

market **FOCUS**

A painkiller for the market hangover

A summer of risk aversion and volatility

Over the summer, global equity markets were sold off with the MSCI AC World Index declining 17% for the third quarter, the worst drop in almost three years, as risks to the global recovery intensified. A combination of the Eurozone debt crisis, the US downgrade by S&P and weak economic data in both regions caused deterioration in the markets.

Solutions not yet in sight

To stabilise the market, investors need to see three things happening: 1) economic data beating expectations; 2) governments in Europe acting on the banking sector's capitalisation problems and 3) a sustainable solution in Greece. A good sign is that all EU countries have now approved the expanded European Financial Stability Facility proposal to shore up European sovereign debt and some developed markets have rebounded from lows for the year. However, it is unlikely there will be quick solutions to these problems in the short term.

DM & EM economic decoupling

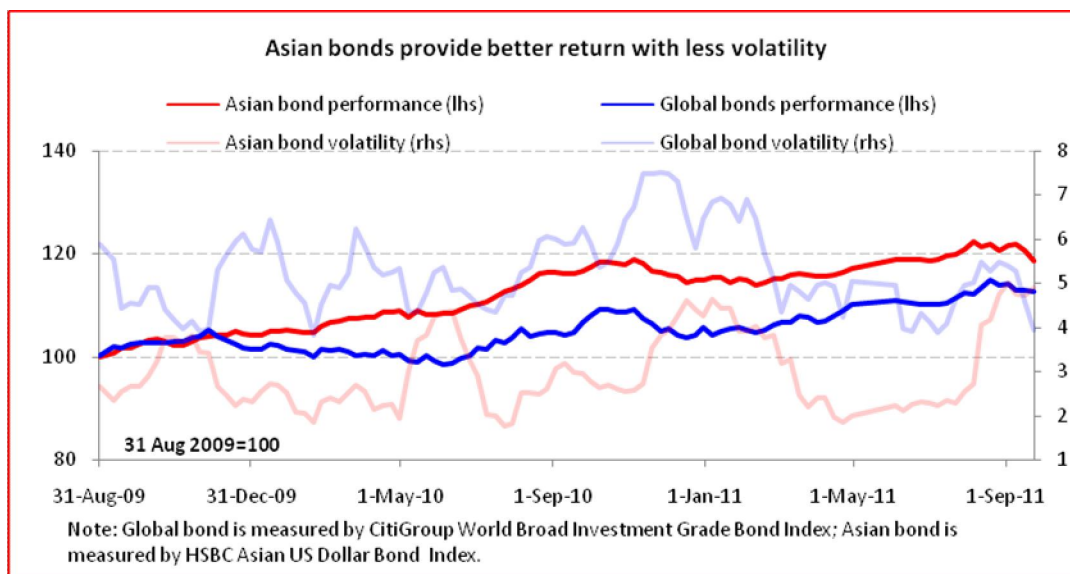
Despite the markets were sold off indiscriminately in both the developed and emerging worlds, there is evidence of real economic decoupling between them. While developed markets are struggling to grow, the economic outlook continues to look fine in many emerging countries. With solid economic fundamentals and strong domestic demand, emerging markets, in particular Asia, are likely to continue to anchor global growth.

Opportunities in corporate debt and high dividend stocks

The heart of the problem nowadays is the government not private sector indebtedness. Corporate balance sheets are generally in good shape and credit spreads have widened in both investment grade and high-yield sectors, which makes corporate debt attractive. In this low-yield environment, high dividend-paying stocks provide an opportunity for yield pick-up.

Don't sit on the sidelines

Markets continue to be volatile as the unsettled European credit crisis and the economic outlook remains at the forefront of investors' concerns. It may be tempting for investors to sit on the sidelines during this turbulent period. However, a too-conservative investment strategy may be dangerous as it exposes your portfolio to the erosive effects of inflation and limits the long-term upside potential.



