Economics
Markets
Strategy

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Economic forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2007	2008	2009	2010f	2011f	2007	2008	2009	2010f	2011f
US	1.9	0.0	-2.6	2.8	2.4	2.9	3.8	-0.3	1.6	1.8
Japan	2.4	-1.2	-5.1	2.7	1.6	0.1	1.4	-1.4	-0.4	0.5
Eurozone	2.7	0.5	-4.0	1.7	1.5	2.1	3.3	0.3	1.5	1.5
Indonesia	6.3	6.0	4.5	6.0	5.8	6.4	9.8	4.9	5.1	6.5
Malaysia	6.2	4.6	-1.7	8.0	5.5	2.0	5.4	0.6	1.8	2.4
Philippines	7.1	3.8	0.9	6.2	5.0	2.8	9.3	3.3	4.0	4.4
Singapore	8.2	1.4	-1.3	15.0	4.5	2.1	6.4	0.6	3.0	2.7
Thailand	4.9	2.5	-2.2	9.0	4.0	2.2	5.5	-0.8	3.0	2.8
Vietnam	8.4	6.2	5.3	6.5	6.9	8.3	23.1	7.0	8.2	7.0
China	13.0	9.6	9.1	10.0	9.5	4.8	5.9	-0.7	4.0	3.0
Hong Kong	6.4	2.1	-2.7	7.0	4.5	2.0	4.3	0.5	3.0	3.0
Taiwan	6.0	0.7	-1.9	9.5	3.8	1.8	3.5	-0.9	0.9	1.4
Korea	5.1	2.3	0.2	6.2	3.9	2.5	4.7	2.8	2.9	3.1
India*	9.2	6.7	7.4	8.8	8.5	4.7	8.4	3.7	8.0	5.3

* India data & forecasts refer to fiscal years beginning April; inflation is WPI
Source: CEIC and DBS Research

Policy and exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	4Q10	1Q11	2Q11	3Q11	current	4Q10	1Q11	2Q11	3Q11
US	0.25	0.25	0.25	0.25	0.50	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.20	83.7	88	90	92	94
Eurozone	1.00	1.00	1.00	1.00	1.25	1.268	1.28	1.30	1.32	1.34
Indonesia	6.50	6.75	7.50	8.00	8.00	8,983	9,200	9,100	9,000	8,900
Malaysia	2.75	2.75	3.00	3.25	3.25	3.11	3.16	3.12	3.09	3.07
Philippines	4.00	4.25	4.50	4.75	5.00	44.2	44.9	45.5	45.3	45.1
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.34	1.36	1.34	1.33	1.32
Thailand	1.75	2.25	2.75	3.00	3.00	30.9	32.2	31.9	31.7	31.5
Vietnam^	8.00	8.00	8.00	8.00	8.00	19,490	19,490	19,540	19,590	19,640
China*	5.31	5.58	5.85	6.12	6.39	6.79	6.78	6.83	6.88	6.93
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.77	7.78	7.77	7.76	7.75
Taiwan	1.38	1.75	2.00	2.25	2.50	31.9	32.0	31.8	31.6	61.4
Korea	2.25	2.75	3.25	3.50	3.75	1167	1200	1190	1180	1170
India	5.75	6.25	6.50	6.50	6.50	46.6	46.6	46.2	45.7	45.3

^ prime rate; * 1-yr lending rate

Source: Bloomberg and DBS Research

Interest Rate Forecasts

%, eop, govt bond yield for 2Y and 10Y, spread in bps

		3-Sep-10	4Q10	1Q11	2Q11	3Q11
US	3m Libor	0.29	0.35	0.35	0.45	0.80
	2Y	0.51	0.63	1.02	1.12	1.86
	10Y	2.70	3.50	4.00	4.00	4.25
	10Y-2Y	219	287	298	288	239
Japan	3m Tibor	0.36	0.38	0.40	0.40	0.50
Eurozone	3m Euribor	0.88	1.00	1.05	1.10	1.50
Indonesia	3m Jibor	6.86	7.05	7.80	8.30	8.30
	2Y	6.89	7.00	7.75	8.25	8.25
	10Y	8.16	8.50	9.00	9.50	9.50
	10Y-2Y	127	150	125	125	125
Malaysia	3m Klibor	2.92	2.90	3.15	3.45	3.45
	3Y	3.16	3.25	3.50	3.75	3.75
	10Y	3.69	3.90	4.00	4.25	4.25
	10Y-3Y	53	65	50	50	50
Philippines	3m Phibor	4.31	4.50	4.75	5.00	5.25
	2Y	5.10	5.25	5.50	5.75	6.00
	10Y	6.67	6.75	7.00	7.50	8.00
	10Y-2Y	158	150	150	175	200
Singapore	3m Sibor	0.54	0.50	0.50	0.55	0.73
	2Y	0.44	0.40	0.77	0.82	1.56
	10Y	2.13	2.55	2.95	2.95	3.15
	10Y-2Y	169	215	218	213	159
Thailand	3m Bibor	1.87	2.50	3.00	3.25	3.25
	2Y	2.41	2.75	3.25	3.50	3.50
	10Y	2.96	3.50	4.00	4.25	4.25
	10Y-2Y	55	75	75	75	75
China	1 yr Lending rate	5.31	5.58	5.85	6.12	6.39
	2Y	2.16	2.75	3.00	3.25	3.50
	10Y	3.25	3.75	4.00	4.00	4.00
	10Y-2Y	109	100	100	75	50
Hong Kong	3m Hibor	0.26	0.25	0.25	0.30	0.60
	2Y	0.46	0.48	0.82	0.92	1.61
	10Y	1.94	2.85	3.55	3.55	4.00
	10Y-2Y	149	237	273	263	239
Taiwan	3M CP	0.54	0.90	1.15	1.35	1.55
	2Y	0.26	0.90	1.15	1.35	1.55
	10Y	1.22	2.00	2.00	2.00	2.00
	10Y-2Y	96	110	85	65	45
Korea	3m CD	2.66	3.25	3.75	4.00	4.25
	3Y	3.65	4.00	4.25	4.50	4.75
	10Y	4.43	4.75	5.00	5.25	5.25
	10Y-3Y	78	75	75	75	50
India	3m Mibor	6.77	7.25	7.50	7.50	7.50
	2Y	6.87	7.00	7.00	7.00	7.00
	10Y	7.96	8.00	8.00	8.00	8.00
	10Y-2Y	110	100	100	100	100

Source: Bloomberg and DBS Research

The immaculate recovery

Seems like every time you turn around lately someone in the G3 is falling over. Earlier this year it was Europe: the Greek debt crisis spread across the continent, sovereign spreads rose and, in shades of Autumn 2008, libor-OIS spreads headed wider too. Belt tightening became the order of the day. Growth forecasts were lowered. Market sentiment soured.

None of this could be good for Asia, which, after all, exports as much to Europe these days as it does to the US. The region's central banks, which had begun to tighten monetary policy in March, paused in May and June. No surprise; discretion is the better part of valor. But they resumed their hikes in July and August. Why? Because Europe wasn't holding back Asia's V-shaped recovery or its rapidly accelerating rate of inflation like they thought it might.

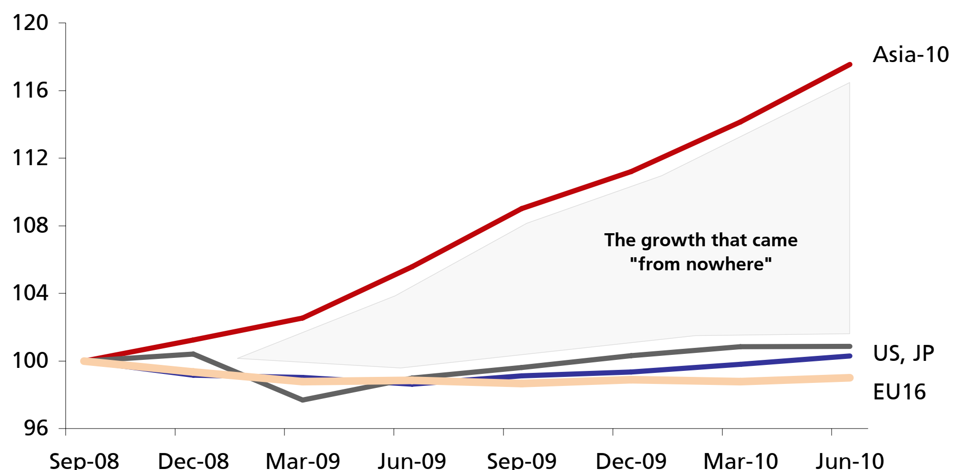
A handful of hikes in half a dozen countries later, it's the US's turn to take a spill. GDP growth drops to 1.6% (QoQ, saar) in 2Q10 and fears of a double-dip consume the markets. The Fed makes a symbolic shift back to strict neutrality and, rather than assuaging markets, only convinces them the sky is falling. Private sector hiring, still barely positive, drops to 67k in August from 107k in July.

None of this looks good for Asia either. The region's central banks – still far behind the curve in normalizing interest rates – will once again put tightening on hold. They will, once again, wait to see how things pan out. And they will, once again, resume tightening in very short order.

By December, most of Asia's central banks will be hiking rates again and we expect their ranks will, by then, include China and Indonesia, Asia's two key holdouts so far (though Indonesia did raise reserve requirements by 300bps at one go last week, a move that's probably equivalent to two 25bps rate hikes).

How can Asia's central banks push ahead with monetary tightening when the Fed is discussing QE2 (additional long-term bond purchases)? More to the point: why isn't trouble in the US and Europe killing Asia's recovery?

The short answer is: the US and Europe did not contribute to it. Or very little anyway. If you only thrown a nickel into the pot, taking it back out again doesn't change much.



INTRODUCTION

Take a look at the consumption plots on the previous page. It's important because consumption is the final demand that drives all other final demands, like investment or imports. At the end of the day, consumption drives global growth, period. And who is doing the driving? Asia. Almost by itself.

In the two years since Lehman Brothers imploded, consumption in the US has gone absolutely nowhere – it still has not returned to precrisis levels. Ditto for Europe. Ditto for Japan. But compared to precrisis (3Q08) levels, consumption in Asia is up by 18%.

Eighteen percent? Hold on a minute. This is Asia – the place that everyone said had to consume more. The place that could only save and could only export. The place that could not possibly grow unless the US was growing because the US was doing all the buying.

Yet there it is. Zero buying in the US. Zero buying in Japan and in Europe. And a boatload of buying in Asia. It's the immaculate recovery – the thing that everyone said could never happen. The pregnant Asian shopper standing next to an utterly superfluous US, JP and EU.

That's why Asia's central banks will be back in tightening mode soon – because Asia's recovery is not about the US. It's about Asia. And there's nothing fishy and certainly nothing religious going on here. The hard fact and simple arithmetic (that we've shown regularly over the past 4-5 years) is that Asia has been growing rapidly for years and, after a few decades, it adds up: Asia is no longer too small to matter. Among other things, this means Asia can and will consume whether the G3 does or not. And it means Asia's monetary policies will depend more on what happens here in Asia and less on what happens elsewhere in the world.

Still, something doesn't add up. Much of this report (below) argues that Asia is finally starting to slow down. If so, why will central banks start hiking again?

Because Asia's slowdown is being driven – or, rather, constrained – by the supply side, not by a slowdown in demand. Asia's V-shaped recovery and double-digit GDP growth over the past 4-5 quarters have exhausted the excess capacity that used to exist. When that happens, output growth starts to fall and inflation starts to rise.

Asia may be slowing on the margin but central banks will have a tougher time dealing with inflation, not an easier time. And if the Fed (counter to expectations) goes ahead with QE2, Asia's tightening will become all the more difficult. And all the more 'ironic'.

David Carbon, for

DBS Group Research

September 9, 2010

The kink in the curve

- Asia's surging growth path is finally turning sideways
- This has nothing to do with slow demand growth from the US or Europe
- In fact, it has nothing to do with weak demand at all. Asia is slowing because supply is now constrained – excess capacity has been exhausted
- With demand continuing to grow and supply constraints now tight, inflation will continue to rise
- Central banks remain behind the curve. We expect 20 more rate hikes in Asia before 2Q11
- China is the key risk to Asia but demand there remains strong. The chance of a significant slowdown in China appears remote

Asia's V-shaped recovery is now turning sideways

At long last, Asia's surging growth path has started to turn sideways. It's been one heck of a ride – in GDP terms, Asia has grown at double-digit rates for 4-5 quarters. And that's a simple average of the Asia-10. Singapore's growth averaged 31% (QoQ, saar) for two quarters. Taiwan's averaged 16% for three; Thailand's, 15% for two; Malaysia's, 12% for three. In short, it was a V-shaped recovery par excellence: significantly sharper and longer-lasting than even we imagined back in 2009 (when everyone was saying that Asia would have to wait for the US to recover before it could).

But we knew it couldn't last. Not even Asia can grow at double-digit rates for long. So we called it the "square root" recovery – the fact that output had to turn sideways before long and the "V" shape would start to look like the square

Nomenclature

References to Asia in this report adhere to the follow conventions:

Asia 10: CH, HK, TW, KR, SG, MY, ID, TH, PH, IN

Asia 9: Asia 10 less IN

Asia 8: Asia 10 less IN and CH

Asia Hi-tech5 (HT5): KR, TW, SG, MY, TH

Asean 5: SG, MY, TH, ID, PH

Asean 4: Asean 5 less SG

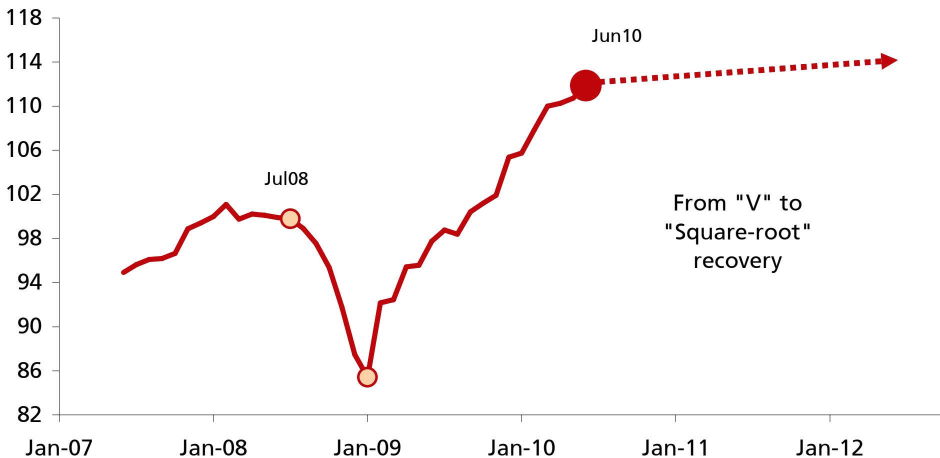
Eurozone: EU12

G4: Asia10, US, JP, EZ

The kink in the curve

Asia 9 – industrial production

Jan08=100, sa, simple avg for Asia



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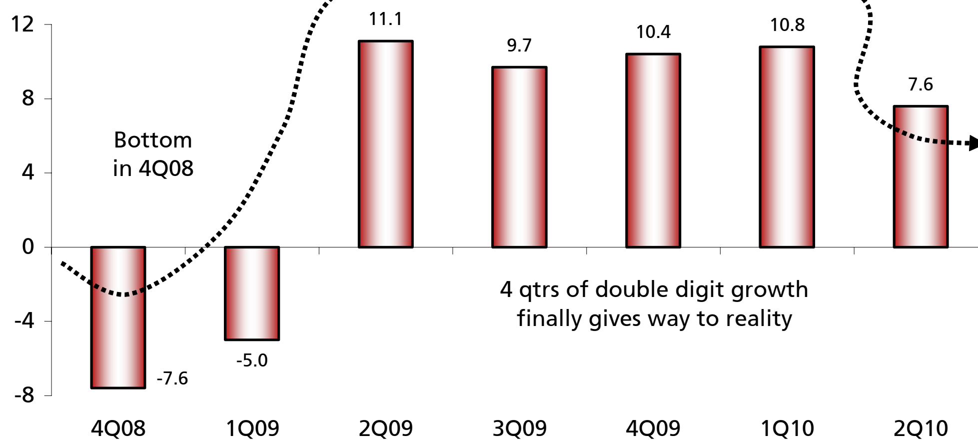
root sign you drew back in high school. That is, a sharp drop, followed by a sharp rise and then a palpable turn sideways as output begins to grow more normally.

But that was back in mid-09 and the turn never came. Output continued to surge north. It'll come, we said, in another month or two. It didn't. October came, no turn. Then December, then March. Still no turn. Four quarters of double-digit GDP growth and no turn in sight. Until now.

Average GDP growth dropped below 8% (QoQ, saar) in 2Q10. Not even Asia can sustain double-digit growth for long

Asia 10 – sequential GDP growth

% QoQ, saar, simple avg



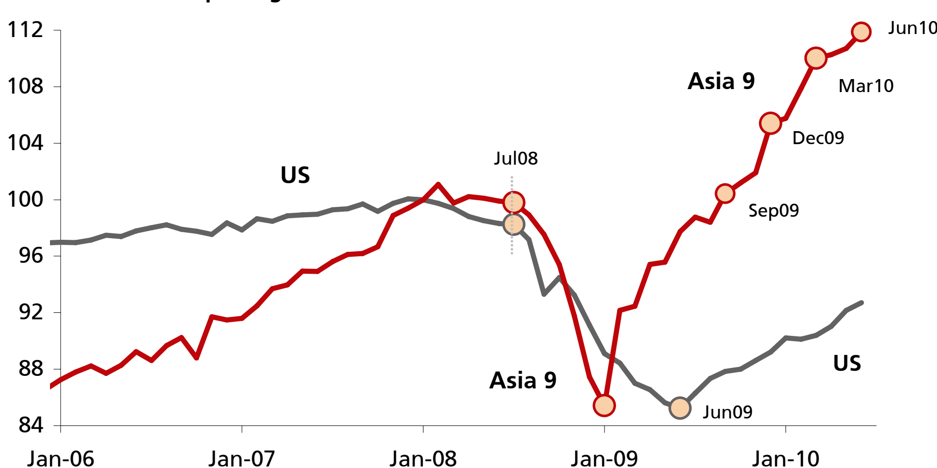
In the second quarter of 2010, GDP growth faded to a 7.6% (QoQ, saar) average rate in the Asia-10 from about 11% in Q1. China's growth dropped to 7% (from 11.5% two quarters before) ; Taiwan's growth dropped to 7%, Malaysia's to 7.1%, Korea's to 6% and Thailand's to -1.7%.

The rock in the road, the stump in the grass, the clog in the pipe – whatever you want to call it, Asia has hit it. Growth has fallen back to earth. Things have slowed. The kink in the curve has finally been reached.

Asia fully recovered precrisis levels of output with no help from the US

Asia 9 and US – industrial production

Jan08=100, sa, simple avg for Asia



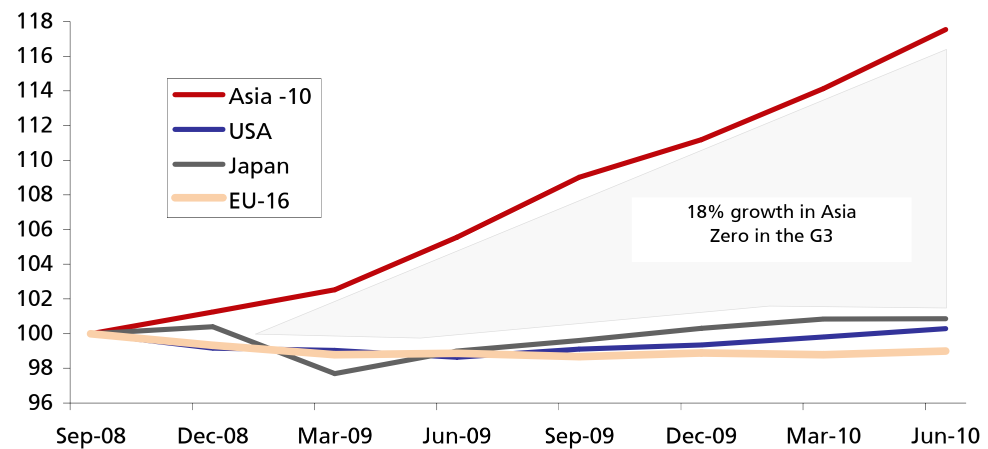
It's not about the US or Europe

So what's the surprise?, you ask. The US is slowing, Europe is slowing. Why shouldn't Asia follow? It always does.

Because it doesn't. You don't have to go any further than the latest crisis and V-shaped recovery to see that. Take a look at the chart at the bottom of the previous page. Asia hit bottom in Jan09 and started to climb sharply thereafter. The US kept *falling* until Jun09. By the time the US finally started to turn north, Asia had already fully recovered precrisis levels of output. Complete recovery in Asia, zero help from the US.

The immaculate recovery: Asia's consumption has soared no help from the G3

That's the supply side. Take a look at the demand side, where Asia's recovery was even more impressive. Compared to precrisis times (taken as 3Q08, when Lehman imploded), consumption in Asia has risen by 18%. Was any of that



driven by the G3? No. US consumption hasn't grown one iota since 3Q08. It's perfectly flat in Japan and Europe too. From a demand side perspective, the US, Japan and Europe have contributed nothing to Asia's recovery. It's the "immaculate recovery" that everyone said could never happen. Without the US consumer and ever rising global imbalances, the conventional wisdom went, nothing in Asia could grow. Yet there it is, in plain sight: Asia's consumption is up by 18%; US (and G3) consumption is up nary a drop.

Slower growth follows from supply constraints, not weak demand. Excess capacity is now exhausted

So Asia doesn't follow the US or the G3. The slowdown here – the kink in the curve – has nothing to do with weak demand from the G3.

It's the supply side, silly

In fact, Asia's slowdown has nothing to do with demand, period. Asia's slowdown is being driven by the supply side. Economies have grown very rapidly over the past 18 months and are now bumping up against capacity constraints. Going forward, output can grow only as fast as those constraints can be moved. The 'easy' growth that came with lots of slack / excess capacity is over.

Does it matter whether the slowdown is being driven by demand side or the supply side? Absolutely. When there is excess capacity and weak demand, one

extra dollar of demand will get you an extra dollar of supply – immediately. If this guy won't supply you the 'widget' you want by 3pm, someone else gladly will. But when excess capacity has been exhausted and factories are running at full steam, an extra dollar of demand won't get you an extra dollar of output. What you'll get instead is inflation.

So what drives the slowdown matters a lot. Low demand will bring low interest rates. But exhausted capacities will bring higher interest rates as markets and central banks try to beat inflation. Other things equal, higher interest rates will tend to bring stronger currencies too. And plainly, whether a kink in the curve follows from weak demand or from constrained supply makes a big difference to profits and equity markets too.

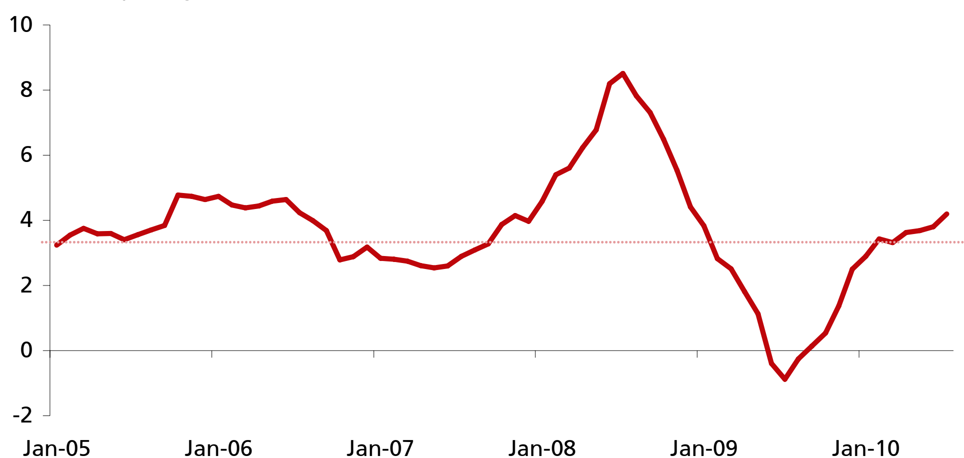
Slower growth means higher rates, not lower rates. The slowdown is being driven from the supply side

In Asia, slower growth owes mainly to the fact that capacity constraints are now being hit. And with demand (shown in the chart of consumption on the previous page) continuing to grow at a 10% (saar) pace – with or without the help of the G3 – the implications for policy are clear. Rates have to go up.

Central banks are still behind the curve

Central banks began hiking interest rates in March of this year with Malaysia and India leading the way. Singapore soon followed with its version of tighter policy: a shift the in the currency regime toward faster appreciation. But the European debt crisis interrupted the process in May, causing central banks to watch and wait. It didn't take long – 1 to 2 months – before tightening in Asia resumed.

The reasons are clear. CPI inflation has surged over the past year and is no longer below average. In China, headline inflation is now up to 3.3% YoY (Jul10). That's not sky high but it is more than double the 1.5% rate averaged since the 97/98 Asian financial crisis. Likewise in India, where the current 10%



Inflation in Asia is back above average. It will continue rising

YoY inflation rate is double the average since 1997. In Singapore, inflation is currently running at a 3.1% rate, 2.4 times faster than the 97-to-date average (of 1.3%). Importantly, inflation everywhere in Asia is still rising.

Policy interest rates, eop
percent

	current	3Q10	4Q10	1Q11	hikes in 4Q	hikes in 1Q11	total hikes by 1Q11
Indonesia	6.50	6.50	6.75	7.50	0.25	0.75	1.00
Malaysia	2.75	2.75	2.75	3.00	0.00	0.25	0.25
Philippines	4.00	4.00	4.25	4.50	0.25	0.25	0.50
Singapore	n.a.	n.a.	n.a.	n.a.			
Thailand	1.75	1.75	2.25	2.75	0.50	0.50	1.00
China*	5.31	5.31	5.58	5.85	0.27	0.27	0.54
Hong Kong	n.a.	n.a.	n.a.	n.a.			
Taiwan	1.38	1.50	1.75	2.00	0.25	0.25	0.63
Korea	2.25	2.25	2.75	3.25	0.50	0.50	1.00
India	5.75	5.75	6.25	6.50	0.50	0.25	0.75
Average Asia-10							0.63
Total number of 25bps hikes					10	12	22

* 1-yr lending rate

We continue to expect 10 hikes in 4Q10 and 12 hikes in 1Q11

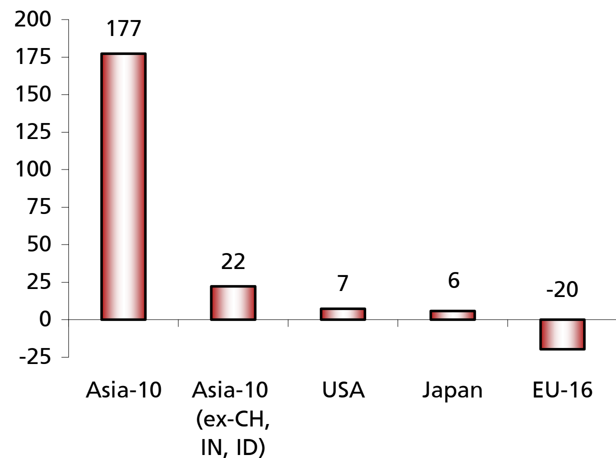
The bottom line is that Asia's central banks are still behind the curve. There have been 11 hikes (or currency regime shifts) so far this year, which still leaves rates far below normal. As they did when the European debt crisis flared up in May, Asia's central banks will now slow the pace of rate hikes to watch developments in the US (where fears of a double-dip are growing). But we continue to expect another 10 rate hikes in Asia in the fourth quarter and around dozen in 1Q11, as per the table above.

China is the risk but the chance of a significant slowdown is remote

China has generated 16 times more new consumption than the US has since 3Q08

Risks to the outlook continue to revolve increasingly around China, not the US and/or the G3. One look back at the picture on page 8 should make clear why. That 18% growth in consumption since 3Q08 translates into $177bn of new consumption and China is responsible for nearly two-thirds of it. In other words, China has put $115bn of new consumer demand on the table since 3Q08 compared to a mere $7bn contribution from the US. If the risks aren't apparent, ask yourself: if you took those contributions to growth / recovery away, which would hurt more?

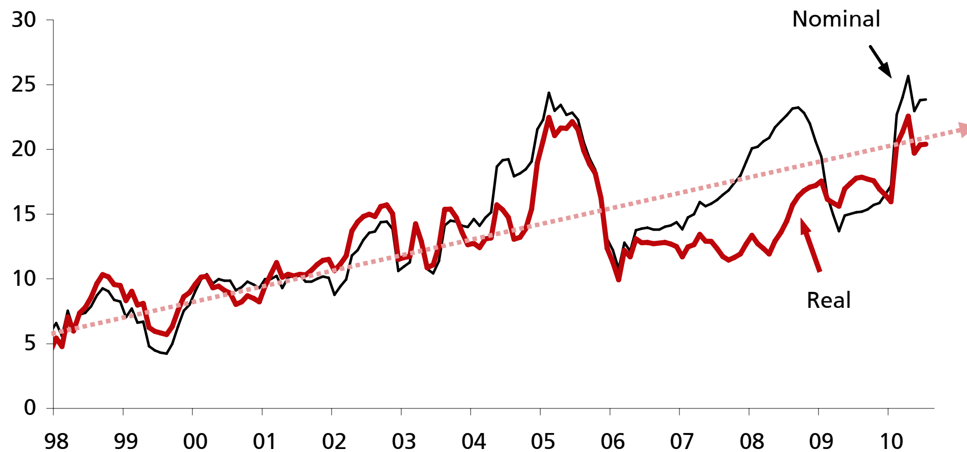
Incremental consumption growth since 3Q08
USD bn, 3Q08 - 2Q10, seas adj



The good news is, despite the recent concerns about a slowdown in China, demand growth there remains very strong and the risk of further slowing seems remote. Take consumption demand, for example, as proxied by retail sales. Growth today is as fast or faster than it's been in a decade in real and / or nominal terms (chart at top of next page). And it's accelerating, not decelerating.

China – retail sales growth

% YoY, 3mma, real sales deflated by CPI

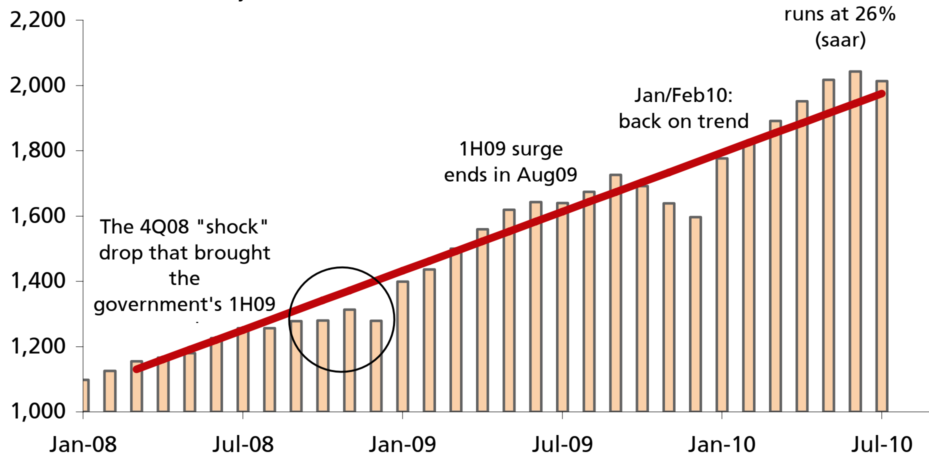


Retail sales growth is the highest in a decade

Fixed asset investment? It continues to grow at a trend pace of 26% (chart below), only a point below the 27% rate averaged since 2004 – a rate that everyone used to say was "too fast".

China – fixed asset investment

CNY bn / mth, seas adj

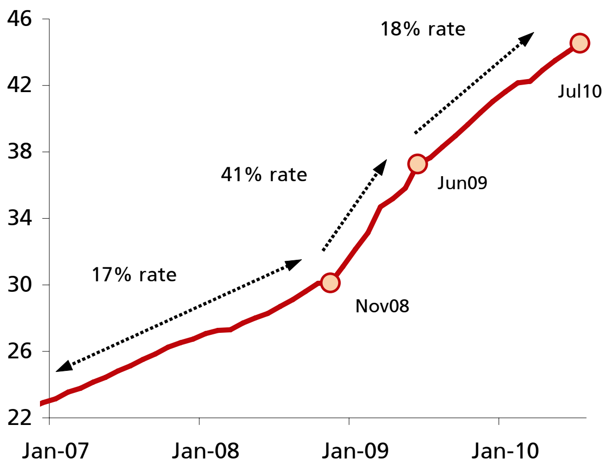


Fixed asset investment has run at a 26% (saar) since Jan10. That's only 1 point slower than the 27% pace that everyone used to say was "too fast"

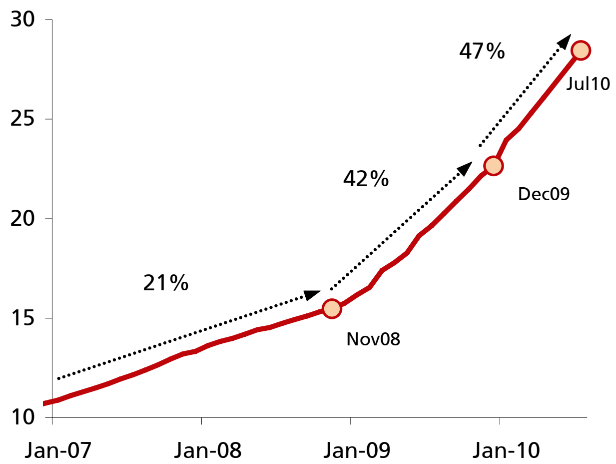
And loan growth? Supposedly the government has put the clamps on – but the data say otherwise. Total loan growth is running at an 18% saar pace (charts at top of next page), which is indeed lower than the 41% saar pace run in 1H09 when everyone was worried about the global financial crisis. But today's 18% growth rate is still higher than the 17% pace averaged during the heydays of 2005-2007 when GDP was growing 12% - 13% per year.

And that's not the half of it. With the focus now on building infrastructure, growth in medium- and long-term loans has not slowed at all – it has accelerated significantly to a 47% saar pace from the 42% pace run in 2009 (chart top right of next page). That's more than twice the pace that prevailed during the go-go years when GDP growth ran at 12%-13%.

China – financial institution loans (total)
CNY trn outstanding, seas adj



China – financial institution loans (med & Long-term)
CNY trn outstanding, sa, med- and long-term



The bottom line is that with this sort of demand growth – consumption, investment and loans – it is very hard to be bearish about the growth outlook in China or Asia more generally. GDP or the PMIs can slip for a quarter or two because they are supply-side measures and lots of things can temporarily interrupt supply. But at the end of the day, supply follows demand like a 4-year old follows his mother. So long as demand continues to grow as steadily and as strongly as it appears to be doing, supply / GDP will never be more than a step or two behind.

China's electronics demand still booming

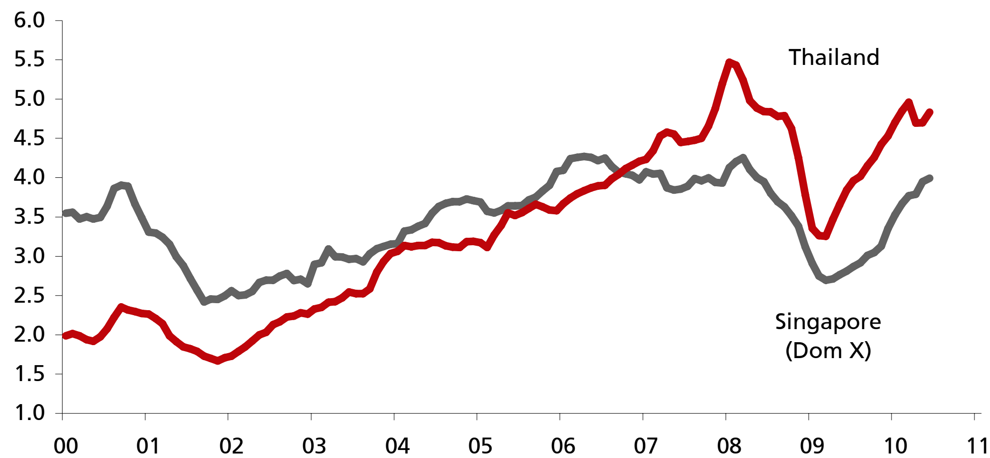
Solid consumption growth begs the question: what's driving it? While the key consumer items of yesteryear – color TVs and refrigerators – have given way to cars and computers and mobile phones (table at side), demand for electronic goods in all its various forms (both final and intermediate) remains key for China and for Asia's exporters who now rely so heavily on the China market. On the whole, Asia's electronics exporters remain who they were ten years ago: Taiwan, Korea, Singapore and Malaysia. The key addition in recent years has been Thailand and, to a lesser extent, the Philippines. Thailand now exports more electronics goods than Singapore, where high wages have obliged a strategic migration to production and export of higher value-added items (chart top of next page). The big difference from yesteryear, though, is that everyone has become much more reliant on the China market and less so on the US market, either directly or indirectly.

Cars, computers and mobile phones. Consumption in China continues to grow rapidly

China – consumer goods demand growth
percent per year, avg

	Unit growth 2001-2010 (%)	Unit growth 2008-10 (%)
Automobiles	45.6	24.1
Mobile phones	27.9	8.5
Computers	26.5	13.5
Pocket cameras	24.5	11.3
Air conditioners	18.6	9.2
Microwaves	16.7	7.5
Pianos	12.0	9.7
Showers	9.9	5.9
Hi-fi stereo	6.0	4.4
Refrig	5.8	4.8
Color TV sets	5.5	5.0
Motorcycles	5.3	5.4
Washing mach	4.5	4.4

The good news is, as one would expect given the sharp V-shaped recovery and the consumption growth paths for Asia (p. 8) and China (p.11) shown above, that Asia's electronics exports have rebounded sharply in the aftermath of the global financial crisis. Given the importance of



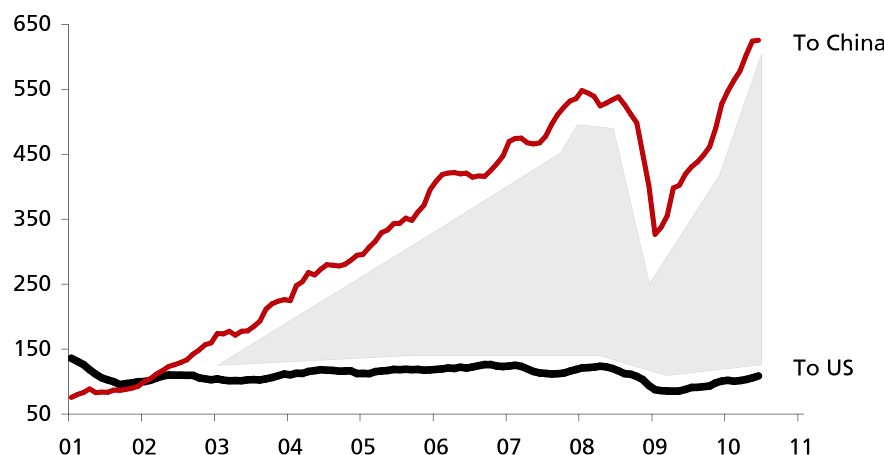
Thailand is the new kid on the electronics block. It now exports more electronics than Singapore

China as a destination for these exports, it could only mean that exports to China have soared and this is indeed the case. Asia's exports of electronics products to China have grown by 85% over the past 18 months as demand for intermediate and final goods continues to grow (chart below).

And, at long last, it should be readily apparent that Asia's export surge into China is not simply, or even mainly, servicing final demand generated in the US as is so often argued. How could it be? The US hasn't generated any new final demand since 3Q08. Consumption is flat as a pancake. Investment is less than flat. If Asia's exports into China were merely being repackaged and flipped to the US, they would be flat as a pancake too. They are anything but flat. They are up by 19% over precrisis times.

That's almost identical to the 18% that Asia's consumption has grown compared to precrisis times too. Coincidence? Of course not. Somebody has to be buying Asia's electronics output and it's not the US and it's not Europe and it's not Japan. It's Asia itself, with China at the center. Asia is where the new final demand in the world is being generated today. 'Twill be even more the case tomorrow [1].

Asia's export surge into China is not servicing final demand from the US. How could it be? US final demand is flat as a pancake. Asia's exports are booming



Endnotes

[1] There are other ways to show that Asia is where the new demand for global output such as electronics is being generated. One such way is the following: Start with the picture of Asia-8 electronics exports to China and the US at the bottom of the previous page. The shaded area between the two plots is one (simple) measure of the amount of new demand generated by China (for such output from the Asia-8) over and above the new demand generated by the US. Between 2003 and 2010, China's demand for Asia-8 electronic exports grew by $99bn. US demand grew by $1.6bn. The grey area amounts to some $97.4bn; China's demand growth outstripped that of the US by 63x.

Of course, some of the rise in Asia-8 elec exports to China is simply 'detour trade' – things that used to go directly to the US but now stop in China first, where they are combined with other inputs and re-exported. How much of Asia's exports into China represent diverted trade and how much is servicing final demand?

That's hard to say but start with a couple observations about trade shares. Suppose for the moment that all of the rise in Asia's exports into China represented diverted trade. Then the share of Asia's exports headed to China and the US would have been a zero sum game and, other things equal, would have remained broadly constant over the years. But as the chart below shows, the share headed into China and the US has risen to 52%, in spite of the sharp decline in the share of exports to the US.

Now, make a simple counterfactual calculation. Assume that *all* of the drop in the US share is due to trade diversion. Then, take back from China, and give back to the US, just enough exports to keep the US share constant. Plainly, that 'gives back' too many exports to the US because even organic growth in final demand in China would tend to drive down the US share.

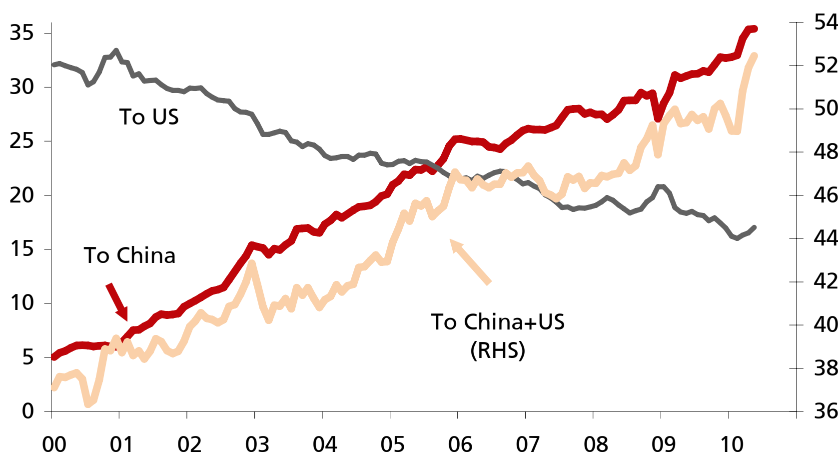
If this overstates the amount of diverted trade, that's okay. In fact, that's good. Because it offers a lower bound for estimates of the true 'organic' growth of demand coming from China. And what does that lower bound look like?

On the same time frame (2003-10), this process redistributes some $34bn of exports to US 'coffers' from China. China's demand growth drops to $65bn and US demand growth rises to $36bn. New demand from China now outstrips that from the US by 'only' 1.8x, rather than 63x previously.

Only 1.8x? That's still nearly twice as many new dollars of demand for Asia's electronics exporters coming out of China since 2003 as came out of the US. And from an economy that was, on average between 2003-2010, one fourth as big. Twice as much horsepower from an economy one-quarter the size. In a very real sense, that's still a factor of 8. A factor that only seems likely to grow larger in the years ahead.

Asia HT5 – electronics exports destinations

% share of total HT5 elec X, both axis



Sources:

Data for all charts and tables come from CEIC and Bloomberg.

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FX: Pause first

Asia: Global slowdown worries will be a drag on Asian currencies in September and October

But by November we expect a return to stronger Asian currencies as stronger data and yuan appreciation prevail

Asian currencies will have a better 2011 than 2010

CNY: Towards a more flexible basket

HKD: More progress towards becoming a yuan financing center

TWD: Defensive on cloudy outlook

KRW: Interest rates over currency to achieve macro balance

SGD: Appreciation trend intact, after a brief pause

MYR: Becoming a more integral part of Asia's growth

THB: Outlook favorable overall but the trade deficit is a drag

IDR: Favoring a stable 9000-9500 range

PHP: A promising laggard

INR: A tough rebalancing act

VND: From devaluation to band widening

USD: Fundamentally weak but no collapse imminent

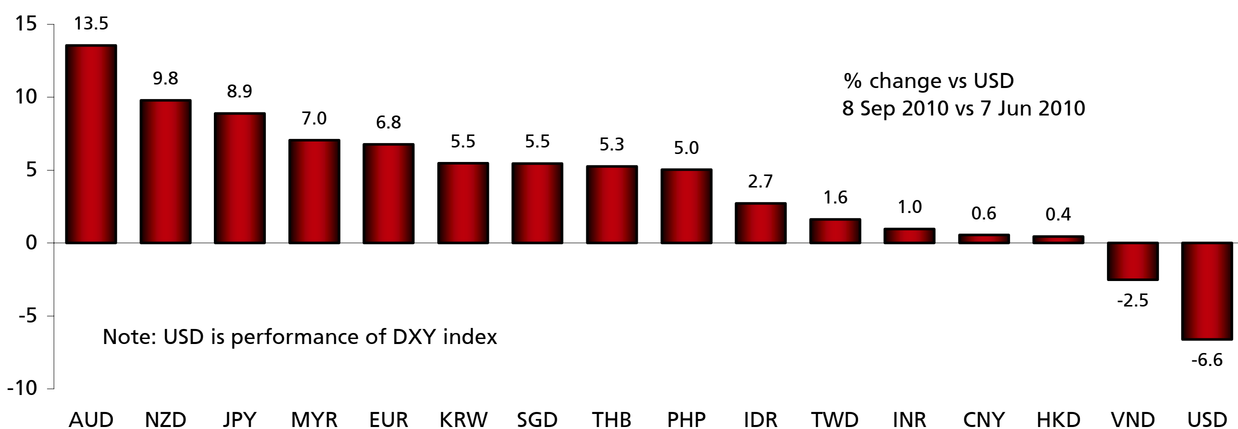
JPY: Intervention risks growing rapidly

EUR: Lacking clarity on ECB-Fed deadlock

AUD: Tone is firm but cautious on Asia's growth normalization

NZD: Caught between a hike and a trade deficit

Currencies after the worst was over for EU sovereign debt crisis



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Currency forecasts

		8-Sep-10	4Q10	1Q11	2Q11	3Q11	4Q11
EUR/usd		**1.2720**	**1.28**	**1.30**	**1.32**	**1.34**	**1.36**
		Poll	1.25	1.26	1.23	1.21	1.23
		Fwd	1.27	1.27	1.27	1.27	1.27
usd/JPY		**83.32**	**88**	**90**	**92**	**94**	**93**
		Poll	89	92	95	94	98
		Fwd	83	83	83	83	83
usd/CNY		**6.7943**	**6.78**	**6.73**	**6.68**	**6.63**	**6.58**
		Poll	6.69	6.64	6.57	6.34	6.40
		Fwd	6.79	6.77	6.73	6.71	6.69
usd/HKD		**7.7698**	**7.78**	**7.77**	**7.76**	**7.75**	**7.75**
		Poll	7.78	7.77	7.75	7.75	7.78
		Fwd	7.77	7.76	7.76	7.75	7.75
usd/TWD		**31.900**	**32.0**	**31.8**	**31.6**	**31.4**	**31.2**
		Poll	31.3	31.0	30.5	30.5	30.3
		Fwd	31.8	31.7	31.5	31.3	30.9
usd/KRW		**1172**	**1200**	**1190**	**1180**	**1170**	**1160**
		Poll	1130	1102	1090	1060	1050
		Fwd	1180	1184	1188	1192	1196
usd/SGD		**1.3440**	**1.36**	**1.34**	**1.33**	**1.32**	**1.31**
		Poll	1.35	1.35	1.34	1.33	1.33
		Fwd	1.34	1.34	1.34	1.34	1.35
usd/MYR		**3.1135**	**3.16**	**3.12**	**3.09**	**3.07**	**3.05**
		Poll	3.15	3.10	3.07	3.02	3.10
		Fwd	3.13	3.15	3.16	3.17	3.19
usd/THB		**31.000**	**32.2**	**31.9**	**31.7**	**31.5**	**31.2**
		Poll	31.8	31.5	31.5	30.8	31.0
		Fwd	31.1	31.1	31.2	31.2	31.3
usd/IDR		**8995**	**9200**	**9100**	**9000**	**8900**	**8800**
		Poll	8900	8825	8800	8800	8625
		Fwd	9125	9240	9362	9518	9821
usd/PHP		**44.180**	**44.9**	**44.4**	**43.9**	**43.4**	**42.9**
		Poll	44.5	44.0	43.5	43.8	42.9
		Fwd	44.9	45.3	45.6	46.0	46.5
usd/INR		**46.630**	**46.6**	**46.2**	**45.7**	**45.3**	**44.8**
		Poll	45.5	44.5	44.0	44.0	43.5
		Fwd	47.4	47.9	48.3	48.8	49.2
usd/VND		**19450**	**19490**	**19540**	**19590**	**19640**	**19690**
		Poll	19700	19725	19800	19800	19800
		Fwd	19994	20449	20914	21485	21939
AUD/usd		**0.9188**	**0.88**	**0.89**	**0.90**	**0.91**	**0.92**
		Poll	0.88	0.87	0.88	0.88	0.85
		Fwd	0.90	0.89	0.88	0.87	0.86
NZD/usd		**0.7233**	**0.70**	**0.71**	**0.72**	**0.73**	**0.74**
		Poll	0.71	0.71	0.71	0.69	0.69
		Fwd	0.71	0.71	0.70	0.69	0.69

DBS forecasts in bold red. Poll are median forecasts from analysts collated by Bloomberg as at 8 September 2010

G3 doldrums vs Asia mania

Our call for calm during the Eurozone sovereign debt crisis paid off. The euro did not collapse as feared. Neither did the single market move towards a break-up. The euro did stabilize near its lifetime average; EUR/USD bottomed at 1.187 in early June. Even so, the market did not turn bullish in the euro. The subsequent recovery to 1.333 in early August was attributed primarily to speculators unwinding their record net short euro positions.

The unwinding of euro shorts was forced by the EU crisis giving way to US double-dip fears brought about by renewed weakness in US housing/jobs data. As the US Fed kept the door for more quantitative easing (QE) measures to safeguard the US recovery, US dollar depreciation expectations returned. Even so, dollar selling could not materialize in a meaningful way as long as QE remains an expectation contingent on a further deterioration in the US economy.

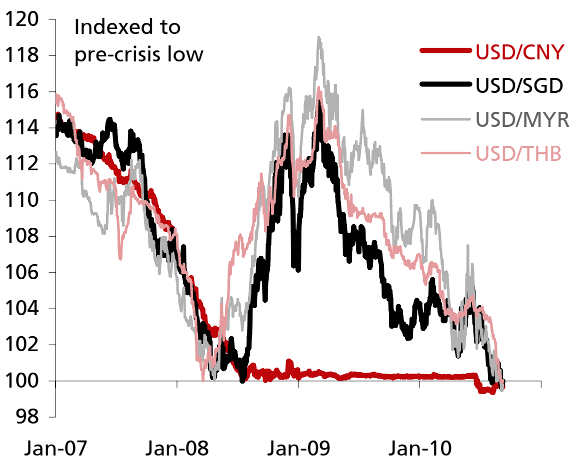
Ironically, fears of the US entering into a Japan-style deflation threatened to push Japan deeper into deflation via a stronger yen. Alarmed, the Japanese government aggressively stepped up verbal interventions with the Bank of Japan further easing its already ultra-accommodative monetary policy to stymie appreciation pressures.

In contrast to the G3, the story for Asia ex Japan (AXJ) currencies was more optimistic. More so in Southeast Asia where most of the region's best performing stock markets were housed. In the third quarter, the Sing dollar, the Malaysian ringgit and the Thai baht joined the Indonesian rupiah in recovering to their pre-crisis highs seen in 2008. Effectively, this signaled their emergence from the global crisis. The Philippine peso should be closely monitored as a potential laggard play here.

Meanwhile, China shifted towards a more flexible exchange rate on June 19. This, however, did not translate into a meaningful yuan appreciation. At its best level on August 9, the yuan was up a paltry 0.9% vs the US dollar. The shift also did not portend an appreciation trend as witnessed during the July 2005-July 2008 period. Instead, China made good its pledge to move towards a two-way yuan market. USD/CNY has been loosely fluctuating with the broader dollar trend since late July. No wonder the non-deliverable forward (NDF) market has been guarded against expecting a repeat of the 2005-2008 appreciation pace.

Yet, not every AXJ currency were favored. Vietnam announced on August 18, its third devaluation since last November to tackle a wide trade deficit. Similarly, the Indian rupee underperformed as record trade deficits and double-digit inflation offset higher Indian equities.

SE Asian currencies recover to pre-crisis levels



Yuan appreciation expectations are more subdued

Deja vu – darkest before dawn (again?)

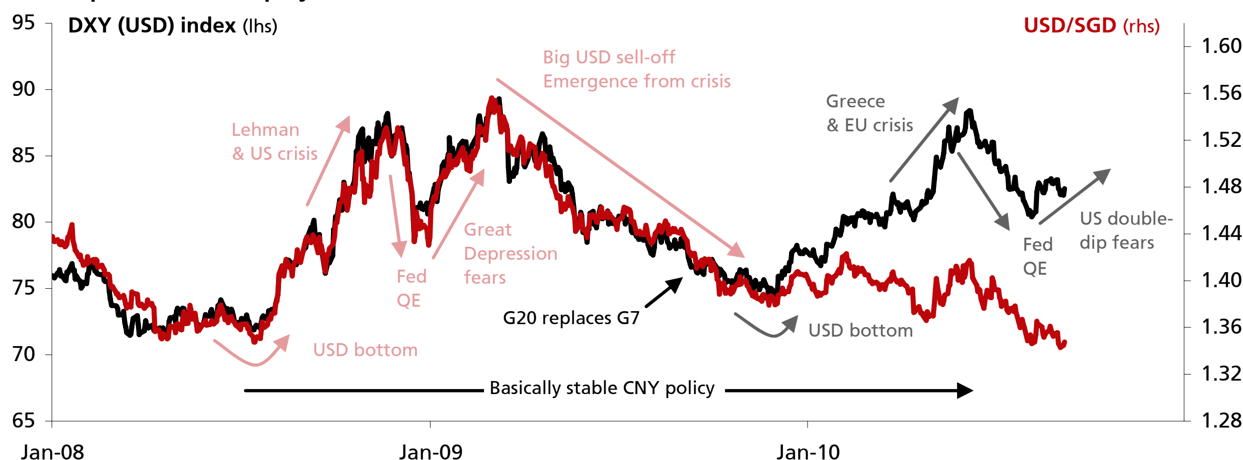
As global financial markets enter the final quarter of 2010, there is sense that things need to get worse before they get better. To help put some perspective here, we compared the performance of the DXY (USD) index since November 2009 with the 2008/09 global crisis. To be sure, we did not relish our findings.

1. DXY bottomed in mid-July 2008 and in November 2009. The DXY's initial rise was attributed to increasing worries over the US subprime crisis in 3Q 2008, and Greece's deteriorating fiscal finances in 1Q 2010.
2. The DXY became a safe-haven when the Lehman's bankruptcy triggered the US credit crisis in August-October 2008, and Greek insolvency risks triggered the Eurozone sovereign debt crisis in April-June 2010. Both crises stabilized after central banks provided unequivocal liquidity support their financial system, with the Fed extending currency swap lines to major central banks.
3. Once the worst was over for financial markets, attention shifted to US economic growth worries. The DXY was subsequently sold off in anticipation of the Fed moving towards QE at its FOMC meetings in December 2008 and August 2010. Interestingly, the dollar could not fall despite the sentiment turning against it on QE. This is where we think markets are at again.

