stage of the current economic expansion, we are of the opinion that growth in major economies could be as good as they get. We are likely to see some moderation in growth in the second half of the year, which suggests both the Fed and the ECB will not be overly aggressive in normalizing monetary policies, boding well for bond markets in general. While the Fed cannot be any clearer in their forward guidance, the ECB rhetoric is what investors should be focusing on even though we expect them to go slow. In this quarter, they are likely to start changing some of their forward guidance leading to a potential announcement in the third quarter on whether QE will end later in September 2018. They are then expected to start making changes to forward guidance on interest rate in September should they let their current asset purchase program expire. Any misstep in their communication is likely to bring about some volatility. Bunds and other European peripheral bonds are highly vulnerable as they still trade at very rich levels.

In summary, synchronised global growth will continue but will likely fade in the second half of the year. Monetary policies will remain accommodative and we focus more on the ECB. Trade wars will bring about more volatility and uncertainty but actual economic impact should not be too significant at this stage. Valuations in Asian credit is looking more attractive post the first quarter sell-off though we see more opportunities from an idiosyncratic basis and will continue to extract value from new issues and relative value trades.

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