

## Asia's Economic and Financial Market Landscape - 2003

Welcome to the now traditional **DSGAsia** year-opener – traditional in the sense that we have stayed in business long enough to produce a third of these missives! The last year was one of the toughest we can recall in financial markets, while operating conditions were generally, extremely difficult; hence we have to admit to being pleasantly surprised with the continued buoyant state of our business. While the concept of independent research has started to reach a wider audience, the business cycle has not left many with spare resources to fund operations such as ours. Therefore, we would like offer our sincere thanks for your continued support, noting in the words of Marx that: “sincerity is the most important asset in life – if you can fake this, you’ve got it made”.<sup>1</sup>

**We are still in business  
– thank you for your  
support**

As is our wont, we will use this opening piece for 2003 both to review our views and calls over the past 12 months, and to set out our roadmap for economies and financial markets in the year ahead. And in case you think we are telling porkies, we invite you to check out our newly revamped website at <http://www.dsgasia.com> where you can access all of our previous articles, not to mention some pretty groovy charts and other assorted goodies. Hours of fun for all the family...

**Check out our newly  
revamped website**

Our big macro calls in 2002 turned out to be pretty accurate though given the capriciousness of markets, we were somewhat relieved to find that our trading recommendations were also in the money when we totted up the results. Based on the trading tilts we suggested in our monthly “Trade Winds” articles (instituted in February 2002), the **DSGAsia** notional portfolio returned around 7% in dollar terms over February-December. We would stress that we are making no claims to being money managers, nor are we considering making the switch. We do not want the stress and in any case, it would be a huge conflict of interest for our business. However, we have been asked by a number of clients to more accurately take ownership of our calls, so voilà... We will leave you to judge the validity of such exercises whichever way you wish.<sup>2</sup>

**Our big macro calls in  
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<sup>1</sup> We are of course referring to the cerebral Marx, Groucho, not his moodier cousin Karl. And before anyone tries to point out that *The Economist* used this line last year, we know, but it is still one of our favourites and therefore worth another airing here.

<sup>2</sup> We are more than happy to discuss our calculation methodology with interested parties. Naturally if our recommendations lose money next year, we will not be repeating the exercise.



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### Summary of Views: January 2003

Regional Views	Strategic Biases			Trading Tilts		
Equities	Long			Flat		
Rates	Flat/Short			Slight Long		
Forex	Flat/Long			Flat		
Country Views	Strategic Biases			Trading Tilts		
	Equities	Rates	Forex	Equities	Rates	Forex
Japan	Long/Short	Flat	Flat	-	-	-
Korea	<b>Long</b>	<b>Short</b>	<b>Long KRW/JPY</b>	-	Long	Long KRW/JPY
Taiwan	Long	-	-	-	-	-
Hong Kong	Long	Short	-	-	-	-
China	-	-	-	-	-	-
Singapore	-	-	-	-	-	<b>Short TWI</b>
Malaysia	<b>Long</b>	-	-	-	-	-
Thailand	-	-	-	-	-	-
Indonesia	Long	Long	-	-	Long	-
Philippines	-	-	-	-	-	-
India	Long	-	-	-	-	-
Australia	-	<b>Short</b>	<b>Long</b>	-	Long	-
New Zealand	-	<b>Short</b>	<b>Long</b>	-	Long	-

#### Global/Regional Drivers

Sub-potential US growth but no recession, Europe even weaker; poor profitability and equity performance  
 Japan muddles through; no extreme Yen weakness. Dollar to remain under downward pressure  
 Asian domestic liquidity to be put to work as local risk appetites improve  
 Asian earnings to outstrip GDP growth; overseas money to follow

#### Sectoral Themes

Sceptical tech but long tech commodities versus infrastructure  
 Long local financials/brokers versus international financials  
 Overweight consumption, resources, energy extraction & exploration  
 Small/mid-caps bias

**Notes: Views in Red = Strong Conviction; Views in Bold = Change of View**

Trading tilts 1-week to 3-months; " - " implies no strong view expressed currently

Equity views do not incorporate tilts against index weightings, trading tilts express strong relative preferences

Rates views are sovereign/money market based; Forex views against the USD unless otherwise stated



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Our own preference is to be viewed as a research outfit that provides the big picture input into far smarter people making real and financial market investments in the region. As such, the key value should be embedded in our strategic musings. Quoting from our article of a year ago we suggested:

We forecast that profitability and developed country stock markets would remain weak...

