



Asian Economies – First To The Exit

March 2010 – Implications of policy adjustments

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Asia – First to the exit

Asian economies have emerged from the global recession earlier and stronger than their global peers. In China and India, economic growth remained positive throughout the downturn, assisted by responsive and aggressive fiscal stimulus measures. As a result, these economies are more advanced in the journey away from emergency support measures and towards the normalisation of policy settings.

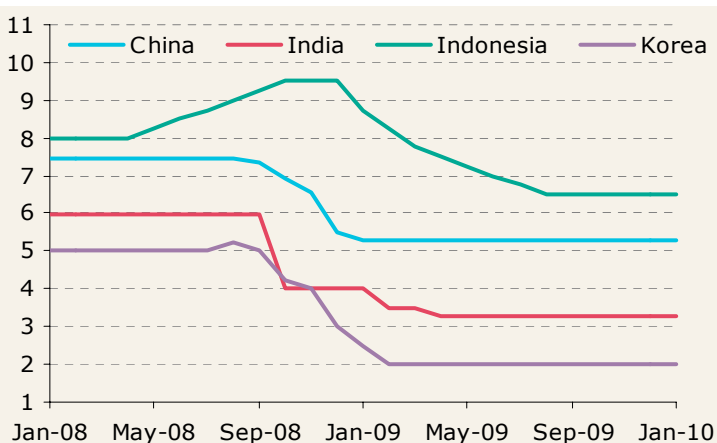
While the rebound in growth is clearly positive for the long-term outlook, the early indications of policy tightening have had a negative impact on Asian equity markets. This reaction raises 2 questions: should investors be worried about the governments' recent change in emphasis and what is the outlook for Asian equities in the medium term?

What tightening measures have we seen so far?

China's economy has arguably weathered the global downturn the best and unsurprisingly has been among the first to signal a change in policy. Early in January the yields on Chinese government bills were increased, raising the cost of finance and reducing liquidity in the banking system. This was followed by two increases in the reserve requirement ratio, totalling 1.0%, taking the rates to 16.5% for large banks and 14.5% for smaller lenders. To further contain the pace of credit growth the government enforced loan quotas and temporarily suspended lending at some banks due to the level of loans extended in January.

Indian authorities also increased bank reserve requirements, revising the ratio up by a greater than forecast 0.75% in January to 5.75%. This move to cool credit expansion reflected the Reserve Bank of India's desire to ease the availability of credit at a time when inflationary pressures have resurfaced. Interest rates, however, remain at historically low levels.

Interest rates have been low and stable for an extended period



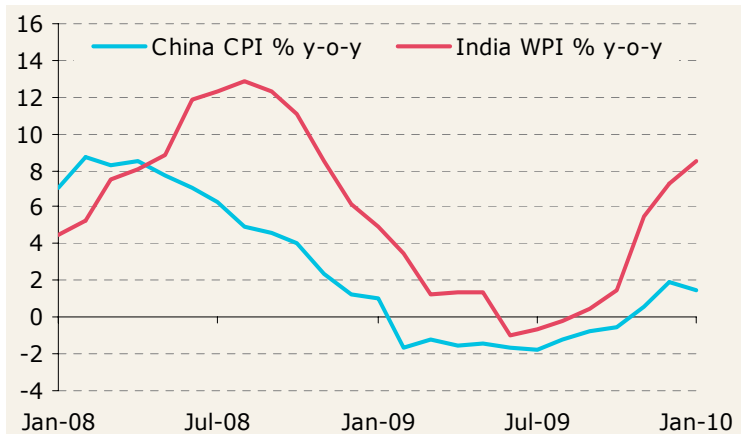
Source: Bloomberg LP, Jan 2008 to Jan 2010

What has prompted the change of course?

Asian economies are growing and key economic indicators suggest that this recovery has a solid footing. In the fourth quarter of 2009, China's economy expanded 10.7% year-on-year (y-o-y) and 8.7% in 2009 as a whole, while India's grew at 6.0% y-o-y in the fourth quarter. Growth rates in China and India have outpaced the wider region and inflationary pressures have started to appear. In China, CPI turned

positive in November after 9 months of declines and WPI in India reached 8.6% y-o-y in January, having been negative as recently as August. In order to avoid the potential disruption from asset price booms and busts, a key concern for policymakers is to keep inflation under control and to maintain a sustainable level of growth in the long-term.

Inflation in China and India has spiked higher recently



Source: Bloomberg LP, Jan 2008 to Jan 2010

The potential for asset prices to overheat has added to the desire of Chinese authorities to cool the pace of loan growth which has been increasing by 30% y-o-y. In 2009, 9.59 trillion yuan (US\$1.4 trillion) of new loans were made and the government has reduced 2010's loan target to 7.5 trillion yuan, which is still more than double the value of new loans extended in 2007. With liquidity abundant, 2009 saw renewed strength in the property market, leading to concerns of a potential housing bubble. In addition to a lower loan target, administrative measures have been taken to curb real estate speculation, including selective changes to property taxes and mortgage interest rates.

