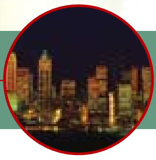
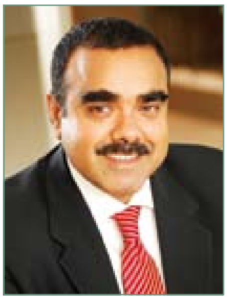


STRATEGY

Asian Investment Strategy:

Q & A Interview with CAAM Funds India and India Infrastructure fund manager Sidharth Mahapatra



Can you elaborate on the Indian general election results?

Yet again, the Indian voter has proven to be difficult to predict and proven that one should not bother listening to political commentators or exit polls. The Congress-led UPA alliance landed a massive victory with 262 seats, in a 543-seat parliament and just 10 short of the 272 seats for simple majority. The main opposition, the BJP lead NDA coalition, has been thrashed and, more importantly, the troublesome Third Front parties, which the markets truly fear and dislike have got decimated. This is a huge positive since the ruling party doesn't need to pander to many such parties who have radically different political agendas. It is worth noting that Dr Manmohan Singh is the first PM to return after finishing a full term, since the 1960s. Simply, these stunning results represent the most decisive election in two decades.

The interesting thing is that the Congress seems to have done well in its traditional rural and semi-urban strongholds but the BJP has got thrashed even in the cities (they lost every seat even in Delhi and Mumbai) which have traditionally prospered under BJP and where recent terrorist attacks or security issues was a reason for BJP to try and beat the Congress. The Indian voter has voted for stability, continuity and optimism (instead of fear politics).

Another important event was the government's budget unveiled early July?

The Indian markets got spooked by the new government's maiden budget, not by what the Finance Minister (FM) Pranab Mukherjee did, but by what he didn't do. Obviously, the expectations were high from a government which has come with a decisive majority and also by media hype about the first 100 days plans from various departments. What got presented was not inspiring, not because it was negative, but because it was not imaginative enough. In fact, it was a badly presented budget with too many loose ends and not a very bad budget by itself.

While the 6.8% fiscal deficit to GDP, up from 6.1% last fiscal (and potentially at 11% including the state government's deficits up from 10%), was seen as a big negative, it is encouraging to see that rating agencies' initial comments show that it is in line with their stance. In fact, the FM did not even try to attempt lowering the fiscal deficit number or masking it. What made this a badly presented budget was the fact that although there seems to be a game-plan to take fiscal deficit down to 5.5% of GDP in fiscal FY11 (Ending March 2011) and 4% in fiscal FY12 (ending March 2012), these guidance are there in the FM's interviews post the budget but were strangely omitted from the speech itself.

For the current fiscal, it is the mathematics behind the government's revenue and expenses that is unnerving. The finance minister wants to allocate higher resources to rural infrastructure and rural growth and has even announced

CAAM Portfolio Allocation Guidelines

Country	Benchmark MSCI AC Far East ex Japan (At 03/07/09)	CAAM Recommendation (At 03/07/09)
China	30.6%	35.1%
Hong Kong	13.0%	12.8%
Indonesia	2.7%	2.7%
Korea	20.0%	19.0%
Malaysia	4.6%	3.1%
Philippines	0.7%	0.0%
Singapore	7.2%	7.2%
Taiwan	19.1%	19.1%
Thailand	2.1%	1.0%
Total	100.0%	100.0%

Country	Benchmark MSCI AC Asia ex Japan (At 03/07/09)	CAAM Recommendation (At 03/07/09)
India	10.9%	12.7%
Pakistan	0.0%	0.0%
China	27.3%	29.3%
Hong Kong	11.6%	11.0%
Indonesia	2.4%	3.3%
Korea	17.8%	16.8%
Malaysia	4.1%	1.6%
Philippines	0.6%	0.0%
Singapore	6.4%	6.4%
Taiwan	17.0%	17.0%
Thailand	1.9%	1.9%
Total	100.0%	100.0%

Country	Benchmark MSCI AC Pacific free (At 03/07/09)	CAAM Recommendation (At 03/07/09)
Far East ex Japan	37.3%	38.3%
Japan	48.3%	48.3%
Australia	14.2%	13.4%
New Zealand	0.2%	0.0%

