Deutsche Bank

Macro

Global Markets Research

15 July 2010

Asia Bond Investor

Undaunted

We remain undaunted despite the wild volatility since our last ABI rebalancing, and only slightly less optimistic about overweight risk exposure to Asian bonds than we were 3 months ago.

Although serious long-term uncertainties still hang over Europe, we judge the near term event risks to be skewed in favor or risk appetite.

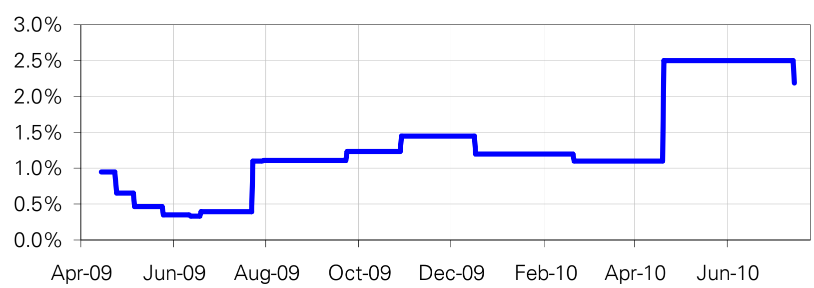
Although our economists have modestly cut our growth forecasts in line with weaker data, we are not subscribers to the double-dip scenario. We are also moderating our growth outlook for Q2 and Q3 in Asia, but we have nonetheless increased Asian growth forecasts in the year to date.

Recent investor flows and movements in money market curves globally seem to support the view of improving risk appetite for Asian assets, as do shifting growth differentials. We take the hawkish tone struck by several Asian central banks in recent weeks as a sign of confidence in the recovery which is potentially as significant for currency policy as for official rates.

Despite some disappointment in the market at the volatility in $/CNY since the policy change a month ago, we view it as a significant event that has broader near-term implications for Asian currencies.

Our view on duration in the region is mixed, colored by generally supportive technicals and steep yield curves.

We are implementing only a small reduction in our risk exposure.



Source: Deutsche Bank

Strategy Update

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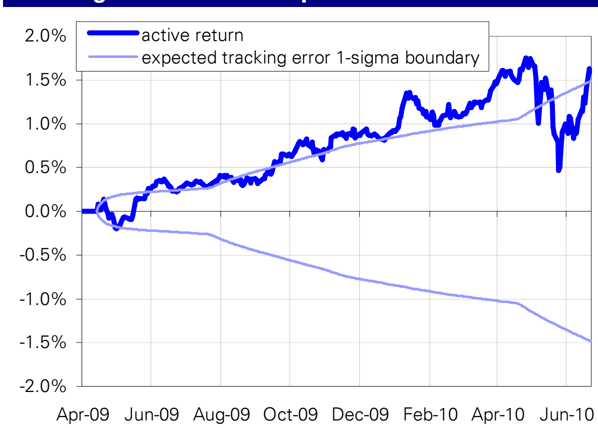
Strategy

Undaunted

Turning to the near-term outlook

Markets have taken us on a wild ride since our unfortunately timed call to increase risk exposure in our Asian local market portfolio in April. [1] We clearly underestimated the political hurdles required to enact the Greece bailout package and policy makers' appetite for brinksmanship during the approval process. Markets have challenged Europe to put its fiscal house in order and come up with a longer-term plan redress structural vulnerability of the Euro. At the same time they have struggled with difficult questions about the recovery in the US and sweeping reform of financial sector regulations. In our previous piece we expressed some views on the longer-term implications of these issues,[2] and armed with that background we return now to our tactical portfolio recommendations on the basis the nearer-term outlook.

Tracking error and risk exposure of our



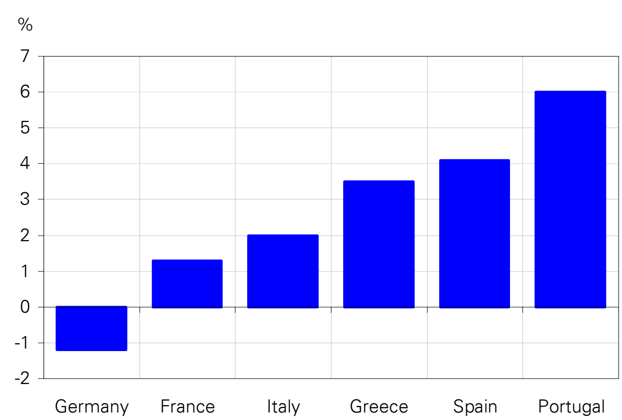
Source: Deutsche Bank

Event risks in Europe

Our first task is to summarize our views and assumptions about the outlook for Europe. In the past 3 months some impressive strides have come in the form of aggressive austerity plans, development of a financial backstop system, the European Financial Stability Facility (EFSF), and commencement of stress tests for the banking system. For us, the highlights of each are the following:

- The fiscal reform packages announced by member countries have indeed been impressive in scope featuring cuts in public sector wages, social benefits, investment and military spending, and increases in various taxes. The political stresses are obvious already and implementation will be uneven. Despite this our economists are forecasting substantial fiscal consolidation as shown below. Any judgment about the viability of the fiscal reforms and their impacts on growth will take time to develop, but the first formal IMF review of Greece's program will be in August.

