First State Investments
首域投資

First State Asian Quality Bond Fund

Monthly Review and Outlook

January 2019

- The Fund invests primarily in debt securities of governments and corporate issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

Market Review

Asian credit market got off to a flying start for the year rebounding strongly from an oversold position. Sentiments throughout the month were boosted by positive development in the trade discussion between US and China, along with China's commitment to prop up its slowing economy. The US Fed turning significantly dovish towards the end of the month further buoyed the already exuberant market, a far cry from the gloom and doom in the second half of 2018. For the month, JACI spreads tightened by 20bps to 271, while 10 year US treasury also rallied by around 5 bps to 2.63%. As a result, the JACI delivered a strong gain of 1.98% for the month. High yield outperformed investment grade with returns of 3.42% and 1.60% respectively. By country, all spread returns were positive with Pakistan, Sri Lanka and Indonesia coming in as the top performers.

On the 24th January, People's Bank of China (PBOC) announced the launch of a bill swap program to help improve liquidity of perpetual bonds issued by banks. This program will allow primary dealers to exchange qualified perpetual bonds they hold for PBOC bills, which qualify as collateral for PBOC's open market operation. Concurrently, China Banking and Insurance Regulatory Commission CBIRC relaxed the restriction to allow insurance companies to invest in perpetual bonds. These moves effectively lower the funding costs of banks' capital instruments, at a time when many need to issue significant amount of total loss absorbing capacity instruments in order to comply with Basel III requirements. These announcements led to a strong rally in the AT1s, which had a positively spillover effect on the rest of the market as investors believe the Chinese government will stay committed in supporting the economy.

In the first meeting of 2019, the US Fed turned significantly dovish by saying they are now "patient" and no longer have a strong bias on whether the next rate move will be up or down. An update on the balance sheet normalisation also suggested that the Fed is moving closer to an early end to balance sheet rundown. The dovish outcome from the meeting led to an immediate bout of dollar weakness, while equity and credit markets rallied strongly.

Primary issuance was highly active throughout the month with total supply coming in at USD 24.4b. While China continued to dominate accounting for 42% of total issuance, we witnessed a better diversification across nine different countries.

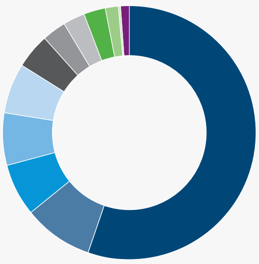
Performance Review

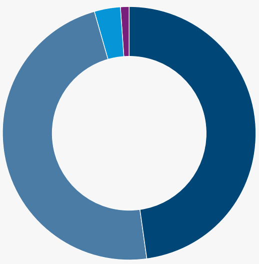
The First State Asian Quality Bond Fund returned 1.68% for the month of January on a net of fees basis. The positive return was largely attributed to the strong rally in credits which recovered from an oversold position and a move to lower yields in US treasury following the dovish Fed rhetoric.

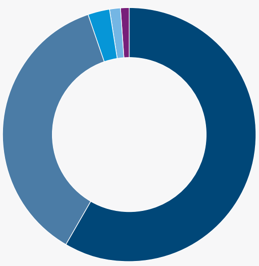
	Cumulative Performance in USD (%) [1]					
	3 mths	YTD	1yr	3yrs	5yrs	Since inception
Class I (USD - Acc)	3.3	1.7	0.8	8.8	17.5	66.2
Benchmark*	3.5	1.6	2.3	10.4	23.4	112.9

	Calendar Year Performance in USD (%) [1]				
	2018	2017	2016	2015	2014
Class I (USD - Acc)	-1.3	5.6	3.4	0.9	6.8
Benchmark*	0.0	5.5	4.5	2.2	9.0

Asset Allocation (%) [1]







Top 10 Issuers (%) [1]

Issuer Name	%
China Huarong	5.8
Bank of Communications Co Ltd	4.6
United Overseas Bank Ltd	4.4
Hyundai Motor Co	4.2
China Vanke Co Ltd	4.0
Nan Fung International Holdings Ltd	3.9
China Overseas Land & Investment Ltd	3.2
Sinochem Hong Kong (Group) Co Ltd	3.2
Ping An Insurance Group Co of China Ltd	3.1
Pertamina Persero PT	3.0

Portfolio Positioning

During the month, we maintained our overweight positioning in IG. We also kept our moderate long position in US interest rate duration as signs of economic slowdown became more apparent in recent months amid the ongoing trade war and a waning fiscal stimulus. 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 we remained concerned about the spillover effects on sentiments coming from the weakening fundamentals of several emerging markets countries. The upcoming election in April will also likely bring about bouts of volatility in Indonesian sovereign and quasi bonds. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We reduced our exposure in India mainly in Power Finance and REC amid the uncertainty and a potential ratings downgrade upon the completion of the deal. We maintained our underweight India banks amid rising NPLs.

Investment Outlook

As we begin the New Year in 2019, worries that have hampered market sentiment look set to persist or even intensify. Consensus is suggesting growth in the US will slow, as effects of fiscal stimulus wane. It is also widely inferred that the inverting yield curve always precede a recession. On top of that, many believe after close to 10 years of economic expansion, the probability of the US economy slowing has increased significantly. With Europe and Japan already slowing significantly in the past few months and the rest of the world starting to feel the pain of the ongoing trade war between the US and China, it is indeed hard for one to be optimistic in the current environment.

