
FIMM TODAY

The GST Cometh

The Unit Trust (UT) industry, operating in the space between investors and capital markets, can be a tricky place to navigate. We and several subject matter experts who occupy this field are constantly juggling several different priorities at once even as forces from both within and outside the jurisdiction act to destabilise our equilibrium.For example, policies and changes that eat into the clients' spending power will undoubtedly have a detrimental impact on the overall returns. After all, if clients have less to spend, it will have an impact on their investments. From the other side of the equation, developments that destabilise the capital markets will also have a detrimental impact on the sales, because consumer confidence will be rocked and they will have less of an appetite to invest.

And then there is the issue of competition as well. Even though it is generally agreed upon, at least philosophically, that liberalisation is certainly a positive development for us as an industry, the picture may be less rosy when viewed from an individual, Unit Trust Consultants (UTC) or Unit Trust Management Companies (UTMCs) perspective. One of the hallmark consequences of a competition is the elimination of the weak and it is a natural function of capitalism that there will be weak players in the economy.

But where there are challenges, there are always opportunities. Challenges force us to rethink our strategy, hone our skills and, with good planning and a little bit of luck, emerge stronger than we were before and rise above all.

The reason that we are penning this note with a bit of caution is because the industry is expected to be swayed by these forces in the upcoming New Year.

Topping the chart is the coming to force of the GST. As a universal tax on consumption, it will doubtless have an impact on our industry.

FIMM is doing its utmost to prepare the industry for the change to come and have we engaged external tax consultants to develop educational materials and to lobby the authorities for some flexibility catering to some unique elements in our industry. We conducted an interview with our tax consultants on this issue and they shared with us a broad overview of what we can expect to see with the coming of the GST.

We would like to take this opportunity to inform our readers, however, that the interview is just an overview of GST and that they should seek to educate themselves on the various aspects of the tax and its effect on them. FIMM Today has really focused to deliver its best to you on this topic as much as possible.

Other than GST, we have also shared this platform with various experts in the industry to share their thoughts on the investment themes in the major markets like US, Europe, Japan and China. According to their thoughts, the industry is also expecting another year of tepid growth in 2015 for Malaysia and other Southeast Asian countries. You will also have the opportunity to view Indonesia economy as it's explored on how its domestic political changes are expected to have a positive impact onto its stock market. Besides that, a zoom of the growing demand for socially responsible investing, a concept adopted by investors nowadays and how this trend has boosted the demand for sukuk and other Islamic financial products is also been discussed.

Finally, we would like to take this opportunity to wish all our readers a very Happy New Year and that we look forward for an exciting year ahead.

Editorial Team

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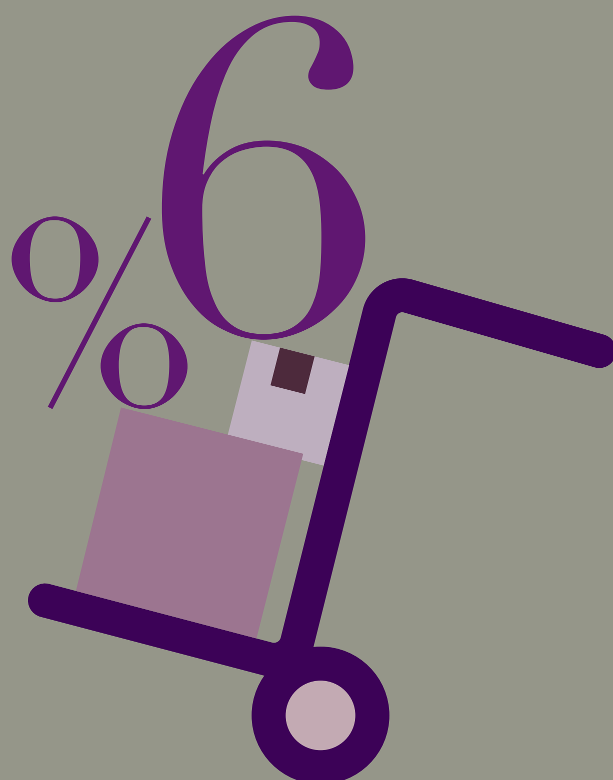
Understanding the GST from a Unit Trust Practitioner's Perspective

By Fong Min Hun



Unit Trust (UT) managers, companies, distributors and Unit Trust consultants (UTC) will feel, along with the rest of the country, the impact of the Goods and Services Tax (GST) that comes into force in April of next year. Billed as a consumption tax, the GST essentially levies a 6% charge on eligible goods and services, which includes the fees and commissions that are part and parcel of the unit trust industry.

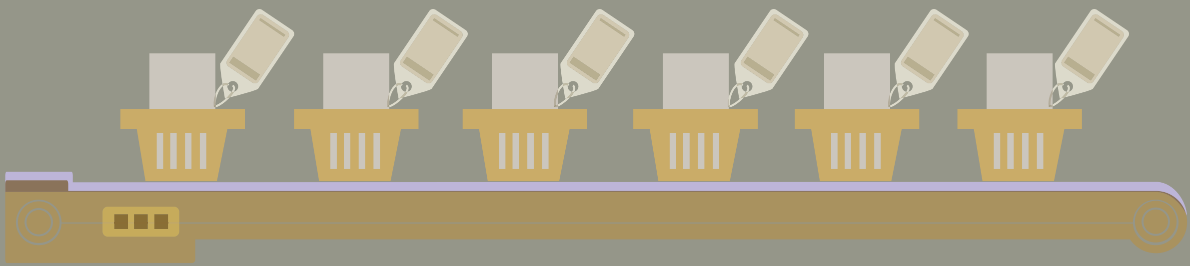
While financial transactions such as the buying and selling of unit trusts, investment income and dividend income have been declared exempt from GST, service fees associated these transactions such as commissions and management fees are not. At its most basic level, this means that fees that Unit Trust Management Companies (UTMCs) charge funds and fees that UTC charge UTMCs both attract the 6% GST.

Dr Veerinderjeet Singh and Mr.Wong in deep conversation on GST.

However, since UTMCs and UTCs are technically the intermediaries within the process of getting the funds from the fund houses to the investor, i.e. they are not technically the end-consumers, the 6% GST on these inputs can be claimed back from the government in the form of credits.

Take the case of the UTC who sells unit trust funds to the retail investor. The UTC receives a fee and commission from the UTMCs in exchange for his/her services. If the UTC is a GST-registered person, he or she will charge an additional 6% for the services on behalf of the government in their tax invoice. In other words, if the total fees come up to RM100, the UTMC will have to pay RM106 to the UTC. The UTC then remits the RM6 to the government in filing his or her GST returns.

But since the UTC's fee is considered a business input of the UTMC's business, the UTMC can claim the RM6 paid to the UTC back from the government when filing its GST returns. As intermediaries, both UTMCs and UTCs—at least in this supply chain—zero the amount of GST paid and collected. As intermediaries between



the funds and investors, (UTMCs) and (UTCs) are not technically end-consumers and thus do not pay GST, which is a consumption tax.

Funds and consumers, meanwhile, will have to bear the brunt of the new tax charges. Consequentially, funds may see taxation bite into their returns and affect distributions to investors. Similarly, investors may find their purchasing power hampered by the new tax

Dr Veerinderjeet Singh, the Chairman of Taxand Malaysia, describes the implementation of the GST as a "transactional" tax, which applies to each individual transaction within a supply chain.

