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ASIA INTELLIGENCE

Manulife Asset Management's regular roundup of market views from our investment teams on-the-ground in ten markets across Asia.

Asia Markets' Viewpoint

Linda Csellak assesses Asian markets – some stocks in particular – that are expected to push through current inflation jitters to end the year higher. Taiwan, South Korea and Indonesia stand out as opportunities.

Mid-2011 finds Asian equities in much the same situation as they were in a year ago, having gone through a slow economic patch over recent months. Both inflationary and growth concerns have been foremost in Asian investors' minds. Yet the Asian markets have still posted a positive return at the year's midpoint. Companies are still performing despite higher interest rates in a number of markets. While Asian markets may remain jittery over the short term, with economic data coming in mixed, we expect to see them higher by the end of the year. And we expect certain stocks to close the year meaningfully higher: those which deliver on the earnings front. Indeed, the best-performing stocks year-to-date are those that have reported better-than-expected earnings.

Countries where we maintain an overweight are Taiwan and South Korea. We like both markets, but for different reasons. In Taiwan, improved cross-strait relations with China have ushered in a renaissance of domestic consumption on the island. Although Chinese group tourists have been permitted for a number of months, the first batch of tourists under the Individual Travel Scheme landed in Taiwan only in early July. Rentals are hitting all-time highs, luxury department store sales are surging, and bank loan growth is benefiting from

increased corporate confidence. Starting in the mid-to late 1990s, Taiwan experienced over a decade of hollowing out of the domestic economy as companies relocated to China in search of better growth. Not so any more, as non-tech manufacturing businesses are returning to Taiwan, and wages are rising. We are fans of domestic stocks in the construction, hotel, banking, and department store sectors.

South Korea Cheap, Globally Competitive

Although Korea has historically been regarded as Asia's most cyclical market, we like it for its globally competitive companies and inexpensive valuation. We believe the Korean growth story is a genuinely structural one. Companies in the technology, auto, shipbuilding, engineering, and construction sectors are gaining share on a global basis, and a number of them earn higher margins than their global peers. The smartphone and tablet component companies will benefit from new product launches in the second half of the year. Technology, a big underperformer thus far this year, is likely to report an improved earnings trend in the second half. We also like companies in the consumer discretionary and construction sectors.

Another market we are watching closely is Indonesia, where inflation appears to have peaked, despite continuing healthy growth. We consider this a relatively untapped market in Asia with strong potential. The economy is expected to see 6% growth this year, and income levels in the country are rising on the back of high agricultural and coal prices. This is expected to translate into strong domestic consumption in the country. Additionally, Indonesia is seeing more foreign direct investment inflows as multinationals move their production base from China to Indonesia to lower their costs and capitalize on the country's burgeoning consumption power. As the attainment of investment-grade status grows ever closer, the cost of capital will decline, and equities will further appreciate.

Finally, India is a market where we have had a change of heart. The catalyst was the government's lifting of the prices for kerosene, diesel, and cooking gas in late June. Early this month, the Environment Ministry lifted its environmental restrictions on the expansion of several coal mines. Both actions indicate that the policy paralysis plaguing the government is easing. We expect inflation to peak later this year, and monetary easing to start early next year. We have reduced our underweight in that market, as stocks have come back to more attractive levels.

Endre Pedersen explains how Asian bonds continue to offer value, particularly in credit. A standout is Indonesia, where good yields, robust sovereign fundamentals and a well-developed market entice foreign investors.

Asian bond markets continue to offer value. Performance year-to-date has been relatively benign, with the JACI (JP Morgan Asian Credit Index) having returned just under 3%, lagging developed credit markets. Heavy issuance is part of the reason; rising corporate governance concerns within China are another. Near-term, we see value primarily in Asian credit, although there is value in Asian currencies as well. We also like select interest rate markets; however, there is a need to be discriminating here, given our view that rates are still likely to rise in some markets.

Indonesia is a compelling part of the Asia bond story, and being a country where we expect to pick up double-digit returns in 2011, it is one of our preferred markets in the region. On a relative basis within Asia, there is no other country with better yield levels and potential for currency appreciation than Indonesia. On an absolute basis, Indonesian yields alone get investors close to high single-digit returns. Similar to our expectations for the region as a whole, we also expect the currency to continue to gradually appreciate. The Indonesian credit market has produced some attractive corporate issues, both in U.S. dollars and the local currency.

The rupiah has been on an appreciating path, and we expect that to continue, as the currency has been flagged by the Bank of Indonesia as one of the tools to combat imported inflation. However, the inflation

concerns that domestic Indonesian bond investors share matter less for foreign investors. Foreign investors look at what they can earn converted back to U.S. dollars, and these investors are not affected by domestic Indonesian inflation.

