INVESTMENT OUTLOOK AND ASSET ALLOCATION

In the last quarter, we wrote about the improvements seen in the global macro backdrop. Not only were the US economic activity levels rising, but the situation in Europe had started to show signs of stability. Meanwhile, inflation stayed benign and this was positive for corporate profitability.

While the US data continued to improve, there has been a marked change in the European landscape. The anti-austerity mood that swept across Europe has triggered more talk of an impending breakup in the Euro zone, as voters support parties or candidates who preach populist policies.

This also heightened the macro uncertainty, and drove investors to stay on the sidelines. It is our view that markets will stay volatile as flows fluctuate in line with newsflow from Europe. For this reason, we believe that a neutral stance on risk assets is warranted in the current environment.

1. Capital flight from Spain threatens further instability

Although a possible Euro zone breakup is still a key risk, the attention is rapidly shifting to the flight of capital from crisis-hit countries. Already, Greeks have withdrawn some 3 billion euros from the country's banking system since its inconclusive election on 6 May, as savers fear Greece leaving the bloc and bringing back the drachma.

What is perhaps disturbing is that the panic has started to spread to the other countries, such as Spain, at the time of writing this report. Data released by Spain's central bank showed that some 97 billion euros had been pulled out in the first quarter of this year – about a tenth of its GDP – as concerns mounted over the country's ability to contain both the economic and financial crises.

If anything, the loss of confidence will also trigger further economic slowdown and exacerbate the financial crisis. When that happens, households typically cut back on spending and a vicious circle of falling incomes and spending then occur. The outcome is usually a recession.

Additionally, the issue of the longer-term stability and survival of the Euro zone continues to exert a pall over the markets. Certainly, there are textbook solutions to the problem, but none of them appears to be feasible or any less painful at the moment. And therefore, a number of investors now believe that the great European "divorce" is not a question of if, but when.

In our view, much still depends on the Greek election outcome on 17 June, and the EU leaders' response to sentiments on the ground. Essentially, the situation has evolved into a game of hawk and dove, and it is a question of which party is prepared to back down first.

If Germany is willing to compromise or if the Greeks are willing to accept some form of austerity in exchange for European Union ("EU") membership, then there is a good chance that the EU marriage will survive. If not, separation appears more likely.

In this case, it is useful to consider three scenarios.

One possible scenario is that Greece leaves the Euro zone in a disorderly way, namely defaulting on its debt, without receiving any assistance from the EU or the IMF. If it does not secure any form of financial support and exits, the economy will slump into a recession (possibly a depression?), and the "new" currency drachma will have to depreciate by over 50% to correct for the economic imbalances. And there is the foreign debt to pay off. It is hard to see how the country can ever get out of such a mess in the next five years.

The second scenario is a managed exit. Under this scenario, Greece receives debt forgiveness and funding from the IMF and EU to restructure the economy and keep the drachma afloat. This case is clearly more palatable than the first, but questions abound. Is there sufficient political will to help Greece once it leaves? How much support should the country receive from the EU? And thirdly, how should support for Greece be balanced between preventing a disorderly exit and keeping exit an unattractive option for other peripheral members?

The best case scenario is a muddle-through scenario in which both Athens and the Troika reach a compromise. In this case, Athens carries out austerity to correct the imbalances in its economy and raise competitiveness, while foreign investors forgive its debt. Hopefully, this measured approach will help lift the country out of its economic mess over time.

2. Impact of European banks' deleveraging on Asia

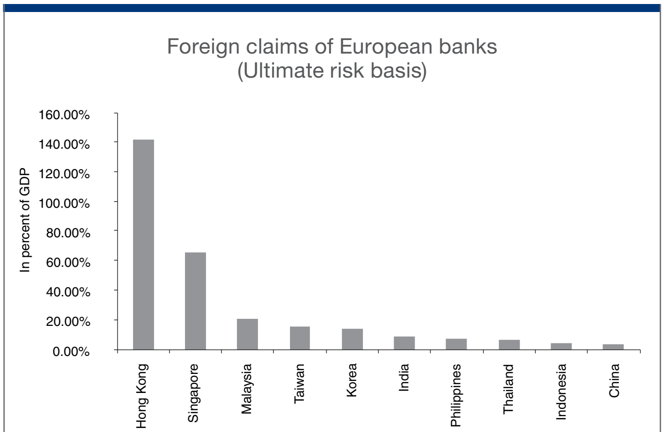
As an Asian-based house, we acknowledge the huge structural improvements made in the region since the 1997 Financial Crisis, and continue to believe the longer term Asian growth story. However, we also recognise that much of Asia's economic growth over the past three decades had been fuelled by growing international trade, and therefore a banking crisis-cum-recession in Europe will definitely have negative repercussions on the region.

