BBVA | RESEARCH

Weekly Watch
Asia

19 August 2011
Economic Analysis

Asia
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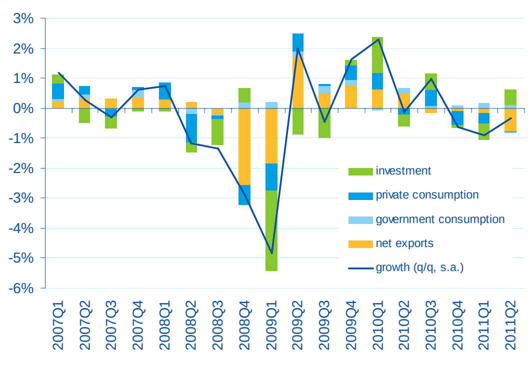
Can Asia hold its ground?

It has been another down week for Asian markets, in tandem with the global financial turbulence. Asian equity markets have turned down, not only because of increased global risk aversion, but also because of concerns, we believe, about the impact on the region's growth prospects from increasing downside risks to external demand. That said, we see reason for optimism that Asia can withstand a weaker global growth outlook (Highlights). In particular, its economic fundamentals are strong, and there is room for policy stimulus. So far, activity indicators are holding up reasonably well (see below). Meanwhile, in Hong Kong, where the stock market this year has been especially weak, sentiment was temporarily boosted with the announcement by Chinese officials of further steps to enhance the city's role as a financial center. These include the marketing of ETFs for Mainland investors in Hong Kong's stock market, repatriation of offshore RMB for direct purchase of securities in China, and Hong Kong companies' use offshore RMB for FDI in China.

Reason for optimism: some activity indicators better than expected

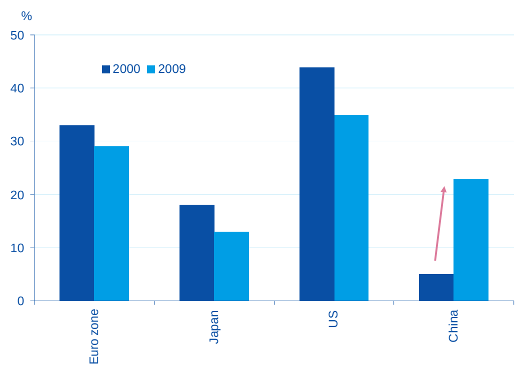
Second quarter GDP outturns, while moderating, came out better than expected in Japan (--0.3% q/q, sa vs. consensus -0.7%) and Malaysia (4.0 %y/y; consensus: 3.6% y/y). In India, June industrial production surprised to the upside, while Hong Kong posted better-than-expected employment data. Nevertheless, weaker-than-expected July exports in Singapore are a reminder of the region's vulnerability. Fortunately, the scope for a slower pace of monetary tightening is increasing due to softer inflation outturns, as in India (9.2% y/y; prior: 9.4%) and Malaysia (3.4% y/y; prior: 3.5%). In the coming week (see Calendar), markets will be watching inflation outturns in Singapore (Weekly Indicator), Hong Kong, Japan, and Vietnam.; Thailand's Q2 GDP; and its monthly monetary policy meeting (the consensus if for a 25bp hike, although the global environment may give the BOT same pause). Finally, the HSBC Flash estimate of China's PMI will be watched.

Chart 1
Japan's growth bottomed out in Q2...



Source: CEIC and BBVA Research

Chart 2
Sources of final demand for Asian exports



Source: Singapore MAS and BBVA Research

Highlights

How vulnerable is Asia?
The region is not immune, but there are reasons for optimism

Japan's economy demonstrates resilience in the post-quake recovery
Despite headwinds, Japan's recovery is picking up

India: Global headwinds add to growth risks amidst high inflation
Global risks come as India's growth is already slowing

Economic Analysis

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Markets

Concerns about slowing growth and stresses on European banks are causing volatility in global financial markets, with spillovers to Asia. Regional stock markets benefited from short-selling bans by several European bourses and took a breather from the downturns at the start of this week. But they relapsed quickly today after the Philly Fed survey hinted at a further deterioration in US Q3 growth and as worries about bank funding issues deepened in Europe. Asian currencies have also been trading in tandem on a risk-on/ risk-off mode. Sharp deterioration in risk appetite on Friday has reversed earlier gains this week.

