Investment Strategy

Equity Strategy

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Guanxi

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Asian markets and the 10-year bond

With the US 10-year bond yield above 5%, single-digit PE cyclical stocks in Asia should outperform. Two of these, LG Petrochem and Sinopec, are also in our list of top-conviction calls, the Asia Pacific Focus 1 list. Relatively small but open economies such as Singapore, Malaysia and the Philippines also benefit from accelerating global growth.

The next phase will be difficult for value investors

1985 to 1995 was a mighty bull market for Asia ex-Japan; in aggregate it rose 400% and its PE jumped from 14x to 29x. From 2003 to now, Asian markets have risen 200%, and their PE has remained constant at 17x, due to strong earnings growth. But today's stories – strong current accounts, strong balance sheets, strong consumer – are much better than the export-driven stories of 1985 to 1995.

Pakistan remains among our favorite markets

We maintain an alliance between President Musharraf and former Prime Minister Benazir Bhutto is the most probable political outcome, and will help diminish the risk. The Karachi Stock Exchange is up 35%, and although there is less value than before, it is still one of Asia's most dynamic and least expensive markets.

Thoughts on China

Definition of a bubble: A market in which I am underinvested that has spiked up. The term has no other useful meaning, and the fact is that China's 1Q EPS growth was up 80% YoY, or a PEG of roughly one, perhaps less. There are many good proxies to China listed overseas. Some of them are obvious (H-shares), while others are less obvious, but just as interesting (the Philippines).

Hong Kong's Twin Engines – Global & China growth

The acceleration we foresee in Chinese and global demand is good for Hong Kong, and the correlation between the Hang Seng Index and A-shares is increasing. We like Henderson Land, Li & Fung, Bank of East Asia, China COSCO, Pacific Basin, Esprit, HK Stock Exchange, CNOOC, CCB and Mengniu.

Also included in this report: Staying overweight Singapore, a subtle hint of big things to come in Malaysia, and borrowing concepts from evolutionary biology.

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Asian markets and the US bond

Merrill Lynch Asian economist TJ Bond, global quantitative strategist Nigel Tupper, and your faithful scribes recently analyzed the reasons for the rising bond yield, and determine it is reflective of an improved outlook for growth (The cyclical case, June 20).

Rising bond yield reflects better growth

Strategy-wise, we have to recognize that markets don't always produce the same reaction to the same events. As a case in point, Asian stock markets have reacted differently in each of the last three recent times the US 10-year bond yield rose above 5.2%.

In May last year, they fell 18%. In June of the same year, they stayed flat. And from June 12 to now, they have risen 4%.

So the first time the interpretation was rates going up means growth goes down. The second time they weren't sure what to think. And now they think rising rates is reflective of rising growth, which is also our view.

US 10-year bond yield since 1981

Source: Bloomberg

The Hang Seng index performance in the same period

Source: Bloomberg

The US 10-year bond started its great bull market from a peak yield of 15.7% at (1981) to its trough of 3.2% (2003). We can in the charts alongside that the Hang Seng index rose eight times in USD terms over the same period. But since then, despite the rising bond yield, the Hang Seng still is up over two times. The message is simply that bonds need not singularly dictate the direction of stocks.

It makes sense in a higher rate environment to go long cyclicals that benefit from stronger global growth, and short stocks with high dividends that are less attractive relative to fixed income.

That works in a developed market like Australia, where Macquarie Infrastructure is down since the bond yield started rising, while BHP is up.

But it doesn't work so well in Asia, because often stocks with good yield also have good growth. The best we can say is we like single-digit PE cyclical stocks – two of those are in our Asia Pacific Focus 1 list of top-conviction stock calls, LG Petrochem and Sinopec. And we like relatively small economies that benefit most from stronger global growth; for example Singapore, Malaysia and the Philippines.

Asian markets will move higher

As recently as April, Asian stock markets fretted over the impact of a US housing slow-down on the region's exports. Yet now they are thankful the US housing worry is still alive, as it provides an excuse for rates to stay low.

As fears subside, Asian stocks go up

It's funny but true -- almost all the Asian market sell-offs this decade have been inspired by events from the US, the most recent case in point the rising US bond yield. (The only locally-caused sell-off this decade was SARS, in 2003).

With no particular bad news out of the US, Asian stock markets are once again in rally mode. Concerns about a US slow down are typically manifested in April and May, so now as we inch closer to the back-to-school period, investors realize the US isn't tanking after all. The more they see the US not tanking, the more they expect catch-up from export laggards in Korea and Taiwan.

With our profit indicators sending a positive signal on global profit growth, and domestic and export demand turning around across the region, we are confident in saying this stock market rally will continue.

What's going on in Asia is both cyclical and structural:

1. It's cyclical because there is pent-up demand from the Asian crisis and its prolonged after-effects, because that cycle is being prolonged by low interest rates, and because Asian investment spending has accelerated despite a slowing US.

Asia is both a cyclical and structural story

2. It's structural because the very foundations of Asian economies have changed, with origins of this change being the reforms instituted in China and India beginning in 1991. They caused those economies to balloon in size, and were the catalysts that propelled their neighbors to move to market economies, and engage in global trade.

Higher valuations

If there is an issue for Asia, it's that investors will need to get comfortable with higher valuations. They aren't here yet – but they will be. We can think that way because it's happened before.

1985-1995 was a great bull market for Asian stocks -- in aggregate they rose 400%. The seven years that followed were a bear market, apart from the narrow space of the TMT bubble. After those years of penitence and reflection, Asian markets started moving up again, and from 2003 to now, they have risen 200%.

In the great Asian bull market of the late 1980s and early 1990s, the story was largely an export one, confined to Taiwan, Korea and Southeast Asia.

