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Economic Update

Executive Summary

United States: We remain positive on the US economy as the bulk of the data remains encouraging. While unemployment rate remains high, household's financial burdens have been on a declining trend. On the other hand, personal income has been rising gradually and steadily. The key risk still lies in the housing market.

China: Economic data has shown that the Chinese economy is clearly slowing. However, we do not expect the Chinese government to end its tightening yet as inflation remains a prime concern.

Japan: In the short run, economic activities are expected to slow in Japan. The severity of the recent event is greater than any of the previous earthquakes and we believe that the reconstruction will be positive for the country. Other global economies are likely to be affected in two ways - Higher commodity prices and a slow down in exports. Nonetheless, we feel that the overall financial position of Japan is adequate to support the massive government spending required for the country's rebuilding moving forward.

United States: The key risk still lies in the housing market

The latest economic releases reinforced our view that US growth continues at a relatively healthy pace. Manufacturing is leading the way, with the Chicago Purchasing Managers' Index rising to 71.2 in February, the highest reading since July 1988. Meanwhile, the national Institute for Supply Management's (ISM) survey of manufacturers rose to 61.4, its highest level since May 2004. While that may be so, we think that the index might slide in the months to come. This is because the disruption of factories in Japan could slow movement of parts to US and hence affect production. In addition, demand could also be affected as rising oil prices dampen consumption. Therefore, we will not be too surprised if the PMI inch lower after this. Meanwhile, the service side of the economy is catching up as the non-manufacturing ISM survey rose to a robust 59.7.

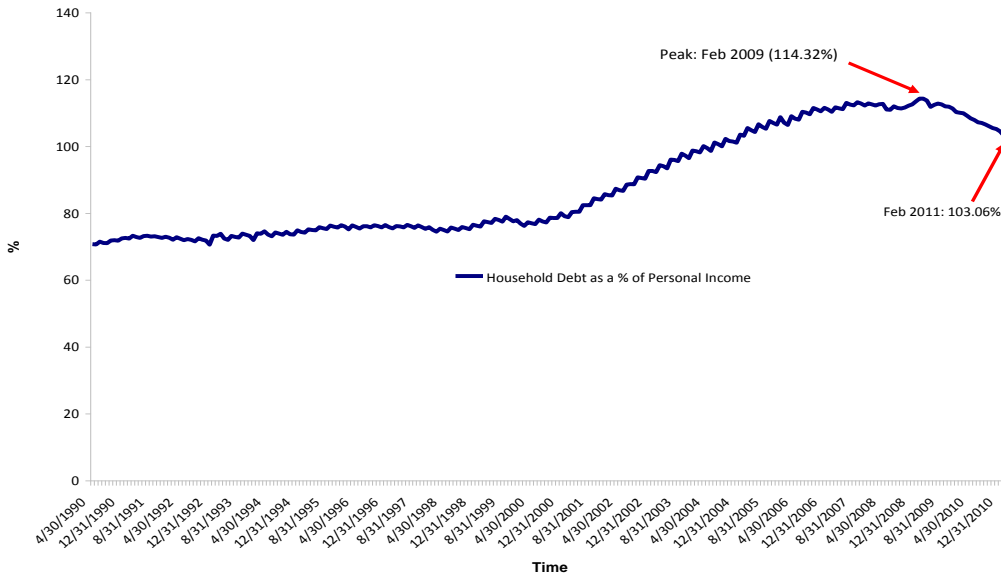
While the unemployment rate remains high, we note that households' financial burdens have been on a declining trend. The amount of household debt as a percentage of disposable income has been sliding. As of Feb 2011, the ratio stands at 103.06 percent. This is a decline of close to 10 percent from the peak. This is an encouraging sign as reduction in financial burden could spur consumption. On another positive note, personal income has been rising gradually and steadily. In February, personal income rose 5.1 percent year-on-year. Therefore, while unemployment rate remains high and housing prices continue to decline, consumption might be supported by higher personal income and lower household debt. The only impediment to this is rising oil prices. Oil prices have been rising (due to geopolitical tension in the Middle East) and this could dampen consumer spending.

