Trim Macro Thoughts

Banking Finesse

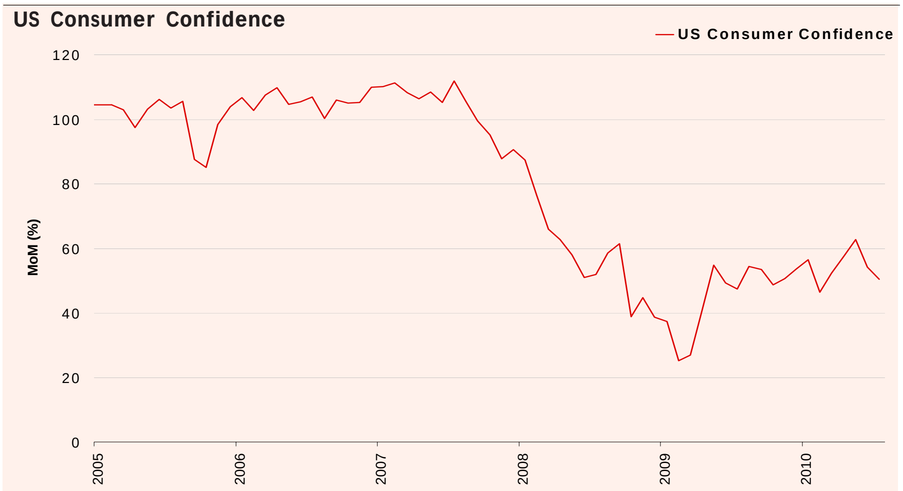
Summary:

- US Consumer Confidence Falters
- EU Stress Test Not Stressful Enough
- CN Chinese Banks Own Stress
- ID Resilient Market
- ID Otoritas Jasa Keuangan, OJK

Recent developments in the past weeks have negated a lot of the macro risks for the Long Term Investors (>12months). Europe stress test turns out to be a sentiment positive event. Chinese stocks outperformance is the positive leading indicator active for the last two weeks. The only resistance to convict to overweight in equities is uncertainty with regards to 3Q10 economic data and threat from domestic inflation. These would be answered in the next few months. Build positions slowly in the next six months on an signs of asset price weakness. Buy On Weakness.

US Consumer Confidence Falters

US Conference Board Consumer Confidence has jittered markets for two months now. Last night July Consumer Confidence reading came in at 50.4 lower than 51.0 expected and 54.3 reading. This is a second consecutive drop since the highest reading achieved since 2008 crisis in Apr'10 which was at 62.7. As such, next few months reading will be important to take note. As discussed in my last week's notes, consumer sector is now the last sector to "reflate" in order to sustain this recovery momentum. Hence consumption factors such as employment, wage growth, consumer credit growth will be of more importance going into the next few months. Obama and Benanke have mention a few times on separate occasion that persistent unemployment in the US is their current most pressing challenge. The view here is for unemployment to disappoint and that US recovery may lose momentum from here on. Leading indicators are already showing signs of peaking. Things should be more confirmed in the next 3 months.



Source Bloomberg

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EU Stress Test Not Stressful Enough

When Friday late night (Asian Saturday Morning) news reported that ECB banking stress test found that 91 European financial heavyweights only need EUR3.5bn of recapitalization, I chuckled. As discussed last week, based on the stress test assumptions leaked last week, the most probable outcome is that this European banking "stress" test will turn out to be a non-event. What I didn't expect though is for the market to take the news quite positively, as they reposition and take their bets on a second "financial" meltdown resulting from the recent PIIGS sovereign risk event off the table. In another words, ECB says "you were wrong not too trust us" and that the message seems to be getting across.

Nevertheles, let's look deeper into this "stress" test assumptions. The "conservative" sovereign risk assumptions that they used are reflected in their adverse 2011 scenario where they claim to reflect "sovereign default". Price of country risk that the ECB used here are highlighted in black bold in the table below. The chuckle comes because the market is already pricing a higher risk than that. As such, current market prices of 5yr USD CDS for the various countries are highlighted in red bold. ECB assumptions are generally 48bps lower than current market prices right now.

