First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

October 2018

Market Review

Sentiments in Asian credit markets were bearish throughout the month of October as equity markets globally experienced a sharp correction. This was largely attributed to the escalating trade war between the US and China as investors start to price in its impact on the real economy. While investment grade spreads were under pressure for a large part of the month, it was the sell-off in high yield that was more pronounced. Rising defaults in onshore China that does not look like abating and high refinancing needs amongst the Chinese property developers were the key factors driving the high yield market substantially weaker. JACI spreads ended the month 21bps wider at +274bps while 10 year US treasury yield also moved 8 bps higher at 3.14%, leading to a negative total return of -1.12%. Investment grade outperformed higher yield with a return of -0.73% vs the latter's -2.50%. By country, spreads return were mostly negative with the exception of Hong Kong and Korea, both of which managed to eke out a small positive return. The largest loser was Sri Lanka as political uncertainty heightened. This was followed by Indonesia as the broader emerging markets sentiment remained very fragile.

As the negative impact of the trade war starts to bite, as evidenced by the weakness in recent readings of the Purchasing Manufacturing Index, the People's Bank of China (PBoC) announced it will cut its reserve requirement ratio for most banks effective 15 October. This move will provide about RMB450bn in funds for banks to repay outstanding MLF loans with the PBoC and there will be another RMB750bn liquidity released to the banking system. This cut is a strong testament that the PBoC will remain on an easing mode for as long as the trade tension persists.

Meanwhile in Singapore, the Monetary Authority of Singapore (MAS) increased slightly the slope of the SGD NEER policy band while keeping the width and level at which it was centered unchanged. The decision to tighten policy is based primarily on the firming domestic inflation outlook. On growth, MAS expects it to continue moderating as we move into 2019 as output in the manufacturing sector levels off. What was interesting is while trade tensions are seen as the main downside risk to growth, there isn't strong evidence at this point to suggest that it has significantly impacted growth in Singapore or other export oriented countries like Taiwan and South Korea.

Due to the golden week holiday in China coupled with a bearish tone in the market, USD issuance declined to USD15.9b from USD 17.2b in September. Year to date supply remained at a significant 27% lower than the same period last year. One notable observation is that the tightening of the final price from the initial price guidance averaged only 10bps, well below the 25-30bps that we are used to. The highlight of the month has to be the multi-tranche issuance by The People's Republic of China. Despite the volatile market backdrop and heightened trade tensions, the deal received a total order that is 4.4x book across the 5, 10 and 30 year tenors. Asian investor participation leaned towards the front end, taking 77% and 67% of the 5 and 10 year tranche respectively. Pertamina also surprised the market by pricing a USD 750m 30 year deal on the last day of the month, having cancelled a tender offer for one of its shorter dated bond and indicating they will not be issuing any bonds just the week before.

Performance Review

The First State Asian Quality Bond Fund (Singapore Unit Trust) returned -0.99% for the month of October on a net of fees SGD term.

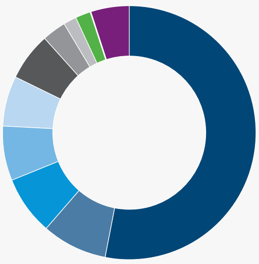
The negative return was largely attributed to rise in US treasury yields coupled with credit spreads widening. On a relative to benchmark basis, our overweight in US duration detracted value as economic data and inflation expectation in the US continue to surprise on the upside. Just as in September, our securities selection continued to detract value as our overweight positions once again lagged the broad market.

On a year to date basis, our short US interest rate duration during Q1 along with our shorts in Indonesia and Philippines we held for a large part of 1st half of the year added value. In Q3, we gave up a big part of the outperformance as our long duration position detracted value amid rising US treasury yields. Our overweight in selected issuers also lagged the broad market.

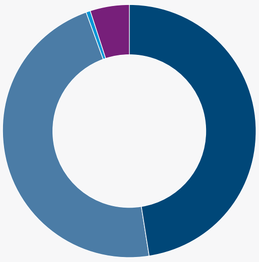
	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-4.0	N/A	N/A	-1.2
Fund (Inc initial charges)	-7.8	N/A	N/A	-3.2
Benchmark*	-2.5	N/A	N/A	-0.1

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Fund (Ex initial charges)	-1.4	-4.0	N/A	N/A	-2.3
Fund (Inc initial charges)	-5.3	-7.8	N/A	N/A	-6.2
Benchmark*	-0.6	-2.5	N/A	N/A	-0.3

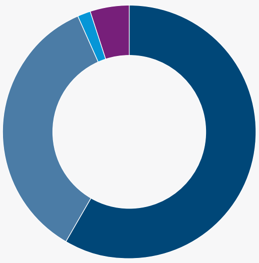
Asset Allocation (%) [2]



Country
- China 53.3
- Hong Kong 8.2
- Singapore 7.5
- South Korea 7.0
- Malaysia 6.5
- India 6.1
- Indonesia 2.9
- Australia 1.8
- Thailand 1.8
- New Zealand 0.2
- Liquidity 4.8



Sector
- Govt Related 47.6
- Corporates 47.1
- Treasury 0.5
- Liquidity 4.8



Credit rating
- BBB 58.6
- A 35.1
- AA 1.6
- Liquidity 4.8

Top 10 Issuers (%) [2]

Issuer Name	%
China Vanke Co Ltd 4.5	4.6
United Overseas Bank Ltd 4.5	4.4
Hyundai Motor Co 4.3	4.3
China Huarong 3.7	3.6
China Overseas Land & Investment Ltd 3.3	3.4
Sinochem Hong Kong (Group) Co Ltd 3.2	3.3
Nan Fung International Holdings Ltd 3.2	3.3
Ping An Insurance Group Co of China Ltd 3.1	3.3
Industrial and Commercial Bank of China Ltd 3.0	3.1
Pertamina Persero PT 2.9	3.1

Portfolio Positioning

During the month, we maintained our modest overweight positioning in IG. We also kept our moderate long position in US interest rate duration as we do not think the current trend of rising inflation and thus rising yield is sustainable amid the ongoing trade war and a fiscal stimulus that is expected to wane as we move into 2019. By countries, we remained overweight in high quality Singapore banks and Hong Kong corporates while underweighting Philippines sovereign on tight valuations. We are also underweight in Indonesia as sentiments around emerging market is expected to remain tentative at best. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We remained underweight India banks amid rising NPLs.