But which Asian markets are most exposed to a banking crisis in Europe? To answer this question, we rate the emerging Asia countries on three fronts. The first front is each country's exposure to a European banking crisis. This can be measured by the amount of European bank claims on a country as a percentage of its GDP. Intuitively, the higher this percentage is, the more likely it is for the emerging economy to be affected by a banking crisis in Europe.

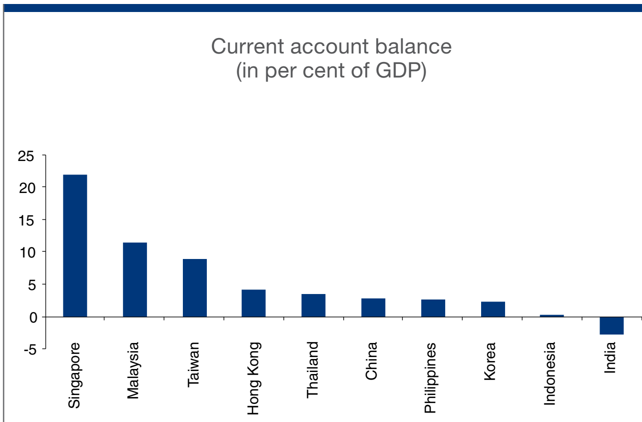
In this regard, we note that Hong Kong, Singapore, Korea and Malaysia appear more vulnerable than their Asian peers, while China and Indonesia are best placed to weather a banking storm in Europe.

Among European banks, UK banks have a particularly significant presence in the region. To some extent, the large local deposit base of banks such as HSBC and Standard Chartered helps cushion them from funding pressures originating in the euro zone.

For most economies in the region, the nonbank private sector—businesses and households—is the main recipient of credit from foreign banks as a whole, based on IMF data. Trade credit may be particularly vulnerable to deleveraging, given the prominent role of European banks in this area. That said, most countries do not have significant direct exposure to the Euro zone banks, and therefore, the fall-out may not be as bad as commonly thought.



Source: BIS, IMF, 11 June 2012

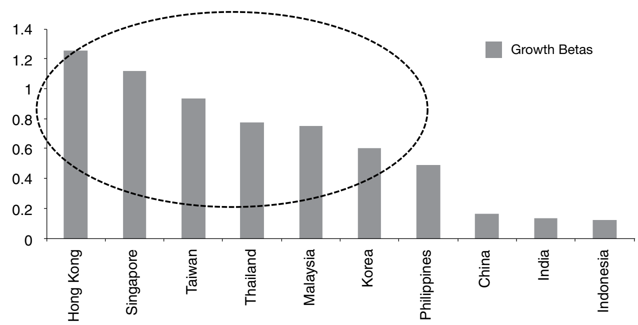


Source: Bloomberg, 11 June 2012

A second channel through which a serious Euro zone crisis can hit Asia is capital flow. In this case, a stronger current account balance (as a percentage of GDP) means that a country is better able to withstand a sudden pull-out of hot money. Although Singapore and Hong Kong fare better in this regard, we note that the EU is a major trading partner for both countries and that these economies are highly leveraged to global growth.

This is clear when we look at the "growth betas" (or sensitivity to a percentage change in G3 growth) for the Asian economies. We note that countries such as Hong Kong, Singapore, Taiwan, Thailand, Malaysia and Korea, and have significantly higher growth betas compared with the other economies. In particular, the first three may be hardest hit owing to the heavy reliance on trade as a driver of growth.

Asia-6 more leveraged to global upswing, compared with remaining four



Source: Bloomberg, 11 June 2012

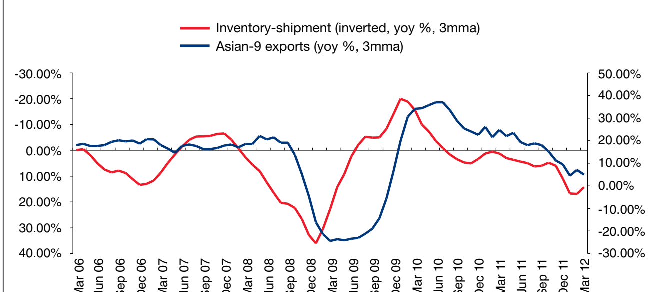
To sum up, we think that Singapore, Hong Kong, Korea and Taiwan appear much more vulnerable to a serious European banking crisis, while China and Indonesia are perhaps best placed to weather the storm.

