Regional Strategy – China & Hong Kong

China's economy consolidating strength, recovery in a moderate pace

Roy Chen, Macro Analyst 23 November 2012
Phillip Securities Research Pte Ltd

CSI300: 2177.55 (-7.17% ytd); HSCEI: 10492.09 (+5.59% ytd); HSI: 21743.20 (+17.95% ytd)

2011 China Real GDP / Inflation: 9.2% / 4.1%
2012(f) China Real GDP / Inflation: 7.8% / 2.2%

- *Head of Research China's top picks are: China Communications & Construction Co. Ltd. (1800.HK) and Agricultural Bank of China (1288.HK); Head of Research Hong Kong's top picks are: HSBC (5.HK) and AIA (1299.HK)*

- *We overweight CSI300, HSCEI and HSI. PhillipETF recommends ChinaAMC CSI300 Index ETF (83188.HK) as a proxy for the A-share CSI300, H-Share Index ETF (2828.HK) as a proxy for the H-share HSCEI, and Tracker Fund of Hong Kong (2800.HK) as a proxy for HSI.*

- *PhillipCFD has long/short "H Shares Index HKD5 CFD" and long/short "FTSE China A50 Index USD1 CFD"*

- *Phillip Unit Trust Department recommends Aberdeen China Opportunities SGD and Fidelity China Focus A USD for China equity market investment.*

- *Marketweight CN bonds & Underweight HK bonds*

In China, October economic data surprised to the upside for a second consecutive month, pointing to a positive economic outlook. Official manufacturing PMI reported 50.2, indicating a slight expansion in manufacturing activities in October. The preliminary reading for Nov HSBC manufacturing PMI returned to above 50 for the first time in 13 months, reporting 50.4, compared to 49.5 in Oct, further backing our conclusion China is bottoming out. Growths of retail sales, fixed asset investment, export and industrial production all showed moderate accelerations from the prior month and at the same time beat the market expectation. Inflation eased slightly to 1.7% in Oct from the earlier 1.9% in Sep, mainly due to a slower growth of food price. Property market also remained relatively healthy. The tame prices have left policymakers with plenty of scope for further monetary loosening, but for the near term, the government will probably refrain from any artificial stimulation. We are pretty sure that China is bottoming out, and we expect expansion to be at a moderate pace as exports, one of China's main growth drivers, would still be subject to the prolonged Europe debt crisis. As for the approaching US fiscal cliff, the Global Macro team is expecting a resolution as both sides have been signalling willingness for compromise. We maintain our GDP growth forecast at 7.8% y-y and lower our inflation estimation to 2.2% for 2012.

For Hong Kong, there is yet no solid sign that the local economy has benefited much from China's moderate recovery. The city's GDP grew by 1.3% y-y in 3q12, slightly faster than the 1.2% y-y pace achieved in 2q12 but slower compared to a market expected 1.7% y-y gain. Private consumption remained sluggish but export growth picked up slightly on China demand. In contrast to the robust retail sales growth in mainland China, retail sales growth in Hong Kong continued to slow down, with the 3m rolling reading reported a 5.8% y-y gain in September, compared to a historical norm of double digit. The Hong Kong government cut its 2012 GDP growth estimate to 1.2% and raised its inflation forecast to 3.9% from earlier 3.7% on 16 Nov.

In our last reports on China (25th Oct) and HK (8th Oct), we became Positive/Overweight (absolute/relative performance) on all 3 indices: the CSI300, the HSCEI, and the HSI on attractive valuations and signs of economic bottoming, we maintain all these stances. Risk for the CSI300 is the spread news of increasing equity issuance ahead while catalysts would be structural reform announcements by the new leadership. As for the HSCEI and HSI, both indices have corrected slightly (on US fiscal cliff worries) after fairly good runs. But as our Global Macro team takes a constructive view on the issue, we maintain our ratings for both indices as we expect fund inflow to Hong Kong stock market to take full advantage of China's economic recovery.

We marketweight China bond market and underweight Hong Kong bond market against peers. We hold a positive outlook for CNY and negative outlook for HKD against peers in the long run.

China Economic Metrics and Growth Outlook:

Fig.1 Real retail sales, FAI and export growth continue to improve, pointing a positive GDP growth outlook in 4q12 and backing our conclusion that China's bottoming out.

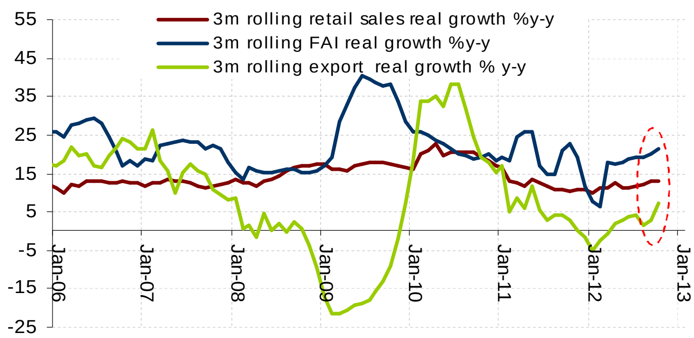


Fig.2 Nominal growth of retail sales accelerated for a second consecutive month, reporting 14.5% y-y in Oct, compared to 14.2% y-y in Sep and beating the market expected 14.4%.

