AMG FINANCIAL GROUP 安柏

AMG Market Commentary

April 2012

Observations and Thoughts from Hokkaido

My family and I had an enjoyable and memorable fly-and-drive holiday in Hokkaido, Japan this past Easter. The last time I was in Japan was more than 8 years ago, and this is the very first time I went there just for leisure – well, more or less anyway. In this month's featured article, I would like to share some of my observations and thoughts from this trip.

To start, our trip spanned 6 days/5 nights and we visited Noboribetsu (登別), Hakodate (函館), Otaru (小樽), Sapporo (札幌). Sapporo was our port of entry and departure. Before our flight, we checked weather forecast which said there could be light snow in the first couple of days and then followed by sunny sky for the rest of the period. It turned out snowing for every single day except the last. The heaviest snow took place during the afternoon we visited Otaru. Our original plan was to have dinner at Otaru before driving to Sapporo so that we can see its historic waterway lighted up at night. Sadly, we had to change plan and left early due to heavy snow fall.

Let me begin with some scattered observations from various destinations.

- Noboribetsu is famous for its mineral-rich hot springs. Although I am not a big fan of soaking in hot springs naked with a bunch of strangers, the experience was less awkward than I feared.
- We had lunch at one lake side restaurant at nearby Toyako (洞爺湖) which serves good food at very reasonable prices against a picturesque view. A truly pleasant experience!
- Hakodate is a beautiful town with deep history and heritage. The night-fall view from Mount Hakodate is claimed to be among the best in the world. Apparently, it is a must-see attraction for tourists visiting Hakodate because the night we were there, the observation deck was packed with people and I counted at least 4 groups of Taiwanese tourists, 2 groups of Hong Kong tourists and 2 groups of Japanese tourists.
- Despite a tourist hot spot, Hakodate is not English-friendly. If our rental car is not equipped with GPS, I cannot imagine how we can navigate ourselves around town. Staffs at the front desk of the hotel we stayed in can only speak broken English at best. During our entire trip, I bumped into two fluent English-speaking Japanese. One of them works in a Tourist Information Centre at the JR Hakodate Station, who lived in Indiana, U.S. when he was young. The other (to my big surprise) is a shopkeeper of a seafood store at the Hakodate wet market.
- From my hotel room, I have a clear and overlooking view of the JR Hakodate train station. The station has a large parking lot that was less than 25% occupied, and trains were running with just two carriages. At around 8am on a Friday morning, I saw few people going in and coming out of the station. There were few buses at the nearby bus station and fewer people there. In stark contrast, there

were a lot of for-hire taxis lining up in front of the JR station but I hardly see any patrons.

- When driving around town, we came across buses and trams with few passengers on board. The streets are orderly and wide, yet traffic was light. My dad wondered aloud the population in Hakodate, which I didn't know at the time. *[According to the website www.stad.com, population is 276,000.]*
- Credit cards are not widely accepted in Hakodate. None of the restaurants we ate at accept credit cards. Even 7-Eleven stores do not take my Visa card, even though the Visa logo was featured in a banner at the cashier counter. When I asked the cashier why (in English of course), he simply shook his head and crossed his forearms to symbolize 'no'.
- Since we depleted our Japanese currency briskly, we went to a bank to exchange for some yen. The JPY-HKD exchange rate I got from a Mizuho Bank was horrendously outrageous. I looked up the Bloomberg website to check the exchange rate beforehand and it showed 10.48, but the rate offered by the bank was 8.818! My mouth dropped to the floor in disbelief. In the end, I have to accept their rate as we only had a few thousand yen left on us. And needless to say, none of the bank staffs speak English – either they can't or they don't want to. Sigh!
- The unpleasant experience at the bank notwithstanding, one of our trip's highlights also took place in Hakodate. It was a tiny café recommended by the young man at the Tourist Information Centre. He said the café sits at the edge of a hillside with a sweeping view of the Hakodate Bay. We keyed in the phone number and followed the GPS instruction. When we arrived, it was in the middle of The Foreign Cemetery. We searched high and low for signage but all we can see were a handful of rather shabby residential houses at one end of the cemetery. Not willing to give up, we walked through the cemetery seeking to ask for direction. It turned out one of the shabby houses is the café itself! A young lady probably in her late-twenties is the sole shopkeeper and she served decent coffee, pastry and desserts. The décor is very basic with memorabilia filling every shelf and corner – old cameras, loudspeakers, HiFi components, sewing machine, and so on. It's a truly hidden treasure!
- Otaru was a small town but it's plain to see a lot of wealth had been generated in the past via trading, based on rolls of large stony warehouses built along the waterway. The town is also known for its glass works and pastry shops. As we walked through the main shopping streets and alleys, the setting kind of reminded me of Zurich in Switzerland.
- Sapporo is the capital of Hokkaido and the fifth largest city by population in Japan. It's a bustling city, which is vividly demonstrated by an over-crowded shopping mall we went for lunch and multi-level parking lots at nearly every street corner in the city centre. Yet for this metropolis, we encountered fairly light road traffic throughout the day and few pedestrians.
- While walking around town, it occurred to me that Japanese, especially the younger generation, are not as 'well behaved' as in the past. Many years ago, I visited Tokyo three times for business. Back then, I have never seen anyone crossing streets when the 'Don't Walk' sign is on. This time in Sapporo, I counted no few than three such 'jaywalkers'.
- We had two memorable eating experience in Sapporo. The first one is in a tiny ramen shop in a narrow alley way. It was snowing heavily that night and my glasses were covered in snow when we dashed into this small noodle shop. There was just one customer sitting at the long bench. Our group of 8 took up all the tables as there are only two. The lone storekeeper is quite a hulk in his early-sixties. To our surprise, he was able to speak a fair bit of English. We each ordered a bowl of ramen and some fried dumplings to share. The 'big' order had the gentleman working a frenzy, all the while pointing to photos and signatures of celebrities on the wall who ate there before. To be honest, the ramen and dumplings were only so-so in terms of taste and look. But these are secondary to watching the gentleman working his best in preparing our food, the coziness of the setting and against coin-sized snowflakes plainly visible through the smoky-colored sliding doors. We left with a warm feeling in our heart and stomach.
- The next evening, which is also our last night for the trip, we ate at this crab-and-shrimp buffet restaurant that was recommended by a friend of mine. The price was surprisingly decent and the food was good. The crabs were fresh, sweet and succulent. I am not particularly fond of eating crabs because of all the fuss, but that meal alone I ate the equivalent of what I had eaten in about three years before. The experience would have marked the climax of our trip if not for the smoke-filled environment. There were a bunch of guys sitting at a table right behind us who were chain-smoking while they eat. It was such a big put off. Why don't restaurants and cafes in Japan have 'non-smoking' sections? I kept on thinking...
- While driving along two-lane freeways in this trip, I oftentimes found myself following tails of big trucks and trailers that occupied on both lanes. In most other cities I have driven across the U.S., Canada, Australia and New Zealand, trucks typically would stay in the slow lane and only use the outside lane (for fast lane) for passing. But this wasn't the case in Hokkaido. There were countless times I had trucks occupying both inside and outside lanes in front of me that show no intention of passing or yielding. I can only conclude that either Japan has a totally different system or that Japanese truck drivers lack basic road etiquette.

