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## Economic Update

### Executive Summary

- **We do think the risk of a recession in the United States has risen. While economic weakness in the first half of this year can be accounted by supply shock factors, aggregate demand on the whole has not picked up and this is a concern moving forward. For growth to be self-sustaining, private final demand (consumer spending and business fixed investment) must ultimately take the lead.**
- **Property curbs in China have been met with some success. The recent price decline can reasonably be expected to continue in the near term. While housing prices have been coming down, we do not expect a total collapse in the property sector. Support for this sector will come primarily from the government's effort to build affordable housing.**
- **We think the engine of growth for the Japanese economy will be led by domestic demand and public fixed investments in the near term. We remain positive on the Japan economy as we expect the post earthquake reconstruction benefits to flow through to the economy.**

#### **United States: It goes beyond the issue of whether a recession is imminent**

Recent actions in the market suggest that sentiments are mainly shifting towards the idea that another recession is imminent. However, few economic indicators currently signal a second recession. Data released in the last couple of weeks have provided the first look at key activity indicators in the third quarter and the tone has been generally positive. For instance, retail sales strengthened in July, rising 0.5%, led by a spurt in auto sales but with support from most other components. This followed a 0.3% rise the month before (originally up 0.1%). Excluding autos, sales were healthy, posting a 0.5% increase, following a 0.2% rise in June (originally flat). Gasoline sales rose 1.6% in the latest month after dropping 1.7%, supporting ex autos. Meanwhile, industrial production also grew. In July, industrial production posted a 0.9% gain; following a 0.4% rise the prior month. By major industry, manufacturing showed significant improvement, advancing 0.6%, following a rise of 0.2% in June (originally no change). The auto component recovered, increasing a monthly 5.2% after three consecutive declines including June's 0.9% decline. Excluding motor vehicles, manufacturing rose 0.3%, following a 0.2% rise in June; generally upbeat. In line with better production figures is an increase in capacity utilization rate. Overall capacity utilization in July improved to 77.5% from 76.9% the prior month. The above data has supported our argument that growth in the second half will be better than the first half as disruption in the supply chain improves.

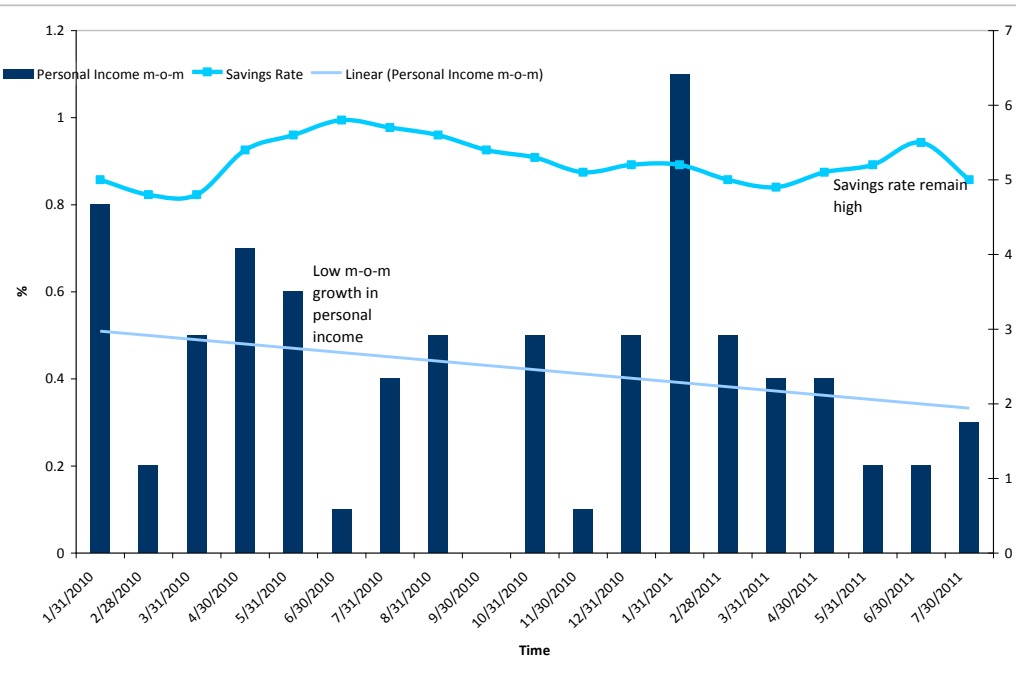
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While the above economic figures have supported our belief that growth in the second half is likely to remain positive but anaemic, the odds of a recession have certainly risen. A look at personal income level suggests that income growth has been on a steady decline. The m-o-m growth in personal income has been declining from 1.1% in January to 0.3% in the latest reading. In conjunction with that, people are saving more. Low income growth and high savings rate is not positive for the economy. Moreover, the job market remains depress and the housing sector is still weak. It is difficult for growth to be self-sustaining with such weak economic fundamentals. Meanwhile, the Fed is running out of tools to spur the economy. The fiscal locker is shut by the need to assuage concerns about fiscal sustainability, while room for monetary easing, which was aggressive in late 2008 and Q1 09, is also more constrained.

