

Executive Summary

Operation Twist In The US, Ballooning Debt Crisis In Europe, And Fault Lines In Asia

The US economic situation has turned more cautious over the last three months, constrained by sluggish jobs recovery and a surprisingly weaker-than-expected recovery in 1H2011. Adding in the heightened external environment, US Fed has extended the average maturity of its securities holdings (popularly known as "Operation Twist"). Our view remains that the US economy will continue to muddle through, but not go into a double-dip recession.

More worrisome, however, is the sovereign debt situation in Europe. Our previous call was 'kicking the can down the road' (effectively buying time or "extend and pretend"), so as to limit the contagion effect into bigger European nations such as Spain or Italy. Clearly, the market is getting increasingly restless and impatient. Short-end Greece interest rates have spiked to levels that are pricing in a certainty of default, as 2-yr Greek government bonds are yielding more than 66% and 1-yr yield at an incredible 130%, admittedly in an extremely illiquid market. Market is now re-visiting issues pertaining to the stability facility EFSF (increasing the size or even leveraging it up), and the possibility of Eurobond issuance. Amidst all the conflicting and inconsistent noises, ECB is the lone major European institution shoring up confidence through direct bond purchases. However, action so far has been tentative.

To be frank, debt crises are actually not new in the world of finance. In previous episodes, be it the Mexican peso crisis (in early 1994), Argentina default (1999 - Nov 2001), Russia default (in 1998), and even Asian financial crisis (in 1997-99), they would include some variant of currency devaluation as well as debt default. But, this option is not available to Greece or broader PIGS countries due to the tying to the "gold standard" of euro currency and membership in a monetary union. In all, the journey ahead looks difficult and challenging for Europe, and choppy for financial markets. Most of the options available (whether it is beefing up EFSF, Eurobond arrangement, ECB outright buying, or even one or two peripherals breaking away) will include some expensive costs for the entire bloc to bear. The next 6-12 months is all about 'political will' to pull things together. Question is whether these actions will be put together 'before or after the capitulation', which will have significant impact on global as well as Asian financial system. We will have to wait-and-see. (We have put together a report laying

out the options available to Europe in this publication.)

For Asia, our call has been that this part of the world will be impacted through the interbank liquidity and credit channels. Recent developments in SGD SOR, and Asian FX weakness clearly reflected this. Another indicator is the Euribor TED spread which signals stresses in the US dollar funding market especially among European banks. So far, the general reading is that we are worse off than Bear Sterns episode, but not as severe as Lehman's situation in 2008. However, we have to watch developments on this front closely. Indeed, given the recent FX weakness, some are questioning if this is another Asian FX crisis in the making. Our view is that such adjustment is not new, seen during the 2008 episode as well. Then, SGD depreciated about 15%, from 1.3504 to 1.5537 between Jul 2008 to Mar 2009. Also, as compared to the Asian financial crisis of 1997, fundamentals in this part of the world are definitely more stable.

However, after the last few years of USD decline, we may be heading for a temporary bottom for now. And, Asian FX is likely to be choppy over the next few months, with the extent of the downside depending on developments in the European space (for more details please refer to our special report on Asia in this publication).

US Economy – Growth Outlook On Weak Bias As Sentiment And Politics Are Its Biggest Problems

The US economic outlook has turned more cautious due to weak 1H and on-going external risk factors. We now expect US GDP to grow by a more sluggish 1.6% in 2011 and a lacklustre 2.0% in 2012, constrained by the slow jobs market recovery, household deleveraging and US policymakers' tug-of-war.

The Fed kept its ultra-low interest rate policy unchanged in its latest September policy meeting but as expected, the US FOMC decided to extend the average maturity of its holdings of securities (popularly known as "Operation Twist"). Fed also maintained its promise to keep rates at "exceptionally low levels ... at least through mid-2013" and its existing policy of rolling over maturing Treasury securities at auction. Longer dated US Treasury yields could head lower in near term as a result of Fed's action to extend the duration of its UST holding. We expect 10Y UST yield to head lower to 1.5% by end-2011 from around 2.0% currently.

