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ECONOMIC UPDATE

Executive Summary

In China, property prices have declined slightly while level of loan growth remains a concern. Recent appreciation of the RMB could lead to a structural change in the Chinese economy in the long run.

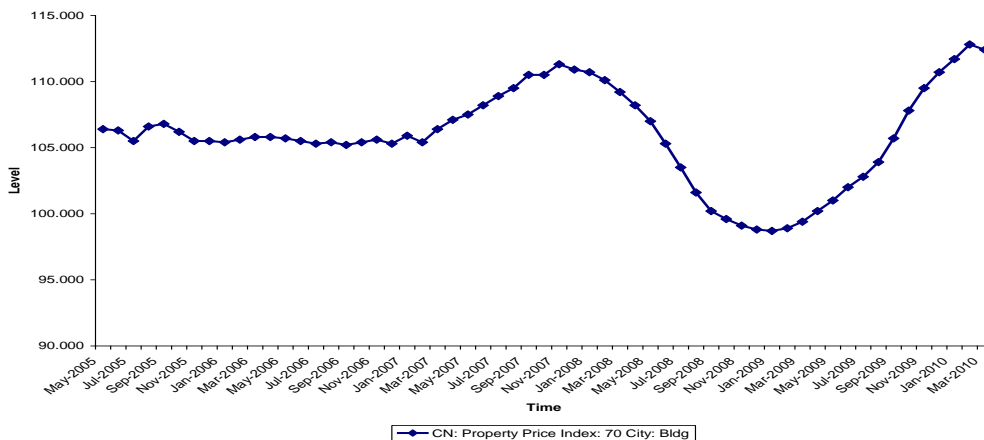
Conditions in the United States have been somewhat cloudy lately and from a fundamental perspective, Asian economies continue to stand on a stronger footing. With the European debt crisis still ongoing, tightening policies are likely to be temporary kept on hold.

Europe

Economic dataflow in China remain positive. For instance, retail sales are still on an upward trend. In the latest reading in April, retail sales rose 2.8 percent from the same period last year. Meanwhile, unemployment rate remains stable at 4.2 percent. Previously, we mentioned two areas that are of utmost concern to the Chinese government; they are rising property prices and level of loan growth. From the latest reading on housing price level, it seems that the government's efforts to curb speculation have been met with some success. Indeed, as shown in figure 1, property prices in China as measured by the China Property Price Index edged down approximately 0.35 percent in May from April.

Economic dataflow in China remain positive.

Figure 1: Property Price Index



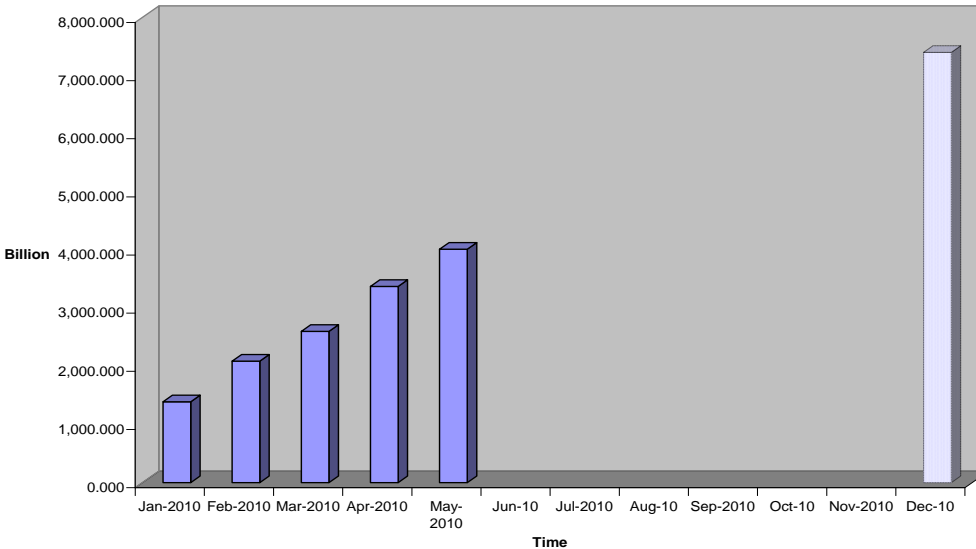
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Source: CEIC. As of May 2010



Till May this year, total loan creation has amounted to RMB 4 trillion. That is approximately 53 percent of the target amount of RMB 7.5 trillion. It will be challenging to keep total loan creation within the target range especially when the Chinese government has recently allowed its domestic currency to appreciate. A stronger currency is expected to increase demand for goods and services which will in turn may affect the level of loans created.

