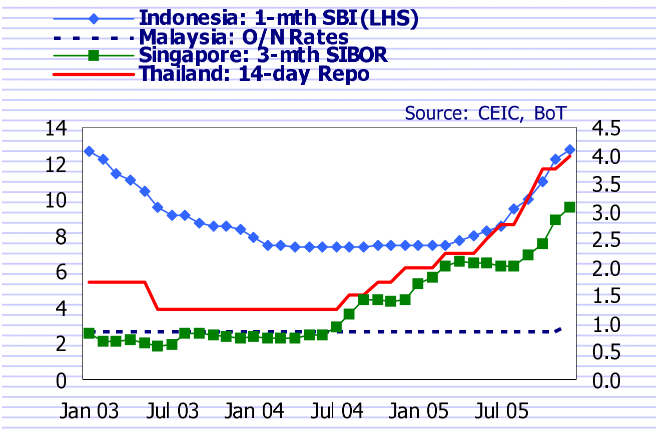
Modeling Interest Rate Peaks

Summary:

- *The rapid fire rate hikes in South East Asia region over the past two months have probably done most of the catching up with that of the US. Going into 1H06, we expect moderate rate increases across the region, and even rate cuts in Indonesia as early as 2Q06.*
- *In Singapore, 3-mth SGD SIBOR is likely to peak at around 3.3% by 2Q-06, as the US Fed fund rates are toppish at 4.50-4.75% by 1Q 06, and domestic credit demand in Singapore remains sluggish at around 2%.*
- *In Malaysia, Bank Negara will be forced to raise overnight policy rates by another 25bps in the next three months to correct the negative real interest rate at home, and a widening interest rate differential against the USD, which has resulted in a significant correction in forex reserve.*
- *Bank of Thailand's 25bps rate hike in Dec following two successive 50bps hikes in Sep and Oct suggests a more measured pace of tightening. At 4%, the policy rate is now close to our estimated inflation expectation of around 4%. We expect a tightening pause in Mar-06 should there be a 25bps hike in Jan-06.*
- *The quick rate hikes by Bank Indonesia post-Oct fuel subsidy withdrawal has shocked the market, although 1-mth SBI rate at 12.75% is still below expected inflation rate of 13%-16%. We expect BI to moderate its future rate hikes given the evidence of sharp domestic consumption slowdown, and underperforming export growth. We expect BI 1-mth SBI to top 13.50% in 1Q-06, and possible rate cut in 2Q-06.*
- *The Philippines has hiked its benchmark o/n reverse repo rate by 75bps to 7.50% so far this year. Inflation is expected to inch up again next year as a result of the EVAT implementation and a 2% point rise in VAT rate to 12% w.e.f. Feb-06. But BSP's indication that rate decisions will take into account 2007 inflation picture suggests slower rate increase going forward. We expect another 25-50bps hike in 2006.*

Rapid Fire Rate Hikes in SE Asia



The rapid fire rate hikes in South East Asia region over the past two months have probably done most of the catching up with that of the US. Further rates hikes will be moderated, even in the case of Indonesia. Based on our expectation of below-trend growth in the US in 2006, and a toppish Fed hike, we have formulated our interest rate view in South East Asia in this report.

Singapore: After the Recent Surge in Cost of Funds

Singapore's benchmark 3-mth SGD interbank rate has eased to around 3% after rising to a 6-year high of 3.25%, from 2.0% some two months back. Besides short-term triggers such as market squaring off positions on year-end factors, hints that the Fed is about to pause in its tightening cycle anytime soon is clearly one of the driving force. The Fed Funds futures are now pricing in only 50% chance of a 25bps in the March meeting.