DB forecast change in primary balances between 2009 and 2011



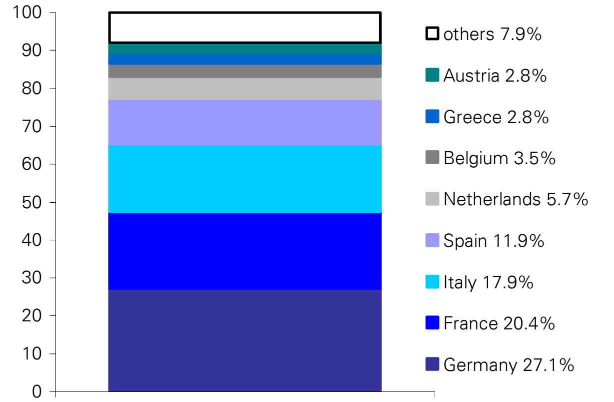
Source: Deutsche Bank

- The launch of the EFSF requires approval of at least 90% of parliaments in the Eurozone, weighted by ECB capital weights. Approval of the top eight countries would suffice to launch the EFSF, although unanimous participation would clearly be preferable for markets. Italy is among the major countries (13% capital weight) that has yet to give formal approval, but that is expected within weeks. The head of the group of euro-area finance ministers, Jean-Claude Juncker has said that the EFSF should be operational by the end of this month. Thereafter a question of the debt rating of its obligations will come to the fore. The intent was to secure a AAA rating by providing guarantees from member states amounting to 120% of the facility. While this wouldn't mark the end of uncertainty about the outcome of the European sovereign debt problem, the full approval and establishment of a AAA-rated financial backstop would, in our view, send a positive message to the markets.

[1] See *Asia Bond Investor: A Rare Constellation* 21 April.

[2] See *Asia Bond Investor: After the Dust Settles,*

Euro area capital weights defining proportionate commitments to the EFSF



Source: Deutsche Bank

- Markets are looking forward to the release of stress tests of the European banking system by the Committee of European Banking Supervisors. Regulators will be striving to strike a conservative balance between credibility of the tests and the risk of inspiring a panic. Early indications are that the stress applied to the system will include only a modest haircut on sovereign debt, akin to widening of spreads, but not a default. The market is busy working out their own stress tests and estimates of capital requirements. Our Quantitative Credit Strategy group tested against a moderate level of stress consistent with a one to two year recession, and a severe level of stress reminiscent of the period following the Lehman collapse. These scenarios give capital requirements of EUR 24bn and EUR 83bn respectively, equivalent to 3% and 10% of tangible common equity. Announcement of the stress test results is scheduled for July 23. We are generally optimistic that markets will view the stress tests as a step in the right direction, despite reservations about their credibility.

While serious questions will hang over Europe for the next several months and possibly years, our impression is that each of these three issues pose positive event risks over the coming month or two.

We are not believers in the double dip scenario[3]

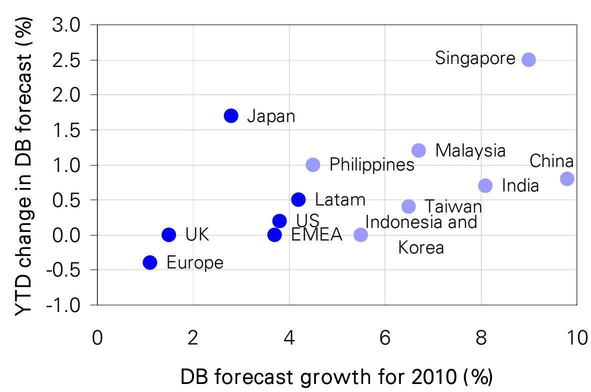
For some, the recent softening in global PMIs and some of the US data is raising the possibility of a double-dip recession, although our economists view the latest soft patch as partially a function of the upward surprises that preceded it. On the back of the stubbornly sluggish recovery in the US labor market our economists lowered growth forecasts there in 2010 from 3.8% to 3.5%. Nonetheless they offer several reasons to doubt that the world will slip back into recession.

- Fiscal adjustments globally, while impressive, seem reasonably calibrated after adjusting for the natural cyclical effects resulting from the economic recovery.
- Monetary policies are likely to remain expansionary for some time. Furthermore, as suggested by the ECB's bond purchase program and recently by the Fed, a return to unconventional policies remains an open option for global central banks.
- Discretionary spending on durables, having already been cut to the bone, has much less room to contract further.
- Pent-up demand is beginning to show through into consumer and business spending suggesting that a positive feed-back loop between investment, employment, and consumption is emerging in many major countries.