The US dollar became a safe haven from December 2008 to early March 2009. During this period, panic over plummeting economic/trade data led to Great Depression fears, not helped by crises in Russia and Eastern Europe. By March 2009, investors were heartened by three developments. First, economic data in many countries were showing signs of bottoming out. Second, countries were coming together ahead of the G20 summit to provide fiscal/monetary support to pull the global economy out of what is now called the Great Recession. Finally, the US dollar weakened after the Fed finally started its QE program to buy treasuries and mortgage-backed securities (MBS).

Today, DXY also held up after the FOMC meeting on August 10. Like December 2008, Fed pledged not to shrink its balance sheet today. The FOMC made the decision to roll over maturing MBS into treasuries while keeping the door open for more QE measures if needed. The similarity between today and 2008/09 is not recession but the deceleration in global growth rates. To some extent, the double-dip fears, like the Great Depression panic, reflected the uncertainty of when and where the data will bottom. Market sentiment is unlikely to improve until some kind of floor is found. As for the US dollar to fall again, it may rest more on China than on the Fed this time around.

DXY reprised US crisis play into EU crisis; Asian FX is more resilient this time around



November is an important month

The most important month in 4Q 2010 is probably November, which houses many key events that look set to politicize the Chinese yuan issue again. Unlike June, there appears to be a bias by the US and other major economies to lean towards the carrot rather than the stick to achieve more progress on the yuan.

- **US Treasury Currency Report** (mid-October)

  The semiannual Currency Report was last delayed in April to "encourage" China to free its yuan from the US dollar. China announced yuan reforms on June 19 to introduce flexibility into its exchange rate. The Treasury finally released the report on July 8 without naming China a currency manipulator.

  The next Currency Report is unlikely to be released on schedule in mid-October owing to the US midterm elections. China is unlikely to be named a manipulator when it is eventually published. The Ministry of Commerce in China has already started to take steps to increase imports. The USD/CNY trading band is also likely to be widened nearer the G20 summit.

- **US midterm elections** (November 2)

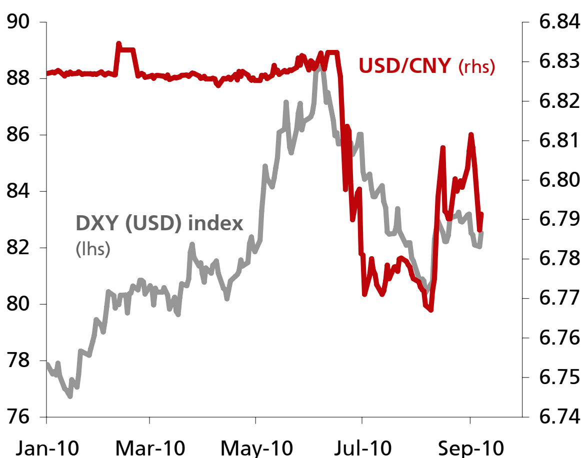
  According to US undersecretary of State Robert Hormats on September 3, US lawmakers have become impatient with a lack of progress by China to address currency and trade issues. With the economy and jobs topping voter concerns ahead of the US midterm elections in November, risks have increased for US lawmakers to become more protectionist.

  A key committee in the US House of Representatives is scheduled to hold a hearing on September 15 to determine if the undervalued yuan has provided unfair advantages to Chinese companies against US Inc. Owing to their interdependency, Washington and Beijing are likely to continue cooperating to avoid the political pitfalls linked to legislation.

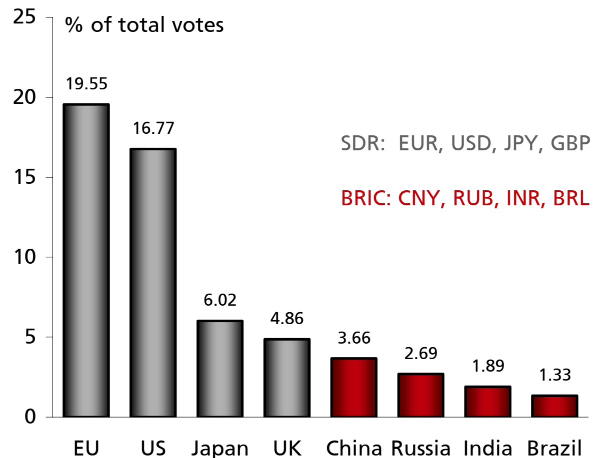
- **G20 summit** (November 11-12)

  Unlike the last G20 summit in June, the US is unlikely to strongly rally emerging countries to pressure China on the yuan. First, emerging countries are less tolerant of currency appreciation because of the second half slowdown story amidst concerns that US double-dip recession risks are no longer zero. Second, the IMF five-year review, which is likely to be held alongside the G20 summit, is expected to boost the voting power of emerging economies. The job now is to persuade China to live up to its global responsibility to address imbalances with its new clout.

More flexible CNY is also USD-sensitive



Voting power in IMF – SDR vs BRIC economies



Looking ahead, the G20 summits in 2011 have more scope to renew the dollar's depreciation. France, who will be assuming the G20 presidency in 2011, has voiced its desire to reform the current international monetary system modelled around the US dollar to reflect an increasingly multipolar global economy.

- **IMF five-year review** (November)

  According to IMF managing director Dominique Strauss-Kahn on June 27, the increase in China's voting power in the IMF is expected to be "rather big". An agreement to shift more (5% or more) voting power in the IMF to under-represented emerging economies was reached at the G20 summit in late September 2009. This was the summit that formalized the G20 as the world's premier economic forum.

  Compared to a year ago, Eurozone no longer appears as keen to share power in the IMF today. After the EU fiscal/debt crisis in 2Q, Eurozone was unhappy that the US placed its recovery over EU's need to emphasize fiscal austerity, as well as China's slow progress in allowing yuan appreciation. Nonetheless, Eurozone is expected to eventually honor its earlier commitment. If so, China is expected to overtake France and UK to become the fourth loudest voice in the IMF, after the US, Japan and Germany.

  The yuan is, however, unlikely to be included in the Special Drawing Right (SDR) for this IMF review. The yuan needs to be closer to the SDR basket of currencies (US dollar, euro, British pound and the Japanese yen) in two regards. The yuan needs to be more market-determined and more convertible on the capital account.

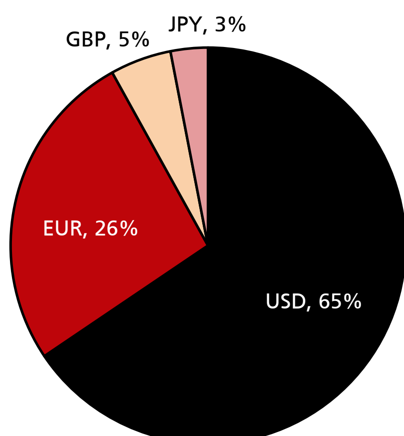
4Q 2010 – a tough transition towards a sustainable global recovery

In summary, the final quarter is likely to comprise two halves. Until economic data improves, especially for the US, global slowdown worries should dominate and support the US dollar as a safe haven currency.

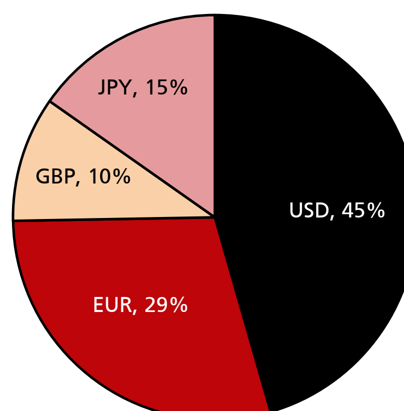
November should be closely watched as a potential turning point for the US dollar to depreciate again. Hopefully by then, most economies would have exhibited signs of returning to a more sustainable moderate growth path, preferably with China allowing more yuan appreciation. If so, this should set the stage for risk appetite to return on the back of a broad-based depreciation in the US dollar.

If 2009/10 was about emerging from the (US/EU) global crisis, 2011 and the next few years will be about moving towards a more sustainable global recovery. When this happens, expect more diversification out of US dollars.

China's foreign reserves breakdown



Weights of basket currencies in SDR



US dollar – fundamentally weak, but no imminent fall yet

DXY (USD) index forecast, eop

	Latest	Prev
Close	82.6	87.9
4Q10	83.2	84.5
1Q11	82.6	83.6
2Q11	82.0	82.8
3Q11	81.4	–
4Q11	80.2	–

Fed Funds Rate forecast, eop

	Latest	Prev
Close	0.25	0.25
4Q10	0.25	0.25
1Q11	0.25	0.50
2Q11	0.25	1.00
3Q11	0.50	1.50
4Q11	0.75	2.00

Latest close on Sep 8
Prev close on Jun 10

The third quarter was overall negative for the US dollar, but its weakness was less generalized and more selective. By and large, growth currencies in emerging Asia (especially Southeast Asia) were the main beneficiaries, with positive spillover into commodity currencies, namely, the Australian and New Zealand dollar. In contrast, the greenback's fall against the euro and sterling in June-August was not due to renewed confidence in these currencies, but from the unwinding of record short positions amassed during the EU sovereign debt crisis.

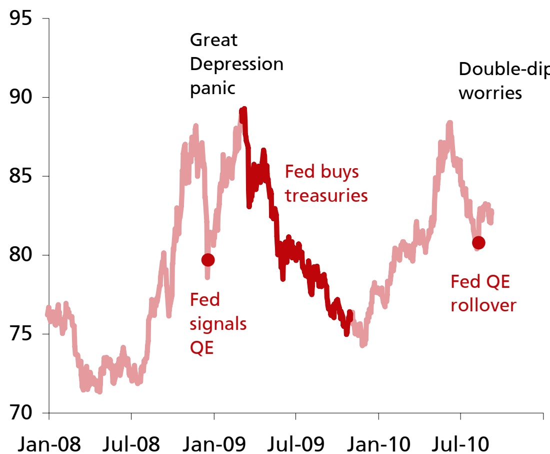
An important development in 3Q was the erosion in the US dollar's safe haven status from quantitative easing (QE) expectations. After financial markets stabilized from the EU crisis in early June, focus turned towards renewed weaknesses in the US housing/jobs data and increased worries that the US recovery was losing momentum. Double-dip fears heightened after Fed chairman Ben Bernanke assessed the US outlook as "unusually uncertain" at his semiannual congressional testimonies on July 21-22. This triggered a dollar sell-off in anticipation of new QE measures at the FOMC meeting on August 10. The market was disappointed when the Fed chose only to maintain the size of its balance sheet by rolling over maturing mortgage-backed securities into treasuries. At Jackson Hole on August 27, Bernanke pledged to provide additional monetary accommodation through unconventional means, "especially if" the outlook were to deteriorate significantly.

This poses one challenge. Things may need to get worse for Fed to adopt QE. Except that risk aversion and growth fears tend to go together and keep the dollar up first. The 2008/09 global crisis also demonstrated that dollar selling only returned after the Fed started to implement QE from early March 2009. After all, QE is the supply of dollars to underpin economic activities.

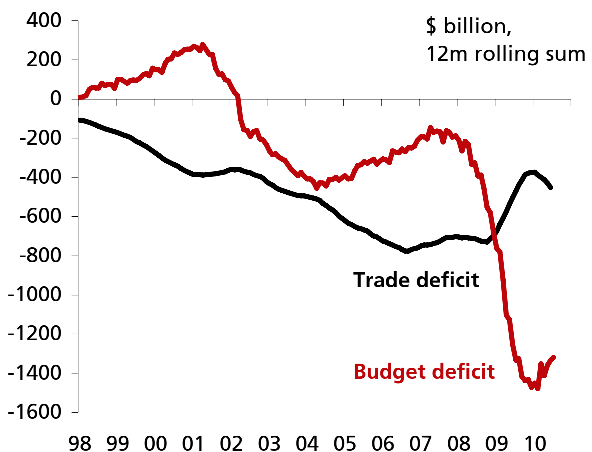
Barring this short-term volatility, the US dollar is fundamentally weak. The ultra-low yield remains unattractive to compensate the twin (budget and trade) deficit risks. The temptation would be to use the greenback as a funding vehicle for more attractive alternatives such as emerging market and commodity currencies, especially those with faster growing domestic-led economies backed by current account surpluses and rising/higher yields.

Hence, the dollar continues to face diversification risks for not satisfactorily meeting all three key criteria – safety, yield and liquidity – of holding foreign reserves. Looking ahead, the G20 intends to have more discussions in 2011 on how to reform the USD-centric international monetary system to enhance stability in an increasingly multipolar world economy. With the yuan starting to become more international this year, there should be more talk about the yuan's prospects as a new reserve currency.

DXY (USD) index and Fed QE



US twin deficits woes



Euro – lacking clarity on ECB-Fed deadlock

In our last quarterly, we did not join the bearish market in predicting that the Eurozone sovereign debt crisis would lead to the demise of the single market or a crash in the euro towards parity. Our historical studies served us well in cautioning that the euro was approaching a bottom its lifetime average around 1.1833. Instead, we believed that EUR/USD would recover and consolidate between 1.20 and 1.30 for the rest of 2010. To understand where we go from here, we need to review what has happened during and after the EU crisis.

When EUR/USD bottomed at 1.1875 on June 7, an important thing happened. US money market (Libor) rates stopped rising and stabilized. The first leg of the euro's recovery to 1.30 came on the back of EU money market (Euribor) rates amidst a stable Libor environment. The next push to 1.33 came on the back of falling Libor after Fed chairman Ben Bernanke called the US recovery outlook "unusually uncertain"; Euribor stopped rising and stabilized. When euro peaked at 1.3333 on August 6, speculators had already fully unwound their net short euro positions amassed during the Greek-led crisis. In this regard, the euro's rise from 1.1875 to 1.3333 was really an unwinding of bearish euro positions, and not because markets had turned bullish on the single currency again.

When euro fell back to 1.2584 on August 24, two things happened. By the FOMC meeting on August 10, US double-dip fears deteriorated into Japan-style deflation worries. While it was not enough for the Fed to give in to market's expectation to expand its balance sheet, it was sufficient enough to inject a dovish tone into Euribor even as Libor continued to slide. More importantly, yen crosses started to fall and weigh on the euro, as global equities retreated on a flight of safety into bonds. Since August 24, the euro had recovered to almost 1.29 on September 3 on the back of better-than-expected US data, as well as another round of monetary easing by the Bank of Japan on August 30 to counter the yen's appreciation.

Unfortunately, the path ahead for the euro is as murky as the one just travelled. For a start, it was intriguing that speculators added to net short euro positions during this latest euro rise. A second half global economic slowdown is still in play. US data remains too mixed to provide clarity while Asia's growth has started to normalize after the strong post-crisis rebound in the first half. Renewed growth worries can hurt euro via a lower Euribor and stable Libor the next time around. Unless there are real upside surprises here, the market is trapped between the Fed and ECB, where both central banks are inclined to do nothing. If so, EUR/USD may well be continuing its consolidation between 1.26 and 1.32 for the rest of the year.

EUR/USD forecast, eop

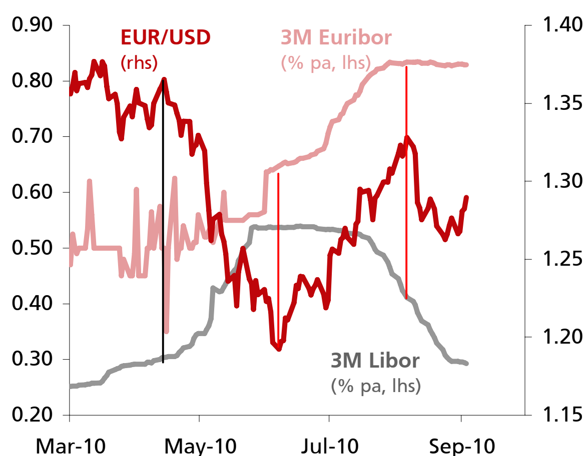
	Latest	Prev
Close	1.27	1.20
4Q10	1.28	1.28
1Q11	1.30	1.30
2Q11	1.32	1.32
3Q11	1.34	1.34
4Q11	1.36	1.36

ECB refi rate forecast, eop

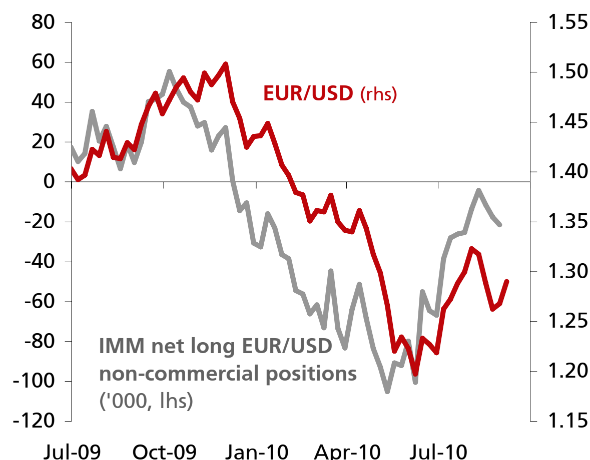
	Latest	Prev
Close	1.00	1.00
4Q10	1.00	1.00
1Q11	1.00	1.00
2Q11	1.00	1.25
3Q11	1.25	1.50
4Q11	1.50	1.75

Latest close on Sep 8
Prev close on Jun 10

EUR/USD struggles on stable EU-US rates



Specs unwound shorts, but did not turn bullish



Japanese yen – intervention risks emerge strongly

USD/JPY forecast, eop

	Latest	Prev
Close	83	91
4Q10	88	95
1Q11	90	96
2Q11	92	94
3Q11	94	93
4Q11	93	92

BOJ o/n target rate forecast, eop

	Latest	Prev
Close	0.10	0.10
4Q10	0.10	0.10
1Q11	0.10	0.20
2Q11	0.10	0.30
3Q11	0.20	0.40
4Q11	0.30	0.50

Latest close on Sep 8
Prev close on Jun 10

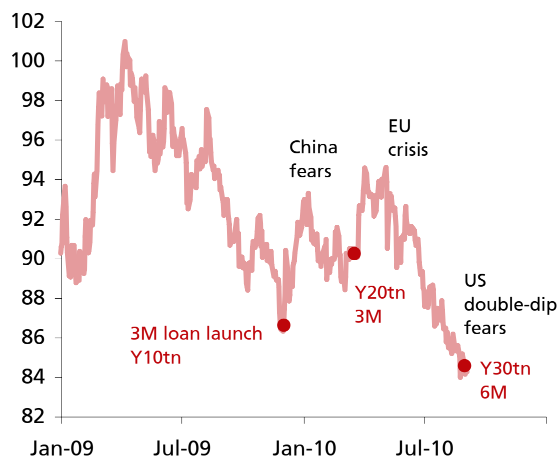
We don't underestimate Japan's intervention threat to arrest the yen's appreciation. Any intervention will have to be unilateral. Concerted intervention is a zero probability on account of the ongoing struggle in the US and Eurozone to emerge stronger from their own crises. Any decision will have to come after the Democratic Party of Japan (DPJ) leadership vote on September 14. DPJ strongman, Ichiro Ozawa, is challenging PM Naoto Kan for the party's presidency and the post of prime minister. Between the two, Ozawa appears more committed to solo intervention and less worried about its effectiveness in reversing the yen's trend.

To prevent USD/JPY from falling sharply below 85, the Bank of Japan (BOJ) expanded its loan program for a second time on August 30. The BOJ first launched a 3-month loan program offering JPY10 trillion loans at 0.1% on December 1, 2009. USD/JPY was 86.64 then and rose to 93.31 by early January 2010 before China's tightening measures hurt global equities. The BOJ program was first expanded to JPY20 trillion on March 17 this year. USD/JPY was 90.27 then as rose to 94.62 in early May until the EU crisis turned global. This time, the limit was raised to JPY30 trillion with the tenor extended to 6 months. USD/JPY was 83.60 on September 8 and has yet to move higher. Based on the past two experiences, USD/JPY could rise as high as 88-91 when markets stabilize with risk appetite returning.

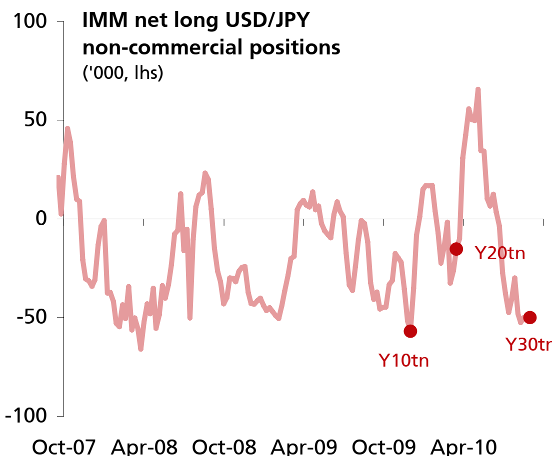
In our view, the yen is not strong currency. It has, like the Swiss franc, become the preferred safe haven currency. Initially, the US dollar also benefited as a safe haven during the Eurozone sovereign debt crisis. It, however, could not hold on to this status after US double-dip fears pushed the Fed to keep the door open on further quantitative easing measures. For Japan, this is an irony. To discount the risk of the US entering into a Japan-style deflation, the market risks pushing Japan deeper into deflation via more yen appreciation.

It is under these circumstances, where markets can no longer be relied upon to set prices based on fundamentals, that interventions can be considered. In today's case, yen strength at these levels has increased the risk of hollowing out by Japan Inc. According to a survey on companies conducted by the Ministry of Economy, Trade and Industry on August 11-24, large manufactures complained that their profits have been hurt by yen strength, not only against the US dollar (65% of respondents) but also the euro (56%). If USD/JPY stays around 85-86, 40% of the respondents are considering moving their production and development centers offshore. Japanese companies also voiced concern that while they have suffered from a stronger yen, their South Korean rivals have become more competitive from a weaker won during/after this global crisis.

USD/JPY & BOJ loan expansion program



Speculative short positions at "limit" in USD/JPY



Chinese yuan – moving towards a more flexibility basket

Look for the Chinese yuan issue to be politicized again into a culmination of major events in November. Apart from the US mid-term elections, the G20 summit and the IMF five-year review are all scheduled to be held in November. The US Treasury is also due to release its semiannual Currency Report in mid-October.

The push on the yuan is likely to focus more on carrots than on sticks this time. To encourage China to fulfil its role as a responsible major economy, especially now that it has overtaken Japan as the world's second largest economy. China's voting rights in the IMF is likely to be increased to reflect its economic clout. The yuan is, however, unlikely to be included in the Special Drawing Right because the exchange rate is still not market-determined and fully convertible on the capital account. The US Treasury may delay its Currency Report, like it did with the previous report, with pressures from US lawmakers to name China a currency manipulator. The US may, but to a lesser extent, rally other emerging countries to pressure China for more yuan gains. We don't discount China responding with more flexibility via a wider trading band for USD/CNY.

China introduced more yuan flexibility on June 19, one week before the G20 summit. A "basically stable" yuan policy was adopted from July 2008 during the US-led global credit crisis into the EU sovereign debt crisis this year. Since the start of the year into June 18, USD/CNY traded within a narrow 0.04% band between 6.8229 and 6.8259. The currency pair fell to the year's lowest level at 6.7670 on August 9, achieving only 0.9% gains for the yuan vs the greenback. Since then, USD/CNY has traded back above 6.80, making good the government's pledge to move towards a two-way exchange rate market.

The People Bank's of China (PBOC) took on a more visible role in setting some "ground rules" for managing the exchange rate. The current account was highlighted as the most important factor in determining the appropriate exchange rate (see chart below). A more flexible exchange rate was also considered as helpful in combating inflation. Also notable was the desire to shift the reference of the yuan from simply the dollar towards a basket of currencies.

Looking beyond the current (fourth) quarter, China is likely to let the yuan appreciate more in 2011. The decision to allow a more flexible yuan probably coincided with the full recovery in exports to pre-crisis levels, which in turn, augmented prospects for the trade surplus to widen again. Another notable trend was the continued rise in China's inflation amidst disinflation in the US. We also expect the US dollar to depreciate next year when recovery hopes displace slowdown worries in the global economy. Hence, we remain comfortable in our call for the yuan to appreciate by 3% in 2011.

USD/CNY forecast, eop

	Latest	*Prev
Close	6.79	6.83
4Q10	6.78	6.69
1Q11	6.73	6.64
2Q11	6.68	6.60
3Q11	6.63	6.55
4Q11	6.58	6.50

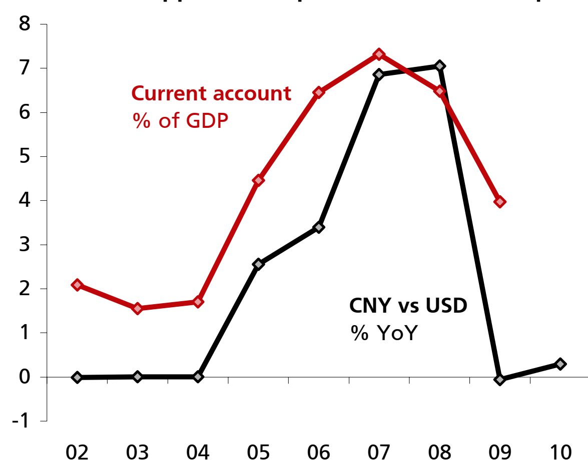
PBOC 1Y lending forecast, eop

	Latest	Prev
Close	5.31	5.31
4Q10	5.58	5.85
1Q11	5.85	6.12
2Q11	6.12	6.39
3Q11	6.39	–
4Q11	–	–

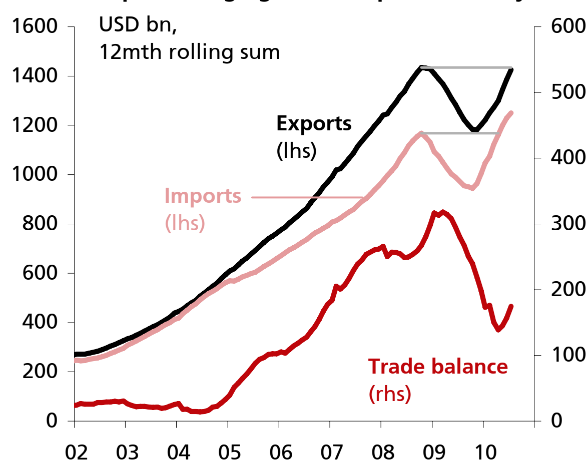
Latest close on Sep 8
Prev close on Jun 10

* revised on Jul 9

PBOC: CNY appreciation pace linked to CA surplus



Trade surplus rising again on export recovery



USD/HKD forecast, eop

	Latest	Prev
Close	7.77	7.81
4Q10	7.78	7.75
1Q11	7.77	7.75
2Q11	7.76	7.75
3Q11	7.75	7.75
4Q11	7.75	7.75

3M Hibor forecast, eop

	Latest	Prev
Close	0.26	0.34
4Q10	0.25	0.30
1Q11	0.25	0.45
2Q11	0.30	0.85
3Q11	0.60	1.35
4Q11	0.80	1.85

Latest close on Sep 8
Prev close on Jun 10

Hong Kong dollar – more progress towards becoming a yuan center

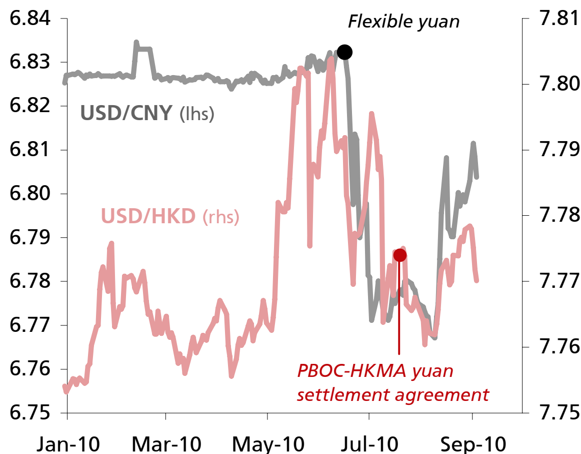
After the Chinese yuan became more flexible in June, the HK dollar has been loosely tracking the yuan, more in direction than in magnitude. This, however, does not imply that the HK dollar is about to shift its peg from the US dollar to the yuan. The market may be simply be treating the HK dollar as a proxy for the yuan. Serious discussion about the future of the HKD peg will eventually surface when China moves closer towards full capital account convertibility. For now, the currency board system will continue to keep USD/HKD trading within its 7.75-7.85 convertibility band.

Rather, increased yuan flexibility was a prelude to a more important development – yuan trading in the territory. Yuan trading activities (forex swaps and forwards, as well as loans and deposits) started from zero after the People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) signed a clearing agreement on July 19 to allow HK banks/insurers to settle yuan-denominated financial products in yuan rather than HK dollars. This would open the door to more yuan-denominated financial intermediary activities (e.g. structured products) in Hong Kong. Earlier in February, HKMA allowed non-Chinese firms to issue yuan-denominated bonds in the territory. Hong Kong also accounted for three quarters of the yuan trade settlements in the first half of 2010. Overall, Hong Kong is witnessing more progress this year in advancing its ambition to become an offshore yuan center by helping China to gradually internationalize the yuan.

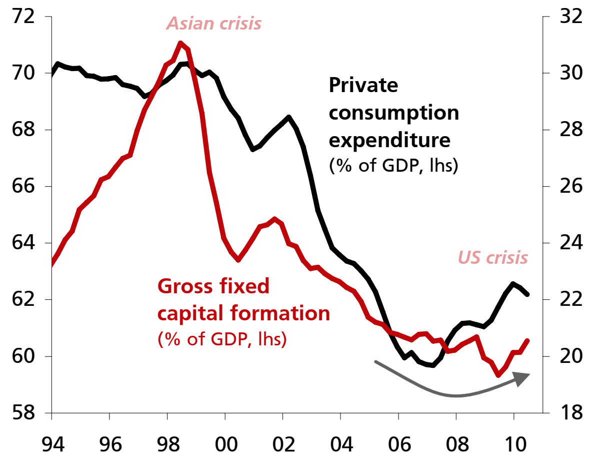
Nonetheless, the HKD peg to the US dollar is posing some challenges for the territory. The main preoccupation of the government this year has been to cool the real estate sector and prevent a property bubble from forming. The task is complicated by the currency peg which keeps HK interest rates ultra-low alongside their US counterparts. Except that HK economy is benefiting more from Asia's robust growth as opposed to a US economy worried about a double-dip recession. And this policy inconsistency is starting to show also in HK's inflation rising with the region amidst disinflation in the US.

To be fair, Hong Kong is not the only one experiencing higher property prices and inflation. Many countries in the Asian region, with more flexible exchange rate regimes and currency appreciation, are also experiencing similar bubble challenges. The problem lies beyond the control of Asia, and in the fragility of the post-crisis US recovery keeping the pressure down on both interest rates and the dollar globally. Interestingly, the combination of a more international yuan and a deleveraging US economy has started to see HK relying more on private consumption expenditure and gross fixed capital formation to drive its post-crisis economic growth story.

USD/HKD vs USD/CNY



Consumption & investment reversing up



Taiwan dollar – defensive on cloudy external outlook

By most measures, the Taiwan dollar should have appreciated more. USD/TWD should have traded lower back towards its precrisis low around 30, like some of its Asian peers. Instead, the currency pair held near the midpoint of its 30-35 post-Asian crisis trading range. Hence, the Taiwan dollar is, and will remain, undervalued based on the following reasons.

Taiwan was one of the three Asian economies that posted two straight quarters of double-digit economic growth in the first half of this year. On average, it was the second best performer after Singapore and China. The current account surplus remained wide at $20.9bn in 1H 2010, second only to last year's all-time high (1H 2009: $23.4bn). This was consistent with the $21.9bn increase in the foreign reserves to $370bn in the first seven months.

The Central Bank of China (CBC) hiked its benchmark discount rate by 12.5bps to 1.375% on June 25. CPI inflation turned positive in January and rose to 1.31% YoY in July. Apart from maintaining positive real rates, the motivation for the hike is more likely to address speculation in the housing sector, as evidenced by the mortgage lending curbs imposed on the same day.

The next quarterly monetary policy meeting on September 30 is likely to deliver another hike. On July 21, CBC governor Perng Fai-nan warned banks to be wary of mortgage speculators following a review of commercial bank's mortgage lending practices. Loan growth at banks first recovered above its precrisis high (October 2008: 4.2% YoY) in May and continued to rise to 6.1% YoY in July.

In the end, the Taiwan dollar is still most correlated with both Taiwan equities (94%) and Asia ex Japan (AXJ) currencies (98%) since early March 2009, when financial markets first stabilized from the global crisis. After hitting a post-crisis high of 8395 in January this year, the TAIEX has been languishing between 7030 and 8190. One can say that the benchmark equity index has already fully discounted the "square-root" recovery i.e. a strong rebound from crisis before returning to more normal trend growth. Except that normal now looks more cautious from increased uncertainties in the G3 outlook. Ergo a Taiwan dollar that was more defensive in appreciating compared to its AXJ counterparts.

One possible explanation is the persistent slide in export orders growth from its 71.8% YoY peak in January to 18.2% in July. There was no doubt that the base effect was at work here. Even so, there is worry that the second slowdown story could give way to US double-dip fears, more so if export orders fail to pick up from current levels, with growth sliding to low single-digit levels, ahead of the year-end US holiday season.

USD/TWD forecast, eop

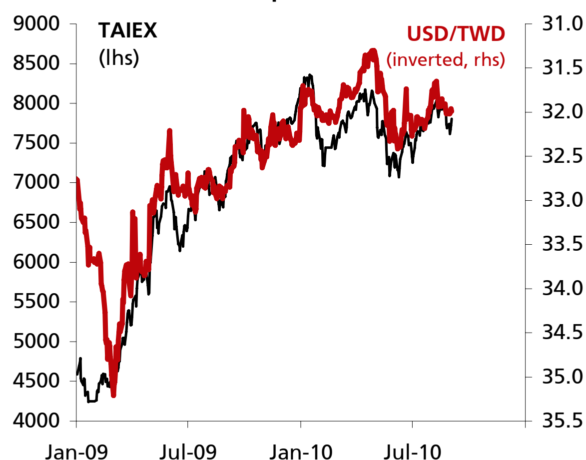
	Latest	Prev
Close	31.9	32.4
4Q10	32.0	31.7
1Q11	31.8	31.5
2Q11	31.6	31.3
3Q11	31.4	31.1
4Q11	31.2	30.9

CBC discount rate forecast, eop

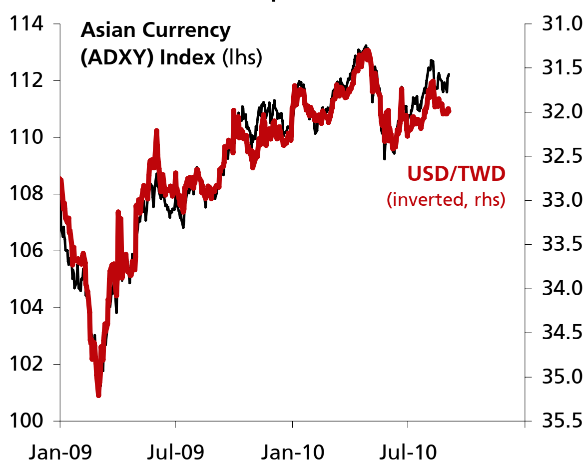
	Latest	Prev
Close	1.38	1.25
4Q10	1.75	1.75
1Q11	2.00	2.00
2Q11	2.25	2.25
3Q11	2.50	2.50
4Q11	–	–

Latest close on Sep 8
Prev close on Jun 10

USD/TWD vs Taiwan equities



USD/TWD vs Asia ex Japan currencies



Korean won – interest rates over currency to achieve macro balance

USD/KRW forecast, eop

	Latest	Prev
Close	1172	1247
4Q10	1200	1150
1Q11	1190	1140
2Q11	1180	1130
3Q11	1170	1120
4Q11	1160	1110

BOK 7D repo, forecast eop

	Latest	Prev
Close	2.25	2.00
4Q10	2.75	3.00
1Q11	3.25	3.50
2Q11	3.50	3.75
3Q11	3.75	4.00
4Q11	4.00	–

Latest close on Sep 8
Prev close on Jun 10

The outlook for the won is mixed with a favorable bias. Positive factors supporting the currency include the start of the interest rate normalization process and a still-wide trade surplus. On the side of caution, the external outlook is obscured by the lack of clarity in G3's economic recovery momentum, at a time when growth rates in manufacturing/production data are normalizing after the sharp rebound from the global crisis. Hence, we have decided to take a view for USD/KRW to trade in the 1100-1200 range in the next twelve months.

The Bank of Korea (BOK) started to exit from its highly accommodative monetary policy on July 9. The base rate was lifted by 25bps to 2.25% from its all-time low of 2.00%. We are projecting the base rate to rise to 2.75% by end-2010 and further to 3.50% by June 2011.

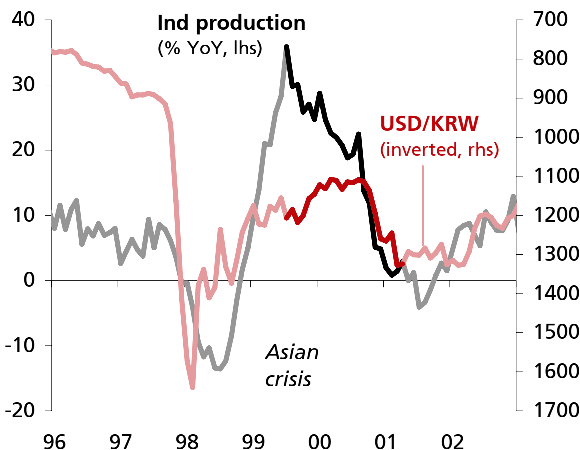
Despite rate inaction at the following month's meeting, BOK governor Kim Choong-soo announced that monetary policy would be geared towards maintaining price stability. The policy rate is still below CPI inflation, which averaged 2.6% YoY in the first eight months of this year. More importantly, core inflation has bottomed at 1.5% in April and rose steadily to 1.8% in August. The central bank expects headline inflation to accelerate to 3.4% in 2011 from a projected 2.8% this year.

The trade surplus remained strong at $24.9bn in the first eight months vs $25.2bn the same period a year ago. Exports in 2010 look set to beat the record year set in 2008 before the global crisis. The current surplus also widened sharply to $10.3bn in 2Q from $1.3bn in 1Q.

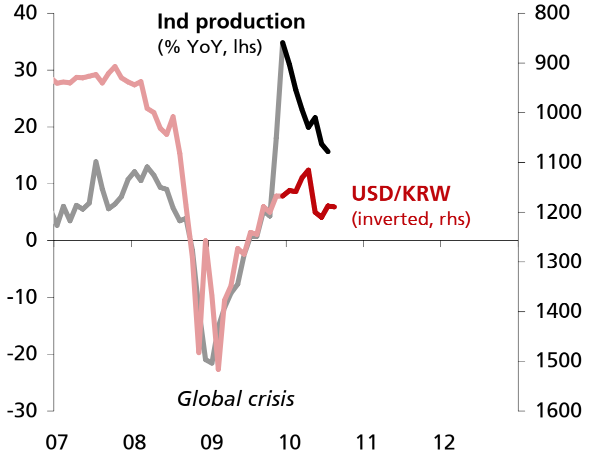
The trade surplus, however, reflected a slower post-crisis rebound in imports. This coupled with a deceleration in services sector growth to 3.4% YoY in July from its peak of 7.3% in February also reflected a less impressive domestic demand. This goes some way to explain why Korea's real GDP growth did not match its Southeast Asia peers.

Against this backdrop, Korea will become more sensitive to global demand. Owing to a rising base from the recovery that started in 2H last year, export and import growth rates have already peaked and started to slide. More importantly, growth in industrial production also retreated sharply to 15.6% YoY in July from 34.8% in December. Month-on-month growth rates were also slower by an average 2.0% in the first seven months compared to the same period a year ago. Falling back on the Asian crisis experience, there should be more resistance to more won appreciation as export/manufacturing growth slows. Perhaps this explains the policy bias for monetary policy to play a bigger role to achieve a better macro balance during this period of rising inflation and slowing export growth.

KRW vs manufacturing during Asian crisis



USD/KRW vs manufacturing today



Singapore dollar – appreciation trend intact, pause first

In early September, the Sing dollar fully retraced its losses incurred during the 2008/09 global crisis. USD/SGD hit its precrisis low of 1.3438 on September 2. The Sing dollar's stellar performance reflected Singapore's position as the fastest growing economy in Asia in the first half of 2010. Chain-linked real GDP started the year on a robust note, expanding 16.9% YoY in 1Q, followed by a more impressive 18.8% in 2Q. Together, this was the fastest first half growth achieved since 1975.

Herein lies the rationale for the two-step tightening in its exchange rate policy at the Monetary Authority of Singapore (MAS) policy review in April. The SGD NEER (nominal effective exchange rate) policy band was re-centered higher and returned to a modest and gradual appreciation pace. The twin steps were important to help contain inflation within the authority's 2.5-3.5% target, where it has been since April.

The next MAS policy review in October is likely to maintain the status quo, balancing between a second half economic slowdown and a still-high inflation rate. Based on its full-year 13-15% growth projected for 2010, the Ministry of Trade and Industry (MITI) is expecting the economy to slow to 8.5-12.4% in the second half of year. The ministry also cautioned of a possible technical recession, defined as two consecutive quarters of negative sequential (QoQ) growth.

Under the circumstances, the appreciation of the Sing dollar is likely to pause in the early part of 4Q 2010. In our view, the Sing dollar's appreciation to its precrisis high reflected the emergence of Singapore from the global crisis. Owing to Singapore's status as a price-taker economy, the next appreciation phase (beyond this record level) should reflect the global economy's transition towards a more sustainable growth path. We think this will happen in 2011 and see the next push towards more Asian currency appreciation emerging around end-2010.

Before this can happen, we need to get past US double-dip worries, as well as the second-half moderation in Asia's lofty growth rates towards a more normal sustainable and non-inflationary trend. For now, the appreciation pace of the Sing dollar is limited by the SGD NEER trading at the strong limit of our in-house policy band, unless the US dollar depreciates meaningfully against its basket of currencies. The lack of clarity over the US and EU recoveries are also reflected by the uncertain outlook for the US dollar and the euro. Until this becomes clearer, China will be slow to resume the appreciation in its yuan. Under these circumstances, other Asian currencies have become more reluctant to tolerate appreciation, and have become more vigilant in conducting interventions.

USD/SGD forecast, eop

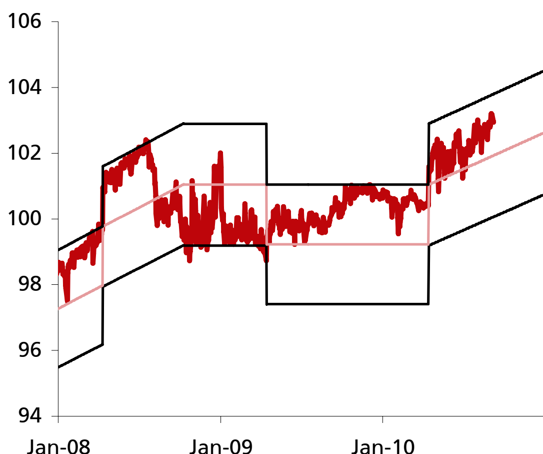
	Latest	Prev
Close	1.34	1.41
4Q10	1.36	1.37
1Q11	1.34	1.36
2Q11	1.33	1.35
3Q11	1.32	1.34
4Q11	1.31	1.33

3M Sibor forecast, eop

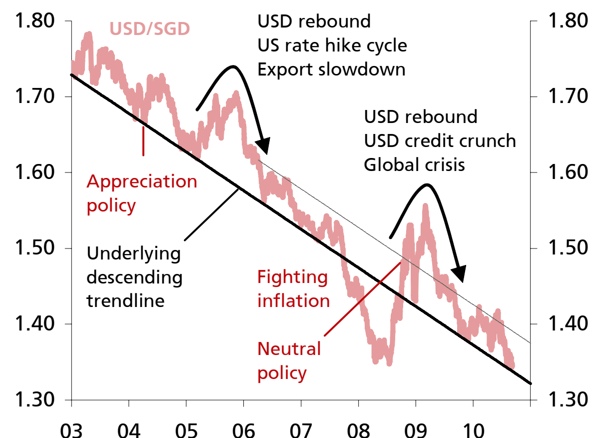
	Latest	Prev
Close	0.52	0.55
4Q10	0.50	0.41
1Q11	0.50	0.49
2Q11	0.55	0.79
3Q11	0.73	1.05
4Q11	0.84	1.31

Latest close on Sep 8
Prev close on Jun 10

SGD NEER at strong half of policy band



USD/SGD at support of trendline



Malaysian ringgit – becoming a more integral part of Asia's growth story

USD/MYR forecast, eop

	Latest	Prev
Close	3.11	3.32
4Q10	3.16	3.20
1Q11	3.12	3.18
2Q11	3.09	3.16
3Q11	3.07	3.14
4Q11	3.05	3.12

BNM o/n policy rate forecast, eop

	Latest	Prev
Close	2.75	2.50
4Q10	2.75	3.00
1Q11	3.00	3.25
2Q11	3.25	3.25
3Q11	3.25	3.25
4Q11	3.25	3.25

Latest close on Sep 8
Prev close on Jun 10

On August 19, USD/MYR fell back to 3.1280, it precrisis low seen in April 2008. Since early September, it has traded below this level. Since then, the currency pair has been stable around these levels with a downside bias. Neither the prime minister nor the central bank governor expressed any concern over the ringgit's appreciation hurting export competitiveness at these levels. As at September 1, the ringgit held on to its position as the best performing emerging Asian currency.

Policy was the main contributing factor to the ringgit's strength in 3Q 2010. On the monetary policy front, Bank Negara Malaysia (BNM) normalized interest rates for the third time this year. The overnight policy rate was lifted by another 25bps to 2.75% on July 8. For most of this year, CPI inflation rose steadily to 1.9% YoY in July from 1.2% in February.

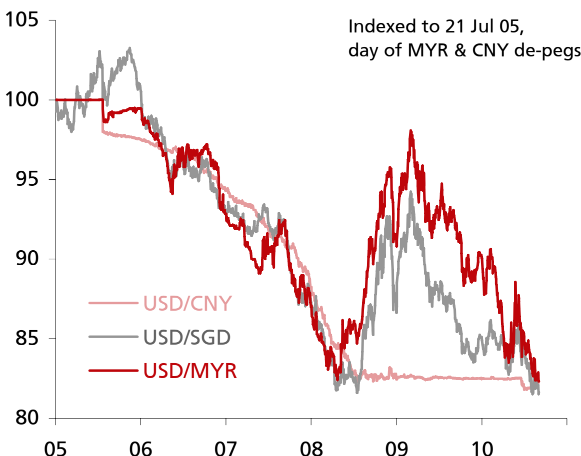
On the exchange rate policy front, there were two major changes announced on August 18. Domestically, Bank Negara Malaysia (BNM) allowed settlement of international trade in goods and services between residents and nonresidents in ringgit while maintaining the ban on offshore ringgit trade. Externally, China started onshore trading of the yuan against the ringgit. The last time China and Malaysia moved together was in July 2005 when they freed their currency pegs.

Was it coincidence that these changes occurred when USD/MYR and USD/SGD not only fell back towards their pre-crisis levels, but also converged with USD/CNY on an indexed basis? If not, this would by default, increase the ringgit's sensitivity to yuan appreciation expectations. The Sing dollar, a popular proxy for Asia ex Japan currencies, would become an important reference to keep the ringgit aligned to regional currency trends.

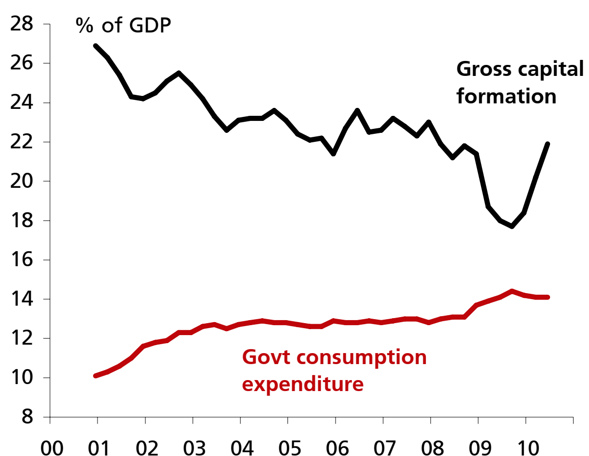
On the bigger picture, Malaysia appears to be keeping in step with China to develop its foreign exchange market. This process is important in several regards. First, it will be part of the country's efforts to comply with regional economic reform to coincide with the establishment of the ASEAN Economic Community (AEC) in 2015, during which the yuan is expected to join the basket of currency within the IMF SDR. Malaysia is a firm believer that Asia will lead global growth and is seeking to seize the opportunity in the next five years to shift its growth driver from fiscal stimulus towards private investment. This coupled with a New Economic Model based on meritocracy and transparency will be important for Malaysia to achieve developed nation status by 2020, which also happened to be China's deadline for Shanghai to become an international centre.

In short, the ringgit is becoming more evident as an integral part of the Asian growth story in the next few years.

MYR emerges from global crisis with SGD & CNY



Moving from govt stimulus to investment



Thai baht – overall favorable but trade deficit may pose a drag

In the third quarter, the Thai baht joined its Southeast Asian peers – the Singapore dollar, Malaysian ringgit and Indonesian rupiah – in recovering back to its precrisis high against the dollar. As at September 1, the baht was the best performing currency in Asia ex Japan with 3.9% gains since end-June. In turn, the baht overtook the rupiah to become the second best performer for the year. This was consistent with the Thai stock market surpassing its Indonesian counterpart for top honors this year.

Not everyone was happy about the baht's appreciation. The Commerce Ministry, in particular, blamed the strong baht for the slide in export growth to 20.6% YoY in July from the 46.3% peak in June. The Finance Ministry and the Bank of Thailand (BOT), however, did not share the Commerce Ministry's concern that a strong baht had led to a loss of export competitiveness. The slower YoY growth was easily attributed to the higher base during the recovery in 2H 2009.

The Finance Ministry also probably viewed the outperforming baht and Thai equities as welcome signs of returning foreign investor confidence. This will be useful for the Democrat-led ruling coalition as it heads into general elections, which could be held as early as November. Unlike the developed nations, elections in emerging Asian countries have been largely peaceful and positive for markets. If Thailand can achieve the same outcome, it could put behind the past years of contentious domestic politics. Fitch has already indicated intentions to lift the Thai sovereign debt rating outlook to stable from negative.

The central bank also probably welcomed a stronger baht as helpful in curbing imported inflation. The BOT hiked its 1-day repo rate by 25bps to 1.75% on August 25, making good its earlier pledge to lift rates to 2.00% by year-end. For now, the policy rate is nestled between headline CPI (July 2010: 3.4% YoY) and core inflation (July 2010: 1.2% YoY). Nonetheless, the first post-crisis hike probably contributed to the baht's appreciation in August, when double-dip and deflation worries clouded US recovery prospects.

Even so, we need to guard against one-way bets in the baht's appreciation. Inasmuch as the baht has surprised on upside recently, it could also quickly reverse course, especially if more trade and current account deficits follow those seen in July. The periods of exception were the weak US dollar period (led by an accelerating yuan appreciation in China) in 1H 2006 and the globally high inflation environment in 1Q 2008. Perhaps this explained why the finance ministry hedged itself by warning that USD/THB would meet more aggressive interventions below the psychological 30 level. To balance these factors, we have decided to profile a modest appreciation path for the baht into 2011.

USD/THB forecast, eop

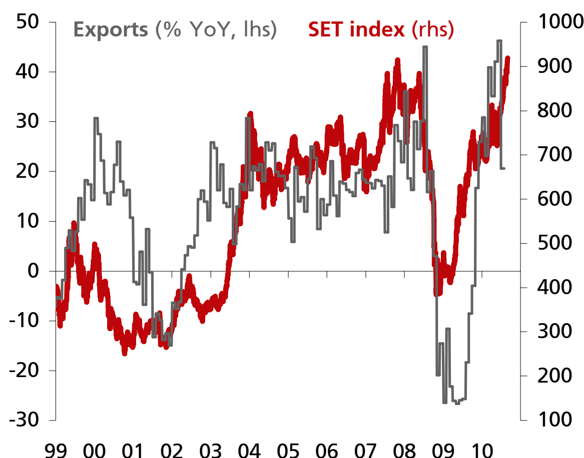
	Latest	Prev
Close	31.0	32.6
4Q10	32.2	32.2
1Q11	31.9	31.9
2Q11	31.7	31.7
3Q11	31.5	31.5
4Q11	31.2	31.2

BOT 1D repo rate forecast, eop

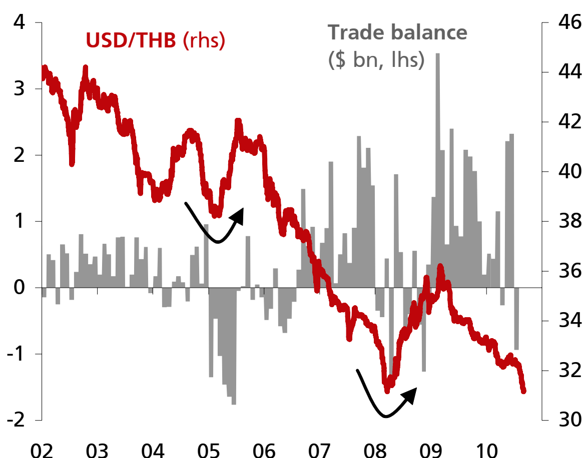
	Latest	Prev
Close	1.75	1.25
4Q10	2.25	2.00
1Q11	2.75	2.50
2Q11	3.00	2.75
3Q11	3.00	2.75
4Q11	3.00	3.00

Latest close on Sep 8
Prev close on Jun 10

Thai equities vs export growth



THB is not immune to trade deficits



Indonesian rupiah – favoring a stable 9000-9500 range

USD/IDR forecast, eop

	Latest	Prev
Close	8995	9245
4Q10	9200	9100
1Q11	9100	9000
2Q11	9000	8900
3Q11	8900	8800
4Q11	8800	8700

BI benchmark rate forecast, eop

	Latest	Prev
Close	6.50	6.50
4Q10	6.75	7.25
1Q11	7.50	7.75
2Q11	8.00	8.00
3Q11	8.00	8.00
4Q11	8.00	8.00

Latest close on Sep 8
Prev close on Jun 10

We have not changed our view for USD/IDR to trade within a stable 9000-9500 range for the rest of the year. Despite the bullish market sentiment, we remain wary that the fundamentals that propelled the rupiah's post-crisis stellar recovery have become less favorable.

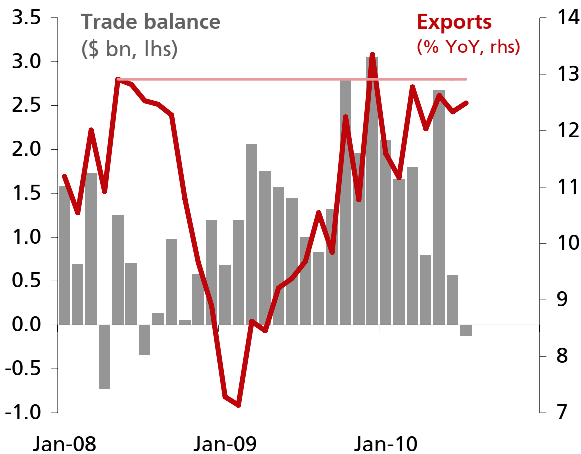
The trade surplus reversed into a $129mn deficit in July 2010, the first shortfall since July 2008. From its peak of $7.8bn in 4Q 2009, the trade surplus has narrowed steadily to $5.6bn and $4.0bn in 1Q and 2Q 2010 respectively. This was largely attributed to the recovery of imports playing catch-up to exports this year. Even so, it has become a concern that exports have languished this year after posting a new record high of $13.3bn in December 2009. Since then, exports have not been able to surpass the precrisis peak of $12.9bn seen in May 2008.

