Asian rafts in a Money tsunami

Asia Quarterly Macro Strategy

Pranay Gupta
Chief Investment Officer – Asia

SUMMARY VIEW

- The Fed and BoJ are goading the ECB and Germany into policy accommodation. Despite modest monetary easing, however, the ECB will not be able to match easing efforts of other central banks due to German intransigence ahead of its federal elections in September.
- China will remain on sidelines in the ongoing global easing efforts as it is worried about the distorting effect of economic model based on control. It could intervene periodically, but it will not return to the era of aggressive FX intervention and higher required reserves.
- With Germany and China not budging much from their current stances, inflows will continue to head into EM economies with good medium-term growth prospects and open financial markets. In this scenario, ASEAN-4 economies will continue to outperform, albeit with increasing bubble risk.
- Business cycle in the US, Japan, and ASEAN-4 economies remain positive. For the world as a whole, however, low growth and high liquidity environment will persist into H2 this year, and as this is the status quo, we are not materially changing our outlook on key economies. We are growing more confident about Japan's chances and more bearish on the Eurozone's growth prospect.
- Political risks will be significant in Europe. Malaysian election is difficult to predict at this point, and the ruling coalition's loss could trigger market sell-off. German federal election in September will be a key positive catalyst as the Eurozone's policy direction will be clearer afterwards.

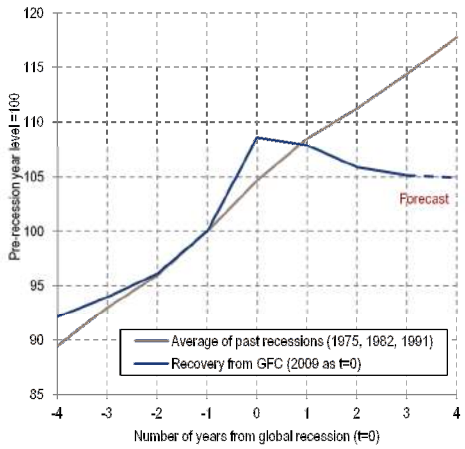
SUMMARY OF RECOMMENDATIONS

- We are overweight equities in the US, Japan, China, India, and Thailand as we like their combinations of business cycles and policy. We remain bearish on European equities.
- We are overweight EM credit and neutral on DM credit. We are cautious on Chinese names, however. For sovereigns, we are underweight.
- In FX, we prefer INR and CNY, and USD. We remain bearish on JPY and EUR.
- We are bearish on industrial commodities, but we believe that gold deserves a place in a portfolio.

Global growth still a captive to austerity

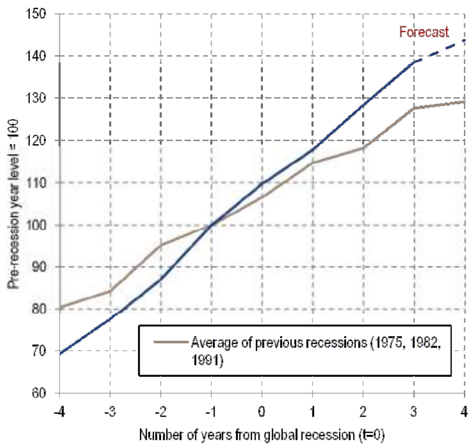
DEVELOPED ECONOMIES GOING ALL-IN ON AUSTERITY…

Real primary government expenditure during recession episodes



…WHILE EMERGING ECONOMIES MAINTAIN SPENDING

Real primary government expenditure during recession episodes



Note: Country classification follows the IMF's
Source: IMF

NORMALIZATION OF BUSINESS CYCLE IMPEDED BY AUSTERITY

(1) Global business cycle still a captive to very inopportune and counter-productive austerity programs in developed economies

A recent IMF analysis shows that developed market (DM) economies have begun aggressively cutting back their government expenditures only a year after the start of their recovery from the Global Financial Crisis (GFC) of 2008, which stands in a stark contrast to past episodes that can be described as 'global recessions.' The resulting fiscal drag has been the main reason why the global economy brushed so closely with recession.

(2) Bulk of fiscal support for the global economy shouldered by emerging economies

Emerging market (EM) economies, on the other hand, have more or less maintained their government expenditures since the GFC. In fact, their fiscal stances have been moderately more expansionary compared to past global recession episodes. This reflects these economies' political need to shore up growth against the backdrop of secular slowdown in key markets in DM.

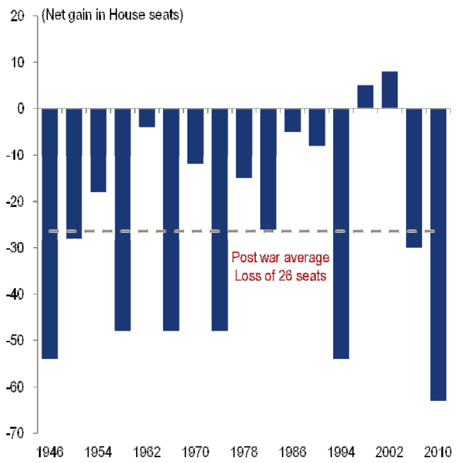
(3) Normalization of business cycle to require DM economies' fiscal policy shift

Most emerging economies are still tightly wedded to the global cycle (with only few exceptions like ASEAN-4, Turkey, and Mexico). Thus, DM economies' stance on fiscal austerity will continue to dictate the near-term path of global growth.

Fed to extend QE purchases into 2014 due to lingering gridlock

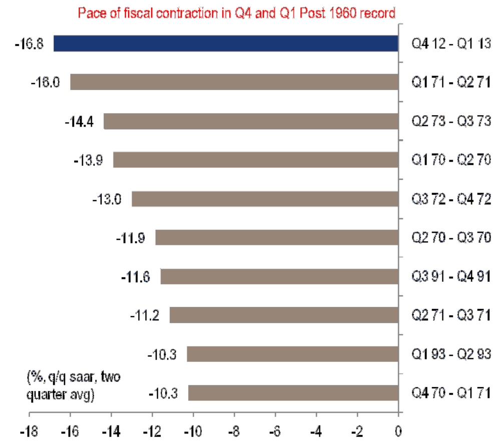
REASON FOR THE CONGRESSIONAL GOP NOT TO BUDGE

Change in House seats for president's party in US mid-terms



FISCAL DRAG TO KEEP THE FED CONCERNED

Largest government spending contraction (2 quarters) since 1960



Source: New York Times (left), Bloomberg (right)

QE PURCHASES WILL CONTINUE INTO 2014

(1) Political gridlock to persist as mid-term elections approach

Domestic politics will keep fiscal uncertainties elevated indefinitely. Republicans will probably retain their control of the House, and they will continue to rely on periodic budget deadlines as a way to extract concessions from the Obama administration. Even if crisis does not occur, markets could be periodically surprised on the downside by partisan wrangling in Washington.

(2) Fed to waver on QE-exit talk due to large fiscal drag, economic soft patch, and Europe

The US economy has been taking fiscal shocks in stride thanks to households' re-leveraging and strong housing cycle, but the picture could be less assuring in Q2 when the negative lagged impact of historic contraction in federal spending become stronger and global cycle undergoes a more uncertain patch. After the Cyprus debacle, the Eurozone's dormant crises are surfacing again, starting with Slovenia that could request bailout from the Eurogroup as early as this month. This is the reason why the Fed appeared to adopt a more data-based guidance on QE in recent weeks. Bernanke is someone who has spent his entire academic life criticizing the BoJ's puzzling passivity during the 1990s. He will not let the same paralysis be the mark of his stewardship of the Fed.

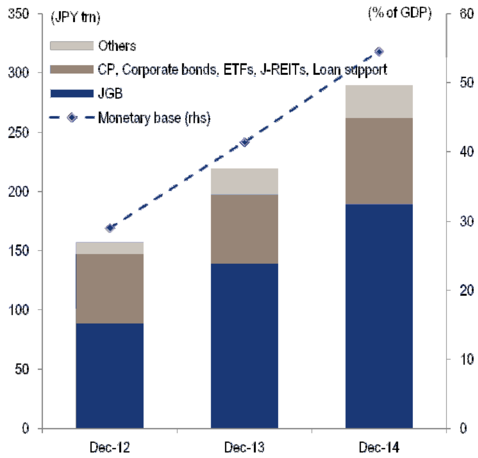
(3) Impact of potential leadership transition at the Fed in 2014 to be limited

Bernanke will likely be replaced by the presumptive favorite Janet Yellen in 2014. We believe that the Senate confirmation hearing will be somewhat contentious, but the symbolism of the first female FRB Chairman will work to the advantage of Yellen. It is difficult to imagine Republicans blocking her nomination given the importance of the Fed's policy at this juncture and political capital they need for other fiscal fights. The membership of the FOMC could become slightly more hawkish with changes in rotating seats, but we believe that doves will maintain an upper hand in policy debates as long as global macro drop remains uncertain. It is also important to note that the Fed is not particularly keen to trigger a multiyear bull-run in USD by visibly tightening its monetary policy.

