

Weekly Report

Tightening in China: How should investors react?

China has taken the first initiatives to tackle two main problems: asset bubbles and rising inflation fears. In fact property prices in China's 70 large and middle sized cities rose 7.5 % y-y in December, which is the fastest pace in 18 months. But more disturbingly, this hefty price increase could even be tame if more representative metrics are used, which would result in increases over 20 % for residential real estate prices. Additionally, continued strong lending data are alarming: 2009 bank loans were more than double the amount of new loans extended the previous year. Data in January show no moderation. Continuing foreign inflows of speculative capital supports the formation of asset bubbles. On top of all, acceleration in economic growth and rising commodity prices seriously increased inflation fears. The latter could indeed become the most challenging economic problem. A quick response was imperative. By increasing the bank reserve requirement ratio (RRR) the People's Bank of China started to rein in liquidity. The effectiveness of this measure may be limited as commercial banks reportedly kept excess reserves markedly above the RRR already. Additionally, rising RRR proved quite inefficient in restraining inflation in the past. As an additional measure, the yields on central bank bills have been raised. Also here, the government had to be careful as the already relatively elevated money market rates potentially attracts even more speculative money. More tightening will occur, including rate hikes. Given the low visibility regarding policy measures and inflation pressures, investors should therefore stay on the sidelines.

Foreign Exchange

An additional measure in order to balance the Chinese economy towards domestic consumption and to counter rising inflationary expectations consists of allowing the Yuan to appreciate. Since such a scenario leads to supplementary speculative money flooding into China, the government tried to calm speculation. The PBoC has limited daily changes in the reference rate to no more than 0.01 % for more than 3 months, signaling that the spot rate of the Yuan is unlikely to change much over coming months. 12-months forward rates indicate however an increase of more than 3 % from current levels. Our assessment of China has of course also important implications for the AUD. Australia, through its commodity exports, has been one of the main beneficiaries of the vigorous manufacturing activities in China. While the Australian economy fared much better than other developed countries and even avoided a recession, uncertainty in respect to the impact of tightening in China will also have repercussions on the AUD. We expect the AUD to move sideways in the near term.

	Short-term trend	Last
EURUSD	→	1.4398
USDCHF	→	1.0238
USDJPY	→	90.695
GBPUSD	→	1.6346

Fixed Income

What are the benefits of taking risk? Currently, there seems no real incentive. The rapidness of which investors plunged into the state of carelessness regarding risk taking is truly impressive. It contrasts sharply to the notion of "the worst is over, but...". At the current stage no doubts seem to prevail. Comparing the Moody's indices "Bond Corp AAA" with "Bond Corp BAA" reveals that we are currently at the exact same level, as the yields of riskier issues have recouped all differences to higher quality names. Furthermore, the level is close to the risk-loving 2005 period. Also the potential of high-yield bonds seems limited. Admittedly, we have not yet reached the 2006 record lows, but further gains might be much harder to achieve and the additional yield seems not to fully reward the higher risks investors have to take. The actual conditions are extremely advantageous to corporations, which can finance themselves at very favorable rates for a reasonable long time period. This is increasingly also true for junk-rated companies: US corporations started to issue debt already in 2H09 and European companies are now also coming into play.

	Forecast end 10	Last
US 10y T %	4.80	3.67
Fed funds	2.25	0-0.25
Bund 10y %	4.00	3.24
ECB rates	1.50	1.00

Stocks

Very first indications point to the reality that even better than expected revenues are insufficient to keep up the positive spirit of investors. This was at least the case for Intel (INTC). Intel's results could have hardly been better: EPS of \$ 0.40 exceeded the consensus of \$ 0.31 by a wide margin, revenues of \$10.57 billion also beat expectations and the gross margin of 65 % was truly impressive. The outlook was also upbeat: Management guided 1Q revenues to \$ 9.3-10.1 billion, which is above the consensus of \$ 9.34 billion. It emphasized that it entered 2010 in a very strong position and it was pleased with the momentum. Importantly, the company sees continued strong gross margins for 2010. On the product side, it sees early demand for new core processors as excellent. Given the much better results, earnings estimates have further increased. We continue to hold the positions with a price target of \$ 24. Indications that IT spending will accelerate in the current year justifies a continued slight overweight of this sector. The strategy for the coming weeks will be to carefully analyze the results and adjust our portfolios accordingly.

	Forecast end 10	Last
S&P 500	1230	1136
NASDAQ	2450	2288
DJ STOXX 600	270	258
SMI	7000	6604