First State Investments

Asian Credit Market Review

Quarterly Review and Outlook

Q3 Review 2018

RISK FACTORS

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The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.

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Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Market Commentary

The third quarter of the year was a highly eventful one during which the trade war between the US and China took a turn for the worse. We also witnessed the US Fed continue to hike policy rates amid strong economic data, while China went the opposite way and loosened financial conditions as the effect of the ongoing trade war started to bite. The retracement in credit spreads (that we were positioning for) came, but not without some volatility. For the quarter, JACI[1] spread finished 14 bps tighter at 253bps. Spread returns were positive across all markets. The third quarter also saw the reversal of consecutive quarterly declines this year, with total return coming in at 1.16%, bringing year to date loss lower to -1.41% (gross of fees).

In light of the prospects of slower growth amid the trade war with the US and the ongoing deleveraging which has been in place for the past two years, China policy makers stepped up their efforts to prop up growth with a series of easing measures during July. This included the China Banking and Insurance Regulatory Commission asking commercial banks to increase loan supply to private companies and small and medium enterprises. The party leaders also agreed at a politburo meeting to adjust the official monetary policy stance from “prudent and neutral” to merely “prudent”- a clear move towards loosening. Nevertheless, Premier Li Keqiang downplayed the impression that the government is returning to heavy handed stimulus by describing the shift towards easing as ‘fine tuning’.

Following months of turmoil including sanctions imposed by the US, sky rocketing inflation and a rapidly depreciating currency, the Central Bank of Turkey (CBT) finally acted by raising its key one week repo rate by 625bps to 24%. This move was well above market’s expectation and more importantly, it went against President Erdogan’s aversion towards conventional monetary policies. Markets cheered the CBT’s ability to remain independent, sending the lira stronger by 7% for the month of September. This strong move in the lira coupled with stability in the renminbi provided some reprieve for emerging market assets. There were also several rate hikes by Asian central banks during the quarter though for varying reasons. Bangko Sentral ng Pilipinas (BSP) hiked to curb inflation amid an overheating economy, whilst Bank Indonesia (BI) hiked in a bid to stabilize the rupiah even though they do not have an inflation problem.

New issuances picked up some momentum during the quarter, especially when compared with a lacklustre first half. Some notable deals included Sinopec USD 2.4bn issuance across 5, 7, 10 and 30 year tranches, Republic of Korea’s USD1bn issue across 10 and 30 year and the biggest deal of the year Sands China bumper USD 5.5bn deal across three tranches, all of which were very well received. Singtel returned to the USD bond market after a two year hiatus and saw strong demand for its 10 year offering. Orders were in excess of 5.7x the issue size with demand coming from mostly Asian fund managers. The 10 year bonds eventually priced at a spread of 105bps, after tightening 20bps from initial price guidance. Despite these mega deals, year to date supply is still 28% lower than the same period last year.

[1] JP Morgan Asia Credit Index

	Cumulative Performance in USD (%)				
	3 mths	YTD	1yr	3yrs	5yrs
Asian Quality Bond Investments	0.53	-1.52	-0.99	10.45	20.47
JPMorgan JACI Investment Grade	0.76	-1.18	-0.88	9.98	22.58

Annual Performance (% in USD) to 30 September 2018

Period	12 mths to 30/09/18	12 mths to 30/09/17	12 mths to 30/09/16	12 mths to 30/09/15	12 mths to 30/09/14
Asian Quality Bond Investments	-0.99	1.49	9.91	2.39	6.52
JPMorgan JACI Investment Grade	-0.88	1.21	9.63	3.20	8.00

Source: First State Investments

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

Source First State Investments (no Lipper at all), Net of Fee Returns as at 30 Sep 2018. Fee applied is 30 b.p. pa
Performance is based on the FS Asian Quality Bond Investments Composite, Inception date 01/01/2000.
*The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index.

Fund Positioning

Throughout the month, we maintained our modest overweight positioning in credit. 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 but were underweight Philippines sovereign on tight valuations. We are also underweight in Indonesia as sentiment around emerging markets is expected to remain tentative at best. Within China, we are overweight the investment grade property, short in technology and underweight banks and LGFVs (Local government financing vehicles). We remained underweight India banks amid rising non-performing loans.

Investment Outlook (For Q4 2018)

As we move into the last lap of a tumultuous year, plenty of uncertainties remain. Concerns around the 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 duration of the third quarter and that looks set to persist. Development around BREXIT and Italy's debt crisis will also start to get more scrutiny. Whilst all of 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 four 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 (the Organisation of the Petroleum Exporting Countries) 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 a guide, such rapid increase will without doubt bring about severe stress to financial markets and 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.

Whilst US growth has been strong for the past few quarters, it was mainly due to the effects of 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 normalisation of interest rates will also start to slow down the economy as financing costs rise, 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, markets will be forced to reassess the currently still benign inflation expectations.

Outside of the US things do not look so rosy. A 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 fact that the current account deficits in the above mentioned countries are still well below 3%, when in 2013 the figures were closer to 4-5% range. Whilst 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 that the Fed will slow up on its interest rate normalisation process.

What does the uncertain outlook mean for the Asian credit market? As the US Fed continues to normalise interest rates, financing conditions globally will continue to tighten as they have in the past few quarters. Moreover, should the ongoing trade war between the US and China slow down, global growth and dampen investors' confidence. Whilst 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[2] 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.

[2] Earnings before interest, tax, depreciation and amortization

The rally in credit we anticipated in our Q2 outlook did materialise. JACI investment grade spread as at end of the third 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 investment grade bonds also offer a yield pickup of up to 50bps vs US peers, further supporting its attractiveness. 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 the 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 storm. We would look to add more US treasuries if 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.

For further institutional enquiries contact institutionalenquiries@firststate.co.uk

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