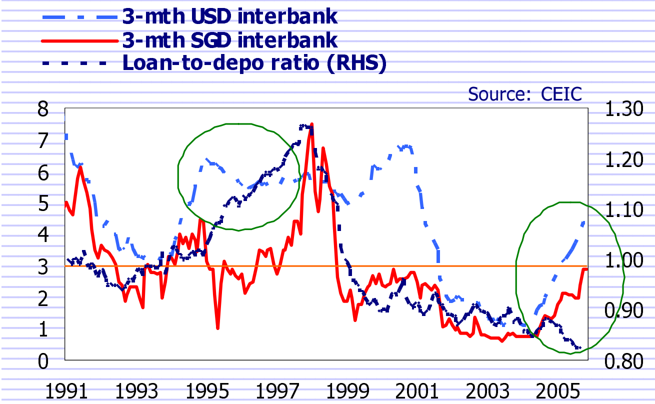
Domestic sentiment is also fast improving, as quarterly GDP growth was repeatedly revised higher. From 'technical recession' fears earlier this year, Singapore's 2Q05 GDP growth momentum eventually more than doubled at 5.4%y/y vs expectation of 2.5%y/y prior to the advance estimate announcement in July. In the first nine months of the year, Singapore's GDP growth was up 5.1%y/y, and the full-yr's figure now looks to come in closer to 5%.

The recent move on SGD yields was in particular led by renewed interest in Singapore's high-end properties, where queues such as those seen prior to the Asian crisis were back again. The fresh life was injected by the govt's announcements to build 2 integrated resorts (IRs) in Apr 2005, worth some S$5bn and expected to generate some 35,000 jobs (direct and indirect). In July 2005, there was the relaxation of rules on property purchases. This was followed by PM Lee Hsien Loong's well-articulated plans to re-make Singapore as a vibrant global city in his National Day Rally's speech in Aug 2005.

With housing loans accounting 30+% of total non-bank loans, potential trickle down effect to the mass markets will inevitably drive up the cost of funds. However, we are doubtful, as potential owners are still struggling with the adverse effects of globalisation. Also, although it is not clear if the Fed will pause at the next few meetings, only a small majority is expecting Fed Funds rate beyond 5% over the next 12 months. Indeed, risk is tilted towards rate cuts into H2-2006.

Overall, our view is that SGD interest rates have probably run

Higher SGD Interest Rates --
Need US Rates & Loan-Depo-Ratio Signficantly Higher



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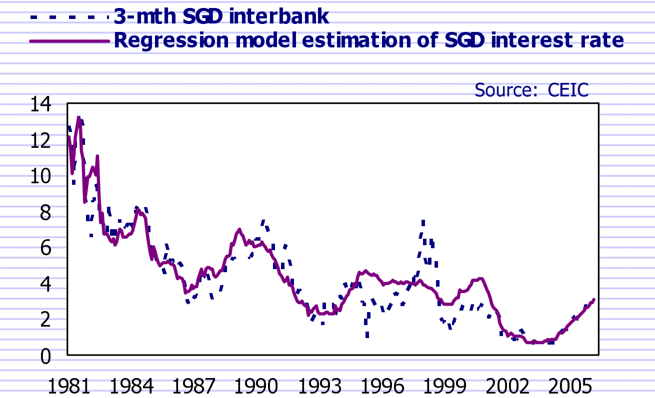
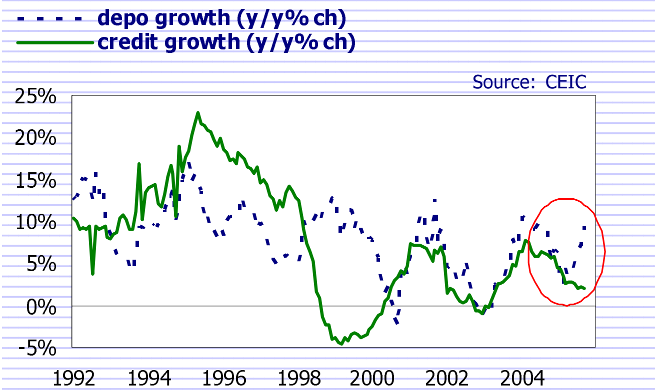


