



Our view

Credit conditions remain fragile despite low real bond yields and gradual balance sheet expansion at the Fed and the ECB. The lagging effects of high input costs continue to undermine central bank policy easing, while earnings estimates are beginning to reflect the slower economic activity. Investors will need to remain mindful of the extent of inventory build-up in emerging markets.

Anchor themes

- ⚓ Global inflation continues to spike at both the headline and producer price levels. In contrast with the developed economies, there is an ongoing monetary tightening in Asia. Dollar strength continues to induce the liquidation of commodities.
- ⚓ Emerging market valuations have moved into line with, or below, global peers. The deleveraging of the financial system is causing the velocity of money to decrease, creating secondary credit problems.

Market calls

We maintain our view that 3Q08 will be a period of capitulation in equity markets, as weak economic growth combines with poor investor sentiment to induce a liquidation of financial assets. Earnings forecasts are still being cut. On 7 August, we added a series of regional emerging market closed-end funds to our short-run basket on substantial discounts to NAV (relative to the respective listed stock markets). We also recommend (as we have for the past six months) a basket of telecom and high dividend yield stocks.

Blocked arteries

- Financial assets still in A&E ward
- How investors can implement our view

Analyst

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① Financial assets still in A&E ward

Doctor: I have some bad news and some very bad news.

Patient: Well, might as well give me the bad news first.

Doctor: The lab called with your test results. They said you have 24 hours to live.

Patient: 24 hours? That's terrible! What could be worse? What's the very bad news?

Doctor: I've been trying to reach you since yesterday.

Patient: What should I do if my temperature goes up a point or more?

Doctor: Sell.

Source: Superiorjokes.com

“Arteries are blood vessels that carry blood away from the heart (as opposed to veins, blood vessels carrying blood toward the heart). The circulatory system is extremely important for sustaining life. Its proper functioning is responsible for the delivery of oxygen and nutrients to all cells, as well as the removal of carbon dioxide and waste products.”

— Wikipedia.com

Investor sentiment remains poor, but this can only be expected given the psychology of falling markets. After four years of consecutive annualised returns, the prospect of further asset price declines is prompting some to question the long-term expected returns on equities. Deleveraging was never going to be pleasant — since the imbalances had been deemed “normal” for an economic cycle, the withdrawal symptoms were always going to trigger a much greater dislocation of expectations.

See the important disclosures and analyst certifications on pages 11 to 13.

While the financial economy tries to deleverage without causing collateral damage in the credit markets, the global real economy is showing more evidence of a rapid slowdown. Aside from rising geopolitical tension, global investors trying to depict the best-case and worst-case scenarios for equities will need to factor in the increasing likelihood of financial distress in the US credit markets couple with a sharp rise in delinquencies. For equity investors, with a synchronised slowdown gelling for Europe, the US and Japan (notwithstanding stronger-than-expected preliminary 2Q08 GDP data for the US), emerging markets have become the last bastions of growth.

As we highlighted in a recent Strategy Notes, *If Guangdong coughs, do emerging markets sneeze?* (13 August), a significant part of China's growth is cyclical due to the nature of its outsourcing role in the world economy. In China and other emerging markets, consumption trends remain robust. Yet, with businesses in the western economies maintaining much lower inventory-to-shipment ratios (relative to previous cycles), inventories are more likely to accumulate if the growth slowdown proves to be sharper than expected.

It should be remembered that while inventory accumulation boosts GDP in the short term, it borrows this growth from the future. Hence, with inventories still well behaved in the western economies (where auto companies have been quick to cut production), any misjudgement of prospective growth would lead to a painful readjustment of the utilisation rates of the North Asian "tigers". It should be stressed that forward-looking purchasing manager indices (PMIs) will be critical for emerging market investors as the next two months represent the "peak" of the Christmas ordering season. Weaker PMIs alongside falling container rates ought to prompt investors to diversify their emerging market exposure even more.

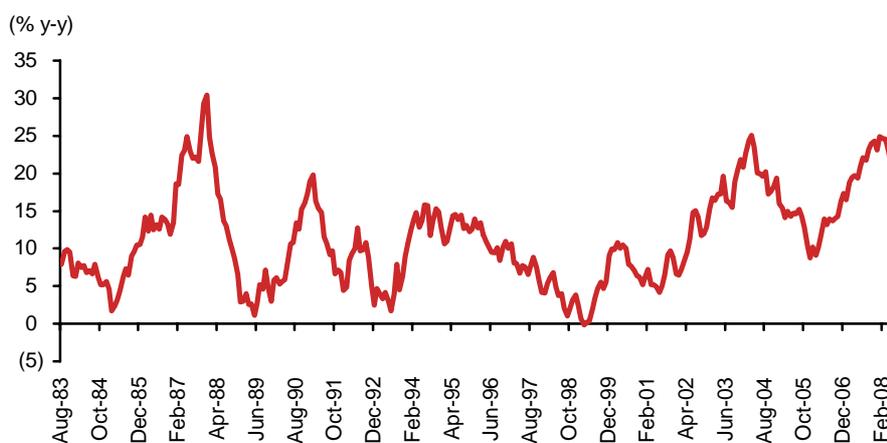
With geopolitics making the headlines more than US financials, investors should be wary of the level of inventory accumulation in emerging markets (especially North Asia and China), given that inventory-to-shipment ratios in the developed economies remain relatively low

