First State Investments

Asian Quality Bond

Monthly Review and Outlook

September 2016

Key highlights:

- The US Fed decided to leave the official Fed Funds target rate unchanged at 0.25%-0.5%.
- We maintained our moderate overweight positions in both credit and duration as we expect the relentless search for yield to continue for the rest of the year.
- We are likely to be stuck in a low growth, low inflation environment for a foreseeable future. What this mean is returns across various asset classes will also be tapered and the income generating feature of an asset class will become more important for investors.
- We have been using any sell-off as opportunities to add risk in both credit and local currency bonds and will continue with this approach as we head into the end of the year.

Market commentary

Following months of relentless rally, Asian credit market was in a cautious mode for a large part of September as investors eagerly awaited policy announcements from the major central banks. Fed officials talking up rate hikes before the Federal Open Market Committee (FOMC) meeting didn't help sentiments and concerns over Deutsche Bank's liquidity problem towards the end of the month exacerbated investors' edgy confidence. JACI spreads widened by 12bps to end the month at 250. This was offset by the positive return from carry, allowing the JACI to deliver yet another month of positive performance at 0.22%. Spreads performance were mixed with Mongolia, Malaysia and Bangladesh delivering the best return, while Pakistan, Vietnam and Philippines were the main laggards.

European central bank (ECB) kicked off a month of central banks galore by keeping policy unchanged, much to the disappointment of the market. Though with Draghi expressing concerns over underlying price pressures in Europe still lack any convincing uptrend, it is widely expected that the ECB will extend its purchase program beyond the current end date of March 2017. A more significant development was Draghi and his team becoming increasingly supportive of a fiscal contribution to the economic recovery in the coming years. Despite reiterating the need to respect the Stability and Growth Pact, they also called for an extension of the Juncker Plan and encouraged those countries with fiscal space i.e. Germany, to use it.

Meanwhile, Bank of Japan (BoJ) went a step further than ECB by introducing yield curve control while maintaining the current pace of assets purchase. Specifically, BoJ will apply a rate of -0.1% to policy rate balances in current accounts held at the BoJ and purchase JGBs so that the 10yr JGB yield remains around 0%. BoJ also affirmed its commitment to keep expanding the monetary base until the year-on-year rate of CPI inflation exceeds the price stability target of 2% and stays firmly above the target.

Despite a few Fed officials talking up rate hikes during the month, the US Fed decided to leave the official Fed Funds target rate unchanged at 0.25%-0.5%. In detailing the policy decision, the Fed judged that the case for an increase in the federal funds rate has strengthened but decided for the time being to wait for further evidence of continued progress towards their objectives. The FOMC decision was not unanimous with three members of the committee dissenting, calling for a 0.25% increase in the federal funds rate. Nevertheless, the Fed has once again reinforced the view that the rate hike cycle is going to be very gradual.

Over in Asia, Bank Indonesia (BI) cut the 7 day reverse repo rate by 25bps to 5% as widely expected while maintaining its GDP growth forecast range at 4.9-5.3%, following a 0.1% reduction last month. While BI remains dovish and committed to support growth, they are likely to assess upcoming data as well as the progress on tax amnesty revenue collection before deciding upon the next move.

New issuance market in Asian credits picked up significantly during the month amounting to $26.1b, the strongest month since April 2014. Year to date supply is now 5% higher than the year prior, a sharp turnaround from the end of August where the figure stood at -10% year over year. What was unchanged was China's continued dominance, accounting for 66% of supply during the month, followed by Hong Kong at 12% and Korea at 8%. Year to date, China's issuance stands at 59%, South Korea at 12% and Hong Kong at 9%.

Performance

In USD terms, the First State Asian Quality Bond Fund returned -0.06% in September.

Portfolio positioning

We maintained our moderate overweight positions in both credit and duration 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. US treasuries remains attractive relative to

its developed market peers whereby around a third are still 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 with the next one being the US election in November.

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

We started the year on a tumultuous note during which markets were crippled by the rapid deterioration in the oil & gas and commodity sector. The poor sentiments were further exacerbated by the heightened uncertain over the extent of China's slowdown. Nevertheless, markets have recovered strongly from the lows and exhibited resilience especially since brushing aside the shocking BREXIT outcome and we expect that trajectory to continue as we move into year end. There are major risk events coming up, which include the US Election, the Italian referendum and of course the Dec FOMC meeting, though we do not expect them to be as disruptive as those factors that have moved the market in the earlier part of the year. Global growth is likely to remain sluggish especially in most developed countries with central banks expected to continue missing their inflation targets. Monetary policies are expected to stay highly accommodative though its effectiveness on the real economy has clearly waned if not dissipated. With productivity remaining low in many countries, fiscal measures will now come under increased scrutiny as countries look for ways to lift their economies. As fiscal policies brings about positive changes only over the mid to long term, we are likely to be stuck in a low growth, low inflation environment for a foreseeable future. What this mean is returns across various asset classes will also be tapered and the income generating feature of an asset class will become more important for investors.

