

**ADD POLITICAL POSTURING TO POLICY UNCERTAINTY
- A POOR RECIPE FOR RISK APPETITE**

Friday, February 05, 2010

January has turned out to be a bit of a wash-out in terms of risky asset market performance, and we expect more risk-on, risk-off trading patterns to persist in February.

In the US, the combination of a record budget deficit (estimated at US\$1.6 trillion budget deficit for FY10, and US\$1.38 trillion for FY10) as well as the Volcker rule (Obama's proposal to limit risk taking activity for banks) did not go down well with markets. Add a notching up of US-China bilateral tensions (as elaborated below), fears about Chinese monetary policy tightening, and lingering fiscal concerns over Greece in the Eurozone, with potential contagion effects on Portugal, and it's no wonder that market sentiment remains fragile in January despite the generally rosier economic data and growth outlook. All these suggest that markets may continue to trade in a two-step forward, one-step back pattern in the near-term.

While much has been made about the global rebalancing that is ongoing between US and China and their economic inter-dependence, bilateral relations may continue to grind in the coming month with the US' decision to sell US\$6.4b arms to Taiwan, and US president Obama's plan to meet the Dalai Lama on 17-18 Feb. China had already reacted by suspending parts of its military relationship with the US and threatened to sanction US companies involved in the arms sale. China has also postponed its second round of free trade talks with Taiwan until after the Lunar New Year holiday. In the Eurozone, Greece continues to beat the drums of fiscal repentance and budget consolidation even as markets fret about tail risks should nobody come to Greece' aid and potential implications for the other PIIGS (Portugal, Ireland, Italy, and Spain). Note the EU has endorsed Greece's stability program, given "the successful correction of its very excessive deficit is not only important for Greece but for the euro area and the EU as a whole". But this may not fully allay market PIIGS fears in the near-term, even though a weaker euro is actually beneficial to European exporters.

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Our view is not to tar the rest of the PIIGS with the same brush as Greece

Below we chart the varying structural and cyclical indicators for the PIIGS. In terms of fiscal risks, Portugal is probably closest to Greece, while Spain and Italy may in a totally different league altogether despite their concurrent challenges of a spike in the unemployment rate and slump in the real estate. We concur with the IMF's view (as below), and while these adjustments will be difficult, even painful, they are not unprecedented (see tables 1 & 2 below):

- Some countries are experiencing a sizeable, simultaneous deterioration of structural balances unrelated to the crisis (eg. Japan and the US).
- Others face a significant deterioration with the crisis that may prove to be structural in nature (eg. Ireland, Spain, the UK).
- Some countries entered the crisis with relatively high initial structural deficit levels that would have required adjustment even in the absence of the crisis (eg. Greece and Portugal).
- For a few countries the adjustment need is almost entirely the result of high pre-crisis debt levels (eg. Belgium and Italy).

Table 1: Debt and primary balances (% of GDP)

