MARKET OUTLOOK

November 2011

How can Asia insulate itself?

Recent developments provided some optimism that the worst may be over for the sell-off in risk assets in Asia. While Citi analysts think the latest proposals from European policy leaders are unlikely to conclusively resolve the sovereign debt crisis, they believe it could put a floor to risk sentiment as it may avert a full-blown financial crisis. Still, the risks to global growth and the potential for financial spillovers persist. In this issue, we take a look at what Asian policymakers can potentially do to buffer the region from uncertainties stemming out of the developed world.

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How can Asia insulate itself?

Spillovers of global growth risks to domestic demand

The slowdown in export growth was more magnified in October, with most countries now exhibiting monthly seasonal-adjusted export declines. Citi analysts believe the first round of spillover effects of manufacturing weakness to domestic demand is likely to be seen in inventory de-stocking and slowdown in export-related investment activity. But the most important driver of consumption behaviour is wage expectations, which are determined by job market conditions. So far, unemployment rates in the region have been stable at historically low levels, but the unemployment rate tends to be a lagging indicator of export performance (by as long as 6-7 months). If export momentum continues to weaken, Citi analysts believe the unemployment rate, especially across key manufacturing countries, could start creeping up by November to December.

Europe's financial linkages – Beyond risk aversion, could credit availability suffer?

Recent developments provide some optimism that the worst may be over for the sell-off in risk assets in Asia. While Citi analysts think the latest proposals from European policy leaders are unlikely to conclusively resolve the sovereign debt crisis, they believe it could put a floor to risk sentiment as it may avert a full-blown financial crisis. The recent announcements from Europe appear to involve a 50% private sector involvement (PSI) or haircut for Greek debt, a bank recapitalization plan of €106 billion and leveraging the European Financial Stability Facility (EFSF) to the tune of €1-1.25 trillion. Citi's European economists argue that a 50% haircut for Greece and the size of proposed bank recapitalization is not enough to both put Greece on the path of fiscal sustainability (not to mention lingering insolvency overhang in Portugal and Ireland) and to address worries about bank system health. Thus, as strains in European banks persist for longer, there is likely to be growing pressure for European banks to tighten their lending standards and shed assets (to raise capital). There is already anecdotal evidence that European banks may be pulling credit lines in the region which would impact the real economy.

Within Asia, Citi analysts find that Hong Kong and Singapore (given the large role of financial services in the economies) as well as Malaysia look the most exposed to European bank claims (total foreign claims as well as claims on non-bank private sector). Thus, the spillover to tighter access to credit in the private sector could be larger there than other countries in Asia if banks were forced to retrench their balance sheets. Nonetheless, most are still less exposed than their Eastern European counterparts. Moreover, in Hong Kong and Malaysia's case, 77-78% of European banking claims are from UK banks, while Singapore's banking system is the best capitalized in the region.

How Can the Asia Region "Insulate" Itself?

First, by letting monetary policy be "a bit" more accommodative

Citi analysts expect Asian Central Banks to either remain on hold or ease their monetary policy stance. An important factor supporting the bias to pause or ease is the moderation to slight decline in inflation expectations, as well as the more favourable commodity price trends (energy and food) that facilitates easing inflation momentum across most countries. Nonetheless, with the exception of Indonesia, Citi analysts only expect very modest monetary easing, if any, across Asia.

