

# QUARTERLY INVESTMENT STRATEGY

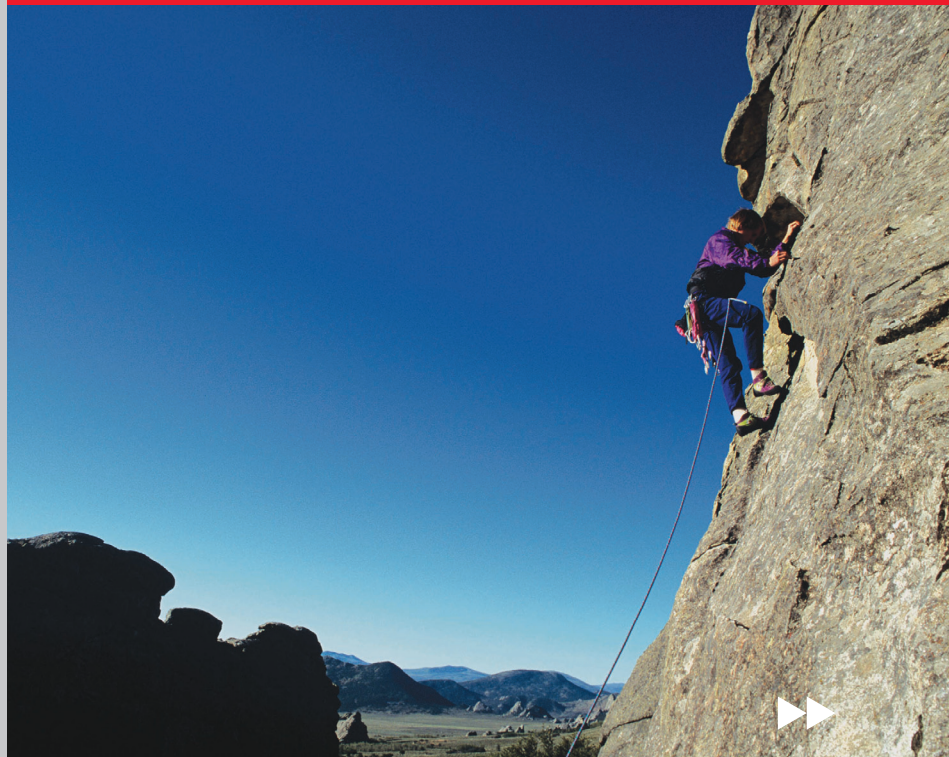
*Strength in Emerging Markets*

Fourth Quarter 2010



BEST ONSHORE FUND HOUSE (SINGAPORE)

**Asia Asset Management**  
 THE JOURNAL OF INVESTMENTS & PENSIONS  
 BEST OF THE BEST AWARDS  
 BEST RETAIL HOUSE (SINGAPORE) 2009



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# CIO MESSAGE

2010 has been a challenging year for investors. There have been strong rallies (as in April), sharp selloffs (as in May) and then stealth rallies that investors have missed out on. Investors whom we speak to seem perplexed by the wide divergence of views they hear. While the economic data is the same for everyone to read, the views will range from “this is evidence that the world is about to double-dip into another recession” to “this is evidence of a strong recovery”. The result of which is that there is a big temptation to stay on the sidelines. As one commentator put it recently “the most crowded trade is the sideline”.

While we also have our view on whether the global economy is double dipping or not (we do not think it will), the reality is that there are many issues affecting investment markets around the world and it has been difficult for even the best economists and strategists to figure out where this all leads. While we provide our best insight on how to position for the next quarter in this report, the reality is that 2010 has been a volatile and choppy year for both the bulls and the bears.

But even without perfect clarity of how each quarter will go over the next year, I think that there is a compelling case that the place not to be is on the sidelines. There are compelling opportunities to invest in Emerging Market equities and bonds, but investors will likely have to accept longer time horizons.

What really stands out to us is that if you look at Emerging Market economies, their industrial productions levels have already surpassed pre-crisis levels and have returned to trend growth. What this says is that even if double dip risks have merit, the reality is that for long-term investors in Emerging Markets, they do not necessarily have to be overly concerned. Even in the deepest recession since the Great Depression, it only took a year and a half to return to trend.

The other main advantage of investing in times like these is that the valuations are very reasonable. In Asia, equity Price Earning (PE) ratios have really only been more attractive at times like the Asian Financial Crisis, SARS and the recent Credit Crisis. Investing when most investors are on the sidelines has the advantage of being able to buy at valuations that have much less downside risk and better than normal upside potential.

In this report we publish our views, forecasts and positioning over the last quarter of 2010. If there is a year that 2010 reminds me of it is 2004, when our investors were similarly frustrated. But in the end, despite the volatility, markets ended strongly and provided solid returns to investors that made those staying on the sidelines regrettable.

**Thio Boon Kiat**, *Group Chief Investment Officer*



# SUMMARY

## **Over the past quarter, the global macroeconomic concerns shifted from Europe to the US.**

Economic growth in core Europe continued to improve with Industrial Production, manufacturing Purchasing Managers' Index (PMI) and business confidence surveys all strengthening during the quarter. The strength in countries like Germany gave markets a degree of confidence that the problems in Greece and other highly leveraged European countries will not necessarily spill over to all of Europe, let alone the rest of the world. Unfortunately the previously strong rebound in the US economy stalled over its summer months and cancelled out potential positives from European stability.

## **The biggest surprise over the last quarter came from the rate of deterioration in the macroeconomic conditions in the US.**

While some slowdown in leading indicators was generally expected, indicators such as the regional PMI surveys, employment trends, housing sales, and durable good orders all started to come in significantly below expectations. The concerns about a double-dip recession were rising and the US economic outlook was increasingly uncertain. US Treasuries strengthened throughout the quarter as investors started to price in weak growth and potentially Japanese-style deflation. Global equities were volatile as investors balanced strong corporate earnings with weak macro data out of the US and relatively strong data in Emerging Markets (EM).

## **Despite the concerns, there have been some early hints that China and the US economy are stabilising.**

In early September, the China PMI, the US Institute for Supply Management (ISM), US housing data, US and European confidence surveys, and US jobs data provided some early indication that the previous month's slowdown was stabilising. Markets will need more data to confirm the new stability in macro data and we think the fourth quarter of 2010 will serve as a "tie-breaker" for the mixed data from the past couple of quarters. If there is more confirmation of stabilisation in economic trends, then markets are likely to take it as a positive signal that the economic slowdown did not trigger a full double dip recession. Such a sign would be bullish for risk assets such as equities and EM investments.

## **We continue to think that the likelihood of another 2008-style recession is low. We retain our overweight in Equities and underweight in Bonds. We also reduce our position to neutral in Commodities.**

Within Equities, we stay overweight in Asia and Latin America, and underweight in the developed markets of US, Europe and Japan. For Fixed Income, we continue to prefer Investment Grade bonds. Within Commodities, we are overweight in Gold.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

Equity markets continued to be marked by volatility and inconsistency in the third quarter of 2010. Investors are likely to be somewhat puzzled by the economic and market trends so far in 2010. By March and April of 2010, the US macroeconomic data had become surprisingly strong and started to convince investors that there was potentially good evidence of a sustainable recovery. But then came several months of disappointing economic trends that would be consistent with a double dip recession. Just as equity and bond investors started to become more conservative, data in US, Germany and China all appeared more stable and investment markets have regained some of its lost confidence.

While we found the slowdown in the recovery a risk, we continue to believe that a double dip recession is not a very likely scenario. We also think the potential stabilisation of economic growth will be bullish for risk assets as investors may start to conclude that the world has survived a double dip test. Barring a new recession, we think there are solid investment opportunities available to investors. Corporate earnings around the world are solid and equity valuations are at low levels. EM has strong fundamentals and we continue to expect the equities and the bonds in EM to do well on the back of strong corporate performance and increased investor appetite for EM investments.

## 1. The US's Summer Slowdown

At the end of the second quarter of 2010, the world's attention was fixated on Europe and the potential risk of Greece being the catalyst to destabilise Europe and in turn affect the recoveries in the rest of the world. Over the third quarter of 2010, the market was reassured by the strengths in core Europe, but then partly blindsided by a sudden weakness in the US. US Federal Reserve (Fed) Chairman, Ben Bernanke commented in congressional testimony that "it appears the recovery has hit an invisible wall" and the outlook was "unusually uncertain".

Various economists have speculated the reasons for the sudden shift. Some speculated that it is normal to see a slowdown in the second year of a recovery while some highlighted the confidence impact of the Gulf Oil spill. Some even thought it was due to the winding down of policy support and there was always a camp that had been calling for a double dip recession all along. All views have some merits but we find the evidence of fiscal and monetary policy roll-off to be the most probable driver.

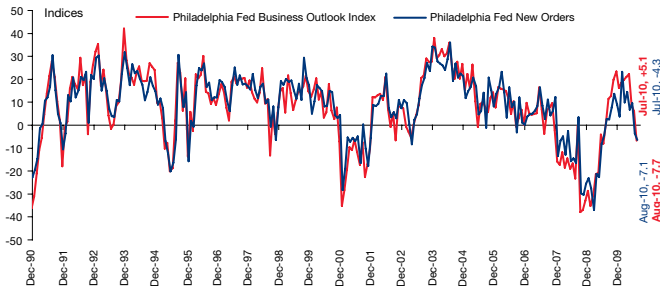
It was easy to miss in this period of super accommodative monetary policy, but starting at the end of March, US monetary policy became tighter. First, Quantitative Easing policies ended in March and then overall M2 growth did not keep up with economic growth implying that liquidity became tighter. At the same time, most of the fiscal policy programs have ended or are winding down. The auto tax credit ended in second half of 2009, the housing tax credit ended in second quarter of 2010, the state funding support had mostly run out by mid 2010 and the various spending programs were winding down to its later stages. Even the tax cuts seemed to be at risk as congress debated various plans over the summer.

Whatever the exact nature of the slowdown was, there were trends that started to worry investors. The regional manufacturing surveys in the US started to show significant deterioration. The Philly Fed survey in particular showed that manufacturing activity fell from a healthy growth rate to a significant contraction in the August report. The levels of contraction seen in the August report have previously been associated with recession and thus supported the case to be worried about a double dip recession.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

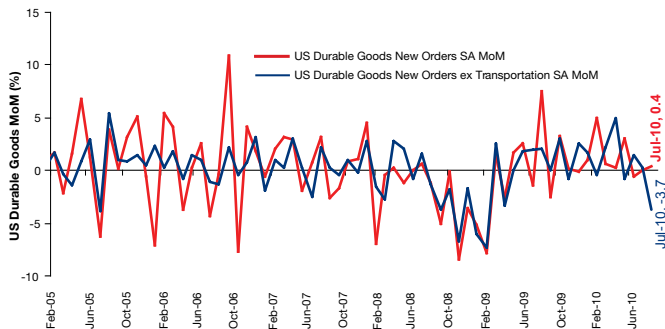
Philly Fed Index



Source: Bloomberg, 20 August 2010

Durable good orders were another indicator of a bad August report. After growing at a very strong 5% rate several months earlier, durable good orders excluding transportation ended -3.8% in the August report.

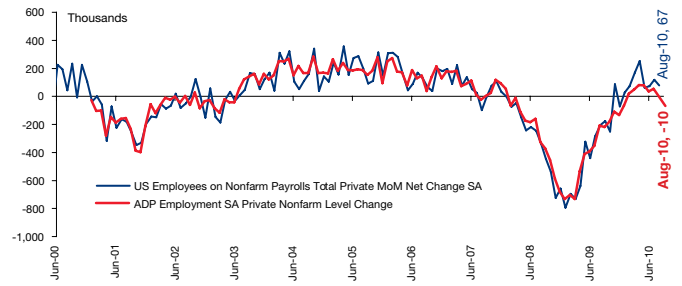
US Durable Goods Orders



Source: Bloomberg, 26 August 2010

And in jobs data, the strong levels of new employment seen in March and April moderated and threatened to turn negative, before finally providing some evidence of stability in the early September data release (which included upward revisions for previous months).

