Market Insights

BNY MELLON
ASSET MANAGEMENT

Emerging Asia Growth Prevails as Inflation Worries Abate

By Hamon Investment Group*

Executive Summary

Investment professionals from Hamon Investment Group argue against a hard landing for China and other emerging Asian countries, as tightening measures aimed at managing inflation without choking off growth seem to be working in their view. The emerging Asia equity managers based in Hong Kong expect to see improved market performance in the second half of the year, with inflation worries easing and global capital flows resuming into the region. They discuss their outlook for China, India and ASEAN[1] countries for the rest of the second half as well as main market developments from the second quarter.

Investment professionals from Hamon Investment Group argue against a hard landing for China and other emerging Asian countries, as tightening measures aimed at managing inflation without choking off growth seem to be working in their view.

Emerging Asia Regional Outlook

For the emerging Asia region, we expect an equity market recovery in the second half of 2011 from the underperformance of the first half, with central banks' tightening measures gradually easing as inflation worries abate, particularly in China and India. In our view, earnings growth forecasts continue to look achievable and valuations are attractive relative to other assets.

We do not share the hard landing scenario for China. We believe that government fiscal measures, such as the acceleration of affordable housing construction and accommodative monetary policies providing easier credit availability to small and medium-sized enterprises (SME) are likely to achieve the solid economic growth in 2012, as envisaged in the Chinese government's five-year plan. We expect a resumption of global capital flows into Asia after the summer, as investors gain confidence that economic growth in Asia is likely to be stronger than in the developed world in both 2011 and 2012, and they see more signs of the end of the monetary tightening cycle as headline inflation begins to show a clear downward trend.

In China, we believe rising wages have been one of the main drivers of inflation, which has been offset by rising productivity levels over the past two decades.

1 **The Association of Southeast Asian Nations** (ASEAN) is a geopolitical and economic organization of ten countries located in Southeast Asia, consisting of Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Burma (Myanmar), Cambodia, Laos, and Vietnam.

HAMON INVESTMENT GROUP

* Hamon's services are offered in the U.S. by Hamon U.S. Investment Advisors Limited. BNY Mellon holds a 19.9% interest in Hamon Investment Group Pte Limited, which is the parent of Hamon U.S. Investment Advisors Limited.

August 2011

Tightened monetary policies, including interest rate and reserve requirement ratio hikes, have already been effective in decelerating inflation pressure. As a result we believe equity performance should improve going into the second half of the year.

Though Asia's economic growth will likely moderate slightly in the second half of the year, we believe overall growth in Asia will still expand at more than twice the pace of growth in developed markets.

In India, despite 10 interest rate rises since March of 2010 amid inflationary pressures, we believe the fundamentals of the economy remain positive due to strong domestic demand. As in China, core inflation in India has been on a structural uptrend in part we believe due to social development policies, improving wages and increased consumption. We expect investors are likely to continue closely monitoring India's wholesale produce index, particularly after the government raised diesel prices to strengthen the budget deficit.

Slowing demand from developed markets might generate headwinds for Korea and Taiwan, particularly for some tech products. Lingering investor concerns about a more significant slowdown in China's economic growth might further weigh on North Asian exporters. On the other hand, the view that production disruptions following Japan's earthquake will not have an adverse effect on component manufacturing should be positive for the sector.

In our view, political concerns have eased in ASEAN countries, resulting in more positive sentiment among both foreign and local investors. We believe regional private-public-partnerships should improve business efficiency and establish needed infrastructure, while policy reforms to lift minimum wages should benefit domestic consumers.

Though Asia's economic growth will likely moderate slightly in the second half of the year, we believe overall growth in Asia will still expand at more than twice the pace of growth in developed markets. Slower growth should also help alleviate inflation and inflation expectations, which have been the key worries for market investors. We believe several key regions are in the advanced stages of their tightening cycles, which should bode well for investor sentiment. We maintain our positive stance towards consumption, technology and software, infrastructure and energy sectors.

Country Review & Outlook

China/Hong Kong

In the second quarter, in our view worries of accelerating inflation and subsequent aggressive tightening policies pulled mainland indices lower. However, economic stimulus measures, such as social housing programs and credit availability to SMEs, will likely help maintain economic growth, supporting our view of a soft landing. Although key macro indicators like the country's Purchasing Managers' Index continues to expand at a decelerated pace, underlying data shows that services are outperforming manufacturing sectors, reflecting that the quality of growth is improving. The Shanghai B share index fell 14.53% over the second quarter as liquidity withdrew from small and mid cap companies.[2] In our view, mainland equities have been oversold, with the market pricing in negative news.

