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Global System Continues to Normalize, Question Now is Prospect into 2011

We started off 2Q2010 with the world continuing to normalize, with the East proceeding much faster than the West. Indeed, most Asia GDP growth numbers outperformed market expectations. Singapore posted growth of 15.5%y/y in the opening quarter of 2010 vs 13.1% in its advance estimate. Full-year's expansion is now expected to hit 7 to 9%, which looks increasingly conservative, even taking into account of renewed pressure points in Europe. Even assuming flat growth in 2H10, Singapore GDP could still hit 10% for 2010.

The question now is prospects into 2011, given the uncertain situation in Europe. How Asia stands this time next year will very much depend on the policy responses over the next few months in Europe. Recall that in May, the situation was certainly far more intense and less predictable. For now, we are a little more comforted, as the liquidity situation appears to have been resolved after the massive €750bn rescue program from EU/ECB/IMF, although solvency is still the issue. In the US, it is not as challenging, despite negative noises from some of high frequency data. Overall, the market seems convinced that double-dip risk is rather remote, although pace of recovery looks to be subdued going into 2011.

De-leveraging in the West remains an issue

The situation in Europe was certainly far more intense than many had predicted. At one point, there were questions whether the entire EU would be dragged down by developments in Greece, through contagion effect into Spain, Portugal, Ireland and perhaps Italy, and then Hungary also got involved. Certainly, the problems of 2008/09, where the public sector underwrote the fall-out in the corporate/banking spaces, have raised questions on the health of sovereign balance sheets.

We have put together a report this quarter on developments and impact of European sovereign crisis in a report: "European sovereign debt, and its implication on Asian growth prospects". While our take is that 'liquidity risk' is retreating, 'solvency' risk is an issue, especially in Greece. This could potentially impact countries including Spain, Portugal, and Ireland, i.e. "contagion risk".

Even if both issues were resolved, harsh austerity measures in Europe mean weaker growth prospects and deflationary pressures. One thing is clear: EUR will continue to weaken, reflecting the problems in Europe and as part of policy response. Over the next few months, developments in Europe will need to be closely monitored, including meeting the IMF-EU conditionality in Greece, refinancing requirement in Spain, Ireland and Portugal. All these would spell 'volatility', across all assets classes and markets.

Potential triggers for financial markets will be from two fronts: (1) Greece meeting EU-IMF conditionalities; (2) Maturing debt and debt auctions in PIGS countries.

We have listed below key schedules for EU-IMF drawdowns, debt maturities and auction dates that the market will be closely watching in the coming months.

Greece key dates: Access and Phasing under the Proposed Stand-By Arrangement, 2010-2013	
Review	Availability
Board Approval of SBA	May 9, 2010
First Observance of End-June 2010 performance criteria, completion of first review	August 30, 2010
Second	November 30, 2010
Third	February 28, 2011
Fourth	May 30, 2011
Fifth	August 30, 2011
Sixth	November 30, 2011
Seventh	February 28, 2012
Eighth	May 30, 2012
Ninth	August 30, 2012
Tenth	November 30, 2012
Eleventh	February 28, 2013
Twelfth	April 30, 2013
Source: IMF May 2010 IMF Country Report No. 10/110, Greece: Staff Report on Request for Stand-By Arrangement	

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Key Redemption Schedule Dates for Greece, Portugal and Spain					
Greece		Spain		Portugal	
Date	EUR(bn)	Date	EUR(bn)	Date	EUR(bn)
July 16, 2010	0.91	July 20, 2010	1.04	July 23, 2010	0.91
July 16, 2010	1.04	July 23, 2010	6.66	September 17, 2010	1.04
July 23, 2010	2.4	July 30, 2010	16.71	November 19, 2010	2.4
September 29, 2010	0.19	August 20, 2010	6.79		
October 15, 2010	1.28	September 24, 2010	5.83		
October 15, 2010	0.96	October 22, 2010	4.95		
		November 19, 2010	5.52		
		December 17, 2010	4.62		
Source: Bloomberg					

Auction dates		
Spain	Portugal	Ireland*
July 1, 2010	June 23, 2010, 5 yr bond, EUR 0.3bn - 0.8 bn	July 20, 2010
July 15, 2010		August 17, 2010
August 5, 2010		September 21, 2010
August 19, 2010		October 19, 2010
September 2, 2010		November 16, 2010
September 16, 2010		
October 7, 2010		
October 21, 2010		
November 4, 2010		
November 18, 2010		
December 2, 2010		
December 16, 2010		
January 13, 2010		
*In each auction, up to two bonds may be offered and the NTMA envisages auction sizes in the range of €1 billion to €1.5 billion.		
Source: National debt management agencies		

European Debt Problem: How will Asia be impacted?