Wayward growth projections could lead to revised utilisation rates in North Asia

② How investors can implement our view

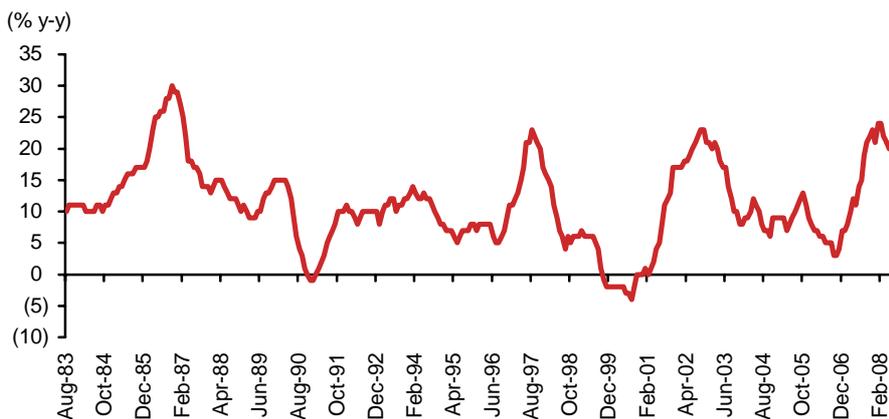
For some time we have regarded 3Q08 as a period of capitulation in equity markets, as weak economic growth combined with low investor sentiment causes a liquidation of financial assets. We recently added a series of regional closed-end funds to our short-run basket given their substantial discounts to NAV relative to the respective stock markets. We flag that earnings estimates continue to head south, and we still recommend (as we have for the past six months) a basket that contains both telecom and dividend yield stocks.

Exhibit 1. Global liquidity: US monetary base plus international reserves minus gold



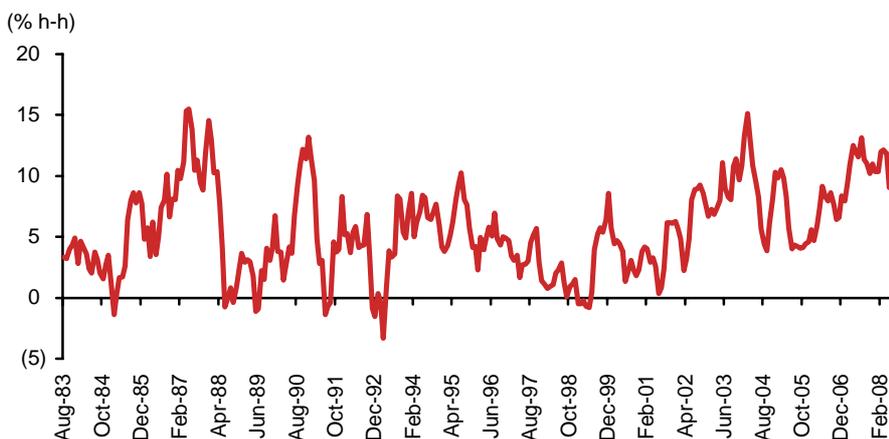
Source: CEIC data

Exhibit 2. Global liquidity: US monetary base plus foreign purchases of treasury bonds and notes (12-month moving average of y-y growth)



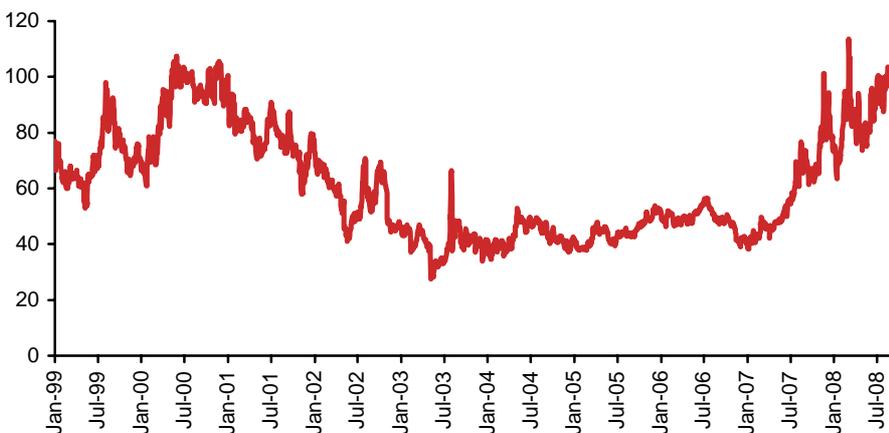
Source: CEIC data

Exhibit 3. Global liquidity: US monetary base plus international reserves minus gold — half-on-half growth (%)



Source: CEIC data

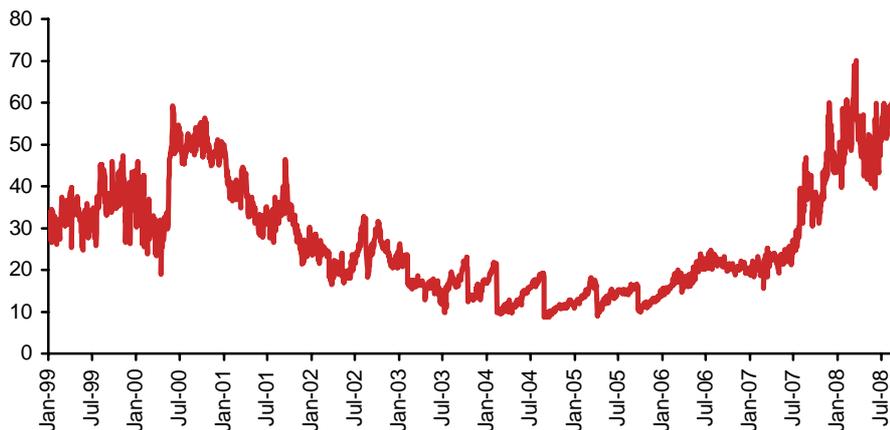
Exhibit 4. US dollar SWAP spread ANN five years



Source: Bloomberg

Despite the abundant liquidity, credit spreads have widened noticeably....