“The runes [OECD free liquidity] say activity is going to pick up. Nothing spectacular. Money multipliers will continue to function sub-potentially since balance sheets are still undergoing repair, any meaningful recovery in CAPEX is most likely a 2003 story (though its rate of decline is already moderating and thus its subtraction from GDP growth should consequentially diminish), and the US consumer will be in savings rebuild mode. Our hunch remains that the strongest quarterly growth in the US could be seen earlier than many expect due to base compression but that this will soon run out of steam as we move into H2.”<sup>3</sup>

Our conclusions, therefore, were that profitability and developed country stock markets would remain weak, interest rates would remain low, and global liquidity would remain abundant. However, we also believed that Asia would “provide a willing home for some of this surplus cash in a regional environment of *stronger* than expected growth and *improving* profitability”.

...and interest rates would remain low with global liquidity abundant

We will return to our country-specific views in due course but at this juncture it seems pertinent to ask what can be expected for this year. In many ways, we see more of the same, albeit markets will have to digest greater potential political risk from various hot spots around the world. Confining ourselves to economic musings for now, we reproduce over our OECD free liquidity chart and its lead message for global activity. As the chart has been predicting, the bounce in global activity from compressed bases seen earlier in 2002, should be moderating further into 2003. However, we would stress that the indicators are not suggesting a plunge back into recession either, which should be generally Asian supportive.

But Asia would yield stronger than expected growth and improving profitability

While we have been stressing that the transmission mechanism from greater liquidity provision to economic activity would be weak, we have not been of the view that monetary policy would be completely impotent. It is necessary in circumstances of a downturn led by over-investment, for the monetary authorities to step in both to provide resources to finance transfers of asset ownership, and to accommodate required fiscal stimulus. If this is done, then the economy should respond, albeit more tepidly than if the

