



# Outlook 2012

Navigating through turbulent times

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## A subdued new world

The end of 2011 left investors wondering whether the world will ever be the same again.

The European sovereign debt crisis has led to many to question the survival of the euro, but more fundamental are questions surrounding current levels of household and government indebtedness. In the US for example, the ratio of non-financial debt to GDP is the highest it has been since the Great Depression of the 1930s.

Investors have started to ask themselves whether market confidence can ever return fully if borrowings remain the primary tool to stimulate growth. And without these large injections of cash, can growth rates of the last decade be repeated?

The answer to this may be obvious and yet too scary to contemplate. Until fresh drivers of growth emerge, investors will need to adjust to what some analysts are calling a "new normal", including tighter credit conditions for corporations, higher unemployment rates and higher taxes. For investors this means an extended period of low global growth, low interest rates, muted inflation and sub par investment returns.

There will of course be periods when markets will rally. In the second half of 2012, for example, abating inflationary pressures and further monetary easing, alongside progress on the European front, are expected to result in a substantial sentiment lift. Over the medium term, a re-rating of emerging market debt and the appreciation of the China renminbi is likely to inject some excitement into the marketplace.

However, any market stability is unlikely to last for long until real structural and fiscal reforms are put in place to address existing and future debt habits. Until then, investors are advised to resist taking on too much risk overall. Instead, a well considered portfolio that combines yield opportunities with high quality assets will leave behind just enough spare cash to take advantage of positive short term developments as they arise.

As with governments, individuals should resist the temptation to be heavily reliant on borrowed money and cross border flows to fund their investment returns.

Finally, ANZ takes this opportunity to wish all its customers good health, wealth and happiness in the year ahead.

Vineet Vohra, CFA  
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# Economic Overview

## A year of diverging growth trends

This year, not only is the world likely to display more differences across regions but also across timeframes. These two trends acting together will give the impression that little is changing as we move from 2011 to 2012. However, the overall growth forecasts masks some important themes that are likely to feature in 2012: firstly, a potential lift in the growth momentum of countries like the US and Japan versus a further weakening of Europe, and secondly, sub-par growth in the first half of the year, especially in the emerging markets, followed by a potential recovery in the latter half.

### GDP Growth Forecasts (%)

	2011F	2012F
World	2.6	2.5
G7	1.4	1.6
US	1.7	1.7
Euro zone	1.5	0.0
Japan	-0.2	2.6
China	9.3	9.0
Asia Pac ex Japan	7.2	7.3

Source: ANZ Economics & Markets Research. Dec 2011.

### US: Fiscal policy poses biggest threat

In 2012, we can expect recession fears in the US to ease further alongside better than expected macro data. US households have made good progress in repairing their balance sheets and the savings rate appears to have stabilised at around 5%, a level deemed likely to be supportive of future consumption.

## Spotlight

### A pause in borrowing

The trend to fund spending through loans and debts may be approaching a temporary end, sparking the need to reassess our economic thinking and existing portfolios.

Between 2000 and 2007, US consumers took on an extraordinary amount of mortgage debt, causing US household borrowings to exceed household income by 1.2 times. However, property is not the only source of a US family's indebtedness. Rising prosperity, falling interest rates, financial innovations and inadequate regulatory oversight have all been blamed for the spectacular climb in the amount that households owe the banks and other financial institutions.

Similarly, when the housing bubble burst, developed market governments, faced with a banking collapse, took the difficult decision to shift private sector debt onto their own books. This despite the fact that fiscal debt burdens were already dire, brought about by the demands of an aging population and the desire to maintain high growth rates.

However, this global debt cycle may have reached an inflection point. In the face of the European debt crisis, policy makers, corporations and consumers alike are viewing debt not as a necessary and innocuous trend, but one with the ability to wreak havoc. A new era of financial conservatism and thrift appears to be beckoning.

Going forward, consumer spending is likely to be more closely linked to income growth than access to loans. Governments too, forced into action by rising sovereign bond yields and credit rating downgrades, are likely to curb their excessive reliance on borrowing to fund growth.

However, this transition to global deleveraging not only suggests new opportunities but also new dangers. With the emerging markets still unlikely to pick up the slack from developed market consumers, governments must learn to tighten their belts, but not too quickly. In addition, governments will be less able to pump prime and smooth out volatile business cycles.

Individual investors too will need to adapt their investment portfolios to this new paradigm. According to Gary Shilling in his book "Age of Deleveraging", dividend paying equities, the USD, healthcare and energy companies, as well as productivity enhancers such as the telecom, biotechnology and technology sectors, are some of the key beneficiaries in the trend to borrow less. This resonates with some of our key themes for 2012.



On the housing front, while there remains a sizable overhang of distressed and foreclosed houses, residential investment actually contributed positively to GDP growth in the third quarter of 2011. With interest rates expected to stay low, and the potential for further aid targeted at the housing market, there is hope that the US economy could further surprise on the upside.

On balance, we expect the US to display a choppy recovery pattern in early 2012, with scope for an upward inflection point in the latter part of the year, possibly through a rebound in residential construction. This could help anchor a more sustained recovery. Key threats to the US economic outlook are a restrictive fiscal policy, sluggish job creation, and negative spill over from Europe. As it stands, the fiscal drag in 2012 is expected to be around 2% of GDP. However, Obama's "Jobs Act", if passed, could offset some of this.

### Europe: Significant downside risks

Prospects for the Eurozone depend on how promptly the European leaders are seen to follow up on their recent actions to resolve the debt crisis. To date, all the agreements reached by the European leaders have fallen short of a satisfactory solution to the crisis. We fear that current solvency concerns could in fact intensify in 2012 amid weakening growth in the region.

Worryingly, moves to impose stringent austerity measures may actually hurt growth further and worsen fiscal positions. We believe that policies should look instead to support growth in the short term, whilst ensuring greater fiscal consolidation in the medium term.

