HSBC Investments

MINUTES OF REGIONAL STRATEGY MEETING – JUNE 2005

While the Asian markets were up modestly in aggregate for the month of May (the MSCI Asia ex-Japan index was up 2.1% during the month), performance at the individual country level was mixed. India was the best performing market during the month (+9%), fueled by ongoing reforms in the banks and government-owned companies. Korea was also up strongly during the month (+5.1%), benefiting from lower global risk aversion.

Companies that had previously benefited from speculation of a RMB revaluation – notably China, Hong Kong and Malaysia – were weaker last month as expectations for a revaluation began to ebb. Rising interest rates hurt real estate counters, particularly in Hong Kong. Thailand was also down during the month, as macroeconomic data remained weak.

While global growth has clearly moderated, the resilience that we have seen in the US consumer should help to prevent GDP growth from decelerating significantly in the wake of the slowdown that we have seen in industrial activity. We expect US GDP growth to oscillate around trend. Core inflation should also remain stable this year.

We continue to believe that Asia will remain one of the most dynamic regions in the global economy. Expectations of strengthening Asian currencies should bring liquidity into the Asian markets. At the same time, given the pullback in markets over the past few months, valuations do not appear overly demanding. We would look to add selectively to our positions.

We continue to see domestic consumption and asset reflation as prominent themes this year. At the same time, companies focused on capital management and delivering attractive yields should also fare well. We will continue to focus our efforts on bottom up stock picking, spending our risk budget on stock specific bets.

Australia

The Australian market is poised for further earnings downward revisions, with the PPI still well above the CPI, placing pressure on core industrial earnings for companies without pricing power and exposed to sectors with rising input costs. This cyclical profit squeeze is entering a precarious phase, with bottom up earnings still well too high for the FY06 and hence share prices do not fully reflect this downside risk. On the economic front, growth in Australia is slowing with higher interest rates. Meanwhile, the influence of China remains vital to the Australian resource sector, as it now accounts for more than 40% of global iron ore demand, and 90% of incremental demand. The medium term outlook for commodity prices remains strong. As the market has already built in sharp commodity price corrections, we remain positive due to undemanding valuations based on current commodity prices. We prefer stocks with relative earnings certainty including banks, insurers, healthcare, gaming and specific stocks that have pricing power in their respective industry.

China

We expect the China market to remain weak over the coming month as trade tension and pending new share issues remain an overhang. China's reliance on textile exports has fallen rapidly over the past decade from 30% of total exports in 1994 to 15% by 2004. We estimate the safeguard measures will affect about 20% of China's textile exports. The actual impact on China's total trade growth will thus be limited. Though unlikely, the risk is that the textile trade dispute may widen into other products. We believe the new property tax and tighter control of fund inflow are intended to prevent speculation on renminbi appreciation rather than a need for intensifying austerity measures. Fixed asset investment and loan growth have already slowed to sustainable levels and CPI inflation remained mild. We believe the introduction of measures to resolve the non-tradable share issue in domestic A shares is a positive step but will likely create volatility as the market awaits to see how these new rules are actually implemented.

Hong Kong

The Hong Kong economy remains on a healthy path of recovery with 1Q05 real GDP growth at 6% YoY, a seventh straight quarter of expansion. While 2Q05 may see a slight slowdown due to rising interest rates, the positive momentum should continue. Reflecting the healthy economic expansion, unemployment for the 3 months to April dropped to a 41-month low of 5.9% while April inflation was 1.4% YoY and is set to pick up further as the lagging effect of rising rents kicks in, keeping real interest rates stable. On the equity market front, while consensus earnings for 2005 and 2006 have been revised up by 3-5% in the last six months, the trend is negative due to rising interest rates, global demand uncertainties and adverse impact from sustained high raw material costs. Liquidity in the market may also be drained in June due to hefty fundraising activities which in turn will lead to a near term consolidation. Thus, Hong Kong equities are expected to remain in the doldrums in 2Q, despite improving fundamentals.

India

India is amongst the fastest growing economies in the world at GDP growth of 7.2% in FY05-06. We expect earnings growth of approximately 15-20% for FY05-06 and the return on equity of the market at 20%. The market is trading at 13x P/E for FY05-06. Mid cap valuations are at a premium relative to large cap stocks. Key risks going forward remain a sharp fall in commodity prices and/or continued government pressure to reign in prices, a swift rise in the rupee and a sharp rise in interest rates and the potential supply of equities from Indian corporates that might cause a market overhang.