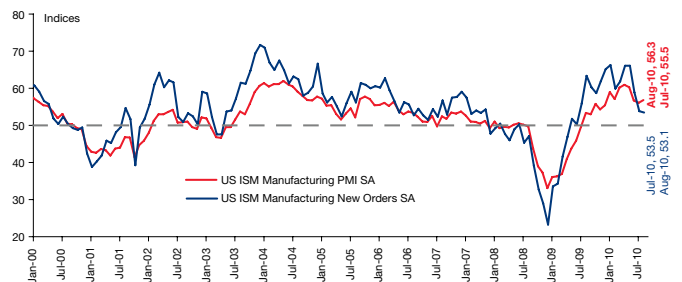
US Payrolls



Source: Bloomberg, 04 September 2010

Along with the better than expected jobs numbers, the national manufacturing survey for the US improved as well. The pending home sales number released in September also went up by 5%. These trends, coupled with the improvement in claims, made the case for a double dip recession seemed significantly weaker.

US ISM



Source: Bloomberg, 02 September 2010

We think the fourth quarter of 2010 could be important as a "tie-breaker". The US had some very positive trends early in the year that were then followed by some weak data points over the summer. There are potential signs of stabilisation in economic trends and if so, we suspect this will be quite bullish for risk assets. In this case, we think a tie goes to the bulls as the economic data does not have to be strong to provide confidence. If the fourth quarter of 2010 achieves more stability in economic trends then there will be a strong case to be made that the US economy has survived its first double dip test.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

Even more important, if the US economy does indeed stabilise after a summer where a large part of the fiscal stimulus support wound down, then investors and business leaders may become significantly more confident. Two of the biggest issues holding back businesses from hiring, and investors from investing have been the risk of a double dip recession and the uncertainty of what will happen when the stimulus runs out. If economic data is stable in the fourth quarter of 2010 then the market may conclude that the two biggest market overhangs have been at least partially alleviated.

Of course, the return of the weak trends of the summer also remains a significant risk. It is still not clear to us why some of the regional manufacturing indices showed significant weakness while the national ISM remained resilient. It has yet to be determined which data series will turn out to be a more accurate indicator.

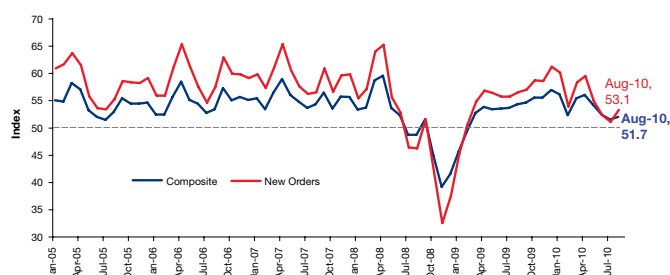
## 2. A Soft Landing for China?

Another major global investment headwind has been the slowdown in China. Over the past year, China authorities have been trying to cool down property prices and to an overheating economy that was risking an inflation spike. The primary concern would be whether the tightening process would result in a hard landing and a recession. Increasingly the evidence appears to be that China should achieve a soft landing similar to that in 2004.

Loan growth targets are a chief policy tool of the China authorities. Loan growth peaked at 34.8%<sup>1</sup> on a year-on-year basis in November 2009, in response to the global financial crisis. But as China fared better than most would have expected, the authorities have been rapidly trying to pull back the levels of loans to more normal growth trends. The government's target for broader money supply growth has been set at 17% for all of 2010, and so far they are on track to meet these trends.

So far the loan and building pullback does not appear to have triggered an economic hard landing. Manufacturing indices showed a slowdown and risked outright levels of contraction but appeared to have stabilised. In particular China's manufacturing new order declined from 60 to close to 50 before rebounding to 53 in August. Domestic consumption trends remained strong, and while exports should moderate, the overall levels of growth remained healthy.

China Manufacturing PMI



Source: Bloomberg, 07 September 2010

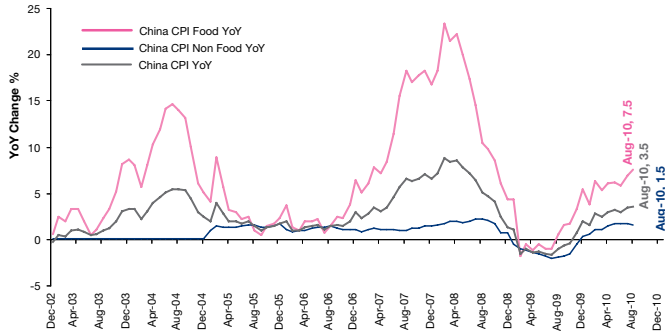
The property policies have had success in stopping the inflating of a bubble, and have not promoted significant declines that would pose risks for other parts of the economy. Inflation has risen but has been within expectations. The main contributor appears to be food inflation due to weather related issues which has less impact on policy decisions. For the month of August, inflation came in at 3.5% which is above the usual threshold of the Chinese authorities, but is still mostly driven by food prices. The market expects that interest rates would likely be raised soon, but does not see the risk of very aggressive rate hikes as the inflation outlook does not appear to be rising rapidly.

<sup>1</sup> Source: JP Morgan, Hands – On China Report, 3 June 2010



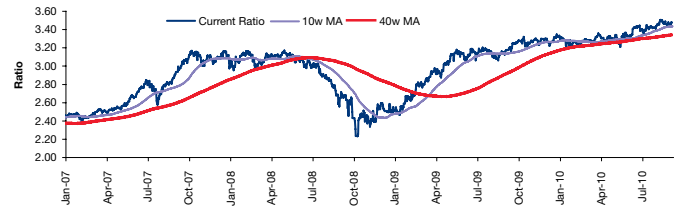
# INVESTMENT OUTLOOK AND ASSET ALLOCATION

CPI Food and CPI Non Food YoY



Source: Bloomberg, 15 September 2010

Emerging Markets Relative to MSCI AC World



Source: Bloomberg, 15 September 2010

### 3. Important New Trends in Emerging Markets

Overweight in Emerging Market (EM) equities and bonds has been a fairly consensus call amongst most investors. The main risk has been that EM have higher beta than developed markets and that China which is a big part of EM had an uncertain slowdown path. We have just noted that China does increasingly appear to have orchestrated a soft landing. There is more evidence that EM is proving to be more resilient than developed markets.

Asian investors frequently joke that “yes, Asia decoupled from the US, when the US fell 10%, Asia fell by 20%”. Despite the fact that the financial crisis in 2008 was primarily due to problems in the US, the Standard and Poor 500 Index fell 38% in 2008 while the MSCI Asia ex Japan Index fell 54%. Likewise in the recovery of 2009 when the S&P 500 increased by 23%, the MSCI Asia ex Japan Index increased by 68%.

There seems to be some evidence of an important shift in investor behaviour. In 2010 through the first eight months of the year, the MSCI World was down 6% for the year, but MSCI Asia ex Japan had a total return of 1%. In the chart below of EM performance relative to the MSCI World, we see the typical pattern of underperformance in the down year of 2008 and outperformance in the up year of 2009. What is different in 2010 is the trend is up despite down markets in the developed world.

One reason may be that investors have learned some lessons about EM during the crisis. While EM economies declined during the global downturn, most have rebounded quickly and now have industrial production that has surpassed pre-crisis levels. The developed markets have not yet returned to pre-crisis levels. Some countries such as India, Indonesia and China arguably never really suffered a recession despite the global downturn. The past several years have shown that EM has had more volatility, but a “Buy and Hold” strategy has worked better with EM than with the developed markets.

There are also signs within the domestic economies that EM does more than make iPods for Americans. Global investors seemed surprised to find that net exports make up less than 10% of the Chinese economy and thus were surprised that China could grow by over 9% in both 2008 and 2009 which were years in which the US economy was collapsing. Domestic consumers and property buyers in EM seem unfazed by double dip risks and appear to be almost hoping for government measures to have success in bringing down property prices in order to have another shot at the market.

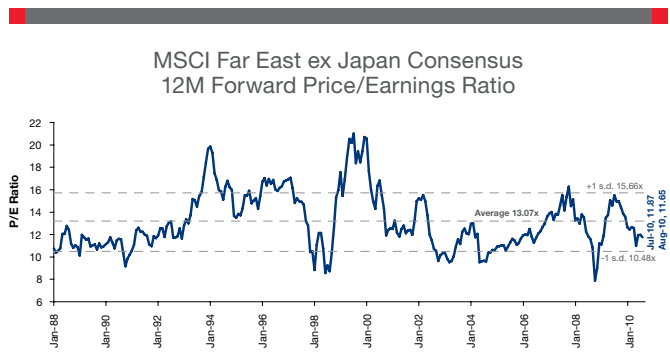
EM bonds have historically traded at wider spreads than developed market bonds even for similarly rated paper. Investors have always maintained a perception of greater volatility risk in the economies and in the liquidity of the markets. But conditions now are increasingly liquid and the economies appear more resilient, creating conditions for more spread compression and stronger returns from EM bonds.



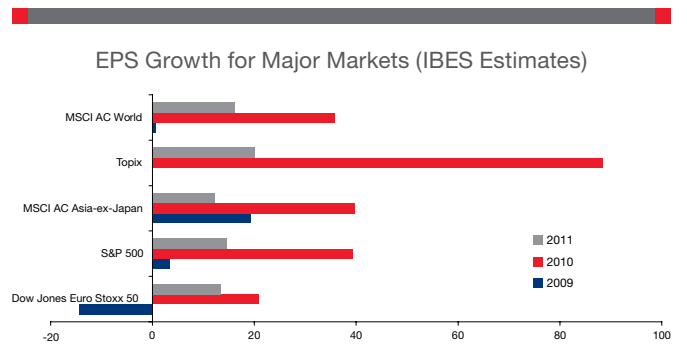
# INVESTMENT OUTLOOK AND ASSET ALLOCATION

EM equities averaged a total return of about 70% in 2009. Despite that return, EM equities remain below long-term historical average valuations. For example as of the end of August, the MSCI Asia ex Japan was trading at 11.65x 12-month forward earnings. This is below the average of 13x. We would also argue that the last time EM was in such favour globally was in the mid 1990's. During the 1990's, MSCI Asia ex Japan traded at averages of 15x 12-month forward earnings. Despite the strong year, EM equities can hardly be called expensive.

Analysts have been relatively cautious, but as results continued to beat consensus expectations, analysts have had to upgrade their forecasts. The consensus expectation is for the S&P 500 earnings to grow by 39%<sup>2</sup> for the full year of 2010 and by 15% in 2011. Globally, analysts are forecasting 36% earnings growth in 2010 and a further 16% in 2011. While corporate profits were driven initially by productivity gains through cost controls, an increasing number of corporations are highlighting revenue growth as an additional driver as of recent reports.



Source: Datastream, MSCI, IBES Estimates, 31 August 2010



\*Topix 2008 EPS was negative, resulting in non meaningful 2009 EPS growth comparison  
Source: Datastream, 31 August 2010

## 4. Corporate profits and Corporate Actions provide continued market support

Two themes that have supported equities throughout the year have been corporate profits and corporate actions (i.e. share buybacks, and mergers and acquisitions). While economic data started to weaken globally in May 2010, it was supported by corporate profit results beating expectations which helped provide some stability to equity market performance over the quarter.