With inflation remaining a top political concern, the People's Bank of China continues to implement further monetary policies to help rein in excess liquidity. The reserve requirement ratio (RRR) was raised for the sixth time over the second quarter. We believe the RRR remains the best policy tool amid current macro conditions, as it demonstrates a symbolic stance against high inflation without instituting aggressive tightening. Measures already in place have helped support social stability efforts and helped cool China's property market.

With inflation remaining a top political concern, the People's Bank of China continues to implement further monetary policies to help rein in excess liquidity. The reserve requirement ratio (RRR) was raised for the sixth time over the second quarter.

In our view, China's fundamentals remain strong and we believe the central bank will unlikely resort to aggressive monetary policy intervention. We expect inflation to peak over the summer and gradually abate as tightening measures show their effect. We generally continue to see a benefit to overweighting consumer staple and discretionary stocks, energy, alternative financing, and telecommunication services, while underweighting materials, banking, and capital goods.

Taiwan

Despite worries of weaker export demand from developed countries as well as China due to aggressive monetary tightening policies weighing on market sentiment, the Taiwanese market (TAIEX) rose 1.54% over the quarter.[3] Stocks were able to maintain gains from an early quarter rally on better clarity that supply chain disruptions from Japan would not have a significant adverse effect.

2 This and all other market data in this article are taken from Bloomberg. Please see index definitions at back.
3 Please see index definitions at back.

In our view, non-tech stocks are positioned to outperform tech stocks during the third quarter, as non-tech stocks are likely to benefit from social housing programs, domestic consumption and niche markets. Market weakness presents an opportunity to accumulate tech stocks, as we believe the sector might rally on anticipation of consumption recovery in the U.S.

We are also positive towards financials as net interest margins improve and improving cross-strait relations with mainland China create new investment opportunities. While tech stocks may encounter sector headwinds, we are positive toward semiconductors as well supply chain components for smartphones and tablet PCs.

While second-quarter GDP numbers are expected to show that Japan's economy contracted for a second consecutive quarter, we believe government spending and private investments should spur growth.

Japan

Japan's Nikkei rose 3.46% over the second quarter, as the market recovered from its devastating earthquake and tsunami earlier this year.[4] Macro reports including the Tankan Survey suggest that Japan's recovery is gaining momentum, with corporations forecasting increased hiring and investments during the second half of this year.

With the recovery exceeding earlier expectations, the resumption of operations at plants and parts makers has eased supply concerns. The major overhang for the market remains electricity demand during the peak summer months, suggesting that production levels are likely to remain flat quarter on quarter.

While second-quarter GDP numbers are expected to show that Japan's economy contracted for a second consecutive quarter, we believe government spending and private investments should spur future growth. We find construction and property development stocks attractive based on the prospect that reconstruction efforts are likely to materialize during the second half of this year. We also believe advanced engineering stocks such as automation and synthetic commodity manufacturers might be attractive.

4 Please see index definitions at back.

ASEAN

ASEAN markets generally outperformed over the second quarter, as overhang worries such as inflation, rising commodity prices and political uncertainties gradually eased by the end of the quarter. Indonesia (JSX) rose 7.27% over the quarter, the best performing market in the region, while Malaysia (FTSE Bursa Malaysia) climbed 2.47%.[5] The Thai market (SET Index) fell 2.03% as liquidity withdrew from the market prior to the presidential election.[6]

Strong balance sheets and low household leverage rates have helped ASEAN policymakers maintain food and fuel subsidies, minimizing pass-through costs to end users. Food prices have also been tamed and regional currencies continue to appreciate, softening input prices.

In our view, rising income wages will likely lead to the normalizing of interest rates by central banks, however, at an accommodative rate to support growth.

We are positive toward ASEAN domestic themes, as rising income and stable food prices should aid household consumption, and more infrastructure development projects are expected to be undertaken in the region.

We are positive toward ASEAN domestic themes, as rising income and stable food prices should aid household consumption, and more infrastructure development projects are expected to be undertaken in the region.

India

Although the Indian market (SENSEX) fell 3.02% over the quarter, the market pared off an early quarter drop as the country's Finance Minister stood by his economic targets amid a string of monetary tightening measures. In our view easing concerns over rising inflation and fiscal tightening renewed sector-specific buying, led by capital goods, financials and information services late in the quarter.

Ten interest rate hikes since March 2010 have eased India's underlying inflation pressure without derailing its structural growth. In our view, the economic potential still hovers above 8% GDP for the 2011 fiscal year, driven by infrastructure spending and rising household expenditure.

