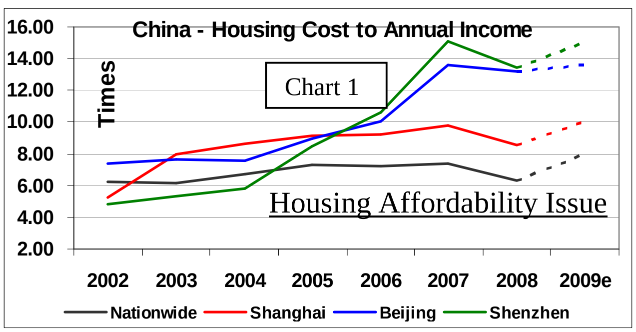
The Issues

April 2010

A PICTURE BOOK OF UNDERLYING TRENDS

The MSCI Asia-Pacific ex Japan Index (MXFEJ) has been trading in a sideways band, marking time since the start of 2010. By the end of 2009, regional and international funds targeting the region would have largely done their window-dressing. Most fund managers would have rebuilt positions in the regional bourses, given the exceptional gain experienced that year as markets made sharp snapbacks from the very oversold situations of 2H08.

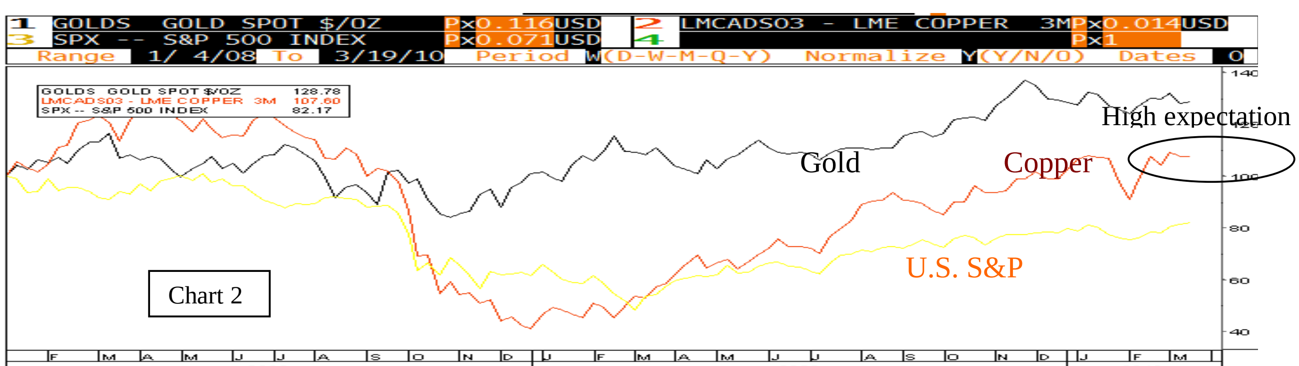
As 2010 unfolds, a few major macro-risk factors have kept major indices at bay. One of them is the property bubble in China and the rapidly inflating ones in Hong Kong and Singapore. The risk is adverse policy responses, e.g., more macro-tightening and talks of introducing capital gains tax on properties in China. In a major way, the surge in property prices is the direct result of interest rates being too low in these economies. Due to the U.S. dollar peg, the interest rate structure in these places reflects rates in the United States, levels suited to an economy emerging from a recession. But these Asian economies are already in a boom. With the rise in inflation rates, a negative interest rate environment has developed. Thanks to a mortgage war, mortgages in Hong Kong are now as low as 0.8% (pegged at a spread over HIBOR, the Hong Kong interbank rate). No wonder property investors/speculators are having a field day.



Source: Wind Data.

The current situation is already in bubble territory because of affordability. Average housing costs in Beijing, Shanghai, Shenzhen, Guangzhou and Hong Kong are at 12x to 15x average household income (vs. 4x to 5x in the U.S. currently). Social and political pressure is now being placed on governments to "do something," which will only gain strength. As a result of policy risks, property stocks (major stock index components in Hong Kong) and banks (major components in China's stock indexes, all subject to sizable capital calls) have been consolidating. This risk overhang is unlikely to dissipate anytime soon.