Comparing '85-95 bull market with today

Admittedly today exports are still a big part of the Asian story, but this time it's coming from China. Balance sheets which were in large net debt positions back then are surplus cash, as are the current accounts of most countries. And there are strong domestic stories in almost all countries across Asia, too.

It's much more than selling Gucci or Prada bags. The regional service sector should grow significantly, in everything from high-end law practices, to accounting firms, to dentists and doctors. The airlines have figured it out, others should as well.

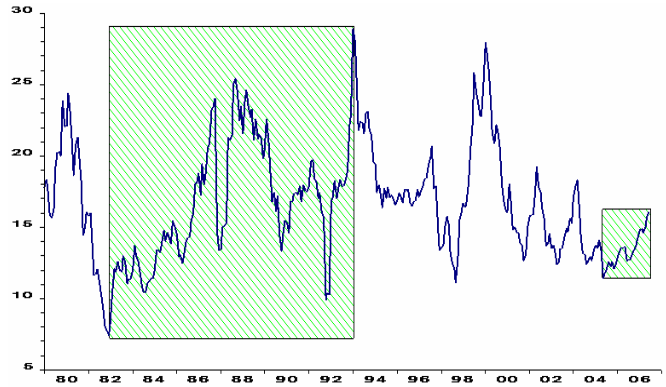
As Asian economies steer towards services encouraging and catering to consumption, total velocity of money leads to faster economic growth. More regulatory change should be expected, following from the beneficial effects of the regulatory change that has brought the region thus far.

Unlocking wealth from systems that are still securitized on a scale similar to the US in the 1940-50s, into a 2007 economic machine, is the real story in Asia, and it is not a small one.

Asia ex-Japan markets, 1980 to now

Source: Datastream

Asia's trailing PE (x). Shaded areas represent bull market of 1982 - 1992, and bull market of 2003 - present



Source: Datastream

Yet despite the fact that things are better today than they were in the previous bull market, valuations are not nearly as high as they were then, as can be seen in the chart above-right, and the numbers below:

- Asia's trailing PE went from 14x in 1985 to a high of 29x in 1994.
- In 2003 it was 17x, and in fact is slightly less than that today.

Performance is the key criterion to Asian markets

The next phase of the Asian bull market will be difficult for those value investors who look at fundamentals very closely. To have a dogmatic view and argue that higher valuations are unjustified is probably not wise at this juncture. What we can observe is that in general higher values are sticking, cheap stocks don't perform, and expensive ones do.

It is a reflection of one of our core views, which is that performance is the key criterion for Asian stock markets, even more key than fundamentals (Guanxi, June 7). When we say performance, what we mean strong economic growth, fostered by pro-market reform and privatization.

Usually it takes a good leader to push those through. Indeed in any collectivity, having good or bad leadership makes all the difference.

Good leadership = good performance

We can think about this at the basic level of the human being, where the brain dictates what the rest of the body does. Famed fitness expert Jack LaLanne says:

> The mind should control the body. When you move your fingers, when you move your toes, that's done by the mind. Remember this: your body is your slave; it works for you. If you had people working for you, employees, and it was very important what condition they were in, boy, you'd make sure you fed them right, you exercised them, gave them everything they needed so they could do things for you, right?

We can also think about performance in the context of an army, where good officers instill loyalty in their troops. Or we can think about it in a company level, where good management inspires workers.

And we can think about performance at a country level, too. There's good evidence how important it is, even in developed countries with large and deep economies, which theoretically should be less susceptible to policy. But they still are. Germany's stock market is up 70% in the past two years. Why? Because it's getting rid of the socialism that held productivity back. Japan's stock market appears to be going nowhere. Why? Because it's moving away from the Koizumi reforms.

Within Asia, if we had to pick the absolute best markets for performance, they would be the Philippines and Pakistan.

The Philippines: exemplary performance

Indeed if you'd just looked at valuations, you would have missed the Philippines completely. Even back in 2003 it was trading on 24x. Since then it has risen two-and-a-half times. For the record, it's now on 16x dropping to 14x in 2008, for around 10% EPS growth in both years. The ROE is 17%.

The really important thing in the Philippines is not the PE multiple. Its that President Arroyo has been able to do things she wanted to do, and as an economist, she knew that short-term pain equaled long-term gain. Two years ago she substantially increased taxes and advanced tax collection. As a result the budget deficit has gone to zero, interest rates have fallen from 12% to 3%, and the Philippines is catching up on its lost decade.

Pakistan remains among our favorites, despite the noise

There is much talk on politics in Pakistan, with the latest being that the former prime ministers Benazir Bhutto and Nawaz Sharif have secured a verbal agreement to a power-sharing arrangement, as reported among others by the Financial Times.

We are not political scientists, but would note that Benazir (to use her appellation in the country) knows that she is a bigger political force than Nawaz at this point, and given the history between the two of them, a power-share is most unlikely.

More interestingly, there is increased debate in local channels about an interim government being created before the elections. That would be helpful in paving the way for an eventual alliance between Benazir and President Musharraf, which we ascribe a high chance to succeeding.

Politics hasn't stopped Pakistan's rise

As for the Chief Justice issue, for the record, the CJ filed a petition contesting the president did not have the authority to file reference of misconduct against him. The government has prepared another case against the CJ's conduct in the event this one doesn't work, saying he has politicized the issue. It will probably keep going on with no resolution, but if the election happens before it is decided, it will also probably fade away.

The details of a deal between Musharraf and Benazir will most likely only be known after the elections, if they are known at all. Once the elections are out of the way and if she comes back, they can just say there was no deal.

It's also unlikely she will come back before the election is over. The government has accused her of corruption, so to allow her to come back and campaign would show Musharraf was pressured. The greater probability is that her Pakistan People's Party wins, and then a party member vacates a seat for her. Then Musharraf can say “A popular party has won”.