*The odds of a recession have risen as it is difficult for growth to be self-sustaining with weak economic fundamentals: Income growth is low and savings rate is high. Meanwhile, the job market remains depress and the housing sector is still weak.*

**Figure 1: Low income growth & high savings rate**



Source: Bloomberg, as of July 2011

Proponents of a new round of quantitative easing say that the Fed will have to act to try to avert what could quickly become a double dip recession. Even if a rabbit is pulled out of the hat (i.e. a stimulus is introduced) along the way to shove up an anaemic economy, it is in our view that these measures will just be a short-term solution to a long-term problem. Put it another way, introducing a third stimulus only provides temporary support to the economy; growth will still not be self-sustaining, as the underlying problems in the economy remain unresolved. Looking back at QE2, it has indeed boosted the stock markets and instilled confidence among investors. However, the wealth effect associated with a rising stock market did not come through. Consumption has not increased by a substantial amount (possibly also because the positive effects of rising stock prices have been almost equally counteracted by the commensurate rise in commodity prices) and unemployment rate remains at elevated levels.

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During the 8 months prior to QE2, total employment (BLS Household Survey) increased by 386,000. Over the 8 months of QE2, total employment rose by only 250,000. Instead, what these short-term measures have done was to merely add onto the government debt and also devalue the greenback.

Although we continue to believe growth in the United States is likely to remain positive (but anaemic) in the near term, we do think the risk of a recession has risen markedly. While economic weakness in the first half of this year can be accounted for by supply shock factors, aggregate demand on the whole has not been picking up and this is a concern moving forward. For growth to be self-sustaining, private final demand (consumer spending and business fixed investment) must ultimately take the lead.

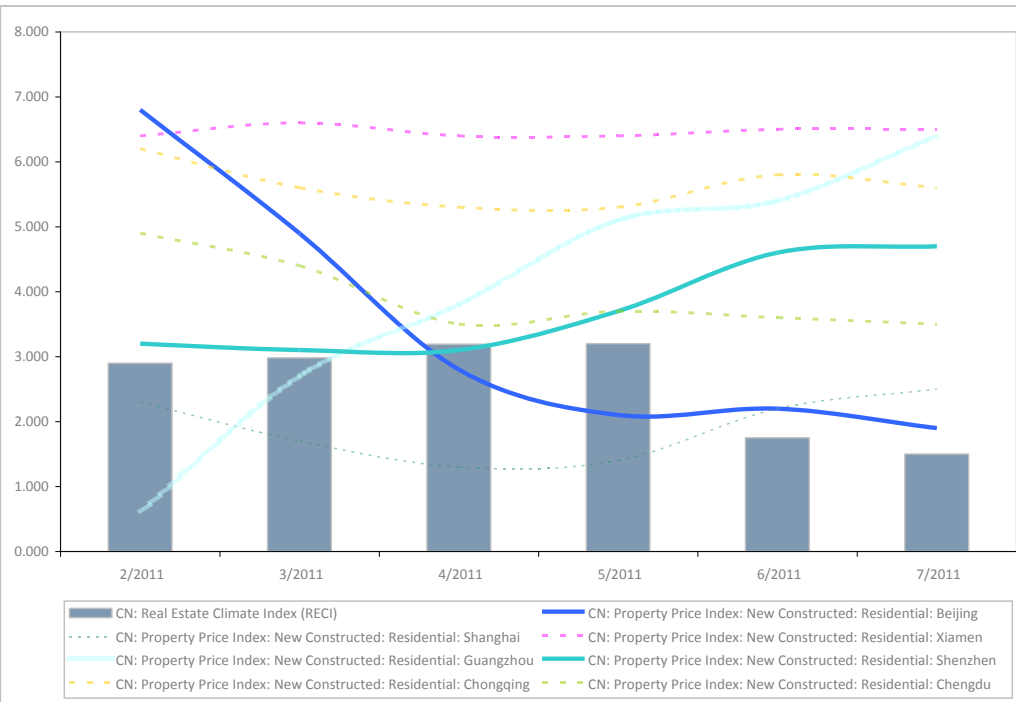
**China: Property curbs met with some success.**

