First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

May 2018

Market Review

Asian credit market has yet another nervous month hampered by negative sentiments towards emerging market especially their currencies, political uncertainty in Italy as well as the perennial Donald Trump's rhetoric swings around trade wars and geopolitical issues. Emergency meetings by central banks in Turkey and Indonesia which were followed by rate hikes did provide some reprieve, though these moves are unlikely to be enough to offset the broader trend of emerging market weakness. JACI spreads widened by a massive 17bps during the month though that was largely offset by a similar size decline in US treasury yields, resulting in a flat total return. Investment grade returned a positive 0.37% outperforming high yield (-1.23%), which remained under pressure amid supply concerns. By country, spread returns were all negative with the largest losses seen in Indonesia and Philippines along with the frontier markets including Sri Lanka, Pakistan and the usually resilient Vietnam.

The most notably news during the month in Asia was the emergence of opposition coalition Pakatan Harapan as the winner in Malaysia's 14th General Elections. This is the first time since Malaysia's independence that the government has changed. The party, led by former Prime Minister Mahathir Bin Mohamad, increased its parliamentary seats to 113 from the 71 won in the 2013 general elections, just one seat above the minimum 112 required to form a simple majority in parliament. While the change in ruling party is likely to bring about uncertainty around new government policies including the close relationship fostered with China, it will likely put a stem to the corruption involving 1MDB which has hampered Malaysia's progress in the longer term.

Amid persistent weakness in the rupiah, Bank Indonesia (BI) raised its 7 day policy repo rate twice by 25bps each to 4.75%. While this did not come as a surprise for many, it was delivered at a time when inflation is still well within BI's target of 2.5-4.5% with no risk of overshooting on the upside, while growth remains well anchored in the 5.1-5.5% range. In fact BI maintained both the growth and inflation forecast in their policy statement. BI stressed that the rate hike was a part of a broader policy mix to ensure IDR stability. It also intends to implement macro-prudential measures if necessary. Nevertheless, we are of the opinion that rupiah's performance very much hinges on how emerging market currencies perform as a whole. With more than 40% foreign ownership in their local currency government bond, Indonesia will always be vulnerable to outflows driven by bearish sentiments towards emerging markets.

Towards the end of the month, market sentiments were further rocked by the intensifying political uncertainty in Italy. While Italian President Sergio Mattarella managed to block the formation of a Euro-skeptic coalition government for now, investors fret that fresh elections could see anti-Euro forces in the parliament gain more traction. As the third largest economy in the Eurozone, an Italian exit from the European Union will have far-reaching impact on the stability of the region.

Amid the bearish sentiments, supply in May dipped significantly to USD 8.5b vs the USD 24b in April. Year to date supply is now 13% below the same period in 2017. However, the decline in issuance is largely in investment grade as we continue to see higher issuance in high yield. Year to date, high yield issuance is 17% higher with more expected to come in the following months.