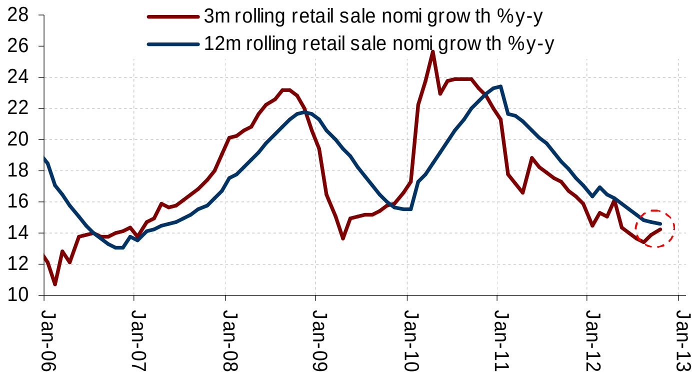


Fig.3 Nominal growth of FAI also accelerated for a second consecutive month in Oct, reporting a 20.7% y-y ytd gain, compared to prior 20.5% y-y ytd gain in Sept and the market expected 20.6%. Going forward, we expect the growth of FAI to pick up further in a moderate manner as previous announced over 1 trillion RMB infrastructure project continues to lend support.

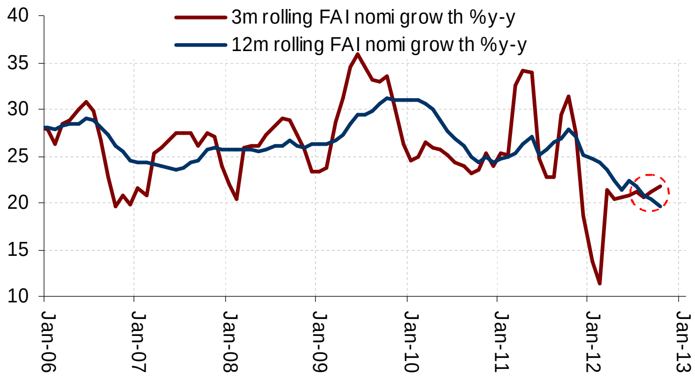


Fig.4 Nominal growth of export to US, EU and ASEAN all picked up, partially because of the lower base in Oct 2011. Export to US rose by 9.0% y-y in Oct, compared to 5.5% y-y gain in Sep. Export to EU fell by 8.1% y-y, a slower pace compared to the 10.7% y-y contraction in Sept. On m-m basis, we are actually seeing some drops in US and EU readings due to the effect of China's 9-day long holiday at the beginning of Oct. However, regardless of the holiday effect, export to ASEAN rose to historical high in Oct on rising demand from Singapore and Malaysia, reporting 19232 mn USD, 44.8% higher than a year ago, compared to 31170 mn USD of US and 26425 mn USD of EU. With the robust growth of demand and a shrinking EU economy, ASEAN is likely to surpass EU and become China's 2nd largest trading partner within the next 3/4 years.

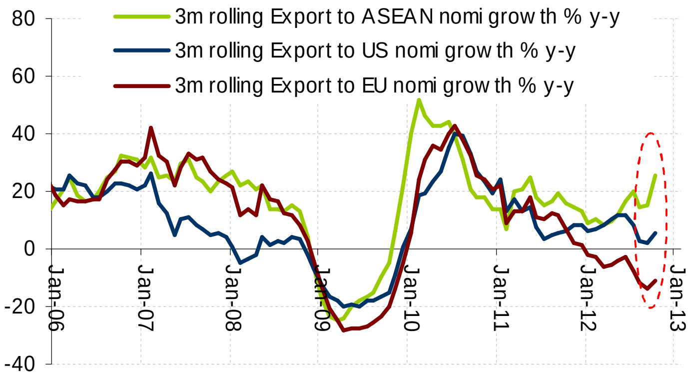


Fig.5 The official manufacturing PMI returned to 50.2 indicating a slight expansion in manufacturing, after the 49.8 reading in Sept. The preliminary reading for Nov HSBC manufacturing PMI returned to above 50 for the first time in 13 months, reporting 50.4, compared to the final readings of 49.5 in Oct and 47.8 Sep, indicating a moderate expansion in the small and medium manufacturing business. The official non-manufacturing PMI also has rebounded from the 17-month low of 53.7 in Sept, reporting 55.5 in Oct, indicating a faster expansion in the nation's non-manufacturing business.

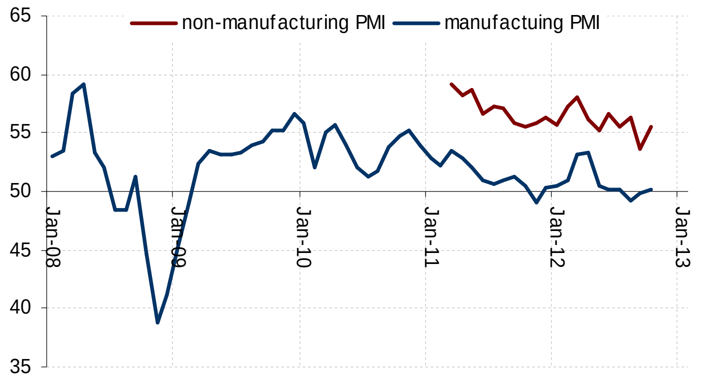


Fig.6 Growth of industrial value added, a nominal measure, is still slowing down on 3m rolling basis. However on monthly basis, the gauge has accelerated for a second consecutive month in Oct, reporting a 9.6% y-y gain, compared to the 9.2% y-y gain in Sept, pointing to better enterprise profit outlook.

