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Economic Update

Executive Summary

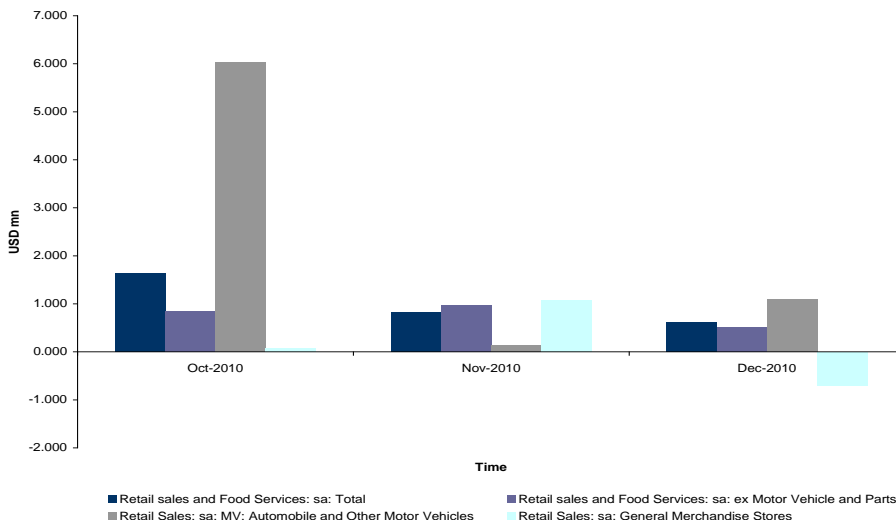
We remain positive on the United States on the back of encouraging economic data. However, we do note that the weakness in the housing market could exert a toll on the economy. With regards to China, while inflationary pressure has eased slightly, we continue to believe that more tightening measures will be imposed in 2011 on the back of two reasons. Firstly, the country's growth in 2010 was stronger than expected. Secondly, there is the determination in reining in the total amount of loans granted in 2011 given that the target was exceeded in 2010. While more tightening measures may be inevitable, there are still sectors that we believe that can thrive in 2011; the service sector being one of them.

United States

Recent economic data from the United States has pointed to strengthening economic growth. Retail sales for December came in strong. After adjusting for seasonal variation and holiday and trading day-differences, retail and food services sales rose 0.5 percent in December from the previous month and 7.9 percent above December 2009. Total sales for the October through December 2010 period were up 7.8 percent from the same period a year ago. Although it appears positive at the headline level, we note that there are signs of fatigue in consumption. The rate of increment has been on the decline over the last quarter. This is shown in the diagram below. While it warrants that this data be monitored closely in the months ahead (as it is a proxy for consumption levels), we think some softening in December is not too surprising as consumers front loaded their holiday purchases in November.

Retail sales for December came in strong. However, we note that there are signs of fatigue in consumption.

Figure 1: US Retail Sales remain positive



Source: Bloomberg. As of Dec 2010



Other than retail sales numbers, the wider-ranging ISM index rose to 57 in December. More importantly, the new orders component (an indicator of future activity) rose to 60.9; a seven month high. Equally encouraging is news from the service sector. The ISM Non-Manufacturing Survey rose from 55 to 57.1 – the highest rate of expansion since May 2006. The advancement in the various data indirectly signals an improvement in confidence level among businessmen and consumers. It is this upbeat sentiment that consumers have started spending more freely and demand for more goods and services. This positive vibe could be attributed to the rise in net worth led by the increase in equity prices.

Meanwhile, inflation remains low in the United States. The CPI for December increased slightly (0.5 percent following a modest 0.1 percent rise the month before) as food and energy prices have risen moderately. Excluding food and energy, CPI inflation came in at 0.1 percent. Even with an increase, inflation remains historically low and it remains below the Federal Reserve target of 2 percent. We expect headline inflation to continue to see some upward pressure in the near term. Core inflation is likely to remain low due to weak housing and heavy competition among retailers.

Despite the improvement in the macro environment, the Fed sees no rush to end its bond purchase program. They will continue to buy bonds through June in an attempt to keep interest rates low and spur spending. While we remain skeptical that the program will have a direct impact on consumption, it will however be able to achieve the objective indirectly; via the inflation of stock prices.