Figure 2: Loans - New Increase (Cumulative)



Source: CEIC. As of May 2010

On 19th June 2010, the People’s Bank of China announced that it is abandoning the 6.83 Yuan peg to the dollar adopted during the global crisis to shield exporters. On 21st June 2010, the Chinese currency rose to its highest level since July 2005. It edged up 0.38 percent in the spot market to 6.8015 against the dollar.

Although the policy move was well received by global markets, some have also emphasized that the appreciation process will be most likely be a “gradual” one. Indeed, the Chinese Yuan weakened against the dollar on the second day after the announcement was made. This may reflect an apparent effort by the central bank to tame hopes of Yuan appreciation and to send a message that China’s exchange rate reform doesn’t mean a guaranteed one-way bet on its currency. Also, if history was of any guide, when currency reform last restarted in 2005, the renminbi gained only 1.0 percent in 12 months. It gained just 0.6 percent in the first six months after revaluation and 1.0 percent after the first 12.

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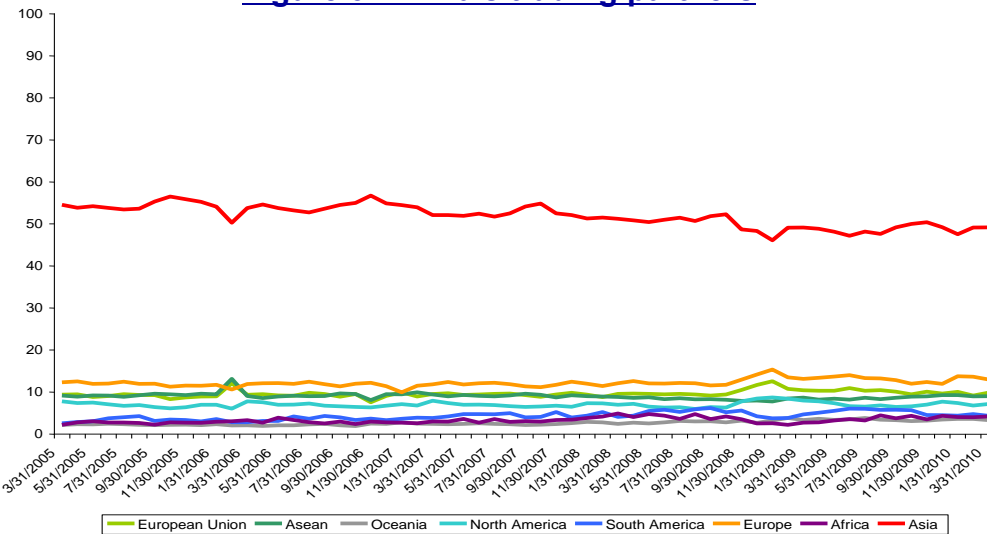
On 19th June 2010, the People’s Bank of China announced that it is abandoning the 6.83 Yuan peg to the dollar adopted during the global crisis to shield exporters. Although the policy move was well received by global markets, many have also emphasized that the appreciation process will be most likely be a “gradual” one.



China's decision to allow its currency to appreciate is positive for the market. There are several reasons why this is so. Firstly, it reduces tensions between US and China; although the impact on trade imbalance will be limited. The huge trade deficit cannot be significantly reduced merely with an appreciation on the Yuan as it is primarily attributed to excess demand in the United States. Indeed, when Japan had a huge bilateral trade surplus with the United States in the 1980s, they were also pushed into increasing the yen. However, the appreciated currency did little to cut Japan' trade surplus.

Secondly, China's signal of an end to the Yuan's fixed rate to the dollar may boost domestic demand. This is good news for global manufacturers and resource companies which supply the world's third biggest economy with the equipment and commodities that it needs to fuel growth. Asia economies are likely to be the greatest beneficiaries as they account for almost 50 percent of China's total imports. This is shown in the diagram below.

Figure 3: China's trading partners



Source: Bloomberg, as of Mar 2010

On the flip side, a stronger currency could dampen the outlook for China's own exporters and commodity producers. While that may be the case, it will be positive for the Chinese economy in the long run. With greater purchasing power, China will be able to reduce its dependence on exports and in turn change the economic structure of the country in the long run. In turn, that could help in the process of "global rebalancing". However, for a structural shift to take place; there is still a need for a concerted effort to improve the country's social safety net. Only with that will Chinese households shrink the need to stash away savings for emergencies.