Indonesian Market Liquidity Up

Liquidity in Indonesia's sovereign bond market is also increasing. In addition to domestic brokers and market-makers, there are also a handful of large international banks that are supporting and driving improved liquidity from foreign investors. Foreign holdings have reached a value of 225 trillion Indonesian rupiah (US\$26 billion), or 33% of overall outstanding government securities. The daily average traded volume is now around \$225 to \$400 million, with bid-offer spreads of 25-100 cents, and as tight as 30-40 cents on good days recently. A supportive central bank, the Bank of Indonesia, has assisted the market well, encouraging foreign investors to participate in the bond market rather than in short-dated bills. Indonesia has a fully developed yield curve, offering bonds out to at least 30 years, with tradable issues available across the yield curve.

The Indonesian curve is one of the steepest in the region, and we expect that as the global hunt for yield and returns continues, Indonesia is likely to become a more important part of investors' portfolios. We remain positive on Indonesian yields, expecting yields to fall further. We expect to see a "bull flattening" as further demand for long-dated bonds pushes the yield curve flatter over time.

Sovereign Upgrade Possible

Indonesia has over the past years been prudently fiscally managed, which has further been underpinned by strongly growing foreign reserves. Foreign reserves have now reached more than US\$100 billion (\$116.5 billion as at May 20, 2011), and if this continues, we see the potential for a sovereign rating upgrade in the not-too-distant future. This would make Indonesia an investment-grade country and would have a significant impact on Indonesian companies whose bonds have been affected by the country-level ratings ceiling. An upgrade could also provide potential for long-term

inclusion in global market indices, as well as for an expanded group of foreign investors who could then invest in Indonesian debt.

One major question mark confronting Indonesia is the next steps the country needs to take to develop its economy and grow at its full potential. To fully realize potential, Indonesia is expected to need to aggressively increase infrastructure spending over the next decade. However, we do not see this happening as quickly as some market participants do; from a bond investor's point of view, this is positive, ensuring that Indonesia will retain its fiscally solid position.

Greater China Markets' Viewpoint

Terrace Chum examines how China appears to engineering a 'soft landing' and Greater China equity valuations are attractive.

Chinese inflation accelerated in May to an above-expected, 34-month high of 5.5%, providing ammunition to those observers who fear China risks a hard landing. While we remain alert to the risks, we are not as concerned about rising inflation as we were in the first quarter of this year. In one sign of easing growth (and inflationary pressure), China's Purchasing Managers Index (PMI) fell to 52.0 in May from 52.9 the previous month, and from 53.9 this time last year. Meanwhile, the Consumer Price Index (CPI) rose to 5.5% from 5.3% year-over-year (y-o-y) in April, and is expected to peak in the coming months. As we expected, the reserve requirement ratio (RRR) was increased by 50 basis points during May - the eighth increase since October - causing tighter liquidity and weaker economic activity.

China has been tightening aggressively since the end of last year, and we expect a few more measures, such as lending quotas for various sectors and perhaps a further rise in domestic banks' RRRs. Recently, however, more lenient lending to small and mid-size enterprises (SME) is evidence that the government is loosening the monetary reins in some areas in order to engineer a soft landing. With growth slowing and inflation still on an uptrend, the Chinese economy is at a critical juncture. We don't share the widely held worries about a hard landing combined with continued inflation fuelled by rising food prices. We expect the market to be volatile until

investors gain confidence that inflation's peak is within sight and a soft economic landing is being engineered; such an outcome could see strong market performance in the latter part of the year.

Market at 10-Year Lows

The market is currently valued at about 12 times current-year earnings, compared with an average in the past 10 years of about 15 times. Turning to sectors, in the summer months, we are looking at cutting back on industrials and commodities due to current high inventories and focusing more on domestic consumption-related sectors such as apparel and jewelry. Strong domestic consumption is boosting the Hong Kong property market, and specifically investment properties, illustrating the reach of mainland Chinese investors.

Another sector we are now underweighting is the financials sector, mainly banks. Even though Chinese banks are considered inexpensive, we are cautious, due to anticipated selling by strategic shareholders and a heavy upcoming schedule of initial public offerings that will bleed liquidity away from listed companies.

The impact of Japan's March earthquake on Taiwanese supply chains appears to be ending, and this may open up opportunities in the technology and automobile sectors. Continued high demand for smartphones and tablet computers makes related sectors attractive in the second half of 2011 and, we suspect, beyond, as China's economy continues to grow.

Japanese Markets' Viewpoint

Hidehiro Tomioka discusses how now is the opportunity for equities in Japan, as they remain cheap despite some strong corporate fundamentals and the prospect of a sharp economic recovery.

The Japanese stock market has been doing fairly well after the sharp drop triggered by the earthquake. Post-earthquake economic indicators were hurt by curtailed production due to impaired supply chains and production activities resulting from power shortages. The market consensus is that in fiscal 2011 (ending March 2012), real GDP will be

held down to around 1%. However, we expect Japanese economic growth to make a V-shaped recovery during the second half of the fiscal year, due to reconstruction activity.

