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Economic Update

Executive Summary

United States: We maintain our stance that QE2 will not make a huge difference to economic conditions. Growth will continue to slow in the United States.

China: We believe the Chinese government will continue to try to rein in any asset price inflation and these actions will inevitably affect the broader economy. Therefore, in the short run, we maintain our stance that growth in China will decelerate. However, in the long run, we remain positive of the prospect of this country.

Capital flows into Asia set to bring stock market bubbles?: Valuations for Asia Pacific ex Japan are reasonable for now. However, in terms of individual countries, Indonesia looks expensive.

United States: Economic data is improving; QE2 will have minimal impact on the economy.

Economic data response:

Of late, economic data is largely improving. The Institute for Supply Management (ISM) reported that its manufacturing index advanced in October to 56.9 from 54.4. Some leading indicators also showed surprising improvement. New orders jumped to 58.9 from 51.1, while inventories dropped to 53.9 from 55.6. On the service side, which makes up close to 70% of the US economy, the ISM Non-Manufacturing Index has also performed better, moving to 54.3 from 53.2. Employment readings in both indexes were also upbeat.

Meanwhile, although the overall job picture remains sluggish, the initial jobless claims recently broke below the 450,000 range. The October labor report did surprise on the upside, showing that although the unemployment rate remained at 9.6%, payrolls were up by 159,000. Despite the continued weakness in the labor market, retailers recently reported largely better-than-expected results and sounded broadly optimistic about the holiday season.

Impact of Quantitative Easing 2 (QE2) on US economy:

The Federal Reserve announced plans to buy \$600 billion Treasury to stimulate the economy. The Fed announcement was unusually direct for the central bank. Instead of reassessing its bond purchase every month given the current economic conditions, the Fed has pledged to purchase \$75 billion of Treasury each month through the middle of next year.

The manufacturing and service sector continue to expand. Overall job picture remains sluggish. Despite so, retailers recently reported largely better-than-expected results and sounded broadly optimistic about the holiday season.

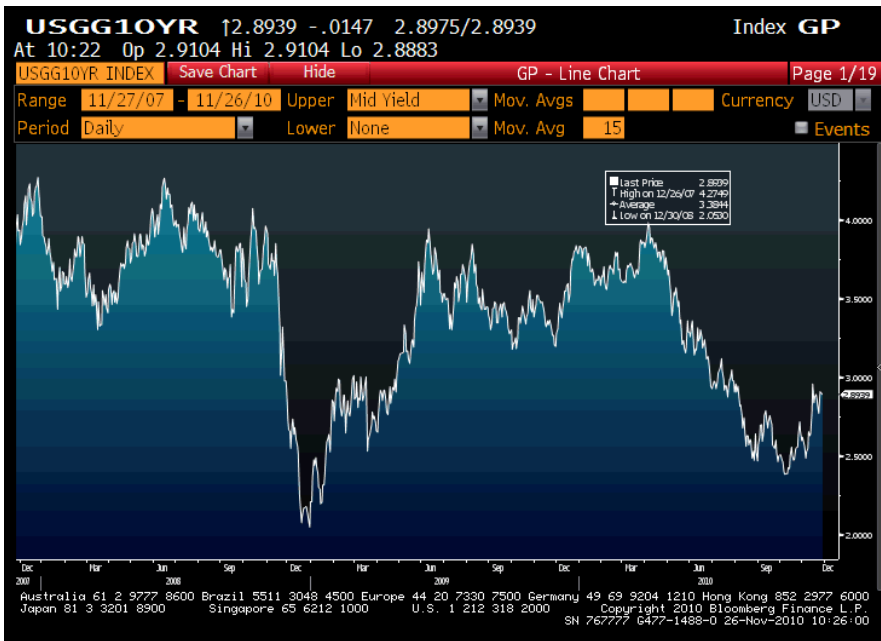


We maintain our view that QE2 will not make a huge difference to economic conditions. This is so because an objective of QE2 is to push down long-term nominal rates so as to stimulate demand for loans (i.e. increase circulation of money). However, long-term interest rates have already been low for a while (even before expectations of further QE), but US consumers and businesses have been unusually reluctant to take advantage of this. Indeed, the Fed's latest survey of Senior Loan Officers revealed a disturbing drop-off in the demand for new loans and a renewed tightening of credit conditions for residential mortgages and other consumer loans.

