First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

June 2018

Market Review

Despite the allure of the World Cup, there were plenty of events during the month which drew investors' attention away from the football pitch. This included the Trump and Kim summit held in Singapore, Fed and ECB meetings and the intensifying trade wars between the US and China which spooked the market. Emerging markets sentiments remained jittery, which compounded on the negative tone in the Asian bond market. As a result, the JACI returned a -0.54%, bringing year to date loss to -2.55%. Both investment grade and high yield weakened with the gap down in prices more pronounced in the latter. Returns for the two over the month were -0.21% and -1.62% respectively.

Amid much fanfare around the Trump-Kim summit, the two leaders signed a joint statement at the end of their talks on the 12th June, agreeing to expeditiously hold follow-up negotiations between US Secretary of State Mike Pompeo and an unspecified high-level official from the Democratic People's Republic of Korea (DPRK). President Trump also committed to provide security guarantees to the DPRK, while Chairman Kim Jong Un reaffirmed his firm and unwavering commitment to complete denuclearisation of the Korean peninsula. Just as market was cheering the positive outcome of the summit, Trump shocked the world a few days later by instructing the U.S. Trade Representative's office to identify $200 billion in Chinese imports for an additional tariffs of 10 percent. He also said the U.S. would impose tariffs on an additional $200 billion should Beijing retaliates. These comments led to significant spread widening along with sharp weakness in Asian currencies.

As signs of slowing growth becomes clearer, coupled with uncertainty brought about by the trade war with the US, the People's Bank of China (PBoC) cut reserve requirement ratio (RRR) by 50bp for most commercial banks, effective on 5 July. This move is a clear indication that policy makers in China are leaning towards further easing of monetary conditions, despite maintaining targeted deleveraging in certain sectors including property. During the last week of the month, the National Development and Reform Commission (NDRC) warned against aggressive foreign debt raising by Chinese property developers and the issuance of short-dated dollar notes. This put further pressure on the already skittish credit markets in particular the property developers' bonds. Meanwhile in other parts of Asia, the continued USD strength led to central banks in India and Indonesia hiking rates with the aim to stabilise their currencies, even though inflation remains largely benign. More notably in the case of Bank Indonesia, the 50bps hike was larger than expected and it followed two emergency hikes in May, a strong testament for BI's determination to keep the rupiah stable.

Supply remains lackluster throughout the month. There was USD 3.6b worth of issuance. As at the end of first half of 2018, supply is 25% lower than that for the same period in 2017. Concerns over US Fed rate hike's trajectory, US trade policies, China liquidity and credit concerns and emerging markets outflows all contributed to the weaker issuance pattern. Issuers have also shifted their focus to shorter tenors or looked at alternative funding sources such as the loan market, which has been less impacted by the volatility in the credit market.

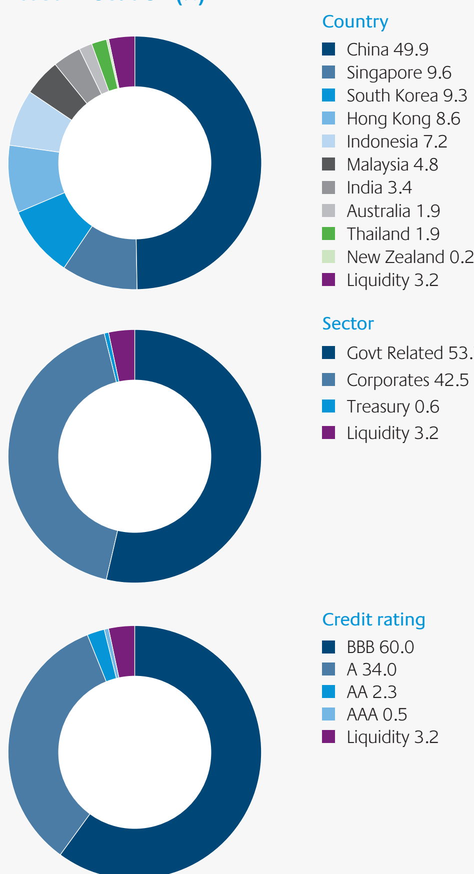
Performance Review

The First State Asian Quality Bond (Singapore Unit Trust) returned -0.67% for the month of June on a net of fees SGD term. The negative return was largely due to continued spreads widening as market remained jittery amid intensifying trade wars and relentless emerging market outflows. The rally in US treasury wasn't enough to offset the losses in credit. On a relative to benchmark basis, our overweight in China and Indonesia quasi detracted value. Our local currency bond holdings also lost ground as the USD continued its relentless rally. On a year to date basis, our short US interest rate duration during Q1 along with our shorts in Indonesia and Philippines since the start of the year added value. The main detractors included our long in China expressed via overweight in several liquid names along with our local currency bond holdings.

	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.9	N/A	N/A	-0.8
Fund (Inc initial charges)	-5.9	N/A	N/A	-3.2
Benchmark*	-0.9	N/A	N/A	0.0

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.4	-1.9	N/A	N/A	-1.4
Fund (Inc initial charges)	-5.4	-5.9	N/A	N/A	-5.3
Benchmark*	-0.7	-0.9	N/A	N/A	-0.1

Asset Allocation (%) [2]



Top 10 Issuers (%) [2]

Issuer Name	%
United Overseas Bank Ltd	4.7
Hyundai Motor Co	4.4
China National Chemical Corp	4.3
Indonesia (Republic of)	4.1
China Huarong	3.8
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	3.0
ICBC Financial Leasing Co Ltd	3.0

Portfolio Positioning

Our strategies were unchanged for the month as we adopted a cautious approach though we believe value is starting to emerge following months of weakness. We maintained our neutral positioning in both investment grade credit and US interest rate duration with a bias to add risk in credit in the coming months. We kept our local currency bonds exposure in the 3-4% range. 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 India banks on tight valuations deteriorating fundamentals, but have recently started reducing our shorts in Indian corporates as valuations have become more attractive.