	Current WEO projections, 2010			Illustrative fiscal adjustment strategy to achieve debt target in 2030	
	Gross Debt	Primary Balance	Structural PB 1/	Structural PB in 2020-30 2/	Required adjustment between 2010 and 2020
Advanced economies					
Australia	22.7	-4.0	-3.4	0.3	3.7
Austria	74.9	-3.1	-2.1	3.1	5.1
Belgium	102.7	-2.3	-0.4	6.3	5.6
Canada	79.3	-3.5	-1.0	2.1	3.1
Denmark	26.9	-2.8	1.9	0.2	-1.7
Finland	48.1	-4.8	-2.3	0.5	2.8
France	85.4	-6.2	-2.1	4.0	6.1
Germany	84.5	-2.3	-0.4	3.0	3.4
Greece	115.0	-2.0	-2.2	6.8	9.0
Iceland	137.3	-2.3	0.4	4.8	4.4
Ireland	75.7	-11.1	-8.2	3.6	11.8
Italy	120.1	-0.7	1.0	5.8	4.8
Japan	227.0	-8.8	-6.9	6.5	13.4
Korea	39.4	-1.0	0.3	0.4	0.1
Netherlands	68.8	-3.6	-2.1	1.4	3.5
New Zealand	30.2	-3.2	-1.9	0.4	2.3
Norway	67.2	8.6	9.2	10.5	1.3
Portugal	81.9	-3.9	-2.9	3.6	6.5
Spain	69.6	-11.0	-5.8	4.9	10.7
Sweden	45.0	-4.5	-1.5	0.5	1.9
United Kingdom	81.7	-10.9	-7.8	6.0	12.8
United States	93.6	-8.1	-3.7	5.1	8.9
<i>Average (PPP-weighted)</i>	102.1	-6.5	-3.3	4.5	7.8
<i>G-20 Advanced economies</i>	106.7	-6.7	-3.4	4.6	8.1
<i>Higher debt</i>	108.2	-6.9	-3.5	4.9	8.4
<i>Lower debt</i>	34.9	-2.9	-0.5	0.4	1.4

Sources: IMF, World Economic Outlook, October 2009 and IMF staff calculations.

1/ Excludes losses from financial system support measures in Japan and the United States. Structural balances are reported in percent of nominal GDP.

2/ Primary balance is assumed to improve gradually during 2011-20; thereafter, it is maintained constant until 2030. The last column shows the primary balance improvement needed to stabilize debt at end-2011 level if the respective debt-to-GDP ratio is less than 60 percent (no shading, "lower debt"); or to bring debt ratio to 60 percent in 2030 (shaded entries, "higher debt"). Illustrative scenarios for Japan are based on its net debt, and assume a target of 80 percent of GDP. For Norway, maintenance of primary surpluses at their projected 2012 level is assumed. The analysis makes simplifying assumptions: in particular, beyond 2011, an interest rate-growth rate differential of 1 percent is assumed, regardless of country-specific circumstances.

Table 2: Countries with large fiscal adjustment in the past

Country (end year)	Size of Adjustment	Length (years)	Cyclically Adjusted Primary Balance	
			At End-Year	Average Over the Five Years After End of Adjustment
<i>Advanced economies</i>				
Ireland (1989)	20.0	11	4.4	3.6
Sweden (2000)	13.3	7	3.8	1.1
Finland (2000)	13.3	7	7.1	3.7
Sweden (1987)	12.5	7	4.8	0.2
Denmark (1986)	12.3	4	6.6	4.3
Greece (1995)	12.1	6	4.8	4.1
Israel (1983)	11.1	3	2.6	7.9
Belgium (1998)	11.1	15	6.7	6.1
Canada (1999)	10.4	14	5.6	3.2
Cyprus (2007)	8.5	4	6.1	...
United Kingdom (2000)	8.3	7	2.9	-0.6
Japan (1990)	8.1	12	2.7	-0.5
Italy (1993)	7.9	8	3.0	4.0
Portugal (1985)	7.5	4	2.6	0.3
Luxembourg (1985)	6.9	4	5.1	3.2
Luxembourg (2001)	6.7	10	6.1	1.0
Iceland (2006)	6.3	4	5.9	...
Netherlands (2000)	6.3	10	4.1	1.0
Denmark (2005)	5.9	11	6.4	...
Australia (1988)	5.8	4	3.7	0.3
Hong Kong SAR (2005) ^{3/}	5.8	4	1.0	...
New Zealand (1995)	5.8	4	7.1	3.9
Austria (2001)	5.8	6	2.2	0.7
Iceland (2000)	5.7	6	3.1	1.6
United States (2000)	5.7	8	3.7	-1.0
Germany (2000)	5.3	9	3.5	-0.7
Germany (1989)	5.3	10	2.7	-0.4
Switzerland (2000)	5.2	7	3.6	1.3
Cyprus (1994)	5.2	3	4.0	0.6
Spain (2006)	5.2	11	3.0	...