Despite so, on an encouraging note, QE2 can have a positive effect in a different way by supporting asset prices through portfolio rebalancing (as investors who have sold government bonds to central banks will have to reinvest the proceeds elsewhere). On that note, we think that this easing program is/will be another impulse for capital flows to emerging markets. Could this lead to a bubble in Asia's (excluding Japan) asset markets? We attempt to address this question in a later part of the report.

We maintain our stance that QE2 will not make a huge difference to economic conditions.

Figure 1: US 10-Year Treasury Rates



Source: Bloomberg. As of 26th Nov 2010

China: Efforts to rein in asset price inflation will continue

New loans continue to edge higher; hardly a surprise:

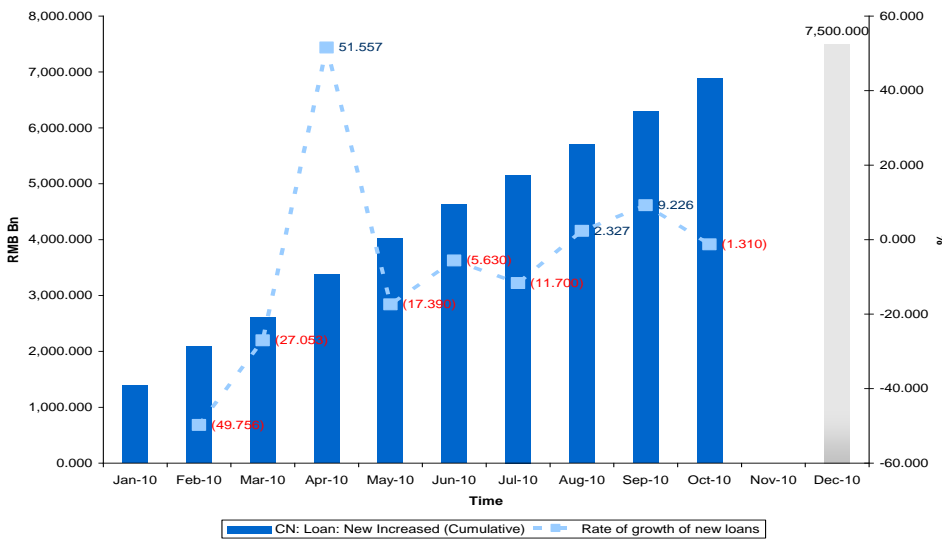
Loan growth has not slowed, despite strong signals from the government that it wants credit policy to tighten. Net new lending remained at a high level (RMB 588bn vs. September's RMB 596bn). We mentioned in July that that to keep the total amount of loans created to RMB 7.5 trillion, the amount of loans granted on a monthly basis should not exceed RMB 463 billion for the rest of the year. Since then, the amount of new loans granted on a monthly basis has consistently exceeded that amount. It would now require a severe contraction in credit growth for banks to stay within the annual lending quota.



We think such a scenario is highly unlikely. As such, amid rising liquidity partly caused by quantitative easing in the United States, the People's Bank of China raised the required reserve ratio for all lenders by 50 basis points, its fourth increase this year. We think the latest hike in required reserve ratio will have little effect on lending behavior. This is so as banks still hold excess reserves at the central bank, so the policy moves does not directly constrain their capacity to lend. Therefore, the latest move could be a signal of the first of more to come.

