



Executive Summary

Macro Overview:

The divergence between developed and developing economies that exists in 2010 is set to continue in 2011. The pace of growth for emerging countries will however moderate as governments impose tightening measures to rein in inflation and to prevent asset bubbles from developing. Nonetheless, we maintain overweight in Asia Pac ex Japan and have changed our stance towards North America. With the sovereign debt crisis still unresolved in Europe, we remain cautious and hence underweight this part of the world.

Sector Allocation:

Asset Class	Overweight	Neutral	Underweight
Equities	Global Resources	China	India
	South East Asia	Global	Japan
	United States	Information Technology	Europe
Fixed Income	Asia Pacific	Global	European Sovereigns
	Corporate	High Yield	U.S Treasuries
Commodities	Metals	Energy	---
	Agricultures	---	---

Marco Outlook:

In December, economic data has remained upbeat for various countries. In the United States, the job market has shown some bright spots. The initial jobless claims posted their lowest four-week moving average since August of 2008, before the financial crisis. Meanwhile, the holiday shopping season gave retail sales a boost. Sales were particularly strong in clothing (2.7% m/m), department store (2.8% m/m) and online store (2.1% m/m). Strong sales suggest that the fourth quarter consumption growth will be strong. In China, PMI reading reached 55.2 in November versus October's 54.7. The better-than-expected reading showed a solid expansion in the manufacturing sector. Meanwhile, the industrial production index raised 13.3% y-o-y in November. Not surprisingly, private consumption showed strong growth momentum. Both urban and rural retail sales growth were 0.1 percentage point and 0.2 percentage point higher than in October, at 19% y-o-y and 17% y-o-y respectively.

Early fears of an imminent double-dip in 2010 were largely unfounded as the global economic recovery has been sustained at a modest pace. Despite so, it has been characterized by significant differences in development between economies. Emerging countries continue to register strong growth while several of the developed nations (such as US, Europe and Japan) remain weak. As a result, policy responses across the world no longer synchronize. Indeed, we saw a second stimulus program (Quantitative Easing II) implemented in the United States. Meanwhile, authorities in some emerging countries are worried about the potential for a destabilizing bubble and have imposed controls to discourage inflows of foreign capital and are tightening up on lending standards for real estate.

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Moving into 2011, we believe we will continue to see two strikingly different performances and policy paths between regions of the world - those that were not directly affected by the financial crisis but suffered from the knock-on effects and those that are still struggling to deal with the shackles of massive private and public sector balance sheet adjustments brought on by the crisis. Asia Pacific ex Japan (and notably South East Asia) displays good prospects for continued robust expansion although a moderation of growth is possible. We maintain our overweight position in this region for 2011. Growth in the United States while weak at the moment might surprise on the upside and therefore we have overweight this country. We are not optimistic on Europe on fears of deterioration of the sovereign debt crisis. While we expect global growth to be positive next year, there are two key risks. Firstly, there is the potential for a widened sovereign debt crisis in Europe if further measures are not taken to quell current market stress. Secondly, widening inflation problem in emerging markets (particularly in Asia), if greater monetary restraint is not imposed.

Asia Pacific ex Japan: The third quarter of 2010 was a weak one for Asia's small, open economies. While growth in China and India was slightly better than expected, most of the other economies in Asia slowed. We think this is a return to the norm rather than the start of a severe slow down.

We maintain an overweight stance on Asia Pacific ex Japan region (with a slight bias towards South East Asia) as its financial systems are generally healthy; domestic demand is robust, supported by growing wealth, low debt levels and high savings rates. Within this region, we are however cautious on China and India as we do expect more interest rate hikes, curbs on capital inflows from the various authorities as controlling inflation and avoiding asset bubbles continue to be the top policy priorities. We explain these concerns in turn below.

China: We believe that growth will continue at a slower pace; supported primarily by internal demand and developments. Consumer demand should strengthen further on the government's supportive measures, improving job market and continued growth in average salary (figure 1). The growth in fixed asset investment (FAI) will only slow moderately as the investment in affordable housing will be able to offset the slowdown in investment in the private housing sector. Importantly, investments in other areas such as rural areas, renewable energy and healthcare are likely to accelerate in 2011. We should have more details when the government releases the 12th Five-Year Plan in 1Q11.

While the above may be the case, China faces some challenges, which include; managing excess liquidity and counter rising inflationary pressure.

The correlation between money and inflation suggests that we should perhaps not be overly concerned over China's inflation problem. The sharp decline in money and credit from a year ago will set the stage for an eventual fall in inflation. However, the recent spike in CPI levels is almost entirely due to rising food and energy prices (food prices soared 11.7% in November), which are set by international markets. Domestic monetary tightening may not be effective in bringing down prices for food and energy. We do not think prices will ease in the near term (refer to the write up on "Commodities – The Run Has Just Begun" below for more details), and hence inflation will remain a concern in China.

Moving into 2011, we believe we will continue to see two strikingly different performances and policy paths between regions of the world

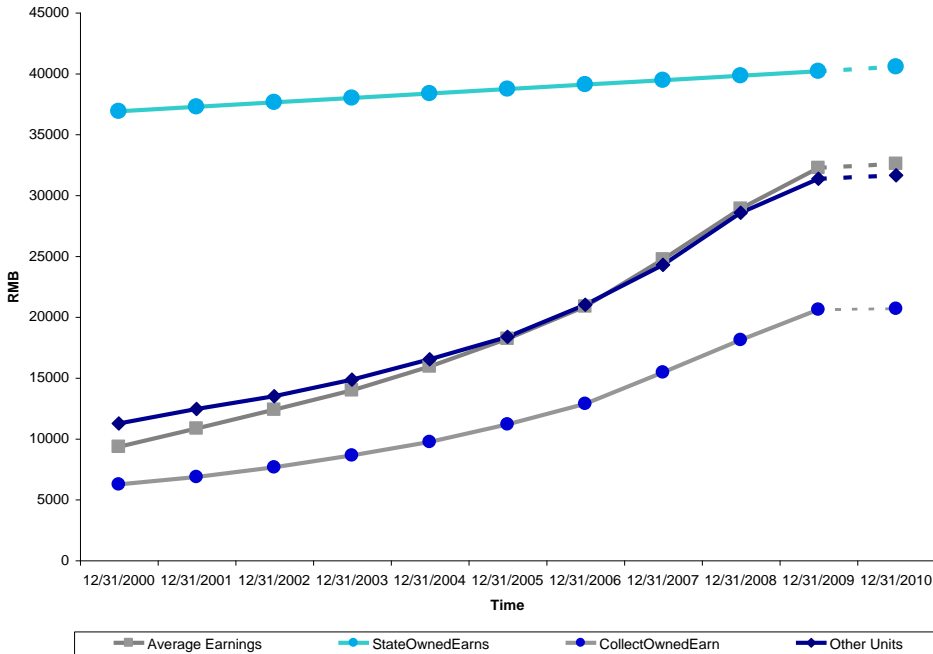
Asia Pacific ex Japan (and notably South East Asia) displays good prospects for continued robust expansion although a moderation of growth is possible. We maintain our overweight position in this region for 2011.

