

## 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

**Morten Frederiksen assesses the Asia Pacific Equity markets where some stocks and markets – like India – look attractive but how global risks and cuts to some Asian earnings forecasts require caution.**

Over the last quarter, we have seen the situation in Europe worsen, and some signs emerging pointing to the potential for the US to fall back into recession, all of which have weighed heavily on Asian markets. Further weighing on the Asian markets over the past quarter has been the emerging concerns related to China's informal lending sector which had heightened the worries and rumors of a hard landing in the media. These events weighed heavily on investor sentiment towards the region causing major sell-off.

Despite regional markets having hit the lowest level since the 2008 global financial crisis, we retain a cautious outlook towards the market. Valuations, at around 1.5x price to book, are attractive relative to history although we are not discounting the potential for markets to move lower as volatility and uncertainty still prevail. According to data compiled by Bank of America-Merrill Lynch, outflows in the Asian region to date have totaled US\$ 13bn, a significant sum for the region. As a clear solution to the woes in Europe seems some way off, the outlook for the region is likely to remain cloudy, despite the appeal of Asian equities.

Earnings forecasts for the region have also been revised downwards, with margins being the main area seeing cuts, and further potential downgrades are looking likely. That said, we continue to see companies with strong positive earnings revisions outperform.

Indonesia as a market has been doing extremely well in recent years, gaining a substantial re-rating and has shed a lot of the negative tags that used to be associated with the market. Valuations for the market are now looking rich, especially compared to other markets in the region as well as relative to its own history. As such, despite the long-term positives and attractions, we feel that the market has reached its peak for now and we have begun lightening our exposure. Elsewhere in ASEAN, Thailand could also begin to see some degree of heightened political risks emerging, following the recent elections as the potential rumored return of former PM Thaksin could de-stabilize parts of the political establishment.

Another country we are re-visiting our views on, after some concern in the past several months, is India. We believe that on a relative basis, it can provide some exciting opportunities, and as such we have been increasing our weightings in Indian equities over the last month. We feel that India's inflation is close to peaking, and as such, we are likely to be near the end of the interest rate tightening cycle. In addition, a large amount of negative news has already been priced into the market, although this still needs to be taken with caution as the political environment remains murky and risks remain.

**Endre Pedersen explains how strong fundamentals of many Asian bond issuers contrast with prices that have fallen largely on jitters about China, creating attractive opportunities in regional bond markets.**

While Asia's own consumer-driven growth is booming, the region is still tied to the purse strings of the US and Europe via its vital trade links and capital flows which inextricably wed Asia's financial markets to those in the West. This makes Asia especially vulnerable as long as US growth falters and uncertainty lingers around policy response to the European debt crisis.

But let's take a step back. Most of the concerns about the impact on the region's economy stem from fears that anemic or non-existent growth in the West will crush Asian exports, decimating earnings. But – and this is crucial – bond investors are less concerned with earnings growth; they look for stability, for the companies in which they invest to be able to pay back their investment. Are Asian companies, buoyed by strong balance sheets and modest leverage in key industries, and less likely to pay back when their bonds mature due to the uncertainties in the West? We believe the answer is no.

Consequently, we believe current Asian bond markets are pricing in an overly pessimistic scenario, dominated more by fear and near panic than true fundamentals. Where there are such pricing discrepancies, there is usually value for investors. As long term bond holders, we see a clear glimmer of light at the end of the tunnel, as either an effective solution to Europe's debt crisis is found or simply from Asian fundamentals shining through the current dark clouds of uncertainty.

### **Hard Landing Jitters Hit Chinese Bonds**

One dark cloud on the horizon is China. Concerns have circulated that a hard landing now seems increasingly likely for this economic powerhouse of Asia, triggering significant price declines in Chinese corporate and government bonds, and particularly sub-investment grade bonds. Underpinning these price drops is a shift in market sentiment which now expects China's once stratospheric growth to come down to earth with a bump.

Our view is that the hard landing being priced into bonds is unlikely. We would agree that China's growth will decelerate from the torrid 10% rate of the recent past to something more sustainable, like 8%. Indeed, the Chinese government's 13th Five Year Plan (2016-2020) forecasts annual growth of 7%. This is against a backdrop of aggressive tightening of monetary policy in order to break inflation's momentum and achieve a "soft landing". The bottom line is that China itself wants to grow slower!

There are four main reasons that we believe fears of a hard landing are overblown. After a year of tightening policy, China has plenty of room to relax monetary policy and give the economy more breathing space. While we don't think China will loosen policy until it can

declare victory over inflation or the real economy truly show strains, the bottom line is that China does have policy tools at its disposal if signs of a "hard landing" emerge.

Secondly, many economists outside the region still view China as a solely export-oriented economy, and fear that an export slowdown will cause an economic train wreck. But China is not so easily derailed. The country has evolved from being highly dependent on exports to an economy much more driven by internal demand from investment and consumption. We estimate that even if China's export growth were zero in 2012, the impact on its GDP growth would be about 1%.

