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Some Things Change Some Things Did Not

Executive Summary

- **Equities – We believe that Indonesian equities will continue to outperform Chinese equities, supported by the macroeconomic environment.**
- **Commodities – Recent surge in Indian gold imports signals that demand is still going strong for the precious metals.**
- **Fixed Income – Shanghai Interbank Overnight Rate sends more bearish signals ahead for the Chinese equities.**

Equities – Relieve Rally in July Awaits

Perhaps the International Monetary Fund got it right when they mentioned about the ongoing market headwinds, highlighting a “greater-than-anticipated weakness in U.S. activity and renewed financial volatility from concerns about the depth of fiscal challenges in the euro area periphery pose greater downside risks”.

With the ongoing headwinds, global equities were hit hard over the 1-month period. China equities continued to head down with a 7.4 percent loss while Singapore equities were also down 3.4 percent in the month of June, with the STI closing near the 3,000 level. On a Year-To-Date basis, global equities were up 1.5 percent while emerging market equities were down 3.0 percent.

According to the average estimate of more than 9,000 analysts compiled by Bloomberg, U.S. S&P 500 Index companies are likely to earn 18 percent more this year than in 2010. Despite the high earnings expectation, investors are reluctant to return to the equity market. At the current levels, we feel that the equity correction is overstretched and a relieve rally in July may be possible.

Table 1: Selected Equity Stock Market Index Returns

Country	Index	Jun. 21	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Malaysia	FTSE Bursa Malaysia KLCI	1562.68	1.40 ▲	3.55 ▲	3.14 ▲	1576.95	1294.37
Japan	Nikkei 225	9582.73	-0.25 ▼	-0.27 ▼	-7.38 ▼	10891.60	8227.63
Indonesia	Jakarta Composite	3813.77	-1.53 ▼	8.42 ▲	5.33 ▲	3872.95	2844.45
Europe	Euro Stoxx 50 Pr	2801.99	-1.82 ▼	-1.85 ▼	-2.36 ▼	3077.24	2502.50
Emerging Markets	MSCI Emerging Markets	1113.03	-2.41 ▼	-0.63 ▼	-1.19 ▼	1211.98	905.15
United States	S&P 500 Index	1295.52	-2.83 ▼	0.14 ▲	2.91 ▲	1370.58	1010.91
Singapore	Straits Times Index	3060.71	-3.40 ▼	1.93 ▲	-2.66 ▼	3313.61	2770.12
India	BSE Sensex 30 Index	17560.30	-4.18 ▼	-2.38 ▼	-12.27 ▼	21108.64	17295.62
Asia Pac ex Japan	MSCI Asia Pacific ex Japan	465.82	-4.61 ▼	0.74 ▲	-0.98 ▼	512.12	373.23
China	Shanghai Composite	2646.20	-7.43 ▼	-9.35 ▼	-8.05 ▼	3186.72	2319.74

Source: Bloomberg, as of 21 Jun 2011

The Chinese equities continued to underperform, down more than 7.4 percent over the 1-month basis.



China versus Indonesia: Two Different Macroeconomic Pictures

Since the start of this year, inflation worries have replaced growth expectations as the headlines for many emerging nations. The environment in emerging markets became difficult as investors were seen pulling out their equity investments. However, several emerging markets have shown considerable resilience while their peers withered.

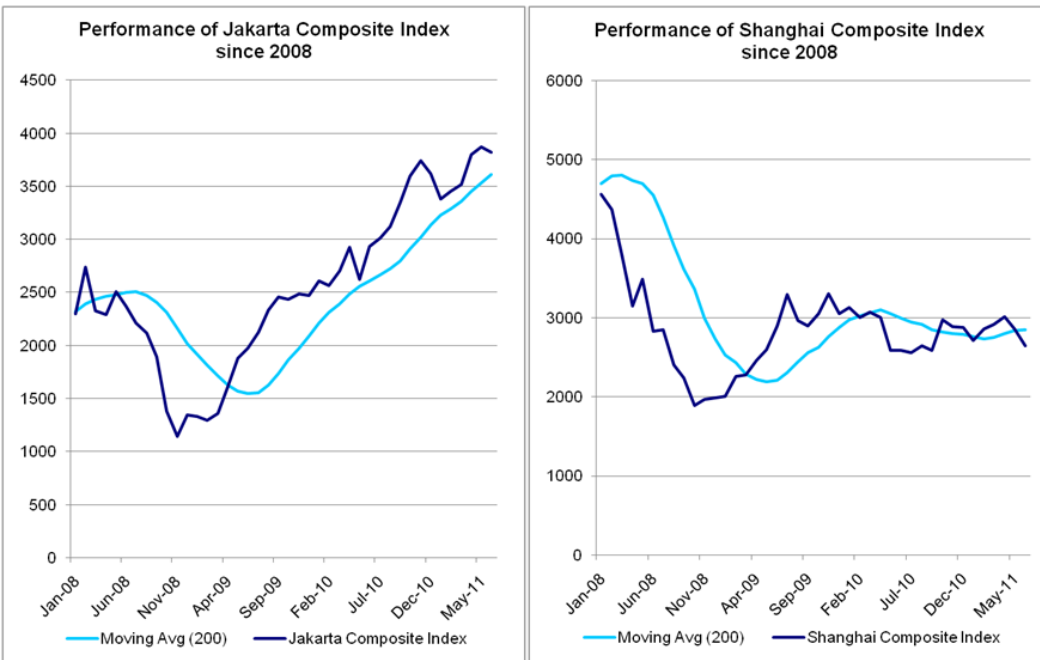
In particular, investors are favoring the Indonesian equities. The country's macroeconomic environment remains supportive helped by a cautious fiscal management. Earlier this year, the Standard & Poor's raised the country's credit rating to the highest level since the Asian financial crisis in 1997, moving a step closer to securing an investment grade rating.