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Figure 2: New loans (cumulative)



Source: Bloomberg. As of Oct 2010

An eye on inflation:

China's consumer price index (CPI) rose to a 25-month high of 4.4% in October. The figure topped the market forecast of around 4% and was sharply up on September's 3.6% growth. On a m-o-m basis, China's CPI rose 0.7% in October. The surge in prices is attributed to rising food prices. The price of food, which accounts for one third of the basket of goods used to calculate China's CPI, surged 10.1% y-o-y in last month. Accordingly, the central bank chief said that the government would impose price ceilings on food items, introduce subsidies for the needy, increase the availability of fuel supplies and crack down on speculation of agricultural commodities.

The central bank chief said that the government would impose price ceilings on food items to combat inflation. Such measures might be counter productive.

To a certain extent, imposing price controls might be counter productive. Firstly, producers might choose to export more to take advantage of higher prices overseas. This in turn can reduce supply at home and hence lead to higher prices. Secondly, price caps can limit the wages of farmers. This runs counter to the government's goals of reducing urban-rural income inequality.

Nonetheless, the recent steps are similar to actions taken in January 2008 to combat inflation. Back then; the aim was also to control food prices. Large-scale producers were required to obtain individual approval before raising prices. The policy was not too successful given that wholesale food prices still rose 17% in the next two months.



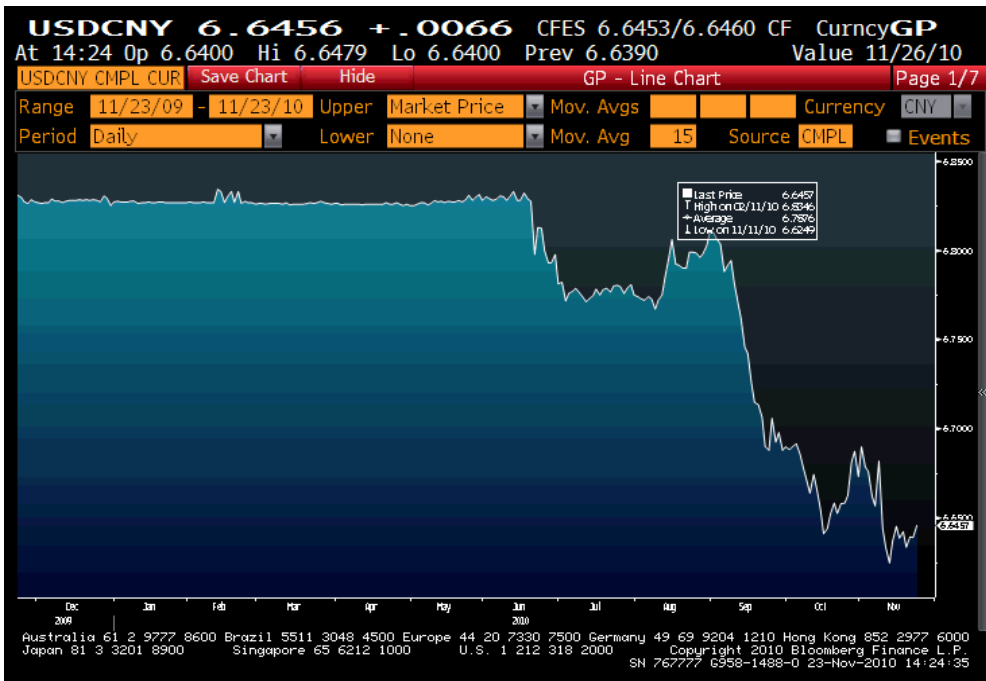
While there are similarities in the measures taken, it is unfair to gauge the probability of success on the latest measure based on historical results. This is so as unlike 2008, food inflation appears to be driven by fast money growth. Indeed, there have been no major droughts or diseases to stoke prices this year.

We think that price controls coupled with higher reserve required ratio and restrictions on bank lending should help to contain prices. Coupled with that, a recovery in the dollar and doubts about the strength of final demand from the west is likely to cause a decline in global commodity prices. The prices of agricultural commodities in particular have already declined by more than 10% in the past week as of this writing. In addition, a stronger Yuan will also help to reduce the cost of imported goods.