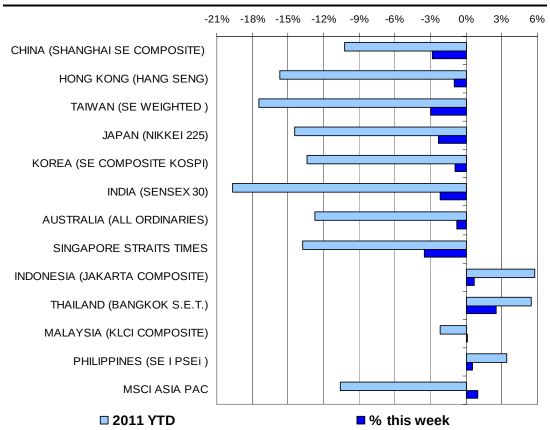
Asian currencies resilient to global soft-landing

We continue to believe that Asia's strong macro fundamentals should help contain the fallout on Asia of a risk scenario of softer global growth (see Highlight). As currency performance in the medium-term is commensurate with relative economic growth, our positive assessment in a downside global risk scenario should support outperformance of Asian FX. But in t he meantime, regional currencies will continue to trade lower in a broadly risk-off mode. Additionally, we think that countries that are more heavily dependent on exports, or those lacking the capacity to add stimulus should face higher currency depreciation pressure. On this scoring system, INR, MYR, AUD and SGD look more susceptible to further deterioration in risk appetite.

CNY appreciation has accelerated, but looks unsustainable

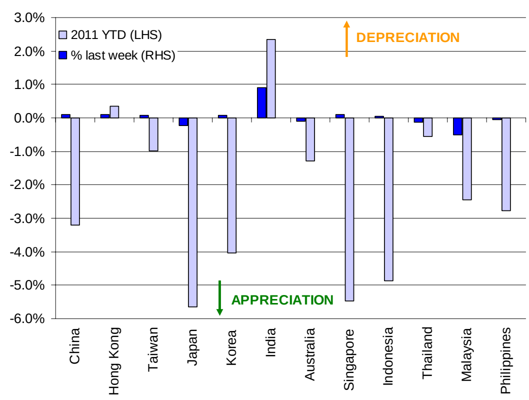
The People's Bank of China (PBoC) set the official mid-rate consecutively lower recently, down from 6.4551 to 6.3925 between August 5 and 16, implying annualized appreciation of 18%. While the official USDCNY mid-rate reversed and was set slightly higher above 6.4000 again today, expectations of further CNY appreciation kept USDCNY spot trading on the lower side of the fix. Markets have generally cited higher exports and CPI prints in July as the key drivers, but these explanations do not align with recent price action in our view. In the past, China's policymakers have rarely changed the pace of CNY appreciation on monthly trade or inflation outturns. Rather, we believe it is better explained by China's plan to issue bonds in Hong Kong as well as this week's political calendar. Specifically, China's Ministry of Finance is in the process of raising CNY 20bn in CNH markets; allowing CNY to appreciate at a quicker-than-usual pace ahead of the bond placement should increase the issue's appeal. Moreover, US Vice President Biden's visit this past week provided an opportune time for appreciation. Going forward, however, we believe the recent quicker-than-normal pace of CNY appreciation is an outlier and is unlikely to be sustained. Stronger global economic headwinds should prompt Chinese policymakers to take a wait-and-see approach and be more cautious before introducing new monetary measures or altering CNY policy. We continue to believe, on average, CNY will appreciate at an annualized pace of 4-5% against the USD, but the pace of appreciation on a monthly / quarterly basis could be lumpy depending on the direction of the USD and political events.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

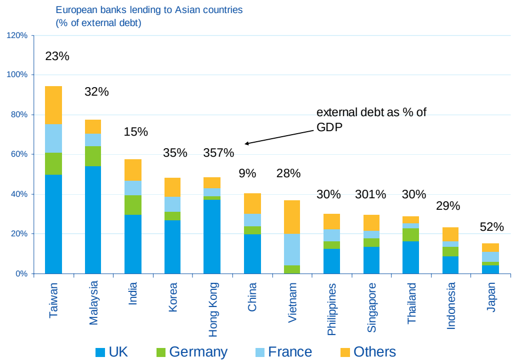
Economic Analysis

Highlights

How vulnerable is Asia?