3. But most of Asia is still in recovery mode

Fortunately, however, there is some evidence that Asia is now in the recovery phase of the business cycle. Since early 2010, growth has recovered from the lows seen in the previous year, while inflation across most of Asia is still benign. Although exports' growth in some Asian economies has moderated in recent months, there are signs that it may pick up again in the second half.

The rebound may occur partly on the US economic resilience, and the fact that intra-regional trade is still holding up. That said, much depends on the situation in Europe, and the assumption is the problems there do not blow up into a full-fledged banking and currency crisis.

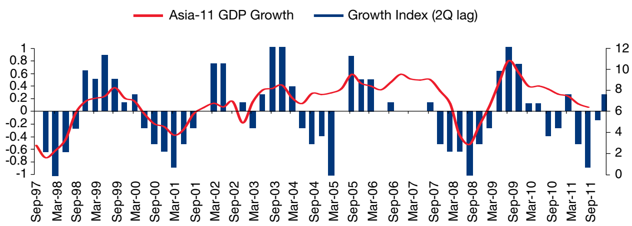
Asia-9 exports growth may have bottomed out



Source: Bloomberg, 11 June 2012

Our leading growth index for Asia points to a possible pick-up in economic momentum a quarter ahead, while inflationary pressures are still benign across the region. This puts Asian economies in the recovery stage of the growth and inflation cycles – a phase that historically favors equities and other risky assets.

Asian growth may pick up soon



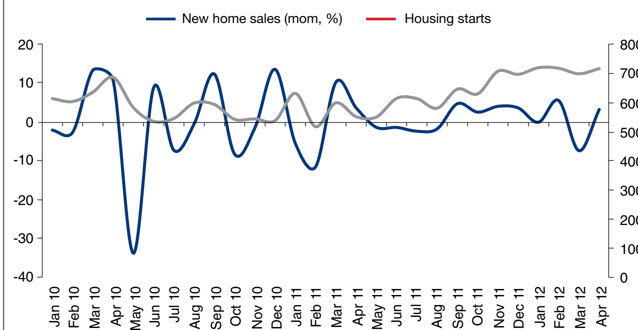
Source: Bloomberg, 11 June 2012

4. US economy holding up

Despite the storm across the Atlantic, the US appears be far more resilient than commonly thought. Indeed, US consumers have benefited from improved job growth along with further income gains reinforced by moderation in the overall pace of consumer price inflation.

Recently, as a sign of better consumer times, there has been a pick-up in the pace of light vehicle sales, suggesting better consumer incomes and confidence. Business equipment investment should also continue to support the domestic expansion as this sector remains an above-trend contributor to growth.

US housing market shows signs of improvement



Source: Bloomberg, 11 June 2012

Meanwhile, the important US housing market has been surprising on the upside, and that lends confidence that the world's largest economy is finally on a path of sustained recovery. In fact, the current housing sales level of over 300,000 is still below the normalised rate of 600,000 to 800,000 levels. Therefore, there is still substantial upside once the housing market normalises to historical levels.

Inflation should moderate in the year ahead as commodity and producer price inflation slows and unit labor costs remain tame. Indeed, the recent correction in oil and other commodity prices mean that the pass-through effects to headline CPI inflation will ease.

Perhaps the bigger issue ahead for the US is the "fiscal cliff" looming in the horizon. According to the Congressional Budget Office, expiry of the Bush-era tax cuts with a scheduled round of automatic spending cuts would drive the US economy down by 1.3% in the first half of 2013. Last summer's debt and budget agreement imposed almost US$1 trillion in cuts to agency budgets over the coming decade and required automatic cuts of about another US$1 trillion. The uncertainty over this issue represents an overhang for the market, and will affect market performance in the second half of the year.

5. Assessment

In summary, the economic outlook in the developed world has worsened. Europe is now caught in a political deadlock and voters in the periphery attempt to fight austerity measures demanded by Germany. The problem has now gone beyond pure economics, and is now a major political issue. At stake here is the future make-up of the Euro zone and the spillover onto the rest of the world.

Meanwhile, the uncertainty has clearly dented activity levels elsewhere as exports' growth in Asia slowed. Meanwhile, some investors have chosen to stay on the sidelines, while some exited the markets.

In our view, it is unclear if the troubled members will leave the union this year, but what is certain is that a disorderly exit will have catastrophic consequences on several economies and financial markets.