- **Indonesia and Singapore have begun explicitly easing –** Indonesia likely to continue, Thailand to follow with (temporary) easing. Bank Indonesia has taken the lead, cutting policy rate by 25 bps in October and Citi analysts expect two more cuts by early 2012. The Monetary Authority of Singapore reduced the slope of its SGD NEER band and depending on how the growth trajectory in the next two quarters pans out, further easing in April 2012 cannot be ruled out (though the hurdle would be high given inflation risks). Bank of Thailand could cut rates by 50 bps before year-end, with a possible inter-policy meeting cut to support growth after the floods, but this is likely to be a temporary move. Assuming production recovers swiftly, these cuts may be reversed by 1H12.
- **Other easing candidates: Malaysia and Philippines –** While not yet Citi's base case, further downside risks to growth leave room for Bank Negara Malaysia and Philippines central bank (BSP) to ease. Malaysia's economy is relatively more vulnerable to global growth risks, inflation remains "managed" and an election cycle looms. BSP also has room to ease policy rates given benign inflation/inflation expectations, relatively high real interest rates and fiscally tight policy stance.
- **End of the tightening cycle this year –** India, Korea and Taiwan. The Reserve Bank of India has room to cut rates if inflation comes off next year as nominal rates are at historically high levels. Bank of Korea is expected to kept rates on hold until end of next year as growth risks weigh more heavily than inflation. With inflation risks remaining very muted but real rates very low, Taiwan's Central Bank is also expected to stay on hold until 2013.

- **China –** Financing conditions do not appear tight, thus outright monetary easing looks unlikely. However, Citi analysts see room to fine-tune monetary policy via a combination of policy rate hikes and reserve requirement ratio (RRR) cut.

Second, lean more on fiscal policy to support demand

While many governments in Asia can use fiscal easing, China's fiscal stance is likely the most important driver for regional growth and risk sentiment. While it is too early for China to announce a big fiscal stimulus, since growth remains resilient and inflation is high, two recent developments on the fiscal front support investor sentiment: 1) China announced some very mild fiscal easing measures; and 2) it announced steps to aid local governments. If growth risks were to escalate, Citi analysts think the government could more aggressively implement (front-load) infrastructure projects (social housing, rail/transport, water/irrigation), but rely more on central rather than local government funding.

Third, pursue structural reforms to create regional growth drivers

China private consumption share to GDP is falling, highlighting room for more re-balancing. But despite the rising investment-to-GDP share, the structure appears to be shifting towards sectors catering to domestic demand such as construction (especially social housing), agriculture and services. Citi analysts think there is much more room to facilitate consumer rebalancing that would lead to sustainable growth by expanding the services sector, boosting social safety nets, reform the income tax system, allow continued RMB appreciation, and eventually, liberalize the financial system including interest rates in order to better reflect cost of capital. The impetus for pursuing these difficult structural reforms favouring consumption should be greater in a prolonged weak global growth environment and when investment-driven growth is already reaching constraints.

Structural investment stories in other parts of Asia also remain at play. While Singapore, Hong Kong, Taiwan and Korea are already highly industrialized, the rest of EM Asia has significant need to upgrade infrastructure, especially as the population continues to urbanize. Among the Asian countries with a dire need for infrastructure upgrade, Vietnam and India face near term challenges with persistently high inflation and much tighter financing conditions (in Vietnam's case, a weakened banking system). However, for Indonesia and Philippines, there is plenty of capital and plenty of fiscal flexibility to boost development spending. The challenge is for these two to overcome institutional/regulatory hurdles to implementation.

Fourth, pooled reserve insurance to strengthen external buffer

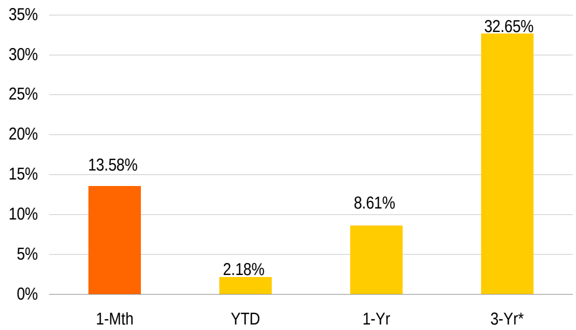
Asia as a whole clearly has a substantial precautionary reserve position. However, how these reserves are allocated vary substantially – some like China, Japan, Philippines, Taiwan and Thailand have excessive reserves, while others like Korea, India and Indonesia and Malaysia are not as "bulletproof". To offset risks from USD illiquidity during times of stress, and to prevent the risk of competitive devaluations or uneven currency sell-offs, Citi analysts think pooling foreign reserves via currency swap arrangements to buffer confidence in a country's external liquidity position could be very helpful. This may help bolster confidence in regional FX stability especially during a period of prolonged portfolio volatility. For example, Korea's recent currency swap lines may help bolster confidence in the won.

