First State Asian Quality Bond

Monthly Review and Outlook
March 2018

Market Review

March was a rather eventful month that kept markets on their toes throughout. News around US imposing trade tariffs on China, Trump's top economic advisor Gary Cohn's resignation and concerns over a hawkish FOMC were some of the noteworthy events that pushed credit spreads wider. From a total return perspective, Asian bonds finally got some reprieve, benefitting from the US treasuries' rally as market was concerned about the possibility of a full blown trade war leading to a slowdown in global economies. As a result, JACI ended the month unchanged, capping year to date loss at -1.37%. Spreads for both investment grade and high yield bonds widened by around 15 bps during the month but that was largely offset by gains in US treasuries as the 10 year rallied by 12 bps to end the month at 2.74%. By countries, spread returns were mostly negative with the largest losses seen in India, Indonesia and Pakistan.

The news that rattled the markets was Trump administration's decision to impose 25% duty on steel and 10% on aluminum. This led to a sharp sell-off which was especially pronounced in the steel related names including Tata Steel and JSW steel. Even though the economic impact up to this point is not likely to be too significant, markets were more concerned about this escalating into a full blown trade war between the US and China. Adding to the uncertain sentiments, Gary Cohn resigned from his position of National Economic Council director, apparently after failing to persuade Trump against the tariffs. Later in the month, the Federal Reserve raised US interest rates by 0.25%, which was widely expected and paved the way for more hikes should economic conditions continue to improve.

The National People's Congress of China was held during the month. Key takeaways included growth target at around 6.5% for 2018 which is the same as 2017 but with higher tolerance for slower growth. The party also aim to reduce fiscal deficit to 2.6% from 3% last year, the first reduction since President Xi took over leadership in 2012. Despite the willingness to accept lower growth and enforce fiscal discipline, the party remains committed to support the new economy, which includes big data, artificial intelligence and electric cars. It was also mentioned that China will open its manufacturing sector completely and further improve market access to its financial services industry.

The much troubled Noble group finally defaulted on its bond during the month. The coupon payment on its bond due March 2022 was missed. In addition, the company also missed the principal payment on its bond due March 2018. Though this is not unexpected, the default compounded on the bearish sentiment especially in the high yield space.

New issuance picked from the low in February reaching USD19.7b for the month of March. Year to date supply at the end of Q1 is 7% lower than the same period last year, not surprising as sentiments have been cautious since the start of the year. The highlight during the month was obviously the USD4.95 multi tranche issue by ChemChina which performed well. This was encouraging amid the tentative tone in the market. Issuance is expected to pick up significantly in April, typically a busy month during the year.

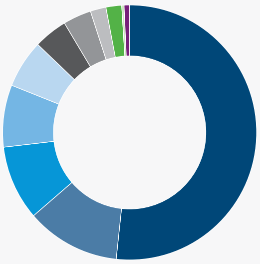
Performance Review

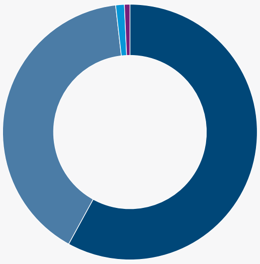
The First State Asian Quality Bond Fund's return was flat for the month of March on a net of fees basis [1]. Spread widening was offset by the rally in US treasuries, resulting in the flat return. On a relative basis, the fund underperformed slightly relative to the JACI IG index mainly due to our underweight at the 30 year part of the curve in both Indonesia and Philippines.

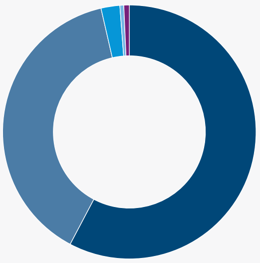
	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	-1.5	-0.1	-1.5	-1.2	0.1
Fund (Inc initial charges)	-5.5	-4.1	-5.5	-5.2	-3.9
Benchmark*	-1.6	0.2	-1.6	-1.4	0.6

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 March 2018. Fund since inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

Asset Allocation (%) [2]







Top 10 Issuers (%) [2]

Issuer Name	%
CNOOC Ltd	4.9
Hyundai Motor Co	4.5
China National Chemical Corp	4.4
China Huarong	4.3
Citic Ltd	3.8
China Overseas Land & Investment Ltd	3.7
China Petrochemical Corp	3.6
Sinochem Hong Kong (Group) Co Ltd	3.5
Pertamina Persero PT	3.4
United Overseas Bank Ltd	3.1

Portfolio Positioning

Following the spread widening since February in both investment grade and high yield bonds, valuations have become more attractive while demand for new issues remains strong. Against this backdrop, we moved our investment grade positioning from neutral to a moderate long. We maintained our interest rate duration positioning at neutral as we expect US interest rates to remain stuck in a range. Our local currency bonds positions were also largely unchanged at around 3-4% of our portfolios. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting the higher beta Indonesia and Philippines sovereign on tight valuations. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (local government financing vehicles). We are underweight India banks on tight valuations and have also recently reduced our exposure in Indian Corporates.

