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Kuwait Finance House

The ISIS Praxis Seminar 2011

"Currency War Inflation, Sovereign Debt Crisis & QE2"

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Managing Director & Vice Chairman

Expansionary monetary policy in developed nations

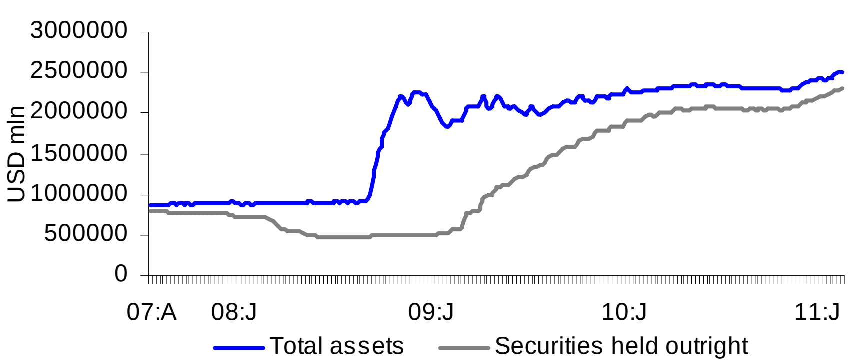
- ✓ Quantitative easing (QE) is an **unconventional monetary policy used by central banks to stimulate the economy**
- ✓ The central bank creates money which it uses to buy government bonds and other financial assets, in order to increase money supply and the excess reserves of the banking system. This also raises the prices of the financial assets bought (which lowers their yield)
- ✓ Expansionary monetary policy normally involves a lowering of short-term interest rates by the central bank. However, when such interest rates are either at or close to zero, normal monetary can no longer function, and QE may be used by the monetary authorities in order to lower interest rates further out on the yield curve and further stimulate the economy
- ✓ QE was used unsuccessfully by the BOJ to fight domestic deflation in early 2000s, whereby BOJ maintains short-term interest rates close to zero since 1999. With QE, it flooded commercial banks with excess liquidity to promote private lending, leaving them with large stocks of excess reserves, and little risk of a liquidity shortage
- ✓ Similar policies have been used by the US, the US and the Eurozone during the financial crisis 2007-2010
- ✓ According to the IMF, the QE policies undertaken by central banks of major developed nations have contributed to the reduction in systemic risks following the bankruptcy of Lehman Brothers. It has also contributed to the recent improvements in market confidence, and the bottoming out of the recession in the G7 economies
- ✓ Risks: (1) higher inflation than desired if it is improperly used, and too much money is created, (2) it can fail if banks opt simply to sit on the additional cash in order to increase their capital reserves in a climate of rising defaults in loan portfolios, (3) can effectively ease the process of deleveraging as it lowers yields, and (4) in the context of a global economy, lower interest rates may contribute to asset bubbles in other economies

Source: IMF, KFHR

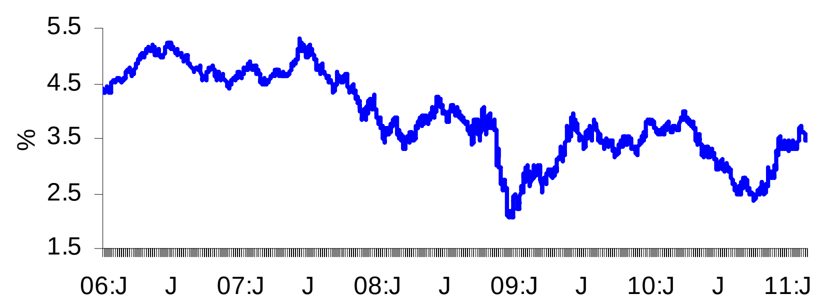
US' quantitative easing

- ✓ During the peak of the financial crisis in 2008, the Fed expanded its balance sheet dramatically by adding new assets and new liabilities without "sterilizing" these by corresponding subtractions
- ✓ The Fed held between USD700-USD800bln of Treasury notes on its balance sheet even before the recession. In late Nov 2008, the Fed started buying USD600bln MBS
- ✓ By March 2009, it held USD1.75tln of bank debt, MBS and Treasury notes, and reached a peak of USD2.1tln in June 2010
- ✓ Further purchases were halted since the economy had started to improve. Holdings started falling naturally as debt matured (projected at USD1.7tln by 2012)
- ✓ However in August 2010, the Fed decided to renew QE, i.e. QE2, because the economy is not growing robustly as anticipated. Its goal was to keep holdings at USD2.054tln level
- ✓ To maintain that level, the Fed bought USD30bln in 2 to 10-year Treasury notes a month
- ✓ In Nov 2010, the Fed announced under QE2, it would be buying USD600bln of Treasury securities by end-2Q11. The market currently expects QE2 to continue until end-2011 (USD1.2tln)

Fed's total assets (2007-Feb 2011)



US' 10-year bond yield (2006-Feb 2011)



