Highlight

A lack of clarity in what would happen next in the UK politics and how UK would then proceed to exit EU means that market could remain quite vulnerable in the short term. We continue to maintain a cautious approach in our 3Q asset allocation, focusing on defensive assets including investment grade bonds and defensive sector equities.

Global Markets

US stocks would stay relatively firm thanks to a supportive Fed policy, which now likely to hold rate unchanged for another while. We prefer defensive sector and low rate beneficiaries such as infrastructure, utility, and consumer stocks. We also hold a more positive view toward emerging market equities in 2H16, as we feel that the case of a global recession following Brexit is still remote at this point. EM equities' undemanding valuation, signs of stability in crude oil price and in many of the emerging market currencies are driving factors for the global fund flows back to EM, in our view.

HK/China Markets

A-share market has outperformed global stock market from May to early July, and we continue to favor A-shares relative to offshore China stocks, as we believe the worst has been over out of the previous deleveraging fears, while central government policy has now turned supportive to the domestic stock market. We would focus on sectors with solid growth prospects, including technology and consumption.

Fixed Income Markets

On fixed income, although many believe that the US long term yield is unable to rise given a weak market sentiment and Fed rate would stay very low for an extended period of time on the back of mild global growth and low inflation expectation, we think geographic, sector, as well as tenor diversification are the keys to defend any future surprise in rates movement and sudden risk appetite changes, and we would continue to put our focus on hard currency investment grade bonds.

Forex Markets

On FX, we think at 1.29 level GBP still presents much downside risks. We are bullish on the safe-haven choices i.e USD, gold, and JPY in 3Q, despite that yen is likely to face MOF intervention at 95. We expect the Brexit risk and US Presidential election uncertainty are likely boost the investment demand for gold further in the months ahead, and we have upgraded our year end target price to US$1,400.
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8 July 2016
EXECUTIVE SUMMARY

Investment Analysis

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<th>Asset Class</th>
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<tr>
<td>US equities</td>
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<td>European equities</td>
<td>=/-</td>
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<tr>
<td>Japanese equities</td>
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<tr>
<td>Hong Kong China equities</td>
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<td>Emerging market equities</td>
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<td>DM Corporate Bonds</td>
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<td>EM Sovereign bonds</td>
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<td>Asian bonds</td>
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<td>Commodity currencies</td>
<td>=/-</td>
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<td>=/+</td>
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"Red" means changes have been made recently
Symbol representation:

=/+ Neutral with a Positive bias
=/- Neutral with a Negative bias
+ Positive
- Negative
= Neutral

- A lack of clarity in what would happen next in the UK politics and how UK would then proceed to exit EU means that market could remain quite vulnerable in the short term. We continue to maintain a cautious approach in our 3Q asset allocation, focusing on defensive assets including investment grade bonds and defensive sector equities.

- US stocks would stay relatively firm thanks to a supportive Fed policy, which now likely to hold rate unchanged for another while. We prefer defensive sector and low rate beneficiaries such as infrastructure, utility, and consumer stocks. We also hold a more positive view toward emerging market equities in 2H16, as we feel that the case of a global recession following Brexit is still remote at this point. EM equities’ undemanding valuation, signs of stability in crude oil price and in many of the emerging market currencies are driving factors for the global fund flows back to EM, in our view.

- On fixed income, although many believe that the US long term yield is unable to rise given a weak market sentiment and Fed rate would stay very low for an extended period of time on the back of mild global growth and low inflation expectation, we think geographic, sector, as well as tenor diversification are the keys to defend any future surprise in rates movement and sudden risk appetite changes, and we would continue to put our focus on hard currency investment grade bonds.

- On FX, we think at 1.29 level GBP still presents much downside risks. We are bullish on the safe-haven choices i.e USD, gold, and JPY in 3Q, despite that yen is likely to face MOF intervention at 95. We expect the Brexit risk and US Presidential election uncertainty are likely boost the investment demand for gold further in the months ahead, and we have upgraded our year end target price to US$1,400.
Our conservative and defensive asset allocation for the past quarter has turned out to work effectively for investors to weather through the risky asset volatility caused by the surprising UK referendum outcome at the end of June. Looking ahead, the lack of clarity in what would happen next in the UK politics and how UK would then proceed to exit EU means that market could remain quite vulnerable in the short term. Moreover, further uncertainty brought by US election later this year is likely to keep market sentiment in check. Therefore we continue to maintain a cautious approach in our 3Q asset allocation, focusing on defensive assets including investment grade bonds and defensive sector equities.

On the equity market front, the contagion following the Brexit vote is yet to be observed, but we expect European equities to remain relatively weak, mainly due to the overhang of Brexit shock and the potentially economic growth downgrade for the uncertainty. In the US, the dollar and S&P have been quite resilient during the market turmoil in 2Q, and US stocks should stay relatively firm thanks to a supportive Fed policy, which now likely to hold rate unchanged for another while. We prefer defensive sector or low rate beneficiaries, such as infrastructure, utility, and consumer stocks. In the meantime, we are holding a more constructive view toward emerging market equities in 2H16, as we feel that the case of a global recession following Brexit is still remote at this point. EM equities’ undemanding valuation, signs of stability in crude oil price and many of the emerging market currencies are driving factors for the global fund flows back to EM, in our view. On China, A share market has outperformed global stock market from May to early July, and we continue to favor A shares relative to offshore China stocks, as we believe the worst has been over out of the previous deleveraging fears, while central government policy has now turned supportive to the domestic stock market. We would focus on sectors with solid growth prospects, including technology and consumption.

On fixed income, US Treasury has had a great run in 2Q as the latest 10-year yield dipped to its historical low of 1.36%. The downgrade of UK sovereign rating after Brexit triggered another flight to quality in fixed income fund flows. Although many believe that the Fed rate is unable to rise given a weak market sentiment and would stay very low for an extended period of time on the back of mild global growth and low inflation expectation, we think that geographic, sector as well as tenor diversification are the keys to defend any future surprise in rates movement and sudden risk appetite changes, and we would continue to put our focus on hard currency investment grade bonds.

On FX, we expect further downside risk for GBP and potentially also for EUR as the risk of Brexit remains in place due to uncertainty of the UK politics. GBP has a high risk to trade much lower than current 1.3 level, since the Brexit comes at a time when UK’s trade deficit is running at a very high level and the country has been relying significantly on foreign capital inflows. On the other hand, we are bullish on the safe-haven choices i.e USD, gold, and JPY in 3Q, despite that yen is likely to face MOF intervention at 95. The Brexit risk and US Presidential election uncertainty are likely boost the investment demand for gold further in the months ahead, and we have upgraded our year end target price to US$1,400.
The U.S. equities continued its gain in 2Q16. The U.S. equities finished the second quarter nicely higher, but the three major indexes went through a roller coaster ride during last three months, with S&P 500 and DJIA indexes closed positively up while the Nasdaq Index dropped slightly during the last quarter. Recent data points are mixed, but we are encouraged by data from the U.S. economy, supported by stable commodity prices.

