

Fundamentals Remain Firm Amidst Political Changes

Summary

- The peaceful military takeover of the Thaksin government on 19 Sep 2006 had minimal impact on Thailand's equity and FX markets. THB weakened initially in a knee-jerk reaction to the coup but USD/THB seemed to find resistance at 38.0 and the pair has since lost some of the gains. We expect USD/THB to trade in the familiar range of 37.25-37.75 and head towards the top of the range towards year-end.
- The military coup is a political event and not a financial one. As there is no change to the economic fundamentals of Thailand and the political developments resulting from the coup have so far been non-intrusive to economic activity, we decided to maintain our 2006 full year GDP growth forecast at 4.5%.
- While BoT kept rates on hold in its latest September meeting, we believe that the benign inflation environment and negative demand outlook has raised the risk of a rate cut for the subsequent two Monetary Policy Committee meetings in late 2006. Our call is for rates to fall 25bps to 4.75% by end-4Q06.

Retracing the Events Since 19 September

- A non-violent military coup led by the army's commander-in-chief, Gen. Sonthi Boonyaratkalin ousted Thaksin from office in the late evening of 19 Sep (Tuesday) when Thaksin was out of the country.
- The coup leaders (from the armed forces and police) have pledged loyalty to the King and have declared a Council of Democratic Reform under Constitutional Monarchy (CDRM), with King Bhumibol as the head of state.
- The well planned coup was the 18th coup in Thailand since 1932 when the country became a constitutional monarchy. The country is now under martial law and the Constitution revoked.
- Wednesday was declared as a public holiday with the Thai financial markets closed, along with banks, schools and government offices. Normal activities were resumed the following day under martial law.
- Thai King Bhumibol endorsed coup leader General Sonthi to head the CDRM "in order to create peace in the country". The endorsement severely limits Thaksin's options and erodes support for him.
- The impact of the coup on sentiment is fairly contained so far. While rating agencies such as S&P and Fitch Ratings put some Thai companies on negative rating watch due to the coup, Moody's viewed the coup as a political event rather than a financial one so they perceived no immediate impact on its nine corporate ratings.
- The CDRM is currently looking at suitable civilian candidates to replace Thaksin and is expected to nominate the replacement within two weeks (by 4 Oct). Gen Sonthi also pledged to hold elections by Oct 2007 as it would probably take one year to complete the writing of the new constitution.
- Possible candidates for the interim PM included the BoT Governor Devakula, a Privy council member Gen. Surayuth Julianond and UNCTAD chief, Supachai Panitchpakdi.
- Since assuming control, the military council has established several anti-corruption panels to investigate accusations of corruption against Thaksin's government.
- BoT Governor and the CDRM Sec-Gen Winai met with fund managers and other investors on Wednesday (27 Sep) to allay their concerns and to assure business continuity in Thailand as the country tries to restore investor confidence.
- Four schools were set on fire in Thaksin's former stronghold in northern Thailand and it was likely an act of defiance against the military leaders. In a separate incident, a grocery store shooting in South Thailand on the same day led to three deaths, a reminder that Muslim insurgency remains defiant in the region. Nonetheless, incidents of unrest were sporadic and the general situation in Thailand remains calm and within control.
- In the latest development, Surayud Chulanont, a former army commander and a close Privy council advisor to the King was appointed as the interim PM, after the King gave his endorsement officially on Sunday (1 Oct). The military says that General Surayud, will only lead the country for one year, until the elections due in October 2007.
- Thailand's military government also presented the interim constitution to the King during the weekend and under the interim constitution, the military is set to play a key role in influencing the future of Thai politics and will be empowered to remove the prime minister.

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Months of political paralysis in Thailand took a new twist on Tuesday (19 Sep) as a non-violent military coup led by the army's commander-in-chief, Gen. Sonthi Boonyaratkalin ousted Thaksin from office. The King played a pivotal role as his endorsement of the coup leader General Sonthi allowed for the smooth temporary ascension of military rule while an interim government is being assembled to replace Thaksin's regime. King Bhumibol, who is well loved and respected by the Thai people, remains a key stabilizing factor in times of uncertainty for Thailand.