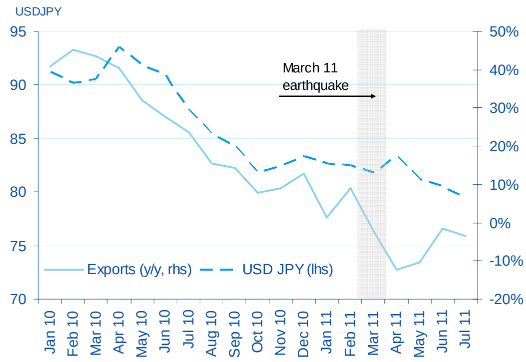
With growth and debt concerns in the US and Europe weighing on financial markets, it is timely to assess Asia's resilience to global turbulence. While Asia would not be immune to a global downturn, we remain relatively confident in the region's ability to withstand external pressures thanks to its strong economic fundamentals and room for policy maneuver. A downturn in the global economy would affect Asia through trade and financial channels. Regarding the former, Asia remains heavily export-dependent, with much of the final demand for its products coming from the US and EU. As a result, the region's smaller and more export-oriented economies would feel the brunt of any global growth slowdown, as was the case in 2008-09 (Hong Kong, Taiwan, Thailand, Malaysia, and Singapore all saw large output contractions in 2009). That said, intra-regional trade may help cushion the effect—China, which is expected to continue growing strongly, has become the region's third largest market for Asian exports (after the US and Europe) when measured by final demand (Chart 2 in the FrontPage). Regarding the financial channel, Asian economies are susceptible to a possible tightening in credit conditions from European banks. However, their overall debt-to-GDP levels and dependence on European banks is limited (see Chart 5). Taiwan, Malaysia, India, and Korea have a relatively high proportion of external financing from European banks, while Hong Kong and Singapore are also vulnerable given their roles as international financial hubs. Australian banks are also exposed given their heavy dependence on wholesale funding from global capital markets. On the policy front, there is room to slow the pace of monetary tightening and, with most Asian economies having low fiscal deficit and debt levels, stimulus measures are available if needed (Japan, India, and Malaysia are notable exceptions).

Chart 5
Asia's borrowing from European banks...



Source: BBVA Research and BIS

Chart 6
Japan's exports under a strong yen...



Source: BBVA Research and CEIC

Japan's economy demonstrates resilience in the post-quake recovery

Japan's second quarter GDP growth was released this past week, showing a better-than-expected outturn of -0.3% q/q (or -1.3% s.a.a.r) consensus (-0.7% q/q s.a.) (Chart 1 in the FrontPage). Importantly, the outturn reflects the full quarterly impact on growth of the March 11 earthquake and tsunami, and was the third consecutive quarterly contraction. For the quarter, exports declined by -5.3% y/y (Chart 6), the result of supply chain disruptions. On the other hand, business investment held up well, and there is evidence of a positive impact from the government's post-quake stimulus packages and a quicker-than-expected restoration of output. A third supplementary budget is expected to be passed in September or October, consisting of a full-fledged reconstruction package of over 10 trillion yen (2% of GDP). On the monetary policy front, the Bank of Japan has announced further liquidity injections and also recently increased the size of its asset-purchasing program by 50%, to 15 trillion yen. Meanwhile, production and exports have recovered more quickly than expected and are now close to pre-quake levels. Recent activity indicators and business sentiment also point to improvement. That said, further yen strength and power shortages remain as headwinds to the recovery. The yen is hovering around 76.5 yen per USD, and could weigh exports prospects; on the supply side, power shortages could curb the

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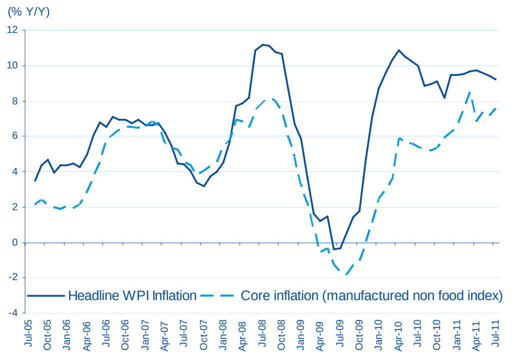
production as the restart of nuclear plants under inspection is likely to be delayed amidst current public nuclear fears. And of course externally, global economic uncertainty could weigh further on exports. On balance, we expect the economy to continue rebounding in the second half year of 2011, leading to a small overall GDP contraction of -0.3% for the year.

