



HOUSEVIEW

Global Economic Outlook

World

- The global economic slowdown continues – Europe and Japan have now both recorded negative GDP growth in the second quarter of 2008.
- The second half of 2008 is shaping up as a period of widespread economic sluggishness.
- Growth will be weaker, though not necessarily deeper, for longer than expected – the least likely outcome is a V-shaped recovery.
- Deleveraging of the household and financial sectors will be a key constraint on growth.
- Falling commodity prices have led to inflation fears giving way to growth fears.
- Central banks have been given greater impetus to ease policy in the face of deteriorating confidence, demand and credit market concerns.
- The \$US most likely has passed its nadir.

United States

- The US consumer is under threat - the twin beneficial impacts of tax rebates and the lower fuel prices, is fading.
- Unemployment is rising, now 5.7%, and unemployment benefit claims have accelerated to their highest level in five years. Consumer wealth continues to be eroded by falling house prices and stockmarkets. Consumer deleveraging and savings will become the hallmarks of the US economy.
- While inflation reached new highs in July, the forces driving it are beginning to reverse, lead by a broad-based retreat in commodity prices.
- There is no relief in sight from the tight credit conditions, elevated borrowing costs and the struggles to recapitalize the financial sector - the Fed will not raise rates.

Europe

- Eurozone real GDP fell in the June quarter, the first quarterly fall for over a decade. Leading indicators of economic activity remain weak.
- Domestic and external demand factors were equally to blame. But persistent stress in the financial sector appears to have been a bigger near-term drag on the economy than was expected.
- Some fiscal easing is possible, though most government's deficits are close to the Stability and Growth Pact limit of 3% of GDP.
- The ECB remains concerned about inflation and in particular second-round effects.

Japan

- The economy has entered another recessionary phase – real GDP contracted in the second quarter.
- Consumer confidence is at its lowest level in more than two decades, reflecting rising inflation and a slowing jobs market. Capex is weak as poor profits limit investment finance. Exports should mitigate some of this domestic weakness.
- Although there is a recession, we do not expect it to be as deep or as severe as previous recessions. This is because the three "excesses" – capacity, labour and inventories – are absent.
- We expect GDP growth to return to positive territory quickly though remain below trend for sometime.

Equities

- Global equity markets will continue to be haunted by multiple fears and uncertainties - slowing economic growth, elevated inflation, excessive earnings expectations and the ongoing credit crunch.
- We expect economic growth to be low and slow. Financial and consumer balance sheets will be under repair. These conditions will put substantial strain on profit growth and (peak cycle) margins.
- We note there is strong empirical evidence that buying cheap equity markets, despite poor earnings, has been a lucrative strategy.
- Falling earnings and stock prices have decoupled when valuations are cheap, inflation has begun to fall, interest rates have fallen significantly and once global lead indicators of economic growth have bottomed. Perhaps that is when economic expectations are most depressed.
- We have adjusted our count on these four criteria and have concluded that only one of these factors – valuations – supports a decoupling right now.
- We expect inflation to fall and economic growth to be weakest in the second half. This will take the edge off the hawkish central bank rhetoric and ease interest rate expectations.
- We therefore recommend international equity exposures be underweight until further into the second half of 2008.

Who Said That?

"The erosion of consumer's purchasing power from shrinking access to credit and dwindling housing wealth has only just begun. The Fed's interest rate policy will be validated by the next two to three quarters of consumer spending and inflation data."

--- George Magnus, Senior Economic Advisor, UBS Investment Bank

Bonds

- Bond markets are confronted with two competing forces - deleveraging required to repair balance sheet of the financial sector and fears arising out of elevated inflation expectations. It will be difficult for bonds to breakout of their trading range.
- Volatility is the third major characteristic in play as market sentiment ebbs and flows between deleveraging and inflation.
- Markets will also be teased by the prospect or not, of a recession in the US.
- We wonder how "sticky" inflation will be. We note demand has eased for oil and food items, and supply for both is improving, though they are changing only slowly. Central banks remain nervous, because historically inflation has held at a high level for extended periods, which raises the risk of spillover into wages, core prices and inflation expectations.
- Still, growth concerns have generally dominated inflation fears in the pricing fixed income securities. This has meant bonds have rallied since the end of May and are beginning to approach levels of valuations rarely seen before.
- We therefore recommend an underweight exposure to international bonds and overweight cash and near-cash securities.

Returns

- North America (for the second month in a row) and Europe outperformed the benchmark. Emerging markets all performed poorly with negative returns, Emerging Europe being the worst.
- Another excellent month for bonds, with many of the major markets achieving a positive return of in excess of 100 basis points for the month. Australia and the UK markets were the best of the best.

