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QE2 – The Beginning (End) of The End (Beginning)?

Executive Summary

Economic

- **United States:** Economic data has been relatively uneven lately. However, we think that this is a typical pattern in a moderate economic expansion and not something to worry about unduly (with the housing sector an exception). In the face of choppy data, we hold the view that the Fed is likely to delay its tightening measures until the expansion becomes more entrenched and the data becomes more uniformly upbeat.
- **China:** The latest economic readings showed that growth momentum in China remains considerably strong. Combined with the "hawkish" tone of the Central Bank, we maintain our view that further tightening in China is highly likely.

Asset Class

- **Equities:** BRIC equities had a poor month in May; We are constructive on the local equities and U.S. non-cyclical stocks at the moment.
- **Commodities:** Signs of a potential slowdown in China's growth may put a dent on base metal prices; Silver and gold prices are likely to be supported.
- **Fixed Income:** Treasury yields trade at a new low for this year; The long term outlook on Treasuries remains negative.

Economic Update: US

During periods of thriving economic expansion, data monitoring is less challenging as almost all of the data points in one direction. However, when the economy continues to grow at a more moderate pace, data tends to be relatively uneven. Such a trend perhaps best describes what the United States is going through.

On the positive note, the April Fed Senior Loan Officer Survey showed that banks have eased their lending standards for consumer loans as well as commercial and industrial loans. Jobless claims have also edged back down.

One positive sign is that the April Fed Senior Loan Officer Survey showed that banks have eased their lending standards for consumer loans, as well as commercial and industrial loans. Some of the reasons cited for easing loan standards are increased competition from other banks and a more favorable (or less uncertain) economic outlook. Also encouraging is that new jobless claims tumbled by 29,000 in the May 14 week to a seasonally adjusted total of 409,000. The drop followed the previous week's decline of 40,000. This brings us back into the range of claims that prevailed before new filings suddenly surged in April and sent shivers down the spines of optimists everywhere. If the weeks ahead bring more signs of progress (just holding steady would be progress at this point), we will be close to shrugging off the recent surge as a one off event which is likely to be triggered by layoffs at the auto manufacturers due to parts shortages.

Readings that have disappointed include housing sales and the ISM nonmanufacturing index.

On some of the readings that have disappointed: while the ISM indexes had been strong in the first quarter of 2011, the nonmanufacturing index declined sharply in April (52.8 from 57.3) while the manufacturing index stayed at a high level (60.4 in April relative to a reading of 61.2 in March). Even as the reading still points to an expansion, the sharp decline in the nonmanufacturing index is a concern. Meanwhile, the housing sector continues to pose a challenge to the economy. Purchases of existing homes dropped 0.8 percent to a 5.05 million annual pace last month with the y-o-y rate moving into the negative double digits at 12.9 percent according to the National Association of Realtors. Supply on

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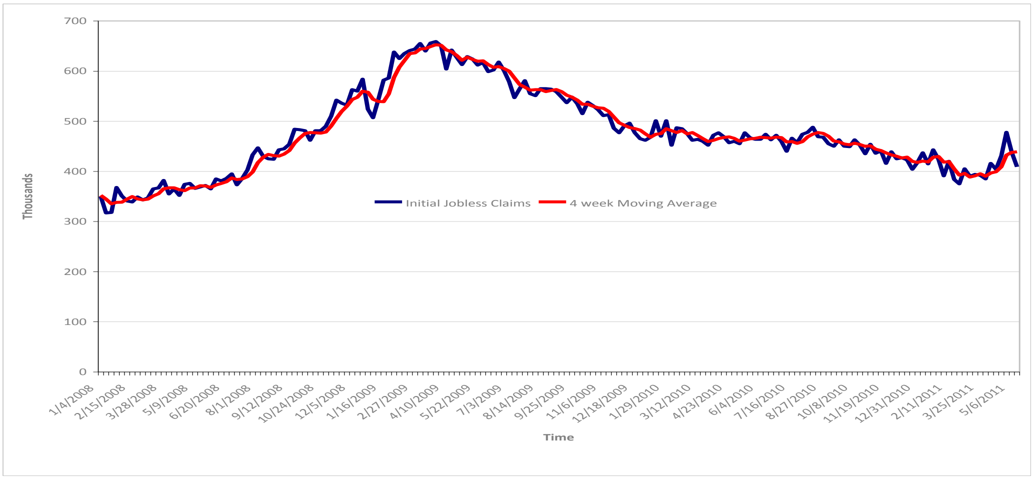
Figure 1: Initital Jobless Claims edged lower in the May 14 week



