First State Investments

First State Asian Quality Bond

Monthly Review and Outlook
February 2019

Market Review

Asian credit delivered a second consecutive month of positive performance as spreads continued to tighten amid a more dovish Fed and positive development around the trade discussion between China and the US. New issuance market remained vibrant despite the week long Lunar New Year holidays in China. JACI spreads tightened by 6 bps to 265bps while US Treasury yields edged higher with 10 year yield up 8 bps to 2.72%. JACI's return was 0.84% with High Yield outperforming Investment Grade with returns of 1.45% and 0.68% respectively. By country, spread returns were largely positive with the exception of Pakistan.

During the month, there were signs of progress in trade talks between the US and China. Proposed tariffs due to be implemented on 1 March 2019 have been delayed pending further negotiations. This was an encouraging development as existing trade tariffs appear to be having a significant adverse impact on trade volumes and in turn manufacturing activity globally. In South Korea, for example, February exports were -11.7% below levels from a year ago and imports were -17.3% lower. The positive trade related development along with the US Fed's willingness to adjust the size of its balance-sheet runoff and perhaps end it altogether by the end of the year underpinned the bullish tone in Asian Credit throughout the month.

The Reserve Bank of India (RBI) cut its policy repo rate by 25bps to 6.25% and at the same time changed its stance from 'calibrated tightening' to neutral. While their outlook for growth remained fairly balanced, they lowered their inflation over the next 9-12 months. Meanwhile, several other central banks in Asia including Bank Indonesia, Bank of Korea and Bank of Thailand all kept their policy rate unchanged. We believe central banks in Asia will remain reactive for now as their currencies have recently stabilized, while the global growth outlook remains highly uncertain.

New issuance activity in February was very vibrant despite the week long Lunar New Year holidays in China. There was a total of USD 23.4b of fixed supply which is an 85% year over year increase. This brought year to date supply to USD 49b, which is 10% higher than the same period last year. China Cinda Asset Management priced USD 1bn of bonds across three tranches on the back of a mammoth order book. Investor appetite for duration was significant as issuance volume was skewed towards the longer dated 10 year tranche. Bonds performed in the secondary trading, with the 5 & 10 year bonds trading more than 10bps tighter. China Resource Land priced a dual tranche deal issuing bonds in the 5.5 and 10 year tenor after being absent from the market for almost five years. The deal saw strong investor demand with order books over USD 10.1bn across both tranches. Both tranches priced 35bps tighter from initial price guidance which was 10 bps higher than the usual tightening.

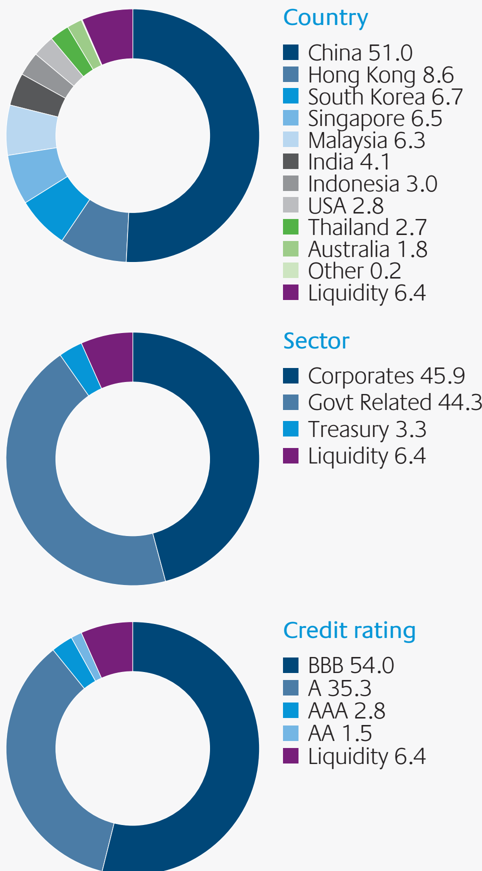
Performance Review

The First State Asian Quality Bond returned 0.82% for the month of February on a net of fees SGD term. The positive return was largely attributed to the continuation of the rally in credit amid positive development on the trade discussion between China and the US along with a more dovish Fed. On a relative basis, the First State Asian Quality Bond has outperformed the index as our overweight in credit along with security selection both added value since the start of the year.