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Figure 1: Household debt as a % of personal income

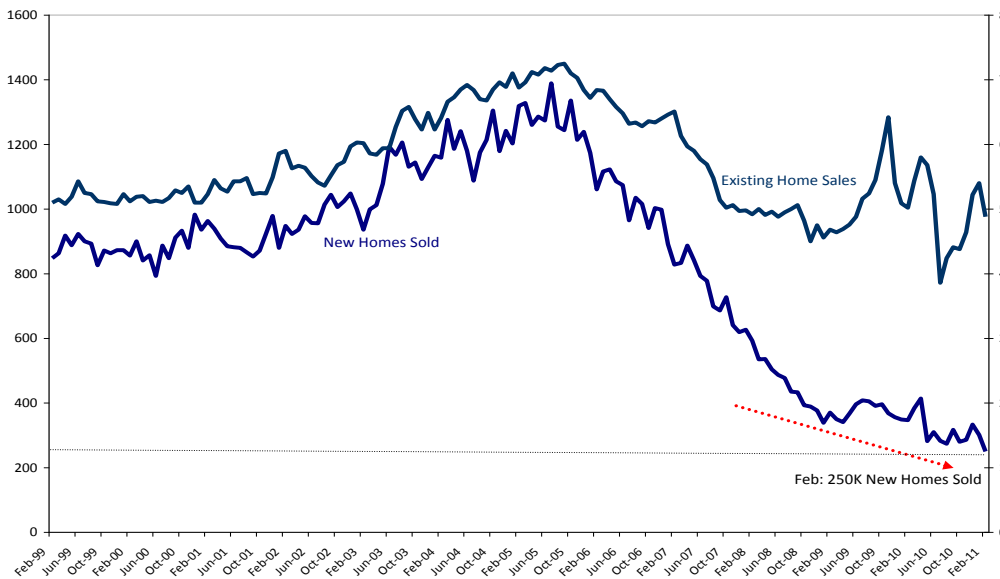


Source: Bloomberg. As of Feb 2011.

As per our previous reports, we remain concern over the housing sector. New home sales for February were reported at 250k (annualized, seasonally adjusted), another record low. Keep in mind that this is with mortgage rates that are low relative to historic times. Existing home sales did not fare any better. The February report for existing home sales showed that sales fell nearly 10 percent to a lower-than-expected annual rate of 4.88 million. Year-on-year, sales are down 2.8 percent.

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Figure 2: Home Sales

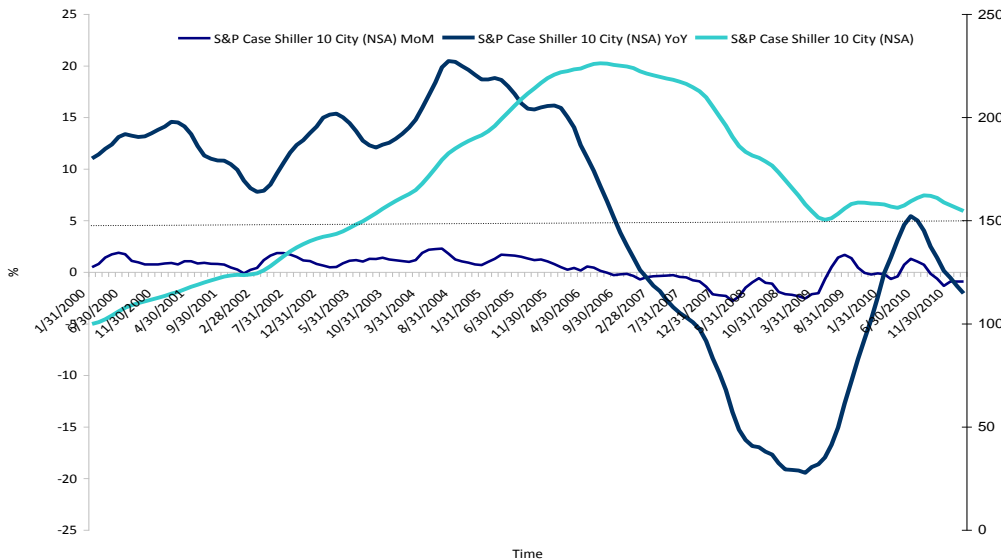


Source: Bloomberg. As of Feb 2011.