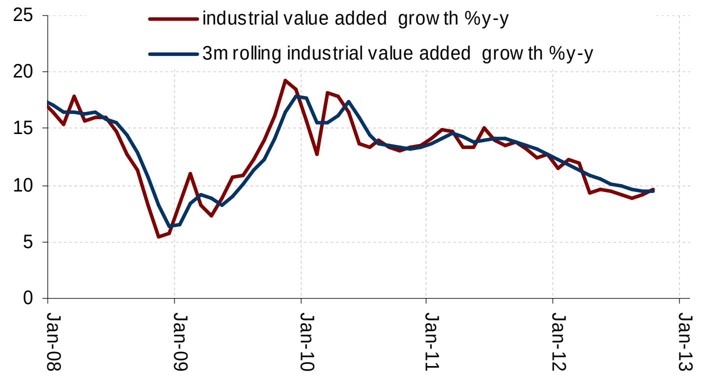


Fig.7 Property price remained tame, with 35 out of the 70 major cities saw monthly increase in housing price in Oct, compared to 31 in Sept. Over the year, 55 cities see decreases in new apartment price; the number holds the same as it was in Sept. Following the two benchmark rate cuts in June and July, we do see a rebound in residential property transaction and some moderate pickup in property price. In fact, this is the ideal situation the government wants. It will maintain the curb in the property market, but will not make it too tight to damp the tentative recovery in the Chinese economy.

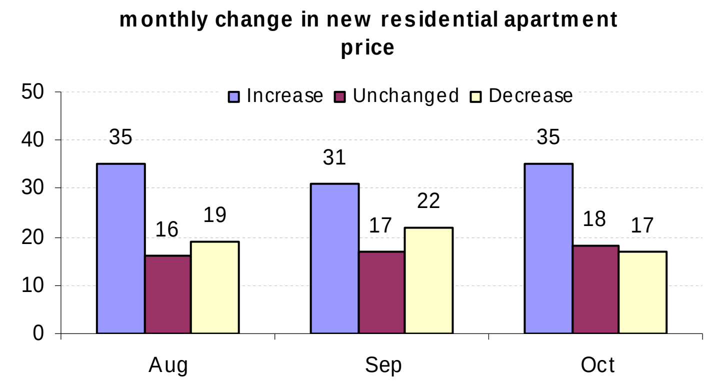
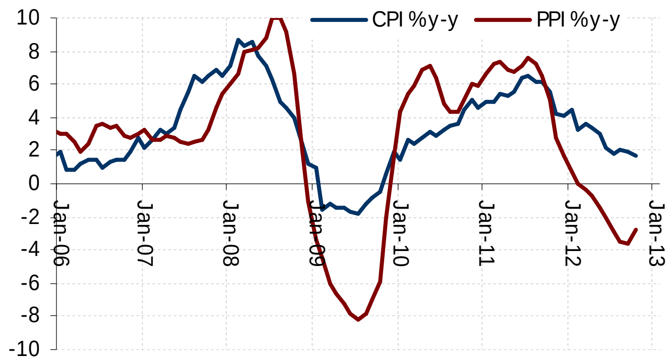


Fig.8 Inflation eased slightly to 1.7% y-y in Oct from 1.9% in Sept due to the slower gain in food price. PPI dropped by 2.8% y-y in Oct, slower compared the 3.6% y-y drop in Sept. The slower drop in PPI indicates a stabilizing production demand for producers, which also adds to our conclusion of China's bottoming out. Going forward, the moderate PPI would still help contain inflation.



China Growth & Inflation Forecast:

- For the past two months there have been upside surprises in the macro data, confirming our earlier projection of China's bottoming out. The over 1 trillion RMB infrastructure investment announced in September will continue lending support to the nation's economic growth for the near term. After the successful transfer of political power, we expect the government to accelerate the pace of economic and financial reform, such as transforming from revenue tax to value added tax, marketizing interest rate, boosting domestic demand and shifting focus from manufacturing industry to tertiary industry. **We hold a positive growth outlook for China and maintain our 2012 GDP growth forecast at 7.8%, with inflation forecast downward adjusted to 2.2%** due to the recent easing growth of food price.

HK Economic Metrics and Growth Outlook:

Fig.9 Hong Kong's GDP rose by 1.3% y-y in 3q12, compared to the market expected 1.7% y-y and the 1.2% y-y gain achieved in 2q12. Growth of private consumption is still weak, reporting a 2.8% y-y gain, compared to the 3.1% y-y gain in 2q12. Growth of gross export picked up to 3.1% y-y, mainly attributable to the recovering demand from mainland China, compared to the 0.5% y-y gain in 2q12. As we are expecting a rather moderate pace of China's bottoming out, the support lent to Hong Kong could be quite limited in the near term.

Fig.10 Retail sales growth in Sept is still sluggish, with 3m rolling reading remaining in a downward trend, adding to our earlier conclusion of weak domestic consumption.

