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Global FX Outlook 2011

Nomura Global FX Strategy

A global balancing act

7 December 2010

Any authors named on this report are research analysts unless otherwise indicated.

Please see important analyst certification and Important disclosures on page 143.

Global FX Outlook 2011

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We believe the outlook for risky currencies is mildly positive for 2011. This assessment is based on a consistent historical pattern of returns during similar points in the cycle. The challenges are: 1) this view is buy-side consensus and we must be alert to overshooting in price and positioning *(*and we have a clear 'value' focus in our recommendations below); 2) a sustained shift in Fed view (something we dispute); 3) that the notion of EM economic outperformance may be tested in 2011 (we think markets will look beyond any temporary growth convergence); 4) EM economic outperformance, butting against continued US political pressures, may exacerbate tensions around global rebalancing in general and around CNY in particular; 5) Events in Europe, most critically Spain, threaten to upset risk markets further.

G10 – The case for consolidation and value

We anticipate 2011 to be a year of consolidation for the dollar versus major currencies. USD versus EM is a different story, given structural growth outperformance in emerging markets.

We expect USD/JPY to trade in the low 80s in the early part of 2011. This view is based primarily on the still relatively weak economic outlook for the US and the large amount of excess capacity in the US economy which will keep US interest rates anchored at low levels (also helped by QE2). Looking further into 2011, we believe USD/JPY is set to edge higher towards 85.

With respect to the euro, sovereign tensions in the eurozone justify a persistent risk premium on the currency. That said, we do not expect sovereign defaults in 2011 or a break-up of the European Monetary Union. Spain is pivotal to eurozone risk premia and our core scenario is that it will take sufficient steps to ensure that its debt dynamics remain sustainable.

- **Buy a basket of EUR/USD DNTs**

Pessimistic sentiment on the UK's growth and fiscal prospects has been reflected in GBP, in our view. GBP is down 25% on average against the G3 since 2007 and is now set to recover.

- **Buy GBP vs. USD, EUR and JPY, equal weights.**

We also expect an end to NZD's underperformance versus its peers, in particular AUD. Policy orientation and improving terms of trade should also be supportive.

- **Go long NZD-TWI proxy (48% AUD, 20% USD, 17% JPY and 15% EUR).**

We also expect the new safe-haven currencies with strong fiscal accounts and strong balance of payments to catch up.

- **Buy NOK/CHF**

Asia FX – Capital flows, growth ebbs

We expect USD/CNY to start to fall ahead of Hu Jintao's state visit to the US (likely to take place over 19-20 January 2011). The considerable focus on domestic inflation risks should provide the underlying justification.

- **Sell 3M USD/CNY NDF**

This will help catalyze further movements in Asia, including KRW, which remains undervalued, and where intervention orientation appears to be changing.

- **Sell 3M USD/KRW NDF**

However, we recognize that with the change in North Korean leadership, new rules of South Korean engagement and the apparent limits to Chinese control over the North, plus a myriad of global risks *(albeit none our central case)* suggest spending some premium on hedges.

- **Take a portfolio hedge in a USD/KRW seagull (buying USD)**

Capital controls and portfolio risks may also be hedged through IDR, where the currency is relatively expensive, the bond market is crowded and the government perhaps more prepared than others to limit capital inflows.

- **Take a portfolio hedge with a 3M USD/IDR call spread**

Relative capital controls risks, relative recent FX performance and carry motivate our final Asian FX trade.

- **Long 3M SGD and MYR against TWD**

Asia rates – History rhymes

We retain a positive view on Asian interest rate markets into 2011, and define our trade recommendations by several of the key themes which frame our view:

Theme 1 - Receive selected front-end interest rates:

- **Receive NZD IRS 1yr**
- **Receive KRW IRS 6mfwd 6M and 1yr**
- **Receive SGD IRS 1fwd 1yr**

Theme 2 – Forward starting curve steepeners:

- **Pay INR OIS 2fwd 2s5s spread**

Theme 3 – Global and Asian regulatory trends:

- **Pay 3yr AUD EFP spread**
- **Receive 10yr KTB ASW**
- **Receive NZD IRS 5fwd 5yr**

Theme 4 – Regional FX strength:

- **Receive SGD IRS 5fwd 5yr vs. paying 0.39 units of USD 5fwd 5yr**
- **Pay CNY vs. HKD/USD 1fwd 1yr vs. 3fwd 2yr box spread**

Theme 5 – Fixing funding market risks:

- **Pay USD FRA-OIS spread to the second IMM date**
- **Sell the KTB ASW 3s10s box spread**

EEMEA – Picking winners in a postmodern policy world

Currency wars are becoming an important risk. Postmodern (unorthodox) monetary and fiscal policy reactions create important trading opportunities.

Postmodern monetary policy is changing priorities for EEMEA policymakers. Postmodern policy gives a lower weight in monetary policy to inflation at the expense of a weaker currency and higher growth in light of capital inflows into EM. This postmodern approach goes beyond traditional monetary policy responses, bringing new realities to the markets (and potentially future inflation). Currency valuation and balance of payments divergence are to become a bigger part of our lives. We recommend five trade ideas to benefit from these related themes.

In FX:

- **Short TRY/RUB,** the most obvious trade to capture postmodern policies, valuations, current account divergence.
- **Short ZAR/MXN,** a trade we have liked for a while, benefiting from currency-centric policies in South Africa, valuations and BOP divergence.

And positive carry steepeners:

- **PLN 1fwd2y vs. 5fwd5y DV01 neutral steepeners**
- **TURKGB Apr 12 vs. paying 7y swap**

EEMEA linkers – Holding R197, with a view to add Polish linkers in 1Q11 (do not hedge nominals, to lock-in breakevens, yet).

Spread trades in 1fwd1y space:

- **Pay EUR vs. Receive CZK (looking to add EUR/CZK downside options at spot reference 25.25)**
- **Pay ILS vs. Receive USD**

Latam – Fighting the inevitable

In Latam in contrast, rising inflation is a clear and present danger. By fighting exchange rate appreciation, policymakers have risked a higher inflation outcome. Latam currencies remain attractive despite risks of slower growth in the developed world.

- **Buy 3m USD/BRL DNT with barrier levels at 1.81 and 1.63.** With global capital inflows balanced by government intervention, expect considerable stability in BRL.
- **Buy 1y USDMXN put spread with strikes at 12.40 and 11.60.** An improved outlook for domestic demand opens the path for a gradual MXN appreciation.
- **Sell 6m USD/COP NDF**
- **Sell 2m USD/CLP NDF**

Outlook Article

Macro Risk Outlook – a pleasant plateau

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We see the outlook for risky currencies[1] as mildly positive in 2011.

- *We base this on the consistent historical pattern of returns that have prevailed during similar points in the economic cycle (a 'plateau' as measured by Nomura's Leading indicators, NOLI).[2]*
- *2011 is likely to be characterized by an acceptance that the world is enjoying sufficiently well-entrenched growth (albeit with a gentle second derivative decline in activity). This creates a high hurdle for event risk to have a prolonged impact on growth, and therefore, the markets.*

The challenges to this view (and responses to these challenges) are as follows:

1. *Our view is probably close to buy-side consensus[3] and thus we need to be alert to overshooting in price and wary of excessive positioning. (a) The good news is that risky-asset valuation work ('Flipping NOLI') indicates that we are probably not overshooting, and FX valuation work identifies pockets of EM undervaluation. (b) Our assessment of both long- and short-term is OK – supporting our core view. The intermediate picture is however of concern.*
2. *Our assessments of price ('Flipping NOLI') need to take into account both the cycle and the risk-free rate. Changes in the assessment of Fed policy, because of changes in the economic or political landscape, are very important. We believe there is a very high probability of QE2 being implemented in full.*
3. *The notion of emerging market (EM) economic outperformance may be tested in 2011, as base effects and the decline in growth of US imports eat into headline GDP growth. However, over the year as a whole, we would expect investors to look beyond what is likely to be a relatively short-term convergence in G3 and EM growth rates.*
4. *EM economic outperformance, plus prolonged US unemployment and political pressure, may exacerbate tensions around global rebalancing and around CNY in particular. The probability is that capital controls risks will grow. However, we believe these disruptions will be marginal and not systematically influence trends. The rate of change in CNY should be sufficient to mitigate the tension.*
5. *Finally, events in Europe threaten to upset risk markets further. We are especially focused on Spain. Our view is that this is unlikely to be the source of a prolonged systemic risk event, based on our assessment that Spain's debt dynamics still look sustainable, even taking into account the additional fiscal burden from bank recapitalization.*

1) Please see Box 2 on page 18 for a definition of risky currencies.
2) Please see Appendix A, page 20 for a brief description of NOLI.
3) Our year-ahead pieces of 5 February 2009 (which was focused on timing the upturn in risky assets) and 30 November 2009 (which looked to time the decline in risk) – were more controversial opinions. That said, we have learned from the past two years that people will say, "but this time it's different, and you can't use historical precedent". While there is an element of truth in this, the supposedly unique experiences of 2009 and 2010 were basically consistent with what occurred in the past (i.e. a post-trough rally, a peak-related decline). That is, the stylized facts (based on historical experience) have been broadly accurate, in our opinion.

Historical precedent for positive returns

"Each time history repeats itself, the price goes up"

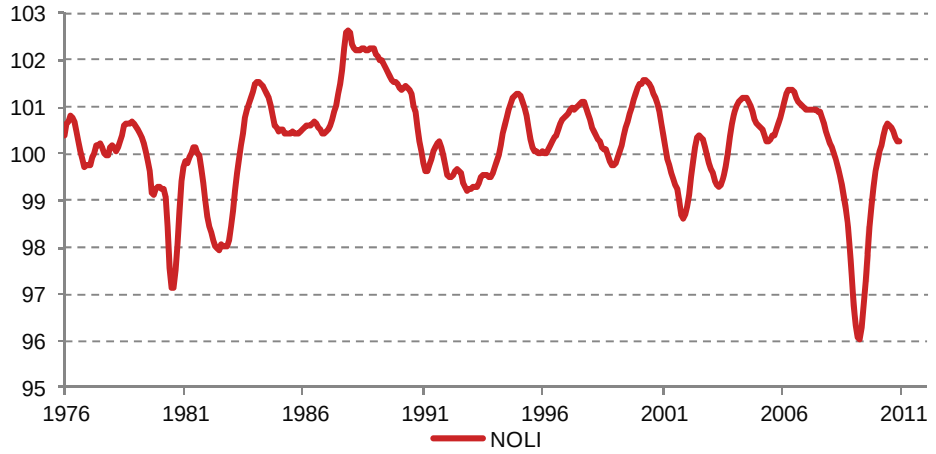
Anonymous[4]

Where are we in the cycle?

… Entrenched growth, but a gently declining second derivative

In terms of Nomura's Leading Indicators (NOLI), we are now 7 months from the most recent peak and 21 from the trough (see Exhibit 1). This 'mid-cycle' sense (what we term a 'plateau') is consistent with our economists' view that the global economy remains on a path of decent, but not increasing growth (See *2011 Global Economic Outlook: Rock road of Recovery*, 6 December 2010).

Exhibit 1. NOLI - descending to a plateau



Source: CEIC, Bloomberg, Nomura. Last data November 2010.

Exhibit 2. Table of NOLI components

		NOLI Components												
		Nov-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10
US	ISM Manufacturing PMI SA	53.7	54.9	58.4	56.5	59.6	60.4	59.7	56.2	55.5	56.3	54.4	56.9	56.6
US	Initial Jobless Claims 4 Week Moving Average SA	492	474	481	468	448	459	461	467	459	487	459	457	436
US	Conference Board's Consumer Confidence Indicator	50.6	53.6	56.5	46.4	52.3	57.7	62.7	54.3	51.0	53.2	48.6	49.9	54.1
EU	EU Manufacturing PMI Overall	51.2	51.6	52.4	54.2	56.6	57.6	55.8	55.6	56.7	55.1	53.7	54.6	55.5
EU	IFO German Manufacturing ex-food bus. Expectations	11.6	10.6	13.2	14.5	14.9	20.4	20.9	17.5	23.1	22.3	18.2	21.1	22.6
EU	Eurozone Manufacturing Production Expectations	2.0	3.3	5.2	7.0	9.0	9.0	9.8	9.3	9.4	10.0	11.7	14.0	15.3
JP	Nomura/JMMA Japan Seasonal PMI	52.3	53.8	52.5	52.5	52.4	53.8	54.7	53.9	52.8	50.1	49.5	47.2	47.3
JP	Japan Economy Watchers Survey: Outlook	34.5	36.3	41.9	44.8	47.0	49.9	48.7	48.3	46.6	40.0	41.4	41.1	41.1
JP	Japan Small Business Confidence (Shoko Chukin)	43.0	40.4	41.3	42.3	45.8	46.8	46.7	47.4	48.1	48.4	47.3	46.4	45.8
Summary NOLI		**99.6**	**99.8**	**100.1**	**100.2**	**100.4**	**100.6**	**100.6**	**100.6**	**100.6**	**100.5**	**100.3**	**100.3**	**100.3**
Summary NOLI, MoM chg		**0.31**	**0.23**	**0.21**	**0.14**	**0.18**	**0.18**	**0.10**	**-0.03**	**-0.04**	**-0.10**	**-0.13**	**-0.07**	**-0.01**

Source: CEIC, Bloomberg, Nomura.
Note: November 2010 NOLI is a pre-assessment based on actual reading of eight components and assuming a flat reading for Japan Economy Watchers Survey.

… which is associated with mildly positive risky asset returns

Historically, at this point of the NOLI cycle (the 'plateau'), risky asset returns have been positive.

Below we illustrate a study of the performance of risky assets[5] in 'plateau' eras since 1950, comparing their performance with that following a trough (last seen in March 2009) and around peaks of NOLI (last seen in April/May 2010).

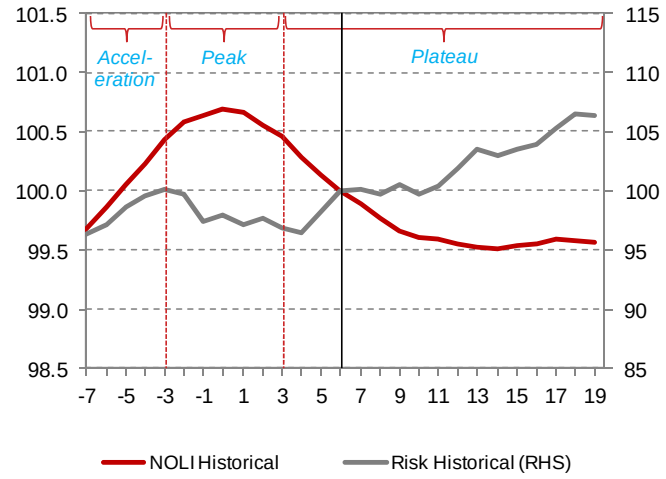
4) Recently quoted in Ronald Wright, *A Short History of Progress*, 2004.
5) The S&P 500 index has been taken as a proxy for the risky assets to increase the historical horizon for study of the relationship between risky assets and NOLI (results go back to 1950). Appendix B provides the detailed results of this study. It also details studies on MSCI World (from 1970) and risky FX (AUD from 1984, NZD from 1986 and EM FX from 2000). There is no obvious difference in results between various time-periods.

The median average inflation-adjusted[6] monthly returns to S&P 500 during the corresponding historical periods (which would be 8th month post-peak through to 19th month post-peak, similar to January 2011 to December 2011 period) have been +0.5% compared with +1.7% in the period following a trough[7], versus -0.6% in a period around a peak (and compared with an average of +0.3% for all months in the sample)[8]. The average monthly hit rates[9] for S&P 500 during the corresponding historical periods have been 53.5% compared with 69.3% in the period following a trough, versus 45.6% in a period around a peak (and slightly below the long-term average of 56.3%).[10]

In Exhibit 3a, we chart the historical median behaviour of risky assets in post-trough eras (month zero is the 'peak'). During the period that we describe as the 'acceleration' (in NOLI) risky assets show strong performance[11], at around the 'peak' (and after), risky asset prices tend to decline[12]. Thereafter, the rate of decline in NOLI begins to fall and we descend to the more comfortable 'plateau'. This period tends to be associated with reasonable risky asset performance.

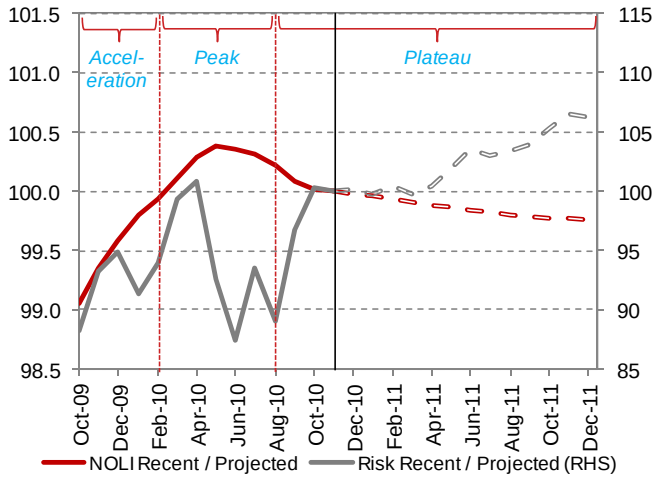
In other words, risky assets seem to have a gentle uptrend in the corresponding historical period where NOLI observes a gradual decline. We have mapped the most recent experience in Exhibit 3b, where (to date at least) NOLI and risky assets have followed broadly similar trajectories to that depicted in Exhibit 3a. Risk was strong through the period of acceleration (to March 2010), and choppy and declining around (and immediately beyond) the peak (from April/May through September). Exhibit 3b then presents the AR-based projection of NOLI and "expected" mildly strong risky asset performance in the plateau based on median historical performance. The Exhibit 3a and 3b show NOLI performance with S&P 500, but are also representative of a wide array of risky asset prices. (See Appendix B, on page 31 covering MSCI world, AUD and EMFX)

Exhibit 3a. Historical performance of NOLI and Risk[13]



Source: Bloomberg, Nomura.
Note: NOLI and Risky Asset Index (based on S&P 500) have been normalized to have a value of 100 at month-6 post-peak. Month zero corresponds to peak.

Exhibit 3b. Recent/projected performance of NOLI and Risk[14]



Source: Bloomberg, Nomura.
Note: For the current NOLI cycle, November 2010 is the month-6 post-peak. Dotted lines show the projected median path for NOLI and risky asset index.

6) We have used a 2yr rolling average of monthly US inflation as an estimate of the inflationary expectations for that particular month (i.e., inflation at the 'centre' between -12M and +12M).
7) We took only a six-month window after the trough for comparison to avoid overlapping effects from the next peak. Also, we used all 19 historical instances of NOLI troughs, starting since 1950.
8) Again, we took a six-month window around the peak (three months before and after) for 19 historical instances of NOLI peaks since 1950.
9) Hit rate signifies the probability of the risky asset having positive inflation adjusted monthly returns.
10) Interestingly, the "neutral" hit-ratio is 56.3% and not 50% due to the fact that risk assets tend to have a sharp downward correction, while the upward movements are relatively gradual.
11) This was first described in *Searching for Green shoots*, 5 February 2009.
12) This was first described in *Beyond Peak Performance*, 30 November 2009.
13) We have taken historical median performance of NOLI and risky assets (S&P 500) in previous 19 post-peak eras since 1950.
14) We have charted the recent performance of NOLI and risky assets (S&P 500) since October 2009 onwards. The projected path of NOLI is based on the autoregressive modelling. The 'projected' path for risky assets is the same as historical median performance.

In addition, the 'plateau' periods are generally associated with relatively moderate volatility (as seen in Exhibit 4). The standard deviation of average monthly returns to S&P 500 in the 2nd and 3rd quartiles have been less than the volatilities in months of rapid rise or rapid fall in NOLI.

… as is the case when gradients are low

Another way of looking at returns is to compare periods when the NOLI gradient has been similar to that we expect to see in the coming 12 months. Our economists' forecasts, our AR-based projections and historical experience all suggest that the NOLI gradient is likely to be low (and initially negative).

Returns during these periods tend to be somewhat average[15] – risky assets are associated with a gentle and general uptrend[16].

We believe that the economy is going to be in the 2nd and 3rd quartile (in terms of NOLI growth rate) for most of 2011[17], and likely to be in the 3rd quartile initially at least. As one might expect, returns are neither likely to be as strong as is the case following the recovery from a trough (the most recent example being following March 2009[18]), nor as poor as is the case around/following a NOLI peak (April/May 2010[19]).

Exhibit 4. NOLI growth rate vs. performance of risk assets[20]

Performance of S&P 500 with first derivative of NOLI	Range of NOLI gradient	Excess Returns	Std. Dev.	Information Ratio
(Higher quartile indicates quicker pace of NOLI rise)				
Top Quartile	**> 0.126%**	0.80%	4.09%	0.68
2nd Quartile	**0.00% - 0.126%**	0.67%	3.56%	0.66
3rd Quartile	**-0.122% - 0%**	0.10%	3.94%	0.08
Bottom Quartile	**< -0.122%**	-0.46%	5.16%	-0.31

Source: Bloomberg, Nomura.
Note: These excess returns are monthly inflation-adjusted returns of the S&P 500 index. Information Ratio is annualized while excess returns and standard deviations are monthly.

Why are returns mildly positive?

The gentle uptrend in risky asset prices can probably be explained by the fact that the sense of 'recovery' is embedded in the markets' psyche (NOLI is 21 months from the trough after all). In this 'plateau' phase, the entrenchment of growth creates a relatively high hurdle for event risk to have a prolonged impact on growth, and therefore the markets. This is as opposed to the sharp rise in risky assets following the excessive despondency that greets a trough in NOLI (most recently around March 2009) and to the decline which follows excessive elation at the peak in acceleration of economic activity (most recently April/May 2010).[21] [22]

All told, this is essentially a relatively less contentious phase, one which (on this occasion) probably started in Q3 2010, and seems likely to continue into 2011.

15) The monthly performance of risk assets (S&P 500) is categorized in periods according to the gradient of NOLI: 1) rapidly rising, 2) moderately rising, 3) moderately declining and 4) rapidly declining. We have removed moving average inflation trends from S&P 500 for easier comparison across asset classes.
16) We observed similar results while analyzing the performance of MSCI World, AUD, EMFX
17) The average annualized inflation-adjusted performance of S&P 500 while the NOLI gradient is in the 2nd and 3rd quartile are 8.0% and1.1%, respectively.
18) The total returns from Mar-09 to Apr-10 were 39.7% for S&P 500. The NOLI growth rate was in the top quartile throughout this period.
19) While, total returns between Apr-10 to Oct-10 were a meagre -0.3%.
20) The long-term inflation-adjusted trend for S&P 500 based on the Jan-48 to Oct-2010 is 3.3% pa. Also, it should be noted that we have not adjusted the index for the dividend payoffs which would further enhance returns.
21) Our next task is to more explicitly 'recover' the first derivative, so we can explore returns for a given condition in the first and second derivative. We are also likely to be focussed on trying to establish the extent of 'reflexivity' that afflicts NOLI/market relations.
22) This situation of superior risky asset returns ioutside G3 (especially EM) may last for a prolonged period of time because local savings are not deployed in local investments – partly as a result of desire for diversification from wealth holding locals. In FX space, full adjustment of FX is prevented through central bank intervention, arguably allowing local FX to retain value.

Challenges to this view (and responses to those challenges)

"If you can meet with Triumph and Disaster and treat those two Impostors just the same; yours is the Earth and everything that's in it."

Rudyard Kipling

1. Prices and positioning

Our core view is probably close to buy-side consensus, and we need to be very alert to overshooting in price and wary of excessive positioning.

At present, our risky-asset valuation work ('Flipping NOLI') indicates that we are probably not overshooting (see section A below), our FX valuation work identifies pockets of undervaluation (see page 134), longer-run trends for EM positioning are highly positive, and short-run measures of positioning are reasonably benign – although as we caution that there is a significant potential digestion problem (see section B below).

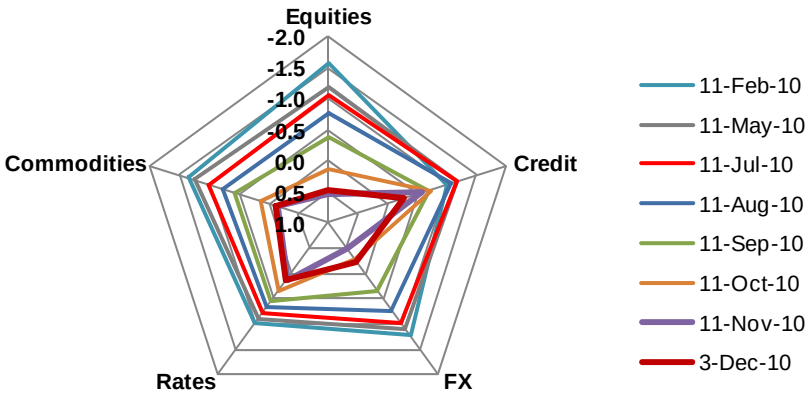
A. Prices. Flipping NOLI[23] – No clear signal, markets fractionally 'cheap'

Our current assessment is that markets fractionally under-price the current status of the cycle (by 0.1 standard deviation). In this respect, there is no clear sign that markets are 'overvalued.' According to the model, equity is overvalued by 0.5 standard deviations, FX and commodities are slightly overvalued by 0.2 and 0.1 standard deviations respectively, while Rates and Credit are undervalued by 0.1 and 0.3 standard deviations respectively, (see Exhibit 5 which shows undervaluation in the individual asset class as one moves further from the centre of the web. The undervaluation of Rates currently implies that the front-end of the UST curve should be flatter and the back-end steeper).

Of course, there is nothing delightfully cheap either, as the last chart in Exhibit 5 shows, the gap between NOLI and the implied level of each asset class had consistently narrowed through 2010, briefly being positive in early November 2010. This brief 'overvaluation' was driven by Equities and FX.

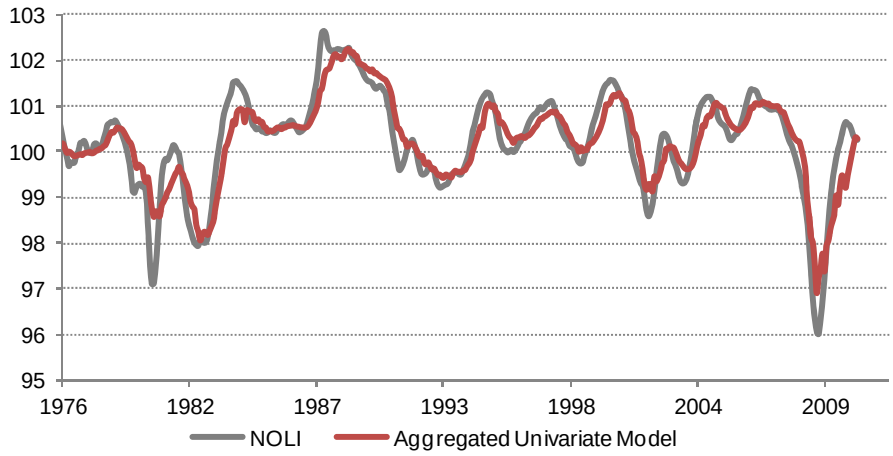
And, this does not preclude overvaluation in some case – as our page on valuations reports, AUD, BRL, ZAR and TRY, for example, are all overvalued and are expected to underperform their peers (see Exhibit 1, page 134 on EMFX valuation and Exhibit 4, page 27 for G10 valuation).

Exhibit 5. Consistent results based on a stacked set of univariate Flipping NOLI



23) Flipping NOLI is created by running rolling univariate regressions with a five-year window on each variable in each asset class (and constrains the coefficients to have economically meaningful values). Data samples in the window have exponential decaying weights. We average the model estimates for NOLI in each asset class. We produce the final market-implied NOLI with model estimates of five asset classes (equities, rates, credit, FX and commodities). Please refer to *Flipping NOLI – Cautious on most risky currencies*, 19 October 2010 and *Flipping NOLI II – how pessimistic is the market?*

Breakdown by asset						
	Equities	Credit	FX	Rates	Commodities	Avg.
11-Jan-10	-0.9	-0.4	-0.7	-1.1	-1.0	**-0.8**
11-Feb-10	-1.6	-1.0	-1.2	-1.0	-1.3	**-1.2**
11-Mar-10	-1.0	-0.7	-1.0	-0.9	-1.2	**-0.9**
11-Apr-10	-0.6	-0.7	-0.8	-0.9	-1.1	**-0.8**
11-May-10	-1.2	-1.2	-1.1	-0.9	-1.3	**-1.1**
11-Jun-10	-1.3	-1.5	-1.5	-0.9	-1.2	**-1.3**
11-Jul-10	-1.1	-1.2	-1.0	-0.8	-1.0	**-1.0**
11-Aug-10	-0.8	-1.1	-0.7	-0.7	-0.8	**-0.8**
11-Sep-10	-0.4	-0.7	-0.3	-0.6	-0.6	**-0.5**
11-Oct-10	0.1	-0.7	0.3	-0.3	-0.1	**-0.2**
11-Nov-10	0.5	-0.6	0.5	-0.1	0.1	**0.1**
3-Dec-10	**0.5**	**-0.3**	**0.2**	**-0.1**	**0.1**	**0.1**



Source: CEIC, Bloomberg, Nomura.
Note: This chart has data up to 3 December 2010. We include S&P 500, MSCI global, MSCI EM, STXE 600 and DAX as equity variables, CDX/iTraxx generic 5Y and Moody's AAA/BAA spreads to 10Y Treasury as credit variables, AUD/NZD/KRW as FX variables, US generic 1s2s and 5s10s spreads as rates variables and CRB index for commodities. Market prices on the 11th of each month are used to calculate implied levels for comparison with NOLI of previous month. Readings on charts are gaps between market-implied NOLI and NOLI in standard deviations.

B. Positioning – Digestion Issues

Our assessments of both long-term and short-term positioning are clearly positive – thus supporting our core view. The 'intermediate' picture is however of concern.

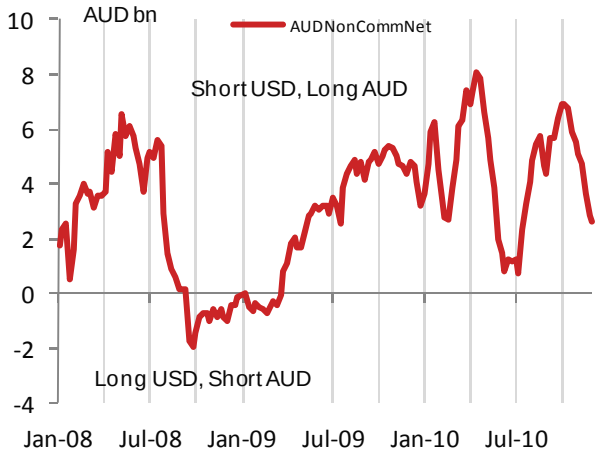
Taking each of these periods in turn:

i. **The long-term trend** is that EM (and to a lesser extent non-core G10) will continue to attract substantial, perhaps overwhelmingly large capital inflows, as global portfolios are rebalanced to reflect persistently superior returns in EM. The potential for further flows is enormous. The IMF's October 2010 *Global Financial Stability Report* (GFSR) stated that a "1 percentage point reallocation of global equity and debt securities held by G4 real money investors, which amounts to about $50 trillion, would result in additional portfolio flows of $485 billion. This would be larger than the record annual portfolio flows to emerging markets of $424 billion recorded in 2007." In this respect, perhaps the 'intermediate-term' digestion problem that we note below can be described as a potential hiccup in an otherwise fairly clear long-term trend.

ii. **The short-term trend.** Short-term positioning in risky assets suggests that some positions have lightened-up recently from high levels seen over October, which were achieved ahead of the Fed's decision to introduce QE2. For instance, AUD IMM positioning has declined significantly (see Exhibit 6a), our Asia FX positioning indices also show that short-term investors are likely to have turned long USD/Asia recently (having shorted

USD/Asia since September) (see Exhibit 6b). That said, positioning in NZD and MXN seem to remain relatively long by historical standards (see *Risk Positioning article*, 6 December 2010 for details).

Exhibit 6a. AUDUSD – w/w change = AUD -0.18bn



Source: Bloomberg, CME, Nomura. Last data as at 30-Nov-10.

Exhibit 6b. Daily positioning tendency

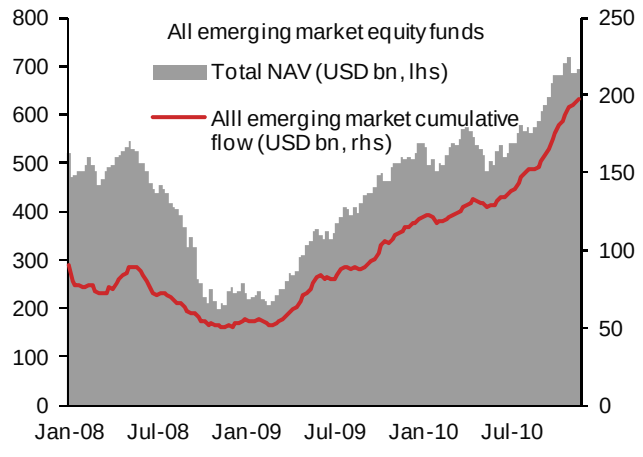
Positioning Signal	USD/KRW	USD/TWD	USD/INR	USD/IDR
6-Dec-10	long	hold	long	hold
3-Dec-10	long	hold	long	long
2-Dec-10	long	hold	long	long
1-Dec-10	long	hold	long	long
30-Nov-10	long	hold	long	long
29-Nov-10	hold	hold	long	long
26-Nov-10	long	long	long	long
25-Nov-10	hold	hold	long	long
24-Nov-10	long	long	long	long
23-Nov-10	long	long	long	long

- color means tending short USD/Asia
- color means tending long USD/Asia
- color means tending neutral USD/Asia

Source: Bloomberg, Nomura. Last data as at 6-Dec-10.

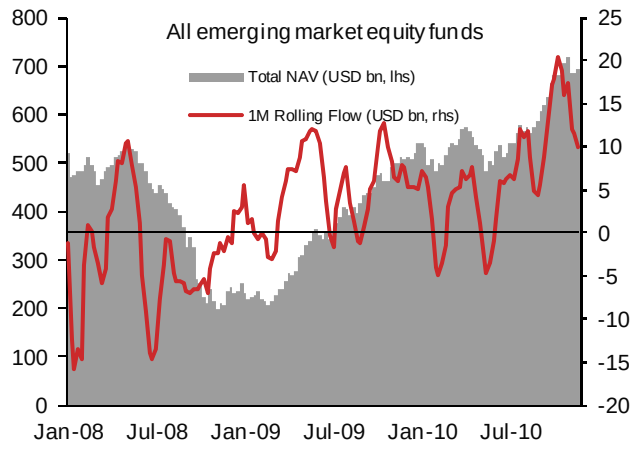
iii. **The 'intermediate digestion' issues.** The long-term trend of persistent and considerable build-up in capital inflows is evident from our analysis of long-term positioning, as measured by the Emerging Portfolio Fund Research (EPFR) mutual fund flows data into EM equities and bonds. Since December 2008 (right after the Fed announced its Large-Scale Asset Purchases program), cumulative mutual fund flow into all EM equities and bonds amounted to US$146bn and US$41bn, respectively. From mid-August 2010 (right after the Fed announced it was keeping its asset holdings constant), cumulative mutual fund flow accelerated to US$45bn and US$11bn, respectively. Cumulative inflows into both EM equities and bonds funds have reached all-time highs. Net asset values of both EM equities and bonds mutual funds are also near all-time highs at US$692bn and US$114bn, respectively. This is not insignificant compared to EM equities and sovereign bonds' respective market capitalisation of US$17trn and US$5trn (see Exhibits 7a and 7b). Herein lies the risk, which may be repeatedly tested: over (probably) short periods, as a result of the kinds of event risks we describe in this paper below, the investor community may be forced to exit positions because of redemption pressures given the large build-up in these positions.

Exhibit 7a. Cumulative change since Dec 08 = USD146bn



Source: EPFR, Nomura. Last data as at 22-Nov-10.

Exhibit 7b. W-o-w change in flow = USD 1.7bn



Source: EPFR, Nomura. Last data as at 22-Nov-10.

2. Our assessment of the risk-free rate and Fed policy

"The job of the central bank is to worry"

Alice Rivlin

Our work on 'Flipping NOLI' (see section 1 a) above) has attempted (but so far failed)[24] to create a model which successfully incorporates the risk-free rate along with the cycle. In the absence of this new model, we deal with the 'risk-free rate' separately in a discussion of Fed policy which reflects and slightly expands on that from our economists.

In assessing the outlook for "riskier" assets in 2011, we assume that Fed policy will play a supportive role. We expect the Fed to retain its current 0.0-0.25% fed funds policy target and its commitment to maintain ultra-loose policy "for an extended period" throughout 2011. We also assume that the Fed will implement the full amount of its planned US$600bn UST purchase program and that the probability of this program being expanded is higher than the risk of it being curtailed. Through extension, we do not expect sentiment towards 'riskier" assets to be undermined by a pronounced and sustained sell-off in USTs caused by the market pricing-in an earlier than currently expected policy tightening from the Fed.

Our view that Fed policy will be supportive of "riskier" asset performance hinges on three factors:

- Our assessment of the US economic outlook
- Our understanding of the Fed's reaction function
- And our assumption that current political processes in the US aimed at altering the Fed's reaction function will not succeed in altering the broad contours of US monetary policy.

We will leave a discussion of our US economic and inflation outlook to our economic research team (See *2011 Global Economic Outlook: Rock road of recovery*, 6 December 2010) and instead focus on the issues surrounding the Fed's reaction function. We believe that recent concerns in the market that the Fed may not implement its renewed program of QE in full – which contributed to the recent sharp sell-off of the UST curve – were based on a misunderstanding of this reaction function.

Many in the market believed that the Fed had already achieved its goal of stabilizing inflation expectations given that market-based measures surged after the Fed signposted additional QE in August. In the US TIPs market, the 5fwd 5yr breakeven inflation spread currently measures 2.88%, down from a recent high of 3.08% on 1 November, but far above the 1.92% low on 24 August. Many investors fear that implementing the planned US$600bn UST purchase program in full could be counterproductive since rising inflation expectations could force the Fed into policy tightening, or force a higher inflation premium to be embedded in the UST curve. These fears crystallized in a move by some Republican economists and GOP congressmen to narrow the Fed's dual mandate in favour of a single inflation focused one.[25]

However, we believe these concerns are misplaced. We believe that the Fed and more specifically, the core of the FOMC (Bernanke, Dudley and Yellen in our opinion) are naturally more focused on the dual mandate for employment and price stability than on more volatile market-based measures of inflation expectations. In terms of the Fed's reaction function, these concepts are fully inter-related since high levels of slack in the economy, in particular the persistently high

24) The model with the risk-free rate shows both risk-free rate and cycle are statistically significant. The model does capture the historical trend, but not variations. This suggests that the risk-free rate is important but that the relationship might not be as simple as to be captured by a linear model (a second order Taylor expansion model fits better and we are working along these lines to create a new model).
25) Indiana Representative Mike Pence introduced legislation (HR 6406) on 16 November to limit the Fed's activities to maintaining price stability and controlling inflation -- a move triggered by the Fed's bond-buying move. Pence said it was time to end the Fed's so-called "dual mandate" of dealing with the issues of inflation and "maximum employment" – senior supporters include Boehner, Ryan and Corker.

rates of unemployment, will have a disinflationary impact and limit the ability for higher market-based inflation expectations to become embedded into actual levels of underlying inflation. Similarly, the Fed tends to look beyond more volatile inflation trends – such as commodity-driven increases in headline CPI, which is also the inflation reference rate for US TIPS – and instead focus on underlying inflation trends. This is reflected in its belief that headline CPI trends converge to core inflation rather than vice versa. Indeed, the recent UST sell-off caused, in part, by fears that the Fed will need to prematurely end QE due to inflation concerns ironically came at a time when the Fed's favoured measure of inflation, the core PCE deflator, rose by a record low 0.9% y-o-y in October – and in 3M/3M saar terms, by just 0.5%.

We think it is highly unlikely that the core of the FOMC will bow to recently increased pressure to alter their reaction functions in a manner that downplays employment growth. Hence, UST sell-offs based on concerns about the Fed being compelled to rein-in QE due to inflation concerns are, in our opinion, likely to prove buying opportunities. However, we do acknowledge that into 2011 there will be increased headline risk regarding legislative efforts aimed at altering the Fed's mandate and the FOMC's autonomy of policy formation.

There are two related legislative assaults likely to occur on the Fed's mandate. As noted above, there is the move by some Republican economists and GOP congressmen to narrow the Fed's dual mandate in favour of a single inflation focused one. The current high rates of unemployment should make it relatively easy for opponents of this legislation to derail the process. Perhaps more problematic is a revival of some form of Ron Paul's proposal to 'audit' the Fed's asset purchases.[26] This is a provision which our political analyst, Alastair Newton, views as a slippery slope – since it can lead to Congressional attempts to influence the FOMC over interest rate setting. Although this provision was previously dropped, it was done so only at the final reconciliation stage. The probability of it passing remains relatively low as even Ron Paul clearly indicates,[27] but it has increased recently. The increased risk stem from the controversial nature of QE2, the Tea Party's probable increased influence over the GOP in the Senate and the vulnerability of half-a-dozen or so Democrat senators who are up for re-election in 2012 (in what look like very vulnerable seats), who may be open to doing deals on potentially populist issues such as Fed-bashing.[28]

In addition, there may be hearings as early as Q1 2011 to examine the Fed's performance during the financial crisis, the most recent introduction of QE2 and a broader discussion of available monetary policy tools. This might see current and former Fed staffers testifying and being publically criticised.

We assume that the US does not pass legislation that alters the Fed's mandate in a manner that requires the institution to adopt a more hawkish bias, especially given the weakness of the economy, but nonetheless legislative procedures have the potential to create adverse headline risks which could temporarily disrupt the performance of "riskier" assets.

26) As a result of the Republicans retaking the House, Paul could be head of a subcommittee overseeing the Fed since he is the ranking member on the Financial Services Subcommittee on Domestic Monetary Policy and Technology. Paul has said that if the Republican Conference votes to confirm him as chairman of the subcommittee, he does not expect to be able to push through his proposal to eliminate the Fed, but will use his position as a "bully pulpit" for his criticisms of the central bank. .H.R. 1207, the Federal Reserve Transparency Act.
27) See *Bernanke's worst nightmare: Ron Paul*, 12 November 2010, CNNMoney.com.
28) See *Issues which keep me awake at night: 2011 Forecast*, Alastair Newton, 24 November 2010.

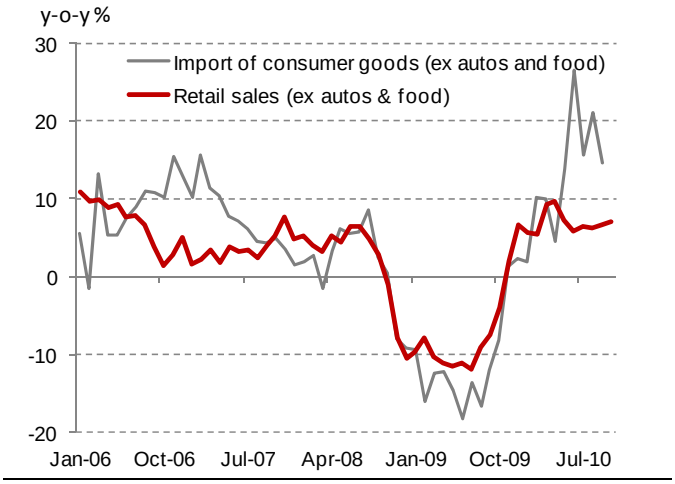
3. EM outperformance in question

"I would rather have a nod from an American, than a snuff-box from an emperor."

Lord Byron

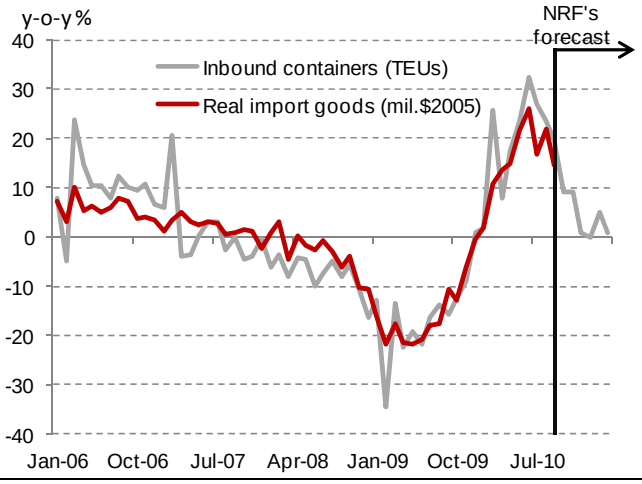
One risk[29] is that US imports will slow further in the next few months. Exhibit 8a looks at the trend in US core retail sales versus imports of consumer goods (ex autos and food). Judging from the big gap between imports and final sales, it would seem retailers have done a fair bit of restocking over the past few months. Our US economics team reckons the restocking has been a function of two things. First, retailers underestimated the extent of the slowing in retail spending over the summer and second, retailers' fears about possible supply-chain disruptions due to a limited availability of ships.[30] Normally, holiday season restocking occurs in the autumn. This year, some of this restocking appeared to take place in the summer. No matter what the reason, the surge in US imports is likely to see some payback in coming months. Exhibit 8b shows a simple model used by our economics team which compares real US imports against inbound container traffic. While the measure is far from precise, it does point to a notable decline in US imports over the coming months.

Exhibit 8a. US core retail sales vs. consumer goods imports



Source: Nomura Global Economics.

Exhibit 8b. Real US imports vs. Inbound containers (TEUs)



Source: Nomura Global Economics Estimates.

To a degree, some of this slowdown may already be showing-up in Asian export data.[31] However, as we examine on page 58, much of the slowdown in exports is to non-US markets, especially China, and thus the greatest challenge may still be ahead of us.

In and of itself, a significant slowdown in US imports (which we arbitrarily define as a decline in the growth rate by 10 percentage points on an annualized basis, or a shift into negative territory), can clearly interrupt the Asian (and broader EM) FX trend, but the association is not especially strong. US import declines in Q4 2000, Q1 2003 and Q4 2008 were associated with poor Asian FX performance. However, Q3 2004 (where imports growth fell from a very fast rate), Q4 2006 (where it was negative) and Q4 2007 were associated with fairly strong Asian FX performance.

29) Please see Jim McCormick's *Macro Daily: Are US imports set to slow?*, 24 November 2010.
30) For example, the US National Retail Federation has said: "While October has long been the busiest month of the year as retailers rush to fill shelves with merchandise for the holiday season, the peak shifted to August this year. The change came both because of a backlog in (import) cargo from earlier in the year after ocean carriers were slow to replace vessels taken out of service during the recession, and because retailers brought merchandise into the country early to avoid the risk of delays this fall." The Federation, cooperating with Hackett Associates, releases its forecasts for import cargo volumes by month. Based on these, US goods imports are likely to decrease in Q4 and be essentially flat in Q1 2011 q-o-q.
31) In fact, the most recent assessment of Q3 is that import growth has fallen by more than 10% in the most recent quarter of data (from more than 20% to less than 10% saar).

Meanwhile, overall inventory-to-sales ratios in the US do not look especially worrisome to our economists. Indeed, while part of the retail restocking over the summer was likely unplanned, overall inventory levels in the retail sector were low prior to this build-up.[32]

4. CNY and capital controls risk

We would view the probability of globally decisive capital controls as perhaps having a 20% probability. For the most part, we believe that such disruptions will be marginal and should not systematically influence trends.

The root cause is likely to remain

However, the root cause of capital controls risk – the divergence in economic performance between G3 and EM – is likely to continue (there is both a cyclical and structural element to this, in the sense that even if growth rates temporarily converge next year, in the longer term the divergence is likely to be large), while policy prescriptions for dealing with it will differ. Indeed, one risk is that the intellectual basis for the rejection of such controls has been undermined (to the extent that even the IMF appears to endorse controls under selective circumstances).

The pivotal relationship – US and China

The pivotal relationship between G3 and EM is that between the US and China. High US unemployment and the elevation of CNY to an issue of international diplomacy are likely to create tension between the world's two paramount powers.

We tend to think that the rate of change in CNY will be sufficient to mitigate Sino-US tensions, but acknowledge significant tail-risk.

As we detailed in our latest Beijing visit notes[33], we would expect USD/CNY to start to fall ahead of Premier Hu Jintao's state visit to the US (likely to take place over 19-20 January 2011).

It makes sense for CNY change to begin sooner rather than later – to create positive momentum in the relationship with the US and to avoid the accusation from local Chinese nationalists that the timing is motivated by the state visit.

With respect to the latter, the increased pace of movement could be tied (implicitly) to decisions and announcements made following the Central Economic Work Conference (likely 8 December, but possibly 12 December), especially given the considerable focus on domestic inflation risks.

A 2% adjustment by 19-20 January would be a reasonable target, in our opinion. Thereafter, it is likely that USD/CNY declines by a further 5-7% during the course of 2011 (see page 56 for more on this and page 74 for our Asian forecasts).

However, we recognize that recent developments in Sino-US relations – the increasingly explicit references to FX adjustment from the US (which have probably annoyed China) and the exigent importance of North Korea – have reduced the probability of such a move into January (to 65% perhaps from our previous (unstated) assumption of around 80%. There are similar, albeit lesser risks to our call for 2011 as a whole.

32) At 1.38 the US retail inventory to sales ratio is considerable below 20-year linear (down) trend, which would put the ratio closer to 1.45.
33) Please see *FX Insights: Beijing Visit Notes*, 29 November 2010.

Capital control risks

"Children have never been very good at listening to their parents, but they never fail to imitate them."

James Baldwin

We would argue that, as implied by the quote above, the current strain in Sino-US relations allows other EMs (especially in Asia) to 'act out' (rather like naughty children) under the assumption that Daddy (the US) is too busy shouting at Mummy (China) to notice.

The 'degraded' atmosphere between the two key partners has allowed the discussion of the use of capital controls to flourish. The most recent G20 communiqué allows the use of such controls under certain conditions. In addition, the gentle apparent endorsement of some forms of controls has emerged from the IMF in congruence with the Shanghai conference held on 18 October (Macro-Prudential Policies: Asian Perspectives). This multilateral 'endorsement' of some forms of controls has (arguably) facilitated the shift in intellectual atmosphere in favour of such controls. The next key event to look out for would be the publication of any document from such global institutions which appears to endorse controls – the G20 communiqué seems to imply that such a document might be published in H1 2011.[34]

Despite these concerns, as we imply above, we expect some marginal progress with respect to the Sino-US relationship – Hu Jintao's state visit in January 2011 and the Strategy and Economic Dialogue (likely in May), should provide focal points for improvements. If the US and China appear to be getting on better, this should at least reduce the scope for trend-changing capital controls in countries where exchange rates are undervalued (see page 134 for our valuation) and/or where there are significant current account surpluses.[35]

See below for an updated version of the calendar which first appeared in our latest *Beijing visit notes*.

34) A counter-argument to this would be: Even if one opposes such controls, it is important for the IMF to occupy this intellectual space, so it can provide intelligent guidance about when such controls are justified.
35) In line with the spirit of the G20's limited endorsement of controls.

Box 1: US-China event calendar

We have put together a calendar of key upcoming events which we believe might have significant impact on the CNY appreciation path and perspectives about capital control risks in EM. The schedule for many of these events is based on our discussion with key local persons and authorities.

Exhibit 1. US-China event calendar for the next 12 months

Date	Event	Location	Remarks
Ongoing	Talks on North Korea, six-party talks may be announced	N.A.	North Korea risks make FX focus less important
Expected soon	US Treasury FX Report	US	May give hints of US stance before and during Hu Jintao's visit about USD/CNY movements. Interesting to see if US makes the language harsher. Seems less probable now that the North Korean situation has flared up (although it depends on the timing)
5-7 Dec 2010*	Central Economic work conference (CEWC)	China	There may be leaks about content ahead of time (could be continued/postponed to 10 or 11 Dec as leadership wants to see CPI data, which is likely to be available to officials ahead of the 13 Dec official release)
8 Dec 2010*	Announcements of decisions at CEWC	China	May set growth targets and tone of year's policy. May even mention FX and discuss reducing the CA surplus (could be postponed to 12 Dec)
13-Dec-10	November CPI Data released	China	Higher than expected CPI figures recently have increased pressure for CNY appreciation. Watch for monthly data releases as higher inflation will make China more amenable to change
14-15 Dec 2010	Joint Commission on Commerce and Trade	US	Featuring Locke, Kirk & Wang Qishan. Even if there is little of substance, the tone of the announcements from both sides is likely to be positive
05-Jan-11	US Congress reconvenes	US	Risk that FX is mentioned before Hu Jintao's visit
19-20 Jan 2011	Hu Jintao visits US	Wash-ington	A very high hurdle to cancellation. Some FX appreciation likely ahead of this. However, preparation for deliverables for the meeting seems mediocre to date
January 2011*	National Financial Work Conference	China	This may be postponed (perhaps Q2 at the earliest), but as it happens only every five years and is focused on financial liberalization, is potentially exciting
March 2011	National People's Congress	China	More details of the Five-year Plan to be released
March 2011	Ryan Act revived?	US	This may be the earliest that the Ryan Act is back on the table given current Congressional priorities
March/April 2011	US-Japan new defence agenda	US	Concern that Japan-US will be more explicit about the threat posed by China
15-Apr-11	US Treasury FX Report	US	
16-17 Apr 2011	IMF/World Bank		Spring meetings
H1 2011	IMF/BIS report on Capital controls	Global	G20 outlined that IMF, BIS and FSB would be asked to examine the use of macro-prudential measures
25-30 May 2011	Strategic & Economic dialogue	US	US and China do tend to work on deliverables for these meetings, including FX change
June-July 2011	Likely publication of IMF Article 4 for China	China	The previous Article 4 included a current account forecast. On this occasion it may do likewise; and/or contain an assessment of the so-called global 'spill-overs' of local policy (presumably commenting on the Chinese contribution to rebalancing)
24-26 Sep 2011	IMF/World Bank annual meetings		2011 Annual Meetings of the World Bank Group and the IMF
15-Oct-11	US Treasury FX Report	US	
3-4 Nov 2011	G20 Summit	Cannes, France	Dates declared by France on 12 Nov, possibility of event being brought forward and having two meetings in the year
12-20 Nov 2011	Annual APEC Economic Leaders' Meetings		

Source: Nomura.
* The dates are subject to change.

5. Europe and Spain

Finally, events in Europe threaten to upset risk markets further. We are especially focused on Spain. Our view is that this is unlikely to be the source of a prolonged systemic risk event, based on our assessment that Spain's debt dynamics still look sustainable, even taking into account the additional fiscal burden from bank recapitalization. For a full discussion please see page 32 on *EUR: Persistent risk premium needed*.

Box 2: What are risky currencies?

- A reasonably high proportion of FX performance (versus USD) is (still) explained by, or is coincident with, a generic measure of risky asset performance.
- Such strong correlations probably exist because of growth correlations with the US (many non-G3 countries appear to have growth betas that exceed 1), extremely loose US monetary policy (associated with a weak USD and strong demand for non-G3 assets), and the broad dollar effect (the denomination of commodity prices, and to a lesser extent external indebtedness).
- In general, we find that one can still describe the Antipodean currencies (current R-squared of 59% based on weekly changes in the past three months), CAD (50%) and most EM currencies as 'risky' (average of 37%). For other G10 (i.e., non-AUD, NZD and CAD) the R-squared average is 16%. The average for our Asian sample is 39%, for Latam 40% and EEMEA 32%. USD and JPY emerge as 'safe havens'. CHF is normally, but not when the EU is the epicentre of trouble.
- The correlations have declined in the past three months and we expect this decline to be sustained into 2011 as the world settles into the mid-cycle recovery.
- However, these correlations are, and are likely to remain, above the long-term (10-year) average as sufficient uncertainty remains – with respect to the strength of the recovery, the capacity of EM's to continue to enjoy high beta, changing expectations of Fed policy and concerns about European sovereign issues (to name a few).

Extracting common risk factors

As observed in the market, most risky assets (equities, FX, commodities and even rates) exhibit significant correlation in returns, which implies that some common factor lies behind all these assets. Given common or highly correlated factors driving risky assets and currencies, we try to extract such factors from broad market prices. In order to extract these proxies representing the risk factors for risky assets and currencies, we conduct a Principal Component Analysis (PCA) on weekly returns (or changes) of generic risky assets and currency pairs, respectively. Some common factors can largely capture a significant degree of variations in returns. Different assets have different loadings to these factors. Variables selected are as follows,

- Equities: SPX, MXWO, MXEF, SXXP, DAX
- Commodities: CRY
- Rates: 10Y constant maturity US Treasury yield (10Y US CMT)
- Credit: Moody's BAA-AAA spread and Moody's AAA-10Y US CMT
- FX: G10, EEMEA, Asia and LatAm

In order to avoid circular reasoning, we exclude currencies when constructing risky asset index. And the first principal component captures the dominant driver across asset classes which we interpret it as the risky asset index.

To gauge the overall risky FX performance and isolate idiosyncratic risk factors' impact on currencies, we do a similar PCA on all currency pairs selected. The results suggest the first FX principal component having significant loadings on risky currencies by convention. Therefore, we interpret this PC as a risky FX factor, which explains more than 20% of return variations in the whole FX space across G10, EEMEA, Asia and LatAm. By definition, it also contributes to the majority of risky FX performance, i.e. 80-90% for AUD recently.

Once we construct both the risky asset index and the risky FX index, we use three-month rolling regressions on weekly returns of currency pairs and the risky FX index on the change of the risk asset index to assess the contribution of risky asset index to variations of currency pairs as well as betas (Exhibit 1).

Please refer to *Assessing the risk correlation of risky FX* published on 1-Dec-2010 for further discussion on methodology, results and implications.

Exhibit 1. Risky currency sensitivity to risky asset index (3M results)

	Relation to risk asset index									
Ccy	R-squared	Avg (1Y)	Z-score	Avg (10Y)	Z-score	Beta	Avg (1Y)	Z-score	Avg (10Y)	Z-score
G10	16%	24%		15%						
EUR	22%	25%	-0.3	17%	0.4	0.23	0.13	2.4	0.04	1.9
GBP	15%	16%	-0.1	14%	0.1	0.11	0.09	0.6	0.04	0.8
JPY	10%	24%	-0.9	16%	-0.3	-0.10	0.10	-3.7	0.03	-1.3
CHF	44%	20%	1.8	14%	2.3	-0.25	-0.09	-2.9	-0.01	-2.3
EURGBP	11%	5%	1.4	4%	1.2	0.11	0.04	2.2	0.00	2.8
EURJPY	8%	48%	-3.0	21%	-0.6	0.12	0.23	-2.9	0.06	0.5
EURCHF	1%	9%	-0.7	17%	-0.9	-0.03	0.04	-1.0	0.02	-1.1
EURNOK	19%	34%	-1.0	14%	0.4	-0.10	-0.10	0.1	-0.05	-1.1
EURSEK	11%	32%	-1.4	18%	-0.4	-0.07	-0.10	1.0	-0.05	-0.4
	42%	59%		25%						
AUD	69%	67%	0.1	28%	1.6	0.37	0.28	1.8	0.12	1.8
CAD	50%	68%	-1.5	23%	1.1	-0.21	-0.22	1.0	-0.08	-1.4
NZD	48%	56%	-0.5	22%	1.1	0.32	0.26	1.3	0.11	1.6
AUDCHF	18%	42%	-1.1	28%	-0.4	0.11	0.20	-1.1	0.11	0.0
NZDJPY	25%	60%	-2.2	25%	0.0	0.22	0.36	-2.5	0.14	0.5
Asia	39%	43%		19%						
CNY	22%	22%	0.0	9%	1.1	-0.06	-0.02	-3.4	0.00	-3.9
HKD	24%	32%	-0.4	10%	1.1	-0.01	-0.01	0.0	0.00	-1.3
IDR	49%	52%	-0.1	23%	1.1	-0.10	-0.14	0.7	-0.09	-0.2
INR	39%	59%	-1.3	22%	0.8	-0.18	-0.15	-1.2	-0.06	-1.7
KRW	46%	59%	-0.7	24%	0.9	-0.24	-0.21	-0.5	-0.08	-1.6
MYR	48%	52%	-0.2	31%	0.7	-0.13	-0.13	0.2	-0.07	-1.2
PHP	38%	51%	-1.0	21%	0.7	-0.18	-0.13	-1.6	-0.06	-1.7
SGD	46%	50%	-0.3	20%	1.2	-0.13	-0.08	-2.5	-0.03	-2.1
THB	49%	11%	4.2	9%	3.5	-0.13	-0.02	-5.1	-0.02	-2.6
TWD	26%	38%	-0.7	17%	0.5	-0.09	-0.07	-1.7	-0.04	-0.8
EEMEA	32%	45%		19%						
EURCZK	17%	25%	-0.7	10%	0.6	-0.04	-0.08	1.0	-0.03	-0.2
EURHUF	4%	38%	-2.4	19%	-0.8	-0.07	-0.16	1.8	-0.08	0.2
EURPLN	52%	51%	0.1	22%	1.7	-0.20	-0.18	-0.5	-0.09	-1.2
ILS	25%	40%	-1.0	15%	0.7	-0.14	-0.09	-2.6	-0.05	-1.4
RUB	16%	50%	-1.8	17%	-0.1	-0.12	-0.17	1.5	-0.05	-0.3
TRY	51%	51%	0.0	29%	0.9	-0.31	-0.19	-3.0	-0.13	-0.9
ZAR	56%	58%	-0.1	24%	1.3	-0.29	-0.26	-0.4	-0.16	-0.9
Latam	40%	43%		22%						
BRL	39%	52%	-1.0	28%	0.5	-0.21	-0.21	0.1	-0.16	-0.4
CLP	32%	25%	0.5	18%	0.8	-0.17	-0.14	-0.3	-0.07	-1.0
MXN	37%	60%	-1.3	27%	0.5	-0.14	-0.20	2.0	-0.10	-0.4
COP	54%	34%	1.8	15%	2.5	-0.18	-0.14	-0.8	-0.08	-1.0

Source: Nomura, Bloomberg.
The bolded columns refer to the past 3M regression results. The historical data includes at least 10 year of data except MYR which started since 2005. We use spot returns in all cases except HKD, where we use the 3M forward and CNY 1where we use the 3M NDF.

Appendix A – NOLI description

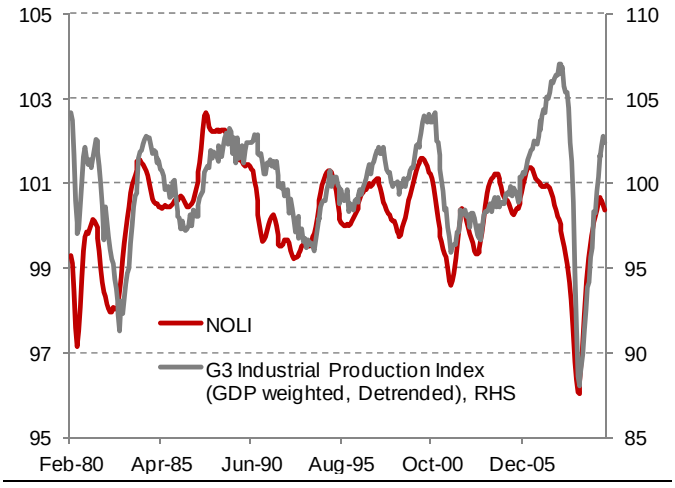
There have been minor changes in the construction of NOLI since 19 October 2010 (see *Flipping NOLI – Cautious on most risky currencies*). We briefly detail the current make-up of NOLI here.