Although the Greek banking sector equity index has fallen by around 47% since the beginning of the year as a result of Greece's fiscal situation, Asian banks appear to have fared better. The weak correlation between Athen's banking stocks and the regional banking/financial stocks showed that the contagion risk has been well-contained and Asian banks' direct exposure is likely to be manageable.

Nonetheless, there are valid concerns that any sharp spike in risk aversion resulting from the European debt and fiscal crisis could lead to large capital outflows from the region. Meanwhile, we believe the most direct impact on Asia is still from the conduit of the real economy which would increase the growth risk for at least the next two years.

EU exports demand from Asia is a function of the EUR currency value and real demand from the EU. Our study shows that that income effect of a slowdown in economic growth in the EU economies would have a greater dampening impact on demand for Asian exports than the price effect of the EUR depreciation (against the respective Asian currency).

In Asia, Singapore, Malaysia and China are the most vulnerable to any economic slowdown or EUR weakness. In China for instance, we estimate that a 1% drop in EU GDP will cause a 4% drop in China's exports to the EU. Comparatively, a 1% depreciation in EUR against the RMB will result in a contraction of 1.5% in China's exports to the EU.

Overall, translating to GDP impact, Singapore and Malaysia are likely to suffer the largest fallout from a decline in exports to

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the EU. This is intuitive as a result of their relative dependence on trade. We estimate that a 10% drop in Singapore's exports to EU will shave its GDP by around 0.8%.

Asset Bubble Risk in the East

In contrast to the West, Asian policy makers continue to roll out additional administrative/regulatory measures and/or outright tightening in order to cool real estate prices since Jan 2010:

In Singapore,

Feb 2010 -- (1) 3% sellers' stamp duty on property sold within a year; (2) lower loan-to-value ratio to 80% from 90%.

Mar 2010 -- HDB resale flats' holding period extended to 3 years from 1 year. Limits on the number of public flats in each block and neighbourhood that can be sold to PRs and citizen-PR couple will have to pay a $10,000 premium for new flats launched by the HDB.

In Hong Kong

Feb 2010 -- Budget 2010: Increase land for residential projects and raise the transaction tax on homes worth >HK$20mn to 4.25% from 3.75%.

Mar 2010 -- Govt plans to sell around 4,000 of its subsidised apartments under the Home Ownership Scheme and will also put on sale 374 subsidised apartments under its Sandwich Class Housing Scheme (23% discount to mkt px for monthly household income<HK$39,000).

In China,

Jan 2010 -- Raise RRR by 50 bps to 16% for large banks and 14% for small banks from 18 Jan. In Guangzhou, enforce rule that developers pay a fee equal to 20% of land price on idle land, unless the delay is out of developers' control.

Feb 2010 -- Several measures in Beijing: (1) foreigners allowed to buy a residential property after staying in the city for at least one year; (2) monitor land sales, including land parcel must be <200,000 sqm, downpayment ≥50%; (3) enhance transparency and info flow of the sector.

Sensitivity Analysis: Impact on affordability from interest rate increase in Singapore

	Dec 2009 Mass Market Private Condo (100-120sqm)				Average 1996
		+100bps	+200bps	+500bps	
Singapore private property affordability	28.1%	31.4%	34.8%	46.2%	57.0%

Source: UOB Economic-Treasury Research

More administrative measures to moderate short-term capital flows, but not outright capital controls

Fearing capital flows disrupting growth prospects and creating volatility in domestic capital markets/currencies, Taiwan kicked off one of Asia's first capital flows management regulations in recent times. Taiwan's central bank in Nov 2009 banned foreign investors from placing funds in time deposits after its governor Perng Fai-nan expressed concerns on 14 Oct about TWD500bn from foreign investors sitting in Taiwan deposit accounts, or 5 times above the level that Taiwan considered as acceptable. Brazil had in Oct imposed a levy on foreign purchases of stocks and bonds as part of its measures to restrain BRL's appreciation. Subsequently, policy makers in South Korea and Indonesia also announced similar measures to moderate the short-term capital flows.

