Outlook for 2017

A shift in sentiment

9 January 2017

MACRO | STRATEGY | GLOBAL

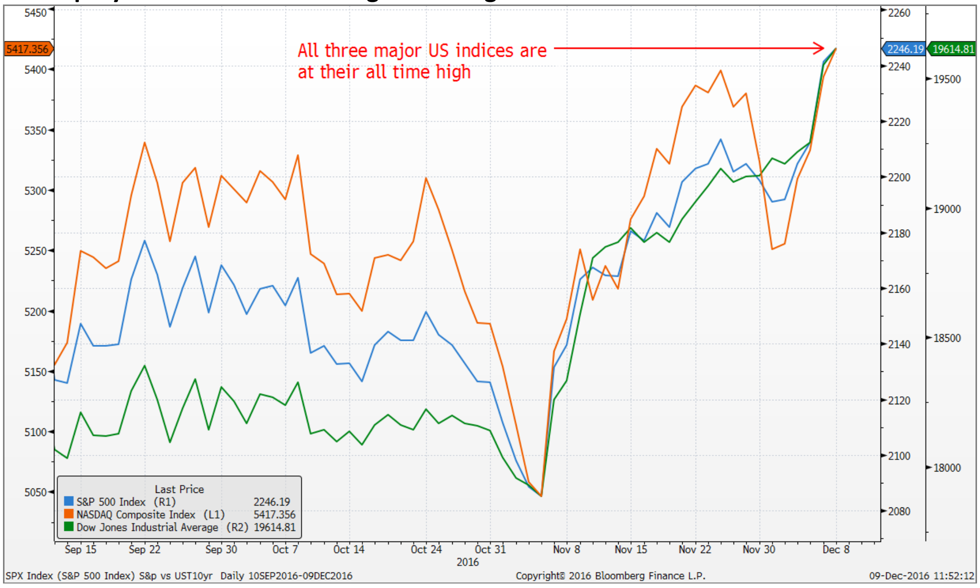
- Global growth and inflation seems to be back on track
- Sentiment has shifted and optimism is finally back in the markets
- The sentiment change should push financial markets to euphoria level
- Excess credit remains a huge risk factor
- We are positive on Russia, China equity markets and Gold in 2017

Investment Strategy

As we close the chapter on another fruitful year of investing in 2016, we look forward to 2017 with a long-awaited optimism. Even as we saw improved economic data pouring in throughout the year of 2016, we had always felt something amiss. Alas, we figured that the missing puzzle-piece was the upswing in sentiments.

The turn of sentiment has subtlety pushed the market upward. "Trumpflation" seems to be spreading its effect all over the world as global equity markets trends higher in rejoice of a U.S. led by Donald Trump. The believe of a de-regulatory financial system, a Keynesian style fiscal spending and a huge tax cut for America corporations created the almost perfect scenario for "America to be great again." All major indices of U.S. are reaching new all-time high. Europe and Japan markets have also found a bottom and has started to build momentum for an upward trend.

U.S. equity market indices making record high

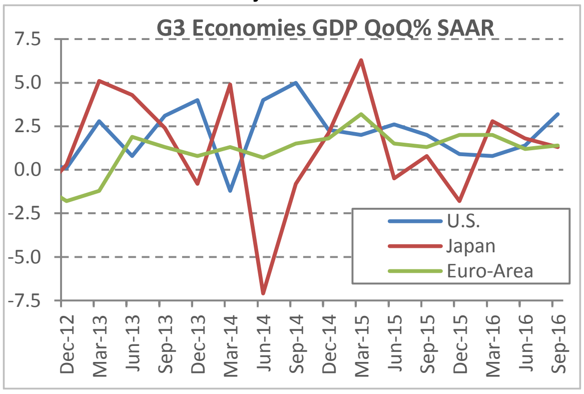


Source: Bloomberg, PSR

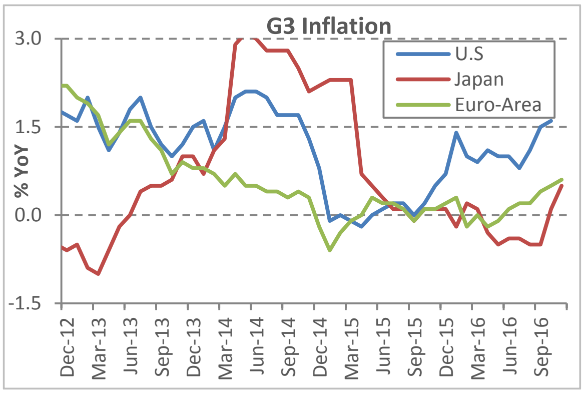
Pei Sai Teng (+65 6212 1856)
Investment Analyst
peist@phillip.com.sg

Global Economy

Growth and Inflations seems to be improving, indicating a supportive environment for markets. The G3 economies had three consecutive quarters of decent growth with no contracting quarters. Inflation, measured in terms of consumer price index (CPI), has also reversed their disinflationary trend this year with all three countries reporting positive inflation in November 2016. Removing the base effect of energy prices, core CPIs which exclude volatile energy and food prices had also been in positive territory for the year of 2016 in these three major economies.

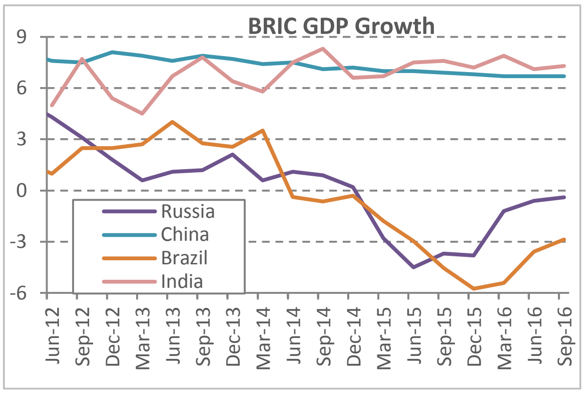


Source: CEIC. PSR

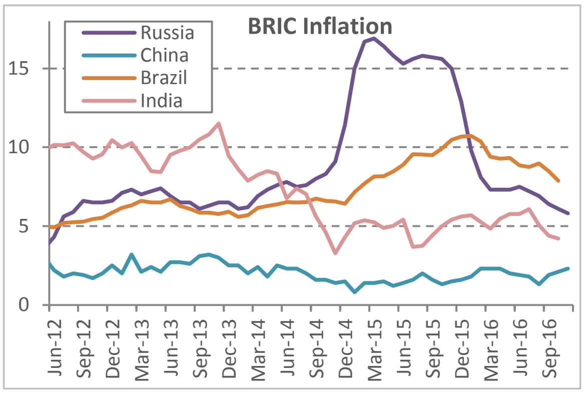


Source: CEIC. PSR

Aside from the G3 economies, other prominent economies such as Brazil, Russia, India and China (BRIC) are also showing similar supportive economies outlook. India and China led the emerging economies with GDP growth above 6%. Brazil and Russia are moving out from their recessionary period as the contraction of their economies decrease. All BRIC countries are expected to have a positive economic growth next year.



