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Quarterly Outlook – Q3 2013

26 July 2013

OVERVIEW

Lion Global Investors (LGI) provides its Quarterly Outlook for Q3 2013

EXECUTIVE SUMMARY

Macroeconomics

- The second quarter of 2013 saw an increase in market volatility. Financial markets rose in the early part of the quarter, before market gains were reversed following comments made by the US Federal Reserve's (the Fed) Chairman Ben Bernanke hinting at the possibility of the Fed tapering its Quantitative Easing (QE) programme earlier than expected.

- Global bond yields rose as bond investors adjusted their interest rate expectations while equities and commodities markets both saw increased volatility.

- Against this backdrop, risk assets had a positive performance (the MSCI AC World Index gained 1.8% in SGD terms) while "safe haven" assets performed negatively (the Citigroup World Government Bond Index declined by 3.0% in SGD terms) in Q2 2013.

Equities – Europe

- European equity markets ended the second quarter down 0.5% in local currency terms. Initial optimism following the resolution of the Italian political stalemate and the 25 bps cut in interest rates by the European Central Bank (ECB) soon gave way to concerns over the Fed's possible QE tapering. In addition, there were concerns about the stability of the Greek government as it lost the support of a coalition partner.

- We continue to maintain our overweight position in the luxury goods sector as we believe that stocks with strong brand names will benefit from the continued resilience in spending for luxury goods. We also maintain our overweight position in the consumer staples sector, given the good growth prospects in emerging markets and the defensive characteristics of this sector.

- We remain vigilant of the tail risks in Europe as well as the austerity measures being undertaken by the various governments to address their fiscal deficits as they could result in a deeper than expected economic slowdown. There is a possibility that China's economic growth may be slower than estimated and this may dent Europe's exports to China.

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Equities – Japan

- The Japanese market rallied in April together with a sharp weakening of the Yen on the back of an aggressive quantitative easing programme. However, the market suffered a major setback in May over rising Japanese Government Bond (JGB) yields as inflation expectations took hold. This was followed by concerns over the Fed's possible QE tapering and weaker data from China. The market recovered part of its losses from the earlier sell-off to end the quarter on a positive note.

- We prefer to invest in companies that achieve their competitive edge through product innovation which provide unique value-add to their customers. These companies usually have a global footprint and will enjoy the tailwind provided by the weaker yen. As the growth of emerging economies may be tempered by rising interest rates in the short term, we are increasing our investment focus on the domestic and US economies during this period.

- The global economic environment remains anaemic and market liquidity is gradually being reined in. Nevertheless, the long-term outlook for Japan has turned a lot more positive as this is the most coordinated and resolute effort yet to put the Japanese economy back on a sustainable growth path.

Equities – Asia Pacific (ex Japan)

- Over the quarter, Asian equity markets fell sharply, mainly due to concerns over the Fed's possible QE tapering. This resulted in a sharp rise in yields of 10-Year US Treasuries, leading to a sell-off in Asian high yield stocks and ASEAN-related stocks. Markets were also concerned about a slowdown in China, following the new Chinese leadership's prioritisation of structural reform over economic growth.

- Both GDP and earnings growth numbers are looking weaker for Asia going forward. Until investors are convinced of the sustainability of a recovery, the region is likely to remain an underperformer in the second half of the year. However, Asia's equity risk premium remains very attractive on a historical basis, especially as the recent market sell-off have caused valuations to look reasonably attractive again.

- Our strategy is to increase exposure to the yield names – albeit with a bias towards so called 'divvy-cyclicals', or stocks that have a yield of over 3.5%, as well as earnings growth of over 10% on a Compound Annual Growth Rate (CAGR) of three years. We are underweight in ASEAN overall, although Singapore has been increased to an overweight. We are also overweight in Korea and Taiwan.

Equities – Australia

- The Australian stock market corrected together with the rest of global equity markets in Q2 2013. With Australian exports being closely linked to China's economic growth, the tightening of credit growth controls in China and its consistently weak economic data also added further to investors' negative sentiment. The Australian Dollar declined as well, dropping by more than 12% against the US Dollar.

- The Chinese stock market has not recovered after the central bank's injection of liquidity, which suggests that it is discounting a further economic slowdown. This does not bode well for Australian miners.

- Over the past quarter, political uncertainty has continued to weigh on both consumer and business confidence. However, domestic confidence could turn quickly once the election passes. We continue to favor stocks with a cyclical skew to earnings, with a special preference for companies with offshore earnings. At a sector level, we remain underweight in the financials, industrial and materials sectors, and prefer to stay more invested in the consumer discretionary, healthcare and energy sectors.