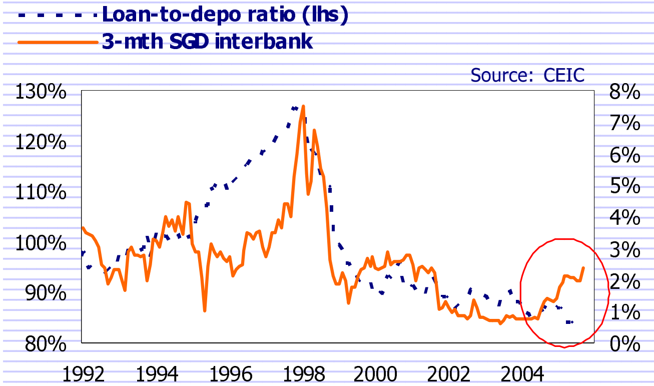
Singapore -- Deposit Growth
Has Rebounded, But Credit Growth is Still Weak



its course for the year, and likely to be capped at 3.1%. Into 2006, the lingering positive sentiment could push yields up another 20-30bps towards 3.20-3.30%. Note that 12-mth interbank is only at 3.2%, indicating interest rates should not be significantly higher 12 months down the road.

Our simple regression analysis (based on current US interest rates and domestic factors) indicates that a fair level for 3-mth SGD interbank is around 2.70%. At current levels, the 3-mth SGD interbank has effectively priced in the Fed Funds at 4.5%.

Singapore --
Loan-to-Depo Ratio Reflects a Liquid System



Singapore Interest Rate Estimation

Based on simple regression model,

Assuming Fed Funds at:	3-mth USD	Credit Growth y/y%	Indicative 3-mth SGD
4.25	4.50	2.00	2.75
4.50	4.75	2.00	2.95
4.75	5.00	2.00	3.10

Source: UOB

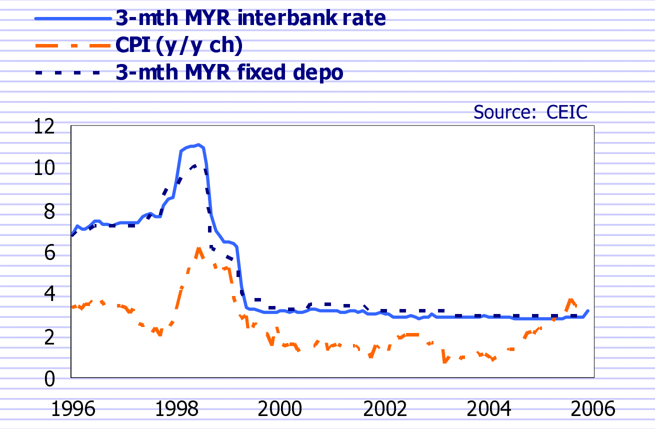
Malaysia: Interest Rate
Adjustment Prospects, Watch the FX Reserves Figures

Bank Negara Malaysia (BNM) raised its Overnight Policy Rate (OPR) by 30bps to 3.0% in early Dec -- the first time it has changed its benchmark rate since the new interest rate framework was introduced in April last year. This was clearly in response to price pressure, as Oct CPI rose 3.3% y/y from a peak of 3.7% y/y in August and 3.4% y/y increase in Sept. Food and transport costs were the two main drivers, increasing 3.7% y/y and 6.0% y/y respectively. The last time inflation was at those levels was in Feb 1999 after the Asian crisis. Year-to-date, inflation is now at 2.3% from 1.8% for the full-year 2004 and inflation is likely to remain above 3% going into the first half of next year.

