



## 2011 4Q Investment Outlook

### Highlights

Equity markets suffered heavy selloff in 3Q11, as uncertainties about EU sovereign debt crisis and concerns on double dipped US economy dominated the investment sentiment. Emerging markets have seen significant fund outflows during the quarter, resulting in currency weakness. Major economic indicators showed that global manufacturing activities have softened further during 3Q, and chances are that EU and US are heading toward stagflation, exacerbated by the Fed's QE programs. On China, equities dipped during 3Q, on worries about credit deterioration and corporate earnings downgrades. Looking ahead, we do not foresee a strong catalyst to reverse the current risk aversion trend.

### Equity Markets:

We think **US** economy is not likely to go into a recession but will be vulnerable to exogenous shocks. We believe that defensive and high-yielding stocks with sustainable dividends would outperform in 4Q.

Uncertainties in **Europe** seem to have priced in and it is possible that the EU nations are gradually coming to an agreement to allow an "orderly" default of Greek sovereign debt, while still keeping Greece within the EU and the EMU. However, political resistance within Germany could slow down the process anytime. Yet so far no one can be certain about when the European debt crisis will come to an end.

In **China**, rising hard landing risks had triggered a big market correction in 3Q and may keep index to trade at low levels, but we think there should be policy inflection at some point. We overweight on energy sector and telecom equipment. We are neutral on basic materials, banks, insurance and consumption. We underweight property.

In **Hong Kong**, we anticipate the following risk factors: 1) outflow of hot money; 2) hardlanding risk in China; 3) global economic slowdown; 4) HK government housing policy initiatives; and 5) sharp fall in asset prices. A defensive portfolio remained our investment strategy. We overweight sectors with high earnings visibility, low leverage and strong dividend support. We also like traditional conglomerates with low earnings risks. We are neutral on banks, as we expect a slow down in loan growth in 2H and margin pressure would hurt profitability. We are cautious on Hong Kong consumption sector on the upsurge in wages and rentals, coupled with the top line growth slow down in 4Q.

### Bond Markets:

European bank and sovereign-credit risk surged, on speculation that Greece may default and on sluggish US economic performance. During 3Q corporate credit has been significantly re-priced due to lower growth expectations and rising recession risks. Federal Reserve has begun purchasing longer-term US Treasuries and selling shorter maturities under operation twist in September. The yield of 30-year Treasuries has tumbled 146 basis points in 3Q, its biggest drop since December 2008. We expect the yield curve to flatten further in 4Q and the markets are likely to stay volatile until further stabilization plan could come out from the Euro zone.



### Forex Markets:

Given the unsettled European debt crisis and deteriorating economy in the region, the **EUR** may dip to 1.30 against the dollar in Q4.

The **AUD** will probably be capped at parity against the greenback amid weakening world economy.

Although **JPY** remains strong after the joint-intervention of Japanese government and the BOJ, the recently announced “operation twist” may help to contain the yen’s strength.

**Gold** has probably seen the peak in the near term and was expected to trade between 1,560 and 1,800 dollar per ounce in the coming quarter.

# CONTENTS

|                           |    |
|---------------------------|----|
| <b>Executive Summary</b>  | 4  |
| <b>Equities</b>           |    |
| US                        | 6  |
| Europe                    | 8  |
| China / Hong Kong         | 10 |
| <b>Global Bond Market</b> | 14 |
| <b>Currencies</b>         |    |
| EUR                       | 15 |
| AUD                       | 16 |
| JPY                       | 17 |
| <b>Precious Metal</b>     |    |
| Gold                      | 18 |

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## *EXECUTIVE SUMMARY*

Equity markets suffered heavy selloff in 3Q11, as uncertainties about EU sovereign debt crisis and concerns on double dipped US economy dominated the investment sentiment. Emerging markets (EM) have seen significant fund outflows during the quarter, resulting in currency weakness. Despite S&P's surprising move to downgrade the US, the dollar index jumped as much as 5.9% in September and 10-year treasury yields touched its record low of below 1.72%, as jittery investors sold risky assets while buying US treasuries and money market funds for safe heaven investments.

Major economic indicators showed that global manufacturing activities have been softened further during 3Q, and chances are that EU and US are going into a stagflation, exacerbated by Fed's QE programs. On China, equities dipped during 3Q, on worries about credit deterioration and corporate earnings downgrades. Banking sector took a hard hit, while facing with mounting non-performing loan risk due to the exposure to highly geared local governments and property developers. A much weaker property transactions and developers' slow down in housing construction, as well as central government's cutting on infrastructure investment in railway and nuclear power facilities, are likely to dampen China's fixed asset investment and slow down the overall industrial growth, despite a relative strong domestic consumption.

Looking ahead, we do not foresee a strong catalyst to reverse the current risk aversion trend. We are situating in another credit crisis period as we were during the financial tsunami back in late 2008. Even if we do not hold the view that US is heading into a recession, the fears of the worst scenario and worries about a much slower global growth would continue to drag the performance of risky assets, in our view. Political climate in both Euro zone and the US have given market little confidence so far. Investors are likely to remain doubtful on any fiscal policy initiatives, and we reckon that there is hardly a short term remedy to revive the economies in the developed market (DM). While the EM economic fundamentals are relatively sound, these countries are still faced with overheating asset prices, government's monetary and fiscal tightening, and sluggish external demand, and hence the risk of hard landing. While deleveraging will continue to be the theme for both DM and EM, we believe investors should maintain a defensive portfolio (i.e. focusing on liquid assets and quality fixed income names) to weather this round of financial crisis.

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**Our investment view for 4Q is summarized as follows:**

**Equities** – Volatilities are expected on major event risk such as EU debt woes and more sovereign rating downgrades. Liquidity would remain weak in emerging market, thus it is very challenging to conclude if these markets are near their trough valuations given unfavourable fund flows and a handful of newly developed global events/risks. Investors should stay defensive by holding large caps with stable yields, low gearing and high earnings visibility. Also look for high quality China domestic consumer plays with further market share upside and prudent cost control.

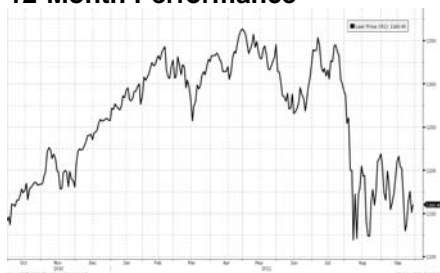
**Fixed income/currency** – Focus on USD investment grade fixed income names to avoid taking currency and liquidity risks. We expect US dollar index to strengthen further in the next few months, despite there is a chance that Fed would launch a new QE program. We believe the global and Euro zone economic uncertainties ahead and less optimistic growth forecast for EM countries, coupled with corporate earnings downgrades, would continue to prevent investors from taking risky assets in the near term.