One sign that this may happen is the faster-than-expected restoration of supply chains and of production, particularly in the automotive and electronics industries. The Japanese automobile industry has surprised the market with the speed of its recovery. We initially expected full production recovery only by the second half of the 2011 fiscal year, but the news reports are that utilization had already returned to 80% in June.

For example, Toyota only restarted domestic production on April 18, but said on May 11 that production would be at 70% of normal by June. The company initially predicted a return to normal pre-earthquake production levels by November, but interviews with Toyota suppliers indicate this could now be accelerated to September or October. The market consensus currently forecasts that this could even move up to August.

We view fiscal year 2011 guidance issued by Toyota and Honda as somewhat conservative and expect some positive surprises in the second half of the year for the Japanese equity market as such companies announce a succession of upward revisions in official earning forecasts or production schedules. The demonstrated strength and resilience of Japanese manufacturers following the earthquake may be a positive catalyst for investing in Japanese equities.

V-Shaped Earnings Recovery Possible

With the earthquake fairly seen as a one-off event, corporate earnings are also expected to have a V-shaped recovery once current production and consumption disruptions end. Reconstruction efforts will further boost the earnings of many companies towards the end of the fiscal year. Consensus expectations are that fiscal year 2011 profits will rise in the electrical appliance, machinery, and wholesale trade sectors and decline for transportation equipment, electric power and gas, and land transportation, among others. The fiscal year 2012 outlook is even rosier, with expectations of across-the-board double-digit profit growth on sales gains. Automotive players are expected to see a particularly strong recovery in profits.

The market sell-off following the earthquake has put the Japanese market at compelling valuation levels, relative to history and global peers, by just about every valuation yardstick, whether price-earnings, price-book, or EBITDA multiples. Given the prospective surge in profit growth and production activities towards fiscal year 2012, we believe the present is a timely opportunity to invest in some very good blue-chip stocks with high growth potential and high overseas exposure.

Keisuke Tsumoto takes a look at how Japan's fixed income market reacted to the earthquake

As Japan's disastrous earthquake and tsunami fade into the past, the economy is expected to return to a moderate recovery path as production activities regain momentum. Thanks to continuous efforts by Japanese manufacturers, supply-side constraints have eased faster than the market had initially expected. As these conditions improve further, we believe household and business sentiment should pick up also.

The downside risk to this outlook is the shortage of electric power, not only in the Greater Kanto region around Tokyo, but possibly nationwide, with the prospect that the country may need to shut down all nuclear power plants due to ongoing safety concerns. Regional governments have been reluctant to restart plants that have been shut down for regular inspection, and this could eventually affect all the nuclear power generators in Japan, if the sentiment continues.

This would be very negative for the Japanese economy, as the cost of alternative power generation would be higher, translating into higher costs of production and services, and lower profits for Japanese companies. If shortages dragged out, manufacturers would consider shifting production overseas and global companies would avoid investing in Japan.

Bond Yields to Remain Low

We expect the 10-year JGB yield to range between 1.0% and 1.5% for the rest of the year. As funding demands from Japanese corporations are very low,

even on an aggregate level, Japanese financial 20 GLOBAL INTELLIGENCE institutions are investing in JGBs, contributing to low Japanese long-term yields.

After the earthquake, credit spreads for Japanese corporations widened sharply, and the corporate bond market did not function at all for about a month, until some major banks returned to the primary market. As the second quarter progressed, other issuers returned to the primary market and have met even stronger demand than before from investors. By the end of the second quarter, credit spreads for most Japanese industrial and financial names had recovered to pre-crisis widths, and were even tighter for some names.

The exception was electric power companies, which saw spreads widen further during the quarter. Tokyo Electric Power Company (TEPCO), which owned the nuclear reactors hit by the earthquake, and other power companies with nuclear operations have been unable to issue bonds and continue to rely solely on bank financing. (The exception is Okinawa Power Electric, which does not operate nuclear facilities.) This has had a marked effect on the Japanese financial system, since bond issuance has traditionally been the primary source of finance for electric power companies, and the utility sector is the largest component of the Japanese corporate bond market.

It will take a long time before these companies will be able to issue bonds on a regular basis. TEPCO has not yet finalized the total amount of disaster compensation it will have to pay out, as radiation continues to leak from its plant. Still outstanding legislation on the disaster relief plan and questions surrounding the future of nuclear power in Japan introduce other uncertainties. Investors should await further developments regarding electric power companies. Otherwise, many domestic credits have become too rich in price, requiring selective investment in domestic bonds and yen issues of foreign issuers.

Singapore Markets' Viewpoint

Cheng Duan Pang discusses Singapore's rising inflation and what the results of the recent general election could mean for local residents.

After registering a strong growth of 9.3% y-o-y in 1Q 2011, 2Q growth came in much weaker at 0.5% on the back of sluggish external demand. At the same time, June CPI spiked to above the 5% level again after showing some signs of peaking in previous months.