Nomura's leading indicators (NOLI) is an aggregation of nine economic indicators (three from each of the three global regions – viz. US, EU and Japan) to gauge economic activity. NOLI comprises, from US indicators, the ISM Manufacturing PMI, Initial Jobless Claims[36] and the Confidence Board's Consumer Confidence Index; from Europe, the EC Manufacturing Overall PMI, the IFO German Manufacturing (ex-food) Expectations and the Euro zone Manufacturing Production Expectations; and from Japan, the Nomura/JMMA Seasonal PMI, Japan Shoko Chukin's Small Business Confidence Index and the Japan Economy Watchers' Future Expectations Survey. We have sidelined a few indicators which were in our old NOLI; namely the ZEW Germany Growth Expectations, US durable goods, University of Michigan Confidence Index and the Japan inventory to shipment ratio. These changes have been done to improve the timeliness of releases, limit revisions and exclude the financial-market "biased" indicators like the ZEW Germany Growth Expectation index.

The indicators are then normalized, rebased and HP-smoothed such that each has a neutral level of 100 and a similar level of variation. The regional aggregation of indicators is done by taking the plain arithmetic average of the normalized growth rates of the three HP-smoothed economic indicators for each region. The global aggregation is then done by computing a weighted average of the growth rate of regional NOLIs, based on the GDP of each region in dollar terms.

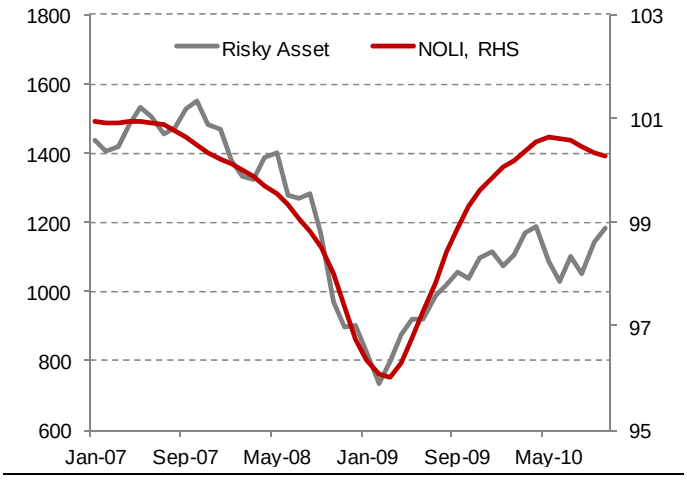
NOLI leads G3 industrial production by three to four months (the average rolling 60-month correlation coefficient is around 74%, compared with a simultaneous correlation of 61%). The relationship could be seen in Exhibit 9a. Similarly, Exhibit 9b shows the close relation between NOLI and risky assets around the most recent trough in economic activity. As expected, and discussed, the relation becomes stronger during periods of crisis.

Exhibit 9a. NOLI leads G3-IP…



Source: Bloomberg, Nomura.

Exhibit 9b. … and correlates well with risky assets



Source: Bloomberg, Nomura.
Note: S&P 500 Index has been taken as a proxy for Risky Asset.

We have also modelled the dynamics of NOLI as an autoregressive process to forecast the future path of NOLI. Our analysis showed that the NOLI could be modelled as an AR(2) process.

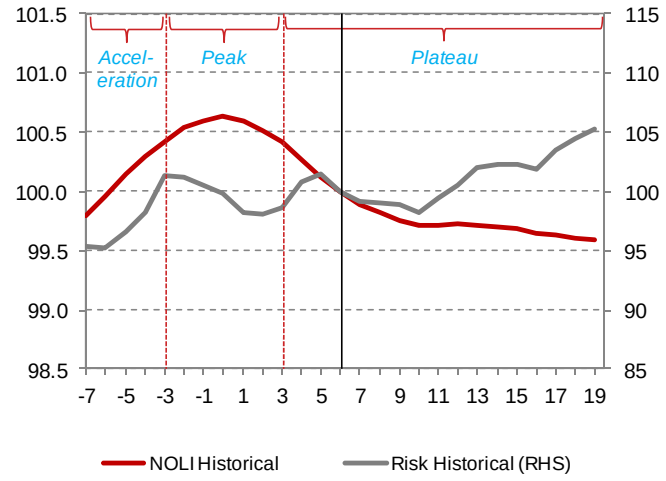
36) We use a 4-week moving average of jobless claims as a fraction of total US population so as to remove any trend due to the rise in population. Our analysis shows that such a treatment of jobless claims improves the lead of the indicator over the G3 IP index by one to two months and the correlation from 52% to 62%.

Appendix B – Interplay of NOLI and other risky assets

MSCI World

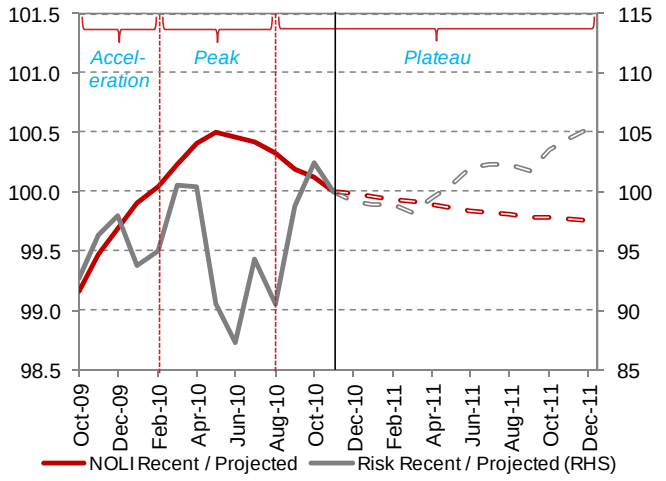
We studied the performance of various risky assets with NOLI cycles, especially in the post-peak era of cycle (plateau). As mentioned earlier and shown in Exhibit 10, the performance of other risky assets (MSCI World in this case) was quite similar to what we showcased for S&P 500 in the main section. The median average inflation-adjusted monthly returns to MSCI World during the corresponding historical periods (which would be 8th month post-peak to 19th month post-peak) have been 0.5% compared with 1.7% in the period following a trough[37], versus -0.4% in a period around a peak[38]. The average monthly hit-ratio for MSCI World during the corresponding historical periods has been 57.6% compared with 74.4% in the period following a trough, versus 43.1% in a period around a peak (keeping in mind that the "neutral" (or long-term historical) hit-ratio of MSCI World is 56.0%). This analysis further enhances our belief that the performance of risky assets will see a gentle uptrend.

Exhibit 10a. Historical Performance of NOLI and MSCI World[39]



Source: Bloomberg, Nomura.
Note: NOLI and Risky Asset Index (based on MSCI World) have been normalized to 100 at month-six post-peak.

Exhibit 10b. Recent/Projected Performance of NOLI and MSCI World[40]



Source: Bloomberg, Nomura.
Note: For the current NOLI cycle, November is month-six post-peak. Dotted lines show the projected path for NOLI and risky asset index.

Exhibit 11. NOLI growth rate vs. performance of MSCI World[41]

Performance of MXWO with first derivative of NOLI	Range of NOLI gradient	Excess Returns	Std. Dev.	Information Ratio
(Higher quartile indicates quicker pace of NOLI rise)				
Top Quartile	**> 0.108%**	0.87%	4.21%	0.71
2nd Quartile	**0.00% - 0.108%**	0.64%	3.43%	0.65
3rd Quartile	**-0.108% - 0%**	-0.08%	4.04%	-0.06
Bottom Quartile	**< -0.108%**	-0.85%	5.55%	-0.53

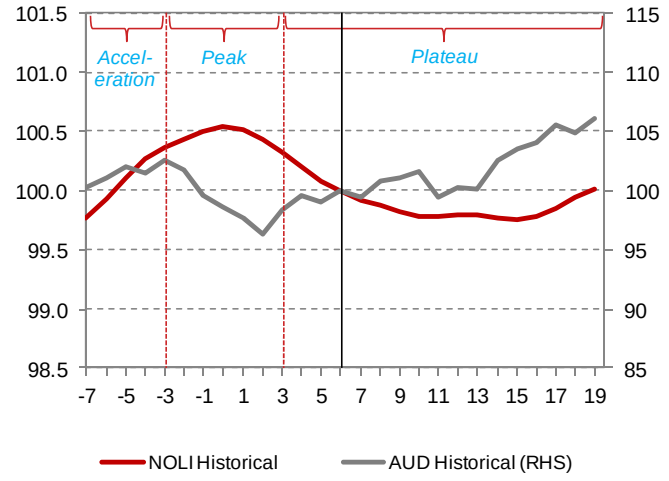
Source: Bloomberg, Nomura.
Note: These excess returns are monthly inflation-adjusted returns of the MSCI World index. The Information Ratio is annualized while excess returns and standard deviations are monthly.

37) We have taken only six-month window post the trough for comparison to avoid effects of future peaks. Also, we used all 13 historical instances of NOLI peak starting since 1970.
38) Again, we have taken only six-month window around the peak (three months before and after) and there have been 12 historical instances of NOLI trough since 1970.
39) We have taken historical median performance of NOLI and risky assets (MSCI World) in the previous 13 post-peak eras since 1950.
40) We have charted the recent performance of NOLI and risky asset (MSCI World) since October 2009 onwards. While, the projected path of NOLI is based on the autoregressive modelling and for risky asset a growth trajectory same as historical median inflation-adjusted performance is assumed.
41) The long-term inflation-adjusted trend for MSCI World based on Jan-70 to Oct-10 is 1.8% p.a.

AUD

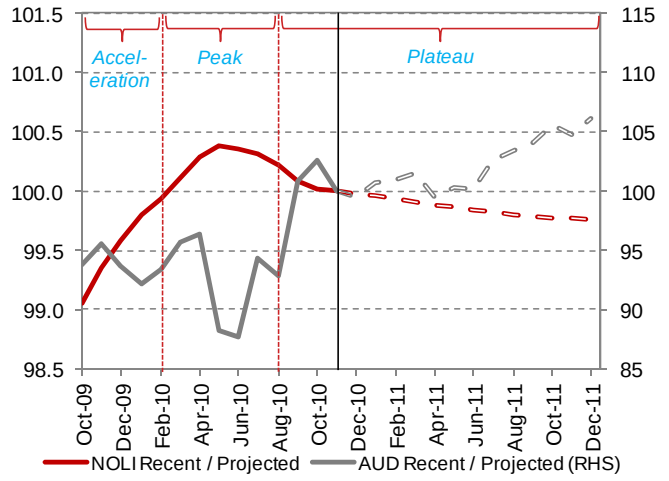
We have also attempted to analyze the performance of risky FX in the NOLI post-peak eras. The results have been quite consistent with our observations about equities given that significant regime shifts historically restrict the validity of the analysis.

Exhibit 12a. Historical performance of NOLI and AUD



Source: Bloomberg, Nomura.
Note: NOLI and Risky Asset Index (based on AUD) have been normalized to 100 at month-six post-peak. We have used seven instances of peaks since 1984 for the analysis. (NB/ returns are not adjusted for carry)

Exhibit 12b. Recent/projected performance of NOLI and AUD



Source: Bloomberg, Nomura.
Note: For the current NOLI cycle, November is month-six post-peak. Dotted lines show the projected path for NOLI (based on autoregressive model) and AUD (based on historical median performance).

Exhibit 13. NOLI growth rate vs. performance of AUD

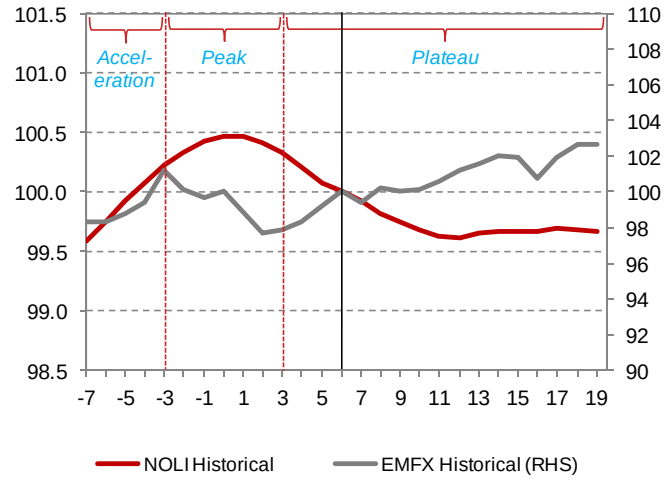
Performance of AUD with first derivative of NOLI	Range of NOLI gradient	Returns	Std. Dev.	Information Ratio
(Higher quartile indicates quicker pace of NOLI rise)				
Top Quartile	**> 0.07%**	0.88%	2.83%	1.08
2nd Quartile	**-0.01% - 0.07%**	-0.29%	3.26%	-0.31
3rd Quartile	**-0.10% - -0.01%**	0.32%	3.27%	0.34
Bottom Quartile	**< -0.10%**	-0.35%	4.17%	-0.29

Source: Bloomberg, Nomura.
Note: The analysis is based on monthly returns of AUD since January 1984.

EMFX

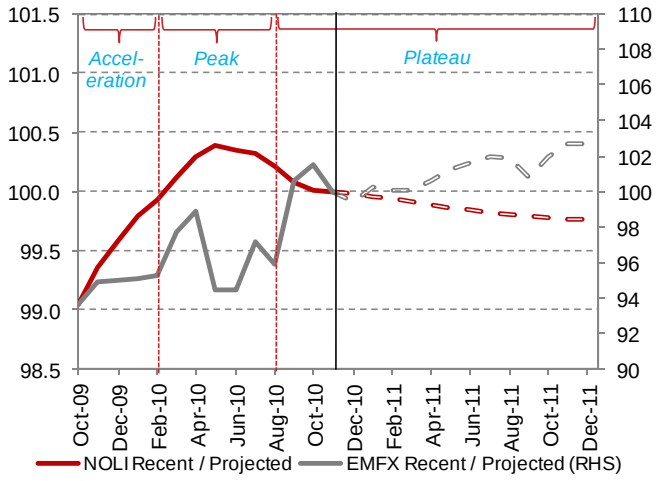
We have also attempted to analyze the performance of EM FX in the NOLI post-peak eras. For the analysis, we selected seven EM currencies – KRW, BRL, MXN, ZAR, TRY, INR and IDR – and looked at their median performance around four post-peak eras of NOLI since January 2000. The average monthly hit ratio for EM FX in post-peak era has been 53.0% compared with 58.3% in the period following a trough, versus 41.1% in a period around a peak (keeping in mind that the "neutral" (or long-term historical since Jan-2000) hit-ratio of EM FX is 56.5%). Hence, we could say that the results have been quite consistent with our observations about equities given that significant country specific risks historically restrict the validity of the analysis.

Exhibit 14a. Historical performance of NOLI and EM FX



Source: Bloomberg, Nomura.
Note: NOLI and Risky Asset Index (based on EMFX) have been normalized to 100 at month-six post-peak. We have used four instances of peaks since 2000 for the analysis and considered the median performance of all EM currencies under consideration. Returns are not adjusted for carry.

Exhibit 14b. Recent/projected performance of NOLI and EM FX



Source: Bloomberg, Nomura.
Note: For the current NOLI cycle, November is month-six post-peak. Dotted lines show the projected path for NOLI (based on autoregressive model) and EM FX (based on historical median performance).

Exhibit 15. NOLI growth rate vs. performance of EMFX

Performance of EMFX with first derivative of NOLI	Range of NOLI gradient	Returns	Std. Dev.	Information Ratio
(Higher quartile indicates quicker pace of NOLI rise)				
Top Quartile	**> 0.07%**	0.92%	1.87%	1.71
2nd Quartile	**-0.01% - 0.07%**	-0.33%	1.69%	-0.67
3rd Quartile	**-0.10% - -0.01%**	0.26%	1.55%	0.58
Bottom Quartile	**< -0.10%**	-1.17%	3.71%	-1.09

Source: Bloomberg, Nomura.
Note: The analysis is based on monthly median returns of EMFX since January 2000.

Outlook Article

G10 Top FX trades and 2011 FX Forecast

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Top G10 FX Trades for 2011

EUR/USD to stay in range: Buy basket of DNTs

- Buy basket of Double-No-Touch options: 3M 1.25-1.45 DNT for 51.25%, 6M 1.25-1.45 DNT for 28.0% and 12M 1.22-1.48 for 19.0%
- Trade benefits from elevated implied EUR/USD volatility. We invest $300K of premium in the trade

UK to outperform G3: buy GBP vs. USD, EUR and JPY, equal weights.

- Go long at index level 100, stop at 97 and target 109. We use $20mn notional for the basket.
- GBP is down 25% on average vs. G3 since 2007 and is now set to recover on the back of a falling relative GBP risk premium.

New Zealand to enjoy cyclical gains: buy NZD TWI

- Go long TWI proxy defined as 48% AUD, 20% USD, 17% JPY and 15% EUR at index level 100, with stop at 97 and target at 107.
- Trade to benefit from rising global agricultural prices. We use $15mn notional for the basket in total.

New safe haven currencies to catch up: buy NOK/CHF

- Go long at 0.1630, with stop at 0.1600 and target at 0.1750. We use $10mn notional for the trade.
- NOK to benefit from demand for new safe-haven currencies with strong fiscal positions.

Exhibit 1. G10 FX Forecasts

		Q4 10		Q1 11		Q2 11		Q3 11		End 2011		Q1 12		Q2 12		Q3 12		End 2012	
	03-Dec	old	new	old	new	old	new	old	new	old	new	old	new	old	new	old	new	old	new
(DXY)	79.3		80.8		79.2		78.5		78.5		78.4		79.1		79.8		80.5		81.2
(USD/JPY)	82.8	82.5	82.5	80.0	80.0	82.5	82.5	85.0	85.0	85.0	85.0	85.0	86.3	85.0	87.5	85.0	88.8	85.0	90.0
(EUR/JPY)	111	111	107	108	106	114	111	117	115	115	115	115	115	115	116	115	116	115	117
(EUR)	1.34	1.35	1.30	1.35	1.32	1.38	1.34	1.38	1.35	1.35	1.35	1.35	1.34	1.35	1.33	1.35	1.31	1.35	1.30
(CHF)	0.98	1.04	1.03	1.04	1.05	1.03	1.06	1.04	1.06	1.07	1.07	1.07	1.07	1.07	1.08	1.07	1.09	1.07	1.09
(EUR/CHF)	1.31	1.40	1.34	1.40	1.38	1.42	1.42	1.43	1.43	1.44	1.44	1.44	1.44	1.44	1.43	1.44	1.43	1.44	1.42
(GBP)	1.57	1.63	1.57	1.67	1.63	1.73	1.68	1.75	1.71	1.73	1.73	1.73	1.73	1.73	1.72	1.73	1.72	1.73	1.71
(EUR/GBP)	0.85	0.83	0.83	0.81	0.81	0.80	0.80	0.79	0.79	0.78	0.78	0.78	0.78	0.78	0.77	0.78	0.77	0.78	0.76
(AUD)	0.99	0.98	0.96	1.00	0.96	1.00	0.98	1.00	1.00	1.00	1.02	1.00	1.02	1.00	1.02	1.00	1.02	1.00	1.02
(CAD)	1.01	0.97	0.99	0.99	0.97	0.99	0.97	0.99	0.99	1.00	0.99	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
(NZD)	0.76	0.78	0.75	0.80	0.77	0.81	0.80	0.82	0.82	0.82	0.84	0.82	0.84	0.82	0.84	0.82	0.84	0.82	0.84
(EUR/NOK)	8.01	7.90	7.90	7.80	7.80	7.70	7.60	7.70	7.60	7.70	7.70	7.70	7.70	7.70	7.70	7.70	7.70	7.70	7.70
(EUR/SEK)	9.13	9.00	9.00	8.90	8.90	9.00	8.80	9.00	8.90	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00

Source: Nomura.

G10 FX Outlook Summary

USD - Time for consolidation: *The Case for USD Consolidation in 2011*, p. 28 and *The USD Outlook: Thinking beyond the FOMC*, 2 November.

EUR – Persistent risk premium needed, p. 32, *EUR outlook: The pivotal role of Spain*, 28 November, *Where is the EUR risk premium heading?*, 24 November, *Measuring the risk premium on the euro*, 15 November.

JPY – Range of 80-85 for most of 2011: *JPY: Peak performance still to come*, p. 35, and *Nomura JPY Weekly*, 29 November.

GBP – Set for a 2011 comeback: The UK pound has been reflecting overly bearish sentiment on the UK's growth and fiscal prospects in our view. QE is neither necessary nor likely in the light of the positive momentum in domestic demand and labour activity. In addition, fiscal consolidation plans are likely to remain credible and reduced political risks from a stronger-than-expected coalition government should support the sterling in the year ahead (see *The Impact of fiscal austerity on FX – it's all relative*, 29 November). We are forecasting EUR/GBP at 0.78 and GBP/USD at 1.73 at end-2011.

AUD – Parity towards year-end: After a strong 2010, AUD is looking rich and with slowing momentum in growth we expect it to remain below parity in the first half of this year. However, with a central bank still in a modest hiking mode and growth likely to continue to be supported by Asian demand, we are looking for AUD to reach parity and above vs. the US dollar toward the end of the year (see *AUD: Sustainably overvalued?*, 21 October). Meanwhile, it should weaken against other high-beta peers, e.g. CAD and NZD.

CAD – Below parity throughout 2011: With a solid domestic recovery, strong terms of trade, and likely decreased drag from the US as economic growth picks up, the BOC should resume its tightening in Q1 2011. With relatively modest pricing of around 62bp until September, we believe there is room for more hikes to be priced in as we are looking for a total of 100bp of hiking in 2011. We revise our end-2011 to 0.99, from 1.00.

NZD – Strong relative value: We think that 2011 will see the end of NZD's underperformance vs. its peers, in particular AUD. As data continues to improve the RBNZ should resume its tightening cycle. Moreover, we believe there is upside in New Zealand's terms of trade as dairy products, having underperformed other commodities this year, may further benefit from increased global demand (see *NZD: Time to regain market focus*, 10 November).

CHF – Strength overdone: The Swiss franc should find reduced support from a central bank which is clearly not ready to hike yet. The strong franc should dampen exports and increase the deflation risk, preventing the SNB to start hiking before H2. In combination with reduced demand for safe-haven assets as the most severe market nervousness around the euro zone may abate, this should allow CHF to depreciate from its current expensive level.

NOK – End of underperformance: The Norwegian krone is set to be supported by a strengthening of the economic recovery, re-pricing of policy rate (as the Norges Bank resumes its tightening cycle), a strong oil price and a sound fiscal position. We expect NOK to catch up after underperformance in H2 2010 and we have revised our EUR/NOK forecasts lower to 7.60 and 7.70 for end-Q2 and end-Q4, respectively (see *Strategic Currency Views: NOK — End of underperformance*, 1 December).

SEK – Towards 6-year highs: The Swedish krona should be supported by very strong and broad-based growth, a hiking central bank and a strong fiscal situation. Having traded in an uptrend in the past two months, EUR/SEK has now broken the trend line, which should continue in 2011. We have revised our EUR/SEK forecasts lower to 8.80 and 9.00 for end-Q2 and end-Q4, respectively (see *Strategic Currency Views: SEK — Towards 6-year highs*, 14 October).

Outlook Article

USD: The case for USD consolidation in 2011

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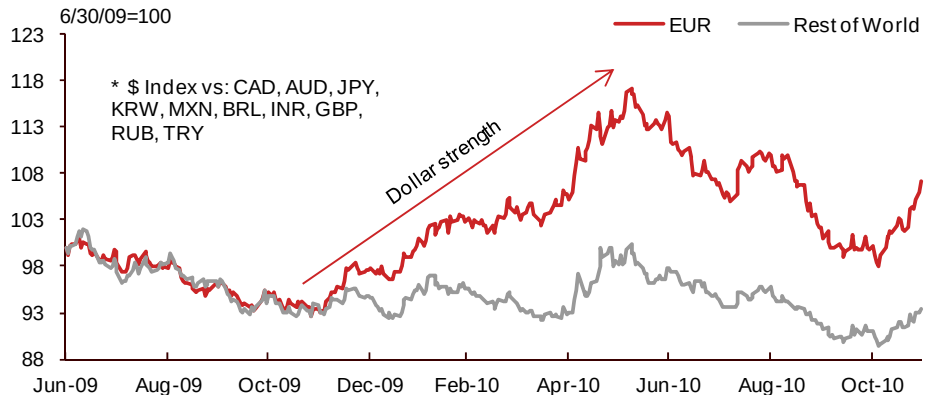
- *When thinking about strategic trades for 2011, strategists often look for a clear directional trend in the dollar. But many of the strong arguments for USD weakness versus majors are running out of steam in our view, and yet it is too early to position for a structural USD recovery. We think 2011 will more likely be a year of consolidation for the dollar versus other major currencies. USD versus EM is a different story, as we have elaborated in our EM FX Outlook.*

A recap of trends in 2010

Before turning to the outlook for 2011, it is useful to frame the discussion in the context of the trends from the year just gone. First, it is worth pointing out that a lot of the volatility in various USD indices, such as the DXY, was driven by the euro and not USD-specific dynamics. Exhibit 1 illustrates this basic point. Second, it is worth noting that the dollar did weaken significantly versus a number of currencies, including AUD, JPY and EM Asia broadly.

Exhibit 1. There is more than one US dollar



Source: Nomura.

The outlook for 2011

With regards to the USD outlook, a number of potential negatives seem to be fading:

First, the effect from QE2 has already been incorporated in market pricing. This is most visible in 10yr real rates, which shifted significantly lower during September and October, as the Fed prepared to announce QE2. But the big leap in equity prices during that period is also testament to the ability of the market to anticipate QE2. From here, we do not think the injection of $600bn of liquidity will have a material impact on the dollar, as it is already priced.

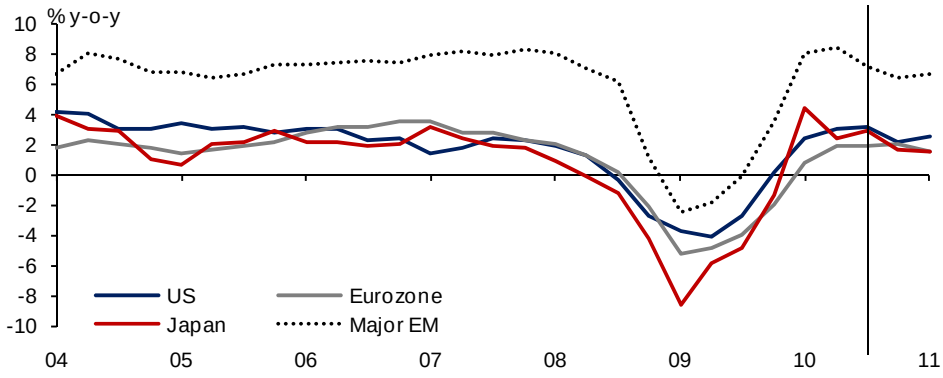
Second, will there be QE3? Given the Fed's dual mandate, the prospect of continued high unemployment could force the Fed to conduct additional balance sheet expansion once QE2 is completed. Surveys of strategists suggest the market is already pricing QE3 in some form. However, QE3 is not part of our central case for the following reasons:

1. Inflation expectations are currently close to the Fed's objective of 2%.
2. The Fed perceives costs related to QE to be different from normal monetary policy. This includes international currency tensions which result from conducting such policy.

3. Growth is set to increase (albeit marginally) during 2011, limiting the need for QE3.

While US growth is weak relative to what is normally expected at this stage of the recovery phase and versus EM as a whole, it is not particularly weak when compared with other G4 economies. For instance, US growth is set to average 2.2% in 2010 compared with 2.0% in the eurozone, and if we look ahead to next year, we expect the US to grow around 1pp faster than the eurozone. Thus, when looking at majors on a relative basis, we do not anticipate any clear US underperformance on this front.

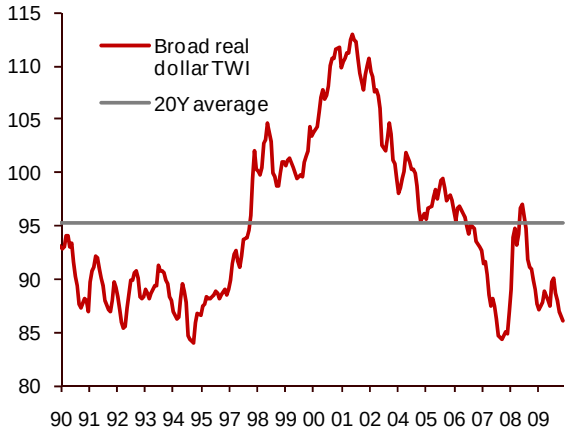
Exhibit 2. Real GDP growth



Source: Haver Analytics, Nomura.
Note: Nomura Global Economics forecast post Q3 2010.

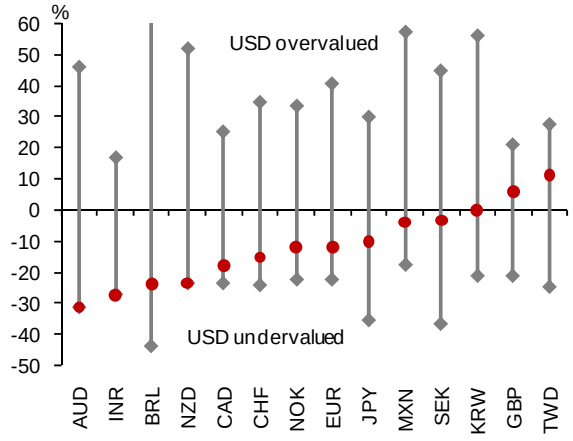
Third, the dollar has already weakened significantly versus major crosses, although the euro (and to a lesser extent, GBP) stands out as an exception. From a valuation perspective, the dollar TWI remains around 10% below its long-term average and is now close to a 20-year low (Exhibit 3).

Exhibit 3. Broad real dollar TWI vs. 20yr avg



Source: Federal Reserve, Nomura.

Exhibit 4. Real FX rates vs. 20yr avg (US perspective)



Source: Nomura. Note: Red dots are current valuation vs 20-year avg.; grey lines represent 20yr range in valuation.

The broad index reflects significant differences in various currencies. Looking simply at the bilateral real exchange rates versus history (Exhibit 5), USD is particularly cheap historically against AUD, INR, BRL, NZD and CAD, and moderately cheap versus EUR. But the dollar's real value versus GBP is higher than the 20yr average and close to the historical average for MXN, SEK and KRW. These metrics do not account for shifts in the terms of trade, which are important for AUD and CAD for example, but they give a broad sense of the level of the dollar currently relative to history in inflation-adjusted terms.

Fourth, the dollar is unlikely to weaken solely as a function of central bank diversification.

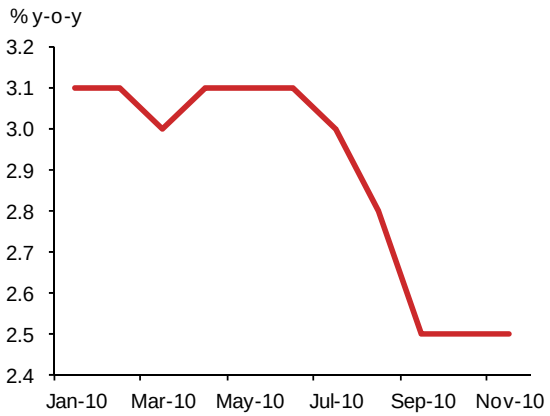
In the build-up to QE2, especially in September, there was an intense focus on the issue of reserve diversification away from USD. But major reserve holders tend to be slow moving, and we would be surprised to see an accelerated pace of diversification away from USD linked to the Fed's decision to engage in renewed quantitative easing. Our calculations show that Q3 was the strongest quarter for dollar reserve accumulation since Q1 2009, supporting the notion that central banks remain persistent buyers of USD.

The clearest new trend in relation to central bank reserve composition has been increased buying of 'other currencies', such as AUD and CAD. This flow has been in the region $100bn over the last year, but it is not clear whether this reflects diversification away from USD only, or whether it is a broader diversification trend, away from G3 currencies and towards new safe-haven currencies.

Exhibit 5. USD share in foreign exchange reserves

Source: IMF, Nomura.

Exhibit 6. Evolution of forecasts for US growth in 2011



Source: Blue Chip Survey.

Too early to position for structural growth recovery in the US

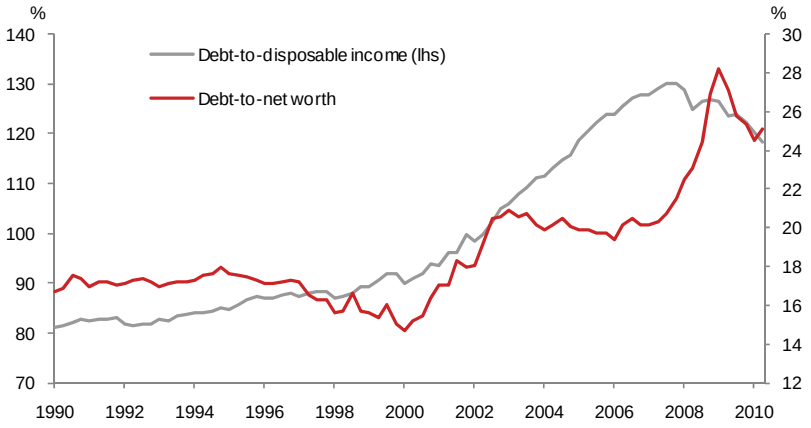
The US growth picture has stabilized in recent months, after a period over the summer when concerns about a double-dip were high (Exhibit 6). But there are still a number of headwinds for US growth, which makes it unlikely that we will see a significant upside surprise.

First, the housing market remains very weak, and is unlikely to see any meaningful recovery in 2011 given continued price declines (latest -1.5% y-o-y based on the Case-Shiller index) and the still very large overhang of excess supply (vacancy rate at 2.5%, compared with 1.5% average, and peak of 2.9%).

Second, fiscal policy is set to flip from a growth positive to a growth negative in 2011. Our economists estimate that the contribution to growth from the 2009 Recovery Act will be -0.3 percentage points in 2011, compared with +0.4 percentage points in 2010. And in terms of sequencing, the effect will be felt beginning in Q1 2011 and should be spread relatively evenly throughout the year. In general, the impact on growth from fiscal tightening may be ambiguous, especially in cases where the negative FX impact from weaker growth is offset by a positive impact from a declining fiscal risk premium. In the US's case, where there has arguably not been much of a fiscal risk premium, the negative impact from growth is likely to dominate.

Third, effects from deleveraging are likely to temper growth still. Households are likely to target persistently higher savings rates, given the drag from negative wealth effects in 2008 and the high level of debt.

Exhibit 7. US Household debt situation



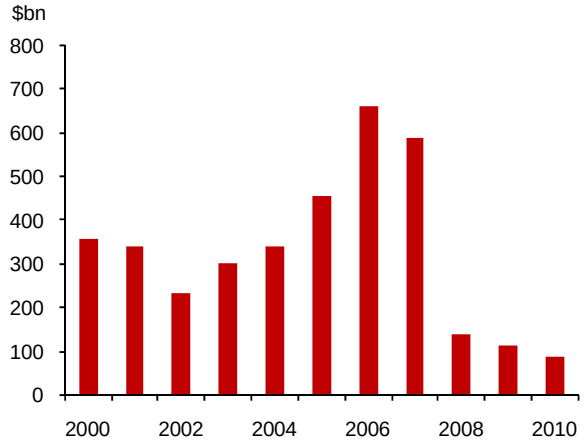
Source: Federal Reserve, Nomura.

Capital inflows still hampered by 'credit hangover'

On the capital flow side, we also see a continued hangover from the bursting of the credit bubble. As such, foreign demand for risky assets in the US remains low by historical standards. Inflows into US equity and corporate bonds are on track for a figure around $100bn in 2010, down from around $600bn in 2006-2007. Meanwhile, US demand for risky assets abroad remains reasonably strong.

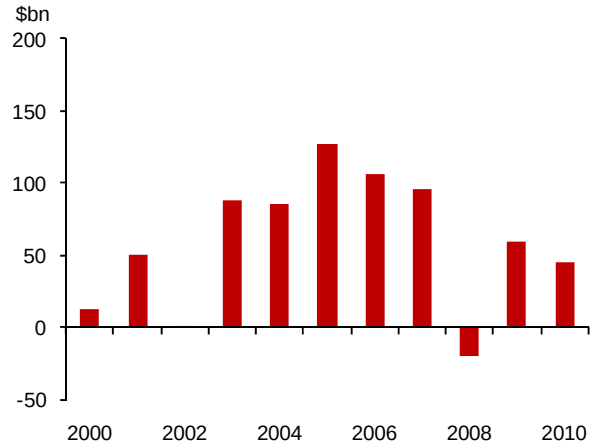
Similarly, on the M&A side, there is little evidence of any improvement in foreign appetite for US assets, reflected by weak foreign direct investment flows into the US. We also see little prospect of any HIA-type legislation (as occurred in 2005) being implemented in 2011.

Exhibit 8. Inflows into US corporate bonds and equities



Source: US Treasury, Nomura. Note: 2010 number is year-to-date annualized.

Exhibit 9. US outflows into foreign equity



Source: US Treasury, Nomura. Note: 2010 number is year-to-date annualized.

Risk aversion can generate temporary USD surges, but no permanent strength

The dollar remains closely correlated with global risk sentiment and we see no reason to believe this is about to change. In particular, given that the eurozone banking sector faces increasing systemic tension linked to the sovereign debt crisis, it is natural that the dollar remains the favoured safe-haven currency. But our core case for the eurozone is that sovereign risks will remain but not escalate significantly further, and that a full-blown banking crisis can be avoided. On this basis, we would view risk-induced spikes in USD as temporary. Moreover, we would not expect a sharp increase in USD strength as we saw in H2 2008 because similar special

dynamics in the USD money market are unlikely to be at play with the US banking system looking relatively safe.

Conclusion

US monetary policy is unlikely to deliver any major surprises vs. the majors until H2 2011 at least, and US growth is unlikely to surprise significantly to the downside. This is the key reason why we think the dollar is likely to consolidate versus other major currencies in 2011. We note that the dollar would weaken versus the euro in a scenario where the risk premium on the euro declines. But our central case is that such a compression in risk premia will be moderate (see *EUR: Persistent risk premium needed*).

We expect EUR/USD to trade in a 1.25-1.45 range, depending on the level of sovereign risk in the eurozone, and will most likely end the year at a level of 1.35. USD/JPY should gradually drift higher, as we expect the rate differential between the US and Japan to widen in 2011, finishing the year at 85. With a second round of QE by the Bank of England very unlikely, GBP is likely to gain some strength in 2011 and we expect its end of year level to be 1.73.

With higher growth than in developed economies, EM countries will be under pressure to let their currencies appreciate throughout the year. On the Asian currency side, the magnitude of the adjustment will likely be determined by China's willingness to let the renminbi appreciate against the dollar. Given most Asian central banks have linked their currency to the Chinese currency, the pace of RMB appreciation should be key for USD/Asia as a whole.

Given this outlook for the dollar, we recommend making a range trade on EUR/USD, in the form of a double-no-touch, to take advantage of the high implied volatility in the cross.

Box: Historical turning points for the dollar

Since the collapse of the Bretton Woods agreement in the early 1970s, the dollar has experienced two major periods of appreciation, the first one from 1978-85 and the second one starting in 1995 and ending in 2002. It is important to pinpoint the key elements in these historical turning points to draw lessons for the current environment.

During 1978-85, the dollar appreciated by more than 50% in real terms. The appreciation was driven by tight monetary policy in the US to fight inflation, higher growth in the US than in other major economics and increased risk aversion following balance-of-payment and debt issues in Latin America. During that period, the policy rate in the US was about 3 percentage points higher than in other major economies, while growth was faster by about 0.5 percentage points despite the sharp recession of the early 1980s. As a consequence of the strength of USD, the US current account went from roughly balanced to a deficit of about 2% of GDP in 1985 when USD started to depreciate (it reached a level of 3.2% of GDP in 1988 because of the lagged response to the change in the exchange rate). The dollar then started to depreciate rapidly, helped by the Plaza Accord and the coordinated FX intervention which followed. The dollar lost about 30% until 1989, and the current account deficit shrank to 0.6% of GDP in 1993.

During 1995-2002, the dollar appreciated by about 35%. The appreciation was mainly the result of stronger growth in the US than elsewhere, supported by strong productivity growth and the belief in the 'new economy'. During that period, the US economy managed to grow almost 1.5 percentage points faster than other major economies countries. This generated substantial portfolio and FDI inflows into the US. US policy rates were also almost 2 percentage points higher than in other major currencies. In addition, the Mexican, Russian and Asian crises over the period kept the level of risk aversion relatively high, further supporting USD, given its safe-haven status. Linked to the USD strength over that period, the current account balance deteriorated from a deficit of 1.5% of GDP to a deficit of 4%. This worsening was similar to previous episodes of USD appreciation.

The dollar has depreciated by about 25% since 2002. However, the current account has continued to deteriorate, reaching a trough around 6% of GDP in 2007, more than five years after the start of the depreciation. Based historical link between FX moves and the external position, the response looks unusually small or unusually slow. A part of the explanation is likely to be linked to the continued widening of the bilateral trade balance with China, especially when compared to the trade balance against other trading partners. In any case, the lack of significant adjustment in USD/CNY so far and the still wide overall trade imbalances suggest that the trade position has not yet improved sufficiently to support a structural USD recovery.

Moreover, we still see a number of structural drags on US growth, including from weak construction and the negative spill-over effects from deleveraging dynamics on consumption. This makes it hard to believe that the US is on the verge of a period of significant outperformance versus other major economies like we saw during 1978-85 and 1995-2002.

Exhibit 10. Broad USD effective exchange rate

Source: Nomura.

Exhibit 11. Relative performance US vs. G3 during USD phases

		1978-1985	1985-1988	1995-2002	2002-2009
Growth	US	3.1	3.7	3.4	1.6
	other major	2.6	3.6	2.0	0.9
Policy rate	US	11.1	7.3	5.3	2.2
	other major	8.0	6.3	3.2	1.8

Source: Nomura. Note: the other major aggregate is the average for Germany, Japan and the UK

Outlook Article

EUR: Persistent risk premium needed

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- *Sovereign tensions in the eurozone justify a persistent risk premium on the euro. That said, we do not expect sovereign defaults in 2011 or a break-up of the European Monetary Union.*
- *Spain is pivotal to eurozone risk premia and our core scenario is that it will take sufficient steps to ensure that its debt dynamics remain sustainable.*
- *We expect EUR/USD to trade in a 1.25-1.45 range over the next six months, and think DNT structures look attractive given elevated implied volatility.*

The last 12 months have seen a regime shift in terms of the euro's trading pattern. We had been used to a regime where fluctuations in the euro were to a large degree determined by shifts in expectations of the ECB's monetary policy stance relative to other central banks, especially the Fed. However, in 2010 the main source of volatility has come from swings in the risk premium on the euro, linked to tensions in eurozone sovereign bond markets.

Moving into 2011, we think swings in the euro risk premium will continue to be the main source of volatility. This is so both because of the great uncertainty over how tensions in the periphery will develop and because the impulse from the US is likely to be less pronounced than it was in H2 2010, when market pricing shifted significantly as a function of QE2.

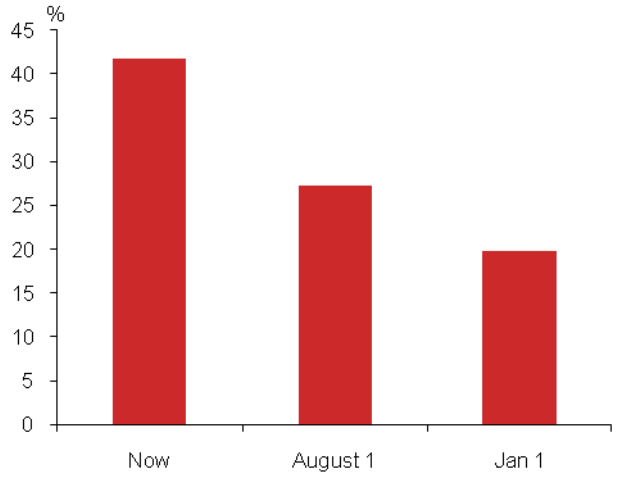
We estimate that this risk premium on the euro spiked to 12% at the end of November, implying EUR/USD would trade above 1.50 in the absence of such a premium. This compares to a risk premium of just 3% at the beginning of 2010, and essentially no risk premium ahead of the financial crisis in 2008.

Our core view is that a persistent risk premium is needed given sovereign tensions, and given the implications of such tensions for bank balance sheets and the risk of a break-up of the eurozone.

The pivotal role of Spain

From a medium-term perspective, we judge that the outlook for Spain will be pivotal to the future risk premium on the euro. Spain is crucial for a number of reasons. First, its economy is substantially bigger than those of Greece, Ireland and Portugal combined.

Exhibit 1. 10Y Implied probability of Spanish default



Source: Nomura.

Exhibit 2. EUR risk premium

Source: Nomura.

Second, a bailout of Spain would essentially require full use of all resources available from the EU, IMF and other sources, putting the back-stop infrastructure to the test. Third, potential losses involved in a restructuring of Spanish debt could trigger a eurozone-wide banking crisis. For these reasons, it is logical that the euro trades closely with sentiment around Spain, and it is likely to continue to do so.

Current 10yr CDS pricing is consistent with a cumulative default probability of 41% for Spain (Exhibit 1). If spreads widen further to 435bp, CDS would imply a default probability of around 60% (on standard assumptions for recovery rate). While there were very good reasons to view Greece's debt dynamics as unsustainable earlier this year, Spain's situation is not the same and not comparable to Ireland's either.

We base our conclusion on the following assumptions:

1. The 6% of GDP fiscal deficit target for 2011 will be approximately achieved;
2. Banking sector restructuring costs will not meaningfully exceed 8% of GDP;
3. Average growth in 2011-12 will not be worse than 0.5%.

Based on those assumptions, Spain's debt-to-GDP ratio will not significantly exceed 80% by end-2012 and can be stabilized at around 90% or below in subsequent years. There are risks to the key assumptions, especially to the growth assumption, given the need for fiscal tightening. But our central case would still be that these assumptions are more likely to play out than not. Given uncertainties involved and the pivotal nature of Spain, there will be a need for a permanent risk premium on the euro. This need is also linked to the fact that sovereign risks in the eurozone extend beyond Greece, Ireland, Portugal and Spain. We have not made any explicit quantification of the risks around Italy or other core eurozone countries at this point, but they are certainly not zero; this also needs to be taken into account when evaluating the appropriate risk premium on the euro.

The risk of a break-up of the eurozone in 2011-12 remains low in our view, but a persistent sovereign risk premium will be required throughout 2011 to compensate for this tail risk. The risk premium can only be expected to come down significantly once fiscal consolidation programs show meaningful progress, which we believe will only happen around mid-2011 at the earliest. In the meantime, the risk premium is likely to fluctuate in line with news about fiscal measures and performance, external support commitments, ratings news and banking sector tensions. Moreover, ECB policy will have an ambiguous impact on the euro; EUR could face offsetting forces from any tightening signals as they may be positive from a "macro" perspective but negative from a financial stability perspective.

All told, we would be surprised to see the risk premium on the euro drop below 7% (the low from August this year, and roughly consistent with EUR/USD at 1.42, all else being equal). At the same time, we can imagine temporary spikes in the risk premium to around 20% (the level consistent with Spanish spreads at 435bp and EUR/USD around 1.23, again all else being equal). This analysis leads us to think that a trading range of roughly 1.25-1.45 for EUR/USD is likely over the bulk of 2011, assuming no major shocks to other drivers of the cross (such as a significant improvement or deterioration in the US outlook).

Scenario analysis for spreads, risk premia and the euro

We consider three different scenarios for sovereign spreads:

1. Spain's spreads increase by 50bp, Portugal's spreads increase to the resulting Irish level.
2. Spain's spreads increase by 100bp, Portugal's spreads increase to the resulting Irish level.
3. Spain's spreads increase by 200bp, Portugal's spreads increase to the resulting Irish level.

In each scenario, we let other European spreads increase based on past correlations to increases in Portugal's and Spain's spreads. Exhibit 3 shows the changes in sovereign spreads in each of the scenarios, the resulting risk premium for the EUR and the projected level of EUR/USD.

Exhibit 3. Simulation results

	Levels in Spreads										Risk	Projected
	SP	AT	BE	Fin	FR	GR	Ire	IT	NL	PT	Premium	EUR/USD
Current	**235**	44	98	26	45	933	586	171	24	435	**10.8%**	**1.37**
Scenario #1	**285**	71	127	50	67	1143	643	209	50	643	**15.1%**	**1.33**
Scenario #2	**335**	88	147	67	79	1175	700	237	69	700	**17.7%**	**1.30**
Scenario #3	**435**	123	185	100	105	1241	815	292	109	815	**22.8%**	**1.23**

Source: Nomura.

The analysis shows that in the worst case, where Spanish spreads widen another 200bp from here, the risk premium on the euro increases to 22.8% and the euro trades at 1.23 against the US dollar (other things being equal). This compares with a EUR/USD level of 1.55 in the absence of any risk premium. Note that this scenario analysis does not take into account the impact from sovereign spreads on the real rate differential with the US (the more realistic scenario would be one where both eurozone and US real rates traded lower as a function of global risk aversion).

Trading strategy

The uncertainty about the outlook for financial stability in the eurozone remains elevated. This makes it extremely hard to have confidence in any precise point estimates for the euro going forward. But our core scenario for the euro is one where a persistent and significant risk premium will be needed to compensate investors for the uncertainty and potential downside risk involved.

Our point estimates are based on this assumption and the view that key eurozone countries, including Spain and Italy, will gradually regain better market access in H1 2011 by delivering on fiscal targets. This should see the risk premium moderate slightly and gradually from current elevated levels. Based on this assumption, we think EUR/USD will trade to 1.32 by end-Q1 and to 1.34 by end-Q2 2011, but the small moves from quarter to quarter are likely to mask bigger trading ranges overall.

Our core view is essentially a muddling-through scenario. On one hand, the meltdown case be avoided. On the other, no final resolution can be achieved given the fiscal challenges at hand and the complicated politics in the eurozone. In light of this, range trading strategies look attractive, especially given elevated implied volatility. Specifically, 6-month EUR/USD implied volatility is currently close to 15%, similar to the peak levels from May, and well above the 12-month average around 13%.

Separately, we also expect the euro risk premium to migrate into other EUR crosses. This issue is hard to track in terms of correlations to risk, as it is likely to happen in a slow-moving fashion independent of short-term correlation to risk. In any case, this could see EUR/SEK, EUR/NOK and EUR/GBP trade lower. Consequently, our year-end forecast calls for EUR/GBP at 0.76, EUR/NOK at 7.80, and EUR/SEK at 9.00.

Given this outlook for EUR, we recommend making a range trade on EUR/USD, in the form of a double-no-touch, to take advantage of the high implied volatility in the cross.

Outlook Article

JPY: Peak performance still to come

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- *We forecast US growth and US interest rates to edge gradually higher during 2011/12. This scenario is consistent with USD/JPY moving back to 85 by end-2011 and to 90 by end-2012.*
- *But there is likely to be considerable volatility around the trend and would not rule out the possibility of USD/JPY testing its all-time low (79.75) in early 2011.*
- *We expect USD/JPY to spend the majority of 2011 in the 80-85 range. But the JPY TWI may turn gradually weaker on the back of outperformance of EM currencies.*

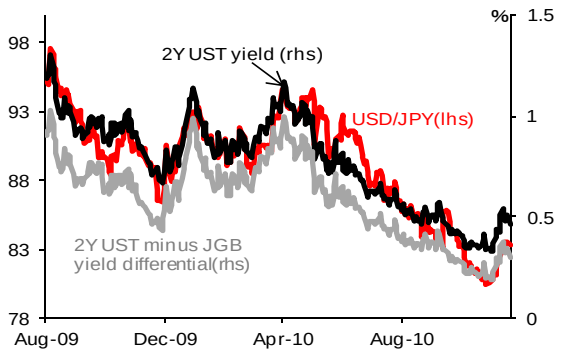
Direction of JPY determined by the US outlook

Our 2010 annual FX theme was *Beyond peak performance*, mainly in reference to a more complex outlook for risk currencies. In a typically cyclical pattern, risk markets lost some of the momentum they had built up during 2009 as the global economy started to recover. However, since USD/JPY tends to lag the business cycle, we expect JPY's peak performance against USD still to be ahead. Indeed, it is possible that USD/JPY may briefly break below its all-time low of 79.75 next year, and we expect the cross to spend most of the year trading in an 80-85 range.

In 2011, we expect USD/JPY to continue to be determined largely by the outlook for the US economy and US interest rates rather than by Japanese factors. We have identified US 2yr interest rates as one of the best indicators of what is likely to happen to USD/JPY (Exhibit 1). Since Japanese interest rates have much less room to move than US rates, US rates on their own have proved a good indicator of the direction of USD/JPY without having to refer to the US-Japanese interest rate spread. Also, while the focus of market participants has recently been on the Fed's quantitative easing (QE) program, medium-to-long-term US interest rates still have room to move and have tended to lead USD/JPY.

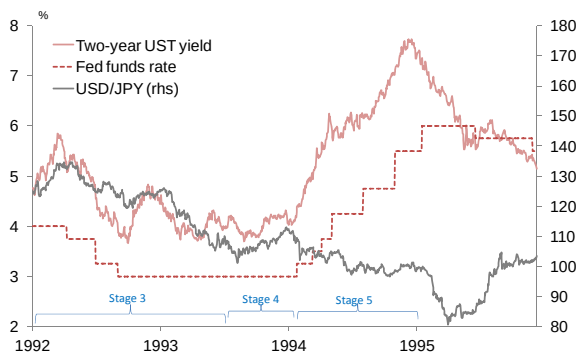
Past cyclical patterns suggest to us that the close correlation between US 2yr interest rates and USD/JPY may continue until just before the Fed begins its next tightening cycle. If, as our economists expect, US economic sentiment and risk markets continue to improve (albeit slowly) in 2011-12, USD/JPY is also likely to rally to the extent that forex market participants expect US interest rates to rise. However, we need to bear in mind that any economic recovery in the US is likely to stall from time to time and that the Fed therefore has little choice but to resort to QE.

Exhibit 1. USD/JPY and 2yr UST and JGB yields



Source: Nomura, Bloomberg.

Exhibit 2. US interest rates and USD/JPY cycle: 1992-95



Source: Nomura, Bloomberg.

Even if US long-term interest rates hit a cyclical bottom, the policy duration effect of the Fed's QE program suggests to us that 2yr interest rates are likely to remain low and that USD/JPY is therefore likely to trade in a range of 80-85. This is not to say that the forex market cannot keep testing USD bearish scenarios every few months during this period and that USD/JPY cannot briefly go as low as the high-70s. However, we do not expect US interest rates to signal a low of more than about 80 and see USD/JPY stabilizing in the 80s once market participants regain their confidence. Forex intervention should also help.

JPY peak performance is still to come

JPY's all-time high against USD is 79.75, which it reached in April 1995. Our view is that, even if JPY records a new high against USD in 2011 before pulling back to the 80s, we are unlikely to see this as the peak of JPY's current cycle. For one thing, USD/JPY is at a different stage of its cycle now than it was in 1995. JPY's rise against USD in 1990-95 formed a typical cyclical pattern. We think a comparison of JPY's rise then with its recent performance offers some interesting pointers to the outlook for USD/JPY in 2011-12.

USD/JPY tends to follow the following cyclical pattern: first, it tends to decline as the economy slows, interest rates decline and stock markets fall (Stage 1); second, it may briefly rally at the start of a risk rally that occurs before the economy bottoms (Stage 2); third, it tends to weaken as US interest rates form a bottom (Stage 3); fourth, it often firms as market participants raise their interest rate expectations as the economic recovery and risk rally continue (Stage 4); and, finally, it tends to reach a cyclical low when stock and bond prices fall soon after the Fed begins a tightening campaign (Stage 5). However, it tends to be eventually supported by higher US interest rates after the Fed has raised its policy rate several times.

In Exhibit 2, 1992-H1 1993 corresponds to Stage 3; H2 1993 to Stage 4; and 1994 to Stage 5. In 1995, USD/JPY broke below 100 after having declined for five years. This coincided with the final round of US-Japanese trade talks and the Mexican economic crisis, with increasingly nervous Japanese investors rushing to either repatriate their investments or to hedge them by selling USD. In a sense this was an unnecessary panic at the final stage of a cyclical USD low/JPY high. While this was going on, the US-Japanese interest rate spread widened sufficiently to later support a rally by USD/JPY.

Our economists do not expect the Fed to begin its tightening campaign in the current cycle before 2013. In other words, JPY's recent rise only corresponds to Stage 3 (1992 and H1 1993) of Exhibit 2. We therefore think that the USD/JPY rally we expect in 2011 is likely to be subdued and driven by expectations of higher US interest rates. We think it would be premature to see that as corresponding to Stage 4 (H2 1993 just before the Fed started rate hikes) and that there is a long way to go before USD/JPY enters an uptrend driven by the US business and interest rate cycles (after stage 5).

JPY vs. USD vs. risk currencies

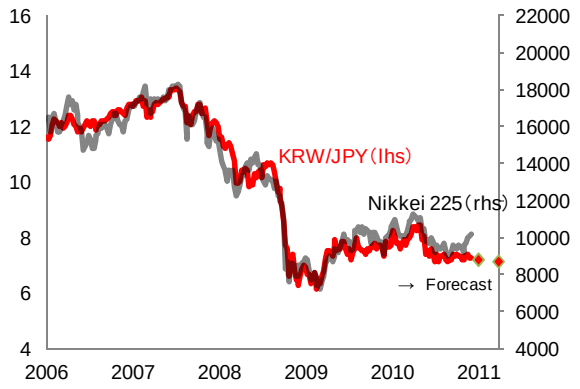
In 2011 we expect USD/JPY to fluctuate in line with US interest rate expectations, as it did in 1992-93. However, we expect JPY and risk currencies (i.e., those of emerging and commodity-producing economies) to frequently move in opposite directions vis-à-vis USD. As the market discounts a US economic recovery and higher US interest rates, USD carry trades aimed at achieving higher returns on the increased supply of USD created by QE could boost risk currencies. In such a situation, JPY would probably decline on the expectations of higher US interest rates, giving the following pecking order: risk currencies > USD > JPY.

If, as was the case in September-October this year – when, the outlook for the US economy was highly uncertain; there was speculation that US interest rates would

decline, but the global economy was not expected to collapse; and emerging and commodity-producing economies were expected to continue to grow strongly – the order would be: risk currencies > JPY > USD. If the outlook for the US economy were to deteriorate and that for emerging and commodity-producing economies was to become more uncertain, risk currencies could decline as long positions are unwound. In contrast, JPY would rise as expectations of lower US interest rates were discounted. In other words, the order for a scenario in which the outlook not just for the US but also for the global economy deteriorated would be: JPY > USD > risk currencies.

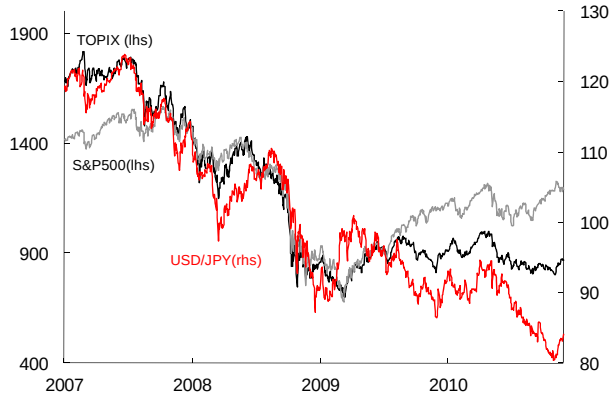
If the outlook for the US were to improve, risk currencies would rise while JPY (as a safe-haven currency) would probably decline. For example, if KRW, a typical risk currency, were to rise while JPY declined, this would be positive for Japanese equities by encouraging a rebalance of flows (Exhibit 3). Japanese equities underperformed in 2009-10 under a strong JPY (Exhibit 4). However, Japanese equities participated in the risk rally that began in the spring of 2009. As a result, their poor performance has been in relative rather than absolute terms. An improvement in US economic sentiment might produce a virtuous cycle by taking some of the momentum out of JPY's uptrend, helping Japanese equities regain lost ground, and encouraging more outward Japanese investment, thereby taking more momentum out of JPY's uptrend.

Exhibit 3. KRW/JPY and Japanese equities



Source: Nomura, Bloomberg.

Exhibit 4. USD/JPY and US/Japanese equities



Source: Nomura, Bloomberg.

Bottom line

Our economists expect US GDP growth in 2011 to stabilize around 2.5% and US interest rates to edge higher, with the long end leading. In line with this, our official forecasts for USD/JPY at the end of each quarter in 2011 are 80, 82.5, 85 and 85, respectively. We then expect USD/JPY to steadily head towards 90, which it should reach at the end of 2012. While USD/JPY is likely to gravitate higher, we do not think that it has entered a strong cyclical uptrend. Our basic view, given the fragility of the economic recovery in the US, is that perceptions of the outlook for the US economy are likely to fluctuate between bullishness and bearishness every few months. Hence, there could be considerable volatility around the underlying slight uptrend.

We expect USD/JPY to rise only marginally in 2011, in part because the interest rate differential between the US and Japan is expected to remain historically low through 2011. In contrast, the economic and interest rate cycles of many EM and commodity-producing economies (i.e., those with risk currencies) have been leading those of the US. In 2011, we expect more Japanese institutional investors to increase their interest in the commodity-exporting and EM (mainly Asian) currencies. Even if USD/JPY does not materially reverse course, we think the effective JPY rate could start to weaken more meaningfully.

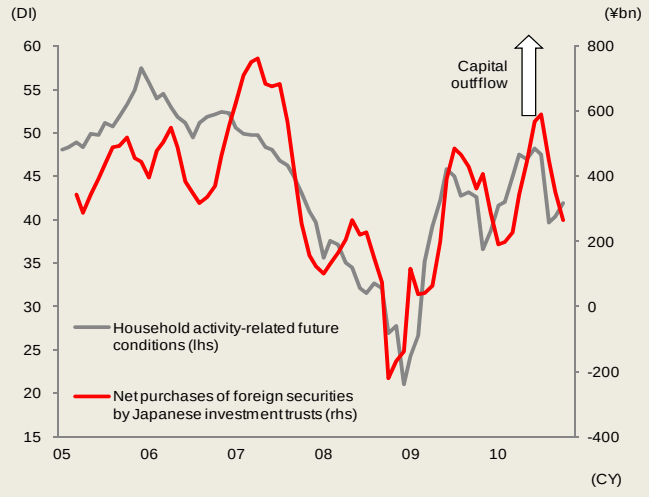
Box 1 - Outward investment flows from Japan in 2011

We look at investment flows from Japan as pointers to the outlook for JPY cross rates in 2011. In particular, we consider retail investment, outward portfolio investment by life insurers and direct investment by companies. Our conclusions for all three are that: (1) outward investment remains weak as the outlook for the economy remains uncertain, (2) outflows will gradually pick up since the economy will not experience a double–dip; and (3) that commodity-producing and EM economies are likely to attract the most investment.

