RESEARCH

Weekly Watch

Asia

15 July 2011
Economic Analysis

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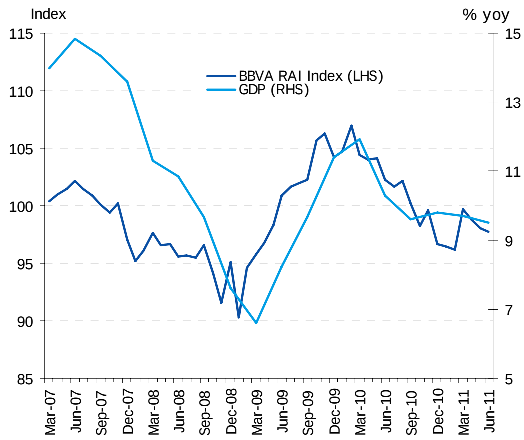
Fears of a hard landing ease in China

Tensions in Asian markets eased this past week on data showing that underlying growth in China remains strong, even as momentum moderates due to ongoing monetary tightening measures. In particular, second quarter GDP came in line with our projection of 9.5% y/y (Chart 1), slowing only slightly from Q1 (9.7% y/y). Other activity indicators were also strong, supporting our view of a soft landing for the Chinese economy during the remainder of 2011 (Highlights). Inflation, however, remains a concern (Chart 2), which could prompt the authorities to tighten monetary policy further in the months ahead, although expect inflation to ease, especially toward the end of the year. Elsewhere in the region, evidence of a slowdown continues to mount, with India's industrial production easing (Highlights), Singapore's GDP contracting (-7.8%, saar), and the Bank of Korea marking down its 2011 projections. Nevertheless, we expect the region's momentum to pick up in coming months on lower commodity prices and as supply disruptions in Japan continue to ease.

Slowing growth and external risks prompt many central banks to stay on hold

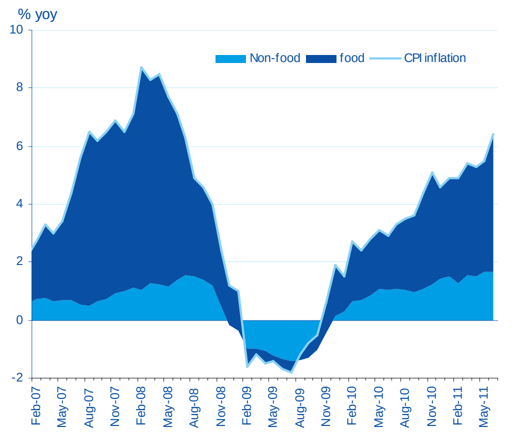
Central banks in Korea, Indonesia and Japan all kept interest rates unchanged at their policy meetings this past week, as expected, while Thailand surprised us with a 25bp hike to 3.25% following the peaceful outturn of general elections held on July 3. Given inflationary pressures, we expect most central banks to resume tightening, but at a very gradual pace given risks to the global environment. In Japan, the yen's strength to below ¥80 per USD continues to frustrate policymakers, and could dampen recovery prospects (see Weekly Indicator).

Chart 1
China: GDP growth moderating to a soft landing



Source: BBVA Research and Bloomberg

Chart 2
China's inflation is driven by rising food prices



Source: BBVA Research and Bloomberg

Highlights

China's robust Q2 GDP outturn eases fears of a hard landing

GDP growth is moderating in a healthy way, although inflation remains a concern

India's policy challenges intensify as inflation rises

India is coping with one of the region's highest inflation rates, even as domestic demand weakens

BBVA 2011 China Real Estate Outlook: healthy trends, with near-term risks

Our latest report finds a healthy and ongoing moderation in housing price increases

Economic Analysis

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Markets

Mounting anxiety about Europe's debt crisis spreading to Italy agitated markets and triggered a sell-off on Monday and Tuesday. Markets later gained ground after a strong GDP print in China and Bernanke's testimony, but most equity indices ended the week in the red. Interestingly, Asian FX continued to demonstrate its resilience to negative European headlines and finished the week with little change. Heading into weekend, most investors are turning more cautious as they watch the European bank stress test results and the Italian budget debate due later today.

