



# HOUSEVIEW

## Global Economic Outlook

### World

- The world economy will continue to slow – few indicators of economic activity, if any, show signs of positive energy in the US, Europe or Japan.
- Growth could be weaker for longer than expected – the least likely outcome is a V-shaped recovery.
- Deleveraging of the household and financial sectors will be a key restraint on growth going forward.
- This process tends to be self-reinforcing and protracted, and is usually accompanied by deflation in asset prices until leverage has been cut back to sustainable levels.
- Elevated inflation expectations are expected to persist - the recent respite in the oil price is welcome, though it may be temporary.

### United States

- Consumer spending was supported in May by tax rebates, however this appears to be short-lived, with further moderation in household spending expected going forward.
- With the Fed balancing between inflation and growth concerns, the latter is seen as prevailing and hence official interest rates are likely to be maintained at an accommodative level (2.0%) for some time yet.
- The rise in unemployment along with the energy shock, will squeeze consumer budgets – the combination poses a new risk for consumer credit assets and outstanding mortgages.
- Distress in the financial sector is not over yet – like the Japanese before them, US and European banks are only writing-off what they can afford.
- Somewhat ironically, job market weakness is restraining wage growth.

### Europe

- Consumer and economic confidence has fallen significantly in recent months and economic weakness is broadening – Germany, France, Italy and the UK have all released weaker than expected data recently.
- European economic activity is slowing down to a clearly below-potential pace.
- Consumption has been undermined by high food and energy prices, increasing unemployment and tightening monetary conditions.
- European Central Bank rhetoric is for further monetary tightening in the face of ongoing inflation pressures, a bias which reinforces expectations for further slowdown in economic growth across the region.

### Japan

- Annual wages growth is not enough to compensate for rising inflation with the result that the fall in real wages is having a noticeable effect on household spending.
- The current negative real interest rate environment should provide some support to the economy.
- However surging energy prices and the slowdown in major trading partners' economies will cap economic activity.
- Domestic and external demand uncertainties will ensure that the Bank of Japan holds to its current monetary policy stance for some time yet.

## Global Market Insights

### Equities

- Global equity markets will continue to be haunted by multiple fears and uncertainties - slowing economic growth, higher inflation, higher interest rates, 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.*
- However there is strong empirical evidence that buying cheap equity markets, despite poor earnings, has been a lucrative strategy.
- Historically profits 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. We are moving in this direction.
- A lot of bad news has been already priced into equity markets and we enter this earnings downturn with prices at 14 times not the 35 times at the top of the last earnings cycle.
- We therefore recommend international equity exposures be moved to a neutral stance.

### Who Said That?

*"Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly."*

--- Jeremy Grantham, Chairman, GMO

## Bonds

- Bond markets are still confronted with two competing forces. First deleveraging surrounding the credit crunch and second rising inflation. It will therefore be difficult for bonds to breakout of their recent trading range.
- Volatility should remain high while financial institutions deleverage.
- When inflation will eventually moderate is difficult to say, but with commodity prices softening prospects are improving.
- Growth concerns have generally dominated inflation fears in pricing fixed income securities over the past six months. Inflation breakevens have risen but nowhere near as fast as headline inflation because flight to quality flows have kept nominal yields low.
- Near term uncertainty about the US economic outlook, recurring concerns about financial stress and weak interest rate differential should ensure the \$US remains under pressure.
- We recommend an underweight exposure to international bonds and overweight cash.

## Returns

- Another month in which no region could manage a positive return. North America was the best performing region, lead by the US, and the worst was Latin America. Asia beat the benchmark.
- An excellent month for bonds with many markets achieving a positive return of in excess of 100 basis points for the month. European markets clearly outperformed Treasuries.

Equities Benchmark	July	Year-to-Date	12 Months
<b>MSCI World</b> (Local currency terms)	-1.82%	-14.40%	-14.55%
Bond Benchmark	July	Year-to-Date	12 Months
<b>World Govt Bond Index</b> (Local currency terms)	1.21%	1.30%	4.58%

## Asia Pacific Economic Outlook

### Overview

- Inflation in Asia is understated – subsidies, price controls and poor data collection are the culprits.
- The synchronised jump in global food prices suggests there is more to the inflation story than simply disruptions to supply caused by “temporary” events. Prices are also rising because loose monetary conditions have boosted domestic demand.
- Another reason why Asian central banks cannot ignore inflation, is that it can quickly spill over into other prices.
- Central banks need to heed headline rates of inflation – monetary policy needs to be tightened and real interest rates need to be positive.

