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## ECONOMIC UPDATE

### Executive Summary

**China:** While growth has slowed, it is still remarkable relative to other economies. We think that after only three months, it is likely too early for China to reverse tightening measures. Besides, property speculation remains a real concern in China. As such, we do think that slowdown in growth is likely to extend over the rest of the year as Beijing continues in their attempt to curb and cool the property market.

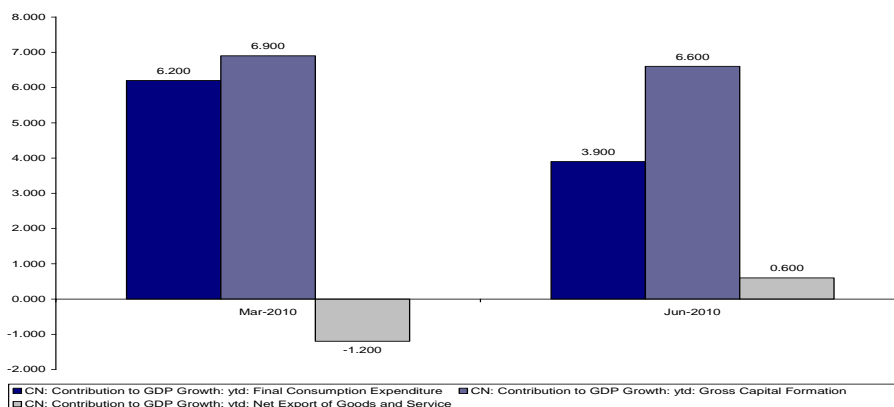
**United States:** At present, a double dip scenario seems unlikely as data is suggesting a slowdown in growth and not a contraction. Nonetheless, it is inevitable that growth in US would slow in the second half of the year as the boosts from the fiscal stimulus and inventory rebuilding fade.

### China

On 15th July 2010, China announced that its economy expanded 10.3 percent year-on-year in Q2 2010, down from 11.9 percent in Q1. Consumption's contribution to GDP growth has fallen to 3.9 percent in the second quarter. On the contrary, the level of contribution from net exports has risen from the first quarter. Net exports' contribution to GDP growth rose from -1.2 percent to 0.6 percent. This did not come as a surprise as exports grew 43.9 percent year-on-year in June. This was in addition to a 48.5 percent growth in May. At the same time, import growth slowed to 34.1 percent year-on-year from 48.3 percent in May.

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**Figure 1: Breakdown of China's GDP**



Source: CEIC. As of June 2010.



While the slow down in growth did not come as a surprise as the government has been implementing policies in an attempt to curb bank lending and to cool the property market, the decline has nonetheless caused concerns about overheating to shift to worries that the economy is heading for a hard landing. This is particularly so as activity data in June suggests that the economy is slowing faster than anticipated. Production for instance rose 13.7 percent year-on-year in June, compared with May growth of 16.5 percent and a (Bloomberg) consensus expectation of 15.1 percent. Annual retail sales growth has also eased to 18.3 percent in June from 18.7 percent in May. Meanwhile, year-to-date investment in urban areas in fixed assets such as flats and factories slowed a notch, growing 25.5 percent from a year earlier after a 25.9 percent rise in May.

With regards to the above concern, we think that after only three months, it's likely too early for China to reverse tightening measures. Besides, as shown in later paragraph, property speculation remains a real concern in China. As such, we do think that slowdown in growth is likely to extend over the rest of the year as Beijing continues in their attempt to curb and cool the property market.

From the latest reading on housing prices, the government's efforts to curb speculation continue to be met with some success. Chinese property prices measured by the 70 city property price index declined for the second month. The index which stands at 111.40 in June 2010 fell by 0.9 percent from the previous month. The magnitude of decline was larger relative to the month before. However, from a year ago, property prices are still higher by approximately 11 percent. As such, the Chinese authority has expressed its stance to maintain its tightening campaign to cool real estate prices.

