First State Investments

First State Asian Quality Bond

Monthly Review and Outlook
October 2017

Market Review

Sentiments in Asian credit was strong throughout the month despite higher US treasury yields and several key events taking place that include ECB's announcement of its QE plan and the China party Congress. There were some profit taking in Chinese SOEs post the sovereign issuance but nevertheless spread for both IG and HY ended the month at a post crisis tight. JACI returned a positive 0.43% for the month largely due to the spread tightening which more than offset the higher US Treasuries yield. This brought year to date gain at an impressive 5.79%. Both IG and HY returned positively in October at 0.34% and 0.73% respectively. By country, all spread returns for the month were positive with the exception of Pakistan. Mongolia and Sri Lanka stood out once again as the top performers.

ECB announced during the month they will extend the asset purchase program (APP) for another nine months from January at a reduced monthly rate of €30 bn. This widely anticipated decision represents the second step in the gradual exit from the APP after last December´s decision to reduce the monthly asset purchases from €80 bn to €60 bn starting from April 2017. However, Draghi chose to leave the APP open-ended, without specifying an end date to this program much to the surprise of many investors. This affirms our belief that the Fed, ECB and BoJ will all cohesively wind down their own quantitative programs in an extremely gradual manner, boding well for asset prices.

Towards the end of the month, we had the most anticipated issuance as China sold its first sovereign USD bond since 2004. The 5 year bond was priced at 15bps over Treasuries while the 10 year was priced at 25bps above. Both bonds each have an issue size of USD1b. The sale followed the conclusion of the Communist Party congress where President Xi Jinping cemented his status as China's strongest leader in decades. Xi has a three-decade vision of turning China into a leading global power, with a plan to deepen China's economic ties with Asia, Europe, and Africa through a global infrastructure initiative. The issuance will help establish a benchmark for pricing foreign currency bonds from China, effectively lowering the funding costs for SOEs and other government related entities. Total issuance for the month remained robust at USD 20.7b, bringing year to date supply to 48% higher than the same period last year.

Performance Review

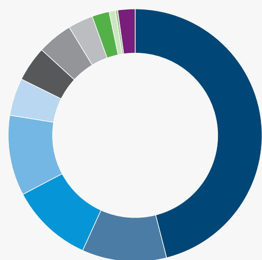
The First State Asian Quality Bond returned 0.4% (excludes initial charges) for the month of October [1].

	Cumulative Performance in SGD (%) [1]				
	YTD	1 mth	3 mths	6 mths	Since inception
Fund (Ex initial charges)	4.9	0.4	0.9	2.3	1.7
Fund (Inc initial charges)	0.7	-3.6	-3.1	-1.8	-2.3
Benchmark*	5.2	0.3	1.0	2.4	2.3

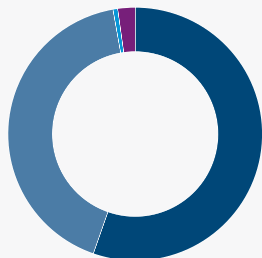
The fund has delivered strong returns this year largely due to the spread tightening in Asian credits. US treasuries yields which are still below where we started the year also contributed to the returns despite losing some ground in recent weeks. In terms of excess return, we maintained an overweight 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 CNH, IDR, INR and SGD. We recently added some AUD corporates to the fund.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 October 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).

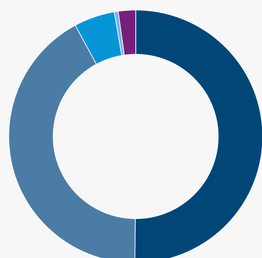
Asset Allocation (%) [2]



Country
- China 46.1
- South Korea 10.8
- Singapore 10.5
- Hong Kong 10.3
- Indonesia 4.8
- India 4.5
- Malaysia 4.5
- Australia 3.2
- Thailand 2.2
- British Virgin Isl 0.8
- Other 0.3
- Liquidity 2.2



Sector
- Govt Related 55.4
- Corporates 41.9
- Treasury 0.6
- Liquidity 2.2



Credit rating
- BBB 50.1
- A 42.0
- AA 5.2
- AAA 0.5
- Liquidity 2.2

Top 10 Issuers (%) [2]

Issuer Name	%
China Huarong	5.8
CNOOC Ltd	5.4
Hyundai Motor Co	4.9
Sinochem Hong Kong (Group) Co Ltd	4.8
China Petrochemical Corp	4.6
China Overseas Land & Investment Ltd	3.9
Pertamina Persero PT	3.8
Overseas Chinese Bk Corp	3.3
United Overseas Bank Ltd	2.8
Beijing Infrastructure Investment Co Ltd	2.8

Portfolio Positioning

We went short tactically in US duration around the middle of the month riding on the strong upward momentum in yields that was driven by optimism around the passing of US tax reforms. This trade worked well and we closed it and went back to neutral towards the end of the month when the 10 year treasury yield trade at close to the top of our identified 2-2.5% range. We also modestly increase our overweight in credit via several new issues including the China sovereign deal and also HuaRong Finance. Elsewhere, we remained overweight in the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. We also took the opportunity of currency weakness post ECB to increase our exposure in local currency credits mainly in AUD and CNH during the month, though overall exposure remain below 5%.