USD Higher On Risk Aversion												
	CHF	NZD	AUD	KRW	MYR	SGD	TWD	EUR	THB	GBP	IDR	RMB
01-Aug-11	0.784	0.877	1.097	1,050.40	2.946	1.202	28.838	1.425	29.71	1.630	8464	6.434
30-Sep-11	0.900	0.766	0.975	1,178.05	3.190	1.298	30.517	1.354	31.17	1.558	8808	6.387
% change vs USD	-13.0	-12.7	-11.1	-10.8	-7.7	-7.4	-5.5	-5.0	-4.7	-4.4	-3.9	0.7

Source: Bloomberg

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Europe – Getting Worse By The Day

It is definitely a clear understatement to say that Europe is in a precarious situation and without a timely and efficient solution, faces the risk of falling into the abyss. The crisis had engulfed Greece, Ireland, and Portugal and now threatens to take down both Italy and Spain. Markets have also focused on the core of the Eurozone, with economic growth stalling in Germany and France, and questions being raised about the financial health of the large French banks and of France's own triple-A credit rating. There are several options available to policymakers at this juncture and we evaluate the effectiveness and ease of implementation. We also like to highlight that the weeks and months ahead will bring greater uncertainty and volatility as there will be some very important decisions, and these developments will potentially impact global market sentiment.

Europe Debt Issue: How Will Asia Be Impacted?

(1) Watch Liquidity And Credit

(2) FX Weakness Or Another FX Crisis In The Making?

Our call has been that this part of the world will be impacted through the interbank liquidity and credit channels. Recent developments in SGD SOR, and Asian FX weakness clearly reflected this. Another indicator is the Euribor TED spread which signals stresses in the US dollar funding market especially among European banks. So far, the general reading is that we are worse off than Bear Sterns episode, but not as severe as Lehman's situation in 2008. However, we have to watch developments on this front closely. If liquidity does dry up, the situation in Asia could change materially.

Another channel is extended FX correction leading to an FX crisis. We believe the recent move in the FX market is a currency adjustment rather than a currency crisis in the making. Yields in Asia have not risen significantly but that will be the key to watch for signs of greater distress in the coming months. Since the start of August, Asian currencies have depreciated by around 5% against USD. The comparison drawn against 2008 suggests that there

could be more downside to the Asian FX given that the Asian currency index fell around 11% back then. However, we maintain that this is not another FX crisis in the making.

Our calculations indicate that the FX reserves in the emerging Asian countries are significantly higher compared with the foreigners' investments in the country's government bonds and equities (since 2002). From the FX perspective, this is some reassurance that the impact from large outflows from these countries will be manageable.

Asia also stands out in terms of its strong economic fundamentals, including current account surpluses and stronger fiscal positions compared with the troubled West. Asian corporates have cut back on leveraging since the Lehman crisis, thereby increasing their resilience should credit or liquidity conditions weaken.

SGD Policy -

MAS Likely To Ease To a Gradual SGD Appreciation

Against the backdrop of a sharp deterioration in the global economy exacerbated by stalling recovery in the US and the ongoing uncertainty in Europe, Singapore's economy is likely to be adversely impacted. Although we think a technical recession in the 3Q for the domestic economy could be averted due to the strong August IP numbers, even in the event of one, we are not expecting the recession to be prolonged, with the 4Q swinging back to growth on a q/q saar basis, with full year growth at 4.8% and 2012 GDP expanding at 4.5%.