	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	1.1	N/A	N/A	0.5
Class A (SGD - Q Dist) (Inc initial charges)	-2.9	N/A	N/A	-1.2
Benchmark*	3.2	N/A	N/A	1.6

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	3.5	1.1	N/A	N/A	1.3
Class A (SGD - Q Dist) (Inc initial charges)	-0.7	-2.9	N/A	N/A	-2.8
Benchmark*	3.5	3.2	N/A	N/A	3.7

Asset Allocation (%) [1]



Top 10 Issuers (%) [1]

Issuer Name	%
China Huarong	5.5
Bank of Communications Co Ltd	4.5
United Overseas Bank Ltd	4.3
Hyundai Motor Co	4.1
Nan Fung International Holdings Ltd	3.8
China Overseas Land & Investment Ltd	3.2
Sinochem Hong Kong (Group) Co Ltd	3.1
Ping An Insurance Group Co of China Ltd	3.0
Pertamina Persero PT	3.0
Industrial and Commercial Bank of China Ltd	2.8

Portfolio Positioning

During the month, we maintained our overweight positioning in investment grade bonds and neutral positioning in high yield. We also kept our moderate long position in US interest rate duration as signs of economic slowdown became more apparent in recent months amid the ongoing trade war and a waning fiscal stimulus. 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 we believe current valuation has already fully reflect the fundamentals. We are also cautious that the upcoming election in April may bring about bouts of volatility in Indonesian sovereign and quasi bonds. Within China, we are overweight the investment grade property, short in technology while underweighting the banks and LGFVs (Local government financing vehicles). We also maintained our underweight India banks and corporates.

Investment Outlook

As we begin the New Year in 2019, worries that have hampered market sentiment look set to persist or even intensify. Consensus is suggesting growth in the US will slow, as effects of fiscal stimulus wane. It is also widely inferred that the inverting yield curve always precede a recession. On top of that, many believe after close to 10 years of economic expansion, the probability of the US economy slowing has increased significantly. With Europe and Japan already slowing significantly in the past few months and the rest of the world starting to feel the pain of the ongoing trade war between the US and China, it is indeed hard for one to be optimistic in the current environment.

The US economy has been leading global growth for a large part of 2018, more notably in the second half of the year. Hence how the economy performs in 2019 and the subsequent impact on the Fed's rate hike trajectory will come under even more scrutiny as it will have a material impact on asset prices for Q1 2019. Many forecasts by economists and even those by the US Fed are pointing to slower growth ahead. Key reasons include the waning of fiscal stimulus, an economy that is already at full employment and the lagged impact of previous rate hikes. Recent trade data also suggests that US exports to China has been declining sharply, as a result of the tariffs imposed by China, providing a further drag on growth. While it is hard to argue against the above reasons and in fact we do think the US economy will eventually slow, we feel the market is a tad too early and too pessimistic in pricing in a recession and pricing out further rate hikes. This is because we believe being in the late cycle of a decade long economic expansion does not necessarily means growth will screech to an abrupt halt. Following the 4th rate hike in 2018, the Fed turned dovish as they are now more cautious of the global growth outlook even though they believe US economy remains strong. They now see only 2 hikes for 2019 which suggest one hike in March and another in June should the economic momentum continues. We agree with the Fed this time as projecting 2 hikes is appropriate at the moment as we expect to see slowdown to start looking more pronounced only in the second half of the year. We also expect the US treasury curve to fully flatten to around the 2.8% handle by the end of Q1. We currently see value in the short end 2-5 year part of the curve. While all attention has been on the trade war leading to an obvious slowdown in growth, we reiterate that a key risk market is not currently prepared for is a tariffs led inflation. If the US and China fail to come to a compromise at the end of the current 90 day trade truce, it could potentially lead to a breakdown in global supply chain and as a result, higher imported prices. This will force market to reassess their inflation expectations, which is currently very benign.

