

HOUSEVIEW

Asia Pacific Strategy

Asset Classes	Current Month	Previous Month
Equities	=	=
Fixed Income	=	=
Real estate	+	=
Commodities	+	=
positive (+), neutral (=), negative (-)		

Equity Sectors	Current	Previous
Energy	+	+
Materials	=	=
Industrials	-	-
Durable consumer goods /services	-	-
Consumer staples	=	=
Health care	+	+
Financials	-	-
Technology	+	+
Telecommunications	+	+
Utilities	=	=
positive (+), neutral (=), negative (-)		

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

Bonds	Current	Previous
10-y bond yield (3m forecast)		
US	2.7%	
Euro zone	2.5%	
Japan	1.1%	
Investment grade credits	-	-
High yield credits	+	+
Emerging market debt		
Hard currency	+	+
Asian HC	+	+
Local currency	+	+
Asian LC	+	+
positive (+), neutral (=), negative (-)		

Key points

- Central banks implement fresh stimuli
- Search for yield intensifies
- EM and dividend stocks still attractive
- Bond yields low for longer in DM; tilt towards EMD maintained

Markets driven by liquidity

Risk appetite improved further in October thanks to strong earnings results combined with the prospect of a new round of quantitative easing by the Fed. More US stimulus lowered double dip fears. The US, Europe and China saw strong PMI readings, while UK GDP growth for Q3 2010 came in better than expected. China surprised with a 0.25% interest rate hike. The US dollar sold off on the back of QE anticipation.

The MSCI AC World Index rose 3.3% in USD terms. The Euro zone (+4.2% in local currency) was the best performing region, while the US (+3.5%) performed also slightly better than the broad market. EM (+1.9% in USD) lagged somewhat after the strong performance in previous months. The weakest market was Japan, losing 1.8% in yen terms. Looking at sectors, cyclical sectors outperformed defensive ones by approximately 200 basis points.

Speculation about the next round of QE in the US, persistent disinflation in developed markets and the search for yield among investors provided support for fixed income markets in October. US Treasuries outperformed their German peers. Spreads on Greek, Portuguese and Irish government bonds increased as fears of sovereign defaults returned. Most parts of credit space enjoyed another good month as yields continued to decline, with high yield bonds performing especially well over the month.

Focus on growth and yield

The influx of liquidity, combined with the low yields on money and government bond markets, has encouraged investors to seek markets that offer higher yields. At the same time, we anticipate a period of lower economic growth in the developed economies. We therefore have a clear preference for emerging market assets, within equities as well as in fixed income. Other assets with attractive yields, like high yield corporate bonds or high dividend stocks, are expected to benefit from this as well.

Economy

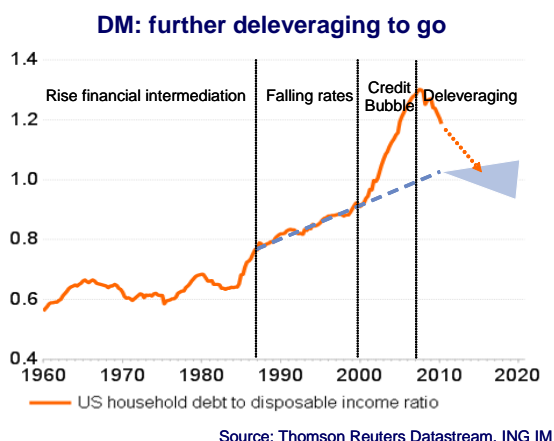
Economic data still point to growth

Divergence between emerging and developed countries remains clear. Recent Asian numbers surprised positively, reducing fears of a sharp slowdown. Moreover, European activity momentum remains positive, while US macro figures have stopped disappointing. These signs suggest growth will continue, although at a more moderate pace. Still, it remains unlikely that the pace of the developed market recovery will be strong enough to prevent disinflationary trends to persist and balance sheet concerns to rise to the forefront again.