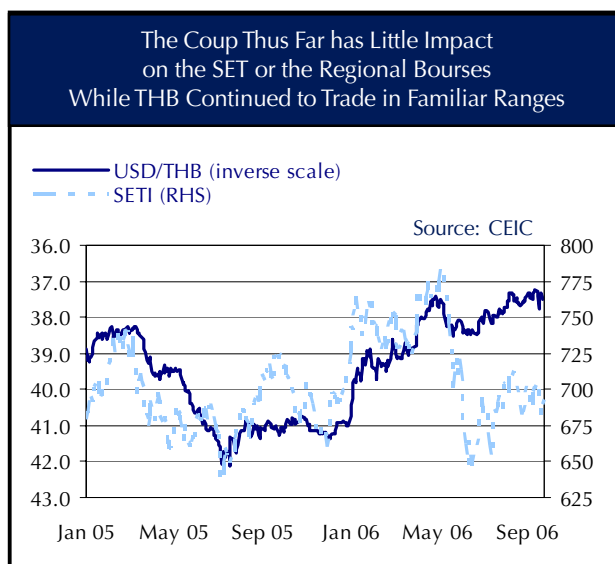
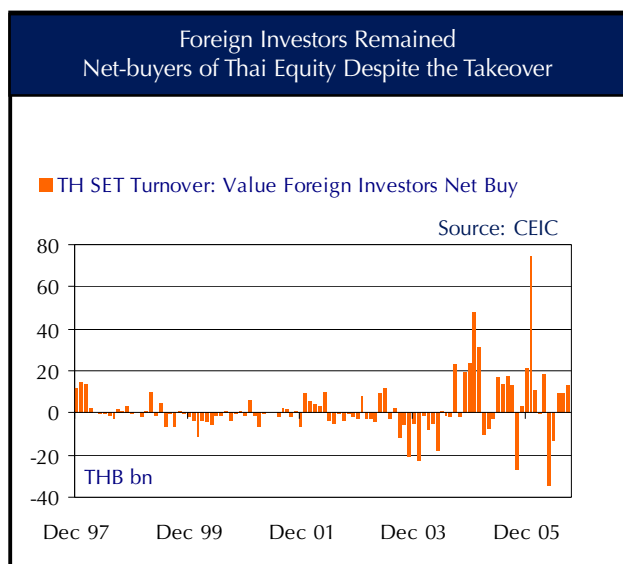
Financial Markets Have So Far Been Orderly

Financial market's response to the coup has been remarkably restrained. Although the Thai stock market was initially shaken by the coup, with the SET closing at a two-month low last Friday (22 Sep), the decline was only 3% from its Tuesday (19 Sep) close before the coup. This was a smaller decline than the markets had initially anticipated with some houses calling for a 10% plunge of the SET index. The SET index has been steadily increasing since and is currently fallen less than 1% since the takeover.

Before the onset of the coup, Thai stocks are already the cheapest around the region, with an estimated PE ratio of around 9.8X versus the average 13.8X for Asia-Pac markets ex-Japan. Going forward, although Thai stocks may continue to face downward pressure due to event risk, we expect the attractive valuations to attract bargain investors into the market, lending some support to the Thai stock prices. Indeed, latest data showed that foreign investors remained net buyers of SET equity in the recent week. Furthermore, according to a research house in Thailand, stock prices historically tend to decline right after the coup event, and in the three weeks thereafter, stock prices rises 11% on average. The last coup in 1991 saw the Thai stock market plunged 8% on the opening day but the SET rebounded nearly 20% in the following three weeks. Therefore, if an effective interim government is put in place soon and the strong upturn in Wall Street continues, we believe that there will be more upside to Thai equity prices in the next few weeks.

In last Wednesday's London/New York trading session when Thai markets were closed, the initial knee-jerk reaction saw USD/THB pair spike up, to 37.85 (still below the recent high of 38.96 on 29 Mar 06) although the pair seemed to have found a resistance at the 38 level. The pair subsequently regained some of the lost ground in Asian morning trading on Thursday and is currently trading slightly above 37.5. On a trade-weighted nominal effective exchange rate basis, UOB's in-house model, that measures the value of the Baht against the currencies of Thailand's top trading partners, did not show that the THB has weakened in September from the previous month. Thai NEER is currently 4.17% stronger since January this year, and THB has appreciated nearly 9.5% against the USD so far this year.

As compared to the volatile May-June period which saw heavy equity sell-off in the regional bourses, the currency response has been generally muted and this is probably due to the peaceful nature of the military takeover as well as expectations of investors that the coup may provide a quick solution to resolve the political deadlock in Thailand and return the country to a functioning government speedily. In the coming weeks, we expect the BoT to continue to minimize its intervention to FX trading and the THB to trade within the familiar range of 37.5-38.0. The risk of sharp THB movement



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remains if there are attempts of a counter-coup or violent street demonstrations against the military rule. So far none of these events have emerged, and we remain confident the situation is well under control by the CDRM.