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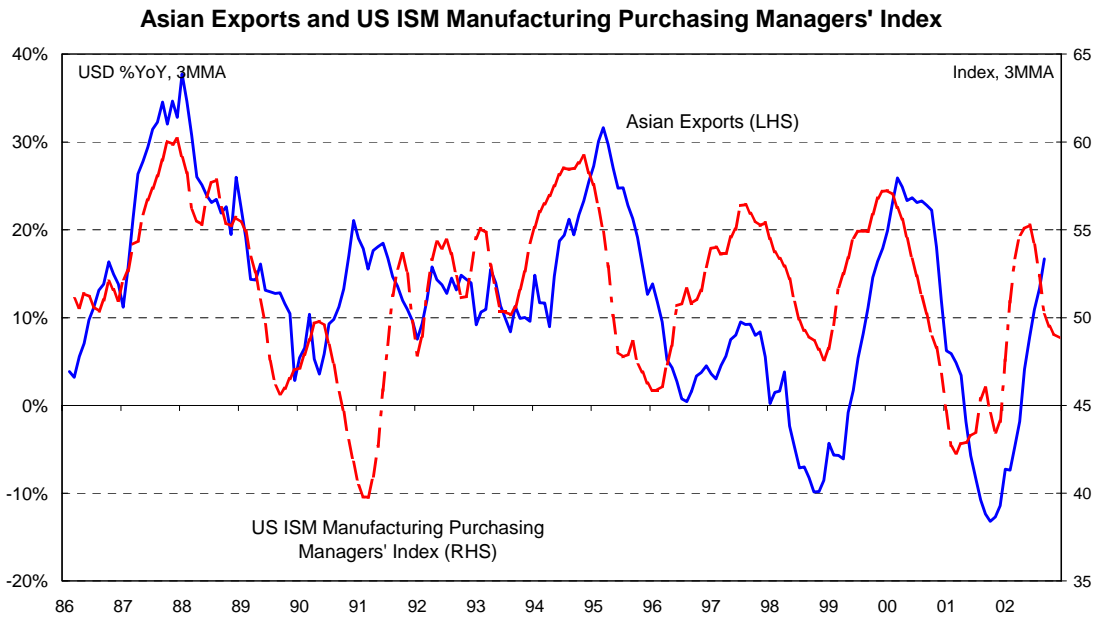
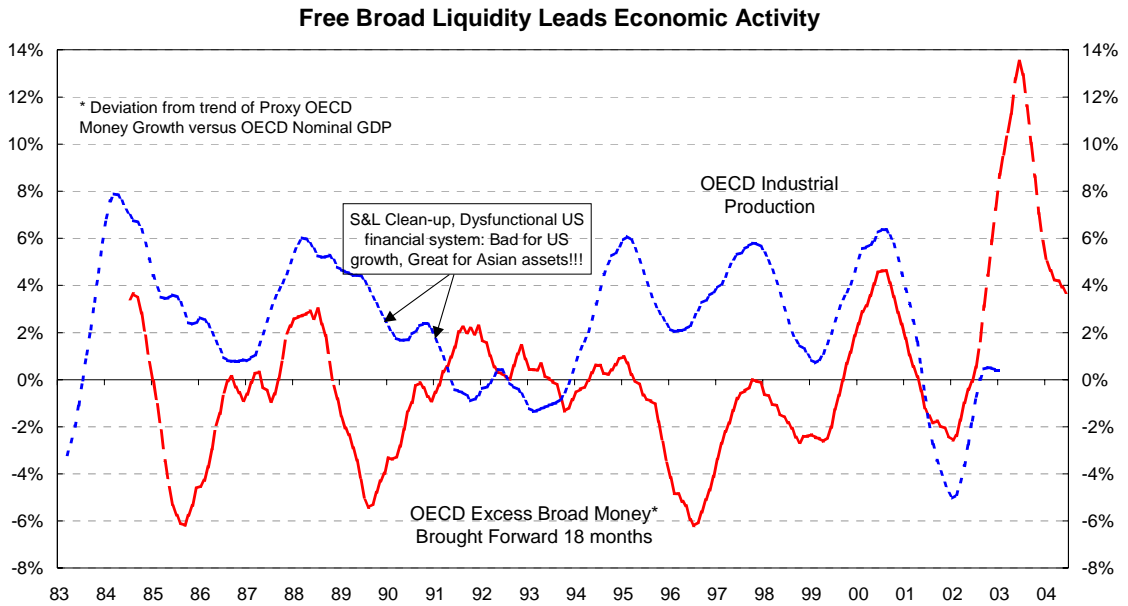
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<sup>3</sup> “Asia's Economic and Financial Market Landscape – 2002”, January 7<sup>th</sup>, 2002.



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private sector was in better shape. And it is notable that America, where fiscal and monetary stimuli have been both more aggressive and more coordinated, has still managed to produce the strongest growth amongst the major economies, despite having greater excesses to purge from the system.



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We still believe that rather than the deflationary slump that some are still predicting, we will see a prolonged period of sub-potential activity in the US, somewhat akin to the early 1990s, where monetary policy remained accommodative, yet real growth remained sluggish. While the consumer is likely to pull in his horns further, we are not expecting a complete halt to such expenditures. Similarly, the stimulus from fiscal policy will likely be less than the record 5% of GDP or so seen in recent times, but the government has the resources and the will to continue to spend as it sees necessary. Finally, CAPEX should edge back into positive territory, as some replacement investment, at least, will come due. Moreover, unlike most elsewhere, corporate adjustment has been brutal and companies have generally been allowed to fail where needs be and/or have been sold at distressed prices to hungry predators. As we have noted in the past, it is this ability for capital to exit that both allows America to adjust more quickly, and will prevent deflation at the manufactured goods level spreading to the broad economy.