In **South Korea**, the authorities have moved to limit banks' foreign exchange forward and derivatives positions which were blamed for the FX volatility and the country's huge short-term foreign currency debt as they are wary of another USD-squeeze similar to the post-Lehman episode. The local and foreign banks have their forward and derivatives positions limited to 50% and 250% of their equity capital respectively effective from Oct this year (2010). The banks have up to two years to adjust their positions and the caps will be reviewed every quarter. For corporates, currency derivatives transactions will be limited to 100% of the value of their physical foreign trade transactions, down from 125% set in November 2009.

In **Indonesia**, against earlier expectations that the BI could restrict foreign buying of the SBIs, the central bank announced a set of more market-friendly measures. The BI would issue SBIs with longer tenors (9-month and 12-month SBIs to start in August and September respectively) as well as require the buyers in the primary market to hold the securities for at least one month. So far, the new policies have limited impact on the IDR but we do not expect the central bank to come up with more restrictions on capital flows in the near-term as this could potentially have a negative impact on investor sentiment.

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Normalisation in interest rate policy: Perhaps a little more moderate

In line with the strong growth momentum, central banks in the East have started to normalize in their respective monetary policy.

RBA

The RBA has been one of the most aggressive central banks in the world to withdraw some of the extraordinary stimulus, having raised the overnight cash rate by 150 basis points since October last year as the economy rapidly recovered from the global downturn. Yet, it paused an aggressive series of interest rate rises at the June meeting, keeping the OCR target unchanged at 4.50%. The Bank now appears to have a neutral policy bias, with Governor Glenn Stevens presenting a balanced statement with the June decision. He indicated that "interest rates to borrowers are around their average levels of the past decade, which is a significant adjustment from the very expansionary settings reached a year ago". Having said that, whilst it may pause again in July to assess the water; beyond that, we still think that the RBA would prefer to have rates closer to 5.0% by the end of the year unless a severe financial crisis threatens the market.

RBNZ

The RBNZ commenced its tightening cycle in June, raising the official cash rate by 25bps to 2.75%. The move was the first rate change since April 2009, and the first increase since July 2007. While the overall tone of the statement was notably more upbeat, the Bank has also noted the considerable uncertainty over the pace at which policy support would be removed, with the RBNZ also explicitly noting that "further removal of stimulus will be reviewed in light of economic and financial market developments". Although the removal of policy stimulus has begun, we still expect the pace to be gradual, and the end-point for the OCR will be lower compared to previous cycles. Our projection is for three further 25bp hikes, taking the OCR to 3.50% by the end 2010.

INR

India embarked on its policy normalization early in 2010, with a 75bps hike to cash reserve ratio to 5.75%. At its Feb meeting, RBI raised its repo and reverse repo rates by 25bps to 5.00% and 3.50%, respectively. This was followed by its smaller-than-expected 25bps hike across the three policy rates at its Apr meeting, bringing the CRR at 6.00%, repo rate at 5.25%, and reserve repo at 3.75%. While Eurozone's debt crisis has dampened sentiment somewhat, the key driver for RBI's decision was mainly domestic price pressures, with food price inflation in double digits since Nov 2009 and wholesale price index rising at an average of 8%y/y since Oct 09 compared to ten-year average of 5%.

CHN

China has raised reserve requirement ratios (RRR) three times in 1H2010, and we expect two additional increases in 2H. With more "flexibility" in RMB trading (announced on 19 Jun), PBoC is entering next phase of policy normalization as interest rate tool will now become available to price credit appropriately in view of domestic inflationary pressures. However, we expect the pace of both RMB appreciation - and interest rate hikes - to be moderate in the 2H.

BNM

BNM was one of the earliest Asian central banks to begin normalizing its interest rates despite the weak domestic inflationary pressure in 1H10. After 50bps rate increase since March, we expect another 25bps hike in 3Q10 which will bring the Overnight Policy Rate (OPR) to 2.75%. The central bank is then expected to pause for the rest of the year.

