



Economic Insight

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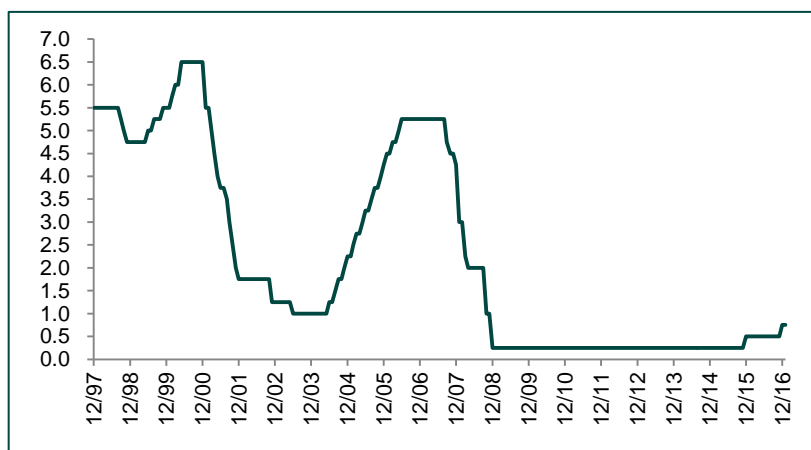
Fed policy outlook in 2017

- The Federal Reserve (the Fed), as expected, decided at its first meeting in 2017 that the target range for the federal funds rate would stay unchanged at 0.50-0.75%.
- We forecast the U.S. interest rate will increase twice in 2017, below thrice as expected by the Fed, as persistent strength of the USD would weigh on economic growth and inflation would remain moderate.
- It remains unclear in terms of how Donald Trump's active fiscal policy will affect the Fed's interest rate moves. Although active fiscal policy could accelerate economic growth, it will also increase budget deficits; hence, getting support from the Congress will be difficult.
- Although the Fed will increase interest rate in 2017, we expect the prime rate in Hong Kong to remain unchanged on the strength of HKD as well as the high aggregate balance and outstanding exchange fund bills and notes.
- With the rising U.S. interest rates, we expect spot USD/CNY rate to approach 7.20 by end-2017, indicating a depreciation of 3.5%, compared with the 6.5% depreciation in 2016. Capital outflow from China, however, would ease as the Chinese government tightens capital account restrictions.

Fed held interest rate steady in its first meeting in 2017

The Fed, as expected, decided at its first meeting in 2017 to leave the target range for the federal funds rate unchanged at 0.50-0.75% (Exhibit 1). The decision was agreed unanimously by the 10 committee members. The Fed said consumer and business sentiment in the U.S. has been rising of late, which was not mentioned in December meeting in 2016. Reasserting that interest rate would rise gradually, the Fed, however, gave no indication in terms of the timing of the next interest rate hike.

Exhibit 1: Federal funds target rate (%)



Source(s): Federal Reserve, ABCI Securities

According to the Fed's policy statement, the labor market has continued to strengthen, and the economic activity has continued to expand at a moderate pace, similar with those wordings in December meeting last year. With regards to inflation, inflation compensation

ABCI Research

9 February 2017



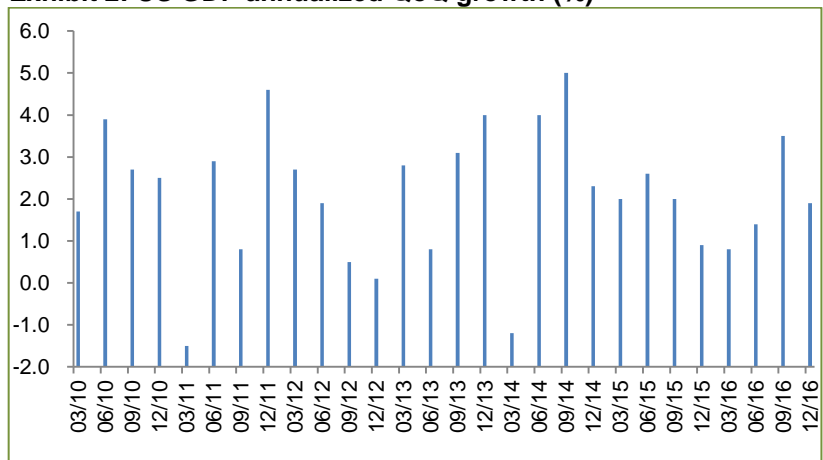
remained low and long-term inflation expectations are of little change, although inflation is expected to rise to 2% over the medium term. No statement was made as to whether Trump’s fiscal and trade policies would affect the Fed’s rate decision. Also omitted were the potential changes in balance sheet policy, which includes the end of reinvestment- an issue that has been attracting the market’s attention lately.