Source: Bloomberg. PSR



Source: Bloomberg. PSR

G3 economies are expected to have benign growth in 2017 and 2018 with modest inflation. China and India are expected to continue leading, in terms of growth, while Russia and Brazil should recover from its respective recession. All BRIC countries are expected to maintain a healthy inflation rate between 2% to 5%.

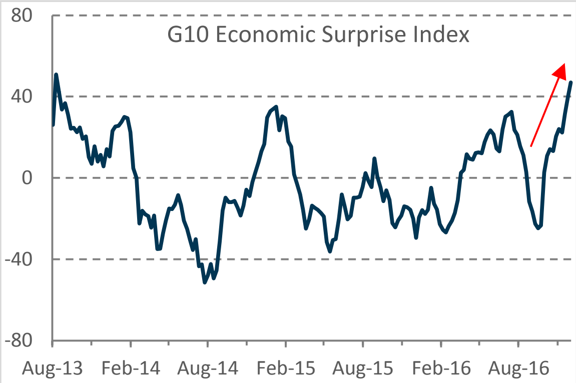
Consensus Forecasts	GDP growth (YoY%)			CPI inflation (YoY%)		
	2016	2017	2018	2016	2017	2018
United States	1.6	2.2	2.3	1.3	2.3	2.4
Eurozone	1.6	1.4	1.5	0.2	1.3	1.5
Japan	0.9	1.0	0.9	-0.2	0.6	1.0
China	6.7	6.5	6.1	2.0	2.2	2.2
India	7.5	7.3	7.6	4.9	4.8	5.0
Brazil	-3.4	0.9	2.2	8.8	5.1	4.7
Russia	-0.6	1.1	1.5	7.1	5.1	4.4

Source: Bloomberg Consensus Estimates

Confidence Game

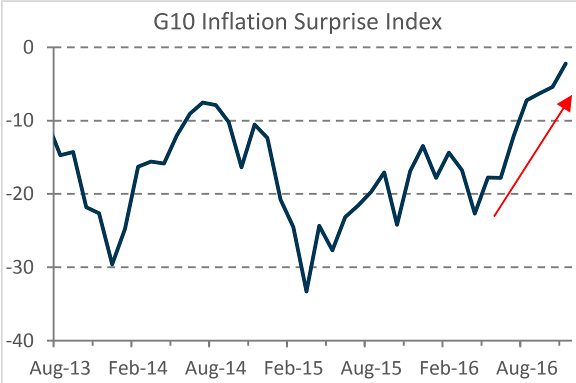
Economic sentiments have shifted as we see more positive surprise in the G10 economies and inflation expectation. Surveys on global manufacturing and service industries showed an increasing optimism on growth expectation.

G10 Economic Surprise Index is at 3 years high



Source: Bloomberg

G10 Inflation Surprise Index is at 4 years high

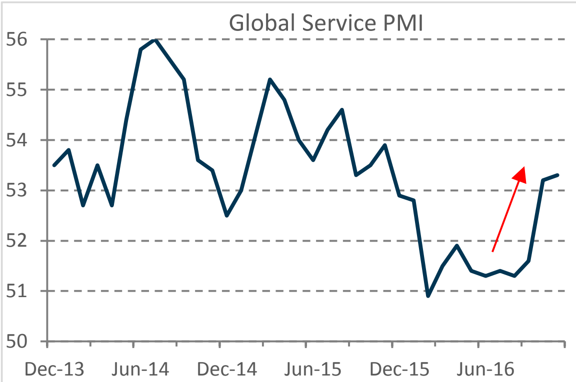


Source: Bloomberg

Global Manufacturing PMI is at 2 years high

Source: Bloomberg

Global Service PMI is at 1 year high

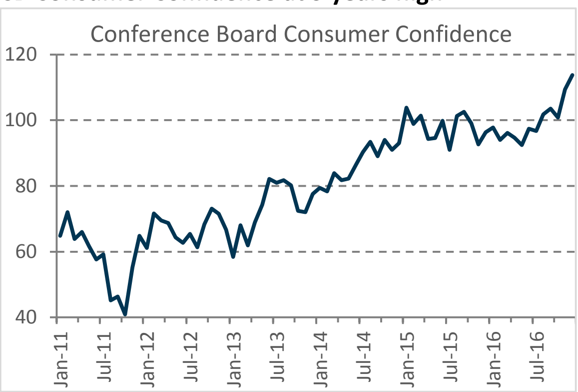


Source: Bloomberg

In view of such a sanguine economic sentiments, investors are already looking for rosier days ahead. The positivity from presidential-elect Trump's campaign promise of infrastructure spending is rubbing off in the financial markets. United State Treasury (UST) yield have spike up with the 10 year UST yield hitting a high of 2.49% from the low of 1.33% in July 2016. This risk-taking behaviour seems to imply that the markets have rekindled the "animal spirit".

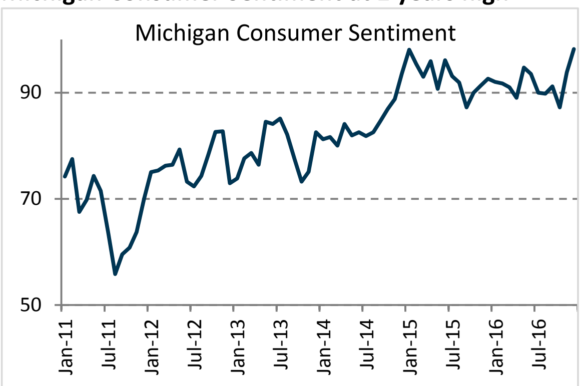
Surveys on U.S. consumer's confidence affirmed the buoyant mentality for the months ahead. These surveys are recording multi-year high.

CB Consumer Confidence at 9 years high



Source: Bloomberg

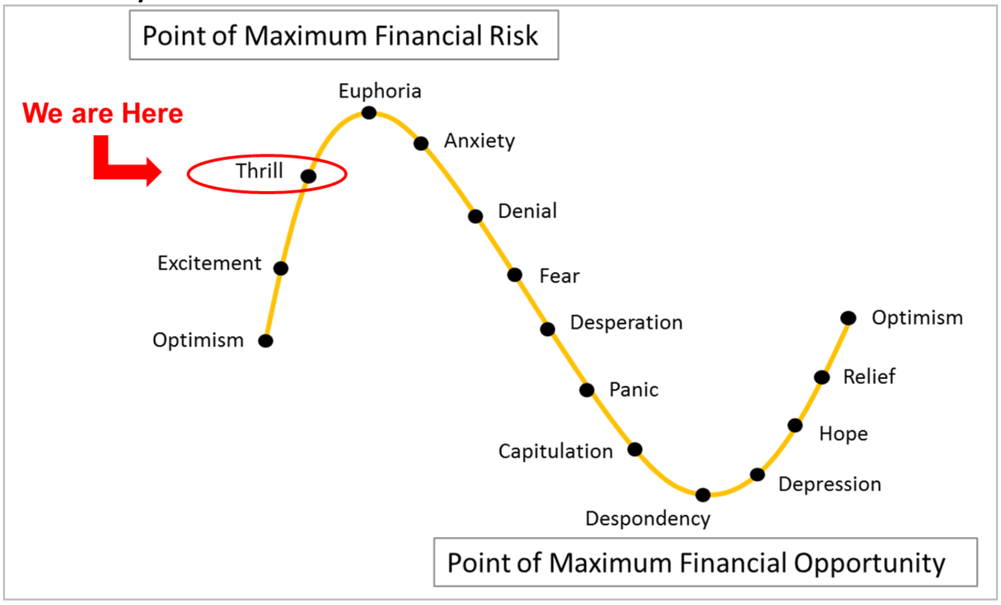
Michigan Consumer Sentiment at 2 years high



Source: Bloomberg

With good news aplenty, especially from the U.S. economic data, we are expecting markets to head towards euphoria conditions soon. Euphoria are usually associated with market peaks and we do not expect it to be any different this time round. However, the question remains on how long such euphoria can continue. The way we see it, the party might be ending soon.