The Monetary Authority of Singapore (MAS) has revised its 2011 CPI forecast from 3-4% to 4-5%. Although MAS tightened its monetary policy again in April 2011 by "re-centering the exchange rate policy band upwards" allowing the Singapore Dollar (SGD) to strengthen further, the revised inflation forecast has increased the probability of fresh monetary tightening policy in October, when MAS will release its monetary policy statement. Even if MAS does not implement further tightening monetary measures, we expect them to keep the SGD on a strengthening bias. And with a weaker than expected global economic recovery, Singapore's growth could be lower than the 5-7% that we had originally forecasted.

The general election 2011 (GE11) was held in May and it turned out to be a watershed event for the People's Action Party (PAP) - the ruling party of Singapore since 1957. Out of the 81 seats contested, PAP lost 6 seats to the Workers' Party (WP). PAP only managed to garner the support of 60.1%, the worst in history, although a 60.1% is a resounding victory by any international standard. This is a drop of 6.5% of votes, compared to the previous general election. Two ministers were voted out, including Foreign Minister, George Yeo, a heavy weight and widely considered as a progressive politician and reformist. Although PAP has spearheaded the economic success of Singapore over the last half a century, younger voters are increasingly looking for a more consultative type of government.

After the election, Prime Minister Lee Hsien Loong announced sweeping changes to the cabinet makeup, mainly the stepping-down of key ministers which we see is a sign towards greater accountability as they were criticized for not handling the home affairs, public housing and public transportation issues well. Finance Minister

Tharman Shanmugaratnam has been promoted to Deputy Prime Minister and the minister coordinating economic and social policies. We view his appointment as positive as he is widely seen as someone who is willing to speak up on issues and able to accept differing opinions. Four newly elected members of parliament, including former MAS chief Heng Swee Keat are given office appointments which we think is evidence that PAP is likely to pursue "inclusive growth" ie, growth which will benefit most citizens, and that is more engaging and willing to listen to comments from the ground.

Amy Low assesses the outlook for Singapore's equity market and explains which sectors are likely to be affected by the rising inflation.

The 2nd quarter GDP in Singapore rose a lower than expected 0.5% y-o-y (consensus expectations: +1% y-o-y). The economic slowdown in the second quarter was likely related to the disruptions to supply chains associated with the earthquake in Japan. Nevertheless, the slowing macro-economic indicators in the US as well as high debt levels and fiscal deficits in both the US and selected European countries continue to be a dampener on economic sentiment and could lead to slower growth for Singapore. The Monetary Authority of Singapore (MAS) in its annual report acknowledged that its 2011 GDP forecast of 5-7% was subject to downside risks.

The MAS has also announced a change in its inflation forecast from 3-4% to 4-5%. The lagged effect of higher commodity prices as well as rising wages and rental costs have contributed to higher inflation. As a result, we expect the SGD to be on a strengthening mode to mitigate inflationary pressures. Therefore, liquidity will be abundant with interest rates capped at low levels as a stronger SGD will continue to attract capital flows.

We expect earnings estimates which were downgraded in the 2nd quarter to meet expectations in the 2nd half but see limited scope for upgrades ahead with current uncertainties. Inflation and rising input costs remain a threat to earnings forecasts. Banks are expected to report better than expected earnings as we forecast loans growth to pick up while margin compression has largely been discounted. Singapore banks also meet the new and more stringent local Basel III requirements

without having to raise additional capital. REITs are expected to report better than expected earnings as rental reversions continue to trend upwards. Transport companies are expected to disappoint due to higher fuel and labor costs.

Indonesia Markets' Viewpoint

Yudhistia Susanto explains which sectors are attractive in Indonesia but that should be looked at with caution.

After a volatile month of June, the Jakarta Composite Index (JCI) gained +1.34% m-o-m and reached a new high level of 3888. Total performance during the 1st half of 2011 reached +5% year-to-date (YTD) in IDR terms and +9.92% YTD in USD terms, outperforming all of its ASEAN peers.

The recent global equity market performance has been mainly driven by two events; the Greece debt concern and the oil price volatility. As the market focused its attention toward a potential Greece default in July 2011, we saw a lot of sell off in global equity market during the first two weeks. The risk aversion trade also happened in the oil market, as the Brent crude oil price reached its lowest level in 2011 at USD 105 per barrel in mid June, down 10% from USD 116 at the end of May 2011. However, with the positive catalyst of Greece's Parliament medium-term fiscal budget and implementation plan approval, which brings assurance of another bail-out package disbursement from the European Union, risk seeking trade came back and drove the global market equity back to the higher level, reinstating consumer sentiment.

Domestic macro economic data shows a continued decline of inflation with June y-o-y down to 5.54%, which is the lowest level in the past year. Global food prices declined and a stronger currency has contributed a lot to this disinflationary environment. With 60% of Indonesia's GDP contributed by consumption expenditure, lower inflation will lead to higher disposable income and we believe this will create an expanding profit margin for consumer

related sector companies listed in the JCI. It is quite understandable that domestic related sectors in the JCI such as consumer discretionary, consumer staples, materials, industrials and financials have outperformed the market this year.