While politics remains a favorite topic on Pakistan, it's not really being given much weight in investment decisions. In fact immediately after the May 12 incident, there were strong foreign inflows into the stock market, and despite all the bad news, the market is up 36% year-to-date.

What could cause some selling is this report, from today's The News:

> The Bank of Punjab (BOP) is about to be hit by a massive scandal, a unique fraud that involves billions of rupees. The State Bank of Pakistan has expressed its great concern over the Bank's "system and controls", terming them "quite weak" while the internal audit of the Bank has repeatedly cautioned the management on the huge facilities offered to certain companies.

Many powerful stories in Pakistan

This event should be seen in isolation – last year the bank had a problem loan with a bank that was close to bankruptcy. Nevertheless the market is likely to ascribe a higher risk to smaller banks which try to compete aggressively with the large banks. Bigger banks do not have similar issues.

Also of note in the same sector is a capital gains tax on equity market investments – 35% on stocks sold by banks within one year, and 10% stocks sold after holding for over a year. So there could be slight downward revisions on banks' other income. Most of the banks have been making a lot of money trading shares; about 5% of their pre-tax profits. However, their overall business dynamics remain strong and that is the reason to own them.

There are many good stories in Pakistan that supersede the bad ones. For example the International News reports today:

> India will push for an accord on a multi-billion dollar pipeline to transport gas from energy-rich Iran through Pakistan by mid-July, oil minister Murli Deora said Wednesday. Oil ministers of the three countries would then meet in July to ink the framework agreement on the 7.4 billion dollar pipeline, he said.

This is not the only pipeline in the works – another is planned between the massive deep-sea Gwadar port that Port of Singapore Authority is building in Pakistan, on the Gulf of Oman. It will take energy from the Middle East to China.

Pakistan valuations

	2003	2004	2005	2006	2007	2008
EPS growth	17.1	22.5	30.2	11.6	11.7	12.1
PER	23.72	19.37	14.88	13.34	11.94	10.65
Div Yield	2.8	2.9	3.4	4.12	4.42	4.9
EV/EBITDA	10.44	8.82	7.37	6.79	6.39	5.45
Price to Book	6.01	4.95	4.01	3.39	2.96	2.60
ROE	26.6	27.6	28.3	25.9	24.9	25.7

Source: KASB Securities

Another positive development is the advent of the REIT sector. One problem in Pakistan has been that, to avoid taxes, land values are stated at just a fifth their actual prices on official papers. Now the government has said property owners selling to REITs do not have to pay taxes. So people will declare their wealth, and this should lead to a pick-up of activity in the property market.

An USD750mn Eurobond priced at 6.7% was issued just after the May 12 incident, while demand was USD4bn, and last year's bond yielded 7.1%. That is a sign of foreign confidence, while local investors, having missed the rally, will want to buy on weakness.

All told, we are sticking with Pakistan as one of our favorite markets. It is on a PE of 11.9x for 12% EPS growth, dropping to 10.6x for 12% EPS growth next year. The dividend yield is 4.4%.

China: not enough stock, but lots of cash

Definition of a bubble: A market in which I am underinvested that has spiked up.

The term has no other useful meaning. The market is only a reflection, and cannot be seen in isolation. The fact is, China had 80% YoY 1Q EPS growth, or a PEG of roughly one, perhaps less.

We are of the view China is a good asset to own, as per June 14's Guanxi.

These two stories, both from Xinhua Financial network, highlight something else that's important -- there is not enough stock in China itself to satisfy demand, and the government knows it.

On June 15 it wrote:

Not enough stock to meet demand

> China is not ready to increase the quota for qualified foreign institutional investors (QFII), a program allowing foreign institutions to invest in the A-share market, said a senior official with the State Administration of Foreign Exchange (SAFE). "We are not in a position to increase the QFII quota because we see a lot of foreign capital coming into China - so it is not likely or a good thing for us to expand QFII at this time," said Gao Song, SAFE's director of capital markets.

And on June 21 it wrote:

> China's securities watchdog released Wednesday a document that authorizes Qualified Domestic Institutional Investor (QDII) including fund management companies, securities companies and custody banks to invest in overseas securities business.

Let's see. China won't let foreigners buy Chinese stocks in China. And China is letting its citizens buy shares overseas. Add the two together; it spells good things for Hong Kong-listed Chinese stocks. While they are the most obvious stomping ground and not expensive, there are many proxies to China.

For example, the Philippine Sun Star reported on June 20:

China in the Philippines

> Shipping giant Cosco announced Monday that it would pour in at least US$3 billion into a shipping complex development project in Sangley Point, Cavite which they hope to build as their main hub in the Southeast Asian region. Francis Chua, special Philippine envoy on China trade and investments, said Wei Jia Fu, Cosco president and chief executive officer (CEO), revealed their plans during a courtesy call on President Gloria Macapagal-Arroyo in Malacañang.

It's interesting to see how China is slowly entering countries like the Philippines. USD3bn is no small chunk of change. The development of Sangley Point into a special economic development zone makes good sense – it's in a prime location and nearer to Manila than Subic.

With the recent removal of all barriers to foreign mining companies in the Philippines, the impact of China investment there over the next five years could be material enough that it could also qualify as a China play, as much as many parts of Africa already are. The difference is that the Philippines already has a great structural story, thanks to President Arroyo. Last week we doubled our overweight position in the Philippines.

China's social and political dynamics

The recent scandal of slave labor in Shanxi province has provoked intense examination of China's social stability, with pessimistic commentary from the usual suspects of an eventual unraveling.