We believe that growth in China will continue at a slower pace; supported primarily by internal demand and developments.

Manage excess liquidity and counter rising inflationary pressure remain a challenge to the Chinese.



Figure 1: Average earnings in China on a rising trend



Source: Bloomberg. As of Sept 2010

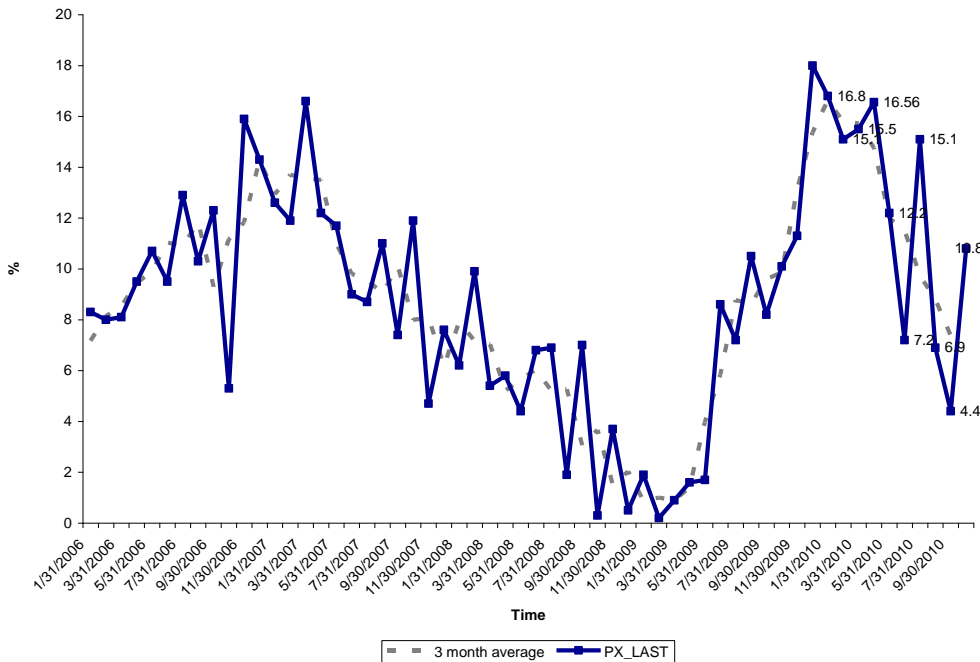
While domestic tightening policies may be ineffective in influencing food prices, it is nonetheless necessary to tighten money and credit to prevent “relative price shocks” from becoming generalized price inflation. It’s been announced that the government will continue to tighten monetary policy next year. As such, it is reasonable to expect more rate hikes in 2011. The 1-year deposit rate may increase from the current 2.5% to 3.5% approaching its pre-crisis level of 4.14%. Meanwhile, we believe that PBOC is likely to continue to use quantitative measures and raising the required reserve ratio to manage the amount of money in circulation.

India: Despite rather tight monetary conditions, GDP growth for the third quarter was at 8.9% y-o-y. We expect growth to slow in 2011, but not much slower from 2010. The greatest obstacle to the country’s growth prospect is of course the possibility that more tightening policies will be imposed to control inflation and reduce the risks of asset bubbles. While further easing in the annual change in wholesale prices is possible in coming months due to base effects, the Reserve Bank (RBI) reminded that annual inflation remains far above its comfort zone of 4-5%. Therefore, we believe that RBI will continue to watch food prices and prices of non-food manufactured goods closely. Any signs of inflation pressures coming through from the broader economy likely lead to actions from RBI. Nonetheless, we expect industrial production (figure 2) and manufacturing to continue to contribute to the country’s growth. Similar to China, household spending could be lifted by income growth and employment gains.

Similar to China, we expect growth to slow in 2011, but not much slower from 2010. The greatest obstacle to the country’s growth prospect is of course the possibility that more tightening policies will be imposed to control inflation and reduce the risks of asset bubbles.



Figure 2: India industrial production y-o-y% change



Source: Bloomberg. As of Oct 2010

United States: There are currently two main schools of thoughts on the future evolution of the U.S. economy. Some argue that the U.S. will follow a Japanese-style adjustment path: multi-year stagnation, price deflation and falling asset values. Others have argued that the Fed’s quantitative easing has put the U.S. economy onto a path that will eventually lead to hyper-inflation. We believe the U.S. economy is heading towards neither extreme at the moment.

In the past few reports, we have written that we believe that the U.S. economy will remain weak. While this may be so in the interim, we believe that in 2011, the economic condition in the U.S. will find traction and that growth might surprise on the upside. We believe this is the case based on a few factors.