Sentiment cycle of Fear and Greed



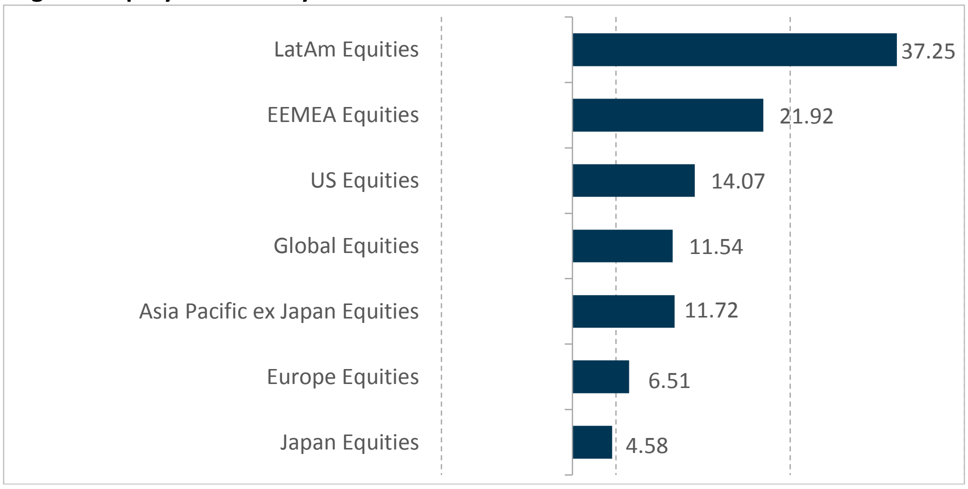
Source: PSR

Assessment and Outlook

Our assessment for the first quarter of 2017 remains neutral. We are not buying the hype on the market but we are not prepared to go against the market trend just yet. Specific country selection will be key as global equity markets have decoupled since the start of the year when correlations coefficient was high.

We saw the Latin America (LatAm) region leading the recovery from the flash crash earlier in 2016 and maintained the lead as the best region for equity market for 2016. Similar to 2016, we expect selective countries outside of U.S. to generate better returns in 2017. The only difference is that we are expecting Asia ex-Japan markets to lead equity returns in 2017.

Regional equity markets 1-year return



Source: Bloomberg, PSR

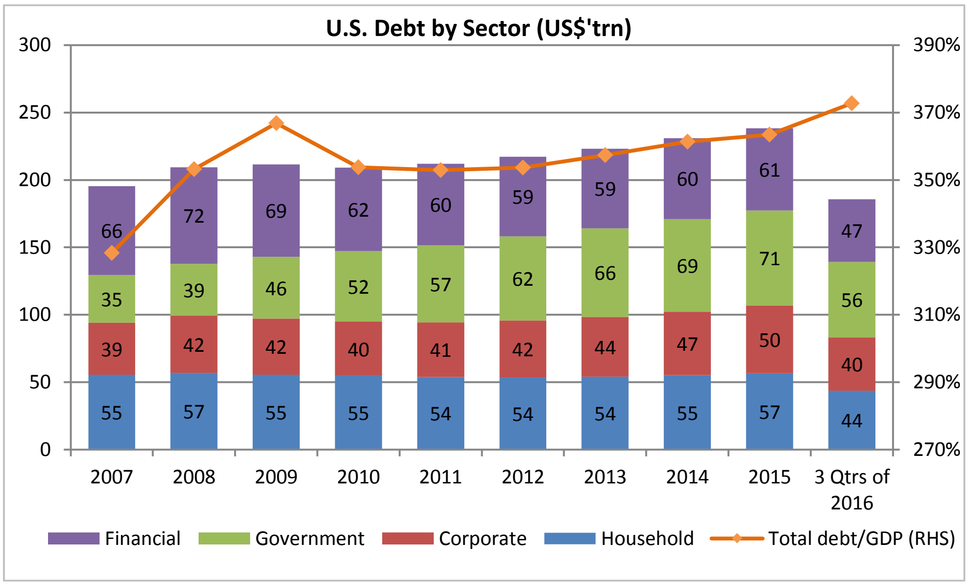
With the US Federal Reserve (Fed) raising rates for the second time in two years, we saw a net outflow of investments from the emerging markets back to developed markets, especially back into U.S. equity markets. The renewed optimism from the markets, coupled with an increase in interest rates, are pushing U.S. equity markets further into overvaluation.

Key Risk to look out for

De-globalisation seems to be the main threat for 2017, with anti-trade sentiment gaining a foothold in some of the world's largest economies. The election of Trump and the event of "Brexit" have partly reflected the protectionism mentality of their respective citizens. However, even if economic growth were to slow down due to lower trade volume, we believe its impact will be less severe for Asia. We see intra-Asia trades improving as the region move closer to a new free-trade agreement.

Excess Credit post the biggest threat

Our most immediate concern has always been the excess credit in the major economies. No doubt, U.S. households and financial institutions have de-leveraged to a certain extend but the credit binge was taken over by the federal government and Corporate America. Total outstanding debt over GDP for U.S. has grew larger than what we saw in 2009.



Source: Bloomberg, PSR

U.S. is not the only economy facing a credit problem. Euro-zone economies have yet to recover from their debt crisis in 2010 and have yet to stabilise their financial institutions. The most recent cast of the European Central Bank (ECB) bailing out Banca Monte dei Paschi, the third biggest bank in Italy, reminds us of the persistent weakness within their banking sector.

In China, the shadow banking is posting a problem for the central government and remains a major concern for foreign investors. The exponential growth of their Wealth Management Product (WMP) has compounded the complexity of their credit problem.

Throughout history, economic slowdown was never a catalyst for market downturn. In fact, market turmoil are usually a result of mismatch between fundamentals and investors' expectation. Although, an economic slowdown may not indicate a fundamental flaw, a buoyant financial markets may still represent an overstretch expectation. When fundamentals can no longer catch up with expectations, financial market will correct to the more sustainable level.

