First State Investments

# Asian Quality Bond

## Monthly Review and Outlook

August 2016

## Key highlights:

- The US Fed Chairman Janet Yellen stated that recent developments had been a little more positive and even though economic growth has not been rapid, it has been sufficient to generate further improvement in the labour market.
- Moving well into the second half of 2016, the uncertainty around growth outlook is set to heighten hot on the heels of the UK BREXIT vote.
- Eurozone's economy has been resilient this year, underpinned by strong domestic demand amid easy monetary policy, low oil and commodity prices and improving labour markets.
- We see Asian credit valuation as fair at this juncture factoring in the narrowing spread premium versus US peers, weakening trend in credit metrics and an uncertainty global growth outlook.
- We remain positive on Asia's longer-term fundamentals and its ability to ride through this period of uncertainty.

## Market commentary

The winning streak in Asian credit remains unrelenting as spreads continued to tighten despite the US Fed talking up expectations of a rate hike in the remaining months of the year. The JACI index gained 0.72% bringing year to date return to 8.86%. JACI spreads ended the month at 235, tightening 13bps partly offset by the rise in US treasury yields, where we see the 10 year rising 13bps to 1.58%. Spreads return across countries were all positive with the exception of Mongolia which came under pressure following the one notch downgrade by Moody's to B3 & Moody's to B3 on continued concerns over deterioration of fiscal metrics and challenging external conditions.

During the annual Jackson Hole economic symposium, the US Fed Chairman Janet Yellen stated that recent developments had been a little more positive and even though economic growth has not been rapid, it has been sufficient to generate further improvement in the labour market. In addition, Yellen was clearer than usual on the policy outlook, stating that continued solid performance of the labour market coupled with the Fed's expectation of moderate growth in real GDP and inflation rising to 2% over the next few years have strengthen the case for an increase in the federal funds rate.

Bank Indonesia (BI) left its new policy rate, the seven-day reverse repo, on hold at 5.25%. Expectations for a rate hike during this meeting were 50-50 but with growth slowing and inflationary pressures low, a rate cut at the next meeting looks like an eventuality. Meanwhile over in South Korea, the Bank of Korea (BOK) kept rate unchanged at a record low of 1.25% as widely expected. With inflation far from the 2 percent target, the won relatively strong and exports struggling, the BOK has reasons to ease. However, this inaction coupled with the subsequent announcement by the government to propose a 3.7% increase in budget spending next year does suggest that monetary policies globally might have run its course as we now turn to fiscal measures to prop up the economy.

There were $9.7bn in USD fixed rate supply in the month of August which was the busiest August on record. Year to date supply is now only 10% behind that in 2015, down from 16% in July. The month's biggest issuers included ROADKG (US$950m across 2 separate bonds), CHALUM (US$750m), DBSSP (US$750m AT1), ORIEAS (US$650m) and UOBSP (US$600m T2).

## Performance

In USD term, the First State Asian Quality Bond Fund returned 0.86% in Aug.

## Portfolio positioning

We increased our credit and duration exposure during the month as we expect the relentless search for yield to continue for the rest of the year. We are now overweight in China, Hong Kong, India and Singapore, while maintaining a short position in Philippines as valuations are still tight. We moved from neutral to moderate long duration in US rates as we deem US treasuries to be attractive to the developed market peers whereby around a third are trading at negative yield. In addition to providing additional carry, a long duration provides a buffer for the portfolio in the event of credit spread widening should the market get hit by a risk event.

By country, we are now overweight in China, Hong Kong, Singapore and India and short in Philippines. We continue to overweight in high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the oil and gas sector which includes names like CNOOC, CNPC and SINOPEC due to potential supply and low profits in these companies amid falling oil price in the past year. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

# Investment outlook

Moving well into the second half of 2016, the uncertainty around growth outlook is set to heighten hot on the heels of the UK BREXIT vote. What is certain now is that there will be more volatility as we move closer to the Italian referendum on constitutional change in October and the US presidential election in November. Donald Trump's rapid rise in popularity is indeed alarming and if he is elected as president, markets are expected to react more negatively than what we witnessed after BREXIT. That said, the silver lining behind the dark clouds could potentially be a concerted effort by the remaining members in the European Union (EU) to agree upon a cohesive response, thereby making the region stronger. Monetary policies around the world are also likely to remain highly accommodative with lower for longer becoming lower forever, boding well for risky assets as the search for yield continues. We now see little chance of a US Fed hike this year barring a sharp spike up in inflation. This potentially means more stability in Asian currencies which have been hampered by expectations of Fed hike. As a result, central banks in Asia can be more accommodative for the remaining of the year. Against the above backdrop, we would adopt a cautious and defensive stance in Asia credits, selectively adding risks as value emerge while turning more bullish on high yielding currencies.