And below are a couple of economic-related after-thoughts.

- While in Sapporo, my father marveled at the wide variety of cars on the streets, both in terms of makes and models. He was particularly amused at the popularity of tiny cars and trucks in Japan that are almost unseen in Hong Kong. Called micro cars or K-cars in Japan, they have very small engine displacement (~600c.c.) and do not appeal to status seeking Hong Kongers. At the same time, I felt my father's observation was quite insightful and decided to investigate further on the Japan auto market. I found that given Japan's population (at 16.24 million at end of 2011, which by the way has been declining for the fifth year, and is the world's tenth largest) and annual auto sales figures, there are too many car makers and car models.

  In Japan, there are eight major passenger car makers, they are: Toyota, Honda, Nissan, Daihatsu, Suzuki, Mazda, Mitsubishi, and Subaru. Some of these car companies also build trucks and buses, such as Toyota, Nissan and Suzuki. But the bigger names in trucks and buses building are Isuzu, Hino, Fuso and U.S. Trucks. From the website of Japan Automobile Manufacturers Association, Inc. I found detailed sales record and have put together the following table for easy reference.

Passenger Cars					
	2007	**2008**	**2009**	**2010**	**2011**
Toyota	1,373,596	1,291,591	1,238,137	1,415,439	1,038,111
Honda	529,921	586,932	595,559	600,399	476,688
Nissan	616,908	579,993	520,492	565,875	514,534
Daihatsu*	492,947	512,238	474,694	477,221	429,669
Suzuki*	529,921	534,998	485,397	483,645	437,092
Total	**4,400,299**	**4,227,643**	**3,923,741**	**4,212,267**	**3,524,788**
**Daihatsu and Suzuki, primarily manufacture mini car (also known as k-car in Japan)*					

  In comparison, the U.S. has a population of 313.33 million by end of 2011 and new car sales of 15.1 million. In other words, Japan's population is about 40% of that of the U.S., but its annual auto sales last year was only 25% of the U.S..

  There are a few issues with this picture. The first that comes to mind is Japan's auto industry is intensely competitive. Secondly, with such a wide range of models to maintain, cost, inventory and operational management is hugely difficult. Furthermore, when the time comes to redesign for the new model year, which for Japanese automakers average once every three to four years, the cost on R&D is immense. Lastly, such a business model requires high investment inputs yet margins are probably only modest at best.

  In recent years, Japanese automakers are conceding global market shares to European makers in the luxury segment, and also to Korean makers in the mass segment. Last year's flood in Thailand was often mentioned as a culprit, but car enthusiasts have also talked about Japanese cars losing out to Korean and American made cars on the bang-for-the-buck measure and trailing behind European cars in terms of styling and driving experience.

- Another Japanese industry that has been losing its former lustrous is electronics and home appliances. For home appliances, Japanese makers are fighting competitors from all fronts. On the entry segment, there are the army of low cost Chinese manufacturers, such as Haier, Gree, Meidi, Chonghong, TCL, Konka, Kelong, and so on. On the high-end segment, there are Siemens and Electrolux from Europe and Samsung and LG from South Korea. A not-so-well-known fact is that the Toshiba home use air-conditioning business in Hong Kong was sold to Carrier, which is a division of United Technologies of the U.S. many years ago.

  In a recent Wall Street Journal story, it talked about rising Chinese investment in Japanese companies. Some of the biggest investments since last year have been in the electronics sector.

About a week ago, Sony's new CEO Kazuo Hirai announced plans to lay off 10,000 employees and of deep cuts at its unprofitable television business. That night at home, I watched the news airing again and again on the Bloomberg channel on my Pioneer plasma TV. I still marveled about the superior picture quality of Pioneer's plasma technology yet they have seized manufacturing of TV sets for years. Then I look at my stereo system and counted no less than four Japanese brands that I once owned that have disappeared, they are Sansui, Aiwa, Akai, and Kenwood. Who would be next, I wondered……

Market Review

US: Neutral

The Bureau of Labour Statistics (BLS) reported a net new 120,000 jobs has been created in March, which is a sharply slower pace of job growth compared with an average 245,000 over the prior three months. Mixed revisions to employment data in February and January resulted in a net addition of 4,000 jobs. Meanwhile, the BLS reported that unemployment rate tickled down to 8.2% from 8.3% in the previous month.

Fig. 3: March employment report

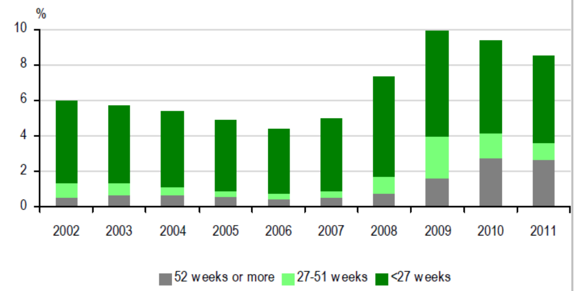
	6-Month Avg.	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	
Total Payrolls	132136	131963	132186	132461	132701	132821	
Change	201	157	223	275	240	120	*Net +4k from back revisions*
Previous Est. Change	167	157	223	284	227		
Diffus. Index--Priv. Sect.	60.4	55.6	63.7	70.3	60.7	59.6	*Broad job gains*
Diffusion Index -- Mfg.	57.7	48.1	64.8	77.8	59.9	67.9	
Private sector	214	178	234	277	233	121	
Manufacturing	20	3	28	52	31	37	
Construction	9	1	26	18	-6	-7	*Weather payback*
Services (Priv)	178	170	172	199	204	90	
Retail Trade	14	33.8	6.8	24.9	-28.6	-33.8	*Puzzling decline possibly due to seasonal shifts*
Government	-13	-21	-11	-2	7	-1	
Household Survey							
Employment	385	317	176	847	428	-31	
(Non-Ag. Priv. Employ.)	394	182	-95	902	812	336	
Unemp. Rate	8.6	8.7	8.5	8.3	8.3	8.2	
Participation Rate	64.0	64.0	64.0	63.7	63.9	63.8	*Troubling labor market statistic*
Establishment Survey							
Wkly. Hrs. (Production)	33.7	33.7	33.7	33.8	33.8	33.8	
Mfg. Hours	41.6	41.5	41.6	41.8	41.9	41.7	
Overtime	4.1	4.1	4.1	4.2	4.2	4.3	
Avg. Hrly. Earn($)- all workers	23.24	23.23	23.25	23.28	23.34	23.39	
% Change	0.1%	0.09%	0.09%	0.13%	0.26%	0.21%	*Up 2.1% y-o-y, not outpacing inflation*

Source: BLS; Nomura Global Economics

The worse-than-expected job figures could be due to a second straight month of significant loss in retail jobs, which were concentrated in general merchandise stores. Yet at the same time, according to the International Council of Shopping Centers (ICSC) comparable chain store sales experienced solid growth in March, both on year-on-year and month-on-month basis.