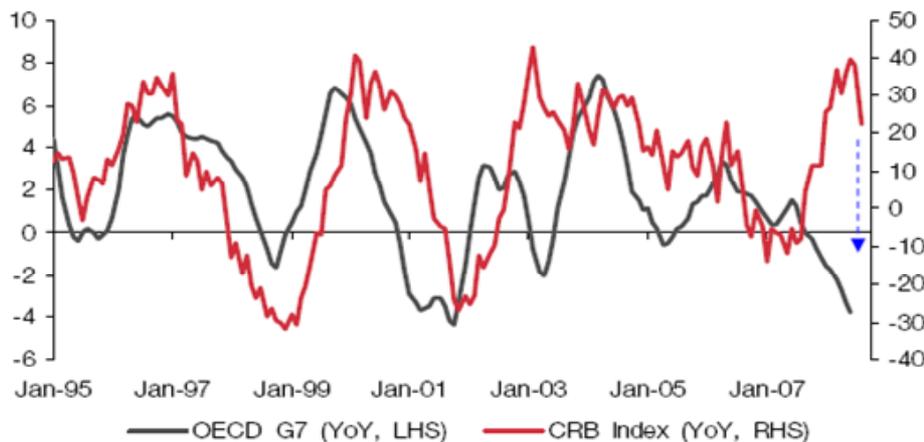
Exhibit 5. EUR SWAP spread five years



Source: Bloomberg

...suggesting that the financial system is still hoarding cash

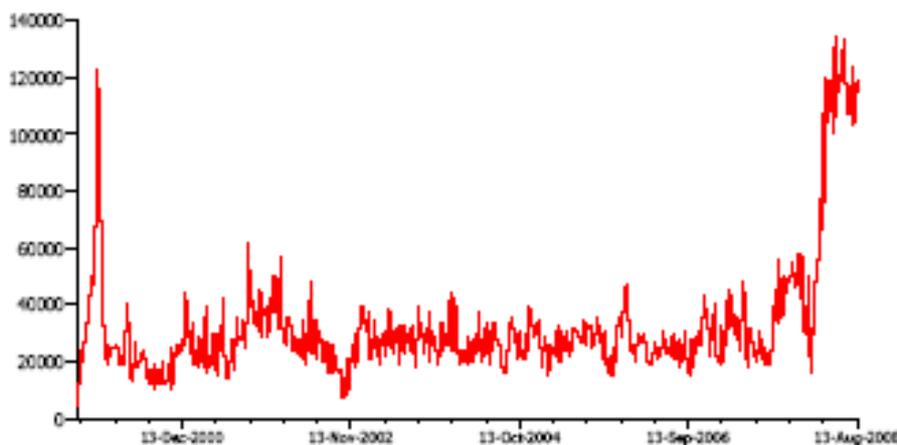
Exhibit 6. OECD lead indicator and CRB index



Source: CEIC data

Nomura's global quantitative team has flagged that the CRB is far removed from the OECD lead indicator; but since China, India and the Middle East are not in the OECD, this may not be a reliable gauge of overall demand

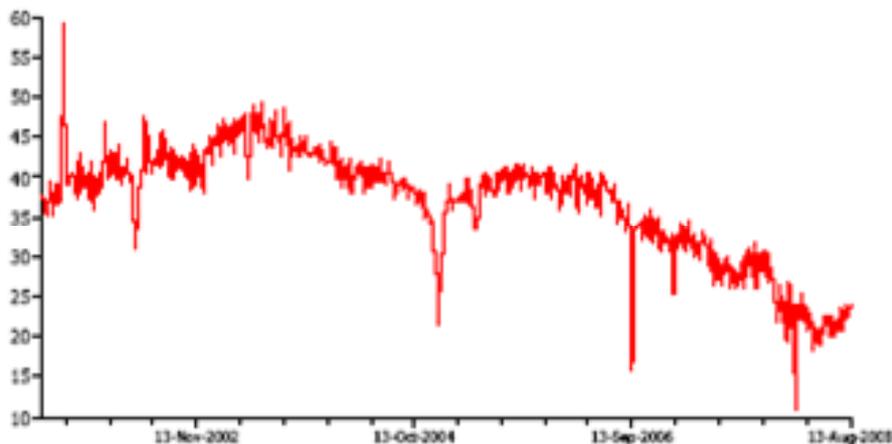
Exhibit 7. US Federal Reserve repo lending (US\$m)



Source: CEIC data

The Fed continues to intervene in the money markets...