U.S. economic backdrop remains mixed but on track. US labor market report for May poured cold water over the US Federal Reserve’s signals to hike the policy rate this summer already. Headline jobs growth of just 38K was disappointingly weak. But the unemployment rate dropped to 4.7%, a sign of confidence in the jobs market. The ISM Manufacturing Index rose 1.9 points in June, its fifth increase in the past six months to 53.2, the highest level since February 2015. The increase suggests a steady improvement in factory activity, consistent with stronger economic growth in Q2, following a lackluster Q1. According to the ISM, the latest reading corresponds to 3.2% real GDP growth annually. Based on data from the current expansion only, we estimate a slower pace of 1.9% annual growth, but nonetheless consistent with continued expansion. The Consumer Confidence Index further improves in June to 98, supported by low energy prices, low unemployment, higher wages, and reduced debt loads. Mortgage rates remain historically low and encouraging demand for housing.

A slower pace in interest rate hike is likely. The US Federal Reserve is now confronted with a potentially longer-lasting return of heightened financial market volatility, weaker growth prospects in Europe, the Bank of England likely under pressure to ease policy again after the Brexit vote, and the risk of further USD appreciation. With the US presidential election due on 8 November 2016, the probability of a rate hike before the election has significantly diminished, in our view. We therefore now expect the US Fed to raise the policy rate only at the December 2016 meeting.

Earnings season kicking off in July will be in focus. Despite the pickup in economic growth, revenue growth for the S&P 500 is expected to decline 0.9%. That will mark the sixth straight quarter that revenue has declined. Once again, the energy sector, which is projected to see a 25.8% YoY decline in revenue, is playing an influential. Strong dollar remained a weight on revenue growth along with the decline in oil prices, a lack of pricing power, and aggregate demand that remained sluggish. Investors would be more interested in the company management’s guidance in the second quarter reporting period than the results being reported, especially the post-Brexit vote now has left over with some uncertainties.
U.S. equities relatively defensive but valuations are not cheap. We are neutral on U.S. equities, given its healthier economic backdrop than other countries and regions. Better fundamentals in U.S. assets would allow the country to be more appealing than the others. Analysts are currently projecting a return to growth in corporate earnings and revenues in the third quarter of 2016 with robust revenues at year end. As the quarter wrapped up the S&P 500 forward P/E is now 17.9x which is above the 5-year P/E of 14.4 and above the 10-year P/E of 14.2. With valuations not cheap, investors still need to be cautious and not chase rallies.

Sector Outlooks

Utilities (+) S&P 500 Utilities Index continued to perform well in the second quarter this year, and played a defensive role. Since utility shares have lower correlation with global stocks and thus have been used for diversification purpose. Historically, utility sector enjoyed the upside in a rising market, while declined less in a falling market. U.S. interest hike is expected to be slower in pace this year, thus reduced potential interest rate risk. Investors therefore would seek after yields under the current low interest rate environment. Dividend payout from utility sector is also attractive. In the past 20 years, the average annual dividends from utility companies are on average at 3-4%, and thus would be served as an investment alternative in volatile market conditions.

Consumer Staple (+) Consumer sentiment in the U.S. is improving, as strengthening job market, stronger dollars, and money saved from lower energy prices boosted spending power. We favor consumer staple sector which is relatively more defensive in volatile but low interest rate environment.

Risk Considerations: 1) uneven economic growth in Europe and the BRIC nations, 2) economic trends in China, 3) oil price volatility and 4) geopolitical threats in Europe and the Middle East. 5) the November Presidential election.
EMERGING MARKETS (EMS)

INVESTMENT SUMMARY

- Emerging market equities continue to pick up in 2Q16.
- Delay in interest rate hike benefit emerging market equities.
- Further gains in emerging market will be subject to test without sustained rally in commodity prices.
- Emerging Asia poses a better picture based on fundamentals

Emerging market equities continue to pick up in 2Q16. The MSCI Emerging Market Index gained 0.8% in 2Q16 and 6.5% in 1H16. Emerging market (EM) stocks exhibited strong performance from mid-February to late April, but the environment reversed somewhat in May. We believe a delayed Fed rate hike, a benign outlook for oil prices, a softer U.S. dollar and Chinese growth should create a stable backdrop for many emerging economies in the short-term.

Delay in interest rate hike benefit emerging market equities. While the Brexit vote heightened the potential for a recession in Europe, and is likely to cause a further drag on the already slow global growth, it will affect the U.S. Fed’s pace in future interest rate hike. Delays in the US Federal Reserve’s rate hike have proved broadly supportive of EM equities during the last two quarters and we continue to see that as positive catalysts for EM equities. Most emerging markets with strong fundamentals have proven to be less vulnerable to Brexit vote. Within EM, we turn neutral on Russian and negative on Brazil equities due to the risk-off environment we expect in the coming weeks, despite an improved macro picture and a positive technical outlook.

Further gains in emerging market will be subject to test without sustained rally in commodity prices. After the recent bounce, we are particularly cautious on certain emerging market countries like Brazil and Russia. Weaker economies have contributed to high inflation and plunging currencies of these countries, and keeping their central banks from needed interest rate cuts. We foresee corporate earnings to be seriously affected for countries that are heavily rely on materials and energy exports. Although these two sectors have fallen the farthest among other sectors last year and have led the global stock market rebound in the first half of this year, they may have a hard time posting further gains without a sustained rally in commodity prices.

Emerging Asia presents a better picture based on fundamentals. All in all, we are still neutral in emerging market equities, specially based on the weaker fundamentals in Latin America and Eastern Europe. But South East Asian economies of Indonesia, India, Thailand present a better picture less vulnerable to the Brexit risk. While these markets may not have rallied as much as Brazil and Russia YTD, they fell a lot less reflecting their better fundamentals, including central bank rate cuts, relatively tame inflation and more stable currencies. While the valuations in these markets are not as low as those in more troubled markets, they are historically inexpensive.
Indonesia (+) Indonesia’s June inflation rate edged up to 3.45% y/y with core inflation up 3.49% y/y, which is within the 3-5% target range and allow central bank scope for further monetary easing. The central bank has already taken advantage of subdued inflation, reducing benchmark interest rate for the fourth time this year. It had another rate cut by 25bps in June to 6.5%. Two key events occurred which supported our positive view to Indonesia equities. The Bank Indonesia had adopted the new Interest Rate Corridor framework to be in place on 19th August, which is interpreted as a form of monetary policy easing by investors. The Indonesia Parliament also approved the passage of the Tax Amnesty Bill, where Indonesian taxpayers who declare their overseas assets a tax amnesty are promised not to face any criminal or legal penalty. Inflow from overseas assets is expected to increase the government’s tax revenue. Along with seven economic packages announced by Indonesian government earlier, we expect the domestic demand could continue to improve.

