

Weekly Watch

Asia

29 July 2011
Economic Analysis

Asia

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Coping with the US debt stalemate

As the US debt ceiling standoff continues, regional investor sentiment has remained quite resilient even though, as elsewhere in the world, equity markets have been under pressure. Sentiment in the region continues to be buoyed by Asia's strong underlying fundamentals, despite rising concerns that a weaker external outlook could dent export growth. Meanwhile, given their large holdings of US Treasuries, Chinese officials have issued fresh statements of discontent about the US stalemate, while at the same time signaling that a large selloff is unlikely (see Highlights).

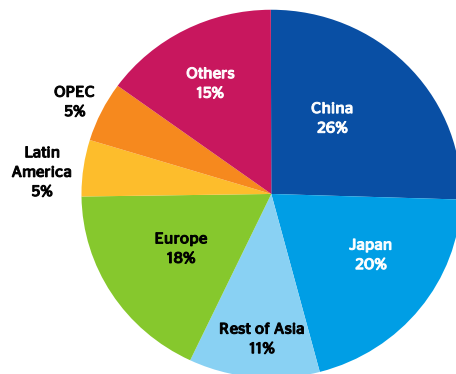
Inflationary pressures continue despite signs of slowing growth

Inflation releases this past week were generally above expectations, further enhancing the market's focus on a batch of CPI outturns for July due out next week. Australia's second quarter CPI outturn was ahead of expectations, as inflation rose to 3.6% y/y (prior: 3.3%; consensus 3.4%), raising expectations of further rate hikes later in the year despite recent signs of slowing growth. Singapore's June inflation outturn rose to 5.2%, slightly ahead of consensus (prior: 4.5%; consensus: 5.1%), adding to further currency appreciation. In Japan, both headline and core inflation for June came in above expectations, which is welcome news given ongoing risks of deflation. Next week, eyes will be on China's PMI (see weekly indicator) and July inflation outturns in Korea, Taiwan, Indonesia, Thailand and the Philippines.

Chart 1

Composition of foreign holdings of US Treasuries

Composition of foreign holdings of U.S. Treasuries*
(As of May 2011)

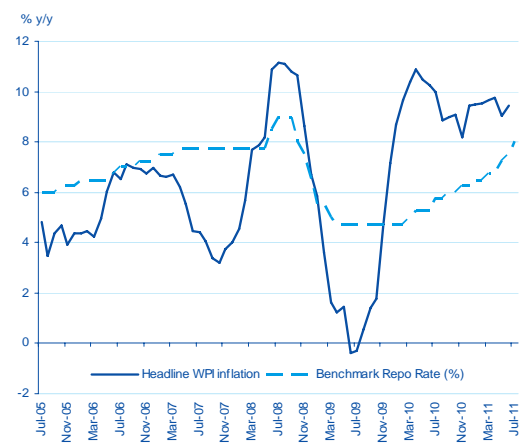


*Foreign holdings represent around 30% of total outstanding US

Source: BBVA Research and Bloomberg

Chart 2

India hikes interest rates to tame inflation



Source: BBVA Research and Bloomberg

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India surprises with a 50 bps rate hike as its battle with inflation intensifies

The Reserve Bank of India takes an aggressive stand (Chart 2) despite signs of slowing demand

US debt woes to have limited impact on Asian dollar reserve holdings

There are few alternatives to the US Treasuries' deep and liquid market for Asian central banks

Vietnam's struggle to maintain macro stability continues

Markets are unconvinced of the central bank's commitment to lowering inflation

Economic Analysis

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Markets

Asian financial markets are feeling the effects, albeit rather limited, of the fallout from tensions over the US debt ceiling standoff. While stock markets declined steadily toward the end of the week, they ended mixed for the week as a whole, and regional FX posted modest gains. As no deal is still in sight entering the weekend, anxiety may continue to build with increases in asset price volatilities on news flows from the US in the coming days.