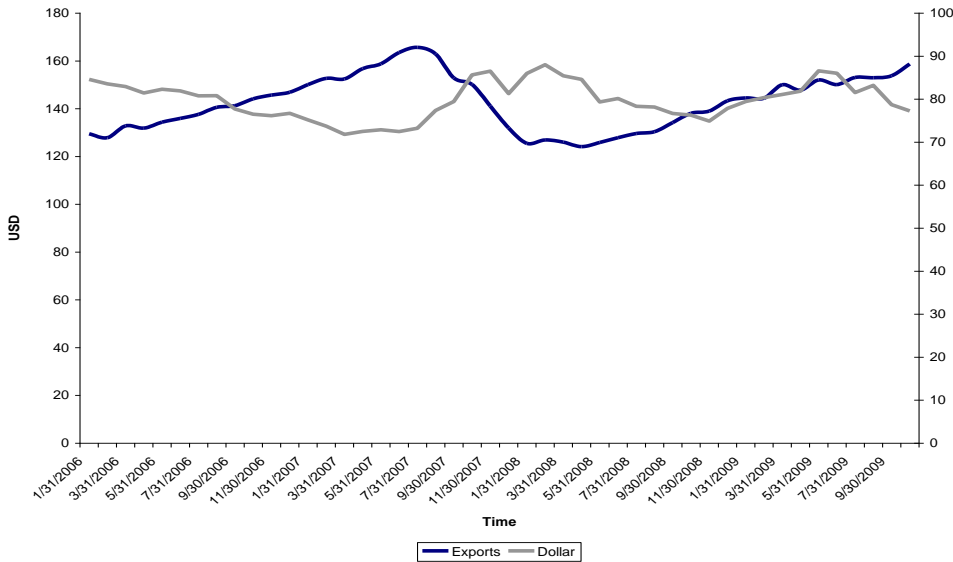
Firstly, we can expect consumption to improve. Consumers went through a severe deleveraging process that caused savings rate to soar to a historical high of 7% in 2008. Since 2009, the savings rate has maintained at an average of 6%. A stabilization in the savings rate means that the drag on growth from deleveraging will slowly dissipate.

Thirdly, improvement in exports will also lend support to overall growth. The dollar has been on the decline. This declining trend in turn has caused American exports to be competitively priced and hence more affordable in many countries. Indeed, we saw a decent revival in U.S. exports. This is shown in figure 3. Along with the improving exports level, the country’s current account deficit has also narrowed significantly. With the weakness in dollar expected to continue, we can reasonably expect exports to remain strong.

We believe that in 2011, the economic condition in the U.S. will find traction and that growth might surprise on the upside.



Figure 3: Inverse relationship between exports and dollar



Source: Bloomberg. As of Oct 2010

While we expect the U.S. economy to find strength in the factors mentioned above, there are key risks to our analysis. Firstly, the housing sector remains weak although it has rebounded. Housing accounts for the bulk of U.S. household net wealth and any renewed slump in housing prices could lead to further increase in savings rate as consumers try to gain back lost wealth. In turn, this could lead to renewed economic weakness.

Secondly, while initial jobless claims have been on the decline, the level of jobs created continues to disappoint. This could lead to weakened income growth and spending. Although recent figures from the various reports have suggested that the private sector continues to hire, we can't be certain that the level of hiring will be maintained next year. Besides, with the globalization of trade, companies do have the option to outsource their projects and hire workers in other countries that are considerably cheaper.

All in all, we are slightly more optimistic of U.S. growth prospect in 2011 than we were last year.

Europe: Economic indicators suggest that the recovery in Europe economies has been gathering pace towards the end of the year. For instance, PMI for the whole region rose by close to two points to 55.5 in November. While that seems to be the case, we expect a divergence in economic development between the financially unstable periphery and the more robust countries to continue in 2011.

While we expect the U.S. economy to find strength, there are key risks to our analysis. Firstly, the housing sector remains weak although it has rebounded. Secondly with the globalization of trade, companies do have the option to outsource their projects and this reduces employment opportunities within the country.

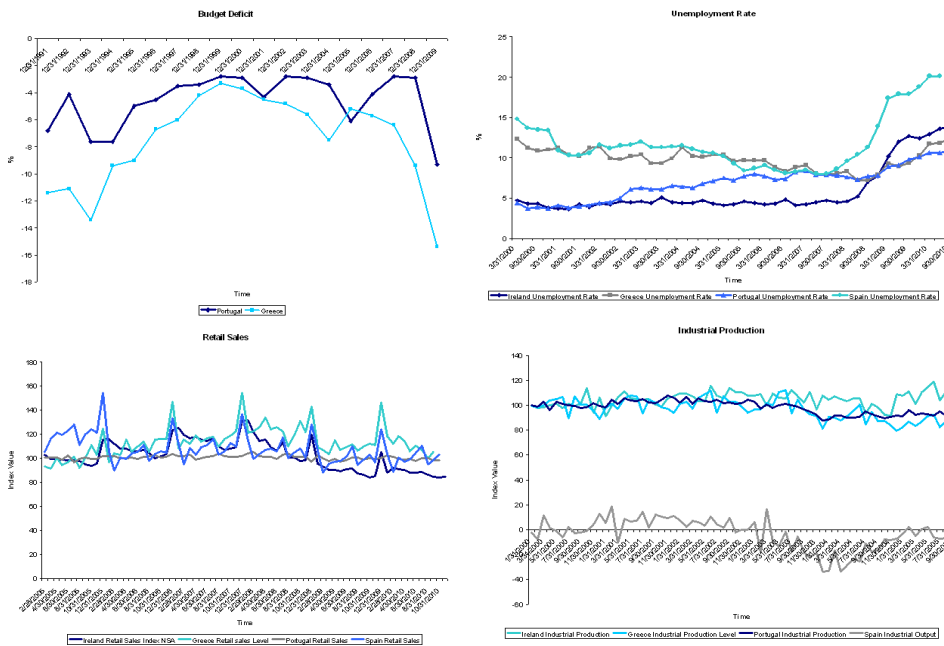
We expect a divergence in economic development between the financially unstable periphery and the more robust countries to continue in 2011.



Economic strength in Germany is expected to continue. In Germany, the business climate indicator rose to a post-reunification high in November. Meanwhile, private consumption and investment in plant and equipment grew 11.3% and 1.2% y-o-y respectively. The prospect for domestic demand is positive. The labor market continues to strengthen and as employees' compensation continues to rise. In the third quarter, compensation rose by 1.9% y-o-y, the fastest growth in a decade.

While the benefits of a stronger Germany will spill over to other parts of Europe, we are not inclined to conclude that growth will be strong in the peripheral economies. This is so as the austerity measures (tax hikes, salary cuts, cuts in welfare spending and curbs on public investment) planned in Greece, Ireland, Portugal and Spain for 2011 will exert a toll on these economies that are already weak. As shown in figure 4, unemployment rate and fiscal deficits in these economies remain high.

Figure 4: Inverse relationship between exports and dollar



Source: Bloomberg. As of Oct 2010.

