

Asian Quality Bond

Monthly Review and Outlook

April 2017

Market commentary

Monetary policy and US political uncertainty took a back seat in April as geopolitical risks and the first round of the French election were the focus during the month. Rising tensions between the US and North Korea over missile testing and the US retaliation on Syria's chemical weapons dominated headlines. The uncertainty largely led to a risk-off tone in Asian credit markets early in the month. This was partly reversed later in the month after the first round of the French election, which saw some of the risks around the political situation in Europe dissipate. The highly anticipated tax reforms in the US left markets trying to decipher the potential impact but currently appear lacking in details.

JACI returned a positive 0.51% on the back of the rally in US treasuries which more than offset the credit spreads widening. US 10 year treasury yield ended the month 10bps lower at 2.28% while the JACI spread widened by 7bps to 228bps. Investment grade underperformed high yield yet again on a spread basis even though both posted positive total returns. Spread returns by countries were mixed. Frontier markets including Vietnam, Mongolia and Pakistan all witnessed tighter spreads, outperforming rest of the universe where spreads widened.

Globally, monetary policy remained unchanged for the month starting with the Reserve Bank of Australia (RBA) which held rates steady at 1.50%. The European Central Bank retained its easing bias but pointed to a more solid growth story than in 2016. The Bank of Japan also kept monetary policy steady but raised its GDP growth forecast. Whilst the US Federal Open Market Committee did not meet in April, Federal Reserve (Fed) Chair Yellen reiterated that the pace of rate hikes will remain gradual and that there was no appetite within the Fed to rapidly increase rates.

Since the start of the year, we witnessed a strong uptick in Asian exports and improving PMIs and this trend looks set to continue. Exports data released during the month from South Korea and Singapore were very encouraging, leading to their respective central banks keeping policy rates unchanged while maintaining a cautiously optimistic outlook. During its monetary policy meeting, Bank of Korea (BoK) left the policy base rate unchanged at 1.25% while raising their 2017 GDP and CPI forecasts by 10bp each to 2.6% and 1.9% respectively. BoK expects the recovery to build momentum in 2018, forecasting next year's growth at 2.9% with CPI steady at 1.9%. Against the backdrop of a higher than expected growth but a still uncertain outlook, Monetary authority of Singapore (MAS) maintained status quo at the semi-annual monetary policy review as widely expected by the market. They maintained a zero appreciation slope, with no change in midpoint or policy band. MAS has reduced

the S\$NEER slope incrementally since 2015 and adopted a zero appreciation slope since Apr-16.

Supply continues to be robust with another USD23.9b of fixed rate issues printed in April bringing year to date supply to 93% higher year on year. Chinese issuance dominated yet again accounting for 85% of this month's supply, though what is more significant is the increase in Chinese high yield since the start of the year amid stricter onshore access and this is expected to continue in the coming months.

Performance

The First State Asian Quality Bond Fund returned 0.37% net of fees for the month of April.¹

Portfolio positioning

During the month, we increased our short US duration strategy as we believe more details around the US tax reforms and the talk of longer dated US treasury issuance are likely to keep US rates elevated in the near term. We kept our neutral positioning on credit spreads as valuation remained fair at best albeit some improvement in financial metrics across many corporates in our universe. 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 Indian corporates. We reduced our local currency bond exposure in Indonesia and India following stellar year to date performance.

Investment outlook

As we move towards mid-year, the uncertainty clouding financial markets looks set to further heighten. Following Macron's victory in the French election, we now turn to the upcoming German elections, BREXIT negotiations has been triggered and now we are faced with increased possibility of a second Scottish referendum. Yellen has just hiked twice in the space of 3 months though remaining dovish, while much attention will once again be on whether Trump can make any progress on his proposed tax cuts and fiscal stimulus. 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

¹ Source: First State Investments as at 30 April, 2017 in USD. Performance is based on First State Asian Quality Bond Fund Class I (USD - Acc).

treasuries issuance, bond market might come under further pressure. This will likely remain the underlying theme driving fixed income markets in the coming months, though the recent fall in commodity prices if continued coupled with weaker than expected economic data might push yields lower.

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 to normalize further. What is encouraging for risky assets is that 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. While positioning for USD strength and higher US rates can be fickle, 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.