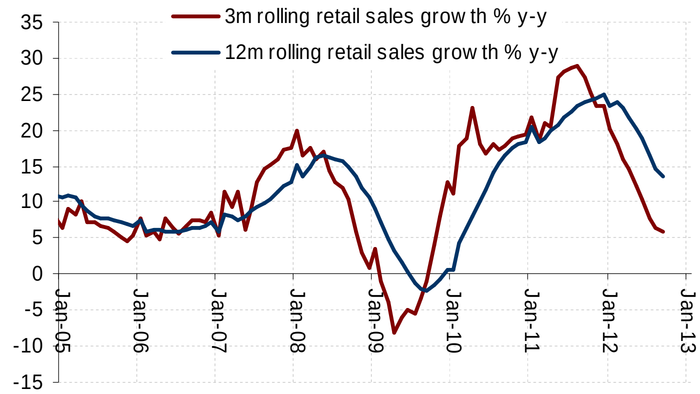


Fig.11 We observe a major improvement in China demand and a minor pickup in US demand. Demand from EU remained sluggish and contracted at a rate close to 10% y-y. Going forward, the sluggish western demand would remain as a drag for Hong Kong's growth.

Fig.12 Hong Kong property market remains hot even after the government introduced a series of tightening policies such as tightening mortgage requirement and imposing tax on overseas buyers. Property price reached historical high in Sept, 27% higher than the 1997 peak where last housing price bubble burst. With HKD pegged to USD and the loosely controlled capital flow, the low interest rate environment and open-ended QE3 by US would likely induce capital inflow to Hong Kong's property market and inflate the property price further.

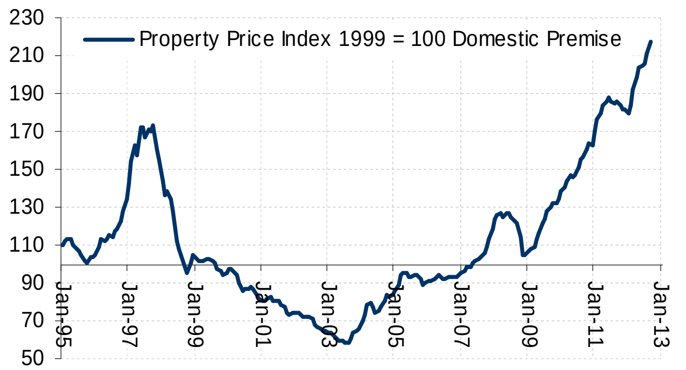


Fig.13 Hong Kong's underlying inflation reported 3.9% in Sept, compared to 3.7% in Aug. There are two competing forces: the easing inflation in mainland China could help contain Hong Kong's inflation; however, with the loose capital flow the city is more vulnerable to the inflation pressure introduced by QE3.

Hong Kong Growth & Inflation Forecast:

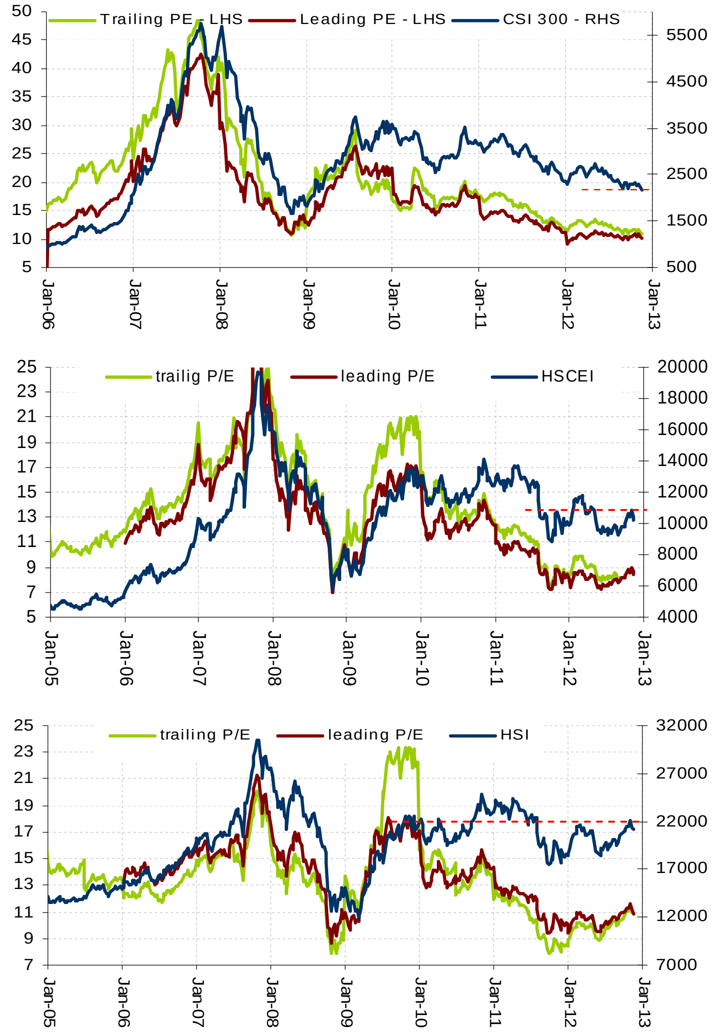
- Aligned with the Hong Kong government, **we forecast a 1.2% GDP growth with an inflation of 3.9% in 2012.**