Macro Assumptions

	Benchmark 2010	Benchmark 2011	Adverse 2010	Adverse 2011
GDP (%)	0.7	1.5	-0.2	-0.6
Unemployment (%)	10.7	10.9	10.8	11.5
ST Interest Rates (%)	1.2	2.1	2.1	3.3
LT Interest Rates (%)	3.5	3.8	4.4	5.3
EURUSD	1.42	1.42	0.7	0.7
CPI (%)	0.7	1.5	1.1	1.1

source: ECB

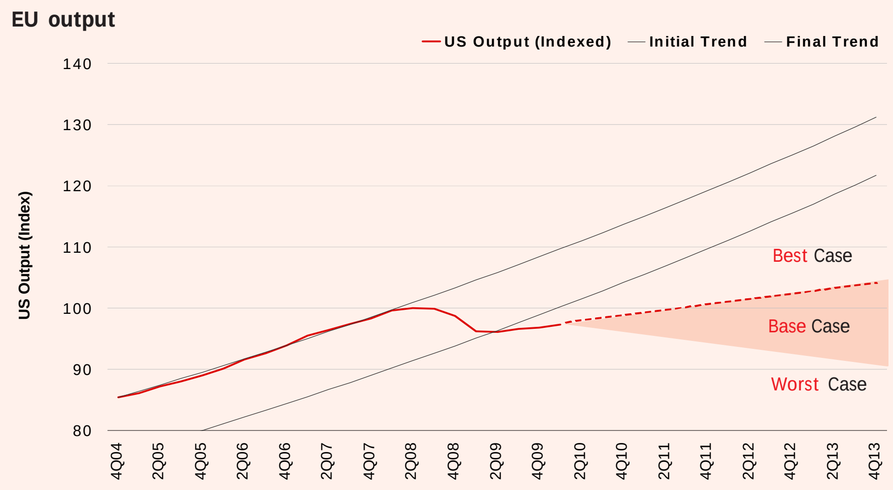
2011 Adverse Scenario Sovereign Risk Assumptions

	Benchmark (%)	Adverse (%)	Common Increase (bps)	Sovereign Risk (A, bps)	Current Market Sovereign Risk (B, bps)	*Difference (A - B)*
Austria	3.03	4.03	75	**25**	**81**	*56*
Belgium	3.23	4.47	75	**49**	**97**	*48*
Cyprus	4.07	5.29	75	**47**	--	--
Finland	3.16	4.16	75	**25**	**25**	*0*
France	2.94	3.92	75	**23**	**67**	*44*
Germany	2.74	3.49	75	**0**	**38**	*38*
Greece	6.28	13.88	75	**685**	**738**	*53*
Ireland	3.28	5.61	75	**158**	**229**	*71*
Italy	3.19	4.80	75	**86**	**147**	*61*
Luxembourg	3.23	4.53	75	**55**	--	--
Malta	4.01	5.07	75	**31**	--	--
The Netherlands	2.87	3.82	75	**20**	**42**	*22*
Portugal	3.96	7.39	75	**268**	**250**	*-18*
Slovakia	3.55	4.40	75	**10**	**85**	*75*
Spain	3.61	5.78	75	**142**	**187**	*45*
Slovenia	3.84	4.80	75	**21**	**77**	*56*

source: ECB

The other leniency is that these adverse assumptions are only applicable to the trading books of the tested banks i.e. government debt within the hold-to-maturity accounts are not subject to the stress test "hair cut" as it is assumed that governments will be able to repay all their debts in the event of a sovereign "default", and that losses incurred outside trading books are limited to defaults from the private sector as loans default due to a general environment of increasing lending rates.

The other thing I would like to bring to our attention is the macro assumptions that ECB used for this exercise. Adverse GDP assumptions are assumed to be -0.2% to -0.6% for both 2010 and 2011 in an adverse environment. This is pretty in line with my base case assumption for the EU output growth trajectory where I have assumed to be between -1.0% to +1.5% GDP growth going forward. Even if such is the ultimate outcome for EU's future, the output trajectory clearly shows a worse than "L" outcome for Europe, which then would continue to result in persistent growth scarcity and unemployment.



