

MARKET OUTLOOK



May 2010

Policy responses to capital inflows

Net private capital flows to Asia has surged since the second half of 2009, Citi analysts say, as the expansion in global liquidity coupled with Asia's robust fundamentals drove capital flows into the region. While they believe that inflows may slow on less compelling valuations in the interim, risks remain that the region's earlier and sharper economic recovery, stronger growth prospects (balance sheet strength) and widening interest rate differentials could still compel excessive capital inflows to the region.

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Feature

Policy responses to capital inflows

Given that excessive capital Asian inflows could potentially fuel inflation pressures, credit expansion and currency and asset price volatility, the focus now turns to the array of arsenal that policymakers in the region have at their disposal, and of course, the implications of each if utilised.

Potential policy response #1: Central Bank FX Intervention/ Increase FX Reserves

Most countries in Asia already have sizeable precautionary FX reserves. Citi analysts think Korea and Indonesia may still have incentive to increase FX reserves for precautionary purposes given lower reserve coverage vis-à-vis their Asian peers. In Indonesia's case, a lot of the FX reserve accumulation was accompanied by an even higher absolute increase in external debt with growing foreign holdings of government bonds (which could be vulnerable to turn in risk sentiment). Two factors, in Citi analysts' opinion, may hinder aggressive FX intervention: 1) rising inflationary/asset price pressure that would be exacerbated by un-sterilized FX intervention; and 2) rising sterilization costs given that for most countries, local yields are higher than yields earned on FX reserve.

Potential policy response #2: Let currencies adjust

Central bank tolerance to FX appreciation hinges partly on export performance and its importance to the economy. Maintaining export competitiveness is likely to be a bigger issue in Singapore, Malaysia, Korea, Taiwan and even Thailand where external demand is a bigger driver of growth. FX appreciation will also help temper inflation and tighten monetary conditions. More domestic-demand driven economies with relatively high inflation expectations such as India and Indonesia are also likely to see more accommodation toward currency strength.

Potential policy response #3: Keep interest rates low... for as long as "possible"

Accommodative policies in the industrialised world is making it increasingly difficult for Central Banks in Asia to hike policy rates aggressively as widening interest rate differentials would exacerbate capital inflows, further complicating liquidity and exchange rate management. Citi analysts as such believe that as long as inflation and asset prices (which can be addressed through regulatory measures) and financial imbalances via leverage are not yet a significant issue, policymakers are likely to opt to hike rates only gradually.

Potential policy response #4: Regulatory measures to control asset prices (especially property)

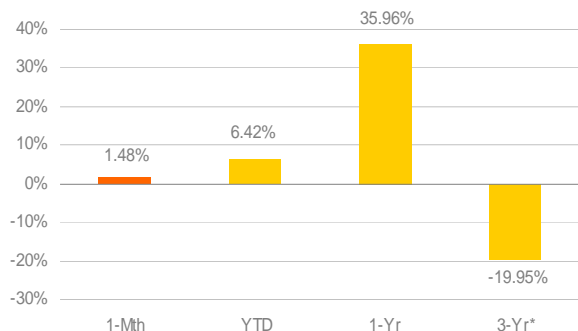
The sharp rise in real estate valuations in some Asian markets has raised concerns, especially since prices have risen far sharper than income. Five property markets have come to the attention of policymakers – China, Hong Kong, Singapore, Korea, and more recently, Taiwan. Recent property measures and tough rhetoric appear to be now concentrated in Greater China and Singapore. Ironically, the more China tightens domestic property regulations, the greater the risk it ends up exporting liquidity to other property markets around the region. Citi analysts believe that the risk of a sharp property price correction amid a brewing bubble has risen, though they do not expect any imminent collapse just yet. In fact, expected renminbi revaluation alongside tighter property regulations could fuel even further upside risks to Hong Kong properties where measures are far less stringent. They expect to see more property regulatory risks going forward in these four "hot" markets.

Potential policy response #5: Capital Flow Regulations – Discourage inflows, encourage outflows

While Citi analysts do not expect punitive capital controls in Asia – at least not this year – they believe that the risk is likely to rise in subsequent years. They note that aside from Taiwan which last year banned foreign institutional investors (FINI) from placing funds in time deposits, and put a 30% limit on their portfolio towards fixed income instruments, there appears to be little overt efforts at capital inflow restrictions elsewhere in the region. It seems that some policymakers may be opting to slow down liberalisation rather than impose capital controls. Meanwhile, a number of countries have taken decisive steps to encourage capital outflows, but the impact on liquidity and FX looks limited. Citi analysts observe that many countries are increasing the overseas investment quotas for major local institutional investors, e.g., Malaysia's Employment Provident Fund and Korea's National Pension Service, and expect Taiwan to eventually increase the overseas investment quota (currently at 40%) for life insurance companies. However, as long as fundamentals in the region look strong, incremental capital outflow measures will likely be offset by continued inflows, and to some extent, countries may be partly just shifting liquidity among each other.