Equities Benchmark	August	Year-to-Date	12 Months
MSCI World (Local currency terms)	1.16%	-13.41%	-13.52%
Bond Benchmark	August	Year-to-Date	12 Months
World Govt Bond Index (Local currency terms)	1.20%	2.52%	4.62%

Asia Pacific Economic Outlook

Overview

- Asia, in recent times, has been a region dominated by export performance. With the exceptions of China and India, the value of exports to nominal GDP in most countries is well in excess of 30%. This makes Asia heavily pro-cyclical.
- Economic activity in Asia has begun to slow, albeit after a delayed response to the global cyclical slowdown. The outlook for the US, Europe and Japan is further deterioration.
- Inflation has moved too high in most economies in Asia to be ignored by central banks, regardless of whether it is pushed up by short-term supplies of food and energy or an underlying monetary phenomenon.
- Failure to tighten monetary policy may well produce an upward shift in inflation expectations that could require a prolonged disinflation policy.

China

- Recent economic data has been mixed. However we expect economic growth to be close to 9% for 2008, a rate, even by recent Chinese standards, that is not really weak. Reconstruction of earthquake regions will support investment growth.
- Headline inflation may be on the decline but remains well above the official target of 4.8%. But non-food CPI is showing an upward trend. Domestic energy costs will likely rise as officials work on programmes to liberalize prices for fuel and electricity.

North Asia

- **Hong Kong** had its first quarter of negative growth in real GDP since 2003. Activity weakened across the board. The easing labour market will dampen wages and confidence. This will have flow-on effects on consumption and the housing market.
- Weak domestic demand will persist in **Korea** and a slowdown in exports to be expected. CPI soared to a 10 year high - rates were hiked with more to come.
- Domestic demand continued to weaken in **Taiwan**. Export growth has slowed somewhat. CPI surged to a 14-year high and rates were raised.

South Asia

- The impact of monetary tightening in **India** has started to kick-in. Inflation however seems firmly set in the double digit range. Further rate rises are likely by a government that has set the highest priority to stabilizing inflationary expectations.
- External and domestic demand in **Malaysia** will slow on the back of the global slowdown and the energy price hikes. CPI is at a 27 year high.
- In **Thailand**, inflation is the main challenge for policymakers. Negative real interest rates need to be addressed. Politics remain an adverse influence.
- We expect sub-par growth in **The Philippines** in 2008. The pass-through of higher fuel prices will sustain inflation in double digits until Q4.

Pacific

- With wage costs benign, the global economic slowdown becoming more widespread, weak financial and housing sectors and leading indicators pointing to further deterioration, monetary policy in **Australia** will continued to be eased.
- **New Zealand** cut interest rates, despite high inflationary pressures, as concerns mounted about the outlook for economic growth, which continued to deteriorate.

Asia Pacific Market Insights

Equities

- Asia continues to be the worst performing regional equity market globally so far this year. The notion of Asian stockmarkets “decoupling” from the rest of the world has been put to rest conclusively, at least for this cycle.
- Valuations have improved considerably over the past few months as markets around the region have fallen.
- However, earnings forecasts are still too optimistic. At the start of 2008 they were +11%. They are now down to +4%.
- We noted above, firstly the export sensitivity of Asia and secondly, that the global growth profile continues to deteriorate. Clearly these factors have implications for earnings in Asia. So not only are there headwinds at the revenue level for Asian corporates from declining exports, but their input costs are rising through inflationary pressures – see Economic Outlook.
- Clearly further EPS downgrades are on the way, though these now are more likely to relate to 2009 than to 2008.
- The current high levels of inflation means that earnings growth in real terms in 2008 is negative and prospectively for 2009 after downgrades. It is arguable that earnings-based valuations should reflect this through some degree of discount to benchmark valuations, since the quality of earnings has been eroded. Asian stockmarkets are not as cheap as they appear.
- The selling pressure by foreign investors has relented in recent weeks to levels they are more comfortable with.
- A resurgent US\$ has implications for Asian equity markets – currency depreciations, more inflation and capital outflows.
- We believe an underweight exposure to Asian equities is appropriate in light of the above circumstances.

Bonds

- A rising dollar, falling oil prices and a deteriorating global economy are shaping Asia’s outlook.
- But inflation is high. The question is whether central bankers are correct in assuming that it will decline because of the “base effect”, or will there be secondary consequences?
- At present, economic policymakers believe the various shocks pushing up inflation are temporary. Monetary policy has been kept accommodative and real interest rates hover in negative territory. As a result, fiscal and monetary policy in Asia is aligned with sustaining growth, rather than containment of price pressures and wage demands.
- But importantly for bonds, Asian economic growth is decelerating - though not to the levels of developed economies.
- Deteriorating or a volatile political environment is causing concerns to bond investors in Korea, Malaysia and Thailand.
- Governments are generally behind the curve in fighting inflation and funding their budgets. But the slowdown in growth supports bonds. We recommend being neutral in this asset class and being overweight in cash.

