First State Investments
首域投資

Asian Quality Bond

Monthly Review and Outlook
March 2017

- First State Asian Quality Bond Fund invests in debt securities of issuers organised, headquartered or having their primary business operations in Asia.
- The Fund invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. The Fund may invest in below investment grade and unrated debt securities. This exposes the Fund to greater liquidity risk, default risk and price changes due to change in the issuer's creditworthiness. The Fund invests in fixed income securities which may be impacted by movement in interest rates. It is possible that the entire value of your investment could be lost.
- For the monthly distributing Shares Class, any fees and expenses relating to this Share Class may be paid out of capital resulting in an increase in distributable income. At times the dividend may be paid out of capital. This amounts to a partial return of an investor's original investment, or from any capital gains attributable to that original investment, and may result in an immediate decrease of the Net Asset Value per share.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

Market commentary

Asian credit market eked out a positive performance during a month that saw credit spreads trading on a firm tone while US treasuries were almost unchanged despite exhibiting some volatility intra-month. The 2nd rate hike by the US Federal Reserve (the Fed) within 3 months accompanied by a relative dovish statement was a huge relief for the market, while many post-election Trump trades continued to fade after the House Republicans failed to garner enough votes to repeal Obamacare. JACI returned a positive 0.23% as spreads tightened by 2bps to end the month at 221bps while US treasuries were largely unchanged despite the 10 year trading back and forth the bounds of the recent 2.3-2.65% range. Both investment grade and high yield performed well with the latter outperforming (0.39% vs 0.19%) yet again, which has been a trend for the past few quarters. Spread returns were largely positive across all markets except in Malaysia, following withdrawals of ratings on 1MDB bonds by S&P. Top performers by country were Indonesia and Mongolia.

After a very slow start to its monetary policy normalization process, with only one rate hike in both 2015 and 2016, the Fed entered a new and more active phase for monetary policy. Through the combination of good economic data and rising inflation, the Fed raised the Fed Fund target rate by a further 25bp to a new 0.75%-1.0% range. However, the Fed statement was little changed from recent months, with no change to the Fed's own expectations for the future path of monetary policy, i.e. the 'dots' for 2017 remained at three rate hikes in total, i.e. two more to come this year.

On 27th March, S&P withdrew its ratings on the two outstanding scandal stricken 1MDB bonds. This follows Moody's action to withdraw their ratings on the bonds back in June 2016. S&P cited the termination of the ratings engagement contract as the reason for the withdrawal of rating, while Moody's previously cited business reasons. Despite being laden with scandals, S&P treated the wording of the letter of support for the bonds akin to a guarantee by the Malaysia sovereign. Nevertheless, the removal of the ratings led to significant spread widening as this means investors who requires a rating for their bond holdings will not be able to participate in these bonds and may even be forced sellers.

Despite anxiety around the Fed rate hike, we witnessed yet another robust month of issuance with total supply coming in at USD34.5b. Bank senior papers accounted for USD12.8b of supply and we also saw high yield corporates making a long awaited return to the market. By country, the leaders were China (65%), Indonesia (11%) and Hong Kong (10%). There were yet again several mega issuance including China Cinda USD3b, Indonesia sovereign sukuk USD3b and ZheShang Bank USD2.2b. The strong and steady issuance since the start of the year brought year to date supply to 38% above that for the same period in 2016.

Performance

The First State Asian Quality Bond Fund returned 0.37% net of fees for the month of March.[1]

Portfolio positioning

During the month, we maintained our short US duration strategy as we have concerns over a potential overshooting in market's positioning for an inflationary environment amidst Donald Trump's expansionary fiscal policies, though we are of the view that it would take time for these policies to change the US economy structurally and bring inflation to higher levels. We kept our neutral positioning on credit spreads as valuation remained tight amid heightened uncertainty in both the political and global growth outlook, though we were fairly active in the participation of some primary issues. We stayed defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting

[1] Source: First State Investments as at March in USD. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc).
The Fund's calendar year performance: 3.4% (2016); 0.9% (2015); 6.8% (2014); -3.0% (2013); 9.1% (2012).

Indonesia and Philippines sovereign. Within China, we are overweight investment grade property and technology while underweighting the banks and LGFVs (Local government financing vehicles). We are underweight India banks on tight valuations offset by an overweight in Corporates. We maintained around 5% exposure to local currency bonds which have performed well since the start of the year.

