First State Investments

Asian Quality Bond

Monthly Review and Outlook

May 2017

Market commentary

May turns out to be an eventful month during which we have two sovereign rating changes, strong new issuance activity and some idiosyncratic risks emerging around some commodities related names most notably Noble group. Nevertheless, overall tone of the market remained firm with spreads still very much stuck in a tight range. JACI returned a positive 0.49% on the back of the rally in US treasuries while spreads return was a small negative. US 10 year treasury yield ended the month 8bps lower at 2.20% while the JACI spread widened by 4bps to 232bps. Investment grade reversed its long spell of underperformance versus high yield delivering a positive return of 0.76% while the latter was down 0.5%. By country, most countries registered modest return while the largest detractors were Hong Kong -1.9% (largely due to Noble group), Philippines -0.3% and India -0.26%.

After being on hold for the past few years, S&P finally raised Indonesia's sovereign rating to investment grade BBB- with a stable outlook from the previous rating of BB+. Following this revision, Indonesia has now acquired investment grade rating from all the three major rating agencies, i.e. S&P, Moody's and Fitch. S&P is now of the view that net government debt will remain below 30% of GDP. The agency is also complimentary of Bank Indonesia's (BI) ability to attenuate financial shocks, increase exchange rate flexibility and commitment to inflation targeting. The increasing reliance on market based instruments in conducting monetary policy has been viewed as a significantly positive development. Lastly, the narrowing of the current account deficit and moderation of inflation were also viewed as positive developments. Later in the month, Moody's downgraded China's credit rating by one notch from Aa3 to A1. This is unsurprising as the rating agency had China's outlook at negative for the past 14 months. Moody's expects that economy-wide leverage will increase further over the coming years. The planned reform program is likely to slow, but not prevent, the rise in leverage. The importance the authorities attach to maintaining robust growth will result in sustained policy stimulus, given the growing structural impediments to achieving current growth targets. Such stimulus will contribute to rising debt across the economy as a whole.

Supply slowed modestly in May with a total of USD 17.4b printed. This is 13% lower year over year and 39% lesser than April. Nevertheless, year to date supply at USD 125b is 91% higher than the same period last year. During the month, we witnessed several Hong Kong perpetual bond issues amounting to USD 6.3b. This included Cheung Kong Property, Sun Hung Kai and NanFung. PLN (USD 2b) and Sri Lanka Sovereign were the other issues of notable size.

Performance

The First State Asian Quality Bond Fund returned 0.87% net of fees for the month of May.[1]

Portfolio positioning

During the month, we reduced our short US duration strategy ahead of the French election as we believe the pay-off is asymmetric should Le Pen wins though we maintain that more details around the US tax reforms and the talk of longer dated US treasury issuance are likely to keep US rates elevated in the near term. We kept our neutral positioning on credit spreads as valuation remained fair at best albeit some improvement in financial metrics across many corporates in our universe. We stayed defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting 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 Indian corporates. We kept our local currency bond exposure at well below 5% mainly CNH and MYR.

Investment outlook

As we move towards mid-year, the uncertainty clouding financial markets looks set to further heighten. Following Macron's victory in the French election, we now turn to the upcoming German elections, BREXIT negotiations has been triggered and now we are faced with increased possibility of a second Scottish referendum. Yellen has just hiked twice in the space of 3 months though remaining dovish, while much attention will once again be on whether Trump can make any progress on his proposed tax cuts and fiscal stimulus. 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. This will likely remain the underlying theme driving fixed income markets in the coming months, though the recent fall in commodity prices if continued coupled with weaker than expected economic data might push yields lower.

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

[1] Source: First State Investments as at 31 May, 2017 in USD. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc).

when compared to historical levels even if policy rates in the US is to normalize further. What is encouraging for risky assets is that China looks to be doing a good job in maneuvering its growth lower without causing much disruption to its economy. During the recent National Party Congress, the Chinese leaders set growth target at 6.5%, which is still a robust number despite being lower than what we were used to. A China growing slower but on a firmer footing would certainly bode well for Asian economies. While positioning for USD strength and higher US rates can be fickle, 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 and has been getting richer since the start of the year, demand and supply technical backdrop has been extremely strong which means any sell-off will likely be brief.

Economic growth in the US has been stable in the past few quarters underpinned by a turnaround in business investment spending as commodity prices continue to recover. Meanwhile, wealth effect arising from a significant increase in home and equity market has not quite translate into robust consumer spending, which has been stable at best. Nevertheless, with the US Fed having achieved its dual mandate of low unemployment of below 5% and inflation of close to 2%, the Fed is likely to continue normalizing interest rate and potentially lighten up its balance sheet before Yellen's tenure as chairman ends. Growth trajectory for 2017-18 will hinge heavily on how much Trump delivers on his proposed tax cuts, effectiveness of his fiscal stimulus and the type of deregulations he rolls out. While responses to Trump's policies have been upbeat and is likely to boost inflation expectations, it is too early to assess whether these will have a longer term structural impact on the US economy, which still faces issues of poor demographics and slow productivity growth.

Despite the Eurozone exhibiting some strong growth momentum with PMI consistently surprising on the upside, we aren't ready to get excited about a region that will grow only in the range of 1-1.5%. Headline inflation has risen to 2% largely due to higher energy prices though core inflation at below 1% is unlikely to give the ECB much comfort in removing their easy monetary policies too quickly. Political uncertainty will continue being the focus now than UK has activated Article 50 and set off a 2 year negotiation process. Should the UK economy performs well in the years ahead, it might trigger thoughts by other EU nations to leave as well. That said, Macron's victory in the recent French election has provided much relief as it dissipates the possibility of a breakup in the Eurozone which appears very likely if Le Pen were to win instead.

Against all odds, we witnessed a strong uptick in Asian exports and improving PMIs in recent months, alleviating much of the concerns that growth in this region will suffer as protectionism truly takes hold. This uptick coincides with a strong recovery of commodities prices possibly driven by an increase in demand from China amid a property market boom and an increase in infrastructure spending. While the improvement in exports is encouraging, we remain cautious as this comes on the back of a low base and demand from the West hasn't really recovered as much as we would have liked. In the coming months, China is likely to continue curbing the rise of property prices especially those in tier one cities and at the same limit the excessive expansion in credit. As an offset, it is likely to selectively spend on infrastructure and step up activities across the region through the One Belt, One Road program. Inflation across Asia is likely to stay benign, giving central banks the flexibility to cut rates should they need to. Nevertheless, with the US Fed promising to deliver another 2-3 hikes this year, we would expect most central banks in this region to adopt a wait and see stance.