Rate hikes and the Asian recovery story

Notwithstanding our expectation that growth will peak in many countries in Q2 or Q3, our growth forecasts for Asia have been upgraded in over the course of the year, in contrast to most of the developing world where growth expectations are either unchanged or lower.

The growth outlook and revisions to the growth outlook for 2010



Source: Deutsche Bank

The chart below shows the change in the 12 month forward 3 month interbank rate over the past 3 months. Money market curves have generally moved in a direction consistent with changes in our growth forecasts. Central banks in the region have encouraged the perception that rate hikes are on the way, in many cases by commencing rate hike cycles. While we wouldn't emphasize the importance of carry implications of the first hike or two for Asian currencies, the expression of confidence could

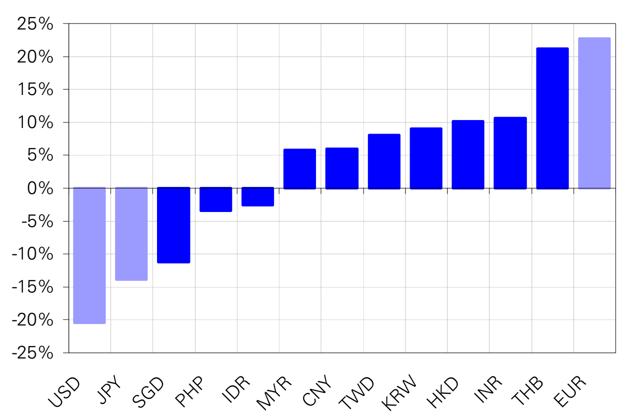
[3] See *World Outlook: A soft patch with risks, not a double dip*, July 2.

reflect on the central banks' appetite for currency appreciation over the coming months.

Apart from that main conclusion, we interpret the chart below as generally supportive for Asian currencies for some other reasons.

- The increase in the back end of the EUR money market curve reflects the market's decreased fear of a breakup of the Euro or imminent sovereign default.
- The decline in SGD interest rates is probably a function of the decline in US interest rates and market's expectation that the SGD will appreciate under an MAS tightening cycle.
- The decline in the short ends of PHP and IDR probably reflects a marginal uptick in global risk appetite.

Percentage changes in the 12M forward 3M interbank rate over the past 3 months.



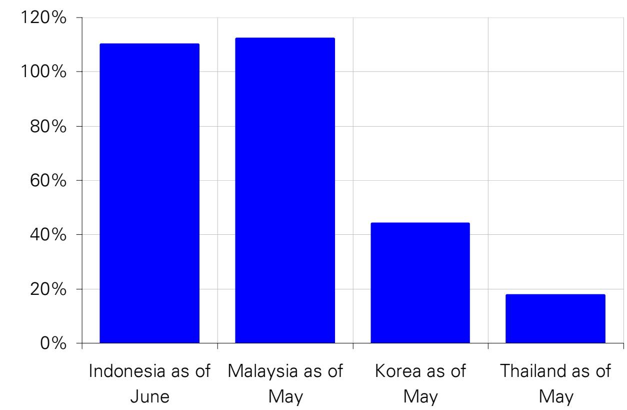
Source: Deutsche Bank

Flows and risk appetite

Despite Asia's light direct exposure to the European debt problem and our relatively sanguine view of double-dip risks in the US, we have to acknowledge that its second order to exposure to these issues, in the form of capital flows, is more serious. We have thus been devoting more attention than usual to measures of capital flows and risk appetite. Below we review a series of indicators most relevant to our markets.

International investors' participation in Asian markets has been one of the most important stories in local bond markets over the past year. The chart shows that in Indonesia and Malaysia, foreign purchases actually exceeded net government issuance, implying that domestic holdings of local bonds have actually decreased over the past year.

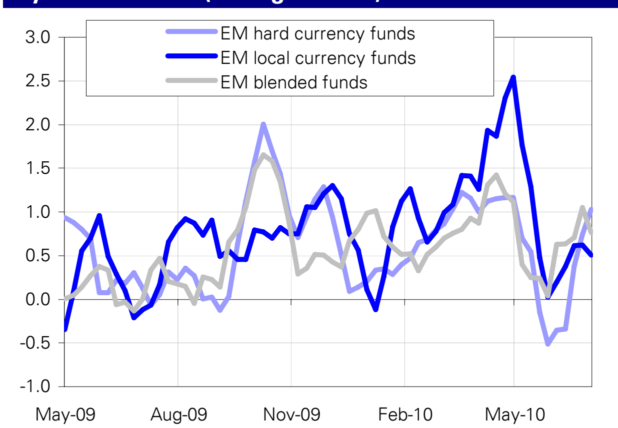
Foreign purchases of onshore bonds over the past 12 months as a percentage of net issuance



Source: Deutsche Bank, central banks

We think that most of these flows into Asian bond markets can be explained by fund flows into local currency EM debt funds, which is a weekly data series summarized below on a rolling 4-week basis. Local currency EM has been among the favorite asset classes for international investors this year. Remarkably, local currency funds never actually recorded outflows during the recent bout of risk aversion in May – at least on a rolling 4-week basis. Flows have since recovered, running at pace of about 1% of assets under management per week over the past month. The chart below puts that into historical perspective as a 0.6 standard deviation event.

