

Highlights

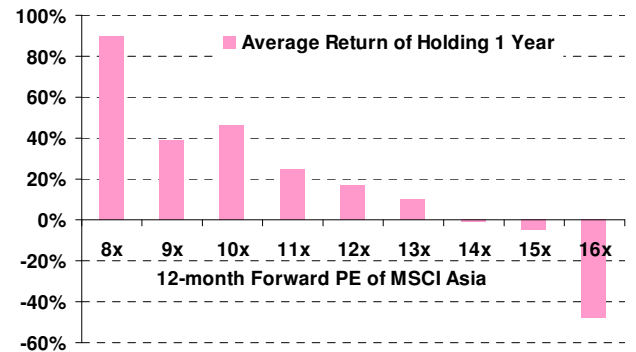
Monthly Theme: Fundamentals and Investment Return

- Making investment decisions based on impulsive sentiment only may not be a wise move. A more advisable way is to invest based on fundamental reasons such as valuation — for example, buying equities when they are cheap and selling when they become expensive.
- Though there is no perfect tool to evaluate the exact value of equities, we can still gain some insight from examining price/earning ratios (PE ratio).
- Historical data shows that investing in Asia equities at lower forward PE levels would, generally, result in a higher average return and greater chance of making a profit.
- However investors are reminded that using the PE ratio as a decision rule has limitations. Analysts may be over-optimistic with earning estimates. Valuation is not a good timing tool over a short period of time as there are other factors that may impact the performance of equity markets.

Monthly Market Review

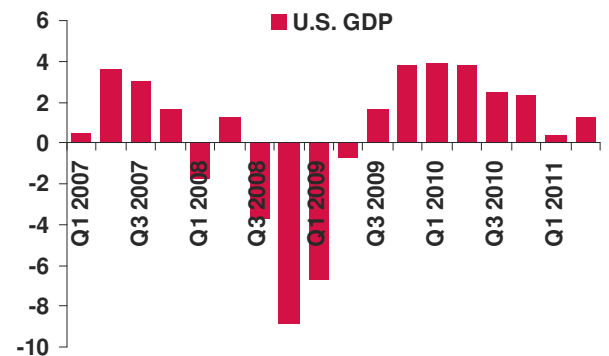
- The equity markets were volatile in July. The sovereign debt crisis, economic uncertainties and monetary policies were the main driving force. Countries with lower risk of further tightening measures and better economic condition outperformed. Gold prices and US Treasuries surged on strong “safe-haven” demand.
- The equities market in the US was dragged down by debt ceiling uncertainties and weak economic growth.
- Germany’s DAX dropped as investment sentiment was hurt by debt issues in the US and Europe. Even though the EU announced a new bailout plan for Greece, investors still worried that the debt crisis would spread to other countries such as Italy.
- Performance of Asia and the emerging markets was mixed. Thailand staged a relief rally after the elections settled down. Countries facing higher inflation pressure and further tightening of monetary policies continued to underperform.
- Uncertainty still remains the bugbear of financial markets in the near term. Apart from sovereign debt issues in the US and Europe, worries about economic recovery returned to the spotlight. On the negative side, worries about debt issues and slower economic growth may cause a lot of volatility and trigger “risk-off” sentiment. On the positive side, stimulus policies from various governments provide support to the markets. The Japanese government has already expanded its stimulus programme. The ECB has also continued to supply liquidity to the market.

Figure 1: In general, average 1-year holding returns are higher when investors purchase equities at a lower PE.



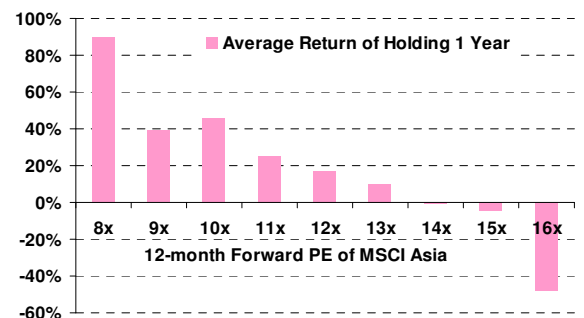
Source: IBES

Figure 2: US GDP rose 1.3% (QoQ) in Q2 2011, much worse than expected.