G3 FX provide no clear safe haven, making EM relatively appealing

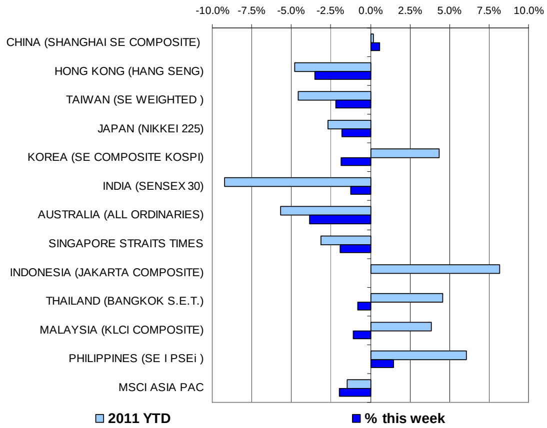
Leading global reserve currencies such as the EUR, USD, GBP and JPY all look weak in certain respects, helping to reduce the sell-off pressures on Asia and other EM FX in the latest bout of risk aversion in our view. In Europe, markets are increasingly worried about possible debt contagion to Italy. The concerns about Italy perhaps originated around a month ago from Moody's (and latter S&P) cut of its credit rating outlook to negative. Given the size of Italy's economy, sluggishness in growth and a public debt amounting to 120% of GDP, investors question if the Italian debt path is sustainable and whether EU has additional resources should Italy also degenerate into a full-blown debt crisis. Markets also raise doubt over the vulnerability of Italian banks given their holdings of government bonds and dependence on wholesale funding. The Italian government struggled to contain the spillover by advancing a 3-year EUR40 billion austerity package to balance the budget, down from 3.9% of GDP this year. The plan will be discussed by the parliament today.

In a typical risk-averse environment, the USD usually provides a safe-haven. But this time around, the USD also looks unsafe, as the country has been under threat of possible downgrade by Moody's and S&P, citing concerns that the Congress might not be able to agree on fiscal consolidation and lift the debt ceiling before August 2. Additionally, the markets were also surprised by Bernanke's remark that QE3 was not completely off the table, and the USD could dive if the Fed launches a new asset purchase program. On a relative basis, the dearth of safe haven currencies increases the appeal of Asian FX given the resilience of the regional economy to what's going on in Europe. Such advantage probably explains the relative resilience of Asian FX.

China's GDP provides a case for Asia's resilience

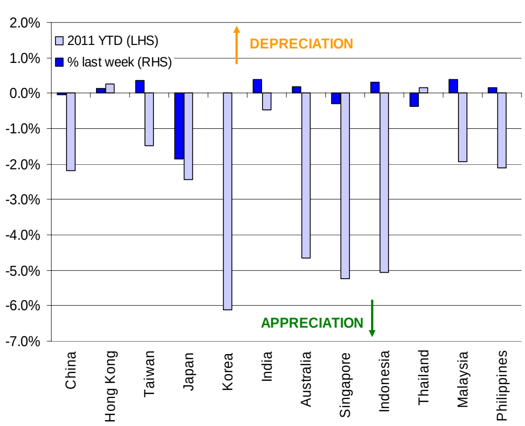
While Europe and the US are beleaguered by risk factors aforementioned, Asia's economy remains resilient, as exemplified by Q2 GDP and other June indicators from China (Highlights). Continued steady growth of the largest economy in the region should offer a buffer against a weakening global backdrop to the rest of the region. As growth dynamics in the region still look superior, and yield advantages continue to favor capital inflows, Asian FX also demonstrates extra-ordinary stability amidst choppy trading in global FX. For example, 1-month historical volatility of USDKRW and USDIDR, the two high beta currencies in the region, hardly moved in the past two weeks and stayed at 6.8 and 3.4 respectively. This stands in odd with the previous peak of 27.6 and 13.8 in the episode in May 2010 when Greece sought a bailout from IMF.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

