First State Investments

First State Asian Quality Bond

Monthly Review and Outlook

August 2019

Market Review

August will be best remembered as a month mired with uncertainties. We have the tit-for-tat retaliations between China and the US which continues to weigh on sentiments. Probability of a no deal Brexit further exacerbated the negative mood in the markets. Renminbi convincingly breached the key 7 handle for the first time in more than ten years, causing much volatility in Asian currencies. On top of that, an inversion of the US treasury curve led to more investors worrying about the state of the global economy as recession now looks imminent in the months ahead. As the risk-off mode went into full swing across risky assets, JACI spreads were not spared widening by 19bps to end the month at 279bps. Nevertheless, total return was positive at 1.48% all thanks to the remarkable rally in US treasuries as market started pricing in rate cuts by the Fed in the coming months. Investment grade bonds outperformed high yield with return of 2.22% vs a negative 0.94% for the latter. By country, spreads return were largely negative with frontier markets including Pakistan, Sri Lanka and Mongolia underperforming by the most. Hong Kong corporates also had a tough month as protest in the territory continued to turn more violent without any signs of abating.

During the month, China announced key interest rate reforms to help steer borrowing costs lower amid a slowing economy. Under the new mechanism, bank lending rates will be linked to the loan prime rate, which will be in turn linked to the People Bank of China's medium term lending facility interest rate. What this means is that in future when policy interest rate falls, loan interest rate will fall too. One thing to note is this liberalization focuses only on the lending rate while the deposit rate was left untouched. Outside of China, we witnessed a series of rate cuts by other Asian central banks from Indonesia, India, Thailand and Philippines. Even though Bank of Korea was on hold during the month, they signaled clearly that they are open for further easing. Most of the above mentioned central banks' rhetoric suggest that their cuts were preemptive, in view of the deteriorating global outlook and uncertainty. Nevertheless, data released in recent months seem to suggest that domestic demand in many Asian economies is clearly on a weakening trend. For instance India, a domestic demand driven economy delivered a Q1 GDP growth at only 5%, the lowest in 25 quarters and the first time since March 2013 that growth has been sub-6% for two consecutive quarters.

Amid the weak sentiments, new issues activity declined significantly during the month with total issuance at USD 8.7b which was 70% lower than the month before. Nevertheless, this brought year-to-date issuance to USD 193b which is still a robust 55% higher than the same period last year. Some notable deals included Sinopec's USD 2b three-tranche deal, which was announced right after the Fed's rate cut announcement. The deal received a healthy demand of USD 4.3b worth of order. Meanwhile, Singtel issued USD 750m of 10-year senior unsecured bonds which was very well received by investors with an order size that is 3.6x of issue size.

Performance Review

The First State Asian Quality Bond returned 2.23% for the month of August on a net of fees SGD term.

The positive return was largely attributed to the spectacular rally in US treasury which more than offset the spread widening in Asian credits. On a relative basis, the fund outperformed the index in August largely due to our overweight in US duration and underweight in Indonesia and Philippines spread duration along with our cautious stance in credit.

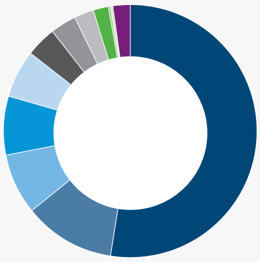
On a year-to-date basis, our overweight in credit along with security selection both added value during the January to April period. Our overweight in US interest rate duration which we held since the start of the year also contributed positively to our excess return. This outperformance was especially significant in the May to August period during which the 10-year US treasury yield rallied by around 100bps. Our underweight in both Indonesia and Philippines spread duration detracted value.

	Annualised Performance in SGD (%) [1]			
	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	9.3	N/A	N/A	3.0
Class A (SGD - Q Dist) (Inc initial charges)	4.9	N/A	N/A	1.5
Benchmark*	10.8	N/A	N/A	4.0

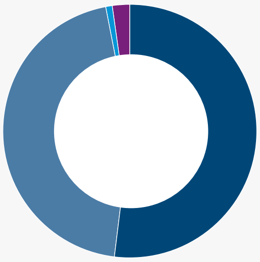
[1] Source: Lipper, First State Investments. Single pricing basis with net income reinvested. Data as at 31 August 2019. The First State Asian Quality Bond inception date: 1 November 2016. * The benchmark displayed is the JP Morgan Asia Credit Investment Grade Index (SGD Index) (Hedged to SGD).

	Cumulative Performance in SGD (%) [1]				
	3 mths	1 yr	3 yrs	5 yrs	Since inception
Class A (SGD - Q Dist) (Ex initial charges)	3.9	9.3	N/A	N/A	8.6
Class A (SGD - Q Dist) (Inc initial charges)	-0.3	4.9	N/A	N/A	4.3
Benchmark*	4.3	10.8	N/A	N/A	11.8

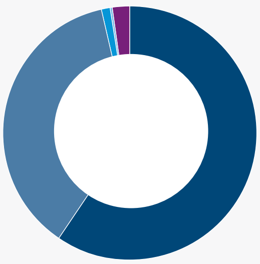
Asset Allocation (%) [1]



Country
- China 52.5
- Hong Kong 11.7
- Singapore 7.8
- Malaysia 7.6
- South Korea 6.1
- India 3.7
- Indonesia 3.4
- Thailand 2.5
- Australia 2.0
- USA 0.3
- Other 0.2
- Liquidity 2.0



Sector
- Corporates 52.1
- Govt Related 45.0
- Treasury 0.8
- Liquidity 2.0



Credit rating
- BBB 59.6
- A 36.9
- AA 1.1
- AAA 0.4
- Liquidity 2.0

Top 10 Issuers (%) [1]