Over the quarter, mergers and acquisitions continued to provide support to equity share prices. Due to low interest rates globally and strong earnings yield, most corporations find it quite earnings accretive to use some financing to merge or acquire other companies.

<sup>2</sup> Source: Datastream, as at 31 August 2010



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

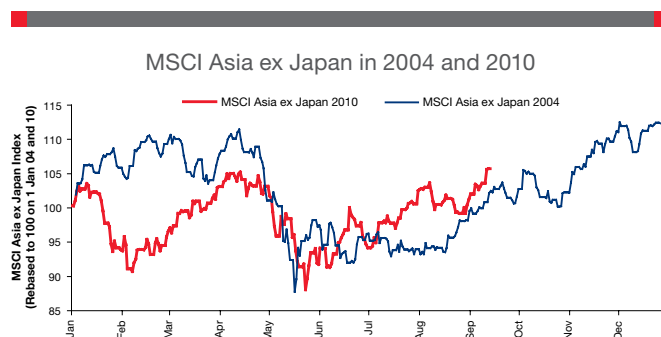
## ASSESSMENT

We think the fourth quarter of 2010 could provide the “tie-breaker” data on the trajectory of the US economy and developed markets in general. The US recovery was strong through April 2010, but then slowed significantly in subsequent months. Developed market macroeconomic data was stable in August but the markets will need evidence over the next quarter to conclude that the developed markets have survived a legitimate double dip test. It is also fair to expect that volatility will remain as the economic trends throughout the year have been inconsistent. Investor confidence is fragile and will likely be easily rattled by any signs of economic weakness.

We continue to believe that a 2008-style double-dip recession is unlikely because the real economy is in a very different position from 2008. Two of the biggest reasons for the fierce downturn in 2008 were the credit crunch and massive inventory drawdown. In the wake of the Lehman shock, corporates or individuals that needed access to capital or credit were unable to attain it and were forced to pull back on investments and reduce capacity. Corporates and households thus dramatically cut back on their spending. The corporates responded to this reduction in consumer spending by allowing their inventories to be drawn down. Although the global economy returned to positive growth about a year ago, global inventories have by and large not been rebuilt. Inventory to sales ratios are near all-time lows. Corporations have also been modest in their capital expenditure budgets, leaving corporations with high levels of cash. Banks have also raised funds and are now better capitalised than before the crisis. The sharp degree of labour retrenchment we saw in 2008 is also unlikely because the private sector has not resumed its hiring in an aggressive manner.

If we accept that a double dip recession is indeed a low probability event, then the investment outlook appears fairly attractive for risk assets like EM equities and bonds. Without a strong double dip risk, then EM would appear to be very attractive with its strong fundamentals and low valuations in a very liquid world.

We think the parallels for Asia equity markets between 2004 and 2010 remain strong. Both 2004 and 2010 were periods where the start of policy tightening became an initial drag on equities. In 2004 the MSCI Asia ex Japan fell by 21% and in 2010 it fell by 16%. But in 2004 after it became clearer that the policy tightening was being achieved without significant adverse economic affects, equities rallied through the end of the year. So far 2010 seems to be following the same pattern. There have been interest rate hikes by banks and significant policies to cool off property. But economic conditions appear stable and robust, and Asian equity markets have been gaining. The pattern of equity market performance in 2010 remains remarkably similar to 2004. And as in 2004, MSCI Asia in 2010 has already surpassed the highs achieved before the sell-off.



Source: Bloomberg, 15 September 2010

Key risks continue to be the sustainability of the recovery in developed markets, policy tightening in EM and spill over risks from the debt crisis in Europe. While we think the recovery is sustainable and that markets have accepted the policy trends of EM, we do not dismiss that there are risks of negative surprises in these areas. While the problems in Greece have not spilled over to core European countries like Germany, there remain risks of social unrest and banking system risks that could still adversely surprise markets.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

## ASSET ALLOCATION

	Conservative	Change from 3Q 2010	Moderate	Change from 3Q 2010	Growth	Change from 3Q 2010
<b>Equities</b> <i>Remaining Overweight</i>	45%	-5%	60%	0%	80%	0%
<b>Bonds</b> <i>Remaining Underweight</i>	45%	5%	32%	+2%	12%	+2%
<b>Commodities</b> <i>Reducing to Neutral</i>	3%	0.5%	5%	-2.5%	6%	-1.5%
<b>Cash instruments</b> <i>Remaining Underweight</i>	7%	-0.5%	3%	0.5%	2%	-0.5%

Note: The neutral Moderate benchmark weights are Equities (55%), Bonds (35%), Commodities (5%) and Cash (5%).

**We remain relatively pro-risk in our asset allocation**, with only minor adjustments to our commodities and bonds recommendations.

### Equities – Remain overweight

Macro stability, healthy financial conditions, strong corporate balance sheets and earnings, mergers and acquisitions and attractive valuations are all supportive.

### Fixed Income – Remain underweight

With some small increase in weightings focused primarily on EM credits.

### Commodities – Reduce to neutral

Commodities tend to be stronger later in the cycle. The developed world recovery is slow enough that we think it will take more time for the commodity cycle to get stronger.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

## Retain overweight position in Equities

We continue to think that 2010 is following a similar trend to 2004, especially in EM. While there are risks that slower growth will raise concerns of a double dip recession, we ultimately think that the global economies are a much different situation than it was in 2008. Barring a 2008-style of double dip recession, which we think is unlikely, we think equities will outperform, especially in the developing world.

The main drivers to support equities in the fourth quarter are 1) stabilising US economic data which will reassure markets it has survived a double dip test, 2) attractive liquidity and financial conditions, 3) strong corporate profitability, and 4) corporate actions such as mergers and acquisitions and share buybacks.

The softness of the US data over the summer has further delayed the possibility of interest rate hikes and in fact has raised the likelihood of further quantitative easing. Interest rates at close to zero are very supportive of risk assets.

While we have remained overweight in equities, we have partly shifted our focus. Previously we were overweight in the US and EM while underweight in Europe and Japan. Now, we have shifted all our overweight to EM and underweight the developed markets.

The **US** economy had a soft patch over the summer but there are some early indications that it is stabilising. The housing market is jittery in the post tax credit period, but prices thus far remain stable and market transactions have been strong over the past year to clear significant amounts of inventory. US corporate profitability remains strong as cost controls have boosted productivity and corporates are increasingly seeing signs of revenue growth. Overall, we expect the US to continue to stabilise but with enough uncertainties to hold back its relative performance versus the emerging markets.



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

In **Europe**, the outlook has become very mixed. Peripheral Europe such as Greece, Spain, Portugal and Ireland are suffering the most from the significant fiscal policy contraction planned. Core Europe such as Germany is thriving as its exports are benefiting from the weaker Euro. The health of the highly leveraged banking system in Europe remains a risk. Despite the fact that European valuations are amongst the cheapest in the world, structural concerns lead us to stay underweight.

For **Japan**, corporate profits are being adversely affected by the stronger yen. Being a very cyclical economy, Japan is also adversely affected by some of the softer economic data coming out of the US. Corporate profitability still needs to recover further before we can justify further capital allocation. We remain underweight in Japan.

We increased our overweight in **Asia ex Japan** and continue to focus on domestic consumption. China has enacted several rounds of policy tightening but appears to have controlled inflation and GDP growth while countering the property bubble. Asian equities remain attractively priced at less than 12x earnings, despite strong fundamentals, rising currencies, and healthy growth prospects.

We continue to like **Latin America** for its strong domestic growth. While there are some near-term risks due to higher inflation, the central banks, most notably Brazil, are generally ahead of the curve in fighting inflation. The region continues to offer strong long-term investment opportunities for equity investors. We remain overweight in Latin America.

Asset Allocation	4Q 2010 Recommendation	Benchmark
<b>Equities</b>	<b>60%</b>	<b>55%</b>
<b>US</b>	40.0%	42.1%
<b>Europe</b>	24.5%	26.0%
<b>Asia ex-Japan</b>	10.5%	9.5%
<b>Japan</b>	7.5%	8.9%
<b>Australia</b>	2.5%	3.3%
<b>Canada</b>	3.5%	4.5%
<b>Latin America</b>	7.5%	3.2%
<b>EMEA</b>	4.0%	2.5%

EMEA – Europe, Middle East and Africa

# INVESTMENT OUTLOOK AND ASSET ALLOCATION

## Retain underweight position in Bonds

### Developed Markets

**Governments Bonds** continued to perform well in the third quarter of 2010 as weak US economic data increased risk aversion and increased the possibilities that the US could suffer Japan-like prolonged deflation. The US 10-year Treasury bond yield fell from 2.97% at the beginning of the quarter to an average of about 2.6% in the later part of the quarter. The recent stabilisation in US economic data has seemed to halt the rally, but further US monetary policy in the form of quantitative easing (FED buying of assets) support could help government bonds further.

Weak economic data and further quantitative easing could support government bonds during the quarter but overall we do not find the risk/return dynamic very attractive and underweight government bonds. We think there is more downside in government bonds from strong economic data than there is upside from weak data. Fundamentally we do not believe in the long-term structural view that the US is going to face a Japan-style deflationary lost decade that led to strong performance in Japanese government bonds. The reasons we do not expect a structural deflation in the US are: 1) The US Fed has been very aggressive in its efforts to fight deflation, 2) demographically the US is in a much different position to Japan – Japan has suffered two decades of declining population growth while the US still has very supportive immigration trends, and 3) the paths to fixing the banking system have been very different, with the US banks already well capitalised and ready to supply credit growth when the economy is ready.

**Corporate Bonds** have also performed well and we think it remains attractive. While there has been a global flood of money flowing into government bonds over the past two quarters, we find it much more sensible to invest in well managed corporates with strong cash flows and balance sheets, then the poorly managed government balance sheet of the world.

Within corporate bonds we prefer **EM credits** to **Developed market credits** and we prefer **Investment Grade bonds** to **High Yield bonds**. Structurally we see better opportunities for EM credits to provide price gains through yield compression as the desirability of investing in EM countries with strong currencies increases.

On the other hand, the volatility in the global macroeconomic data poses risks to the strong corporate bond rally of the past two quarters. If the US macro environment weakens in the fourth quarter of 2010 instead of continuing recent signs of stability, then spreads will likely widen instead of tightening. Reducing risks in this period of uncertainty is the main reason for our overweight stance in Investment Grade bonds over High Yield bonds.

# INVESTMENT OUTLOOK AND ASSET ALLOCATION

We also prefer US to European names which are directly exposed to the macroeconomic problems in Europe. Sectors we like are Utilities, for their stable cash flows and strong credit profiles; Capital Goods, where cost cutting has been aggressive; Basic Materials and Energy, where balance sheets have been deleveraged via asset disposals and reduced capital spending; and the Insurance sub-sectors where capital levels have improved and US Managed Care companies which are able to absorb the cost impact of the US healthcare reforms.