Another major risk overhang on market sentiment is the risk of disappointment over global growth rates. At present, investor expectations are still high for a noticeable recovery in global growth—witness the high prices prevailing in commodities such as copper and metals. Should growth in the U.S., EU and Japan remain anemic, a most likely scenario in our view, disappointments over the degree of corporate earnings recovery will zap market sentiment at some stage. This risk will likely to continue to overhang most materials stocks (major index components in MXFEJ).



Source: Bloomberg.

In a slow growth economic environment, we can expect protectionist sentiment, not only in the U.S. but elsewhere, to surface with threatening escalations. So far, the war of words has been between the U.S. and China, but we would not rule out Europe entering the scene. The EU, as a bloc, could resort to a major devaluation of the euro to stimulate external sectors of weaker members straight-jacketed by fiscal deficit problems. Most of these members would not mind a weaker euro, that being the only means of stimulus available. However, should that come about, it would undoubtedly pose head-on competition with the U.S. and Japan, as both countries also see exports as one of their growth engines. This is the one of the key structural issues of the post-Bretton Woods global financial architecture—<u>if everyone sees exports as a key economic driver, who's willing, and *big* enough, to import all these goods to fuel global growth and liquidity? For decades, the U.S. played that role, but no longer</u>.

Composition of MXFEJ

The top 150 market cap stocks in the MXFEJ constitute 72% of the index weighting (Table 1). Factors discussed above have clouded the risk profiles of near-to mid-term earnings outlook for property, bank and commodity stocks, the heavyweights in the top 150. Telecoms are also big index stocks. Their performance has been dismal across the whole region, their outlook bisected by slowing overall growth and persistent trend erosion of revenue per subscriber. Baring a renewed global liquidity-driven flow of funds, e.g., ETFs, on 'buy Asia' momentum theme, it would be difficult for MXFEJ to stage a strong rally.

Table 1 25-Mar-10	Korea	Taiwan	China*	Hong Kong	Sing	Mal	Indo	Thai	Total
% Wt. MSCI Far East x J	**21.1**	**17.3**	**30.6**	**12.5**	**7.7**	**5**	**3.4**	**2.5**	100
Top 150 stocks % Wt	15.8	11.4	22.6	10.8	5.8				**72**
US$ billion (MSCI Index)	**414**	**339**	**599**	**245**	**150**	**92**	**67**	**48**	**1958**
Mkt Cap of Bourses	**857**	**616**		n/a	**454**	**310**	**248**	**198**	
% Rep - MSCI Stocks	**48**	**55**	**>95%**	n/a	**33**	**30**	**27**	**24**	
*China stocks listed in Hong Kong					Source: MSCI				

MSCI FE x J – 503 stocks

Top 150 – >72% weight

Large segments of markets left out of MSCI

Figures in the fifth row show the percentage representation of MSCI constituent stocks in each of the respective stock markets. For instance, more than half of the total stock market capitalization of Korea is left out of the index, and 45% of Taiwan. The representation in Asean bourses is even worse. The YTD sideways performance of MXFEJ has masked the market uptrends in Asean and exciting sector themes and bottom-up stock situations in East Asia bourses. Below, we provide some examples.

Underlying Trends—A Picture Book

Chart 3 below shows the outperformance of Indonesia (+15% YTD to end-March), Thailand (+11%) and Malaysia (+6%). All these economies are enjoying good capital inflows and strengthening currencies. The Malaysian ringitt, a top performer, has appreciated +2.5% vs. the U.S. dollar. By comparison, China H-shares are down -5% (and the MXFEJ, flat).

Chart 3

Source: Bloomberg.

Propelling these better-performing markets, sectors and stocks is double-digit earnings growth outlook driven by: (1) the feel-good factor (supported by wealth effect of the rise in home values and income), which is underpinning buoyant consumption; (2) rising activities in home sales, which are driving construction as a growth engine across the region; (3) in varying degrees, rising domestic investments by countries' private and public sectors; and (4) sector dynamics and individual growth companies.

The following charts speak for themselves.

