

March 2010

Overview: Some recovery in risk appetite

The month of February saw mixed and range-bound markets across most Asian risky assets, with concerns continuing to linger over policy tightening in China and the fiscal and public debt problems in Greece and other peripheral European economies. However, risk appetite showed a modest recovery from mid-month on bargain hunting, short covering and a growing expectation that a bailout package will be engineered for Greece.

Our medium-term views remain constructive for credits, Asian currencies and Asian equities. We continue to favour Asian bank capital securities, despite recent downgrades by Moody's in this space. We also like Asian quasi-sovereign bonds on attractive yields, and look to add to our Asian currencies exposure. In Asian equities, we continue to emphasize stock and sector selection, and favour cyclical sectors on expectations of a continued economic recovery in Asia. We are also overweight China and Singapore.

Global and Asian Credit: Buying into dips

Mixed month for credit markets on concerns over China and Greece

Credit markets continued to be weak in early February as investors remained cautious over potentially more policy tightening in China and the public debt problems in Greece. Credit spreads widened 3-8% before the market found a bottom around mid-February as bargain hunters emerged on the back of short covering and increased flows into Asian credits. Credit spreads eventually tightened off the wides for the month, but still ended February moderately wider than the month before. Among Asian credits, high-yield outperformed high-grade, due to stronger technical factors. Barring unforeseen circumstances, we believe Asian credits could see near-term decoupling from the debt problems in Greece and Dubai, given stronger fundamentals.

Moody's downgrades of bank hybrids a non-event in Asia

During the month, Moody's downgraded certain banks' hybrid securities globally, in line with its revised guidelines for rating bank hybrids and subordinated debt, published in November 2009. The new guidelines specifically affected Upper Tier 2 (UT2) and Tier 1 (T1) securities, resulting in downgrades of between 1-2 and 2-5 notches, respectively. The downgrades were a non-event in Asia, as most Asian hybrid investors are relatively rating-insensitive. We continue to like these securities given their attractive valuations and the capital strength of Asian issuers. Selected bank capital issues offer value both in terms of yield as well as potential price appreciation in the event of being called, in our view.

Remain positive on Asian credits

Concerns over the debt situation in Greece and Dubai, as well as the weak U.S. recovery, will likely weigh on credit market performance in the near term. Moreover, the spill-over of pending new issues from February into March could add to supply pressure. However, strong investor flows into Asia should be supportive of Asian credits. We maintain our view that the macroeconomic outlook remains favourable for credit over the medium term, and consider interim corrections as good opportunities to pick up selected credits at attractive prices. We will selectively participate in new issues which are attractive on both fundamental and technical grounds.

Asian Rates: Continue to like Asian quasi-sovereigns

Markets traded in a broad range on a multitude of factors

In February, markets traded in a range amid mixed economic data, the Fed's discount rate hike and uncertainty over the bailout plan for Greece. U.S. unemployment numbers for January were mixed as the unemployment rate unexpectedly declined to 9.7% while non-farm payrolls shrank by 20,000. The Fed surprised the market by raising its discount rate by 25bp, the first hike in 3.5 years, but was quick to qualify that the hike was a normalization of its lending facilities and does not signal a change in the outlook for the US. economy or monetary policy. FOMC minutes continued to state that rates will remain low for "an extended period".

Asian central banks kept policy rates unchanged

Central banks across Asia left their benchmark policy rates unchanged in February amid global economic uncertainty. The Reserve Bank of Australia unexpectedly held its policy rate at 3.75%, citing the need to gauge the economic impact of its previous three increases, and concerns that European sovereign risks may weaken the global economic recovery. The Philippines completed its 2010 target for foreign debt issuances with the successful launch of a JPY100b Samurai debt issue. This assured investors that the country can meet its funding needs. Indian government bonds underperformed after its central bank governor said that government borrowing in the next fiscal year may exceed 2010's record level.