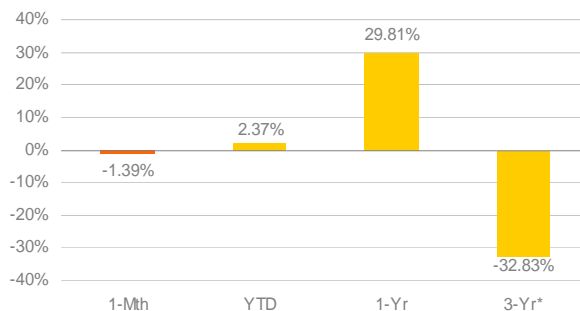
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 April 2010
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 30 April 2010
Source: Bloomberg

United States

Increasing signs of a sustainable upturn

- Despite lingering obstacles to a powerful recovery, strengthening final demand and re-energized financial conditions point increasingly to a sustainable upturn, Citi analysts say. Strong corporate earnings have prompted new hiring in many industries and renewed gains in labour income are supplanting fading government supports.
- The Federal Reserve's (Fed) efforts to loosen credit and aid market functioning have substantially slowed financial headwinds impeding recovery. However, actively exiting from maximum monetary easing is likely to require compelling proof that recovery is self-sustaining and that key financial roadblocks are cleared. Initial interest rate hikes are not expected until 4Q09, with reserve-draining just ahead of that.
- Inflation is slowing to near 1%, reflecting the sharp relative decline in housing costs and substantial economic slack, according to Citi analysts. Limited private credit demand is expected to mute upward cyclical pressures on interest rates. However, the lack of a fiscal exit strategy amid an eroding long-run deficit outlook poses a threat of crowding out pressures as recovery matures.
- Nevertheless, Citi's recent institutional investor survey underscores a changing mindset within the investment community. Optimism is beginning to overtake the prevalent scepticism seen in last year's and January 2010's responses. About 85% of investors think an economic double dip is unlikely.
- Separately, although retailing stocks have rallied strongly this year, up almost two times the S&P 500's gain year-to-date, concerns have arisen in regards to the sector's potential trading trends in the next year, ranging from fundamentals, to earnings revision momentum and valuation.

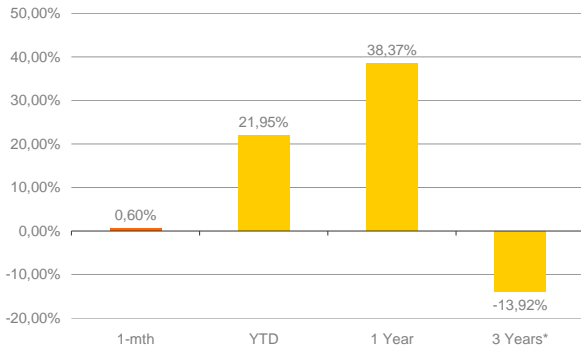
Euro-Area

Anticipating a modest recovery in GDP

- With an upbeat outlook for global demand and a somewhat weakened EUR, increasing exports are likely to support overall GDP growth, according to Citi analysts. In addition, a recovery in capital expenditures and an improvement in private consumption are likely to offset the expected negative contribution of tighter fiscal policy on GDP.
- Meanwhile, a €110bn financial lifeline by the other euro-area countries and the International Monetary Fund (IMF) was recently made available to Greece for the next three years. In contrast to European Union (EU) officials, Citi analysts doubt that this package will be sufficient to stop the contagion of the crisis to other countries – which has already started.
- Should there be a further escalation to the funding situation of other euro-area countries, Citi analysts would expect additional Greek-style support packages. Furthermore, they believe the European Central Bank (ECB) could also likely amend its collateral rules and also re-introduce unlimited access to the 3M Long-term Refinancing Operations (LTROs). But given the outlook for weak growth and inflation in the coming years, rate hikes are only expected to commence in 2011.
- Despite macro concerns over fiscal deficits and exit strategies, European equities posted decent returns in 1Q10. Going forward, strengthening recovery and positive operational leverage may drive a robust rebound in corporate earnings. Citi analysts are expecting 2010 & 2011 European earnings growth of 20%+.
- However, Citi analysts feel that there may be better structural growth opportunities in emerging markets and better cyclical growth opportunities in the US than those offered by exposure to the domestic economy. Thus they continue to prefer companies with international exposure.