Feel-Good Factor **From the Wealth Effect of Rising Home Values**

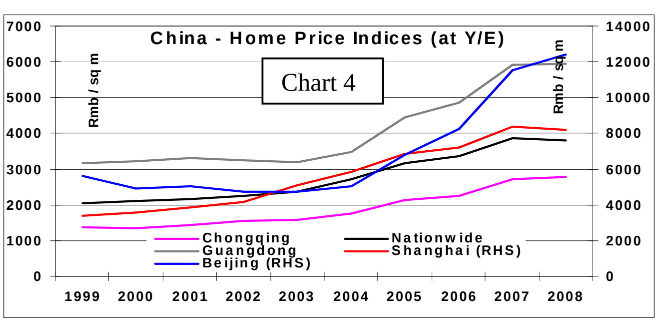


Chart 4

Source: Charts 4, 7, 8: Wind Data.

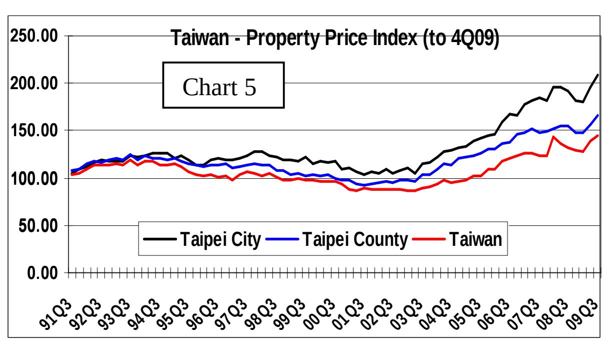
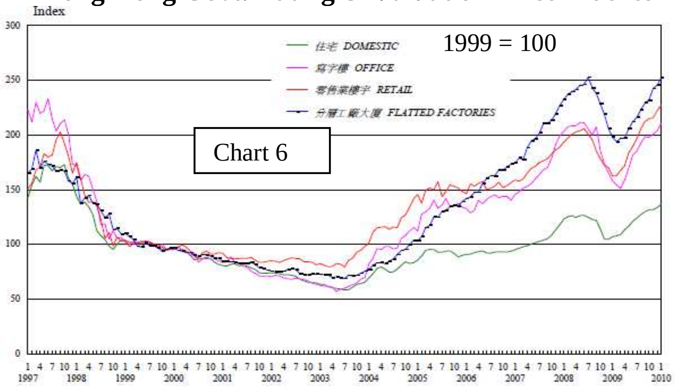


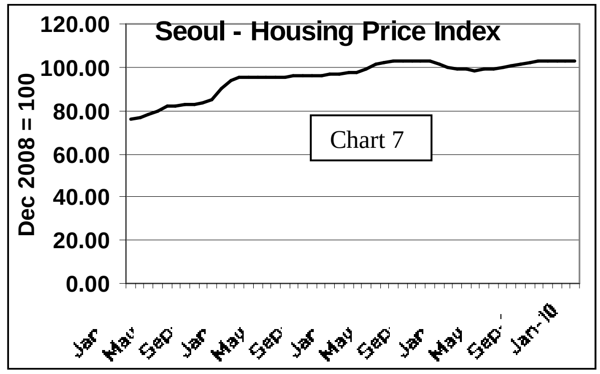
Chart 5

Source: Charts 5, 6, 9: Xinyi Realty, Taiwan.

