ASIA EX-JAPAN

After a modest improvement in Asia's economic outlook in the previous quarter, the growth outlook has started to moderate somewhat. Uncertainty arising from the Eurozone debt crisis, weaker external demand (trade) and a moderation in domestic demand has caused key leading indicators to dip. While Asia's banking systems remain healthy and are better positioned to absorb the impact of Euro zone credit challenges, trade linkages and a concurrent drop in external demand are placing a downward bias to the growth outlook. Lower oil prices and moderating inflation have enabled central banks to ease policy stance by lowering reserve requirements and in some instance lowering interest rates. The weaker economic backdrop is filtering through to the corporate sector and is placing downward pressure on operating margins and corporate profitability.

Growth indicators in China, India, Taiwan and Singapore have negatively surprised so far. Meanwhile, inflation has remained stickier than expected in Singapore, Hong Kong and India. Industrial production in the big four economies of China, India, South Korea and Taiwan have moderated in recent months, while those in the Asean economies of Indonesia, Philippines, Malaysia and Thailand have in general held up better.

Weaker industrial data is to a large extent being influenced by weaker external demand. Exports have been growing at negative or single-digit growth rates across most of the region. While still a bright spot, domestic consumption has been decelerating too. Relatively stronger domestic demand, thanks largely to higher income levels, is still creating end market opportunities. For example, China retail sales have grown steadily at 15% year-on-year.

Asia's direct financial exposure to the Euro zone is modest. There is a negligible amount of private sector debt holdings in the peripheral European countries of Greece, Portugal, Ireland, Italy and Spain. And while the availability of credit was temporarily affected by the exodus of Euro zone banks from the region, other players (UK and Asian) have stepped in to fill the gap.

The main mechanism of transmission of the Euro zone's problems has been through trade linkages. Exports to the developed world have been tracking below trend. The slowdown in Euro zone growth is recycling into weaker global demand. Asia's high export dependency suggests that growth rates will correlate with this weaker external backdrop. Certain economies that are more domestically driven are less exposed to the trade shock (e.g., India, Indonesia and the Philippines), although some, such as India, face domestic challenges as well.

With energy prices having declined and inflation data starting to soften, policy makers have more flexibility to relax monetary conditions to counter the dip in demand. However, with several of the regions' currencies weakening (Indian rupee and Indonesian rupiah), inflation pressures have remained sticker than otherwise expected. China, Thailand and Malaysia are better positioned to relax monetary policy. On the fiscal front, most Asian governments have room to stimulate the economies. At the point of writing this report, moderate fiscal stimulus from China is in the works.

The impact of prior wage and input price increases, coupled with a slowdown in final demand, is creating renewed margin challenges for the corporate sector. Profit margins across all major sectors started to narrow in the first quarter, and earnings continue to adjust to these changes (top-line and margin). The first quarter reporting season can best be characterized as one of more misses than beats in terms of expectations. This pressure is expected to persist given the weaker growth backdrop, although the pace of revisions has slowed.

Valuations are now very attractive, with stocks trading at or near one standard deviation below mean, both on a forward Price/Earnings and Price/Book Value basis. The risk is that earnings could be revised down further.

Our strategy is to continue to stay defensive and focus on high quality growth stocks. We maintain our bias for the **consumer** sector in which higher wages continue to drive medium to long term opportunities. We further reduce our exposure to the cyclical sectors (energy and industrials), which face potential margins downside and are highly leveraged to changes in growth expectations.

In terms of sector allocation, we are overweight the **consumer**, **healthcare**, **telecommunications** and **utilities** sectors. We are underweight the **materials**, **energy**, **industrials** and **real estate** sectors. We are neutral on the **financials** and **technology** sectors.

Our greatest overweight is in the **consumer** sector, in which the staples stocks are seeing resilient earnings as margins stabilize in the short to medium term (benefiting from falling raw material and soft commodity prices). The **utilities** and **telecommunications** sectors are more defensive and backed by stable dividend yields.

Larger underweights are in the **materials**, **energy** and **industrials** sectors. The **materials** sector is more susceptible to an economic slowdown and external factors while the **energy** sector is facing headwinds from the weak oil prices and reduced capital expenditure in the oil and gas upstream segment. We are cautious on the outlook for the **industrials** sector due to reduced order levels and declines in margins, especially in the large emerging economies of India and China.

Key additions to the Model Portfolio

Chow Tai Fook

Hong Kong-listed Chow Tai Fook is the largest retailer of jewellery in Hong Kong and China and has been in operation for more than 80 years. The company is well-positioned in the fastest growing jewellery market in Asia with a well-established brand, capable management with a strong track record, and the largest distribution network covering not just first-tier cities but also lower-tier cities in China. Their operations are vertically integrated and their current scale gives them an edge in terms of marketing and managing their costs. The company is now trading at a forward PER of 11x, which we think is cheap relative to a forecast compound annual growth rate of more than 25% in the coming two to three years and return on equity of 30%. The stock has also been sold down from its IPO price of HK$15 due to investors' pessimism on the prospects of luxury sales in China. Our channel checks suggest that the company is gaining market share from its competitors and that the results are likely to surprise the market.

Capitamall Trust

Capitamall Trust (CMT) is the largest listed Real Estate Investment Trust (REIT) and the largest owner of retail shopping malls in Singapore with 15 assets. CMT has a decent track record of asset management, asset enhancement initiatives and yield-accretive acquisitions. We expect CMT to continue to grow its portfolio through acquisitions both in Singapore and regionally. Of its portfolio, 70% is in suburban areas and hence fairly resilient. The Singapore retail segment has generally been fairly defensive and the group's extensive asset enhancement projects should continue to contribute to healthy earnings growth while rental reversions should remain on a positive trend. CMT also owns a 20 % stake in CapitaRetail China Trust but this only contributes to less than 10 % of its portfolio. CMT's current gearing stands at 38.3 %, and it has issued US$400mn notes to partially refinance its S$783mn collateralised mortgage backed securities (CMBS) due in October 2012. Committed bank facilities have been obtained to refinance the remaining amount, hence mitigating any refinancing risk for 2012.

MODEL PORTFOLIO

SECTOR	WEIGHT	TOP PICKS
Consumer	Overweight	ITC, Hyundai Home Shopping
Industrials	Underweight	Shenzhen Expressway
Conglomerates	Overweight	Hutchison Whampoa
Financials	Neutral	Axis Bank, Bank Mandiri
Property	Underweight	Cheung Kong
Technology	Neutral	Hon Hai, Baidu
Telecoms	Overweight	Smartone
Materials	Underweight	Semen Gresik
Energy	Underweight	CNOOC
Utilities	Overweight	NTPC
Healthcare	Overweight	Celltrion