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Policies start to shift direction

Executive Summary

➤ **China:** While real estate investment is likely to come down in months ahead and the manufacturing sector has also shown signs of softening, a hard landing scenario (while not totally impossible) remains unlikely. Like we have mentioned before, the Chinese government stands ready to prop the economy and recent actions have also shown their commitment in doing so. With inflation coming down, it will give them more room to promote growth within the country. For overall policy bias to shift from tightening to loosening will be conditional on more definite downside risks to both inflation and growth.

➤ **United States:** It is not exactly a disaster that no deal was struck by the deadline. Failure to reach an agreement just means the automatic across-the-board budget cuts will be triggered in 2013. Sector most at risk would be the defense sector. In turn, share price of companies dependent on US defense contracts will also be affected. An immediate and bigger concern is the likelihood that the various tax cuts, set to expire at the end of this year, will be extended. Failure to extend the cut is likely to have a detrimental effect on next year's growth. Meanwhile, while Fed officials held detailed discussions over alternative monetary policy strategies, we do not think the flow of economic data is going to be weak enough to push the Fed into announcing more easing in the next FOMC meeting in December.

China: Government support and actions is the key

We have not heard the last of the property market –impending risk

Previously, we wrote that property prices have been on the decline in China. This trend continued and accelerated in October. China's National Bureau of Statistics (NBS) reported that the sales prices of newly constructed residential buildings fell in 33 of 70 cities tracked by the government, an increase from 16 cities in September. Prices in 23 others were unchanged. The m-o-m increase was less than 0.2% for those cities with increasing prices. Relative to a year ago, the sales prices decreased in two cities (Ningbo and Wenzhou) while the y-o-y increase rate dropped in 59 cities. Falling values of real estate investments has caused developers to feel a backlash from early homebuyers. According to Chinadaily.com, the higher-than-expected price decline has triggered strong protests from earlier buyers in Beijing and Shanghai, with some storming sales offices asking for refunds.

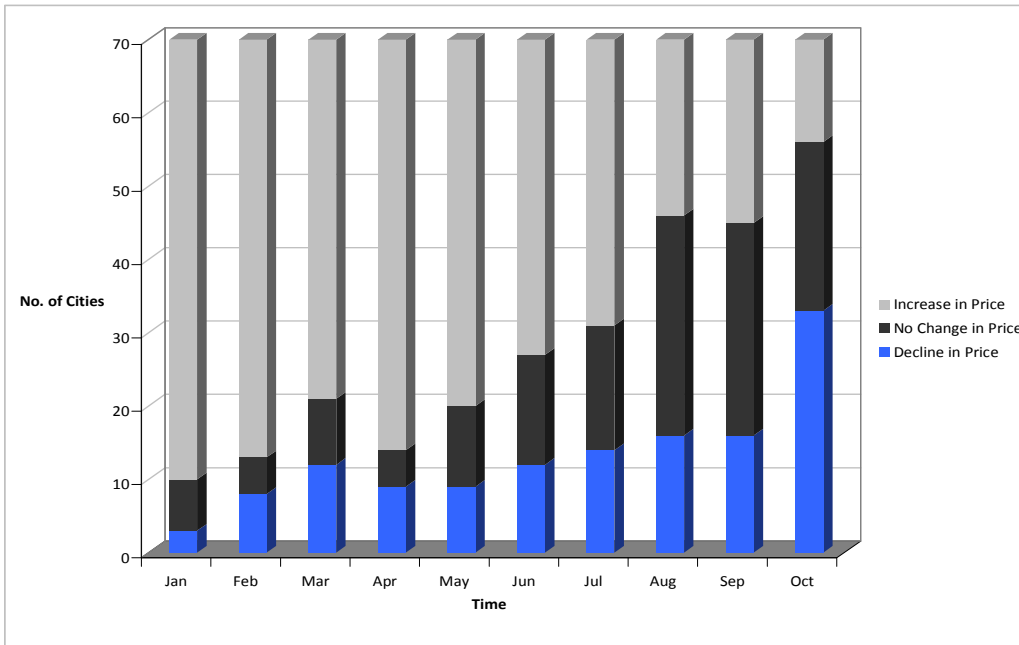
Inline with the poor showing in newly constructed residential buildings, sales prices of second-hand residential buildings also decreased. It fell in 38 cities, 13 more as compared to the month of September. 19 cities remained at the same level. The m-o-m increases were less than 0.5% for cities with increasing prices.