For now, we think that the impact of the change in exchange rate policy will be limited in the near term; as moves in the Yuan are likely to be slow and controlled. Nonetheless, it does signal a move in the right direction.

China's decision to allow its currency to appreciate is positive for the market. It will encourage domestic demand as well as reduces tensions between US and China.

While a stronger currency encourages consumption, for China to reduce its dependence on exports, there is still a need for a concerted effort to improve the country's social safety net.



United States – A cloudy environment:

Getting a good read on the health of the United States in the current environment has been challenging as data has been mixed and wide ranging.

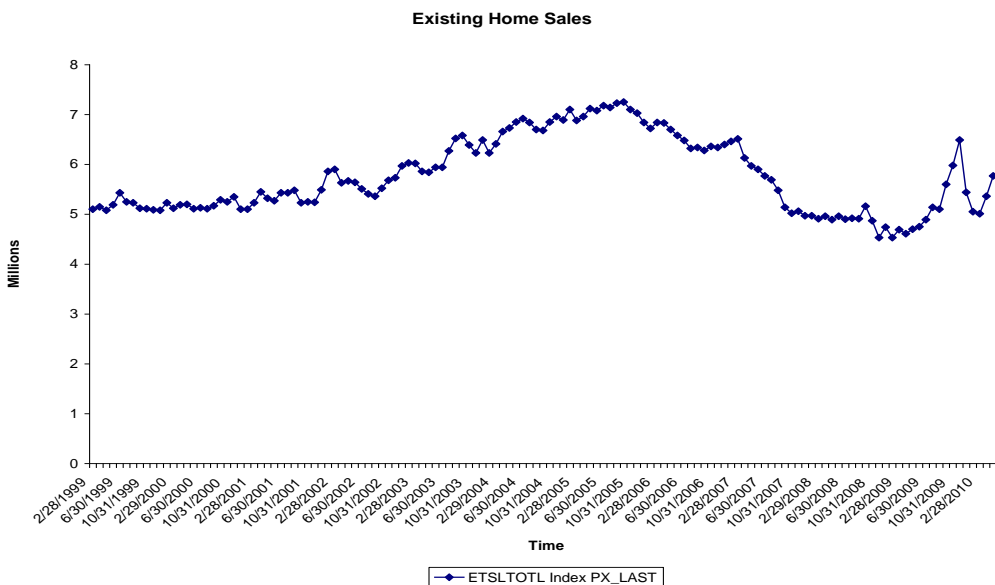
On one hand, the job picture has improved. An average of about 200,000 jobs was added to the US economy between January and May. There have also been gains in both hours worked and hourly earnings. While the job story is not yet a good one, the improvement will help all areas of the economy.

On the other hand, data from the housing sector has been disappointing. While activity was expected to fall as buyers brought forward purchases to take advantage of the tax credit before it ends, the fall-off has been more marked than expected given that there was an extension in the settlement date for the tax credit program. Indeed, existing home sales declined 2.2 percent from 5.79 million in April to 5.66 million in May. The pending home sales index had suggested that existing sales would reach 6.2 million.

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Figure 4: Existing Home Sales



