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Economic Update

Executive Summary

- **Political events in the United States and Europe region have dominated price actions across asset markets over the past weeks while fundamental economic developments and earning results have remained backstage.**
- **Incoming activity data from Japan has held up and we remain positive on Japan economy as we await post earthquake reconstruction benefits to flow through.**
- **Economic data from China continues to suggest a deceleration in growth. However we do not think that we are in a hard landing scenario.**
- **We believe it is unlikely that there will be an actual default in US debt. However, an eventual effort to reduce the amount of deficit in the United States will inevitably affect the country's economic development in the long run.**

Political events in the United States and Europe region have dominated price actions across asset markets over the past weeks while fundamental economic developments and earning results have remained backstage. Incoming activity data from Japan has held up while economic data from China continues to suggest a deceleration in growth. While we do not think that China is heading for a hard landing, a slow down in growth will affect performance of the Chinese equities. Meanwhile, we remain positive on Japan economy as we await post earthquake reconstruction benefits to flow through. As for United States, an eventual effort to reduce the state's budget deficit might inevitably affect the country's economic development in the long run.

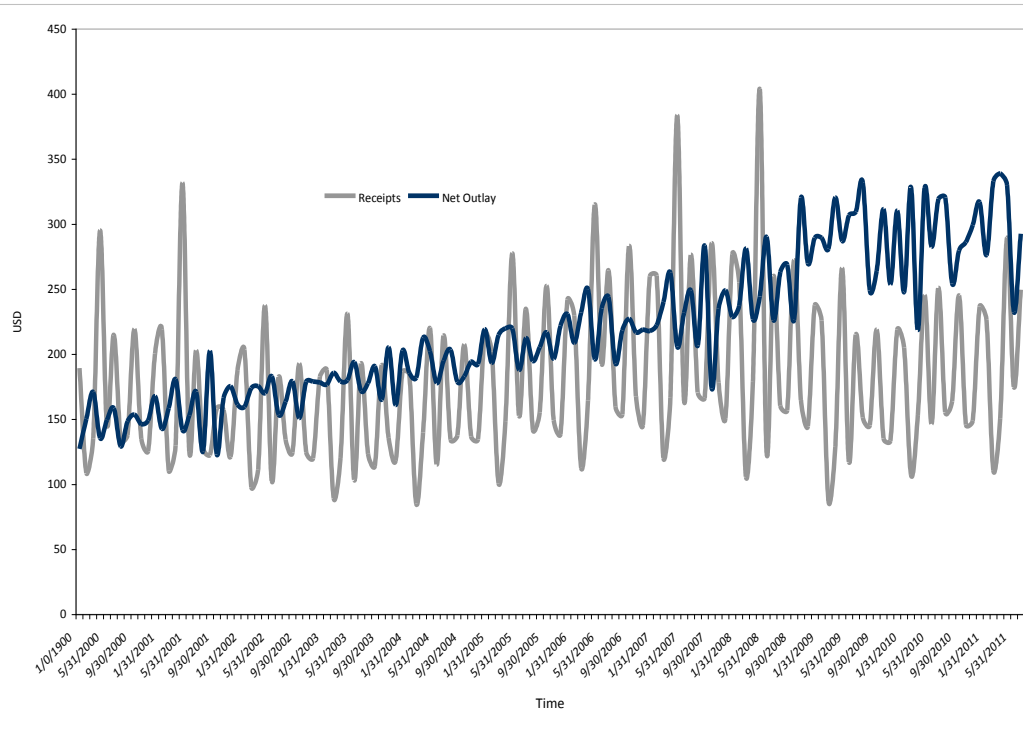
United States: Downside risk has increased

The focus has mainly revolved around the probability of United States defaulting on its debt. With discussion on rising the debt ceiling and reducing deficit still ongoing as of this writing, it is natural that there is fear that no agreement will be reached before the deadline (2nd August) and the country will default on its debt. It is crucial that the debt ceiling be raised, as the Treasury needs to pay interest and principal on maturing Treasury securities. In addition, there are other obligations to fund such as Social Security, Medicare and payment to federal workers. Incoming revenue is unable to support spending at the moment.