While the focus has been very much been on residential property prices, we note that prices of commercial buildings have also been softening. The cost per square meter of a commercial building in October relative to the start of the year is lower by approximately 4%. Commercial buildings were pushed higher earlier in the year partly triggered by the central government's tough restrictions on residential property trading, which diverted capital into the commercial property market.

Property prices continued to fall in October. This declining trend is not only seen in newly constructed residential buildings. It is also seen in second-hand residential buildings and commercial buildings.



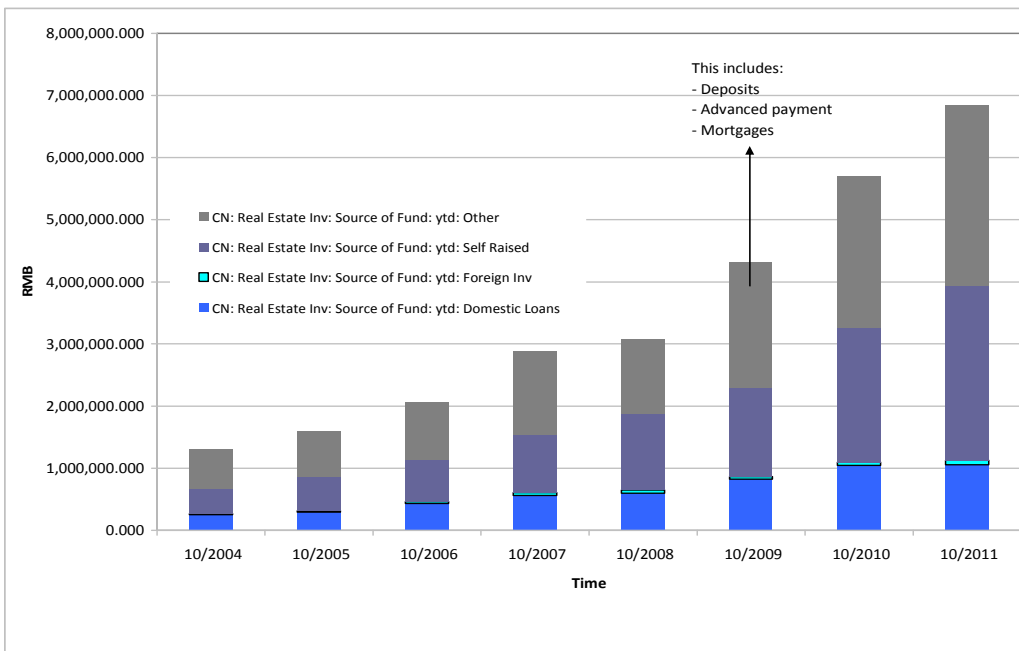
Figure 1: More cities report a fall in sale price of newly constructed buildings



Downward trend in prices is likely to persist as developers are pressurized into reducing prices further so as to secure more sales.

Source: CEIC & UT Research Calculation, as of Oct 2011.

Figure 2: Bulk of funds in system comes from enterprises and commoners



Nonetheless, we do not think poorer sales will lead to systematic risk in the Chinese banking system as bulk of the funds which participated in the system comes from enterprises and commoners.

Source: CEIC, as of Oct 2011.

This downward trend in prices in residential buildings is likely to continue as developers are pressurized into reducing prices further so as to secure more sales, especially as we approach the end of the year. As mentioned previously, we do not think poorer sales (which leads to higher probability of default among developers) will lead to systematic risk in the Chinese banking system. This is because bulk of the funds which participated in the system comes from enterprises and commoners. This is shown in the figure 2.