Kuroda's BoJ joins the global QE race

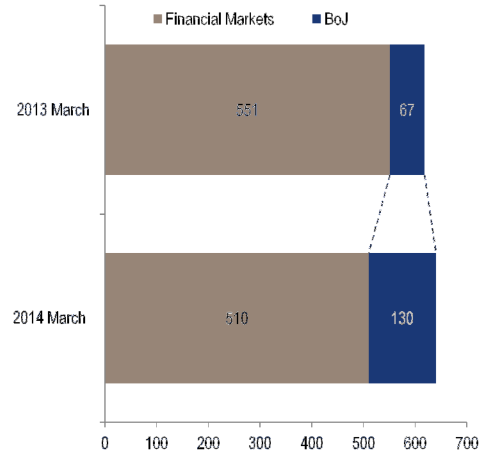
BOJ TO BE ON QE BINGE…

Expected composition of BoJ asset holdings in 2013 and 2014



…PUSHING JGB HOLDERS INTO OTHER MARKETS

Share of JGB holdings between BoJ and financial market



* Figures excluding government bonds of 1 year duration or less, and in stock figures (i.e. net of run-offs)
* Units in JPY trn

Source: IMF (left), Deutsche Bank (right)

BOJ TO PUSH DOMESTIC INVESTORS OUT TO OVERSEAS MARKETS

(1) BoJ purchase of JGBs to increase materially

BoJ has set itself an ambitious inflation target (2% within 2 years), and to this end, it is aiming to boost its asset holdings to nearly 60% of GDP by the end of 2014. With the new monetary policy framework that removed most obstacles to extending the maturity of its JGB holdings, the bank will add onto its balance sheet, in next 12 months, the amount of JGB nearly four times the government's expected net issuance during the same period.

(2) Quantitative and qualitative easing (QQE) will push domestic investors into other assets

The exceptional scale of the BoJ's asset purchases means that the much doubted 'portfolio balance' impact of the bank's easing program could be substantial this time. In the JGB space, the bank will double its JGB holdings, but the financial market's holding will probably contract a bit from current JPY 551 trillion to 510 trillion. Private investors, especially life insurers and pension funds, will be pushed into buying assets other than JGBs.

(3) Institutional and retail investors to drive JPY lower and overseas assets higher

The liquidity spill-over will also affect overseas financial markets as Japanese investors are rather active yield chasers. We see JPY weakening to 100 and 110 and staying in that range for a while. Bearish outlook on JPY will encourage Toshin funds to start investing aggressively in high yielding currencies in EM markets such as Latin America and EMEA. EM Asia, the market these investors have been rather timid about, will probably benefit on the margin as well.

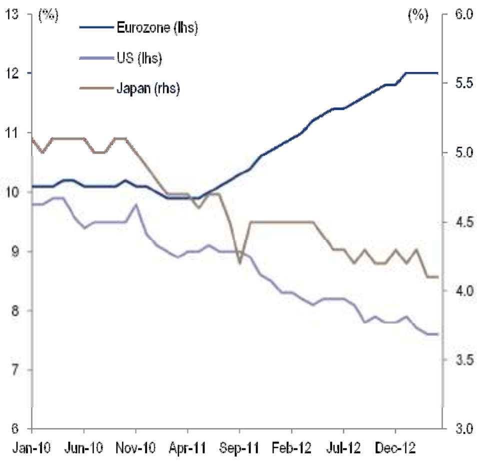
...leaving ECB looking more and more like an odd man out

DRAINING, NOT INJECTING, LIQUIDITY...

Central bank balance sheets since January 2010

...WHILE UNEMPLOYMENT IS RISING EVEN HIGHER

Unemployment rate (sa)



Source: Bloomberg (left), CEIC (right)

ECB WILL START EASING AGAIN, ALBEIT CAUTIOUSLY

(1) ECB finds itself significantly out of sync with its global peers due to its recent inaction

After a few months of lackadaisical management of early LTRO repayments, the ECB inadvertently (?) withdrew nearly 16% of liquidity from the banking system while the other two central banks, the Fed and the BoJ, began ramping up their QE purchases. If the bank does not address this problem with new policy initiatives, the bank could end up spending most of 2013 draining liquidity from the system instead of injecting it.

(2) Economic and political needs will force the ECB to act

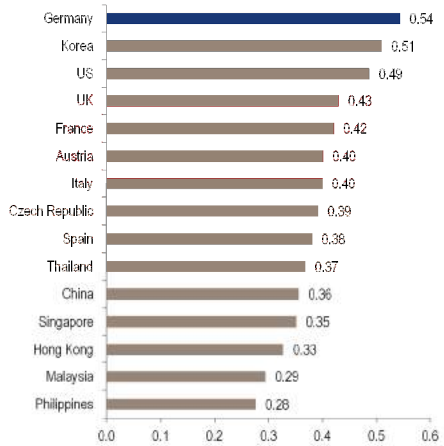
The across-the-board deterioration in recent macro data, relative strength of Euro, and peripheral countries' increasing frustration with the ECB's inaction will likely prompt a rate cut or even a new version of LTRO scheme in next few months. In recent policy meetings, the ECB has been stressing their displeasure with stubborn bifurcation problem in the lending channel, thus hinting at a corrective action in the near-term. Certainly, the easiest way to go about this would be a rate cut. Due to rate corridor framework and fundamental doubts about monetary transmission mechanism (sovereign yields in periphery), however, a cut larger than 25 bp is difficult to imagine.

(3) Due to German political calendar, no additional institutional innovation is expected.

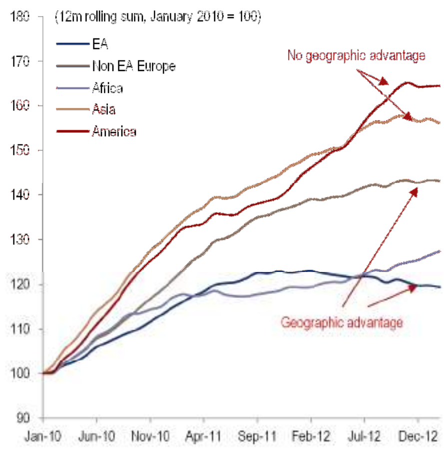
The European discussion on banking union, in which the ECB plays an important part, will not see any significant progress until Germany wraps up its upcoming federal elections in September. Thus, the fundamental risk of Cyprus-inspired bank run in the periphery will remain in place for most of the remaining year. The Cyprus episode also highlighted the key flaw in the ELA mechanism as the bank had to wait for Troika negotiations and deposit bail-in decisions before supplying liquidity to the country's banking sector. Recent compression in yield reduces the chance of OMT activation in the near-term, but in our view the seeming improvement in credit market bifurcation is merely a production of lowered-expectations: peripheral yields are still too high compared to yields in core economies such as Germany and France.

Japan's reflation efforts to make Germany very uncomfortable

GERMANY FIRMLY IN JAPAN'S CROSSHAIRS
Japan's export similarity index (1 = identical export structure)



ASIA & AMERICA: KEY GROWTH MARKETS FOR GERMANY
Germany's exports to key regions since January 2010



Source: IMF (left), CEIC (right)

JAPAN'S STRATEGY WILL MAKE GERMANY VERY UNCOMFORTABLE

(1) Japan's rise spells a more rough road ahead for German exporters.

Japan is Germany's biggest export competitor as both countries share core industrial bases in auto, machinery, and other high-end manufacturing components. While Germany has natural geographic advantage over Japan in Europe, it does not have similar advantage in faster growing markets in America and Asia. If JPY weakness is a multiyear phenomenon, German exporters will find it progressively more difficult to compete on a level playing field.

(2) This could be a positive development because it motivates more lenient policy in Europe.

The crux of German strategy is to force the peripheral economies to adjust their wages so that they can be more self-reliant in terms of financing. Some of this has already happened as many peripheral economies dramatically narrowed their current account deficits last year. However, the outcome was perversely beneficial to Germany because the economic and sociopolitical difficulty of that adjustment process raised tail risks in the Eurozone, thus lowering the value of Euro far below what was appropriate for Germany's relatively low debt, large surplus economy. Japan's reflation strategy changes the calculus. (1) If the Eurogroup successfully averts dormant crisis from materializing before its federal elections, then the resulting rise in Euro and yield compression will render peripheral economies more uncompetitive again while reducing the urgency of reforms (i.e. Spain's avoidance of OMT so far). (2) If a crisis erupts despite the Eurogroup's efforts to maintain stability, then the BoJ will have to be even more aggressive to keep JPY from strengthening, which will, in turn, prompt other central banks to follow suit and leave the ECB in complete isolation. In that scenario, the risk of bank runs or euro exit (Greece and Cyprus in particular) will require major leaps in fiscal or banking union discussions. Either way, Japan will likely force Germany to rethink its crisis management.

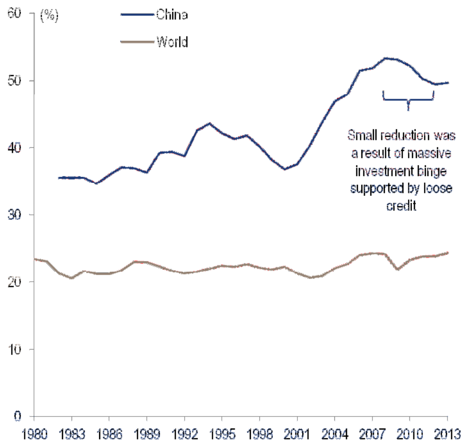
(3) The problem is that such a shift in policy will not occur in the near-term.

The Cyprus debacle was a reminder that domestic politics in Germany will continue to be a hurdle for the Eurozone's efforts in crisis management. Given the moralizing tendencies of campaign rhetoric in the country, we do not expect to see a noteworthy shift in Germany's strategy until the end of the year. It policy will remain more reactive than proactive in nature.

