The Royal Bank of Scotland

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Asia Navigator

Regional macro trends

We made another modest upward revision to our 2010 forecast mainly to reflect India's strengthening growth prospects. The pace of the recovery in India has decisively quickened in recent months with the December industrial production reading of 16.8% yoy providing the latest evidence. Other indicators such as business optimism survey, narrow money trends and exports are also suggesting a stronger than initially anticipated outcome.

In general, the recovery process in Non-Japan Asia is chugging along nicely. Q4 09 GDP data and high frequency indicators such as exports continue to gather steam. This dynamic is becoming evident even in laggard countries like Thailand. The month end December economic report for Thailand highlighted a remarkable improvement in consumer and business confidence as well as a marked improvement in private consumption and investment indicators.

Why is NJA turning around at a faster pace? The most formidable shift seems to be taking place on the export front. By and large, January export growth from both China and Korea at 21% yoy and 46% yoy were excellent numbers even if the annual increase was exaggerated by favourable base effects. Additionally, domestic demand continues to gather steam thanks to timely fiscal responses, strong household balance-sheets and relatively healthy labour markets. Wealth effects from recovering property prices have provided further impetus.

We also take this opportunity to emphasise the structural superiority of Asian sovereign balance-sheets, considering that this has been an area of investor focus in recent weeks. Public debt to GDP is sub-50% of GDP in the region. The only exceptions are India and Philippines but even so, low levels of foreign participation limit vulnerability. Similarly, external indebtedness is extremely low in Asia, generally less than 30% of GDP. In this context, any risk aversion driven assault on NJA assets is unlikely to be aggressive and may even present a buying opportunity. Overall, the NJA asset price appreciation story remains intact and investors can particularly benefit from short EUR/Asia positions.

What are the risks to NJA? We believe that the most formidable risk is that of a policy mis-step in China. Policymakers in China are currently grappling with several issues including rapid credit/monetary growth, hot money inflows, an undervalued currency and potentially rising inflation. Resolving these issues could result in a policy mis-step most likely in the form of a severe clamp down on credit, thereby hurting internal demand/asset prices. Such a scenario (though a tail risk at present) will have a non-trivial impact on the rest of NJA. We note that business cycle synchronisation with China has strengthened in the post-Asian financial crisis presumably due to trade linkages. Slowing internal demand in China will have a marked impact on NJA exports and should it result in greater aggression by Chinese manufacturers in third country markets, will result in a deflationary predatory export pricing. Our analysis also shows that financial market correlation with China has also increased substantially. Although this may be more due to global risks feeding through NJA financial markets as a whole, the point is that foreign investors tend to view regional financial markets as a homogenous block rather than individual markets.

This scenario is a tail risk for now, but nonetheless a risk that needs to be monitored particularly in the context of recent reserve requirement hikes in China.

Sanjay Mathur

Key trades

FX stabilizing, curves flattening

After a topsy-turvy start in January and much of February, Asian currencies appear to have stabilized into broad ranges while yield curves have started to flatten towards the end of February (Figure 1 and Figure 2). If Asia's macro picture continues to beat consensus expectations, not to mention the G11 macro numbers – as seen in the latest string of Q4 GDP reports, the region is likely to break away from the G11 market conundrum.

FX: We initiated no new FX trades nor closed any in February. Market directions were too fuzzy; and since we continue to believe in the themes we established from last December, we do not see the need to take profit early or cut loss amid the market turbulence. The short EUR theme needless to say turned out to be the best performing, which was expressed in EURSGD. We have revised the target twice from 1.95 to 1.92 and now to 1.90 which looks like a firm near-term technical support. The short JPY theme remains modestly in the money versus KRW and INR but not TWD although the gains were very choppy. As the EUR fiasco is having a side effect of boosting the JPY, we will look to close out these positions in the coming month.

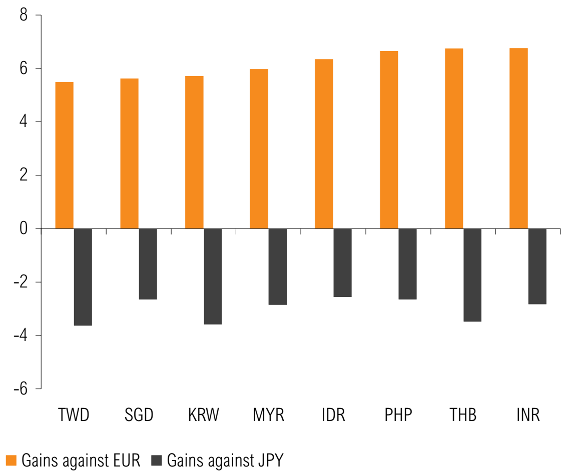
The short USD/ Asia theme re-established in early January expressed in a short USDTWD straddle and short USDINR NDF are giving mixed performance, with the former in the black and latter in the red. We remain overall bullish on INR, especially after the Union Budget carried out the key reforms on subsidies and spending to work towards fiscal consolidation, we believe the INR will start to strengthen faster. The last theme was an intra-regional one where we have primarily went short THB and long KRW and IDR, both of which are performing. As Thai political risk has escalated to another echelon – with the start of the ex-premier's trial – we stay short THB for the time being.

Rates: Our conviction for curve flatteners has been bolstered by the Fed's discount rate hike and the recent strong macro numbers. While the Fed's discount rate hike holds little meaning for the US' own interest rate policy direction, Asian market watchers generally see the Fed's move as a strong push on Asian central banks to start acting on their own policy front. The only trick remains as to which central bank will come forth as the first with a formal interest rate hike. The bets on the pecking order keep revolving – now they are on the Bank Negara Malaysia for as early as on 4 March while the bets are off for the Bank of Korea.

Depending on the extent of short-end excess liquidity, extent of rate hikes priced into the curve and the amount of outright rate and steepening moves, we initiated a batch of flatteners with either neutral or slight long duration risk to balance between slides and carry costs. Our two highest conviction trades are the SGD 2s5s swap and receiving INR 3y forward 2y swap. We are re-entering the SGD flattener after cutting out of it two months ago since this time, we are more confident that the 6m SOR has hit a floor. In INR, the RBI's 75bp hike in cash reserve ratio has drained some excess liquidity from the front and given the sharp run-up in rates and curve slope, we see a good trade-off in receiving a long-dated forward starting swap into the belly to extract the maximum roll-down with minimum fixing risk against some long duration risk. We like to do the same in KRW forward-starting swap but prefer to wait for better entry since there is a not insignificant risk that the Bank of Korea continues to delay its rate hike.

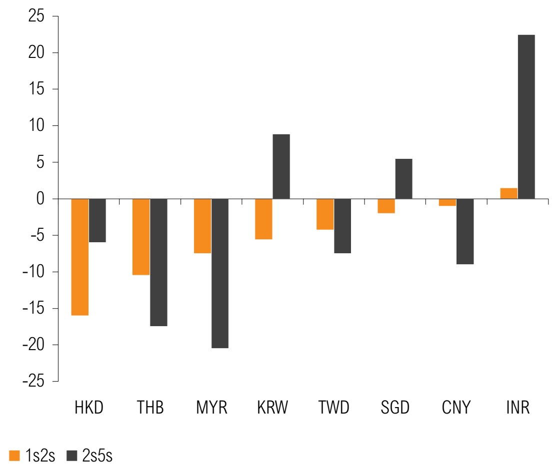
We still have two outstanding long bond-swap spread positions – while the 10y KTB ASW has finally started to perform, the 5y MGS ASW was hit when the underlying bond rolled off the benchmark. It was a mistake not to have unwound prior to the benchmark switch which lost half of our earlier, albeit modest gain. The bigger reason for its underperformance was that risk appetite was heavily favouring the long end after being starved of duration last year. At this juncture, the best case scenario for us to exit this position is that the central bank hike rates and return to a neutral stance.

Figure 1. Asian currencies' gains against EUR and JPY since Jan-10



Source: Bloomberg, RBS

Figure 2. Asian curves since the Jan-10



Source: Bloomberg, RBS

Woon Khien Chia

Summary of views on rates, bonds and FX for next 3m

	Swaps	Bonds	FX
CN	Bearish 3s5s flattener	Bullish relative to swaps	Bullish Short USD/CNY 1y NDF
HK	Neutral Receive 3y2y HKD vs. pay 3y2y USD	Bearish	Bullish Sell USD/HKD 1y fwd pt
IN	Bearish 2s5s flattener Receive 3y2y	Bearish	Bullish Short JPY/INR for 6m horizon Short USD/INR 3m NDF
ID	Neutral	Bullish 15y sector to outperform	Bullish
KR	Bearish 1s2s flattener Target receive 3y2y at entry level above 4.8%	Bullish relative to swaps Long 10y KTB ASW	Bullish Short JPY/KRW
MY	Bearish 1y forward 2s4s flattener Tactically receive 1y	Bullish relative to swaps Long 5y MGS ASW or dollar ASW	Neutral
PH	Bearish	Bearish	Neutral
SG	Neutral Receive 2y SGD vs. pay 2y USD 2s5s flattener	Neutral	Bullish Short EUR/SGD
TW	Neutral 1s2s flattener	Bullish relative to swaps	Neutral Sell USD/TWD straddle Short JPY/TWD
TH	Bearish 1s2s flattener	Bullish relative to swaps	Bearish Long USD/THB 6m NDF Short THB vs. KRW and IDR

Source: RBS

Open FX Trades

Trade	Entry Date	Entry Level	Current Level	Target Level	Stop Loss	P/L (%)	Comments	Publication
Sell USD/TWD 3m straddle	15-Jan-10	Premium 2.98% Strike 32.00 Spot 31.83	Premium 1.43% Spot 32.08			1.55	We sell vols on view that the risk positive environment is likely to guide FX vols back to pre-crisis levels. TWD being a risk immune currency is most likely to benefit.	Asia FX: On track to full recovery
Short USD/CNY 12m NDF	15-Jan-10	6.7725 & 6.67 Spot: 6.8295 & 6.827	Mtm 6.7007 & 6.6897 Spot 6.826	6.50	6.98	0.78	PBOC is likely to resume a modest appreciation policy as it resumes diversifying its reserves out of USD.	China: Diversifying reserves from USD into SDR
Short USD/INR 3m NDF	15-Jan-10	3m NDF 45.76 Spot 45.68	Mtm NDF 46.24 Spot 46.11	43.9		**-1.04**	We remain positive on Asian currencies as the region experiences a much faster recovery. Monetary tightening is unlikely to be achieved without currency appreciation.	Asia FX: On track to full recovery
Long TWD/JPY 3m forward	15-Jan-10	3m NDF 2.834 JPY spot 90.68 TWD spot 32.35	2.853 JPY spot 90.86 TWD spot 31.85	3.125		**-2.05**	We first initiated this trade in the October issue of Trade Monitor as we saw the current consolidation in Asian currencies as an opportunity to close the gaps between leaders and laggards in the region. We rolled over this position after slight profit in the first 3m.	Asia FX: On track to full recovery
Buy USD/HKD spot vs sell USD/HKD 1y forward	06-Jan-10	-200 Spot 7.756 1y fwd 7.736	-185 Spot 7.763 1y fwd 7.763	-600		-0.27	With the US recovery underway, USD/HKD spot and USD Libor is likely to rise, restoring the counter-cyclical nature between the USD/HKD forward points and spot rate broken since the Fed adopted its zero interest rate policy.	Hong Kong: Sell USD/HKD forward
Short EUR/SGD 6m forward	11-Dec-09	6m fwd 2.047 Spot 2.049	Mtm fwd 1.915 Spot 1.914	1.92		6.44	The PBOC is likely to resume its appreciation path as recovery hold which is likely to have an adverse effect on EUR. We like to short EUR/Asia using SGD as a proxy.	Asia Pacific Markets Outlook - 2010
Long USD/THB 6m NDF	11-Dec-09	6m NDF 33.18 Spot 33.11	Mtm NDF 33.11 Spot 33.04	34.5	32.5	**-0.21**	Asian central banks which are more likely to hike rates slower than the Fed are most vulnerable to a USD rebound.	Asia Pacific Markets Outlook - 2010
Short JPY/INR	11-Dec-09	0.5252	0.5166	0.45	0.54	1.64	Asian central banks such as RBI and BoK are likely to hike around the same time as Fed and hence able to hold up their currencies. We choose to express this view via JPY which is saddled by poor economic fundamentals as a safer option than against USD.	Asia Pacific Markets Outlook - 2010
Long KRW/THB 3m NDF	11-Dec-09	3m NDF 0.0284 KRW spot 1163.93 THB spot 33.11	Mtm NDF 0.0286 KRW spot 1157.95 THB spot 33.04	0.0302		0.58	We think that the IDR and KRW remains undervalued relative to THB based on economic fundamentals.	Asia Pacific Markets Outlook - 2010
Long IDR/THB 3m NDF	11-Dec-09	3m NDF 0.0035 IDR spot 9448 THB spot 33.11	Mtm NDF 0.0035 IDR spot 9335 THB spot 33.04	0.00371		1.53	As above.	Asia Pacific Markets Outlook - 2010
Short JPY/KRW	01-Dec-09	13.33	12.98	11	14.5	2.63	This trade was first initiated in Top themes and Trades for reasons highlighted as above.	Asia Pacific Markets Outlook - 2010

Note: PL figures are in percentage of notional for FX trades and in running basis point for rates trades. They are evaluated at mid prices without bid/ask spreads and thus only serve as proxies for trade performances. Source: RBS

Open Rates Trades

Trade	Entry Date	Entry Level	Current Level	Target Level	Stop Loss	Break-even	P/L (bp)	Comments	Publication
Receive MYR 1y	25-Feb-10	2.645	2.620	15bp	2.8		2	With at least 75bp of rate hikes priced into the curve, we believe that the market is able to stomach a hawkish stand without rates shooting higher. We therefore believe that market participants are likely to cover outright paid positions going into the MPC.	MYR rates: Take profit ahead of MPC
Receive HKD 3y2y vs pay USD 3y2y	22-Feb-10	-35 HKD 3y2y 3.992 USD 3y2y 4.337	-40 HKD 3y2y 3.729 USD 3y2y 4.132	-70bp			4	With the HKD 2s5s close to its peak, we like to receive the spread in the forward space to avoid the low Hibor fixing while hedging the implicit USD Libor fixing risk by paying the equivalent USD rate.	Asia rates: Fed's discount rate hikes paves way for curve flatteners
THB 1s2s flattener	22-Feb-10	79 1y 1.295 2y 2.08	74 1y 1.295 2y 2.035	45bp	102bp		4	We like front-end flattener given that any political fallout will lead to a sell-off in THB, spilling over to the FX forward space and causing SOR to spike up. Even if political situation stabilizes, the BoT is in a better position to start hiking rates which is not yet priced into the curve.	Asia rates: Fed's discount rate hikes paves way for curve flatteners
Receive INR 3y2y	22-Feb-10	8.453	8.328	8.05%	8.70%		13	Given the punitive carry cost, steep curve and the recent run-up in rates, we like to receive rates at the belly where slide is steepest.	Asia rates: Fed's discount rate hikes paves way for curve flatteners
SGD2s5s flattener	22-Feb-10	99 2y 1.285 5y 2.275	98 2y 1.235 5y 2.21	50bp	120bp	96bp	1	The spread is at its peak and the 6m SOR fixing is likelyt to bottom from here as the odds of the MAS returning to an appreciation policy have gone up sharply.	Asia rates: Fed's discount rate hikes paves way for curve flatteners
Buy THB5y5y payer vs sell USD 5y5y payer	28-Jan-10	-14 THB 5y5y 4.96 USD 5y5y 5.10	-20.5 THB 5y5y 4.884 USD 5y5y 5.089	15bp	-34bp		-3	The THB 5y5y still lags behind its long term average and is likely to head north with economic recovery in place. We like to express this together with a receive USD 5y5y to hedge against any risk from US rates.	THB rates: Pay THB 5y5y vs receive USD 5y5y
INR 2s5s flattener	25-Jan-10	125 2y 5.665 5y 6.915	133 2y 5.69 5y 7.02	95bp	140bp		-16	With back-end forwards already trading significantly higher than their long term averages, curve will most likely flatten when RBI starts hiking interest rate.	Asia Navigator - January 10
KRW 1s2s flattener	21-Jan-10	54 1y 3.49 2y 4.02	48 1y 3.31 2y 3.79	30bp	70bp		13	As rate hike draws nearer, the steepest part of the curve at the 1s2s is likely to flatten. This is also the part of the curve most responsive to any policy moves.	Asia Navigator - January 10
Receive 2y SGD vs. pay 2y USD	21-Jan-10	21 SGD 2y 1.375 USD 2y 1.1625	16 SGD 2y 1.235 USD 2y 1.0765	-10bp	40bp		0	The SGD curve is much flatter than the USD curve with 2s5s box spread at a historical high. Hence, SGD front end rates are likely to underperform relative to USD when bear flattening trend starts.	Asia Navigator - January 10
TWD 5y forward 2s5s steepener	21-Jan-10	1.78 5y2y 2.726 5y5y 2.744	-3.1 5y2y 2.656 5y5y 2.625	32bp	-20bp		1	This spread hardly dipped below zero on a sustained basis. Monetary tightening from such low rate levels will also widen than tighten the spread. This trade also appeals given its attractive roll-down with no fixing risk.	Asia Navigator - January 10
CNY 3s5s flattener	11-Jan-10	59 3y 3.43 5y 4.02	46 3y 3.27 5y 3.73	35bp	75bp		5	The 7d repo is set to rise as the PBOC starts tightening monetary policy. This is likely to flatten the curve and we see good value in the 3s5s.	CNY rates: Pay 3y rates or enter 3s5s flattener
Buy 5y MGS asset swap	24-Dec-09	-7 5y MGS 3.8 5y IRS 3.865	2 5y MGS 3.85 5y IRS 3.835	-37bp	13bp		-13	With fiscal consolidation, bonds are likely to outperform swaps. Bond-swap spreads are likely to widen on the belly where bond supply is cut most heavily.	Malaysia: MGS/GII auction calendar for 2010
MYR 1y forward 2s4s flattener	11-Dec-09	69 1y2y 3.493 1y4y 4.181	50 1y2y 3.67 1y4y 4.169	40bp	90bp	69bp	18	The MYR curve has priced in the least rate hikes in the region and thus, most vulnerable to an increase in rate hike expectations. The 1y 2s4s flattener allows us to express this view with no exposure to fixing risk and little roll-down cost.	Asia Pacific Markets Outlook - 2010

Note: PL figures are in percentage of notional for FX trades and in running basis point for rates trades. They are evaluated at mid prices without bid/ask spreads and thus only serve as proxies for trade performances. Source: RBS

Trade	Entry Date	Entry Level	Current Level	Target Level	Stop Loss	Break-even	P/L (bp)	Comments	Publication
TWD 1s2s flattener	30-Oct-09	41 1y:0.68 2y 1.09	30 1y 0.66 2y 0.96	16bp	57bp		15	The CBC has has accelerated its OMO and this is likely to put upward pressure on the interbank 3m CP rate which fixes the interest rate swap.	Taiwan: Enter 1s2s flattener
Buy 10y KTB asset swap	07-Jul-09	93 10y KTB 5.14 10y IRS 4.28	64 10y KTB 5.15 10y IRS 4.505	40bp	120bp	100 bp	25	Examining the cheapness/richness of swap spreads against their historical correlations, KRW on the long end and MYR on the front end look the cheapest.	Asia rates: Taking stock of liquidity, Part 2

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Closed FX Trades

Trade	Entry Date	Entry Level	Closed Level	Closed date	P/L (%)	Comments	Publication
Buy 6m expiry 25-delta INR call USD put.	22-Jul-09	Premium: 1.36% Strike 46.35 Spot: 48.55	Spot 45.56	21-Jan-10	0.28	While FY10 fiscal deficit target was likely to be funded comfortably, fiscal consolidation in the medium term is a concern. However, we remained positive on INR although the pace of appreciation was likely to be slower. The option expired in the money.	India: Fiscal consolidation remains a challenge
Short USD/KRW 3m NDF	15-Jan-10	3m NDF 1124 Spot 1125.75	Mtm NDF 1143.9 Spot 1142.03	21-Jan-10	**-1.77**	We viewed the KRW as undervalued based on economic fundamentals despite the strong rally last year. We took loss on the trade as risk aversion set in.	Asia FX: On track to full recovery
Long USD/PHP 6m NDF	11-Dec-09	6m NDF 46.87 Spot 46.13	6m NDF 46.52 Spot 45.54	15-Jan-10	**-1.01**	Asian central banks which are more likely to hike rates slower than the Fed are most vulnerable to a USD rebound. We took loss on the trade.	Asia Pacific Markets Outlook - 2010
Sell USD/IDR 3m NDF vs. buy USD/IDR 12m NDF	19-Nov-09	460 3m NDF 9660 12m NDF10120 Spot 9550	393 Mtm 3m 9302 Mtm 12m 9695 Spot 9197	15-Jan-10	**-1.07**	We believe some USD/IDR short-covering was likely to be done gradually. Hence, we suggested going tactically long USD/IDR through the 3m & 12m NDFs as the NDF curve has a tendency to steepen with a gradual rise in spot rate. We took loss as market turned bullish on IDR.	Indonesia: Consolidation ahead
Long MYR/SGD 3m forward	21-Oct-09	0.4114 Spot SGD 1.3938 Spot MYR 3.3865	0.4159 Spot SGD 1.3893 Spot MYR 3.3407	15-Jan-10	1.06	We saw the consolidation in Asian currencies as an opportunity to close the gaps between leaders and laggards in the region. We took profits as the gap closed.	Trade Monitor Asia, October
Buy USD call spread/SGD	12-Oct-09	Premium 0.73% Strikes 1.40/1.43 Spot 1.4017	Spot 1.3825	12-Jan-10	**-0.73**	The MAS issued a dovish statement and kept to its zero appreciation policy. Given the USD rebounded against the majors, we saw USD/SGD trading back to the 1.41-1.43 range. The option expired out of the money.	Singapore: Dovish MAS statement surprises
Buy USD/SGD 3m vs. sell USD/SGD 12m forward	15-Jul-09	4 pips 3m fwd 1.4536 12m fwd 1.4540 Spot 1.4532	14 pips Mtm 3m 1.3842 Mtm 12m 1.3856 Spot 1.3835	19-Nov-09	**-0.14**	Q2 GDP came in stronger than expected, supporting MAS' move to start mopping up excess liquidity. Next policy move was likely back to strong SGD policy albeit not in another year's time. We took slight loss on the trade.	Singapore: Out of the woods but no 'V'
Sell USD/IDR 12m NDF	24-Sep-09	10370 Spot: 9960	Mtm 10004 Spot 9560	19-Nov-09	3.66	The USD rebound provided a good opportunity to increase our long Asian currencies exposure. We took profits on our trade as IDR and KRW outperformed their peers.	Asia FX: Extend longs in KRW, IDR, SGD
Sell USD/KRW 12m NDF	24-Sep-09	1202 Spot: 1196	Mtm 1169 Spot 1160	19-Nov-09	2.86	As above.	Asia FX: Extend longs in KRW, IDR, SGD
Sell USD/SGD 12m forward	24-Sep-09	1.4155 Spot 1.4130	Mtm 1.3956 Spot 1.4155	21-Oct-09	1.42	As above.	Asia FX: Extend longs in KRW, IDR, SGD
Buy 6m ATMF USD put/KRW call and USD put/IDR call vs. 2 x Sell 6m ATMF USD put/TWD call and USD put/THB call.	28-Aug-09	Premium 0.95% KRW spot 1242.7 Strike 1244.5 IDR spot 10050 Strike 10380 TWD spot 32.92 Strike 32.43 THB spot 34.01 Strike 34.02	Premium 6.77% KRW spot 1170.1 IDR spot 9398 TWD spot 32.29 THB spot 33.43	16-Oct-09	2.9	Trade was initiated on view that convergence force will drive the more undervalued currencies like KRW and IDR to converge with the stronger ones like THB and TWD. We closed out the positions as KRW and IDR are most vulnerable to any sharp turnaround on Asian currencies.	Asia FX: Convergence amid recovery
Buy a 1X2 USD/IDR 6m put spread	28-Aug-09	Premium 0.15% Strikes 9980/ 10380 Spot 10050	Premium -3.83% Spot 9398	16-Oct-09	**-3.98**	As above.	Asia FX: Convergence amid recovery
Buy a 1X2 USD/KRW 6m put spread with strikes OTMF 1190 and ATMF 1244.5 at zero cost (receive 2.2%X2 vs. pay 4.4%). Breakeven at 1164 and 1244.5.	28-Aug-09	Premium 0% Strikes 1190/ 1244.5 Spot 1242.7	Premium -1.05% Spot 1170.1	16-Oct-09	**-1.05**	As above.	Asia FX: Convergence amid recovery

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Trade	Entry Date	Entry Level	Closed Level	Closed date	P/L (%)	Comments	Publication
Long USD/MYR 6m NDF	07-May-09	3.56	3.55	7-Sep-09	**-1.64**	Sustained risk rally led to a catch-up in MYR performance although the country's recovery continues to lag.	Malaysia: Fiscal funding woes
Buy USD/ THB straddle	11-Jun-09	Premium 3.79% Strike 34.21 Spot 34.12	Premium 0.87% Spot 34.01	25-Aug-09	**-2.92**	Buy straddles on currencies most sensitive to swings in risk appetite.	Asia FX: What's driving risk, who's loving it
Buy USD/PHP straddle	11-Jun-09	Premium 4.741% Strike 48.286 Spot 47.82	Premium 1.1% Spot 48.43	25-Aug-09	**-3.64**	As above	Asia FX: What's driving risk, who's loving it
Buy USD/SGD straddle	11-Jun-09	Premium 3.717% Strike 1.4510 Spot 1.451	Premium 1.13% Spot 1.44	25-Aug-09	**-2.59**	As above	Asia FX: What's driving risk, who's loving it
Buy USD/INR straddle	11-Jun-09	Premium 5.321% Strike 48.005 Spot 47.56	Premium 2.03% Spot 48.57	25-Aug-09	**-3.29**	As above	Asia FX: What's driving risk, who's loving it
Short INR/ long TWD	11-Jun-09	0.69	0.68	18-Aug-09	1.88	Trade was recommended on view of falling risk appetite. TWD had been relatively risk immune while INR was risk loving. We took profit on concern about the impact of typhoon damage on TWD.	Asia FX: What's driving risk, who's loving it
Buy USD call/MYR put 3m spread	7-May-09	Premium 1.20% Strikes 3.527/ 3.65	Spot 3.5065	7-Aug-09	**-1.20**	Worsening fiscal funding position pointed to MYR weakness.	Malaysia: Fiscal funding woes

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Closed Rates Trades

Trade	Entry Date	Entry Level	Closed Level	Closed date	P/L (bp)	Comments	Publication
Buy THB5y5y payer vs sell USD 5y5y payer	28-Jan-10	THB 5y5y 4.96 USD 5y5y 5.10	THB 5y5y 4.841 USD 5y5y 5.098	26-Feb-10	-3	The THB 5y5y still lags behind its long term average and is likely to head north with economic recovery in place. We like to express this together with a receive USD 5y5y to hedge against any risk from US rates.	THB rates: Pay THB 5y5y vs receive USD 5y5y
SGD 2s5s flattener	07-Jul-09	83 2y 1.640 5y 2.470	91.5 2y 1.37 5y 2.285	21-Jan-10	-16	MAS started in May to rebuild its long FX forward positions to dampen the excessive build-up of liquidity. This would set a floor to the front end rates, paving the way for a flattening further up the curve. We took loss on this trade.	Asia rates: Taking stock of liquidity, Part 2
Buy 2y3y USD ATM payer vs. sell2y3y SGD payer with 0.5:1.0 notional ratio	11-Dec-09	Premium 0cts USD 2y3y 3.6037 SGD 2y3y 3.0272	Premium 15cts USD 2y3y 3.8408 SGD 2y3y 2.9338	21-Jan-10	5	We expected SGD rates to underperform relative to USD rates when the Fed hikes and recommended selling SGD payers vs. buying USD payers to express this view. We took profit on the view that underperformance of SGD curve will be more pronounced on the short end.	Asia Pacific Markets Outlook - 2010
Buy TWD 2y5y payer spread at 2.75%-3.75% vs. sell 1y1y payer with 1:2.5 notional ratio	18-Nov-09	Premium 5cts 2y5y 2.38 1y1y 1.41	Premium 25cts 2y5y 2.49 1y1y 1.36	21-Jan-10	5	We expected CBC to keep policy rate on hold until the end of 2010. With rate hikes priced in too early in the curve, selling a 1y1y payer to fund a 2y5y payer spread allowed us to express this view efficiently.	Taiwan: Buy 2y5y payer spread vs. sell 1y1y payer
Receive body in INR OIS PCA weighted 1s2s5s butterfly	14-Sep-09	-23 1y 4.90 2y 5.67 5y 6.71	-48 1y 4.96 2y 5.67 5y 6.91	21-Jan-10	19	The 1s2s5s is likely to mean revert once monetary tightening is in sight and there will likely be an aggressive bear-flattening of the 1s2s relative to the 2s5s. We took profit as the trade performed well.	India: Strategy for a policy exit
TWD 2y forward 3s5s steepener	09-Sep-09	2 2y3y 2.19 2y5y 2.21	14 2y3y 2.42 2y5y 2.55	21-Jan-10	19	This spread hardly dipped below zero on a sustained basis. Monetary tightening from such low rate levels will also widen rather than tighten the spread. This trade also appealed given its attractive roll-down with no fixing risk. We took profit as we thought the steepening has run its course.	Taiwan: 2y forward 3s5s steepener
3y non-call range accrual note, pay THB 6m SOR flat and receive 4.05% semi-annually over the number of days that THB 6m SOR stays within 1.0-4.0%	27-Aug-09	6m SOR 1.30	6m 0.89	21-Jan-10	58	Our conviction was that the fixing rate, THB 6m SOR, was likely to stay stable around the current level for at least another year. Given this outlook, we believed too much rate hike had been priced in the front-end. We took profit on view that SOR is likely to remain out of range.	Thailand: Banking on fiscal spending
Buy a 3y non-call range accrual note: pay THB 6m SOR flat and receive 3.5% semi-annually over the number of days that THB 6m SOR stays in 1%-3.75% range.	06-Mar-09	6m 2.48	6m 0.89	21-Jan-10	53	THB swaption volatilies had risen sharply and even implied volatilities were above realised volatilities. We suggested selling short tenor straddles on view that short-end rates would pull back as BoT was likely to cut another 50bp in its overnight repo policy rate and that the banking system was flush with THB excess liquidity.	THB rates: Sell swaption volatilities
Receive SGD 1y1y	26-Nov-09	1.87	1.93	11-Dec-09	1	With market expectations on the timing of the Fed's hiking cycle being gradually pushed back, there may be a little more room for the USD Libor curve to shift lower and flatter. We expected the SGD SOR to follow suit. We closed this trade on view change.	Asia Navigator - November
SGD 1s2s steepener	27-Aug-09	45 1y 1.19 2y 1.64	46.25 1y 0.91 2y 1.37	25-Nov-09	-32	We suggested entering a 1s2s steepener on view that MAS was sufficiently comfortable with the level of liquidity and its non-action would have made the 6m SOR fixing gradually drop below the USD Libor. We no longer see any scope for the 6m to correct and closed the 1y leg to leave an outright 2y payer.	Asia Navigator - August
CNY 2s10s flattener	27-Aug-09	155 2y 2.39 10y 3.97	159.25 2y 2.55 10y 4.14	25-Nov-09	-12	The PBOC looked likely to continue reining in credit with a modest risk of a CRR hike in Q4, leading to continuous upward pressure on short-end rates. The swap curve looked steep and we recommended a flattener trade. We closed out the non performing trade.	Asia Navigator - August
Pay TWD 1y1y	21-Aug-09	1.33	1.3717	25-Nov-09	-21	We saw scope for the TWD 1y1y rate to rise further to gradually price in the view that the rate cutting cycle had ended. We closed out the trade in line with our change in view.	Asia: Finding values in mis-aligned policy expectations

Note: PL figures are in percentage of notional for FX trades and in running basis point for rates trades. They are evaluated at mid prices without bid/ask spreads and thus only serve as proxies for trade performances. Source: RBS