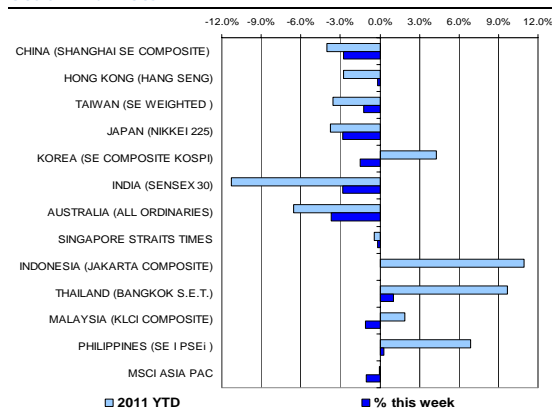
Inflation concerns send AUD and SGD to new highs

The past week saw AUD reaching a fresh all-time high of 1.1081 vs. the USD on July 27, though the pair retraced slightly afterwards to a tad below 1.1000 on Friday. In addition to USD weakness, the currency appreciation was driven by upside surprise in Australia's Q2 CPI (3.6% y/y as compared to a Bloomberg consensus survey of 3.4%). The data support our out-of-consensus forecast of an additional 25 bp hike by the RBA in H2 to curb price pressure. AUD responded significantly as the markets had anticipated rate cuts in the next 12 months, with over 50 bps cuts priced in the OIS curve. While we anticipated a higher AUDUSD, the sharp increases this week have surpassed our July target of 1.0850. We caution that the extended valuation make AUD look vulnerable to corrections, especially if and when US lawmakers reach a deal on the debt ceiling.

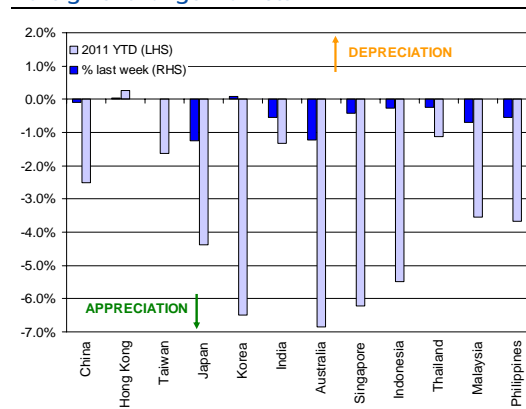
SGD also hit new highs this week, breaching 1.20 vs. the USD on July 27 briefly. But the pair failed to sustain and climbed back to 1.2040, little changed from the previous week's close. The strength in SGD stemmed from a higher CPI print in June, up 5.2% y/y from 4.5% in April. Higher inflation fuelled expectation that the Monetary Authority of Singapore will remain hawkish, allowing SGD NEER to continue to trade at the upper end of the perceived band. On the one hand, we see little surprise in June inflation, as we have already flagged that low base effects last year should boost y/y figures and has been largely anticipated by the markets. On the other hand, we are more worried about continued strength in domestic demand and tight labor markets, which may keep inflation elevated for the remainder of the year. The latter developments pose downside risks to our USDSGD forecasts, currently at 1.2350 by end-2011.

Possibility of Bank of Japan intervention

In light of the stalemate in the US debt debate, investors have been piling funds into safe currencies and precious metals, stretching valuations in these assets. In particular, risk aversion sparked a slide in USDJPY, down to 77.56 on Friday, a new low since March earthquake. We think the current strength in JPY is overdone. Coupled with an extended net-long positioning in the latest CFTC reports, USDJPY seems vulnerable to correction. We caution a possible reversal in the pair should a last-minute debt ceiling deal be reached in the US before August 2nd, as in our base-case scenario. We also see the possibility of BoJ intervention should JPY continue to strengthen. In fact, JPY's nominal effective exchange rate has been on a gradual rise, not far away from the level that triggered intervention in March. Markets are aware of this possibility given the latest comments by the BoJ and have been reluctant to push down USDJPY aggressively.

