

Key points

- Economic momentum robust, but risks are high
- Time to revert to “risk-on” mode again

- Move commodities and equities back to overweight;
- Real estate remain neutral and treasuries underweight
- More positive on EM assets

HOUSEVIEW



ING Investment Management Asia Pacific

April 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	3.7%	3.6%
Euro zone	3.7%	3.5%
Japan	1.3%	1.3%

Extraordinarily uncertain environment

Investors have been facing an extraordinarily uncertain environment in recent weeks. On the one hand, economic indicators point to an ongoing strong momentum, particularly in the US and Europe. On the other hand, the markets have struggled with a very opaque political situation in North Africa and the Middle East, which is significantly pushing up oil prices. In addition, Japan was hit by a devastating earthquake in March, which disrupted energy suppliers in major parts of the country and caused serious problems within a nuclear power plant. The fact that the ECB prepared the markets in March for an imminent rate hike also added to the market uncertainty.

Global equity markets lost 0.4% in USD terms in March, leading to a year-to-date performance of +4.5%. Emerging market equities (+4%), as well as Asia ex-Japan (+3%) moved against the trend and both outperformed in local currency terms. Japan (-7.8%) was the poorest performing region. The US performed in line with the broad market, while Europe lagged. Global real estate remained more or less stable in USD terms. Sector wise IT, utilities, financials and consumer discretionary underperformed as these sectors are expected to be potentially hit the hardest by the Japanese disaster and the ensuing nuclear fallout. Defensive sectors and energy outperformed. Elsewhere, small cap outperformed large cap and growth outperformed value. High dividend was the best performing style.

Within fixed income, the German 10y bond yield ended 20bps higher at 3.35%, while the US 10y bond yield declined to 3.33%. Spread products (especially EMD) outperformed government bonds. Within the European peripheral bond markets, Spain and Italy outperformed Portugal, Ireland & Greece.

View: Time to revert to “risk-on” mode again

The global economic recovery is clearly continuing, but uncertainties are high. Mounting risk aversion made us reduce risks further in the course of March, especially after the Japanese disaster. Currently, some of the uncertainty surrounding our base case outlook is fading due to more visibility on both Japan and the European sovereign story. Therefore, in early April, we moved towards a medium overweight in commodities, a small overweight in equities and a small underweight in treasuries, after being neutral on all asset classes since the Japanese disaster last month.

Economy

Economic momentum robust, but risks are high

Markets and investors are trying to analyse how the cross currents in the global economy will shape the global growth outlook in the near future. The main undercurrent, that is momentum as indicated by survey evidence and data on the real economy, remains very strong and broad based. The improving US labour market will encourage consumers to spend more, which should help the US economy maintain a reasonable level of growth. Boosted by strong export growth and a reasonable expansion in its domestic sectors, Germany should remain the growth engine within the Eurozone.

However, this strong undercurrent is undermined by other shocks. Tensions in the Middle East linger and an oil price shock cannot be excluded. In addition, the Japan earthquake, ensuing tsunami and nuclear problems represent another shock to the global economy. Furthermore, Chinese purchasing managers' data suggest that industrial activity in China is on a modest downward trend, which usually feeds through to the rest of the world with a three month delay. Our base case assumption is for global momentum to slow in Q2'11 and stabilise at a still robust level. We expect the global economy to grow by 4% to 4.5% in 2011 and 2012. The risks should be watched closely, as our forecasts for continued robust final demand is very sensitive to consumer and business confidence, a factor that is as important as it is difficult to forecast.

Japan to recover but the big question is when

A month after the tragic disaster in Japan, there is much uncertainty about its ultimate economic impact, due to power supply disruptions in a region that accounts for more than 40% of GDP. The power outages may be over by the end of April when the seasonal demand for heating declines, but may be reinstated in Q3 when demand for air-conditioning rises. The effects will be felt both within the manufacturing and service sectors. The positive growth effect from the rebuilding efforts should outweigh these disruptive effects at some point. Hence, we retain our view that growth will be depressed in H1, but rebound strongly in H2 and into 2012.