Hong Kong Govt. Rating & Valuation Price Indexes

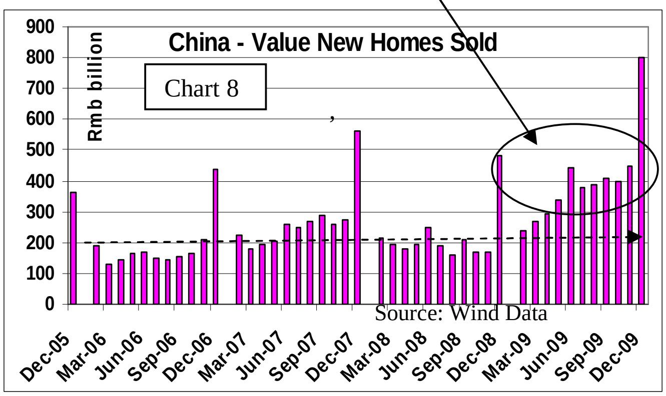


Korea--Kookmin Bank Index

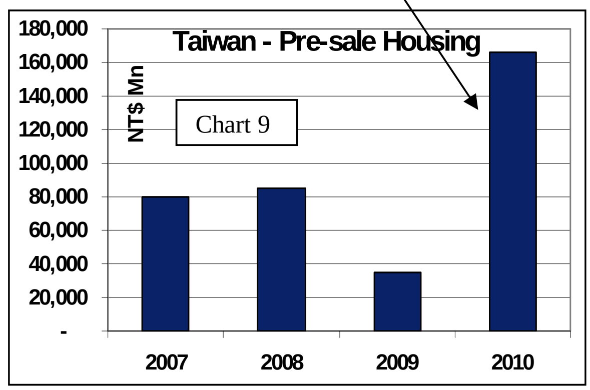


Rising construction activities → GDP growth

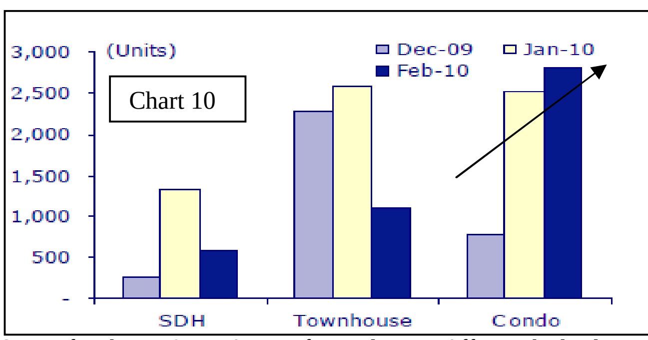
China--Presale volumes doubled in 2009



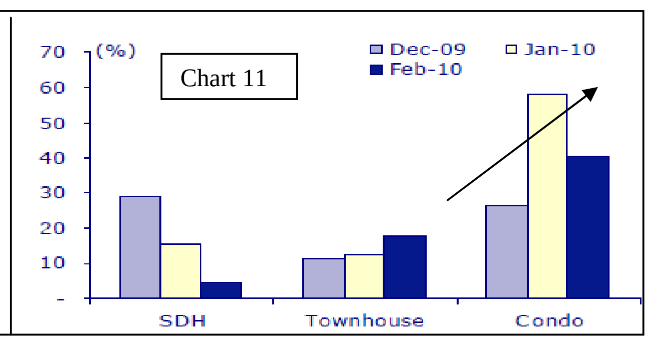
Taiwan--Surge in presale projects in 2010



Thailand Property--New launches

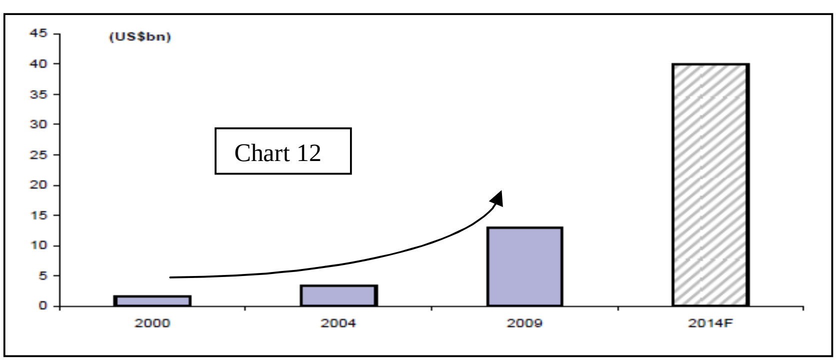


Take-up rate



Source for charts 10, 11: Agency for Real Estate Affairs, Thailand.

Indonesia–Exponential growth of home mortgages



Source: ClSA Asia-Pacific Markets, Bank Indonesia.