China to remain on sidelines due to difficult policy transition

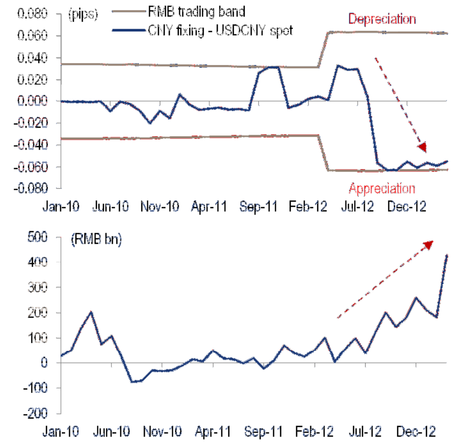
GROSS NATIONAL SAVING RATE STILL EXTREMELY HIGH

Gross national savings as % of GDP since 1980



TOLEREANCE OF STRONGER RMB AND MISALLOCATION

CNY trading band trends (top) and trust loans (bottom)



Source: IMF (left), Bloomberg (right)

AGONY OVER MEDIUM-TERM POLICY MEANS INACTION IN BEIJING ON QE

(1) Beijing's preference for muddle-through means 8% growth in 2013.

After a brush with political instability last year, China's new leadership team will likely focus on economic stability than reforms for a few years. The idea is to manage a multiyear soft-landing of the economy through stimulus and gradual reforms while the political standing of the leadership becomes more secure. This means that some of the well-known economic excesses can be tolerated as long as risk and reward balance is acceptable. Growth is important to labor market stability and thus income expectations of the urban middle class households, the key political constituency of the Communist Party of China. For this reason, we believe that the government will use policy tools to defend a 'genuine' 8% growth this year, in spite of its aggressive policy announcements on credit and real estate markets. The fact that the government is targeting larger fiscal deficit (2% of GDP) and tolerating liquidity growth in excess of its stated target supports this view.

(2) Strains of this approach will become more apparent in coming years.

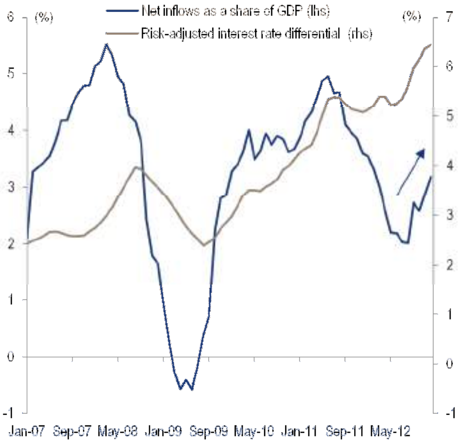
The government's focus on stability is positive for the economy's near-term cyclical path, but the choice increases long-term risks by exacerbating fundamental economic distortions within the country. With so much domestic money eager on speculative opportunities (excess capacity means lack of appeal in capex) and market institutions vulnerable to massive misallocation, any aggressive loosening of policy to address the current cyclical weakness could quicken the onset of a major crisis in the country.

(3) Clash of counter-cyclical policy and medium-term reform needs mean inaction on FX

Recent rhetoric from Beijing indicates that new leaders are acutely aware of the policy dilemma and remain biased to accelerating reforms at some point in the future. This leads us to conclude that they are not too keen on undermining the ongoing liberalization efforts with heavy FX intervention, which creates all kinds of distortions for the banking sector (reserve requirements, interest rate control, etc). As a result, we expect China to remain mostly on sidelines in the ongoing QE race among major economies.

Conclusion: EM Asia still caught in the middle of money tsunami

RE-INTENSIFYING SEARCH FOR YIELD IN EM MARKETS
Net inflows as % of GDP and risk-adjusted interest differential



BOND MARKETS LOOKING MORE AND MORE BUBBLY
10 year government bond yield in Philippines, Italy, and Korea

Source: IMF (left), Bloomberg (right)

SOUTH EXPOSED TO HOT MONEY, NORTH COPING WITH WEAK EXPORTS

(1) With largest capital exporters not budging, EM Asia remains exposed to inflow issues.

As we explained earlier, the world's two largest capital exporters (Germany and China) are unlikely to change their economic policies in the near-term. Thus, they will keep exporting capital to other economies. Along with aggressive balance expansion by major central banks, this reality means the continuation of inflow problems for the most open and fast growing segment of EM Asia. In this regards, ASEAN-4 first comes to mind. Due to their unique monetary policy framework, Singapore and Hong Kong will be vulnerable to hot money flows as well.

(2) Key corollary of this trend is asset inflation and strong growth.

Many asset classes in these six economies are at price levels that can only be described as 'bubbly.' For example, property prices in Hong Kong and Singapore are at the top of the world's rankings, and bond yields in previously ostracized bond markets such as Philippines are now at levels below some large peripheral economies such as Italy and nearly at par with popular, developed pocket of Asia like Korea. Even if positive growth prospects are considered, this appears somewhat excessive. Although total capital inflows do not rely as much on portfolio inflows as they used to, there is some ground for caution. For the near-term economic path, however, this liquidity support also means that policymakers continue to be inactive due to 'trilemma problem' (inflows too strong to be countered with interest rate policies), and banking sector remain well positioned to increase credit supply further. Economic growth, as a result, will continue to be robust.

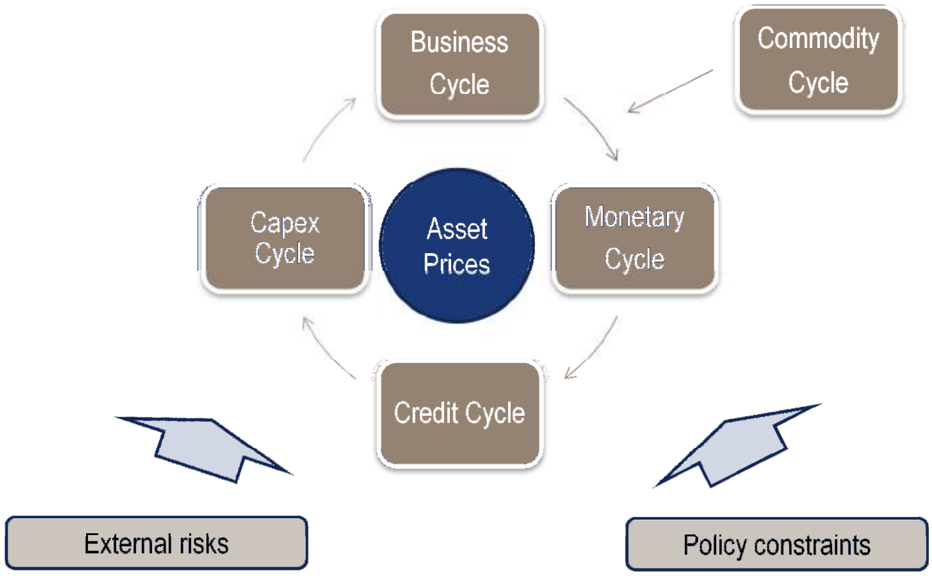
(3) India and Indonesia to keep tracking

Another important corollary of our base case view is that India and Indonesia will manage to avoid destabilizing runs on their currencies due to strong support from offshore. India in particular stands a decent chance of succeeding in its efforts to engineering an economic turnaround with the help of capital inflows.

(4) 'Global' part of Asia will be exposed to structural weakness in global demand.

Economies at the top of Asia's export chain will face the problem of weaker yen and subdued demand in China and Europe. Dimming growth prospects will limit inflows as well.

Our investment framework : Focus on economic cycles



ALLOCATION, TIMING, AND RISK VIEWS BASED ON CYCLE ANALYSIS

(1) Our investment framework is based on the analysis of five key cycles in economy.

Five cycles we includes in our analysis of a given economy and market are business cycle (aggregate activity), monetary cycle (central bank policy, money supply), credit cycle (credit demand, banking sector, housing), and capex cycle (business investment). We include commodity cycle as a key factor for business and monetary cycles.

(2) We complement our analysis of these cycles with views on policy constraints and risks.

We also add our views on policy constraints (fiscal space, inflation) and other external risks (political events, geopolitical risks) to enrich the overall analysis. For Asia, these two are particularly important.

(3) In our view, this is the right approach to enhance allocation, timing, and risk management.

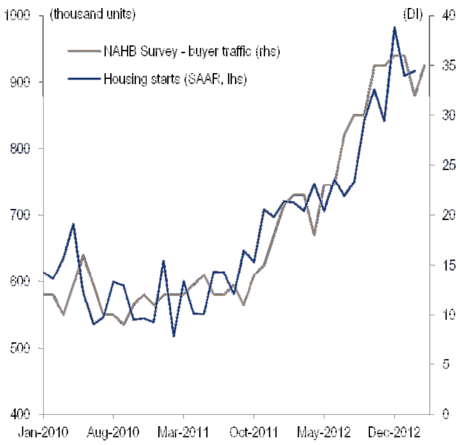
By separating the economic cycle into these more granular modules of analysis, we are able to detect alpha opportunities more effectively. For example, simple reliance on business and monetary cycles miss the slower but ultimately more important cycles in credit and capex. Models that are exclusively quantitative in nature also miss the key alpha opportunities related to policy and external risks, for which reliable data are often unavailable.

Business Cycle : US

Underlying growth withstanding fiscal headwinds

HOUSING DATA STABLE DESPITE FISCAL HEADWINDS

Housing starts and buyer's traffic



STRONG WORK WEEK HINTING STABLE PAYROLL AHEAD

Average weekly hours worked and nonfarm payroll

Source: Bloomberg

US: MACRO RESILIENCE TO CONTINUE FOR THE WHOLE YEAR

(1) We are confident that the US economy will maintain its growth momentum for the year.

As we highlighted in our previous two quarterly reports, the underlying growth is driven by forces that cannot be easily undermined by a weak quarter or two in other parts of the economy (housing, durables consumption, banking sector health). Meanwhile, the prospect of destabilizing policy gridlock in Washington will prompt the Fed to maintain its asset purchases into 2014.