Along with the lower sales, prices edged lower as well. The S&P Case-Shiller 10-City Home Price Index (non-seasonally adjusted) showed a third 0.9 month-on-month decline. Year-on-year, the decline continue to deepen to -2.0 percent in January from -1.3 percent in December. From a historical perspective, prices seem to be inching to levels seen during the financial crisis. This is a concern especially when the market has not been flooded with the foreclosure supplies. We will continue to monitor the housing sector closely.

Figure 3: Housing Price Level



Source: Bloomberg. As of Jan 2011.

All in all, we remain positive on the US economy as the bulk of the data remains encouraging. Nonetheless, the key risk lies in the housing market.

China – Latest data points to further weakness in the economy

With the public & media focus on the triple catastrophe in Japan, market’s reaction to yet another hike in the required reserved ratio by half a percentage point was relatively muted. This is the third increase this year and it took effect on March 25. With that, banks are required to set aside 20 percent of their reserves. The hike came after inflationary pressures remain high in February.

On a positive note, Beijing and Shanghai statistics bureaus said their local real estate markets cooled after the central and local governments implemented market controls. January year-on-year residential sales fell 21.1 percent in Beijing and 31.3 percent in Shanghai. Meanwhile, fewer large and medium size cities reported a rise in home prices compared with the previous month. Prices of newly built residential properties in 56 of the 70 large and medium-size Chinese cities covered by a survey rose in February from the previous month, a slight improvement from January, which saw 60 of the 70 cities’ prices rise. Credit growth on the other hand eased from a year ago. A total of RMB 535 billion loans were granted in February. This is markedly lower than the RMB 700 billion loaned out in the same period a year ago. Perhaps, the tightening policies have indeed been more effective and successful than many have expected. While, property prices and credit growth have eased, we do not think that the Chinese authorities

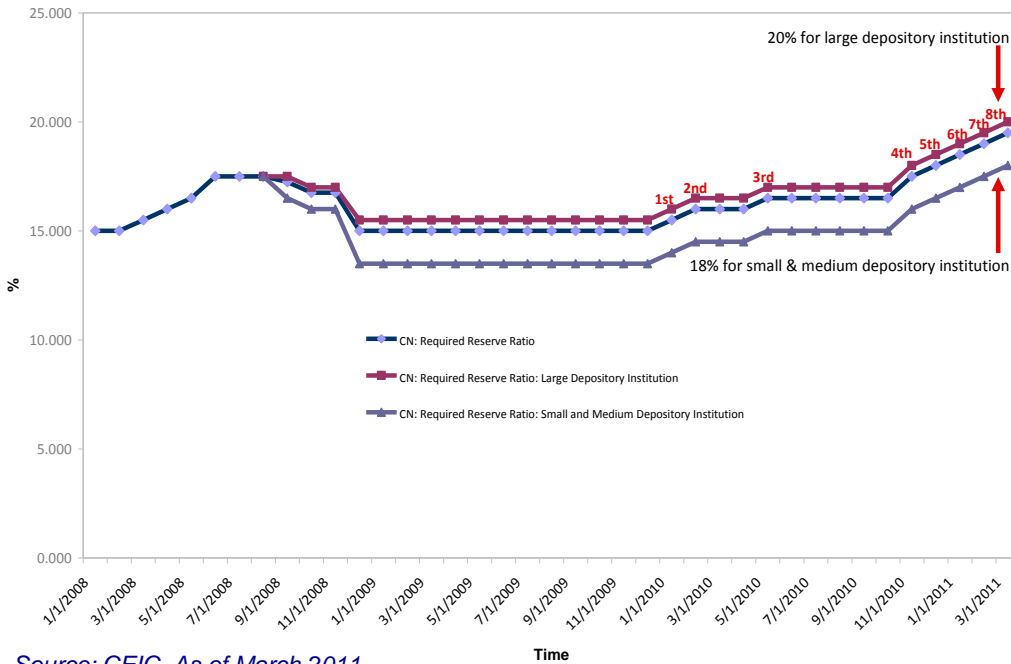
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The pace of credit growth has improved.