Outward portfolio investment via investment trusts to moderate JPY appreciation

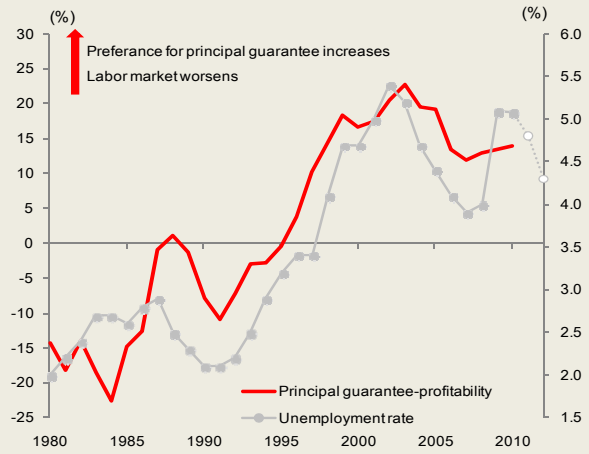
In May 2010, when the consensus view of the outlook for the global economy was still bullish, Japanese investors purchased a net ¥799.2bn of overseas securities via investment trusts, the largest amount for any month since February 2007. Net purchases then declined to ¥148.8bn in October. Outward portfolio investment via investment trusts tends to vary according to retail investor risk aversion. As we can see from the decline in the Economy Watchers Survey's forecast DI of household activity, the deterioration in consumer confidence since mid-2010 appears to have caused the slowdown in investment that began soon afterwards (Exhibit 1). The fact that the unemployment rate has remained persistently high at around 5% also suggests to us that household risk tolerance is low (Exhibit 2).

Exhibit 1. Economy Watchers Survey and outward portfolio investment via investment trusts



Source: MOF, Cabinet Office.
Note: (1) The forecast DI of household activity has been seasonally adjusted by Nomura; (2) Data on outward portfolio investment via investment trusts are three-month trailing averages.

Exhibit 2. Unemployment rate and retail investor risk appetite



Source: Central Council for Financial Services Information, MIAC and Bloomberg.

We expect growth to have been negative in Q4 2010. As a result, our economic research team expects the unemployment rate to remain at around 5% through H1 2011. Given this, retail risk tolerance is unlikely to increase and we would not expect outward retail portfolio investment to pick up until mid-2011, at the earliest.

That said, we expect the global economy to avoid a double-dip recession and that net outward investment by retail investors is unlikely to turn negative. Exhibit 3 shows the results of a sensitivity analysis that estimates outward portfolio investment via investment trusts, using the unemployment rate and Japanese long-term interest rates as predictors. We estimate that, with an unemployment rate of 4.6% and a 10yr JGB yield of 1.55% at end-2011, retail investors are likely to purchase a net ¥4.4trn of overseas securities a year. Our findings indicate that the rate of investment is likely to be slightly higher than in H2 2010 but not as high as in H1 2010. We think it fair to say that while outward portfolio investment via investment trusts in 2011 is unlikely to lead JPY lower, it should moderate JPY appreciation.

Japanese retail investors have a preference for high-yielding and commodity currencies such as AUD and BRL rather than USD or EUR, for example. Between end-2009 and October 2010 the proportion of USD assets in foreign currency investment trusts remained roughly unchanged (32.8% → 33.7%), while that of EUR fell (19.9% → 13.1%); those of AUD and BRL increased (14.0% → 17.2% and 6.4% → 10.2%, respectively). The Nomura Individual Investor Survey also shows a preference for AUD, while BRL is also more popular than other major currencies. We expect the moderating effect of retail investment on JPY appreciation to be particularly noticeable in cross rates such as these.

Exhibit 3. Sensitivity analysis of outward investment via investment trusts (2011)

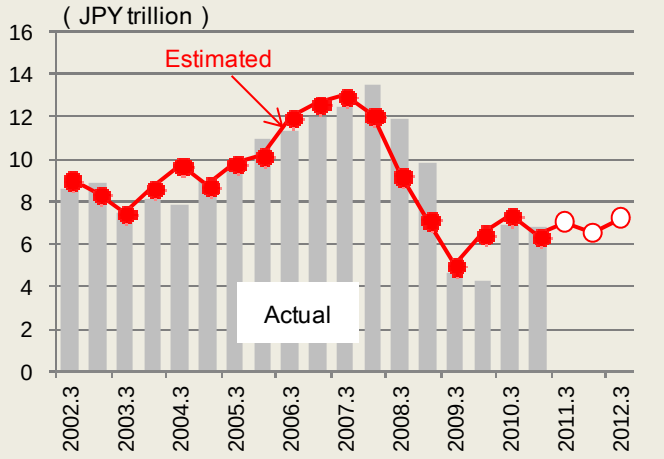
(JPY trillion / year)		Unemployment rate										
		5.30	5.20	5.10	5.00	4.90	4.80	4.70	4.60	4.50	4.40	4.30
JGB 10y yields	1.8	3.1	3.2	3.4	3.5	3.6	3.8	3.9	4.1	4.2	4.4	4.5
	1.7	3.2	3.3	3.5	3.6	3.8	3.9	4.1	4.2	4.3	4.5	4.6
	1.6	3.3	3.5	3.6	3.7	3.9	4.0	4.2	4.3	4.5	4.6	4.8
	1.5	3.4	3.6	3.7	3.9	4.0	4.2	4.3	4.5	4.6	4.7	4.9
	1.4	3.6	3.7	3.8	4.0	4.1	4.3	4.4	4.6	4.7	4.9	5.0
	1.3	3.7	3.8	4.0	4.1	4.3	4.4	4.6	4.7	4.8	5.0	5.1
	1.2	3.8	3.9	4.1	4.2	4.4	4.5	4.7	4.8	5.0	5.1	5.3
	1.1	3.9	4.1	4.2	4.4	4.5	4.7	4.8	4.9	5.1	5.2	5.4
	1.0	4.1	4.2	4.3	4.5	4.6	4.8	4.9	5.1	5.2	5.4	5.5
	0.9	4.2	4.3	4.5	4.6	4.8	4.9	5.0	5.2	5.3	5.5	5.6
	0.8	4.3	4.4	4.6	4.7	4.9	5.0	5.2	5.3	5.5	5.6	5.7
	0.7	4.4	4.6	4.7	4.9	5.0	5.1	5.3	5.4	5.6	5.7	5.9
	0.6	4.5	4.7	4.8	5.0	5.1	5.3	5.4	5.6	5.7	5.9	6.0

Source: MOF, Cabinet Office
Note: (1) The analysis uses the unemployment rate, the yield on 10-year JGBs, theTED spread and the CRB Index. (2) The TED spread and the CRB Index are assumedto remain at the same level after October 2010. (3) Combinations producing a larger figure than the average for H1 2010 (¥4.8trn annualized) or a lower figure than theaverage for H2 2010 (Jul-Oct, ¥3.7trn annualized) are shaded. (4) The unemployment rate (4.6%) and 10-year JGB yield (1.55%) are Nomura year-end forecasts.

Life insurers may turn their attention to high-yielding currencies

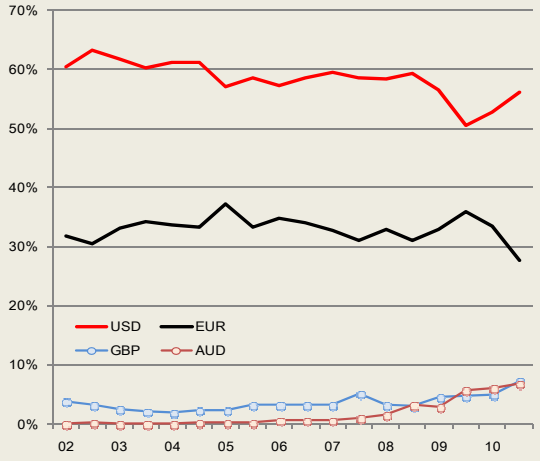
We now turn to the life insurers. The nine largest life insurers' currency hedge ratio declined substantially until end-March 2010. However, it was slightly higher again by end-September. We think that many raised their hedge ratios partly because of factors such as mounting selling pressure on USD in expectation of QE2 and

Exhibit 4. Unhedged foreign currency assets of nine biggest Japanese life insurers (actual and estimates)



Source: Company materials, Life Insurance Association of Japan, and Bloomberg.
Note: (1) Analysis uses net asset ratio, US-Japanese 10-year government bond yield spread, and deviation from USD/JPY on a purchasing power parity basis. (2) The TOPIX, the US-Japanese yield spread, and USD/JPY are assumed to move in line with Nomura's forecasts.

Exhibit 5. Currency breakdown of nine biggest life insurers' foreign currency assets (major currencies)



Source: Company materials.

concern about the fiscal and political problems of peripheral eurozone economies. Their investment plans for H2 2010 revealed that they were looking for better returns by investing in overseas bonds than they could obtain in Japan and were using combinations of hedged and unhedged positions. However, with little prospect of interest rate spreads with Europe and the US widening in the near future, we cannot envisage a situation where JPY suddenly depreciates as a result of massive currency dehedging.

Using our simulation model and our forecasts on financial variables, we estimate that life insurers' unhedged foreign currency assets are likely to remain at about the same level (¥6-7trn) in 2011 as at end-September 2010 (Exhibit 4). We think that for the foreseeable future their hedge ratios may remain high and fluctuate within a narrow range. Increased rehedging could limit the potential for a rebound by USD/JPY if JPY weakens without a rise in US interest rates.

A breakdown by currency reveals that, with interest rates in Europe and the US still low, life insurers, like retail investors, have been increasing their exposure to currencies such as AUD and GBP (Exhibit 5). In the past, life insurers have tended not to invest in currencies, such as AUD, that are less liquid than USD and EUR. However, with little prospect of an interest rate increase from the Fed, we think they have little option but to

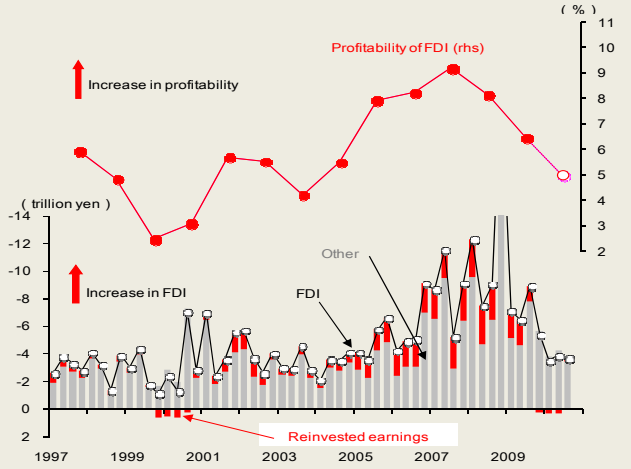
invest in higher-yielding currencies in order to obtain their desired returns. Due to the high cost of hedging AUD positions, AUD hedge ratios have tended to be low and the impact on exchange rates may be much greater than investment in USD and EUR. With interest rates in the eurozone and the US likely to remain low for some time, we think that investments by life insurers in high-yielding currencies such as AUD could cause JPY to weaken against such currencies.

Direct investment linked to capital investment cycle

We do not expect to see much of a pick-up in direct investment by Japanese companies, either, in the near future. While some observers take the view that direct investment is likely to pick up as a result of JPY appreciation thus far (because it gives Japanese companies the opportunity to acquire overseas companies on favourable terms or because it may force them to move overseas), it has actually failed to do so. We think this is because Japanese direct investment tends to correlate closely with the capital investment cycle and because Japanese companies are concerned about the economic outlook. Another likely reason why direct investment has failed to pick up is that returns on direct investment remain low, reflecting weakness of the economic recovery, especially in industrialized economies (Exhibit 6). We therefore think that Japanese direct investment is unlikely to pick up until Japanese companies are much more confident about the economic outlook at home and abroad.

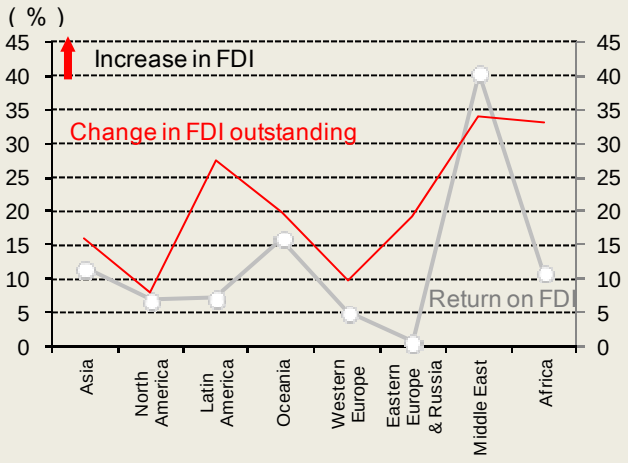
As our economic research team does not expect a double-dip recession in either Japan or the rest of the world, we cannot rule out the possibility that direct investment may pick up again in H2 2011-2012. However, even if that proves to be the case, any direct investment is more likely to be made in EM than in industrialized economies, in our opinion. A comparison of returns on direct investment in the main regions of the world between 2005 and 2009 reveals that, while direct investment in regions such as Asia and Oceania generated double-digit average returns and a large increase in cumulative investment, returns in North America and Western Europe were relatively low (Exhibit 7). According to data from the Cabinet Office, two of the main

Exhibit 6. Japanese FDI and its returns



Source: BOJ

Exhibit 7. Japanese FDI and its returns (by region)



Source: BOJ
Note: Averages for the past five years (2005–2009).

reasons why Japanese companies set up operations overseas are that "demand [is] strong or expected to increase" and "low labour costs". Like Japanese retail investors and life insurers, Japanese companies are casting their net wider than Europe and the US. Therefore, even if FDI begins to pick up, any resulting JPY depreciation is more likely to be against currencies such as AUD and other EM currencies than against USD or EUR.

Outward investment flows point to turning JPY in crosses

We conclude the following: (1) Japanese outward investment is likely to remain fairly subdued in the aggregate, as the outlook for the economy remains uncertain. (2) Capital outflows from Japan should pick up gradually, together with economic sentiment (assuming the global economy does not experience a double-dip). (3) Capital is more likely to flow into commodity-producing and EM economies than Europe and the US. As a result, the JPY is likely to depreciate in crosses and on an effective basis. We will need to monitor the activities of each investor category to assess more precisely when this is likely to happen.

Outlook Article

JPY: Will yen strength self-correct?

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- *USD/JPY has remained below 90 for six months. Many investors take the view that this has done great damage to corporate earnings, growth and trade performance, setting the scene for a period of JPY weakness.*
- *However, we see three facts which contradict this view. First, USD/JPY is not excessively low in real terms; second, the impact of JPY appreciation on corporate earnings and Japanese equity investment flows has not been that great; and, third, the impact on non-speculative demand flows via Japan's balance of trade and Japanese foreign direct investment is likely to be moderate in 2011.*
- *We believe is is unlikely that yen strength will materially self-correct and we believe USD/JPY is likely to continue to trade below 90 in 2011.*

USD/JPY has spent its longest time below 90

USD/JPY has already spent almost six months below 90, longer than the 4.5 months that it spent below 90 from mid-March to early August back in 1995. Against this background, many non-resident investors take the view that the longer USD/JPY spends below 90, the more damage it will do to Japanese corporate earnings, growth and trade performance; and the more likely the yen is to form a base for a rebound in the future.

We concede that each time USD/JPY has broken below a key psychological level (namely, 90, 85 and 80), Japanese companies have held up their hands in horror and forecast their own demise, but the following three facts tell a rather different story. First, USD/JPY is not excessively low in real terms; second, the impact of JPY appreciation on corporate earnings and Japanese equity investment flows has not been that great; and, third, the impact on non-speculative demand flows via Japan's balance of trade and Japanese foreign direct investment (FDI) is likely to be fairly moderate, based on the historical experience.

In real terms, USD/JPY is at a reasonable level

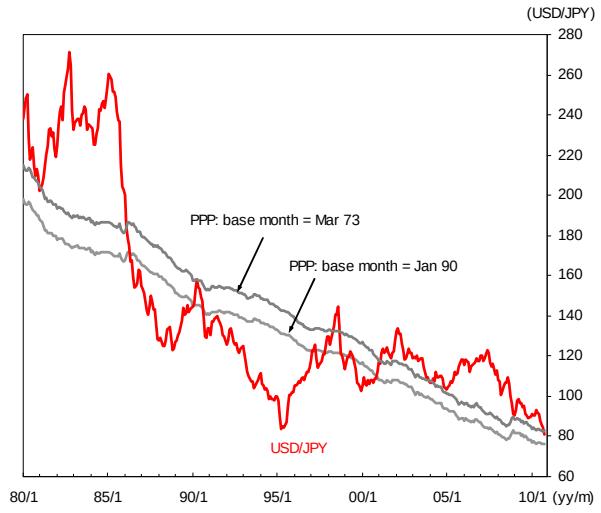
On 1 November, USD/JPY declined at one point to 80.22, just short of the all-time low of 79.75 recorded on 19 April 1995. However, inflation data for the US and Japan for the past 15 years show a differential of 3.5 percentage points (pp) per annum in terms of producer prices and 2.5pp in terms of consumer prices. As a result, USD/JPY on a purchasing power parity (PPP) basis would be valued in a range of 76-83 (Exhibit 1). Similarly, the real effective JPY rate calculated by the BOJ is currently only about 5% above its 10-year moving average (Exhibit 2). This shows that even if USD/JPY were trading at 80, the JPY would not be abnormally overvalued in real (i.e. inflation-adjusted) terms.

This raises the question of why Japanese companies have been complaining that JPY appreciation has been causing them great difficulty. One possible answer is a decline in the competitiveness of Japanese companies, something that cannot be measured simply by real exchange rates. For example, competition with Korean automobile and electrical machinery manufacturers may have become increasingly fierce since the 1990s. While the total value of (USD-denominated) Japanese exports has increased only 60% since 1995, that of Korean exports has expanded some 200% (Exhibit 3). The very fact that major Japanese exporters compete with

Korean companies in many fields probably means that their concerns about the impact of JPY appreciation are likely to make headlines.

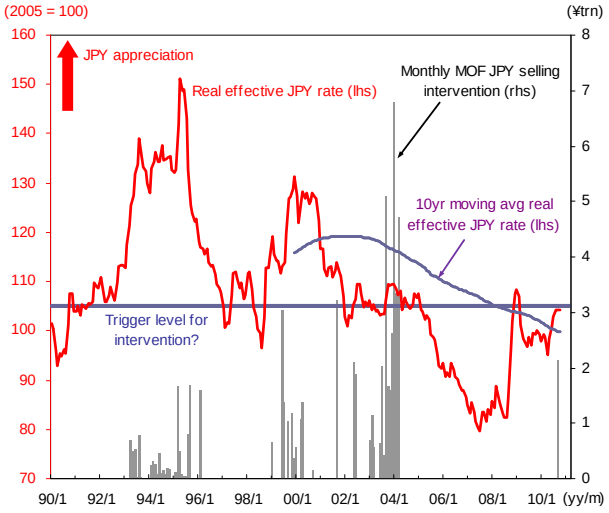
Another factor is that companies base their exchange rate assumptions and export plans on past exchange rates. We think that this is likely to make life difficult for them and make them very sensitive to the negative effects if a currency continues to move in one direction over an extended period, as JPY has done recently. As a Cabinet Office survey of exporters' breakeven rates shows, Japanese companies have tended to adapt to periods of JPY strength fairly quickly. However, USD/JPY continued to trade below breakeven levels in 1993-95 and has done so again (since 2009) (Exhibit 4).

Exhibit 1. USD/JPY on a PPP basis



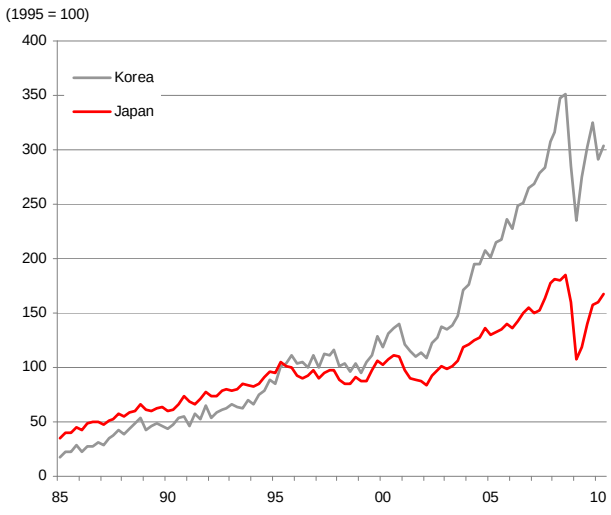
Note: Calculated using US and Japanese domestic final goods price indices (producer prices for US and corporate goods prices for Japan)
Source: Nomura, based on Datastream data.

Exhibit 2. Real effective JPY exchange rate and MOF intervention to sell JPY



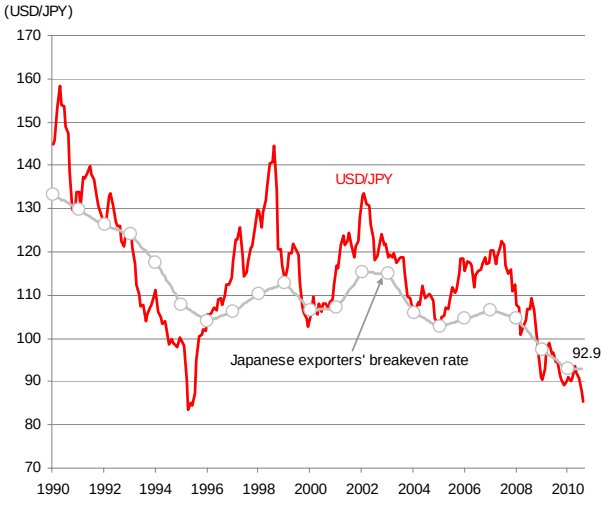
Source: Nomura, based on MOF and BOJ data.

Exhibit 3. Trends in total export values of Japan and Korea



Source: Nomura, based on Datastream data.
Note: Calculated using US and Japanese domestic final goods price indices (producer prices for US and corporate goods prices for Japan).

Exhibit 4. USD/JPY and Japanese exporters' breakeven rate



Source: Nomura, based on MOF and BOJ data.

Do not overestimate the impact on corporate earnings

Corporate earnings in Japan are clearly negatively impacted by yen strength. But one should not overestimate the impact of JPY appreciation on corporate earnings. Data collated by Nomura equity strategists indicate that a 10% appreciation by JPY against USD reduces Japanese companies' current profits by only 4.6%, while a similar appreciation against EUR reduces them by 2.3%, giving a total impact of 6.9% even if JPY appreciates across the board (Exhibit 5). These figures are more or less consistent with the TOPIX's beta versus JPY of 0.6 (Exhibit 6).

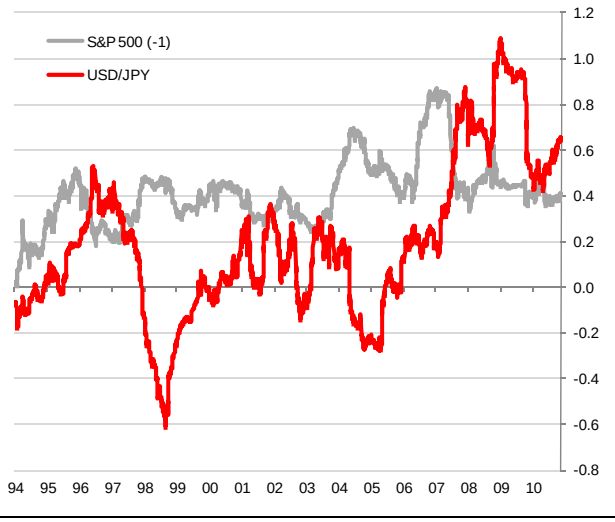
Exhibit 5. Impact of JPY appreciation on Japanese corporate profits

(% impact on current profits)

	10% appreciation of JPY against		
	USD	EUR	USD + EUR
NOMURA 400	-4.6	-2.3	-6.9
NOMURA 400 (ex financials)	-5.1	-2.6	-7.7
Manufacturing	-7.6	-3.7	-11.3
Basic materials	-1.2	-0.3	-1.5
Processing	-12.8	-6.2	-19.0
Nonmanufacturing	-1.2	-0.8	-2.0
Nonmanufacturing (ex financials)	-1.3	-0.9	-2.2
Materials	-1.2	-0.3	-1.5
Machinery & autos	-17.1	-4.3	-21.4
Electronics	-7.5	-8.4	-16.0
Consumption & distribution	-1.4	-0.6	-2.0
Information	-2.3	-2.8	-5.1
Utilities & infrastructure	-0.6	-0.1	-0.7
Financials	-1.0	-0.5	-1.5

Source: Nomura, based on Datastream data.
Note: Calculated using Nomura data on impact per ¥1 of JPY appreciation.

Exhibit 6. TOPIX beta vs. USD/JPY and S&P500



Source: Nomura.
Note: Betas calculated using daily data on rolling 260-trading-day basis

What would be the impact on investment flows if JPY appreciation caused a major correction in Japanese equities? Using data for the most recent 52 weeks for which data are available, we calculate that a 1% decline in the TOPIX would generate JPY57bn of Japanese equity sales by non-resident investors (Exhibit 7). Therefore, if a 10% appreciation by JPY causes a 6% decline in Japanese equities, non-resident investors could be expected to sell about JPY340bn worth of Japanese equities. Furthermore, this figure would include sales by hedge funds, which normally hedge exchange rate risk, so the selling pressure on JPY would be less.

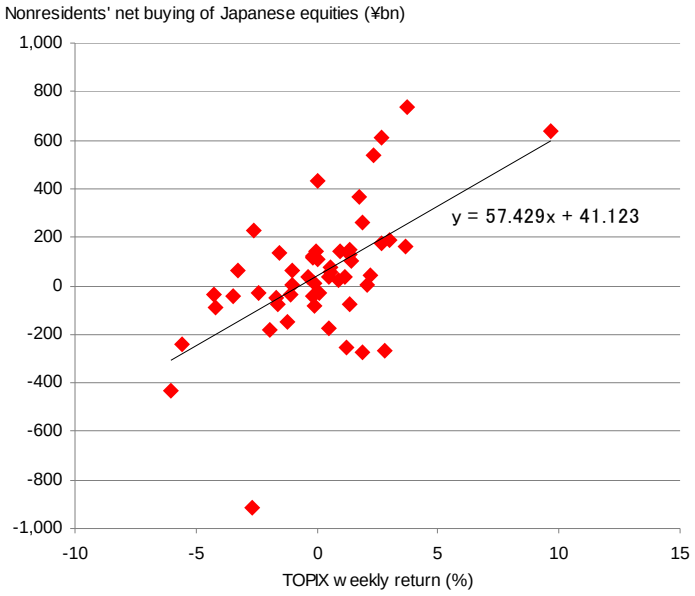
Impact on trade balance should also be moderate; what happened after failure of Lehman Brothers was exceptional

Next we consider the impact of JPY appreciation on flows generated by Japan's balance of trade. Using the Cabinet Office's macroeconomic model, we estimate that a 10% appreciation by JPY would reduce Japan's current account balance as a percentage of GDP by 0.18pp in the first year and by 0.06pp in the second year. The cumulative impact would be 0.24pp, or JPY1.2trn (Exhibit 8). While the cumulative figure is not to be taken lightly, the monthly impact would only be JPY50bn.

In this context it is perhaps worth considering the impact on USD/JPY of the sharp fall in Japan's current account balance that followed the collapse of Lehman Brothers. The cumulative year-on-year impact (from October 2008 to September 2009) on Japan's current account balance as a percentage of GDP was 1.8pp, equivalent to an average monthly decline of JPY750bn (Exhibit 9). We think that this sudden change in Japan's balance of trade probably was partly responsible for JPY depreciation in February 2009, when USD/JPY rose from 89.9 to 97.6. At the time, a sharp fall in Japanese companies' actual and expected exports led them to cover an unnecessarily large amount of forward USD sales, while a sharp deterioration in the financial situation led

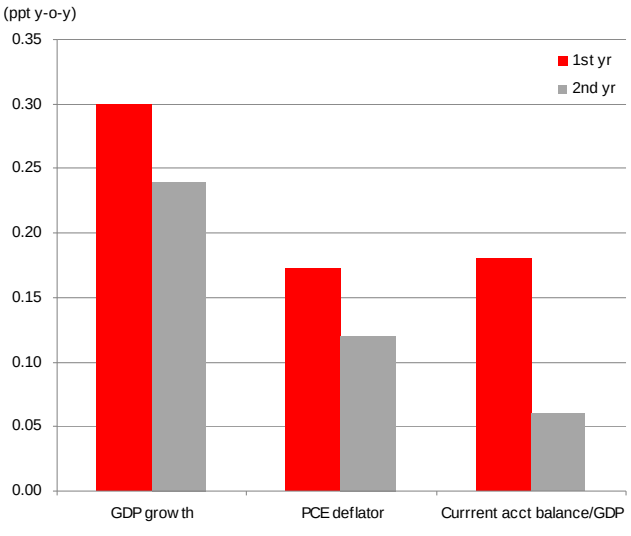
currency speculators to unwind their long JPY positions. However, the steep decline in Japan's trade surplus was partly the result of a decidedly financial phenomenon, namely a shortage of trade credit in the rest of Asia. We think that a sudden drop in non-speculative USD sales on such a scale cannot be explained purely by JPY appreciation.

Exhibit 7. Japanese equity performance and non-residents' investment in Japanese equities



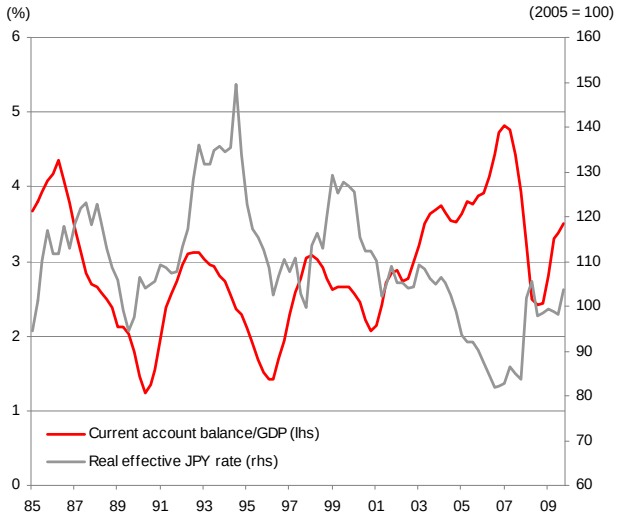
Source: Nomura, based on Bloomberg data.
Note: Calculated using data for 52 weeks through 19 November 2010

Exhibit 8. Estimated impact on Japanese economy of 10% JPY appreciation against USD



Source: Nomura, based on Cabinet Office data.
Note: Based on simple averages of Cabinet Office model multipliers for 2005, 2006, and 2008.

Exhibit 9. Effective JPY rate and Japan's current account balance as percentage of GDP



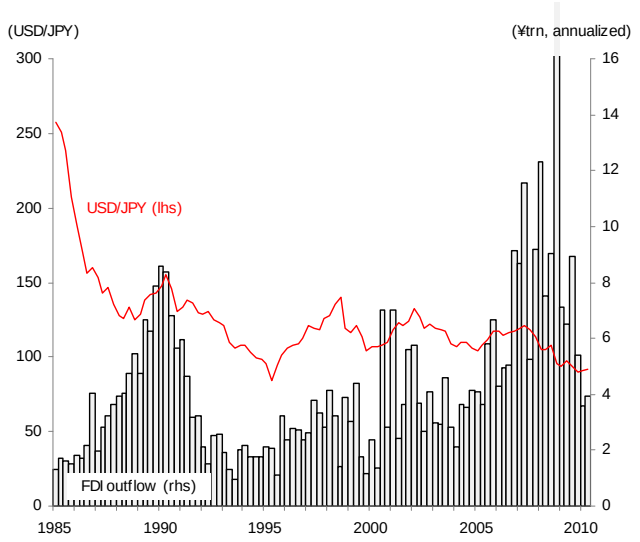
Source: Nomura, based on Bloomberg data.

FDI trends are affected by the business cycle more than by exchange rates

Finally, we consider whether JPY's prolonged appreciation is likely to lead to an increase in outward FDI (i.e., JPY sales). According to a METI survey of Japanese companies on the impact of JPY appreciation (conducted at the end of August), 40% of Japanese manufacturers would transfer production and R&D overseas if USD/JPY continued to trade at 85. However, we need to allow for the possibility that some companies may have an incentive to overstate the impact of JPY appreciation when replying to such surveys.

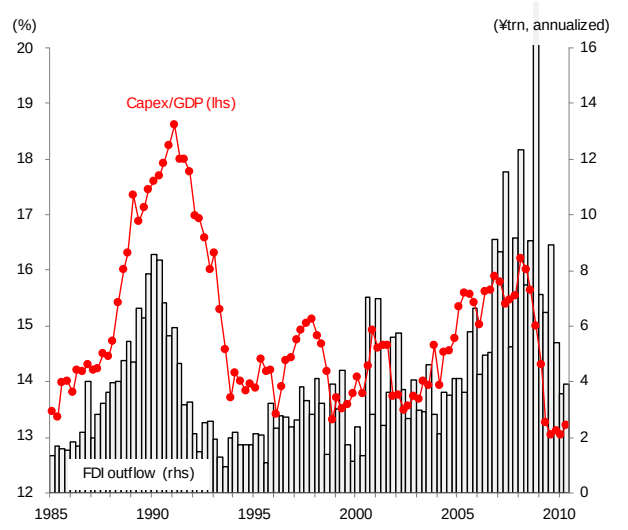
We certainly have been unable to find any evidence from data on Japanese outward FDI that JPY appreciation has ever led to an increase in FDI (Exhibit 10). In fact, we find an inverse correlation – that FDI tends to increase after a phase of JPY depreciation. We believe that this may be explained by the correlation between FDI and domestic capital investment. What we find is that domestic capital investment as a percentage of GDP has a similar cycle to FDI and that what matters is whether companies want to expand their operations, be it in Japan or overseas (Exhibit 11). In other words, if JPY appreciation hits corporate earnings, companies are likely to be less willing to invest, even in expanding their overseas operations. We therefore think that a FDI boom involving Japanese companies is unlikely to occur until the US economy has recovered materially.

Exhibit 10. USD/JPY and outward FDI



Source: Nomura, based on Datastream data.

Exhibit 11. Outward FDI and the capital investment cycle



Source: Nomura, based on Datastrem data.

Conclusion

We conclude that the impact of a prolonged period of JPY strength (with USD/JPY trading close to 80) is unlikely to lead to strong self-correcting dynamics though its impact on corporate earnings, trade performance and FDI & portfolio flows. In our view, USD/JPY is likely to remain below 90 in 2011.

Outlook Article

Asia FX: Capital flows, growth ebbs

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Asia FX trades for 2011

- **Short 3M USD/CNY (entry 6.6720, notional $15mn, S/L 2%, expiry 1 March 2011)[42].** Our 1Q11 USD/CNY forecast is 6.50. The fundamental supports for CNY appreciation include a strengthening trade surplus, rising capital inflows, FX liberalisation, strong growth (Nomura: 9.8% GDP in 2011) and 17% currency undervaluation. The near-term political calendar (January's Sino-US meeting and December's local political events) should sustain pressure on China to allow CNY appreciation. Risks to our view are slower growth (including global growth risks) and CNY legislation.
- **Long 3M KRW against USD (entry 1165, notional US$15mn, S/L 1188, expiry 25 Feb 2011)[43].** North Korean provocation has raised the risk of retaliation in the future, but we believe the most recent event is unlikely to have a lasting market impact. Other risks include capital controls and an intensification of EU financial sector pressures. Locally, there is some evidence of authorities allowing for gradual KRW appreciation (official comments, FX reserve and FX forward data, and sterilisation operations) and additional support comes from a strong current account surplus, normalisation of monetary conditions through FX strength, reserve diversification into Korea assets, and 7% currency undervaluation. We forecast 1080 by 1Q11.
- **Long 3M SGD and MYR against TWD (SGD/TWD 22.99 and MYR/TWD 9.5030, notional US$7.5mn each, S/L 3%, positive carry of 3.0% annualised, entry 6 December 2010, expiry 9 March 2011).** TWD has outperformed both MYR and SGD (1 Jul to 30 Nov 2010) against the USD and on a NEER basis. We see a higher risk of more capital controls in Taiwan against a lower risk in Malaysia and Singapore. Scope for FX flexibility in Taiwan may be fading, while we expect the relatively aggressive MAS FX policy tightening to be maintained through the duration of this trade (S$NEER at +2.7% on the policy band, 6 Dec 2010, 1600 SGT). Malaysia's bias towards FX liberalisation and support for MYR strength are also intact.
- **Short 2Y USD/HKD (7.7205, notional $20mn, S/L 1.5%, entry 6 December 2010, expiry 10 December 2012).** Our baseline view is no change to the USD/HKD currency board and peg at 7.80 in 2011, but the risks are rising and this position should benefit from tests of 7.750. Our entry is only 38bp below the strong side 7.750 convertibility undertaking rate.
- **Portfolio hedges: 2M USD/KRW seagull – buy USD call/KRW put spread 1160/1215 and sell USD put/KRW call 1090 (premium 46.25bp, 1138.8 NDF ref, notional US$15mn, entry 6 December 2010, expiry 8 February 2011).** Hedging against Korean and non-core EU risk.
- **Buy a 3M USD call/IDR put spread (1x1.5, strikes at 9100 and 9450, 45.75bp premium, 9050 NDF ref, notional US$10mn, entry 6 December 2010, expiry 9 March 2011).** Aside from the risk of a deterioration in the global risk backdrop, IDR is likely to underperform in the region given capital controls and continued FX intervention because of changing perceptions of authorities on the benefits of IDR appreciation and heavy foreign positioning. However, as highlighted in our sterilisation analysis, there is increasing risk beyond 2Q11 of a significant change in BI's FX stance and USD/IDR could fall sharply.

42) See *Asia FX Insights – Beijing Visit Notes, 29 November 2010*.

Key themes for 2011

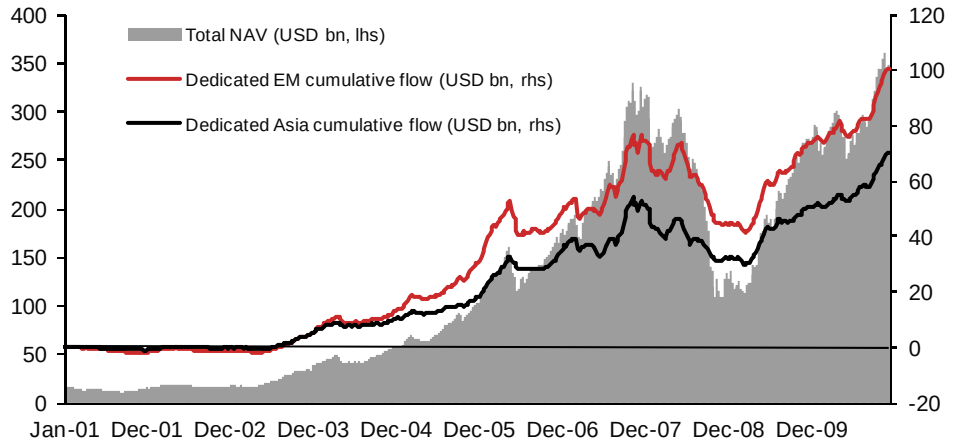
We identify the following key themes driving Asia FX into 2011:

1. **Capital inflows into EM and particularly Asia;**
2. **Asian central banks implementing more capital controls;**
3. **The impact of capital controls and the risks of an FX policy shift towards allowing appreciation;**
4. **CNY appreciation; and**
5. **Relative Asia growth outperformance, but risks of growth slowing.**

1) Capital inflows into EM and particularly Asia

We expect strong capital inflows into Asia to continue in 2011. Since the US FOMC embarked on its first round of quantitative easing (end-Nov 2008), EPFR fund data from 1-Dec-08 to 22-Nov-10 show that the cumulative inflows into dedicated emerging market (EM) equity mutual funds rose sharply by US$57bn (to US$101bn last). This compares with the previous cumulative peak of US$73.5bn (in May 2008) before the US financial crisis. In particular, flows into Asia accounted for 68%, or US$38.6bn, of all dedicated regional EM flow from 1-Dec-08 to 22-Nov-10 (Exhibit 1). The improved sentiment in Asia is also reflected in a strengthening portfolio investment surplus to US$372bn in the 12 months to June 2010 (latest data including China), versus a portfolio investment deficit of US$136bn in the previous 12 months to June 2009. Although the size of inflows raises some concern over foreign positioning, our positioning metrics from foreign equity holdings as % of market cap and foreign ownership of bonds as % of total outstanding show that positioning in the region does not appear over-stretched. It is only Indonesia bond/SBI holdings and India equities where foreign positioning is reaching new record levels (see Appendix A).

Exhibit 1. Cumulative flows into all EM equity funds – 1 Jan 01 to 22 Nov 10



Source: EPFR, Nomura.

43) See *Asian Strategy Snapshot – Korea: FX and interest rate implications of North Korean provocation, 23 November 2010.*

Into 2011, we see Asia continuing to attract large capital inflows because of:

a) **Relative growth outperformance of Asia in the world;**

b) **Prolonged low US rates versus relatively high yield and tightening of monetary conditions in Asia;**

c) **Most favourable EM FX valuations;**

d) **Seasonality in asset allocation.**

1a) Relative growth outperformance of Asia in the world

In an environment where there is a search for growth, we expect Asia to be one of the main beneficiaries. Nomura Economics forecasts strong Asia (including China) GDP growth of 8.1% in 2011 (from 9.1% in 2010), especially when this compares with 4.3% and 3.8% in Latam and EEMEA, respectively, over the same period. Even Asia ex-China is forecast to outperform in EM at 6.2% in 2011 – Exhibit 2. This growth outperformance is also evident when compared with our G3 GDP growth forecast of 2.1% in 2011.

Exhibit 2. EM GDP growth comparison

Real GDP (% over a year ago)	2009 Actual	2010 Forecast	2011 Forecast	2012 Forecast	2010 Cons	2011 Cons	2012 Cons
Asia	**5.8**	**9.1**	**8.1**	**8.3**	**8.8**	**7.8**	**N.A.**
China	8.7	10.2	9.8	9.5	10.0	9.0	N.A.
Hong Kong	-2.8	6.5	4.7	5.3	6.0	4.5	4.8
India	6.7	8.8	8.0	8.6	8.7	8.6	N.A.
Indonesia	4.5	5.9	6.5	7.0	6.1	6.3	6.3
Malaysia	-1.7	7.0	5.2	5.5	5.9	4.7	N.A.
Philippines	0.9	7.0	5.4	5.7	6.0	4.5	5.0
Singapore	-1.3	15.5	5.3	5.8	10.2	4.6	N.A.
South Korea	0.2	5.9	3.5	5.0	6.1	4.2	5.0
Taiwan	-1.9	9.9	4.9	5.3	7.1	4.1	N.A.
Thailand	-2.3	7.7	4.8	5.2	6.8	4.5	N.A.
EEMEA	**-3.5**	**3.8**	**3.8**	**3.5**			
Czech Republic	-4.5	2.3	1.4	2.6			
Hungary	-6.3	1.0	1.5	2.0			
Israel	0.3	3.3	4.0	4.0			
Poland	1.7	3.8	4.5	4.6			
Romania	-7.0	-2.0	1.5	2.5			
Russia	-7.9	3.8	3.5	3.3			
South Africa	-1.8	2.8	3.3	3.8			
Turkey	-4.7	7.2	5.4	4.3			
Ukraine	-14.0	4.7	4.8	5.0			
LATAM	**-1.6**	**6.6**	**4.3**	**4.4**			
Argentina	1.9	9.0	5.0	4.7			
Brazil	-0.2	7.4	4.0	4.9			
Chile	2.1	5.5	6.5	5.0			
Columbia	2.5	4.8	5.0	4.5			
Mexico	-6.5	5.3	4.0	3.4			

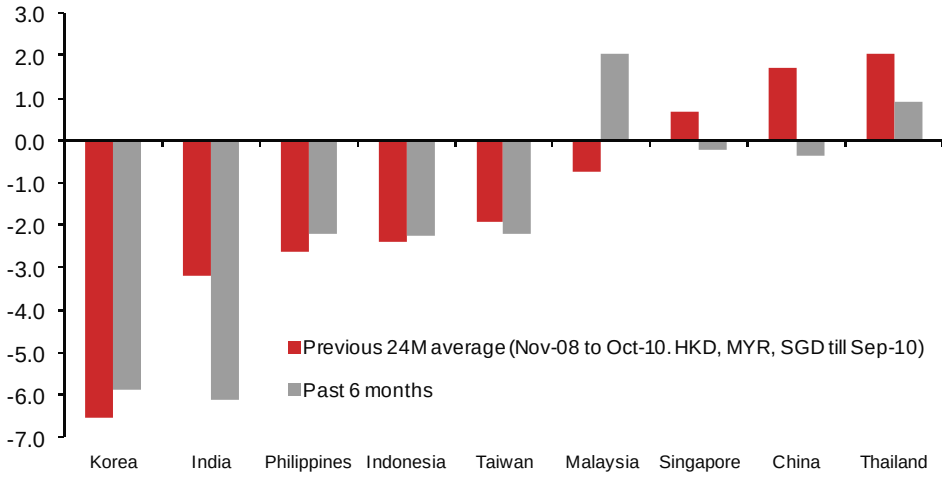
Source: Bloomberg, Nomura.
Note: Bloomberg consensus as of 2-Dec-2010.

1b) Prolonged low US rates versus relatively high yield and tightening of monetary conditions in Asia

Aside from growth, if there is a search for yield and where monetary conditions are being normalised through both FX and rates, we believe Asia stands to benefit, especially compared with the US where monetary policy risks remaining loose for longer (after further QE from the Fed in November 2010). Asian central banks are broadly in the process of normalising monetary conditions and we believe this will continue into 2011 through both local FX appreciation and possibly through rate hikes (most recently by the People's Bank of China, the Bank of Korea, and the

Bank of Thailand). This is based on our view that monetary conditions are still broadly loose, especially in India and Korea – Exhibit 3.

Exhibit 3. Asian monetary conditions to tighten



Source: Bloomberg, BIS, CEIC, Nomura.
Note: Rates to FX Ratio – CNY(4:1), INR(6:1), IDR(5:1), KRW(3.5:1), MYR(2:1), PHP(4:1), SGD(3:1), TWD(3:1), THB(3:1).

1c) Most favourable EM FX valuations

Asia also holds the most attractive FX valuations in EM with an average undervaluation of 10.7% according to the average of our FEER and SEER models. This compares with the latest average overvaluation of 0.6% in Latam (BRL is 11.3% overvalued) and undervaluation of 7.6% in EEMEA. The most undervalued currencies in Asia are TWD, CNY and SGD at 24.2%, 16.7% and 14.7%, respectively – Exhibits 4a and 4b.

Exhibit 4a. Favourable Asia FX valuations

	Raw Model Output			Filtered result		
	FEER	SEER	Average	FEER	SEER	Average
ASIA						**-10.7**
India	-5.7	-3.1	-4.4	-1.5	1.0	**-0.2**
Indonesia	-8.5	-4.2	-6.4	-3.4	0.8	**-1.3**
Hong Kong	-3.8	-4.2	-4.0	-5.4	-5.8	**-5.6**
Korea	-10.2	-14.4	-12.3	-5.1	-9.1	**-7.1**
Malaysia	-5.3	-24.7	-15.0	-1.2	-19.7	**-10.4**
Thailand	-14.6	-12.8	-13.7	-12.8	-11.0	**-11.9**
Philippines	-17.4	-9.3	-13.3	-18.7	-10.5	**-14.6**
Singapore	-25.5	-9.5	-17.5	-22.5	-6.9	**-14.7**
China	-11.7	-20.9	-16.3	-12.1	-21.3	**-16.7**
Taiwan	-59.9	10.1	-24.9	-59.0	10.6	**-24.2**
LATAM						**0.6**
Brazil	0.2	14.4	7.3	4.5	18.1	**11.3**
Colombia	-13.2	2.5	-5.3	-6.9	8.0	**0.6**
Mexico	-3.4	0.0	-1.7	-2.0	1.4	**-0.3**
Argentina	-8.4	1.1	-3.7	-8.2	1.4	**-3.4**
Chile	-6.3	-2.7	-4.5	-6.9	-3.3	**-5.1**

Source: Bloomberg, CEIC, Nomura.

Exhibit 4b. FX valuations for EMEA and CIS

	Raw Model Output			Filtered result		
	FEER	SEER	Average	FEER	SEER	Average
EEMEA						**-7.6**
South Africa	4.9	18.8	11.9	12.3	25.2	**18.7**
Turkey	15.0	11.8	13.4	16.5	13.4	**14.9**
Czech	0.1	3.5	1.8	-1.6	1.9	**0.1**
Poland	-5.8	-2.9	-4.3	-5.6	-2.7	**-4.2**
Romania	-9.1	8.9	-0.1	-14.0	4.7	**-4.7**
Egypt	-16.3	1.3	-7.5	-16.2	1.4	**-7.4**
Hungary	-1.7	-14.0	-7.8	-4.1	-16.7	**-10.4**
Israel	-18.3	-14.3	-16.3	-17.3	-13.4	**-15.4**
Estonia	-7.3	-21.9	-14.6	-11.7	-26.8	**-19.3**
Latvia	-17.1	-17.3	-17.2	-24.4	-24.5	**-24.5**
Kazakhstan	-41.3	21.5	-9.9	-42.1	21.0	**-10.5**
Ukraine	-4.0	-18.3	-11.2	-5.7	-20.2	**-12.9**
Russia	-37.0	-6.4	-21.7	-39.2	-8.1	**-23.7**

Source: Bloomberg, CEIC, Nomura.

1d) Seasonality in asset allocation

In thinking about FX performance in the year ahead, we also note that there has historically been strong seasonal support for most Asian FX in December and January, which may be a function of asset allocation by both real money accounts and the speculative community. In December, seasonality is strongest for Singapore and the Philippines, while in January, it is strongest in Korea, Thailand

and Taiwan. This is reflected in our seasonality analysis (see Appendix B) from 1999 through to 2007, which excludes the US financial crisis years – Exhibit 5. Given the sell-off in riskier assets over the past month, we believe there is some scope for a positive December and January effect.

Exhibit 5. Strong seasonal support for Asian FX in December and January

Annualised Information Ratio (1999-2007)							
Month	SGD	TWD	THB	KRW	IDR	PHP	INR
January	-0.6	2.1	2.4	2.6	-0.7	1.9	1.2
Feburary	-0.9	-0.6	-0.9	-1.1	-0.5	-0.1	-1.7
March	-1.0	-0.6	-0.9	-1.1	-0.8	0.4	1.5
April	1.0	0.6	0.3	2.7	0.1	0.5	0.3
May	-0.3	-0.4	-0.6	1.1	-0.1	-0.3	-1.6
June	-0.9	-0.3	-0.1	0.6	0.5	-2.8	-0.3
July	3.2	-2.6	-1.3	-0.6	0.5	-1.1	-0.5
August	1.2	-0.8	0.5	0.4	-0.3	-0.4	-1.5
September	-0.2	-0.9	-1.3	-0.2	-1.6	-0.5	1.1
October	0.7	-0.6	1.0	0.4	0.3	-0.6	0.5
November	1.3	1.1	1.3	0.5	-1.0	1.0	-0.6
December	3.5	0.8	2.2	-0.1	0.8	2.5	2.4

Source: Bloomberg, Nomura.
Note: Positive number means local FX has appreciated against USD. Annualised information ratios larger than 2.0 or smaller than -2.0 are highlighted.

2) Asian central banks implementing more capital controls

Rising capital inflows into Asia are likely to lead to more capital control measures from central banks given:

a) **Relatively fast FX appreciation since mid-2010, concerns over FX volatility and asset allocation;**

b) **Increased noise from local industries and a slowing external sector; and**

c) **Fed's QE2 and risk of a currency war.**

2a) Relatively fast FX appreciation since mid-2010, concerns over FX volatility and asset allocation

With a rapid average 4.3% strengthening of Asia FX against the USD in the region from 1 July to 1 December 2010, the appreciation supported from capital inflows has raised concerns over speculative capital and the risk of increased FX volatility. Indonesia and Taiwan have been most verbal in the region, with Taiwan regularly highlighting foreign investors holding onto TWD cash rather than investing into real underlying assets. Indonesia also continues to attempt to redirect foreign capital inflows from SBIs (central bank bills) into longer duration government debt. We expect a step up in controls especially given the experience of the 1997-98 Asia financial crisis, which was triggered by a sudden exodus of capital. That said, the likelihood of a financial crisis in Asia is now significantly lower as reflected in the relatively low banking sector leverage and high levels of FX reserve ratios – Exhibit 6.

Exhibit 6. Less leveraged and less vulnerable now than before the Asia crisis (July 1997)

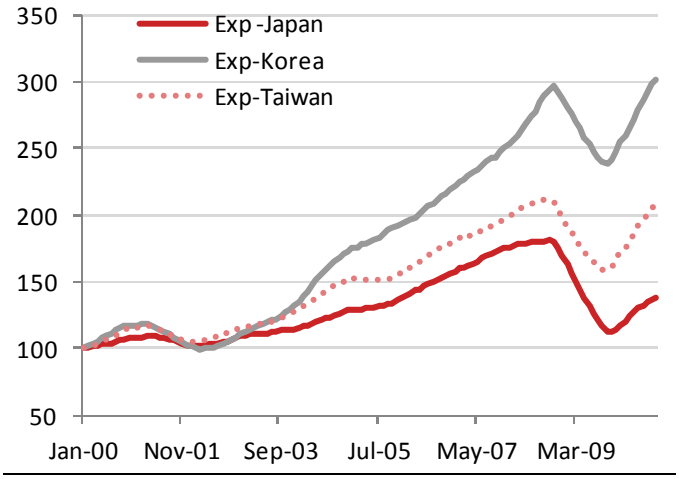
	Loan to Deposit Ratio		FX Reserve to ST Ext Debt		FX Reserve to Import	
	Asia Financial Crisis (onset Jul-97)	Latest	Jul-97	Latest	Jul-97	Latest
China	90.2%	66.0%	7.4*	7.4	9.9	20.7
India	55.70%	73.4%	3.3**	4.5	7.3	9.5
Indonesia	107.6%	76.9%	0.6#	3.2	6.2*	7.2
Korea	108.2%	115.3%	0.4	1.9	2.7	8.0
Malaysia	89.2%	81.3%	2.7*	4.1	4.6*	7.2
Philippines	97.2%	57.1%	1.2	9.1	3.1	11.2
Taiwan	109.2%	80.1%	n.a.	5.2	8.7	18.1
Thailand	134.5%	114.8%	0.6#	4.2	5.8	11.1

Source: CEIC, World Economic Outlook, Central banks & monetary authorities of respective countries, academic papers and books on Asian financial crisis.
Note: * December 1996 values, ** March 1997 values, # June 1997 values.

2b) Increased noise from local industries and slowing external sector

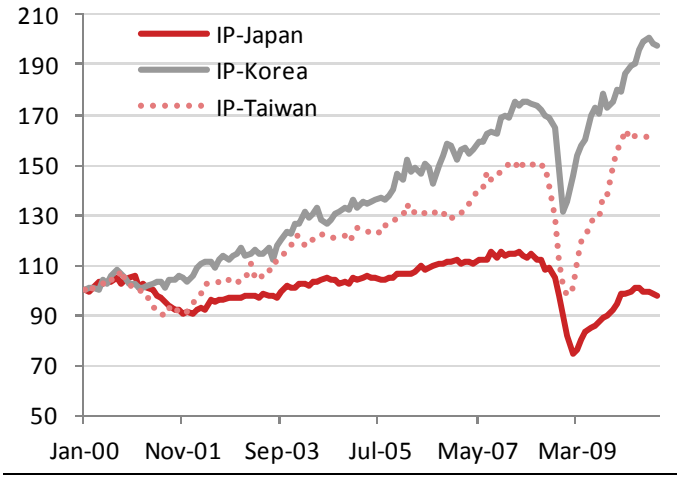
The other factor behind likely increased capital controls in the region is more noise from local industries over competitiveness as well as an expected slowdown in local growth momentum into 2011. This has been most evident in the Philippines and Indonesia, where Indonesian authorities have highlighted less benefits of further FX appreciation to lowering inflation. For Indonesia, the risk of additional capital controls may also be higher given the perception that IDR is becoming less competitive[44] with our FX valuation analysis showing it moving closer towards fair value (1.3% undervalued on the average of FEER and SEER valuations). That said, despite some concerns over a moderation in the growth momentum (see 'Relative Asia growth outperformance, but risks of growth slowing' section ahead) it is hard for some authorities such as those in South Korea and Taiwan to view this as a reason to justify implementing capital controls. Relative to its regional competitor Japan, South Korean and Taiwanese exports have tripled and doubled over the past 10 years, respectively. Industrial sectors in both countries have powered ahead of Japan's and no surprise given that KRW and TWD are also about 30% weaker against JPY in the same period – Exhibits 7a and 7b.

Exhibit 7a. Korean and Taiwan export sectors are racing ahead of Japan. Jan 2000 = 100



Source: CEIC, Nomura.

Exhibit 7b. Severe underperformance of Japan's IP vs. Korea and Taiwan. Jan 2000=100



Source: CEIC, Nomura.

44) See *FX Insights: Indonesia – Seven risks to watch*, 29 September 2010.

2c) Fed's QE2 and risk of a currency war

With authorities in emerging markets critical of QE2 and some indications from the IMF that macro-prudential policies (in the form of capital controls) may be acceptable, the risk is a step up in capital controls. Although, there are still no strong indication that this is likely to turn out to be an outright global currency war – especially after the November G20 summit agreement that countries facing overvalued exchange rates (such as Brazil) could implement carefully designed measures – there remains a risk that Asia steps up controls as growth momentum slows and raises competitiveness concerns. We expect capital controls to be most severe in Indonesia, Taiwan and Thailand. Korea and the Philippines may implement additional measures, while Hong Kong, Singapore, India, Malaysia and China are the least likely to implement controls over the next three to six months, in our view – Exhibit 8.

Exhibit 8. Capital controls and risks ahead

Country	Further Capital Controls	Drivers in the direction of controls	Measures so far	Possible controls
Indonesia	Most likely	1. Pre-emptive measures given Asian financial crisis experience 2. 2010 aggregate net capital inflows to-date over US$20bn	1. 1-3M SBIs suspended, 1-3M term deposits only for local banks. 2. Minimum 1M SBI holding period.	1. Tenure of term loans could increase and replace SBIs. 2. Increasing minimum holding period or taxes/penalties for short term investors. 3. Regulation of vostro accounts
Taiwan	Most likely	1. Over 5% appreciation of TWD since Sept 2010. 2. Consistent fear of speculative foreign capital	1. Prohibit foreigners (Nov 09) from TWD time deposit. 2. 30% cap in government bonds vs. total investments for foreigners.	1. Taxes on non-invested funds/speculative investments. 2. FSC states possible 20% tax on FI FX speculation.
Thailand	Most likely	1. THB appreciation (~12% since Jan 2010) 2. Increased PI inflows	1. 15% withholding tax on foreigner's gains from government bonds.	1. Unrenumerated reserve requirement. 2. Taxes on capital & forex gains. 3. Levies on capital inflows, including Tobin-style tax.
Korea	Maybe	1. Large inflows (e.g. USD16bn in local bonds since Jan 2010) 2. To reduce NDF influence on onshore USD/KRW	1. Announced Jun 10 a reduction in local and foreign bank net derivative positions to 50% and to 250% of capital over 2-years.	1. Withholding tax on interest income on foreign holdings of bonds. 2. Further reduction in FX derivatives of foreign banks.
Philippines	Maybe	1. Sporadic concerns from officials in periods of PHP outperformance. 2. Already taken action to increase outflows.	1. Outward investment on debt doubled to US$60mn (Oct 10) 2. OTC FX purchase by residents doubled to US$60K (Oct 10)	1. Shift from external debt issuance to more local PHP-denominated bond issues for funding. 2. Department of Finance may look to repay external debt earlier.
India	Less likely	1. If there is a consistent pickup in capital inflows (NRD, ECB, FDI and especially PI) in excess of the current account deficit.	No recent tightening and capital controls on debt instruments exist by means of limits to foreign borrowings.	RBI states it is not taking measures such as Tobin taxes, unrenumerated reserve ratio (URR) off the table, but would carefully evaluate before implementation. Little chance of controls over the next 3-6 months.
China	Less likely	1. If there is a consistent acceleration in some evidence from the rise in PI and FX reserves in excess of basic balance	1. SAFE restrictions on foreign debt quotas for banks and new rules for currency provisioning. 2. Maintaining export revenues overseas to encourage outflows.	1. Restrictions on QFIIs like reducing the quota allocated or not allowing new entrants into the bond market.
Malaysia	Less likely	1. Similar to China and India, a consistent acceleration in PI inflows is required	1. No recent controls and BNM is actually liberalising as there is a desire for FDI to support Economic Transformation Programme and 10th Malaysia Plan	Little chance of controls on inflows over the next 3-6 months

Source: Central banks & monetary authorities of respective countries , Nomura

Indonesia has already introduced a minimum one-month holding period for SBIs, suspended 1-3M SBIs, and is offering 'term deposits' that are only available for local banks. Although authorities are trying to push foreign inflows into longer duration investments, the risk is that authorities further increase holding periods and end up eliminating the SBI market. As of October 2010, foreign holdings of government bonds were US$21.5bn (30% of total outstanding) and SBIs at US$8.1bn (or a record 32% of total outstanding).

Taiwan has already stopped foreign investment in TWD time deposits and restricted investment in local bonds (at 30% of total investment). We expect

authorities to continue actively checking financial institutions over foreign TWD cash holdings with a high risk of further controls, such as the FSC highlighting a possible 20% tax on gains of foreign investors from FX speculation.

South Korea's measures to reduce the net derivative positions of local banks to 50% of capital and 250% of capital for foreign banks over a two-year period (19 Oct was the first quarterly audit of banks) may be stepped up with a further reduction in foreign bank derivative positions or a reduction in the thin-cap. All of these, as well as the possibility of a reintroduction of a withholding tax on interest income on foreign holdings of bonds, are risks, but they may have been delayed given the flare up of relations with the North.

We expect the Philippines to pursue non-draconian measures over the next six months. After a doubling of investor outward investments in debt papers each year to US$60mn (October 2010), the government is likely to a) shift from external debt issuance to more local PHP-denominated bond issues for funding; and b) increase outflows with some discussion that the Department of Finance may repay its external debt earlier. As much as the policy of earlier debt repayments sounds like a real possibility, this may be relatively difficult given the government's relatively unhealthy fiscal finances. A fiscal deficit at 4.0% of GDP (12M to September) compares with 1.1% in 2006 when the government repaid US$1.4bn of foreign debt ahead of schedule (including US$220mn to the IMF). In addition, there are questions about whether or not this is even needed/plausible given that short-term external debt (due within 12 months) stands at US$5.5bn (with large amounts of debt maturing over the next two to three years).