"Once one understands the flow of the transaction, things fall into place," he tells FIMMToday. "The issue really is that because of the way business is done with intermediaries, whether we can just exclude them and pass it from the supplier to the end user. But GST is based on a transaction flow. If you provide a service from A to C, there is a GST applied in the transaction from A to B, and from B to C. You can't do it from A to C."

Thus in the above example, even though the GST ultimately is paid for by the funds themselves and the investors, the GST must be calculated and accounted for

> "The other thing is you also need to be aware that once you are within the system and file GST returns, these have to be done accurately. Over-reporting and under-reporting are offences under the Act and carry penalties"

by each entity within the supply chain. The practical implications here are that funds become more "expensive" for investors and the fund's cost of doing business increases with the introduction of the GST. But for intermediaries, there should be a zero impact within this particular supply chain considered in isolation.

However, intermediaries such as UTCs and UTMCs must also be aware that their cost of doing business will also rise as GST will be charged on their inputs, i.e. everything ranging from office supplies to fees paid to third parties. While UTMCs, as substantially larger entities, will understandably be GST-registered entities who can claim the GST paid on inputs back from the government, UTCs have the option of choosing to be GST registered or not if they earn less than RM500,000 in revenue.

UTCs who choose to become GST-registered entities—mandatory if they earn more than half a million in revenue and voluntary otherwise—can claim GST paid on their inputs, but non-registered UTCs must absorb the GST paid on their inputs. While the natural inclination is to register for GST in order to claim back taxes paid on inputs, Wong Chow Yang, Associate Director at Taxand, warns that registration comes with specific responsibilities.

"One of the main concerns as a UTC is the reporting obligations," Wong says. "Once you're in the system you have to be there for two years. As a GST-registered person, you have to file tax returns every month or quarter. This means you have to tabulate all your output taxes, which requires you to maintain proper records, i.e. issuing tax invoices and holding tax invoices for claims on inputs.

"The other thing is you also need to be aware that once you are within the system and file GST returns, these have to be done accurately. Over-reporting and under-reporting are offences under the Act and carry penalties. So UTCs have to balance between the ability to claim back GST inputs and the cost of compliance [i.e. the cost of having to maintain those records]."

UTCs who are thinking of registering for GST must thus be proactive in seeking information about GST, Wong advises. Depending on the volume of transaction, individual UTCs may not need to seek external tax help, but he or she must certainly be aware of the various obligations, which has been publicised on the Royal Malaysian Customs Department (Customs) website and in the literature produced by FIMM.

The collection of GST may not always be a straightforward process, adds Veerinderjeet. The Federation of Investment Managers Malaysia (FIMM) has engaged Taxand to assess the impact of the GST on their members, and though the generic issues have been mostly resolved, there are details specific to the industry that requires further work. These have been submitted to the Customs, which is the authority responsible for the administration and collection of GST.

One example of a complication specific to the unit trust industry is the variability of fees and commissions charged: "One of our submissions to Customs is to ask for the ability of UTMCs to issue a [GST] self-bill because it may be difficult to determine the value of supply," Veerinderjeet says. "UTCs, when they supply services to UTMCs, won't know how much their commissions are. Under a self-bill system, UTMCs will raise the bill on behalf of the UTCs to simplify the administrative part of it otherwise."

FIMM, together with Taxand, has also raised other issues related to the unit trust industry to the Royal Customs. However, if readers have any specific questions, they are welcome to send their questions in to FIMM for clarification. FIMM will strive to update stakeholders as soon as any new developments crop up.

Source:

1. General information about GST at the Royal Customs website: http://gst.customs.gov.my
2. FIMM's FAQ on GST: Availalable at the FIMM website – http://www.fimm.com.my

2015 Global Economic Outlook and Key Investment Themes

By IFast Research Team

It has been a bumpy ride for the global market in 2014 with the occurrence of geopolitical tensions in Russia-Ukraine and Middle East, an Ebola outbreak in West Africa, the stagnating economies in Europe, a dampened outlook in Asia ex-Japan region as well as the “currency wars” among major economies in the world. Despite that, the global economic growth remained intact on its path of recovery in 2014, albeit slower than initial expectations.

Within the equity market spectrum, the US economy has continued to stride ahead in 2014, extending its bull rally for the sixth year with its stock market achieving yet another record high towards the end of the year. On the other hand, while Europe and Japan managed to register positive returns in local currency terms albeit continuing the struggle to revive their economies, hefty depreciations of their currencies against

Malaysian ringgit, owing to the adoption of loose monetary policy measures by their respective central banks to spur economic growth, have caused these stock markets to be in the red. Stock performances of the Asia ex-Japan region and Emerging Markets have also lagged behind our expectations owing to the gradual downgrades of their earnings growths as well as the disappointments of corporate earnings. In the fixed income segment, accommodative monetary policy had led to declines in yields, contributing to the outperformance of Asian debt and Emerging Market debt as investors' funds flow into these segments in search for yield.

Our outlook for 2015 remains fairly aligned with that of 2014. We continue to favour equities vis-à-vis bonds, Asia ex-Japan region over its developed counterparts, while preferring some of the equity markets within the region that have relatively attractive valuations such as China. In the fixed income space, Asian debt and Emerging Market debt remain our preferable picks and we maintain our caution on duration risk, especially in the G7 sovereign debt space.

With 2015 on the horizon, we will now present our outlook and some of our key investment themes in the following section for the consideration of investors:

2015 Economic Outlook

Still too early to call an end to the global economic expansion

- Alongside a strengthening US economy, there remains plenty of room for growth to bounce back in Japan (after slipping into recession in 3Q 14) and in Europe (which posted a marginal quarterly expansion in 3Q 14); growth engines in both Japan and Europe have spluttered for much of 2014, and 2015 is likely to be a year of recovery for both economies. In addition, China's multiyear rebalancing act has brought growth to the 7% range, a more sustainable level and down from the double digit growth rates seen prior to the Global Financial Crisis, entailing a stabilisation of growth rates for Asia.

- Divergent rates of economic growth globally also means the risk of synchronised "overheating" is considerably low; receding global inflationary pressures suggests that the process of interest rate normalisation in the US could be a little slower than anticipated, while the fragile growth environment in a large part of the developed world means looser monetary policy for longer. With these factors in mind, we think that it is premature to call an end to the current global economic

"...while preferring some of the equity markets within the region that have relatively attractive valuations such as China. In the fixed income space, Asian debt and Emerging Market debt remain our preferable picks and we maintain our caution on duration risk, especially in the G7 sovereign debt space"

expansion, with both developed and developing economies geared for more growth in 2015 – we expect to see economic expansion continue well into 2015 and beyond that, albeit at varying paces for different regions. (see Figure 1)

Europe is still fragile, but should avoid slipping back into recession

- Growth in Europe has been disappointing in 2014, but a low base for capital expenditures and improving household spending should see the region avoid slipping back into recession after a near-scare in 2Q 14. Also, the ECB remains highly accommodative, while fairly positive bank stress tests results should quell banking sector concerns, which could finally give anaemic credit growth a boost.

Inflation unlikely to be an issue, rate hikes could be delayed

- While the consensus largely expects rate hikes from the US Fed in mid-2015, an environment of sub-par global growth coupled with muted inflationary risks (thanks to the decline in commodity and energy prices) means the Fed may not be in a hurry to raise rates. An initial interest rate hike in 2015 is widely expected of the Fed, but this would probably be more symbolic (marking the start of a gradual return to normalisation), with subsequent rate hikes likely to be measured carefully against both US economic progress and the global economic environment. Lower energy prices may even provide a boost to personal consumption expenditures, as real discretionary incomes rise, a positive for economic growth in consumption – dominated economies like the US. For economies like Europe and Japan, price declines remain a risk, although their respective central banks have already committed to asset purchases to quell deflationary risks in both markets.