Source: Bloomberg, as of 20 May 2011

the market ballooned to 9.2 months at the current sales rate versus 8.3 months in March. High supply is not supportive for increases in house prices. With the continued slide in housing sales, recovery in housing will be challenging.

We think the uneven trend in economic data is a typical pattern in a moderate economic expansion and not something to worry about unduly (with the housing sector an exception). In the face of choppy data, we hold the view that the Fed is likely to delay its tightening measures until the expansion becomes more entrenched and the data becomes more uniformly upbeat. In addition, we feel that a third round of quantitative easing is unlikely at the moment as the trade-off is less attractive. (For more details on the latter, please refer to the economic update report dated 30 April 2011).

We think the uneven trend in economic data is a typical pattern in a moderate expansion and not something to worry about unduly (with the housing sector an exception).

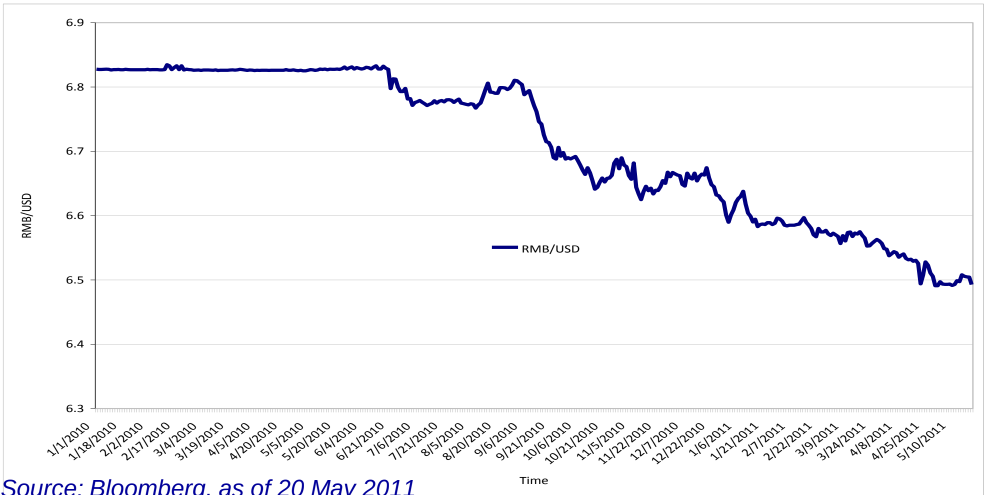
In the face of choppy data, we hold the view that the Fed is likely to delay its tightening measures until the expansion becomes more entrenched and the data becomes more uniformly upbeat.

China

Over the last two months, we have seen a rapid appreciation of the Chinese Yuan against USD. In April, the domestic currency gained approximately 0.86 percent against the greenback. Month to date (20th May 2011), it appreciated by another 0.02 percent. Year-to-date basis, the Yuan has gained 1.6 percent. The move to promote currency flexibility could be an effort by the Central Bank to reduce excess liquidity from capital inflows/reserve build-up and to ease inflation pressure.

Chinese Yuan has appreciated rapidly against the USD over the last two months. It could be an effort by the central bank to reduce excess liquidity from capital inflows/reserve build-up and to ease inflation pressure.

