ASIA

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Asia Macro Views

Waiting for Bottoming

Key points

- **The financial turmoil triggered by the sub-prime problem has not yet shown signs of bottoming, due to continued housing deterioration, unexpected financial tightening and widespread repricing of risks**
- **Asian asset markets have already suffered serious damage, with share prices falling by an average of 16.3% and currencies declining by an average of 1.9% during the past months**
- **Our base case is that sub-par growth, not recession, should continue in the US, while decisive policy easing would limit downside risks to the financial markets**
- **We now expect Asian currencies to show further weakening in the near term before the strengthening trend resumes. Asian central banks are now more likely to cut rates**
- **In a worst-case scenario, however, US housing prices might decline by more than 25% while the economy could fall into recession. As a result, the US dollar would probably collapse**
- **If that happens, Asia likely will suffer more, on its high dependence on US markets and the adverse impact on local liquidity conditions. A 1ppt slowdown in US growth could cut Asian growth by 1.1ppt**

Global financial turmoil

The consequences of the sub-prime problem-triggered market volatility are much greater than many policymakers and investors expected when the risks emerged initially about two weeks ago. By August 17, US share prices had corrected by about 10%, the sharpest decline since 2002. Stock market indices rallied by an average of 2% on August 17 after the Fed approved a temporary reduction in the discount rate by 50bps to 5¾%, effectively narrowing the spread between the prime credit rate and the Fed's target funds rate to 50bps.

The sharper-than-expected moves of financial markets probably reflected at least three problems:

1) The decline in the US housing market has not shown any signs of bottoming. We previously expected inventories of the housing sector to be cleared during the first quarter of 2007, which should then effectively limit the downside risks of housing prices. But contrary to our expectation, the amount of unsold new houses kept rising earlier this year and remains at the elevated level. Recent sharp fall in buy traffic further point to weaker demand going forward. Housing prices have declined by about 8% since the peak. The financial markets appear to have priced in a total fall of 25%. This, if true, would be the deepest meltdown since the Great Depression.

2) Financial conditions have become a lot tighter, which threatens the growth outlook. According to Citi's estimation, deviation of the financial conditions index from the mean fell from 0.5% sigma in June to 0 sigma in July and an estimated –0.4 sigma currently. The most acute source of financial distress is short-term funding of high quality assets. The spread between 3-month LIBOR and 3-month Treasury bill widened from less than 50bps during much of the past five years to almost 200bps recently. The Fed's recent policies, supplying liquidity to the markets and reducing the discount rate, were likely the beginning of a series of policy actions.

3) The subprime problem has already evolved into a broad repricing of credit risks. Citi's ESBI spread, for instance, rebounded from below 140bps in mid-June to above 200bps lately, after declining from 225bps in mid-2006. Repricing of risks, however, has concentrated more in the corporate sector. Price adjustments were generally greater for low-quality assets than for high-quality assets, evidenced by a sharper decline of high-yield bonds than high-grade bonds.

Impacts on Asia

The sub-prime problem is largely external to Asia. But Asian asset prices have already been seriously affected by the global financial market turmoil through at least the following channels:

- Some Asian institutions have exposure to sub-prime mortgage-backed assets and other CDOs;
- Repricing of corporate risks in the US probably caused some normalization of risk premiums;
- Tighter liquidity conditions in US and Europe may also affect capital flows to and from Asia; and
- Uncertainty of the growth outlook in the US also points to downside risks for Asian economies, especially their export sectors.

Chinese, Korean and Singaporean banks and Taiwanese insurance companies are among those institutions. At this stage, it is difficult to figure out the total amount of losses in those institutions' asset values. Some analysts believe that while the overall exposure may not be particularly large, relative to their assets, much of the assets belonged to low trenches of credit rating.

Between July 18 and August 17, Asian equity price indices declined by 9-30%. The Philippine, Korean, Indonesian and Taiwanese markets led the current equity price slide (see figure below). The A-share market is the only one that still recorded close to a 20% gain during the past month.

The financial meltdown began to reverse capital flows. Some investors were probably forced to sell their holding of Asian assets to compensate for losses made elsewhere. Others rushed to more quality assets, such as US Treasuries, amidst market volatility. The recent tightening of liquidity conditions in industrial economies probably also exacerbated changes in Asian asset prices. The 3-month interbank rates rose from 4.38% on July 25 to 4.79% on August 17 in Hong Kong and from 2.56% to 2.63% during the same period in Singapore. As a result, Asian currencies weakened by around 2% on average during the past month.