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**Figure 2: China Property Price Index**



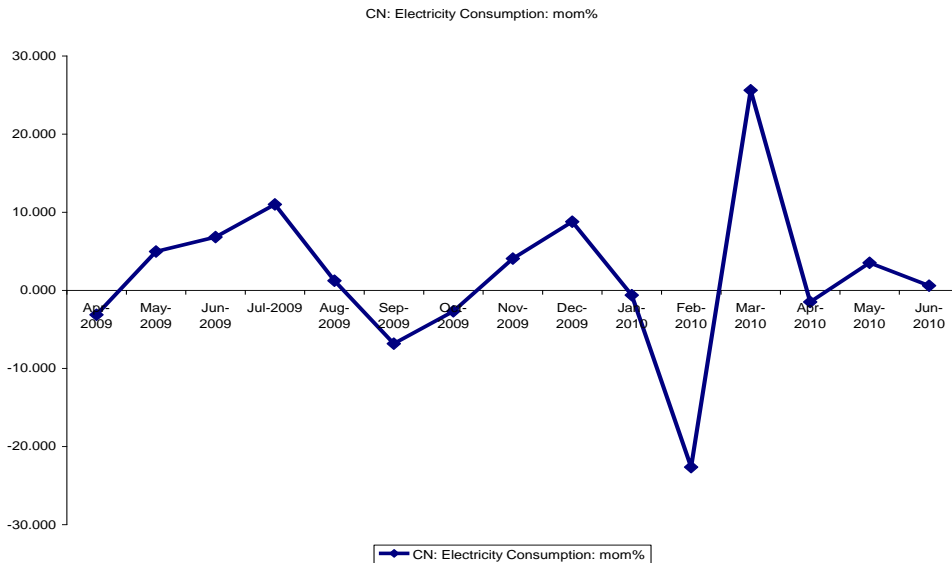
Source: CEIC. As of June 2010



Property speculation is a very real concern in China. This is the case as estimates from electricity consumption readings suggest that many apartments and houses stand empty in China's urban area. As shown in the figure below, electricity consumption did not increase tremendously despite the spike in demand for houses. As such, we can still expect efforts by the Chinese government to cool the property market.

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**Figure 3: Electricity Consumption in China**



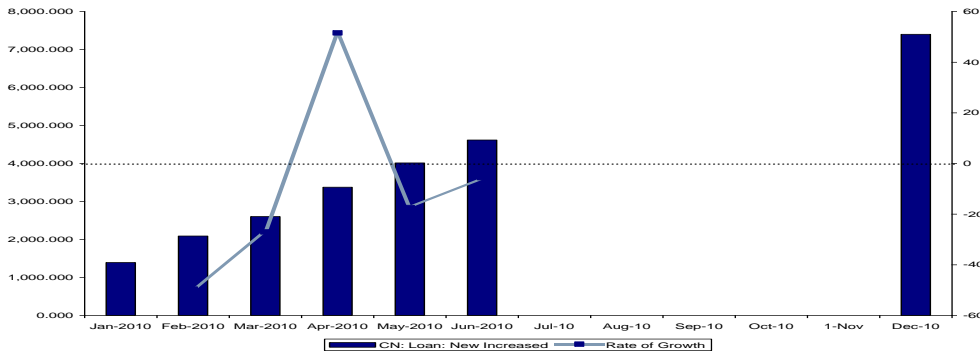
Source: CEIC. As of June 2010.

With respect to loan growth, the rate of growth has declined for a second consecutive month in June. The cumulative amount of new loans granted till date is approximately RMB 4.6 trillion. To keep the total amount of loans created to RMB 7.5 trillion, the amount of loans granted on a monthly basis should not exceed RMB 463 billion for the rest of the year. We think that given the current rate in which loans are granted, it seems likely that loan growth will exceed the RMB 7.5 trillion target. As such, we can perhaps expect the government to react accordingly when the need arises.

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**Figure 4: Cumulative new loan growth**



Source: CEIC. As of June 2010

On the whole, we think that there is a need to recognize that while growth has slowed; it is still remarkable relative to other economies; and even those in Asia (except Singapore). As such, the Chinese might probably be reluctant to reverse its tightening policies at the moment. Besides, it is also important to note that businesses have recapitalized, household net wealth and income levels are rising and monetary policy is still extraordinarily accommodative. As such, as we expect some dire effects on the Chinese economy as the government continue to deal with the issue on property prices, the impact will not be drastic as many probably have perceived. Nonetheless, it is inevitable that the economy will slow.