Trade	Entry Date	Entry Level	Closed Level	Closed date	P/L (bp)	Comments	Publication
Receive body in KRW 1s3s5s butterfly	23-Jun-09	85 1y 2.98 3y 3.98 5y 4.13	55.75 1y 3.385 3y 4.11 5y 4.28	25-Nov-09	12	The bear-steepening has led to a rise in curvature which also does not fit into a "non-V'" recovery.	Asia rates: Imminent collapse in convexity
Receive body in HKD 1s3s5s butterfly	22-Jun-09	71 1y 0.73 3y 2.19 5y 2.94	39.85 1y 0.3615 3y 1.65 5y 2.53	25-Nov-09	69	As above.	Asia rates: Imminent collapse in convexity
Buy IDR FR30	07-Jul-09	9.90	9.52	19-Nov-09	57	Comparing our economists' projected economic recovery path for each country over the next 6 quarters with the respective nominal 5y bond yield, KRW and IDR bonds looked the cheapest in the region. Foreign investors returned to these markets but their participation rates were still well below the historical records.	Asia rates: Taking stock of liquidity, Part 2
Buy IDR FR22	10-Jun-09	8.52	7.87	19-Nov-09	97	This trade was founded on the general improvement on the macro front, especially the fiscal picture which warrants an upgrade in sovereign rating. However, we recommended a short-dated bond, as the presidential election still posed some small risk. The 2y area also offered the best carry and slide.	Indonesia: Weathering the storm
Pay KRW 3y forward 2y IRS	10-Sep-09	3y2y 4.74	4.85	02-Nov-09	11	The BOK turned hawkish and we saw value to pay in the belly of the curve through a long dated forward start to avoid the fixing risk.	Korea: Pay KRW rates - BOK turns hawkish
THB 1s3s flattener	27-Aug-09	141 1y 1.74 3y 3.15	138 1y 1.7 3y 3.08	20-Oct-09	8	Our conviction was that the fixing rate, THB 6m SOR, was likely to stay stable around the current level for at least another year. Given this outlook, we believed too much rate hike had been priced in the front-end and we saw good value in front-end flatteners.	Thailand: Banking on fiscal spending
MYR 2s5s flattener	27-Aug-09	102 2y 2.71 5y 3.73	98 2y 2.89 5y 3.87	20-Oct-09	3	Supply/demand conditions were becoming favourable for the back end of the curve. Our view was that this should support a flatter curve combined with the improving fiscal conditions.	Asia Navigator - August
Sell IDR 5y CDS vs. buy PHP 5y CDS	21-Aug-09	IDR CDS 220 PHP CDS 200	IDR CDS 165 PHP CDS 154	20-Oct-09	8	The global credit crunch has driven up the sovereign credit risk for the Asian markets and distorted ASW markets. Currently, the IDR $ASW spread is tighter than the PHP $ASW but the IDR CDS spread is wider than PHP CDS. Given that the 2 sovereign risks are rated on par with IDR on a positive outlook by Moody's, we believe that a tightening of the CDS relative to the PHP CDS is likely.	Asia: Finding values in mis-aligned policy expectations
Buy KRW 5y $ASW vs. buy MYR 5y CDS	21-Aug-09	5y KTB 4.81 5y swap 4.28 KRW basis -118 MYR CDS 98	5y KTB 4.97 5y swap 4.61 KRW basis -106 MYR CDS 82	20-Oct-09	16	Although the KRW is rated a notch above MYR on both its foreign and local currency sovereign risks, its CDS spread and $ASW spread were both wider than the equivalent MYR spreads. We therefore long KRW risk from $ASW (cheaper than KRW CDS) and short MYR risk from the MYR CDS (more expensive than MYR $ASW). The position was closed to take profit.	Asia: Finding values in mis-aligned policy expectations
Pay HKD 1y IRS vs. receive USD 3y IRS	13-Aug-09	HKD 1y 0.59 USD 3y 2.20	HKD 1y 0.49 USD 3y 1.87	20-Oct-09	42	Trade was recommended based on the view that pressure on HKMA's strong side of the Convertibility Undertaking (CU) was likely to subside and HKMA will move to mop up liquidity. We took profit on the trade as USD 3y rates moved in our favour.	HKD rates: Pay HKD 1y vs receive USD 3y
Receive 6m1y SGD IRS vs. pay 6m1y USD IRS	15-Jul-09	34.54 SGD 6m1y 1.6676 USD6m1y 1.3222	29.33 SGD 6m1y 1.573 USD6m1y 1.2797	20-Oct-09	-11	We expected the USD/SGD forward curve to invert (see Open FX Trades) and the spread between SGD 6m SOR fixing and the 6m USD Libor rate to widen.	Singapore: Out of the woods but no 'V'
Receive INR 1y1y OIS	31-Jul-09	0.61	6.20	08-Sep-09	-4	RBI governor commented that domestic inflation is "becoming a concern sooner than anticipated". This is the first time the governor stated clearly his concerns about inflation, which is not positive for rates, especially on the front-end. We therefore close our received position.	India: Fiscal consolidation remains a challenge
Sell THB 6m2y ATM straddle	06-Mar-09	Strike 2.63% 2y 2.43	2y 2.41	06-Sep-09	81	This option was held to maturity.	THB rates: Sell swaption volatilities

Note: PL figures are in percentage of notional for FX trades and in running basis point for rates trades. They are evaluated at mid prices without bid/ask spreads and thus only serve as proxies for trade performances. Source: RBS

Trade	Entry Date	Entry Level	Closed Level	Closed date	P/L (bp)	Comments	Publication
Receive HKD 1y1y IRS	07-Jul-09	0.61	0.56	25-Aug-09	6	The risk rally in the past few months pushed up front end rates to price in a "V"-shaped recovery which was unlikely to materialize. Comparing to the last prolonged policy pause in 2002-04, the current 1y1y spreads over central bank policy rates were well over the peaks during the previous period for some markets such as KRW and HKD.	Asia rates: Taking stock of liquidity, Part 2
Buy 3y MGS asset swap	07-Jul-09	65 3y MGS 2.93 3y IRS 3.020	-22 3y MGS 2.86 3y IRS 3.08	25-Aug-09	7	Examining the cheapness/richness of swap spreads against their historical correlations, MYR looked cheap on the front end. We took profit on view that supply/demand conditions will be more favourable for the back end.	Asia rates: Taking stock of liquidity, Part 2
Sell THB ATM 1y1y payer	24-Jun-09	Premium 52bp 1y1y 3.30	Premium 41bp 1y1y 1.75	25-Aug-09	11	Increasing deflationary pressure, a sharp fall in growth and excessive short-term liquidity will ensure that the short-term rates stay low.	Asia rates: Front-end swaption trade ideas
Sell THB 100bp wide 1y1y risk reversal	24-Jun-09	Premium 6bp 1y1y 3.30	Premium 22bp 1y1y 1.75	25-Aug-09	13	As above.	Asia rates: Front-end swaption trade ideas
Sell HKD ATM 1y1y payer	24-Jun-09	Premium 54bp 1y1y 2.14	Premium 36 bp 1y1y 2.06	25-Aug-09	35	Compared to the flat Hibor curve, the front part of IRS curve was very steep with high implied volatilities and skewed more expensive on payer side. We took profit as monetary policy now looks more likely for tightening.	Asia rates: Front-end swaption trade ideas
Sell HKD 100bp wide 1y1y risk reversal	24-Jun-09	Premium 7bp 1y1y 2.14	Premium 20 1y1y 2.06	25-Aug-09	17	As above, selling risk reversal would also benefit from a sharp fall of the underlying rates. An unlikely rate hike of 2.5-2.75% was required for these HKD trades to lose money.	Asia rates: Front-end swaption trade ideas
Receive body in TWD 1s3s5s butterfly	22-Jun-09	37 1y 0.715 3y 1.38 5y 1.68	20 1y 0.675 3y 1.345 5y 1.73	25-Aug-09	16	The bear-steepening led to a rise in curvature which also did not fit into a "non-V"' recovery. We took profits as the curve flattened.	Asia rates: Imminent collapse in convexity
Receive THB 5y IRS	10-Jun-09	3.85	3.74	25-Aug-09	28	As below	Thailand: Ample liquidity for fiscal expansion
Buy Thai government bond (05/2014, 5.25%)	08-Jun-09	3.04	3.07	25-Aug-09	6	As below. This position is meant as a long-term strategy.	Thailand: Ample liquidity for fiscal expansion
Receive THB 1y1y IRS	02-Jun-09	2.90	3.38	25-Aug-09	**-5**	As below	Thailand: Ample liquidity for fiscal expansion
Receive THB 2y IRS	28-May-09	2.40	2.55	25-Aug-09	8	Thai govt bonds appeared oversold, especially against the fact the system has ample liquidity to absorb the extra budget funding.	Thailand: Ample liquidity for fiscal expansion
Receive TWD 2y1y IRS	18-Mar-09	1.75	1.99	25-Aug-09	2	Trade was recommended when the IRS curve steepened significantly on the front to intermediate sectors. We believed that the belly of the curve was likely to outperform if deflation deepened.	TWD rates: Receive TWD 2y forward 1y IRS
Pay CNY 2y ND-IRS	11-May-09	1.57	2.41	25-Aug-09	63	Trade recommended on view that upside pressures on rates would persist in the near term as the PBOC started to mop up excess liquidity.	China Monthly: 2009 GDP revised up. But growth has a narrow base
MYR 2s5s steepener	07-May-09	116 2y 2.54 5yr3.70	101 2y 2.73 5y 3.74	25-Aug-09	**-14**	Worsening fiscal funding pointed to a steepening curve.	Malaysia: Fiscal funding woes
Pay 3y KRW ND-CCS-IRS basis swap	31-Mar-09	-350.00	-155.50	25-Aug-09	160	The Fed's swap line had succeeded in restoring liquidity in the domestic rates market and in turn, stability to the FX market. We expect the BoK to maintain ample liquidity by withholding FX intervention. As such, we see stability in the FX market gradually normalizing the CCS basis market.	Korea rates: From bearish to neutral
MYR 5s10s flattener	06-Mar-09	108 5y 3.12 10y 4.2	71 5y 3.74 10y4.45	25-Aug-09	26	The MYR IRS curve had steepened significantly on concerns of the fiscal position of the Malaysian Federal government. We believed then that the worry over fiscal pressure was overhyped as there was enough liquidity within the economy to absorb increased issuance to fund the fiscal deficit. Although we subsequently revisited the fiscal story, this trade was kept on as the cushion offered tremendous protection and furthermore, the fiscal problem was exerting more pressure on the front half of the curve rather than the back half.	MYR rates: Fiscal pressure overhyped

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Regional structural indicators

Regional Structural Indicators

	Population		GDP structure (% GDP) [a]								Nominal GDP		Sovereign rating		Competitiveness	
	mn	life expectancy at birth (yrs)	Agriculture and mining	Industry	Construction	Services	Private consumption	Govern-ment consump-tion	Investment	Net Exports	GDP, USD bn (2008)	Purchasing power parity GDP per capita, USD th [b]	Moody's	S&P	share of 2006 world exports %	WEF competitiveness ranking, percentile
Australia	22	79	2	27	7	64	54	18	28	0	1,010	34.9	Aaa	AAA	1.0	15
China	1,320	72	8	50	NA	42	35	13	41	8	4,359	35.7	A1	A+	8.0	29
Hong Kong	7	82	0	5	2	79	59	8	21	11	215	42.3	Aa2	AA+	0.2	11
India	1,123	64	18	17	7	56	62	11	34	-5	1,074	2.8	Baa3	BBB-	1.0	49
Indonesia	226	68	22	27	6	45	57	8	24	10	508	3.7	Ba2	BB-	0.9	54
Japan	128	81	1	20	6	72	55	18	22	5	4,911	4.0	Aa2	AA	5.4	8
Korea	48	78	3	30	9	46	48	13	27	14	814	26.8	A2	A	2.7	19
Malaysia	26	74	16	29	3	55	52	14	22	13	222	27.9	A3	A-	1.3	24
Philippines	88	71	20	59	5	13	77	4	18	4	156	3.4	Ba3	BB-	0.4	87
Singapore	5	80	0	31	4	67	39	10	29	20	182	3.5	Aaa	AAA	1.2	3
Taiwan	23	77	2	31	2	55	54	11	17	17	392	30.3	Aa3	AA-	1.9	12
Thailand	64	70	11	40	2	47	52	9	22	15	273	7.4	Baa1	BBB+	1.1	36
US	302	78	3	28	3	67	71	18	15	-3	14,265	7.7	Aaa	AAA	8.6	1
New Zealand	4	78	5	16	4	75	59	20	23	-2	128	27.3	Aaa	AA+	0.2	20

Source: UN comtrade; WTO; CEIC; World Competitiveness Report; World Bank; Bloomberg; Australian Bureau of Statistics; Econdata; New Zealand Debt Office; Australia Office of Financial Management; RBS

[a] In 2008 figures.
[b] Australia and Thailand are in 2007 figures; the rest are in 2008 figures.

Quarterly GDP and inflation forecasts

	2008	2009	2010	2011	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% yoy)																
Emerging Asia (ex Japan)	7.2	5.9	8.2	7.9	3.3	5.1	6.4	8.3	9.1	8.0	7.9	7.8	8.0	7.8	7.9	7.9
ex Japan, China and India	3.0	0.2	5.7	5.0	-3.5	-1.9	0.4	5.4	6.3	5.4	5.1	4.8	4.7	4.8	4.8	5.0
Australia	2.2	0.9	2.5	3.5	0.3	0.6	0.0	3.6	2.0	2.1	2.8	3.2	3.4	3.6	3.5	3.4
China	9.0	8.5	10.0	9.5	6.1	7.9	8.9	10.7	11.5	10.0	9.5	9.5	9.5	9.5	9.5	9.5
Hong Kong	2.5	-2.7	5.3	4.0	-7.8	-3.6	-2.4	2.6	6.0	5.0	4.0	4.0	4.0	4.0	4.0	4.0
India	7.4	5.8	6.7	7.4	4.1	6.0	6.7	6.0	6.5	6.0	7.2	7.0	8.0	7.0	7.3	7.3
Indonesia	6.1	4.5	5.9	6.3	4.5	4.1	4.2	5.4	5.4	5.9	5.9	6.3	6.4	6.2	6.2	6.4
Japan	-1.2	-5.1	1.9	1.7	-8.6	-7.0	-4.5	-0.4	2.7	1.5	2.0	1.3	1.5	1.8	1.8	1.8
Korea	2.2	0.2	7.0	4.5	-4.2	-2.2	0.9	6.0	9.0	7.0	6.0	5.0	4.0	4.0	4.0	4.0
Malaysia	4.7	-1.7	4.5	5.6	-6.2	-3.9	-1.2	4.5	4.8	3.8	4.4	4.7	5.1	5.4	5.1	6.6
Philippines	3.8	0.9	5.4	5.0	0.6	0.8	0.4	1.8	4.4	5.2	5.7	6.1	5.5	4.7	5.1	5.1
Singapore	1.1	-2.0	5.2	6.3	-9.4	-3.1	0.6	4.0	5.4	5.5	5.2	6.0	6.6	6.3	6.2	6.0
Taiwan	0.1	-1.9	6.4	4.0	-9.1	-6.9	-1.0	9.2	9.0	6.0	5.0	4.0	4.0	4.0	4.0	4.0
Thailand	2.5	-2.3	3.6	5.0	-7.1	-4.9	-2.7	5.8	3.5	3.5	3.7	3.8	4.6	4.7	5.0	5.6
CPI (% yoy)																
Emerging Asia (ex Japan)	6.4	2.3	3.7	3.6	2.7	1.6	2.0	3.2	4.3	4.2	3.1	2.9	3.2	3.4	3.7	4.2
ex Japan, China and India	6.2	1.9	2.7	3.6	3.9	1.8	0.4	1.6	2.5	2.6	2.6	2.7	3.2	3.6	3.9	4.1
Australia	4.4	1.9	2.6	2.6	2.5	1.5	1.3	2.6	2.8	2.9	2.5	2.4	2.4	2.5	2.6	2.7
China	5.9	-0.8	3.0	3.9	-0.6	-1.5	-1.3	0.7	2.2	2.9	3.4	3.2	3.5	3.6	3.9	4.5
Hong Kong	4.3	0.8	5.1	7.2	1.7	-0.1	-0.9	1.3	2.9	4.1	5.6	7.7	9.5	9.0	6.6	3.9
India	8.0	10.2	6.4	3.1	9.4	8.9	11.8	10.8	11.2	9.2	2.9	2.3	2.6	2.9	3.2	3.7
Indonesia	9.8	4.8	4.9	6.0	8.6	5.6	2.8	2.7	4.4	4.8	5.0	5.3	5.6	6.2	6.0	6.3
Japan	1.5	-1.3	-1.0	-0.6	0.0	-1.0	-2.3	-1.7	-1.4	-1.1	-0.7	-0.7	-0.7	-0.7	-0.6	-0.6
Korea	4.7	2.7	1.5	2.5	3.9	2.8	2.0	2.4	1.8	1.2	1.1	1.7	2.0	2.3	2.6	2.9
Malaysia	5.4	0.6	2.9	3.4	3.7	1.3	-2.3	-0.2	2.0	3.1	3.3	3.3	3.1	3.2	3.5	3.9
Philippines	9.1	3.3	4.8	5.7	6.9	3.2	0.3	3.0	3.0	4.2	6.2	5.8	6.1	5.4	5.5	5.7
Singapore	6.5	0.2	1.7	1.8	2.1	-0.5	-0.4	-0.3	0.4	1.9	1.9	2.4	2.1	2.1	1.7	1.2
Taiwan	3.5	-0.8	-0.3	1.2	0.0	-0.8	-1.3	-1.2	1.3	0.2	-1.2	-1.4	-0.2	0.9	1.7	2.2
Thailand	5.5	-0.8	2.2	1.8	-0.2	-2.8	-2.2	1.9	2.5	2.9	1.6	0.3	1.0	1.7	3.5	4.5

Source: RBS

Quarterly FX and policy rate forecasts

Foreign exchange rate forecast

	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
AUD/USD	0.90	1.00	0.95	0.90	0.87	0.85	0.85	0.85	0.85
USD/CNY	6.827	6.800	6.700	6.600	6.500	6.400	6.300	6.200	6.200
USD/HKD	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
USD/INR	46.53	45.50	43.75	43.50	43.50	43.50	44.00	44.25	44.25
USD/IDR	9,404	9,200	8,800	8,850	8,900	8950	8975	9000	9000
USD/JPY	93	91	93	97	100	102	104	106	110
USD/KRW	1164	1130	1110	1100	1080	1075	1080	1090	1100
USD/MYR	3.43	3.40	3.38	3.36	3.34	3.32	3.33	3.34	3.35
USD/PHP	46.2	46.8	46.5	46.0	45.5	46.3	46.5	46.8	47.0
USD/SGD	1.405	1.400	1.390	1.380	1.370	1.375	1.375	1.370	1.370
USD/TWD	32.0	31.8	31.8	31.5	31.2	31.4	31.4	31.3	31.3
USD/THB	33.4	33.0	32.9	32.8	32.5	33.3	33.5	33.8	34.0
EUR/USD	1.43	1.38	1.35	1.32	1.28	1.26	1.27	1.25	1.25

Source: RBS

Policy rate forecast

	Q4:09	Q1:10	Q2:10	Q3:10	Q4:10	Q1:11	Q2:11	Q3:11	Q4:11
Australia	3.75	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00
China	5.31	5.31	5.58	5.85	5.85	6.12	6.12	6.39	6.39
Hong Kong	0.50	0.50	1.25	2.25	3.25	4.00	4.50	5.00	5.25
India (repo rate)	3.25	3.25	3.50	3.75	4.00	4.25	4.50	4.75	5.00
Indonesia	6.50	6.50	6.50	7.25	8.00	8.75	9.00	9.00	9.00
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Korea	2.00	2.00	2.25	2.25	2.50	2.50	2.75	3.00	3.25
Malaysia	2.00	2.00	2.25	2.50	2.50	2.75	3.00	3.00	3.25
Philippines	4.00	4.00	4.00	4.50	5.00	5.50	6.00	6.00	6.00
Taiwan	1.25	1.25	1.25	1.25	1.25	1.38	1.50	1.63	1.75
Thailand	1.25	1.25	1.25	1.25	1.25	1.75	2.25	3.00	4.00
Fed funds rate	0.25	0.25	1.00	2.00	3.00	3.75	4.25	4.75	5.00
ECB rate	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75	2.25

Source: RBS

Country Sections

Australia

Kieran Davies, Felicity Emmett, Skye Masters, and Greg Gibbs

Macro Economy

FX Outlook: After dipping early in the month, the currency has recovered in recent days back towards 0.90. While there are some issues that could potentially unsettle risk appetite in the near term, we expect that higher local interest rates, strong export demand from Asia and general economic outperformance to help support the AUD. That said, while a return to recent highs is possible in the near term, the currency is unlikely to rise sharply from current levels as our US colleagues still expect the Fed to start moving rates away from zero around the middle of this year.

Interest rate outlook: Although we were surprised by the RBA's decision to keep rates on hold in February, our view is basically unchanged and we continue to expect the cash rate to reach 5% by the end of 2010 and 6% by end-2011. The tone of the Bank's *Statement on Monetary Policy,* as well as that of recent RBA speeches, has been very upbeat about the prospects of the Australian economy, while the Governor has highlighted that lending rates need to go higher. In the very near term, we expect the RBA will lift rates at the March meeting, although the market is uncertain about this given the surprise outcome in February.

Key economic fundamentals: The economy looks to have started the year on a solid note, with the labour market showing a remarkable improvement. Recent numbers confirm that unemployment rate peaked below 6%, has already turned around sharply and is back down to 5.3%. We are therefore entering into this upswing with less excess capacity than was earlier forecasted. A big government stimulus has been a key factor, but the strength in Asian demand has also been particularly important in Australia's better-than-expected performance.

We continue to expect the economy to gather momentum this year with growth likely to be able to absorb the impact of higher interest rates. Given our increasingly important links to Asia, the risks around our outlook (both upside and downside) continue to relate to the ongoing uncertainty regarding Chinese growth.

New Zealand: Recent news from New Zealand confirms that its recovery from recession has lagged Australia as NZ unemployment has continued to rise, whereas unemployment in Australia has peaked and is falling. Forward indicators suggest that the recovery will gather some momentum and we still expect the RBNZ to start raising interest rates around the middle of this year.

Strategy

Rates strategy

Key events in March are the RBA Board meeting on the 2nd and the futures roll on the 15th. As to the former, current pricing shows that the front end of the IB curve is most vulnerable to a sell-off. We favour being short the IBs and/or holding curve-flattening trades into March. As to the latter, the futures curve is expected to trade in a range of 60-75bp, with a move to the lower end of this range leading into the meeting. This should be used as an opportunity to exit curve-flattening trades expressed via futures. Hold flatteners in the front of the swap curve (ie, 1Y5Y or 1Y3Y) and look for the market to re-price the cash rate profile through to mid-year.

For the futures roll, the June 3Y basket will change on the day of the roll, with the April 2015 bond included and the yield on the contract trading higher. The pricing of the roll will vary in the lead-up to the roll date, but fair value has it at 17pts. On current levels, this would put the 3Y EFP at 14bp, which is too narrow given the fundamental backdrop of a higher cash rate and lower bond supply. To compensate for the roll, the market is likely to take the 3Y EFP wider ahead of the roll. In the low 30s, we look to pay the 3YEFP, targeting an exit of 45bp.

For the semi-government sector, the announced 31 December end-date for the Guarantee Scheme for State and Territory Borrowing means that the focus is now on the relative pricing of guaranteed and unguaranteed paper. With a sizeable issuance programme, QTC has been quick off the mark pricing unguaranteed bonds that were well supported. By year-end, QTC and NSWTcorp will have established unguaranteed curves. We still expect long-dated semi paper to outperform this year on a spread basis relative to short-dated paper.

FX

In early February, we lowered our Q1 forecast for the AUD to 0.85, anticipating a bounce-back in Q2 to 0.90. This reflected our concern that the market would fret over policy tightening in Asia, a pause in QE in the US and UK, a regulatory shift to rein in bank risk taking, and ballooning sovereign debt. The USD was also seen as due for a bounce. Against this, we acknowledged that the domestic and global data flow was supportive, with strength in global manufacturing PMIs and key Australian indicators. We also noted iron ore and coal prices in spot markets were at extremely high levels after a strong December/January.

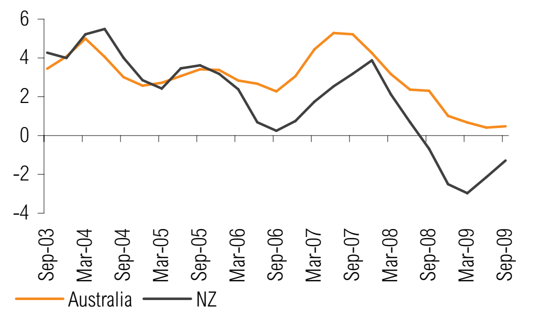
Since then, the USD's gains have generally been muted and industrial metal and oil prices have rebounded strongly. There remain several factors that might unsettle risk appetite, but the US Fed's reaffirmation of low rates for an extended period is helping to keep these at bay. The AUD and other commodity currencies are unlikely to resume the rising trend from the first half of last year, but a return to recent highs is possible in the near term.

The AUD/NZD has lifted over the last month to test the highs of last year. This move is well-founded as the New Zealand economy continues to lag Australia. New Zealand is expected to emphasise fiscal consolidation in the May Budget and make changes to remove incentives for housing investment. Policymakers in New Zealand also sound less confident, contrasting with upbeat assessments in Australia. As such, we see AUD/NZD extending recent gains to 1.34 over coming months.

Australia/New Zealand

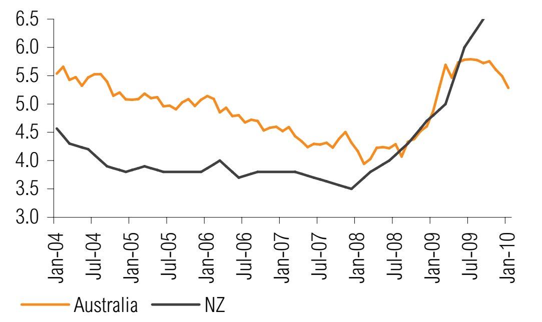
Unemployment in Australia has peaked at less than 6% and is falling

Figure 1: Real GDP growth (%yoy)



Source: Australian Bureau of Statistics; Econdata; RBS

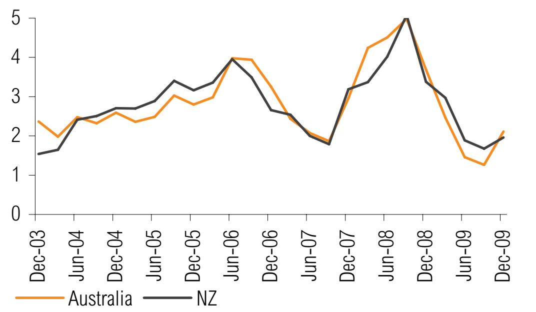
Figure 2: Unemployment rate (%)



Source: Australian Bureau of Statistics; Econdata; RBS

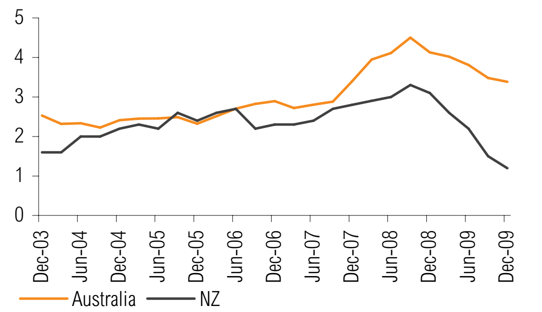
Inflation should be moderate in the near term before picking up next year

Figure 3: Inflation (%yoy)



Source: Australian Bureau of Statistics; Econdata; RBS

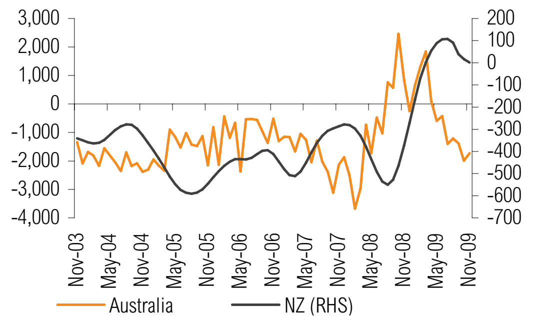
Figure 4: Underlying inflation (%yoy)



Source: Reserve Bank of Australia; Econdata; RBS

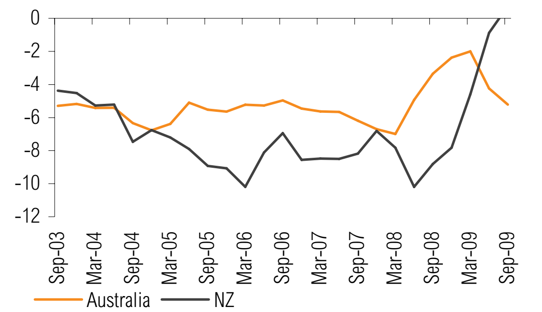
The mining sector looks likely to win very big contract price rises for key exports

Figure 5: Trade balance (AUD mn & NZD mn)



Source: Australian Bureau of Statistics; Econdata; RBS

Figure 6: Current account balance (% of GDP)

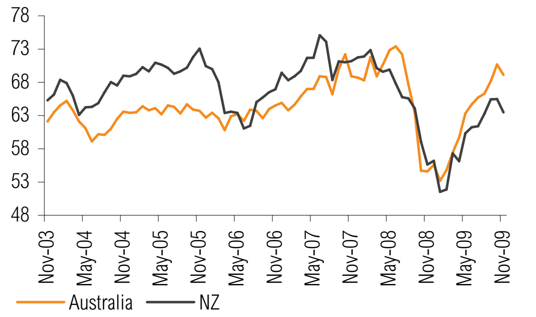


Source: Australian Bureau of Statistics; Econdata; RBS

Australia/New Zealand

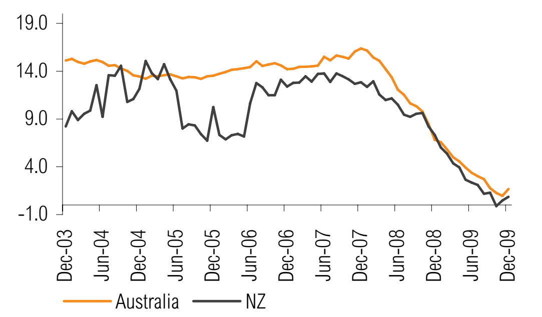
Credit is weak in Australia because companies are reducing debt, while the currency is supported by high interest rates

Figure 7: Trade weighted index of the exchange rate (NEER)



Source: Reserve Bank of Australia; Reserve Bank of New Zealand; RBS

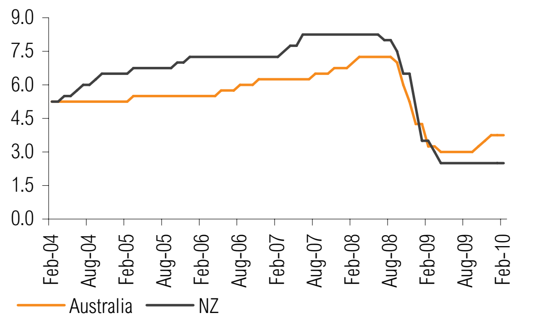
Figure 8: Credit growth (%yoy)



Source: Reserve Bank of Australia; Reserve Bank of New Zealand; RBS

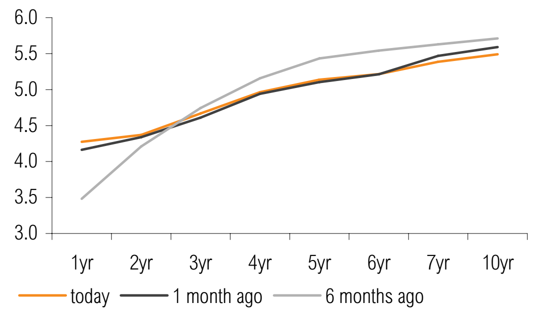
The RBA surprised by pausing in February, but has signalled that it has more to do

Figure 9: Policy rates (%)



Source: Reserve Bank of Australia; Reserve Bank of New Zealand; RBS

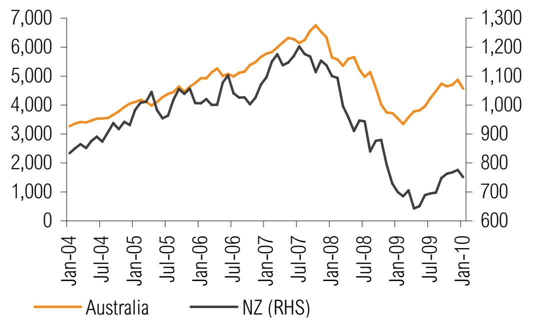
Figure 10: Australia yield curve (%)



Source: Bloomberg; RBS

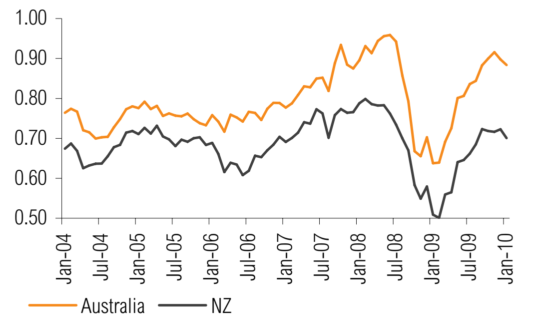
The Australian stock market has become increasingly tied to the US market

Figure 11: Stock prices (index)



Source: Bloomberg; RBS

Figure 12: Exchange rates (USD)



Source: Bloomberg; RBS

Source: Australian Bureau of Statistics; Econdata; RBS

Australia Key Economic Indicators

	2008	2009	2010	2011
Real GDP (%)				
Private consumption	2.4	1.5	1.9	2.7
Residential investment	2.6	-5.8	1.8	3.0
Equipment investment	16.8	-6.0	7.2	13.3
Non-residential construction	9.3	-1.9	-10.2	14.9
Other investment	10.2	6.3	8.5	10.3
Business investment	12.9	-2.5	0.6	13.3
Private investment	8.4	-2.9	0.0	9.8
Private demand	4.2	0.1	1.3	4.8
Public consumption	3.3	2.4	3.2	3.1
Public investment	17.7	3.4	36.2	0.5
Public demand	6.2	2.6	10.6	2.4
Domestic demand	4.5	0.7	3.4	4.3
Farm inventories (contribution)	-0.3	0.3	0.0	0.0
Non-farm inventories (contribution)	-0.1	-0.9	0.5	0.2
Total inventories (contribution)	-0.4	-0.7	0.6	0.2
Gross national expenditure	4.3	-0.1	4.0	4.5
Exports	3.8	1.1	1.4	2.9
Imports	11.4	-8.2	8.1	8.5
Net exports (contribution)	-1.6	2.1	-1.4	-1.3
Farm GDP	29.8	-9.4	8.7	12.6
Non-farm GDP	1.5	1.1	2.9	3.3
GDP	2.2	0.9	2.5	3.5
Inflation & unemployment				
CPI (% end period)	3.7	2.3	2.3	2.7
CPI (%)	4.4	1.9	2.6	2.6
Underlying inflation (% end period)	4.1	3.5	2.4	2.7
Underlying inflation (%)	4.2	3.7	2.8	2.8
Unemployment rate (% end period)	4.6	5.6	5.0	4.8
FX and interest rates				
AUDUSD (end period)	0.70	0.97	0.83	0.82
Cash rate (end period)	4.25	3.75	5.00	6.00
10Y bond yield (end period)	4.0	5.5	6.0	6.3
Fiscal accounts (% of GDP)				
Underlying cash Budget balance (financial year)	1.7	-2.2	-3.8	-3.5
Balance of payments				
Terms of trade (% yoy)	13.6	-12.3	-0.7	4.9
Trade balance (% GDP)	-0.7	-0.8	-1.8	-2.0
Current account balance (% GDP)	-4.6	-4.7	-6.2	-6.6

Source: Australian Bureau of Statistics; Econdata; RBS

New Zealand Key Economic and Financial Forecast

	2008	2009	2010	2011
Real GDP (%)	-0.1	-1.6	2.0	3.2
CPI (%)	4.0	2.3	2.6	2.7
Cash rate (% end period)	5.00	2.50	4.50	5.00
NZDUSD (end period)	0.58	0.77	0.63	0.63

Source: Australian Bureau of Statistics; Econdata; RBS

China

Ben Simpfendorfer, Pin Ru Tan

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/CNY
Q4:09	10.7	0.7	5.31	6.83
Q1:10	11.5	2.2	5.31	6.80
Q2:10	10.0	2.9	5.58	6.70
Q3:10	9.5	3.4	5.85	6.60
Q4:10	9.5	3.2	5.85	6.50
Q1:11	9.5	3.5	6.12	6.40
Q2:11	9.5	3.6	6.12	6.30
Q3:11	9.5	3.9	6.39	6.20
Q4:11	9.5	4.5	6.39	6.20

Source: RBS

Real Economy: There has been no change to China's outlook over the past month. The 2010 GDP growth forecast was earlier revised up to 10.0% after a strong 1Q result. However, the monthly data has since provided nothing to challenge that forecast. Moreover, the data is typically volatile around the Lunar New Year period, meaning it is better to wait for the March data for a cleaner read of the trend.