Controls in Singapore and Hong Kong are unlikely given that both economies are financial centres and asset-market-specific measures (such as in property) are being taken. Hong Kong is also constrained by Basic Law Article 112, which highlights 'no foreign exchange control policies shall be applied.' In India, the desire for inflows to fund infrastructure projects and difficultly in funding the current account deficit makes it unlikely, in our opinion, that authorities will implement controls over the next six months. Controls are also unlikely in Malaysia as the government has been relaxing capital account rules allowing for inflows to support investment under the Economic Transformation Program and the 10th Malaysia Plan. In addition, the capital account has only recently stabilized (MYR0.7bn surplus against eight previous quarters of deficits).

3) The impact of capital controls and monitoring sterilisation indicators for risk of an FX policy shift towards appreciation

Although an intensification of capital controls into 2011 is expected in broad Asia as capital inflows and sterilisation costs increase, we do not expect these to break the medium-term Asia FX appreciation trend. Even if authorities are able to stop speculative inflows, which even if you assume to be a large portion of allocation into bond and equity markets, Asia continues to face strong basic balance (current account and net FDI) surpluses.

As of June 2010, Asia's[45] basic balances (12M rolling sum) stood at 5.1% of GDP (US$474bn) against portfolio investment of 4.0% of GDP (US$372bn). Malaysia's basic balance surplus stands at 11% of GDP (12M rolling to June 2010), Taiwan's at 8.8% and China's at 7.1%. In fact, Korea is the only country in the region where its portfolio investment surplus (5.0% of GDP) has been larger than the basic balance surplus (2.2%) on a 12M rolling basis to June 2010. Excluding China, Asia's basic balance falls to 2.4% of GDP (US$95bn), but is still larger than the portfolio investment surplus of 2.1% of GDP (US$83bn) as of June 2010 (12M rolling sum).

The limited impact of capital controls on Asia FX appreciation has been consistently experienced in the region in recent years, with even Thailand's

45) Excluding Hong Kong and Singapore.

December 2006 30% unremunerated reserve ratio (viewed as aggressive), failing to stem THB appreciation. THB strengthened 12% (vs. USD) from December 2006 to March 2008 (when the URR was abandoned) given the basic balance of 8.6% of GDP (average monthly US$2.1bn) in the same period. Even more recent measures –Indonesia's extension of SBI (central bank bills) holding periods, Thailand's re-imposition of a 15% withholding tax on foreign purchases of government bonds and Korea's reduction in net derivative positions of local and foreign banks – have all had only a limited impact in stemming foreign inflows or local FX appreciation. We believe that in the months ahead, authorities will increase controls further, which risks leading to knee-jerk sell-offs in Asian FX. However, unless the controls are so draconian that they affect real flows (some risk that the consistent addition of controls will hurt investor confidence), we expect any initial negative impact on Asia FX to be faded.

Monitor sterilisation indicators for risk of a policy shift towards appreciation

If capital inflows accelerate rapidly despite the implementation of more capital controls, there is a risk that the cost of FX intervention in parts of Asia could be severe enough to lead to a shift in FX policy. Although there are signs of a shift in FX policy in parts of the region such as Korea (not viewed as cost driven), pressures from sterilisation losses are building up in Indonesia, the Philippines and Malaysia. While diplomatic pressure on Asia to increase FX flexibility can be expected to increase into 2011, key is to watch whether local political pressures on central bank balance sheet losses rise.

South Korea is where we currently see some evidence of authorities allowing for gradual KRW appreciation and the rationale that this may continue over the coming months may be supported from the BoK normalizing monetary conditions, rising headline inflation and increased international pressure to increase FX flexibility. We hold this view of gradual KRW appreciation from two perspectives.

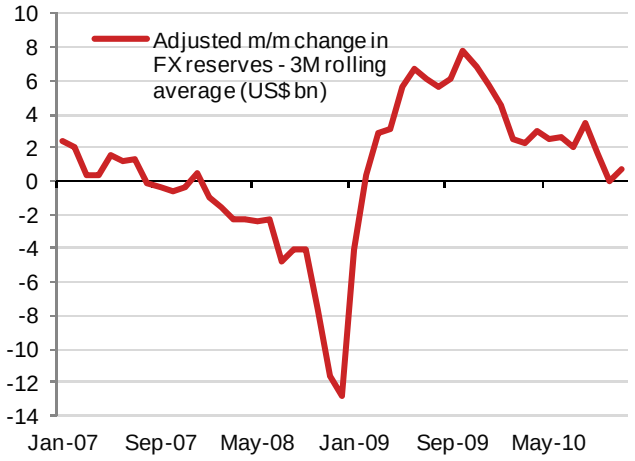
The first is the limited gains in FX reserves, where over the past three months to November, FX reserves (adjusted for FX valuations and coupon payments) rose by an average US$0.7bn per month compared with an average of US$4.4bn in the previous 18 months (Exhibit 9). In particular, September FX reserves fell by US$1.9bn after FX valuations and coupon adjustments despite 5% KRW appreciation vs. USD in the month. Part of this fall may be explained by the transfer of FX reserves to Korea Investment Corporation (which is believed to have been around US$2bn), but even the September FX forward data was relatively subdued at US$3.6bn m-o-m (close to the average US$2.8bn over the previous six months). There is some risk that action in the FX forward market rises ahead if KRW appreciation pressure picks up, but we expect any increase in intervention to lean against KRW appreciation rather than stem it.

Another support for increased KRW flexibility can be seen from the BoK's sterilisation operations. In previous instances (namely April-July 2002 and November 2004-February 2005), KRW undervaluation (by about 4% in both periods), strong basic balance and portfolio investment surpluses[46] and verbal support of more FX flexibility from officials[47], saw KRW appreciate by around KRW150-160 against USD in those periods. In the April-July 2002 period, MSB outstanding and the cost of sterilisation began to stabilise and fall in the run up to sharp KRW appreciation. In the November 2004-February 2005 period, MSBs outstanding and sterilisation costs fell before USD/KRW began its decent. Although FX intervention pickup up in November as reflected in the FX reserve accumulation and the rise in sterilisation operations, it was clear that this was only to lean against KRW appreciation – Exhibit 10.

46) Before the sharp KRW appreciation from April to July 2002, Korea's basic balance and portfolio investment surpluses were approximately 1% and 1% of GDP, respectively. Before the sharp KRW appreciation from November 2004 to February 2005, Korea's basic balance and portfolio investment surpluses were around 4% and 2% of GDP, respectively

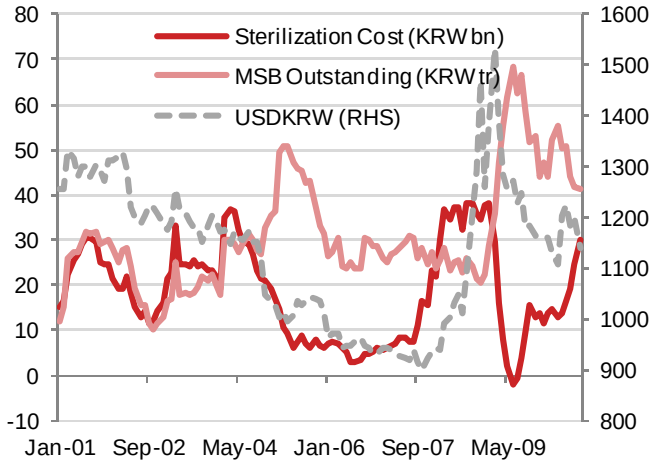
47) In the period November 2004-February 2005, the BoK's research department announced it should let markets determine KRW value. Assistant Governor Rhee Yeung Kyun also highlighted KRW strength was being caused by broad USD weakness.

Exhibit 9. S.Korea valuation and coupon-adjusted changes in FX reserves



Source: Bloomberg, CEIC, Nomura.

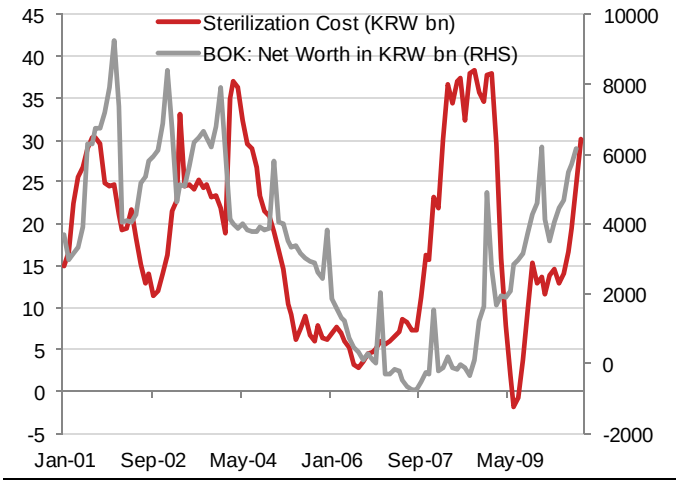
Exhibit 10. Sterilisation cost to the BoK



Source: Bloomberg, CEIC, Nomura.
Note: Sterilisation instruments for Korea are short term maturity MSBs (< 1year).

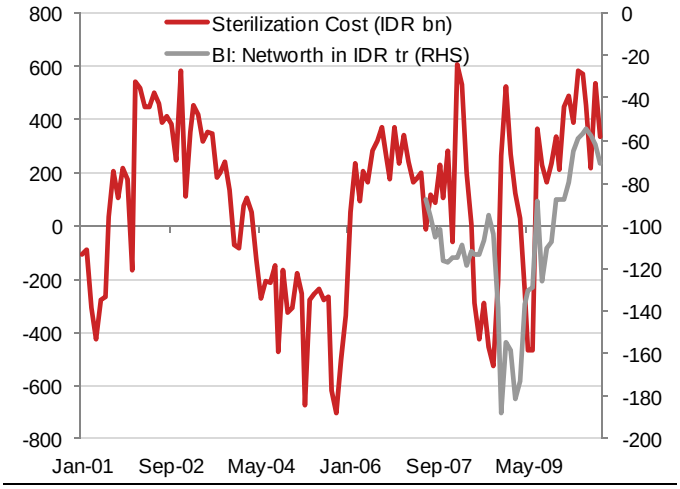
Indeed, the supports this time around are also compelling with KRW around 7.1% undervalued, the basic balance and portfolio investment account surplus at 2.2% and 5.0% of GDP respectively, and the Finance Ministry highlighting that S.Korea's FX reserves were adequate measured by various yardsticks for any crisis (Oct 4). An additional source of pressure at this juncture is international diplomatic pressure, where a significant focus of G20 is on countries with strong current account surpluses allowing for greater local FX appreciation. That said, given that the BoK's capital base has strengthened post the US financial crisis and the cost of sterilisation remains low, there is limited pressure for BoK to move – Exhibit 11. In addition, over the past ten years there does not appear to be any strong relationship with the BoK's capital base and authorities allowing for greater FX flexibility.

Exhibit 11. Sterilisation cost – Net worth for BoK



Source: Bloomberg, CEIC, Nomura.
Note: The sterilisation cost estimation is explained in Appendix C. BoK's networth is a sum of legal reserve, voluntary reserve and undivided earned surplus.

Exhibit 12. Sterilisation cost – Net worth for BI



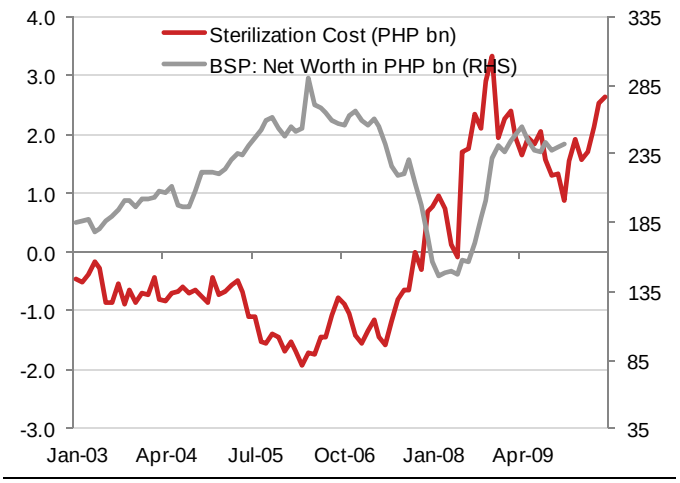
Source: Bloomberg, CEIC, Nomura.
Note: Sterilization instruments for Indonesia are SBIs and Repo Operations. BI's networth is a sum of paid-up capital, retained earnings, general/ special reserves and valuation adjustment reserves.

However, for Indonesia, high sterilisation costs and consistent losses on the central bank's balance sheet highlight the risk that BI is one of the central banks that may have to allow for greater FX appreciation if capital inflows continue to rise. Although there has not been any debate on BI's balance sheet losses yet, the risk

of this is rising, which could eventually pressure BI to step off its interventionist stance. Our calculations on BI's sterilisation cost shows that this totalled around US$522mn over the 12 months to end-Q3 2010. The risk of a policy change into 2011 is still low in our view, but moving through 2011 we expect the probability of an FX regime shift to rise – Exhibit 12.

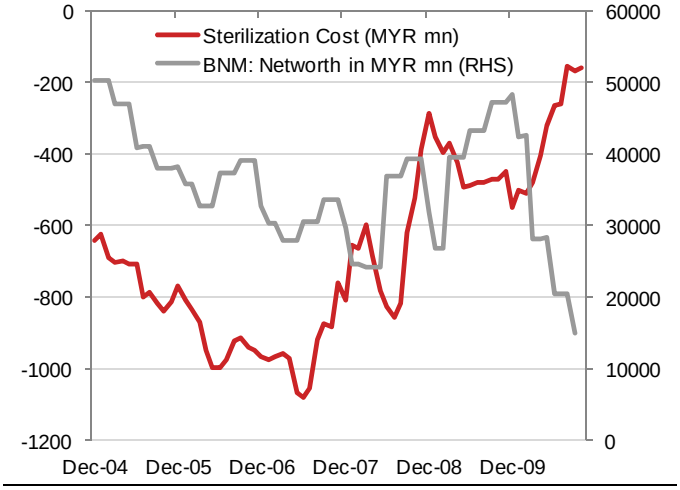
Rising costs of sterilisation in the Philippines and Malaysia highlight the risk of FX policy shifts in these countries also. In the Philippines over the period 1Q06-1Q08, BSP allowed PHP appreciation in the face of a deteriorating capital base and relatively high sterilisation costs - Exhibit 13. In the run up to 2006, fundamental supports in the Philippines such as 5% FX undervaluation, a basic balance surplus (4% of GDP) and strong equity inflows (5% of GDP) in 2H05 provided space for BSP to ease off its interventionist stance. Current conditions of 15% FX undervaluation and a basic balance surplus at 6% of GDP give BSP space to allow for greater PHP appreciation, in our view – but there could be less pressure on BSP given that its capital base has strengthened in recent years.

Exhibit 13. Sterilisation cost – Net worth for BSP



Source: Bloomberg, CEIC, Nomura.
Note: Sterilization instruments for Philippines are Reserve Deposits, Special Deposit Account and Repo Operations . BSP's networth is sum of the paid up capital and surplus reserves.

Exhibit 14. Sterilisation cost – Net worth for BNM



Source: Bloomberg, CEIC, Nomura.
Note: Sterilization instruments for Malaysia are Bank Negara Bills/Bonds and Repo Operations. BNM's networth is a sum of paid-up capital, general reserve fund and other reserves.

In Malaysia, the rise in sterilisation costs and deterioration in BNM's balance sheet in recent months highlights the increase in FX intervention in the face of rapid MYR appreciation. Although current economic conditions such as FX undervaluation (10.4%), a strong basic balance surplus (11.0% of GDP) and BNM highlighting limited FX concerns, favour BNM allowing greater FX flexibility (similar to the March 2009-April 2010 period), a sharper deterioration in BNM's capital base may be required before there is a shift in policy – Exhibit 14.

We currently view India, China and Taiwan as the least likely to be pressured to shift FX policy aggressively based on sterilisation costs and the relative strength of capital bases. India's capital base has strengthened substantially over the past two and a half years, whilst there is also no issue over sterilisation costs. China's sterilisation costs have risen in line with increased CNY flexibility, and although sterilisation costs are likely to rise further in 2011 given local rate hikes, the net worth of the PBOC remains relatively strong, which could (similar to Taiwan) allow the PBOC to prolong its FX interventionist stance.(See Appendix C on sterilisation.)

4) CNY appreciation

We expect CNY appreciation (vs USD) to continue over the medium term, towards 6.22 by end-2011 (see Appendix D for Asia FX forecasts). Fears of a hard landing in China have fallen markedly in recent months (Nomura Economics forecasts

9.8% 2011 GDP growth), as key economic data such as industrial production, fixed asset investment and the official PMI survey have strengthened after slowing marginally in the third quarter.

China's basic balance surplus[48] has also widened to around US$88.5bn in Q3 2010 (the highest since Q4 2009) from US$64.8bn in Q2, while FX reserves (in excess of the basic balance) picked up to US$13bn in September from the previous four months of a shortfall. The basic balance has strengthened further in October with the trade surplus widening to US$27bn from a monthly average of US$21.2bn in Q3 (and US$9.0bn in H1 2010) with net FDI remaining strong at US$7.7bn in October (US$8.4bn in September).

The fast pace of FX liberalisation should be another source of CNY support, with the creation of the deliverable CNY market in Hong Kong for trade and investment products in July 2010[49]. We expect this to lead to an acceleration in demand for CNY, with CNY deposits in Hong Kong rising 157% y-o-y in September (to CNY149bn, or 2.6% of total deposits).

In addition, global political pressure encouraged China to allow for CNY appreciation on 19 June 2010 and ahead of the 11-12 November G20 Leaders Summit in Seoul. We expect political pressure to continue into 2011 with the next main events to watch being the bi-lateral meeting between US President Obama and China's President Hu Jintao[50] (19-20 January) preceded by announcements from China's Central Economic Work Conference (8 December) and the Joint Commission on Commerce and Trade in the US (14-15 December) – (see Risk Outlook – a pleasant plateau in this publication). In the local political scene, the bias of authorities as announced by China's Politburo (3 Dec) is that they will shift its monetary policy stance from relatively loose to prudent next year. We expect this to entail more CNY appreciation.

This should keep CNY appreciation pressures intact, which in turn should support our recommendation to be short 3M USD/CNY NDF. The strengthening CNY trend will also be an additional driver of Asia FX strength. In weighing up the main influences on Asia FX, including global growth (proxied by MSCI global), broad USD, and CNY (12M USD/CNY NDFs), our PCA regression analysis (see Appendix E for the methodology) shows that from July 2005 to July 2008, the CNY impact was sizeable and statistically significant with a coefficient of 19.7% - Exhibit 15. This was the period when China abandoned its peg against USD and allowed for faster CNY appreciation. In taking the two periods of July 2005 to July 2008 and from June to November 2010, the influence of CNY on Asia becomes statistically irrelevant because of the brief (specifically July to August 2010) period where USD/CNY remained unchanged.

Exhibit 15. Influence of RMB, USD and global growth on Asia FX

(Jul-05 to Jul-08)	Asia ex China		ADXY		INR		IDR		KRW	
	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val
Dollar factor	19.4%	0.0%	-14.3%	0.0%	9.5%	6.1%	15.7%	4.4%	17.3%	2.1%
Global grow th factor	-12.1%	0.0%	9.4%	0.0%	-12.5%	0.0%	-20.6%	0.0%	-17.5%	0.0%
RMB factor	19.7%	0.2%	-16.7%	0.0%	14.0%	16.0%	4.8%	75.3%	24.5%	9.4%
	MYR		PHP		SGD		TWD		THB	
	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val
Dollar factor	21.8%	0.0%	4.8%	44.5%	34.4%	0.0%	23.5%	0.0%	28.4%	0.0%
Global grow th factor	-8.1%	0.0%	-14.9%	0.0%	-11.1%	0.0%	-6.9%	0.0%	-5.5%	14.1%
RMB factor	31.3%	0.0%	25.7%	3.9%	12.9%	3.0%	10.5%	15.5%	34.1%	1.8%

Source: Bloomberg, Nomura.
Note: Asia ex China is based on a simple average of the weekly Asian currency returns (INR, IDR, KRW, MYR, PHP, SGD, TWD, THB). Text highlight in red font are coefficients with opposite (with respect to intuition) signs or with insignificant p-values.

48) Proxied by the trade surplus and net FDI.

49) See *Asia FX Insights – China: Impact of further CNY liberalization in HK*, 23 July 2010.

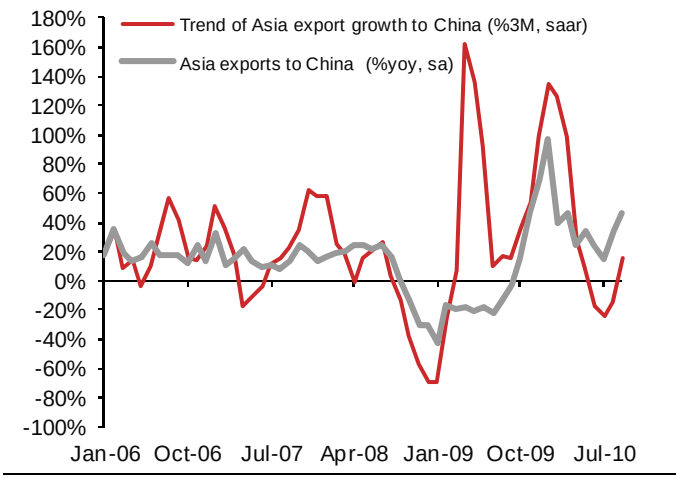
50) See *Asia FX Insights – Bejing Visit Notes*, 29 November 2010.

5) Relative Asia growth outperformance, but risks of growth slowing

In our last Asia FX outlook annual *Long beyond the peak* (30 November 2009) a main theme we highlighted was the cyclical recovery in Asia from base effects, the rise in Asia's inventory cycle, loose monetary conditions and strengthening support from China's growth surge. This strengthening of the cycle panned out as expected and we now believe that the cycle may slow into 2011.

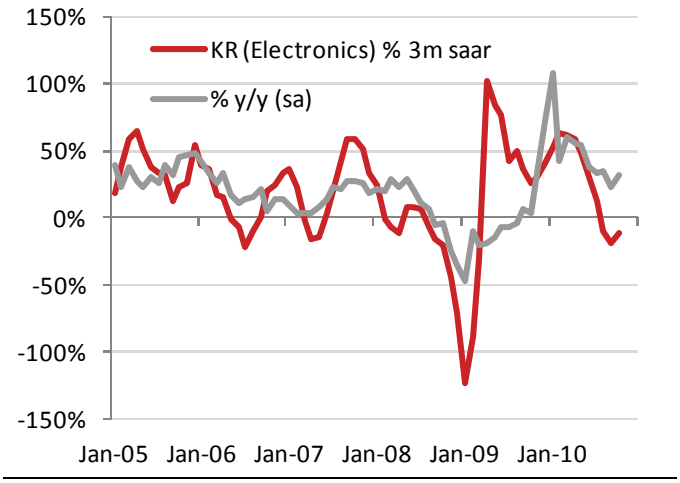
This is evidenced by the slowdown in the trend of exports (% 3M saar) with Asia trend growth falling -2% in September (the first fall since April 2009) from a high of 64% in December 2009. The Philippines is the only country in Asia where the trend of exports (up 48% on a 3M saar basis in September, led by electronics exports to Singapore) has remained strong, but risks weakening ahead. In particular, Asia %3M saar exports trend to China fell from a high of 135% in January to 15% in September (after contracting by an average 19% in June to August) – Exhibit 16a. And by specific Asia exports to China, Indonesia's commodity exports, Taiwan's electronic exports, Korea's Machinery and Transportation and electronic exports are all contracting on a %3M saar basis – Exhibit 16b.

Exhibit 16a. Asia exports to China trend (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.

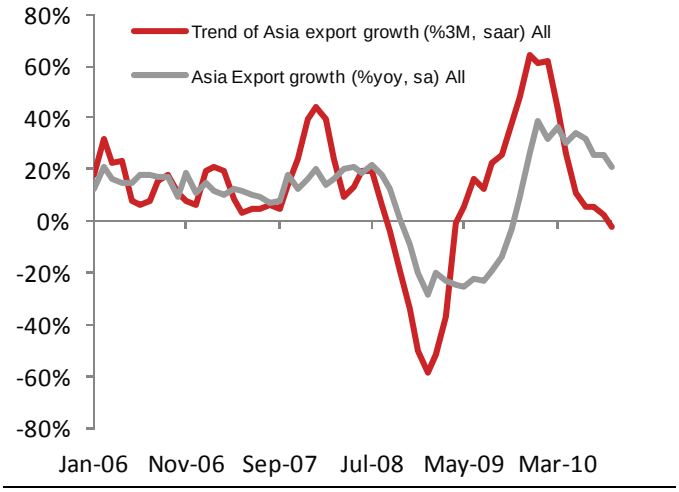
Exhibit 16b. Korean electronics exports to China (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.

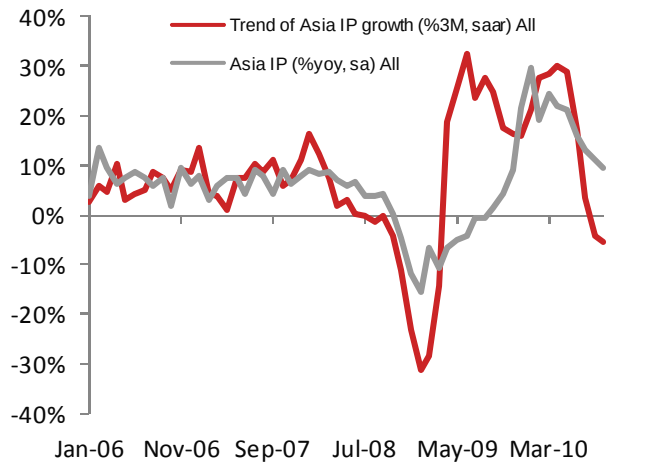
Asia growth concern is also reflected in Asia IP trends (%3M saar), which has fallen for the second consecutive month in September 2010 (by -5%) even though % y/y Asia IP is still holding in positive territory at 9.3% in September (vs. high of 29.8% in January 2010). On a trend basis, Singapore, Malaysia, Philippines, Thailand, Indonesia, and Taiwan have seen contractions in recent months, whilst China, India, and S.Korea continue to show positive expansion, but weaker from 1H10 – Exhibits 17a and 17b.

Exhibit 17a. Asia exports trend (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.
Note: Average of all Asia.

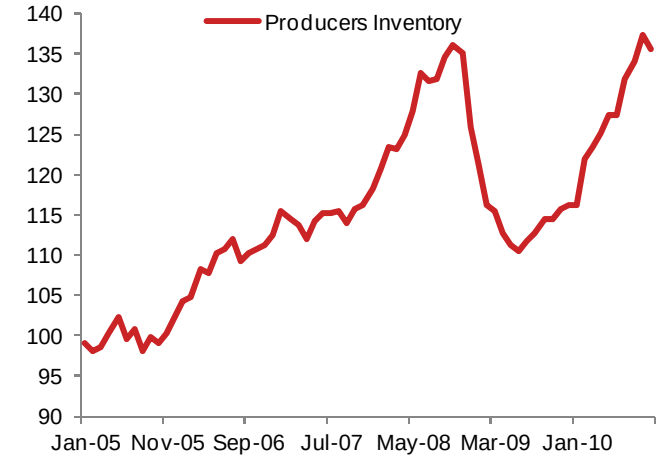
Exhibit 17b. Asia IP trend (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.
Note: Average of all Asia.

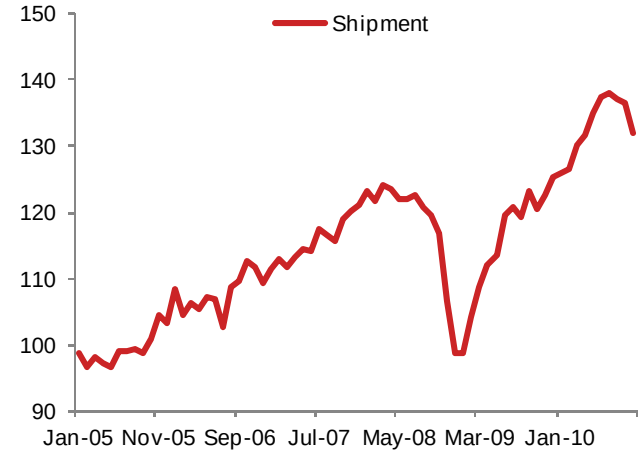
Adding to Asia slowdown worries is evidence that inventories in parts of Asia (where data is available) have risen substantially. South Korea's inventory-to-shipment ratio rose to 1.03 in October (the highest since March 2009) led by electronics (electronics IS ratio at 1.56 in September; the highest since January 2009). Overall Korean producer inventories are also above pre-US financial crisis highs, while shipments appear to have peaked in July– Exhibit 18a and b. Taiwan is where inventory-to-shipment data is also readily available and despite the IS ratio remaining relatively low at 0.91 in September (highest since February), there are some indications that this could rise further given the significant slowdown in Taiwan IP trend to 0% in September, a third consecutive fall in exports (Oct exports %3M saar at -26%) and the trend of inventory growth rising sharply.

Exhibit 18a. Korea producers' inventory index - sa



Source: CEIC, Nomura.

Exhibit 18b. Korea producers' shipment index - sa



Source: CEIC, Nomura.

Despite the risk of Asia slowing into 2011, Nomura Economics 2011 Asia GDP forecast of 8.1% from 9.1% in 2010 implies only a modest slowdown and limited impact on Asia FX. Our PCA regression analysis based of Asia dollar index (ADXY) returns against global growth (proxied by MSCI global returns), broad USD (DXY returns) and local growth (proxied by MSCI EM Asia less MSCI global returns) highlights that from January 2000 to November 2010, global growth and USD have been the primary drivers of Asian FX rather than local growth (see Appendix E for methodology). The beta of local growth is relatively low at 1.1%, while the betas on global growth and the broad US dollar are much larger at 7.7%

and -15.2%, respectively – Exhibit 19. Even running our PCA regression analysis from January 2000 to December 2007 (to avoid the US financial crisis influence), the beta of local growth only rises to 2.9% compared with global growth and the broad US dollar of 5.6% and -14.3%, respectively, which again highlights more importance of the broad USD and global growth for Asia FX. The risk here is if markets view China as the main reason for slower Asian growth since our PCA regression analysis highlights the importance of global growth (China's increased role) and USD/CNY for Asia FX to perform.

Exhibit 19. Global factors remain paramount to Asian FX returns

2000 to Nov-2010	ADXY		KRW		IDR		INR		PHP	
	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val
Dollar factor	-15.2%	0.0%	25.9%	0.0%	20.5%	0.1%	11.6%	0.0%	8.9%	0.4%
Global risk factor	7.7%	0.0%	-24.6%	0.0%	-11.9%	0.0%	-9.5%	0.0%	-8.8%	0.0%
Local factor	1.1%	**14.8%**	-8.2%	0.4%	-6.7%	10.0%	-0.1%	**95.8%**	-3.5%	**10.5%**
2000 to Nov-2010	**TWD**		**SGD**		**MYR**		**CNY**			
	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val	Coeff	P-Val		
Dollar factor	18.4%	0.0%	32.6%	0.0%	18.9%	0.0%	20.1%	0.0%		
Global risk factor	-6.9%	0.0%	-7.9%	0.0%	-10.0%	0.0%	-6.5%	0.0%		
Local factor	-3.4%	0.5%	**2.6%**	2.7%	-2.4%	**34.4%**	**2.0%**	**37.8%**		

Source: Bloomberg, Nomura. Note: Bold are coefficients with insignificant p-value at 10% level or wrong sign. MYR and CNY analysis from Jul 2005 to Nov 2010.

Country specifics

Korea: Fade North Korea risk events; KRW to perform

We see scope for KRW to perform over the next six months, especially following the recent increase in the political risk premium after North Korea's provocation on 23 November. Although the event highlights the political risks South Korea faces, especially given the eventual succession of Kim Jong-il by his son, North Korea has historically resorted to this kind of tactic to draw international attention and restart six-party talks. Unless additional action by Pyongyang leads to some retaliation from the South that prolongs the political risk, it is unlikely that this will have a significant impact on FX policy. Regarding events of 23 November, there is some relief that there is a broad consensus (from South Korean President Lee's comments to those of China) in attempting to calm the situation. This supports our short 3M USD/KRW recommendation on 23 November[51].

On the subject of risks to being long KRW, South Korea authorities are likely to increase capital controls (though there looks to be a temporary delay into 2011 because of events with the North). Authorities are reviewing derivative positions of banks and non-bank balance sheets (with the next quarterly review due in mid-December) and there could be more significant controls to align foreign institutions with local institutions on derivative positions. Currently, foreign institutions derivative positions can be a maximum of 250% of capital (from 300%), which based on 1Q10 data, implies around a US$8.3bn reduction in positions. This has had a limited impact on KRW and no surprise given that this is to be completed over a two-year period. That said, if authorities were to announce a reduction to 50% of capital (matching local banks and implying a large US$41.3bn reduction in positions), and/or some measure on the thin-cap rule, the impact on pushing spot USD/KRW higher as seen historically through USD squeezes may be significant.

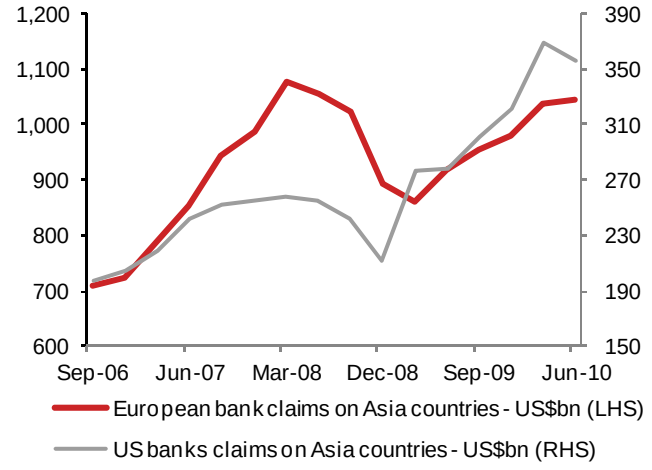
Another control being discussed is the reintroduction of the withholding tax[52] (WHT) that was repealed in March 2009. This looks most likely to be a risk for the latter part of 1Q11, but should not have a long lasting negative impact on KRW as this has been long discussed as a possibility. Secondly, the rule is likely to be forward-looking and non-disruptive (as experienced when Thailand reintroduced its 15%

51) See *Asian Strategy Snapshot – Korea: FX and interest rate implications of North Korean provocation*, 23 November 2010.
52) The tax used to impose a 10% levy on capital gains and a 14% levy on coupon payments on government bonds.

tax in September) and possibly even toned down. Third, we note that even if foreign flows into the local bond market slow, this is unlikely to be a trend-breaker for KRW appreciation. Average monthly net purchases of government bonds this year (Jan-Oct) has been a large US$2.2bn, but this compares with an average monthly current account surplus of US$2.9bn (around 3.6% of GDP, or US$28bn in Jan-Oct 2010), and average monthly net foreign equity inflows of US$1.5bn over the same period.

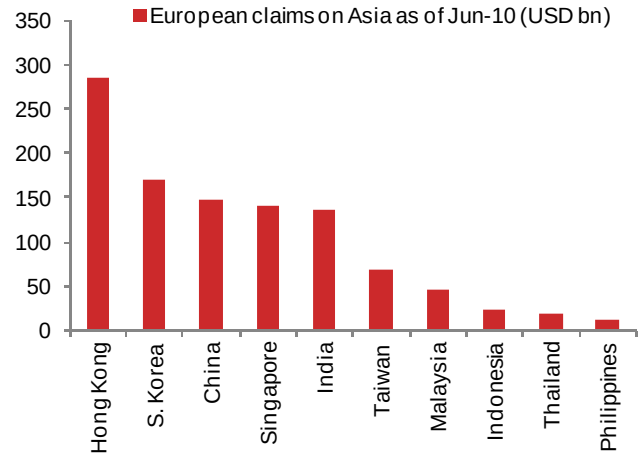
If the stress in the European financial system intensifies, one concern is the US$1.04trn (as of 2Q10) of European[53] banks' claims on Asia[54]. Even if you assume that around a third of this is related to bank operations/funding from head offices into Asia, the size of claims is still extremely large at US$696bn. By country, UK, French and German banks account for around 83.4%[55] (US$870bn) of European bank lending to Asia. The UK is the largest at 62.0%, or US$647bn in 2Q10. By country, European claims on Asia (as of 2Q10) are highest for Hong Kong (US$286bn), South Korea (US$171bn), China (US$148bn), Singapore (US$141bn) and India (US$136bn), and lowest in Thailand (US$19bn) and the Philippines (US$13bn) - Exhibits 20a and 20b.

Exhibit 20a. European and US claims on Asia countries



Source: BIS, Nomura.

Exhibit 20b. European claims on Asia



Source: BIS, Nomura.

Also underlining the risk to Asia is the fact that European bank exposure is significantly larger than US bank claims on Asia (US$356bn in 2Q10). During the US financial crisis, global repatriation/deleveraging saw a US$234bn fall in foreign claims on Asia (from 1Q08 to 4Q08). This led to a considerable USD liquidity squeeze and pressured currencies in the region, namely USD/KRW higher. Although there is limited evidence of extreme bank stress and rapid deleveraging in Europe, this remains a risk for Asia and previous foreign currency swap lines may have to be re-established with global central banks to dampen global foreign currency liquidity concerns. However, that would unlikely eliminate the negative implications for credit extension (primarily in Europe) and the subsequent negative consequences for growth and Asia exports.

These risks aside, we expect KRW to be an outperformer in 2011 and the recent flare up with the North has provided an opportunity; we expect KRW to be supported by numerous local economic factors. Nomura's Economics team has revised up its 2011 current account forecast to USD21bn or 1.9% of GDP (from US$15bn previous), reflecting the strength of the trade surplus.

53) Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden, Switzerland and the United Kingdom. Data are ultimate risk basis.
54) Hong Kong, Singapore, China, Taiwan, India, Indonesia, Malaysia, Philippines, South Korea and Thailand.
55) In 2Q10, British, French and German banks accounted for 62.0%, 12.8% and 8.6% of European lending to Asia.

Net portfolio inflows have also accelerated to US$39.3bn in Jan-Oct, with a significant pick-up in interest in Korean local government bonds from China. As part of China's FX reserve diversification, China's holdings of KTBs continue to rise sharply to KRW6.1tn (USD5.3bn) as of November 2010, which is up more than three times this year. This is only 0.2% of China's US$2.65tn of FX reserves, suggesting that even if there is a further marginal increase in allocation into KTBs, this could have a significant positive KRW impact.

We also see some evidence that Korean authorities' have stepped back in their bids on USD/KRW. Aside from the Finance Ministry (4 October), stating "our current reserves are seen by international yardsticks as enough to endure a crisis," the average monthly gains in FX reserves (adjusting for FX valuation and coupon payments) over the past three months has been small at US$0.7bn. Another encouraging sign is the US$3.6bn monthly rise in September FX forwards, which is not too far from the average US$2.8bn over the past six months. Although there is some risk that authorities could increase the extent of FX intervention in the coming months if capital inflows rise, we expect this to be a bias to lean against the trend, rather than stem it.

Additional evidence of an easing in the BoK's FX interventionist stance can be seen from its sterilisation operations. As we highlight in the section of this report entitled "Monitor sterilisation indicators for risk of a policy shift towards appreciation", authorities allowed for greater KRW appreciation in April-July 2002 and November 2004 to February 2005. In the April-July 2002 episode, MSB outstanding and the cost of sterilisation began to stabilise and fall before sharp KRW appreciation ensued. In the November 2004 to February 2005 episode, MSBs outstanding stabilised and sterilisation costs fell before USD/KRW began its descent in November. But intervention picked up quickly through November, but only to lean against KRW strength. Current sterilisation operations look similar to the 2002 period.

We also expect (similar to other parts of the region) authorities to allow for FX appreciation to help tighten monetary conditions. The BoK in its October monetary policy meeting said that the currency was a major consideration when it kept rates unchanged, highlighting a bias towards allowing KRW appreciation. Although the BoK hiked by 25bp in November, the view that monetary policy was not at a neutral level highlights that there is still scope for further FX strength to help normalise monetary conditions. Given KRW weakness (especially since the US financial crisis) has been a major component in driving loose monetary conditions and there is a strong relationship between inflation and FX (the BoK estimates a 1% fall in annual CPI inflation from a 10% KRW appreciation against the USD), authorities should allow for KRW appreciation.

Indeed, based on our FX valuation analysis, our REER (deviation from 10-year average, BIS data) shows undervaluation of 9.2%, while our filtered FEER and SEER models show an average undervaluation of 7.1%.

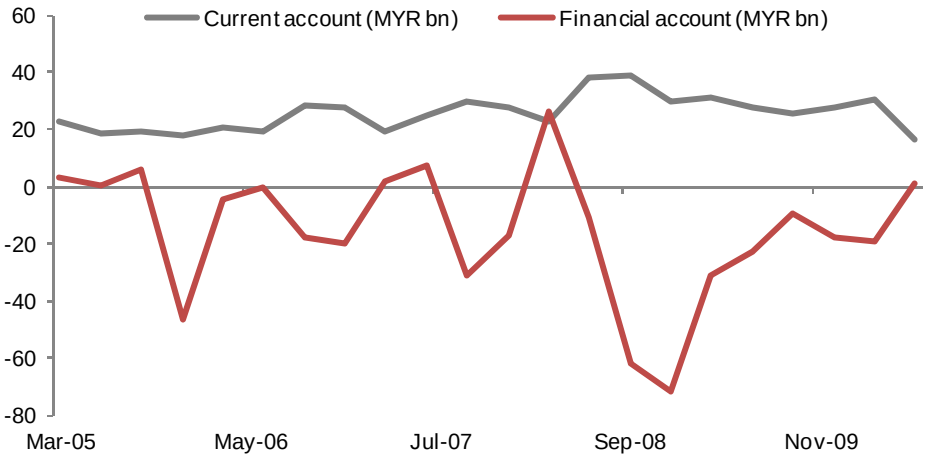
Malaysia: Supports for MYR appreciation

We remain optimistic on MYR appreciation (vs. USD) towards 2.97 by mid-2011 and 2.88 by end-2011, supported by: 1) the resumption of CNY appreciation; 2) FX liberalisation by Bank Negara (BNM); 3) BNM being supportive of MYR strength; 4) a stabilisation of the capital and financial accounts; 5) a strong basic balance; and 6) the 10th Malaysia plan and stable politics.

Our view is that CNY can appreciate to beyond 6.60 (/USD) into January, which may see USD/MYR trade towards a 3.0 figure in January. We note that FX intervention from BNM to support USD/MYR picked up from August to October, reflected in both the FX reserve and FX forward data, while BNM's sterilisation operations have picked up, reflected in both the outstanding bills/bonds and repo operations and also the rising cost of sterilisation.

That said, we expect resistance against MYR appreciation to fall as CNY appreciation resumes. The bias of authorities to move towards FX liberalisation as reflected in the 18 August measures allowing for trade settlement in MYR, as well as local companies being able to borrow foreign currency from their affiliated companies abroad should also support the recent stabilisation in the capital and financial account. The capital and financial account in 2Q10 showed a surplus of MYR0.7bn, the first surplus after eight consecutive quarters of deficit to 1Q10 – Exhibit 21. Beyond the expected improvement in the capital and financial account, the basic balance surplus remains a strong support for MYR at 11% of GDP in the 12 months to June. Lastly, more stable local politics and Prime Minister Najib's drive (10th Malaysia Plan) should also increase private sector involvement in infrastructure and attract foreign inflows. We see some scope for Prime Minister Najib to call for an early general election (to be held by April 2013) possibly before May 2011 given his still strong approval ratings and an opposition party (PKR) still in disarray.

Exhibit 21. Malaysia capital and financial account and current account surplus



Source: CEIC, Nomura.

Singapore: SGD to perform amongst the lower beta FX (vs USD)

In Singapore, the MAS for a second consecutive meeting in October 2010 surprised the broad market with its relatively aggressive monetary policy tightening[56] - Exhibit 22. In the 14 October meeting, the MAS increased the slope of FX appreciation and widened the policy band "slightly" highlighting that inflation will stay high in the first half of 2011 with domestic cost pressures rising from the high level of resource utilisation and tight labour market. Our assumption is that the slope is a 3% annualised appreciation (from 2%) and the band width is +/- 3% (from +/- 2%).

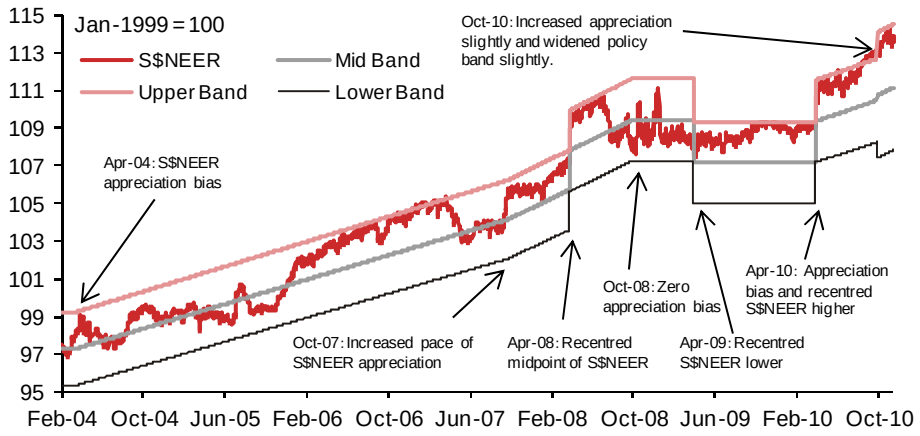
With our view that there is unlikely to be any change in policy over the next three months and even possibly at the April 2011 MAS policy announcement, we see scope for SGD to strengthen further against the USD towards 1.265 by Q1 2011 (utilising our global FX forecasts and our view on the slope and bands) before the S$NEER hits the +3% strong side of the policy band (S$NEER at +2.7% deviation, 6 December, 16:00pm SGT).

SGD should also see support from our view of no double-dip in the US, while as Asia increases capital controls, SGD should also be a beneficiary with limited risk of controls. Aside from the risk of slower global growth, another risk to long SGD positions is if there is the perception from authorities that there is greater external sector certainty and less volatility in markets. This could see MAS narrow the S$NEER policy bands. The last time MAS widened its policy band was on 10

56) See *Asia FX Insights – MAS surprises with effective tightening*, 14 October 2010.

October 2001 (a non-policy date) following the 11 September 2001 terrorist attacks and because of "greater uncertainty in the external environment and more volatile market conditions." However, the widening only lasted until 2 January 2002 when "a narrower policy band" was restored "as market and economic conditions have become less volatile."

Exhibit 22. S$NEER and policy announcements



Source: Bloomberg, MAS, Nomura.

Thailand and Taiwan: Capital control risks

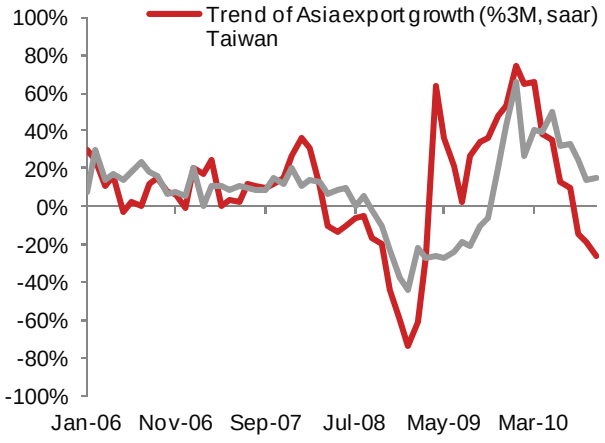
THB appreciation towards 28.5 against the USD by June 2011 is expected based on the basic balance surplus of 6% of GDP in August. The local political backdrop has also improved following the Constitutional Court's dismissal of the Democratic Party dissolution case (29 November). That said, regular protests by the opposition People's Power Party (formerly the Thai Rak Thai party) remains a risk. While a comparison of the structure of Thailand's balance of payments over the past year to October with that in 2006 provides little economic rationale for implementing capital controls, the risk remains high with Thailand having a history of surprising with unconventional capital control policies. In 2006, net private equity inflows totalled US$2.3bn, or 1.1% of GDP (basic balance 6.1% GDP) compared with close to zero in the 12 months to September 2010 (basic balance 6.6% of GDP). The latest capital control is the 15% WHT on foreign holdings of government bonds (effective 13 October), but this has had little impact as foreign participation is small (foreign ownership being just 4%, or USD3.6bn, of total outstanding government bonds as of June). The risk is that more controls will emerge over the next 12 months (see Exhibit 8).

We expect TWD to continue to appreciate owing to CNY appreciation, benefits from reform and liberalisation related to China, as well as a solid current account surplus (Nomura Economics 2011 forecast at US$47.1bn, or 10% of GDP). However, the risk of more aggressive capital controls has risen and may limit the pace of TWD strength ahead. This follows the ban on foreign investors placing money in TWD time deposits and more recently authorities limiting foreign investments in government bonds at 30% of total investment. There have also been discussions of possibly implementing various taxes on speculative foreign flows, while authorities continue to highlight the risk of capital inflows and monitor financial institutions for any misallocation of foreign funds.

Another risk is that the trend of growth (both in exports and IP) is slowing, while inflation pressures remain subdued as reflected in the trend (%3M saar) and % y-o-y growth rates of headline and core CPI – Exhibits 23a and 23b. This may lower the scope of authorities tightening monetary conditions ahead, which is a change

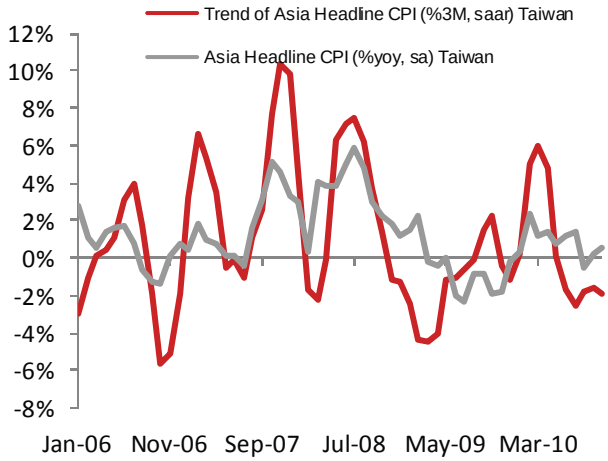
from our view in July[57] where we saw some scope of a change in FX policy stance similar to episodes in August 2004-March 2005 and October 2007-April 2008 (10% and 9% TWD appreciation vs. USD respectively). Both of those periods were supported by broad USD weakness (-6% and -10%, respectively) and strong local fundamental backdrops (above-trend GDP growth, rising inflation, falling unemployment rates).

Exhibit 23a. Taiwan exports trend (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.

Exhibit 23b. Taiwan CPI trend (3m saar vs. % y-o-y)



Source: Bloomberg, CEIC, Nomura.

Philippines: Support from positive investment climate, but watch growth, fiscal momentum and controls

We have been positive on PHP since President Aquino took office in June, recommending long PHP positions because of expectations of an improving fiscal backdrop, strengthening investment climate (in part from the government's infrastructure summit), the drive against tax evasion/corruption and a strong basic balance surplus (especially into year-end).

We see scope for the positive investment climate to continue in the coming months and provide support for PHP as the government pushes ahead with its well received 18-19 November infrastructure summit (10 major infrastructure projects were announced worth PHP127bn, in rail, airports, roads and water), as well as its fight against tax evasion (BIR's Run After Tax Evasion program continues to file bi-weekly high level cases).

However, aside from the positive investor climate, there have been a few less supportive developments that may limit PHP performance in 2011, including fiscal developments, slower-than-expected local growth and capital controls.

Aside from the current negative global risk backdrop from European fiscal concerns and tensions on the Korea peninsula, the improvement in the Philippines fiscal deficit is less impressive than the headlines imply, in our opinion. The deficit in Jul-Oct (President Aquino took office at the end of June) narrowed to PHP73.6bn from PHP112bn in the same period in 2009. However, the reason for this improvement is that spending has fallen (on a % y-o-y basis) for three consecutive months (averaging -5.7% y-o-y in Aug-Oct). BIR revenue growth has improved, with a 15.1% y-o-y rise in October, but has yet to show a sustained improvement following an 8.7% y-o-y fall in September (Exhibit 24). President Aquino has highlighted that the main source of revenue will be from targeting tax evaders (an estimated PHP150bn of tax revenues lost annually) and so a consistent improvement in BIR revenues will be required to garner confidence that fiscal targets can be met without hiking taxes. Recent slower-than-expected Q3 GDP growth at -0.5% q-o-q and 6.5% y-o-y (Consensus: +0.9% q-o-q, 7.3% y-o-y)

57) See *Asia FX Insights – Taiwan: Strengthening drivers for TWD appreciation*, 29 July 2010.

and a likely slowdown into 2011 highlights additional risk to the fiscal outlook and positive investor sentiment on Aquino's ability to instigate structural change in the economy.

Capital control risks in the Philippines are also rising. Although they are unlikely to be harsh, if capital inflows pick up again (on some stabilisation in the risk backdrop) and PHP appreciation resumes, the government is likely to initially look to: 1) shift external debt issuance to more local PHP-denominated bond issues for funding; and 2) increase outflows with some discussion for the Department of Finance to repay its external debt earlier. Although earlier debt repayments will help to limit PHP appreciation, it may be relatively difficult given government finances and heavy short-term obligations. While the Philippines has consistently wanted to repay debt early (such as in 2006; US$1.4bn of foreign debt paid ahead of schedule including US$220m to the IMF. Note total external debt was US$54.2bn at end-2005), this was because of the government's relatively healthy fiscal finances at the time. The budget deficit in 2006 was only around 1.1% of GDP compared with the current deficit of 4.0% of GDP (12M to September). In addition, Philippines short-term external debt (due within 12 months) stands at US$5.5bn with large amounts of debt maturing over the next two to three years (September total external debt at US$57bn).

India: Equity flows – the main swing factor for INR

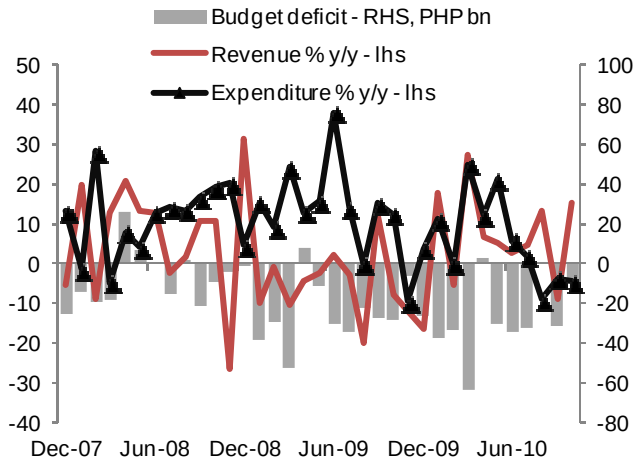
Our view that INR would struggle to perform given its dependence on capital inflows was proven wrong in September following an unexpected surge in net foreign equity inflows in the month at US$6.4bn (versus an average monthly US$1.6bn in January-August). INR weakened by 0.5% in January-August (/USD) and strengthened by 4.2% (/USD) in September alone. However, this proved to be temporary with net foreign equity inflows slowing in October (US$5.5bn) and further in November (US$3.8bn) leading INR appreciation to fade with 1% strengthening and 3.4% depreciation (/USD) respectively.

We hold the view that INR is unlikely to perform without a positive risk backdrop given the difficulty in financing the current account deficit. Equity inflows remain the main swing factor for INR performance given the relative volatility of this component compared with the other sources of capital inflows. As of 2Q10 (latest data), the current account deficit of US$13.7bn compared with net capital inflows of US$11.5bn [58] (US$4.6bn net portfolio investment, US$2.7bn external commercial borrowing, US$1.1bn non-resident deposits and US$3.2bn net FDI) – Exhibit 25. Because of this funding concerns, the government has implemented policies to attract capital (contrary to most of Asia) such as the increase in the limits for foreign institutional investors in government securities and corporate bonds by US$5bn respectively (23 September). We believe India is likely to maintain that policy bias.

Two further factors that could weigh on INR are signs of local growth slowing, while the monetary policy tightening cycle may have reached a peak, at least for the coming months. INR is also close to fair value based on our FX valuation analysis, which may also limit the extent of further INR appreciation.

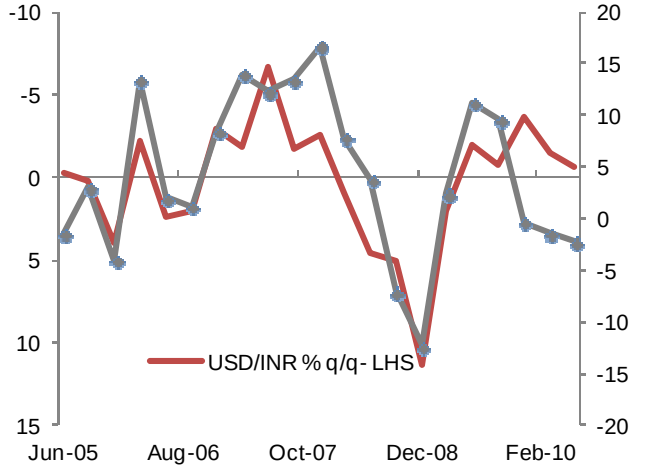
58) Excluding external assistance, short term loans, banking capital (non-NRI deposit component) and other capital.

Exhibit 24. Philippines budget position



Source: Bloomberg, CEIC, Nomura.

Exhibit 25. India: funding the current account deficit



Source: Bloomberg, CEIC, Nomura.

Indonesia – Risk from positioning risk and BI policy stance

We believe the economic rationale for being long IDR is supported by strong economic growth prospects led by consumption and investment, political stability, relative monetary and fiscal policy credibility, relatively high yield and possible sovereign rating upgrades.

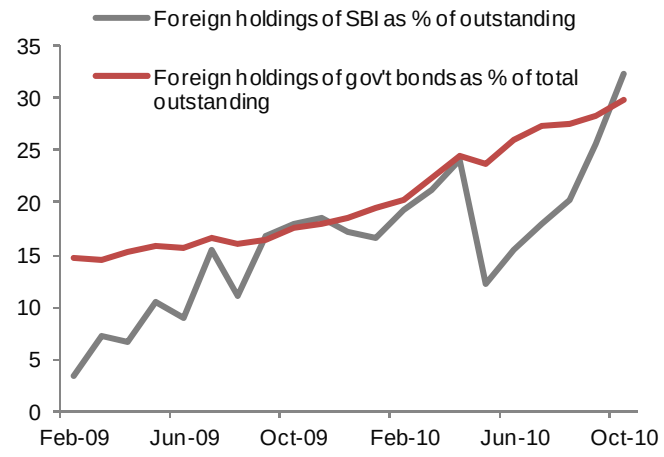
However, this is a widely held view and we see several risks. We believe the risk of capital controls in Indonesia is very high, with BI recently introducing a minimum one-month holding period on SBIs (7 July) and a one-month 'term deposit' that is accessible only to local banks, effectively replacing the one-month SBI. The government has increased the 'term deposit' to the three-month tenor and the risk is that there may eventually be a complete replacement of SBIs. This is a risk as despite the minimum holding period and 'term deposit' measures implemented, foreign holdings of SBIs continue to accelerate to US$8.1bn (32.3% of total outstanding) in October and up US$3.4bn (or 72%) from July when the measures were first introduced – Exhibit 26. Aside from the shift to term deposits and eradicating the SBI market, some other measures being discussed include extending the holding period on SBIs further or possibly taking a similar stance to that of Brazil and Thailand through imposing a tax on fixed income instruments.

In addition, we note that beyond the foreign positioning and capital control risk, there is an increasing perception by authorities of less favourable IDR FX valuations (our valuations shows only a 1.3% undervaluation), reduced benefits of further IDR appreciation on inflation and rising concerns from manufacturers (namely textiles companies) – Exhibit 27. In addition, there is scope for disappointing news on regulation (related to the set up of a Financial Services Authority). In our earlier report[59] on risks to IDR, we highlighted some large corporate debt obligations that needed to be financed by year end. However, some time has been bought with those obligations being largely met by loan extensions as well as issuing debt to repay debt.

The main caveat to being long USD/IDR or implementing a short IDR position as a hedge to being long Asia FX is if the surge in the cost of sterilisation and the losses on BI's balance sheet becomes a political issue. There is no evidence of this yet and this is unlikely over the next three to six months in our view, as BI's current line of defence is through stepping up capital controls. But beyond six months, if capital controls are unable to limit the negative impact on BI's balance sheet, the risk is that BI will be pressured to shift its FX policy stance towards allowing for more IDR appreciation.

59) See *Asia FX Insights: Indonesia – Seven risks to watch*, 29 September 2010.

Exhibit 26. Foreign ownership of SBIs still rising



Source: BI, CEIC, Nomura.

Exhibit 27. Indonesia: textile production

Source: Bloomberg, CEIC, Nomura.

HKD: No change expected over the medium term, but rising risk of a regime shift

Our baseline view is no change in the USD/HKD currency board/peg regime over the next one to two years[60]. However, what would make a move possible in this time frame would be a significant rise in local inflation and increased social pressure for change. For now, these factors do not suggest a change is imminent, but we expect pressures to rise.

Local asset market prices continue to climb in part from the limited policy options as a result of HKD's peg to USD, which has left Hong Kong captive to the weaker USD backdrop with close to zero short-term interest rates in line with US rates. Hong Kong's close integration with China's economy, in which income growth continues to rise rapidly, is also leading to capital inflows. Without a negative global event/shock, conditions are set for Hong Kong property prices and imported inflation to rise even further - Exhibits 28 and 29.

There has been much discussion about shifting the USD/HKD peg to a HKD/CNY peg following the HKMA's recent announcement of a possible partial conversion of FX reserves into CNY, its activation of the PBOC's CNY swap facility, rapid growth of the USD/CNY deliverable market and growth of CNY deposits in Hong Kong.

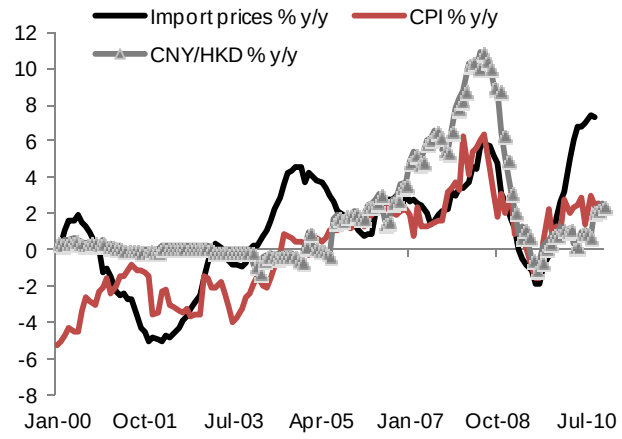
However, we believe that CNY convertibility and further development/ strengthening in China's financial sector/economy may be a prerequisite to pegging HKD to CNY. In our view, a move to a basket regime similar to Singapore's would be most likely (given some similarities in Hong Kong's economic structure) if authorities were to abandon the peg against USD over the next one to two years. The risk of a shift to a free-float regime or re-pegging against USD at a lower level or widening the convertibility undertaking rates are less probable, in our view. A free float of HKD may incur higher FX volatility and may make it difficult for the government to achieve its objective of maintaining currency stability (stipulated under Basic Law Article 111). This is probably not what is desirable for a service-based economy and widening the convertibility undertaking bands would likely lead to speculative inflows, while a revaluation (and maintaining the peg) will have to be very large to stem speculation (raising the risk of an FX-related shock to the economy).