Figure 2: Rapid appreciation of the Chinese Yuan against USD



Source: Bloomberg, as of 20 May 2011

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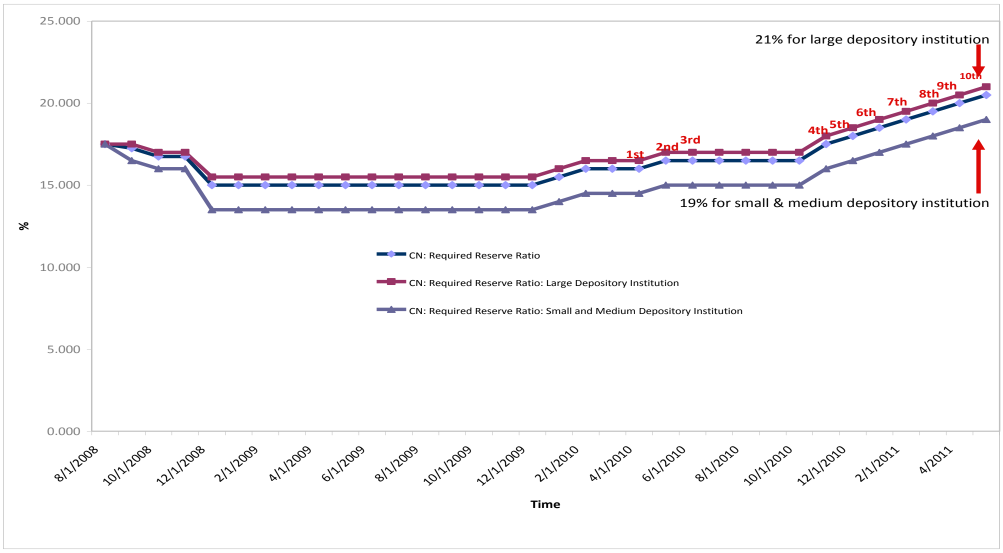
In terms of economic data, the latest reading still points to a considerable growth momentum in China. Consumption remains strong despite higher prices (China's consumer price index rose 5.3 percent in April from a year ago. The figure was down 0.1 percentage points from March). This is evident in the retail sales (by value) of consumer goods which rose 17.1 percent in April from a year ago. This figure is 0.3 percentage points lower than that of March. For the first four months of the year, China's retail sales grew 16.5 percent from the same period last year, faster than a 16.3 percent annual increase for the first quarter. Bank lending remains strong, Chinese banks extended 739.6 billion yuan in local currency loans in April, a decline of 208 billion from a year earlier. By the end of April, the outstanding yuan-denominated loans stood at 50.21 trillion yuan, up 17.5 percent from a year ago. This rise was 0.4 percentage points lower than that at end of March.

Latest economic readings in China still points to considerable growth momentum.

The PBoC recently announced in its first-quarter monetary policy report that “stabilizing prices and managing inflation expectations are critical” and that there is no “absolute ceiling” to bank reserve requirements. The latter indicates that while the reserve requirement ratio (RRR) is high, there is no limit as to how far it can be raised. Judging from this “hawkish” stance of the central bank, it reaffirms our expectation that more tightening policies will be implemented. The latest move was a 0.5 percentage hike in the RRR which took effect on the 18th May 2011.

The PBoC recently mentioned that there is no limit as to how far the reserve required ratio can be raised. Judging from this “hawkish” stance of the central bank, it reaffirms our expectation that more tightening will be implemented.

Figure 3: Another hike in reserve required ratio



Source: CEIC, as of 18 May 2011

In all, the latest economic readings showed that growth momentum in China remains considerably strong. Combined with the “hawkish” tone of the Central Bank, we maintain our view that further tightening in China is highly likely.

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Asset Class Update

Equities – May Effect Took Its Grip on Equities

Global equities had a rough month in the month of May. In particular, equities in the BRIC region were down a hefty 5 to 7 percent on average. This was coincidental with the pullback in commodity prices as well. The "sell in May and go away" effect took its toll on the risk appetite among investors. (See Table 1 below)

Locally, Singapore equities are holding up well although their performance was flat over the month. The Straits Times Index is trading slightly in the positive region on a month-on-month basis. On the valuation front, Singapore equities are trading at a Price-to-Book value of 1.62, a discount relative to regional peers. We remain constructive on the local equities outlook at the moment.