The forecast assumes that public investment slows gradually in 1H as the PBOC curbs credit growth and the government cracks down on wasteful spending. Stronger residential investment will help make up the shortfall in 1H, joined by improved private business investment in 2H. Private consumption provides steady support to growth, albeit partly reliant on fiscal subsidies. Exports are tentatively recovering.

January's export growth was a strong 21.0%y/y, although it dipped modestly m/m. The underlying trend was also firm. Yet, exporters are anecdotally still concerned about the post-Lunar New Year outlook. The recent strength in exports appears to owe to more than restocking, but foreign retail sales have yet to turn up convincingly. A recovery in exports is crucial to stronger private business investment in 2H.

Policy Outlook: January's CPI was a low 1.5%y/y against expectations of 2.1%y/y. The underlying trend was largely steady at 5%3m/3m, saar. Food prices provided the largest surprise, rising just 3.7%y/y versus 5.3%y/y the previous month. That was unexpected as base effects and snowstorms were expected to have pushed the y/y change sharply higher. In the event, the snowstorms had a smaller effect on food prices than expected.

Food prices are the major drivers of the CPI. Inflation is thus unlikely to rise much above 3% in 2H. However, inflation expectations are worsening, especially with home prices rising, wage inflation returning, and the published economic data still robust. The PBOC is concerned that the private sector has not fully recovered, but we expect it will hike its policy rate, the 1-year lending rate, in 2Q in response to home prices and inflation expectations.

FX outlook: Talk of a one-off CNY revaluation has captured headlines. The argument for revaluation is typically based on either curbing rising inflation or capital inflows. The two are legitimate reasons for concern. But one-off revaluation would not necessarily solve either problem, as inflation owes largely to home and food prices, while capital inflows might rise if a revaluation is not large enough to curb appreciation expectations.

We are still looking for appreciation to resume from 2Q, targeting 6.500 by end-2010, or modestly more than what is priced in by 12M non-deliverable forwards. We cannot rule out the possibility of a small revaluation. But gradualism is likely to remain the guiding rule.

Fixed income analysis

Supply: The PBOC hiked its reserve requirement ratio by 50bps for the second time in two months on 25th February. This was a necessary move given that CNY1.4trn of bills and repos are maturing in February and March (Figure 1). Even after taking into the account liquidity drained from the RRR hike, the PBOC still net injected around CNY250bn into the market in February. However, it is almost certain that the PBOC will increase bill issuance in March as historically, the central bank has always carried out the most intensive OMO in the month after the Chinese New Year to reduce market liquidity (Figure 2). We also highlight that the PBOC will possibly reintroduce the 3-year bills in the near-term, which were last introduced in June 2008, in a sign of further quantitative tightening.

Separately, in the government bond space, the ministry of finance will issue 1y, 3y, 7y and 10y in March with no bonds due for redemption.

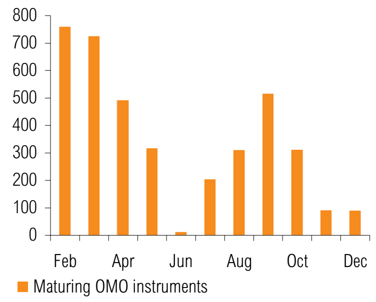
Demand: As evident from the 7-day repo rate which is still below 2% (Figure 3), liquidity remains flush despite two RRR hikes. The bond market therefore remains well-supported by flush liquidity conditions. Banks continued to load up, particularly long-end bonds, in secondary trading. Recent bond auctions also garnered good demand with the 30y auction chalking a bid-cover ratio of 2.12 and an average yield of 4.05%, 7bps lower than the level traded in the secondary market.

Valuation: NDIRS came off significantly, as much as 11bps, in late February as market participants still felt that there was ample liquidity in the system and that the PBOC is unlikely to take stringent actions soon. The downward move was more pronounced on the back-end of the curve, leading the curve to bull-flatten by 4bps on the 2s10s.

Bonds have rallied since late January with the 10y bonds trading close to a 6-month high. Reaction to the second RRR hike has been relatively muted in the bond market compared to the swap market, leading the bond-swap spread to richen. Aggressive quantitative tightening will undermine the wall of cash propping up the bond market. However, investors' appetite for bonds has always been more dependent on the 1-year lending policy rate as well as banks' new loans and less on the RRR and quantitative tightening. Hence, banks will continue to shift their asset allocation in favour of bonds as long as the clampdown on bank lending continues. With new loans expected to fall further, the bond-swap spread could richen further in March.

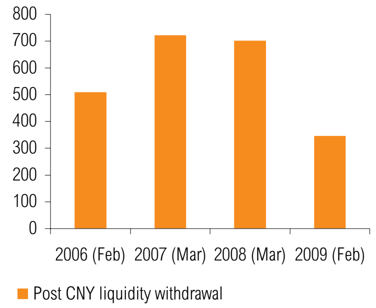
Strategy: There are several key events to watch out for: the congress meeting on 5th March, reintroduction of 3y PBOC bills, hikes in PBOC bill yields and/or further hikes in the RRR. The market is generally not expecting major surprises in the premier's 2010 work report to congress. However, there is a good probability that tightening measures will be gradually rolled out in the aftermath of the congress meeting. The high carry and roll-down cost for initiating outright paid positions in CNY rates makes it imperative to get the timing of the events right. Hence, as an alternative, we prefer putting on curve flatteners, like the 3s5s position we recommended in early January, to similarly bet on the events but at a much lower holding cost. We do not recommend chasing the recent downward move in rates as it is likely to be short-lived. Moreover, any potential gains are not attractive when weighed against the high event risk.

Figure 1. Maturing OMO instruments (CNY bn)



Source: CEIC, RBS

Figure 2. Net liquidity withdrawal after Chinese New Year (CNY bn)



Source: CEIC, RBS

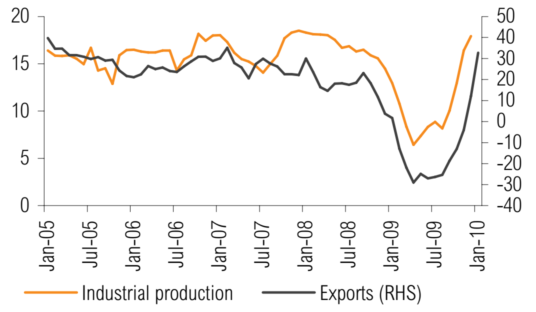
Figure 3. 7-day repo rate (%)

Source: CEIC, RBS

China

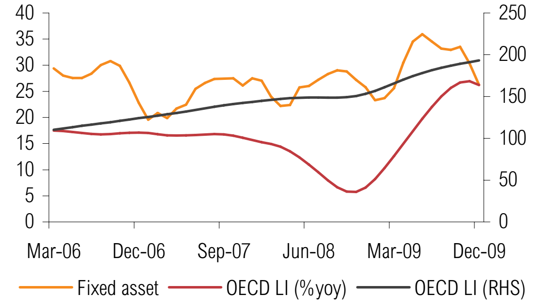
December's industrial production was strong, again, on base effects and robust heavy industrial production.

Figure 1: Industrial production (yoy, 3mma) and exports (% yoy, 3mrs)



Source: CEIC; RBS

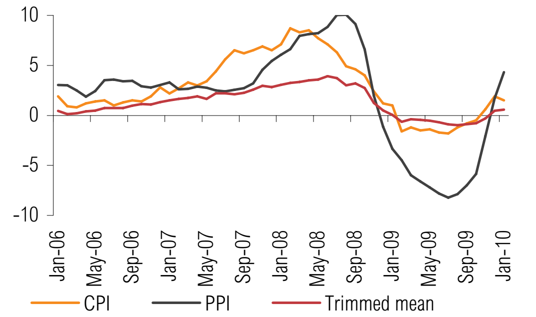
Figure 2: Fixed asset investment (% yoy, 3mrs) and OECD Leading Indicator (levels & %yoy)



Source: CEIC; Bloomberg; RBS

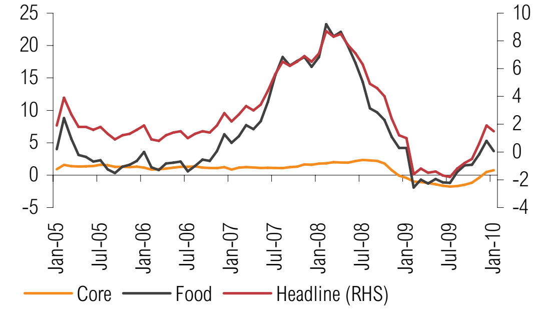
January's CPI slowed modestly to 1.5%y/y as food prices eased. But the rate is forecast to rise again this month.

Figure 3: Consumer and producer price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

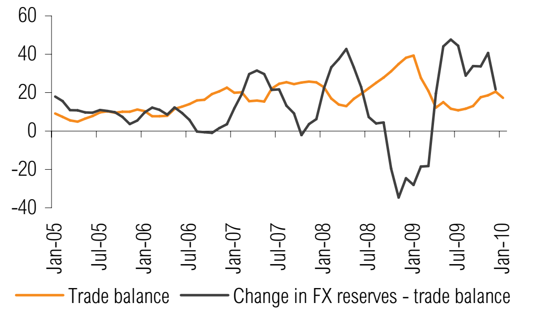
Figure 4: Headline, core and food CPI (% yoy)



Source: CEIC; RBS

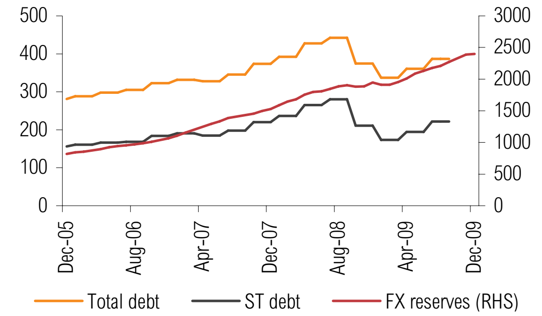
January's export growth remained strong on a y/y basis, although the underlying trend softened modestly. Exports are volatile this time of year.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: Government external debt and FX reserves (USD bn)



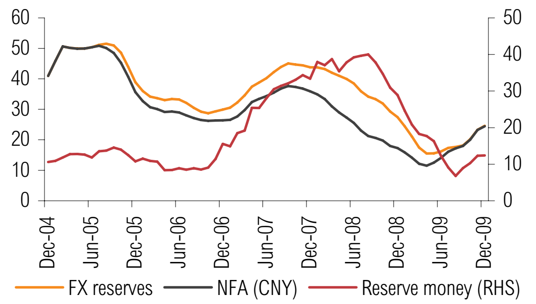
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum.

China

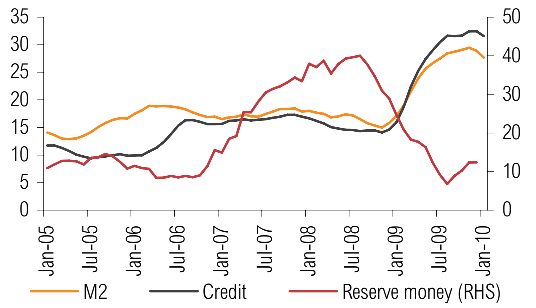
Credit growth surged in January. Further tightening is needed if annual credit growth is to slow to around a forecast 7 trillion yuan.

Figure 7: Foreign asset, FX reserves and reserve money growth (% yoy, 3mrs)



Source: CEIC; RBS

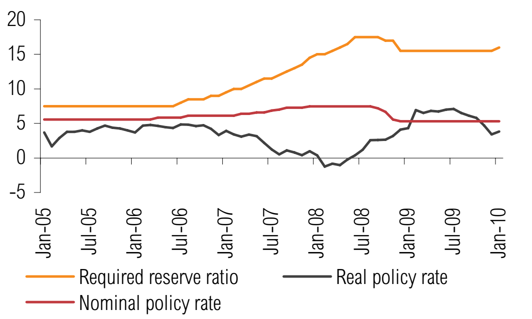
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

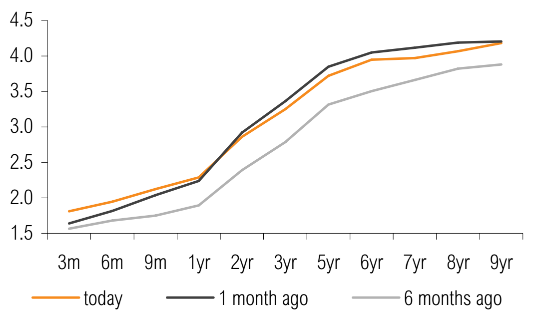
The real policy rate is now falling as inflation returns, and policy rates remain unchanged.

Figure 9: Policy rate and required reserve ratio (%)



Source: CEIC; RBS

Figure 10: Yield curve (%)



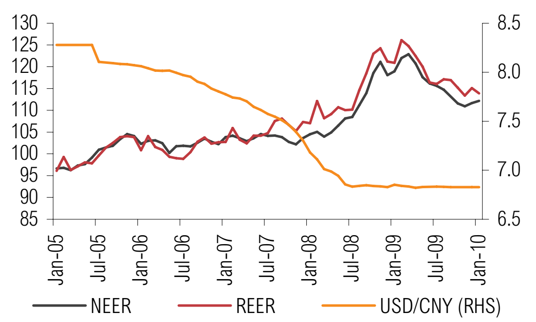
Source: Bloomberg; RBS

Equity prices continue to fall as the market worried about the effect of tightening, especially for the financial and property sectors, and rising inflation.

Figure 11: Stock exchange index and PE ratio

Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 =100)



Source: CEIC; RBS

China Key Economic Indicators

	2005	2006	2007	2008	2009	2010F	2011F
Growth (% yoy)							
Real GDP	10.4	11.6	11.9	9.0	8.5	10.0	9.5
Domestic demand	9.4	10.6	10.9	8.7	10.3	11.0	10.6
- Private consumption	7.6	9.0	10.6	9.0	7.9	10.5	10.2
- Government spending	7.5	9.0	11.0	12.4	21.5	14.0	12.0
- Fixed investment	12.1	12.8	11.2	9.1	8.1	11.7	11.2
Fixed investment (% GDP)	40.7	41.1	40.8	40.4	39.5	40.5	41.0
Exports	40.9	25.0	22.4	17.0	-15.0	10.0	10.0
Imports	37.2	25.0	20.0	16.4	-15.0	14.0	15.0
Domestic demand contribution to growth	8.9	9.9	10.2	8.2	9.7	10.6	10.2
Net exports contribution to growth	1.2	0.8	1.5	0.8	-1.3	-0.6	-0.8
Inflation, FX and interest rates							
CPI inflation (%, end of period)	1.6	2.8	6.5	1.2	1.9	4.0	4.7
CPI inflation (%, period average)	1.8	1.5	4.8	5.9	-0.8	3.0	3.9
Property price index (%, end of period)	7.1	6.3	11.4	-10.0	5.0	15.0	15.0
USD/CNY, end-period	8.070	7.812	7.304	6.823	6.800	6.500	6.200
USD/CNY, period average	8.193	7.972	7.607	6.949	6.825	6.650	6.275
REER (% end of period)	2.3	2.9	2.4	3.0	-1.0	3.0	5.0
Policy rate % end of year	5.58	6.12	7.47	5.31	5.31	5.85	6.39
3 month CNY CHIBOR (end-year, %)	2.50	3.26	4.74	1.80	1.50	2.10	2.50
Fiscal accounts (% of GDP)							
Central government fiscal balance	-1.2	-1.0	0.3	-0.4	-3.0	-2.5	-2.2
- Government expenditure	18.5	19.1	20.0	19.5	10.0	10.0	15.0
- Government revenue	17.3	18.3	20.6	26.0	25.0	25.0	20.0
Primary fiscal balance	-	-	-	-	-	-	-
Local government fiscal balance	-	-	-	-	-	-	-
Government debt (% of GDP)	17.2	16.1	21.8	17.7	22.7	25.3	20.8
- Domestic	15.7	14.8	20.7	16.9	21.8	24.4	20.1
- External	1.5	1.3	1.0	0.8	0.9	0.8	0.7
Money and credit (% yoy)							
M2	15.0	16.9	16.7	17.8	29.0	22.0	20.0
Private sector credit	13.0	15.1	16.1	15.9	32.0	20.0	18.0
Private sector credit % of GDP	106.3	106.3	104.9	100.9	126.9	135.9	139.5
Balance of payments (USD bn)							
Exports	762.5	969.7	1,220.0	1,434.6	1,190.7	1,309.8	1,440.8
% yoy	28.5	27.2	25.8	17.6	-17.0	10.0	10.0
Imports	628.3	751.9	904.6	1,073.9	934.3	1,074.4	1,235.6
% yoy	17.6	19.7	20.3	18.7	-13.0	15.0	15.0
Trade balance	134.2	217.7	315.4	360.7	256.4	235.4	205.2
Current account balance	160.8	249.9	371.8	426.1	306.4	285.4	255.2
Current account balance % of GDP	7.2	9.4	11.0	9.8	6.6	5.4	3.9
Gross FDI	67.8	60.3	121.4	94.3	60.0	60.0	80.0
Overall balance	207.0	247.0	461.7	417.8	400.0	350.0	250.0
Foreign reserves and debts (USD bn)							
FX reserves	818.9	1,066.3	1,528.2	1,946.0	2,346.0	2,696.0	2,946.0
FX reserves, months of imports	15.6	17.0	20.3	21.7	30.1	30.1	28.6
FX reserves, % of ST debt	585.8	633.1	775.0	883.8	977.5	898.7	841.7
FX debt	281.5	323.2	373.6	410.1	440.0	500.0	550.0
FX debt % GDP	12.6	12.2	11.0	9.5	9.5	9.4	8.5
ST FX debt	139.8	168.4	197.2	220.2	240.0	300.0	350.0
Nominal GDP							
Nominal GDP, USD bn	2,236.2	2,658.2	3,382.7	4,326.6	4,625.7	5,317.1	6,480.1
Nominal GDP, CNY bn	18,321.8	21,192.4	25,730.6	30,067.0	31,570.4	35,358.8	40,662.6
GDP per capita, USD	1,710.2	2,022.3	2,560.2	3,258.2	3,449.0	3,925.3	4,736.5

Source: CEIC; Bloomberg; RBS

Hong Kong

Dominique Dwor-Frecaut, Woon Khien Chia

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/HKD
Q4:09	2.6	1.3	0.50	7.75
Q1:10	6.0	2.9	0.50	7.75
Q2:10	5.0	4.1	1.25	7.75
Q3:10	4.0	5.6	2.25	7.75
Q4:10	4.0	7.7	3.25	7.75
Q1:11	4.0	9.5	4.00	7.75
Q2:11	4.0	9.0	4.50	7.75
Q3:11	4.0	6.6	5.00	7.75
Q4:11	4.0	3.9	5.25	7.75

Source: RBS

Real economy: GDP growth picked up in Q4, accelerating to 9.2% saar from 1.6% saar in Q3. For the whole of 2009, the economy contracted by 2.7%. Unemployment has been declining since September but remain high at 4.9%. Equity prices have peaked, in line with global trends. Property prices are back above their pre-crisis levels though they paused in Q4 09. The government has warned against the risk of a property bubble, lowered the loan to value ratio, raised taxes on luxury home transactions and announced plans to release more land. With labor market stabilization and higher asset prices, domestic demand is recovering: Q4 real retail sales increased by 34.4% qoq saar. Excluding one-off government relief measures, inflation has remained around 0%yoy since June 09 and has yet to show the impact of the stabilization of the labor and goods market. By contrast the recovery of credit growth is firming up in line with the higher collateral values associated with rising property prices and the stabilization of domestic demand.

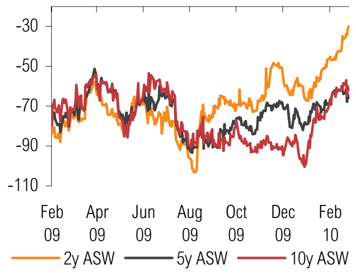
The balance of payments surpluses have reached unprecedented levels. Since 2001, the HKD REER has fallen by 30%. This has fuelled persistent and rising current account surpluses, 13% of GDP on average during 2006-08. In the past these used to be offset by capital account deficits. But the capital account has turned to a surplus due to: strong equity inflows that reflect HK's proxy role for the mainland equity markets; property investments from the mainland; and most importantly due to repatriations by HK-based banks. As a result, HK is going through an unprecedented accumulation of FX reserves. At end-January 10, FX reserves represented USD257 bn or 115% of GDP, up from USD155 bn or 72% of GDP at end-October 08. FX reserves increases have paused since November 09 in line with global and regional trends. There is no clear indication however that the trend of very large balance of payments surpluses has reversed.

Policy outlook: Under the peg, HK's unprecedented external surpluses have translated into an enormous increase in banks' reserves at the central bank. At end-January 10, these represented HKD264 bn, up from HKD5 bn at end-August 08. So far weak credit demand has prevented this liquidity build up from fuelling goods or asset price inflation. However, with the recovery in credit demand, there is a risk that banks' reserves at the central bank could fuel an unprecedented increase in credit. The credit growth in turn could fuel property price inflation and ignite a property price / credit spiral. In such an instance, the first line of defence of the HKMA is likely to be additional regulatory tightening. But the magnitude of the liquidity build up is such that, if balance of payments surpluses continue, HK may have no choice but to eventually allow for currency flexibility in order to break a credit property price spiral.

FX outlook: Starting in late January the forward discount has started to increase again, in line with a widening of the hibor libor spread which reflects libor rather than hibor movements. In addition, USD/HKD forwards have gone down which suggests still ample HKD liquidity and limited capital outflows which is consistent with HK's stable FX reserves. Contrary to expectations increases in mainland banks reserves requirements have not led to a tightening of HKD liquidity, possibly due to ample liquidity in the mainland banking system.

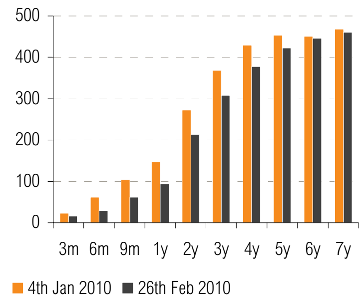
Fixed income analysis

Figure 2: Rate hike expectation (3m fwds, bp)



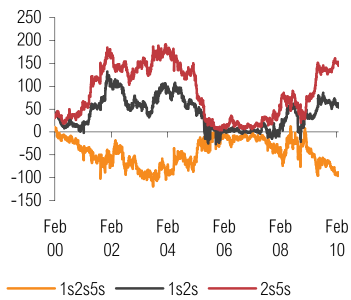
Source: Bloomberg, RBS

Figure 2: Rate hike expectation (3m fwds, bp)



Source: Bloomberg, RBS

Figure 3: 1s2s, 2s5s and 1s2s5s (bp)



Source: Bloomberg, RBS

Supply: The government announced its tentative schedule for the Hong Kong Government Bond Program (GBP) covering Mar-Aug 2010 in late January. Similar to the previous half (Sep 2009- Feb 2010), the tenors offered are 2y (new issue), 5y (reopening of 05GB1411) and 10y (reopening of 10GB2001). While the combined issuance under the GBP is unchanged from the previous half-year at HKD8bn, the distribution is slightly different. The 5y reopening will only be HKD1.5bn, HKD0.5bn less than its initial issue. The shortfall is made up by the 10y reopening in May. For the month of March, gross supply will only be on the short-end to the belly of the curve (2y-5y), amounting to HKD5.7bn.

Demand: Demand at auctions will likely remain solid in the near term due to the excess liquidity and low net supply. The 15y new EFN issue in late February was met with exceptionally good demand with bid cover ratio at 7.06, signalling robust demand for duration.

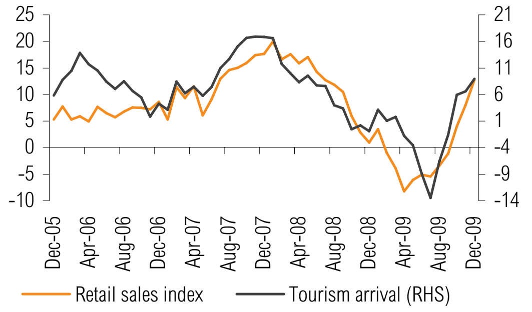
Valuation: EFN asset swap spreads tightened significantly in February as swap yields collapsed on the global risk aversion. The 2y EFN ASW was the most affected (see Figure 1) and in this case, it was aggravated by the sell-off in the short-dated EFN. In turn, the reason for the short-dated EFN sell-off is likely due to the precipitous drop in banks' aggregate balance at the HKMA after the USD's rally lifted the USD/HKD spot from the HKMA's intervention band, which meant that the authority could start to take away some of the excess liquidity at the banks' aggregate balance. On the swap curve, rate hike expectations have been pushed back significantly (Figure 2), causing 2y-3y sector to become extremely rich.

Strategy: Despite the sharp correction in EFN-IRS asset swap spreads, we still would not recommend buying EFNs given their low absolute yields. For swaps, we stay received 2y-3y sector of the curve, which has worked well so far. With the HKD 2s5s spread close to its historical peak, we see scope for the curve to flatten. Hence, we recently initiated a received position in the forward space on the 3y2y to avoid the low Hibor fixing. At the same, we hedge the implicit USD Libor fixing risk by paying the equivalent USD rate. The alternative strategy is to pay front-end butterflies as they are reaching the widest levels in 10 years. Amongst them, the 1s2s5s fly looks the most compelling from a risk/reward perspective. At the current level, we can expect around 30bp of profit in the next 3 months, with negative carry/roll of 11bp for the same holding window.

Hong Kong

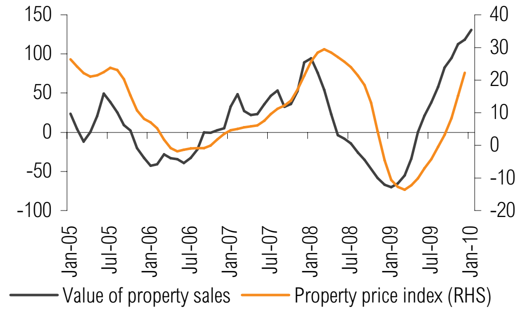
Retail sales are recovering in line with labor market stabilization and rising asset prices.

Figure 1: Retail sales and tourism arrivals (% yoy, 3mrs)



Source: CEIC; RBS

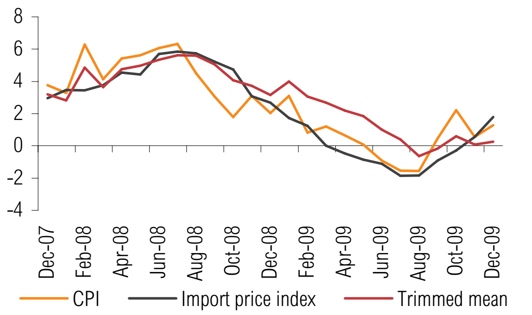
Figure 2: Property price index & value of property sales (% yoy, 3mrs)



Source: CEIC; RBS

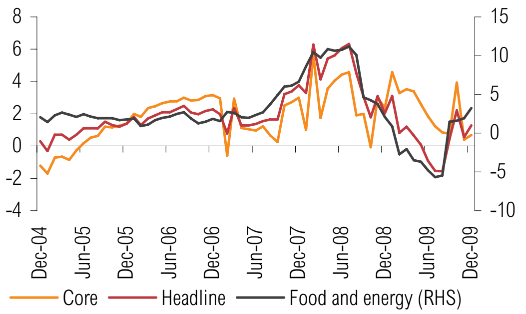
Inflation is also stabilizing.

Figure 3: Consumer and import price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

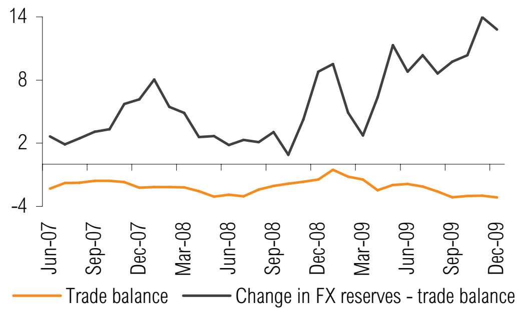
Figure 4: Headline, core and food and energy CPI (% yoy)



Source: CEIC; RBS

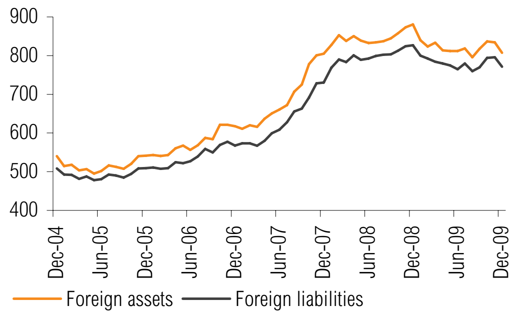
Capital inflows have stabilized at high levels.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: Bank's FX assets and liabilities (USD bn)



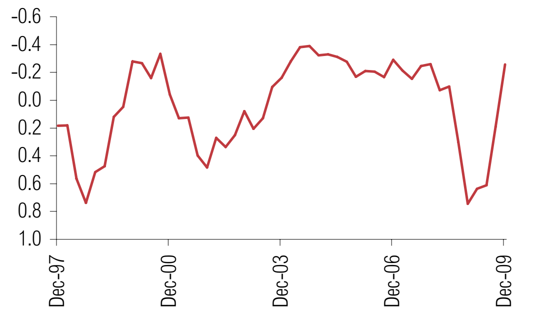
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index

Hong Kong

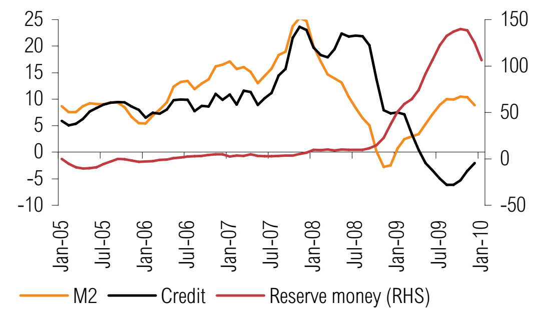
Reserve money growth has dropped as capital inflows stopped rising. Credit is recovering.

Figure 7: Financial conditions index (%yoy, inverted)



Source: CEIC; Bloomberg; RBS

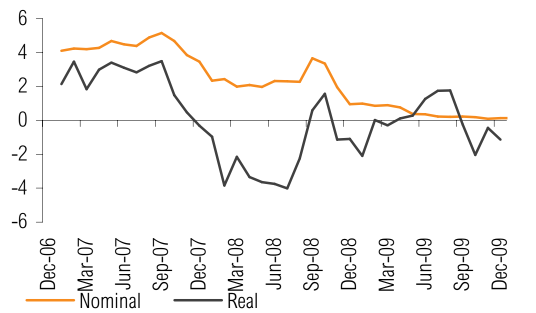
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

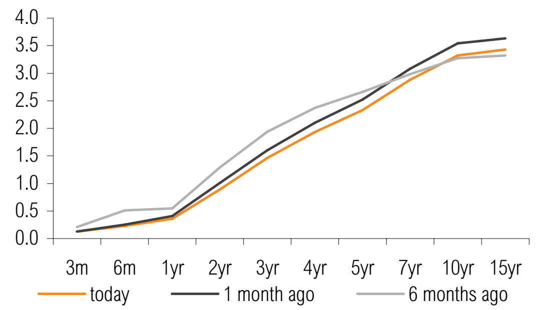
With nominal hibor rates at 0 the stabilization of inflation has lowered real hibor rates when the economy is recovering.

