First State Investments

First State Asian Quality Bond

Monthly Review and Outlook
September 2018

Market Review

In a rather eventful month during which we saw numerous rate hikes across the globe as well as rising tension in the trade war between the US and China, credit spreads actually tightened for both investment grade and high yield. Total return however was negative as market started pricing in more rate hikes by the Fed as economic momentum remains strong, leading to higher Treasury yields. JACI spread ended the month 8bps tighter at 253bps. This was more than offset by the move higher in US treasury yield which saw the 10 year yield increasing by 20 bps to 3.06%. As a result, JACI returned negative at -0.12% for the month, once again widening year to date loss to -1.41%. While spreads all moved tighter, we witnessed a divergence in investment grade and high yield total returns at -0.33% and 0.59% respectively. By country, spread returns were all positive with the most significant gains seen in Pakistan and Sri Lanka.

Following months of turmoil including sanctions imposed by US, sky rocketing inflation and a rapidly depreciating currency, Central Bank of Turkey (CBT) finally acted by raising its key one week repo rate by 625bps to 24%. This move was well above market's expectation and more importantly, it went against President Erdogan's aversion towards conventional monetary policies. Market cheered the CBT's ability to remain independent, sending the lira stronger by 7% for the month. This strong move in the lira coupled with stability in the renminbi alleviated some of concerns surrounding emerging markets FX, bringing about a turnaround in sentiments towards risky assets in general. There were also several central banks meetings held in Asia during the month. Bangko Sentral ng Pilipinas (BSP) raised its overnight reverse repurchase policy rate by 50bps to 4.50% amid rising inflation and an overheating economy. Bank Indonesia (BI) hiked its 7-day reverse repo policy rate by 25bps to 5.75% in a bid to stabilize the rupiah even though they do not have an inflation problem. Meanwhile, Bank of Thailand and Bank Negara Malaysia also met but both chose to keep policy rate unchanged.

Trade wars between China and the US continued to escalate during the month. Despite the US expressing interest to resume trade talk on the 12th of Sep, they proceeded to announce the first tranche of USD200b worth of tariffs effective 24th Sep just five days later. Upon China's retaliation the following day, Trump threatened to expand the tariffs to USD 267b. Notwithstanding the ongoing trade war, US economy continues to do well. Manufacturing sector stays strong while unemployment rate continues to fall, with more than 200,000 new jobs being added in August. Against this backdrop, the US Fed increased policy rate as widely expected by 25bps and will likely continue hiking at the current pace should the US economy maintain the current growth momentum.

There were a total of USD 17.2b gross USD supply in September, up from the USD 14.1b in August. Despite this increase, year to date supply is still running at 28% lower than the same period last year. Some notable deals included Sinopec USD 2.4b issuance across 5, 7, 10 and 30 year tranches and Republic of Korea's USD1b issue across 10 and 30 year. Both deals were well received by investors.

Performance Review

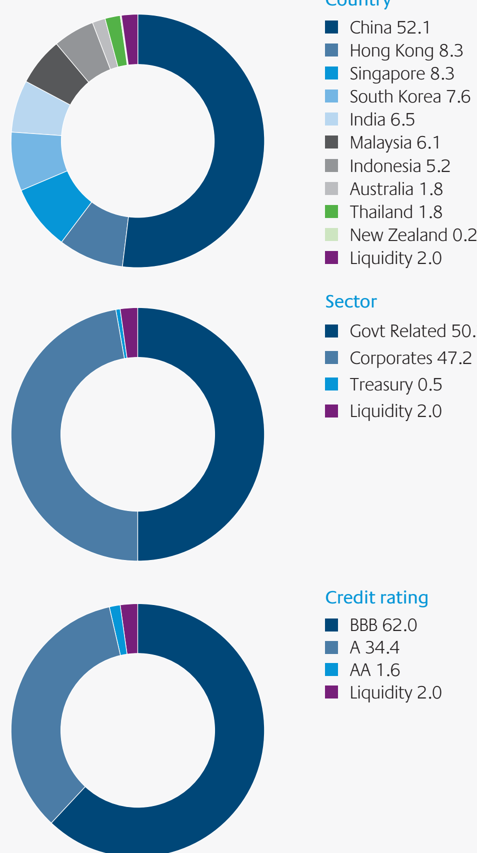
The First State Asian Quality Bond returned -0.69% for the month of September on a net of fees SGD term. The negative return was largely attributed to rise in US treasury despite credit spreads tightening. On a relative to benchmark basis, our overweight in US duration detracted value as economic data and inflation expectation in the US continue to surprise on the upside. Our securities selection also detracted value as we are overweight in several credits which did not perform as well as the broad market.

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. In Q3, we gave up a big part of the outperformance as our long duration position detracted value amid rising US treasury yields. Our overweight in selected issuers also lagged the broad market.