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Equities – China / Hong Kong

- Sentiment towards China/HK equities turned negative in Q2 2013, as concerns over a slow-down in China's economy, on the back of poor economic data and the new leadership's prioritisation of structural reform over economic growth, combined with concerns over the Fed's possible QE tapering.

- With the Government unlikely to launch any stimulus program, the growth outlook is expected to stay subdued as policy tightening in Q2 2013 exerts downside pressure on activity and the export markets remain lacklustre. GDP growth forecasts will likely need to be revised down, but a hard landing for China's economy is not expected.

- Tighter credit conditions are expected to persist in 2H 2013, though with less volatility. Overall, valuations look attractive on both a relative and historical basis, although the extent of earnings' revisions will vary at the individual corporate level. Against this backdrop, we see few catalysts for growth and will adopt a more balanced strategy in the near-term. With tighter liquidity conditions, we will focus on companies with strong balance sheets until credit creation resumes.

Equities – India

- The MSCI India Index gained 2.5% in Q2 2013 in local currency terms. The positive performance of the Indian market in April up to mid-May was based on the anticipation of looser monetary conditions, before global equity markets corrected. The Indian Rupee (INR) was particularly weak, losing 9.4% against the US Dollar for the quarter.

- We believe that the combination of lower inflation figures, a good monsoon, limited corporate pricing power in a soft demand scenario and the Government focusing on curtailing trade deficit will help the Reserve Bank of India restart the rate cut cycle from August onwards. Therefore, we are positive on selective rate-sensitive cyclicals.

- We continue to believe in the theme of Indian MNCs, with a focus on Indian exporters. We expect pre-election related spending, better agriculture output and lower interest rates to support demand and will add selectively to staples that are more geared towards the Indian rural economy. In summary, we believe that FY 2014 will be the year where India's real economy gradually bottoms out, but with volatility originating from global factors.

Equities – Korea

- It was a quarter of two contrasting halves for the Korean market. Trading in the first 6 weeks of Q2 2013 was relatively calm, until global equity markets corrected. The Korean bourse declined significantly, with Technology shares coming under selling pressure as investors grew concerned over the slowing momentum from Samsung Electronics' handsets business.

- The outlook for the Korean economy is improving given that a new and proactive administration committed to getting the economy back on track is in place. The recent upgrade in GDP growth by the Bank of Korea for 2013 and 2014, to 2.8% and 4% respectively is an indication that early pump-priming measures by the government are beginning to filter through to the economy.

- With growth being underpinned by the Government's efforts, a stronger finish to the year is expected of the Korean market. With valuations attractive both relative to historical and versus its regional peers, we expect the Korean market to benefit from domestic fund flows, and possibly foreign inflows in the latter part of the year. We expect earnings visibility for Korean corporates to improve towards the end of 2013 if the strong recovery in the US economy continues and there is no sharp contraction in China's growth.

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Equities – Taiwan

- For the Taiwanese market, trading in the first 6 weeks of Q2 2013 was relatively calm, until global equity markets corrected. China's weaker-than-expected economic performance and a shift in its monetary and credit policy stance exerted further downside pressure on markets. The Taiwanese bourse corrected significantly as well, despite positive domestic developments such as the passing of an Amendment bill for the New Capital Gain Tax exempting retail investors from taxation.

- There was a significant pick-up in the technology sector's capital expenditure plans in Q1 2013, reflecting underlying optimism in certain tech sub-sectors. We expect new product launches in the pipeline to potentially spur consumers to spend and to revive interest in the sector. The industries of China and Taiwan are also expected to forge increasingly closer ties as bilateral investment picks up.

- While the market is likely to see upside being limited in the near term, we are more positive over the medium-term period. We see sentiment improving, catalysed by revisions to the capital gain tax, further progress on the cross straits front and the end of a traditionally weaker first half of the year for the technology sector.

Equities – Singapore

- The MSCI Singapore Index declined together with regional markets, returning -4.2% in Q2 2013 in Singapore Dollar terms. In Singapore, the decline in performance was broad-based, with interest rate sensitive assets, predominantly the Real Estate Investment Trusts, seeing the largest drop. Banks remained less impacted but were still down for the quarter.

- After the correction, market valuation is looking more compelling. However, in a stagflationary environment, due to weak GDP growth and sticky inflationary pressures, corporate earnings could continue to be lacklustre. Current consensus MSCI EPS growth is 0.8% in 2013, though this is expected to pick up to 9% in 2014.

- We expect the market to be volatile and trade range-bound, with investors adopting a cautious stance. Despite more attractive valuations, the overhang of a possible rising interest rate environment could be a headwind to the market. We believe that stock selection is key to performance, and continue to recommend a barbell strategy of investing in cyclicals, both in laggards as well as in companies with regional/global exposure. We also favour defensive high dividend yielding stocks with earnings growth.