While not meaning to minimize the gravity of the event in any way, we think recent comments from Singapore's Minister Mentor Lee Kuan Yew are more realistic. Singapore's Business Times wrote on his attendance and comments at a seminar on China organized by the East Asian Institute this week:

> He said that he has travelled fairly widely across China and has spoken with people who do business in various parts of the country. 'Maybe they are biased because they are running a business, but they find the young people wanting to succeed in life. And to succeed, China must grow - and for China to grow, you need stability, and you need policies that will encourage growth. 'And if you have politics like you have in Taiwan or South Korea, I think they know that that would not be conducive for growth,' said Mr Lee.

China needs stability at home and abroad

Of interest in matters of Chinese foreign policy, The Hindu reported on June 14:

> Days before the first-ever official-level security consultation between the United States, India, Japan and Australia last month, China issued démarches to each of the participants seeking to know the purpose behind their meeting … For Japan, India is a key part of the 'Arc of Prosperity and Freedom' it is trying to build around the 'outer rim of the Eurasian continent.'

This has no direct relevance for markets, but it is one of many indications that beneath the surface of things, there is a geo-political game going on, and a contest for influence. Countries which presently have large economies are trying to shape countervailing structures and processes, to prepare for the day when China will be a great power. China is trying to prevent this from happening and is quietly trying to subdue the influence of the others.

China's need for long-term peace to build itself up, and America's preoccupation with Iraq and terrorism (as well as its need for Chinese cooperation over North Korea, proliferation, etc.) prevents these underlying structural tensions from surfacing very much.

But at some point in coming years they probably will, because there are those who will never accept the idea of China displacing the US as the pre-eminent power, even if it is 40 years away.

Hong Kong's twin engines – global and Chinese growth

Ten years ago, the British flag went down and the Chinese flag went up in Hong Kong. While some things have changed, others have not.

One thing that hasn't changed is the appetite for China. It was what fueled red-chip fever in 1997, and it is what is behind H-shares today. The difference is, red chips were on 52x back in 1997, whereas H-shares are on 19.8x today.

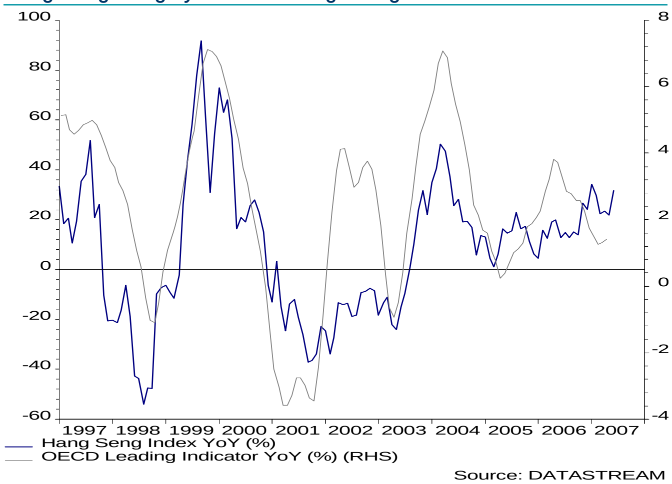
Hong Kong correlation to China rising

Hong Kong is a market that is highly correlated to cyclical growth. Hence it is fortuitously positioned now, as our economic team expects global and Chinese GDP growth will be 4.9% and 10.4% respectively this year.

We favor direct beneficiaries of strong Chinese and global growth, which includes companies taking advantage of the global outsourcing trend, the strong shipping cycle and the Chinese consumer. We also like stocks that profit from rising nominal salaries and asset prices.

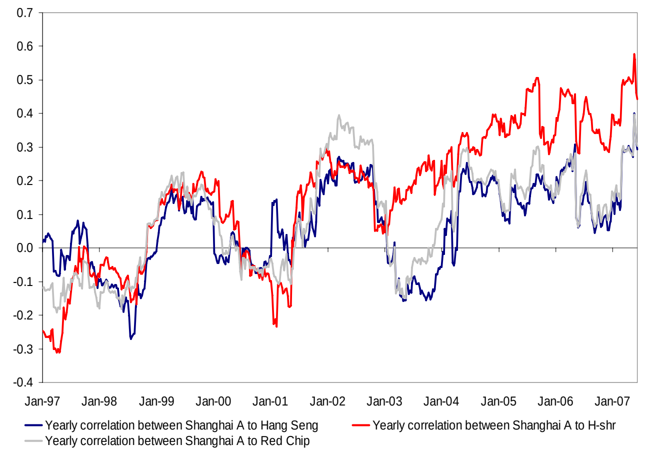
As the chart below-right shows, the annual correlation between A-shares and the Hang Seng index has risen from zero in 1997 to 0.3 now. We expect the correlation to keep increasing.

Hong Kong is highly correlated to global growth



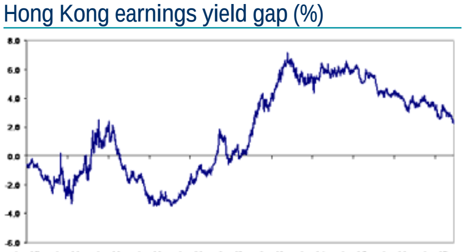
Source: Thomson Financial DataStream

Correlation between Hang Seng Index and Shanghai A-shares



Source: Thomson Financial DataStream, Merrill Lynch Asia Pacific Equity Strategy Group

Hong Kong earnings yield gap (%)



Source: Merrill Lynch Asia Pacific Equity Strategy team

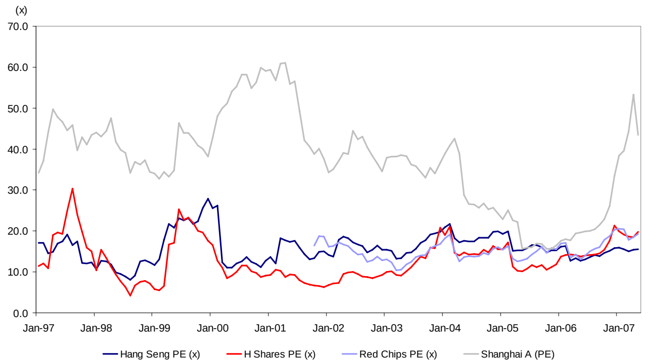
The Hang Seng index is trading at 14.8x forward PE, which is still below the 10-year average PE of 15.7x, and almost half its 2000 peak of 28x. It is also cheaper than A-shares, H-shares and red chips.