Figure 9: 3m Hibor (%)



Source: CEIC; Bloomberg; RBS

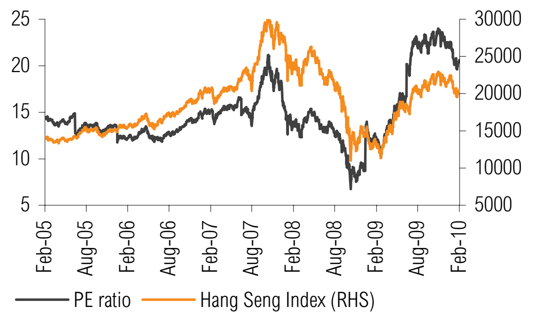
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

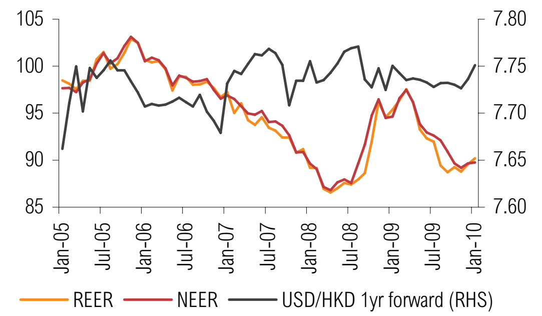
The Hang Seng index has peaked and has yet to reach 2008 highs.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

Hong Kong Key Economic Indicators

	2005	2006	2007	2008	2009	2010F	2011F
Growth (% yoy)							
Real GDP	7.1	7.0	6.4	2.5	-2.7	5.3	4.0
Domestic demand	1.5	5.9	7.8	1.1	0.8	1.3	5.7
- Private consumption	3.0	6.0	7.8	1.8	-0.3	5.0	4.0
- Government spending	-3.2	0.1	2.3	2.0	2.0	2.0	2.0
- Fixed investment	4.1	7.0	4.2	2.5	-2.2	4.0	4.0
Exports	10.6	9.4	8.1	-0.3	-10.2	6.0	6.0
Imports	8.0	9.1	8.8	2.7	-9.1	4.0	7.0
Domestic demand contribution to growth	1.5	5.3	6.9	2.1	0.7	1.1	5.1
Net exports contribution to growth	5.6	1.7	-0.5	0.4	-3.3	4.2	-1.1
Inflation, FX and interest rates							
CPI inflation (%, end of period)	1.4	2.3	3.8	2.0	2.4	8.5	3.2
CPI inflation (%, period average)	0.9	2.0	2.0	4.3	0.8	5.1	7.2
Property price index (%, end of period)	8.2	4.1	25.7	-11.4	10.0	50.0	10.0
USD/HKD, end-period	7.75	7.78	7.80	7.75	7.75	7.75	7.75
USD/HKD, period average	7.78	7.77	7.80	7.78	7.75	7.75	7.75
Base rate, end of year	5.75	6.75	5.75	0.50	0.50	3.50	5.00
3 month Hibor rate (end-year, %)	4.2	4.0	3.5	0.9	0.1	3.0	4.5
5 year government bond yield (end-year, %)	4.1	3.7	3.1	1.7	1.5	4.0	5.0
Fiscal accounts (% of GDP)							
Government fiscal balance	1.3	1.7	8.6	4.1	-2.0	0.0	0.0
- Government revenue	18.2	17.4	22.9	20.2	19.0	17.0	17.0
- Government expenditure	16.9	15.7	14.3	16.1	21.0	17.0	17.0
Primary fiscal balance*	0.3	2.0	5.9	-2.0	-4.0	-2.0	-2.0
Government debt	1.8	1.5	1.3	1.3	1.3	1.3	1.3
- Domestic	0.9	0.6	0.5	0.5	0.5	0.5	0.5
- External	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Fiscal reserves	21.0	25.0	27.3	27.7	25.7	25.7	25.7
Money and credit (% y/y)							
M2	5.1	15.4	20.8	2.7	5.0	14.0	8.0
Private sector credit	7.7	2.3	15.2	11.0	-1.9	25.0	12.0
% of GDP	139.6	133.7	140.7	143.2	143.2	143.2	143.2
Balance of payments (USD bn)							
Merchandise exports	290	318	346	364	328	347	397
% yoy	11	10	9	6	-10	6	14
Merchandise imports	297	332	366	388	352	373	422
% yoy	10	12	10	7	-9	6	13
Trade balance	-8	-14	-20	-24	-24	-27	-26
Services balance	30	36	42	33	42	50	50
Current account balance	20	23	28	47	26	29	26
% of GDP	11	12	14	22	12	12	10
Portfolio balance	-32	-27	-3	-38	-15	20	-35
Other investments balance	0	3	-16	30	60	60	-10
Capital account balance	-23	-27	-32	4	43	79	-46
Overall balance	-3	-4	-4	35	69	108	-20
Foreign Reserves and debts (USD bn)							
FX reserves	124.3	133.2	152.7	182.5	251.4	359.1	339.5
Monetary base	36.4	38.0	41.1	65.1	125.0	221.0	204.0
FX reserves in excess of monetary base	88	95	112	117	126	138	135
Banking sector FX liabilities	506	566	730	818	860	950	950
Nominal GDP							
Nominal GDP, USD bn	178	190	207	216	212	235	262
Nominal GDP, HKD bn	1,384	1,476	1,615	1,679	1,646	1,822	2,030
GDP per capita, USD th	26,007	27,499	29,691	30,678	29,906	32,766	36,152

** Excluding investment income*

Source: CEIC; BIS; RBS

India

Sanjay Mathur, Teck Wee Yeo

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/INR
Q4:09	6.0	10.8	3.25	46.5
Q1:10	6.5	11.2	3.25	45.5
Q2:10	6.0	9.2	3.50	43.8
Q3:10	7.2	2.9	3.75	43.5
Q4:10	7.0	2.3	4.00	43.5
Q1:11	8.0	2.6	4.25	43.5
Q2:11	7.0	2.9	4.50	44.0
Q3:11	7.3	3.2	4.75	44.3
Q4:11	7.3	3.7	5.00	44.3

Source: RBS

Real Economy: Evidence abounds in plenty that the authorities should start to unwind the fiscal stimulus - the economy either is or will soon enough start to fire on all fronts. In December, manufacturing output shot up by 18.5% yoy with the component behaviour validating accelerating consumption and investment. Consumer durables continued with the recent uptrend rising 46%yoy while capital goods (ex-transport equipment) jumped 45% yoy. On a seasonally adjusted mom basis, the data also showed a marked expansion thereby indicating a genuine recovery. Meanwhile exports are also starting to stir up – December goods exports crossed USD14bn for the first time since the financial crisis. Software exports are still weak but the upturn in infocomm spending in the US highlights improved prospects in the coming quarters. Earnings guidance by domestic software companies also validates this view. The improvement in overall prospects are also being captured in corporate confidence – the Dun & Bradstreet business optimism survey shows a sharp improvement in expectations on sales volumes, profits and hiring levels.

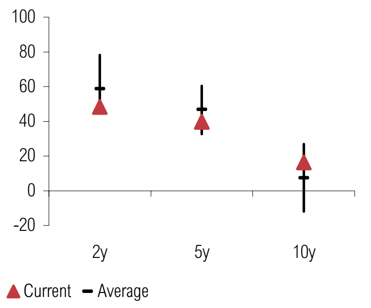
This acceleration in growth should not be construed as inflationary. As has been the case in recent years, stiff competition both domestically and via imports has helped in containing manufacturing inflation. The recent rise in manufacturing inflation (January 2010: 2.6% yoy) is largely base effect related and well within the RBI's comfort zone. Food inflation remains a septic issue but should subside following a favourable winter crop and supply side measures.

Policy outlook: Overall macro data is now shouting for policy normalisation on both the fiscal and monetary fronts. On the monetary front, the RBI has already initiated a formal exit via a 75bps increase in the cash reserve ratio (CRR). Subsequent measures are likely to be in the form of a quarterly 25bps increase in the reverse repo rate – this is also being priced into the curve. Further increases in the CRR will however, depend on the scale of increase in capital flows/monetary aggregates. Both are fairly well behaved for now and are likely to remain within tolerable limits at least, until mid-year. On the fiscal side, the government signalled the end to the issuance of oil bonds, rose excise/services tax rates, reformed fertilizer subsidies and targets the imposition of GST by April 2001. All in all, the fiscal deficit for FY11 (fiscal year starting April 2010) is targeted at 5.5% of GDP. On a medium term basis, the government is likely to re-introduce the fiscal responsibility bill. We expect these measures to result in a lower fiscal risk premium.

FX outlook: We have revised up our Q12010 USD/INR forecast from 44 to 45.50 to reflect changing global risk conditions. This however, does not undermine our structural bullishness on the INR. Other than a reduction in the fiscal risk premium, the overall trends in the balance of payments are encouraging. During July-September 2010, surplus on the capital account shot up to 8.2% of GDP in response to a broadbased improvement in FDI, portfolio flows and borrowings. The current account deficit remained high at 4.4% of GDP but we believe it was mainly due to one-off government purchases. Going forward, these purchases are set to normalise. The current account is also likely to benefit from higher software exports as discussed above.

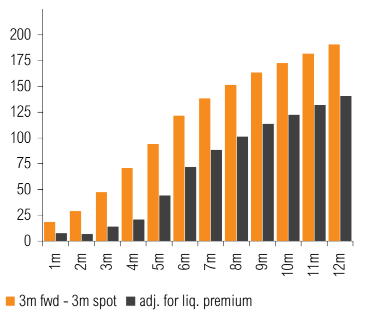
Fixed income analysis

Figure 1: Gsec ASW ranges in the last 3m (bp)



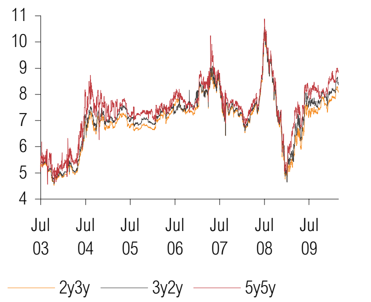
Source: Bloomberg, RBS

Figure 2: Rate hike expectation implied from forward 3m rate



Source: Bloomberg, Reuters, RBS

Figure 3: Forwards show the long end is attractive to receive



Source: Bloomberg, RBS

Supply: The government completed its FY10 borrowing programme on 5 February with a INR80bn auction and is unlikely to tap the bond market for further financing for the rest of the fiscal year ending March 2010. But even if the government stopped its issuance until fiscal year-end, it has already issued about INR4.2trn worth of dated bonds which is almost 60% above the FY09 gross issuance of INR2.6trn. The gross issuance for FY11 has been set at INR4.57bn against INR1.12trn of redemption. In net terms, the upcoming FY11 issuance will be 13% lower than the current FY net issuance.

Demand: While there was no devolvement in the last auction, yields were slightly higher than expected. We think that there is likely to be a pick up in demand for bonds in the near term in response to the budget announcement. The phasing out of oil bonds starting from the new FY would also marginally benefit the government bonds (see Alert | INR rates | Phasing out oil bonds). However, we are still bearish on bonds in the medium term for two reasons. Firstly, banks still hold around 29.4% of government securities against their liabilities, well above the statutory liquidity ratio requirement of 25%. Secondly, the RBI is only at the early stage of normalising monetary policy including interest rate hikes.

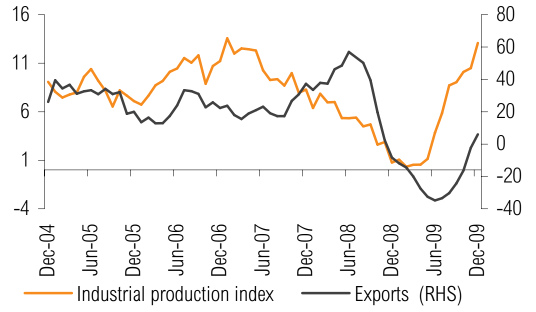
Valuation: Bonds continued to outperform swap at the front-end of the curve as investors' continued to prefer short-dated issues. The outperformance of ASWs on the front end was also due to a vicious bear-steepening of the swap curve which followed the decision to hike cash reserve ratio (CRR) by 75bp by the RBI. Rate hike expectation at the very front-end of the curve was, however, only pushed up marginally. Our economist believes that the RBI is likely to hike repo and reverse repo rates by 25bp each in the next four consecutive policy meetings while ruling out inter-meeting hikes. If this scenario plays out, we think valuation at the front-end of the curve still significantly lacks risk premium, leaving the front-end vulnerable to upside risk.

Strategy: We remain on the sidelines for bonds as we find no compelling reasons to buy given the expensive valuation and the vulnerability to liquidity withdrawal. In swap space, our suggestion in the last Navigator to tactically pay 1y going to the policy meeting turned out to be correct. What caught us by surprise was the vicious bear-steepening of the curve, hurting our 2s5s flattener. Pricing on the forward curve, as Figure 3 shows, has now reached a rather extreme level which can hardly be justified by any fundamental reasons. We firmly believe that the cheapness of the back end of the curve has reached its extreme – hence, we still see scope for the 2s5s flattener to perform in due course. In the interim, we took advantage of the recent run-up in rates earlier to add a received position in 3y2y forward as a more aggressive way of expressing our flattening view on the curve.

India

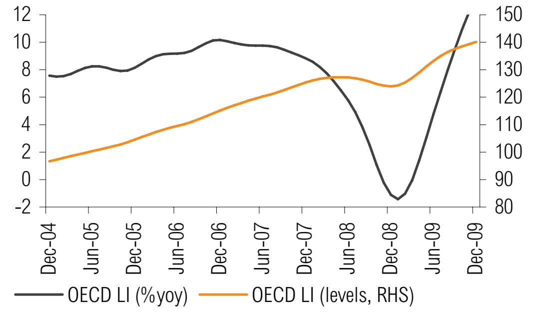
Industrial production has rebounded with a bang

Figure 1: Industrial production and exports (%yoy, 3mrs)



Source: CEIC; RBS

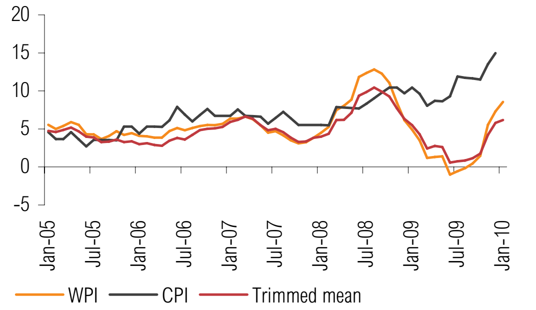
Figure 2: OECD Leading indicator (levels and %yoy growth)



Source: Bloomberg; RBS

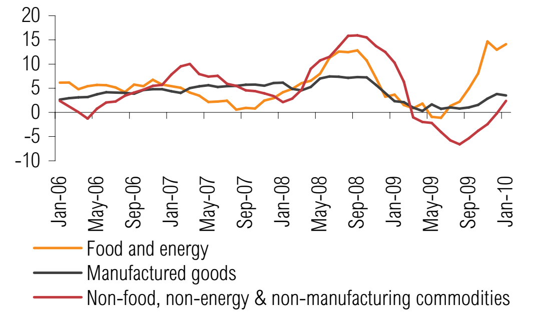
Expect inflation to normalize from April; policy rate hikes will however continue

Figure 3: Consumer and wholesale price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

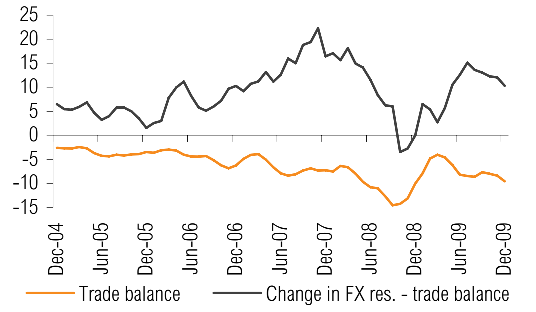
Figure 4: Manufactured goods, non-food non-energy commodities, food & energy WPI (% yoy)



Source: CEIC; RBS

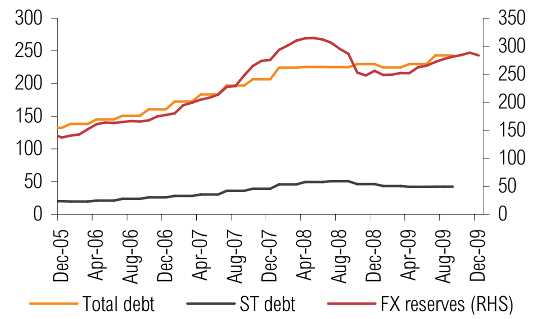
Overall BoP remains in good health

Figure 5: Balance of trade and other flows (3mma, USD bn)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



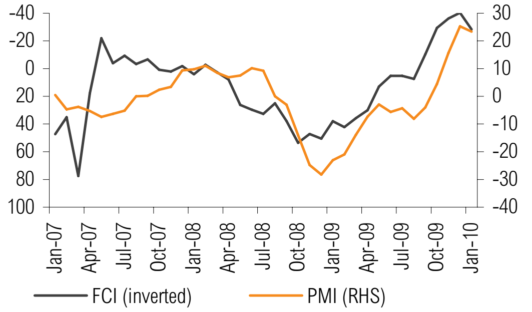
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

India

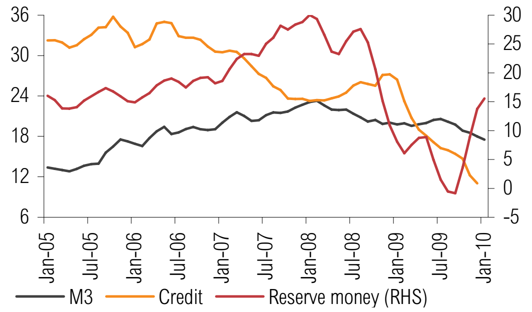
We believe credit growth turned the corner in December.

Figure 7: Purchasing managers index (PMI, % yoy) and FCI (%yoy)



Source: CEIC; Bloomberg; RBS

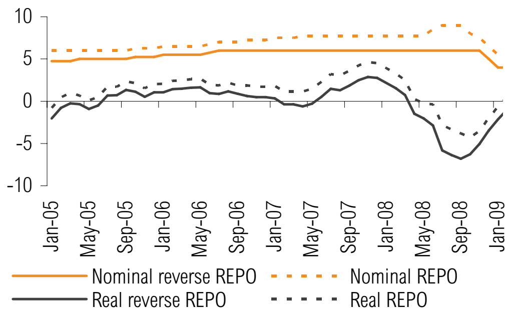
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; Bloomberg; RB

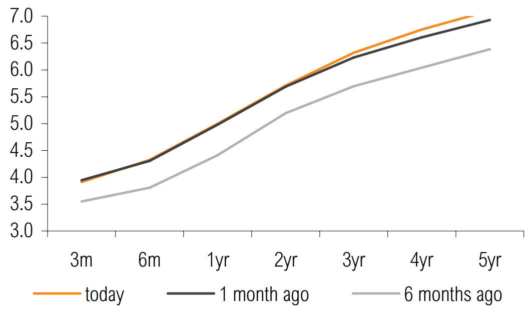
The curve is now adequately pricing in a tighter monetary policy.

Figure 9: Policy rates (%)



Source: Bloomberg; RBS

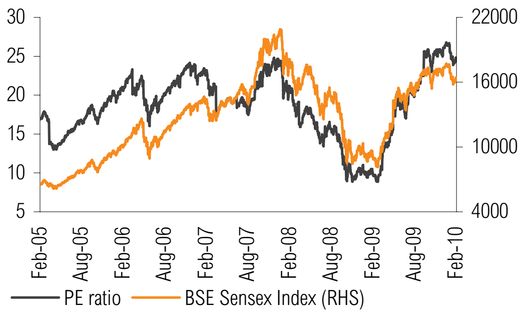
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

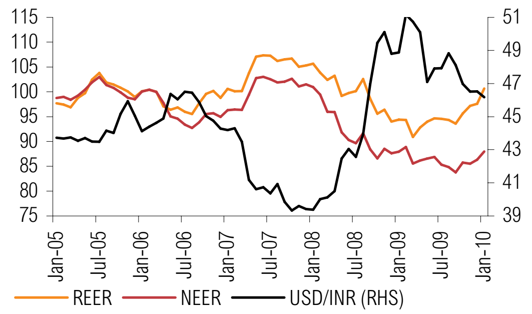
USD/INR should all on the back of higher capital flows/potential reduction in fiscal risk premium

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

India Key Economic Indicators

(fiscal year starting April)	2005/06	2006/07	2007/08	2008/09F	2009/10	2010/11F	2011/12F
Growth (%)							
Real GDP	9.3	9.4	9.6	5.1	7.2	8.0	7.8
Domestic demand	10.9	10.3	11.5	4.8	6.2	8.0	8.9
- Private consumption	9.0	8.2	9.8	6.8	4.3	5.7	5.7
- Government spending	8.3	3.8	9.7	16.7	13.3	5.6	4.0
- Fixed investment	15.3	14.3	15.2	4.0	6.9	13.2	16.6
Fixed investment (% GDP)	30.3	31.7	33.3	32.9	32.9	34.4	37.3
Exports	25.9	21.8	5.2	19.3	-5.3	11.3	10.2
Imports	32.5	22.0	10.0	23.0	-3.1	10.5	13.8
Domestic demad contribution to growth	11.2	10.8	12.1	5.1	6.6	8.5	9.4
Net export contribution to growth	-1.7	-0.8	-1.4	-1.9	-0.3	-0.5	-1.6
Inflation, FX and interest rates							
WPI inflation (% Fiscal year - March over March)	4.1	6.7	6.7	0.8	6.8	4.2	4.5
WPI inflation (% change in average index for the fiscal year)	4.7	4.9	4.8	8.4	3.0	2.7	4.0
Exchange rate (INR per US, end-year)	44.6	43.6	40.0	51.0	45.5	43.5	47.0
Exchange rate (INR per US, average)	44.3	45.0	40.0	47.3	46.9	45.8	44.9
REER (% end of period)	3.7	0.2	2.4				
Reverse repo rate (end-year %)	5.5	6.0	6.0	3.5	3.3	4.8	6.0
10 year bond yield (end-year, %)	7.5	7.9	7.6	7.0	7.4	8.0	6.5
Fiscal accounts (% of GDP)							
Central government fiscal balance	-3.9	-3.6	-2.9	-5.9	-6.5		
- Government expenditure	13.7	13.6	14.3	16.2	16.2		
- Government revenue	9.8	10.0	11.4	10.3	10.3		
Primary fiscal balance	-0.4	-0.1	0.6	-2.4	-2.8		
State government fiscal balance	-2.5	-1.9	-1.5	-2.7	-3.4		
Government debt[1]	80.2	77.2	73.1	73.1	76.8		
- Domestic	77.5	74.7	70.8	70.8	74.4		
- External	2.6	2.5	2.4	2.3	2.4		
Money and credit (% yoy)							
M3 money supply	21.2	21.5	20.9	18.8	19.0	19.8	22.5
Private sector credit	37.0	28.1	22.3	17.5	13.0	15.0	18.0
% of GDP	36.8	42.9	42.9	47.3	47.0	50.2	49.8
Balance of payments (USD bn)							
Merchandise exports	105.2	128.9	166.2	175.2	138.4	152.2	169.0
% yoy	23.4	22.6	28.9	5.4	-21.0	10.0	11.0
Merchandise imports	157.1	190.7	257.8	294.6	241.6	282.6	327.8
% yoy	32.1	21.4	35.2	14.3	-18.0	17.0	16.0
Trade balance	-51.9	-61.8	-91.6	-119.4	-103.2	-130.4	-158.9
Current account balance	-9.9	-9.6	-17.0	-29.8	-24.4	-34.6	-46.5
% of GDP	-1.2	-1.0	-1.4	-2.5	-1.9	-2.2	-2.6
Net portfolio flows	12.5	7.1	29.6	-14.0	10.0	16.0	15.0
Gross FDI	3.0	7.7	15.4	17.5	12.0	14.0	17.0
Capital account balance	25.5	45.2	108.0	9.1	39.8	57.7	66.1
Overall balance	15.6	35.6	91.0	-20.7	15.4	23.1	19.6
FX reserves and debt (USD bn)							
FX reserves	145.1	191.9	299.2	241.7	258.1	282.2	302.8
Import coverage (months)	11.1	12.1	13.9	9.8	12.8	12.0	11.1
FX reserves (x short term debt)	7.4	7.3	6.7	4.3	4.0	4.0	4.3
Foreign debt	149.8	181.6	238.0	257.5	280.4	295.0	305.0
Foreign debt (% GDP)	18.5	19.8	20.1	22.9	22.5	20.4	18.1
ST FX debt	19.7	26.4	44.4	56.2	63.9	70.0	71.0
Nominal GDP and per capita							
Nominal GDP, USD bn	809.7	918.3	1181.8	1124.6	1246.4	1447.6	1689.7
Nominal GDP, INR bn	35867	41292	47234	53218	58420	66363	75826
GDP per capita, USD	728	814	1032	968	1058	1210	1392

Source: BIS; CEIC; RBS

Indonesia

Sanjay Mathur, Teck Wee Yeo

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/IDR
Q4:09	5.4	2.7	6.50	9,404
Q1:10	5.4	4.4	6.50	9,200
Q2:10	5.9	4.8	6.50	8,800
Q3:10	5.9	5.0	7.25	8,850
Q4:10	6.3	5.3	8.00	8,900
Q1:11	6.4	5.6	8.75	8,950
Q2:11	6.2	6.2	9.00	8,975
Q3:11	6.2	6.0	9.00	9,000
Q4:11	6.4	6.3	9.00	9,000

Source: RBS

Real Economy: Q4 09 growth of 5.4% yoy was alleviated mainly by improving investment and net exports. Consumption was softer mainly as the one-off boost from election related spending faded. Government spending nonetheless, remained on a high, rising 17% yoy. We continue to forecast growth to accelerate to 5.9% this year from 4.5% in 2009. The drivers are increasingly more broad-based: from strengthening consumption and investment spending to recovering non-energy exports. Consumer confidence remains solid with 6-12 month expectations of household income and employment improving further. Investment spending is likely to take off with more concrete steps already undertaken to support infrastructure spending and the overall investment climate. The government has established a state company that will guarantee infrastructure projects jointly developed with the private sector and it is also close to establishing a one-stop shop that will significantly reduce transactions costs in setting up onshore businesses. The latest trade data point to increasingly positive net export contributions even as imports bottom out, driven by demand for non-energy commodity exports particularly from China and India.

At the same time, risks to growth are higher now than before. There has been a marked pick-up in the sequential pace of inflation (January 2010: 0.8% mom) and the odds of hitting 6% yoy in Q2 10 have risen. On the external front, the ASEAN-China FTA is challenging the competitiveness of industries such as textiles and basic metals and exports may well suffer.

Policy outlook: For now, we continue to share Bank Indonesia's view that inflation will likely 'normalize' in that environment but not threaten to exceed their inflation target to warrant a change in the policy stance in the near-term. And indeed, BI has maintained its policy rate and dovish tone intact. Nonetheless, the recent inflation print raises the odds of an earlier than expected hike. On fiscal policy, the government has revised its 2010 projection to 2.1% of GDP from 1.6% earlier mainly on account of higher fuel subsidies. This follows an increase in the oil price assumption from USD65/barrel to USD77.80/barrel. We think funding this fiscal slippage will not involve any additional funding – the government has unspent funds of around USD5bn from 2008 and 2009. Nonetheless, further increases in oil prices will warrant additional borrowing. We are disappointed by the administration's inability to carry out fuel pricing reforms.

FX outlook: IDR assets continue to be a hot favourite– foreign ownership in local currency bonds has increased to 19% from a post-crisis low of 14.7% and 5 year CDS has declined to 246 bps. Reflecting renewed interest in IDR assets, there has been a massive surge in external reserves from USD49bn at end-2008 to USD67bn as of end Jan2010. This improvement in the external reserve position should help underpin the IDR. At the same time, the news flow from Indonesia has been negative – inflation, fiscal slippage and controversies surrounding the Bank Century issue. Considering that both IDR and dollar denominated assets are priced at very tight levels, the scope for a short term retreat is high. For now, we are maintaining our end-2010 USD/IDR forecast of 9000 but the downside risks to our forecasts appear to be diminishing.

Fixed income analysis

Supply: There will be two treasury bonds/bills (T-bonds/T-bills) auctions and two non-retail sukuk auctions in March. Year to date, the government has already raised IDR49 or 27.6% of the full year target of IDR175trn from its domestic (IDR30.5trn) and international (IDR18.5trn) market borrowings. Part of this came from the IDR8trn retail sukuk issue in February, which far exceeded the IDR3trn target. This is likely to ease supply in the upcoming auctions as the government looks firmly on track to meet its Q1 domestic issuance target of IDR40.6trn. We therefore expect the target amount of the two T-bonds/T-bills auctions in March to average IDR4trn. While priority is given to domestic issuance, the government is also likely to issue around USD1.1bn in samurai bonds in April.

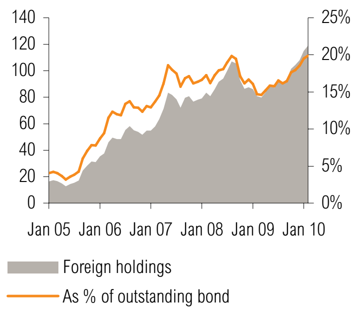
Demand: Demand for the local currency sovereign debt remained strong in February, evident from the high bid cover ratios at the February auctions and strong net foreign inflow. Foreign ownership continued to climb in February by nearly 3.6% to IDR119trn, compared to the end of January. As of 18 February, foreign ownership of the government bonds reached an all-time high of 19.9% of outstanding bonds. Despite the recent bout of global risk aversion, continuing net foreign inflow into IDR bonds can be seen as a vote of confidence in Indonesia's strong economic fundamentals and its fiscal health. With IDR27.9trn worth of redemptions in February and March (including retail bonds), demand is likely to stay strong well into March.

Valuation: Despite Fitch's late January upgrade of the local currency sovereign bonds to BB+ which is just one notch short of investment grade, bonds failed to stage another rally seen in early January due to global risk aversion. The bond curve slightly bear steepened in February as investors trimmed down on duration and switched to the belly. 10y bonds were hit rather badly with yields creeping up by nearly 15bp. Without an active money market, the 5y benchmark being the most liquid shorter dated bond benefitted from this move and yields dipped marginally.

The broad rally in IDR bonds over the last six months can be split into two stages of 3m each. Short dated bonds (2y-3y) and long dated bonds (15y or more) led the rally in the first 3m period with the belly (5y-10y) lagging behind (see Figure 2). The belly of the curve subsequently rallied in the next 3m period, bringing it in line with the rest of the curve. We therefore see limited scope for the belly of the curve to continue its outperformance against the rest of the curve heading into next few months.

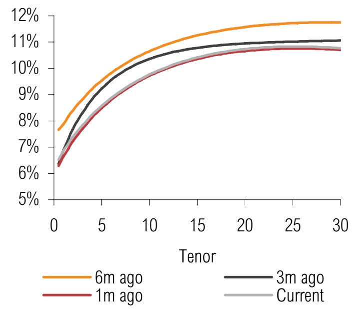
Strategy: We continue to remain positive on IDR bonds for three main reasons. The extremely strong foreign demand amidst worries on peripheral Euro debt shows investors' appetite for 'quality' emerging markets debt remains healthy. The relative high yields of IDR bonds and expectations of a stronger IDR will continue to attract foreign investors to IDR bonds. Secondly, while there has been a pick up in inflation, it is still well within the 5±1% full year inflation target set by BI. The central bank also remains extremely dovish and we are not likely to see any immediate change in policy stance. Lastly, the banking system remains flush with liquidity as seen in the pick up in open market operations since last year. We continue to prefer the 15y segment for two reasons. Firstly, supply on the 15y in March is light with 1 auction compared to two 5y auctions. Secondly, yields on the 15y benchmark remained relatively stable when investors cut duration earlier in February, selling more on both the 10y and 20y benchmarks.

Figure 1: Foreign ownership of government bond (IDR trn)



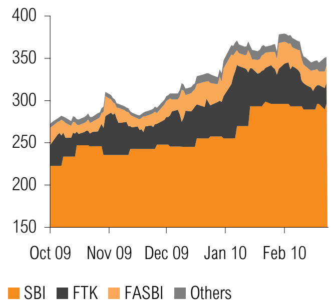
Source: Debt Management Office, RBS

Figure 2: IDR yield curve*



*Yield curve was smoothed out using the exponential spline method. Source: Bloomberg, RBS

Figure 3: Net open market operations (IDR trn)*

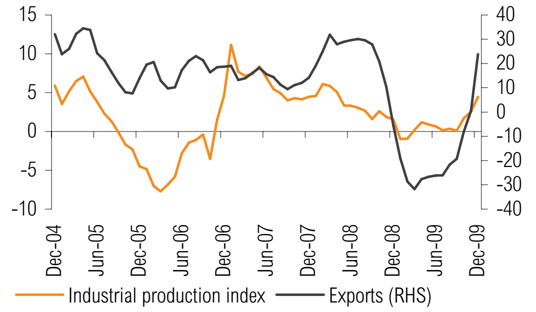


*FTK = Fine tune contraction, others include reverse repo and Islamic instruments. Source: Bloomberg, RBS

Indonesia

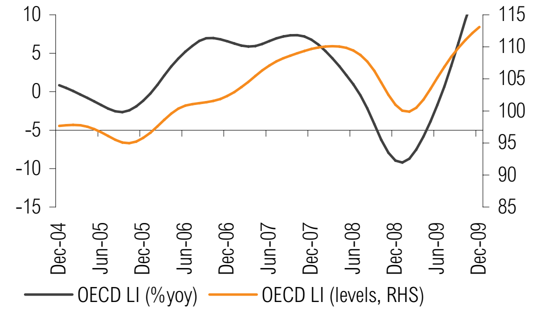
Industrial output is starting to show the improvement in exports.

Figure 1: Industrial production index and exports (% yoy, 3mrs)



Source: CEIC; RBS

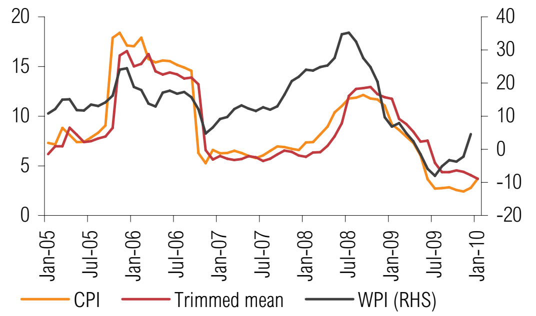
Figure 2: OECD Leading indicator (OECD LI, levels and %yoy growth)



Source: Bloomberg; RBS

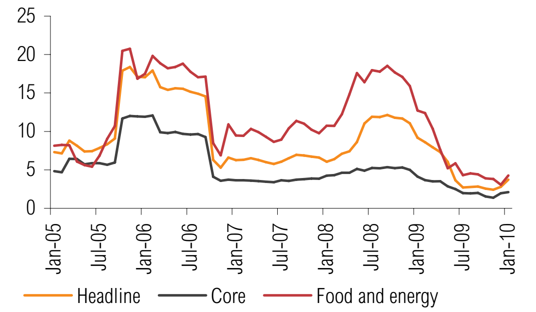
Inflation risks are rising

Figure 3: Consumer and wholesale price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

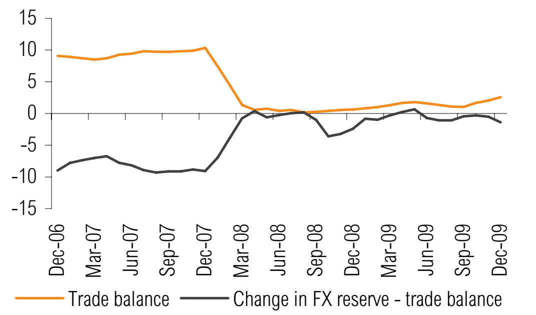
Figure 4: Headline, core and food and energy CPI (% yoy)



Source: CEIC; RBS

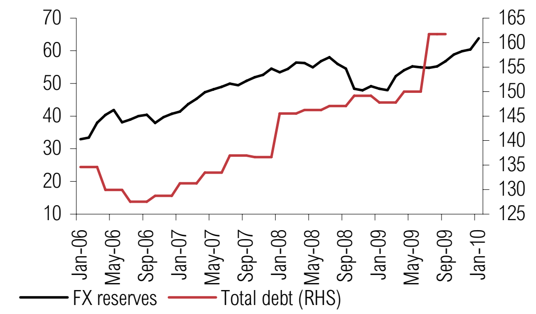
External liquidity continued to improve driven by portfolio capital inflows.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



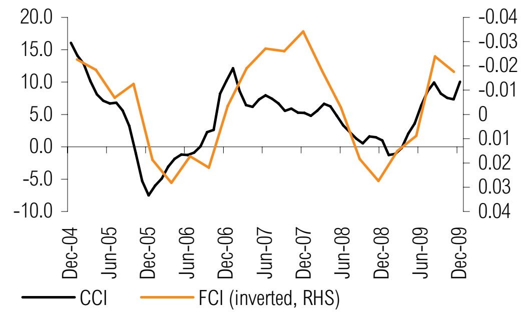
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Indonesia

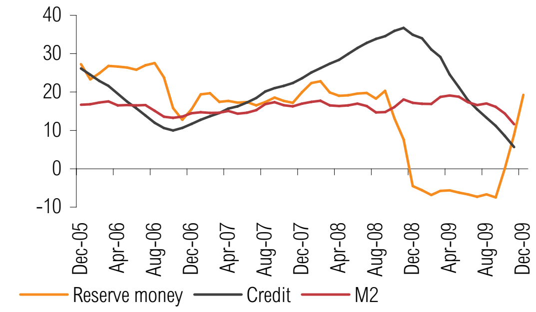
The central bank assessed that credit growth remain subdued and are lining up administrative policies to encourage lending activity.