MAS could loosen monetary policy by moving to a more gradual appreciation stance. Our current estimation of the SGD NEER slope is at 3.5%, and we project that it could be moved back to 2.0%, with no change in band width nor mid-point. Domestic inflation is likely to ease from the first half of the year but still remain elevated. More weakness could be in store for the SGD on USD funding concerns and the deterioration in Europe. We have revised our USD/SGD

Growth Moderation Trend												
y/y % change	2009	2010	2011F	2012F	1Q10	2Q10	3Q10	4Q10	1Q11F	2Q11	3Q11F	4Q11F
China	9.2	10.3	9.2	8.5	11.9	10.3	9.6	9.8	9.7	9.5	9.0	8.5
Hong Kong	-2.7	7.0	5.2	4.2	8.0	6.7	6.9	6.4	7.5	5.1	4.7	3.8
Indonesia	4.6	6.1	6.4	6.0	5.6	6.1	5.8	6.9	6.5	6.5	6.4	6.1
Malaysia	-1.6	7.2	4.8	4.9	10.1	9.0	5.3	4.8	4.9	4.0	5.4	4.9
Philippines	1.1	7.6	4.5	4.7	8.4	8.9	7.3	6.1	4.6	3.4	4.4	5.0
Singapore	-0.8	14.5	4.8	4.5	17.5	19.4	10.5	12.0	9.3	0.9	4.6	4.6
South Korea	0.3	6.2	4.2	4.2	8.5	7.5	4.4	4.7	4.2	3.4	4.2	5.2
Taiwan	-1.9	10.9	5.2	4.5	13.6	12.9	10.7	7.1	6.2	5.0	4.7	5.6
Thailand	-2.3	7.8	4.0	4.3	12.0	9.2	6.6	3.8	3.2	2.6	5.0	5.2
US	-3.5	3.0	1.6	2.0	3.9	3.8	2.5	2.3	0.4	1.0	2.0	2.1

Source: Bloomberg, CEIC, UOB Economic-Treasury Research

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forecasts to 1.29 for end- 2011. Risks are tilted towards SGD weakening further on the possible worsening.

Singapore - Easing Growth On Heightened Global Uncertainty, Flat Interest Rates

The key manufacturing and export segment of electronics still looks weak, while recent lifts in data have been driven by the volatile pharmaceutical segment. But weak external demand will impact Singapore's economy adversely. Next year, we expect to see slower growth in the economy of around 4.0-4.5%, brought on by weak external demand as well as the restrictions in foreign labour, which would hit labour intensive sectors such as manufacturing, construction and some service sectors. As for interest rates, the 3M SGD SIBOR looks likely to continue to hold steady at around a rate of 0.4% for an extended period of time, into 2013, mirroring the low US Fed funds rate. Historically the direction of the SIBOR moves in tandem with the US fed funds.

Global FX

EUR: Despite recent steps taken to address the sovereign debt crisis, a lot more clarity is needed and the persisting uncertainty remains a headwind for the Euro region. As it stands, EUR/USD has already fallen considerably from August's high of 1.4549 to where it is trading currently. Given that there are several developments that will potentially impact the Euro currency, there is still some room to decline should these pressures intensify. As it stands, European bank stocks have been hit hard, dragging broader equity markets lower. And the negative developments out of Europe could well carry on beyond the effects of the problems of weak growth in the US. As such, amid further volatility in the EUR/USD, we are looking for a depreciating trend in the EUR/USD going forward.

GBP: Downward pressure in the GBP/USD has intensified over the last few weeks. From the highs of 1.6618 (August 19) attained in the previous quarter, prices have fallen to below the 1.5400-levels. A worsening economic backdrop in recent weeks has seen the British currency lose much of its appeal as interest rate expectations from the BoE continue to diminish amid fears that the economy may slide back into recession. Hence, a big market mover looming on the horizon for the sterling would be the MPC. With the BoE seen holding on rates for the foreseeable future and talk of further quantitative easing measures on the horizon, the pound is likely to remain under pressure against the greenback. Apart from the economic backdrop and monetary policy expectations, the landscape in the GBP/USD is always complicated by the re-emergence of a significant link to broad-based risk sentiment. Adding to pound weights is the sovereign debt crisis, although problems in the UK is still, to a certain extent, better off than the US or Eurozone. So until the currency finds a serious fundamental driver that can overwhelm the larger broad trends in risk appetite,

GBP/USD is vulnerable to further downward pressure, and we are looking for a year-end target of around 1.5300.