While there are compelling arguments that the European leaders will eventually get their act together (not least because a breakup is costly), the fact is that politicians (and voters themselves) may sometimes opt for solutions that are not mutually beneficial. Seen in this light, it becomes clear that there are no easy solutions to this problem.

Against this backdrop, we recommend a neutral weighting in equities, on the lack of clarity on the European political situation. The economic and credit crisis has evolved into a political issue, and it is unclear how it will all pan out.

Within fixed income, we raise the underweight in government paper, as the segment pales in comparison to high yield corporate credits in the developed markets. Meanwhile, we also reduce the overweight position in investment grade corporate credits on the back of a more sustained economic recovery in the US.

In emerging markets, we retain its overall overweight relative to developed markets. Within the group, we like Asia and Latin America, but avoid Africa and Eastern Europe at the moment.

ASSET ALLOCATION

	Conservative	Change from 2Q 2012	Moderate	Change from 2Q 2012	Growth	Change from 2Q 2012
Equities *Slight Overweight*	45%	1%	55%	-5%	70%	5%
Bonds *Remain Underweight*	42%	0%	38%	4%	20%	-5%
Commodities *Overweight*	5%	1%	5%	0%	9%	0%
Cash instruments *Overweight*	8%	-2%	2%	1%	1%	0%

Note: The neutral Moderate benchmark weights are Equities 55%, Bonds 38%, Commodities 5% and Cash 2%.

We are neutral in our asset allocation.

Equities – Downgrade to Neutral
Macro uncertainty, slower GDP growth, and event risks are not supportive of risk assets.

Fixed Income – Neutral
Flight to safety favours safe fixed income instruments, but a risk-on mode may trigger sell-offs. As the macro backdrop is highly uncertain, we opt to stay neutral.

Commodities – Neutral
Like equities, commodities rise and fall in line with the economic cycle, and the uncertainty is clearly weighing on prices here. As the odds of a downturn or upswing are unclear at this point, a neutral stance is warranted.

Neutral position in Equities

The global macro climate continues to be cloudy. While the US economic data have improved, the situation in Europe has clearly and significantly worsened. The wave of anti-austerity that is now sweeping across Europe is complicating matters, as voters in the troubled countries demand a re-negotiation of the rescue pacts.

The political deadlock between Germany and the troubled members means that the likelihood of a Euro zone breakup (beginning with Greece) has now increased. But what is at stake here is not just the size of the Euro membership, but the contagion across the rest of the continent.

As Europe is a major trading partner for most Asian countries, the threat of a debt, banking and political crisis on the continent is weighing on exports' growth and could potentially trigger a serious economic downturn in the region.

Weighing the balance of probabilities is difficult, and therefore, we prefer a neutral stance on equities.

The **US** economy is proving to be far more resilient than commonly thought. The nation-wide indicators such as Michigan Confidence, ISM and jobless claims are holding up, even though the regional Purchasing Managers' Indices ("PMIs") have moderated. Overall, we think that the US is possibly the only beacon of hope in the developed markets, and stocks there should hold up better than in Europe or elsewhere.

In **Europe**, a recession appears inevitable. Leading economic indicators have turned down, as the continent seeks to contain a worsening banking and capital account crisis. The political deadlock between core and peripheral countries further complicates the situation, and therefore, an underweight here is definitely warranted.

For **Japan**, exports have been recovering moderately, but they could decelerate if external conditions worsen. Meanwhile, earnings revision momentum has turned negative again after four months of strong uptrend. We think that the turnaround may occur only in July after companies release Q1 results and review their forecasts.

We have raised our overweight in **Asia ex Japan**, owing to the better fundamentals and attractive valuations. However, we note that the growth cycle in Asia is rapidly shifting down, and an external shock such as a Greece exit could deal a severe blow to the region's near term prospects. On balance, we maintain an overweight in Asia relative to the developed world.

We continue to like **Latin America** for its strong domestic growth. The region continues to offer strong long-term investment opportunities for equity investors. We remain overweight in Latin America.

Asset Allocation	3Q 2012 Recommendation	Benchmark
Equities	**55%**	**55%**
US	52.5%	47.9%
Europe	18%	22.6%
Asia ex Japan	10.5%	9.4%
Japan	6%	7.8%
Australia	2%	3.1%
Canada	3%	4.3%
Latin America	6.5%	2.8%
EMEA	1.5%	2.2%

EMEA – Europe, Middle East and Africa

Neutral position in Bonds

Developed markets' governments bonds may face further headwinds as the debt troubles in Europe continue to fester. Even as the analysts debate over the likelihood and mode of a Greece exit, there are now growing signs of financial contagion infecting the other members of Euro zone. Spain has now been cut off from the credit markets, as the country seeks to stem a flight of capital from its shores. Our view is that the headwinds are formidable, and the risk premium priced into European government bonds will likely grow bigger. For this reason, we are underweight in government bonds in the developed markets.

