First State Investments

Asian Quality Bond

Monthly Review and Outlook

February 2016

Key highlights:

- Collapse in oil price, global recession fears and concern over the renminbi's devaluation continued to weigh on the market the way they did in January, before market sentiment showed some signs of stabilisation towards the end of the month.
- Total return for both investment grade and high yield were largely in line at around 0.6%. Spread returns were mixed. Macau, Bangladesh, Indonesia and Vietnam returned positive while Mongolia and Thailand spreads detracted value.
- 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

Collapse in oil price, global recession fears and concern over the renminbi's devaluation continued to weigh on the market the way they did in January, before market sentiment showed some signs of stabilisation towards the end of the month. Spread of the JPMorgan Asia Credit Index (JACI) widened all the way to 340 bps before retracing moderately to close the month 10bps wider at 319bps. The negative yields in developed market government bonds led to a strong rally in US treasuries, with the decline in yield more than offsetting the widening of credit spreads. This led to the JACI delivering yet another month of positive return at 0.57%, despite the broad-based weakness in risky assets. Total return for both investment grade and high yield were largely in line at around 0.6%. Spread returns were mixed. Macau, Bangladesh, Indonesia and Vietnam returned positive while Mongolia and Thailand spreads detracted value.

India announced the FY17 budget which aims to compress fiscal deficit from 3.9% of GDP in FY16 to 3.5% of GDP in FY17. This reinforces the government's commitment to its fiscal consolidation roadmap which is to achieve by FY18, a fiscal deficit at 3% of GDP. The budget also kept its focus on boosting rural demand and supporting infrastructure growth.

On the last day of February, the People's Bank of China (PBoC) announced a 50bps cut in its reserve requirement ratio (RRR) for all financial institutions, effective 1 March 2016. The new RRR will now be 17% for large depository institutions. This RRR cut is broadly in line with expectations and will unlock CNY 650-700bn of deposits for lending. The main objectives of this cut include maintaining sufficient liquidity in the financial system coupled with ensuring steady growth of money supply and credit, both of which should provide a financial environment conducive for the ongoing structural reform.

New issuance declined further amidst heightened market volatility and the Lunar New Year holidays, as we witnessed only US$ 5.95b worth of supply. Investment grade accounted for 41% a bulk of which came from Philippines's sovereign deal.

Performance

In USD term, the First State Asian Quality Bond Fund returned 0.65% in February.

Portfolio positioning

We increased our exposure in India amid the continued spread widening while at the same time trim our overweight position in Singapore banks which has worked well for us. We also increased our short US duration position at both the 5 year and 10 year part of the curve as we believe the global recession fear is overdone and it is too early for the market to be pricing out rate hike by the Fed. 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 materialised 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 destabilising 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 markets development over the past decade has led to reduced reliance on USD funding. The 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 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 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. 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.