The deleveraging of European banks in an attempt to shore up their capital levels is yet another risk. Rather than providing a solution to the crisis, more cut backs in

lending could hurt businesses further and limit growth prospects. It appears that European leaders will make the necessary hard decisions only when the Eurozone reaches a tipping point. However, even if this were to happen, the massive debt levels and imbalances in the economy make it unlikely that growth prospects can turn around in the course of just one year.

### Japan: Domestic demand may drive recovery

There appears to be some cause for optimism in the Japanese economy. The job to applicant ratio, a key leading indicator of labour demand, continues to track higher, a positive sign which could in turn help boost domestic consumption.

Meanwhile, monetary and fiscal policy is likely to be supportive of growth in 2012. The Bank of Japan is committed to keeping rates low and is not averse to expanding its asset purchases in order to stimulate growth.

Furthermore, by the time this report goes to print, the Japanese government will most likely have passed its third supplementary budget of ¥12.2 trillion, aimed largely at boosting the country's reconstruction efforts. That said, the package is expected to be funded by higher taxes and reduced household assistance, such as a cut in child support allowances, resulting in a net contribution to growth of only 1% in FY12.

Taking into account the brighter picture for domestic consumption, but a more subdued outlook for exports, we are left with a small but nevertheless significant uptick in our Japanese economic forecast to 2.6% in 2012, from -0.2% last year.

# Economic Overview

## Australia: Headwinds loom in 1H12

Our headline forecasts for the Australian economy for 2012 appear benign: we expect GDP growth of 3.5%, unemployment to peak at 5.5% and just one further RBA rate cut of 25 basis points in February.

However, challenges to the Australian economy are becoming more apparent and could be substantial, particularly in the first half of 2012. While the Australian economy is expected to benefit from strong mining investment, there is the possibility that this could be outweighed by severe global financial market dislocations.

In particular, a slowdown in China that threatens to be sharper and deeper than expected could be highly damaging if policy makers do not react quickly enough. Ongoing disruption from domestic structural change may also require rates to be eased soon.

By the second half of 2012 however, we expect RBA policy easing, a rebound in Chinese growth and the broadening of the mining investment boom to support a consolidation of growth and a much needed turnaround in the labour market.

## Asia: A sub-par 2012

We are forecasting a sub-par 2012 for Emerging Asia, particularly in the first half, as Asia faces potential contagion from Europe in the form of lower exports and funding stress. High beta economies such as Singapore, Taiwan and Hong Kong could suffer the most from a fall off in trade. Bank funding could also become problematic although much less so than in 2009 as deposits currently exceed loans.

As risk aversion rises, countries that run current account deficits may also be at risk as capital inflows decline. On this front, India, which runs just such a deficit, has seen its currency weaken dramatically. The rupee was the worst performing currency in the region in 2011.

On a more positive note, most Asian central banks have the scope to cut rates and expand fiscally, if required. On balance, we see growth staying flat in 2012 compared to 2011, but this is not to suggest a smooth ride for the year. Instead, momentum is expected to fall off further in the first half of 2012, before stabilising and recovering as we head into the back end of the year.

## China: Policy easing needed

The Chinese economy is decelerating and we believe that further policy easing is required to secure a soft landing. The outlook for the property market is particularly worrying, with the government's tough anti-speculation measures now resulting in a reversal of the trend ie widespread prices cuts and falling sales volumes.

This, coupled with tight credit conditions, is likely to result in significant stress for China's property developers. A decline in property investment could in turn hurt related sectors such as steel, cement and building materials.

Sluggish property prices also jeopardises local governments' finances, given their historically heavy reliance on land sale revenues. The values of the Chinese banks' land and property collateral are also at risk, and threaten to lead to higher provisions and further credit contraction. All in all, the spectre of lower economic growth hangs over the Chinese economy.

This is not however to suggest that China cannot be pulled from the brink. In fact the reverse is true, and armed with a centralised economy and moderating inflation, China's policy makers have considerable room for manoeuvre. We believe that inflation is set to stabilise towards the government's target of 4% in 2012 and further cuts in the banks' Reserve Requirement Ratio is likely during the year. Robust investment growth in public housing and infrastructure, plus a pick up in domestic consumption is also expected to help underpin growth in 2012.

As a result, we expect GDP growth to slow to 8.6% and 8.9% in the first and second quarter of 2012 respectively, but with an eventual improvement in liquidity and policy easing gradually taking effect, we would expect the economy to make up for lost time in the third and fourth quarters.

## Asia Pacific ex Japan GDP Growth Forecasts (%)

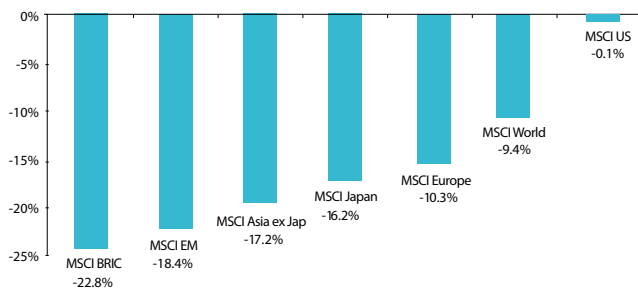
	2011F	2012F		2011F	2012F
Asia Pacific ex Jap	7.2	7.3	Malaysia	5.2	4.5
Australia	1.5	3.5	Philippines	3.9	4.0
China	9.3	9.0	Singapore	5.0	3.0
Hong Kong	4.8	3.9	South Korea	3.7	3.9
India	7.5	7.6	Taiwan	4.3	4.1
Indonesia	6.3	6.3	Thailand	1.9	5.3

Source: ANZ Economics & Markets Research, Dec 2011.

