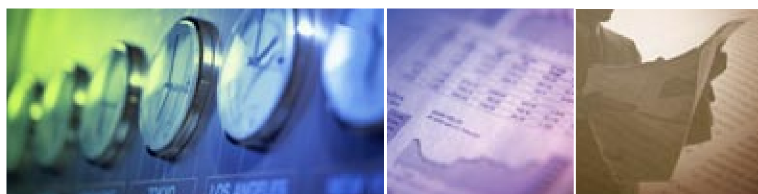
Key points

- Middle East situation weighs on sentiment
- Reducing emerging market exposure
- Positive on equities, commodities, real estate & spread products
- High yield and emerging market debt local currency are our favourites within fixed income

HOUSEVIEW



ING Investment Management Asia Pacific

February 2011

positive (+), neutral (=), negative (-)

Asset Classes	Current Month	Previous Month
Equities	+	+
Fixed Income	-	-
Real estate	+	+
Commodities	+	+

Equity Sectors	Current	Previous
Energy	+	+
Materials	+	=
Industrials	-	-
Durable consumer goods /services	-	-
Consumer staples	-	-
Health care	=	+
Financials	=	-
Technology	+	+
Telecommunications	+	+
Utilities	-	-

Equity Regions	Current	Previous
United States	+	+
Europe	-	-
Japan	+	+
Asia Pacific (ex Japan)	=	=
Emerging markets	-	=

Bonds	Current	Previous
Investment grade credits	-	-
High yield credits	+	+
Emerging market debt		
Hard currency	=	=
Asian HC	=	=
Local currency	+	+
Asian LC	+	+

	Forecast	Current
10-y bond yield (3m forecast)		
US	3.5%	3.3%
Euro zone	3.3%	3.2%
Japan	1.3%	1.2%

Middle East situation weighs on sentiment

The year started off on a strong note, helped by good corporate earnings, improving macro data and a more positive rhetoric on the Eurozone sovereign debt crisis. The IMF raised its global economic growth forecast for 2011 from 4.2% to 4.4%, reflecting the stronger economic momentum in the developed world. The US economy expanded 3.2% in 4Q 2010, driven by a 4.4% gain in consumer spending. In the Euro zone, business confidence improved further, boosted by the strong growth momentum in Germany. Chinese fourth quarter GDP growth (+9.8%) came in stronger than expected. However, escalating political unrest in the Middle East and growing concerns about Chinese inflationary pressures weighed on risky assets in the second half of January. The USD and JPY declined versus the Euro.

Global equity markets gained 1.6% in USD terms. European equities, which lagged in 2010, outperformed, gaining almost 4% in USD terms. Emerging market equities lost almost 3%, Asia ex-Japan declined more than 1%, while Japanese stocks also lagged. Global real estate showed a slight positive return in January. Within fixed income, the sell-off in government bonds continued. The German 10y bond yield rose from 2.9% to 3.2%, while the yield of US 10y treasuries climbed a few basis points. Successful debt auctions by Spain and Portugal and rumours about restructuring of the European Financial Stability Facility improved sentiment towards the Eurozone area. Most spread products were also able to benefit from the positive macro environment. High yield bonds were the strongest performers, whilst emerging markets debt underperformed the other spread products. Commodities gained 2%, with Agriculture outperforming, while precious metals were the worst performing commodity segment.

View: Reducing EM exposure

As the macroeconomic momentum became more supportive of risky assets, we increased risk positions during the second half of Q4 2010. We are currently positive on equities, real estate and commodities. We also favour spread products within fixed income. Although we continue to like the long term fundamentals of emerging markets (EM), we are temporarily more cautious, both with regard to equities and fixed income, as developed market (DM) momentum is clearly accelerating. Inflationary pressures are also on the rise in EM, creating uncertainty about monetary policy. We are especially positive on US and Japanese equities. High Yield bonds still look attractive for FI investors.

Economy

DM economic momentum surprises positively

Global economic momentum is clearly picking up. This is mainly due to the surprisingly robust recovery in the US economy, which has improved from its weak position over the summer. For 2011 and 2012, we anticipate growth of 3.1% and 3.2% for the US, slightly above its long-term average. The breadth of the recovery is positive. Furthermore, the recovery in activity in the service sector is creating jobs. Over the past three months, an average of 140,000 new jobs a month has been created, which should encourage families to increase their spending and also to continue saving. Companies are displaying greater confidence by investing more. The number of mergers and acquisitions is also growing.