Investment Outlook

As we start the 2nd quarter on the back of a dismal Q1 fixed income performance, one can't help but feel nervous as the uncertain factors clouding the market do not look like dissipating anytime soon. While our optimism at the start of the year now looks misplaced, the positive trend of synchronised global growth and still accommodative central banks policies we identified remain intact. Though the ongoing trade war between the US and China looks set to intensify, the actual economic impact does not look too significant despite the damage it has done to market sentiments. As credit valuations are now looking more attractive after the sell-off despite solid fundamentals, staying the course, looking through the noises while identifying idiosyncratic relative value opportunities would be our key theme to extract value for this quarter.

There is no doubt the trade war between the US and China spooks the financial markets. However, it is too early to ascertain the true economic impact on the two nations given the retaliatory nature and also the interconnectivity of the world now. Trade wars are not new and if history is of any guide, there are very few winners, which leads to our belief that Trump is unlikely to take this too far especially when lawmakers from his own party are against him doing it. On the March 8 when Trump signed a presidential proclamation on adjusting imports of steel in the United States, he was surrounded by a carefully arranged group of factory workers. The very people who helped him get elected. This suggests that Trump's recent moves could be part of his ploy to show his supporters he has been delivering on his promises ahead of the mid-term election later this year, without the real intention of letting it escalate into a full blown trade war with China.

The US-China spat is likely to have mixed effects on various Asian economies though overall economic impact effect on this region is likely to remain manageable. This is because overall trade trajectory is ultimately drive by global demand conditions, which up till now remain strong and is less likely to be derailed by trade wars. Should the trade war between US and China escalates from here, Taiwan, Singapore and South Korea will be the most exposed. However, these countries would also stand to benefit if US or China diversify to other import sources as a result of the higher tariffs. If trade war persists for the longer term, higher tariffs will lead to diversification into alternative production bases, which means countries with favorable demographics and lower manufacturing costs such as Vietnam, Indonesia and the Philippines will benefit. What we are more worried in Asia, is that should this trade war drags on, sentiments will be affected leading to tighter financial conditions, deferred domestic demand and ultimately slower economic growth.

On a more positive note, there were some encouraging development following the China's National People's Congress that concluded recently on the March 20. While 2018 growth

[2] Source: First State Investments as at 31 March 2018.

target was maintained at 6.5%, emphasis has shifted to improving the quality of growth through moving up the value chain and implementing supply side reform. Budget deficit target is set at 2.6% of GDP, which is lower than the 2.9% in 2017, a clear sign of improving financial discipline. There is also an increase focus on the effectiveness of fiscal stimulus and policy mix. Amid the deleveraging exercise in the past 2 years, M2 growth has fallen from the previous double digits territory to 8.2% in 2017. While double digit M2 growth was excessive, the 8% handle will lend good support to the economy if is maintained. Inflation target is left unchanged at 3%, which supports recently appointed People's Bank of China's governor Yi Gang's commitment to keep monetary policies prudent and neutral. We do think the People's Bank of China will guide the renminbi to move in line with the basket of currency used to manage its foreign exchange regime. We do not think currency will be used as a retaliation tool in the trade wars with the US as China would want a stable currency at a time they are accelerating reforms to its capital accounts and opening up its financial service sector.

Our previous assessment of key economic trends in major economies remain unchanged. We expect the current synchronised growth in global economies to continue at least for the current quarter, which means the Fed will continue to hike interest rate while the ECB will continue tapering its QE program. However, as we approach the late stage of the current economic expansion, we are of the opinion that growth in major economies could be as good as they get. We are likely to see some moderation in growth in the second half of the year, which suggests both the Fed and the ECB will not be overly aggressive in normalising monetary policies, boding well for bond markets in general. While the Fed cannot be any clearer in their forward guidance, the ECB rhetoric is what investors should be focusing on even though we expect them to go slow. In this quarter, they are likely to start changing some of their forward guidance leading to a potential announcement in the third quarter on whether QE will end later in September 2018. They are then expected to start making changes to forward guidance on interest rate in September should they let their current asset purchase program expire. Any misstep in their communication is likely to bring about some volatility. Bunds and other European peripheral bonds are highly vulnerable as they still trade at very rich levels.

In summary, synchronised global growth will continue but will likely fade in the second half of the year. Monetary policies will remain accommodative and we focus more on the ECB. Trade wars will bring about more volatility and uncertainty but actual economic impact should not be too significant at this stage. Valuations in Asian credit is looking more attractive post the first quarter sell-off though we see more opportunities from an idiosyncratic basis and will continue to extract value from new issues and relative value trades.