Chart 3
Stock markets

Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets

Source: BBVA Research and Bloomberg

Highlights

India's surprises with a 50 bps rate hike as its battle with inflation intensifies

India's ongoing battle with inflation, among the highest in the region, intensified this week as the Reserve Bank of India (RBI) surprised markets with a larger-than-expected 50 bps hike in interest rates at its scheduled policy meeting (see Chart 2 on cover page). The move pushes the benchmark repo rate up to 8.0%, the eleventh rate hike since the tightening cycle began in March 2010, and only the third 50bp increase (the last increase of this magnitude was in May 2011). The RBI also raised its inflation outlook for March 2012 to 7.0% y/y from 6.0% previously, while retaining its projection for GDP growth at 8.0% y/y, broadly in line with our projections. Policymakers noted that the aggressive approach was warranted as the combination of commodity price increases and buoyant domestic demand have caused inflation to rise to unacceptable levels. (Over the past 18 months, inflation has risen to three times the RBI's medium term target of 3% and about twice its comfort level of 4.5%). The RBI emphasized that its next action will be data dependent, and a change in policy stance would be driven by signs of a sustainable downturn in inflation. Given favorable weather patterns and our outlook for benign global oil price movements, we foresee inflation trending lower in the months ahead. With growth slowing, risks are rising that an overtly tight policy could stifle growth momentum, although the likelihood is still low. Against this backdrop, we believe that RBI has reached the end of its rate hike cycle, although risks remain on the upside for interest rates.

US debt woes to have limited impact on Asian Dollar reserve holdings

Markets sentiment across Asia has remained generally calm as the US debt ceiling standoff unfolds, although equity markets have declined and the Japanese Yen has appreciated due to safe haven effects. A more interesting issue concerns the impact that all of this uncertainty might have on the composition of Asian foreign exchange reserves. Even if a last-minute debt-ceiling deal is clinched, as is widely expected, a rating downgrade could still follow, putting the US's AAA-rating at risk. Since Asian central banks are major holders of US treasuries—the region accounts for over half of the total held by foreigners, led by China and Japan (see Chart 1 on the cover)—any shift out of the US dollar could have large effects on global currency and debt markets. Nevertheless, we believe an abrupt shift is unlikely for the following reasons. First, the impact of any rating downgrade on bond yields is expected to be limited as domestic demand for US Treasuries remains hefty. In addition, and perhaps most important, there is a lack of alternatives to the liquid US treasury market. Indeed, statements by Chinese officials in recent days echo this theme. In short, Asian monetary authorities are likely to continue their reserve diversification strategy at a gradual pace, as in the past decade (Chart 5), but they are unlikely to panic.

Vietnam's struggle to maintain macro stability continues

The latest inflation data release from Vietnam underscores the authorities' ongoing difficulties in maintaining macro stability in their overheating economy. Inflation continues to soar, reaching 22.2% y/y in July, driven by rising food prices which have been exacerbated by successive currency devaluations (Chart 6). Meanwhile, markets have reacted with skepticism following an unexpected interest rate cut earlier this month by the Central Bank, which was aimed at achieving "reasonable" rates for loans for rural and agricultural companies. We expect inflation to remain high, at around 17-20% y/y through the end of the year. Besides reining in price pressures, policy makers are facing other challenges such as curbing a wide trade deficit, and stemming downward currency pressures due to weak market sentiment following last year's downgrades by all main rating agencies to a negative outlook. On the positive side, even though economic growth has eased somewhat, it remains reasonably strong, with Q2 GDP rising by 5.6%y/y, accelerating from the previous period. Our outlook for GDP growth in 2011 is 6.2% y/y from 6.8% in 2010, in line with the consensus.