High overcapacity won't dissipate yet

Above-average growth is needed for US unemployment to fall. Until recently, the number of new jobs did not grow as employees worked longer hours. Since this situation is unlikely to continue, companies will meet labour demand mainly through new job creation in the next few months. In the short term, the expansionary budget policy will help to reduce unemployment (currently at around 9.5%). However, the actual structural reason for the overcapacity not disappearing rapidly is the credit crisis. Experience has shown that economic growth remains moderate for several years in the wake of such a crisis, due to obstacles in the supply and demand for credit. The overcapacity in the economy is therefore expected to persist. We expect the unemployment rate in the US to remain at more than 8% over the next two years. Since such a high level of unemployment has never accompanied high inflation since the Second World War, we believe that fears of higher inflation appear to be premature.

Germany is Europe's engine

Even the biggest optimists continue to be surprised by the strength in the German economy. Strong demand from EM and the re-awakening of German consumers mean that overcapacity is dropping rapidly in the largest economy in the euro zone. The other core countries are experiencing growth at around the long-term average, whilst the peripheral countries are displaying low growth or a slight contraction. The euro zone economy is therefore experiencing a recovery at three different levels.

Increasing inflation in India

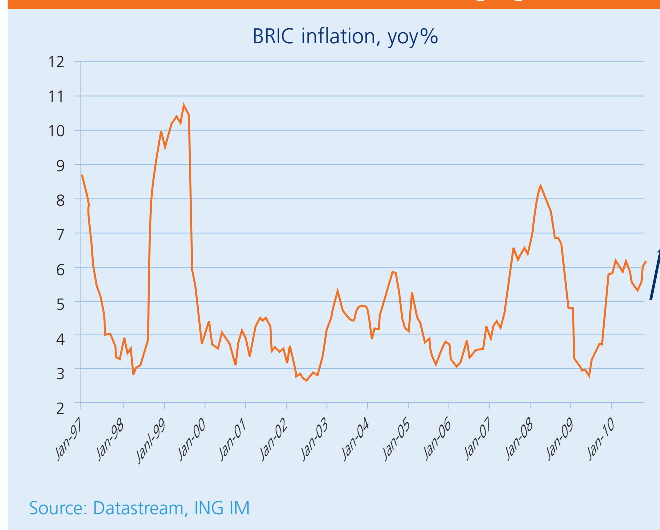
The Reserve Bank of India raised its repo rate from 6.25% to 6.50% in January. Since it started to hike rates in March 2010, the central bank has raised the benchmark rate by 175 bps. With inflationary pressures still too high for comfort – December core inflation was 1% month-on-month – the RBI is likely to continue raising rates in the next few months. It raised its inflation projection for the end of the fiscal year (March 2011) from 5.5% to 7.0%. Inflationary pressure in India is one of the highest in the emerging world due to high capacity utilisation and a high sensitivity to food prices.

Slight moderation in Chinese business confidence

In China, business confidence weakened in January for the second month in a row, as the PMI declined by 1 point to 52.9. The new orders index was slightly lower, mainly because of a modest decline in infrastructure-related items. The sharpest drop was in new export orders, which decreased by 2 points. The decline in the PMI is in line with our gradual soft landing scenario, although ahead of the Chinese New Year, the statistical distortions are large, which makes it difficult to draw conclusions on the basis of these numbers. In the PMI-data, the input prices component was higher, mainly due to metals and energy prices. As long as commodity prices maintain their upward trend, Chinese inflationary pressure is likely to remain elevated. Nevertheless, due to base effects and the economic slowdown, we expect headline inflation to start moderating in Q2.

Appreciation in the renminbi expected

One of the methods of combating inflation is an appreciation in the renminbi. Over the next twelve months, the markets have priced in a rise of 3% in the renminbi versus the US dollar, which we believe is rather low. We expect the authorities to allow a higher rise. At more than 5%, inflation is already too high. The central bank is aware of this and has already implemented measures to cool the economy. We assume that the Chinese central bank will not apply the brakes too hard on the economy. For investors, uncertainty remains surrounding the monetary policy to be pursued. The tighter policy will lead to China's import and export growth moving between 10-20% in the next few quarters. Domestic demand in China appears likely to remain higher than the growth in global demand.