Equities in the U.S. and Indonesia markets are performing strongly at the moment. Indonesian equities were one of the best performing globally over the past three month period, up 10.2 percent. The U.S. equities performed well over the six month period but was flat over the near three month period. We will discuss more on the U.S. equities next.

BRIC equities had a rough month during the month of April. Indonesian equities were top performing group at the moment.

Table 1: Selected Equity Stock Market Index Returns

Country	Index	May. 20	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Indonesia	Jakarta Composite Index	3859.81	1.71 ▲	10.23 ▲	3.62 ▲	3867.27	2502.05
United States	S&P 500 Index	1343.60	1.00 ▲	0.04 ▲	11.99 ▲	1370.58	1010.91
Japan	Nikkei 225	9655.99	0.51 ▲	-10.95 ▼	-3.66 ▼	10891.60	8227.63
Singapore	Straits Times Index	3174.26	0.27 ▲	2.83 ▲	-0.72 ▼	3313.61	2648.15
Europe	Euro Stoxx 50	2890.60	-1.06 ▼	-5.78 ▼	1.58 ▲	3077.24	2448.10
Hong Kong	Hang Seng Index	23232.34	-2.78 ▼	-1.54 ▼	-1.58 ▼	24988.57	18971.52
China	Shanghai SE Composite	2859.51	-4.91 ▼	-1.39 ▼	-1.01 ▼	3186.72	2319.74
India	BSE Sensex 30 Index	18141.40	-6.83 ▼	-0.39 ▼	-7.37 ▼	21108.64	15960.15
Brazil	Brazil Bovespa Index	62367.36	-6.99 ▼	-8.37 ▼	-12.03 ▼	73103.28	57633.90
Russia	Micex Index	1630.72	-7.11 ▼	-3.51 ▼	4.75 ▲	1865.25	1194.96

Source: Bloomberg, as of 20 May 2011

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Defensive Stocks or Cyclical Stocks – Which Side Are You On?

The market leadership among U.S. stocks is changing. Companies in the non-cyclical (defensive) sector are outperforming their peers in the cyclical sector. From Chart 1 below, the cyclical-to-non-cyclical ratio fell drastically since the start of February, reflecting the recent strong outperformance of the non-cyclical sector.

As a guide, the defensive sector include companies in the business of utilities and healthcare. On the other end, cyclical companies tend to do well during boom times and is dependent on the macroeconomic outlook. Cyclical companies include the financials and technology companies.

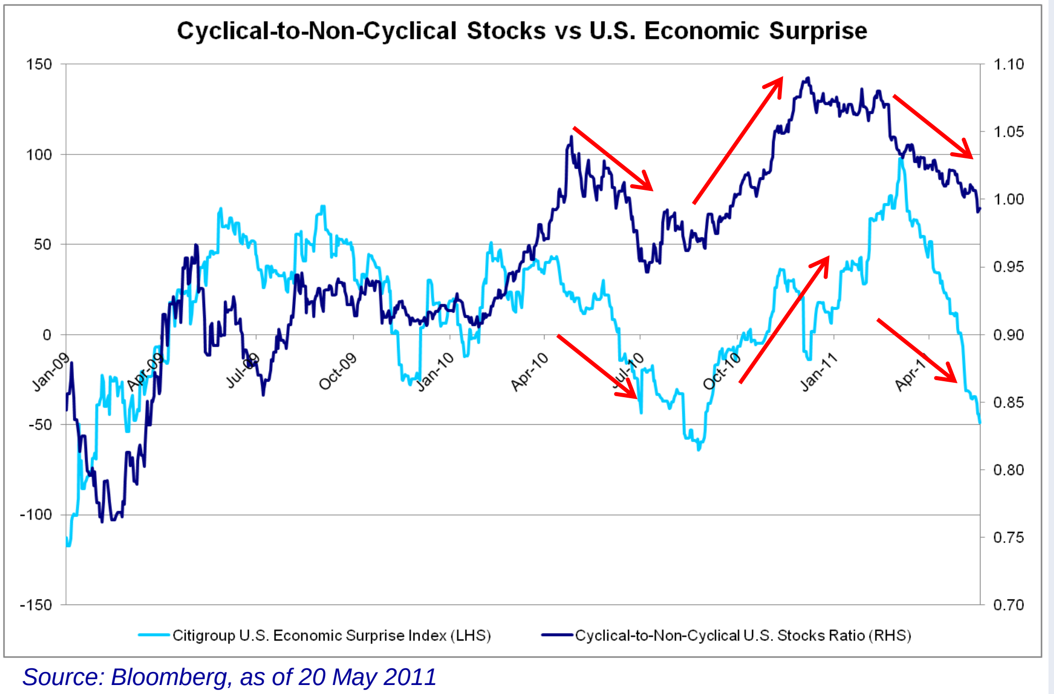
We feel that the defensive sector may continue to outperform the cyclical sector for the coming quarters. Since July last year, defensive stocks have been a laggard relative to the cyclical stocks (See Chart 1). As the U.S. economic numbers surprised to the upside in the third quarter of 2010, the cyclical stocks enjoyed a good run up to the start of December last year.