## Staying defensive but watchful

Despite the many grand plans to solve the Eurozone sovereign debt crisis, a weakening global economic momentum going into 2012 suggest that current solvency concerns may intensify rather than lessen. While we do not rule out decisive policy measures that could eventually stabilise market conditions, it is still too early to be looking for bargains. As such, we advocate investors limit their equity exposure while staying alert to a turn in sentiment over the course of the year.

Regional Equity Market Returns (2011)



Source: Bloomberg. ANZ Asia Wealth Management. Total returns are in USD terms. Past performance is not a guarantee of future returns. As of 30 Dec 2011.

### Japan: Sustained by yen strength

As long as risk aversion remains elevated, Japanese equities could outperform European and Emerging market equities, on the back of continuing yen strength. However, a strong currency is a double-edged sword. Japanese exporters, already buffeted by slower global growth, could see less demand for their goods.

Therefore, domestically-focused equities are expected to fare better, which is also in line with the brighter prospects for domestic consumption (see economic section). Note however that this currency-backed advantage is not expected to persist over the long term.

## Spotlight

### US Equities: Light amid the gloom

With uncertainty set to continue across many markets, the US offers some cause for optimism.

This time last year, we made known our positive assessment of the US market. As it turned out, the US proved to be the only major market capable of withstanding the endless onslaught of bad news. This year, our conviction about market conditions in the US is maintained.

In fact, there are perhaps a few more reasons to think that the US has the potential to impress. While corporate balance sheets are still expected to stay healthy, on the macro front, the economy has been surprising on the upside. Should the housing sector become less of a drag over the course of 2012, and improved labour prospects help support domestic consumption, then the prospect of a broad lift in sentiment becomes even greater.

For Asian based investors, an added source of US outperformance could come from the USD. The currency's safe haven appeal is thought unlikely to dissipate in the near to medium term. While a strong currency could be a drag on US earnings, especially for the large multi-nationals, this could be offset by tame labour costs and low interest expenses.

On balance, US corporates still appear lean and efficient and US equity valuations are not expensive. However, in the current climate, it is monetary policy that is expected to provide investors with the necessary confidence, and here too the US government is expected to take a proactive stance if deemed necessary.

This is not to say that investors can afford to be complacent. We continue to recommend seeking out high quality companies with stable earnings streams. Those with the potential to pay high and sustainable dividends are also likely to remain in demand as they offer some buffer in volatile times.

# Equities



## Europe: Stay away

Recent actions taken by policymakers to address Europe's banking and sovereign debt crisis has been welcomed by investors and politicians alike. In our opinion however, many issues remain unresolved. In particular, while the ECB may have given its commitment to help fund EU banks, there has been limited progress on the challenge to impose common fiscal rules backed by sanctions. Furthermore, the ECB has side-stepped calls for it to become the region's "lender of last resort".

Until these two elements are in place, we continue to shy away from European equities, despite seemingly cheap valuations. In fact, it is possible that a bottom to the market will only come about once some form of panic in global markets finally induces a major shift in the ECB's stance. Meanwhile, corporate balance sheets, already weaker in Europe compared to the US, are likely to have to contend with sliding earnings forecasts. This increases the risk of bankruptcy should Europe experience a deep recession.

Overall, if investors have good reason to enter the region, then the UK would appear to be the most promising, even though the UK economy is unlikely to be immune from a global slowdown. However, unlike its neighbours, the country can at least draw on the fact that it has a credible lender of last resort (i.e. the BOE), a simpler political backdrop and a freely floating currency.

## Emerging Markets: Cautious for now

Emerging markets as a whole peaked in the third quarter of 2010 and have been underperforming the global benchmark and US equities since then. This may seem surprising given that growth in the emerging markets have strongly outpaced the developed markets, and is expected to do the same in 2012. However, the emerging markets have been demonstrating their vulnerability to negative global sentiment, and this trend may actually get worse before it gets better.

The time to turn more positive on emerging market equities could be when China moves aggressively to reflate the system via a major fiscal stimulus, liquidity injections and bailouts if needed. However, this is yet to take shape and until then, we would warn that the impact of a potential global slowdown on emerging economies may be more significant than what markets are currently anticipating.

## Asia In Detail

### China/Hong Kong: Awaiting a catalyst

We believe that the Chinese economy will slow, but avoid a hard landing although it would be difficult to avoid the downward pressure on earnings. Some would argue that at 8x the 12-month forward PE, much of this downtrend in earnings is already discounted.

Still, worrying headline macro numbers (e.g. export, industrial production etc) in the first half of 2012 could continue to rattle investors and weigh on the market in the near term.

On the bright side, growth that is proving to be slower than desired, coupled with abating inflationary pressures, could prompt the Chinese authorities to embark on further fiscal and monetary stimulus. This could potentially trigger a rally in the Chinese equity market, finally rewarding long-suffering investors. We remain optimistic that the positives will outweigh the negatives and China remains our favoured market within Asia.

### Taiwan: Potential reflation beneficiary

We are neutral on this market going into the January 14 presidential elections. The elections now appear to be a much closer race than expected, with sectors deemed to be more sensitive to cross strait relations, for example airlines, asset plays, tourism and banks expected to be particularly affected by the election outcome.

Meanwhile, we acknowledge that the technology sector has suffered downward earnings revisions earlier and far deeper than the other sectors in Taiwan. Given the sector's significant weighting in the broader index, and the fact that most investors are reportedly still underweight, there seems to be potential upside for these stocks once earnings revisions stabilise and the positive effects of reflation become more evident in the global economy, most likely in the latter part of the year.

### **South Korea: Added uncertainty**

At 1.2x price to book value, Korea's valuations are certainly not demanding, although valuations did fall lower during the Global Financial Crisis on the back of significant funding pressures given the country's high reliance on wholesale funding then.

Since then, Korean banks have brought down their loan to deposit ratios below 100%, significantly reducing their vulnerability to a withdrawal in foreign funds.

