

Pacific Basin Market Overview – July 2010

In July, the MSCI AC Asia Pacific Free Index including Japan appreciated by 5.57%, while the MSCI AC Asia Pacific Free Index excluding Japan Free Index rose by 6.89%.

After fluctuating throughout July, the Tokyo Stock Price Index (TOPIX) ended the month with a gain of 1.82%. Japanese companies started to report quarterly earning results for the March-June period of FY2011, and companies in the Manufacturing related sectors generally exceeded forecasts. However, wider concerns such as uncertainty over the state of the U.S. economic recovery and the strengthening Japanese yen (“yen”) tended to undermine the Japanese equity market, which lagged behind the other major markets this month. However, a mid-month recovery was supported by international news: firstly from the EU, where stress tests on European banks revealed a positive outcome, and then from China, where the authorities appeared ready to scale back their credit tightening policies.

Weak U.S. economic data helped to boost the safe haven appeal of the yen and weaken the U.S. dollar, which pulled down the share prices of Japanese exporters. Yet currency movements were also mixed, as the yen weakened slightly against the Euro. Foreign investors turned net buyers of Japanese equities to a limited degree in July.

Australia’s outperformance came mainly from the Banking sector on the back of lower than expected funding costs and improved sentiment from the benign results of the European stress tests.

China underperformed in July, with the country’s largest offshore oil producer falling along with the decline in oil prices. The Telecommunications sector also lagged behind. In Hong Kong, the defensive Utilities sector underperformed while Banking and Property stocks performed well as the weak economic numbers in the U.S. led to a belief that China’s policy tightening stance would be eased back to a more neutral position. Steel stocks advanced in the Korean market on the back of rising steel prices and the removal of export rebates in China. In Taiwan, the Technology sector outperformed, helped by seasonal re-stocking in 3Q2010 coupled with undemanding valuations. Meanwhile, in India, the Energy sector underperformed due to weak results and delays in pipeline expansion plans.

Indonesia's underperformance this month was mainly caused by positions in the Commodities sector, due to accounting irregularities and reports of cash discrepancies. In the Philippines, although macroeconomic fundamentals remained strong, investors started to take profits on banks after their strong year to date performance.

Singapore's outperformance in July was mainly attributed to strong tourist arrival figures, while Malaysia's market underperformed. Thailand's outperformance came from the Banking sector as the 2Q10 results showed that banks were not affected by the political unrest and rioting in May as earlier feared by investors. In addition, foreign investors bought into the banks after a major sell off in May.

Market Outlook and Strategy

Global economic growth is starting to slow down somewhat; although in our view, a double-dip recession will be avoided. The generally robust health of the U.S. private sector should soon manifest itself in renewed hiring and increased capital expenditure. We expect this to partially offset the withdrawal of government fiscal stimulus measures aimed at boosting consumer demand. The core economies of Europe, especially Germany, are also exhibiting strength, which should help to alleviate short-term concerns about the health of peripheral countries.

Emerging economies, however, have continued to drive the global economy. The Chinese economy slowed down, but it has actually decelerated to a more sustainable level that suggests monetary policy could be eased soon. The Chinese yuan is expected to rise at a gradual pace, and other Asian currencies will also face pressure to appreciate.

For several months we have been stating that regional markets will experience a consolidation phase before any renewed upward move. Our current view is that this consolidation pattern seems to be almost complete and we expect Asia Pacific stocks to rise further.

The performance of the Japan market has been disappointing and still faces several well-known structural impediments. However, the Japanese market appears oversold and bearishness is at extreme levels while the underlying economy looks robust and many stocks appear extremely cheap with dividend yields substantially above the domestic 10-year bond rate.

China was the first market and economy to bottom out during the global financial crisis and the first to consolidate. Our view is that it could also be a leader in the second stage of the bull market. Over the next 2-3 months we will seek opportunities to add, but with the usual caveat, that any increase will depend on the availability of good stocks with management focused on shareholder value, and with little negative policy risk. The only other country change has been our decision to validate the slight reduction in the overweight exposure to Korea caused by relative market movements. We believe the resulting cash would be better deployed in China, while the overall cash levels will be kept to a minimum.

Our main overweight positions remain in some of the smaller ASEAN (The Association of South-east Asian Nations) markets, most notably, Thailand, the Philippines, and Indonesia. As for the sector strategy, we intend to hold an overweight position in the Financials sector, Consumer Cyclical, and Technology given our positive stance on the prospect for reflation in Asia. In contrast, we have underweight exposures to the more defensive, Utility, Telecom, and Consumer Staple sectors.

International investing involves certain risks and increased volatility not associated with investing solely in the U.S. These risks include currency fluctuations, economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments. These risks are magnified in emerging markets. Securities focusing on limited geographic areas and/or sectors may result in greater market volatility. Investing in securities issued by smaller companies typically involves greater risk than investing in larger, more established companies.

This material contains the current opinions of the author, which are subject to change without notice. This material has been distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information used to compile this report has been obtained by sources deemed to be reliable, but its accuracy and completeness are not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. Past performance is no guarantee of future results.

MSCI AC Asia Pacific ex Japan Index is an unmanaged free float-adjusted market capitalization index that is designed to measure the equity market performance in the Asia Pacific region excluding Japan. One cannot invest directly in an index.

The MSCI information contained in this material may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.