



PHILLIP SECURITIES PTE LTD

Unit Trust – Economic Update

22 Oct 2010

Analyst

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ECONOMIC UPDATE

Executive Summary

United States: We think a second round of asset purchase to push interest rates down and to jump start the sluggish economy will be met with limited success. Such actions will only cause the dollar to depreciate further. We maintain our stance that growth will be slow in the United States in the interim.

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. 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.

United States: Overweight Financials & Energy

Economic data response – “Bad news is good news”: After registering better than expected readings on most fronts in September; economic data was once again mixed in October. The ISM index stayed in the expansionary territory, but fell to 54.4 from 56.3. The new orders component fell to 51.1 from 53.1, indicating softening demand. Meanwhile, the employment component too fell. On a positive note, the ISM Non-Manufacturing Survey, which represents the larger service sector, improved in September from 51.5 to 53.2, while employment element jumped back into expansion region. Meanwhile, pending homes sales, a leading indicator of existing home sales rose 4.3 percent month-on-month in September. That also represents a decline of 18.4 percent from a year earlier. In light of the ongoing foreclosure mess, there might be greater stability in housing prices as inventory in the market decline. This however depends on how the foreclosure issue turns out (refer to the next section - “foreclosure concerns” for a greater discussion). From the above, it is evident that numbers remain positive. However, there aren’t any significant improvements. And because of this, the market is cheering on weaker economic data, believing that it increases the possibility of a new round of Fed action. As some say, “Bad news is good news”.

Foreclosure concerns: A joint effort in 50 states is investigating whether banks have used questionable documents to evict homeowners and foreclose properties. The focus of the investigation is on several key states that have the highest foreclosure rates. These include California, Florida and Arizona. The White House has supported the probe and recognizes that the moratorium could have a negative effect on the market.

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We think that it is still a little premature to comment on how the event will affect the banks, the housing market and the wider economy; given that there is still a lack of clarity. No one knows for sure whether the foreclosure will morph into a larger calamity akin to what happened in 2008 to 2009. Nonetheless, below are some possible outcomes.

In the first scenario, foreclosed properties that had been taken off the market are soon put back on, normal foreclosure proceedings resume. Even in this scenario, home sales are likely to decline in the near term, as sales on some foreclosed properties fall through or are put on hold. The supply of homes for sale may fall and this could put upward pressure on prices. Home sellers who aren't in foreclosure may benefit from this. After a few months, sales and supply would bounce back and the housing market is back to the current state.

The second scenario is that the reviews into foreclosure will take months to complete and some banks are found guilty of bad conduct. In this situation, if the lenders halt sales on foreclosure, the number of home sales will fall. The indirect effects could be even greater, as there could be a knock-on effect on sales of non-foreclosed properties. More importantly, if the lenders can't sell the foreclosed homes, at some point, banks may have to endure the losses. This could cause the banks' equity prices to fall and the sustainability of the recovery in the wider economy will then be in doubt.

Once again, we think it is difficult to say for certain which of the above scenarios is the most likely outcome. Nonetheless, we will continue to monitor this event and provide further updates in due course.

Is Quantitative Easing 2 necessary? Recent price actions in the equity markets showed that investors are expecting another round of quantitative easing. Is it necessary? In our September report, we mentioned that economic conditions have not deteriorated to an extent where a second round of stimulus becomes necessary. Indeed, the section on "economic data response" has reiterated our point that the economy continues to grow, amid at a slow pace. Therefore, further quantitative easing will not do much to spur growth. We have reasons to believe so. Firstly, considering many consumers' lack of confidence in the economic recovery and the government policy, money is not getting out into the economy. In order words, there is a lack of velocity of money in the economy. This is shown in figure 1. Secondly, enhanced liquidity from the United States is likely to eventually find its way to Asia via the carry trade and larger FX reserves held by sovereign wealth funds. Thirdly, government spending needs to be paid for and that could come about with the printing of more money. Such actions will only result in higher prices, not a bigger economy.