Investment Outlook

After months of relentless rally during which we witnessed risky assets brushing aside Fed rate hikes, geo-political tension in the Korean peninsula and China's rating downgrade, one can't help but ask is there anything that could ever derail this strong performance as we head into the final months in 2017. The Fed looks set to continue hiking interest rate and have since announced the start of their balance sheet unwind, while ECB is set to follow suit with a reduction in their own bond purchase program once the current one ends in December. Conventional wisdom suggests these actions could put upward pressure on interest rates, though recent episodes of US taper and interest rate hikes have actually led to the opposite outcome. As major central banks rhetoric has been for a long time "easy and gradual", we see little room for surprises. Investors in the short term will likely focus instead on the upcoming US debt ceiling negotiation and tax reforms. The appointment of Jerome Powell as Janet Yellen's successor as the Fed Chairman all but ensure continuity for gradual normalization process. Amid the synchronized global growth as evidenced by many developed and emerging economies posting positive figures in manufacturing PMIs, risk appetite should remain well supported. Nevertheless, we remain defensive as tight valuations make markets more vulnerable to unexpected shocks, which can include fraud and war. The biggest risks we see at the moment for bond markets especially, would be a more hawkish than expected ECB and a sudden spike up in inflation in both the US and the Eurozone.

US economy maintains its positive momentum amid a strong rebound in business investment spending, which increased by 7% in the first half and looks set to continue. Consumers' sentiment has also been strong, staying well above pre-crisis level throughout the whole of this year. With unemployment close to low 4% and non-farm payroll averaging close to 180k in the past few quarters, the Fed looks set to continue normalizing its monetary policies with both rate hikes and a reduction in their balance sheet. Nevertheless, we believe the current strong momentum in the US economy could be more cyclical in nature and the 2-2.5% GDP growth is possibly as good as it gets. With inflation likely be stuck well below the Fed's target of 2%, we believe the Fed's projection of 1 more hike and December, 3 in 2018 and a few more in 2019 is overly optimistic. Economic fundamentals certainly points to a continuation of a low growth, low interest rate environment for years to come. That said, there are several upcoming events that could lead to investors positioning for higher rates. These include positive development around fiscal policies and tax reforms and a larger than expected inflation print that will spook the market as expectations for inflation has been very low for a long time.

Eurozone growth continues to surprise us on the upside in the past few quarters as PMIs across many countries remain strong and household spending stays robust. This strong growth is especially impressive if we factor in the weaker exports which were dragged down by a strong Euro currency. Full year growth for 2017 is likely to move above 2% having been stuck at around 1.5% for the past few years. Despite the recent optimism, we are of the opinion that Eurozone trend growth remains stuck

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

at around the 1.5% level as the region still faces structural issues including an elevated unemployment rate and a lack of fiscal union amongst the members. The possibility of Catalonia declaring independence from Spain is a timely reminder that nationalistic mindset is still highly prevalent in Europe and is highly destabilizing for the region at a time when collaboration is much desired in order for the region to move forward with reforms that will improve Europe structurally. On monetary policies, ECB announced they will extend their QE for another nine months when it ends in December, albeit at a reduced amount of purchase and without an end date. Rate hike however is unlikely as inflation in the Eurozone remains very low at close to only 1% amid high unemployment rate and low wage growth.

In the past few quarters, Asian economies have largely benefitted from strong global trade and China's continued growth. While China's growth is expected to remain respectable, the risk to Asia is that the global trade cycle might have peaked. Exports figures are showing signs of softening and Taiwan's ex-China exports, which is a leading indicator for regional exports looks to have turned. Despite an outlook of slower growth as well as some central banks lamenting about the lack of growth, Asian economies are still by far expanding at a much higher level than other regions. Indonesia at above 5% and India at above 6% are more than double that of many emerging market countries. While low inflation has allowed Bank Indonesia and Reserve Bank of India to cut rates to spur economic activities, we do feel these moves are driven more by politics instead of economics.

China's excessive debt issue has been well documented and is something they will continue to tackle. However, what many had not focus on is the resurgence of China's exports after taking a back seat post the GFC during which consumption and infrastructure investments took over as major drivers of growth. What is encouraging is that China exports have structurally shifted up the value chain and have become more competitive. The high tech goods such as Huawei telecom equipment is now getting international recognition amid the private sector's shifting its focus on information technology and industrial automation. This trend if continued, will likely underpin China's ambitious goal to double its GDP by 2020. Post the 19th Party Congress, Premier Xi JinPing further consolidated his power, which will allow his party to continue with reforms that will include reducing leverage in SOEs and making them more efficient, promoting quality economic development with focus on green investment and tougher environmental regulations. We are also likely to see some easing of entry barriers, tax cuts and other measures aim at providing a more favorable backdrop for the private sector to further develop which will likely be announced in the upcoming months.

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 also unlikely to wane providing further support for the market. Nevertheless, we maintain a cautious stance as rich valuations and a strong year to date performance make our market more vulnerable to unexpected events.

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