Korea (=) Our view in Korea remains neutral, as the market has enjoyed a decent rally led by commodity-related and technology sectors. Although any easing from the Bank of Korea would be positive for the equity market, it is being partly offset by the risk of capital outflows. The National Pension Service of Korea’s decision to increase allocation toward overseas equities could also diminish the risk appetite for domestic equities. Economic data in Korea is still mixed depending on global economic recovery progress.

Taiwan (=) Taiwan’s central bank lowered its benchmark interest rate by 12.5bps to 1.375% in a widely expected decision as the export-dependent economy’s growth prospects remain under pressure. Taiwan equities rallied 2.6% in June on the back of a pick-up in technology sector buying ahead of the expected iPhone 7 launch in September. However, we maintain our neutral view on the market as we wait for more clarity on the cross-strait relationship as China is reported to have recently reduced the tourist quota to Taiwan by half.

Russia (=/-) Following a year of deep recession caused by Western sanctions and suppressed oil prices, Russia’s economy showed signs of stabilization in 1H16. Thanks to the more stable oil prices and an increase in activity from within non-oil related sectors. But the country still faces obstacle of weakness in consumer demand. Given these premises, Russia’s economy is likely to post another GDP decline in 2016 overall. We remain cautious and maintain our underperform view of Russian equities. Risks from further U.S. Federal Reserve rate hikes, coupled with headwinds for commodities and industrial metals, are likely to adversely impact the market’s relative performance.

India (+/=) India’s macroeconomic picture appears robust, despite the surprise resignation of the Governor of the Reserve Bank of India and concerns about his replacement, the approaching monsoon should reduce inflationary pressure and provide room for monetary policy easing. While expectations for the passing of the Goods and Services Tax bill and banking sector reforms have also improved sentiment. But valuations of India equities (Sensex Index) appear a bit rich trading at a 12-month forward PE of 17.3x.
Brazil (-) Brazil is facing economic contraction as Brazil’s government cannot meet its tax revenue and public spending is under pressure. Brazilian equities (Ibovespa Brasil Sao Paulo Stock Exchange Index) rallied by over 18% in 1H16. Thanks to the rebound in energy and commodity prices, the dovish tones from the U.S. and European central banks. Contributing to the upside was also investors’ pricing in impeachment against ex-president Rousseff, and the incoming administration from Temer would hopefully set a more market-friendly tone. We believe the earlier rally had priced in all the mentioned positive news, and continued upside is limited, as Brazil will be facing difficult economic and political challenges in the coming quarter. We maintain our negative view on Brazil.

Risk Considerations:
1) Political, liquidity, and currency risks, 2) further downside on oil / commodity prices, 3) Further slowdown in China or U.S, 4) unexpected tightening on Fed funds rate, 5) significant depreciation of CNY/CNH
INVESTMENT SUMMARY

- The European equities closed soft by the end 2Q16.
- U.K. faces weak economic outlook after the Brexit vote.
- The process of Brexit leaves U.K. with much more uncertainty.
- Political risks rise on EU concerns
- U.K and European equities face downside risk ahead.

The European equities closed soft by the end 2Q16. The European and UK equities rose during last quarter until the U.K. voted to leave the European Union (EU). On 23rd June, the UK has voted by 52% to 48% in favor of leaving the EU, which caught the market by surprise. The financial markets went through a major sell-off. Led by peripheral bourses, losses in Eurozone equities surprising were larger than the U.K. equities. The UK FTSE 100 Index and Europe Stoxx 600 Price Index in USD terms fell by 1.8% and 3.1% respectively during last quarter.

U.K. faces weak economic outlook after the Brexit vote. The unexpected result of Brexit vote sent GBP into free-fall, hitting its lowest level against the dollar since 1985 and the currency is still under downward pressure currently at 1.29 levels. The outlook for the UK economy has become considerably more uncertain after the Brexit vote, as weak investment outlook would most likely cause an economic slowdown. The economic impact of Brexit on U.K. may involve different aspects, but we think the effects on employment, wages, trade, and investment inflows matter the most. Investment is likely to slow substantially in the months ahead, even though the weaker GBP will support U.K.’s exports in the long run. Given the uncertainty and expected weakening in growth, the Bank of England is likely to lower its policy rate and may potentially resume asset purchases.

The process of Brexit leaves U.K. with much more uncertainty. The leaving process for the U.K is not clear since the referendum result is not binding. The political rivalry of triggering Article 50 of the Treaty on EU will dominate headlines in the coming weeks, with Europe pressing for an immediate activation of the article and U.K takes little urgency. Scotland and North Ireland have already made contact with the EU regarding its future as a European state. It shows that the difficult negotiation process has started in earnest which fuels more political instability.

Political risks rise on EU concerns. The Brexit decision amplified political movements in other EU countries pushing for more independence. The next focus will be on Italy’s constitutional referendum in October. It raised the questions about cohesion among EU countries, as Holland, France, Germany, Italy, Hungary and Austria will face their elections in the coming next two years. Given the vulnerability of Italian banks and the country’s huge public sector debt, political parties with anti-EU views in France and the Netherlands could also threaten EU cohesion. We believe Euro currencies are likely to be volatile. The growth and inflation prospects for the Eurozone could be weakened after the UK referendum. Nevertheless, the chance of Eurozone economy moving back into recession at this point is still slim given ECB pledges to offer substantial policy support.

U.K and European equities face downside risk ahead. We reduced our long-term positive view in European equities, as “Brexit” vote adds to market
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With earnings growth in Europe and U.K. expected to be revised downward, and uncertainties unlikely to subside meaningfully in the short term after the Brexit vote, we turned negative on European including UK equities. While accommodative policies are expected to implement by central banks, European stocks are likely to be volatile. Although a weaker GBP should benefit U.K. large cap with international exposure, U.K equities are likely to underperform as economic fears likely to increase.

Germany (+=-) After GDP growth of 1.4% YoY in 2015, the German economy is expected to continue to grow despite a volatile financial market. The German GDP grew strongly by 0.7% QoQ in 1Q though likely to be softened in the second quarter. We see Germany to be less influenced by Brexit among the others, as the country’s economy is mainly supported by private and public consumption. Increased migration into Germany also contributed to retail sales and construction spending.

U.K. (-) We revised downward our view on UK equities from neutral to underperform. After the Brexit vote, the FTSE 100 has initially held up well. But we believe it was driven mainly by a weaker GBP, which the market perceived as helpful for UK exporters (72% of FTSE 100 EPS is generated abroad). But now that the foreign exchange (FX) impact is priced in, we see material downside risks for the index level. Investors are therefore suggested to reduce their UK equity exposure.