The US will not see deflation but a prolonged period of sub-potential activity

Deflation remains far more of a risk in Japan and parts of Europe, but in the latter at least, policy may be shifting – glacially it seems at times – to head off such an eventuality. Throughout last year, we shared the consensus that the euro would be, by default, the strongest of the three majors, despite our structural view that the single currency was an economic and political abomination. This was primarily based upon a view of significant undervaluation, rather than a call for superior economic growth prospects. With much of the valuation argument unwound, and with a belief that the US will still generate superior economic activity this year, we find it hard to get too excited about significant further euro appreciation from here. We will reassess this view if either the American economy does roll over hard, or if the EU decides to meaningfully abrogate the stability pact to accommodate the fiscal stimulus the continent badly requires. Naturally, we hope to be surprised by the latter as opposed to the former.

Deflation remains far more of a risk in Japan and parts of Europe

Some have been advocating the idea of a new Plaza Accord to coordinate currency re-alignments amongst the majors, but we still view this as an idea that will remain confined to the drawing boards of think-tankers, and the delusional world of Japan's Ministry of Finance.<sup>4</sup> While the Europeans are probably willing to accept a further strengthening in the euro from here (for reasons of machismo rather than good economics), we suspect that the

The dollar will not fall out of bed

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<sup>4</sup> We wrote about the weird and wonderful Kasumigaseki view of the world in an article a couple of weeks ago entitled: "The Picture of Mori-san Grey", December 16<sup>th</sup> 2002.



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tightening in monetary conditions this implies, will hardly be helpful for the sclerotic economies of the centre. One can expect significant amounts of often-contradictory jawboning in the coming months from various central bankers and finance officials (and hence noise-induced market volatility), but do not expect the sort of policy coordination that some are hoping for. In fact, we rather fear the further rise of protectionism as a malignant response to 'unfair' currency policies. The reality is that none of the major economies could do with a significantly stronger exchange rate; indeed they are all doing their best to debase their domestic units as we speak. It was a good trade for us last year – both in print and p.a. – and we suspect it has a lot further to go still. There's gold in them thar hills....

A final wild card is of course politics, though if one is looking to price in some of the nastier eventualities that might emanate from either Iraq or North Korea, we still believe the Swiss Franc and again, gold, are the places to be. We take an unashamed hard-line on dealing with the potential threat from regimes such as these, and Kim Jong-il's admissions and actions in recent times have done nothing to disprove our prejudices. History has shown time and time again that appeasement does nothing to deter dastardly dictators. Pyongyang's systematic cheating on its nuclear agreements, should serve as a loud wake-up call for those who wish to use the same tactics with Baghdad.

**History has shown time and time again that appeasement does nothing to deter dastardly dictators**

We will leave others to pontificate about the merits of a conflict with Iraq, and the ability for any campaign to be successful and quick. However, on the subject of North Korea, we strongly believe that China now has a tremendous opportunity to demonstrate it is ready to take on a more mature and constructive role in global affairs. You may recall we wrote about the decay of the North Korean regime last year and its potential to upset the geopolitical balance.<sup>5</sup> Events appear to be moving towards the fast end of our expected time-decay spectrum, and passivity in the face of desperately belligerent actions from the North, is unlikely to do more than delay the inevitable collapse.