On the economic backdrop, Indonesia's economy posted more than 6 percent growth rates since 2006, breezing past the 2008-09 crisis. The robust growth is helped by a young population of 230 million with a high literacy rate (estimated at more than 90 percent among the youth).

On the other hand, the macroeconomic environment in China is less than favorable. With the surging interbank rates and heightened expectation of further rate hikes, the Chinese interbank liquidity is showing signs of drying up and the Chinese equities took a tumble. Also, allegations of lax corporate governance and fraud further add to the near term uncertainty for the Chinese equities. Indeed, the Chinese equities broke the daily 200-Day moving average earlier the month, sending a key bearish sign ahead (See Chart 1 below).

Given the factors mentioned above, we are favoring the Indonesian equities to continue their outperformance against the Chinese equities. Nevertheless, Indonesian equities are trading at a sizable premium with a high Price-to-Book value of 3.0. Caution should be exercised as valuations are on the high side.

Chart 1: Indonesia Equities on a Fine Run While Chinese Equities Trend Lower



Differing macroeconomic environment in Indonesia and China should continue to impact on their equities' performance.

Source: Bloomberg, as of 21 Jun 2011



U.S. Banks – Punished by the Renewal Write-downs in Residential MBS

The ABX-HE index series is designed using a series of credit default swap contracts to determine the overall value of subprime mortgages. In general, the ABX-HE index measures the implied write-downs and a decline in the ABX-HE index indicates that the market for these subprime securities is deteriorating.

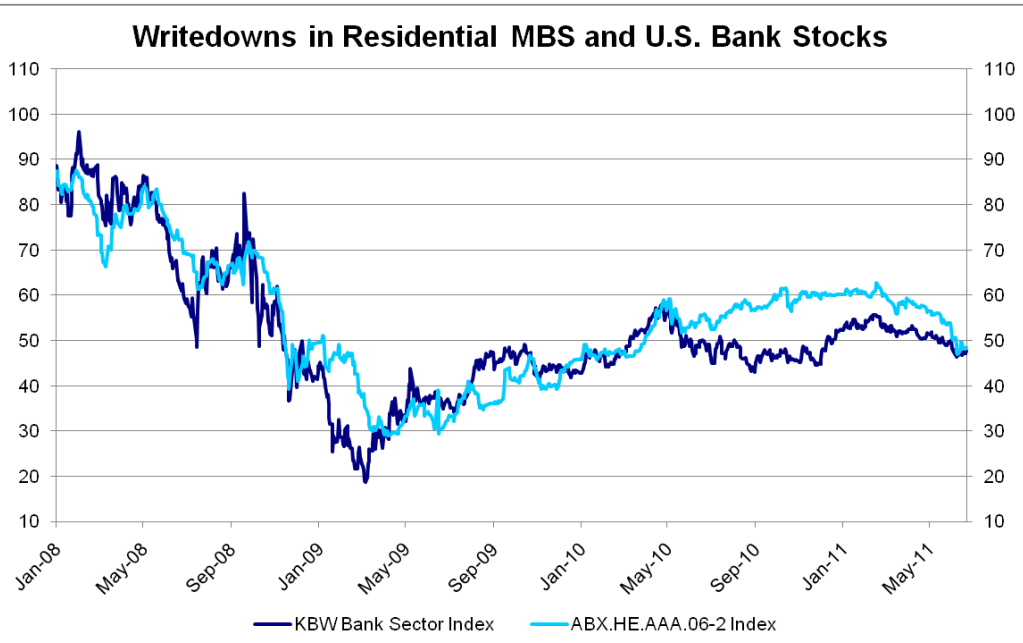
In 2008, the massive subprime write-downs brought upon one of the greatest financial crisis. During that period, the collapse of subprime securities resulted in heavy losses to holders of these “toxic” mortgage assets. To the demise of many, there is strong indication that the value of subprime mortgages has been falling off the roof again since February this year. The pace of decline has not been observed since April 2009.