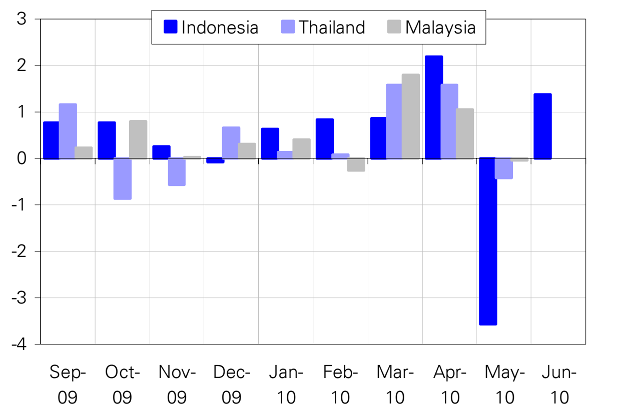
5-year z-score of (rolling 4-week) mutual fund inflows



Source: EPFR, Deutsche Bank

While end investor flows into mutual funds have been relatively stable, investor flows into Asian local markets have not. During May flows out of Indonesian bills and bonds exceeded $5bn, a 3.5-standard deviation event as shown below; however flows have since rebounded in June. Once the official data for Malaysia and Thailand is released we expect to see modest recoveries there as well.

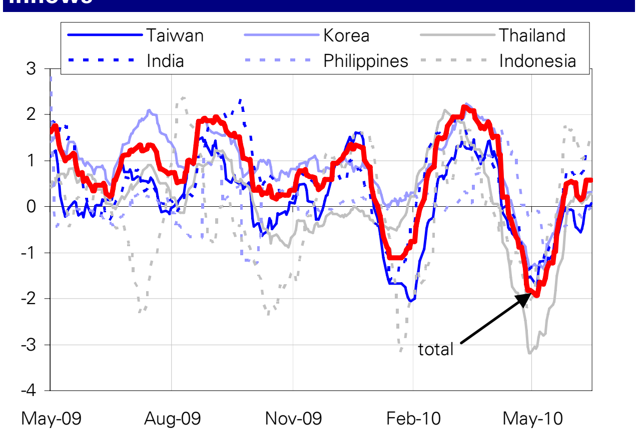
5-year z-score of net monthly foreign bond purchases



Source: Deutsche Bank, central banks

Six of the regions stock exchanges publish daily net foreign flows into local equity markets. These are a good concurrent indication of the direction of pressure on Asian currencies, and we suspect also a proxy for international investors' appetite for Asian bond markets. After a sharp withdrawal of from equity markets, flows have turned positive over the past four weeks, to level of 0.6 standard deviations. Interestingly, the z-scores on flows into the riskier markets of Indonesia and India are higher than average at 1.4 and 1.2 standard deviations respectively.

5-year z-score on (rolling 4-week) foreign equity inflows



Source: Deutsche Bank

We take the above as indications that the risk appetite for Asian local assets is still recovering, and the outlook looks mildly positive.

Understanding the PBOC's Yuan policy

Like those central banks that have been turning more hawkish, the PBOC's shift to a more flexibly Yuan policy could be read as a sign of confidence. Since the June 18 announcement, the market has been considering the implications of the shift. The PBOC will clearly continue to manage the exchange rate heavily, working against market forces. Early evidence would suggest that the new regime can't easily be described as a pure basket system, nor does it look much like the creeping Dollar peg that was in place between mid-2005 to mid-2008.

Our senior currency strategist Mirza Baig has done some interesting work devising a model for describing and understanding the PBOC's policy.[4] We are not proposing that this may be a formal strategy of the PBOC, but it nonetheless may be a useful way of structuring one's expectations about its actions and forming a view on USD/CNY.

Briefly, he argues that we can consider the USD/CNY exchange rate as determined by the combination of managed (fixed) exchange rate versus a basket of floating currencies, plus a targeted annual pace of appreciation against the Dollar that would apply in a situation where the basket remains completely stable.

Mathematically we can think of the appreciation in CNY versus the dollar as

$$\lambda + \beta * \text{currency basket appreciation} + \text{error}$$

Where λ represents the default pace of appreciation against the Dollar, and β is a parameter than weights the importance of the currency basket. The PBOC will have the flexibility to adjust β and λ according to whatever inputs, whether related to politics or international trade. When political pressures arise β may be decreased and λ increased. Conversely when international trade is slowing or the PBOC becomes less confident about the economy's competitiveness, β can be increased and λ decreased.

We fitted β and λ to the price action in the early days after the policy change and found that β of 20% and λ of 4% minimizes the error in the price action. That is, the policy looks at this stage like something more like a creeping dollar peg with an annual target pace of appreciation of 4% than it does a basket system.