Source: Bloomberg, KFHR

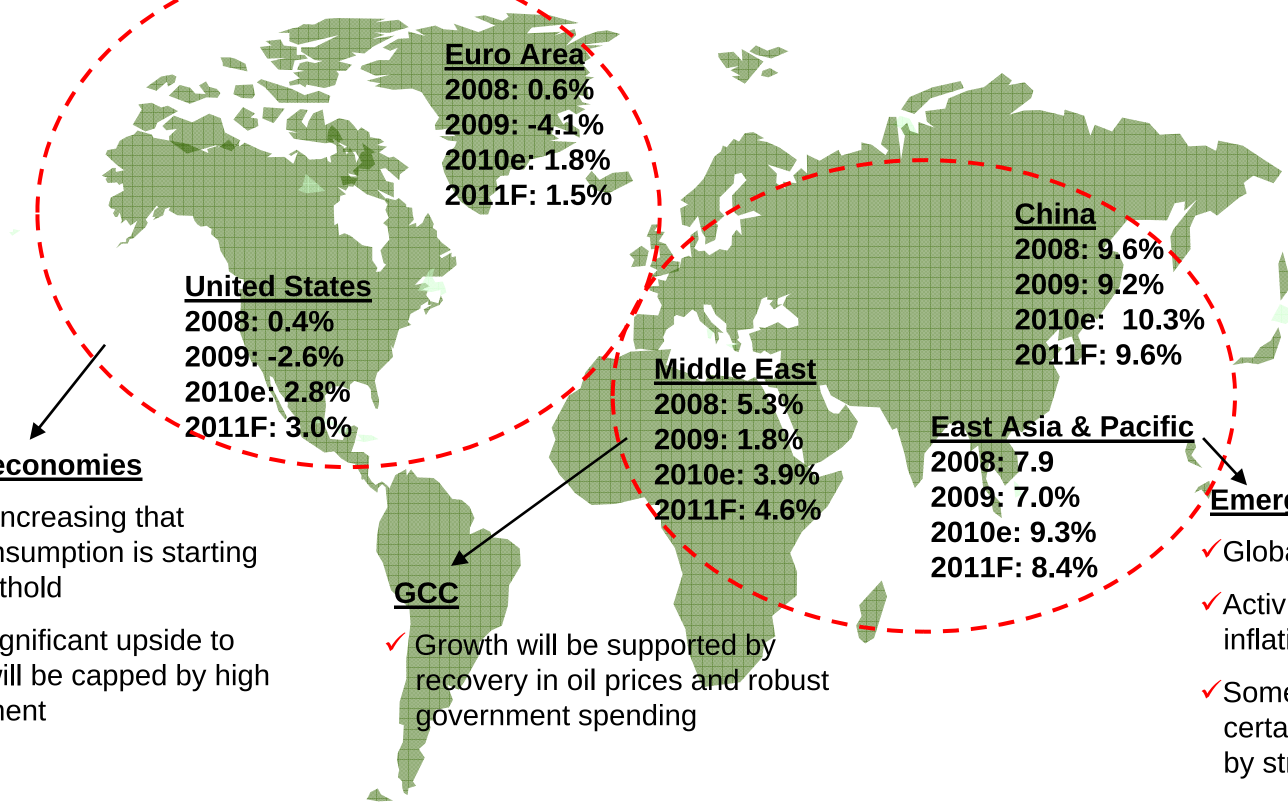
QE2 and its consequences

- ✓ **Monetary inflation** is one result of QE2. When Fed buys US Treasuries, it injects newly created money into the financial system, which in turn reduces the value of the USD
- ✓ **A lower USD** could stimulate US exports, however with unintended consequences, e.g. excess liquidity that could lead to asset price bubbles in the US
- ✓ Low interest rates are fuelling a **USD carry trade that create asset price bubbles beyond US**
- ✓ Exporters must control inflation via raising interest rates, but must also debase their currencies to maintain exports competitiveness
- ✓ QE2 is a doubly destructive policy for exporters i.e. capital inflows are inflationary while exports are reduced due to currency appreciation
- ✓ Debasing the USD reduces the value of China's US Treasury holdings while China relies on exports to the US, totaling between USD200-USD300bln annually
- ✓ While it stimulate exports and help create conditions for renewed economic growth in the US, QE2 represents a debasement of the USD and suggests that demand for US debt may be weakening
- ✓ Current facts regarding the US economy do not justify the AAA rating of US sovereign debt. In Feb 2010, Moody's warned that it might have to cut the rating on US government debt. The warning was reiterated in Dec 2010
- ✓ Confidence in US sovereign debt and in the USD will continue to deteriorate unless the economy shows stronger growth, federal government gets deficit under control (expected at 8.3% of GDP for 2011)

Source: IMF, Bloomberg, KFHR

Global economic outlook 2011

Global GDP Growth (2008-2011F)



Advanced economies

- ✓ Signs are increasing that private consumption is starting to gain foothold
- ✓ However significant upside to spending will be capped by high unemployment

GCC

- ✓ Growth will be supported by recovery in oil prices and robust government spending

Emerging economies

- ✓ Global growth driver in 2011
- ✓ Activity remains buoyant, inflation pressures are emerging
- ✓ Some signs of overheating in certain countries, driven in part by strong capital inflows

- ✓ IMF projects **World GDP growth of 4.4% in 2011**, up from earlier forecast of 4.2%, mostly due to QE2 in the US that is expected to boost economic growth by 0.5% to 3.0% for the country
- ✓ Emerging economies will drive global growth in 2011, underpinned by strong private consumption and infrastructure spending plans

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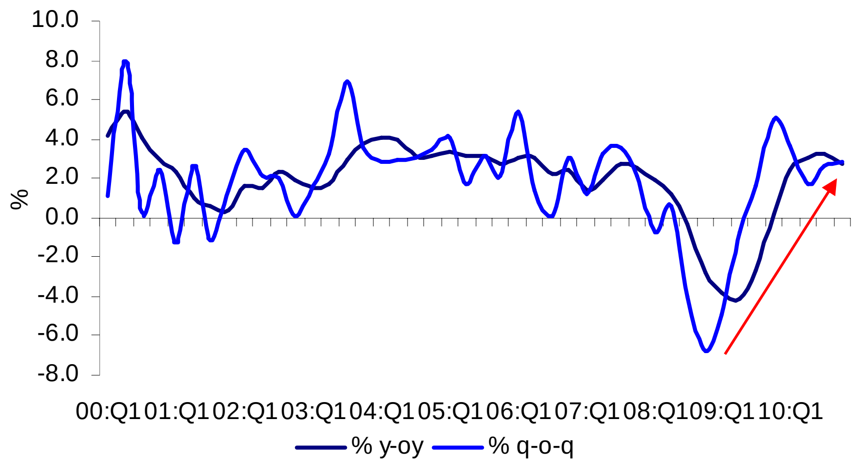
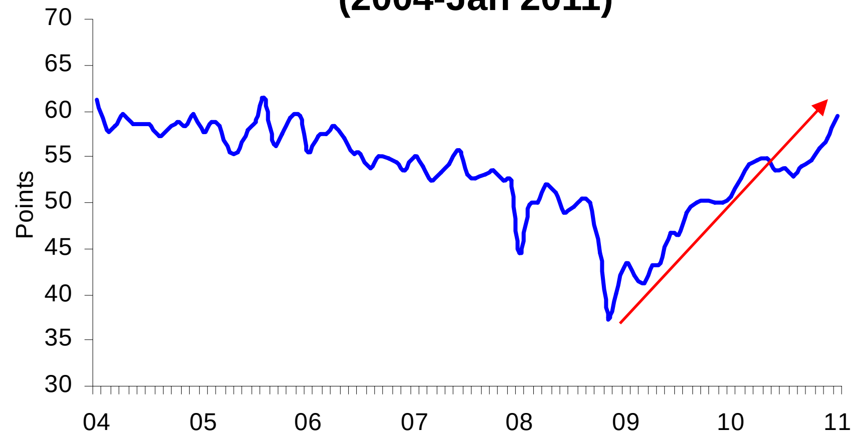
Source: IMF, KFHR

US' economic outlook 2011

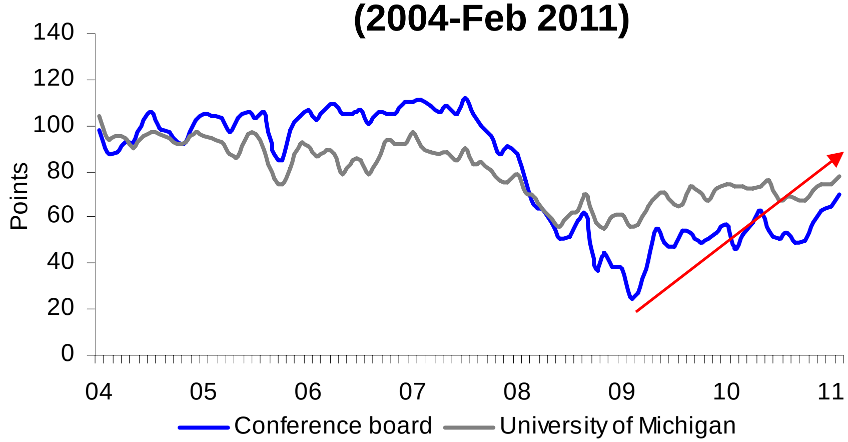
US' GDP growth trend (2000-2010)