Although, we do not expect a change in the regime, tests of the 7.750 strong side convertibility undertaking rate are expected, especially if USD/Asia continues to trade lower, capital inflows pick up and there is any social pressure for a regime

60) See *Asia FX Insights: HKD Peg: No change expected over the medium term, but rising risk of a regime shift*, 1 November 2010.

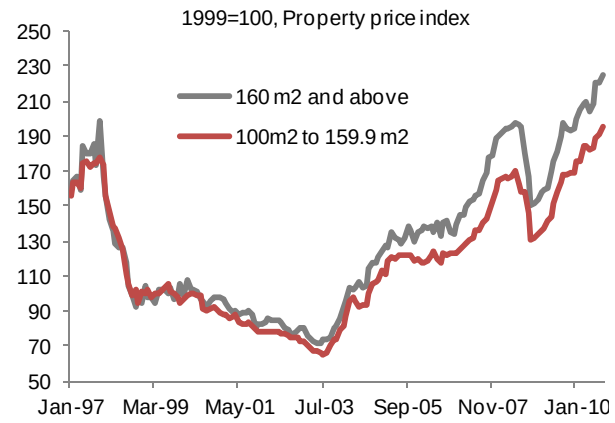
shift. This would pressure long-end USD/HKD lower (2yr is around 38bp below the strong side 7.750 convertibility undertaking rate) and also highlights some value in establishing low-delta long-dated (2yr+) USD put/HKD calls.

Exhibit 28 – HK: Rising import prices and CPI



Source: Bloomberg, CEIC, Nomura.

Exhibit 29 – HK: Rising property price pressures



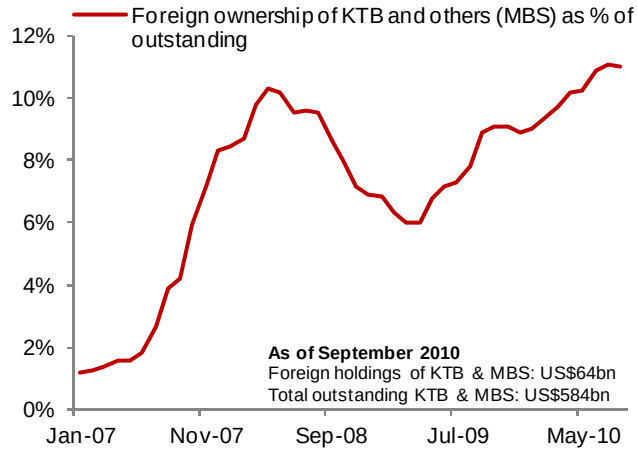
Source: Bloomberg, CEIC, Nomura.

Appendix A – Foreign positioning

Exhibit 30a. Foreign Positioning - Malaysia Bond

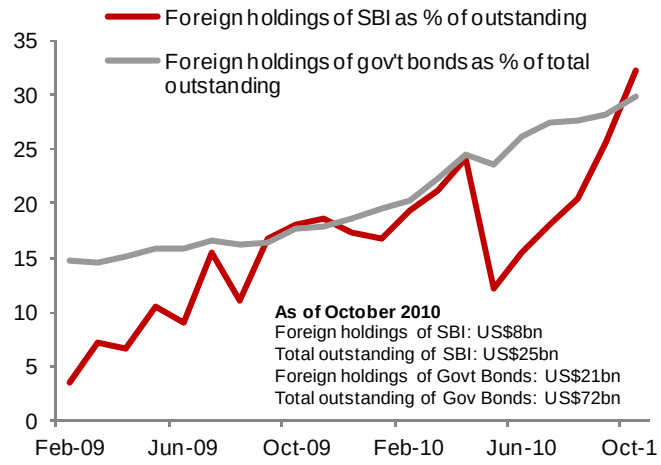
Source: CEIC, Nomura.

Exhibit 30b. Foreign Positioning - Korea Bond



Source: CEIC, Nomura

Exhibit 30c. Foreign Positioning - Indonesia Bond



Source: CEIC, Nomura.

Exhibit 30d. Foreign Positioning - India Bond

Source: CEIC, Nomura.
Note: Includes all debt instruments by all issuers

Exhibit 31. Foreign Positioning - Asia Equity

	India	Indonesia	Philippines	Korea	Taiwan	Thailand	China	Hong Kong	Malaysia	Singapore
	%	%	%	%	%	%	%	%	%	%
12/31/2007	16.7%	**19.0%**	18.5%	**23.3%**	**21.9%**	21.9%	8.7%	12.3%	**16.5%**	**25.7%**
1/31/2008	17.6%	18.3%	**18.5%**	22.3%	21.3%	23.2%	8.4%	12.1%	16.2%	25.0%
2/29/2008	17.7%	18.5%	18.1%	22.1%	21.5%	24.5%	8.3%	11.9%	16.3%	24.5%
3/31/2008	**18.0%**	17.7%	18.0%	21.4%	21.3%	24.8%	8.1%	12.0%	15.9%	24.7%
4/30/2008	17.7%	17.8%	17.6%	21.5%	20.9%	**24.9%**	8.1%	12.2%	15.8%	25.0%
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
10/31/2008	17.9%	18.6%	16.4%	19.8%	18.3%	21.4%	8.3%	14.2%	13.8%	22.3%
11/28/2008	17.6%	17.4%	17.0%	18.2%	18.0%	20.8%	8.2%	13.5%	13.7%	22.1%
12/31/2008	16.7%	17.4%	15.7%	18.6%	18.0%	20.3%	9.3%	13.7%	13.7%	21.7%
1/30/2009	17.1%	18.3%	15.2%	18.8%	17.6%	20.2%	9.1%	13.5%	13.6%	21.3%
2/27/2009	16.8%	17.6%	15.5%	18.2%	17.4%	20.1%	9.0%	13.3%	13.6%	20.6%
3/31/2009	17.1%	17.6%	15.2%	18.1%	17.5%	20.2%	8.9%	13.2%	13.5%	21.1%
4/30/2009	17.5%	18.0%	15.8%	18.5%	18.3%	20.3%	9.1%	13.8%	13.9%	21.7%
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
5/31/2010	16.9%	17.9%	15.9%	20.9%	19.4%	19.9%	9.8%	12.3%	15.1%	23.1%
6/30/2010	17.1%	17.9%	15.5%	21.1%	18.4%	19.9%	9.9%	12.6%	15.1%	23.1%
7/30/2010	17.3%	17.9%	15.4%	21.3%	18.7%	20.1%	9.4%	12.6%	15.4%	23.3%
8/31/2010	17.1%	17.8%	15.3%	21.2%	18.5%	20.1%	8.9%	12.4%	15.5%	22.9%
9/30/2010	18.1%	18.2%	15.6%	21.4%	19.5%	20.5%	8.7%	12.6%	15.9%	23.4%
10/29/2010	18.1%	17.7%	15.0%	21.7%	19.6%	20.6%	8.8%	12.2%	15.7%	23.2%
11/30/2010	18.4%	17.3%	13.6%	21.9%	19.7%	20.5%	8.5%	12.4%	15.3%	23.3%

Source: CEIC, Bloomberg, Nomura.

Appendix B – Seasonality in USD/Asia FX

We test for monthly seasonality in Asian FX[61] using dummy variables regression and information ratios. In the former approach, we regressed log returns of currencies on dummy variables (that give a value of 1 for a particular month and 0 elsewhere). There was evidence of December and January effects in some Asian currencies. We summarize some interesting findings below:

Exhibit 32. Stronger evidence of a January effect when we exclude the US financial crisis years

Annualised Information Ratio (1999-2007)

Month	SGD	TWD	THB	KRW	IDR	PHP	INR
January	-0.6	2.1	2.4	2.6	-0.7	1.9	1.2
Feburary	-0.9	-0.6	-0.9	-1.1	-0.5	-0.1	-1.7
March	-1.0	-0.6	-0.9	-1.1	-0.8	0.4	1.5
April	1.0	0.6	0.3	2.7	0.1	0.5	0.3
May	-0.3	-0.4	-0.6	1.1	-0.1	-0.3	-1.6
June	-0.9	-0.3	-0.1	0.6	0.5	-2.8	-0.3
July	3.2	-2.6	-1.3	-0.6	0.5	-1.1	-0.5
August	1.2	-0.8	0.5	0.4	-0.3	-0.4	-1.5
September	-0.2	-0.9	-1.3	-0.2	-1.6	-0.5	1.1
October	0.7	-0.6	1.0	0.4	0.3	-0.6	0.5
November	1.3	1.1	1.3	0.5	-1.0	1.0	-0.6
December	3.5	0.8	2.2	-0.1	0.8	2.5	2.4

Source: Bloomberg, Nomura.
Note: Positive number means local FX has appreciated against USD. Annualised information ratios larger than 2.0 or smaller than -2.0 are highlighted in pink.

Annualised Information Ratio (1999-2009)

Month	SGD	TWD	THB	KRW	IDR	PHP	INR
January	-0.9	1.1	2.3	0.4	-0.7	2.5	1.1
Feburary	-0.7	-0.2	-0.2	-1.4	-0.8	-0.9	-1.7
March	-0.3	0.8	-0.3	-0.2	-0.5	-0.1	1.5
April	1.8	1.0	0.3	2.3	0.6	0.1	0.3
May	0.2	0.1	-0.4	0.9	0.1	-0.4	-0.5
June	-0.8	-0.4	-0.6	-0.2	0.5	-3.4	-1.3
July	2.6	-2.8	-1.2	0.7	0.7	-0.7	0.1
August	0.1	-1.3	0.1	-0.9	-0.4	-1.1	-2.2
September	0.1	-0.5	-0.8	-0.4	-1.3	-0.2	-0.3
October	0.1	-1.3	0.4	-0.8	-0.2	-0.9	-0.1
November	0.6	1.0	1.0	-0.2	-1.3	1.1	-0.5
December	2.1	1.3	2.2	0.9	1.4	3.2	2.6

Source: Bloomberg, Nomura.
Note: Positive number means local FX has appreciated against USD. Annualised information ratios larger than 2.0 or smaller than -2.0 are highlighted in pink.

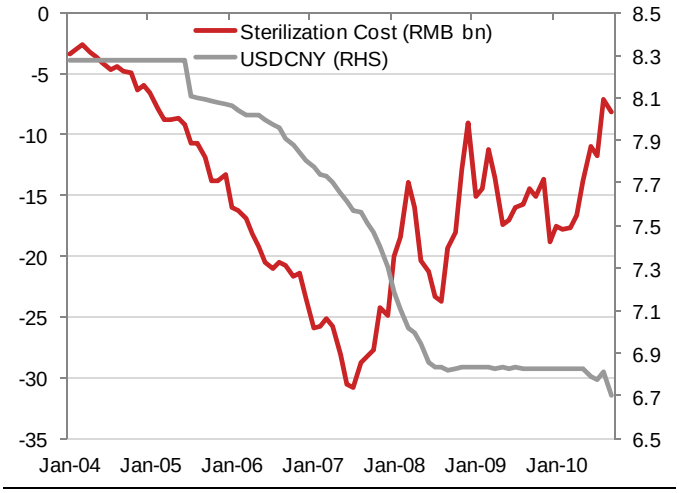
Perceptions of asset allocation in December and January into Asia for the year ahead were evident in December in our full sample analysis (1999-2009) with almost all holding relatively high information ratios. Those with information ratios above 2.0 are also statistically significant in our coefficient of seasonal dummy variables (Exhibit 32). However, the "January effect" was less evident and a closer look reveals that returns for January 2009 (after the US financial crisis) could have skewed the results of our small sample analysis. Excluding 2008-09 from our analysis (avoiding the impacts of the US housing and financial crises), Asia FX demonstrated more consistent outperformance in January (1 more significant coefficient and higher information ratio) (Exhibit 32).

61) See *Asia FX Insights: Lunar New Year effect and monthly seasonality*, 21 January 2010.

Appendix C – Asian sterilisation costs

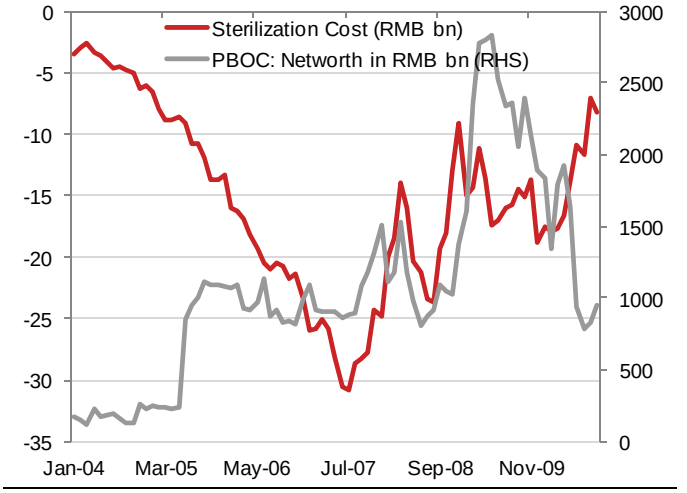
Central banks' FX reserves have been assumed to be invested in US (70%) and EU (30%), within which 40% are in short-term Treasury bills (3m) and 60% in 10yr Treasury bonds and a weighted yield on these instruments is considered as the net interest earned by the central banks on FX reserves. Net monthly sterilisation costs have been computed by taking a difference of monthly interest expense on the sterilisation instruments and monthly interest income on FX reserves as specified above.

Exhibit 33a. China – sterilisation cost



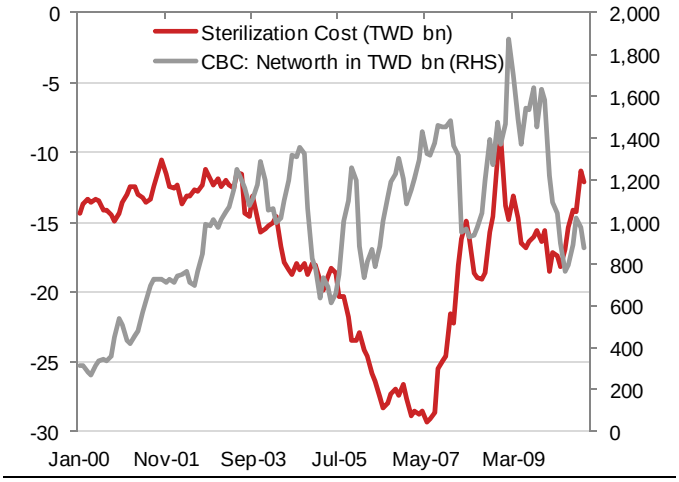
Source: Bloomberg, CEIC, Nomura.
Note: Sterilisation instruments for China are required reserve requirement, bank bills and Repo Operations.

Exhibit 33b. PBOC – Net worth and sterilisation cost



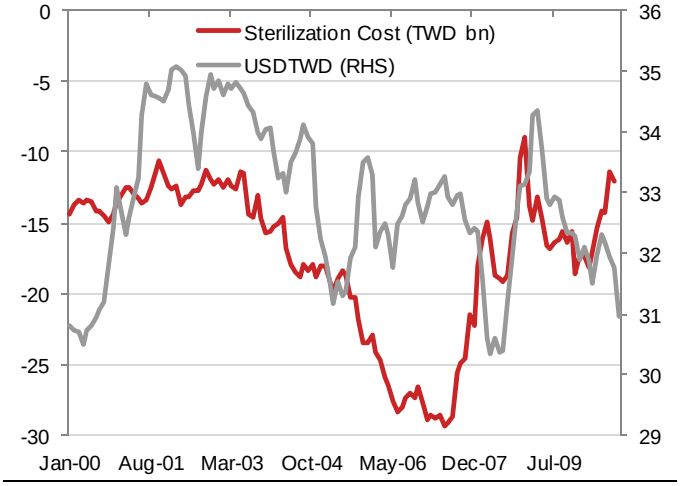
Source: Bloomberg, CEIC, Nomura.
Note: PBOC's networth is proxied from paid-up capital and other liabilities.

Exhibit 34a. Taiwan – sterilisation cost



Source: Bloomberg, CEIC, Nomura.
Note: Sterilisation instruments for Taiwan are CDs and NCDs issued by CBC.

Exhibit 34b. CBC – Net worth and sterilisation cost



Source: Bloomberg, CEIC, Nomura.
Note: CBC's networth is a difference of CBC's total assets and total liabilities.

Appendix D – Nomura Asia FX forecasts

Exhibit 35.Asia FX Forecasts

	3-Dec-10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12
MYR	3.15	3.08	3.00	2.97	2.93	2.88	2.84	2.80	2.76	2.72
PHP	43.8	43.2	42.4	41.9	41.4	40.9	40.4	39.9	39.4	38.9
SGD	1.31	1.29	1.27	1.25	1.24	1.22	1.21	1.20	1.18	1.17
THB	30.0	29.5	29.0	28.5	28.1	27.8	27.6	27.3	27.1	26.8
TWD	30.3	30.0	29.6	29.3	29.0	28.7	28.4	28.1	27.8	27.5
KRW	1139	1110	1080	1060	1040	1020	1005	990	975	960
CNY	6.66	6.60	6.50	6.40	6.30	6.22	6.14	6.06	5.98	5.90
HKD	7.77	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
IDR	9010	8970	8900	8800	8680	8520	8440	8360	8280	8200
INR	45.1	44.6	44.1	43.4	42.8	42.3	41.8	41.3	40.8	40.3

Source: Nomura.

Appendix E – PCA on Asia growth impact

We quantify how Asian currencies are related to global growth, local growth factors and the broad dollar effect through a simple OLS regression on the MSCI Global equity index (as a proxy for global growth), the MSCI EM Asia equity index (proxy for local growth) and the broad dollar index.

However, given the problem of multi-collinearity due to high correlation between these factors, we resolve this issue by applying principle components analysis (PCA) on these variables to construct three orthogonal components that have zero correlation to one another. The loadings of these three components suggest that they can be intuitively classified as Global Growth factor, Local Growth factor and Dollar factor.

Exhibit 36 gives the PCA component loadings. We have used weekly non-overlapping return data since January 2000. The first component is mostly a linear combination between MSCI Global and MSCI EM Asia equity returns which can be broadly viewed as a proxy for global growth. The second component is mainly MSCI EM Asia returns subtracted from MSCI Global equity returns, which is a proxy of Asian local growth. The third component is mainly a factor of broad dollar returns.

Exhibit 36. PCA components loadings

Loading of PCA Components (2000 to Nov-2010)			
	1st Comp	2nd Comp	3rd Comp
Variance Contribution	*81%*	*13%*	*6%*
DXY	-10%	15%	**98%**
MSCI Global	**59%**	**-78%**	18%
MSCI EM Asia	**80%**	**60%**	-1%

Source: Bloomberg, Nomura.

From the results of multiple regression (Jan-2000 to Nov-2010), we can quantify the influence of these factors on the Asian currency index.

$$R_{ADXY} = \beta_1 R_{DollarFactor} + \beta_2 R_{GlobalGrowthFactor} + \beta_3 R_{LocalGrowthFactor}$$

where,

$$\beta_1 = -15.2\%, p - value = 0.0\%$$
$$\beta_2 = 7.7\%, p - value = 0.0\%$$
$$\beta_3 = 1.1\%, p - value = 14.8\%$$

All regression coefficients have correct and intuitive signs and significant p-values, albeit the third coefficient is slightly off the 10% cut-off.

Using data from Jan-2000 to Dec-2007 for the regression analysis, we obtain a similar set of betas with a higher beta for local growth.

$$\beta_1 = -14.3\%, p - value = 0.00\%$$
$$\beta_2 = 5.6\%, p - value = 0.00\%$$
$$\beta_3 = 2.9\%, p - value = 0.13\%$$

Box: Nomura's USD/CNY fixing model

Kewei Yang, Prashant Pande

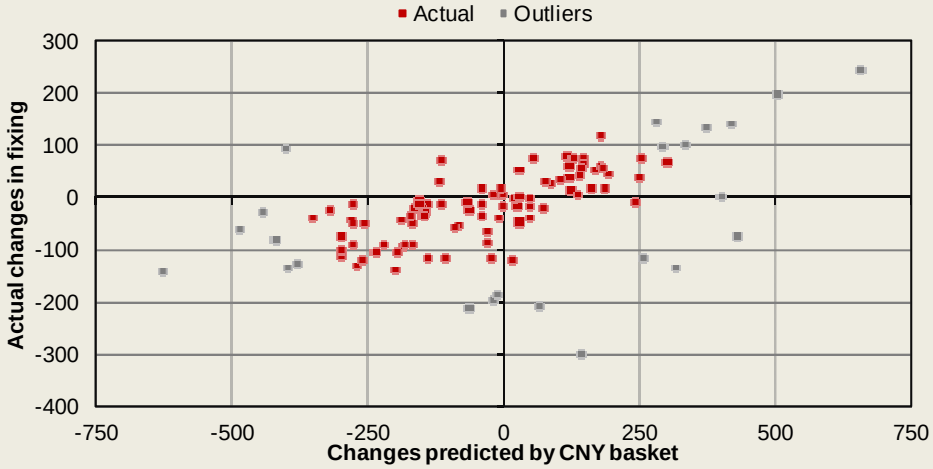
Following the PBOC's announcement on 19 June that it was proceeding with further flexibility of the CNY FX regime, emphasising market demand and supply, we created a basket based model to forecast the USD/CNY fix. Out-sample results since our model creation suggest that there is great predictability in the direction of the USD/CNY fix from utilising our basket (see *Asia FX Insights – Forecasting the USD/CNY fix*, 26 June 2010).

However, the PBOC has explicitly stated that it makes reference to a basket of currencies (rather than manage USD/CNY). There are other unknown factors, alluded to by the China Foreign Exchange Trading System (CFETS) that the authorities use to determine the fix. Hence, it is not surprising that there are relatively large errors in forecasting the value of the fix.

Over time, we noticed that the direction was predicted accurately on about 81% of occasions, but the magnitude of change predicted could be improved. Intuition upon recent observations motivates us to improve the accuracy of the magnitude of prediction from the basket.

We therefore build a mathematical model that modifies the magnitude of the predicted change while preserving the direction of prediction. The model must be flexible enough to adapt to the trend seen in the previous actual and predicted fixings (see Exhibit 1). Based on the above criteria, we fit a variation of sigmoid function using recent observations of basket predicted changes and actual changes in USD/CNY fixings.

Exhibit 1. Actual USD/CNY fixing changes vs. predicted changes (pips)



Source: Bloomberg, Nomura. Note: Data from 21 June to 3 December 2010.

Methodology:

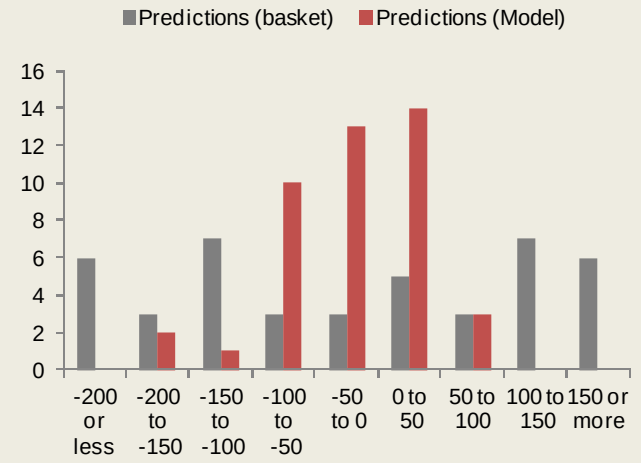
The broad methodology involves filtering out some of the extreme values of predicted and actual changes. We use a clustering algorithm to filter out these outliers and optimise the parameters of our sigmoid function on the observed values of actual and predicted fixings. The parameters are then fed into the model to predict the change in the next fixing. The parameters were first optimized using 60 data points available from 21st June to 13th September to predict for 14th September. Since then, the model is optimized on a daily basis. It dynamically learns and adapts to the trends in fixing changes. .

Results:

The model was back-tested on data from 14 September to 3 December 2010. The results for fixings with correct directional prediction are listed in Exhibit 2. All the predictions listed in Exhibit 2 are out-sample results. It clearly indicates that the modified predictions are closer to the actual changes in fixing. The average error compressed significantly from 153 pips to 46 pips.

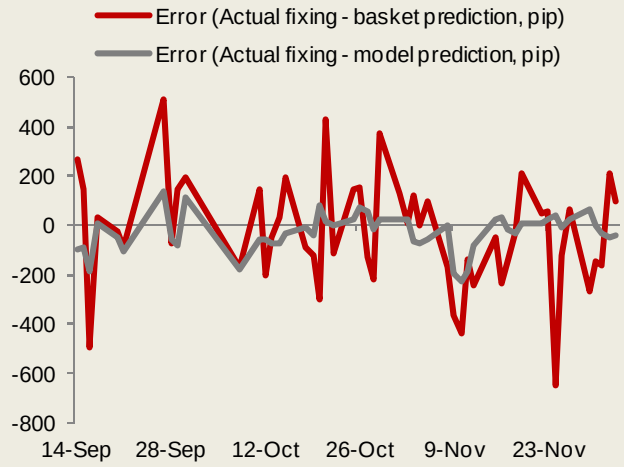
Exhibit 3 shows the variation of the fixings based on actual changes, changes predicted by the basket and changes predicted by the model. We can see that the predictions made by the new model follow the actual fixings more closely than the original basket predictions.

Exhibit 2. Variation of errors (pips) decreases significantly (14 September to 3 December)



Source: Bloomberg, Nomura.

Exhibit 3. Error in predictions



Source: Bloomberg, Nomura.

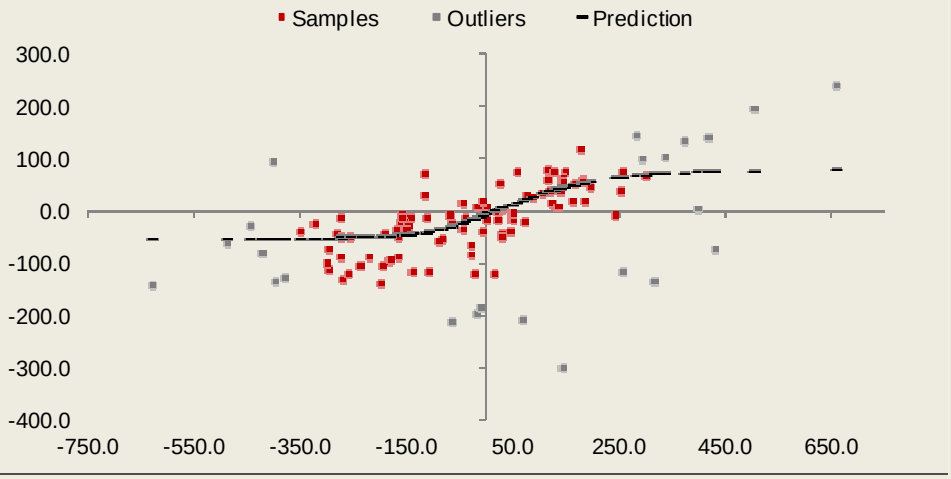
Conclusions

In order to improve the accuracy of our model in terms of magnitude prediction, we assume a nonlinear sensitivity of actual fixing changes to basket-implied changes. In this way, the accuracy of magnitude prediction is largely improved while the directional accuracy is maintained.

According to the data points to date, we see that:

1. USD/CNY fixing has by and large followed the basket, as evidenced by an impressive 81% hit ratio from 21 June to 3 December 2010 (111 observations);
2. Asymmetrical bias on USD/CNY, similar to July 2005 to June 2008. From 21 June to 3 December, 13 of 21 wrong predictions from our fixing model came when the USD/CNY fix should have been higher, but actually fell. Fixings are also more likely to be lower (negative readings), over the same period (65 out of 111 observations);
3. But the actual fixing change/predicted fixing change ratios are smaller when fixings are expected to be lower. This means that even though the actual fixings do follow a basket movement, the magnitude of downward changes is contained more than upward changes.
4. Furthermore, actual fixings are less responsive to extreme movements in the basket, which help keep the daily volatility low and stabilize the USD/CNY path.

Exhibit 4. Prediction of model for existing sample



Source: Bloomberg, Nomura. Note: Data from 21 June to 3 December 2010.

Outlook Article

Asian interest rate strategy 2011: History ryhmes

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We retain a positive view on Asian interest rate markets into 2011. Our view is underpinned by several factors: 1) an ongoing regional economic slowdown; 2) our assumption that there will be less pass-through of high commodity prices to underlying inflation than the market believes; 3) the changed reaction function of regional central banks who are less inclined to tighten policy into a commodity price-driven rise in headline inflation than they were in 2007-08; 4) regulatory changes in the global banking, insurance and pension industries, which are spurring demand for duration; and 5) a bias among regional policy makers to tighten monetary conditions via exchange rates rather than interest rates.

However, there are clear risks to our view. There is the potential for the market to express a view that Asia faces a commodity-driven period of sharply higher inflation and higher yields. Secondly, the fear that policymakers will impose tighter capital controls which could disrupt fixing rates in Asia, or at the extreme, allow central banks to raise interest rates by more than we assume. We are comfortable with these risk factors, but suggest some ways to express a bullish view on Asian interest rate markets which takes into these risk factors. For instance, forward starting curve steepeners involving a received position in the Reds/Greens in selected markets in Asia will have the properties of a received position, but with the added potential for investors expressing the "inflation trade" to do so via paying interest rates in the 5-10 year part of the curve. We also suggest ways to hedge fixing risks in Asian markets caused by periods of increased funding market stress.

"History never repeats itself, but it rhymes"

Our Asian interest rate market outlook for 2011 has many similarities with our outlook a year ago. Now, as then, we recommend investors maintain a long-duration bias, and we favour forward starting curve steepeners which have the properties of "received" positions at the front end of regional yield curves. We also expect market trends to be driven by many of the themes we highlighted a year ago: we believe that the front end of many Asian yield curves are too steep as they price-in an overly aggressive monetary tightening cycle; global regulatory trends will spur demand for fixed income products and in particular government bonds; US economic recovery will remain softer than expected; we are more sanguine on inflation risks in Asia than the market.

However, there are more risk factors to our view than a year ago:

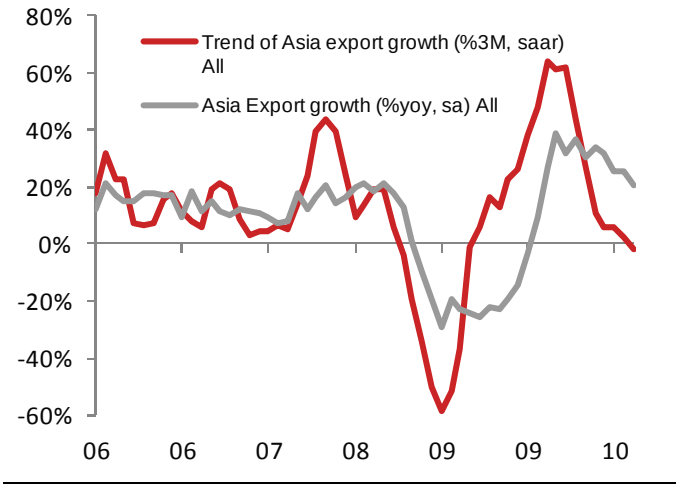
- **Market positioning.** A year ago our bullish interest rate view was clearly counter-consensus. This contributed to the pronounced early year rally in Asia interest rate markets as "paid" positions were closed-out. At present, while the market is still biased to 'pay' Asian interest rates, positions are lighter and views more balanced, which means that positioning risk is more symmetric than at the start of 2010.
- **Capital controls.** The willingness of Asian regulators to re-regulate capital flows raises the potential for central banks to tighten monetary conditions more via interest rates than via currency appreciation.
- **The "inflation trade".** The growing market consensus is that regional policymakers will need to respond aggressively to rising inflation risks caused by high commodity prices. While we are far more sanguine on Asian inflation risks than the market, there is clearly a non-negligible risk of the market expressing an "inflation trade" through broad-based "paid" positions in regional IRS curves.

Below we highlight the main factors underlying our bullish duration view on Asian markets. We then outline the risk factors before, in our third section, expressing the various trading strategies which we recommend as ways to express our core view, taking into account the risk factors.

Part 1: The arguments for long duration positions in Asian interest rate markets

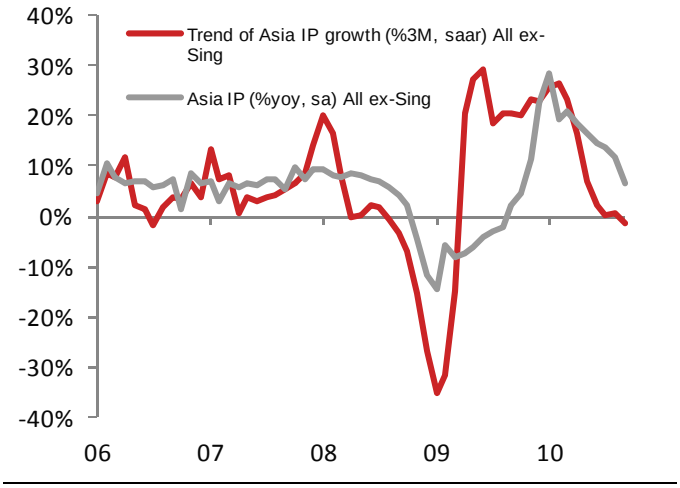
Below we highlight the main factors which underpin our positive view on Asian interest rate markets. Unlike last year, we do not focus on G3 bond markets and in particular USTs. This is because – despite the recent rise in UST yields – the market has become increasingly comfortable with the view that any rise in UST yields will be contained by the steepness of the curve, the structural demand for USTs stemming from deleveraging flows and regulatory factors (see below) and the likely maintenance of the 0.0-0.25% fed funds target rate over the medium term. As such, while our last year ahead outlook had to focus considerable space in outlining our bullish view on USTs, this year we feel able to focus on more regional factors. Nomura's house view sees 10yr UST yields within a 2.25-3.50% range in 2011.

Exhibit 1. Asian export growth is slowing...



Source: Nomura Research, Bloomberg.

Exhibit 2. ...which is paring back output growth



Source: Nomura Research, Bloomberg.

Business-cycle dynamics – Asia does not require restrictive policy settings

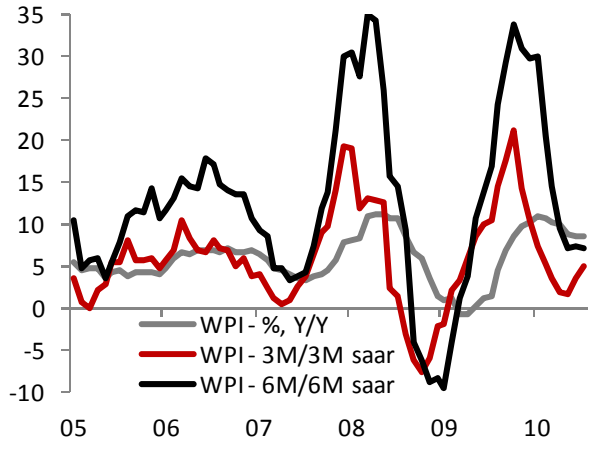
In 2011, economic growth is expected to slow across the region, which reflects the fading impetus to growth created in 2009-10 by global manufacturing sector inventory rebuilding and by the positive external shock of a fiscal-stimulus-induced bounce in G3 demand. Indeed, as US economic growth slowed to below-trend levels of output in H2 2010, the momentum of Asian economic growth has slowed. The deceleration of growth has been most evident in the region's more industrialized economies. In Korea, the 3M/3M saar growth rate of industrial production declined by 20.9% in October, while in Taiwan it declined by 9.2% in September. Exhibits 1 and 2 show the current deceleration in the momentum of regional export and industrial production growth in terms of 3M/3M saar changes. This deceleration of output is tending to be ignored as the market instead focuses on still high year-on-year growth rates which are inflated by a base effect. The notable current exception is China, where the authorities continue to encourage a surge in investment activity financed by rapid credit growth. Strong Chinese demand remains an important factor in limiting (but not obviating) the impact of weaker G3 demand in other Asian economies, but in terms of Chinese interest rate markets these are driven by interbank liquidity conditions rather than domestic growth, inflation and policy trade trends, and hence provide an inefficient way of expressing views on the Chinese business cycle. Moreover, we expect slower Chinese growth in 2011 as the

authorities rein-in both credit and investment growth. The government announced on 3 December that it will shift its monetary policy stance from “relatively loose” to “prudent” next year.

Meanwhile, as our Asian Economic research team notes, there are upside risks to headline inflation in Asia given their assumption of high commodity prices. However, the market has tended to consistently over-estimate the degree of second-round inflation effects which stem from food and energy price gains in Asian markets. This is most evident in India and China where commodities feature heavily in inflation baskets, but where periods of commodity-driven inflation tend to result in swift periods of disinflation over the subsequent 12 months as second-round inflation effects prove muted. This creates an opportunity to receive interest rates into the latter stages of a phase of commodity-driven inflation since yield curves tend to price in notable second-round inflation effects which rarely materialize to the extent assumed.

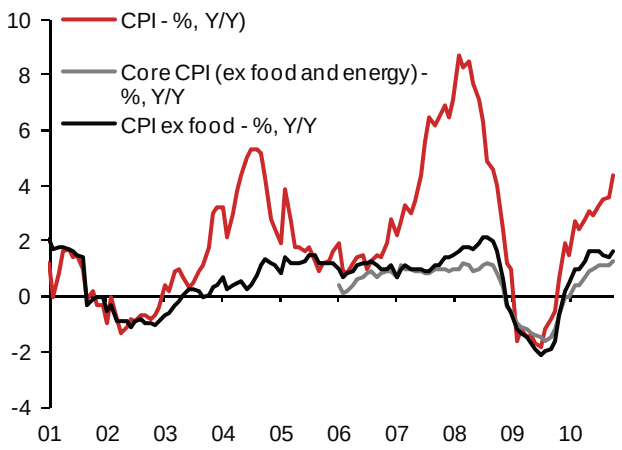
Instead, in the 12 months following a commodity driven rise in Asian inflation, base effects tend to dominate second-round effects and result in a period of swift disinflation. This partly reflects how high food and energy prices, in the first instance, represent a squeeze in disposable incomes which tends not to be fully compensated for in the form of offsetting wage increases. Hence, headline inflation tends to converge to core rather than vice versa. Korea is exhibiting a widening divergence of headline and core inflation. While November’s headline CPI rose by 3.3% y-o-y, core inflation rose by just 1.8%, comfortably within the Bank of Korea’s 2.0-4.0% target band.

Exhibit 3. India tends to experience steep disinflation after a commodity driven rise in prices



Source: Nomura Research, Bloomberg.

Exhibit 4. Underlying Chinese inflation is milder that headline inflation



Source: Nomura Research, Bloomberg.

Similarly, in China, while headline inflation rose to 25-month high 4.4% y-o-y in October, core CPI was a far more modest 1.3% y-o-y. The trend is even clearer when looking at goods prices in China as measured by the RPI. Despite market fears of higher manufacturing sector wage settlements and high commodity prices resulting in higher Chinese goods prices, a 3.9% y-o-y rise in the headline RPI in October contrasts with the 0.0% y-o-y rise in core RPI. With the post-Q4 2008 surge in Chinese investment resulting in a steady supply of fresh manufacturing capacity, we find it hard to get too concerned over Chinese goods price inflation.

Our assumption of decelerating economic growth and more muted second-round inflation effects than the market expects, means that Asian policy settings do not need to move into restrictive territory. When combined with the point below – the changed reaction function of regional central banks – business-cycle dynamics actually suggest that monetary conditions will remain accommodative across much

of Asia into 2011, with the pace and extent of policy tightening again falling short of that priced-in to most forward curves.

The changed reaction function of regional central banks – tightening to again fall short of forward curve pricing

Another of our central strategy assumptions is that the market has not acknowledged how the reaction function of most regional central banks has changed since the experience of H1 2010, when regional central banks in the region believed that the key risks to their economic growth and inflation forecasts were on the upside and were looking to tighten monetary policy. The 2008-09 collapse in global and regional economic growth reduced many Asian policymakers confidence in the concept of economic "decoupling" from G3 growth. Moreover, fewer central banks are willing to aggressively tighten monetary policy in response to a rise in headline inflation that is driven by food and energy price gains unless there is clear evidence of second round inflation effects.

However, the market tends to view Asian central bank reaction functions as being largely unchanged from H1 2008. As a result, throughout 2010 for almost all markets in Asia ex-Japan, the pace of monetary tightening has fallen short of that which has been priced into forward curves, which has spurred our bias to recommend investors receive interest rates in the overly steep 1-3 year part of Asian yield curves. In 2010, only two central banks in Asia – The Reserve Bank of India (RBI) and Bank Negara Malaysia (BNM) – tightened monetary policy and pushed the IRS fixing rate up by more than the market was forecasting at the end-of 2009, according to our model of interest rate expectations. Moreover, in the case of India while at end-2009 the market was forecasting a 3M MIBOR rate of 6.79% compared to current levels of 8.29%, the reason for this overshoot of market forecast is the RBI's inability to avert tight liquidity conditions. The market's original end-2010 3M MIBOR forecast is actually above the current 5.25-6.25% RBI policy corridor. By contrast, the KRW IRS market was forecasting a 91-day CB fix of 4.47% at end-2010, whereas the current 2.80% level is actually 6bp below the end-2009 fix.

Our latest model which shows the degree of fixing rate increases priced into regional IRS curves (*Asian Local Market Rate Expectations*, 2 December 2010) shows how many markets the Whites/Reds are too steep in. In Singapore for instance, the IRS curve prices in a 36bp increase in the SGD 6M SOR over the coming 12 months, which would be in addition to the 31bp a year term premium. As we discuss below, such an increase would require either a sustained rise in USD Libor rates or a notable period of SGD depreciation against the USD, neither of which we expect. In New Zealand, the IRS curve prices in a 61bp increase in the 3.20% 3M Bank Bill fixing rate over the coming 12 months, which is in addition to 14bp a year term premium, which again we believe overstated the degree to which the Reserve Bank of New Zealand (RBNZ) will tighten policy. Even in Taiwan, where the IRS curve prices in just a 35bp increase in the 0.59% fixing rate over the next 12 months, the curve seems overly steep: Taiwan's central bank has paused its tightening cycle, which tends to amount to 12.5bp hikes per quarter, which translates into just a 6-7bp increase in the fix.

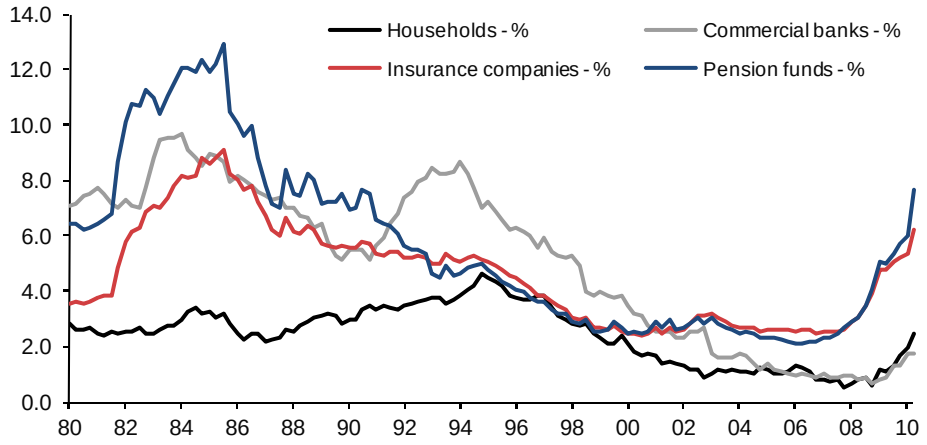
Regulatory changes to spur duration demand for duration

Over the past two years we have forecast that the OECD and more advanced emerging markets will experience a structural asset allocation into fixed income instruments, but in particular government bonds. This asset allocation is clearly already taking place. Latest US data, for instance, show that in Q2 2010, 2.4% of household financial assets were held in USTs, up from a record low of just 0.5% in Q4 2008 and the highest proportion since Q4 1998. The US insurance industry held 6.2% of its assets in USTs, the highest since Q3 1988, while US pension funds held 7.7% of their assets in USTs, the highest since Q4 1998 (Exhibit 5). This trend is global and we believe it has further to run, and is in addition to demand for government bonds that may be created by ongoing trends of quantitative easing by central banks. Over the next eight months, for instance, the US Fed will purchase

USD110bn of USTs a month, which approximates the average monthly supply of fresh duration. Several factors underpin our assumption of continued asset allocation into fixed income:

- In light of asset market trends in the 1990s and 2000s and given the current low inflation environment, asset managers and households are likely to lessen their appetite for buying assets which provide capital gains relative to income-generating assets. Indeed, throughout much of the OECD, financial exposure to government bonds was reaching record lows heading into the financial crisis.
- Financial sector and household deleveraging in the more crisis-affected countries is fueling fresh demand for government bonds as the proceeds of debt repayment need to be reinvested. In the US, in the year to June, outstanding federal debt increased by USD1.47trn, but non-federal debt declined by USD2.12trn.
- Regulatory trends are expected to spur increased demand for government bonds. Below we discuss the key thrusts of regulatory reform as they impact the global banking, insurance and pension sectors.

Exhibit 5. US economic agents: the proportion of financial assets held in USTs - %



Source: Bloomberg, Nomura

Basel III – driving banking sector demand for duration

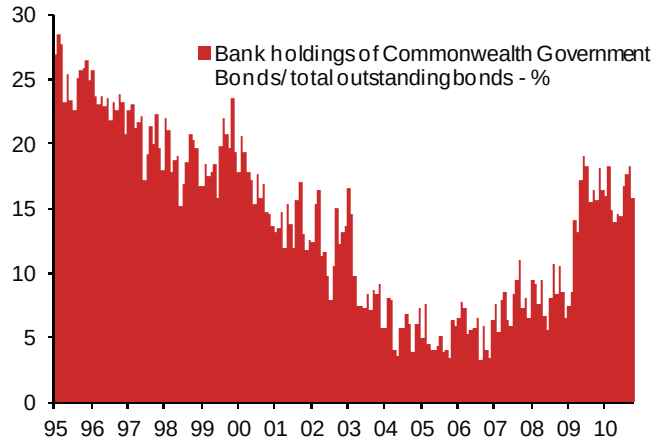
One of our longer-term strategy themes is the impact Basel III – and specifically the liquidity framework aspect of this regulation – will have on global interest rate markets:

- Basel III will require banks to accumulate a buffer of high-quality liquid assets eligible for central bank repo operations. Government bonds are likely to comprise a minimum of 60% of the liquidity buffer.
- Bank funding costs will increase as banks are penalized from obtaining short-term wholesale funding and are instead required to fund themselves with more long-term debt issuance and deposits.
- Banks are expected to pass on higher funding costs to customers in the form of wider lending rate spreads to the policy rate…
- …which effectively lowers the "neutral" policy rate.

These factors are positive for interest rate markets and as Basel III is implemented over the coming decade its impact will increasingly be felt across the OECD and more developed Asian markets (see *Asian Interest Rate Strategy - Basel III - A government bond friendly latest and potentially final draft*, 13 September 2010). Australia and New Zealand provide a guide to how the Basel III trends will unfold

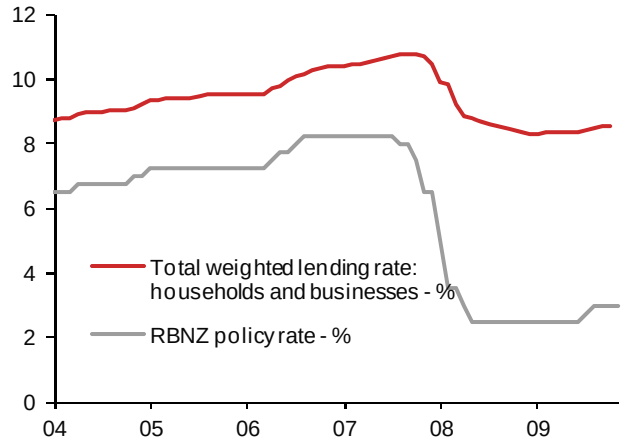
since both countries have been developing the liquidity framework since 2008. In both countries, there has been a clear asset allocation into government bonds by banks. In October, banks held 15.7% of all outstanding Australian government bonds, up from 6.4% at end-2007 (Exhibit 6), while in New Zealand in Q4 2010 banks held 24.7% of total outstanding bonds compared to 6.8% at end-2007.

Exhibit 6. The Basel III effect is spurring Australian bank demand or government bonds



Source: Nomura Research, Bloomberg.

Exhibit 7. The Basel III effect has tightened monetary conditions outside of RBNZ rate hikes

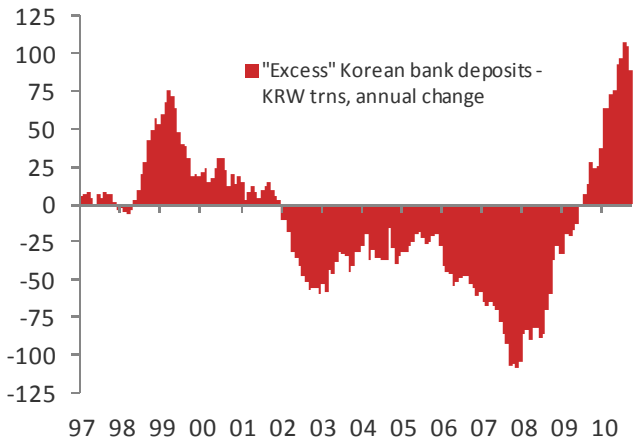


Source: Nomura Research, Bloomberg.

Meanwhile, there has been an equally significant impact on bank lending rate spreads. In Australia, the spread between the variable mortgage rate and the RBA policy rate has widened to 300bp from 180bp seen during the decade prior to the financial crisis. This widening of lending rate spreads underpins our assumption that the "neutral" policy rate for the RBA has declined by around 100bp due to the Basel III effect to around 4.50%. In New Zealand, the impact on bank lending spreads has been even more pronounced, and – we estimate – has lowered the RBNZ's "neutral" rate by at least 150bp to 4.50%. While the current 3.0% policy rate is 525bp below the 8.25% cycle peak in 2008, our measure of the aggregate weighted bank lending rate (which encompasses consumer lending rates, best corporate lending rates and fixed and variable mortgage rates) measures 8.55%, or just 224bp below the cycle peak of August 2008 (Exhibit 7). With monetary conditions far tighter than is implied by a 3.0% policy rate, we continue to recommend receiving the NZD Whites/Reds since the likelihood of aggressive RBNZ rate hikes is in our view less than the market expects (see *Asian Strategy Snapshot: Receive the NZD IRS 1yr*, 4 November 2010).

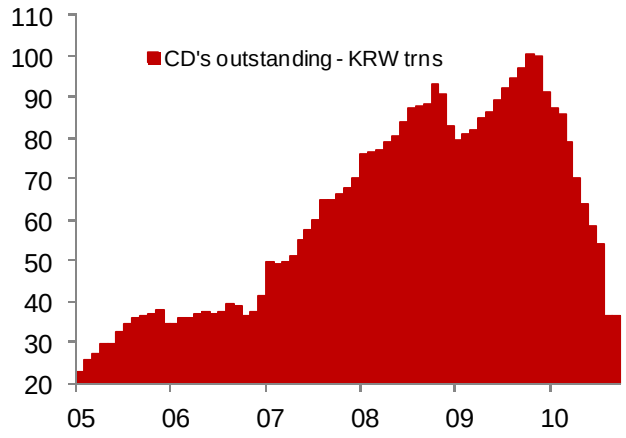
The other country that is relatively advanced in implementing Basel III is Korea, where the government is trying to reduce the banking sector's reliance on wholesale funding. It has targeted a banking system loan-to-deposit ratio of 1.0 by 2013 and has already got it down to 1.15 in September from 1.30 a year ago. The deleveraging of the banking system is helping to generate onshore demand for KTBs. In September, "excess" bank deposits (deposits minus loans and minus required reserves) grew by KRW88.6trn y-o-y, which is more than 2.5x the KRW34.9trn y-o-y increase in outstanding KTBs (Exhibits 8 and 9). Banking sector deleveraging has already significantly reduced the potential for finding market stress in Korea as banks are able to scale back their wholesale funding program. In September the value of outstanding CDs measured KRW36.5trn, which compares to a historic high of KRW100.3trn in October 2009. Banking sector deleveraging therefore improves our confidence that the 91-day CD fix in Korea will remain stable with regards the policy rate in 2011 (see *Korea: Is a withholding tax priced into the KTB and KRW FX markets?*, 15 November 2010).

Exhibit 8. Korean banks are rapidly deleveraging. Excess deposits: deposits minus loans and minus required reserves



Source: Nomura Research, Bloomberg.

Exhibit 9. Korean banks are reducing their reliance on short-term wholesale funding



Source: Nomura Research, Bloomberg.

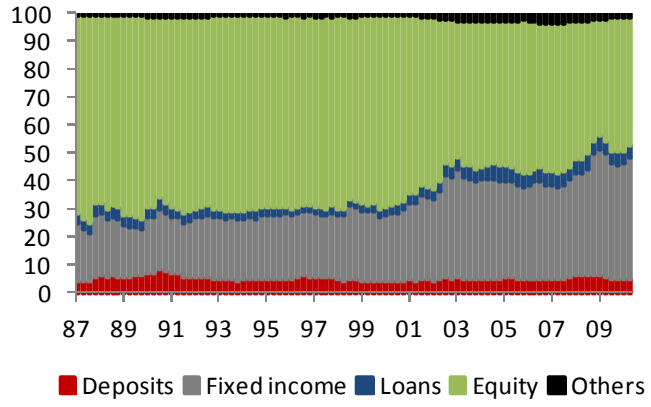
Insurance industry reform - Solvency II

The insurance industry is experiencing its own wave of regulatory changes aimed at increasing systemic resilience. The main thrust of insurance industry regulation is termed Solvency II. The key element of Solvency II is to strengthen the balance sheets of insurance companies by implementing a more rigorous set of capital requirements, both a Solvency Capital Requirement and a Minimum Capital Requirement. As part of this process, Solvency II introduces into the insurance industry the risk-weighted capital requirements which were inherent in the Basel II reforms for the banking system.

While this is an EU-driven regulatory drive – and due to be implemented in the EU by end-2012 – the key principals of this framework are being adopted by global regulators and specifically by regulators in Asia's more developed financial centres, such as Korea, Hong Kong and Singapore. Indeed, in Korea the insurance industry is preparing for a move to risk-based capital measures to be implemented in April 2011 and which is spurring increased demand for duration.

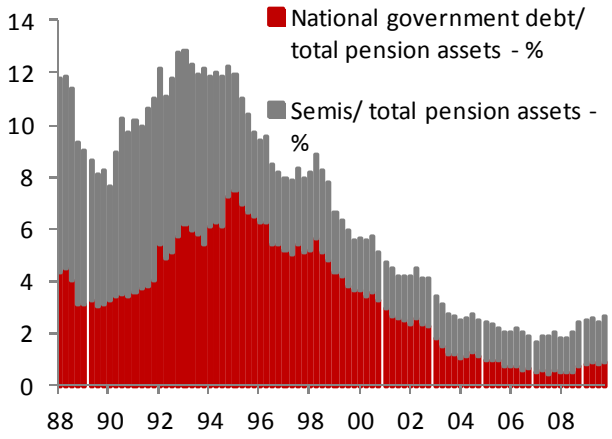
The natural implication of risk weighted capital is that insurance companies have less incentive to increase their exposure to "riskier" assets which carry higher risk weightings compared to government bonds. In this respect, Solvency II is expected to support an asset allocation of insurance company assets towards risk-free assets. This demand for duration is already evident in Asian markets where insurance companies are increasing their asset allocation into government bonds or – where market liquidity falls short of potential demand - generating duration by receiving IRS or purchasing structured products that replicate duration exposure. We believe this trend will remain a multi-year phenomenon despite Asian insurance companies tending to already have a far larger portion of their assets held in government bonds than is the case with US or European firms. Korea has one of the largest Asian insurance industries, with total assets measuring USD340bn, or around a third of GDP. While government bonds comprised a record 44% of all assets in August, up from 39.1% at end-2007, insurance company balance sheets still comprise a sizable portion of assets which are likely to face a higher risk weighting: in August real estate assets measured 4.1% of total assets, while outstanding loans measured 22.3% of assets.

Exhibit 10. The UK insurance industry is increasing its allocation to bonds: assets / total assets - %



Source: Nomura Research, Bloomberg.

Exhibit 11. Australian banks are expected to further increase their holding of AUD government bonds



Source: Nomura Research, Bloomberg.

Pension industry reform - IAS 19

Pension industry reform is also expected to add to structural demand for interest rate products. The International Accounting Standards Board is currently encouraging discussion of a series of proposed accounting changes (IAS 19) which it hopes to have finalised by mid-2011 ahead of formal implementation in 2013. There are two aspects of the proposed changes that have particular bearing on interest rate markets:

- **Corridor accounting change.** IAS 19 proposes that pension fund liabilities are formally brought onto balance sheets, thus forcing companies to crystalise these liabilities as losses. This will result in declining levels of profitability among pension funds with unfunded liabilities, and could lead to the need for capital raising. These circumstances are likely to create a more "risk averse" investment strategy by pension funds over the coming years, especially in light of the second key change.
- **Return on asset assumptions.** Pension funds will need to make the expected return on their asset equal to the discount rate used on their liabilities and interest costs. This is aimed at preventing pension funds from failing to address funding short-falls by assuming overly optimistic returns from their assets. This policy directly reduces the incentive for pension funds to increase their allocation to riskier assets such as equities since firms can only account for expected returns rather than ease balance-sheet risk by assuming high rates of future returns. This reform is supportive of pension funds increasing their allocations towards fixed income securities.

This regulatory change is likely to have an increasingly important bearing on Asian financial markets given the rapid growth in the region's pension industry. At present the largest pension industry in Asia ex-Japan is Australia's, where the superannuation market had assets under management (AUM) of AUD1.23trn as of Q2 2010. Elsewhere in Asia, state pension schemes often dominate AUM, most notably in Singapore's Central Provident Fund. However, there is a growing trend to outsource public management of pension fund assets to private sector managers in Asia. Moreover, in many markets, private pension industries are rapidly expanding and there remains significant room for further growth. In Korea, for instance, despite rapid growth in private sector pensions since the government enacted supportive legislation in 2005, currently only 15% of companies have corporate pensions.

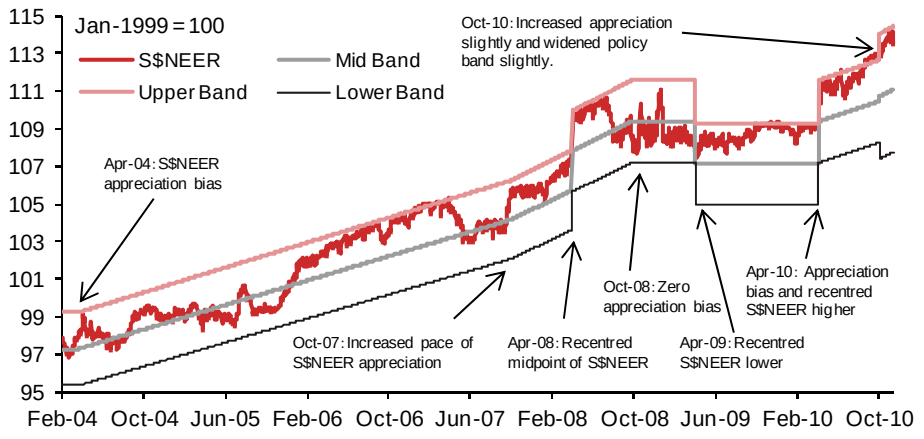
Monetary tightening via exchange rates

We continue to believe that monetary conditions in Asia will be tightened at least in part by exchange rate appreciation, which will lessen the need for interest rate increases and thus help policy rates/fixing rate increases fall short of the pricing of forward curves. For many countries, tightening monetary conditions via exchange rates rather than interest rates is a more optimal policy response:

- The key source of inflation in Asia derives from food and energy prices, which are exogenous to interest rate policy but where a stronger currency can reduce the scale of commodity inflation in local-currency terms.
- Regional exchange rates remain generally undervalued and have room to appreciate before the region encounters notable competitiveness issues. In contrast, in many countries the domestic economy is a source of relative weakness. This is most notable in Korea where the Bank of Korea's (BOK) reluctance to raise interest rates swiftly reflects the weakness of the domestic construction sector and the more domestically focused SME sector, which accounts for 85% of Korean employment. (While large-scale Korean industrial companies have increased their output by 30.8% since the start of 2007, SME companies have only increased their output by 8.5%).
- Asia's exchange rate policies and persistently large current account surplus is increasingly a focus of global trade frictions. With the US, Japan and the Eurozone urging reduced FX intervention and stronger currencies within Asia, especially China, our FX strategy team believe that regional policy makers will at least partly accede to this pressure if only to preclude the risk of actual trade protectionism.

Across Asia, central banks have been explicit in noting that stronger currencies are a factor limiting the imperative for interest rate hikes. Of course, the most explicit instance of monetary tightening via exchange rates is Singapore, where the SGD TWI is the monetary anchor of the Monetary Authority of Singapore (MAS) with domestic interest rates viewed as exogenous. The MAS' current policy of appreciating the SGD by 3% a year naturally places downward pressure on the SGD 6M SOR fix since this is calculated by combining 6M USD Libor with the SGD appreciation priced into the USD/SGD 6M FX forward. With the FX forwards pricing-in SGD appreciation, the SGD SOR is expected to remain below Libor throughout 2010.

Exhibit 12. MAS's monetary anchor is the SGD TWI, with interest rates exogenously determined



Source: Bloomberg, Nomura.

Part 2: The risk factors to long duration positions

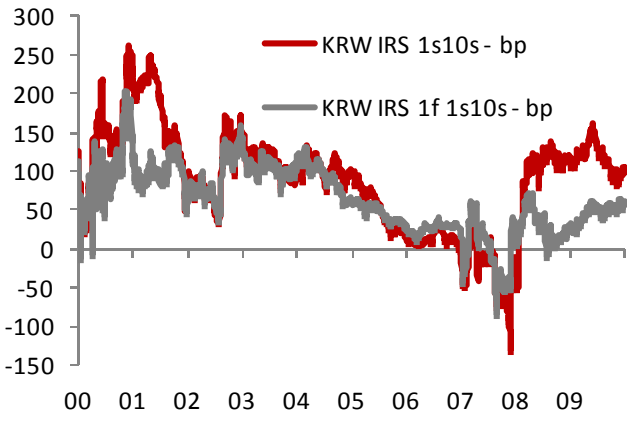
Hedge the "inflation trade" with forward starting curve steepeners

One significant risk factor to a bullish duration view on Asian interest rate markets is that investors position for higher inflation across Asia as rising commodity prices push headline CPIs higher. Many investors talk of price action which could resemble Q2 2008, when fears of commodity-driven inflation resulted in a surge in yields across Asian rates markets, at a time when the global – and regional – economy was clearly poised for a deep downturn as the credit crisis spread across the world.

However, as noted above, we are far more sanguine on inflation risks in Asia in 2011. At the core level, inflation in Asia is stable, while the reaction functions of regional central banks have altered since 2008, as they are less reactive to high headline food and energy price gains. Moreover, given the steepness of curves, the negative carry involved in "paying" interest rates means that bearish interest rate trades can incur often painful levels of negative carry which can limit the holding power of investors. Nonetheless, we cannot rule out the potential for the market to position for the "inflation trade" and for yields to overshoot on the upside.