### United States

The likelihood of a back-to-back recession got a lot more attention recently as some economic indicators continued to pull back from the highs they reached during the recovery. For instance, the Institute for Supply Management Manufacturing Index for June pulled back to 56.2 from 59.7. The peak for this index was 60.4 registered in April. On the other hand, the ISM Non-Manufacturing index – which tracks the more dominant service sector – declined to 53.8 from 55.4.

June’s retail sales data is yet another piece of evidence that suggest that the economy is shifting into a lower gear at the end of the second quarter. In June, retail sales declined by 0.5 percent from the previous month, the second consecutive month of decline. The slow down was broad base. Furniture and building material sales fell. Electronic sales were the only sector that bucked the downward trend, rising in both May and June.

Meanwhile, the latest reading on the housing market seems to suggest that the sector is struggling to stand on its own in the absence of the government’s support. The NAHB housing index fell to 14 in July from 16 in June; the second month of decline. This shows that demand for new homes has weakened further. Such a trend did not come as a surprise as activities are bound to decline as buyers brought forward purchases before the tax credit expire. However, it is prominent that the index fell from the peak of 22 in May to a 15 month low.

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A decline in housing demand will inevitably affect housing prices. We have mentioned the importance of housing prices holding up previously. To reiterate, consumption is closely linked to housing price levels as the latter influences individual's net worth. Therefore, if housing prices were to fall in the later half of the year, consumption would be affected to somewhat extent.

In Fed Chairman Ben Bernanke's latest testimony to Congress, he has reaffirmed investors' fears that the US economy has weakened – "even as the Federal Reserve continues prudent planning for the ultimate withdrawal of monetary policy accommodation, we also recognize that the economic outlook remains unusually uncertain." Also, in his pre-prepared remarks, he said that "we remain prepared to take further policy actions as needed to foster a return to full utilization of our nation's productive potential in a context of price stability." In other words, at present, there is no plan for further stimulus.

At present, a double dip scenario seems unlikely as data is suggesting a slowdown in growth and not a contraction. Nonetheless, it is inevitable that growth in US would slow in the second half of the year as the boosts from the fiscal stimulus and inventory rebuilding faded.

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## THE ROUTE TO RECOVERY HAS ROCKS ON IT

### Executive Summary

**Equities** – Global equities were mixed as Southeast Asia equities, in particular, decoupled away from the weak performance of other regional markets.

**Commodities** – The Gold price support at the US\$1180/Oz. region is likely to provide good short term support; Oil price will meet resistance at the US\$80 /bbl. mark.

**Fixed income** – Emerging market and high yield bonds should continue to enjoy similar strong fund inflows for the second half of the year on the back of strong fundamentals.

### Equities – A Sign of Asia Decoupling

General performance among global equities were mixed in the month of July. The Southeast Asia region continued to perform strongly against other regional markets. Singapore equities were up 4% on a monthly basis (See Table 1 below). Indonesia and Malaysia were equally outstanding with a 1.5% gain over the same one month period. In the latest sign that Asia's growth is decoupling from the West, trade data from Thailand, Korea, Indonesia and Taiwan showed exports holding up better than expected. Also, the BIS reported record lending to Asia in Q1-2010, as well as continuing buoyant economic activity in the region (Korean GDP growth, Singapore industrial production etc). However, the Greater China equities continued to be the laggard in the MSCI Asia Pacific ex Japan basket, with the Shanghai Composite leading the decline with -1.4%. We remain optimistic on the outlook of China equities given that valuations are still below its 3-Year and 5-Year average and the premium mainland investors paid for shares listed domestically over H-shares is near convergence, a scenario not seen in recent history.