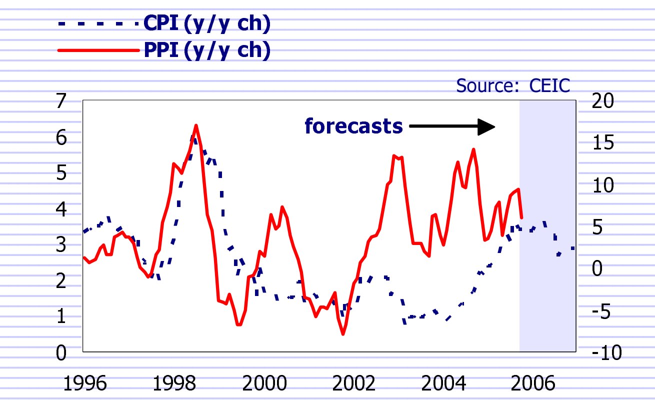
Real Interest Rate in Negative Territory

The move was also to address Malaysia's negative real interest rates, and with a now more open capital account, the CB needed to act to prevent funds from leaving the country in search of better returns. The fact that Malaysia's rates have hitherto stayed constant stands out particularly as its neighbours have been tightening to keep pace with the US Fed, which has raised rates by 13 times since it embarked on its latest tightening cycle in the middle of last year. (Thailand, for example, has raised rates by nine times since August last year.)

Malaysia: Real Interest Rate Already in the Negative Territory



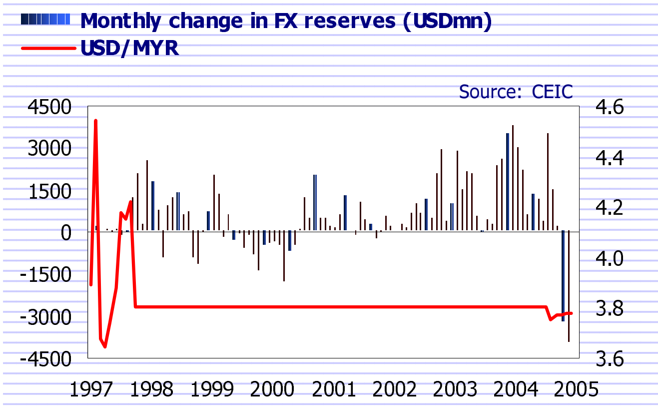
Malaysia: Headline Inflation Should Peak in Mid-2006



Capital Leaving Malaysia

More importantly, Malaysia is operating with greater capital account openness (since Apr 2005), which means maintaining a positive real interest rate is now more crucial. Indeed, Malaysia's FX reserves have been reflecting the need for higher real interest rate, although also the result of 'tired' ringgit longs squaring their positions. Despite c/acct surplus excess of USD1.5bn/monthly since the start of the year, in the first two weeks of November, reserves fell by $1.4bn or 1.8% on Nov 15. This follows a drop of $3.3bn in the month of Oct - the largest monthly drop since a 13% crash during the Asian financial crisis. While FX reserves still stand at $75.7bn (8.4 months of retained imports and 5.7 times short-term debt), risk is certainly on the downside for FX reserves. Foreigners have poured in some $20bn of funds into Malaysia stocks and bonds since

FX Reserves Change Indicate Malaysia May Have to Adjust Rates Soon



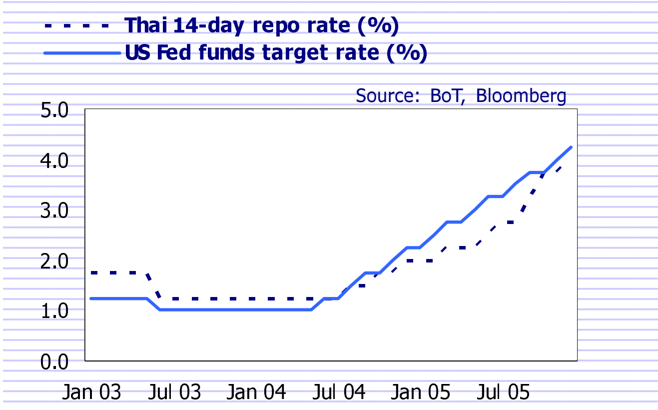
Oct 2003, in-anticipation of further ringgit appreciation. However, FX adjustment has been disappointing so far, with the ringgit hardly adjusting beyond 3.7490 in the aftermath of the ringgit un-peg on 21 Jul. Indeed, with risk of more unwinding, we would not rule out USD/MYR breaching 3.80 in the months ahead, especially with broad USD still on an uptrend.