* *For detailed country allocation breakdown and strategy within the Far East ex-Japan markets, please refer to the MSCI AC Far East Free ex Japan asset allocation guideline.*

Source: Bloomberg, CAAM

higher targets for some urban schemes and roads etc. Although many believe that the amounts themselves are not large enough but it is the financing that is strange. By the finance minister's own projections, he is expecting higher revenue from corporate tax and from the 3G auction (USD7bn target), but it will not compensate for his own projections of lower revenue from income tax, customs, excise, disinvestment and securities transactions. The divestment target of around INR11bn is really low, where the market expectation was at least 10-15x that amount. The government wants to do a 50% increase in bond issuances over last year, which itself was a 300% rise over the previous fiscal. Also, by giving tax breaks to individuals, the government has effectively provided an equivalent of a consumption stimulus of 0.2-0.3% of GDP. Although, the FM's speech initially was about how important foreign investments are, there was nothing in the budget to help increase that.

Essentially, the FM is banking on the domestic recovery momentum to continue through construction, consumption, manufacturing and services, which will help sustain the economic growth through a positive cycle we saw couple of years ago and this, in turn, should attract FDI and FII investors, rather than do anything directly to attract them in the budget itself. The other gamble being taken by the government is that the rating agencies do not downgrade India on the high fiscal deficit issue since the Indian growth rate is accelerating and even today is better than most countries in the world.

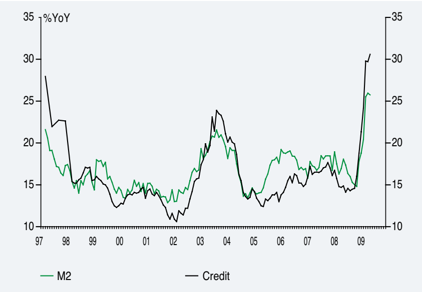
What is the outlook for India?

If the government's plans materialize in the fashion they have announced in terms of borrowings but without commensurate growth in GDP or revenue, then we could see a more rapid rise in rates than expected and that could hurt valuations. If that happens, that will again cramp investments, consumption, throw up potential NPLs fears and de-rate asset valuations again. We are sure that the government is acutely aware of this. It is quite likely that the government will take many policy decisions outside of the budget and at the next budget in February 2010, just 7 months away. The proof of that is the fact that oil prices were raised pre-budget and the fact that proposals for more de-regulation in insurance are already on the floor of the parliament.

In post budget interviews, the FM's statements indicate that the government thinks that 7% GDP growth this year is achievable. He is aware of potential funding issues & rate problems later and will be consultation with the RBI on innovative ways of keeping things under control. We will need to wait and see what that involves but the RBI has already made a statement that they have enough monetary tools to manage the situation.

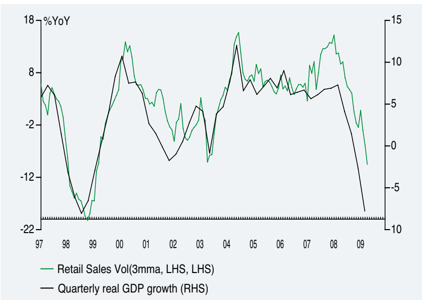
Two of the three things the market was focusing on near term are out of the way. The monsoon data is becoming incrementally better and the budget was less inspiring that expected. That leaves just the third event of April-June 2009 quarter results from the corporate which will be over the course of July. In aggregate they should be quite good but by themselves will not aid further rise in overall estimates that have seen upward revisions recently. The markets could remain range bound between 10-12% up or down from current levels depending on (i) the government's off-budget policy commitment plus a well laid out policy implementation schedule (ii) global risk appetite (India still has a better growth outlook even after this budget) and (iii) bottom-up stories, which are still key for a market like India. We are back to a stage when bottom-up stock picking is the key rather than a top-down macro bet. We remain very positive for the medium term.

3Q09 Investment Outlook and Strategy



CHINA

Source: UBS



HONG KONG

Source: UBS

CHINA

In the past couple of months, domestic economic activity rebounded on account of government stimulus which was accompanied by surging bank lending and rebound of investment in infrastructure. While exports declined further as global economy continued to contract, orders and shipment have become less bad as expectation and trade finance stabilized.