Competitive devaluations of currency:

To address the inflexibility of the Chinese renminbi (RMB) and concerns that the US is actively seeking to weaken the dollar, during the G20 Summit meeting, the leaders have committed to “move toward more market determined exchange rate systems and enhance exchange rate flexibility to reflect underlying economic fundamentals and refrain from competitive devaluation of currencies”. We do not think this this will cause RMB to appreciate significantly. This is so as such commitments were made by China from as long ago as July 2005. While China did allow its domestic currency to appreciate, it took the form of a crawling peg against the dollar and the bilateral exchange rate was fixed again in 2008 when the global financial crisis broke. Nonetheless, we believe that the Chinese authorities will continue to attempt to strike a balance between political tension and economic growth.

Figure 3: RMB Vs Dollar



Source: Bloomberg. As of 23rd Nov 2010.

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On the whole, we believe the Chinese government will continue to try to rein in any asset price inflation and these actions will inevitably affect the broader economy. However, we also believe that they have no intention of hitting the brakes on economic growth. Therefore, in the short run, we maintain our stance that growth in China will decelerate. However, in the long run, we remain positive of the prospect of this country.

Capital flows into Asia set to bring stock market bubbles?

The fundamental economic difference in emerging markets and developed markets has led to the strategy of “sell developed markets and buy Asia” over the last two years. In turn, this has resulted in a massive flow of capital into Asia. Capital inflows into Asia markets that publish these numbers, soared to \$11.88bn in October. This is an increase from Q3’s \$8.46bn average monthly inflow.

Table 1: Capital inflows into stocks (US\$bn)

Country	2009	First half of 2010	Third Quarter	October
India	17.64	6.7	12.55	5.58
Indonesia	1.38	0.86	1.43	0.04
Philippines	0.42	0.38	0.25	0.63
South Korea	24.45	5.14	5.8	3.62
Taiwan	15.62	-0.11	3.37	1.42
Thailand	1.14	-0.54	1.89	0.52
Vietnam	0.07	0.27	0.09	0.07

Source: Bloomberg. As of 23rd Nov 2010.

The inflows will almost certainly stay strong in coming months given the extension of quantitative easing in the US and the prospect that investors wanting higher returns will keep targeting emerging markets. Some countries are looking at introducing capital controls. This has led many to question if a stock market bubble is developing in Asia.

From a price-to-book (P/BV) value perspective, Asia Pacific ex Japan is currently trading at 2.05X. The 10-year average stands at 1.78X. In comparison, current valuation does look expensive. However, P/BV for previous peaks is at 2.93X. If history was of any guide, it suggests that there is no bubble as yet.

For price-to-earnings (P/E), we are currently trading at 15.05X, just below the 10-year average of 16.33X. Over the course of the last 10 years, market peaks range from the all time high of 31X in 2001 to between 21-26X. As such, with the current P/E at 15.05X, we are not quite yet at the prior peaks.

Therefore, region-wide there is no valuation bubble in Asia Pacific ex Japan now. While that may be the case, in terms of individual countries, Indonesia looks expensive. It is trading at 3.44X P/BV, significantly higher than its 10-year historical average of 2.31X. In terms of price-to-earnings value, Indonesia is also trading notably higher than its historical average, 32X versus 22X.

We believe the Chinese government will continue to try to rein in any asset price inflation and these actions will inevitably affect the broader economy.

