

First State Asian Quality Bond

Monthly Review and Outlook

June 2017



Market Review

Asian credit market had a relatively quiet month trading in a moderately narrow range until towards the end of the month when commentary from the President of the European Central Bank (ECB) provided a reminder of the future path towards tighter monetary policy. The market reacted accordingly with a spike in global government bond yields despite President Draghi making it clear any movements would be measured and gradual and dependent on continued economic recovery.

JACI returned a positive 0.21% (USD terms) on the back of a modest spread tightening in investment grade bonds, while US treasury return was flat. High Yield spreads were dragged wider following the larger than expected mega issue by property developer Evergrande. The negative sentiments in high yield were further exacerbated by reports that China Banking Regulatory Commission (CBRC) probed into offshore M&A lending activities of property developers including Fosun and Dalian Wanda. By country, spread returns were largely positive with the exception of Indonesia, Mongolia and Sri Lanka. Pakistan and Vietnam led the pack with the best performance.

Sticking to the gradual tone, the US Federal Open Market Committee (FOMC) raised the Fed Funds target rate by a further 25bp to a 1.0%-1.25% range at its June meeting. The market was expecting the hike, pricing in a 98% probability ahead of the meeting. The FOMC kept the outlook largely unchanged with a third hike in 2017 and three more in 2018 still in the plans. This continues to be a much faster acceleration than the market believes, as pricing indicates a notably flatter rate path over the coming years (cumulating at around 150bps lower). Nevertheless, it's likely the Fed will be focusing on the balance sheet unwind at its next meeting in September.

Continuing the talk of normalisation, the Bank of England turned more hawkish than expected at its early June meeting with three of eight members calling for an immediate hike in rates. This came on the back of a strong inflation print despite

the contrasting slow wage growth. While rates remained unchanged, the surprise change in sentiment caused Sterling to rally. The latter was much needed following the currency's earlier pounding following the unsuccessful snap election gamble by PM Teresa May where the Conservatives failed to win an outright majority. Sentiments in the UK was further impacted by two unrelated terror attacks in Manchester and London during the month.

Issuance activity picked up in June with a total of US\$22.8b printed, a 31% increase over the previous month. This brings year to date supply to USD 152b, an astounding 104% increase over the same period last year. There were yet again several mega issues including Evergrande (US\$6.6b), Kaisa (US\$3.9b), Baidu (US\$1.5b) and China State Construction (US\$1b). High yield issuance has picked up significantly this year, providing this segment of the market with much needed liquidity which has been sorely lacking.

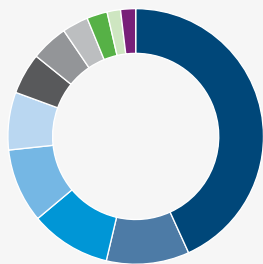
Performance Review

The First State Asian Quality Bond returned 0.31% (excludes initial charges) for the month of June ¹.

	Cumulative performance in SGD (%) ¹				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	3.7	0.3	1.4	3.7	0.6
Fund (Inc initial charges)	-0.4	-3.7	-2.6	-0.4	-3.4
Benchmark*	3.7	0.2	1.4	3.7	0.9

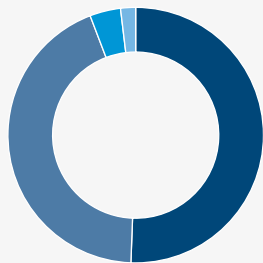
¹ Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 June 2017. Fund since inception date: 1 November 2016. The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

Asset Allocation (%)¹



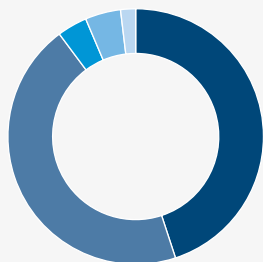
Country

- China 43.2
- Singapore 10.5
- Hong Kong 10.2
- South Korea 9.4
- India 7.3
- Malaysia 5.2
- Indonesia 4.7
- USA 3.3
- Thailand 2.6
- Australia 1.7
- Liquidity 1.9



Sector

- Govt Related 50.6
- Corporates 43.6
- Treasury 3.9
- Liquidity 1.9



Credit rating

- A 45.0
- BBB 44.9
- AAA 3.8
- AA 4.5
- Liquidity 1.9

Top 10 issuers (%)¹

Issuer name	%
Sinochem Hong Kong (Group) Co Ltd	4.2
China Overseas Land & Investment Ltd	4.0
CNOOC Ltd	3.8
China Huarong	3.7
Pertamina Persero PT	3.7
Overseas Chinese Bk Corp	3.4
United States Treasury	3.4
Beijing Infrastructure Investment Co Ltd	2.9
Hyundai Motor Co	2.6
Bank of Communications Co Ltd	2.6

Portfolio Positioning

We maintained our moderate short US duration strategy as we deem the long end bonds to be less attractive following the normalisation of short end rates. We also kept our neutral positioning on credit spreads as valuation remained fair at best albeit some improvement in financial metrics across many corporates in our universe. We stayed defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. Within China, we are overweight the investment grade property and technology while underweighting the banks and LGFVs (Local government financing vehicles) on supply concerns. We reduced some of our Alibaba exposure as it has done

remarkably well for the past few quarters. We are underweight India banks on tight valuations offset by an overweight in Indian corporates. We kept our local currency bond exposure at well below 5% mainly CNH and MYR.