Figure 4: Required reserve ratio historical trend



Source: CEIC. As of March 2011

will end its tightening as yet. This is so as inflation is still at an elevated level. Like we mentioned previously, while the current drivers of inflation are much more global and structural than domestic and cyclical, it is still a monetary phenomenon at the end of the day.

On economic data, China’s manufacturing sector continued to expand in February but its growth pace fell to a six month low, according to data released by the China’s Federation of Logistics and Purchasing. The PMI fell to 52.2 percent in February from 52.9 percent in January. The data released also showed a decline in overseas orders and a hike in importing price index.

Meanwhile, the Chinese economy registered a trade deficit in February as export growth slowed significantly; partly due to the effect of the Spring Festival. Further weakness is expected in the short term as trade with Japan is disrupted. However, it may rebound subsequently due to greater demand from developed markets like Japan.

Combined retail sales in January and February rose 15.8 percent from the same two-month period a year ago. However, sales have significantly slowed from the fast pace set in December. There are perhaps two reasons to account for this. Firstly, consumer prices rose as much as 4.9 percent as the year began. Rising prices caused household purchasing power to fall and hence affects consumption. Secondly, a slowdown in the auto sector dragged down sales for a series of related products. Auto sales have weakened as the government ended a tax-break program that encouraged sales of small passenger cars, particularly to help the country weather the 2008 global financial crisis. On a separate note, sales of gold, silver and other precious metals were up; correlating with inflationary expectations. And in January and February, precious metals sales increased 51.4 percent over

Data has shown that the Chinese economy is clearly slowing.



the previous year and 3.7 percent from December.

In sum, the pace of credit growth has improved and the above data has shown that the Chinese economy is clearly slowing. While this is so, we do not expect the Chinese government to end its tightening as yet as inflation remains a prime concern.

Japan

Japan economy was dealt a devastating blow by the magnitude-9 earthquake and tsunami that pummeled the country on March 11. Damaged nuclear power plants in Fukushima further aggravated matters as workers try to stop radioactive leaks and potential meltdown. While we are unable to ascertain the costs of the damage, we discuss the key economic impacts on Japan and other global markets in this report.

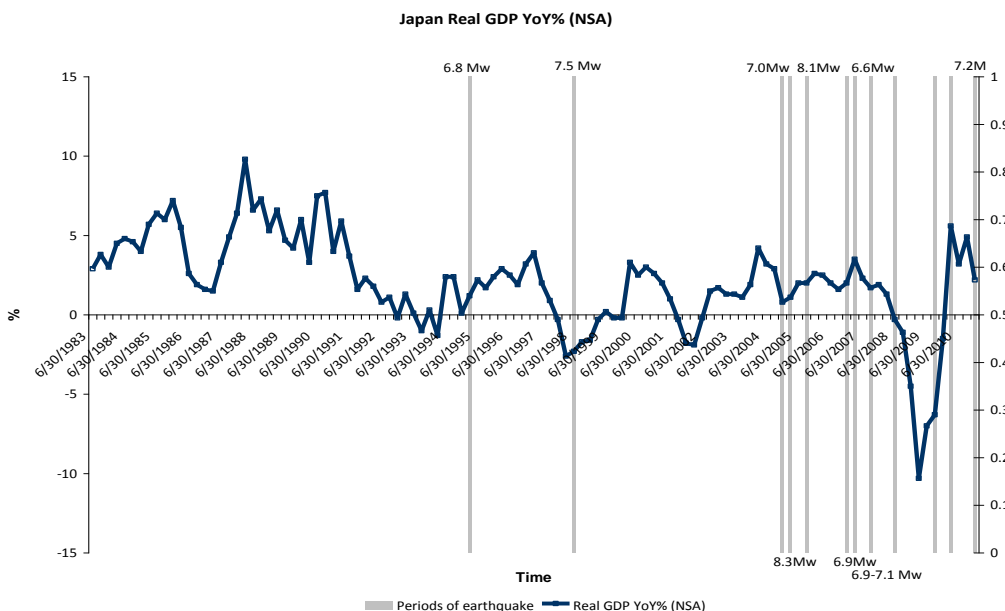
In the short run, economic activities are expected to slow in Japan as infrastructures are ruined, and energy supply crippled with the closure of the nuclear power plants. Trade is also expected to ease as production comes to a standstill and as trading partners blocks food imports from Japan. As of this writing, United States became the first country to block food imports from Japan. Tourism sector will also be affected as foreigners shun the country on concerns of high levels of radiation. With that, we can also reasonably expect retail sales to inch lower in the interim. Plummeting confidence among Japanese could also exert a toll on retail sales.