**Gold** – We believe that the fundamental reason for investors to expose to gold investment stayed unchanged, i.e. low interest rate in US, inflation, unstable political environment and de-risking in financial market. The unsettled European debt crisis and risk of recession in US would increase the marginal demand for gold, especially from EM central banks. However, after strong outperformance year to date, we believe gold price would consolidate at current level in the short term, partly driven by profit taking and by the strength of US dollar.



## UNITED STATES

### 12-Month Performance



— S&P 500 Index

### S&P 500 Index Data

|                    |                  |
|--------------------|------------------|
| Market cap         | \$10.56 Trillion |
| 52-week Hi / Lo    | 1,364 / 1,119    |
| 3-Mth Return       | -15.54%          |
| Y-T-D Return       | -10.04%          |
| 50 / 250 Mov.Avg.  | 1,197 / 1,264    |
| Dividend Yield     | 2.30%            |
| Historic P/E       | 12.38X           |
| 2011 Estimated P/E | 11.41X           |
| Historic P/B       | 1.85X            |

Source: Bloomberg L.P.  
As of 09/30/2011

### INVESTMENT SUMMARY

- The US economy is unlikely to go into a recession but will be vulnerable to exogenous shocks
- From now, the economic data receive only a passing grade
- Core inflation should continue edging a little higher over the near term then stabilize
- Corporate profits should continue to outperform the economy but perhaps by a lesser margin than last couple of years
- We believe that defensive and high-yielding stocks with sustainable dividends should relatively outperform

**Recession, Yes or No?** Equity markets have a poor track record in predicting recessions by providing many false alarms. The inverted yield curve is one of the better predictors, and the curve is now staying at one of the steepest levels ever, suggesting that it is still too early to conclude US will go into a double-dipped recession. However, it is hard to ignore the slow pace of growth so far this year and the prospect of fiscal tightening posing risks to the US recovery.

**Are stocks cheap?** S&P dividend yield is greater than 10-year US Treasury suggesting that we are still not at the level reached during the Lehman fiasco. We forecast higher dividend yields in 4Q11, driven by increases in payout ratios and higher earning yields. Therefore, absent from a substantial cheapening of the entire market, we believe there are some values in stocks which have a net cash position and tendency for management shares buyback.

**US companies still cash-rich?** As US corporate balance sheet is as strong as ever, there has never been a recession since 1950 when they are flushed with cash. Cash as a percentage of assets is 11% and represents excess cash of US\$836bn.

**Are there values to be found among all the negativities?** The unstable conditions in the financial markets have deeply shaken investor confidence and largely reduced household wealth, though some data points (i.e., strong balance sheet) could lead us to a possible rebound in early 2012. Although our expectation is the US government will push out various economic stimulus packages but we refrain from incorporating the potential benefits into our economic outlook. In summary, we predict that the S&P500 will consolidate at current levels in 4Q11 on low visibility on earnings and economic outlook.

### Sector Outlooks

**Financials (underweight).** Financial sector stocks have lagged the broader equity market since the end of 2010. With the floundering rate of home sales and the flat trend in home prices, along with the historically elevated U.S. unemployment rate, the demand for financials have been lackluster. Some thought the worst is at an inflection point, but there are plenty of signs to indicate that the sector still remains fragile and faces an uphill battle.

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**Technology (overweight).** Given the general fragility of the economy, the technology sector will face some challenges to maintain the growth rate we have seen in 2010. One trend that is persistent is that technology corporate deal values have surged as leading corporate companies have used their strong cash positions to do deals at reasonable valuations.

**Materials and energy (neutral).** Materials and energy sector profits are likely to remain flat in 4Q11 on lower crude oil prices and pressure on profit margins, leading to a neutral outlook. We forecast that the global economy will weaken, leading to slower growth in oil consumption. Moreover, production from Libya will return, also helping to ease market tightness over the coming quarters.

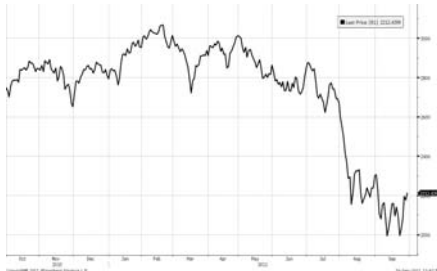
**Consumer staples (overweight).** Stocks in the consumer staples sector have traditionally fared better than the stock market, and especially can outperform cyclical companies during market declines. The macro climate in consumer staples is generally stable and we expect the sector would continue to do well under the backdrop of likely extension of unemployment benefit and further fiscal policy to ease the unemployment rate in the medium term.

**Risk Considerations:** 1) prolonged period of deleveraging continue to keep risks skewed towards negative sentiment; 2) unresolved European sovereign debt crisis; 3) negative economic data; 4) commodities prices



## EUROPE

### 12-Month Performance



DJ Euro Stoxx 50 Index

### DJ Euro Stoxx 50 Index Data

|                    |                   |
|--------------------|-------------------|
| Market cap         | EUR 1.56 Trillion |
| 52-week Hi / Lo    | 3,068 / 1,995     |
| 3-Mth Return       | -24.20%           |
| Y-T-D Return       | -21.95%           |
| 50 / 250 Mov.Avg.  | 2,262 / 2,745     |
| Dividend Yield     | 5.49%             |
| Historic P/E       | 9.07X             |
| 2011 Estimated P/E | 8.05X             |
| Historic P/B       | 1.02X             |

Source: Bloomberg L.P.  
As of 09/30/2011

### INVESTMENT SUMMARY

- We are looking forward to an agreement that resolves the EU debt crisis through an “orderly default” of Greece sovereign debt and mutually agreed “haircuts”
- We are formulating our strategy based on the fact that Continental Europe is heading towards a mild recession
- Despite the turmoil, there are still potentials in certain sectors, particularly the attractively valued exporters focusing on markets outside of the EU

**Uncertainties in the EU Area.** At present, the markets seem to have priced in and there is a consensus of the fact that the EU nations will come to an agreement, which allows an “orderly” default of Greek sovereign debt eventually, while still keeping Greece within the EU and the EMU. The details including how much of a “haircut” is required (less than 50%? any private sector participations?), by how much the EFSF is to be expanded (for implementation of some of the proposed solutions), and how do we set up firewalls to prevent runs against the financials (and also the need to capitalize them), etc., are still to be determined. In addition, political resistance similar to the opposition within Germany could slow down the process anytime. Assuming those obstacles are all overcome, still no one has been able to pinpoint a date that indicates the end of the European debt crisis (at least a temporary end), even though there have been talks of a “final” agreement being reached in early November (G20 meeting Nov 4). Without turning the above “assumptions” into realities, it would be irrelevant and impossible to discuss the economic outlook of the EU zone, whether we are heading towards a recession or the possibility of a rebound in the equities market.