<u>**Sector Beneficiaries**</u> of trends:

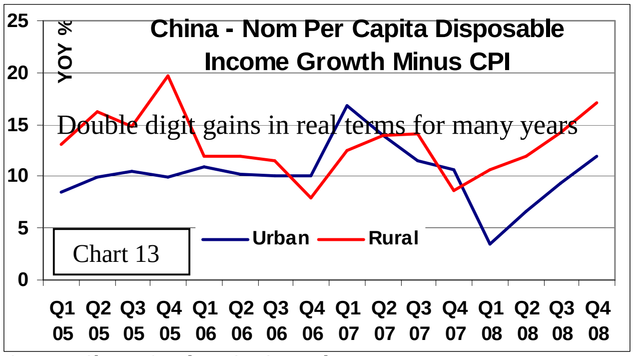
- Asset stocks in Taiwan

- Cement and construction sectors in Asean

- Asean banks enjoying mortgage growth

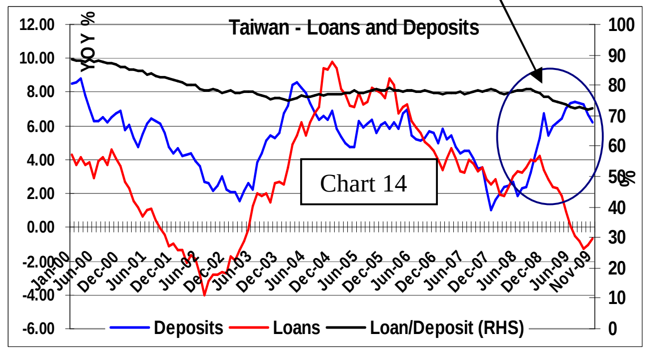
Feel-Good Factor **From Strong Gains in Income**

Income growth in double-digits (real terms)



Sources: Charts 13 and 15: CEIC, Wind Data.

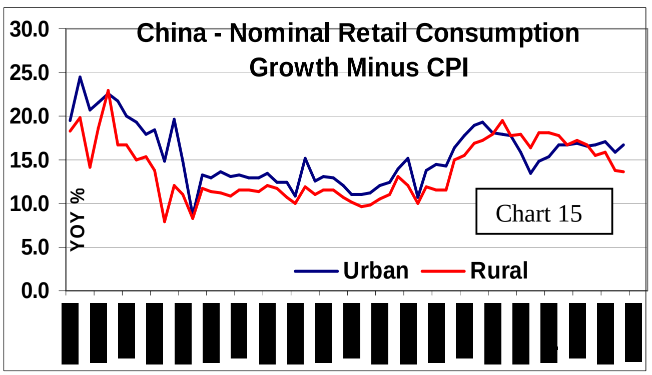
Taiwanese repatriating money from abroad



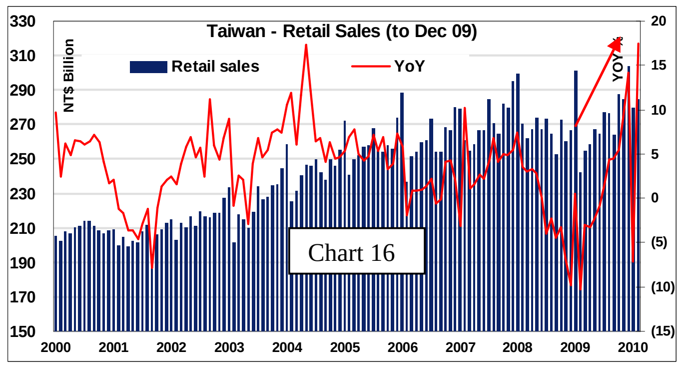
Source: Charts 14 and 16: Central Bank, Taiwan.

Sector Beneficiaries--Retail sales, auto, airline traffic, jewelry and watches, hypermarkets

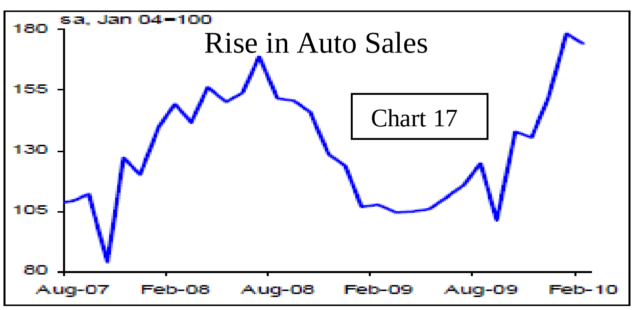
China—Double-digit gains in real terms for years