Meanwhile, the data released in the past few weeks reveal that the economy was accelerating strongly from the contraction seen in Q4'10 when the earthquake struck. The most timely and reliable Japanese confidence surveys (Eco Watchers and Shoukochukin) show confidence improving around the turn of 2011 on accelerating global growth and a stable Yen. Since businesses and consumers know that the effects of a natural disaster are temporary, this improving momentum is a positive. This will be especially the case if the Yen does not appreciate. Monetary and fiscal policy will also be supportive. A first supplementary budget of around JPY 2 trillion will be presented to the Diet in April, but the ultimate cumulative increase in spending may be around 10 trillion (2% of GDP).

The data flow is expected to be heavily distorted in the near future, as was the case in March, when the manufacturing PMI fell 6.5 points to 46.4, the lowest level in two years. The Tankan survey also fell 36 points to -20, suggesting that industrial production may fall by between 10-15% m-o-m in March. We expect a more moderate decline in April. Whilst output should rise, it seems likely that the average output in April will be below that seen in March. Looking further out, the level of output should rise above its pre-quake level sometime towards the end of the year.

Another interest rate hike in China

In China, the central bank raised interest rates in early April. The move was widely expected, but it came earlier than anticipated. The lending and deposit rates were raised by 25 bps to 5.31% and 3.25%, respectively. While food inflation has started to ease, core inflation has not stabilized yet, which is keeping the authorities cautious. Nevertheless, recent comments by the central bank have been dovish, and it is widely expected that the end of the tightening cycle is close. The timing of the latest rate hike suggests that the March CPI reading will be on the high side. We expect inflation to reach 5.1% in March and to peak in June at 6.3% and anticipate one more interest rate hike before the summer and one or two reserve requirement ratio increases.

Japan had an upward momentum when the disaster hit



Source: Thomson Reuters Datastream, ING IM

Asset Allocation

As mentioned above, some of the uncertainty surrounding our base case outlook has started to fade. The main driver of a renewed risk tilt in our asset allocation is clear support from investor flows into risky assets such as equities and commodities, and positive signals from both medium-term and short-term price trend indicators. At the same time, negative price momentum has started to build in treasury markets. In early April, we moved towards a medium overweight in commodities, a small overweight in equities and a small underweight in treasuries.

Preference for commodities

With somewhat less uncertainty on the macro horizon and a rising probability of a renewed restocking need in China, we moved commodities back to an overweight stance. Energy and agriculture remain the preferred segments, as the continued geopolitical risks and resilient demand reduce the physical surplus in the oil market while most agricultural commodities markets remain tight. We are neutral on real estate. Improving fundamentals and the search for yield are supportive for the asset class. However, excess inventories remain high and valuations are no longer cheap. Equity fundamentals are supportive, as corporate earnings continue to perform well. High margins are tangible drivers of profit outcomes, with other drivers being global growth, a small increase in margins and low financing costs. Corporates may use the cash on their balance sheet to pursue further buy-backs, M&A & capex. Therefore, fundamentals still support a small overweight in equities.

Equity

We had an overweight position in Japanese equities when the earthquake struck, but closed this position shortly afterwards. However, we are not too pessimistic as Japan offers good value. At the end of March, we upgraded emerging markets from underweight to neutral in view of the convergence of the tightening cycle between DM and EM, a peaking in DM leading indicators and the improved momentum for EM. In early April, we upgraded EM further to a medium overweight as price momentum further improved. EM as an asset class is witnessing inflows again. Expected earnings growth in EM for this year and next is +17.2% and +14.3%, which is higher than in DM (+16.7% and +13.6%). The biggest risk factor is a further increase in energy prices due to a supply shock as this may hurt global growth and increase inflationary pressures in EM given their higher energy intensity and the link with food prices.

We financed the above move equally out of Europe and the US. The risk/reward between the two regions is balanced. Europe has lower valuations (18% PE discount and 26% PB discount, in line with LT averages). The tightening cycle has started in Europe, where sovereign risks linger and the USD weakness may benefit the earnings growth of US companies. This is visible in the earnings momentum divergence between the two regions and we should see more clarity with the upcoming results season.