We believe that stable and improving domestic macro economic data will be vital in supporting the JCI performance for the remainder of the year. Although there are some risk concerns driven by: 1) the potential rising Treasury yield after the end of quantitative easing part two, 2) China economic slowdown impact on Indonesia's export commodity price such as coal and metals, we see that Indonesia's strong consumption story will be the special differentiating factor for a global equity investor.

Djumala Sutedja discusses why Indonesia is attractive to offshore investors.

Indonesian inflation were on the downside with July inflation figure released at 4.61% y-o-y, below the market expectation of 4.80% y-o-y and nearly a percent down from the previous month mostly due to base effect. The month-on-month (m-o-m) figure actually increased in July by 0.67% m-o-m from 0.55% m-o-m in the previous month, with the main driver being the increase in food prices attributed to seasonal factors as we get into a month of fasting. However pressure from food prices should not be a concern going forward as the government ensures sufficient food supply. As of July, YTD inflation reached 1.73% and full year inflation is expected to fall well within the Bank of Indonesia's (BI) 2011 inflation target range of 4-6%, indicating better macro management.

The bond market booked a positive return of 3.44% in July as indicated by the performance of HSBC Bond Index. July was the second best month in 2011 after month of March that returned 4.56%. Investment in the government bond market delivers a total return of 9.88% on YTD basis. This strong performance has been mainly driven by overwhelming offshore appetite for Indonesian government bonds that holding reached record high of Indonesian Rupiah (IDR) 248.8 trillion or 35.5% of total tradable government bonds as of end of July. Offshore investors are particularly attracted by

strong prospect of Indonesian economy and a strengthening IDR.

Although the IDR strengthened by 0.88% against USD in July, it has not been a great performer as it lagged other Asian currencies. The pace of the IDR strength slowed in the last couple of months however the outlook remains positive. Trade surplus for the month of June is still robust at USD 3.3bn. On a YTD basis the 1H2011 recorded surplus of USD 15bn compared to merely USD 9.6bn in the same period in 2010. June export rose by a robust 49% y-o-y against 28.3% y-o-y for imports. Foreign reserves also reached a new peak of USD 119.7 bn as of June indicating robust current account surpluses.

Eurozone debt crisis and US slowdown concern are still among the major issues that dictate global risk appetite. However unlike in the past, the Indonesian bond market has been at less risk to the negative sentiments in the developed market and in fact, during those periods the Indonesian bond market continued receiving investment reallocation from global investors. We think this pattern will continue as long as global policy makers are able to avoid systemic risk from occurring.

China Markets' Viewpoint

David Chen outlines what's going on in China's bond and equity markets.

China's concern of a 'hard landing' was eased after a better than expected GDP rate of 9.5% in Q2 was recorded. Inflation continues as the top concern in the economy with June's CPI inflation jumping to a new high of 6.4% and producer price index (PPI) inflation also stayed high at 7.1%. High food prices are the key driver of the rising inflation, especially the surging pork price. The CPI is expected to stay high in Q3 before the stabilizing of the price of pork, but we are likely to see it decline in Q4.

From the policy front, as inflationary pressures remain and growth is slowing only modestly, the government is expected to maintain its current tightening policy stance. The interest rate hike in

early July might not be the last one, and another rate hike can not be ruled out if the CPI stays at 6.4% or climbs higher in order to manage inflation expectation and reduce the gap of negative real interest rate.

The bond yields moved tightly during June but shifted up quickly in the mid of July. As of July 22, the 1-year government bond yield surged to 3.82% by 35bps from the last month-end, and the benchmark 10-year government bond yield rose to 4.09%, up by 20bps. We believe the bond market is mainly driven by liquidity. Particularly, the large movement of short-term yields highly reflected the tight liquidity condition in the market.

Besides the liquidity reason, the sell-off of mid-to-long-term bonds by trading portfolio also helped to push up the yield curve quickly. Investors' concerns on high and persistent inflation as well as credit issue of local government financing vehicle loans (LGFV) were the further catalysts of the curve movement.

The primary market was also impacted by the liquidity constraint. The new issue of 10-year government bond on 20 July was priced at 4.05%, higher than secondary offering but with relative low subscription ratio of 1.7x. Moreover, the Ministry of Railway's (MOR) 1-year commercial paper was first time undersubscribed, and China Development Bank (CDB) had to cancel its issuance of a 6-month discounted bill due to concerns on high financing cost.

Our view on the bond market is mainly driven by market liquidity. The yield curve is expected to stay at the current level before the easing of liquidity constraint in the market, especially the short-end. The long-end of current curve is somewhat overpriced in our view as long-term bond supplies are relatively limited in the market compared to short tenors.