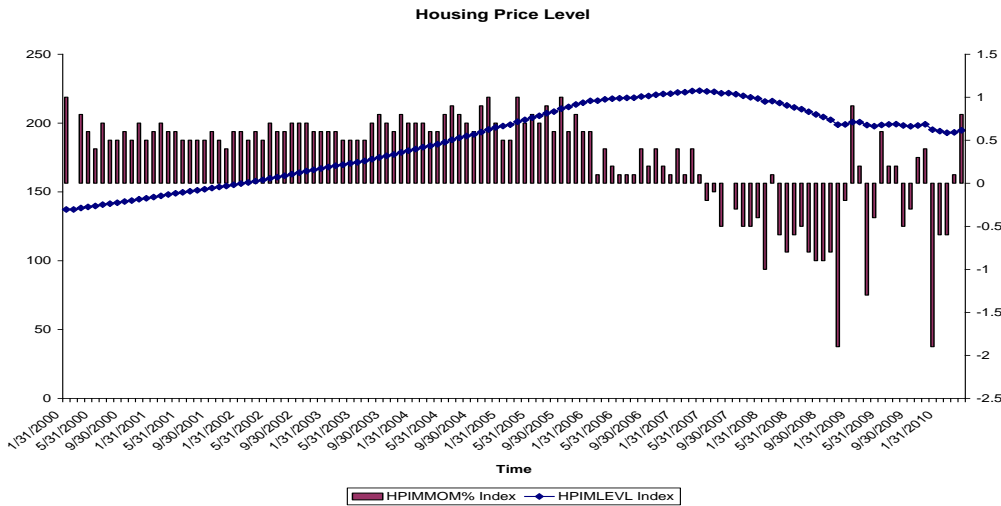
Source: Bloomberg, as of May 2010

The tax credit-induced surge in demand has helped to boost housing prices from rather depressed levels. The 0.8 percent month-on-month increase in seasonally-adjusted FHFA house prices in April was the largest since the heady days of the housing boom. Now that demand is no longer being supported by tax credit, the recent downward trend in prices is likely to accelerate.

Housing price levels might not hold up in the coming months.



Figure 5: Housing Price Level



Source: Bloomberg, as of Apr 2010

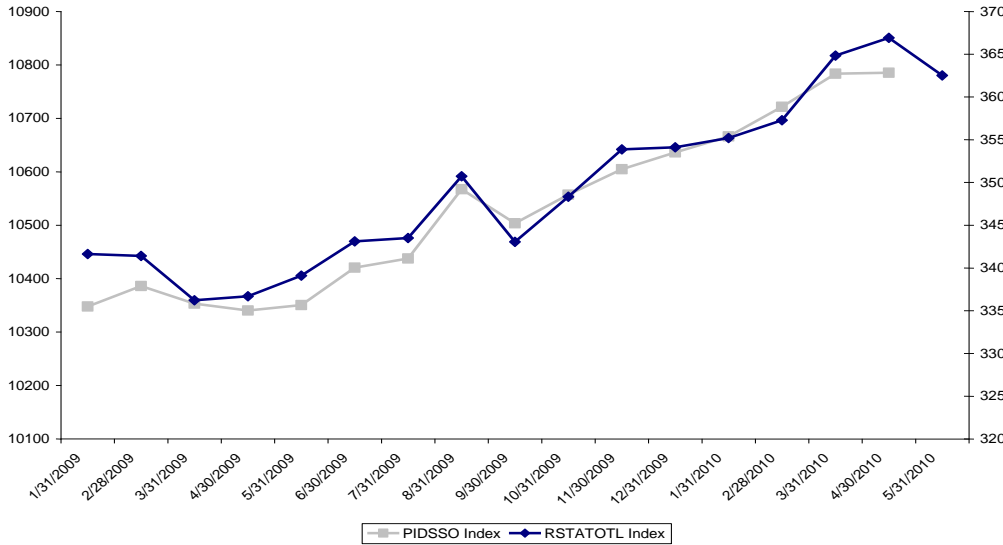
We have mentioned the importance of housing prices holding up previously. To reiterate, consumption is closely linked to housing price levels as the latter influences an individual's net worth. Therefore, if housing prices were to fall in the later half of the year, consumption would be negatively affected.

Another negative data stamp from retail sales. Retail sales declined sharply in May. The decline in retail sales in May was partly due to declines in auto and gasoline sales. Despite excluding those items, sales fell by 0.8 percent, dragging the level of this measure underlying sales back below its pre-recession peak. Underlying sales were pulled down by a 9.3 percent plunge in building material sales. This means that consumption growth in the second quarter is unlikely to match the 3.5 percent annualized gain seen in the first quarter. Consumption growth may accelerate a little in the second half of the year, but it is likely to remain subdued by historical standards.

Retail sales have declined sharply in May.



Figure 6: Retail Sales and Consumption



Source: Bloomberg, as of May 2010

While FOMC left its key rate unchanged at between 0 percent to 0.25 percent and reiterated its pledge to keep rates there for an extended period of time, they have also delivered a more dovish statement on the economy after the two days meeting which ended on 23rd June 2010. In the latest statement, the economic recovery is now characterized as “proceeding” rather than “continuing to strengthen”. This assessment hardly comes as a surprise as incoming economic data has been weaker (as shown earlier) and the European sovereign debt crisis still on going.

Conclusion:

Conditions in the United States have been somewhat cloudy lately and from a fundamental perspective, Asian economies continue to stand on a stronger footing. With the European debt crisis still ongoing, tightening policies are likely to be temporary kept on hold.

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FINDING FOOTING IN A DESTABILISING WORLD

Executive Summary

Equities – Global equities recovered prior month losses since the start of June; Jakarta Composite Index outperform significantly with a monthly gain of 11.8%.