China's own self-confidence about its economy and its ability to control growth is abundantly clear in the official renminbi (RMB) exchange rates set by the central bank, the People's Bank of China. During the third quarter, the RMB appreciated by 1.65% even as surrounding Asian currencies weakened against the US dollar. In fact, the only major currency which outperformed the RMB was the Japanese yen. This is clear evidence of China's confidence in the vigor of its own internal demand and domestic economy.

### **China Can Handle Its Bad Loans**

China certainly has plenty of its policy challenges. According to Reuters, local governments had amassed 10.7 trillion yuan (approx US\$1.7 trillion) in debt at the end of 2010. The government expects 2.5-3.0 trillion yuan (up to US\$0.5 trillion) of that will turn sour, while Standard Chartered Bank reckons as much as 8-9 trillion yuan will not be repaid. But this is in the context of a country with strong state and corporate balance sheets, and an economy that is still growing well where individual incomes are rising. The most likely scenario is that China will easily grow its way out of the problem. We are confident that China's banks could cope with a hike in non-performing loans and if not, the state has a sizeable war chest of more than \$3 trillion in foreign exchange reserves with which to tackle its debts.

So our view is that while China's export engine may stutter in the short term, its economy is well able to

refuel its tanks with government investment and consumer demand.

We believe it is important for investors to cut through the uncertainty about which way economies will turn, which policy path European leaders will follow and focus on the longer term fundamentals of Asia's bond markets.

Fixed income is fundamentally different from equity investing in that there is a maturity date for every bond. As long as the company or government in Asia remains in business and is financially sound, then it will pay its interest coupons and ultimately return principal. We focus on ensuring we own debts issued by companies which are fundamentally solid, which have the balance sheet strength to pay us back and which do not rely on strong export growth.

## Greater China Markets' Viewpoint

**Terrace Chum examines how China is slowing fast and Hong Kong property values are falling, but select stocks offer cheap valuations and strong earnings, and could rise sharply when risk appetites return.**

The end of September saw Asia's indices bruised and battered following weeks of volatility in the region's markets. It was a far cry from the second quarter, when commentators were mostly concerned with continuing tightening policies and rising inflation. Key economic developments coming out of the US and Europe are fuelling pessimism in investors globally.

To compound this, we were starting to see evidence of potential cracks in China's lending system. Liquidity was tight due to recent stories of "underground lending" and "runaway bosses" have set alarm bells ringing about the potential that some companies may be unable to pay back their loans. Although we are starting to see recent easing in SME funding and better liquidity flows in the banking system coupled with the recent pro-growth policies implemented by the government, such as a reduction in business tax. We could see the PMI figures remaining above 50 in the coming months as long as the European debt crisis doesn't hamper exports any further.

## China Outlook Revised Lower

The International Monetary Fund ('IMF') and the Asia Development Bank ('ADB') have both lowered their estimates for China's growth for this year and the next. China is now pricing in a harder landing than previously expected with the original predictions of growth of 9% being revised downwards although with stronger than expected PMI figures, hard landing concerns can be shelved.

Hong Kong has had a booming property market over the past year and is finally seeing prices correct. This has also come at a time when banks have also started raising their mortgage rates, and so we expect to see continued correction in the market.

On a positive note, we are seeing some attractive valuations for some potential long term gain. With the emphasis on long term, though, we are looking at the current situation as a time to de-risk. The economic slowdown will continue to weigh on the cyclical and commodity sectors. While consumption stocks have also been sold off, we think some of those are worth revisiting given resilient domestic consumption. In terms of asset allocation for the portfolio, we continue to underweight the materials and industrial sectors going into a slower economy, while overweighting the consumer related stocks.

## Little Market Downside Seen

At quarter end, the Hong Kong market was approximately 10% above the trough valuation seen after the financial crisis, a level which we view as attractive and potentially close to the lowest we could see. If we take the financial crisis as an example, we need to keep in mind the strength with which the economy can jump back in just 12 months after hitting its trough, potentially providing attractive returns for investors. It's a waiting game with a carefully executed entry required and we are currently identifying companies that are at their most attractive levels with sound earnings. Our next move will rely heavily on news we get from the US and Europe, in particular any positive signals indicating a change for the better.

## Japanese Markets' Viewpoint

### Hidehiro Tomioka discusses how rising government spending is creating some interesting investment opportunities in Japanese equities.

Japan was not immune from the third quarter global equity market rout due to concerns about a US economic slowdown and fiscal problems in Greece and other peripheral European countries. The Japanese yen's status as a safe haven currency added to the headwinds facing Japanese equities as it appreciated during the "risk-off" market conditions that prevailed for much of the quarter.

These external factors remain a risk, but on the domestic side, demand is sound as it continues to recover sharply from the drop in demand and production after last spring's earthquake. Moreover, Japan is one of the very few developed countries that is set to increase government spending.

Private consumption has been recovering strongly after dipping following the earthquake. Passenger volume on the Shinkansen bullet train (typically a good proxy for economic activity) has been improving sharply and has turned positive year over year since August. Earnings of consumption related companies are not as bad as earlier estimated, resulting in a continuous upward revision in consensus earnings forecast. Consumption sentiments are also firmly improving in the Tohoku region that was worst hit by the earthquake and resulting tsunami, as reconstruction spending and donations are feeding into the area. In August, Tohoku region department store sales were up 6.8% year over year. Turning to employment, the jobs-to-applicant ratio has recovered continuously after the earthquake. Japanese automobile manufacturers had again reached pre-earthquake production levels by August.