France (=) The French economy posted a strong start to 2016, unexpectedly expanding by 0.6% QoQ. The main growth drivers were private consumption and investment. Going forward, we would not exclude some temporary setbacks, as the most recent growth rates seem barely sustainable. But overall growth should be supported by domestic demands and improving labor market. The European football championships will likely add mildly to private consumption in second quarter. French equities would be a relatively defensive market within Europe, but the possibility of joining referendum for independence next year would pose the country to political risk.

Italy (-) Italian growth should be gradually picking up due to improving labor market and private consumption, lower oil prices, accommodative monetary policy and some progress on administrative reforms. But ongoing concerns about non-performing loans in Italy’s banking sector are likely to slow capital flows and reduce earnings. We see the recent stress in the banking sector and the upcoming referendum on the constitutional reform would pose the country to downside risk.

Spain (-) Given still high leverage in the economy, Spain is one of the prime beneficiaries of the improving financing conditions induced by various ECB measures. Debt servicing costs have fallen significantly due to lower rate. Low energy and moderate inflation have continued to support the country’s domestic demand. However, Spanish politics is a concern as the second election in Spain once again presents no clear possibilities for a stable government. If Prime Minister Mariano Rajoy cannot put together a ruling coalition, another poll is likely and more difficult negotiations are expected ahead. Political instability should undermine Spain’s economy.
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Risk Considerations: 1) Economic slowdown in U.K. due to Brexit; 2) Political stresses related to the refugee crisis, Spanish election, and other referendum in Eurozone; 3) Challenge of low inflation; 4) Resurgence of tension with Russia; 5) Slowdown in emerging markets, especially China, or weaker-than-expected demand in major emerging markets; 6) Failures to act timely by the ECB on stimulus program; 7) Slump in oil prices which further adds pressure on inflation.
INVESTMENT SUMMARY

- The Japanese equities had been sold off in 1H16.
- Strong Yen weighed on Japanese equities.
- A declining population growth also affected private consumption.
- Ineffective monetary policy kept investors disappointed.
- Structural reforms to be tested.
- We revised downward our view on Japan to negative.

The Japanese equities had been sold off in 1H16. Having gone through a major sell-off in 1Q16, the Japanese Nikkei 225 Stock Index continued its decline by 7% in 2Q16, caused by strengthening of Japanese Yen as safe-haven. The introduction of Negative Interest Rate by the Bank of Japan (BoJ) to control strengthening Yen in beginning of this year has been affecting investors’ confidence and further dragged Japanese equities down. Japan faces significant headwinds to growth including: a rising currency, the slowdown in China, a declining workforce, and ineffective monetary policy.

Strong Yen weighed on Japanese equities. Despite low interest rates, the yen has appreciated by almost 15% this year, climbing to $102 per dollar as of 27 Jun from over 120 at the end of 2015. According to the BOJ’s June Tankan business survey, large Japanese manufacturing companies had expected the yen to average just over 117 in 2016. The rise in the yen has reduced the value of overseas sales and makes goods more expensive in overseas markets. The strength in the yen means many multinational companies have to revise down their earnings forecasts. Policymakers in Japan have been struggling to keep its currency from strengthening and deflation from reemerging. Japanese equities have been suffering in lock step with the rise in the yen.

A declining population growth also affected private consumption. The inflation in Japan has been held back over the past quarters because of weak private consumption, as a result of falling wage growth. Japan’s population is declining by a million people every year, according to the Ministry of Health, Labor and Welfare. Disposable personal income has been stagnating. While many are retiring even those of working-age are concerned about the risks of outliving their retirement savings and of future cuts to benefits, motivating them to reduce spending and boost savings.

Ineffective monetary policy kept investors disappointed. The effectiveness of the BOJ’s negative interest rate policy is far from assured and increasingly negative interest rates may weigh heavily on the stock market and on drivers of economic growth. The market’s primary concern is that the BoJ’s policy maneuvering ability is technically limited, given the size of asset purchases to drain market liquidity. The BoJ has long been calling for fiscal support by the government as monetary policy alone will be insufficient to stimulate growth. That said, the situation where the government is expected to undertake fiscal actions is another factor which highlights the limitation of the BoJ’s accommodative policy, especially after the decision to delay the tax hike. Our economics team and many market participants expect the BoJ to step in for further monetary accommodation in the July meeting. It is noteworthy whether the BoJ will be able not just to reiterate its technical limit of policy maneuvers but to convince financial markets that the
current policy is sustainable, which will provide the best source of relief to the market.

**Structural reforms to be tested.** Japan’s upper house election will be held on 10 July 2016. We do not see any major policy changes or narrowing of the focus of Abenomics. Due to the Japanese government’s financial situation, we believe the size of the fiscal stimulus package could be limited. Due to modest inflation, the Bank of Japan (BoJ) would have to take additional policy action. We expect to see meaningful progress on the structural reform plan, especially policy action for the declining working age population. The International Monetary Fund (IMF) pointed out recently that Japan’s potential GDP growth will drop to 0% by 2030 due to its aging society. We think effective policy actions and structural reforms to turn around the declining working age population will influence the long-term investment strategy.

**We revised downward our view on Japan to negative.** Against a backdrop of declining economic outlook in 2016, inefficient economic reforms and strong Yen that is affecting corporate margins, we suggested investors to remain sideline from Japanese equities until the above mentioned factors turnaround.

**Risk Considerations:** 1) Inability to implement structural and other economic reforms; 2) Yen appreciation due to global risk-off sentiment; 3) significant surge in JGB yield 4) fiscal deficits caused by delayed sales taxes increase; 5) BOJ fails to enact further easing in order to boost inflation; 6) China’s slowdown, as China is Japan’s second largest trading partner.
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CHINA / HONG KONG

INVESTMENT SUMMARY
- Brexit adds to global uncertainties in the mid-longer run
- China A-shares remain relatively stable post-Brexit and its outlook has improved in 3Q16
- The Chinese economy has not shown signs of improvement, but hard landing is unlikely
- We favor those sectors with less exposure to global economies, such as TMT, pharmaceutical, autos and infrastructure

Brexit adds to global uncertainties in the mid-longer run

Brexit remains a market focus now. As UK goes on its way to leave the European Union (EU), certain trade treaties signed by UK with other countries under an EU membership may need renegotiations and renewals, which would take years to be done. Although UK can save billions of pounds for annual fees that it pays to EU, market expects the UK economy would fall into recessions. GDP is estimated to decline at an annual pace of 1-2% from now to 2020. During this period, there is a material chance that Scotland and Northern Ireland would call for their own referendum, while Euroskeptics in other European countries (i.e. France, Italy, Netherlands) would also hold a similar vote to leave EU, which may add to uncertainties on the global and HK/China markets in the mid-to long run.