Equities – ASEAN (ex Singapore)

- After reaching an all-time high in mid-May, the ASEAN markets fell sharply in Q2 2013, in line with other regional markets as concerns over the Fed's possible QE tapering caused long term interest rates in Asia to rise. The MSCI South East Asia Index dropped by 1.3% in local terms in Q2 2013, with Malaysia being the best performing market (+8.4%) while Indonesia declined the most (-4.8%) for the quarter.

- Within Asia, ASEAN has benefited disproportionately in recent years from the flow of foreign funds as investors sought for solace in economies that were less leveraged to the global economy. With the US and Japan economies expected to continue their improvement, there could be some portfolio re-balancing to the North Asian markets, which will be major beneficiaries of a global economic recovery.

- As such, we prefer to be a bit more defensively positioned in the ASEAN region in the short-term. Our market preferences have shifted to Singapore and Malaysia as these markets have the highest exposure to exports within ASEAN and have stronger current account/foreign reserves. In addition, we have a cash position of around 4% currently and are looking to re-invest into the "TIP" markets (Thailand, Indonesia and the Philippines) on weakness.

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Fixed Income – US / Europe

- The second quarter of 2013 ended on a negative note for global fixed income investors, as a significant and broad market sell-down was triggered by concerns over the Fed's possible QE tapering. Credit spreads widened as the market saw a record amount of outflows in mutual funds and ETFs, with Emerging Market bonds bearing the brunt of the sell-down. The more optimistic economic outlook projected by the Fed in June also prompted an upward re-pricing of US interest rates.

- Going into the second half of 2013, the US rates market appears to have stabilised, with the 10-year US Treasury yield staying around 2.5%. Whether the Fed can realise its intentions of tapering its asset purchases will depend very much on the economic data to be released in the near term, in particular, the US non-farm payrolls numbers.

- Barring weakness in the economy, the Fed is likely to implement its intentions to wind down or reduce its purchases of securities. On the back of this and the continued recovery in the economy, longer-term bond yields will continue to normalize towards higher levels over time. The recent sharp increase in yields has to a certain extent more than factored in these developments. We expect 10-year UST bond yields to trade within a wide range around 2.6% before resuming its upward journey.

Fixed Income – Asia

- Risk aversion took a sharp turn for the worse from late May onwards, with the Asian credit market posting a poor performance in Q2 2013. The JACI Composite Total Return Index dropped by 4.3% during the quarter, with High Yield (HY) bonds outperforming Investment Grade (IG) bonds marginally on the back of higher coupon carry, which helped to offset the price drag from rising bond yields.

- Looking ahead for Q3 2013, we think credit spreads will continue to be a function of US Treasury yields. The performance of IG bonds will mainly be driven by the movements of US Treasuries, while yield carry will be the main source of return. New issuance is expected to be relatively light, as a fair amount of headline risk remains in the near term, and as the summer break in August approaches.

- We are neutral in terms of allocation between IG and HY bonds, with a slight overweight bias on the high quality short duration HY bonds for the yield carry.

Fixed Income – Singapore

- Singapore fixed income markets also saw increased volatility in Q2 2013, as SGD bonds rallied sharply in April, only to return their gains and deepen their losses in May and June. This was further exacerbated by the 7-year Singapore Government Securities (SGS) and 10-year SGS auctions held in late May and late June respectively.

- Unless future economic data releases disappoint, the hurdle rate for yields has increased. The sell-off in Asian local currency bond markets from May to June was driven by capital out-flows. For Singapore, which is much less dependent on portfolio flows to maintain external balance, local dynamics may help to mitigate or exacerbate the performance of SGD interest rates.

- While there is room for rates to move higher in the near term, current levels present much better entry levels. SGS yields are expected to trade within a range, with their direction largely driven by that of US Treasuries. Corporate bond supply will likely remain relatively subdued for now. Over the longer term, we see rates moving higher.

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About Lion Global Investors

Lion Global Investors, a member of the Oversea-Chinese Banking Corporation Limited (OCBC) Group, is one of the largest asset management companies in Southeast Asia, with total assets under management of S$29.4 billion (US$23.2 billion) as at 30 June 2013. Established as an Asian asset specialist since 1986, Lion Global Investors' core competencies are in managing Asian equities and fixed income strategies and funds to both institutional and retail investors. Its large and experienced investment team of over 40 investment professionals averaging 15 years of relevant investment experience is firmly dedicated to Asian and global equities and fixed income markets.

Lion Global Investors' network of regional offices outside of Singapore includes Malaysia, Brunei and China.
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