Apart from fewer jobs created, slow wage growth is also a concern. Average hourly earnings increased by 2.1% YoY, not enough to outpace inflation.

Long-term unemployed represent an unusually high percentage of the unemployed population. In 2011 2.7% of the labor force had been unemployed for more than 52 weeks, more than four times the normal 0.6%.

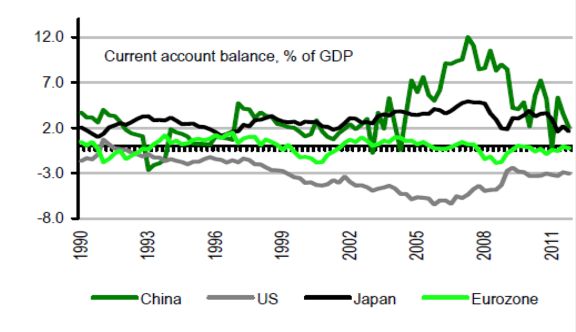


Source: BLS

As for the drop in unemployment rate to 8.2%, a dip in the labour force participation rate plays an important role. The labour force participation rate declined to 63.8% in March, compared with 63.9% in February and 64.5% a year ago. Meanwhile, a significant increase in long-term unemployment rate is also worrisome as well. This suggests the labor market suffers from a combination of skills mismatch and labor immobility. Statistics show that the share of long-term unemployed population in 2011 is four times of that in 2007.

Fed Chairman Bernanke has expressed his puzzlement over the sharp decline in the unemployment rate since last fall on the backdrop of weak economic growth. As Bernanke questioned whether the strong pace of hiring in recent month will persist and some members of FOMC commented that they do not expect the labour market to improve rapidly, it is still too early to rule out the possibility of QE3.

Current account balances – major economies



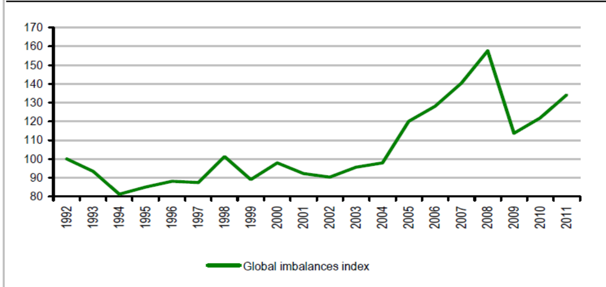
Source: IMF. 2011 data are UBS forecasts.

There has been some optimism recently that the world economy is achieving better balance. Current account surpluses have narrowed substantially in recent years in China, Japan, and some oil exporting economies. The U.S. current account deficit in the meantime is considerably smaller than it was prior to crisis.

However, the so-called Greenspan measure of imbalances, which is a broader measure of global imbalances that sums up every economy's absolute current account position (i.e., ignoring the sign), has started climbing up again since the year before after having shown a big improvement in 2009.

The U.S. trade deficit has also been widening again recently accompanying with higher domestic and import demand. This suggests that improvement of imbalance in 2009 may not a secular phenomenon.

A measure of global imbalances



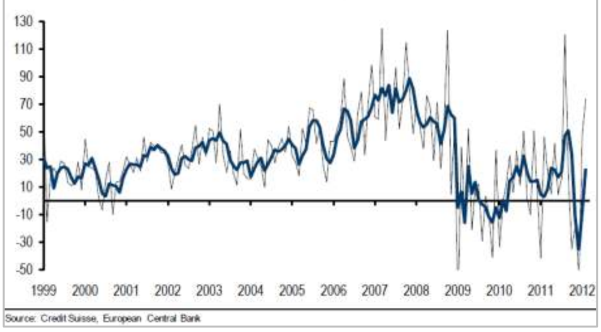
Source: UBS calculations. This metric takes the sum of every economy's current account surplus or deficit position in any given year (relative to GDP) ignoring the sign. The data is indexed to 1992 = 100.

Europe: Negative

New evidences provided additional proofs to the validity of ECB's twin LTROs. Having seen broad contraction in Q4 2011, euro area M3 has rebounded sharply in the first two months of this year, a sign of financial system regaining stabilization. Meanwhile, liquidity provided to banks from the two LTROs has found its way into government bonds. ECB's record shows European banks purchased a net € 76bn of government bonds in January and February. Such purchases by European banks help governments securing a significant portion of financing needs for this year.

Exhibit 1: Euro area M3 bounces back to life

Euro area M3, seasonally adjusted monthly flows and 3 month average, €bn

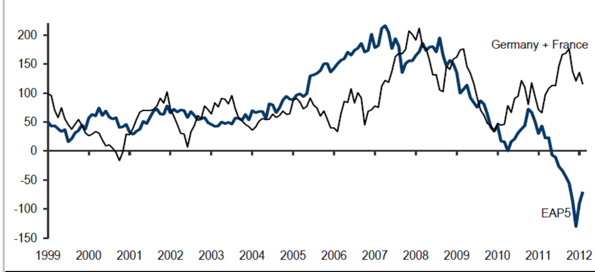


Source: Credit Suisse, European Central Bank

Another sign of improvement is the rapid outflow of bank deposits from peripheral European countries' banking sectors appears to be halting. We have expressed our worries on this issue previously and recent statistics help lessened our worries somewhat. A report from Credit Suisse found that bank deposits in the five peripheral economies fell by over € 100bn in the last two months of 2011. However, the outflow has stopped and reversed in both January and February. In contrast, deposit growth in Germany and France dropped.

Exhibit 2: Deposit flight from the periphery stops in 2012

Non-financial private sector bank deposits, 6m flow, €bn, seasonally adjusted; EAP5=Euro area periphery 5



After the two rounds of LTRO, investors are placing more concerns over the European Financial Stability Facility (EFSF). Look closer into the facility's features, we see that investors in EFSF securities are effectively holding a portfolio of Euro sovereign issues, excluding those currently under assistance. Country allocations within the portfolio roughly correspond to sizes of their GDP, with slightly over-weight on Germany and under-weight on Italy.

EFSF & ESM Capital Contributions

Contributor	EFSF Amended commitments (€ bn)	EFSF Amended contribution key (%)	ESM commitments (€ bn)	ESM contribution key (%)
Austria	22	2.99	19	2.78
Belgium	27	3.72	24	3.48
Cyprus	2	0.21	1	0.20
Estonia	2	0.27	1	0.19
Finland	14	1.92	13	1.80
France	158	21.83	143	20.39
Germany	211	29.07	190	27.15
Greece	0	0.00	20	2.82
Ireland	0	0.00	11	1.59
Italy	139	19.18	125	17.91
Luxembourg	2	0.27	2	0.25
Malta	1	0.10	1	0.07
Netherlands	44	6.12	40	5.72
Portugal	0	0.00	18	2.51
Slovakia	8	1.06	6	0.82
Slovenia	4	0.51	3	0.43
Spain	93	12.75	83	11.90
TOTAL	726	100	700	100

Highlighted countries have highest rating from at least two ratings agencies.