### China

- Growth moderated in Q2. External account weakness was partially offset by domestic demand strength. We expect overall growth to slow further under pressures of global slowdown and tightening policies.
- Headline inflation softened again in June, the third consecutive month though inflation continues to be understated. However it remains elevated at 7.1% YoY.

### North Asia

- Recent statistics paint a picture of a less robust **Hong Kong** economy. Exports and retail sales have clearly weakened. Inflation is elevated yet US interest rates are on hold.
- Exports and manufacturing production in **Korea** have shown signs of peaking while we saw further weakness in consumption and investment. Inflation has jumped and policy will be tightened.
- Domestic demand weakened during Q2 in **Taiwan**, though net exports continued to grow strongly. However the risks for the latter are to the downside. Inflation has surged.

### South Asia

- The impact of monetary tightening in **India** has started to kick in with economic activity declining. Inflation however seems firmly in the double digit range. Further rate rises are necessary.
- External and domestic demand in **Malaysia** will slow on the back of the global slowdown and the energy price hikes.
- 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 an uptrend.

### Pacific

- The **Australian** economy's leading index has fallen away appreciably in 2008, though this is offset by a booming commodity sector.
- **New Zealand** is in the midst of a significant economic slowdown - a recession is distinctly possible. The central bank will cut rates.

## Asia Pacific Market Insights

### Equities

- The worst performing regional equity market so far this year, clearly has been Asia. The notion of Asia “decoupling” has been put to rest conclusively, at least for this cycle.
- Valuations, encapsulated in various composite indicators, have improved considerably over the past three months to the point where they are now attractive and discount significant bad news.
- There has been extensive selling by foreign investors as they have reduced their exposures to Asia as their appetite for risk has decreased.
- However earnings forecasts are still too optimistic. At the start of 2008 they were +11%. They are now down to +6%. But with input costs rising and volumes slowing there is a clear message that further EPS downgrades are on the way.
- As a larger percentage of disposable income in Asia is spent on food and basic necessities, the region is and has been harder hit by inflation than mature economies.
- The trade-off between safeguarding export growth and fighting inflation becomes increasingly obvious and higher interest rates are essential.
- We believe that a move to neutral exposure to Asian equities is appropriate given the extent of poor performance so far this year, the extent of capital outflows over the same period, attractive valuations and investor risk appetite is now at a low point.

### Bonds

- Asian economic policymakers believe the various shocks pushing up inflation, as temporary (as there was in the US in the 1970’s). 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 the rising cost of energy and agricultural goods is unlikely to fade soon and inflation data is understated in most countries through the use of subsidies.
- Central banks need to focus on restraining money supply growth and establishing a relatively high short term real interest rate environment in order to push inflation expectations downward.
- Governments are generally behind the curve in fighting inflation and funding their budgets. We recommend being underweight this asset class and being overweight cash.

### Returns

- Another poor month for Asian stockmarkets. However, the two worst performing markets in recent months - China and India – both had strong positive returns. The Philippines had a very strong month while Thailand lost 13.21% in the month.
- Sovereign bond markets performed well over the month and clearly outperformed credits. The strong month was most assisted by The Philippines and Indonesia.

Equities Benchmark	July	Year-to-Date	12 Months
<b>MSCI Asia Pacific Ex Japan</b> (Local currency terms)	-3.08%	-19.74%	-13.86%

Bond Benchmark	July	Year-to-Date	12 Months
<b>JACI Composite Index</b> (USD terms)	1.12%	0.07%	4.6%

Recommended Asset Exposures	
<b>International Equities</b>	Neutral
<b>Asian Equities</b>	Neutral
<b>International Bonds</b>	Underweight
<b>Asian Bonds</b>	Underweight
<b>Cash</b>	Overweight