Weakening Dollar: The DXY index (dollar measured against a basket of currencies) continues to head south. It has depreciated as much as 12 percent over the last five months. From a peak of 88.405, it now stands at 77.45. The dollar has been depreciating on rising speculation that the Fed will add to asset purchases to boost the economy. From a technical perspective, the dollar is in the oversold territory and we can expect a short-term correction. In the long run, the dollar is poised to weaken further.

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Further quantitative easing will not do much to spur growth.

The dollar is poised to weaken further in the long run. However, from an economic perspective, a weaker dollar is not all that negative.

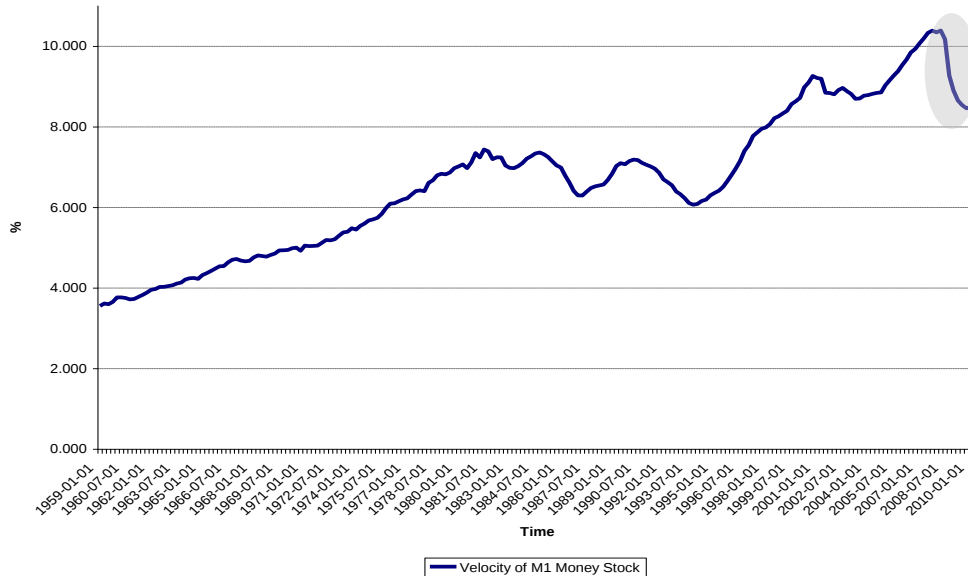


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Figure 1: M1 Money Multiplier Ratio



Source: Federal Reserve Bank of St. Louis, Oct 2010

From an economic perspective, a weaker dollar is not all that negative. At the least, a weaker currency will allow exporters to benefit. These companies could either boost their profit margin by keeping the foreign currency price of its exports unchanged, or it could attempt to gain market share through slashing of prices. US firms selling goods at home that compete with imports should also gain from a weaker currency. Unless foreign competitors are prepared to keep the dollar price of their exports unchanged, which will involve a loss of profit in home currency, they will lose market share. In addition, a significant amount of US companies' overall profits comes from their foreign operations. As the dollar decline, overseas earnings are worth more in US currency.

Conclusion: In sum, we think a second round of asset purchase to push interest rates down and to jump start the sluggish economy will be met with limited success. Such actions will only cause the dollar to depreciate further. We maintain our stance that growth will be slow in the United States in the interim.