Rocketing property prices have been a major government concern since the start of the year. Fearing that ordinary citizens are unable to afford an apartment, the Chinese government has restricted the purchase of a second or third home by requiring higher down payments for mortgages and instituting new property taxes in cities like Chongqing and Shanghai. These measures have recently been met with some success; new home prices fell in 14 of the 70 cities monitored by the government. However, from a year ago, new home prices are still mostly higher. In Beijing, new home prices rose 1.9% in July from a year ago, while prices in Shanghai advanced 2.5%. Nonetheless, it is notable that the rate of increment in some areas (such as Beijing) has been easing. Meanwhile, existing home prices in Beijing rose 1.8% in July from a year ago and in Shanghai, prices gained 3.8% from last year

*In the near term, we do think the risk of a recession has risen markedly. While economic weakness in the first half of this year can be accounted for by supply shock factors, aggregate demand on the whole has not picked up and this is a concern moving forward. For growth to be self-sustaining, private final demand (consumer spending and business fixed investment) must ultimately take the lead.*

*Property curbs in China have been met with some success.*

**Figure 2: Property curbs met with some success**



Source: CEIC. As of July 2011



The recent price decline in China properties can reasonably be expected to continue in the near term. There are two reasons for this. Firstly, we can expect more second and third tier cities to introduce purchase restriction policies. Secondly, some Chinese developers, including Vanke and Poly have started to cut prices slightly in order to boost sales as the market outlook turn against them. Other developers are expected to follow suit in the next few months as they speed up efforts to sell down record high inventories. Indeed, inventories have been piling for some developers. For instance, China's Vanke Co, the country's largest property developer by market value, had 171.37 billion Yuan of unsold houses as of June 30, up 28.5% from three months earlier.

While moderation in housing prices is what the government has been striving to achieve, the fact that prices have been coming down has led to concerns as to whether this sector will slow drastically. First and foremost, we do not expect a total collapse in the property sector. However, we do expect this sector to moderate. With a record amount of inventory, we can expect developers to go slow on building new projects. Support for this sector will come primarily from the government's effort to build affordable housing. Indeed, property investments have remained strong. Property investments in China grew 33.6% in the first seven months of this year from the same period a year earlier. State owned and holding enterprise real estate investment grew 22.5% year to date, up from the 18.5% in the first half of the year. On a lighter note, a lack of a broader set of financial instruments for the population to invest in will also provide some support for this sector. As such, while we do not expect a total collapse in this sector, a slowdown in this area might be inevitable.

While a slowdown in the property sector will inevitably have an impact on the economy, we continue to hold the view that the probability of a hard landing or severe slowdown scenario in China is low. China's commitment to affordable housing projects and private consumption should support growth.

#### **Japan:**

Japan's economy shrank at an annualized rate of 1.3% in the three months ending June 30, marking three consecutive quarters of declines. The contraction was less than the 2.5% decline expected by 25 economists surveyed by Bloomberg. The result also marked an improvement from the first quarter, when the nation's economy shrank at a 3.6% annualized rate. The boost came from non residential investments which grew 0.2% q-o-q as well as public fixed investment which expanded 3% q-o-q. This suggests that both the public and private sector have embarked on post earthquake reconstruction efforts. Domestic consumption has also been resilient despite the catastrophe in March, adding 0.4% q-o-q.