Conclusion: The divergence between developed and developing economies that exists in 2010 is set to continue in 2011. The pace of growth for emerging countries will however moderate; as governments impose tightening measures to rein in inflation and to prevent asset bubbles from developing. Nonetheless, we maintain overweight in Asia Pac ex Japan and have changed our stance towards North America. With the sovereign debt crisis still unresolved in Europe, we remain cautious and hence underweight this part of the world.

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PHILLIP SECURITIES PTE LTD

Unit Trust – Investment Outlook 2011

31 Dec 2010

Top Sector Allocation for 2011

Asset Class	Overweight	Neutral	Underweight
Equities	Global Resources	China	India
	South East Asia	Global	Japan
	United States	Information Technology	Europe
Fixed Income	Asia Pacific	Global	European Sovereigns
	Corporate	High Yield	U.S Treasuries
Commodities	Metals	Energy	---
	Agricultures	---	---

Equities – The Last Chance Saloon

As 2010 draws to a close, global equities are looking to end 2010 near their highs for the year. Major indices are trading at a level not seen since September 2008 when Lehman Brothers filed for bankruptcy.

Market sentiments are in a definite bullish mode at the moment. The latest Investor's Intelligence survey showed a fresh high bullish reading of 58.8%. This was the highest reading since the second week of October 2007. Expectations that stocks prices will rise over the next six months, stayed above its historical average for a 16th consecutive week in the latest AAI Sentiment Survey.

In fact, global equities performed exceptionally well during the final few weeks of the year. The S&P 500 was up 6.5% (as of 22nd Dec) in just 16 trading sessions in December. Also, 14 of the 16 trading sessions had been positive, an 88% win rate. Overall, we expect the bullish bias in equities to continue heading into the first quarter of next year but will be cautious for the remaining three quarters of 2011.

Table 1: Major Indices Market Performance in 2010

Country	Index	Dec. 28	Year-To-Date	2009	2008	52 week High	52 week Low
Indonesia	Jakarta Composite	3625.27	43.04 ▲	92.10 ▲	-49.33 ▼	3788.57	2431.84
Thailand	Stock Exch of Thai	1019.46	38.79 ▲	71.35 ▲	-45.09 ▼	1055.25	679.45
Philippines	Philippine SE Index	4169.13	36.53 ▲	71.01 ▲	-46.28 ▼	4413.42	2787.66
Middle East	MSCI GCC Index	526.04	24.16 ▲	4.67 ▲	-52.86 ▼	522.00	394.61
South Korea	KOSPI Index	2039.05	21.17 ▲	51.80 ▲	-39.66 ▼	2045.39	1532.68
Malaysia	Bursa Malaysia KLCI	1524.49	19.72 ▲	49.95 ▲	-36.23 ▼	1531.99	1224.37
South Africa	FTSE/JSE Africa	32037.06	15.80 ▲	32.07 ▲	-23.06 ▼	32180.64	25733.31
India	BSE Sensex 30	20028.93	14.68 ▲	78.51 ▲	-51.83 ▼	21108.64	15651.99
United States	S&P 500 Index	1257.54	12.77 ▲	26.47 ▲	-37.00 ▼	1259.39	1010.91
United Kingdom	FTSE 100 Index	6008.92	11.01 ▲	27.90 ▲	-27.99 ▼	6008.92	4790.04
Singapore	Straits Times Index	3166.63	9.31 ▲	70.81 ▲	-47.05 ▼	3313.61	2648.15
Taiwan	Taiwan Taiex Index	8892.75	8.53 ▲	83.31 ▲	-43.03 ▼	8919.26	7032.40
Hong Kong	Hang Seng index	22642.63	3.37 ▲	56.63 ▲	-46.39 ▼	24988.57	18971.52
Australia	S&P/ASX 200 Index	4777.30	-1.92 ▼	39.28 ▲	-37.43 ▼	5025.10	4175.70
Japan	Nikkei 225	10316.95	-2.18 ▼	21.10 ▲	-41.11 ▼	11408.17	8796.45
China	Shanghai Composite	2767.65	-15.75 ▼	82.62 ▲	-64.89 ▼	3306.75	2319.74

Source: Bloomberg, as of 28 Dec 2010

Major global equities were mostly up on a Year-To-Date basis. Southeast Asia equities outperformed strongly while the overall Greater China equities underperformed.



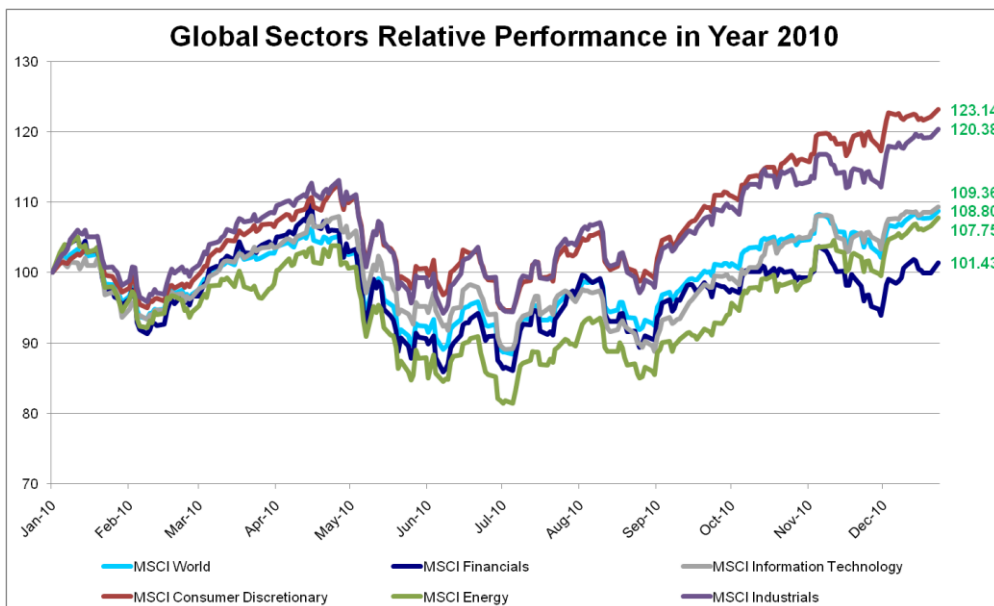
2010 Round Up

Table 1 on the previous page provides the performance overview of selected global equities from a geographical perspective. South East Asia equities continued their outstanding performance from 2009. In particular, Indonesia was up more than 43% (as of 28th Dec 2010) since the start of the year. Thailand and Philippines performed equivalently well and were up 38% and 36% respectively over the same period. However, inflation fears and a potential property bubble were a constant drag throughout the year on the Greater China equities, the Mainland China stocks underperformed and were down more than 15% relative to the start of the year.