Strategy - Overweight

Although market-based economic activity remains weak and investment demand likely dormant, we expect that the fiscal stimulus and bank lending will translate to a rapid fixed investment growth, mainly in government-related sectors and projects. CPI inflation is likely to be contained by the weakness in commodity and food prices, and by a decline in core manufacturing prices due to falling export demand and weaker growth in domestic consumption. But the excess liquidity in the system increases the risk of resource misallocation and an asset market bubble.

HONG KONG

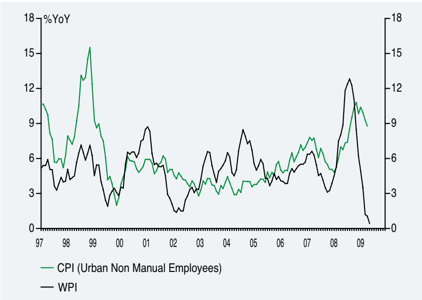
1Q09 GDP contracted -7.8% YoY and fell -17.3% QoQ annualized. This was the fourth sequential decline in GDP for Hong Kong. Consumption is getting hit from slower income growth from falling exports and negative wealth effects from the drop in financial markets. Hopefully the recent rise in equity and property prices will begin to reverse some of this. Private consumption in 1Q09 was down 5.5% YoY, though it improved a bit sequentially relative to 4Q08.

Strategy - Slightly underweight

Going forward we expect to see the bulk of the slowdown to come from investment as businesses go into a "wait and see" mode while the global economic cycle remains uncertain. 1Q09 fixed investment was down 12.6% YoY. Inflation has fallen sharply from the peak of 6.3% in July 2008 to 0.6% as of April 2009, as the volatile food and energy prices have fallen with the drop in international commodity prices, and the weakness is in the real economy has increased the unemployment rate sharply. These factors combined will push CPI to average just 0.7% in 2009E.

INDIA

The real GDP in March quarter grew 5.8% and was revised to 5.8% in 4Q08. Agriculture bounced back strongly to 2.7% YoY while manufacturing sector slowed further from 0.9% to -1.4% in Q408. Services and constructions held up the roof and stopped the headline GDP number slowing towards 5%. Constructions accelerated from 4.2% to 6.8% in Q408 while the biggest sector: trade, transport & communications services moved up from 5.9% to 6.3% YoY. Dividing up GDP by expenditure the revisions on private consumption has been steeply downward: revised from 7.9% in June 2008 to 4.5%, from 7.6% in September 2008 to 2.1%. Latest numbers show much weaker profile of private consumption through 2009, December 2008 at 2.3% and March 2009 at 2.7%. Government consumption has been revised up massively from high single digit growth to 56% in December 2008 and 21.5% in March 2009 (all in YoY terms). Real investment is much closer to our expectations of 5% in December 2008 to 6.4% in March 2009. What all this adds up to is a slowdown in real GDP from 9.1% in 2007-8 to 6.1% in 2008-9. Within this slowdown investment slowed from 13% to 8.2% and private consumption slowed more from 8.5% to 2.9%.



INDIA

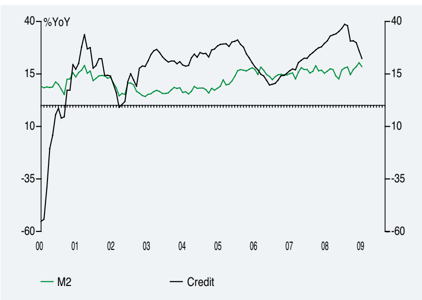
Source: UBS

Strategy – Overweight

At the end of June 2009, all eyes were on the new government's first budget (expected on 6 July 2009) and on the first quarter earnings. FIIs showed continued support during June 2009, with USD823 mn net inflows and domestic MFs were net buyers of USD235 mn worth of stock. That helped the markets from closing any lower despite the profit taking and despite the large supply of paper from various companies.