Investment Outlook

Despite starting the year with heightened uncertainty, markets actually remain very resilient with volatility declining significantly. Fed rate hikes, Trump's policies, French elections and terrorist attacks in the UK all seem to have muted effect on markets leading us to ponder what could possibly derail the rally as we move into the second half of the year. While fundamentals have been stable, rich valuations would call for caution especially when markets have slipped into a complacent mode.

Despite years of zero interest rate policy and quantitative easing, US growth never get to the heights of 4% growth in the period preceding the GFC in 2008-9. One explanation is that the high growth rate that was previously achieved was driven by excessive leverage by both consumer and corporates, both of whom have been rather cautious in the past 8 years and they look likely to stay this way. While unemployment rate at 4.3% is well below what many would define as full employment, underemployment as measure by U6 is still at elevated level of 8.4%. This means that while the economy has recovered, there is still plenty of slack as many workers are still underemployed, something Yellen has been stressing upon as she pushed back on normalising interest rates over the past few years. Many who lost their jobs during the financial crisis were unable to gain employment in the same capacity as many lost finance positions were not being replaced. Technological advancement in recent years has also led to many workers being replaced by machineries. This forces the displaced workers to seek out less automated, lower skill, lower wage jobs, thereby creating a downward spiral in wages. As a result, inflation has stayed benign for so many years despite the impressive economic recovery and we expect it to stay low for many years to come. The job market has also gone through structural changes. There has been a noticeable emergence of pay by tasks jobs over the past few years, such as UBER, Deliveroo. Many also take on freelance web-based jobs amid the internet boom. As such jobs lack stability, they are likely to decrease disposable income as compared to regular salaried jobs. As a consequence, consumer patterns are likely to shift towards a more cautious one and hence putting further downward pressure on inflation.

Easy monetary policies also look to have run its course in the US as well as Europe and Japan. We now have to look to Donald Trump's fiscal stimulus for the US economy to have a chance of lifting its trend growth higher than the current range which we believe to be around 2-2.5%. Talks of the Fed reducing its balance sheet as well as the ECB tapering its purchase will be key drivers for markets for the next few months. This may also bring about some volatility in the markets which has gone missing since the start of the year. While markets may overshoot while positioning for changes in central banks' rhetoric likely action, we believe both the Fed and the ECB will be very gradual in their approach to lighten their balance sheets.

China continues to defy all odds, delivering strong economic performance in a run that looked to have started since Q316.

¹ Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 30 June 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).

Consensus expectation of a renminbi devaluation now look like a farce as the Chinese currency remained stable amid further liberalisation of the country's capital account. Consumption has become an important contributor to growth as income level rises and consumers' confidence gained strength. We also witnessed robust foreign direct investment into the high-end segments of both the services and manufacturing industries which helped keep growth elevated. Old economies such as imports & exports and agriculture has also seen stable and modest growth, giving the Chinese government the much needed room to maneuver and rebalance its economy.

While China continues to tackle issues such as excess capacity and high leverage, we are cautiously optimistic in its longer term economic development as there are several domestic growth drivers that can continue to underpin China's economic growth. This includes industrial upgrading, environmental protection, urbanisation and further growth of services sectors such as medical and education. China's effort and ability to carry out supply-side reforms while engineering slower credit expansion has been commendable and we believe they will continue with a targeted approach in boosting economic growth while maintaining stability in both liquidity management and monetary policies.

Asian economies have largely benefitted from an increase in external demand amid a synchronised growth in the developed economies. China's stable and impressive growth has also been an important factor too. Thus the near-term outlook for Asian economies will be highly dependent on the continuation of these two trends. That said, many Asian countries are not resting on their laurels. Philippines and Indonesia stands out as economies with strong structural stories. Singapore, which has been export-oriented has moved its focus to increasing productivity in recent years as it strive to rebalance its economy. Its close neighbor Malaysia has also improved ties with China through numerous infrastructure initiatives.

Asian credit market has been highly resilient and supply up to the mid-year mark has already surpassed total issuance in 2016. Valuation is looking rich as spreads are now trading near the post crisis tightness though credit metrics do suggest we are in the bottoming out phase especially for many Investment Grade corporates while idiosyncratic risks in the high yield space remains. Supply and demand technical 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 also unlikely to wane providing further support for the market. Asian currencies and local bonds have done very well year to date and we have turned cautious. While the high yielders such as Indonesia and India will continue to be in favor should the low yielding environment persists, we would await for a pull-back before re-entering these markets. The period of easing monetary policies is also likely to be behind us. While we are not expecting rapid rate hikes, certain central banks such as Bangko Sentral ng Pilipinas BSP and Bank Indonesia are very close to normalising rates amid strong economic performance.

Will 2017 be a tale of two halves? Stable fundamentals bodes well for markets. However, tight valuation calls for caution especially when central banks, led by the Fed are taking advantage of good economic data to normalise monetary policies, which could potentially lead to repricing of risk premium across asset classes. A return of volatility in the months ahead is getting likely but more importantly it opens up more opportunities.

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