Source Bloomberg

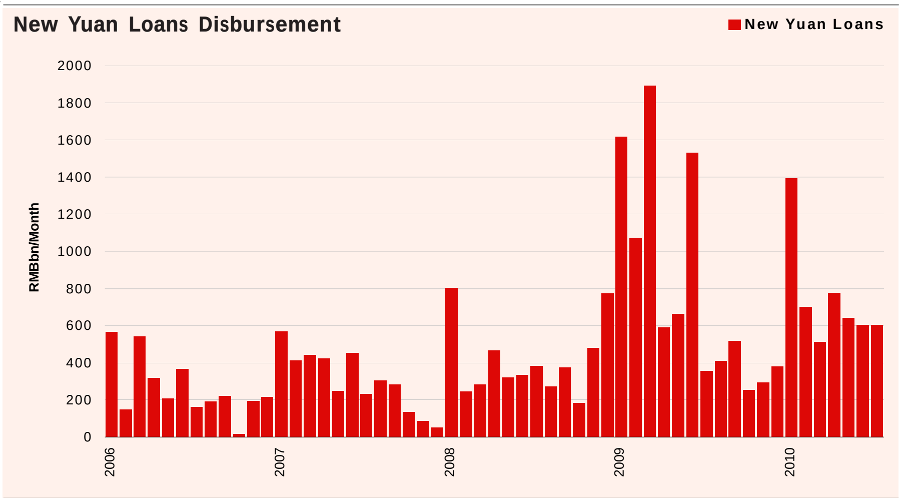
The reason the macro picture looked so grim about 2 months back in April, when Greece sovereign debt crisis blew due to ECB's lack of decisiveness in dealing with Greece tight refinancing schedule and its final decision to stick with a regional austerity programme instead of a monetary bailout that is widely hoped by the market. As such, the EURUSD ran as low as 1.1920 at that time.

The implications for such a weak EURUSD exchange rate maybe good for EU exporters such as Germany; but is definitely devastating for the US manufacturing/exports led recovery story. Projecting a global economy based on 1.19 EURUSD levels definitely felt scary. Now that liquidity and sentiment has been restored, and that EURUSD has settled at a sweet spot at 1.30. This compared to EURUSD at 1.50 where it is hurting German exports or when it was at 1.19 when it was hurting US exports, the macro backdrop seems to have improved somewhat from April.

CN Chinese Banks Own Stress

One big news that the market may have missed or disregarded totally (as the news was leaked on Sunday when everyone is looking at ECB's bank stress test) is the news that Chinese banks may struggle to recoup 23% of the total CNY7.7tr they disbursed in 2009 in support of the government stimulus programme tailored to the 2008 Great financial crisis. The regulator insider said that half of all loans need to be serviced by a secondary source including guarantors as the ventures could not generate sufficient revenue to cover interest can capital payments on these loans. Only 27% are performing loans and can be repaid in full.

Laws and regulations caps banks' direct lending to central governments in China; This is why local governments created SPVs to get their hands on more easy money. Central government has ordered Central Governments to stop such activities in order to rein in lending activities to control economic overheating. Central government has also warned banks that they will not guarantee the loss on such SPVs if these loans become non-performing.



Source Bloomberg

To put the numbers into perspective, CNY lent a total of CNY9.5tr in 2009, i.e. equivalent to 31% of its 2009 nominal GDP in the span of 12 months. Chinese Banks have lent out another CNY5.2tr YTD, a rate the same as last year if annualized. This is definitely unhealthy and not sustainable in the long term. It will be interesting to observe what a sudden contraction of lending will lead to.

Based on the above figures, if 23% of Loans to SPVs amounting to CNY7.7tr cannot be recouped, then we are looking at 6% to 2009 Nominal GDP kind of banking crisis. Coincidentally, I can remember that top 5 Chinese banks has announced at different times to raise a total of USD50bn this year to replenish their capital after aggressive lending last year. Hence in this context, there is still a shortfall of CNY1.5tr or USD230bn in capital should these loans are written off 100%.

There has been reports on Bloomberg that banks has continued "lending" to the local governments through repackage loans / projects which are then sold directly to investors as an investment asset class. As of July 2010, there were no less than CNY7.7tr lent to such SPVs. The Chinese government has already started investigation on the matter based on June reports submitted to its regulator.

If regulators are already stepping on the breaks, Investors should keep checking your rear view mirror from here on. This extreme leveraging of the Chinese economy in the past 18 months must have its consequences.

