First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

July 2019

Market Review

The lower for longer theme continues to dominate market sentiments in July as investors debated whether the Fed should cut by 25bps or 50bps when they meet at the end of the month. New issuance market remained strong though most deals are priced without much premium for investors. JACI spreads ended the month 4bps tighter, while 10 year US treasury yield was unchanged at 2.01%. Total return came in at 0.58% bringing year to date performance to 8.67%. Spread returns by country were mostly positive, led by Vietnam, Pakistan and Sri Lanka even though performance was more muted when compared to June. Asian credit market also reached a notable milestone with the JACI index market capitalization surpassing the USD 1 trillion mark on 31 July 2019 following exponential growth in issuance over the past 5 years.

Asian USD bond issuance remained robust in July with a total of USD 29.2b being issued. This brought year to date issuance to USD 184b, an 83% year-over-year increase. The largest deals during the month came from Indonesia. Perusahaan Listrik Negara priced a dual tranche USD 1.4b jumbo deal across 10 year and 30 year tranches at 3.95% and 4.95%. Meanwhile, PT Pertamina priced USD 1.5b of 10 year and 30 year bonds at 3.65% and 4.7% yield. Both bonds drew strong investor demand despite priced tightly especially Pertamina; a strong reflection of the strength of the market.

At its July meeting held on the 31st, the FOMC voted to cut the federal funds rate target range by 25bps, to 2.00%-2.25%. It was not a consensual decision as Esther George and Eric Rosengren dissented. While Chairman Powell also announced an early end to the balance sheet unwind, he disappointed the market by saying this cut should not be construed as the start of a rate cut cycle and subsequent decision will be data driven.

Another notable event for the month came from the UK, where markets increasingly factored in the prospect of a disorderly withdrawal from the European Union. Boris Johnson won the Conservative Party leadership contest and was sworn in as the new Prime Minister. Johnson has talked openly about his willingness to pursue a ‘no deal’ Brexit in October if terms cannot be agreed with European officials.

Performance Review

The First State Asian Quality Bond returned 0.33% for the month of July on a net of fees SGD term.

The positive return was largely attributed to continued spread tightening underpinned by the lower for longer theme.

On a relative basis, the fund underperformed the index in July largely due to our underweight in Indonesia and Philippines both of which continued to rally just like they did in June.

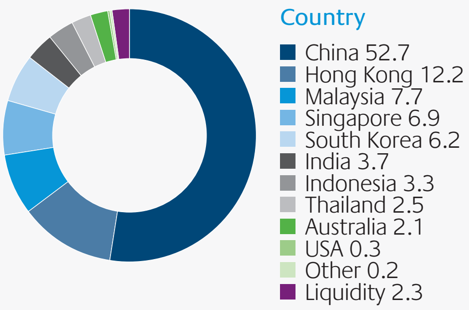
On a year to date basis, our overweight in credit along with security selection both added value especially during the January to April period. Our overweight in US interest rate duration which we held since the start of the year also contributed positively to our excess return. Our underweight in both Indonesia and Philippines detracted value.

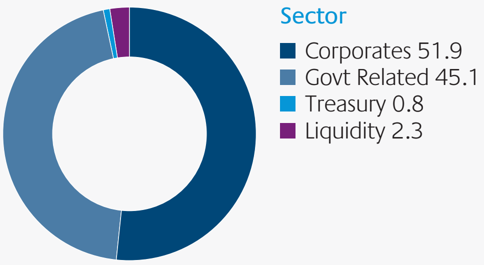
	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	7.2	N/A	N/A	2.2
Class A (SGD - Q Dist) (Inc initial charges)	2.9	N/A	N/A	0.7
Benchmark*	9.0	N/A	N/A	3.3

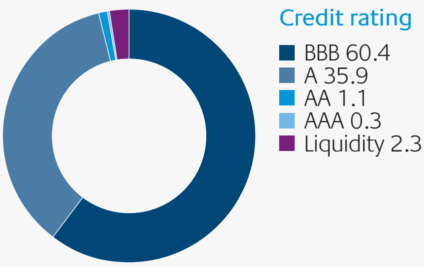
	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	2.9	7.2	N/A	N/A	6.3
Class A (SGD - Q Dist) (Inc initial charges)	-1.2	2.9	N/A	N/A	2.0
Benchmark*	3.4	9.0	N/A	N/A	9.4

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 July 2019. The First State Asian Quality Bond inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

Asset Allocation (%) [1]







Top 10 Issuers (%) [1]

Issuer Name	%
China Huarong	4.8
Genting Berhad	4.2
Bank of Communications Co Ltd	4.0
United Overseas Bank Ltd	3.9
Sinochem Hong Kong (Group) Co Ltd	3.8
Hyundai Motor Co	3.7
Industrial and Commercial Bank of China Ltd	3.6
Nan Fung International Holdings Ltd	3.5
China Construction Bank Corp	3.0
China Overseas Land & Investment Ltd	2.9

