

1Q 2010

Market Review and Investment Outlook

Abstract

We expect a continued recovery in Asian risky assets in 2010. Asian central banks are expected to raise rates modestly in the short term as U.S. short-end rates are likely to stay low. Therefore, we favour Indonesian and Korean government bonds because overblown rate hike expectations have been priced in. We like Asian currencies such as the KRW, IDR and AUD as they are supported by current account surpluses, strong economic fundamentals and attractive valuations. Asian credits are also expected to gain modestly and our strategy is to focus on credit selection. We are positive on Asian equities, especially China, Hong Kong and Singapore. Fiscal spending is expected to wane as a growth driver while exports are likely to become a significant driver. Hot money inflows are also expected to be a key theme, creating both opportunities and risks.

Asian Rates: Modest rate hikes likely in Asia

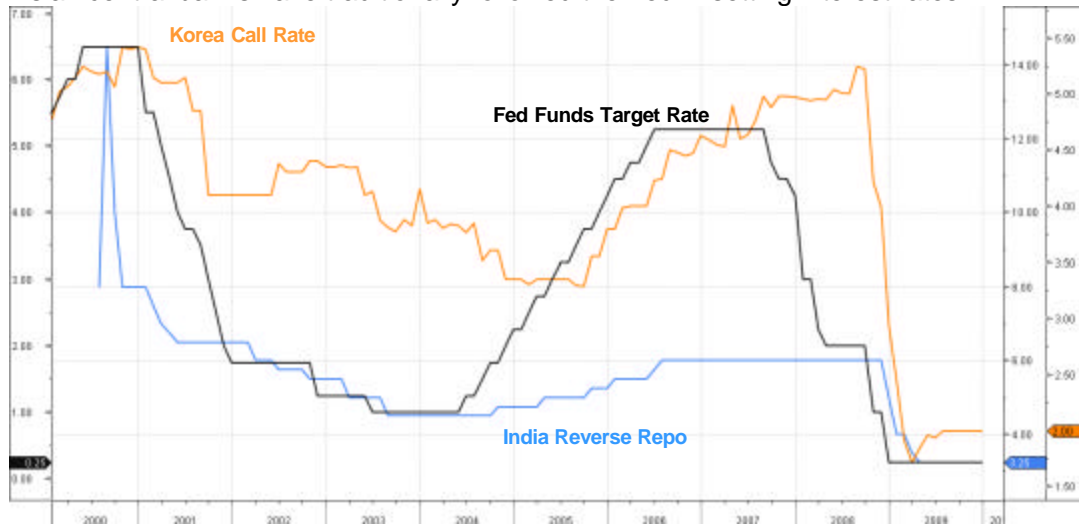
U.S. Treasury yield curve likely to bear-steepen

In 2010, we believe that the U.S. Treasury (UST) yield curve will continue to bear-steepen. The Fed is unlikely to hike its policy rate in the short term because U.S. economic recovery is still anemic. On the long end, yields are likely to trend higher as the deteriorating budget deficit causes the Fed to increase the supply of UST. However, the demand for UST by foreign central banks could wane, given that a large portion of the strong buying in 2009 was to replace Agency bond holdings, which were sold off aggressively during the crisis. We believe that demand from commercial banks - traditional buyers of UST after a banking crisis - is unlikely to meet the surge in UST supply.

Asian rates are unlikely to be hiked aggressively

Asian central banks have traditionally followed the Fed in setting interest rates, usually with a lag. While the Asian economies have rebounded strongly post-crisis, we believe that central banks are unlikely to pursue an aggressive normalization of domestic interest rates independent of the Fed. In the short term, we anticipate only preemptive, modest tightening in India and Korea. As such, we see value in the 2 to 3-year Asian government bonds of Indonesia and Korea, which have over-discounted potential rate hikes.

Asian central banks have traditionally followed the Fed in setting interest rates.



Source: Bloomberg, December 2009

Asian FX: Positive on Asian currencies

Structural problems remain a drag on the USD

The sharp deterioration in the U.S. fiscal position as well as unfunded government liabilities, particularly in healthcare and pensions, remain long-term concerns for the USD. In addition, investors seeking diversification out of the U.S. in search of higher interest rates and yields will affect the USD negatively. However, we expect any pick-up in risk aversion to result in a limited, short-term rebound in the USD. We believe that a repeat of the 16% trough-to-peak rebound of the DXY following the Lehman crisis is unlikely.