There was also a notable tonal change in Bank Indonesia (BI) over the rupiah's appreciation in August. The first sign came shortly after the FOMC meeting on August 10 sharply increased US recovery doubts with the Fed's decision to rollover maturing securities into treasuries. BI governor Darmin Nasution hinted on August 13 that USD/IDR was uncomfortably low at 8965 and should be higher above the psychological 9000 level. The rest of August witnessed Japan (Indonesia's largest export market) struggling to prevent further yen appreciation from hammering its fragile economy. Hence, it should not come as a surprise why Nasution predicted on August 31 a weaker rupiah in 2011 on lower capital inflows.

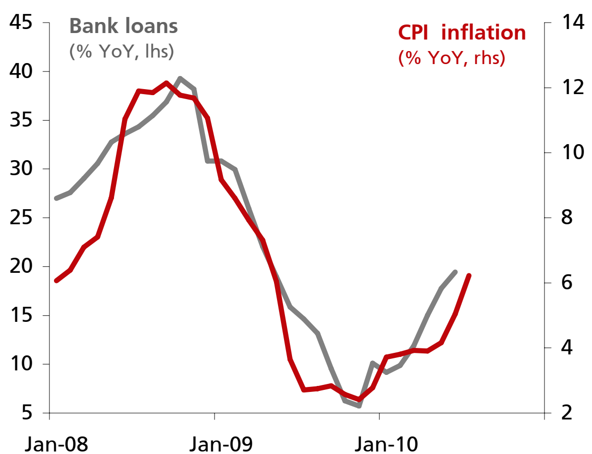
Apart from export competitiveness, arresting rupiah appreciation expectations is also probably targeted at discouraging inflows. This would, in turn, provide a window to address the excess liquidity in the banking system. With CPI inflation and bank lending growth rising together in recovery, the challenge ahead is how to keep up lending without triggering rate hikes. Despite inflation rising to 6.44% YoY and converging with the 6.50% policy reference rate, BI has resisted raising rates, taking comfort in a still-low core inflation rate of 4.53% (August).

Like it or not, outstanding tradable rupiah bonds held by foreigners increased IDR64.2 trillion ($19.1bn at USD/IDR 9000 rate) in the first seven months. And foreign reserves increased $12.7bn in the comparable period to a record high of $78.8bn in July. To some extent, the cloudy US recovery outlook may turn out to be a blessing in disguise by keeping the Fed hikes at bay. For now, BI is likely to rely on managing the banks' reserve requirement levels and loan/deposit ratios to absorb the excess liquidity and improve credit allocation to safeguard the economic recovery and the banking sector. This would put Indonesia in a stronger position to capitalize on the global recovery when the outlook improves again.

First trade deficit, languishing exports



Is it possible to keep lending without inflation?



Philippine peso – a promising laggard in SE Asia

The performance of the peso has been a mixed bag in 2010. Compared to its Southeast Asian peers, the peso has been disappointing. The Singapore dollar, Malaysian ringgit, Thai baht and Indonesian rupiah appreciated back to their pre-crisis highs, while the peso retraced only 40% of its losses incurred during the 2008/09 global crisis. On the other hand, the peso could also be considered as resilient too. During the recovery from the crisis from May 2009, the peso has traded mostly at parity with the Indian peso, until recently. In 3Q10, the peso appreciated even as the Indian rupee depreciated.

For the medium-term, the peso probably has more scope to play catch up with its Southeast Asia counterparts than the rupee. This is more of a 2011 outlook. In the short-term, we remain wary of slowdown risks in the global economy, especially those pertaining to the US and other G3 economies.

Following the swearing in of Benigno Aquino III as President on June 30, business confidence hit a record high in a BSP survey conducted from July 1 to August 10. The usual factors were cited for the optimism in the next twelve months – better-than-expected GDP growth of 7.8% in 1H 2010, well-anchored inflationary expectations and low interest rates, a stronger export recovery and higher overseas foreign worker remittances.

Beyond these usual factors, the Aquino government is also seen keen to keep the economy on a high growth path. Unlike his predecessor, President Aquino is not seeking to balance the budget during his six-year term. The finance ministry aims only to lower the deficit from a projected 3.9% of GDP this year to 2% in 2013, where it will stay until 2016. For a start, the finance ministry is proposing infrastructure spending in its upcoming budget to achieve a 7-8% growth rate in 2011. If both the upper and lower houses deliver a smooth passage in the spending bill, this will be a clear departure from the previous administration's frustration with delayed spending bills. Against this background, the central bank would probably not be in a rush to hike rates, especially now that key inflation gauges have fallen below the policy rate again. The overnight borrowing rate has been unchanged at 4.00% since July 2009.

Longer-term, the external debt position needs monitoring, especially if the government is leaning on increasing leverage to spur growth. Having bottomed at $51.8bn in 2Q 2009, external debt rose to $55.4bn in 1Q 2010 and is converging on its all-time high of $57.4bn in 4Q 2003. For now, this remains comfortably low as a proportion of GDP, at 33.1% in 1Q 2010 vs 72.1% in 4Q 2003. It would also be good if the current account maintains its surpluses.

USD/PHP forecast, eop

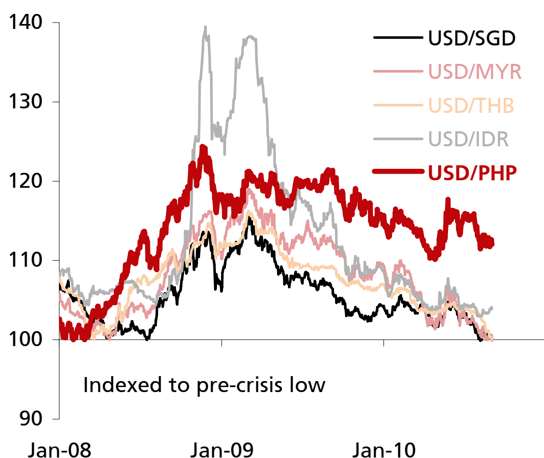
	Latest	Prev
Close	44.2	46.6
4Q10	44.9	45.5
1Q11	44.4	45.3
2Q11	43.9	45.1
3Q11	43.4	44.9
4Q11	42.9	44.7

BSP o/n call rate forecast, eop

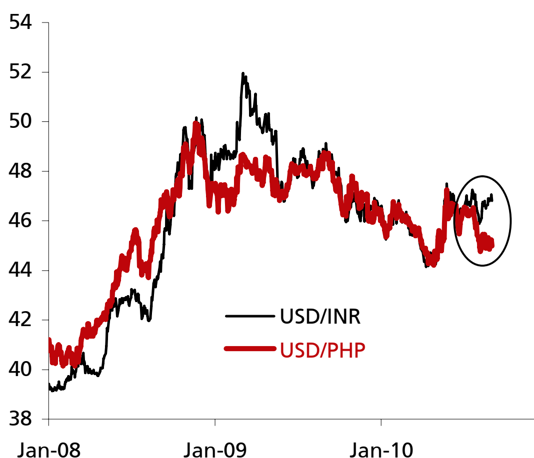
	Latest	Prev
Close	4.00	4.00
4Q10	4.25	4.50
1Q11	4.50	4.75
2Q11	4.75	5.00
3Q11	5.00	5.25
4Q11	5.25	5.50

Latest close on Sep 8
Prev close on Jun 10

PHP underperformed SE Asian peers



PHP resilient to INR weakness



Indian rupee – a tough rebalancing act

USD/INR forecast, eop

	Latest	Prev
Close	46.6	47.0
4Q10	46.6	45.6
1Q11	46.2	45.4
2Q11	45.7	45.2
3Q11	45.3	45.0
4Q11	44.8	44.8

RBI repo rate forecast, eop

	Latest	Prev
Close	5.75	5.53
4Q10	6.25	6.25
1Q11	6.50	6.50
2Q11	6.50	6.50
3Q11	6.50	6.50
4Q11	6.50	6.50

Latest close on Sep 8
Prev close on Jun 10

The rupee was, as at September 3, the second worst performing currency in Asia ex Japan (AXJ) in the third quarter. Although the depreciation was small at 0.4% against the US dollar, the performance was disappointing after taking into account the 2.9% rise in Indian equities and the average 1.8% appreciation in AXJ currencies.

The rupee's underperformance highlights the challenges confronted by India to rebalance its economy. The post-crisis return to a high economic growth path was accompanied by its worst-ever trade deficit (1H 2010: $61.4bn) and its record wide current account deficit (1Q 2001: $13.0bn), as well as double-digit inflation.

With imports continuing to outpace exports, the full-year deficit for this calendar year is likely to exceed the record $126bn (7.8% of GDP) deficit in 2008. The current account deficit was also symptomatic of a negative real interest rate environment encouraging more investment and less savings.

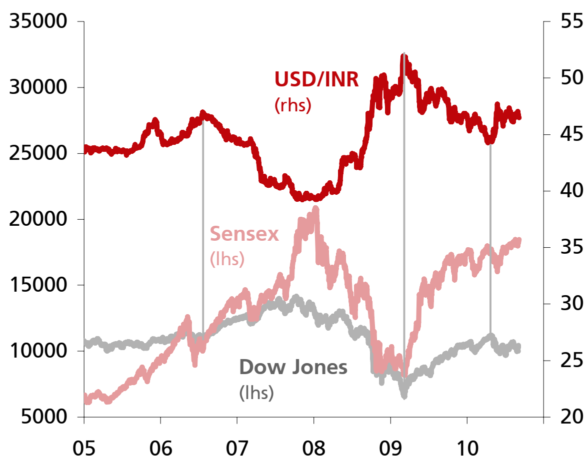
The persistence of this trend implies that India will become increasingly reliant on capital inflows to fund the current account deficit. This helped to explain why foreign reserves (July 2010: $284bn), unlike many of its Asian counterparts, has yet to recover to its pre-crisis high (May 2008: $315bn). That was probably why the rupee has not been able to capitalize on Sensex's rise this year, as much as it did last year.

To complicate matters, industrial activities have started to moderate, alongside worries over a global slowdown in 2H 2010. Industrial production growth, which has a habit of leading the rupee, has decelerated to 11.7% YoY (3mth moving average) in June from its peak of 16.3% in February. Similarly, export growth moderated to 24.5% in July from its post-crisis high of 41.4% in April.

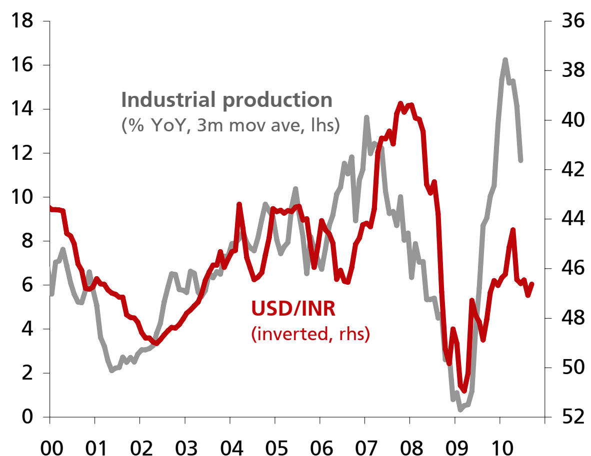
The moderation in the manufacturing/export sectors presents a challenge to rein in double-digit inflation. Although key inflation gauges have eased from their peaks, they were still high in July, at 10.0% YoY and 11.3% for WPI and CPI respectively. It is hoped that the better monsoons will help to bring inflation lower and narrow the gap with interest rates. Between February and July, the reverse repo was increased by 125bps to 4.50%, the repo by 100bps to 5.75% and the cash reserve ratio by 100bps to 6.00%.

To provide support for growth, the Planning Commission has indicated that government spending will pick up again after the June-September monsoon rains. Fortunately, the fiscal deficit is likely to undershoot the INR3.81 trillion (5.5% of GDP) target for the current fiscal year ending March 2011. The budget shortfall was INR909bn in the first four months ending July 2010.

INR has been less reponsive to stocks this year



INR faces drag from manufacturing slowdown



Vietnam dong – from devaluation to band widening

The State Bank of Vietnam (SBV) devalued the dong on August 18 for the third time since last November, with each move smaller than the previous episode. The devaluation in August 2010 was 2.0%, compared to 3.3% in February 2010 and 5.4% in November 2009. By end-August this year, the dong had depreciated a total 5.2% year-to-date, compared to the full-year fall of 7.1% in 2009.

Looking ahead, we don't expect another devaluation, but don't discount a further weakening via a widening in the USD/VND trading band back to ±5%. The band was last narrowed in November 2009 to ±3% from ±5%. If so, this would translate into a de facto 1% devaluation. This would allow the spot USD/VND rate to trade higher towards 19,879 from the current ceiling of 19,500.

The steady deceleration in the dong's devaluation pace has been consistent with the improvement in cyclical factors ameliorating pressures on the trade and budget deficits. Based on 12-month rolling sum data, the trade deficit has been narrowing modestly on a trend basis since May on the back of exports recovering to pre-crisis highs. The Ministry of Planning and Investment now expects exports to rise 19.2% in 2010, compared to its earlier forecast of 6%. The budget deficit is also unlikely to exceed the official target of VND120.7 trillion (or 6.2% of GDP) for 2010. The shortfall in the first seven months totaled VND31.6 trillion, thanks to a tighter rein in government spending against modestly slower revenue.

Barring any unforeseen shocks to recovery prospects, Vietnam is also unlikely to tolerate significantly more currency weakness as it proceeds to tackle inflation. PM Nguyen Tan Dung announced on August 5 that the government aimed to bring inflation below 8% (Aug10: 8.18% YoY) and lower bank lending rates by end-year. The Finance Ministry confirmed that it was proceeding with plans to impose price control measures starting from October 1. The central bank also affirmed that it will keep the base rate at 8%, where it has stayed since the 100bps hike in December 2009.

Even so, Vietnam still faces downside risks in its sovereign debt ratings. On July 29, Fitch downgraded the country's long-term foreign currency debt rating by one notch to "B+", four months after placing the country on negative watch in March. Moody's and S&P, who have negative watches for Vietnam's ratings, may be the next to move. Their ratings for Vietnam are also one and two notches above Fitch's rating. On our part, we feel that Vietnam also needs to improve the timeliness of its economic data releases, for example, the current account balance and foreign reserves.

USD/VND forecast, eop

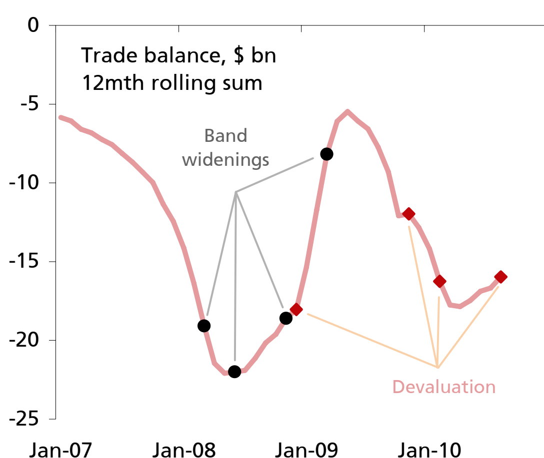
	Latest	Prev
Close	19450	18960
4Q10	19490	19420
1Q11	19540	19450
2Q11	19590	19450
3Q11	19640	19480
4Q11	19690	19480

SBV prime rate forecast, eop

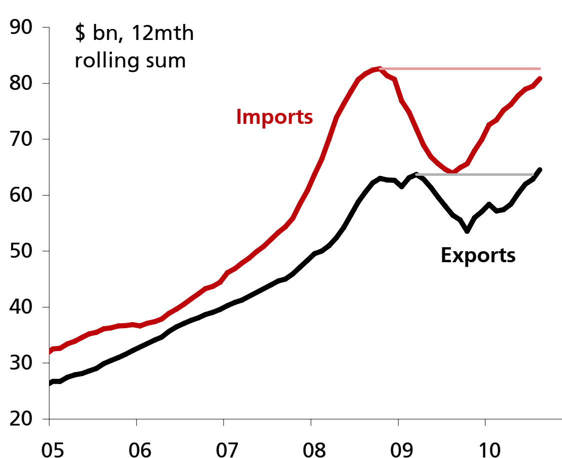
	Latest	Prev
Close	8.00	8.00
4Q10	8.00	8.00
1Q11	8.00	8.00
2Q11	8.00	8.00
3Q11	8.00	8.00
4Q11	8.00	8.00

Latest close on Sep 8
Prev close on Jun 10

Weakening VND to address trade deficit



Exports recovered to pre-crisis high



Australian dollar – tone firm but wary of Asia's growth normalization

AUD/USD forecast, eop

	Latest	Prev
Close	0.92	0.83
4Q10	0.88	0.88
1Q11	0.89	0.89
2Q11	0.90	0.90
3Q11	0.91	0.91
4Q11	0.92	0.92

90D bank bill futures, % pa

	Latest	Prev
RBA	4.50	4.50
Cash	4.73	4.91
Dec10	4.78	4.84
Mar11	4.82	4.93
Jun11	4.86	5.04
Sep11	4.88	5.20
Dec11	4.96	5.29

Latest close on Sep 8
Prev close on Jun 10

The Reserve Bank of Australia (RBA) left its cash target rate unchanged at 4.50% after delivering six rate hikes totalling 150bps from October 2009 to May 2010. Consensus expects the policy rate to rise by another 100bps to 5.50% by end-2011, starting with 25bps in 4Q 2010.

The RBA believes that the economy is operating near full capacity and that the labor market is also near full employment. The central bank remains alert to inflation risks, especially after its index of commodity prices hit its lifetime high in August. Real GDP growth was also better-than-expected at 3.3% YoY in 2Q 2010 (vs 2.8% consensus and 2.6% previous), with the real surprise coming from stronger consumption expenditure.

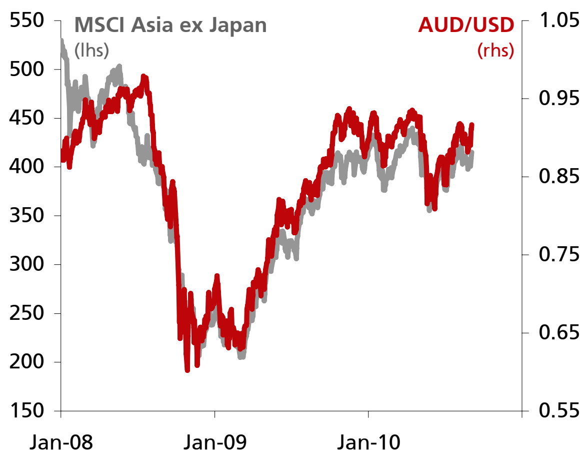
Despite persistent worries over the sustainability of the US recovery, the RBA believes that Australia's growth in the next two years is safeguarded by strong demand from China and Asia contributing to resource export earnings and mining investment.

Given the above circumstances, the RBA does not appear too concerned about the Australian dollar's strength, and probably also the appreciating pressures from a dovish US rate outlook. It also helped that the trade balance reported four straight months of surpluses into July. In turn, this helped the current account deficit to narrow sharply to AUD5.6bn in 2Q 2010 from AUD16.5bn in the previous quarter.

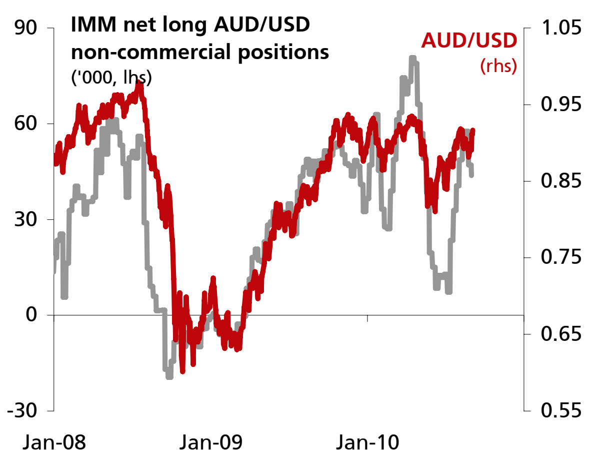
Although the above assessment is positive for Australian dollar, we remain mindful that the Australian dollar remains highly correlated with Asia ex Japan equities. And it is here that the Australian dollar is tied to US growth fears regardless of the Australian policymakers' belief in the resilience of their economy. That's why we remain wary about the slowing momentum in the US economy into the rest of the year amidst signs of Asia's robust post-crisis growth rates normalizing. With speculators having already accumulated more-than-modest net long Australian dollar positions, unwinding risks are no longer low.

The true benefit of Australia's favorable fundamentals is best felt when risk appetite returns to global financial markets on improving economic data. The appreciation pressure will be strongest when markets renew RBA rate hike bets, amidst a dovish US rate environment and a weak yen spurring carry trades. We believe the next opportunity will present itself after November, when the market is friendlier with China ready to allow more appreciation in its yuan exchange rate. Until then, we reckon that the AUD/USD will probably be trading its familiar 0.87-0.94 range.

AUD needs higher Asian equities to move higher



Unwinding risks from short-term speculators



New Zealand dollar – caught between rate hike and trade deficit

Economic growth recovered to 1.9% YoY in 1Q 2010 from -3.1% in 1Q 2009. Exports and tourism contributed to the turnaround, with the country now more reliant on China and Australia. This goes some way to explain why NZ dollar has been fluctuating closely with both the Australian dollar and Asia ex Japan equities since the global crisis. Nonetheless, the recovery remains uneven, with the jobless rate still high at 6.8% in 2Q 2010, and slow to move lower from its crisis peak of 7.1% in 4Q 2009.

Rate hike expectations are likely to support the NZ dollar too. Consensus is looking for the Reserve Bank of New Zealand (RBNZ) to lift its official cash rate to 3.50% by end-2010 and 4.50% by 3Q 2011. The policy rate was hiked twice, on June 10 and July 29, by a total 50bps to 3.00%. Although inflation has been stable at 1.7-2.0% YoY since 2Q 2009, the RBNZ has projected inflation to rise and peak at 5.0% in 2Q 2011. This was due to the increase in the goods and services tax announced in the May budget and taking effect from October 1.

Another positive factor is the government's campaign to restore fiscal credibility. Following the EU sovereign debt crisis in the second quarter, Finance Minister Bill English revealed on July 12, his determination to return to a budget surplus ahead of the 2015/16 target. In addition limiting new budget operating allowances at NZD1.1bn a year, the government has reprioritized about NZD3.8bn in spending. The finance ministry announced on August 24 that it has set up a Savings Working Group to find ways to boost national savings, improve the current account deficit and reduce reliance on foreign borrowings.

On the external front, the current account deficit narrowed to 2.4% of GDP in 1Q, the lowest in almost 21 years. This was attributed to trade surpluses and reduced borrowings then. The current account deficit would probably narrow again in 2Q because of higher trade surpluses. Even so, the RBNZ still favors a weaker NZ dollar to rebalance the savings-investments gap.

Beyond that, it will be hard to say because the trade deficit returned in July. The higher-than-expected imports was attributed to more consumer imports, which in turn, implies a pre-GST retail spending boost for the economy in the third quarter. The trade deficit also presented a note of caution from lower-than-expected exports signaling possible headwinds in the external sector, namely, slowdown risks from the US and other sluggish G3 economies. It is with this mind that we resist the temptation to aggressively push up our NZ dollar forecasts. Instead, we prefer to reflect our optimistic bias by keeping the numbers above the psychological 0.70 level.

NZD/USD forecast, eop

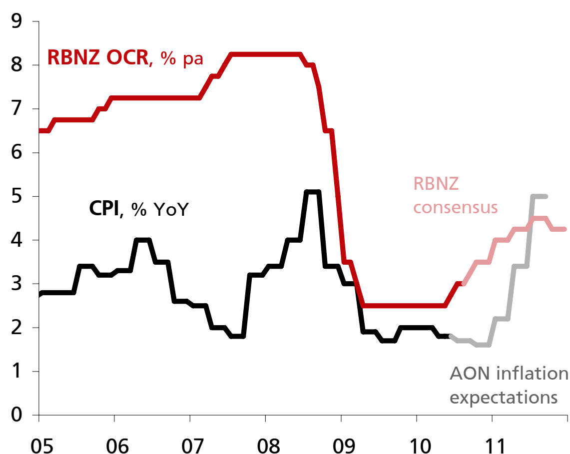
	Latest	Prev
Close	0.72	0.67
4Q10	0.70	0.71
1Q11	0.71	0.72
2Q11	0.72	0.73
3Q11	0.73	0.74
4Q11	0.74	0.75

90D bank bill futures, % pa

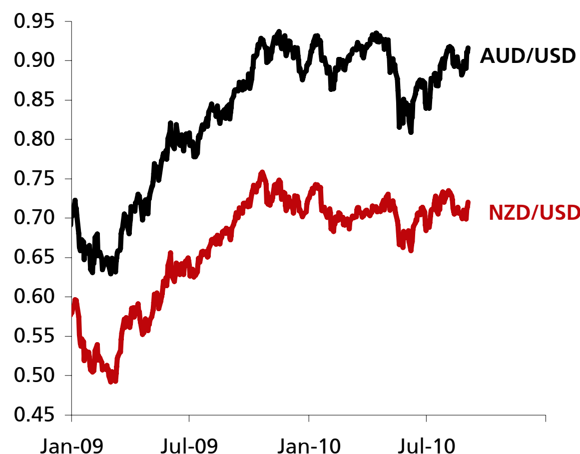
	Latest	Prev
RBNZ	3.00	2.75
Cash	3.01	3.07
Dec10	3.37	3.90
Mar11	3.50	4.30
Jun11	3.74	4.92
Sep11	3.92	–
Dec11	4.20	–

Latest close on Sep 8
Prev close on Jun 10

Rate hike & inflation expectations in NZ



NZD tracks AUD, more direction, less magnitude



Yield: Not the place to be

- US: We are confident the US will avoid a double dip. Yes, GDP growth will be slow in the coming quarters, but slow growth is a far cry from negative growth; USD yields need to be a lot higher if recession fears drop from the picture
- SG: The upcoming policy review in October is likely to be a nonevent for SGD rates markets. Short-term interest rates like 3M Sibors will continue to trade sideways in a narrow range. The swap curve will steepen
- HK: Like the USD and SGD yield curves, the HKD yield curves are too flat and understate the probability of a rise in short-term interest rates in 2H11 and 2012
- KR: The Bank of Korea is likely to continue with hikes in its policy rate in 4Q10 and into 2011. As swaps are far below January levels the onshore swap market is complacent about rate hikes. We think more tightening will be priced into the curve later in 4Q10 when sentiment improves
- TW: A string of rate hikes from the Central Bank of China will keep yields under upward pressure. As excess reserves have fallen to zero, market rates should be expected to move higher as there will be upward pressure on rates in reserve markets
- TH: We think there is a good chance that rate hikes from the Bank of Thailand push the 6M THBFIX above 2.5% in 1H11. That is not priced in; swaps underestimate the rise in policy and short-term interest rates
- ID: Upside surprises in inflation mean rate hikes are on the horizon. This is despite the government's desire for larger credit expansion and a more active use of reserve requirement ratios in the management of monetary policy
- PH: Domestic debt sales are being stepped up, but we continue to think that government bond yields will stay low. Despite strong growth, central bank rate hikes are not imminent
- MY: A return of short-term interest rates to pre-crisis levels is not adequately priced into the swap curve. Swap rates understate the probability of future rate increases
- IN: Liquidity conditions in the Indian banking system are improving. Swap rates have already started to fall, but in our view are still too high and overestimate future average levels of the overnight rate
- CH: With short-term interest rates like Shibors back above the 1-year deposit rate and the 7-day repo rate having trended lower, upward pressure on longer-term interest rates has eased considerably. Until the PBOC hikes rates, range trading in Chinese bonds is more likely than a bearish trend

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US: Disconnect with fundamentals

After five months of downward pressure, Treasury yields are likely to rise in 4Q10 and 1H11. While Fed policy makers said at the August 10 FOMC meeting that "the pace of economic recovery is likely to be more modest in the near term than had been anticipated", the outlook remains positive. As explained in the US economics section, we are confident that a recession can be avoided.

Treasury yields are likely to rise in 4Q10

Moreover, Bernanke at the Fed's annual monetary symposium in Jackson Hole reassured markets that the Fed "will do all that it can" to ensure that the economic recovery continues. He promised "to provide additional monetary accommodation through unconventional measures (security purchases, a commitment to keep rates low, and/or lower interest rates on bank deposits) if necessary.

More importantly, the central bank still sees the preconditions for faster growth in 2011 in place and believes that a handoff from fiscal stimulus and inventory restocking to consumer spending and business investment is under way. At the same time, the risk of undesirably high inflation is seen as low, as is the risk of deflation.

Bottom line, a lot was promised at Jackson Hole and this, after the substantial adjustments in US rates markets in 2Q and 3Q, should be enough to keep Treasury yields from falling further. Much of the rally in Treasuries over the past five months is explained by the evaporation of rate hike expectations (***Chart 1***) and the sharp fall in short-term interest rates (12M OIS rates are now essentially at the same level as Effective Fed Funds). This story has come to an end. Incoming data releases just aren't weak enough to make a strong case for negative growth.

Slow growth is a far cry from recession. Yields need to be a lot higher if recession fears are out of the picture

Yes, US real GDP growth will be slow in the coming quarters, but slow growth is a far cry from recession and USD yields need to be a lot higher, if recession fears are completely out of the picture. Our best guess is that USD yield curves will steepen to discount an earlier and more rapid rise in short-term interest rates later in 4Q10 and through 1H11.

That said, mixed data and the fear of recession will keep the market divided on the economic outlook for a while and prevent yields from rising sharply in the near-term (***Chart 2***).

We expect US Treasuries to consolidate in the near-term before yields rise to 1% in the 2Y sector and 4% in the 10Y sector in 1H11. The 2Y/10Y curve will steepen in 1H11 before it flattens in 2H11.

Chart 1: Dec 11 vs Dec 10 Fed Funds Future Yields

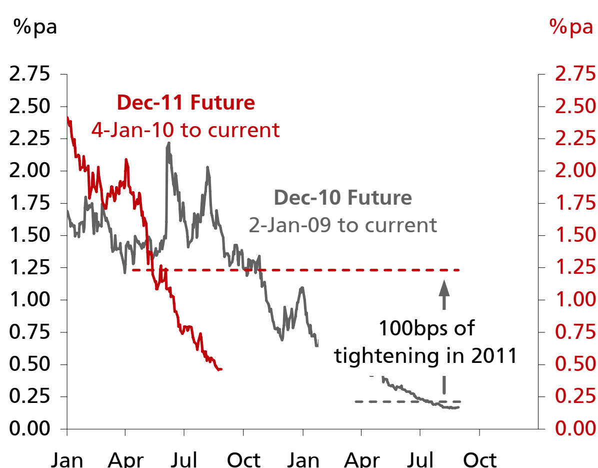
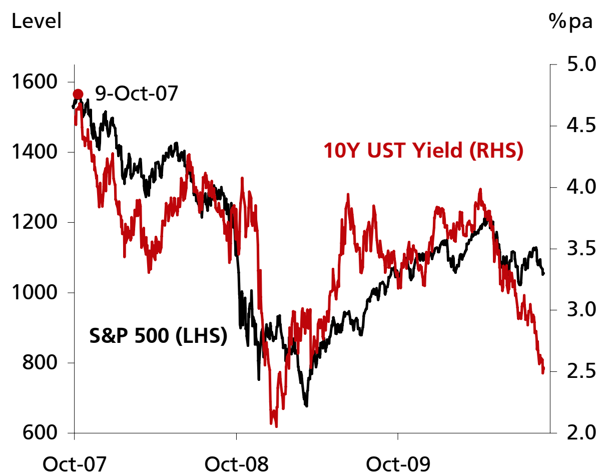


Chart 2: 10Y UST Yield vs S&P 500



Singapore: Yield curve too flat

The policy review in October is likely to be a nonevent. We expect no change in stance toward the SGD NEER

The upcoming policy review in October is likely to be a nonevent for SGD rates markets. We don't expect any change in the policy stance for the S$ NEER. The exchange rate policy band of modest and gradual appreciation that has been put in place in April remains appropriate given the outlook for growth and inflation. Real GDP is likely to expand 15% this year and 4.5% next year and we expect CPI inflation of 3% this year and 2.7% next year. On the one hand, the deterioration in the growth outlook since early August is not severe enough to suggest that a horizontal policy band of zero appreciation is needed in the near-term. On the other hand, growth will slow in 2011 and inflation pressures ease somewhat, which means that there will neither be a case for recentering or a steeper slope of the policy band.

That means that short-term interest rates like 3M Sibors will continue to trade sideways in a narrow range (***Chart 3***). As USD Libors are stabilizing, FX-implied SGD SORs too are more likely to be in a range than fall any further. SGD Sibors and SORs will rise again, when Fed hikes push USD Libors higher. However, the rise in SGD rates will likely be more moderate than that in USD Libors, because SGD forwards will price in more SGD appreciation when the Fed lifts its target for Fed Funds and USD Libors rise. Put differently, once USD Libors start rising, interest rate differentials will widen somewhat and FX forwards will price in a steeper fall in USD/SGD from spot levels.

The USD and SGD swap curves are too flat and will steepen in the coming quarters to reflect a higher probability of a rise in Libors in 2H11 and 2012

While SGD swap rates have been under downward pressure and the swap market now only prices in a slow rise in SORs, we still think that both USD Libors and SGD SORs are likely to reach their long-term averages in 2012. In our view, the swap curves in both countries are too flat and will steepen in the coming quarters to reflect a higher probability of a rise in Libors in 2H11 and 2012 (***Chart 4***). As it will become clear over the next three months that the US will avoid a recession, USD swap rates will end the year higher. SGD swap rates will come under upward pressure when USD swap rates rise, but they are unlikely to rise quite as fast as USD swap rates. SGS yields too are likely to rise in the coming months and end the year higher.

We expect the SGS curve to steepen somewhat in 4Q10. Yields are likely to end the year around 0.4% in the 2Y sector and around 2.5% in the 10Y sector.

Chart 3: SOR 3M vs Libor 3M

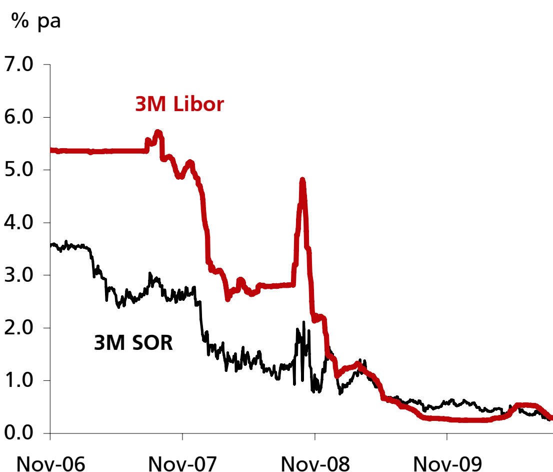
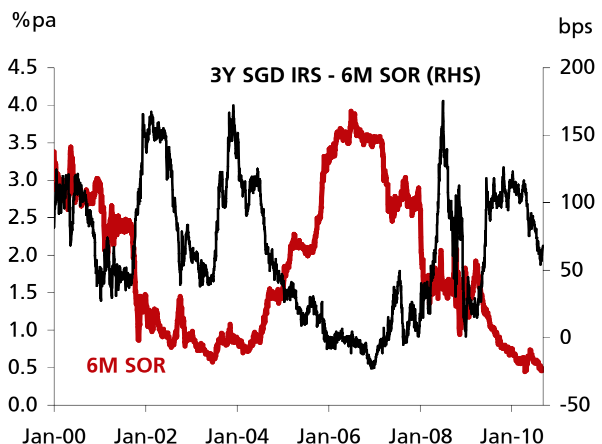


Chart 4: SGD 3Y Swap Rate Less 6M SGD SOR vs 6M SGD SOR



Hong Kong: Short rates will stay low well into 2011

Like the USD and SGD yield curves, the HKD yield curves are too flat and understate the probability of a rise in Hibors in 2H11 and 2012. That will change in the coming quarters when markets realize that US recession fears are unfounded. US real GDP growth will be slow, but slow growth is a far cry from recession and yields need to be a lot higher if recession fears disappear.

In the coming months upward pressure on HKD yields will solely be the function of US rate hike expectations, which will force spreads between short-term interest rates and longer-term interest rates wider

Hibor/Libor spreads are unlikely to change much in the foreseeable future as FX forwards will continue to price in downward pressure for USD/HKD. As long as that is the case, Hibors will trade below Libors and continue to track Libors. In the coming months upward pressure on HKD yields will solely be the function of US rate hike expectations, which will force spreads between short-term interest rates and longer-term interest rates wider.

The monetary base (currency + reserves + Exchange Fund bills and notes) remains high as there has been no decrease in the amount of outstanding Exchange Fund bills yet. Reserves (the balance of the clearing accounts of banks kept with the HKMA, the Aggregate Balances) have dropped to HKD 149bn from a high of HKD 318bn in November last year, but they only account for about 15% of the monetary base (***Chart 5***).

Little has changed in the Hong Kong rates market in 3Q10 and rates are going to stay low well into 2011 despite strong GDP growth and inflationary pressures

Bank investment in EFNs has started to fall, as lending has picked up and this trend is likely to continue. Therefore, there will be less demand for securities from banks. However, this is unlikely to have an impact on yield trends. We expect the amount of outstanding EFN bills to fall in response to falling demand from banks.

Swap spreads are likely to remain little changed and uncorrelated to USD swap spreads. Moreover, they should remain wider in HK than in the US, where bond supply is keeping spreads tight. Especially in the 10Y sector, spreads are likely to remain much wider in HK than in the US, as EFN yields are likely to continue to trade about 50bps below our fair value estimate in this sector (***Chart 6***).

Bottom line, little has changed changed in the Hong Kong rates market in 3Q10 and short rates are going to stay low well into 2011 despite strong GDP growth and inflationary pressures. Longer-term swap rates and EFN yields have bottomed and will come under upward pressure, but not because of domestic economic or monetary conditions, but because of returning Fed rate hike expectations for 2011.

We expect EFN yields to rise in 4Q10 and 1H11. Yields are likely to end the year around 0.48% in the 2Y sector and above 2.5% in the 10Y sector.

Chart 5: Exchange Fund Bills & Notes & Reserves

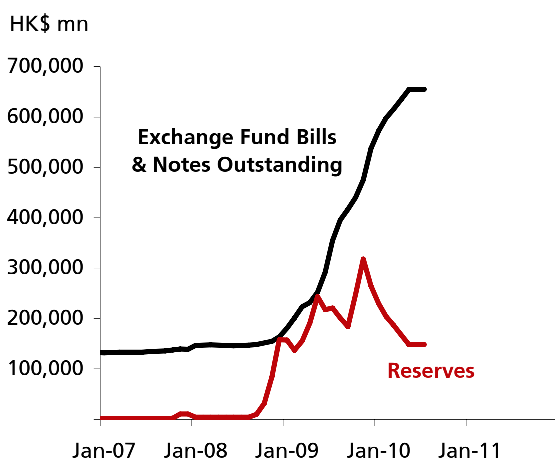
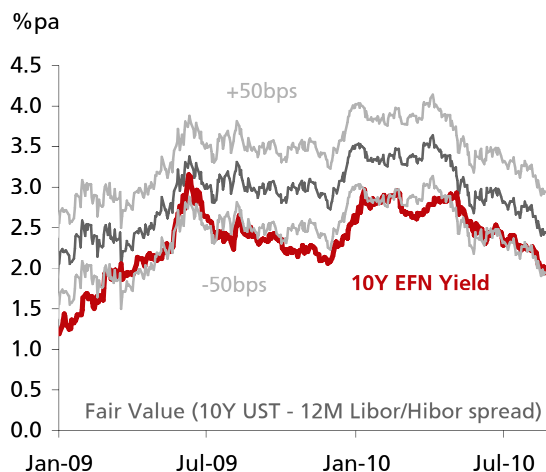


Chart 6: EFN 10Y Yield



Korea: No more bull-flattening

The Bank of Korea is likely to continue with hikes in its policy rate in 4Q10, taking the 7-day repo rate to 2.75% by year-end from 2.25% in August. The policy rate currently still sits at levels below annual inflation (2.6%YoY in August), resulting in negative real short-term interest rates.

The Bank of Korea is likely to continue with hikes in its policy rate in 4Q10 and into 2011

Inflation is not particularly fast, but with demand-side inflationary pressures expected to build in the coming months, the annual CPI inflation measure is likely to rise further to the mid-point of the 2-4% official target range and inflation expectations may rise. Moreover, in line with our expectation for a gradual build-up of demand-side price pressures due to capacity constraints and higher inflation expectations, core inflation is trending higher (1.8%YoY in August versus the low of 1.5% in April).

Given a) better-than-expected GDP growth in 2Q10 (1.4% QoQ sa), b) still negative real rates, c) 8.2%YoY growth in household debt and the risk of an excessive increase in household liabilities, and d) rising inflation and upside risks to the inflation outlook, the Bank of Korea will continue to raise interest rates. Expectation of this should put upward pressure on market rates again soon. As swaps are far below January levels the onshore swap market is quite complacent about rate hikes. We think more tightening will be priced into the curve later in 4Q10 when sentiment improves. Swap curve implied forward rates like 2Y, 3Y forward near 4% are too low, as are Korean Treasury Bond (KTB) yields (***Chart 7***).

The onshore swap market is too complacent about rate hikes. We think more tightening will be priced into the curve soon

Supply and demand dynamics have benefited KTBs, but given the above, the bull-flattening in the 3Y/10Y benchmark curve is likely over (***Chart 8***). In the first half of the year, Korea's fiscal deficit amounted to only KRW11.4 trillion, down from KRW25.8 trillion in the first half of 2009 and in line with the country's aim to reduce its national debt to below 35% of GDP by 2014, from an estimated 36.1% in 2010. Moreover, news of China boosting holdings of KTBs has helped drive yields lower. The PRC's holdings of KTBs surged 111% to KRW4.0 trillion in June from KRW1.9 trillion in December.

Separately, the Bank of Korea announced in August the introduction of a term deposit facility to domestic banks from Oct. 1 to absorb excess liquidity. Bonds haven't been as effective as expected in curbing liquidity partly because their yields attract foreign investors and partly because bond issuance has limitations in draining funds when financial institutions are reluctant to buy bonds in fear of rising rates.

We expect 3Y KTB yields to rise to 4% and 10Y KTB yields to rise to 4.75% in 4Q10.

Chart 7: 2Y IRS, 3Y fwd

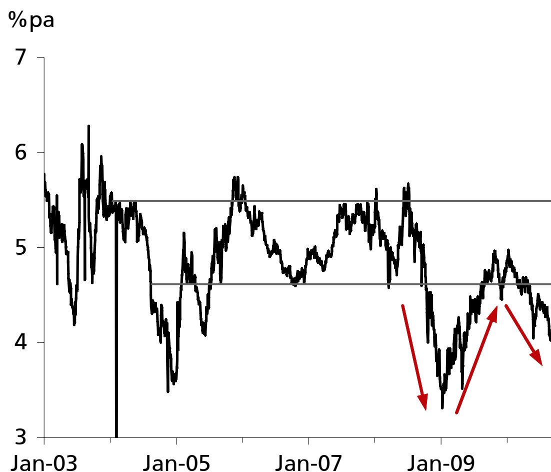
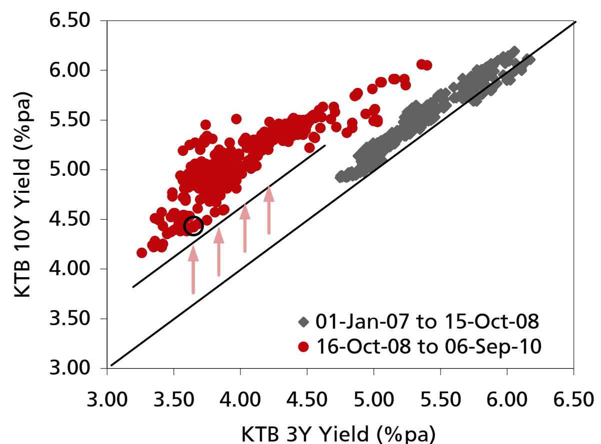


Chart 8: KTB 10Y Yield vs KTB 3Y Yield



Taiwan: More rate hikes likely

The Central Bank of China (CBC) on 24 June surprised the market with a 12.5bps rate hike in its benchmark interet rate to 1.375%. Given substantial improvements in economic conditions, ultra-low policy rates are no longer appropriate.

GDP growth so far this year has surprised on the upside. Exports, the key engine of near-term economic growth, have already fully recovered to the pre-crisis levels and gross fixed capital formation is strong. Overall, the economy expanded 10.9% QoQ saar in 1Q and 7.2% in 2Q and we forecast full-year GDP growth of 9.5% for 2010. With official forecasts of 8.2% for 2010, we are slightly more bullish than official forecasters.

Given substantial improvements in economic conditions, ultra-low policy rates are no longer appropriate

In addition to better-than-expected growth, there has been a pick-up in bank lending (***Charts 9 & 10***). Bank credit increased, fuelling an increase in property and consumer prices. Moreover, as a result of aggressive lending, "the total value of real estate loans (for home purchases, home renovations, and building construction) extended by all banks have amounted to 38.3% of their total lending, a value equivalent to 52.0% of GDP."

Excess reserves in the banking system have fallen to zero, as the CBC continues to absorb excess funds from the banking system. The outstanding amount of CBC certificates of deposit has reached TWD 6.4trn and will continue to increase if the deposit base increases further. As excess reserves have fallen to zero, market rates should be expected to move higher as there will be upward pressure on rates in reserve markets. The overnight call rate, the rate at which members of the Taipei Interbank Money Center borrow overnight funds from other members, has already risen to 0.2% from 0.11% in January.

As excess reserves have fallen to zero, market rates should be expected to move higher as there will be upward pressure on rates in reserve markets

Intermediate maturity swaps have been under downward pressure, but it is unlikely that the swap curve flattens any further. Three-year swaps, for example, barely discount the impact of a complete string of 12 quarterly 12.5bps rate hikes (assuming a beta of 0.5 between the 3M CP rate (the swaps' floating leg fixing index) and the rediscount rate).

We think swap rates will be range-bound in the near-term, before they come under upward pressure in 4Q10 and 1H11. Bond yields too are likely to rise.

We expect 2Y TWgov yields to end the year near 0.9% and 10Y TWgov yields to rise to 2%.

Chart 9: Growth in Loans & Deposits

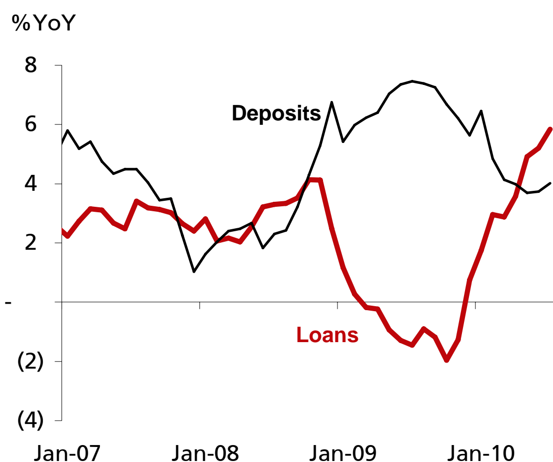
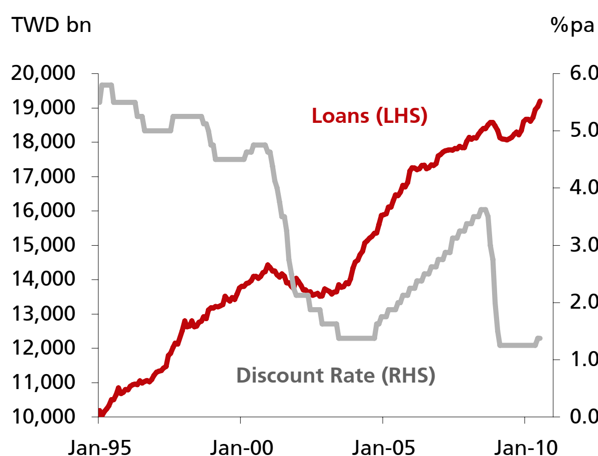


Chart 10: Loans of Major Financial Institutions



Thailand: Curve needs to steepen

The BoT will continue with interest rate normalization in 4Q10

The Bank of Thailand (BoT) is likely to continue with policy interest rate normalization in 4Q10 and this should put upward pressure on yields. GDP growth momentum is likely to slow, but credit is expanding and consumer prices are up 3.3% from a year ago, which suggests that further increases in the policy rate are appropriate. The slowdown in global growth and its impact on the performance of regional economies is unlikely to oblige the BoT to delay further rate hikes.

So far, other than very short-term market rates have not come under considerable upward pressure, but there is no room for a continuation of the bond rally. In fact, the onset of the rate hike cycle in Thailand should not only mean that the rally in long-dated Thai local currency government bonds is over, but also that they should rise. The 10Y government bond yield at around 3.12% - more than 100bps below its 10Y average – trades rich and at levels not consistent with a scenario of policy interest rate normalization. Moreover, with inflation running at 3.3%YoY real 10Y rates are negative, which is inconsistent with economic growth and inflation prospects (***Chart 11***).

We think the BoT could lift rates beyond 2.5%, which is not priced into the swap market

Front-end swap rates trade below bond yields, which is unusual and we think that the swap market is underestimating the rise in yields. The 1-year swap rate trades less than 50bps above the policy rate and the 6M THBFIX (the swaps' floating rate fixing index) and is expected to rise less than 100bps over the next 12 months. We think the BoT could easily lift rates beyond 2.5%, which would put the 6M THBFIX above 2.5% and the 1Y swap above 3%.

While there is considerable volatility in the FX implied 6M THBFIX, the rate on average has traded close to the policy rate (***Chart 12***) and policy rate hikes should mean upward pressure. It could of course rise less than the policy rate and interbank rates if FX forwards reflect less depreciation of the THB against the USD as suggested by the yield spread between interbank rates. Given widespread market expectations for the appreciation of Asian currencies, some of this is in fact likely. If USD/THB FX forwards fail to fall enough below USD/THB spot, the 6M THB/FIX will lag the rise in the policy rate. In other words, the 6M THBFIX is likely to continue to trade below 6M Bibor and possibly below the policy rate for the foreseeable future.

The 2Y/10Y curve should exhibit a steepening bias in 4Q10. We expect 2Y Thai government bond yields to rise above 2.5% in the next 3 months and 10Y yields to rise to 3.5%.

Chart 11: 6M THBFIX vs Policy Rate

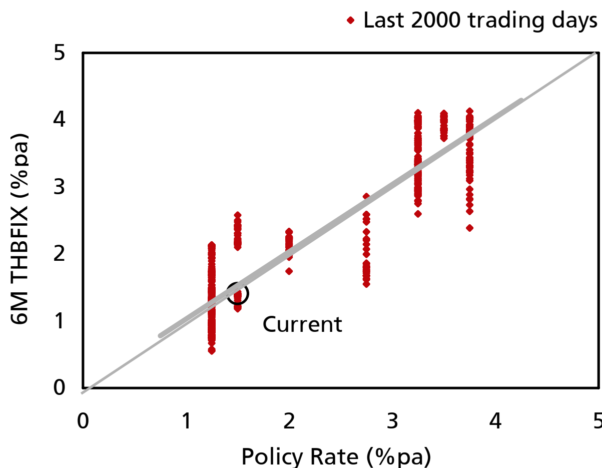
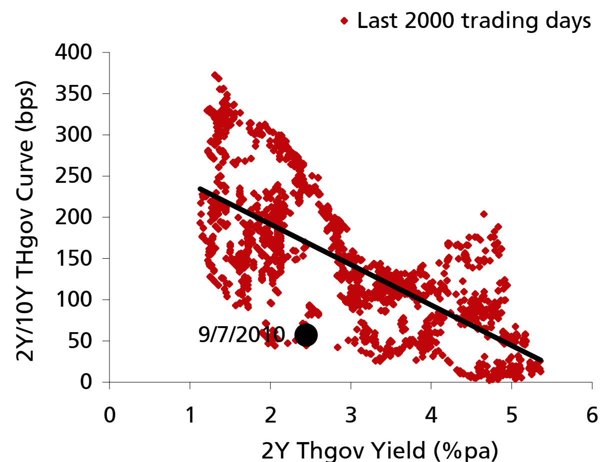


Chart 12: THgov 2Y/10Y Curve vs 2Y THgov Yield



Malaysia: Policy tightening will continue in 2011

Bank Negara on September 2 left the Overnight Policy Rate (OPR), its key policy interest rate, unchanged at 2.75%. External demand is slowing due to a moderation in growth momentum in advanced economies, resulting in a moderation in the pace of growth of the Malaysian economy.

Bank Negara is now widely expected to leave its policy rate unchanged at 2.75% in the coming months. In fact, given the uncertain outlook and slower growth momentum the majority of market participants does not expect policy interest rate tightening to return the OPR to the pre-crisis level of 3.5%.

Bank Negara will leave rates unchanged at 2.75% in 4Q11, but policy tightening will resume in 2011

While the policy rate is likely to remain at 2.75% in 4Q10, further rate hikes from Bank Negara are likely in 1H11, as the stance of monetary policy continues to remain accommodative, loan growth is strong and the growth outlook remains positive. As both loans and deposits are up about MYR100m from a year ago, loan growth is above 10%YoY and outpacing growth in the deposit base, which is running at 8.7%YoY (***Chart 14***). So far, the pick-up in lending has not led a large unwinding of banks' positions in government securities, but banks' holdings have fallen by about MYR5bn to MYR44.4bn between Jun-09 and Jun-10 and further decreases cannot be ruled out. Moreover, the growth outlook is by no means weak. Thanks in part to resilient domestic demand, full-year growth is expected to be 8% this year and 5.5% (at potential) next year, with inflation likely to stay above 2.00% in the coming months due to domestic demand pull inflationary pressures and policy changes on subsidies. This kind of growth is not very different from the conditions that prevailed in 2006 and 2007 when policy rates were at 3.5%.

MYR swap rates understate the probability of future rate increases in short-term rates

Whether Bank Negara hikes rates again in the next six months or not, we think that MYR swap rates will come under upward pressure in 4Q10. With the 3Y swap trading near 3%, a return of short-term interest rates to pre-crisis levels is not priced in and swap rates in our view understate the probability of future rate increases in short-term interest rates. Similarly, MGS yields need to rise.

Foreign holdings of Malaysian debt securities (public and private) increased by MYR 49bn to MYR 96.1bn in the twelve months from Jun-09 to Jun-10. Foreign entities primarily bought public debt securities (MYR46.3bn), with holdings of Government Securities increasing 30.7bn to a record high of MYR59bn. As such, foreign entities absorbed the entire net supply of these securities over the past year and now own 23% of the market. Domestic sectors reduced holdings of Government Securities by a total of MYR6.5bn (***Chart 13***).

We expect 3Y MGS yields to be pushed higher to 3.25% in 4Q10 and 10Y MGS yields to rise to 3.9%.

Chart 13: Bank Holdings of Government Securities

cumulative since 2Q09

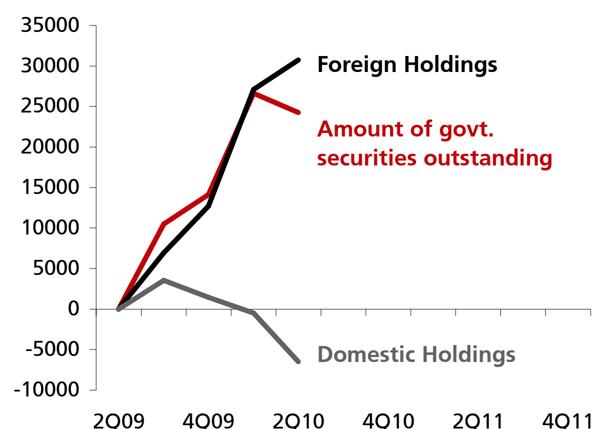
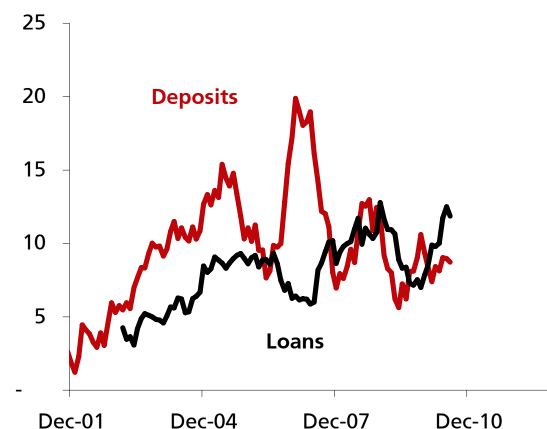


Chart 14: Total Loans & Total Deposits

%YoY



Indonesia: Risks of an early start to policy tightening no longer exceed those associated with a later start

Inflation has surprised on the upside and rates will soon rise

Upside surprises in inflation data in 3Q10 mean that the probability of rate hikes within the next six months is increasing. August inflation data showed consumer prices up 6.44% from a year ago (***Chart 15***). As such, the annual inflation rate is now more than a whole percentage point higher than in June (5.05%) and many view the risks to the inflation outlook as to the upside. Above 6% policy makers are getting more concerned about the inflation outlook as inflation measures approach long-term averages.

