

# PRU MONTHLY INVESTMENT BRIEFING

JUNE 2008

Fears of a protracted US recession are retreating. Investors are increasingly grappling with inflation woes though much, we suspect, is a knee-jerk reaction; "core" inflation generally remains low. The bears still argue that this is merely a slow slide into recession given some murky US economic data and rising oil prices. They may be right, but more "hard" evidence must emerge. Investors, beset by a year of bad news, may take anything less in their stride.

## United States

- Inflation has surpassed credit recession as investor's prime concern, leading the US Fed to announce an end to its rate cuts. Soaring energy and food costs are pushing prices, yet core inflation has mostly remained stable, which should help ease worries.
- Despite the up-tick in unemployment, other economic data is more resilient. April's nonresidential construction, for example, rose a surprisingly strong 1.6%. May's retail sales rose 1%, twice as much as forecast.<sup>1</sup> The preliminary estimate of 1Q, 2008 real GDP growth was revised upwards to +0.9% from the +0.6% flash estimate.<sup>1</sup>
- After more than a year of slashing forecasts, analysts have begun reducing next year's projected losses for US banks over the past two months, indicating the worst is over. Contrary to many expectations, non-financial forecasts have been upgraded recently.

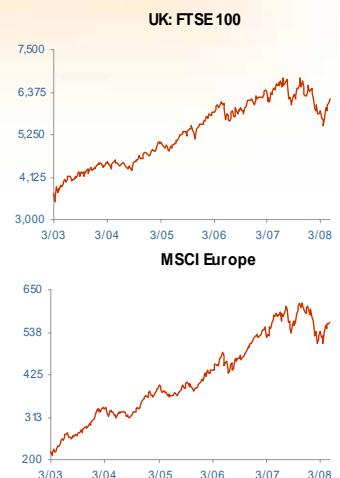
## Europe

- The emerging economic data is mixed. While demand indicators signal a slowing, others suggest resilience; Germany is strong, but the "olive oil" belt (Spain, Italy and some other Mediterranean economies) are softening. Still, Eurozone industrial output rose 3.9% yoy in April, beating expectations of 2.9%.<sup>2</sup>
- Eurozone inflation hit 3.6% in May, well above the 2% target.<sup>2</sup> Chances of a future rate cut are slim as the European Central Bank has opted for a more hawkish stance.
- Markets slipped over the second half of May with banking and housing dominating in terms of noise and reaction. Equity valuations bounce along historical lows incorporating recently reduced profits forecasts. Eurozone equities are some of the world's cheapest. Whether investors take the bait is another issue.

<sup>1</sup> Bloomberg, as at 13 June 2008.

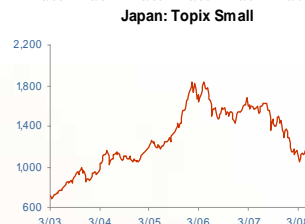
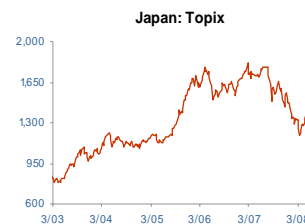
<sup>2</sup> Bloomberg, as at 10 June 2008.

Source of charts: Bloomberg, as at 30 May 2008.



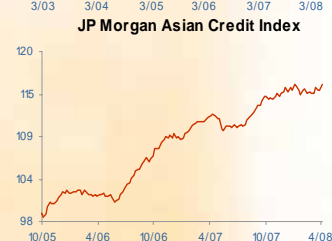
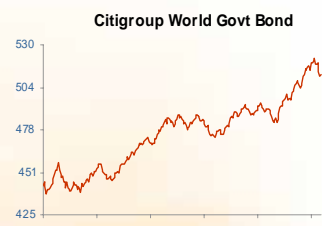
## Japan

- Despite volatility, Japanese equities rose for the second successive month. The market reacted positively to announcements by Japanese companies of rising dividend payments and increasing share buybacks.
- There are now strong valuation signals for Japanese equities especially as more than 60% of Japanese companies are trading below book value. Though not immune to the global cycle, valuations in Japan have already fallen further than in other markets.
- As the underlying medium-term economic trends remain supportive - recovering profits, productivity gains and contained labour costs all bode well for the economy. Stocks with a domestic focus stand out as good value.
- Japan is an inflation beneficiary. Higher inflation would allow companies to push through price rises that "stick" - a feature notably absent over the past decade.



## Bonds

- Government bond markets fell on heightened inflation expectations – though less so in the Euro Area than in the UK and US. The retreat was mostly at the short end on rate hike fears rather than at the long end (reflecting sustained rising inflation expectations)
- US issuers rushed to access low all-in yields as improving credit conditions brought investors back to the table. Financials have refinanced most of their near-term maturities. Utilities and telecoms are among the few expected to show organic growth as new capacity comes on stream.
- The upward trend in default rates continued into April. The global default rate has almost "doubled" since bottoming at a 25-year low in November 2007.



