SOCIETE GENERALE
Corporate & Investment Banking

Looking both ways

Regional markets are changing faster than ever, and investors outside the region are looking to repatriate funds amid growing inflation concerns and profit taking. Société Générale explains why it is dedicated to thought leadership through research and strategy, as investors find it difficult to track changing market trends

Asia has seen unprecedented investment intra-regionally, as well as flows from outside the continent. Société Générale's Hong Kong-based Asia co-head of flow fixed income and currencies, Robert Reilly says it is a good opportunity to offer repatriation services, as investors across the spectrum look to cash in on their returns.


Robert Reilly

"Eurozone sovereign risk and volatility in the US markets have resulted in currency flows into Asia, as well as demand for euro rates products and substantial increases in euro and Asian currency crosses," Reilly says.

"With increased volatility and flows into the region, our customers' hedging strategies have also become more active towards offsetting their rates and foreign exchange exposures."

"Already you can see the Standard & Poor's index has outperformed Asian equities in the last quarter, and this is largely a result of people repatriating funds after profiting on Asian investments, as well as now looking for where the next investment opportunity will be."

In addition to investors cashing in their portfolios, there are concerns the Asian markets are set for a correction as a result of inflation. "Specifically, food price concerns across emerging markets in Asia have made some investors a bit nervous about regional equities," Reilly says. This is especially true for such places as China and India, with the latter proving a good example of how food price inflation has made investors jittery in the sub-continent. The Sensex has reflected this – correcting 9% in the last three months (ending February 18, 2011), as consumer price index figures place inflation at the top of the agenda for several regional central banks.

"In Asia, we will see the central banks intervene to extinguish the fire of inflation by increasing the interest rates. And in the US, Federal Reserve chairman Ben Bernanke is indicating the rates will continue to stay low. As a result, we can expect to see the fund flows exiting Asia and back into the US markets," Reilly says.

China's inflationary woes

It will be particularly interesting to keep a close eye on China over the course of the year, according to strategy reports released on Société Générale's cross-asset-class research platform. The current year will be one of transition – economically and politically.

Politically, the government is seeing a transition of power as younger leaders come through. The so-called 'new princelings' will be inducted at the National People's Congress in March 2012. They represent a generational change and are likely to be more assertive and somewhat bolder in reform.

For now, however, the rapid rise in inflation has caught policy-makers and central bankers in China by surprise. Société Générale believes China's underlying strategy to tackle the problem and ensure the hard-landing scenario does not become a reality, will be frequent (even weekly) adjustments to the required reserve ratio.

The ratio will be bank-specific, depending on the lending policies and current loan portfolios of individual banks. Meanwhile, interest rate hikes will be more evident in 2011, as Société Générale will also seek to raise rates to cool the economy.

Reilly says the repatriation of funds from the region will continue in the second half of the year and might even accelerate. "Which is why it is now a question of providing hedging tools in the rates and currency classes for investors outside the region that are still invested in Asian markets, as well as providing Asian investors with an avenue for investing in US and other markets." Reilly says this trend is largely driven by the real-money international hedge fund accounts.

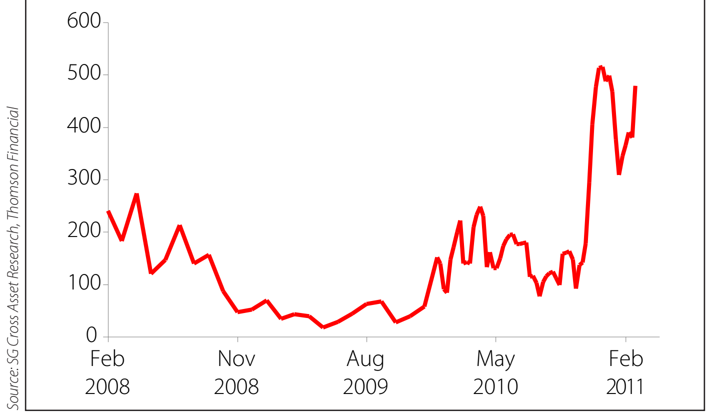
Where the action will be

Banks positioned to offer services in currencies such as the Japanese yen and Korean won, and to a lesser extent in Indian rupee and the Taiwan dollar, will be best placed to benefit from the increased liquidity in the rates and forex space.