	Key Drivers	Key Risks	Risk Rating
<b>World Economy</b>	<ul style="list-style-type: none"> <li>Sustainability of consumer expenditure in US, Japan and Europe.</li> <li>Stance of central banks – fight inflation or lower risk of recession?</li> </ul>	<ul style="list-style-type: none"> <li>US economy falls into recession.</li> <li>US slowdown is longer than expected.</li> <li>Credit/mortgage crisis impacts real economy.</li> </ul>	<p>High</p> <p>High</p> <p>High</p>
<b>Global Equities</b>	<ul style="list-style-type: none"> <li>Extent and spread of world economic slowdown.</li> <li>Earnings growth and the extent of revisions.</li> <li>Extent to which financial sector is impacted by credit crisis.</li> </ul>	<ul style="list-style-type: none"> <li>Earnings downgrades surprise on the downside.</li> <li>Interest rates rise.</li> </ul>	<p>High</p> <p>High</p>
<b>Global Bonds</b>	<ul style="list-style-type: none"> <li>Pace of global economic slowdown.</li> <li>Degree of inflation expectations.</li> </ul>	<ul style="list-style-type: none"> <li>Inflation surprises on the upside.</li> <li>Inflation spills over into wages.</li> <li>\$US falls faster than expected.</li> </ul>	<p>High</p> <p>Medium</p> <p>Low</p>
<b>Asian Equities</b>	<ul style="list-style-type: none"> <li>Economic growth slows - slowly.</li> <li>International investors appetite for risk.</li> <li>Impact of inflation.</li> </ul>	<ul style="list-style-type: none"> <li>Earnings revisions surprise to the downside.</li> <li>Interest rates rise.</li> <li>Valuations fail to halt market slide.</li> </ul>	<p>High</p> <p>High</p> <p>High</p>
<b>Asian Bonds</b>	<ul style="list-style-type: none"> <li>Extent of inflationary pressure.</li> <li>Foreign capital flows.</li> <li>Bond issuance to cover fiscal deficits.</li> </ul>	<ul style="list-style-type: none"> <li>Central banks tighten monetary conditions – though not enough.</li> <li>Inflation higher than expected.</li> </ul>	<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-Jul-08	ING Forecast For Next 3 Mths	Actual 31-Jul-08	ING Forecast For Next 3 Mths
<b>The World</b>	2.9	0	2.7	0	4.6	+	3.4	0				
<b>USA</b>	1.5	0	1.5	0	4.3	0	2.8	0	1.68%	Rising	4.04%	Steady
<b>Europe</b>	1.8	0	1.4	0	3.5	0	2.6	0	4.96%	Rising	4.34%	Rising
<b>Japan</b>	1.4	0	1.3	0	1.4	0	1	0	0.85%	Steady	1.55%	Steady
<b>Australia</b>	2.9	0	2.8	0	4.2	+	3.2	0	7.76%	Steady	6.22%	Steady
<b>China</b>	10.0	-	9.3	-	7.0	+	4.8	+	7.47%	Rising	7.83%	Rising
<b>Hong Kong</b>	4.9	0	4.9	-	4.7	0	4.3	0	2.31%	Steady	3.69%	Steady
<b>India</b>	7.6	+	8.0	0	7.8	+	6.3	0	9.20%	Rising	9.05%	Rising
<b>Indonesia</b>	5.9	+	5.8	0	10.1	+	7.9	0	7.42%	Rising	11.87%	Rising
<b>Malaysia</b>	5.5	-	5.4	0	5.0	0	4.1	0	3.70%	Rising	4.84%	Rising
<b>Philippines</b>	5.1	-	5.2	0	8.8	0	5.8	0	5.19%	Rising	9.66%	Steady
<b>Singapore</b>	4.7	0	5.3	0	6.1	0	3.2	0	2.82%	Steady	3.20%	Steady
<b>South Korea</b>	4.5	0	4.7	0	4.6	+	3.8	0	5.68%	Steady	5.86%	Rising
<b>Taiwan</b>	4.4	0	4.7	+	3.5	+	2.8	-	2.26%	Steady	2.50%	Rising
<b>Thailand</b>	4.8	0	4.9	+	7.1	+	4.4	+	3.78%	Rising	5.08%	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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