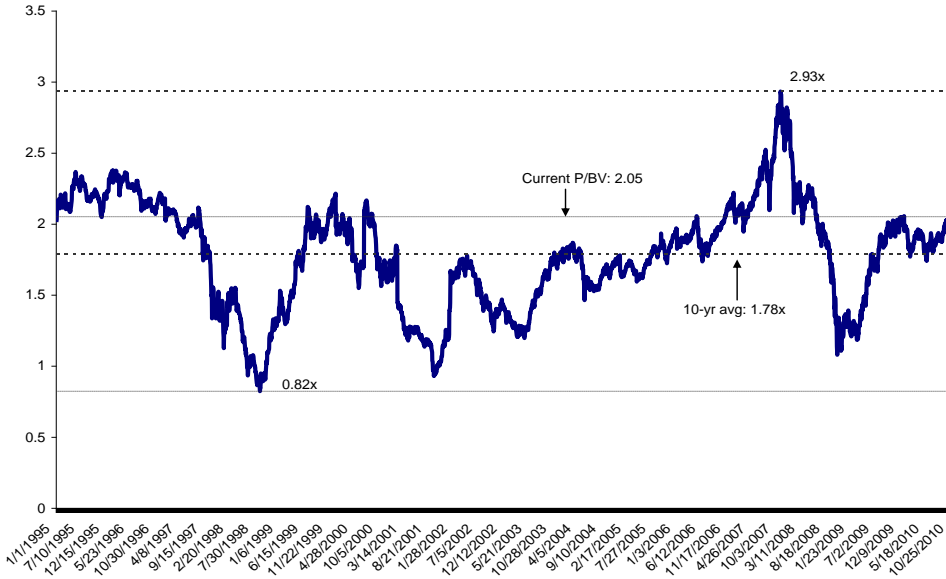
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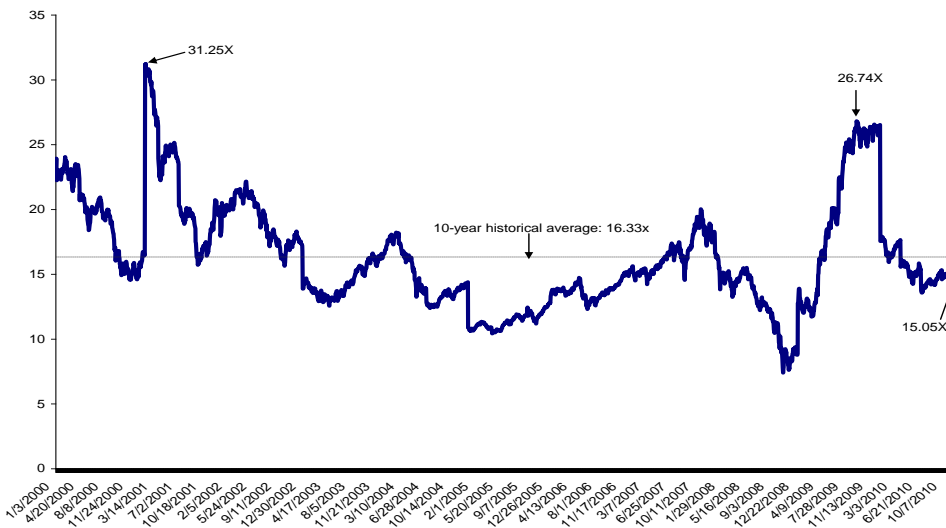


Figure 4: Price to Book Value



Source: Bloomberg, as of 22nd Nov 2010

Figure 5: Price to Earnings Value



Source: Bloomberg, as of 22nd Nov 2010



Table 2: Price-to-Book value for various countries

Country/Region	23 rd Nov 2010	Historical average
Australia	1.98	2.3
China	2.63	3.32
Hong Kong	1.96	1.89
India	3.4	3.26
Indonesia	3.44	2.31
Japan	1.33	1.74
Korea	1.33	1.17
Malaysia	2.41	1.78
Thailand	2.02	1.72

Source: Bloomberg, as of 23rd Nov 2010

Conclusion:

In sum, valuations for this region are reasonable for now. We expect inflows will almost certainly stay strong in coming months. There is no catalyst to end this momentum run. In terms of individual countries, Indonesia equities look expensive.

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