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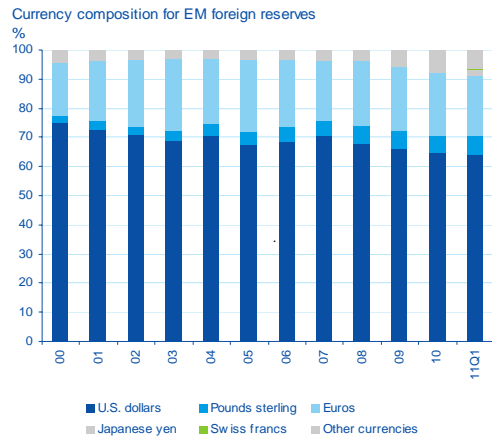
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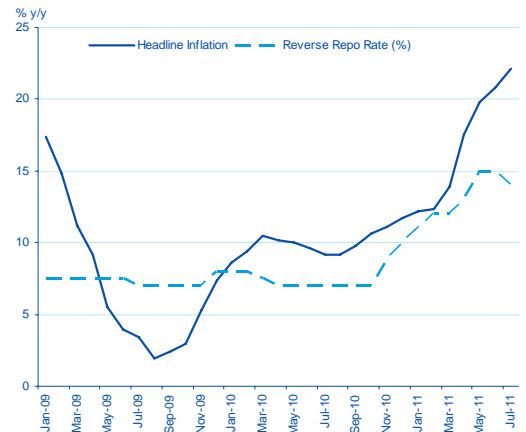
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Chart 5
Emerging economies are been gradually diversifying FX reserves away the US dollar



Source: BBVA Research and Bloomberg

Chart 6
Vietnam's inflation is accelerating



Source: BBVA Research and Bloomberg

Calendar Indicators

Australia	Date	Period	Prior	Cons.
House Price Index YoY	2-Aug	2Q	-0.20%	--
Building Approvals (YoY)	2-Aug	JUN	-14.40%	--
RBA Commodity Index SDR YoY%	2-Aug	JUL	28.20%	--
Retail Sales Ex Inflation(QoQ)	3-Aug	2Q	0.00%	--
China	Date	Period	Prior	Cons.
PMI Manufacturing	1-Aug	JUL	50.9	50.2
HSBC Manufacturing PMI	1-Aug	JUL	50.1	--
China Non-manufacturing PMI	3-Aug	JUL	57	--
China HSBC Services PMI	3-Aug	JUL	54.1	--
Hong Kong	Date	Period	Prior	Cons.
Retail Sales - Value (YoY)	1-Aug	JUN	27.80%	--
Indonesia	Date	Period	Prior	Cons.
CPI Inflation (YoY)	1-Aug	JUL	5.54%	4.80%
Exports (YoY)	1-Aug	JUN	45.30%	45.00%
Imports (YoY)	1-Aug	JUN	48.50%	32.00%
GDP Constant Price (YoY)	5-Aug	2Q	6.46%	--
India	Date	Period	Prior	Cons.
Exports (YoY)	1-Aug	JUN	56.90%	--
Imports (YoY)	1-Aug	JUN	54.10%	--
Japan	Date	Period	Prior	Cons.
Vehicle Sales (YoY)	1-Aug	JUL	-23.30%	--
Philippines	Date	Period	Prior	Cons.
Budget Deficit/Surplus	29 J - 02 A	JUN	-9.6B	--
CPI Inflation (YoY)	5-Aug	JUL	5.20%	4.90%
Korea	Date	Period	Prior	Cons.
CPI Inflation (YoY)	1-Aug	JUL	4.40%	4.40%
Ext Trade - Export (YoY)	1-Aug	JUL	14.50%	17.10%
Ext Trade - Imports (YoY)	1-Aug	JUL	27.40%	26.10%
Taiwan	Date	Period	Prior	Cons.
CPI Inflation (YoY)	5-Aug	JUL	1.93%	2.00%
WPI YoY%	5-Aug	JUL	3.94%	4.28%
Thailand	Date	Period	Prior	Cons.
CPI Inflation (YoY)	1-Aug	JUL	4.06%	4.15%

Indicator of the Week: China's PMI for July (August 1)