**Is EU heading towards a recession?** With the implementation of measures taken to stamp out the debt crisis, it will certainly bring further fiscal tightening, peripheral European deflation, and credit crunch. The tightening requirements imposed upon peripheral Europe in exchange for financial aid and the move towards balanced budgets by most countries are expected to negatively impact EU zone GDP by at least 1%. Reduction in wages and difficulty of banks raising funds will certainly worsen the economic condition. Certain leading indicators (e.g. Euro zone manufacturing PMI: new orders, 3m lead) are already indicating that the European economies are heading into recession. Given these circumstances, we expect an ECB rate cut is imminent. It will send a positive message to markets that ECB are responding to the deteriorating conditions and is ahead of the curve. A weaker Euro could also be part of the solution.

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**When will EMU respond to the recent escalation in the Greek debt crisis?** We expect to see substantial debt restructuring in the near future, likely in 2012 or 2013, as delay in restructuring in order to buy time for banks to raise capital to withstand sovereign losses could further deepen the fiscal problems within the Euro Area. As mentioned, a response from the policymakers is imminent as the current fear is not solely based on worries about the repayment capabilities of the Greece government, but also its impact on the rest of the euro area and the global markets.

**Should we be relieved to see an early restructuring?** It depends, but an early restructuring could be even more disruptive to economies and financial markets as it involves applying haircuts on sovereign debts and possibly large wage cuts. In short, restructuring will be done at the expense of someone, either investors or the government.

**Unlikely to see a break up of the euro, but what if?** We believe the chances are slim for a break up, and it would almost be impossible for us to quantify the costs if there is one. First, a break up could lead to extreme volatility in currencies that are going to replace the euro. Also, a break up could adversely affect intra-euro area trading, especially for those with sharp appreciation in their currencies (i.e. Germany). Needless to say, a sharp currency appreciation will not only affect its large trade exposure to both euro countries and area outside the euro area, but will also lead to a substantial decline in Germany's net international investment positions with other euro area countries. Again, it is not easy to measure the costs of a euro break up and hence we consider the probability of one extremely unlikely.

**Is there value to be found in the turmoil?** The market believes that Continental Europe is around 15% oversold relative to the US. However historically the underperformance could be continuing for an extended period of time. Other measures such as sector-adjusted P/E or P/B ratios revealed that Continental Europe is not exceptionally cheap. However there are still certain opportunities that are worth looking into:

**Overweight on.**

Germany has underperformed lately given its high exposures to global slowdown. Historically this presented conditions for outperforming rebound of the DAX. Its equity market also represents more attractive valuations compared to Continental Europe. Overall we would suggest picking companies that are attractively priced and exporters which could benefit from a weakening Euro. Such companies are usually found in sectors such as consumer goods and breweries.

**Neutral on.**

Overall Italy has been perceived to be the country with better fundamentals than the rest of peripheral Europe, and it has been unfairly punished in this crisis; However its equities valuations are not attractive relative to its index-linked bond yields.

**Cautious on.**

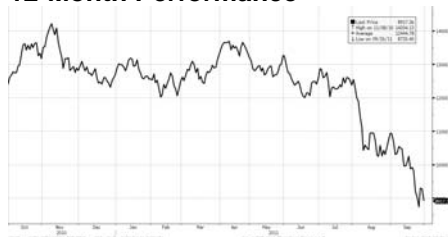
While we do expect a significant rebound of European financials given a successful and effective resolution to the European debt crisis, we still see headwinds in years coming including the BASEL III requirements and the newly proposed financial transaction tax.

**Risk Considerations:** 1) disorderly default of Greece sovereign debt; 2) breakup of EMU; 3) appreciation of the Euro; 4) EU members leaving EU



## CHINA / HONG KONG

### 12-Month Performance



HS China Enterprise Index

### HS China Enterprise Index Data

|                    |                 |
|--------------------|-----------------|
| Market cap         | HKD1.86Trillion |
| 52-week Hi / Lo    | 14,219 / 8,575  |
| 3-Mth Return       | -29.1%          |
| Y-T-D Return       | -29.7%          |
| 50 / 250 Mov.Avg.  | 10,731 / 12,444 |
| Est Dividend Yield | 4.4%            |
| 2011 Estimated P/E | 7.6x            |
| 2012 Estimated P/E | 6.4x            |
| Historic P/B       | 1.3x            |

Source: Bloomberg L.P.  
As of 09/30/2011

### INVESTMENT SUMMARY

- Rising hard landing risks had triggered a big market correction in 3Q and may keep index to trade at low levels, but we think there should be policy inflection at some point.
- We overweight on resources and telecom equipment. We are neutral on basic materials, banks, insurance and consumption. We underweight property.

**Rising hard landing risks led to a big market de-rating.** HSCEI, SHCOMP and CSI300 dropped 29.7%, 16%, and 17.5% qoq respectively. During 3Q, China maintained a policy status quo as national property prices and CPI hovered at high levels. Global economic recovery remained sluggish amid the renewed Euro zone sovereign debt crisis. Exports were weak while consumption and fixed assets investment growth were stable. Hard landing risk is rising in light of worsening financial situation of local governments with no concrete bailout plan of the RMB2-3trn bad loans incurred by them, rising failures of SMEs, stagnant property market and the potential NPLs from the RMB3-4trn of "informal lendings".

**Any light at the end of the tunnel?** PBOC chief Mr. Zhou Xiaochuan cited that Beijing has to remain flexible to keep growth on track and avoid 'hard landing' for its economy. We still see there is room for policy easing when CPI is under control - at below 4%, significant drop in property prices - which is happening as developers are slashing prices by over 15% since September, banks in good shape and lastly to be concerted with economic policies of other developed countries. However, we expect the earliest possibilities of policy inflection point to be around 1Q next year.

**Earnings visibilities into 2012 remain blurred.** Policy risks of the banking sector remained high to comply with more stringent capital requirements and uptrend in NPLs. We are neutral with the banking sector as valuation of large cap state banks is at historic low levels. We underweight property sector on deteriorating financial position. We downgraded insurance sector to neutral as slowing premium growth. We also downgraded basic materials and consumption to Neutral on their high operating leverage and valuation. We overweight energy sector for their strong balance sheet and stable demand.