Changes in Asian Asset Prices Between July 18-August 17 (%)

	Equity Index (%)	Government Bond Yield (Basis points)	Currency (%)
China	18.2	-0.08	-0.41
Hong Kong	-12.0	-0.27	0.03
India	-8.7	0.14	-1.85
Indonesia	-20.2	0.42	-4.49
Malaysia	-16.5	0.06	-1.87
Philippines	-29.5	--	-2.88
Singapore	-16.1	-0.07	-1.38
Korea	-18.0	-0.22	-2.88
Taiwan	-17.6	-0.21	-0.88
Thailand	-13.0	0.14	-2.19

Source: Citi estimates.

Changes in long-term government bond yields across Asia were more mixed. Yields rose in India, Indonesia, Malaysia and Thailand, reflecting growing financial market risks and squeezing liquidity conditions. Corporate bonds, especially high-yield bonds, fell more sharply. These changes in Asia were consistent with those in the industrial world where realignment of risk premiums occurred more in the corporate sector.

What if the worst case occurs?

Continuous deterioration of market conditions has seriously dampened investors' sentiment for the past 5-6 weeks. The market has already priced in the risk of a 25% plunge in housing prices, while some investors have been expecting a recession in the US based on leading indicators such as the inverted yield curve.

Our base case is that while we expect the housing weakness to persist longer than we previously expected, a recession is still very unlikely. The key supporting evidence is robust fundamentals outside the housing sector. Despite temporary softening in the second quarter, consumption is likely to expand at least by 2.5% in the second half of 2007 and in 2008.

A comprehensive model involving indicators such as yield curve and financial conditions predicts the probability of recession in the US at less than 20% currently, although the probability has risen significantly from about 10-15% a month ago. Recent decisive policy actions by the Fed and other central banks are also an important factor limiting downside risks for the economies and markets.

As a stress test, however, we examine a worst-case scenario. For this purpose, we assume:

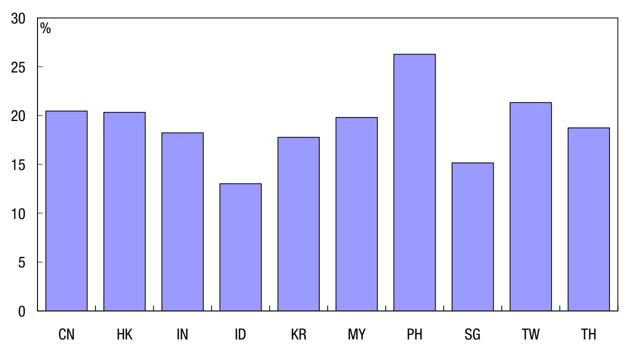
- Housing prices drop by 25% in the US;
- Credit crunch problems spread across the world;
- The US economy falls into a recession.

In such a hypothetical scenario, significant weakening of the housing market could further exacerbate the sub-prime problems, as the mortgage default rate could pick up more rapidly. Residential construction and consumer spending likely will also weaken further. Meanwhile, US equity indices and corporate bonds probably will fall much more sharply, although the magnitudes of the adjustments are difficult to estimate. A recession in the US should be negative for the US dollar outlook, although a flight to quality could also provide some support to US Treasuries.

Slowing US growth, particularly weakening consumption, could impact Asia directly. Given Asia's high dependence on exports and external markets, it is likely premature to argue that Asia has decoupled from the US. Asia may be able to survive a gentle softening of US growth, due to Asia's generally significant fiscal and monetary policy flexibility. But if the US economy slides into a recession, it would be impossible for Asia to remain unaffected.

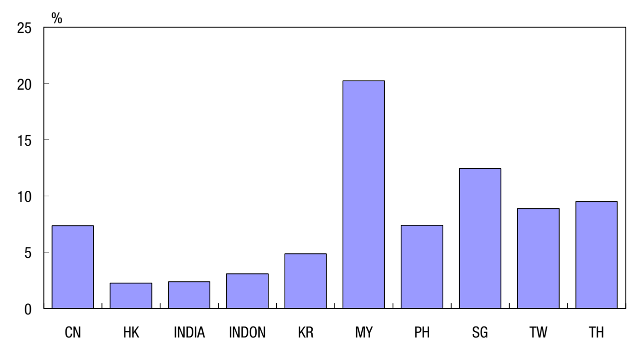
Exports to the US accounted for an average of 19% of Asia's total exports in 1996-2006 (see the left figure below). And exports to the US were equivalent to an average of 7.8% of Asia's GDP in 2006 (see the right figure below). In China, for instance, exports to the US were about 21% of total exports and 7.4% of GDP.

