



HOUSEVIEW

Global Economic Outlook

World

- There is increasing evidence and much hope that the Americas and Europe are set to join an already established Asian economic upturn this quarter. However, high unemployment and tight credit conditions are expected to temper the upturn.
- While investment sentiment has improved, investors by and large have been cautious thereby missing the strong market rally. Cash levels are still high and are being increasingly deployed providing support to asset markets.
- While bond yields have backed up over the last three months, concerns of imminent inflationary pressures are overdone. A high unemployment rate, low capacity utilisation and low velocity of money will keep inflation in check until economic recovery reasserts itself.
- Oil and other commodity prices remain on an uptrend supported by indications of global recovery. But, inventory levels are rising.

United States

- Equity markets are buoyant as expectations grow that the US economy will post sequential growth in the current quarter. Industrial production is also expected to be particularly strong as it recovers from sharp declines in the previous quarters. Accompanying this bounce, the labour market and housing indicators should also show some improvement.
- The 2Q09 corporate earnings will be an important factor in maintaining equity market momentum. American companies have addressed the adverse macro environment by dramatically cutting costs. This means that bottom line will perhaps surprise on the upside despite disappointing top line trend.
- Consumer spending has remained sluggish through June as in the past few months after a strong bounce early in the year, however, both housing starts and building permits have shown a modest improvement.

Europe

- The OECD has cut its outlook for the Euro area, predicting a 4.8% contraction in 2009 to be followed by a gradual recovery in 2010.
- The Euro area PMI has continued to improve with the latest reading at 42.6 however industrial orders declined for the ninth month in a row.
- The Bank of England has surprised the market by not extending its quantitative easing programme further this month and has stated that it will review the program in the context of the August Inflation Report.

Japan

- Following LDP's loss of the Tokyo local election, Prime Minister Aso has called a Lower House election for 30 August. There remains a high probability that the LDP could be on the brink of losing control over both houses of the Diet. Such a development will at least break the legislative gridlock but beyond that not much can be foreseen as the opposition DPJ has not published its manifesto.
- Despite unfavourable labour market conditions, consumer sentiment continues to rise reinforcing the message from other indicators such as PMI and new auto sales that consumption is being boosted by several government measures.
- The BoJ has extended its credit easing operations from end-September until year end.

Global Market Insight

Equities

- Fiscal stimulus programmes in play over the last six to nine months are probably at their peak level of efficacy. Accommodative monetary policy over the same time period has also reached its optimal level of effectiveness. Coupled together, this has propped up global demand in the face of global deleveraging and rising household savings. As the impact from these stimulatory policies fade away over the coming months some moderation in the rapid rise in investor sentiment is bound to follow.
- Emerging economies in Asia led by China and India are slowly but surely progressing on their path of incremental decoupling from the G7 economies. Low debt levels in the household, corporate and public sector is the key distinguishing factor between Asia ex Japan and the developed economies. This is also reflected in superior equity market performance.
- The previous six months have confirmed that a major systemic collapse have been averted and by extension that a recovery should emerge in time. Equity prices across regions fully reflect this improvement in economic outlook as valuations are rich. With buoyant investor sentiment and a slowly recovering economy on the one hand and rich valuations on the other, we recommend a neutral weighting in equities.

Bonds

- The outlook for the global economy has brightened in recent months on the back of a massive inventory correction, policy stimulus and easier financial conditions. For now this exerts upward pressure on bond yields, even if the lack of sustainable sources of private sector demand growth make a return to potential growth unlikely over the next year or two.
- With US monetary policy makers already having taken a lot of action, the majority of policy stimulus is likely to come from the fiscal side. We however do not expect any near-term tightening either and expect the Fed to keep interest rates in the 0-0.25% range until Q3'10, and only to modestly increase the policy rate thereafter. We project the ECB to keep the refinance rate at 1% until late 2010, and Japan to keep overnight rates at 0.1% throughout 2009 and 2010.
- After a strong performance of government bonds in recent weeks, the rally is likely to slow, as risk appetite recovers on the back of better than expected Q2 results. We favor European over US bonds.

Returns

- A strong performance from equity markets over the past three months stalled in June as Japan gained, US remained flat and Europe declined.
- Global government bonds started the month poorly with a sharp sell off mid-June before rallying in the 2nd half of the month on the back of weaker risk appetite and green shoot concerns

Equities Benchmark	June	Year-to-Date	12 Months
MSCI World (USD terms)	-0.45%	6.35%	-29.50%
Bond Benchmark	June	Year-to-Date	12 Months
World Govt Bond Index (USD terms, unhedged)	0.11%	-1.50%	4.00%

Asia Pacific Economic Outlook

Overview

- Despite improvements in activity, exports remain negative on a year on year basis.
- Unemployment rates continue to climb though selective regions witnessing moderation as government stimulus plans take effect.
- In many countries, the resurgence in property transactions and rise in property prices continues unabated.
- The strength in Asian currencies have moderated in the past one month as the US dollar gained strength.