The share market experienced a 7% rebound from June 20, when the index fell to a low 2611 while the Shanghai Composite Index currently trades at around 2700-2800. During the market rebound, those stocks in small to medium enterprises (SME) recorded significant outperformance. Technology, media & telecommunications (TMT), health care, consumption sectors rallied more than 9%, which we believe was mainly attributed to their pressed performance during

the first half of the year. At the same time, big-cap cycle names lagged during this period. Bank and energy sectors only rose around 2% with the concern on LGFV.

We expect the market index to continue to stay strong without much movement as market liquidity is not enough to trigger a big rally. Going forward, we will be paying close attention to the profit-taking pressure in the near term, particularly in stock in SME considering their strong performance recently

Taiwan Markets' Viewpoint

Karen Chang takes a look at the measures that the Taiwan government is introducing in efforts to rebalance the economy.

The Taiwan Stock Exchange (TAIEX) dropped 3.74% in June due to concerns of global economic growth combined with the overwhelming concerns about Europe also putting pressure on share price performance.

We are cautious about the technology sector, as even though smartphone and tablet product demand remains relatively high, we see LED, TV and solar demand facing some slowdown. Recent major tech company downgrades triggered market selling pressure among smartphones and semiconductor segments. Overall, we think that all sectors face pressure, in particular the technology demand, given the US unemployment rate remaining high at 9%. In addition, TV sales are expected to be lower due to weaker than expected demand. On the other hand, domestic consumption is relatively stable with auto sales better than expected. We expect auto sales to reach 360K, up 15.4% y-o-y in 2011 making it attractive.

The valuation of the TAIEX is at 15.3x 2011e and 13.3x 2012e P/E. The TAIEX now trades at 1.83x P/B, having bounced back from its previous low of 1.61x (June 2010) and above its long-term average of 1.70x on a trailing basis. We see the recent profit downward revisions putting an overall pressure on share prices in the third quarter. According to Morgan Stanley, MSCI Taiwan EPS growth is being

cut to 4% Y-o-y, down from 12% three months ago.

We will keep the current strategy of focusing on bottom up stock picks and high cash dividend policies. We believe investing in stocks with stable pay out ratios, positive free cash flows and better than expected earnings outlook are the best bet. Our views on tech sub sectors remain similar to last quarter where we saw Apple product supply chain outperform while LED and solar sectors underperform given weaker than expected demand.

Overall, we are positive on the financial sector as we continue to see a rerating cycle. Emerging M&A activities and the opening of new branches in China due to the Economic Cooperation Framework Agreement (ECFA) effect lifted valuation premium as it is now easier for Taiwan to export into China so we could see a lot of activity in this area.

Bryan Hsu examines the outlook for the Taiwan fixed income market.

As expected, the Central Bank of the Republic of China (Taiwan) (CBC) hiked policy rates by another 12.5bps. in June. Despite concerns about recent global issues, the CBC believes that inflation risks could still increase in the second half of the year although believes that raising policy rates could potentially help in cooling down inflation expectations. We could see the CBC continue with 12.5bps policy rate hikes before the end of the year.

The Consumer Price Index (CPI) increased 1.9% y-o-y in June, higher than 1.7% in May where food prices were the major driver due to the outbreak of plasticizer issues leading to higher fruit prices. Directorate General of Budget, Accounting and Statistics (DGBAS) forecasts that the CPI inflation is likely jump to 2.83% in the second half of 2011, potentially increasing Taiwan's 2011 CPI to 2.1%. However, core inflation remained stable at 1.2% y-o-y in June (vs. 1.2% in May) and is expected to remain controlled.

Exports increased 9.5% y-o-y in May, below April's 24.6% growth due to a high base effect. Exports to China increased merely 0.2% y-o-y in May, while exports to the advanced markets remained resilient.

Import growth also decelerated to 19.3% y-o-y (vs. 25.7% y-o-y) in May. We think exports are more likely to continue to show mild growth due to the high base effect. The shipment to China was 12.16%, compared to 16.78% growth to all regions and countries for the first half of 2011. We see no significant impact from the effect of the Economic Cooperation Framework Agreement (ECFA) and early harvest list. We believe the growth of export to China is more related to China's tightening policy. We think the further negotiation to broaden the scope and to add in more significant trade items for tariff concession would be the next key to drive the export growth to China.

Manufacturers remained positive and added headcounts expanding their capacity, while the unemployment rate was up slightly to 4.41% in May from 4.35% in April illustrated growing confidence. Furthermore, the booming tourism sector due to the opening of Taiwan's borders to independent Chinese travelers could provide significant job creation in the coming months and we believe the labor market is on a solid recovery path.

Malaysia Markets' Viewpoint

Chin Hui Tock explains why the oil and gas sector is a standout among the rest.

One of the key areas of focus under the Malaysian Government's Economic Transformation Program (ETP) is the oil & gas sector. There are about 12 Entry Point Projects (EPP) identified under this sector, aiming for a 5% annual growth rate, lifting the country's gross national income by RM 131.4bn by 2020. To date, this is by far the most active sector, making most progress relative to the other 11 sectors, considering all EPP's have commenced and are at various stages of progress. The government's ambition is to (i) have a more sustainable oil & gas production profile; (ii) enhance downstream/value added growth; (iii) position Malaysia as the No.1 Asian hub for oil and gas field services; and lastly (iv) build a sustainable energy platform.