US' non-ISM services index (2004-Jan 2011)



US' consumer confidence/ sentiment (2004-Feb 2011)



- ✓ US' economy expanded by 2.8% in 2010, the most in 5 years, after shrinking 2.6% in 2009
- ✓ Household purchases rose 4.1% in 4Q10 (3Q10: 2.4%), boosted by various tax cuts and renewal of emergency jobless benefits for the unemployed
- ✓ Consumer confidence increased in February to the highest level in 3 years supported by a drop in unemployment
- ✓ Risks to growth: rising oil prices and more cutbacks by state and local governments given rising costs of food and fuel

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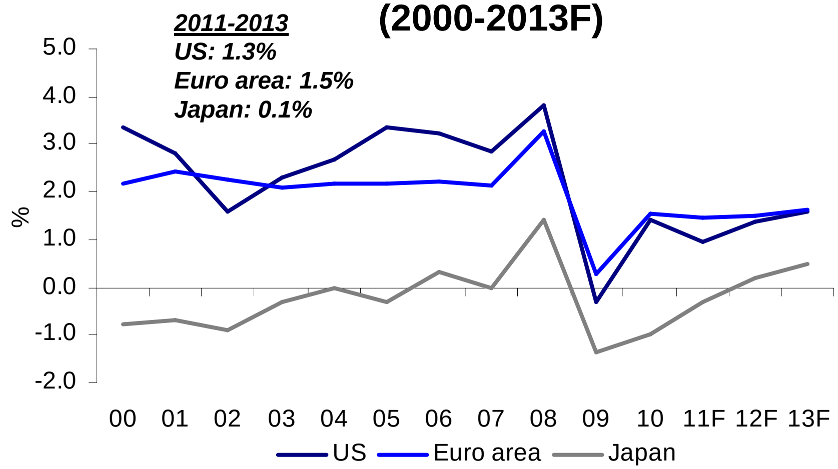
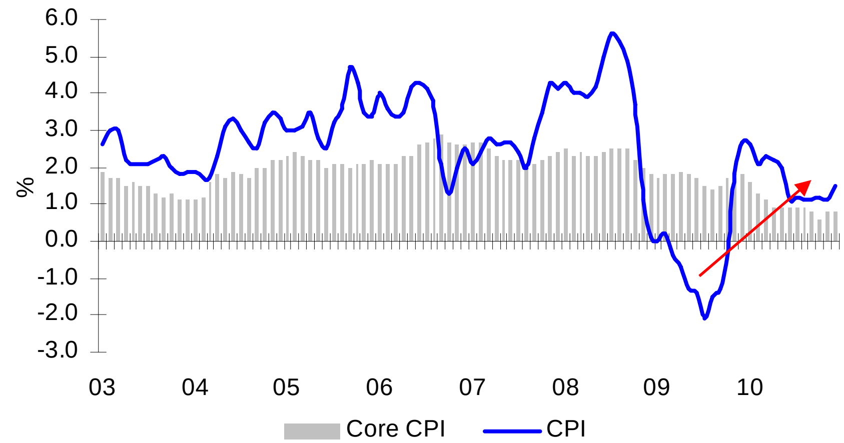
Source: Bloomberg, KFHR

Inflation remains manageable, with spending capped by the still high unemployment

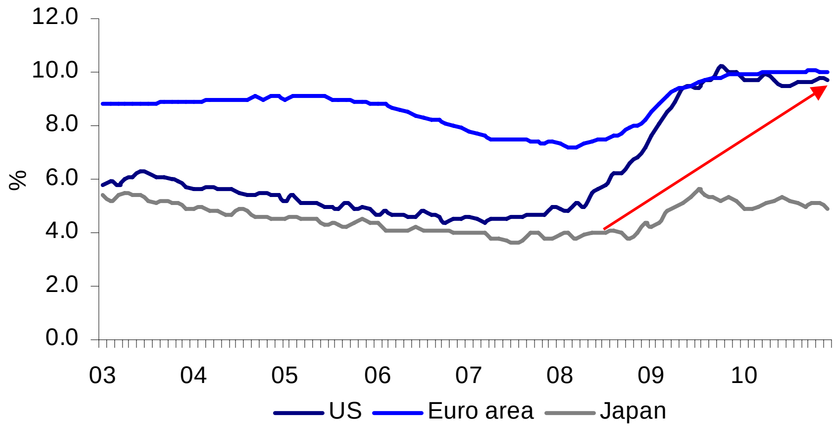
Inflation: US vs. developed nations (2000-2013F)



US' CPI vs. core CPI (2003-2010)



Unemployment: US vs. developed nations (2003-2010)

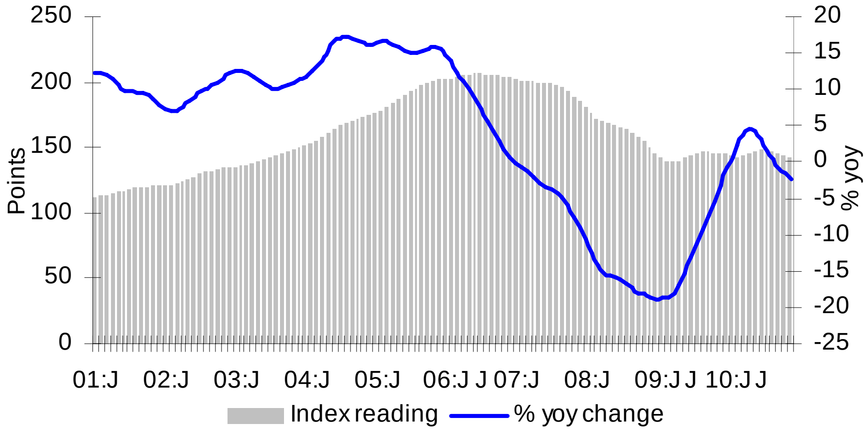


- ✓ US' CPI rose slightly by 1.6% in Jan 2011 (Dec: 1.5%), as higher prices for food and fuel may have starting to filter through to other goods and services
- ✓ Core CPI stood at 1.0% in Jan 2011 (Dec: 0.8%), the most since Feb 2009
- ✓ Even with soaring commodity prices, the Fed remains concern that inflation is below its long-term target of 1.6%-2.0%
- ✓ Unemployment rate held at or above 9.0% since May 2009, restraining consumption