Source: Bloomberg. Data as of 7 October, 2011

Look for yield income: Negative real interest rates are prevailing in Hong Kong as the Fed committed to keep interest rate low together with rising inflation. Investment grade corporate bond as an income vehicle provides you regular income if there is no default by the bond issuer to preserve your purchasing power. However, if the bond issuer defaults, the holder of bonds may not be able to receive any interest and the principal invested.

Access Asia's strong growth through Asian bonds: While equity volatility remains high, Asian bond markets have held up relatively well as investors have distinguished between the strong fundamentals of Asia versus other regions. Asian bonds have shown a favourable historical risk-return profile, taking less risk while obtaining a return comparable to the majority of other asset classes.

Smooth out market volatility: Bonds tend to have a low correlation with equities. Over the past 10 years as of September 2011 the correlation between bonds and global equities was 0.16, which could help smooth out the volatility of a portfolio. Bonds can also add diversification to a portfolio concentrating on equities.

UNITED STATES



stabilised at low levels. However, it was the Fed's pessimistic assessment of the economy that became a catalyst for 'risk-off' behaviour in the markets in September. Investors are reluctant to look at P/E valuations given concerns on earnings revisions.

Earnings growth estimates at 16.2% for 2011 and 13.6% for 2012 for US companies remain attractive and earnings results for Q2 2011 were stronger compared to Q1 2011. US equity valuation measures, such as the 12-month forward price/earnings ratio of about 11.1x, continue to look undemanding. Most of the economic data in the US point to a stagnant economy. After the August declines, manufacturing surveys and consumer sentiments have

EUROPE

Although peripheral fiscal Eurozone issues remain a concern and recent economic data releases have been weaker, overall economic activity remains mildly positive. Whilst the possibility of a technical recession in Europe has increased, we do not expect it to be deep. The growth figures do not indicate a slowdown significant enough to warrant the major earnings downgrades implied by global equity market prices at the moment. Valuations for riskier asset classes, especially equities, are unusually compelling, yet they are not driving market performance. In addition, our central view is still for rates to remain accommodative in 2011 and 2012 due to the potential impact on fragile growth in the region.



BONDS

While S&P's rating action had a strong symbolic value and was negative for market sentiment, it appears not to have weakened US government bonds with yields actually moving lower over the month. The Federal Reserve cut US growth forecasts for the rest of 2011 and 2012 'notably' following the release of revised annualized Q2 GDP growth figures of 1.0% q-o-q. This is in line with our central scenario for the US and other major developed economies as they deal with gradual debt reduction and greater fiscal restraint. Despite a slowdown in the pace of economic recovery and an anemic growth outlook, US Treasury yields appear unattractive both relative to history and to other asset classes.

ASIA EX-JAPAN



base case to expect the world to enter into a deep recession. We therefore do not anticipate significant adverse earnings revisions.

The slowdown in global demand continues to weigh on the economic performance of most Asian countries. However, Asia ex Japan countries still carry more favourable economic prospects than other developed countries. Given that we have started to see inflation in the region moderating from its peak, future monetary and fiscal policy for those Asian countries should be less restrictive given an extended slower growth situation. We expect equity markets will continue to be affected by higher volatility, while investment sentiment will also be driven considerably by various uncertainties. However, it is not our

JAPAN

Risk aversion continued to drive equities lower while the developments in the Eurozone have done little to reverse weak sentiment. While we acknowledge the short term volatility in the stock market, we are confident that Japan will perform relatively better given support from the government's recovery plan. Economic data, such as export growth and industrial production, will inevitably be impacted by slower external demand. However, local demand and retail consumption could help the economy resist falling into a deep recession. We expect that the Bank of Japan will maintain their accommodative monetary policy.

CURRENCIES.

Safe haven currencies are becoming scarce. The Swiss National Bank has, so far at least, successfully capped the appreciation of the Swiss franc, the previously high flying Australian dollar is now less attractive because of softening commodity prices and Norwegian krone liquidity was never sufficient for the major players. This leaves the USD, which, despite the rating downgrade of US sovereign debt by S&P in August, the faltering economy, low interest rates and probably unsustainable levels of government debt, is finding support. The Euro will continue to be buffeted by the uneven process of finding resolution to the debt crisis of the peripheral Eurozone countries.

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