This could mean that the policy rate is raised from the current level of 6.5% soon, if the inflation outlook deteriorates considerably further. This is despite a the government's desire for larger credit expansion and a more active use of reserve requirement ratios in the management of monetary policy. Sustained upward pressure on local-currency government bond yields is likely once Bank Indonesia is hiking rates.

Government bond yields are set to rise when BI starts hiking rates (in Dec10)

On the fiscal front, the 2011 spending plan announced in August is fairly conservative. The government expects total spending of IDR 1202trn in 2011, only 6.7% higher than the budgeted spending in 2010. Subsidy spending will be reduced further to help free up capital for economic development. Total subsidy spending could go down by as much as 8% or IDR 16.5trn next year, mainly on lower electricity subsidies (the electricity tariffs will be hiked by about 15% in 2011 after the 10% rise in July 10). On the revenue side, total government revenue is projected to increase 9.5% to IDR 1086trn in 2011. This estimation too is conservative, compared with official 2011 GDP and inflation forecasts of 6.3% and 5.3% respectively (DBSf: 5.8% and 6.5%). On balance, official projections are for the fiscal deficit to narrow to IDR 115.7trn (1.7% GDP) next year from IDR 133.7trn (2.1% of GDP) this year. We reckon that the actual deficit could be even smaller at less than 1% of GDP.

All of the above means that the supply of government securities to the market will remain limited. With demand from foreign entities strong (***Chart 16***), government bonds will continue to trade rich and the curve will remain fairly flat, even if bank lending is strong and bank demand for bonds weak. Yield will rise only when Bank Indonesia decided to lift its policy rate.

We expect yields on 2Y Indonesian government bonds to rise above 8% and those on 10Y bonds to rise above 9.5% in 4Q10.

Chart 15: Headline CPI Inflation

%YoY, sa

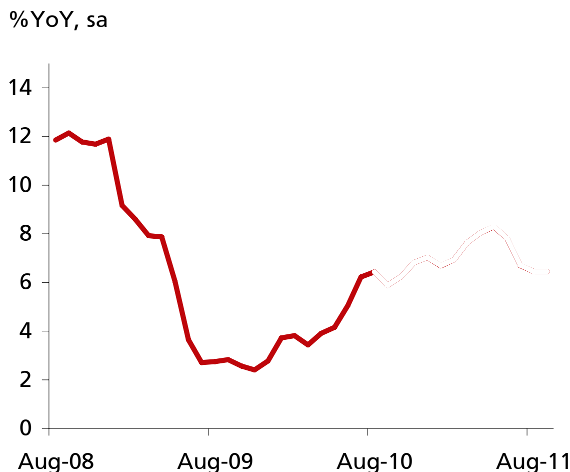
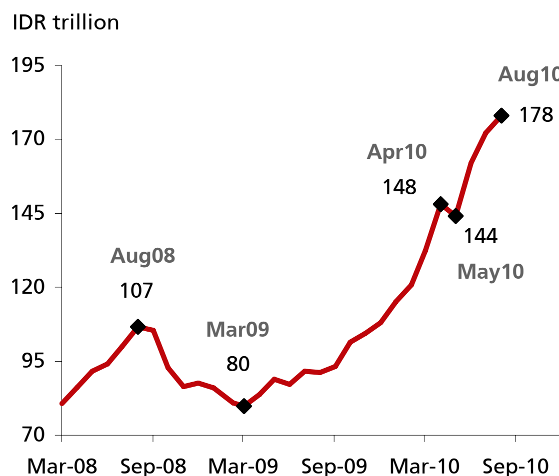


Chart 16: Foreign Holdings of Indon LC Govt Bonds

IDR trillion



Philippines: Bond yields will stay low until the central bank hikes rates

The governments fiscal position continues to weaken. For the January-July period this year, the country's budget deficit was PHP229.4 billion, up from PHP188.0 billion for the same period last year. Moreover, the deficit is below the linear trend towards the government's 2010 full-year target of PHP325bn (***Chart 17***). Spending is up 5.8%YoY, but tax revenues missed targets as revenues are up only 2.8YoY despite strong GDP growth (real GDP expanded by 3% QoQ sa in 1Q10 and 1.3% in 2Q10 and real output is now up 7.9% from a year ago). Bottom line, the Philippines will be one of the few countries this year where the government's full-year budget deficit is worse than last year.

The deterioration in the government's fiscal position is a concern

That the government is sticking to its full-year budget-deficit ceiling of PHP325bn and promises to push revenue agencies to bolster collection is providing little comfort. Deterioration from last year in the context of stronger economic performance is a concern and domestic debt sales will be stepped up. That said, even if borrowing in the domestic bond market has to increase, we think the government is still comfortable with its funding prospects and will be able to fund this year's deficit without major difficulties. In fact, it will take advantage of low longer-term yields and bring more long-term bonds to the market. Ten-year benchmark yields will likely stay low during 4Q10, below the 8% weighted average fixed coupon on outstanding local currency government debt, as liquidity conditions in the banking system and the supply/demand balance remain highly favourable.

Domestic debt sales are being stepped up, but we continue to think that government bond yields will stay low until the central bank hikes rates

The peso bond market is domestically driven and the negative developments on the fiscal front clearly have not mattered to yield trends in the market. Ample liquidity, benign inflation and a bond-friendly monetary policy outlook have been more important and until there is a rate hike signal from the central bank or much faster inflation, government bond yields can stay low (***Chart 18***).

We don't think such a signal is imminent. Deputy Governor Diwa Guinigundo said in August that the central bank is not "in a hurry to raise interest rates" because the "inflation outlook continues to be benign." Our best guess is that the Philippines will start to lift rates in December or in 1Q11.

If yields trade sideways in 4Q10, total returns for market representative investments will be positive in the range of 2.0 to 2.5%.

We expect yields on 2Y and 10Y Philippine government bonds to stay low until the central bank hikes rates.

Chart 17: Budget Balance & 10Y Phgov Yield

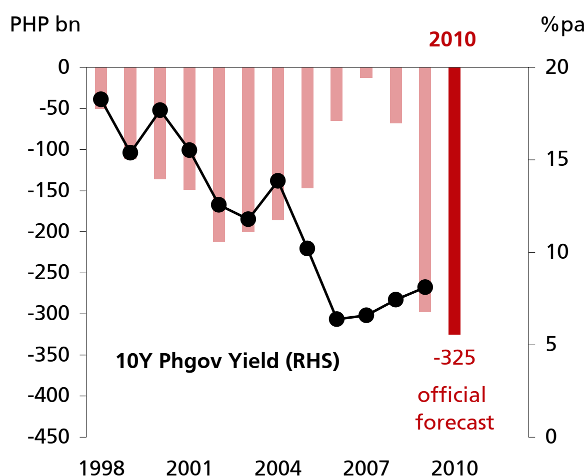
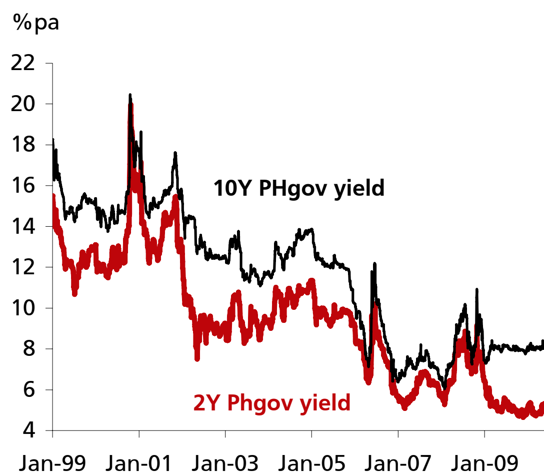


Chart 18: 2Y PHgov yield vs 10Y PHgov yield



India: OIS market overestimates future average levels of the overnight rate

Liquidity in the banking system is improving

Liquidity conditions in the Indian banking system are improving. After a shortage of funds in the money market in June and July due to tax outflows and payments for 3G licences by telecom companies, there are finally signs that liquidity conditions have normalized.

RBI liquidity absorptions via reverse repos are exceeding liquidity injections via repos again, suggesting that the bout of tight liquidity is over. Put differently, the RBI, through its open market operations (OMOs), on a net basis is no longer injecting liquidity, but absorbing liquidity. Daily repo amounts have fallen to near zero and daily reverse repo amounts have started to pick up.

Improving liquidity means downward pressure for overnight interbank rates and overnight indexed swap (OIS) rates. If liquidity conditions remain normal, overnight rates are more likely to trade at the bottom (currently 4.5%) of the policy rate corridor than the top (currently 5.75%).

Swap rates have already started to fall, but in our view are still too high and overestimate future average levels of the overnight rate. The 1Y spot rate is trading around 6.1% and the curve implied 1Y spot rate one year in the future is trading around 6.7%. This compares with the overnight rate currently at 4.6%.

We think there is a good chance that the implied future 1Y spot rate level of 6.7% will not materialize over the next twelve months if liquidity conditions remain favourable. Moreover, there also is a good chance that swap rates fall further in the near-term as RBI and liquidity expectations are adjusted downwards.

Swap rates have started to fall, but are still too high

Even if the RBI lifts the reverse repo rate (the floor of the policy rate corridor) to the pre-crisis level of 6%, 1Y rates will not necessarily be pushed to or above 6.7%. The average pre-crisis spread (measured from Jan-03 to Sep-08) between the 1Y spot rate and the reverse repo rate was only 85bps. Moreover, the 1Y average of overnight rates should be expected to fall within the policy rate corridor and, therefore, not too much above the reverse repo rate.

We recommend investors receive 1Y, 1Y forward on the view that the 1Y spot rate over the coming 12 months will fail to reach 6.7%, as implied by the yield curve. The risk is that the RBI hikes the reverse repo rate beyond 6% within the next twelve months or that liquidity becomes (and remains) tight again. With the global economic outlook and sentiment deteriorating, that is a risk worth taking.

We expect the 2Y Gilt yield to remain under upward pressure, while the 10Y Gilt yield is likely to be stable in 4Q10, causing the 2Y/10Y curve to flatten.

Chart 19: RBI Repo & Reverse Repo Rate & CRR

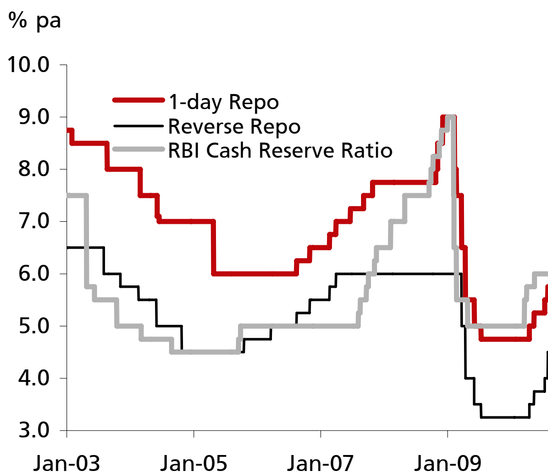
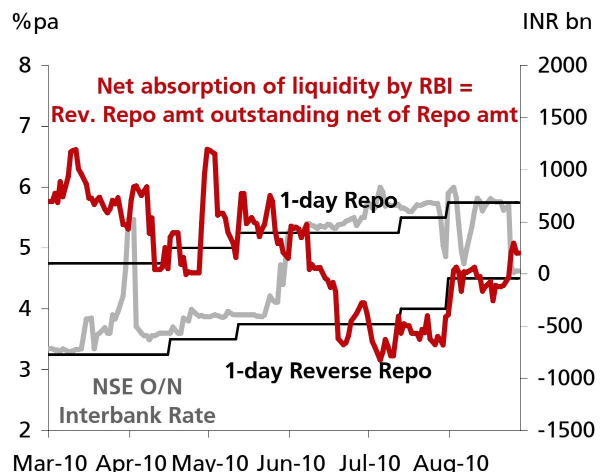


Chart 20: O/N Rate, Policy Rates & OMOs



China: Range trading until there are rate hikes from the PBOC

With short-term interest rates like Shibors back above the 1-year deposit rate (2.25%), and the 7-day repo rate having trended lower, upward pressure on interest rates has eased considerably. The USD/CNY fixing too has been moving higher, reflecting a less positive outlook for China and the world economy and, therefore, a lower probability of further increases in short-term interest rates in China.

Upward pressure on interest rates has eased considerably

We think rate hikes later in 4Q10 are likely, but the global economic outlook has to improve for policymakers to act. While GDP growth will remain strong in 2011 (we forecast 9.5%), growth momentum has slowed and policy interest rate adjustments in the next three months are not a done deal if the outlook remains unusually uncertain and if consumer price inflation is stable around 3%YoY and producer price inflation stable around 6%YoY (***Chart 21***).

Bank lending too has slowed to 17% YoY from 33.9% in December 2009 and the deposit/loan gap has been rising as there continue to be inflows (***Chart 22***). This means that tighter monetary policy will be needed at one point, but the PBOC is probably not in a hurry to hike interest rates. Even cash reserve ratio hikes probably are not imminent despite the fact that financial institutions' net liquidity (deposit/loan gap net of required reserves) continues to increase in CNY terms. While net liquidity now amounts to a record CNY 11.3tr, it is fairly stable relative to the size of the deposit base, hovering between 15-20% of deposits. Unless deposits expand considerably relative to loans, the PBOC will continue to use open market operations to control liquidity in the banking system and refrain from further cash reserve ratio hikes for a while. If so, major upward pressure on yields in unlikely. In fact, the widening deposit/loan gap explains the neutral flattening pressure that the CNY yield curves have been under.

Range trading in Chinese bonds is more likely than a bullish or bearish trend

For government bonds that means that as long as the deposit/loan gap increases and there are no rate hikes, range trading is more likely than a bearish trend. Government bond yields in the 2Y sector have returned to levels close to the 1-year deposit rate and are likely to trade mostly between 1.75-2.25% in 4Q10. In fact, the 2Y yield is unlikely to rise above 2.25% until there are rate hikes in the 1-year deposit rate, which it should be expected to track. The 10Y government bond yield too is likely to trade sideways now, after having fallen to around 3.3% from above 3.6% in Dec09 and 4.5% in mid-2008.

Yields on 2Y Chinese government bonds are likely to trade sideways until the PBOC hikes the 1Y deposit rate.

Chart 21: Producer & Consumer Prices

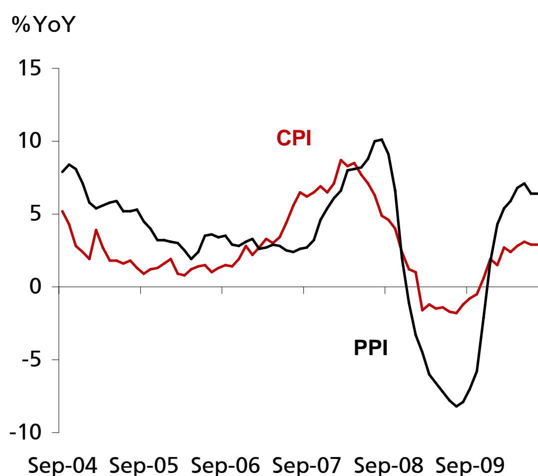
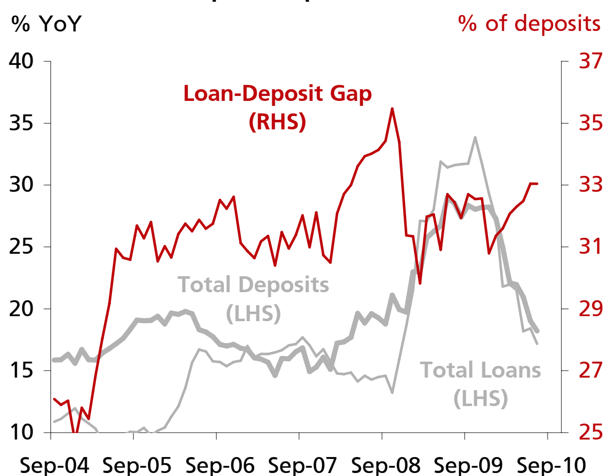


Chart 22: Loan-Deposit Gap



Summary

The market environment is likely to get more unfriendly and challenging for bond investors in 4Q10 and 2011. Markets will realize that US recession fears are unfounded and yields will rise as a return of rate hike expectations drives a re-steepening of the front-end curve segments - not only in the US, but also in Asia.

Yes, US real GDP growth will be slow in the coming quarters, but slow growth is a far cry from recession and USD yields need to be a lot higher, if recession fears drop out of the picture. USD yield curves will steepen to discount an earlier and more rapid rise in short-term interest rates. If that happens, the bond market is not the place to be.

A rise in market rates in the US will have a strong impact on yield levels in Hong Kong and Singapore, where yield curves will come under steepening pressure, because yields tend to follow those in the US because of the exchange rate focused monetary policy frameworks. But it is not only in markets where monetary policy is focused on the exchange rate that yield curves will re-steepen in Asia. Improvements in the macro outlook will oblige many Asian central banks to tighten monetary policy further in 2011 and expectations of that will put upward pressure on yields.

We think that Malaysia, Korea and Thailand will see yields rise and curves steepen on a more positive global economic outlook and rate hike expectations. In Malaysia, a return of short-term interest rates to pre-crisis levels should be priced into intermediate maturity swaps. Similarly, in Korea and Thailand, swaps reflect too slow a rise in short-term interest rates.

Only in India, the Philippines and Indonesia, curves are unlikely to bear-steepen considerably at the front end. In India, the OIS curve is already very steep and in our view overestimates future average levels of the overnight rates. In the Philippines, bond-friendly monetary policy and banking system liquidity are unlikely to change much in 4Q10 as the government remains focused on generating fast economic growth to reduce high budget deficits.

Bond markets are likely to continue to benefit from fund inflows in 2011. Indonesia, Korea, Malaysia, in particular, and to some extent, Thailand are likely to see further direct investment of foreign entities into their local currency government bond markets. Other markets will benefit from wider deposit/loan gaps and strong demand for bonds out of the banking sector.

That means the demand/supply balance in the bond markets should remain skewed towards demand and yield curves can remain fairly flat. However, that does not mean that yields will stay low. We think policy rate hikes and not fund flows will be the primary driver or yields in the coming quarters. Yields will rise when central banks continue to hike rates.

Sources:

Sources for all charts and tables are Bloomberg. Forecasts are by DBS Research.

Interest rate forecasts

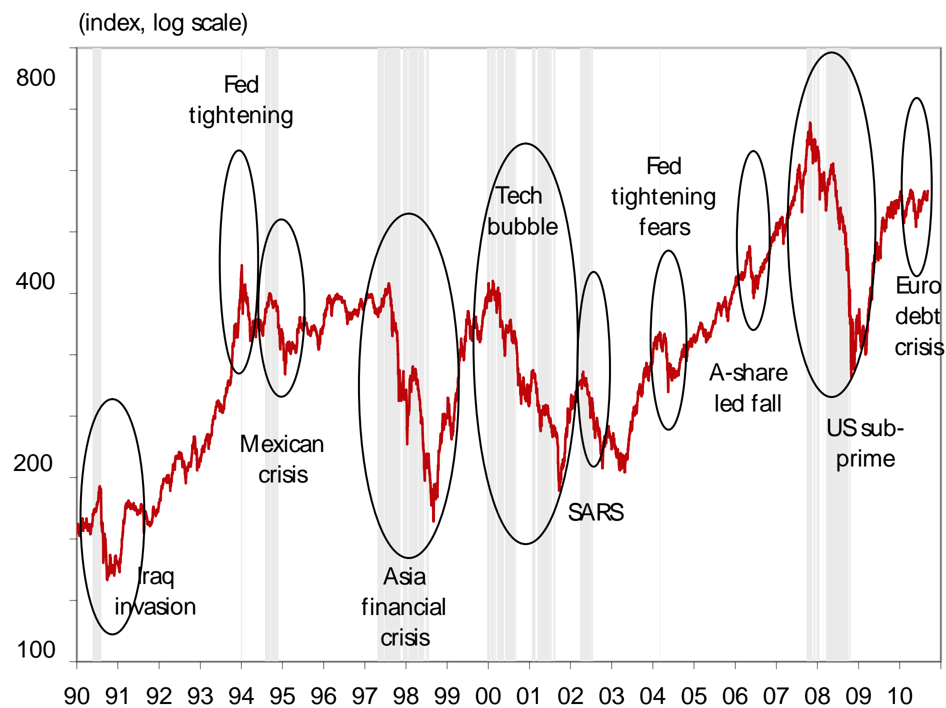
%, eop, govt bond yield for 2Y and 10Y, spread bps

		3-Sep-10	4Q10	1Q11	2Q11	3Q11
US	Fed Funds	0.25	0.25	0.25	0.25	0.50
	3m Libor	0.29	0.35	0.35	0.45	0.80
	2Y	0.51	0.63	1.02	1.12	1.86
	10Y	2.70	3.50	4.00	4.00	4.25
	10Y-2Y	219	287	298	288	239
Japan	O/N Call Rate	0.09	0.10	0.10	0.10	0.20
	3m Tibor	0.36	0.38	0.40	0.40	0.50
Eurozone	Refi Rate	1.00	1.00	1.00	1.00	1.25
	3m Euribor	0.88	1.00	1.05	1.10	1.50
Indonesia	BI Reference Rate	6.50	6.75	7.50	8.00	8.00
	3m Jibor	6.86	7.05	7.80	8.30	8.30
	2Y	6.89	7.00	7.75	8.25	8.25
	10Y	8.16	8.50	9.00	9.50	9.50
	10Y-2Y	127	150	125	125	125
Malaysia	O/N Policy Rate	2.75	2.75	3.00	3.25	3.25
	3m Klibor	2.92	2.90	3.15	3.45	3.45
	3Y	3.16	3.25	3.50	3.75	3.75
	10Y	3.69	3.90	4.00	4.25	4.25
	10Y-3Y	53	65	50	50	50
Philippines	O/N Reverse Repo Rate	4.00	4.25	4.50	4.75	5.00
	3m Phibor	4.31	4.50	4.75	5.00	5.25
	2Y	5.10	5.25	5.50	5.75	6.00
	10Y	6.67	6.75	7.00	7.50	8.00
	10Y-2Y	158	150	150	175	200
Singapore	..	..	..	..	..	..
	3m Sibor	0.54	0.50	0.50	0.55	0.73
	2Y	0.44	0.40	0.77	0.82	1.56
	10Y	2.13	2.55	2.95	2.95	3.15
	10Y-2Y	169	215	218	213	159
Thailand	O/N Repo	1.75	2.25	2.75	3.00	3.00
	3m Bibor	1.87	2.50	3.00	3.25	3.25
	2Y	2.41	2.75	3.25	3.50	3.50
	10Y	2.96	3.50	4.00	4.25	4.25
	10Y-2Y	55	75	75	75	75
China	1 yr Lending rate	5.31	5.58	5.85	6.12	6.39
	1yr deposit rate	2.25	2.43	2.61	2.79	2.97
	2Y	2.16	2.75	3.00	3.25	3.50
	10Y	3.25	3.75	4.00	4.00	4.00
	10Y-2Y	109	100	100	75	50
Hong Kong	..	..	..	..	..	..
	3m Hibor	0.26	0.25	0.25	0.30	0.60
	2Y	0.46	0.48	0.82	0.92	1.61
	10Y	1.94	2.85	3.55	3.55	4.00
	10Y-2Y	149	237	273	263	239
Taiwan	Rediscount Rate	1.38	1.75	2.00	2.25	2.50
	3M CP	0.54	0.90	1.15	1.35	1.55
	2Y	0.26	0.90	1.15	1.35	1.55
	10Y	1.22	2.00	2.00	2.00	2.00
	10Y-2Y	96	110	85	65	45
Korea	7d Repo	2.25	2.75	3.25	3.50	3.75
	3m CD	2.66	3.25	3.75	4.00	4.25
	3Y	3.65	4.00	4.25	4.50	4.75
	10Y	4.43	4.75	5.00	5.25	5.25
	10Y-2Y	78	75	75	75	50
India	1d Repo	5.75	6.25	6.50	6.50	6.50
	3m Mibor	6.77	7.25	7.50	7.50	7.50
	2Y	6.87	7.00	7.00	7.00	7.00
	10Y	7.96	8.00	8.00	8.00	8.00
	10Y-2Y	110	100	100	100	100

Asia equity: Saving par

- Investor sentiment has been fluctuating throughout 3Q10. The past couple of weeks were clouded by concerns of a double-dip recession. Therefore, until we get macro-news that is consistent, we believe the equities markets will be choppy
- Unless conditions deteriorate to an outright recession, which will force investment portfolios to reduce allocation of riskier assets we do not see much downside from current levels
- Mixed policy actions globally add to the uncertainty. We think that Asia equities can continue to be well supported underpinned by attractive valuations and resilient domestic growth
- We are Overweight in Thailand, Indonesia, Korea and China; Neutral Singapore and Hong Kong; and Underweight Taiwan and India. Malaysia is raised from Underweight to Neutral

Fig. 1: MSCI Asia ex-Japan index and key event drivers



Source: Datastream, DBS

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Executive summary

Investor sentiment has been fluctuating throughout 3Q10. The past couple of weeks were clouded by concerns about the risks of a double-dip recession. Thus, until we get macro-news that is consistent, we believe the equities market will be choppy.

We think that current fears of a global double dip are overdone. A rollover in economic leading indicators is typical from early expansion to mid cycle expansion phase. Investors are not convinced whether this is just a mid cycle slowdown or a persistent slowdown. Unfortunately, there is not much clarity. Unless conditions deteriorate to an outright recession, which will force investment portfolios to reduce allocation of riskier assets, we do not see much downside from current levels.

Several indicators suggest that much of the pessimism is priced in. Namely : (i) The cyclical spending categories - durables, housing, capex, and inventories - are already at depressed levels. (ii) Bond yields have fallen to very low levels and bond funds are attracting substantial money inflows. (iii) The G3 central banks are assuring us, by way of actions (Japan and Europe), or words (US Fed) that they will do what they can to get the recovery to continue. (iv) Valuations are attractive and are now based, in our view, on more realistic growth expectations. These could imply that stocks may become more resilient to poor economic indicators going forward, and in fact gain if money that had shifted to bonds on extreme concern over the economy, moves back to equities. In addition, we should still see an environment of ample liquidity if Fed expands its quantitative easing (“QE”) programme.

We should also be hopeful of events in 4Q10, which could signal a shift in expectations and lead to equities breaking out from the current trading range. The US elections in early November could reshape US monetary and fiscal policies and remove some measure of political uncertainty. The trend for the USD should also be clearer after the elections.

In Asia, higher inflation across the region is pressuring central banks to raise rates but rising economic risks provide a case to delay normalising interest rates. Asia's vote of confidence will be tested in the next round of policy meetings. The case in point is Malaysia, which paused its monetary tightening cycle at 2.75%, after 3 hikes from the bottom, and is still shy of precrisis level of 3.5%. The Reserve Bank of Australia also kept its key interest rate unchanged

We think that Asia equities can continue to be well supported by attractive valuations and resilient domestic growth. Although the correlation between Asia and the US is high, there is a strong case for decoupling between the US and Asia; and between bonds and equities.

Our conviction is in Asia's growth, including China. But policy uncertainties, and sectors sensitive to the global economy are going to cap upside. We are sticking to our recommendation for domestic demand and yield plays in the region.

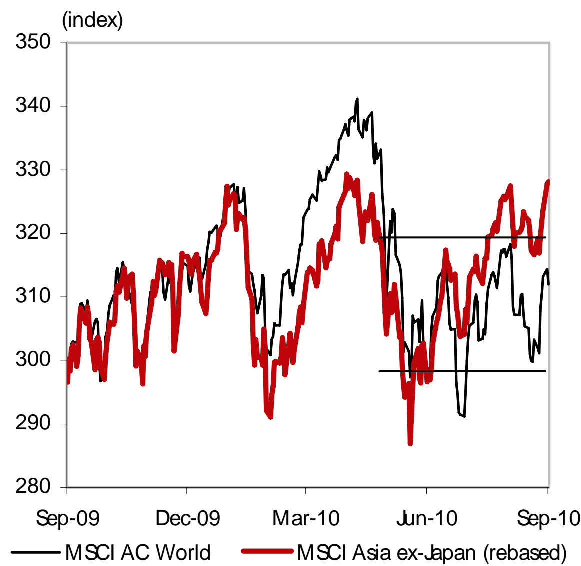
Fixated on the US

Market views on US growth have started to moderate, triggered by the weaker than expected preliminary release of 2Q GDP growth of 2.5%, later revised downwards to 1.6%. Bernanke's "unusually uncertain" assessment on the outlook of the economy was taken negatively as plunging home sales, weak retail sales and higher job losses, jobless claims and employment rate added to downside risks. The PCE series were also revised downwards significantly, giving some credibility to suspicion that growth may not be as strong as previously thought.

This led to lower bond yields, with the Fed funds futures markets pushing out the first rate hike to December 2011. We are beginning to see significant downward revisions in growth forecasts for the US economy. Growth estimates for 2010 and 2011 are now below 3%.

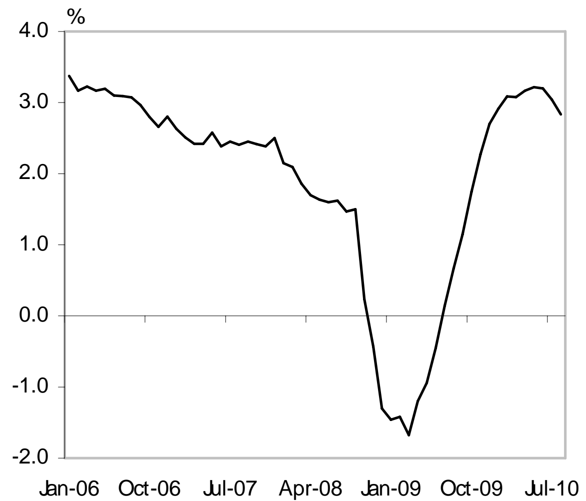
Equities, however, remained in their 3-month trading range pattern despite the mounting uncertainty. Meanwhile Asia equities have outperformed the developed market equities, helped by strong domestic growth and capital inflows.

Fig. 2: MSCI AC world vs Asia ex-Japan Index



Source: Datastream, DBS

Fig. 3: 12-month forward US GDP growth forecast trend



Source: Consensus Economics Inc., DBS

Amid the uncertainty we see possibility of a weakening scenario developing. Our generally sanguine outlook on the growth front leaves us with a more positive base case in that global equities should recover from over pessimism and that Asia equities should continue to outperform global equities. Given the volatility on the financial markets, investors should consider risk hedging strategies based on the following scenarios.

Scenario 1: Conditions get worse before getting better

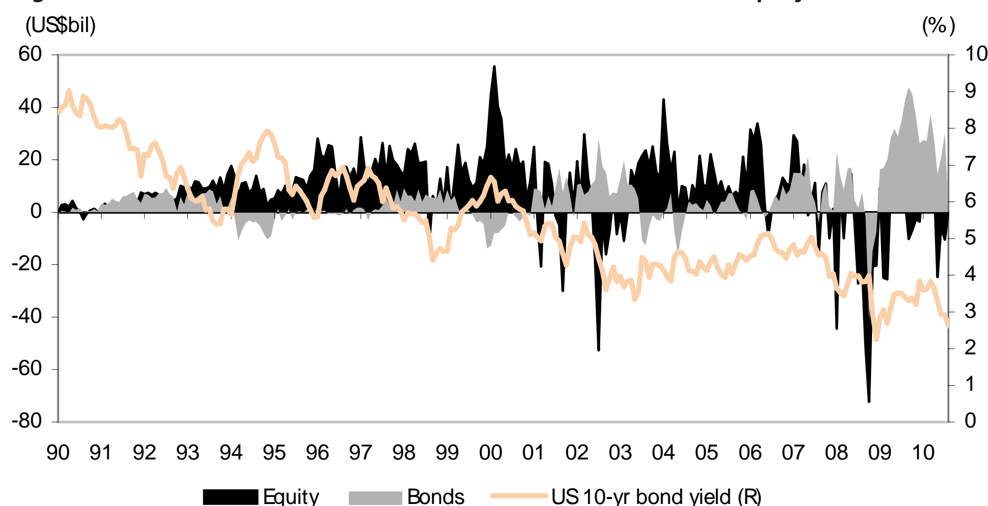
The bond market continues to push for lower bond yields. There is scope for more stimulus measures and the market is frustrated because policy makers are not prepared to pull the trigger just yet.

In order for this to happen mixed data signals will be interpreted as bad. We think that even if this happens, it will be very temporary as the bond yields are already at very low levels - just 50bps shy of the all time low during the subprime crisis. The markets would like to see that Fed print more money to bolster the US economy. Timing wise, we believe it should take place before the US elections. With the latest unemployment rate at 9.6%, we expect Obama's administration to announce fiscal measures to boost job growth.

Our fixed income strategist believes that it is unlikely that bond yields will fall further from current levels. Even at the height of the subprime crisis when Fed funds rate first fell to near zero, 10-year bond yields was 2.1%. Thus, in this instance when the Fed funds rate has no room to fall further, another dip towards 2.1% would effectively price in a recession.

If the Fed opts for an expansion of the QE program, bond yields should continue to stay at the current low levels. An expansion of the QE programme should also keep liquidity abundant in the system. A normalisation of bond yields would bring 10-year bond yields to 3%, and trigger a fair amount of fund flows into equities.

Fig. 4: US mutual fund flows - net cashflow into bond funds and equity funds



Source: Datastream

We recommend staying invested with defensive portfolios such as yield plays and momentum plays until there are clearer signs with a couple of months of data, at least till the end of October. We also expect high volatility in the forex and bond market.

Scenario 2: A US double dip

The US "double dip" talks had deepened following the recent weak data reports. Some market watchers interpreted the latest set of less negative data as a "dead-cat bounce". The fear is that even with more QE and fiscal measures, due to the very suppressed level of economic activity and high employment rate, they won't be enough to pull the economy out of recession. Japan had the same market response when it announced the support programmes for the economy two weeks ago where markets were skeptical about the effectiveness of these programmes.

Under such a scenario we believe that investors will begin de-risking their portfolios. This would involve selling risky assets including Asia, and Asia currencies. Yield plays from sectors like Telecoms and Utilities should be in favour.

Meanwhile Asia currencies should also suffer from weaker exports and hence the currency appreciation in the first half of this year should pause. It doesn't help that exports have started to slow after the V-shaped recovery in the first half of the year. An already slower growth outlook for next year has to be trimmed down further.

Under this scenario we believe that markets like Thailand, Taiwan and Singapore which do not have much domestic cushion are more at risks. We are underweight Taiwan and neutral in Singapore, and will be prepared to take profit in Thailand once the first signs of US recession came about.

We also recommend investors look into utility yield plays, which are less sensitive to the US economy. We are upgrading Malaysia to Neutral as a hedge against downside risks from a US recession. Korea may be downgraded if there are signs that this scenario is playing out.

Policy uncertainties in Asia

In Asia, policy uncertainties will be the main concern. In 3Q10, Asia central banks showed their confidence on growth with rate hikes. Due to very strong domestic demand, inflation in Asia continued to rise, pressurising central banks to raise rates.

That said, the strategy team believes that Asia central banks are facing a dilemma in balancing growth and inflation. As such, a rate hike should signal confidence rather being seen as restrictive on growth. On the other hand, central banks might send the wrong signal if rates are not raised. A case in point is the Malaysian central bank, which paused after raising rates 3 times from the bottom of the interest rate cycle. Its policy rate is now 3%, still about 4 hikes away from the precrisis peak of 5%. Interest rate normalisation, at least hiking towards midpoint of the precrisis level, should be taken as a healthy move towards prevention of a build up of inflationary expectations. The strategy team believes most Asia countries will slow the rate normalisation process.

China's hard landing risks

With all concerns fixated on the US in the 3Q, China's Q2 GDP came in adequately strong to dispel concerns of a hard landing and the need to tighten monetary conditions. Flood conditions during the better part of 3Q also helped divert attention, and it is generally expected that China's inflation will continue to trend upwards because of food inflation. Under these conditions, the strategy team believes that rate hikes are quite unlikely in the near term. DBS economics still has interest rate hikes pencilled in for 4Q, reflecting the uncertainty in China's policies. We continue to favor domestic demand sectors, which are unlikely to be affected by rate hikes, and where growth remains very strong. Retail sales growth is accelerating, buoyed by rising income levels and rapid urbanization.

Europe could surprise

Europe's 2Q GDP surprised on the upside. With the upwards revision in the consumption series (as opposed to the US' downward revision), growth could exceed expectations in the coming quarters. The latest indicators for the Eurozone suggest that the strong momentum in 2Q could carry over into the 3Q. The strategy team believes that there is a lag in the European economy with the global economy, and with a peaking Q2, we should be expecting some sort of moderation going forward, not withstanding the European crisis. All said, Europe may not disappoint in the coming quarters.

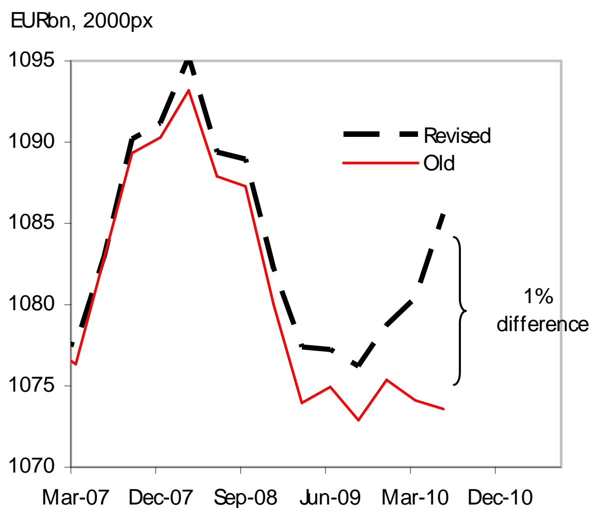
Decoupling

Historical relationship between bond yields, equities and economic growth should be a positive correlation - bond yields and equities rise when economic growth is strong and both fall when economic growth falters.

The current case of falling bond yields but a still sanguine equities market suggest a convergence is likely to take place; either bond yields will have to rise or equity markets will have to fall. The final outcome from the "unusually uncertain" outlook means that either bonds or equities will be right in pricing in the outlook for the economy.

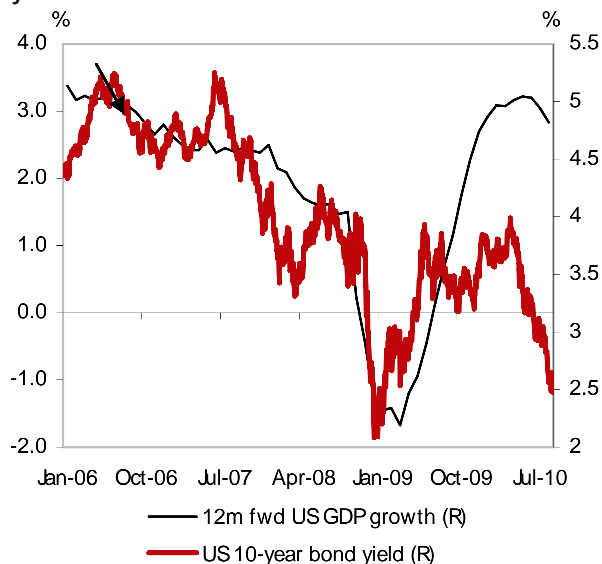
With the US economy still improving, especially on the demand side, DBS chief economist believes that equity markets are more right. *(See "US Fed: between a stock and a bond place", David Carbon, 10 August 2010)*. Indeed if one sees the chart below on growth expectations and bond yields, bond yields must have overshot on the downside.

Fig. 5: Eurozone private consumption



Source: CEIC, Bloomberg, DBS

Fig. 6: US GDP growth expectations vs bond yields



Source: Consensus Economics Inc., Datastream, DBS

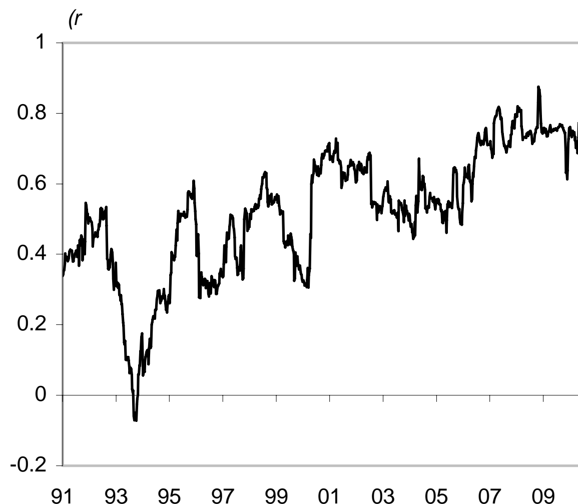
Asia vs the US decoupling

The correlation between Asia and the US has remained high at 0.75 since 2007. As all eyes are on the US now, Asia markets have been outperforming amid high volatility.

A key issue is whether the subpar growth and a prolonged soft patch in the US economy will create a negative feedback loop in the US and hence Asia equities.

We think not. As long as the downside to growth is limited to slow but not negative growth, financial markets will find a way to limit downside, in our view, for the following reasons. Firstly, global equity valuations are not expensive. Secondly, a low interest rate environment will continue to support expenditure growth. Thirdly, further actions from central banks are likely given their assuring words. Fourthly, emerging markets' self-fulfilling growth is providing a positive feedback loop to the US companies that benefit from emerging markets demand. Finally, it has been discussed widely that the profits of corporate America are not representative of the US economy - a slow down in the economy may not signal a slowdown in US corporate profits.

Fig. 7: Asia vs US - 52 week rolling correlation of weekly returns



Source: Datastream, DBS

A peek into 2011

Investors have also a lot to look forward to in 2011. Obama is in his 3rd presidential year or the year before the next election year - it is widely expected that fiscal expansion should accelerate to assure a second term victory.

China's next 5-year plan begins next year. Policy directions early in the year should clear some uncertainty. Anecdotal evidence suggests that investments typically pick-up in the beginning of the 5-year plan. Next year should also be one step closer to the completion of the nationwide transportation system; we should then expect to see rapid developments in the inner cities once these railways start operating.

A number of Asian countries, such as Singapore, Malaysia and Taiwan will have their elections either end of this year or early next year. Thailand will probably have it end of next year. Volatility in these markets can be expected.

We should also see normalised growth next year. There should not be any excuses of high base or low base effects on year on year comparisons as the global economy enters the second year of recovery. We should see reduced uncertainty from data releases.

Valuations, earnings growth and index targets

Corporate earnings in Asia hit precrisis highs before softening again. We believe going forward earnings upgrades may have hit a speed bump considering the softer economic outlook. However, we expect improving earnings outlook to come from emerging markets, and the consumer and industrial sectors.

Valuations in Asia are below average valuations. Earnings growth of 11.5% in 2011 is not aggressive, in our view. This is in line with the average nominal GDP growth, normalised after the V-shaped recovery this year.

Our index targets based on PE and mean reversion leads to MSCI Asia ex-Japan index (585 as of 7Sep) target of 603 by year end and 714 for 2011 - a gain of 3% and 22% respectively. ***(Fig. 10)***

Fig. 8: MSCI Asia ex-Japan 12-month forward earnings integer forecasts

Source: Datastream, IBES

Fig. 9: Asia regional markets - Consensus valuations and earnings growth forecasts

	P/E					Earnings Growth		
	Avg*	-1SD	10F	11F	12F	10F	11F	12F
Hong Kong								
HSI	14.4	12.3	13.0	11.2	9.8	25.2	15.2	14.5
MSCI CH	13.3	9.7	13.1	11.2	9.5	25.5	17.0	16.9
MSCI HK	15.9	13.9	15.8	14.9	13.3	25.8	5.8	11.6
China 'A'	14.2	9.5	17.7	14.4	11.7	29.3	22.3	19.1
Singapore	14.7	12.5	14.4	13.0	11.9	21.7	10.8	9.7
Korea	9.1	7.2	9.1	8.6	7.9	55.7	6.4	7.9
Taiwan	14.4	10.6	13.3	11.5	10.5	110.7	10.8	10.5
India	14.1	10.8	17.3	14.2	11.9	22.7	22.0	17.3
Malaysia	14.1	12.7	16.2	14.2	12.8	27.5	15.1	10.2
Thailand	10.4	9.0	12.8	10.8	9.3	18.2	18.3	16.1
Indonesia	14.0**	10.7	15.0	12.4	10.9	20.3	21.1	13.2
Philippines	13.9	11.7	15.8	14.1	12.4	23.1	12.1	13.6
AXJ	**12.3**	**10.6**	**12.8**	**11.4**	**10.1**	**40.7**	**12.2**	**12.4**

Source: Datastream, IBES. * 10- year average using simple average, ** Except for Indonesia which uses a trend line average. Figures in bold are below average; figures shaded are less than one sigma.

Key assumptions in arriving at the index targets are (1) that the current valuation is fair - there is no re-rating or de-rating by year end; (2) there is case for conversion in global valuations in the longer term considering that financial markets are now more correlated, and that interests rates are a lot lower than before. Key markets will converge towards average valuations which currently stand at 11.7x and 10.4x for the US and emerging markets respectively. It means cheaper markets like Korea has the potential to re-rate in a sustainable manner. Relatively expensive markets like MSCI HK and India will need a lot of drivers to justify the higher valuations. (3) the underweight in India and Taiwan, despite higher return forecasts based on valuations are due to downside risks on valuation de-rating for India, and downside risks to growth for Taiwan.

Fig. 10: Index and PER targets

		End 2010 Target			End 2011 Target			12mth Target		
	Current Inde	PER (x)	Index	Return	PER (x)	Index	Return	Index	Return	Recommendation
Hong Kong										
HSI	21089	11.6	21762	3%	12.3	26456	25%	25533	21%	Overweight
MSCI Chin	64	11.6	66	4%	12.3	82	29%	79	24%	Overweight
MSCI HK	10777	15.0	10859	1%	15.0	12110	12%	11769	9%	Neutral
Singapore	3011	13.4	3095	3%	13.4	3401	13%	3321	10%	Neutral
Korea	1779	8.7	1808	2%	9.1	2039	15%	1999	12%	Overweight
Taiwan	7851	11.8	8048	3%	11.8	8836	13%	8623	10%	Underweight
India	18667	15.5	20492	10%	14.1	22132	19%	21112	13%	Underweight
Malaysia	1434	14.4	1459	2%	14.1	1574	10%	1535	7%	Neutral
Thailand	924	11.2	961	4%	11.2	1116	21%	1073	16%	Overweight
Indonesia	3231	13.0	3378	5%	14.0	4135	28%	4002	24%	Overweight
Asia ex-Japar	585	11.7	603	3%	12.3	714	22%	692	18%	Overweight vs DM

Source: Datastream, IBES

Asset allocation and strategy

Our base case assumption is for a softening growth outlook and for further G3 policy actions to support recovery. Asia may slow in heading towards normalisation in view of external uncertainty, but rising inflationary pressure is pushing Asian central banks to allow more currency appreciation. Low interest rates and capital inflows will further support Asia's domestic demand growth.

Under a slow growth low interest rate environment, we recommend staying long in emerging Asia markets with exposure to domestic demand proxies. We also favour sustainable high yielding stocks, such as REITS, and beneficiaries of the buoyant tourist sector.

After the V-shaped recovery, we believe we are still in the early-to-mid cycle expansion stage. The divergence in inflation and growth between Asia and G3 and identifying sectors relating to these are challenging. For example, Asia is facing inflationary pressures while G3's deflationary risk is growing. Macro policies between Asia and G3 will have to be different. However, with the high correlation between the financial markets, sectors may or may not respond accordingly to the cycle dynamics. As such we prefer to stay Neutral in the global economic sensitive sectors, focusing on alpha picks in these sectors.

The following table shows the sector performance in Asia together with the best performing stocks in that sector. In fact, the best performing sectors are those which are benefiting from domestic demand in Asia. We recommend overweighting these sectors where it will be easier to identify the stocks likely to outperform. Global sectors like Banks, Utilities, Commodities, and Tech performed in line or underperformed. Special situation drivers will be more applicable for these sectors. We will be Neutral in Banks on valuations, Underweight in Utilities as these will be deemed too defensive in the context of Asia's growth, Neutral in Commodities in view of China's demand, and Underweight Tech.

We are overweight in Thailand, Indonesia, Korea and China; Neutral in Singapore and Hong Kong; and Underweight Taiwan and India. Malaysia is raised from Underweight to Neutral.

Fig. 11: Asia ex Japan sector performance ranked in order of 3-month performance with the corresponding best performing stock in that sector

Asia ex-Japan sectors		Performance		Best performing stock		Performance	
Sector	**Weight**	**YTD**	**3M**	**Name**	**Country**	**YTD**	**3M return**
H/H Gds,Home Con	0.1	15.4	29.3	Land And Houses	Thailand	2.4	30.0
Fd & Drug Rtl	0.4	38.3	23.5	CP All	Thailand	54.2	34.2
Tobacco	1.1	44.0	23.4	Gudang Garam	Indonesia	122.7	52.6
Chemicals	2.1	26.0	21.5	PCI	Korea	62.9	76.2
Support Svs	0.5	32.2	19.1	Hanwha	Korea	-1.3	35.1
General Inds	3.9	15.1	19.0	Hyosung	Korea	19.7	49.3
Media	0.4	28.5	18.6	Honbridge Holdings	Hong Kong	53.4	54.2
Travel & Leis	2.8	19.8	16.6	Galaxy Entertainment Gp.	Hong Kong	81.3	59.0
H/C Eq & Svs	0.2	36.8	15.9	Bgk.Dusit Med.Svs.	Thailand	40.6	37.3
Fd Producers	3.2	14.3	15.8	San Miguel Pure Foods	Philippine	565.1	565.1
Inds Eng	2	18.1	15.6	Hyundai Mipo Dockyard	Korea	61.7	32.1
Auto & Parts	2.6	23.6	15.4	Yulon Motor	Taiwan	30.9	52.3
Gen Retailers	1.4	7.7	15.3	Home Product Center	Thailand	138.0	70.3
REITs	0.5	13.7	15.2	Capitacommercial Trust	Singapore	18.8	18.8
Con & Mat	3.1	7.2	15.0	Jasa Marga	Indonesia	68.5	52.5
Inds Transpt	1.8	19.0	13.8	Hong Kong Aircraft Engr.	Hong Kong	10.6	32.7
Personal Goods	2.1	19.4	13.8	Bosideng Intl.Holdings	Hong Kong	56.3	52.8
Beverages	0.5	12.9	13.1	Yantai Changyu Pion.Wine	Shenzen	27.5	36.1
Real Est Inv,Svs	6.1	-3.2	12.5	Filinvest Dev.	Philippine	98.6	93.0
Mobile T/Cm	7.6	10.9	12.3	True Corporation	Thailand	122.2	150.0
Oil/Eq Svs/Dst	0.5	0.7	12.0	China Oilfield Svs.'H'	Hong Kong	16.1	18.0
Nonlife Insur	0.4	5.2	12.0	PICC Property & Clty.'H'	Hong Kong	33.6	34.3
Fxd Line T/Cm	1.2	7.4	10.6	PCCW	Hong Kong	38.5	20.5
Banks	19.5	3.1	9.1	TMB Bank	Thailand	108.1	94.0
Gs/Wt/Mul Util	1	3.9	8.1	Xinao Gas Holdings	Hong Kong	4.3	27.8
Financial Svs(4)	2.9	-2.8	7.3	Bank Tabungan Negara	Indonesia	116.7	30.9
Oil & Gas Prod	8	5.3	5.6	Hindustan Petroleum	Bombay	30.7	40.4
Alt. Energy	0.2	-15.9	5.2	Chin.Longyuan Pwr.Gp.'H'	Hong Kong	-18.0	5.1
Aero/Defence	0.2	-0.1	5.1	Singapore Techs.Engr.	Singapore	0.6	2.2
Ind. Met & Mines	3.5	-11.5	4.1	Korea Zinc	Korea	38.7	47.0
Electricity	3.9	1.0	3.6	Gcl-Poly Energy Holdings	Hong Kong	-17.2	28.9
S/W & Comp Svs	2.9	-1.0	3.4	SK C&C	Korea	100.5	29.6
Eltro/Elec Eq	1.9	-5.0	2.2	LS Industrial Sys.	Korea	0.0	42.4
Pharm & Bio	0.8	12.5	2.2	Kalbe Farma	Indonesia	82.7	25.7
Life Insurance	2	-8.5	2.1	Bangkok Life Assurance	Thailand	89.3	33.1
Forestry & Pap	0.2	-4.5	1.3	Indah Kiat Pulp & Paper	Indonesia	23.6	19.4
Mining	2.3	-16.1	0.3	Semirara Mining	Philippine	138.1	73.4
Leisure Gds	0.3	-6.5	-0.3	NCsoft	Korea	53.2	19.6
Tch H/W & Eq	5.6	-10.3	-1.0	HTC	Taiwan	76.2	54.5
Asia ex-Japan Total market idx		**4**	**9.4**	**Thailand**			**20**

Source: Datastream, DBS

Singapore (Neutral)

Near-term outlook

The Singapore market performed in line with the region in the third quarter. Domestic demand theme and yield plays performed relatively well as investors sought safe havens amid external uncertainty. We believe these will still be the main themes in the fourth quarter as the domestic economy has potential to surprise on the upside.

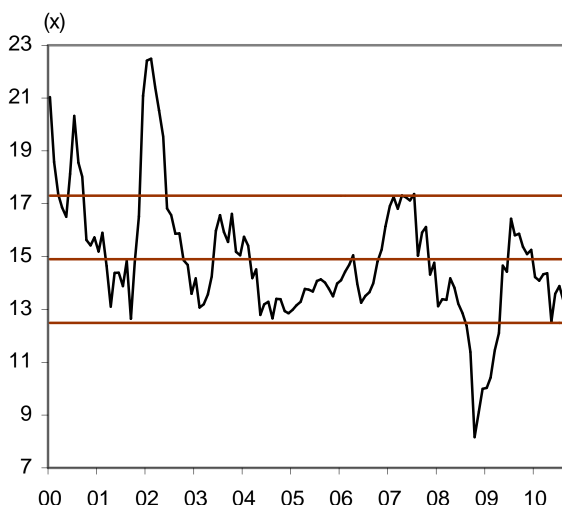
Tourist arrivals climbed again in July reaching a record of 1.07 million, bringing the target of 12.5m visitors for 2010 a step closer. The higher tourist numbers also brought along higher hotel occupancy rates, longer tourists stay-days and more bus and taxi rides. We expect the trend to continue in the second half of the year with the continued success of the IRs, tourists-targeted events like the Formula One and the festive light up seasons. We favor the tourism sector proxies like the retail REITS, IRs and airlines.

Singapore population reached 5.08m in 2010. The growth rate was lower than previous years but foreigners now make up 36% of the general population. There were calls for the government to review its immigration policy amid complaints from Singaporeans that quality of life has been compromised. We do not see this as a stumbling block towards reaching the 6m population target, but that more capacity will have to be added. We continue to favor the domestic economy proxies such as SPH and SMRT.

The Singapore government has also announced more stringent property measures to cool the red-hot property market. While tough, many believe that these measures are positive for the long-term development of the property market. We believe that property transactions would shrink amid stable prices in the next two years. Thereafter more supply will come on board adding pressure to property prices. The property sector has underperformed the broad market in the past one year. Although trading at discounts to RNAV, we don't see any catalysts driving the sector in the near term. We continue to underweight the property sector.