Domestic capital commitment from Petronas Bhd (the national oil company) alone is about RM250bn over the next 5 years. We believe spending emphasis will be mainly in (i) the deepwater exploration activities (ii) marginal field developments (iii) Enhanced Oil Recovery based rejuvenation projects (iv) storage and trading hub and (v) downstream, value-added activities in petrol chemical and gas retailing. Hence, we see strong growth catalyst and multi-year re-rating for the Malaysian oil and gas service providers. We also see potential uplift in the local providers' technical capabilities as they expand beyond their traditional scope of work. This eventually may lead to another investment theme within the sector, i.e. consolidation / mergers & acquisitions for the required technology capabilities, capacities as well as track record and size.

Philippines Markets' Viewpoint

Aira Gaspar explains why the Philippines' economic recovery is expected to gain further traction.

Business sentiment remains sanguine despite near term headwinds coming from rising prices of oil and other commodities, remittance risk from the Middle East and North African (MENA) region and sluggish global economic growth.

Improving macroeconomic fundamentals have been providing a strong anchor to business sentiment. Positive structural changes such as the sharp reduction of government debt levels and continual domestic liquidity formation have supported a low interest rate environment amid rising inflation risk. In addition, better than expected fiscal performance has strengthened expectations of a return to a path of fiscal consolidation. Improving fiscal profile and strengthening external payments position underpin the recent credit rating upgrades gained by the Philippines amid an environment of worsening fiscal challenges in many developed economies.

While the government's prudent fiscal spending bias could limit the fiscal contribution to near-term economic growth, favorable business sentiment could provide the catalyst for a more solid economic growth. Reflective of strong business and investment activity, bank lending to

the manufacturing sector increased by 20.2% y-o-y in May while investment in durable equipment grew by 16.7% y-o-y in the first quarter of 2011.

The government's focus to increase infrastructure investment via public-private partnership could provide a potent spark for a more broad-based and sustainable economic growth in the medium term. While the implementation of the public-private partnership program has encountered delays, the strong interest from the private sector to participate in this government program is encouraging as it reflects the high level of confidence of the business sector in the medium-term growth prospects of the economy.

Thailand Markets' Viewpoint

Vasu Suthiphongchai examines the outlook for Thailand's fixed income market.

Following the election which we saw the majority won by Puea Thai (PT) (265 out of 500 seats) will ensure at least 3-6 months stability as it will take at least 1-2 months to select a PM and (her) cabinet. The government coalition will consist of 5 parties and command 299 out of 500 seats. So far, Thailand certificate of deposits (CD) have tightened by 20 bps after the election. However, medium-term political risk still remains from anti-Thaksin groups. The next possible obstacle is the military annual reshuffle in September as we believe the stability of the government will hinge upon how they approach the sensitive issues such as: Thaksin Amnesty and recuperation of THB 46 billion, Phra Viharn temple and border issues with Cambodia.

We expect to see the short-term yields rising faster than long-term yields with a bear-flattening bias on the back of concern over the Bank of Thailand's (BOT) stance and inflationary pressure stemming from "Populist Policies" while the long-end of the curve is supported by life insurance firms.

Populist policies by the new government will likely cost around THB 1.85 trillion over the next 5 years and probably delay the plan for the balanced budget from 2016 to 2018. These policies include

raising minimum daily wage from THB 159-221 to THB 300, hike minimum salary for graduates to THB 15,000, rice pledging program at THB 15,000 ton vs. market price of around THB 10,000-11,000, ten lines of mass transit trains and corporate tax cuts from 30% to 23%. These policies are quite inflationary. Thus, the BOT has already warned recently that sizeable fiscal expansion could prompt the central bank to raise its policy rate beyond what would otherwise be required to control inflation. The BOT and the National Economic and Social Development Board of Thailand (NESDB) are urging the new government to adhere to the budget deficit of THB 350 bn and the balanced budget within 5 years. In addition, the Ministry of Finance (MOF) announced that the government bond supply for Q4 FY2011 will amount to THB 125 billion, excluding the first issuance of inflation-linked bonds (ILB) of 20-40 bn., slightly higher than market expectation of THB 100 bn. Off-shore interest into the Thai bond market is still solid as foreign investors' holdings rose marginally and net bought THB 21.8 billion in June 2011 vs. THB 19.5 billion in May 2011. However, most of the investment focused on short-term bonds with below 1-yr maturity. Net holding by off-shore investors also declined slightly from THB 371 bn. to THB 368 bn. for the corresponding period.

Jintana Mekintharangur examines the outlook for Thailand's equity market and how the recent election could benefit certain sectors.