	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-2.6	N/A	N/A	-0.7
Fund (Inc initial charges)	-6.5	N/A	N/A	-2.8
Benchmark*	-1.4	N/A	N/A	0.3

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	0.1	-2.6	N/A	N/A	-1.3
Fund (Inc initial charges)	-4.0	-6.5	N/A	N/A	-5.3
Benchmark*	0.6	-1.4	N/A	N/A	0.6

Asset Allocation (%) [2]



Top 10 Issuers (%) [2]

Issuer Name	%
United Overseas Bank Ltd	4.6
Hyundai Motor Co	4.3
China National Chemical Corp	4.2
China Huarong	3.5
China Overseas Land & Investment Ltd	3.3
China Vanke Co Ltd	3.3
Sinochem Hong Kong (Group) Co Ltd	3.2
Nan Fung International Holdings Ltd	3.2
Pertamina Persero PT	3.1
Ping An Insurance Group Co of China Ltd	3.1

Portfolio Positioning

Throughout the month, we maintained our modest overweight positioning in both IG and HY. We also kept our moderate long position in US interest rate duration as we do not think the current trend of rising inflation and thus rising yield is sustainable amid the ongoing trade war and a fiscal stimulus that is expected to wane as we move into 2019. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting Philippines sovereign on tight valuations. We are also underweight in Indonesia as sentiments around emerging market is expected to remain tentative at best. 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

As we move into the last lap of a tumultuous year, plenty of uncertainties remain. Concerns around trade war between China and the US and a faster pace of Fed rate hike have been on the mind of investors for the whole of the 3rd quarter and that looks set to persist. Development around BREXIT and Italy's debt crisis will also start to get more scrutiny. While all these events have the potential to bring about more volatility, it is the rising oil price that we are more concerned about given its direct implication on inflation expectations and hence bond prices.

Since the US re-imposed economic sanctions on Iran on the 6 August, oil price rallied to the highest level in 4 years as Iranian shipment dropped sharply. A drop in oil production in Venezuela due to its ongoing economic crisis exacerbated the move higher in oil price. While OPEC members are increasing output to help alleviate the situation, the risk is that they fall short especially if demand remains strong or increases, which could easily bring oil price towards $100. If history is of any guide, such rapid increase will without doubt bring about severe stress to financial markets and market emerging markets economies. In fact we would attribute the current move higher in US treasury yields to the higher oil price instead of solely due to a faster pace of rate hikes by the US Fed in 2019. The silver lining is that supply shocks such as this one tend to be short-lived when compared to a demand driven price increase.

While US growth has been strong for the past few quarters, it was mainly due to the effects of the corporate tax cuts and investment tax incentives both of which are expected to wane as we move into 2019. If the November mid-term election lead to Democratic Party control of the House of Representatives, further fiscal plans will be even harder to negotiate and approve. The normalization of interest rate will also start to slow down the economy as financing costs rise and hence we are not convinced the Fed can continue to deliver rate hikes after the first half of 2019. The risk to our sanguine US interest rate outlook is none other than tariffs or sanctions led inflation. If the trade war escalates further leading to sharply higher imported prices, market will be forced to reassess the currently still benign inflation expectations.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 September 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 30 September 2018.

Outside of the US things do not look so rosy. Rising oil price has already started putting pressure on countries like India, which imports more than 80% of its crude oil needs. Rising US interest rates have also put pressure on the currencies of countries running current account deficits which include India, Indonesia and the Philippines in a similar fashion as the 2013 taper tantrums. This is despite the current account deficits in the above mentioned countries still well below 3%, while in 2013, the figures were closer to 4-5% range. While we still expect many central banks in Asia to intervene when their currency volatility heightens, we know by now that may not be enough to stem the decline. This is especially so when foreign ownership of local assets is high, as is the case for Indonesia. While this is not our base case, more aggressive rate hikes by the US Fed does not bode well for emerging markets economies and Asia will not be spared. Against this backdrop, we are maintaining a cautious stance on Asian currencies at least until signs the Fed will slow up on its interest rate normalization process.

What does the uncertain outlook mean for the Asian credit market? As the US Fed continues to normalize interest rate, financing conditions globally will continue to tighten as it did in the past few quarters. Moreover, the ongoing trade war between the US and China will slow down global growth and dampen investors' confidence. While it is difficult to predict how the trade war will pan out or whether the Fed will hike interest rates more aggressively, focusing on Asian corporates' fundamentals does provide some optimism that many will be able to weather the storm. Across the investment grade universe, key measures such as EBITDA and net income margins have improved over the last three years. Debt ratios have also come off while liquidity remains ample with the average cash level at more than 30% of total debt. In the high yield space, the above mentioned metrics have also started to improve since 2017, following several years of deterioration. Hence barring a complete meltdown on the trade war front and Asian currency depreciation spiraling out of control, Asia as a region is still expected to grow at a decent rate that is well above its peers. This will likely provide strong support for the improving credit trends and translate into positive rating actions.

The rally in credit we anticipated in our Q2 outlook did materialized. JACI IG spread as at end of 3rd quarter was about 10bps tighter than the wide this year. While it is still around 30bps tighter than the post crisis average, the all in yield is now at a post crisis high following the recent run up in treasury yield. This should increase demand for Asian bonds amongst the long term investors and lifers. Asian IG bonds also offer a yield pickup of up to 50bps vs US peers, further supporting its attractiveness. Asian high yield spread has also tightened in Q3 by approximately 50bps from an oversold territory. While the spread pickup vs US HY has increased, bringing it closer to historical average, we are mindful of the idiosyncratic risks that is omnipresent amid the tightening of financial conditions. Spike in oil price will also likely bring about another bout of volatility. Despite expectations of a pickup in supply post China's Golden week in October, we do think deal size and pricing will be favorable for investors against the current backdrop of an uncertain economic outlook. Hence we believe total supply for the year will come in lower than previous year's level, providing market with a balanced technical backdrop.

Uncertainty remains, caution warranted. Stick to quality and fundamentals is still the way to ride through any storms. We would look to add more US treasuries is sell-off continues, be selective and hold a diversified portfolio of credits with strong fundamentals and avoid local currency bonds as we expect more volatility ahead.

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