



3Q10 Quarterly Forum Report

Abstract

We believe that the impact of the Eurozone debt crisis on global markets will not be as severe as that of the global financial crisis in 2008. The asset quality problems of European banks relate mostly to transparent vanilla bonds, unlike the exotic instruments which were the focus of the financial crisis. In our view, the EU-IMF aid package, which covers the funding needs for Greece, Spain, Portugal and Ireland over the next three years, acts as a sufficient buffer for austerity measures in these countries to gain traction and market credibility. We believe that economic fundamentals in Asia remain intact and contagion risk is limited. We also believe that there will be no hard landing for the Chinese economy.

Against this backdrop, we expect most Asian government yield curves to bull-flatten, and favour Korean and Indonesian government bonds. We also remain positive on Asian currencies, particularly the IDR, KRW, MYR and AUD. We will buy credits on corrections, and favour high-grade corporate and Asian bank capital securities. We expect Asian equities to trade in a wide range. We continue to place greater emphasis on stock selection over country allocation, and prefer stocks in the consumer discretionary and industrial sectors.

- ***Eurozone debt crisis: We are sanguine overall***
- ***Chinese economy: No hard landing***
- ***Asian rates: Monetary tightening likely to be delayed***
- ***Asian FX: Positive view intact***
- ***Global and Asian credits: Buying into corrections***
- ***Asian equities: Likely to trade in a wide range***
- ***Prefer China, Singapore and Hong Kong***

Eurozone debt crisis: We are sanguine overall

Eurozone crisis unlikely to have as large an impact as the global financial crisis

We believe that the impact of the Eurozone debt crisis on global markets will not be as severe as that of the global financial crisis triggered by the Lehman bankruptcy. While measures of funding difficulty, such as the USD LIBOR-OIS spread and CDS spreads for major European banks, have trended higher in recent months, the levels are nowhere near where they were during the Lehman crisis. The usage of USD swap lines has also been very limited throughout the current Eurozone crisis.

Asset quality issues involve simple, transparent instruments

Importantly, the asset quality problems of European banks relate to peripheral European government bond holdings. These are mostly transparent vanilla bonds, unlike the exotic instruments which were the focus of the global financial crisis. Additionally, these government bonds are eligible for repo with the European Central Bank (ECB), which is an important funding source for the peripheral European banks, and may also be purchased by the ECB in the secondary market.

EU-IMF aid package appears sufficient

In our view, the EUR750b EU-IMF aid package, which covers the funding needs for Greece, Spain, Portugal and Ireland over the next three years, acts as a sufficient buffer for austerity measures in these countries to gain traction and market credibility. However, we believe that the path ahead will likely be volatile, driven by potential disagreement between EU members over the disbursement of funds and resistance in the troubled countries to fiscal tightening.

Asian economic fundamentals remain intact

We believe that economic fundamentals in Asia remain intact and contagion risk is limited despite the correction in Asian asset prices due to issues in the Eurozone. As seen from recent economic data, which surprised on the upside, Asian economic growth remains strong. The region's long-term economic outlook also remains favourable on the back of rising domestic demand, growing inter-regional trade and the strong fiscal positions of most Asian countries.

Chinese economy: No hard landing

Tightening measures may have ended for now

We believe that the Chinese economy will not see a hard landing despite the Eurozone debt crisis and recently-introduced tightening measures, particularly those in the property sector. Consensus expectations for Chinese GDP growth in 2010 remain in the 9-10% range, though this has been reduced from 10-11% over the last few months. Our positive view is underpinned by the belief that contagion effects from the Eurozone crisis on the Asian economies are likely to be limited, and that the global economy should continue to recover. Given the sharp decline in primary sales over the last two months, we also believe that no new tightening measures will be instituted in the property sector. We are also circumspect on recent headlines on minimum wage increases with regard to corporate margins. Chinese employers have historically faced high wage growth, and yet have been able to keep unit labour costs down.

Asian rates: Monetary tightening likely to be delayed

Asian government yield curves likely to bull-flatten

The Eurozone debt crisis has led to slower growth expectations in Europe due to the implementation of fiscal austerity measures. Correspondingly, monetary tightening in Asia is also likely to be delayed, which should lead to a bull-flattening in most Asian government yield curves, we believe. In particular, we think that the Korean bond markets have over-

discounted the magnitude of potential rate hikes. Coupled with the structural shift in Korea to buy longer-dated government bonds, this leads us to find value in Korean 5- to 10-year Treasury Bonds. Fundamentals for Indonesian local currency government bonds also remain sound, with subdued inflation and resilient foreign demand. Continued strength and reduced volatility of the IDR is also likely to support demand, in our view.

Asian FX: Positive view intact

Rate differentials and flexible CNY positive for Asian currencies

Asian central banks have accumulated substantial reserves following the global financial crisis, and reserve levels are at all-time highs despite the Eurozone crisis. As the G3 countries maintain low rates in order to support their vulnerable economies, interest rate differentials between Asia and the U.S. will likely attract investors seeking higher yields from Asian currencies. The recent announcement by the People's Bank of China of a flexible exchange rate regime for the CNY supports our constructive view on Asian currencies. We believe that China will seek a gradual and modest appreciation of the CNY against a currency basket representative of its trade partners. Asian currencies which we favour include the IDR, KRW, MYR and AUD.

Global and Asian credits: Buying into corrections

Remain positive on credits; favour buying into corrections

We remain constructive on global and Asian credits going into 2H10. Global economies have continued to recover, with inflation remaining benign. Corporates and banks have significantly deleveraged their balance sheets since the financial crisis. In addition, defaults in the high-yield space have continued to decline. Valuations are reasonable, with credit spreads remaining elevated against historical levels. While credit markets could remain volatile given the ongoing debt issues in the Eurozone, we would view any material correction as a buying opportunity. We favour high-grade corporate and Asian bank capital securities over high-yield securities, as they are likely to outperform on a risk-adjusted basis, in our view. We continue to focus on short- and mid-duration securities.

Asian equities: Likely to trade in a wide range

Asian stocks could remain volatile; emphasize stock selection

We expect Asian stock markets to remain volatile and trade in a wide range as concerns over the Eurozone debt crisis continue to linger. However, we believe that stocks are likely to remain supported by the continued economic recovery and abundant liquidity due to a delay in monetary tightening. We continue to place greater emphasis on stock selection over country allocation, and prefer stocks in the consumer discretionary and industrial sectors. We are underweight banks, telcos and utility stocks.

Prefer China, Singapore and Hong Kong

In our country allocation ranking for 3Q10, China, Singapore and Hong Kong are our key overweights. Valuations are a key consideration this quarter, with all three markets appearing attractive relative to historical averages. We also like China because of resilient economic growth and the likelihood that a flexible CNY will remove some pressure for monetary tightening. In Singapore, economic growth continues to be underpinned by FDI inflows and tourism arrivals. In Hong Kong, continued low interest rates and the likelihood of a stronger CNY bodes well for asset prices.

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