**In the case of North Korea, China now has a tremendous opportunity to demonstrate it is ready to take on a more mature and constructive role in global affairs**

Unsurprisingly, Japan has put its head in the sand. Meanwhile the reactions from Seoul have been predictably emotional. This is understandable, since South Koreans are in the front line of any stray missiles and are dealing with their ethnic brothers and sisters, but unhelpful, nonetheless. If American troops could have learnt to drive a little more carefully, perhaps Washington would now be dealing with a President-elect with a less idealistic view of

**Expect little help from Tokyo or Seoul**

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<sup>5</sup> "Asia's Perfect Political Storm", September 9<sup>th</sup> 2002.



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the world. However, the reality is that events are playing into the long-standing plan of Pyongyang to encourage a fissure between the US and the South.

This leaves China with the chance to show some real regional leadership. One preferred scenario might be for Beijing to have a word in Kim Jong-il's ear, and offer him and his coterie lavish retirement homes in Inner Mongolia in return for them going quietly. There is no way of telling whether the PRC has the influence to effect such a plan, nor whether the permed and portly one would be willing to play ball. But at the very least, Beijing must tell him that the game is up. If Kim Jong-il does take the bait, then massive infusions of global aid could follow. And if he does not, then it is clear he has no intention of negotiating himself out of business, in which case, better to face up to the military reality sooner rather than later, when he may have additional and even nastier toys to throw around.

**Kim Jong-il should be offered a lavish retirement home in Inner Mongolia**

Anyway, enough cheery stuff. If one is looking for war on the Korean Peninsular (possibly in tandem with conflict in the Middle East), then there are few risk assets out there that are cheap enough. However, more benign outcomes imply that Asian assets are inexpensive and attractive in both relative and absolute terms. Throughout last year we maintained a long strategic bias towards regional equities, even though we cut our longs on a trading view (to be fair, not quite fast enough to avoid giving back some gains) around mid-year, when the global environment started to roll over again. We see little out there – economically at least – that makes us want to change this bias, and stand ready to pile back in as and when it becomes clearer that the world is not collapsing around us. While the time is not now – see our Summary of Views table near the beginning of this article – our target would be some time around Q2.

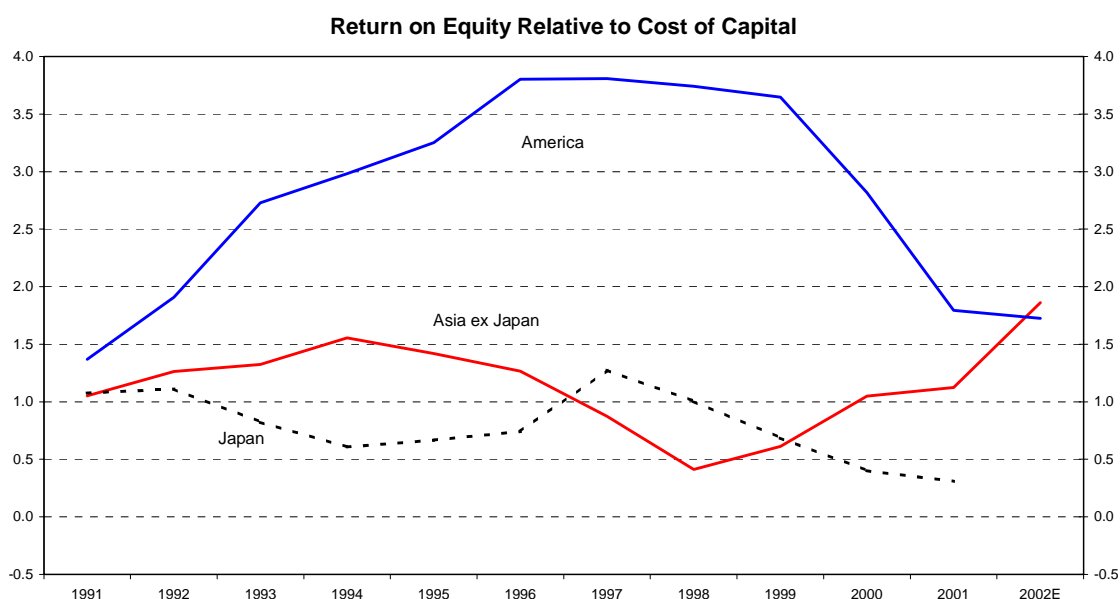
**In the absence of war, Asian assets are inexpensive and attractive in both relative and absolute terms**