Asset Allocation	4Q 2010 Recommendation	Benchmark
<b>Fixed Income</b>	<b>32.5%</b>	<b>35%</b>
<b>Developed</b>	<b>35%</b>	<b>70%</b>
Government	46%	71%
High Grade	47%	21%
High yield	7%	8%
<b>Emerging</b>	<b>65%</b>	<b>30%</b>
Asia	33%	30%
Latin America	33%	33%
CIS/EE	27%	27%
Middle East/Africa	7%	10%

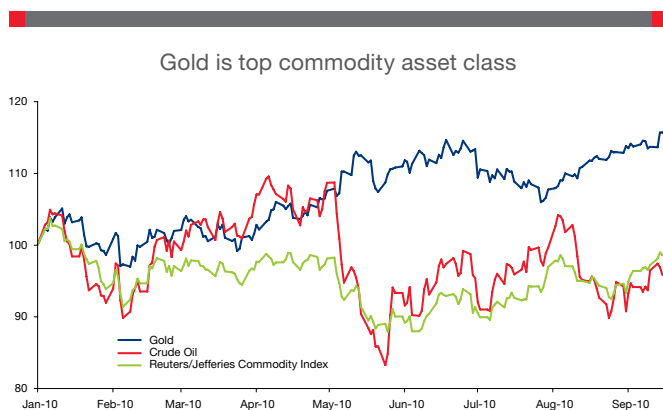
CIS – Commonwealth of Independent States  
EE – Eastern Europe



# INVESTMENT OUTLOOK AND ASSET ALLOCATION

## Reducing Commodities to neutral position

The recent combination of higher commodity prices but mixed and variable global economic data means we have downgraded our overall commodities weighting to neutral. However, within the commodities space, we retain our overweight position in **Gold**. While structural concerns overhanging certain Eurozone economies have abated in recent weeks, the potential for renewed credit risk and currency market volatility remains. In this environment, Central Banks and private investors are viewing gold as an independent store of monetary value in its own right, and are increasing their exposure to the metal. Central Banks are now aggregate net buyers of gold, and private investment demand via physical purchases, gold Exchange Traded Funds (ETFs) and the COMEX futures market remain at elevated levels.



We move to a neutral position in **Base Metals & Bulk Commodities**. Base Metal prices have risen sharply since the second quarter but are now at elevated levels compared to outstanding London Metal Exchange (LME) inventories and conflicting economic data. Bulk commodities demand has softened with normal China destocking over the summer period and the leading developed markets remaining well supplied. High rainfall has boosted Chinese hydroelectric output, and may threaten the normal increase in thermal coal prices from stronger North Asian demand towards Chinese New Year.

We have upgraded our **Agriculture** position to neutral. Wheat prices have strengthened in recent months due to poor weather conditions in Russia and a resulting ban in Russian wheat exports. This also pushed up other agricultural prices as investors remain nervous that other weather-related events could curtail 2010 production. However, overall stock levels are actually at fairly comfortable levels, and prices are likely to drift downwards in the absence of further negative news.

Asset Allocation	4Q 2010 Recommendation	Benchmark
Commodities	5%	5%
Gold	35%	25%
Base Metals	20%	20%
Agriculture	15%	20%
Energy	30%	35%

We retain our underweight position in **Energy**. A lackluster summer driving season has left crude oil inventories at relatively high levels in the US, which remains the most important consuming market. Although the International Energy Agency (IEA) increased its FY10-11 global crude oil demand forecasts in August 2010, the combination of high inventory levels and sizeable OPEC spare capacity makes it unlikely that crude oil prices will move significantly above the US\$80/bbl level in the fourth quarter. There continues to be surplus refining capacity in the developed economies and increasing amounts of refining capacity being added in developing economies. The strong growth in shale gas production means that US natural gas prices are unlikely to spike higher, despite increased winter-related demand.

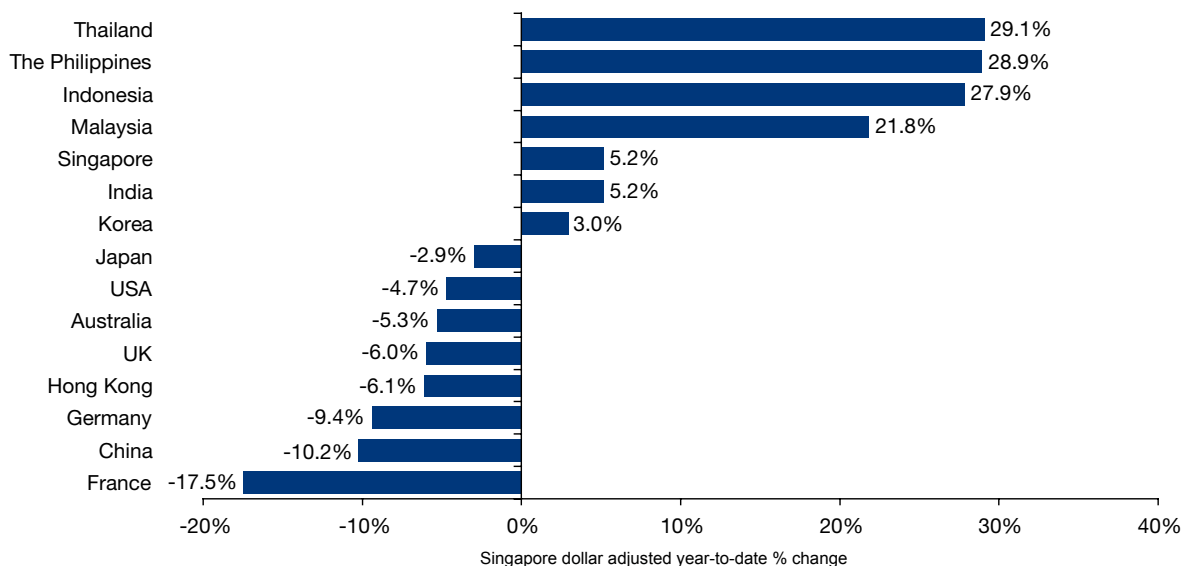


# GLOBAL EQUITY STRATEGY



## Market Returns

Year to date Equity Market Returns As At 14 September 2010



Source: Bloomberg, 14 September 2010

## US

### Equity Strategy

Just as economic leading indicators have started to roll over the past few months, various company surveys of business activity have also started to downshift. In an ISI Company survey of 300 companies and their key executives on how they rate their sales activity relative to their expectations, we note that the readings of many of the early cycle sectors like retail, airlines, and consumer staples, have started to register inflexion points. That is, these readings while still in the strong territory, are dipping. For the late cycle sectors and companies, like the capital goods and manufacturing companies, orders are still strong. Regionally, US and Europe ranged from strong to mixed, while sales activity in Asia was a little slower. Anecdotally, companies say they have yet to feel the spill over from European related issues, which is good news. The survey of technology companies produced

mixed results, but is off the highs because of softer consumer electronic demand and some slowing in the semiconductor area. Business spending has moderated but to a lesser extent. Business spending on technology equipment is still firm. So overall, signs are clear that we are heading into the midpoint of the current business cycle, which generally also implies a more muted equity market performance.

On a brighter note, valuations are attractive and earnings are likely to remain strong. S&P 500 is currently trading at 11.5x 2011 earnings and is attractive against its already reduced low-teens forward growth expectations. The bond yield/ earnings yield relationship continues to be strongly in favour of equities, with US earnings yield at 8.7%, which is higher than Moody's Baa Corporate Bond yield of 5.6% and 10-year Treasuries which sits below 3%. Our earnings discount model, which assumes a long term risk-free rate of 4.5% and conservative equity risk premium of 5.5%, indicates a 17.3% upside.



# GLOBAL EQUITY STRATEGY

At the same time, we also highlight a number of risks that could weigh on stock multiples and add to stock market volatility as we head into the year end. On the earnings front, earnings growth has most likely peaked and earnings surprises may be of smaller magnitude due to a tougher year-over-year comparison, and the waning effect of operating leverage. At the policy front, the US government has to continue to balance public demand for more stimulus against having to manage large fiscal state imbalances. There is also uncertainty surrounding the impact of new financial regulations and bank capital standards.

In view of the above factors, we have been adopting a balanced allocation between cyclical and non-cyclical sectors as we are heading towards the mid point of this US business cycle. This quarter we extended the strategy further by balancing cyclical within the Technology sector. Earlier in the year, the portfolio had been overweight in

Semiconductors and Computer Hardware, when revenue growth for the technology sector was accelerating. Now, that manufacturing activity around the world is starting to decelerate and future demand for Technology goods (ie new orders for computers and electronic products) is beginning to roll over from a high level. Consequently, we expect technology revenue growth to decelerate into the next several quarters. Inventory shortage is clearly easing and in certain cases, inventory is rising above seasonal patterns. We have started to bring down the weights of the more cyclical sub-sectors for example semiconductors and computer hardware in favour of communication equipment, where demand has been slower to pick up. Wireline capacity is keeping up with video demand, while wireless is meeting with more robust demand. This is mainly due to the success of Android as an alternative to iPhone and Blackberry.



# GLOBAL EQUITY STRATEGY

## Key Additions to the Model Portfolio

Within the Technology sector, we added **Cisco** to increase our exposure in the enterprise IT space. Cisco is the undisputed leader in enterprise networking and holds the key technologies and solutions to resolve bandwidth bottlenecks due to the rise in data-sapping content. Another new addition is **Motorola** whose strategy to adopt Google's up and coming Android operating system as its smartphone platform has proven to be right. Coupled with its revamped handset strategy, Motorola is in a sweet spot to capture more market share in the growing smartphone market. Cisco and Motorola trade at undemanding valuation of 11x and 15x FY11 earnings respectively.

In Telecom Services, we added **Verizon**, the largest US wireless operator by subscribers and the operator with the best in class US mobile network. This has translated into double digit service revenue growth, the highest percentage of post-paid subscribers, highest post-paid Average Revenue Per User (ARPU) and lowest subscriber turnover in the industry. Its achievement is all the more commendable because it does not sell the iPhone, but relies on a slew of smartphones (Blackberries, Androids, etc) for which it does not offer as much handset subsidies to users. Verizon has also made substantial progress in stemming the secular decline in their landline division via cost control and has made in-roads into the fibre optic Pay TV space. Verizon offers investors a 6.4% dividend yield and trades at an inexpensive 13x FY11 earnings.

MODEL PORTFOLIO		
SECTOR	WEIGHT	TOP PICKS
Consumer Discretionary	Underweight	McDonald's Corp
Consumer Staples	Overweight	PepsiCo
Energy	Neutral	Occidental Petroleum
Financials	Neutral	Visa
Healthcare	Overweight	AmerisourceBergen
Industrials	Neutral	General Electric
Information Technology	Neutral	Apple
Materials	Slight Overweight	Newmont Mining
Telecom Services	Neutral	Comcast
Utilities	Underweight	Dominion Resources



## EUROPE

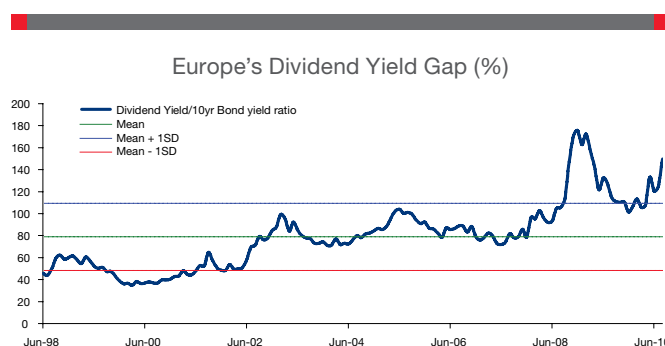
### Equity Strategy

From the middle of April to early July, the MSCI Europe Index fell by close to 20% driven by fears of an imploding European sovereign debt crisis and the subsequent breakup of the European Union. All of these fears are overblown in our view. Notably, the approximately €750 billion European Financial Stability Facility is comprehensive and covers the financing needs of Greece, Spain and Portugal over the next two to three years. This will give these economies some time to lower its fiscal deficits to more manageable levels so that they can eventually regain full access to international funding. In fact, the International Monetary Fund (IMF) recently highlighted in a study, "Default In Today's Advanced Economies: Unnecessary, Undesirable and Unlikely", that defaulting countries do not see any significant improvements in their required fiscal adjustments but suffer more serious economic dislocations than would otherwise be the case. Moreover, European Central Bank (ECB) has been ensuring adequate liquidity in the European financial system by buying government and private securities on the secondary market.