The US economy has been leading global growth for a large part of 2018, more notably in the second half of the year. Hence how the economy performs in 2019 and the subsequent impact on the Fed's rate hike trajectory will come under even more scrutiny as it will have a material impact on asset prices for Q1 2019. Many forecasts by economists and even those by the US Fed are pointing to slower growth ahead. Key reasons include the waning of fiscal stimulus, an economy that is already at full employment and the lagged impact of previous rate hikes. Recent trade data also suggests that US exports to China has

[1] Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 January 2019. Fund since inception date: 14 July 2003. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc) is the non-dividend distributing class of the fund. *The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.

been declining sharply, as a result of the tariffs imposed by China, providing a further drag on growth. While it is hard to argue against the above reasons and in fact we do think the US economy will eventually slow, we feel the market is a tad too early and too pessimistic in pricing in a recession and pricing out further rate hikes. This is because we believe being in the late cycle of a decade long economic expansion does not necessarily means growth will screech to an abrupt halt. Following the 4th rate hike in 2018, the Fed turned dovish as they are now more cautious of the global growth outlook even though they believe US economy remains strong. They now see only 2 hikes for 2019 which suggest one hike in March and another in June should the economic momentum continues. We agree with the Fed this time as projecting 2 hikes is appropriate at the moment as we expect to see slowdown to start looking more pronounced only in the second half of the year. We also expect the US treasury curve to fully flatten to around the 2.8% handle by the end of Q1. We currently see value in the short end 2-5 year part of the curve. While all attention has been on the trade war leading to an obvious slowdown in growth, we reiterate that a key risk market is not currently prepared for is a tariffs led inflation. If the US and China fail to come to a compromise at the end of the current 90 day trade truce, it could potentially lead to a breakdown in global supply chain and as a result, higher imported prices. This will force market to reassess their inflation expectations, which is currently very benign.

While market remains fixated on the development of the US-China trade war, cheering any reprieve in trade tensions between the two nations, we believe the ongoing spat between the number one and two economy will persist as the US will pull out all the stops to prevent or at least slow down the ascend of China. In other words, market volatility will remain heighten as asset prices continues to react to these political noise. Trade war will never be positive for anyone. That said, export data from recent months seem to suggest that China has coped much better than the US. This was largely attributed to China's nimbleness in diversifying its export markets away from the US, policy support for exporters in the form of export tax rebates, as well as a favorable exchange rate as the renminbi continues to weaken against the dollar. We expect China to continue pushing forward reforms despite a slowing economy and continue boosting liquidity as it has done in 2018. Amid slower growth and challenges arising from the trade war, we expect the Chinese government to increase the budget deficit to 3.0% of GDP in 2019 from 2.6% in 2018, providing policy support in targeted area, not the broad based stimulus many are hoping for. We also expect the People's Bank of China (PBoC) to continue cutting the reserve requirement ratio (RRR) by another 200bps next year to keep an easing bias in the monetary policy. In summary, we are positive that China still has plenty of levers to rebalance and prop up the economy to above the 6% handle despite the challenges they are facing at the moment.

Away from China, the rest of Asia ex Japan is still expecting to deliver a decent growth of well above 5%, albeit at a slower rate when compared to previous years. The more open and trade focused economies including Singapore, South Korea and Taiwan will be more vulnerable in the current environment especially if the trade tension between the US and China is to intensify. Thus growth rates in these economies are likely to surprise on the downside. Philippines stood out throughout the whole of 2018 delivering exceptional growth and this strong momentum is set to continue into 2019 as the government continues to roll over infrastructure projects. This strong growth came at a price as it brought about an inflation problem amid an overheating economy even though inflation looked to have peaked. Apart from the Philippines, inflation across Asia remains very benign. In 2018, many Asian central banks hiked policy rates for varied reasons. Bangko Sentral ng Pilipinas hiked to combat inflation, Bank Indonesia and Reserve Bank of India hiked to stem currency weakness, while Bank of Thailand and Bank of Korea hiked as part of the monetary policy normalisation process. While there could still one or two hikes left namely in Thailand and South Korea, we believe the tightening cycle in Asia is largely behind us. We expect central banks to be more reactive instead of preemptive in their next move. In fact we would not be surprised if some even cut rates should growth deteriorates sharply. Key events to look out for includes election in both Indonesia and India around April, which may bring about some volatility.

In 2018, focusing on credit fundamentals and relative value opportunities was key in delivering good performance as we begin to see divergence in spreads across sectors and issuers. We would expect this to be more important in the New Year as we are at the late part of the economic cycle. Across the investment grade universe, we continue to get comfort that 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. Earnings growth for Asian corporates as a whole is also expected to perform strongly in 2019 despite a slowdown in Korea, Taiwan and specifically the technology and telecommunication sectors. At the point of writing, the JACI IG spread at above 200bps is approximately 50bps wider than the recent tights. We view this level as fair, considering the strong credit fundamentals though the uncertain macro environment calls for caution. Within China, value is already emerging in the IG property space with spreads well above 200bps. Technology names including Tencent and Alibaba have also weakened to an attractive level though they are still vulnerable to headline news concerning US and China. We have turned cautious on Indian corporates amid the political uncertainty in the country. Indonesian sovereign and quasi's performance will very much be dependent on whether emerging market as an asset class bounce back from a dismay year of performance in 2018. The biggest risks for Asian IG at the moment would be a continued weakness in US IG, which has shown more pronounced weakness in the recent months, having held up very well for a big part of 2018. Any further weakness in US IG will inevitably have a spillover impact on Asian credits notwithstanding our stronger fundamentals. Nevertheless, further spread widening should provide investors with opportunities to accumulate exposures in high quality names at an attractive price. So be patient as we await opportunities in what we think would be a tumultuous year for risky assets.