### Over \$200 Billion in Fiscal Stimulus added for Earthquake recovery

Japan is one of the few countries that are set to expand government spending. According to an estimate, the government spending needed for the earthquake reconstruction during the next five years is expected to total around 19 trillion yen (US\$238 billion). The supplementary budget (additional budget) for the current fiscal year ending March 2012, which has been

revised 3 times already since the earthquake, is now anticipated to be 18 trillion yen (US\$225 billion). This is expected to boost GDP by about one percentage point in both fiscal 2011 and 2012.

The stock market is trading at historically low valuations and, although external risks remain, offering good opportunities for long term investors. Over the near term, domestic demand from both the government and the private sector is likely to support corporate earnings and the stock market.

### Keisuke Tsumoto takes a look at how Japan's sovereign debt could hit 220% of GDP by 2020, but a deep domestic market should keep yields low.

In August, Moody's downgraded Japan's sovereign rating by one notch to Aa3 from Aa2. In January, Standard and Poor's had downgraded Japan from AA to AA- and since then S&P has maintained a negative outlook on Japan. The percentage ratio of Japanese government debt to GDP is now the worst among developed countries and investors are worrying whether the deterioration in the Japanese government's creditworthiness would eventually lead to an increase in Japanese Government Bond (JGB) yields.

Past issues of Global Intelligence have from time to time discussed Japan's chronic fiscal problems – a topic we believe worth revisiting at this time. Japan's fiscal deficit was around 8% of GDP in 2010. This was better than that of the US and the UK. However, Japan's total outstanding government debt was high at around 180% of GDP in 2010. This figure is as a result of successive fiscal deficits over the last two decades and is forecasted to increase to 220% by 2020, according to Japan's Cabinet Office projection. That's higher than Greece's or Italy's debt, raising serious concerns about Japan's solvency. And in a vicious cycle like that witnessed on the European periphery, rising JGB yields would significantly increase debt service expenses, worsening the government debt balance.

While solvency is certainly an important part of sovereign credit analysis, so is liquidity and on this

front, Japan is different. For many years, the Japanese government has been able to finance its debt with domestic investors. Foreign investors hold just 7% of JGBs, while domestic investors hold the rest, according to Bank of Japan flow of funds statistics. Japanese households have been net savers for many years and Japanese corporations became net savers in the 1990s as they scrambled to deleverage balance sheets after Japan's asset bubble burst. At the same time, Japanese banks, facing lower loan demand, also accumulated JGBs. This has allowed the Japanese government to enjoy domestic finance and low yields, without relying on foreign investors.

Historically, most sovereign debt crises have been caused by a rapid and massive outflow of capital. In the pre-crisis period, a country with a fiscal deficit is able to finance its debt with external funding, and foreign investors usually enjoyed higher yields than invested elsewhere. Once the flow starts to reverse, foreign investors rush to divest risk, causing a huge outflow of capital from the country and severely impairing the country's ability to finance its deficit.

Given Japan's unique sovereign debt financing profile, we see very little probability of the kind of sovereign crisis described above. As long as Japan's non-government sectors maintain a strong home country bias, private sector savings will remain ample and able to fund the government's deficit. Consequently, we think investors should expect JGB yields to remain low for the foreseeable future.

In such an environment, we run our portfolios with two main objectives. One is to enhance the portfolio's carry, or gains relative to JGBs simply from holding the portfolio. Even in a low yield, low spread environment, investors should pursue a superior risk-adjusted carry over JGBs by selective investment in credits. Another is to enjoy a roll-down effect on the shoulder of the yield curve. With a careful examination of the shape of yield curve, investors should look for a greater total return over the curve. With those objectives in mind, we maintain an overweight in Japanese corporate bonds and medium-term maturities.

## Singapore Markets' Viewpoint

### Cheng Duan Pang discusses Singapore's rising inflation and the government's initiatives place Singapore on a path of steady but gradual growth

Narrowly avoiding a technical recession, Singapore's 3Q GDP registered a weak 1.3% quarter-on-quarter (q/q) growth versus -6.3% in 2Q. Growth, particularly in electronics exports, was weighed down by faltering global demand. The good news was that the volatile biomedical exports managed to cover the gap in electronic exports and supported the growth. With the weak sentiment in global markets, the financial sector was also negatively affected. The Monetary Authority of Singapore (MAS) now expects 2011 growth to be around 5% as compared to the previously forecasted range of 4% to 6%. The MAS cautions that economic growth in 2012 will expand more slowly and could be below its potential growth rate of 3%-5% if the slowdown in the global economies becomes more pronounced.