**Table 1: Selected Equity Stock Market Index Returns**

Country	Index	Jul. 20	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Singapore	Straits Times Index	2949.25	4.09 ▲	-1.08 ▼	1.94 ▲	3037.97	2423.60
India	BSE Sensex Index	17928.42	2.04 ▲	2.68 ▲	2.60 ▲	18167.22	14684.45
Indonesia	Jakarta Composite	2975.57	1.57 ▲	2.92 ▲	11.56 ▲	2996.42	2060.62
Malaysia	FTSE Bursa	1336.69	1.44 ▲	0.06 ▲	2.30 ▲	1349.92	1120.90
Korea	Kospi Index	1732.69	1.21 ▲	0.85 ▲	1.07 ▲	1764.81	1447.11
Hong Kong	Hang Seng Index	20090.95	-0.96 ▼	-7.09 ▼	-5.62 ▼	23099.57	18960.54
China	Shanghai Composite	2477.753	-1.41 ▼	-16.84 ▼	-21.39 ▼	3478.01	2319.74
United States	S&P 500 Index	1071.25	-4.14 ▼	-11.26 ▼	-5.87 ▼	1219.80	940.99
Japan	Nikkei 225 Index	9318.28	-6.77 ▼	-14.58 ▼	-13.44 ▼	11408.17	9076.41

Source: Bloomberg, as of 20 Jul 2010

*Major global equities were mixed on a monthly basis. Southeast Asia equities continued their strong performance.*

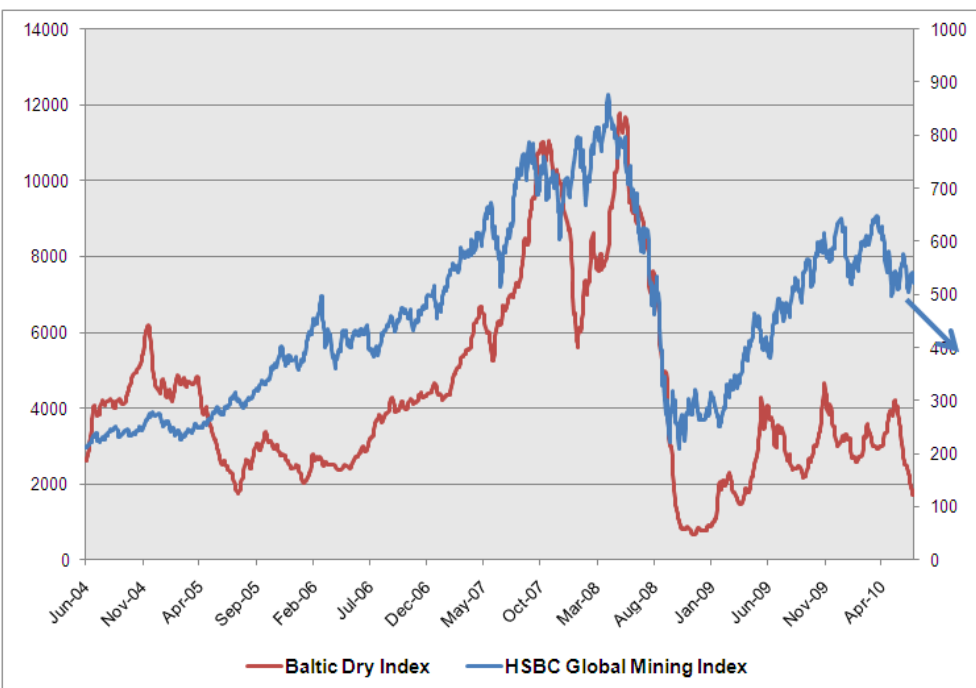


The Baltic Dry Index gives an idea of the spot price for hiring a commodity-carrying ship at a given point in time. (These ships tend to carry dry-bulk goods like ores, such as iron and coal.) A high Baltic Dry Index value is generally a good proxy for the health of global trade. However, the Index had declined a sharp 59.6% since 26<sup>th</sup> May 2010, the longest streak of consecutive declines for 9 years. Indeed, the recent drop in shipping rates can be attributed to a reduction of stocks of major inputs in China's manufacturing sector. We saw the China's Manufacturing PMIs for New Orders and New Export Orders coming off their May-highs, a likely seasonal effect due to food and energy seasonal consumption especially grain and coal. Also, the decision to allow the Yuan to float more freely had probably resulted in China's importers holding off on imports in anticipation of lower import prices due to the expected strengthening of the Yuan against the U.S. dollar.

