First State Investments

Asian Quality Bond

Monthly Review and Outlook

January 2017

Key highlights:

- Asian credit spreads started the year on a positive note, grinding tighter as they continued to be resilient to the unfolding political events.
- The outlook for Asian economies looks challenging for 2017. The region is facing heightened external uncertainties which include potentially a faster than expected Fed rate hike.
- Asian central banks have room to cut policy rates to spur growth, though we believe many will at least wait for their currencies to stabilize before contemplating their next move.

Market commentary

Asian credit spreads started the year on a positive note, grinding tighter as they continued to be resilient to the unfolding political events. New issuance market was especially active as we witnessed a record January with USD 20.7b worth of new bonds as issuers all tried to squeeze in before the Lunar New Year holidays which starts just before the month ends.

J.P. Morgan Asia Credit Index (JACI) returned a positive 0.89% largely due to spreads tightening by 6 bps to 231 while US treasuries ended the month almost unchanged. Investment grade underperformed High yield once again with a 0.76% gain versus 1.38%. Spread returns were all positive across countries with Malaysia, Mongolia and Sri Lanka the top performers.

Political risk continues to be the key theme as we enter 2017. President Trump was inaugurated amidst global protests which continued as he signed numerous contentious executive orders in his first two weeks. Most of these orders targeted Trumps most vocal campaign promises; repealing Obamacare, restricting migration into the US and building a wall on the Mexican border. These executive orders have done little to move markets in January overall, but individually are creating news headline risks on a daily basis. Certainly recent events are impacting market sentiment but largely the market continues to wait for more affirmative direction on any policy changes that are likely to impact inflation, growth and trade relative to what has already been priced in to financial markets.

There were no changes to global monetary policy in January as was expected. The market continues to price out the prospect of further rate hikes in the US until mid-2017 despite rhetoric from the US Federal Reserve (the Fed) that rate hikes will continue in 2017 at an increased pace. That said, the Fed has been true to its word in flagging that the re-investment of proceeds from its previous bond purchase programs may come to an end as the tightening cycle continues. The ECB was similarly unchanged, after its decision to reduce but extend its bond purchase program in December. Over in Asia, Bank Indonesia (B.I.) kept the 7 day reverse repo rate unchanged at 4.75% despite rising inflation as they still expect prices to range between B.I.'s target of 3-5%.

New issuance was very active during the month with a total of USD 20.7b printed, a 91% year over year increase. This included several mega deals from Huarong ($2.6b), Philippines ($2b) and Export-Import bank of Korea ($1.5b).

Performance

In USD terms, the First State Asian Quality Bond Fund returned 0.7% net of fees for the month of January.

Portfolio positioning

During the month, we moved our US duration strategy from neutral to short as we have concerns over a potential overshooting in market's positioning for an inflationary environment amidst Donald Trump's expansionary fiscal policies, though we maintain that it would take time for these policies to change the US economy structurally especially on the inflation front. We also turned cautious on credit spreads moving from an overweight to neutral on the back on tight valuations amid heightened uncertainty in both the political and global growth outlook. We are defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting the higher beta Indonesia and Philippines sovereign. Within China, we are overweight the investment grade property and technology while underweighting the banks and LGFVs (Local government financing vehicles) on supply concerns. We are underweight India banks on tight valuations offset by an overweight in Corporates. We maintained around 5% exposure to local currency bonds.

Investment outlook

If you think last year was tumultuous, 2017 is unlikely to be any smoother as we face continued uncertainty around global growth and several political headwinds. We have the French and German elections coming up, BREXIT negotiations will soon start and what is now on every investors' mind Donald Trump's protectionism and fiscal policies. Fiscal stimulus from the US if implemented on a large

scale could provide immediate boost to both consumers' and markets' confidence, which is good for risky assets. However, if this leads to higher inflation and more US treasuries issuance, bond market might come under further pressure. There are also some clear signs that inflation in the US is edging higher, this is likely to be exacerbated by the low base effect of crude oil as prices continue to recover from 2016 lows, not great news for bond investors.