The shift in sentiment will bring temporary joy to those who have stayed invested in 2016. As always, we try to identified potential pitfall and avoid them as much as possible. We are in a unique environment whereby economies have yet to fully recover from the previous downturn but financial markets are already ahead of itself. Majority of the world governments have selected to continue on a path of ruin by selecting the easy way out with monetary easing. We believe the USD hegemony monetary regime might be ending soon and that will have a material impact on all our financial decision.

Global Asset Allocation Summary

With our known-knowns and unknown-knowns, we give our base case scenarios as to where we could possibly find our pains and gains in the markets for year 2017.

Global Asset Allocation*: Overweight Equities, Underweight Fixed Income

	Underweight	Neutral	Overweight
Equities	○	→	●
Fixed income	●	←	○
Commodities	○	○	●
Cash	●	○	○

This represent the opinion of PSR macro team as at December 2016.
The weights are relative to our model portfolio benchmarks.
**three to six months horizon*

Equities – Overweight

Equities were upgraded to overweight this quarter as the turn in momentum continues. From our technical indicators, all markets are signaling a "Green light" except for the East Europe Middle-east and Africa (EEMEA) Region and a few specific countries such as Spain, South Korea, India, Malaysia, Philippines, Colombia and Mexico.

We maintain our overweight position on equities going into next quarter on view that the continuous monetary easing from ECB and Bank of Japan (BOJ) will provide the backstop for the equity market for the time being. Furthermore, we expect expansionary fiscal spending in U.S. to benefit all markets. However, we are going to be selective in our pick for the equity markets as we are already seeing overvaluation in some of these markets.

Fixed income – Underweight

This is a crowded trade, but we are following the crowd on this trade and seek to reduce our position in fixed income. We see limited upside with the Fed ready to increase interest rate. Markets have fully priced in the rate hike with yields of 10 years UST and 30 years UST spiking.

Although credit spread continues to narrow, this may not last long with interest rate rising, a lot of the borrowing rates will be re-priced in the coming years, this may spell higher interest expenses for those highly leverage companies and we could see default risk starting to pick-up. The result will be a wider credit spread thus negatively impact bond prices.

Commodities – Overweight

We maintain our overweight view on commodities as global growth and inflation conditions remain supportive. We believe we have seen the bottom of the commodities cycle at the start of 2016 and we expect commodities to pick up from here onwards.

Cash – Underweight

With an improving global economic environment and financial markets, real return on cash will be negative with an increasing interest rate environment.

Equities Strategy

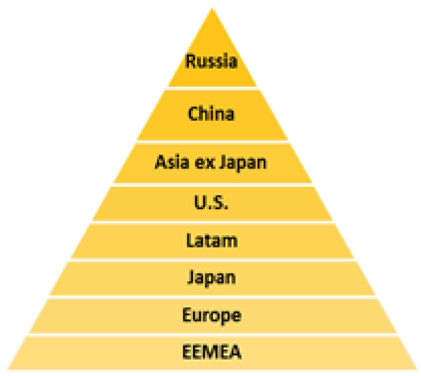
The sentiment for equity in 2017 seems to be very positive. Investors are putting on their "risk-on" trades, pushing the U.S. equity market indices to all time high. A Donald Trump presidential victory and the Fed rate hike decision have been positively reflected in the markets. We do note that there are overvaluations in some of the regional indices, especially the U.S. markets. Indices can be expensive but value can still be found in individual stocks. Therefore, stock selection will be vital in 2017.

<u>Regional Allocation: Overweight Asia ex Japan</u>

	Underweight	Neutral	Overweight
Asia ex Japan	○	→	●
Latin America	○	●	○
U.S.	→	●	○
Japan	→	●	○
Europe	●	○	○
EEMEA	●	←	○

We are slightly overweight on equity as we believe it has a relatively higher upside compared to other asset classes. The overweight on Asia ex Japan region stem from our positive view on China. The other Asia countries, especially the South-east Asia markets, are doing well relative to other emerging markets albeit an outflow of investment from emerging markets back to developed markets.

Hierarchy of Equity Markets

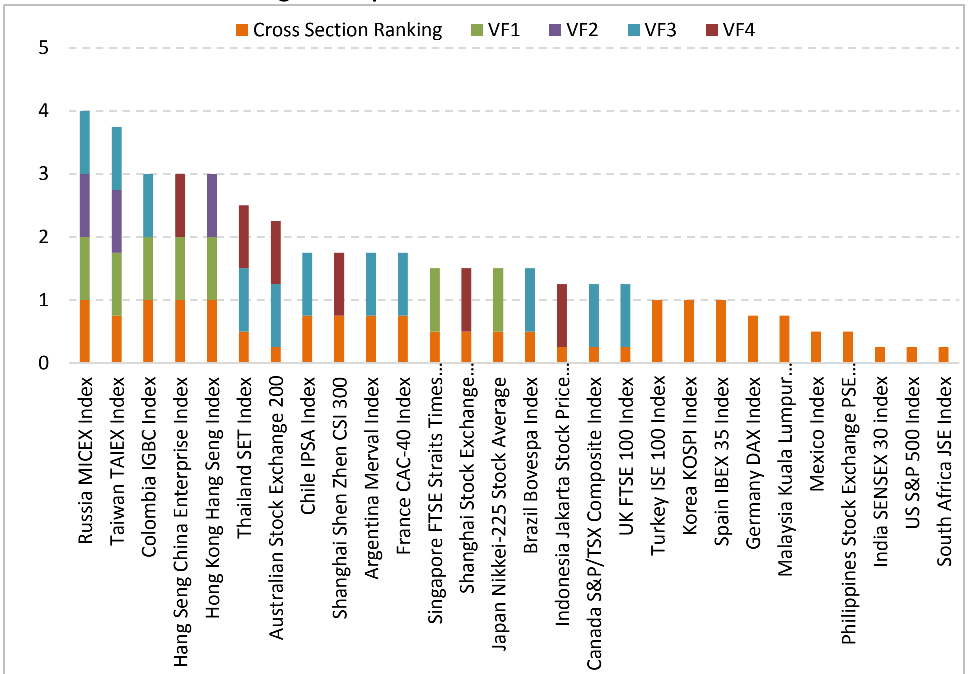


Based on PSR macro team overall investment assessment

Growth found outside US

Russia and China are single out for ranking as we found these two specific markets to be very favourable in our assessment. As we mention, the key to investment in 2017 will be in selective countries – Russia and China markets sit nicely at the cheaper end of the valuation hierarchy relative to other markets.