Commodities – Oil price is likely to find near term support at the \$75.50 (USD/bbl.) region. The secular bull run in Gold price continues and fundamentals remain strong.

Fixed income – Flight-to-quality is pushing bond yields on developed economies to recent lows; Inflation expectation, as mirrored by the spread between TIPS and Treasury, is down to 2%.

Equities – Upward move on the back of thin volumes

Global equities started the month of June on a positive note. Fears that a sovereign debt crisis in the euro zone could derail the global economic recovery were casted aside for the time being. This was helped by a number of successful European bond auctions (with the latest coming from Spain in its €3.5 billion bond auction). Majority of the global indices performed relatively well on a one month basis. In particular, the Indonesian equities outperformed, gaining well above 11% for the month itself. The Jakarta Composite index is up about 15% this year as the country's central bank kept its benchmark interest rate at a record-low 6.5% for the ten months through June. Chinese equities continue to underperform, up slightly 0.2% (See Table 1 below). The Shanghai Composite Index touches a 52-week low on 7 Jun before recovering part of the losses. The index rallied briefly following the announcement of China's Yuan flexibility pledge. Market activity was quiet across global markets as trading volumes were fairly light for most part of the month due to the ongoing World Cup in South Africa.

Table 1: Selected Equity Stock Market Index Returns

Country	Index	Jun. 22	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Indonesia	Jakarta Composite	2933.85	11.84 ▲	8.56 ▲	18.89 ▲	2996.42	1888.82
India	BSE Sensex 30	17798.72	8.23 ▲	2.23 ▲	6.63 ▲	18047.86	13219.99
Korea	Kospi Index	1731.48	8.21 ▲	3.52 ▲	4.59 ▲	1757.76	1350.31
Singapore	Straits Times Index	2881.64	6.68 ▲	-0.26 ▼	2.05 ▲	3037.97	2211.81
Hong Kong	Hang Seng Index	20819.08	6.51 ▲	-0.55 ▼	-1.29 ▼	23099.57	17185.96
Taiwan	Taiex Index	7612.68	5.18 ▲	-2.85 ▼	-3.10 ▼	8395.39	6191.63
Japan	Nikkei 225 Index	10112.89	3.36 ▲	-6.58 ▼	-2.55 ▼	11408.17	9050.33
U.S.	S&P 500 Index	1113.20	2.35 ▲	-4.51 ▼	-0.43 ▼	1219.80	869.32
China	Shanghai Composite	2588.70	0.20 ▲	-15.80 ▼	-15.14 ▼	3478.01	2481.97

Major global equities were up on a monthly basis. Indonesian equities are up more than 11% as the upward trend continues.