(2) Housing upswing remains firm despite multiple shocks from Washington and overseas

Shortage will likely persist well into H2 even if homebuilders expand their supplies further due to strong demand that quickly absorbs new supplies coming online. Housing starts are tracking upward, and rising prices are generating healthy traffic of potential buyers.

(3) Labor market is tracking at a reasonably healthy pace.

While March nonfarm payroll was disappointing, work week figure at multiyear high pointed to benign payroll numbers in coming months. Businesses remain more upbeat about the economy than they were last year. They are cautiously adding more people to their payrolls and remain biased to expand work force further if growth momentum becomes even clearer.

(4) Households also continue to leverage up, effectively ending deleveraging trends.

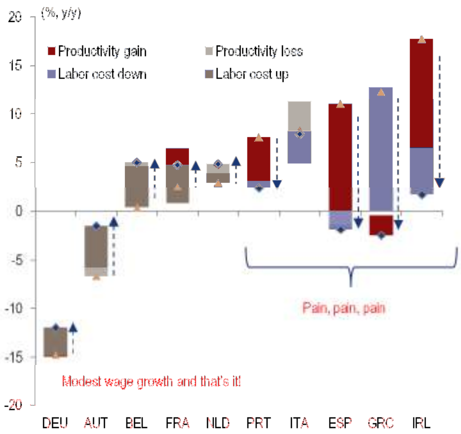
Loans of all types to households are growing steadily as households are warming to the medium-term prospect of the job market. The pace is nothing compared to similar recovery episodes last year, but in comparison to that in other countries, it is much better (e.g. Europe's borrowing is deeply depressed). Wealth impact from house and stock price appreciation seems to have influenced this shift in borrowing behavior as well.

Business Cycle : Eurozone

German intransigence to continue for the rest of the year

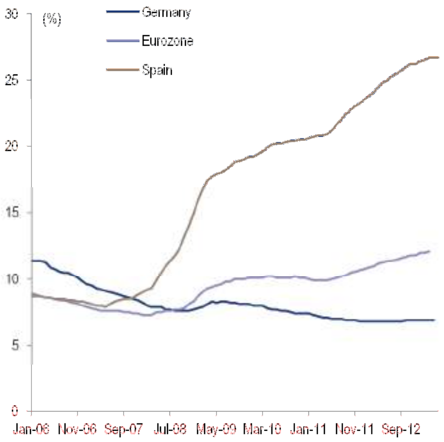
GERMAN WAGE GROWTH STILL ABNORMALLY LOW…

Average wage growth relative to Eurozone average



…MAKING EVERYONE ELSE UNHAPPY IN THE EUROZONE

Eurozone unemployment rate (sa)



Source: IMF (left), Bloomberg (right)

EUROZONE: 'AUSTERITY' REGIME TO REMAIN, DESPITE GRUMBLINGS

(1) Eurozone is still stuck in recession and unlikely to recover until German elections are over.

We remain bearish on the near-term prospect of the Eurozone, even if the ECB ends up announcing a rate cut in its upcoming policy meetings. Credit market bifurcation is a fundamental problem that stems from structural deficiency of the monetary union. Germany will not adopt proactive stance in its crisis management when the federal election campaign kicks into high gear.

(2) German intransigence on wages will remain the source of the Eurozone's problem.

Despite years of painful wage adjustment in the periphery, their average wage growth came in much higher than that for Germany. As long as Germany is willing to keep wage growth depressed via conservative monetary policy (pressure on the ECB), the gap between the two will not be abridged easily. That is particularly so because benign labor markets in Germany are keeping the country's politicians and wage earners relatively content with the state of their economy, the condition that only entrenches the current policy choice. Peripheral economies, on the other hand, are driven to the lower end of the production chain for which core European demand is somewhat irrelevant. Germany is bound to dominate intra-regional trade in the current set of policies. Higher German wage would help the peripheral economies substantially, but we do not see any reason to count on that prospect. As a result, peripheral economies will continue to rely on the funding of its finances by official lenders. This means more years of austerity.

(3) Potential flashpoints will lurk beneath the Eurozone economy for some time.

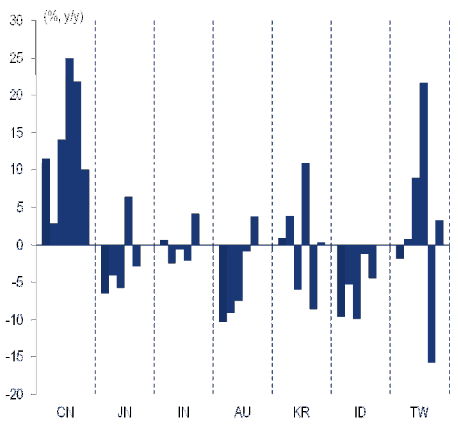
Skyrocketing unemployment in peripheral economies will keep all of them exposed to significant sociopolitical upheavals. Economies such as Greece and Cyprus are particularly vulnerable to extremist sentiments that could precipitate their decision to withdraw from the monetary union. Meanwhile, austerity fatigue is growing larger in other key economies such as France, Spain, and Portugal. The good news is that Italy's new coalition government has made some constructive noises on structural reforms. Due to Berlusconi's ambitions, however, the coalition could fracture at any given moment, triggering another round of elections. Slovenia could also experience a banking crisis, given the fragility of its financing.

Business Cycle : Asia

Export recovery more uneven than expected, domestic drivers key

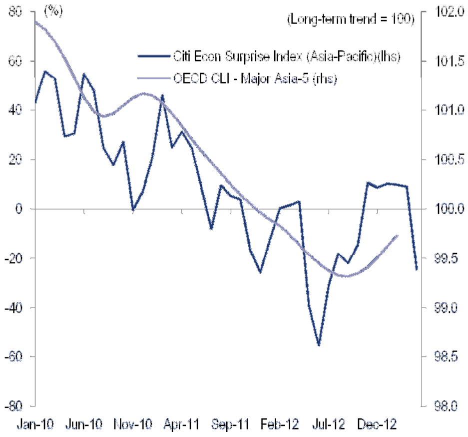
EXPORT RECOVERY UNEVEN IN Q1…

Export growth between October 2012 and March 2013



SIGNALS SOMEWHAT MIXED ON OVERALL RECOVERY

Citi Economic Surprise Index (Asia-Pacific), and OECD CLI



Source: Bloomberg

ASIA: EXPORT GROWTH TO MODERATE SLIGHTLY IN Q2

(1) The pace of export recovery in Asia could be weaker in Q2 than our initial projection.

Volatile fluctuations around Lunar New Year will likely give way to more stable uptrend from April and onward, but the pace will be impacted by more subdued demand in the US and Eurozone. We believe that demand from the US side will stabilize, but we do not have confidence on the prospect of recovery in the latter. In terms of individual country performance, Japan's export numbers have been rather disappointing, but we expect them to improve substantially from this point on. China's exports, on the other hand, were artificially boosted in the first two months (possibly due to informal FX hedging by corporates) and will moderate from this point on. Exports in NIE-4 economies will be mostly downbeat outside the tech value chain that will see stronger order flows due to product launches. Indonesia's exports will be driven lower by renewed weakness in commodity prices, but Thailand, Malaysia, and Philippines will likely see better export outturns in coming quarters as structural tailwinds strengthen from sustained capacity expansion.

(2) Domestic drivers will be mixed across countries.

Middling outlook for exports highlight the importance of domestic drivers for Asia's business cycles. Domestic drivers differ sharply across countries due to different policy mixes. Due to accommodative monetary and fiscal policies, consumption and investment will improve significantly in Japan, start improving in India, and remain robust in all ASEAN-4 economies. China could also see some rebound once the adverse impact of the government's frugality campaign fades. Lack of policy support and headwinds from structurally weaker export growth explain more subdued consumption and investment in NIE-4 economies. Domestic drivers in Korea and Singapore look particularly weaker. The latter could see some policy support going forward, but we will hold our judgment until export cycle turns up more clearly.

(3) In aggregate, the growth momentum is still turning up, but it is short of expectations.

OECD composite leading indicators for the major five Asian economies show that the region remains on an uptrend that began last year. But Citi Economic Surprise Index illustrates that growth is weaker than initially expected.

Monetary Cycle

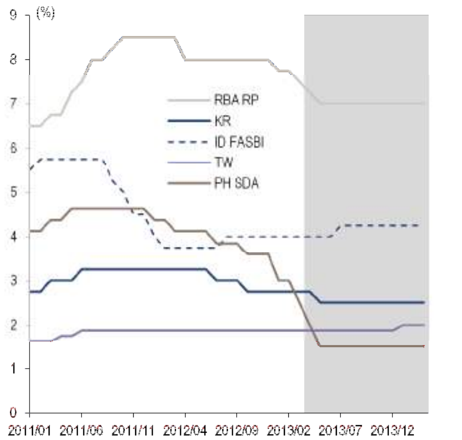
EM-Asia: Central banks expected to maintain accommodative stance

FINANCIAL CONDITION FAVORABLE IN 'LOCAL' ASIA

Financial condition index (by IMF)

EXPECTED POLICY RATES FOR KEY CENTRAL BANKS

Central banks we expect to see rate changes in next 12 months



Source: IMF (left), LODH Asia (right)

BENIGN INFLATION + FX CONCERNS = STATUS QUO (ACCOMMODATION)

(1) Structural impediments to policy change in NIE-4

Weak domestic demand is a concern for central banks in all NIE-4 economies, but they face significant constraints in addressing them through monetary policy. Hong Kong's dollar peg will not change anytime soon, and Singapore's hawkishness is motivated by structurally high inflation. Taiwan's inflation and property prices are not at comfortably low levels, and Korea runs the risk of exacerbating household debt overhang by easing. We still see BoK's 25 bp cut in Q2.