Source: Bloomberg

Figure 3: In general, average 1-year holding returns are higher should investors purchase equities at lower PE.



Source: IBES

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Monthly Theme: Fundamentals and Investment Return

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- Though there is no perfect tool to evaluate the exact value of equities, we can still gain some insight from examining price/earning ratios (PE ratio).
- Historical data shows that investing in Asia equities at lower forward PE levels would, generally, result in a higher average return and greater chance of making a profit.
- However investors are reminded that using the PE ratio as a decision rule has limitations. Analysts may be over-optimistic with earning estimates. Valuation is not a good timing tool over a short period of time as there are other factors that may impact the performance of equity markets.

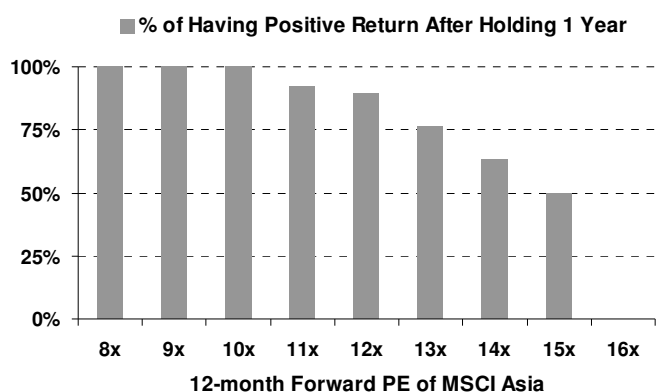
Equity markets are generally influenced by various bullish and bearish news and events. Market sentiment, as a result, is driven by greed and fear and moves from one extreme to another. If investors were to base their investment decisions on impulsive sentiment only, they may possibly end up “buying high and selling low”, i.e. buying equities at a high price when sentiment is extremely positive and selling stocks at low price when sentiment turns bearish. A more advisable way is to invest based on fundamental reasons such as valuation — for example, buying equities when they are cheap, and selling when they become expensive. Though there is no perfect tool to evaluate the exact value of equities, we can still gain some insight from examining price/earning ratios (PE ratio).

PE Ratio

The PE ratio, which is one of the most popular and useful measures for estimating value, is defined as price per share divided by earnings per share. In general, a lower PE ratio indicates that the equity is cheaper, assuming other factors are the same.

Since the equity market is forward-looking, using estimated future earnings would be more meaningful. Therefore, we could use the 12-month forward PE ratio (12M Fwd PE), which is calculated by dividing the equity price by the 12-month forward estimated earnings.

Figure 4: The possibility of gaining positive returns will generally drop if investors purchase equities with higher



Source: IBES

Average Return

Historical data shows that investing in Asia equities at lower forward PE levels would, generally, result in a higher average return and greater chance of making a profit.

For Asia equities, we look at the monthly data of MSCI Asia Pacific ex Japan (MSCI Asia) during May 2001 to July 2011. As shown in figure 3, the average return for 1-year holding period increased along with lower 12M Fwd PE. Based on historical data, if investors purchased MSCI Asia when 12M Fwd PE was at 8x, the average return for 1-year holding period would be more than 80%. However, if investors purchased MSCI Asia when the 12M Fwd PE was at 16x, investors would, on average, lose more than 40% with a 1-year holding period.

Possibility of Positive Return

Apart from average return, the possibility of winning is also impacted by the level of the PE ratio. As shown in figure 4, buying Asia equities at a high PE level generally results in a lower chance of making a profit. Within the study period, if investors were to purchase Asia equities at 16x 12M Fwd PE level, they would end up with losses. However, the chance of making a profit improves significantly if the PE multiple is lower.

Implications and Limitations

Based on historical figures, investors should invest in the equity market when the PE is low, in order to increase return potential and the possibility of winning. However, investors are reminded that past performance is not a guarantee of future results and using the PE ratio as a decision rule has its limitations.

One major risk is over-optimism on earnings estimates. If earning estimates are revised downwards, the PE ratio will rise. At the end of July, the 12 Fwd PE of MSCI Asia Pacific ex Japan was at 11x. If the earning estimations are too optimistic and revised downwards by 10%, the 12 Fwd PE will rise to 12x and the historical average return will drop. If the earning estimates are revised downwards by 15%, the 12 Fwd PE will rise to 13x and the historical average return will drop further.

