



HOUSEVIEW

Global Economic Outlook

World

- The gradual healing of the global economy that began in March is continuing. The improvement is broad based across developed and emerging markets and across regions. Asia Pacific is at the forefront of the revival with China and India leading.
- The improvement in the economies has been reflected across asset markets with equities and more recently credit markets marking rapid gains. Currency markets are signalling increasing preference with a weakening bias for the USD.
- With improvements in the economy commodity prices have witnessed massive gains with oil and copper as two of the more closely watched commodities gaining more than 50% YTD.
- However, inflation remains subdued universally with high unemployment, low capacity utilisation and a still shrinking global economy. While commodity prices have improved they are largely well below prices last year.

United States

- A decline in jobless claims below 610,000 in each of the two most recent weeks from an average of 658,000 in March is the most reassuring signal so far from the US.
- There exists a plethora of indicators for the future health of the global economy. Amongst all, US treasuries being one of the most liquid and widely followed have historically been one of the few which have been consistent and prescient. Recently, the US yield curve has steepened dramatically with the 10 yr yield close to 4% and the 30 yr yield close to 5%. Indicating one or a combination of the following (i) a strongly reviving US/global economy, (ii) surging inflation in the future arising from aggressive monetary and fiscal initiatives from the US government and the federal reserve, (iii) a weakening confidence in the USD or (iv) a declining confidence in the US government's ability to successfully negotiate its future obligations.
- Yet (i) looks doubtful, (ii) appears unlikely in the near term with rising unemployment and a large output gap, (iii) presents a difficult dilemma as there are no other viable alternatives for a reserve currency and (iv) is outright alarming. The message is sobering!

Europe

- The Euro area is showing signs of stabilisation with PMI rising to 40.7 in May from 36.8 in the previous month with the output component highlighting that the pace of contraction in industry is slowing.
- UK house prices rebounded in May in a sign that the property market slump is easing. Consumer confidence also matched the highest level in 11 months in May as people became more optimistic that they can weather the recession.

Japan

- The Japanese economy has been one of the worst hit in the current downturn with real GDP declining 4.3% and 8.8% YoY in 4Q08 and 1Q09.
- A weak domestic demand environment coupled with plunging exports, declining around 40% YoY has had a severe impact on the economy.
- Japan remains an economy most exposed and therefore most sensitive to a global economic recovery. A strong outperformance from the Japanese stock market should provide the strongest sign that the global recovery is sustainable and for real. Such signs are not apparent yet.

Global Market Insight

Equities

- Aggressive policy support leading to improving credit conditions have resulted in increasing consumer and business confidence which has been adequately reflected in asset markets. Recent investment considerations are, however, shifting from growing confidence about the economy to the recovery's sustainability.
- Emerging markets have seen larger inflows than developed markets since March as investors have been chasing 'higher beta' cyclicals with the Greater China region being a prime beneficiary. Of late this trend is reversing with global equity funds finding favour over emerging markets as laggard plays.
- While the global economy appears better than few months back the future trend in unemployment remains a big uncertainty, wealth destruction has taken place on a massive scale, developed world savings rate is on the rise, G7 consumption (>80% of global consumption) is expected to remain weak and banks will be less willing to supply credit as they repair their balance sheets. Under these conditions any recovery will be weak. Equity markets are pricing in a robust 'V' shaped recovery with a P/E ratio 15.9x 2009 and 12.7x 2010 with EPS growth (-13%, 2009) and (+25% 2010). These valuations represent a strong recovery beginning very soon – a scenario which is burdened with risk of disappointment.

Bonds

- US Treasuries once again weakened over the month, with improving macro sentiment, fiscally-induced supply and the diminished safe-haven appeal all contributing to the upwards pressure on yields. The yield curve steepened, with 10-year yields ending the month 34bps higher at 3.46%.
- Although the outlook for the global economy has brightened in recent months, we continue to believe that the lack of sustainable sources of private sector demand growth due to ongoing deleveraging and weakening income growth make it unlikely that economic equilibrium or a return to potential growth will be reached 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. However, further QE action cannot be excluded if financial conditions do not ease over the coming months. We expect the Fed to keep interest rates in the 0-0.25% range until Q3'10, and to modestly rise thereafter. We expect the ECB to continue to ease, bringing the refinance rate to 0.75% by Q3'09.