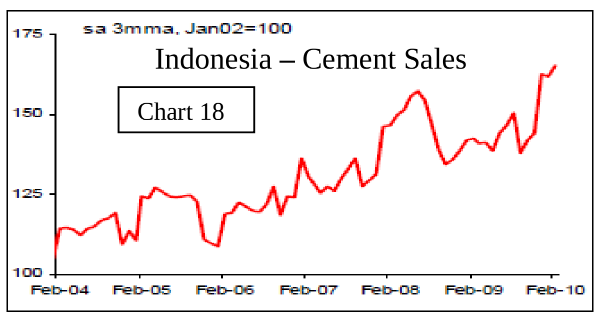
Taiwan--Strong cyclical rebound



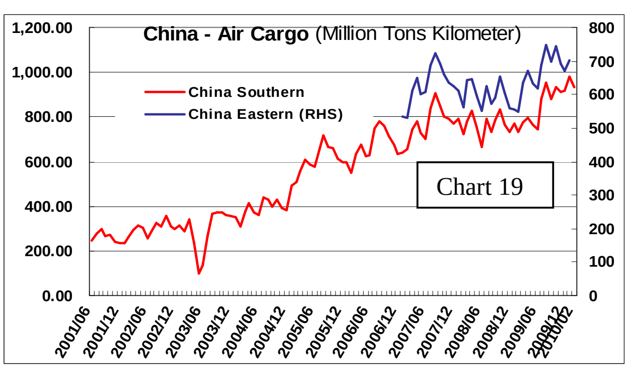
Indonesia--Auto sales

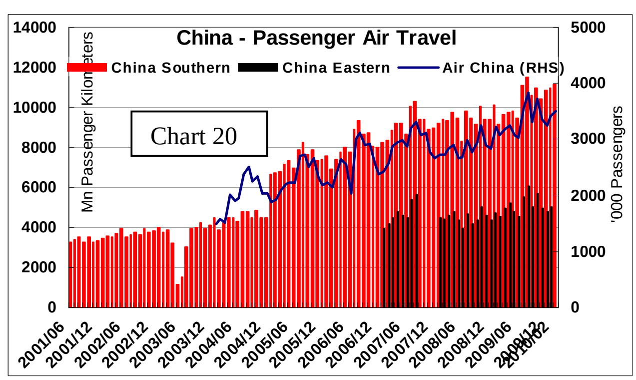


Indonesia--Cement Sales



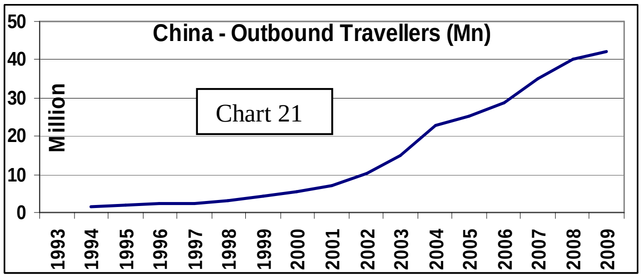
Airlines--Rising load factor and utilization rates of planes

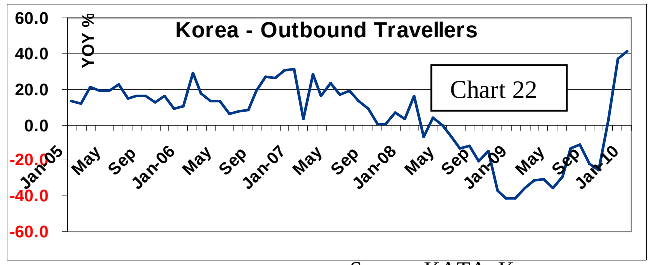




Growth in outbound tourism

(15% tourism spending in France – visitors from China, per VAT Refund)

