

# Asian Quality Bond

## Monthly Review and Outlook

As at January 2016

### Key highlights:

- The continued collapse in oil price, concerns over China's growth and the inability of the Chinese authority to control the stampede in the A share market all presented the perfect ingredients for the storm in risky assets as we begin the New Year.
- Total return for investment grade bonds was positive for the month, outperforming the negative return delivered by high yield.
- As widely expected, the US Federal Reserve (the Fed) held the Fed Funds target rate steady at the 0.25%-0.5% range set in mid-December 2015.
- Challenging times are ahead for Asia though we see some bright spots. Reforms in China, India and Singapore are long-term positive despite the near term growth uncertainty.
- Longer term growth prospects in Asia remain intact and return from local currency bonds especially the high yield Indonesia and India will likely outperform those of developed market if investors are able to take a longer term view and ride out the current volatility.

### Market Commentary

The continued collapse in oil price, concerns over China's growth and the inability of the Chinese authority to control the stampede in the A share market all presented the perfect ingredients for the storm in risky assets as we begin the New Year. Major asset classes exhibited highly positive correlations and Asian credits were not spared despite showing better resilience. Spread of the JPMorgan Asia Credit Index (JACI) widened by a considerable 27 bps to close the month at 311bps. By country, spreads widened across all markets with the frontier names such as Mongolia, Macau and Pakistan bearing the brunt of the sell-off. Nonetheless, total return was positive at 1.03% as US treasuries rallied strongly, benefitting from safe haven flows as the 10 year yield declined by 35bps to close the month at 1.92%. Total return for investment grade bonds was positive for the month, outperforming the negative return delivered by high yield.

On the first trading day of the year, a weaker than expected China Caixin PMI, at 48.2 vs market forecast of 48.9 triggered a sharp slide in Chinese A-shares. The SHCOMP index fell 6.9%, prompting a market shut-down triggered by the circuit-breaker that was established last December. Days later, another sharp sell-off saw the circuit breaker being triggered yet again after only 30 minutes of trading. Confidence sank to a low when China Securities Regulatory Commission (CSRC) decided suspend the market protection mechanism, raising further doubts in the Chinese authority's ability to stabilize markets and rebalance the economy. Sentiments remained nervous as we progressed through the month with oil price hitting a new 12 year lows, heightening anxieties over the ability to stay afloat for many oil and gas related companies.

As widely expected, the US Federal Reserve (the Fed) held the Fed Funds target rate steady at the 0.25%-0.5% range set in mid-December 2015. The statement accompanying the policy decision highlighted the view that labour market conditions improved further even as economic growth slowed late last year. In addition, household spending and business fixed investment have been increasing at moderate pace in recent months while the housing sector showed further improvement. Net exports have been soft while inventory investment slowed. On inflation, the Fed stated that it has continued to run below the Committee's 2 percent longer-term objective, partly reflecting declines in energy prices and in prices of non-energy imports. Overall, market perceived the latest statement as dovish and continued to price out rate hikes for the rest of 2016.

Just as we ponder whether global monetary conditions will be as easy as before, the Bank of Japan (BoJ) surprised the market and brought interest rate to negative. In their three-tiered interest rate regime, the central bank will pay an interest rate of -0.1% on all balances of the banks' reserve held at the BoJ over and above the other 2 tiers of reserve, namely the "Basic Balance" and "Macro Add-On Balanced". This new regime of Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate is implemented with the objective of moving towards the price stability target of 2 percent at the earliest possible time. While markets cheered BoJ latest move, many remained sceptical whether Japan can ever achieve the 2% inflation target.

New issuance slowed down significantly in January at US\$ 10.9 billion, a 46% decline year over year. Largest supply came from financials at 63%. Chinese issuers dominated once again just like in 2015, accounting for almost 50% of issuance while Korea followed closely at 30%.

### Performance

In USD terms, the **First State Asian Quality Bond Fund** gained 0.7% in January 2016.

### Fund Positioning

We reduced our risk in China during the month though still maintaining a modest overweight position in spread duration terms. We added some exposure in Indonesian sovereign after spreads widened to an attractive levels and selectively picked up some oversold Indian credits namely Bharti and ONGC during the month. We maintained our short US duration position at the front end of the curve. Our positioning in local currency bonds remained modest at around 5% of portfolio.

By country, we remained overweight in China and Hong Kong, partly offset by a short in Philippines. We continue to overweight in high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the oil and gas sector which includes names like CNOOC, CNPC and SINOPEC due to large supply and downward pressure in oil price. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

### Investment Outlook

As we move into 2016, market sentiments will continue to be dictated by a slowing global growth along with the policy divergence between the Fed and other major central banks. Corporate credit fundamentals have been weakening in the past few quarters adding to the already murky outlook. Nevertheless, the weakening trend has not reach a level that is a cause for concern, with the exception of several high yield names in the oil & gas and commodity sector. On a brighter note, with the first rate hike by the Fed behind us, much uncertainty has been removed allowing investors to focus on the fundamentals. Technical backdrop remains favorable for Asian credits while on the currency front, we can potentially see Asian currencies doing well in the second half of the year should the dollar strength wanes or even reverse. At this juncture, we see the biggest risks for the market in 2016 to be another leg down in oil price, leading to a wave of defaults or US inflation overshooting market expectations leading to an unorderly sell-off in the longer dated US treasuries.

