First State
Investments

First State Asian Quality Bond

Monthly Review and Outlook
August 2018

Market Review

Markets turned cautious again in August as uncertainties continued to increase. Ongoing trade wars between the US and China, crisis in Turkey coupled with expectations of more issuance in the months ahead led to the weak performance in the Asian Credit market. JACI spread ended the month 8bps wider at 251bps though this was largely offset by the rally in US treasury amid global uncertainties which saw the 10 year yield moving lower by 10bps during the month to 2.86%. As a result, JACI eked out a positive return of 0.51% for the month. By country, returns were mixed. Indonesia, India and the frontier markets including Sri Lanka and Pakistan were amongst the largest losers in spread returns, while heavyweights China and Korea held up well.

During the month, China's banking regulator ordered banks to boost lending to infrastructure projects and exporters in a bid to counter the negative impact brought about by the intensifying trade was between the US and China. This came amid intense selling pressure in both the currency and stock market. At one point in August, the Renminbi has fallen more than 10% from its peak in April, while the Shanghai composite was 25% off its recent high earlier this year. Beijing has also taken steps to boost investments, though they stopped short of extraordinary stimulus measures.

Market was also spooked by the ongoing crisis in Turkey, following the escalation of tensions with the US and the announcement of tariffs on Turkish steel and Aluminium. The Turkish Lira at one stage plummet by more than 40% while the yield on 10-year Turkish government bonds rose by more than 200bp, from 18% to above 20%. These large moves were a huge drag on emerging markets' sentiments. Its spillover effect in Asia was especially felt in Indonesia and Indian credits throughout the month.

Despite the negative sentiments, things on the issuance side looked more positive. We saw USD 14.1b of USD supply, up from the USD 10.3b in July. Singtel returned to the USD bond market after a 2 year hiatus and saw strong demand for its 10 year offering. Orders were in excess of 5.7x the issue size with demand coming from mostly Asian fund managers. The 10 year bonds eventually priced at a spread of 105bps, after tightening 20bps from initial price guidance. Sands China grabbed the limelight with a bumper USD 5.5b deal across three tranches. This deal is the biggest Asian USD deal in 2018 following Tencent's USD 5b 4 tranche deal in January. Notwithstanding the strong demand from investors, Sands did not tighten final pricing too aggressively. With initial price talk of T+200bps, 235bps and 260bps for the 5 years, 7 years and 10 years tranches respectively, final pricing was just 15bps tighter for the 7 and 10 years while the 5 year was eventually priced at 25bps tighter.

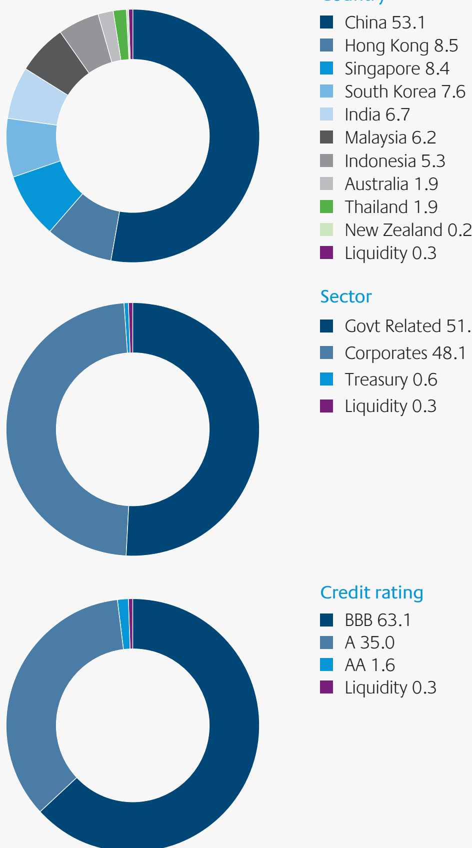
Performance Review

The First State Asian Quality Bond returned 0.39% for the month of August on a net of fees SGD term. The positive return was largely attributed to the rally in US treasury despite spreads widening. On a relative to benchmark basis, our overweight in US duration added value while our short in Indonesia detracted value. On a year to date basis, our short US interest rate duration during Q1 along with our shorts in Indonesia and Philippines we held for a large part of 1st half of the year added value enabling the fund to deliver good year to date excess returns versus the benchmark.

	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-2.3	N/A	N/A	-0.3
Fund (Inc initial charges)	-6.2	N/A	N/A	-2.5
Benchmark*	-1.2	N/A	N/A	0.5

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	0.1	-2.3	N/A	N/A	-0.6
Fund (Inc initial charges)	-3.9	-6.2	N/A	N/A	-4.6
Benchmark*	0.7	-1.2	N/A	N/A	0.9

Asset Allocation (%) [2]



Top 10 Issuers (%) [2]

Issuer Name	%
United Overseas Bank Ltd	4.6
China National Chemical Corp	4.4
Hyundai Motor Co	4.3
China Huarong	3.6
China Overseas Land & Investment Ltd	3.4
China Vanke Co Ltd	3.3
Sinochem Hong Kong (Group) Co Ltd	3.3
Nan Fung International Holdings Ltd	3.3
Vigorous Champion International Limited	3.1
Pertamina Persero PT	3.1

Portfolio Positioning

Towards the end of the month, we reduced our positioning in both IG and HY in anticipation of more supply though still maintaining an overweight bias. We also kept our moderate long position in US interest rate duration as we believe treasury yields will remain stuck in a range. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting Philippines sovereign on tight valuations. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We remained underweight India banks amid rising NPLs.