5 Please see index definitions at back.
6 Please see index definitions at back.

We believe infrastructure names remain a key investment, as the government looks to increase spending to help address structural and regulatory bottlenecks. We also favor domestic consumption stocks, particularly for high-end items, because of rising disposable income. Rising real interest rates and the risk of demand destruction due to higher inflation are clear risks for our growth outlook, while rising oil prices might also lower investor risk appetite, given India's high exposure to rising prices.

Domestic demand offset some of the weaker exporters in Korea, as Europe's debt crisis and slowing U.S. growth began dampening demand for Asian goods.

Korea

Domestic demand offset some of the weaker exporters in Korea, as Europe's debt crisis and slowing U.S. growth began dampening demand for Asian goods. The Korean Kospi stock exchange index rallied early in the quarter on speculation of manufacturer market share gains due to disruption in Japan's production and ended the second quarter up 2.49%.[7] The shipment inventory cycle in Korea indicates that the economy is still on an expansionary trajectory.

Selective Korean tech names fared well in the second quarter, including semiconductors, on expectations of a second-half recovery, and automakers, on market share gains. Domestic consumption stocks, mainly shopping networks for increasing sales exposure to China's household market, also outperformed. In our view, petrochemicals and shipbuilders in Korea are likely to be beneficiaries of rising oil prices and continued recovery in the global economy.

7 Please see index definitions at back.

Index Definitions

Korean Composite Stock Price Indexes (KOSPI) is a series of indexes that track the overall Korean Stock Exchange and its components. These indexes use a weighted average based on market calculation to calculate the value of the indexes.

The Nikkei is a stock market index for the Tokyo Stock Exchange (TSE). It is a price-weighted average and is the most widely quoted average of Japanese equities.

The Hang Seng Index is a freefloat-adjusted market capitalization-weighted stock market index in Hong Kong. It is used to record and monitor daily changes of the largest companies of the Hong Kong stock market and is the main indicator of the overall market performance in Hong Kong.

Malaysia FTSE Bursa Malaysia Index is a comprehensive range of real-time indices, which cover all eligible companies listed on the Bursa Malyasia Main Board. The index is used to measure the performance of the major capital segments of the Malaysian market.

The JSX Composite is an index of all stocks that trade on the Indonesia Stock Exchange Shanghai B Share Index is a weighted average share price index compiled by the Shanghai Stock Exchange with the number of shares issued of all listed B Shares as weight number.

SET Index is a composite index which represents the price movement for all common stocks trading on the Stock Exchange of Thailand

Taiwan Capitalization Weighted Stock Index is a stock market index for companies traded on the Taiwan Stock Exchange (TWSE). TAIEX covers all of the listed stocks excluding preferred stocks, full-delivery stocks and newly listed stocks, which are listed for less than one calendar month.

The Bombay Stock Exchange SENSEX is a free-float market capitalization-weighted index of 30 well-established and financially sound companies listed on Bombay Stock Exchange.

The indexes are trademarks of the foregoing licensers and are used herein solely for comparative purposes. The foregoing index licensers do not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and they make no representation regarding the advisability of investing in the products or strategies described herein.

BNY Mellon Asset Management is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this article are those of the authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This article is of general nature, does not constitute investment, legal or tax advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. However, this material is not intended, and should not be construed, as an offer or solicitation of services or products or an endorsement thereof in any jurisdiction or in any circumstance that is otherwise unlawful or unauthorized. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In Australia, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In Brazil, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • Investment vehicles may be offered and sold in Canada through BNY Mellon Asset Management Canada Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • In Dubai, United Arab Emirates, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In Germany, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in Hong Kong, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities, and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In Japan, this document is issued by BNY Mellon Asset Management Japan Limited, Marunouchi Trust Tower Main Building, 1-8-3 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In Korea, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taepyungro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. • In Singapore, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professionalinvestors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the UK and in mainland Europe (excluding Germany), by BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the United States by BNY Mellon Asset Management.

BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • Ankura, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Beta Management is a division of The Bank of New York Mellon, a wholly-owned banking subsidiary of BNY Mellon. • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon owns a 19.9% minority interest in The Hamon Investment Group Pte Limited, the parent company of Blackfriars Asset Management Limited and Hamon U.S. Investment Advisors Limited, through whom Hamon offers services in the U.S. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.

BNY MELLON
ASSET MANAGEMENT

The Alcentra Group
Ankura Capital Pty Limited
Blackfriars Asset Management Limited
BNY Mellon ARX
BNY Mellon Beta Management
BNY Mellon Cash Investment Strategies
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management

©2011 The Bank of New York Mellon Corporation. 8/11