Forecast: 50.2	Consensus: 50.1	Prior: 50.9
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Comment: The Purchasing Managers' Index (PMI) for July will be closely watched against the backdrop of lingering worries of a hard landing. A strong Q2 GDP outturn (9.5% y/y) allayed such concerns, but they could reemerge as signs of further growth moderation appear and as the PMI flirts with the important benchmark level of 50 (reflecting expansion/contraction). We expect the PMI to decline for a fourth consecutive month to 50.2, due in part to seasonal effects (despite NBS efforts to seasonally adjust the series). We expect a rebound in August, in line with seasonal trends and our soft landing scenario.

Market impact: A lower-than-expected reading, especially below 50, could dent market sentiment by exacerbating fears of a hard landing.

Calendar Events

Australia - RBA Cash Target, August 2

We expect no change in the interest rates.

Japan - BOJ Target Rate, August 5

We expect no change in the interest rates.

Current	Consensus
4.75%	4.75%

Current	Consensus
0.10%	0.10%

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STOCK MARKETS	INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
	China - Shanghai Comp.	2695.2	-2.7	-4.0	1.8
	Hong Kong - Hang Seng	22405.0	-0.2	-2.7	6.2
	Taiwan - Weighted	8654.2	-1.3	-3.5	11.0
	Japan - Nikkei 225	9847.3	-2.8	-3.7	1.6
	Korea - Kospi	2139.2	-1.5	4.3	20.8
	India - Sensex 30	18194.2	-2.8	-11.3	1.1
	Australia - SPX/ASX 200	4434.5	-3.7	-6.5	-2.0
	Singapore - Strait Times	3176.4	-0.2	-0.4	6.0
	Indonesia - Jakarta Comp	4110.3	0.1	11.0	32.7
	Thailand - SET	1132.3	1.0	9.6	32.5
	Malaysia - KLCI	1547.5	-1.1	1.9	13.9
	Philippines - Manila Comp.	4491.6	0.3	6.9	31.0

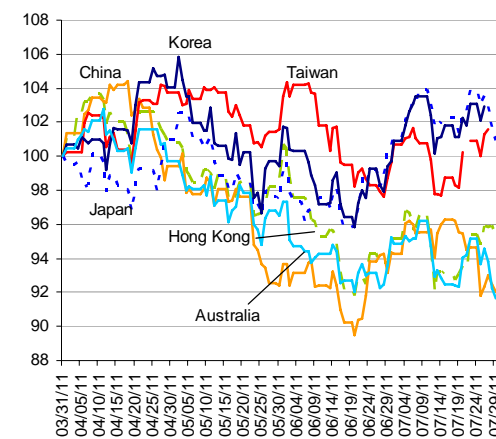
Last update: Friday, 11:15 Hong Kong time.

FOREIGN EXCHANGE MARKETS	CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
	China (CNY/USD)	6.44	0.09	6.43	6.38
	Hong Kong (HKD/USD)	7.79	-0.04	7.8	8
	Taiwan (TWD/USD)	28.8	-0.02	28.68	28.22
	Japan (JPY/USD)	77.6	1.25	77.5	77.2
	Korea (KRW/USD)	1053	-0.09	1059.85	1072.50
	India (INR/USD)	44.1	0.56	44.5	46
	Australia (USD/AUD)	1.10	1.25	1	n.a.
	Singapore (SGD/USD)	1.20	0.42	1.20	1.2
	Indonesia (IDR/USD)	8502	0.26	8527	8765
	Thailand (THB/USD)	29.7	0.24	29.89	30.4
	Malaysia (MYR/USD)	2.95	0.71	3.0	3
	Philippines (PHP/USD)	42.2	0.56	42.32	42.59

Last update: Friday, 11:15 Hong Kong time.