On the supply side, new ship vessels are adding to the oversupply at a rate of 23 vessels per month. Global fleet already saw a 23% increase in size in the first half of this year. The collapse in the Baltic Dry Index is a clear indication that supply of ships is more than the demand for their cargoes.

Historically, the Baltic Dry Index had a high correlation against the performance of the Global Mining industry (See Chart 1 below). On the back of weaker base metal prices and slowdown in global trade (mentioned earlier), we do expect headwinds on the mining industry in the near term. What may be a normal seasonal lull in shipping might translate into a halt to the booming mining sector.

**Chart 1: Mining Stocks moving in tandem with Baltic Dry Index**

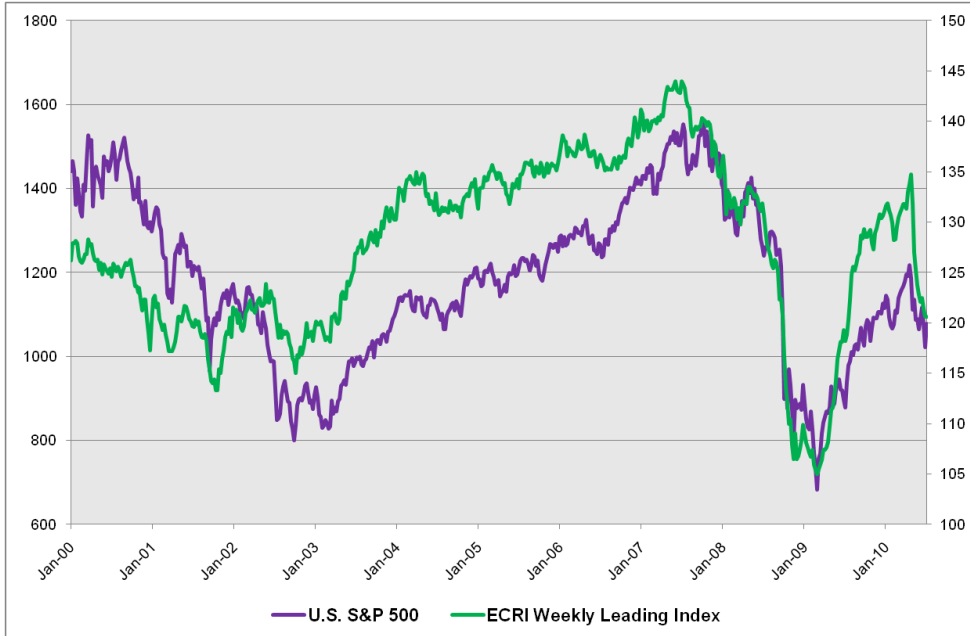


*Mining sector is likely to face headwinds with the Baltic Dry Index pointing to a weak global trade outlook.*

Source: Bloomberg, as of 21 Jul 2010



### Chart 2: ECRI Weekly Leading Indicator with S&P 500 Index



Source: Bloomberg, as of 21 Jul 2010

*The ECRI Weekly Leading Indicator points to a less than positive outlook on equities following a sharp decline in April.*

Another leading indicator which is pointing to a weak outlook on equities is the Economic Cycle Research Institute (ECRI) Weekly Leading Index (which was used to predict recession and potential recovery). The Index is composed of several components. They include: the Mortgage Bankers Association's home purchase index, money supply, stock prices, initial jobless claims, corporate yield spreads (inverted), and corporate bond quality spreads. The Index had been steadily declining since the end of April. It registered a negative weekly reading of 3.46 for the first time since mid-2009, the beginning of the end of U.S. economic woes.

As shown in Chart 2, the Index movement coincide with the U.S. S&P 500 stocks performance. Although it may be questionable whether the Index exhibits any cumulative and exploitable predictive power for stocks, the recent sharp decline on the Index should be a cause of concern for investors in the near term. At the same time, it is a gentle reminder of how rocky the path of recovery can be in quarters ahead.