AUD: AUD/USD saw a painfully volatile quarter. One which saw the pair powered up to 1.1081 record-highs before being dragged all the way to below the 0.9600-levels. Underlying risk appetite trends will be key to guiding the currency pair. And, that is where the currency found much of its negative pressure. The currency is also influenced by its own interest rate expectations. Hence, we think that the AUD potentially may find further support if the substantial cuts priced in for the RBA are partially unwound in coming months. Besides, the AUD still remains attractive in a world where the Fed has stated that interest rates will remain near zero for potentially two years and the BoJ as well as the SNB are flooding the market with liquidity. In addition, it seems that market participants continue to favor the antipodean as a viable alternative in a backwards market environment where safe haven currencies are no longer attractive and the higher yielding currencies are considered the new safe haven option. Taking these factors into consideration, we still see support in the AUD/USD, although current price action suggests that upside is limited. We are looking for the pair to hover at the lower end of its current range of around 0.950 by the end of the year.

NZD: The NZD/USD pair had found itself on an appreciation path for most of this year, touching highs of 0.8843 in July, before falling to current levels. The recent rapid decline in the currency pair came on the back of the downgrade of New Zealand's sovereign credit rating. Fitch and S&P announced their credit-rating downgrades for the country within hours of one another. Both agencies downgraded New Zealand's foreign-currency rating one level from AA+ to AA, while S&P also cut the country's local-currency rating from AAA to AA+. On the interest rate front, although expectations of a near-term RBNZ rate hike are low; with yields continuing to play a critical role in currency markets, the NZD should still find support from being one of the highest yielding currencies within the G10 space. And just like its Australian counterpart, an important issue to consider in the context of the NZD/USD is market risk appetite. As such, prices have the potential for big moves in either direction. We are looking for NZD/USD to hover around 0.730 by the end of this year. Whilst upside in the currency pair seems limited for now, we see the pair finding its way higher subsequently.

Asia FX

IDR: Significant risks in the Eurozone and bumpy economic recovery in the US have changed our assessment of USD/IDR in the near-term although we expect the downward trend in the long-term to remain intact given the re-rating potential for the country. We have revised our forecast for USD/IDR to 9,000 by end-Q411 and 8,950 in 1Q12 to reflect the risks ahead from a closing low of 8,460 in 3Q11. We

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expect much sharper correction in the IDR should there be a liquidity shock. Recall that the IDR lost as much as 25% of its value against USD in the wake of Lehman failure as it slumped to a low of 12,400/USD from around 9,200.

MYR: We expect USD/MYR to remain biased higher in 4Q11, potentially spiking above 3.20. Further weakness in the US economy in 1H12 will carry added risks for the MYR even though lackluster growth in US could entail some form of stimulus monetary measures as early as 4Q11. The key risk to the MYR is a liquidity shock similar to the Lehman collapse in 2008. Foreigners hold a record high 34% of total Malaysian government bonds as at end-2Q11 (one of the highest in Asia), putting the country in the spotlight as funds withdrew from the emerging markets. Assuming no severe crunch in the interbank market, we now expect USD/MYR at 3.17 by end-4Q11 before easing lower to 3.12 by end-2Q12.

THB: In the next few months, Asian currencies will continue to exhibit weakness against the USD, as long as the problems in the Eurozone remain unresolved. During the Lehman crisis, the THB depreciated around 16% from peak to trough. With the current conditions of tight liquidity and risk aversion very similar to 2008, the THB could possibly fall by the same magnitude. That implies that USD/THB could potentially go to 34.3 from a low of 29.6 in Nov 2010. With no resolution in sight to the European crisis and the market shunning Asian currencies, we are expecting the THB to head towards 31.50 by year-end, and continuing to strengthen slightly to 30.7 by end 2012. Risks are biased towards the downside, as the uncertainty in Europe continue exact its toll on the Asian currencies. Next year, volatility looks likely to persist, with the THB trading in a wide range, but year end could see the THB end at 30.7.