UST likely to remain supported; rate hikes likely in Asia

We expect U.S. Treasuries (UST) to remain range-bound. Demand should be supported as risk aversion remains elevated due to the fiscal and debt problems Europe. Despite the Fed's discount rate hike, we maintain our view that the Fed funds rate will stay unchanged for most of 2010 due to the nascent economic recovery in the U.S. In Asia, we continue to see policy tightening as credit growth remains robust. India and China are likely to continue tightening gradually to curb inflation risk. This is especially so in India where the wholesale price index for January continued to surprise on the upside, rising 8.6% YOY. In Malaysia, a 25bp rate hike in March appears likely, after Bank Negara warned that borrowing costs cannot be kept too low for too long.

Prefer Asian quasi-sovereign bonds on attractive yield pickup

Given their strong fundamentals, the Asian economies are likely to be the least impacted by the problems in Greece and peripheral Europe, in our view. We expect Asian high-yield sovereign credit spreads to remain resilient, and especially favour quasi-sovereigns such as PSALM of the Philippines and PLNIJ from Indonesia, which offer an attractive 100-150bp yield pickup over sovereigns.

Asian FX: Raising exposure to Asian currencies

Asian currencies marginally higher in February

Asian currencies closed marginally higher against the USD in February. The AUD was the top performer, gaining 1.3% against the greenback. The PHP also did well, rising 0.8% against the USD, while THB, MYR and INR gained 0.2-0.4%. The FX market was range-bound, and appeared to be led by the ebb and flow of risk appetite. The unwinding of dollar-funded carry trades and the debt woes in Greece continued to nudge the USD higher against the major currencies, with the DXY gaining 1.4% in February.

Asian currency appreciation to resume albeit at a moderate pace

We maintain our view of a modest appreciation in Asian currencies in the medium term on the region's robust economic growth, healthy external balances, and imminent monetary policy tightening. With continued uncertainty over a bailout plan for Greece, we expect global risk aversion to support the USD versus the major currencies. We expect the SGD to underperform its Asian peers due to the substantial weighting of the weakening EUR in the SGD trade-weighted index. In our portfolios, we will look to increase our exposure to Asian currencies.

Asian Equities: Continue to prefer cyclicals, China and Singapore

Asian equity markets gained in February

Asian equity markets generally ended the month of February higher, with bargain hunting offsetting earlier losses. Renewed concerns over the fiscal problems in Greece as well as China's second hike in its reserve requirement ratio spooked investors earlier in the month. However, markets recovered towards month end on increased optimism that the ECB would put together a rescue package for Greece. Signs that China's loan growth has begun to moderate further calmed the markets.

Thailand, Hong Kong and China outperformed

Thailand was one of the strongest Asian stock markets, rebounding as the verdict in Thaksin's corruption trial yielded no surprises, leading to relatively peaceful conditions thereafter. Hong Kong and China stocks outperformed, led by export-related sectors such as shipping, in reaction to recovering global trade and firming freight rates. In Singapore, stocks rose marginally, barely reacting to the 2010 Budget due to its long-term focus. Indonesian stocks eased on profit taking following months of outperformance. Korea and Taiwan stocks also eased on concerns that tech orders may have been inflated due to double-booking on fears of component shortages.

Risk aversion could stay elevated, but fundamentals are improving

Fiscal problems in peripheral Europe and concerns over tightening measures in China could keep risk aversion elevated for some time, in our view. From a bottom-up perspective, however, we continue to witness a cyclical recovery in the Asian economies. Recent price action also appears to be less sensitive to negative headlines, suggesting that downside risks may have already been well-discounted. We expect Asian stock markets to trade within a broad range and end the year with modest gains. We also expect investment spending and loan growth in China to continue moderating in the coming months, leading to further improvement in sentiment.

Focus remains on stock selection; prefer China and Singapore

We continue to emphasise earnings over macro and liquidity factors, and focus on stock and sector selection. Earnings revisions should remain constructive, in our view, and we intend to take advantage of market weakness to add selected mid- and small-cap names. Many quality stocks in these segments still trade far below their peak valuations in 2007. Our portfolios remain tilted towards cyclical sectors such as consumer discretionary and industrials, on expectations for a sustained economic recovery in Asia. We continue to favour China due to potential CNY appreciation. We also like Singapore, where we are overweight transport stocks on recovering exports, which should be positive for traffic flows.

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