(2) Stable inflation outlook and currency strength to motivate easy policy in ASEAN-4

Lower commodity prices and modest strengthening in local currency have helped ASEAN-4 economies inflation at comfortable levels (Indonesia is an exception). Wage growth is strong in the region, but aggressive expansion in capacity has offset much of the rise in labor cost. While central banks in the region are likely to tolerate currency strength at today's levels, they could be deterred from tightening policy and increasing the appeal of their assets amidst intensifying global yield search. As a result, we expect the policy status quo persisting in the rest of the year.

(3) India is at an ideal juncture to ease policy aggressively. Philippines will be forced to ease.

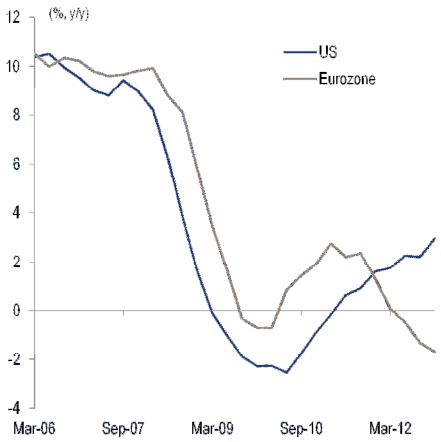
Improving data on inflation, fiscal deficit, and current account deficit give enough confidence to the RBI to ease its rates further, which would be a boon to the economy that has been laboring under one of the tightest monetary policies in the EM space for two years. Philippines, on other hand, will be forced to cut its SDA rates because of rising sterilization cost from FX market interventions.

(5) Indonesia is probably the first country in the region to tighten policy.

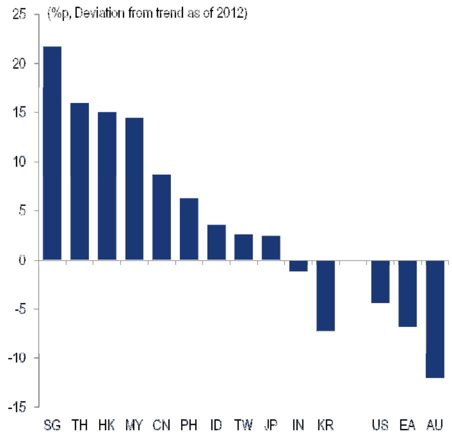
Barring any significant change in the government's subsidized fuel policy (draft of the plan sits on the president's desk, but it has not been signed yet), Indonesia will continue to experience significant current account deficit due to growing imports of petroleum products. This will continue to weigh on rupiah in the near-term. The Bank Indonesia is likely to attempt at mitigating FX pressure by sending a tightening signal through FASBI rate hike, which we see happening at some point in H2 this year.

Credit Cycle
US credit cycle to underpin growth, credit overheating risks in EM Asia

DELEVERAGING IN FULL SWING IN THE EUROZONE
Private sector credit growth in the US and Eurozone



CREDIT CYCLE VERY STRONG IN ASEAN, SG, HK, AND CN
Credit growth in excess of long-term trend



Source: IMF

OVERHEATING IN EM-ASIA, HEALTHY RECOVERY IN THE US

(1) 'Atlantic divide' remains wide between the US and the Eurozone.

Credit and housing market indicators show that the US and Eurozone are still far apart from each other due to policy risks. The US households probably ended their deleveraging and began a multi-year secular uptrend in re-leveraging, even if the pace is slower than past recovery episodes. House prices have turn around as well, accelerating this trend further. Meanwhile, Europe's credit markets remain deeply depressed along with the housing market. Buffeted on all fronts by massive unemployment, austerity programs, and general economic instability, households and businesses in Europe are firmly in retrenchment mode and expected to remain that way for an extended period of time.

(2) Credit market in EM-Asia is showing signs of overheating risks.

In China, credit growth came in stronger than expected in March. While some of this is due to seasonal effect, we expect the authorities to gradually tighten their control of non-banking sector loans, and even allow more defaults to discipline the system in coming months. All four ASEAN economies are registering credit growth rates that are at multiyear high, and it is likely that authorities will deem these unsustainable in H2. In the cases of Thailand and Malaysia, total leverage is rather high for their income levels, and requires more proactive management going forward. Indonesia and Philippines enjoy enviably low leverage due to a decade long deleveraging process, but credit growth has been rising at uncomfortable pace in recent months.

(3) Credit impulse is improving in Japan.

Latest loan officer's survey shows that Japan's credit impulse is improving steadily, hence increasing the chance of the BoJ's reflation efforts (credit demand is a key ingredient of monetary transmission mechanism). We expect this trend to continue for the rest of the year.

(4) Credit growth in Korea remains very weak. Credit downturn in India is bottoming out.

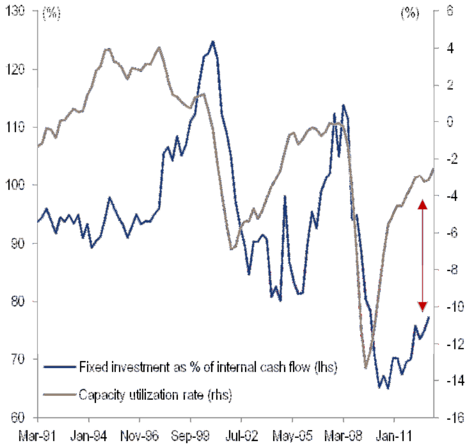
Debt overhang continues to weigh on household balance sheets in Korea, where the debt level rose to 136% of disposable income in 2012. This has forced the government to draw the next of round of stimulus and property curb revisions. India's credit demand is stabilizing due to rate cuts.

Capex Cycle

US capex steadily improving, 'Global' and 'Local' divide in Asian capex

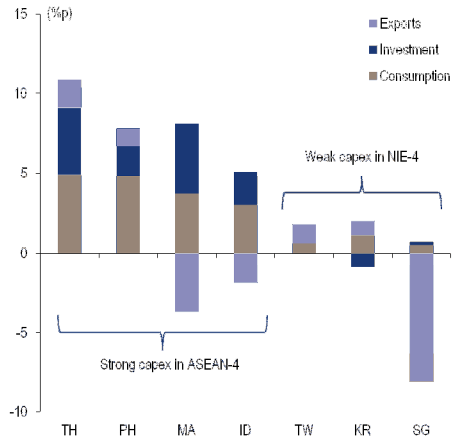
LARGE SCOPE FOR CAPEX EXPANSION IN THE US

Capex vs. internal cash flow and capacity utilization rate



CAPEX CYCLE CONTINUED TO BE STRONG IN ASEAN-4

Expenditure account contribution to GDP in 4Q 2012



Source: IMF

US WAITING FOR CAPEX TAKE-OFF, GLOBAL / LOCAL DIVIDE IN ASIA

(1) The Atlantic gulf between the US and Europe remain wide in capex as well.

US corporates have begun increasing their capex relative to cash flows, but much scope remains for further capex expansion. Capex relative to internal cash flow remain well below the historical average, so there is scope for improvement.

(2) We expect capex cycle to start improving more visibly in Japan

Recent machine orders data, which began stabilizing since the beginning of the year, bear this out. The government's stimulus plan is offsetting fading reconstruction disbursements and improving business capex intentions at the same time. Most of the survey data improvements are consistent with capex recovery as well. We expect

(3) Capex in China and India are somewhat mixed.

India's capex cycle improved slightly since the beginning of the year, but due to various administrative inefficiencies, they remain very depressed in absolute terms. Outlook is better, but we are mindful that the upcoming RBI rate cuts will be offset on the margin by the government's aggressive spending cuts and election uncertainty. China's capex remains heavily dependent on government-led infrastructure projects. Private sector capex remains quite subdued.

(3) ASEAN-4 investment cycle remain strong.

Investment accounted for major portions of headline growth in economies such as Malaysia and Thailand in Q4. Going forward, however, investment cycle in Malaysia will slow down due to political uncertainties. In Philippines, investment cycle has been rather muted despite initial excitement about PPP projects. Implementation of some projects has been sluggish due to administrative reasons. In Indonesia, infrastructure spending is being offset by slowdown in mining investments related to coal. All in all, however, capex cycle in the region remains healthy.

(4) NIE-4 economies are mostly stuck in very weak investment cycles.

Key exporters in Korea, Taiwan, and Singapore have been struggling significantly due to more subdued demand overseas, particularly China and the Eurozone. Japan's new policy on JPY will exacerbate this problem. In sequential terms, however, capex will recovery from 2012's lows.

Commodity Cycle

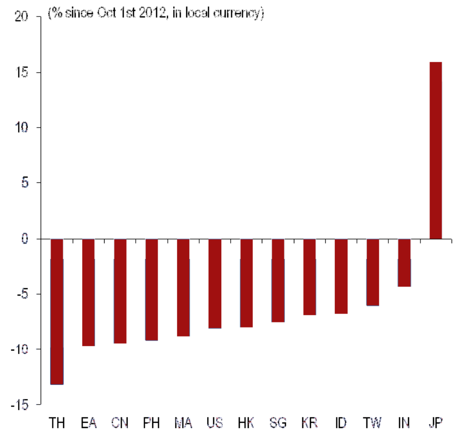
Gold sell-off overdone, oil price still painful to Japan

GOLD AFFECTED BY SHIFTING INFLATION EXPECTATION...

Gold price and yield for 10 year US TIPS

DANGEROUS SIDE OF JAPAN'S MONETARY EXPERIMENT

Change in the price of spot Brent crude in local currencies



Source: Bloomberg

GOLD PRICES TO STABILIZE, WEAKNESS TO PERSIST IN COMMODITIES

(1) Gold has more upside potential despite the dramatic price fall in mid-April.