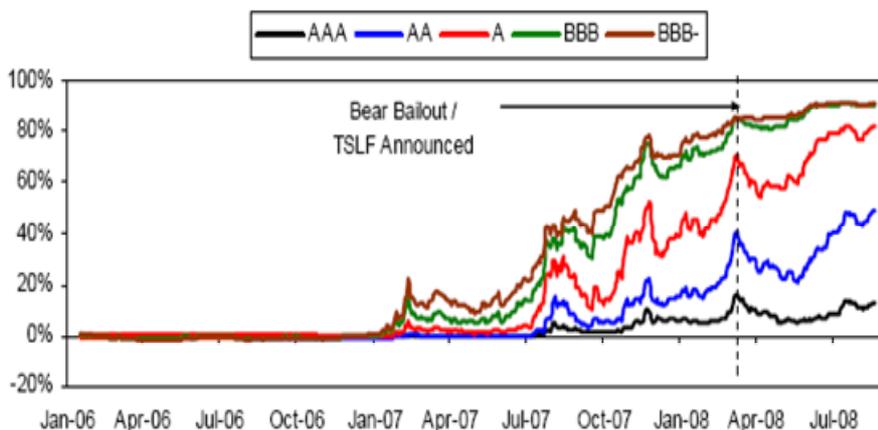
Exhibit 8. US Federal Reserve balance sheet growth (y-y %)



Source: CEIC data

...and has begun to slowly expand the balance sheet

Exhibit 9. ABX tranche % below par for 1H06 vintages



Source: Halkin, Markit

Asset conditions have seen no underlying improvement ...

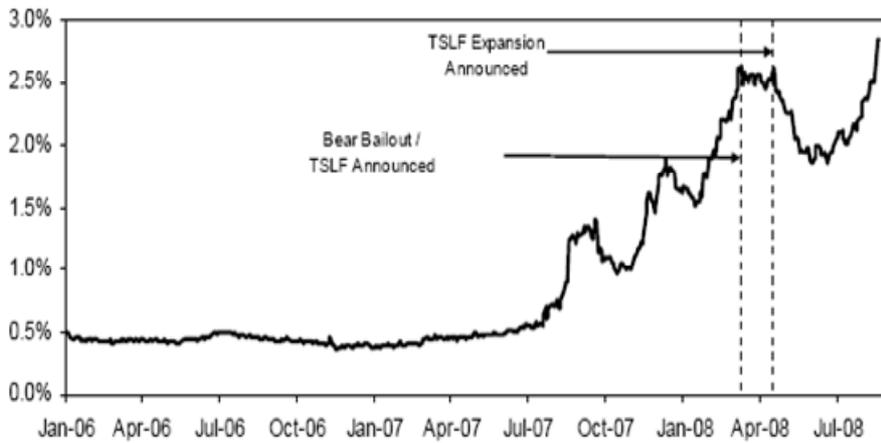
Exhibit 10. AAA corporate bid option adjusted spread



Source: CEIC data

...hence financial asset prices appear to be stuck

Exhibit 11. US credit card ABS index option adjusted spread



Source: CEIC data

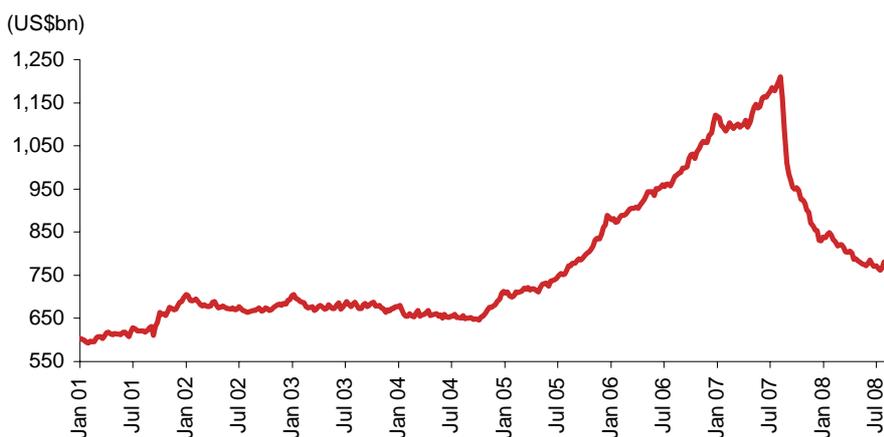
Exhibit 12. US BAA corporate bond market (%)



Source: Datastream

Indeed, long term corporate bond spreads are rising

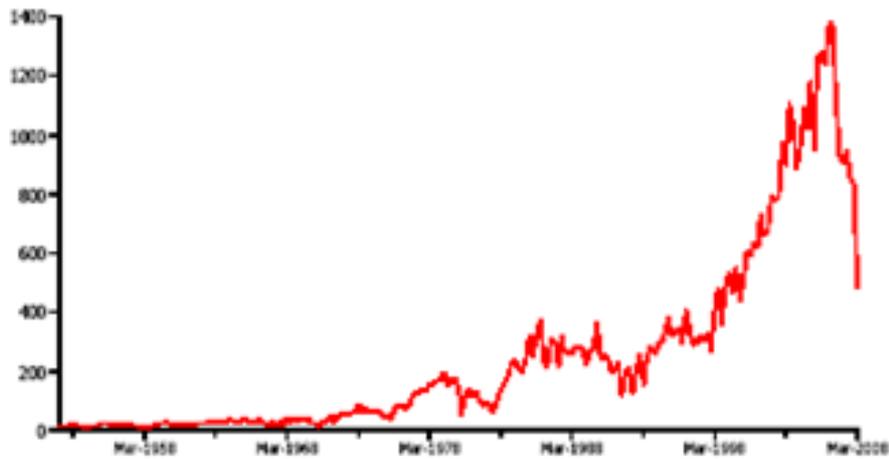
Exhibit 13. Commercial paper (asset-backed) outstanding