Returns

- Another poor month for Asian stockmarkets with a negative return overall largely contributed by China and Korea . The Pacific region performed better, though again its return was negative. The best performing markets were India, the Philippines and Thailand.
- Sovereign bond markets again performed well over the month and outperformed credits. The strong month was most assisted by Malaysia and Hong Kong.

Equities Benchmark	August	Year-to-Date	12 Months
MSCI Asia Pacific Ex Japan (Local currency terms)	-2.16%	-21.48%	-16.35%

Bond Benchmark	August	Year-to-Date	12 Months
JACI Composite Index (USD terms)	1.17%	1.98%	6.38%

Recommended Asset Exposures	
International Equities	Underweight
Asian Equities	Underweight
International Bonds	Underweight
Asian Bonds	Neutral
Cash	Overweight

	Key Drivers	Key Risks	Risk Rating
World Economy	<ul style="list-style-type: none"> Sustainability of consumer expenditure in US, Japan and Europe. Stance of central banks – fight inflation or lower risk of recession? 	<ul style="list-style-type: none"> US economy falls into recession. US slowdown is longer than expected. Credit/mortgage crisis impacts real economy. 	<p>High</p> <p>High</p> <p>High</p>
Global Equities	<ul style="list-style-type: none"> Extent and spread of world economic slowdown. Earnings growth and the extent of revisions. Extent to which financial sector is impacted by credit crisis. 	<ul style="list-style-type: none"> Earnings downgrades surprise on the downside. Interest rates rise. 	<p>High</p> <p>High</p>
Global Bonds	<ul style="list-style-type: none"> Pace of global economic slowdown. Degree of inflation expectations. 	<ul style="list-style-type: none"> Inflation surprises on the upside. Inflation spills over into wages. US\$ falls faster than expected. 	<p>High</p> <p>Medium</p> <p>Low</p>
Asian Equities	<ul style="list-style-type: none"> Economic growth slows - slowly. International investors appetite for risk. Impact of inflation. 	<ul style="list-style-type: none"> Earnings revisions surprise to the downside. Interest rates rise. Valuations fail to halt market slide. 	<p>High</p> <p>High</p> <p>High</p>
Asian Bonds	<ul style="list-style-type: none"> Extent of inflationary pressure. Foreign capital flows. Bond issuance to cover fiscal deficits. 	<ul style="list-style-type: none"> Central banks tighten monetary conditions – though not enough. Inflation higher than expected. 	<p>High</p> <p>Medium</p>

Key Forecasts

	Real GDP				Inflation				90 Day Interest Rates*		10 Year Bond Yields	
	2008E#	ING	2009E#	ING	2008E#	ING	2009E#	ING	Actual 31-Aug-08	ING Forecast For Next 3 Mths	Actual 31-Aug-08	ING Forecast For Next 3 Mths
The World	2.8	0	2.6	0	4.8	+	3.5	0				
USA	1.6	0	1.4	0	4.5	0	2.9	0	1.73%	Steady	3.81%	Rising
Europe	1.8	0	1.4	0	3.6	0	2.7	0	4.96%	Rising	4.18%	Rising
Japan	1.3	0	1.2	0	1.4	0	0.9	0	0.85%	Steady	1.49%	Steady
Australia	2.7	0	2.6	0	4.4	+	3.3	0	7.27%	Falling	5.76%	Steady
China	9.9	-	9.2	-	6.9	+	4.7	+	7.47%	Rising	7.83%	Rising
Hong Kong	4.9	0	4.7	-	4.9	0	4.7	0	2.26%	Steady	2.98%	Rising
India	7.5	+	7.7	0	8.1	+	6.4	0	9.02%	Rising	8.71%	Rising
Indonesia	5.9	+	5.7	0	10.6	+	8.3	0	7.54%	Steady	12.20%	Steady
Malaysia	5.5	-	5.2	0	5.3	0	4.4	0	3.70%	Rising	4.72%	Steady
Philippines	4.7	-	4.9	0	9.7	0	7.0	0	4.63%	Rising	8.06%	Steady
Singapore	4.7	0	5.0	0	6.4	0	3.2	0	2.83%	Steady	3.17%	Steady
South Korea	4.4	0	4.4	0	4.8	+	3.8	0	5.79%	Steady	5.76%	Rising
Taiwan	4.5	0	4.7	+	3.6	+	2.9	-	2.25%	Steady	2.50%	Rising
Thailand	4.8	0	4.9	+	7.5	+	4.8	+	3.85%	Rising	4.34%	Rising

Consensus Forecast, ING Bias (“+” Higher, “0” in line, “-” Lower than Consensus Forecast)

* Australia 90 day BBSW Rate, Hong Kong Malaysia Singapore and Thailand 90 Day Interbank Rate, Indonesia Japan and Korea 90 day Deposit Rate, China 1 Year Loan, India 90 Day Treasury Bill and Taiwan 90 Day Commercial paper Secondary Mkt

Asia Pacific Consensus Forecasts - Consensus Economics Inc.

INVESTMENT MANAGEMENT



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