Merrill Lynch estimates earnings growth for Hong Kong of 16.3% in 2007, and 6.3% in 2008. Based on the earnings-yield gap model, the Hang Seng index's earnings yield is still much higher than the bond yield.

Due to its linked exchange rate scheme, Hong Kong is not in a rising interest rate cycle, which contrasts sharply with the monetary tightening cycle in China and other Asian economies. As can be seen in the chart below, the 3 month HIBOR rate is still at a discount to LIBOR.

Anticipated RMB appreciation and money flows from mainland Chinese QDII mean more money will come to Hong Kong.

Heng Seng's PE is cheaper than H-shrs, red-chips and A-shrs



Source: CEIC

Money is still parking in HK,

Source: Thomson Financial DataStream

In Hong Kong, we like the following:

1. Companies with land in China, or agricultural land in Hong Kong that can be converted,
2. Hong Kong banks with China exposure,
3. Major red chips and H-shares which could be listed on the A-share market,

Ten Hong Kong names to like

4. Companies which benefit from the accelerating trend in global outsourcing and the strong shipping cycle,
5. Chinese banks and insurances companies which have benefited from the relaxation of QDII, and/or have strong loan growth and rising net income spreads under the current China tightening environment,
6. High quality Chinese consumer stocks.

To meet the above criteria, we recommend investors to take a look at Henderson Land, Li & Fung, Bank of East Asia, China COSCO, Pacific Basin, Esprit, Hong Kong Stock Exchange, CNOOC, China Construction Bank and China Mengniu.

Singapore: staying overweight

Singapore is a tough call. On the one hand it's a tiny country of 4.5mn people that has outperformed the rest of the region by 65% over the past five years.

On 18.5x dropping to 16.6x next year, it's not cheap. In the early stages of the bull market it made sense to be overweight, but in the second stages do you go for more aggressive markets?

We stick with our overweight. There is a lot of positive news to come, and one big reason to be optimistic is because so many firms are setting up in Singapore. Reuters reported on June 18:

> Hedge fund managers around the world have clustered in locations with character such as leafy Greenwich, Connecticut in the U.S. and the stately Mayfair neighbourhood in London. The latest focal point for hedge

> funds is Singapore's picturesque Chinatown, where pastel-coloured traditional shop houses, ornate Buddhist temples and Chinese clan houses are within walking distance from the city-state's financial district.

That trend shows no signs of stopping. According to Hedge Fund Research, in 2002 USD99bn went into hedge funds. In 2006, it was USD126bn. And in 1Q of this year, USD60bn went in. Where's it coming from? Places like these, to use the examples from this week:

Bloomberg reports: Calpers to Invest $12 Billion With Activist Managers.

Forbes reports: The German government is drafting new regulations that would allow life insurance companies to place more investments in hedge funds and commodities

Globalpension.com reports: The Parliamentary Contributory Pension Fund has remained tight lipped over a GBP9m mandate awarded to hedge fund of fund managers, Quellos Capital Management.

Meanwhile within the hedge fund industry, Asia and emerging markets are providing good returns.

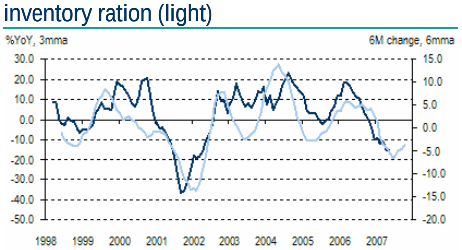
As examples of such, the main Eurekahedge Hedge Fund Index rose 2.5% in May and 7.4% YTD. But the Eurekahedge Emerging Markets Hedge Fund Index rose 4.2% in May and is up 12.7% YTD. And the Eurekahedge Asian Hedge Fund Index rose 3.6% in May and is up 9.8% YTD.

In this context, Singapore's development into an important hedge fund hub is significant. Merrill Lynch estimates that hedge fund assets managed in Singapore are USD25bn, and could rise to USD100bn in three years.

And the Financial Times reported on June 20:

> Singapore's stock exchange wants more than half of its listed companies to be foreign by 2012, as part of a push by the city-state to become a more powerful regional financial centre … No leading global bourse has more foreign than local listings. The SGX would need to attract several hundred overseas listings to become the first.

S'pre tech exports (dark) vs. US tech shipment-inventory ration (light)



Source: Merrill Lynch

Not to be forgotten is that with an export-to-GDP ratio of 190%, Singapore benefits from accelerating global GDP growth. Recent numbers are supportive. Non-oil domestic exports (NODX) rose 3.7% year-on-year in May, up from -0.5% in April and above market expectations of 1.7%. We expect the trade cycle to turn more favorable as tech recovers, allowing Singapore to deliver an even more broad-based economic expansion in 2H.

And Merrill Lynch's Singapore property team wrote a report highlighting the tourism sector, where they expect arrivals to rise from 9.7mn in 2006 to 17.7mn in 2015 (Singapore hotel room rates to triple by 2015, June 18).

Lastly and more longer-term, if Singapore is successful in its transformation as we think it will be, that will be of benefit to Johor state in Malaysia next door, which has just embarked on an ambitious attempt to transform itself into an outsourcing hub for Singapore in the same way that Shenzhen is to Hong Kong. Can it work? We think yes – in Singapore manufacturing is 27% of GDP, in Hong Kong it is 3%.