Share of Exports to the US, 1996-2006 Average (% of Total Exports)



Note: Domestic exports data are used for Hong Kong and Singapore

Share of Exports to the US, 2006 (% of GDP)

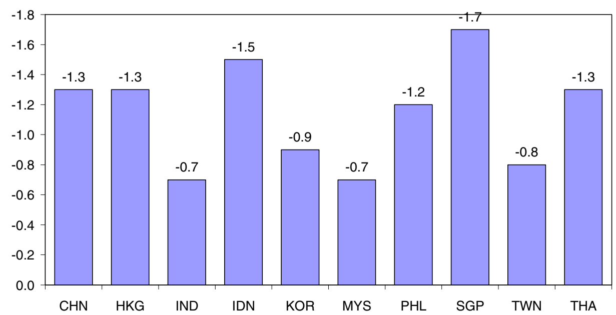


Note: Domestic exports data are used for Hong Kong and Singapore

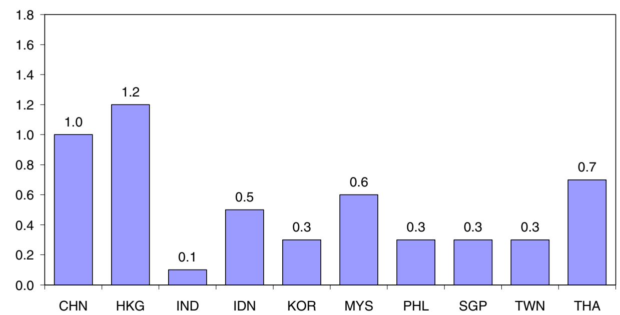
Source: CEIC and Citi estimates.

According to analysis applying the Oxford Macroeconomic Model, a 1ppt slowdown in the US would probably lead to a decline in Asian growth of an average of 1.1ppt (see the left chart below). Given that the US is currently expanding at around 2.5%, a recession could mean a decline of growth by around 3ppts. The model estimates and Citi's current forecasts imply that GDP growth could fall to close to or no higher than 2% in Hong Kong, Indonesia, Korea, Singapore, Taiwan and Thailand.

Impact of a 1ppt US Slowdown on Asian Growth (Percentage Points)



Impact of a 1ppt Acceleration of Chinese Growth on Asian Growth (Percentage Points)



Source: Citi estimates applying the OEF model.

GDP growth could also decelerate to around 7% in both China and India. Such growth performance, however, could be devastating, especially for China. In addition, even if China is able to support growth through fiscal and monetary policies, like it did during the East Asian financial crisis, it is not likely sufficient to offset the impact of slowing US growth (see the right figure above).

Market implications

In general the current market jitters should shift central banks' monetary policy bias more toward easing. We now expect the Fed to cut the policy rate by 25bps no later than September 18, and it could continue to cut in the following months. While the ECB and BOJ are still on their hiking cycles, we think that they are likely to delay their tightening in the near term.

The currency markets have moved significantly for the past weeks. As a result of the unwinding of the carry trade, the yen/dollar rate adjusted from 120.6 on July 25 to 113.0 on August 17. High yield and commodity currencies such as Australian, New Zealand and Canadian dollars all weakened sharply. We now expect all these trends are likely to continue in the near term, although over time we think dollar weakness should resume.

For Asian economies, downside risks increased significantly, although we haven't downgraded any GDP forecasts so far. We lower our Malaysia ringgit, Philippine peso, Singapore dollar, Thai baht, Taiwan dollar and Vietnamese dong forecasts on recent currency weakness caused by recent global financial market turbulence. Over a 3- to 6-month horizon, however, we expect most Asian currencies to continue their appreciation trends.

Most Asian central banks will likely either ease or maintain stable monetary policies, on benign inflation, risks of credit crunch and expected rate cuts in the US. We expect Indonesia, the Philippines and Thailand to cut policy rates in the coming months. Others may keep their policy rates at current levels, unless risks to the economies and markets escalate. China is the only major economy in Asia where we still expect continuous policy tightening given rising inflation.

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