On core inflation, the MAS expect the slowdown in global and domestic economic activities to reduce tightness in the labor market and alleviate some price pressures. Core inflation could fall to 1.5% to 2% in 2012 compared to an estimated 2.1% in 2011. Headline inflation has been running above 5% in recent months on higher rental and private transportation cost. The MAS continues to expect elevated core inflation prints before easing in the second half of 2012. For the full year, the central bank expects headline inflation to come in at around 5% in 2011 and 2.5% to 3.5% in 2012. If not because of this high inflationary pressures, real growth in Singapore would be even stronger. As expected, while the MAS has maintained a stance of "modest and gradual appreciation", it has reduced the slope of the band to take care of a weakening growth path ahead. This stance caught some market participants by surprise with the Singapore Dollar (SGD) rallying by about 1% in a day post the announcement.

Going forward, we continue to expect the SGD to outperform the USD and to re-test the 1.23 level in the next few months. The expected slowdown in growth in 2012 is a reflection of the weaker growth landscape in the developed economies although growth in Asia is still expected to outperform. With the MAS is taking a less hawkish stance, the pace of appreciation of the SGD versus its Asian counterparts will moderate. The SGD could potentially underperform some Asian currencies, eg, the Chinese Yuan as we still see the Yuan on a steady strengthening path.

### **Lisa Yong assesses the outlook for Singapore's equity market and explains which sectors are attractive but why they should be looked at with caution**

The Singapore equity market was not spared in the recent global financial rout, as uncertainty in the European debt situation posed a risk to global economies. Though we managed to escape a technical recession in the third quarter, Singapore is likely to see slower growth in the next few quarters. Already, the manufacturing sector has started to see signs of slowing exports and weak industrial orders. Near term, global macroeconomic concerns are likely to dominate headlines.

After the major sell-down, we saw the Singapore market as close to recession valuation levels of 2001/2003 on a P/E basis. However, the market is still around 30% above the 2008 global financial crisis levels. Currently, consensus earnings estimates appear slightly high and hence, further earnings downgrades are expected.

Against this backdrop, we favor companies with greater earnings visibility including industrial and retail real estate investment trusts and telecommunication stocks. Land transportation stocks are looking interesting too, given the growth opportunities in public transport ridership. The Singapore government plans to curb further vehicle growth and shift usage to public transport. In addition, these stocks are supported by attractive dividends and valuations. On the other hand, we are cautious on companies with relatively high gearing levels, as they are vulnerable to the availability of financing.

## **Indonesia Markets' Viewpoint**

### **Yudhistia Susanto explains why Indonesian bonds could be highly attractive option once the global economy starts seeing signs of recovery.**

Indonesia's September monthly inflation is at low 0.27%, compared to previous month at 0.93%, and significantly below consensus at 0.50%. As of September, YTD inflation stayed low at 2.97% and the full year inflation is expected to fall below 5%. Core inflation eased to 4.93%, from 5.15% y-o-y last month, reflecting the expected weakened seasonal factor post a major Muslim festival.

Cheaper food prices were the main contributor to inflation stabilization and with this manageable inflation the Central Bank is expected to keep policy rates at 6.75% for the rest of the year. Despite the volatile market, the Indonesian bond market continued to book positive returns including 1.55% in September as indicated by the performance of HSBC Bond Index. Investment in government bonds delivered a total return of 14.7% on YTD basis. Foreign holding of IDR bonds decreased by IDR 29.3 trillion, historically the largest monthly reduction, to IDR 218.1 trillion (reducing foreign portion to 31.3% of total tradable government bonds) as end of September. This reduction is a short-term tactical move rather than a long-term strategic asset allocation decision and we believe global investors are still attracted by strong prospects in the long term.

The Indonesian economy's recent yield increase and Rupiah depreciation are major incentives for global investors to buy Indonesian bonds as and when the market starts to stabilize. In fact, Indonesia is considered a "safe haven" compared to other emerging markets such as Brazil.

The Rupiah depreciated by 4.9% against the USD last month, wiping out all appreciation since early 2011. High portion foreign position in IDR government bonds contributed to the exchange rate volatility as foreign bond sellers converted their Rupiah into US Dollar. Trade surplus for the month

of August jumped to USD 3.8 bn, much higher than USD 1.4 bn in July. On a YTD basis the August trade surplus reached USD 20 bn compared to USD 11 bn in the same period in 2010. YTD August export rose by a robust 36.6% y-o-y against 31% y-o-y for imports. However, recent market turmoil also reduced Indonesian foreign reserves to USD 114.5 bn as of September compared to a previous high of USD 124.6 bn as of August.

Uncertainty due to the Euro zone debt crisis and the US economic slowdown are the major issues that caused volatile global financial markets during September. Fear of China's economic weakness also contributed to risk aversion in Asia's emerging market investments, where Indonesia is one of the favorites. Although locally, prudent macro policy and orderly Indonesia government interventions in bond and exchange rate market have calmed the market.

### **Siswa Rizali discusses why Indonesia is attractive to offshore investors as a result of the recent turmoil**

The global risk aversion sell off and foreign fund redemption have taken out around USD 8.8 billion from both of the Indonesian equity and bond market in the month of September alone.