Société Générale has emerged as a market leader in Korean won interest rate options, coming first in the category in the *Asia Risk Interdealer Rankings 2010*. It also came second in currency options and non-deliverable forwards, also in the Korean won. For Japanese yen cross-currency swaps of up to two-year tenors and currency forwards beyond two years, the bank was placed first.

Reilly says there have been expansionary steps taken and resources ramped up in the sales and trading space, specifically in places such as

1 China inflation newsflow indicates that fears of overheating are rising



SG proprietary Chinese inflation newsflow: number of economic news articles dealing with China inflation theme. Latest data as of 10 January 2010.

Korea. "We have built up our platform to offer a lot more products and for varying maturities because, in places like Korea, flows are picking up. But, the investment term tends to be longer in the more developed Asian markets and, until there isn't an active long end of the curve, investors will not enter the market readily," he explains.

While investors will be put off until an inflationary environment persists in India and China, Japan is likely to see fund inflows lead to a Nikkei rally amid expectations there may be a Japanese yen sell off. This will make Japanese exports competitive in the global marketplace.

According to the bank's equity strategy, there has been an under-investment in Japanese equities regarding emerging markets. As a result, this should push the Topix to 1283 by the end of the year. This coincides with the Bank of Japan's fundraising activities, which might find investors shying away from Japanese government bonds in favour of Japanese riskier securities. These securities are performing in line with Japan's macro-economic situation, which the Bank of Japan believes is coming out of a stalling phase.

Société Générale also sees corporate flows in EUR/CNY increasing, as the expectation from the corporate base is that CNY will be relatively stable this year. Expectation of further appreciation in the CNY is seen further out the curve in the three- to five-year time frame. As a result, corporates are taking advantage of the forward discount and buying EUR/CNY forwards in the three- to five-year maturities.

Through the repatriation of funds to eurozone economies, US equities are likely to see continued strength amid widespread bullishness towards the greenback among Asian investors.

Leading the way in research and strategy

Regional markets are often proving volatile, and bets on Asia can turn sour quickly. Regulating inflation in China and India, managing yen appreciation in Japan and cooling property speculation in Hong Kong are just some examples of problems that go from being small issues to major policy shapers during a financial quarter.

Société Générale has also dedicated resources in the areas of research and price information. "We have grown our research team globally but, specific to Asia, we have another four heads of our research team concentrating on the emerging markets space in the forex and rates classes," Reilly adds.

He says the reason why price information and research are important is "for example, in Korea, your service has to be on a client-by-client basis. For the local clients, we need to provide research and strategy on where we can expect markets to go. While, for the international investors, they need to know why prices have moved and when it is a reasonable time to get in and out."

The bank is emerging as a forerunner in the thought leadership space, where clients are frequently provided with a variety of scenarios specific to single markets and, further still, specific to asset classes. This allows investors to keep in place a variety of investment strategies to respond to the potential scenarios.

Regulatory environment

Some major changes to the regulatory environment will also shape the coming year. Reilly says to expect changes in the levels of bank capital required across the globe as a result of trade surpluses in Asia and large pools of wealth amassed in the region.

Even with regard to mortgage-backed securities, Reilly says regulators are discussing keeping these on their balance sheets. This is likely to contribute to the development of Basel III, in both developed and emerging markets, because – despite large pools of cash – there is a basic need for Asian banks to avoid the same mistakes made by US and European banks.

Another major development is the opening up of the Chinese yuan offshore market (CNH). "We have plans to participate in the CNH market also. But currently we see there is a fundamental imbalance with a lot more deposits than investments, which is why the opportunity is there and will be for a long time still," Reilly says. For innovation in the longer term, CNH deposits will be needed before there can be a developed cross-currency swap market. While the long-term end of the curve develops, corporates will continue to use the offshore market.

Société Générale has added to its team on the ground in Shanghai and Mumbai. It is well placed to offer price discovery and client-specific strategy with an amalgamation of existing resources, priming the bank to take advantage of increased financial market liberalisation in Asia. Additionally, as investors look both within and outside of Asia for emerging market plays, Société Générale is adding to its suite of products and supporting it with onshore and offshore research and pricing capabilities.

But, making sense of all the market movements in volatile times is where Société Générale is emerging as a leader. The type of thought-leadership role it is taking is enabling its customers to stay ahead of the curve and be more prepared for market movements.

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