Sources: IMF, World Economic Outlook, October 2009 and IMF staff calculations.

^{1/} Cumulative change in cyclically-adjusted primary balance in percent of GDP. In a given consolidation episode, the cyclically adjusted primary balance should not be reversed by more than 1 percentage point from one year to the next.

^{2/} Table lists largest adjustments per country, unless episodes for a given country are fully nonoverlapping.

^{3/} Further adjustment through 2006 to 2007 as a result of asset price effects is not taken into account.

Besides, selected countries like Ireland, even Spain, had made fair progress in terms of its fiscal balance when growth was good up to 2007.

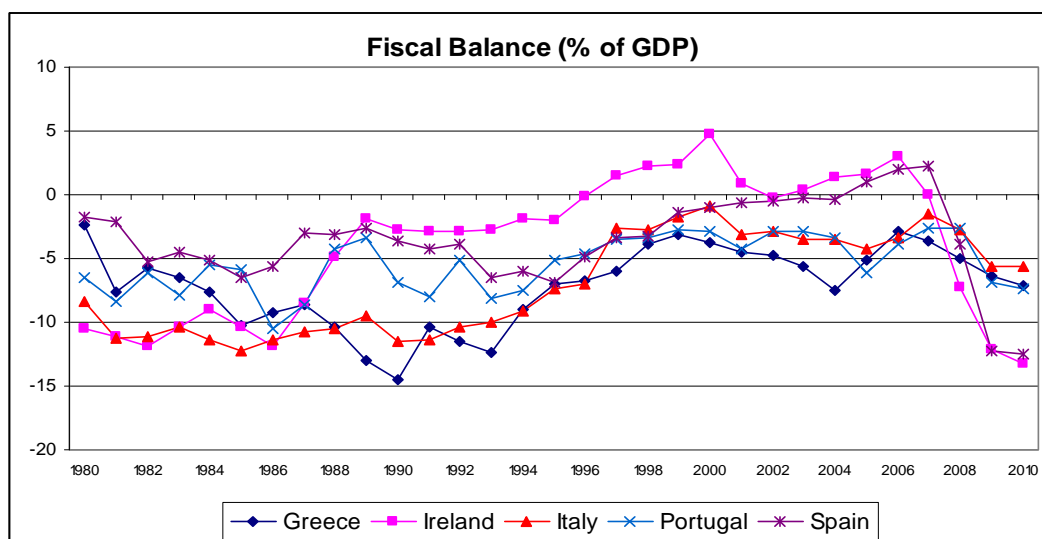


Table 3: Decomposition of large reductions in government debt-to-GDP ratios in advanced economies

Episodes 2/	Starting Debt Ratio	Debt Reduction	Ending Debt Ratio	Primary Surplus Contribution	Growth - Interest Rate Differential 3/	Residual
Ireland (1987-2002)	109.2	77.1	32.2	53.3	31.1	-7.4
Denmark (1993-2008)	80.1	58.1	22.0	51.3	-26.7	33.4
Belgium (1993-2007)	136.9	53.0	84.0	70.2	-25.2	8.0
New Zealand (1986-2001)	71.6	41.8	29.8	52.1	-8.9	-1.4
Canada (1996-2008)	101.7	39.0	62.7	39.3	-19.2	18.9
Sweden (1996-2008)	73.2	35.2	38.0	21.0	-4.6	18.7
Iceland (1995-2005)	58.9	33.6	25.4	17.4	4.7	11.4
Netherlands (1993-2007)	78.5	32.9	45.6	27.5	-8.3	13.7
Spain (1996-2007)	67.4	31.4	36.1	21.6	11.5	-1.7
Norway (1979-1984)	56.5	21.4	35.1	24.2	11.7	-14.5
Average	83.4	42.3	41.1	37.8	-3.4	7.9