Since February this year, the underlying value of subprime securities in the AAA tranche declined by a massive 22.6 percent, as indicated by the ABX-HE AAA 06-2 Index. With many of the commercial and investment banks still carrying these securitized mortgage assets on their books, it justified the recent underperformance of the U.S. financials (as measured by the KBW Bank Sector Index). These massive write-downs should not come as a surprise given that the housing slump in the U.S. is still taking its toll on the U.S. economy.

As mentioned in our previous economic update on the U.S., factors such as unemployment, distressed inventory and home price momentum are adding to the downward pressure in the U.S. housing prices. It seems that the US\$600 billion QE2 has done little to stimulate the housing market so far.

Having said that, there is still no sense of extreme risk on the U.S. equities as investors are slowly adjusting to lower growth expectations. However, should the write-downs in the subprime mortgages exacerbate, we will be looking at another leg down for the U.S. equities, with the U.S. banks highly susceptible.

Chart 2: Write-Downs in the Residential MBS Likely to Hurt U.S. Banks



The rapid pace of write-downs in the residential MBS is likely to be a key risk to watch out for moving forward.

Source: Bloomberg, as of 21 Jun 2011



Precious Metals – Gold Likely to Be Supported by India and China Factor

We feel that the demand for gold commodity is likely to be driven by India and China moving forward. The World Gold Council reported that the most recent India and China’s annual gold consumption were 963 tonnes and 580 tonnes respectively. At the moment, these two countries accounted for more than half of the global gold production from mines (See Chart 3 below).

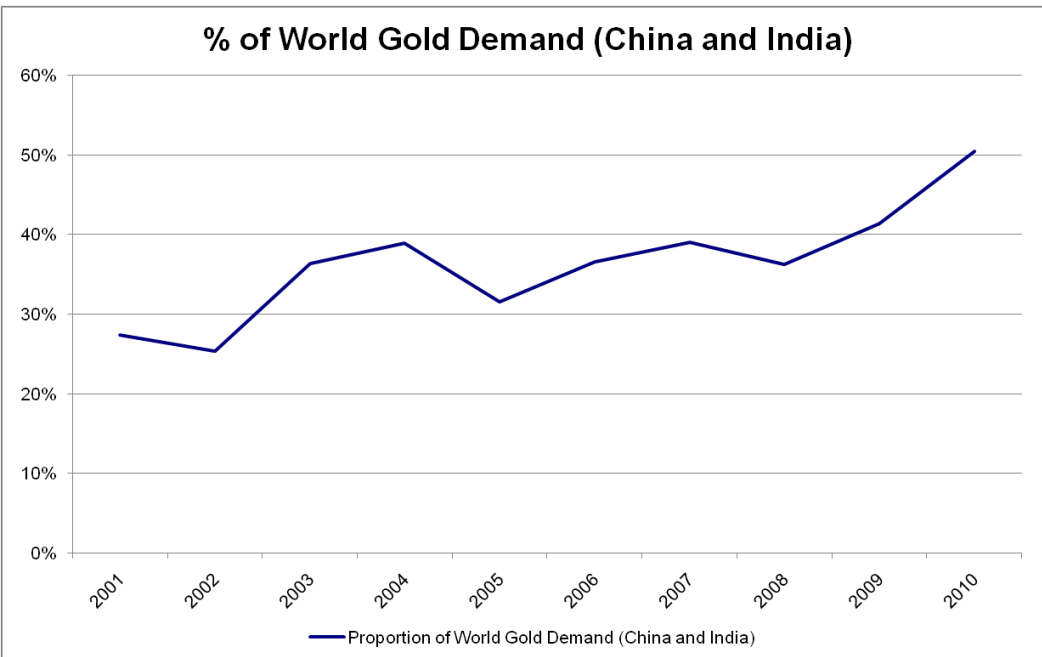
In particular, India’s recent demand for precious metals is growing at a rapid pace amidst high prices. India’s commerce and industry minister Anand Sharma announced the May imports in gold and silver rose by 222 percent to US\$13.5 billion over a one year period. The strong increase in gold and silver imports widened the country’s trade deficit to US\$15 billion, a 67 percent increase which is the largest since August 2008.