However, the same chart also shows that the Citigroup U.S. Economic Surprise Index has peaked. Citigroup U.S. Economic Surprise Index gauges the rate at which data are exceeding or trailing economists' estimates and is following through a declining trend. A period of declining economic surprises will generally see the defensive stocks outperforming the cyclical stocks.

So far to a certain extent, the broad U.S. stock market has been supported by the good performance of the defensive stocks. We feel that investors should consider reducing exposure to the cyclical sector and increase their exposure to the defensive stocks as economic numbers in U.S. may continue to miss forecasts.

On a side note, equity funds investing in biotechnology, pharmaceutical and healthcare can provide a good sector play in this aspect. UOB United Global Healthcare is one of the top five performing funds so far this year (up 9.7 percent).

Chart 1: Non-Cyclical U.S. Stocks are Outperforming the Cyclical Stocks



Source: Bloomberg, as of 20 May 2011

Non-cyclical stocks are outperforming; Poor economic surprise will further dampen the outlook on the cyclical sector.

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Commodities – Impact of China's Growth on Base Metals

Over the last couple of years, the boom in commodity demand is often associated with the rapid growth in emerging markets, in particular China. We feel that a similar boom in the base metals space may not occur as some have expected for this year. In fact, China's growth may be well below the 10 percent mark for this year itself (as forecasted by the World Bank at 9.3 percent).

1) China's recent April PMI indicated that the government has room to further raise interest rates and allowed faster gains in the yuan to tame inflation. The benchmark manufacturing index fell to 52.9 from 53.4. China is facing a period of high inflationary pressure domestically, with rise in consumer prices well above the government's target at 4 percent. Consumer prices last rose 5.3 percent from a year earlier.

2) As highlighted by several sources, asset bubbles are forming in both the residential real estate and infrastructure development in China. In particular, there are concerns about the under-populated and investment-heavy "ghost cities" in China itself. More importantly, China recently plans to cut railway investment this year. The China railways ministry will invest 745.5 billion yuan in 2011 compared with 823.5 billion in 2010. The ministry earlier posted a loss of 3.76 billion yuan in the first quarter of 2011 which further signals the unprofitability of these mega-projects.

3) From Table 2 below, a cut in spending on mega-projects in China can have profound impacts on the demand for base metal commodities. As compared to oil (10 percent), China makes up more than 40 percent of world consumption of base metals. We believe that the current tightening policy in China may also dampen investments in construction projects, cooling demand for base metals moving forward. Therefore, base metals prices should face downward pressure in near term.

Table 2: China's Share of Base Metals Consumption

Base Metals	China % Share of World Consumption
Iron Ore	48
Lead	45
Zinc	41
Aluminum	41
Copper	39
Nickel	36
Oil	10

Source: Bloomberg, as of 20 May 2011

China makes up almost 40 percent of the world base metals consumption, helped by construction boom domestically.

Precious Metals – Likely to Be Supported By Demand Factors

The biggest slump for silver since February 1983 took place during the first week of May. The Comex exchange in New York triggered a massive sell-off after increasing the margin requirements for speculators to trade the silver metal.