Malaysia: A subtle sign of big things to come

On Thursday June 14, Malaysian Prime Minister Abdullah Badawi spoke at the Kuala Lumpur Business Club. The New Straits Times reported on the dinner:

PM Badawi is very under-appreciated

> In his speech, Abdullah outlined his vision of where Malaysia should be when it celebrates its centennial independence. The rise of regional economic powers would motivate Malaysia to find its competitive advantage and lead in many strategic industries.
>
> On whether the Iskandar Development Region in Johor could be a model for the rest of the country if it succeeded in wooing more foreigners through its liberal policy, the prime minister said "yes". Earlier this year, Abdullah announced the move to scrap the requirement of giving 30 per cent equity to Bumiputeras for Iskandar projects. He was also instrumental in bringing together incentives including tax holidays.

This confirms our view on Johor, which is that it is a test-case for removing the Bumi law across the country. Badawi is very under-appreciated, in part due to his mild manner.

That manner was precisely why he was put in to follow Dr. Mahathir -- because he was seen as a quiescent pair of hands to continue the Mahathir era. But since then he has undone the mega projects and become friendly to Singapore.

Dr. Mahathir's tirades and the keris-waving UMNO delegates are in fact a good sign, because they are a sign of desperation - the last gasp of the New Economic Policy, which has been an enormous hand-brake on the Malaysian economy in the past twenty years.

Expect big things from Malaysia.

Borrowing concepts from evolutionary biology

Often we get insight from children. The author enjoys speaking with his 12-year old son about his current area of interest, evolutionary biology.

In school he learned that that a monkey born with five fingers instead of four will have children with other monkeys – they don’t care about aesthetic appearances the way we humans do.

Eventually the other monkeys will see that having five fingers is actually better than just four, because you can grab more things with them. And so there are more and more of the five-fingered monkeys, until the four-fingered ones gradually disappear.

There is also a theory in evolutionary biology known as "punctuated equilibrium".

From Wikipedia:

> Punctuated equilibrium (also called punctuated equilibria) is a theory in evolutionary biology, which states that most sexually reproducing species will show little change for most of their geological history. When phenotypic evolution occurs, it is localized in rare events of branching speciation (called cladogenesis), and occurs relatively quickly compared to the species' full and stable duration on earth.

> In 1972 paleontologists Niles Eldredge and Stephen Jay Gould published a landmark paper developing this idea. Eldredge and Gould proposed that the gradualism predicted by Charles Darwin was virtually nonexistent in the fossil record, and that stasis dominates the history of most fossil species.

All life as we know it is made of carbon -- plants, animals, etc. We have only ever seen or known things that are carbon-based. If we saw one that wasn't, we wouldn't know.

The stock market is not carbon-based. But it has a life in some strange way, in the sense that it reflects the economy, which in turn is a reflection of our lives. And in our own time as students of the market, we have seen that when changes in mindset do occur, they tend to occur quite quickly.

Whether the grade 7 version of evolutionary biology is right, or punctuated equilibria is right, perhaps we can borrow parallels in evolutionary biology for the stock markets. Could we be at the point of cladogenesis for Asian market valuations? Could they be the five-fingered monkeys?

Reuters wrote on June 7:

> Schroders' Allan Conway thinks the dynamics of emerging market economies have now changed, making them stronger than developed economies. He thinks the days when they were merely a proxy for global growth are over, so too the days when their economic fundamentals were characterised by boom and bust features like hyper inflation and defaulted debt repayments.
>
> "Emerging markets are increasingly generating growth and momentum of their own. The arrival of China and India has been providing growth for emerging markets as a whole," Conway says. "As a result I think that for the next 10-15 years emerging market economies will grow 3.5-4 percent faster than developed economies."

And on June 19, the same news service wrote:

> U.S. fund firm Putnam Investments reckons many investors are not properly valuing what emerging market economic growth can mean for stocks in developed economies. "The U.S., the other developed economies, are no longer the engine for global economic growth," said Shigeki Makino, chief investment officer for global core equities. But investors, Putnam argues, have yet to see how much established developed market companies can gain from this.

This jives well with our own view - in 1999 then-Treasury Secretary Lawrence Summers said "the world is flying on one engine". That was true at the time when the other three engines - Europe, Japan and the emerging world -- were weak. But now they are strong. That is why we are very optimistic on Asian markets.

The Asia-Pacific Focus 1 list

The list represents the highest-conviction stock recommendations from Merrill Lynch's Asia-Pacific research analysts. It is designed to contain 15-40 Asia-Pacific stocks at any given time.

Hyundai Dev: V-shaped recovery expected - Reiterate BUY

We are adding Hyundai Development to our Asia-Pacific Focus 1 list. We reiterate Buy on Hyundai Development with a PO of W87,000, driven by the following factors: 1) EPS is expected to grow 30.9% YoY in 2008E and 53.2% YoY in 2009E, respectively, and 1Q07 was the inflection point in earnings. 2) Visibility is increasing as the company is on track with its pre-sale schedule. 3) It is the biggest beneficiary of housing market recovery. 4) Valuation remains attractive, considering faster-than-industry growth and its characteristics as a developer.

City Developments removed

We are taking City Developments (CDL) out of our Focus 1 list considering its strong 50% share price performance since Nov 2006. We believe CDL's upside momentum would moderate from its current levels.