US Fed may delay rate hike to cope with Brexit risks
Against such a backdrop, the Referendum could impact on China and Hong Kong economies, in terms of financial markets and global trades. Global central banks are preparing measures to manage the macro risks. In the US, market now expects the Fed to raise interest rate only once this year, while the chance of a December rate hike now rests at 10%. As a reminder, a few of market analysis now see a possible rate cut by the Fed, while Fed’s stance toward rates will have a direct impact on local equities, especially those with higher sensitivity to rates.

HK/China markets are indirectly affected by the European turmoil
Upon the release of referendum results, HK/China equities remain more stable than the European and US equities. HSI was well supported at above 20,000 level. SHCOMP also broke its 100-day moving average and 3,000 level, partly because the market was supported by month-end effect of futures index settlement, the semi-annual settlement of funds, and expectation on the potential opening of the Shenzhen-HK Stock Connect. More importantly, HK/China, as a part of Asian region, is less involved in the European turmoil, resulting in a relatively indirect impact to capital flows. In terms of performance, the MSCI Europe index rose 1.1% from before Brexit to 6th July, while MSCI Asia (ex Japan) rose 3.6%.

A-share market was relatively stable post-Brexit and its outlook has improved in 3Q16
The A-share market also showed signs of break-out recently. The Shanghai Composite Index has rebounded and exceeded 3,000 points. The A-share total turnover has risen to RMB710bn (Jun average: RMB570bn), and the outstanding balance of margin trading has gone up from RMB820bn (lowest year to date) to RMB860bn, indicating the A-share market sentiment has improved. In addition, the margin trading balance has come down by 60% since the peak last year, suggesting that pressure from deleveraging was relieved. We have a more positive on the A-market than HK market.

INVESTMENT SUMMARY

HS China Enterprise Index Data
- Market cap (HKD) 2.31 Trillion
- 52-week Hi / Lo 12,981 / 7,505
- 3-Mth Return +0.3%
- Y-T-D Return -6.5%
- 50 / 250 Mov. Avg. 8,657 / 9,524
- 2016 Est Yield 4.0%
- 2015 P/E 6.6x
- 2016 Estimated P/E 7.4x
- 2016 Estimated P/B 0.82x

Source: Bloomberg L.P.
As of 6/30/2016

CSI 300 Index Data
- Market cap (RMB) 8.53 Trillion
- 52-week Hi / Lo 4,473 / 2,854
- 3-Mth Total Return -1.1%
- Y-T-D Total Return -14.7%
- 50 / 250 Mov. Avg. 3,126 / 3,429
- 2016 Est Yield 2.2%
- 2015 P/E 13.4x
- 2016 Estimated P/E 13.0x
- 2016 Estimated P/B 1.59x

Source: Bloomberg L.P.
As of 6/30/2016
Mainland economy shows no signs of recovery, yet still resilient

On the economic data front, Caixin China Manufacturing PMI in June shrank 0.6 mom to 48.6 and below consensus expectations, reflecting a tough condition facing the small and medium enterprises. Recent data all show mom drop (another example is the Chinese industrial profits in May), though the drop is relatively small. We see no significant improvement in sight, nor any major significant decline, which is in line with the previous view of an “L-shaped” recovery. We slightly lower HSCEI year-end target from 11,000 to 10,500.

We favor those sectors less exposed to global economies

We believe TMT, pharmaceutical, autos and infrastructure sectors would be benefited from China’s favourable policies as well as their defensive nature with less exposure to global economies. We expect these sectors to outperform amidst the above uncertainties. HK REITs also have consistent payouts and defensiveness, although their valuations have become stretched post Brexit. On the other hand, oil price in the short-term has little room to climb higher after it has topped the $50/barrel level, therefore we don’t have a bullish view on it. Given weak demand and overcapacity, we expect further upside on basic material sector to be limited, except gold mining stocks which are likely to outperform the market.

Risk Considerations:

a) slow down in demand; b) deflation risks in mainland; c) policies not producing the desired outcome; d) RMB depreciation risks.
China Sector Snapshot

China brokerage (maintain Overweight) Although A-share market failed to be included in MSCI Emerging Market Index, the market was not surprised. Also, even if MSCI includes A-share market, the actual impact is likely to be immaterial as the potential fund inflow is limited at the initial year. Market now eyes on the coming Shenzhen-HK Stock Connect which is the major catalyst for China brokerage sector. Moreover, outstanding balance of A-share margin trading has contracted by more than 60% and has stabilized at ~RMB800-900bn. De-leverage pressure is likely to be eased. We believe A-share market is relatively stable as it does not have significant direct impact from Brexit. Also, at end-Dec 2015, brokers’ direct equity exposure was limited to 4-9% of their net assets. Equity market exposure is manageable.

China property (maintain Overweight) Home price index of 70 large and medium cities continued to rise in May 2016, but the gain slowed down, especially in tier-1 cities. Given the austerity property measures in tier-1 cities, the mom increment of new home prices in Tier-1 cities narrowed by 0.3ppt, while tier-2 and tier-3 cities slowed down by 0.2ppt and 0.1ppt, respectively. Although government may introduce some purchase restriction in some tier-2 cities to prevent overheating, property sales of the overall tier-2 cities are likely to be still strong, driven by first-time upgraders. In the first 5 months of 2016, property sales area jumped 33.2% yoy and sales value surged 50.7% yoy. We recommend some large China property developers with diversified geographical exposure.

Pharmaceutical (maintain Overweight) The Chinese government implemented “two-invoice systems” in some trial provinces. “Two-invoice systems” means manufacturers would sell drugs to hospitals through one tier of distributors, instead of multiple tiers of distributors which will reduce the layers of the value chain and lower drug prices. However, the policy will increase the cost of distributors, especially small players, as they need to expand distribution network to deliver drugs to hospitals directly. We expect large distributors to gain more market share and benefit from “Two-invoice systems”. For drug manufacturers, government raised the new drug entry barriers and will increase manufacturers’ R&D expenses. Although sector growth is expected to further slowdown in 2016, industry consolidation will accelerate and large players will benefit.

Infrastructure (maintain Overweight) Although fixed-asset investment (FAI) in China slowed to 9.6% yoy in 5M16, the slowest rate since 2000. But infrastructure FAI has increased 20% yoy, accelerating 1ppt from 4M16. We believe government will keep infrastructure investment at a high level to boost the slowing economy. China government plans to launch 303 infrastructure projects with total investment value of RMB4.7 trillion during 2016-18. In this plan, investment in railway and urban transit railway is planned to be RMB2 trillion and RMB1.6 trillion, respectively. The planned investment in urban transit railway of RMB1.6 trillion in 2016-18 already exceeds that of RMB1.1 trillion in 12th Five Year Plan. We believe the growth driver of infrastructure sector will shift from railway to urban transit railway in the coming years.