Overall Valuation Ranking – Cheapest on the left



Source: Bloomberg, PSR

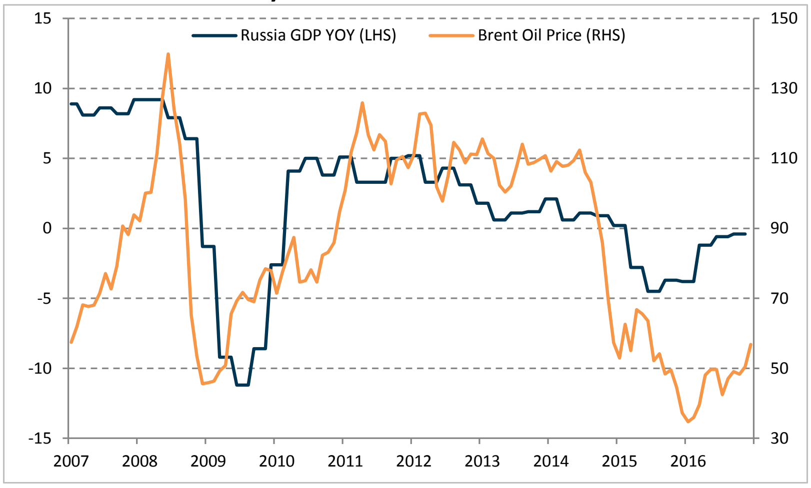
**VF denotes Valuation Factors. Includes Forward PE, EV/EBITDA, Price-to-book and Free Cashflow.*

Russia

We believe that the recovery story of Russia's economy has room to run. Russia's economy was badly hit by the sanction imposed on them by U.S. and E.U countries in 2014. Although the sanction was never officially lifted, Russia seems to have picked itself up from the initial adverse impact on its economy.

Russia's economy is closely linked to energy prices, as such, its economy got hit badly when the oil prices started falling in June 2014 to a low of US$26/barrel in February 2016. The effect of sanction and falling oil price pushed Russia's economy into a recession in the first quarter of 2015. However, with the recovery of oil prices and the impact of the sanction priced into the economy, the Russia's recovery story is very much in play.

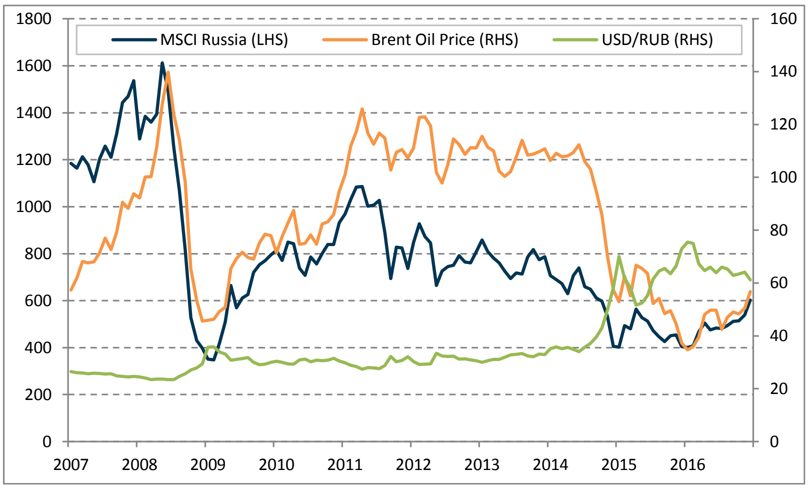
Russia GDP is affected by Oil Prices



Source: Bloomberg, PSR

Furthermore, when Russia-friendly Donald Trump gets inaugurated on the 20th January 2017, we expect to see Mr Trump's administration reversing the trade sanctions. This will give Russia's economy an additional boost in terms of trade.

Russia's equity market also suffered when the economy contracted but just like the Russia's economy, the MSCI Russia Index have reverse its down trend in tandem with higher oil prices.

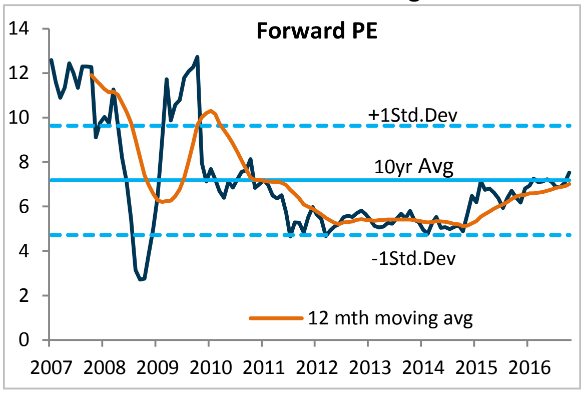


Source: Bloomberg, PSR

In terms of valuation, Russia MICEX index is currently rank the cheapest across all region. Comparing the valuation historically, it is also in a nice recovery trend. When we look at the valuation matrices, we are not only looking at the absolute value but also the trend of the valuation. We prefer to see the 12-month moving average of each matrix to be below its 10- year average and have reversed its downtrend momentum. This will be inverse for the free cash flow yield.

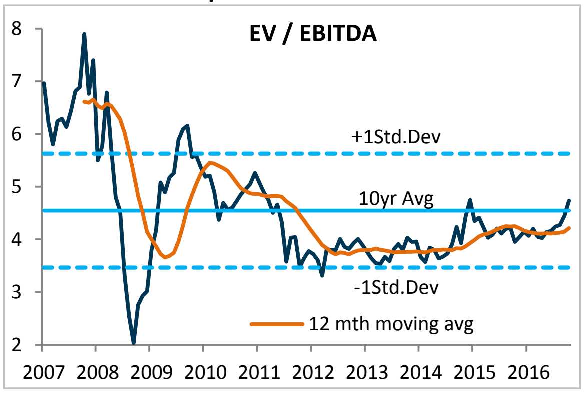
Looking at the MICEX index valuation matrices, we see three out of the four matrices in a favourable conditions.

MICEX index Forward Price to Earnings Ratio



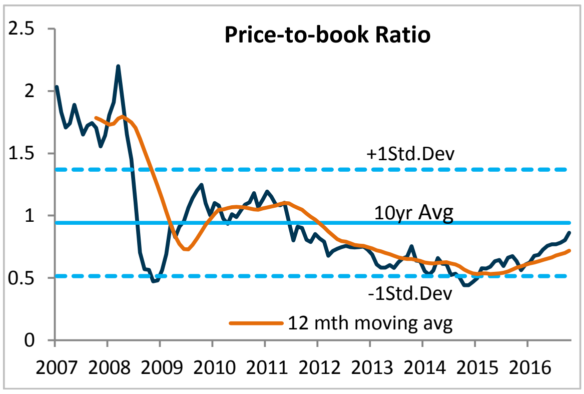
Source: Bloomberg, PSR

MICEX Index Enterprise Value over EBITDA



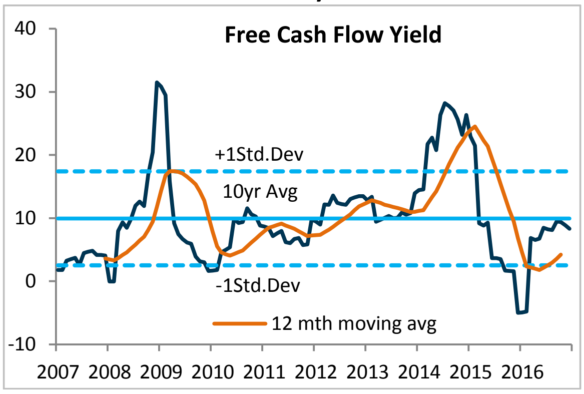
Source: Bloomberg, PSR

MICEX Index Price-to-Book Ratio



Source: Bloomberg, PSR

MICEX Index Free cash flow yield



Source: Bloomberg, PSR

China

A lot of questions have been asked about the economy of China and whether they will be able to sustain an annual GDP growth above 6.5%. We believe that the top line growth number is of a lesser importance. We are more concern on how they achieve their targeted growth.

