First State Asian Quality Bond

Monthly Review and Outlook

November 2018

Market Review

The bearish sentiments from the previous month extended into November as Asian credit spreads continued to widen with the sell-off most pronounced in Chinese high yield properties and Indonesian high yield corporates. However, this weakness was more than offset by the strong rally in US treasuries amid a collapse in oil price as well as perceived dovishness from the US Fed, following Chairman Powell's comment that Fed fund rate is now just below the neutral range.

JACI spreads ended the month 12 bps wider at +285 bps while 10 year US treasury yield rallied 16bps to end the month at 2.99%, resulting in a positive total return of 0.45%. This narrowed year to date loss to just above -2%. While spread returns are both negative, investment grade outperform high yield on both a spread and total return basis. By country, spread returns were mostly negative with the largest losses seen in frontier markets including Pakistan, Mongolia and Sri Lanka.

The 2018 US midterm elections took place during the early part of the month and the outcome was a split Congress, with Democrats taking control of the House and Republicans gaining a few seats in the Senate to increase their majority. The results were largely in line with expectations much to the relief of market participants amid the current fragile sentiment. Meanwhile the November FOMC meeting was a non-event as the Fed kept policy rate unchanged and only made slight tweaks to the statement, noting moderating capex from a rapid pace earlier in the year and still strong consumption. Subsequently, all eyes were turned to the G20 Summit, slated to take place on the 30th November -1 December, during which Trump and Xi will discuss on the trade conflicts between the US and China.

There were numerous central bank meetings in Asia during the month which yielded different outcomes. South Korea, Indonesia and Philippines all hiked rates as they continue to normalise monetary policies, while Malaysia and Thailand kept policy rate unchanged, amid heightened uncertainty over growth outlook. With the exception of Philippines, there are clear signs that growth in the above mentioned Asian economies has been moderating, albeit maintaining above decent levels. Inflation also remains largely benign which suggest that central banks will be under less pressure to hike rates in the months ahead.

Despite the cautious tone, new issuance market remains vibrant. Following the recent PT Perusahaan Listrik Negara and PT Pertamina issues, the relentless issuance from Indonesia continues with PT Indonesia Asahan Aluminium USD4bn multi-tranche deal. Amid strong investors demand, final pricing was an average of 50bps price tighter from initial price guidance across the 4 tenors. Despite the aggressive tightening, bonds performed well in the secondary market. Total supply in November amounted to USD22.1b, up from USD15.8b in October. Nevertheless, year to date supply still lag the same period last year by 29%.

Performance Review

The First State Asian Quality Bond returned 0.15% for the month of November on a net of fees SGD term.

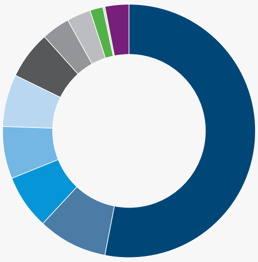
The positive return was largely attributed to the strong rally in US treasury despite credit spreads being under pressure throughout the month. On a relative to benchmark basis, our overweight in US duration added value as Fed Chairman Powell's comment that policy rate is now just below the neutral range led to market pricing out further rate hikes in 2019. Our securities selection however, continued to detract value as our overweight positions showed further weakness during the month.

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 during the second half of the year.

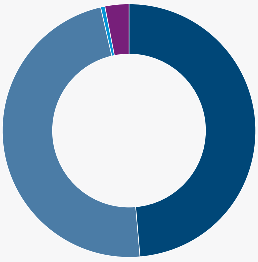
	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-3.6	N/A	N/A	-1.0
Fund (Inc initial charges)	-7.5	N/A	N/A	-3.0
Benchmark*	-1.9	N/A	N/A	0.1

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.5	-3.6	N/A	N/A	-2.1
Fund (Inc initial charges)	-5.5	-7.5	N/A	N/A	-6.1
Benchmark*	-0.7	-1.9	N/A	N/A	0.2

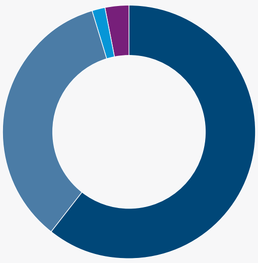
Asset Allocation (%) [2]



Country
- China 53.2
- Hong Kong 8.9
- South Korea 7.0
- Singapore 6.7
- Malaysia 6.5
- India 6.1
- Indonesia 3.8
- Thailand 2.8
- Australia 1.8
- New Zealand 0.2
- Liquidity 3.0



Sector
- Corporates 48.8
- Govt Related 47.6
- Treasury 0.5
- Liquidity 3.0



Credit rating
- BBB 60.6
- A 34.8
- AA 1.6
- Liquidity 3.0

Top 10 Issuers (%) [2]

Issuer Name	%
United Overseas Bank Ltd	4.5
China Vanke Co Ltd	4.5
Hyundai Motor Co	4.3
Nan Fung International Holdings Ltd	3.8
China Huarong	3.7
China Overseas Land & Investment Ltd	3.3
Sinochem Hong Kong (Group) Co Ltd	3.2
Ping An Insurance Group Co of China Ltd	3.1
Industrial and Commercial Bank of China Ltd	2.9
Pertamina Persero PT	2.9

Portfolio Positioning

There were no change in our strategy during the month. We maintained our overweight positioning in both IG and HY as valuation has become more attractive following months of spread widening. 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 normalisation 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

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

prices, market will be forced to reassess the currently still benign inflation expectations.

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 normalisation process.

What does the uncertain outlook mean for the Asian credit market? As the US Fed continues to normalise 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 materialised. 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.