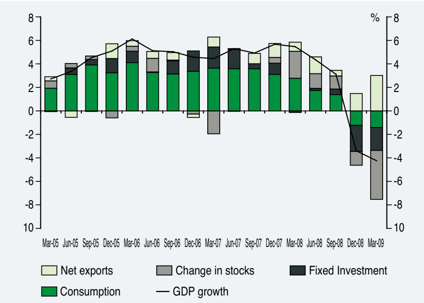
INDONESIA

Private consumption growth was surprisingly strong in 1Q09, most likely due to lower price inflation. Inflation is still falling, but we expect the trend in consumption to moderate as consumer confidence takes a knock from capacity rationalisation. Although considerably more modest than in most of South East Asia, excess capacity and reduced income expectations were leading to reduce investment spending. This and lower small company profit expectations should dampen employment prospects and household confidence and income. On the other hand, increased global demand and commodity prices should boost export growth.

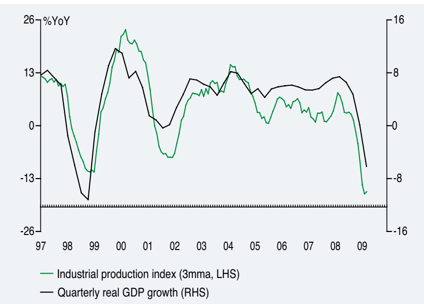


INDONEIA

Source: UBS



KOREA
Source: UBS



MALAYIA
Source: UBS

Strategy - Overweight

Although the downswing had a relatively modest impact on manufacturing activity and GDP growth, we doubt a global inventory and policy stimulus led export bounce will have a significant impact on the upside. Domestic fiscal and monetary policy will be supportive of activity going forward (as election spending in 2Q09 and 3Q09), but the degree of fiscal stimulus is less than elsewhere and monetary policy effectiveness is hampered by the reluctance of the banks to pass on policy rate cuts.

KOREA

The economy has bottomed and is set to improve on a sequential basis. The monetary easing and fiscal policy are increasingly gaining traction and pulling the economy back from the brink and this, along with a sharp decline inventories, is leading to a resumption of sequential growth from a cyclical perspective. First, leading indicators are turning up globally and in Korea. Korea's own composite leading indicators have now risen strongly for three consecutive months with all of the subcomponents turning positive. Business and consumption sentiment indices are also rising. Second, industrial production grew on a sequential basis in the past four months and inventories are continuing to fall as we had hoped, meaning that even weak demand must be increasingly met with output even as we go into 2H09. Third, the coincident indicator index suggests that on a monthly basis the economy is now expanding again on a sequential basis, whereas toward the end of last year the economy was probably contracting close to a -25% MoM annualized rate.

Strategy - Slightly underweight

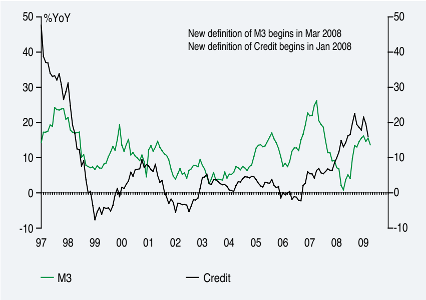
Export sectors like technology and autos will continue to recover with Korean companies gaining market share at the expense of other competitors. Banks will see NIM to improve in 3Q09 and asset quality has started to improve. Construction sector is seeing property prices and transaction volume increase. With oil price back to USD70 per barrel, overseas projects have started to flow in and domestic infrastructure projects kicked in 2H09.

MALAYSIA

Latest GDP data shows that the economy contracted a seasonally adjusted 4.8% on the quarter and 6.2% on the year in 1Q09. In addition to these declines in real activity, the income shock from lower commodity prices is putting downward pressure on incomes in the mining and agricultural sectors.

Strategy - Underweight

Manufacturing production probably reached a new low in March if seasonal variations are accounted for. However, while Malaysia's recent economic performance has been dire, a likely large inventory correction in 1Q09 and the rise in manufacturing production in early 2Q09 seen elsewhere in the region (and which we expect to see in Malaysia) points to a return to positive growth in 2Q09.