For the first half of 2011, the Stock Exchange of Thailand (SET) Index moved up 8.72 points or 0.84% from the end of 2010 to close at 1041.48. The market fluctuated greatly with the ebbs and flows of sentiment and foreign fund flows in response to internal and external factors ranging from economic, to geopolitics and natural disasters, but managed to crawl back by midyear. The market was driven by a strong domestic economy, with healthy domestic demand and earnings growth that surprised on the upside and attracted foreign fund inflow. The negative factors were mostly external – Middle East and North Africa tension, Japan's disaster, European debt crisis, China's monetary tightening – with the changeover in government dominating the domestic landscape.

We expect 3Q11 to be a honeymoon period for Thai politics after Puea Thai (PT) won an outright majority in

the election. Its decision to beef up the government seats to 299 - out of 500 seats - by teaming up with four other parties implies the government will be stable and able to roll out numerous populist policies. In addition, the implication of populist policies rolled out by Yingluck: 1) subsidies for farmers 2) raise minimum wages from THB 159 - 221/day to THB 300/day) could support both personal consumption and domestic spending. We recommend overweight on consumer play sectors like Banking, Commerce, and Property.

Vietnam Markets' Viewpoint

Mark Canizares explains why investors should remain positive about Vietnam's equity market despite short term challenges.

Macroeconomic concerns continue to be the main driving factor affecting investor sentiment for the Vietnam market. By the end of July, inflation had crept up to 22.16% y-o-y, after breaching the 20% level in June (20.82% y-o-y). Although still a long way from the high figures we saw in 2008, the question of whether it will taper off or reach the August 2008 high of 28.32% in the second half of 2011 is certainly on investors' minds. With the latest inflation clip, investor participation remains minimal in the equity markets as expectations that interest rates will remain high continue to coax local players to put their money into high yielding short term deposits.

On the back of this, we believe Vietnamese equity markets will remain lackluster in the short term, especially since interest rates are providing superior returns for now versus equity markets. Interest rates on short term deposits currently yield 14% pa (as of June 2011). The sense that we get here on the ground is that retail investor sentiment – which is still generating the bulk of the activity in the local market, is likely to remain negative, given the lack of positive catalysts.

Earnings season is likely to give the market some direction. Unexciting numbers are expected for most of the residential/commercial property plays on

account of tepid demand vis-à-vis the influx of new supply in the market. Consumer-domestic plays are likely to report continued earnings resilience on the back of strong domestic consumption. A blue-chip milk producer reported after tax profits of +20% during the first half of 2011, while telecom and IT profits before tax expanded by only 10%. Banks are also likely to catch investors' attention on account of reasonable valuations. Talks on foreign partners surveying the sector for some strategic stakes are likely to keep share liquidity and activity in this sector quite high.

On the regulatory front, a new law which allows for multiple broker accounts to be opened came into effect August 1. Hopes are high that this new regulation, which brings Vietnam a step closer to how regional markets operate, would also serve as a catalyst in attracting new funds to the market.

The Vietnamese market's valuations are way off its peak at 8x P/E. We are viewing the current downward move and the lack of interest as an opportune time to slowly accumulate shares, before the rest of the herd swoops back in once the economic data points start to turn positive.

Putu Yudhana looks into the factors influencing Vietnam's fixed income market.

One of the on-going challenges facing the Vietnam economy is still the stability and confidence of its currency. In the beginning of February, the Central bank announced the devaluation of the Vietnamese Dong (VND) by 9.3%, and narrowed the trading band from 3% to 1%.

However, one of the pressures faced by the currency is the widening trade deficit. The Ministry of Planning and Investment previously expected the 2011 deficit to reach USD 14 billion, compared to USD 12.4 billion in 2010.

Whether the devaluation will in fact boost export performance is yet to be determined, as it will much depend on the global demand outlook for Vietnamese goods. The tight monetary policy, reiterated by the base rate hike last November by 100 bps, will also theoretically weaken the local currency as interest rate parity needs to be maintained.

The inflation figures in the following months are likely to be clearer indicators for what to expect in 2011. We expect the government to continue a tighter monetary policy framework. Recently the Central bank also increased the refinancing rate, a facility for Commercial banks to borrow funds from the Central bank, from 7% to 9%. This move is expected to slow down credit growth for 2011 to 20%, as the cost of borrowing increases.

The local bond market trend has generally followed the direction of the monetary policy, with yields increasing after the base rate hike. However, it will also much depend on supply/demand dynamics, with auction volumes and frequency as the main factors. The recent auction results indicate that the government is more willing to meet market expectations. Foreign participation is still minimal and in December, S&P and Moody's downgraded Vietnam's sovereign rating by one notch to BB/BB-(l/c) and B1, respectively. The risk in Balance of Payments, the rise in inflation, and the rise in contingent liabilities in the government's budget, are cited as the reasons behind the rating action. Policymaking direction in the next couple of months, and the clarity of it, is critical to determining investors' appetite for the country.

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