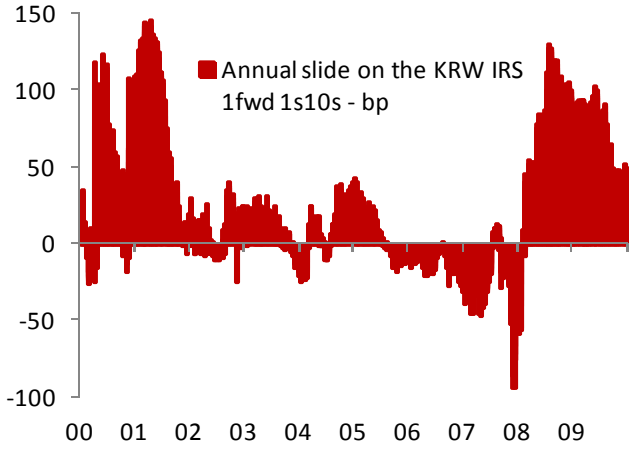
One way to position generally net-received portfolios for the risk of the "inflation trade" is to express received positions via forward starting curve steepeners in those markets where the front leg of the trade involves receiving a steep curve in the Whites-to-Greens. In many markets, such forward starting curve steepeners are alternative ways of expressing a received position since the majority of gains on paid positions accrue from the forward curve siding up to spot, with the majority of the slide accruing from the front end. For instance, one of our current trade recommendations is the pay the KRW IRS 1fwd 1s10s. This currently measures 65.5bp and slides up to a spot 1s10s of 107bp. In terms of legs, paying the KRW 1wd 10yr incurs a negative annual slide of 16.5bp which is offset by a 58bp positive annual slide on the 1fwd 1yr. Given the limited likelihood of an aggressive BoK policy tightening, we believe that the slide at the front end of the KRW curve will fully captured, which will drive returns on the forwards starting curve trade. However, if the market positions for an "inflation trade", it will likely so do by "paying" liquid points on the curve beyond 5-years where the negative carry is less punishing than at the front-end. This could see the spot 1s10s IRS curve steepen, and increase the annual slide on the forward steepener.

Exhibit 13. We continue to recommend forward starting curve steepeners in KRW



Source: Nomura Research, Bloomberg.

Exhibit 14. The front end of the forward steepener dominates the annual slide



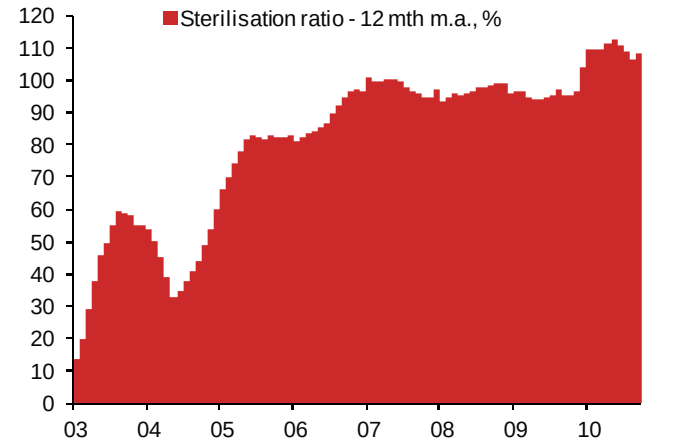
Source: Nomura Research, Bloomberg.

Capital controls to allow for a greater policy focus on interest rates?

In economic theory, policymakers require for each independent policy target they pursue an equal or greater number of independent policy tools (Tinbergen's principle). Within Asia, this principle runs contrary to the desire for regional policymakers to target domestic interest rates, currency valuations and to support a free flow of capital. Whereas at the start of 2010, this "impossible trinity" was being used to forecast the imperative for large-scale appreciation of regional currencies, in recent weeks it has become clear that many regional policymakers are addressing this problem by re-regulating capital accounts. For instance, Thailand and Korea have both announced the reintroduction of withholding taxes (WHT) on foreign purchases of domestic bonds, although the Korean authorities have suggested that they may reconsider the tax in light of recent KRW weakness amid tensions with North Korea.

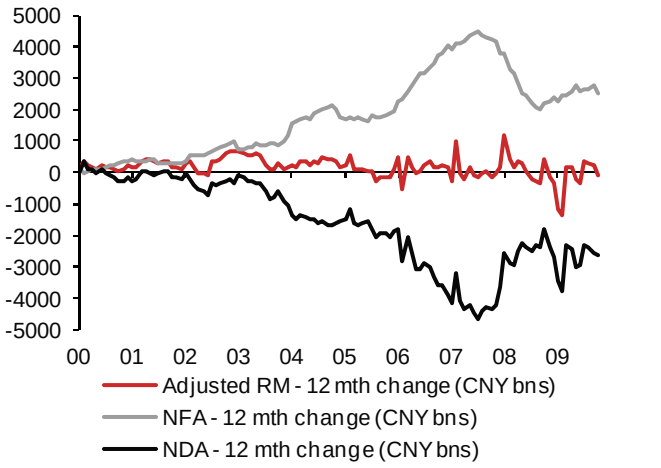
At one extreme, regulators could close their capital accounts to the point where foreign portfolio investment is no longer able to flow into domestic fixed income markets, and hence central banks will have increased their ability to conduct an independent interest rate policy. Such a scenario could clearly be highly negative for interest rate markets across the region as more policy tightening could take place via policy rates rather than exchange rates.

Exhibit 15. PBoC has a sterilisation ratio of over 100%



Source: Nomura Research, Bloomberg.

Exhibit 16. Monetary base growth is subdued



Source: Nomura Research, Bloomberg.

However, while regional policymakers have once again embraced re-regulation as a policy tool, we believe it is unlikely that they will alter capital account regulations to the extent that the trend towards stronger Asian currencies is reversed rather than merely slowed, and more pertinently, that the pace of central bank rate hikes is notably increased:

- Most regional policymakers feel more comfortable in tightening monetary conditions via exchanges rates than interest rates given their ongoing efforts to boost domestic demand. Indeed, to tighten policy via interest rates rather than exchange rates would risk inflaming international trade tensions by potentially increasing the size of Asia's current account surplus.
- Unlike the 1995-97 period when Asia was last flooded with a torrent of liquidity which spurred asset bubbles and set the scene for the Asian financial crisis, most regional central banks are able to sterilize the impact of their FX reserve purchases and hence have not yet lost control of domestic interest rates. The sterilization rate on FX reserve accumulation is typically between 90-100% across the region at present. In China, the country experiencing the fastest accumulation of FX reserves in Asia, the

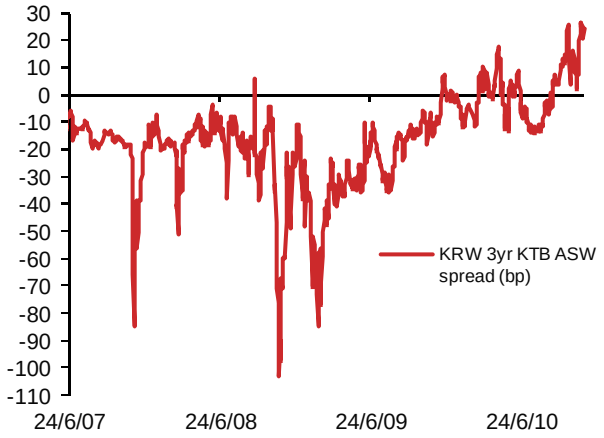
Peoples Bank of China (PBoC) is actually withdrawing more CNY liquidity from the system than it is injecting via FX intervention, with the September sterilization ratio measuring 108.5% (Exhibits 15 and 16). Some central banks, most notably Bank Indonesia (BI), face domestic political pressure to scale back FX intervention due to fears that they may post losses and have their capital base eroded. (In the current climate, sterilized FX intervention incurs a negative carry, while the translation losses stemming from a stronger local currency can erode the FX valuation buffer account which most central banks in Asia.) However, in most cases Asian governments view the potential fiscal costs of FX intervention as an acceptable trade-off for the boost to growth that derives from stemming the pace of FX appreciation. Additionally, as long as regulators are comfortable that a central bank will not seek to replenish its capital by running overly loose monetary policy and obtaining profits via seigniorage, there is no reason why a central bank cannot operate with a zero capital base.

For these reasons, the level of capital controls which are being implemented in Asia are not expected to be sufficiently strong to reverse the trend towards regional currency appreciation. Through extension, capital controls might – at the margin – allow central banks to raise domestic interest rates by more than we would otherwise assume. However, we would expect any such impact to be moderate and not result in a particularly noteworthy deviation of policy rate trends from our core assumptions. We still feel comfortable that in most Asian markets, the forward curves overstate the likely pace of policy rate/fixing rate increases in 2011.

A greater concern for us is not that central banks impose strict capital controls that insulate FX trends from interest rate policy, but more that policies aimed at slowing the pace of capital inflows have the unintended consequence of creating volatility in the local-currency funding markets and the fixing rates for IRS curves. Many of these risks stem from Korea.

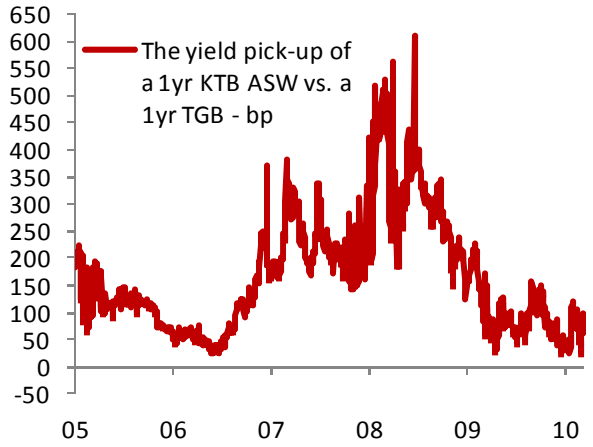
- **Korea funding market risks.** In Korea there is potential for policymakers to tighten regulations on capital flows in a more disruptive manner. In recent years, authorities have tried to limit foreign bank funding by adjusting the thin cap rule, which determined the amount of tax efficient borrowing a subsidiary bank can obtain from its parent as a proportion of its onshore capital base. On 1 January 2008 the authorities reduced the thin cap rule from 6x to 3x, and the build-up to this change saw a sharp rise in USD/KRW, a widening of the KRW cross-currency basis swap, and a pronounced widening of the KTB ASW spread as a rise in KRW IRS yields was more than offset by a surge in KTB yields. (In November 2007, the 3yr KTB future ASW spread widened to -100bp from a -16bp to -24bp range). These trends were driven by foreign banks seeking USD funding and scaling back their domestic balance sheets. As a result of this adverse reaction the 6x thin cap rule was re-instated. We would expect the memory of this market disruption to prevent the authorities lowering the thin cap limit once more, but nonetheless one cannot fully rule out the possibility of re-regulation in this area. Similarly, if the authorities were to lower the ceiling on FX derivatives held by foreign banks from the current 250% of their capital base to the 50% level of domestic (and better capitalized) banks, that would require an approximately USD33bn decline in derivatives outstanding to just USD8.3bn. Such a limited threshold could limit the ability of foreign banks to hedge their USD funding and their KRW asset purchases, both of which would adversely impact KTBs (see *Asian Strategy Note: A Bank of Korea tightening cycle and the IRS curve*, 8 July 2010).

Exhibit 17. The KRW 3yr ASW - bp



Source: Nomura Research, Bloomberg.

Exhibit 18. The reduced attraction for Thai investors to undertake fresh "Kimchi" trades



Source: Nomura Research, Bloomberg.

- **The THB SOR fix and withholding tax changes.** In Thailand, the risk to the THB IRS curve is indirect. The fixing rate for the THB IRS curve is the 6M SOR derived from the FX forwards. This tends to trade below the Bank of Thailand's (BoT) policy rate (currently 2.0%) due to the significant overseas investment by Thai banks and asset managers who purchase Asian bonds and asset swap them into THB, which has the effect of generating receiving interest in the USD/THB FX forwards and lowering the SOR. The current THB 6M SOR is 1.34%. If central banks across Asia were to increase WHTs and we did not see an offsetting widening of each country's basis swap, then the incentive for Thai asset managers to ASW foreign assets would be reduced. For instance, the current yield pick-up over 1yr TGBs for a Thai investor purchasing a 1yr KTB and swapping it into THB is 99bp (Exhibit 18). However, if Korea reintroduces a 14% WHT on coupons, the 3% coupon on 1yr KTBs would lower returns by 45bp, meaning that the pick-up is just 54bp. If the KRW basis swap tightens again as recent global funding market concerns ease, then there is the risk that the stock of ASW flows are unwound and the associated "paying" of the THB FX forwards pushes the 6M SOR higher.

Part 3: Thematic strategy recommendations

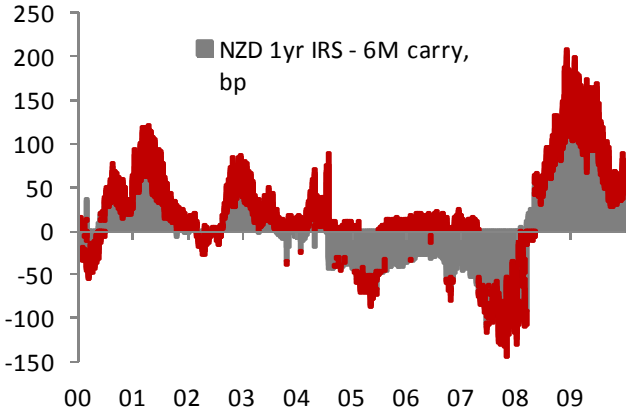
Below we suggest some trades that marry our core positive view on Asian interest rate markets with the risk factors we outlined. In the interests of brevity, we focus only on fresh trade recommendations and changes to our model portfolio. Moreover, our outlook is naturally more medium-term in nature as we express core strategic thoughts. One near-term risk to our view is that in thin market conditions heading into the calendar year-end we see more volatile markets that could result in mark-to-market losses. However, this was also a trend seen last December when in thin markets Asian interest rate markets sold-off as investors shed duration, and ultimately provided significant opportunities to receive regional rates into the start of 2010 as liquidity returned to markets and fundamental factors began to have a greater bearing on markets. (The prices in the section below are based on pricing at close of business on 2 December)

Theme 1 – Receive selected front-end interest rates

Receive NZD IRS 1yr

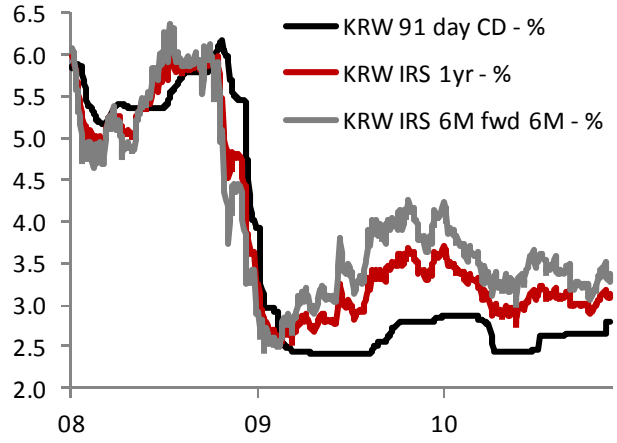
The combination of a sluggish economic recovery and the tightening of monetary conditions implicit in the Basel III effect has underpinned our bias to receive the NZD IRS Whites/Reds. Although the 1yr NZD IRS yield has declined by 13.5bp since we recommended investors receive this interest rate at 3.58% on 4 November, the steepness of the curve suggests that there is still considerable value in receiving the NZD Whites. The 6M carry and slide for receiving the NZD IRS is currently 63bp (Exhibit 19). We add to our recommendation to receive the NZD IRS 1yr, with an additional USD2,500 at 3.43.5%. We expect the 6M carry and slide to be fully captured.

Exhibit 19. The 6M carry and slide on the NZD 1yr IRS - bp



Source: Nomura Research, Bloomberg.

Exhibit 20. We recommend receiving the KRW IRS Whites



Source: Nomura Research, Bloomberg.

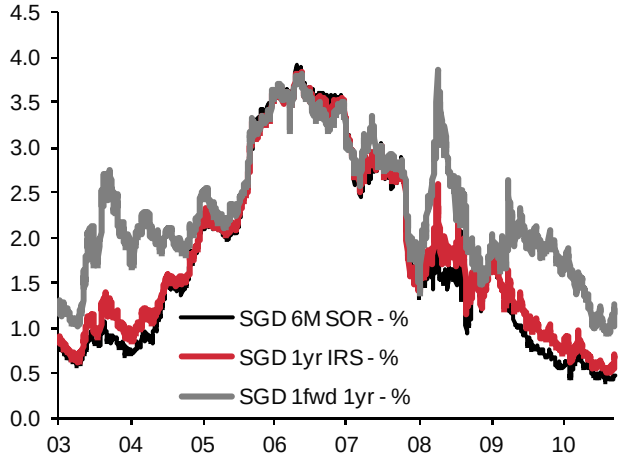
Receive KRW Whites/Reds

Our existing model portfolio includes a recommendation to receive the KRW IRS 6M fwd 6M and 1yr, which were initiated on 22 April and 9 July 2010, respectively. Both trades have rolled down towards the 6M tenor. We take profit on these recommendations and initiate fresh positions. We again recommend receiving KRW IRS 6M fwd 6M and receive USD5,000 DV01 at 3.25%. We target this to roll down towards the 6M rate which we expect to remain around the current level of 2.934% given that we believe that the BoK will leave policy rates stable throughout H1 2010. Similarly, we receive USD5,000 DV01 of the KRW IRS 1yr at 3.06%.

SGD IRS – receive the SGD IRS 1fwd 1yr

One of our longest-held recommendations has been to receive the SGD IRS 2fwd 1yr, which we initiated in May 2009. This trade has had the benefit of tending to slide toward the “sweet spot” on the curve – at present it is a 6M fwd 1yr which as Exhibit 22 shows, has among the highest ratio of slide to volatility on the SGD curve. However, we wish to add to our recommendation to receive the front end of the SGD IRS curve, reflecting out view that USD Libor will remain low in 2011, that the SGD 6M SOR will be biased below this level, and that the current volatility in funding markets (which has pushed the SGD 6M SOR to 0.471%, or above USD Libor of 0.467%) is unlikely to prove persistent and is something to hedge against rather than a spur to close out positions. We receive USD10,000 DV01 of the SGD IRS 1fwd 1yr at 1.34% and target a move towards a 1yr rate of around 60bp.

Exhibit 21. The SGD Reds remain high relative to the Whites, in particular to the SGD 6M SOR fix



Source: Nomura Research, Bloomberg.

Exhibit 22. Receiving the SGD IRS 1fwd 1yr has attractive return to volatility characteristics

Slide to Annualised Historical Volatility in SGD					
	3m fwd	6m fwd	9m fwd	1fwd	2fwd
3m	0.2	4.6	0.1	2.6	1.5
6m	3.2	1.9	1.4	2.3	1.4
9m	1.7	2.2	1.7	2.1	1.4
1yr	2.1	2.2	1.7	2.0	1.4
2yr	1.9	1.7	1.5	1.7	1.5
3yr	1.7	1.6	1.5	1.6	1.6
4yr	1.7	1.6	1.6	1.7	1.7
5yr	1.7	1.6	1.6	1.8	1.7

Source: Nomura Research, Bloomberg.

Theme 2 – Forward starting curve steepeners

Our highest conviction forward starting curve steepener recommendation is in Korea, where we initiated in our model portfolio a recommendation to pay the KRW IRS 1fwd 1s10s at 54bp on 4 November. Both the spot and forward curves have steepened and the forward spread currently measures 65.5bp. We would look to pay this forward spread into any renewed flattening to below 55bp. We discuss some of our other steepening recommendations:

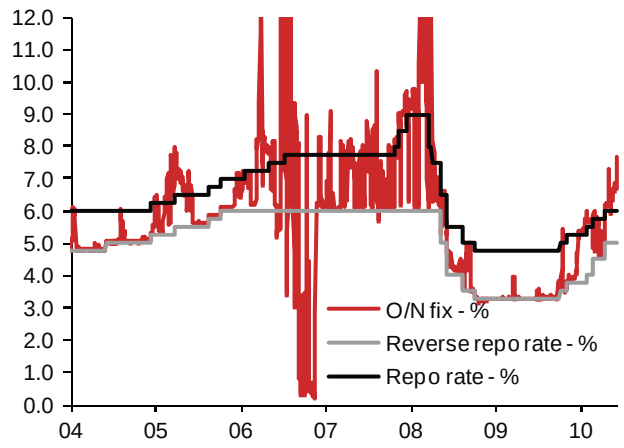
INR OIS – Pay 2fwd 2s5s spread

In 2010, the RBI hiked rates six times, taking the repo and reverse repo rate from March levels of 4.75% and 3.25%, respectively, to current levels of 6.25% and 5.25%. At its last policy meeting, however, the RBI made a very important forward-looking statement on further rate actions, saying that "Based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low. However, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either the global or domestic environment".

We believe that the RBI is less willing to hike rates going forward and that this will be bullish for front-end rates. However, the current level of front-end rates is also a reflection of tight liquidity in the banking system. It is notable that overnight MIBOR fixings average well above the upper band of the LAF corridor. Over the last 30 days, MIBOR fixings have averaged around 6.90%. The system is currently running in tight liquidity to the extent of 2% net demand and time liabilities of the banking system (estimated at around INR50trn). One of the reasons for this excessive liquidity deficit is a high government operating surplus, which we estimate to be about INR800bn in mid-November. We think the RBI would be willing to return the liquidity situation to normal and that once liquidity returns, , front-end rates will rally and the curve will steepen.

We favour paying the INR OIS 2fwd 2s5s spread as a way to express our steepening view. It is currently trading at 15bp and has a positive slide of 4bp over 3M and 8bp over 12M. We would also like to express a similar steepening view in the spot space, but would wait for the liquidity situation to improve before putting this on. We initiated a recommendation to pay this spread in October at 14bp. (see *India: Entering an INR OIS 2fwd 2s5s steepener recommendation*, 21 October 2010). We add USD10,000 DV01 to this position and, within our model portfolio, pay the INR OIS 2fwd 2s5s spread at 16bp.

Exhibit 23. MIBOR fixings and the RBI's policy corridor - %



Source: Nomura Research, Bloomberg.

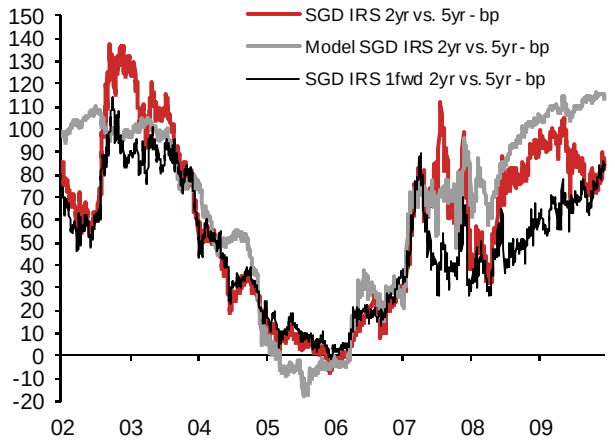
Exhibit 24. INR OIS 2s5s spread, spot and 2fwd - bp

Source: Nomura Research, Bloomberg.

Singapore – take profit on forward steepeners, switch instead to a clearer long-duration bias

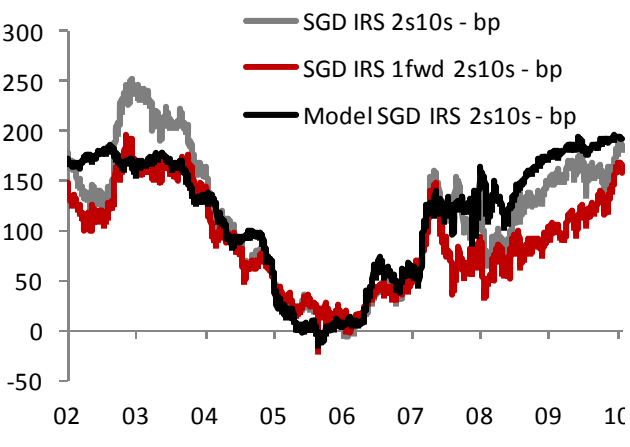
We have decided to take profit on our forward starting curve steepeners in Singapore. We have within our portfolio a residual SGD IRS 1fwd 2s5s spread, which has rolled up the curve such that it is currently 4M forward. We do not see particular value in maintaining this trade. The slide on forward steepeners involving 2s5s has moderated, whereby the 1fwd 2s5s currently measures 82bp or close to the spot curve of 85bp. Admittedly, the level of spot 2s5s appears flat relative to the current level of the SGD 6M SOR (0.47%), and historically the slope of the SGD IRS curve tends to be closely allied to the level of the fix. However, we expect a widening residual error in models of SGD 2s5s versus the fixing rate given that the SGD IRS curve is correlated to the US, where the implementation of quantitative easing by the Fed will depress this spread. Similarly, we take profit on our recommendation to pay the SGD IRS 1fwd 2s10s. We initiated this recommendation on 14 April at 118.5bp and it has since rolled up to 178bp. Moreover, the spot 2s10s currently measures 185bp and no longer appears low relative to a model of 2s10s based on the SOR fix. ("Fair value" for 1s10s is currently 192bp). We actually believe that yields on the 5-10 year part of the SGD IRS cure are too high and, as we discuss below, are inclined to receive the SGD IRS 5fwd 5yr (currently 3.95%), in addition to the 1fwd 1yr we initiated above.

Exhibit 25. The Fed's QE is leading to widening residual errors on SGD IRS 2s5s curve models



Source: Nomura Research, Bloomberg.

Exhibit 26. The SGD IRS 1fwd 2s10s spread has returned to our estimate of "fair value"



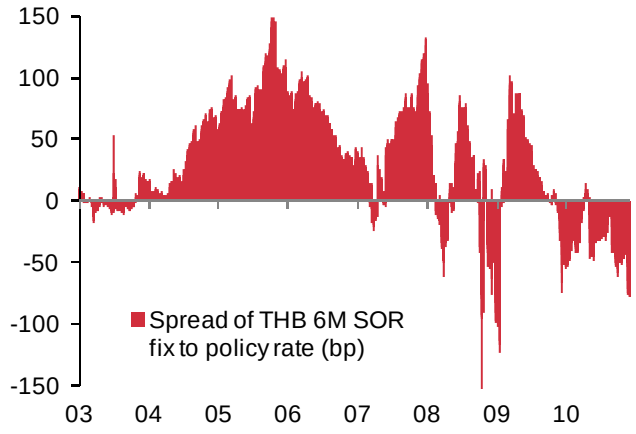
Source: Nomura Research, Bloomberg.

Thailand – take profit on forward steepeners. Look to re-enter into a pick-up in the THB SOR

We believe the underlying backdrop of slower growth momentum following two quarters of declines in GDP growth (putting Thailand technically in recession after a 0.2% q-o-q (sa) decline in Q3 GDP growth followed a 0.6% decline in Q2, with domestic demand falling by 0.8% q-o-q (sa) in Q3) and muted core inflation are supportive of receiving rates. As such, despite the surprise 25bp rate hike on 1 December – which leaves us cautious about making assumptions on the Bank of Thailand's reaction function – we think that there will have to be a significant pick-up in growth momentum for the rates market to start pricing in a much more aggressive central bank.

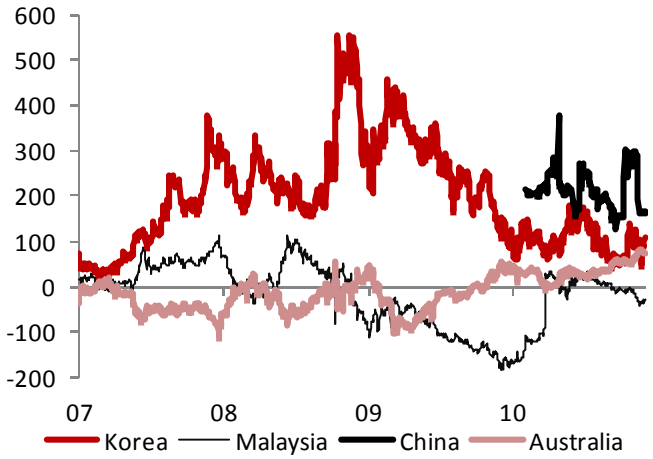
We recently pared our exposure to the front end of the curve (see *Thailand: Reducing exposure to the front-end of the IRS curve*, 1 December 2010), amid the widening spread between the THB 6M SOR and the policy rate (-66bp vs -41bp a month ago) and as the proposed withholding tax in Korea erodes returns for Thai investors in 2011 (should the tax be implemented, the expected 14% rate that will be imposed on coupon payments could lower expected returns to Thai ASW investors by 45bp). In turn, this may limit the extent to which flows will be maintained and result in the unwinding of the receive THB CCS transaction that is part of "Kimchi flows" and potentially pushing the swap-offer rate higher than its current 1.34% (see *An acceleration of "Kimchi flows" to suppress the THB 6M SOR fix?*, 28 October 2010).

Exhibit 27. "Kimchi flows" helped to push the fixing rate below the policy rate



Source: Nomura Research, Bloomberg.

Exhibit 28. There is a lack of foreign options for Thai investor flows



Source: Nomura Research, Bloomberg.

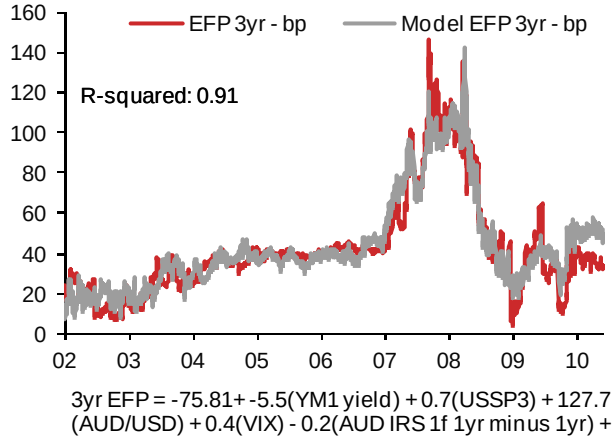
The risk of a higher THB SOR is increased to some extent by the fact that there are few natural alternatives to KTBs in terms of foreign bonds which can be asset swapped into THB at a sizable yield pick-up. As Exhibit 28 shows, the natural alternative is that Thai investors buy CNY bonds listed in Hong Kong and take advantage of the CNY CCS. However, the supply of these CNY bonds is insufficient to meet demand from a significant allocation shift away from KTBs. The amount outstanding of CNY bonds is less than USD7bn, while the holdings of KTBs and MSBs by Thai investors is USD13bn, and these prospective flows would be competing with other investors positioning for a CNY revaluation via a positive-carry bond position as opposed to a negative-carry NDF trade. A more natural alternative, would in our opinion, be for Korean investors to purchase AUD bonds, where the ASW return approximates the pre-WHT returns currently available on buying KTBs. However, this yield pick-up may not be sufficiently wide to encourage Thai investors to start purchasing assets in a new market.

We do not expect Thai investors to unwind their Kimchi flows since there is still a yield pick-up which is likely to encourage a roll-over of positions. Moreover, if we do see any unwinding, the risk is that we see a relatively brief rise in the THB 6M SOR since any notable rightward move in the THB FX forward curve would increase yield pick-up and result in fresh Kimchi flows. For these reasons we retain our recommendation to receive the THB IRS 1fwd 1yr. However, given the current wide spread of the THB 6M SOR to the policy rate and the reduced post-tax returns accruing to Thai investors, we think is prudent to scale back our exposure to the fixing rate and hence take profit on our forward steepening positions. We would look to reinstate, and indeed add, to our front-end received position into any notable rise in the THB SOR fix that is sufficient to flatten the curve and push front-end THB IRS yields higher.

Theme 3 – Global and Asian regulatory trends

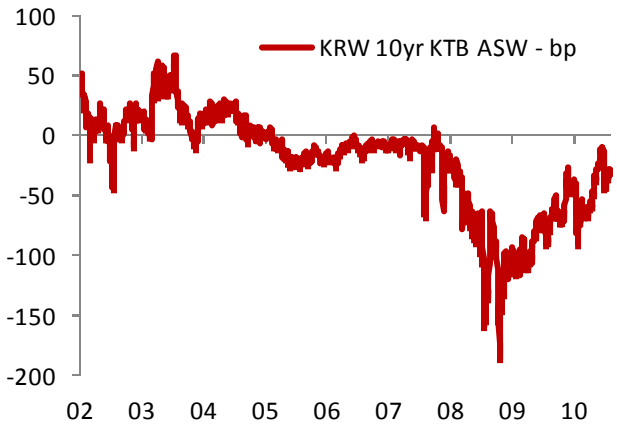
As we analyzed in the section above, regulatory changes confronting the global banking, insurance and pension industries will in general spur increased demand for government bonds. Demand for bonds should be particularly strong in those countries where the authorities are implementing Basel III in advance of the BIS timeframe. In Australia and Korea, we believe that the structural demand for government bonds could be sufficiently strong that bonds notably outperform the IRS curve (in the NZD market, bond-swap spreads tend not to be actively traded). In both countries there are domestic factors which support our preference for bonds to outperform IRS.

Exhibit 29. The AUD 3yr EFP spread is too tight. We expect widening to be driven mainly by strength in 3yr bonds



Source: Nomura Research, Bloomberg.

Exhibit 30. We expect the 10yr KTB ASW spread to move to 0bp over 3-6 months



Source: Nomura Research, Bloomberg.

Pay 3yr AUD EFP spread

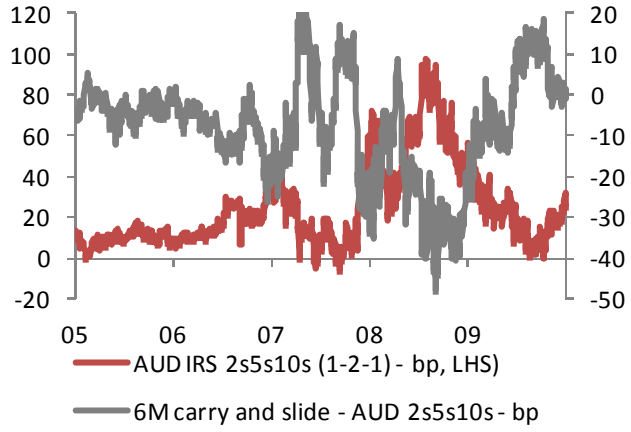
In Australia, the 3yr EFP spread (using the YM1 bond future contract) shows the current 35.25bp spread to be too tight relative to our "fair value" estimate of 58bp. Moreover, we believe that the market will further scale back the degree of rate hikes which the RBA will deliver over the coming 12 months, with RBA Governor Stevens announcing on 26 November that the current 4.75% policy rate was "a bit above normal". One of the key explanatory variables in our model is the AUD IRS Whites/Reds spread, specifically the 1fwd 1yr. We expect this spread to tighten, which would widen the EFP spread. Moreover, when the RBA is on hold the 3yr bond yield tends to trade flat to the policy rate. With the 3yr YM1 trading at 4.99% versus a policy rate of 4.75%, there is room for bond yields to decline, which would

widen the EFP spread. We recommend paying USD20,000 DV01 of the 3yr EFP spread at 34.5bp.

Receive 10yr KTB ASW spread

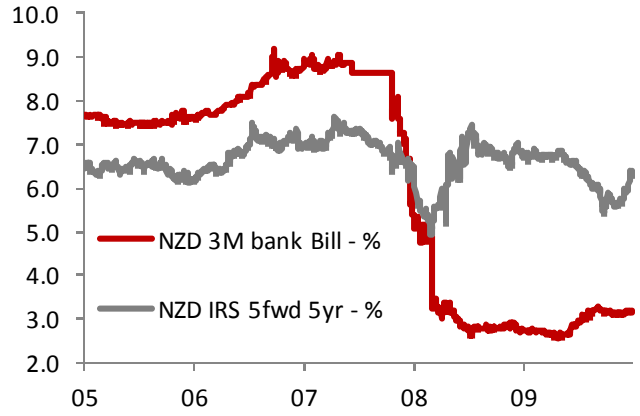
In Korea, KTB yields have historically traded above IRS yields, but we expect this trend to reverse and the spread to normalise. The regulatory-related demand for KTBs is one factor behind this view, but an additional factor is that the Korean authorities – despite the retrograde step of reimposing a withholding tax – are nonetheless continuing to try to develop the KRW fixed income markets. They have recently changed the 10yr KTB future contract so that it resembles the more liquid 3yr future contract. Moreover, they are planning to implement a KTB repo market. The lack of an onshore repo market is the key reason why KTBs have yielded more than KRW IRS since they require a liquidity premium because into a fixed income market sell-off there is a lack of short covering to create demand for KTBs. Front-end ASW spreads have already normalised, with 3yr KTB yields 35.5bp below IRS yields and we expect the 10yr ASW spread to head towards 0bp over the coming months, from -23bp at present. We recently expressed our bullish view towards 10yr KTBs by initiating a recommendation to buy USD5,000 of these bonds and were hoping to add to this and initiate a 10yr KTB ASW spread tightener into any notable widening of yields. We have yet to see this pull back and hence have decided to start to scale into the ASW spread lightener. We recommend initiating a 10yr KTB ASW spread tightener in USD5,000 at -22bp.

Exhibit 31. We recommend receiving the belly of the AUD IRS 2s5s10s fly (1-2-1) targeting a move below 0bp



Source: Nomura Research, Bloomberg.

Exhibit 32. The NZD IRS 5fwd 5yr is too high considering that the RBNZ's ""neutral" rate has declined



Source: Nomura Research, Bloomberg.

Receive the NZD IRS 5fwd 5yr

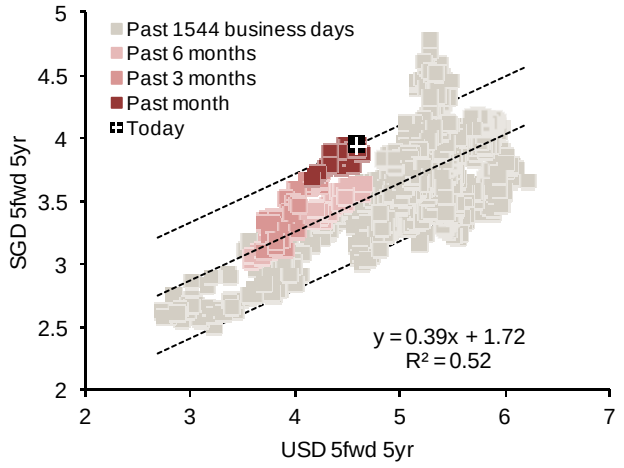
A central aspect of the Basel III liquidity framework is that the "neutral" policy rate will be lowered. In both Australia and New Zealand this means that the government bond and IRS curves will be biased to invert at lower yield levels as policy will become "restrictive" at lower levels of policy and fixing rates. In Australia we believe that the RBA has already pushed rates into restrictive territory and expect further tightening to result in an inversion of the AUD 2s10s IRS spread, and a decline in curvature sufficient to push the AUD IRS 2s5s10s fly to 0bp from current levels of around 21bp. In New Zealand, we believe that the back end of the IRS curve is too steep and recommend investors scale into a received position in the NZD IRS 5fwd 5yr. (see *RBNZ signals slow path to a lower "neutral" rate: Receive NZD IRS 5fwd 5yr*, 16 September 2010). This currently yields 6.535% which seem too high in terms of both the level of rates and the 5s10s slope component, where this spread is currently 76bp. We add to our recommendation to receive the NZD IRS 5fwd 5yr by receiving USD5,000 DV01 at 6.52%.

Theme 4 – Regional FX strength

SGD vs. USD IRS: take profit on front-end regression-weighted spreads tightener; add to 5fwd 5yr tightener

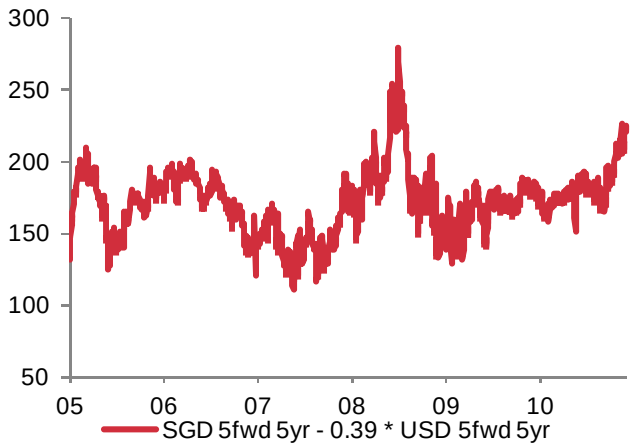
With the SGD 6M SOR expected to remain below USD Libor in 2011 as MAS tightens monetary policy via the exchange rate, we see grounds for an outperformance of the SGD IRS curve vs. the USD IRS curve on a regression-weighted basis. The front end of the SGD IRS curve has already outperformed, and we have decided to take profit on our recommendation to receive the SGD IRS vs. paying 0.46 units of USD IRS. We received this spread at 74bp on 28 March, since which it has tightened to 59bp and rolled down towards the 1yr regression-weighted spread of 42.5bp. However, as the market grows more comfortable with the likelihood of a SGD SOR fix that will be biased to being below USD Libor throughout 2011, we see room for the back end of the SGD IRS curve to reverse its recent underperformance. We add to our recommendation to receive the SGD 5fwd 5yr vs. paying 0.39 units of USD 5fwd 5yr. Currently the spread is 221bp (our "fair value" 165bp); within our model portfolio we receive USD10,000 DV01 of this spread at 223bp.

Exhibit 33. The SGD IRS 5fwd 5yr is 2sd cheap to the USD IRS 5fwd 5yr



Source: Nomura Research, Bloomberg.

Exhibit 34. Receive the SGD IRS 5fwd 5yr vs. paying 0.39 units of USD IRS 5fwd 5yr



Source: Nomura Research, Bloomberg.

Pay CNY vs. HKD/ USD 3yr fwd 2yr vs. 1yr fwd 1yr IRS box spread

We see value in adding to our recommendation to initiate a CNY vs. USD and HKD box trade (see *China: A 3fwd 2yr vs. 1fwd 1yr box trade between CNY and HKD and USD IRS curves*, 2 November 2010). In simplistic terms, this trade is a CNY steepener vs. USD/HKD flattener in forward-starting swap space. In reality, we assume with the box trade that the front-end spread between CNY and USD/HKD curves (1fwd 1yr spread) is not expected to widen 90-100bp (1yr roll-down) more than the spread in the belly between CNY and USD/HKD (3fwd 2yr spread). We can illustrate the trade by discussing the individual legs. The PBOC's policy response to FX intervention needed to slow the appreciation the CNY is a key component of this trade.

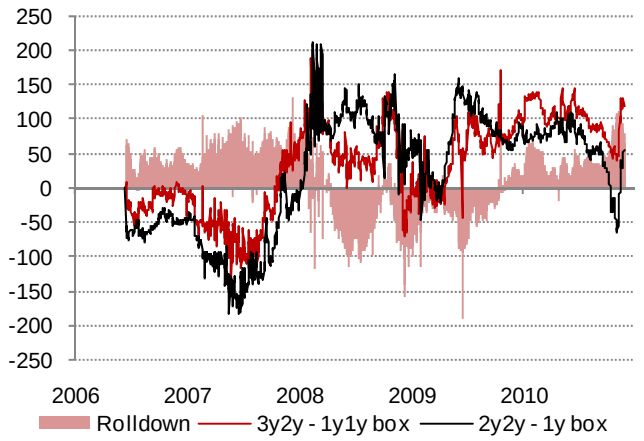
CNY liquidity: A key element of the trade is the receive the CNY 1fwd 1yr leg. The China IRS curve is indexed to the 7-day repo rate, which reflects the cost of funds in the interbank market and is directly related to liquidity in the banking system. Though the PBOC has frequently used reserve requirements (RRs) to withdraw liquidity and hiked policy rates in October, we do not expect a significant impact on the overall interbank liquidity situation, and hence the 7-day repo rate. To offset the passive liquidity injected into the system due to FX reserve accumulation, PBOC needs to step up open market operations (OMO) and utilize RRs in combination. As

year-end and lunar year-end approach, the effectiveness of OMOs is decreasing, especially for PBOC bills. This is because the normal tenors are beyond 3M, which means the liquidity locked in will not come back into year-end (especially lunar year-end). Hence, to control liquidity expansion, the PBOC can hike the RRR or increase interbank rates. The recent failure to complete a bill auction suggests the central bank is reluctant to push up interbank rates, so the PBOC will rely more on required reserves. However, aggregate liquidity in the system remains plentiful.

QE/reflation and China inflation: A second key element of the box trade is to receive the USD/HKD 3yr fwd 2yr. Once we break down the US curve into forward buckets, 3fwd 2yr stands out as the pivot of the whole curve in a QE environment. As we expect QE to contain the US rate level in 5yr, it is very attractive to benefit from the rolldown from the belly of the curve.

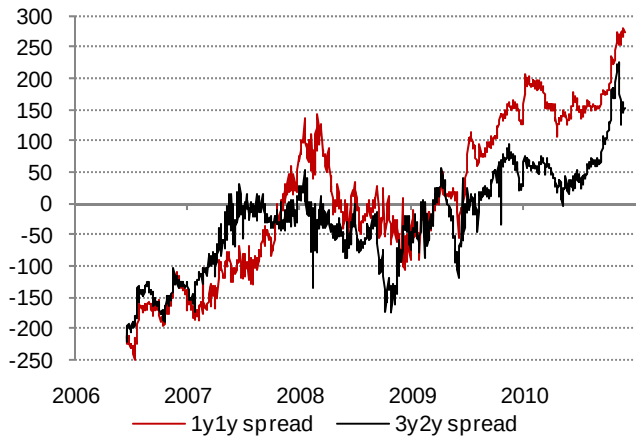
The reverse trade is to pay the CNY 3fwd 2yr. The implementation of QE in the US is increasing expectations of liquidity flowing into emerging markets, increasing market optimism in terms of the region's growth outlook and raising inflation concerns. While we are less concerned than the market about these risks, there has nonetheless been a clear tendency in the market to pay CNY IRS in the 5yr risk bucket as a way to express QE/reflation.

Exhibit 35. Box spread and rolldown – bp



Source: Nomura Research, Bloomberg.

Exhibit 36. 1y fwd 1y spread vs. 3y fwd 2y spread – bp



Source: Nomura Research, Bloomberg.

The event risk leg

We would like to pay the front end of USD curve, i.e. 1y fwd 1y, as a cheap hedge to event risk such as dollar-funding stress, perhaps caused by deepened solvency concerns in Europe. The front end of the US curve has priced in quite flat policy rate path (as evidenced in OIS or FF futures) and risk premiums have been compressed, so there is limited room for the front end to go even lower.

We initiated our CNY vs. USD/HKD box trade recommendation on 2 November and added to it on 11 November (see *China: Required reserve hikes and a CPI surprise – add to our CNY vs HKD/USD box trade*, 11 November 2010). We still think the rationale is intact and the current level for the spread is around historic highs as the front end of the CNY curve has underperformed in recent weeks due to market concerns over the potential for tighter money market liquidity conditions. Hence, we take advantage of the aggressive US rates sell-off in the past weeks to add USD10,000 DV01 to our existing USD15,000 by receiving the box spread at 130bp.

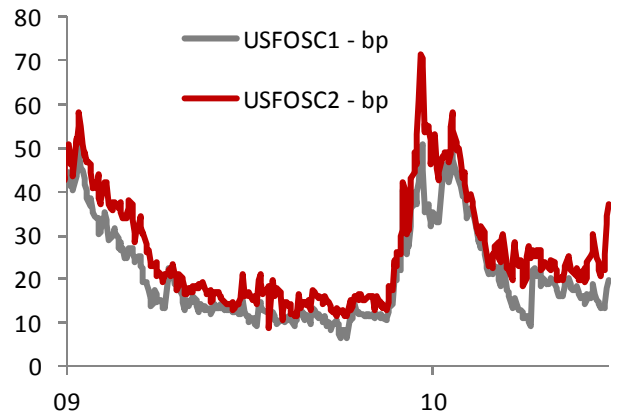
Theme 5 – Fixing/ funding market risks

Pay the USD FRA-OIS to the second IMM date

One natural risk to our portfolio bias is that we see a Libor event, which could push fixing rates higher, especially in those markets where the fixing rate has a direct Libor component, most notably the THB and SGD markets. While central banks are aware of the importance of maintaining stable funding markets after the 2008-09 experience, we have already seen evidence of a credit premium once again being embedded in funding markets given the ongoing concerns over sovereign credit worthiness in the Eurozone.

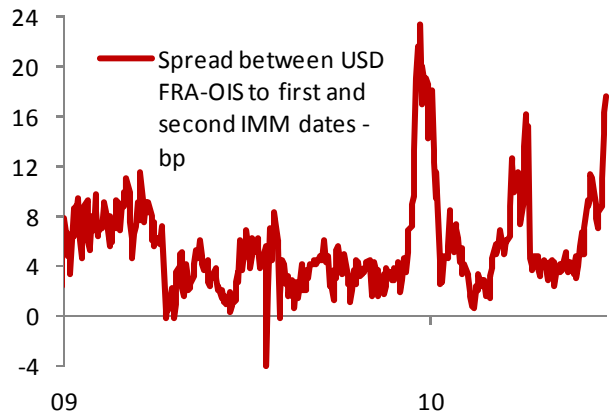
Given these risks, we continue to recommend including within interest rate portfolios a hedge against a funding market blow-out. We recommend paying the USD FRA-OIS spread to the second IMM date. This tends to be one of the first instruments investors use to hedge their Libor exposure and this spread can widen when the 6M USD Libor is stable. Similarly, the US FRA-OIS spread to the second IMM date can widen relative to the front IMM date. The second IMM date USD FRA-OIS spread has widened to 35.1bp currently from 21.5bp a week ago, while the spread to the first IMM contract has widened to 18.2bp from 9bp. In our portfolio we maintain a core USD10,000 DV01 paid position in this contract, but would look to add to it if the spread contracts back below 20bp.

Exhibit 37. USD FRA OIS spreads to the first and second IMM dates - bp



Source: Nomura Research, Bloomberg.

Exhibit 38. Paying the USD FRA-OIS spread to the second IMM date is an attractive hedge against Libor risk



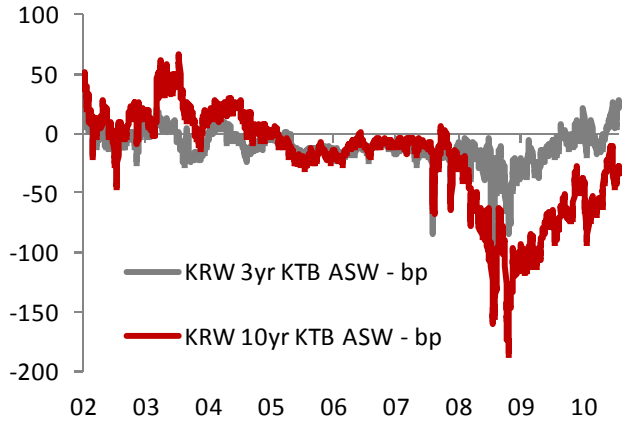
Source: Nomura Research, Bloomberg.

Korea – sell the KTB 3s10s ASW box spread

We have noted that many of the fixing risks concerns within Asia originate directly and indirectly from Korea, and in particular the risk that the authorities seek to curb USD funding by foreign banks. We do not expect these risks to materialize, but one potential hedge could be through a KTB 3s10s ASW box trade (the 3yr leg can be expressed by using the 3yr future, but the current limited level of liquidity in the 10yr KTB means that we would express this part of the trade via a total return swap. However, for ease of explication, we would track the bond spread via the spread to 3yr and 10yr KTBs, thus stripping-out the 3yr bond future basis spread). If the BoK were to tighten funding for foreign banks, then the associated reduction in the balance sheets would affect short-term KTBs more than longer tenors since foreign banks tend to have a shorter maturity to their bond portfolios. With the front-end of the KTB market also having normalised in ASW spread terms, we would see the potential for the 3yr KTB ASW spread to head closer towards 0bp in the event of a funding market squeeze from 35.5bp at present. The current 3s10s KTB ASW box is currently 58.5bp (35.5bp on the 3yr KTB and -23bp on the 10yr) and we would expect this to tighten (Exhibits 39 and 40 below).To help hedge fixing rate risks,

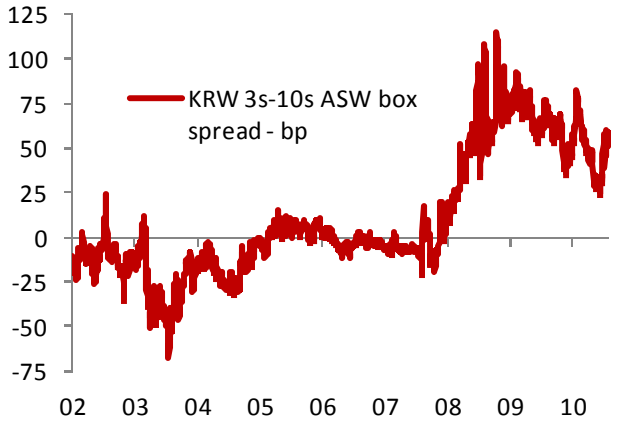
albeit indirectly, we therefore initiate in our model portfolio a 3s10s KTB ASW box spread at 57bp in USD5,000 DV01.

Exhibit 39. The back end of the KTB ASW curve has yet to normalise…



Source: Nomura Research, Bloomberg.

Exhibit 40. … into a Korean funding shock, front-end ASW spreads would likely underperform.



Source: Nomura Research, Bloomberg.

Outlook Article

EEMEA: Picking winners in a postmodern policy world

"Postmodernism cost literature its audience."

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Solvency, debt dynamics and growth differentials have been priced in by EEMEA assets throughout 2009 and 2010. We believe the markets are poised to catch up on a new theme with currency wars becoming an important reality for the markets to cope with: Postmodern (unorthodox) monetary and fiscal policies pave the way to important trading opportunities.

Our main understanding of postmodern monetary policy is changing priorities for EEMEA policy makers. Postmodern policy gives a lower weight in monetary policy to inflation at the expense of a weaker currency and higher growth in light of capital inflows into EM. This postmodern approach goes beyond traditional monetary policy responses bringing new realities to the markets (and potentially future inflation and real rates). Currency valuation and balance of payments divergence are to become a bigger part of our lives. We recommend five trade ideas to benefit from this theme.

EEMEA Top Trades of 2011

1. *Short TRY/RUB, the most obvious trade to capture postmodern policies, valuations, current account divergence. Entry at 21.13 (21.5 increasing, 22.1 stop-loss point, 19.0 target).*
2. *Short ZAR/MXN, a trade we liked for a while, benefiting from currency-centric policies in South Africa, valuations, BOP divergence, increase at 1.7920, target 1.68, stop-loss 1.84.*
3. *Increase (double)positive carry steepeners we like:*
   a. *PLN 1fwd2y vs. 5fwd5y dv01 neutral steepeners (increase at +27, target 85, stop -20, 6bp carry /month).*
   b. *TURKGB Apr 12 vs. paying 7y swap (increase at +2bp, 7.64% comp on Apr 12, 7.66% on 7y, target +120, stop loss -40).*
4. *EEMEA linkers – Own R197 now (real yield 2.6%) with a view to add Polish linkers in 1Q11 (don't hedge nominals to lock break-even yet)*
5. *Spread trades in 1fwd1y IRS space:*
   a. *Receive CZK vs. EUR at 27, target -90, stop loss +65b, carry 2bp/month (looking to add EUR/CZK downside options at spot reference 25.25).*
   b. *Pay ILS vs. Receive USD at 245 bp, target 350 bp, stop loss 195 bp, carry -1.6 bp/month.*

Setting the scene for postmodern monetary policy

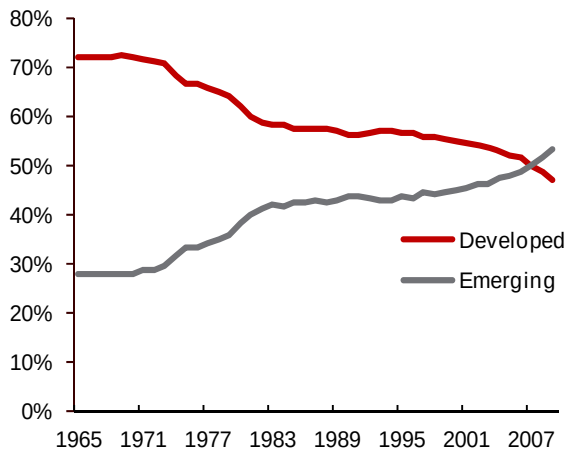
Markets can move on themes. In a way it is a bit like different colours being fashionable in different years. Debt dynamics (both projections of level, liquidity and solvency) have been the main focus throughout 2009 and 2010. Since the second half of 2010, as the expectations of quantitative easing started to dominate, the market seemed to be in search of a new dominant theme to latch on to. (See Box 1

for more on what determined FX returns in 2010). The new theme we believe is postmodern monetary policy. Before discussing our understanding of these shifts in themes, we believe it is worth going over a few changes in the inflation outlook in particular:

1. Gradual decoupling between EM and the developing world is becoming a reality (Exhibit 2) as trade diversifies.
2. Output gaps in EEMEA reflect this dynamic and are significantly narrower now than a year ago and should be largely closed by mid-2011 in most of the countries in our region. In 2011, Poland and Turkey will run positive output gaps close to 1% of GDP, South Africa's gap will have closed and Hungary and Czech Republic's gaps will have narrowed to 1% of GDP, according to our forecasts.
3. Oil demand from EM has already exceeded developed market demand, industrial metal and food demand is also increasing across EM from already very high levels. With the G3 central banks on hold and EM growth continuing, the direction of the risks should be clear (Exhibits 1 and 2) for commodities through 2011 and will be an important driver.

Exhibit 1. Share of global oil consumption

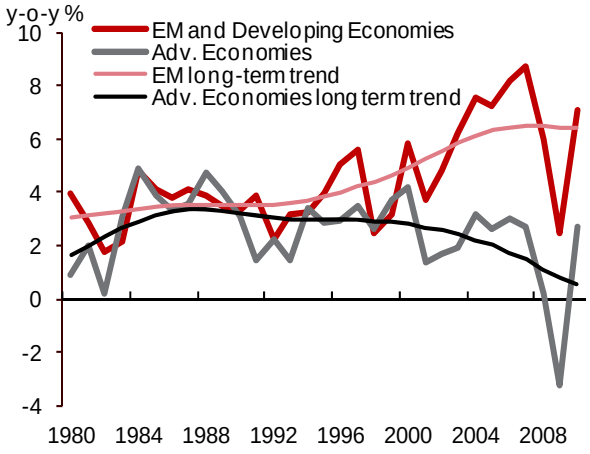
Emerging Markets drive commodity markets



Source: Nomura, BP.

Exhibit 2. EM GDP growth vs. Developed growth

Gradual decoupling in long-term growth



Source: Nomura, IMF.

Postmodern policy

Recent evidence is pointing to the emergence of a new currency theme in EEMEA. Central bankers have had a tough juggling act through this crisis. All central banks in our coverage (with the exception of CIS and GCC countries) are inflation targeting, but sharp recessions, financial stability, risk premia concerns, currency moves and the impact of fiscal policy have all had to be contended with – not to mention the unusually high uncertainty around the external dynamic for each country. We examine the evidence of a new theme in Exhibit 3.

"Currency watching", not only a trader's focus these days

It is instructive to consider both the level of emphasis that various MPC's (collectively) place on currency, inflation, growth and premia or external considerations and how this emphasis is changing. Exhibit 4 lays this out in percentage terms based on our qualitative understanding of each MPC. (Reaction functions would be unlikely to show up changes in the very short term that are becoming evident in rhetoric and MPC minutes.)

We can see that the importance of the currency is increasing in most countries. While inflation is generally declining in importance or at least not increasing in MPC reaction functions, as inflation is generally at or around its base and weak demand and output gaps are seen persisting by central banks even if we have a different view. The two exceptions are actually Hungary and Romania where fiscal consolidation has led budgets to be inflationary through tax changes. It is also worth noting that none of the EEMEA countries are pursuing very tight fiscal policy to give a big breathing space to the CBs. We can see this in Exhibit 5. We see most countries with a tightening in fiscal policy next year (or Romania already remaining tight). This allows room for monetary policy to either remain loose or only move into more neutral territory over 2011. Even in Poland which has one of the stronger recoveries, we don't think it will really be until 2012 before monetary policy can enter tight territory.

Exhibit 3. Evidence of postmodern monetary policy in EEMEA

Country	Action
Israel	Started its hiking cycle early (Aug 09), but implicit basis targeting kept implied forward rates remained below policy rates by at least 100bp as it started the hiking cycle.
Turkey	Surprise 400bp cut on the borrowing rate during 4q10 (when inflation was at 8.6%) puts the overnight borrowing to 1.75%. This is yet another effort to implicitly target the basis from the country where the output gap has been closed and there is no slack left, but at the same time they hike reserve requirement rates.
South Africa	Strongly dovish bias and more cuts possible, ex-ante real interest rates reached negative territory even as the economy recovers and with inflation rising can reach historic lows in 3-months.
Poland	Delayed hikes, highly volatile spectrum of MPC members changed tack when they were about to hike when zloty briefly broke 3.90, getting more sensitive on currency every day.
Romania	Known to be the biggest actor in the basis swap market when needed in order to control capital flows and the impact on the currency.
Czech Republic	CB governor Singer pointed at H1 2008 currency gains recently and said they "won't allow" a repeat, which comes across as an interesting statement when the koruna is only 6% off the strongest point of 2008 and is already at 2008-average.
Hungary	Whilst the level of concern around the currency has now dropped, its impact on financial stability is also lessened, but the overall levels of concern remains at a high level. The MPC remains locked in disagreement about the impact of the currency on inflation with some looking for a strong currency to actually mean higher inflation given the impact on household FX borrowing.

Source: Nomura.

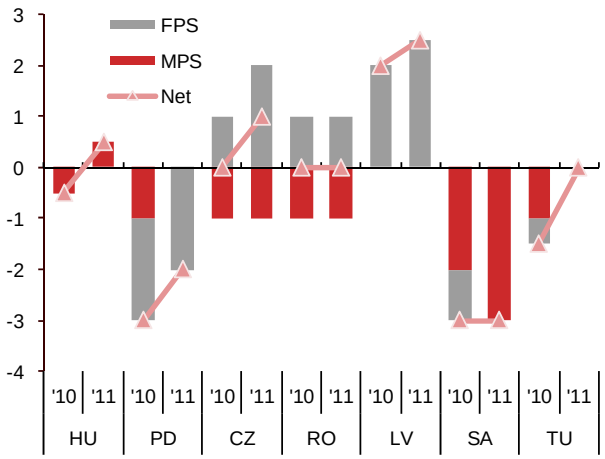
Historically, a Taylor rule was enough to analyse monetary policy for EM. However now not only are the "real interest rate assumptions" in Taylor rules changing (going lower in the short-term, but risks of higher real rates are rising), but also in order to capture what these central banks are up to, we may need another variable – REERs.