Investment Themes

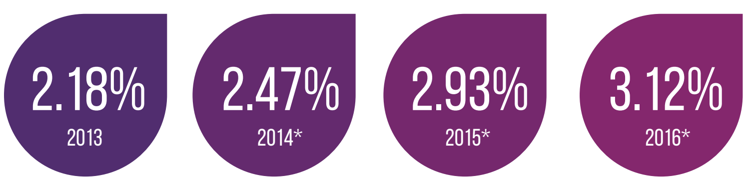
Disappointing earnings forecasts to reverse course

- Outside of the US and Japan, earnings momentum has been fairly weak across various markets in 2014. Asia ex-Japan equities have seen earnings downgrades since 2011 (see Figure 2), with 2014 marking a fourth consecutive year where corporate profits have come in weaker than initially-expected. This has also coincided with a period of weakness in Asian/Chinese GDP estimates; with the region's economic growth forecasts stabilising, we believe that the Asia ex-Japan earnings revision cycle will finally be on the mend.

Stocks to head higher

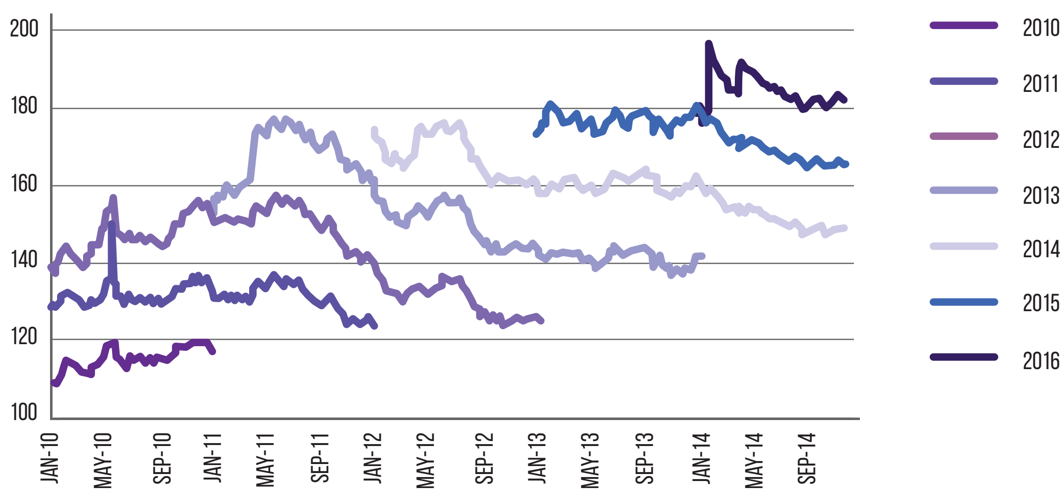
- An environment of positive growth, low inflation and accommodative central banks should be a positive for earnings, and hence, stocks. Even as stock indices for the US, Germany, India and the Philippines all made new record-highs in 2014, more markets are likely to follow suit

Figure 1: Global GDP Growth (%)



Source: Bloomberg estimates, iFAST compilations *Forcasted figures

Figure 2: Asia ex-Japan Earning Forecasts



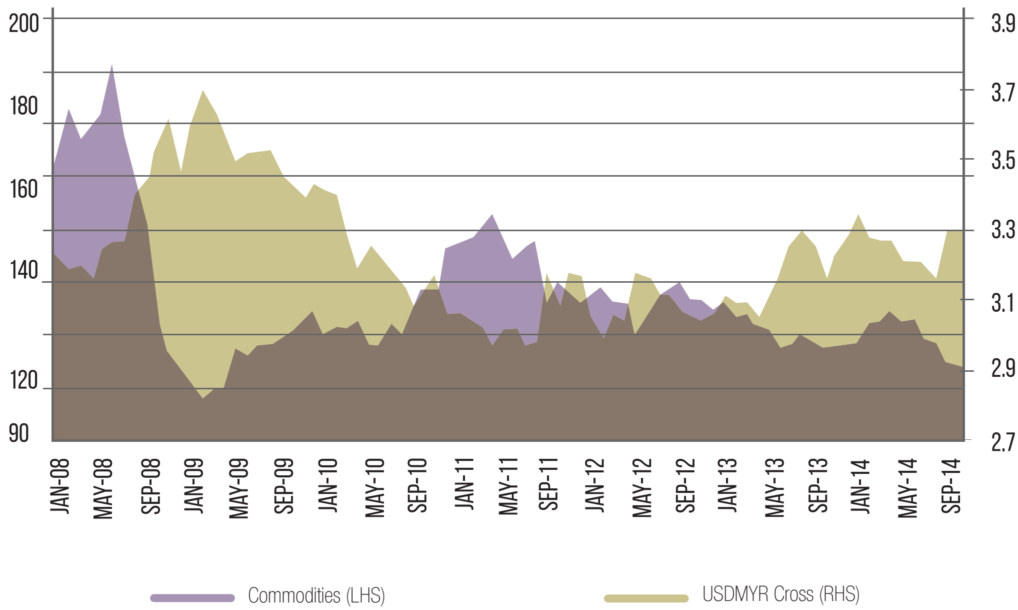
Source: Bloomberg estimates, iFAST compilations

as corporate earnings continue to grow. Modest interest rate hikes are likely to have a minimal impact on stock market valuations, with higher developed market valuations likely to be sustained on a continuation of low risk-free rates. For Asian equities, a turnaround in the earnings revision cycle should be a key catalyst for valuations to mean-revert from their low current levels – the North Asian markets are expected to do some heavy-lifting to allow the Asian benchmark index to head back towards its 2007 highs.

Return expectations tampered

- With returns for developed markets like the US, Europe and Japan over the past few years outpacing the rate of earnings growth, valuations have already normalised to fair levels, which means stock markets will require earnings to continue growing to post a reasonable rate of return for investors. As in our outlook for 2014, investors looking for strong double digit returns in 2015 from a well-diversified portfolio of global equities (with a fairly large allocation to developed markets) may be disappointed, with stock returns expected to track earnings growth much more closely going forward. In the fixed income

Figure 3: Correlation between USD and Commodities



Source: Bloomberg, iFAST compilations. Commodities: Bloomberg Commodities Index

space, historically-low yields mean return expectations are low, although stabilising risk-free rates mean investors could see decent returns from credit spreads, like in the case of high yield debt, Asian bonds as well as Emerging Market debt.

Don't underestimate the value of active management

- Following strong returns for both stock and bond markets over the past few years, investors have gravitated towards passively-managed investments, with Morningstar data suggesting that passive mutual funds in the US have taken a 75% share of net flows over the past year (ending September 2014). With bond yields at historically-low levels and selected equity markets trading at or near all-time highs, we think actively-managed investments are more appropriate, with active stock-pickers able to shun more expensive stocks in favour of more attractive ones, while interest rate uncertainty coupled with historically-low rates means credit selection, currency expertise and a more flexible positioning should aid in driving fixed income strategy returns to a greater degree going forward.

A strengthening USD presents headwinds for commodities…

- Commodity prices and the USD have increasingly become negatively correlated in recent years, with the recent strength in the USD coinciding with the lowest commodity prices since early-2009. Commodity prices have declined -50.5% from their 2008 all-time highs (as of end-October 2014), and with the consensus already expecting a stronger USD, it may appear that commodity prices could remain under pressure going forward.