Besides, valuation is only one of the factors impacting the performance of equity markets. Over the past several years, we have come across many unprecedented events which have a great impact on the equity markets. Investors are reminded to take into consideration other factors (such as the macroeconomic situation, quality of management, and the industry's prospect for individual stocks) when making investment decisions.

Moreover, valuation is not an ideal timing tool over a short period of time. The investment horizon for the above study is one year. So, even if the 1-year return is positive, returns over a shorter period, say 1 month, may be negative.

Monthly Market Review

- The equity markets were volatile in July. The sovereign debt crisis, economic uncertainties and monetary policies were the main driving force. Countries with lower risk of further tightening measures and better economic condition outperformed. Gold prices and US Treasuries surged on strong “safe-haven” demand.
- The equities market in the US was dragged down by debt ceiling uncertainties and weak economic growth.
- Germany’s stocks dropped as investment sentiment was hurt by debt issues in the US and Europe. Even though the EU announced a new bailout plan for Greece, investors still worried that the debt crisis would spread to other countries, such as Italy.
- Performance of Asia and the emerging markets was mixed. Thailand staged a relief rally after the elections settled down. Countries facing higher inflation pressure and further tightening of monetary policies continued to underperform.
- Uncertainty remains the bugbear of financial markets in the near term. Apart from sovereign debt issues in the US and Europe, worries about economic recovery also returned to the spotlight. On the negative side, worries about debt issues and slower economic growth may cause a lot of volatility and trigger “risk-off” sentiment. On the positive side, stimulus policies from various governments provide support to the markets. The Japanese government has already expanded its stimulus programme. The ECB has also continued to supply liquidity to the market.

Equities

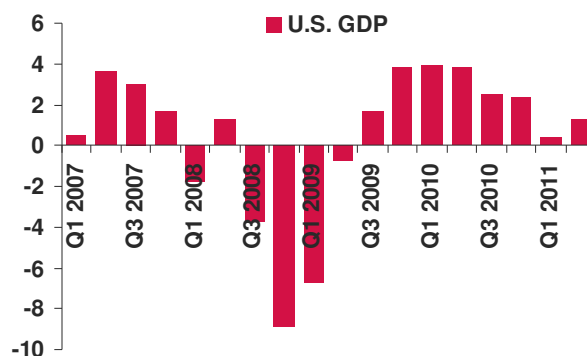
US Equities

- US equities dropped on worries over the Greek debt issues, the US debt ceiling stalemate and a weak US economic recovery. The S&P 500 dropped 2.1%, Dow Jones lost 2.2% and the Nasdaq fell 0.6%.
- US economic growth was disappointing. The GDP rose 1.3% (QoQ) in Q2 2011, much worse than expected, and Q1 2011 GDP growth rate was revised to 0.4%. Personal consumption rose only 0.1% (QoQ) in Q2.
- Durable goods orders dropped 2.1% in June, much worse than expected.
- The housing market was mixed. The S&P/CS Composite-20 Home Price Index dropped 4.51% (YoY) in May. New home sales dropped 1.0% (MoM) in June, worse than expected. Pending home sales rose 17.3% (YoY) and 2.4% (MoM) in June, higher than expected.
- The debt ceiling issue remained unresolved in July.
- The employment market was, overall, not as good as forecast. Nonfarm payroll increased by 46,000 in June. The unemployment rate rose to 9.2% in June, slightly higher than expected.