The US economy, as we had expected, expanded at a healthy pace prompting the Fed to deliver its first hike in almost a decade in December 2015. We are looking for a continuation of this positive albeit modest growth momentum, underpin by decent expansion in consumer spending despite business investment remaining largely subdued. With the world slowing, the US economy has done well up to this point, though we expect it to remain entrenched in the 2-2.5%

growth trajectory with risk to the downside should global growth worsen. Inflation expectation has been low in the US on the back of extremely low oil and commodity prices amid a strong dollar. We expect this trend to continue at least for Q1 2016 and thus the path for rate hike will be extremely gradual.

Eurozone has performed reasonably well in the past year on the back of an improving labour market and an increased in consumer spending, as households are able to spend more due to savings from a lower oil price. The region has also benefitted from both the European Central Bank (ECB) massive Quantitative Easing (QE) program and a lenient European Commission that has reduced the pressure of austerity. Despite achieving close to 1.5% growth in 2015, we are not overly excited about Europe as business investment remains very weak and the easy fiscal conditions that have been supportive towards growth may not persist. Even if the region is to maintain growth at around 1.5%, it will not be enough to close the output gap. Against this backdrop, we expect inflation to remain low for a considerable time and monetary policy to remain easy for a big part of 2016. Similar to the Eurozone, we expect monetary conditions in Japan to remain easy as inflation continue to significantly lag Bank of Japan's (BoJ) target of 2%. Nevertheless, we do not expect the BoJ to further expand the scale of its already massive asset purchases barring a nasty external shock. Japan's growth outlook for 2016 in fact is starting to look more optimistic, underpinned by strong consumption as household expenditure got a boost from a broad based wage growth which is expected to continue for the 3rd consecutive year. Fiscal policy also looks supportive for the household sector following the recent announcement by the government to provide subsidy for 12.5 million low income household as part of the JPY 3.5 trillion budget.

The ongoing rebalancing of the Chinese economy from an investment-driven model to a consumption-led one has inevitably weighed on growth. Coupled with the decline in trade numbers, aggressive monetary and fiscal policies need to be implemented should the government want to achieve its growth target of at least 6.5%. We expect at least 2 rate cuts and banks' reserve ratio cut of up to 400 bps for 2016. Currency is also expected to weaken gradually though with the intention of having it move more in line with other major currencies instead of using its weakness to spur exports. Fiscal policies will likely continue to be supportive of growth. However, similar to what we have witnessed in the past year, they are likely to be more targeted. The magnitude will also be far from the size delivered during the 2008 global financial crisis as China is still reeling from excess capacity in many segments of the economy.

In 2015, we highlighted our concerns that Asian economies could potentially be stuck in a protracted period of anemic growth should the slowdown in China persists. This has materialized and is likely to continue. Furthermore, the recovery in the west, notably the US and Europe has not lifted Asian exports the way it used to as many of these developed

economies started producing what they used to import as cost of production decreases. China's shift to a more consumption driven model also mean that demand for import from other Asian economies will continue to stay weak. Most Asian central banks still have room to cut policy rates should growth continue to surprise on the downside. Nonetheless, with the Fed having started a hiking cycle, we do expect them to tread more cautiously as a divergence in monetary policy from the US could lead to outflows which is very destabilizing for the economy. Countries including Indonesia, Malaysia and Sri Lanka are likely to be the most vulnerable in such a scenario. Key to watch in 2016 will be the reforms that will be rolled out especially those measures that target an improvement in productivity. Despite facing an uncertain outlook, we do not see the current situation culminating into a financial crisis. Asian's local currency bonds market's development over the past decade has led to reduced reliance on USD funding. FX regime is now more flexible in Asia unlike in the 1990s when many of them have some form of a peg to the USD. On top of a higher FX reserves, many central banks now have multi-lateral and bilateral currency swaps agreements which serve as a useful liquidity tool in times of stress.

Challenging times ahead for Asia though we see some bright spots. Reforms in China, India and Singapore are long term positive despite the near term growth uncertainty. Credit valuations does not look stretched especially against the backdrop of very strong technical factors including the demand from China onshore investors' and the overwhelming demand for high quality Asian issues. After more than a year of brutal sell-off, Asian currencies are looking significantly oversold, bringing them to levels that do not reflect fundamentals. Longer-term growth prospects in Asia remain intact and return from local currency bonds especially the high yield Indonesia and India will likely outperform those of developed market if investors are able to take a longer-term view and ride out the current volatility.

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