Exhibit 4. MPC emphasis and its change

	Currency	Inflation	Growth	Premia/Ext
Hungary	30	40	10	20
Poland	30	30	30	10
Czech	15	30	35	20
Romania	25	40	10	25
SA	35	25	35	5
Turkey	25	45	30	0
Israel	30	25	25	20

Source: StatsSA, Nomura Global Economics.
Note: Green implies rising importance, red declining.

Exhibit 5. Changes in the monetary policy stance (MPS) and fiscal policy stance (FPS) between now and future



Source: Nomura Global Economics.
Note: Numbers based on our qualitative assessment. Higher implies tighter policy, lower looser.

For inflation targeting central banks, however, we do worry that adding more variables into an MPC's reaction function risks policy mistakes. In particular if concern is over the currency's reaction to hikes, or that output gaps play a particularly important part, or that real rates have dropped – these arguments can lead to later hiking, and given our bearish view on inflation in general driven by global commodity prices initially (to be followed by core inflation and second round effects), MPCs can become behind the curve. Inflation can start to move higher (or decline much more slowly) and expectations can then become unanchored. Such a mistake may become apparent in 2012 through not however its effects until 2012.

Sub-themes on EM flows and risk premia

Postmodern monetary policy is not the only theme in EEMEA. We also see three sub-themes lurking in the background:

1. Secular inflows continuing into EM as an asset class – both a reflection of gradual growth, and also as a reflection of relative low share of EM capital markets in existing allocations,
2. Inflows into EM equities helping outperformance and having a currency impact but potential for outflows from EM bonds after such a strong year of performance in 2010.
3. The relatively low level of risk premium – particularly in terms of real rates and back-ends of the curves and this being reinforced by central bank policy.

Please see Box 2 for a more detailed analysis where we discuss the correlation with risk premium and the pace of inflows to dedicated EM funds which recently created a very high hurdle to sustain.

Postmodern policies trade idea 1: Sell TRY, Buy RUB

Sell TRY/RUB (half allocation at 21.13 (adding point 21.5, stop 22.1, and target 19).

In an ideal world (to reflect trade weights) we would have added both trades versus a basket of USD and EUR, given the similarity of basket weights, TRY/RUB is the right instrument. An alternative way to put this trade on is via RUB options and USD/TRY cash (a stronger liquidity-adjusted way of expressing the view, in our opinion). Hence, we are entering a RUB call spread structure with RUB now (rolling our EUR/RUB and USD/RUB put spreads to 6 months on the portfolio – Exhibit 6) with a view to trade the TRY leg more tactically (we will view retracements in EUR/TRY toward 1.90 as a trigger to buy USD/TRY and EUR/TRY calls). This structure would address investors who want to look at their exposures dynamically.

Exhibit 6. Rolling our put-spreads to 6-month

USD/RUB	Spot Ref	ATM Vol
	31.225	**10.95**

	Leg 1	Leg 2
Deal	Buy Put	Sell Put
Expiry	6M	6M
Strike	**30.9**	**29.10**
% from spot	-1.04%	-6.81%
Vol	10.57	11.14
Premium	1.74%	0.49%
Total premium		**-1.25%**
Max profit		4.93%
Risk/reward		**3.94**

EUR/RUB	Spot Ref	ATM Vol
	41.5652	**11.22**

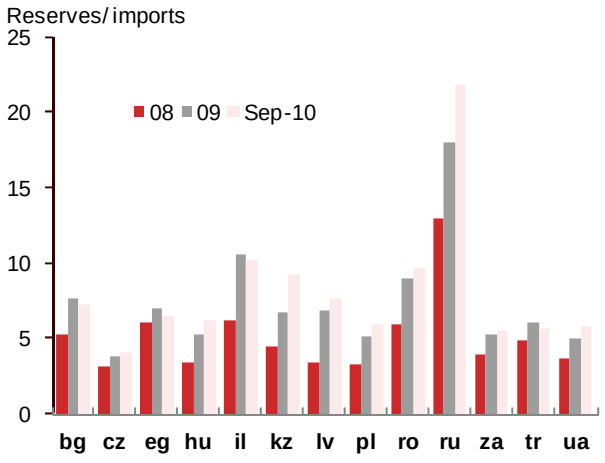
	Leg 1	Leg 2
Deal	Buy Put	Sell Put
Expiry	6M	6M
Strike	**41.20**	**38.35**
% from spot	-0.88%	-7.74%
Vol	10.9	11.57
Premium	1.94%	0.45%
Total premium		**-1.49%**
Max profit		5.94%
Risk/reward		**3.98**

Basket levels	Spot Ref	Implied Leg 1	Implied Leg 2
	35.88	**35.54**	**33.26**

Source: Nomura.

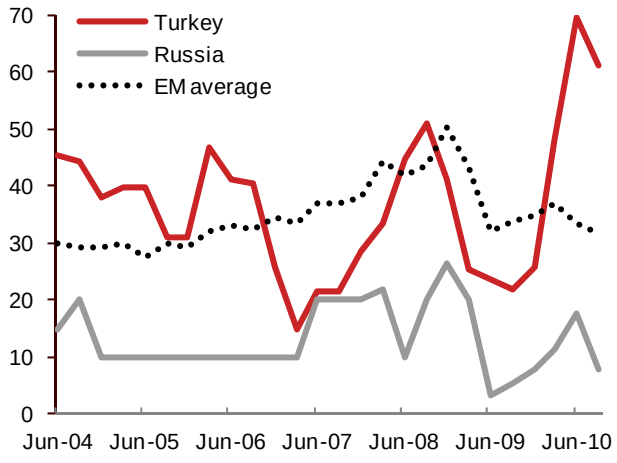
1. **RUB vs TRY is a currency wars trade:** Central Bank of Russia sold around US$8bn since the beginning of September. The Central Bank is using orthodox policies in a period where there have been strong outflows from the currency (largely one-off M&A deals and locals preparing for a hefty redemption schedule in December by buying USD). In the age of currency wars, it is an aggressive policy to support the currency to influence inflationary expectations. CB policies and the comfort with the current valuation is likely to attracts capital into Russia. Turkey on the other hand is likely to accelerate its FX buying auctions at the central bank while resorting also to the postmodern policies highlighted in Exhibit 3).

Exhibit 7. EEMEA Reserves / Imports (months)



Source: Nomura, Bloomberg.

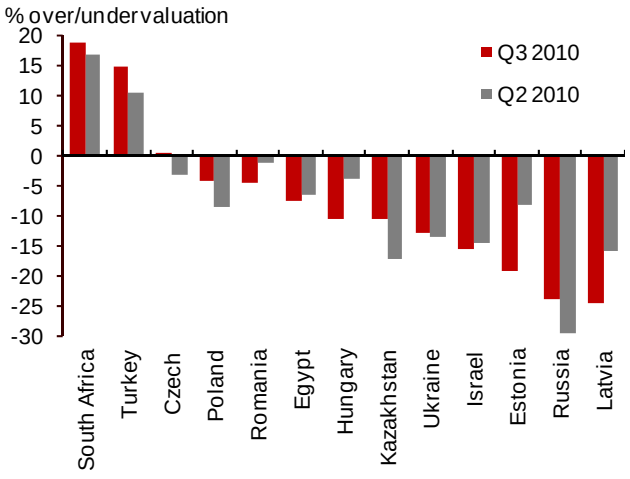
Exhibit 8. Russia/Turkey GEMaRI



Source: Nomura.

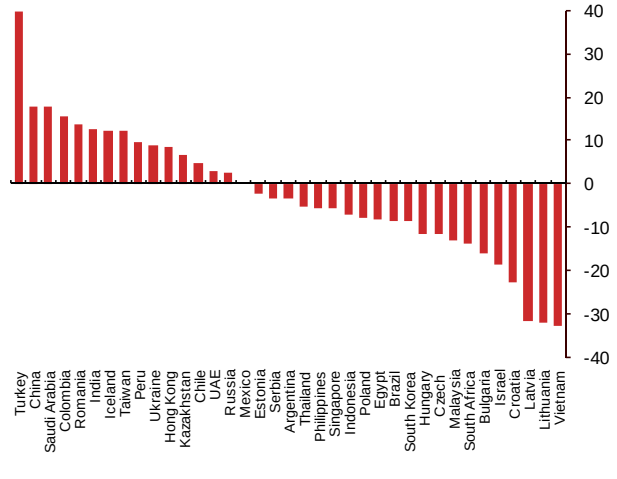
2. **RUB vs TRY is a GEMaRI trade:** Turkey's GEMaRI score is deteriorating rapidly due to a doubling of current account deficit. In fact the current account deficit is likely to reach 6.4% of GDP in 2011 according to our base case vs Russia's surplus of 2.5% of GDP. It is also worth noting Turkey's GEMaRI scores changed the fastest (in a negative way) across EM (Exhibits 10, 11)
3. **RUB vs TRY is a valuation trade:** We estimate RUB to be undervalued by 23% and TRY to be overvalued 15% (Exhibit 9) This underscores one of the biggest divergences in EEMEA.

Exhibit 9. FX valuations in EMEA and CIS



Source: Nomura, Bloomberg.

Exhibit 10. GEMaRI score change past 1 year

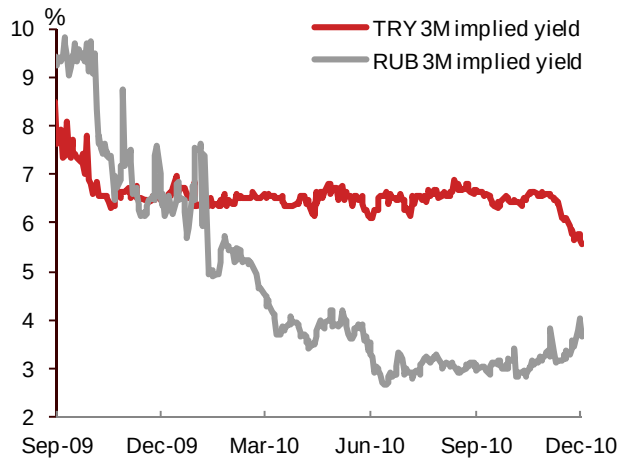


Source: Nomura, Bloomberg.

4. **RUB vs TRY is also a postmodern interest differential trade**: Russia's implied yield curve on FX forwards has always been disjointed from the policy rates. Turkey seems to move in that direction with the recent O/N borrowing rate cut from TCMB to 1% implied rates have collapsed. Russia, on the other hand is going the other way with the central bank signalling the first hike in early 2011 in line with our expectations (Exhibit 11).

5. **RUB vs TRY is not as sensitive to oil or EURUSD as one would expect.** A classic feedback on RUB vs TRY is it is an oil trade, in fact our rolling correlation analysis of RUB/TRY returns with oil and EUR/USD suggests it is not an oil trade or EURUSD trade per se (Exhibit 12). However that does not mean the market will not react as such to this supposed terms of trade 'factoid' and so it is something to watch.

Exhibit 11. TRY, RUB 3M implied yields



Source: Nomura, Bloomberg.

Exhibit 12. TRY/RUB sensitivity to oil prices and EUR/USD

		Average Beta**:		
	Starting Period:	6m Rolling	12m Rolling	24m Rolling
Sensitivity to EURUSD	Jan-02	0.20	0.21	0.22
	Jan-05	0.17	0.20	0.21
	Jan-08	0.08	0.13	0.15
	Frequency of Rsq. less than 5%*	67%	79%	79%
Sensitivity to Oil price	Jan-02	0.03	0.03	0.04
	Jan-05	0.04	0.04	0.04
	Jan-08	0.04	0.05	0.06
	Frequency of Rsq. less than 5%*	87%	93%	97%

Note: *For the frequency calculations we use the sample starting from Jan-2002. **Beta is the coefficient derived by regressing RUBTRY returns on returns in EURUSD or Oil prices, respectively.

Source: Nomura, Bloomberg.

Postmodern policies trade idea 2: Sell ZAR, Buy MXN

We first initiated our ZAR/MXN trade on 07 Sep (*FX Insights: EMFX RV can be simple: Buy MXN vs ZAR*) and increased it on 23 Sep (*EMFX Portfolio Update: Increasing ZAR/MXN shorts*). We recently reduced risk, taking partial profits at the back of a view on erratic year-end price action on relative value trades (*EMFX Portfolio Update: Reducing risk as liquidity dries up*). The trade still applies as:

1. Valuations are still extreme (ZAR is undervalued by 19% vs fair value in MXN) in our models and supported by REER deviations from trend too.

2. Positioning is heavily tilted toward long ZAR positions currently (See Box 3 for an analysis of our estimations of long-only positions).

3. We do not expect any postmodern policy response from the central bank in Mexico, as cuts are not in the pipeline. For South Africa, however, in February we do expect to see more rhetoric around the currency and we do expect further action to try and weaken it. While further cuts are not our base case, there is still a significant chance of very dovish outturn from the SARB at the January meeting and the chances of cuts are not insignificant.

4. US growth surprises have been suggesting that this cross should trade around 1.70, (see Exhibit 13). Given the evolution of the currency wars theme in line with strengthening data in US, we continue to like this trade. Our strategists in Latin America are getting more bullish on MXN (see *Latin American – Fighting the inevitable*, page 122), as it looks attractive due to

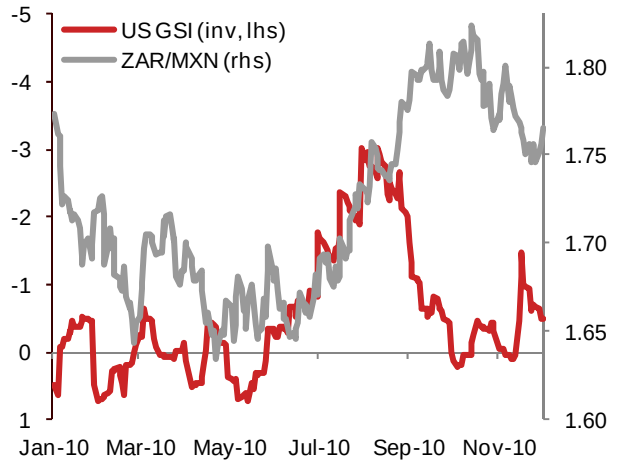
improved sentiment for domestic private consumption, moderate increase in government spending, beginning of normalization of consumer lending. We upgraded our 2011 GDP forecast to 4.0% from 3.0%.

Postmodern policies trade idea 3: TRY and PLN steepeners

We already have these positive carry steepeners in our portfolio (see *Converting TRY 5y payers to bill/swap steepeners* and *Some steepeners (such as PLN) are more equal than others*). We pay TRY 7y vs April 12 T-bills on a dv01 neutral basis (and borrow 3-month cash) positive carry is 8 bp/ month. In PLN, we receive 1fwd2 vs 5fwd5s. Positive carry is 6bp/month.

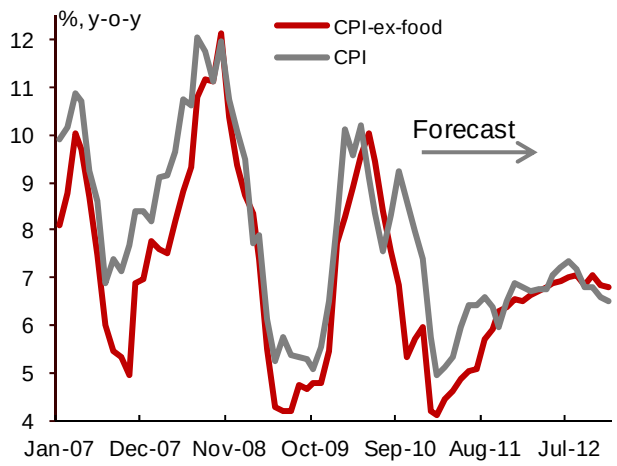
We do believe that with postmodern policies – frontend receivers will get a big boost either in the form of delayed hikes or a smaller hiking cycle, partly because of currency appreciation taking the brunt of financial condition tightening. In fact, in Box 5, we show that receiving rates after the start of a hiking cycle historically has not worked as well in G4 cycles, but in the post-crisis world receiving 1fwd1y always worked in EM after the first hike, especially Asia.

Exhibit 13. US Nomura Growth Surprise Index vs. ZARMXN



Source: Nomura, Bloomberg.

Exhibit 14. Turkey CPI and CPI ex-food



Source: Nomura, CEIC.

Other reasons supporting these trade ideas:

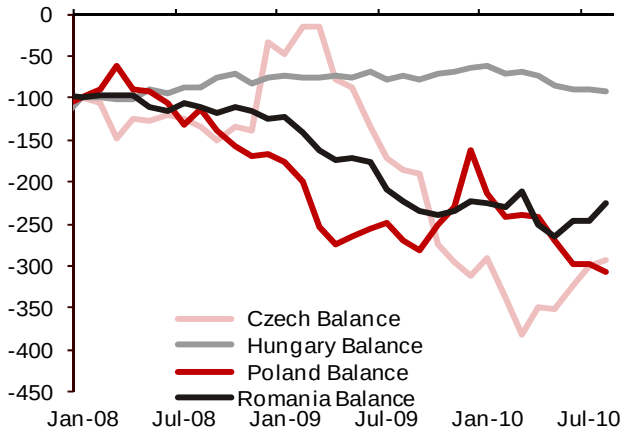
1. Turkey's loan growth is enjoying rates of 30% y-o-y, real wages are rising and we expect core inflation to rise significantly soon,
2. Front-end of both curves will benefit from duration reduction from local and international players in the face of inflation pressures,
3. Fiscal policies in both countries are not particularly restrictive,
4. Both trades are positive carry and will benefit from any possible outflows from EM asset class or a very rapid acceleration in global growth for the reasons mentioned in Box 2.

Exhibit 15. Global steepener dynamics, GDPs and CPIs

	1fwd2y	5fwd5y	5fwd5y - 1fwd2y	GDP*	CPI**	5fwd5y - GDP	5fwd5y - CPI
PLN	5.51	5.67	16.1	6.3	2.6	-0.6	3.1
HUF	6.90	7.42	52.4	5.6	5.1	1.8	2.3
INR	7.33	7.75	42.4	18.0	8.9	-10.3	-1.1
AUD	5.48	6.38	90.2	6.5	3.0	-0.1	3.4
TRY	7.93	9.03	109.9	13.5	7.2	-4.5	1.8
KRW	3.78	4.59	80.4	9.0	2.8	-4.4	1.8
CZK	2.57	3.73	115.5	2.3	1.7	1.4	2.0
JPY	0.48	1.91	142.9	2.1	-0.9	-0.2	2.8
NZD	4.66	6.54	188.0	4.9	2.1	1.7	4.4
ZAR	6.82	8.78	195.8	7.8	4.5	0.9	4.3
EUR	2.10	4.13	203.2	3.2	1.6	0.9	2.5
MXN	6.19	8.39	219.6	8.2	3.9	0.2	4.5
ILS	3.71	5.84	213.1	5.8	3.0	0.1	2.8
SGD	1.59	3.97	238.1	18.7	2.8	-14.8	1.2
USD	1.80	4.58	277.6	4.2	1.6	0.3	3.0
GBP	2.11	4.81	269.5	5.0	3.2	-0.1	1.6

Source: Nomura, Bloomberg.

Exhibit 16. CEE budget deficits (12M rolling)
Rebased to January 2008 = 100



Source: Nomura, Bloomberg.

Postmodern policies trade idea 4: EM Linkers (Stay long R197, with a view to add Polish linkers and hedge nominals in 1Q11)

In whole Asia continent there are only two bonds to hedge inflation whilst most countries in EEMEA have ILBs and there are three markets that are particularly liquid. EEMEA is a perfect region to benefit from a potential inflation hedge as the stock of inflation linkers is not worryingly high. We believe South Africa linkers offer the best value at the moment.

We look at five metrics:

1. The deviation of current inflation from historic averages (Exhibit 17),
2. The deviation of break-evens from historic averages (Exhibit 18),
3. Central Banks success rate to keep inflation within targets (Exhibit 19),
4. Our comfort level with the real rates,
5. Our inflation forecast vs break evens.

The results of all five metrics point at South Africa. Turkey scores highly in chances of high inflation, but we are not comfortable with the real rates at 50 bp above France. Furthermore, linkers sold off 1000 bp during 4Q08 which compares to 40bp selloff for South Africa linkers.

We believe break-evens are too high in Turkey and Israel. We also believe that Poland linkers offer good risk reward should the break-evens came off. Hence we will be looking to fade moves below 3% on Poland 2016s break-evens.

Exhibit 17. Current inflation and historic averages

CPI (%, y-o-y)	Israel	Poland	Turkey	South Africa
Last	2.50	2.80	8.62	3.40
10y average	2.13	2.87	19.45	6.09
10 std dev	2.31	1.77	17.95	3.26
Std dev from mean	0.16	-0.04	-0.60	-0.82
5y average	2.65	2.69	8.76	6.94
5y std dev	1.72	1.22	1.83	2.82
Std dev from mean	-0.09	0.09	-0.08	-1.26

Source: Nomura, Bloomberg.

Exhibit 18. 10y break-even and historic averages

10y breakeven (%)	Israel	Poland	Turkey (5Y b/e)	South Africa
Last	2.64	3.52	7.36	5.85
Whole period average	1.57	2.57	5.98	5.58
Whole period std dev	0.53	0.48	2.04	0.69
Std dev from mean	2.02	1.98	0.68	0.39
5y average	1.57	2.58	5.98	5.68
5y std dev	0.53	0.50	2.04	0.69
Std dev from mean	2.02	1.86	0.68	0.24

Source: Nomura, Bloomberg.

Exhibit19. Central Banks success rate to keep inflation within targets

	Frequency of inflation outside of inflation target range (from 2005)				Absolute Deviation (AD) from the target range (from 2005)	
	Overall	Upper bound violated	Lower bound violated	On average how long outside the target range (months)	Mean AD	St.dev of AD
Czech Rep.	54%	19%	36%	9.50	1.21	1.06
Poland	49%	29%	20%	5.86	0.53	0.37
Israel	66%	43%	23%	7.67	0.99	0.72
Turkey	70%	63%	7%	12.25	3.00	1.82
Hungary	64%	57%	7%	11.25	2.18	1.40
South Africa	55%	51%	4%	9.50	2.73	2.42

Source: Nomura, Bloomberg. Note: We assume inflation target band +/-1 pp to the mid -point of inflation target.

Postmodern policies trade idea 5: spread trades

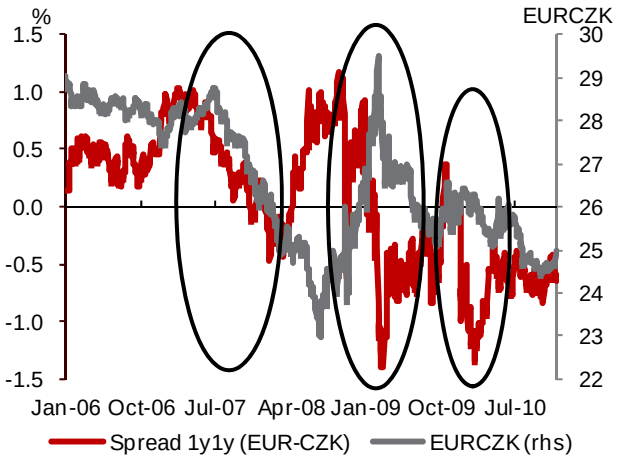
1. Receive CZK 1fwd1y vs. EUR – and buy EUR/CZK puts
2. Pay ILS 1fwd1y vs. USD

CZK receiver vs. EUR overlayed with EUR/CZK

Israel and Czech Republic are two countries in EEMEA where markets did not have big trend momentum recently and come across usually as "boring" to many investors because of lack of volatility. We do see compelling trade opportunities in both markets of late which tie in very strongly with our postmodern policy themes.

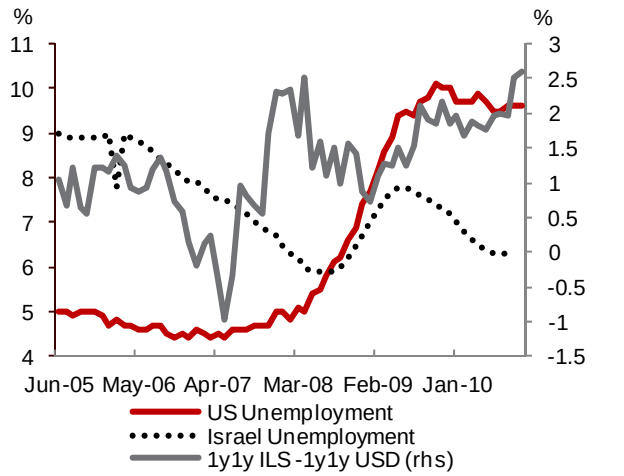
The Czech Republic is enjoying a lack of leverages in its economy and is one of the safe havens in EEMEA. This does allow Czech Republic to pursue post-modern monetary policies. As a small open economy, with a broadly balanced current account, the currency is under consistent appreciation pressure. Lately, the central bank changed tactic and is increasingly sounding dovish in response to these currency moves and the impact on competitiveness.

Exhibit 20. EURCZK vs. 1y1y CZK vs. EUR spread



Source: Nomura, Bloomberg.

Exhibit 21. US, Israel unemployment and 1y1y ILS vs USD spread



Source: Nomura, CEIC.

The business cycle to some extent supports the central bank and we do believe that Czech Republic will lag any bear market in global rates to an important extent.

Furthermore, it is also worth highlighting the extremely close relation between 1fwd1y in EUR and CZK with the currency (Exhibit 20).

Hence we believe that the CZK front-end can easily trade through Europe in a very short time as much as 100 bp. We estimate the hedge ratio ultimately should be around US$10k worth of spread position vs. US$10 mn. Our target area to buy EUR/CZK downside options is 25.25.

ILS 1fwd1y payer vs. USD

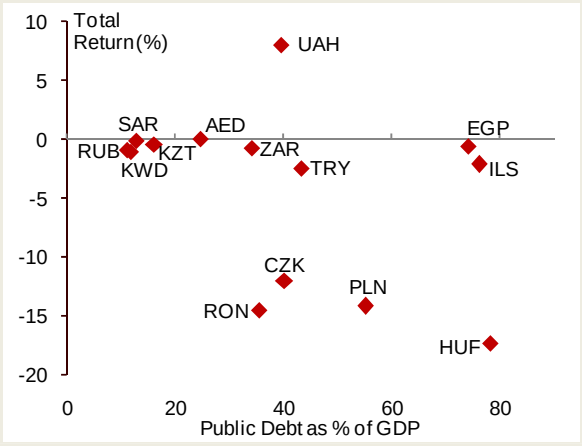
Israel is less postmodern in terms of CB policy where the priorities over inflation has not declined. For a long time Israel rates have been traded in tandem with US rates, where the seasonal adjusted unemployment rates do not suggest any similar policy should be expected (Exhibit 21).

Bank of Israel strikes us the only central bank in EEMEA that can tighten very aggressively within a short-time frame should inflation move out of control. Recently the business cycle somewhat moderated and the BoI is coming across as relatively dovish. When considering the recent front-end sell-off in US, the spread trade is a great opportunity to be able to pay ILS rates without paying carry.

Box 1 – Fiscal themes are largely priced in, BOP themes are not

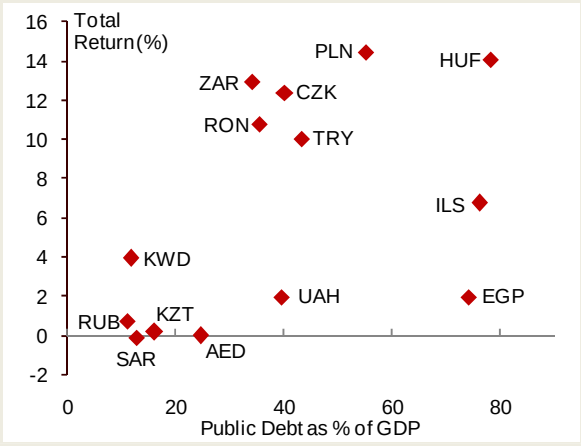
2010 for EEMEA can be characterized as having two halves: 1) fiscal themes overruled – where the bond inflows paved way to currency strength in solvent countries, 2) second half has largely been a correction – though to a much less extent. In the current backdrop, the CDS and currency markets have largely factored in the major fiscal themes. Accordingly, as the markets have shown signs of pricing in QE II and going for late cycle or laggard trades in the second half of 2010, the correlation on FX returns with public debt disappeared. We will probably see debt dynamics and first derivative (fiscal) less in play in 2011 (Exhibits 1, 2).

Exhibit 1. Public debt to GDP vs. 1H2010 FX total returns (from USD perspective)



Source: Nomura, IMF.

Exhibit 2. Public debt to GDP vs 2H2010-to-date FX total returns (from USD perspective)



Source: Nomura, IMF.

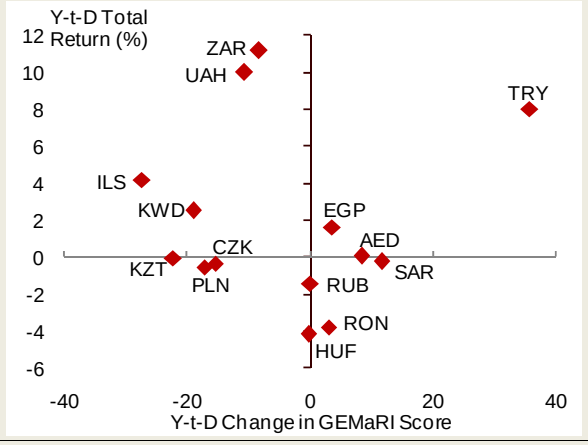
In the current backdrop, the markets have factored in quite significant shifts in debt dynamics, which is evidently seen in non-currency markets as well. To cite a few examples using Turkey and South Africa as two countries that have a stronger debt dynamics backdrop (particularly for public and private external debt) over Poland and Hungary:

1. The South Africa and Turkey CDS now trades through Poland CDS – showing an outperformance of around 50bp during 2010.
2. The 10Y bond yield spread of South Africa to Poland narrowed 100bp this year in favour of South Africa. Similarly, Turkey's 10Y bond yields tightened 110bp versus Hungary 10Y bonds.
3. Turkey and South Africa equities outperformed Hungary, Poland, and Romania during 2010.

Balance of payments have been largely ignored by the markets in previous years due to the dominance of fiscal themes.

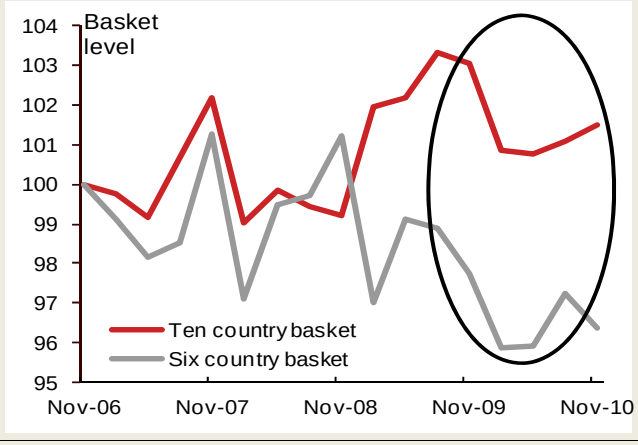
Looking at the performance of EEMEA currencies, there is no strong link to their change in GEMaRI scores (Exhibit 3). We would have expected a negatively sloped correlation on a broader scale. Looking at a wider EM basket, however, we see that being short countries with high GEMaRI scores, and long countries with low GEMaRI scores has not worked in 2010 (Exhibit 4).

Exhibit 3. Y-t-D EEMEA FX (against USD) total returns vs. Y-t-D change in GEMaRI Score



Source: Nomura, Bloomberg.

Exhibit 4. Spot Performance of GEMaRI basket (short vulnerable currencies, long safer currencies)



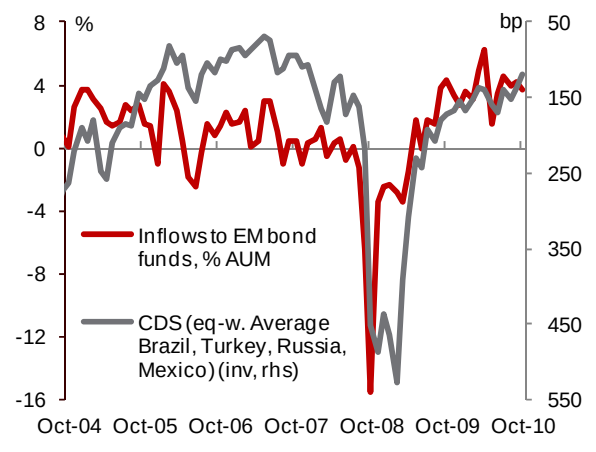
Source: Nomura, Bloomberg.

Box 2 – Secular inflows continuing to EM, but...

Debt-to-GDP ratios and growth in EM suggest the secular inflows could and should continue in EM. Even if that's not likely to match the recent speed, there is still some good reason for increasing allocations to EM. In our view, the inflows during 2011 are likely to show three characteristics which will be relevant for investors:

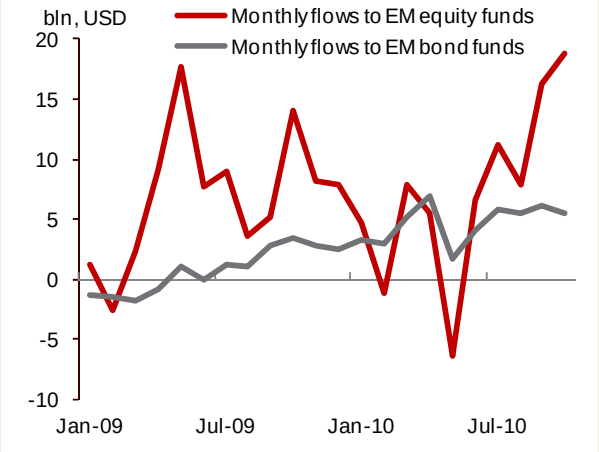
1. **Deceleration into the bonds funds:** Using history as a guide, 2008 has important lessons. In an environment of credit premium declining over EM, a potential outlook that sees inflation loom large may not be able to sustain the inflows at the current pace. 2007 was the previous time when inflows were running near 5% of assets under management, and with credit premium reaching almost 100bp over Treasuries. In that period we saw bond outflows first slowing in the second half of 2007, and outflows starting in 2008 with a deteriorating inflation outlook largely as a result of global growth and commodity prices.
2. **Inflows into Equity markets to continue:** There are already signs of inflows into EM equities outperforming EM bonds. This has fed into the data and this fits with the 2007- 2008 example – another period of strong expectations around EM decoupling.
3. **Prospects of EEMEA allocations:** Underweights have been closed in EEMEA. Looking at inflows to EM dedicated funds and inflows from the dedicated funds to the region shows an important differentiation. Investors seemed to be underweight until early 2010 where the inflows to EEMEA have not benefited. Since 1Q11 this has changed and EEMEA did benefit. We believe most underweight positions have been closed except Hungary (see next Box).

Exhibit 1. Monthly EM bond fund inflows as % AUM vs. EM CDS



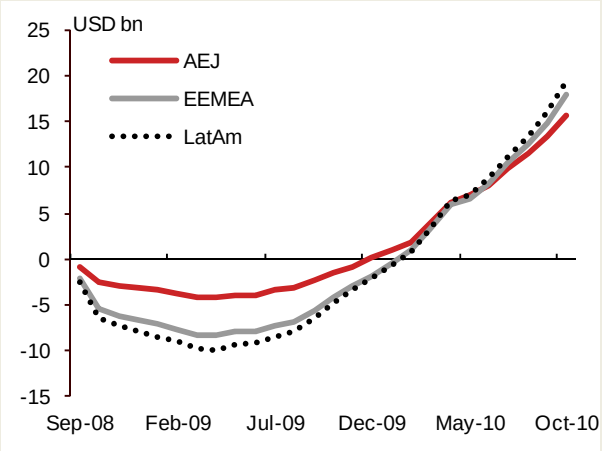
Source: Nomura, EPFR.

Exhibit 2. Monthly EM bond fund flows vs. EM equity fund flows



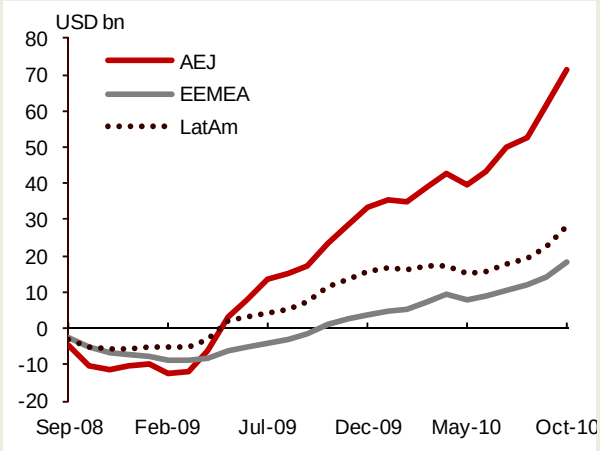
Source: Nomura, EPFR.

Exhibit 3. Cumulative bond flows since Sep-08



Source: Nomura, EPFR.

Exhibit 4. Cumulative equity flows since Sep-08



Source: Nomura, EPFR.

Box 3 – Hungary, strong technical position (for a weak fundamental reason)

Hungary shorts are very crowded

EM dedicated bond funds received US$32.5bn in 2010 and US$41bn since 2009 according to Emerging Portfolio Fund Research (EPFR). Assuming dedicated funds put all the funds to work; the tracking (of the EM indexes) requires investments to the main emerging market countries. Hungary's weight in dedicated local bond fund indexes varies from 5% to 7.5%. We believe the amount of inflows to EM or the size of asset class when compared with actual inflows to countries provides an invaluable technical positioning insight.

Exhibit 1. Estimate of under/over investment based on theoretical weighted flows and actual flows

	Fast- allocation shift assumption		Slow - allocation shift assumption		Actual Flows		over/under investment: Fast- allocation shift assumption		over/under investment: Slow - allocation shift assumption	
	Since Jan -10	Since Jan -09	Since Jan -10	Since Jan -09	Since Jan -10	Since Jan -09	Since Jan -10	Since Jan -09	Since Jan -10	Since Jan -09
Poland	5.4	14	3.2	8.2	14.5	22.5	9.1	8.5	11.3	14.3
Safrica	4.6	11.8	2.7	6.9	8.8	12	4.2	0.2	6.1	5.1
Turkey	4.3	11.1	2.5	6.4	9.4	8.1	5.1	-3	6.9	1.7
Hungary	2.8	7.2	1.6	4.2	0	-1	-2.8	8.2	-1.6	5.2

Source: Nomura, EPFR, AKK, Turk Treasury

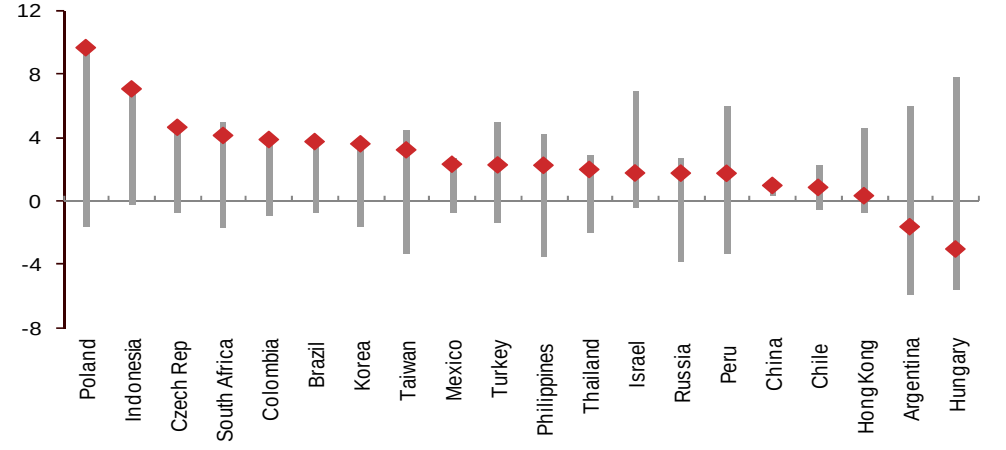
No inflows to Hungary in the past two years

Non-resident holdings of Hungarian government bonds suggest that in 2010 and 2009, the Hungarian bond market saw no inflows (Exhibit 1). Even using the EPFR EM bond inflow number (US$41bn) and assuming 5% of the inflows should have gone to Hungary leaves an investment gap of US$2bn.

We make some more assumptions using a fast allocation from EM sovereign funds to local market funds, and using different weights on EM indexes. These suggest that Hungary is the most "under-owned" market in EEMEA. Depending on the assumptions made, the amount of over- or under-investment in EEMEA markets changes (Exhibit 1). However, we believe that the ranking does not change with the assumptions; we believe the positioning (from high to low) is: Poland, South Africa, Turkey, Hungary.

A key figure from the IMF's Financial Stability report supports our claim on market technicals in our view. Looking at inflows as a percent of equity and debt market cap, Hungary's underweights appear the most aggressive in EM. In contrast, Poland's overweights appear the most extreme in EM (note that the IMF figure shows the same ranking as our analysis: Poland, South Africa, Turkey and Hungary, Exhibit 2).

Exhibit 2. Equity and Debt portfolio inflows (percent of equity market capitalization and debt outstanding)



Source: Nomura, Bloomberg
Note: Lines indicate range of inflows (4-quarter trailing average) during Q4 2003 and Q1 2010 as a percentage of the debt outstanding and equity market cap. Diamonds are Q1 2010 values and Q4 2009 for China, Colombia, Hong Kong, SAR, Hungary, Israel, Mexico and Peru.

One of the markets with the greatest policy risk next year is Hungary. Firstly we have the backdrop of non-credible fiscal policy which is undertaking distortionary sectoral taxes and impinging on the constitutional court's role and one of the most stringent banking taxes globally. Markets have however largely ignored this backdrop (though it has underperformed in recent months) instead looking to Hungary's low fiscal deficit target for 2011 of -2.9% GDP and its current account surplus. However some of the policy changes are going to be directly impacting the market through 2011.

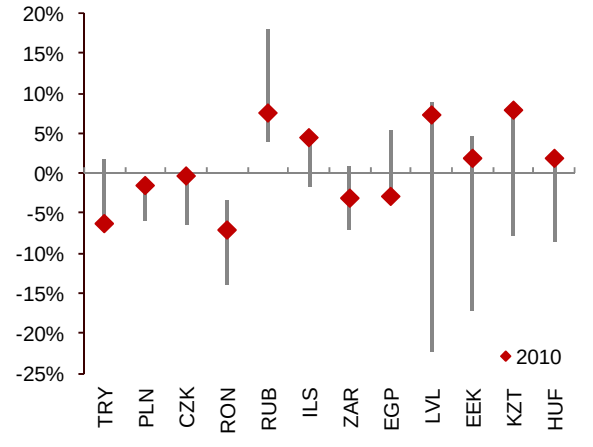
MNB MPC: Four of the seven MPC members will be changed over on 1st March. The FIDESZ government is trying to change the law in order to ensure it can appoint all four new members itself, as opposed to just two under the current rules (with the other two being nominated by the MNB Governor). Also however the government has said it would want these four new members to vote through a raise in the inflation target – of which the power to change does lay with the MPC. This shows a worrying disregard for the independence of the MPC and risks stoking inflation expectations, a worrying prospect for a country that has had issues on this front in the past and where inflation looks set to remain highly sticky anyway. More than this though is the looming commitment of FIDESZ during the election that it wanted to see rates set at 4.50% at that time. They also said they would like to see QE on corporate and development bank bonds. Rate cuts and QE now would be very dangerous both directly in spurring overheating and inflation but also through direct funding of the budget and a large credibility hit. This drastic scenario cannot be ruled out, but even under a less extreme scenario we look set to see large rate volatility as the current MPC hikes and then a new one may even cut back. Trading this will be exceedingly difficult but steepeners may be the easiest way to do it.

Pension reforms: The abolishing of the tier 2, semi-private semi-public, pension system is going to have some profound effects on the debt markets through 2011. First it should be noted the policy is in order to fill the funding gap in the social security fund, reduce government expenditure paying into these pensions (some HUF360bn per year) and lower the level of outstanding debt. The transfer of the assets back to the state will mean some HUF1.4tr of debt will be written off and so lowering the debt to GDP level by around 4.6pp. Equally the greater inflows of funds from the sale of the other assets should mean that some HUF480bn of debt is not issued next year. On the flip side an important marginal buyer will be removed from the market (the old tier 2 funds) which should result is around HUF245bn less debt buying next year. Net (change in demand minus change in supply) means there will be reduced market balance of some HUF235bn. Whilst debt levels will start falling as a result of this change it does remove a key local secondary market trading presence that is important during times of market stress.

Box 4 – Balance of payments dynamics and REER

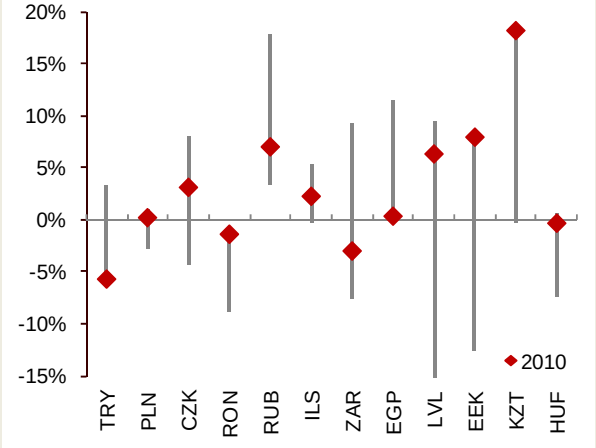
Currency valuations are still our major guide post and in fact there are some signs of extreme valuations. On the weak side, Baltic currencies as well as CIS currencies look cheap. On the expensive side, TRY, ZAR look expensive. We provide a box going further beyond our FEER and SEER models. We provide two more analysis on this box looking at the picture from the result – making a deduction on causality. We compare the current accounts, current account + FDI, and current account + FDI and other investments to see how they are faring in order to see if any currencies are showing signs of being overvalued. This analysis suggests ZAR overvaluation has not fed to BOP yet, whereas TRY BOP have been deteriorating fairly fast. The BOP also supports the zloty. Finally, we look at the REER and how they compare to history. This picture supports the CEE3 currencies.

Exhibit 1. Current account, % of GDP (latest level and 2000-10 range)



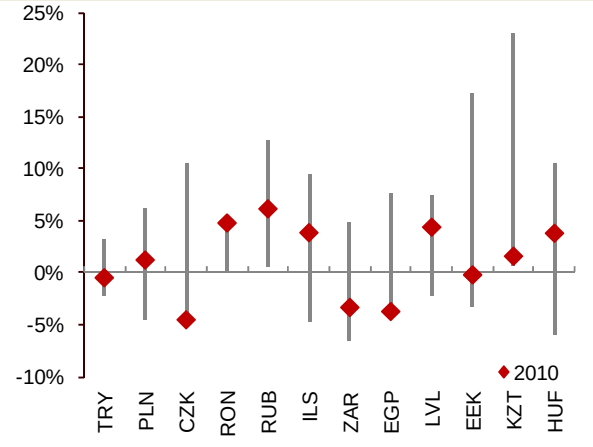
Source: Nomura, EMED, Datastream, Bloomberg.

Exhibit 2. Current account + FDI, % of GDP (latest level and 2000-10 range)



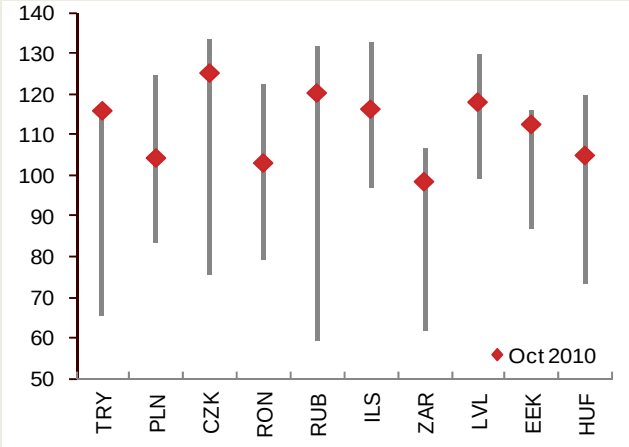
Source: Nomura, EMED, Datastream, Bloomberg.

Exhibit 3. Current account + FDI + Other Investment, % of GDP (latest level and 2000-10 range)



Source: Nomura, EMED, Datastream, Bloomberg.

Exhibit 2. REER (10-year range)



Source: Nomura, EMED, Datastream, Bloomberg.

Box 5 – Receiving front-end after the first hike, profitable in the new normal

Historically receiving 1y1y after the first hike has been a tricky strategy for a rates trader, as the risk premium built into the curve may not have been enough. In the new normal post-Lehman Brothers world, this has changed. In this box we look at the hiking cycles over the past 10 years for USD, EUR, AUD and GBP curves as well as the strategies on how has receiving the rates after the first hike has performed.

We are looking at total returns following receiving 1 week after the first hike as well as receiving 2 weeks after the first hike. On a 6-month horizon, there are no cases in the recent 2-years that resulted in a period where an investor lost money.

We believe that the post-modern policy or currency wars will make this dynamic skew further into receiving.

In other words, even for the countries that may hike, this dynamic should give steepeners an important support.

Exhibit 1. Total return (including the roll down) (%) of the 1y1y receiver entered 1 week or 2 weeks after the beginning of the hiking cycle

			receive 1y1y 1w after the first hike				receive 1y1y 2w after the first hike			
Cycle Inception	Currency	Cycle Size (bp)	+1M	+3M	+6M	+1Y	+1M	+3M	+6M	+1Y
Sep-99	GBP	100	0.35	0.73	1.22	2.15	-0.05	0.29	0.70	1.48
Nov-03	GBP	125	0.17	0.45	0.34	0.86	0.18	0.47	0.36	0.87
Aug-06	GBP	125	0.22	-0.02	-0.44	-0.69	0.13	-0.12	-0.55	-0.83
Jun-99	USD	175	-0.25	0.15	-0.36	-0.31	-0.29	0.10	-0.41	-0.36
Jun-04	USD	425	0.00	0.57	0.52	0.94	0.10	0.68	0.64	1.09
Nov-99	EUR	225	-0.11	-0.53	-0.61	-0.17	0.06	-0.34	-0.39	0.13
Dec-05	EUR	200	-0.14	-0.31	-0.63	-0.41	-0.06	-0.23	-0.54	-0.31
Jul-08	EUR	25	0.30	1.12	2.22	2.79	0.29	1.11	2.21	2.80
Nov-99	AUD	150	-0.10	-0.64	0.16	1.20	-0.15	-0.68	0.14	1.20
May-02	AUD	50	0.22	1.19	1.72	2.81	-0.03	0.88	1.33	2.25
Nov-03	AUD	75	0.09	0.55	0.57	1.29	-0.04	0.39	0.38	1.02
May-06	AUD	75	0.30	0.10	0.15	0.12	0.13	-0.09	-0.07	-0.17
Aug-07	AUD	100	0.22	-0.67	-0.50	0.37	0.07	-0.83	-0.68	0.15
Oct-09	AUD	150	-0.14	0.42	0.54	1.62	0.28	0.86	1.03	2.19
Jul-10	SEK	75	0.08	0.37			0.09	0.38		
Jun-10	NZD	50	0.25	0.86			0.14	0.75		
Mar-10	INR	200	-0.11	0.29	0.35		-0.11	0.30	0.37	
Jul-10	KRW	50	0.05	0.67			-0.08	0.53		
Aug-09	ILS	150	0.47	0.79	1.57	2.79	0.24	0.55	1.32	2.52
Oct-09	NOK	75	0.32	0.58	1.41	2.43	0.23	0.48	1.30	2.31

Source: Nomura, Bloomberg.

Box: Towards EMU: An anchor in the depths

Peter Attard Montalto

Because of events in the eurozone developments in ERM II and euro adoption are likely to remain of limited impact on to markets. However we think convergence remains important. We do not expect any major EMU events in 2011.

We think the market's view that EMU convergence has ended is overstated. Admittedly, there have been significant developments for both the eurozone and candidate countries, because of the crisis in periphery Europe, and that the sustainability of the euro-project is being questioned by the market. However, as the euro is a fundamentally political project it has both positive and negative factors, suggesting that it remains of importance for Emerging Europe.

In January Estonia will adopt the euro as its currency, and this is being viewed by Brussels as a victory for the euro area and a sign that the project is alive – bringing in a new, dynamic and competitive economy. The factors pushing countries into the eurozone include: 1) the geopolitics- are generally more integrationist than their Western counterparts and emerging European countries view EMU entry as key to securing their place at the table within the EU; 2) euro adoption would also lower the cost of doing business and provide businesses with easier access to other markets; and 3) political – domestic politicians in the region can, in general, ride on the pro-EU wave, which is good for their standing, and equally domestic populations that have little trust in post-communist governments, view the euro as an effective lock in a more credible institution. On the flip side there are the pull factors, drawing countries in: 1) EU policymakers viewing the need for the eurozone's ongoing expansion as a sign that it is functioning normally; 2) getting emerging European countries to join as part of their path to a greater European state; and 3) it acts as a fiscal straight jacket for the region.

On top of this there are the countries in the EU (or who are about to join the EU) that have not joined EMU. We think these forces combined suggest that convergence can still act as an anchor and there is some evidence on long-term fiscal planning that it does. Poland is a good example where ERM II timing even though it is not public, means the long-run deficit plans show the deficit in line with Maastricht Criteria in 2013. Markets have questioned the commitment of countries to the EMU path. This has been partly caused by governments becoming more cautious about being explicit about entry dates after being caught out during the crisis when schedules were thrown off course by rising deficits and debt. However, we believe that countries do have explicit time tables even if they are not public. For instance we believe that Poland is working towards EMU entry in 2015, in line with the Presidential election later that year, and Hungary will enter early in the current government's second term in 2016. We think Serbia and Croatia are equally targeting EMU shortly after they join the EU.

It is worth considering however if it is worth these countries joining the EMU. For small states that are closely linked with the eurozone already and moves away are unlikely, though we think a positive case can still be made. However for larger countries such as Poland and Hungary the case is less clear cut. Should such states lock themselves into a framework that has failed to address key structural difficulties? And who's long-run sustainability is in doubt? The answer may be no on the economics front and indeed when considering long-run political realities. The costs of entry and then rapidly (in the grand scheme of things) exiting would likely far outweigh the economic benefits of entering EMU. Politics is not about cost benefit analysis. The drive for EU integration will ultimately take priority over the economics argument, and hence convergence remains – even if it is surrounded by uncertainty in the shorter term.

Exhibit 1. Nomura Masstricht scorecard

	Convergence criteria						Forecast dates					Forecast FX	
Country	HICP Inflation rate	Government finances: annual gov deficit to GDP	Government finances: gross gov debt to GDP	Long Interest rate	In ERM II	Obligation to adopt	ERM II	Euro	EU	EU joining date / forecast	ERM II central parity rate	Currency spot rate	Gap
Criteria	<2.2%	-3%<	<60%	<5.7%	2 years								
Czech	1.0	-3.8	43.8	4.0	No	Yes	2014	2017	Y	2004	26.0	25.0	-4.1%
Hungary	4.9	-3.0	80.3	8.2	No	Yes	H1 2012	2016	Y	2004	275.0	279.2	1.5%
Poland	2.8	-4.5	54.6	6.1	No	Yes	Q1 2012	2015	Y	2004	3.70	4.00	7.6%
Romania	5.5	-4.0	42.0	7.2	No	Yes	2013	2016	Y	2007	4.00	4.30	6.9%
Bulgaria	2.5	-2.0	20.0	5.4	No	Yes	2013	2016	Y	2007	1.96	1.96	0.0%
Estonia	1.6	-3.0	13.2	n.a.	6 years	Yes	2004	2011	Y	2004	EMU IRCR =	15.65	0%
Latvia	-1.8	-8.5	60.0	5.3	5 years	Yes	2005	2014	Y	2004	0.70	0.70	0%
Lithuania	0.9	-7.5	48.0	4.2	6 years	Yes	2004	2014	Y	2004	3.45	3.45	0%
Croatia	1.4	-3.5	42.5	6.4	No	Yes in EU		2015	N	2012			
Serbia	8.9	-3.8	42.0	n.a.	No	Yes in EU		2022	N	2017			
Iceland	2.6	-1.1	74.7	5.8	No	Yes in EU		2022	EEC	2018			
Denmark	1.9	-3.5	48.0	2.1	12 years	No, Referendum	1999	Soon after referendum	Y	1973			
Sweden	2.0	-1.5	42.0	1.0	No	Yes	After referendum	Not set	Y	1995			
UK	3.1	-7.3	88.2	3.8	No	No	Never	Never	Y	1973			
	Last	*2012 forecast*	*2012 forecast*	*Last*	*Current*		*Forecasts*				*Forecasts*	*Current*	*Current*

Source: Nomura, EU Commission, IMF.

Outlook Article

EEMEA Rates: What's priced in for 2011?

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- *In January we will be launching a new bi-weekly product that looks at what markets are pricing in for MPC policy rate decisions over the short to medium run.*
- *Here, we preview this product by presenting a view on what rate markets are pricing in for 2011 and how that compares with our own forecasts. We also discuss how our trade ideas fit in with it.*

Our forthcoming product, the *What's Priced In Monitor* (WPM), aims to gauge market expectations with regards to EEMEA policy rates for each policy meeting. To do this we use the Nomura traders' defined swap curves to derive the implied policy rate for the different countries. The database used to build the curves consists of market data. From this we then define a three-month forward curve. We then extract from this the forward rate between meeting dates, and convert the basis and day count of the curve back to the correct basis and day count of the monetary policy reference rate instrument of choice. Within this adjustment we also account for the average spread between the three-month rate and the policy rate since the last meeting. We use this measure as a simple way of accounting for this gap; it is better than assuming it is constant and also better than trying to derive some cycle-based, econometric prediction.

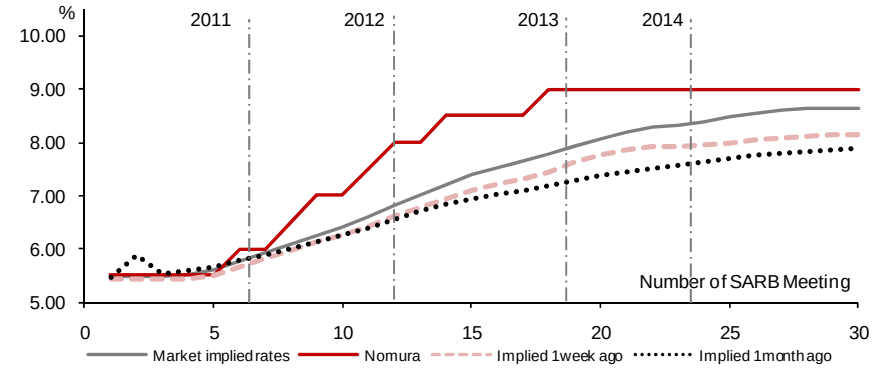
When looking at what markets were pricing in in the past, we use the same methodology and adjust the spread between the market three-month rate and policy rates to the average at that time from the last meeting.

We do not make adjustments for term premia or convexity. This is because we believe that such calculations and the choices of which type to use and their size can be arbitrary and can cause confusion. Equally, over the course of a year or so where the most interest will be these factors are minimal (around 1bp or so), and even over the rest of the time period we show the adjustments are still not particularly significant. We therefore find it easiest to exclude these factors. Readers can make their own mental adjustments if necessary.

We will be launching this model as a bi-weekly product in January. In the graphs below we look at what is currently priced in ('market implied rates'), our own forecast ('Nomura') and also what was priced in one week ago and one month ago ('implied 1 week ago', 'implied 1 month ago'). The x axis shows number of meetings into the future.

South Africa

Exhibit 1. Forward Rates Between Central Bank Meetings: ZAR



Source: Nomura

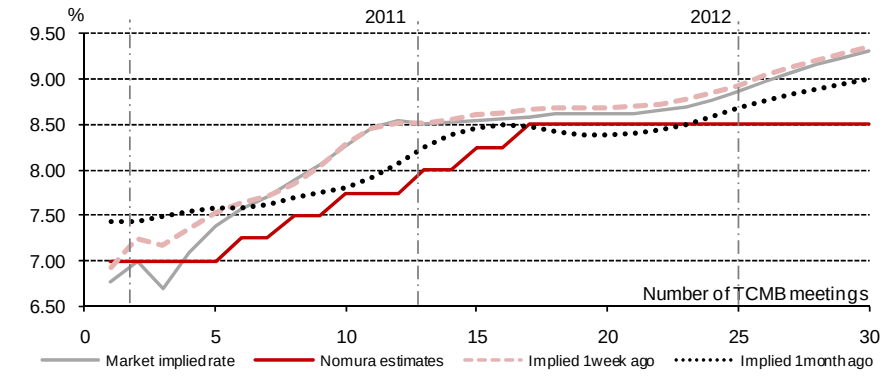
In South Africa we see a markedly faster rate hiking cycle than the market does, though we broadly agree that it could get under way at the end of next year (or start of 2012). There is also some agreement on the terminal rate of 9.0% or just below. We believe this has dropped since the last cycle as faster fiscal consolidation could open up room for lower long-run rates. Nevertheless, strong inflation going up and out of target would necessitate rate rises at a pretty rapid pace even if real rates remained pretty low overall.

Markets are, however, pricing only the slimmest possibility of a cut in January, despite risks being substantial in our view (even though it is not our baseline). in particular, we expect growth to remain sluggish and the SARB's forecast to show long-run inflation still low (although we are more bearish).

While the curves above may suggest paying in around 12-18 meetings into the future (which is two to three years on the curve), the data outturns and the SARB's own rhetoric are likely to keep the market being better receivers. We therefore steer clear of these at the moment.

Turkey

Exhibit 2. Forward Rates Between Central Bank Meetings: TRY

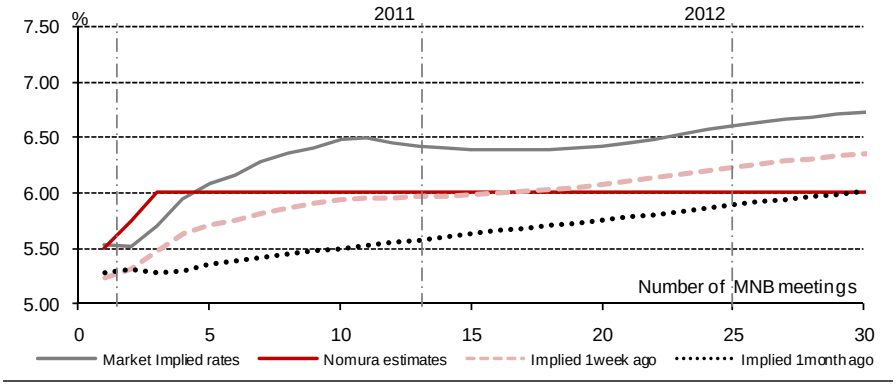


Source: Nomura

In Turkey, the rate hike cycle implied by the cross currency swaps is much more hawkish than Nomura forecasts especially around the 1-year area. We believe this is because of the TCMB's recent 400bp in its borrowing rate resulting in a distortion of the cross currency swaps which prevents them being an efficient proxy yet – partly because of still extreme slope from 3-month to 1-year. Hence we think the curve will be volatile in the near term as the markets price the basis between onshore and offshore markets. Due to this inefficiency currently imposed by the cross currency swap pricing, we recommend staying away from the front end in Turkey.