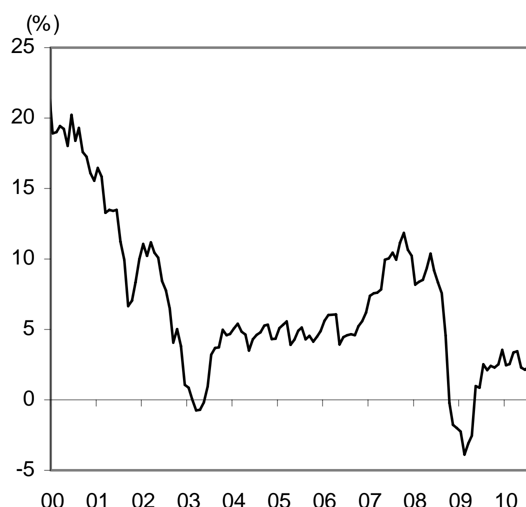
Valuations are attractive in Singapore, giving it room for re-rating and cushion for downside. (Fig. 12-13). Our implied growth model suggests that the market is pricing at 2% earnings growth. This, when, compared with a long term 7.5% nominal GDP growth looks low.

Fig. 12: MSCI Singapore 12-mth forward P/E



Source: Datastream, DBS

Fig. 13: Singapore market implied growth



Source: Datastream, IBES

In 4Q we expect the domestic economy to surprise on the upside, while the tail effects of the property measures will test underlying market strength. Meanwhile, the offshore marine heavyweights are still pending for Petrobras orders. After a poor set of results by the consumer stocks, we expect this sector to trade on valuations. Consumer stocks remain a play on laggards and valuations, given its long term structural story.

We maintain Neutral for Singapore.

Singapore's growth sustainability could come from:

1) Capacity expansion to cater for bigger population, including property, healthcare, transportation, and infrastructure.
2) Services sector from increased economic activities and population growth;
3) Improving Singapore / Malaysia bilateral ties.
4) Construction, pharmaceutical, and services sectors should cushion the cyclicality of the electronics sector.

Drivers:

- The economy is highly cyclical and should expand in tandem with the global recovery this year. Strong GDP growth in 1H10 should leave the domestic sectors with enough buffer against any global uncertainties going forward.
- Structural changes are underway to transform the economy from exports oriented to domestic demand driven. Government initiatives to boost population growth and tourism are expected to bear fruits with the delivery of the Integrated Resorts this year. Visitor arrivals are on track to reach the 20% growth target. An improving Singapore / Malaysia relationship will also help to sustain Singapore's growth in the next 10 years.
- Prudent government finances. Sovereign risk is very low among the developed markets. The economic stimulus package, termed the "resilience package" in 2009 was drawn down from its reserves. Reserves currently make up 4 times of GDP size, which is strong enough to withstand external shocks. Government has committed the same budget spending for this year.
- An appreciation bias SGD currency should instil investor confidence in Singapore. A low interest rate environment should prevail, and encourage spending and investments.

Risks:

- The market is highly correlated to the global markets and is sensitive to global risk events.
- Stricter banking regulations emerging from global banking sector reform could require higher provisions for Singapore banks and another round of capital raising may be needed. The 3 large banks constitute 21% of total market cap in the STI. A low SIBOR will continue to compress NIMs.
- GDP growth has peaked in 2Q10. With the sharp rise in the market last year, we believe the market has priced in a V-shaped economic recovery. Growth momentum is expected to moderate from now and it will need a lot of positive surprises for the market to move up higher.
- Austerity measures imposed on the property sector could risk the beginning of a property price down cycle, thus affecting wealth effect and consumer spending.
- Equity supply in the second half could cap market upside.

Thailand (Overweight)

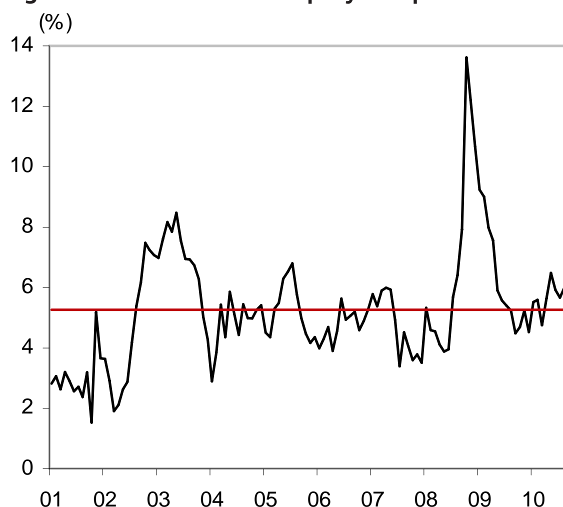
Near term outlook

The Thai market in 2H of 2010 will be driven by 1) strong corporate earnings; 2) positive political development; and 3) foreign fund inflows.

Despite the riots in Apr-May and European sovereign debt crisis, Thailand economy continued to surprise on the upside and we recently raised our GDP forecast to 9.0%.

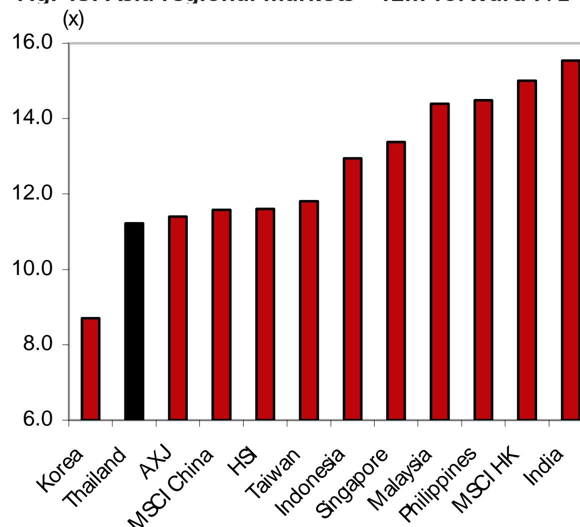
While short-term valuation opportunities have become harder to identify following the recent rally in Thailand, it is still one of the cheapest markets in the region. Implied equity risk premium is higher compared to during 2004-07 after the coup against Thaksin when consumer confidence dropped to its lowest. We believe that Thailand has passed the peak of the political crisis after the worst riot in history.

Fig. 14: Thailand market equity risk premium



Source: Datastream, DBS

Fig. 15: Asia regional markets - 12m forward P/E



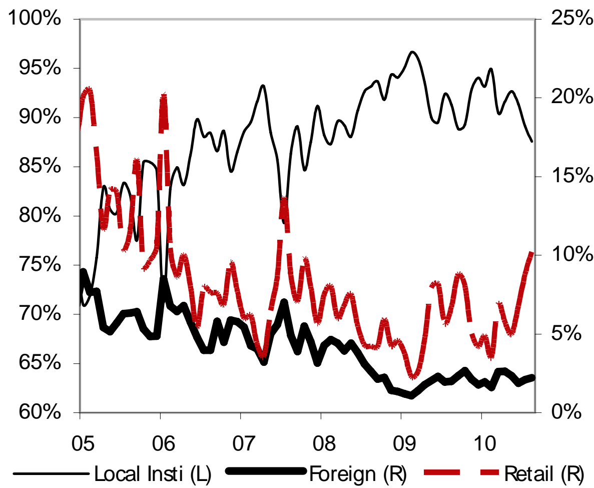
Source: Datastream, IBES

Foreign investors sold during the political crisis. Despite the recent rally foreigners net bought positions were only back to pre-riots levels ***(Fig. 17)***. Although it is not all unlikely that the political situation may take another turn for the worse later on, we take comfort in fact that foreign buying has yet to catch up.

So far, the current rally has largely been driven by local investors. Retail participation in the market was 10% at end of August compared to 5% at end of May. Although this has risen, it is still half of what they used to trade in 2005! ***(Fig. 16)***. We expect buying interests from the local investors to continue given the low interest rate and strong economic growth environment, notwithstanding the political uncertainty.

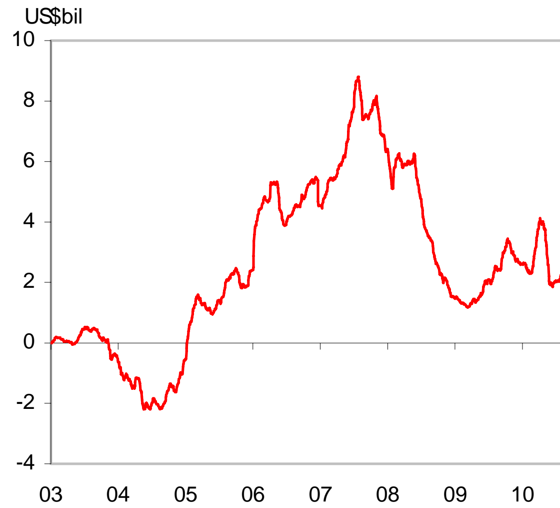
We see that the Thai market has surpassed its 2007 level. Asia emerging markets were less affected by the subprime crisis and had all recovered to precrisis GDP and earnings levels. ***(Fig. 18)***. The SET Index could potentially trade towards the upper limit of its historical P/E range in the last 10 years.

Fig. 16: Thailand - Trading turnover breakdown by investors group



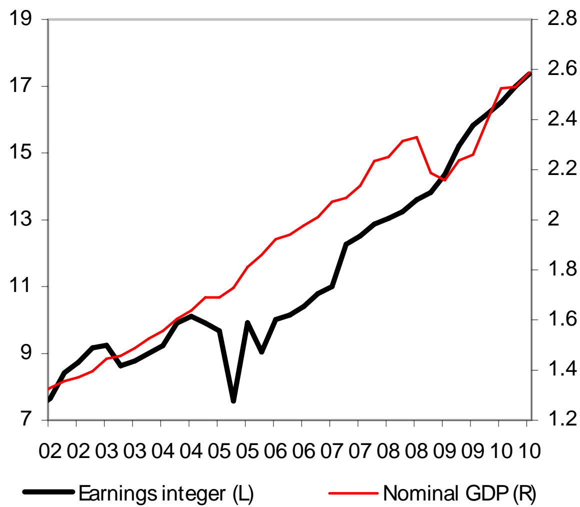
Source: Bloomberg

Fig. 17: Thailand - Cumulative net foreign buying



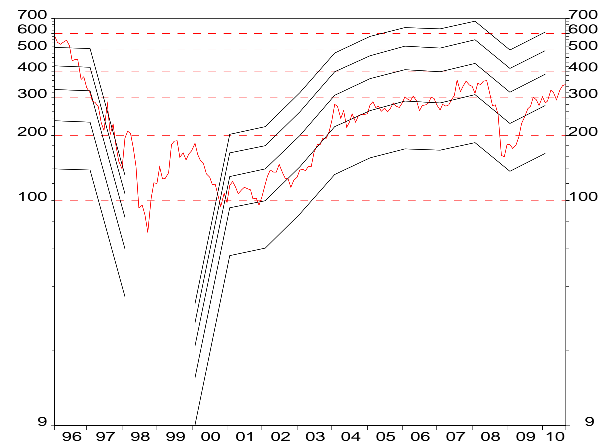
Source: Bloomberg

Fig. 18: Thailand - Nominal GDP and earnings integer



Source: Datastream, IBES

Fig. 19: Thailand - 12-mth forward PER bands (6,10,14,18, 22x)



Source: Datastream

Drivers:

- The Thai market is relatively cheap compared to regional peers. While valuations are affected by the political uncertainties, we believe political risk has passed its peak.
- Political developments are expected to improve in short to medium term. With the Democrat Party wining Bangkok's City Assembly and District Councils elections last week, this could be a strong signal from Bangkok residents that they do not like the role played by the pro-Thaksin Pheu Thai Party in the riots in Apr-May, and still favor the Democrat Party. The election results reaffirmed our view that Thaksin is losing momentum, especially after the riots in Apr-May, and the probability for Democrat Party to win seats in Bangkok in the general elections next year is quite high. This is positive for the equity market.

- Commodity prices are also a major driver for the Thai market since commodity-related stocks (e.g., Oil & Gas, Refiners and Petrochemical) accounted for c. 35-40% of SET's total market capitalization. SET Index will strengthen with expectations of higher oil prices in 2H 2011. These sectors also trade at cheaper valuations compared to the regional peers.

Risks:

- History suggests the SET Index has strong negative correlation with interest rate movements. Although our economist expects another 75bps hikes in policy rate this year (from 1.50% currently to 2.25% by end-2010), we believe any market correction should be minor this time, as this is simply policy normalization rather than policy tightening.
- Regulatory risk is another major concern for Thailand. The environmental requirement at Map Tha Phut area (Eastern seaboard) caused delays in construction of more than 60 major plants, and delays in the award of 3G licenses (on 2.1GHz band), which disappointed investors. Although these two issues have been resolved, it raises concerns, especially to foreign investors if there will be any other regulatory issues popping up in the future.
- The Thai market is highly volatile due to the political uncertainties as well as dominance of the Energy sector, which has high earnings volatility, in the market. In addition, local retail investors mostly trade rather than invest in the stock market.

Indonesia (Overweight)

Near term outlook

We believe risks are rising in Indonesia in the near term. The market is pricing in a lot of positives in our view. These include an investment ratings upgrade, the belief that interest rate will continue to stay low, and that Rupiah will continue to strengthen. While we believe these are all highly possible, they are not going to happen overnight.

Foreign investors' participation in the stock market is a lot higher now than before, which means that foreign flows have a bigger impact on the market rather than domestic investors. Hence the re-rating in the past cannot continue as foreigners are making regional comparisons on valuations, risks, and sectors. There is a general fear that global investors will turn away upon rising valuations and global risk factors.

We need to see stronger domestic liquidity to overcome this apprehension. With rising inflationary pressure, the fear has been that the central bank will tighten liquidity. Last week the central bank raised the RRR from 5% to 8% to mop up excess liquidity, meanwhile keeping the interest rate at current low levels. The core CPI basket was also revised. Earlier on, the loan-to-deposit target was set at 78-100%.

Recent BI actions seem to have shaken investors' confidence on the central bank's creditability, as some of the measures are perceived to be contradictory in controlling liquidity and inflation, and expanding loan growth. At this stage when both BI governor and the Finance Minister are new, we think it is important that BI manage expectations in a credible manner, which is more important than the impact of the actions themselves.

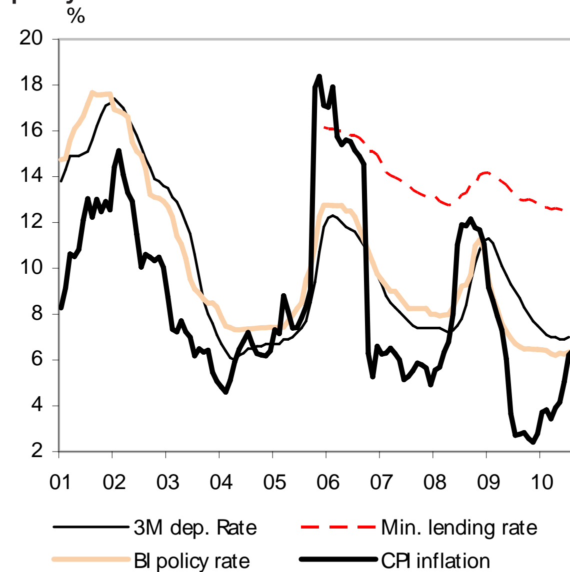
In our view, there are no contradictions in these policy actions. The 300bps hike in RRR will freeze rupiah liquidity by about IDR 53trn (USD 5.9bn) among commercial

banks according to our calculation. This is still a moderate amount, given that banks have excess reserves of IDR 52trn placed in the central bank, and banks' holdings of central bank certificates (near IDR 270trn) are also liquid. Total excess liquidity in the banking sector is more than IDR 300trn. As such, the RRR move may help ease the urgency to raise interest rates in the next couple of months.

Meanwhile, BI stipulated that banks must maintain the loan-to-deposit ratio in the range of 78%-100%, starting from March 2011. Banks that fail to meet the LDR requirement will be penalized with additional reserve requirements. As the current LDR level in the banking system averages at 78%, the new LDR regulation clearly targets at higher credit growth. The LDR measure should be viewed as a medium-to-long term strategy to improve the banking sector's intermediation function and enhance the economy's growth potential. The RRR hike represents the near-term policy stance of tightening.

DBS Economics now expects the first rate hike to be in December. We do not expect domestic demand to be affected by rate hikes. Lending rate is still at a wide spread to policy rate and has been coming off. Banks are also encouraged to lend as funds parked overnight with BI are penalized. We continue to see a lower lending rate to support loan demand.

Fig. 20: Indonesia - CPI, lending, deposit and policy rates



Source: Datastream

Our economist views the investment upgrade as highly likely but it remains to be seen whether it will bring an immediate positive impact on the economy. (See "Indonesia: upgrading expectations" by Tieying Ma included in this report.) DBS' Fixed income strategist believes that Indonesia's bond yield should rise if the economic outlook is good and that the yield curve will have to rise once BI starts hiking rates. In short we do not think that the long-term bond yield has room to fall from current levels even with an investment upgrade.

Near term we believe Indonesia equities market will trade within a volatile range. We recommend adding positions on any significant pull back as Indonesia has consistently offered the best risk-return reward.

Drivers:

- Indonesia's president SBY, now in his second term, has successfully pushed his reform agenda on economic policies and anti-corruption drive. This has translated to higher FDI flows, improving balance of payments, and strong private consumption growth.

- Indonesia has also been able to ride on the positive commodity cycle. With the mining reform in place, FDI inflows have helped with capacity expansion. The potential challenges under the current environment would be weaker growth and USD, which may drive commodity prices lower. However, we expect the continuous improvement in FDI to lift income levels and hence

private consumption growth. Indonesia is one of the few countries that did not suffer a recession during the US financial crisis because of the high component of domestic demand in GDP growth.

- With the ASEAN/China FTA, 90% of products between China and Indonesia are tariff-free. As Indonesia has the advantage of being more cost competitive than China, we expect manufacturing activities to pick up in Indonesia, thereby improving income levels.

- Indonesia is still enjoying higher loan growth rates amid rising investment and consumption. However, tight banking regulations prevent banks from lending more. A "shadow" banking system fills the gap for now. We expect relaxation in banking regulations to improve loan growth going forward.

  On this end BI has encouraged bank lending by setting a higher L/D ratio and higher penalty overnight rates. We continue to see loan growth to improve. YTD bank loan is 9% but seasonal effects should boost loan growth in the second half.

- As the only Asian country with a significant commodities exports sector, Indonesia has become an important portfolio in emerging market funds and comparison was made for its similarities to the "BRIC"s countries. While lacking size at the moment, we expect more IPO listings to improve market's breadth and a higher potential GDP growth from reform efforts.

Risks:

- There is always a fear of capital flight considering Indonesia's large foreign bond holdings. Attractive interest rate spreads between US and IDR also make Indonesian bonds and bills very attractive carry play. Hence, volatility in the equities market are closely linked to volatility in the Rupiah.

- This is SBY's last term in the office and hence, the crucial leadership succession will be in play. Political risks in Indonesia have eased over the last few years under SBY's leadership but the struggle between the reformists and powerful vested interests is ongoing. The conflict emerged early this year when SBY was forced to let go of his important right hand man and that his VP was being investigated for a bank bailout case during the US financial crisis. This would slow the pace of reform.

- Foreign flows have a bigger impact on the market rather than domestic investors. This means that re-rating in the past cannot continue as foreigners are making regional comparisons on valuations, risks, and sectors. It also suggests that Indonesia market will be more open to external global factors, just like the US subprime and the Eurozone crisis.

Malaysia (Neutral)

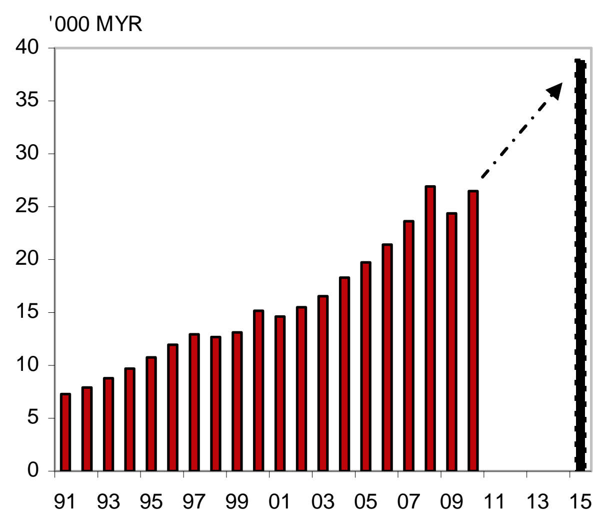
Near term outlook

We foresee positive domestic factors for Malaysia such as the country's transformation program, push to improve public transportation in the 10th Malaysian Plan, redevelopment of government land and measures to improve the market's investability. Although there will likely be intermittent profit-taking following 14% gain in the benchmark KLCI since mid-May, we believe the uptrend is intact and target the KLCI to reach 1,500 points (14x 2011 earnings) by end-2010.

A wave of changes

Since Datuk Seri Najib Tun Razak became the Prime Minister, we have seen a wave of changes. The significant policy changes include repealing the guidelines that cover the acquisition of equity stakes, mergers and takeovers, and easing Bumiputera requirements for listings and property transactions. We view such changes positively.

Fig. 21: Malaysia GDP per capita



Source: Datastream, DBS

More changes on the way

The Prime Minister has indicated that there will be more measures to - (1) transform the government into a more effective and accountable entity (government transformation program: GTP); (2) revitalize and spur growth in key economic sectors to achieve high-income status (economic transformation program: ETP); and (3) improve investability of the Malaysian market.

Drivers:

In our view, the approach and ideas/initiatives of the program inspire optimism. If implemented successfully, these programs could help fundamentally transform the country and attract major investments to stimulate growth.

10MP boost. The 10th Malaysia Plan (10MP) outlines the macroeconomic framework and strategies for 2011-2015. The government intends to facilitate greater private sector participation to drive economic growth over the next 5 years. Several contracts have since been awarded where contractors are also responsible for financing - easing the pressure on government's finances.

The plan increased its emphasis on improving public transportation systems with projects such as LRT extensions and MRT. In our view, the construction sector has more upside with the award of these projects. The MRT could double Gamuda's order book and triple MMC's.

We understand there has been a pick-up in the number of construction and infrastructure tenders. Although competition remains keen, we see more positive project news flow for the sector in the coming months.

Government land sales. Apart from the construction and infrastructure projects, we are optimistic over the value-enhancement opportunities from the redevelopment of strategic government land. We expect MRCB's appointment as master developer of the Rubber Research Institute Malaysia (RRIM) land to be a key catalyst for the stock. Government linked companies (GLCs) and players with strong balance sheets could be winners for such projects.

Resilient domestic demand. Following the strong 2Q10 GDP growth of 8.9% YoY, we expect 2H10 growth to moderate - due to the erosion of the low base coupled with a general slowdown in global growth momentum. Despite the projected moderation in 2H10, full year growth is expected to be a solid 8% and healthy 5.5% in 2011, on the back of resilient domestic demand. The resilient domestic demand bodes well for banks, as positive sentiment would drive demand

for consumer and business loans. Other beneficiaries are Tenaga and aviation-related plays such as AirAsia and Malaysia Airports. We also believe it could boost demand for big-ticket items (such as property; our sector picks: SP Setia, E&O, Bolton).

Improve investability. We expect further divestments in government linked company (GLC) stakes, privatizations and M&A to increase free float, liquidity and valuations. This together should help attract foreign interests - which remain at relatively low levels (c.21%).

Risks:

Delays in execution of the transformation program or roll-out of infrastructure projects. There will definitely be major challenges and resistance. Implementation is a key test for the government and economic transformation.

Hong Kong / China (Overweight)

Near term outlook

The Chinese A-share market recovered from its low of 2477 to 2827 currently. We remain hopeful that the market has passed its worst in terms of policy actions.

With inflation risks returning we believe that market will be fixated on interest rates. China's 2Q GDP came in at 10.3% YoY compared to 11.9% in 1Q. GDP in 1H10 grew by 11.1%. The numbers suggest that policies should remain status quo for now as the economy returns to a more sustainable path. It won't be necessary to introduce more fiscal stimulus measures or ease the current monetary policy stance.

Consensus is looking at no further tightening policies, a relief for the equity market. While DBS economists still have interest rate hikes pencilled in reflecting the uncertainty on the policy front, recent signals do suggest the lower probability of further tightening. These include 1) a flexible RMB policy regime; 2) slower growth momentum; 3) end of the 11th 5-yr plan in 2010; 4) lower inflation; and 5) global growth uncertainty.

Investors are generally less enthusiastic on the Chinese market on two major concerns - the banking and the property sectors because of the exceptional loan growth last year. While this year's loan growth has normalized, the lingering effect especially on loan quality and capital raising requirements still haunt. We believe uncertainties will remain, as there are doubts on the data quality emerging out of these two sectors. In our view the promising demand outlook in China and low valuations justify investors' position in the banking sector.

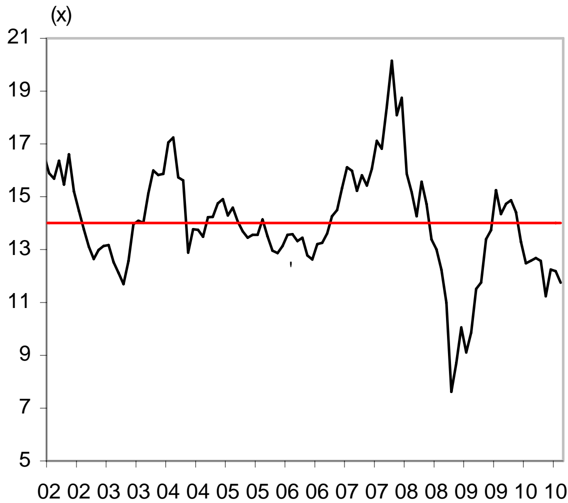
However the China property sector should go through a longer adjustment process as supply situation, sticky housing prices, austerity measures, corporates' balance sheet should continue to weigh on this sector.

We prefer direct beneficiaries of domestic demand like retail, food and beverage, and industries, which manufacture for China's domestic demand. Companies that are strong in the inner cities should have stronger growths going forward as economic activities began to shift inwards. High wage pressures from the coastal regions and the near completion of the railway transportation should justify the economic sense.

The property and the banking sector in Hong Kong meanwhile has a lot to cheer about. Despite the austerity measures delivered by the government, property prices continue to rise. We believe this is because of the recent auctions of "prized" parcels of land in the Kowloon area, which has never been available

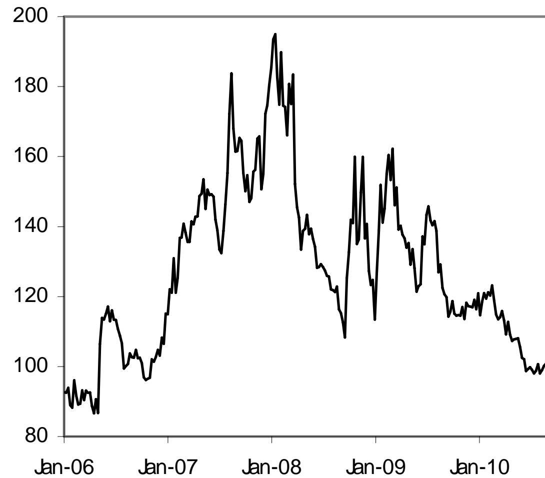
for a long time. Moreover with abundant liquidity from Hong Kong and China as a result of lower interest rates and cheaper HKD, we continue to see asset price rise in Hong Kong.

Fig. 22: HSI 12-month forward PER



Source: Datastream, IBES

Fig. 23: China A/H premium index



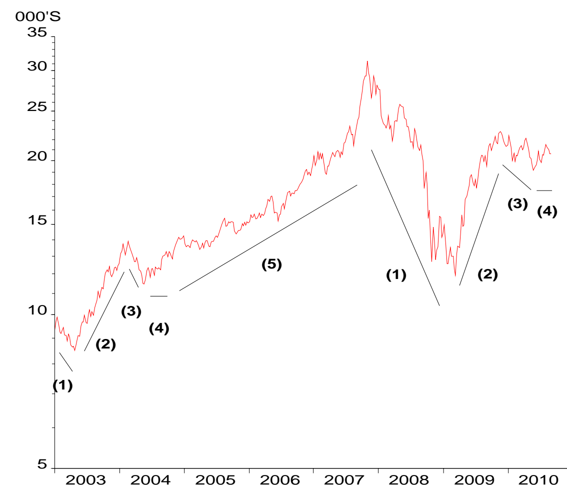
Source: Datastream

The unemployment picture is also looking better. Hong Kong is perceived as the "gateway" to China where demand growth is strong. Moreover, Hong Kong is the only place in the world where onshore CNY can be exchanged into USD currently. We expect more overseas companies from all sectors to set up offices in Hong Kong, hence improving the employment outlook. (*For details, please see "HK: Hovering at an inflection point", Chris Leung, 4Q Economics-Markets-Strategy, 10 Sep 2010).*

Meanwhile valuation for the HSI has risen to 13.3x, but still below historical average of 14.4x. H-shares trade at 13.5x above the historical mean.

The A-H premium has also narrowed to historical low, indicative of value in Chinese A shares. With the Chinese 'A' share index having corrected 18% YTD (lowest at 28%), we believe there is value in the Chinese market.

Fig. 24: HSI performance



Source: Datastream

The current scenario resembles 2004 -the year after Asia's recession from the Tech bubble and SARS. China was poised to raise rates after the aggressive easing to support the anaemic economic growth. At the same time global economic data was rolling over, and China's hard landing fears stoked a sell-off in commodities and

emerging markets. MSCI Asia ex-Japan retraced 25% from its high to a low in 2004. In the scale of things a 25% correction for a market, which had run up 100% is par for the course. The upside risk was RMB revaluation which would stoke a rally in Asia equities. After the correction in 2004, Asian equities recovered once the hard landing fears faded, and as RMB revaluation speculation powered a strong multi-year rally.

It is worth noting that next year marks the beginning of the 12th year plan where policy guidelines will be delivered in the beginning of the year. In view of the turbulent past 5 years in the global markets, we expect more directions to address the volatility and measures to protect China's interest amid the volatility.

Whether HSI will perform like it does during 2005 - 2007 remains to be seen. But the Shanghai 'A' index surged five folds in 2006-7, during the first two years of the 5-year plan. Conspiracy theory is suggesting that liquidity from the property will be channelled to the stock market, now that the government is tightening its grip on the sector.

Drivers:

- We do not hold to a hard-landing scenario for China. Beyond the volatility this quarter, we believe China should be in a good position to showcase its resilience in the face of global uncertainty, considering its strong fiscal muscle and flexibility in monetary policies.
- The earlier than expected completion of the railway transportation system will expand China's growth into the second and third tier cities, thus relieving overheating pressures on the coastal cities and ensuring the sustainability of growth.
- Rising wages and policies to build a safety net with healthcare, education and insurance sectors should continue to support domestic demand growth.

Risks:

- Rising inflation continues to be a threat with calls for policy tightening.
- Uncertainty of the impact from property measures raise risks of deterioration in corporate balance sheets.

India (Underweight)

Near term outlook

We are less negative on India compared to the last quarter. Growth seems to be losing steam but we believe it is normalizing after the scorching pace in the previous quarter, notwithstanding the higher inflation and rates hikes that could also possibly dampen demand.

The reform agenda supports a longer-term positive outlook. It is also enough to support the 8% GDP growth target as well as alleviating the high budget deficit and inflation concerns in the near term.

While strong nominal GDP growth could be positive for earnings growth in India, we are cognizant of higher operating costs eating into profits especially after recent fuel and wage hikes. Inflation at its extreme may also snap consumer demand and hurt top line growth, in our view.

Valuation in India is expensive and earnings expectations barely changed throughout the year. We suspect Sensex will continue to rise and thus valuations as well as risk for the market.

We maintain Underweight on India on valuation grounds.

Drivers:

- The economy is primarily driven by domestic consumption. Long term infrastructure development and the need to improve living conditions (reduce slum areas, improve education and reduce poverty) imply long-term potential growth of 7.5%. The growth rate may be understated considering the huge population and the government's recent reform efforts.
- Post re-election of the ruling UPA government last year, the government is expected to step up its reform efforts and better quality growth can be achieved.
- We believe growth can surprise on the upside following the 2010/11 budget, which is thought to be well-balanced. Government forecasts 9% growth this year and double-digit growth rates in the coming years.
- Relaxation in FDI rules and capital flows should encourage more investor flows into India. Stock market reforms like privatization and increase in foreign ownership will improve market efficiency.
- A strong domestic savers' pool contributes to the long-term growth potential of the market.

Risks:

- India valuations trade towards the higher end of the range and do not provide enough cushion should risk aversion persists. The market is more volatile than most Asian markets.
- Supply constraints as a result of under-investment will continue to challenge the inflation outlook in our view.

Korea (Overweight)

Near term outlook

The outlook for KOSPI is positive given its competitive valuations and currency. Its domestic economy is poised to pick up after exceptional corporate profits and continuous fiscal support from the government.

Korea is emerging from the European crisis as an unexpected beneficiary. The cheaper Won and the stimulus programs by the government played an important role in exports recovery last year. The fear of unwinding stimulus and policy actions created an overhang in the market earlier in the year when global recovery gathered pace. With rising global uncertainties, the Korean government continued with the fiscal expansion, including maintaining a cheaper won.

Drivers:

- The Korean market remains largely a macro story on the direction of interest rates, exit strategies and Won direction. Positive surprises can come in the form of a delay in rate hikes, a stable Won, and the extension of the pro-growth strategies. These look likely now in view of the European crisis raising external risks.
- 3Q financial results are expected to be strong, as the Korean won remains fairly stable. The outlook should be positive given Japanese Yen's strength against Korean Won.
- Korea valuations are deemed cheap on a regional basis. Foreign investors will continue to be attracted to the cheaper valuations vis-a-vis other markets.

Risks:

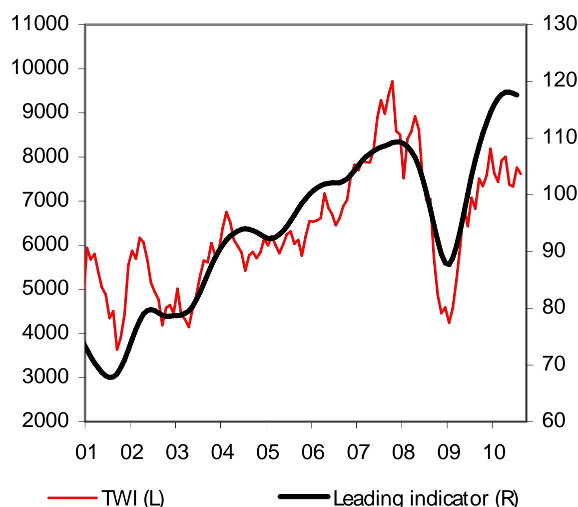
- Stimulus exit strategy can potentially derail growth, which should otherwise benefit from a synchronized global upturn. Government stimulus has been higher than most Asian countries.
- SMEs are always a major concern in Korea as the government assistance in this sector is substantial. The sector holds the key to social and economic stability as it hires a big labour force and the banks are highly leveraged to this sector. SME reform has been slow and remains a sensitive issue to banks' NPLs and the labour unions. The Korean discount will be there as long as the overhang remains and SMEs reform is delayed.
- Government's intervention in the private sector is large when compared to other countries. This could be due to the country having been hit hard by several crises in the past decade.
- Sentiments are affected by political tensions in the North Korea Peninsular.
- Local investors hold a big portion of Korean equities through mutual funds and savings scheme. Korea is considered expensive from a historical perspective. Redemption pressure will cap market upside when the market starts moving up, unless foreign investors buy in a big way.
- Leading indicators for the Korean economy are turning southwards. There is a risk that recovery could be stalled.

Taiwan (Underweight)

Near term outlook

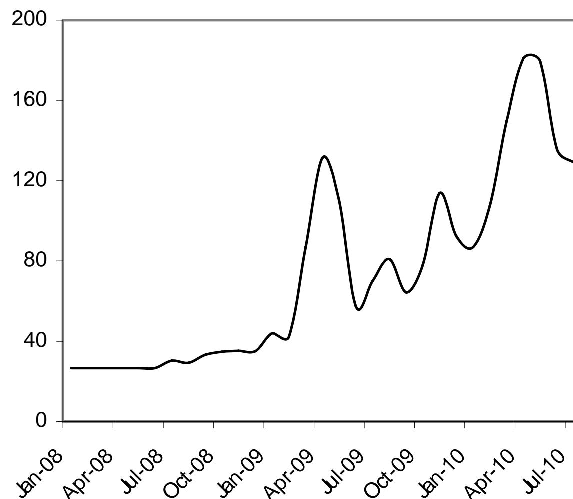
We expect Taiwan market to be affected by a downshift in economic activities in 4Q brought about by the weakened external environment. Export orders going into the 4Q is showing signs of flattening, which signals a peaking in industrial activities by the end of the year. Unless the US and China surprise otherwise, there are concerns that the strong tech upswing may have run its course.

Fig. 25: Taiwan index vs leading indicator



Source: Datastream

Fig. 26: Taiwan - tourist arrivals from China



Source: Bloomberg

Domestic demand is expected to pick up following the conclusion of ECFA (Economic Cooperation Framework Agreement) in June. The benefiting sectors are the retail, hospitality and tourism sectors. However the impact on domestic demand could be overstated following the initial surge in tourist arrivals from mainland.

We expect China-Taiwan relationship to stall for the moment before the Taiwan municipality elections on November 27. It may not be wise for Ma Ying-Jeou to play the China cards as his pro-China policies may have affected his popularity. China may also want to wait for the elections results, which is an indication of Ma Ying-Jeou’s winning chance in the 2012 presidential elections. All said the focus in the 4Q will be the elections.

Taiwan is much at risk if the US slowdown accelerates. Likewise our underweight on Taiwan could be at risk if things actually turned out to be better. That said with the leading indicator already peaking, we expect the index to consolidate at current levels, pending on my clarity on the outlook.

Drivers:

- Domestic demand is poised to pick up following the improved economic conditions after ECFA.
- Positive news flows from the financial MOU and ECFA.
- Favorable interest rate environment and positive pre election market sentiment.

Risks:

- Domestic political noise could slow down the progress of Ma Ying-Jeou's economic reform process.
- High leverage on G3's growth if growth recovery disappoints.

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CN: Deepening contradictions

- **Inaction on lending and deposit rates and limited CNY appreciation suggest that the Chinese government wants to focus on sustaining economic growth despite growing inflationary pressures**
- **GDP growth of 10% is expected this year with CPI inflation exceeding 3%. The deposit rate in real terms is becoming increasingly negative as inflationary pressures mount**
- **The current interest rate policy has resulted in asset inflation and over-capacity in certain industries. The negative real interest rate environment is also undermining the long-term policy goal of strengthening private consumption as the primary driver of growth**

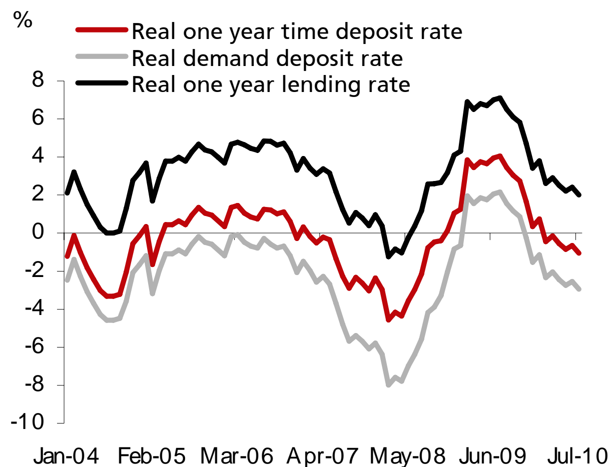
The economic complexity

The meeting of global central bankers at Jackson Hole in the US has renewed fears over the US economic outlook. From China's perspective, although the trade numbers have vastly improved from crisis-levels, the medium-term outlook of the global economy is still rather uncertain. China's trade surplus in the past three months has rebounded owing to decelerating import growth. This trend may not continue for the rest of the year as rising demand for raw materials will likely increase as de-stocking of commodities has likely ended in the first half of the year. The annual trade surplus is likely to fall further to USD140bn this year from USD196bn in 2009, offering justification for limited currency gains. Besides, the CNY has already been riding on an appreciating trend from an NEER perspective (Chart 1).

US mid-term elections are around the corner, and agendas involving the CNY will likely come under the spotlight. Given that the fed funds rate will likely remain at current levels for most of 2011 alongside ominous optimism in Asia, policymakers in China may worry that raising domestic interest rates now will

Chart 1: June 05 = 100

Chart 2: Real interest rates



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ignite a new round of speculative capital inflows. In fact, Beijing has controlled currency expectations quite well in recent months. The announcement of pegging CNY to a currency basket on Jun19 did not induce strong reactions from the global equity market. There has not been an obvious acceleration in foreign reserves accumulation either.

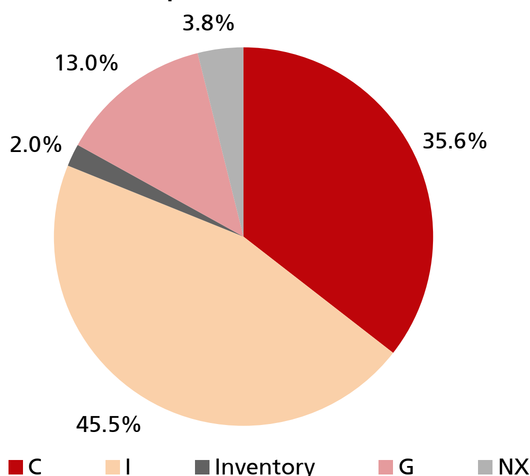
Rate inaction hinders the rebalancing of the domestic economy

The government is more worried about growth than inflation

If one holds the view that nominal interest rates will remain at current levels for an extended period, the property sector will always appear attractive to investors. This is especially when inflation expectations are rising and real interest rates falling (Chart 2). Depositors facing negative yields are encouraged to take risk and property developers facing declining real funding costs are encouraged to overinvest. Depositors are subsidizing the net users of capital, which include local governments, property developers and other infrastructure-related enterprises. This helps explain why the nationwide property price index did not face a drastic correction.

Although the government is artificially restraining loan demand through stringent administrative measures, the real cost of capital remains low. This system often encourages investment-led growth, and entails asset bubbles and overcapacity in certain industries. The former is under-represented in the CPI as housing-related spending accounts for only 14% of the CPI basket (Chart 3). The latter has already exerted a disinflationary effect on some of the tradable consumables within the CPI basket. The two forces have produced an artificially lower CPI reading relative to the nominal GDP and money supply growth. Yet, monetary policy decisions continue to rely heavily on the CPI.

Chart 3: GDP composition (2009)



Real interest rates are negative and falling

Fixed asset investment as a share of GDP was around 46% in 2009 versus only 36% for private consumption (Chart 4). The contribution from investment to overall GDP growth last year was more than 60%. Meaningful reductions in fixed asset investments will be difficult in the near-term as the 12th five-year plan is approaching in 2012. Investments are usually front-loaded to the first two years of a five-year plan based on historical experiences.

Raising wages could be the way out

In the absence of rate hikes and a rapid currency appreciation trend, the credible way to foster private consumption is to raise household income substantially in the next few years. If there is no plan to transfer more state assets directly to households to boost household wealth (ex-Premier Zhu Rongji introduced free housing in 1998 to state workers to jump-start the housing market), China would have to implement wage increases more rapidly than in the previous years (Chart 5).

Rising housing/food prices have become the primary forces driving demand for higher wages across the country. This also explains the jump in minimum wages, which rose 10%-15% or about 4 to 5 times the current CPI level (in-line with the

advances of the property price index). Some may argue that the recent upward wage pressure is a pro-cyclical cost-push phenomenon. This may be the case in southern China, but for the labor residing in central China, the surge in wages are genuinely demand-driven. There is a growing demand for labor from inland China as the financial crisis has triggered much more foreign direct investment seeking opportunities in the inner provinces.

Chart 4: CPI under-represents property prices

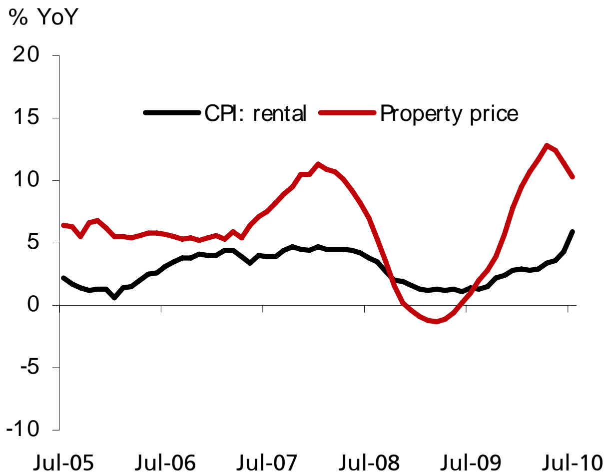
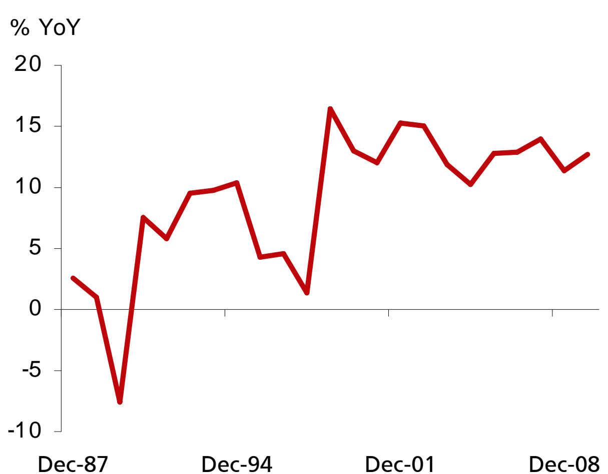


Chart 5: Average real wage increase



For the multi-year wage increase to sustain and help boost private consumption, the state needs to ensure that there is also a parallel improvement in productivity growth. This will help prevent a wage-driven cost-push inflation spiral from taking hold. From firms' cost perspective, once the high-speed rail system is competed in 2012/13, the savings in logistic and time costs should be more than enough to compensate for the rise in wages. Moreover, to improve productivity, foreign enterprises seeking direct investment in China in the future should be mandated to involve labor training and transfer of technological know-how.

Inflation is projected to rise to 3.8% YoY in August

Simultaneously, China should launch reforms on social policies to reduce the burden on households. Health expenditure as a share of GDP barely increased in the last 30 years, rising only to 5% in 2009 from 3% in 1980. Yet, health expenditure per capita has been growing at an average of 20% during 2006-2009. These figures suggest that there is still a lot to be done.

Conclusion

Inflation, as measured by the CPI, is projected to rise to 3.8% YoY in August from 3.3% in July primarily owing to surging food and housing prices, and partially to a low comparison base of -1.2% in August 2009. CPI inflation may even reach 4% in Sep/Oct. Although the deceleration of M2 (from 26% in Jan10 to probably 17% in Jul10) suggests lower inflationary pressure going forward, it will likely only be achieved by restraining loan demand with stringent administrative measures aimed at the property market.

Property transaction volumes in major cities such as Beijing and Shanghai have even rebounded in August despite the ongoing presence of anti-speculation measures. As highlighted, this main culprit here is falling real interest rates. The inconvertibility of the capital account further accentuates the problem by locking funds onshore.

The issue here is not really the actual CPI reading, but rising inflation expectations over the medium-term. We should see a gradual uptrend in the CPI in the next few years in light of a multi-year wage increase. If real wage growth accelerates to 20% levels (from a 3-year average of 13%) or higher in the next 3-5 years owing to improved productivity growth, disinflationary forces from non-food/housing components should lessen over time as well. Given that inflation over the past five years averaged 3% per annum, inflation for the next five years should be around 4%-5%.

The longer the PBoC delays hiking rates, the deeper will China's contradictions grow

The outlook of the US economy matters but the strength of domestic demand in China should offer adequate justification for rate hikes. The longer the PBoC delays, the deeper will grow the contradictions.

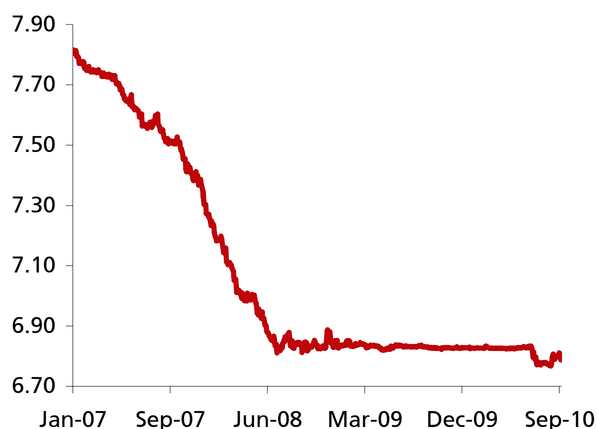
China Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real GDP growth	8.7	10.0	9.5	11.5	10.5	9.5	9.7	9.4	9.0
GDP by expenditure: current price									
Private consumption	9.0	18.0	15.5	18.5	19.0	17.0	16.5	16	15.9
Government consumption	6.4	14.0	13.5	15.5	13.5	12.0	15.0	13.5	14
Fixed asset investmt growth (ytd)	30.5	24.5	23.5	26.0	25.5	25.0	24.0	23.2	22.8
Retail sales - consumer goods	15.5	18.0	17.0	18.5	19.5	18.0	18.0	17.5	17.0
External									
Exports (USD bn)	1,202	1,622	1,947	389	437	454	536	474	529
- % YoY	-15.8	34	20	41	35	28	23	22	21
Imports (USD bn)	1,006	1,478	1,838	348	420	396	521	435	529.73
- % YoY	-11.2	48	26	44	47	36	24	25	26
Trade balance (USD bn)	196	144	108	41	17	58	15.5	40	0
Current account balance (USD bn)	297	245	210	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	5.9	4.3	3.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	2,399	2,550	2,700	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (USD bn, YTD)	94	100	100	51.4	75	100	25	48	76
Inflation & money									
CPI inflation	-0.6	4.0	3.0	3.0	3.7	3.7	3.3	3.2	3.2
RPI inflation	-1.2	3.2	2.5	3.0	3.2	3.2	2.8	2.5	2.5
M1 growth	32.3	20.0	19.0	24.5	22.0	20.0	20.0	19.0	19.0
M2 growth	27.7	17.0	18.0	18.4	17.5	17.0	17.0	18.0	18.0
Other									
Nominal GDP (USD bn)	5,022	5,675	6,469	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.2	-2.8	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified

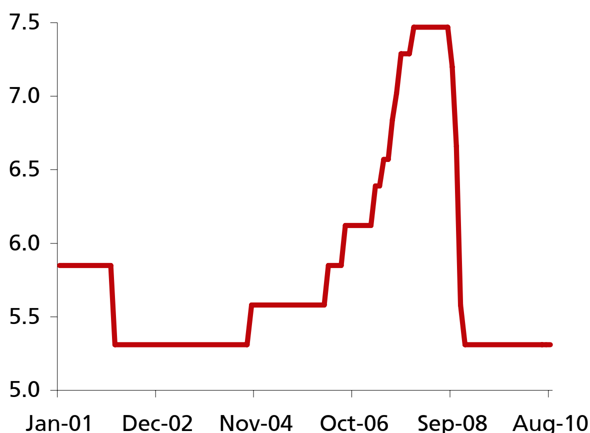
CN - nominal exchange rate

CNY per USD



CN – policy rate

%, 1-yr lending rate



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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HK: At an inflection point

- **GDP growth jumped to 6.5% YoY in 2Q10 on the back of consumption and private investment. We expect full year growth of 7%, and a moderation to trend growth of 4.5% next year**
- **Property prices continue to hold up firmly despite governmentsefforts to calm the market. But demand for mortgages is strengthening due to persistently low interest rates. The labor market is getting tighter as overseas enterprises establish companies targeting the China market. This is supporting wages, salaries and rentals, and ultimately property prices**
- **China's long-run aim to mould HK into a major CNY offshore center will only create more business opportunities. HK now stands at an infection point. The financial sector possesses all the technological and human talent necessary to take the offshore CNY idea forward**

Health check on the economy

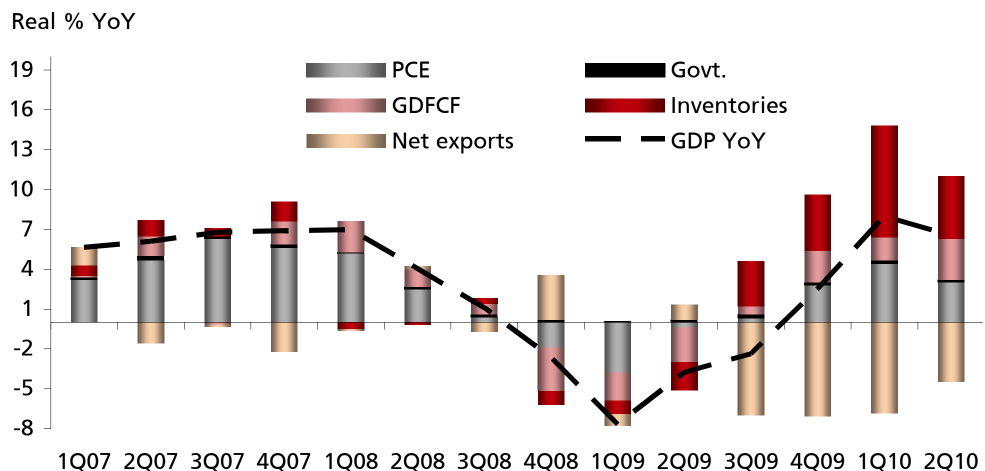
Total exports and imports for the first seven months of this year went up 20% and 24% respectively. Net exports have gradually become less of a negative contributor to GDP, particularly in 2Q10 (Chart 1).

Exports to the EU and the US market grew by 11% and 19.6% in 2Q respectively, outpacing growth in 1Q. However, since the EU and US markets together account for 22% of total exports, prolonged economic uncertainty in these markets may dampen export growth somewhat in 2H10.

The good news is domestic demand has stayed buoyant. Private consumption has contributed to the bulk of the headline GDP growth since 4Q09, primarily due to the wealth effect from a robust property market. Retail sales value and volume growth, in particular, has recovered from pre-crisis levels and far out-

Chart 1: Contribution to GDP growth

Real % YoY



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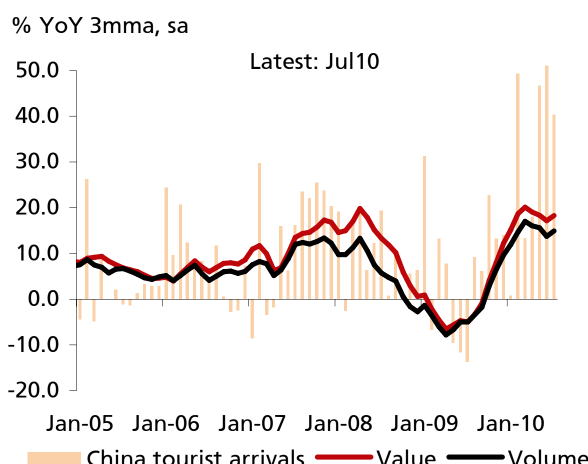
beat market expectations in July, rising 19% and 16% respectively (Chart 2).

A look at the retail sales breakdown indicates tourist spending might have helped bolster retail sales growth. Chart 3 shows items that exhibited more than 10% growth over the first seven months of the year are those most supported by tourist purchases. China tourist arrivals rose by 29% for the first seven months this year.

Chart 2: Retail sales index



Another bright spot is private investment. In particular, the machinery and equipment component of private investment (>65% of private investment) has been strong (up 15% ytd) given investment activities from corporations has started to rev up again after coming to a halt last year. Since real deposit rates have been consistently negative since Sep09 and will likely remain in negative turf for an extended period, investment is likely to hold up firmly going forward.