European Equities

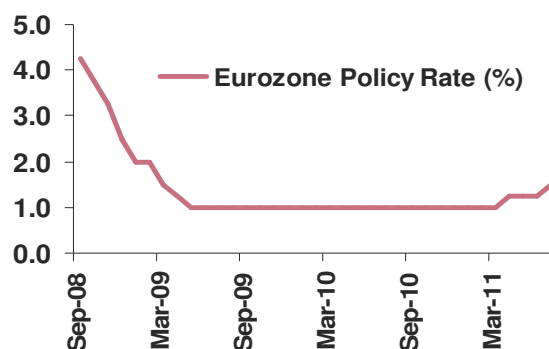
- European equities fell as investment sentiment was hurt by debt issues in the US and Europe. Germany’s DAX dropped 2.9% and UK’s FTSE 100 lost 2.2%.
- The EU eventually announced 159 billion euros in new aid for Greece. The Greek financing package will consist of 109 billion euros from the eurozone and the International Monetary Fund. Financial institutions will contribute 50 billion euros.
- The ECB raised interest rates by 0.25% to 1.5%, as expected, as inflation was still above the ECB’s target. The CPI rose 2.5% (YoY) in July.
- Economic growth in the UK was still slow. The country’s GDP rose 0.7% (YoY) and 0.2% (QoQ) in Q2 2011.
- The UK housing market was better than expected. House prices dropped 0.4% (YoY) but rose 0.2% (MoM) in July. The country’s CPI rose 4.2% (YoY) but dropped 0.1% (MoM) in June. Unemployment rate was steady at 7.7% in May, in line with expectation.
- The BoE kept interest rates unchanged, as expected.

Figure 5: US GDP rose 1.3% (QoQ) in Q2 2011, much worse than expected.



Source: Bloomberg

Figure 6: The ECB raised interest rates by 0.25% to 1.5%.



Source: Bloomberg

Japan Equities

- Japan's Nikkei 225 rebounded 0.2% as the economy showed signs of recovery from the quake.
- The BoJ kept its policy rate unchanged, as expected, and raised its economic assessment on the country for a second month.
- Retail trade rose 1.1% (YoY) and 2.9% (MoM) in June, both better than expected. Industrial production dropped 1.6% (YoY) but rose 3.9% (MoM) in June, both worse than expected.
- However, the jobless rate rose to 4.6% in June, in line with expectation.

Asia and Emerging Market Equities

- Performance of Asia and the emerging markets was mixed. Countries with a severe inflation problem and thus continued monetary tightening underperformed.
- Thailand's SET jumped 8.8% after the Puea Thai Party, a party allied with exiled former Prime Minister Thaksin, won a decisive election victory. The economic situation in the country remained stable. Its central bank raised the policy rate by 0.25% to 3.25% even when CPI dropped to 4.06% (YoY) in June.
- Indonesia's JCI rose 6.2% as the country's economic figures were better than expected and its central bank kept policy rates unchanged. Exports rose 45.3% (YoY) and the trade surplus widened to US\$3,509 million in May. Inflation pressure lessened to 5.54% (YoY) and consumer confidence rose to 109.0 in June.
- Philippines' PSEi rose 5.0% as its central bank kept rates unchanged while raising the reserve requirement to 21% from 20%. Trade deficit narrowed down to US\$780 million in May.
- Brazil's Bovespa plunged 5.7% as its central bank raised the policy rate by 0.25% to 12.5%. Inflation rose 6.71% (YoY) in June. The manufacturing PMI dropped to 49 in June, showing that the sector was contracting. Retail sales growth slowed down to 6.2% (YoY) in May.
- India's Sensex dropped 3.4% as its central bank surprised the market by raising the policy rate by 0.5% to 7.0%, more than expected. Food inflation rose 7.33% (YoY) in the week ended 16 July 2011. Industrial production growth slowed down to 5.6% (YoY) in May.
- China's H-share index dropped 1.6% as inflation pressure remained strong. The CPI rose 6.4% (YoY) in June, higher than expected. The PBoC raised benchmark interest rates by 0.25%, and announced that the one-year lending rate will increase to 6.56% and one-year deposit rate will rise to 3.5%. Industrial production growth accelerated to 15.1% (YoY) in June.
- Singapore's STI rose 2.2% as industrial production rose 10.5% (YoY) and bank loan and advances rose 26.2% (YoY) in June. However, its economic growth in Q2 2011 slowed down to +0.5% (YoY).