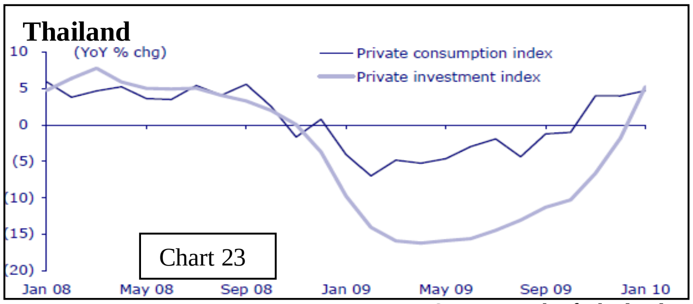


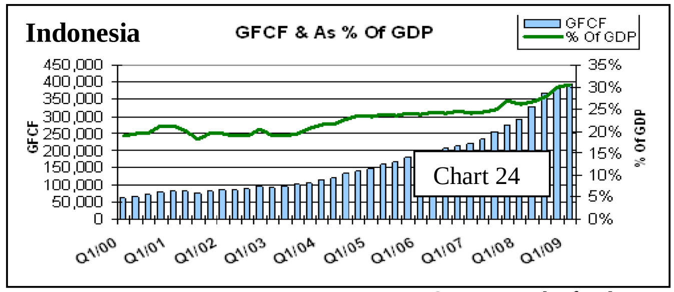


Source: KATA, Korea.

. Source: Wind Data.

Domestic investment cycle picking up

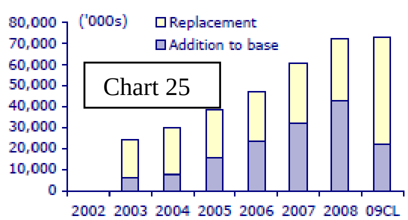




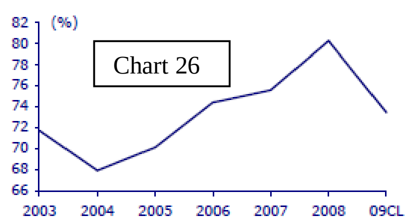
Source: Bank of Thailand. Source: Bank of Indonesia.

Examples of sector growth trends **IT cap ex replacement cycle** **Notebook & desktop replacement cycle**

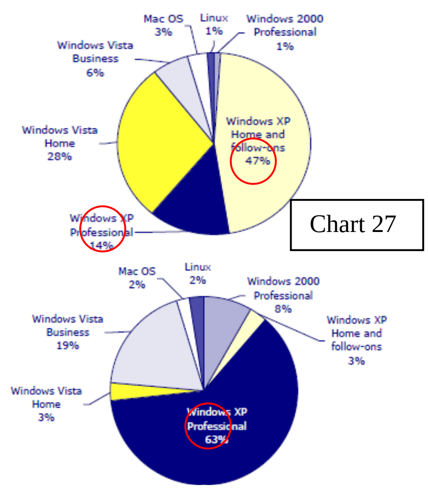
Enterprise notebook replacement picked up in 2009



Share of notebooks at or above 3 years of age

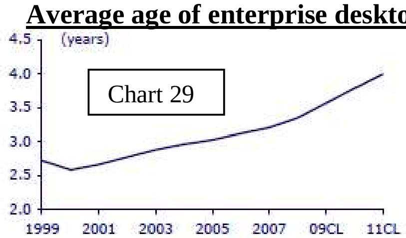


No service on XP O/S after 2012



Replacement as % of installed base

Average age of enterprise desktops



Source: Charts 25-29: CLSA Asia Capital Markets.

Our Investment Policy

The macro-scene in Asean economies is positive, and we expect outperformance of their stock markets to continue. In terms of sector situations, we see a number of potential growth segments. In the IT area, aside from the replacement cycle of notebooks and desktops, other growth areas are capacitive touch panels (iPhone, iPad, Win-7) and LED applications. Outside the IT area, interesting growth sectors include waste to energy, waste water treatment, wind power, nuclear power and plant construction, to name a few.

Our regional funds' investment disposition is focused on the underlying situations of interest in Asia Pacific ex Japan. We have increased our investment in these areas and reduced our cash content to low single-digits over recent weeks.

The Net Asset Values GSI Asian Capital Growth—US$25.23 The Long/Short Fund—US$23.42 (Apr 1st, 2010)