Shanghai A, Banks And Property performance

	Aug Peak to May Bottom Performance (%)	May Bottom to YTD Performance (%)
SHANGHAI SE COMPOSITE	**(31.9)**	**8.9**
IND & COMM BK OF CHINA - A	(23.1)	5.4
BANK OF CHINA LTD-A	(26.6)	5.3
CHINA MERCHANTS BANK-A	(29.2)	10.4
INDUSTRIAL BANK CO LTD -A	(41.7)	14.9
CHINA CONSTRUCTION BANK-A	(25.2)	2.3
Major Bank Average	**(29.2)**	**7.7**
POLY REAL ESTATE GROUP CO -A	(48.4)	15.6
SHANGHAI SHIMAO CO LTD-A	(26.2)	8.3
JIANGXI ZHONGJIANG REAL EA-A	(22.8)	11.2
Major Shanghai Listed Developer Average	**(32.5)**	**11.7**
SUN HUNG KAI PROPERTIES	(11.6)	8.4
CHEUNG KONG HOLDINGS LTD	(6.0)	2.3
CHINA OVERSEAS LAND & INVEST	(21.8)	15.6
HENDERSON LAND DEVELOPMENT	(13.4)	5.8
NEW WORLD DEVELOPMENT	(29.6)	11.4
SINO LAND CO	(13.2)	6.0
CHINA RESOURCES LAND LTD	(21.5)	16.3
Major Hong Kong Listed Developer Average	**(16.7)**	**9.4**

Source: Bloomberg

Risks aside, the more interesting thing is Shanghai's continued past outperformance in the past week. I have started writing about wanting to start betting on Shanghai's outperformance because the policy risk for China may have past its "peak". As such, SHCOMP Index rose 1.6% WoW, and has clocked up 8.9% in gains since its April bottom on 5th July 2010. This is quite timely given the fact that NDRC prices has recorded its first MoM decline in June since regulation tightening in Aug'09. Data from this front in the next 1-2 months will be crucial to determine the time at which 15%-20% house price decline target widely expected by the government and market maybe achieved. Markets don't need a clear blue sky to start pricing in good news. All it needs is enough certainty as to the opportunity or risks. As such, once a base case trajectory can be set with 1 or 2 more data points, then certainty for policy risks will firm and that markets can start to price in new expectations that the worst is over and that the outlook going forward will be brighter. On top of that, 8 months of underperformance relative to the region, cheap valuations provides a limited risk investment climate for investors willing to bet early in the game. Global regional indices have also been in a consolidation mode for 3 months now. The risk-return profile seems right for calculated risks.

ID Resilient Market

And if this is the regional market call, then the probability to see our index breaking new high in the next 3-6 months from here seems very likely. The issue however is that our Indonesian market has outperformed the regional index during this correction period given our resilient growth and improving risks profile. The real wake up call for our sovereign risk is when Japan Credit Rating Agency (JCA) upgraded us to their version of investment grade. As such foreign money has been flowing into our bond market speculating that the other three western Ratings Agencies will follow suit, pushing 10yr IDR goverment bond yields down from 10.1% to 8.1% YTD. As such, MSCI Indonesia has also rerated back to +1std dev levels recorded last Aug'09. Micro indicators have also been providing good news flows on a month-to-month basis during this period, justifying Index performance from an EPS / operational fundamental perspective.

Index Performance

27-Jul-10	Price	YTD (%)	P/E (x)	P/BV (x)		Price	YTD (%)	P/E (x)	P/BV (x)
MSCI World	1,130	(3.3)	13.2	1.6	**Japan**		(8.4)	**17.0**	**1.1**
					Nikkei 225 (Japan)	9,497	(10.0)	17.7	1.2
US		**0.5**	**13.1**	**2.2**	Topix Index (Tokyo)	846	(6.8)	16.4	1.0
S&P 500	1,115	(0.0)	13.5	1.9					
INDU (Dow Jones)	10,525	0.9	12.8	2.4	**Developed Asia**		(0.4)	**12.8**	**1.6**
Nasdaq	2,296	1.2	17.5	2.5	KOSPI (Korea)	1,768	5.1	9.8	1.3
					Hang Seng (HK)	20,973	(4.1)	13.9	1.7
Europe		(2.6)	**11.4**	**1.5**	TAIEX (Taiwan)	7,748	(5.4)	13.3	1.7
EU Stoxx 50	2,772.7	(6.5)	10.7	1.3	STI (Singapore)	2,979	2.8	14.5	1.7
FTSE 100 (UK)	5,393	(0.4)	11.1	1.7					
DAX (GR)	6,227	4.5	11.8	1.4	**ASEAN**		**8.9**	**12.7**	**2.0**
CAC 40 (FR)	3,672	(6.7)	11.3	1.2	PSE (Phillipines)	3,437	12.6	12.8	2.0
SMI (SWISS)	6,277	(4.1)	11.9	2.0	SET (Thailaind)	854	16.2	12.3	1.7
					VinIndex(Vietnam)	498	0.6	10.4	2.3
BRIC		(4.4)	**13.3**	**1.9**	KLCI (Malaysia)	1,352	6.2	15.1	2.1
Bovespa (Brazil)	66,443	(3.1)	12.9	1.7					
MICEX (Russia)	1,406	2.6	7.7	1.0	**Indonesia**		**15.9**	**15.6**	**3.5**
Nifty (India)	5,431	4.4	17.4	2.8	JCI Index	3,042	20.0	15.2	3.0
Shanghai A (China)	2,575	(21.4)	15.2	2.2	JII Index	479	14.7	16.3	3.7
					MSCI Indonesia	4,080	12.9	15.4	3.7