Figure 7: Composite coincident index (CCI, % yoy, 3mma) and FCI (%yoy)



Source: CEIC; Bloomberg; RBS

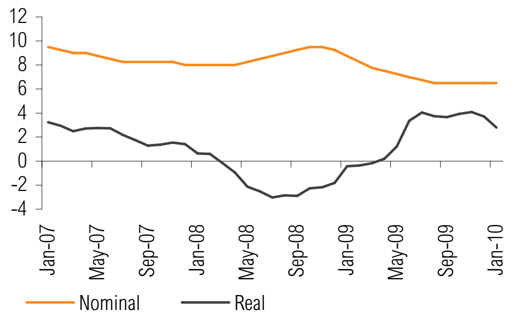
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

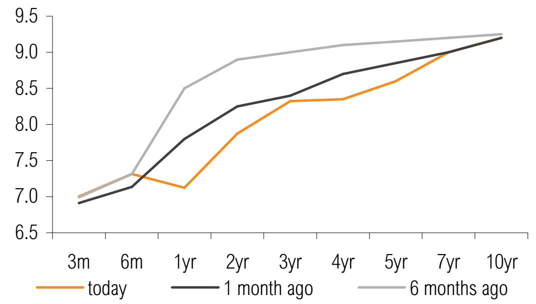
Short end of the curve has hardened following the latest inflation numbers

Figure 9: Policy rate (%)



Source: CEIC; RBS

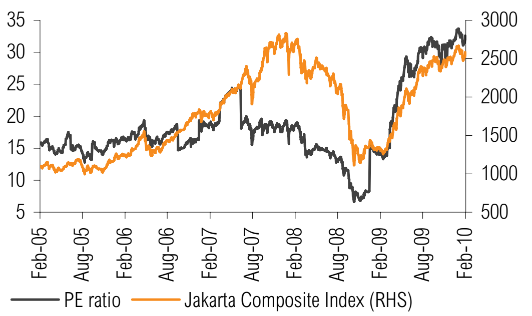
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

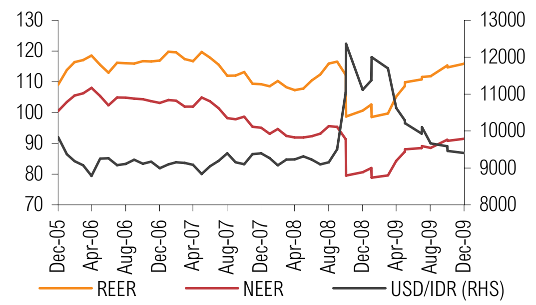
IDR appreciation has persisted, thanks to risk appetite and attractive local bond yields.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; CEIC; RBS

Indonesia Key Economic Indicators

	2005	2006	2007	2008	2009	2010 F	2011 F
Growth (% yoy)							
Real GDP	5.7	5.5	6.3	6.1	4.5	5.9	6.3
Domestic demand	5.8	3.5	6.0	5.9	3.7	6.5	7.0
Private consumption	4.0	3.2	5.0	5.3	4.9	5.5	6.0
Government spending	6.6	9.6	3.9	10.4	15.7	8.0	5.0
Fixed investment	10.9	2.5	9.2	11.7	3.3	8.0	12.0
Fixed investment (% GDP)	22.5	21.8	22.4	23.7	23.4	24.1	25.4
Exports	16.6	9.4	8.0	9.5	-9.7	6.5	9.5
Imports	17.8	8.6	8.9	10.0	-15.0	8.5	12.5
Domestic demand contribution to growth	4.7	4.4	5.9	5.4	3.4	5.9	6.4
Net exports contribution to growth	1.0	1.1	0.4	0.7	1.2	0.0	-0.1
Inflation, FX, and interest rates							
CPI inflation (% yoy, end of period)	17.1	6.6	6.6	11.1	3.1	5.5	6.3
CPI inflation (% yoy, period average)	10.5	13.1	6.4	9.8	4.8	4.9	6.0
USD/IDR, end-year	9,825	8,989	9,390	12,200	9,404	8,900	9,000
USD/IDR, average	9,830	9,132	9,170	9,892	10,244	8,938	8,981
REER (% end of period)	12.9	7.6	-6.3	-7.9	15.2	-0.8	0.0
Policy rate (end-year, %)	12.8	9.8	8.0	9.25	6.50	8.00	9.00
3-month interbank rate (end-year, %)	14.6	9.8	8.0	12.1	6.9	8.8	9.5
10 year bond yield (end-year, %)	13.6	10.2	10.0	11.9	10.0	9.5	10.0
Fiscal accounts (% GDP)							
Central government fiscal balance	-0.5	-0.9	-1.1	-0.1	-2.4	-1.7	-1.5
Government expenditure	18.4	20.0	20.0	20.6	18.8	18.2	18.0
Government revenue	17.9	19.1	18.9	20.6	16.4	16.5	16.5
Primary fiscal balance	1.8	1.5	1.0	1.8	-0.4	0.2	0.2
Central government debt[4]	43.4	37.2	33.4	30.9	31.9	27.7	26.3
Domestic	19.8	18.8	17.3	14.8	15.0	13.5	12.9
External	23.6	18.5	16.0	16.1	16.8	14.2	13.3
Money and credit (% yoy)							
M2	16.4	14.9	18.9	13.0	6.0	10.0	16.0
Private sector credit	24.6	14.1	26.4	29.3	11.7	14.7	20.0
Private sector credit (% GDP)	24.9	23.6	25.1	26.9	27.5	28.5	30.5
Balance of payments (USDbn)							
Exports of goods and non-factor services	96.4	113.7	125.4	152.8	113.5	126.5	144.9
Export growth (% yoy)	23.2	17.9	10.2	21.8	-25.7	11.5	14.5
Imports of goods and non-factor services	88.0	94.0	104.5	142.6	84.6	96.0	114.2
Import growth (% yoy)	31.5	6.7	11.2	36.4	-40.7	13.5	19.0
Trade balance	8.4	19.8	20.9	10.2	28.9	30.5	30.6
Non-oil & gas trade balance	26.2	37.5	39.5	35.3	-	-	-
Current account balance	0.3	10.8	10.4	0.3	8.6	9.4	6.6
% GDP	0.1	3.0	2.4	0.1	1.7	1.5	0.9
Capital account balance	0.3	2.9	3.3	-2.9	4.2	1.3	5.0
Overall balance	0.4	14.5	12.7	-6.4	14.3	8.2	8.6
Foreign Reserves and debts (USD bn)							
FX reserves	34.7	42.6	56.9	51.0	65.3	73.5	82.1
Import coverage (months)	4.7	5.4	6.5	4.3	9.3	9.2	8.6
FX reserves, % ST debt	315.0	348.8	305.1	255.0	284.1	306.3	328.5
Foreign debt	130.7	128.7	136.6	150.0	153.0	160.0	170.0
Foreign debt (% GDP)	46.3	35.2	31.7	31.0	30.1	25.1	22.5
ST FX debt	11.0	12.2	18.7	20.0	23.0	24.0	25.0
Nominal GDP							
Nominal GDP, USD bn	282	366	432	483	510	647	723
Nominal GDP, IDR tn	9,830	9,132	9,170	9,892	10,244	8,938	8,981
GDP per capita, USD	1,287	1,648	1,921	2,128	2,210	2,760	3,023

Source: Bank Indonesia; Ministry of Finance; Statistics Bureau; CEIC; RBS

Japan

Junko Nishioka, RuiXue Xu, Akane Vallery Uchida

Macroeconomic forecast

	GDP % qoq annualised	Core CPI % yoy	Policy rate (o/n)	USD/JPY
Q4:09	4.6	-1.7	0.10	93.02
Q1:10	0.8	-1.4	0.10	91.00
Q2:10	0.7	-1.1	0.10	93.00
Q3:10	1.7	-0.7	0.10	97.00
Q4:10	1.8	-0.7	0.10	100.00
Q1:11	1.7	-0.7	0.10	102.00
Q2:11	1.8	-0.7	0.10	104.00
Q3 11	1.8	-0.6	0.10	106.00
Q4 11	1.8	-0.6	0.10	110

Source: RBS

Key economic fundamentals: Japan's 4Q GDP grew at an annualised 4.6% qoq, underscoring the effectiveness of fiscal stimulus, especially in household consumption, and the strong tailwind from the steady recovery in overseas demand. The most remarkable development in the Q4 GDP was the increase in capex after six quarters of consecutive declines. As the government has not shown any clear change in its expansionary fiscal policy ahead of the Upper House election, and given positive signs that the recovery in overseas demand will continue, we think the economy will see a steady recovery.

The timing of the BoJ's interest rate normalisation continues to depend on the timing of when core CPI returns to positive growth. Even if the economy grows steadily over the forecasting period, we believe the output gap can only return to positive territory after 2013. Based on this output gap scenario, we forecast core CPI will remain in negative growth territory until 2012. As long as core CPI remains negative growth, we think the BoJ will not resume interest rate normalisation. Thus, we assume the BoJ's next rate hike will not happen until 2Q13, a long way off.

Policy outlook: Japan is in the line of fire for its fiscal discipline. Outstanding public sector debt climbed to 188% of GDP in FY09 and could increase further in FY10. If the government implements additional stimulus measures and issues more JGBs, the ratio is likely to exceed 200% in the near future and would again heighten market concerns about the fiscal-risk premium. Assuming the Upper House election is in July this year, additional fiscal stimulus could be announced as early as 2Q this year. The government may be obliged to rely on new issuance of JGBs as its source of funding.

We continue to expect the government to press the BoJ to buy more JGBs to support further issuance. However, we expect the BOJ to continue to sit on the fence and ward off such pressure. If the yen strengthens to below 85 against the USD, we expect the BOJ to implement easing measures by extending a fixed-rate funds-supply operation against pooled collateral as its first step.

View on JGBs: 10-year JGB yields dropped again to below 1.30% after hitting a high of 1.38% in early February. Similar to January, the signals were mixed for JGB in February. Market participants featured limited reaction, despite the Fed's discount rate rise and China's additional 50bp hike of required reserve ratio. The market sentiment will likely remain relatively bullish and the JGB market is holding its ground even as investors' buying and selling activities slow ahead of the fiscal year-end. We think the recent relatively stronger buying interest bodes well for the market in the near term.

At this time of the year, JGB market investors usually close their books for the current fiscal year and enter the final stages of investment planning for the next fiscal year. Domestic investors' willingness to buy the JGB is expected to remain intact, given the strengthening deflationary pressure, easy BoJ monetary policy and huge excess liquidity. The price action over the past several weeks reaffirmed that 10-year yields at above 1.35% are attractive to dip buyers. On the other hand, the pressure of profit-taking for book closing will likely prevent 10-year yields from falling close to 1.20%. In a nutshell, the JGB market will continue range-bound trading into the FY-end.

FX outlook: Bouts of risk aversion have caused the USD/JPY to weaken. However it remains significantly higher compared to its lows in late November. Investor concerns surrounding sovereign risks in the Eurozone, tighter bank regulation and reduced fiscal stimulus will continue to hold USD/JPY back into the Japanese financial year end. But in the medium-term, the market will not be able to ignore the fiscal and monetary policy mix in Japan which is still clearly JPY negative.

S&P lowered the outlook on Japan's sovereign rating to negative from stable last month, putting the country's AA rating at risk. The immediate impact from this on USD/JPY was limited, as the foreign ownership of Japanese government bonds is low. However, the outlook downgrade is a warning of the difficult conditions Japan is faces. S&P said "the policies of the new Democratic Party of Japan government point to a slower pace of fiscal consolidation than we had previously expected" and should economic data remain weak and measures to boost medium term growth fail, Japan would slip a notch in its grading.

We forecast Japan's 4Q GDP to mark an above-potential growth of 3.5% qoq annualised on the back of positive exports and corporate investments. Yet, as policy stimulus fades and household consumption slows as wages stagnate, growth is forecasted to fall to near zero again in 1H this year.

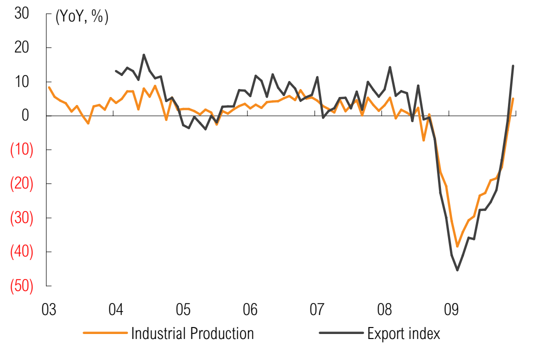
Japan's core consumer prices slipped 1.3% yoy in December, while the core CPI for the Tokyo area, a leading indicator for the nation, fell 2% yoy in January. With the Bank of Japan forecasting the deflationary trend to continue until the end of March 2012, the government is likely to work against a JPY strengthening policy to overcome deflation. Finance Minister Naoto Kan will keep up pressure on the BoJ to adhere to monetary easing and possibly further government bond purchases to support the economy. The vocal finance minister is also likely to express his dismay in any significant weakening of USD/JPY, as levels close to last year's November low of around 85 would mean a major blow to the economy, which still relies heavily on exports.

USD/JPY may on occasion slip lower, but given weak Japanese economic fundamentals and the government's disapproval of a stronger domestic currency, gains in the JPY will be contained. Given the high correlation between US treasuries and USD/JPY, the JPY is likely to become the most eligible candidate for funding currency when the Fed moves further toward monetary policy tightening near the end of the year, leading USD/JPY higher again.

Japan

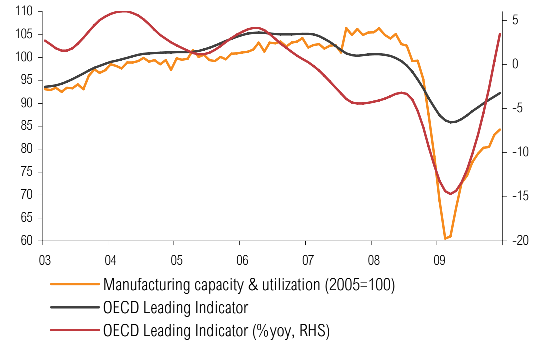
Industrial production and capacity are steadily recovering, accompanied by a v-shaped recovery in exports.

Figure 1: Industrial production and exports



Source: METI, MoF, RBS Global Banking & Markets

Figure 2: Manufacturing capacity utilisation index

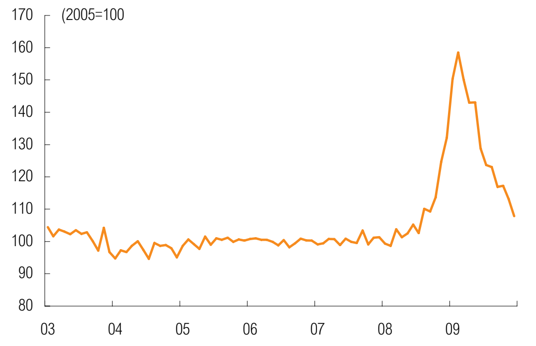


Source: METI; RBS Global Banking & Markets

Inventory liquidation progressed rapidly, gradually getting close to its average level.

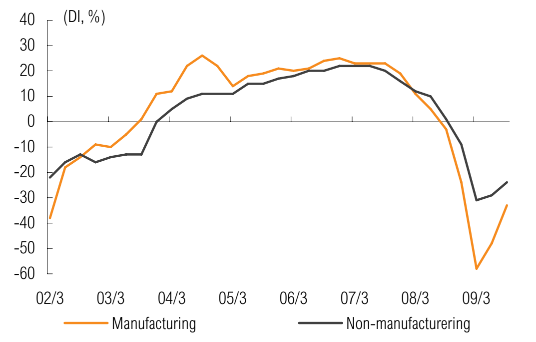
Business confidence improved only marginally.

Figure 3: Inventory / shipment ratio



Source: METI; RBS Global Banking & Markets

Figure 4: Business confidence (BoJ Tankan)

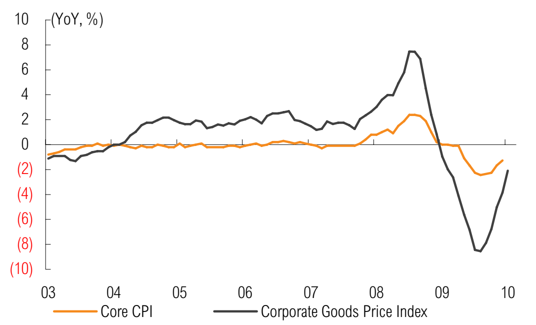


Source: METI; RBS Global Banking & Markets

Core CPI is expected to fall further through this year.

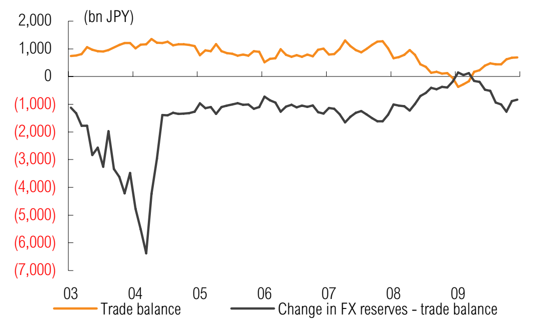
Current account improved after posting a deficit once in early 09, but there still remains a risk of IS balance break.

Figure 5: Core CPI and CGPI



Source: MoF; RBS Global Banking & Markets

Figure 6: Balance of trade and other flows (JPY bn, 3mma)

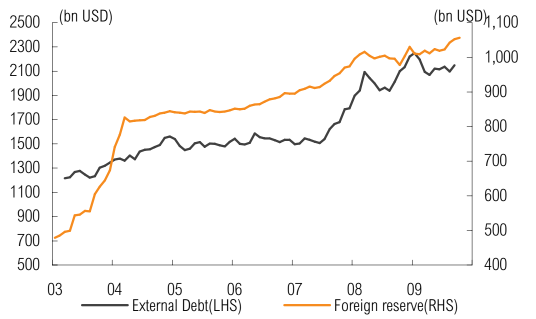


Source: MoF; RBS Global Banking & Markets

Japan

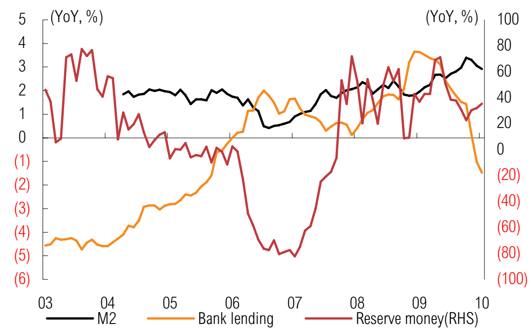
Bank lending registered yoy negative growth after the CP market returned to stability and slow down of credit requirement.

Figure 7: External debt and foreign reserve



Source: Mhlw; RBS Global Banking & Markets

Figure 8: Money and credit growth

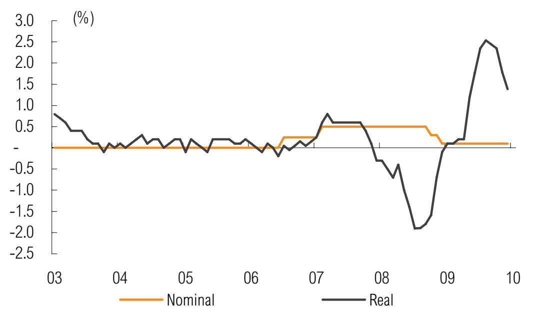


Source: Statistic Bureau; RBS Global Banking & Markets

Increase in the real interest rate is expected to weigh on business activity.

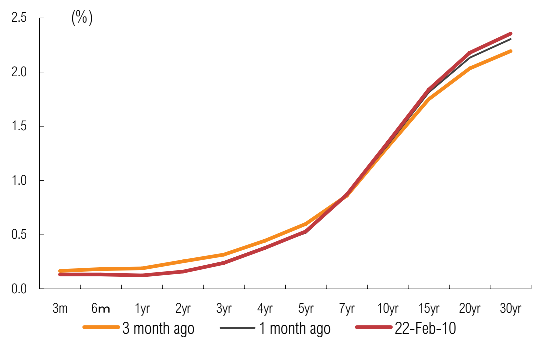
JGB yield curve in the short- to mid-term flattened on expectations of a prolonged accommodative

Figure 9: Policy rate



Source: BoJ, Statistic Bureau; RBS Global Banking & Markets

Figure 10: Yield curve (%)



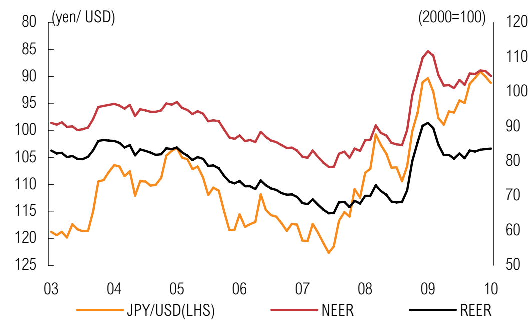
Source: Bloomberg; RBS Global Banking & Markets

Near-term risk encouraged some yen sales as governments globally step up crisis prevention measures, but any yen sell-off is unlikely to last long.

Figure 11: Stock change index and PE ratio

Source: Bloomberg; RBS Global Banking & Markets

Figure 12: Exchange rates



Source: Bloomberg; RBS Global Banking & Markets

Japan selected economic indicators

	2006	2007	2008	2009F	2010F	2011F
Growth (% yoy)						
Real GDP	1.3	2.3	-1.2	-5.1	1.9	1.7
Domestic demand	1.2	1.2	-1.4	-3.8	0.9	1.3
Private Demand	1.9	1.5	-1.4	-5.6	1.2	1.7
- Private consumption	1.5	0.7	-0.6	-1.1	1.4	0.8
- Residential investment	0.6	-9.4	-8.5	-13.9	-11.2	1.1
- Fixed investment	2.4	5.3	-0.1	-19.2	2.2	5.9
- Contribution of private inventory	0.2	0.3	-0.4	-0.1	-0.1	0.0
Public demand	-0.9	0.1	-1.3	2.4	0.2	0.0
- Government consumption	0.4	1.9	0.2	1.7	1.3	0.8
- Public investment	-5.9	-7.3	-8.6	6.4	-6.0	-4.3
External demand (contribution rate)	0.9	1.1	0.2	-2.0	1.5	0.4
- Exports	9.7	8.4	1.7	-24.2	16.6	5.6
- Imports	4.2	1.5	0.9	-17.1	6.0	3.7
Total Fixed investment	0.5	0.7	-2.8	-14.2	-1.1	3.5
Nominal GDP	1.1	1.6	-2.0	-6.0	0.2	1.2
GDP deflator	-0.9	-0.7	-0.8	-1.0	-1.6	-0.5
Inflation, FX and interest rates						
CPI inflation (% yoy, period average))	0.2	0.1	1.4	-1.3	-1.0	-0.6
Core CPI inflation (% yoy, period average)	0.1	0.0	1.5	-1.3	-1.0	-0.6
Core of core CPI (% yoy, period average)	-0.4	-0.3	0.0	-0.7	-0.9	-0.6
Policy rate (end-year, %)	0.25	0.50	0.10	0.10	0.10	0.10
2 year JGB yield (end-year, %)	0.80	0.71	0.38	0.15	0.15	0.25
5 year JGB yield (end-year, %)	1.25	1.01	0.69	0.47	0.50	0.60
10 year JGB yield (end-year, %)	1.69	1.51	1.17	1.30	1.40	1.50
20year JGB yield (end-year, %)	2.07	2.10	1.70	2.10	2.20	2.20
30year JGB yield (end –year, %)	2.26	2.34	1.74	2.28	2.30	2.30
JPY/USD, end-period	119.05	112.28	90.64	93.02	100.00	106.00
Finance						
Current account (% Nominal GDP)	3.9	4.9	3.2	2.8	3.5	3.7
Trade balance (trn JPY)	9.4	12.6	4.0	3.9	7.7	9.4
Budget balance (trn JPY)	-5.4	-4.9	-6.7	-9.3	-9.3	-9.1
General government debt (trn JPY)	164	165	168	182	191	192
Other key indicators						
Industrial Production (yoy, %)	4.2	2.9	-3.4	-21.6	14.4	3.5
Corporate goods price (yoy, %)	2.2	1.8	4.6	-5.2	-0.7	1.2
Employment (yoy, %)	1.5	0.9	0.0	-1.1	-0.3	0.5
Unemployment rate (%)	4.1	3.9	4.0	5.1	5.1	4.6
Corporate profits (yoy, %)	9.3	3.3	-26.2	-50.9	10.8	17.7

Source: RBS

Korea

Dominique Dwor-Frecaut, Woon Khien Chia

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/KRW
Q4:09	6.0	2.4	2.00	1,164
Q1:10	9.0	1.8	2.00	1,130
Q2:10	7.0	1.2	2.25	1,110
Q3:10	6.0	1.1	2.25	1,100
Q4:10	5.0	1.7	2.50	1,080
Q1:11	4.0	2.0	2.50	1,075
Q2:11	4.0	2.3	2.75	1,080
Q3:11	4.0	2.6	3.00	1,090
Q4:11	4.0	2.9	3.25	1,100

Source: RBS

Real economy: The GDP recovery is continuing albeit at a slower pace: Q4 GDP grew by 0.8% qoq saar following 11.7% growth in Q3. Slower growth reflects largely the tapering off of the government stimulus program. Private final domestic demand has yet to show convincing signs of sustainable recovery. Following the end of public employment schemes, employment has started to contract again in Q4 which will weigh negatively on consumption and eventually investment. Core inflation is slowing, in line with a positive output gap and rising unemployment. High and rising unemployment, together with slower aggregate demand growth going forward suggest muted medium term inflation, despite a recent increase in energy and commodities price. Even if these remain high, they are more likely to affect headline than core inflation.

After a pause in December 09, the increase in FX reserves resumed in January 10. The current account surplus fell sharply in December largely due to a fall in the trade surplus. This reflected mainly faster import growth on the back of higher import prices for food and energy. Export growth remains solid for now though this may not last once advanced economies' rebuilding of inventory is over, around mid-year.

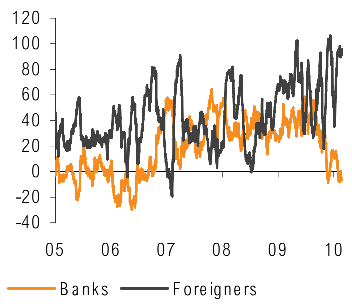
Policy outlook: The BoK governor has indicated at the January 2010 MPC meeting that a normalization of the policy rate to reflect economic and financial stabilization would be appropriate. However the BoK has stayed on hold since then and a rate a hike appears unlikely before the governor mandate expires in March. The incoming governor appears likely to continue with supportive monetary policy. In any event, the uncertainty surrounding domestic and external demand, the difficulty of sterilizing the strong external surpluses and a debt overhang in the SME and household sectors suggest gradual rate hikes. My base case scenario is for two 25 bp increases in the policy rate during 2010.

FX outlook: Korea is finding it increasingly difficult to keep a lid on KRW appreciation, rebuild its FX reserves and tighten onshore liquidity against a backdrop of large balance of payments surpluses. With tighter liquidity in the banking system, MSB issuance is putting upward pressure on onshore rates. The fastest ever pace of FX reserves accumulation suggests sterilized intervention may have become self-defeating, though slower credit growth in late 09 may have created limited room for sterilized intervention. Should capital inflows recover strongly, I believe concerns over excessive household debts will eventually lead the BoK to choose the tightening of onshore liquidity over external competitiveness. Based on the continuation of the global risk rally, USD/KRW could revisit the lows of 2007 or 900 in H1 10. On the other hand, the global risk rally appears to reflect policy easing and an inventory rebuilding rather than a sustainable recovery in private final demand. I believe that by the second half of 2010, the risk rally could have given way to a global risk sell off. In such an instance the KRW would underperform due to the likely scale of capital outflows from Korea, a continued BoK focus on competitiveness and the need to use FX reserves sparingly. In such an instance however USD/KRW would be unlikely to revisit the highs of Q4 08 - Q1 09 as these reflected the shutting down of the global interbank market, which appears unlikely to happen again.

Fixed income analysis

Supply: Taking advantage of the global risk aversion, the finance ministry continued to upsize its issuance in February, this time loading up the two tails – 2y and 20y. Given that it had been able to exceed its issuance target by 21% in the first two months of the year, the ministry has cut down its March issuance target by 5.3%. It also confirmed that it will start its buyback programme in March with KRW2trn. Another KRW0.5trn will be used to exchange new bonds for illiquid bonds. The latter two moves were signalled well in advance, which probably helped to bolster the market. In an about-turn, policymakers have subtly reversed the call on quasi-sovereign issuers to hold back from overseas fund-raising to avoid adding pressure on the KRW. This was out of concern that the unfolding Greek crisis could undermine the Korean issuers at a later stage. They are now encouraged to expedite fund-raising overseas before the crisis worsens. Again, this might have marginal impact on bolstering sentiment since the market no longer needs to worry about additional supply from the quasi issuers compelled to fund onshore.

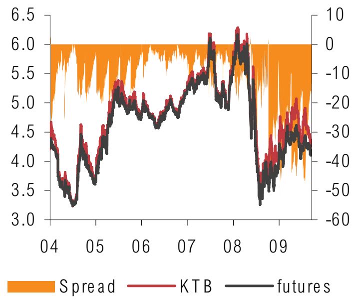
Figure 1: Outstanding long positions in futures ('000)



Source: Bloomberg, RBS

Demand: Investors' appetite continues to improve, with foreign investors taking a clear lead over domestic investors. Foreigners' outstanding futures contracts have again reached close to the historical peak. In contrast, banks' futures positions have collapsed and even turned marginally short (Figure 1). The gap between the two sides is now at its widest. This distortion is largely a result of the unusual situation in the past year when banks went long into futures rather than buying cash bonds, so much that the implied futures yield spread over the KTB benchmark yield dipped to a historical low of -40bp (Figure 2). We thus believe that banks' reduction in futures exposures probably came with a shift back into cash bonds. It is no wonder that the 20y auction result in February came in better than the auction in January, with a bid-cover ratio of 3.65 versus 3.34 in the previous month.

Figure 2: 3y futures yield spread over 3y KTB benchmark (bp)



Source: RBS

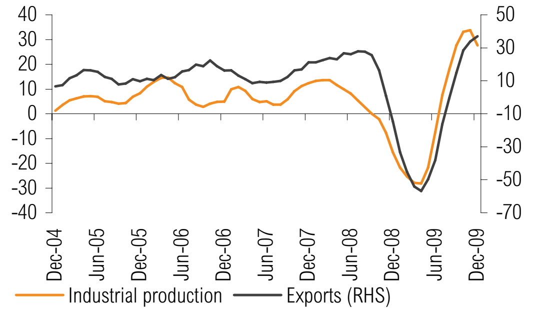
Valuation: The outperformance of 2y KTB over 10y KTB both outright and in asset swap spread terms is making the short-dated KTB look expensive. In the near term, this is unlikely to change as supply still favours the short end, given especially that the MOSF usually did its buyback on the short end. The two things which could overturn the trend are: first, the inclusion of KTB into the Citigroup World Government Bond Index (WGBI) as index investors usually favour the long end; and second, that the Bank of Korea hikes rates and turns neutral. Both events seem only likely in mid-year. The January MPC minutes showed a unanimous decision to keep rates on hold while the MOSF does not want to expedite the WGBI inclusion, worried that an influx of funds would drive the KRW too strong. On the swap curve, our principal component analysis (PCA) showed further scope for rates to rise and the curve to flatten but the curvature seems to have dropped too low, suggesting the curve steepness is now largely in the back end.

Strategy: We maintain the same trade ideas of long 10y KTB-IRS ASW and 1s2s swap flattener – the latter hinged on an early rate hike. In the event, a 25bp hike is unlikely to impact the 3m CD fixing much. We like to receive a long forward-starting rate around the belly to express our flattening view while avoiding the carry cost.

Korea

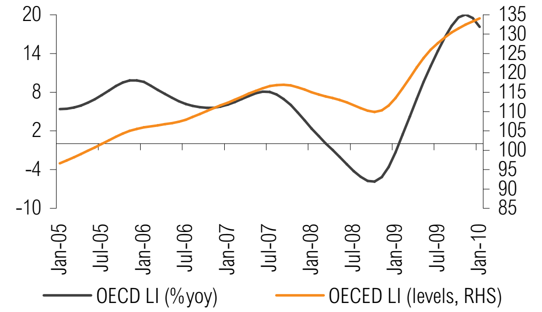
The recovery in industrial production and exports is starting to slow.