Source: EFSF, ESM Treaty

The EFSF has no paid-in capital, but rather is backed by financial guarantees which is amounting to € 726bn. After France's downgrade, the weighted average rating of the sovereign is AA-. EFSF long-term bonds are currently rated AA+ by S&P, and the highest rating by Moody's and Fitch.

EFSF Currently Outstanding Bonds

Maturity	Issued	Amount - EUR million	Coupon
12/03/2013	08/03/2012	15,000	0.40
12/03/2014	08/03/2012	15,000	1.00
04/02/2015	12/01/2012	3,000	1.625
18/07/2016	01/02/2011	5,000	2.75
05/12/2016	29/06/2011	3,000	2.75
15/05/2017	28/03/2012	4,000	2.00
05/07/2021	22/06/2011	5,000	3.375
04/02/2022	14/11/2011	3,000	3.50
30/03/2032	26/03/2012	1,500	3.875
	TOTAL	54,500	

Source: EFSF, Bloomberg

Due to escalation of sovereign risk last year, the facility seeks to leverage its resources through two special purpose vehicles: a European Sovereign Bond Protection Facility and a European Sovereign Bond Investment Facility. The first one is to provide partial risk protection for sovereign bonds. The second one is a co-investment fund open to both the private and public sector dedicated to EMU area government bond. These help to reduce refinancing risk and systematic risk accruing to the previous bond holders.

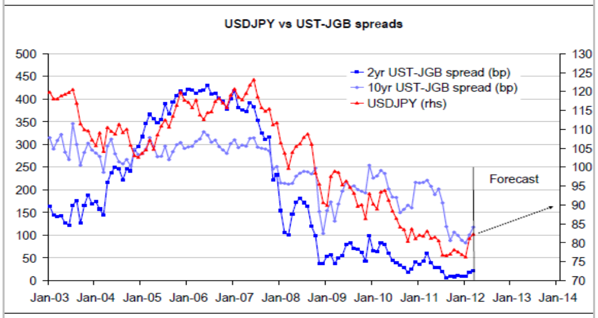
In contrast to EFSF, the European Stability Mechanism is a permanent facility and will replace the EFSF from July 2012. The ESM will have an initial lending capacity of € 500bn and a total subscribed capital of € 700bn. Under current agreement, the consolidated lending capacity of the EFSF and ESM is restricted to below € 500bn. But the upper limit is in active debate to uplift.

Japan: Neutral

The Japanese yen has stayed weaker (from its record high early this year, that is) after Bank of Japan's unexpected intervention. In the right hand chart, it can be seen that the USDJPY exchange rate moves along with yield spread of U.S. treasury and Japanese government bond. Thus, it is essential to monitor the two governments for their attitudes toward monetary policies.

Investors are paying more attention on U.S. government response than Japanese government since past interventions by Japanese government were largely futile. Recent economic figures from the U.S. paint a picture of sustaining growth that may indicate a shift towards earlier tightening in the monetary base than the often mentioned "late 2014" timeframe. Contrary to an improving U.S. economy, Japanese trade deficit reached record high in February. The divergence in the economies would force the Japanese government to stick to or even add to its current easing policy.

Chart 1: As UST-JGB spreads go, so does USDJPY



Source: Bloomberg

China: Neutral

Date announced	Liberalisation measure
1980	Liberalised FDI in four Special Economic Zones
1996	Current account transactions were liberalised
1999	FDI liberalisation extended to all provinces, but subject to limits varying by sector
2001	Under WTO commitment, the services sector is opened up to FDI, including the financial sector
2002	Opening the domestic capital market for selected Qualified Foreign Institutional Investors (QFII)
2004	The approval requirement for firms' overseas investment was repealed
2004	Allowing Hong Kong residents to open RMB deposit accounts at Hong Kong banks
2005	RMB de-pegged from USD; daily trading range of CNY/USD is set at ±0.3%
2006	Opening investment abroad for selected Qualified Domestic Institutional Investors (QDII)
2007	CNY/USD daily trading range expanded to ±0.5%
2007	Domestic financial institutions allowed to issue RMB-denominated bonds in Hong Kong subject to approval
2008	Domestic commercial banks allowed to provide loans to firms for use in cross-border M&A
2009	Local firms allowed to register the source of their foreign exchange financing after their investment overseas rather than requiring approval in advance
2009	Introduced RMB as a cross-border trade settlement currency, but restricted to trade between five Chinese cities (Shanghai, Shenzhen, Guangzhou, Dongguan and Zhuhai) and Hong Kong, Macau and ASEAN countries (open to all Chinese importers but only a small number of exporting firms)
2010	RMB as cross-border trade settlement currency program was expanded to include trade transactions between Chinese firms in 20 provinces and cities and the rest of the world. The number of Chinese exporting firms who may participate in the program was also expanded
2010	Foreign companies were authorized to issue RMB-denominated bonds in Hong Kong
2010	Renminbi transactions in Hong Kong were further relaxed to allow: 1) renminbi lending for any purpose; 2) renminbi remittance to mainland by companies subject to approval by China's government
2010	Hong Kong banks involved in renminbi cross-border trade settlement allowed to access the on-shore interbank bond market
2010	Allowed export companies to keep their export revenues overseas (introduced to export companies in Beijing, Guangdong, Shenzhen, Shandong, Jiangsu first in October 2010 and expanded nationwide on 1 January 2011)
2011	US companies and residents can trade renminbi in US branches of Bank of China. Individual accounts can convert US$4000 a day into renminbi (annual quota is US$10,000)
2011	Introduced pilot scheme on allowing qualified foreign institutions to make private equity investment in China
2011*	To launch Renminbi QFII, which would allow foreign investors to invest in mainland securities with an initial quota size of RMB20bn
	To expand the renminbi trade settlement scheme nationwide
	To allow Hong Kong firms to invest directly into mainland China using renminbi
	To expand Treasury bond sales in Hong Kong
	To launch an ETF linked to Hong Kong stocks in mainland China
2011	Allowed Hong Kong listed companies to raise renminbi through share placements or rights issues. Investment banks are also allowed to issue RMB-denominated derivative warrants based on renminbi shares

Note: * These planned measures were announced by Vice Premier Li Keqiang during a special visit to Hong Kong on 17 August 2011, but have yet to be fully implemented.
Source: Nomura Global Economics.

