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8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

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ASIAN RATES AND YIELDS: The outlook for 2015

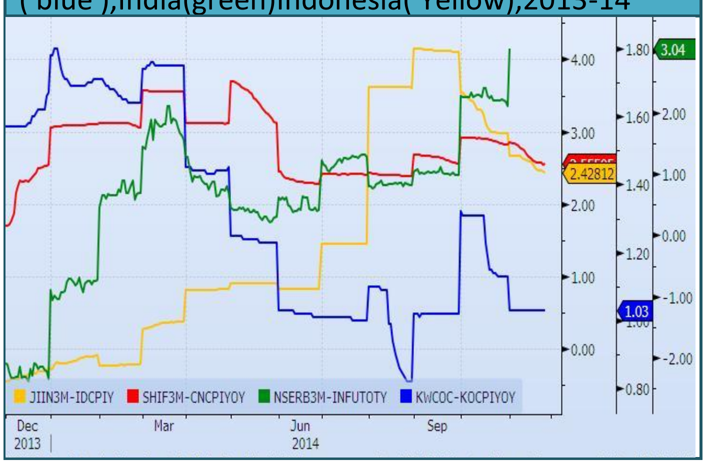
Summary	Investment Conclusions
The current volatility in the global markets has its roots in the disintegration of any semblance of "global trends" with Japan and the EU flat out with loose (albeit ineffectual) monetary policies while the US Fed is, seemingly, on a steady course to hike rates. And all the while, Asian interest rates are moving in all directions dictated by domestic considerations. Even more importantly, several equity markets in Asia by their performances are mostly pricing- in low to falling rates--so much for the dire expectations of what a tighter US monetary policy would do to Asian economies! Bottom line is that Asian rates are determined locally and not by the Fed.	We expect that rates in China, S.Korea, Thailand and India will fall in 1H.15, while in Philippines and Malaysia the authorities may stay on hold till then, while Indonesia could hike once more. Taiwan's long "neutrality" may shift to a cut. Hong Kong rates will increase with the Fed, while Singapore's forex policy may stay neutral given its benign inflation. Equities in China and India will remain supported while in Thailand, Indonesia and Philippines may start to show some strains of their high valuations, but will still perform well given their macro and rates outlook.

Decoupling is the word

For Asian short term interest rates to follow USD rates, Asian exchange rates must be, in some way, linked to the USD. The only two currencies which have this link, is the HKD which is pegged and the CNY which is tightly managed and with capital controls. It now follows that the HKD interest rates will follow USD rates but not the Chinese rates. The rest of the Asian exchange rates float and are managed to variable degrees but not tightly enough to generate a linear link to USD rates. Domestic cycles play an important role in the movements of Asian rates with some the evidence presented in Chart 1 and in the Factbox. Real rates (nominal 3M interbank or similar, minus CPI inflation) for a selected group of Asian economies, mostly the ones whose equities markets which have done best ytd, exhibit widely different cyclical patterns. Real rates in India are rising because of inflation concerns, in S.Korea are now falling as the authorities have loosened, as they are in China where the trend is likely to accelerate after the recent cut in nominal rates. Indonesia's case is more ambivalent as real rates are falling although the authorities hiked nominal rates. As the data in the Factbox show, the present stance of most Asian central banks is evenly divided between hiking (+), cutting (-) or standing still (=).We expect that most of the official moves in 1H.15 will be to cut or to stand still despite the widespread expectation of the Fed

To repeat, Asian domestic rates are moved by domestic considerations, especially inflation, and Asian exchange rates are freely floating with the exceptions of Hong Kong and of China. However,we are slowly but steadily moving towards the belief that the Fed will NOT hike in 2015, as it will be constrained by global developments,thereby making this discusion redundant.This issue will be addressed in our next Econote.

Chart 1: Asian real 3M rates, China(red),S.Korea (blue),India(green)Indonesia(Yellow),2013-14



Source: Bloomberg

The ups and downs of yields

The case of China is of importance as the recent move to cut both lending and deposit rates was seen as yet another move to deregulate interest rates.Deregulation in this juncture of the cycle could prove a double-edged sword. Regulated rates are interest rates which are lower than in a freely competitive market.This has been the case with bank deposits in China.So lifting controls while cutting the controlled rates will likely lead to rates **rising** than falling.Indeed this is what happened with the deposits offered by major banks in China as they took advantage of the rule which allowed them to offer, subject to a cap, higher rates than the ones set by the government ! As far as government bond yields are concerned ,Chart 2 shows not relative spreads but movements .For ease of comparison we use here 10Y

Factbox: Central bank action 2014, 1H.15 (forecast)

Country	Last move	1H.15 Forecast
China	-	=
Hong Kong	-	+
Taiwan	+	-
India	+	-
S.Korea	-	-
Thailand	-	-
Malaysia	+	=
Indonesia	+	+
Philippines	+	=
Singapore	NA	NA

Bonds, despite the fact that for some Asian markets these are not necessarily the more frequently used benchmarks. Asian 10Y govies yield more than the 10Y UST, but their movements since 2013 do not exhibit any consistent pattern following those of the 10Y UST (red in Chart 2).The last "spasm" of the UST in October this year was hardly reflected on Asian government bond yields. The overall trend in the Asian bonds we examine here is falling and we see no reason why this trend should not be maintained going to 1H.15, especially as fiscal tightening and control is prevalent in economies such as Indonesia and India. We expect that forex rates in the region will remain range- bound but unlikely to weaken further versus the USD as local macros plus rate differential movements may not justify further weakness

Chart 2: Asian, 10Y govies, 2013=100,(see text *) legend

Source: Bloomberg

Differentiating the outlook

We expect that Asian short term interest rates in the major economies of China, India and S.Korea will remain supportive for the equity markets with the central banks cutting rates or keeping them constant, irrespective of what the US Fed does in the course of the first half of 2015.The expectation of low oil prices for 2015 will help to keep actual and expected inflation down and will help India and Indonesia to persist with their removal of energy subsidies without incurring political or inflationary costs thus keeping their yields down. Some of the smaller equity markets (Philippines, Thailand and Indonesia) may be impacted by hikes in official rates and coupled with their high valuations this may reduce some of the attractiveness.

(*) Legend for Chart 2, UST(red),China (yellow),India (blue),S.Korea (mauve),Indonesia (violet) Philippines (green)

Andrew Freris

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