**2011 index targets trimmed.** To recap, the HSCEI had been trading at PE of between 6.3 – 29.7x PE (average at 15.7x) and 1 – 5.4x P/BV (average at 2.5x) during 2007 – 2011 with index range at between 4,990 – 20,400. Market had been revisiting the bear range during the Lehman crisis in 4Q 2008 i.e. PE range at ~ 6-11x and P/BV range at 1-1.7x for HSCEI on concerns that the Euro zone debt crisis may trigger a bigger recession than Lehman. However, market is still looking at about 12% yoy earnings growth for 2011 and ~14% for 2012. We think this is too optimistic considering the earnings growth of finance (~40% of index weightings) may drop to single digit on bear case scenario vs forecast at ~15-20% growth, and those of resources and materials (~30% of index weightings) may drop 10-15% from the high base effect in 2011. Assuming flat earnings growth in 2012 for conservativeness, we expect trading range of HSCEI at between 7,600 – 10,000 representing ~6.5-8.5x FY12 PE, and 1.0 / 1.3x FY12 P/BV which coincide with the valuation during the Lehman crisis. A 1x FY12 forward P/BV shall put support at 7,400.

**Key Risks Considerations:** 1) OECD economies double-dip; 2) regulatory; 3) hard-landing in China economy; 4) large scale hot money outflows.

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## China Sector Snapshot

**Banks (maintained Neutral).** The interim results of the banking sector remained strong but momentum may slacken in 2H on stricter regulations over wealth management products and reverse of the downtrend in credit costs. It is estimated that the weighted average new loan yield of the China banks increased by 110bps hoh to 7.29% in 1H11 which should help widen most H-share banks' NIM by 5-35bps in 2011. However, the benefits from widening NIM may be offset by rising credit costs. Adopted a worst-case scenario with an assumption of a 10% annual increase in the NPLs of the H-share banks' manufacturing loans in 2011-13, coupled with the increased provisions for local government loans would raise the credit cost of H-share banks by 32-240bps for 2011. In such case the EPS of H-share banks may decline or show minimal growth in 2011-12 that current expectation of ~ 10-20% yoy growth for 2012. We think the impact could be bigger factoring the potential defaults from "informal lending". We think a simple RRR cuts may help to boost sentiment but not to resolve the NPL problems of banks going forward. While we are NEUTRAL with the sector due to its low valuation, our outlook is cautious.

**Insurance (downgraded to Neutral).** Market in general is pessimistic on the growth of China insurance industry given the restrictions on bancassurance sales and the intensifying competition from banks. Sales is expected to slow down further in 2H on more stringent implementation of bancassurance sales restrictions in third tier cities, as well as keen competition from banks' wealth management products. The implementation of the commercial auto insurance liberalization reforms appears to have been delayed from Jan 2012 to mid-2012. Yet market expects adverse impact as: (1) P&C insurers should use the new net loss rate and new clauses provided by the China Insurance Association. The new clauses could increase the insurance liabilities undertaken by P&C insurers but with limited change to the net loss rate pricing assumptions, which may increase P&C insurers' operating risks, bad debt risks and loss ratio; (2) P&C insurers can decide their own additional expense rates, which may induce intensifying competition. As such, auto insurance profitability could peak by 1H12. Market expects new business value growth may slow to single digit at ~5% during 2H11 which may lead to further derating of the sector.

**Property (maintained Underweight).** For Jan-Aug, the sales value of commodity properties rose 25.9% yoy to RMB3,326bn. The GFA sold for commodity property rose 13.6% yoy to 599mn sqm. That said, national property prices still climbed about 12% yoy. In Aug, ASP in the 100 cities was Rmb 8,880/sqm, up 0.07% mom which is unsatisfactory. To further rein in property prices, third and above tier cities are being asked to roll out their own home purchase restrictions. Meanwhile, the CBRC has investigated into trust loans which are a key financing source of property developers. It is estimated that trust loans accounted for about 7-20% of total lendings of developers and the clamp down may further squeeze their liquidity coupling with dwindling sales volume. We think solvency risks remain the key overhang of the sector. In fact, national developers are giving up top line growth to deleverage their balance sheet. We expects more aggressive price cuts going forward, but we still recommend to accumulate establish national developers which shall gain market share on this round of industry consolidation.

**Basic materials (maintained Neutral).** Commodity prices rose in 1H11 but fell back in 3Q11 on the back of slowing global economy. Despite improving demand/supply outlook, weak property and railway construction will dampen demand for construction materials, such as cement and steel. We see earnings downside risk for cement and steel sectors. However, share price of cement sector has already plunged and we maintain Neutral for cement sector. Given the weak long-term outlook, such as continuous overcapacity, thin margins and high iron ore prices, we are bearish on steel sector and downgrade to Underperform. On the other hand, copper prices in 3Q11 are lower than our expectation, but we believe restocking in 4Q11 and supply deficit will support copper prices. Recent share price sell off in copper sector is oversold. Maintain Overweight for copper miners.

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**Energy (maintained Overweight).** For coal sector, the market is still positive on coal prices. But slowdown of industrial production will result in slowing power generation growth, weakening coal demand. Potential hydropower recovery, slowing economic and increase in coal imports will add downward pressure on spot coal price in 2012, which will come as a negative surprise to the market. Yet, there is still room for contract coal prices to rise. Maintain Neutral for coal sector. Due to weak global economy, crude oil prices have peaked in 2Q11. OPEC may not further increase oil production which will offset increase in Libya's production. Supporting from strong oil demand from China, a significant plunge in oil price is not likely to happen but mild downside is possible. Overweight for oil sector.

**Consumers (downgraded to Neutral).** We remain positive on the long-term outlook of consumer sector. However, the margins pressure, coupled with the eventual slowing growth momentum may result in a valuation de-rating. Volatility in share prices of Hong Kong/China consumer plays has continued in September. The market is highly sensitive to negative news flow and pressure on the sector seems to have become increasingly indiscriminating. Going forward, possible disappointing Golden Week may drag down consumer plays share prices. It is prudent to keep a cautious stance on the sector in 4Q11 amid an uncertain macro outlook and a potentially disappointing October Golden Week.

In our view, consumer staples may outperform consumer discretionary in 4Q11 because: 1) strong seasonality in 4Q; 2) channel stocking; and 3) softening raw materials prices.

Share price performance risk factors: 1) Consumer sector valuations are not particularly attractive, 2) There could be further downside surprises on margins, 3) Possible valuation de-rating. We downgraded consumer sector to Neutral.