We have a neutral position in Asia ex-Japan. Loose US monetary policy, combined with high Asian growth, underpins these markets. Australia is also driven by rising commodity prices. We favour Hong Kong, as it is a prime beneficiary of the high liquidity since this market offers both a lower-for-longer (US)-like interest rates and exchange rates with a higher (China)-linked economic growth. We also believe that the banking sector, representing almost 40% of the Hang Seng benchmark, will outperform in the short-term given a steepening in the yield curve. Chinese tightening is a potential headwind, but the tightening cycle is already well advanced.

In emerging Asia, we have a clear preference for China, where we expect that the authorities are close to the end of their policy tightening measures. We also like India, where valuation levels are more attractive after several quarters of underperformance. Indian inflation has started to ease. We see less upside in Korea and Taiwan, as expectations about global growth have limited room to surprise on the upside. Elsewhere, we focus on commodities, balance sheet quality and dividend growth. We have a balanced sector allocation, with preferences for telecom, healthcare, IT and energy. We favour high dividend as these will outgrow earnings and represent a larger part of total returns in 2011.

Fixed income

Although the media focuses strongly on inflation in the mature economies, currently, we do not envisage any structurally higher inflation risks in the US and the Eurozone. Inflation could run slightly higher in Germany, however, as this country is already operating at almost full capacity. Nevertheless, Germany's higher inflation may be largely offset by price pressures in other Eurozone countries, where there is still considerable overcapacity. In the US & the Eurozone, we do not envisage 10-year bond yields rising too much above the current levels in the coming months. Japanese bond yields are likely to move between 0.9% and 1.4%.

Within fixed income, we have a modest overweight in spread products on the back of the search for yield, healthy macro and earnings fundamentals and a resilient cyclical outlook. Within spreads, we prefer non-financial corporate exposure (High Yield / Senior bank loans), which benefits from solid inflows, low defaults and strong corporate fundamentals. We also have an overweight in diversified emerging FX and EMD hard currency as momentum in investor flows and prices have strengthened recently. Elsewhere, investment grade credit and AAA ABS are neutral, while EM local rates exposure is an underweight.

The outlook for Asian hard currency debt remains attractive on the back of strong regional credit fundamentals and declining default expectations. The impact on Asian issuers by events in MENA and higher oil prices is manageable. Monetary policy normalization and inflation concerns continue to exert downward price pressure on Asian local currency debt markets. However the expected policy tightening is priced in by now, and we expect inflation to peak in the region over the next few months. Local currency bond returns will benefit from controlled FX appreciation.

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 becoming more stretched. Still, based on our global economic outlook, we do expect that returns on high yielding FX investments will continue to be positive, especially in H1'11, when economic momentum is expected to be strong.

A prolonged period of JPY weakness is likely, due mainly to the clear differentiation in monetary policy. The ECB hiked rates last week, and will do so again later this year (and next year). For the Fed, the first rate hike might be further away, but within the next two years, US monetary tightening is very likely. The BoJ, on the other hand, is expected to loosen monetary policy even further in the near future. Rate hikes are unlikely in Japan in the next two years.

One important driver of structural yen strength has been Japan's trade surplus, which is likely to decline as a result of the earthquake. Exports will probably suffer as a result of the damage to production capacity. At the same time, imports will rise, mainly due to higher fuel imports to replace lost nuclear power generation capacity. The impact of capital repatriation on the yen is more uncertain. Our view is that the impact is limited, but we acknowledge that large capital repatriation is the biggest risk to our bearish yen view.

Global Markets Performance

Equity: Selected Indices	1M	3M	YTD	1Y
MSCI AC World NR USD	-0.10	4.42	4.42	14.08
MSCI AC Asia Ex Japan NR USD	6.28	1.16	1.16	19.49
DJ Industrial Average TR USD	0.91	7.07	7.07	16.51
S&P 500 NR USD	0.00	5.77	5.77	14.96
NASDAQ Composite PR USD	-0.04	4.83	4.83	15.98
FTSE 100 TR GBP	-0.94	1.10	1.10	7.44
FSE DAX TR EUR	-3.18	1.84	1.84	14.43
S&P/ASX All Ordinaries TR	0.64	2.92	2.92	4.80
Nikkei 500 PR JPY	-6.54	-2.22	-2.22	-9.25
Hang Seng HSI PR HKD	0.81	2.14	2.14	10.77
KSE KOSPI Korea PR KRW	8.63	2.72	2.72	24.45
TSEC 50	1.27	-2.23	-2.23	11.06
StreetTRACKS Straits Times Idx	3.28	-3.37	-3.37	8.96
Shanghai SE Composite PR CNY	0.79	4.27	4.27	-5.82
Shenzhen SE Composite PR CNY	-3.25	-2.88	-2.88	3.50