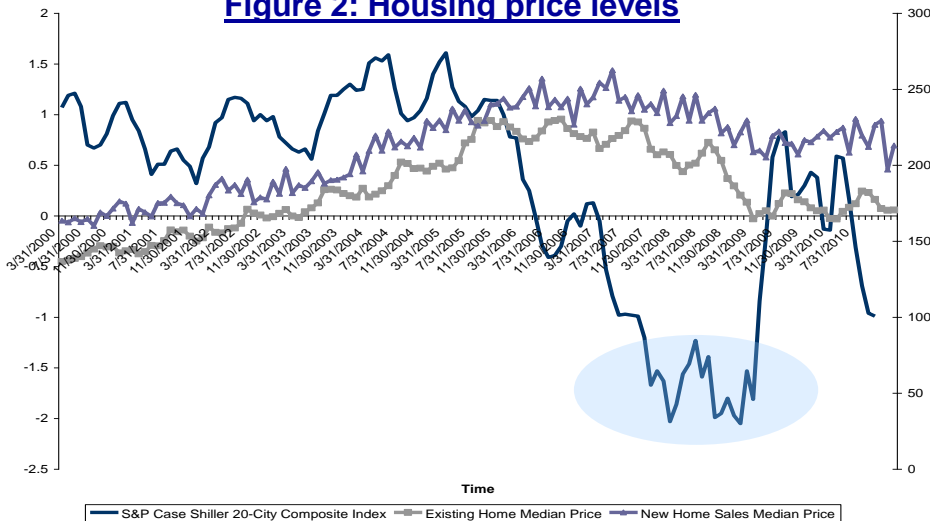
While it may seem that things are rosy for the US economy, the near term risk in the market revolves around the housing market. The S&P/Case-Shiller 20-City Composite Home Price index fell 0.8% from their levels in October 2009. This mark the fifth consecutive month where the annual growth rates moderated from their prior month's pace, confirming a clear deceleration in home price returns. This lead us back to the question: "Will there be a double dip for the housing sector?" From the figure below, it seems to suggest that a double dip is imminent. As shown in figure 2, the S&P/Case-Shiller 20-City Composite Home Price index is almost back at levels seen in 2008.

There are also notable signs of improvement in the manufacturing and non-manufacturing sector. This could signal confidence among businessmen and consumers.

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The near term risk in the market revolves around the housing market. Housing prices continue to decline. This lead us back to the question: "Will there be a double dip for the housing sector?"

Figure 2: Housing price levels



Source: Bloomberg. As of Oct 2010



The tax incentives are over and the national economy remained lackluster in October. Existing home sales and housing starts have been reported for both October and November, and neither is giving any sense of optimism that pent up demand will drive prices higher. On a year-over-year basis, sales are down more than 25 percent. Meanwhile, housing starts are still hovering near 30-year lows. On the supply side, majority of those foreclosures will eventually come back to the system and hit the market. Add pent up selling demand (i.e. sellers who have kept their homes off the market, waiting for a bottom), it is likely that we see inventories head higher in the months to come. In economics 101, low demand and high supply implies that prices will be lower.

Before we jump to the conclusion that housing prices will continue to head south, we also note that housing starts have been flat and at very low levels for almost two years. As such, the coming supply of foreclosed homes may be effectively offset by the combination of a multi-year dearth of new construction and the ongoing increase in new household formations. Hence, the housing market may have found a new equilibrium.

At this moment, we do not think that prices will be heading south drastically in the interim. This is because there might be a lag between price and sales. With sales having improved towards the end of the year and as the market has not been flooded by the foreclosure supply, prices might be stable in the meantime. However, there remains a possibility that things might reverse in the longer term especially if demand for housing does not pick up.

All in all, we remain positive on the US economy given that bulk of the data coming forth remains encouraging. While risks remain in the housing sector, we think it is probably not a great cause of concern at the moment.

China: Inflation in December slowed to 4.6 percent year-on-year compared with 5.1 percent in November. For the year, China's consumer price index rose 3.3 percent from a year ago, exceeding Beijing's full year target of 3 percent. While the rise in prices was mostly due to soaring food prices, the authorities have once again stepped up its effort in reining in excess money supply. China's central bank has raised the lenders' required reserves by 50 basis points on 14th Jan 2011, its seventh increase since early 2010. The ratio, which determines the amount of funds banks must put aside as reserves, will rise to 19 percent for major lenders.