Asset Strategy

- In our last reports on China (25th Oct) and HK (8th Oct), **we became Positive/Overweight on all 3 indices** on signs of economic bottoming, and valuations - P/E ratios are at approximate 10X for CSI300, 9X for HSCEI and 11X for HSI. For CSI300 and HSCEI, P/E ratios are below or close to their respective historical low, while for HSI, P/E is at the lower end of historical range. We thus maintain these ratings as the evidence for economic bottoming increases while valuations remain very attractive. Risk for the CSI300 is recently spread news of increased equity issuance (which China mainland stock has previously suffered from) while catalysts would be accelerated pace of structural reforms by the new leadership going forward. We caution that the index is currently close to the supporting level near 2180. If the supporting level is validly broken through, it could induce another round of selloff purely due to market sentiment. Even so, we do not envisage the downside magnitude to be great on valuation support, while the upside magnitude could be very substantial if the economy picks up, which we believe the evidence suggests. As for the HSCEI and HSI, both indices have corrected slightly (on US fiscal cliff worries) after fairly good runs. But as our Global Macro team takes a constructive view on the issue, we maintain our positions for both indices as we expect fund inflow to Hong Kong stock market to take full advantage of China's economic recovery.

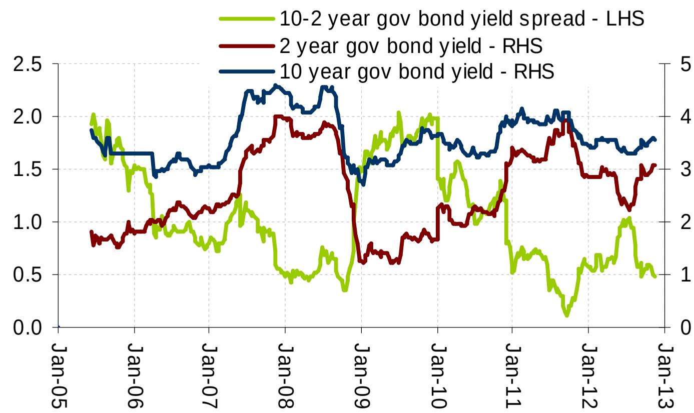
- **We recommend the physically backed ETF, ChinaAMC CSI300 ETF (83188.HK) as a proxy for A-share CSI300 index. For HSCEI we recommend H-Share Index ETF (2828.HK) as a proxy. And we recommend 2800.HK as a proxy for HSI.** CSI300 and HSCEI indices have their major business exposure in mainland China. CSI300 contains 300 major big cap Chinese companies listed in Shanghai and Shenzhen exchange and the CSI300 ETF is dominated in CNY. HSCEI contains all the Chinese enterprises listed in Hong Kong market and the corresponding 2828.HK ETF is dominated in HKD. HSI contains 49 largest companies listed in Hong Kong and serves as the main indicator of the overall Hong Kong market performance. The index constituent companies also have significant business exposures in China. The corresponding index ETF 2800.HK is dominated in HKD. In the long run, we see 3 indices tracking each other well as the indices are all highly correlated with the well-being of China's economy. Nevertheless there could be short term discrepancies in the 3 indices due to the different constituent companies and differences in market sentiments of buyers. The majority of CSI300 constituent stock buyers are mainland domiciled while HSCEI and HSI are much more open for Hong Kong based as well international investors.

Fig.14 CSI300 and HSCEI have their PE ratios at or close to their respective historical low at Lehman Meltdown. HSI also has its PE ratios at lower region of historical band.



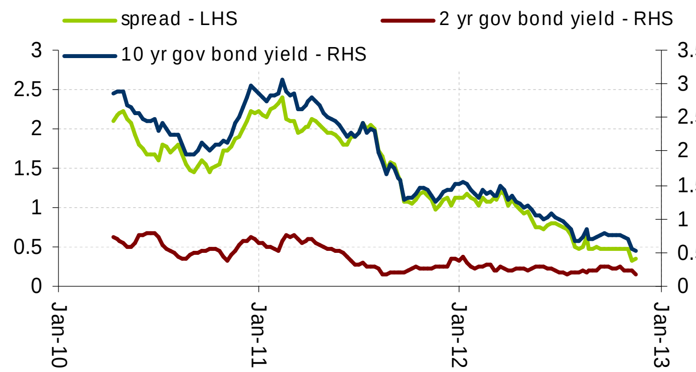
- **Bond Market:** We observe some pickups in the 2 yr and 10 yr government bond yield, reflecting that the market is correcting its expectation about further monetary loosening. The tame inflation and property price do grant the central bank enough scope for further monetary loosening, but the recent better than expected economic data has suppressed the needs for an immediate loosening. The government might keep targeting the liquidity in the mild and accurate manner by a series of reverse repos. Despite this, we still do not rule out the possibility of further loosening going forward as the economy is still consolidating its strength. **We assign a marketweight rating to China's bond market.**

Fig.15 China Government 2y/10y bond yields and spread



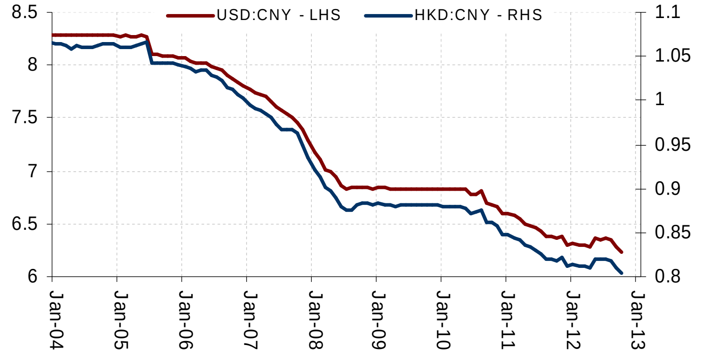
- **We assign an underweight rating to Hong Kong's bond market** as the yield is already so low and there is no much room to going down further.