The recent rise in India’s gold import volume was in line with an earlier decision by Reserve Bank of India to grant license to seven more banks to import gold bullion, pushing up gold imports.

In the meantime, the Chinese government also lifted a ban preventing its citizens from owning gold and commercial banks are offering new gold or gold-backed investments to the locals. The Industrial and Commercial Bank of China (ICBC) sold nearly 1 billion yuan in gold-price-linked term deposits in 2010.

So far this year, the Indian and Chinese stock market have been underperforming. Domestic governments in China and India are undertaking aggressive monetary tightening campaign, prompting the wealthy citizens looking at alternative investments to park their excess funds. We believe that gold will remain as an irreplaceable archaic relic, especially among the Chinese and Indian masses. Therefore, it is likely that gold will preserve its value for investors for a substantial period of time to come.

Chart 3: Gold Imports in China and India Soared since 2008



According to 2010 figures by World Gold Council, China and India made up more than half of the world gold consumption.

Source: World Gold Council, as of 21 Jun 2011



Fixed Income – Russia and China Cut Their U.S. Treasury Holdings Sharply

There are signs that Russia and China are shunning away from U.S. dollar assets with their new FX reserves. Since the start of June 2010, these two emerging nations have been actively reducing the proportion of U.S. dollar assets in their foreign reserves holdings. Over the past one year period, it was estimated that Russia lowered the proportion of U.S. dollar assets from 40.5 percent to 26.9 percent while China lowered its share from 44 percent to 37.8 percent. China and Russia hold the world’s largest and third largest foreign reserves respectively.

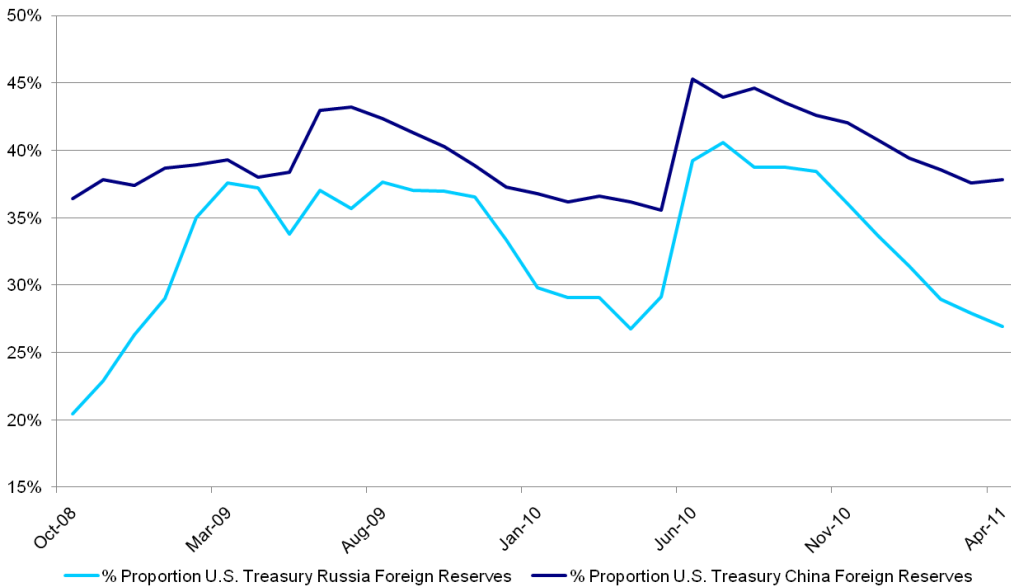
According to initial estimates from Treasury International Capital, Russia lowered its U.S. debt holdings from US\$175 billion to US\$125 billion, becoming a net seller. Wall Street Journal further reported that Russia is likely to continue lowering its U.S. debt holdings as Washington struggles to contain a budget deficit and bolster a tepid economic recovery. At the same time, the Russian central bank is diversifying its foreign reserves to include the Canadian dollar and Australian dollar as alternatives to the dollar.

People’s Bank of China Governor Zhou Xiaochuan mentioned repeatedly that the country’s excessive stockpile of USD reserves has to be urgently diversified. Members from the monetary policy committee also stated that China should invest its foreign exchange reserves more strategically, using them to acquire resources and technology needed for the real economy.

With the central banks from China and Russia cutting back their holdings, more uncertainty will be added to the outlook for the U.S. Treasury. Also, the political battle over raising the federal debt ceiling is fast approaching the Aug 2 deadline with no compromise in sight. Moody’s Investors Service on Jun 2 said that it expects to place the U.S. government’s top credit rating under review for a possible downgrade if there’s no progress on increasing the debt limit by mid-July. The market continues to wait.