US economy recovered from the doldrums in the oil and gas sector earlier this year as evidenced by an improvement in energy mining investments in the 2nd and 3rd quarter. We continue to see an improvement in the labor market though momentum has clearly slowed down with average monthly job gains falling to 182,000 in the first eight months of this year as compared to 219,000 in 2015. The unemployment rate fell from 5.7% in January 2015 to 4.9% in January 2016, but has since stalled. Meanwhile, core PCE price inflation has been stable at close to 1.6% though still below the US Fed's 2.0% target rate. Against this backdrop, we believe the Fed has enough reasons to further normalize interest rate though with uncertainty around the US election outcome, we would not be surprised if they choose to once again push back on hiking. The US election appears to be increasingly competitive. Just like the "unthinkable" BREXIT, a Trump victory cannot be ruled out despite the polls showing Hillary Clinton still having a comfortable lead. A Trump win is perceived to be good for growth, leading to higher inflation notwithstanding the increased political uncertainty which is bad for markets in general. Nevertheless, with the check and balance mechanism put in place in the form of the Congress, it is unlikely many of Trump's promises will be legislated even if he is elected. In the short term, we believe a Trump victory is negative for the fixed income market. However the trajectory of bond yields will eventually be decided by economic fundamentals.

Eurozone growth remains resilient largely underpinned by strong domestic consumption despite the shocking result of the UK referendum to leave the European Union. Nevertheless, there is a risk that the impact on businesses and household spending has been simply delayed until the UK invokes Article 50 next year. On the inflation front, price pressure remains very low with core inflation stuck at below 1%, which is the average pace it has been running at since 2013. This means the European Central Bank's inflation target is unlikely to be met and thus we expect them to extend the time horizon for its asset purchase program to late 2017. Political landscape in Europe poses another risk to the stability of the region with the upcoming Italian referendum on reform taking place in October while elections in France and Germany will be held in 2017. Even though growth has been stable, many challenges remain.

Abenomics is starting to look like a distant memory despite government's efforts to launch more economic stimulus to prop up the economy. Japan continues to struggle with poor domestic demand and a loss in exporters' competitiveness amid a strong yen. The strong currency has also been a major driver of low inflation, as Bank of Japan (BoJ) struggles to achieve their inflation target of 2%. BoJ's altering of the policy framework which includes a specific targeting of the 10 year JGB yield, suggests that they are now concerned about how a flat yield curve is hurting the financial positions of pension funds and life insurance firms. This is a concern we shared not just in Japan but also in Europe. To top it all, rapid deterioration in growth amongst Japan's main trading partners most notably China add another risk to the numerous challenges the country is already facing.

While it has been gloomy and murky in the developed world, we could find some bright spots in Asia. Signs of stabilization in the Chinese economy were further affirmed by data observed over the 3rd quarter. Growth has been supported by the strong momentum in the property market along with boosts to infrastructure spending amidst aggressive municipal bond issuance plans. Exports also got a lift following the renminbi's depreciation over the past year while moderation in wage growth helped in bringing down the costs of production. Against this backdrop, the government is en route to achieve the growth target of 6.5%-7% for this year. China's stability is a much needed boost to other Asian economies, which have been struggling with anemic growth. Trade numbers have been lackluster, and this is evidenced in the poor showing of the exports oriented countries including Singapore, Malaysia, South Korea and Taiwan. Though central banks in Asia have more room to cut rates as compared to their developed market counterparts, the emphasis on reforms remains crucial. Countries targeting an improvement in productivity such as Singapore will come out top over the longer term, as easy monetary policies while useful in supporting short term growth will inevitably run its course at some stage.

We are cautiously optimistic at this juncture though we see Asian credit valuation as tight factoring in the narrowing spread premium versus US peers, weakening trend in credit metrics and an uncertainty global growth outlook. Nevertheless, with lower for longer looking more like lower forever, technical backdrop remains very favorable for the market as investors continue their relentless search for yield. We remained positive on Asian rates and currencies especially the higher yielding ones namely Indonesia rupiah and India rupee, with the Fed rate hike looking more looking more like a yearly event. Following a strong year to date performance of high single digit gains for Asian bonds, we are now defensive in our positioning though as value based investors, we have been using any sell-off as opportunities to add risk in both credit and local currency bonds and will continue with this approach as we head into the end of the year.

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