However, the Euro area proved to be more resilient as upgrades were seen both at economy and corporate levels. The ECB recently raised the Euro area GDP growth rate forecast to 1.6% in 2010 and 1.4% in 2011 from its earlier projections of 1.0% in 2010 and 1.2% in 2011. Meanwhile, the second quarter earnings season saw net upgrades in more than two-thirds of the sectors. This helped lift sentiment in the European market.

Despite the 13% rally in the MSCI Europe Index, valuations remain undemanding. The Earnings Yield gap is near historic highs while Dividend Yield is higher than Earnings Yield, all of which are supportive of equities. Our Dividend Discount Model, which conservatively assumes a risk free rate of 5% and equity risk premium of 6%, indicates a 16% upside to the European market. This is based on below consensus earnings growth of 29% in 2010 and 13% in 2011 respectively. However, some of the key leading indicators like the OECD Composite Leading Index and PMI Indicator for Euro-zone area are now rolling over which warrant a more defensive stance.

We have largely trimmed our overweight positions in most Cyclical sectors including Industrial, Energy and Materials to a more neutral stance. However, we have kept our overweight position in Consumer Discretionary given their high exposure to buoyant EM consumption. Many European companies have built up formidable branding in these markets and are expected to sustain outperformance going forward. Meanwhile, we have also increased our weights in both Telecoms and Utilities where their Dividend Yield and Credit Yield spreads are twice as wide as the average. Our underlying basis for stock investments remains a fundamental focus on balance sheet strength that is combined with capable management and strong product positioning.



Source: Bloomberg, 30 August 2010

MODEL PORTFOLIO		
SECTOR	WEIGHT	TOP PICKS
Consumer Staples	Overweight	Carrefour
Consumer Discretionary	Neutral	Volkswagen
Energy	Neutral	BG Group
Financials	Underweight	BBVA
Healthcare	Neutral	Sonova
Industrials	Neutral	Weir Group
Information Technology	Overweight	Aixtron
Materials	Neutral	Xstrata
Telecom Services	Neutral	KPN
Utilities	Underweight	EDF



# GLOBAL EQUITY STRATEGY

## JAPAN

### Equity Strategy

Economic indicators for Japan have weakened in line with slowing external growth. Recent strengthening of the yen could start to impact Japan's exports negatively in the quarters ahead. Domestic demand may also moderate after various eco-point programmes expire.

Japan's earnings revision momentum has levelled off. Going forward, we see downward pressure on FY2011 expectations due to worsening macro conditions, and the stronger yen.

While the Bank of Japan (BOJ) has just announced moves to weaken the yen, it is uncertain if the intervention will have lasting impact, especially if the US Fed carries out another round of quantitative easing later this year.

At the current TOPIX level of 837.65, Japanese stocks appear oversold and inexpensive. The price-to-book ratio for TSE1 companies has fallen to 1.0x, the lower end of the historical range. FY2010 expected dividend yield of 2.1% also exceeds the 10-year JGB yield of almost 1%. Any sustained rebound in Japanese stocks will require a much stronger outlook for the US economy, in our view. Nevertheless, for those with a longer-term investment horizon, the current weakness presents buying opportunity.

We are broadly sector neutral, emphasising structural growth, quality and yield. We are overweight in Industrials, Materials and Consumer Discretionary. We are neutral in Technology, Info-Communications, Pharmaceuticals, Banks, Real Estate and Consumer Staples, and underweight in Utilities, and Non-Banks.

### Key Additions to the Model Portfolio

We have not made any changes to our model portfolio stocks. However, we have made minor changes to our target sector weights.

We have raised Financials to neutral, mainly by increasing our weighting in the banks given their near-trough valuations and reduced risk of additional capital issuance. Our preferred picks include **MUFG** and **Suruga Bank**.

We have also raised our weightings in Pharmaceuticals and Telecommunications to neutral at the expense of Technology and Energy. Within Pharmaceuticals, we favour generic companies such as **Sawai Pharmaceutical**, because of the Japanese government's push for more affordable drugs and companies that derive all of their sales domestically, like **Tsumura**, due to the strong yen. Within Telecommunications, **NTT** looks deeply undervalued, and offers an attractive yield of 3.2%.

We have turned less positive on Technology because the demand-supply outlook has deteriorated. We have trimmed our weighting in PC-related stocks. Companies with relatively stronger gearing to corporate demand (**Canon**, and **Fujitsu**), and those actively embarking on mergers and acquisitions (**Nidec**), and restructuring (**Fujifilm**) appear better positioned to weather the industry slowdown.

MODEL PORTFOLIO		
SECTOR	WEIGHT	TOP PICKS
Autos	Neutral	Honda
Real Estate	Neutral	Mitsubishi Estate
Energy	Neutral	Inpex
Financials	Neutral	MUFG, Suruga Bank
Materials	Overweight	Nippon Electric Glass, Shin-Etsu Chemical
Technology	Neutral	Canon, Nidec, Fujitsu, Fujifilm
Industrials	Overweight	Kubota, Mitsui & Co., Fanuc
Healthcare	Neutral	Tsumura, Sawai Pharmaceutical
Consumer Staples	Neutral	Toyo Suisan
Retail	Overweight	Sundrug, ABC Mart
Info-Comm	Neutral	NTT
Utilities	Underweight	Tokyo Gas



## ASIA EX-JAPAN

### Equity Strategy

Asian economies are poised to soften as we enter the last quarter of 2010. With the US ISM new orders index rolling over from its peak, we think Asian export and industrial production growth are likely to peak in the third quarter of 2010 and slow in the fourth quarter of 2010. China's economic growth is likely to slow in the fourth quarter of 2010 due to the government's property tightening measures and reduced liquidity in the system. Inflation may also be an issue for China and India, but will be contained for the rest of Asia. Nonetheless, amidst the slowing economic growth momentum in Asia, we think valuations are inexpensive relative to historical averages and are likely to provide some support to stock prices.

Our key strategy going forward is to maintain our growth bias and focus on Asia's robust domestic demand, which in our view will drive corporate earnings growth and valuation expansion. In navigating the uncertain financial markets, we seek clarity through identifying and investing in Asia's domestic consumption trends.

We maintain our overweight positions in the Consumer, Healthcare and Industrials sectors as we target domestic consumption growth in these areas. We also maintain our overweight position in Technology as we identify several technology migration trends. We maintain our underweight positions in Properties and Financials on policy risks and in the relatively slower growth sectors like Telecoms.

**Consumer** – We maintain our overweight in this sector as we think consumption will continue to remain strong especially during China's long Golden Week Holidays. With short term growth prospects remaining unchanged and valuations still at attractive levels, we think markets have over-discounted the slowdown in the Chinese economy in the last quarter. As such, we position ourselves in companies that continue to outperform peers in the last quarter and hopefully in the coming quarter as well. We maintain our preference for domestic consumer discretionary stocks and continue to look for or hold onto stocks which investors have low expectations relative to their growth prospects.

**Industrials** – We maintain our overweight in this sector with a positive view in the alternative energy space as key economies like China and India ramp up nuclear and wind energy generation targets. Infrastructure plays like Zhuzhou CSR Times Electric and Midas are also likely to benefit from continued spending in China's high speed railway and metro sectors. Although companies may face lower margins on rising raw material prices as well as reduced infrastructure spending in China, we believe the strong domestic demand will drive corporate earnings expansion and valuation within the sector.

**Conglomerates** – We remain neutral in this sector on attractive valuations as conglomerates now trade at decent discounts to sum-of-parts valuations. We selectively position ourselves in cyclical sectors and expect earnings to rebound as the global economy recovers. We like prime beneficiaries of the global economic recovery such as Hutchison Whampoa, which is exposed to port, retail and property sectors. Stable oil prices should encourage higher exploration and production spending and lead to more contract flows for Keppel Corporation. Meanwhile, increased gas supply in China will support earnings growth of gas distributors like Beijing Enterprises.

**Financials** – We maintain our underweight position in this sector as we see downside risks to earnings expectations from slowing loan growth and a slower-than-expected net interest margin recovery. We think policy risks on loan provisioning could lead to negative earnings surprises in China and Korea. On the flip side, Chinese banks offer attractive valuations over the medium-term horizon, although policy risks could weigh on performance in the short-term. We like large banks which benefit from rising net interest margins in the early part of the interest rate hike cycle.



# GLOBAL EQUITY STRATEGY

**Real Estate** – We maintain our underweight position in this sector as policy risk continues to be an overhang with new measures to cool the property market announced in Hong Kong and Singapore, as well as the reiteration of current tight policy in China seen last quarter. Elsewhere, other Asian governments like Malaysia are also considering imposing restrictions to rein in a potential asset bubble. China property volumes look to have bottomed in June and will likely continue to recover in the peak September to November sales season. Within the sector, we prefer Singapore commercial property players over Chinese and Hong Kong developers for its shelter from policy risks.

**Technology** – We maintain our overweight position in Technology as we identify the emergence of two key technology migration trends in the PC and handset chain. In addition, we think telecommunication equipment suppliers are likely to benefit from capital expenditure spending for 2G network enhancements and 3G network expansions. With the sector trading at attractive valuations relative to history, we think players in these sectors are likely to face upward divergences in earnings growth and possible valuation re-ratings driven by market share gains and margin expansion.

**Telecom Services** – We maintain our underweight position in the Telecom sector as we expect growth to remain largely subdued, although we see pockets of growth opportunities in selected countries. Nonetheless, the recovery of regional economies would drive minutes of usage and subscriber take-ups, which will offset the decline in tariffs. Net additions in subscribers should continue regionally, with the strongest being in China, India and Indonesia where penetration rates are still low. While earnings are expected to be stable for most players, valuations are undemanding.

**Materials** – We maintain our underweight position in this sector on concerns of decelerating economic and industrial production growth in China. We think sharp rises in material prices and industry overcapacity are likely to act as headwinds in the sector. On the flip side, we expect government measures that control capacity expansion to benefit existing players with the capability to consolidate smaller companies. Within the sector, we selectively position ourselves in stocks with decent earnings growth and valuations such as paper companies.

**Energy** – We continue to expect oil prices to be range-bound after its strong rally, but think prices are unlikely to drop significantly due to oil supply discipline and the stabilisation of economic activity. We are of the view that the economic recovery bodes well for the coal sector but policy risk will be a key overhang for Chinese coal stocks. We favour the upstream exploration and production companies with strong production growth such as CNOOC.

**Utilities** – We upgrade the sector to an overweight position as we see investment opportunities in the alternative energy and environmental protection space as Asia battles pollution and diversify its energy sources. While power demand growth slows as economic momentum eases, countries such as China are aggressively expanding the production capacity of alternative energy sources. We also see opportunities in wastewater treatment as governments increase spending on environmental protection. We like companies with strong operational track records which have shown the ability to secure more projects and record strong earnings growth.

**Healthcare** – We maintain our overweight position in the sector as we think it is a safe haven given the onset of ageing population and increased government budget allocations for healthcare spending. We expect pharmaceuticals and medical equipment sales to grow strongly on the back of healthcare reforms in China in the next two years. We also see healthcare providers in Southeast Asia benefitting from the growth in medical tourism in the region.



# GLOBAL EQUITY STRATEGY

## Key Additions to the Model Portfolio

In the Utilities sector, we have added **Beijing Enterprises Water** (BEW), a leading water sewage and consultancy services provider in China, as we think China's water treatment sector will continue its strong growth due to its low water resources per capita and low waste water treatment ratio. BEW is likely to experience aggressive capacity expansion through acquisitions and asset injections from its parent, with waste water treatment capacity increasing from 3.5 million tonnes in 2009 to 10 million tonnes in 2011. Its build-operate-transfer and transfer-operate-transfer business models should provide high earnings and cash flow visibility. BEW will also continue to bid for Build-Transfer projects, which requires lower capital expenditure. Other earnings drivers include its venture into water desalination and expansion into overseas markets. As such, we expect very strong earnings growth for BEW over the next two years.