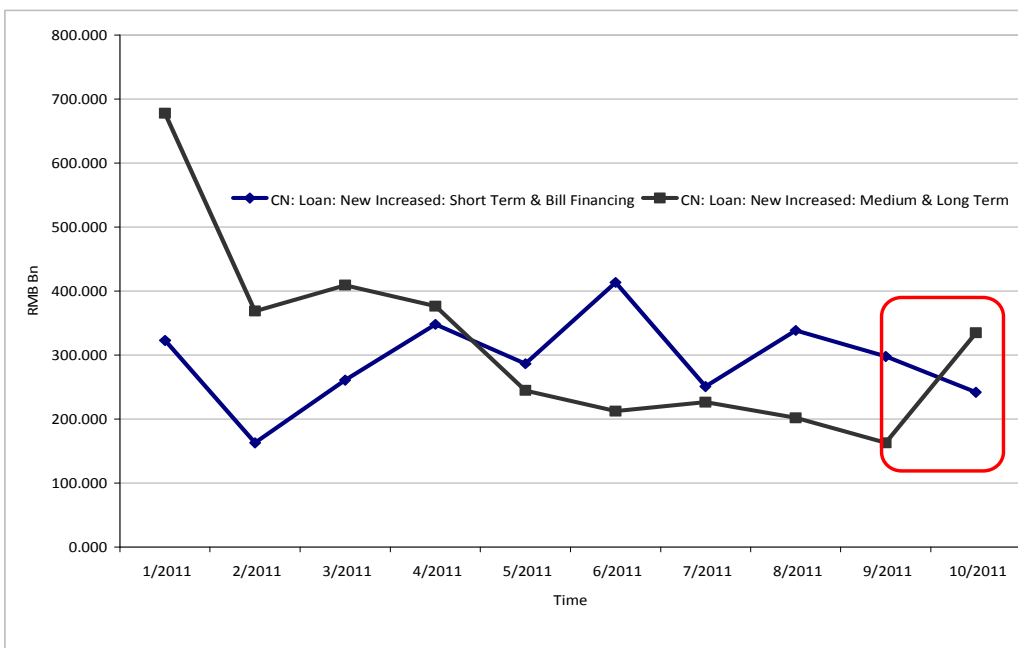
While the above is the case, a bigger concern is the impact of poorer sales on real estate investments and hence the impact on the Chinese economy. From January to October, investment in real estate development was 4,992.3 billion Yuan, a y-o-y growth of 31.1%, of which, the investment in residential buildings reached 3,583.2 billion Yuan, up by 34.3%. With sales set to slow as buyers adopt a wait and see approach, investments in this area are set to slow as well. Current investments in real estate development account for approximately 20% of total investment in fixed assets. While 20% may not seem a lot, it remains important on everything from global steel and copper prices to the final products in the economy that are related to the property sector. The knock-on effect to the economy remains significant.

Nonetheless, a crash is unlikely in the near term. While the central government has expressed that they wouldn't want to stop tightening in this sector as yet, should conditions deteriorate, they could be forced into reversing some of the tightening measures implemented earlier in the year.

Lending rebound, policy starts to turn

Bank loans registered an uptick in October. The value of outstanding RMB loans rose by RMB 587bn in October, higher than the RMB 470bn in September. The rise in bank loans was due to a rebound in medium and long-term loans and it coincides with the time in which the government urged banks to lend more to smaller firms. Therefore, the rebound in bank loans can be seen as a return of funds to banks.

Figure 3: Rise in medium and long term loans



Source: CEIC, as of Oct 2011.

To a certain extent, the rise in loans should not be overhyped as PBOC now focuses more on total social financing. Total social financing declined from the beginning of the year, falling from 4.2 trillion Yuan in 1Q to 3.6 trillion Yuan in 2Q and 2 trillion Yuan in 3Q. This trend probably continued in October, partly illustrated by slowing M2 growth. PBOC may make efforts to ensure that bank credit grows at a reasonable pace, especially as non-bank lending starts to shrink as a share of total social financing in recent months.

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A crash in the property sector is unlikely in the near term. Should conditions deteriorate, the central government could be forced into reversing some of the tightening measures implemented earlier in the year.

Amount of new loans rose in October due to a rebound in medium and long term loans; coinciding with the time in which the government urged banks to lend more to smaller firms.

The rise in loans should not be overhyped as PBOC now focuses more on total social financing, which has been declining from the beginning of the year.