At the other end, the MSCI Emerging Market Index had gained almost 140% from its March 2009 low as developing economies exited the global recession in better shape than advanced countries by almost every measure. However, the BRIC equities (up more than 5% YTD) had underperformed the broader emerging equities (up more than 13% YTD) during the year itself. Brazil (down 0.5% YTD) and China were the laggards among the BRIC nations while Russia and India outperformed strongly.

From a sector perspective, the performance of key sectors was mixed in 2010. From Chart 1 below, Consumer discretionary (up more than 23% YTD) had been one of the best performing sector alongside with the Industrials (up more than 20% YTD). In fact, the MSCI Consumer Discretionary Index and the MSCI Industrials Index had been the leading performers as compared against the broader market, as measured by the MSCI World Equities Index, throughout the year. Nevertheless, Financials continued to be the lagging sector, up more than 1% YTD.

Chart 1: MSCI Laggards and Outperformers (2010 Roundup)



Consumer discretionary and Industrials were the outperformers for 2010. Financials underperformed with respect to the broader world equities.

Source: Bloomberg, as of 23 Dec 2010



The Last Chance Saloon

The phrase “last chance saloon” is often referred to as a situation considered to be the last opportunity for success. In other words, the phrase describes a situation beyond which hope or good fortune will greatly diminish. For the year 2011, there are still opportunities in some regions or sectors to buy back in and ride on the current rise in equities during the first quarter itself. However, we will be more cautious come the second quarter and beyond.

Among equities, we are overweight on the United States, South East Asia and Global Resources for the coming quarter itself. At the same time, we are underweight on India equities on the back of rich valuations. Japanese equities are likely to be adversely affected by the sluggish growth and deflationary environment domestically. The ongoing uncertainty brought upon by the Europe debt woes made the outlook of European equities gloomy heading into 2011 (See Table 2 below). Looking beyond the first quarter, the pace of rise on global equities should slow.

At the moment, we viewed that majority of equity markets at current levels look to be skewed by the optimism brought upon by QE2 and the US congress tax deal announced back to back previously. Nevertheless, things can remain irrational for longer than we would think.

On the global equity front, we believe that continual rise from current level will eventually bring about an overvalued, overbought and overextended syndrome. When that happens, equities will show signs of an imminent top with lagging breadth, a lower number of new highs and overly enthusiastic sentiment. On the volume side, there will be higher volume down days and a more frequent number of late-day selloffs. When these selling signals occur, investors can look to an imminent pullback on global equities.

Nevertheless, we are optimistic that South East Asia, United States and Global Resources are likely to outperform in the coming quarter. Over the longer term, investors should pay attention to the evolvement of the “new normal” which will be elaborated in the next section.

Table 2: Overweight and Underweight (Equities)

Overweight	Underweight
South East Asia	India
United States	Europe
Global Resources	Japan

Source: UT Research, as of 31 Dec 2010

On equities, we are overweight on South East, United States and Global Resources for the coming quarter.



The “New Normal” – Two Speed World & Market Volatility Alert

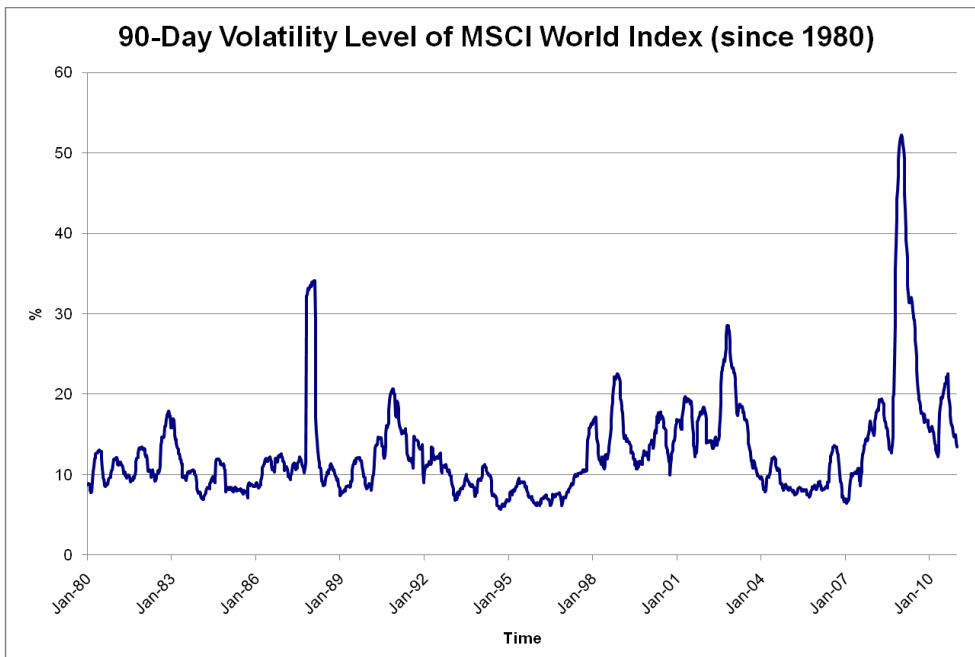
For some, the “new normal” can be referred to as an environment of subdued growth in the developed markets as a result of ongoing deleveraging while emerging economies continue their astounding growth rate. Broadly speaking, this can be termed as the “Two Speed World”. On the other end, many others highlighted that the “new normal” will be a prolonged period of higher volatility in the economies and asset markets. In short, returns will likely to see a flatter distribution with fatter tails in markets with higher volatility.

We are in favour that both of the above-mentioned “new normal” concepts are likely to be the dominant theme of equities investment for many years down the road. From a long term perspective, we maintain the view that the divergence in economic fundamentals between the emerging economies and developed world will point to the relative outperformance of the emerging market equities. Rising trade flows from inter-region to intra-region among emerging markets will become the dominant theme.