Indonesia's macroeconomic balance got hit hard by the global market correction. The IDR hit 9,120 and the yield curve shot up drastically. In the 3rd week of September, 10 Year IDR bonds yield hit 7.6% from 6.7% at the beginning of the month showing Bank Indonesia's ability to restore the macro balance using aggressive intervention on the currency market and becoming the market maker for IDR government bonds to facilitate the redemption from offshore fund managers.

Fear dominated global fund manager's minds and significantly impacted their portfolio decision making. The uncertainty regarding Greece bailouts or it defaulting is a major source of investors' concerns, with the latest meeting between IMF, ECB and the European commission not having provided a clear solution. The event triggered the USD to strengthen against global currencies, and correction in global commodity prices, including oil and even 'safe haven' instruments like gold. Although we are cautious of the above we are also recognizing the Jakarta Composite Index (JCI) valuation

is becoming more interesting for value-seeking investors. Trading at 10.7x PE 2012, now the JCI earnings yield is 9.34%, compared to current HSBC benchmark portfolio yield of 7.4%. And with the expected 2012 EPS growth of 16% plus dividend yield expectation of 3%, we are expecting a 19% target return in 2012.

## **China Markets' Viewpoint**

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

The China economy continues to grow albeit at a slowing rate. The forecasted GDP growth figure for Q3 – 9.2% – is still considered high as it's supported by stable domestic economic activity including the Fixed Asset Investment and consumption that has partially offset the negative impact from recent US and European market turmoil. We believe China can ease concerns of a "hard landing", however, inflation continues to remain the top concern in the current economy fuelled by high food prices. The Consumer Price Index (CPI) inflation is likely to have peaked at 6.5% in July and as expected we have seen this drop to 6.1% recorded in September which we can attribute stabilizing food prices. Although we believe we have seen the CPI reach its peak, the monetary policies remains tight as the central bank expresses concern about the CPI levels as they are still considered to be high.

M2 growth continued to decline to below 14% in Q3, vs the year-end target of 16% as the People's Bank of China (PBOC) further tightened the liquidity in the quarter. However, with the worsening of European sovereign debt crisis and a possible recession in the US economy we feel that this could further drag down China's export activity in coming months as the PBOC is becoming more cautious when making policy decisions. We could see the interest rate hike in July possibly being the last one in this cycle and moderating monetary tightening would be the major policy stance of the PBOC in the near future. This tactic is to create the balance between keeping the economy's growth steady whilst controlling inflation expectation.

### **Bond market and Yield Outlook**

The overall bond yield curve shifted up and flattened over the month. The temporary liquidity constraint in the last quarter pushed the 10-year government bond to reach 4.12% high during the quarter and also narrowed the spread between 1- and 10-year bond yield to 9bps only, vs YTD average of 120bps. With the moderating easing of market liquidity after PBOC's net money injection in later of September through open-market operation, the 10-year government bond yield went back to 3.9% level. However, short-term bond yield still closed high with 20bps over Q2 end indicating tightening liquidity conditions in the market.

The credit spread further expanded over the quarter due to investor's concerns on default risk of several local debt financing projects. The change of investor's risk appetite moving towards being more risk averse led to 50bps widening of credit spread between local AAA corporate against government issues in Q3. The spread stands at 210bps in 10-year sector at the end of September and is expected to persist in the market.

Market research is expecting that the bond yield may continually fluctuate in a narrow range with liquidity conditions as the major drive for this in the short run. Given the expectation of gradually easing Consumer Price Index (CPI) inflation pressure and possible external economy recession, we are starting to see a bullish sentiment appearing in the market given the yield curve has likely peaked in this cycle.

### **Equity Market**

The A-share market continued weakening, and as we saw all over Asia, the Shanghai composite index further declined by 15% over Q3 to close at 2359 points at the end of September. Global investor's sentiment was seriously damaged as European's debt crisis was spreading and US's economy profile was showing no signs of immediate recovery, both of which intensified the local market's worry on the global economy slow-down to impact China's exports.

Meanwhile, domestically, the elevated CPI data, policy tightening, and liquidity constraint further dampened domestic investors' confidence. Under such a bear scenario, only the defensive names, like stocks in health care, food & beverage, media and consumer service

sectors, recorded positive returns. We saw almost all cyclical names slump with the concerns of the economy.

We expect the market will maintain a weakness in the midst of the intensifying European debt crisis and heighten risk aversion among investors causing more sell off. Global investors and policy makers are all concerned on the settlement of the Euro debt crisis. We estimate if global demand conditions deteriorate further and affect the domestic economy growth, China's central bank would re-orient its policy to protecting growth, in which A-share would meet a rebound.

### **Taiwan Markets' Viewpoint**

**Karen Chang looks at how external factors have impacted Taiwan's equity market but how the technology sector could be a stand out.**

Following a global equity market decline, the Taiwan Exchange (TAIEX) dropped 6.67% in September as European sovereign debt concerns triggered concerns about global economic growth in 2012. Various institutions including UBS, IMF cut GDP forecast further dampened investment sentiment. For sector performance, tourism, oil and gas and IT sectors outperformed the index while cement, chemical and biotech sectors underperformed.