Chart 4: Russia and China Cutting Their Treasury Holdings

% of Treasury in China and Russia Foreign Reserves



Source: Bloomberg, as of 21 Jun 2011

China and Russia cut their proportion of U.S. Treasury holdings since June 2010 with mounting concerns on its long term outlook.



Shanghai Interbank Overnight Rates – Too Big to Ignore

There are further signs that things are turning sour in China’s credit market. As reported by Reuters earlier, the central government in Beijing is about to shift up to 3 trillion yuan in local debt to the Federal books. Sources also mentioned this is to reduce the risk of a wave of defaults on bad debts on local governments should revenues from real estate dries up.

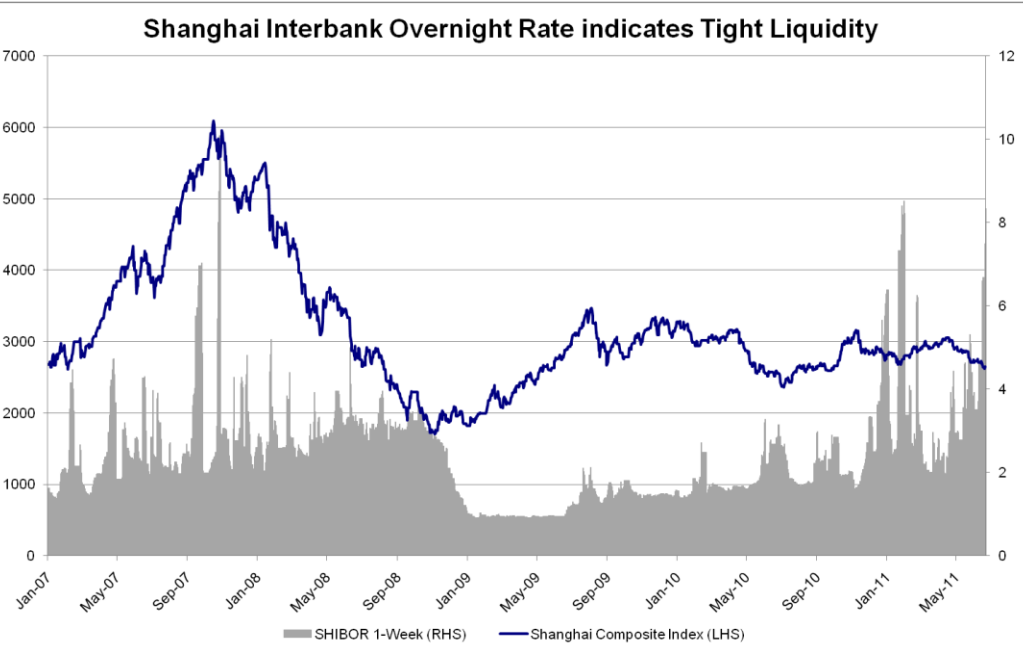
Currently, Chinese banks are saddled with piles of debts after issuing massive loans as part of the China’s economic stimulus plan during the late 2008. Recently, the Economic Observer newspaper reported that the local government debt is likely to hit 12 trillion yuan by end of this year.

As history suggested, recapitalization of state-owned banks by the Chinese central government is nothing new. Back in 1999, the central government in Beijing took 1.4 trillion yuan in bad loans off the books of the large state-owned banks.

High leverage is never a problem until things turn sour. There are signs that we may be starting to see a surge in bad loans in China itself. In particular, the short-term liquidity situation in the interbank market is showing signs of drying up. The 1-Week Shanghai Interbank Offered Rate (SHIBOR) hit a new recent high of 9.07 percent on 23 June. The last time it went as high as 10.08 percent during the late 2007, liquidity dried up and China stocks took a hefty 70 percent loss over the next one year period (See Chart 5 below).

We feel that given the need for the Chinese central bank to tighten policies further to tackle inflationary pressures, liquidity conditions are likely to remain tight and SHIBOR to remain high. In particular, this will cause refinancing and repayment problems at the borrowers’ level, with the possibility of pushing individuals and corporations into delinquency. It is going to be a worrisome situation should the recapitalization at the banks’ level fail.

Chart 5: Shanghai Interbank Overnight Rate Spiked Up Above 9%



The 1-Week Shanghai Interbank Offered Rate (SHIBOR) hit a new recent high of 9.07 percent on 23 June.

Source: Bloomberg, as of 23 Jun 2011



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