

Asian Quality Bond

Monthly Review and Outlook

February 2017

Market commentary

Despite continued uncertainties around Trump's policies and European politics, coupled with rising expectation of a March rate hike by the US Fed, risky assets including Asian credits have a strong month of performance as volatility remained subdued. JACI returned a positive 1.41% as spreads tightened by 8 bps to end the month at 223bps while US treasury rallied with the 10 year yield ending the month 6 bps lower at 2.39%. Both investment grade and high yield performed well with the latter outperforming (1.7% vs 1.34%) as it continues to be favored as market's expectation is still for US rates to head higher over time. Spread returns were largely positive across all markets except negligible declines in India and South Korea. Top performers for the month were Mongolia (1.73%) and Sri Lanka (0.64%).

At its first meeting for 2017, the US Federal Reserve Open Market Committee (FOMC) left the official Fed Funds target rate unchanged at 0.5%-0.75%. The decision was largely expected by markets and is consistent with expectations that the Fed will wait for more insight into any potential fiscal stimulus coming from Trump. Overall, the Fed gave an upbeat assessment on the US economy. During the month, investors were keenly awaiting development of two events. President Trump's highly anticipated address to Congress and comments from the FOMC on 1 March. The former did little to move markets as Trump's address turned out to be much ado about nothing, failing to provide further clarity on tax policies. However, the latter had a notable impact as key US Federal Reserve members convinced markets that a rate hike in March was likely.

Over in Asia, central banks from South Korea, Indonesia, Philippines and Thailand all kept their policy rate unchanged amid benign inflation and uncertainty over Trump's policies. We sense that there is a general cautiousness towards what subsequent rate hikes in the US will do to Asian currencies. This inaction also affirmed our belief that rate cut cycle is effective over in Asia barring a major downturn in the regional economies.

New issuance in Asia was very robust with a total of USD12.99b printed. Demand remained very strong despite market expectations that US interest rate will rise through the course of the year. China was once again the largest issuer, accounting for 67% of supply. This was followed by Hong Kong and Korea, each accounting for 8%. We also saw a significant increase in high yield issuance, accounting for 32% of total supply following a barren spell for a large part of 2016. There was yet again several mega issues which included China Development bank (US\$2B), Bank of China (US\$2B), ICBC (US\$2B), Huawei (US\$1.5B), Korea Development Banks (US\$1.5B), Citic limited (US\$1.25B) and Hong Kong government (US\$1B Sukuk) all of which were very well received.

Performance

The First State Asian Quality Bond Fund returned 1.33% net of fees for the month of February.¹

Portfolio positioning

During the month, we maintained our short US duration strategy as we have concerns over a potential overshooting in market's positioning for an inflationary environment amidst Donald Trump's expansionary fiscal policies, though we maintain that it would take time for these policies to change the US economy structurally especially on the inflation front. We maintained a neutral positioning on credit spreads as valuation remained tight amid heightened uncertainty in both the political and global growth outlook, though we were fairly active in some of the primary issues. We stayed defensively positioned, overweighting the high quality Singapore banks and Hong Kong corporates while underweighting Indonesia and Philippines sovereign. Within China, we are overweight the investment grade property and technology while underweighting the banks and LGFVs (Local government financing vehicles) on supply concerns. We are underweight India banks on tight valuations offset by an overweight in Corporates. We maintained around 5% exposure to local currency bonds.

Investment outlook

As we move into Q2, the uncertainty clouding financial markets does not seem to be abating. We have the French and German elections coming up, BREXIT negotiations will soon start and Yellen has all but guided the first rate hike for the year is about to come. Donald Trump's protectionism and fiscal policies remain on the forefront of investors' mind. Fiscal stimulus from the US if implemented on a large scale could provide immediate boost to both consumers' and markets' confidence, which is good for risky assets. However, if this leads to higher inflation and more US treasuries issuance, bond market might come under further pressure. There are also some clear signs that inflation in the US is edging higher, this is likely to be exacerbated by the low base effect of crude oil as prices continue to recover from 2016 lows, not great news for bond investors.