[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 28 February 2019. the First State Asian Quality Bond inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

While market remains fixated on the development of the US-China trade war, cheering any reprieve in trade tensions between the two nations, we believe the ongoing spat between the number one and two economy will persist as the US will pull out all the stops to prevent or at least slow down the ascend of China. In other words, market volatility will remain heighten as asset prices continues to react to these political noise. Trade war will never be positive for anyone. That said, export data from recent months seem to suggest that China has coped much better than the US. This was largely attributed to China's nimbleness in diversifying its export markets away from the US, policy support for exporters in the form of export tax rebates, as well as a favorable exchange rate as the renminbi continues to weaken against the dollar. We expect China to continue pushing forward reforms despite a slowing economy and continue boosting liquidity as it has done in 2018. Amid slower growth and challenges arising from the trade war, we expect the Chinese government to increase the budget deficit to 3.0% of GDP in 2019 from 2.6% in 2018, providing policy support in targeted area, not the broad based stimulus many are hoping for. We also expect the People's Bank of China (PBoC) to continue cutting the reserve requirement ratio (RRR) by another 200bps next year to keep an easing bias in the monetary policy. In summary, we are positive that China still has plenty of levers to rebalance and prop up the economy to above the 6% handle despite the challenges they are facing at the moment.

Away from China, the rest of Asia ex Japan is still expecting to deliver a decent growth of well above 5%, albeit at a slower rate when compared to previous years. The more open and trade focused economies including Singapore, South Korea and Taiwan will be more vulnerable in the current environment especially if the trade tension between the US and China is to intensify. Thus growth rates in these economies are likely to surprise on the downside. Philippines stood out throughout the whole of 2018 delivering exceptional growth and this strong momentum is set to continue into 2019 as the government continues to roll over infrastructure projects. This strong growth came at a price as it brought about an inflation problem amid an overheating economy even though inflation looked to have peaked. Apart from the Philippines, inflation across Asia remains very benign. In 2018, many Asian central banks hiked policy rates for varied reasons. Bangko Sentral ng Pilipinas hiked to combat inflation, Bank Indonesia and Reserve Bank of India hiked to stem currency weakness, while Bank of Thailand and Bank of Korea hiked as part of the monetary policy normalization process. While there could still one or two hikes left namely in Thailand and South Korea, we believe the tightening cycle in Asia is largely behind us. We expect central banks to be more reactive instead of preemptive in their next move. In fact we would not be surprised if some even cut rates should growth deteriorates sharply. Key events to look out for includes election in both Indonesia and India around April, which may bring about some volatility.

In 2018, focusing on credit fundamentals and relative value opportunities was key in delivering good performance as we begin to see divergence in spreads across sectors and issuers. We would expect this to be more important in the New Year as we are at the late part of the economic cycle. Across the investment grade universe, we continue to get comfort that 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. Earnings growth for Asian corporates as a whole is also expected to perform strongly in 2019 despite a slowdown in Korea, Taiwan and specifically the technology and telecommunication sectors. At the point of writing, the JACI IG spread at above 200bps is approximately 50bps wider than the recent tights. We view this level as fair, considering the strong credit fundamentals though the uncertain macro environment calls for caution. Within China, value is already emerging in the IG property space with spreads well above 200bps. Technology names including Tencent and Alibaba have also weakened to an attractive level though they are still vulnerable to headline news concerning US and China. We have turned cautious on Indian corporates amid the political uncertainty in the country. Indonesian sovereign and quasi's performance will very much be dependent on whether emerging market as an asset class bounce back from a dismay year of performance in 2018. The biggest risks for Asian IG at the moment would be a continued weakness in US IG, which has shown more pronounced weakness in the recent months, having held up very well for a big part of 2018. Any further weakness in US IG will inevitably have a spillover impact on Asian credits notwithstanding our stronger fundamentals. Nevertheless, further spread widening should provide investors with opportunities to accumulate exposures in high quality names at an attractive price. So be patient as we await opportunities in what we think would be a tumultuous year for risky assets.

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