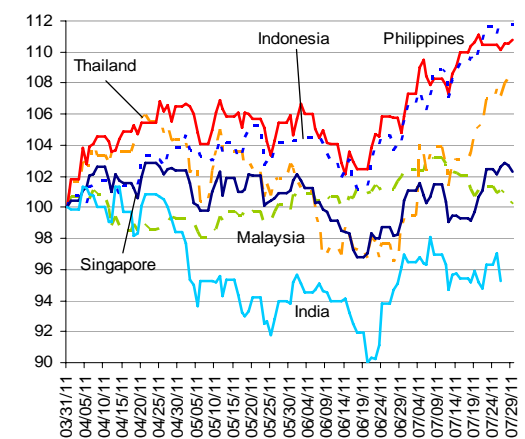
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Chart 7
Stock Markets



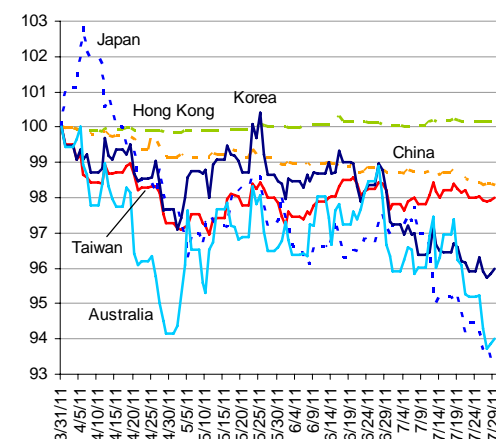
Source: BBVA Research and Bloomberg

Chart 8
Stock Markets



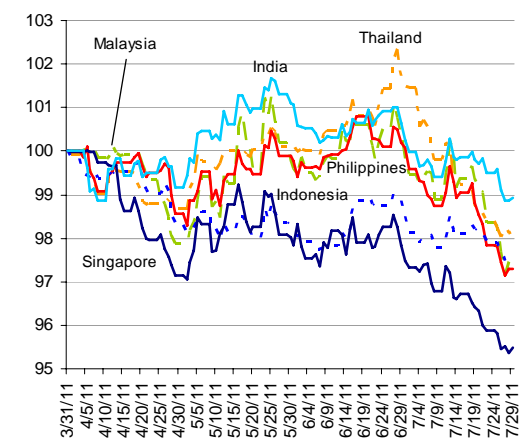
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



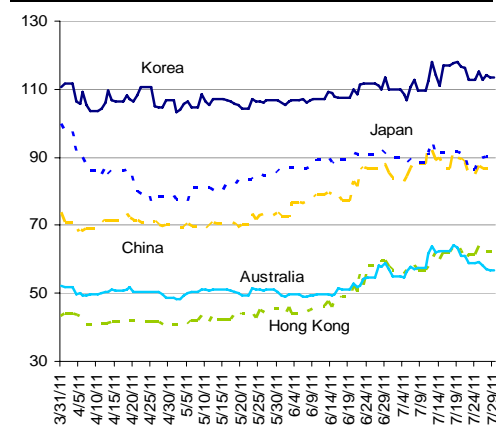
Source: BBVA Research and Bloomberg

Chart 10
Foreign Exchange Markets



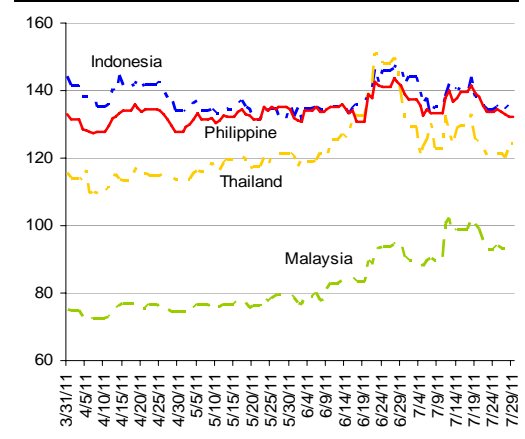
Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 12
Credit Default Swaps



Source: BBVA Research and Bloomberg

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