In the Technology space, we have added **Young Fast Optoelectronics** (YFO), one of the world's leading and most profitable handset touch panel manufacturers and assemblers. YFO offers a complete range of resistive and capacitive touch panels and is a good proxy of the growing adoption of touch panel among smart phones. Its major customers (which accounts for 70% to 75% of its revenue) are gaining market share through the rising adoption of Android phones. The concentration of revenue from existing customers is expected to reduce to 55% upon the inclusion of new customers next year such as Nokia, Motorola and RIMM. Earnings in the second quarter of this year were ahead of consensus on better yield and material cost reduction with the management guiding 3Q10's revenue to reach a new high as they operate at full capacity. Valuations remain attractive and we foresee upside risks as brokers should revise their earnings forecast for 2010 and 2011 upwards going forward.

In the Technology sector, we have added **Pegatron**, a Taiwanese design, manufacturing and services company. We think Pegatron's market share should surprise positively on new order wins, at the expense of the existing industry leaders like Quanta and Compal Electronics. We also expect Pegatron to gain new orders in Acer's notebook, Sony's Playstation 3 and Apple's iPod shuffle and CDMA iPhone. Separately, Pegatron has also submitted a bid to be qualified as Apple's second supplier of its iPad products after Hon Hai. Due to these reasons, we think Pegatron should have a stronger growth momentum relative to its notebook peers because of its product diversification. We think valuations are not excessive given the possibilities of earnings upgrades from potential new orders in the CDMA iPhone, new notebook PC orders and the possible successful qualification as a supplier in iPad products. Its current utilisation rate of 55% to 60% could also surprise on the upside, which may see the stock rerate further.

MODEL PORTFOLIO		
SECTOR	WEIGHT	TOP PICKS
Consumer	Overweight	Man Wah Holdings and Great Wall Motor
Industrials	Overweight	Zhuzhou CSR and Dongfang Electric
Conglomerates	Neutral	Beijing Enterprises
Financials	Underweight	China Construction Bank and Ping An Insurance
Property	Underweight	Overseas Union Enterprise
Technology	Overweight	Young Fast Optoelectronics and Pegatron
Telecoms	Underweight	China Telecom
Materials	Underweight	Shandong Chenming Paper
Energy	Neutral	PT Tambang Batubara Bukit Asam
Utilities	Overweight	Beijing Enterprises Water
Healthcare	Overweight	China Shineway



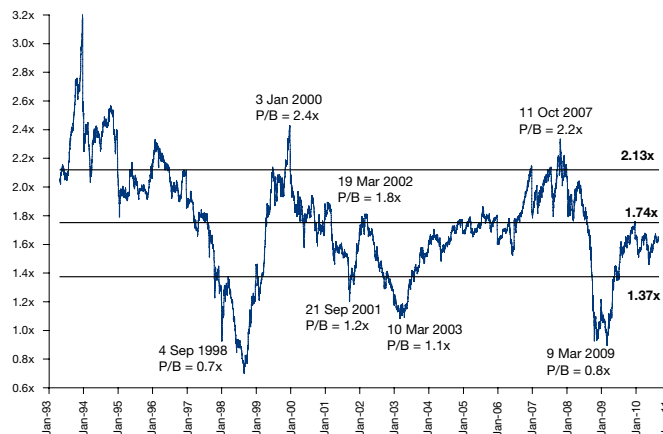
## SINGAPORE

### Equity Strategy

External events continued to dictate the direction of the Singapore market and these largely centred on the risk of a double dip recession in the developed markets. While events in Europe initially influenced the local market during the quarter, fears over a double dip recession in the US subsequently took over, especially when payroll numbers turned out much softer than expected. The soft patch experienced by equity markets took a turn for the better when the US ISM data for the month of August rose month-on-month instead of falling, and August US private payroll numbers posted a positive surprise. Sentiment started improving noticeably following these important economic data points and this eventually lifted the Straits Times Index beyond the psychologically important 3,000 points level.

If, as we are assuming, the global economy does not enter a double dip recession, the Singapore market is still quite attractive from a valuation perspective. At nearly half standard deviation below mean Price/Book and close to one standard deviation below mean Price/Earnings (12-month forward), the market has been cheaper on only three occasions – the 1997 Asian Financial Crisis, the 2003 SARS episode and the recent Global Financial Crisis. As we are of the view that this is a cyclical bull market correction, our top-down (mean Price/Book of 1.74x on 2010 book) approach derives an FSSTI fair value of 3,150 for year end.

Singapore Equities Price/Book Valuations



Source: Citi Investment Research, 2 September 2010

On the local front, the government unveiled further measures to curb property speculation by stipulating a maximum loan-to-value ratio of 70% for loans beyond the first mortgage, in addition to other specifics such as imposing more conditions on the purchase of resale HDB flats. Property stocks bore the brunt of selling as the property measures were not expected, as this was the third time the government has acted to cool the property market in under a year.

For the fourth quarter of 2010, we have an overweight stance on the banks, tourism plays, office and selected supply chain managers. We remain cautious on the property developers in general given the potential for more government measures to dampen speculation if transaction volumes and prices stay high. We added **OUE** to the model portfolio for exposure to the improving office sector in Singapore and the positive outlook for the hotel sector.



# GLOBAL EQUITY STRATEGY

## Key Addition to the Model Portfolio

We favour **OUE** for its prime office and hotel assets exposure in which we see potential for more valuation upgrades than the local residential sector. The Group is among the few local landlords with a pipeline of prime office completions (only 12% pre-committed) that are positioned to ride the current recovery in office demand and rental rates. Its prime hotel asset, Mandarin Orchard will continue to do well on the back of increasing tourist arrivals with the completions of more tourist attractions in 2011. We estimate its RNAV to be \$3.80/share and we expect the discount to RNAV to narrow as the Group secures higher commitment at its new offices at higher rates.

MODEL PORTFOLIO		
SECTOR	WEIGHT	TOP PICKS
Consumer Discretionary	Underweight	Jardine Cycle & Carriage
Consumer Staples	Overweight	Wilmar International, Pacific Andes
Financials (Banks)	Overweight	OCBC, UOB
Financials (Real Estate)	Overweight	Capitaland , CDL Hospitality Trust, OUE
Healthcare	Neutral	-
Industrials (Capital Goods)	Underweight	Keppel Corporation, SembCorp Industries
Industrials (Transportation)	Underweight	SIA, Tiger Airways
Information Technology	Neutral	-
Telecommunications	Underweight	Singapore Telecom



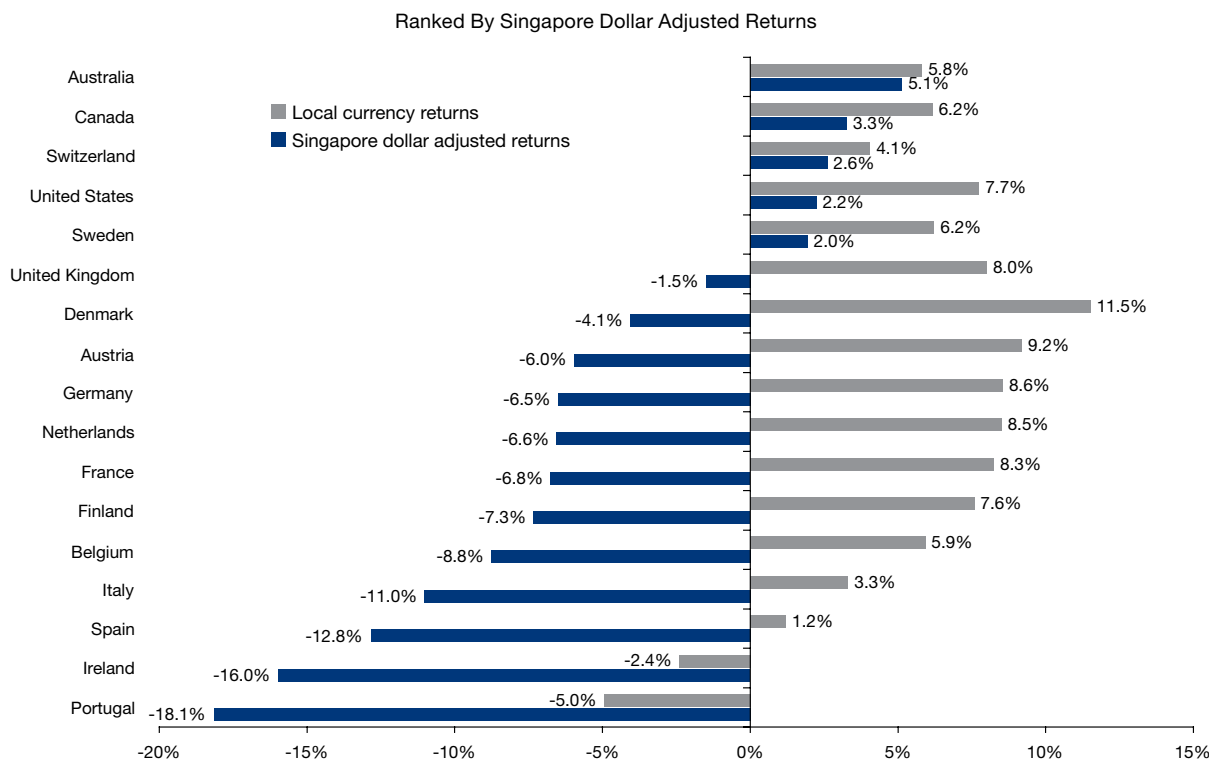
# GLOBAL FIXED INCOME STRATEGY



# GLOBAL FIXED INCOME STRATEGY

## Bond Market Returns

Year to date Bond Market Returns as at 14 September 2010



Source: Bloomberg, 14 September 2010

## G-10 FIXED INCOME

### Outlook And Strategy

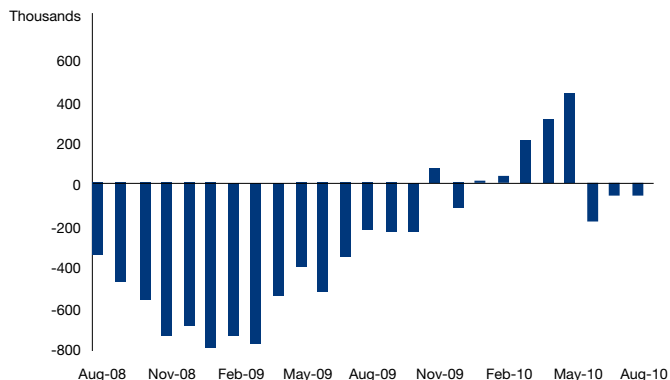
The quarter saw government bond yields falling further as the economic environment started to show signs of macroeconomic weakness; especially so in the US. Some of the past fiscal measures (cash for clunkers, extended unemployment claims, housing tax credit) have come to an end. The recent weak performance in the US housing market sparked concerns over the fragility of the consumer without governmental support. Further softening in the regional manufacturing indices cast doubts on the sustainability of the business sector as the inventory replenishment in the early part of the year appears to be mostly completed. Weak

employment growth in the US and Europe also weighed on investor concerns. In Europe, the poor economic performance of the peripheral countries (Ireland, Spain, and Greece) in light of the continuing harsh austerity measures in a slowing global economic environment was reflected in their respective wider credit spreads against Germany. With the European banking stress test completed, however lenient the stress parameters might have been; the future remains bleak as the path to fiscal consolidation begins. Japan, was also struggling with its economic performance and had to announce another monetary stimulus which was perceived to be half hearted as it experienced another change in political leadership. The developed economies continued to face many challenges in domestic demand. Although official intervention prevented the worst, sustainable domestic growth remains fleeting without help.