Demand for the iPhone 4S is higher than market expectation making the tech sector very attractive with estimates to ship over 25 mn units in Q4 this year. In addition, the iPad 3 is expected to release in Q1 2012 which is expected to generate sales with the positive impact on tech suppliers here.

For non-tech, we maintain our positive views on domestic consumption companies that continue to register record high revenue in September. For the financial sector the market was focused on possible write-off from the European sovereign debt exposure for insurance companies. Most insurance firms faced selling pressure except Cathay Insurance while investors believed downside risk is limited

given relatively low valuation, trading below EV/share.

We expect concerns over the European sovereign debt crisis to have been gradually priced in for the Taiwan equity market. However, recent global GDP downward revisions signaled relatively mild growth in 2012 which may put pressure on tech spending for consumers. In addition, Korea and USA are expected to sign a Free Trade Agreement (FTA) soon. With Korea being the main competitor for Taiwan tech/petrochemical products, we will be paying close attention for further negative impacts. After a lower than expected Consumer Price Index (CPI) release, we think China's tightening monetary policy may have a chance to ease which could help on investment sentiment for the greater China region.

Given current low valuations, trading at below historical average PBR, we adjust our previously cautious view on the TAIEX. We expect market to consolidate as negatives being largely priced in. However, due to the lack of fundamental driven catalysts, we think the index will trade sideways. For sector performance, we expect non-tech and financial sectors to outperform while IT sector to underperform except for Apple supply chain.

### **Bryan Hsu examines the outlook for the Taiwan fixed income market with a focus on credit.**

Due to the high saving rate (29% of GNP, 10Y average), Taiwan has accumulated significant capital in the household sector. Demand of Taiwan Fixed Income products was always strong. Hence, Taiwan has one of the lowest yield curves around the world, and spreads are narrow between different qualities of corporate bonds.

In the first 3 quarters of 2011, the gross amount of issuance in the Taiwan bond market was NT\$398bn (corporate and bank debenture) with a growth of 29% yoy. In the corporate sector, the issuance volume increased 19%. Being more specific in corporate sector, there are 3 types of issuers which are government support entity (GSE), non-tech sector, and tech sector. In the past, spreads of GSE was generally 40bp-45bp over Taiwan Government bond while 1st tier Tech Company was 50-55bp. However, situation is changing. IPO in early October, spreads of Taiwan Power bond (largest

GSE issuer) has narrowed to 30bps. Few days later, Taiwan Power announced a trench of private placement bond (NTD4bn; \$130mn) to Cathay Life, the largest local life insurance.

Although no details are available, market generally believes the spread is lower than 30bp. On the other hand, just 1 month ago (mid Sep), Hon Hai (Parent company of Foxcom, 1st tier tech company) planed to issue NTD6bn (\$200mn) bond. The company canceled the IPO due to the spread is too high to accept.

Looking forward demand of corporate will remain strong, but investors will be more selective. GSE bond spreads will narrow while the Tech sector spread will widen and supply of local corporate bonds could shrink as the tech sector reducing their issuance due to higher costs.

## **Malaysia Markets' Viewpoint**

### **Chin Hui Tock explains why the current market should be looked at with optimism and how construction could benefit**

One of the sectors to look out for in Malaysia is the construction sector. Amidst further slowdown in external economies, we believe there is greater urgency for the Malaysian government to pump-prime the local economy through selected big construction projects in the next 12 months. We believe, as the dust settles, investors will return to fundamentals and one of the biggest drivers for Malaysia is domestic cyclical (e.g. construction / oil & gas). Hence, we are looking at current market weaknesses as an opportunity to bottom-fish within this sector.

So far, the government financing arm for transportation awarded two packages of the LRT extension line on 16 August 2011 after a year long delay. We think this is only the start of the construction news flow, setting the stage for progressive awards going forward.

Given that equity risk premiums have risen, we advocate selected exposure to liquid construction stocks that have a relatively higher chance of securing “catalyst” projects given their capabilities, niche position as well as management and balance sheet strength. This is in contrast to going down the value chain into small-cap construction companies. We also attach a lower target PER of 16x on forward construction earnings, in contrast to 2006-2008 peak of 20x, as our benchmark valuation across the sector.

**Elsie Tham discusses the opportunities available and the measures that could be taken to boost the economy.**

Over the next few months, local investors will pay close attention to global development for fresh leads on where the market is headed. In Malaysia, with foreign ownership of government bonds in excess of 25% as at end July 2011, the local bond market reacted strongly to signs of liquidity flows in and out of the country, which in turn hinges on developments in Europe. To this end, we believe that such conditions will persist as long as no concrete and sustainable solution is found to resolve the Eurozone crisis.

We expect Bank Negara Malaysia (BNM) to maintain the policy rate at 3.0% for the remainder of the year in view of the waning global economic outlook and easing inflationary pressure. In fact, we do not rule out the possibility of seeing rate cuts early next year if the economic condition worsens. Under such circumstances, we foresee a bullish steepening of the yield curve due to (i) buying interest in short-dated bonds by investors to shorten duration in times of uncertainties; and (ii) market pricing in some sort of monetary policy easing in respond to the economic turmoil. Apart from that, we note that the fiscal deficit targets announced in the most recent Budget 2012 imply a light reduction in the supply of government bonds for next year, which could have a positive affect on the market given that demand will likely outstrip supply of government bonds.