Meanwhile, there are growing hints and signs that policy is starting to shift direction. The latest hint came from the Monetary Policy Report. The third quarter Monetary Policy Report was released on 16th November and relative to the previous quarter report, the latter incorporated some changes in policy tone. They include:

- Changed “price stability as the top priority” with “maintaining overall price stability and preventing systemic risks”.
- Modified policy target from “ensuring reasonable total social financing” to “ensuring reasonable growth of money, credit and total social financing”.
- Pointing to the importance of appropriate “fine tuning” in macroeconomic policies.

In fact, selective easing took place in October when the government called on commercial banks to extend more credits to small enterprises across the country. The latest effort comes from the easing of lending restrictions for small banks. The PBOC has reduced the reserve requirement ratio for six rural lenders in the coastal region by half a percentage point. For the central bank to adopt an overall loosening bias will depend very much on level of growth and inflation. Nonetheless, for now, “fine tuning” should continue in the coming months.

Although monetary easing is generally positive for the stock market, recent loosening is unlikely to cause Chinese equities to move in a big way. This is because policy response this time is probably not going to be as massive in scale (unless situation in Europe deteriorates drastically) as three years ago. In 2008, the Chinese not only reduce the lending rates and reserve requirement ratio, it also announced various stimulus programs. A repeat of the above is unlikely for now. In addition, global economic backdrop is less supportive for equities at the moment. Hence, any boost to China’s stock market as a result of recent monetary easing is likely to be capped.

In all, while real estate investment is likely to come down in months ahead and the manufacturing sector has also shown signs of softening, a hard landing scenario (while not totally impossible) remains unlikely. Like we have mentioned before, the Chinese government stands ready to prop the economy and recent actions have also shown their commitment in doing so. With inflation coming down, it will give them more room to promote growth within the country. For overall policy bias to shift from tightening to loosening will be conditional on more definite downside risks to both inflation and growth.

United States:

No super committee, not as awful.

The super committee was tasked to recommend ways to trim \$1.2 trillion from the country’s budget deficit at least two days before 23rd November. Not too surprisingly, no agreement was reached 48 hours before the deadline. The co-chairs of the super committee announced that they have failed to reach a deal on reducing federal government deficits. Markets headed south and volatility spiked upon the announcement; S&P 500 declined close to 2% on 21st November.

It is not exactly a disaster that no deal was struck by the deadline. Failure to reach an agreement just means the automatic across-the-board budget cuts, spanned over 10 years, will be triggered in 2013. The cuts will be split equally between defense and non-defense programs (such as education and public housing programs). Meanwhile, programs such as Children’s Health Programs, Social Security and others will be exempted from the cuts. Needless to say, with the automatic tax cuts, the sector most at risk would be the defense sector. In turn, revenues, profits and

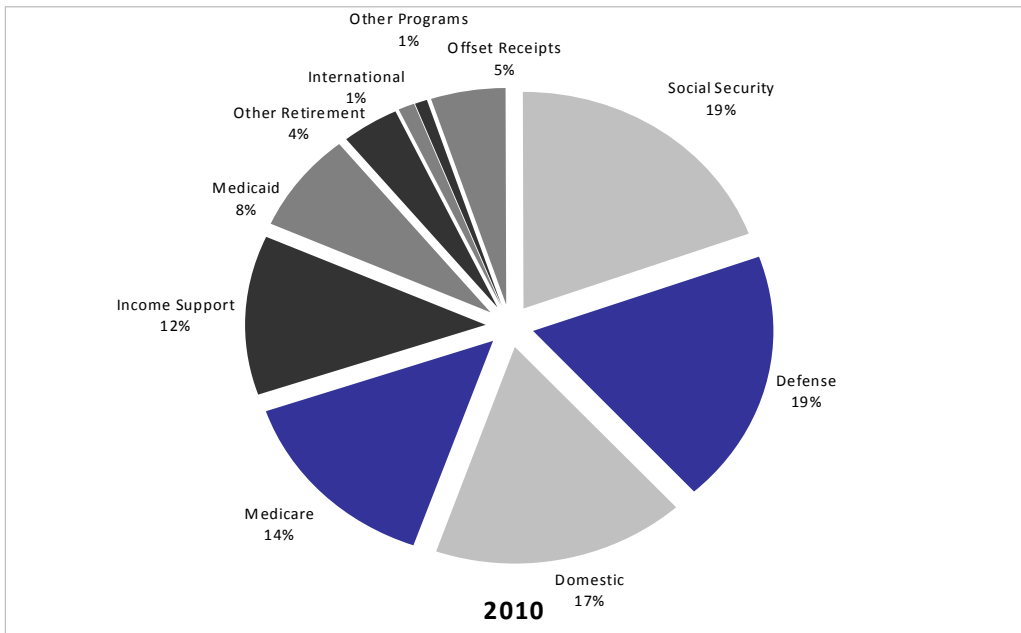
Policy has start to shift. Selective easing took place in October when the government called on commercial banks to extend more credits to small enterprises across the country. The latest effort comes from the easing of lending restrictions for small banks.