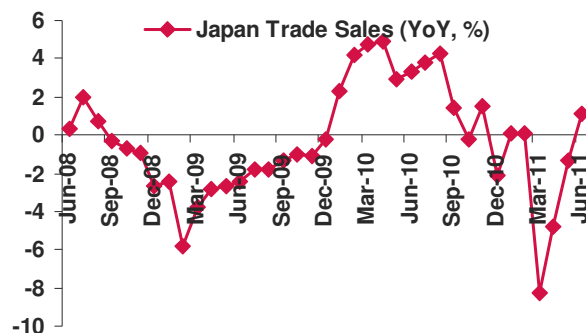
Bonds

- Yields of 10-year US Treasury (UST) dropped as no agreement was reached over the US debt ceiling issue in July and economic growth was much weaker than expected.

Commodities

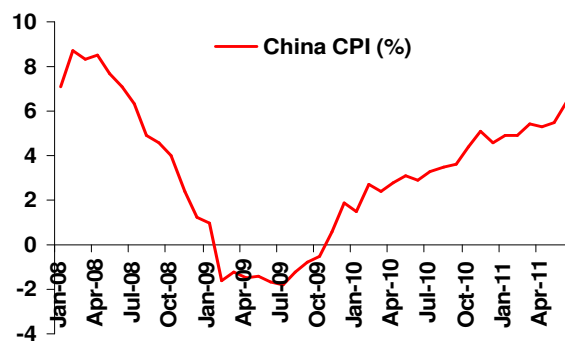
- Gold prices rose on safe-haven demand triggered by uncertainties over debt issues in the US and Europe.
- WTI crude oil prices managed to gain as the IEA announced that they did not plan to extend the release of emergency oil stockpiles.

Figure 7: Japan's retail trade rose 1.1% (YoY) and 2.9% (MoM) in June, both better than expected.



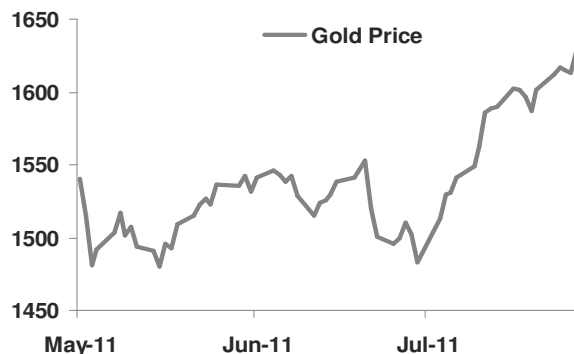
Source: Bloomberg

Figure 8: China's CPI rose 6.4% (YoY) in June, higher than expected.



Source: Bloomberg

Figure 9: Gold prices rose on safe-haven demand triggered by uncertainties over debt issues in the US and Europe.



Source: Bloomberg

Key Market Data

Equities	Month-end Level	Monthly Change	YTD Change
S&P 500	1,292	-2.1%	2.8%
Dow Jones	12,143	-2.2%	4.9%
Nasdaq	2,756	-0.6%	3.9%
FTSE 100	5,815	-2.2%	-1.4%
DAX	7,159	-2.9%	3.5%
Nikkei 225	9,833	0.2%	-3.9%
Hang Seng Index	22,440	0.2%	-2.6%
Straits Times	3,189	2.2%	0.0%
Taiwan Weighted	8,644	-0.1%	-3.7%
KOSPI	2,133	1.5%	4.0%
Brazil Bovespa	58,823	-5.7%	-15.1%
Russia RTSI	1,965	3.1%	10.9%
India SENSEX	18,197	-3.4%	-11.3%
China H Index	12,374	-1.6%	-2.5%
Thailand SET	1,134	8.8%	9.8%
Malaysia KLCI	1,549	-1.9%	2.0%
Philippine PSEI	4,504	5.0%	7.2%
Jakarta JCI	4,131	6.2%	11.5%

Commodities	Month-end Level	Monthly Change	YTD Change
Gold (comex)	1,628.3	8.4%	14.6%
WTI crude oil (nymex)	95.7	0.3%	4.7%

Currencies	Month-end Level	Monthly Change	YTD Change
Euro (EUR-USD)	1.4398	-0.7%	7.6%
JPY (USD-JPY)	76.76	5.0%	5.7%

Bonds (10-year yield)	Month-end Yield (%)	Monthly Change (Basis Points)	YTD Change (Basis Points)
US	2.80	-36	-50
UK	2.86	-52	-54
Germany	2.54	-49	-43
Japan	1.08	-6	-5

As at the end of July 2011
 Source: Bloomberg

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