ASIA

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Asia Macro Views

Weathering the Subprime Storm

Key points

- **Asian financial markets have been hit by the US subprime mortgage problem during the past month, with generally lower share prices, wider credit spreads and weaker currencies**
- **With a couple of exceptions, Asian financial institutions do not have high exposure to CDO, especially subprime mortgage-backed credits**
- **Significant change in the US growth outlook could impact Asian economies. However, a comprehensive model estimates the probability of a US recession at less than 20% currently**
- **Repricing of corporate credit and risks of credit crunch could also affect asset prices in Asia, especially the equities and corporate credits**
- **Asia's strong fundamentals, including healthy current accounts and fiscal positions, should generally support asset prices**
- **Central banks are more likely to ease, especially in Korea, India, Indonesia and Thailand, given lower inflation rates, risk of a credit crunch and an expected rate cut by the Fed**

Discussion

The subprime mortgage problem has taken center stage in the global financial markets since Bear Stern first revealed that two of its flagship hedge funds became worthless about a month ago. Market participants' concerns heightened further when central banks around the world – including the US Federal Reserve Bank, European Central Bank, Bank of Japan and Reserve Bank of Australia - injected liquidity to money markets late last week.

We now expect the Fed to cut the overnight Fed funds rate by 25bps in 2007 and 25-50bps in 2008. While the US economic expansion remains robust, a normalization of economic and financial activities is probably conditional on lower policy rates. Inflation rates stay elevated, but are already declining. Since June, however, the housing market imbalance has not narrowed, which points to serious and persistent housing market adjustments ahead.

In reality, however, the subprime mortgage problem in the US is an important issue, but not an overwhelmingly large one. As of end of 2006, the total value of subprime mortgages and Alter-A mortgages was US$1trn, about one-third of the total mortgage market, or 10% of commercial banks' total assets. The total value of delinquency so far is only about 3% of bank capital. The market has priced in a 25% decline in US housing prices. But the US hasn't seen such large housing price correction since the Great Depression.

How would the latest developments affect Asian economies and markets? Asia may be affected through three likely channels: 1) exposure of Asian financial institutions to the subprime mortgage credits in the US; 2) spillovers from the repricing of US corporate credit and risks of a credit crunch; and 3) the direct impact of a deteriorating US growth outlook.

First, most Asian financial institutions do not have high CDO exposure, let alone high exposure to subprime mortgage-backed credits in the US. The only exceptions could include a few Singapore, China and Korea banks and some Taiwan insurance companies. Even for those with CDO exposure, the key risk is probably not the default of subprime mortgage credit but the repricing of CDOs.[1] It is probably reasonable to assume that direct hits at the financial institutions by the subprime problem should be modest at most.

Second, a potential US recession could have major negative impacts on Asian economies. However, despite the recent deterioration of sentiment among market participants, the US economic expansion remains robust outside the housing sector. Our comprehensive model puts the probability of a recession in the US at merely 20%. If the US economy can maintain its slightly below-trend growth, then the direct economic impact on Asia may be more limited.

Third, repricing of credit in the US has already generated important impacts in Asian markets. During the past month, for instance, Asian share prices went lower, bond spreads grew wider and Asian currencies became weaker. If the credit crunch turns into a global problem, then financial conditions could tighten significantly and economic activities could suffer more seriously.

So what could be the direct implications for Asian financial markets? Asian monetary policy biases are likely to swing toward easing, while investors of Asian assets could become more conservative in their risk appetite.

Inflation rates have moderated in most economies, except China and Taiwan, during the past months. This has reduced the need for monetary policy tightening in much of the region. But if financial conditions tighten, risks of a credit crunch rise and the Fed cuts rates, then most Asian central banks could shift into an easing mood.

Last week, Bank of Korea (BOK) surprised the market with an earlier-than-expected rate hike, possibly to finish the job ahead of the expected easing by the Fed. We

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[1] Tracy Yu, “Asian Financials. Sell-off Overdone: Impact of US Subprime Crisis Manageable”, Citi Investment Research.

think short rates have peaked in Korea and India and any future moves in these two countries will likely be downward.

Although Bank Indonesia (BI) held the rate last week due to a rebound in inflation, we expect BI to cut the one-month BI rate by at least another 25bps before the end of the year. Likewise, Bank of Thailand (BOT) could also lower the policy rate by at least 25bps.

The only economies in Asia where policy rates could still rise are probably China and Taiwan. China just reported 5.6% headline CPI for July, the highest in several years. Even though the high inflation was mainly driven by food prices, especially pork prices, rising CPI is likely to prompt further tightening by the People's Bank of China, possibly another 27bps rate hike and 50bps increase in the reserve requirement. Taiwan's central bank may also continue its tightening process as inflation expectations have picked up lately.

We think some investors may be too pessimistic about the consequences of the subprime mortgage problem. But many investors are likely to stay more averse to risks going forward. This could add caution to the outlook for risky assets, especially equities and corporate bonds. But we do not expect the risk premiums to return to the high levels that prevailed two years ago, given significant improvements in corporate, financial and government balance sheets.

Asian currencies generally weakened against the US dollar in recent weeks amid the market volatilities. This is probably a result of uncertainty. However, Asian currencies are likely to continue their paths of appreciation in the near term, at least against the dollar. Their relative moves against other currencies such as the euro, pound and Australian dollar may be more limited.

It is important to recognize that the subprime problem is still evolving. Given that the US housing sector inventory has risen over the past months, it is difficult to predict at this stage when and where the problem will reach its bottom. We think the subprime problem represents only a tiny portion of the economy and markets, but we cannot rule out more devastating consequences through reinforcing mechanisms. Therefore, we need to monitor developments in this area very closely in coming months.

The best strategy for investors to follow at this stage is to focus on the fundamentals. During the past 10 years, Asia has increased stability of macroeconomic indicators, improved the current accounts and fiscal positions, reduced external, especially short-term, debt burdens and strengthened financial institutions. Even if Asia were to weather heavier subprime storms, we believe that it would likely come out in better shape than most other emerging market economies.

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