In the mid term, if history was of any guide, it tells us that reconstruction need not necessarily lead to growth in the economy. As shown in the figure below, between 2007 and 2008, real GDP declined in the next quarter after an earthquake hits.

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Figure 5: Japan real GDP YoY% & periods of earthquake

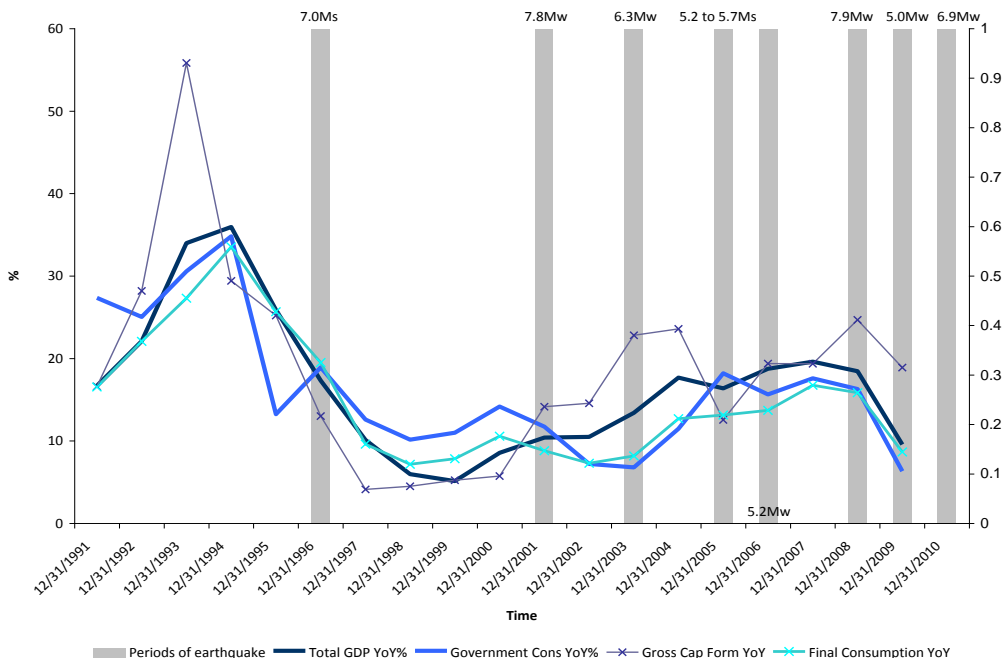


Source: Bloomberg. As of Dec 2010



China paints a similar picture. As shown in figure 6, the country's GDP did not increase after a natural disaster occurs.

Figure 6: China's GDP YoY% & periods of earthquake



Source: Bloomberg. As of Dec 2010

On the other hand, the severity of the recent event is greater than any of the previous earthquakes that occurred and we believe that the reconstruction will be positive for the country. Sectors that are likely to benefit include industrials, basic materials and consumer, non-cyclical industries. According to a report on Nikkei newspaper reported on 23rd March, the Japanese government expects total damage to reach 15 trillion to 25 trillion yen. The estimate covers damages to roads, homes, factories and other infrastructure but does not include losses to economy activity. According to the report, that amount is larger than the 10 trillion yen in damage from the Kobe earthquake in 1995.