Source: Bloomberg

The commercial paper market (asset-backed) is dead

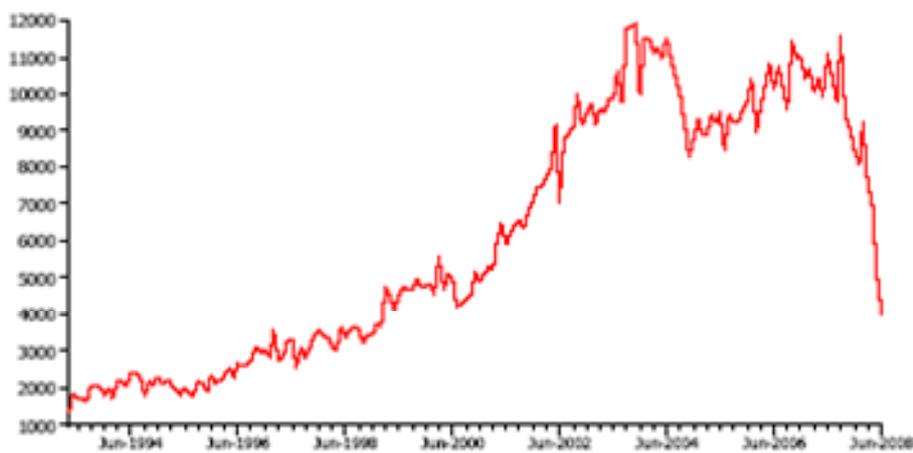
Exhibit 14. US: household borrowing (US\$bn)



Source: CEIC data

The tight credit conditions have restricted borrowing in the US...

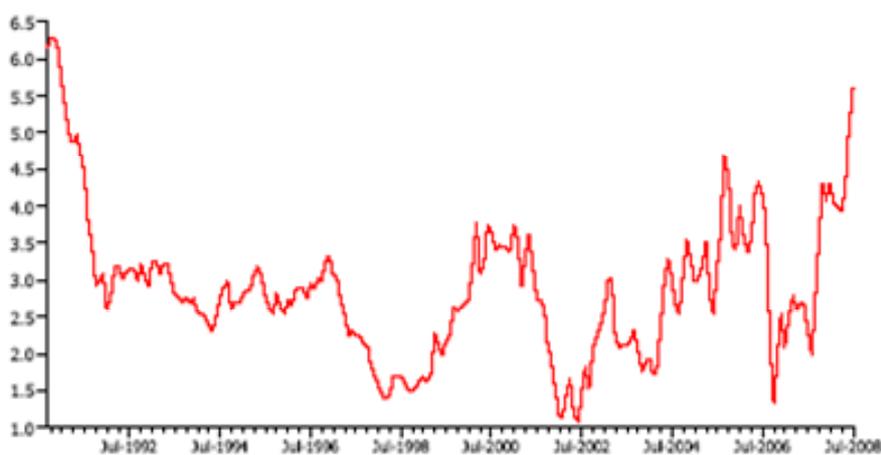
Exhibit 15. UK net lending (GBPmn)



Source: CEIC data

...and in the UK

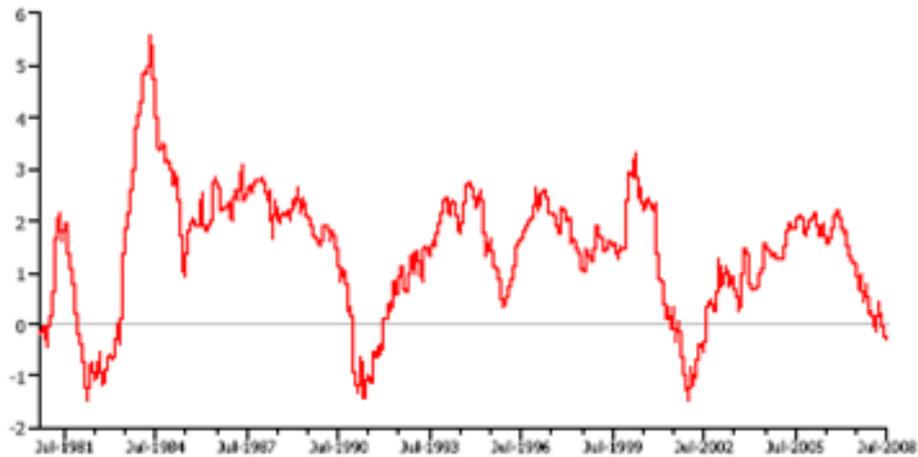
Exhibit 16. US: headline inflation



Source: CEIC data

Meanwhile, inflation conditions remain aggravated...

