First State Asian Quality Bond

Monthly Review and Outlook

December 2017

Market Review

Asian credit market was largely stuck in a range with spreads almost unchanged despite some optimism arising from the US passing a tax plan and a dovish and largely anticipated Fed rate hike. JACI returned 0.17% with gains coming mainly from coupons received. This gain brought year to date return to 5.78%, impressive when we in the uncertainties we faced throughout the year including Fed's rate hikes, Trump protectionist stance and geo-political tension between the US and North Korea. Returns by country were mostly positive during the month with frontier markets Mongolia and Pakistan leading the pack.

As widely expected, the US Fed hiked policy rate for the 3rd time bringing the Fed fund rate from 1.25% to 1.5%. The rate hike was predicated around solid job gains with unemployment falling further despite inflation still well below the Fed's target of 2%. Going forward, the Fed is expecting to see moderate growth with labor market remaining strong. The FOMC median estimates show 3 hikes in 2018 and two in 2019, while the estimate of longer run Fed fund rate remaining at 2.8%.

Following the Fed's hike, the People's Bank of China (PBOC) to market's surprise hiked 1 year medium-term lending facility (MLF) and reverse repo rates by 5bps. While the hike is smaller than the usual 10bps moves during January and March, it is a signal that PBOC wants to keep the renminbi stable. We do not see this as a hawkish signal as PBOC commented that money market rates are already high. This is evidenced by the muted reaction from the market following the hike.

New issuance activity slowed in December though at USD 17.8b it is still one of the busiest December in recent years. Chinese issuers accounted for 69%, followed by Indonesia at 23% and India at 8%. For the full year, total fixed rate issuance hit USD 271b, a 56% increase year over year.

Performance Review

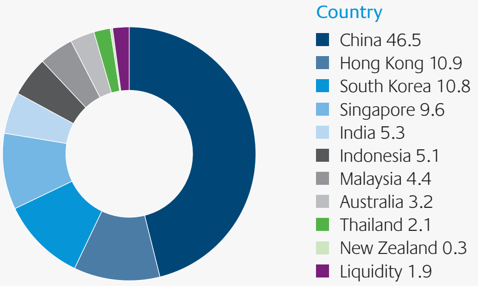
The First State Asian Quality Bond returned 0.1% (excludes initial charges) for the month of December [1].

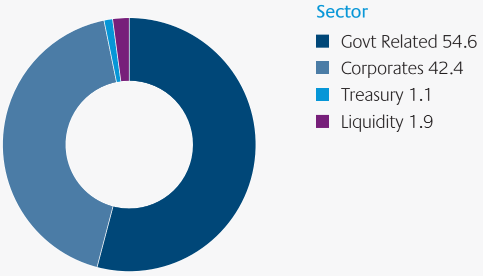
	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	4.8	0.1	0.3	1.0	1.6
Fund (Inc initial charges)	0.6	-3.9	-3.7	-3.0	-2.5
Benchmark*	5.1	0.1	0.2	1.4	2.2

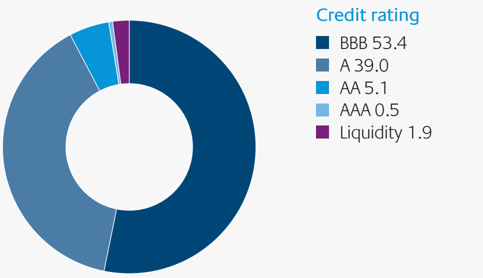
The fund has delivered strong returns this year largely due to the spread tightening in Asian credits. In terms of excess return, we maintained an overweight in credit for a big part of the year and that has done well. Securities selection has been the largest component of excess returns this year. Names we held overweight positions include Alibaba, China Overseas Land, OCBC and Pertamina. Local currency bonds that we opportunistically added to the fund over the past few years also made a significant contribution to excess return this year from both a currency and rates perspective. Our holdings in local bonds are mainly in AUD, CNH, IDR, and MYR.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 December 2017. 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	5.2
Hyundai Motor Co	4.7
China Huarong	4.5
China Petrochemical Corp	4.5
Sinochem Hong Kong (Group) Co Ltd	4.5
China Overseas Land & Investment Ltd	3.8
Pertamina Persero PT	3.6
Citic Ltd	3.3
Reliance Industries Ltd	2.8
United Overseas Bank Ltd	2.7

Portfolio Positioning

We maintained neutral in US duration throughout the month though we think the short end is starting to look attractive as the curve flattened significantly with 2-10 spreads now at around 50bps. We also maintained our overweight in credit amid the favorable technical backdrop. By countries, we are overweight in China mainly via the core SOEs as we believe spreads will continue to tighten over time now that we have a China sovereign benchmark curve. We remained positive in the high quality Singapore banks and Hong Kong corporates given their defensive qualities through economic cycles. Our underweights are largely expressed in Indonesia and Philippines sovereign where valuations have been tight, even though fundamentals remain sound. Our local currency bonds exposure remains at below 5%.

Investment Outlook

Market and economic conditions look a lot more favorable as we start 2018 versus a year ago when it was clouded with uncertainties. We now have a synchronized global growth that looks set to continue at least in the first quarter along with Fed rate hikes that has been well communicated and thus bringing no surprises. There is also optimism around US tax reforms and China's ability to rebalance its economy without derailing its growth. Amid this positive backdrop, the more plausible risks that we see derailing the risky assets rally would be limited to a more hawkish than expected ECB as it winds down its QE and a sudden spike up in inflation in the developed economy forcing the Fed and ECB to move quicker. Supply and demand technical in the Asian credit market remains extremely favorable as we believe the current situation of too much cash chasing after a limited pool of assets is likely to persist. The onshore Chinese investors' bid is becoming a structural development that bodes well for the market. In short, we are bullish in Asian fixed income for Q1 barring significant changes to the above mentioned factors.