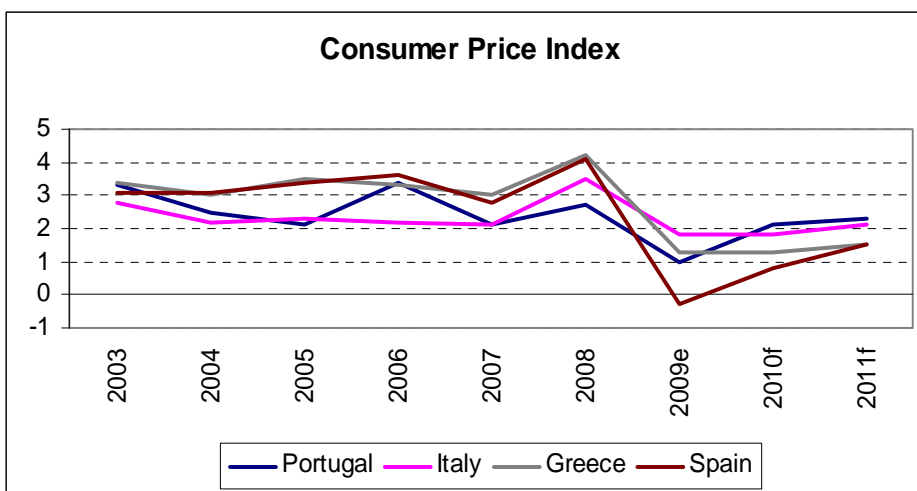
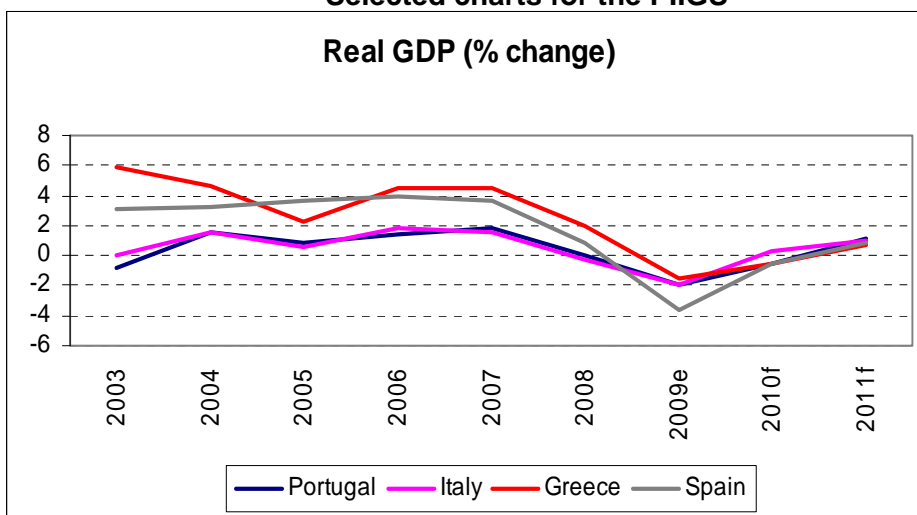
Sources: *World Economic Outlook* database, September 2009; and IMF staff calculations.