India: Global headwinds add to growth risks amidst high inflation

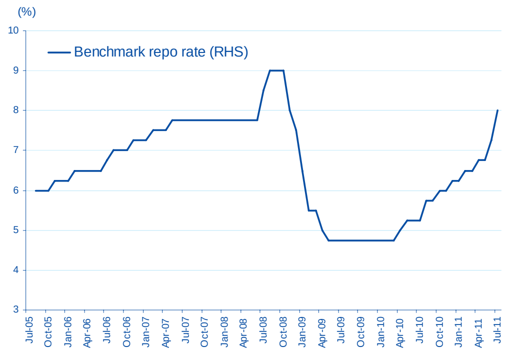
As the global macro environment deteriorates, investors are assessing the implications for Asia. As was seen during the 2008 Lehman crisis, India is not immune to contagion risks, through both the trade and financial channels, although the effects should be limited. The issue for India is that its macro outlook is already challenging, given signs of a slowdown in growth, persistently high inflation, and limited room for monetary and fiscal maneuver. In this context, key data prints over the past week helped to boost confidence, but not by much. The June industrial production index jumped by 8.8% y/y (consensus: 5.5% y/y) from a nine month low of 5.9% in May, the headline number masked slowing growth momentum that was evident after stripping off the notoriously volatile capital goods component. Excluding capital goods, the IP index growth edged lower to 4.3% y/y from 5.9% in May. Meanwhile, wholesale price inflation eased to 9.2% y/y in July from 9.4% in June (Chart 7), matching expectations and suggesting a gradual let-up in supply pressures. However, inflation is still much above the authorities' comfort zone and core inflation remains firm, and manufacturers continue to face margin pressures. Looking ahead, the ongoing easing in global commodity prices alongside domestic growth moderation augur well for overall inflation. With downside risks to domestic growth increasing, moderating inflation strengthens our case for the RBI to stay put at its next policy meeting, scheduled on September 16 (Chart 8).

Chart 7
India: inflation eases on commodity prices



Source: BBVA Research and CEIC

Chart 8
India: interest rate hikes may be finished



Source: BBVA Research and CEIC

Calendar Indicators

China	Date	Period	Prior	Cons.
HSBC Flash China Manufacturing PMI	23-Aug	AUG	48.9	- -
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
CPI (YoY)	22-Aug	JUL	5.60%	- -
Exports (YoY)	25-Aug	JUL	9.20%	- -
Imports (YoY)	25-Aug	JUL	11.50%	- -
Trade Balance	25-Aug	JUL	-40.3B	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Supermarket Sales (YoY)	22-Aug	JUL	0.10%	- -
Convenience Store Sales (YoY)	22-Aug	JUL	9.00%	- -
CPI (YoY)	26-Aug	JUL	0.20%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
Unemployment Rate	26-Aug	2Q	3.10%	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Imports (YoY)	25-Aug	JUN	1.60%	- -
Trade Balance	25-Aug	JUN	-$780M	- -
Singapore	**Date**	**Period**	**Prior**	**Cons.**
CPI (YoY)	23-Aug	JUL	5.20%	5.00%
Industrial Production (MoM) - SA	26-Aug	JUL	1.60%	0.80%
Industrial Production (YoY)	26-Aug	JUL	10.50%	9.00%
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
Unemployment Rate - sa	22-Aug	JUL	4.40%	4.36%
Industrial Production (YoY)	23-Aug	JUL	3.61%	4.80%
Money Supply M2 Daily Avg (YoY)	25-Aug	JUL	5.99%	5.90%
Thailand	**Date**	**Period**	**Prior**	**Cons.**
Gross Domestic Product SA (QoQ)	22-Aug	2Q	2.00%	0.60%
Gross Domestic Product (YoY)	22-Aug	2Q	3.00%	3.60%
Customs Exports (YoY)	22-25 AUG	JUL	16.80%	31.30%
Customs Imports (YoY)	22-25 AUG	JUL	26.10%	21.00%
Customs Trade Balance	22-25 AUG	JUL	$1270M	$351M
Vietnam	**Date**	**Period**	**Prior**	**Cons.**
Exports YTD (YoY)	24-31 AUG	AUG	33.50%	- -
Imports YTD (YoY)	24-31 AUG	AUG	26.20%	- -
Industrial Production (YoY)	24-31 AUG	AUG	9.60%	- -
CPI (YoY)	24-31 AUG	AUG	22.20%	- -