source: ECB

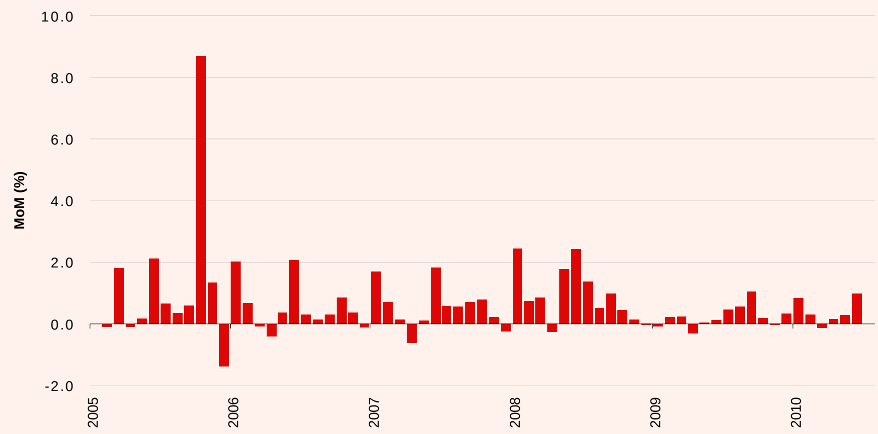
Micro Consumption Indicator

		1H09	1H10	Growth (%)
Cement	mnton	17.6	19.5	11.0
Modern Retail	Rptr	31.4	36.0	14.6
F&B	Rptr	245.0	270.0	10.2
Autos	'000 units	210.2	369.4	75.7
Motorcycles	mnunits	2.5	3.6	41.3

Source: Investor Daily

The key macro risk for Indonesia right now is domestic supply pushed inflation. As discussed last week, businesses are using the recent increased electricity bill to raise prices. Soft commodities are also rising in view of bad weather and harvest. As such inflation accumulated has reached 0.97% MoM. With Ramadan in Aug, the risk that we may miss our 5.5% - 6.0% inflation target is rising by the day. The key here is whether our MoM inflation can stay below 1.0% during the coming Ramadan months (Aug-Sept), and for 2H10 inflattion to average of 0.6% MoM. Should this not happen, our credit driven consumption led growth momentum will start fading because higher inflation eats into purchasing power while higher interest rates that follow makes borrowing costs higher.

ID inflation



Source Bloomberg

ID Otoritas Jasa Keuangan, OJK

In view of the recent banking sector stress test issues in the region, I would like to just add some local news with regards to our own banking sector. Otoritas Jasa Keuangan (OJK), or the formation of such an authority has been haunting the finance industry since the year 2000. OJK is a new institution set up to be a master supervisor for the banking, capital markets, asset managers, finance, pension funds and insurance institutions. OJK was primarily in talks to prevent the re-occurrence of our own 1997/98 financial crisis. The idea popped out upon consultation with Helmut Schlesinger, Ex German Central Banker and was decreed to form through UU no.23/1999. In 2004, UU no.24/2004 states that OJK must be formed latest by 2010.

