First State Investments

Asian Quality Bond

Monthly Review and Outlook

November 2016

Key highlights:

- Post the US election, we reduced some credit exposures though maintaining a moderate overweight position.
- Moving towards the end of the year, global growth is likely to remain sluggish especially in most developed countries with central banks expected to continue missing their inflation targets.
- ECB and BoJ are unlikely to stop quantitative easing anytime soon while US Fed rates' normalization is still expected to be gradual.

Market commentary

Bond markets were roiled in the month of November following the surprise win for Donald Trump and the Republican Party in the US election. Trump's policies which include tax cuts and massive infrastructure spending are highly expansionary and will likely lead to more bond issuance as well as inflation or at least that is what market expects. US treasuries sold off brutally with the 10 year yield rising by 55bps over the month. There was also a broad based USD strength leading to weak performance in many Asian currencies. J.P. Morgan Asia Credit Index (JACI) returned -2.07%, with investment grade underperforming high yield with return of -2.38% and -0.88% respectively. Surprisingly, spreads held up pretty well exhibiting strong resilience. The JACI spreads ended the month at 239bps, 6bps tighter than the previous month. India, Pakistan and Macau delivered the best positive spread returns, while Vietnam, Mongolia and Malaysia were the biggest laggards.

Following the shock election result, Fed Chairman Janet Yellen said in her prepared speech that a policy rate increase could become appropriate relatively soon if incoming data provide some further evidence of continued progress toward the Committee's objectives. This all but confirms the 25bps rate hike during the next Fed meeting in December. Yellen also affirms her commitment to see through her current term, which will end in February 2018, despite Donald Trump's pre-election promise that he will fire her if he got elected as the president of the United States.

Bank Indonesia (BI) maintained its 7 day reverse repo rate at 4.75%, in line with market expectation. Overall tone was cautious in light of the uncertain global developments, primarily the surprise US election outcome and the expected hike in the Fed Funds rate in December. During the month, BI was seen intervening in the FX market to stem the sharp fall in the rupiah as foreign investor trim risky assets especially those that have performed well year to date. We also saw similar intervention move in Malaysia as the ringgit plummeted to multi year low. Bank Negara Malaysia also kept its overnight policy rate unchanged at 3%. With inflation still benign there is scope for them to ease should economy weaken further though the currency weakness is more likely to be their utmost concern at the moment.

New issuance remained robust despite the heightened volatility in bond markets. We witnessed USD 15.3b worth of supply bringing year to date issuance to USD 162.3b a 14% increase over the same period in 2015. China was the main issuing country last month, accounting for 84% of supply, while the rest came from Hong Kong (10%) and Korea (5%). For the year, issuance from China stands at 60%, followed by 13% from Korea and 9% from Hong Kong.

Performance

In USD terms, the First State Asian Quality Bond Fund returned -3.02% for the month of November.

Portfolio positioning

Post the US election, we reduced some credit exposures though maintaining a moderate overweight position. We also kept our overweight interest rate duration position as we believe while inflation expectations have heightened, it would take time for Trump's policies to change the US economy structurally. With European Central Bank (ECB) and Bank of Japan (BoJ) likely to maintain an easy bias for a while, we expect the relentless search for yield to continue and US treasuries now look very attractive to its developed market peers. In credit, we are now overweight in China, Hong Kong, India and Singapore, while maintaining a short position in Philippines as valuations are still tight. We continue to overweight high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the Chinese banks and asset management companies due to potential supply and weakening fundamentals. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles. We have around 5% exposure to local currency bonds which we have accumulated over the past few years as we still believe in the fundamentals of Asian economies in the long term.

Investment outlook

Following Donald Trump's victory in the US election, we are now faced with more uncertainty as it is unclear how many of his pre-election propaganda will be delivered. What is more uncertain for fixed income investors is whether Trump's policies, which are widely expansionary, will lead to a runaway inflation and hence quicker rate normalization by the US Fed. To add to the already murky outlook, we have the upcoming Italian referendum which could further dampen sentiments.