Hungary

Exhibit 3. Forward Rates Between Central Bank Meetings: HUF



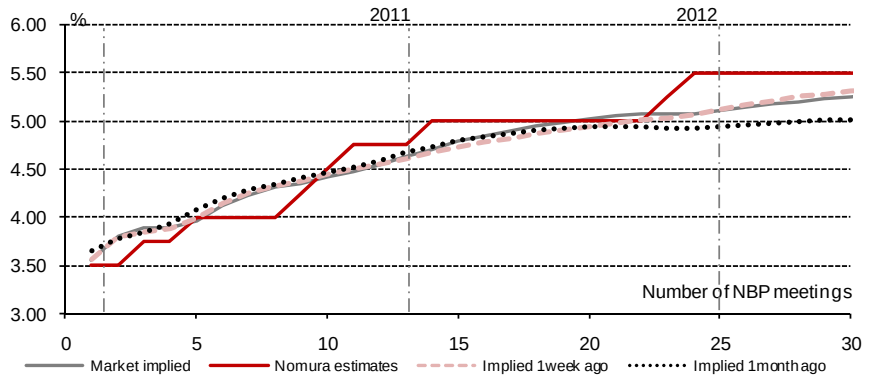
Source: Nomura

We see hikes continuing in the short term as rising inflation and worries about risk perception, premia and inflation expectations cause the current MPC to hike twice more. After that in March, however, we should see a new more highly politicised MPC which will likely look to raise the inflation target from 3.0% to 3.5%. Given government rhetoric during the election about wanting rate cuts and QE to buy development bank bonds, the risks to rates next year are totally known but may well be very volatile, as should market expectations. The implied rates above do therefore contain significant premia in our view, even in the very short end of the curve, and also the probability of emergency rate hikes in order to stabilise the currency if it were to ever have a significant sell-off.

Given the rate outlook and policy uncertainty we have a bias towards more steepening in the longer end of the curve, not the front end, though we do not put the trade on yet, awaiting better levels if the implied rates above move back towards where they were a month ago.

Poland

Exhibit 4. Forward Rates Between Central Bank Meetings: PLN

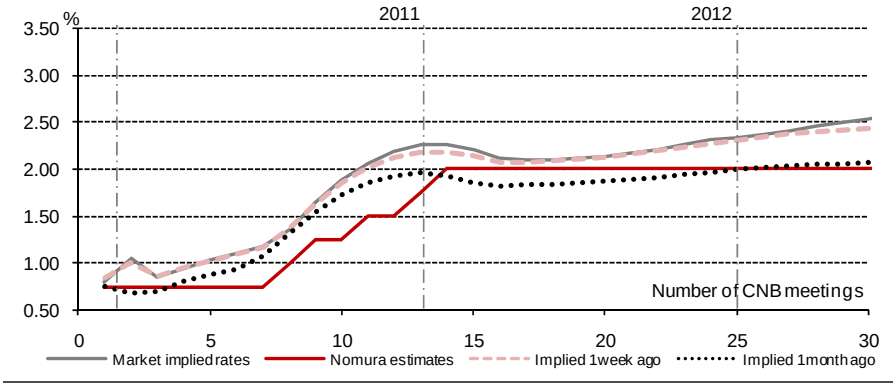


Source: Nomura

In Poland the market may well have got slightly ahead of itself in the very front end with the amount of hikes it is pricing in. Part of this may be as result of confusion given the mass of rhetoric recently from MPC members, veering between being dovish and hawkish. Overall, despite policy tightening starting in October with a hike to the reserve rate requirement, we now think the MPC will not be ready to hike the base rate until February and the inflation report at that time. PLN remains a key drag given some MPC members' views that it will aggressively strengthen as hikes start – a view we disagree with. Nevertheless, currency concern should cause a stop-start hiking cycle. We do see some value in a positive carry trade with 1fwd2 vs 5fwd5, given both the fiscal concerns we have about Poland into next year and the market's possible underestimation of how far rates can be hiked in this cycle.

Czech Republic

Exhibit 5. Forward Rates Between Central Bank Meetings: CZK

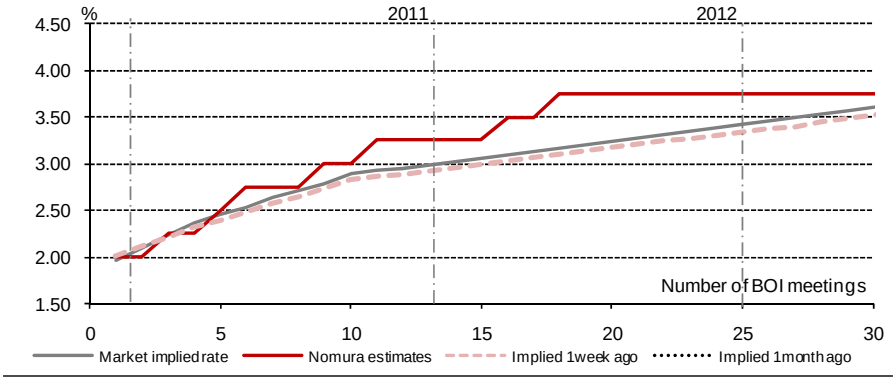


Source: Nomura

In Czech the market seems to have got ahead of itself in the front end and hence we like our pay EUR vs receive CZK trade in the 1fwd1y space. The MPC has now said the CZK strength is causing most of the tightening of the monetary policy conditions, and with fiscal consolidation late in the cycle and lower growth next year, rates look set to be on hold till the end of next year. We then expect a slow hiking cycle to a low neutral rate given a slow external recovery in EU domestic demand in particular.

Israel

Exhibit 6. Forward Rates Between Central Bank Meetings: ILS



Source: Nomura

In Israel, our policy rate view is in line with the market for the next six to seven months. Then we start to diverge from the market, mostly in the one to two year part of the curve most. This is consistent with our payer recommendation in 1fwd1y.

Outlook Article

Latin America: Fighting the inevitable

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- *Rising inflation is a clear and present danger. By fighting exchange rate appreciation, policy makers have risked a higher inflation outcome.*
- *Latin American currencies remain attractive despite risks of slower growth in the developed world.*
- ***Buy 3m USD/BRL DNT with barrier levels at 1.81 and 1.63.*** *With global capital inflows balanced by government intervention, expect considerable stability in BRL.*
- ***Buy 1 year USDMXN put spread with strikes at 12.40 and 11.60.*** *An improved outlook for domestic demand opens the path for a gradual MXN appreciation.*

Latin American exchange rates are under pressure from a variety of sources. With currencies appreciating since the start of 2009, further quantitative easing by the Fed led to a further influx of capital. But this time the authorities in the region are fighting back, by slowing down the pace of expected monetary tightening (all countries), intervening to buy USD (Brazil, Colombia and Mexico), or by imposing capital controls (Brazil).

Appreciation fears bring back intervention

The rush to intervene has a common explanation: all countries are worried about the effects of currency appreciation on manufacturing competitiveness, and most of the currencies have seen strong appreciation trends (Table 1). This is especially true in Brazil, where high relative inflation has led to very strong BRL appreciation. Brazil has a large industrial sector but has been "pushed" by the trend higher in commodity prices since 2002 into a progressive specialization in commodity exports. As we showed in "How vulnerable is Brazil to China?" (August 12, 2010), commodities now make up around 70% of Brazil's exports. Afraid of further "deindustrialization", the Brazilian authorities famously declared that the world was facing a "currency war" before the expected announcement of QE2, and promptly slapped punitive taxes on fixed income inflows.

Table 1. Percentage change of Latin American currencies since 2009

	Nominal	REER	GEMaRI
Brazil	35.9%	41.0%	17
Mexico	11.3%	9.7%	7
Argentina	-14.8%	-13.8%	0
Colombia	21.2%	15.6%	28
Chile	33.0%	2.9%	54

Note: Higher GEMaRI indicates higher possibility of a currency crisis.
Source: Nomura, Bloomberg, Haver Analytics.

The worries about losing competitiveness due to FX appreciation are particularly poignant in economies with low total factor productivity such as Mexico. Low productivity coupled with a negative shock from Mexico's main trade partner, the US, exerted significant pressure on the MXN during the crises. With the US economy in a process of deleveraging, US demand for Mexican goods has dropped, which exacerbated the need to have a cheap currency. Indeed, the MXN is the only currency among inflation targeting economies that remains cheap in real terms with

respect to its 10 year average. A strong MXN appreciation would be detrimental to growth.

These worries are shared in the region; though no country has followed Brazil's lead in imposing capital controls (see Box: *Capital Controls in Latin America*). While we doubt that these measures can do much to deal with secular trends in manufacturing competitiveness and economic specialization, we see real risks that these attempts to slow down the appreciation of nominal exchange rates can greatly increase the real threat to the region in 2011: inflation.

A two-sided inflation threat

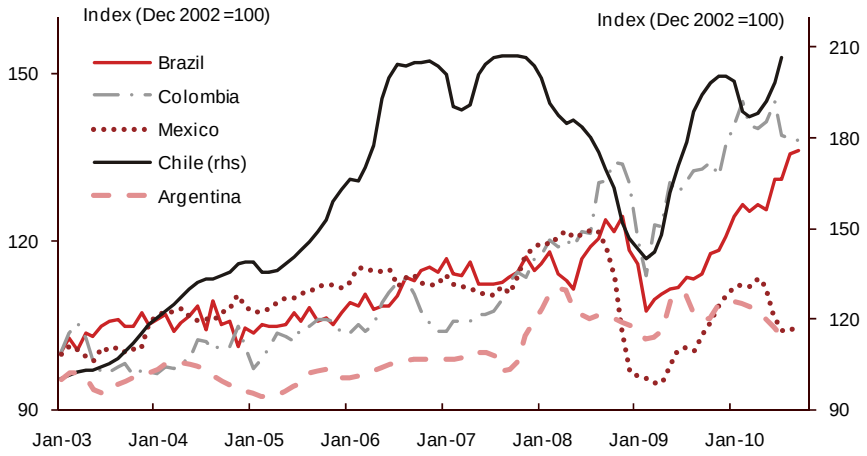
The inflation threat caused by QE comes from two distinct sources. Most obviously, higher commodity prices are already feeding into higher headline inflation across the region. The first victim is food prices: in the case of Brazil, which have risen by 6.6% year-to-date, with the last reading showing a 1.9% m-o-m rise (food prices make up 22.6% of the IPCA inflation index); in the case of Chile, food prices are up by a more modest 3.5% year-to-date, but this compares with headline inflation still running at only 2% (food prices make up 18.9% of the CPI index). Similar to Chile, food prices in Mexico have increased moderately by 3.3% y-o-y during the year. However, this dynamic could be the calm before the storm. Indeed, when soft commodity prices peaked in June 2008, annual food inflation jumped to between 7.4% and 9.7% during the following 17 months despite the fact that as early as February 2009 soft commodity prices had corrected back by 36%. This indicates that in Mexico, the soft commodity shock in 2008-2009 stayed in the system for a prolonged period of time because it was accompanied by a sharp FX depreciation. Most of the currencies in LatAm not only depreciated by less than the MXN but also normalized sooner. In Colombia, food inflation has been remarkably tamed as it had remained capped below 2.0% y/y during the year. The closure of the trade with Venezuela, a natural importer of food from Colombia, has increased the supply and resulted in low food inflation in spite of rising soft commodity prices.

Unfortunately, food prices in the region respond with long lags to higher international prices. For example (see "Food inflation déjà vu?" Global Weekly Economic Monitor, November 19, 2010), which discussed how changes in the CRB food index impacted local food prices in Brazil for at least a year, with the pass-through coefficient being equal to 0.36 since 2005. During the same period, a 1% appreciation of BRL helped diminish domestic food prices effect by 0.22%, showing the importance of currency appreciation in diminishing the eventual impact on local food inflation from higher international prices.

Besides the primary inflation impact, higher commodity prices also help to boost demand. This is because higher commodity prices boost the region's terms of trade which, with the exception of Mexico and Argentina, are now above the peaks seen before the crisis (Exhibit 1). Higher terms of trade represent higher income as export prices rise relative to import prices, stoking up demand and consumption. These "second round" effects are the real threat, as they may perpetuate the initial shock through higher inflation expectations and higher wage pressures.

How each country in the region responds to these common dynamics will largely determine the currency and rates outlook for 2011.

Exhibit 1. Terms of trade in Latin American



Source: Nomura, Bloomberg, Haver Analytics.

Brazil – Who blinks first?

In Brazil, uncertainty is particularly high due to doubts about the general direction of economic policy under the administration of President-elect Dilma Rousseff. In our view, although Rousseff was elected as a "continuity" candidate to President Lula, she needs to assert her control over the government by making substantive changes to policy (see "Dilma's first '100 days'", August 25, 2010). **In our view, this argues for tighter fiscal policy for both economic and political reasons.**

The "big picture" question in Brazil is whether the new government will change the paradigm followed in Lula's time: boost wages and transfer payments, and use higher interest rates to control inflation. Politically this model was highly successful, but it is showing signs of strain: investment levels are low and increasingly reliant on foreign inflows that appreciates the currency. The new government, through figures such as likely Chief of Staff Antonio Palocci, is pointing to a shift in emphasis from current spending into higher investments, where less spending on current costs can lead to lower interest rates, a cheaper currency and more government investments "crowding-in" private investments. Brazil's anomalous real interest rates are seen as the biggest impediment, and short-term cyclical considerations aside, the new government has made lowering them a stated policy goal, something that was never the case with Lula.

Given the terrible fiscal performance in 2010, the market is understandably sceptical about these new intentions, and the temptation to just continue on the presently popular path is obviously great. Nonetheless we believe the new government understands that without these shifts in policy, the current account deficit will continue to increase, and some market analysts are forecasting it to reach 5% or even 7% of GDP. Such levels are seen as unsustainable, but the other choice would be to shift growth lower, which would damage the government politically.

The government also understands that now is the right time to effect this change: Brazil is the recipient of large (too large in some ways) investment inflows, alleviating any external constraint. After years of healthy wage gains, and with no near term national elections, the government can better manage the demands of the civil service. And, perhaps obviously, a new government always enjoys a honey moon period of high political capital.

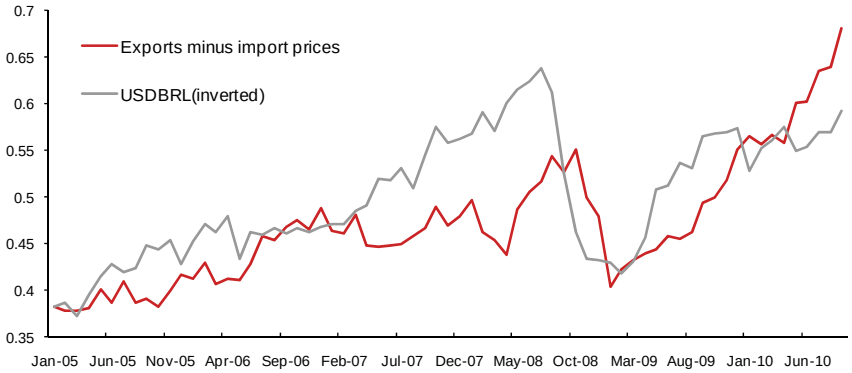
Fiscal consolidation is the key

As Brazil is already facing a heavy dose of food inflation that should take headline inflation up to 5.7% y-o-y or higher at the beginning of 2011, the Central Bank of Brazil (BCB) will be under intense market pressure to raise rates. This is already

reflected in current market pricing, with about 180bp of rate hikes priced-in for next year and the IPCA inflation expectations index expected to close at 5.20% next year against a 4.5% target.The BCB will only be able to "hold the line" if it can look forward to tighter fiscal policy while it waits (and hopes) for commodity/food prices to fall, taking the heat of headline inflation. In fact, in the BCB's last minutes, it has already been made clear that its inflation forecast, which shows inflation converging to target by the end of 2011, depend on tighter "fiscal and credit policy" from the government.

If fiscal policy is not tightened in a credible manner, the combination of higher headline inflation, high inflation expectations and excessively strong labor markets could create serious inflation problems in 2011, especially as the government's foreign exchange policy has impeded BRL from fully reflecting the strong improvements in the terms of trade (Exhibit 2). A decision to boost the minimum wage in real terms, against the government's own policy, would also signal that once again the government will choose to pay for wage populism with higher interest rates.

Exhibit 2. BRL and terms of trade



Source: Nomura, Bloomberg, Haver Analytics.

Tombini at the helm

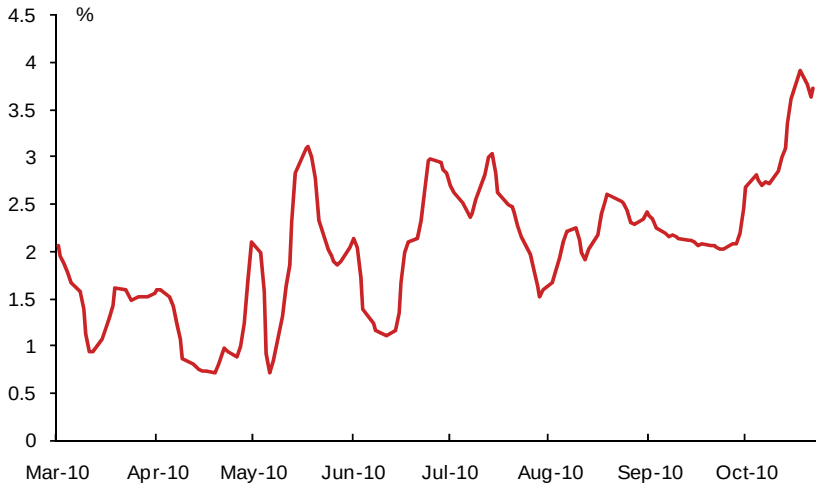
The recent nomination of current Deputy Governor Alexandre Tombini to head the BCB plus of ex-Finance Minister Antonio Palocci to the important Chief of Staff post has served to reduce some of the uncertainty around the continuity of economic policy. We believe that in fact fiscal policy will be tightened, and that since the current inflation surge is mostly tied to higher commodity prices (which unfortunately is having a larger impact on inflation due to the government's exchange rate policy) and service prices which can be better dealt with by changes in fiscal and wage policies, the BCB can "take the heat" and does not need to hike Selic. Nonetheless there is now a broad market consensus on the need for higher policy rates, higher headline inflation, alongside higher inflation expectations (see "Who's afraid of inflation expectations?" November 19, 2010) have often pushed the BCB into tightening cycles, especially at the beginning of the term of new BCB heads (both past heads of the BCB during the inflation targeting regime, Arminio Fraga and Henrique Meirelles, hiked rates in the beginning of their terms). Our forecast remains that the BCB will hold the line and not tighten rates (though we should get a better signal of intentions at the December Copom meeting), while the implementation of tighter fiscal policy will also allow the BCB to cut Selic in the second half of the year from 10.75% to 10.00% as headline inflation falls and the economy cools. Headline inflation will still likely come in above target in 2011, but this will be mostly due to higher prices at the beginning of the year. Our call for lower rates by the close of 2011 is conditional on the implementation of tighter fiscal and wage policies during the year. But the risks to our call are clear: if the new government does not decide to tighten fiscal and credit policy, it will quickly face the choice of either hiking interest rates or seeing inflation surge to the top of the current band, 6.5%. Given that either choice is politically inferior to cutting spending at this

point of the electoral cycle, we maintain that the optimal choice will be fiscal restraint, but we cannot totally discount the risk of a serious mistake being made by a political novice like President-elect Rousseff.

Further pressures from terms of trade

Even though BRL has been extremely strong in real effective terms, the currency has been supported by a continued increase in export prices in relation to import prices (Exhibit 2) as well as some of the highest real rates in the world. We do not expect these underlying conditions to change materially in 2011: Chinese growth is forecast to remain strong, which should support commodity prices, and Brazilian real interest rates will remain very high, though we believe that the secular move lower in real rates will continue. Nonetheless the government has been effective in suppressing the exchange rate, in the face of sometimes strong inflows. The end result has been to dampen volatility, and the spread between implied and realized volatility has widened (Exhibit 3). We expect realized volatility to remain steadily below implied by the contrary forces of the market and the authorities.

Exhibit 3. BRL volatility spread: 1-year implied minus realized volatility



Source: Nomura, Bloomberg, Haver Analytics.

A major determinant of BRL's performance this year has been the imposition of capital controls, specifically the 6% "IOF" entry tax for fixed-income investors. The tax has been successful in curtailing financial inflows into Brazil, which went from US$16.7 billion in September to US$5.1 billion in October. We believe that the government's intention in imposing capital controls is not to devalue the currency but to manage the pace of appreciation for two reasons: First, to give the manufacturing sector time to invest and raise productivity so as not to further lose competitiveness. Second, to allow time for the new government to implement policies to lower real interest rates, seen as the major factor in BRL appreciation.

Given the need to finance a growing current account deficit which is expected near the US$70 billion region in 2011, we believe that now the threshold for new capital controls is fairly high. The tax on fixed income has already been quite effective. Equity and FDI flows are seen as "good foreign capital", and the government will try to avoid taxing these inflows. Re-instating income tax on the earnings of foreign investors is a possibility, but the government is aware that punishing foreign investors is a dangerous game given the volatility of risk appetite in an uncertain international environment. Thus unless, for whatever reason, BRL appreciation accelerates meaningfully, we do not expect the imposition of further capital controls.

Taking advantage of BRL stability

Overall we expect a slower appreciation of BRL in 2011. However, with global capital inflows balanced by government intervention, we expect considerable stability both in terms of level and volatility in BRL, especially in the first quarter of 2011. BRL has traded within a relatively narrow range of 1.6530 - 1.7926 (8.4% trading range) since June and we expect BRL to be contained in this range in early 2011. Therefore we recommend buying a 3 month double-no-touch option.

Buy 3m USD/BRL DNT with barrier levels at 1.81 and 1.63– The barrier levels represent an 11% trading range. The premium is 34% of the notional with a spot reference of 1.6750. We are investing $102k for a potential payout of $300k.

BRL forecasts

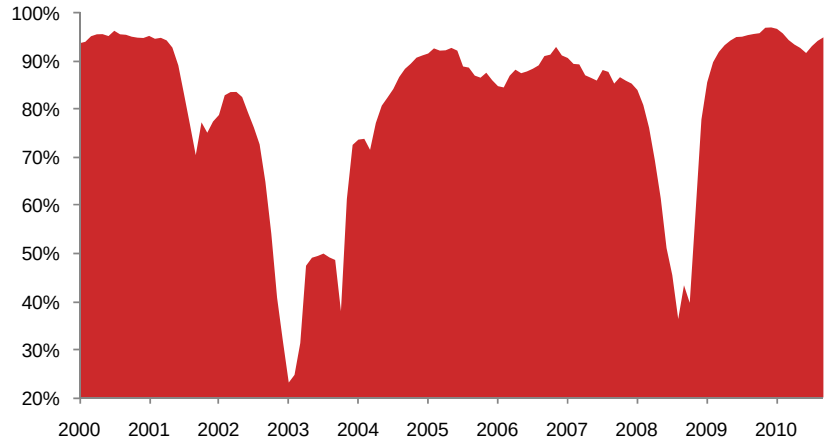
	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDBRL	1.70	1.72	1.68	1.65	1.62

Note: Values as of period end.
Source: Nomura.

Mexico – The other dollar

The MXN suffers from a dual personality disorder: sometimes it trades like an EM currency and sometimes like the dollar. While towards the end of 2010 the MXN traded like an EM currency with QE2 being the main support for the rally, we expect it to trade like the dollar for most of 2011 on the back of better than expected data releases in the US and improvement in domestic consumption. Given the strong links between the Mexican and US manufacturing sectors, Mexico stands to gain the most from a recovery north of the Rio Grande (Exhibit 4).

Exhibit 4. Rolling correlation, Mexico-US manufacturing industrial production



Note: 24 month rolling correlation.
Source: Nomura, Bloomberg, Haver Analytics.

With the prospect for a sustained, albeit gradual, recovery in the US consolidates, the MXN will likely rally to 11.70 by year end 2011. In addition, domestic consumption is finally recovering. The 2010 weakness of the domestic economy had to do with several reasons that include: the increase in non-performing loans, particularly from the credit card sector; lack of recovery in skilled employment and low consumer confidence. However, we are now cautiously optimistic about the recovery of domestic consumption as consumer lending has stabilized and has started growing moderately. While lending to GDP is low at below 20%, implying its impact on domestic consumption is low, the fact that credit card lending was contracting could have been one of the factors dragging down consumption. The deleveraging of the consumer balance sheet took place in 2009-2010 and we expect

that lending should resume during 2011, which coupled with the expansion of skilled-labor employment should be positive for domestic consumption.

2011: a year of reforms

Mexico's low total factor productivity has been limited, in part, by the lack of structural reforms. While there is limited scope for the passage of fiscal and energy reforms in the remainder of President Calderon's term, which are needed to increase non-oil fiscal revenues and investment in the energy sector, we believe there is significant probability that Congress approves three proposals in 2011: i) A proposal to strengthen the independent anti-trust entity (COFECO in Spanish) was approved by the lower house this year but Senate has to ratify it in 2011. The proposal would allow the COFECO to apply penalties of up to 10% of the potential revenues to companies that engage in monopolistic practices. There is a risk that the PRI in the Senate dilutes the proposal. ii) The second proposal has to do with the re-organization of police forces. In 2011 Congress will likely pass a government proposal to consolidate various municipal police forces into one unified police force per state. The law would also provide financial resources for state-level police training. iii) The third proposal that has a chance to be approved in 2011, albeit limited, is the labor reform. If approved it could add flexibility to the labor market. The proposal would allow for a wider variety of labor contracts, and instruments to expedite legal proceedings among other measures. We assign a probability of 60% to the passage of these reforms.

Indeed, their passage could be affected by six gubernatorial elections mostly in July 2011. The centre left PRI party which ruled Mexico from the 1910 Revolution to 2000 and the left leaning PRD party are likely to split the control of the six states (PRI: Estado de Mexico, Nayarit and Coahuila. PRD: Guerrero, Baja California Sur and Michoacan). The gubernatorial race in the State of Mexico (July 3rd, 2011) will be particularly important because the current governor, Enrique Peña Nieto from the PRI, is the leading candidate in the opinion polls for 2012 presidential race. If the PRI were to lose the control of the State of Mexico, which is unlikely, other party members with intentions to run for the presidency will likely challenge Peña Nieto.

Even the "narcos" can't kill FDI

Based on the experience of Colombia, narco violence is here to stay in Mexico for at least 5 years in our view. While the violence is concentrated in only 66 out of the more than 2,000 municipalities in the country, it has had a disproportionate impact on the image of Mexico. Tourism, domestic consumption, and investment have suffered from the spike in violence, but it is difficult to estimate precisely the cost to the economy. In the case of FDI, it is hard to know if a company was planning to invest in Mexico and decided not to do so because of the violence In other words, the counterfactual is not known. There is limited evidence of companies that left the country due to violence. If anything, the low unit labor costs seemed to have attracted FDI to Mexico recently. According to the A.T. Kearney's Foreign Direct Investment Confidence Index, the ranking of Mexico as a destination of FDI increased dramatically to 8th place from 19th in 2007. In fact, comparing the ratio of H1 2010 as a percentage of H1 2007 FDI for several EM countries reveals that Mexico with 85% has been a favorite destination of FDI with Turkey at 22%, and Brazil at 83%. Other EM giants such as Poland and Korea have not been able to attract FDI in net terms.

Betting on moderate appreciation

Overall we expect a gradual appreciation of MXN over the next 12 months. However for the reasons discussed above, we believe the appreciation pressure will be contained. In this case we prefer monetizing our view via a put spread which allows us to maximize our profit by buying only the appreciation range.

- ***Buy 1 year USDMXN put spread with strikes at 12.40 and 11.60*** ($5mn notional with the spot reference of 12.37). Our target is 11.70 with a 12 month horizon.

MXN forecasts

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDMXN	12.25	11.90	11.80	11.75	11.70

Note: Values as of period end.
Source: Nomura.

Argentina – Inflation plus capital flight risk

The Argentine peso (ARS) is a tightly managed currency. Along with a series of capital controls, authorities intervene heavily in the FX market in order to minimize ARS fluctuations.

Assuming a normal harvest and current commodity prices, we project the trade surplus in 2011 to fall to a still healthy $10.6bn (2.6% of GDP), from almost $14bn this year (3.8% of GDP). The key to our ARS forecast for 2011 then is the projected path of capital flight, which is a usual phenomenon in Argentina.

A year of two halves

Inflation is likely to run at 25% in 2011, and yet authorities are to keep running loose fiscal and monetary policies in order to inflate the economy before October's general elections. Thus, in the first half of the year, the ARS is likely to be under control, as it's the authorities' only nominal anchor to control inflation. This strategy is likely to be successful in the first half, as we expect capital flight to be rather subdued. However, as we enter the second half of the year, with general elections approaching, locals are likely to get anxious and capital flight is to pick up. At that point, authorities are likely to allow for a "controlled" pace of devaluation, using international reserves in the process. Eventually, we expect the ARS to correct some of the overshooting as uncertainty around the election dissipates.

ARS forecasts

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDARS	3.96	4.05	4.10	4.40	4.40

Note: Values as of period end.
Source: Nomura.

Chile – Lots of room to go?

While CLP has been one of the best performing currencies in the region (Table 1) the low inflation seen in Chile means that in real effective terms CLP has actually risen by less than any other currency outside the heavily managed ARS. And the good inflation performance continues: while inflation in Brazil is running at 5.2% y-o-y, in Chile inflation is still running at a below target 2.0% y-o-y, and is forecast to rise to a still tame 3.2% by the end of 2011. Meanwhile the terms of trade continue to improve.

Besides great inflation performance, Chile has also some of the best balanced growth in the region, and again the contrast with Brazil is illustrative. While in Brazil industrial production is slowing sharply even as labor markets remain strong, in Chile growth is better distributed across sectors (with perhaps construction still lagging) as the economy benefits from strong export demand; investments (due to reconstruction after this year's earthquake); and consumption (especially durables, also helped by reconstruction).

Rate hikes slowing but not "the end"

The Central Bank of Chile (BCCh) has slowed down the pace of monetary policy normalization from 50bp per meeting to 25bp on the back of good current inflation numbers and the strength of the currency. The policy rate is now at 3.00%, which is close to zero in real terms. We expect the pace of tightening to continue to at least 4%, at which point any further tightening will become heavily data-dependent,

though we see room for further rate hikes. But while the BCCh, like all central banks in the region, is worried about the currency, they have made it clear that Brazil-like capital controls are highly unlikely, something that we see as positive for the currency.

With what we expect to be a market friendly approach, and the risks to the economy being to the upside given what we see as a risky dovish stance by the BCCh, CLP should be one of the best performing currencies in the region. The fact that Chile is still running a 1.6% current account surplus adds further support to a positive CLP outlook.

Strong economy, strong CLP

We therefore recommend going long CLP with a 12 month horizon. We prefer expressing this view via selling short term NDFs and rolling our position to better adjust to the potential rate hikes beyond our forecasts in the coming months. Implied forward rate curve of the NDFs already prices 0.25% hikes in the next 4 consecutive meeting of the BCCh and no hikes thereafter, in line with our forecasts. However, we see upside risks to the Chilean economy and hence a risk of further rate hikes. Rolling short term contracts allow us to capture any possible rise in interest rates. Furthermore, based on the analysis of the implied interest rate curve of NDFs, we believe the 2 month NDF contract offers good value with an implied interest rate of 2.85% that is comparable to 2.92% for the 3 month contract. We don't believe the difference justifies extending the tenor given the upside pressure to the interest rates. Therefore, as the first step of our trade, we are selling 2 month NDFs.

- ***Short USDCLP by selling 2m NDF at 481.10 –*** The spot reference level is 479. We target 440 with 12 month horizon for a $10mn notional amount. Our stop loss level is 490.

CLP forecasts

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDCLP	480	475	465	450	440

Note: Values as of period end.
Source: Nomura.

Colombia – A likely investment upgrade

The Colombian peso (COP) was one of the best-performing currencies up to Q3 2010 since it appreciated by 13%. However, in October authorities successfully implemented a series of measures to weaken the COP that included purchasing dollars by the central bank, reducing the monetization of the dollar cash-position to finance the fiscal deficit and leaving the dividend from state-controlled oil giant Ecopetrol in the offshore market. The government used the FX appreciation to implement other measures such as reducing import tariffs, and eliminating tax deductions on external debt interests.

The super COP

However, in 2011 we believe the COP will resume an appreciative path despite the measures from authorities. In essence, the appreciation is a function of better structural policies that will likely trigger the coveted investment grade. We expect Congress to approve a fiscal rule that will address one of the weakest aspects of the economy, a persistently high fiscal deficit.

In addition, Colombia will likely benefit from higher commodity prices as the production of oil, gas, coal, and gold will continue to increase next year. For instance, oil analysts believe Colombia could double the production of oil by 2015. This in turn will increase trade related inflows in the coming years and therefore adding to the appreciative trend of COP.

Flooding FDI

FDI inflows north of US$9bn in 2011 will finance the current account deficit and continue to drive the appreciation. In terms of growth, we expect the 2011 GDP to expand by 5.0% slightly above the growth rate of 2010. Inflation will benefit from a strong COP and will likely remain below 3.0%, which is the middle of the target band. However, rising food inflation could push inflation to 3.5%, still within the target band (3.0% +/- 1%). We maintain our view that the central bank will start the tightening cycle in Q4 2011 by increasing the policy rate by 100bp to 4.0% by year end 2011.

We believe COP has one of the biggest appreciation potentials among the Latin American currencies in our coverage. We forecast a particularly fast appreciation in the first quarter of 2011 to 1820. The shape of the NDF curve implies negative carry for tenors shorter than 6 months due to extreme positioning of investors. Hence to largely avoid negative carry and capture the strong appreciation in the first half of 2011, we recommend selling 6 month USDCOP NDF contracts.

- ***Short USDCOP by selling 6 month NDF at 1885 –*** For a notional amount of $10mn, our 6 month target is 1800 with a stop loss at 1920. The spot reference of 1889 implies almost flat carry for the position.

COP forecasts

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDCOP	1860	1820	1800	1780	1760

Note: Values as of period end.
Source: Nomura.

Peru – Controlled appreciation

The central bank of Peru (BCRP) intervenes heavily in the FX market to keep value of the Peruvian Sol (PEN) stable, with cumulative intervention totalling around US$9bn year-to-date (6.4% of GDP). As a result, PEN appreciated by only 2.5% in 2010.

Looking forward, we expect BCRP intervention to be successful in stemming excessive appreciation in 2011 by keeping the USDPEN close to 2.8. The currency is likely to strengthen mildly in the first half of next year, mainly because of elections-related uncertainties. The pace of appreciation will accelerate in H2, on the back of robust growth outlook (8.7% for 2010 and 6% for 2011), commodities-related FDI, as well as portfolio inflows in expectation of a Pan-Andean stock exchange.

Keep an eye on the elections

We see two major downside risks to our forecast. First, a “market-unfriendly” candidate takes presidency next April. Chances are quite low, in our view, but such a scenario cannot be completely ruled out. Second, fluctuations in international commodity prices, likely triggered by tightening measures in China, may lead to growth disruptions and currency volatilities.

PEN forecasts

	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
USDPEN	2.81	2.80	2.75	2.70	2.60

Note: Values as of period end.
Source: Nomura.

Box: Capital Controls in Latin America

Latin America's experience with capital controls has usually been to keep flows from leaving the country rather than preventing them entering the country. In fact, Venezuela currently has controls on capital outflows. However, during the past decade most economies in the region started targeting inflation; since then inflation has fallen to below 5%. Disinflation, coupled with more responsible fiscal policies, trade liberalization, deepening of local capital markets and more flexible exchange rates opened the region to a new set of problems. Improved fundamentals, higher domestic interest rates (vs. the G3) and QE2 in the US have triggered sizable inflows into the region. Controls offer a way for inflation targeters to tighten monetary policy without causing further appreciation of the real exchange rate (Exhibit 1).

We examine each of the inflation targeters susceptible to large inflows:

- **Brazil** switched to a "managed floating" currency scheme following the 2002 crisis and since then has frequently intervened in the FX market through various measures. These measures involved a combination of direct intervention in the spot market and several unique measures such as reverse currency swap auctions and major regulatory changes. The main tool for capital controls during the recent crisis, however, was the IOF tax levied on capital inflows. Since March 2008 when the IOF tax was first imposed, the tax rate has been adjusted several times, from 1.5% in March 2008 to 0% in October 2008 and then up to 6% in October 2010, following the overall trend in capital flows. Most recently, as another radical measure, the sovereign wealth fund was authorized to intervene in the FX market to curb the appreciation of BRL. If the trend turns decidedly to a stronger real, Brazil is likely to adopt harsher measures given the extreme REER appreciation and given the actions taken so far.

- After the banking crisis of 1995, **Mexican** authorities allowed the MXN to float. Since then, intervention has been minimal except after the 2008-09 financial crisis. The authorities bought dollars discretionally through auctions and via auctioning put options (which they continue to do). Partly because the MXN remains cheap in real terms and partly because of the authorities' pro-market framework, we think imposing controls is unlikely.

- In 2007, **Colombian** authorities imposed an unremunerated reserve requirement (URR) of 50% on external borrowing and portfolio inflows reviving policies instituted in 1993 and 2000. In addition, banks' positions in derivatives were limited to 550% of their capital (excl. pension funds). To close loopholes, a minimum stay of two years was imposed on FDI. By Q4 2008 controls had been removed. In 2010 the authorities have mainly relied on purchases of dollars and other market-friendly measures (the government stopped monetizing dollars for fiscal needs, it kept the dividend from the state-controlled oil company Ecopetrol in the offshore market, and lowered import tariffs among others) to ease FX pressures. We think Colombia could re-establish controls if COP were to appreciate because the REER has already strengthened significantly and in the past authorities have used market-unfriendly policies.

- In 1998, **Chile** removed all capital controls. Between 1991 and 1998 authorities imposed URRs to curb short-term inflows. The policy had some effect in keeping a spread between local and foreign interest rates and curbing short-term inflows but it did little to avoid appreciation. While the central bank has avoided intervention in the FX market, at specific moments it has intervened. Chilean academics at the central bank don't seem to be convinced that imposing capital controls was the most beneficial policy in the past. Given the policy framework and the preference for market-friendly policies, we doubt Chile will adopt capital controls.

- **Peru's** 1993 Constitution guarantees free access to FX. Yet the central bank (BCRP), from time to time, amends rules regarding reserve requirements and possession of local-currency certificates of deposits for non-resident accounts, to fend off speculative inflows. Such administrative measures were most often seen in 2007-08 and 2010, when the PEN faced excessive appreciation pressure. Given the small size of the FX market, the BCRP is able to influence the PEN with intervention without having to resort to capital controls.

Exhibit 1. REER in Latin America

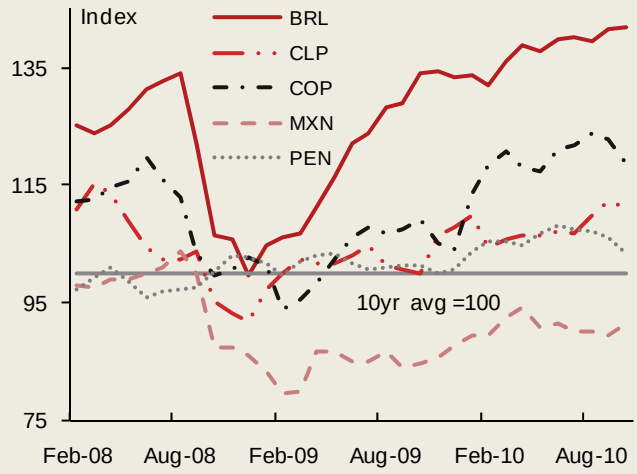


Exhibit 2. Capital controls heat map

	REER	History	Rate diff.	Terms of trade
Brazil	+42	C	10.50	32%
Mexico	-8	NC	4.25	12%
Colombia	+19	C	2.75	23%
Chile	+11	NC	3.00	48%
Peru	+3	NC	2.75	38%

REER = % deviation from 10 yr avg (+ is overvalued; - is undervalued).
History: C = Controls. NC = No controls.
Rate diff: O/N interest rate diff. with US.
Terms of trade = % increase since January 2009.
Countries highlighted in red are more likely to impose capital controls.

Box: GEMaRI: Brave new world

Peter Attard Montalto

The G20 has shifted its attention to imbalances and the potential effects of cash flowing into EM. GEMaRI, Nomura's Global Emerging Market's risk index, can provide pointers.

Our Global Emerging Market Risk Index (GEMaRI) measures the risk that a currency crisis will occur in the next 12 months. Our GEMaRI scores for Q3 continue to suggest that the emerging market macroeconomic and financial environment is relatively benign. For the 37 countries that we cover, only Iceland's GEMaRI score has risen above the initial danger threshold of 73.

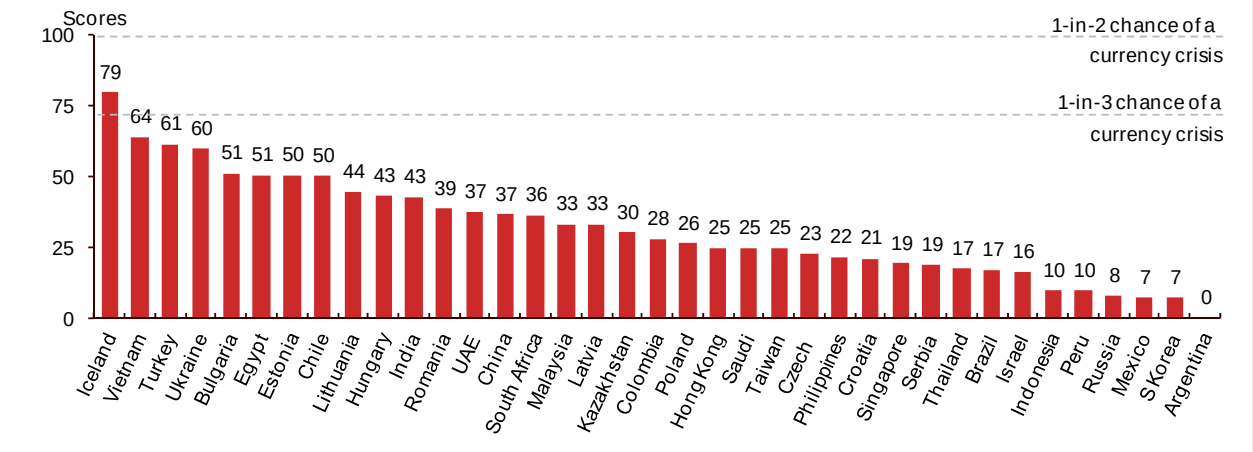
Aggregate regional scores fell back (indicating a reduced likelihood of a currency crisis) in Q3 for EEMEA and to a lesser extent Asia after falling in the previous quarter too. LatAm scores, however, increased on aggregate given the strong recovery that is taking place in that region. Turkey, the fastest riser in Q2, has now fallen back, while a number of stressed CEE countries have increased their scores. EEMEA scores remain volatile as growth softened in Q3 on lower external demand.

Asia's GEMaRI scores fell on aggregate in Q3 as the strong recovery continued there. Asia has the strongest growth prospects of any region in GEMaRI because of its loose macro policies, sound economic fundamentals and positive spillover effects from the robust China. High and rising FX reserves, current account surpluses and low public debt suggest that full-blown exchange rate crises are highly unlikely. The one possible exception is Vietnam, which at 64, has Asia's highest GEMaRI score, because of low FX reserves, twin trade and fiscal deficits. India's GEMaRI score (43) is the second highest in Asia because it too has large current account and fiscal deficits and high inflation.

The moves in GEMaRI scores this quarter are eclipsed by the developments in periphery Europe. These countries, which would score at the very highest end of GEMaRI in view of significant external and public sector debt, fiscal deficits and other imbalances cannot have balance of payments-related stresses as they are within the euro, but instead such stresses and imbalances are exposed through liquidity issues. Such 'developed' market issues, however, highlight the dissociation between risk and reward in many EM countries and the breakdown in correlation between FX and CDS moves with GEMaRI as financial decoupling because of continued strong capital inflows. If further contagion occurs around the periphery this decoupling is unlikely to last and spreads could spring back to higher levels and again move more in step with developed market spreads. At such a juncture markets may well hone back in on fundamentals and on imbalances in particular. Hence markets could return to moving in step with GEMaRI risk indications.

On the flip side, however, we believe that some degree of economic decoupling can continue, even if financial market recouping is the order of the day. However, economic decoupling does risk a continued flow of liquidity entering EM and finding its way through the banking system to household leverage, higher real rates, burgeoning current account deficits and other imbalances monitored by GEMaRI. GEMaRI provided an early warning of such previous inflow-led imbalances before the Asia crisis, LatAm crisis and then from 2007 onwards globally with easy money again flowing in EM. However, the issue is more that a structural asset allocation shift is occurring within global portfolios to increase weight on EM given growth outperformance. Such a move can be targeted by looking at individual country risks and imbalances (in other words, where GEMaRI can be of some use). Alternatively, if the shift is more indiscriminate, not based as much on country specifics, then it risks a leveraging up of imbalances and so GEMaRI will still be of use in highlighting the risks building here. Offsetting policy with reserve accumulation and tighter rates, as well as macro-prudential policy on bank lending and fiscal discipline, will all be needed to prevent the build-up in imbalances and a rise in GEMaRI scores.

Exhibit 1. Nomura GEMaRI Index



Source: Nomura.

Outlook Article

EMFX valuation: A G20, policy-centric world[62]

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- *EMFX valuations are becoming increasingly important indicators following the G20 Seoul Summit, where external imbalances were under more scrutiny.*
- *We present here a Q3 valuation update for EM currencies using our FEER and SEER models.*
- *There has been an interesting split in the results.*
- *Asian currencies have almost all moved further into (or towards) undervaluation territory.*
- *LatAm currencies have generally moved towards overvaluation.*
- *EEMEA currencies are split, those previously more undervalued are becoming more so, while those around fair value and those overvalued are moving up towards further overvaluation.*
- *Currency policy responses may well be behind these moves.*

In our last EMFX valuation update – "Currency policy pointers" – we showed how looking at valuation could be useful for the global debate that was taking place at the time on global imbalances and how the G20 might view currencies and policies that potentially sustain them away from fair value. Since that time the debate has crystallised on the G20 Seoul Summit and the policy outcomes from there.

In particular, the IMF and the G20 Finance Ministers look set to undertake detailed work to study individual country policies and external imbalance metrics to see if currencies are at levels in keeping with their macro-economic fundamentals. We believe that such a framework will be closely related to the IMF's existing CGER framework, which looks at imbalances, sustainability and currency valuations. Our own FEER and SEER models are based on this CGER framework. They look at if a shift in the REER is required in order to reach an equilibrium in external stocks and flow balances of the net foreign assets and current account. FEER also specifically takes into account how a country is growing vs not only its own trend output but also

Exhibit 1. Exchange rate misalignment in EEMEA and CIS

	Raw Model Output			Filtered result		
	FEER	SEER	Average	FEER	SEER	Average
EMEA						
South Africa	4.9	18.8	11.9	12.3	25.2	**18.7**
Turkey	15.0	11.8	13.4	16.5	13.4	**14.9**
Czech	0.1	3.5	1.8	-1.6	1.9	**0.1**
Poland	-5.8	-2.9	-4.3	-5.6	-2.7	**-4.2**
Romania	-9.1	8.9	-0.1	-14.0	4.7	**-4.7**
Egypt	-16.3	1.3	-7.5	-16.2	1.4	**-7.4**
Hungary	-1.7	-14.0	-7.8	-4.1	-16.7	**-10.4**
Israel	-18.3	-14.3	-16.3	-17.3	-13.4	**-15.4**
Estonia	-7.3	-21.9	-14.6	-11.7	-26.8	**-19.3**
Latvia	-17.1	-17.3	-17.2	-24.4	-24.5	**-24.5**
CIS						
Kazakhstan	-41.3	21.5	-9.9	-42.1	21.0	**-10.5**
Ukraine	-4.0	-18.3	-11.2	-5.7	-20.2	**-12.9**
Russia	-37.0	-6.4	-21.7	-39.2	-8.1	**-23.7**

Source: Nomura.
Note: Raw data for Q2 2010 filtered for Q3 2010.

Exhibit 2. Exchange rate misalignment in LatAm and Asia

	Raw Model Output			Filtered result		
	FEER	SEER	Average	FEER	SEER	Average
LATAM						
Brazil	0.2	14.4	7.3	4.5	18.1	**11.3**
Colombia	-13.2	2.5	-5.3	-6.9	8.0	**0.6**
Mexico	-3.4	0.0	-1.7	-2.0	1.4	**-0.3**
Argentina	-8.4	1.1	-3.7	-8.2	1.4	**-3.4**
Chile	-6.3	-2.7	-4.5	-6.9	-3.3	**-5.1**
ASIA						
India	-5.7	-3.1	-4.4	-1.5	1.0	**-0.2**
Indonesia	-8.5	-4.2	-6.4	-3.4	0.8	**-1.3**
Hong Kong	-3.8	-4.2	-4.0	-5.4	-5.8	**-5.6**
Korea	-10.2	-14.4	-12.3	-5.1	-9.1	**-7.1**
Malaysia	-5.3	-24.7	-15.0	-1.2	-19.7	**-10.4**
Thailand	-14.6	-12.8	-13.7	-12.8	-11.0	**-11.9**
Philippines	-17.4	-9.3	-13.3	-18.7	-10.5	**-14.6**
Singapore	-25.5	-9.5	-17.5	-22.5	-6.9	**-14.7**
China	-11.7	-20.9	-16.3	-12.1	-21.3	**-16.7**
Taiwan	-59.9	10.1	-24.9	-59.0	10.6	**-24.2**

Source: Nomura.
Note: Raw data for Q2 2010 filtered for Q3 2010.

62) First publish as an FX Insights article on 2 December 2010.

vs. the global cycle. This differentiation was specifically mentioned by the G20 as something to be accounted for when looking at currency fair value.

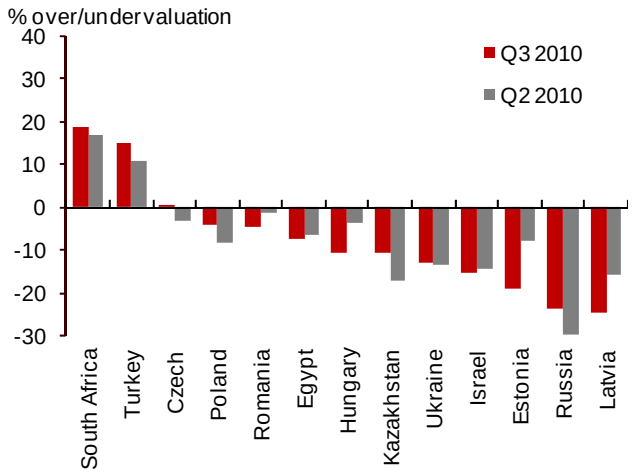
Our models are also not swayed by short-term bubbles of potentially unsustainable portfolio inflows. FEER discounts portfolio flows as not being sustainable long-run financing, while SEER does not use the flow funding side of the balance of payments at all, instead look at the stock of net foreign assets. Otherwise valuation metrics could show that a country is being significantly undervalued if it had strong inflows, on the back of an asset price bubble.

Although policies cannot be directly incorporated into the model, the effects of rapid reserve accumulation increasing net foreign assets does show up in SEER and hence there is at least one form of policy measure visible through our valuation metrics.

We note that the IMF and G20 will take into account a far larger range of inputs than we do here, and ultimately much politics may also come into play on the actions to be taken by countries having deliberately misaligned currencies (if not before, at the stage of identifying who actually is). However, in the context of G20 policy, EM countries that already have healthy reserves can put in place “macro-prudential measures” (which we believe means capital controls and other currency policy measures), and our valuation metric can at least provide some pointers to the categories that the currencies will fall into.

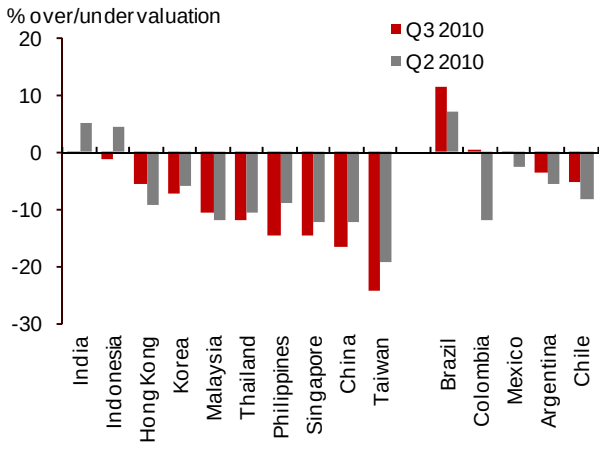
We therefore split currencies within our valuation models (using the average filtered result) into three groups: “Allowed” where we think valuation possibly points to macro prudential measures being allowed, these are currencies that are in overvaluation territory in our models. “Debateable” where the decision may be marginal or further appreciation would move them into overvaluation territory. Currencies here are less than 10% undervalued. We then have the “not allowed” category where currencies are more than 10% undervalued.

Exhibit 3. Changes in valuation – EEMEA and CIS



Source: Nomura.
Note: Filtered data, average of FEER and SEER.

Exhibit 4. Changes in valuation – Asia and LatAm



Source: Nomura.
Note: Filtered data, average of FEER and SEER.

Grouping	Currency	Measures to weaken currency already taken?	Policy comment
Allowed	SA	Y	Exchange outflow control relaxation, rapid reserve accumulation
	Brazil	Y	Inflow taxes, intervention
	Turkey	Y	FX auctions, reserve changes, widening on/off-shore rate gap
	Colombia	Y	Bank FX controls, intervention
	Mexico	Y	Option selling, intervention
	India	Y	Regulatory measures
	Czech	N	Continued loss of competitiveness to push CNB to action
Debateable	Poland	Y	Small intervention, more possible
	Romania	N	Can use basis market if needed
	Egypt	Y	Heavily managed already
	Argentina	Y	Intervention
	Chile	Y	Intervention, regulatory moves taken
	Indonesia	Y	Capital controls, reserve accumulation
	Hong Kong	Y	Heavily managed already, variety of macro prudential measures
	Korea	Y	Bank/regulatory measures already taken, direct intervention
Not allowed	China	Y	Heavily managed already, slow strengthening path
	Rest of Asia	Y	Macro prudential or capital controls, direct intervention
	Hungary	N	Given FX loan issue unlikely to do anything, govt/MNB conflict
	Estonia	N	No shift given euro adoption in January
	Latvia	N	Peg already
	Israel	Y	Currency intervention and reserve buying continue
	Russia	Y	Heavily managed already, not averse to appreciation
	Rest of CIS	Y	Heavily managed already

Source: Nomura

Please see below regional and country-specific results from our valuation models in this context.

ASIA

Our FX valuation analysis shows that the majority of Asian currencies remain undervalued on both a raw and filtered basis. TWD, CNY and SGD are the most undervalued at 24.2%, 16.7% and 14.7%, respectively, based on the average filtered result of our FEER and SEER models. By contrast, INR and IDR are the least undervalued at 0.2% and 1.3%, respectively based on the same metrics.

In view the size of India's current account deficit and its relative FX overvaluation, we still think that further INR appreciation (through capital inflows) is unlikely without a positive risk backdrop. Equity inflows should remain the main swing factor for INR performance given the relative volatility of this component compared with other sources of capital inflows. The IDR's less favourable valuation is also in line with the authorities' recent rhetoric. Along with foreign positioning, capital control risk and

rising concerns from manufacturers (namely some companies in the textiles industry), poor valuation could limit IDR appreciation.

EEMEA

Scores have in general moved towards overvalued territory in our filtered results thanks to their real exchange rates strengthening. Although only South Africa, Turkey and Poland have seen portfolio inflows of note and so marked REER appreciation, other currencies in the region have strengthened because of the global capital flow and currency war theme, even if they are not in the first round of any such conflict. Underlying valuations also changed for Latvia and Estonia as the economies recover and current accounts have not turned around particularly sharply as they are locked into currency pegs. Equally, the Czech Republic has slipped into overvalued territory, as fiscal consolidation takes effect and a sluggish recovery, combined with a strengthening of the REER on post-election fiscal credibility makes the currency look out of synch. A recovery in global commodity prices makes the commodity producers look more overvalued (such as Kazakhstan and Russia), while it makes some energy importers look a little more undervalued such as Israel. Once of the most marked turnarounds is Hungary as the currency sold off because of political risk premia being priced in after the elections and on various policy changes. The underlying score there was broadly unchanged. In Turkey there has been a move into further overvaluation because of the economy's strong recovery, but the currency has lagged this to some extent. Policy makers have attempted to counter this with FX auctions and widening of the onshore/offshore fx rate differential. Whilst it appears in the "allowable" section of the table above this refers more to its ability to take action (as it has done) than to do capital controls, which we do not think will occur any time soon.

LatAm

The Colombian peso (COP) experienced the biggest valuation changes in the region, going from 12% undervalued in Q2 to 0.6% overvalued in Q3, according to the filtered results. The valuation changes reflect the strong appreciation of COP during summer, from around 1,900 in early July to around 1,800 in late September (although as this report goes to press the COP is back at 1,900). We think the authorities are obviously concerned with the speed of appreciation and have already rolled out a number of intervention measures. Nevertheless, we still have a very positive outlook for COP, because of strong economic fundamentals, FDI inflows and the expected passage of a fiscal rule next year. The Brazilian real (BRL) retains the strongest overvaluation in the region. In fact, the filtered results indicate further BRL appreciation in Q3, as QE2 expectations pushed yield-seeking funds into Brazil, and the Petrobras IPO only exacerbated such capital account inflows. The Brazilian government twice raised the IOF entry tax on fixed income inflows in October, in a bid to dampen BRL strength. Argentina, Chile and Mexico remain undervalued based on both metrics, yet they all witnessed appreciation of varying degrees, given the general weakness in USD and strength in EM currencies.

Appendix

FEER is the Flow Equilibrium Exchange Rate model and SEER is the Stock Equilibrium Exchange Rate model. They look at the flow and stock of external imbalances and find the required shift in the real effective exchange rate to achieve external equilibrium in either stock of flow terms. These are not currency smoothing models or regression based. Although data used are only up until Q2 2010 given data lags, the 'filtered results' then remove from the raw model output any change in REER between Q2 and the end of Q3. See *'A little look at EM FX fair value'* for more details.

Global FX Forecasts

FX Forecasts

		06-Dec	Q4 10	Q1 11	Q2 11	Q3 11	Q4 2011	End 2012
G10								
US Dollar Index	(DXY)	79.8	80.8	79.2	78.5	78.5	78.4	81.2
Japanese yen	(USD/JPY)	82.7	82.5	80.0	82.5	85.0	85.0	90.0
	(EUR/JPY)	110	107 ↓	106 ↓	111 ↓	115 ↓	115	117
Euro	(EUR)	1.33	1.30 ↓	1.32 ↓	1.34 ↓	1.35 ↓	1.35	1.30
Swiss Franc	(CHF)	0.99	1.03 ↓	1.05 ↑	1.06 ↑	1.06 ↑	1.07	1.09
	(EUR/CHF)	1.31	1.34 ↓	1.38 ↓	1.42	1.43	1.44	1.42
British Pound	(GBP)	1.57	1.57 ↓	1.63 ↓	1.68 ↓	1.71 ↓	1.73	1.71
	(EUR/GBP)	0.85	0.83	0.81	0.80	0.79	0.78	0.76
Australian Dollar	(AUD)	0.99	0.96 ↓	0.96 ↓	0.98 ↓	1.00	1.02 ↑	1.02
Canadian Dollar	(CAD)	1.01	0.99 ↑	0.97 ↓	0.97 ↓	0.99	0.99 ↓	1.00
New Zealand Dollar	(NZD)	0.76	0.75 ↓	0.77 ↓	0.80 ↓	0.82	0.84 ↑	0.84
Norwegian Krone	(EUR/NOK)	7.99	7.90	7.80	7.60 ↓	7.60 ↓	7.70	7.70
Swedish Krona	(EUR/SEK)	9.10	9.00	8.90	8.80 ↓	8.90 ↓	9.00	9.00
Asia								
Chinese Renminbi	(CNY)	6.65	6.60	6.50	6.40	6.30	6.22	5.90
Hong Kong Dollar	(HKD)	7.76	7.75	7.75	7.75	7.75	7.75	7.75
Indonesian Rupiah	(IDR)	9011	8970 ↑	8900 ↑	8800 ↑	8680 ↑	8520 ↑	8200
Indian Rupee	(INR)	45.0	44.6 ↑	44.1 ↑	43.4 ↑	42.9 ↑	42.3 ↑	40.3
Korean Won	(KRW)	1133	1110 ↑	1080 ↑	1060 ↑	1040 ↑	1020 ↑	960
Malaysian Ringgit	(MYR)	3.15	3.08 ↑	3.00 ↑	2.97 ↑	2.93 ↑	2.88 ↑	2.72
Philippine Peso	(PHP)	43.8	43.2 ↑	42.4 ↑	41.9 ↑	41.4 ↑	40.9 ↑	38.9
Singapore Dollar	(SGD)	1.31	1.29 ↑	1.27 ↑	1.25	1.24 ↑	1.22 ↑	1.17
Thai Baht	(THB)	30.0	29.5	29.0 ↓	28.5 ↓	28.1 ↓	27.8 ↓	26.8
Taiwan Dollar	(TWD)	30.1	30.0 ↓	29.6 ↓	29.3	29.0	28.7 ↑	27.5
Europe and Africa								
Czech Koruna	(EUR/CZK)	25.1	25.0 ↑	25.0	24.5	24.0	23.5	23.5
Hungarian Forint	(EUR/HUF)	280	280 ↑	285	288	286	285	290
Polish Zloty	(EUR/PLN)	4.02	4.00 ↑	4.00 ↑	4.00 ↑	3.90 ↑	3.80 ↑	3.70
Israeli Shekel	(ILS)	3.63	3.70 ↑	3.65 ↑	3.55 ↑	3.50 ↑	3.50 ↑	3.60
Russian Ruble	(RUB)	31.3	30.8 ↑	29.8	29.5 ↓	29.6 ↑	30.7 ↑	31.5
Turkish Lira	(TRY)	1.49	1.47 ↑	1.45 ↑	1.47 ↑	1.40	1.40 ↓	1.50
South African Rand	(ZAR)	6.89	6.90 ↑	7.50	7.67 ↓	7.83 ↑	8.00	8.50
Ukrainian Hryvnia	(UAH)	7.95	7.90	8.00 ↑	7.90 ↑	8.00 ↑	7.70	7.50
Kazakhstan Tenge	(KZT)	148	147 ↓	145 ↓	144 ↓	143 ↓	142 ↓	138
Latin America								
Brazilian Real	(BRL)	1.69	1.70	1.72 ↑	1.68 ↑	1.65 ↑	1.62 ↑	1.60
Chilean Peso	(CLP)	478	480	475 ↑	465	450 ↓	440 ↓	420
Mexican Peso	(MXN)	12.39	12.25 ↓	11.90 ↓	11.80 ↓	11.75 ↓	11.70 ↓	11.50
Colombian Peso	(COP)	1888	1860 ↑	1820 ↑	1800 ↑	1780 ↑	1760	1750
Argentine peso	(ARS)	3.98	3.96	4.05	4.10	4.40	4.40	4.50
Peruvian Nuevo Sol	(PEN)	2.82	2.81	2.80	2.75	2.70	2.60	2.50

Note: Forecasts are for end of quarter

Source: Nomura

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