Outlook for Asian currencies continues to be optimistic

We continue to be positive on Asian currencies in 2010. Current account surpluses in most Asian economies are supportive of their currencies, while the NEER model suggests that most Asian currencies remain undervalued. Moreover, foreign investment in Asia has not been fully rebuilt to pre-crisis levels, suggesting that there is room for further recovery. In particular, there is pressure on the CNY to appreciate as reserves accumulation and money supply growth are now close to peak levels. We remain particularly positive on the KRW and the IDR due to the robust economic growth and attractive yields. We also continue to be optimistic on the AUD in the longer term because of strong economic fundamentals.

Asian Credit: More modest gains likely

Remain positive on Asian credit

We remain positive on the Asian credit market in 2010, but expect to see a moderate tightening in spreads given the market's remarkable performance in 2009. Credit fundamentals are healthy, with Asian economies on track for a strong rebound. Despite the strong rally in 2009, we think that Asian credit spreads are still pricing in excessive default probabilities. In addition, we also expect a narrowing of the premium between Asian and U.S. credit spreads. Selected Asian bonds are also offering wide negative basis (i.e. CDS spreads tighter than cash bond spreads), suggesting the potential for further tightening of cash spreads.

Credit selection is key in 2010

In 2010, we believe that excess returns in Asian credits are likely to be derived from credit selection. In the Asian high-grade space, we favour short- to mid-duration bank and corporate debt, bearing in mind that financial spreads still trade at a premium over corporate spreads. We also favour longer-duration high-grade credits, but will hedge against rising long-end rates. In the high-yield space, we favor short- to mid-duration quasi-sovereign bonds and selected corporate bonds.

Asian Equities: Exports replacing fiscal stimulus as growth driver

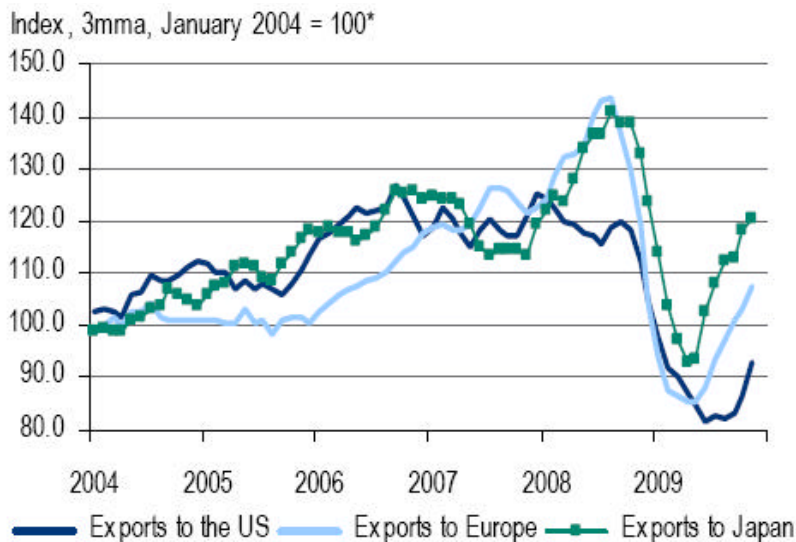
Impact of fiscal spending likely to wane in 2010

The economic effect of government fiscal spending in Asia is likely to wane in 2010. For example, we studied projected fiscal spending in China, given its significance for the Asian economies and the aggressiveness of its fiscal stimulus in 2009. Our findings suggest that China is unlikely to drastically reduce its fiscal spending in 2010, a view which is validated by the government's supportive stance on active fiscal policy during the Central Economic Work Conference held in December 2009. We believe that China's fiscal deficit will likely be 2.5-3.0% of GDP in 2010-2011, from 3.0% in 2009. This suggests that growth in fiscal spending could moderate to about 12% annually over 2010-2011, from 22% in 2009. As GDP growth is only driven by fiscal spending, we conclude that fiscal spending will be a muted source of economic growth in 2010 for China.

Asian export recovery remains on track

Across the region, there is evidence of a continued recovery in Asian exports. In November, export data from China, Korea and Taiwan continued to show significant improvements. Leading indicators also remain supportive of a recovery. U.S. inventories remain low, but could pick up steadily as U.S. retailers are reporting signs of pent-up demand and a gradual return of shoppers since October. The U.S. ISM New Order Index also continues to suggest a recovery in Asian exports. In Asia, data points remain positive, including order flows from key trade fairs, import processing volumes, and both air and container cargo volumes. Finally, consumer confidence and business sentiment continue to improve globally.

