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# Quarterly Asset Allocation Strategy

December 2010

[AIA.COM.SG](http://AIA.COM.SG)



## Highlights

- We expect equity funds to outperform bond funds in 2011. Asia will still be the main engine of global economic growth. Growth momentum in developed countries will be weak but positive. Such developments should lend support to corporate earnings and thus equity prices.
- We are optimistic about US equity funds. Recently released economic data supports our view that a double-dip recession is unlikely. The profits of US companies rose in Q3 by USD1.66 trillion, the highest annual increment on record. Even though the labour market is still in the doldrums, the impact of further quantitative easing and the latest tax cut extension should be positive for the labour market.
- We continue to believe that Asia (ex Japan) equity funds will do well in 2011. Economic growth next year will be slower than this year due to a high comparison base but Asian economies will still be the world's growth dynamo. The excess money created from US quantitative easing and Europe's bond purchases are expected to flood the financial markets in Asia and inflate local prices.
- We are cautious on European equity funds. The Dow Jones Euro Stoxx Index went down by 5.2% in November, the deepest decline since May this year. The chance of Portugal and even Spain being dragged into the sovereign debt crisis was too high to ignore.
- Bond funds are expected to under-perform equity funds as we expect the Fed's quantitative easing to start creating inflation expectations in the US. We recently saw the 10-year US Treasury yield rise above 3% for the first time since July.

Asset Classes	Outlook
<b>Equity Funds</b>	<b>+</b>
US	+
Europe	=
Japan	=
Asia (ex Japan)	+
Emerging Markets (ex Asia)	+
<b>Bond Funds</b>	<b>-</b>
Government (Developed economies)	-
Corporate (Developed economies)	+
Emerging Markets	+
<b>Money Markets Funds &amp; Cash</b>	<b>=</b>

Note: + (overweight); = (neutral); - (underweight)

## Traditional Asset Classes

We expect equity funds to outperform bond funds in 2011. Asia will still be the main engine of global economic growth. Growth momentum in developed countries will be weak but positive. Such developments should lend support to corporate earnings and thus equity prices.

Excess liquidity generated from quantitative easing in the US and the European Central Bank's (ECB) government bond purchase programme is another positive contributor to equity prices. With the extremely low returns of holding cash, investors are likely to pull their money out of bank deposits and chase after risky but potentially higher return assets such as equities.

The key risk of holding equities is from government policy. Will the Chinese government over-tighten their monetary stance leading to an economic hard-landing? Could the ECB win sufficient political backing to bail out the peripheral European countries and stop the sovereign debt crisis from spreading? Would quantitative easing achieve its desired impact in the US? In addition to the aforementioned policy risks, political uncertainty on the Korean peninsula will also be the major source of volatility in the equity markets next year.

### US Equity Funds

We are optimistic about US equity funds. Recently released economic data supports our view that a double-dip recession is unlikely. In Q3, real GDP rose at a seasonally-adjusted annual rate of 2.5%, higher than the preliminary 2% estimate. American consumers have started to spend. In October, retail sales rose 1.2%, the largest monthly jump since March. Profits of US companies rose in Q3 by USD1.66 trillion, the highest annual increment on record, due to cost cutting and improved sales.

The labour market is still in the doldrums despite improvement in other parts of the economy. The unemployment rate rose to 9.8% in November after staying at 9.6% for 3 consecutive months. However, the impact of further quantitative easing and the latest tax cut extension should be positive for the labour market. Hence, we are upgrading the rating on US equity funds to positive.

### European Equity Funds

We are cautious on European equity funds. Renewed concerns on sovereign credit risk in some peripheral European countries triggered a market sell-off. The Dow Jones Euro Stoxx Index went down by 5.2% in November, the deepest decline since May this year. The chance of Portugal and even Spain being dragged into the sovereign debt crisis was too high to ignore. Diverse national interests will prevent the ECB from reacting quickly and proactively to the crisis. The bond yields of Ireland and Portugal shot up substantially in early October. However it was not until late November that the ECB provided Ireland with economic aid to bail out local cash-strapped banks and plug the fiscal shortfall.

### Japanese Equity Funds

Although the Nikkei 225 Index was up 8% in November, our cautious view on Japanese equity funds remains unchanged. Japan's recovery is losing momentum with industrial production (seasonally adjusted) falling for a fifth month in October, shrinking by 1.8% from September. The unemployment rate rose unexpectedly to 5.1% from 5% a month ago. A strong yen hurt Japanese companies by weakening the international price competitiveness of Japan's exports. In October, export growth slowed to 7.8%, the slowest annual growth this year.

### Asian (ex Japan) Equity Funds

We continue to believe Asia (ex Japan) equity funds will do well in 2011. Economic growth next year will be slower than this year due to a high comparison base and anti-inflationary government measures. However, Asian economies will still be the world's growth dynamo. This should translate into better corporate earnings and higher equity prices.