Economic growth in the US has been stable in the past few quarters underpinned by a turnaround in business investment spending as commodity prices continue to recover. Meanwhile, wealth effect arising from a significant increase in home and equity market has not quite translate into robust consumer spending, which has been stable at best. Nevertheless, with the US Fed having achieved its dual mandate of low unemployment of below 5% and inflation of close to 2%, the Fed is likely to continue normalizing interest rate and potentially lighten up its balance sheet before Yellen's tenure as chairman ends. Growth trajectory for 2017-18 will hinge heavily on how much Trump delivers on his proposed tax cuts, effectiveness of

his fiscal stimulus and the type of deregulations he rolls out. While responses to Trump's policies have been upbeat and is likely to boost inflation expectations, it is too early to assess whether these will have a longer term structural impact on the US economy, which still faces issues of poor demographics and slow productivity growth.

Despite the Eurozone exhibiting some strong growth momentum with PMI consistently surprising on the upside, we aren't ready to get excited about a region that will grow only in the range of 1-1.5%. Headline inflation has risen to 2% largely due to higher energy prices though core inflation at below 1% is unlikely to give the ECB much comfort in removing their easy monetary policies too quickly. Political uncertainty will continue being the focus now than UK has activated Article 50 and set off a 2 year negotiation process. Should the UK economy performs well in the years ahead, it might trigger thoughts by other EU nations to leave as well. That said, Macron's victory in the recent French election has provided much relief as it dissipates the possibility of a breakup in the Eurozone which appears very likely if Le Pen were to win instead.

Against all odds, we witnessed a strong uptick in Asian exports and improving PMIs in recent months, alleviating much of the concerns that growth in this region will suffer as protectionism truly takes hold. This uptick coincides with a strong recovery of commodities prices possibly driven by an increase in demand from China amid a property market boom and an increase in infrastructure spending. While the improvement in exports is encouraging, we remain cautious as this comes on the back of a low base and demand from the West hasn't really recovered as much as we would have liked. In the coming months, China is likely to continue curbing the rise of property prices especially those in tier one cities and at the same limit the excessive expansion in credit. As an offset, it is likely to selectively spend on infrastructure and step up activities across the region through the One Belt, One Road program. Inflation across Asia is likely to stay benign, giving central banks the flexibility to cut rates should they need to. Nevertheless, with the US Fed promising to deliver another 2-3 hikes this year, we would expect most central banks in this region to adopt a wait and see stance.

Disclaimer

This document is prepared by First State Investments (Singapore) ("FSI") (Co. Reg No. 196900420D.) whose views and opinions expressed or implied in the document are subject to change without notice. FSI accepts no liability whatsoever for any loss, whether direct or indirect, arising from any use of or reliance on this document. This document is published for general information and general circulation only and does not have any regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive this document. Investors may wish to seek advice from a financial adviser and should read the Prospectus, available from First State Investments (Singapore) or any of our Distributors before deciding to subscribe for the Fund. In the event that the investor chooses not to seek advice from a financial adviser, he should consider carefully whether the Fund in question is suitable for him. Past performance of the Fund or the Manager, and any economic and market trends or forecast, are not indicative of the future or likely performance of the Fund or the Manager. The value of units in the Fund, and any income accruing to the units from the Fund, may fall as well as rise. Investors should note that their investment is exposed to fluctuations in exchange rates if the base currency of the Fund and/or underlying investment is different from the currency of your investment. Units are not available to US persons. Applications for units of the Fund must be made on the application forms accompanying the prospectus. Investments in unit trusts are not obligations of, deposits in, or guaranteed or insured by First State Investments (Singapore), and are subject to risks, including the possible loss of the principal amount invested.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. All securities mentioned herein may or may not form part of the holdings of First State Investments' portfolios at a certain point in time, and the holdings may change over time. In the event of discrepancies between the marketing materials and the Prospectus, the Prospectus shall prevail. First State Investments (registration number 53236800B) is a business division of First State Investments (Singapore).

Commonwealth Bank of Australia (the "Bank") and its subsidiaries are not responsible for any statement or information contained in this document. Neither the Bank nor any of its subsidiaries guarantee the performance of the Company or the repayment of capital by the Company. Investments in the Company are not deposits or other liabilities of the Bank or its subsidiaries, and the Company is subject to investment risk, including loss of income and capital invested.