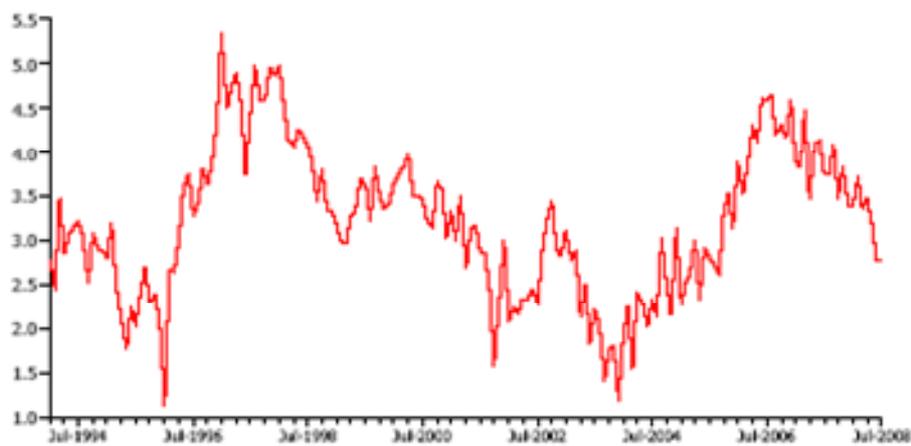
Exhibit 17. US employment growth (%)



Source: CEIC data

...and employment conditions
have deteriorated

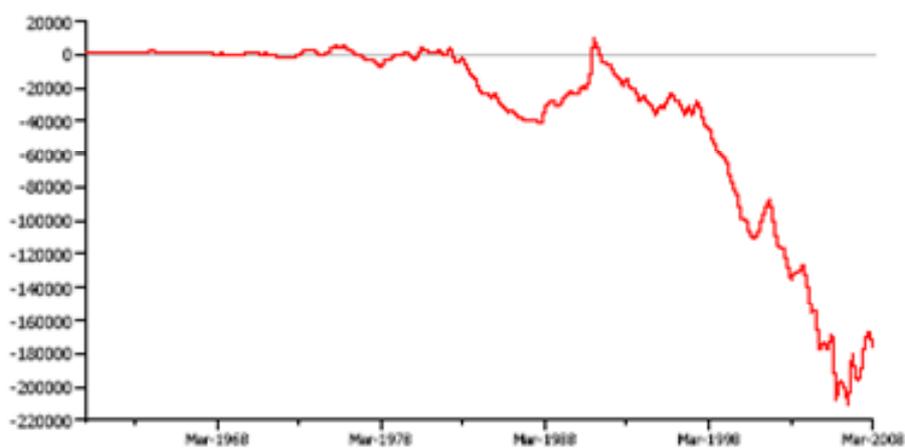
Exhibit 18. US nominal weekly wages (y-y %)



Source: CEIC data

There are no signs of wage
pressure in the US

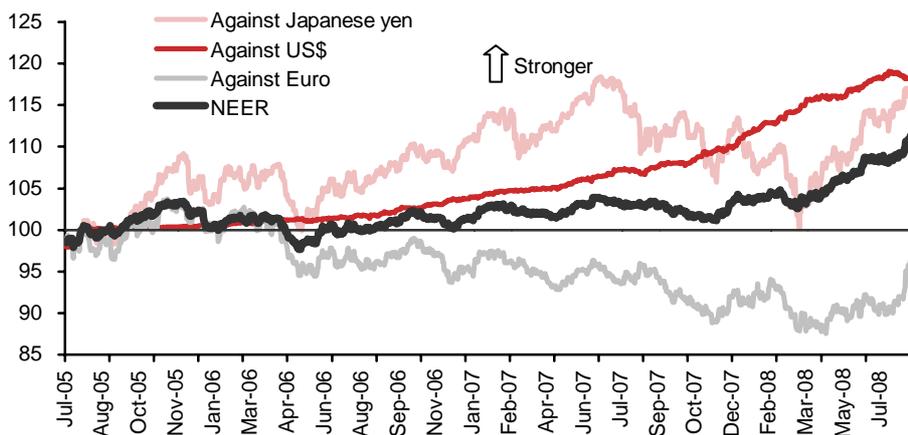
Exhibit 19. US current account (US\$m)



Source: CEIC data

The relative improvement in US
exports along with a drop in US
imports has improved the
greenback's prospects

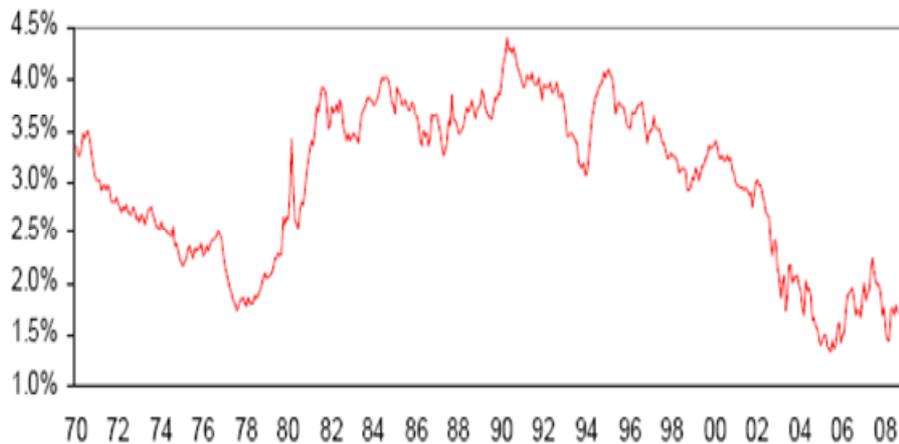
Exhibit 20. RMB vs other currencies



Source: CEIC data

Meanwhile, the renminbi has stalled relative to the US dollar; on a normal trade-weighted basis it is still climbing

