Equity Market Commentary

14 March 2011

Summary

Japan Earthquake & Tsunami

At 2:46pm on Friday, 11 March 2011, Japan was hit by a devastating earthquake. The quake registered 9.0 in magnitude, the largest in Japan's recorded history.

Preliminary estimates place economic losses in the range of ¥ 4 trillion to ¥6 trillion (US$50 billion-75 billion).

There is no change to the Firm's equity asset allocation to Japan. We were underweight on Japan before the earthquake, due mainly to concerns over the strong Yen and of higher energy and input prices and perceived risk of margin pressures.

Because of the disruption, we have adopted a more defensive posture for our Japan investments. We have scaled back our exposure to the consumer sector and have raised our focus on the sectors and companies that could benefit from rebuilding, namely construction, metal products, building materials.

As the experience from the Kobe Earthquake reveals (or Katrina in the US), the broader economy has the potential to get back on track relatively quickly following major catastrophic events. While this rebuilding process is expected to take years to complete, the benefits to the economy and to businesses positioned to help in the rebuilding process typically come sooner. We will look to invest in companies that can contribute to this process.

Japan earthquake & tsunami

At 2:46pm on Friday, 11 March 2011, Japan was hit by a devastating earthquake. The quake registered 9.0 in magnitude, the largest in Japan's recorded history. It occurred off the northeastern coast of Japan, causing a giant tsunami that impacted Miyagi prefecture, wide-spread damage, loss of life, power & transportation outages, and massive structural damage. Beyond the immediate impact of the earthquake and tsunami, several of Japan's nuclear facilities were also hit by breakdown in cooling systems, and continue to pose a risk to their surrounding communities.

Meanwhile, besides presenting an update to our investors, we would like to extend our deepest condolences to everyone who suffered from this catastrophe.

Top 5 Earthquake Reinsurance Claims Paid

Date of occurance	Earthquake	Magnitude	Reinsurance claims paid (¥bn)
17 Jan. 1995	Hyogo-ken Nanbu	7.3	78.3
24 Mar. 2001	Geiyo	6.7	16.9
20 Mar. 2005	Fukuoka-ken Seiho-oki	7.0	16.9
23 Oct. 2004	Niigata-ken Cheutsu	6.8	14.9
16 Jul. 2007	Niigata-ken Cheutsu-oki	6.8	8.2

Source: The General Insurance Association of Japan, BofA Merrill Lynch

Compared to the 1995 Kobe Earthquake, the extent of the damage caused by the Tohoku Pacific Earthquake appears to be greater and covers a wider area. Preliminary estimates place economic losses in the range of ¥ 4trillion to ¥6 trillion (US$50 billion-75 billion).

To put this into perspective, the Kobe Earthquake resulted in approximately ¥10 trillion of losses. Beyond the losses of property, infrastructure was severely damaged, with ports, roads, and power infrastructure impacted. This will likely result in a sharp drop in manufacturing activity for the next few months, and some observers even suggest the possibility of a recession. However, activity levels should eventually recover as public-driven initiatives to restore infrastructure get implemented.

As mentioned earlier, the economic loss is forecast to exceed ¥ 4trillion, and a good portion of the losses will not be recoverable. This is because most earthquakes related insurance schemes are targeted at homeowners, and also, there are caps and limits on the coverage.

Under existing schemes, the liability limit for private-sector insurers is about ¥1.2 trillion. The Government via the Japan Earthquake Reinsurance Co and other secondary reinsurers is likely to be on the hook for insured losses of up to ¥4.3 trillion. So the insurance sector, with ¥1.0 trillion of contingency loss reserves, should be in a decent position to meet claims obligations.

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Meanwhile power outages and transportation disruptions will likely negatively impact production. Production and output were disrupted by about a month following the Kobe Quake. Given the more extensive damage to power infrastructure, it would be reasonable to assume that the disruption could be slightly longer this time around.

The bigger risk is the knock-on effects from the meltdown at the Dai-Ichi Nuclear Power Plant in Fukushima. Japan has had a hugely successful nuclear industry, which accounts for over a quarter of electricity power generation. Given current oil price levels and the potential need to re-activate coal and oil fired power facilities, the balance for energy demand could shift. This could have implications on energy prices down the road, especially if the Japan earthquake triggers broader concern over the use of nuclear energy.

Market Reaction

It is inevitable that Japanese equity markets will be impacted. At the time of writing, the Topix was off by nearly 7%. Following the Kobe Quake, the Topix slid by 22%, JGB bonds yields fell from 4.7% to 2.6% and the Yen strengthened by 19%.

Policy makers are expected to respond aggressively to cushioning the negative economic impact of the earthquake. The Bank of Japan announced that it will pump in a record ¥12 trillion (US$146 billion) into the financial system. This boost in liquidity should help to stabilize equity markets, and limit any further appreciation in the Yen. Unlike the 1995 Kobe crisis, when equity valuations were expensive, valuations are now very supportive. The Topix was trading at a 10-year cyclically-adjusted PER of 38x and P/BV of 2x in 1995. Today it is on 15x PER and 1.1x P/BV.

Investment Strategy

There is no change to the Firm's equity asset allocation to Japan. We were underweight on Japan before the earthquake, due mainly to concerns over the strong Yen and of higher energy and input prices and perceived risk of margin pressures. The current allocation is detailed in the following table.

Equity Allocation (2Q 2011)

	MSCI AC WORLD	POLICY	ADJUST	TARGET WEIGHT
US	42.8%	**Overweight**	1.2%	44.0%
EUROPE	25.9%	**Neutral**	-0.4%	25.5%
ASIA (ex. Japan)	9.0%	**Neutral**	-0.5%	8.5%
JAPAN	8.7%	**Underweight**	-0.7%	8.0%
AUSTRALIA	3.4%	**Neutral**	-0.4%	3.0%
CANADA	4.8%	**Neutral**	-0.3%	4.5%
LATIN AMERICA	3.1%	**Overweight**	1.5%	4.5%
EMEA	2.5%	**Underweight**	-0.5%	2.0%
TOTAL	100.0%			100.0%

Source: UOB Asset Management

Japan Exposure

Because of the disruption, we have adopted a more defensive posture for our Japan investments. We have scaled back our exposure to the consumer sector and have raised our focus on the sectors and companies that could benefit from rebuilding, namely construction, metal products, building materials.

As the experience from the Kobe Earthquake reveals (or Katrina in the US), the broader economy has the potential to get back on track relatively quickly following major catastrophic events. The short term hit to output can quickly be overtaken by a significant initiative by both public and private sectors to rebuild and repair infrastructure. While this rebuilding process is expected to take years to complete, the benefits to the economy and to businesses positioned to help in the rebuilding process typically come sooner. We will look to invest in companies that can contribute to this process.

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