Investment Outlook

As we move into the last lap of a tumultuous year, plenty of uncertainties remain. Concerns around trade war between China and the US and a faster pace of Fed rate hike have been on the mind of investors for the whole of the 3rd quarter and that looks set to persist. Development around BREXIT and Italy's debt crisis will also start to get more scrutiny. While all these events have the potential to bring about more volatility, it is the rising oil price that we are more concerned about given its direct implication on inflation expectations and hence bond prices.

Since the US re-imposed economic sanctions on Iran on the 6 August, oil price rallied to the highest level in 4 years as Iranian shipment dropped sharply. A drop in oil production in Venezuela due to its ongoing economic crisis exacerbated the move higher in oil price. While OPEC members are increasing output to help alleviate the situation, the risk is that they fall short especially if demand remains strong or increases, which could easily bring oil price towards $100. If history is of any guide, such rapid increase will without doubt bring about severe stress to financial markets and market emerging markets economies. In fact we would attribute the current move higher in US treasury yields to the higher oil price instead of solely due to a faster pace of rate hikes by the US Fed in 2019. The silver lining is that supply shocks such as this one tend to be short-lived when compared to a demand driven price increase.

While US growth has been strong for the past few quarters, it was mainly due to the effects of the corporate tax cuts and investment tax incentives both of which are expected to wane as we move into 2019. If the November mid-term election lead to Democratic Party control of the House of Representatives, further fiscal plans will be even harder to negotiate and approve. The normalization of interest rate will also start to slow down the economy as financing costs rise and hence we are not convinced the Fed can continue to deliver rate hikes after the first half of 2019. The risk to our sanguine US interest rate outlook is none other than tariffs or sanctions led inflation. If the trade war escalates further leading to sharply higher imported prices, market will be forced to reassess the currently still benign inflation expectations.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 October 2018. Fund inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

[2] Source: First State Investments as at 31 October 2018.

Outside of the US things do not look so rosy. Rising oil price has already started putting pressure on countries like India, which imports more than 80% of its crude oil needs. Rising US interest rates have also put pressure on the currencies of countries running current account deficits which include India, Indonesia and the Philippines in a similar fashion as the 2013 taper tantrums. This is despite the current account deficits in the above mentioned countries still well below 3%, while in 2013, the figures were closer to 4-5% range. While we still expect many central banks in Asia to intervene when their currency volatility heightens, we know by now that may not be enough to stem the decline. This is especially so when foreign ownership of local assets is high, as is the case for Indonesia. While this is not our base case, more aggressive rate hikes by the US Fed does not bode well for emerging markets economies and Asia will not be spared. Against this backdrop, we are maintaining a cautious stance on Asian currencies at least until signs the Fed will slow up on its interest rate normalization process.

What does the uncertain outlook mean for the Asian credit market? As the US Fed continues to normalize interest rate, financing conditions globally will continue to tighten as it did in the past few quarters. Moreover, the ongoing trade war between the US and China will slow down global growth and dampen investors' confidence. While it is difficult to predict how the trade war will pan out or whether the Fed will hike interest rates more aggressively, focusing on Asian corporates' fundamentals does provide some optimism that many will be able to weather the storm. Across the investment grade universe, key measures such as EBITDA and net income margins have improved over the last three years. Debt ratios have also come off while liquidity remains ample with the average cash level at more than 30% of total debt. In the high yield space, the above mentioned metrics have also started to improve since 2017, following several years of deterioration. Hence barring a complete meltdown on the trade war front and Asian currency depreciation spiraling out of control, Asia as a region is still expected to grow at a decent rate that is well above its peers. This will likely provide strong support for the improving credit trends and translate into positive rating actions.

The rally in credit we anticipated in our Q2 outlook did materialized. JACI IG spread as at end of 3rd quarter was about 10bps tighter than the wide this year. While it is still around 30bps tighter than the post crisis average, the all in yield is now at a post crisis high following the recent run up in treasury yield. This should increase demand for Asian bonds amongst the long term investors and lifers. Asian IG bonds also offer a yield pickup of up to 50bps vs US peers, further supporting its attractiveness. Asian high yield spread has also tightened in Q3 by approximately 50bps from an oversold territory. While the spread pickup vs US HY has increased, bringing it closer to historical average, we are mindful of the idiosyncratic risks that is omnipresent amid the tightening of financial conditions. Spike in oil price will also likely bring about another bout of volatility. Despite expectations of a pickup in supply post China's Golden week in October, we do think deal size and pricing will be favorable for investors against the current backdrop of an uncertain economic outlook. Hence we believe total supply for the year will come in lower than previous year's level, providing market with a balanced technical backdrop.

Uncertainty remains, caution warranted. Stick to quality and fundamentals is still the way to ride through any storms. We would look to add more US treasuries is sell-off continues, be selective and hold a diversified portfolio of credits with strong fundamentals and avoid local currency bonds as we expect more volatility ahead.