It is crucial that the debt ceiling be raised, as the Treasury needs to pay interest and principal on maturing Treasury securities as well as other obligations. Current revenue receipts are unable to support spending.



Figure 1: Outlay has exceeded receipt over the years



Source: Bloomberg, as of Jun 2011

We believe it is unlikely that there will be an actual default caused by the failure to raise the debt ceiling by the deadline. Instead, we do think that the debt ceiling is likely to be raised at the very last minute; accompanied by a substantial plan to reduce spending so as to stabilize the longer-term debt to GDP ratio. While that might help to avert a near term catastrophe, it remains possible that US debt will lose its AAA credit rating. Some implications with a credit downgrade include:

1. Interest rates will increase – In the near term, interest rates will rise on the basis that United States is deemed to be less creditworthy and therefore investors require higher interest rates to compensate the additional risks involve in holding US debt. Having said that, a caveat is that it is no secret that US has a high budget deficit all this while and the amount has been raising over the years. Despite so, the long term interest rates have remained low. Nonetheless, we still expect rates to rise in the long run, driven by steps taken to address the budget deficit and other economic factors such as inflation.

2. Pressure on the dollar – A downgrade may reduce the demand for US Treasury securities which in turn will reduce the demand for dollar. In addition, the dollar’s status as the world’s primary reserve currency will once again be challenged and this might put further downward pressure on the greenback. The dollar has been depreciating against other currencies, in particular Asian currencies. We do not rule out the possibility that the trend will continue especially in the event of a credit rating downgrade.

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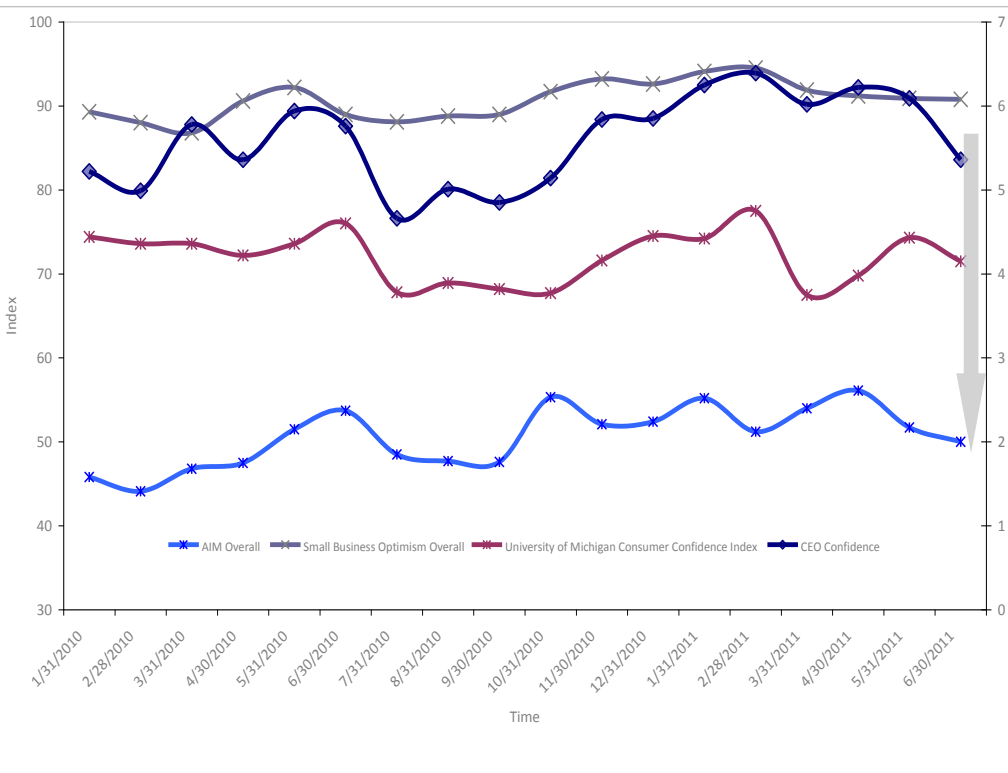
- 1) Rise in interest rates
- 2) Downward pressure on the dollar