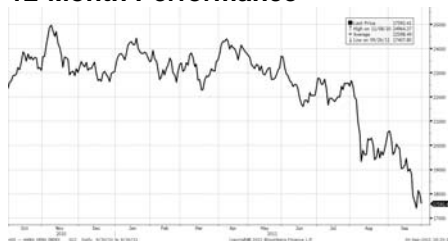
**Telecom (maintained Neutral).** The three largest telcos reported August 2011 monthly figures. China Unicom (762.HK) reported 2.364m total net adds in August 2011. 3G net adds surged to 2.05m. The mom improvement was mainly due to the launch of W-CDMA ZTE V880 smartphone (retailing at Rmb999). The net addition split of 53.8% China Mobile (941.HK), 24.1% China Telecom (728.HK) and 22% for China Unicom suggests China Mobile and China Unicom have been gaining market share of net addition while China Telecom has been losing market share since Jan 2011.

Handsets short supply may impact Sept 3G adds. The market saw a noticeable shortage of supply for CU's popular thousand-RMB models (ZTE V880 and Lenovo A60) in many outlets, which may impact its Sept 3G net adds. CU revealed that it has secured 8m units of supply in 4Q11. Going into 4Q, 3G net adds numbers should continue to remain of key interest for the sector because it is a leading indicator for revenue.

**Telecom Equipment (maintained Overweight).** Telecom equipment stocks should benefit from robust global demand for telecom equipment, which supported by strong wireless network/capacity growth and fixed-network upgrades. The global long-term prospects remain positive, with spending driven by data demand, faster connectivity and technology upgrades such as 4G. ZTE's share in wireless equipment (ex. North America) to grow from 10% in 2010 to 13% in 2013 and its smartphone market share to grow from 0.7% to 4.9% or 37m units in 2013.

China Unicom's recent project launch for optical and WCDMA network upgrades, together with China Telecom's PON equipment purchase and China Mobile's launch of the 5<sup>th</sup> round of TD-SCDMA bidding in late July, suggest that China telcos are accelerating their infrastructure expenditure in 2H11. Also, demand for V880 in China has exceeded 300K per month, exceed market expectations and thus drives ZTE's margins upside in 2H11 on improving production scale.

## 12-Month Performance



Hang Seng Index

## Hang Seng Index Data

|                    |                   |
|--------------------|-------------------|
| Market cap         | HKD 4.99 Trillion |
| 52-week Hi / Lo    | 24,989 / 17,000   |
| 3-Mth Return       | -21.5%            |
| Y-T-D Return       | -23.6%            |
| 50 / 250 Mov.Avg.  | 20,093 / 22,598   |
| Est Dividend Yield | 4.4%              |
| 2011 Estimated P/E | 8.1x              |
| 2012 Estimated P/E | 8.4x              |
| Historic P/B       | 1.3x              |

Source: Bloomberg L.P.  
As of 09/30/2011

## Hong Kong Sector Snapshot

**Rising recession risks.** While market is all focusing on when US and Europe will enter into recession, this is in sight in HK with GDP shrank 0.5% qoq and one more quarter of negative growth to be dragged by dwindling asset prices will put HK into a technical recession. Yet CPI tapered off to 5.7% in Aug from the peak at 7.9% in Jul Retail sales maintained at a brisk pace which grew 29.1% yoy in July and unemployment at low level of 3.2% in August. The HKSAR government expects GDP growth at 5-6% and CPI at 5.4% for 2011.

**Hot money a two way sword.** HKD against USD had been weakened during the past quarter. Hang Seng Index dropped 21.5% qoq in tandem. We think the liquidity outflows stemming from global financial institutions unwinding their positions. With rising mortgage rates and tight liquidity, property prices slackened and rose 11% ytd (vs 14% year to June) with the Centaline Index retreated to 98 in September from year highs at 100 levels during June.

**Stay defensive remained our investment strategy.** We overweight sectors with high earnings visibility, low leverage and dividend support. We like investors and REITS as the commercial and retail rental revisions cycle remained positive. We also like traditional conglomerates which have high earnings visibility. We are neutral on banks as we think a slow down in loan growth in 2H and margin pressure may hurt profitability. We are cautious with the Hong Kong consumption sector on the upsurge in wages and rentals amid a slow down in growth momentum in 4Q.

**2011 Index target trimmed.** To recap, the HSI had been trading at PE of between 6.8 – 24.4x PE (average at 14.7x) and 1 – 3.3x P/BV (average at 2x) during 2007 – 2011 with index range at between 11,016 – 31,638. Market had been revisiting the bear range during the Lehman crisis in 4Q 2008 i.e. PE range at ~7-10x and P/BV range at 1-1.5x for HSI. Market is looking at about 17% yoy earnings growth for 2011 and ~4% drop for 2012. Factoring about a 5% earnings drop for conservativeness, we expect trading range of HSI at between 15,500 – 19,500 representing ~7.5-9.5x FY12 PE, and 1 / 1.3x FY12 P/BV which coincide with the valuation during the Lehman crisis. We see market should find firm support at 1x price to FY12 forward book or index levels at ~14,200 which is the worst case scenario.

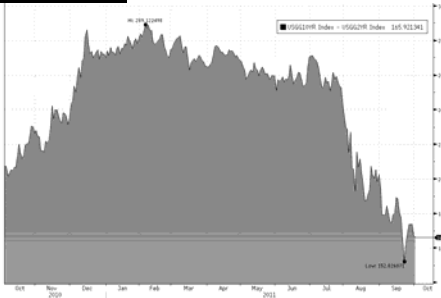
**Key risks considerations.** i) Massive outflow of hotmoney; ii) Hardlanding in China; iii) Prolonged global recession; iv) Government regulation; and v) Sharp drop in asset prices.