China insurance (maintain Overweight) China’s total insurance premium rose 38% yoy to RMB1,612bn in 5M16, with P&C premium and life premium up 9% and 50% respectively. Premium growth this year is expected to maintain at a relative fast pace. In addition, the Central government is expected to roll out reform measures on health insurance and pension.
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Insurance to cope with the aging population. Last year, a personal tax exemption program was launched in 31 trial locations in China for promoting the use of health insurance. The market expects the scope to widen. As the internet is becoming more prevalent, insurance companies might team up with tech companies to expand their market share with the broad active user base.

Technology, Media & Telecommunications (maintain Overweight) Total 4G subscribers in China at end-May 2016 reached 562mn users and penetration rate has ramped up to 43.2%. Going forward, the telecom sector will continue to benefit from: a) 4G migration, including direct upgrades from 2G; b) higher demand for data driven by 4K video, gaming and virtual reality applications; and c) the fact that the effect of price-cut measures and VAT measures from the regulators last year have faded; d) lower capex in general will result in lower depreciation expenses. However, investors should be aware that the one-off gain from the sales of assets to China Tower was booked only in 2015 and there will be an earnings gap this year. Also, the lease expense from China Tower will also be reflected in the book starting this year, causing pressure on the margins. We also expect more intense competition among the leading telecom players as they fight for higher market share.

In 1Q16 the online advertising sector experienced fast growth, but not to the extent that the market expected because advertisers were hesitant on spending due to concern on economic slowdown. However, mobile gaming continues to see strong growth momentum with solid pipeline. Game developers were also investing more on copyrights on comics, animation and novels to build better games and fuel growth. Cloud services were also growing fast and are catching up with the Western peers, serving as growth drivers in future years.

Auto (upgrade to Overweight) In the first 5 months of 2016, passenger vehicles (PV) grew 7.8% yoy, accelerating from 6.7% in the first 4 months. SUV remained the sector growth driver which increased 45% yoy. In Sept 2015, China government reduced vehicle purchase tax on PV with 1.6L or lower by 50%, resulting in strong sales rebound in small PVs. In the first 5 months of 2016, sales of <1.6L-PVs jumped 18.8% yoy. China Association of Automotive Manufacturers suggests government to reduce vehicle purchase tax permanently which would be a major catalyst. Also, sales of new energy vehicles surged 128% yoy, of which pure electric vehicles (EV) soared by 162% yoy. On the back of more EV charging stations, we believe EV would be the major long-term growth driver of auto sector.

New energy (upgrade to Overweight) In order to improve pollution, China government has introduced several measures or targets to encourage the use of clean energy, including wind power. It targets non-hydro renewable energy to contribute 9% of total energy consumption by 2020. Non-hydro renewable energy accounted for ~4% of total energy consumption in 2015, implying 17.6% CAGR during 2016-2020. On the other hand, NDRC announced minimum utilization hour policy for wind power in 9 provinces. The minimum utilization hour in 9 provinces is 19% higher than that in 2015 on average. These policies showed a clear government’s target for renewable energy and would help to lower curtailment rate. We believe market will re-rate wind power sector.
<table>
<thead>
<tr>
<th>Rating</th>
<th>Sectors</th>
<th>Comments</th>
<th>3Q 2016 Investment Outlook 8 July 2016</th>
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<tbody>
<tr>
<td></td>
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<tr>
<td>Overweight</td>
<td></td>
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<tr>
<td>Insurance</td>
<td>Strong premium growth of 38% in 5M16 and growth momentum is expected to continue in 2016. Benefit from reform on health and pension insurance.</td>
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<tr>
<td>Brokerage</td>
<td>A-share market is expected to be stable and coming Shenzhen-HK Stock Connect would be a major investment catalyst.</td>
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<tr>
<td>China property</td>
<td>Home prices slowed down in tier-1 cities, but overall sales volume is still strong. Large property developers with diversified geographical exposure will be beneficiary.</td>
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<tr>
<td>Pharmaceutical</td>
<td>“Two-invoice system” will squeeze out small drug distributors and accelerate market consolidation. Government has raised manufacturers’ entry barrier which will benefit large players.</td>
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<tr>
<td>TMT</td>
<td>4G migration and higher data usage will continue to drive growth. Effects of price-cut and VAT measures have also come to pass. Internet sector will benefit from strong growth in mobile gaming and online advertising.</td>
<td></td>
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</tr>
<tr>
<td>Infrastructure</td>
<td>Infrastructure FAI has increased 20% yoy in the first 5 months of 2016. We believe government will keep infrastructure investment at high level to boost economy. Also, infrastructure companies will expand overseas business through “One Belt One Road”.</td>
<td></td>
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<tr>
<td>Auto</td>
<td>Given more charging stations, new energy vehicles would be the sector major growth driver in the mid- to long-term.</td>
<td></td>
<td></td>
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<tr>
<td>New energy</td>
<td>Government introduced several measures to support new energy, including targeting non-hydro renewable energy to contribute 9% of total energy consumption in 2020 and setting up minimum utilization hours for wind and solar power.</td>
<td></td>
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<tr>
<td>Gold mining</td>
<td>Gold prices are expected to be a safe haven and to outperform following the Brexit turmoil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neutral</td>
<td>China banks</td>
<td>Earnings are expected to be sluggish in 2016 due to contraction in NIM, rise in loan provision and weak loan demand. Market concerns on further rise in NPL and dividend payout cut.</td>
<td></td>
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<tr>
<td>Consumer</td>
<td>Slowdown in retail sales and increase in market competition will squeeze sector earnings.</td>
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<tr>
<td>Macau gaming</td>
<td>Gaming revenue year-on-year decline narrow. But the timing of breakeven is longer than expected. Anticorruption measures still dampens sentiments. But, the launch of new properties will be another investment catalyst.</td>
<td></td>
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<table>
<thead>
<tr>
<th>Sector</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gas</td>
<td>Although gas demand has rebounded in 1H16, crude oil price is expected to stay low, dragging the demand for natural gas.</td>
</tr>
<tr>
<td>HK banks</td>
<td>Loan demand from China and HK mortgage are weak. Non-interest income is expected to decline given sluggish market sentiment.</td>
</tr>
<tr>
<td>HK property</td>
<td>HK property sector will benefit from the delay in US rate hike. Yet, property price is forecasted to decline given weakening HK economy.</td>
</tr>
<tr>
<td>Utilities</td>
<td>Expensive valuation will cap the upside potential despite strong fundamental and cashflow.</td>
</tr>
<tr>
<td>Basic materials</td>
<td>Demand/supply dynamic is expected to improve in 2016, but overcapacity in coal, cement and steel sector is still a problem. In contrast, gold sector is likely to outperform as risk-averse market will boost gold prices.</td>
</tr>
<tr>
<td>Energy</td>
<td>US oil rigs are likely to resume production if crude oil prices further rise. Global economic slowdown will dampen oil demand.</td>
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**Underweight**
Brexit may cause recession in UK and hurt European corporate credits performance

