REDWARD ASSOCIATES

EMERGING ASIA TODAY

7 February 2012

Rising growth expectations are negative for the USD.

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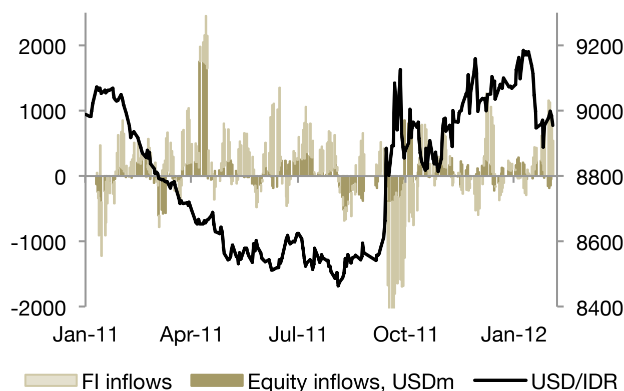
IDR LOSING ITS BETA

Balance of payments flows remain solidly supportive of IDR. We expect Indonesia to post a current account surplus in the region of USD 4bn (0.4% of GDP) in 2012, while net FDI inflows are likely to continue to improve, to a projected USD 16bn (1.6% of GDP), leaving the basic balance of payments in surplus in the order of USD 20bn (2% of GDP). Year-to-date, foreign portfolio inflows have resumed, with net purchases of USD 1.217bn in INDOGB's and USD 317m in Indonesian equities. The resumption of inflows into Indonesian portfolio assets is the strongest since early 2011 and should be confirmed this week by strong reserve accumulation in January. Improved flows have been associated with the recent decline in USD/IDR, option volatility and risk reversals (see Figure 1). Bank Indonesia holds its Monetary Policy Committee meeting on Thursday. Expectations are for no change to the BI rate – although a rate cut has been achieved de-facto via the lowering of the policy corridor, with the o/n rate now trading around 4.05%. We expect foreign inflows into Indonesia to be light ahead of the policy meeting owing to BI's capacity to surprise, but we look for a further rise in IDR to our target of 8,800/USD.

Figure 1: Inflows into Indonesia have picked-up significantly year-to-date (5-day MA)



Source: Bloomberg, Redward Associates

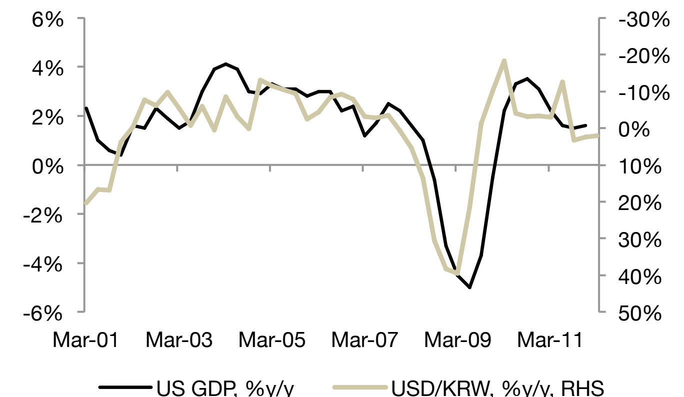
GROWTH EXPECTATIONS AND THE USD

In recent days, we've begun to hear comments that stronger US economic data will prove positive for the USD. In our opinion, this view is misguided. Stronger US economic data may, or may not, lead to a stronger USD depending on the nature of the shock and the conditions under which it occurs.

Stronger US economic growth can prove positive for the USD. For instance, a boost to shale oil extraction may lead to both a narrower US trade and current account deficit – supporting the USD – and a rise in the net contribution to GDP growth from trade. Similarly, an autonomous boost to productivity growth through technological innovation may lead to a temporarily higher pace of GDP growth, leading to a widening of US-RoW interest rate differentials, and a stronger USD. While these examples show that it is possible to have stronger US economic activity lead to a stronger USD, we believe it is more likely that a stronger US economy will be associated with: 1) a deterioration in the US current account deficit, 2) a widening of US-RoW interest rate differentials against the USD, and; 3) improving risk appetite and a reduction in flight-to-quality demand for USD denominated assets.

The US current account deficit is highly pro-cyclical, driven by a high elasticity of demand for imports and pro-cyclical energy prices. As the US economy picks-up, the current account deficit will rise. While a stronger US economy should bring forward Fed rate hike expectations, low PCE inflation and clear statements by Fed Chairman Bernanke that economic conditions *"warrant exceptionally low levels for the federal funds rate though late 2014"* mean that, perversely, we are likely to see a deterioration in US-RoW rate differentials (at least in the near term), pressuring the USD lower. With the US growth outlook improving, we are likely to see a continuation of funds flowing into EM Asia, and as activity here picks-up, policymakers will become more willing to allow currency appreciation in line with historical patterns.