Taiwan's exports continue to improve.

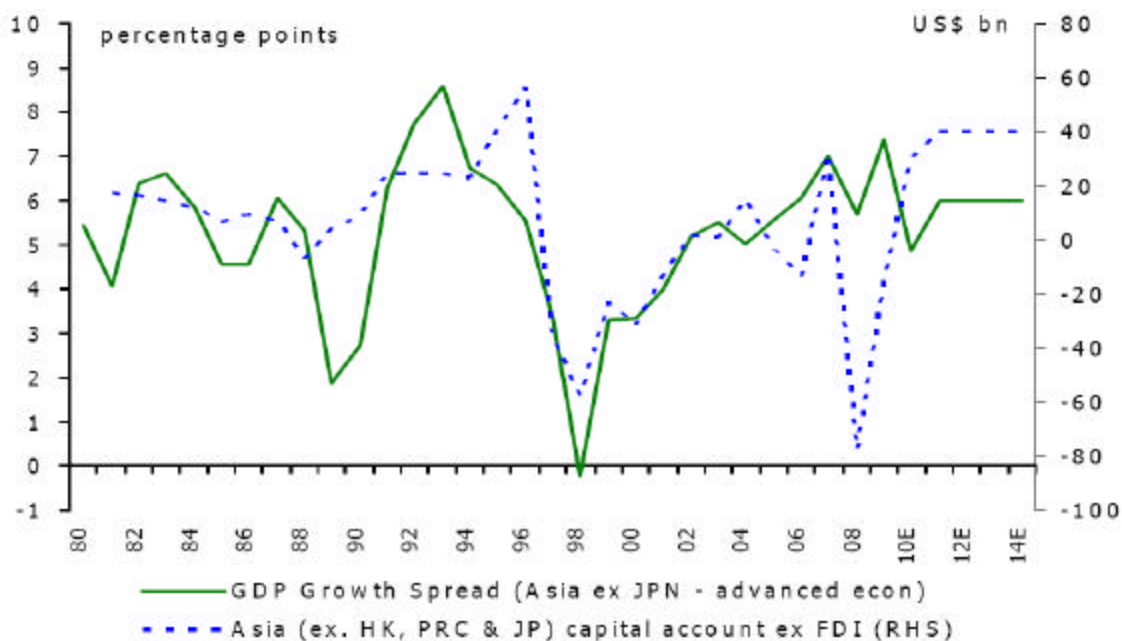


Source: CEIC, Bank of America Merrill Lynch Global Research, December 2009

Hot money flows likely to create opportunities and risks

We believe that hot money flows into Asia will be a key theme in 2010. Inflows will likely be driven, in our view, by the spread between Asian and G3 interest rates, significantly better growth prospects in Asia, an anticipated appreciation in Asian currencies, and abating risk aversion. So far, fund inflows have led to a strong recovery in Asian property and stock markets, but we believe neither is at bubble proportions. To counter the effects of hot money inflows, we think that policy makers are likely to focus on non-monetary measures targeted at specific asset classes like property. Given the currency peg, Hong Kong is likely to be the recipient of significant fund inflows, which we believe is positive for Hong Kong-listed stocks. Mindful of the risks arising from hot money inflows, we continue to be vigilant of asset bubbles and are cautious on markets which may resort to drastic capital controls to curb inflows.

Stronger growth prospects in Asia expected to drive fund inflows.



Source: UBS, December 2009

Positive on Asian equities; favour China, Singapore and Hong Kong

We are positive on Asian equities in 2010. China, Hong Kong and Singapore are our key overweights. We expect strong macroeconomic data to underpin Chinese stocks in the coming months. Corporate earnings have already recovered to pre-crisis levels by 3Q09, and continued growth is expected. We also expect the CNY to appreciate in 2010, enhancing the attractiveness of Chinese assets. We are positive on Hong Kong due to anticipated strong fund inflows following the re-opening of the QDII program. Hong Kong asset prices are likely to re-inflate as interest rates stay in line with low U.S. rates due to the currency peg. We continue to favour Singapore for showing one of the strongest economic turnarounds in the region. India, Indonesia, Malaysia and Philippines are our key underweights.

Recommendations

In light of the positive Asian investment outlook, we have highlighted our flagship DBSAM funds, across the two major asset classes:

Equities

- Shenton Thrift Fund
- Shenton Twin City Fund
- Shenton Asia Pacific Fund

Fixed Income

- Shenton Income Fund
- DBS Asia Bond Fund
- DBS Enhanced Income Fund

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