Silver prices hit a low of US$32.35/Oz. after touching a high of US$49.78/Oz. in the last week of April. This signals a collapse of more than 35 percent in a space of 15 trading days. Silver's 10-day historical volatility jumped more than 80 percent, the highest since March 2009.

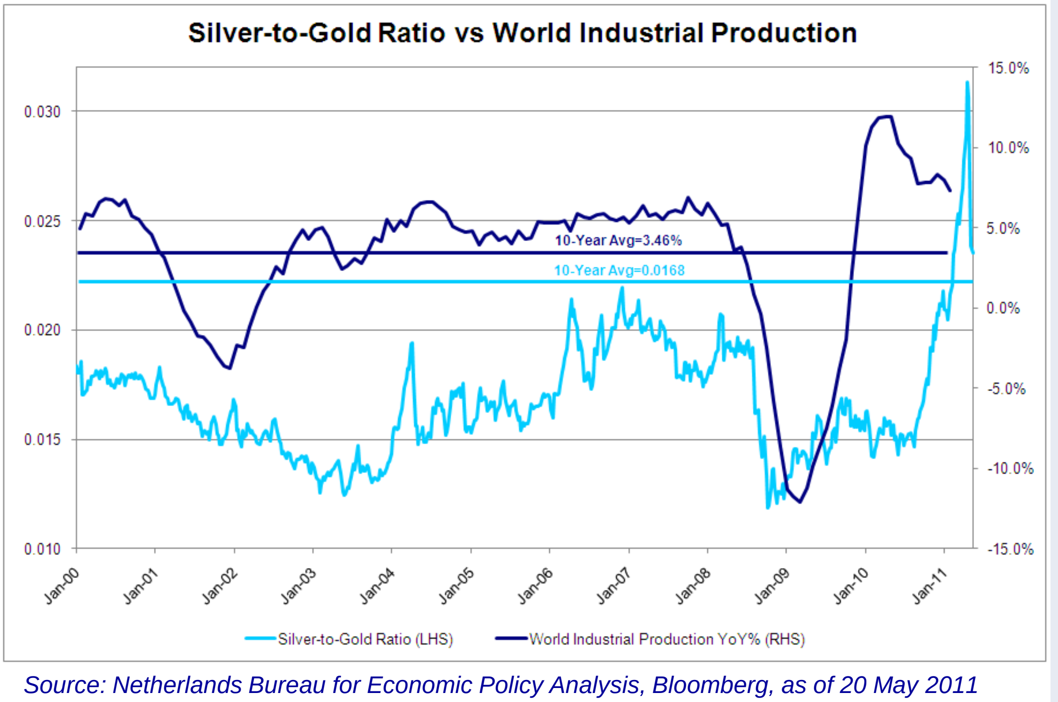
As mentioned in earlier reports, we believe that the precious metals sector should perform well in the medium to long term. This is backed by the low interest rate environment together with two massive rounds of quantitative easing by the Federal Reserve. The uncertainty brought upon by Middle East unrest and Europe debt crisis further intensify the need for alternative hard asset investment.

We believe that the recovery in world industrial production will continue to spur the physical demand of silver. Given that silver has industrial applications while gold is often perceived as a safe haven hedge, the silver-to-gold ratio tends to decrease during the time of crisis and increase during boom times. (See Chart 2 below)

We believe that world industrial production growth will stay above its 10-Year average (3.46 percent) and the silver-to-gold ratio will remain high over the medium term. At the same time, the Financial Times reported earlier that "the sharp drop in gold and silver prices has stimulated a surge in buying from India in a sign that consumers in the world's largest gold-buying country retain faith in the decade-long bull story for precious metals."

Therefore, the recent sell-offs in the commodities market may provide investment opportunities within the precious metals space which investors can look to capitalize on.

Chart 2: Silver Demand is Supported by World Industrial Production Growth



Source: Netherlands Bureau for Economic Policy Analysis, Bloomberg, as of 20 May 2011

The Silver-to-Gold ratio is likely to remain high, supported by the world industrial production growth in the medium term.