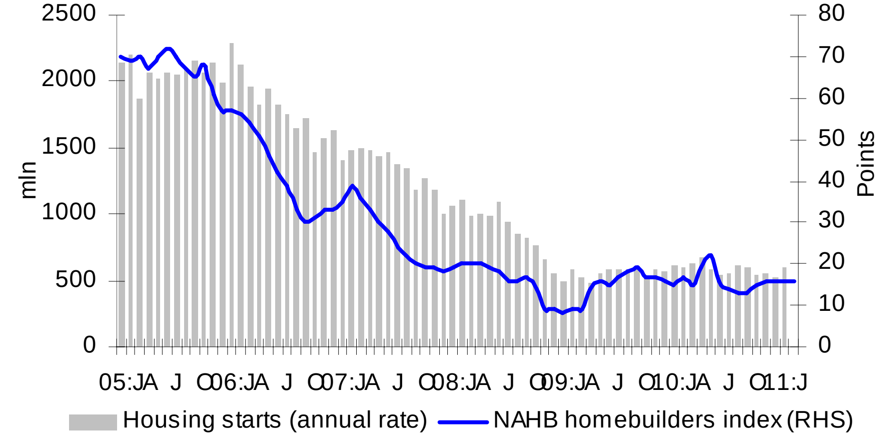
Source: Bloomberg, KFHR

US housing market is struggling even as the rest of the economy recovers

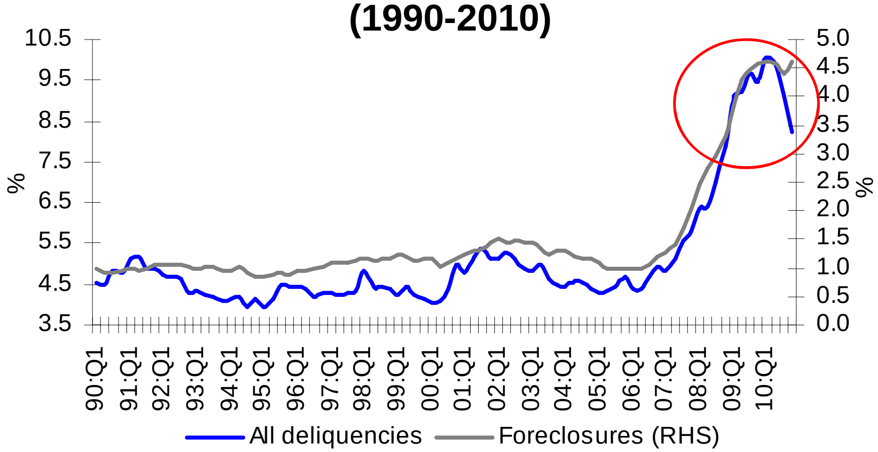
S&P/ case-shiller house price index (2001-2010)



Housing starts & NAHB homebuilders index (2005-Feb 2011)



Mortgage delinquencies & foreclosures (1990-2010)



- ✓ US home values fell 2.4% yoy in Dec 2010, the biggest decline since Dec 2009
- ✓ Mortgage delinquency rate was the highest at 10.1% in 1Q10, easing to 8.22% by end-2010
- ✓ Foreclosures expected to increase as banks resume seizures. The number of homes receiving a foreclosure notice is expected to climb 20% in 2011
- ✓ This may depress home values further, prompting would-be buyers to hold off on purchases

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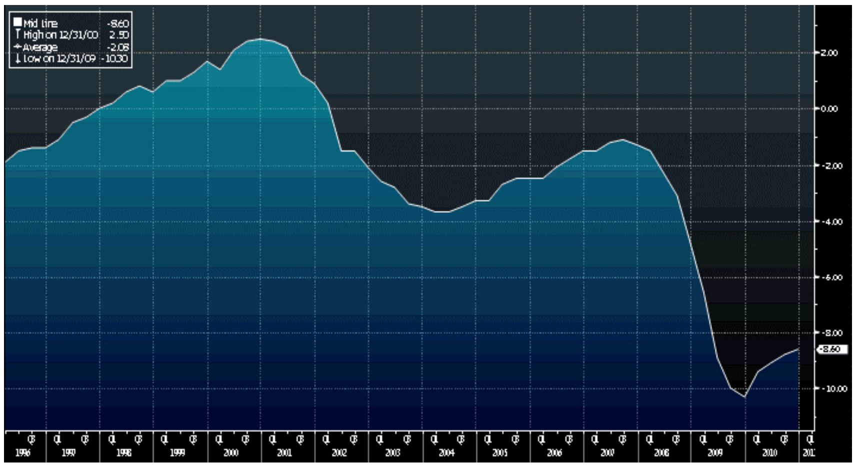
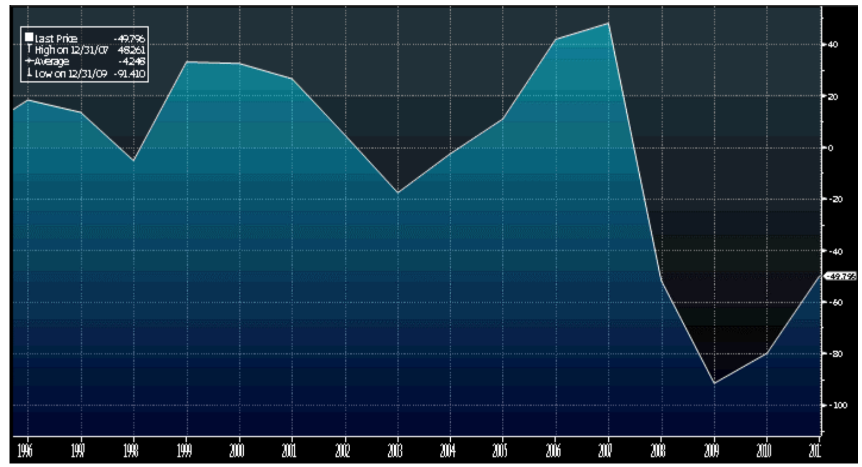
Source: Bloomberg, KFHR

US' fiscal deficit topped 10.6% of GDP in FY2010

US' fiscal deficit % GDP (1996-2010)



US' budget deficit, USD bln (1996-2010)



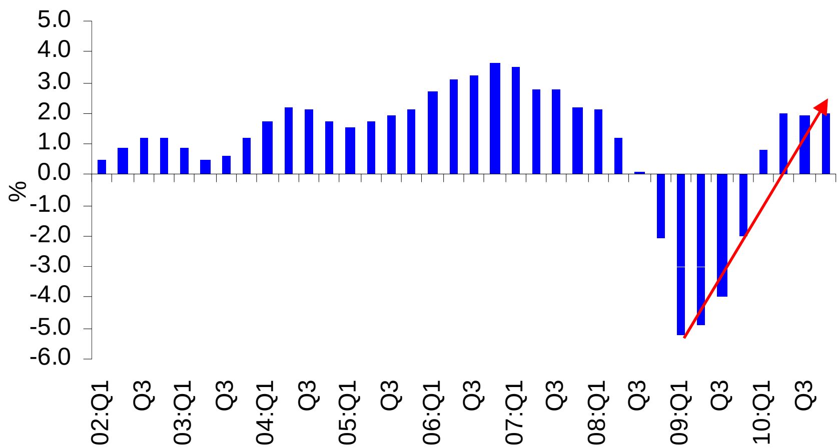
US' current account deficit % GDP (1996-2010)