The trigger for further ringgit interest rate adjustment is likely to be FX reserves. While our call is for BNM to raise rates to at least 3.25% by mid-2006 and to subsequently take the queue from the US Fed, we doubt they would be sufficient to keep 'tired' longs in the system.

Thailand: Where are Interest Rates Headed?

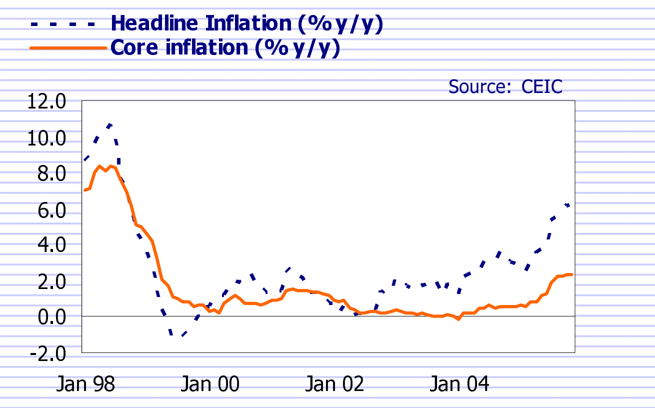
The Bank of Thailand has hiked benchmark 14-day repo rates nine times for a total of 275 bps since it started its latest tightening cycle in Aug 2004, including two unexpected rate hikes of 50 bps each in Sept and Oct. The central bank's tightening started two months after the US Fed embarked on its interest rate hikes in June last year and has kept pace with the Fed, albeit in a catch-up mode. The Thai benchmark rate, now at 4%, is still 25 bps below the US Fed fund target rate of 4.25% after the Fed's 25 bps hike in Dec.

Thai Rates Keeping Pace with Fed Fund Rates

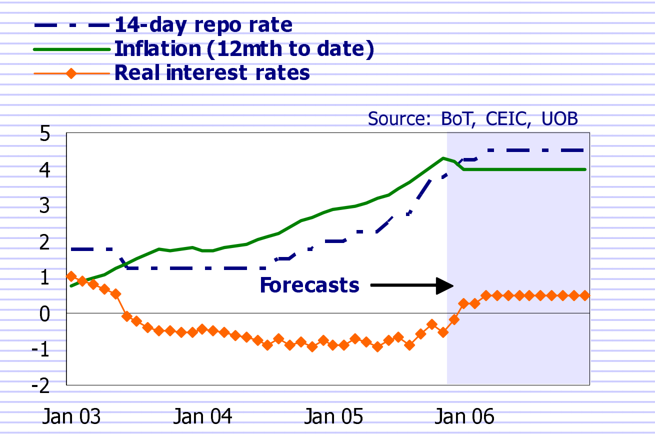


The BoT's two surprised 50 bps rate hikes stems from its concern that inflation has hovered at a 7-year high. After the Thai government removed diesel subsidy to allow retail diesel prices to float freely in mid-June, headline inflation shot up to 5.3% y/y in July from 3.8% y/y in June in the face of rising global oil prices. Inflationary pressures showed no signs of abating, with CPI increasing each month to hit a high of 6.24% in Oct.

Inflation Hovers at 7-year High



Negative Real Rates



More importantly, core inflation (strip out food and energy) has been creeping up to beyond 2% y/y since August. The increase in retail fuel prices, filtering into transport costs, was the main culprit for the rise in core rates to 2.4% in Oct-Nov. This raised the spectre of BoT breaching its mandate of keeping core inflation at below 3.5% in 2006. To pre-empt a further escalation of inflation and keep a lid on prices, BoT saw the need to deal a double dose of 50-bps hikes in succession.