KRW: The KRW was one of the worst-hit currencies in Asia in the current market pullback, correcting more than 10% against USD from its recent closing low of 1,050 at the end of July. What makes South Korea more vulnerable is its large short-term external debt although we have seen sharp improvements since the Lehman crisis. Korea's short-term foreign debt has fallen to 49% of its FX reserves at end-2Q11 from 79% in 3Q08, in part due to tougher regulations on the banking sector. USD-shortage at the onshore market drove the widening of spreads between USD/KRW cross currency swap and KRW interest rate swap as evidenced in the 1Y basis swaps doubling to -250 bps from mid-2011 levels. The 10-year KTB yields also picked up as an indication of market stress as foreign money exits. Using 2008 as a comparison, we note that there is certainly more downside to the market indicators. We have raised our year-end target for USD/KRW to 1,170 but meanwhile, the pair could test higher if the 500 pips surge during the global financial crisis in 2008 is any gauge.

RMB: There has been a divergence between onshore CNY and daily fixings as well as between onshore and offshore RMB prices in recent months. We attribute this to the uncertain global environment, rather than a fundamental change in FX policy. In "normal" environment, demand for RMB would typically show up in a lower USD/CNH price vs. USD/CNY. However, the situation has been in reverse since around Aug but this is likely to be due to risk aversion and demand for US dollar liquidity, which also played out in Singapore's SOR market. In the absence of a major crisis or outbreak in global market, we expect China's gradual appreciation FX policy to stay the course. To accommodate the acceleration in central parity, we are adjusting our end-2011 USD/CNY forecast marginally, to 6.30 from 6.35 previously, as well as our end-2012 forecast to 6.05, from 6.10 previously.

Global Interest Rate

US Fed: The Fed's downbeat economic outlook and benign inflation expectation were likely the factors prompting the latest Fed action for the "Operation Twist". While it did not announce QE3 at the Sep meeting, the FOMC statement did repeat the same point that opens the door to further policy action. We continue to expect QE3 to be announced either at the end of 2011 or in 1Q of 2012. Unfortunately, markets have little (or no) faith that the maturity extension programme ("Operation Twist") will have a material impact on the real economy, a view that we concur. The "twist" did not work back in 1961, and after 50 years, it is also not likely to succeed in 2011 either to boost growth and employment. And by that extension, we could also get the same disappointing outcome with QE3.

We have to realize that US monetary policy is likely to have hit its limits to provide any additional grease to oil the stalling economy. While the Fed needs to be seen that it is doing something (or anything) to address the anemic growth situation no matter how limited the effectiveness maybe, the negative stock market reaction on 21 September despite the FOMC decision should serve as a warning signal to the American economic policy makers that the ball is back on their court. US monetary policy just doesn't have any bite anymore.

ECB: The September ECB meeting has culminated in the decision to hold the benchmark interest rate unchanged at 1.50%, as expected. There was a distinctly dovish change in the rhetoric out of the ECB, though. The ECB's new staff forecasts for GDP growth have been revised down slightly — to a central rate of 1.6% for this year (versus 1.9% in June) and 1.3% for 2012 (from 1.7% in June). The risks to growth have intensified and moved to the downside from being balanced. Meanwhile, HICP inflation forecasts were also revised lower to 2.5-2.7% in 2011 and 1.2-2.2% in 2012. Critically, while inflation is seen to stay above 2% in the

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coming months, inflation risks are “balanced”, no longer on the upside. Clearly, the ECB has effectively withdrawn its inclination to raise rates, with Trichet maintaining that the ECB would continue to monitor very closely all developments. It does seem that the reversal of prior rate hikes has become more likely although the central bank is unlikely to do so quickly. December will be a crucial month since it will coincide with the next staff forecasts. But for now, we think that the refi rate is likely to stay at 1.5%.