Source: Bloomberg, as of 22 Jun 2010

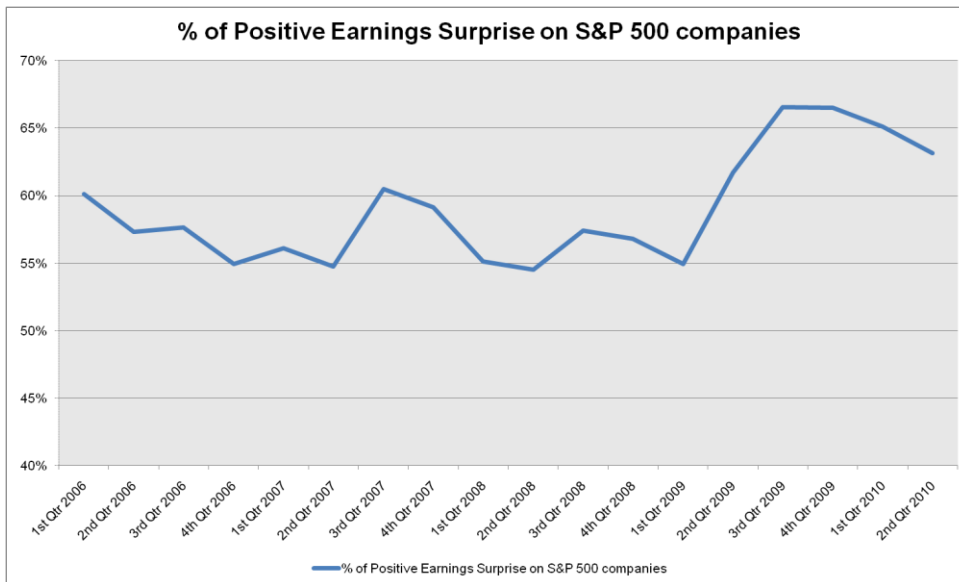


On the U.S. companies, Federal Reserve reported that the companies were holding out US\$1.84 trillion in cash and other liquid assets as of the end of March, up 26% from a year earlier and the largest-ever increase in records going back to 1952. Cash made up about 7% of all company assets, the highest level since 1963. With memories of the Lehman-collapse credit freeze still fresh, companies were hesitant to spend the cash on hiring or expansion amid doubts about the Europe's debt troubles. This behavioral shift had prompted companies to return the money to investors through share buybacks. So far in 2010, companies have announced 33 new buybacks for US\$178 billion, according to Bank of America's Merrill Lynch unit. If buybacks were to continue at the same rate for all of 2010, the total would come to almost US\$900 billion. That would be the most since 2007.

Nevertheless, companies' earnings continued to surprise on the upside with the percentage of positive earnings surprise on U.S. S&P 500 companies at 63%, higher than the pre-crisis levels (See Chart 1 below). Earnings beat analysts' estimates by 22% in the first quarter of 2010.

On this note, it is very likely that earnings will continue to surprise to the upside in the near term, given the ongoing recovery we are seeing on the macroeconomic front. However, this is unlikely to be sustainable for the long term with companies hoarding huge amount of cash and postponing expansion plans for future organic growth. At the same time, this is going to dash hopes that the high unemployment situation in U.S. will recover any time soon and domestic consumption will remain weak for the foreseeable term.

Chart 1: U.S. Corporate Earnings Looking Healthy



The percentage of positive earnings surprise on U.S. S&P 500 companies remains high.

Source: Bloomberg, as of 22 Jun 2010



Chart 2: Shanghai Composite Price Chart



The Shanghai Composite Index starting to find support in the 2540 region. Buying opportunity in the near term.

Source: Bloomberg, as of 24 Jun 2010

From Chart 2 above, the Chinese equities have found support at the 2538 region. The 2370-2540 region highlighted by the yellow lines in the chart above remains a possible buying opportunity for equity investors. We maintain the view that China cooling concerns will be headwinds in the near term but it is a positive move to the extent the Chinese are lowering the risk of overheating. Equities' valuations are still at a discount to its 3-Year average and 5-Year average, which are in contrary with the latest set of positive economic numbers from China.

To sum up on the Chinese equities, the fundamental growth story of China over the last 3 decades had brought about a leap in productivity through its low cost manufacturing sector. With China's global creditor status and massive internal savings, the next stage of growth lies in rapid urbanization. While the recent economic growth may have been partially supported by enormous stimulus through domestic bank lending, the industrial and infrastructure activities remain robust. With a strong policy discipline and massive foreign reserves at its disposal, China's fiscal situation puts it in a much better position to deal with any shocks and undesirable events.



Commodities – Oil broke key support; Gold broke previous record high

Previously, we saw Gold price surge against major currencies on the back of possible sovereign credit default and risk aversion was the primary catalyst. Also, Oil price plunged as speculative interests settle after the EU's bailout. Moving forward, Oil price are likely to stay range-bound with the existing high crude inventories & pending budget cuts across Europe pointing to a slowdown in economic activities. As for the Gold commodity, there are evidences to show that it is in the middle of a secular bull run with respect to previous financial bubbles in the last century. Fundamentally, central banks are net buyer of gold and speculative activities remain high to the long side. Lastly, the outlook on US Dollar is less than positive. We feel that Crude oil had entered into a region of consolidation for the near term. From Chart 3 below, the visible support level is at \$75.50 (USD/bbl.) while a rally above \$80 (USD/bbl.) seems unlikely

Chart 3: Price Performance of Oil Price



Source: Bloomberg, as of 23 Jun 2010

On Chart 4 on the next page, we compared the rally in Gold prices since 2002 with the previous IT bubble and the more recent housing bubble. As the diagram illustrates, the formation of a financial bubble typically takes about 10 years to peak before coming off sharply. Applying the same time frame on Gold commodity, we have just completed its 8½ year of rally and yet to peak. With the ongoing uncertainty surrounding the long term validity of paper currencies still lingering, the long term outlook on physical asset Gold remains bullish. More recently, Saudi Arabian Monetary Agency, the country's central bank, reported to be hoarding twice as much Gold as thought. Lastly, we turn slightly bearish on the US Dollar Index on the back of decreasing net long positions according to the latest CFTC report (See Chart 5 for details).