We think more tightening measures will be imposed in 2011 on the back of two reasons. Firstly, the country's growth in 2010 was stronger than expected. China's annual gross domestic product growth sped up in the fourth quarter to 9.8 percent from 9.6 percent in the third quarter, defying expectations for a slowdown to 9.2 percent. Full-year growth picked up to 10.3 percent from 9.2 percent in 2009. Domestic investment and consumption contributed 9.5 percentage points to its growth last year, while net exports added just 0.8 percentage point. The strength in the economy may give officials the confidence to take more aggressive steps to quell price pressures. Secondly, the total actual amount of loans granted in 2010 clearly exceeded the permissible amount. Hence, the authorities will be even more resolute to rein in the total amount of loans granted in 2011. As of this writing, while no target amount has been announced, it is reasonable to expect the amount to be lesser than the year before.

We do not think that prices will be heading south drastically in the interim. Hence, we remain positive on the US economy given that the bulk of the economic data remains encouraging.

Inflation eased in December. However, the authorities have once again stepped up its effort in reining in excess money supply.

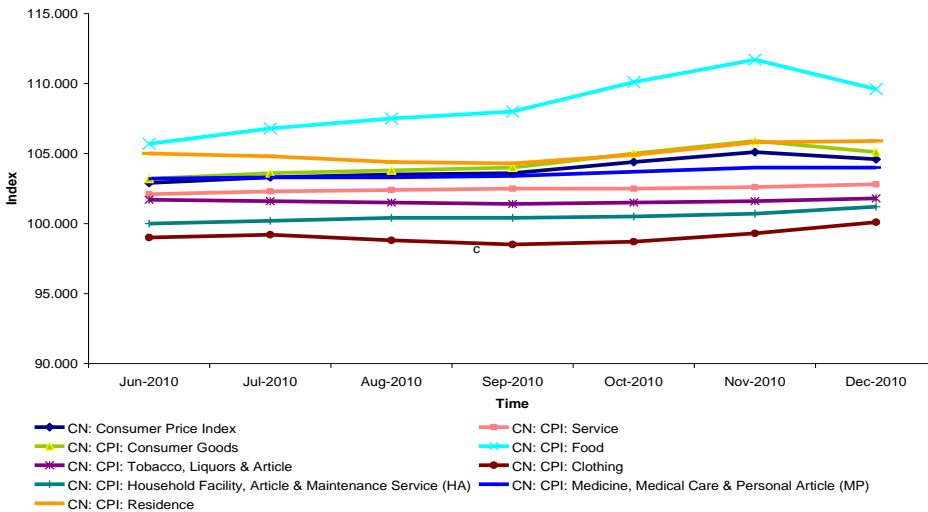
We think more tightening measures will be imposed in 2011 on the back of two reasons.

1. The country's growth in 2010 was stronger than expected.

2. Determination in reining in the total amount of loans granted in 2011 given that the target was exceeded in 2010.



Figure 3: China CPI



Source: CEIC. As of Dec 2010

While it is inevitable that we will see more tightening measures, there are still sectors that we believe that can thrive in 2011; the service sector being one of them. As part of the country’s efforts to move economic growth away from export-oriented industries to domestic consumption, there is greater urgency to develop the service sector. The country plans to promote the service sector through tax reforms and other policies. This will bode well for companies in the information technology and perhaps health care sector. In conjunction with the aim to boost domestic consumption, consumer discretionary sector should also benefit.

Conclusion: In sum, we remain positive on the United States on the back of encouraging economic data. However, we do note that the weakness in the housing market could exert a toll on the economy. With regards to China, while inflationary pressure has eased slightly, we continue to believe that more tightening measures will be imposed in 2011 on the back of two reasons. Firstly, the country’s growth in 2010 was stronger than expected. Secondly, there is the determination in reining in the total amount of loans granted in 2011 given that the target was exceeded in 2010. While more tightening measures may be inevitable, there are still sectors that we believe that can thrive in 2011; the service sector being one of them.

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