- ✓ US' fiscal deficit official forecast of USD1.267tln or 8.3% of GDP in FY2011 (FY2010: 10.6% of GDP)
- ✓ Stimulus measures: extended unemployment benefits and healthcare subsidies for the unemployed, tax and credit incentive for small businesses to invest and hire workers, extended payroll tax cuts for the middle class, increased funding for states, infrastructure and transportation
- ✓ US plans to reduce fiscal deficit in 2012 and brings it below 4% of GDP by 2014

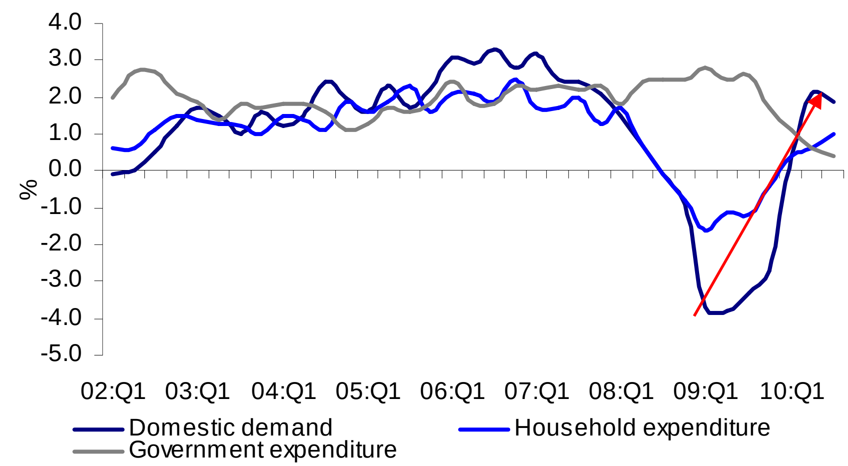
Source: Bloomberg, US Budget FY2011

EU economic outlook 2011

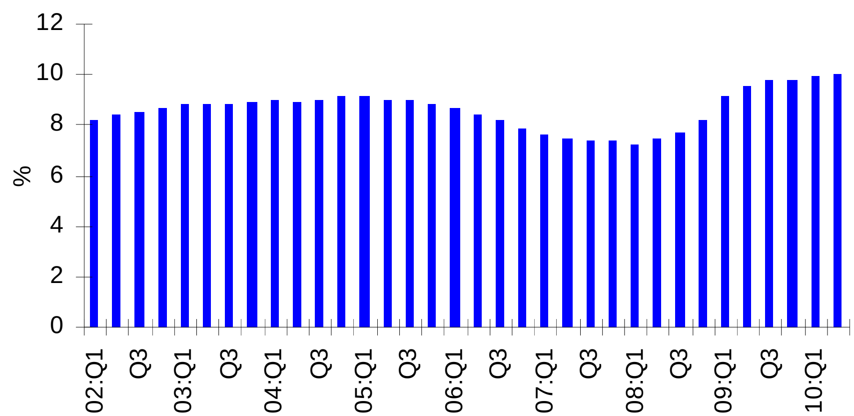
EU GDP growth trend (2002-2010)



EU GDP by sector (2002-2010)



EU unemployment rate (2002-2010)



- ✓ Official GDP in the euro region is projected to increase by 1.6% in 2011, up from an earlier forecast of 1.5%
- ✓ Services and manufacturing industries in February grew at the fastest pace in more than 4 years
- ✓ Unemployment rate fell to 9.9% in Jan 2011, down from 10% in Dec 2010
- ✓ Inflation gathered pace to 2.4% in Feb 2011, and is expected to average at 2.2% this year, above the ECB's ceiling of 2.0%

Source: Bloomberg, KFHR

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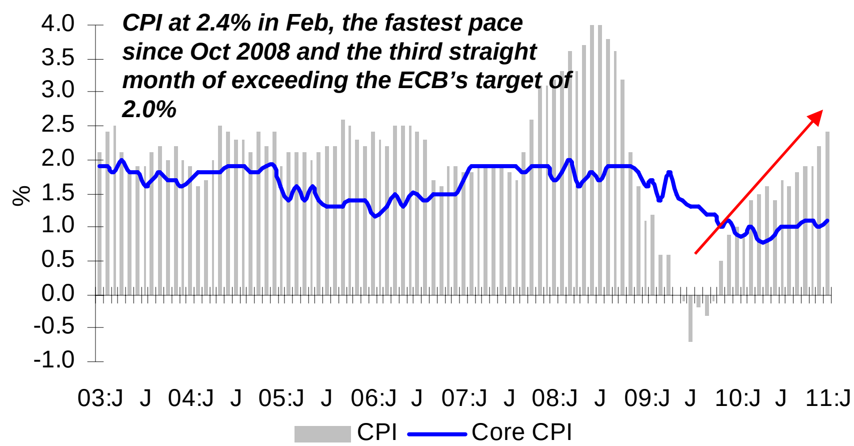
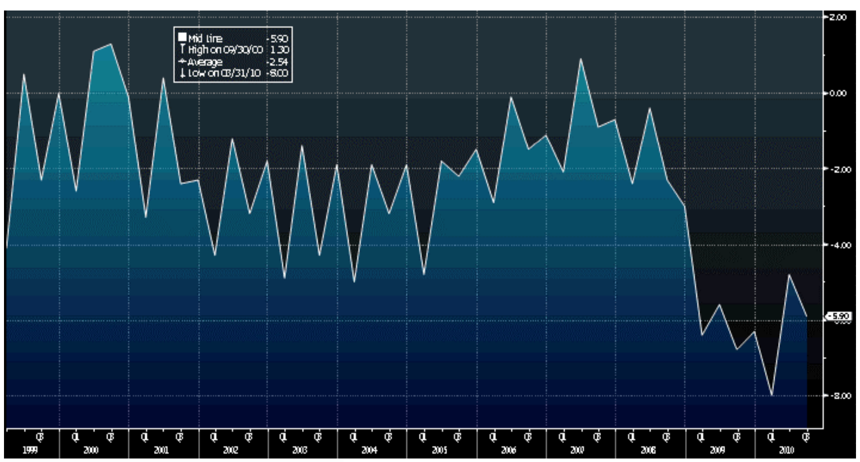
ECB is expected to raise interest rates to counter rising inflation

EU CPI vs. core CPI (2003-Jan 2011)



EU 10-year bond yield (2006-2 Mar 2011)

EU fiscal deficit % GDP (1999-2010)