As UK has decided to leave European Union (“EU”), UK will be the main victim and the negative shock will extend to EU and global economy. Investors are now expecting UK will enter recession and Bank of England will cut interest rate and restart quantitative easing in 3rd quarter this year. However, it is not likely to change the deterioration expectation of the UK economic as S&P and Fitch has already cut UK’s rating to AA. UK corporates credits are expected to face a wave of downgrading pressure. As for EU after UK referendum, markets are worrying more similar idiosyncratic developments in the euro area. Political instability will further drag down investor’s confidence and European corporate credits will face a strong headwind in the near future.

US may have fewer rate hikes ahead

Heightened global economy uncertainty and weakness in investor confidence on spending due to the Brexit may lead FOMC to adopt a more cautious approach in rate hikes decision. Based on the Fed fund future markets, the current possibility of rate hike on July, September and November is minimal. Investors are expecting there would be only one rate hike by the end of this year. Therefore, US treasury yield is expected to stay low at its historical level and it can provide support on the USD corporate bond market.

Asian credits show resilient under Brexit

Asian economies generally have low correlation with European market as their exports to European Union are usually in single digit percentage of their GDP. Therefore, Asian credits performance are expected to outperform the European credits under the Brexit situation. However, certain sectors (as follow) may still have a more direct linkage to UK market but their creditability remains strong.

- HK blue chip conglomerates: They tend to have a higher exposure to UK due to historical reasons. Certain companies may even involve in UK infrastructure and utilities businesses. However, their fundamental, liquidity and cash generation ability are still healthy since their UK businesses are in stable and non-cyclical sectors.
- Asian auto and parts companies: Certain portions of their products may be sold to European countries. Any deterioration on European spending may impact their revenue. However, companies in this sector usually put US, Chinese and their local markets as their focus. European market is usually not to be their first priority growth engine in their business model.

Brexit may cause FX lost in Asian corporates but expect to be manageable

Brexit may cause strengthening of US dollars and in return induce FX loss in Asian corporations, especially India and Indonesia corporate credits as they normally don’t fully hedge their FX position. However, these countries economies have a sufficient GDP growth and strong capital inflow, the depreciation of their local currency is not expected in a great magnitude. As for Chinese credits, the increasing popularity of onshore funding since 2015 has help Chinese corporates to reduce their FX debt exposure by early redemption of their foreign debt.

In summary, uncertainty in European and UK investment markets can attract more investors to flow into the more stable Asian investment market and Asian bond markets can be benefited from it. Reduced rate hike expectation also supports the performance of the USD bond market. Current Asian
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Investment Grade bonds provide a more reasonable risk-return profile and investors can diversify their risk exposure by considering them.

Risk Considerations:

i) Unexpected and aggressive rate hike in US;

ii) Deterioration of US and Chinese economy;

iii) Prolonged global recession;

iv) Unexpected global deflation;

Sharp decline in commodity prices.
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GBP / USD

12-Month Performance

<table>
<thead>
<tr>
<th>BoC Overnight</th>
<th>0.50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate Target</td>
<td>1.5776 / 1.3225</td>
</tr>
<tr>
<td>52-week Hi / Lo</td>
<td></td>
</tr>
<tr>
<td>Y-T-D Total Return</td>
<td>-9.73%</td>
</tr>
<tr>
<td>Source: Bloomberg L.P.</td>
<td></td>
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<tr>
<td>As of 30/6/2016</td>
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INVESTMENT SUMMARY
- Political turmoil in UK brings uncertainty to its prospect
- UK is facing the risk of break-up post Brexit
- Brexit will drag on UK economy
- BoE plans to restart QE to boost its economy

Political turmoil in UK brings uncertainty to its prospect
Upon Cameron’s resignation from the UK Prime Minister after the Brexit referendum, a campaign for the new leader of the ruling Conservative Party began, which won’t be concluded until all of its members has cast a vote this September. It’s not easy to seek consensus within a party that is suffering from a faction among its members, especially when the debate between the “Leave” camp and “Remain” camp still heated post referendum. Moreover, the new leader will become Prime Minister automatically rather than by way of a general election. The new Prime Minister’s credibility and recognition will be challenged by the public, which may result in an early election in UK and add to its political uncertainty. The referendum has caused a severe split within the party and deepened antagonism in the society, while the exit process yet to begin, UK is falling into political turmoil.

UK is facing the risk of break-up post Brexit
Scotland decided to remain in Britain by a gap of 10 percentages in the 2014 referendum, and there were also over 60% of Scottish supported UK to remain in EU this time. Scotland will hold a referendum to seek independence in two years, said Nicola Sturgeon, the First Minister of Scotland. Obviously, this is determined by the fact that UK will take two years to finish the exit process through negotiations with EU, as Scotland wants to vote while UK remains in EU and tries to inherit its membership. Although EU reiterated that, Scotland would not get an EU membership automatically after it leaves UK, we believe that there is a great chance that Scotland will hold a referendum again. Northern Ireland is also in the “Remain” camp. UK government has no democratic authority to negotiate with EU on behalf of Northern Ireland, said James McGuinness, the deputy First Minister of Northern Ireland, who also suggests a referendum to leave UK and push forward a united Ireland. With UK is facing with troubles at home and from abroad, as well as uncertainty in mid-longer run, rating agency S&P and Fitch have downgraded its sovereignty ratings and outlook.

Brexit will drag on UK economy
UK will take at least two years to finish the exit process, according to Article 50 of the Lisbon Treaty. As for the rights and duties of both parties during the negotiations, the description is rather ambiguous, and no one knows how to implement such article as there is no precedent. UK needs to negotiate with 27 EU members for terms regarding diplomacy, visa, tariff and financial trading for a long time, which will bring a period of political and economic uncertainty to UK, dampening local business and consumer confidence, and even causing a recession. For the longer run, the two-year negotiation period under Article 50 gives more priorities to EU, which may force UK to accept the terms by EU, or leaving the negotiation period matured, UK will leave EU automatically and lose its rights and interests without any new agreements. As expected, it’s not easy for UK to gain any favorable terms. UK has millions of jobs which are closely related to EU.
Meanwhile, almost half of its trading relies on EU. As the financial hub of Europe, financial service in London is the major export industry of UK. EU is planning to relocate the European Banking Authority (EBA) away from London. Paris and Frankfurt is competing to become the new home of EBA. This highlights the fact that UK may be ruled out from the European financial regulation system or even European capital market after it decides to leave EU, and London would lose its status as a financial center. Banks and financial institutions based in London may lose the financial passport to the single market, or they may plan to leave UK, thus causing severe loss to local financial service industry.