Highlights

China's robust Q2 GDP outturn eases fears of a hard landing

As scheduled, this past week featured a stream of important economic data from China, including second quarter GDP, June inflation, credit growth, and other high frequency activity indicators. The data were of interest given worries in the market that overheating risks may have given way to prospects of a hard landing on ongoing policy tightening to stem inflation. On this front, the data brought good news, with signs of a gradual slowdown growth momentum, in line with our expectations of a soft landing for the economy during the course of 2011. GDP growth eased to 9.5% y/y from 9.7% in Q1, in line with our expectations, but above consensus (9.3% y/y). Robust growth momentum is also reflected in other activity indicators for June, including retail sales, urban fixed asset investment and industrial production, most of which surprised to the upside. Nevertheless, rising prices remain a concern, with June inflation reaching a higher-than-expected 6.4% y/y on account of higher food (especially pork) prices. We maintain our growth projection of 9.4% for 2011 and 9.1% in 2012, although the higher inflation print poses modest upside risks to our 5% year-average inflation outlook. We anticipate one more rate hike and another 50bp hike in the required reserve ratio during the remainder of the year, as the authorities take a more cautious approach to policy tightening in view of moderating growth indicators.

India's policy challenges intensify as inflation rises

Policy settings are becoming even more complex for the Indian authorities as inflation notches higher (Chart 5), even as domestic demand eases and investment activity remains sluggish. Data released this past week show that wholesale price inflation rose to an uncomfortably high 9.4% y/y in June (9.1% in May) with industrial production (IP) growth slowing to a 16-month low of 6.7% y/y in May from 7.1% in April (both expressed on a 3-month moving average basis to reduce m/m volatility). The pick-up in inflation was in part attributed to a discretionary policy move last month to raise administered fuel prices, but was mainly driven by continued price pressures from manufactured products. Meanwhile, the slowdown in IP data was consistent with subdued investment activity and weakening consumption spending as buyers postpone discretionary purchases amidst high inflation expectations. Policy delays, high commodity prices and rising interest costs has led to a slowdown in India's investment cycle over the past three quarters, a key factor weighing on growth momentum. As in China, the present scenario, however, paints a case for a soft landing, and is consistent with our full-year growth outlook of 8.1% for 2011 and average inflation at 9.0% y/y. It is also consistent with our view that the RBI will end its tightening cycle following another 25 bps hike at its next scheduled policy meeting on the July 26 as it adopts a wait and see approach following the significant policy tightening already in the pipeline.

BBVA 2011 China Real Estate Outlook: healthy trends, with near-term risks

Our third annual *Real Estate Outlook* on China, prepared with CITIC Bank and published this past week, updates recent developments, policies, and the outlook for China's residential property market. Investment in the property market has become an increasingly important driver of GDP growth and, given China's large contribution to global growth, it has become an increasingly significant determinant of the global outlook. In light of this, China's property sector has attracted intense interest, especially due to concerns of rapid price increases and overheating risks. In our report, we find that, encouragingly, property price increases in China have moderated over the past year (Chart 6) under the influence of government cooling measures, which include efforts to reign in liquidity, tighten credit, and intensify various macro-prudential measures. We estimate that the degree of overvaluation of current prices relative to fundamentals has narrowed in comparison to last year's assessment due both to improvements in our estimation methodology and to the moderation in actual price increases. Moreover, the rise in China's prices in recent years does not appear worrisome compared with international bubbles elsewhere (U.S., Spain, and Japan) and given China's strong medium-term GDP growth prospects. Nevertheless, pockets of more severe overvaluation may exist in certain sectors and in some of the larger cities. If left unchecked, further price increases could lead to bubbles in the future, justifying the government's early efforts to forestall bubble risks. In the medium term, we maintain our positive outlook for property prices, given China's rapid projected income growth and urbanization. Our report also highlights the government's ambitious plans to provide affordable housing, and it draws on lessons from international experience for useful lessons.