The news of Cyprus possible use of official gold reserves to fund its bail-out and speculations about the Fed's exit from QE triggered massive sell-off in the gold market, but we believe that the price is more likely to rise from this point on than fall. First, we do not believe that the Fed will exit from QE this year. Second, the Cyprus story was included only in a draft plan and might not materialize. Besides, other Eurozone members face significant political and legal obstacles in using their official gold reserves. Third, the nature of tail risks in Europe and Japan are such that gold make a reasonable insurance. Simple analysis of the US money base indicate that 2,000 per ounce is the rough fair value for the yellow metal. Shift in inflation expectation needs to be considered, but the fall in gold prices appears too excessive compared to that in TIPS yield.

(2) Industrial commodities are still in need of positive macro catalyst.

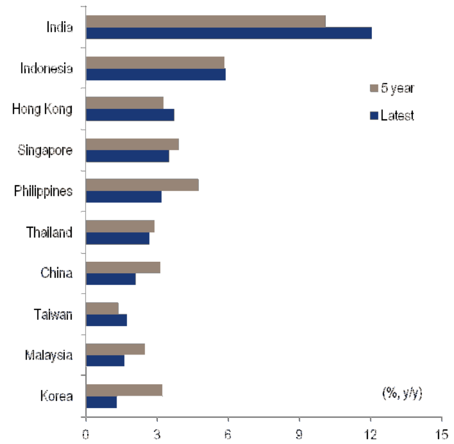
Q2 soft patch in the US, heightened awareness of tail risk in the Eurozone, and general disinflationary trend in DM economies will continue to weigh on industrial commodity prices in Q2. Oil prices in particular will move sideways from their current level as they are buffeted by both downside supply (shale gas) and demand (US and Europe) risks. Financial markets in general appear to be exhausted from costly contango bets in the early phase of post-GFC recovery, and negative yielding environment is incentivizing backwardation plays by physical suppliers. The situation could change in H2, but we maintain our cautious outlook for now.

(3) Commodity markets' impact on Asia will be varied due to their policies on currency.

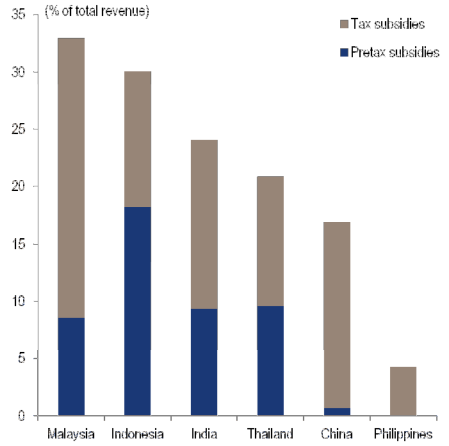
One stumbling block for Japan's reflation strategy is the much-dreaded J-curve impact on its trade balances. Japan's trade balance will likely suffer more despite JPY depreciation in the near-term as the economy tries to find a sustainable equilibrium. With this in mind, therefore, the BoJ will likely try to stabilize JPY between 100 and 110 with the view that 1% inflation will be acceptable for the time being. Repatriation flows into the country targeting domestic equities have been quite beneficial in this regard. As for other key economies, impact of commodity cycle has been rather beneficial. Commodity prices in absolute terms have been mostly declining since February, and eased the pressure on manufacturers and households alike. Key EM economies such as China, India, and Indonesia are all expected to keep accommodative stance longer.

Policy constraints
Subsidies to remain as an issue soon in EM Asia, DM debt debate shifting

INFLATION UNDER CONTROL FOR THE TIME BEING...
CPI inflation: 5 year average vs. latest readings



...BUT AT THE EXPENSE OF FISCAL DISCIPLINE FOR SOME
Pretax and tax energy subsidies in key EM Asian economies



Source: IMF

INFLATION-BUDGET LINKAGE TO REMAIN AS A CONCERN FOR EM-ASIA

(1) Most EM Asian economies do not face policy constraint from inflation.

EM Asia in general have benefited from benign inflation except India and Indonesia. CPI inflation in most EM Asian economies remain slightly below their 5 year averages, and inflationary impulse do not look worrisome. In India, CPI inflation is high, but wholesale prices have come down significantly.

(2) But for some economies the linkage between inflation and subsidies will be an issue.

Economies such as India, Indonesia, and Malaysia all have substantial fiscal support to the household sector in terms of energy and food subsidies. In Indonesia, the government is under constant pressure to cut its energy subsidies. It has already raised electricity prices, but due to the popularity of fuel subsidies, it is not doing the same for RON 88 gasoline. Due to political incentive to play populist card ahead of the national elections in 2014, we do not expect this situation to change in the near-term. In India, cuts in diesel subsidies are expected to lift prices higher in H2 this year. This gives a limited window for the RBI's rate cuts, which we expected to be front-loaded like last year. The Thai government also faces a similar problem, but Yingluck government will be keen on maintaining these subsidies to boost its political standing.

(3) For DM economies, the focus is likely to shift from debt levels to growth.

The latest scandal regarding the 'tipping point dynamics' of Reinhart and Rogoff (2010) and growing exhaustion with austerity programs will prompt policymakers to shift their focus back to growth. Japan's experiment in particular has the potential to discourage debt hawks from dominating policy discussion because its debt problems are supposed to be the worst in the world. 'Debt-ceiling' debate in the US will be pushed back to September because of increased tax receipts that the fiscal cliff compromise brought. In Europe, however, debt will continue to be an issue due to the structure of financial rescue mechanism that stresses austerity, not growth.

Risks

September shaping up to be an eventful month

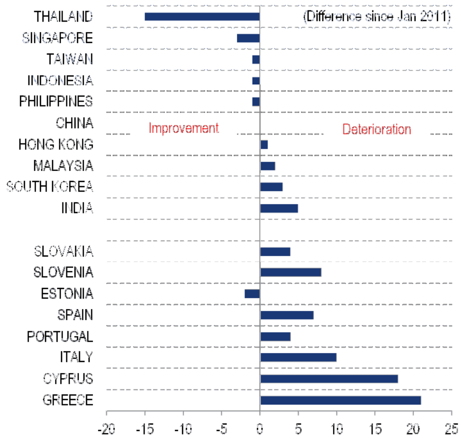
KEY POLITICAL EVENTS IN 2013

Election, budget deadline, and other political events

Date	Event (Downside Scenario)
May 2013	Malaysian general elections (BN / UMNO loss)
	Philippines mid-term elections (Liberal party's loss)
Jul 2013	Japanese upper house election (LDP short of majority)
Sep 2013	German parliamentary election (No clear mandate)
	Austrian parliamentary election
	Possible US debt-ceiling deadline (Gridlock)
	G20 Summit in St. Petersburg
	Australian federal election
2013~2014	Indian general election (Large gain for regional parties)
Unknown	Thaksin's return to Thailand
Uncertain	New election in Italy

POLITICAL RISKS WORSENING IN EUROPE

EIU political risk index (difference between Jan 2011 and Mar 2013)



Source: News reports (left), Economist Intelligence Unit (right)

ELECTIONS, GEOPOLITICS, AND FISCAL CRISIS STILL KEY RISKS

(1) Election risks

The most immediate risk in the region will be Malaysia's general election on May 5th, which will be followed by mid-term elections in Philippines. BN's loss in the Malaysian election could trigger a sell-off, as the opposition coalition is fractious and their victory could augur the unraveling of careful consensual politics that BN has nurtured over years. September will be an important month due to a series of elections scheduled in the month. German election will be a positive catalyst as long as it merely confirms the two party status quo with FDP losing ground. On the other hand, we believe that it is too early to be complacent about political stability in Italy despite the establishment of a new coalition government and president's election. India could experience sell-off if the electorate begins to move their support toward smaller parties instead of the Congress or BJP.

(2) Geopolitics in Middle East and Asia

Iran's upcoming election could renew instabilities in the Middle East, but we do not see that happening yet. Barring significant upheaval in the region (a big if, due to election in Tunisia and the ongoing conflict in Syria), oil shock risk appears contained for now. The bigger risk for the Asian economy is the possibility of accidental military conflict (1) between the two Koreas, (2) near Senkaku / Diaoyudao, and (3) South China sea.

(3) Japanese policy mistakes or delays

The key risk to our base case scenario for Japan is a delay in policy measures that are designed to enhance the country's potential growth. Market disappointment on the government's policies on pension, labor force, and free trade could trigger a significant correction in financial markets and render the entire 'three arrows' reflation strategy questionable. We believe that the conservative backlash against recent reforms will rise after the July upper house elections. For the time being, Japan's X-day scenario does not look likely, but it would be prudent to protect against this through assets such as gold.

(4) Eurozone risks

Various potential flashpoints in the Eurozone could lead to new crisis in the region and cause shift in economic outlooks for key economies around the world. We see the greatest near-term risks in Italy, Greece, and Slovenia. EM Asia's political environment has improved markedly.

Summary of Cycle Views

RECOMMENDATION – US, JAPAN, THAILAND, CHINA, AND INDIA

(1) Positive growth development in US, Japan, China, India, and ASEAN

US, Japan, and Philippines remain as the most compelling growth stories in the world. Macro cycle is also quite decent in Thailand, China, and India as well. All of these economies enjoy the favorable combination of supportive policy, healthy domestic drivers, and limited policy risks. Due to worrisome valuation levels, we do not recommend Philippines at the moment.

(2) Business cycle

Business cycles are very strong in the three pacific economies of the US, Japan, and Philippines. They are very weak, however, in Singapore, Korea, and Eurozone. Eurozone's recession will probably continue in Q2.