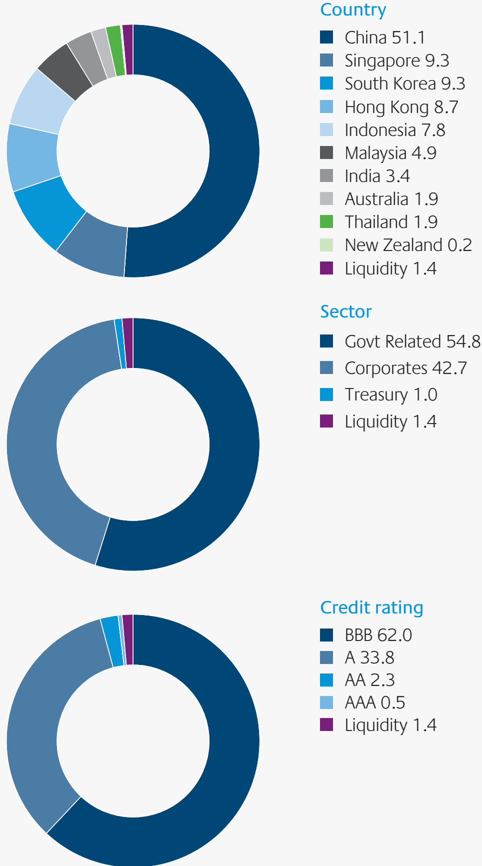
Performance Review

The First State Asian Quality Bond ("Fund") returned 0.17% for the month of May on a net of fees SGD term. The positive return was largely a result of a rally in US treasuries which more than offset the widening of credit spread. On a relative to benchmark basis, our short positioning in Indonesia and Philippines added value amid persistent weakness in emerging market sovereign spreads, while our local currency bond holdings detracted value as the USD continued its rally. On a year to date basis, our short US interest rate duration positioning along with our shorts in Indonesia and Philippines added value while our long China detracted value.

	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	-2.3	0.2	-0.9	-2.2	-0.7
Fund (Inc initial charges)	-6.2	-3.8	-4.8	-6.1	-4.7
Benchmark*	-2.0	0.3	-0.2	-1.9	0.2

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 May 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	%
Indonesia (Republic of)	4.7
United Overseas Bank Ltd	4.7
Hyundai Motor Co	4.5
China National Chemical Corp	4.4
China Huarong	3.7
Citic Ltd	3.7
China Overseas Land & Investment Ltd	3.5
Sinochem Hong Kong (Group) Co Ltd	3.4
Pertamina Persero PT	3.1
Peking University Founder Group Co Ltd	3.1

Portfolio Positioning

While maintaining a defensive stance throughout the month, we did close our short in Indonesia around month end as we believe spreads have widened significantly and signs of stabilisation have emerged. Aside from the negative sentiments around emerging markets which may continue to drag Indonesia asset prices down, the country's fundamentals remain positive and that is likely to provide support for bond prices. Meanwhile, high yield valuation is starting to look more attractive after months of sell-off and that led us to move from a neutral to overweight positioning. We maintained a neutral positioning on interest rate duration. 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 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 both India banks and corporates on tight valuations deteriorating fundamentals.

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 8th March 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.

[2] Source: First State Investments as at 30 May 2018.

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

Disclaimer

This document is prepared by First State Investments (Singapore) ("FSI") (Co. Reg No. 196900420D) whose views and opinions expressed or implied in the document are subject to change without notice. FSI accepts no liability whatsoever for any loss, whether direct or indirect, arising from any use of or reliance on this document. This document is published for general information and general circulation only and does not have any regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive this document. Investors may wish to seek advice from a financial adviser and should read the Prospectus, available from First State Investments (Singapore) or any of our Distributors before deciding to subscribe for the Fund. In the event that the investor chooses not to seek advice from a financial adviser, he should consider carefully whether the Fund in question is suitable for him. Past performance of the Fund or the Manager, and any economic and market trends or forecast, are not indicative of the future or likely performance of the Fund or the Manager. The value of units in the Fund, and any income accruing to the units from the Fund, may fall as well as rise. Investors should note that their investment is exposed to fluctuations in exchange rates if the base currency of the Fund and/or underlying investment is different from the currency of your investment. Units are not available to US persons. Applications for units of the Fund must be made on the application forms accompanying the prospectus. Investments in unit trusts are not obligations of, deposits in, or guaranteed or insured by First State Investments (Singapore), and are subject to risks, including the possible loss of the principal amount invested.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. All securities mentioned herein may or may not form part of the holdings of First State Investments' portfolios at a certain point in time, and the holdings may change over time. In the event of discrepancies between the marketing materials and the Prospectus, the Prospectus shall prevail. First State Investments (registration number 53236800B) is a business division of First State Investments (Singapore).

Commonwealth Bank of Australia (the "Bank") and its subsidiaries are not responsible for any statement or information contained in this document. Neither the Bank nor any of its subsidiaries guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of the Bank or its subsidiaries, and are subject to investment risk, including loss of income and capital invested.