Source: Datastream, ING IM

Asset Allocation

Improving macro momentum and more stimulus in the US limit global cyclical downside risks. At the same time, this could provide some further fundamental tailwind for risky assets. Recognizing the environment of downward inflation pressure, policymakers in developed economies are expected to remain accommodative, hence policy rates in developed markets should remain low. The risks surrounding our outlined base case scenario are higher than usual. We identify five key risks: Additional sovereign stress in the Eurozone, policy errors in emerging markets and inflation in emerging markets with many countries behind the curve. Also, the US deficit may come into focus later in the year. More recently, geopolitical concerns have surfaced as the situation in the Middle East and the risk of contagion to the rest of the region cannot be ignored. Soaring oil prices could have a negative impact on global growth and further increase inflationary pressures.

Preference for risky assets

Although (policy) risks remain high, improving fundamentals & a positive trend in equities have led us to overweight equity (and underweight bonds) in multi-asset portfolios since mid-December. We believe equity valuations adequately discount the uncertain environment. Indeed, the price/earnings ratios are still at, or slightly below, their long-term averages in the various equity regions, while low bond yields further contribute to the attractiveness of equities. Although corporate earnings growth will probably slow, it should still be above trend in 2011. We also like real estate, where fundamentals are turning positive, valuations are fair and the search for yield should support the asset class.

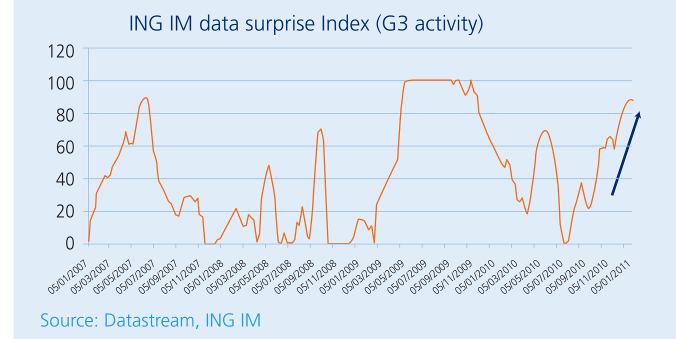
Meanwhile, our outlook for commodities remains bullish, as positive drivers for commodity investing outweigh the risks. An improving global economic outlook and higher (real) rates is likely to shift investment demand away from precious metals into industrial metals and the agricultural segment in the coming weeks. Tight physical markets and the still solid credit growth in China provide support for higher industrial metal prices in the short to medium term. Structural and weather-related supply issues, a northern hemisphere crop season that will only be completed by Q3’ 2011, as well as resilient agri-demand, are likely to continue to push agricultural prices further up in 1H 2011.

Equity

We remain positive on US equities. In addition to the already visible improvement in the economic picture, companies in the US will also profit from President Obama’s 2011 tax plan. As a consequence, we have not only adjusted our forecasts for US economic growth upwards, but also our forecasts for US corporate earnings growth.

We upgraded Japanese equities to a small overweight in early January. Japan strongly underperformed other developed markets in local currency terms. Low valuations and extremely negative sentiment act are contrarian signals in favour of Japan. Longer term, however, structural issues remain and will cap valuations.

Developed market macro data continue to surprise on the upside



Source: Datastream, ING IM

We reduced EM equity exposure to a small underweight, although we retain our long term positive view. Rising inflation in China may put the central bank under more pressure to raise interest rates. Within EM, we keep the focus on the domestic consumption theme. In EM Asia, we favour China and Taiwan at the expense of Malaysia, as Chinese equities lagged somewhat in the last months of 2010 and are not expensive given their strong fundamentals.

Emerging markets are faced with increasing inflationary risks caused by higher food prices and low output gaps. Further monetary tightening will weigh on the performance of EM equity markets, while at the same time developed markets have a positive dynamic driven by macro data that is expected to continue to surprise on the upside.

Within the Euroland, sovereign issues seem to have moved into the background (although we believe the problems are far from solved). This is visible in the decline in spreads in the peripheral markets, as well as the strong equity performance in these markets. As a consequence, we have somewhat reduced our Europe underweight.