Nevertheless a lacklustre export outlook, coupled with a highly-indebted Korean consumer does not bode well for corporate earnings in 2012. Finally, the recent demise of Kim Jong Il raises added uncertainty for the market. We remain neutral on the Kospi for now.

### **India: Growth worries**

India's growth continues to decelerate as the effect of higher interest rates start to filter through the economy. Meanwhile, the Indian rupee, which has fallen almost 8% in 2011 on the back of a liquidity squeeze, is increasing the costs of imports, worsening India's fiscal balance as well as its inflation outlook.

Given the central bank's reluctance to intervene in the currency market, INR weakness may linger for a while, further deterring foreign investors from Indian equities. The weak INR is also placing increasing stress on Indian corporates who have about US\$16b worth of foreign currency denominated debt maturing in March 2012.

Therefore, even though India's longer term growth fundamentals remain intact, we would advocate a cautious stance on the Indian market while liquidity conditions remain tight.

### **Singapore: Selective opportunities exist**

We are neutral on the Singapore market. The market appears to be pricing in a recession and on a security level, there are stocks which are trading close to SARS and GFC lows which could potentially represent value for longer term investors. On the other hand, we would advocate a more cautious stance towards the more leveraged sectors such as the REITs which is likely to experience higher funding costs and a challenging rental outlook.

### **Asean: Expensive**

The Asean markets, having largely outperformed the regional benchmark year to date, appear expensive trading at a 30% to 160% premium to MSCI Asia ex Japan. These markets continue to be favoured by investors to date, and have not experienced the extent of capital outflows seen in the other Asian markets. Therefore, they could be vulnerable to capital repatriation flows should the crisis in Europe escalates. Within Asean, in the current risk averse climate, we would favour Philippines and Malaysia, which are low beta markets, although as mentioned, valuations are admittedly rich.

# Fixed Income

## Exploring alternative bond markets

As the global economy continues to lose momentum going into 2012, and financial market tension stays elevated, high quality liquid bonds are likely to remain a favoured investment option. However, G3 sovereign bonds, despite their traditional appeal as low risk instruments, are looking overvalued, and other developed markets corporates plus selected emerging market sovereigns may prove interesting alternatives.

### Sovereigns: Looking beyond G3

In our opinion, high quality sovereign bonds should be able to benefit from stable spreads during periods of intense financial market stress. In addition this asset class should offer positive real yields and low volatility. However, given that some developed market bonds are looking pricey, investors may want to consider Swiss, Australian, Canada and Scandinavia (SACS) bonds and UK gilts.

We also view Australian and New Zealand fixed income favourably, given the fact that the rates in these economies are expected to stay lower for longer. Relatively higher yields are also expected to sustain interest. Importantly, the markets' depth, liquidity as well as credible fiscal and monetary policy support suggest that these are likely destinations for "flight to quality" flows.

## Spotlight

### Resilience in tough times

Despite the fact that the re-rating of many emerging market sovereign bonds went largely unnoticed, this asset class deserves more attention.

For most of 2011, the market's attention was firmly fixed on the Eurozone crisis. So it not surprising that the ratings agencies' decision to re-rate a number of emerging market sovereigns was not greeted with a great deal of interest.

It is true that some bond spreads did widen in 2011, but these were better anchored than in 2008. Meanwhile, Brazilian, Mexican and Filipino bonds displayed stand out performances. On the other hand, Indonesia, South Africa and Russia performed less well while Emerging Europe suffered disproportionately from the Eurozone contagion.

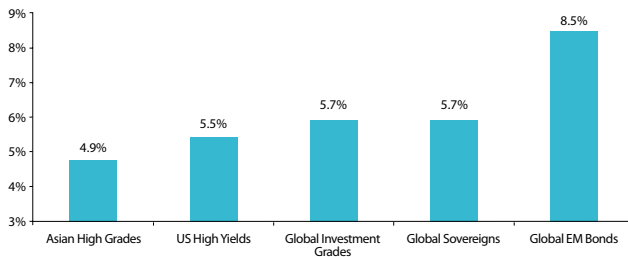
The re-rating of emerging market debt has come on the back of improved legal, regulatory and economic factors. Relatively robust economic growth over the past few years has boosted central bank reserves to levels that would cause many developed markets to salivate. Budget positions also compare favourably to those in the developed market.

These improved fundamentals have resulted in credit rating upgrades, and consequently, lower borrowing costs. While emerging market debt has historically been more volatile than their developed market counterparts, the emergence of local pension funds and deeper markets have reduced the fluctuations and improved liquidity.

Going forward, the ongoing process of stabilising debt levels and limiting new offers in the US, Japan and European countries may persuade more fixed income investors to consider this relatively unknown asset class. The volume induced by such interest could spiral the market further towards mainstream status.

Before valuations become too extended, yield seeking investors may want to consider a small, diversified exposure. In the near term, given funding pressures and ongoing risk aversion, dollar-denominated emerging market sovereigns may fare better. However, investors with a longer term investment horizon may want to consider bonds denominated in emerging market currencies for potential currency upside.

Global Bond Market Returns (2011)



Source: Bloomberg, ANZ Asia Wealth Management. In USD terms. As of 30 Dec 2011. Past performance is not a guarantee of future returns.

After its impressive rally in 2011, Australian fixed income, like some other developed market bonds is looking fairly valued. Nevertheless, while the room for spread compression may be more limited in 2012, Australian fixed income's positive real yield is still expected to offer investors decent returns in the year ahead.

In particular, we like the AAA-rated semi government papers in Australia as the lower-rated offerings could face pressure from a poor revenue outlook, more bond supply and a potential credit de-rating. Over in Asia, semi sovereigns also potentially offer investors credit quality, as well as some yield pick up over similarly-rated sovereign papers.