We think this approach may be a useful prescription for forming views on USD/CNY in the future. At this stage our emphasis is much more on the model for describing the PBOC's behavior than our estimates of β and λ. But for expository purposes, we can run through an example using DB 12M exchange rate forecasts and our current estimates of β and λ.

[4] See *Asia Strategy Notes: CNY: a basket or another crawling peg,* July 6.

Are USD/CNY forwards pricing in enough?
An example scenario using β of 20%, λ of 4% and DB 12M forward forecasts for global exchange rates

currency	basket	today	12M forward scenario	change
EUR	47.0%	1.26	1.35	7.2%
JPY	22.2%	88.7	82.0	8.1%
GBP	3.9%	1.50	1.73	15.1%
AUD	4.3%	0.87	0.80	-8.4%
CAD	3.9%	1.04	0.95	9.0%
SGD	4.3%	1.38	1.34	3.2%
KRW	8.0%	1209	1070	13.0%
BRL	6.4%	1.76	1.85	-4.8%

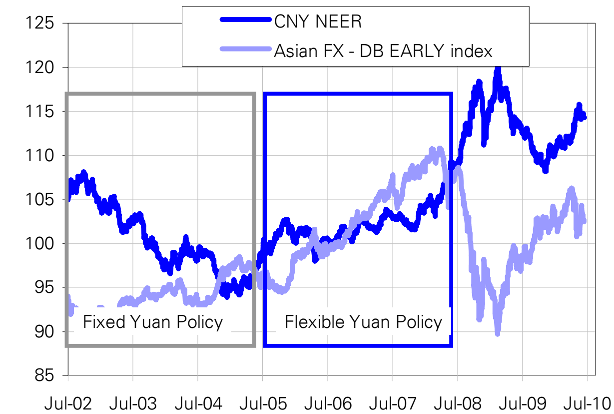
basket	6.6%
β * basket	1.3%
λ	4.0%
CNY vs USD	5.3%
versus $/CNY forwards	1.7%

Source: Deutsche Bank

Using our forecasts for the basket, and taking our assumptions on β and λ, this approach leads to an expected appreciation in the CNY versus the Dollar of 5.3%. On that basis we would judge the NDFs to imply too little appreciation. Running similar scenarios can be useful to judge the sensitivity of the fair value of USD/CNY to the various assumptions. Doing so leads us to believe that NDFs are probably under-pricing CNY appreciation at these levels.

But what does the shift in PBOC policy mean for the rest of Asia? Did the previous change in PBOC policy towards a more flexible exchange rate have an impact on Asian central banks' appetite to slow their own currencies appreciation? The evidence would suggest that it did, if we compare that three year period to the preceding one.

CNY nominal effective exchange rate and Asian FX rates as represented by our DB EARLY index



Source: Deutsche Bank

We estimate that from July 2002 to 2005, when the Yuan was effectively pegged to the Dollar, Asian central banks accumulated $338bn in reserves (after valuation effects), containing the annual pace of appreciation to less than 1% per annum. However in the following three years when the Yuan was appreciating at almost 6% per annum against the Dollar, Asian central banks accumulated $402bn in reserves, but also allowed their currencies to appreciate by 3.9% (on a weighted average basis).

Will a more flexible Yuan affect the behavior of Asian central banks?

	CNY appreciation versus USD	CNY NEER appreciation	Asian FX appreciation (DB Early)	change in Asia-x-China reserves ($bn)
Flexible Yuan Policy: July 2005 to 2008	5.9%	3.1%	3.9%	402
Fixed Yuan Policy: Preceding 3 years	0.0%	-2.2%	0.9%	338

Source: Deutsche Bank

We think this precedent is significant enough to believe that Asian central banks will be more compliant about appreciation of their currencies over the long-run, perhaps allowing a faster convergence to fair valuations.

Mixed view on duration

Despite the fact that central bank policy is turning decidedly hawkish, our call on local duration exposure is mixed because curves in many cases already price in enough, and technicals are relatively supportive. We've already mentioned instances above (IDR and MYR) in which foreign investments have exceeded net government issuances. In general also, local liquidity has remained more supportive than expected, enabling governments to make good progress in their funding programs, as indicated in the table below.