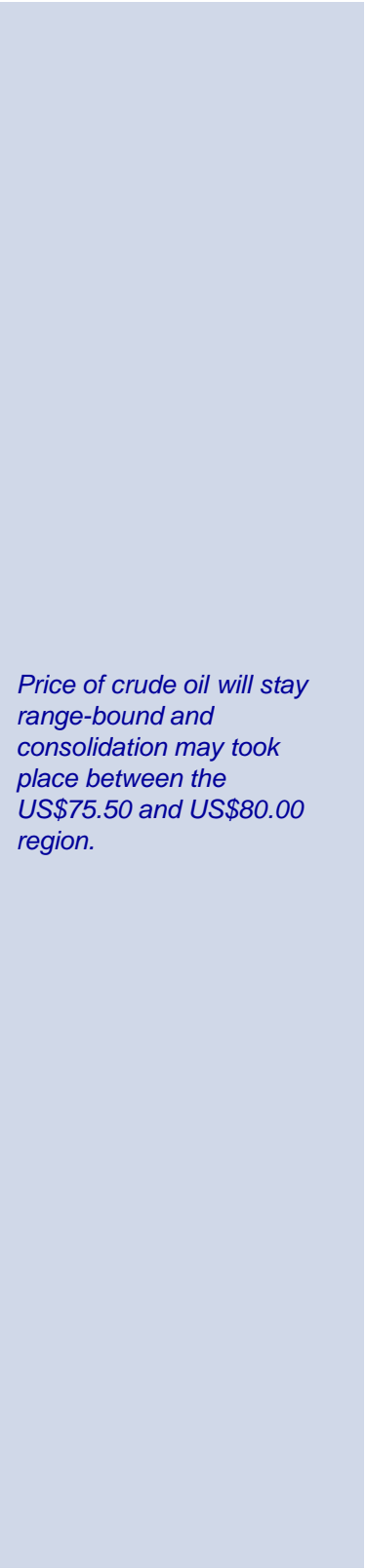




Chart 4: Gold Run-up – Compared to previous bubble scenarios



Source: Bloomberg, as of 22 Jun 2010

The secular bull run in Gold price has yet to peak compared to previous financial bubbles.

Chart 5: Trading Activity on US Dollar Index (With Price)



Source: Bloomberg, as of 22 Jun 2010

With the net long position on US Dollar Index coming off substantially since February, the near term outlook has turned bearish.



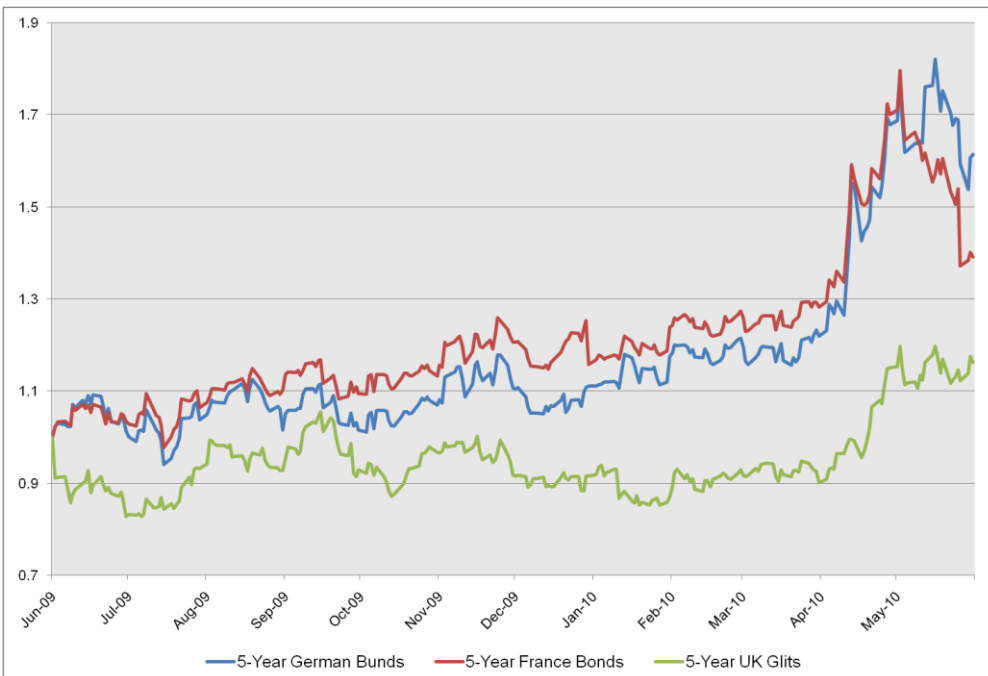
Fixed Income – Flight-to-quality trade dominates

