Market Insights

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Emerging Asia Growth Prevails as Inflation Worries Abate

By Hamon Investment Group*

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Executive Summary

Investment professionals from Hamon Investment Group argue against a hard landing for China and other emerging Asian countries, as tightening measures aimed at managing inflation without choking off growth seem to be working in their view. The emerging Asia equity managers based in Hong Kong expect to see improved market performance in the second half of the year, with inflation worries easing and global capital flows resuming into the region. They discuss their outlook for China, India and ASEAN[1] countries for the rest of the second half as well as main market developments from the second quarter.

Emerging Asia Regional Outlook

For the emerging Asia region, we expect an equity market recovery in the second half of 2011 from the underperformance of the first half, with central banks' tightening measures gradually easing as inflation worries abate, particularly in China and India. In our view, earnings growth forecasts continue to look achievable and valuations are attractive relative to other assets.

We do not share the hard landing scenario for China. We believe that government fiscal measures, such as the acceleration of affordable housing construction and accommodative monetary policies providing easier credit availability to small and medium-sized enterprises (SME) are likely to achieve the solid economic growth in 2012, as envisaged in the Chinese government's five-year plan. We expect a resumption of global capital flows into Asia after the summer, as investors gain confidence that economic growth in Asia is likely to be stronger than in the developed world in both 2011 and 2012, and they see more signs of the end of the monetary tightening cycle as headline inflation begins to show a clear downward trend.

In China, we believe rising wages have been one of the main drivers of inflation, which has been offset by rising productivity levels over the past two decades.

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1 **The Association of Southeast Asian Nations** (ASEAN) is a geopolitical and economic organization of ten countries located in Southeast Asia, consisting of Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Burma (Myanmar), Cambodia, Laos, and Vietnam.

Tightened monetary policies, including interest rate and reserve requirement ratio hikes, have already been effective in decelerating inflation pressure. As a result we believe equity performance should improve going into the second half of the year.

Though Asia's economic growth will likely moderate slightly in the second half of the year, we believe overall growth in Asia will still expand at more than twice the pace of growth in developed markets.

In India, despite 10 interest rate rises since March of 2010 amid inflationary pressures, we believe the fundamentals of the economy remain positive due to strong domestic demand. As in China, core inflation in India has been on a structural uptrend in part we believe due to social development policies, improving wages and increased consumption. We expect investors are likely to continue closely monitoring India's wholesale produce index, particularly after the government raised diesel prices to strengthen the budget deficit.

Slowing demand from developed markets might generate headwinds for Korea and Taiwan, particularly for some tech products. Lingering investor concerns about a more significant slowdown in China's economic growth might further weigh on North Asian exporters. On the other hand, the view that production disruptions following Japan's earthquake will not have an adverse effect on component manufacturing should be positive for the sector.

In our view, political concerns have eased in ASEAN countries, resulting in more positive sentiment among both foreign and local investors. We believe regional private-public-partnerships should improve business efficiency and establish needed infrastructure, while policy reforms to lift minimum wages should benefit domestic consumers.

Though Asia's economic growth will likely moderate slightly in the second half of the year, we believe overall growth in Asia will still expand at more than twice the pace of growth in developed markets. Slower growth should also help alleviate inflation and inflation expectations, which have been the key worries for market investors. We believe several key regions are in the advanced stages of their tightening cycles, which should bode well for investor sentiment. We maintain our positive stance towards consumption, technology and software, infrastructure and energy sectors.

Country Review & Outlook

China/Hong Kong

In the second quarter, in our view worries of accelerating inflation and subsequent aggressive tightening policies pulled mainland indices lower. However, economic stimulus measures, such as social housing programs and credit availability to SMEs, will likely help maintain economic growth, supporting our view of a soft landing. Although key macro indicators like the country's Purchasing Managers' Index continues to expand at a decelerated pace, underlying data shows that services are outperforming manufacturing sectors, reflecting that the quality of growth is improving. The Shanghai B share index fell 14.53% over the second quarter as liquidity withdrew from small and mid cap companies.[2] In our view, mainland equities have been oversold, with the market pricing in negative news.

With inflation remaining a top political concern, the People's Bank of China continues to implement further monetary policies to help rein in excess liquidity. The reserve requirement ratio (RRR) was raised for the sixth time over the second quarter. We believe the RRR remains the best policy tool amid current macro conditions, as it demonstrates a symbolic stance against high inflation without instituting aggressive tightening. Measures already in place have helped support social stability efforts and helped cool China's property market.

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In our view, China's fundamentals remain strong and we believe the central bank will unlikely resort to aggressive monetary policy intervention. We expect inflation to peak over the summer and gradually abate as tightening measures show their effect. We generally continue to see a benefit to overweighting consumer staple and discretionary stocks, energy, alternative financing, and telecommunication services, while underweighting materials, banking, and capital goods.

Taiwan

Despite worries of weaker export demand from developed countries as well as China due to aggressive monetary tightening policies weighing on market sentiment, the Taiwanese market (TAIEX) rose 1.54% over the quarter.[3] Stocks were able to maintain gains from an early quarter rally on better clarity that supply chain disruptions from Japan would not have a significant adverse effect.

2 This and all other market data in this article are taken from Bloomberg. Please see index definitions at back.
3 Please see index definitions at back.

In our view, non-tech stocks are positioned to outperform tech stocks during the third quarter, as non-tech stocks are likely to benefit from social housing programs, domestic consumption and niche markets. Market weakness presents an opportunity to accumulate tech stocks, as we believe the sector might rally on anticipation of consumption recovery in the U.S.