Portfolio Positioning

Despite the lower for longer euphoria, we remained cautious in the credit market holding on to our neutral to modest long credit spread duration positioning. We maintained our limit long strategy for US interest rate duration as our view on global economic growth outlook remains bearish. Powell's signaling Fed's willingness to cut policy rate further underpins our conviction that US interest rates will head even lower. By country, we remained underweight in Philippines sovereign on tight valuations. We do not like India banks and corporates as valuation does not reflect the fast weakening fundamentals. We are also underweight in Indonesia as we believe all the good news have been priced in following the spectacular year to date performance in Indonesian spreads. Within China, we are overweight Investment grade property, Banks' leasing companies and Asset Management companies while underweighting core SOEs, banks and LGFVs (local government financing vehicles).

Investment Outlook

Financial markets entered the second half of the year on a sanguine beat following the resumption of trade talks between the US and China, coupled with dovish rhetoric from both the Fed and the ECB. The search for yield in the bond market will likely persist for a while as the lower for longer theme re-emerges following a period of monetary tightening. However, if we look beyond the positive technical backdrop, there is hardly anything to cheer about when it comes to fundamentals as global growth outlook continues to deteriorate. With fixed income markets delivering extraordinary returns year to date; many of which have exceeded double digits by the half year mark, it pays to be cautious as we navigate the murky path for the rest of the year.

When we started the year, market was pricing in two Fed rate hikes for 2019. That expectation has now become two rate cuts between now and the end of the year. While the debate will continue on whether the US goes into a recession and by how much the Fed should cut rates, the trend towards slower growth has become more apparent since the last quarter. We would also reiterate our skepticism towards the effectiveness of the Fed and ECB's ultra-easy monetary policies following a decade long of reckless money printing. We further question the ability of these major central banks to cope with the next crisis as it now has limited options in their toolkit with interest rates so low and monetary conditions already very easy.

While many are relieved that trade talks between the US and China has resumed, we are of the opinion that the damage is already done. Business confidence has taken a hit and that will take time to recover. The disruption to supply chain in the technology sector is highly worrisome and the impact is somehow underestimated by many. Even if the trade war is to stop, the technology war between the US and China looks set to continue as both strive for world dominance. Against the backdrop of slower growth, a lack of inflation and rate cuts from the Fed, we remain very bullish on US treasuries especially when compared to the meagre yields in other developed markets.

Global growth outlook seems to have turned for the worse. Amongst the world's 16 largest economies, 11 now have a PMI reading of under 50, the largest number since April 2011. With the slowdown in exports, countries such as South Korea and Singapore have both lowered growth forecasts. Even economies with a strong domestic story which include Indonesia and Philippines are facing slower growth too. Just like the developed economies, inflation across Asia remains very benign. For instance Indonesia and India, economies that were used to inflation in the 5-6% range are now printing at half or less of that range. This gives Asian central banks the flexibility to cut rates if they need to. In fact Malaysia, India and Philippines have already done so, with South Korea and Indonesia likely to follow suit in the coming months. China has been bearing the brunt of the trade war and inevitably monetary and government policies will continue to ease in order to support growth. At this point, we are of the opinion that fiscal policies will remain targeted as there are still traces of the excesses from the mammoth stimulus rolled out during the last global financial crisis. While China has the levers to prop up their economy and prevent a collapse, we do not share the same hype as other market participants as the quality of growth will be poor. Furthermore, many issues that China is facing right now are mostly external and are beyond their control.

Credit markets have entered into a “buy first, worry later” mode amid the lower for longer theme. However, we believe such reckless behavior will be punished once investors realize whatever the central banks do may not be enough to prevent the next downturn. Following the strong rally this year, risk premium is way too low to compensate for the heightened uncertainty of trade war, technology war and the imminent slower global growth. A key risk for credit market we would like to highlight is that US corporates have accumulated significant amount of debt in the past decade, taking advantage of the low interest rate environment. Total non-financial corporate debt to GDP ratio has now risen to the highest level by record. The multi-fold expansion of the BBB segment of US investment grade bonds makes it very vulnerable should slower growth in the US eventually lead to a slew ratings downgrade in this segment. Any downgrade related forced selling will inevitably put pressure on Asian credit spreads despite our stronger fundamentals.

At the end of June, JACI spread has tightened by almost 30bps year to date despite rising uncertainty and weakening fundamentals. At the same time, 10 year US treasury yield has declined by almost 70bps as market swung from pricing in rate hike to now rate cuts. Total return at above 8% for the JACI is now approaching two times that of the five year index average return. While we are still confident that US treasury will continue its rally thereby boosting total return, we are less certain of the trajectory of credit spreads should a US or global recession materialize. The risk reward certainly does not warrant moving down the credit curve notwithstanding the near term technical backdrop which remains very strong. Against this backdrop, stay with quality and look before you leap!