Fifth, facilitate regional financial Integration

Increased financial integration and reduced reliance on capital from the West could also help insulate Asia from contagion from the developed markets. Despite the region's significant trade integration, the process of financial integration has proceeded much more slowly. Citi analysts believe enhancing regional financial integration has benefits as it helps facilitate more efficient allocation of capital, risk-sharing across the region, improve access to financing (which can be used to support domestic demand), and helps reduce the sensitivity of the region to negative shocks in the developed markets (though on the flipside, greater regional financial integration raises contagion risks from shocks within the region). The lack of financial market integration in Asia has both supply side drivers (lack of development of financial markets, especially (corporate) bond markets, leaving limited scope for investment), as well as demand drivers (regulatory restrictions, costs of accessing, lack of development of non-bank financial sectors in some).

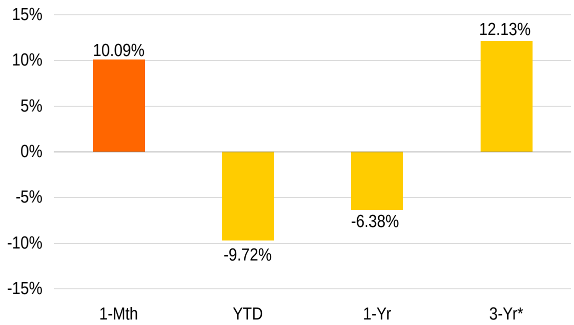
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 October 2011
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 31 October 2011
Source: Bloomberg

United States
Recession calls seem premature

- The reversal of some temporary drags from the first half has given near-term growth a boost as consumer and business spending have surprised. But Citi analysts continue to expect below-trend growth on average through next year, with the jobless rate likely to edge up slightly from already elevated levels. Fragile financial supports for growth and continued deleveraging are still important headwinds.

- Although some Federal Reserve (Fed) officials have kept alive the chances of new support for housing, Citi analysts think enhanced accommodation is more likely to be in the form of communications strategies to alter rate expectations. The scheduled expiration of payroll tax relief is likely to be extended but prospects for more substantive longer-term fiscal consolidation remain in limbo, with possible financial market repercussions.

- While there has been softer-than-expected data across a wide spectrum including leading indices and weak ISM orders, the recently released National Federation of Independent Business survey results does not intimate a dire outcome. Indeed, small businesses look a bit more ready to increase capital spending over the next three-to-six months. While there were still less than 25% of firms looking to increase capex, this was the best number seen in roughly three years. Small-business owners also seemed to suggest that financing conditions had eased and were likely to get even easier, possibly reflecting some thawing in credit availability and the typical lag between eased credit conditions and actual lending activity.

- If small businesses are truly the engine of the economy, it does not seem to be failing now. Thus, barring a credit collapse emanating out of Europe, Citi analysts believe that recession calls seem premature and equity markets look enticing.

Euro-Area
No interest rate cut anticipated in November

- The November Governing Council Meeting will mark the beginning of the era of President Mario Draghi at the European Central Bank (ECB). After the announcement at the last meeting of a huge range of decisions regarding the non-standard measures, Citi analysts do not expect new initiatives on that front in November. Neither is a different ECB approach on government bond purchases expected.

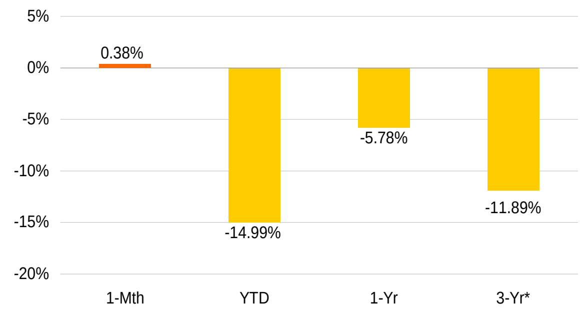
- While not ruling out an interest rate cut, which has already been discussed at the October meeting, Citi analysts expect that the ECB is likely to leave interest rates unchanged in the first meeting led by the new Italian ECB President. However, with more hard data and the new – most likely much weaker – ECB staff growth projections at hand, a rate cut of 50 bps to 1.0% is anticipated in December.

