First State Investments

First State Asian Quality Bond

Monthly Review and Outlook
September 2017

Market Review

The tone in Asian credit market was firm during the month of September as concerns over geo-political tension in North Korea waned despite Kim Jong Un's unrelenting resolve to continue missiles testing. Both ECB and Fed were notably more hawkish despite keeping policy rates unchanged as they discussed reduction of bond purchases, which pushed US treasuries and Bunds yield higher. There is also renewed optimism over Trump delivering tax cuts or reforms further exacerbating the upward move in bond yields. With the positive sentiments in credit being negated by higher interest rates, JACI ended the month little changed at -0.01%. Investment grade returned a -0.16%, underperforming high yield which continued to deliver positive returns of 0.51% for the month.

By country, spread returns were all positive except for South Korea (-0.12%) as investors shunned Korean papers amid the geo-political uncertainty despite spreads having widened by 20-30bps in recent months. Notwithstanding the tight valuations, EM markets sovereign continue to do well with Indonesia, Pakistan and Vietnam leading the pack when ranked by spread returns.

While the European Central Bank (ECB) left its QE program unchanged as widely expected, Draghi said in the press conference that they discussed the pros and cons of various QE scenarios and tasked committees to continue working on them. He indicated that the bulk of QE decisions will be taken in October. Nevertheless, he stressed that not all relevant information may be available by the late-October meeting and if so, the decision on the asset purchase program may have to be postponed until mid-December, right before the program ends. Meanwhile, the US Fed left policy rate unchanged and confirmed reinvestment tapering will begin in October. It will start with a reduction in purchase of $10bn in October, followed by a $20bn reduction in January and subsequently increasing the amount reduced by $10bn every consecutive quarter till it reaches a maximum of $50bn. Barring negative surprises, Yellen said the Fed is on track to raise rates one more time this year and still expects three hikes in 2018. While she recognizes that inflation has been below their target of late, she is confident that labor market tightness will eventually push inflation up and the Fed wants to avoid having to tighten policy aggressively to deal with an inflation problem and thereby cause a recession. The current low level of inflation allows the Fed to move relatively slowly and cautiously.

During the month, we continued to see tensions heightening between the US and North Korea though that is largely brushed aside by the resilient markets. There were several political developments all of which have muted effect on the markets. Japan's Prime Minister Abe dissolved the lower house of parliament and called for a snap election while Angel Merkel's party came in first in the German national election, assuring her of a fourth term as chancellor.

On rating actions, S&P cut China's sovereign credit rating for the first time since 1999, citing the risks from soaring debt and revised its outlook to stable from negative. The sovereign rating was cut by one notch to A+ from AA-. S&P said China's prolonged period of strong credit growth has increased its economic and financial risks. They added that although this credit growth had contributed to strong real gross domestic product growth and higher asset prices, it has also diminished financial stability to some extent.

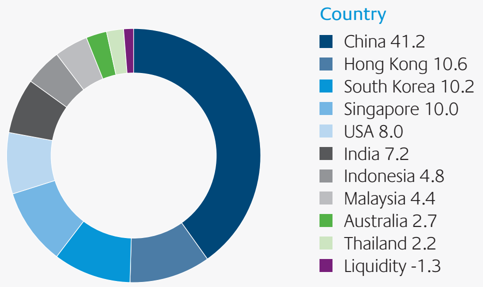
New issuance remained robust at USD 28.4b most of which were investment grade and bank capitals. China accounts for 68% of total issuance followed by Hong Kong at 16%. Year to date supply is now 54% higher than the same period last year.

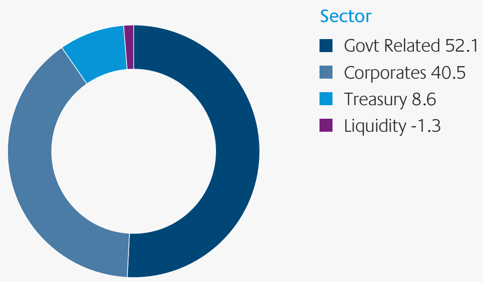
Performance Review

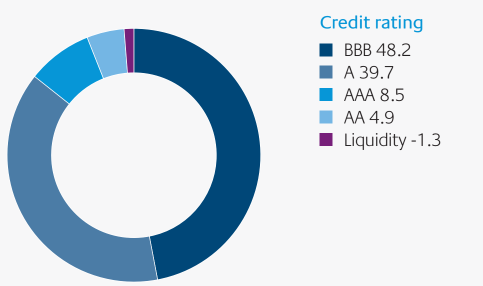
The First State Asian Quality Bond returned -0.4% (excludes initial charges) for the month of September [1].

	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	4.5	-0.4	0.8	2.2	1.3
Fund (Inc initial charges)	0.3	-4.3	-3.3	-1.9	-2.7
Benchmark*	4.9	-0.2	1.1	2.5	2.0

Asset Allocation (%) [1]







Top 10 Issuers (%) [1]

Issuer Name	%
United States Treasury	8.0
CNOOC Ltd	5.3
Sinochem Hong Kong (Group) Co Ltd	4.9
China Overseas Land & Investment Ltd	3.9
Hyundai Motor Co	3.8
Pertamina Persero PT	3.7
China Huarong	3.6
Overseas Chinese Bk Corp	3.3
Beijing Infrastructure Investment Co Ltd	2.8
Bank of Communications Co Ltd	2.5

Portfolio Positioning

We remained neutral in US duration as we believe there are various drivers in the near term that could lead to Treasury yields heading either way. We maintained our modest overweight credit strategy while remaining in the more defensive names, 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 on supply concerns and LGFVs (Local government financing vehicles) because of the poor underlying credit quality. We are underweight India banks on tight valuations offset by an overweight in Indian corporates. We continued to take profit on our local currency bond exposure during the month especially in CNH bonds as the renminbi continued its relentless rally. Our local currency bonds exposure now stands at below 2% and is largely in CNH and MYR.