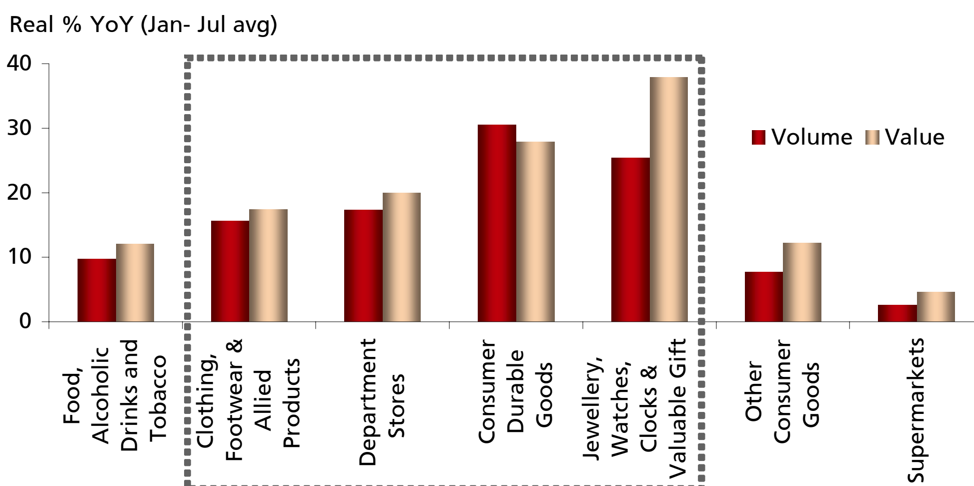
Property market sees support

Property prices in HK are getting very close to 97 levels (Chart 4). In light of this, in August, the government introduced new measures to cool the property market, including increasing down-payment requirements and limiting confirmor transactions. Market activity held back for a week and rebounded somewhat (Chart 5) after more land were auctioned at exorbitant prices, totalling HKD33.9bn ytd and beating land revenues for the whole of 1997. This signals ongoing bullish view held by property developers due to a persistent low rate environment. In fact, real funding cost will likely decline further as inflation mounts.

The CPI cannot reflect the true extent of inflation expectation

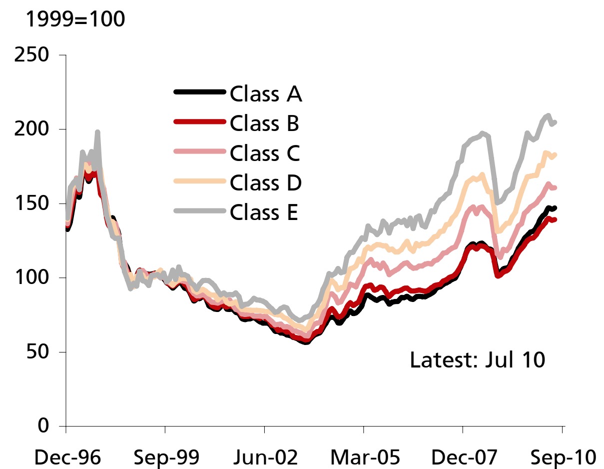
Although the headline composite CPI rose by 2.1% YoY in the first seven months of the year (Chart 6), it does not truly reflect the heightening inflation expectation faced by households.

Chart 3: Retail sales growth



Housing prices is a major determinant of inflation expectations. Even though it (private and public rentals etc.) accounts for 29% of the composite CPI, this component only moved up by 0.1% in 1H10, versus a 27.4% leap in the property price index in the same period. This shows that the housing component of the CPI underestimates asset price inflation in the private residential property sector. Headline inflation will face more upward pressure going forward as high property prices should eventually feed into rentals when the two-year rental contract expires (Most people took advantage of rent reduction during the onset of the financial crisis in 3Q08.). Let's also not forget food prices have been edging upward steadily in tandem with rising food prices in China. Full year CPI inflation is projected to average 3%, up from 0.5% in 2009.

Chart 4: Property price index: domestic premise



Companies are hiring again

On the demand side, the labor market is getting tighter as well. Unemployment rate (3mma) went down to 4.3% in Jul after staying flat at 4.6% in May and Jun. That is unusual because the new supply of university graduates usually jets up the unemployment rate slightly during such period. Most respondents in the latest Business Tendency Survey also indicate they foresee hiring to increase steadily for the remainder of the year and early next year.

The fact that the labor market recovered much quicker this time compared to all crises in the past decade (Chart 7) is attributed primarily to ominous optimism in China, which was largely unscathed from the global financial crisis. The prolonged uncertainty of western economies helps accentuate the diversion of investment to the east. As a result, overseas companies are all rushing to set up either headquarters or representative offices in HK targeting the immense Chinese

Chart 5: Centa-city leading index and mass (estate) centa-city leading Index

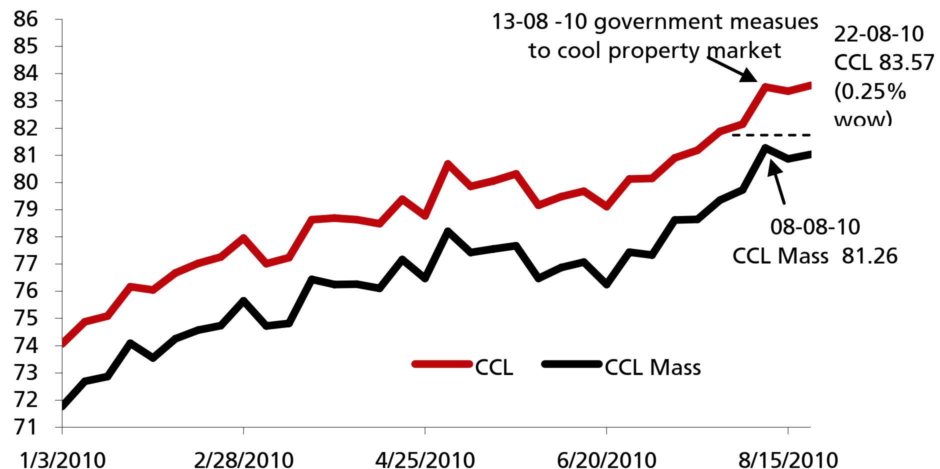


Chart 6: CPI

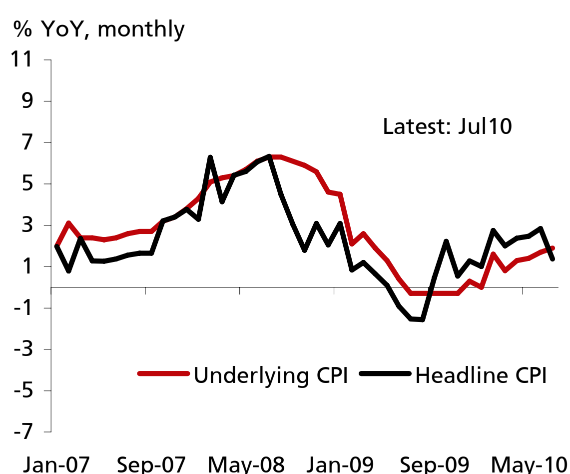
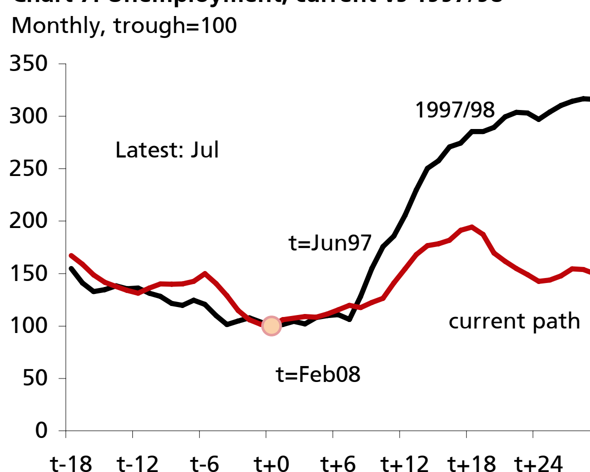


Chart 7: Unemployment, current vs 1997/98



market. For instance, even Soros Fund Management LLC plans to open an office in HK to capture growing investor interest in the Chinese market. It will not be a surprise to see unemployment rate falling further to 4% by the end of this year. The tightness of the labor market has already begun to exert upward pressure on compensation. Rising salaries in turn will lend support to the property market.

Therefore, it is extremely difficult for the visible hand to calm down the property market. The fact that China has determined to mould HK into a major CNY offshore center in the long run will only create more business opportunities.

An infection point for HK - Development of an offshore CNY center

Thanks to an extension of the Cross Border Trade Settlement and the signing of a Supplementary Memorandum of Co-operation to expand CNY business in HK in Jun and Jul, HK is bracing itself to become a major offshore CNY center in the long run.

The development of HK as a major offshore CNY center will be beneficial to all parties. In the FX market, CNY denominated deliverable forwards can now be settled in CNY. The appearance of an offshore CNY DF market creates arbitrage opportunities due to the pricing gaps between onshore and offshore CNY DF/NDFs. Traders and importers are already taking advantage of this newly created market structure. Meanwhile, restrictions on the amount of CNY conversion/remittances for business purposes have been relaxed. This is a major step in the right direction because such relaxation will spur the growth of offshore CNY deposits in HK rapidly over the medium term.

Should USD funding in HK remains ample and interest rates to stay low for an extended period of time (which is very likely given the weak US economic outlook), the incentive for mainland enterprises to obtain USD funding from HK will heighten. Conversely, HK banks lacking CNY deposits will be eager to obtain CNY from mainland enterprises. Currently, HK is the only place in the world where onshore CNY can be exchanged into USD. Also, cost of funding in HK is lower than China, thereby encouraging mainland enterprises to issue debts denominated in CNY offshore. Depositors in HK, practically facing negative yields now, are eager to enhance their yields by investing in such offshore debt and other emerging CNY denominated products so as to capture the potential CNY appreciation gains as well.

The aforementioned conditions and development will facilitate much faster CNY deposit growth in HK in addition to cross-border trade growth. That is why

banks are fiercely competing for CNY deposits now in anticipation of further liberalization in the mainland capital market despite the absence of the asset side of the balance sheet for the moment. Authorities in Beijing are studying ways to re-channel such growing CNY deposits back into the mainland through "mini QFII" and by permitting limited parties to invest in the mainland inter-bank bond market. In the absence of CNY loan demand in HK, this is the most logical and direct way to strengthen the demand for CNY locally.

The primary prerequisite of the above mechanism requires a growing CNY deposit base in the first place. CNY deposits currently account for 1.8% of total deposits in HK as of Jul10. The following scenario study asks the question - "When will CNY deposits as a share of total deposits in HK reach 5% and 10% respectively (USD deposits currently accounts for 31.6% of total deposits in HK)? .

We have simulated three scenarios with different assumptions. The first assumes CNY deposits in HK will follow HK's trade (export plus import) growth with China. The second assumes CNY deposits in HK will grow in tandem with CNY deposits onshore. In the third scenario, we simply follow the current growth of CNY deposit in HK which is 42% Jun10 YTD. All scenarios share the follow assumptions:

1. Total deposits in HK will grow at 10.8% per annum (historical trend growth rate)
2. CNY appreciation 2% per annum
3. HKD exchange rate to stay constant

Other assumptions are as follows:

Scenario	Assumption:		%
1	Cross border trade growth	5 year average (2003-2007)	14.7
2	Onshore CNY deposit growth	5 year average (07/06-07/10)	19.7
3	Offshore CNY deposits growth	Growth Jun10 YTD	42.3

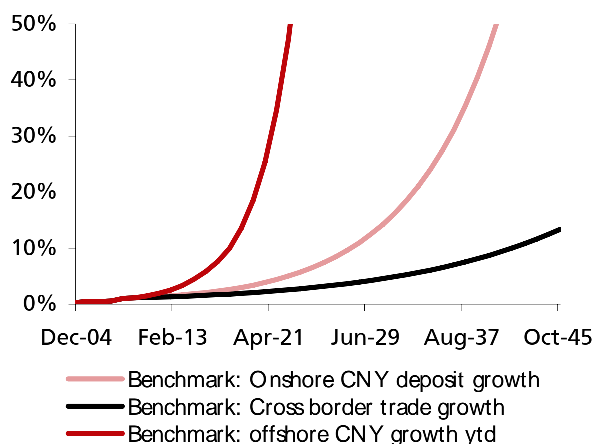
Results of the study

Projections of offshore CNY deposit growth benchmarking on onshore CNY deposit growth and HK/China cross-border trade growth, though makes sense theoretically, produce very conservative results. In both scenarios, CNY deposits offshore will only respectively reach 5% and 10% of total deposit in HK by 2032/2041 (Scenario 1) and 2022/2028 (Scenario 2). These numbers seem too conservative.

Scenario 3 which assumes CNY deposit growth just simply follows preceding trend growth up to 1H10 will yield a much faster result of respectively reaching 5%/10% of total deposit in HK in 2015/2017. The simulation even shows it will reach 30% of total deposits by 2022 which is not surprising given the base has become larger and larger in subsequent years (Chart 8).

There are projections claiming that CNY deposits will reach 30% of Hong Kong's total deposits

Chart 8: Projection - CNY deposit as a share of total deposits in HK



within 5 years. We can also assume arbitrarily the amount of direct transfer from the mainland to Hong Kong will hasten the progress. It is also tempting to simply benchmark the development of the Eurodollar market in London during the 1960s and impose the historical development trend to Hong Kong. But there is a notable difference. The USD at that time was already a freely convertible international currency; whereas the CNY is still an inconvertible currency and will likely remain so in the next few years, given Beijing's cautious stance on the liberalization of the capital account.

That said, policy stance could always change abruptly. We are certain that offshore CNY deposit growth in the next few years may not simply follow cross-border trade growth in a linear manner. The ultimate development on these fronts could be much faster than expected. The simulation nevertheless gives us an idea of how offshore CNY deposits can evolve over time under different assumptions.

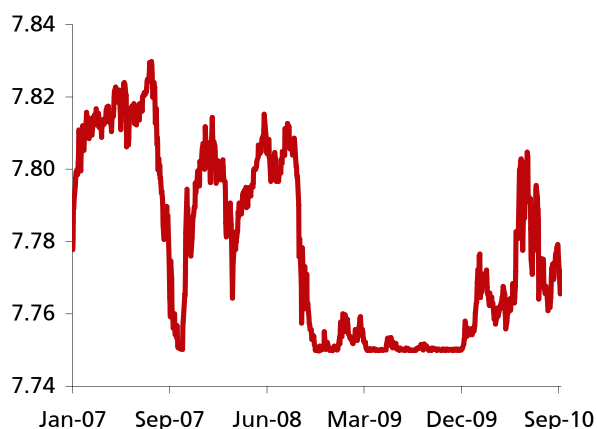
Hong Kong Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth (08P)	-2.7	7.0	4.5	6.5	7.2	6.4	5.3	4.6	4.1
Private consumption	-0.3	6.3	4.6	4.6	7.2	6.5	6.3	4.1	4.0
Government consumption	2.0	3.3	2.8	2.7	3.5	3.5	3.0	3.0	2.5
Gross domestic fixed capital	-2.2	14.1	9.8	15.2	17.0	16.0	11.0	11.0	9.0
Net exports		-8.4	-9.1	-82	13	63	95	417	-30
Net exports (HKD bn)	116	106	97	6	34	59	15	30	24
External (nominal)									
Merch exports (USD bn)	310	380	429	98	98	102	95	112	110
- % YoY	-13	22	13	26	20	18	16	14	12
Merch imports (USD bn)	338	443	517	110	117	122	111	130	136
- % YoY	-10	31	17	32	30	28	20	18	16
Trade balance (USD bn)	-28	-62	-88	-12	-19	-20	-17	-18	-26
Current acct balance (USD bn)	18.3	22.0	26.0	-	-	-	-	-	-
% of GDP	8.7	9.6	10.6	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	255.8	285	330	-	-	-	-	-	-
Inflation									
CPI inflation	0.5	3.0	3.0	2.6	3.6	3.8	3.3	3	2.9
Other									
Nominal GDP (USD bn)	211	229	246	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	4.9	4.0	3.5	4.6	4.3	4.0	3.9	3.8	3.6

* % change, year-on-year, unless otherwise specified

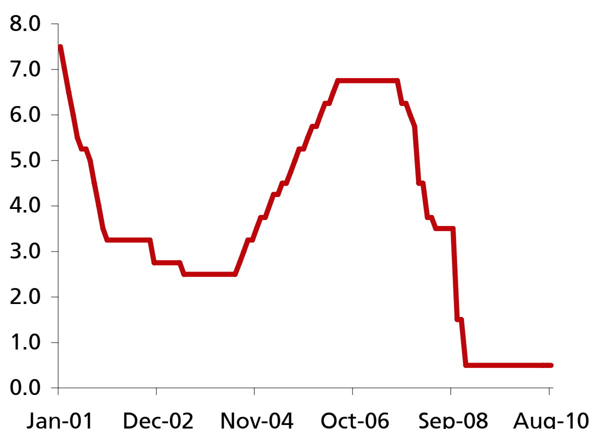
HK - nominal exchange rate

HKD per USD



HK – policy rate

%, base rate



Sources for all charts and tables are CEIC. Forecasts are by DBS Group Research

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TW: Slower, more balanced growth

- **Growth is expected to slow and to come more evenly from exports and domestic demand. Exports are flattening; the domestic outlook is improving**
- **Asset inflation is a concern. Interest rates are far below neutral and the banking system is flush with liquidity as a result of strong external surplus, continued FX intervention and incomplete sterilization. The central bank has so far hiked rates only in baby steps (12.5bps per quarter). Bigger steps will be on the horizon**

Slower exports, improving domestic outlook

Taiwan's real GDP growth decelerated to 7.2% QoQ saar in 2Q from 10.9% in 1Q, mainly because of slower growth in exports and inventories. Exports, as the foremost factor affecting Taiwan's near-term economic trend, are likely to continue softening ahead in light of a less favorable global environment (inflation challenges in emerging markets and fiscal constraints in advanced economies). Taiwan's export orders, as a leading indicator for actual exports in the next 1-3 months, have exhibited a flattening trend in the entire second quarter and in July (Chart 1). Having said that, we also need to point out the resilience of the industrial sector. Manufacturing inventory remains lean, with the inventory-to-shipment ratio staying subpar at only 0.87 as of June (Chart 2). Manufacturers are reluctant to expand production and accumulate inventories in anticipation of weaker sales outlook in the overseas markets. Should the performance of final demand turn out to be better than expected, industrial output can bounce back resiliently.

The domestic growth outlook is improving on the other hand. The cross-strait Economic Cooperation Framework Agreement was signed successfully in June, and approved by the Taiwanese legislation in August. Effective beginning next year, China will lower tariffs for Taiwanese exporters on 539 goods items (16%

Chart 1: Export demand cooling off

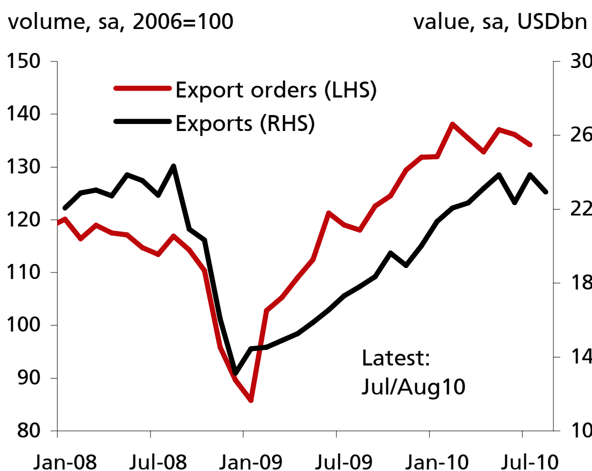
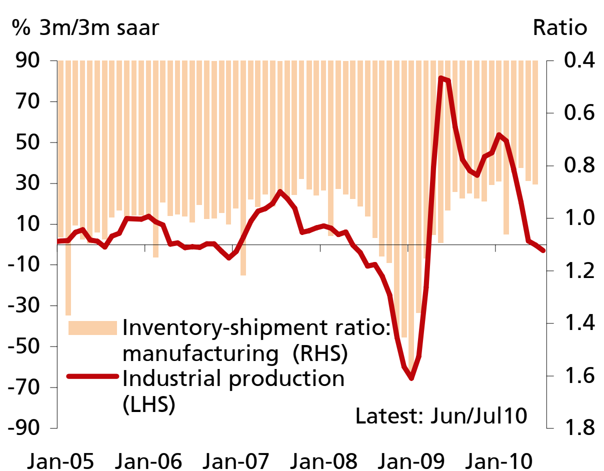


Chart 2: Inventory remaining at low levels



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of China's total imports from Taiwan) and ease market entry conditions for Taiwanese services suppliers in 11 sectors (such as financial, medical, computer and R&D). The ECFA should strengthen Taiwan's trade competitiveness over time and boost investment and hiring activities in the corporate sector. The near-term effects are reflected in sentiments. Consumer confidence has climbed to a 6-year high on the back of stronger expectations about general economic climate and employment opportunities (Chart 3). This is in contrast with the regional phenomenon of slipping confidence and growing worries about global slowdown.

Stronger consumer confidence, better employment outlook

Meanwhile, deregulation of the cross-strait direct transportation and tourism (since 2H08) may be yielding positive return. Though it is not easy to identify whether the growth in Taiwan's services industry is cyclical or structural because of the sharp swing in global economic cycle as a result of the financial crisis, one interesting observation is that services employment recovered ahead of manufacturing employment, particularly in the sub-sectors of accommodation

Chart 3: Consumption growth holding up

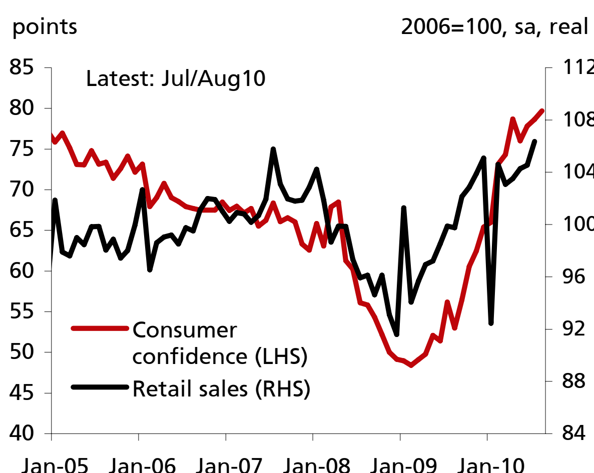
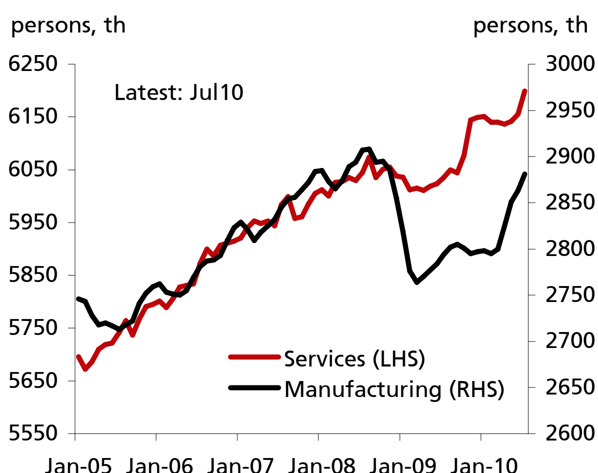


Chart 4: Services employment vs. manufacturing



and food services (Chart 4). This is probably a sign demonstrating the benefits realized from cross-strait links of tourism and transportation.

Asset inflation is a concern

Asset inflation is a concern in Taiwan. Residential property prices have continued to rise sharply, with the Sinyi price index (for existing home sales) registering a 12.7% YoY rise during 2Q, and the Cathay index (for new home sales) gaining 9.1% YoY (Chart 5). This is despite the central bank's attempt to cool the property market through mortgage regulations and moral suasions in the second quarter.

The risks to asset inflation are still on the upside, as the current monetary policy remains highly accommodative and interest rate levels are far below neutral. Although the central bank raised the benchmark discount rate for the first time since crisis, by 12.5bps in June, the hike has had little impact on market rates (Chart 6). This is because of abundant market liquidity resulting from still-strong external surplus, continued FX intervention and incomplete sterilization, as well as competition amongst the banks. Note that official foreign reserves increased by USD 9.7bn in the Jul-Aug period to a new record high of USD 372bn, and base money growth has reached double-digit rate on the sequential basis (15.8%

3M/3M saar as of July). Moreover, Taiwan's central bank schedules monetary policy meeting only once every three months. The process of interest rates normalization will naturally take longer than many regional peers (and increase upside risks to asset inflation) should the central bank continue raising rates in baby steps of 12.5bps each meeting.

Chart 5: Housing prices continued rising

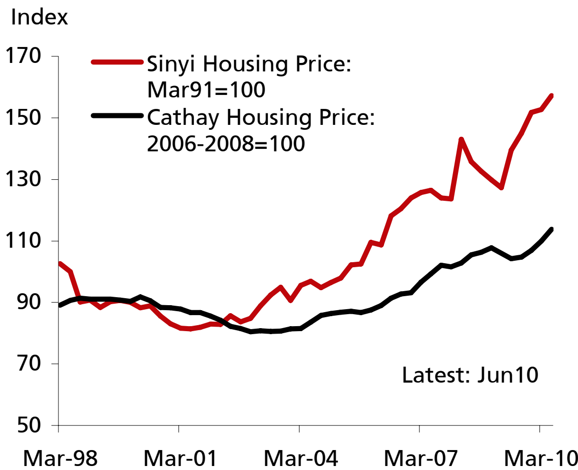
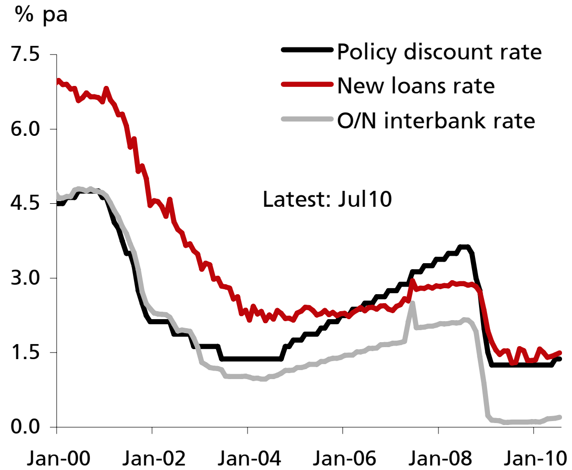


Chart 6: Interest rates at ultra-low levels



Policymakers will have to be cautious about the impacts of low interest rates on asset markets and overall financial stability. Lesson learnt from the 2008 global financial crisis is that loose monetary policy can fuel asset bubbles and excessive leveraging. We think the central bank would have to accelerate the pace of monetary policy normalization sooner or later. In our interest rate forecast, we have penciled in a 12.5bps hike at the upcoming policy meeting in end-September, followed by 25bps hike per quarter from 4Q onwards till end 2011. The risks to our forecast mainly stem from external factors such as weaker-than-expected growth performance in the US and China.

Fiscal concerns subsided

Asset inflation and ultra-low interest rates are concerns

Market concerns about Taiwan's fiscal deterioration have subsided, because of the resilient recovery in the real economy and improvement in government revenue. During the first seven months of this year, the general government's tax revenue increased a solid 5.3% YoY. In June rating agency S&P revised Taiwan's sovereign credit rating outlook to "stable", withdrawing its "negative" call during global financial crisis.

The government is also gradually removing stimulus along with the recovery. According to the 2011 budget of the central government proposed in August, the spending level for next year will only stay unchanged as compared to this year (combining the general budget and special budget for public construction). Considering the link between expected growth in government revenue and nominal GDP, we reckon that fiscal deficit will narrow further to 1.6% of GDP in 2011 from 2.1% in 2010, and public debt-to-GDP ratio will stabilize below 40%.

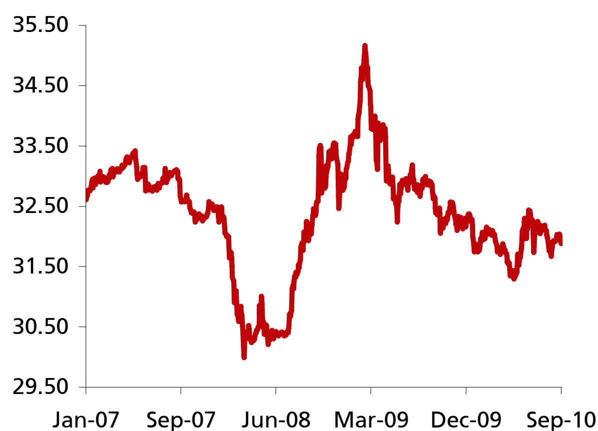
Taiwan Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth	-1.9	9.5	3.8	12.5	8.0	4.9	3.5	2.7	4.5
Private consumption	1.4	2.9	2.8	4.4	3.8	0.4	3.3	2.4	2.6
Government consumption	3.6	1.2	0.4	1.7	1.1	0.5	0.6	0.3	0.3
Gross fixed capital formation	-11.8	22.1	4.4	30.8	20.5	12.0	7.2	3.6	3.6
Net exports (TWDbn, 01P)	1794	2144	2311	547	550	636	491	518	585
Exports (% YoY)	-9.1	26.1	6.3	34.3	20.5	14.2	9.3	2.4	6.2
Imports (% YoY)	-13.4	27.9	5.9	34.3	21.9	13.7	7.2	4.3	6.1
External (nominal)									
Merch exports (USDbn)	204	275	296	70	72	71	67	74	77
- % chg	-20.3	35.1	7.6	46.2	30.0	19.2	8.5	5.3	7.2
Merch imports (USDbn)	174	250	273	63	65	65	61	69	72
- % chg	-27.5	43.5	9.1	54.3	34.3	22.4	7.1	9.5	10.7
Trade balance (USD bn)	29	25	23	7	6	7	6	5	5
Current account balance (USD bn)	43	38	26	-	-	-	-	-	-
% of GDP	11.2	8.9	8.0	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	348	380	405	-	-	-	-	-	-
Inflation									
CPI inflation	-0.9	0.9	1.4	1.1	0.3	0.9	1.2	1.4	1.6
Other									
Nominal GDP (USDbn)	379	431	457	-	-	-	-	-	-
Unemployment rate (eop %, sa)	5.8	5.0	4.6	5.2	5.1	5.0	4.9	4.8	4.7
Fiscal balance (% of GDP)	-3.5	-2.1	-1.6	-	-	-	-	-	-

* % growth, year-on-year, unless otherwise specified

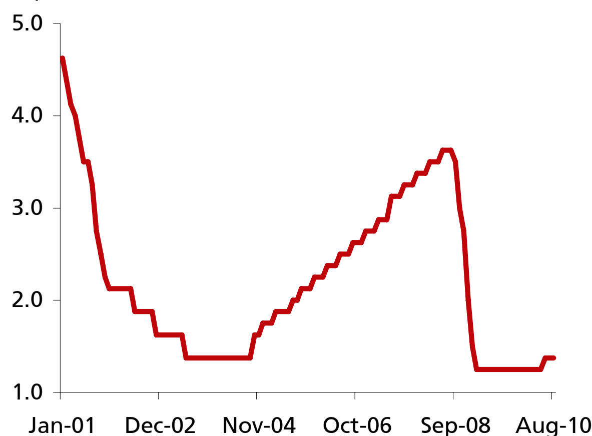
TW - nominal exchange rate

TWD per USD



TW – policy rate

%, rediscount rate



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

KR: Currency stimulus at work

- Despite widespread expectations for slower global growth, a weak won and a strong yen are helping Korean exports, hence growth. The current account is naturally benefiting too
- A weak property market has been a drag on the domestic sector. Whilst the government eased regulations on mortgage lending, the central bank has been hiking interest rates. Subpar consumption growth will continue

Export engine remains intact

Korea's real GDP growth recorded 6.0% (QoQ saar) in 2Q, slightly lower than 8.8% in 1Q. Growth was largely driven by exports (32.1%), facilities investment (41.9%) and inventory rebuilding. By contrast, private consumption stayed slightly below the long-run growth rate of 4% for the third consecutive quarter (3.4% in 2Q). And construction investment fell significantly by -13.7% owing to the sluggishness in the residential property market.

A cheap won and an expensive yen are helping Korea

Going forward we remain constructive on Korea's export outlook, despite widespread market expectations of a slowdown in global economic growth. Amid the post-crisis global recovery starting from early-2009, Korea has demonstrated its export strength relative to the regional competitors especially Japan. Korean exporters have gained market shares in major overseas markets including the US (a share of 2.5% of US total imports in 2009-1H10, up from 2.3% in 2008), EU (2.7%, up from 2.5%) and also China (10.1%, up from 9.9%, Chart 1). A weak won is undoubtedly an important stimulus for Korean exports and this stimulus remains intact in the near term, given that the won stays almost 20% cheaper than its pre-crisis level of 1000, while the yen has recently appreciated to a 15 year high

Chart 1: Korean exporters gaining market shares overseas

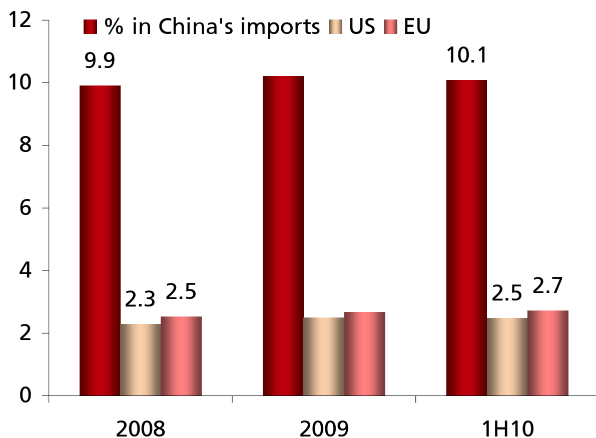


Chart 2: Japan losing market shares

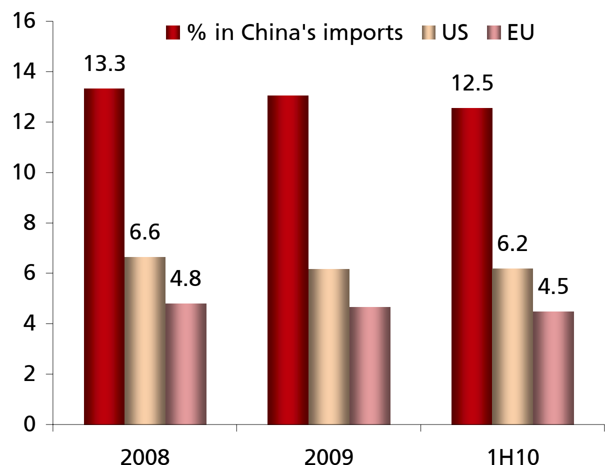


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Chart 3: The won weakening against the yen

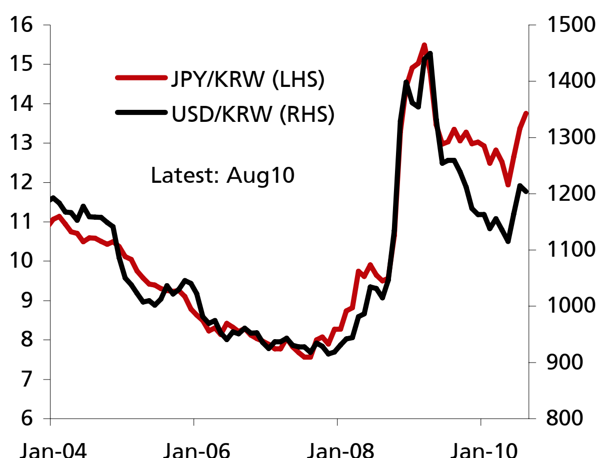
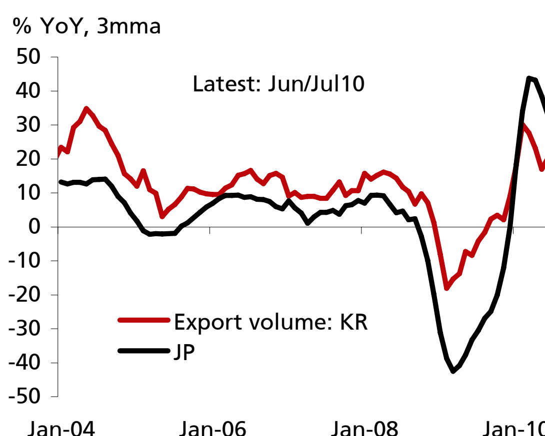


Chart 4: Korea's exports outperformed Japan's even before the crisis

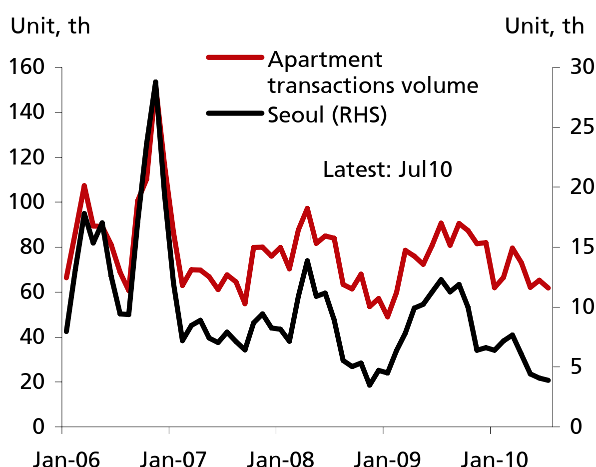


of 84 (Chart 3). Meanwhile, the non-price competitiveness of Korean exports is also strong thanks to technology advantages and brand recognition. Note that during 2004-2007 when the won appreciated a cumulative 25% against the yen within four years, Korea's export volume growth still outperformed Japan persistently (Chart 4). Strong technology gains are reflected in growth of labor productivity. Korea's manufacturing labor productivity rose by 9.3% YoY on average during 2004-2007, in sharp contrast with the 2.7% gains in Japan.

Lending rules partially relaxed, but interest rates on the rise

On the domestic front, the drag from the property market weakness is unlikely to fade soon. Since the authorities tightened regulations on financial institutions' mortgage lending in 2H09 to preempt the risks of property bubbles and household over-leveraging (via the debt-to-income ratio and loan-to-value ratio), the volumes of residential property transactions have fallen significantly from the peak seen in mid-09 (Chart 5), and housing prices have slipped month-on-month recently in 3Q10. In end-August the government decided to ease the debt-to-income requirement for first-time homebuyers and owners of one residence. This would help avoid penalizing genuine homebuyers without relaxing its guard against property bubbles. The decision of partially relaxing the lending rules also came after the central bank's rate hike in July, as interest costs for household borrowers are already on the rise. The Bank of Korea (BOK) has raised the benchmark 7-day repo rate by 25bps in July from 2.0% to 2.25%. Although the BOK held rate steady in August-September, it left the door open for more hikes, as hinted in the latest policy statement on Sep.9. The BOK acknowledged external risks stemming from US slowdown and fiscal woes in Europe, but maintained a view that the Korean economy will register "solid growth" in the coming months, and inflation will accelerate as "the demand-side pressures

Chart 5: The property market has cooled



increase". We expect the BOK to continue normalizing interest rates step by step towards a neutral level of 4-5%. We don't expect a double-dip recession in the global economy. A slower-than-expected global growth could slow the pace of policy normalization in Korea, but will unlikely alter the direction of higher interest rates. We project that the policy rate will go up to 2.75% by the end of 2010, and 4.0% by the end of 2011.

Macro stability improving

The macro stability has improved somewhat in Korea. The current account registered a larger-than-expected surplus of USD 17.5bn in the first seven months of this year (1.8% of annual GDP), already hitting our whole-year forecast for the current account balance (Chart 6). Aside from the strength in exports and weakness in the won as we elaborated above, the slower-than-expected rises in international oil prices have also saved costs for Korean importers. Accordingly, we have lifted forecast for the current account in 2010, to USD 28bn or 2.9% of nominal GDP.

Current account surplus stronger-than-expected, fiscal deficit narrowing, external debt stabilizing

Meanwhile, the government's fiscal balance is improving continuously. In the first half of this year the central government's total revenue grew 7.5% YoY, compared to the -4% reduction in expenditures, which left the consolidated fiscal balance at a small deficit of KRW 11.4trn, or 1% of annual GDP. The government well understands the importance of maintaining fiscal disciplines and protecting fiscal sustainability. Whilst the finance ministry proposed a tax revision plan in August to offer tax incentives for companies to create jobs and support the low-income class, it also removed other forms of unneeded tax exemptions. The official projections show that the net impact on overall tax revenue will still be positive, at KRW 1.9trn over the next five years.

In addition, the upward tendency in the country's gross external debt has been checked recently in 2Q. External debt as a percentage of external assets (or foreign reserves) is falling or at least, stabilizing (Chart 7). This is partly owing to reduced risk appetite in global financial markets amid the worsening of European debt crisis in 2Q. The Korean financial regulator has also intervened in June to tighten FX regulations (such as capping FX derivatives trading of both local and foreign banks, reinforcing rules on companies' use of FX loans). Whilst these controls would dampen capital inflows and slow the recovery in the Korean won, reducing banks and companies' dependence on external financing especially short-term borrowings should bode well for the stability in the financial system and also the overall economy.

Chart 6: Current account maintained strong surplus

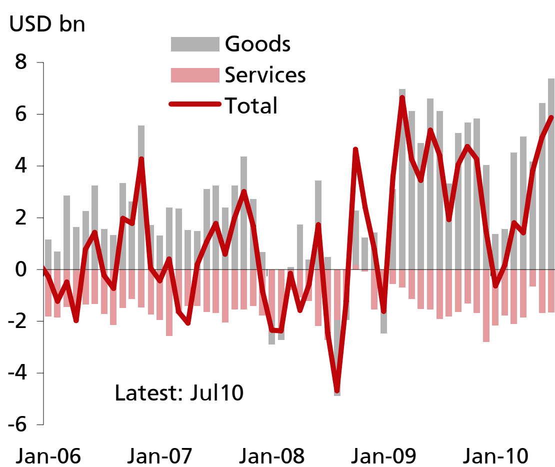
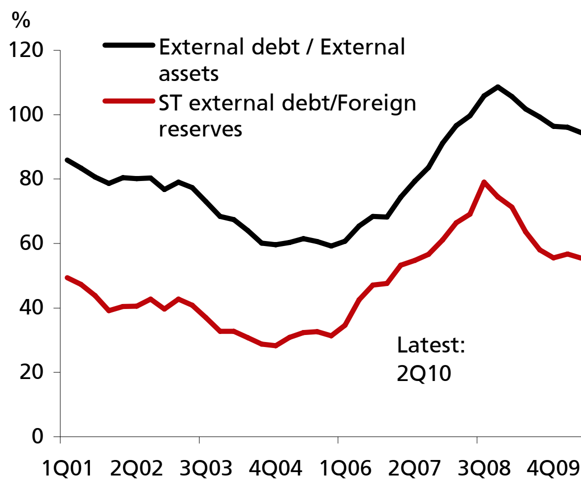


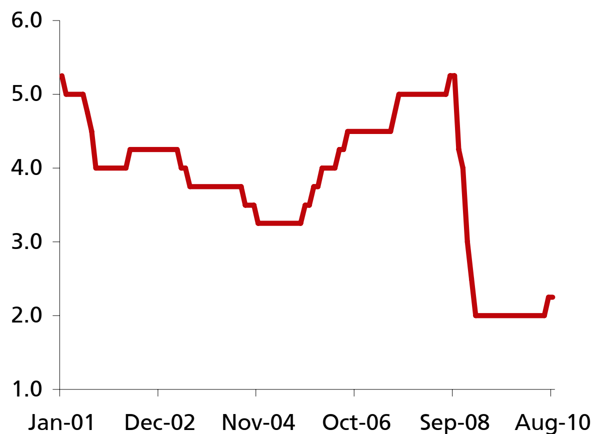
Chart 7: External debt stabilized



Korea Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP (05P)	0.2	6.2	3.9	7.2	4.6	5.4	4.1	3.6	3.9
Private consumption	0.2	4.0	3.4	3.7	2.8	3.2	3.3	3.3	3.4
Government consumption	5.0	2.9	1.7	3.2	1.8	2.7	-0.9	0.9	2.5
Gross fixed capital formation	-0.2	6.3	3.4	6.1	4.9	4.1	3.4	3.4	3.4
Net exports (KRW trn)	74	70	76	19	18	20	14	21	20
Exports	-0.8	13.5	8.7	13.9	11.4	12.6	11.9	6.7	7.1
Imports	-8.2	17.0	8.8	19.0	14.5	14.4	12.1	6.7	7.0
External (nominal)									
Merch exports (USD bn)	364	459	499	120	119	118	110	128	131
- % YoY	-13.9	26.3	8.8	33.1	26.1	13.8	8.9	6.8	9.3
Merch imports (USD bn)	323	427	480	106	110	113	109	118	127
- % YoY	-25.8	32.1	12.4	43.2	29.3	21.9	10.8	11.4	16.0
Trade balance (USD bn)	40	32	19	14	10	5	1	10	3
Current account balance (USD bn)	43	28	12	-	-	-	-	-	-
% of GDP	5.1	2.9	1.2	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	270	299	317	-	-	-	-	-	-
Inflation									
CPI inflation	2.8	2.9	3.1	2.6	2.8	3.4	3.0	3.3	3.3
Other									
Nominal GDP (USD bn)	834	972	1032	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.6	3.4	3.1	3.5	3.4	3.4	3.3	3.2	3.2
Fiscal balance (% of GDP)	-4.1	-2.0	-1.8	-	-	-	-	-	-

* % change, year-on-year, unless otherwise specified



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

IN: Overheating or slowing?

- The sharp slowdown in June industrial production growth (in YoY terms) has led to worries about an imminent slowdown. Only a few months ago, the sharp rise in the same rate led to worries about overheating
- The economy neither went through a phase of overheating nor slowing, rather a temporary surge in demand (owing to pent-up factors such as recovery from the post-Lehman shock) and is now seeing a phase of normalization that may well include an "undershoot"
- We continue to forecast 8.8% growth in FY10/11, slightly above-consensus. We also expect the central bank to continue with rate hikes until at least Mar11. We forecast another 75bps of rate hikes in the repo rate and another 100bps of hike in the reverse repo rate by Mar11
- There has been some progress on the reform front, notably on oil pricing and a reduction in government stakes in public sector companies. We expect progress on tax reform, land reform and further liberalization of FDI to support investment and growth

Summary

If worries about the evolution of the European debt crisis was the dominant concern in the markets in the Apr-Jun quarter, presently, worries about a double-dip recession in US and China are the risk factors keeping markets edgy. Our take in the Apr-Jun quarter was that a slower Europe (assuming no full-blown financial crisis) by itself would not derail global growth since Europe follows global growth, not leads it. Given our view on the importance of China to global and Asian growth, the prevailing uncertainties are more serious. However, we also believe final consumption (and investment) demand growth in China

Chart 1: GDP contribution by sector

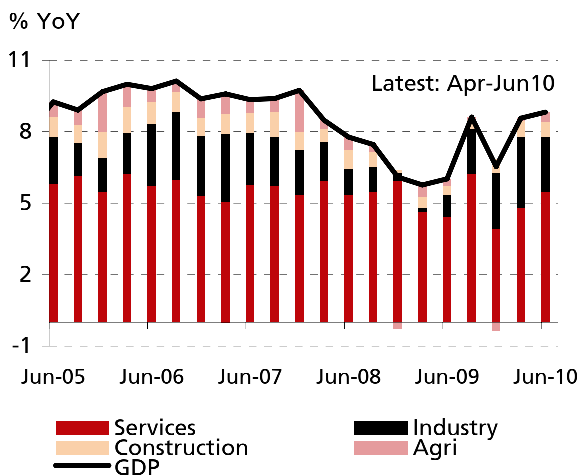


Chart 2: GDP by expenditure -breakdown unreliable

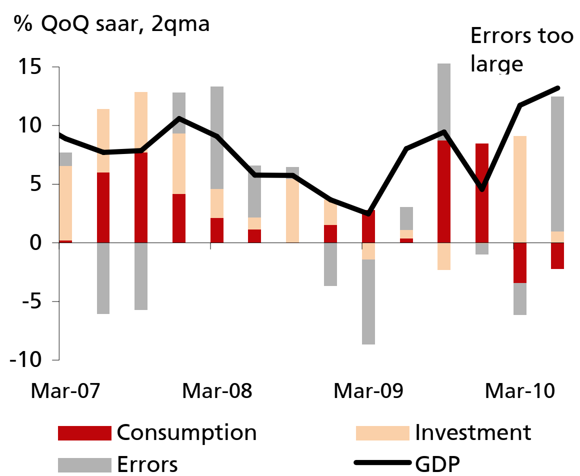


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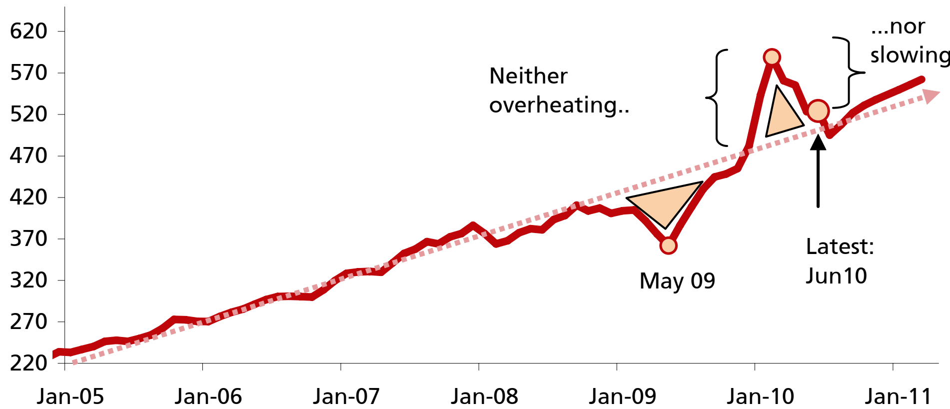
Chart 3: Capital goods - neither overheating nor slowing - just normalizing

Index 1993/94=100, SA, 3mma



remains resilient and will continue to support growth in China. In fact, we think growth in the second half of 2010 in China would be better than 2Q. US consumer demand, while weaker than thought earlier, (following significant backward revisions to the past year's data) is expected to grind higher at a two percentage annual pace. As such, we think current mixed global data trends are only a reflection of normalization in demand and / or temporary weakness in the supply response. Even as uncertainties hounded the global recovery, we upgraded our FY10/11 (Apr-Mar) GDP forecast for India in late July to 8.8% from 8.3%. Available data so far, including GDP for Apr-June quarter which grew by 8.8% (YoY) support our view. While data out of India has also been more mixed of late, we do not perceive anything more than a much necessary normalization in the economy (Chart 1 & 2).

We upgraded our FY10/11 GDP forecast to 8.8% from 8.3%

Neither overheating nor slipping back

Is the Indian economy overheating? This was the worry in Apr-May as industrial production growth registered 14% (YoY) and inflation galloped to double digits. Now with production growth halving to 7% (YoY) in June, the worry is that the economy has lost momentum and inflation and rate hikes are slowing growth. Our take is India was neither overheating nor is slowing now. The year-on-year numbers are misleading and lagging by definition as it cumulates monthly growth that took place in the past *twelve months*. In our reading, what has actually transpired is growth slowed more than fundamentals dictated in Oct08-Jun09 owing to market panic and from Jul09-Mar10 the economy, especially the industrial sector, grew at a scorching pace, to offset the earlier weakness. In other words, the economy was not overheating, but only growing at a temporarily strong pace (Chart 3). To be sure, this did lead to some temporary price pressures as capacity constraints were reached, and this, combined with supply-shocks that pushed food prices higher, fanned concerns of overheating.

Neither "overheating" nor "a slowdown" explain the volatility in (YoY) growth rates

In the Apr-June quarter, we witnessed a "slowdown" in production reflecting what we think is a "normalization" in demand. Since such production adjustments don't happen in a straight line – after all businesses operate with imperfect information in an uncertain world, – there is a good chance that we have also seen some "undershoot". Therefore, in the interim, the data may paint a picture of an economy that has run out of steam. All this is most dramatically illustrated in the most cyclical component of the economy — investment demand (Chart 3, above). Rather than extrapolate the present "slowdown", we read the recent data as a normalization to trend, and one that may lead to some volatility in data for a quarter or so. In fact, not all data even point to a normalization in India. While industrial production for June and core production (a sub-index)

Chart 4: Manufacturing PMI

index, sa; 50 = no chg from previous month

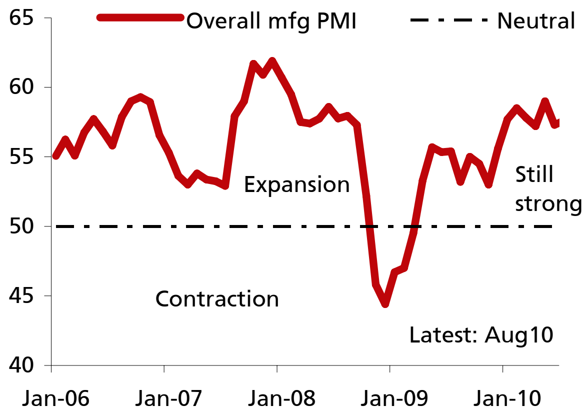
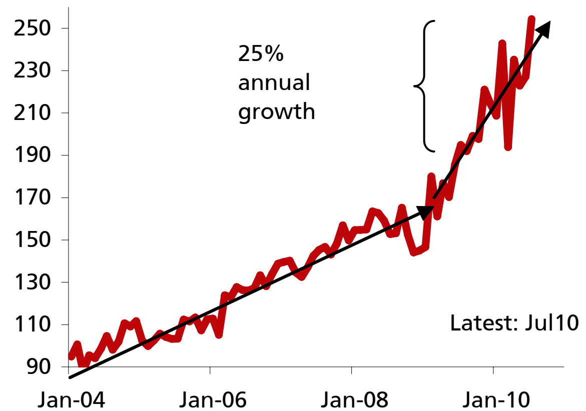


Chart 5: Vehicle sales - passenger vehicles

Levels in '000s, SA



for July have slowed, manufacturing and services PMI, as well as other indicators such as loan growth and vehicle sales remain very strong (Chart 4 & 5).

How one interprets the data is obviously important as one projects future growth and inflation. We think the "undershoot" in some sectors points to a stronger quarterly pace of growth in the current Jul-Sep quarter (in QoQ saar terms) and then a return to potential growth rates of 8% (QoQ, saar) following that. We expect rate hikes and inflation to temper the growth momentum but not kill growth.

Inflation - headline to moderate, core to pick up

Core inflation to pick up, rate hikes to continue

We expect core inflation pressures to rise with the renewed growth momentum and this clearly requires a normalization in policy interest rates. However, the current double-digit headline inflation rates (in YoY terms) clearly overstates the pressures as it is distorted by higher food prices and a low base of comparison. Additionally, faced with a sudden surge in demand (which was partly due to pent-up forces), supply could not respond especially when capacity constraints were reached. All these factors led to upward pressure on prices. As such, by Mar-11, we expect headline inflation to ease to under-5% (Chart 6), even as core inflation picks up. The inflation forecast assumes the central bank hikes interest rates in line with our forecast. We project the repo rate at 6.50% by Mar-11. At next week's policy meeting, we expect the central bank to raise the reverse repo rates by 25bps to 4.75% but leave the repo rate unchanged at 5.75%.

Renewed push for reform to support growth

So what's holding up demand? The firming up of the labour market, resilience in software exports and the renewed push for economic reform all help to support domestic demand growth. The government has already taken some steps on the oil price reform front in late June liberalizing the pricing of petrol, raising the price of kerosene and LPG sharply and promising to free diesel pricing too. Disinvestment and tax reform are other policies seeing some progress. This should support investor sentiment, key to energise investment spending and support the 8% growth rate. We have also seen improvement in rural infrastructure as well as rural employment opportunities and safety-nets. These efforts and steps help support rural demand and agriculture (even as it is dwarfed by the challenges the rural economy and agriculture sector face).