…but investors should be wary of blindly following conventional wisdom

- However, investors should note that just like forecasting currency movements, guessing which way commodity prices are likely to move is an incredibly difficult art; we refrain from doing both, and would prefer to focus on the positives of lower current commodity and energy prices - this should boost consumer spending and ease budget and fiscal deficits for countries which have significant fuel subsidies and substantial energy imports. Just as importantly, we would caution against mounting expectations of an ever-strengthening USD – the currency has already posted strong appreciation in 2H 14 while selected Asian and EM currencies are already trading at multi-year lows against the greenback.

What should investors do?

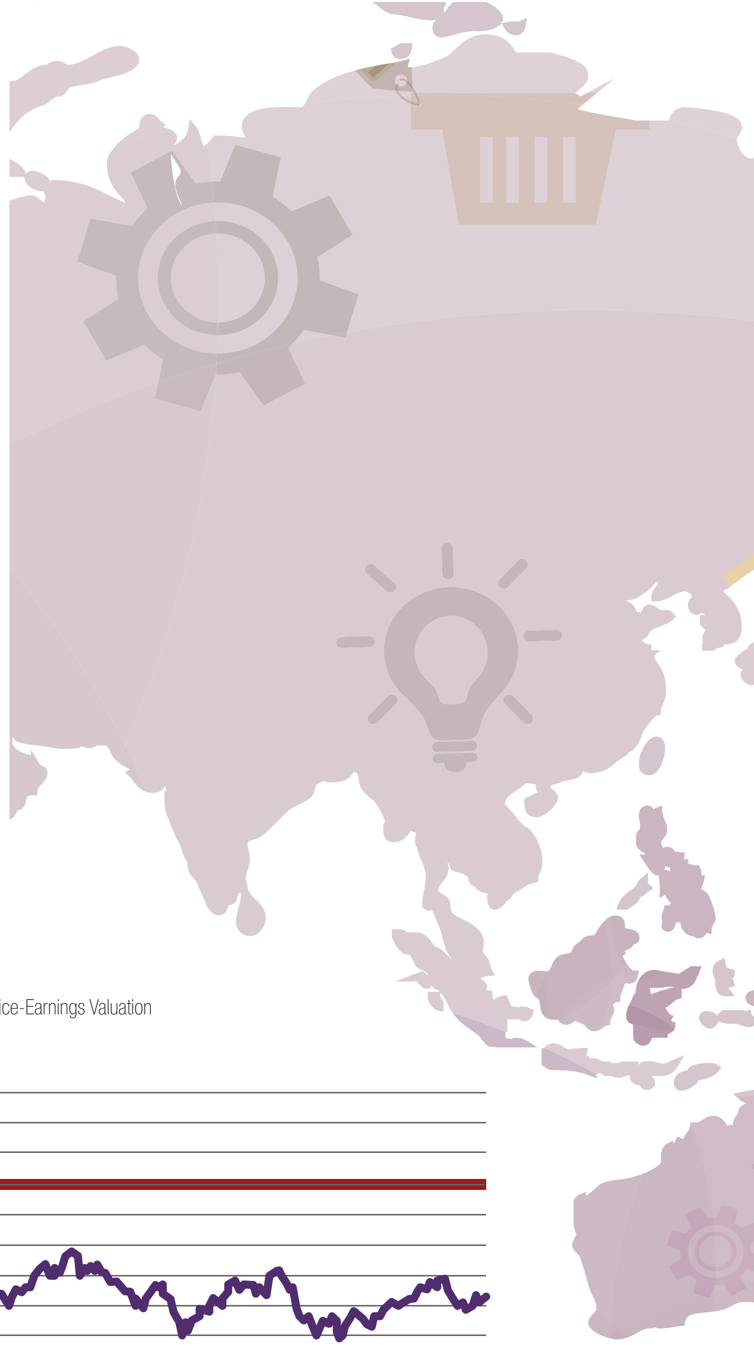
Overweight equities vis-à-vis bonds

- For a seventh year in a row, we think investors should favour equities over bonds. Our preference for equities is predicated on continued earnings growth amidst fairly modest inflation and generally accommodative monetary policy which should be supportive of economic growth.
- Bond yields still remain near historical lows, an indication of the low expected returns which characterise the asset class. With interest rates yet to normalise, we think that it is still too early in the cycle to turn positive on fixed income, despite low anticipated inflationary risk.

“Just as importantly, we would caution against mounting expectations of an ever-strengthening USD – the currency has already posted strong appreciation in 2H 14 while selected Asian and EM currencies are already trading at multi-year lows against the greenback”

Figure 4: Asia ex-Japan: Price-Earnings Valuation

Source: Bloomberg, iFAST compilations as of 17th November 2014



- Admittedly, valuations for selected developed markets have normalised, although we expect earnings growth to drive the majority of returns for these equity markets; cheaper Emerging Market and Asian equity markets may provide heftier gains as their valuations mean-revert.

Continue to favour Asia ex-Japan equities

- Corporate earnings disappointments have been a feature of Asian equity markets since 2011, which has weighed on stock performance in the region. The stabilisation in China/Asian GDP growth alongside marginal improvements in developed market growth rates should promote a recovery in Asian earnings and forecasts; 2015 could finally be a year of upward-revisions for Asian earnings.

- With a 4.4% total return (in MYR terms, as of 20 November 2014), Asia ex-Japan equities have kept pace with global equities so far in 2014, although tepid gains are reflective of the disappointing earnings growth the region's stocks are expected to deliver in 2014 (presently running at about 3%). Nevertheless, at just 12.7X 2014

Figure 5: China: Price-Earnings Valuation

Source: Bloomberg, iFAST compilations as of 17th November 2014

earnings, Asian equities remain undervalued at this juncture (see Figure 4), and we believe that a recovery in the earnings revisions cycle for Asia ex-Japan equities will be a key catalyst for Asian equity valuations to mean-revert higher. A normalisation to 14.5X PE would see the market deliver a 21% annualised return by end-2016 (or nearly 50% upside on a cumulative basis, including dividends).