MAS

On 14 Apr, MAS surprised the market by tightening the monetary policy aggressively. The policy band was re-centred at the prevailing level of the S$NEER, and the slope of the band was shifted to one of modest and gradual appreciation, from a zero appreciation path, with the policy bandwidth unchanged. This was the first time the central bank had undertaken two tightening measures in one meeting. With this, we expect a strengthening trend in the SGD for the rest of the year.

TWN

Taiwan's CBC hiked its official rediscount rate unexpectedly at its 24 Jun meeting, by 0.125% to 1.375%. With the stated aim of keeping real interest rate positive, we expect CBC to continue its modest rate hike quarterly into 2011. Against a moderate inflationary background, we look for the official rediscount rate rising to 1.75% by end-2010 and 2.75% by end-2011.

Singapore: Firing on All Cylinders

After the economy exhibited exceptionally strong gains in the 1Q, 2Q GDP looks on track for another double-digit growth, while full year GDP looks robust. The recent NODX however possibly showed the beginnings of a slowdown in Singapore's exports, on concerns that the austerity measures in Europe will aversely impact the goods and services that Singapore exports to the EU. We could see some slowdown in the second half of the year given the slow growth and fiscal austerity measures in Europe. We are however, projecting some weakness in Singapore's exports arising from the Eurozone problems, and are looking at some contraction on a q/q saar basis in the 2Q and 4Q, bringing full year growth to 9.0%. We are thus revising up our GDP forecast for 2010 to 9.0%, up from our original forecast of 7.5%. For 2011, we are still keeping to our forecast of 5.0%. 2011 will not have the benefit of a low basis effect and also with companies adjusting to the foreign worker levies and current productivity drive, we think there might be some impact on growth.

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SGD to strengthen towards year-end

With the announcement of the RMB exchange rate regime reform, we think this will hasten the appreciation in the SGD. The RMB currently makes up a sizeable portion of our SGD TWI, and with this adjustment, the SGD is slated to strengthen. The risk of unresolved sovereign debt problems in the Eurozone still stand, and should also ensure that the gains in SGD will not be a straight path, with volatility interspersed. **We see the USD/SGD going to 1.38 at the end of 3Q, and then moving lower to around 1.36 by year end, as the economic growth fundamentals in this region further give rise to inflows here.**

Singapore SIBOR to remain low throughout 2010, but watch the Fed in 2011

As the SGD is set on an appreciating path, this would likely attract more capital inflows, thereby lowering cost of borrowing The ' policy trilemma' faced by small open economy economies with free capital mobility, targeting FX as a monetary policy choice, is that policy makers have fairly little control over domestic interest rate and money supply. Thus, domestic interest rates are largely dictated by external factors, especially USD interest rates. This also means that the impact of Singapore's central bank actions on interest rates is less direct. Generally, the uncovered interest rate parity rule holds in Singapore over the medium to long term. Under the UIP condition, the movement of domestic interest rates in Singapore are determined by the level of interest rates abroad, and market expectations of the direction of the Singapore dollar exchange rate. So, according to the UIP, holding everything else constant, we think Singapore's domestic interest rates should edge downwards, as the SGD continues climbing and capital inflows persist, on the back of expected appreciation in the SGD. The biggest factor affecting Singapore's domestic interest rates, however, is still the US Fed funds rate.

Our view is that SGD interest rates will remain low for the remainder of the year. Beyond that, focus will shift to the Fed interest rate tightening bias. **With our expectation of the Fed tightening monetary policy in 1Q2011 (instead of 4Q2010 as envisioned earlier), the 3M SGD SIBOR should move up to 0.8% by 1Q2011. However, do note that SGD interest rate will be a little volatile, when the Fed begins on its normalisation process into 2011, as the initial journey could be quite aggressive.**

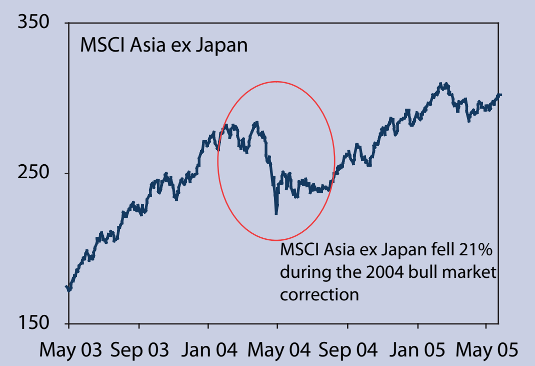
Global Investment Strategy-Slowdown, not double-dip (Contributed by UOB Asset Management)

Equity markets continued to be marked by volatility in the second quarter of 2010. Investors remain troubled by the debt problems in Europe and their fears of a hard landing in China have grown stronger. The rise in risk aversion in financial markets has however not spilled over into the real economy and global economic indicators are still showing signs of a continuing recovery.