The bottom line for equities so far this year is that investors are likely to get whipsaw if they buy into rallies and sell on declines. Successful investors sell near emotional extreme of a rally and buy near the emotional extreme of a decline. Following this mental discipline can prove to be crucial to an investor's portfolio returns for the rest of the year.

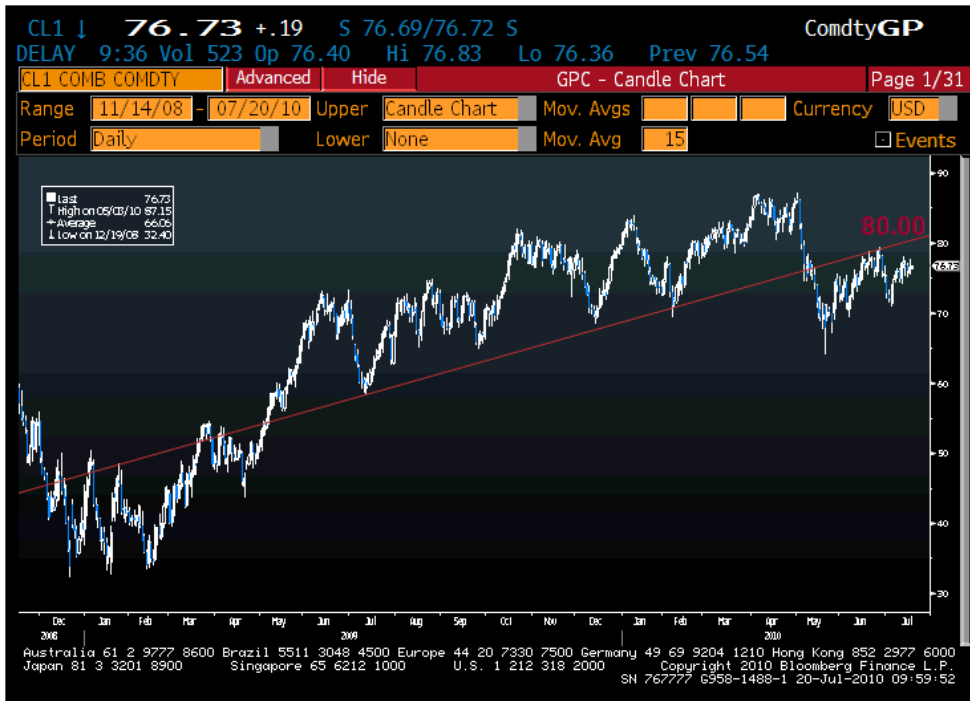


### Commodities – Oil is range-bound; Gold hit its trend line support

Crude oil advanced for the month of July with a single primary catalyst – based on what has not happened. We saw a 26.3% decline in oil prices during May amid concerns over global economic recovery on real demand for the energy supplies. However, those worst-case economic fears have subsidised so far and the oil commodity is back to more normalized levels.

Over the long term chart, we observed that crude oil had been largely range-bound, fluctuating between the upper-\$60's and the lower-\$80's since September'09. From a technical perspective, crude oil is trading at the top of the range and near-term resistance at US\$80/bbl. The fate of Gulf of Mexico production will provide near term upside risk. Also, underlying demand from emerging markets remained strong. However, we would expect higher OPEC production to meet any near-term demand growth, adding downward price pressure.

**Chart 3: Price Performance of Oil Price**



*Outlook on crude oil remain bearish with resistance at the US\$80.00 mark.*

Source: Bloomberg, as of 20 Jul 2010

Gold had held up despite a steady liquidation by investors, (data on ETF holdings showed a decline of 500,000 troy ounces from record levels). Technically, consolidation is probing support, but the uptrend remains intact. From Chart 4 on the next page, the current price level is trading near the base of the upward channel, highlighted in yellow. Resistance is at the US\$1,225/Oz. mark on the gold commodity.

Base metals had been performing very poorly for most part of this year. We observed that recent attempts to break higher during the month failed to draw out follow-through buyers, a clear sign of weak price action. See Chart 5 on the next page for details.