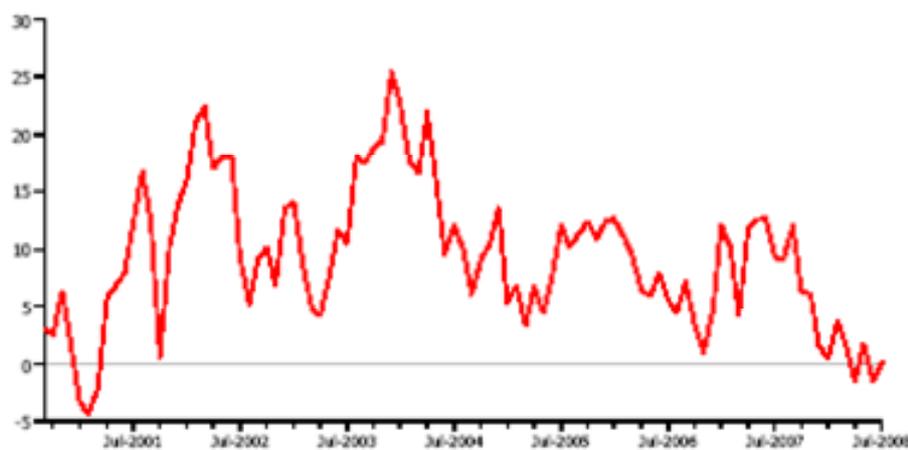
Exhibit 21. Developed world real yield (GDP-weighted)



Source: Bloomberg

Global real yields continue to support financial assets

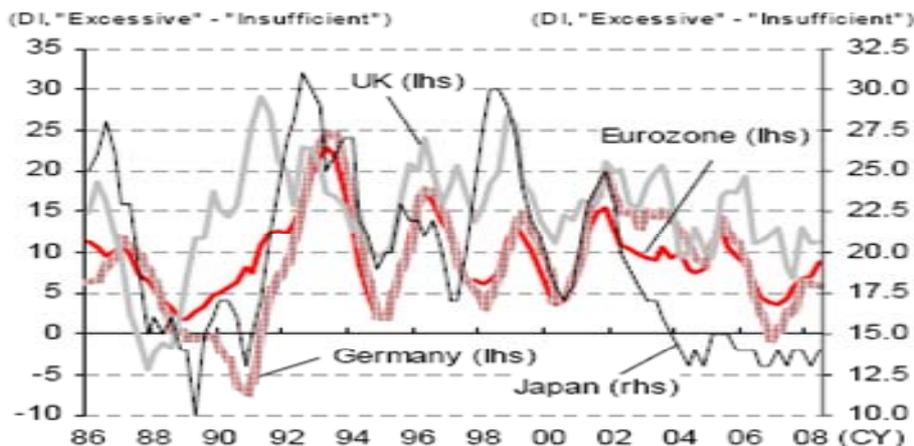
Exhibit 22. US: new orders minus inventories (ISM-derived)



Source: Bloomberg

There is no sign of an immediate rebound in US orders to overseas plants

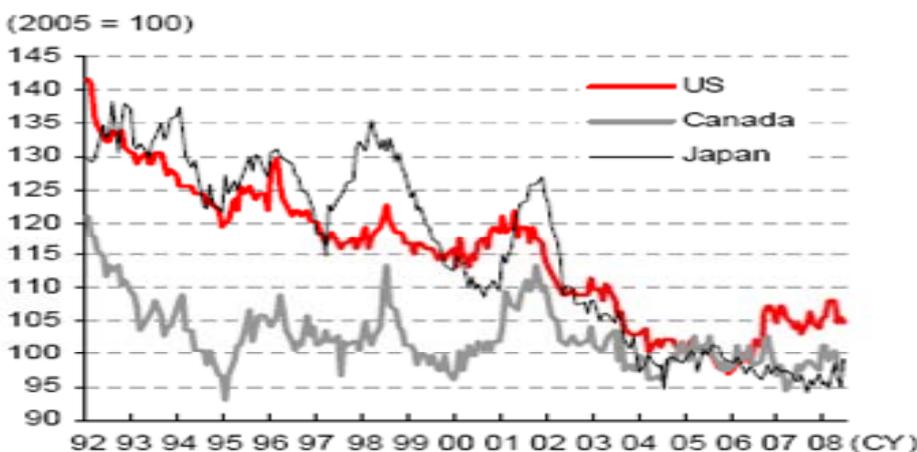
Exhibit 23. Companies assessment of inventories



Source: Nomura estimates, using Bank of Japan and EC Commission data

R. Sakagami, our UK-based Japanese economist, feels that inventory levels are manageable as companies appear to be prepared for a downturn...