Meanwhile in economic data, readings remain relatively soft. The manufacturing index rebounded from 53.5 to 55.3 in June, with the new order and employment component posting modest gains. The ISM Non-Manufacturing Index on the other hand remains in the expansion territory although new orders fell slightly. The labor market remains weak and housing prices continue to stay low as demand fails to improve - existing and new home sales are still trending downwards. In addition, sentiments among consumers and businessmen have declined recently. In all, there continues to be no sign of improvement in the areas that we are constantly monitoring (mainly the housing sector and labor market). With the policy makers running out of bullets to support growth, it might prove difficult for economic activities to sustain and downside risk has certainly increased.

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Figure 2: Confidence among consumer and businessmen has declined recently



Source: Bloomberg, as of Jun 2011

While the chronic structural problems within the economy continue to exist, commodities prices have eased off their highs recently and this in turn could support additional spending. Data releases over the next few months will be critical as it gives a clearer picture as to whether the economy is able to sustain without additional stimulus packages from the government. Like we have mentioned earlier, policymakers are running out of bullets and further deterioration in economic activities will not be positive for the US economy.

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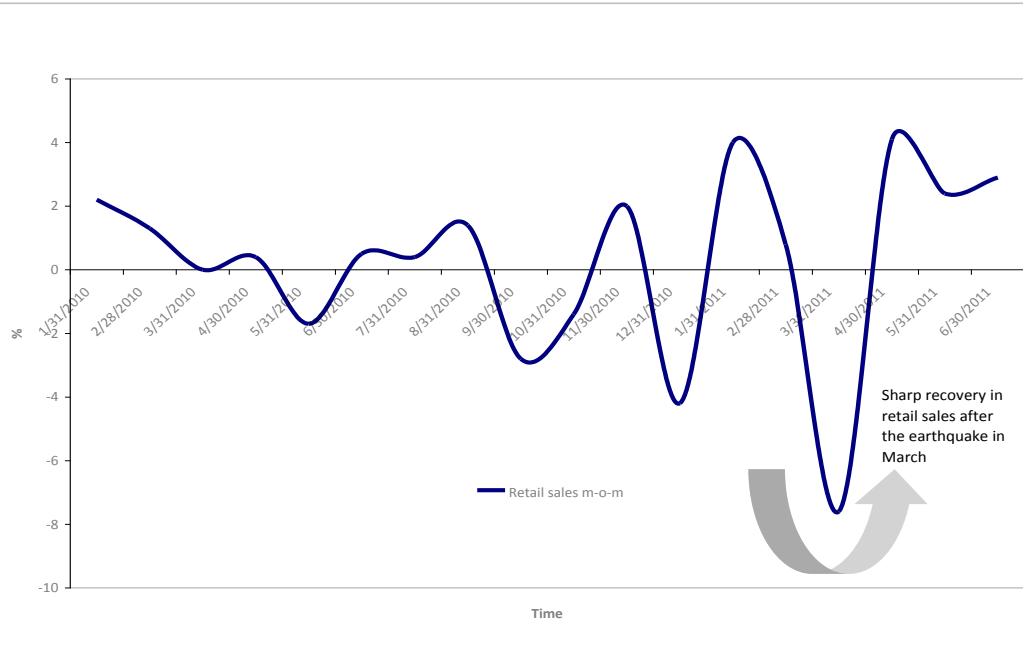
Japan – Continue to expect post reconstruction benefits to flow through

Japan posted its first trade surplus in three months in June. The country logged a 70.7 billion yen trade surplus last month, contrary to expectations of a deficit. According to a poll conducted by Dow Jones Newswires and the Nikkei Business Daily, economists had on average expected a deficit of 148.6 billion yen. Exports rose for a second consecutive month on a seasonally adjusted basis. The improvement partially reflects a recovery in industrial production since the earthquake in March and that this supply side recovery has enabled Japanese exporters to be able to meet overseas demand. Nonetheless, production might still be disrupted in the near term as constraints have been imposed on power supply.

