monthlyoutlook

DBS ASSET MANAGEMENT

July 2010

Overview: Cautiously positive

Asian risky assets delivered a generally positive month amidst continued volatility in global markets. Asian credits and most long-end Asian government bonds were well-supported, while Asian stocks edged higher. Only Asian currencies ended mixed despite the shift to a flexible exchange rate regime for the CNY. We remain constructive on the Asian economies, and think that a double-dip recession is unlikely. However, the path ahead could be volatile as Europe continues to deal with its sovereign debt problems. Eventually, we think that the issues are likely to be mostly containable, with the EU-IMF aid package acting as a sufficient buffer in the medium term for austerity measures in the fiscally-challenged nations to gain market credibility.

We are adopting a cautious stance in the short term, and expect trading in Asian credits and Asian equities to remain volatile. However, we remain constructive longer term on Asian government bonds and risky assets, including credits, currencies and stocks. We like government bonds in Korea and Indonesia, as well as their respective currencies. We also favour consumer discretionary stocks in Asia, and stock markets in Singapore, China and Hong Kong.

Asian and Global Credits: Bumpy road to recovery

Slower pace of spread widening; Europe underperformed

Spreads of major high-grade bond indices globally widened between 7-22bp in June, while in Europe and the U.S., high-yield credit spreads largely tightened. The pace of spread widening for high-grade credits moderated, suggesting that some calm may have returned to credit markets. Bonds in the U.S. and Asia outperformed those in Europe as the European debt crisis remained a concern. In Asia, new issuance volume in June was much lower than in previous months. However, secondary trading was firm, especially for a new high-yield issue by an Indonesian corporate, suggesting that demand remained healthy for attractive new issues.

Weaker leading indicators sparked double-dip fears

Leading indicators from the U.S. and China were weaker than expected in June, sparking renewed concerns that the global economy could be headed for a double-

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dip recession. Investors were further spooked when the U.S. FOMC June statement cautioned that the debt problems in Europe could slow American economic growth. However, liquidity among the European banks appeared better than investors had expected. In June, the banks rolled over a much lower-than- expected amount of borrowings into the ECB's new 3-month lending facility, from its previous 12-month lending facility.

Bumpy road ahead but long-term fundamentals intact

Our longer-term outlook for Asian credit markets remains constructive, though we are cautious that the coming months will likely remain volatile due to lingering concerns over the debt problems in Europe. Our base case scenario for global growth is that of a slow and gradual recovery, but a double-dip recession cannot be completely ruled out. We will keep a close eye on the unfolding of the European crisis and other pertinent global events, along with key economic indicators. Meanwhile, we continue to be cautious on USD-denominated high-yield Asian credits due to a heavy supply pipeline and weak credit metrics.

Asian Rates: Remain constructive on Asia

UST rallied on weak data and heightened concerns over Europe

U.S. Treasuries (UST) rallied in June on the back of weak economic data and heightened concerns over the fiscal troubles in peripheral Europe. Greece's 5-year CDS spread reached an all-time high of 1125bp due to speculation that Greece may have to tap into the EU-IMF package, as well as the announcement that it was putting up some of its islands for sale. For the first time this year, the 10-year UST yield dipped below 3%, and the yield curve bull-flattened.

Long-end government bonds outperformed in most Asian markets

Continuing macro concerns provided support to long-end government bonds in most Asian markets. In Indonesia, Moody's upgrade of its rating outlook further lifted government bonds. Bank Indonesia's move to increase the maturity range of its debt instruments was also viewed positively by the markets. Central banks in Taiwan and New Zealand raised their policy rates by 0.125% and 0.25% respectively. While the move by New Zealand was widely expected, Taiwan's was against consensus. Correspondingly, government bonds in China and Taiwan were sold off.

Remain constructive on Asian economies but expect volatility ahead

We remain constructive on the Asian economies. While we think that a double-dip recession is unlikely in Asia, the path ahead will likely be volatile due to continued concerns over Europe's debt problems. We think that Europe's fiscal debt crisis is likely to be mostly containable, unlike the 2008 credit crisis resulting from the Lehman bankruptcy. The EUR750b EU-IMF aid package, which covers the funding needs for Greece, Spain, Portugal and Ireland over the next three years, should act as a sufficient buffer in the medium term for austerity measures to gain market credibility.