### Corporates: Better value

However, with various high quality sovereign yields plumbing new lows, investors may want to look to high quality corporates for additional yield. Many corporates have taken advantage of the low rate environment to address their refinancing needs. Armed with robust balance sheets, many corporates are entering 2012 in a much better shape than their respective governments. Within corporates, we would prefer Asian/Australian financial bonds to European, UK and US financials.

Within Asia, investment grade corporates also appear to offer better value relative to Asian sovereigns. With Asian currencies likely to experience further volatility and downward pressure in the short term (see currency section), shorter term investors may want to consider USD-denominated issues instead. Others may prefer to tough out the short term currency volatility and enjoy the fruits of potential currency appreciation over the longer term.

Finally, the recent dim sum bond market sell off (see currency section) has resulted in more reasonable valuations. That said, investors will have to contend with a shallow market, low liquidity and significant volatility should the crisis in Europe escalates. The potential for additional gains from RMB currency appreciation may also be limited in the near term.

### Europe: Patience required

Although European politicians and the ECB have recently taken steps to put the union on a firmer footing and bolster regional liquidity, solvency risk has not dissipated. In fact, we would expect such risks to intensify in the near term amid faltering European growth.

A diminution of current solvency concerns will require the establishment of a credible fiscal consolidation framework, but this, even if possible, will take time to achieve. Meanwhile, such concerns are likely to dominate market sentiment and recent European ratings downgrades will not have soothed fraying nerves.

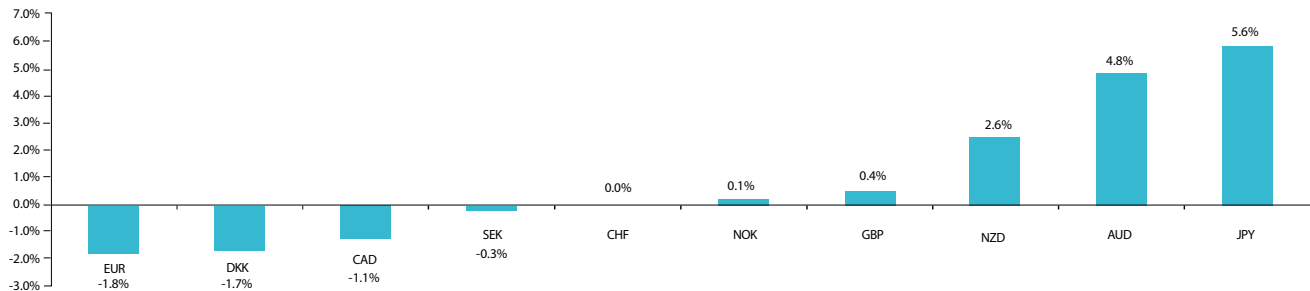
We would remain wary of European corporates and peripheral government bonds going into 2012. While we acknowledge that European bond valuations could rebound should market conditions stabilise, we prefer to exercise caution for now, given the possibility that things could get far worse before they get better.

# Currencies

## A broadening USD rally

With European sovereign debt issues likely to remain a key feature of the macro landscape for the foreseeable future, trade financing and bank deleveraging may become a more prominent feature of currency markets. Against this backdrop, while the USD seems structurally flawed, it could be well supported in the short term. On the other hand, the AUD, KRW, IDR and MYR appear particularly vulnerable to repatriation flows.

### G10 Currency Returns (2011)



Source: Bloomberg, ANZ Asia Wealth Management. Returns (which include spot movement and accumulated interest) are as of 30 Dec 2011 and against the USD. Past performance is not a guarantee of future returns.

## Spotlight

### RMB appreciation no longer a sure thing

The launch of the CNH market made it even easier to jump on the RMB bandwagon. But what was once thought to be a one-way ride is now looking less certain.

The offshore renminbi market, also known as the CNH market, was launched in 2010 amid great fanfare. Unlike the onshore renminbi (i.e. CNY) market, the CNH is free of intervention from the PBoC. This made the CNH market not only open to speculation but also hugely attractive to local and overseas investors.

Not surprisingly, interest in holding the RMB currency mounted after the launch of the CNH market. RMB deposits in Hong Kong jumped 12-fold from March 2009 to September 2011, and at the end of this period stood at more than RMB600 billion. Given this large supply of RMB deposits, the demand for RMB-denominated financial products, such as the dim sum bonds, also reached new heights.

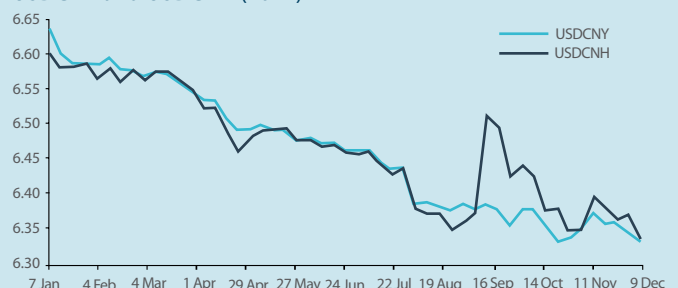
In September 2011 however, the ground beneath the CNH market began to tremble. Fears over the European debt crisis, increased risk aversion and stronger demand for the US dollar caused the CNH market to see a sell-off. The spread between the CNY and CNH exchange rates widened significantly (see chart). And more bad news came in November 2011, when the PBoC actually moved to lower the CNY exchange rate, prompting many to question whether the RMB's appreciation should be taken for granted.

It would appear not. While ANZ forecasters expect a small 3% strengthening against the USD this year, the trend is for less, not more, exchange rate certainties. In the medium term, we believe that China is ready to allow a more flexible

exchange rate by expanding the RMB's trading band against the USD. The increased volatility in the USDCNY rate would force corporates and financial institutions to make use of FX derivatives on order to hedge their FX exposures. This would have the effect of deepening and broadening China's onshore financial market.