The BoT's increased optimism on growth prospects also made its decision easier. In its latest October Inflation Report, the central bank turned more upbeat on growth for the year, revising up its forecast for 2005 to 4.25%-4.75% from an earlier forecast of 3.5-4.5%. It kept the projection for 2006 GDP at 4.5-6.0%. Its rosier outlook was fuelled by an improvement in consumption and net exports as exports continued to recover and oil imports fall. The BoT cited an improvement in growth outlook of its trading partners, in particular Japan and the rest of Asia. It raised the 2005 growth outlook of Japan, Thailand's No. 3 export destination with 14% of exports, to 2.0% from 1.3%.

For the better part of next year, inflation will likely climb down from its seven-year highs. As the secondary effect of higher fuel prices since the middle of the year works through the system, headline inflation will stay elevated. But there are offsetting factors working at the same time. The real effect of the central bank's rate hikes on domestic consumption will become more evident with commercial banks getting into a faster pace of raising retail interest rates. This will be helped in part by global oil prices coming off from its peak in August and moderating to below USD60 recently, and Thailand's now fully-floating retail fuel prices reflecting this fall (diesel prices were cut in Oct for the first time in three months).

In terms of interest rate direction, what this means is that the BoT will likely continue on its tightening path, but less aggressively. With year-to-Nov inflation at 4.4% and policy rates now at close to our estimated 4-4.2% inflation expectation, real interest rate are close to 'neutral' now. Accordingly, we expect BoT's tightening cycle to be nearing its end. Our call is for at least one more 25 bps hike in Q106 (there are two meetings on 18th Jan and 8th March) before the BoT pauses with rates at 4.25-4.50%, and taking the cue from the US Fed for any subsequent moves.

Indonesia: How Far Can BI Rates Go?

Bank Indonesia is beginning to prepare the market for an eventual unwinding of its tightening stance. As the surprise 125bps rate hike announced just prior to the long Aid-Fitri holidays in November has jolted the market to price in another aggressive move in December, BI only raise the 1-mth SB target rate by 50bps to 12.75%, as opposed to the 75-100bps hike anticipated. The market has been caught footed largely because of their overestimation of inflation expectation in Novermber, after underestimating it in October.

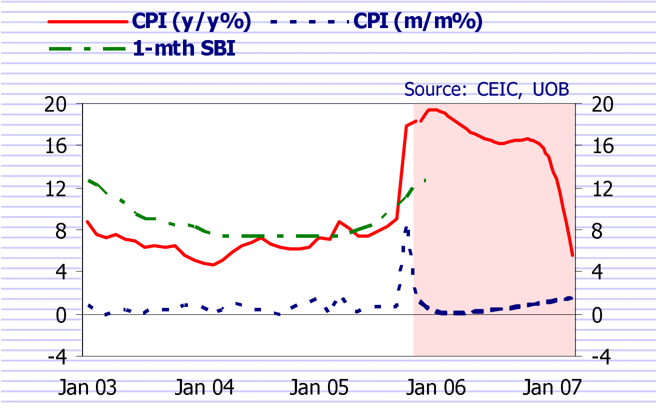
But we are not surprised by such a move since the November CPI has told us that underlying inflation expectation has moderated significantly (Country Analyst, Downside Risk to Dec CPI Suggests 50bps Rate Hike is Optimal Next Tueday, 02 Dec 2005). Looking at the month/month change - a measurement which we think is more appropriate to calibrate short-term inflation expectation during periods of severe price shock, the 1.3% rise in November headline CPI seems to suggest there is no runaway inflation expectation thus far. This single month rise is only 0.4 percentage higher than the average 0.9% m/m rise recorded in the month of October in the preceding two years.Translated into an annualized rate, it simply means inflation expectation has increased by 5% more than what people were expecting in the last two years. Adding this additional inflation expectation to the average 8% CPI inflation in the first nine months of the year, we get an inflation expectation of about 13%.

More importantly, transportation cost - a key driver to sustain secondary inflation - has rapidly normalized in November, with the m/m change immediately falling back to a historical average of +0.6% after a one-off 42% jump in October. In fact, we will not be surprised if the transportation CPI component does record a m/m decline in December, given that the recent correction in global energy prices having been translated to a 13% drop in domestic prices of unregulated fuel products. In addition, we also expect the impact of post-Aid Fitri food prices correction to be more prevalent in the next CPI survey in December.