Exhibit 24. Inventory-to-shipment ratios in Japan, US and Canada



Source: Nomura estimates, using Bank of Japan and EC Commission data

...and outside the US we see no dramatic increase in inventory-to-shipment ratios; our only concern is the possibility that inventory may be accumulating in Asia, particularly China

See Asia & Emerging Markets Strategy: *If Guangdong coughs, do emerging markets sneeze? (13 August, 2008)*

See Asia & Emerging Markets Strategy: *Whatever happened to plan B? (7 August, 2008)*

Strategy | ASIA & EMERGING MARKETS

NOMURA

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TOP
DOWN

Our view
While China fixed asset investment and consumption trends remain firm, gross goods exports about 40% of GDP are slipping. And with global PMI falling, imports are set to slow. Marginal changes in China's export demand are enough to cool commodities in the short term. An improved OECD lead indicator and rising PMI ought to signal an attractive entry point for investors in cyclical.

Anchor themes
China GDP grew 10.1% y/y in 2008, the smallest increase since 2005 and down from a 15.0% y/y increase in 2008. Processing trade comprised 50% of China's total exports and on average half of its total foreign trade over 1985-2005, and has been the main source of the country's trade surplus.

According to industry experts, China is set to overtake the US next year as the world's biggest manufacturer of goods.

Market calls
We introduce two new short-run baskets. The first includes companies benefiting from lower input costs: PetroChina, China Pacific, Transport International and Formosa Petrochemical. We also recommend a basket of China F&B plays riding on higher incomes in China: Wai Yant, China Ocean and Fudean.

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If Guangdong coughs, do emerging markets sneeze?

- Catching an export cold in China
- How investors can implement our view

Catching an export cold in China
"Guangzhou in the south, Nanjing as the steel post of China, had for centuries been in touch with the countries of southeast Asia, with India and the Arabs. Since the sixteenth century, when the Portuguese had been allowed to establish a trading colony at Macao on the western shore of the Pearl Estuary, the city had also been in touch with Europe. All the nations of the west dreamed of tapping China's fabulously rich resources, and for many years several of them had been permitted to operate "factories" or warehouses on the waterfront of Guangzhou, the only Chinese city where foreigners were allowed to land... Hong Kong Epitaph to an Empire, Jan Moss

"China's export growth has moderated, slowing in value terms to 22.7% y/y in the first seven months, from 28.7% y/y in the same period of 2007. The slowdown is more pronounced in volume terms, with growth falling for three consecutive quarters to 10.9% y/y in 2008, 11.2% y/y in 2008, and 14.8% y/y in 2007. From 21.2% y/y in 2007, note that export growth slowed in 2008 despite a strong rebound in May, which was attributable to holiday distortion. Without the holiday effect, 2008 export growth would have been weaker. The EU has now surpassed the US as China's top export destination, with a 20.1% share of total shipments from China, versus 18.7% for the US. Including goods re-exported via Hong Kong, we estimate that the share of China's exports to the EU exceeds 25%." - China Economics, China exports under pressure, 12 August, 2008.

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Strategy | ASIA & EMERGING MARKETS

NOMURA

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TOP
DOWN

Our view
The retreat in commodity prices comes amid growing evidence of a global slowdown. Credit conditions remain fragile and we see no data to suggest the worst of the storm is behind us. China and India are set to benefit from a modest drop in raw material prices but this will be at the expense of a growth shock to the top line. The terms of trade are shifting back to Asia from Brazil and Russia but all equities remain highly correlated to credit markets. No decoupling.

Anchor themes
Inflation is spiking throughout the emerging markets and monetary policy continues to be tightened as global growth slows. Asia is set for a virtual terms of trade improvement but top line growth will still experience earnings.

A serious reversal in metal scrap prices would highlight a deep correction in great growth as it would indicate a weakening in China demand.

Market calls
We close out our regional bank shipping and port stock basket. We closed out our inflation protection and commodity commodity baskets in May. Emerging markets remain strongly correlated to global credit conditions - there has been too much decoupling. Valuations of closed and emerging market funds suggest emerging market stocks have made a temporary bottom.

Whatever happened to plan B?

- A confluence of factors, a myriad of questions
- How investors can implement our view

A confluence of factors, a myriad of questions
"Two writers are out in the woods when one of them collapses. He doesn't seem to be breathing and his eyes are closed. The other guy runs out his phone and calls the emergency services. He waits. "My friend is dead! What can I do?" The operator says "Calm down, I can help. First, let's make sure he's dead." There is a silence, and then a shot is heard. Back on the phone, the guy says "OK, now what?" - Spike Milligan

"With the oil futures market moving from backreaction to contango, rising OI, lower yields and changes to fuel subsidies in emerging markets, we would expect a bid of prices to correct. As Asia and emerging market current accounts and fiscal surpluses diminish due to higher energy input costs, the amount of money to be recycled into the bond markets is falling, forcing an upward shift in yield curves." - Strategy Notes, From pockets of inflation to speculative excess (II), 27 May 2008

Earlier this year we provided investors with a body of evidence that suggested commodities would likely rise despite the worsening credit conditions. In particular, we pointed out that China's relaxed monetary policy along with subsidies was encouraging above-trend demand. We termed this dynamic "stabilization". However, by May we had highlighted that there were considerable economic feedback loops that were eroding support for commodities. China was fighting a rear guard battle against inflation while global central banks were raising interest rates in the face of higher domestic prices.

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	% for which material IB services (c) have been provided	7	3	0
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Sources: Nomura International plc, Nomura Securities Co. Ltd. and Nomura International (Hong Kong) Ltd. as at 30 June 2008.

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- A "**Buy**" recommendation indicates that upside is between 10% and 20%.
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