China is now at a crossroad for their economic future. China is in a process of restructuring its economy and the loss of economic growth is inevitable when a country changes its growth engine.

China still needs to rely on trades

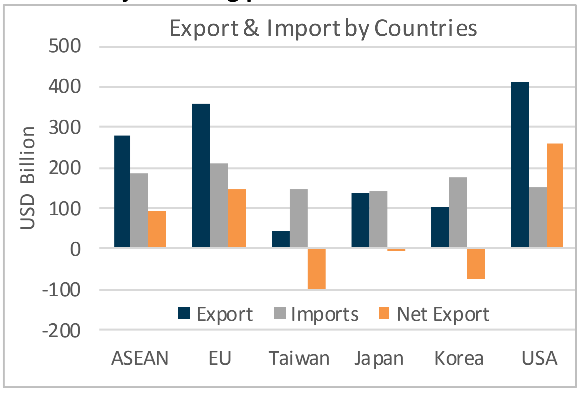
The failure of the **Trans Pacific Partnership (TPP)** can only spell good news for China. Initially, it seems that China's trade would have suffered some losses, having been left out of the negotiation of the TPP. However, with an "anti-free trade" Donald Trump as the incoming president of U.S., TPP might suffer a huge setback.

For the Asia region, the **Free Trade Area of Asia Pacific (FTAAP)** and the Regional **Comprehensive Economic Partnership (RECP)** gives the next best alternative for a trade deal. Both of the proposed free trade agreement involves China, allowing China to further assert their position as the trade leader in the region.

Notwithstanding the trade deals are still at the negotiation stage, the "One Belt, One Road" initiative taken by China in 2016 will boost international trade and economic growth within Asian region. The creation of Asian Infrastructure Investment Bank (AIIB) will give China an advocated rights to help funnel capital to projects in the Asian region.

Another important trade-related development which we will monitor closely is the proposed tariffs which Donald Trump promise to impose on all China imports. We should get a better clarity during his inauguration speech to understand if President Trump will go ahead with his promise during his presidential campaign. If the tariffs materialize, it can be detrimental for China's trade as U.S. is still the largest exporting destination for China.

China's major trading partners



Source: CEIC, PSR

China's exports to US is still expanding

Source: CEIC, PSR

Controlling capital outflow will be vital for China's capital market

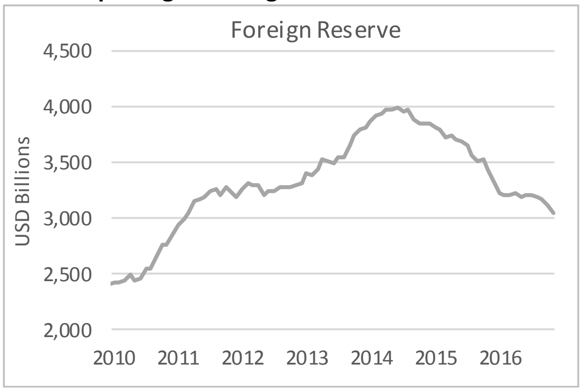
The continuous depreciation of the Chinese yuan (RMB) has caused a lot of concern for both local and foreign investors. Local investors have been looking for ways to convert their RMB holding into foreign currency amid a tightening foreign exchange regime. This had thrown China's capital market into a disarray.

In order to defend the RMB devaluation, China's central bank, the People's Bank of China (PBOC) has been depleting its foreign reserve to prevent the USDCNH from reaching the crucial 7 RMB per US dollar. However, the action had an adverse impact on the nation's capital accounts.

PBOC successfully defended the RMB from reaching 7

Source: Bloomberg, PSR

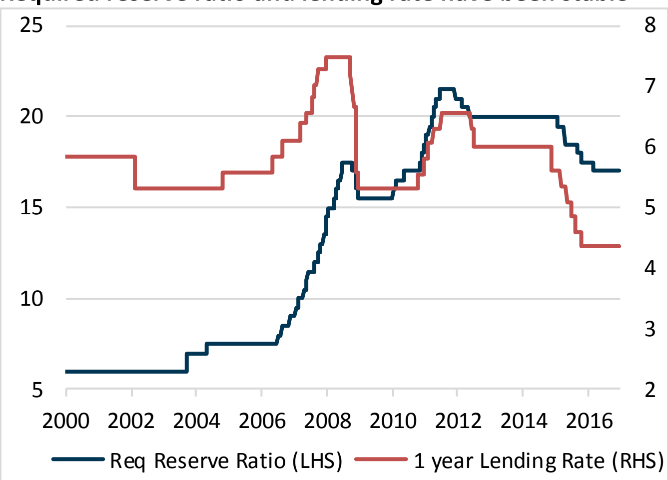
PBOC depleting its foreign reserve



Source: CEIC, PSR

The government is aware of the capital flight and have chosen not to decrease the required reserve ratio since March 2016 and maintained its main lending rate at 4.35% since November 2015.

Required reserve ratio and lending rate have been stable



Source: Bloomberg, PSR

We believe PBOC has been competent in their use of monetary policy to prevent the RMB from devaluing. Once RMB stabilised, we should see local investors returning to their equity markets. After all, their equity market is still predominantly a market for retail investors.

Fixed-Income Strategy

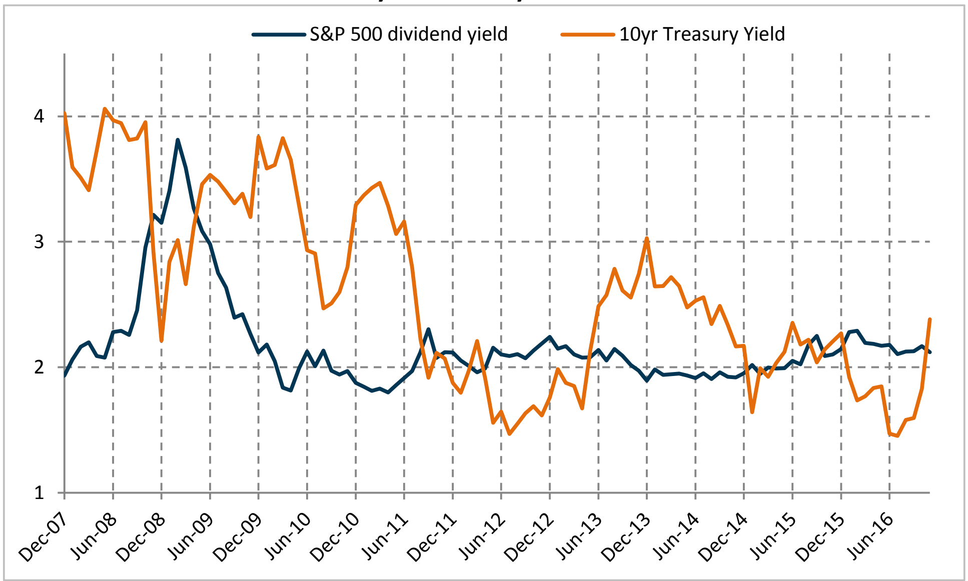
Fixed Income Allocation: Underweight High Yield, Duration & local currencies