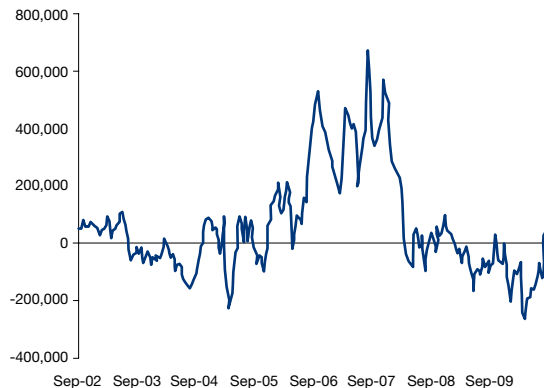
# GLOBAL FIXED INCOME STRATEGY

Nonfarm payroll employment over-the-month change, seasonally adjusted, August 2008 – August 2010



Source: Bureau of Labour Statistics

10yr Note: Combined Futures & Options Spec. Position



Source: Barclays Capital

Fed Chairman, Ben Bernanke summed the current economic environment as “unusually uncertain”; and took lengths to explain the remaining policy tools available to further stimulate the economy. The speech was delivered after an earlier move to keep the US Fed balance sheet at a fixed size in light of the uncertain economic outlook. The concern is that the supply and cost of credit are not the real problems as demonstrated by the overall lower level of interest rates, tighter credit spreads and historically low mortgage rates. With inflation likely to stay low and unlikely to rise as long as the demand picture remains soft, there is room to further push on the monetary pedals that Fed Chairman had detailed. However, the question remains on the efficacy and the ability to generate sustainable future growth.

In light of the likely lower growth profile and hence a prolonged lower official interest rates, we are recommending a neutral duration profile despite current low yields. Without further deterioration in the growth profile, the current low interest rates in the developed markets might struggle to further rally. We prefer overweight exposures in European debt markets as the best of growth is likely over, coupled with further austerity measures which would likely dampen future growth. Already, the debt markets are starting to price in worsening economic and financial conditions in the peripheral countries in Europe. Japan remains underweight as 10-year government yields had reached a bottom at slightly below 1%.

Despite the recent drop in global government interest rates at the long end, the bond market is not necessarily over-bought, according to the position survey data. Position data appears to point to neutralisation in positions rather than an extreme economic outcome. The key risk to the bond market continues to be an unexpected large increase in issuance if the recent monetary measures fail to work as expected; whereby, fiscal policy stimulus measures could re-accelerate and worsen an already poor fiscal position. Policymakers though, remained split on the willingness to increase the quantum of fiscal measures but the time may come where there is no choice but to expand the fiscal malaise. However, the 2008 crisis started due to excessive debt financing; will more debt help economic recovery?



# GLOBAL FIXED INCOME STRATEGY

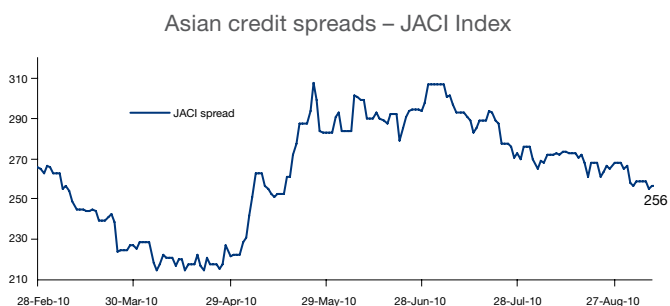
## ASIA FIXED INCOME

### Outlook And Strategy

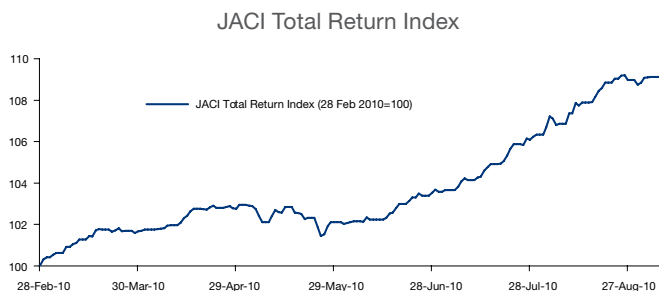
The Asia credit market rallied over the past quarter. Over the past three months, Asian credit spreads fell 50 bps to 256 bps. The current spread of 256 bps on 9 September 2010 is the tightest since 16 May 2010.

At the current spread of 256 bps, Asian credit spreads is 42 bps wider than the recent tight range of 214 bps which was reached on 21 April 2010. JACI on a total return basis (including accrued interest and in USD terms) rose 5.4% during the period of 30 June 2010 to 9 September 2010.

We think that the Asian credit market is fairly valued at the current spread of 256 bps. The current spread implies a real Asian GDP growth rate of 7 to 7.5% over the next one year.



Source: Bloomberg, 9 September 2010



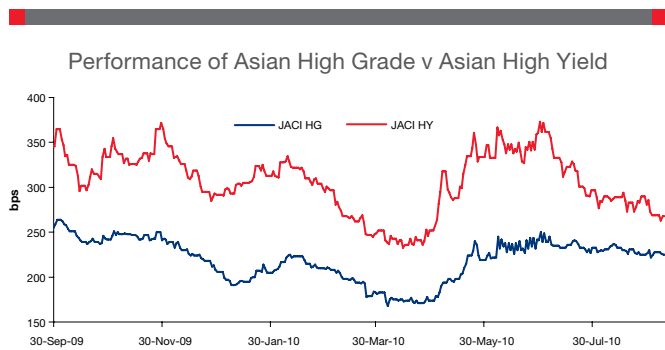
Source: Bloomberg, 9 September 2010

We remain defensive on the Asian fixed income market due to the uncertainties over US economic growth. If growth slows sharply with disappointing consensus expectations in the second half of 2010, the recent rally in Asian credit could be at risk. We also believe that growth in China in the second half of 2010 could be another risk.

There are indications that the Chinese economic growth could cool towards 8% to 9% growth rates in the second half of 2010. Slowing Asian GDP growth could lead to wider credit spreads. Hence, we are currently defensively positioned, with an overweight position in High Grade credits and an underweight position in High Yield credits.



# GLOBAL FIXED INCOME STRATEGY



Source: Bloomberg, 9 September 2010

With US interest rates likely to stay low in the next three to six months, we continue to like Asian long duration High Grade corporate bonds. We prefer Singapore and Hong Kong High Grade names as these two countries are viewed as safe havens.

In **High Grade**, we maintain our overweight positions in Hong Kong and Singapore High Grade corporates. The Hong Kong credits include **New World Development**, **Henderson Land** and **Hutchison**. These companies offer decent yield pick-up over similarly rated credits and duration without a compromise in credit quality. We also like defensive triple-A rated bonds like **Temasek** 5.375% 11/2039 and **PSASP** 3.875% 02/2021 as these bonds will be a key beneficiary of a further decline in US interest rates.

In **High Yield**, we prefer good quality corporate bonds like **Adaro** and **Cogard** that have strong balance sheets and solid business models. We also like **Indosat** and **Stats ChipPac** for their strong parentage and decent yield. Indosat is 65% owned by Qatar Telecoms and 14% owned by the Indonesian government while Stats ChipPac is 84% owned by Temasek.



# GLOBAL FIXED INCOME STRATEGY

SECTOR	CREDIT OUTLOOK
<b>Banks</b>	<ul style="list-style-type: none"> <li>The Basel Committee has made amendments to the initial proposal dated December 2009, with a less onerous framework being adopted. We think that the less onerous requirement is a positive development for the sector as it reduces the risk that regulation would worsen credit availability.</li> <li>While the committee is still finalising the definition of Tier 1 capital as well as the minimum regulatory core capital ratio, the new definition of Tier 1 capital will see minimal impact on Asian banks.</li> <li>Asian banks are generally well-capitalised with core capital comprising a majority of Tier 1 capital.</li> <li>In addition, given the tightened regulatory language for hybrid capitals, we think that the existing bank capital such as the Tier 1s and Tier 2s issues should fetch a premium on the back of this development.</li> </ul>
<b>Industrials</b>	<ul style="list-style-type: none"> <li>Our view for the industrial sector remains neutral.</li> <li>We still like corporates that have strong balance sheets and sound business models. But we also see risks of corporates turning aggressive with an uptick of debt-funded M&amp;A, more shareholder friendly activities such as dividends and buybacks, as well as opportunistic debt raising due to low cost of debt financing.</li> <li>We continue to see relative value in unrated corporate bonds which give some spread premium over similarly rated issuers.</li> <li>We continue to like the Indonesian coal sector. We believe that its fundamental backdrop remains strong as the sector will benefit from supportive coal prices and strong demand from China and India, as well as domestic power producers. While trading technicals also remain supportive of this sector, we note that valuations are turning rich.</li> </ul>
<b>Property</b>	<ul style="list-style-type: none"> <li>We are turning neutral on the Chinese property sector as this sector has been a laggard due to policy risks as well as supply risks. We are also staying cautious on headline policy risks and supply risks as new names are looking to issue bonds.</li> <li>While the series of measures in April have hit sentiments and lowered prices, we see that contracted sales remained largely in line with company forecast. We remain cautious on the policy front.</li> <li>We are also seeing a strong pipeline of supply in this sector from new names and smallish developers, which we think will limit upside.</li> <li>We prefer larger and well-established issuers.</li> <li>We also prefer to stay invested in the unrated Hong Kong developers which provide premiums over similarly rated issuers.</li> </ul>
<b>Oil &amp; Gas</b>	<ul style="list-style-type: none"> <li>Refining margins continue to improve from the low in the fourth quarter of 2009.</li> <li>However valuations of the Korean refineries remain expensive versus other Korean quasi-sovereigns, despite the recent market correction. Hence we are maintaining an underweight position on this sector.</li> </ul>
<b>Utilities</b>	<ul style="list-style-type: none"> <li>We like this sector for its defensive and stable qualities. Revenue and earnings have been stable. Balance sheet remains robust, with continued improvement in credit metrics.</li> <li>We think there could be supply risk as companies take advantage of the low rates to issue bonds. We also do not rule out debt-funded M&amp;A/shareholder-friendly transactions.</li> <li>We also remain positive on the Korean utilities, and would participate in new issuances with attractive valuations. We continue to believe that the fuel pass-through mechanism will be implemented in July 2011 as guided by the Korean Ministry of Knowledge Economy.</li> </ul>
<b>Consumer</b>	<ul style="list-style-type: none"> <li>Although we believe fundamentals will remain supported by resilient consumer spending, we are neutral on this sector due to the lack of superior risk-reward opportunities.</li> </ul>
<b>Telecommunication</b>	<ul style="list-style-type: none"> <li>We expect to see continued subscriber growth and also increased average revenue per user, driven by the roll-out of new services, as well as mobile and broadband network expansion in most countries.</li> <li>In addition, competition between telcos in Korea and Indonesia has subsided, and margin pressure should ease further.</li> <li>Despite its defensive qualities, valuations remain expensive in general; hence, we are neutral on this sector. That said, consolidation in the Indonesian telco industry may create selective buying opportunities.</li> </ul>



## SINGAPORE FIXED INCOME

### Third Quarter Review

Second quarter of 2010 GDP growth increased to 18.8% year-on-year from 16.9% year-on-year in the first quarter of 2010. On a seasonally adjusted annualised basis, real GDP jumped 24% quarter-on-quarter in the second quarter of 2010 from 26% quarter-on-quarter previously. The strong second quarter of 2010 GDP growth took first half 2010 GDP growth to 17.9% year-on-year.