Investment Outlook

Trade wars, tighter monetary conditions, emerging markets outflows and the list goes on. Conditions that hampered the markets in the first half of the year look set to continue or even intensify. The only constant seems to be uncertainty. The easy way out is to take cover, especially if you had not already done so. But as we all know, following the crowd might not always lead to the best outcome, particularly when the shelter is overly crowded. As the market has been bearish for such a long time, we believe pockets of value are emerging and that presents opportunities as we enter the second half of the year.

In our outlook for Q2, we correctly anticipated a continuation of global synchronized growth, which allowed the Fed to continue hiking interest rate and the ECB to taper its QE program. We also anticipated global growth to slow in the second half of the year and there are some signs of that already happening. While US growth is still being propped up by the ongoing fiscal stimulus, exports growth in Europe has slowed significantly. Taiwan's semiconductor exports also look to have peaked, a strong indication that the days of strong global trade are behind us. The recent dollar strength is more likely due to the divergence of growth momentum between US and Europe, rather than the ongoing trade wars between US and its trading partners. Inflation in US and Europe have been trending higher towards the respective central banks targets. However, we do not think that trend is sustainable especially in Europe where inflation numbers have been driven by a weaker euro and higher oil prices both of which are cyclical in nature. In terms of monetary policies, the still decent growth, low unemployment and a gradually rising inflation will allow the US Fed to continue raising policy rate at the pace of one 25bps hike per quarter for the remaining of this year. However, we are less certain of whether they can continue hiking at the same pace through 2019 as the risk to growth is clearly on the downside. As for the ECB, Draghi sounded rather dovish recently signaling that the first rate hike will not come until the summer of 2019, right before he steps down. While the recent softening in growth supports the dovishness, it remain questionable whether the Eurozone still need such ultra-easy policies after so many years. Germany's Jens Weimann, the early favorite to succeed Draghi, has taken a hard line against loose monetary policy. If appointed

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 August 2018. Fund inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

[2] Source: First State Investments as at 31 August 2018.

he could bring about a radical change in monetary policies that the market is not prepared for.

While Asian growth is still expected to look decent and inflation staying benign for the full year, trade wars, stronger USD and months of relentless outflows have pressured Asian central banks to react, albeit in different manner and we expect them to stay highly vigilant. China's central bank People's Bank of China (PBOC) shifted to an easing bias, prioritizing growth and liquidity in spite of the government's ongoing efforts to enforce tighter regulations on shadow banking and deleverage specific sectors. We now expect the PBOC to stop hiking rates in tandem with the US Fed and deliver more Banks' Reserve Ratio Requirement RRR cuts. Indian and Indonesia have been victims of the stronger dollar as we witnessed acute weakness in both the rupee and the rupiah. Both the Reserve Bank of India (RBI) and the Bank Indonesia (BI) reacted by hiking policy rates. This was despite inflation remaining contained and current account deficits staying within manageable ranges. More notably in the case of BI, we witnessed 3 hikes amounting to a total of 100bps over just 6 weeks, a strong willingness to stay ahead of the curve. That said, Indonesia remains vulnerable to risk and flow sentiments. Foreign holdings of Indonesia government bonds fell from the peak of 40% to 38% leading to the rupiah weakness. Should we get a similar or larger magnitude of decline in the months ahead, any BI actions will be in vain. The same can be said for Malaysia, which has an equally high foreign holdings in their Malaysian Government Securities (MGS). In short, while fundamentals remain sound in Asia, external factors are more likely to drive local markets FX and rates performance in the coming quarters.

Asian credit market sentiments have been weighed down by a wide range of negative factors and uncertainty, most notably the ongoing credit crunch and rising defaults in China. The negative sentiments were further exacerbated by the trade wars between China and the US which is likely to last for a while. While we expect fears around trade war to eventually dissipate as Trump shift his focus to the mid-term elections, development around the credit conditions in onshore China should be closely watched as further meltdown will effectively erase any hope of a rebound in Asian Credit in the second half of the year. That said, we are not feeling too nervous about the current situation in China. After all, the deleveraging process is voluntary and self-imposed, which means the government will have the ability to slow down or even reverse some of the deleveraging should conditions become too acute. Furthermore, allowing the weaker names to default actually promotes a healthy development of the debt market in the long run. In fact we believe credit differentiation is long overdue in China. Asian Credit valuation has become more attractive following months of spread widening. As at the end of the 1st half, JACI IG spread has widened around 42bps to 190, bringing it very close to its 5 year average. The high yield sell-off has been more pronounced with spreads widening by 124bps since the start of the year till 30th June, bringing it to almost 61bps above its 5 year average. Adding in the upward move in US treasury yield, Asian credits' all in yield to maturity is now just 20bps shy of the peak we reached during the 2013 taper tantrums, whereas fundamentals are much stronger now than before. This makes Asian credit highly attractive especially for the long term, all in yield investors such as the pension funds and insurance companies. Anecdotally, real money investors are holding high single digit cash levels, which will inevitably help to limit the downside from an already oversold position. In short, market could be setting ourselves up for a period of strong performance in the second half of the year.

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