Although the ongoing volatility in financial markets raises the risk that business and consumer confidence will be affected, our view is that we are likely to avoid a double-dip recession. This is because the global economy is at a very different stage of the business cycle compared to 2008. Companies have not been hiring aggressively and business inventories have not been rebuilt. The degree of retrenchment we saw after the Lehman episode is therefore unlikely to be repeated.

As we do not expect another recession, we believe the market is experiencing a bull market correction, akin to 2004, and that this is not the start of a bear market.

2004 Correction of MSCI Asia ex Japan



Source: Bloomberg 15 June 2010

The investment environment is however not exactly like 2004 as the cyclical picture is being complicated by structural problems, i.e. the large and growing fiscal deficits in the developed economies. As there is more uncertainty, the volatility in markets could last longer than normal.

Investors are likely to stay edgy until fears of a sovereign default in Europe are assuaged. More initiatives by the European policymakers and signs that funding stress in the interbank market is abating would help calm investors.

For China, it is likely that the government will continue to stay tough on the property market in the near term as the government has never reversed policy within three months of a major change. A signal that the government has seen sufficient evidence of property prices coming under control and that policy tightening is over would be welcomed by the market.

The market will also be focussed on economic data in the coming months to gauge if the recovery is sustainable or if the debt crisis in Europe has affected the real economy. Resilient economic data is likely to stabilise equity markets.

We retain our Overweight in Equities and the Underweight in Bonds. We also stay overweight Commodities.

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Within Equities we remain overweight the US, Asia and Latin America, and stay underweight Europe and Japan. In Fixed Income we continue to prefer Investment Grade bonds. In Commodities, we are overweight in Gold and Base Metals.

FX Outlook: More uncertainty going forward

This is an area that has made material change over the quarter, and the driving factor is clearly the extended weakness in EUR/USD. As such, AUD, NZD, GBP are all expected to pare gains in the coming quarters. Asian FX continues its uptrend trajectory, although the extent will be dependent on the extent of RMB appreciation. **Despite the announcement of a RMB depeg on 19 Jun, our take is that RMB will end the year around 6.77/USD, about 0.8% from the pre-depeg value of 6.83, based on considerations of EUR weakness, trade-weighted RMB, and impact on Chinese exporters.**

Broad USD outlook: Watch the EUR/USD

USD: Given the prolonged eurozone sovereign risk situation and jittery markets responding to any negative newsflows out of the eurozone, the near-term trajectory of the USD should be upwards. However, without a worsening risk appetite, there is no reason for the USD to be fundamentally stronger - other than the possibility that the USD will continue to be a funding currency against most global currencies until 2011.

EUR: The eurozone sovereign debt issue dominated EUR's moves for most of 2Q 2010. Developments in Greece, EU's delayed response to Greece's fiscal problems, inconsistent remarks by EU officials and concerns about contagion risks to other eurozone countries and financial markets continue to add downward pressure and volatility in the euro. Even after the EUR750bn IMF-EU bailout package and ECB measures in early May, the euro continued to fall amid concerns about Greece's ability to undertake its fiscal measures. Since the start of the year, the single currency has dropped more than 2000 pips from its high of around 1.45 in Jan 2010. The EUR/USD fell below 1.19 in early June, and year-to-date was about 12% lower, making it the worst-performing major currency to date. It has since recovered to around 1.23 by 22 June as negative sentiment on the eurozone dissipated somewhat. **Overall, we expect EUR/USD towards 1.19 end-2010, and then 1.15 into end-2Q-2011. Our assumption assumes no departure or any sort of default from Greece. Otherwise, a collapse in confidence could result in EUR towards 1.10 or lower.**