Figure 1: Industrial production and exports (6m/6m saar)



Source: CEIC; RBS

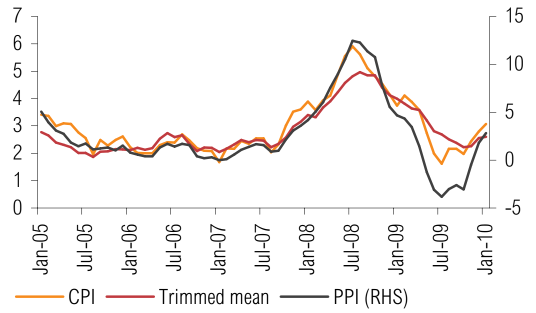
Figure 2: OECD Leading indicator (levels and %yoy growth)



Source: Bloomberg; RBS

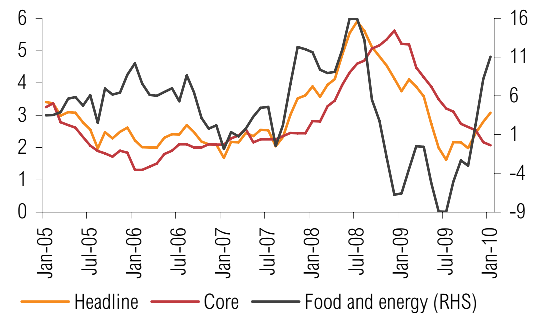
Core inflation is slowing, in line with a positive output gap and rising unemployment.

Figure 3: Consumer and producer price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

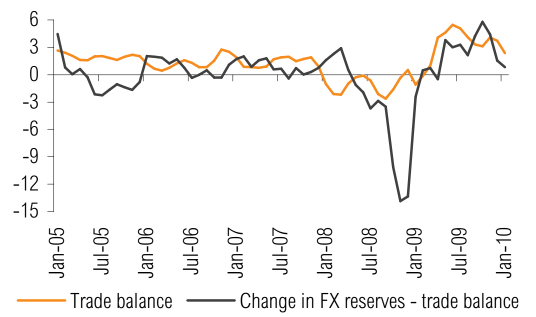
Figure 4: Core and food and energy CPI (% yoy)



Source: CEIC; RBS

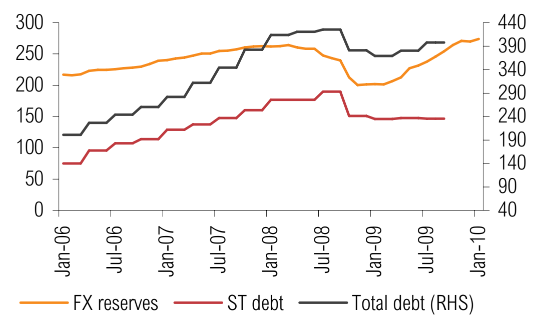
Balance of payments surpluses remain substantial.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



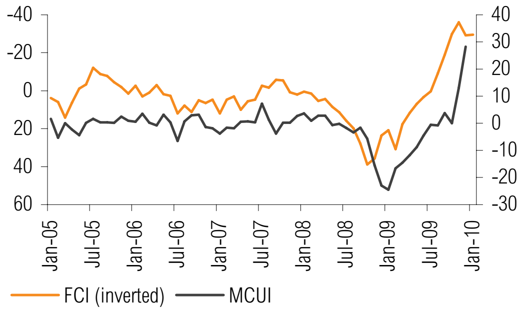
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Korea

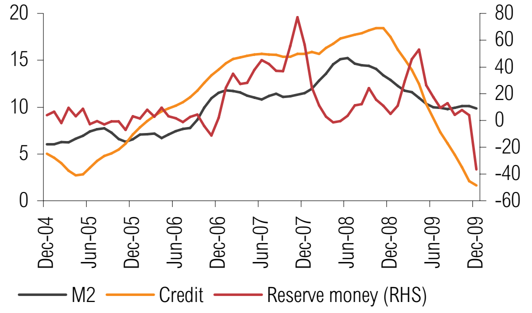
The FCI has started to stall; credit growth is still slowing due to weak demand.

Figure 7: Manufacturing capacity utilization index (sa, 3mma) and FCI (%yoy)



Source: CEIC; Bloomberg; RBS

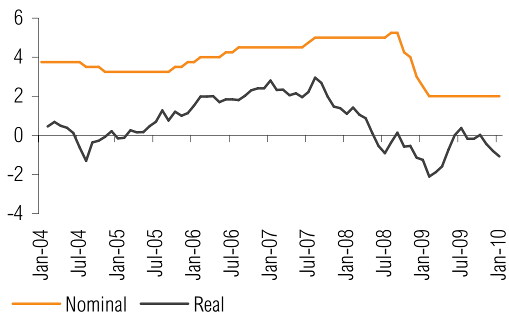
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

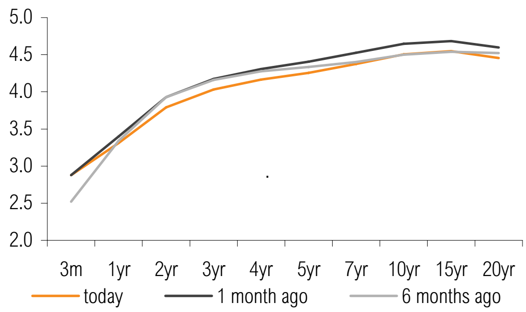
With headline inflation rising slightly, real policy rate has dipped into negative territory. The BoK has announced the end of the tightening cycle but made it clear hikes were unlikely in 09.

Figure 9: Policy rate (%)



Source: CEIC; RBS

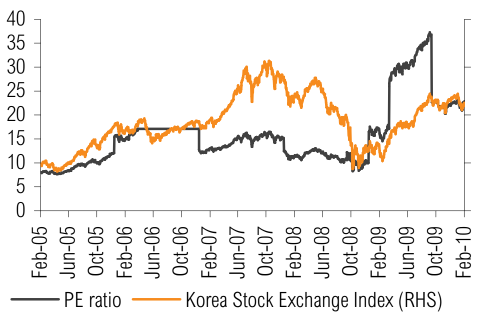
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

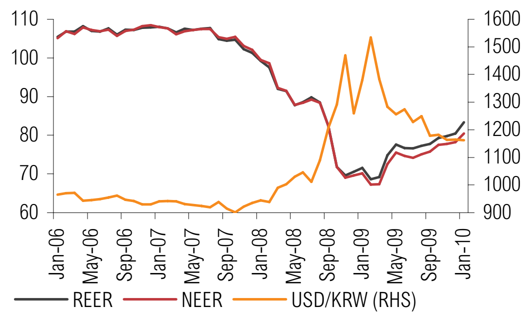
The Kospi recovery is continuing, in line with global indices.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

Korea Key Economic Indicators

	2005	2006	2007	2008	2009	2010F	2011F
Growth (% yoy)							
Real GDP	4.2	5.1	5.0	2.2	0.2	7.0	4.5
Domestic demand	3.3	4.5	4.0	1.5	-3.5	8.0	4.3
- Private consumption	3.6	4.5	4.5	0.9	0.2	5.0	4.0
- Government spending	5.0	6.2	5.8	4.2	4.9	3.0	3.0
- Fixed investment	2.4	3.6	4.0	-1.7	-0.9	5.0	4.0
Fixed investment (% GDP)	28.8	28.3	28.1	27.1	26.8	26.3	26.2
Exports	8.5	11.8	12.1	5.7	-1.0	6.0	6.0
Imports	7.3	11.3	11.9	3.7	-9.0	8.0	6.0
Domestic demand contribution to growth	2.3	3.0	2.5	1.4	-3.4	7.4	4.0
Net exports contribution to growth	1.9	2.1	2.5	0.8	3.6	-0.4	0.4
Inflation, FX and interest rates							
CPI inflation (%, end of period)	2.6	2.1	3.6	4.1	2.5	1.8	3.0
CPI inflation (%, period average)	2.8	2.2	2.5	4.7	2.7	1.5	2.5
Property price index (%, end of period)	4.0	11.6	3.0	1.7	3.0	6.0	4.0
USD/KRW, end-period	1,010	931	934	1,260	1,164	1,300	1,200
USD/KRW, average	1,023	951	929	1,110	1,233	1,175	1,213
REER (% end of period)	8.9	5.9	-5.8	-32.0			
Policy rate (end-year, %)	3.75	4.50	5.00	3.00	2.00	2.50	3.25
3 month CD rate (end-year, %)	4.09	4.87	5.85	3.94	2.85	3.65	4.05
5 year KTB yield (end-year, %)	5.44	5.00	5.81	3.78	4.70	5.20	5.50
Fiscal accounts (% of GDP)							
Central government fiscal balance*	-2.5	-2.6	0.5	-2.0	-5.4	-3.0	-2.0
- Government revenue*	17.8	18.7	22.0	21.3	21.0	20.0	21.0
- Government expenditure	20.3	21.3	21.5	23.3	26.4	23.0	23.0
Primary fiscal balance*	-1.3	-1.3	1.9	-0.4	-4.6	-1.4	-0.4
Government debt	29.4	32.3	32.1	33.0	38.0	41.0	43.0
- Domestic	28.0	31.0	31.0	32.0	36.0	39.0	41.0
- External	1.4	1.3	1.1	1.0	2.0	2.0	2.0
Money and credit (% yoy eop)							
M2	7.0	12.5	10.8	12.0	8.6	14.8	13.5
Private sector credit	8.5	13.9	14.9	14.0	8.6	5.0	7.0
Private sector credit % GDP	71.0	77.0	82.0	90.0	95.0	91.9	91.8
Balance of payments (USD bn)							
Merchandise exports	289	332	379	434	391	420	440
% yoy	12.1	14.8	14.2	14.4	-9.8	7.4	4.8
Merchandise imports	256	304	350	427	340	370	390
% yoy	16.4	18.6	15.0	22.2	-20.4	8.8	5.4
Trade balance	33	28	29	7	51	50	50
Current account balance	15	5	6	-6	39	29	29
% of GDP	1.9	0.6	0.6	-0.7	4.6	3.0	2.9
Portfolio balance	-2	-23	-19	-35	25	10	-10
Capital account balance	5	18	6	-53	23	56	6
Overall balance	20	23	12	-59	62	85	35
Foreign Reserves and debts(USD bn)							
FX reserves	210	239	262	202	274	359	394
FX reserves, months of imports	9.9	9.4	9.0	5.7	9.7	11.6	12.1
FX reserves, % of ST debt	319	210	164	134	183	232	246
Foreign debt	188	260	382	380	410	450	475
Foreign debt (% of GDP)	23.7	29.2	39.4	41.2	48.7	46.6	47.3
ST FX debt	66	114	160	151	150	155	160
Nominal GDP							
Nominal GDP, USD bn	792	892	970	923	843	966	1,004
Nominal GDP KRW tn	811	848	901	1,024	1,039	1,135	1,217
GDP per capita, USD	16,440	18,380	20,011	18,964	17,271	19,738	20,510

**Excluding social security*

Source: CEIC; BIS; RBS

Malaysia

Shehryar Khan, Teck Wee Yeo

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/MYR
Q4:09	4.5	-0.2	2.00	3.43
Q1:10	4.8	2.0	2.00	3.40
Q2:10	3.8	3.1	2.25	3.38
Q3:10	4.4	3.3	2.50	3.36
Q4:10	4.7	3.3	2.50	3.34
Q1:11	5.1	3.1	2.75	3.32
Q2:11	5.4	3.2	3.00	3.33
Q3:11	5.1	3.5	3.00	3.34
Q4:11	6.6	3.9	3.25	3.35

Source: RBS

Q4 09 GDP growth was above our and market expectations, registering 4.5%yoy (14.9%qoq, seasonally adjusted annualised). This was the first annual positive growth in four quarters. Gross fixed capital formation was the main driver of growth, increasing by 8.2%yoy. This in turn is likely to have been driven by higher government investment. This view is supported by strong performance of the construction sector (9.2%yoy) that the authorities attributed to the ongoing implementation of the stimulus packages. There was also broad based improvement in private sector activity. Private consumption increased by 1.7%yoy compared with 1.5%yoy in last quarter and net exports grew by 11.4%yoy compared with -16.9%yoy in last quarter. On the supply side, manufacturing sector accelerated to 5.5%yoy from -8.6%yoy in the previous quarter. Several indicators suggest that this recovery will gain strength in the next few quarters. Average wage levels in the manufacturing sector rose 6%yoy in Q4 09. Real currency in circulation, an appropriate measure of transactions demand in cash based economy like Malaysia, troughed in mid-09 and has been on a gentle uptrend since. Similarly, vehicle sales are on the mend. The uptrend in the more encompassing leading index suggests that these improvements will continue.

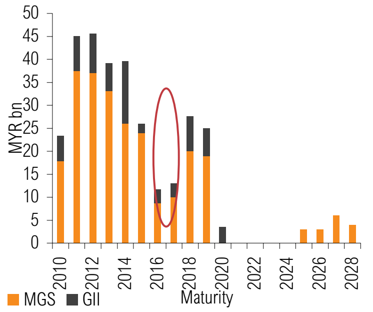
We need to however, bear in mind that this improvement is still inadequate to close the output gap. Level data by and large is still well short of pre-crisis levels – for example, the manufacturing index is still around 7% short of pre-crisis peaks implying that capacity utilisation rates are still languishing at around 70%. The same applies to other indicators such as auto sales and hotel occupancy rates. This would suggest that demand-pull inflation is unlikely to be an issue. The very modest 1.3%yoy inflation in January is in line with this view. We do expect an increase in inflation in the coming months, but this will be driven by an adjustment in the subsidy structure. In general, subsidy adjustment tends to have a one-off impact on price levels and do not warrant a policy response.

Policy outlook: In this regard, the hawkish turn in Bank Negara's tone is not driven by concerns over inflation. Sticky external reserves at around USD96bn, limited appreciation of stock market and tepid growth in monetary aggregates suggest there is no threat of inflation. Bank Negara's view is that policy normalisation is becoming essential to avoid financial market imbalances. In all likelihood, the real concern lies in the high level of resident outflows. With private sector activity recovering but still well below the pre-crisis level and a very benign inflation backdrop, we believe the authorities are unlikely to increase the policy rate in the March 4 policy meeting. But given the economy is flush with liquidity, Bank Negara may hike the statutory reserve requirement by 50bps to drain some of the excess liquidity while having a gentler impact on the market than a policy rate hike.

FX outlook: Against these poor internal dynamics, it is difficult to see a sustained rally in the MYR. Valuation on traditional parameters are fair only at the surface, but less so when juxtaposed against capital outflows and political problems. The political environment is becoming increasingly complicated with the recent surge in religious tensions. The supports for the MYR are periodic but unpredictable shifts in global risk sentiment and higher commodity prices. MYR/SGD cross rate in 2009 has increased from 2.39 to 2.44 reflecting the starkly different internal dynamics of the two neighbours.

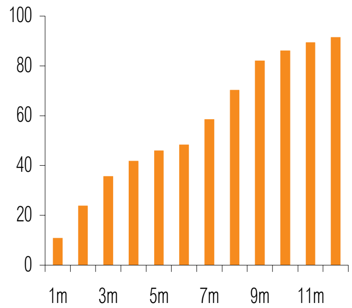
Fixed income analysis

Figure 1: Maturity profile of outstanding government bonds



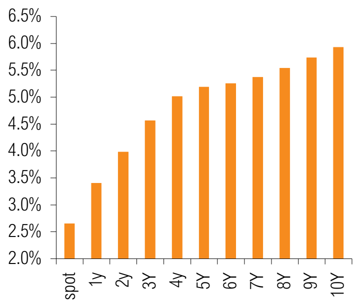
Source: Bloomberg, RBS

Figure 2: Rate hike expectation in the next 1 year (bp)



Source: Reuters, RBS

Figure 3: Forwards on the 1y tenor



Source: Reuters, RBS

Supply: A new 5.5y MGS was issued in February as the new benchmark for the 5y tenor. The issuance size was MYR3.5bn, bringing year to date gross issuance to MYR12bn or nearly 19% of the full year target. There will be two new issues in March, a 5.5y GII and a 7.5y MGS. We expect the issuance amount to be around MYR3.5bn each. The 7.5y tenor has not been issued since September 2004 and is now issued presumably to spread out the pressure on the belly (Figure 1).

Demand: Demand for government bonds at the last two auctions was relatively strong. The 10y auction in January was relatively well bided with bid cover ratio at 2.1 and average yield coming quite in line with expectations. The new 5.5y MGS auction in February also produced a high bid cover ratio of 2 but it traded broadly flat post-auction. This largely reflected the market's heavily skewed risk appetite towards the long end. The upcoming 7.5y MGS auction is likely to face similarly good response for two reasons. Firstly, there should be no concerns about it being illiquid as it will be reopened twice later this year. Secondly, the large redemption of approximately MYR14.4bn worth of MGS and GII between February and March will provide ample liquidity to absorb the issue.

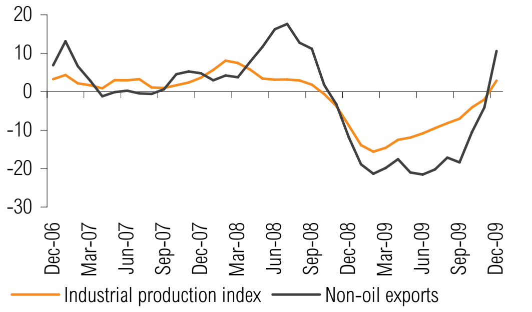
Valuation: The 1y-3y sector on the swap curve underperformed significantly in February as we had expected. This reaction was triggered by the governor's comments to normalise rates with economic recovery in place. As implied by forwards on the 3m tenor (see Figure 2), we note that around 50bp of rate hike has been priced in for the next 6m and at least another 40bp for the subsequent 6m. With our economist's forecast for the start of the hiking cycle to begin only in H2, we believe that that the 1y has amply priced in rate hike expectation. On the other hand, the 2y-3y sector looks more unclear. While the 2y-3y has run up to their highs in the past year, this sector may be still under-pricing term premium. Specifically, 1y rate has historically traded between 3.4% and 3.8% when policy rate was at 3% but 1y1y and 2y1y are currently trading only around 3.4% and 4% respectively which hardly reflect any term premium (Figure 3).

Strategy: Given that the market seems already positioned for a rate hike in the upcoming monetary policy meeting on 4 March, there is a greater downside risk for rates if the central bank stands pat on the policy rate and we therefore avoid outright paying. Our recommended 1y forward 2s4s flattener had a good run in February as the market re-evaluated the front end of the curve. The trade is currently 18bp in the money since its inception last December and we see further scope for the trade to perform. We therefore maintain this position going into the monetary policy meeting on 4 March to bet on any possible flattening of the curve post policy meeting. On the MGS curve, we stay long the 5y ASW position established earlier as a long-term strategy. The trade has been undermined by the switch in the underlying bond benchmark in February, when we missed out the opportunity to take profit. We now look for the overall market sentiment to retreat from its bearish stance to cut loss on this position.

Malaysia

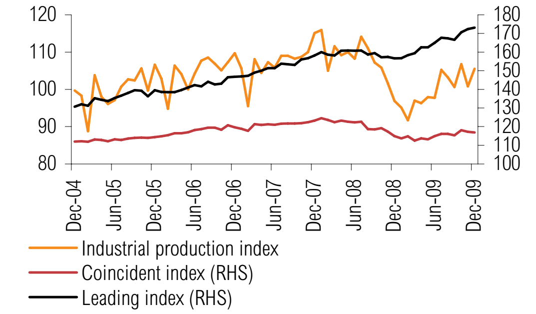
A recovery seems to be falling in place, although we expect it to be slow and uneven.

Figure 1: Industrial production index and non-oil exports (% yoy, 3mrs)



Source: CEIC; RBS

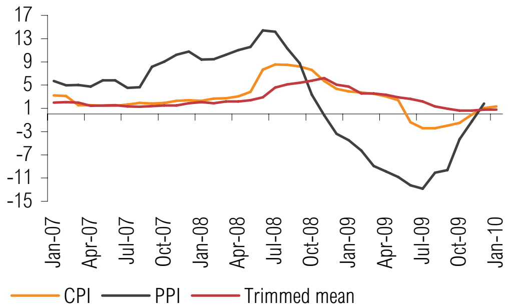
Figure 2: Industrial production index, coincident and leading index (levels)



Source: CEIC; RBS

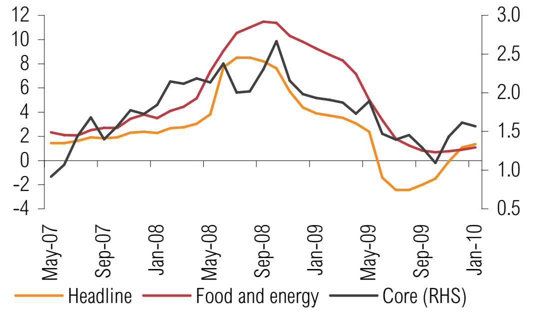
Inflation inching towards positive territory, but we expect it to stay within manageable levels.

Figure 3: Consumer and producer price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

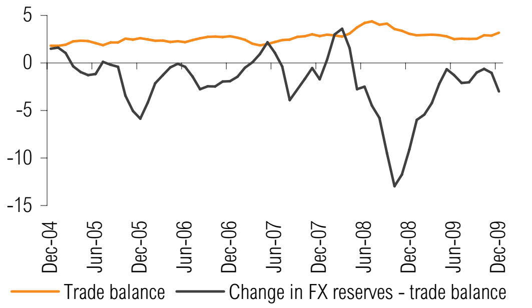
Figure 4: Headline, food and energy and core CPI (% yoy)



Source: CEIC; RBS

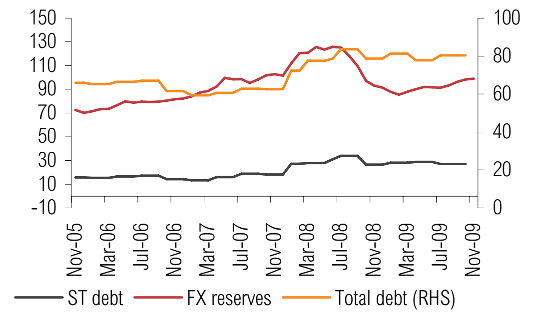
External reserves should rise at a faster pace as higher commodity prices widen the trade surplus and portfolio outflow ease.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



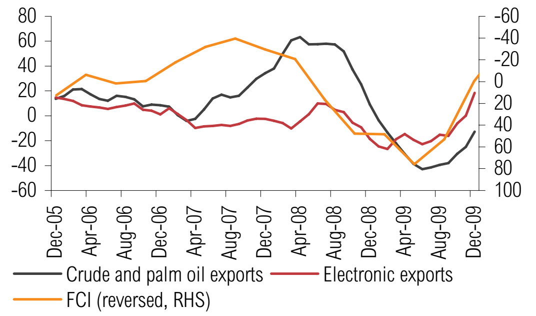
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Malaysia

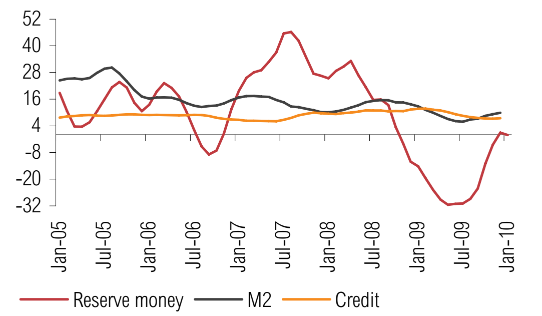
Reserve money growth continues to improve, in line with FX reserves. Weak credit demand has however, limited the impact on final liquidity.

Figure 7: Crude and palm oil & electronic exports (% yoy, 3mrs); FCI (%yoy)



Source: CEIC; Bloomberg; RBS

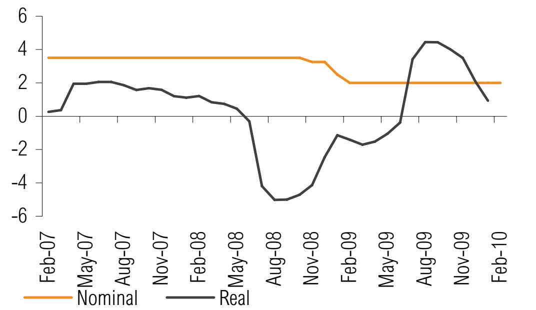
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

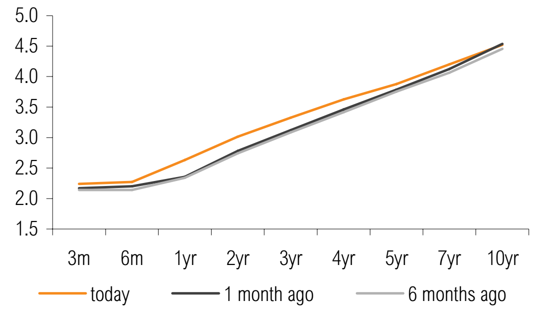
We expect moderate rate hikes starting from H2 2010.

Figure 9: Policy rate (%)



Source: Bloomberg; RBS

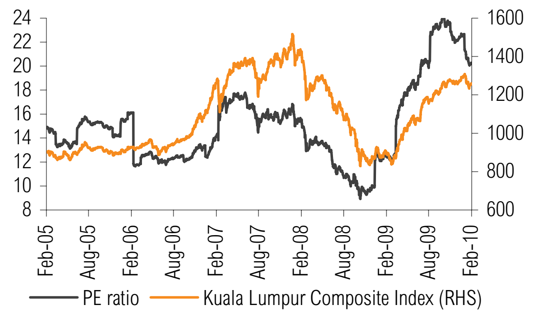
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

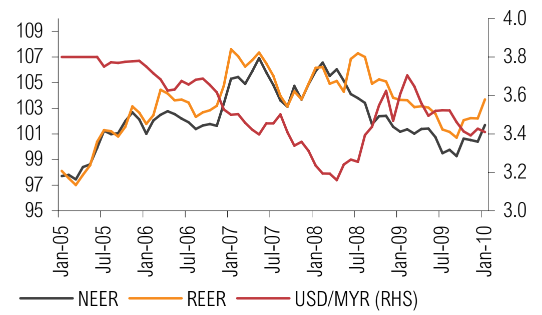
The macro backdrop for the MYR continues to be favourable. Do not expect the MYR to outperform though

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

Malaysia Key Economic Indicators

	2005	2006	2007	2008	2009	2010F	2011F
GDP (%)							
Real GDP	5.3	5.9	6.2	4.7	-1.7	4.5	5.6
Domestic demand	5.5	7.7	8.5	6.0	-3.2	6.8	5.7
- Private consumption	9.1	6.8	10.4	8.5	0.8	3.1	3.2
- Government spending	5.6	4.9	6.9	10.9	3.7	2.6	3.7
- Fixed investment	4.9	7.7	9.6	0.8	-5.5	0.3	5.8
Fixed investment (% GDP)	22.2	22.1	22.4	23.2	21.4	20.9	20.1
Exports	8.3	6.6	4.5	1.3	-10.1	4.8	6.5
Imports	8.9	8.1	6.0	1.9	-12.5	7.1	6.8
Domestic demand contribution to growth	4.5	6.3	7.1	5.1	-2.8	5.7	4.8
Net exports contribution to growth	0.8	-0.5	-1.0	-0.5	1.1	-1.3	0.7
Inflation, FX and interest rates							
CPI inflation (%, end of period)	3.3	3.1	2.4	4.4	1.1	3.3	4.0
CPI inflation (%, period average)	3.0	3.6	2.0	5.4	0.6	2.9	3.4
USD/MYR, end-period	3.78	3.53	3.31	3.45	3.37	3.41	3.34
USD/MYR, period-average	3.79	3.66	3.43	3.34	3.50	3.36	3.37
REER (% end of period)	5.83	2.43	0.48	1.50	-2.43		
Policy rate (end-year, %)	3.50	3.50	3.25	3.25	2.00	2.50	2.75
3 month KLIBOR (end-year, %)	3.20	3.65	3.60	3.25	2.00	2.50	2.75
10 year bond yield (end-year, %)	3.78	3.50	4.00	3.23	4.00	4.10	3.75
Fiscal accounts (% of GDP)							
Central government fiscal balance	-3.6	-3.3	-3.2	-4.8	-7.4	-5.6	
- Government expenditure	23.9	24.8	25.1	26.5	30.8	26.1	
- Government revenue	20.4	21.5	21.9	21.6	23.4	20.5	
Primary fiscal balance	-1.4	-1.2	-1.2	-3.1	-5.4	-3.4	
Government debt (% GDP)	43.8	42.2	41.7	41.5	48.5	58.9	
- Domestic	38.0	37.8	38.6	38.7	46.7	56.3	
- External	5.7	4.4	3.1	2.8	1.8	2.6	
Money and credit (% yoy)							
M3 money supply	8.3	13.0	14.0	15.1	7.0	9.0	11.0
Private sector credit	8.6	6.3	8.6	12.8	6.5	9.4	10.2
% of GDP	106.8	103.2	100.0	100.0	114.8	116.5	115.5
Balance of payments (USD bn)							
Merchandise exports	142.5	161.3	176.8	199.1	157.8	172.6	184.7
% yoy	12.4	13.2	9.6	12.6	-20.7	9.3	7.0
Merchandise imports	108.5	123.8	139.5	148.0	117.3	130.0	142.8
% yoy	9.3	14.1	12.7	6.1	-20.8	10.8	9.8
Trade balance	34.1	37.5	37.3	51.1	40.6	42.6	41.9
Non-commodities trade balance	18.9	19.5	13.3	16.3			
Current account balance	20.7	26.3	29.3	38.8	33.8	32.2	30.2
% of GDP	15.0	16.7	15.7	17.5	17.5	14.9	12.6
Gross FDI	1.0	0.0	-2.7	-7.8	-3.0	2.7	-3.6
Capital account balance	-9.8	-11.9	-11.0	-35.3	-22.5	-3.8	-10.4
Overall balance	3.6	6.9	13.2	-5.5	9.2	25.5	18.6
FX reserves and debt (USD bn)							
FX reserves	66.2	78.4	95.0	92.1	101.4	126.9	145.4
Import (retained) coverage (months)	7.3	7.6	8.2	7.5	10.4	11.7	12.2
FX reserves (X short term FX debt)	5.3	6.5	5.8	4.0	4.6	5.6	5.7
Foreign debt	52.2	50.4	54.7	70.8	66.7	71.4	71.9
Foreign debt (% of GDP)	37.8	32.1	29.1	32.5	34.6	33.0	30.0
ST FX debt	12.4	12.1	16.5	23.1	22.3	22.8	25.4
Nominal GDP and per capita							
Nominal GDP, USD bn	138.0	157.0	186.7	221.4	192.8	216.2	239.8
Nominal GDP, MYR bn	522.4	574.4	639.8	738.7	673.9	726.3	807.1
GDP per capita, USD	5396	6011	7007	8149	6957	7650	8319

Source: BIS; CEIC; RBS

Philippines

Ruzette Morales Mariano

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/PHP
Q4:09	1.8	3.0	4.00	46.2
Q1:10	4.4	3.0	4.00	46.8
Q2:10	5.2	4.2	4.00	46.5
Q3:10	5.7	6.2	4.50	46.0
Q4:10	6.1	5.8	5.00	45.5
Q1:11	5.5	6.1	5.50	46.3
Q2:11	4.7	5.4	6.00	46.5
Q3:11	5.1	5.5	6.00	46.8
Q4:11	5.1	5.7	6.00	47.0

Source: RBS

Real economy: The industrial sector has gained strength and became the main driver of the 1.8%yoy GDP expansion in Q4; it more than compensated for the typhoon-related losses in agriculture. Its recovery was seen in tandem with the recent, notwithstanding fragile, improvement in the imports of capital goods and production. This also coincided with the improvement of average capacity utilization rate of manufacturing industries which reached a record level of 83% by November 2009. On the expenditure side, private spending, which comprised almost 80% of total GDP, grew 3.8%yoy. It was mainly driven by relatively crisis-resilient remittances. Remittances grew stronger than expected at 5.6% on the year in 2009; its momentum picked up in Q3 and was fairly strong in Q4. This trend in remittances was traced by real narrow money supply, which demonstrated an upward inflection in Q4 09. Moreover, the sluggish increase in real wages (up by 1% in 2009) across all sectors could have helped a broader base of workers keep their jobs and retain aggregate purchasing power during the global economic slowdown. Unemployment and underemployment rates were contained at normal levels of 7.5% and 19%, respectively.

We see an economic rebound in 2010 mainly due to base effects and consumption support from remittances. Typhoon-related refurbishing activities would also continuously take place in the first half of the year. Exports would expand along side improving global demand. Moreover, base effects would continue to bolster its yoy growth. Election-related spending would also stir up economic activity for a good part of H1 2010. These developments would be significant but downside risks have also risen. One of these is the El Niño phenomenon which the Philippine Atmospheric Geophysical and Astronomical Services Administration (PAGASA) predicts to run through H1 2010. Historically, El Niño-induced drought have dented agriculture production and rural wages.

The 2009 fiscal deficit reached 3.9% of GDP (PHP 298.5bn), the widest in six years. The fiscal weakness was mainly due to the adverse effect of the economic slowdown on public revenues and counter tax revenue policy measures that were recently imposed. The annual PHP 1.12bn revenue was 9% lower than government target and 6.6% lower than that of 2008. In contrast, the government underspent by 4.5% against its target. Going forward, a moderately weak fiscal position is expected in 2010 as the recovery in public revenues may be hampered by counter tax revenue policy measures. Its reversal would depend on the policy thrust of the new administration.

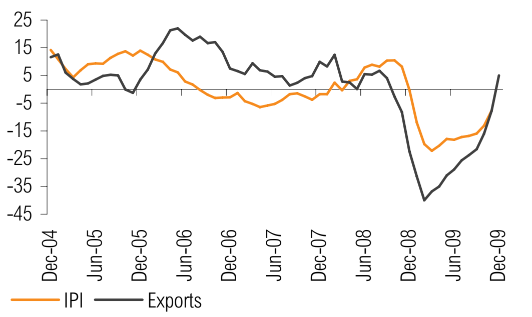
Policy outlook: The recent moderation in headline and core inflation suggested that the impact of the past typhoons on prices has started to wane. This was consistent with central bank's decision to maintain its key policy rate at 4%. The impending effects of the El Niño phenomenon on food and fuel prices would be evident by Q1, though such supply-related shocks to prices may also prove to be temporary. We reiterate our view of a policy hike in H2 2010 as part of normalization.