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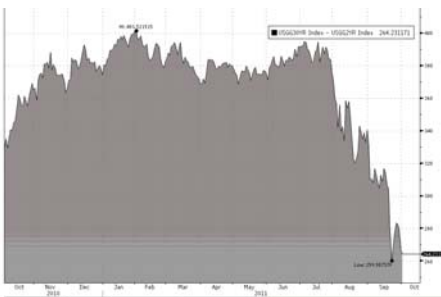
## BONDS

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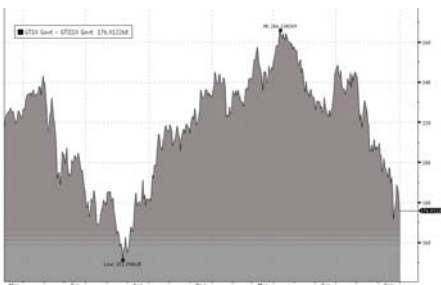
### Spread Between 2-year and 10-year UST



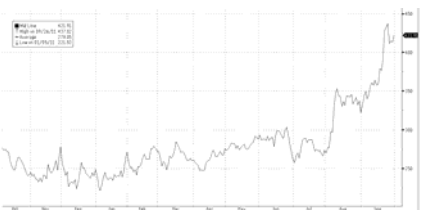
### Spread Between 2-year and 30-year UST



### 10-year TIPS Breakeven



### JPM EM+ Plus Index



### Slowing down of the Global Economy

European bank and sovereign-credit risk surged, on speculation that Greece may default and on sluggish US economic performance. During 3Q corporate credit has been significantly re-priced due to lower growth expectations and rising recession risks. Federal Reserve has begun purchasing longer-term US Treasuries and selling shorter maturities under operation twist in September. The yield of 30-year Treasuries has tumbled 146 basis points in 3Q, its biggest drop since December 2008. We expect the yield curve to flatten further in 4Q and the markets are likely to stay volatile until further stabilization plan could come out from the Eurozone.

### Asian credits

Fears of a potential hard landing in china are overshadowing the European sovereign crisis and the main driver of price action in Asian credit recently. China sovereign Credit Default Swap and china high grade bonds are underperformed. There was also renewed momentum in the longstanding theme of weakness in Chinese high yield sector, especially property and industrials. China Investment Grade Quasi-sovereigns credits have been one of the worst performing sector year to date, we believe the China IG Quasi-sovereigns can outperform as credit in China is unlikely to be eased soon, but the SOEs have preferential access to banks and are backed by the sovereign with the strongest external debt coverage metrics in the region and indeed in global Emerging Markets.

We believe Asian credit can outperform global market on the back of stronger economic backdrop, lower systemic risk, supportive flow technical and compelling valuations in 2012.

### Dim Sum market

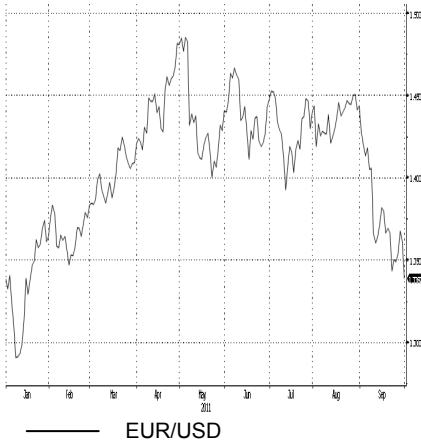
Despite challenging conditions in the global credit market, CNH primary market has seen steady pace of supply in Q3. So far Q3 gross issuance of bonds and CDs has reached RMB 76.5bn, and net supply at RMB 62bn. Supply has been dominated by high-grade issuers and the supply by commercial banks and corporations saw the strongest growth and increasing geographic diversification among issuers. 2011 full-year new issuance forecast of RMB 190bn gross supply and expect RMB 30bn gross supply in Q4. Chinese large SOEs, MNCs and Chinese commercial banks will likely be the top three issuers in Q4.

### Europe

In the G20 meetings, a clearer sense of urgency regarding potential solutions to the crisis emerged. As expected, German and Finnish parliaments approved the July changes/ expansion of the EFSF. In addition, Greece approved further consolidation measures, including a property tax increase. All these developments contributed to a much better tone in Italy and Spain. The potential to "leverage" the EFSF to achieve the scale required to be creditable in the face of market concerns. Until there are signs of broad-based political commitment to a well defined proposal for Europe, we expect credit markets to continue to price in some risk of an adverse systemic event. Greek 10-year debt yields reached 20%.



Year-To-Date Performance



EUR/USD Data

|                   |                |
|-------------------|----------------|
| ECB Refin. Rate   | 1.50%          |
| 52-week Hi / Lo   | 1.4940/ 1.2867 |
| 3-Mth Return      | -7.52%         |
| Y-T-D Return      | 0.02%          |
| 50 / 250 Mov.Avg. | 1.4103/ 1.3955 |
| Historical High   | 1.6038         |
| Historical Low    | 0.8230         |

Source: Bloomberg L.P.  
As of 09/30/2011

INVESTMENT SUMMARY

- EU needs more time to solve the debt crisis
- Outlook for the region's economy deteriorates
- From rate hike to rate deduction
- The QE option for ECB

**Eye on the development of debt crisis.** The biggest surprise for the market in the last quarter should be Standard & Poor's (S&P) downgrading of U.S. on its highest AAA rating. This is not only a business of the U.S. itself, but also have a great impact on other currencies, including the euro. It was among the few currencies that were little affected by the event and in fact, the euro was benefited by the downgrading and climbed to 1.45 against greenback. However, the Fed held on launching the third round of quantitative easing on the Jackson-hole annual meeting and the euro started to loose its momentum. Besides, after worrying about the U.S. debt crisis in early August, the market soon got its focus back to the Europe. The European Union, European Central Bank (ECB) and IMF were unsatisfied by the progress of Greek in cutting the budget deficits and the negotiation was held up in September. What's worse, Italy's credit rating was later cut by S&P, the country's first downgrade in five years, as Greece's worsening fiscal crisis fans concern that contagion will engulf countries such as Spain and Italy. S&P lowered its rating to A from A+, saying that weakening economic growth, a "fragile" government and rising borrowing costs would make it difficult to reduce Europe's second-biggest debt load. The development of European debt crisis is hard to predict, as the bailout of Greece still remain highly uncertain. The only thing more certain is that the end of the debt crisis looks remote and we believe it will be hard for the euro to break 1.38 dollar in the rest of the year.

**Signs of weak economy.** Euro-area services and manufacturing output shrank for the first time in more than two years in September as the region's worsening debt crisis added to concerns that the economy could slide back into a recession. A composite index based on a survey of purchasing managers in both industries fell below 50, indicating contraction, for the first time since July 2009, according to London-based Markit Economics. The index fell to 49.2 this month from 50.7 in August, a deeper slide than the drop to 49.8 that economists had forecast.

**Market expectation towards the future trend of rate changes.** Given the rapidly deteriorating global economic outlook, more and more investors began to doubt whether the 50 bps rate hike turns out to be a mistake made by the ECB earlier this year. Some even speculate on a sharp rate cut of 0.50% at a time. However, the market is generally anticipating a milder cut to reduce the impact it can have on the region's inflation.