Meanwhile, retail sales continue to increase. On a seasonally adjusted basis; sales rose 2.9% in June from the previous month; faster than the 2.4% gain in May. Compared to a year ago, it rose 1.1%. The gain came as households snap up energy efficient goods to cope with electricity shortages and also as they buy new TV before the switch to digital from analogue broadcasting. The steady momentum in consumption signals that consumers are more willing to spend as sentiment gradually recovers from the devastating earthquake

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Figure 3: Retail sales continue to pick up after the earthquake in March



Source: Bloomberg, as of May 2011

With activity data largely positive, we continue to be positive on Japan economy as we hold the view that the post-earthquake reconstruction will benefit the economy. Previously we note that disunity within parliament and the ruling Democratic Party of Japan is likely to cause deliberations on the budget to be held up. On 25th July 2011, the Diet passed an extra budget for reconstruction relief worth 2 trillion yen which will largely be funded through a surplus from FY 2010 rather than new bond issuances or tax increases.

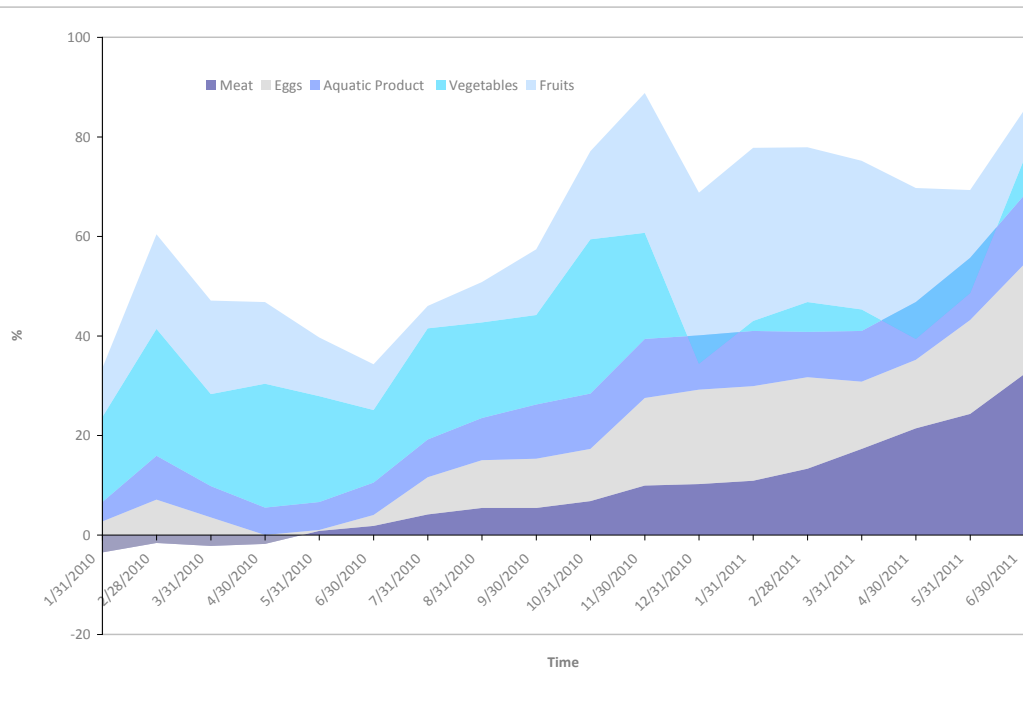


This budget is smaller than the first supplementary budget worth 4 trillion yen passed on May 2, 2011. With the Japan’s Cabinet office estimating the earthquake related damage to be approximately 16.9 trillion yen, we can reasonably expect another budget to be passed in time to come. To be able to finance the reconstruction costs and not breach the government’s limit on new bond issuance for the year, it is said that the government will increase taxes worth 10.3 trillion yen over the next five years. While details have not been announced as of this writing, future growth will inevitably be affected to a certain extent with the hike in taxes. Nonetheless, in the meanwhile, we remain positive on the Japan economy.

China: Still the same issue – inflation

Inflationary pressure persists. Consumer prices edged higher to 6.4% y-o-y in June. The hike came as meat prices soared. The government has released some pork supply from its reserves. However, higher prices look set to last for a while as the market takes time to adjust and as the Ministry of commerce reported that food prices are still on the rise. Nonetheless, we still expect headline inflation to ease on base effects and lower food/pork prices as supply picks up.