Manufacturing sector was the key driver of growth, rising 44.5% year-on-year versus the first quarter of 2010 growth of 37.9%. Manufacturing jumped 60% quarter-on-quarter in second quarter of 2010 from 199.1% quarter-on-quarter in the first quarter of 2010 on robust biomedical and electronics. Services growth slowed to 11.2% year-on-year from 11.4% year-on-year in the first quarter of 2010. However, growth remained robust, led by the wholesale and retail trade, financial services, and tourism related sectors.

The Ministry of Trade and Industry (MTI) kept its 2010 GDP growth forecast at 13% to 15%. MTI noted that US growth, especially consumer spending, will weaken in the second half of 2010. In addition, the economic recovery in Europe will be sluggish. Asia's growth has also been affected by slower external demand, with China's growth momentum moderating. MTI expects that while Singapore's second half of 2010 growth to remain healthy, negative quarter-on-quarter growth is likely in the second half of 2010 with a "possible" technical recession (defined as two consecutive quarters of quarter-on-quarter decline). Anticipated plant maintenance shutdowns in biomedical will also be a drag, although sustained growth in electronics should provide important support.

MAS maintained that inflationary pressures are within expectations and are not alarming. It is maintaining the 2.5% to 3.5% 2010 inflation forecast and the surge in wheat price will not be significant to domestic price surge. They also believe that the current monetary policy stance is "appropriate". We maintain our expectation for the Singapore dollar to weaken from 1.3360 to around 1.35 to 1.38 in the fourth quarter of 2010 on the back of a weaker US economy as well as a cooling Chinese economy.

### Outlook And Strategy

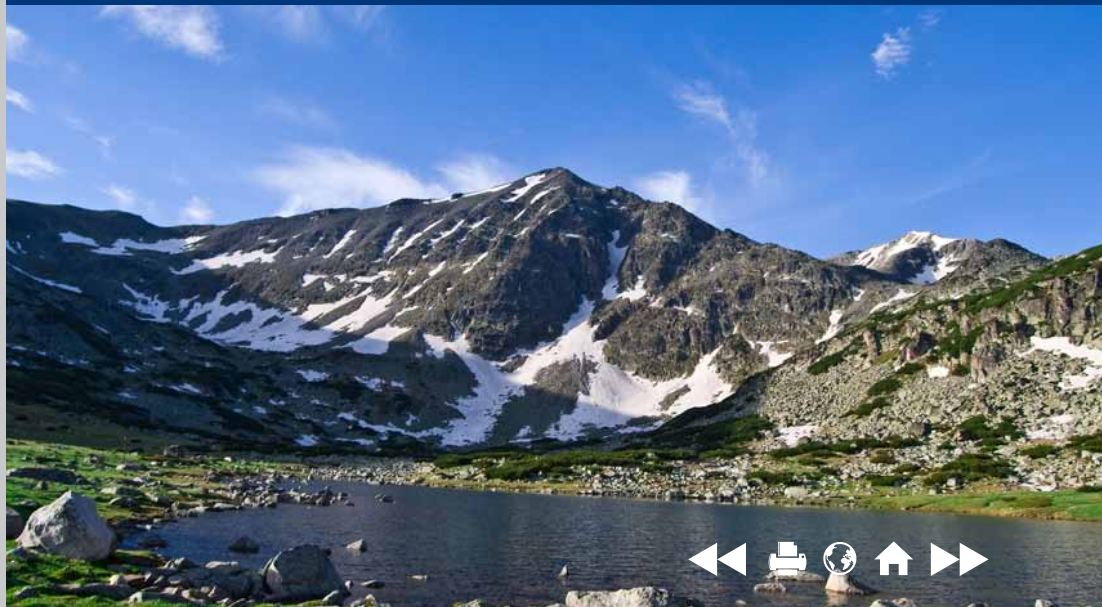
US Treasuries (USTs) rallied in the third quarter of 2010 on the back of the US Fed's announcement that they will reinvest receipts from maturing Mortgage-backed securities into USTs. The UST curve "bull flattened", that is, yields at the long end fell more than at the short end. The yield on two-year USTs fell 10.5 bps to 0.504% while the yield on 10-year USTs fell 24 bps to 2.70%. The 2-10 curve flattened by 13.1 bps to 2.195%.

Singapore Government Securities (SGS) also rallied in the third quarter of 2010. The two-year SGS yield rose 5.3 bps to 0.48% while the 10-year SGS yield fell 18 bps to 2.191%. Consequently, the 2-10 spread flattened by 13 bps, to 1.703%.

With leading indicators continuing to turn south, we believe that the market is underpricing a growth slowdown in the second half of 2010. However, the strong rally in SGS over the past three months has pushed yields to the deeply over-valued territory. Hence, we are maintaining our neutral position in SGS. We continue to believe that the 10-year SGS yield at 2.2% currently looks expensive although we concede that yields could fall further by 10 to 15 bps if US Fed embarks on quantitative easing again.



# CURRENCIES



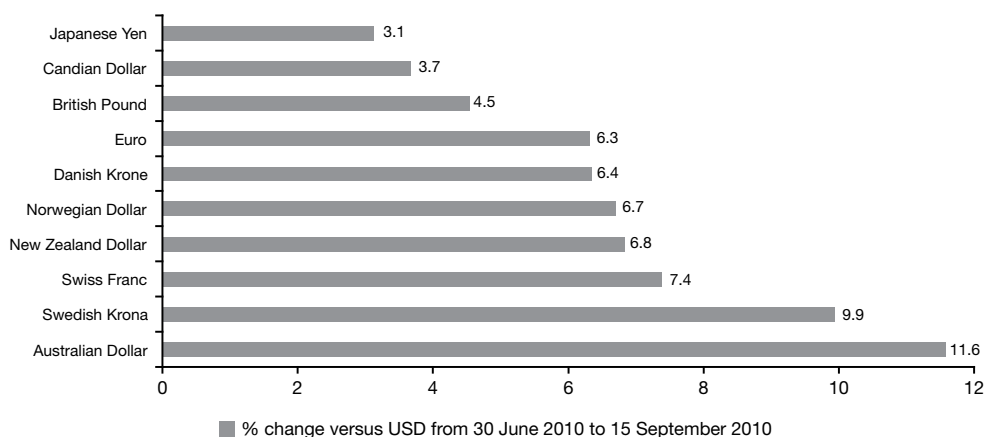
# CURRENCIES

## Third Quarter Review

The US dollar (USD) weakened in the third quarter of 2010 as the sovereign debt crisis in Europe abated and the US Fed announced in August that they will purchase UST. The pressure on Euro has abated since the announcement of the €750 billion stabilisation package by ECB in May. The best performing G10 currency was the Australian dollar, which surged 11.6% on the back of expectations of further rate hikes by the Reserve Bank of Australia as well as optimism over the growth prospects in China. The Japanese yen (JPY) was one of the worst performing G10 FX but was still up by 3.1% against the US in third quarter of 2010. The JPY was affected by Bank of Japan (BOJ) intervention to weaken the currency in the third week of September.

Asian currencies were also stronger against USD over the third quarter of 2010. The Thai baht, Korean won and Philippine peso were up 5.25%, 5.22% and 4.67% respectively against the USD, and were the top three performing FX in Asia in the third quarter of 2010. The worst performing Asian FX were Indian rupee (+0.19%), Hong Kong dollar (+0.28%) and Chinese renminbi (+0.57%) but even these FX also gained against the USD.

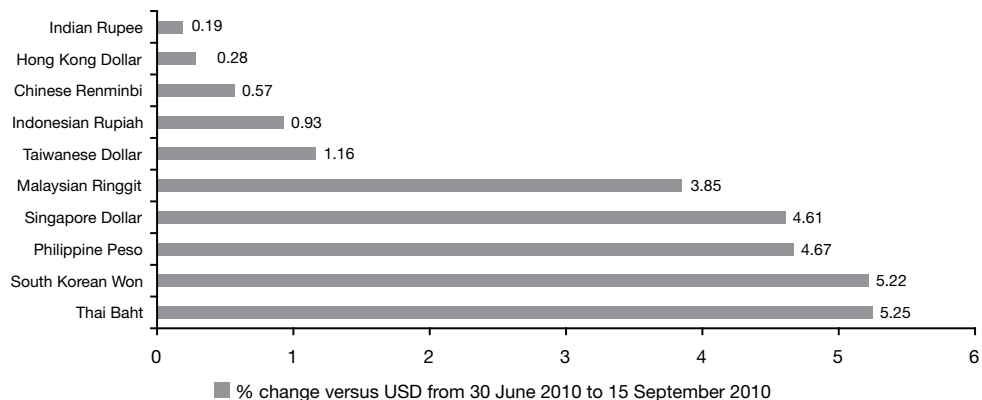
G-10 currencies against US Dollar



Source: Bloomberg, 15 September 2010

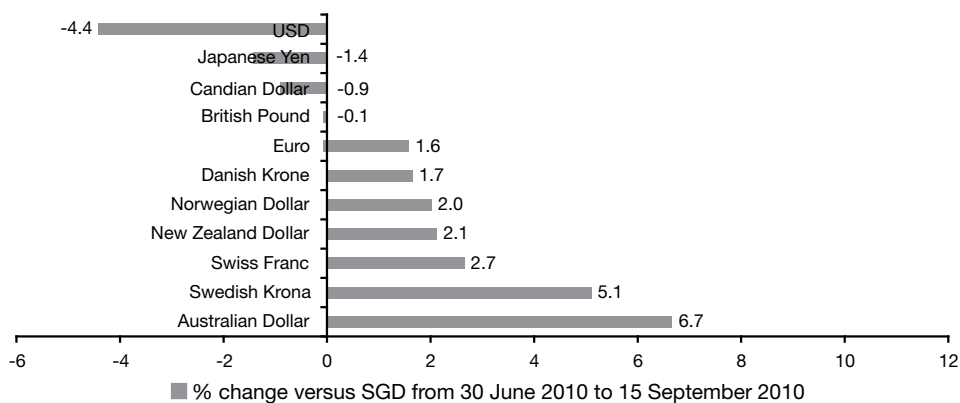


US dollar against Asian currencies



Source: Bloomberg, 15 September 2010

G10 currencies against Singapore dollar



Source: Bloomberg, 15 September 2010



# CURRENCIES

## Outlook And Strategy

We think that it is highly unlikely that the USD will depreciate at the same rate in the fourth quarter of 2010. We think worries over the European sovereign crisis as well as the economic slowdown globally could cause a small rally in the USD in the fourth quarter of 2010.

With the strong rally in Asian FX over the past three months, most Asian FX appears to be richly valued currently. On the Real Effective Exchange Rate (REER) basis (which is a traded-weighted basket of FX adjusted for inflation differential), most Asian FX, with the exception of Hong Kong dollar, Korean won and Taiwanese dollar, are above the 10-year REER average.

Furthermore, our econometric model suggests that only Chinese renminbi, Indian rupee and Hong Kong dollar are under-valued against the USD. The rest of the Asian FX is over-valued by 1.2 to 21.2% against the USD. Our model indicates that JPY is now extremely over-valued by 21.2%. We think that the intervention by BOJ could push the JPY to 87 to 88 over the next few weeks. For the rest of the Asian FX, with the possible exception of Chinese renminbi, Indonesian rupiah and Malaysian ringgit, we expect a modest weakening against the USD in the final quarter of 2010. We also expect the Indonesian rupiah, Malaysian ringgit and Indian rupee to outperform as they have attractive “carry” and are attractively valued with a compelling structural story.

CURRENCY FORECAST		
Currency	Against USD 15 September 2010	Forecast End 4Q 2010
Japanese Yen (JPY)	85	87
Euro (EUR)	1.30	1.25
Singapore dollar (SGD)	1.3380	1.36

Source: Forecast figures are consensus numbers from Bloomberg, 15 September 2010.



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