The above table outlined the history of China government liberalizing its capital account. While it is a fact that the China currency market is a closed one for decades, inevitably the capital account will be liberalized in the future. There are a number of benefits in opening the capital account: (1) It allows Chinese local companies to develop and compete on an international scale; (2) It encourages the internationalization of RMB; and (3) It promotes further structural development of the economy.

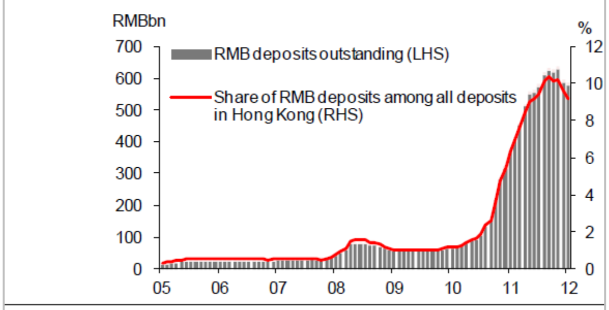
It was believed that China government would achieve this goal in steps. Firstly, the government would relax foreign direct investment related to real business activity to help Chinese companies seeking overseas investment. Secondly, the government would relax controls on commercial credit related to merchandise trade activity in order to promote offshore RMB flowing back into China. Finally, the government would liberalize the remaining capital controls including real estate investment and bank-related capital flows. Nomura Research has summed up the rationale of the sequence in the table below.

Figure 2: General principals on the sequence of capital account liberalisation shown in the proposal

	General principle	Rationale of the sequence
1	Liberalise capital inflows first, then capital outflows	Potential negative effects tend to be larger for capital outflows than capital inflows as they lower FX reserves and reduce domestic liquidity.
2	Liberalise long-term capital first, then short-term capital	Short-term capital flows tend to be more volatile and thus could negatively affect domestic financial markets.
3	Liberalise direct investment first, then indirect (eg. portfolio) investment	Direct investment is unlikely to cause sudden, large capital flows.
4	Liberalise investment by institutional investors first, then individual investors	Non-professional, individual investors generally need time to understand risks involved in overseas investment.
5	Liberalise major (first-grade) markets first, then minor (second-grade) markets	Transaction volumes in major, first-grade domestic financial markets, such as Shanghai's A-share market, are larger than those in minor markets and thus major markets tend to more easily absorb shocks from capital inflows.
6	Liberalise non-resident investment in China first, then residents' investment abroad.	Potential negative effects tend to be larger for capital outflows than capital inflows as they lower FX reserves and reduce domestic liquidity.

Source: Nomura Global Economics.

Fig. 5: RMB deposits in Hong Kong

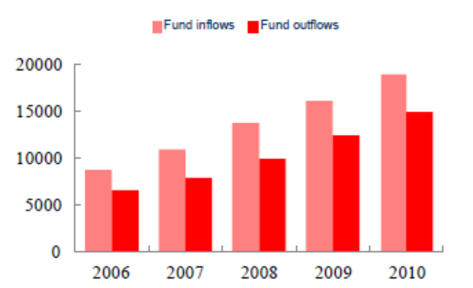


Source: CEIC and Nomura Global Economics.

Opening FDI is already what the government has done. China government is undergoing Step 2, i.e. relax controls on commercial credit related to merchandize activity.

A clear manifestation of that motion is the allowance of Hong Kong banks to settle international trade via RMB in 2010. Since then, RMB deposit locally has risen dramatically. The share of RMB deposit to total deposit reached a record high of 9.6% last year. Meanwhile, as the spread on deposit rates between China and Hong Kong widens, investors have seized the incentive to deposit or invest across border, undermining China's remaining capital control.

Fig. 13: Gap in the balance of payment in the NCSSF (In Rmb 100 mn)



Source: Ministry of Human Resources and Social Security, CITIC Securities Research

According to Xinhua News Agency, in a move that was commissioned by the Guangdong provincial government and approved by the State Council, the National Council for Social Security Fund (NCSSF) will be managing Rmb100bn of pension funds for workers in Guangdong province. It is estimated that at most 20% of the pension fund can be invested in the equity market. According to an annual report from the NCSSF, the balance of China basic pension funds has reached Rmb1.92 trillion as of the end of 2011.

The move is considered an essential one. Due to the vast gap in the balance of payments, the huge deficit in personal accounts, limited investment channel and the lack of initiatives from regulatory authorities, local social security funds are exposed to relatively large payment pressures. Annual surplus of the NCSSF was in the range of Rmb350bn to Rmb 400bn from 2007 to 2010. If we expect that 10% of the fund would be allocating to equities and the size of NCSSF will continue to expand, there would be over 35bn flowing into the stock market annually.

Figure 1. PMI Breakdown

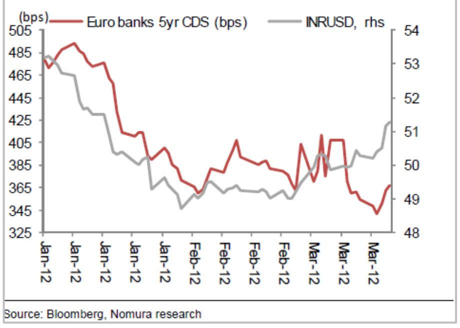
	12-Mar	12-Feb	12-Jan	11-Dec	11-Nov	11-Oct	11-Sep	11-Aug	11-Jul
PMI	**53.1**	**51.0**	**50.5**	**50.3**	**49.0**	**50.4**	**51.2**	**50.9**	**50.7**
New Orders	55.1	51.0	50.4	49.8	47.8	50.5	51.3	51.1	51.1
Production	55.2	53.8	53.6	53.4	50.9	52.3	52.7	52.3	52.1
Employment	51.0	49.5	47.1	48.7	49.0	49.7	51.0	50.4	50.5
Delivery Time	48.9	50.3	49.7	50.1	50.4	50.7	49.5	49.9	50.3
Inventories Raw Materials	49.5	48.8	49.7	48.3	46.7	48.5	49.0	48.8	47.6
New Export Orders	51.9	51.1	46.9	48.6	45.6	48.6	50.9	48.3	50.4
Inventories Finished Goods	50.8	50.5	48.0	50.6	53.1	50.3	49.9	48.9	49.2
Purchases Quantity	54.8	53.6	50.2	50.9	49.8	50.7	51.5	51.2	52.0
Input Prices	55.9	54.0	50.0	47.1	44.4	46.2	56.6	57.2	56.3

Source: Bloomberg and Citi Investment Research and Analysis

The national March manufacturing PMI of China rose to 53.1, with almost all sub-indices gaining. Components in output, new orders, finished goods inventories and employment show improvement.
Among these, new order index is most encouraging, jumping to 55.1 from 51.0 and hitting the highest level since last year. While the data are encouraging, there exists conflicting readings between NBS and Markit-HSBC PMIs for the month of March, suggesting advancement is not universal and that uncertainty of growth momentum of the China economy remains for the coming quarters.