Figure 4: Rising meat prices



Source: Bloomberg. As of June 2011

Meanwhile bank lending in China rebounded in June. The total amount of new loans granted last month amounted to RMB 633.9, bringing the y-t-d total to approximately RMB 4.2 trillion. Relative to the same period last year, the current total is slightly lower by about RMB 0.4 trillion.

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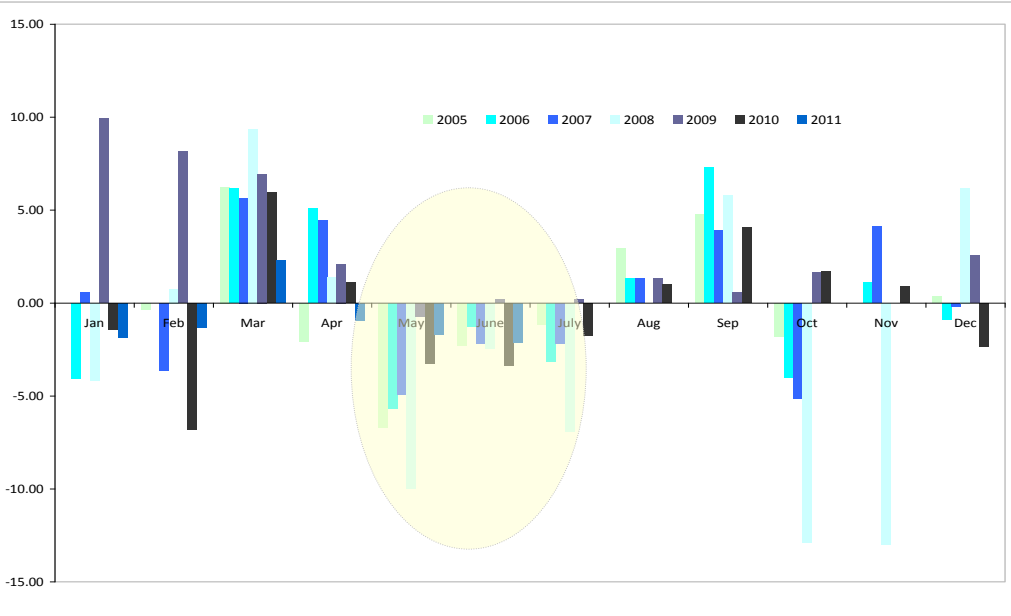
In line with surging CPI figures and bank lending, it was well within expectation that a rate hike will take place sooner or later. The PBOC raised the benchmark one-year deposit and lending rate by 25bp to 3.5% and 6.56% respectively. This is the fifth rate hike since the central bank began tightening in October 2010.

The effects of ongoing monetary tightening policy have been coming through. The latest evidence comes from the HSBC China PMI July reading. The July HSBC China PMI came in at 48.9. This is the first reading below 50 since July 2010 and it indicates a contraction in industrial activity. While questions have been raised as to whether this signals a hard landing in China, we think the weak print is partly due to the effects of policy tightening finally coming through. Meanwhile, the weakness can also be attributed to seasonal weakness in industrial activities in the months of May, June and July. It should be noted that the survey mainly involve small and medium companies and these companies have had limited access to credit facilities. Therefore activities are affected to a certain extent. Further weakness in industrial production in months to come will not be too much of a surprise as we expect the effects of tightening to continue to filter through

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Figure 5: Historically PMI tends to decline m-o-m in May, June & July



Source: Bloomberg. As of June 2011

Deceleration in activities has once again raised concerns over whether there will be a hard landing scenario in China. We have previously mentioned that a soft landing case is more probable and we continue to hold on to this opinion. China's commitment to affordable housing projects and private consumption growth should provide support for growth. These projects are driven by political imperative and hence should be less sensitive to monetary policy.

In sum, we continue to view the probability of a hard landing or severe slowdown scenario low. Growth in China will slow but remain higher than many developed nations. The Chinese government continues to be in a position to finance any stimulus program should the need arise.

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