We expect tightening to be gradual and an overall growth bias to remain

Against a more stable background with economic growth and corporate and household confidence picking-up, we believe it is prudent for Asian authorities to begin removing emergency stimulus measures. Policy can be tightened while still remaining accommodative. We expect the removal of policy supports to be gradual as uncertainties persist over the strength of recovery in developed economies, which still pose a downside risk to Asia's short-term growth outlook.

In our view, China will continue to see policy tightening during 2010. The combination of strong GDP growth, rising inflation and abundant liquidity are likely to result in interest rate hikes, which we would anticipate during the second half of the year. Some gradual appreciation of the currency is also possible, but given the economy's sensitivity to exports we would expect any move to be modest and gradual. In our view, the case for higher interest rates is stronger in India and we expect rates to rise in order to contain the inflationary pressures that have built over recent months.

Economic data outside of China and India has recovered but, on aggregate, does not warrant significant policy adjustments. In general, inflationary pressures are not acute but they will likely rise in the short term due to the lower



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base effect from the early parts of 2009. In our view, a largely stable outlook for food and energy prices should limit upward pressure in the short-term, particularly as there are still deflationary pressures in manufacturing. In addition, loan growth is also not sufficiently strong to pose a near-term threat, with growth in Asian credit (excluding China) at the start of 2010 up only 4% from a year earlier, according to Credit Suisse figures. However, the loan growth in China has been substantial in 2009 but this must be placed in the context of declining bank credit to GDP in the 6 years prior to 2009. As 2010 progresses, we are likely to see more Asian economies begin to slowly remove policy supports but the overall bias is likely to remain accommodative for some time.

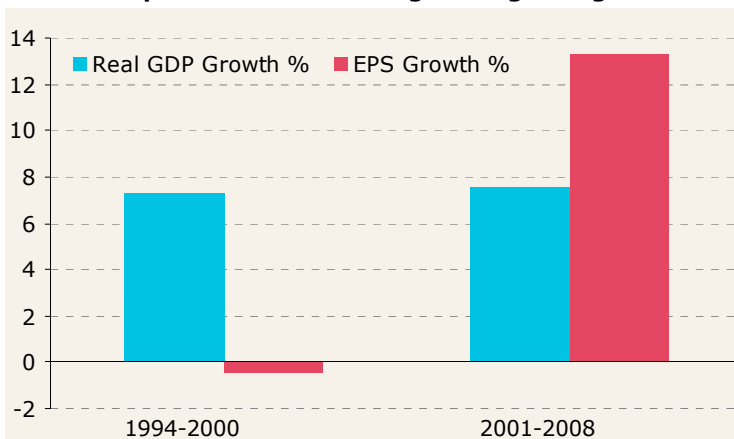
The outlook for Asian economies

In our view, pre-emptive policy measures to cool excessive growth in lending and to anchor inflation at acceptable levels are prudent and are positive steps for Asia's long-term growth prospects. While there are risks that tightening too fast or too soon could damage the recovery, we believe this is unlikely as the bias will continue to favour growth, just not to the same extent as in 2009. The alternative, of tightening too late, risks asset price bubbles and runaway inflation, leading to restrictive policies needing to be higher for longer and we believe this would represent a greater risk to Asia's long-term development.

In our view, policy tightening is not a barrier to positive economic growth or robust equity market performance. Analysis of previous tightening cycles suggests that Asian stocks underperform at the beginning of a tightening cycle, but that this is a short-term phase and we would regard such a period as an opportunity to build positions in attractively valued Asian companies. Volatility may increase around data and policy announcements, but we expect Asia to remain a key driver of global economic growth in the years ahead. Asia is benefiting from recovery in the developed world and domestic demand remains a powerful long-term theme.

Asia's strong economic fundamentals are complemented by the emergence of an increasing number of high quality companies that have come through the recent recession having cut costs and increased operational efficiency, steps which are translating into higher profitability as global demand recovers.

Asian companies are harnessing the region's growth



Source: UBS, annual data to 31 December 2008.

We believe that when looking through the near-term concerns, Asia's fundamentals remain stronger than those of developed markets. Tightening of monetary and fiscal policies is a natural progression during a period of economic recovery and is not something that we believe should be feared by investors. While volatility is likely to remain an integral part of investment in the region, we believe the long-term case for Asia remains one of the most compelling in today's global equity markets.

Important Information

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns. Where Invesco has expressed views and opinions, these may change.

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