In the long term, we feel the market will remain supported by strong domestic fundamentals as well as strong demand from local investors. Meanwhile, the volatile backdrop provides ample opportunities to buy on weaknesses. There are also selective opportunities in

the credit space given that corporate bonds are less sensitive to liquidity flows.

**Philippines Markets' Viewpoint**

**Mark Canizares explains why the Philippines' economic recovery is expected to gain further traction.**

While the local stock market will not be immune to negative exogenous factors, we believe that the market will draw support from favorable macroeconomic fundamentals. The International Monetary Fund (IMF) reduced its full year GDP growth forecast for the Philippines to 4.7% this year from 5% mainly due to the economic woes in the US and Europe. We are not too concerned however given that we believe that fiscal and monetary policies would be supportive of growth and domestic consumption would remain resilient. Electricity sales for Meralco, the nation's largest distributor, for one, has already started to rebound in the third quarter q/q, rising 3%, while loan demand has continued to accelerate, rising 19.8% y/y in August.

The government recently unveiled a USD 1.7 billion stimulus package, becoming the first Asian nation ex-Japan to do so. The measure, which calls for additional spending until the end of the year, includes supporting local governments for infrastructure development and poverty alleviation.

This would help mitigate the impact of delays in additional infrastructure spending expected to be brought about by the Public-Private Partnerships (PPP), in our view. Furthermore, a plan to “tweak” the PPP offering by using ODA (Official Development Assistance) loans for the initial capital outlay for capital intensive projects and involving the private sector for the operations and maintenance is likely to enhance the attractiveness of the program. However, we are expecting that any impact that this will have on economic growth is likely to be felt next year when the projects are bid out.

We continue to hold a positive view on the domestic economy as consumer confidence has seen a

rebound following encouraging inflation figures for September of 4.8%, a decline from the 5.1% seen in June. Moreover, overseas Filipino workers remittances remain strong despite global uncertainties, rising 11% y/y in August to US\$1.67 billion. Coming into the fourth quarter, which is seasonally a strong quarter for remittances, we expect domestic consumption to keep the economy afloat amid global headwinds.

## Thailand Markets' Viewpoint

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

In the aftermath of a healthy correction in September we believe going forward, yields of government bonds will have room to rally. Furthermore, the supply schedule for the first quarter of this fiscal year announced by the government proved to be much lighter than anticipated (THB32 billion vs. last year average of THB113 billion) due to better revenue collection.

On the other hand, inflationary pressures seem to have subsided as the latest Consumer Price Index (CPI) recorded in September 2011 fell to 4.03% from August's 4.29% following the oil subsidy initiatives implemented by the government, where in the government cut the oil tax to reduce retail oil price. Although we think the flooding occurring throughout Thailand could have an upward impact on inflationary pressure but is likely to be only temporary. The Bank of Thailand (BOT) has publicly stated that it will exclude such short-term price surges from its Monetary Policy Committee (MPC) decision. As such, we opine that the BOT will maintain a policy rate at 3.5% when it convenes for the next MPC meeting on October 19, 2011, which should shore up the bond market sentiment. Subsequently, the BOT's Monetary Policy Committee (MPC) voted by 6:1 to keep its policy rate on hold at 3.5%, as expected.

On a more serious note, the recent flood situation in Thailand has deteriorated much faster than what we had expected. All five major industrial estates in Ayutthaya province with a total investment value exceeding THB200 billion have all been submerged. The BOT estimates the initial cost of the inundation to reach THB

60bn, or about 0.6% of GDP. The government planning agency, the National Economic and Social Development Board (NESDB), has a higher estimate of THB 80-90bn, or about 0.8-0.9% of GDP. Whilst the University of Thailand Chamber of Commerce (UTCC) predicts the losses from this year's floods at THB150bn (c.1.5% of GDP). This would certainly dampen the GDP growth outlook for 2011 and bolster the appetite for government bonds.

In addition, the protracted problem of Greece sovereign debt, in spite of the two packages from the IMF and ECB, render the market to believe that Greece's debt restructuring may be unavoidable; and hence, reduce demand for risky assets. Nonetheless, the effort to ratify the expansion of the European System of Financial Supervisors (EFSF) and the plan to leverage up the fund size should provide a more flexible tool to fortify the stability of the euro area. The plan, if approved, will boost the size of the EFSF to EUR440 billion before any leverage and enable it to buy sovereign debts, extend loans to countries and recapitalize banks.

On the monetary policy front, the BOT are proposing a shift in inflation target from core inflation to headline inflation because headline inflation which entail food and energy items are better representative of an average person's inflation. Currently, the central bank targets core inflation at between 0.5-3.0% as a guideline for monetary policy. From 2012 onward, Thailand may shift the target to "headline inflation" of 3% +/- 1.5%, which is effectively between 1.5-4.5%. The proposal will be submitted to the cabinet for approval by year-end and become effective in the early of 2012. However, the challenge of targeting headline inflation is that both energy and food prices are highly volatile. Therefore, it is possible that we could see a less frequent move with a larger magnitude on the MPC decision by the BOT going forward.