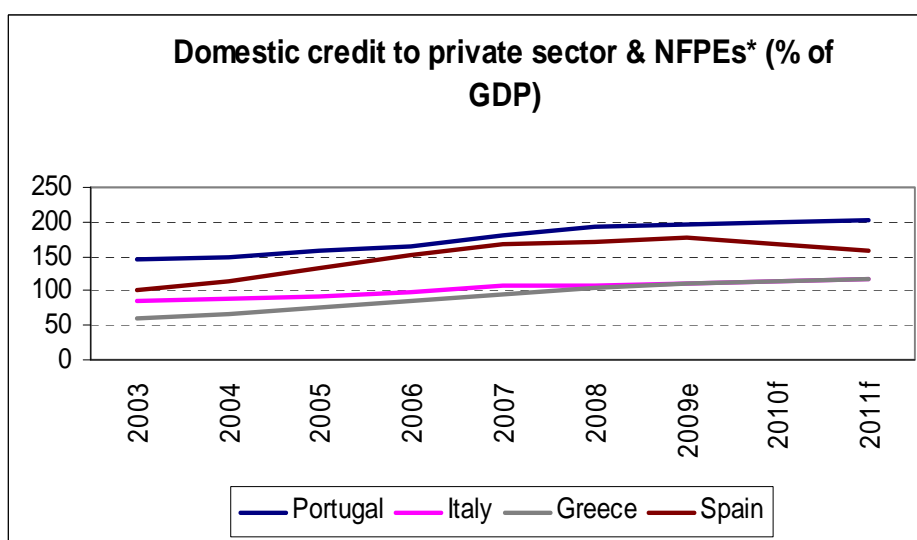
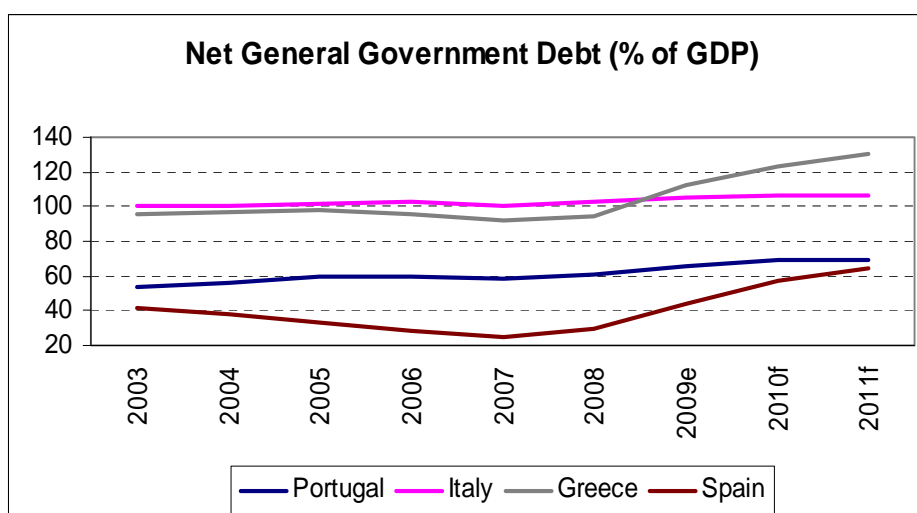
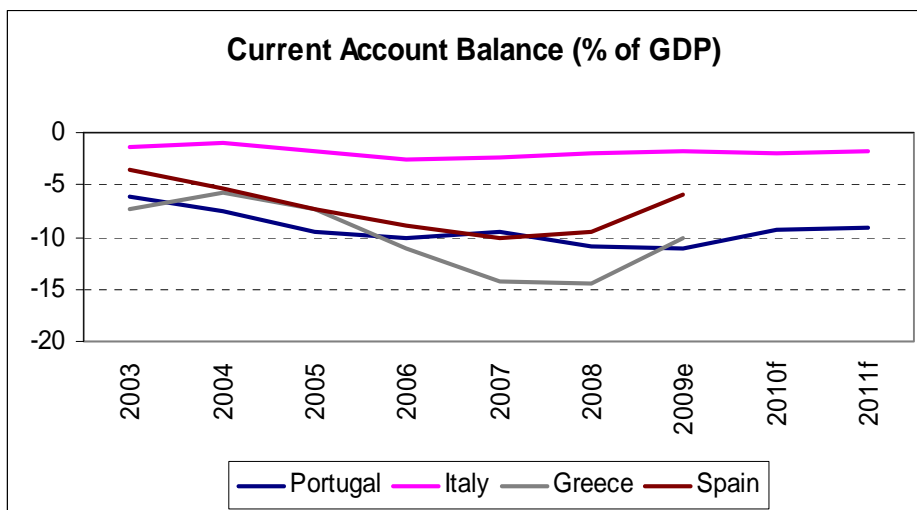
1/ Figures are in percent of GDP.