Meanwhile, we think the triple catastrophes are likely to affect other global economies in two ways. Firstly, we are concerned that reconstruction in Japan might exert further pressure on commodity prices; which are currently at elevated levels. This in turn might aggravate inflationary pressures especially in emerging countries. Secondly, Japan is after all the third largest economy and any slowdown in economic activity is likely to be felt in other regions of the world. This impact is likely to be felt through lower Japanese exports. Other than Japanese food products, Japan also supplies technological products, semi-conductors and other materials to the global manufacturing industry. Disruptions in the supply of these components are likely to affect the production of these economies. While the above are the likely impacts, we do not think that it will cause global economies to sink back into recession. This is so as the fundamentals of these other economies are strong and positive at the moment.

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- *Japan is after all the third largest economy and any slowdown in economic activity is likely to be felt in other regions of the world; most likely through lower Japanese exports.*



Financing the cost of reconstruction

We feel that the overall financial position of Japan is adequate to support the massive government spending required for the country's rebuilding moving forward. Many economists pointed out previously that Japan's public debt level (200% of GDP) may prove to be a major impediment in the country's recovery. We seek to investigate the components of the public debt level below.

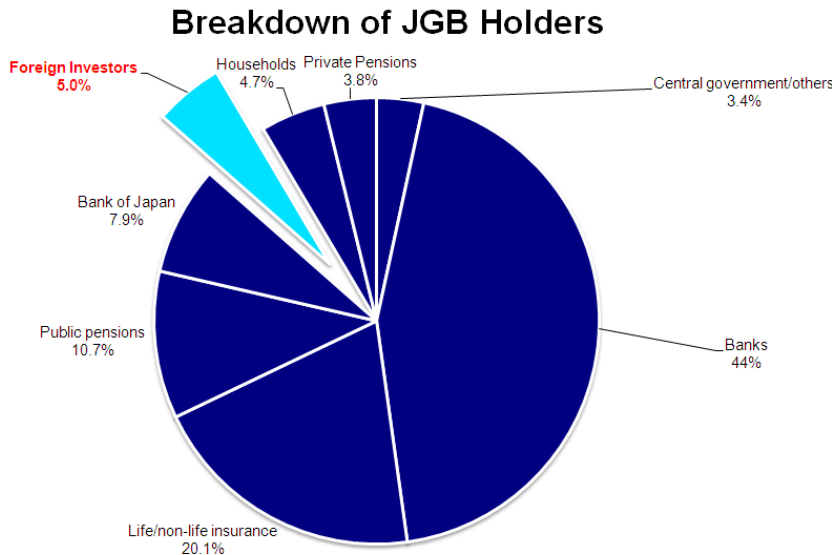
Firstly, majority of Japan's sovereign debts are held locally. 95% of Japanese public debts are held by the locals (See Chart 3 below). The debt of one government agency is held by another governmental agency as an asset. As such, Japan's net foreign liabilities is much lower than many believe. This is supported by the low debt interest burden as well. The debt interest as a percent of GDP in Japan is half of the European counterparts, with the yield on 10 year Japanese government bonds standing at 1.2% post earthquake.

In terms of funds available for rainy days, Japan's central bank (BOJ) holds over US\$1 trillion of foreign reserves (roughly 20% of its GDP), second only to China. At the same time, the Japanese yen is a fiat currency issued by the BOJ, which has full control over the issuance of the currency. The central bank has absolute control over its monetary policy. To calm the market, it has pumped a record amount of funds into the financial system since Mar. 11 to great efficiency. Lenders' deposits with the central bank stood at an all-time high of US\$539 billion as of Mar. 22, from US\$218 billion the day before the temblor struck, according to Bloomberg. Any sovereign debt default risk as a result of the earthquake disaster is perhaps overstated. A similar European PIIGS debt implosion is also unlikely.

Lastly, Japan derives most of its wealth from its private sector. The total wealth of Japan's private sector is estimated to be more than four times its net public sector debt. The net worth of its private sector is estimated to be at US\$23 trillion as of end 2009. The financial position of Japan is in a less than undesirable state.

We feel that the overall financial position of Japan is adequate to support the massive government spending required for the country's rebuilding moving forward.

Figure 6: Foreign Holdings of Japanese Government Bond is Low



Source: Bank of Japan. As of Dec 2010



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