Bond: Selected Indices	1M	3M	YTD	1Y
BarCap Global Aggregate TR USD	0.47	1.24	1.24	7.15
JPM EMBI Global TR USD	1.27	1.02	1.02	8.65
HSBC Asian USD Bond TR	0.48	0.77	0.77	7.71

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

ING IM 2011 Market Outlook

Bond yields (10y)				
quarter end (%)	Q1'11	Q2 '11	Q3'11	Q4'11
Countries				
US	3.5%	3.6%	3.6%	3.7%
Eurozone	3.3%	3.5%	3.6%	3.8%
Japan	1.3%	1.3%	1.3%	1.3%
UK	3.7%	3.8%	3.9%	4.0%

Corporate bond (IG) yields				
quarter end (%)	Q1'11	Q2 '11	Q3'11	Q4'11
Countries				
US	4.1%	4.1%	4.1%	4.1%
Eurozone	3.7%	3.8%	3.9%	4.0%
Japan	0.7%	0.8%	0.9%	1.0%
UK	5.6%	5.6%	5.7%	5.8%

Equity				
quarter end	Q1'11	Q2 '11	Q3'11	Q4'11
Countries				
S&P 500	1340	1360	1380	1400
Euro stoxx 600	300	303	307	310
TOPIX	975	1000	1025	1050
FTSE 100	6150	6300	6450	6600
MSCI EM Free	1150	1200	1250	1300

Foreign exchange rates				
quarter end	Q1 '11	Q2 '11	Q3'11	Q4'11
Currencies				
EUR/USD	1.30	1.30	1.30	1.25
USD/JPY	80	85	90	95
GBP/USD	1.44	1.53	1.57	1.56
EUR/JPY	104	111	117	119
EUR/GBP	0.90	0.85	0.83	0.80

Source: Q1 historical data from IMF (GDP, inflation) and Economist Intelligence Unit (rest data); Q2-Q4 forecasts from ING IM.

ING IM Global Economic Outlook

	Real GDP			Inflation			Policy Rates (% , YE)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
World	5.0	4.2	4.3	3.0	3.2	3.0			
Developed	2.6	2.3	2.5	1.4	1.7	1.5	0.45	0.74	1.31
US	2.9	3.1	3.2	1.6	1.7	1.5	0.13	0.13	0.75
Euro	1.7	1.8	2.0	1.6	2.1	2.0	1.00	1.75	2.50
Japan	4.0	1.5	2.0	-1.0	-0.2	-0.1	0.10	0.10	0.10
UK	1.8	1.8	2.1	3.3	3.5	2.0	0.50	1.00	1.50
Emerging	8.1	6.7	6.5	5.1	5.1	5.0			
China	10.1	9.0	9.0	2.9	4.1	4.0			

	Unemployment rate			Budget balance			Current account		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Developed	9.0	8.6	8.1	-8.0	-7.4	-5.8	-1.3	-1.3	-1.4
US	9.7	9.0	8.5	-8.9	-9.0	-7.0	-3.5	-3.9	-3.9
Euro	10.0	9.7	9.4	-6.4	-4.8	-3.7	0.0	0.1	-0.2
Japan	5.1	4.7	4.3	-8.0	-7.9	-6.1	3.5	3.6	3.5
UK	7.8	7.8	7.5	-10.1	-8.6	-7.6	-2.0	-1.7	-1.2
Emerging									
China	6.1	6.5	6.4	-2.2	-1.7	-1.6	6.1	4.3	3.9

Source: Forecasts from ING IM, historical data from IMF (GDP, inflation) and Economist Intelligence Unit (rest data)

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