Monetary policy settings remain accommodative, with policymakers in developed economies continuing to reinforce the need for accommodation. Obviously the recent QE initiatives in Japan and the US underscore this. Therefore, DM policy rates are expected to remain lower for even longer. Also, policy makers in emerging countries still seem quite focused on keeping accommodation in place by fighting upward currency pressures. Attention to fiscal policy also remains, in particular the need to address the very large fiscal imbalances existing in most developed economies. In some cases, dramatic, short-term austerity measures have been taken.

Disinflation still medium-term concern

The need for balance sheet repair remains present from a medium term perspective in DM household, financial and sovereign sectors. Large output gaps in major economies remain in place, pointing to a deflationary bias over the coming 2-3 years. It seems that inflation risks have shifted more to the downside over the summer as core inflation and inflation expectations have drifted lower, even as policy commitment to fighting these trends pre-emptively is undermined by divergence of policy maker opinion or political constraints. We think the “lower for longer” interest rates theme is likely to persist for most of next year as well.



For the Asian region the inflation outlook remains mixed, with persistent deflation in Japan and gradually rising upward inflation risks in China and India.

Contraction chances rising in Japan

The Japanese cyclical outlook has deteriorated recently. In H1 2010 the economy clearly benefited from rising exports and increasing

signs that this was spilling over into stronger domestic demand via an increase in capital expenditures as well as an improvement in labour income. Nevertheless, while exports were still relatively solid heading into the summer, they may start to feel the combined burden of the slowdown in global industrial production and the Yen appreciation in the final months of the year and into 2011.

In this respect, the short-term momentum in exports and industrial production has now already fallen to negative territory for the first time since Q2 2009. What's more, the near term outlook also remains subdued as the manufacturing PMI fell to 47.2 in October (from a May peak of 54.7) with the new orders sub index remaining stuck in the lower 40s. Adding it all up, there is a real chance that Japanese GDP will show an outright contraction in Q4 2010.

Chinese communist party presents 5-year plan

The Chinese communist party presented recently its economic plan for the 2011-2015 period. Two main objectives stand out: (1) to maintain stable and relatively strong economic growth; and (2) to move faster towards rebalancing the economy. The targeted economic growth over the five-year period is 7%, which is below the 7.5% target of the past five years. While all plans' targets have been beaten by a large margin by the actual economic performance since 1990, it is nevertheless important to notice that the growth target is set at a lower pace, given the demographic headwinds that will start emerging in the next few years.

To reflect the new demographic reality, in which the labour market will grow at a much lower pace and the active proportion of the population will gradually decline, the authorities want to speed up the rebalancing of the Chinese economy. This means that the labour intensive export sector and the capital intensive fixed-investment component will fall as a share of the total economy. Meanwhile, private consumption will increase substantially from the current 34% of GDP with more progress to be seen in regard to poverty reduction and the reduction of regional income disparities. Within the fixed investment sphere, priorities will be given to social infrastructure (public housing, hospitals and schools). All changes will continue to be gradual. There is no room for radical change in the way monetary and exchange-rate policy is conducted.

Economic growth in China may have turned the corner

October manufacturing PMI was 54.7 – the strongest reading in six months. The domestic-demand components were strong, in particular. We thus upgrade our 2011 China GDP growth forecast from 8.5% to 9.0%. The economy may continue to be driven mainly by consumption and investment growth, while damage in the export sector from declining world trade growth appears limited. For 2012-2016, however, we expect growth to move between 6% and 9%.

While fiscal policy remains loose in China, monetary policy is likely to remain rather tight. The strong domestic growth picture in combination with rising raw material prices globally is pushing up inflationary pressure in the economy. We increase our 2011 CPI forecast from 3.6% to 4.1%. Although we continue to believe that we have seen the worst in the current tightening cycle (loan quota for banks are unlikely to be reduced again), we may probably see more symbolic interest rate hikes and also perhaps more increases in the reserve requirement ratio for banks.

Asset Allocation

New QE initiatives provide more insurance against global cyclical downside risks and could give some further tailwind to risky assets. However, less cyclical and fiscal policy support is anticipated going forward. In general, policy uncertainties remain high.