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Fixed Income – Treasury Yields Decline but Outlook Remains Negative

Investors are driving the U.S. Treasury yields to the lowest level in 2011. The 6-month Treasury yield close at 0.056 percent on 17 May as demand for Treasuries rise. Clearly, the safety haven status of the Treasury overshadows the debt ceiling debacle (See Chart 3 below).

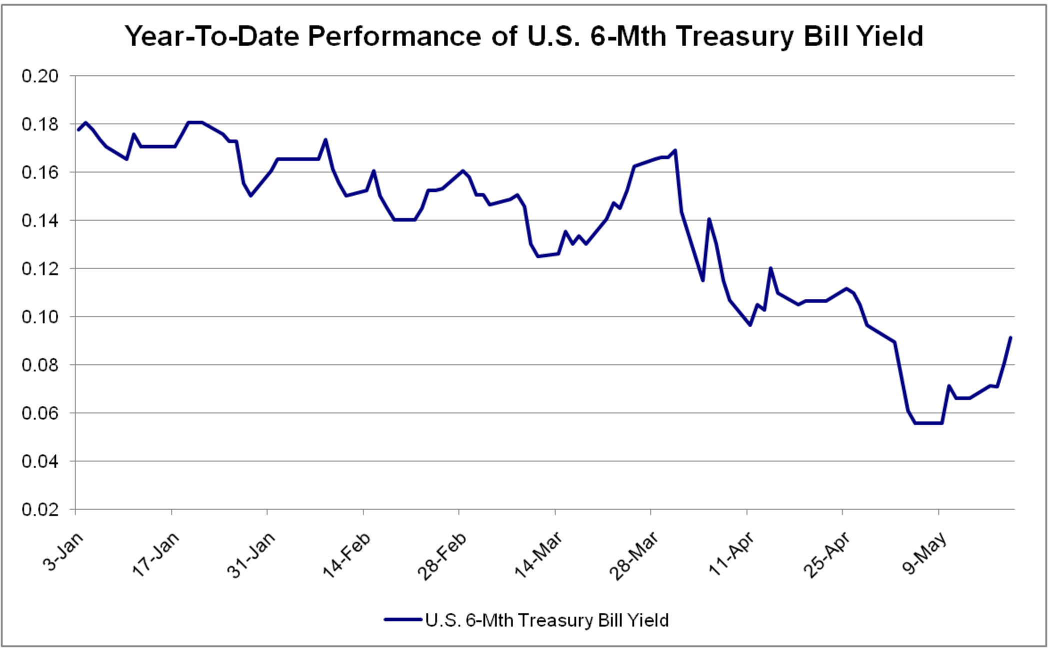
What is a debt ceiling? It is an upper limit on the amount of debt federal government can borrow to operate economic activities of the country. The primary purpose of setting the debt ceiling is to control the budget deficit, keeping its spending in check. According to the Congressional Research Service, the debt ceiling has been raised 74 times since March 1962.

Back on the debt ceiling debacle, the U.S. Congress are still voting to increase the debt limit as the country's debt ceiling reached the US$14.3 trillion mark. If the ceiling is not raised, the country will threaten a government default on the Treasury. The U.S. budget deficit this year alone is set to be a record breaking US$1.5 trillion.

In the latest attempt to convince the U.S. Congress on raising the debt ceiling, Treasury Secretary Tim Geithner warned that "Failure to increase the debt limit in a timely manner would threaten this position and compromise America's creditworthiness in the eyes of the world." He further explained that "Given the gravity of the challenges facing the U.S. and world economies, the world's confidence in our creditworthiness is even more critical today."

We believe that the market as a whole is unconcerned with the threat of a U.S. default at the moment. However, we should be more concerned about the imprudent fiscal and monetary policies in the U.S., which will lead to higher interest rates over the long term. As such, we remain negative on Treasury investments in the long term.

Chart 3: New Low for U.S. 6-Month Treasury Bill Yield This Year



Source: Bloomberg, as of 20 May 2011

Treasury yields are trading at a new low for this year. 6-month Treasury bill yield fell below 0.06 as the safe haven play took hold.

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