India: Neutral
India is one of the Asian countries greatly influenced by global risk sentiment. A large amount of external commercial borrowings by India's corporate sector during 2006-2007 would be due on this year and a great sum of foreign currency convertible bonds should be redeemed this year. These two add up to a heightening tail risk for India. The graph on the right illustrates the strong relationship between the global risk sentiment and foreign exchange capital flows in India.

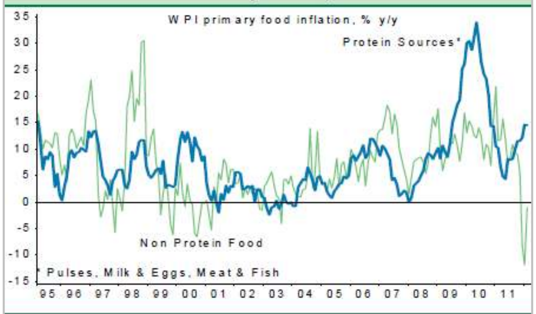
Fig. 1: As a high-beta currency the rupee's moves have been tightly correlated with global risk sentiment, proxied here by CDS spreads on European banks. However, the correlation broke down in March



Source: Bloomberg, Nomura research

In response to persistent inflation pressures, the Reserve Bank of India has hiked its benchmark policy rate to 8.5% and the effect is a notable slowdown of economic growth. Despite having the highest interest rates among bigger economies in Asia, the threat of inflation has not greatly receded.

Chart 2: Structurally faster protein inflation



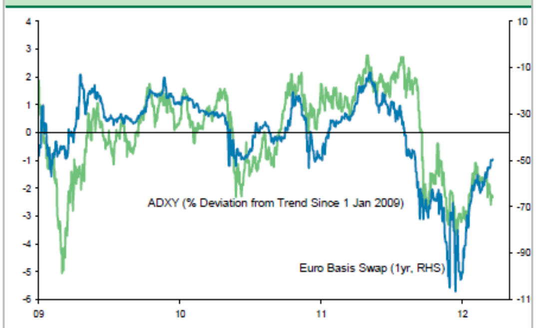
Source: Reuters EcoWin Pro, BNP Paribas

Although food inflation has dropped in recent months, it appears to be a weather-related phenomenon. Fresh fruit and vegetable inflation have reversed and surging anew in February. More importantly, a rapid rise in the price of protein source is observed. Protein source is deemed as the leading driver of food inflation in recent years. It is thus probable that inflation will return soon and stay high regardless of elevated policy rate.

Furthermore, scandals of corruption and stalled structural reforms of the India's political system are undermining investors' confidence. As the influence of liquidity-driven stabilisation of the euro debt crisis and retrenchment in inflation fades out, investors should be cautious on Indian equities.

Asia Pacific: Neutral
The risk of financial contagion has eased off in Asia. ECB's twin LTROs and continued efforts from G-7 central banks to provide USD liquidity have eased global liquidity shortage. Historically, USD liquidity has proved to have a strong relationship with Asian currencies.

Chart 2: Improved liquidity to boost currencies

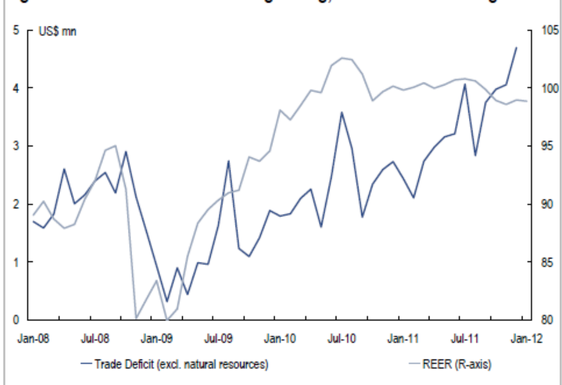


Source: Reuters Ecowin Pro, BNP Paribas

Easy monetary policies have reduced the risk of disorderly deleveraging by the European banking sector and dampened concern that banks may be forced to retrieve their investment in Asian countries. As a result, Asian currencies have strengthened thanks to less volatile capital flow.

In 2005 and 2008, the Bank of Indonesia raised interest rate significantly in response to exchange rate depreciation and fuel prices hikes, and was further amplified by heavy foreign positioning in short term instruments. Not so today. There are no serious worries over its fiscal sustainability and foreign investors are longer permitted to hold short term instruments for more than 6 months. Thus, Bank of Indonesia is feeling no urgency to raise interest rate.

Figure 59. Trade deficit has been growing, as REER is at strong levels



Source: CEIC Data Company Ltd., and CIRA

Lately, Indonesian government is trying to get support from various parties to remove the subsidy on fuel prices in order to relieve its financial burden. It is estimated that the move would mean gasoline prices rising by 33% to IDR 6,000/L.

Indonesia's trading account, excluding primary commodities, is in deficit and it is widening. Amid strong growth in domestic demand, monthly trade deficit excluding non-natural resources reach a record high last December.

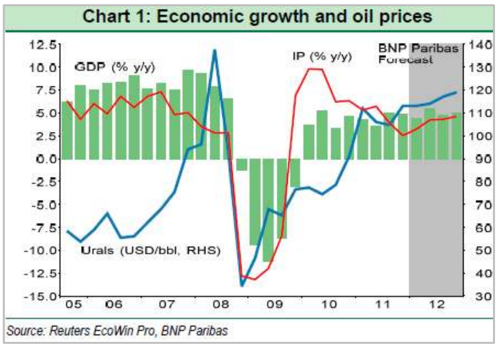
Investors should closely monitor Indonesia's trade deficit because currently the non-commodity trade deficit was offset by strong natural resource export. With prices of coal, the largest non-oil export commodity, recently easing off along with soft data on the China economy and meanwhile higher oil prices may further dent the trade balance from the import side, the trading picture could deteriorate rather rapidly.

In South Korea, seasonally adjusted jobless rate rose to 3.7% in February as more people looked for jobs. The unemployment rate may not extend its uptrend in the near-term due to lesser job seekers. Job growth is likely to slow down as well since the impact of consumption slowdown on the labour market is going to materialize.

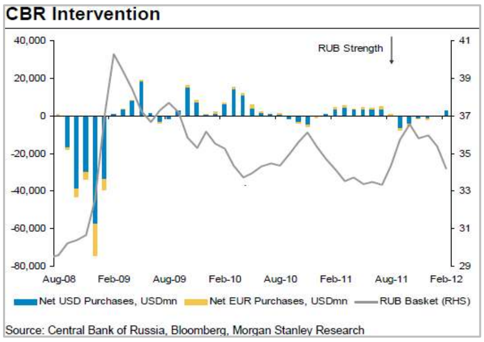
Meanwhile, Korean leading indicators such as manufacturing PMI and local confidence surveys are improving. It is also important that export growth rebound in February. Solid export growth should support machinery and equipment investment, which fell in Q3 and Q4 in 2011.