BoE plans to restart QE to boost its economy
BoE has kept its benchmark rates at 0.5% since 2009. Market had expected UK to follow the Fed after it began the rate hike cycle last year. To cope with the recession risks post Brexit, the Bank would need more easing to boost the economy this summer, said Mark Carney, Governor of BoE, and he expects a rate cut and further expansion of asset purchase program would be among BoE’s options.

We expect GBP/USD to continue its downward trend, and trades toward 1.2000 by year end.
INVESTMENT SUMMARY
- Brexit decision causes political and economic uncertainty globally
- Expectation for monetary easing by central banks heats up

Brexit decision causes political and economic uncertainty globally
UK’s decision to leave EU came as a shock, not only making Scotland and Northern Ireland to restart a campaign for independence, but also pushing UK into a period of political and economic uncertainty, while the process of European integration is challenged, Euroskeptics in other EU countries would become stronger and evoke more referendums to leave EU. For instance, the far-right Party for Freedom in Netherlands, the Five Star Movement in Italy, the Red-Green Alliance in Denmark and National Front in France, all called for their own EU referendum. Recent polls in eight EU countries including France, Germany and Italy show that, 45% of respondents suggest their government to hold EU referendum. In France and Italy, those calling for a referendum accounts for 55% and 58% respectively, of which over 40% claimed they would cast a “Leave” vote. Another poll in June also suggests that, among the current EU members, less than a half of the public in Spain, France and Greece show their likes to EU, while in Netherlands and Germany, only a half of them say they “Like” EU. If these countries follow UK’s step, could bring a splitting risk to EU, and greater barriers to Global trades. Moreover, Italy is going to hold a referendum for constitutional amendment this October, and France, Germany and Netherlands will hold general elections next year. In recent years, Euroskeptics parties with influential power have emerged in many EU countries. Against a backdrop of rising populism, the world is facing greater political and economic uncertainty ahead, which could result in more Black Swan events. Investors sought shelter and gold is typically considered as a safe heaven.

Expectation for monetary easing by central banks heats up
Central banks may restart more QEs to boost the growth, as the slump of GBP and significant volatility in global financial market post Brexit has dampened sentiments and growth globally, while a rate hike by Fed also delayed. Japanese Prime Minister Shinzo Abe pledged to deploy any policy tools to support Japan economy, and Bank of Japan Governor Haruhiko Kuroda also noted that the Bank would provide infinite USD liquidity if financial institutions need it. Market expects BOJ to further expand QE as early as in July. As UK’s overall prospect deteriorated by the uncertainty post Brexit, the Bank may need more easing to boost the UK economy in the months ahead, said Mark Carney, Governor of BoE, and he expects a rate cut and further expansion of asset purchase program would be among BoE’s options. Although ECB is unlikely to further expand its QE program in the near future, it may widen the scope of asset purchase to ensure sufficient bond supply to support its QE program. According to ECB President Mario Draghi, Brexit would drag on the growth of Eurozone by 0.3 to 0.5 percentages in the three years ahead, and he expects ECB to keep an accommodative stance in the future. Moreover, there is an even greater chance that China will cut its RRR or interest rates again. As for the Fed, despite an expanding household consumption and resilient labor market, its plan to have two rate hikes this year has been interrupted by Brexit. As rate futures indicated, the chance that Fed increase rates this year has fallen to below 12%, some even sees a rate cut. Meanwhile, the chances of rate cut...
by BoE in July, ECB in September, RBA and RBNZ in August have been over 50%. The question is, major central banks have limited room for further easing, and its stimulus to growth is also decreasing significantly. If negative interest rate policy becomes the new norm, the demand for gold as investment is likely to surge.

The rally in gold price will be supported by investment demand. Looking ahead, we are positive on gold, and expect gold price to trade toward $1,380 in 3Q16, and $1,400 by year end.
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NZD/USD 12-Month Performance

INVESTMENT SUMMARY

- Brexit may hurt New Zealand on trade earnings in the short term
- New Zealand economy is expected to slow down
- RBNZ may restart rate cut cycle

Brexit may hurt New Zealand on trade earnings in the short term

Brexit may impact the global economy and has a negative effect on New Zealand in terms of trade earnings to a certain extent. Europe accounts for over 10% of New Zealand’s total export, of which about a third is to UK. After Brexit, UK may strengthen its trade links with Asia including New Zealand, which would be favorable to New Zealand economy in the long run. However, given the current uncertainty on growth prospect in UK and EU, UK may fall into a recession which will severely hurt its import demand. In addition, the depressed exchange rate of GBP and Euro would also have an impact on the trade sector of New Zealand. What’s more, as the Free Trade Agreement (FTA) between New Zealand and EU is yet to implement, the negotiation may be delayed as a result of Brexit.

New Zealand economy is expected to slow down

Despite showing some signs of stability year-to-date, international dairy prices remain weak, and this will continue to drag on export earnings of New Zealand. Over the past year, New Zealand has been reducing its dependence on dairy industry. It seeks to strengthen its construction and tourism industry, in addition to other agricultural products. Given a booming property market and more labor force from increasing immigration, construction activities in New Zealand has witnessed a strong growth in recent year. Supported by the increase of spending by visitors, Local service industry recorded a surplus of NZD 1.1 billion in the first Quarter, the largest surplus in record. Although the rapid growth of these new pillars has brought a promising prospect to New Zealand in the long term, it takes time for New Zealand to reduce its dependence on dairy industry, which is the major driver to its economy for so many years. GDP growth for the first quarter this year slows down slightly to 0.7% qoq, and we expect this slowing trend may extend through this year.

RBNZ may restart rate cut cycle

After cutting rate by 25bps in March as a surprise, RBNZ has kept its policy rates unchanged at a record low of 2.25%. NZD surged since market speculated that RBNZ had no intention to deliver further rate cut. Nevertheless, as market sentiment turned down after Brexit, the pace of global growth is disrupted, and New Zealand is also facing risks in its growth prospect. Major central banks may restart a wave of rate cut and QEs, while the Fed is believed to delay its plan of rate hike this year. For New Zealand, as inflation has been well below the lower end of the 1% to 3% range set by RBNZ, combined with concerns on global prospect, RBNZ is facing even greater pressure to ease its policy, which may drag on NZD.

Dragged by external factors post Brexit, it is difficult for NZD/USD to extend its rally. We expect NZD/USD to trade toward 0.6800 in 3Q16.
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