FX outlook: The political environment would be less supportive of the PHP as uncertainty remains high from February when official campaign for the national election starts until June when the new president takes over. Continuing fiscal concerns and the impending El Niño effects on prices and trade would also restrain PHP. Remittances would however, continuously provide harness against full impact of these headwinds as deployment of higher-skilled workers firms.

Philippines

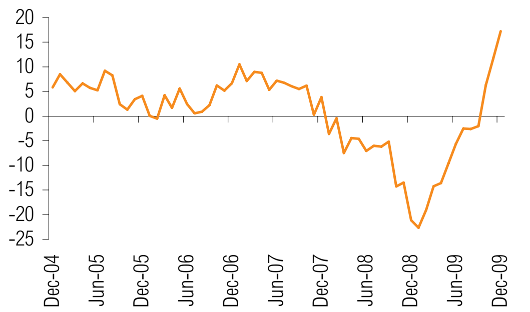
Export growth would increase further due to base effects. Electronics exports would also increase. Room for improvement, however, is still significant given that levels are still below 2008-highs.

Figure 1: Industrial production index and exports (% yoy, 3mrs)



Source: CEIC; RBS

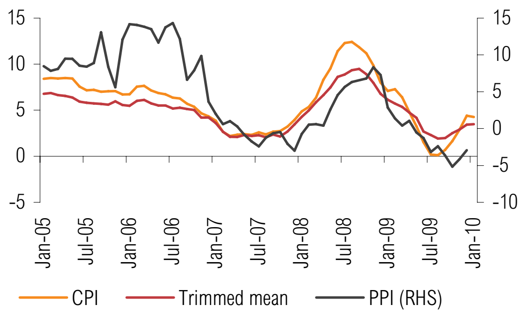
Figure 2: Composite coincident index (CCI, %yoy)



Source: CEIC; RBS

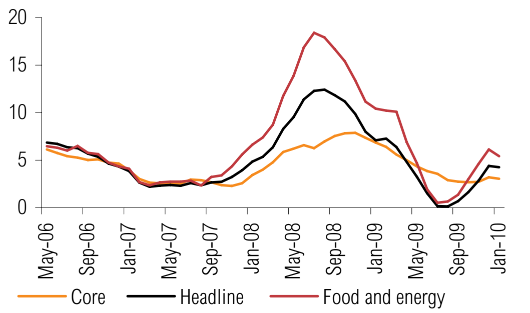
The effect of the recent storms on prices has started to dissipate. However, a looming risk of an increase in prices due to the effects of the progressing El Niño phenomenon cannot be discounted.

Figure 3: Consumer and producers price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

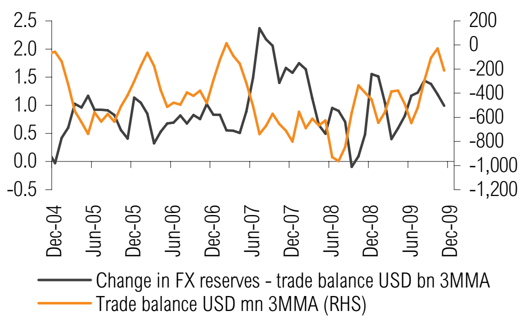
Figure 4: Core and food and energy inflation (% yoy)



Source: CEIC; RBS

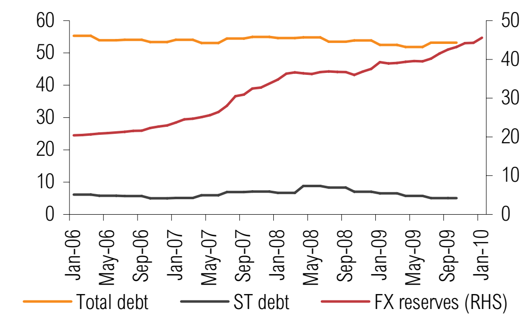
External liquidity remains adequate vis-à-vis short-term foreign debt.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



Source: CEIC; RBS

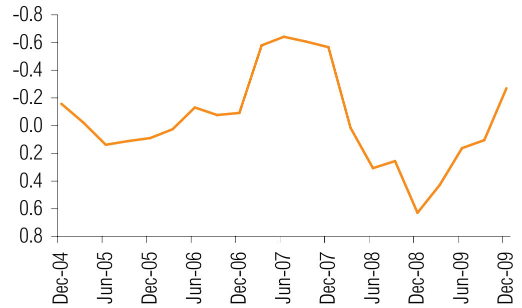
Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Philippines

The upward trending financial conditions index reflects recovery underway.

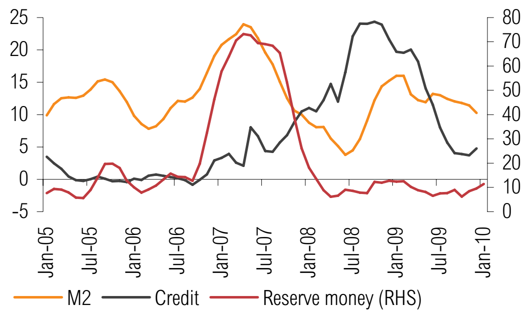
Credit is showing signs of a possible pick-up soon.

Figure 7: Financial conditions index (%yoy, inverted)



Source: CEIC; Bloomberg; RBS

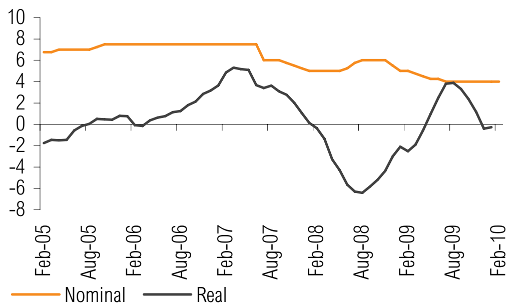
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

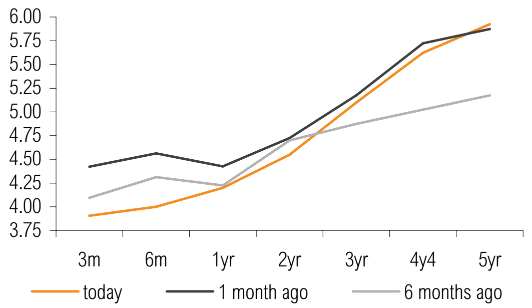
The real rate is already below zero and may remain in the negative until the central bank raises policy rate in H2.

Figure 9: Policy rate (%)



Source: CEIC; RBS

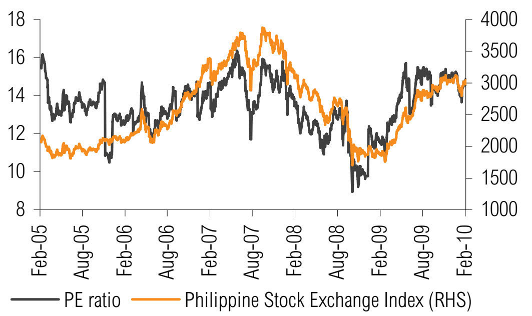
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

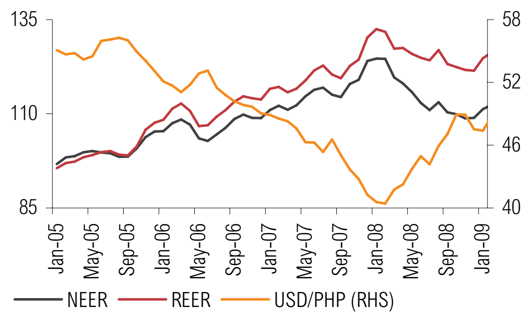
The political uncertainty brought by the coming presidential elections provides headwinds against PHP.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS, Bloomberg; RBS

Philippines Key Economic Indicators

	2005	2006	2007	2008	2009	2010 F	2011 F
Growth (% yoy)							
Real GDP	4.9	5.4	7.2	3.8	0.9	5.4	5.0
Domestic demand	2.0	5.0	6.8	5.0	1.71	5.5	4.0
Private consumption	4.8	5.5	6.0	4.5	3.82	5.7	4.5
Government spending	1.6	6.1	10.0	4.7	8.54	5.8	2.0
Fixed investment	-6.6	1.4	9.5	6.7	-3.47	4.5	2.5
Exports	4.8	11.2	3.1	2.3	-14.18	5.5	8.0
Imports	2.4	1.9	-5.4	3.7	-5.79	7.5	9.0
Domestic demand contribution to growth	3.9	1.2	3.0	4.2	4.9	6.1	5.3
Net exports contribution to growth	0.9	4.2	4.3	-0.6	-4.0	-0.7	-0.3
CPI, FX, and interest rates							
CPI inflation (% yoy, end of period)	6.6	4.3	3.9	8.0	4.3	5.0	5.7
CPI inflation (% yoy, period average)	7.7	6.3	2.8	8.9	3.3	5.4	5.4
PHP per USD, end-year	53.0	49.0	41.2	47.5	45.5	47.0	46.0
PHP per USD, average	54.9	50.8	45.1	44.6	48.3	46.9	46.9
REER (% end of period)	15.7	6.9	14.6	-7.2	3.0	10.8	-
Policy rate (end-year, %)	7.50	7.50	5.25	5.50	4.00	5.00	6.00
3-month interbank rate (end-year, %)	7.8	6.6	6.6	5.2	4.3	5.2	6.4
10 year bond yield (end-year, %)	11.9	7.7	6.4	7.4	8.5	14.0	10.0
Fiscal accounts (% GDP)							
Central government fiscal balance	-2.7	-1.1	-0.1	-0.9	-3.9	-3.8	-3.2
Government expenditure	17.3	17.3	17.3	16.8	18.5	18.2	17.8
Government revenue	14.6	16.2	17.1	15.9	14.7	14.5	14.6
- privatization proceeds	0.0	0.1	1.4	0.4	0.0	0.0	0.0
Primary fiscal balance	2.8	4.1	3.9	2.8	-0.3	-0.3	0.2
Central government debt	82.3	73.3	63.3	56.0	61.4	63.8	63.6
Domestic	40.7	36.9	34.2	30.6	31.9	31.4	30.5
External	41.6	36.4	29.1	25.5	29.5	32.4	33.1
Money and credit (% yoy)							
M2	9.8	22.1	9.4	10.0	7.0	12.0	10.0
Private sector credit	-0.3	6.7	7.2	6.5	4.0	8.0	9.0
% of GDP	28.3	28.1	27.9	26.6	26.6	26.0	25.6
Balance of payments (USDbn)							
Exports of goods	40.3	46.5	49.5	48.3	31.7	33.4	35.9
Export growth (% yoy)	3.8	15.6	6.4	-2.5	-34.4	5.5	7.5
Imports of goods	48.0	53.3	57.7	61.1	42.6	45.6	48.3
Import growth (% yoy)	8.0	10.9	8.4	5.9	-30.4	7.2	5.8
Trade balance	-7.8	-6.7	-8.2	-12.9	-10.9	-12.2	-12.4
Overseas worker remittances	11.4	13.2	14.0	15.2	15.5	16.6	18.3
Current account balance	2.0	5.3	6.4	3.9	5.6	4.1	5.0
% of GDP	2.0	4.5	4.3	2.3	3.5	2.2	2.5
Capital account balance	0.9	0.0	2.9	-0.1	0.3	0.8	1.9
Overall balance	2.4	3.8	8.6	0.3	2.9	0.9	2.9
Foreign Reserves and debts(USD bn)							
FX reserves	17.7	23.0	33.7	36.0	38.9	39.8	42.7
Import coverage (months)	3.8	4.2	5.7	6.2	9.3	8.8	8.7
FX reserves, % ST debt	131.6	250.1	271.4	273.1	274.2	274.7	328.4
Foreign debt	54.2	53.4	54.9	53.8	65.1	68.7	67.0
Foreign debt (% GDP)	54.7	45.0	38.1	32.4	40.6	37.8	33.3
ST FX debt	13.4	9.2	13.2	13.2	14.2	14.5	13.0
Nominal GDP and overseas workers							
Nominal GDP, USD bn	99.1	118.7	146.8	166.3	160.7	183.4	202.4
Nominal GDP, PHP bn	5438	6033	6626	7423	7757	8595	9486
GDP per capita, USD	1162	1365	1655	1829	1724	1910	2047
Overseas worker deployment (% yoy)	5.8	2.6	15.0	28.0	-5.0	10.0	12.0

Source: Bangko Sentral ng Pilipinas; Department of Finance; CEIC; RBS

Singapore

Sanjay Mathur, Woon Khien Chia

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	USD/SGD
Q4:09	4.0	-0.3	1.40
Q1:10	5.4	0.4	1.40
Q2:10	5.5	1.9	1.39
Q3:10	5.2	1.9	1.38
Q4:10	6.0	2.4	1.37
Q1:11	6.6	2.1	1.38
Q2:11	6.3	2.1	1.38
Q3:11	6.2	1.7	1.37
Q4:11	6.0	1.2	1.37

Source: RBS

Real economy: The final Q4 09 GDP printed 4% yoy (-2.8% qoq saar) compared with the advance estimate of 3.6% yoy (-6.8% qoq saar). Based on this trend as well as other indicators, the authorities have upped their 2010 growth forecast range from 3%-5% to 4.5%-6.5%. Of the indicators that are likely to have been considered are (1) improvement in the labour market; (2) a massive drop in inventories and (3) on-going improvement in global demand. Developments in the labour market have been particularly encouraging – total employment grew 38,700 allowing the unemployment rate to decline to 2.1% from a cyclical peak of 3.4%. Equally, the contraction in wages has slowed considerably. This combination of improving employment and wages suggests that the 4.3% yoy growth in Q4 09 will likely be maintained. We also note that in Q4 09, the reduction in inventories amounted to 15.3% of GDP and a significant replenishment would be required further out. The progressive strengthening of the electronics PMI and the new export orders component further attest to our view. In January, this component reached its highest level in more than a year.

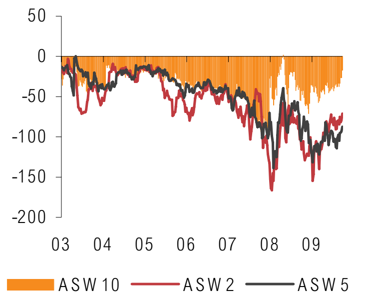
Other indicators such as visitor arrivals are also chugging along nicely. Visitor arrivals rose 9.4% yoy in December with the absolute number of arrivals being amongst the highest on record. Finally, we are also encouraged by recent developments in the construction sector. It has been widely expected that growth in this sector will tail off once the integrated resorts are completed. Nonetheless, the upswing in the property market and rising potential for en-bloc sales suggests that residential construction will provide a significant buffer. Overall, we will be re-visiting our 2010 GDP forecast of 5.2%.

Policy outlook: Following this GDP release, the MAS has reiterated that its current policy stance of zero appreciation of the SGD NEER is appropriate. At the same time, it also signals the central bank's comfort with allowing the SGD to remain in the top half of the band. Our take is that the authorities will start to normalise policy by reverting to a gradual and upward crawl of the band. Also from a structural perspective, we believe that the inclination of the authorities would be to allow for a gradual appreciation of the SGD NEER. The Economic Strategies Committee (ESC) has emphasised a doubling of productivity growth to 2%-3% from the 1% level averaged over the previous decade. Underlying this shift in the growth path are (1) reduced reliance on low skilled workers; (2) an increase in value added services and (3) technology enhancement particularly towards labour savings technologies. To assist this process, we believe that the authorities will accept a faster appreciation of the SGD similar to the process in the mid-1980s.

FX outlook: In the absence of a policy shift, USD/SGD will respond only to USD weakness and the recent upside in the pair reflects USD strength. Nonetheless, we are optimistic on a policy shift as discussed above and therefore, continue to target USD/SGD at 1.36 by mid-year. A further catalyst could potentially come from CNY flexibility. Considering both the political pressure and continued surge in hot money inflows, our house view is that a revaluation would take place in Q2 2010.

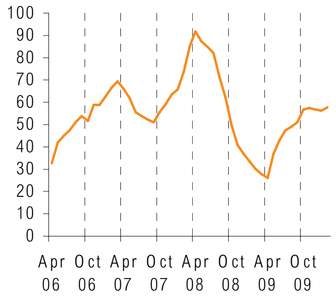
Fixed income analysis

Figure 1. SGS-IRS swap spreads – 2y, 5y and 10y (bp)



Source: Bloomberg, RBS

Figure 2. MAS FX forward positions (USD bn)



Source: Bloomberg, RBS

Supply: Both the 2y and 15y issues in February came in slightly above market expectations at SGD2.2bn and SGS1.1bn. Right on the tail of the SGS15y auction, Temasek came out with a 15y and a 25y note, which was rather unexpected since the firm sold a 10y note less than a month ago. Market was expecting the firm to issue USD bonds instead, which is probably still on the cards in March. It seems clear that Temasek is attempting to build a benchmark curve for its name. Interests in the Temasek papers are generally stronger than for SGS as seen in the higher bid-cover ratios, given their higher yields above SGS and being rated on par with SGS at AAA.

The next SGS auction on the calendar is a new 7y issue on 29 March. Besides Temasek, the corporate issuance pipeline appears to be building up.

Demand: The 15y SGS auction was reasonably well received with the average accepted yield about 10bp below the pre-auction level and a bid-cover of 2.14 but a fat tail (3.31% cut-off against 3.11% average) probably showing strong interests from real money accounts since trading accounts usually cluster around the last-done price. Demand for the 2y reopening earlier in the month was relatively more subdued with a 1.53 bid-cover, probably because the size is quite large. In the last week of February, SGS sold off despite the emergence of global risk-aversion which drove a rally in government bonds including the US treasuries. This can be broadly attributed to the launch of the Temasek issues. February thus turned out to be the first month since November that the SGS market underperformed the US treasury market.

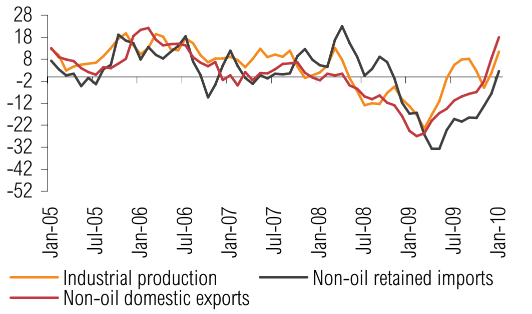
Valuation: With a further contraction in bond-swap spreads (bond yields rose while swaps were marginally lower), the 10y SGS no longer looks expensive but neither has it become very cheap (see Figure 1). The 5y remains the most expensive part on the curve while the 2y is more neutral. As mentioned before, the directionality of swap spreads to bond yields is historically a negative one – hence, the turn in market sentiment from bullish to bearish in February has helped to rein the swap spread correction faster.

Strategy: As supply remains thin in the next two months, SGS may still find some support in the coming month although competition from corporate issuance will gradually get bigger. Also, we expect the MAS to reaccelerate its pace of open market operations to drain liquidity (see Figure 2). In addition to the likelihood that Fed's discount rate hike has firmly established a floor to USD Libor, duration appetite is likely to get shorter. On SGS, we favour a bar-bell strategy. In swaps, we have re-initiated the 2s5s flattener after the Fed's discount rate hike. The spread is at its peak and the 6m SOR fixing is likely to bottom from here together with the USD Libor. We maintain the idea to receive 2y SGD swap vs. paying 2y USD swap. Both legs traded lower in the past month but we expect that once the market turns decisively more bearish, the SGD rates will trail the USD rates.

Singapore

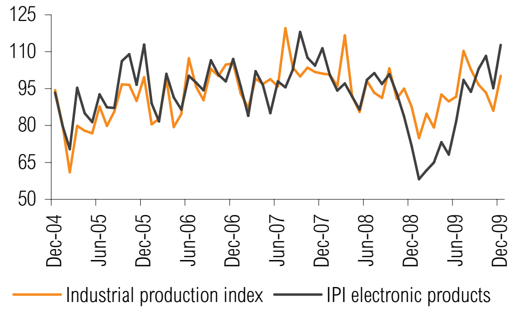
Growth conditions are set to improve further.

Figure 1: Industrial production index, non-oil retained imports & domestic exports (% yoy, 3mrs)



Source: CEIC; RBS

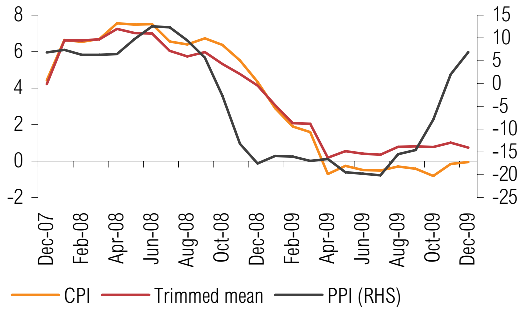
Figure 2: Industrial production index (IPI) and IPI electronic products (levels)



Source: CEIC; RBS

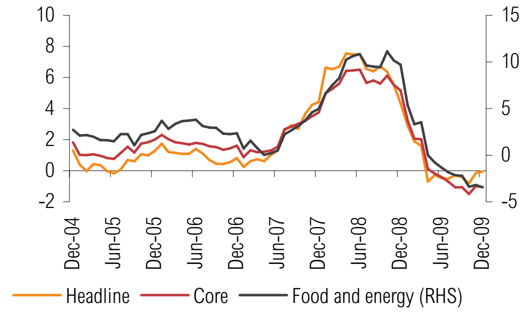
Sequentially, inflation has started to turn up and the MAS may start to tighten modestly from April.

Figure 3: Consumer and manufactured producer price indexes and trimmed inflation (% yoy)



Source: CEIC; RBS

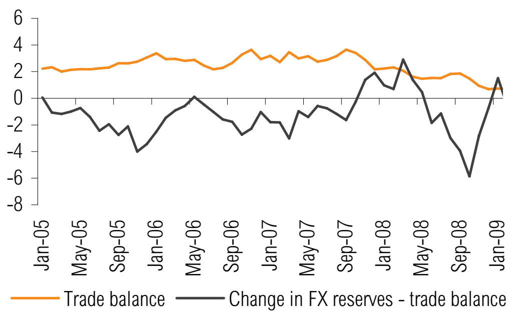
Figure 4: Headline, core, food and energy inflation (% yoy)



Source: CEIC; RBS

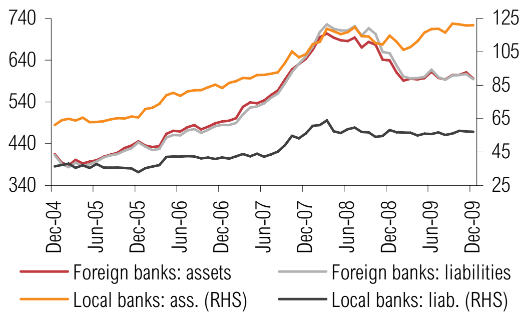
No stress on the external front – MAS has even started to rebuild its forward book.

Figure 5: Balance of trade and other flows (3mma, USD bn)



Source: CEIC; RBS

Figure 6: Bank's FX assets and liabilities (USD bn)



Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Singapore

Credit growth will revive only around mid-2010.

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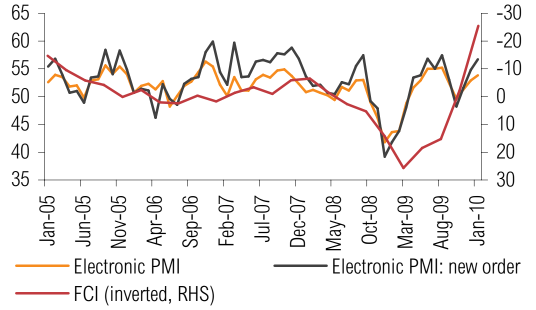
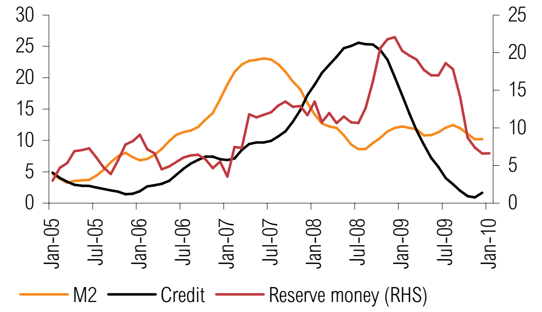
Figure 7: Electronic purchasing manager index & new orders (levels); FCI (%yoy)



Source: CEIC; Bloomberg; RBS

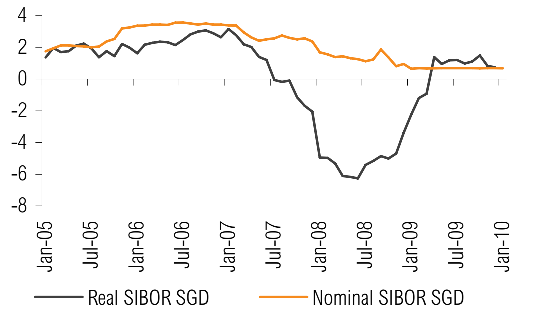
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

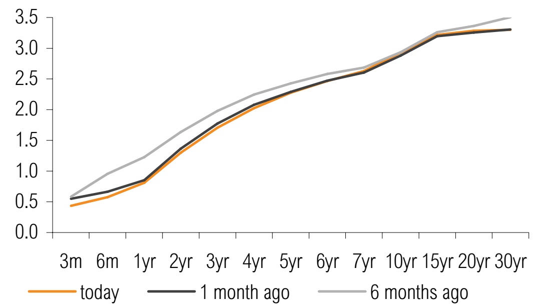
Short term rates have come off as market participants have become more sanguine on the SGD.

Figure 9: Interest rate structure (3 month SIBOR, SGD) (%)



Source: CEIC; Bloomberg; RBS

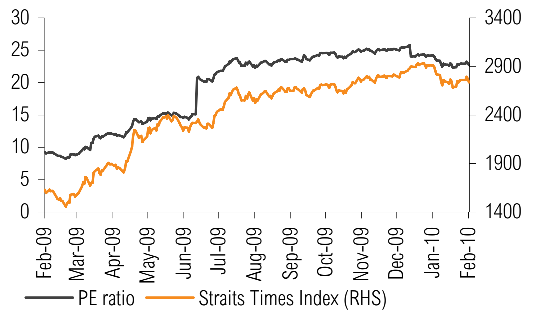
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

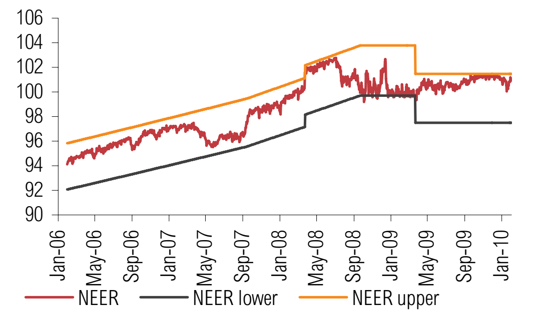
SGD NEER is still in the top half of the policy band.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (October 2007 = 100)



Source: Bloomberg; RBS

Singapore Key Economic Indicators

	2005	2006	2007	2008	2009F	2010F	2011F
Growth (% yoy)							
Real GDP	7.3	8.4	7.8	1.1	-2.3	5.2	5.6
Domestic demand	2.4	7.4	6.0	17.0	-4.4	6.0	2.2
- Private consumption	3.8	4.0	5.2	2.4	-3.0	2.5	4.0
- Government spending	6.7	6.6	2.2	8.1	3.3	5.8	5.0
- Fixed investment	-0.1	13.3	19.2	13.7	-5.9	4.4	6.5
Fixed investment (% GDP)	22.0	23.0	25.4	28.6	27.5	27.3	27.5
Exports	12.3	11.7	8.7	1.3	-11.4	5.6	10.0
Imports	11.2	11.9	8.3	6.1	-12.8	5.9	9.2
Domestic demand contribution to growth	1.8	5.2	4.2	11.7	-3.5	4.7	1.7
Net exports contribution to growth	5.6	3.1	3.6	-10.6	1.2	0.6	3.9
Inflation, FX and interest rates							
CPI inflation (% yoy, end of period)	1.3	0.8	4.4	4.3	0.2	2.6	1.2
CPI inflation (% yoy, period average)	0.5	1.0	2.1	6.5	0.2	1.7	1.8
Property price index (% yoy end of period)	3.9	10.2	31.2	-4.7	-2.9	2.0	8.0
USD/SGD, end-period	1.66	1.54	1.44	1.43	1.38	1.40	1.37
USD/SGD, average	1.67	1.58	1.50	1.41	1.46	1.38	1.38
REER (% end of period)	-0.04	1.54	2.31	4.38	-1.19	-	-
3 month SGD SIBOR (end-year, %)	3.25	3.44	2.38	0.96	0.70	1.50	3.00
10 year bond yield (end-year, %)	3.21	3.05	2.68	2.05	2.50	2.80	4.00
Fiscal accounts (% GDP)							
Central government fiscal balance	0.7	0.0	3.4	-0.9	-3.5	-	-
- Government expenditure	13.9	13.2	12.8	15.4	17.5	-	-
- Government revenue	13.7	13.8	16.0	16.0	13.4	-	-
Primary fiscal balance	-0.2	0.6	3.2	0.6	-4.1	-	-
Government debt (% GDP)	99.4	93.4	93.0	99.2	114.8	-	-
Money and credit (% yoy)							
M2 money supply	6.2	19.4	13.4	9.8	9.8	7.5	12.0
Private sector credit	2.2	6.3	19.9	16.6	2.9	7.5	10.0
% GDP	91.0	88.0	92.8	105.7	111.1	111.8	114.5
Balance of payments (USD bn)							
Merchandise exports	232.7	274.7	303.7	343.3	273.2	312.3	347.2
Merchandise exports (% yoy)	16.8	18.1	10.5	13.1	-20.4	14.3	11.2
Non-oil domestic exports	92.9	100.7	103.1	94.9	83.6	89.4	98.4
Non-oil domestic exports (% yoy)	9.6	8.5	2.3	-7.9	-12.0	7.0	10.0
Merchandise imports	196.3	232.0	256.5	312.6	239.4	271.0	305.2
Merchandise imports (% yoy)	16.4	18.2	10.6	21.9	-23.4	13.2	12.6
Trade balance	36.4	42.8	47.2	30.7	33.7	41.2	42.0
Current account balance	27.5	35.4	39.2	27.0	24.0	29.3	38.1
Current account (% GDP)	22.7	25.4	23.5	14.8	13.9	15.0	18.2
Net FDI	3.2	14.4	7.1	13.8	9.8	14.5	21.7
Capital account balance	-17.7	-21.9	-22.2	-11.2	-19.1	-17.0	-18.1
Overall balance	12.3	17.0	19.4	13.1	4.8	12.3	16.3
Foreign reserves and financial obligations (USD bn)							
FX reserves	116.2	136.3	163.0	176.2	181.0	193.4	209.7
Import coverage (months)	15.5	15.7	17.5	14.2	20.3	19.3	19.1
Local banks FX assets	65.8	83.4	103.6	115.4	-	-	-
Local banks FX debt	32.9	41.9	56.2	58.5	-	-	-
Foreign banks FX assets	570.1	657.9	856.9	905.2	-	-	-
Foreign banks FX debt	445.4	492.9	643.2	643.3	-	-	-
Per capita GDP & unemployment							
Nominal GDP, USD bn	121	139	156	161	173	195	209
GDP per capita, USD	28,351	31,650	34,058	33,245	34,678	38,361	40,169
Nominal wage growth (% yoy)	3.5	3.2	8.0	8.5	1.5	2.8	5.0

Source: CEIC; BIS; RBS

Taiwan

Dominique Dwor-Frecaut, Pin Ru Tan

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/TWD
Q4:09	9.2	-1.2	1.25	32.0
Q1:10	9.0	1.3	1.25	31.8
Q2:10	6.0	0.2	1.25	31.8
Q3:10	5.0	-1.2	1.25	31.5
Q4:10	4.0	-1.4	1.25	31.2
Q1:11	4.0	-0.2	1.38	31.4
Q2:11	4.0	0.9	1.50	31.4
Q3:11	4.0	1.7	1.63	31.3
Q4:11	4.0	2.2	1.75	31.3

Source: RBS

Real economy: Q4 GDP growth accelerated to 16.8% yoy saar from 8% qoq saar in Q3 largely due to faster exports and state enterprise investment growth. Overall, GDP contracted by 1.9% in 2009. Going forward, the fiscal consolidation planned for 2010 could add downside risks to growth. At the same time, Taiwan has the highest ratio of private sector credit to GDP in Asia. This debt overhang will weigh on the domestic demand recovery. In line with the slowing recovery, the headline CPI has been falling mom since August 09 while core has been roughly flat mom since end-08 and falling yoy. Employment has started to recover in Q3 but unemployment remains high at 5.7%, compared with less than 4% before the onset of the crisis. Overall, deflation is likely to continue into H2 2010.

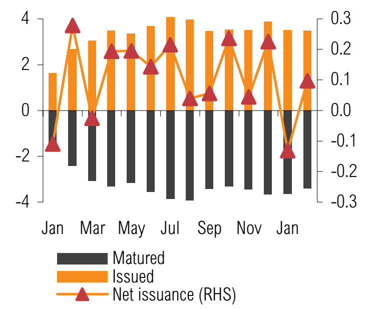
In line with regional and global trends, the increase in FX reserves slowed in Q4. The trade balance is falling since its Q2 peak, largely due to a slower recovery in exports than in imports. The capital and financial account widened in Q4 largely due to larger portfolio outflows and smaller loan inflows, in line with a Q4 09 tightening of regulations on holdings of bank deposits by foreigners could see a moderation of capital inflows. Large investment flows from the mainland, following recent economic agreements, have yet to materialize.

Policy outlook: Banks' excess reserves are still well above their pre-crisis level, though they have fallen substantially relative to their peak. This could reflect the recovery in property prices to close to their pre-crisis peak, supported by a rebound in mortgage lending. Yet Taiwan is still caught in the liquidity trap: the Taylor rule interest rate was -3.0% in Q3 09. At the December policy meeting the CBC indicated it would not start tightening monetary policy until inflation, output and employment had recovered to their pre-crisis levels. It noted the still substantial output gap and uncertainty on domestic and external demand. The CBC track record suggests a rate hike is unlikely to take place until inflation is firmly back into positive territory, sometime in H1 2011.