GBP: Attaining lows of 1.4231 in May, GBP/USD was on a decline for most of the quarter. The downward move in the currency pair was almost inevitable given the general election held in the country, as well as the worries about fiscal debt as European woes rattled markets. Of late though, the GBP/USD has been benefiting from the rise in risk appetite. And the new government's first budget was largely in line with expectations, and that was reflected in a stronger GBP following the announcement. Having said that, risks still remain for this volatile GBP/USD pair. The new budget would probably be of a temporary relief only, with absolute direction keying off the broader trends in risk markets and broader perceptions over the growth outlook since the sizable retrenchment on the fiscal side is likely to bring a sharp slowdown in economic activity in the UK. **GBP/USD could hover around 1.450 by the end of 3Q, before going to around 1.440 by year-end.**

AUD: Over the past quarter, volatility has picked up considerably in the AUD/USD, just as it has for most currency pairs and for most financial instruments in general, given the spike in risk aversion amid the European sovereign debt crisis. The AUD/USD, from highs of 0.9389 (attained on April 12) had plunged to lows of 0.8067 in late May. Although the pair has since climbed to higher grounds, now trading around the 0.8700-levels, the price action in the last couple of months suggest that the broad trend in risk appetite across global financial markets is the dominant catalyst driving the exchange rate. **Assuming that financial markets stabilise, we look for the AUD/USD to trade comfortably around the 0.8500-levels by the end of the third quarter to about 0.8600 by the end of the year.**

NZD: We had seen a lackluster performance in the NZD/USD at the start of the second quarter, with trades congesting around the 0.7100-area. More recently, however, the currency has experienced a surge in volatility as heightened risk aversion takes centre stage amid the European debt crisis. The pair hit lows of 0.6561 in early May and is now trading around the 0.7000 levels. We are still maintaining our view that the New Zealand dollar will still see some support intact, but at the same time, we do bear in mind that against the larger backdrop of the recent European debt crisis, the New Zealand dollar will continue taking its cues from broad trends in risk sentiment. It is likely that we will continue seeing more whip-saw price action around the current ranges. **We are looking for the NZD/USD pair to trade around the 0.690-levels by the end of the third quarter to around 0.7000 by the end of the year.**

Asian FX

RMB: China finally announced its long-anticipated FX policy shift on 19 Jun, promising more flexibility for the RMB but effectively ruling out a one-off large reval. One key question is how undervalued is the RMB? Based on a recent academic study, the RMB undervaluation ranges from as low as 13% to as much as 63% against the USD. Given the wide range of estimates, it is not surprising that the RMB valuation issue has been contentious. Another question to ponder is the pace of appreciation for the RMB. With the track record in 2005-2008, it should be reasonable to expect a 3-5% annual appreciation pace, although that was under the best of circumstances then and we are faced with a world with structural issues and deleveraging that is still working through the system. **Taking into account EUR continued weakness, a firmer trade-**

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weighted RMB, and impact on exporters, we maintain our USD/RMB forecast at 6.77 by end-2010, which would be a 0.8% change from the pre-depeg level of 6.83.

MYR: Despite the market turmoil triggered by the European debt woes, the MYR has remained positive against USD ytd throughout 2Q10. Expectation that Bank Negara will pause in its monetary normalization soon is unlikely to have much implication for the MYR but USD/RMB, which was largely flat since the start of the year, will probably drive the MYR for the months ahead as the PBoC formally announced its intention to resume its RMB exchange rate reform. However, any move by the PBoC is likely to be on a measured pace which means substantial gains in the MYR will not be sustainable especially since the currency has probably moved ahead of the other Asian currencies so far this year. **On the back of our assumption that the RMB will appreciate by around 0.8% until year-end and factoring in uncertainties in the European markets, we could see USD/MYR at 3.18 by end-2010. That means MYR appreciation of 7.6% against USD for the year.**

IDR: Domestically, BI's measures to discourage further short-term capital inflows in mid-June were the focus. Given the volatile market conditions, there were concerns that the strong capital inflows into Indonesia post-global financial crisis would make the country more vulnerable to hot money reversals. This was particularly so for the bond market as foreigners hold around a quarter of the Indonesian government bonds. Against earlier expectations that the BI could restrict foreign buying of the SBIs, the central bank announced a set of more market-friendly measures.