2/ The episodes listed are based on a sorting of the largest reductions in the Government Debt-to-GDP ratio observed between any two years up to 15 years apart over the last three decades.

3/ The interest rate used in the computation of the growth interest rate differential is the "effective" interest rate, calculated as a ratio of government interest payments to the previous period's ending debt stock.

Selected charts for the PIIGS





Source: IMF, S&P, OCBC BANK

Sovereign ratings in the spotlight

Ratings	Foreign currency	Local currency
Greece: Fitch Moody's S&P	BBB+ (negative) A2 (negative) BBB+ (watch negative)	BBB+ (negative) A2 (negative) BBB+ (watch negative)
Portugal: Fitch Moody's S&P	AA (negative) Aa2 (negative) A+ (negative)	AA (negative) Aa2 (negative) A+ (negative)
Italy: Fitch Moody's S&P	Aa- (stable) Aa2 (stable) A+ (stable)	AA- (stable) Aa2 (stable) A+ (stable)
Spain: Fitch Moody's S&P	AAA (stable) Aaa (stable) AA+ (negative)	AAA (stable) Aaa (stable) AA+ (negative)

Despite the fear of a potential capital reversal out of Asia, recent developments have not been all negative:

- Thailand is encouraging currency outflows, including easing limits on investment and lending abroad as well as looser regulation of corporate management of foreign-exchange risk. Contrast to Dec 2006 when government imposed capital controls to cap short-term speculative flows.
- BNM is talking about normalization of interest rates, albeit sometime down the road, with the recognition of a need to ensure that the stance of monetary policy is appropriate to prevent the build up of financial imbalances that could arise from interest rates being too low for a prolonged period of time. In the interim, monetary policy would remain accommodative to ensure that the economic recovery is well entrenched.
- Hong Kong remains concerned about asset bubbles forming due to ample liquidity. HKMA's Chan said capital inflows amounted to HK\$640b between Q4 08 to Q4 09, with more than half related to IPOs and share placements by mainland China firms, and about HK\$300b in the HK banking system as at end-09 could potentially return to mainland China.
- Singapore's economic indicators continued to improve - Q4 09 unemployment rate unexpectedly fell 1.3% points to 2.1%, the lowest since Q1 08, while the resident unemployment rate also fell a sharp 2% points to 3%, the lowest

since Q1 08. 38.7k new jobs were added in Q4, with services industries the key driver. Bank loans growth also accelerated for the second straight month from 1.8% yoy in Nov to 3.4% yoy in Dec, bringing full-year loans growth in 2009 to 5.3% yoy. In on-month terms, bank loans improved for the second consecutive month by 1.1% in Dec. Looking at the industry breakdown, the loan contraction to businesses has eased from 5% to 3% yoy, while consumer loans growth continued to pick up speed at 11.9% yoy led by housing/bridging loans (14.8%).

SGS bond outlook:

Next up is the re-opening of the 15-year SGS bond on 1 March. The Sep'2024 bond is currently yielding around 3.1% which is fairly close to the cut-off yield when the bond was auctioned back in August 2009. Assuming the re-opening size is reasonable (below \$1.5 billion?), demand should be relatively decent in the current risk-off environment.

15-year SGS bond auction results

Auction Amt (\$ mil)	Auction Date	Bid-to-Cover Ratio	Cut-Off Yield (%)	Ave Yield
800	29/08/2006	2.49	3.48	3.43
2300	29/08/2007	1.75	3.20	3.07
1000	28/08/2008	1.79	3.45	3.36
1400	27/08/2009	1.87	3.11	3.03

Source: MAS SGS

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