Indicator of the Week: Singapore CPI inflation for July (August 23)

Forecast: 5.1% y/y	Consensus: 5.0% y/y	Prior: 5.2% y/y

Comment: After rising to its fastest pace since January, inflation is expected to remain elevated in July on rising transportation and housing costs. Recent indicators show that domestic demand is holding up, and that inflationary pressures from the demand side are still evident. However, given its small size and export-dependence, Singapore's economy is especially vulnerable to a possible weakening of global demand. Market impact: Given downside risks to the global economy and the recent decline in exports (-2.8% yoy in July), markets do not expect an increase in the pace of appreciation at the Monetary Authority of Singapore's next policy meeting in October; however, a higher-than expected inflation outturn could change these expectations and set the stage for further regional currency appreciation.

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Calendar Events

Thailand – Benchmark Interest Rate, August 24	Current	Consensus
We expect no change in the benchmark rate.	3.25%	3.50%

Markets Data

STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2520.9	-2.8	-10.2	-6.2
Hong Kong – Hang Seng	19424.6	-1.0	-15.7	-7.8
Taiwan – Weighted	7406.5	-3.0	-17.5	-6.6
Japan – Nikkei 225	8751.7	-2.4	-14.4	-6.5
Korea – Kospi	1776.7	-0.9	-13.4	-0.2
India – Sensex 30	16469.8	-2.2	-19.7	-10.8
Australia – SPX/ASX 200	4139.3	-0.8	-12.8	-7.6
Singapore – Strait Times	2751.3	-3.5	-13.8	-6.6
Indonesia – Jakarta Comp	3918.8	0.7	5.8	26.2
Thailand – SET	1089.1	2.5	5.5	22.2
Malaysia – KLCI	1485.4	0.1	-2.2	6.7
Philippines – Manila Comp.	4344.9	0.5	3.4	22.0

Last update: Friday, 11.15 Hong Kong time.

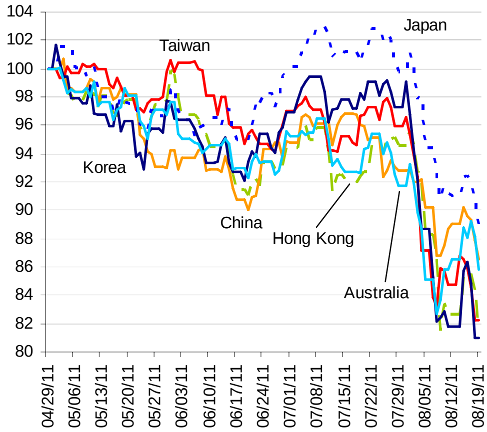
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.40	0.71	6.36	6.27
Hong Kong (HKD/USD)	7.79	0.17	7.8	8
Taiwan (TWD/USD)	28.9	-0.01	28.70	28.29
Japan (JPY/USD)	76.8	2.03	76.7	76.3
Korea (KRW/USD)	1078	-0.98	1083.10	1088.20
India (INR/USD)	45.4	-1.87	45.5	46
Australia (USD/AUD)	1.03	-1.12	1	n.a.
Singapore (SGD/USD)	1.21	0.48	1.21	1.2
Indonesia (IDR/USD)	8546	0.02	8620	8840
Thailand (THB/USD)	29.9	-0.13	30.01	30.3
Malaysia (MYR/USD)	2.99	0.72	3.0	3
Philippines (PHP/USD)	42.6	0.16	42.45	42.55

Last update: Friday, 11.15 Hong Kong time.