Developed markets still necessary for portfolio diversification

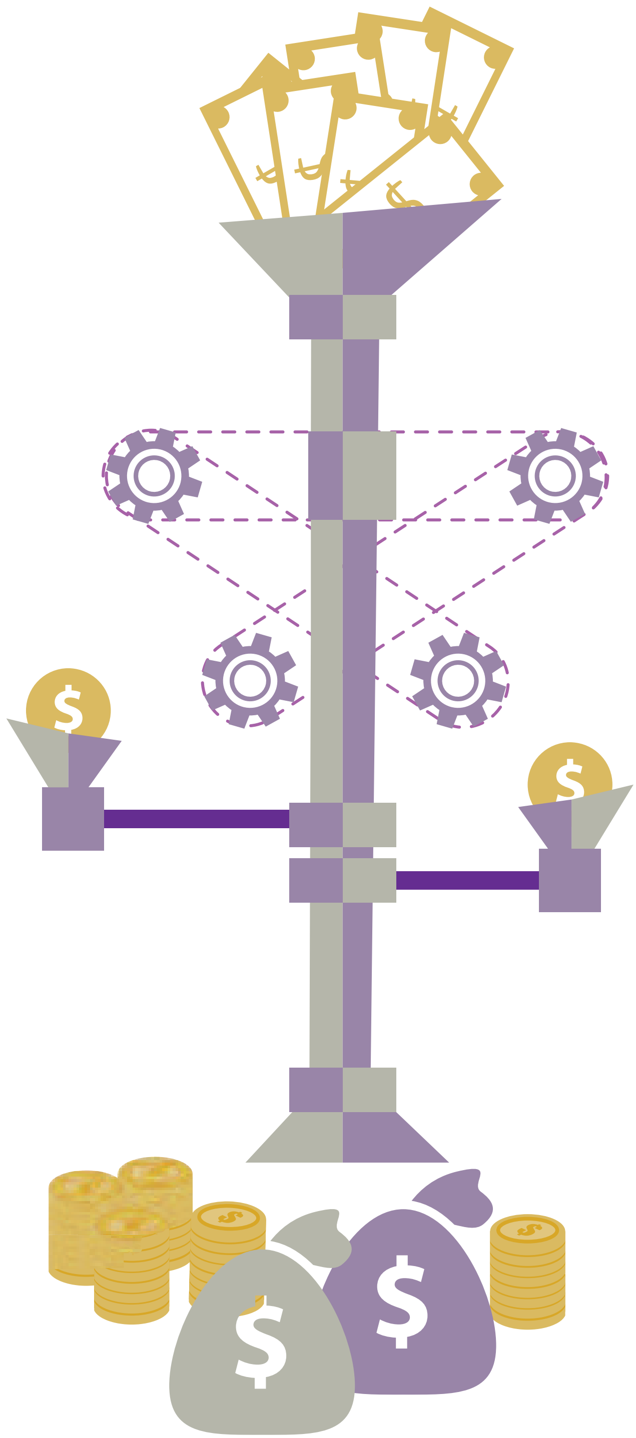
- Our forecasted returns for developed markets like the US and Europe have fallen in 2014 on higher valuations, which has seen us lower our ratings on both markets to "neutral" in mid-2014. Despite the lower potential upside for both markets, we still expect both markets to deliver fairly reasonable (single-digit) returns for investors, in line with the pace of earnings growth in the absence of valuation gains. Also, both markets remain home to some of the largest companies which have global businesses with operations spanning across the world, allowing them to benefit from growth outside of their respective regions while diversifying revenue and profits geographically. We continue to advocate an allocation to developed markets for portfolio diversification purposes, with the expectation that 2015 should be another year of positive earnings growth for developed market companies.

China is still cheap

- We had perhaps called for a rebound in China a little too early, as the world's second largest economy remains in a transitory stage of "rebalancing" from a more export/investment-driven economy towards a consumption-led economy. From a peak of 14.2% GDP growth in 2007, China's economy has moderated to 7.3% growth in 3Q 14, while the consensus has now adjusted down 2015 and 2016 estimates to a 7% rate. Such a drastic moderation in growth rates alongside the ongoing anti-corruption crackdown has had profound effects on the corporate sector; like Asian earnings, China's corporate earnings have been on a trend of disappointment in recent years.
- Critically, the pace of earnings downgrades for China equities has slowed in 2014 alongside a moderation in GDP forecasts, which sets the stage for 2015 to be a year of outperformance for the China equity market. Valuations remain very undemanding at this juncture; China equities trade at just 9.2X 2014 earnings (as of 17 November 2014), a long distance away from the 13X fair PE we attribute to the market (see Figure 5). On our estimates, the China equity market is on track to deliver a 33.6% annualised return by end-2016, driven primarily by an expansion of the market's PE ratio.

Seek out riskier bonds for better returns in fixed income

- Despite our suggestion to underweight fixed income, we maintain that fixed income remains an integral and relevant part of an investor's portfolio. While uncertainty surrounds the actual timing of Fed rate hikes in 2015, we expect muted inflation to contribute to a more gradual rate hike cycle, which could contribute to more stability in bond yields in 2015.
- Nevertheless, yields on safer fixed income instruments like G7 sovereign bonds remain unattractive at this juncture (and are also expected to be hurt more should the Fed hike rates quicker-than-anticipated). In the current environment, we prefer High Yield bonds, which now sport a fairly attractive spread over similar maturity Treasuries



(the spreads have widened since our cautious note on the sector early this year. Asian and EM debt have had a decent run in 2014, but still sport rather decent spread levels over risk-free securities, while Asian High Yield bonds still offer some of the highest potential returns in fixed income today, albeit with higher credit risk.

- For investors seeking lower risk alternatives in fixed income, we think our long-standing preference for short duration bond funds still makes sense, despite the asset class now becoming a consensus favourite. While we expect a gradual hike in rates in 2015, longer duration risk-free bond yields still offer little in terms of an additional yield to offset the possibility that rates may rise quicker-than-anticipated, making the short duration space a far more desirable fixed income segment to be in.

Commodity-related equities are cheap, but difficult to price

- Investors may feel that commodity-related equities are cheap at this juncture; as an example, gold miners in the NYSE Acra Exchange Gold BUGS index have declined -73% from their 2011 highs, and presently trade at a PB ratio of just 0.77X (as of 17 November 2014), down significantly from a PB ratio of 4X back in 2006. However, pricing commodity companies remains difficult given the inability to forecast commodity price changes; unless investors have a strong conviction on the future direction in commodity prices, it can be difficult to assess the attractiveness of these companies.

- This is also evident in our view on Russia, which has been hammered by EU and US sanctions following Putin's "exploits" in Ukraine. A weaker rouble has hurt returns for investors so far in 2014, although Russian exporters are likely to benefit from rouble depreciation. At a PE ratio of just 4.9X 2014 estimated earnings, the Russian market is one of the cheapest markets anywhere in the world. However, materials and energy companies have a fairly large representation within the Russian index, which adds significantly to the uncertainty in Russian corporate earnings forecasts; we have thus elected to keep our 4.0 star "very attractive" rating on the market as opposed to upgrading the market on performance weakness