Local government issuance progress report

	2010 Plan	YTD	As of	% YTD	% YTD 2009*
CNY (bn)	1646	633	8-Jul	38%	47%
HKD (bn)	36.4	8.7	8-Jul	24%	15%
INR (tn)	4.6	1.6	8-Jul	34%	39%
IDR (tn)	134.5	96.7	8-Jul	72%	58%
KRW (tn)	77.7	40.7	8-Jul	63%	53%
MYR (bn)	56.5	36	8-Jul	64%	57%
PHP (bn)	465.7	204.3	31-May	44%	49%
SGD (bn)	19.1	13.4	8-Jul	70%	64%
TWD (bn)	516	340	8-Jul	66%	47%
THB (bn)	425	316.6	8-Jul	74%	70%

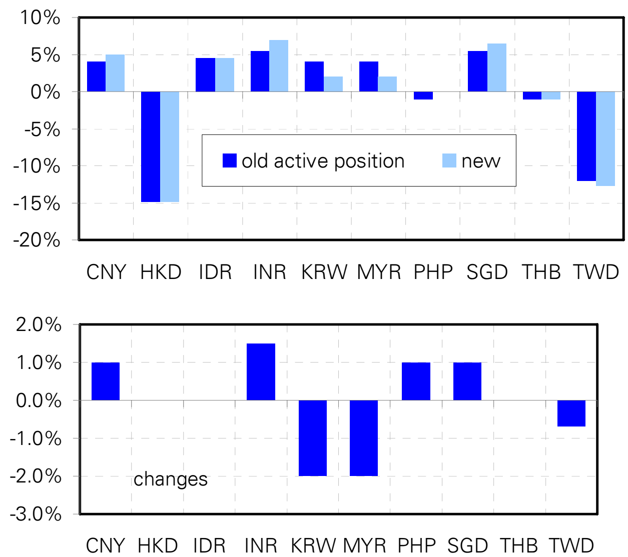
Source: Deutsche Bank

Asia Bond Investor model portfolio

Only a modest reduction in risk

Although we will scale back risk slightly, we are still looking to maintain a relatively aggressive risk exposure in our portfolio this time, for reasons described above. The charts below show the changes in allocation to each market in the current rebalancing.

Old and new active FX positions and changes in this rebalancing



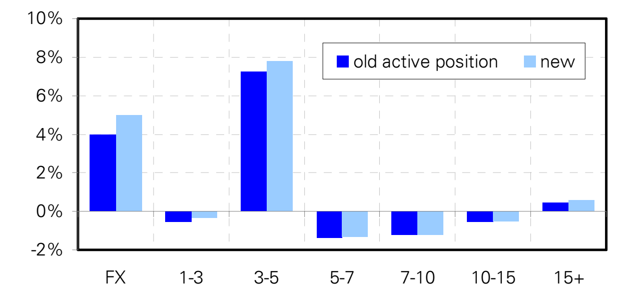
Source: Deutsche Bank

- We accomplish some reduction in tracking error by scaling back our KRW position from a 4% to 2% overweight.
- We noted that the markets seem to under price CNY appreciation in the NDF market, and all the more so for investors who can access onshore bonds.
- We are still funding overweight positions in Asian currencies with HKD to express a bullish view on Asian currencies.
- We have sold out of what was left of our TWD positions because we still feel that the CBC is least likely to allow currency appreciation, and because the carry is so unsatisfactory compared to other markets.

Adding CGBs in the 3-5Y sector

Our increase in CNY exposure is coming from purchases of the 3-5Y part of the yield curve. Liquidity has been recovering recently, but low t-bill yields at less than the rate of inflation are becoming less attractive to local banks. The Q2 GDP report seems to suggest that growth will moderate in a very healthy range, and thus the central bank seems unlikely to provide unpleasant surprises in its rate policy. We expect the market to be range bound and therefore like the carry and rolldown on offer in the 3-5Y bucket.

Changes in our CNY bond portfolio

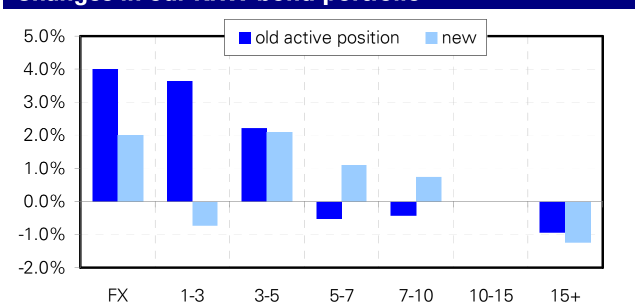


Source: Deutsche Bank

Scale back KRW risk by selling out of the short end

As mentioned above we have chosen to pare back our KRW exposure as a risk reduction strategy given the very high level of volatility. We have chosen to do so by selling in the 1-3Y bucket because we expect the BoK to follow its rate hike with some withdrawal of liquidity via MSBs. The central bank added $4bn in reserves in June, but allowed the stock of MSBs to decline, thus injecting liquidity.