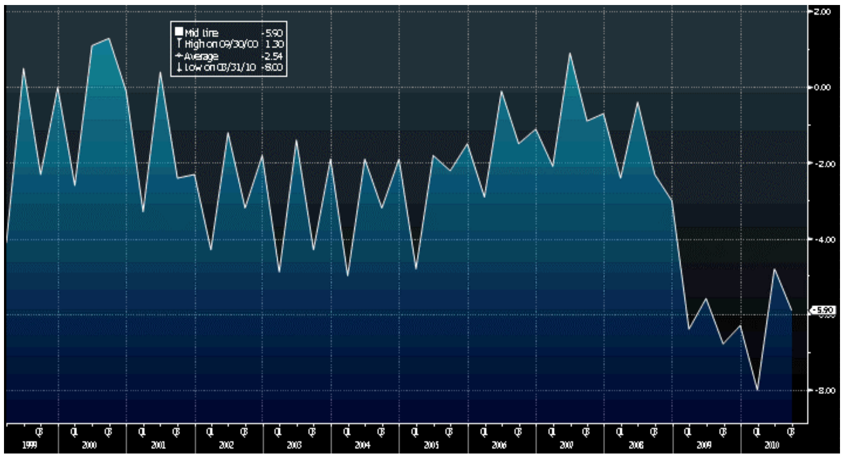


- ✓ Quickened inflation puts pressure on the ECB to raise rates later in 2011
- ✓ The ECB has toughened its inflation-fighting rhetoric over the past 2 weeks, indicating it is moving closer to raising rates from a record low even as Europe grapples with a sovereign debt crisis
- ✓ Market expects the ECB to make its move in Sept 2011

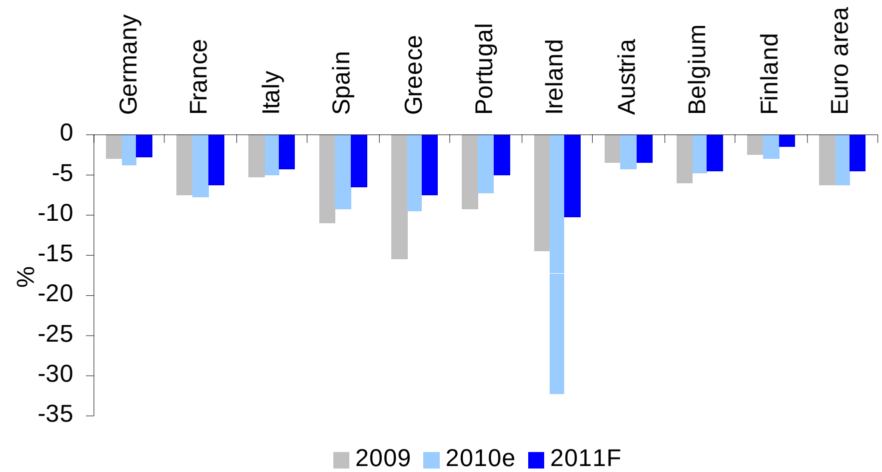
Source: ECB, Bloomberg, KFHR

Sovereign debt crisis

EU fiscal deficit % of GDP (1996-2010)



Euro area fiscal deficit % GDP (2009-2011F)



Euro countries downgraded by rating agencies

Country	Rating prior to 2009 (Moody's/ S&P/ Fitch)	Rating as at Mar 2011 (Moody's/ S&P/ Fitch)	Downgraded by (notches) (Moody's/ S&P/ Fitch)
Ireland	Aaa/AAA/AAA	Baa1/A-/BBB+	7/6/7
Greece	A1/A/A	Ba1/BB+/BB+	6/5/5
Portugal	Aa2/AA-/AA	A1/A-/A+	2/3/2
Spain	Aaa/AAA/AAA	Aa1/AA/AA+	1/2/4

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Source: ECB, Bloomberg, KFHR

Recovery in commodity prices bode well for emerging and resource-based economies

Crude oil price (2006-2 Mar 2011)

Gold price (2006-2 Mar 2011)

Copper price (2006-2 Mar 2011)

- ✓ Crude oil price surged to a 29-month high at USD99.63pb amidst political unrest in the MENA region, gaining 10.9%YTD
- ✓ Commodity prices surged as investors turn to safe-haven investments
- ✓ Gold prices gained 2.04%YTD at USD1,433.28/ ounce, aluminium rose 6.4%YTD, platinum surged 76.7%YTD

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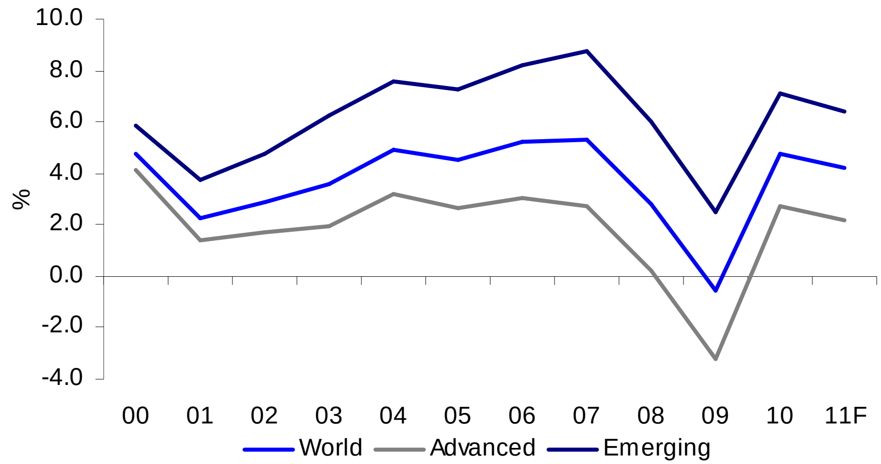
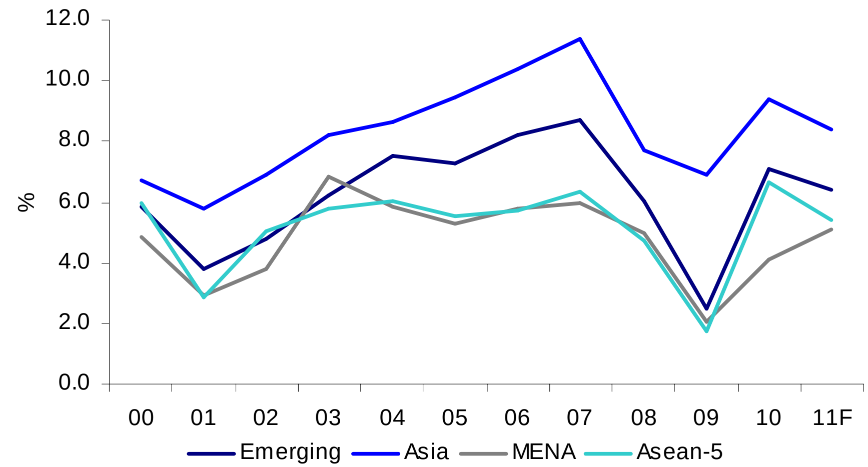
Source: Bloomberg

Emerging economies registered strong growth rates

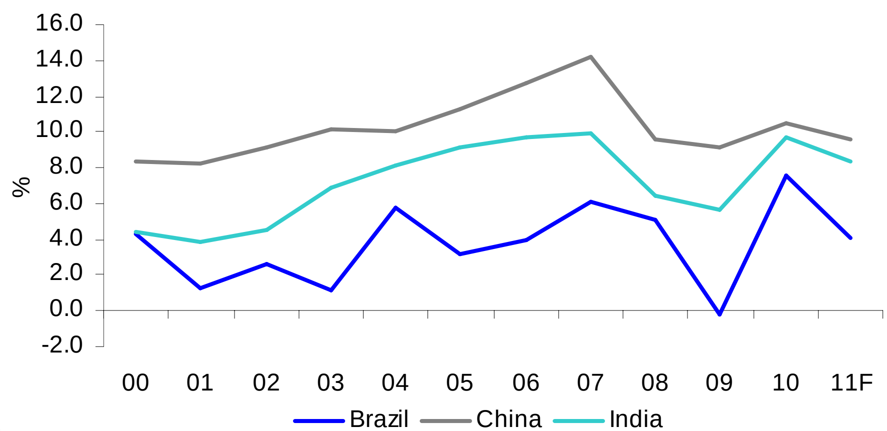
GDP by region (2000-2011F)