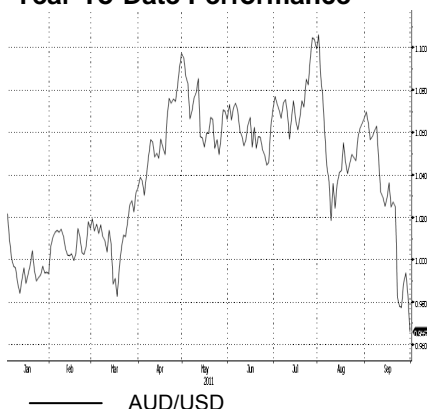
**Think about the unthinkable.** The euro zone debt crisis has reached a critical point in which markets -- rationally or not -- begin to speculate about the unthinkable. There comes a question -- is it possible for the ECB to launch QE as its U.S. counterpart does? Unlike the Bank of England or the U.S. Federal Reserve, the ECB does not have a history of creating massive amounts of new money through asset purchases and has hardly seemed open to such a move given that its mandate is to keep inflation in check. Even at the height of 2008's financial turmoil, the closest the bank went to so-called quantitative easing was the purchase of relatively obscure covered bonds and it has sterilized all of its other liquidity measures to prevent any impact on inflation. What's more, the solutions available to governments, such as common euro zone bonds, could face potentially lengthy constitutional challenges and may simply be politically undoable.

**Risk Considerations:** 1) Development of European debt crisis; 2) The trend of inflation in the region; 3) Decision on QE3 by the Fed.



AUD/USD

## Year-To-Date Performance



## AUD/USD Data

|                   |                 |
|-------------------|-----------------|
| RBA Cash Rate     | 4.75%           |
| 52-week Hi / Lo   | 1.1081 / 0.9537 |
| 3-Mth Return      | -9.81%          |
| Y-T-D Return      | -5.58%          |
| 50 / 250 Mov.Avg. | 1.0438 / 1.0289 |
| Historical High   | 1.4885          |
| Historical Low    | 0.4776          |

Source: Bloomberg L.P.  
As of 09/30/2011

## INVESTMENT SUMMARY

- Slump amid fear of global recession
- The emerging market cannot keep fast growth alone
- The outlook of Australia's exports – in a longer term

**Watch out for the coming quarter – the worst may have not been seen yet.** Aussie experienced a deep retracement in the third quarter. Many have never thought of the possibility that the Aussie can quickly break the strong support at parity against the greenback just two month after recording the recent high of 1.1081 dollar. Although it really looks attractive at the current levels, we have to say some more room at the downside is still likely. The previous support at parity against the dollar will become a strong resistance for the Aussie in the following quarter, during which we see little possibility of launching QE3 by the U.S. Fed. Meanwhile, the sluggish world recovery will hinder the prospects of Australia's economy. However, the extremely low U.S. interest rate still adds appeal to the high-yielding Aussie. According to market consensus, the Reserve Bank of Australia will leave its cash-rate target at a developed-world high of 4.75% until the middle of next year.

**Slowdown contagion – from the developed countries to the emerging countries.** As the commodity currency that is most sensitive to the world economy, the Aussie lost almost 10% last quarter as the investors turned pessimistic about the pace of recovery in the coming days, especially when no QE3 was announced in the Fed's September meeting. On the other hand, economy in both European and Japan also lacks surprises. But what worries the market most is that even the fast-growing emerging economies saw slowdowns recently. For example, the economy of China and South Korea have been seeing slowdown for two quarters on an year-on-year (YoY) basis as of in the second quarter. Meanwhile, the India's YoY GDP growth has dropped for three quarters in a row by the end of June. These figures well-prove that the emerging market can not keep its fast growth when the developed economies are facing the danger of recession. The reason behind is simple – most of the emerging countries have an export-led economy. When the exports fall dramatically amid sluggish economy in U.S. and Europe, the growth of these emerging countries can hardly make up for the loss by raising internal demand. We can imagine lots of the people who currently belong to the middle-class in the emerging countries can easily fall back to the bottom tier later, which further contains their purchasing power.

**Still there is hope in the longer term.** However, we do not expect a sharp slump as what we saw during the time of financial tsunami and the Aussie still has its merits in a longer term.

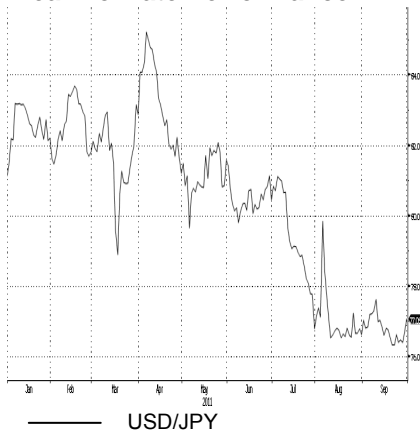
Australia lifted its projections for iron ore output and exports on 20 September, relieving concerns over the global economy as Asian demand roars along, though it cut its forecast for coal output on a slow recovery from natural disasters. Exports of iron ore, a key steelmaking ingredient, are seen at 449 million tonnes -- 40 percent of global trade -- in fiscal 2012, a 3 percent increase from an earlier projection and a 10 percent rise on the previous year, as Japanese and Chinese steel output expands rapidly. Revenue from iron ore exports is seen rising even faster, by 26 percent to A\$68 billion (\$69 billion), as prices are declining only slowly from their highs hit in early 2011, the country's Bureau of Resources and Energy Economics said in a quarterly report.

**Risk Considerations:** 1) The pace of worldwide recovery; 2) Price outlook for copper, iron core and coal; 3) The rate outlook of the RBA; 4) Decision on QE3 by the Fed.



## USD/JPY

### Year-To-Date Performance



### USD/JPY Data

|                   |              |
|-------------------|--------------|
| BOJ O/N Rate      | 0.10%        |
| 52-week Hi / Lo   | 85.53/ 75.95 |
| 3-Mth Return      | -4.20%       |
| Y-T-D Return      | -5.00%       |
| 50 / 250 Mov.Avg. | 76.99/ 80.93 |
| Historical High   | 358.44       |
| Historical Low    | 75.95        |

Source: Bloomberg L.P.  
As of 09/30/2011

### INVESTMENT SUMMARY

- Safe heaven in a turbulent market
- Short-lived BOJ intervention on the strong yen
- The Franc's peg towards the euro adds pressure to the yen
- "Operation Twist" of Fed and the impact on the yen

**Stay strong in the narrow range.** Among all the G7 foreign currencies, the yen became the best-performer in the last quarter. It started to trend up against the greenback from the beginning of the Jul and aroused the attention of Japanese government. Shortly after the government's unilateral intervention which brought the yen down by about 300 bps against the USD, however, the S&P downgraded the solvency credit rating of the U.S. and triggered panic. The yen quickly returned to the levels before intervention around 76 against the dollar and was kept in the narrow range of 76 – 78 in the rest of time in the third quarter.