After the first meeting, the Fed funds futures indicates there will be two rate hikes in 2017, with the first occurring in June and the second in December. As forecasted in December meeting in 2016, the Fed, however, expected three rate hikes for 2017.

Fed policy outlook for 2017

We forecast the U.S. interest rate will increase twice in 2017, below thrice as expected by the Fed, as persisting strength of the USD would weigh on economic growth and inflation would be mild. In fact, the U.S. real GDP growth eased to 1.9% on an annualized quarterly basis in 4Q16 (Exhibit 2), lower than the 3.5% expansion in 3Q16 and below the market expectation of 2.2%. The deceleration in real GDP in 4Q16 reflected that a significant appreciation in USD had led to deterioration in net export. In 2016, the real GDP only expanded by 1.6%, the lowest since 2011 and far below the average rate of 2.1% in 2011-2015.

Exhibit 2: US GDP annualized QoQ growth (%)



Source(s): Bloomberg, ABCI Securities

Inflation is also contained. Excluding food and energy prices, the core PCE inflation, also known to be the most important price indicator for the Fed, was 1.7% in 2016, below the Fed’s 2% target. Recent data show the average hourly earnings was up only by 2.5% on a yearly basis in January 2017, less than expected, and earlier months were revised down. With a weak global growth environment and a strong USD, core PCE inflation would remain moderate in 2017.

It remains unclear in terms of how Donald Trump’s active fiscal policy, which includes slashing corporate income tax from 35% to 15% and increasing infrastructure spending, will affect the Fed’s interest rate moves. Although active fiscal policy could accelerate economic growth, it will also increase budget deficits; hence, getting support from the Congress will be difficult. While the Republican Party has retained control of both houses of Congress, the Republican Party



has been against budget deficit in recent years. Thus, Trump would first need to obtain agreement within the Republican Party. Nevertheless, the market reaction to Trump's election has been positive so far, with Dow Jones Index climbing by more than 8% since Trump's winning in November 2016.

Although the Fed will increase interest rate in 2017, the prime rate in Hong Kong¹ is expected to remain unchanged on the gradual tightening of the Fed's monetary policy. The aggregate balance, a measure of interbank liquidity in Hong Kong's banking sector, is still high at HK\$ 260bn, although the 1-month HIBOR has risen significantly over the past 3 months. The outstanding exchange fund bills and notes are high at HK\$ 960bn, while HKD has stayed near at 7.75, the strong side of the linked exchange rate, implying no major capital outflow has occurred in the region yet.

With the rising U.S. interest rates, we expect spot USD/CNY rate to approach 7.20 by end-2017, indicating a depreciation of 3.5% for 2017, compared with the 6.5% depreciation in 2016. Capital outflow from China is expected to ease on tightened capital account restrictions by the Chinese government.

¹ 5.0% quoted by HSBC, HSB and BOCHK and 5.25% by SCB since November 2008



China Economic Indicators

	2015		2016											
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Real GDP (YoY %)	---	6.8	---	---	6.7	---	---	6.7	---	---	6.7	---	---	6.8
Export Growth (USD, YoY %)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)	(4.4)	(2.8)	(10.0)	(7.3)	0.1	(6.1)
Import Growth (USD, YoY %)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)	(12.5)	1.5	(1.9)	(1.4)	6.7	3.1
Trade Balance (USD bn)	54.1	60.9	63.3	32.6	29.9	45.6	50.0	48.1	52.3	52.1	42.0	49.1	44.6	40.8
Retail Sales Growth (YoY %)	11.2	11.1	10.2		10.5	10.1	10.0	10.6	10.2	10.6	10.7	10.0	10.8	10.9
Industrial Production (YoY %)	6.2	5.9	5.4		6.8	6.0	6.0	6.2	6.0	6.3	6.1	6.1	6.2	6.0
PMI - Manufacturing (%)	49.6	49.7	49.4	50.2	50.1	50.1	50.0	49.9	50.4	50.4	50.4	51.2	51.7	51.4
PMI - Non-manufacturing (%)	53.6	54.4	53.5	53.8	53.5	53.1	53.7	53.9	53.5	53.7	53.7	51.2	50.9	51.9
FAI (YTD) (YoY %)	10.2	10.0	10.2		10.7	10.5	9.6	9.0	8.1	8.1	8.2	8.3	8.3	8.1
CPI (YoY %)	1.5	1.6	1.8	2.3	2.3	2.0	1.9	1.8	1.3	1.9	1.9	2.1	2.3	2.1
PPI (YoY %)	(5.9)	(5.9)	(5.3)	(4.3)	(3.4)	(2.8)	(2.6)	(1.7)	(0.8)	0.1	0.1	1.2	3.3	5.5
M2 (YoY %)	13.7	13.3	14.0	13.4	12.8	11.8	11.8	10.2	11.4	11.5	11.5	11.6	11.4	11.3
New Lending (RMB bn)	709	598	2510	727	1370	556	986	1380	464	949	1220	651	795	1040
Aggregate Financing (RMB bn)	1020	1815	3425	825	2404	751	660	1629	488	1470	1720	896	1740	1630