As we correctly anticipated, the US economy progressed well enough throughout the year to allow the US Fed to continue normalizing monetary policies. To put some numbers into perspective, the US economy has created nearly 10 million jobs since Janet Yellen took charge in February 2014. Unemployment rate has declined from 6.7% to 4.1% while GDP growth has averaged a healthy though unspectacular 2.1% post the global financial crisis from 2010 to present. If such trends continue or are at least maintained, we do expect the Fed to continue hiking policy rate albeit at a slower rate than what they had projected. Yellen's successor Jerome Powell is also unlikely to bring about any material change to the rate hike trajectory. Just like December 2016 post the US presidential elections, there has been huge optimism from the markets amid the imminent passing of tax cuts and possibility of tax reforms in 2018. Consensus is projecting tax cuts to add around 0.3% to 2018 growth while an increase in fiscal spending in defense and infrastructure to add another 0.2%. While I believe Trump will deliver some of his agenda, his path will unlikely be smooth as the prospects of a widening budget deficit is unlikely to be popular amongst both House Republican and Congressional Democrats. The boost to economic growth is also likely to be short-termed. Drastic and effective structural reforms are what we need to see in order to lift the US economy above its trend growth, which we believe is in the 2-2.5% range. Low productivity growth and poor demographics, something we mentioned repeatedly in the past remain the key issues faced by the US as well as other developed economies.

Europe's growth has consistently surprised us on the upside in the past year, led by robust growth in the Germany and France coinciding with a period of synchronized global growth. Leading indicators also point to a continuation of this strong momentum as we head into 2018. That said, we believe this bout of strong economic performance is largely cyclical and exaggerated by consumer and business sentiments recovering from a low base. We do not share the same optimism as many investors do, as we believe Europe as a region has not implemented any meaningful structural reforms that will boost its longer term growth

[2] Source: First State Investments as at 31 December 2017.

prospects. Also, the continued strength of the Euro will start to weigh on exports. ECB has signaled its intention to taper its QE program by reducing their monthly purchase starting January 2018. It will not be until the middle of 2018 before they announce whether QE will be extended beyond September. In the absence of inflation, policy rate rise will not happen until 2019. This means monetary policies will remain highly accommodative.

Japan's economy has also been delivering good performance amid strong exports growth. Prime Minister Abe winning another strong mandate at the snap elections in October also ensures continuity of Abenomics and its three arrows of easy monetary policy, fiscal stimulus and structural reforms. This was evidenced in the adoption of a JPY2 trillion fiscal package on the 8 December. Similar to Europe, inflation has fallen short of central banks' target and hence interest rates in Japan are expected to stay low. While much attention is on the continued rate hike by the US Fed, the bigger risks to the market is actually an earlier than expected exit from the easy monetary policies by the ECB or BoJ should the strong economic performance continues. This is because while the US rates have started normalizing, Bunds and JGBs are still stuck near zero, making them more vulnerable to a rise in yields.

Despite all the skepticism from the developed nations around China especially in 2016 when the renminbi depreciated sharply, China did a remarkable job in delivering strong growth while undergoing economic reforms. It successfully rebalanced its economy away from investments into consumption, while exporters structurally shifted up the value chain and have become more competitive. We have been bullish on China and remain positive as we believe Premier Xi JinPing will continue to drive reforms after he consolidated his authority at the 19th Party Congress. High level of debt remains a problem in China though the pace of credit growth has been slowing. We are not overly concerned as the bulk of the debt is domestic and hence any blowup can be more easily contained. In other words, any crisis from China will pale in comparison to the global financial crisis in 2008 or the European crisis in 2011. A key development we are closing watching in 2018 is the opening up of the China onshore interbank bond market. This is something that investors cannot ignore as this market will eventually form a significant portion of the major global bond indices. The recent spike up in onshore yields brought the 10 year Chinese government bond yield close to 4% which is an attractive level especially when compared against the meagre developed market yields. We believe the renminbi will remain stable though the movement will be dictated by the broad US dollar trend rather than China's macroeconomic performance. PBOC's recent rate hike following on the heels of the US Fed's hike is a clear indication of its determination to keep the renminbi stable.

Amid the synchronized global growth, Asia as a region has benefitted from strong exports growth though that is likely to wane in the second half of 2018 as the developed economies reach the mature state of the current cycle. Countries that are relatively more export oriented including the likes of Singapore, Malaysia and Thailand will be vulnerable to a turn in the global trend, while those with a stronger domestic demand story such as Indonesia and Philippines will likely prove to be more resilient. Accommodative monetary policies have pretty much run its course and most central banks are likely to move towards a tighter stance albeit a very gradual one, with the intention of normalizing policy rates and at the same time stabilizing their currencies. The most hawkish of the lot is likely to be the Banko Sentral ng Pilipinas (BSP), where we expect at least two 25bps hikes especially should the US Fed continues tightening. BSP historically has been by far the most aligned to the US and with its current account deficit widening putting pressure on the peso, rate hikes look imminent in 2018. With inflation largely subdued and likely to remain so for most part of this region, expectations of rate hike by central banks in Indonesia, Thailand and Malaysia range from only 1-2 hikes. As monetary policies take a back seat, development around fiscal policies will be in focus especially in countries where we are expecting elections namely Indonesia and Malaysia. In order for fiscal stimulus to be effective, it needs to bring about along lasting impact on the structural aspects of an economy. Singapore's push to improving workers' skills and productivity are examples of such reforms and if the rest of the region could follow suit, the longer term prospects of Asia will inevitably look even brighter.