So far, the new policies have limited impact on the IDR but we do not expect the central bank to come up with more restrictions on capital flows in the near-term as this could potentially have a negative impact on investor sentiment. While we expect the current account surplus to narrow to 1.3% of GDP this year from 2.0% in 2009, investment inflows are likely to remain supportive, particularly as economic growth in the region is expected to stay firm. **Under our assumption of a gradual RMB appreciation pace, USD/IDR is likely to consolidate lower at 9,000 by end-3Q10 before breaking the key support to end at around 8,950 by end-4Q10.**

THB: Even as China announced a more flexible RMB exchange rate regime, resulting in likely strengthening in other Asian currencies such as the THB, we think the magnitude of the gain will not be large. The RMB will probably not see a quick pace of appreciation for this year, hence we do not expect to see a big jump in the THB. The current semblance of normalcy in Thailand might provide support for the THB. As the Eurozone problems also still continue to unfold, we think risk aversion will remain very much on the cards, resulting in investors seeking safe haven in the USD, lifting the USD. But this should start to ebb slightly towards the end of the year, as Asia's relatively stronger economic fundamentals come to the fore again. We are projecting the THB to strengthen slightly for the remainder of the year, with periods of volatility and choppiness in between. **USD/THB could reach around 32.20 by the end of 3Q, before going to around 31.90 at the end of the year.**

KRW: KRW succumbed to selling pressures in 2Q10 from the European debt problems as well as the new FX rules meant to limit speculative capital flows in the country. The KRW touched an intraday low of 1,271.50/USD in June (end-April: 1,108.4) prior to the announcement of the measures but subsequently recovered some lost grounds after the banks were allowed two years' grace period to comply fully with the regulations which would cap their foreign exchange forward and derivatives positions. The FX measures are expected to cut liquidity in the market and thus could have some negative implication on the KRW.

Barring another round of sharp sell-off in EUR/USD amid risk aversion from the European debt crisis, we expect USD/KRW to edge lower to around 1,170 by end-3Q10 and then 1,160 by year-end. The start of USD/RMB downtrend following the PBoC's statement on its currency reform will be a boost for the Asian currencies in general. Meanwhile, there is some tail-end event risk from the geopolitical tensions in the Korean peninsular in relation to the sinking of a South Korean warship in March but that is unlikely to be a key driver for the currency in the coming quarter.

Global Central Bank Policy:

US Fed: The speed of Fed normalization may be predicated on labour market developments and SME recovery. Given the low inflation numbers, slow pace of recovery in the US economy coupled with high levels of unemployment driven by small businesses, as well as euro-zone spillover risks, the Fed may delay its normalization process even longer. The Fed must balance the competing influences on US activity and domestic inflationary pressures amidst an increasingly uneven global recovery. The Fed will probably closely monitor labour market conditions and medium term inflationary risks within a global environment of prolonged fiscal deficits and ultra aggressive liquidity conditions. It will also be useful to monitor the growth of monetary aggregates going forward as an indication of medium term inflation risk. The 23 June 2010 policy statement saw few changes to the FOMC statement and the extended period language remain unaltered. The Fed remains cautiously optimistic with respect to the growth outlook.

Given the rather weak US employment situation, low medium term inflation risk and slow pace of economic activity coupled with risk of a weaker European economic recovery, the delay in hiking the rates to 1Q 2011 or 2Q 2011 seem plausible. **We are now factoring-in a 25 bps Fed hike towards the end of**

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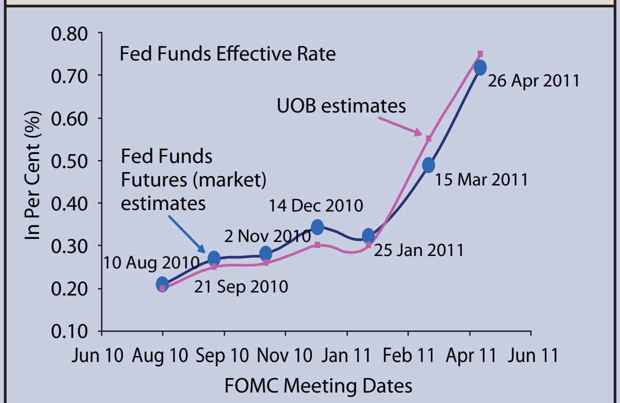
1Q11, followed by subsequent 50bps hikes over the next few quarters to end 2011 at 2.00%.