Fig.16 Hong Kong Government 2y/10y bond yields and spread



- **Currency Outlook:** We hold a positive outlook for CNY against major trading currencies in the long term as CNY is still moderately undervalued. For the near term, there are competing forces. On one hand, the recovery of China's economy would likely induce fund inflow to China (i.e. appreciation) to take advantage of China's bottoming out. On the other hand, the government has an incentive to maintain a stable or weak CNY to bolster the nation's faltering export growth. Therefore, we assign a neutral rating to CNY against major trading currencies in the near term. To sum up, **we expect CNY exchange rate to remain relatively stable in the short term, but tilt upward in the long run. As for HKD, which is pegged to USD, the open-ended QE3 would likely depreciate HKD against other major trading currencies.**

Fig.17 USD:CNY, HKY:CNY exchange rates

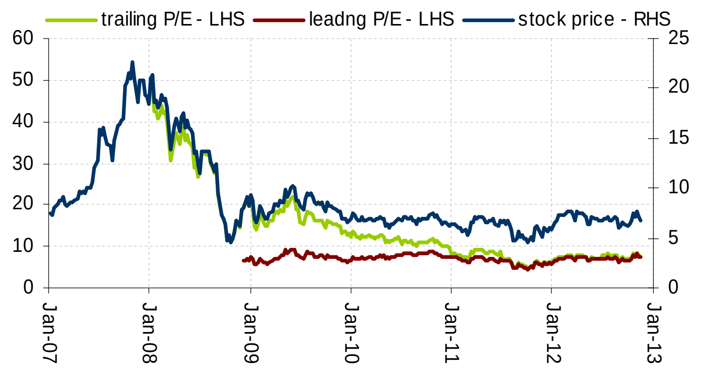


STOCK PICKS:

- **Head of Research China Mainland's top picks are: *CCCC (1800.HK) and ABC (1288.HK)***

China Construction Communications Co. Ltd (1800. HK)

Fig.18 CCCC



- CCCC total income reported RMB200.48 billion during the first three quarters of 2012, declining by 5.2% from a year before, and operating profit fell by 5.9% yoy. Net profit attributable to the parent company reached RMB6.92 billion, down by 14.46% yoy, corresponding to EPS RMB0.44, compared with RMB0.55 a year before. The performance decline was mainly attributed to slowdown of China infrastructure industry. In addition, there was a debt regrouping gain of RMB930 million a year before, but there was none during the period this year, so non operating income declined by 68% yoy.

- Affected by the bullet training rear-end collision accident last year, the Company railway construction business completely came to a standstill, but the Company timely adjusted its business portfolio, pressed ahead overseas market exploration and domestic investment business

(BT, BOT/BOO projects, etc.) and, drove up percentage of investment business and overseas business of high gross margin, and the Company gross margin in the first three quarters rose by 0.7 ppts to 12.52%.

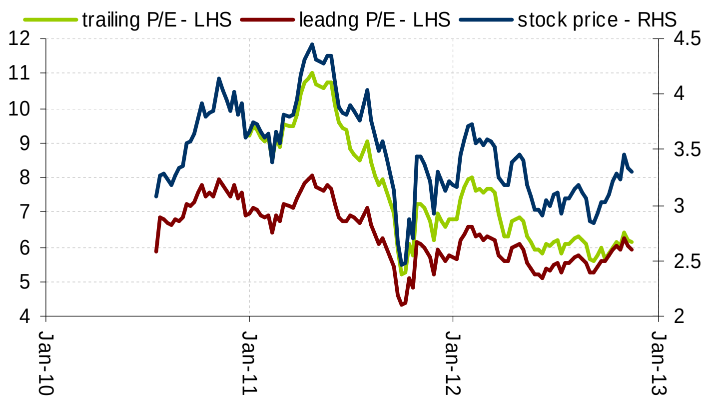
- CCCC newly signed RMB322.8 billion contracts in the first three quarters of 2012, up by 10.7% yoy, among which port construction orders amounted to RMB43.2 billion, up by 3.3% yoy, while road and bridge construction orders amounted to RMB56.5 billion, down by 40.6% yoy. Investment business orders reached RMB99.9 billion, up by 71% yoy and overseas infrastructure construction orders amounted to RMB58.0 billion, up by 54%. Investment business growth was still robust.

- Due to the Company unique information advantages in the mainland road planning and subsequently forward-looking judgment of future road network distribution and traffic flow change, CCCC's investment business enjoyed obvious advantages. During the 12th Five-Year Plan period, the Company will continue to raise investment business proportion. What's more, a considerable number of former investment projects would have entered the payback period. We believe the Company profitability is expected to further improve.

- The clarity of China's "stable growth" policy has a positive impact on the infrastructure sector and the growth of Company's new orders is expected to rebound further. Comprehensively considering the Company's position in China infrastructure sector and sustainable development capability, we grant 12-m target price at HKD8.73, corresponding to 8x P/E of 2013E EPS, hence Buy rating.