Most Asian central banks likely to pause on tightening measures

We believe most Asian central banks will pause on their monetary tightening measures amid heightened economic uncertainty. Therefore, we expect to see a general bull-flattening in most Asian government yield curves. The exception would be India, where policy rates are widely expected to move higher to contain rising inflation. In particular, we are bullish Korean Treasury Bonds as we think that rate hike expectations in Korea have been over-discounted. We are also positive on Indonesia due to strong economic fundamentals and subdued inflation. Indonesian government bonds, which offer some of the highest yields in Asia, should be supported by foreign inflows, reduced volatility of the IDR and the recent credit rating upgrade by Moody's, in our view.

Asian FX: Maintain exposure to Asian currencies

China announced exchange rate regime shift

The People's Bank of China (PBOC) has adopted a new exchange rate regime which emphasizes two-way flexibility, whereby the CNY will be pegged to a basket of currencies rather than solely to the dollar. The daily fixing of the USD/CNY now appears to be referenced off the prior day's spot close, rather than the prior day's fix. This makes intraday trading of the CNY more relevant, which is consistent with a shift to a more "market-determined" regime. The initial reaction to the policy change was a strengthening in Asian currencies, which subsequently fizzled out as global risk aversion continued to dominate risk markets. Asian currencies ended the month with mixed performances against the dollar.

CNY revaluation positive for Asian currencies but effects will likely be gradual

We believe that a CNY revaluation will be generally positive for Asian currencies. Countries which compete with China for exports will now have more leeway to permit their currencies to appreciate in tandem with the CNY. However, we do not expect the CNY to strengthen aggressively in the near term because it has already appreciated substantially on a trade-weighted basis over the past few years. We look to maintain our exposure to Asian currencies. In our view, Asian currencies such as KRW and IDR still have substantial upside against the USD in the medium term, due to strong external balances and foreign reserves.

Asian Equities: Accumulate on weakness

Asia ex-Japan the only regional equity index to post gains

Asia was the only major region among global equity markets to post a gain in June. The MSCI AC Asia ex-Japan Index edged up 0.7% over the month, with Indonesia, India and Singapore outperforming, and Korea and Taiwan among the major underperformers. Among sectors, telcos and consumer staples outperformed due to their defensive characteristics, while tech and materials lagged on concerns over slowing growth. The shift in exchange rate regime for the CNY led to a temporary spike in Asian equities as investors thought that a flexible CNY will alleviate some pressure for monetary tightening in China. However, stocks weakened towards month-end with weak data from China and the U.S.

Data pointed to continued Asian growth, though momentum is moderating

Economic data across Asia was generally mixed. Industrial production in India and South Korea remained strong while Chinese production moderated. The PMI manufacturing index, a leading indicator for the Chinese economy, moderated to 53.9

in May from 55.7 in April, but remained above 50, suggesting that China's economy has not been derailed from its expansionary track. Retail spending in Singapore weakened unexpectedly, while Chinese retail sales growth accelerated to 18.7% YOY in May, from 18.5% in April.

Look to opportunistically accumulate positions on market weakness

We expect Asian markets to remain volatile in the near term, and be driven mainly by key global events, particularly the debt crisis in Europe. Nonetheless, we believe that Asian stocks will likely grind higher in the longer term on the back of steady upgrades to corporate earnings and fair valuations. Apart from Indonesia, the Asian stock markets trade at earnings multiples generally below the past five years' average. As such, we will look to opportunistically accumulate positions on market weakness. We continue to place greater emphasis on stock selection over country allocation. We are positive on the consumer discretionary sector in countries with growing incomes, such as China and Indonesia.

Overweight Singapore, China and Hong Kong

Among countries, we remain overweight Singapore as economic growth continues to be underpinned by FDI inflows and tourism arrivals. We also continue to like China due to its resilient economic growth and the likelihood that a flexible CNY regime will alleviate some pressure for monetary tightening. Wage pressures in China, which has been drawing attention in recent months, could lead to higher costs for companies. However, higher wages are also likely to boost discretionary spending, and provide an important impetus for corporate spending on automation. These trends could provide interesting stock-picking ideas, in our view. We also like Hong Kong, where continued low interest rates and the potential for a stronger CNY bode well for asset prices.

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