Russia & Emerging Europe: Cautious

Consumer inflation in Russia hit an exceedingly low 3.7% year-on-year gain in February and is likely to stay below 5% in the coming months. It should be attributed to the government's decision to postpone the annual hike in utility tariffs until July 2012. This leaves room for the Central Bank of Russia to cut down refinancing and repurchase rates. Slowdown of capital outflows supports the government's continually strong investment intention.



Russian fiscal performance should be healthy this year given oil prices stay steady at high levels. This has prompted Russia to issue rouble-denominated Eurobonds to test the market. Net domestic issuance is expected to rise from RUB 939bn in 2011 to RUB 1,209bn in 2012.



For a long time, the Russian rouble (RUB) followed a crawling peg regime until July 1998, after which the currency devalued and the regime shifted to a heavily managed float. Following a second devaluation in August 2008, flexibility around the managed float regime increased. The Central Bank of Russia (CBR) manages the currency against a EUR (45%) and USD (55%) basket.

When CBR intervenes, it usually does so through the Moscow Interbank Currency Exchange (MICEX). As Russia is transforming to an inflation-targeting regime, the CBR is in the process of relaxing its control over the exchange rate.

Now that Vladimir Putin becomes the prime minister again, observers are looking forward to reforms in some key financial areas:

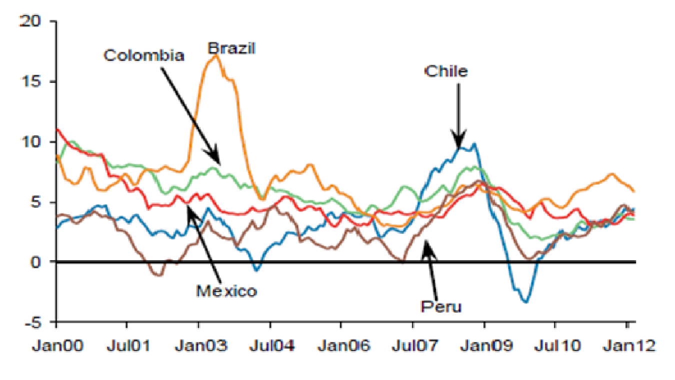
1. Forcing politicians to resign from board positions in State-controlled companies
2. Capital market reform
3. Speed up of WTO entry
4. A stronger economy
5. Significant infrastructure spending

Latin America: Cautious

Policymakers across Latin America are facing a so-called "policy trilemma", i.e. the impossible task to control inflation and currency at the same time with free international capital flow. Policy response vary across different countries according to the degree of governmental market intervention, inflation, and openness of market.
CPI inflation in Latin America picked up from the bottom of 2010 to a peak of 2011 and reined in these few months except for Argentina and Venezuela.

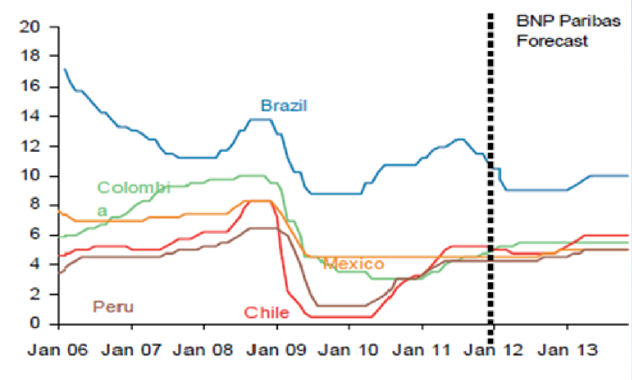
Brazil is the most worrisome country in terms of controlling inflation. But given evidence of CPI receding in recent months, BNP Paribas forecasts Brazil may trim its policy rate further this year. Apart from Brazil, Mexico, Peru and Chile are less urgent to cut down on interest rate as their domestic demand is quite resilient and relatively unaffected by the European sovereign crisis.

Chart 3: CPI inflation (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

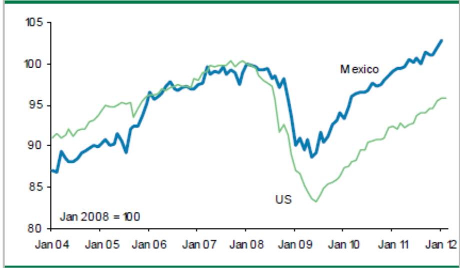
Chart 4: Policy interest rate (%)



Source: Reuters EcoWin Pro, BNP Paribas

We have long maintained that China's economic well-being is a big concern for Latin American countries being a major trading partner for their various commodities. Copper matters a great deal to Chile and Peru, oil to Columbia and Mexico, iron ore and soybean to Brazil and Argentina. Hence, robust growth of China economy and buoyant commodity prices are essential factors to supporting Latin American countries.

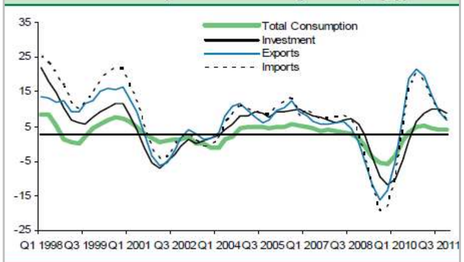
Chart 1: Mexican industrial production rebounding



Source: Reuters EcoWin Pro, BNP Paribas

Mexico continues to benefit from U.S. recovery, more so than its neighbors. The MXP (Mexican Peso) has already reached the upper bound of market consensus forecast for this year. Industrial production has risen strongly and the trend is encouraging. The job market is improving, with unemployment rate fallen to 4.8% in February compared to 5.7% in June 2011.

Chart 1: Components of GDP growth (% y/y)



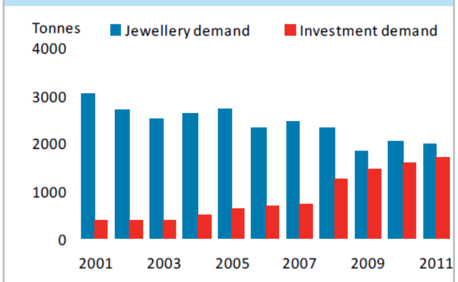
Source: Reuters EcoWin Pro, BNP Paribas

As for major risks, investors should be aware that Mexico is a net oil importer, hence higher oil price would adversely affect inflation and growth. Escalating involvement of drug-trafficking gangs in the country's election and politics is also worth noticed, albeit market might have discounted that in the risk premium.

Commodities: Negative

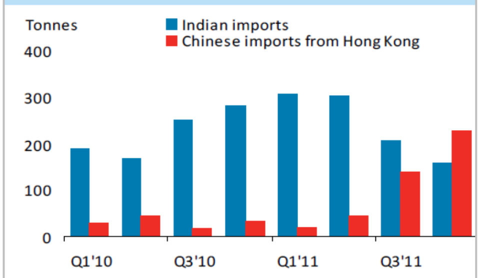
The World Gold Council has released full year data for 2011. Investment demand continued to be a key driver in the gold market. Heightened risk aversion among retail investors notably boosted demand for gold bar & coin, which was up by 27% to 1,530 tonnes in 2011. In terms of country, growth in demand mainly originated from India, China and South East Asia (Thailand and Vietnam). In contrast, jewellery demand declined by 4% to 1,963 tonnes. The decline was mainly linked to slumping Indian imports as a weaker currency means the price of gold soared in Rupee terms.