At the same time, secular forces of deflation in developed world will coincide against recurring rounds of policy re-flation and create market volatility we might not be expecting. It is crucial to acknowledge that market may remain irrational for a longer period of time than expected in this “new normal” (See Chart 2 below). To illustrate this heightened volatility, global equity markets experienced a significant upside volatility when the QE2 and recent tax deal were previously announced back to back previously.

In the long run, investors should stay invested in equities whose markets are going to be supported by growth in the respective region’s or countries’ economy and not be swayed by day to day volatility.

Chart 2: Volatility level of world equities will remain high



Source: Bloomberg, as of 28 Dec 2010

Volatility of world equities is likely to remain high from a historical perspective.



Commodities – The Run Has Just Begun

The ongoing effects of the most recent QE2 are likely to impact more on commodities prices as compared to equities in 2011. Broadly speaking, with further quantitative easing, demand for general commodities will be lifted as ongoing recovery took place. Also, QE2 can be viewed as a dollar devaluation policy and commodities will be priced higher with the declining purchasing power of the US dollar. At the same time, we are expecting to see a substantial amount of liquidity moving into the physical assets space as inflationary fears start to surface.

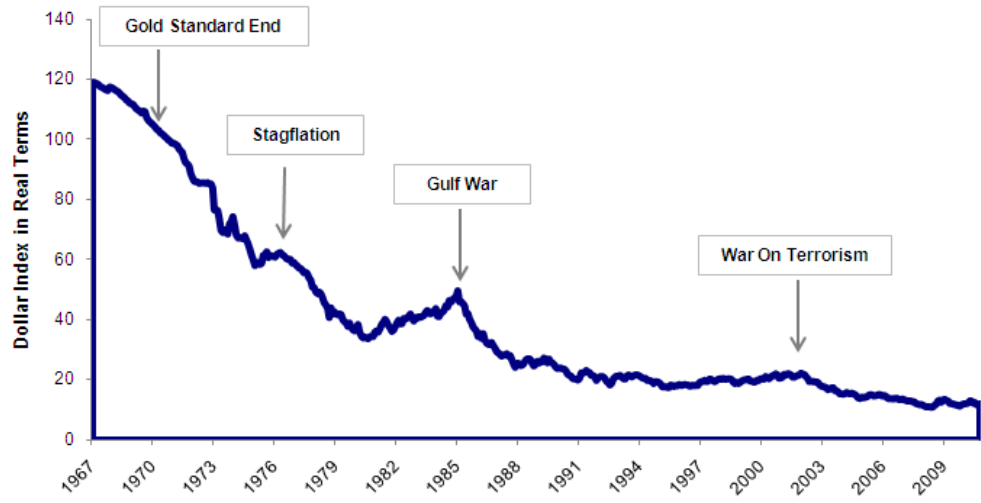
From Chart 3 below, we noted that the US dollar had been depreciating in real terms over recent decades. In terms of recent trend, the US dollar had moved in the opposite direction of commodity prices 18 of the past 22 quarters, according to data compiled by Bloomberg. Therefore, we continue to believe that the continual decline in the purchasing power of the US dollar should provide support to the extension of the bull run in commodities in 2011.

In terms of liquidity, traders had almost tripled their net-long positions in 20 raw-material futures the past 5 months to the highest level in at least 4 years, driving a 26% gain in the Thomson Reuters/Jefferies CRB Index. The surge in commodities' prices is distinct from early October to early November 2010. Sugar was up more than 30% and cotton rose more than 50% over the one month period.

In terms of risk, commodities' prices will be susceptible to central banks' policy measures to a great extent in 2011. For instance, policy tightening process through a series of interest rate hike by China's central bank as well as the re-emergence of a euro-area debt crisis could dent commodity demand moving forward.

Chart 3: Depreciating U.S. Dollar in Real Terms

U.S. Dollar Purchasing Power (Base Year: 1967)



Source: Bloomberg, as of 23 Dec 2010

Depreciation of the US dollar (in real terms) since the Gold Standard ended in 1971.



Metals – Don't Leave Out the Base Metals

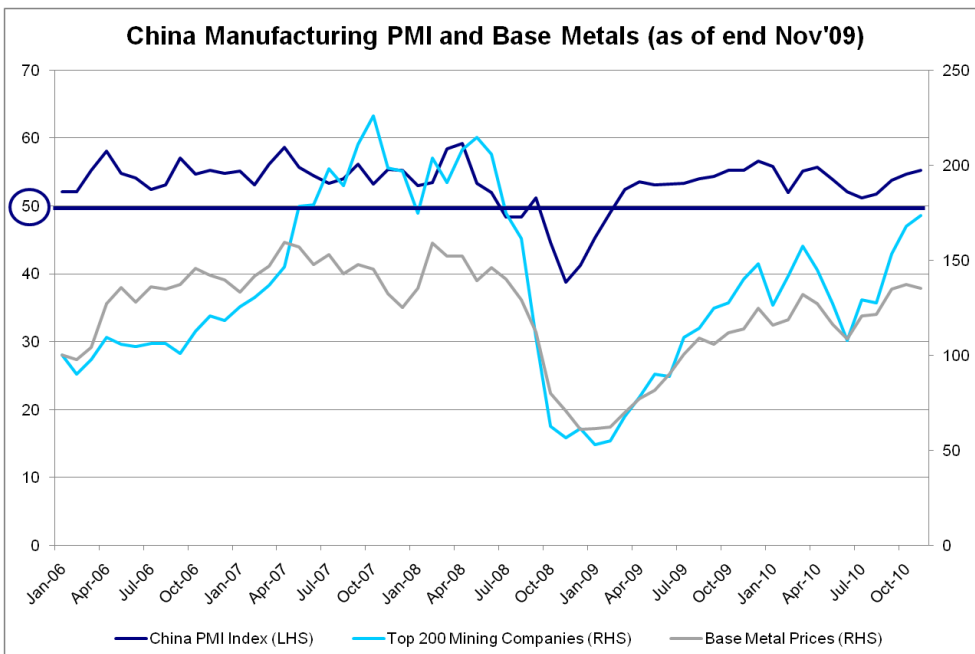
Gold prices rallied an astounding 28% over the year and hit an all-time high of US\$1,425 per ounce on 9th Nov 10. This corresponding rise in the gold run up had not always be consistent and linear as small or large corrections occurred along the way. Fundamentally, we believe that the rising investment demand for gold played a more crucial role in this gold rally as compared to the non-investment demand for gold. Overall, we are positive on the outlook of gold and that just because gold has been in a long-term advance does not mean it represents a bubble (yet). Gold is likely to continue its outperformance in 2011.