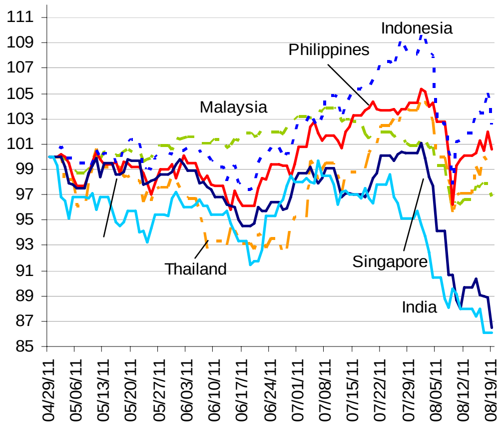
Charts

Chart 9
Stock Markets



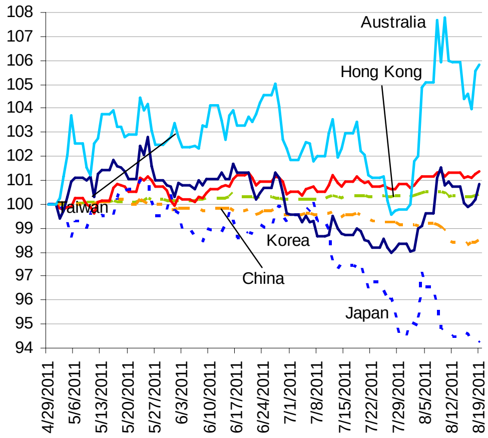
Source: BBVA Research and Bloomberg

Chart 10
Stock Markets



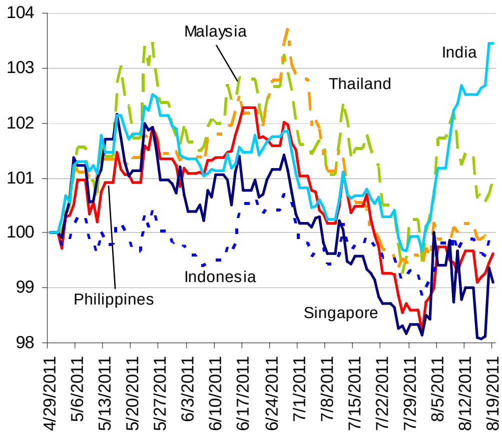
Source: BBVA Research and Bloomberg

Chart 11
Foreign Exchange Markets



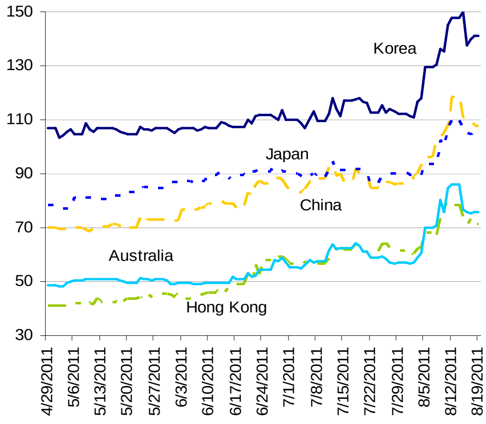
Source: BBVA Research and Bloomberg

Chart 12
Foreign Exchange Markets



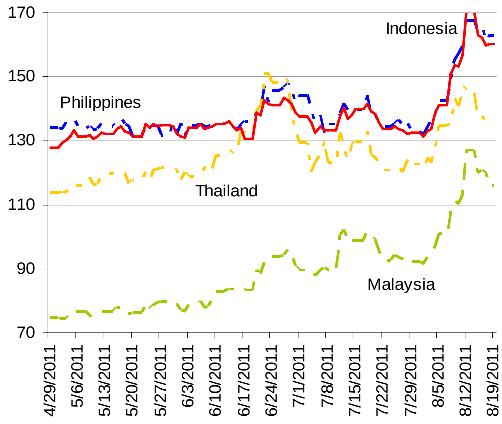
Source: BBVA Research and Bloomberg

Chart 13
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14
Credit Default Swaps



Source: BBVA Research and Bloomberg

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