Emerging economies GDP (2000-2011F)



Brazil, China & India GDP growth (2000-2011F)

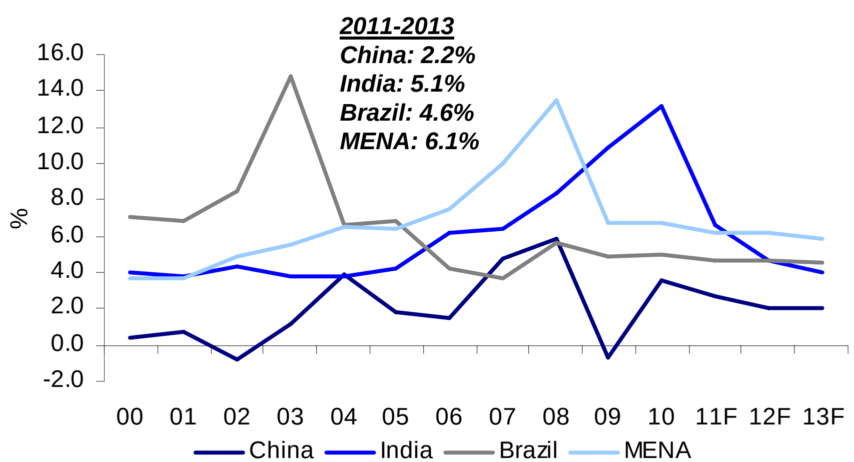


- ✓ Global economic growth will be driven by emerging economies this year, namely Asia Pacific (8.4%) and GCC (4.6%)
- ✓ Growth drivers: high commodity prices, strong private consumption and huge infrastructure spending plans
- ✓ 2011 GDP growth projections: China at 9.6% in 2011 (2010: 10.3%), India at 8.4% (2010: 9.7%), SEA at 5.5%, Brazil at 4.5%
- ✓ Risks: political unrests in the MENA region, rising inflationary pressures

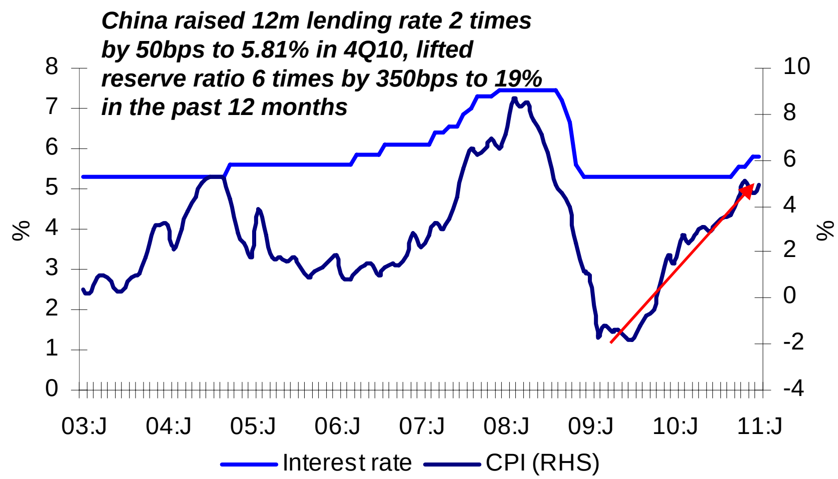
Source: IMF, Bloomberg, KFHR

Inflation is accelerating at a 6% pace in emerging economies vs. 2% in developed nations

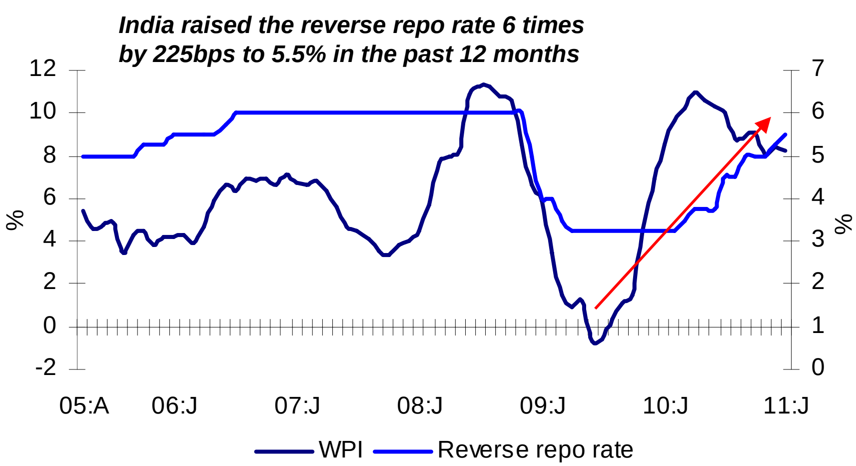
Emerging economies inflation (2000-2013F)



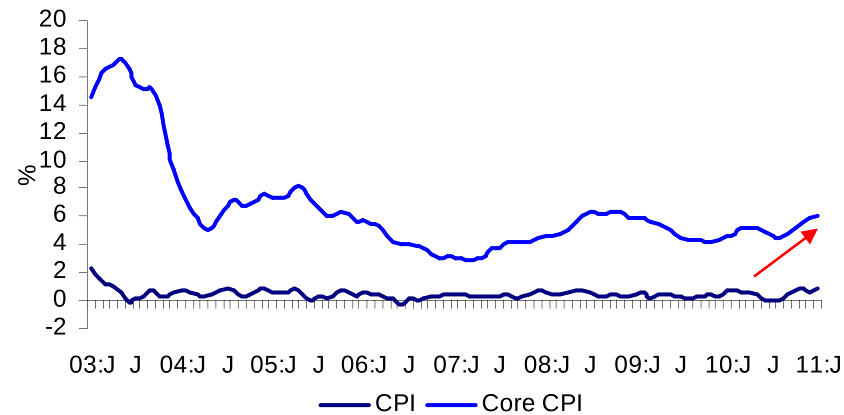
China CPI vs. interest rates (2003-2011)



India WPI vs. interest rates (2005-2011)



Brazil inflation trends (2003-2010)