	Underweight	Neutral	Overweight
Developed Markets	○	●	○
DM Sovereign	○	●	○
DM Investment Grade	→	●	○
DM High Yield	●	←	○
Emerging Markets	●	○	○
EM Sovereign	○	●	○
EM Credit	●	○	○
Duration	●	←	○
Local Currency	●	←	○

The 30 year Bull Run for fixed-income might finally be coming to an end. Fed raised their interest rate for the second time in two years, and it seems to be on a plan to gradually bring the interest higher to a normalised rate. However, this is not the first time that Fed raised its targeted interest rate in the past 30 years. There were three previous cycles when Fed raise their targeted interest rate but had resulted in minimal impact on the bond prices.

We feel that this time round it will be different. In this current cycle, it has been the first time since 1958 when the 10-year treasury yield went below the S&P equity dividend yield. Prior to 1958, equity has always maintained a higher yield relative to treasuries so as to compensate for the additional volatility. That was the reasoning then, and no one managed to explain the anomaly in the past 50 years. Perhaps equity yields have been greatly compressed due to the growth of the equity markets. The spread between the dividend yield and the Treasury Yield remains an academy debate. Nonetheless, we note the significant in the crossover and the emphasis that U.S. 10-year treasury yield have never been as low as 1.33 we saw in July 2016.

S&P500 Dividend Yield vs U.S. 10-year Treasury Yield



Source: Bloomberg, PSR

USD strength hurt local currencies bonds

We see two major themes playing out in 2017 for fixed-income: (i) strengthening of USD; and (ii) rising default rate. The increase in US fed targeted interest rates will undoubtingly strengthen the U.S. dollar. This will be positive to all current US debt lenders but affect hard currencies bond negatively. A stronger dollar will likely have a negative impact internationally especially emerging markets. Therefore we are underweighting local currency bonds.

Default risk rising

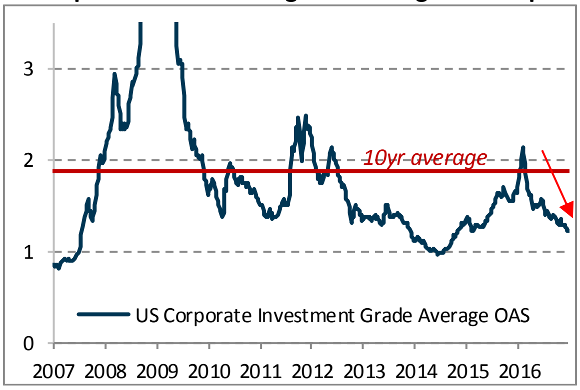
The second theme is a risk in default rate. As interest rate rises, we expect the overleverage corporates to face potential headwind in paying off their debt. As mentioned earlier, businesses in U.S. have be leveraging up for corporate finance activities such as merger and acquisitions or paying dividend. This will put stress on their balance sheet and increase likelihood of a default especially for businesses which earnings have yet to recover to their 2007 high.

Credit Spread continue to tighten

Credit spread peak in early February 2016, not coincidentally with the bottom of oil prices. The credit stress experienced earlier in 2016 were mainly due to the severe pressure in the energy sector. Default rates spiked up to 6% in the high-yield sector, majority of which were energy companies.

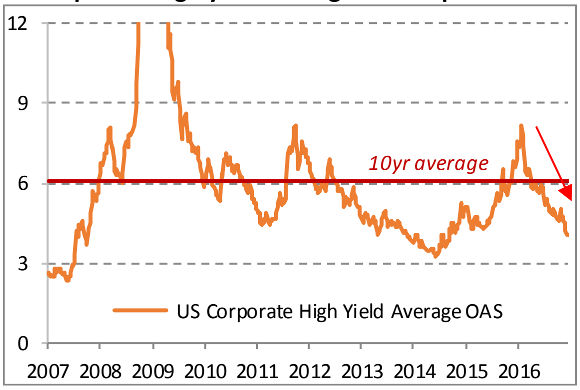
Since February, credit spreads has narrowed across the credit spectrum.