Why do we remain optimistic? For many of the same reasons as last year, namely: fabulous local liquidity; robust domestic consumption; undervalued currencies; BoP strength; and balance sheet repairs being further advanced than elsewhere. While the potential for export growth to slow is high – see again the second chart on page 4 – much of this is due to less favourable bases, as opposed to a collapse in underlying growth momentum. In any case, the region continues to win market share even in an environment of moribund overall demand. We still expect non-Japan Asia to grow its dollar exports around 5-10% over the course of 2003.

**The time is not yet, but be ready to pile back in as and when it becomes clearer that the world is not collapsing around us**



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Moreover, as the chart above, updated from this time last year shows, returns on investment continue to improve. Some of the gains have been a function of a lower cost of capital, though in reality, the costs of equity and corporate credit have not fallen as fast as sovereign and money market rates. Indeed, they have risen in many cases.<sup>6</sup> However, we believe we are still in the early stages of a structural increase in corporate profitability across Asia. Although performance between different companies will vary widely, the aggregates continue to suggest that more and more local business leaders are recognising the benefits of enhancing shareholder performance.

**Returns on investment continue to improve**

Moving on to different countries in the region, we will start with the biggest (for now) and ugliest, Japan. Throughout last year, we saw little mileage in expending huge amounts of macro capital to what we believed would be primarily a micro-driven story. We cut our long USD/JPY position in February – slightly too early but at least it saved us the perennial heartache of the macro community of being wiped out by the short Yen and JGB trades – but could not bring ourselves to go long Yen despite our belief it

**We have seen little mileage in expending huge amounts of macro capital on Japan**

<sup>6</sup> For a more detailed discussion of such issues, please see: “The Myth of Asian Profitability Revisited”, June 10<sup>th</sup>, 2002. We have not updated the Japan numbers since shareholder’s equity has plunged so far that even minor changes are causing wild swings in the calculated ratios.



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should move higher. Our preference was to play JPY-proxies and other crosses, which we will discuss in due course.

As for our views for this year, these were discussed in the aforementioned article on Japan only a couple of weeks ago, so we will not rehash them in any great detail here. In brief, while the choice of the new BoJ governor could have some near term impact on the direction of the Yen, with a dove likely to get the markets all excited about a much weaker currency, our core expectation remains that the change of the guard at the central bank will be a bit of a non-event. However, even if more radical measures ensue, this being Japan, one should also consider non-market measures to be part of the government's arsenal. These might include capital controls, interest rate caps and perhaps the imposition of deposit lock-ups to prevent a rush for the exits. Banks will also need to be *de facto* nationalised or at least instructed to continue to buy at least part of the additional JGB supply that would likely ensue. All of the above could make trading the market particularly hazardous, and there will be few prizes, we suspect, for being early. There are better uses for your capital elsewhere.

**Beware – non-market measures will be part of Tokyo's arsenal**

Korea still seems to be one of the most attractive destinations, in all asset classes, notwithstanding its rising political profile. Given our China-related comments above, we still view the potential for a full-blown conflict on the Peninsular as being low, which appears to be the view being shared by the currency and rate markets. (We suspect the equity swoon has been at least as much related to global market weakness.) As we still expect global growth to be weak into the first half of the year, and the probabilities favour the Yen at worst trading water against the dollar, we are more than happy to keep our long KRW/JPY and Korean rates positions in place for now.

**Korea remains one of the most attractive destinations, in all asset classes...**

Further out, the case for Korean equities and Won appreciation remains strong (though this is when we reverse our long rates position). We have viewed with favour the regulatory approach to dealing with excessive consumer credit provision instituted by the authorities, and expect it to be successful in ultimately prolonging the cyclical upturn. Meanwhile, domestic demand is still expanding, a destructive CAPEX cycle seems a distant prospect for now, and exports seem set to continue to perform admirably, helped in no small part by an obscenely undervalued currency.