Instead, we take a more constructive view of investment grade credits which are not only safe havens, but offer higher yields than loans to governments that are struggling with fiscal problems. Our cautious stance also led us to underweight high yield credits which may be sold off during periods of extreme stress.

Emerging markets is still our preferred region, thanks to the supportive macroeconomic environment. The region that we prefer is Asia. Asia is still head and shoulders above its peers in terms of growth profile and credit standing. Latin America also stands out for its relatively positive backdrop. We are underweight in Africa and Eastern Europe.

Asset Allocation	3Q 2012 Recommendation	Benchmark
Fixed Income	**38%**	**38%**
Developed	***30%***	***70%***
Government	40%	71%
High Grade	55%	21%
High Yield	5%	8%
Emerging	***70%***	***30%***
Asia	33%	30%
Latin America	32%	33%
CIS/EE	25%	27%
Middle East/Africa	10%	10%

CIS – Commonwealth of Independent States
EE – Eastern Europe

Neutral position in Commodities

We continue to hold a neutral weight in commodities. Recent data points to a softening in the global economic outlook and this suggests two possible scenarios. Our base case assumption is that the recent weakness in economic data is temporary, as we see nascent positive trends in US housing and unemployment, while China benefits from easing credit conditions.

However, if global economic data remains weak, we believe that the US Federal Reserve and other monetary authorities will take coordinated policy steps to boost activity. This comes as the contagion from the Euro zone is now seriously infecting other members, and policy makers have to deal with the sovereign debt crisis, declining economic activity and worsening banking conditions.

Yet a growing number of policy options is now under discussion, with most involving expanded support efforts via the European Commission and the European Central Bank (ECB). The uncertain economic outlook has already resulted in weaker commodity prices, with prices now appearing reasonably valued for all but most pessimistic deflationary developments. The commitment of policy makers makes such developments unlikely.

We maintain our overweight position in **Gold** given continued strong physical demand. The latest quarterly update from the World Gold Council shows that central banks remain sizeable aggregate buyers, that China has now overtaken India as the main retail market for physical gold, and that private investors have continued strong investment in both physical gold and gold Exchange Traded Funds (ETF). Monetary policy stance remains accommodative in all of the main global regions, with negative real interest rates likely to continue into 2013. Although gold-related equities have underperformed relative to the physical gold price, gold producers are producing record levels of operating cashflow and look inexpensive on a historical basis.

Within the **Energy** space, we retain an overweight position in Crude Oil and a neutral position in Natural Gas. Crude oil prices have fallen in recent weeks with a reduction in Iran-Israeli tensions and normalisation of Libyan oil production. However, the ongoing fighting in Syria suggests that tensions could increase again at any moment. In addition, there are growing signals that Saudi Arabia has raised its minimum target oil price from US$80 per barrel ("/bbl") towards the US$100/bbl level, in order to support increasing domestic budget expenditure. While US natural gas prices remain at depressed levels, there are increasing signs that prices have now bottomed.

We stay with a neutral weight in **Bulk Commodities** and a predominantly underweight position in **Base Metals**. Chinese steel production has rebounded to the robust levels seen in 2011, with steel inventories falling to normalised levels. Chinese iron ore producers continue to have relatively high production costs, meaning that Australian and Brazilian producers continue to benefit from robust profit margins. Chinese and Indian demand for seaborne thermal coal remains at high levels.

However, coal prices have fallen due to increased US export supply as increasing numbers of US customers switch to cheaper natural gas. With the exception of copper, base metals prices remain at subdued levels. Continuing low inventory levels mean that copper prices have the potential to benefit from stronger 2H12 industrial production levels in China and the United States.

We continue to underweight **Agriculture**. The continuing absence of weather-related shocks means there is no near-term probability of a supply squeeze in the agricultural complex. Early projections for 2012 harvests remain positive. We will monitor our agricultural exposure and react to negative weather-related developments in the main export producing countries.

Asset Allocation	3Q 2012 Recommendation	Benchmark
Commodities	**5%**	**5%**
Gold	30%	25%
Base Metals	15%	20%
Agriculture	15%	20%
Energy	40%	35%