Issuer Name	%
China Huarong	4.8
Genting Berhad	4.1
Bank of Communications Co Ltd	3.9
United Overseas Bank Ltd	3.8
Sinochem Hong Kong (Group) Co Ltd	3.7
Hyundai Motor Co	3.6
Industrial and Commercial Bank of China Ltd	3.5
Nan Fung International Holdings Ltd	3.5
China Construction Bank Corp	3.0
China Overseas Land & Investment Ltd	2.9

Portfolio Positioning

We remained cautious in the credit market holding on to our neutral to modest long spread duration positioning in both investment grade and high yield, even though value is starting to emerge in some investment grade Hong Kong corporates. We maintained our maximum long strategy for US interest rate duration as our view on global economic growth outlook remains bearish. With trillions worth of developed market debt in negative yielding territory, US treasuries look very attractive. Furthermore, Powell's signaling Fed's willingness to cut policy rate further will lend more support to US treasuries. By country, we remained underweight in Philippines sovereign on tight valuations. We do not like India banks and corporates as valuation does not reflect the fast weakening fundamentals. We are also underweight in Indonesia as we believe all the good news have been priced in following the spectacular year-to-date performance in Indonesian spreads. Within China, we are overweight investment grade properties, banks' leasing companies and asset management companies while underweighting core SOEs, banks and LGFVs (local government financing vehicles).

Q3 Investment Outlook

Financial markets entered the second half of the year on a sanguine beat following the resumption of trade talks between the US and China, coupled with dovish rhetoric from both the Fed and the ECB. The search for yield in the bond market will likely persist for a while as the lower for longer theme re-emerges following a period of monetary tightening. However, if we look beyond the positive technical backdrop, there is hardly anything to cheer about when it comes to fundamentals as global growth outlook continues to deteriorate. With fixed income markets delivering extraordinary returns year-to-date; many of which have exceeded double digits by the half-year mark, it pays to be cautious as we navigate the murky path for the rest of the year.

When we started the year, market was pricing in two Fed rate hikes for 2019. That expectation has now become two rate cuts between now and the end of the year. While the debate will continue on whether the US goes into a recession and by how much the Fed should cut rates, the trend towards slower growth has become more apparent since the last quarter. We would also reiterate our skepticism towards the effectiveness of the Fed and ECB's ultra- easy monetary policies following a decade long of reckless money printing. We further question the ability of these major central banks to cope with the next crisis as it now has limited options in their toolkit with interest rates so low and monetary conditions already very easy.

While many are relieved that trade talks between the US and China has resumed, we are of the opinion that the damage is already done. Business confidence has taken a hit and that will take time to recover. The disruption to supply chain in the technology sector is highly worrisome and the impact is somehow underestimated by many. Even if the trade war is to stop, the technology war between the US and China looks set to continue as both strive for world dominance. Against the backdrop of slower growth, a lack of inflation and rate cuts from the Fed, we remain very bullish on US treasuries especially when compared to the meagre yields in other developed markets.

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

Global growth outlook seems to have turned for the worse. Amongst the world's 16 largest economies, 11 now have a PMI reading of under 50, the largest number since April 2011. With the slowdown in exports, countries such as South Korea and Singapore have both lowered growth forecasts. Even economies with a strong domestic story which include Indonesia and Philippines are facing slower growth too. Just like the developed economies, inflation across Asia remains very benign. For instance Indonesia and India, economies that were used to inflation in the 5-6% range are now printing at half or less of that range. This gives Asian central banks the flexibility to cut rates if they need to. In fact Malaysia, India and Philippines have already done so, with South Korea and Indonesia likely to follow suit in the coming months. China has been bearing the brunt of the trade war and inevitably monetary and government policies will continue to ease in order to support growth. At this point, we are of the opinion that fiscal policies will remain targeted as there are still traces of the excesses from the mammoth stimulus rolled out during the last global financial crisis. While China has the levers to prop up their economy and prevent a collapse, we do not share the same hype as other market participants as the quality of growth will be poor. Furthermore, many issues that China is facing right now are mostly external and are beyond their control.

Credit markets have entered into a "buy first, worry later" mode amid the lower for longer theme. However, we believe such reckless behavior will be punished once investors realize whatever the central banks do may not be enough to prevent the next downturn. Following the strong rally this year, risk premium is way too low to compensate for the heightened uncertainty of trade war, technology war and the imminent slower global growth. A key risk for credit market we would like to highlight is that US corporates have accumulated significant amount of debt in the past decade, taking advantage of the low interest rate environment. Total non-financial corporate debt to GDP ratio has now risen to the highest level by record. The multi-fold expansion of the BBB segment of US investment grade bonds makes it very vulnerable should slower growth in the US eventually lead to a slew ratings downgrade in this segment. Any downgrade related forced selling will inevitably put pressure on Asian credit spreads despite our stronger fundamentals.

At the end of June, JACI spread has tightened by almost 30bps year-to-date despite rising uncertainty and weakening fundamentals. At the same time, 10-year US treasury yield has declined by almost 70bps as market swung from pricing in rate hike to now rate cuts. Total return at above 8% for the JACI is now approaching two times that of the 5-year index average return. While we are still confident that US treasury will continue its rally thereby boosting total return, we are less certain of the trajectory of credit spreads should a US or global recession materialize. The risk reward certainly does not warrant moving down the credit curve notwithstanding the near term technical backdrop which remains very strong. Against this backdrop, stay with quality and look before you leap!