Indonesia

We expect to see the market to move sideways for the next few quarters. After the first quarter hype of an infrastructure-led capex cycle, the market has now realised how difficult it is to plan investment overnight. The government only begins to understand that projects like ports, airports, toll roads, power etc, need to have centralised planning and coordination. While independent regulatory boards are still in the planning stage, a long list of reform items including tariff regulations, arbitration procedures, reducing timing requires for business-licensing procedures and land acquisition policy are yet to be in place. In addition, the government's crackdown on corruption is another important development. We believe the impact of infrastructure spending on macro economy and corporate profits is not likely to be felt until 1H2006 at the earliest. In the meantime, higher interest rates and the crackdown on lending policies in the banking sector spell bad news for 2005 earnings expectations.

Korea

Having corrected in March and April, the market rebounded from the low 900 level as it appears to be discounting the slower growth prospects in 2005. We believe that 2006 is the mid-cycle earnings year during which the 11.2x could be reached (if so, KOSPI will be at 1,600). In the short term, the market could be overly optimistic on earnings growth in 2H05 and in 2006. In terms of stock selection, we continue to focus on select companies with 1) pricing power (able to pass through higher costs); 2) trading at discounts to NAV; 3) growing dividend payout. In the near term, the massively underperforming cyclicals (petrochem, transport, refiners, steel) could see a relief rally. Earnings expectations on tech stocks appear too rosy; retailers have outperformed and could take a breather as consumption growth is muted. Banking shares have underperformed on the back of concerns over margin squeeze that appears to be easing.

Malaysia

We have become slightly less cautious on Malaysia, given its defensive nature and 8% underperformance versus MSCI Asia. We expect Khazanah to accelerate capital management initiatives in 2H05, providing upside catalysts for GLC-linked stocks. We expect more companies to actively manage capital, after having observed share price benefits for early adopters. A potential upside catalyst could come from speculative inflows owing to any renminbi repeg leading to a ringgit repeg. However, expectations are low after the speculative flows exited the market in 1Q. We prefer unloved, lower PE value stocks with capital management focus.

Philippines

The market was boosted by the impressive fiscal improvements with the passage of the VAT bill. The country is now more likely to reduce government borrowings and budget deficit ratios on a sustainable basis. April tax receipts was at record level, indicating the clampdown on tax evaders may finally be bearing fruit. Together with a surplus budget for the month, Fitch was prompted to upgrade their credit rating to “positive” from “stable”, and other agencies are expected to follow suit. On the other hand, economic data including higher inflation, declines in trade data, as well as slowing GDP paint a less rosy picture. On the earnings front, consumer companies are reporting that spending trends are being hit by higher costs and new taxes with the increase of corporate taxes from 32% to 35%. We are neutral on the market in light of the reduced risk factors on a macro basis and with equities having corrected 10% from its highs in March. As sentiment is clearly turning on the Philippines, the equity market is likely to continue its recent rally.

Singapore

We expect the market to remain range-bound in an uncertain growth environment as the market is trading close to fair value. We still expect the market’s 3-4% net yield to limit market downside with capital management increasingly priced in, but see limited upside catalysts. We expect a slight tilt back towards defensive yield stocks on the back of lower Singapore dollar long bond yields and higher risk aversion. We have added to higher yield plays with greater scope for yield spread compression. We maintain our preference for laggard asset reflation trades such as high-end residential property plays. For large caps, we maintain our views on cheap, unloved stocks, which have scope for better capital management, and with management under pressure to improve core business profitability. We have reduced banks on disappointing Q1 results, and prefer bank capital management plays.

Taiwan

After the recent strong move as a result of the MSCI re-weighting, we could see some profit taking over the near term as local sentiment/ confidence remains weak. We maintain our view that the market will remain range bound in the near future. We have adjusted our earnings expectations downwards for 2004 and 2005 after companies released 4Q04 and 1Q05 results. Negative currency impact and rule SF 35 has dragged down earnings growth. Valuation for the market remains fair. In terms of sector outlook, we are positive on the technology sector focusing on the foundry, IC packaging and IC design segments and memory. We also prefer the telecom sector, which provides us with strong dividend yield, and the cyclical sector, primarily focusing on companies with strong domestic demand and asset play. We remain cautious on the financial and consumer sectors.

Thailand

April macro economic trends were weak with distortions caused by the long Songkran holidays. Bright spots include the private investment index that rose by 4%, driven by expansion in construction and equipment. Exports also grew 14.8% and imports jumped 33%. Over a shorter term, government’s move to float diesel prices effective June 1 will likely put upward pressure on inflation if oil price moves above USD52/bbl. Interest rate will rise on the back of rising inflation and 1Q05 GDP growth to be announced soon will likely be weak at around 3% but these are expected by the market. The Ministry of Finance’s battle to strip bank supervision from Bank of Thailand may create market jitters even though the move may aim to relax some of the stricter rules on Thai banks by the Central Bank. Barring further significant increase in oil price, we expect tourism recovery after the 2Q rainy season, as well as a potential pick up in both private and public investments to drive a potential turnaround of the Thai economy in 2H05.