PHILIPPINES

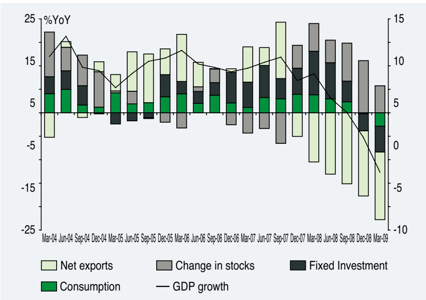
Source: UBS

PHILIPPINES

Philippines is exposed to global trade, financial markets and sentiment shifts, albeit to a lesser extent than Singapore, Malaysia and Thailand. In this context, while 1Q09 growth data was weaker than we expected, it was not out of line with the pattern across the region. Moreover, with the slowdown being centered on the manufacturing sector and de-stocking, the effect of which is waning globally, positive growth may already have returned to the Philippine economy in 2Q09.

Strategy - Underweight

The economy's growth path into 2010 remains dependent on global demand, financial and (commodity) price developments, but with FX market performance allowing loose monetary and fiscal policy a recovery in growth to 3-4% in 2010 should be possible.



SINGAPORE

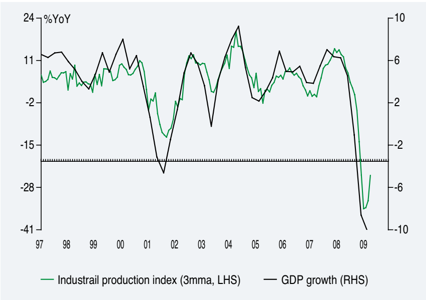
Source: UBS

SINGAPORE

Constructions and services were the key growth drivers in 2007. By 1Q09 however, services growth had fallen to -5.2% YoY from the high 8.2% YoY in 2H07. Given services make up 60-70% of GDP, weakness in this area will continue to pose a drag to growth.

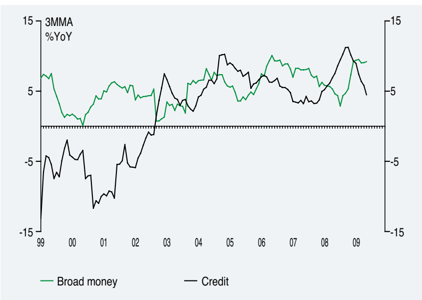
Strategy - Neutral

We expect export and investment growth to continue to experience significant headwinds in 2009. Meanwhile, construction volume growth has likely peaked. Property volumes and demand have seen some pickup, but should lead construction growth down YoY from the high base registered in previous quarters. Public constructions however should help provide some offset. Negative assets, income and wealth effects arising from the weak growth and dimmer employment outlook should put downward pressure on private consumption and property market sentiment in the coming year. Nevertheless, industrial inventory de-stocking should moderate and trade financing is improving. This, along with fiscal and monetary stimulus should allow Singapore to quickly respond to a global economic recovery.



TAIWAN

Source: UBS



THAILAND

Source: UBS

TAIWAN

Taiwan has fallen into a deep recession. Exports to G3 will likely remain low for 2009, though we expect improvement in 2H09. Exports generate income for households and businesses and weaker exports will reduce income growth and lead to less private consumption and investment.

Strategy - Neutral

Recent leading indicators show that the worst is over and we should see sequential recovery in 2H09. Inflation is rapidly slowing as food and energy prices are falling and slower economic activity should keep a lid on wages. The central bank is well into the easing cycle and sees growth risk out-weighing inflation risk. The TWD is unlikely to appreciate much from here.

THAILAND

The decline in GDP of 1.9% on the quarter and 7.1% on the year in 1Q09 was vicious. We find the contraction in the economy over the last two quarters was broad based, but most acute in the manufacturing and construction sectors. This was consistent with the combination of the regional slump in exports and (to a lesser extent) the disruption to trade caused by the closure of the airports by political protestors. More positively, and consistent with global indicators of the business cycle, Thai manufacturing production has now risen over 10% from its lows and local business sentiment is edging higher.

Strategy - Underweight

This has led us to revise our expectation of a return to positive growth from 2H09 to 2Q09. We leave our year average GDP forecast unchanged as a lack of recovery in exports and rising inventories suggest a near term retrenchment around an upward trend in activity. However, if manufacturing production continues its rise in coming months, the upside risks to our GDP forecast will be crystallized.

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Published by
Crédit Agricole Asset Management Hong Kong Ltd
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