Over the longer term, we expect China to move steadily towards its eventual goal of currency internationalisation. Furthermore, as China opens up more channels for capital inflow (e.g. QFII, FDI etc), the CNH is likely to trade more in line with the CNY. While we believe that the RMB's structural appreciation trend remains intact, there are no guarantees that this will be a smooth path or that temporary reversals will not happen again.

### USDCNY and USDCNH (2011)



Source: Bloomberg, ANZ Asia Wealth Management. As of 28 Dec 2011. Past performance is not a guarantee of future returns.



## **EUR: Grinding lower**

The EUR is likely to grind lower, especially against the yen, as it becomes increasingly obvious that the Eurozone requires currency weakening in order to facilitate prolonged economic adjustment. The ECB is also likely to loosen monetary policy more aggressively than the BoJ. On the other hand, the ECB is unlikely to loosen monetary policy more aggressively than the US, therefore this may limit significant gains in the EURUSD.

## **JPY: Staying resilient**

We expect the JPYUSD to stay resilient going into the new year. With global economic activity deteriorating and financial tensions likely to remain high, the yen's safe haven status is set to see strong demand. Moreover, the BoJ's balance sheet is unlikely to expand more rapidly than the Fed's or the ECB's. Our December 12 forecast for USDJPY stands at 72.

## **GBP: Can outperform the euro**

The fundamentals for the GBP are not exactly attractive – further public sectors cuts, weak growth, and the possibility of more quantitative easing do not bode well for the currency. This said, the sterling can still outperform the euro if the Eurozone continues to kick the can down the road with continued policy indecisiveness.

The search for alternatives to the dollar and the euro may also push investors to give the sterling a second look. Likewise, the Swiss National Bank's decision to put a floor to the EURCHF could continue to divert capital flows into the sterling. We see the USDGBP averaging 1.63 in December 2012.

## **AUD: Vulnerable in the short term**

While we are positive the AUD over the longer term, we believe that the global credit crunch, coupled with China's likely slowdown, could cause the AUD to be vulnerable in the near term. In particular, we could see higher AUD volatility against the USD, SGD, EUR and NZD in early 2012.

That said, on the interest rate front, we expect the RBA to cut by only another 25 basis points in February 2012, significantly below the 117 basis points of cuts currently expected by the market over the next 12 months. For the latter to materialise, a lot would have to go wrong, in our opinion. Our December 12 forecast for the AUDUSD stands at 1.10.

## **NZD: Global factors dominate in the near term**

Global factors are also likely to dominate the outlook for the NZD in the near term. Meanwhile, the market is also pricing in a small rate cut (~3 basis points) by the RBNZ over the next 12 months.

Nevertheless, we maintain our non-consensus view that the RBNZ will hike rates, most likely in December 2012, although commodity price movements and funding costs are risks to our outlook. A sharp decline in commodity prices as well as significantly higher funding costs would be potential catalysts for the RBNZ to cut rates. This would translate into further downside for the NZD. Barring this outcome, we see the NZDUSD averaging 0.89 in December 2012.

# Currencies

## ASIA: Weak bias amid elevated risk aversion

Elevated risk aversion is likely to result in a weakening bias for Asian ex Japan currencies against the USD. In addition, following the death of Kim Jong Il, currency markets are likely to be very sensitive to negative new flows out of the Korean peninsula over the period ahead. This should favour a stronger US dollar in the near term.

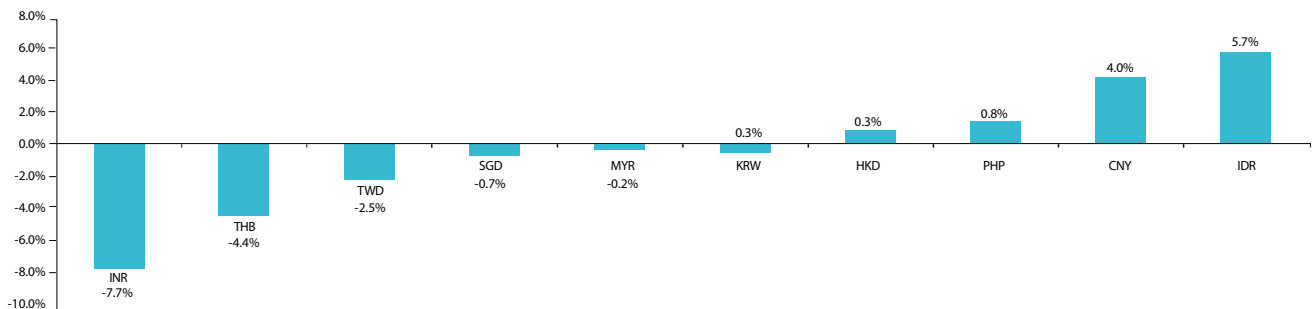
That said, we are unlikely to see GFC extremes being tested, with the exception of the Indian rupee. The INR has recently been subject to fresh lows against the USD, on the back of portfolio outflows. While the Reserve Bank of India in December has enacted measures to curb currency speculation, we believe that these measures are unlikely to turn the tide of downward pressure on the rupee.

In particular, the risks of a shortage of onshore USD liquidity continue to threaten the stability of the currency. Further pressures on India's foreign exchange reserves could also trigger another bout of INR weakness, especially if both global and domestic sentiment deteriorates.

Among the other Asian currencies, the KRW, IDR and MYR look most vulnerable to repatriation flows, given the large foreign holdings of domestic bonds. On the other hand, we expect the CNY, SGD and PHP to outperform. The S\$NEER (nominal effective exchange rate) appears to be trading close to our estimate of its lower boundary, which may trigger intervention from the Monetary Authority of Singapore. Meanwhile, the Philippines' current account surplus is a plus in the current risk adverse environment. (Please see table at the end of the report for forecasts of key Asian currencies).