Investment Outlook

After months of relentless rally during which we witnessed risky assets brushing aside Fed rate hikes, geo-political tension in the Korean peninsula and China's rating downgrade, one can't help but ask is there anything that could ever derail this strong performance as we head into the final months in 2017. The Fed looks set to continue hiking interest rate and have since announced the start of their balance sheet unwind, while ECB is set to follow suit with a reduction in their own bond purchase program once the current one ends in December. Conventional wisdom suggests these actions could put upward pressure on interest rates, though recent episodes of US taper and interest rate hikes have actually led to the opposite outcome. As major central banks rhetoric has been for a long time "easy and gradual", we see little room for surprises. Investors in the short term will likely focus instead on the upcoming US debt ceiling negotiation and tax reforms. Speculation around Janet Yellen's successor for the Fed Chairman role will also likely to have impact on market positioning for the future path of interest rates. Amid the synchronized global growth as evidenced by many developed and emerging economies posting positive figures in manufacturing PMIs, risk appetite should remain well supported. Nevertheless, we remain defensive as tight valuations make markets more vulnerable to unexpected shocks, which can include fraud and war. The biggest risks we see at the moment for bond markets especially, would be a more hawkish than expected ECB and a sudden spike up in inflation in both the US and the Eurozone.

US economy maintains its positive momentum amid a strong rebound in business investment spending, which increased by 7% in the first half and looks set to continue. Consumers' sentiment has also been strong, staying well above pre-crisis level throughout the whole of this year. With unemployment close to low 4% and non-farm payroll averaging close to 180k in the past few quarters, the Fed looks set to continue normalizing its monetary policies with both rate hikes and a reduction in their balance sheet. Nevertheless, we believe the current strong momentum in the US economy could be more cyclical in nature and the 2-2.5% GDP growth is possibly as good as it gets. With inflation likely be stuck well below the Fed's target of 2%, we believe the Fed's projection of 1 more hike and December, 3 in 2018 and a few more in 2019 is overly optimistic. Economic fundamentals certainly points to a continuation of a

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 September 2017. Fund since inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

low growth, low interest rate environment for years to come. That said, there are several upcoming events that could lead to investors positioning for higher rates. These include positive development around fiscal policies and tax reforms, appointment of a "hawkish" successor for Fed chairman Janet Yellen and a larger than expected inflation print that will spook the market as expectations for inflation has been very low for a long time.

Eurozone growth continues to surprise us on the upside in the past few quarters as PMIs across many countries remain strong and household spending stays robust. This strong growth is especially impressive if we factor in the weaker exports which were dragged down by a strong Euro currency. Full year growth for 2017 is likely to move above 2% having been stuck at around 1.5% for the past few years. Despite the recent optimism, we are of the opinion that Eurozone trend growth remains stuck at around the 1.5% level as the region still faces structural issues including an elevated unemployment rate and a lack of fiscal union amongst the members. The possibility of Catalonia declaring independence from Spain is a timely reminder that nationalistic mindset is still highly prevalent in Europe and is highly destabilizing for the region at a time when collaboration is much desired in order for the region to move forward with reforms that will improve Europe structurally. On monetary policies, ECB looks set to extend their QE for another six months when it ends in December, albeit at a reduced amount of purchase. Rate hike however is unlikely as inflation in the Eurozone remains very low at close to only 1% amid high unemployment rate and low wage growth.

In the past few quarters, Asian economies have largely benefitted from strong global trade and China's continued growth. While China's growth is expected to remain respectable, the risk to Asia is that the global trade cycle might have peaked. Exports figures are showing signs of softening and Taiwan's ex-China exports, which is a leading indicator for regional exports looks to have turned. Despite an outlook of slower growth as well as some central banks lamenting about the lack of growth, Asian economies are still by far expanding at a much higher level than other regions. Indonesia at above 5% and India at above 6% are more than double that of many emerging market countries. While low inflation has allowed Bank Indonesia and Reserve Bank of India to cut rates to spur economic activities, we do feel these moves are driven more by politics instead of economics.

China's excessive debt issue has been well documented and is something they will continue to tackle. However, what many had not focus on is the resurgence of China's exports after taking a back seat post the GFC during which consumption and infrastructure investments took over as major drivers of growth. What is encouraging is that China exports have structurally shifted up the value chain and have become more competitive. The high tech goods such as Huawei telecom equipment is now getting international recognition amid the private sector's shifting its focus on information technology and industrial automation. This trend if continued, will likely underpin China's ambitious goal to double its GDP by 2020. The 19th Party Congress in October will likely see Premier Xi JinPing further consolidate his power, allowing his party to continue with reforms that will likely include reducing leverage in SOEs and making them more efficient, promoting quality economic development with focus on green investment and tougher environmental regulations. We are also likely to see easing of entry barriers, tax cuts and other measures aim at providing a more favorable backdrop for the private sector to further develop.

Supply and demand technical in the Asian credit market remains extremely favorable as we believe the current situation of too much cash chasing after a limited pool of assets is likely to persist. The onshore Chinese investors' bid is also unlikely to wane providing further support for the market. Nevertheless, we maintain a cautious stance as rich valuations and a strong year to date performance make our market more vulnerable to unexpected events.