FX outlook: The long term focus of FX policy is likely to remain competitiveness due to: Taiwan has been losing global market share since 2000; a spike in exporters' bankruptcies in Q4 08 that is translating into a subdued export recovery; limits on fiscal and monetary policy that effectively leave FX policy as the main counter cyclical policy tool. These suggest the CBC will maintain the TWD as one of the regional laggards, likely through USD purchases and strong regulatory intervention. We expect the CBC to maintain the TWD on its long term REER downtrend.

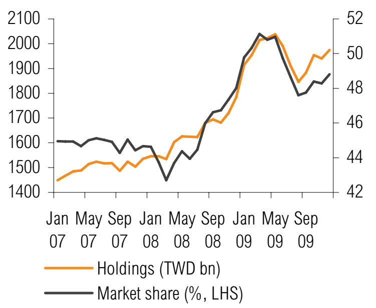
Fixed income analysis

Figure 1. Open market operations (TWD trn)



Source: CEIC, RBS

Figure 2. Banks' holdings of government bonds



Source: CEIC, RBS

Supply: There is a 10y auction left for this quarter before the government announces the size of 5y,10y,20y and 30y auctions, lined up for Q2, in late March. Having issued TWD190bn of bonds in Q1 against a full-year target of TWD520bn, the MoF will likely take advantage of the liquidity in the system to issue more than one-third of the remaining TWD330bn in Q2. In its open market operation (OMO), the CBC has drained TWD100bn from the system in February (Figure 1).

Demand: The 2y and 20y auctions in late January were well-bid with the 2-year auction chalking the lowest yield ever for a government bond issue at 0.10%. Insurance companies took up 8% of the issue in an interesting departure from their usual demand patterns. Local insurers tend to stick to the long-end issues and have historically shown little interest for the 5y, not to mention the very short-end. This goes to emphasise the ample liquidity within the system.

Securities firms significantly bumped up their holdings of government bonds by more than 50% in January although their market share remains small at slightly above 1%. Chunghwa Post, the largest single holder of government bonds, also net increased its bond holdings by TWD12bn in January via exchange and over-the-counter trading.

Demand for bonds in the medium-term, though, is expected to wane. The MoF has proposed to withdraw TWD3.6trn worth of government deposits to support public projects to achieve the dual objectives of lowering government debt and reducing excess market liquidity. The association of banks has given its support for the plan but recommends that the plan be carried out in phases to avoid liquidity shocks to the banks. This is negative news for TWD rates and particularly the local bond market as it will potentially reduce banks' ability to buy government bonds given that the amount is equivalent to 16% of banks' deposits. Banks (and Chunghwa Post) hold TWD2 trn of government bonds in total or almost 50% of market share. There is no firm timeline released but we expect it to occur within the next 3-6 months. Till further confirmation, bond investors will remain unfazed.

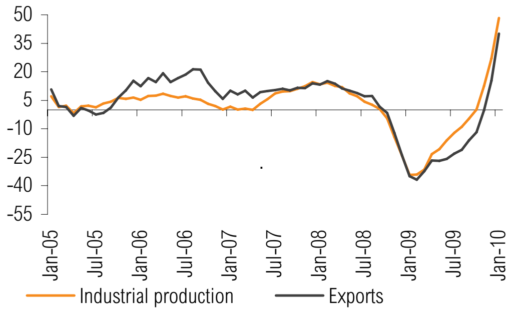
Valuation: Swaps continued to range-trade in February. Yields fell 2bps at the front end, leading to a slight bull-steepening of the curve. Bonds outperformed swaps at the long-end, contrary to January when the outperformance was consistent across the curve. In the near-term, the bond curve has scope to flatten further as long-end issues are still relatively more favored by local FIs.

Strategy: TWD rates remain the least volatile in the region which makes it attractive to receive rates to extract carry gains but until there is greater clarity with regards to the withdrawal of government deposits from banks, we are inclined to stay neutral outright. Instead, we maintain our 1s2s flattener which has recorded16bps in profits. The rate hike expectations priced into the 1y1y has come off significantly from 85bps when we first initiated the trade in late October to 55bps at current. While expectations have become much more reasonable, we prefer to hold the flattener position through the upcoming monetary policy meeting. We also keep our 5y forward 2s5s steepener position as there is scope for the spread to widen further. Moreover, there is no cost incurred in holding the position.

Taiwan

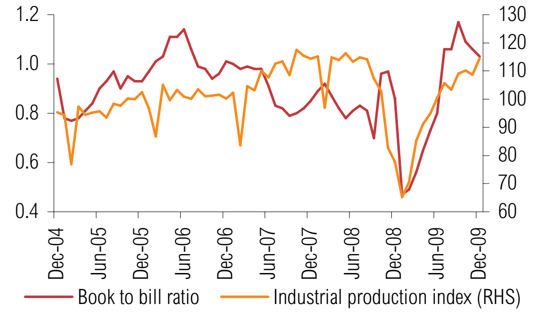
Exports and industrial production have been recovering.

Figure 1: Industrial production and exports (% yoy, 3mrs)



Source: CEIC; RBS

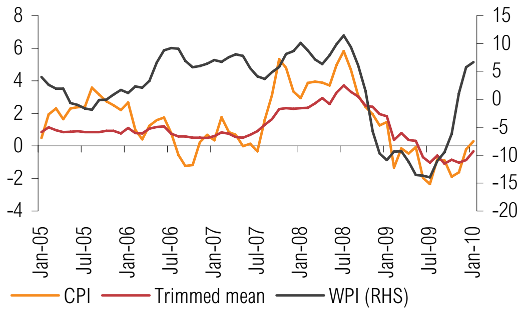
Figure 2: Industrial production index and US semiconductor book to bill ratio (levels)



Source: CEIC; RBS

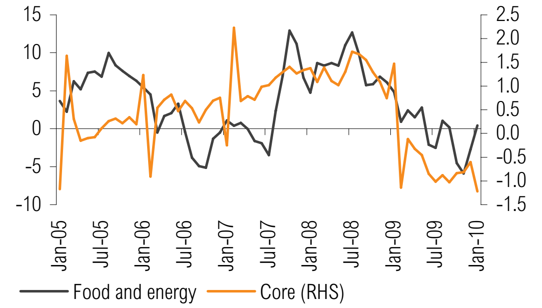
Headline inflation recently, moderately picking up

Figure 3: Consumer and wholesale price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

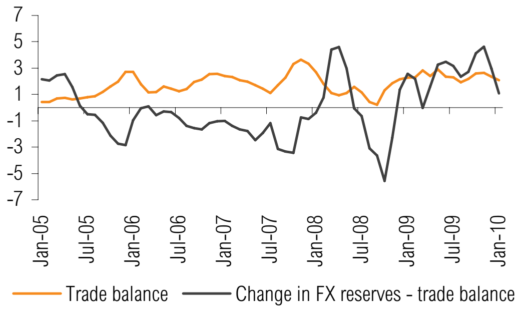
Figure 4: Core and food and energy inflation (% yoy)



Source: CEIC; RBS

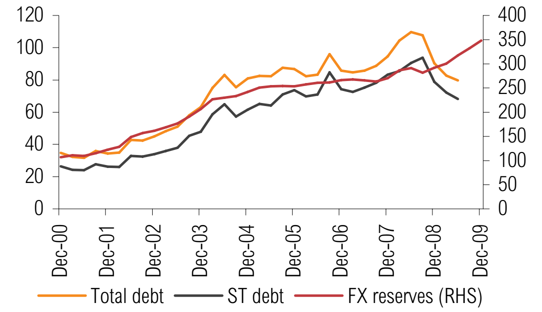
The capital account and the trade balance remain in surplus.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: Total and short-term external debt and FX reserves (USD bn)



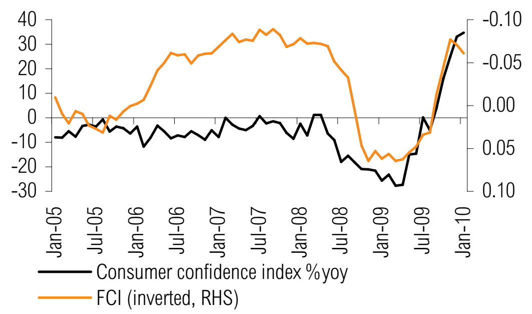
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum; FCI = financial conditions index.

Taiwan

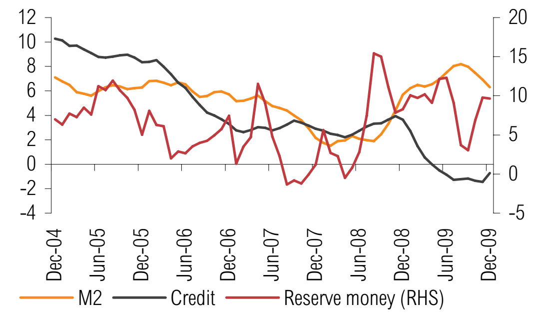
Reserve money growth has accelerated. Credit has stabilized.

Figure 7: Consumer confidence index (%yoy); FCI (%yoy)



Source: CEIC; Bloomberg; RBS

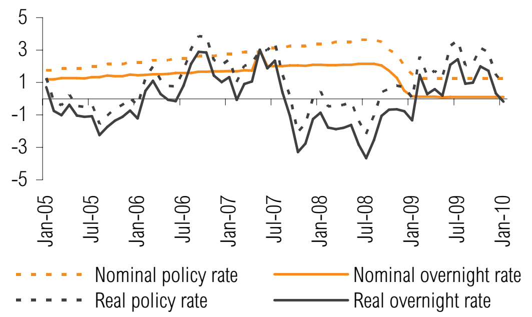
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

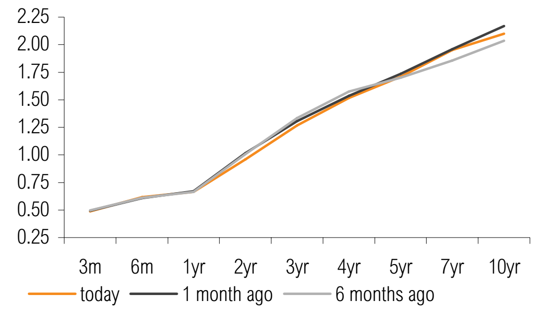
The overnight rate at 10 bp is close to the zero bound. Real overnight rate turned negative in January in line with the modest rise in headline inflation.

Figure 9: Policy rate and overnight rate (%)



Source: Bloomberg; RBS

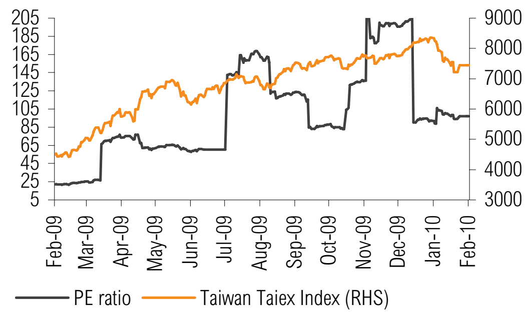
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

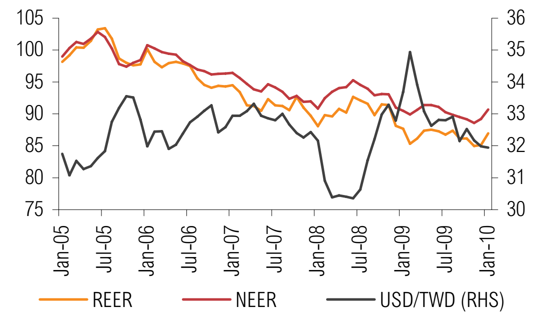
The Taiex index is continuing to recover in line with global indices.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

Taiwan Key Economic Indicators

	2005	2006	2007	2008	2009	2010F	2011F
Growth (% yoy)							
Real GDP	4.2	4.9	5.7	0.1	-1.9	6.4	4.0
Domestic demand	1.7	1.2	2.1	-2.4	-3.8	6.5	3.7
- Private consumption	3.0	1.8	2.6	-0.3	1.5	5.0	4.0
- Government spending	1.1	-0.4	0.8	1.1	1.5	5.0	4.0
- Fixed investment	1.2	0.6	2.4	-10.6	-11.8	5.0	4.0
Fixed investment (% of GDP)	20.1	19.3	18.6	16.7	16.8	16.5	16.5
Exports	7.6	10.4	8.8	0.0	-9.2	6.0	6.0
Imports	3.8	5.2	3.7	-4.0	-13.7	6.0	6.0
Domestic demand contribution to growth	1.5	1.1	1.8	-2.0	-3.3	5.6	3.2
Net exports contribution to growth	2.6	3.8	3.9	2.1	1.5	0.8	0.8
Inflation, FX and interest rates							
CPI inflation (%, end of period)	2.2	0.7	3.3	1.2	-0.2	-0.3	2.4
CPI inflation (%, period average)	2.3	0.6	1.8	3.5	-0.9	-0.4	1.6
Property price index (%, end of period)	1.0	1.0	5.5	5.0	15.0	10.0	5.0
USD/TWD, end-period	33.0	32.6	32.4	32.8	32.1	31.5	31.3
USD/TWD, average	32.2	32.5	32.8	31.5	32.7	31.8	31.2
REER (%, end of period)	0.5	-3.6	-4.8	-1.0			
Policy rate % end of year	2.25	2.75	3.75	1.50	1.25	1.25	1.75
3 month CP rate (end-year, %)	1.53	1.76	2.22	1.10	0.50	0.50	0.90
5 year government bond yield (end-year, %)	1.75	1.94	2.51	1.16	0.90	0.90	1.20
Fiscal accounts (% of GDP)							
General government fiscal balance	-1.7	-0.8	-0.3	-1.8	-5.0	-4.0	-2.0
- Government revenue	18.5	18.1	19.6	19.2	17.0	17.8	18.8
- Government expenditure	20.2	18.9	19.9	21.0	22.0	21.8	20.8
Primary fiscal balance	-0.4	0.5	1.0	-0.6	-4.0	-3.0	-1.0
Government debt	44.9	43.1	41.0	43.3	49.0	53.0	55.0
Money and credit (% yoy eop)							
M2	6.6	5.3	0.9	7.0	7.0	9.0	9.0
Private sector credit	10.4	4.6	4.2	2.2	-2.6	0.0	5.6
Private sector credit (% GDP)	134.0	134.0	132.0	139.0	138.0	137.0	139.0
Balance of payments (USD bn)							
Merchandise exports	198	224	247	255	199	213	223
% yoy	9	13	10	3	-22	7	5
Merchandise imports	181	200	215	237	162	174	182
% yoy	-23	-23	-23	10	-32	7	5
Trade balance	18	23	31	18	37	39	41
Current account balance	16	25	33	25	48	49	51
% of GDP	5	7	9	6	13	12	12
FDI balance	-4	0	-3	-5	-3	-6	-6
Portfolio balance	-3	-19	-40	-12	-8	-15	-30
Other investments	10	-1	5	14	20	10	5
Capital account balance	2	-20	-39	-2	10	-9	-29
Overall balance	18	5	-6	23	58	41	23
FX reserves and debts, USD bn							
FX reserves	253	266	270	300	350	390	413
FX reserves, months of imports	17	16	15	15	26	27	27
FX reserves, % of ST debt	343	358	325	381	538	651	689
Foreign debt	87	85	95	96	116	126	131
Foreign debt (% of GDP)	24	23	25	25	32	31	30
ST FX debt	74	74	83	79	65	60	60
Nominal GDP							
Nominal GDP, USD bn	356	367	385	392	367	400	431
Nominal GDP, TWD bn	11,455	11,918	12,636	12,340	12,004	12,721	13,442
GDP per capita, USD	15,689	16,036	16,761	17,515	16,346	17,788	19,138

Source: BIS; CEIC; RBS

Thailand

Euben Paracuelles, Pin Ru Tan

Macro Economics

Macroeconomic Forecast

	GDP % yoy	CPI % yoy	Policy rate %	USD/THB
Q4:09	5.8	1.9	1.25	33.4
Q1:10	3.5	2.5	1.25	33.0
Q2:10	3.5	2.9	1.25	32.9
Q3:10	3.7	1.6	1.25	32.8
Q4:10	3.8	0.3	1.25	32.5
Q1:11	4.6	1.0	1.75	33.3
Q2:11	4.7	1.7	2.25	33.5
Q3:11	5.0	3.5	3.00	33.8
Q4:11	5.6	4.5	4.00	34.0

Source: RBS

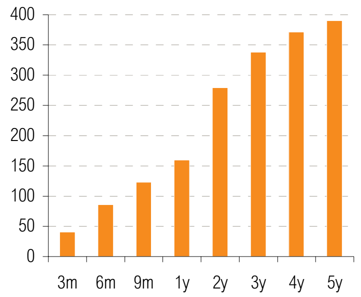
Real economy: We have become more sanguine on Thailand's growth prospects. Business sentiment has picked up remarkably, hitting a four year high of 50.4 and it was also reflected in an upturn in business investment. Also aiding the broader improvement in growth is an upturn in consumer sentiment, both on the back of greater political stability and rising agriculture projects. Political stability, though far from assured on a durable basis, has clearly been benefiting from the fiscal stimulus programme of the government. The government has embarked on a three year public investment programme of USD43bn or 15% of GDP. The implementation of the stimulus programme has become more assured following the Supreme Court's decision to allow some of the disputed projects to proceed. On the external side, exports have started to perk up not only for electronics but also autos and agriculture products. The rise in agriculture products has also given a boost to unit export values thereby mitigating an oil price-induced deterioration in the terms of trade. Finally, visitor arrivals have recovered to multi-year highs. In December 09, visitor arrivals reached 168,000 the highest on record since 2001. This has provided a substantial lift to hotel occupancy rates. The importance of this industry in the Thai context is significant. Overall, we are likely to revisit our 2010 GDP forecast of 3.6%.

Policy outlook: The fiscal stimulus programme implies that the consolidated public sector deficit will rise to 4.5% of GDP for the year ending September 2010 from 3.4% in the preceding year. The stimulus is also expected to lift the public debt ratio from 45% to 60% of GDP following which the government intends to return to a path of balanced budgets. This is unlikely to pressure interest rates as excess liquid assets of banks have been rising aggressively. The main risk to liquidity lies with inflation – in January, both core and headline inflation rose sharply, pretty breaking the long streak of benign readings. Still much would depend on how much steam the current recovery gathers.

FX outlook: The Bank of Thailand (BoT) continued to resist appreciation pressures on the THB. Following a flat December, monthly external reserve accretion returned to around the USD4bn level. Even so, large current account surpluses are making it difficult for the Bank of Thailand to fully neutralise the upward pressure. As growth gathers further momentum on a broadbased basis, we expect that the Bank of Thailand will become less resistant to THB appreciation.

Fixed income analysis

Figure 1: Spread between forward 6m and spot 6m rates



Source: Bloomberg, RBS

Supply: Supply pressure will mount in March. Issuance stands at THB44bn while redemption is low at THB0.5bn. Issuance will be heavy on the 5y-10y sector with THB13bn on the 5y and THB12bn on the 9y. Heavy supply combined with the fact that the belly of the curve has the thinnest investor base will likely put a lot of pressure on the sector. Going forward, we believe the government might spread issuance to the 7y if the 5y yield shoots up on supply concerns.

Demand: The 14y and 5y auctions saw good demand with bid-cover ratio of 2.60 and 2.51 respectively. Demand by lifers and cheap valuation has kept the long-end bonds well-bid. However, near-term demand is unlikely to be as encouraging given the heavy supply.

Valuation: Bonds underperformed swaps during in February especially at the 5y. This was a pull-back from a strong performance in January and was partly due to supply concerns. In the swap space, the front-end flattened as we had earlier expected. 1s2s shrank by 15bp to 75bp at the time of writing compared to 90bp in early January. We expect more correction ahead given that it remains hard to justify the aggressive rate hike scenario priced in the 2y-3y sector of the curve (Figure 1).

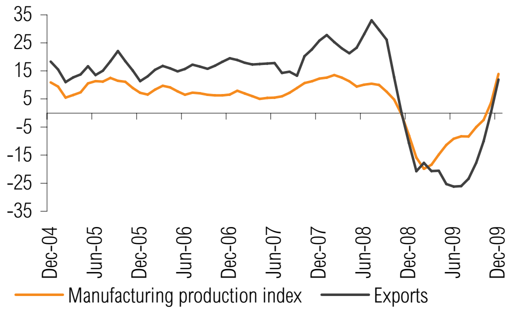
Strategy: We still like receiving the front-end, particularly the 2y-3y segment. Sharp moves were seen in the sector in early February. Yields were pushed up aggressively on higher-than-expected inflation numbers and hawkish comments from the central bank but fell sharply thereafter on global risk aversion sentiment. The yields are still trading lower but mark-to-market risks have been high due to the fluctuations in yields as well as the 6m SOR fixing. We hence initiated a 1s2s curve flattener instead as we believe that any political fallout would lead to a more severe sell-off in THB and spill over into the FX forward space, causing the THB 6m SOR to spike up. On the other hand, if the political situation stabilizes in time, the Bank of Thailand would be in a better position to start hiking rates which are yet to be fully priced into the curve. Investors can pick up net 3m carry gains of 3bps on this trade and we target the spread to tighten to 45bp over 3 months. Separately, we recommended buying THB 5y5y ATM payer funded by selling USD 5y5y payer in late January. We close this trade and take a small loss as the vols been slow to correct.

In the bond space, correction in the ASW has already taken place with the underperformance of the 5y ASW as mentioned above. It is now compelling to go long as the spread is already trading in the positive territory and the 6m SOR is also on the uptrend. The next 5y auction may be a good entry point if the belly sells off ahead of the auction.

Thailand

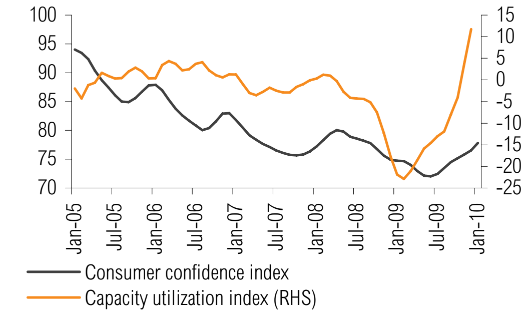
Domestic economic activity is distinctly picking up

Figure 1: Manufacturing production index and exports (% yoy, 3mrs)



Source: CEIC; RBS

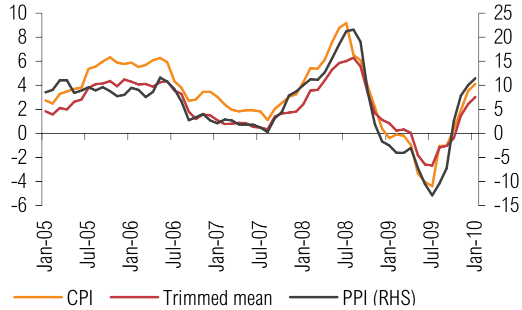
Figure 2: Consumer confidence index (levels) and capacity utilization rate (% yoy, 3mrs)



Source: CEIC; RBS

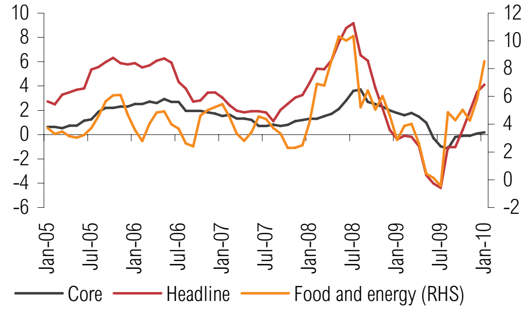
Core inflation remains subdued although headline CPI has already surged.

Figure 3: Consumer and producer price indexes and trimmed mean inflation (% yoy)



Source: CEIC; RBS

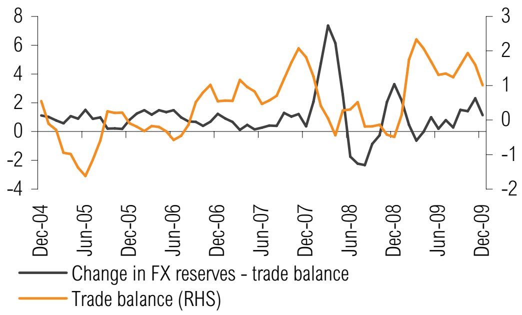
Figure 4: Headline, Core and Food and energy CPI (% yoy)



Source: CEIC; RBS

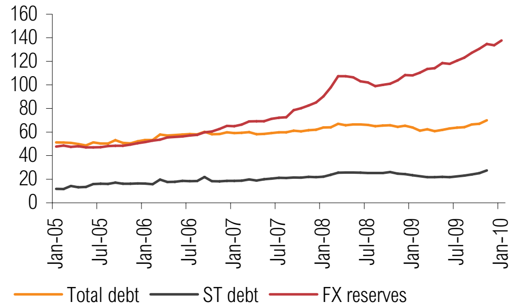
FX reserves buildup is accelerating due to BoT interventions.

Figure 5: Balance of trade and other flows (USD bn, 3mma)



Source: CEIC; RBS

Figure 6: External debt and FX reserves (USD bn)



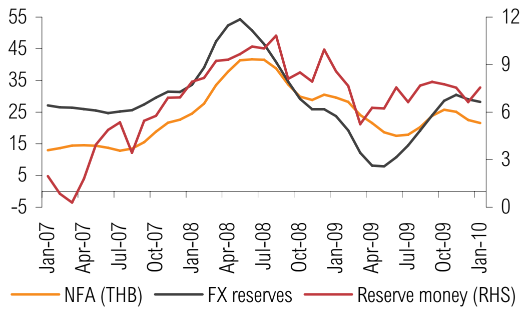
Source: CEIC; RBS

Note: 3mma = 3-month moving average; yoy = year on year; 3mrs = 3-month rolling sum.

Thailand

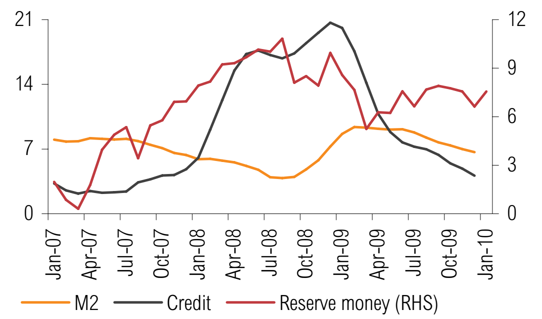
Credit growth has bottomed but domestic liquidity remains flush.

Figure 7: Net foreign assets, FX reserves and reserve money growth (% yoy, 3mrs)



Source: CEIC; RBS

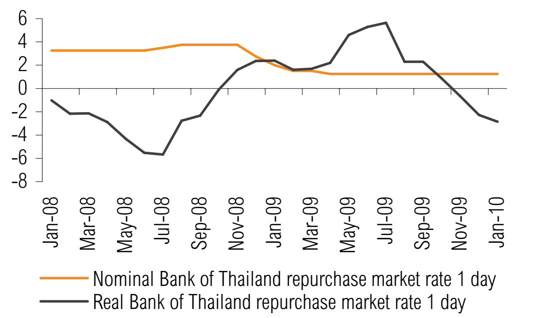
Figure 8: Money and credit growth (% yoy, 3mrs)



Source: CEIC; RBS

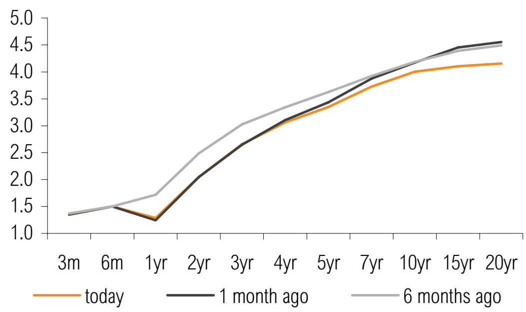
The policy rate may be raised earlier than is being priced in

Figure 9: Policy rate (%)



Source: CEIC; Bloomberg; RBS

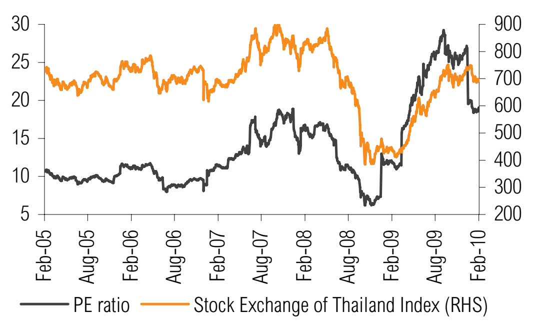
Figure 10: Yield curve (%)



Source: Bloomberg; RBS

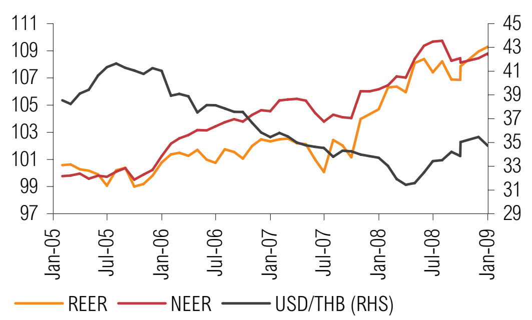
THB appreciation has been supported by record current account surpluses.

Figure 11: Stock exchange index and PE ratio



Source: Bloomberg; RBS

Figure 12: Exchange rates (2005 = 100)



Source: BIS; Bloomberg; RBS

Thailand Key Economic Indicators

	2005	2006	2007	2008	2009	2010 F	2011 F
Growth (% yoy)							
Real GDP	4.5	5.2	4.9	2.6	-2.3	3.6	5.0
Domestic demand	6.7	3.2	2.4	1.9	-6.7	3.8	5.6
Private consumption	4.4	3.0	1.6	2.5	-1.1	2.8	4.5
Government spending	12.2	2.4	9.2	0.5	5.8	6.0	6.0
Fixed investment	11.4	3.9	1.3	1.1	-9.0	5.5	8.0
Fixed investment (% GDP)	23.4	23.1	22.3	22.0	20.5	21.0	21.6
Exports	3.9	8.5	7.1	5.4	-12.7	7.0	10.0
Imports	8.7	2.6	3.5	7.5	-21.8	9.3	12.2
Domestic demand contribution to growth	6.6	2.3	2.7	2.8	-5.7	3.5	4.5
Net exports contribution to growth	-2.1	4.1	2.9	-0.2	3.4	0.1	0.5
Inflation, FX and interest rates							
CPI inflation (% yoy, end of period)	5.8	3.5	3.2	0.4	2.0	0.3	4.5
CPI inflation (% yoy, period average)	4.5	4.6	2.2	5.5	-0.8	1.8	2.7
THB per USD, end-year	41.0	35.5	33.7	36.0	33.4	32.5	34.0
THB per USD, average	40.3	37.6	34.5	33.2	34.1	32.8	33.7
REER (% end of period)	4.0	11.1	1.0	-4.3	2.5	5.6	-
Policy rate (end-year, %)[1]	2.75	5.00	3.22	2.75	1.25	1.25	4.00
3-month interbank rate (end-year, %)	4.4	5.2	3.9	3.1	1.4	1.6	5.5
10 year bond yield (end-year, %)	5.8	5.0	5.1	2.8	4.5	5.0	7.3
Fiscal accounts (% GDP)[2]							
Central government fiscal balance	-0.6	1.1	-1.7	-1.1	-4.9	-4.2	-4.1
Government expenditure	18.0	16.3	19.4	17.6	21.3	20.6	21.1
Government revenue	17.3	17.5	17.7	16.5	16.4	16.4	17.0
Primary fiscal balance	0.6	2.3	-0.7	0.0	-3.7	-2.9	-2.5
Central government debt[3]	25.7	25.1	24.5	23.8	29.7	32.4	34.1
Domestic	22.2	22.7	23.2	23.0	28.1	30.6	32.2
External	3.5	2.5	1.3	0.7	1.6	1.8	1.9
Money and credit (% yoy)							
Broad money supply	6.1	8.2	6.3	9.2	4.3	6.8	7.4
Private sector credit	8.2	3.6	5.1	21.7	2.8	11.9	9.7
% of GDP	78.1	73.3	72.0	80.6	86.5	91.8	93.5
Balance of payments (USD bn)							
Exports of goods and non-factor services	129.5	152.8	180.2	208.6	171.9	178.8	191.3
Export growth (% yoy)	13.6	17.9	17.9	15.8	-17.6	4.0	7.0
Imports of goods and non-factor services	133.0	147.1	163.5	203.7	152.7	166.8	187.1
Import growth (% yoy)	24.0	10.6	11.1	24.6	-25.1	9.3	12.2
Trade balance	-3.5	5.7	16.7	4.9	19.3	12.0	4.2
Current account balance	-7.6	2.2	14.9	1.6	15.8	7.0	2.2
% GDP	-4.3	1.1	6.1	0.6	6.2	2.7	0.7
FDI balance	7.5	8.5	9.4	6.0	1.5	2.0	4.0
Other investments balance	-2.0	-5.9	-5.1	10.7	0.4	-2.0	-3.0
Capital account balance	11.1	6.8	-2.4	14.6	1.3	2.5	4.0
Overall balance	5.4	12.7	17.1	24.7	17.1	9.5	6.2
Foreign Reserves and debts (USD bn)							
FX reserves	52.1	67.0	87.6	111.0	128.1	137.6	143.8
Import coverage (months)	4.7	5.5	6.4	6.5	10.1	9.9	9.2
FX reserves, % ST debt	317.5	361.1	404.5	462.5	474.6	550.5	625.3
Foreign debt	52.0	59.6	61.7	60.0	65.0	63.0	60.0
Foreign debt (% GDP)	29.6	28.7	25.4	21.9	25.5	24.1	20.3
ST FX debt	16.4	18.6	21.7	24.0	27.0	25.0	23.0
Nominal and per capita GDP							
Nominal GDP, USD bn	176.1	208.0	243.0	273.8	255.8	281.4	295.4
Nominal GDP, THB bn	7,096	7,830	8,377	9,103	8,723	9,231	9,940
GDP per capita, USD	2,821	3,313	3,855	4,309	3,994	4,383	4,544

Source: Bank of Thailand; National Economic and Social Development Board; CEIC; RBS

Footnotes:

[1] Through 2006, the policy rate was the 14-day repo rate

[2] Data for central government only on a cash basis

[3] Includes central government, non-financial SOEs and financial institution development fund

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