Agricultural Bank of China (1288.HK)

Fig.19 ABC



- Agricultural Bank of China (ABC or the Group) was founded as Agricultural Cooperative Bank in 1951, and restructured into a joint stock limited liability company in Jan 2009. ABC was listed in A+H Shares in Jul 2010. In 2011, ABC ranked No.127 in the global Fortune 500 companies, A1/stable in Moody's long-term deposit rating and outlook, A/B+ in Fitch's long-term sovereign crediting rating/banking stable rating, with the outlook of stable. By the end of 3Q2012, based on total assets, ABC was the third largest bank in China.

- According to ABC's third quarterly report, as at the end of Sep 2012, net interest income reached to RMB253.233 billion with the year-on-year growth rate of 13.37% benefited from the stable performance of NIM as 2.82%, decreased quarter by quarter this year but increased by 2bp y-o-y;

- Affected by the market environment, the Group's intermediate business incomes slowed down obviously of which accumulated net fee and commission incomes only increased approximately by 6% to RMB58.11 billion, higher than the peers. The portion of net fee to operating income recorded to 18.3%, went down quarter by quarter, and also lower than that of the same period of last year;

- Net profit of ABC achieved to RMB120.083 billion, increased by 19.18% y-o-y, slightly higher than our expectation. The profit growth was on the top among the peers;

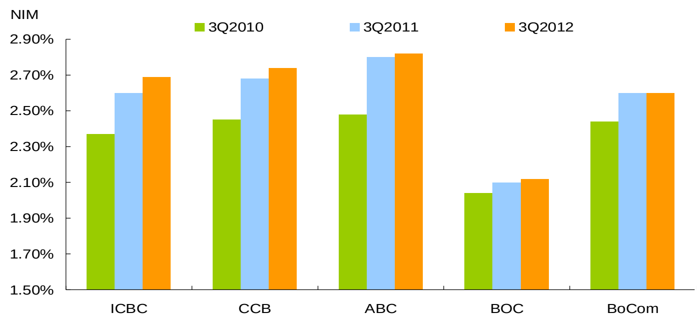
- Total assets rose 11.85% to RMB13.06 trillion compared with the end of last year. Net assets increased by 11.86% to RMB726.674 billion with BVPS of RMB2.24.

- ABC's ability of risk control continued to be developed with the improvement of loans quality. NPLs decreased by RMB3.407 billion compared with the beginning of the year, and the NPL ratio cut 0.21 percentage pointes to 1.34%. Meanwhile, the coverage ratio increased significantly by 48.10 percentage points to 311.20%;

- The bank's capital pressures continued to reduce currently, CAR and Core CAR increased by 0.13 and 0.26 percentage points to 12.07% and 9.76% respectively, but obviously lower than other large-sized banks. We believe ABC would face larger capital pressures in future considering the implementation of Chinese Basel III at the beginning next year;

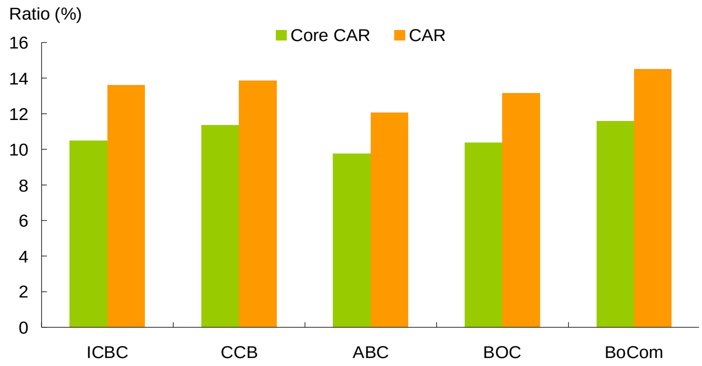
- Overall, ABC gained stable operating performance, and profit growth slowed down but higher than the peers, we believe it would keep a stable increase over the next two years. Considering strong rebound of share price recently, and negative effects from the deterioration of loans quality and the increase of capital pressures in future, we cut ABC's 12-m target price to HK$3.90, 14.04% higher than current price, equivalent to P/E5.9x and P/B1.2x in 2013 respectively. Maintain ABC on accumulate rating.

Fig. 20 NIM of Big-5 in 3Q2012



Source: PSR, Company report

Fig. 21 CAR and Core CAR of Big-5 in 3Q2012

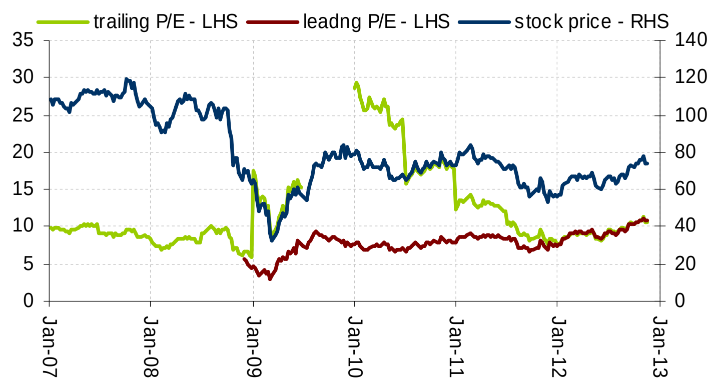


Source: PSR, Company report

- **Head of Research Hong Kong's top picks are:** ***HSBC(5.HK) and AIA(1299.HK)***

HSBC (5.HK)