### Jintana Mekinthagur examines the outlook for Thailand's equity market and how the recent floods have impacted.

In the third quarter, global equity markets were hit by the waves of concern over the European debt

crisis and global economic slowdown. Getting into the early part of the fourth quarter, investors shift their concerns from global to domestic risk. With the latest flooding situation - Thailand's worst flooding in five decades – we are likely to see slower GDP growth for the rest of the year following the closure of factories in the Ayutthaya province – where the flood has caused the most damage including supply chain disruptions to the auto and electronics industries. Government agencies have estimated that the floods crisis will result in a 0.6-0.9% reduction in GDP growth this year, depending on whether the floods will reach central Bangkok and how long it takes the floodwaters to recede.

However, the government has planned fiscal policies to stimulate the economy. The most important policy is the approval of cutting the corporate tax rate from 30% to 23% which will be effective next year. We anticipate this could boost the corporate earnings and support the stock market. Given the concerns over global recession or financial shocks from the EU sovereign crisis we are overweighting stocks that link to personal consumption and domestic spending.

## Vietnam Markets' Viewpoint

### Cuong Tran explains why investors should remain positive about Vietnam's equity market despite short term challenges.

The Vietnam Index (VNIndex) has increased strongly in the first half of September reaching 467 pts (+10.6% from August 31) to reflect market expectation of a lower inflation rate in September after its peak in August. The State Bank of Vietnam's (SBV) putting a cap on deposit interest rates (maximum 14%/year) in September also had positive impacts on equity market. However, that uptrend was severely reversed in the second half of September where we saw the VNIndex significantly drop to 428 pts level (-8.9% from the peak) at month end, wiping out all of August's gains. A few reasons can be attributed to this, such as interest rates are still considered high at 14%/year and as a result, local players continue to put their money into the bank to earn high risk adjusted return of 14%/year rather than investing in risky equity market. And most significantly,

the thread of the European debt crisis, speculation activities on gold, the gloomy outlook on 3Q earnings for majority of companies also limit the cash flow to the stock market from the second half of September.

We expect the Vietnamese equity markets to move sideways until the end of the year given the lack of positive catalysts. Valuation shows that Vietnamese equities are cheaper than they were when the markets bottomed in February 2009 after the last global financial crisis and is trading at ~8.5x P/E. As a medium and long term investor, we see this as a good time to slowly accumulate shares, paying close attention to some stocks in the banking sector as we feel the valuations have been quite attractive and bank earnings have also proven quite resilient at least for the big listed banks.

### Hai Nguyen looks into the factors influencing Vietnam's fixed income market.

The tightening stance adopted at the beginning of the year has begun to take effect - we could have seen inflation peak as YoY figures are now on the down trend with monthly rates of less than 1% as compared to 2-3% in the first quarter. However, seasonal factors and premature policy loosening might increase the risk of inflation returning. In fact, from the end of August the State Bank of Vietnam (SBV) started to inject liquidity into the system in order to lower the level of lending rates. Improved liquidity has resulted in lower short-end yields by about 30 basis points. However, supply/demand dynamics are also a critical factor affecting bond yields, especially for long tenors because ready demand for long-term bonds and limited supply resulted in little change in the long-end of the yield curve.

In addition, the exchange rate has benefited from the tightened policies. For the past few months, the USD/VND exchange rate has been stable and the SBV has managed to increase its foreign exchange reserves to US\$ 16 billion from the previous year end level of about US\$11.7 billion. Improvements in foreign exchange reserves, balance of payments,

budget deficits and export growth have enabled Vietnam to better deal with foreign exchange pressures.

Vietnam is still facing inflation and exchange rate risks as a result of its policy uncertainty. Though inflation is still an evident problem, the SBV unexpectedly loosened its monetary policy by cutting its repo rates by 1% from 15% to 14% and injected liquidity to the banking system. In addition, the Bank also installed an interest rate cap of 14% on deposits. Such action has further reduced confidence in the local currency, which is already low. The move from local currency to gold and US dollars has put the USD/VND exchange rate under heavy pressure. In response, the SBV had to adjust the exchange rate and raise two key policy rates. In fact, refinancing and overnight rates have been adjusted recently by 1% and 2% respectively. We believe that policy uncertainty has been a major risk that makes Vietnam's inflation and exchange rate a chronic problem and deters foreign participation in Vietnam local bond markets. Thus, the performance of the local bond market will be dependent on policy direction in the coming months and the Government's determination to fundamentally solve this issue.

Amongst this landscape of uncertainty we are seeing this as a good opportunity to get into the Vietnam local market. The new Government has expressed the need to continue Resolution 11, which outlines a package of restrictive measures to tighten both monetary and fiscal policies well into 2012. Such tightening stances will help control inflation and improve other economic indicators. Thus, the current high rate environment might present a good opportunity for long-term bond investors.

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