China

- China's PMI stood at 53.2 in June and points to continued expansion.
- Exports decline accelerated to 26.4% in the month of May.
- Domestic consumption remained firm with retail sales growing 15.2% in May.

North Asia

- Hong Kong's unemployment remained steady at 5.3% in May with no month on month worsening.
- Industrial production showed sequential improvement for Korea and gained 1.6% in May over the previous month.
- Taiwan's leading Index is also showing sequential improvement by gaining 3.3% in May.

South Asia

- Furthering its monetary easing efforts, Indonesia's central bank lowered its benchmark rate by 25bps to 6.75%.
- Despite the collapse in both imports and exports, Malaysia nevertheless posted a healthy RM10 billion trade surplus.
- Philippines' OFW remittance remained robust growing 2.2% in the month of April.
- India's recent budget proved to be disappointing as no substantial new reforms were announced and fiscal deficit is expected to soar to 6.8% in FY10.

Pacific

- Australia's unemployment rose to 5.7% in the month of May inline with expectations.

Asia Pacific Market Insights

Equities

- Economic indicators in Asia ex-Japan has improved as global economic environment is showing signs of stabilisation.
- Fiscal policies have been successful in shoring up domestic demand and has helped cushion the blow from falling exports.
- Very low interest rate environment and better appetite for lending helped to revive property markets around the region with transaction volumes returning to pre-Lehman levels.
- Positive earnings upgrades continues for the region as analysts reassess their bearish estimates amid signs of stabilisation for the global economy.
- Asia Pacific's 2009 estimated PE stands at 15.5X with an estimated earnings growth of -2.6% and 3 months earnings revision of +5.6%.
- The next milestone for the market will be second quarter earnings where it will be likely that investors will focus more on future guidance than current earnings and will set the tone for equity market performance in the third quarter.

Bonds

- Inflation has bottomed in Asia, and is bound to rise to more normal levels on the back of base effects and the YTD rise in commodity prices. A sharp rebound in asset prices is a source of concern in several countries, particularly Korea.
- The monetary easing cycle is over, with only the occasional rate cut in Indonesia and the Philippines likely. Rate hikes within 2009 for the rest of Asia are unlikely. For 2010 we expect Korea and India to be among the first to start tightening policy.
- Macro-indicators across Asia point to a budding economic recovery, but after the impact of fiscal stimulus has worn off and the restocking process is completed, the outlook for domestic and external demand for Asia remains uncertain. This sets the stage for short term upward pressure on bond yields, but a relatively bond friendly environment in the longer term.
- Asian bond yields are well off their mid-June peaks, when fiscal sustainability concerns, inflation fears, and noise about exit strategies from quant easing had an exaggerated impact on bond markets globally. At current levels we retain a more neutral outlook on Asian bond markets.
- We remain fundamentally bullish on Asian currencies medium term, but see near term risks as risk appetite consolidates.

Returns

- Since bottoming in October 2008, Asia Pacific ex-Japan equities have been outperforming global markets for eight months in a row.
- Asian local currency debt had a relatively poor month, with currencies generally weakening, and yields rising on the back of expected tightening and inflation fears.

Equities Benchmark	June	Year-to-Date	12 Months
MSCI Asia Pacific Ex Japan (USD terms)	0.92%	33.01%	-22.21%

Bond Benchmark	June	Year-to-Date	12 Months
HSBC Asia Local Bond Index (USD terms)	-0.49%	0.26%	2.92%

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

	Key Drivers	Key Risks	Risk Rating
World Economy	<ul style="list-style-type: none"> Deleveraging of consumer, financial and corporate sectors Continued co-ordinated approach to the financial and economic crises 	<ul style="list-style-type: none"> Emerging markets decline into recession Protectionism emerges 	<p>High</p> <p>Low</p>
Global Equities	<ul style="list-style-type: none"> Prospects for economic growth Earnings growth and the extent of revision. 	<ul style="list-style-type: none"> Earnings downgrades surprise on the downside Availability of credit diminishes 	<p>High</p> <p>Medium</p>
Global Bonds	<ul style="list-style-type: none"> Accommodative monetary stance Deficit spending and bond supply Weak growth, despite recent green shoots Increased G-20 and IMF support to EM economies 	<ul style="list-style-type: none"> Return of risk appetite/ demand for risky assets Inflation worries escalating Increasing fiscal deficits, rising public debt 	<p>Medium</p> <p>Low</p> <p>Low</p>
Asian Equities	<ul style="list-style-type: none"> Extent Asia is impacted by the global economic slowdown International investors appetite for risk 	<ul style="list-style-type: none"> Earnings revisions surprise to the downside Valuations fail to halt market slide 	<p>High</p> <p>High</p>
Asian Bonds	<ul style="list-style-type: none"> Bond supply and deteriorating fiscal dynamics Accommodative monetary stance Weak growth, despite recent green shoots Increased G-20 and IMF support to EM economies 	<ul style="list-style-type: none"> Increased bond supply Higher G3 bond yields Increased inflation (due to higher commodity prices) 	<p>Low</p> <p>Low</p> <p>Low</p>