BI will maintain its tightening stance in the meantime to show the market that it is committed to kill inflation expectation. But the pace of rate hike will depend on the monthly variation of inflation expectation. In the very near term, should the December CPI data turn out to be what we are expecting (18.1% y/y), which is in line with 13%-16% annual inflation expectation according to our back-of-envelope calculation, BI will then only have to move by another 50bps in January.

Barring another spurt in global oil prices, there is a high likelihood that BI may tighten by another 25bps in either February or March such that the 1-mth SBI rate should reach 13.5% by end-Q1. As inflation picture becomes clearer then, BI could begin cutting rate as early as 2Q to avoid risking a prolong period of economic stagnation. This is not a unreasonable prospect, especially with the IDR having recovered 2% to firmly below 10,000 level on renewed confidence in the new economic team. Our call for a rate cut in 2Q is a quarter earlier than what is indicated by BI. But this is not unusual given the need for the central bank's bias to be conservative.

BI Rates at Below Expected Inflation Path Pose Risk to Market Swing

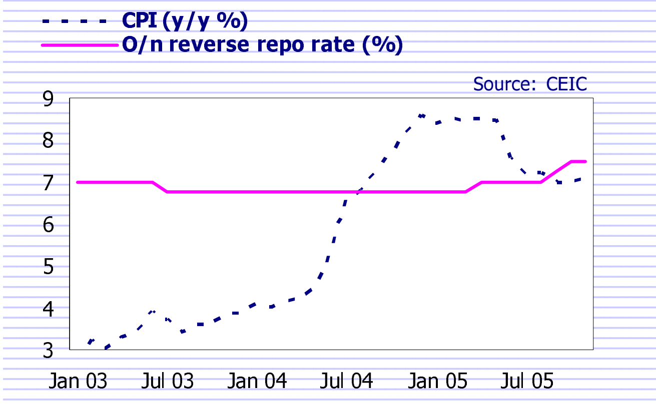


The risk of economic stagnation probably looms larger than inflation risk. The oil-induced terms-of-trade shock has led to car sales to fall by 1/3 from a year-ago level for two consecutive months since October. Although overall motorcycle sales have remained stable at 30% y/y pace in the same months, the fact that there is not obvious substitution effect from car purchases is worrying. As such, BI will likely to target on the lower-end of inflation expectation which according to our calculation is currently at 13%. In other words, 75bps rate hike from BI in 1Q will probably be suffice to contain inflation in 1Q. A stable inflation outlook will then give BI the confidence to cut rate in the following quarter.

Philippines: Latest Inflation Assessment

Headline inflation has plateued at around 7% y/y since July from an elevated 8.5% level in y-t-May, and core inflation has consistently trended lower to 6.1% in Nov from the 8.1% peak in Feb-05. Yet latent inflation risks still persist. The BSP has conceded that headline inflation could exceed its 5.0-6.0% target in 2006 by 2.0-3.5% point as a result of second-round effects from high oil prices and the planned increase in the VAT rate.

Real Interest Rate Back in the Positive Territory



But interest rate may not move much higher from here since the 2007 inflation outlook will guide monetary policy decision given the significant lag time for the policy to work through. The impact of the EVAT implementation on 1-Nov-05 and the planned VAT rate hike to 12% from 10% w.e.f. Feb-06 is expected to be most significant for 2006's inflationary outlook, but in nature, they are one-off events. Longer term uncertainty over the oil prices and BSP's belief that monetary tightening could take more than 1 year to show its effects likely suggest that the CB will not be too aggressive in its rate hikes going forward. Firmer peso and plans to buffer the impact by cutting the import duty on oil products will also help to alleviate some of the price pressure. Therefore, the BSP is likely to scale back the pace of tightening, probably hiking its benchmark o/n reverse repo rate by 25-50bps to around 7.75-8.0% in 2006.