While short term outlook for fixed income looks challenging, we are still mired in a long term sluggish global growth environment amidst low productivity and deteriorating demographics in both the US and other developed economies, all of which are structural in nature. This means that interest rates globally is likely to remain much lower when compared to historical levels even if policy rates in the US is to normalize further. Also, China looks to be doing a good job in maneuvering its growth lower without causing much disruption to its economy. A China growing slower but on a firmer footing would certainly bode well for Asian economies as this will likely underpin a case for more robust intra-Asia trades.

Positioning for USD strength and higher US rates has been heavy and is likely to persist barring Trump overpromising and under-delivering. Nevertheless, European Central Bank and Bank of Japan staying accommodative means that the global search for yield will likely continue. Asian credit market has been resilient, surviving the past few risk driven events including Brexit and Trump relatively unscathed. While valuation appears rich, demand and supply technical backdrop has been extremely strong which means any sell-off will likely be brief. Asian currencies have been oversold since last November and we are likely to start seeing some intervention from Asian central banks should this depreciating trend continues. On the other hand, should development in the US fall short of market's optimistic expectations, we could see a quick reversal in the unrelenting dollar strength.

Economic growth in the US has been stable in the past few quarters bringing the US Fed closer to achieving its dual mandate of full employment and price stability. Unemployment rate is now below 5% while core PCE has been hovering around the 1.7% level with strong signs of edging towards the Fed's target of 2%. Growth trajectory for 2017 will hinge heavily on how much Trump delivers on his pre-election promises, which include significant tax cuts, increase in fiscal stimulus and lesser regulations. Trump's policies will certainly have some impact on the Fed's assessment on the US economy though subsequent rate hikes are still expected to be gradual for now. What is certain though is that expectations for a boost to the economy led by Trump's policies are very high, which lends itself to some disappointment should Trump under delivers.

Despite exhibiting some strong growth momentum with PMI in Q4 hitting a 2016 high at 54.4, growth within the big four economies in the Eurozone remains mixed with Germany and Spain showing positive development while France and Italy lagged. Growth outlook for the New Year is one that would be slow and steady, likely in the 1-1.5% range though that would be lower than the 1.9% in 2015 and 1.6% projected for 2016. Against this backdrop, we see little price pressure in Eurozone especially with wage growth remaining subdued as productivity remains low just like that in the US. Political uncertainty would once again be of focus with the France and Germany elections expected to take place this year. Thus it would be hard to get excited over Europe's growth prospects and the slow but steady growth in the 1% handle looks to be the best outcome one can expect over the next few years.

Over in Japan, it looks to be another year of more stimulus from Abenomics though as we have mentioned in the past few years things hasn't really changed structurally for the land of the rising sun. A weaker yen in 2017 will likely give a further boost to exports, which surprisingly held up very well for a big part of 2016. Unemployment in Japan continues to move lower hitting a mid-1990s low at around 3%. However, that hasn't translated into higher inflation which BOJ has been targeting for years without success and it is something we doubt they will ever achieve. Against this moderately positive economic backdrop, BOJ should have some breathing space and has lesser urgency for further monetary easing in the near term.

The outlook for Asian economies looks challenging for 2017. The region is facing heightened external uncertainties which include potentially a faster than expected Fed rate hike, US trade policies which for now look unfavorable if Donald Trump executes his pre-election promises and a China that is willing to accept slower growth in the next five years. Trump's US trade policies will likely keep Asian exports subdued despite recent Asian currencies' weakness which is expected to boost volume. Asian central banks have room to cut policy rates to spur growth, though we believe many will at least wait for their currencies to stabilize before contemplating their next move. Against this backdrop, we expect export oriented economies like Singapore, South Korea and Taiwan to be more vulnerable, while countries that have a favorable domestic story including Indonesia, Philippines and Vietnam to fare better. On a brighter note, the Chinese economy looks to be on a firmer footing despite the slower growth. This has been largely driven by targeted infrastructure spending and a robust property market. Going into the New Year, we expect to see some property cooling measures in the top tier cities, continued reforms on the SOE front and some infrastructure spending in specific areas such as public housing and rails. China also has to do more in terms of corporate deleveraging and preventing capital outflows amid a depreciating currency. Nevertheless, we believe the government still has the levers to guide growth towards their target of around 6.5% before the China National People's Congress.

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