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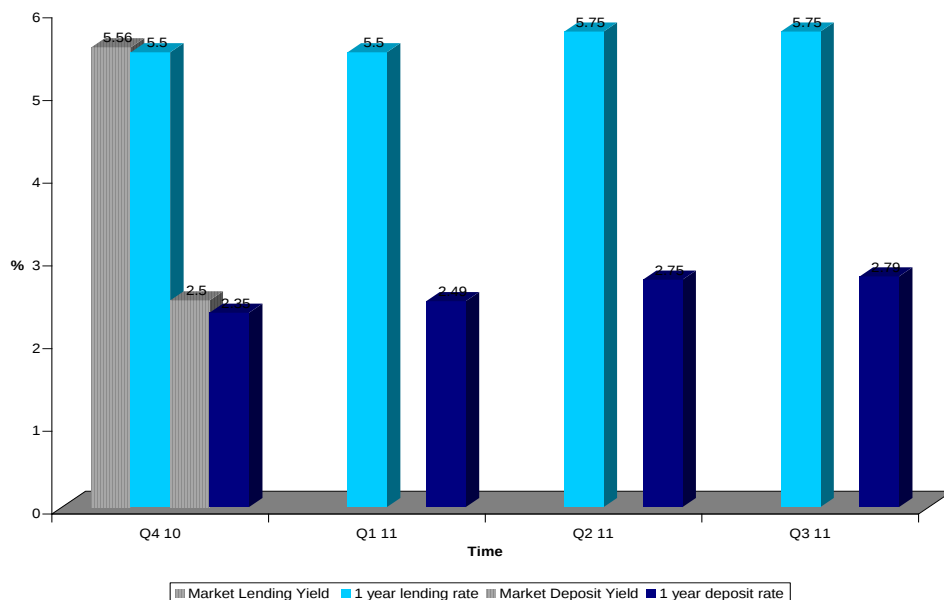
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China

Rate Hike: The People Bank of China raise its benchmark one-year lending and deposit rates by 25 basis points on 19th October 2010; the first increase since 2007. This policy shift was a surprise. Several economists surveyed by Bloomberg did not expect a rate hike to happen till second quarter of 2011. This is shown in the figure below.

Figure 2: Bloomberg Consensus



Source: Bloomberg, Oct 2010.

There are a few possible explanations for the policy shift. Firstly, the authorities might be looking at combating high inflation. In September, China's consumer price index (CPI) rose 3.6 percent year-on-year, building on a rise of 3.5 percent in August. We think this is less likely to be the reason behind the rate hike as the rise in CPI has primarily been due to food. Food prices surged 8 percent in September according to the National Bureau of Statistics of China. Stripping food and energy, the prices rose by 1.1 percent.

The second and more probable reason is that there are increased concerns over the pace of lending. In July, we mentioned 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. In September, net new lending has amounted to RMB 596 billion compared with the RMB 450 billion; consistent with meeting the lending quota. The Chinese government has been trying to prevent an excessive flow of money into the system, as it will lead to an asset bubble. This is especially so with regards to property prices. At the end of September, the Chinese government took further steps to curb stubbornly high property prices, ordering banks nationwide to halt lending for third and subsequent home purchases and raising the minimum down payment for all first-time home buyers. The latest pledge to tighten its grip on the property sector followed a series of similar measures unveiled in April that have so far achieved limited success.

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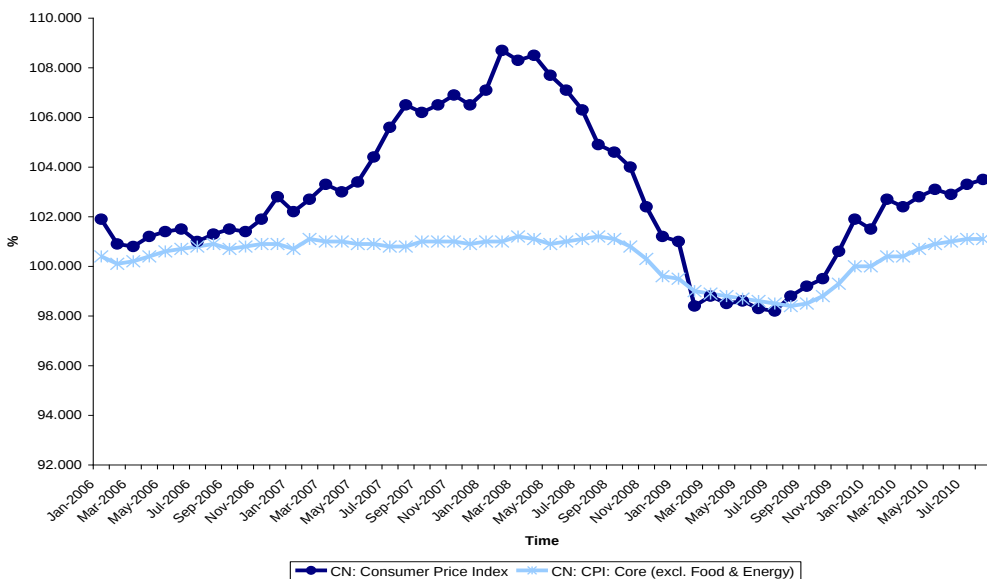