- In Citi's view, the recently announced Euro Area deal represents positive steps rather than a comprehensive solution to the region's sovereign debt and banking crisis. Confidence is being gradually underpinned, but there is still a long way to go. Details are still to be finalized on the latest deal and there will be execution risk. Furthermore, there are also concerns about the bigger peripheral economies.

- Nevertheless, Citi analysts believe that recent announcements are likely to help reduce extreme downside risks for European economies and equities. Indeed, Citi analysts believe that a combination of attractive equity valuations, increasing confidence, removal/reduction of extreme downside risk and investor positioning combine to present near-term upside risks for markets. Having said that, risks remain and clients should remain vigilant and not to get too carried away.

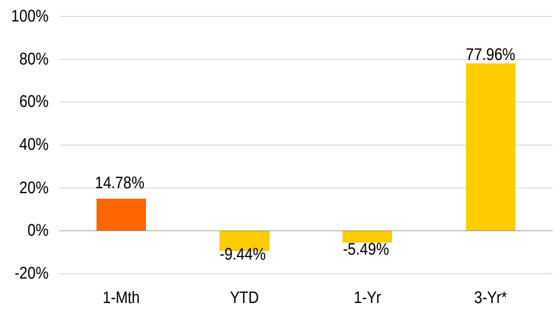
Equity markets

Chart 3:
Topix Index



*Denotes cumulative performance
Performance data as of 31 October 2011
Source: Bloomberg

Chart 4:
MSCI Asia ex Japan Index



*Denotes cumulative performance
Performance data as of 31 October 2011
Source: Bloomberg

Japan
Above trend growth of 2.1% expected in 2012

- While exports could probably stall in the first half of 2012 amid the continued slowdown in the global economy, reconstruction demand from the disaster is likely to provide timely offsets. As a result, Citi analysts expect above-trend growth of 2.1% for 2012. Meanwhile, reconstruction demand – in both public and private sectors – is likely to support economic activity in quarters to come. The Administration plans to propose the third supplementary budget of roughly ¥12 trillion in late October.

- The Bank of Japan (BoJ) may take additional easing measures depending on external developments. Possible policy options include: 1) reducing the interest paid on excess reserves; 2) strengthening its commitment to keep rates low for an extended period; and 3) extending the maximum maturity of JGBs that the BoJ buys under the asset purchase programme, from two years currently.

- Given concerns that the European and US economies could “turn Japanese”, Citi analysts take a look back at the Japanese stock market since the 1990s and examined investment strategies that worked during the “lost two decades”. In their view, key themes for the Japanese equity market are “deflation” “Internet”, and “unique technology + overseas expansion”.

- Base on historical reference, even if the European and US economies “turn Japanese”, they believe we could still potentially see relatively strong share price performance by companies that 1) have a business model able to benefit in a deflationary environment, 2) have appealing technology, and 3) can benefit from growth in demand from overseas markets.

Asia Pacific
Potential for further gains

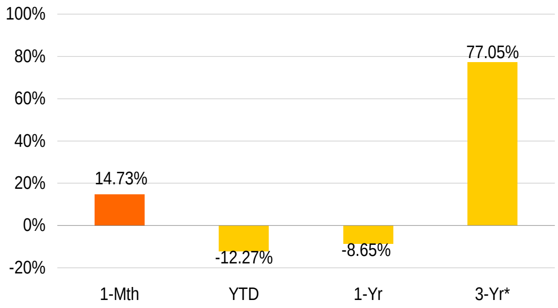
- Weakening exports could lead to further inventory de-stocking and slowdown in investment activity tied to manufacturing/trade. Unemployment (UE) rates in the region remain low and stable, but the UE rate tends to lag export performance by 6-7 months. Thus, if weakness continues, the UE rate could start creeping up by year-end.