BoE: The BoE left its monetary policy settings unaltered in September, maintaining the official Bank Rate at 0.5%, and keeping the program of asset purchases, financed through reserves issuance, paused at GBP200 billion. Whilst the vote on asset purchases was unchanged at 8-1 in September (with Adam Posen remaining the sole dissenter calling for an immediate GBP50 billion extension), it was clear that other members were starting to lean in that direction. The minutes revealed an increasingly dovish tale as the central bank said it reviewed a range of actions available to loosen policy, including the possibility of cutting rates further to 0.25%, although it was decided that when further easing is called for asset purchases would be the “preferable option”. With the BoE mulling its options to ease policy, it seems that the more dovish drift in the tone of the MPC will continue, with the expansion of QE a clear possibility ahead. At this juncture, we are with the view that the Bank Rate, held at 0.5% since March 2009, will likely be on hold at least until the middle of next year. As for the possibility of further QE, we think that more active discussion will be seen within the market. If no additional members vote for further asset purchases in the interim, the November Inflation Report remains the next major focal point.

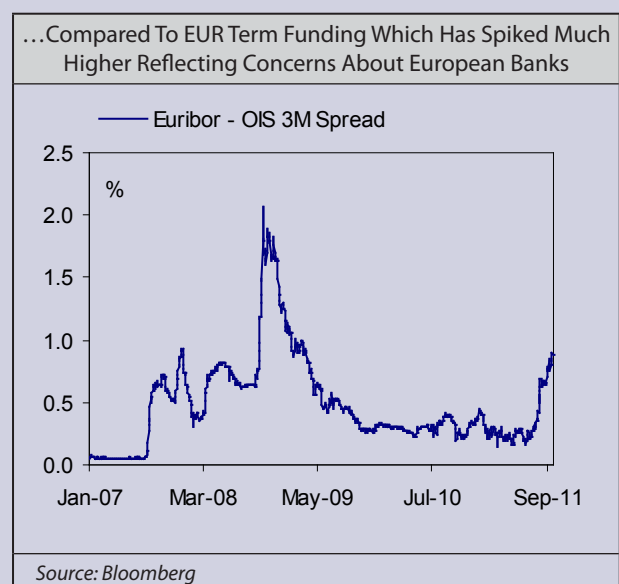
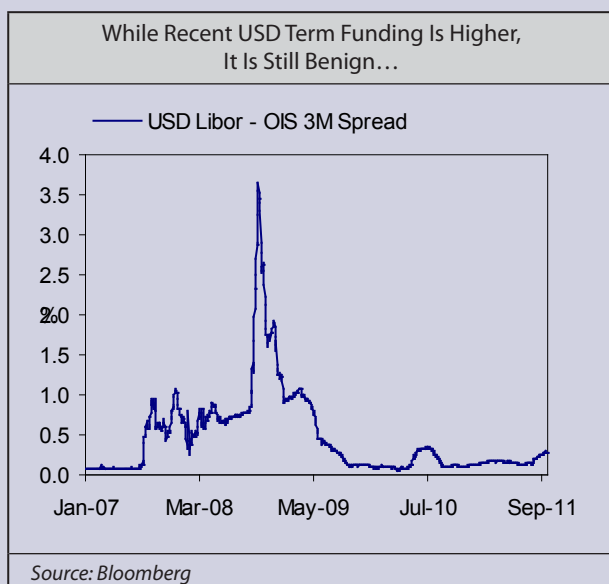
RBA: The RBA left the cash rate unchanged at its September board meeting. This is the ninth straight month that the Bank has left its benchmark interest rate steady at 4.75%.

Significant in the commentary were the references of Eurozone sovereign debt problems and US growth prospects, suggesting that they are becoming more concerned about the outlook for these two regions in particular. The outlook for inflation was another key concern highlighted by the RBA. We do note that the RBA meeting came before some key economic data. Despite reassuringly strong GDP numbers for Q2, the August employment report showed that the Australian economy has been slowing into the third quarter. Typically, the trend in the unemployment rate often holds significance to RBA moves. Some weakening in the labour market was required to get inflation of the system, though clearly if this trend picks up pace, the risk of a rate cut will build. Given that it is a little difficult at this juncture to see how these will play out, it is best for the RBA to stay pat. We see them remaining on hold for the rest of the year.