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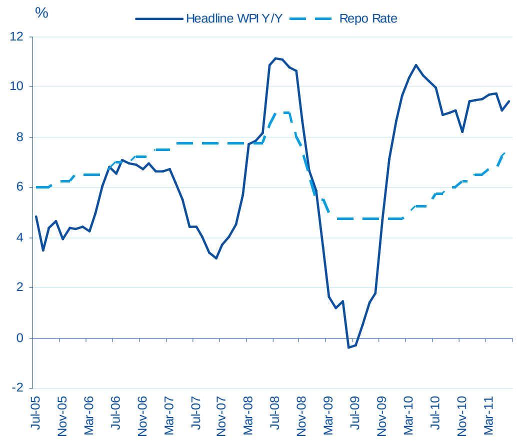
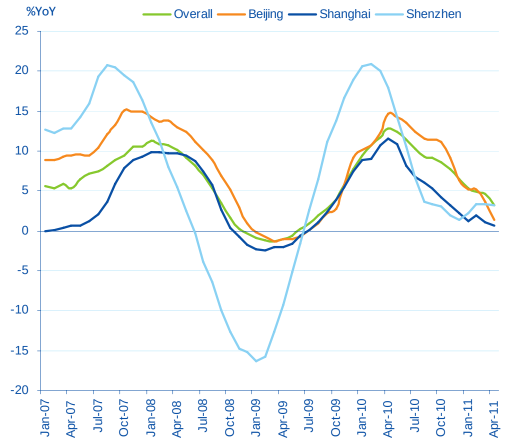
Chart 5
India's headline inflation remains high



Source: BBVA Research and Bloomberg

Chart 6
China's property price increases have eased



Source: BBVA Research and Bloomberg

Calendar Indicators

Australia	Date	Period	Prior	Cons.
New Motor Vehicle Sales (YoY)	18-Jul	JUN	-14.50%	- -
Import price index (QoQ)	22-Jul	2Q	1.40%	-1.10%
Export price index (QoQ)	22-Jul	2Q	5.20%	4.50%
China	**Date**	**Period**	**Prior**	**Cons.**
HSBC Flash China Manufacturing PMI	21-Jul	JUL	50.1	- -
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
Unemployment Rate SA	19-Jul	JUN	3.50%	3.50%
Composite Interest Rate	19-Jul	JUN	0.26%	- -
CPI Inflation (YoY)	21-Jul	JUN	5.20%	5.40%
Japan	**Date**	**Period**	**Prior**	**Cons.**
Convenience Store Sales (YoY)	20-Jul	JUN	5.70%	- -
Adjusted Trade Balance	21-Jul	JUN	-¥474.6B	-¥250.4B
Exports (YoY)	21-Jul	JUN	-10.3	-4.2
Imports (YoY)	21-Jul	JUN	12.3	11
All Industry Activity Index (MoM)	21-Jul	MAY	1.50%	1.80%
Supermarket Sales (YoY)	22-Jul	JUN	-1.40%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
CPI Inflation (YoY)	20-Jul	JUN	3.30%	3.60%
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Balance of Payments	19-Jul	JUN	$217M	- -
Budget Deficit/Surplus	21-25 JUL	JUN	-9.6B	- -
Singapore	**Date**	**Period**	**Prior**	**Cons.**
Electronic Exports (YoY)	18-Jul	JUN	-15.20%	- -
Non-oil Domestic Exports (YoY)	18-Jul	JUN	7.80%	4.10%
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
Exports (YoY)	20-Jul	JUN	11.53%	- -
Unemployment Rate SA	22-Jul	JUN	4.41%	- -
Thailand	**Date**	**Period**	**Prior**	**Cons.**
Total Car Sales	18-22 JUL	JUN	55851	- -
Exports (YoY)	20-25 JUL	JUN	17.60%	10.00%
Imports (YoY)	20-25 JUL	JUN	33.80%	24.20%
Trade Balance	20-25 JUL	JUN	$278M	- -