Most indicators starting July have been largely strong, with industrial production rising for three straight months since the plunge in March. Companies are forecasting that they will boost output this month to make up for lost capacity resulting from the natural disaster. With the recovery of supply chains, growth in the second half of the year can be expected to be higher. Meanwhile, policy makers are planning on the third earthquake reconstruction budget. Two budgets have been passed and the sum has been used to clear debris and also build

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*Japan's economy shrank at a slower than expected pace in the three months ending June 30. The boost came from non residential investment and public fixed investment.*

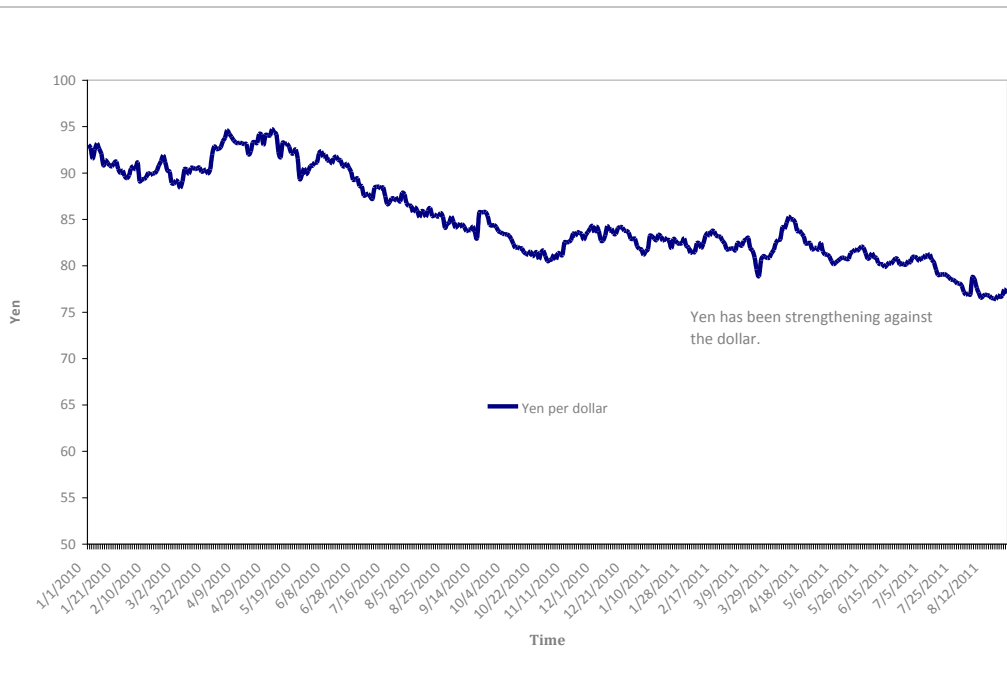
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temporary homes in disaster-hit areas. As such, when the third budget takes place, the funds could be spent on other forms of public investments, which could provide support to the economy in the months ahead even as other countries continue to slow. Therefore, with recovery in the supply chain and as other forms of public investments take place, there will be some form of support for the economy.

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**Figure 3: Yen has been strengthening against the dollar**



Source: Bloomberg. As of 26<sup>th</sup> Aug 2011

A threat to growth lies in the strength of the Yen. Yen has appreciated as much as 5% against the USD since the beginning of the year. With regards to a strong Yen, the Japanese officials have signalled that they would intervene in the currency market so as to keep Yen weak. However, a subsequent \$100 billion effort aim to help companies cope with a surging yen was unveiled. Such actions seem to suggest that the officials may have be resigned to the currency remaining high and that businesses need to come up with their own ways to deal with the strengthening currency. A strong Yen will weigh on exports and capital spending and hence dampen growth momentum. Exports have been strong as supply catch up with demand in the aftermath of the earthquake. Indeed, auto exports have been on the rise. However, if Yen was to remain strong, demand for Japanese export might be dampened.

*A threat to growth lies in the strength of the Yen the*

Meanwhile, a strong yen will also make imports cheaper and this is positive as imports are likely to remain strong due to increase in oil imports as a substitute for nuclear energy as well increase in demand linked to post-earthquake reconstruction. From a net export perspective, we do not think that this area will contribute much to the country's growth in the months ahead.



In all, we think the engine of growth for the Japanese economy in the near term will primarily be led by domestic demand as well as public fixed investments. With the imminent arrival of the third earthquake reconstruction budget, we remain positive on the Japan economy as we expect the post earthquake reconstruction benefits to flow through to the economy.

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