Chart 3: Physical investment vs. Jewellery demand



Source: World Gold Council, BNP Paribas

Chart 4: Chinese and Indian gold imports

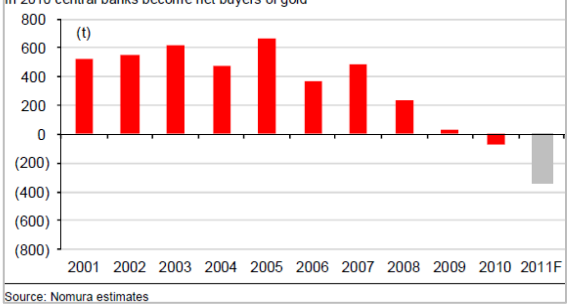


Source: GFMS, Hong Kong trade data, BNP Paribas

Another notable development in 2011 was the acceleration of central bank purchases of gold. Since 2010, central banks have become net buyers of gold again. In 2011, net purchases by central banks totalled 440 tonnes, the highest level since 1964.

Fig. 81: Net change in central bank divestments / (purchases)

In 2010 central banks become net buyers of gold



Source: Nomura estimates

Some researches indicate that central bank net buying is a major driver of gold price in recent year, and it was mainly done by the emerging countries. Mexico, Russia and Turkey are the biggest central bank buyers so far this year.

Another factor that may support gold price is the possibility of QE3. It has been long believed that gold price is closely related to inflation expectation. BNP Paribas found that gold price have traded at similar pattern to U.S.. Treasury 2 year-10 year yield spread, albeit imperfect. Although the market expects the new round of QE, if it takes place, would be in a sterilised form, QE would effectively lower interest rates hence might fuel future inflation and rekindle demand for gold.

Chart 7: Gold vs. US Treasury 2yr-10yr yield spread

Source: Bloomberg, BNP Paribas

Hedge Funds: Mixed

For the month of February, all except dedicated Short Bias strategy hedge funds posted positive returns on the back of favourable macroeconomic trends. Economic data in the U.S. and the ECB's second long-term refinancing operation (LTRO) program helped stabilize markets and promote liquidity. In addition, thanks to corporate actions such as buybacks and dividend hikes, convertible arbitrage managers have delivered good performance. Emerging Markets managers recorded strong gains as markets continued to renormalize and both risk assets and European sovereign bonds attracted renewed investor interest.

In the U.S., an otherwise positive month took a negative turn following the remarks by Federal Reserve Chairman Ben Bernanke that suggest additional asset purchases are not imminent given the current economic environment. This triggered a mild sell-off in Treasuries with the bulk of selling hitting the so-called belly of the curve as10 year yields traded up to 2.05%. Fortunately, Fixed Income Arbitrage managers have generally maintained a cautious, tactical trading approach given the complexities of the political dynamics within the markets and scored decent gains.

	Feb	YTD	Avg. Annualized Performance*	Annualized Vol.*
Dow Jones Credit Suisse Hedge Fund Index	**1.61%**	**3.98%**	**8.87%**	**7.60%**
Convertible Arbitrage	1.88%	4.29%	7.66%	6.97%
Dedicated Short Bias	-4.66%	-11.88%	-4.04%	17.03%
Emerging Markets	2.92%	6.77%	7.65%	14.96%
Equity Market Neutral	1.33%	1.51%	5.10%	10.37%
Event Driven	1.58%	4.43%	9.37%	6.37%
Fixed Income Arbitrage	1.00%	2.19%	5.31%	5.76%
Global Macro	0.79%	2.02%	12.13%	9.76%
Long/Short Equity	2.64%	6.65%	9.49%	9.97%
Managed Futures	1.21%	2.36%	6.08%	11.72%
Multi Strategy	1.72%	4.24%	8.03%	5.42%

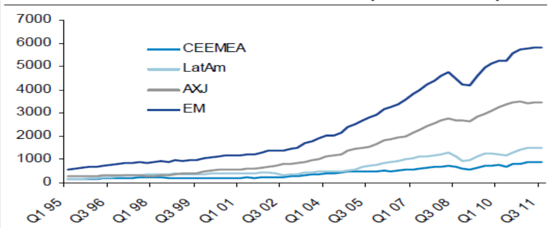
*Average annualized Index data begins January 1994. Source: Credit Suisse Hedge Index, LLC.

Bonds: Mixed

Investors have shown more interest toward emerging market bonds due to improved accessibility and tradability (more instruments and fewer investment restrictions). This is evidenced by the expanding investor base. The rapid surge in the market size of emerging market bonds, shown in the right hand chart, confirms their popularity. Central & Eastern Europe, Middle East and Africa (CEEMEA) and Asia ex. Japan are among the most favoured regions by investors.

Exhibit 4

Size of EM Domestic Bond Market (US$ million)



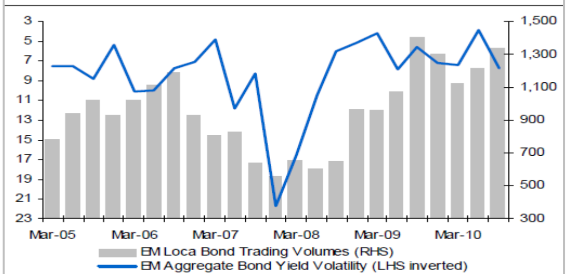
The data for Asia includes the Local Currency Government Bonds only, i.e., Treasury Bonds for China, Treasury Bonds and Recaps for Indonesia, Government Bonds for India, Treasury Bonds and Central Bank Bills for Korea, Government Securities and Islamic Issues for Malaysia, Government bonds for Singapore, Thailand and Taiwan.
Source: BIS, Morgan Stanley Research

In additional to foreign institutional investors, domestic pension funds were also as keen buyers too. Pension funds in emerging markets tend to invest the majority of their portfolios in their own government's bonds.

According to Emerging Markets Trade Association, trading volume for EM local bonds has exceeded those of external debt since 2006. There is also evidence of clear correlation between trading volume and yield volatility. According to Bloomberg, trading volume of local EM bonds increased dramatically during the financial crisis in 2008 as bond yields heightened. However, investors should bear in mind that those EM bonds with lower sovereign credit ratings will be more volatile.

Exhibit 6

Yield Volatility Spikes as Trading Volume Decreases



Source: Bloomberg, Morgan Stanley Research

* Unless otherwise stated, all figures and informa tion are collected from WSJ, Bloomberg or Haver Analytics.

a result of currency and market fluctuations. The recipients of this document should seek for professional advice if they are in any doubt about any of the information contained herein.

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