**... notwithstanding its rising political profile**

Our other favoured economy has been Malaysia, and again, we see little reason to alter our assessment. Domestic demand seems well balanced, the financial sector is cleaner than most, the government continues to champion the corporate restructuring process, albeit within the ambit of its own political agenda, and the external accounts seem healthy (and are benefiting

**Our other favoured economy has been Malaysia**



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from stronger oil prices for now). The country is faced with political risk of a different kind to Korea, trying to manage both a leadership transition process and internal security challenges. Predictably, the redoubtable Dr. Mahathir has led the regional reaction to the comments of Australian premier Howard regarding the Lucky Country's option to pre-emptively strike at terrorists overseas. Yet in reality, we suspect that the views of the two are not that far apart. We expect the political environment to remain stable.

Singapore will also enjoy political stability but not a great deal else. As with Hong Kong, domestic demand is weaker than most elsewhere, and the economy is flirting with a resumption of recession. Having encouraged the trade-weighted SGD to appreciate, presumably in the expectation of a more sustainable economic upturn, we now think that it will be allowed to soften again. Our trading tilts reflect this. At a structural level, though the government has at least been asking some of the right questions, it is by no means clear that they intend to follow the full implications of the uncomfortable answers that have materialised. Unemployment is set to remain high – especially among the unskilled whose jobs are being lost to overseas – while the City State is surrounded by less than warm neighbours. A global cyclical upturn would clearly help but for now, times will remain tough.

Singapore will enjoy political stability but not a great deal else

Hong Kong shares many of the same problems, but we continue to believe these are less intractable. For sure, the SAR's woeful political leadership continues to demonstrate an inability to discern its coccyx from its lower humerus joint, but Hong Kong has two major advantages: a hinterland it is fully engaging with and a vibrant entrepreneurial seam reflected in a plethora of cross-border activity and listed SMEs. This is of little solace to those whose jobs are being lost or those who bought property at the top of the bubble, but painful though it is, the economy is reinventing itself from the bottom up. One should continue to see the disconnect between GDP and GNP grow.

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Another economy experiencing this GDP-GNP dichotomy is Taiwan. At a micro level, Taiwanese companies appear to be successfully exploiting the opportunities afforded by the Mainland, though playing this through the listed sector is often tough. Again the challenge for the government is to create an environment that allows those who are being 'hollowed-out' to find new opportunities in the domestic economy. Given the backwardness of its financial and service sectors compared to Hong Kong and Singapore, this should be a somewhat easier task although in practice, the political environment has tended to retard the transition process. Aside from calling

The GDP-GNP dichotomy is acute in Taiwan



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the turn in the external cycle, we continue to believe that progress on financial sector restructuring will be a key test case for both broader market performance and demonstrating the DPP government's competency. Despite the recent climb-down over reform of the rural co-operatives, we are still optimistic that the bill governing the increased funding of the Financial Reconstruction Fund will be passed during the first half of this year. If the legislation is indeed approved, we believe it will go a long way to cauterising the bad loan problem.

Naturally, the performance of China looms large in any assessment of Hong Kong and Taiwan, or anywhere else in the region for that matter. As we have written at length in the past, we remain comfortable with the broad macro environment, but view as crucial the ending of policy paralysis now the new leadership has ascended to power. While these new leaders are still finding their feet and jockeying for real position and influence in the hierarchy, we do not expect to see much in the way of radical measures introduced. Rather we see the low-key reactivation of various policy initiatives that have stalled over the past year. We expect China's growth to chug along nicely – albeit unequally across the country – and thus an activist and redistributive fiscal policy to be maintained. As ever, the problem will be finding domestic asset plays to capture such trends. Certainly we are not rushing out to apply for our QFII licence.