Despite the nervousness in the market, we believe that a Trump's victory is not all bad news. A Trump win is perceived to be good for growth, leading to higher inflation notwithstanding the increased political uncertainty which is bad for markets in general. Nevertheless, with the check and balance mechanism put in place in the form of the Congress, it is unlikely many of Trump's promises will be legislated. In the near term, we believe the Trump factor will continue to put bond markets under pressure. However the trajectory of bond yields will eventually be decided by economic fundamentals and it is too early to make an assessment whether we will get structurally higher inflation with Trump's policies.

Moving towards the end of the year, global growth is likely to remain sluggish especially in most developed countries with central banks expected to continue missing their inflation targets. Monetary policies are expected to stay highly accommodative though its effectiveness on the real economy has clearly waned if not dissipated. With productivity remaining low in many countries, fiscal measures will now come under increased scrutiny as countries look for ways to lift their economies. As fiscal policies brings about positive changes only over the mid to long term, we are likely to be stuck in a low growth, low inflation environment for a foreseeable future. What this mean is returns across various asset classes will also be tapered and the income generating feature of an asset class will become more important for investors.

US economy recovered from the doldrums in the oil and gas sector earlier this year as evidenced by an improvement in energy mining investments in the 2nd and 3rd quarter. We continue to see an improvement in the labor market though momentum has clearly slowed down with average monthly job gains falling to 182,000 in the first eight months of this year as compared to 219,000 in 2015. The unemployment rate fell from 5.7% in January 2015 to 4.9% in January 2016, but has since stalled. Meanwhile, core PCE price inflation has been stable at close to 1.6% though still below the US Fed's 2.0% target rate. Against this backdrop, we believe the Fed will hike rate this coming December though the pace subsequent hikes will still be very gradual despite the spike up recently in inflation expectations.

Eurozone growth remains resilient largely underpinned by strong domestic consumption despite the shocking result of the UK referendum to leave the European Union. Nevertheless, there is a risk that the impact on businesses and household spending has been simply delayed until the UK invokes Article 50 next year. On the inflation front, price pressure remains very low with core inflation stuck at below 1%, which is the average pace it has been running at since 2013. This means the European Central Bank's inflation target is unlikely to be met and thus we expect them to extend the time horizon for its asset purchase program to late 2017. Political landscape in Europe poses another risk to the stability of the region with the upcoming Italian referendum on reform taking place in October while elections in France and Germany will be held in 2017. Even though growth has been stable, many challenges remain.

Abenomics is starting to look like a distant memory despite government's efforts to launch more economic stimulus to prop up the economy. Japan continues to struggle with poor domestic demand and a loss in exporters' competitiveness amid a strong yen. The strong currency has also been a major driver of low inflation, as BoJ struggles to achieve their inflation target of 2%. BoJ's altering of the policy framework which includes a specific targeting of the 10 year JGB yield, suggests that they are now concerned about how a flat yield curve is hurting the financial positions of pension funds and life insurance firms. This is a concern we shared not just in Japan but also in Europe. To top it all, rapid deterioration in growth amongst Japan's main trading partners most notably China add another risk to the numerous challenges the country is already facing.

While it has been gloomy and murky in the developed world, we could find some bright spots in Asia. Signs of stabilization in the Chinese economy were further affirmed by data observed over the 3rd quarter. Growth has been supported by the strong momentum in the property market along with boosts to infrastructure spending amidst aggressive municipal bond issuance plans. Exports also got a lift following the renminbi's depreciation over the past year while moderation in wage growth helped in bringing down the costs of production. Against this backdrop, the government is en route to achieve the growth target of 6.5%-7% for this year. China's stability is a much needed boost to other Asian economies, which have been struggling with anemic growth. Trade numbers have been lackluster, and this is evidenced in the poor showing of the exports oriented countries including Singapore, Malaysia, South Korea and Taiwan. Though central banks in Asia have more room to cut rates as compared to their developed market counterparts, the emphasis on reforms remains crucial. Countries targeting an improvement in productivity such as Singapore will come out top over the longer term, as easy monetary policies while useful in supporting short term growth will inevitably run its course at some stage.

While investors have turned nervous towards fixed income markets, we do think the global search for yield will remain as ECB and BoJ are unlikely to stop quantitative easing anytime soon while the US Fed rates' normalization is still expected to be gradual. The recent sell-off in both Asian credits and credit actually make valuation look more attractive and we see further weakness as any opportunity for investors to reload on risk as we move to a new year in 2017.

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