Longer term, we expect Asian currencies to experience upside pressure once Europe-related angst dissipates. After all, Asian economies appear more resilient than in 2009 and Asian policymakers have ample scope to guard against a downturn. Further monetary easing in Europe and the US also suggests that cheap dollars and euros could start to flood the AXJ asset markets, once risk appetite stabilises.

## Asian Currency Returns (2011)



Source: Bloomberg. ANZ Asia Wealth Management. Returns (which include spot movement and accumulated interest) are as of 30 Dec 2011 and against the USD. Past performance is not a guarantee of future returns.

## A more cautious footing

2012 trends, namely European sovereign debt issues, weaker Chinese growth and safe-haven support for the USD, do not bode well for the commodities sector. After all, this is an asset class that has traditionally relied on strong growth dynamics to outperform. The increased availability of short term investment funds and exchange traded vehicles may also keep volatility at elevated levels. That said, commodity prices have the potential to firm up in the second half of the year as risk aversion eases.

### Oil: Downside may be limited

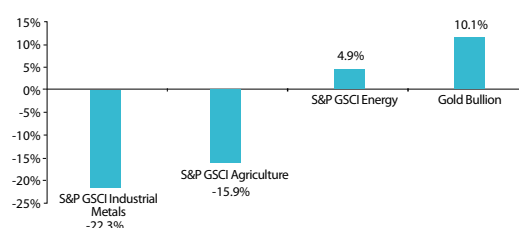
While oil prices are traditionally seen as a bellwether for positive economic trends, the downside for prices in 2012 may be limited.

There are a number of reasons for this. Firstly, OPEC may be prepared to defend the basket price for its oil at US\$100/bbl. Investors may recall that despite lacklustre global growth, Saudi Arabia promptly cut its production in October 2011 when the OPEC basket price dipped below US\$100/bbl. This would potentially put the floor price for Brent and WTI at about US\$105/bbl and US\$95/bbl respectively.

In addition, while the world has been fixated by Europe's debt woes, the escalating tension in Iran should not be ignored.

These geopolitical concerns and limited spare global capacity could also help underpin prices going forward. ANZ analysts expect Brent to reach US\$114/bbl by December 2012.

### Commodity Returns (2011)



Source: Bloomberg. ANZ Asia Wealth Management. Returns in USD and are as of 30 Dec 2011. Past performance is not a guarantee of future returns.

## Spotlight

### Gold bullion or gold equities?

Gold mining stocks have traditionally served as proxies for physical gold investments but investors should not take them at face value.

Gold bullion prices may have eased off since the third quarter of last year, but returns from the physical asset still beat gold mining equities (based on the FTSE Gold Mines Index) by about 25% in 2011. The large divergence in performance has led some to speculate that the price of gold mining stocks may play "catch up" over the course of this year, especially once global risk appetite stabilises. This sounds reasonable if one considers that, with a five-year correlation of 0.79 (against a perfect correlation of 1.0), gold equity prices appears to demonstrate a reasonably high correlation to the actual price movement of the commodity.

However, the outlook for gold equities can be influenced by far more than the price of gold. Tax issues, production output, cost inflation, risk of strikes all serve to impact the fundamentals of gold mining companies.

So how do the risks and opportunities of gold equities stack up against their physical counterparts? On the one hand, investors should not overlook the fact that gold company investments can offer yield via dividend payouts, a benefit not available to investments in the physical metal. Proponents of gold equities would also point to the potential for merger and acquisition activity, and a

company's ability to lift stock valuations by exercising control over its operating costs.

On the other hand, the volatility of the gold equities is historically much higher than the price movement of the metal (although gold price volatility has been creeping up over the last year). Finally, gold's correlation to risk assets, despite a rising trend, is still below that of gold equities, and therefore has the potential to provide diversification and hedging benefits (see table below).

Overall, investors are advised to look into the merits of gold versus gold mining equities as separate, albeit related, opportunities. Should you decide to include gold mining stocks in your portfolio, then careful stock selection is also required.

	5-yr	1-yr
<b>Volatility</b>		
Gold	21%	27%
Gold miners	39%	28%
<b>Correlation to MSCI World</b>		
Gold	0.15	0.35
Gold miners	0.49	0.59

Source: ANZ Asia Wealth Management. Bloomberg. As of 30 December 2011. Past performance is not a guarantee of future returns.



## **Base metals: Upside potential still exists for copper**

We expect copper prices to average around US\$3.83/lb for 2012, supported by China's continuing urbanisation and development of its power sector. While we have revised down our copper price forecasts for 2012, it still represents potential attractive upside from current levels.

On the other hand, the outlook for aluminium prices is more subdued due to oversupply conditions and slower auto demand growth in China and Europe. Meanwhile, one third of the world's aluminium smelters are unprofitable at current prices. More smelter closures, particularly in Europe and North America are likely to depress demand further.

## **Bulks: Likely to ease**

Bulk prices in 2012 are expected to ease off last year's elevated levels. This is because the outlook for various bulk commodities is dependent, not surprisingly, on demand from China. In particular, China's housing market is expected to have significant bearing on iron ore prices. While the private housing sector in China is undergoing a period of weakness, a relatively more robust public housing program is expected to help underpin iron ore prices. Meanwhile, Indian iron ore export supply continues to shrink as domestic demand rises.

On the other hand, the very strong demand and tight supply conditions that occurred for coking coal in 2011 are unlikely to be repeated in 2012. That said, there could be upside risk to prices as Queensland, which accounts for over half of the world's seaborne supply is particularly vulnerable to severe seasonal flooding.

Finally, thermal coal prices are likely to trade in a tight range for most of 2012 as China is likely to run down its inflated domestic stockpiles in the second and third quarters of 2012. The Chinese government's cap on domestic contract coal price increases is likely to limit the upside to international thermal coal prices.