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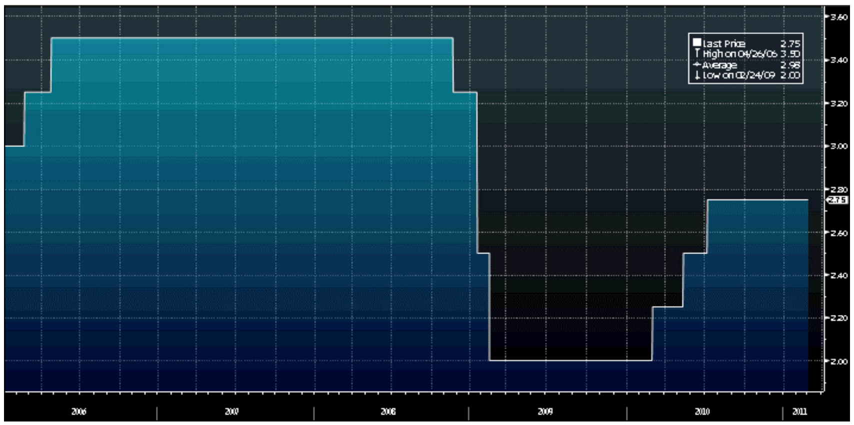
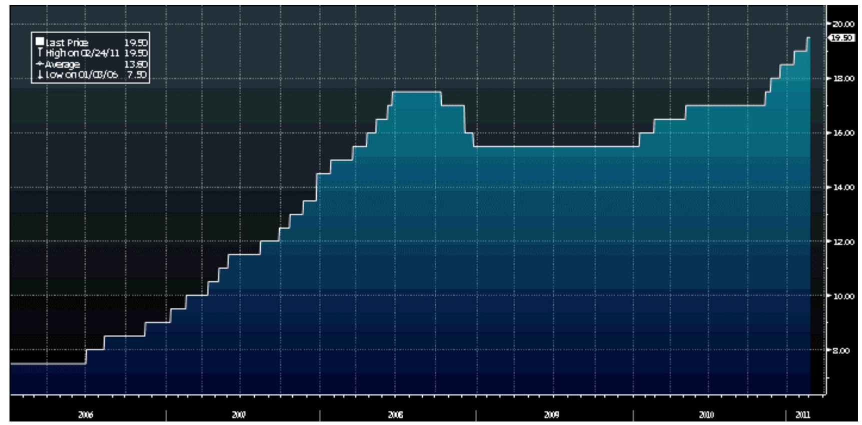
Source: IMF, Bloomberg, KFHR

Central banks raise rates to fight inflation

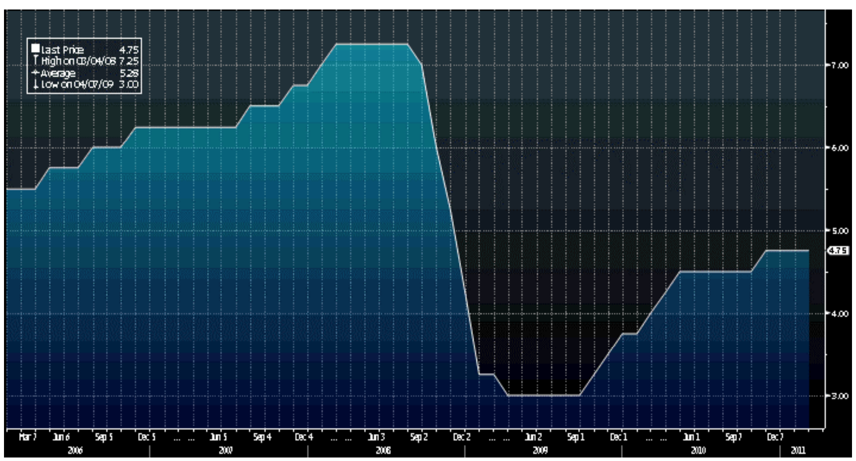
Malaysia's Overnight Policy Rate (2006-Feb 2011)



China's reserve requirement ratio (2006-Feb 2011)



Australia's target interest rate (2006-Feb 2011)



- ✓ Australia was the first country in Asia Pacific to raise interest rates, 4 times since Dec 2009, from 3.0% to 4.75%
- ✓ China raised 12m lending rate 2 times by 50bps to 5.81% in 4Q10, lifted reserve ratio 6 times by 350bps to 19% in the past 12 months
- ✓ India raised the reverse repo rate 6 times by 225bps to 5.5% in the past 12 months
- ✓ Malaysia raised the OPR 3 times since Feb 2010, by 75bps to 2.75%

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Source: Bloomberg

Huge capital inflows into emerging economies post challenges in monetary policy management

ASX 200 Index (2006-2 Mar 2011)

Shanghai Composite Index (2006-2 Mar 2011)

BSE Sensex Index (2006-2 Mar 2011)

Hang Seng Index (2006-2 Mar 2012)

Source: Bloomberg

Currency appreciation for Asia Pacific and emerging and economies

China's yuan/ USD (2006-2 Mar 2011)

Australia's AUD/ USD (2006-2 Mar 2011)

Brazil's real/ USD (2006-2 Mar 2011)

- ✓ China's yuan has strengthened 4.23% since mid-2008 to 6.5750/USD
- ✓ AUD has reached parity vs. USD
- ✓ South Africa's rand appreciated by 44% vs. USD in the past 2 years
- ✓ Ringgit appreciated 10.4% to 3.0350/USD in the past 12 months
- ✓ South Africa and Indonesia highlighted that stronger currencies may quell rising prices. Russia favours a "very flexible" exchange rate

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Source: Bloomberg

Conclusion

✓ Despite the aggressive fiscal stimuli provided by central banks around the world since the beginning of 2009, private expenditure has not picked up, and economic recovery remains fragile and uneven in the US and Euro region

✓ While bond yields and mortgage rates are at record lows, credit growth in the US remains very subdued

✓ We think further lowering of interest rates (via QE2) would do little to stimulate demand, due to the still high unemployment and weak housing market in the US. Consumers continue to deleverage by paying down debt. While QE2 improved sentiments temporarily, it is unlikely to pull the US economy out of its current lacklustre economic cycle

✓ In contrast, QE has caused its own share of side effects which include:

- Further established USD as a funding currency for carry trades
- Global markets rallied, as lower bond yields make equities and other risky assets relatively attractive
- QE caused a decline in USD, forcing emerging economies policymakers to intervene in the forex markets

✓ Emerging economies are forced to trace the Fed's decision of monetary easing to prevent unwanted currency appreciation i.e. an "international currency war" with emerging economies trying to avoid the appreciation of their currencies in order to support the growth of exports in a challenging global economic environment

✓ The search for yield, growth and inflation protection is likely to continue

Source: IMF, KFHR

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International Islamic Finance Forum
April 2009

"Best Islamic Research Company"
Islamic Finance News Awards Poll 2008
January 2009

"Best Islamic Finance Research House"
The Asset Triple A Islamic Finance Awards
2009

"Best Research in Islamic Finance"
Master of Islamic Funds Award
November 2007

"New Provider for Islamic Finance Research"
5th KLIFF Islamic Finance Awards
November 2008

"Best Islamic Research Company"
Islamic Finance News Awards Poll 2009
January 2010

"Outstanding Contribution to Islamic Finance"
Failaka-Amanie Symposium, Dubai
April 2010

"Best Islamic Finance Research House"
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2010

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