Indicator of the Week: Japan export growth for June (July 21)

Forecast: -4.2% y/y	Consensus: -4.9% y/y	Prior: -10.3% y/y

Comment: Japan's activity indicators are showing signs of a rebound, in some cases more quickly than expected, as production and supply chains resume after the March 11 earthquake and tsunami. The auto sector is restoring facilities and hiring workers to return capacity back to normal levels. Exports and industrial production appear to have bottomed out in April, setting the stage for a recovery that began in May, and which we expect to see continue in June. That said, the outlook remains uncertain due to the shaky external environment, concerns of electricity shortages, and limits on fiscal policy due to Japan's heavy public debt burden. Market impact: A lower-than-expected outturn would reinforce concerns about growth prospects in H2.

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Calendar Events

Australia – Reserve Bank's Board July Minutes, July 19

Markets Data

STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2813.8	0.6	0.2	16.1
Hong Kong – Hang Seng	21927.7	-3.5	-4.8	8.3
Taiwan – Weighted	8560.6	-2.2	-4.6	11.1
Japan – Nikkei 225	9955.6	-1.8	-2.7	2.8
Korea – Kospi	2139.2	-1.9	4.3	22.2
India – Sensex 30	18618.2	-1.3	-9.2	4.0
Australia – SPX/ASX 200	4473.4	-3.9	-5.7	0.7
Singapore – Strait Times	3089.8	-2.0	-3.1	5.0
Indonesia – Jakarta Comp	4007.2	0.1	8.2	34.4
Thailand – SET	1079.9	-0.8	4.6	31.5
Malaysia – KLCI	1577.2	-1.1	3.8	18.2
Philippines – Manila Comp.	4453.6	1.4	6.0	28.4

Last update: Thursday, 11.15 Hong Kong time.

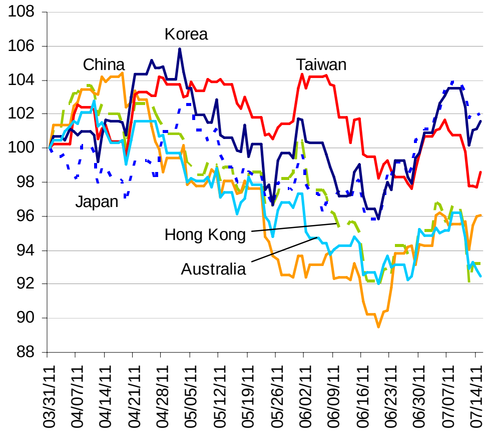
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.46	0.04	6.45	6.39
Hong Kong (HKD/USD)	7.79	-0.13	7.8	8
Taiwan (TWD/USD)	28.9	-0.35	28.74	28.26
Japan (JPY/USD)	79.2	1.88	79.1	78.8
Korea (KRW/USD)	1057	-0.01	1063.55	1075.11
India (INR/USD)	44.5	-0.16	45.0	47
Australia (USD/AUD)	1.07	-0.20	1	n.a.
Singapore (SGD/USD)	1.22	0.30	1.22	1.2
Indonesia (IDR/USD)	8540	-0.30	8597	8860
Thailand (THB/USD)	30.1	0.37	30.28	30.8
Malaysia (MYR/USD)	3.00	-0.39	3.0	3
Philippines (PHP/USD)	42.9	-0.15	43.06	43.35

Last update: Thursday, 11.15 Hong Kong time.