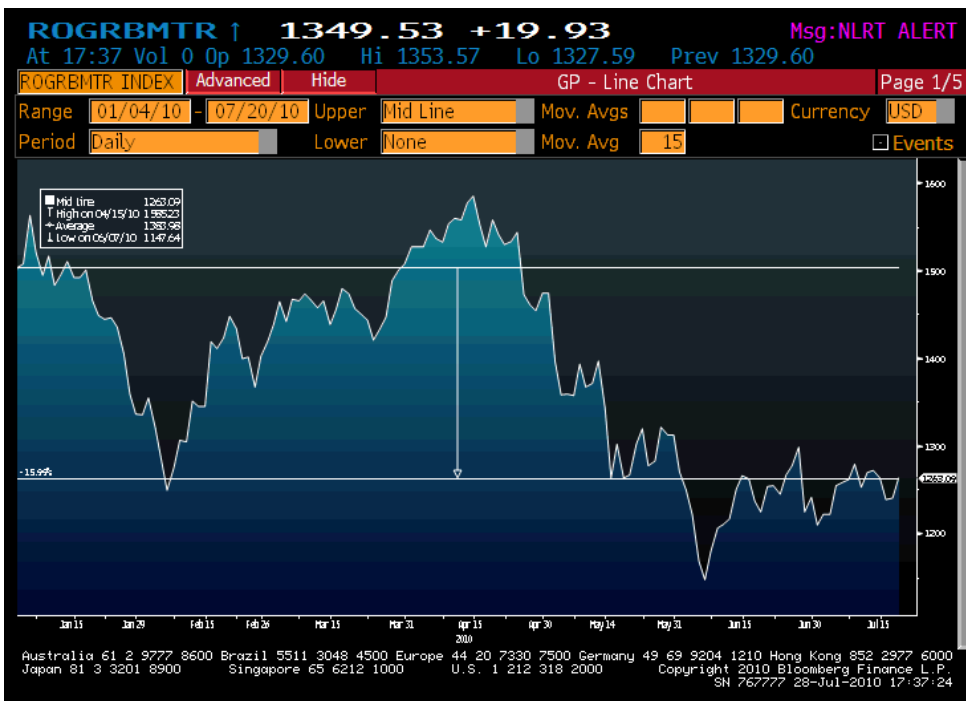
**Chart 4: Price Performance of Gold Price (USD)**



Source: Bloomberg, as of 21 Jul 2010

Gold price is at the base of the uptrend channel at the moment, consolidation is probing support.

**Chart 5: Rogers Industrial Base Metals Total Return Index**



Source: Bloomberg, as of 20 Jul 2010

The industrial base metals price (as measured by the Rogers Industrial Base Metals TR Index) are still down 16% on a Year-To-Date basis.



### Fixed Income – Emerging market & High Yield bonds taking the spotlight

The market adage goes, “When all the experts and forecasts agree, something else is going to happen”. This was evident from the strong rebound on the Eurodollar currency during the month of July. To recall back in the month of May, Euro was deemed by many as on the brink of collapse. However, the Euro currency continued to receive backings from major central banks and stress test on European banking system had brought upon a relief, if not temporarily, to the European fixed income space.

Previously, we mentioned that the flight-to-quality trade is dominating the fixed income space at the moment. From Chart 6 below, the 10-Year yield on the U.S. Treasury had found support at the 2.87% region. Although the current 2-year low is at the 2.03% region, retesting this level is highly unlikely in the near term. Given the slowly improving economic numbers from U.S., the yield on the 10-Year should be expected to reverse its downward trend. The Merrill Lynch’s MOVE Index, which spikes higher when bond yields decline significantly, signals an absence of additional demand for options and hedging needs. (The MOVE Index increased 5.2 percent to 112.70 when the 10-Year made lower lows by touching 3.06 percent on May 25.) Therefore, the recent descent in Treasury yields may be running out of steam in the very near term. However, a refocus of the European debt crisis coupled with an appreciating dollar or signs of more price disinflation/deflation may provide the additional downward push on Treasury yields towards the 2.5% region, a level last seen in Mar’09.