Fig.22 HSBC

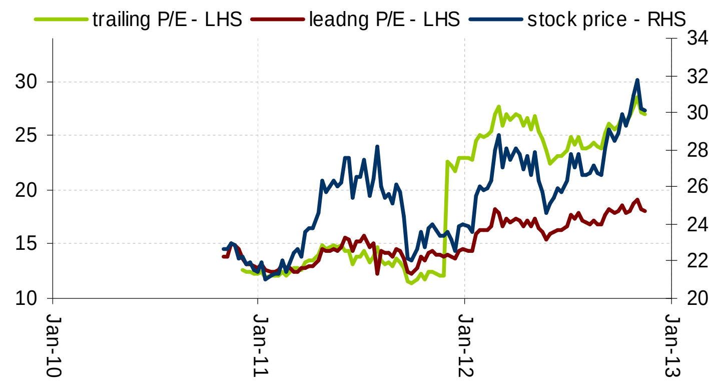


- Since our last published research report, HSBC's share price performed slightly better than we expected. The market still expected to see HSBC's brilliant third quarter results to be announced. However, we believe that the current share price overrates the third quarter result. The share price may drop after the announcement of the third quarter's result. Investors are recommended to be prudent. If the share price returns to around $ 75, it will be a good opportunity to buy for a long-term investment.

- HSBC's stock price continued to rise since August, coupled with fewer fines of Standard Chartered Bank than the market expected which favors HSBC's relatively lighter money laundering allegations. At the same time, HSBC made USD$700 million reserve for the related money laundering case in the interim results. If the fines are fewer than expected, HSBC can make an appropriate call-back which has positive impact. From the fundamental view, there is still room for improvement for HSBC's business. For HSBC's global restructuring, we expect the Group will be able to reach the lower limit of the target set by last year. In addition, HSBC's profit contribution is evenly distributed in different regions, not like Standard Chartered Bank which only focuses on emerging markets. If the regulators tighten the supervision on emerging markets, Standard Chartered Bank will be expected to suffer from greater negative impact. Therefore, the overall prospect of HSBC is better. From the above reason, we maintain the " Accumulate " investment rating or HSBC and the target price of $75. We expect the short term trend follows the market fluctuation. Investors should pay attention to the Group's third quarter operating report. As stated in our August report, our target price and investment rating will be based on the Group's third quarter operating condition.

AIA (1299.HK)

Fig.23 AIA



- Since our recommendation on May this year, stock price rose as we expected. In particular, after a major shareholder of AIG sold his shares at premium price, share price rose sharply to close very near to the target price of $32 we set on May. If investors follow our recommendations to buy AIG on 7th September, a return of nearly 14% will be obtained within two months while the return will be more than 15% for half year holding which was relatively good among the constituent stocks of the Hang Seng Index.

- In addition, AIA will generate positive synergies after acquisition of ING Malaysia business and will become the market leader in that region. The share price has been very close to our target price, so we slightly increase our target price to $34. AIA's business is concentrated in the emerging markets of Asia-Pacific. Although its share price performance should reflect its intrinsic value, but we think that AIA's operating outlook is still the industry's top pick. Coupled with the region's investment sentiment slightly improved, the continuing inflow of hot money will also help to improve the Group's return on investment.

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Please contact Phillip Securities Research at [65 65311240] in respect of any matters arising from, or in connection with, this document.

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Contact Information (Singapore Research Team)

Chan Wai Chee
CEO, Research
Special Opportunities
+65 6531 1231
yebo@phillip.com.sg

Lee Kok Joo, CFA
Head of Research
S-Chips, Strategy
+65 6531 1685
leekj@phillip.com.sg

Joshua Tan
Strategist
+65 6531 1249
joshuatan@phillip.com.sg

Magdalene Choong
Investment Analyst
SG & US Financials, Gaming
+65 6531 1791
magdalenechoongss@phillip.com.sg

Go Choon Koay, Bryan
Investment Analyst
Property
+65 6531 1792
gock@phillip.com.sg

Derrick Heng
Investment Analyst
Transportation, Telecom.
+65 6531 1221
derrickhengch@phillip.com.sg

Ken Ang
Investment Analyst
Financials
+65 6531 1793
kenangwy@phillip.com.sg

Travis Seah
Investment Analyst
REITS
+65 6531 1229
travisseahhk@phillip.com.sg

Ng Weiwen
Macro Analyst
Global Macro, Asset Strategy
+65 6531 1735
ngww@phillip.com.sg

Roy Chen
Macro Analyst
Global Macro, Asset Strategy
+65 6531 1535
roychencz@phillip.com.sg

Nicholas Ong
Investment Analyst
Commodities (Agriculture/Trading)
+65 6531 5440
nicholasonghg@phillip.com.sg

Research Assistant
General Enquiries
+65 6531 1240 (Phone)
+65 6336 7607 (Fax)
research@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites**:** www.phillip.com.hk

JAPAN
Phillip Securities Japan, Ltd.
4-2 Nihonbashi Kabuto-cho Chuo-ku
Tokyo 103-0026
Tel (81-3) 3666-2101
Fax (81-3) 3666-6090
Website:www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co. Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel (86-21) 51699200
Fax (86-21) 63512940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005

AUSTRALIA
PhillipCapital Australia
Level 37, 530 Collins Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96298380
Fax (613) 96148309
Website: www.phillipcapital.com.au