Asia-Pacific Focus 1 list

									P/E (x)	
ML ticker	BBG ticker	Company	Analyst	Rating	Date added	Curr	Price when added	Current price	2006	2007
BHRVF	NBHEL IN	BHEL	Parekh,Bharat	C-1-7	9-Oct-06	Rs	1162.68	1440.15	41.89	29.20
WOLWF	WOW AU	Woolworths	Errington,David	A-1-7	9-Oct-06	A$	20.58	27.53	30.29	24.57
TACSF	NTCS IN	TCS	Ghosh,Mitali	C-1-7	18-Oct-06	Rs	1106.25	1158.00	39.31	27.75
XMUCF	MCB PA	MCB Bank	Scarff,Alistair	C-1-7	12-Dec-06	PRs	228.26	365.00	15.90	14.88
CIADF	2319 HK	Mengniu Dairy	Chai,Denise	C-1-7	12-Dec-06	HK$	17.04	26.75	49.04	38.04
SNPMF	386 HK	Sinopec	Guan,Bin	C-1-7	12-Dec-06	HK$	6.38	8.96	14.97	12.43
SFLGF	055550 KS	Shinhan FG	Song,Bryan	C-1-7	17-Jan-07	W	49200.00	58500.00	11.81	9.58
HPDLF	754 HK	Hopson	Fong,Robert	C-1-7	31-Jan-07	HK$	18.60	22.85	18.97	12.27
SPAAF	SIA SP	Singapore Airlines	Dewberry,Paul	B-1-7	6-Mar-07	S$	16.10	18.90	18.58	10.95
HBWYF	000140 KS	Hite Brewery	Han,Young-Ah	C-1-7	22-Mar-07	W	114000.00	126000.00	18.88	14.88
KHICF	034020 KS	Doosan Heavy	Rana,Sanjeev	C-1-8	22-Mar-07	W	59500.00	95400.00	132.89	30.56
PPAAF	PGAS IJ	Perusahaan Gas	Budiman,Verdi	C-1-7	4-Apr-07	Rp	10450.00	9450.00	22.65	27.65
HLDVF	12 HK	Henderson Land	Yeung,Keith	B-1-7	3-May-07	HK$	50.60	54.80	7.34	17.36
RSWSF	RNB MK	Resorts World	Boey,Melvyn	B-1-7	4-May-07	RM	3.44	3.44	21.48	17.31
ASXCF	2311 TT	Advanced Semi Engr	Heyler,Daniel	C-1-7	15-May-07	NT$	38.95	45.15	12.06	12.10
SMSHF	010140 KS	Samsung Heavy	Rana,Sanjeev	C-1-7	21-May-07	W	38650.00	44800.00	67.15	25.52
LGPCF	012990 KS	LG Petrochem	Han,Stephan	C-1-8	23-May-07	W	41500.00	35250.00	7.81	5.31
AXAPF	AXA AU	AXA Asia Pacific	Kearnan,Andrew	B-1-7	23-May-07	A$	8.11	7.73	19.90	22.83
CICHF	939 HK	CCB	Scarff,Alistair	C-1-7	29-May-07	HK$	4.68	5.30	25.05	17.87
LFUGF	494 HK	Li & Fung	Chai,Denise	B-1-7	29-May-07	HK$	25.45	27.25	41.15	30.75
HBPWF	1133 HK	Harbin Power	Lu,Min	C-1-7	7-Jun-07	HK$	10.60	11.28	13.64	12.66
HYHVF	012630 KS	Hyundai Development	Choi,Angela	C-1-7	21-Jun-07	W		63100.00	16.63	17.18

Source: : Merrill Lynch estimates

Current asset allocation

Asia Pacific ex-Japan country asset allocation & valuations

Country	ML Weight (%)	Asset Allocation	EPS Growth (%) 2007F	EPS Growth (%) 2008F	PE (x) 2007F	PE (x) 2008F	PB (x) 2007F	PB (x) 2008F	RoE (%) 2007F	RoE (%) 2008F	DY (%) 2007F	DY (%) 2008F
South Korea	17.8	OW	6.4	23.4	15.3	12.4	1.7	1.6	12.0	13.3	1.5	1.6
Taiwan	10.5	UW	19.7	22.2	15.4	12.6	2.3	2.2	15.2	17.1	3.6	4.4
Hong Kong	10.0	MW	16.3	6.3	15.5	14.3	2.3	2.1	14.5	14.8	3.0	3.4
China	11.0	MW	23.6	20.7	18.8	15.6	3.0	2.7	16.1	17.2	2.1	2.5
Singapore	7.2	OW	12.3	12.1	18.8	16.7	2.4	2.3	13.0	13.5	2.7	2.9
Malaysia	5.0	OW	13.3	7.2	18.1	16.9	2.3	2.1	18.4	17.9	3.6	3.6
Thailand	1.0	UW	(0.1)	16.1	10.8	9.0	2.8	2.4	16.3	17.3	4.1	4.2
Indonesia	0.5	UW	39.2	19.5	16.6	13.9	4.7	4.2	26.5	25.5	3.0	3.5
Philippines	2.0	OW	9.5	9.7	16.3	14.9	2.5	2.6	15.1	17.3	2.0	1.7
Vietnam	2.0	OW	10.0	8.0	39.5	36.2	3.8	3.6	20.2	19.6	1.1	1.0
Australasia	28.0	MW	8.7	6.4	16.7	15.5	2.9	2.7	17.4	17.4	3.5	3.8
Pakistan	2.5	OW	11.7	12.1	11.9	10.7	2.9	2.6	24.9	25.7	4.4	4.9
India	2.5	UW	17.9	12.7	17.1	15.2	3.6	3.1	23.7	21.9	1.3	1.5
Total	100.0											

Source: Merrill Lynch Asia Pacific Equity Strategy Group

- **Korea** - OW. Better times are ahead as the economy recovers, politics improve and funds return to the market after a year of solid selling.
- Rotation into energy names is likely to be the new theme in **Pakistan.** Credit growth in the banks still robust at 18%-20% and market is both cheap with high yield. OW.
- Positive policy changes and corporate restructuring are now taking place in **Malaysia,** while the MYR is amongst the most under-valued regional currency. OW
- We still like **Vietnam** but the market is no longer cheap and have top sliced to fund our increased conviction in our favourite market, the **Philippines**. Mining could be the next fillip for the Filipino economy. OW
- **China** moves up to a MW. We believe the market can move higher due to strong liquidity and see parallels with Taiwan in the late 1980s.
- **India** is an UW. Market multiple is under pressure as cost pressures begin to bite.