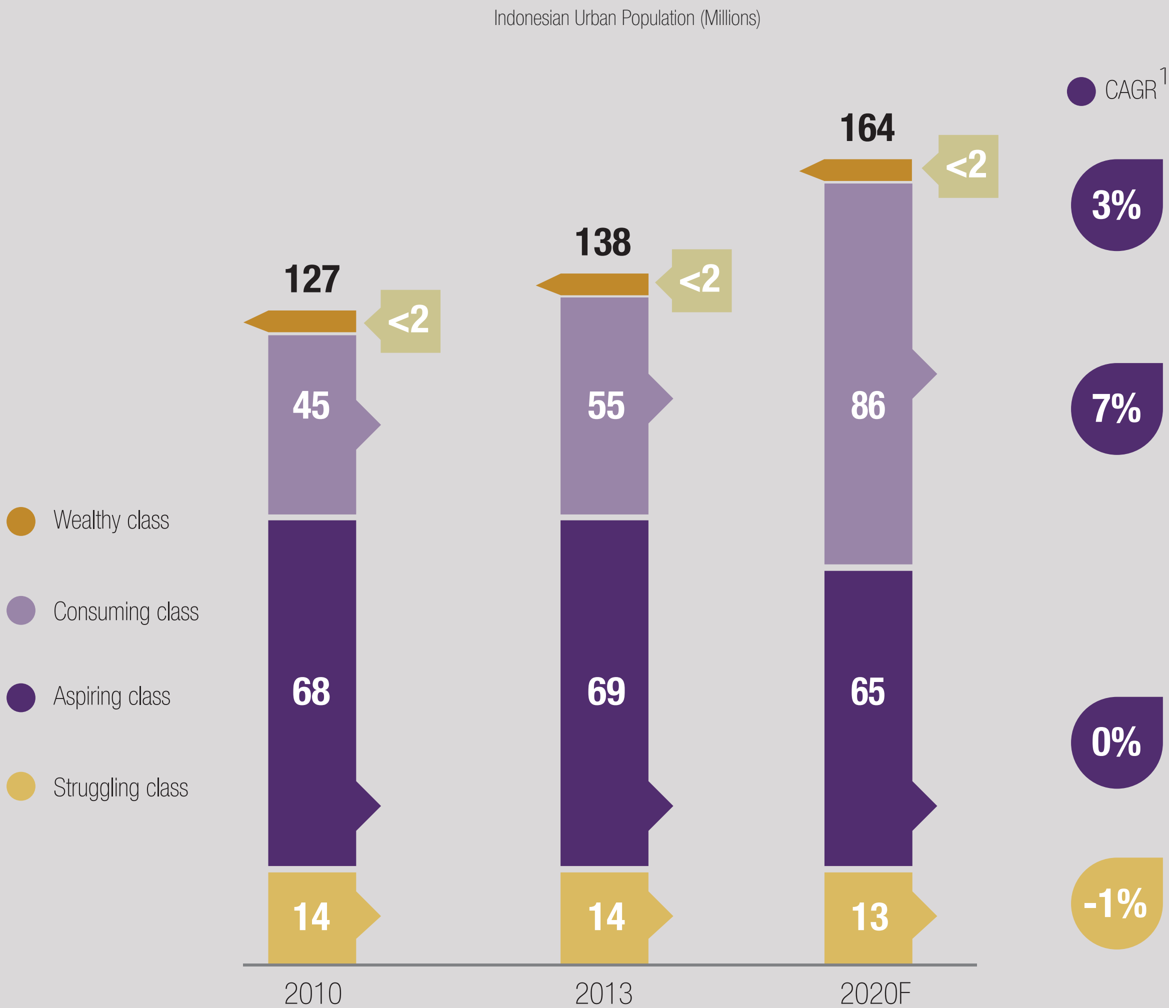
"While we expect a gradual hike in rates in 2015, longer duration risk-free bond yields still offer little in terms of an additional yield to offset the possibility that rates may rise quicker-than-anticipated, making the short duration space a far more desirable fixed income segment to be in"

Indonesian Optimism

By Tek Khoan Ong, CFA
Senior Executive Vice President
Managing Director
Templeton Emerging Markets Group

As investors in Indonesia, we think there is much to be excited about. Indonesia has a large and young population that is fast-urbanizing and hence, fueling growth in income and consumption. It has the world's 4th largest population of more than 240 million (5th largest considering the European Union as a whole, as of 2013), more than 40% of which are younger than 25 years old.[1] Indonesia's resource-rich economy is the 16th largest in the world, and it could become the 7th largest by 2030, if the economy's GDP growth trend of 5-6% per annum continues.[2] Indonesia's urban population of 110 million alone is expected to increase to over 200 million by 2030[3] and consumer spending is increasing rapidly among the estimated 45 million middle-income Indonesians.[4] It means by 2030, Indonesia's economic strength could even overtake the economies of all EU countries, including Germany and the United Kingdom.

T1. The World Bank, 2013 data.
2. The World Bank, GDP (current USD$) 2013 data.
3. McKinsey & Co., "The Evolving Indonesian Consumer," November 2013.
4. Ibid.



1 Compound annual growth rate for 2010-2020 (Forcast) Source: McKinsey Consumer Insights Indonesia, 2013

As the largest nation in Southeast Asia by population, we believe Indonesia's growing prosperity will benefit the region as a whole.

High Hopes for The People's President

Voted in as the "People's President" based on his humble background and his strong track record as Mayor of Solo and Governor of Jakarta, there are high expectations that President Joko Widodo (or "Jokowi" as he is popularly known) will be able to replicate his successes in those cities nationwide. We believe he has his heart and intentions in the right place and has a good core team to help him, but there will likely be speed bumps along the way. Regarded as a political outsider, Jokowi faces a number of challenges, which include dealing with his own party, the Indonesian Democratic Party-Struggle (PDI-P), and a fragmented Parliament. A case in point is the selection of his Cabinet; a practical combination and one of the stronger governance teams in years—but with some members not his first choice. Then there are issues of corruption and a slowing economy with a twin (fiscal and current account) deficit. But Jokowi's biggest challenge is probably meeting the expectations of the Indonesian people.

Fuel subsidies, one legacy of former President Suharto, have been a subject of hot debate within the new regime. Fuel subsidies total about US$20-25 billion a year, or roughly 20% of Indonesia's budget, compared with just about 10% for infrastructure and 5% for health care.[5] The fuel subsidy, when introduced, was meant to benefit the poor, but it has also benefited the rich so it is a blunt tool. In our view, reducing fuel subsidies should help Indonesia reduce its fiscal deficit and better allocate funds for much-needed reforms in infrastructure, health care and education. There had been previous fuel price hikes in fiscal years, 2005/2006 and 2008/2009, as well as most recently in 2013. Such price hikes have been accompanied by monthly cash subsidies to the poorest households for 2-9 months. In our view, any political fallout from such a reduction or removal should be temporary, especially given the president's popularity and his ability to engage the masses.

Corruption and Bureaucratic Inefficiency: More Work to Be Done

Indonesia has made inroads in addressing corruption with the establishment of the anti-corruption commission, officially named Komisi Pemberantasan Korupsi (KPK). Established by law in 2002, the KPK is modeled after Hong Kong's Independent Commission Against Corruption (ICAC). KPK has prosecuted hundreds of cases with an excellent success rate, including successful cases against the Chief Justice of an Indonesian constitutional court, and the police inspector-general. Prominent businessmen, Ministers and even former President Susilo Bambang Yudhoyono's son have not been immune to investigation. We think much still needs to be done, as law enforcement is weak and coupled with regional autonomy, widespread corruption continues. We believe President Jokowi will need to continue supporting and strengthening the efforts of the KPK. Recognizing that reducing corruption will require a change in mindset, President Jokowi is introducing a mental revolution in the education system, whereby the emphasis from a young age and in primary school will be on character building.

Addressing bureaucratic inefficiencies will need to take several forms, in our view. These include hiring capable people and putting in place a merit-based performance appraisal system, including better accountability and key performance indicators, as well as impromptu visits from senior officials, more online systems to improve transparency and fairness, and budget allocation based on targeted priorities.

The Investment Outlook

The Indonesian stock market has been performing quite well this year on the heels of strong performances in 2013, some of which has been tied to reform optimism with the new regime. President Jokowi is a change from all past Presidents since Indonesia gained independence in 1945. Hence, we think some degree of optimism is justified, although as mentioned earlier, it will not be without hurdles. Given the performance of the market, it is indeed more expensive today than a year or two ago. However, we do not believe Indonesia's market is overvalued yet, provided the macroeconomic environment remains stable.

We are finding potential investment opportunities in many sectors that benefit from existing demographics and expected reforms. These includes banks, which lend to both fast-growing corporates and provide mortgages, credit cards and other retail banking products to consumers, and companies in the consumer, resources and infrastructure-related sectors.