**Government's intervention turned out to have minimal effects on weakening the yen's exchange rate.** In the morning of 4 August, the Japanese authorities intervened to weaken the yen. Shortly after a 124pt spike higher in USD-JPY, Finance Minister Noda then confirmed the intervention, also stating it was a unilateral move. On the other hand, the Bank of Japan also added monetary stimulus after authorities intervened to stem an advance in the yen to protect the nation's economic recovery. The central bank expanded its asset-purchase fund to 15 trillion yen from 10 trillion yen. It also expanded a credit facility by 5 trillion yen to 35 trillion and kept its benchmark interest rate near zero. It was the first time the central bank expanded the asset-buying fund, its main policy tool, since March, when it stepped up purchases to combat a plunge and stocks and a surge in the yen after the earthquake and tsunami.

**SNB Setting Minimum Franc Exchange Rate against the euro.** On 6 September, the Swiss central bank said it's setting a minimum franc exchange rate of 1.20 against the euro and will defend the target with the "utmost determination" if needed. The franc tumbled to a two-month low against the euro after the announcement and also weakened a lot against the greenback. As the Swiss Franc was one of the major safe-heavens before the decision, this has added enormous upside pressures to the yen, which is now apparently the only currency, other than the USD, serves as safe-heaven.

**Drop of short-term U.S. treasury yield due to "Operation Twist" – the bearish factor for the yen.** Although the intervention of the Japanese government seems effortless, the decision of the U.S. Fed somehow did the job. In the FOMC meeting ending on 21 September, there is no QE3 announced. However, the Fed said it would shuffle \$400 billion of its portfolio to try to drive down long-term interest rates and get the economy going. The Fed will sell \$400 billion from its holdings of short-term U.S. government debt -- Treasury bills and notes that mature in three years or sooner. It will use that money to buy Treasury notes and bonds with maturities of six to 30 years. The Fed said the shift would be complete by June. The benchmark 2-year treasury yield has picked up notably after the launching of such "operation twist." As the borrowing cost of the USD increases, we expect more investors will short-sell yen instead of the dollar in the future, which may help to weaken the yen to levels around 80 by year-end.

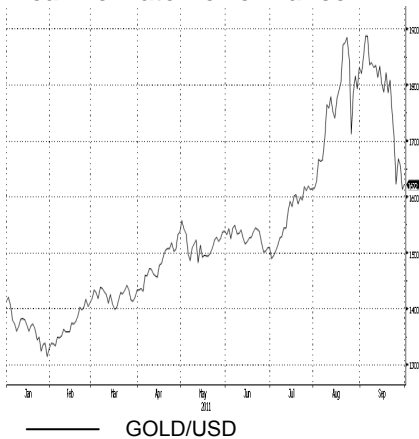
**Risk Considerations:** 1) The future decision of the Fed's monetary policy and short-term treasury yields; 2) Market sentiment towards investment.

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## GOLD/USD

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### Year-To-Date Performance



### Gold Data

|                   |                    |
|-------------------|--------------------|
| 52-week Hi / Lo   | 1,921.15/ 1,308.25 |
| 3-Mth Return      | 7.41%              |
| Y-T-D Return      | 14.83%             |
| 50 / 250 Mov.Avg. | 1,753.88/ 1,500.30 |
| Historical High   | 1,921.15           |
| Historical Low    | 35                 |

Source: Bloomberg L.P.  
As of 09/30/2011

### INVESTMENT SUMMARY

- The effect of unwinding challenges the safe-haven role of gold
- WGC's view on the prospect of gold
- There is still support from the fundamentals

**Technical double tops occurred.** Compared to other foreign currencies, the yellow metal was still relatively strong during the three months from July to September and accumulated a year-to-date gain of over 10%. Amid the market panic on both the U.S. debt crisis in August and the European debt crisis in Sep, the gold price made another record as high as 1,921.15 dollar per ounce. However, it may seem strange that even the European debt crisis persisted until the end of the past quarter, the gold still sees a "double-top" in technical terms. In fact, the metal's safe-haven role was eroded when the market began to worry about a double-dip in the world's economy. Investors around the world, including the fund managers, rushed to unwind investments into cash, i.e., the USD. In fact, the sluggish world economy also has a negative impact on the gold in terms of gold jewelry. The yellow metal turned out to be extremely volatile after peaking out at its second top and we believe it will be hard for the gold price to return to the previous high before the end of this year.

**Demand from China and India.** Gold's roller-coaster ride may continue for some time, but the recent rush for the precious metal hasn't created a bubble waiting to be burst as projected by some global analysts, because demand from India and China still remains robust, according to a top executive with the World Gold Council. Ajay Mitra, managing director (India and Middle East) of the World Gold Council, said that although gold prices are witnessing a correction, the robust physical demand from India, the world's largest consumer, and China will prevent any sustained slump in the precious metal's movement for a long period.

**Central banks' choice.** After Standard and Poor's cut the top-notch credit rating for the US and the debt crisis aggravated in Europe, it may be easily linked to a benefit of the gold as all the central bank may need to increase their gold reserve. However, this may not be as true as it apparently looks. It is undeniable that gold sales by European nations under an annual agreement between central banks in the past year were 1.1 metric tons, the least since the first accord began more than a decade ago, data from the World Gold Council showed late September. Besides, emerging-market countries continued to top up their gold reserves in August, with Russia, Thailand and Bolivia among those to add to their holdings. Central banks have bought gold as some seek to diversify foreign-exchange reserves that have grown along with emerging market export industries. But the important thing to bear in mind is that the gold market is relatively small and not deep enough to absorb huge capital. Therefore, the impact of the central bank purchases can have very limited impact on driving the price of gold higher.

**An unchanged story -- low interest, excess liquidity and high uncertainty.** We believe that the fundamental story for the backdrop of gold investment somehow stayed unchanged, say, the extremely low interest rate prevailing in the U.S., the ample liquidity created under the so-called quantitative easing in various forms by different central banks and the world stays highly unstable both politically and financially. The unsettled European debt crisis will keep bothering the market and bring supports to the precious metal. However, do not expect too much for the upside amid the overall weak market sentiment we expect during the fourth quarter and watch out for high volatility before investment.

**Risk Considerations:** 1) Global interest rate hike; 2) The development of European debt crisis; 3) U.S. monetary policy.

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