We have a neutral position on Asia ex-Japan. Loose US monetary policy, combined with high Asian growth, should underpin these markets. Australia is also driven by rising commodity prices. On the other hand, valuations are less attractive, with 2011 PE at a 15% premium relative to DM. We currently like Hong Kong, as it could become a prime beneficiary of the current liquidity as this market combines low (US-like) interest and exchange rates, with a higher (China-linked) economic growth. We also believe that the banking sector, which represents almost 40% of the Hang Seng Index, will outperform in the short term, given a steepening in the yield curve. Chinese tightening, however, is a potential threat.

Elsewhere, we continue to focus on commodities, balance sheet quality and earnings and dividend growth. Overall, we have a balanced sector allocation, favouring Telecom, IT and Energy. We like high dividends as we expect dividends to exceed earnings growth and hence represent a larger part of total returns in 2011.

Fixed income

The improving macro momentum does not materially change our outlook for core inflation or monetary policy, since large output gaps in major economies remain in place, pointing to a deflationary bias in the coming 1-2 years. The need for balance sheet repair remains in the medium to long term in the household, financial and sovereign sectors, limiting the DM growth outlook in the coming years. German and US 10y yields should hover within the top half of their ranges of the past 1.5 years. It is unlikely that they will break out of these ranges in the next 6 months. US yields are likely to remain below 4%, whilst German yields should stay below 3.5%. Japanese bond yields are likely to move between 0.9% and 1.4%.

Within fixed income, we overweight spread products due to the search for yield, reduced cyclical risks and market momentum. We prefer non-financial corporate exposure (high yield and senior bank loans), which benefit from improved US cyclical momentum, and diversified emerging FX exposure, as strong fundamentals and the possible use of currencies to compress inflationary pressures make the risk-return trade-off attractive. We have a medium term underweight in investment grade credit due to its sensitivity to sovereign and financial sector stress.

Monetary policy normalization and inflation concerns should keep downward price pressure on Asian debt markets. However, Asian bonds outperformed G3 sovereign debt in the sell-off last month. Foreign inflows into Asian bonds moderated, but domestic supply and demand remain supportive. The long-term outlook for Asian hard currency debt remains attractive, on the back of strong regional fundamentals and declining default expectations. The outlook for Asian local currency debt also remains positive, as controlled FX appreciation helps to ease inflation pressures.

Foreign Exchange

For 2011, we expect that any further positive return of commodity and EM FX will be more moderate than in 2010, as valuations and positioning are more stretched. Based on our global economic outlook, we do expect that returns on high yielding FX investments will continue to be positive, especially in 1H 2011, when economic momentum is strong.

The JPY was the most surprising performer in 2010 against the USD, mainly due to the continuing decline in the USD-JPY 2yr rate spread. It is difficult to see a further decline in USD 2yr yields. However, a rise is only possible if markets start anticipating tighter US monetary policy in 2012. Based on rate differentials, a sideways performance of USD/JPY is therefore expected.

Global Markets Performance

Equity: Selected Indices	1M	3M	YTD	1Y
MSCI AC World	1.57	6.58	1.57	19.61
MSCI AC Asia Ex Japan	(0.98)	2.96	(0.98)	26.06
DJ Industrial Average	2.85	7.67	2.85	21.35
S&P 500	2.34	9.07	2.34	21.45
NASDAQ Composite	1.78	7.68	1.78	25.74
S&P/ASX All Ordinaries	0.07	3.15	0.07	9.80
FTSE 100	(0.55)	3.80	(0.55)	16.78
DAX	2.36	7.21	2.36	26.19
Nikkei 500	0.54	11.75	0.54	2.00
Hang Seng HIS	1.79	1.52	1.79	16.53
KOSPI Korea	0.91	9.92	0.91	29.16
TSEC 50	2.96	12.85	2.96	18.87
Straits Times Idex	(1.53)	0.31	(1.53)	17.04
Shanghai SE Composite	(0.62)	(6.32)	(0.62)	(6.64)
Shenzhen SE Composite	(7.22)	(8.14)	(7.22)	6.89

Bond: Selected Indices	1M	3M	YTD	1Y
Barclays Capital Global Aggregate	0.18	(2.38)	0.18	5.30
JPM EMBI Global TR	(0.54)	(4.03)	(0.54)	11.02
HSBC Asian USD Bond	0.07	(2.38)	0.07	9.41

Source: Morningstar Direct as of 31 January, 2011, measured in the base currencies.

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