Chart 6: M3 - credit to commercial sector

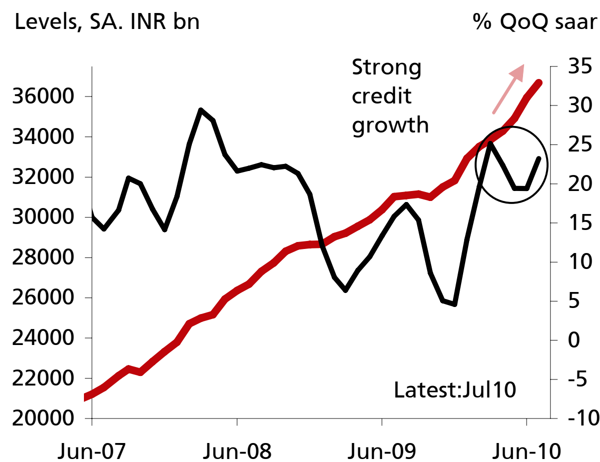
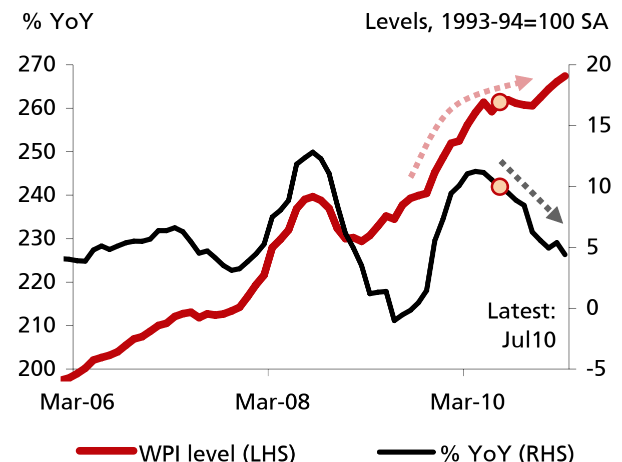


Chart 7: WPI headline



The reform agenda includes ambitious direct and indirect tax reform, oil price reform, lifting of FDI limits in sectors such as insurance, retail, education, divestment of government stakes in public sector companies, introduction of new and fair land rehabilitation laws, introduction of biometric unique identity cards (there is no nationwide identity card at present) and pursuit of further openness and trade liberalization. While we do not expect the government to deliver on all these fronts in the near-term, concrete progress on even some of these in a multi-year time frame will go a long way to support consumer and investment demand. It would be a mistake to doubt the sustainability of India's growth on the basis of the progress (or the lack thereof) on reform thus far. It is clear to successive governments that political success depends on delivering high and inclusive growth. The government will never be able to do all it has to do to support growth (the ruling coalition is fractured and only enjoys a slim majority) or be ahead of the curve in galvanising growth. But it is more than keen to ensure GDP growth stays above 8% and moves further up to 9% and above in the medium-term.

High inflation and wide trade deficits are the main risks

Risks

One of the main risks facing the economy arises from the higher fiscal deficit and the supply-constrained nature of the economy (both not unrelated). Despite collecting three times as much money as the targeted INR 300bn in third-generation telecom auction licences this year, the government has said that the fiscal deficit would not be lower than initially planned. The government's strategy is to use all money possible on social spending. That is fine if it were mainly education and health. However, the government continues to spend significant amounts on wasteful and ill-directed subsidies that do not reach the targeted recipients (the latest addition are planned increase to food subsidies). There is a legitimate place for food subsidies, and such would also help halt the erosion of political capital (and hence reform momentum) from higher inflation. However, the larger fact is short-term and demand-side policy management continues to dominate the government's strategy at the expense of sustainable supply side reform (infrastructure, education spending, agriculture investment). The risk then is not as much slow growth as it is that inflation (and fiscal deficit) will not be as low as it could otherwise be.

India Economic Indicators

	2009	2010(f)	2011(f)	2Q10	3Q10(f)	4Q10(f)	1Q11(f)	2Q11(f)	3Q11(f)
Real output (99/00P)									
GDP	7.2	8.8	8.5	8.8	6.9	10.0	9.1	9.3	8.3
Agriculture	0.2	5.3	3.0	2.8	4.1	7.6	4.7	3.8	2.9
Industry	10.4	7.7	8.7	11.4	7.4	7.0	5.1	8.7	8.7
Services	8.5	10.0	9.6	9.7	8.4	10.3	11.7	10.6	9.2
Construction	6.5	9.9	10.4	7.5	8.8	13.8	9.7	10.4	10.4
External (nominal)									
Merch exports (USD bn)	182	214	250	52	52	51	60	57	61
- % YoY	-4	18	17	32	19	9	14	10	17
Merch imports (USD bn)	299	354	443	85	90	88	91	108	114
- % YoY	-3	18	25	31	24	12	9	27	26
Trade balance (USD bn)	-117	-140	-193	-33	-38	-37	-32	-51	-53
Current a/c balance (USD bn)	-38	-35	-63	-11	-12	-9	-4	-23	-20
% of GDP	-2.9	-2.2	-3.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves(USD bn, eop)	280	290	330	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
WPI inflation (% YoY)	3.5	8.0	5.3	11	9	7	5	4	5
Manfg WPI (% QoQ, saar)^	3.2	6.0	5.3	8	2	5	6	6	6
Other									
Nominal GDP (USD tn)	1.3	1.6	1.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
National fiscal bal (% of GDP)	-9.7	-9.1	-7.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Money supply(M3, annual avg)	19	17	21	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

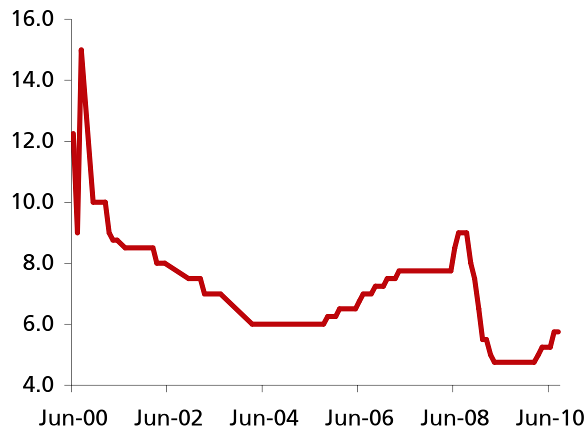
* % change year-on-year, unless otherwise specified
** Annual data refers to fiscal years beginning April of calendar year.
***Quarterly data is with reference to calendar year for ease of comparison with other economies
^ Used as a proxy for core by the RBI

IN - nominal exchange rate

INR per USD

IN – policy rate

% repo rate



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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ID: Inflation risks

- **Strong economic growth is being accompanied by rising inflation. Pressures stem largely from food prices but risks are rising for the core too**
- **Bank Indonesia raised bank reserve requirements by 300bps in September to absorb liquidity and anchor inflation expectations. Rate hikes are likely in December**
- **Measures to counter inflation will cool growth in the short-term, although the outlook for investment in the medium- and longer-term continues to improve**

Growth accelerated in 2Q

In contrast to the regional trend of economic slowdown, growth in Indonesia has continued to accelerate as of the second quarter. Real GDP growth registered a robust 6.2% YoY in 2Q, higher than the 5.7% rate in 1Q (Chart 1). Private consumption marked a strong growth of 5.0% (up from 3.9% in 1Q). Investment maintained a stable expansion pace of 8.0% (7.8% in 1Q). Strong growth in private domestic demand has successfully offset the slowdown in external demand and declines in government spending. Export growth eased to 14.6% from 20% in the previous quarter. Government consumption fell by about -9% for the second consecutive quarter due to disciplined spending guidelines and also delays in budget implementation. On a sequential basis, we reckon that the quarter-on-quarter GDP growth has also improved to 6.5% (seasonally adjusted, annualized) in 2Q, up from 5.3% in 1Q.

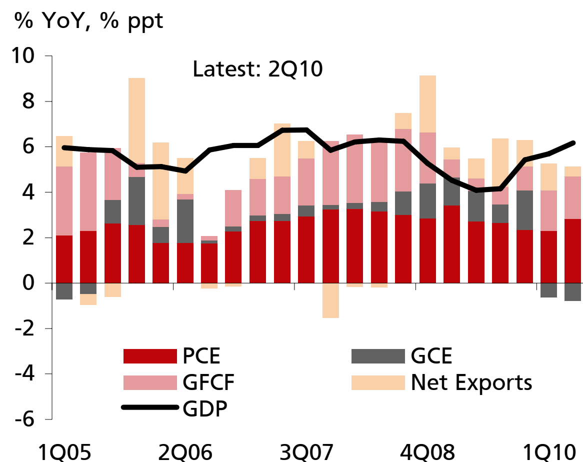
But inflation risks also emerging

Strong economic growth was accompanied by the pickup in inflation, however. CPI inflation rose to 6.3% YoY in Jul-Aug, sharply higher than 4.4% in 2Q and exceeding the central bank's target of 4-6% (Chart 2). For the time being, inflationary pressures have largely come from the jump in food prices, a result of weather and festive factors. The government's hike in public electricity tariffs this summer has also contributed to the rises in headline CPI. Core inflation rose relatively slowly to 4.2% YoY as of August from 3.8% in 2Q.

Inflation likely to dip below 6% in Sep-Oct, but return to 6.5% in Nov-Dec

Nonetheless, we are mindful of the risks that inflation may not be able to ease substantially even after the above mentioned temporary factors subside in the coming months. We project that the headline inflation numbers will dip below 6% in the Sep-Oct period but return to 6.5% YoY in

Chart 1: GDP growth accelerated in 2Q10



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Nov-Dec. We expect the underlying price pressures to develop in accordance with the existence of demand-supply imbalance in the overall economy. Private consumption growth of 5.0% in 2Q is well above its historical trend of 4.6% averaged during the past five years since 2004. The real growth in food consumption (excluding price factors) was 3.7% in 2Q, also higher than its trend growth of 3.0%. The supply-side constraints remain in place on the other hand – investment growth of 8.0% in 2Q is still below the 5-year average of 8.8%. Meanwhile, we also noticed that the rises in food and electricity prices have elevated consumers' general inflation expectations. Inflation expectations for the next six months have been gradually heading north, as seen in a wide range of goods and services components, not solely food and electricity (Chart 3).

Chart 2: Inflation also picking up

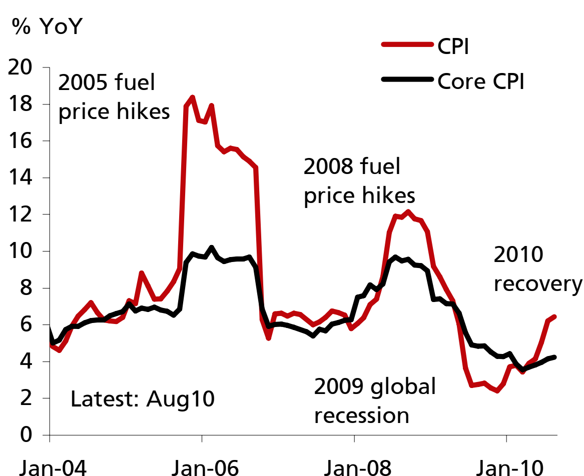
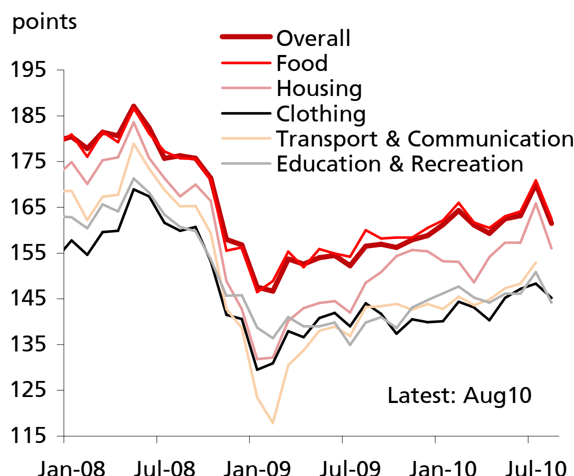


Chart 3: Inflation expectations elevated



Pressures of policy tightening

The pressures of policy tightening are growing, in light of strong consumption-driven economic growth and rises in inflation risks. Bank lending growth, another important variable monitored by Bank Indonesia, has also accelerated on the back of strong loan demand. Total loans among commercial and rural banks increased 19.4% YoY as of June, already catching up with the trend growth in nominal GDP of about 19%; and credit growth has picked up further to 20.3% YoY in August according to the central bank statement.

The RRR hike is unlikely to materially tame inflation

Bank Indonesia has become more vigilant about inflation risks. At this moment BI prefers to react in a moderate manner to anchor inflation expectations first without depressing demand growth significantly. Instead of hiking interest rates, BI opted to raise banks' primary reserve requirement ratio on September 3, from 5% to 8%. The 300bps hike in RRR can freeze liquidity by about IDR 53trn (USD 5.9bn) among commercial banks. This is not a burdensome amount, given the fact that banks currently hold excess reserves of IDR 52trn; and combining banks' liquidable assets such as the central bank certificates, total excess liquidity in the banking sector amounts to more than IDR 300trn. Whilst this RRR move may have a stabilizing impact on inflation expectations, whether it can tame inflation materially via the monetary channels is doubtful. And the issue of demand-supply imbalance in the overall economy is left unresolved. Rate hikes, as a harsher measure to directly adjust the prices of liquidity, are likely to be used several months later in December.

Growth to moderate

Inflation erodes consumers' purchasing power. In low-income economies like Indonesia where the basic living items account for the bulk of household spending (food for instance, accounts for one half of total household spending in Indonesia), the negative effects of inflation should be pronounced. The high-frequency indicators for consumption growth have moderated slightly in 3Q. Consumer confidence slipped in Jul-Aug by a total of 7 points, though the index level has remained in the expansionary territory. Growth in motorcycle sales and motor vehicle sales also leveled off in July (Chart 4).

We expect GDP growth of 5.5-6.0% (QoQ, saar) in 2H, slightly slower than 6.5% in 2Q

Investment in Indonesia has the potential to grow and play a more important role to drive the overall economy over time. Gross fixed capital formation as a percentage of real GDP stood at 23% in 2009, far below the 30% level prior to the 1997/98 Asian financial crisis. Market expectations for investment growth are high. Indonesia is widely believed to possess the potential to attract FDI inflows due to the natural advantages of a large and young population pool and cheap labor costs. This attractiveness is further enhanced in view of the recent pressure for wage increases in China and the related push to explore lower-costs production bases as substitutes in the region. However, there are still considerable structural reforms needed in Indonesia to enhance the business

Chart 4: Consumption growth begins to level off

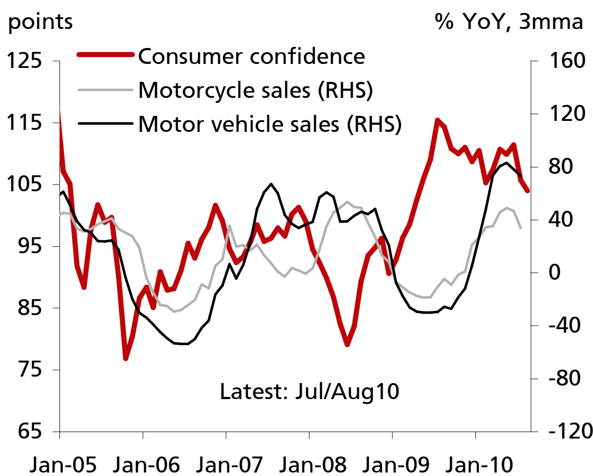
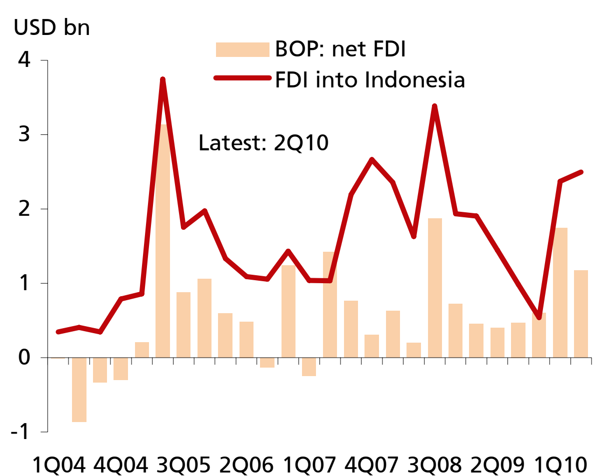


Chart 5: FDI inflows on the rise



environment and reduce hurdles to investment. For example, aspects such as labor market flexibility, labor skills straining, institutional efficiency, infrastructure and legal frameworks etc, need attention. As such, structural transformations cannot happen overnight. FDI inflows (according to the BOP statistics) increased USD 2.5bn in 2Q, similar as USD 2.4bn in 1Q, and only returning to the precrisis levels of USD 2-3bn per quarter in 2008 (Chart 5). We don't think investment can grow sufficiently to offset the moderation in private consumption and exports in the near term. Overall, we expect quarter-on-quarter GDP growth of 5.5-6.0% (saar) in the second half, slightly slower than 6.5% recorded in 2Q.

BOP: trade balance weakening

On the external front, the trade and current accounts maintained solid surplus as of the second quarter (CA surplus: USD 1.8bn). Starting from June however, merchandise trade balance weakened significantly and it slipped into a modest deficit of USD 0.1bn in July, the first monthly deficit recorded in two years

(Chart 6). Indonesia's export structure is dominated by commodities. Food, animal & vegetable oils, crude materials and minerals account for one half of Indonesia's total exports. If we add components such as chemicals and metals, we estimate that around 70% of Indonesian exports are commodities-related. On the other hand, the import base is tilted less towards commodities, and comprised of manufacturing goods to a higher degree. Machinery, transport equipments and miscellaneous manufactured goods account for 40% of Indonesia's total imports, reflecting local consumption and investment demand. Export growth is currently cooling off amid a weaker global environment which has moderated the prices of energy commodities, whilst the underlying upward trend in imports is relatively stable on the back of the strength in domestic demand.

Chart 6: Trade balance weakening

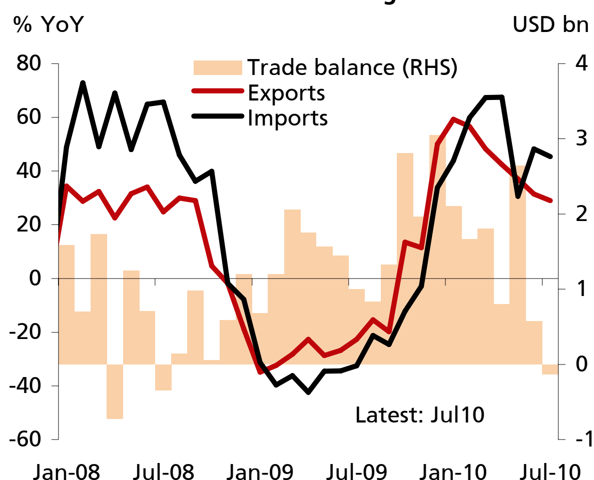
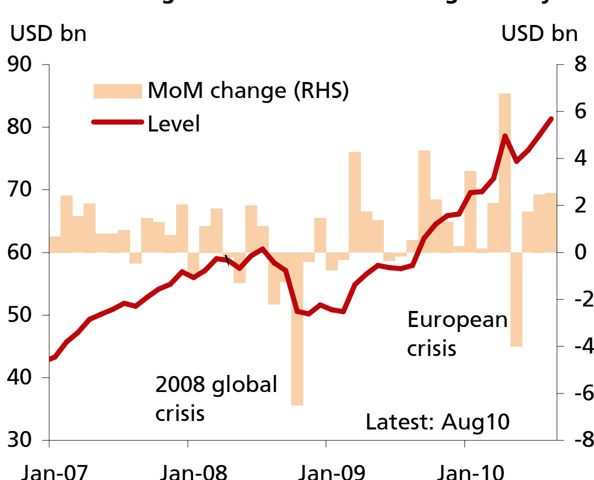


Chart 7: Foreign reserves still increasing steadily



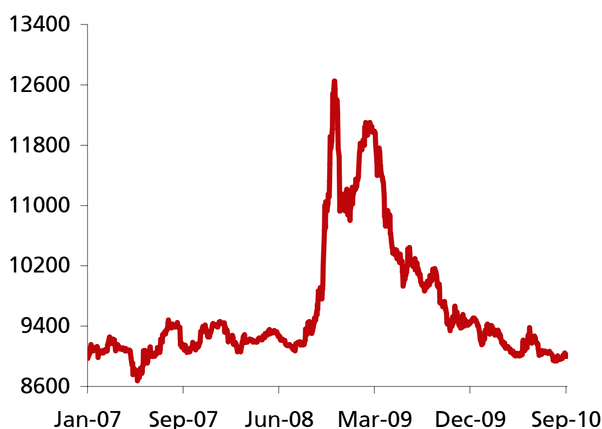
The overall balance of payments has continued to strengthen thus far, with the increases in portfolio capital inflows compensating the deterioration in trade balance. Despite the regulations introduced by the central bank on foreign ownership of central bank certificates in June (requirement of a 1-month holding period) in order to curb short-term capital inflows, longer-term inflows into the bond market have remained buoyant. Foreign holdings of Indonesian local currency government bonds rose USD 4.0bn in the Jun-Aug period. Official foreign reserves increased by USD 6.7bn during the same timeframe (Chart 7). Nonetheless, the downward trend in merchandise trade balance is still an unfavorable development. The pace of rupiah appreciation could slow because of the weakening in trade balance, especially if international capital inflows also fade due to the change in risk appetite.

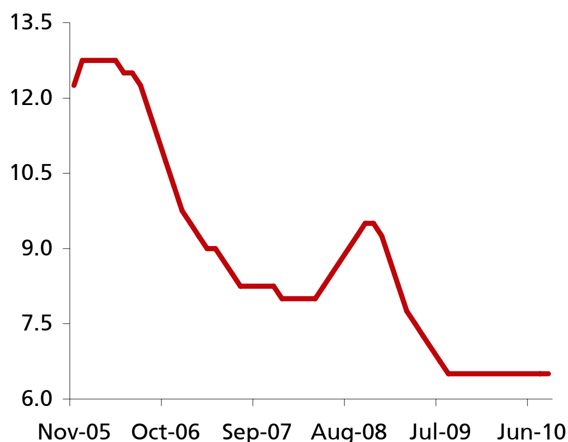
The upward trend in imports is relatively stable and reflects strong domestic demand

Indonesia Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Output and Demand									
Real GDP growth	4.5	6.0	5.8	6.2	6.1	5.9	6.0	5.8	5.8
Private consumption	4.9	4.9	4.7	5.0	5.0	5.6	4.8	4.6	4.6
Government consumption	15.7	-7.6	13.1	-9.0	-5.4	-7.4	14.4	15.8	13.1
Gross fixed capital formation	3.3	7.8	8.8	8.0	7.6	7.8	8.0	9.0	9.0
Net exports (IDRtrn, 00P)	223.5	227.0	237.0	54.6	52.8	61.9	59.2	57.3	55.2
Exports	-9.7	12.0	9.2	14.6	10.0	5.1	7.6	9.5	9.7
Imports	-15.0	15.2	10.6	17.7	15.3	7.2	9.1	10.8	11.0
External									
Merch exports (USDbn)	117	148	163	37	38	38	36	41	43
- % chg	-15.0	26.9	10.2	36.9	24.8	3.7	2.4	10.0	14.0
Merch imports (USDbn)**	97	136	157	33	38	35	33	39	44
- % chg	-25.0	40.5	15.3	48.0	41.3	23.1	11.5	19.0	15.3
Merch trade balance (USD bn)**	20	12	6	4	0	3	3	1	-1
Current account bal (USD bn)	10.7	5.1	1.6	-	-	-	-	-	-
% of GDP	2.0	0.7	0.2	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	66	83	93	-	-	-	-	-	-
Inflation									
CPI inflation	4.9	5.1	6.5	4.4	6.1	6.5	6.8	6.9	6.1
Other									
Nominal GDP (USDbn)	539	708	836	-	-	-	-	-	-
Fiscal balance (% of GDP)	-1.6	-1.3	-0.8	-	-	-	-	-	-

* % change, year-on-year, unless otherwise specified
** includes bonded zones





Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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MY: Domestic force

- The economy grew by a strong 8.9% YoY in the second quarter on the back of domestic demand
- Continued growth in consumption and investment, though at a slower pace, will pick up some of the slack from an external slowdown
- The economy remains for growth of 8.0% and 5.5% for 2010 and 2011
- Inflation will remain benign at 1.8% in 2010 but should rise to 2.4% in 2011
- Bank Negara is expected to take a more gradual approach in its normalisation process

More strong growth

Headline GDP grew by 8.9% YoY in the second quarter. Though this is a moderation from the 10.1% growth in the first quarter, it is largely due to the erosion of base effect. On a sequential basis, growth has actually accelerated to 7.5% QoQ saar, up from 4.0% in the previous quarter, thanks to strong domestic demand.

Domestic demand is an important growth driver in Malaysia and has continued to power the economy (Chart 1). Private consumption rose by 7.9% in the quarter, from 5.1% in 1Q10, while investment has outperformed expectation with a 12.9% surge, up from 5.4% previously. On the other hand, net exports continue to remain a drag as imports (21.9%) far outpaced exports (13.8%) due to strong domestic demand. From the supply side, the manufacturing sector continues to lead all sectors with a healthy, albeit slower growth pace of 15.9% (Chart 2). Key services sector posted a slower growth of 7.3% but the moderation has more to do with the dissipation of the low base effect rather than a genuine decline in momentum.

Chart 1: Domestic demand the key driver

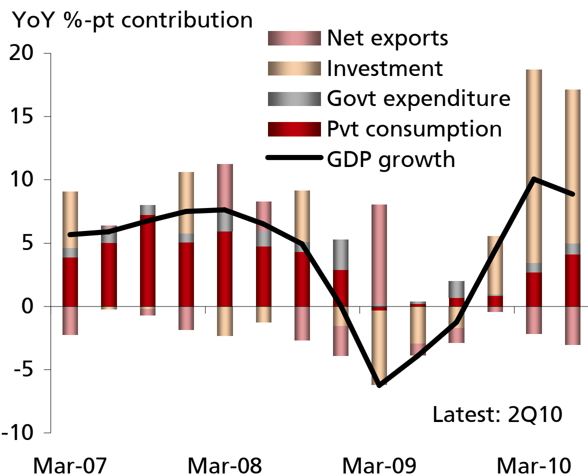
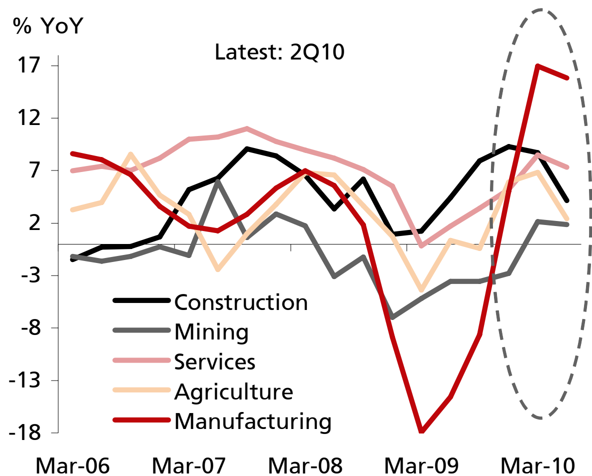


Chart 2: Healthy growth recorded across all



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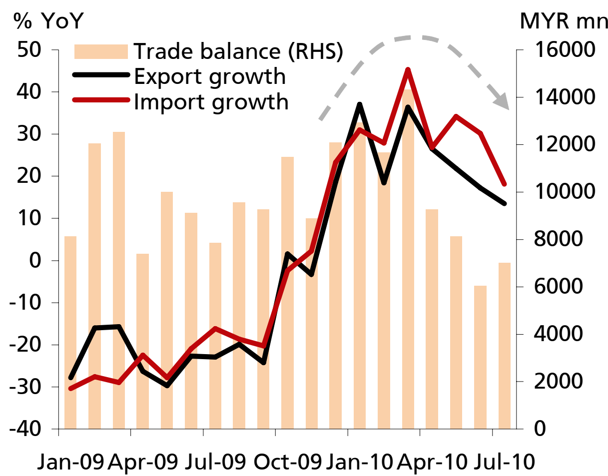
External demand to soften

However, external growth momentum is slowing as shown by recent export performance. July export growth moderated to 13.5% YoY, from 17.2% in June (Chart 3). In fact, export growth has peaked in March and has been trending downwards ever since. PMIs for key markets are also gradually tapering off as companies are anticipating weaker orders ahead (Chart 4). Moreover, though the electronics sector has benefited greatly from the recent surge in demand for electronics components due to the introduction of new IT gadgets, that too has been showing signs of cooling off. While leading indicators such as the SEMI book-to-bill ratio has continued to point at expansion in the IT sector, growth in global semiconductor sales has probably peaked and we could be seeing a slower pace of expansion in the electronics sector ahead (Chart 5). And in the same light, we can expect similar trend being manifested in the manufacturing sector in the coming quarters.

Chart 3: A gradual slowdown on the external front



Domestic demand will remain supportive of growth

However, the gradual moderation on the external front is expected to be partially offset by a fairly healthy domestic demand, as both private consumption and investment should remain supportive to economic growth going forward. A buoyant employment outlook as well as positive consumer sentiment should continue to underpin private consumption growth. Domestic business investment is expected to remain strong, on the back of the ongoing projects from the earlier stimulus packages as well as projects arising from the 10th Malaysia Plan (10MP) in time to come. Disbursement of public fund for projects under the 10MP may start as early as the end of this year, and the impact is expected to filter through the economy by the middle of next year.

Chart 4: Mfg PMIs showing signs of slowing down

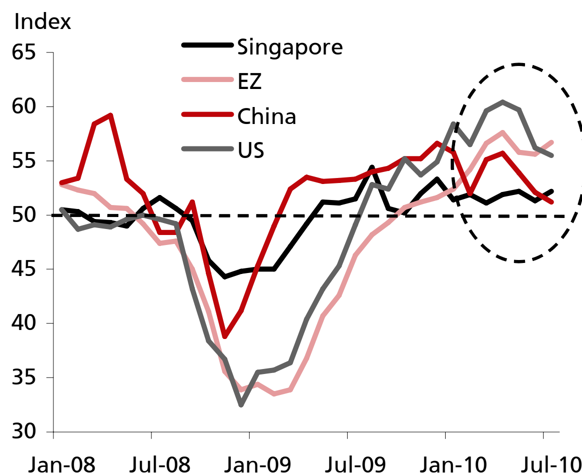


Chart 5: Global electronics cycle may have peaked

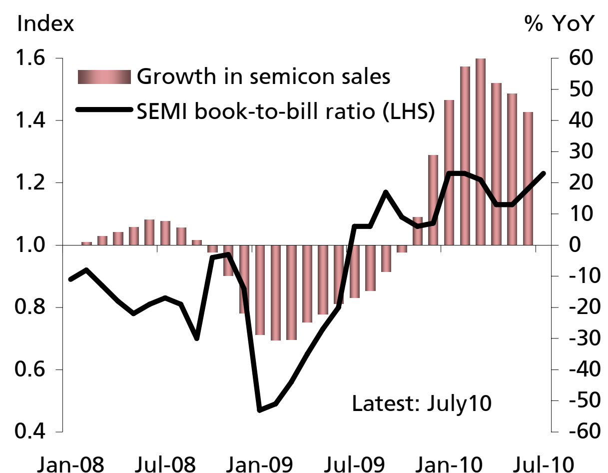


Chart 6: Pte consumption to moderate

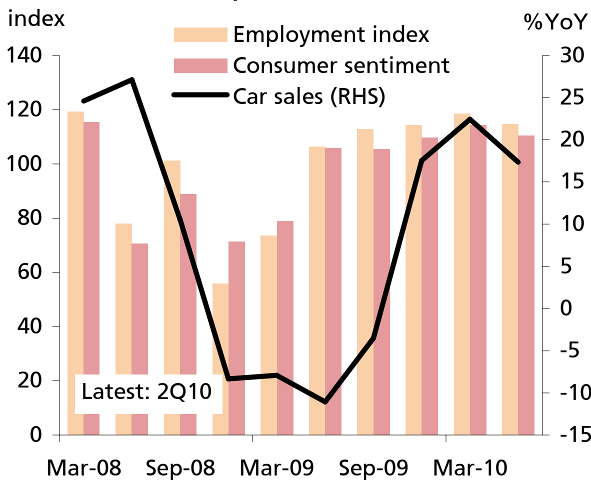
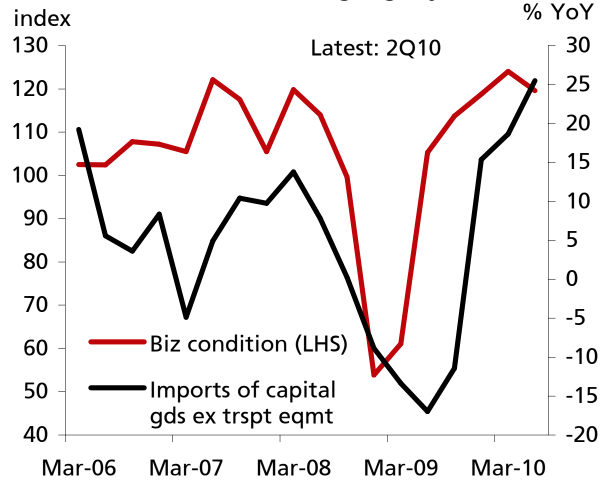


Chart 7: Biz sentiment turning slightly cautious



Yet, there are some degree of cooling in these domestic engines as well, probably due to the drag from external uncertainties. While we still believe that consumption and investment growth will remain fairly healthy in the months ahead, signs are certainly pointing to a more subdued domestic impetus ahead. Consumer sentiments have receded slightly while business expectation has turned slightly cautious in recent months (Chart 6 and 7).

Growth forecast unchanged

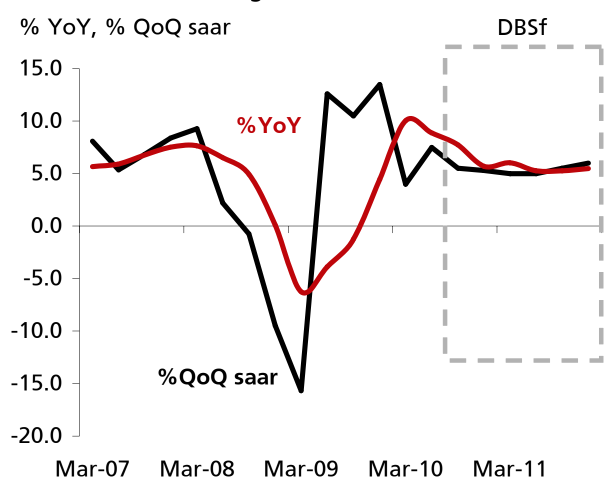
Nonetheless, we still think that despite the moderation in external demand, domestic growth, albeit slower, will be able to help lift full year GDP growth to 8.0% this year. Moreover, the exceptionally strong first half growth performance has provided a strong boost to the full year number. Essentially, first half GDP growth was well in line with our expectation (9.5% YoY, 5.8% QoQ saar) and even if growth slows to an average of 6.8% YoY (5.3% QoQ saar) in 2H10, an annual growth rate of 8.0% is still achievable (Chart 8). That said, uncertainties in the external environment has cast a shadow on the outlook going forward and the slower growth momentum is likely to spillover into 2011. With that, we expect GDP growth next year to register a slower pace of 5.5%.

Temporary pause to policy normalisation

A more gradual approach to policy normalisation

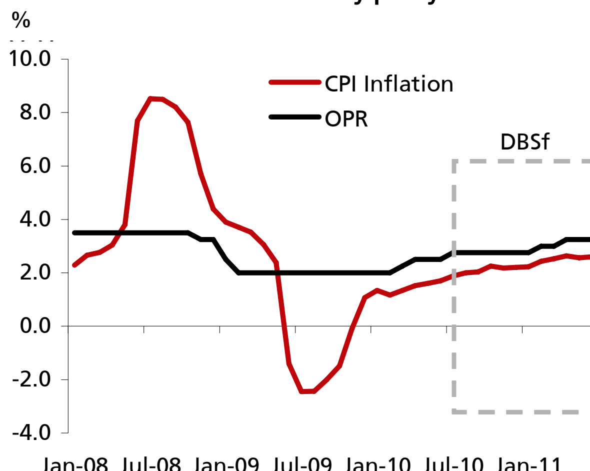
After hiking a total of 75bps in the last three meetings, Bank Negara paused for the first time in its monetary policy normalisation process. The central bank kept its Overnight Policy Rate (OPR) unchanged at 2.75% during its recent policy meeting in September, citing concerns that growth momentum has moderated in advanced economies following continued weakness in the labour market as well as the fading impact of the inventory build up and the earlier policy stimulus.

Chart 8: Slower GDP growth momentum ahead



Essentially, the central bank is now adopting a more cautious approach in its assessment of the external economic conditions. And though it expects domestic growth to remain strong, overall growth momentum will slow. In addition, the central bank has also reiterated its view on inflation, stating that "despite the adjustment in retail fuel prices in July, inflation is expected to rise at a modest pace in the coming months".

Chart 9: Inflation and monetary policy



Hence, it appears that unless economic activity or inflation picks up sharply, the central bank will most likely stand pat on its current policy rate level of 2.75% for the rest of the year. But this does not imply that the central bank is putting an end to its normalization process. In our view, it could be taking a more gradual approach to its interest rate normalisation process. In short, Bank Negara will most likely adopt a wait and see approach in the coming months before a firmer recovery takes place which will thus prompt the authority to tighten policy again in 2011. We now expect the next rate hike of 25bps in 1Q11 to 3.00%, followed by another in 2Q11 (Chart 9).

Inflation pressure to remain modest

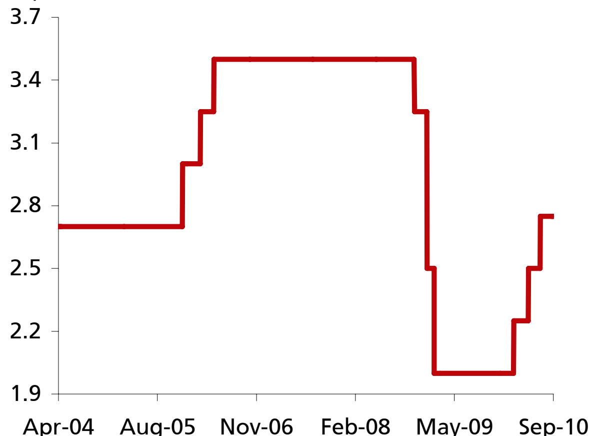
Inflation is in line with expectations

Indeed, we tend to agree with the central bank's assessment on the inflation outlook. Headline inflation has remained fairly modest at about 2.0% in the recent months despite the strong growth performance in the first half. A stronger currency probably has helped to keep imported inflation at bay while the pre-emptive interest rate normalization by the central bank is expected to keep the lid on any demand-pull inflationary pressure. However, though we do not expect a sharp spike-up in prices arising from the recent cuts in fuel and sugar subsidies, some modest impact on inflation will still be visible. Yet, we view the most recent subsidy rationalization move as a step in the right direction towards longer term fiscal sustainability in Malaysia. And any inflationary impact is expected to be transient, as is the case for most policy-induced inflation. Hence, we are maintaining our inflation forecasts for 2010 and 2011 at 1.8% and 2.4% respectively (Chart 9).

Malaysia Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth	-1.7	8.0	5.5	8.9	7.7	5.7	6.0	5.3	5.3
Private consumption	0.7	6.1	6.3	7.9	5.5	5.8	6.0	6.3	6.4
Government consumption	3.1	4.9	4.7	6.8	4.7	3.0	2.0	6.5	5.0
Gross fixed capital formation	-5.6	8.6	7.0	12.9	7.8	8.0	6.0	8.5	6.6
Exports	-10.4	14.6	7.2	13.8	17.0	9.1	7.0	8.0	7.0
Imports	-12.3	17.2	7.3	21.9	16.5	6.9	7.2	6.6	7.5
External (nominal)									
Exports (USD bn)	157	204	227	48	54	54	53	56	59
Imports (USD bn)	123	173	196	41	48	49	47	48	51
Trade balance (USD bn)	34	30	31	7	6	5	6	8	9
Current account bal (USD bn)	32	34	37	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	16.6	16.1	16.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, yr-end)	97	108	119	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	0.6	1.8	2.4	1.6	2.0	2.2	2.4	2.6	2.4
Other									
Nominal GDP (USDbn)	193	211	227	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-7.4	-5.0	-4.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % growth, year-on-year, unless otherwise specified



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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TH: Upside surprise

- Stronger-than-expected 2Q growth points to 9% full year growth, far higher than consensus expectations of 7%
- In 2011, we expect the economy to normalize to 4% growth
- Growth is expected to be driven by both domestic demand and exports. However, domestic demand will continue to be be sub-par owing to political uncertainties
- Thus, Thailand will continue to underperform developing Asia, and remain more vulnerable to external forces than it need be
- We expect the central bank to hike rates by another 125bps to 3% by mid-2011. This should not derail the recovery but help cap inflation.

Summary

Second quarter growth was stronger-than-expected despite the unrest in April and May and the closure of airspace in many European countries. Faster than expected normalization in private consumption and private investment is a key factor behind the resilience. Moving into the third quarter, fears are that a slower China and/or US would derail the recovery. July has not got off to a great start for Thailand. However, our thinking and bias is that China is normalizing, not slowing and that the second half would be better for China than the second quarter. In the US, we think consumption growth would continue to grind upwards at a 2% annualized rate. Together, this means Thai exports should continue to grow and that the drop in July will be reversed in the months ahead. As such, we continue to be more optimistic than consensus and recently upgraded our GDP growth forecast to 9% in 2010 (consensus: 6.8%). Even though domestic demand (and the overall economy) continues to be constrained by political instability from a medium-term perspective, 2010 is poised to see strong growth rates due

Chart 1: GDP , Quarterly

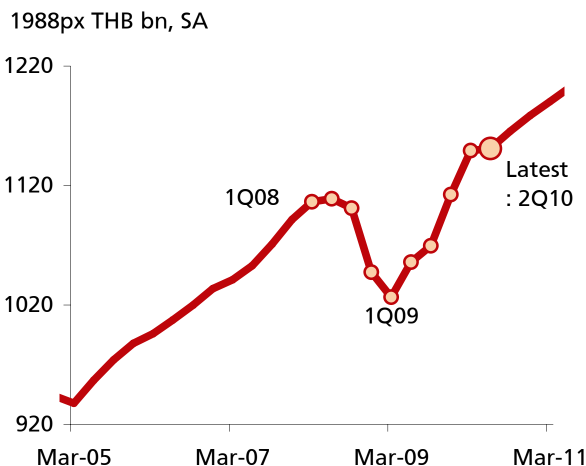
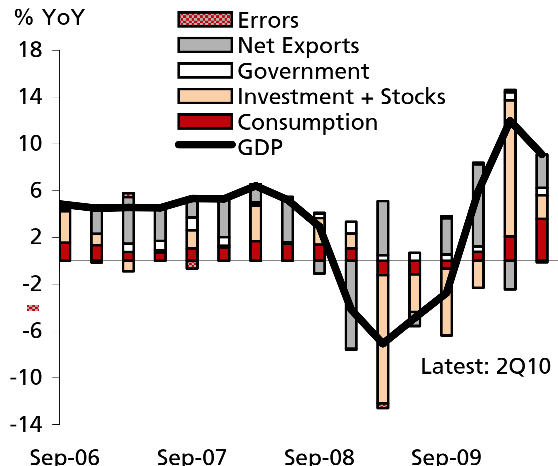


Chart 2: GDP contribution by expenditure



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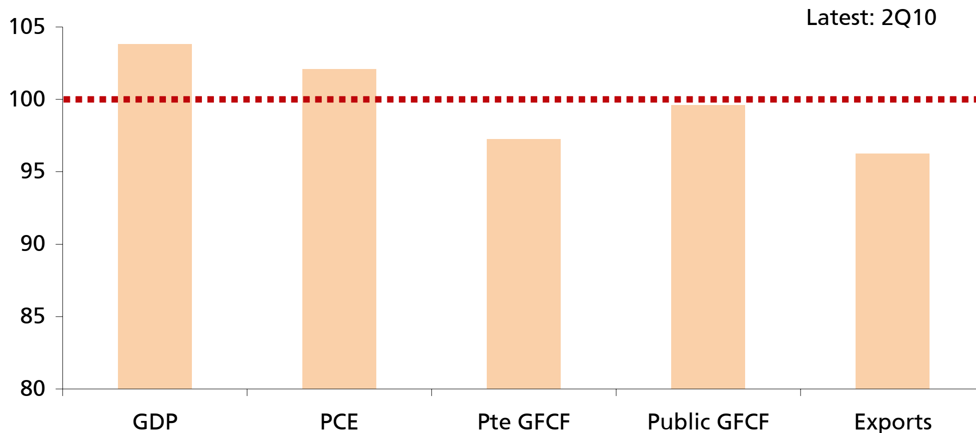
THAILAND

Chart 3: GDP expenditure drivers: % of previous peak



to the low base (this also means we should not think the 9% growth rate is particularly "strong"). In 2011 and as long as politics is a constraint on growth, we think Thai GDP growth should match world GDP growth (where it used to outperform global growth previously). This means about 4% growth in 2011. This is decent (and much better than G3 economies) but would mean the Thai economy will continue to underperform most of developing Asia and be more vulnerable to external slowdown than it need be (Chart 1 & 2).

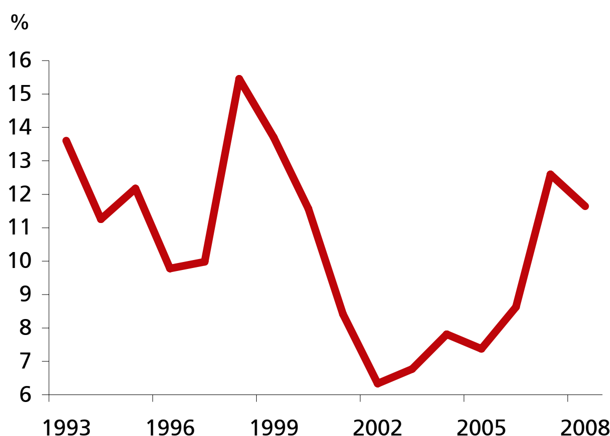
Domestically, high personal savings and pent-up investment demand support

Domestic demand important even if weakened by political instability

The recovery in domestic demand has played a key role in lifting Thai growth in 2010. It is a common misconception that Thai growth is driven only or mainly by exports. Sometimes this misconception extends to other small open economies, and sometimes even to larger Asian economies (such as China). Despite the political unrest, private consumption demand in Thailand is already two percentage points above the earlier peak reached in mid-08. In contrast, exports are still 4% below the earlier peaks (Chart 3, above). Plainly, domestic demand is very important for Thailand, even if it is running at half the rate it could due to political uncertainties.

With unemployment low and savings rate high (Chart 4), domestic consumer spending should grow by at least 3% each year in the medium-term. In the next two quarters, we think the still low base would support an even faster rise. Likewise, despite low capacity utilisation rates in several sectors, the excessive drop in private investment – more than warranted by fundamentals – suggests a couple of quarters more of rapid growth before growth normalizes. In 2011 and beyond, there is a good chance that private investment will accelerate (relative to the lull in 2006-08) despite political uncertainties. This is simply because

Chart 4: Personal savings as % of personal disposable income



investment has not seen a cyclical upswing since 2005 when political uncertainties came to the forefront. Indeed, the economy has gone through the global boom in 2006-08 without much growth in investment. A couple of years of economic expansion would therefore lift capacity utilization rates to sufficiently high levels to trigger greater investment. That said, in view of the political uncertainties, investment spending may mainly consist of expansion of existing capacity than greenfield projects, and should be targeted at particularly rapidly growing export oriented sectors.

Table: Sectors that drive manufacturing growth

	Relative growth rates*		
	2002-08	1989-2001	
	(1).	(2).	(1)/(2).
Electronic Products	2.7	2.0	1.4
Vehicles and Equipments	1.7	1.4	1.2
Foods	0.6	0.5	1.1
Beverages	1.1	0.9	1.1
Construction Materials	0.6	0.8	0.7
Iron & Steel Products	0.6	0.9	0.7
Textiles & Textile Products	0.3	0.8	0.4
Rubber & Rubber Products	0.6	1.8	0.3
Electrical Appliance	0.4	1.7	0.3
Petroleum Products	0.3	1.3	0.2
Pulp & Paper Products	0.4	2.1	0.2
Chemical Products	0.5	3.3	0.1
Tobacco	0.0	-0.1	-0.5

*(1) and (2) are sectoral growth rates divided by overall mfg growth in the respective periods

External demand

The stronger THB doesn't alter export or GDP growth forecasts

Exports are a key driver of Thai growth, especially manufacturing. In terms of growth contribution shares, exports have contributed to about one half of GDP growth. From a sectoral perspective, electronics and auto sectors dominate (Table above, column1). The inter-sectoral differences are driven by greater specialization in the region led by greater competition and trade liberalization, including free-trade agreements in the region.

The third quarter has not got off to a great start in Thailand with exports down sharply in July. However, month-to-month volatility is significant, especially in a post-financial crisis recovery. Our take is the drop in exports is temporary and will be reversed in the months ahead. The fundamental drivers of exports, Asian demand with China at the centre, followed by modest recovery in US consumption, remain in place.

THB strength doesn't alter growth forecasts

The baht has strengthened sharply against the dollar in recent months leading to concerns in some quarters over the impact on exports and GDP growth. For several reasons, we do not expect THB strength to materially alter our export or GDP growth forecasts. First, the pace of appreciation is broadly in line with of the regional countries, many of whom are third market competitors for Thailand (Chart 5, next page). Second, THB appreciation also helps limit imported intermediate input costs for exporters. Therefore, a stronger currency doesn't automatically worsen cost competitiveness. Third, expansion in volumes arising from expanding demand in Asia and improving market share of Thailand would offset the impact of a strong currency. Since the strengthening of the local unit doesn't happen in isolation but in the backdrop of expanding global growth, it doesn't by itself crimp export growth. Indeed, given our view that Asian demand is central to Asian and global growth, and taken together with prevalence of current account surpluses in many Asian economies, stronger Asian currencies can help further underpin Asian demand and hence global growth and growth in Thai exports. Lastly, within Asia, we also note that wages in Thailand remain low relative to

Chart 5: THB outperforming but not out of line with regionals

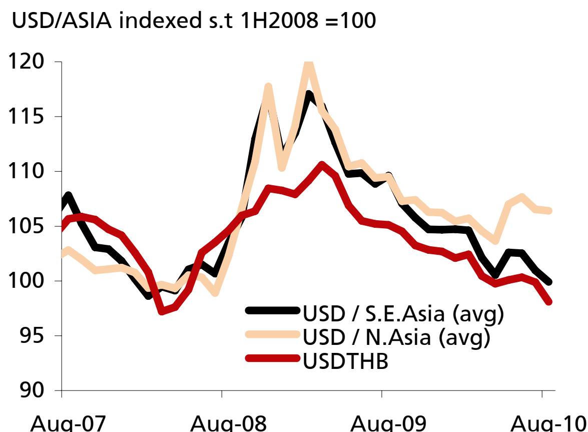
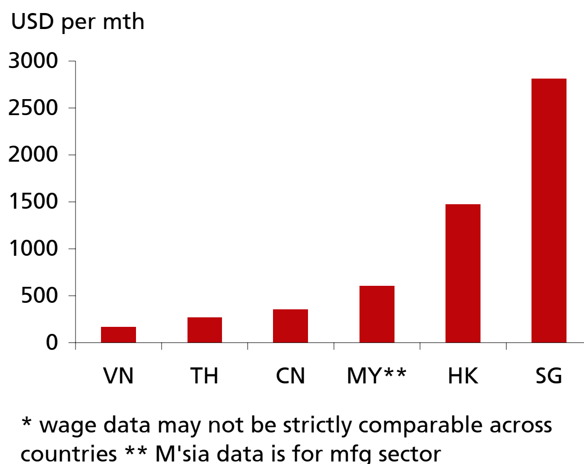


Chart 6: Average wage data* across Asia, 2008



the rest of Asia, especially China, which is viewed as a close competitor (Chart 6). This should also help preserve cost competitiveness of Thai exporters in the face of THB appreciation.

Inflation and rates

While inflation is unlikely to be a major concern at this point in the cycle, a low base and removal of subsidies are bound to keep prices supported in 2010 and 2011. Inflation is likely to be thus elevated at 3% in 2010 and 2.8% in 2011. Therefore, timely rate normalization is critical. We expect slightly more rate hikes than consensus projections (see table in the beginning of this publication). The central bank's fan chart for inflation published in its inflation report reveals that it is sees a real risk of core inflation breaching the target range of 0.5%-3.0% in 2011. As such, given the relatively low rates in Thailand, it makes sense for the central bank to lift rates by another 50bps by end-2010 despite double-dip worries and further to 3% by mid-2011.

Thailand Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth (88P)	-2.2	9.0	4.0	9.1	8.7	6.3	3.5	4.5	4.3
Private consumption	-1.1	5.2	3.8	6.5	6.6	3.7	3.8	4.6	3.8
Government consumption	5.8	6.0	6.0	6.3	7.8	2.1	5.6	6.1	6.1
Gross fixed capital formation	-9.0	12.6	8.4	12.2	10.7	14.7	12.8	9.7	6.2
Net exports (THBbn)	784	807	790	186	216	188	192	142	227
Exports	-13	16	6	22	17	10	7	6	6
Imports	-22	21	9	24	19	14	15	15	6
External									
Merch exports (USDbn)	151	191	208	48	50	49	48	51	56
- % YoY	-14	27	9	42	22	16	9	5	12
Merch imports (USDbn)	131	177	200	44	47	45	46	50	54
- % YoY	-25	35	13	45	33	12	9	15	14
Trade balance (USD bn)	19	14	8	5	3	4	2	0	2
Current account balance (USD bn)	20	15	10	1	2	7	6	-3	1
% of GDP	8	5	3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	-0.8	3.0	2.8	3.2	3.2	2.4	1.9	3.2	3.5
Other									
Nominal GDP (USDbn)	264	317	351	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate, %	1.2	1.0	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-4.4	-3.0	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

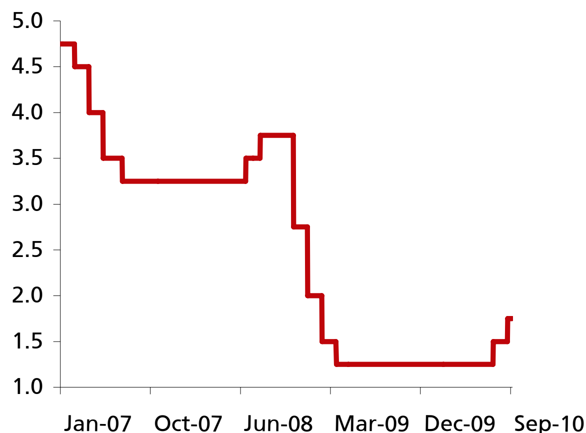
* % change, year-on-year, unless otherwise specified

TH - nominal exchange rate

THB per USD

TH – policy rate

%, 1-day RRP



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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SG: Moderation is a virtue

- **A strong start to the year but a slowdown awaits**
- **Headwinds against the manufacturing sector are picking up while growth has peaked in the services sector**
- **GDP growth forecast for 2010 remains at 15.0% but growth will cruise to a relatively slower pace of 4.5% in 2011**
- **Inflation remains on track to hit our target of 3.0% in 2010 and 2.7% in 2011**
- **With slower growth momentum and stable inflation, the MAS is expected to stand pat in October.**

Strong start but slowdown awaits

Having posted a strong 16.9% YoY expansion in the first quarter, the Singapore economy roared further ahead with another record showing of 18.8% (24.0% QoQ saar). With that, overall economic growth for the first half of the year now registers a stunning 17.9%.