The performance of China looms large in any assessment of the region

A growing China should remain a net positive for the region, in the sense that its marginal demand should outweigh its negative influence on low-end employment elsewhere. Capital goods and raw materials exporters should continue to fair especially well, which in part reflects our continued positive stance towards commodity-based currencies. Combine this with our shiny-metal predilections, and we see the AUD and NZD continuing their rises.

China should remain a net positive

Meanwhile, North Asia has both the companies and the export mixes to benefit from the PRC's growth, even as workers in traditional industries are feeling the pinch. However, the greatest challenge is faced by the poorer ASEAN economies. As we argue in a forthcoming article, relative labour costs and currency valuations, Indonesia aside, cannot explain falls in market share in manufactured exports and FDI. Other factors must also be at work and the task for the rest of the region is to identify areas of comparative advantage, rather than try to take on China head-to-head and/or protect local operatives.

North Asia has both the companies and the export mixes to benefit from the PRC's growth

Of the three, Thailand seems to be having the most success, though the recent strength of the economy is still built on pretty shallow foundations in our opinion. Thailand was the market we were most wrong about last year,

The greatest challenge is faced by the poorer ASEAN economies



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underestimating the strength of foreign interest, and also the success of Prime Minister Thaksin's policies in stoking up near-term demand.<sup>7</sup> To be fair to the government, some of the initiatives, such as targeted fiscal disbursements to villages and incentives for individuals to borrow and buy houses, were well thought-out, and succeeded in boosting consumer confidence. And as one wag confided to us: "The P.M. is a clever man – other politicians bribe us with their own money, Thaksin uses the public purse". However, fiscal impetus will need to be moderated as the government bumps up against debt constraints, while we remain highly sceptical about the pace and thrust of corporate and financial sector reform. Rolling out the problem is good politics, in that it keeps in power the elite who caused the problems in the first place. But it also threatens to knock a chunk out of potential growth going forward. Nobody starves in Thailand and the people are generally optimistic, but we still cannot find it in ourselves to go beyond our earlier and less-than-enthusiastic 'hold-your-nose' recommendation.

In contrast to Thailand, our Indonesian and Philippines calls during 2002 were far more on the mark. Going into 2003, we retain our long IDR rates bias and will look to re-engage in stocks as the year progresses. Despite serious concerns about the country's medium-term competitiveness, not to mention its fissiparous political environment, we still see scope for interest rates to fall further, while equities on almost any measure are cheap. It is far harder to get enthused about the Philippines where rates are at rock bottom and stocks seem expensive. We have been sceptics about "Sister Glo" Arroyo from day one, viewing her as part of the elite problem afflicting the country, and have seen little to disprove this view. Her decision to not to run for the Presidency again, whether you view this cynically or not (you can guess our biases), will make little difference. There is nobody amongst the ruling class either willing or able to take the trough away from the oligarchs. We have not been to Manila for three years now, and see little reason to be booking up our flights any time soon.

Finally, we also tended to steer clear of India, where our generally negative view on the political environment served to offset our more constructive opinions about the economy. The landslide victory of the BJP's Hinduvista

They need to identify areas of comparative advantage, rather than try to take on China head-to-head and/or protect local operatives

Thailand seems to be having the most success

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<sup>7</sup> To have missed the second best performing equity market in the region – in local currency terms anyway, Indonesia (which we were engaged with) did better in dollars – was disappointing. In defence, we did call the regional star, Pakistan, even if we did not have the balls to do anything about it.



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Chief Minister of Gujarat, Narendra Modi, in the recent State election, will do little to boost the cause for either liberal politics or economics in our opinion. Once again the macro looks pretty good while the micro story is as diverse and interesting as ever. In the early part of the year, if global markets are still struggling, India may perform relatively well. However, if we are correct in believing that risk appetites towards the region will be improving a few months hence, it will not be the place to be looking for beta.

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