## **Precious metals: A repeat of gold's stunning rise is unlikely**

Gold's fall from grace since September 2011 has led sceptics to sound its death knell. Not helping is the fact that gold showed an increased correlation to risk assets in the latter half of 2011, as Europe-related stress re-ignited gains for the dollar. This backdrop could continue into early 2012, leading us to trim our gold price forecasts to average US\$1722/oz for 2012.

However, beyond the short term, we remain positive on gold, although we do not expect to see the same parabolic rise as witnessed in the early part of last year. Central bank purchases are likely to continue to underpin prices. Low and falling real interest rates, as well as further monetary easing and potential quantitative easing are also expected to be constructive of gold going forward.

Conversely, the outlook for platinum is lacklustre for 2012. The impending downturn in Europe, where diesel engines dominate, is expected to weigh on auto sales and depress the demand for platinum in auto catalysts.

Meanwhile, the outlook for palladium hinges on auto sales growth in China and the US.

### **Agriculture: May not test 2011's record highs**

We believe that it will require a severe and unforeseen supply shock (caused possibly by extremely unfavourable weather conditions and/or severe trade disruptions) for agricultural commodity prices to re-test the record highs of 2011. Nevertheless, prices could stay relatively elevated in 2012. After all, global grain inventory has fallen to about 10 weeks' worth of global consumption, close to a multi-decade low.

Meanwhile, almost 50% of the global grain inventory is concentrated in China and India, and not available to the export market. Speculative positioning in agricultural commodity markets has also wound back significantly, after peaking in early 2011. Any improvement in risk appetite could therefore result in a rebuilding of speculative positions.

Finally, China's increasing import volumes across a number of agricultural commodities, in particular sugar and corn, was a milestone for the market in 2011. We expect this trend to continue as China's rapid industrialisation and rising wealth results in a structural shift from self sufficiency to net importer status across multiple agricultural sectors.

# Forecasts

## Policy Rate Forecasts (%)

	Current 28 Dec 11	Mar – 12	Jun – 12	Sep – 12	Dec – 12
US	0.25	0.25	0.25	0.25	0.25
Euro zone	1.00	0.75	0.75	0.75	0.75
Japan	0.10	0-0.10	0-0.10	0-0.10	0-0.10
UK	0.50	0.50	0.50	0.50	0.50
Australia	4.25	4.00	4.00	4.00	4.00
New Zealand	2.50	2.50	2.50	2.50	2.75
<b>Emerging Asia</b>					
China	6.56	6.56	6.56	6.81	6.81
HK	0.50	0.50	0.50	0.50	0.50
India	8.50	8.50	8.25	8.25	8.00
Indonesia	6.00	6.00	6.00	6.00	6.25
Malaysia	3.00	3.00	3.00	3.00	3.25
Philippines	4.50	4.50	4.25	4.25	4.25
Singapore	0.38	0.38	0.38	0.38	0.38
South Korea	3.25	3.50	3.75	3.75	4.00
Taiwan	1.875	1.875	2.00	2.125	2.250
Thailand	3.25	3.00	3.00	3.00	3.25
Vietnam	15.00	15.00	14.00	13.00	12.00

Source: ANZ, relevant central banks, Bloomberg. As of Dec 2011.

## Foreign Exchange Rate Forecasts

	Current 28 Dec 11	Mar – 12	Jun – 12	Sep – 12	Dec – 12
<b>Majors</b>					
A\$/US\$	1.01	1.00	1.05	1.10	1.10
NZ\$/US\$	0.77	0.80	0.83	0.86	0.89
US\$/¥	77.9	75.0	72.0	72.0	72.0
€/US\$	1.29	1.37	1.40	1.42	1.45
£/US\$	1.55	1.57	1.59	1.61	1.63

Source: Bloomberg, ANZ. As of Dec 2011.

	Current 28 Dec 11	Mar – 12	Jun – 12	Sep – 12	Dec – 12
<b>Asian currencies</b>					
US\$/CNY	6.32	6.35	6.29	6.23	6.17
US\$/IDR	9073	8747	8572	8400	8232
US\$/INR	53.06	48.4	47.4	46.5	45.6
US\$/KRW	1156	1171	1148	1125	1102
US\$/MYR	3.17	3.16	3.13	3.10	3.06
US\$/PHP	44.0	43.2	42.6	42.0	41.3
US\$/SGD	1.30	1.30	1.28	1.27	1.26
US\$/THB	31.60	31.00	30.90	30.70	30.6
US\$/TWD	30.3	30.40	30.30	30.10	30.00
US\$/VND	21006	21400	22000	22400	22400

## Commodity Price Forecasts

	Unit	Mar – 12	Jun – 12	Sep – 12	Dec – 12
<b>Base Metals</b>					
Aluminium	US\$/lb	0.93	0.98	1.02	1.05
Copper	US\$/lb	3.52	3.75	3.98	4.08
Nickel	US\$/lb	8.70	9.15	9.70	10.15
Zinc	US\$/lb	0.85	0.88	0.91	0.95
Lead	US\$/lb	0.91	0.93	0.96	0.99
<b>Precious Metals</b>					
Gold	US\$/oz	1607	1690	1765	1825
Platinum	US\$/oz	1426	1505	1600	1680
Palladium	US\$/oz	653	670	720	775
Silver	US\$/oz	29.9	33.0	34.8	36.2
<b>Energy</b>					
WTI Nymex	US\$/bbl	100.9	104.3	106.8	110.5
Brent	US\$/bbl	109.8	113.0	115.0	117.5
<b>Agriculture</b>					
Corn	US\$/bu	648	627	585	621
Wheat	US\$/bu	661	647	677	667
Soybeans	US\$/bu	1139	1116	1104	1150
Sugar	US\$/lb	27	23	24	25
Cotton	US\$/lb	105	98	91	103
Palm Oil	MYR/t	3069	3007	3038	3131

Source: ANZ. As of Jan 2012. Forecasts are average prices for the year.

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