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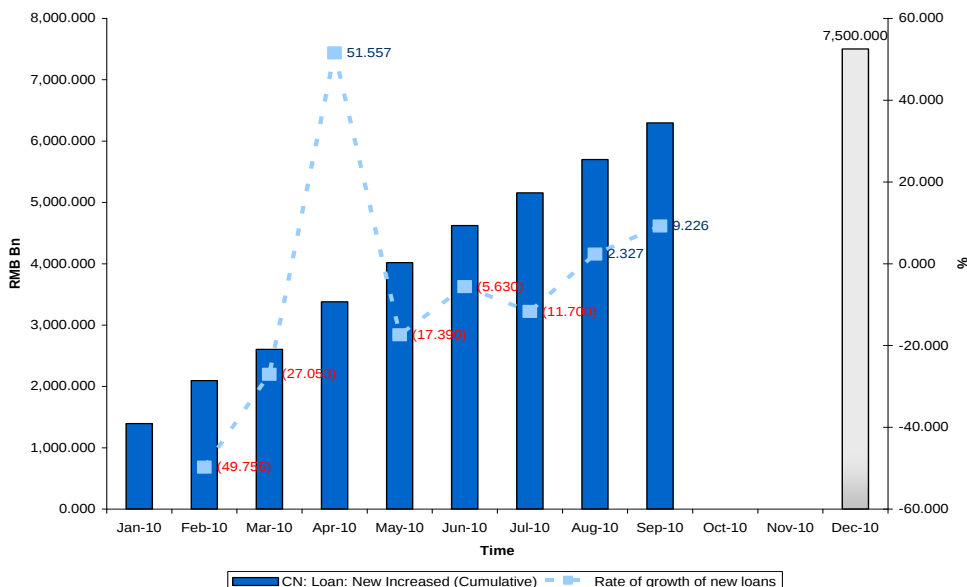
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Figure 3: China Consumer Price Index



Source: CEIC, Sep 2010..

Figure 4: New Loan Increase in China



Source: CEIC, Sep 2010.

We think that the rate hike will have little direct impact on economic conditions. With benchmark one-year lending rate now up to 5.56 percent from 5.31 percent, the move will not affect the amount banks lend since credit demand will still be strong (refer to figure 6). On the other hand, with deposit rates also higher, it is raising the income of saver; a small step that could promote economic rebalancing in the long run.