Investment Outlook

Trade wars, tighter monetary conditions, emerging markets outflows and the list goes on. Conditions that hampered the markets in the first half of the year look set to continue or even intensify. The only constant seems to be uncertainty. The easy way out is to take cover, especially if you had not already done so. But as we all know, following the crowd might not always lead to the best outcome, particularly when the shelter is overly crowded. As the market has been bearish for such a long time, we believe pockets of value are emerging and that presents opportunities as we enter the second half of the year.

In our outlook for Q2, we correctly anticipated a continuation of global synchronised growth, which allowed the Fed to continue hiking interest rate and the ECB to taper its QE program. We also anticipated global growth to slow in the second half of the year and there are some signs of that already happening. While US growth is still being propped up by the ongoing fiscal stimulus, exports growth in Europe has slowed significantly. Taiwan's semiconductor exports also look to have peaked, a strong indication that the days of strong global trade are behind us. The recent dollar strength is more likely due to the divergence of growth momentum between US and Europe, rather than the ongoing trade wars between US and its trading partners. Inflation in US and Europe have been trending higher towards the respective central banks targets. However, we do not think that trend is sustainable especially in Europe where inflation numbers have been driven by a weaker euro and higher oil prices both of which are cyclical in nature. In terms of monetary policies, the still decent growth, low unemployment and a gradually rising inflation will allow the US Fed to continue raising policy rate at the pace of one 25bps hike per quarter for the remaining of this year. However, we are less certain of whether they can continue hiking at the same pace through 2019 as the risk to growth is clearly on the downside. As for the ECB, Draghi sounded rather dovish recently signaling that the first rate hike will not come until the summer of 2019, right before he steps down. While the recent softening in growth supports the dovishness, it remain questionable whether the

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 June 2018. Fund inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

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

Eurozone still need such ultra-easy policies after so many years. Germany's Jens Weimann, the early favorite to succeed Draghi, has taken a hard line against loose monetary policy. If appointed he could bring about a radical change in monetary policies that the market is not prepared for.

While Asian growth is still expected to look decent and inflation staying benign for the full year, trade wars, stronger USD and months of relentless outflows have pressured Asian central banks to react, albeit in different manner and we expect them to stay highly vigilant. China's central bank People's Bank of China (PBOC) shifted to an easing bias, prioritising growth and liquidity in spite of the government's ongoing efforts to enforce tighter regulations on shadow banking and deleverage specific sectors. We now expect the PBOC to stop hiking rates in tandem with the US Fed and deliver more Banks' Reserve Ratio Requirement RRR cuts. Indian and Indonesia have been victims of the stronger dollar as we witnessed acute weakness in both the rupee and the rupiah. Both the Reserve Bank of India (RBI) and the Bank Indonesia (BI) reacted by hiking policy rates. This was despite inflation remaining contained and current account deficits staying within manageable ranges. More notably in the case of BI, we witnessed 3 hikes amounting to a total of 100bps over just 6 weeks, a strong willingness to stay ahead of the curve. That said, Indonesia remains vulnerable to risk and flow sentiments. Foreign holdings of Indonesia government bonds fell from the peak of 40% to 38% leading to the rupiah weakness. Should we get a similar or larger magnitude of decline in the months ahead, any BI actions will be in vain. The same can be said for Malaysia, which has an equally high foreign holdings in their Malaysian Government Securities (MGS). In short, while fundamentals remain sound in Asia, external factors are more likely to drive local markets FX and rates performance in the coming quarters.

Asian credit market sentiments have been weighed down by a wide range of negative factors and uncertainty, most notably the ongoing credit crunch and rising defaults in China. The negative sentiments were further exacerbated by the trade wars between China and the US which is likely to last for a while. While we expect fears around trade war to eventually dissipate as Trump shift his focus to the mid-term elections, development around the credit conditions in onshore China should be closely watched as further meltdown will effectively erase any hope of a rebound in Asian Credit in the second half of the year. That said, we are not feeling too nervous about the current situation in China. After all, the deleveraging process is voluntary and self-imposed, which means the government will have the ability to slow down or even reverse some of the deleveraging should conditions become too acute. Furthermore, allowing the weaker names to default actually promotes a healthy development of the debt market in the long run. In fact we believe credit differentiation is long overdue in China. Asian Credit valuation has become more attractive following months of spread widening. As at the end of the 1st half, JACI IG spread has widened around 42bps to 190, bringing it very close to its 5 year average. The high yield sell-off has been more pronounced with spreads widening by 124bps since the start of the year till 30th June, bringing it to almost 61bps above its 5 year average. Adding in the upward move in US treasury yield, Asian credits' all in yield to maturity is now just 20bps shy of the peak we reached during the 2013 taper tantrums, whereas fundamentals are much stronger now than before. This makes Asian credit highly attractive especially for the long term, all in yield investors such as the pension funds and insurance companies. Anecdotally, real money investors are holding high single digit cash levels, which will inevitably help to limit the downside from an already oversold position. In short, market could be setting ourselves up for a period of strong performance in the second half of the year.

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