Recognizing the environment of downward inflation pressure, policymakers in developed economies currently maintain an accommodative stance. Therefore, developed market policy rates are expected to remain lower for even longer than previously expected.

Still, we like to caution against too much earnings pessimism. On the one hand, the weaker economic momentum will undoubtedly have a negative impact on earnings growth. On the other hand, it would probably take a global recession (which is *not* our base case) to generate negative earnings growth in 2011. We maintain our earnings targets of 35% + in 2010 and around 10% in 2011.

Preference for commodities and real estate

In the low growth environment, future performance will be more driven by yield than capital gains. Therefore, we maintain a neutral position for equities compared to fixed income. We have moved real estate to a small overweight. Fundamentals are turning positive, valuations are fair and the search for yield supports the asset class.

Meanwhile, we decide to move commodities to a medium overweight. Not only does the underlying momentum in the asset class remain strong; the negative roll yield (carry) has on average come down in recent weeks. Next to these supportive market dynamics, the Chinese restocking suggests that a further rise in spot prices remains in the offing for the next couple of months.



Equity

We keep our overweight position on emerging markets as against DM. Despite recent EM outperformance, we think this theme has further to run in 2011. Developed economies are facing low nominal growth prospects, while government finances are in poor shape. On the contrary, in the EM world, debt levels are low, economic growth is high and sustainable, and earnings growth in 2011 is poised to exceed earnings growth in developed markets. Within EM, we keep the focus on the domestic consumption theme. In EM Asia, we favour China, India and Indonesia at the expense of Malaysia, Korea and Taiwan, economies of which are more export driven.

We maintain a neutral position on Asia Pacific ex Japan. Loose monetary policy in the US combined with high Asian growth underpins these markets. Australia is also supported by rising commodity prices. On the other hand valuations in the region have become less attractive. 2011 PE is at a 15% premium relative to DM and earnings momentum has turned negative. We currently like Hong Kong, as it could become a prime beneficiary of the liquidity increase as this market couples lower for longer (US)-like interest rates and exchange rate with a higher (China)-linked economic growth. We also feel that the banking sector, which represents almost 40% of the Hang Seng benchmark, will outperform in the short term given a steepening of the yield curve and positive credit growth. We remain cautious on Japanese equities. Despite its attractive valuation (even compared to other DMs) we think that investors have lost patience with the multi-year underperformance of Japanese equities. A further weakening of the USD may also hurt corporate profitability in Japan.

Elsewhere we continue to focus on commodities, balance sheet quality and earnings and dividend growth. Overall we have a defensive bias in our sector allocation, with preferences for Health Care, Telecom, IT and Energy. We maintain our preference for growth stocks as earnings momentum will fade, but still like high dividend as well, underscoring the increasing importance of dividends in a low growth / low return environment.

Fixed income

Government bond yields are likely to remain low, as long as the surplus savings in the global economy are not sufficiently deployed to boost private sector expenditure (investments, consumer spending). We forecast that US and German bond yields will hover between 2% and 3% for the time being; Japanese bond yields, on the other hand, between 0.8% and 1.3%.

Within fixed income, we have a medium overweight for spread products on the back of improved liquidity conditions, reduced cyclical risks and the ongoing search for yield. We maintain an EM tilt, but also have small overweights in High Yield and Senior Bank Loans. Persisting disinflationary trends in Europe make us favour nominal treasuries over inflation linked bonds. We have a small underweight in investment grade credits.

The outlook for Asian HC debt remains favourable: economic growth is supported by strong domestic demand, corporate earnings are solid and valuations remain attractive. Also, the outlook for Asian LC debt remains positive, as the region responds to strong capital inflows driven by a combination of controlled FX appreciation, continued intervention and targeted capital controls in selected countries. Asian credit spreads are likely to gradually grind tighter.

Foreign Exchange

We maintain a positive outlook on Asian currencies given increasing growth differentials vs DM, a supportive balance of payments, and reasonable valuations. QE2 measures in the US add to the downside pressure on the USD in the near term, with FX intervention by regional CBs slowing but not halting Asian FX appreciation.

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