US corporate investment grade average credit spread



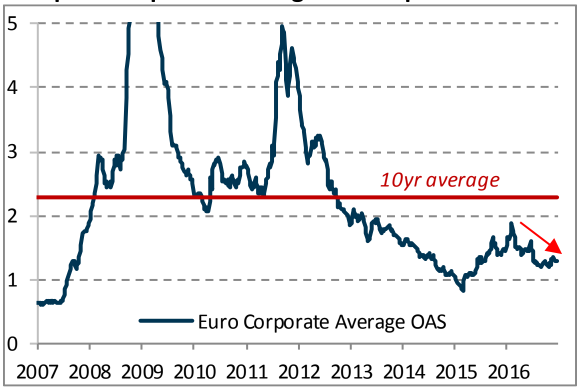
Source: Bloomberg, PSR

US corporate high yield average credit spread



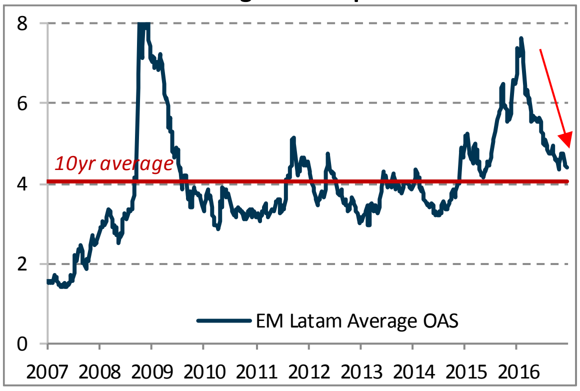
Source: Bloomberg, PSR

European corporate average credit spread



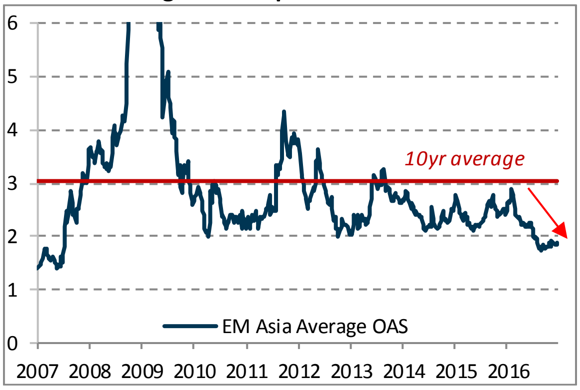
Source: Bloomberg, PSR

Latin American Average credit spread



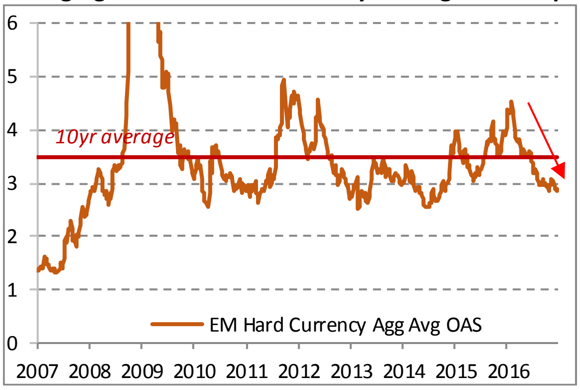
Source: Bloomberg, PSR

EM Asia Average credit spread



Source: Bloomberg, PSR

Emerging Markets Hard Currency Average credit spread



Source: Bloomberg, PSR

We are disenchanted by the risk-taking behavior of the markets. Markets seems to be pricing the risk of default too cheaply. Companies with weaker balance sheet are likely to suffer when interest rates pick up. In summary, we are underweighting High-yield bonds and duration due to the expectation of an increasing interest rate environment.

Commodities Strategy

Commodities Allocation: Overweight Gold

	Underweight	Neutral	Overweight
Precious Metals	○	○	●
Industrial Metals	○	●	○
Energy	○	●	○
Agriculture	○	●	○

Energy

With Organization of the Petroleum Exporting Countries (OPEC) and Non-OPEC members agreeing to cut their crude oil output recently in November and December 2016 respectively, WTI Crude oil rebounded sharply from US$45/barrel to US54/barrel within a short time span of 3 weeks and stabilized around the US$52/barrel to U$54/barrel. More specifically, OPEC agreed to reduce their output to 32.5 million barrel per day (MMbpd) by January 2017 while Non-OPEC members agreed to cut crude output by 600,000 barrels per day. However, looking into more details from the Non-OPEC agreement, Russia, the largest contributor of the cut, 300,000 barrel per day, would only gradually cut oil output in H1 2017. Moreover, Russian energy minister Novak gave no indication from which level Russia is ready to cut output, implying a moving goalposts target for Russia.

It appears that the US shale producers are coming back online due to the recent rise in WTI Crude oil as the amount of oil rig count as reported by Baker Hughes experienced a strong pick up to 525 rigs, the highest since January 2016. With the additional supply pumping out from the US shale producers, expect the Crude Oil price to be capped below $US60/barrel in 2017. Therefore we remain neutral on Energy commodities.

Gold

Inflation in U.S. should start picking up and accelerating in 2017 as the base effect from Crude oil kicks in with WTI Crude Oil stabilising within the range of US$50/barrel to US$55/barrel in 2017. On a side note, the low of WTI crude oil was around US$26/barrel back in February 2016 implying a 100% gain if prices hold at current level.

President-Elected Trump has been very vocal on policies designed to implement trade tariffs of up to 45% on imported Chinese goods. In addition, President-Elected Trump has also hinted on imposing a 35% tariff on U.S. companies that operate and produce outside the country if they sell the goods back to U.S. If this tariff strategy works, more jobs will be created in the U.S. but prices are going to increase as well due to the higher labour costs in U.S. as compared to countries like Mexico and China. Hence, expect higher inflation number moving into 2017 which would be beneficial for Gold.

Geopolitical risk emanating from Europe should remain heightened looking at what 2016 ushered in. We expect more market volatility and uncertainties from the General election in the Netherlands, presidential and general election in France, Catalonia independence referendum, general election in Germany and general election in Italy which are all happening in 2017. Gold tends to do well during period of uncertainties.

Contact Information (Singapore Research Team)

Research Operations Officer
Mohamed Amiruddin - amiruddin@phillip.com.sg

Consumer | Healthcare
Soh Lin Sin - sohls@phillip.com.sg

Property | Infrastructure
Peter Ng - peterngmc@phillip.com.sg

Macro
Pei Sai Teng - peist@phillip.com.sg

Transport | REITs (Industrial)
Richard Leow, CFTe, FRM - richardleowwt@phillip.com.sg

REITs (Commercial, Retail, Healthcare) | Property
Dehong Tan - tandh@phillip.com.sg

Technical Analysis
Jeremy Ng - jeremyngch@phillip.com.sg

Banking and Finance
Jeremy Teong - jeremyteongfh@phillip.com.sg

US Equity
Ho Kang Wei - hokw@phillip.com.sg

Oil & Gas | Energy
Chen Guangzhi - chengz@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel +65 6533 6001
Fax +65 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel +603 2162 8841
Fax +603 2166 5099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
11/F United Centre 95 Queensway
Hong Kong
Tel +852 2277 6600
Fax +852 2868 5307
Websites: www.phillip.com.hk

JAPAN
Phillip Securities Japan, Ltd.
4-2 Nihonbashi Kabuto-cho Chuo-ku,
Tokyo 103-0026
Tel +81-3 3666 2101
Fax +81-3 3666 6090
Website: www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel +62-21 5790 0800
Fax +62-21 5790 0809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel +86-21 5169 9200
Fax +86-21 6351 2940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel +66-2 6351700 / 22680999
Fax +66-2 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel +33-1 45633100
Fax +33-1 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel +44-20 7426 5950
Fax +44-20 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1-312 356 9000
Fax +1-312 356 9005
Website: www.phillipusa.com

AUSTRALIA
Phillip Capital Limited
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel +61-03 9629 8288
Fax +61-03 9629 8882
Website: www.phillipcapital.com.au

SRI LANKA
Asha Phillip Securities Limited
2nd Floor, Lakshmans Building,
No. 321, Galle Road,
Colombo 03, Sri Lanka
Tel: (94) 11 2429 100
Fax: (94) 11 2429 199
Website: www.ashaphillip.net

INDIA
PhillipCapital (India) Private Limited
No.1, 18th Floor, Urmi Estate
95, Ganpatrao Kadam Marg
Lower Parel West, Mumbai 400-013
Maharashtra, India
Tel: +91-22-2300 2999 / Fax: +91-22-2300 2969
Website: www.phillipcapital.in

TURKEY
PhillipCapital Menkul Degerler
Dr. Cemil Bengü Cad. Hak Is Merkezi
No. 2 Kat. 6A Caglayan
34403 Istanbul, Turkey
Tel: 0212 296 84 84
Fax: 0212 233 69 29
Website: www.phillipcapital.com.tr

DUBAI
Phillip Futures DMCC
Member of the Dubai Gold and
Commodities Exchange (DGCX)
Unit No 601, Plot No 58, White Crown Bldg,
Sheikh Zayed Road, P.O.Box 212291
Dubai-UAE
Tel: +971-4-3325052 / Fax: + 971-4-3328895

CAMBODIA
Phillip Bank Plc
Ground Floor of B-Office Centre,#61-64,
Norodom Blvd Corner Street 306,Sangkat
Boeung Keng Kang 1, Khan Chamkamorn,
Phnom Penh, Cambodia
Tel: 855 (0) 7796 6151/855 (0) 1620 0769
Website: www.phillipbank.com.kh

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