**Chart 6: 10-Year Treasury Yields finding support at 2.87 region**



*10 Year Treasury yield decline is likely to run out of steam after finding support at the 2.87% region.*

Source: Bloomberg, as of 26 Jul 2010

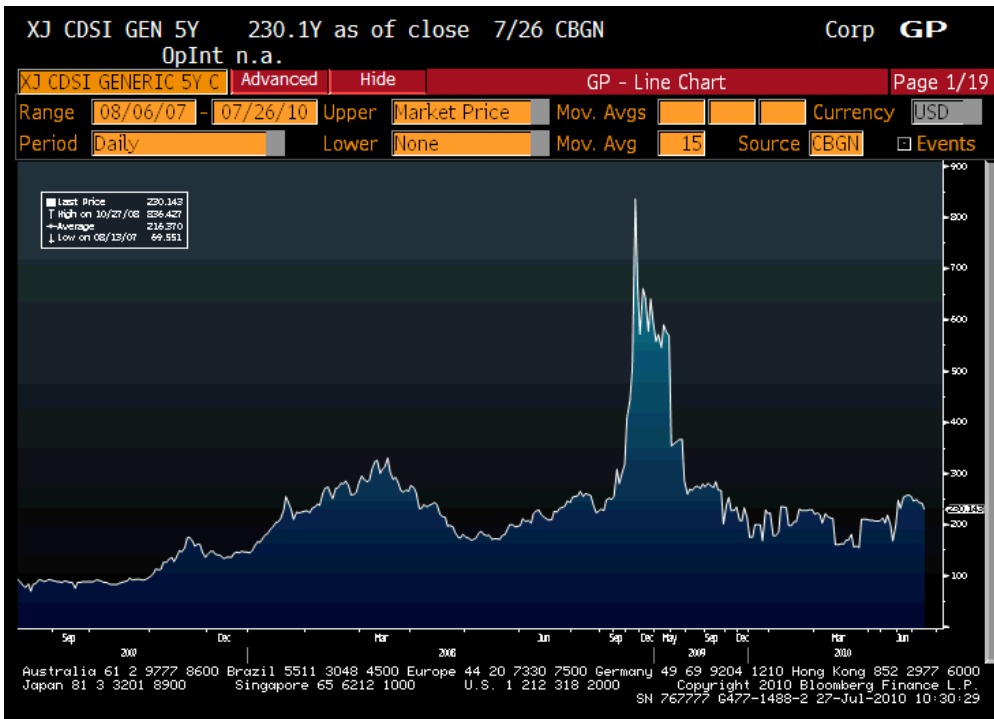


According to EPFR Global data, money market funds saw continued outflows of US\$15.3 billion for the week ended 21 July (prior week outflows was US\$21.8 billion). Risk appetite returned to the Emerging market bond funds with an inflow of US\$875 million, bringing the Year-To-Date cumulative inflow to US\$19.4 billion. High-yield bond funds also saw inflows of US\$948 million. On a whole, Emerging market bonds funds are in investors' demand for the most part of this year, with consistently positive weekly inflows.

Another observation on the Emerging market bond fund flows is the demand for local currency funds way surpassed that of hard currency funds. Year-To-Date cumulative inflows for local currency stood at US\$10.3 billion, while hard currency funds saw Year-To-Date cumulative inflows of only US\$4.5 billion. This could be attributed to the market confidence in the strength of the local currencies. For instance, the Asian currencies had been performing relatively well against the other major currencies since the start of the credit crisis.

At the same time, the cost of protecting Asia-Pacific corporate and sovereign bonds (Investment-grade and High Yield) from default signals that the market may be discounting the positive fundamentals on Asian bonds at the moment. The Markit iTraxx Asia ex-Japan index of 50 investment-grade and 20 non-investment grade borrowers outside Japan is still at a level above its 3 year average (See Chart 7 below). A decline below the 200 level will bring about further upside on the Asian bonds space. Therefore, we maintain our previous positive call on Asian bond funds.

**Chart 7: Markit iTraxx Asia ex Japan Index**



The Markit iTraxx Asia ex Japan index comprises two indices (A 50 equally-weighted investment grade and a 20 equally-weighted high yield CDS index of Asian entities).

Source: Bloomberg, as of 26 Jul 2010



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