US economy's improvement in recent quarters has been underpinned by continued strength in consumer spending as unemployment falls to below 5% and a strong housing market that has benefitted from the ultra-low interest rates. However, business spending and exports have been lethargic at best and following BREXIT they are both likely to turn weaker amidst the uncertainty in Europe. Against this backdrop, it will be hard if not impossible for the US Fed to hike rates as they have repeatedly cited global economic uncertainty as one of the main factor whenever they decided to go on hold. This make their projection of 2 hikes for 2016 look very aggressive in the current environment barring a sudden spike up in inflation. The steady rise in oil price in the past few months has helped stabilise the fragile sentiments in the oil and gas sector which was in distress early this year. Any sharp correction in oil and commodity prices will likely be detrimental to US growth outlook for the remaining of the year.

Eurozone's economy has been resilient this year, underpinned by strong domestic demand amid easy monetary policy, low oil and commodity prices and improving labour markets. Nevertheless, UK's vote to leave the EU will have severe ramifications since the country accounts for 13% of all exports from the Eurozone. While it is unclear how much global business confidence, investment and employment are affected at this stage, the risk is clearly an underestimation of the consequences. The 1.5% GDP growth which we had expected since the start of the year is likely to be revised downwards and as such, the output gap will definitely remain wide while disinflationary pressure amplifies. Political landscape in Europe will be put under further scrutiny with the upcoming Italian referendum on reform taking place in October while elections in France and Germany will be held in 2017. Negative rates across Europe will also eventually put stress on the banking and insurance industry, certainly a development that warrants closer scrutiny by the European Central Bank.

Following sluggish growth in the past few quarters and a worse than expected Bank of Japan's (BoJ) tankan survey for business conditions, the government announced a shift towards fiscal easing. It was also confirmed that they would be postponing the April 2017 consumption tax hike to Oct 2019. Prime Minister Abe promised that the government would implement bold economic measures, suggesting that a second supplementary budget will be legislated around September 2016. While the government is committed to support growth amid a bleak outlook, Japan continues to face several downside risks to its economy. This includes rapid deterioration in growth amongst Japan's main trading partners most notably China and further appreciation in the Yen leading to a reduction in Japan's exports competitiveness.

Despite the ongoing reforms and an uncertain outlook, there are positive signs that the Chinese economy is stabilising. Housing related investment might slow down in the second half of the year, as government is likely to rein in the recent sharp rise in property prices witnessed in top tier cities. Exports might contract further as sentiments turned cautious in Europe following UK decision to leave the EU. Nevertheless, bank lending remains robust and looking at the aggressive municipal bond issuance plans, the government looked determined to support growth and achieve the growth target of 6.5%-7%. In the days following the shocked result in the UK referendum, the People's Bank of China (PBoC) allowed the renminbi to drift weaker, underperforming most Asian currencies. While this move re-ignited fears of more currency devaluation, we see it as more of a preemptive easing amid the uncertain outlook. We also expect the PBoC to ease monetary policies further with a combination of banks' reserve ratio requirement and interest rate cuts and continue to remain supportive of growth.

At the beginning of the year, we were of the view that Asian economies will be stuck in a protracted period of anemic growth as China slows. This will likely be exacerbated by what could be a structural trend of developed economies starting to produce what they used to import, as cost of production falls. This assessment turned out to be spot on as Asian exports especially in countries like Singapore, Malaysia, South Korea and Taiwan experienced sharp declines. With BREXIT dragging down business sentiments in Europe, we are unlikely to see a turnaround in exports anytime soon. The good news is, central banks in Asia can afford to remain accommodative or become more aggressive in easing as the likelihood of the US Fed hiking rate waned substantially amid the uncertainty around BREXIT. That said, continuation of reforms by major Asian economies remains crucial especially those targeting an improvement in productivity, as easy monetary policies while useful in supporting short term growth will inevitably run its course at some stage.

We see Asian credit valuation as fair at this juncture factoring in the narrowing spread premium versus US peers, weakening trend in credit metrics and an uncertainty global growth outlook. Nevertheless, with global growth outlook murky and major central banks expected to keep rates low for longer, if not forever, the search for yield continues and thus providing a favorably technical backdrop for the market. This was evidenced by how quickly the market recovered and rallied post BREXIT. We have also turned positive on Asian rates and currencies especially the higher yielding ones namely Indonesia rupiah and India rupee, as the Fed rate hike looking more distant as the global economy slows down further. As value based investors, we have been using any sell-off as opportunities to re-establish long positions in both credit and local currency bonds and we will continue with this approach as we head into the second half of the year as we remain positive on Asia's longer term fundamentals and its ability to ride through this period of uncertainty.