To date, the debate over the formation of OJK is still hot and current. Some are arguing for OJK to not be formed because (1) BI do not wish to lose the authority of supervision and there were lobbies for BI governor to head OJK as a compromise to the new structure. If such is the case, then the need for another institution becomes redundant. Just have everything under BI for better coordination. (2) Till today, there are no examples of OJKs being formed and implemented successfully in recent history. For example, England, which pioneered the idea, is reverting back to the old system of all under one roof monetary supervision through 1 institution after the failure of English OJK to detect and prevent Nothern Rock Bank from failing in 2008 puts their OJK into question into question.

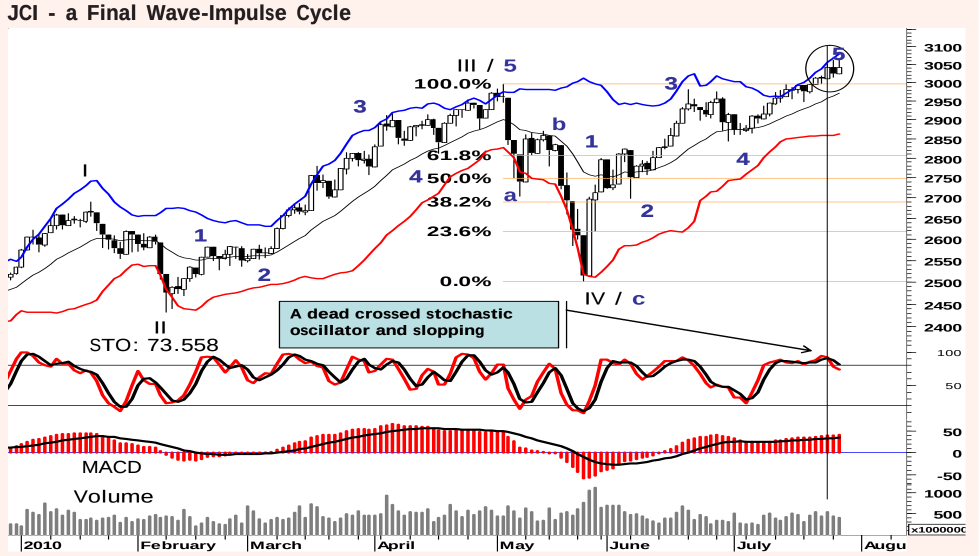
Roles of Central Bank and Other Financial Supervisory

German	Bunderbank (Central Bank) supervises banks and insurance. BaFin (Subsidairy of Bunderbank) watches over market.
France	Prudenitial Supervisory Unit is a non-independent unit within Central Bank and is responsible over the supervision of Banks and Insurance
UK	Re-united both entities and functions back into Central Bank
Ireland	Started to move authority of supervision back to Central Bank
US	Increased functions / authority of Central Bank
Thailand	Reports to Central Bank with regards to Banking, multifinance and other supervision
Singapore	Reports to Central Bank with regards to Banking, Insurance, all aspects of Finance, Securities and the Financial Sector
Malaysia	Supervises Banks, Insurance and Syariah Insurance
Phillippines	Responsible for Supervision of Banks

Source: Bisnis Indonesia, Bank Indonesia

Market Strategy

ST JCI was successful in sustaining its rally after penetrating 2,996.42 and has recorded a new high of 3,062.95. This momentum is still worth betting on as JCI remains above its short-term as well as medium-term moving averages. 5days Stochastic still remains in its neutral range of around 73.56 levels. For the past 2 weeks, JCI has gained 1.65% and we believe the ST direction is still potentially to be north.



Source : Trim Research

However, if we observe a longer term chart (shown above), JCI is currently nearing its peak and has entered an overbought area. This is also reflected in the slow stochastic oscillator that has entered into its negative territory, crossing the fast-moving average at the same time a few days ago. Did 3,062.95 complete wave-impulse 5? If so, JCI then should correct and find support as it start its first corrective wave or wave (a). A potential and suitable support level for this first wave-correction should bring JCI back to 2,996 levels or at 2980 based on 38.2% retracement of the July advance.

LT Recent developments in the past weeks have negated a lot of the macro risks for the Long Term Investors (>12months). Europe stress test turns out to be a sentiment positive event. Chinese stocks outperformance is the positive leading indicator active for the last two weeks. The only resistance to convict to overweight in equities is uncertainty with regards to 3Q10 economic data and threat from domestic inflation. These would be answered in the next few months. Build positions slowly in the next six months on any signs of asset price weakness. Buy On Weakness.

Happy Investing,

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