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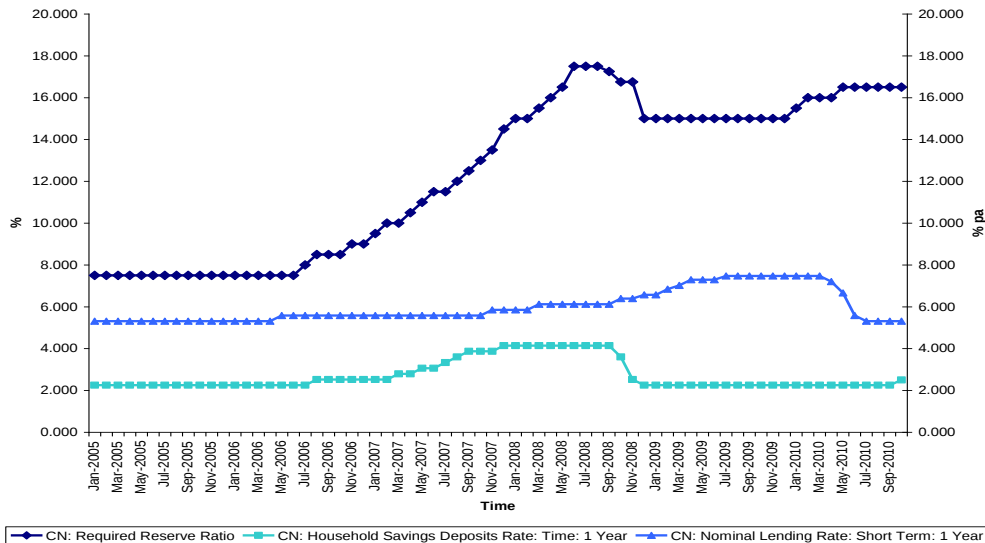


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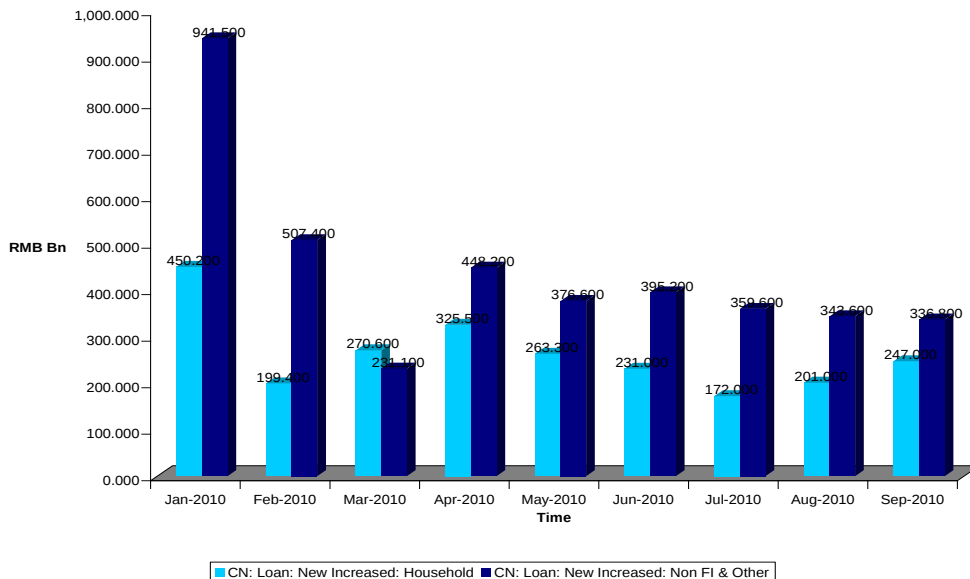
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Figure 5: China Policy Rates



Source: CEIC, Oct 2010

Figure 6: Demand for loans



Source: CEIC, Sep 2010.

RMB continues to appreciate against the dollar in October: As of 20th October, the Chinese currency has gained another 0.5 percent; this is in addition to the 1.7 percent gain in September. Despite the stronger currency, exports continue to surge in September. The government said its exports rose 25 percent while imports gained 24 percent. Such a trend however may not last, as exports will inevitably fall with a stronger currency.

We do think that the Chinese will once again be pressured into raising its currency in the weeks ahead.



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We do think that the Chinese will once again be pressured into raising its currency in the weeks ahead. China relaxed the dollar peg in June as criticism mounted ahead of the last G20 summit meeting and it allowed the appreciation to speed up last month. Further gains are likely before the G20 Leaders Summit on 11th – 12th November. Political pressure will not die away after that – particularly if US starts considering some legislation targeting at China. Having said that, we do think the Chinese will attempt to strike a balance between succumbing to political pressures and watching over economic considerations.

Conclusion: 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 the authorities 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.

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