We also think there is room for equity investing to grow its domestic base. Indonesia historically has had high interest rates and inflation rates. As such, many Indonesians prefer to leave their savings in cash and deposits given the high returns, or invest them in properties as an inflation hedge. The fact that many Indonesian investors lost money in the stock market during the Asian crisis in 1997-1998 did not help the perception of the equity asset class. While equities may come with volatility, we think this is an attractive asset class over a mid - to long-period of time. For instance, over the past 10 years, the Jakarta Composite index (JCI) has delivered an annual return in US dollar terms of just under 20% per annum. 6 We believe that with more investment education, a younger investing community, and a lower and more stable interest rate and inflation environment, there will eventually be more interest in equities, and in Indonesia, among the global investment community at large.

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5. The World Bank, “Economic Premise,” March 2014. Based on 2012 data.
6. Jakarta Stock Exchange Composite Index. Indexes are unmanaged and one cannot directly invest in an index. Past performance does not guarantee future results.

Tepid Growth but Better Than 2014

By Lynn Lim

Economists to keep close watch on China's economic growth that is widely expected to decelerate gradually amid a deliberately engineered shift in growth drivers and development strategies.

The positives may outweigh the negatives in most economies in Southeast Asia next year, even as China looks to be downshifting to its slowest growth since 1990s.

Prospects for emerging economies in this region look supportive, with steady growth projected next year, helped by a combination of stronger demand from advanced economies, and relatively expansionary policies in Southeast Asia. Japan's recent additional quantitative easing to ease deflationary pressures in its economy lent a positive sentiment for markets around the world as well.

But a weaker pace of expansion in China, the largest trading partner for most Southeast Asian economies, may cast a pall over the region's economies. While China's current GDP numbers would be the envy of other nations, they pale in comparison to its remarkable period of double-digit growth.

China's trade data in September showed industrial output expanded at its weakest since the 2008 Global Financial Crisis, prompting the World Bank to lower its forecast for growth in the world's second-largest economy in the world. The World Bank, in its October forecast, tipped China to expand 7.2% next year, compared with a previous project of 7.55%.

"That doesn't mean Asia's growing dominance in the global economy will fade. On the contrary, it will accelerate. Even with slower GDP growth, the time it takes for Asia to "put a Germany on the map" will grow shorter and shorter," David Carbon, the Managing Director for Economic and Currency Research at DBS Bank said in a market strategy report.

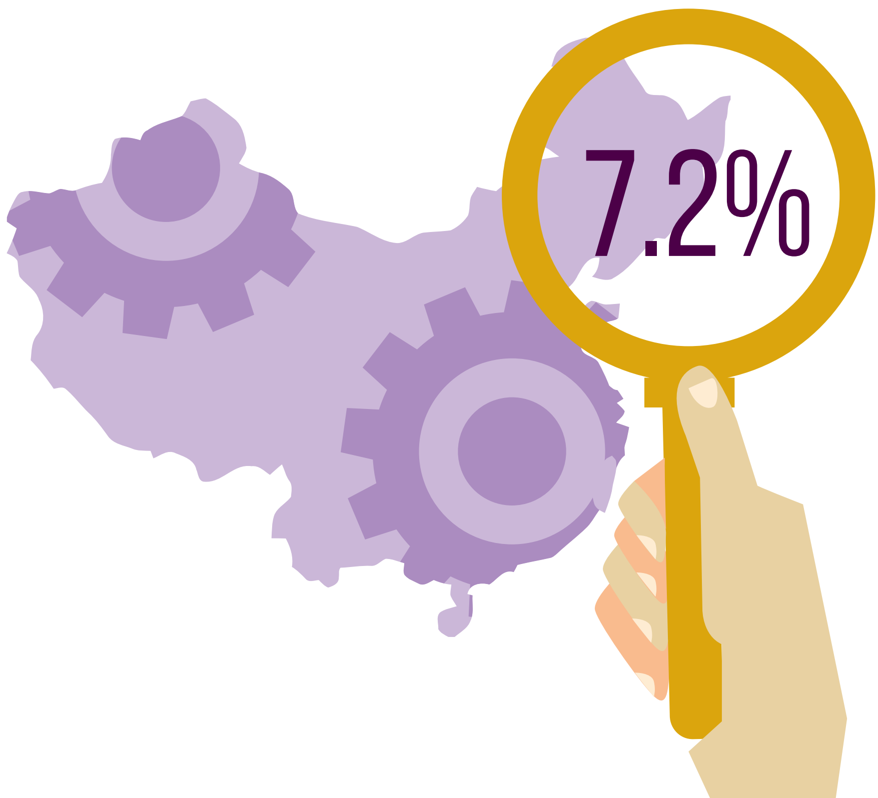
> "China's trade data in September showed industrial output expanded at its weakest since the 2008 Global Financial Crisis, prompting the World Bank to lower its forecast for growth in the world's second-largest economy in the world. The World Bank, in its October forecast, tipped China to expand 7.2% next year, compared with a previous project of 7.55%"

Nevertheless, close attention will be paid to the world's second largest economy after the U.S., and as its government implement crucial fiscal and financial reforms to better safeguard against future risks.

For the region, economists at World Bank and Asian Development Bank expect growth to accelerate to 5.3% in 2015, up from their 2014 forecasts of 4.8% and 4.6%, respectively. "Better performance in the major industrial economies and Thailand's recovery from its slump will spur Southeast Asian growth to 5.3%," the ADB said.

Malaysia's Prospects in 2015

Since the beginning of the year, the Malaysian economy has charted remarkable economic performance, with gross



domestic product (GDP) growth topping 6% for two quarters. This is attributed by strong exports, foreign direct investments and robust domestic consumption.

But Malaysia's macroeconomic headwinds are likely to dampen the economy in 2015, with inflation expected to touch 4% as the country seeks to restore fiscal balance through fuel and electricity subsidy rationalisation, and the implementation of Goods and Services Tax (GST) in April. For 2015, GDP growth is projected at 5.3%, compared with this year's forecast of 5.8%.

"We believe domestic demand momentum is likely to remain moderate with policymakers continuing on fiscal consolidation efforts as well as fixed capital expenditure (capex) momentum normalising from the spurt in the initial days of the Economic Transformation Program," Morgan Stanley Research said in a report, adding that it expects further narrowing in Malaysia's fiscal deficit target from 3.5% of GDP in 2014 to 3% in 2015.

In the face of rising inflation, Malaysia's central bank will likely avoid further policy rate hikes at least in the first half of 2015, which could pave the way for a trading window for ringgit bonds.

Elsewhere in Southeast Asia

Expansionary government policies have largely helped markets in Southeast Asia avert a major slowdown, despite concerns about growth in advanced economies in Europe and Japan, which is taking a longer time to recuperate from the debt-fuelled crises in the U.S. and Europe.

The July election of pro-reform and business-friendly Joko Widodo as Indonesia's President came at a time of weaker economic performance, owing to tighter monetary constraints and a ban on the shipments of unprocessed mineral ores.

As such, Indonesia's performance in 2015 will hinge on President Widodo's government to pursue key structural reforms to improve business climate and make Indonesia more competitive in the long run. "At this juncture, we think that [Indonesia's] GDP growth may underperform the 6.5% potential for at least a couple of years to come," DBS's Carbon said.

It is hardly surprising that Thailand remains as the weakest economy in Southeast Asia after the Thai army seized power in a couple following months of implacable political protests. The political turmoil within the country has stifled growth and

subdued business activity, with the Finance Ministry trimming this year's GDP estimate to 1.4% from 2.0%, although it forecasts a recovery in 2015, with both the ministry and Bank of Thailand (BOT) pegging next year's GDP growth at 4.1% and 4.8%, respectively.