(3) Monetary cycle

Monetary cycles are extremely supportive of liquidity and growth in the US and Japan. Inflows have rendered monetary cycles better in Philippines, India, and Hong Kong. The Eurozone is suffering from inadvertent liquidity drain from LTRO repayments.

(4) Credit / capex cycle

Credit growth remains very strong in ASEAN economies. It is on the cusp of major secular turnaround in Japan, and tracking well in the US due to the end of household deleveraging. Capex cycle remains on a multi-year uptrend in ASEAN economies and remains healthy in the US. Japan will soon start experiencing marked improvement in corporate investment soon.

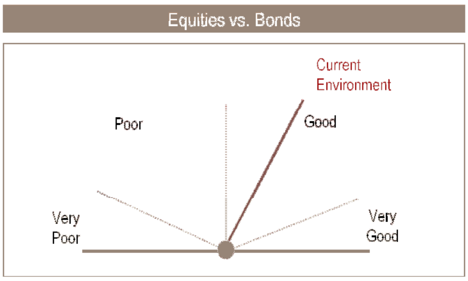
(6) Commodity cycle impact

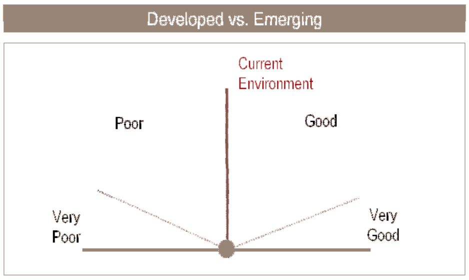
Most economies will be helped by the broad-based weakness in commodity markets. The economies that stand to gain most from this trend are India and China because of inflation data sensitivity to commodity prices.

(7) Political risk

Japan's Abe cabinet is enjoying very strong public support. Europe's political risks are growing.

Recommended Asset Allocation





CROSS ASSET VIEW	+ve	N	-ve	Rationale
Cash			•	Opportunity cost to be significant, zero or negative yielding in most markets
Government Bond			•	Exceptional richness still worrisome
Corporate Credit		•		Central bank asset purchases to provide support, compression too tight
Equities	•			Attractive valuation and high risk premium in many pockets
Commodities ex gold			•	Supply glut still remaining (energy, metals), lingering doubts about demand
Gold		•		Recent correction overdone, useful hedge for redenomination risks

STRUCTURAL ADVANTAGES FOR EQUITIES

- **Cash & Fixed Income**: We are underweight on cash and duration with the view that much of the safe haven trade has been completed and the class does not offer any compelling reward for the medium-term. We remain constructive on short duration risks in corporate credit space.
- **Equities**: Equities still have the most compelling risk and reward balance, both in absolute level and relative premium to bonds. With right country selection, rewards could be significant for investors.
- **Commodities and gold**: We are bearish on commodities for the short-term (3M) as some of the idiosyncratic excess supply conditions have not been resolved yet. We are more constructive on gold after its dramatic adjustment in recent weeks.

Preferences 'within' key asset classes

EQUITIES	+ ve	N	- ve	Rationale
US	•			QE to be supportive for risk assets to the year-end, despite data noises
Europe (EA 17 & UK)			•	Passive crisis management, many dormant implementation risks
Japan	•			Still the best macro story in the world, with 'reform' catalyst in summer
China	•			Policy more lenient than expected, earnings momentum decent
India	•			Tailwind from commodity markets, RBI cuts to fuel mini rally in Q2
NIE-4 (KR, TW, SG, HK)			•	Impact from weak JPY, limited policy options, Europe exposure
ASEAN-4	•			Constructive on Thailand, waiting for Malaysia's election results
SOVEREIGN				
DM sovereign			•	Slim picking over-all, extremely rich and vulnerable to convexity risk
EM sovereign		•		Opportunities in high yielding markets such as India
CREDIT				
DM credit		•		High yields to be better way to get ready for eventual yield rise
EM credit	•			Liquidity cycle supportive , avoiding Chinese names for now
FX & Gold				
EM Asian currencies	•			Favor CNY, INR
Gold		•		Reasonable hedge against currency related tail risks (Japan, Europe)

FAVOR EQUITIES IN THE US, JAPAN, CHINA, INDIA, AND THAILAND

(1) 'Within' equities

- From macro perspective, we like the country mix of US, Japan, China, India, Thailand, and Malaysia. Macro momentum is strongest in Philippines, but the valuation in the equity market is such that it is difficult to make a high conviction recommendation.
- US equities are favored for both macro and supply issues. Distortion in risk premium is incentivizing companies to pursue LBO and M&A opportunities, and various buybacks are keeping net issuance at very low levels. Underlying macro momentum is strong, and the Fed is expected to maintain its policy stance accommodative for a while.
- Japanese equities are still compelling bets. If the Abe cabinet delivers in its "third arrow" of Abenomics (structural reform) at some point in summer, markets will perceive the economy as a genuine growth story. We are optimistic that the Abe cabinet will not disappoint.
- China and India make good tactical bets due to commodity tailwind and policy support in the near-term. Valuations are also compelling. We are acutely aware of China's structural problems, but now is not the time to be overly worried. We like Thailand most among ASEAN-4 markets.

(2) 'Within' fixed income

- **Govies**: Much of the rally in DM sovereigns, including the Eurozone periphery has already occurred. The asset class still suffers from very significant convexity problem.
- **Credit**: We are becoming somewhat cautious on DM credit due to their rich valuation and growing idiosyncratic credit risk (especially in Europe). We like EM credit outside China.

(3) 'Within' FX and Gold

- Persuasive medium-term backdrop (demography, regulatory flexibility, banking sector health, and housing) and gradually rising expectations of the Fed's asset purchases should draw investors to USD. We see significant upside for the currency in 1~2 years. In EM-Asia, we like CNY and INR.
- We believe that gold still deserves a place in a portfolio. Not all tail risks favor the asset, but they do at this particular juncture (possibility of Japan's failure, Eurozone break-up scenario). The asset will also benefit from turnaround in inflation expectation, the prospect that we still see as possible.

Appendix : Select market views

China

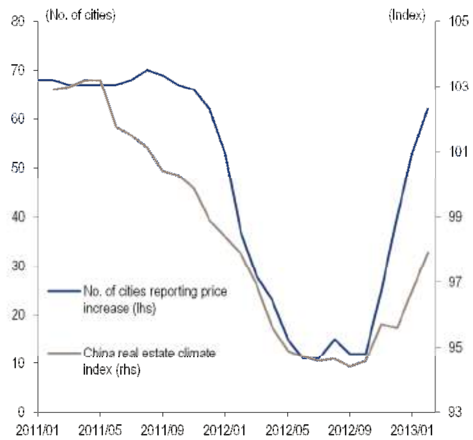
Recovery still intact, despite data noises and policy announcements

RELIABLE BUSINESS CYCLE INDICATORS EDGING UP

OECD composite leading indicator, ordinary import growth

PROPERTY MARKET STRONG DESPITE POLICY INITIATIVES

Cities reporting property price increase, real estate climate index



Source: CEIC , Bloomberg

Q1 DATA TO INDUCE MORE SUPPORTIVE POLICY IN THE NEAR-TERM

(1) Q1 softness reflects temporary factors

Q1 was marked by a confluence of unfavorable, but temporary, factors. The government's frugality campaign and unprecedented air pollution during spring season dampened consumption and various macro-prudential measures (WMP and property) prompted concerns about sharp slowdown in credit growth. Most of these are only temporary in nature and will fade in Q2.

(2) Reliable macro indicators showing underlying growth momentum mostly intact

OECD composite leading indicator for China has passed a cyclical trough in 4Q last year, and growth in ordinary imports (which is intended for domestic consumption) is following this movement with a lag. Credit impulse will support growth with one or two quarters of lag, even if its impact is limited by secular downtrend in credit multiplier.

(3) Policy to be more accommodative for the time-being in the aftermath of Q1 data readings

Following a series of weak readings in output (including Q1 GDP at 7.7%), PMI, and industrial profits, policymakers, who are also mindful of the downside risk, will keep policy more accommodative in the near-term. Money growth is in the excess of the government's stated target, and credit impulse was very strong in Q1. Inflation risk remains well-contained. The government's fiscal deficit target of 2% implies that it is willing to increase disbursements a bit more to support growth via investments.

(4) Reforms to be limited to politically safe ones, immediate impact unlikely

The government will expand sales and property tax schemes to other cities to reduce tax burden on businesses and improve local government financing at the same time. Increased SOE dividends, limited hukou reform, and one-child policy reform are also in the cards. Full scale SOE restructuring, rural land reform, and full financial liberalization do not appear likely, however.

(5) Market view (OW equities and CNY | Neutral on duration | UW corp credit)

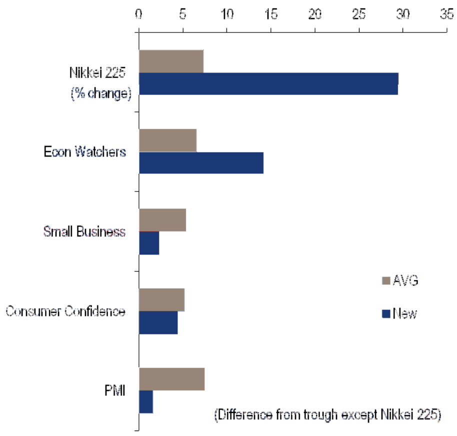
We are modest overweight in equities. An upturn in industrial profit growth could trigger mini re-rating episodes as valuation is still very low. Increased issuance by both government and corporates make us cautious about fixed income market in general. We see CNY strengthening.