Base metals also had been making decent gains since the second half of this year. A series of expansionary Chinese PMI data alleviated fears surrounding a possible slowdown in China's economic growth (See Chart 4 below). China imports large quantities of nickel, copper and iron ore to meet its growing consumer and industrial demand. The country's need for large amounts of steel for constructing highways and building its infrastructure will continue to boost the demand for the base metals moving forward.

In terms of the investment demand of base metals, the Wall Street Journal recently reported a single trader owned 80%-90% of the copper sitting in London Metal Exchange warehouses, equal to about half of the world's exchange-registered copper stockpile and worth about US\$3 billion. Copper for delivery in three months on the London Metal Exchange touched an all-time high of US\$9,392 per metric ton on 21st Dec 10.

We believe that with the QE2 effect setting in and tightening supply constraints on a number of metal categories, precious and base metals are likely to outperform in 2011.

Chart 4: Chinese PMI against Base Metals Price Index



Source: Bloomberg, as of 28 Dec 2010

The performance of base metals is likely to pick up in 2011 with the expansionary industrial demand in China as key driver.



Energy – Post-Recession High for Crude Oil Prices

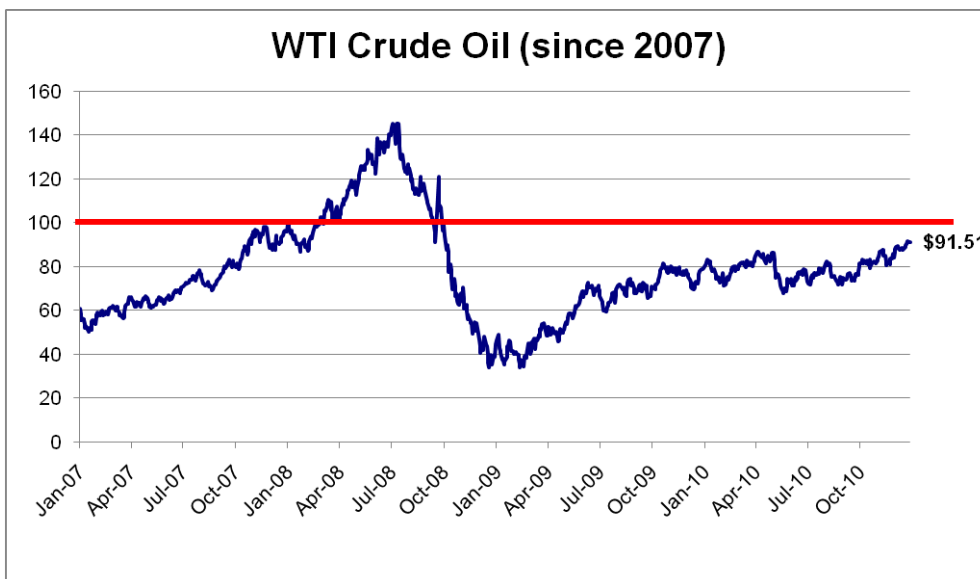
Crude oil prices had moved to new post-recession high ground in the last few weeks of 2010, after staying range-bound for most part of the recovery (See Chart 5 below). Prices had been making higher highs and indicators are that the trend is still solidly up. Although crude oil is marching higher as a result of increased demand, we view that any upside above the US\$100 per barrel mark is limited. The supply-demand balance is likely to stay benign in 2011 and that macroeconomic picture is likely to dominate energy prices as a whole.

On the supply front, supply growth is likely to match up with demand growth over the course of 2011. Energy Information Administration (EIA) projected that crude oil will stay at US\$89 a barrel by the fourth quarter of 2011. In 2011, EIA expects crude oil prices will average US\$86 a barrel. Recent upward revisions are based on the expectation that the world oil market should gradually tighten in 2010 and 2011, provided the global economic recovery continues.

As mentioned earlier, the QE2 initiated by the Federal Reserve is likely to provide an accommodative environment for commodities in 2011. So far, the rise in crude oil can be attributed to a weak U.S. dollar against G10, leaving room for further rise as emerging market currencies strengthen against the U.S. dollar heading into 2011. Though we do not expect crude oil prices to surpass the US\$100 per barrel mark in the near term, we do suggest investors to pay more attention to any surge in crude oil prices for 2011. A surging crude oil prices will create some tremendous imbalances in the global financial markets.

For the year 2011, we are positive on the overall commodities despite a decade of high commodity prices. We view a significant structural supply constraint as the key driver for higher commodity prices. In particular, the metals are likely to outperform within the commodity space.

Chart 5: Oil Broke Through the US\$90 per Barrel Mark



Source: Bloomberg, as of 28 Dec 2010

Crude oil is looking at the key resistance level at the US\$100 per barrel mark following recent breakout.