Changes in our KRW bond portfolio

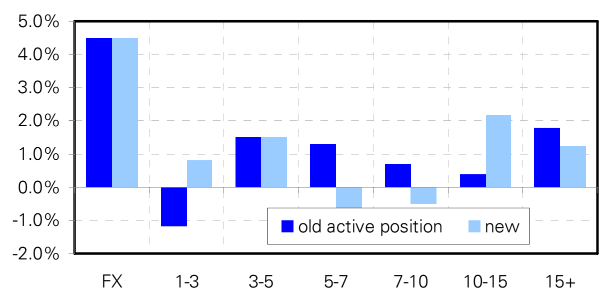


Source: Deutsche Bank

Barbelling exposure to duration in Indonesia

There is little to fault the fundamentals of Indonesian fixed income, with a strongly supportive mix of growth-inflation profile (DB expects inflation to stay within the CB target zone of 4-6% for at least another quarter), a benign policy stance from BI, attractive yield differentials (versus the US), healthy external surpluses and a favorable credit trajectory (notably FX reserves coverage), reduced political noise, and robust market technicals. The government has completed 72% of its gross local issuance requirements for the year, and with the realization on budget spending yet again lagging, is in a very comfortable cash position. The new restrictions on holding period for SBIs should cause some reallocation of funds into short dated bonds. At the other end of the curve, with 10Y yields looking a tad rich below our target of 8.25% (and at a spread of under 200bp over 1M SBI), we are looking for some bull flattening in the 10Y+ sector.

Changes in our IDR bond portfolio

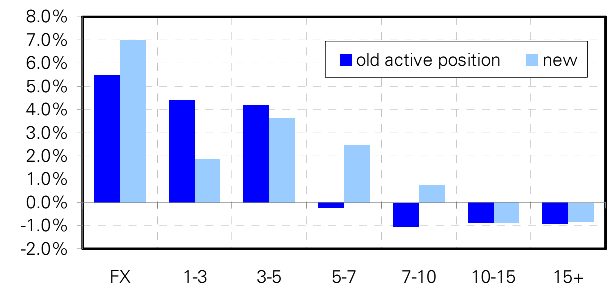


Source: Deutsche Bank

Increase INR bonds, reducing duration underweight

The recent INR weakness has been exaggerated by outward FDI related flows, which we think are now over. Improved carry, a hawkish CB, and a healthy privatization driven IPO pipeline should be supportive of INR appreciation, and the latter is unlikely to be resisted by RBI. The much larger than expected yield on the 3G (and broadband) auctions is potentially a game changer for technicals of the bond market, particularly also with the government's steps to partially liberalize fuel pricing likely mitigating the subsidy payouts for the year. Besides with inflation likely to peak in the next couple of months, and RBI keeping to its 'calibrated' stance on policy tightening, any easing of the current cash crunch into end of this month (with government spending part of its 3G kitty) should be supportive for the front end and belly of the curve.

Changes in our INR bond portfolio

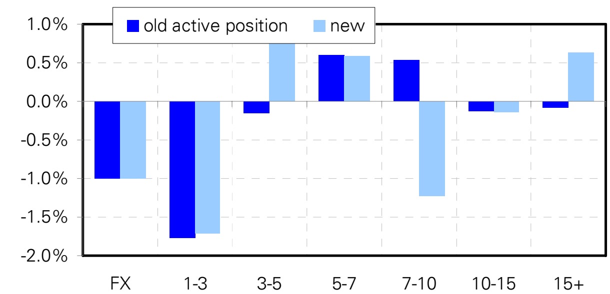


Source: Deutsche Bank

Switching out of 10Y exposure in Thailand

With BOT having begun the process of normalizing its policy rates, but faced with healthy technicals for the bond markets (strong fiscal revenues, and continued inflows from EM index based funds), we are staying close to neutral on our duration exposure. The 10Y part of the bond curve has richened considerably since May, driven mostly by duration demand from insurers and pension funds. We are switching out of our exposure in the 7-10Y bucket, and distributing that into the 3-5Y and 15Y+ bucket to keep flat on our overall duration exposure.

Changes in our THB bond portfolio

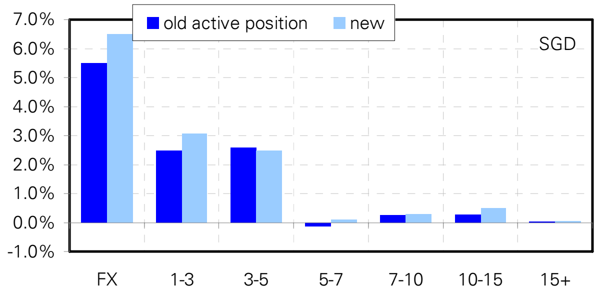


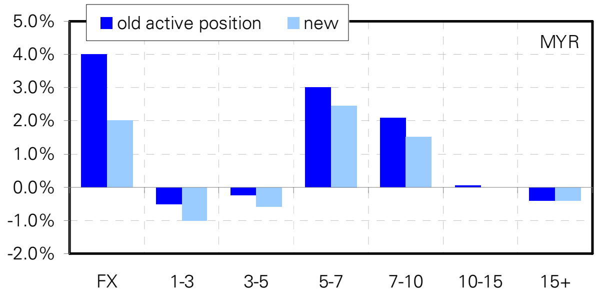
Source: Deutsche Bank

Increase SGS at the expense of MGS

Over the long run we think that MYR and SGD represent very similar risk exposures in general. But the Q2 GDP report should at least prolong the market’s expectations of MAS policy tightening (via FX), or even intensify it. At these levels of growth we think the SGD should be trading near the top of the MAS policy band. At the only 1.2% above the mid-point of the band it still has scope for further outperformance even relative to the 2% annual pace of appreciation.