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Figure 4: Defense sector and companies dependent on US defense contracts most at risk with automatic tax cuts



Source: Bloomberg, as of Dec 2010.

eventually the share price of companies dependent on US defense contracts will also be affected.

Despite so, we should also note that there is still a considerable amount of time before the automatic spending cuts kicks in officially. From now till then, legislation to exempt more programs could still be introduced, approved by both chambers of congress and signed off by the president. As such, the ultimate impact on the US economy and the various industries and sector cannot be fully determined at the moment.

An immediate and bigger concern with the failure of the super committee is the likelihood that the various tax cuts, set to expire at the end of this year, will be extended. The payroll tax cut was reduced from 6.2% to 4.2% this year. However, this amount is set to revert to 6.2% on January 1, 2012. Although extending the payroll tax cut for another year would be costly, failure to do so is likely to have a detrimental effect on next year's growth. While consumption has held up in recent times, it is likely to be affected by the expiration of the payroll tax cut. Moreover, people will also be more inclined to save in view of the uncertainty in the global environment. Meanwhile, businesses are also concerned with the expiration of the R&D tax credit and other expiring tax provisions.

Latest FOMC meeting minutes reveal extensive discussion on unconventional policy easing; QE3 remains unlikely.

On the economic front, data has not been too disappointing (but not spectacular). Bank lending rose both among consumers and businesses. Existing home sales increased 1.4% in October to a 4.97 million annual rate. At the current sales rate, supply is down to 8 months from 8.3 months in September and well down from the 10.6 months registered in the same period a year ago. Meanwhile, headline inflation is cooling. The consumer price index (CPI) in October declined 0.1%, following a 0.3% boost in September. From a year ago, CPI rose 3.5%, a substantial slowdown

The sector most at risk with the automatic tax cuts would be the defense sector. In turn, companies dependent on US defense contracts will also be affected.

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An immediate and bigger concern with the failure of the super committee is the likelihood that the various tax cuts, set to expire at the end of this year, will be extended. Failure to extend the cuts would almost certainly have a detrimental effect on next year's growth.

Recent economic data has not been too disappointing.



from the 3.9% y-o-y pace recorded in September. The deceleration in headline CPI can be attributed to a decline in the energy component of the CPI basket. Energy declined 2.0%, following a jump of 2.0% in September. Gasoline dropped 3.1% after spurting 2.9% higher in September.

While data has held up lately, latest FOMC meeting minutes revealed that most FOMC participants see downside risks to growth greater than upside risks. The biggest risk to growth is the potential effects from European sovereign debt developments on financial markets. In response to the growing concern, the minutes also revealed that Fed officials held a detailed discussion over alternative monetary policy strategies as well as enhancing clarity of their public communications. For instance: the committee debated over specifying an inflation target, and possibly clarifying other aspects of the committee's longer-run goals. While participants pointed to the merits of specifying an explicit longer-run inflation goal, it was noted that such a step could be misperceived as placing greater weight on price stability than on maximum employment. Other guidance that were raised during the meeting include: publishing an explicit path for the federal funds rate and introducing a nominal GDP target.

Recent statements by Fed speakers are certainly encouraging in terms of prospects for more unconventional policy easing by the Fed. However, we do not think the flow of economic data is going to be weak enough to push the Fed into more easing. As such, probability that QE3 will be announced when the FOMC meets again in early December remains low.

For now, we continue to hold the view that there are still a number of internal structural problems that the country must work towards resolving, although recent economic data has held up. Only when these issues are resolved, will the current economic momentum strengthen and be sustainable.

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