We are also positive towards financials as net interest margins improve and improving cross-strait relations with mainland China create new investment opportunities. While tech stocks may encounter sector headwinds, we are positive toward semiconductors as well supply chain components for smartphones and tablet PCs.

While second-quarter GDP numbers are expected to show that Japan's economy contracted for a second consecutive quarter, we believe government spending and private investments should spur growth.

Japan

Japan's Nikkei rose 3.46% over the second quarter, as the market recovered from its devastating earthquake and tsunami earlier this year.[4] Macro reports including the Tankan Survey suggest that Japan's recovery is gaining momentum, with corporations forecasting increased hiring and investments during the second half of this year.

With the recovery exceeding earlier expectations, the resumption of operations at plants and parts makers has eased supply concerns. The major overhang for the market remains electricity demand during the peak summer months, suggesting that production levels are likely to remain flat quarter on quarter.

While second-quarter GDP numbers are expected to show that Japan's economy contracted for a second consecutive quarter, we believe government spending and private investments should spur future growth. We find construction and property development stocks attractive based on the prospect that reconstruction efforts are likely to materialize during the second half of this year. We also believe advanced engineering stocks such as automation and synthetic commodity manufacturers might be attractive.

4 Please see index definitions at back.

We are positive toward ASEAN domestic themes, as rising income and stable food prices should aid household consumption, and more infrastructure development projects are expected to be undertaken in the region.

ASEAN

ASEAN markets generally outperformed over the second quarter, as overhang worries such as inflation, rising commodity prices and political uncertainties gradually eased by the end of the quarter. Indonesia (JSX) rose 7.27% over the quarter, the best performing market in the region, while Malaysia (FTSE Bursa Malaysia) climbed 2.47%.[5] The Thai market (SET Index) fell 2.03% as liquidity withdrew from the market prior to the presidential election.[6]

Strong balance sheets and low household leverage rates have helped ASEAN policymakers maintain food and fuel subsidies, minimizing pass-through costs to end users. Food prices have also been tamed and regional currencies continue to appreciate, softening input prices.

In our view, rising income wages will likely lead to the normalizing of interest rates by central banks, however, at an accommodative rate to support growth.

We are positive toward ASEAN domestic themes, as rising income and stable food prices should aid household consumption, and more infrastructure development projects are expected to be undertaken in the region.

India

Although the Indian market (SENSEX) fell 3.02% over the quarter, the market pared off an early quarter drop as the country's Finance Minister stood by his economic targets amid a string of monetary tightening measures. In our view easing concerns over rising inflation and fiscal tightening renewed sector-specific buying, led by capital goods, financials and information services late in the quarter.

Ten interest rate hikes since March 2010 have eased India's underlying inflation pressure without derailing its structural growth. In our view, the economic potential still hovers above 8% GDP for the 2011 fiscal year, driven by infrastructure spending and rising household expenditure.

5 Please see index definitions at back.
6 Please see index definitions at back.

We believe infrastructure names remain a key investment, as the government looks to increase spending to help address structural and regulatory bottlenecks. We also favor domestic consumption stocks, particularly for high-end items, because of rising disposable income. Rising real interest rates and the risk of demand destruction due to higher inflation are clear risks for our growth outlook, while rising oil prices might also lower investor risk appetite, given India's high exposure to rising prices.

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Korea

Domestic demand offset some of the weaker exporters in Korea, as Europe's debt crisis and slowing U.S. growth began dampening demand for Asian goods. The Korean Kospi stock exchange index rallied early in the quarter on speculation of manufacturer market share gains due to disruption in Japan's production and ended the second quarter up 2.49%.[7] The shipment inventory cycle in Korea indicates that the economy is still on an expansionary trajectory.

Selective Korean tech names fared well in the second quarter, including semiconductors, on expectations of a second-half recovery, and automakers, on market share gains. Domestic consumption stocks, mainly shopping networks for increasing sales exposure to China's household market, also outperformed. In our view, petrochemicals and shipbuilders in Korea are likely to be beneficiaries of rising oil prices and continued recovery in the global economy.

7 Please see index definitions at back.

Index Definitions

Korean Composite Stock Price Indexes (KOSPI) is a series of indexes that track the overall Korean Stock Exchange and its components. These indexes use a weighted average based on market calculation to calculate the value of the indexes.

The Nikkei is a stock market index for the Tokyo Stock Exchange (TSE). It is a price-weighted average and is the most widely quoted average of Japanese equities.

The **Hang Seng Index** is a freefloat-adjusted market capitalization-weighted stock market index in Hong Kong. It is used to record and monitor daily changes of the largest companies of the Hong Kong stock market and is the main indicator of the overall market performance in Hong Kong.

Malaysia FTSE Bursa Malaysia Index is a comprehensive range of real-time indices, which cover all eligible companies listed on the Bursa Malyasia Main Board. The index is used to measure the performance of the major capital segments of the Malaysian market.

The JSX Composite is an index of all stocks that trade on the Indonesia Stock Exchange Shanghai B Share Index is a weighted average share price index compiled by the Shanghai Stock Exchange with the number of shares issued of all listed B Shares as weight number.

SET Index is a composite index which represents the price movement for all common stocks trading on the Stock Exchange of Thailand

Taiwan Capitalization Weighted Stock Index is a stock market index for companies traded on the Taiwan Stock Exchange (TWSE). TAIEX covers all of the listed stocks excluding preferred stocks, full-delivery stocks and newly listed stocks, which are listed for less than one calendar month.

The Bombay Stock Exchange SENSEX is a free-float market capitalization-weighted index of 30 well-established and financially sound companies listed on Bombay Stock Exchange.

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