Changes in our SGD and MYR bond portfolios





Source: Deutsche Bank

Key exposures and risk analysis

The minor rebalancing described above leaves us with the following portfolio and risk characteristics.

- We maintain a heavy short $/Asia bias, along with an intraregional carry bias.
- Our tracking error has been scaled back modestly from about 2.5% to 2.2% this time.
- Looking across all markets we are running a slight duration underweight, but this is deceiving since we are heavily underweight Taiwan with very little volatility, and overweight Indonesia and India that have considerably more.

Asia Bond Investor model portfolio

	total	1-3Y	3-5Y	5-7Y	7-10Y	10-15Y	15+Y
CNY	5.0%	-0.3%	7.8%	-1.3%	-1.2%	-0.5%	0.6%
HKD	-14.9%	-7.6%	-3.3%	-0.7%	-2.5%	-0.8%	0.0%
IDR	4.5%	0.8%	1.5%	-0.7%	-0.5%	2.2%	1.2%
INR	7.0%	1.8%	3.6%	2.5%	0.8%	-0.9%	-0.9%
KRW	2.0%	-0.7%	2.1%	1.1%	0.7%	0.0%	-1.2%
MYR	2.0%	-1.0%	-0.6%	2.5%	1.5%	0.0%	-0.4%
PHP	0.0%	-0.2%	-0.4%	0.0%	1.1%	0.0%	-0.4%
SGD	6.5%	3.1%	2.5%	0.1%	0.3%	0.5%	0.1%
THB	-1.0%	-1.7%	0.9%	0.6%	-1.2%	-0.1%	0.6%
TWD	-12.7%	-2.3%	-2.5%	-1.8%	-2.0%	-2.1%	-2.0%
USD	1.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ Cash	1.6%						
total	0.0%	-8.2%	11.5%	2.2%	-3.1%	-1.7%	-2.3%

Source: Deutsche Bank

Summary of active exposures

	FX	local market duration	effective duration	yield (bps)
CNY	5.0%	-0.68	1.15	79
HKD	-14.9%	0.00	-3.96	-123
IDR	4.5%	0.07	5.79	839
INR	7.0%	-2.16	2.90	853
KRW	2.0%	-0.34	0.17	66
MYR	2.0%	0.52	1.72	94
PHP	0.0%	0.20	0.20	12
SGD	6.5%	-0.63	1.83	43
THB	-1.0%	0.83	0.06	-22
TWD	-12.7%	0.00	-7.14	-135
USD	1.6%	0.08	0.08	53
Total		-0.48	-0.48	218

Source: Deutsche Bank

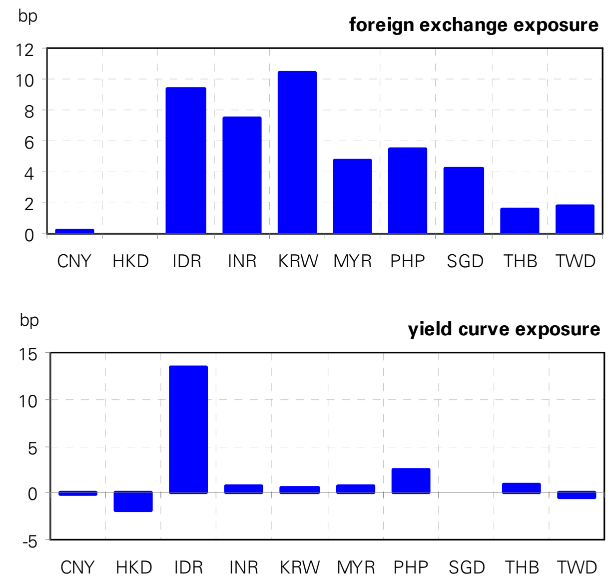
Risk measures

	Benchmark Risk	Portfolio Risk	Tracking Error (bps)
FX	4.76%	5.85%	128
Yield Curve	2.40%	2.94%	117
Total	6.47%	8.25%	218

Source: Deutsche Bank

- Our marginal contributions to tracking error for FX exposure highlight our short $/Asia bias. This can be seen because we could reduce out tracking error even further if we further reduced our TWD position further, even though we are already 13% underweight TWD. In general we have a more even risk exposure to Asia following the rebalance, with MCTE for INR increasing for example, relative to Korea. Korean Won still makes the largest contribution to our marginal tracking error because it has been so much more volatile than other currencies.
- We have taken an even more aggressive position on IDR duration this time around, reflected by our MCTE for yield curve exposure. None of the other risk exposures to curve movements are nearly as material, though as we mentioned above, we are fractionally overweight fixed income risk right now on a volatility weighted basis.

Marginal contributions to tracking error



Source: Deutsche Bank

Appendix 1

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Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates – these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

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