U.S. Treasuries Alert – Fed Reserve is the biggest owner of U.S. debt

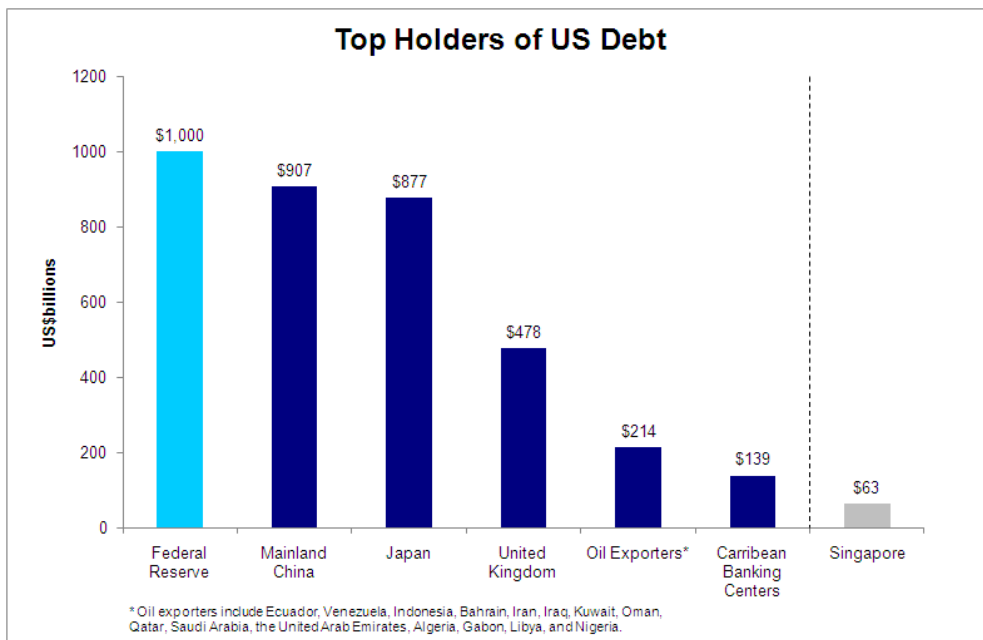
Almost certainly, the level of quantitative easing from the Federal Reserve did brought about one significant change so far: The biggest owner of the amount of U.S. debt is now the Federal Reserve itself. In the layman's term, United States can be deemed as lending money to itself.

As of end Oct 2010, the Fed's Treasury holdings have surpassed US\$1 trillion (See Chart 6 below). This US\$1 trillion mark does not include the more than US\$1 trillion in Mortgage-Backed-Securities and agency debts already held by the Fed. Many argue that the Fed is now the de facto purchaser of the many fixed income securities in its desperate attempt to bring down the rates.

With an additional US\$600 billion Treasuries purchase coming through mid-2011, the difference between the Fed and the second largest holder of Treasuries (Mainland China) is likely to surpass US\$100 billion. This gap is likely to increase at an average of US\$50-70 billion a month, and it will not stop.

As the saying goes, increasing the supply of credit to boost the domestic GDP growth and employment is like leading the horse to water, getting the horse to drink is another matter. To add on, the inflationist and deflationist are likely to agree that further quantitative easing is not always beneficiary. In fact, further quantitative easing will only increase the inherent risk of holding onto Treasuries (which are supposed to be risk-free). What the Fed is doing may backfire one day. When that day does come along, the central bank will lose control over the rates, be it the inflation rate and interest rates. In any case, more is not always better.

Chart 6: Top Holders of U.S. Debt (as of end Oct 2010)



Source: Treasury International Capital, as of end Oct 2010

The Fed's Treasury holdings have surpassed US\$1 trillion, making it the largest owner of its own debt.



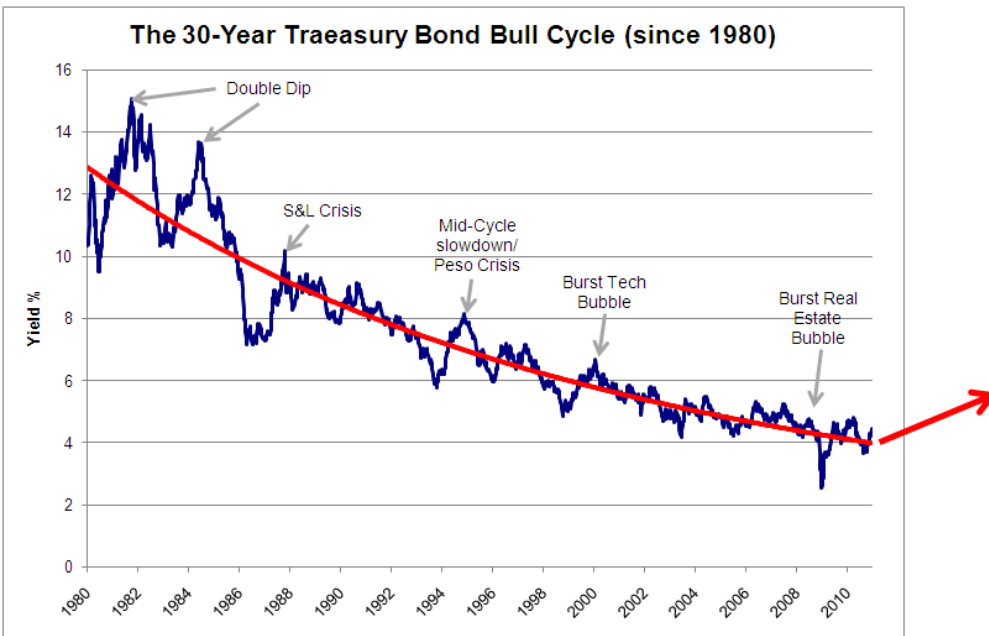
U.S. Treasuries Alert – Get Ready for a Rollercoaster Ride in 2011

The latest tax deal between President Obama and Congressional Republicans may be just the trigger point for a long term upward movement in yields. More tax cuts will only aggravate the federal deficit. As Washington continues to spend and borrow on its unfunded liabilities, investors will be inclined to demand higher rates on new long term bonds, making comparable securities issued earlier worth less in the secondary market. As a result, this heightened interest rate risk will most likely make the Treasuries a more risky investment moving forward.

Secondly, the global bond market itself (US\$91 trillion) is about 10 times the size of the global commodities market. In the scenario we start to enter the secular bear market in bonds, bond investments will start to flow into riskier asset such as commodities, pushing up inflation. Inflation is commonly regarded as a bane for bond investors. More money may move out of bonds into commodities and the inflationary cycle continues. Not the least, a possible debasement of the U.S. dollar (though unlikely at the moment) will make U.S. Treasuries even susceptible to higher volatility.

Lastly, for nearly 30 years, the bond market had been on an almost uninterrupted bull run as the 30-Year Treasury yields declined steadily from a high of 15.0% in the 1980s to a new low of 2.5% during the 2008 financial meltdown (See Chart 7 below for details). The question is: Have the US Treasury bonds yields (really) bottom out? If the answer is positive, it may be time to go short on the U.S. Treasuries.

Chart 7: The Long Term Decline on Treasury Yields to a Halt



Source: Bloomberg, as of 23 Dec 2010

The bond bull cycle since the 1980s on US Treasuries may be ending soon.

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