- Citi analysts, however believe that Asia can potentially insulate itself from developed market uncertainties in the following ways: 1) Monetary policy can ease “a bit” as inflation expectations come off; 2) Governments have room to use fiscal policy, most importantly in China; 3) Structural growth drivers in the region can be pursued; 4) Pooled reserve insurance to strengthen external buffers; and 5) Greater regional financial integration to reduce contagion from the West.

- Equity markets have stepped away from pricing a Lehman II and have started to rally after EU leaders struck a deal to contain the sovereign debt crisis. Although the MSCI Asia ex Japan index is up 18.7% (as of October 31) from its low on October 5, Citi analysts see potential for further gains based on the following: 1) Risk appetite has returned, but we are a long way off the average let along peak levels of risk appetite; 2) Economic numbers as well as corporate earnings have been coming out better than expected in the US, EU and in Asia; 3) Valuations remain attractive both in price-to-book and price-to-earnings terms, and implied earnings based valuations show that expectations remain low.

- As risk appetite normalizes, valuations should too, and markets could continue to recover. North Asia still has the biggest valuation disconnect in terms of cheapness, while ASEAN looks expensive. Financials, real estate and cyclicals all look very attractive versus defensives and consumers.

Chart 5:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 31 October 2011
Source: Bloomberg

Emerging Markets
CEEMEA currencies could come under pressure

- Latin America appears to be coping well with global instability, though there has been a sharp deceleration in manufacturing and retail activity in some cases, particularly Brazil, where Citi's growth forecasts have been revised downwards to 3.3% in 2011 and 3.5% in 2012 (from 3.7% and 4%, respectively).

- Over in CEEMEA[1], the deteriorating global growth environment and announcements of fiscal austerity measures in Hungary have led Citi analysts to further downgrade their GDP forecasts to 1.1% and 0.5% for 2011 and 2012 respectively. Meanwhile, the Bank of Israel kept its rate unchanged at 3% as expected. Downside growth risks and stable inflation expectations could justify another cut by year-end.

- CEEMEA currencies, in particular the Hungarian Forint (HUF) and Turkish Lira (TRY) are expected to come under the most pressure. On the other hand, Latam currencies, particularly Mexican Peso (MXN) and Colombian Peso (COP) are anticipated to outperform.

- In Citi's view, Latam equities currently discount too pessimistic a decline in corporate earnings for next year. Backing out an implied 2012 EPS growth (assuming the long term average P/E is fair value), the market appears to be pricing in an earnings decline of 15%. While further downgrades to consensus estimates is expected, currently at +9%, regional EPS growth of 0-5% seems attainable. Citi analysts are overweight Brazil and Chile.

- In CEEMEA, Citi analysts are neutral on Russia based on new uncertainties over the policymaking environment as well as the potential for more weakness in crude prices. They are now overweight Czech Republic (alongside Turkey) given that it is likely to hold its value relatively well in the near term environment of continued uncertainty.

1. CEEMEA is the collective term for Central and Eastern Europe, Middle East and Africa.

Positive on High-grade corporates and Emerging market debt

US Treasuries

Slow growth and fading inflation pressures could keep rates low. In Citi's view, curves are likely to bull-flatten further but gains appear poised to be less robust.

US Corporates

The fundamental backdrop remains solid and valuations appear compelling. Citi analysts favour long-dated maturities and defensive sectors. On the other hand, while valuations have become more attractive for High-Yield bonds, Citi analysts remain cautious about gains for the sector in the near term as they expect risk assets to remain volatile and potential spread compression could be limited.

Euro Bonds

With greater room for monetary easing at the European Central Bank (hawkish members have hiked the refinancing rate twice this year, from 1.0% to 1.5%), Citi analysts favour short-dated German Bunds over short-dated US Treasuries.

Emerging Market Debt

Spreads are still attractive as improving fundamentals and credit quality of emerging market debt provides investors with a way to diversify their sovereign holdings from developed markets.