While short term outlook for fixed income looks challenging, we are still mired in a long term sluggish global growth environment amidst low productivity and deteriorating demographics in both the US and other developed economies, all of which are structural in nature. This means that interest rates globally is likely to remain much lower when compared to historical levels even if policy rates in the US is

¹ Source: First State Investments as at February in USD.

to normalize further. Also, China looks to be doing a good job in maneuvering its growth lower without causing much disruption to its economy. During the recent National Party Congress, the Chinese leaders set growth target at 6.5%, which is still a robust number despite being lower than what we were used to. A China growing slower but on a firmer footing would certainly bode well for Asian economies as this will likely underpin a case for more robust intra-Asia trades.

Positioning for USD strength and higher US rates has been waning but is likely to return barring Trump overpromising and under-delivering. Nevertheless, European Central Bank and Bank of Japan staying accommodative means that the global search for yield will likely continue. Asian credit market has been resilient, surviving the past few risk driven events including Brexit and Trump relatively unscathed. While valuation appears rich and has been getting richer since the start of the year, demand and supply technical backdrop has been extremely strong which means any sell-off will likely be brief. Asian currencies have been oversold since last November and we are likely to start seeing some intervention from Asian central banks should this depreciating trend continues. On the other hand, should development in the US fall short of market's optimistic expectations, we could see a quick reversal in the unrelenting dollar strength.

Economic growth in the US has been stable in the past few quarters bringing the US Fed closer to achieving its dual mandate of full employment and price stability. Unemployment rate is now below 5% while core PCE has been hovering around the 1.7% level with strong signs of edging towards the Fed's target of 2%. Growth trajectory for 2017 will hinge heavily on how much Trump delivers on his pre-election promises, which include significant tax cuts, increase in fiscal stimulus and lesser regulations. Trump's policies will certainly have some impact on the Fed's assessment on the US economy though subsequent rate hikes are still expected to be gradual for now. What is certain though is that expectations for a boost to the economy led by Trump's policies are very high, which lends itself to some disappointment should Trump under delivers.

Despite exhibiting some strong growth momentum with PMI in Q4 hitting a 2016 high at 54.4, growth within the big four economies in the Eurozone remains mixed with Germany and Spain showing positive development while France and Italy lagged. Growth outlook for the New Year is one that would be slow and steady, likely in the 1-1.5% range though that would be lower than the 1.9% in 2015 and 1.6% projected for 2016. Against this backdrop, we see little price pressure in Eurozone especially with wage growth remaining subdued

as productivity remains low just like that in the US. Political uncertainty would once again be of focus with the France and Germany elections expected to take place this year. Thus it would be hard to get excited over Europe's growth prospects and the slow but steady growth in the 1% handle looks to be the best outcome one can expect over the next few years.

Over in Japan, it looks to be another year of more stimulus from Abenomics though as we have mentioned in the past few years things hasn't really changed structurally for the land of the rising sun. A weaker yen in 2017 will likely give a further boost to exports, which surprisingly held up very well for a big part of 2016. Unemployment in Japan continues to move lower hitting a mid-1990s low at around 3%. However, that hasn't translated into higher inflation which BOJ has been targeting for years without success and it is something we doubt they will ever achieve. Against this moderately positive economic backdrop, BOJ should have some breathing space and has lesser urgency for further monetary easing in the near term.

The outlook for Asian economies looks challenging for 2017. The region is facing heightened external uncertainties which include potentially a faster than expected Fed rate hike, US trade policies which for now look unfavorable if Donald Trump executes his pre-election promises and a China that is willing to accept slower growth in the next five years. Trump's US trade policies will likely keep Asian exports subdued despite recent Asian currencies' weakness which is expected to boost volume. Asian central banks have room to cut policy rates to spur growth, though we believe many will at least wait for their currencies to stabilize before contemplating their next move. Against this backdrop, we expect export oriented economies like Singapore, South Korea and Taiwan to be more vulnerable, while countries that have a favorable domestic story including Indonesia, Philippines and Vietnam to fare better. On a brighter note, the Chinese economy looks to be on a firmer footing despite the slower growth. This has been largely driven by targeted infrastructure spending and a robust property market. Going into the New Year, we expect to see some property cooling measures in the top tier cities, continued reforms on the SOE front and some infrastructure spending in specific areas such as public housing and rails. China also has to do more in terms of corporate deleveraging and preventing capital outflows amid a depreciating currency. Nevertheless, we believe the government still has the levers to guide growth towards their target of around 6.5%.

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