The manufacturing sector remains the key driver of growth and has continued to power ahead at a neck-breaking pace of 44.5% in the quarter, up from an already strong 37.9% in 1Q10. But despite the rosy figures, headwinds against the manufacturing sector are picking up as well. The non-oil domestic exports and industrial production growth for July moderated to 18.2% YoY and 9.9% respectively, compared to 28.5% and 29.5% in the previous month (Chart 1). A pullback in production within the pharmaceutical segment is the key reason for recent dismal showing (Chart 2). Indeed, volatility is the "hallmark" of the pharmaceutical industry due to the nature of its production process. Having ramped up production for the first six months, it came as no surprise to see some producers shutting

Chart 1: NODX and IP growth fell in July

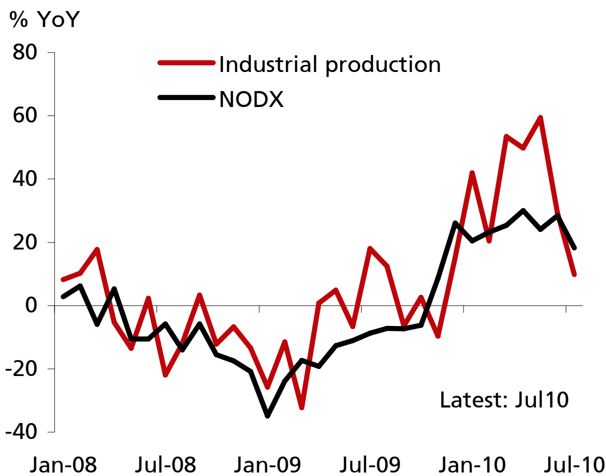
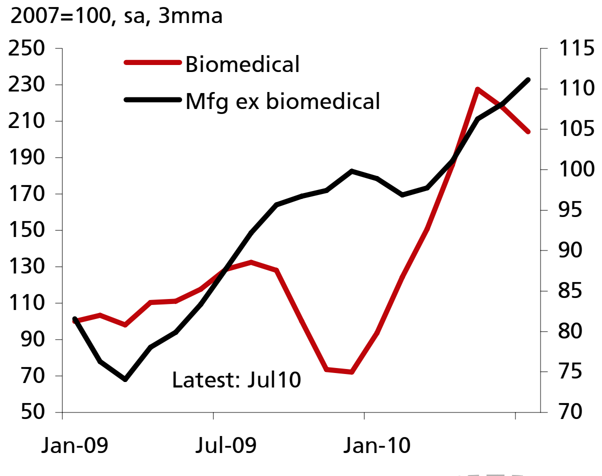


Chart 2: Pharma and ex-pharma output



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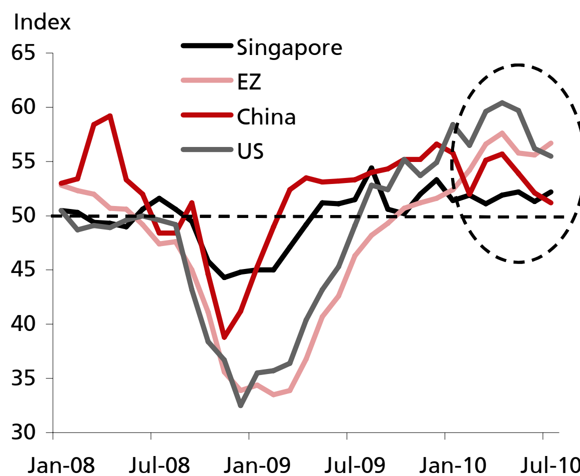
down production in July to do the necessary maintenance and sterilization before embarking on the next batch of drugs. We have highlighted this in the past and it is one of the reasons why the stunning performance by the manufacturing sector in 1H10 will not last going into the second half (see "A year of two halves" dated 30 Jun10).

Moreover, manufacturing PMIs in key markets such as China and US are tapering off, signalling a possible slowdown in demand ahead (Chart 3). If we juxtaposed a subpar recovery in the US against a China economy that is due for some soft landing as well as the potential drag coming from the Eurozone, the manufacturing sector is set for some slowdown in the months ahead. As such, the strong start posted by the manufacturing sector in the first half of 2010 will most likely fizzle out going forward (Chart 4).

Chart 3: Mfg PMIs showing signs of slowing down



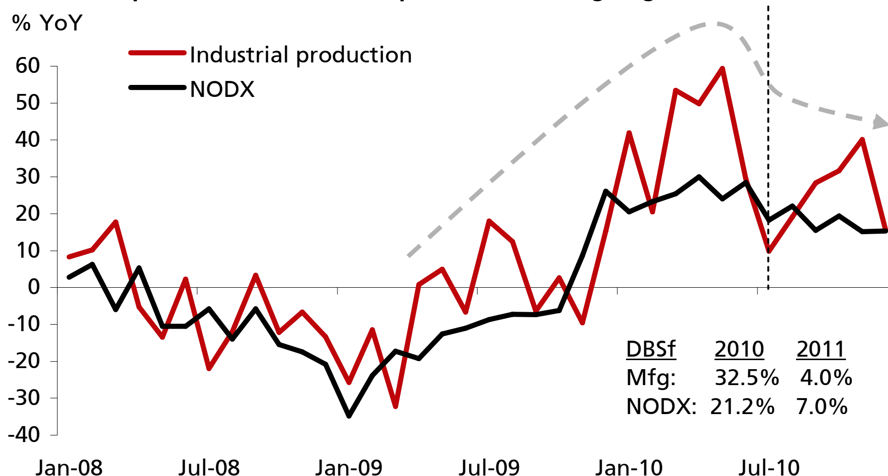
Manufacturing growth will moderate

Services growth has peaked

The services sector posted a fairly robust growth of 11.2% YoY in 2Q10. Growth was led by the wholesale and retail trade (18.9%), hotels and restaurants (10.4%) as well as the other services segment (12.9%). While key financial services has continued to post double digit growth of 10.2% in the quarter, its growth pace has in fact moderated significantly from 19.1% in 1Q10, on account of risk aversion in the financial markets due to the European debt crisis.

Separately, growth in the "Other Services" segment rose sharply. This segment is a mixed bag of industries such as the recreational, education, parks and performing arts services etc. This sector accounts for about 10% of GDP and its growth pace has traditionally been very stable. But this changed from the first quarter of this year onwards when the Department of Statistics decided to allocate the gaming returns from the two newly opened IRs into this particular segment. As a result, growth in this sector rose to 7.5% in 1Q10 and 12.9% in 2Q10, significantly

Chart 4: Exports and industrial output to moderate going forward



IRs to contribute SGD 2bn to the economy in 2010

higher than its historical average growth rate of 6.1%. On a sequentiaL basis, it posted a robust expansion of 14.6% and 25.2% in the first two quarters. In fact, based on our estimation, the two IRs have contributed SGD 470mn (0.3% of GDP) to the economy in 1H10 and are expected to add a total of SGD 2.0bn (0.7% of GDP) to the economy this year (see "GDP contributions of the IRs" dated 26 Aug10 and Chart 5).

While we expect the two IRs to contribute significantly to the economy, particularly in the years ahead when they become fully operational, some near term downside risks continue to cast a shadow on the outlook of the services sector. Risk aversion will continue to affect the financial markets from time to time given the "wobbly" recovery thus far. Global trade flows will most likely moderate on slower economic activities ahead. Recent measures introduced by the government to cool the red-hot property market will also put a dent on the domestic segment of the financial sector (mortgage related financing) as well as the real estate services industry. As such, we believe growth has peaked in the services sector and a gradual moderation in the growth path lies ahead (Chart 6).

Chart 5: Strong positive GDP contributions by the IRs

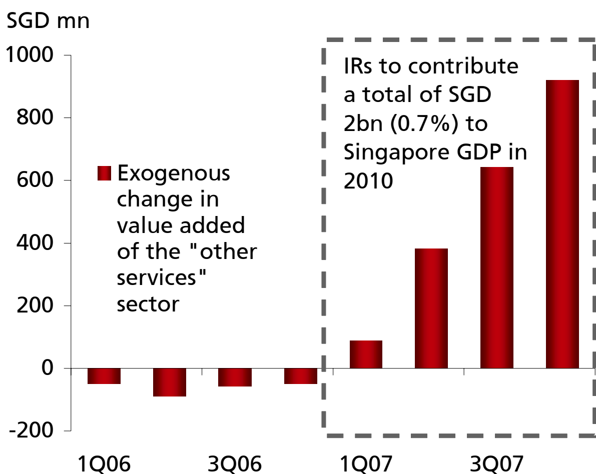
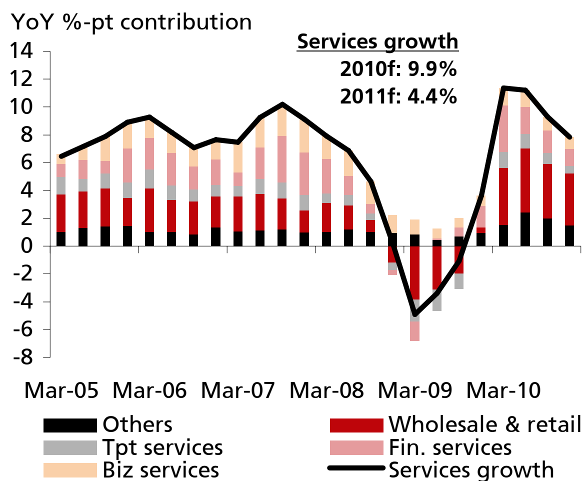


Chart 6: Services growth has peaked



GDP growth forecasts unchanged

The world's fastest growing economy in 2010?

Going forward, while risks associated with the European debt crisis have subsided, poor job and housing data in the US have renewed concerns regarding the sustainability of the current recovery. In addition, high frequency data from the region are suggesting that Asia is poised for some cooling off. Though domestic demand, particularly private consumption in the region will continue to be a strong driver of regional growth, the withdrawal of fiscal support and monetary tightening in Asia will likely have some cooling effects on Singapore's economic growth. That said, we view this moderation as a healthy normalisation process given the last few quarters of exceptionally strong growth. We're maintaining our GDP growth forecast for 2010 as the "strong lift" in 1H10 is enough to bring headline growth to 15% despite a slower second half. And though this is enough to place this island state as the fastest growing economy in the world this year, growth is expected to slow to 4.5% next year on weaker external demand.

Rising inflation in line with expectations

So much has been said about the higher inflation that will follow the "supernormal" growth in the first half of the year. The headline price gauge did just that in July after a temporary dip in June. Inflation shot back to 3.1% after falling to 2.7% in June. A double digit (10.7%) increase in transportation costs was the key factor and that has a lot to do with the high COE prices (Chart 7). In a bid to control car population, COE quota has been trimmed significantly, which led to the sharp spike-up in COE prices. However, such policy induced inflationary impacts tend to be transient and dissipate on account of its own base effect. More importantly, wage inflation is picking up due to a tighter labour market and hikes in foreign worker levies (Chart 8). While it is difficult to ascertain the extent of wage pressure on inflation, some inflationary impact will surely be felt at some stage. Moreover, rises in rentals and electricity tariffs are also expected to push housing cost higher. With that, inflation is on track to meet our existing forecast of 3.0% before receding to 2.7% in 2011 on weaker growth momentum.

Inflation to register 3.0% this year and 2.7% in 2011

Chart 7: COE prices and private transport costs

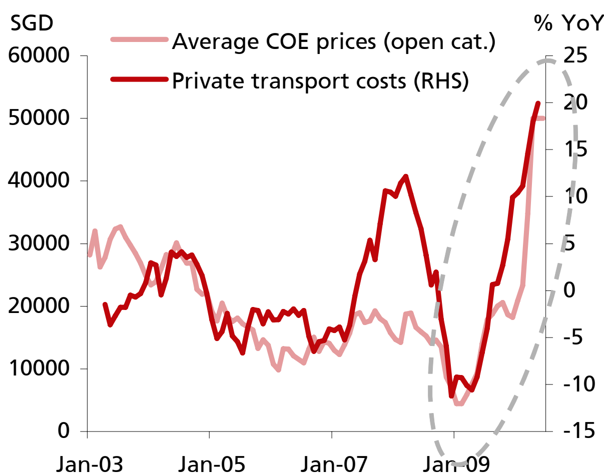
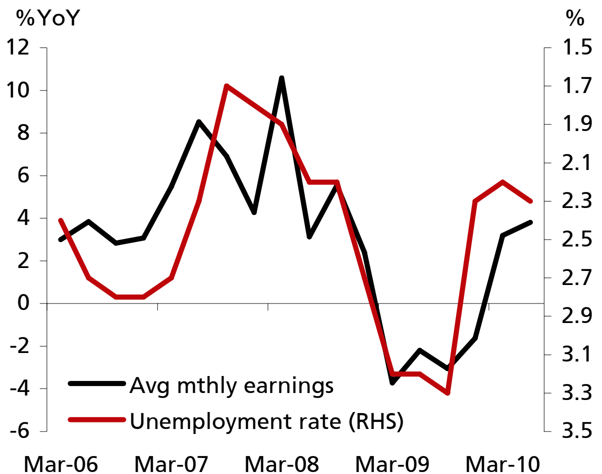


Chart 8: Labour market getting tighter



No change to exchange rate policy

We do not expect the Monetary Authority of Singapore (MAS) to further tighten the exchange rate policy in October. Unless growth momentum is expected to remain strong going forward, there is little basis to justify further tightening beyond the existing policy stance. In fact, we believe the earlier "double-tightening" move by the authority would have taken into account a robust growth performance for the first half of the year. Moreover, growth momentum is expected to moderate over the coming quarters as uncertainties about the sustainability this global recovery pick up.

MAS to stand pat in October

That said, the only factor that could invite further policy action by the central bank would be higher than usual inflation readings. But on that front, inflation though is expected to rise, will still stay within the comfort zone of the policymakers, that is, between 2.5-3.5% on an annual basis. Indeed, the risks between higher inflation and slower growth appear well-balanced and with that, we believe the authority will most likely stand pat on policy in the coming meeting.

Singapore Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
Real GDP (00P)	-1.3	15.0	4.5	18.8	12.0	12.6	4.5	0.6	5.6
Private consumption	0.4	6.2	6.1	6.7	6.2	6.0	5.8	6.0	6.2
Government consumption	10.1	7.0	7.8	5.0	5.0	2.5	8.0	10.0	6.0
Gross fixed investment	-2.9	7.1	6.9	-1.2	10.0	9.0	5.4	6.4	7.2
Exports	-8.8	18.3	8.9	23.3	16.5	13.5	10.1	10.0	8.0
Imports	-10.9	17.3	10.0	21.1	14.7	16.3	11.0	12.0	9.5
Real supply									
Manufacturing	-4.1	32.6	4.3	44.5	21.3	28.7	3.7	-6.0	7.1
Construction	16.2	8.3	5.0	11.5	8.7	3.9	4.9	6.0	5.0
Services	-1.4	9.9	4.5	11.2	9.3	7.8	4.4	3.0	5.3
External (nominal)									
Non-oil domestic exports	-10.6	21.2	7.0	27.6	18.5	16.5	13.6	5.2	4.6
Current account balance (USD bn)	30	39	36	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	17	18	16	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn)	188	214	235	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	0.6	3.0	2.7	3.1	3.8	4.5	4.2	3.6	2.6
Other									
Nominal GDP (USDbn)	182	215	230	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	2.1	2.0	1.8	2.1	2.1	2.0	1.9	1.9	1.8

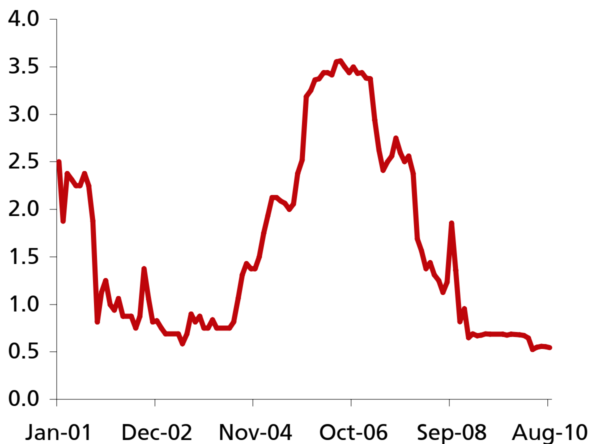
- % change, year-on-year, unless otherwise specified

SG - nominal exchange rate

SGD per USD

SG – 3mth SIBOR

% pa



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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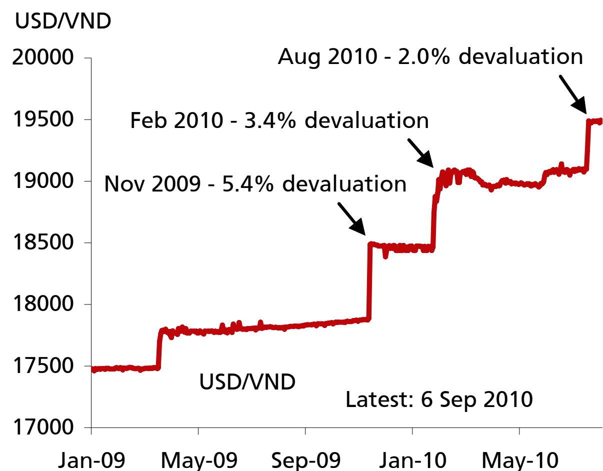
VN: Lingering apprehension

- The State Bank of Vietnam (SBV) devalued the VND by about 2% in August in a bid to curb the widening trade deficit
- The trade deficit actually widened between April to July if the surge in gold exports is excluded
- Expect more devaluation ahead although we believe continued devaluation is not the long term solution
- Inflation has been stabilising and we have lowered our inflation forecasts for 2010 and 2011 to 8.2% and 7.0% respectively
- Headline GDP growth has been in line with expectation thus far and remains on track to register 6.5% in 2010 and 6.9% in 2011

Another devaluation

Much in line with expectation, the State Bank of Vietnam (SBV) recently devalued its currency, the dong, (VND) for the third time since Nov09. The dong was lowered by about 2% to 18,932 on 18 Aug while the +3% trading range was retained (Chart 1). Dollar shortage, lack of confidence in the local currency and concerns of a persistent trade deficit were the driving factors. We suspect this will not be the last devaluation. Policy credibility and market expectations of more depreciation will continue to exert pressure on the currency. We expect another 1% depreciation against the US dollara (to 19,690) by the end of 2011 and see risks of the policy band being widened to account for greater volatility ahead.

Chart 1: Dong devaluation



Devaluation not a long term solution

More importantly, we do not think that a continued devaluation of the local currency will bring about a lasting effect on the trade balance. As we've mentioned in several of our writings in the past, the root of the trade deficit problem stems from an exceedingly fast growth path, which also coincides with the country's accession to the WTO that saw a broad-based reduction of its import tariff regime in Jan 07. In addition ,domestic demand has surged too rapidly, causing unnecessary stress on the external balance, thereby inviting depreciative pressure. Hence, further depreciation will only buy time for the authority but will not help to resolve the underlying structural problem and policy deficiency in the economy.

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Vietnam may need to grow slower

Policy making is essentially about the delicate balancing of the various economic objectives as well as the risks involved. While we believe that Vietnam certainly has the potential to achieve robust economic growth, a "growth at all costs" strategy is certainly not sustainable. The outcome is typically excessive inflationary pressure or a huge external deficit, or both as is the case for Vietnam in recent years. Moreover, the benchmark base rate has lost its relevance after the SBV lifted the interest rate cap in March. Though the spike up in market interest rates has helped to cool economic activity in the earlier part of this year, and that other policy instruments such as the capital adequacy ratio can still be used, the point to note is that the state bank has essentially given up one important monetary policy tools for fine-tuning the economy. If external inflationary pressure picks up sharply, Vietnam could be in for another bout of high inflation again. Hence, it is not surprising that Fitch has recently downgraded Vietnam's sovereign rating by a notch to B+, citing worsening external finances, higher funding needs and inconsistent state policies.

Trade deficit still wide

More devaluation ahead

The uncomfortably high trade deficit has remained a concern (Chart 2). Though the trade deficit has stabilised at about USD 900mn per month, from about USD 1.1bn per month in 1Q10, it was largely due to a USD 1.5bn surge in gold exports in the second quarter (Chart 3). Excluding gold exports, the trade balance actually worsened to USD 1.26bn per month between Apr-Aug, from an average of USD 1.16bn per month in the first three months of the year. This essentially affirms our earlier point that devaluation of the currency will have limited impact in terms of addressing the trade deficit problem. As long as the government continues with its expansionary fiscal policy and maintains its present loose monetary policy in order to achieve its ambitious growth target, risks of fallout in the trade balance and current account balance will remain persistent. With that, one can reasonably expect more depreciative pressure on the currency in the years ahead. And note that such expectation can often be self-fulfilling.

At least inflation has stabilised for now

Perhaps the brightest spark in the Vietnam economy is that inflation has been stabilizing, at least for now. Headline inflation remained steady at 8.2% in Aug10, unchanged from the previous month. And on a MoM sa basis, inflation has moderated significantly, thanks mainly to the decline in food prices as a result of a good harvest and to a lesser extent, a fall in prices for petrol and oil. Specifically, sequential inflation has moderated to an average of just 0.2% MoM sa, down sharply from about 1.4% between Jan-Mar10 (Chart 4).

Chart 2: Trade deficit still wide

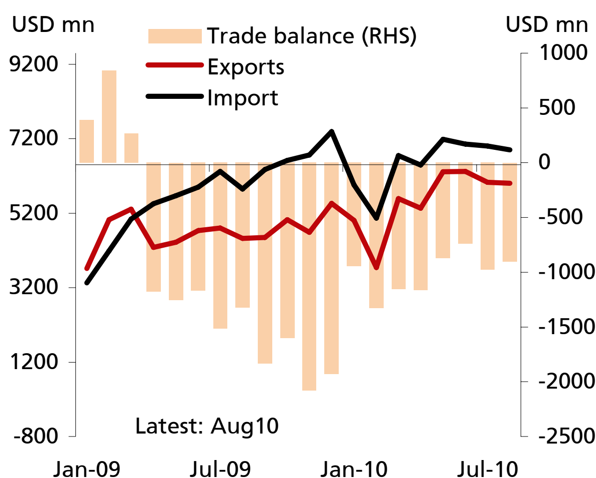


Chart 3: Surge in gold exports bolster trade balance

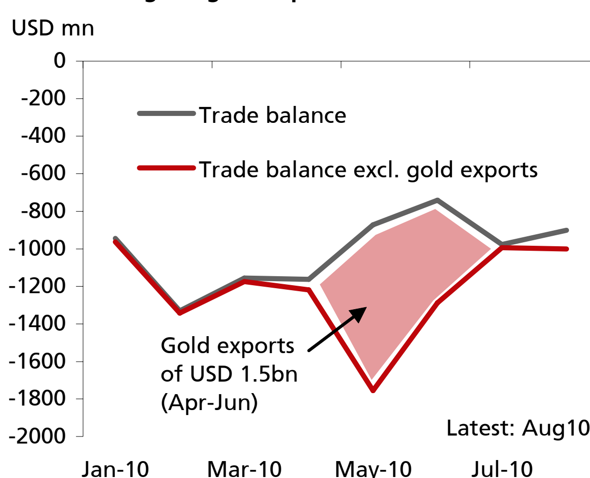


Chart 4: Food and overall inflation stabilised

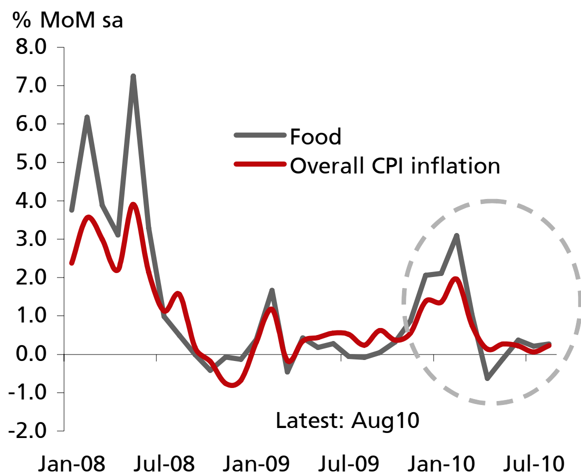


Chart 5: Inflation to remain stable

Inflation forecasts lowered

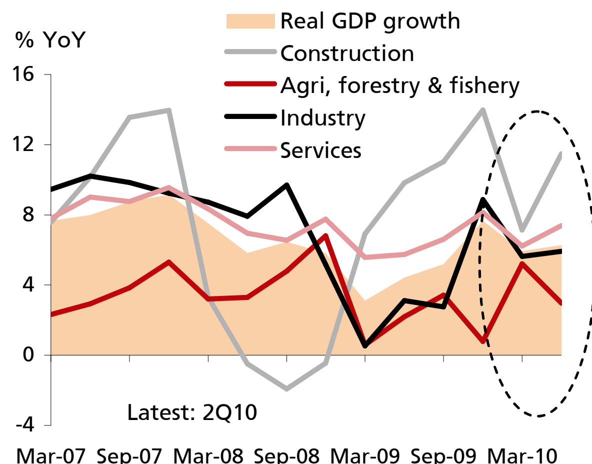
With economic conditions expected to return to normal, inflation should average about 0.3% on a month-on-month basis before a possible spike-up during the festive season in December. That will bring headline inflation to 8.2% this year, slightly below our previous forecast of 9.0%. Going forward, the government has announced that effective from 1 Oct10, it will be able to impose price controls on a range of products. These include industrial inputs such as cement, steel, LPG, animal feeds etc and basic necessities like rice, sugar, salt, papers and railway fares. Nevertheless, we expect inflation to continue moderating to about 5.5% by middle of next year before picking up again on account of faster growth (Chart 5). Full year inflation in 2011 is now expected to register 7.0%, down from our previous estimate of 8.0%.

Growth still on track

Growth outlook still good

The economy rebounded strongly by 10.5% QoQ saar in the second quarter, up from a contraction of about 7.1% in the first quarter. On a yearly basis, growth registered 6.3% YoY, from 5.9% in the previous quarter. Apart from the agriculture sector which saw some moderation in its growth pace, all key sectors posted better growth performance (Chart 6). Essentially, the recovery in the global economy as well as a still resilient domestic demand have bolstered overall GDP growth in the second quarter. Steps taken by the SBV to rein in market lending rates have also helped to "resuscitate" the economy, which was facing a liquidity crunch in the first quarter (see 3Q10 DBS quarterly report on Vietnam). Going forward, although uncertainties in the global environment are likely to weigh in on export performance, a loose monetary regime juxtaposed with continued disbursement of state investment and strong domestic consumption, should help the economy achieve GDP growth of 6.5% this year. In fact, this domestic impetus will also be the crucial factor behind an anticipated 6.9% growth in 2011.

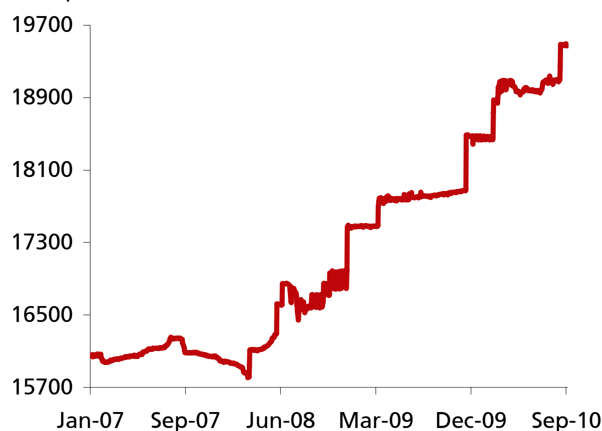
Chart 6: Growth still on track

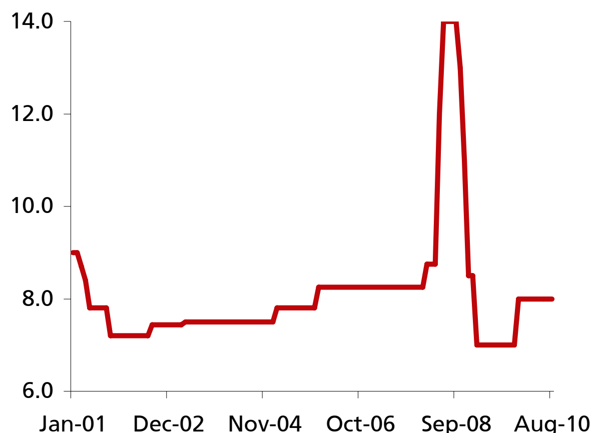


Vietnam Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth	5.3	6.5	6.9	6.3	7.0	6.6	6.6	6.5	7.1
Real supply									
Agriculture & forestry	1.8	2.3	2.9	3.0	1.7	0.8	3.1	2.7	3.2
Industry	4.0	8.2	8.8	5.9	10.6	10.0	7.4	8.3	9.1
Construction	11.4	6.0	6.7	11.5	3.2	4.5	7.0	6.5	6.4
Services	6.6	7.0	7.0	7.4	6.9	7.1	6.9	7.0	7.1
External (nominal)									
Exports (USD bn)	56.5	72.6	84.8	18.0	18.3	20.7	18.0	20.9	20.7
Imports (USD bn)	68.9	84.2	94.7	20.7	21.4	23.9	20.0	23.3	24.0
Trade balance (USD bn)	-12.4	-12.4	-10.8	-2.8	-3.0	-3.2	-2.1	-2.4	-3.3
Current account bal (USD bn)	-7.0	-7.0	-6.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-7.2	-6.4	-4.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	7.0	8.2	7.0	9.0	8.0	7.4	5.8	5.8	7.5
Other									
Nominal GDP (USDbn)	97.2	110.1	127.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	4.4	4.0	3.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % change, year-on-year, unless otherwise specified
- Figures may deviate from official sources due to difference in reporting format





Sources for charts and tables are CEIC, Bloomberg. Estimates are by DBS Group Research.

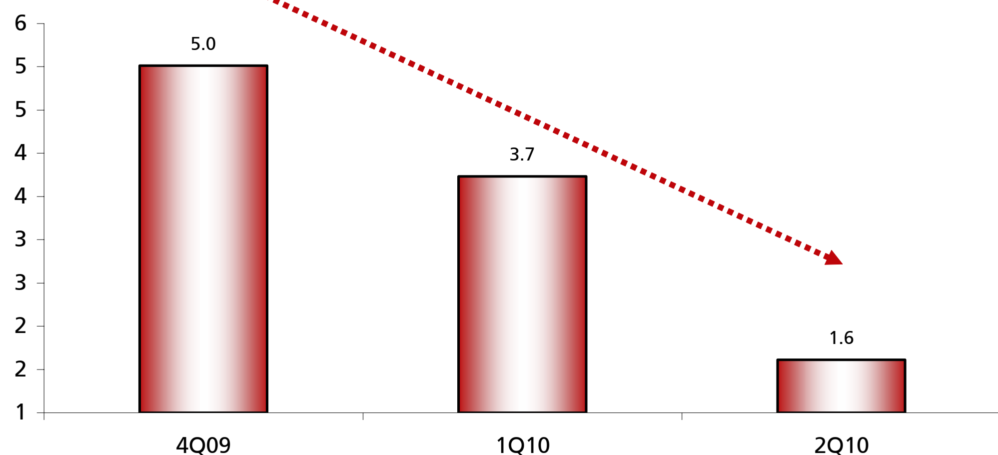
US: the 'slowdown'

- **Fears of a double-dip recession have obsessed markets in recent weeks**
- **Supply (GDP) growth dropped to 1.6% in 2Q10**
- **But demand growth – even after taking out inventories and government spending – accelerated to 4.4%. That's the fastest rate in years**
- **What's more important, demand or supply? Demand: It leads, supply follows**
- **Recovery will continue but GDP growth will be muted in Q3 and Q4. We expect average growth of 2% - 2.25% (QoQ, saar) in 2H10**
- **The Fed will not opt for QE2, we think, but interest rate hikes seem unlikely for another year**

Fears have grown over a possible double-dip recession. The main source of concern is focused on 2Q GDP growth, which fell to a rate of 1.6% (QoQ, saar) from 3.7% in the prior quarter and 5% in the quarter before that. Demand is falling, or so it is said, and with it, the markets. Yields on 10-year Treasuries are 130bps below early-April levels of 4% and were down 20bps more than that at one point. Equity markets are down 10% from early-April levels (and were down by 16% at one point).

GDP (supply) growth is falling. But demand growth is at a multi-year high. Which is more important?

The thing is, demand isn't falling. It isn't even growing more slowly. In the second quarter, US demand growth accelerated to a 5.3% (QoQ, saar) rate, its fastest pace since 3Q03! Okay, some of that is inventories. And some of that is government spending. Neither can prop the economy up for very long, as Bernanke pointed out when he spoke two weeks ago at the Fed's annual get together in Jackson Hole. Bernanke noted what most will readily agree with: what is absolutely key for sustained recovery is growth in private final demand.



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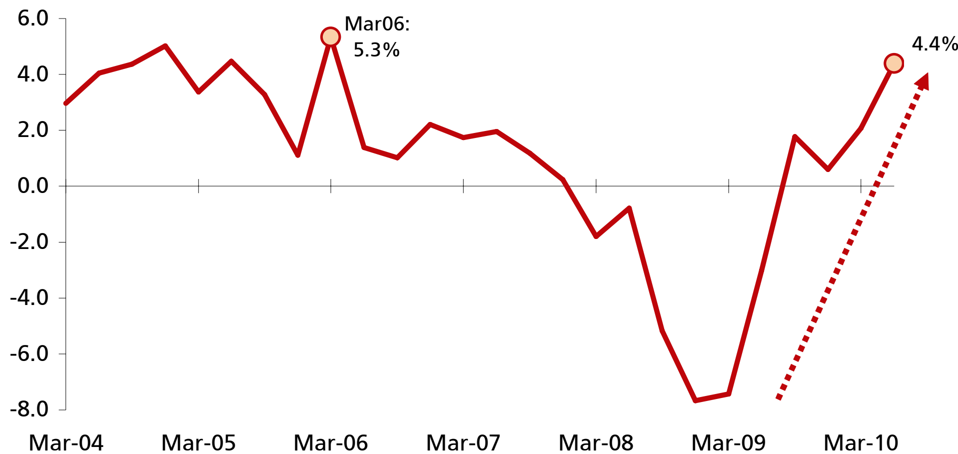
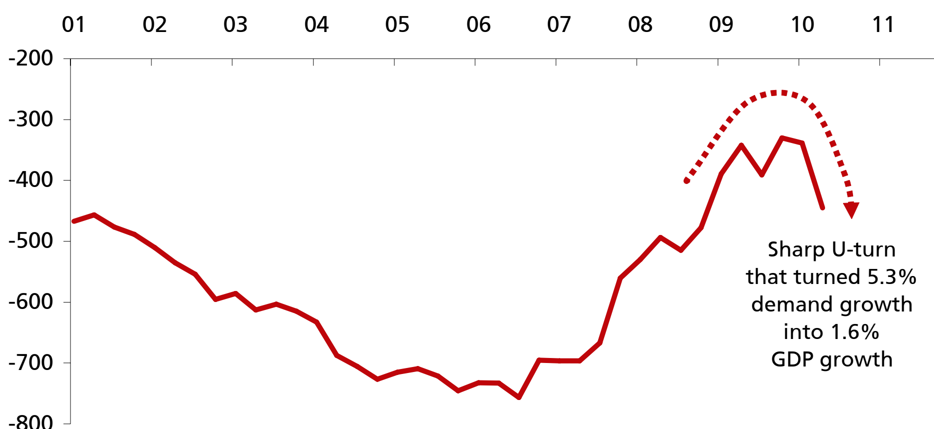


So take out the inventories. Take out the government spending. Take out the foreign demand (which was already taken out of GDP to get the 5.3% US demand growth figure). What do you find?

You find that private final demand – consumption, business investment (excluding inventories) and residential housing – is accelerating too. Growth rose to 4.4% in the second quarter, not far from the 5.3% figure that included inventories and government spending. And like total demand, private final demand is at a many year high. If it weren't for a funny spike in 1Q06, current growth in PFD would also be at a seven year high (chart above).

Go ahead: Take out the inventories. Take out the government. The private final demand you are left with is growing at 4.4% rate, the highest in years

What's the difference between supply / GDP growth and demand growth? The trade balance. The US is once again spurting red ink. All that US demand – or an awful lot of it anyway – went to foreign producers, not US producers. In the second quarter, heavy imports are mainly what turned US demand growth of 5.3% into US supply / GDP growth of 1.6%.



That's the bad news: an awful lot of US demand went to foreign factories and foreign wages. The good news is, demand leads supply. That is, after all, why Bernanke said PFD was the key to the outlook. So long as demand growth remains steady, the outlook for recovery remains intact.

Consumption is the weak link

The only question is, why Bernanke didn't point out how strong growth in PFD currently is, or the fact that it is accelerating, not slowing down? The reason probably has to do with the path of consumption, because at the end of the day, consumption is the final demand of final demand.

What's the difference between 5.3% demand growth and 1.6% GDP growth? The trade balance – it's spurting red ink again

The worst part of the 2Q GDP report was the discovery (via revised data) that the recovery in consumption had been much milder than what people thought had been the case before. After hitting bottom in Jun09, revised data show consumption has grown at but a 2% (saar) pace compared to the 2.8% growth path that everyone thought had prevailed (chart below). That's a big difference for something that accounts for 70% of GDP and the worry is that unless consumption does a little better, the strong growth in business investment (17% QoQ, saar in 2Q10) will start to fade.

For the next two quarters, GDP growth is indeed likely to remain muted. The contribution from housing seen in 2Q will not be sustained and business investment is likely to run closer to an 8%-9% pace than the 17% registered in 2Q10 (see forecast table on next page). Some technical 'payback' in net exports should be seen in 3Q and 4Q which would help headline GDP but, adding everything up, growth seems likely to run at about a 2% (QoQ, saar) to 2.25% pace in the third and fourth quarters of this year.

Next year will feature modestly stronger growth in private consumption demand (and steady business investment) juxtaposed against significant headwinds from a tighter fiscal policy and the need to reduce / constrain the federal budget deficit. We envision below-potential GDP growth of 2.5% (QoQ, saar) to 2.6% prevailing through most of the year, which would lead to annual average growth of 2.4%

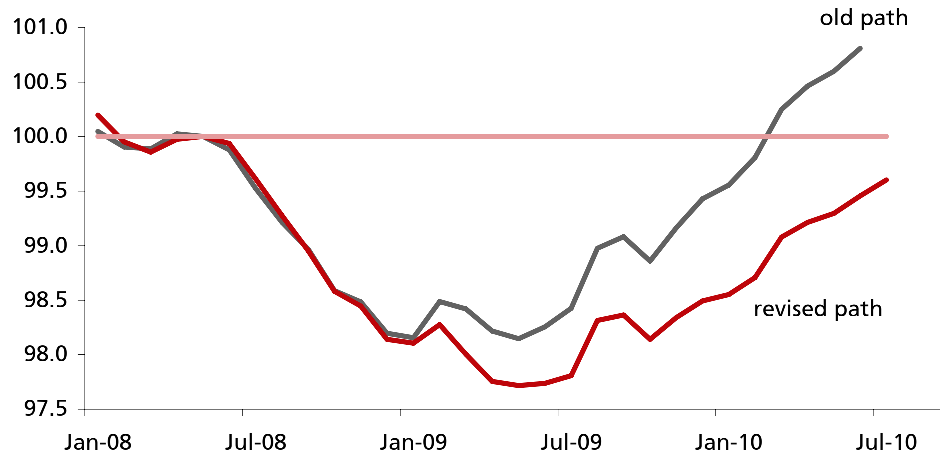
Fed

Slower GDP and a still high unemployment rate of 9.6% have raised the possibility of further monetary easing by the Fed. Since short-term rates are already at

The recovery in consumption has been far milder than previously thought

US – consumption (real)

Jun08=100, sa, 2mma



United States Economic Indicators

	2009	2010(f)	2011(f)	-- 2010 -- Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)	--- 2011 --- Q1 (f)	Q2 (f)	Q3 (f)
Output & Demand										
Real GDP*	-2.6	2.7	2.4	3.7	1.6	2.1	2.1	2.6	2.7	2.5
Private consumption	-1.2	1.6	2.3	1.9	2.0	2.1	2.2	2.3	2.3	2.4
Business investment	-17.1	5.6	9.4	7.8	17.6	8.0	8.0	10.0	9.0	9.0
Residential construction	-22.9	-1.1	3.1	-12.3	27.1	-15.0	0.0	5.0	5.0	8.0
Government spending	1.6	0.9	0.9	-1.6	4.3	1.0	2.0	0.5	0.0	0.0
Exports (G&S)	-9.5	15.2	22.3	11.4	9.2	32.2	13.6	22.4	27.5	25.0
Imports (G&S)	-13.8	14.3	20.7	11.2	32.4	15.0	15.0	22.0	24.0	22.0
Net exports ($bn, 05P, ar)	-363	-401	-455	-338	-445	-400	-420	-440	-450	-460
Stocks (chg, $bn, 05P, ar)	-113	37	38	44	63	20	20	30	40	40
Contribution to GDP (pct pts)										
Domestic final sales (C+FI+G)	-3.3	1.8	2.8	1.4	4.5	2.0	2.8	2.8	2.8	2.8
Net exports	1.1	-0.3	-0.4	-0.3	-3.2	1.4	-0.6	-0.6	-0.6	-0.6
Inventories	-0.6	1.2	0.0	2.5	0.6	-1.3	0.0	0.0	0.0	0.0
Inflation										
GDP deflator (% YoY, pd avg)	0.9	1.2	1.4							
CPI (% YoY, pd avg)	-0.3	1.6	1.8	2.4	1.8	1.1	1.0	1.2	1.6	2.1
CPI core (% YoY, pd avg)	1.7	1.1	1.8	1.3	1.0	1.0	1.1	1.5	1.8	1.9
PCE core (% YoY, pd avg)	1.6	1.5	1.7	1.8	1.5	1.4	1.2	1.5	1.7	1.8
External accounts										
Current acct balance ($bn)	-378	-477	-552							
Current account (% of GDP)	-2.7	-3.3	-3.6							
Other										
Nominal GDP (US$ trn)	14.2	14.7	15.3							
Federal budget bal (% of GDP)	-10.3	-7.4	-5.0							
Nonfarm payrolls**				87	190	-19	150	200	250	300
Unemployment rate (%, pd avg)				9.7	9.7	9.6	9.5	9.0	8.5	8.0

* % period on period at seas adj annualized rate, unless otherwise specified
** Change, x1000, month avg

zero, further easing would likely take the form of more purchases of longer-term Treasury bonds. This option has been referred to as 'quantitative easing II" or QE2.

We do not expect another round of quantitative easing. But rate hikes seem unlikely for another year

We do not expect the Fed to resort to another round of large-scale bond purchases (because the recovery will be strong enough to forestall it) and believe the Fed would not engage in small scale purchases (because it would be seen as ineffectual). That said, the path of GDP growth we now envision does not call for Fed hikes for as far as the eye can see. We now guesstimate a first Fed in 3Q11, a full year from now.

Sources:

Sources for all charts and tables are CEIC and Bloomberg . Forecasts are DBS Group Research.

EZ: Still weak

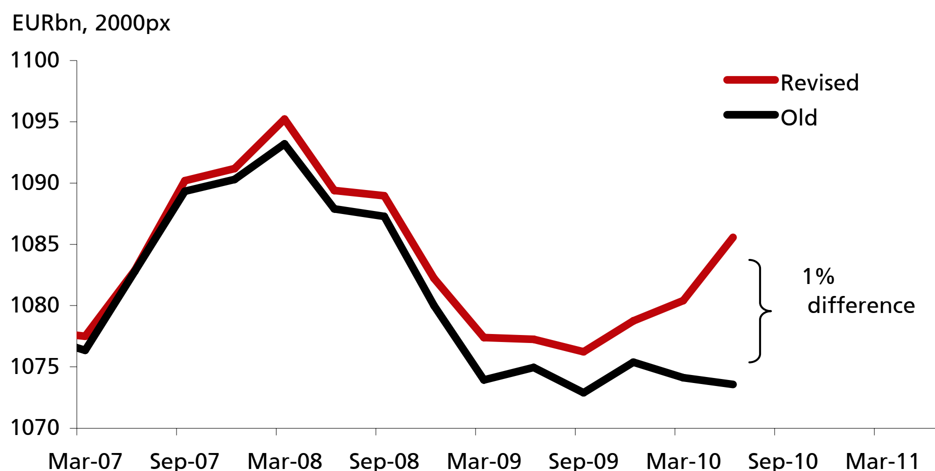
- We have lifted our GDP forecast for 2010 and 2011 to 1.7% and 1.5% on the back of the stronger-than-expected second quarter GDP (4% QoQ saar), and upward revisions to consumer spending data over the past year
- While the revisions are a pleasant surprise, the economy is still fragile and faces high and stubborn unemployment
- Headline inflation has also remained firm. Rather than bring the ECB in early, the risk is higher headline inflation further suppresses consumption
- We have pushed expectations for a first rate hike out by a quarter to 3Q11

2Q10 review and summary outlook

We have lifted our GDP forecast for 2010 and 2011 to 1.7% and 1.5%

We have lifted our GDP forecast for 2010 and 2011 to 1.7% and 1.5% on the back of the stronger-than-expected second quarter GDP (4% QoQ saar), and importantly, upward revisions to consumer spending data for the past year (Chart 1) . Eurozone data have undergone revisions of similar magnitude as US consumer spending data did recently, only the revisions were in the opposite direction (US data revisions were downward). The breakdown of second quarter GDP also revealed some interesting trends. Growth was driven almost entirely by domestic demand with net exports contributing a meager 0.1%-point to sequential growth in 2Q. Consumption spending (1.1ppt), investment spending (1.4ppt) and inventories (0.7ppt) made up most of the near-4% sequential growth. While growth is likely to be weaker in the second half and beyond as the low base disappears and impact of fiscal austerity undertaken kicks in, it has to be noted that the Eurozone consumer is not as weak as the retail sales data had painted initially. This means that the economy, weak as it is, is not entirely dependent on exports to stay above water. Given a still substantial excess capacity and expectation for softer growth ahead, the ECB is likely to stand pat on rates at least until 3Q11.

Chart 1: Pte consmptn - revised and old data



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EUROZONE

Domestic demand – better than expected but likely to falter ahead

Following the revision to GDP data, consumption demand is a full percentage point stronger in 2Q than thought earlier (Chart 1). In fact, consumption demand has been rising for three consecutive quarters now at an average rate of 1.2% QoQ saar, rather than moving sideways as suggested by the earlier data (or falling in the second quarter under the weight of the sovereign debt crisis). Instead, GDP data now show that inventories and investment were weaker than thought earlier. This changes the outlook quite substantially as consumption is the final demand in an economy and everything else, including investment and inventories, depends on the trends in consumption spending. As an illustration, if investment spending expands more than warranted by the strength of final consumption demand, it is usually a sign of an investment bubble (this is, for example, one of the risks for China). On the other hand, if consumer spending rises, it leads to a virtuous growth cycle as it leads to tighter capacity utilization and hence higher investment spending.

2H10 outlook remains weak

Table: Comparing trends in the past two cycles (% YoY)

	GDP	PCE	GCF	Exports	Imports
1997-2003 avg	2.3	2.2	2.7	6.4	6.5
2004-08 avg	2.0	1.5	3.0	5.5	5.4
2004-09 avg	1.0	1.0	0.0	2.5	2.6

If consumption is that important to the economic outlook, it is obviously important to understand what drove consumer spending and if it is sustainable. We think the low base more than anything else is responsible for the faster consumption growth. In the last business cycle spanning 2004-2009, the annual consumer spending growth rate more than halved to 1%, compared to the 2.2% rate chalked in the previous cycle that span (Table, above; Chart 2 & 3, below). The weakening consumption expenditure trend is driven by a confluence of longer-term forces such as an ageing population, labour market rigidities, and rising competition from emerging markets. These headwinds have offset supportive factors such as a moderate savings rate (14% vs 5% in US) and low household debt levels (65% of GDP vs 100% in US). There is little reason to think any of

Chart 2: GDP growth

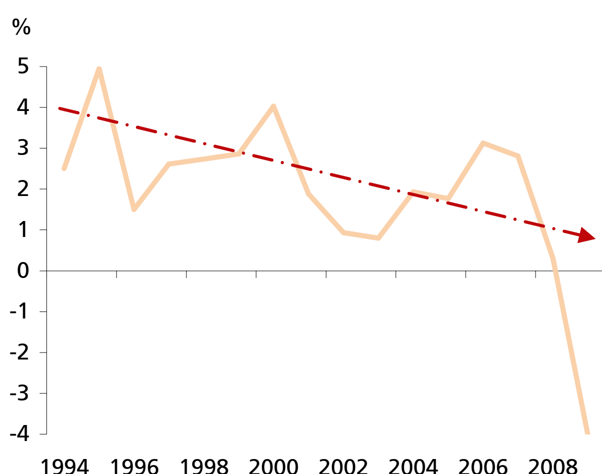


Chart 3: Private consumption spending growth

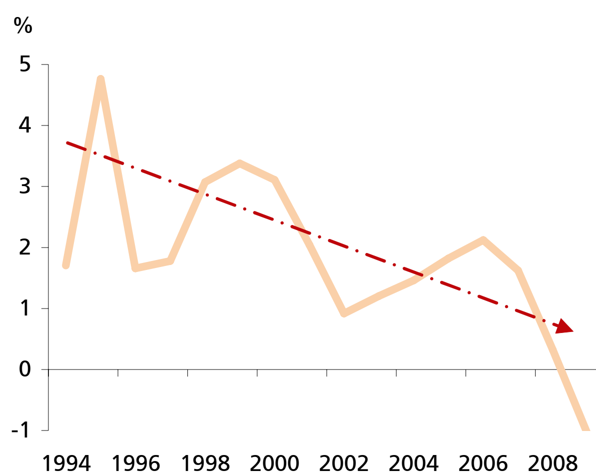
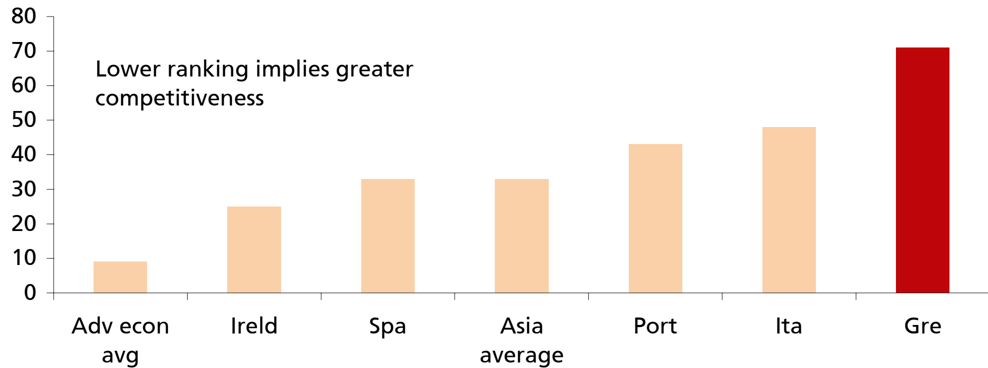


Chart 4: Global competitiveness rankings

Rank (out of133 economies)



Source: World Competitiveness Report, 2009-10

these structural headwinds have disappeared following the crisis. Indeed, while the evident expansion in consumer spending in the past three quarters is a pleasant surprise, if viewed together with the prevailing low base, it is still a trickle. If anything, the structural and policy shortcomings are made more vivid and plain by the high unemployment rate, especially in many Southern European economies. Youth unemployment in Eurozone presently stands at 20% while in economies such as Spain it is twice as high. Clearly, fiscal austerity is not enough to get out of this mess. Eurozone economies badly need further labour market flexibility and pro-market reform to stimulate consumption and improve the trend growth rate. The good news is that the economy will get the medicine it needs. Taking preventative medicine can be a matter of choice, but once one is taken ill, medicine is not an option but the only way out. Likewise for Eurozone, with unemployment unlikely to ease to bearable levels in the quarters ahead, there is little choice but to embark on further reform (Chart 4).

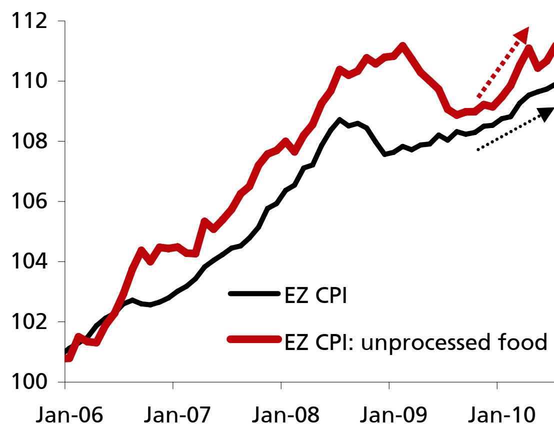
Food prices behind higher inflation – another roadblock for consumption

Higher food prices are driving higher inflation

We lifted our inflation forecast for 2010 and 2011 substantially to 1.5% on the back of recent inflation trends that have surprised on the upside. Headline inflation is stronger than one would expect in an economy that has substantial excess capacity. Headline inflation has run at a 2% (QoQ, saar) through 1H10, twice as much as the six months preceding (Chart 5). While it is tempting to point to euro weakness as a chief explanatory variable, we note that it has not made much of a difference to core prices. Core inflation has been benign in 1H10 averaging under-1% (QoQ, saar), same as in the six months preceding. Likewise, retail fuel oil prices in euro terms (taking France as a case in point) have also been softer in 1H10 than

Chart 5: Rising food price behind higher CPI

2005=100, SA



in the six months preceding. We think the main explanation for the higher inflation is food prices. As long as food prices do not fall, core price pressures may remain benign but headline inflation will be high. Will the higher headline inflation bring the ECB in sooner than otherwise? We think not. From the perspective of Eurozone, higher food prices are entirely a supply-side phenomenon (and likewise when global oil prices rise, that too cannot be attributed to higher demand from Eurozone and has to be a supply-side phenomenon). We think the risk is that higher inflation in the backdrop of a weak labour market further erodes the already fragile consumer spending. The more the rest of the world grows leaving behind a weak Eurozone (and that's pretty much our base case scenario), the greater the risk that the Eurozone consumer is priced out. As long as this remains the case, ECB rate hikes too remain a distant prospect. We recently pushed out the first rate hike to 3Q11 from 2Q11.

Eurozone Economic Indicators

	2009	2010f	2011f	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f
Real output and demand									
GDP growth (00P)	-4.0	1.7	1.5	3.8	2.0	2.3	1.3	0.8	0.7
Private consumption	-1.1	0.8	0.9	1.9	0.8	0.8	0.8	0.8	1.0
Government consumption	2.5	0.9	-0.9	1.9	0.0	-0.5	-1.5	-1.5	-1.5
Gross capital formation	-14.8	4.3	4.1	11.1	-7.9	10.0	5.7	3.3	2.3
Net exports (EURbn)	52.8	73.6	113.3	8	29	28	28	28	28
Exports (G&S)	-13.2	10.6	11.1	18	12	12	10	10	8
Imports (G&S)	-11.9	10.1	10.2	18	2	12	10	10	8
External (nominal)									
Merch exports (EURbn)	1291	1493	1676	388	361	395	397	433	406
- % YoY	-18	16	12	24	12	13	14	12	12
Merch imports (EURbn)	1251	1437	1574	379	343	370	383	410	378
- % YoY	-22	15	10	27	11	13	11	8	10
Trade balance (EUR bn)	41	56	101	9	19	26	14	23	28
Current account balance (USD bn)	-43	-33	16	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-0.3	-0.3	0.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
HICP (harmonized, % YoY)	0.3	1.5	1.5	1.5	1.7	1.7	1.6	1.4	1.4
Other									
Nominal GDP (USD tn)	12.4	11.3	12.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	9.8	10.0	9.8	10.1	10.1	10.0	10.0	9.9	9.8

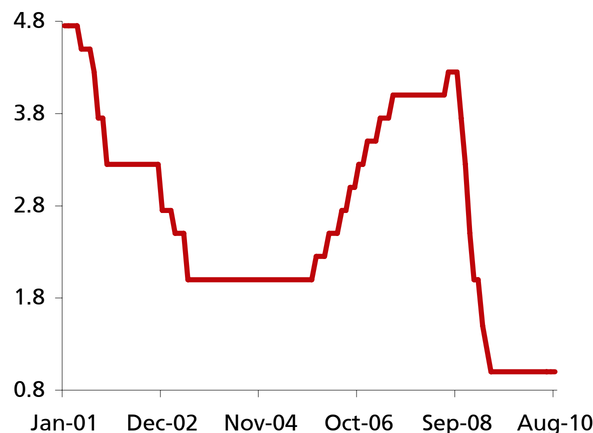
* % change, period-on-period, seas adj, annualised unless otherwise specified

EZ - nominal exchange rate

EUR per USD

EZ – policy rate

%, refi rate



Sources for charts and tables are CEIC, Bloomberg and DBS Research (forecasts and data transformations)

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