Returns

- Since the lows in early March, equity markets have rallied strongly for three months in a row.
- Global bonds had a strong month in May. Contribution from bonds was negative, with yields rising in most markets. However, sharp USD weakness resulted in very strong contribution from FX (in USD terms), leading to the strong performance of the index over the month.

Equities Benchmark	May	Year-to-Date	12 Months
MSCI World (USD terms)	9.06%	6.83%	-34.83%
Bond Benchmark	May	Year-to-Date	12 Months
World Govt Bond Index (USD terms, unhedged)	3.33%	-1.61%	4.35%

Asia Pacific Economic Outlook

Overview

- Despite improvements in activity, exports remain negative on a year-on-year basis.
- 1Q GDP reports were mixed with most posting worse than expected numbers as exports collapsed.
- Continuing to witness sequential improvements in economic indicators as the global economic climate stabilises.
- Asian currencies continues to appreciate amidst further bouts of US dollar weakness.
- Strong liquidity is driving markets higher and further foreign capital inflows are expected.

China

- China's PMI stood at 53.1 in May declining from 53.5 in April though still signalling expansion.
- Exports decline accelerated to 22.6% in the month of April.
- Domestic consumption remained firm with retail sales growing 14.8% in April.

North Asia

- Hong Kong's GDP fell sharper than expected, down 7.8% in first quarter of 2009.
- Industrial production fell 8.8% in April and improved 2.6% from March in Korea.
- Taiwan's first quarter GDP fell 10.2%, which was worse than expectations.

South Asia

- Despite a dramatic slowdown, Indonesia's GDP nevertheless grew 4.4% in the first quarter.
- Malaysia's GDP fell by 6.2% in the first quarter as exports collapsed.
- Philippines' OFW remittance remained robust growing 3.1% in the month of March.
- Due to increased government spending, India's first quarter GDP grew at a better than expected 5.8%.

Pacific

- As an indication of Australia's sluggish real estate sector, new building approvals fell 16.1% compared to year ago although improved 5.1% on a month on month basis.

Asia Pacific Market Insights

Equities

- Economic indicators point to stabilising economic conditions though exports remain deeply negative on yearly basis.
- Liquidity remains abundant with investors willing to venture back into illiquid small and mid cap stocks.
- Asian currency strength is being further driven by US dollar weakness.
- There have been some earnings upgrades with positive momentum developing in earnings revisions.
- Market volume has picked up significantly unlike the rally in January where price gains were not matched with volume gains.
- Asia Pacific's 2009 estimated PE stands at 16.8X with an estimated earnings growth of -4.7% and 3 months earnings revision of +1.6%.
- This is a full valuation reflecting a strong recovery. We expect that the market is done some correction.

Bonds

- Asian local rates markets returned a positive performance during the month, with the strong performance of Asian FX being somewhat muted by the accompanying weakness in local bonds.
- Yield curves steepened across most of the regional markets, as improving macro fundamentals, upcoming supply and some inflationary concerns caused the longer end yields to back-up, while the short end remained well-anchored. Indonesia was the best performer, while Thailand's bond market was the worst impacted.
- We have moved to a neutral outlook on Asian bond markets (from overweight earlier), as heavy government bond supply, the end of the rate cutting cycle in most markets and some recovery in underlying growth data result in re-pricing of various yield curves in Asia. Upward momentum in US Treasury yields is also likely to negatively impact Asian bond markets.
- The near term environment remains favourable for risk appetite and is likely to keep the USD under pressure. We expect Asian currencies to continue strengthening, as strong current accounts supported by capital inflows into the regions' equity markets provide a favorable backdrop.

Returns

- Asia Pacific equity markets have outperformed developed markets. The Indian stock markets led with a gain of 36.68% in May as the results of the national elections were viewed positively.
- Asian local currency debt performed well in May. Strong performance by Asian currencies was somewhat muted by flat performance by bond markets.

Equities Benchmark	May	Year-to-Date	12 Months
MSCI Asia Pacific Ex Japan (USD terms)	14.42%	31.80%	-30.89%
Bond Benchmark	May	Year-to-Date	12 Months
HSBC Asia Local Bond Index (USD terms)	1.65%	0.76%	1.91%

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>