World Economic/Financial Indicators

Equity Indices				Global Commodities				Bond Yields & Key Rates			
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Volume (5-Day avg.)		Yield (%)	Chg. WTD (Bps)	
U.S.				Energy				US Fed Fund Rate			
DJIA	20,054.34	(0.09)	18.49	NYMEX WTI	USD/bbl.	52.57	(2.34)	543,618		0.75	0.00
S&P 500	2,294.67	(0.12)	21.09	ICE Brent Oil	USD/bbl	55.39	(2.50)	308,363	US Prime Rate	3.75	0.00
NASDAQ	5,682.45	0.28	33.53	NYMEX Natural Gas	USD/MMBtu	3.17	3.49	155,493	US Discount Window	1.25	0.00
MSCI US	2,187.08	(0.11)	21.63	China Qinhuangdao Port Thermal Coal ²	USD/Metric Tonne	61.80	N/A	N/A	US Treasury (1 Yr)	0.4970	2.03
Europe				Basic Metals				US Treasury (5Yr)			
FTSE 100	7,188.82	0.01	50.68	LME Aluminum Cash	USD/MT	1,830.00	0.45	9,230	US Treasury (10 Yr)	2.3469	(11.8)
DAX	11,543.38	(0.93)	17.70	LME Aluminum 3 -mth. Rolling Fwd.	USD/MT	1,847.50	0.71	27,094	Japan 10-Yr Gov. Bond	0.0870	(1.30)
CAC40	4,766.60	(1.22)	23.06	CMX Copper Active	USD/lb.	5,879.50	2.07	8,163	China 10-Yr Gov. Bond	3.4500	2.70
IBEX 35	9,329.70	(1.41)	22.79	LME Copper 3- mth Rolling Fwd.	USD/MT	5,895.00	2.13	34,994	ECB Rate (Refinancing)	0.00	0.00
FTSE MIB	18,771.78	(1.80)	54.51	Precious Metals				1-Month LIBOR			
Stoxx 600	363.94	(0.04)	26.14	CMX Gold	USD/T. oz	1,242.70	1.79	213,457	3 Month LIBOR	1.0382	0.42
MSCI UK	2,093.02	0.11	52.05	CMX Silver	USD/T. oz	17.77	1.66	59,028	O/N SHIBOR	2.2720	5.40
MSCI France	135.84	(1.22)	21.46	NYMEX Platinum	USD/T. oz	1,020.10	1.33	12,328	1-mth SHIBOR	3.9839	10.78
MSCI Germany	146.17	(0.82)	18.48	Agricultural Products				3-mth HIBOR			
MSCI Italy	52.30	(1.89)	30.65	CBOT Corn	USD/bu	369.25	1.10	161,055	Corporate Bonds (Moody's)		
Asia				CBOT Wheat	USD/bu	430.25	0.00	77,751	Aaa	3.96	(8.00)
NIKKEI 225	18,907.67	(0.06)	22.40	NYB-ICE Sugar	USD/lb.	20.76	(1.66)	76,935	Baa	4.64	(9.00)
S&P/ASX 200	5,664.62	0.77	25.47	CBOT Soybeans	USD/bu.	1,053.75	2.60	122,522			
HSI	23,557.12	1.85	13.05								
HSCEI	10,076.95	4.07	8.32								
CSI300	3,389.91	0.76	15.21								
SSE Composite	3,174.96	1.11	18.29								
SZSE Composite	1,952.21	2.22	44.38								
MSCI China	63.82	2.31	13.98								
MSCI Hong Kong	12,921.15	1.18	14.95								
MSCI Japan	916.26	0.63	18.93								

Note:

1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

Currency

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.0676	1.2508	0.7624	112.23	0.9966	6.8695	7.7588	7.0990
Chg. WTD (%)	(0.99)	0.19	(0.73)	0.34	(0.36)	(0.03)	(0.02)	(0.01)



Disclosures

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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	2.6 \leq 180 day volatility/180 day benchmark index volatility
High	1.5 \leq 180 day volatility/180 day benchmark index volatility < 2.6
Medium	1.0 \leq 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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