RBNZ: The RBNZ retained the OCR at 2.5% during the September meeting. The last rate cut took place in March this year, where the OCR policy rate was slashed by 50bps to 2.5% on account of the February earthquake. This brings the cash rate back to the “emergency” lows, which is different from Australia and across the Asian countries. Hence, whilst the possible increase in borrowing costs associated with the recent downgrades could imply that the RBNZ would be less likely to raise interest rates anytime soon; it would be true to say that the RBNZ has room to increase rates, and it would probably not want to fall behind the curve, especially given the positive momentum in the economy. Unless the global economy worsens enough for them to warrant rates at current levels, we believe that it is possible that the RBNZ may begin moving rates upwards early next year.

Asia Interest Rate

China: We believe the current uncertain global market conditions and Eurozone’s ongoing sovereign debt crisis have reduced significantly the odds of further interest rate



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and reserve requirement ratio (RRR) increases in China, at least in the near term. Taiwan on 29 Sep became the latest Asian central bank to halt its rate hike cycle, and Singapore's MAS is likely to do likewise in Oct. In China's case, this would mean the interest rate and ratio tightening cycle to be on hold for now, keeping the 1Y deposit rate at 3.50%, 1Y lending rate at 6.56%, and RRR at 21.50%. However, as we expect China's inflation rate to continue to stay above the 1Y deposit rate in 2012, there is still a risk that PBoC could resume its rate hike cycle next year, especially if global conditions stabilize and domestic environment remains "overheated" in terms of prices and loans demand.

Indonesia: The unexpected lowering of the overnight deposit facility rate (Fasbi) at the central bank to 5.25% in September from 5.75% has led to some speculation that Bank Indonesia could begin to cut the benchmark interest rates in the coming months if the market rout is prolonged. With inflation staying contained and rising global growth risks in the near-term, BI could be expected to remain on hold for the rest of the year until 1H12 at least. Unless the growth risks rise substantially, we believe an interest rate cut before year-end is still fairly unlikely at this point as the move could increase capital outflow risks.

Thailand: Amidst the backdrop of slowing economic growth and heightened uncertainty, the Bank of Thailand is likely to pause in its rate tightening cycle. After raising the benchmark interest rate by 25 bps to 3.50% in Aug, the BoT now looks likely to keep rates steady during the monetary policy meeting 19 Oct, as the external environment has deteriorated rapidly. On growth prospects, we think the 2H

of the year should still post growth of around 5% on private investment, while private and government consumption should also pick up, on Pheu Thai's expansionary policies. We are maintaining our full year GDP growth forecast of 4.0%.

Malaysia: Bank Negara has turned more dovish as it now expects the weaker growth prospects to have a moderating effect on inflation. In its September monetary policy statement, the central bank said that inflation "is expected to remain relatively stable for the rest of the year". This is a strong indication of stable interest rate in the coming months and the balance of risk has shifted towards monetary easing given the combination of heightened global market risk and expectation that inflation will ease back below 3.0% next year.

Korea: The BoK has already normalised its base rate by 125 bps since July 2010 compared with 325 bps cut during the global financial crisis. If not for the downward spiral in the global outlook, the central bank would most likely continue to hike a further 25-50 bps in the coming months given that inflation has continued to exceed expectations. Even at its September meeting, the BoK has said that the decision to keep a steady rate was not unanimous and that the monetary policy committee members are clear about the need to continue raising interest rates to achieve price stability. The tone has weakened now as the external uncertainties dragged on with the BoK indicating it will be prudent. Given the significant increase in external risks, we are now expecting the BoK to keep its benchmark policy rate steady at 3.25% through 2012.