In a flight-to-quality bid, U.S. Treasuries rallied across the curve, with the 10-Year Treasuries yield now stands within distance from the recent lows and technical barrier of 3.10%. It appears that despite the heavy Treasury supply, the world economic situation does not appear to be improve as much as expected and the run to quality is underway. From Chart 6 (1-Year normalised bond prices) below, we observed that the flight-to-quality trade affected markets from the developed economies as well. German 5-Year bunds tightened to a yield of 1.58%. France's 5-Year declined to a yield of 2.05% while the yield on 5-Year U.K. Gilts dropped 7 basis points to 2.19 %. The start of these rallies go back to the beginnings of the Greek crisis.

Inflation expectations as evident by the yield differential between 10-Year Treasuries and 10-Year Treasury Inflation Protected Securities, came off from a high of 2.47% during start of the year to end at the 2% mark. The decline coincides with subdued inflation expectations in the near term and further dashed hopes on a Fed rate hike anytime soon.

The LIBOR-OIS USD spread finished slightly higher at 32.9 basis points, showing signs of stress still exist in the credit markets. This is largely attributed to the contagion fear persisting in the European continent. Concerns over either a default or restructuring on Greek bonds together with the rest of the PIIGS members will continue to stay at least for the next few quarters and credit markets will be prone to the slightest shock. The European problems are not going to spontaneously heal themselves.

Chart 6: 5-Year Bond Prices on Developed Economies Rallied



Source: Bloomberg, as of 22 Jun 2010

The flight-to-quality in the fixed income space is evident from the rally in developed economies bond prices since the start of the Greek crisis.

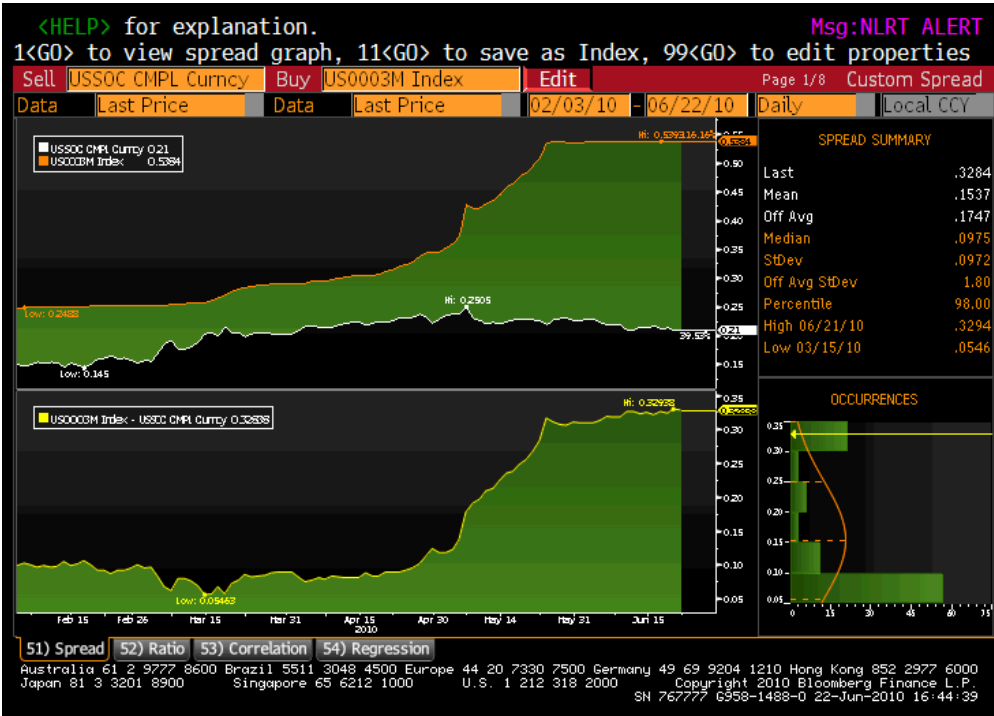


Chart 7: Inflation Expectation Coming Off Recent Highs



Source: Bloomberg, as of 22 Jun 2010

Chart 8: LIBOR-OIS Spread at 33 Basis Point



Source: Bloomberg, as of 22 Jun 2010

Lower inflation expectation in the bond market will hinder possible rate hikes.

LIBOR-OIS spread is likely to stay high for the time being with ongoing uncertainty from the European continent.



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