Figure 2: Stronger US GDP growth remains strongly positively correlated with Asian currencies



Source: Bloomberg, Redward Associates

PORTFOLIO

- **Short 3s12s CNY. Entry -17bp, target -75bp, (USD 1m), P&L 3k. Hold.**
- **Short USD/HKD via a 1yr, 25-delta put (strike 7.65), VaR 10k (USD 1m), P&L 0.4k. Hold.**
- **Short USD/IDR via the 1M NDF at 9,205, targeting 8,800, stop 9,050, VaR 50k (USD 500k), P&L 12k. Hold.**
- **Short USD/SGD via a 1M, 25-delta put (strike 1.25), VaR 100k (USD 1m), P&L 9k. Hold.**
- **Short USD/TWD via the 1M NDF at 30.24, targeting 29, stop 29.85, VaR 50k (USD 500k), P&L 23k. Hold.**
- **Long THB/PHP via the 1M NDF at 1.37 targeting 1.3950, stop at 1.37, VaR 50k, Notional USD 200k. P&L 0.8k. Hold.**

The Monetary Authority of Singapore releases its January FX reserve data today. We expect a modest rise in FX reserves in the region of 1%m/m, to around USD 239bn, consistent with favorable valuation effects, downward pressure on USD/SGD and minimal intervention from the MAS. Over the past week, USD/SGD has lost some of its downward momentum, being impacted by fluctuations in the EUR/USD exchange rate. We continue to look for a modest rise in the SGD NEER target zone, an appreciation of SGD within the target zone towards the upper quartile of the basket, and, in USD/SGD space, downward pressure on the basket driven by USD weakness. We remain short USD/SGD via a 1m USD put/SGD call, struck 25-delta (1.25/USD).

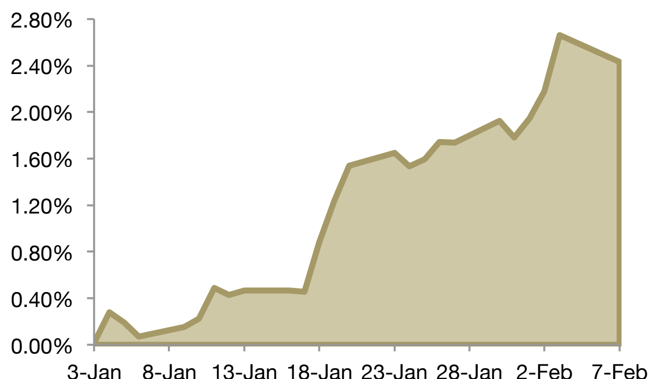
Last week, we reduced our exposure to the TWD after it reached our target of 29.45/USD. We expect the TWD to trade around current levels for now, but we remain positively predisposed towards the currency, looking for it to break lower, towards our revised target of 29/USD. The TWD is benefitting from a strong basic balance of payments surplus, which we project to be in the region of USD 25bn (4.8% of GDP) and renewed foreign equity inflows totaling some USD 2.21bn year-to-date. FX reserves rose a healthy USD 4.75bn in January to USD 390.3bn and the manufacturing PMI strengthened to 48.9 from 47.1 the prior month. CPI inflation has picked up, rising 2.37%y/y in January, although this was largely on the back of a 4.54%y/y rise in food prices due to weather related disruption to supply of fresh fruit and vegetables. While the rise in CPI inflation can be put down to idiosyncratic factors, the Central Bank of China will be closely monitoring its effects on inflation expectations as well as any potential spill-over into core CPI inflation, which remains lower at 1.82%y/y (although rising).

DATA WATCH

PHILLIPINES (09:00 SIN) CPI (Jan) Last 4.2% (y/y) Forecast 4.0% (y/y)

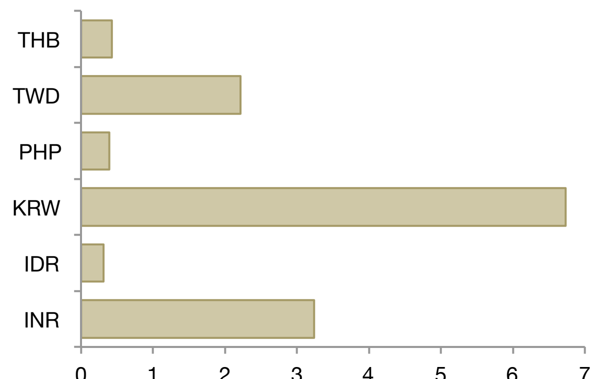
TAIWAN (16:00 SIN) Trade Balance (Jan) Last USD2.32B Forecast USD2.29B

Figure 3: Portfolio returns, YTD%



Source: Bloomberg, Redward Associates

Figure 4: Foreign net equity inflows, USDbn



Source: Bloomberg, Redward Associates

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Peter Redward

m: +64 27 510 8820

e: peter@redwardassociates.com

p/f: +64 9 445 8108

41A Victoria Road | Devonport

Auckland 0624 | New Zealand

www.redwardassociates.com

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