Asia Pacific ex-Japan sector asset allocation and valuations

Sector	ML Weight (%)	Asset Allocation	EPS Growth (%) 2007F	EPS Growth (%) 2008F	PE (x) 2007F	PE (x) 2008F	PB (x) 2007F	PB (x) 2008F	RoE (%) 2007F	RoE (%) 2008F	DY (%) 2007F	DY (%) 2008F
Banks	20.0	OW	15.1	13.4	15.9	13.8	2.6	2.3	16.1	16.8	3.0	3.4
Non-Banks	18.0	OW	8.7	9.8	19.8	17.9	2.8	2.5	14.4	14.1	2.4	2.6
Materials	12.0	MW	15.5	11.2	10.7	10.4	2.5	2.2	26.8	21.0	3.2	3.1
Industrials	10.0	MW	8.7	17.8	23.6	19.5	2.6	2.4	11.4	12.3	2.0	2.2
Consumer Discretionary	7.0	MW	20.4	18.3	16.0	13.8	2.3	2.1	14.2	15.0	2.7	3.0
IT - Semis	12.0	MW	10.1	11.3	11.8	10.4	1.9	1.7	16.4	16.3	2.3	2.5
IT - Non Semis	2.0	MW	46.4	22.3	18.5	14.2	3.2	2.7	17.2	19.2	1.7	2.0
Telecom	7.0	OW	15.7	13.1	15.9	14.0	2.7	2.5	17.0	17.6	3.4	3.9
Consumer Staples & Health Care	6.0	MW	15.0	14.1	22.5	19.9	4.9	4.4	21.6	22.1	2.4	2.7
Utilities	1.0	UW	13.2	12.4	15.2	13.5	1.6	1.5	10.6	11.3	2.9	3.3
Energy	5.0	MW	15.7	12.0	14.3	13.7	2.9	2.5	20.9	18.5	2.8	2.8
Total	100.0											

Source: Merrill Lynch Asia Pacific Equity Strategy Group

- **Bank** OW reflects the near-term peak in interest rates and improving outlook for regional investment, plus M&A.
- **Tech** should do better once global leading indicators bottom. For now it remains UW.
- **Telecom** OW. Valuations still at too steep a discount to region while the sector also acts as a defensive hedge against further slow-down in the US economy.

Price Objective Basis & Risk

Our price objective for Hyundai Development of W87,000 is based on sum-of-the-parts valuation: (1) we have applied 9.0x 2008E EV/EBITDA for its main construction operation; (2) we have added values from investment securities and fixed assets (Park Hyatt Seoul and a commercial building); (3) we have calculated the net asset value of principal housing development projects on major land banks estimated at W1.2tn excluding the 2007 and 2008 portion.

Risks: (1) Slower-than-expected recovery in the suburban market would have a negative impact on Hyundai Dev as it has a relatively high exposure to the suburban housing market; (2) The government's move to control presale price is likely to press down overall margin, but the presale price assumption in the feasibility study by Hyundai Dev is conservative and we believe the probability of downward revision from the current presale price assumption is not high.

Analyst Certification

We, Mark Matthews and Angela Choi, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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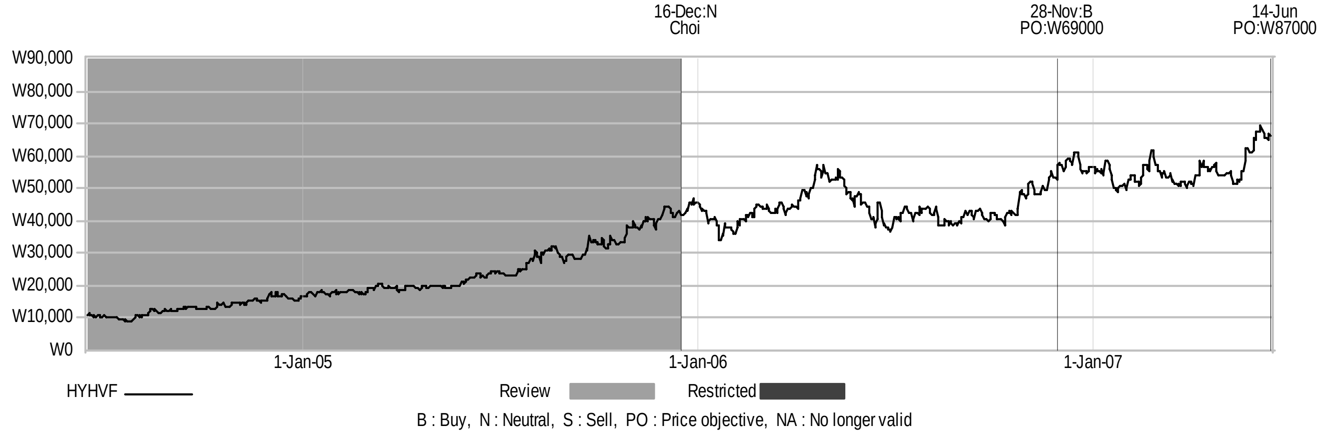
Important Disclosures

HYHVF Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of May 31, 2007 or such later date as indicated.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	47	47.96%	Buy	10	22.73%
Neutral	37	37.76%	Neutral	7	20.59%
Sell	14	14.29%	Sell	1	9.09%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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