Expected US Federal Funds Rates Based on Fed Funds Futures



Source: Fed Reserve, UOB estimates

ECB: Growth in 2010 and 2011 is expected to remain weak. This can be largely attributed to various sectors continuing to repair their balance sheets, while private consumption is dampened by high unemployment, precautionary savings and modest income growth within an environment of fiscal austerity. The eurozone is thus expected to grow by a modest 1.1% in 2010, and 1.3% in 2011, despite a sharp decline of 4.1% in 2009. Looking further ahead, inflation rates should remain moderate. However, the euro depreciation over the past six months and rising commodity prices should exert upward pressure on prices, even as euro zone domestic price pressures are expected to remain low. Given the continued weak economic outlook, broadly balanced risks to the medium term outlook for price developments, coupled with continuing sovereign debt problems, the ECB is unlikely to move at the upcoming meeting on 8 July. **We maintain our call for an ECB rate hike only in 2011. It is plausible the ECB will begin to tighten policy in 2Q 2011 (25bp) after a US Fed move.**

Asian Interest rate:

China: With the RMB becoming more flexible from 19 Jun, PBoC's interest rate policy will be freed from the exchange rate shackle and is expected to be the next policy tool to be deployed. So far, the preferred (or only) instrument has been the reserve requirement ratio (RRR) due to the fixed exchange rate regime. We expect two additional increases in RRR in second half (one each in 3Q and 4Q) to 18.0%, as the focus is likely to shift to FX and interest rate space in second half of 2010. **We look for China's key interest rates to be raised twice in the second half of 2010. This means by end-2010, 1Y working capital interest rate should be at 5.85% (from 5.31% currently) and 1Y deposit rate at 2.79% (from 2.25% currently).**

Malaysia: BNM has hiked its Overnight Policy Rate (OPR) by a total of 50bps at two monetary policy meetings in March and May. Other than the expected spike in the inflation rate in 2H10, the improving domestic economic conditions augur well with another rate increase this year. We expect another 25bps rate hike in 3Q10 to bring the OPR to a neutral rate of around 2.75% before the central bank pauses for the rest of the year. This would recover half of the 150bps rate cut during the financial crisis. There are two meetings (8 July and 2 September) scheduled in 3Q10. There is also a possibility that the central bank could push back further rate increase to November if we encounter market hiccups around the date of the monetary policy decision in July and September.

Indonesia: Since the beginning of the year, government officials have consistently signaled that the policy interest rate will remain unchanged for the whole of 2010 as a result of the mild domestic inflation. The BI has more recently provided a clearer signal for the benchmark rate which it said would rise by 50bps to 7.0% in 2011. The overnight rate has been at 6.5% since August 2009 and the latest BI measure to widen the spread between its overnight repurchase rate and the benchmark overnight rate to 100bps from 50 bps previously meant that the interbank overnight rate has more room to fluctuate without having to hike its policy rate.

Despite BI's rhetoric, we would expect the central bank to begin normalising interest rate by 4Q10 as inflation heads higher following the planned 10% hike in electricity tariffs starting July 1. Even then, the mild inflationary pressure so far has caused us to pare back our forecast for the overnight rate hike to 50bps for 2010 with the bulk of the normalisation to take place next year.

Thailand: With the cessation of street protests, the Bank of Thailand would now be able to resume its policy interest rate normalization, which was put on hold when the protests escalated in Bangkok in May. Now, the fiscal problems in the Eurozone may be a main factor weighing on BoT's rate decisions. We think it is likely that the Thai central bank will start to hike rates at its 14 Jul monetary policy committee meeting. The Thai economy has rebounded strongly and economic indicators had all showed increments every month, until Apr, when the political situation worsened. The case for policy normalization is strong in light of inflation coming back.

South Korea: Holding back BoK's hands are concerns over higher debt servicing costs as the household indebtedness stood at a record high 69% of GDP in 2009. Although the cooling property market meant that policy makers are no longer thinking of raising interest rate to deter speculators, there are now concerns that the household balance sheets could take a hit. Both house prices and transaction volume in Seoul have eased slightly in 2Q10 following measures on higher loan-to-value as well as debt-to-income ratio regulation last year. Still, the firmer economy and inflation consideration will likely bring about interest rate hikes beginning in September or October this year. **We now expect the BoK to hike its base rate by around 75bps this year to bring it to 2.75%.**