Equity markets

Chart 3:
MSCI Asia Pacific



*Denotes cumulative performance
Performance data as of 30 April 2010
Source: Bloomberg

Japan

Bank of Japan likely to keep policy rates on hold through 1H11

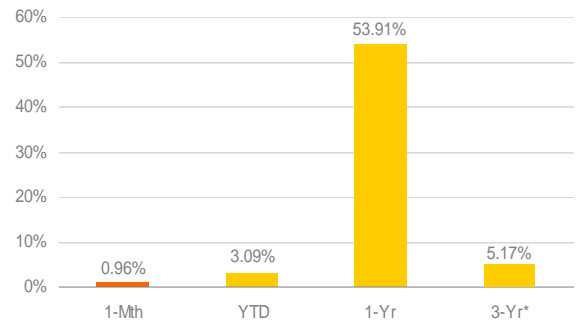
- The economy may continue to grow at a pace above the potential growth rate in quarters to come, under a combination of a continued uptrend in exports, a pickup in business and housing investment and a modest improvement in labour conditions. In Citi's view, the cyclical mechanism in which export growth drives activity could remain intact in 2010, thanks to the resilience in other Asian economies.
- Meanwhile, companies appear to remain cautious about increasing personnel costs and this is likely to limit a spillover to household income but may push up corporate profits strongly this year.
- Citi analysts expect the Bank of Japan (BOJ) to maintain the current policy rates until late-2011.

Asia Pacific

Excess liquidity continues to decelerate, undermining rally sustainability

- Asia's recovery is broadening, with sustained final demand recovery in the US and domestic demand revival in the region, according to Citi analysts.
- Meanwhile, inflation has recently almost unanimously surprised on the downside. Citi analysts think subdued demand in advanced economies has inadvertently slowed the inflationary upturn in Asia, allowing Asian policymakers to be less aggressive in unwinding its very accommodative policies.
- In particular, Citi analysts favour the North Asian markets of Hong Kong, Korea and Taiwan. Sector-wise, they believe that banks have an inevitable role in all economic recoveries. At the same time, valuations look attractive.

Chart 4:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 30 April 2010
Source: Bloomberg

Emerging Markets

Rate hikes may be barely visible in CEEMEA

- While other Emerging Markets may continue to normalise monetary conditions through policy rate hikes in the coming months, hikes may be barely visible in CEEMEA¹, where in many cases rates are still high in the wake of the crisis-related need for monetary tightening in 2009. The biggest hike this year could come through in Turkey, where rates remain unsustainably low, in Citi's view.
- Latin America's recovery appears on track and Citi analysts believe that rising inflation, higher inflation expectations and smaller output gaps should prompt most of the tightening cycle in the region.
- Most Latin American currencies are likely to continue benefiting from the global recovery, commodity prices and capital inflows in the short term. In CEEMEA, Citi still forecasts currency appreciation (particularly South African Rand (ZAR) and Polish Zloty (PLN)), despite the ongoing concerns in the Eurozone periphery.
- Citi analysts believe 2010 is likely to be a year of more modest gains in MSCI Latin America as markets wait for corporate earnings to catch up to the high valuations at end-2009. They are overweight Brazil and Mexico.
- Despite a number of global concerns, Citi analysts remain positive on CEEMEA over the medium term given that economic data has been beating expectations, earnings forecasts have been rising and valuations remain undemanding although they acknowledge a potential higher vulnerability in the near term to the Sovereign credit crisis in the Euro Area. They are overweight Russia.

1. CEEMEA is the collective term for Central and Eastern Europe, Middle East and Africa.

Bond markets

High-grade corporate debt expected to outperform

US Treasuries

Citi analysts expect interest rates to be range-bound with tighter monetary measures beginning in the second half of the year, boosting term premiums.

US Corporates

While further narrowing is likely to be modest given that spreads are approaching long-term equilibrium levels, Citi analysts continue to expect corporate debt to outperform other high-grade sectors. Meanwhile, High yield spreads are anticipated to continue grinding tighter over time as positive technical factors and improving fundamentals support performance.

Euro Bonds

Fiscal burdens in peripheral Euro zone nations present key risks to higher rates in Germany. In the UK, Citi analysts favour short duration exposure as outsized fiscal burdens and inflation pressures dampen performance prospects.

Emerging Market Debt

Citi analysts are constructive on Asia and Latin America credits as improved liquidity and risk appetite persist.

General Disclosure

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Chart 5:
Currencies (vs USD on 1 month)



*Denotes cumulative performance
Performance data as of 31 March 2010
Source: Bloomberg

Currencies

- The USD rally is likely to persist, sustained by US asset market and economic out performance, according to Citi analysts. Contrary to conventional wisdom, Fed tightening could be a potential roadblock later this year, with higher rates hurting the USD if they hit US equities.
- In the near term, the difficulties of the European regulators to convince markets of their capacity to solve the sovereign credit crisis could lead the Euro to test the 1,25 USD level.
- Citi analysts expect the Japanese Yen to broadly follow the trend of the US dollar. They estimate that with both Government and Central Bank more confident of the economic outlook, new policy initiatives are unlikely for now meaning that recent attempts to drive the JPY weaker are unlikely to continue.
- Over 6-12 months, Citi analysts forecast EUR at 1.30, GBP at 1.48 and JPY at 93.
- In CEEMEA, Citi analysts' forecasts still assume short and medium term appreciation generally, despite the ongoing concerns in the Eurozone periphery. We expect ZAR to outperform short term. PLN should outperform CEEMEA peers in the medium term.