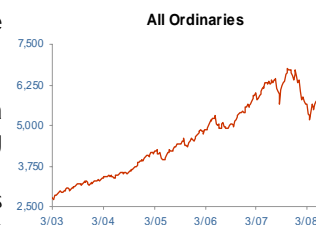
## Currency

- With policy makers now more focused on inflation than growth, the US dollar seems to be gaining momentum. Grounds for a stronger dollar are falling into place especially considering 2009's projected improvement in the budget deficit. Watch this space.
- A revival of the yen carry trade seems to be on the cards as investors' risk appetite return on the back of market stability.
- Most Asian currencies (bar the NT dollar) weakened against the US dollar on growth concerns once oil hit USD 135 per barrel. Asian currencies remain cheap, however.



## Australia

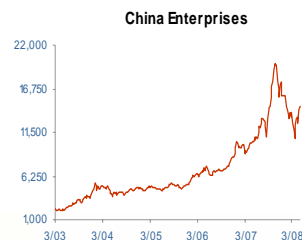
- Australian equity market continued to rally led by energy and iron ore companies against the backdrop of record oil prices and ongoing M&A activity in the iron ore and domestic gas sectors. Energy, Resources and Telecom outperformed while REITs, Financials and Industrials slacked.
- Reserve Bank of Australia kept rates on hold for a second consecutive month as economic data flow is showing clear signs that the domestic economy is slowing especially retail sales, building approvals and credit growth.
- The key issue this year remains the trade-off between risks to corporate earnings versus increasingly reasonable valuation. As risks of domestic recession seem high, the portfolio is positioned fairly defensively.



Source of charts: Bloomberg, as at 30 May 2008.

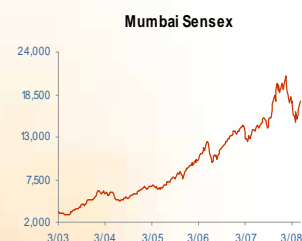
## China / Hong Kong

- MSCI China contracted, the third worst performer in Asia ex-Japan after Pakistan and India. Telecom industry retreated while Utility and Material sectors performed better. On May 12, the deadliest earthquake in 32 years hit Sichuan province, however many believed that the impact on China economy is unlikely to be significant.
- In China, the central bank has allowed faster yuan appreciation (yuan rose to highest since end of peg, reaching an 11-year high in Feb) and raised the bank's reserve ratio for the fifth time this year to curb inflation.
- In Hong Kong, market was down with utilities sector being the resilient one. 1Q08 GDP grew by a substantial amount, the fastest pace in two years thanks to stronger net exports. Jobless rate fell to a decade-low for April.
- Current valuation does not look particularly compelling. We think overall market expectations have moderated, therefore we are looking for opportunities to add stocks opportunistically.



## India

- India's inflation rose at its fastest pace in almost 3.5 years due to rising consumer demand and record commodity and energy prices. In order to contain prices, the central bank raised key interest rates to the highest in 5 years, but it was the first increase in more than a year.
- The government has also taken steps to ban the future trading of staples. 1Q08 GDP has robust growth. India's fiscal deficit continued to be high for the past 12 months. Earnings are expected to grow by 20.4% for December 2008 and 24.5% for December 2009. India market's ROE continues to be strong with projected ROE of MSCI India index to be 19.1% for December. Markets should broadly follow the earnings progression.



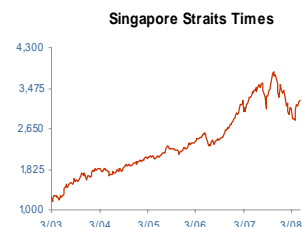
## Korea

- Korea's stock market inched up marginally in May on the back of improved foreign investors' confidence. Commodity-related sectors outperformed while Financial sector underperformed.
- Inflation continues to surprise on the upside. On the political front, the new government struggles as its decision to import beef from the U.S. triggered massive public protests.
- The IBES consensus forecasts for 2008 EPS growth has fallen below 10% from mid-teen levels a couple of months ago. But valuation of the Korean market has improved after the sharp correction. Valuation divergence still exists with large-cap blue chip names.



## South East Asia

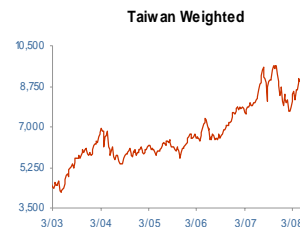
- In general, the South East Asian equity markets have moderated in line with the rest in Asia due to U.S. macro backdrop weakening, rising inflationary risks and escalating oil prices. There is a growing list of central banks opting to tackle inflation at the expense of economic growth by raising their key interest rates.
- Thailand remains by far the most attractive. Singapore and the Philippines are also looking increasingly attractive compared to other Asian equity markets. Malaysia continues to be valued at mid-range of its historical levels.
- We believe the region's macroeconomic outlook is fine and valuation is fair. We remain upbeat about medium-term equity returns in light of Asia's strong economic backdrop but short-term volatility is likely to persist.



Source of charts: Bloomberg, as at 30 May 2008.

## Taiwan

- The TWSE index slipped. Prudential maintains overweight on Taiwan as both absolute valuation and relative valuation are cheap compared to history and dividend yield is attractive as well.
- Taiwan's government is offering subsidies to low-income families to offset the effect of higher energy prices. Jobless rate rose slightly in April as workers resigned after their employers filed for bankruptcy protection.



Source of charts: Bloomberg, as at 30 May 2008.

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