Political Stalemate Hampered 2Q Growth

The economic situation was already negatively affected by the political impasse before the coup. Although Thailand's 2Q06 GDP came in 4.9%, in line with market expectations, growth was largely anchored by its robust exports while private investments and domestic spending remain lackluster on the back of an uncertain political future for Thailand. The absence of a fully functioning government continued to deter the much needed private investments and dampen domestic demand in 2Q. The fiscal boost was also unavailable to the government as the lack of a proper government meant a delay in the implementation of the FY 2007 budget which is due to start in 1 October, and the holdup could stall as much as US\$45bn in infrastructure spending.

Although the 2nd quarter results were unimpressive, latest data pointed to a tentative recovery of domestic demand with capital and consumer goods imports rising in the recent months. In addition, BoT has hinted that the government budget for FY2007 may get a speedy approval from the interim government and will be available for disbursement as early as January next year, giving the domestic economy a much needed and long-awaited fiscal stimulus. We remain cautiously optimistic at this juncture that the political situation will be positively resolved with the setting up of a credible interim government which will carry the long-delayed necessary budgetary spending, setting the right environment for the democratic elections scheduled for next year, and most importantly, restore investor confidence to the fundamentally sound Thai economy which has been unfortunately hampered by political turmoil for most of 2006. As the political developments resulting from the coup have so far been non-intrusive to the regular economic activity, we decided to maintain our 2006 full year GDP growth forecast at 4.5%. This puts us well within BoT's forecast range of 4-5%.

GDP by Expenditure						
	Weight 2005	2003	2004	2005	Q1	Q2
		% y/y change			2006	
Private Consumption	54.6	6.4	5.9	4.4	4.1	3.7
Government Consumption	8.3	2.3	4.7	12.2	-0.9	3.4
Investment	22.3	12.1	13.8	11.3	6.6	3.9
Private	16.6	17.7	16.3	11.2	7.2	3.6
Public	5.7	-0.7	6.8	11.7	4.7	5.0
Exports	66.6	7.0	9.6	4.4	13.5	9.2
Goods	54.1	9.5	8.4	4.3	14.1	9.6
Services	12.5	-2.9	15.5	4.6	11.4	7.6
Imports	53.9	8.5	13.5	9.3	0.5	-2.2
Goods	45.5	10.7	12.3	8.9	-3.3	-4.5
Services	8.3	-3.0	20.4	11.6	22.5	11.4
GDP	100.0	7.0	6.2	4.5	6.1	4.9

Source: NESDB, UOB

Rates Cut Likely in 4Q06

The BOT left its key 14-day repurchase market target rate steady at 5% in their September meeting, in line with the market and our expectation. BOT also noted in the meeting that it was too early to consider any rate cuts as Thailand's inflation has only started moderating for three months since peaking at 6.2%/y/y in May. However, while calm pervades the Thai financial markets, the overall economy is likely to see receding foreign investments and lower tourist arrivals in the next few months. Domestic demand may also be dampened as the Thai people remain uncertain about the future political developments. We have indicated in an earlier report prior to the military coup (**Bank of Thailand Holds Rates Steady but Rate Cuts Could be on the Cards by End-2006, 7 Sep 06**) that the risk of a rate cut has risen for the subsequent two meetings in 2006 because of 1) the detrimental domestic political developments and 2) external developments that may dampen 2H06 demand for Thai exports.

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As mentioned earlier, CPI inflation has moderated in the recent months, hitting a 19-month low in September at 2.7%/y and expectations are for the inflation to remain subdued for the rest of 2006 and 1H07 due to the high base effect caused by the removal of fuel subsidies in June 2005. Core inflation also softened in recent months falling well within the target range, easing to around 2%/y in Jul-Sep period after hovering around the 2.5-2.9% range during the first half of 2006. The BOT uses the core inflation, which excludes food and energy, as the policy target, setting the target range of 0-3.5%. We believe the easing inflation outlook will give BOT more downside maneuverability for their interest rate policy decisions. As a final point, we note that the Thai's 14-day repurchase rate has been tracking the US Fed rate fairly closely for the past few years. As we expect the Fed could cut rates as early as 4Q06, we believe that BOT will also follow suit.

Therefore, facing a benign inflation environment and a more negative demand outlook, we think that it is very likely for the BoT to cut rates in 4Q06 so as to loosen monetary policy while inflation easing gains momentum. We are factoring a 50% probability of a 25bps rate cut in the 18 Oct meeting, and a 90% probability for a 25bps rate cut in the 13 Dec meeting.