"There could be renewed pressure on the BOT to allow more weakening of the baht. Export growth is now estimated to be flat for the full-year and remain below 5% in 2015. For GDP growth to return to the normal 5% to 5.5% trend, export growth needs to bounce back to around 12%," Carbon said.

To that end, there is "probably little that the central bank can do to shape GDP growth momentum into 2015. As such, no shift in its policy stance is likely to be seen." Thai central bank has left its one-day repurchase rate at 2% since March, when the rate was slashed by 25 basis points to boost business activity.

Socially Responsible Investing to Benefit from Sovereign Sukuk Sales

By Lynn Lim

For years Islamic bankers found it tough to get non-OIC, or Organisation of Islamic Cooperation, countries to venture into Islamic finance. However, accelerated interest in socially responsible investing (SRI) and sovereign sukuk issuances in Western financial markets is turning out to be the crucial element the industry needs to boost liquidity.

This growing global sentiment on sound and ethical investments emerged in the aftermath of the Global Financial Crisis of 2008. Today, the European retail market for funds focused on SRI has grown 18% to €127 billion (RM528 billion) in the 12 months to June this year, according to a joint report on corporate responsibility assessment from Vigeo and investment researcher Morningstar released in October 2014.

“SRI is growing on a global scale and is set to grow further as a growing number of investors sign on to the United Nations-supported Principles for Responsible Investing Initiatives,” William Truscott, Chief Executive Officer, Global Asset Management, Ameriprise Financial Inc., said at the recent Global Islamic Finance Forum (GIFF) in Kuala Lumpur.

Other markets have gone through similar growth in recent years. Based on International Finance Corporation’s figures, the size of investment funds managed according to SRI criteria stood at

USD11.2 trillion, with 97% of the assets domiciled in Europe, US and Canada.

At the same time, Islamic banking has grown, from a little-known segment of financial services that adheres to Shariah principles and prohibits usury, into a global industry that is estimated to be worth USD2 trillion.

The push for ethical financing has seen Western investors increasingly considering investments in Islamic financial products due to the commonalities it shares with SRI, encouraging top financial centres like London, New York and Hong Kong to increase cross-border linkages with Islamic finance hubs of Gulf Cooperation Council countries and Asia. This perhaps, is the most significant nod to Islamic finance in non-OIC nations.

“Islamic finance has all the signs that the market is about to grow bigger and SRI is poised to be a game changer [for Islamic finance],” Truscott said.

So where does SRI and Islamic finance converge? Both segments seek to achieve ethical conviction, avoid excessive debt and social inclusion; all of which are relevant globally.

Therefore, creating linkages between Islamic finance and SRI is needed. Financial regulators in Malaysia took a proactive approach, a move that started with the release of a SRI sukuk framework announced by the Securities Commission at the end of October this year.

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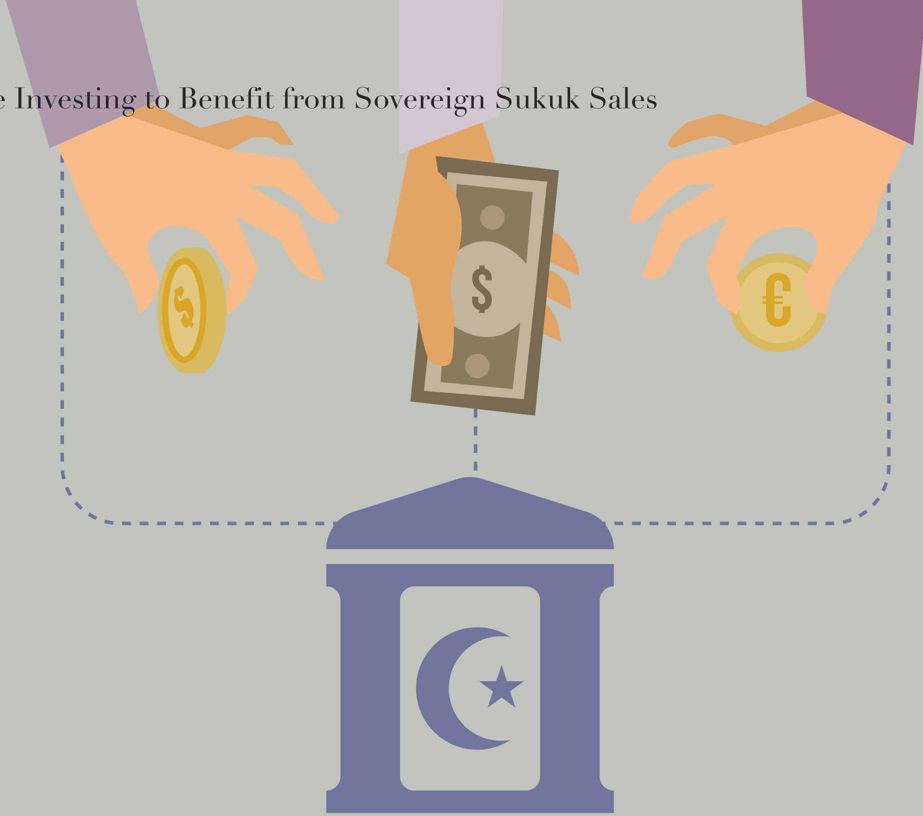

"The new framework will facilitate and encourage the issuance of sukuk to raise financing for Shariah-compliant projects that fulfil the responsible innovation criteria and enable investors to participate in such projects, thus potentially growing the size and improving the depth and liquidity of the Islamic capital market," said Nik Ramlah Mahmood, Deputy Chief Executive at Securities Commission Malaysia at the International Capital Market Forum held in conjunction with GIFF.

Sustained Growth in Sovereign Sukuk Issuances

The most recent financial crises in developed markets, a consequence of unbridled financial engineering and large disconnect between the financial system and the real economy, underscored the need for reforms to enhance the resilience of global financial systems. This resulted in the shift towards SRI and a more socially-responsible financial system.

Given that the sukuk is in essence, backed by tangible assets, rather than by debt, a growing number of economies and corporates are turning to this segment as a viable funding mechanism. This is evident in the evolution of the sukuk market. From a basic corporate financing instrument in the 1990s, the market has evolved into a primary area of growth in Islamic finance, with over USD100 billion worth of issuances in the last two years.

This strong growth momentum is likely to be sustainable in the medium-term, according to a Moody's investor Service forecast, as "both Islamic and non-Islamic governments aim to tap increased demand for Shariah-compliant financial assets and further support their policy goals for Islamic finance."

While the size and value of sukuk issuances remain small compared to conventional bonds, there is a notable groundswell of new issuances from major non-Islamic countries in 2014, with Hong Kong the latest capital market hub after UK and South Africa to turn to the sukuk market to meet its sovereign funding needs.

Moody's estimated that total sovereign sukuk outstanding now accounts for more than 36%, or USD106 billion, of the USD296 billion of outstanding sukuk as of July 2014. It also expects sovereign sukuk issuance to reach around USD30 billion by the end of 2014, with the overall outstanding amount to reach USD115 billion. A continued expansion in the number of sukuk-issuing governments is also expected in 2015.

"[These] transactions indicate a significant change in the potential size, depth and liquidity of this market," said Khalid Howladar, Moody's Global Head for Islamic Finance.

"Investors' growing comfort with relatively complex Islamic instruments, the increasing financing needs and leverage appetites of some Islamic countries, as well as a desire for a stronger investment links with the faster growing economies in the Gulf and Asia are driving this growth," Howladar added.

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