Japan

Gaining confidence on reflation strategy

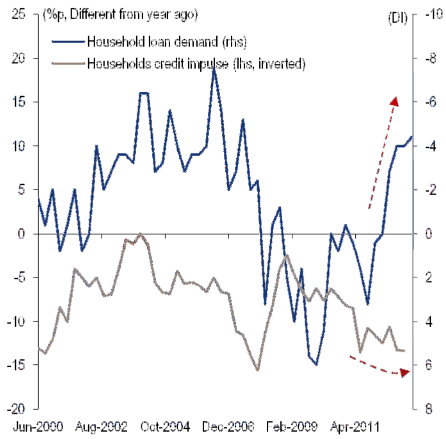
SENTIMENT INDICATORS RISING ACROSS THE BOARD

Survey indicator improvement since OECD CLI trough



CREDIT CHANNEL FINALLY BEING REPAIRED?

Household credit impulse, Survey of household loan demand



Source: Bloomberg (left), CEIC (right)

STEADY PROGRESS DESPITE SOME MIXED DATA IN RECENT MONTHS

(1) Clear growth momentum

There is a large upside potential to economic performance this year and the next. Leading indicators are already very positive. Activity measures like retail sales have turned around strongly since Q4 2012, which bodes well for consumption that takes up about 60~65% of GDP. Rarely have so many leading indicators improved simultaneously and failed to predict recovery afterward. We are also encouraged by the steady improvement in credit growth, which might reflect repaired transmission mechanism for monetary policy. Return of credit demand will be pivotal for achieving inflation.

(2) First two "arrows": well-calibrated and aggressive enough to be effective

Japan is the only DM economy where both fiscal and monetary stimuli are being applied to support aggregate demand. Both policies are well-calibrated, and they will likely be very effective in boosting demand. Fiscal stimulus rightly targets high multiplier items such as infrastructure investment. Meanwhile, the government has the option of delaying or offsetting the permanent VAT hikes which are already written into law. The BoJ has the markets by their horns and could anchor JPY at appropriate levels, which is crucial for smoothing out the trajectory of the country's current account balances, which will likely suffer at the initial phase of JPY depreciation.

(3) Confidence in the third "arrow" of structural reforms

To maximize the growth synergy, the government needs to convince markets that it is also serious about structural reforms. Judging from Abe's April 19th preview of reform initiatives, we remain positive on this prospect. Key reforms we particularly like and deem realistic are free trade agreements and labor market reforms. Public support is remarkably high (above 70%).

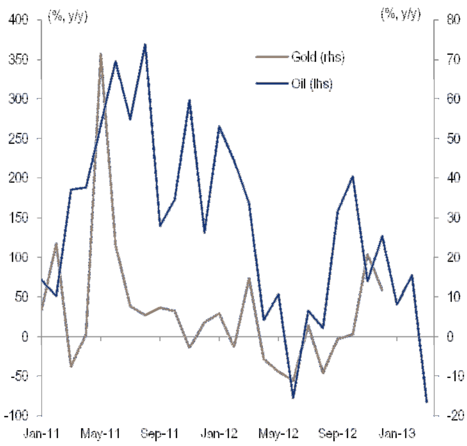
(4) Market view (OW equities | UW duration, corp credit, and FX)

Kuroda's QE has sent equities soaring past most well-known resistance levels, and both the BoJ and markets will try to take stock of the BoJ regime change until Abe cabinet begins to make noises in summer. We close our tactical call on Japanese equities at 14.7% profit in USD, but with a bias for re-entry in summer. Due to limited upside, we remain bearish on JPY and bonds.

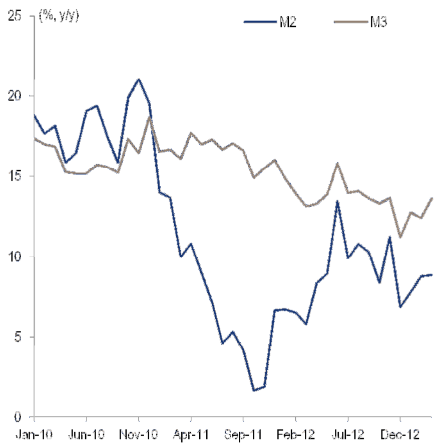
India

Commodity tailwind to the rescue, RBI easing to improve liquidity

COMMODITY IMPORT BILLS DECLINING
Growth in gold and oil imports (in USD)



BROAD MONEY GROWTH HINTING TURNAROUND
M2 and M3 growth



Source: CEIC

RBI EASING TO STRENGTHEN RECOVERY

(1) Tailwind from commodity markets

India's key vulnerability has been its persistently large current account deficit, but recent weakness in commodity markets lessens the burden significantly. The value of oil and gold imports, which take up nearly 40% of India's total imports, will likely start coming down soon as INR has been steady. This will be positive for containing inflation as well.

(2) RBI cuts to continue due to encouraging inflation and commodity data

Recent macro outturns on the activity side have been rather disappointing (weak industrial production and PMI reading in March), but inflation data have been quite encouraging as wholesale prices in March came in below 6% for the first time since 2009. This should give the RBI sufficient comfort to go ahead with 50~75 bp rate cuts in coming months.

(3) Easing liquidity a key to more sure-footed recovery

India's policy rate (repo) stands at 7.5%, which is merely 100 basis points from its post-crisis high of 8.5%. Broad money growth has been quite weak despite the beginning of easing cycle in H1 2012. The good news is that aggressive cash reserve ratio cuts seems to have stabilize broad money growth recently. Further cuts will reinforce this trend.

(4) Political risks significant but contained at the moment

The ruling UPA coalition has been steadily losing partners over last few months, but it still enjoys the structural advantage (tacit alliance, religious affiliations) over the opposition in terms of vote-counting. The cabinet's investment committee will begin to tackle logjam in project approval (over INR 10 bn). Fiscal consolidation including diesel price hike has reduced deficit considerably.

(5) Market view (OW equities, duration, and corp credit | Neutral on FX)

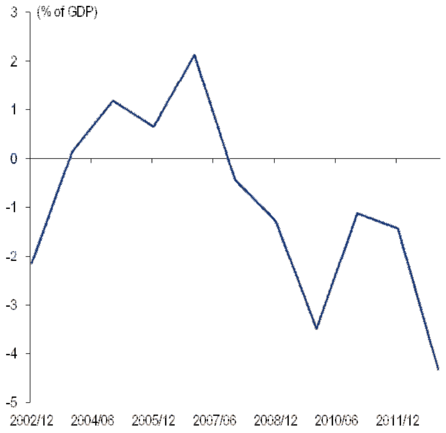
The combination of rate cuts and steady recovery in global growth are welcome, but it would be naïve to assume that equities could re-rate quickly with numerous idiosyncratic risks on the horizon. We are overweight equities on a tactical basis. We are also overweight duration and corporate credit with constructive outlooks on inflation and liquidity cycle. On the other hand, we are neutral on INR due to risks of reversal in capital inflows and RBI's FX recoup.

Thailand

Confluence of favorable macro factors, political risks to be contained for now

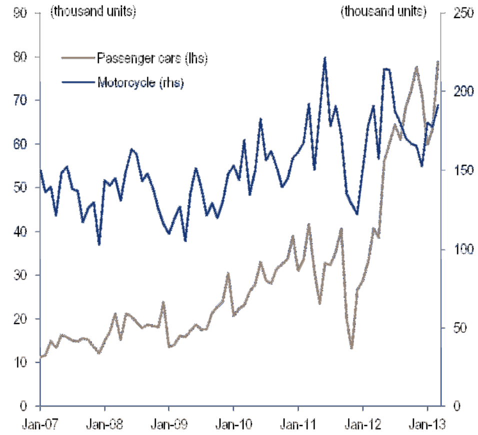
FISCAL IMPULSE STRONG IN 2012

Consolidated budget balance as % of GDP



CONSUMPTION RISING STRONGLY AS A RESULT

Thailand's vehicle sales data



Source: CEIC

STRONG FISCAL IMPULSE, ROBUST CONSUMPTION AND INVESTMENT

(1) Thai economy to record another year of strong growth in 2013.

Headline growth will moderate from 6.4% to 5% this year, but that pace is higher than what markets expected at the end of last year. Much of this will be due to resilience in domestic demand.

(2) Domestic driver is underpinned by very supportive fiscal policy.

In addition to various populist giveaways in rural areas (rice mortgage scheme, minimum wage, and salary increases), the government is running substantial deficit to support its infrastructure investments (water management, transportation). The total deficit arising from on and off-budget items is expected to exceed 3% of GDP. Fiscal impulse is quite strong

(3) Monetary policy will not tighten due to FX concerns.

The Bank of Thailand has kept its repo rate at 2.75% as consumer price inflation remains moderate. Due to baht strength, the bank will likely restrain from tightening via policy rate hikes. Macro prudential measures could strengthen from this point on, but there is a strong political pressure to keep policy accommodative while headline growth goes through a modest soft-landing from last year's flood related boom.

(4) Ideally position to benefit from domestic and external drivers.

In addition to domestic drivers, which the government has some fiscal room to support, the country is also ideally positioned to benefit from global business cycle due to its growing manufacturing base. The economy's location is helpful as Myanmar becomes a genuine growth story, and the entire Indochina peninsula goes through a period of infrastructure enhancement in transportation connectivity, a project supported by the likes of China and Japan.

(5) Market view (OW equities and rate | Neutral on duration and FX)

Fitch's recent rating upgrade gives us more confidence that an immediate political crisis is unlikely after the Thai new year (April 13~15th). Thus, we are overweight in equities, if on a tactical basis. We are neutral on duration, but constructive on credit for potential Japanese inflows. Drivers of FX appreciation remain, but recent rally in baht feels somewhat overdone.