The excess money created from US quantitative easing and Europe's bond purchases is expected to flood the financial markets in Asia and inflate local prices. To prevent inflation and asset bubbles from building up, governments in China, Korea and Singapore have already started to tighten their monetary stance. If traditional monetary policy fails to contain local inflationary pressure, we would not be surprised to see some Asian countries introducing some forms of "soft" capital control to prevent excessive inflow of hot money. In October, Thailand's government removed a 15% tax exemption for foreigners on income from domestic bonds. In November, Taiwan's government placed a limit on foreign ownership in the island's debt as it strives to curb capital inflows from abroad. Concerns about policy over-reaction could be one of the major sources of volatility in equity markets next year.

### Emerging Markets (ex Asia) Equity Funds

We have upgraded emerging market (ex Asia) equity funds to positive. As the global economic situation stabilises, demand for natural resources should gradually pick up. This should benefit resource-rich emerging markets such as Brazil and Russia. In November, consumer confidence in Brazil rose to 125 from 122 a month ago. Export growth in November accelerated to 39.8% year-on-year from October's 30.5%.

### Bond Funds

Bond funds are expected to under-perform equity funds as we expect the Fed's quantitative easing to start creating inflation expectations in the US. We recently saw the 10-year US Treasury yield rise above 3% for the first time since July. The Government bond yields of Japan and the eurozone, with the same tenure, also went up. Since we do not believe the US will slump into a double-dip recession and Asia's growth will remain robust, we expect investors' appetite for risk to increase. Money, under this scenario, should shift from bonds back to risky assets like equities.

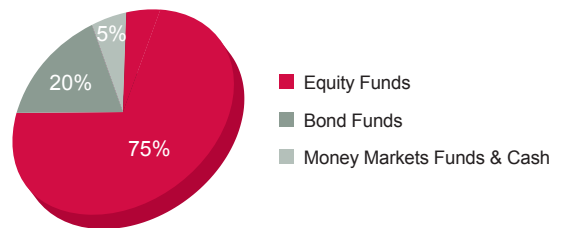
## GDP Forecast for 2011

2011 GDP (%)	US	UK	Eurozone	Japan	China	Hong Kong	Singapore
Market Consensus	2.7	2.0	1.5	1.1	9.1	4.7	4.8
AIA	2.7	1.2	1.2	1.5	9.0	4.8	5.0

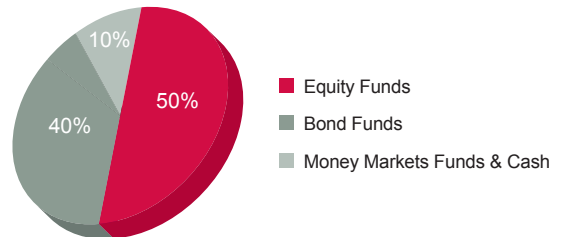
Source: AIA & Consensus Economics

## Benchmark Portfolios

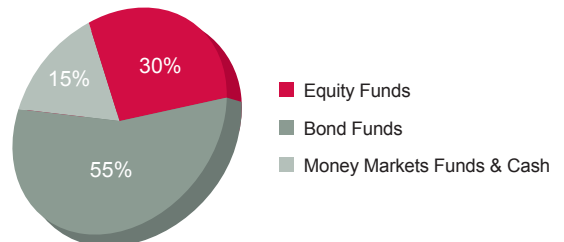
Adventurous	
Equity Funds	75%
Bond Funds	20%
Money Markets Funds & Cash	5%



Balanced	
Equity Funds	50%
Bond Funds	40%
Money Markets Funds & Cash	10%



Cautious	
Equity Funds	30%
Bond Funds	55%
Money Markets Funds & Cash	15%



Note: Range for equities and bonds is ± 10%  
 Range for money markets instruments & cash is ± 5%

## Key Market Data

Equities	Month-end Level	Monthly Change	YTD Change
S&P 500	1,181	-0.2%	5.9%
Dow Jones	11,006	-1.0%	5.5%
Nasdaq	2,498	-0.4%	10.1%
FTSE 100	5,528	-2.6%	2.1%
DAX	6,688	1.3%	12.3%
Nikkei 225	9,937	8.0%	-5.8%
Hang Seng Index	23,008	-0.4%	5.2%
Strait Times	3,145	0.1%	8.5%
Taiwan Weighted	8,372	1.0%	2.3%
KOSPI	1,905	1.2%	13.2%
Brazil Bovespa	67,705	-4.2%	-1.3%
Russia RTSI	1,597	0.6%	10.6%
India SENSEX	19,521	-2.6%	11.8%
China H Index	12,818	-2.7%	0.2%
Commodities	Month-end Level	Monthly Change	YTD Change
Gold (comex)	1,385.0	2.0%	26.4%
WTI crude oil (nymex)	84.1	3.3%	6.0%
Currencies	Month-end Level	Monthly Change	YTD Change
EUR-USD (euro)	1.2983	-6.9%	-9.4%
USD-JPY (JPY)	83.69	-3.9%	1.1%
Bonds (10-year yield)	Month-end Yield (%)	Monthly Change (Basis Points)	YTD Change (Basis Points)
US	2.80	20	-104
UK	3.23	15	-79
Germany	2.67	15	-72
Japan	1.19	26	-10

As at the end of November 2010  
Source: Bloomberg

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