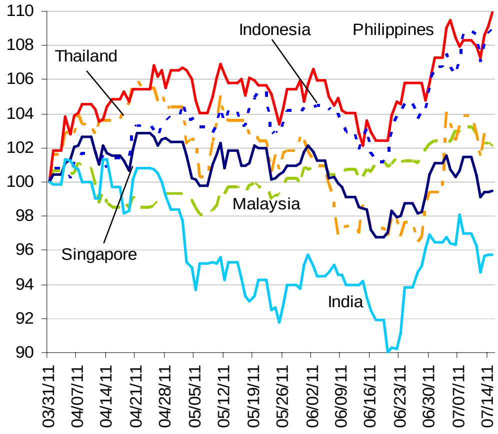
Charts

Chart 7
Stock Markets



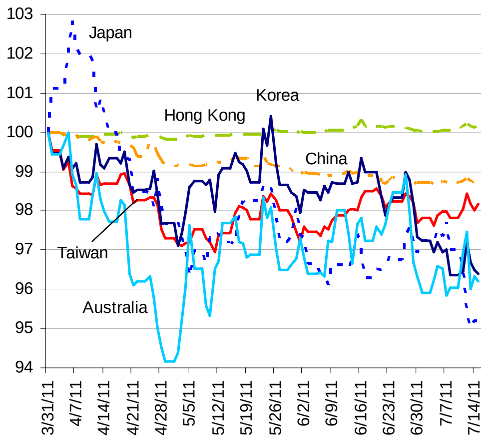
Source: BBVA Research and Bloomberg

Chart 8
Stock Markets



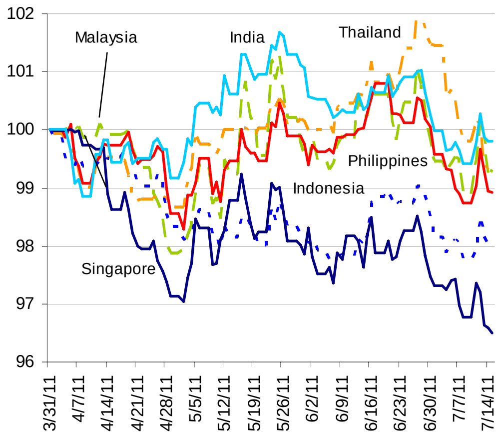
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



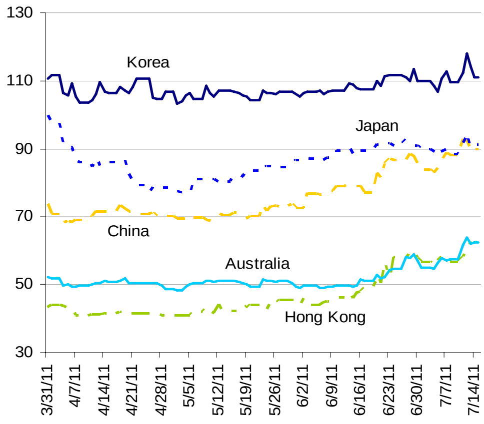
Source: BBVA Research and Bloomberg

Chart 10
Foreign Exchange Markets



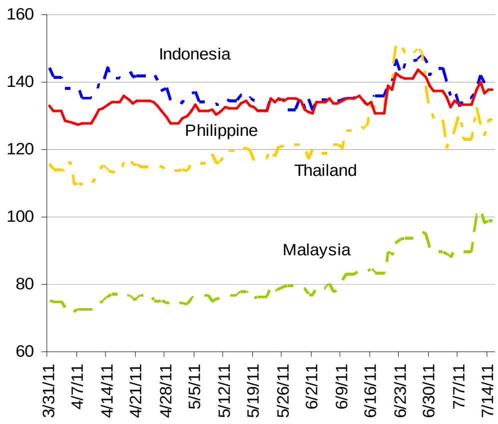
Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 12
Credit Default Swaps



Source: BBVA Research and Bloomberg

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