Investment outlook

As we move into Q2, the uncertainty clouding financial markets looks set to further heighten. We have the French and German elections coming up, BREXIT negotiations has been triggered and now we are faced with increased possibility of a second Scottish referendum. Yellen has just hiked twice in the space of 3 months though remaining dovish, while much attention will once again be on whether Trump can make any progress on his proposed tax cuts and fiscal stimulus. Fiscal stimulus from the US if implemented on a large scale could provide immediate boost to both consumers' and markets' confidence, which is good for risky assets. However, if this leads to higher inflation and more US treasuries issuance, bond market might come under further pressure. This will likely remain the underlying theme driving fixed income markets in the coming quarter, though unexpected events like a Le Pen victory in the French election or weaker than expected economic data might push yields lower.

While short term outlook for fixed income looks challenging, we are still mired in a long term sluggish global growth environment amidst low productivity and deteriorating demographics in both the US and other developed economies, all of which are structural in nature. This means that interest rates globally is likely to remain much lower when compared to historical levels even if policy rates in the US is to normalise further. What is encouraging for risky assets is that China looks to be doing a good job in maneuvering its growth lower without causing much disruption to its economy. During the recent National Party Congress, the Chinese leaders set growth target at 6.5%, which is still a robust number despite being lower than what we were used to. A China growing slower but on a firmer footing would certainly bode well for Asian economies. While positioning for USD strength and higher US rates can be fickle, European Central Bank and Bank of Japan staying accommodative means that the global search for yield will likely continue. Asian credit market has been resilient, surviving the past few risk driven events including Brexit and Trump relatively unscathed. While valuation appears rich and has been getting richer since the start of the year, demand and supply technical backdrop has been extremely strong which means any sell-off will likely be brief.

Economic growth in the US has been stable in the past few quarters underpinned by a turnaround in business investment spending as commodity prices continue to recover. Meanwhile, wealth effect arising from a significant increase in home and equity market has not quite translate into robust consumer spending, which has been stable at best. Nevertheless, with the Fed having achieved its dual mandate of low unemployment of below 5% and inflation of close to 2%, the Fed is likely to continue normalising interest rate and potentially lighten up its balance sheet before Yellen's tenure as chairman ends. Growth trajectory for 2017-18 will hinge heavily on how much Trump delivers on his proposed tax cuts, effectiveness of his fiscal stimulus and the type of deregulations he rolls out. While responses to Trump's policies have been upbeat and is likely to boost inflation expectations, it is too early to assess whether these will have a longer term structural impact on the US economy, which still faces issues of poor demographics and slow productivity growth.

Despite the Eurozone exhibiting some strong growth momentum with PMI consistently surprising on the upside, we aren't ready to get excited about a region that will grow only in the range of 1-1.5%. Headline inflation has risen to 2% largely due to higher energy prices though core inflation at below 1% is unlikely to give the ECB much comfort in removing their easy monetary policies too quickly. Political uncertainty will continue being the focus now than UK has activated Article 50 and set off a 2 year negotiation process. Should the UK economy performs well in the years ahead, it might trigger thoughts by other EU nations to leave as well. In the near term, we have to contend with the French election in May and the German election in September, both of which have potential to bring about market volatility should we get any unexpected outcome. Instability or a breakup of the Eurozone is likely to have more severe repercussion when compared to BREXIT or Trump.

Against all odds, we witnessed a strong uptick in Asian exports and improving PMIs in recent months, alleviating much of the concerns that growth in this region will suffer as protectionism truly takes hold. This uptick coincides with a strong recovery of commodities prices possibly driven by an increase in demand from China amid a property market boom and an increase in infrastructure spending. While the improvement in exports is encouraging, we remain cautious as this comes on the back of a low base and demand from the West hasn't really recovered as much as we would have liked. In the coming months, China is likely to continue curbing the rise of property prices especially those in tier one cities and at the same limit the excessive expansion in credit. As an offset, it is likely to selectively spend on infrastructure and step up activities across the region through the One Belt, One Road program. Inflation across Asia is likely to stay benign, giving central banks the flexibility to cut rates should they need to. Nevertheless, with the US Fed promising to deliver another 2-3 hikes this year, we would expect most central banks in this region to adopt a wait and see stance.

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