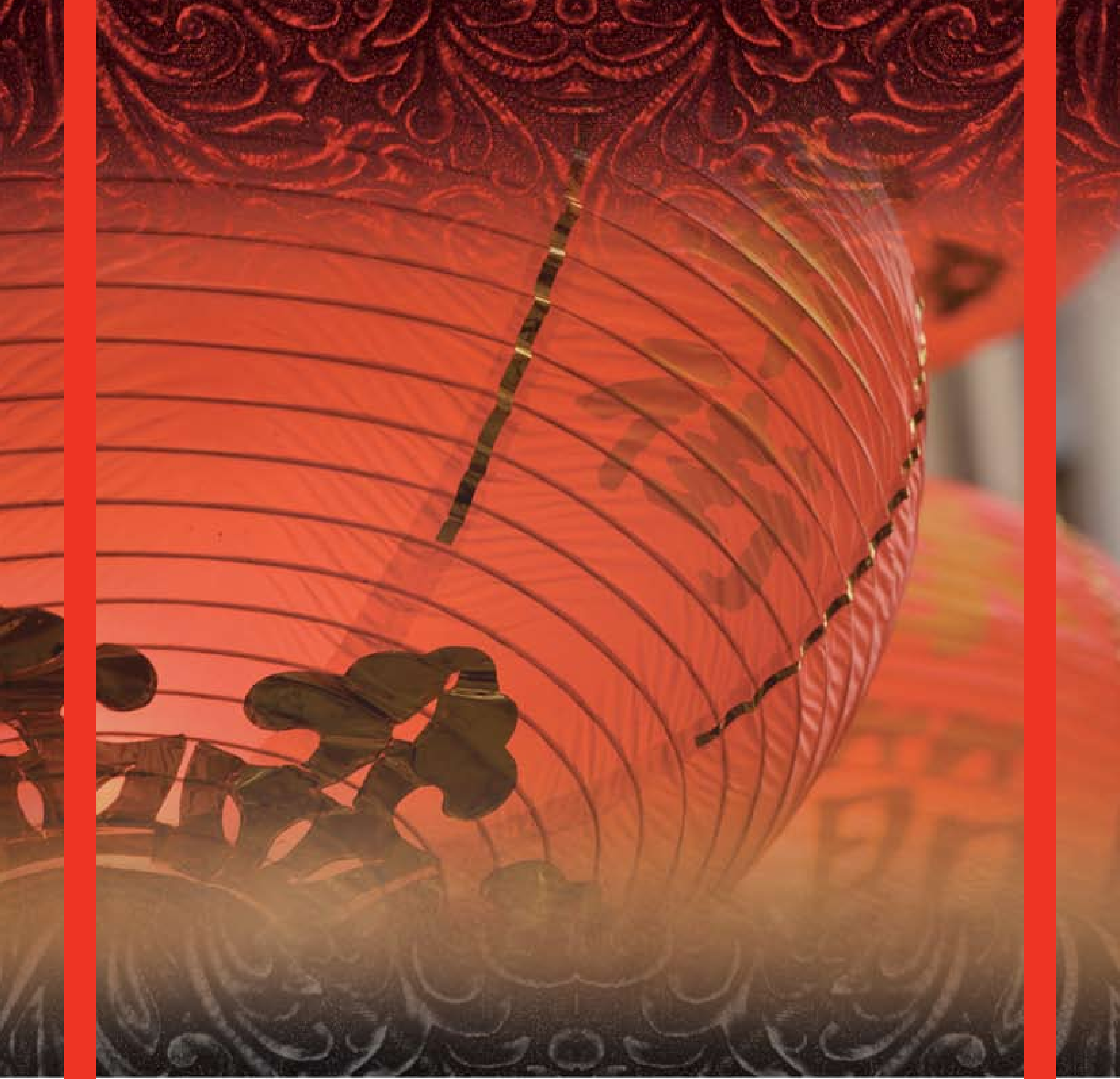
HSBC Emerging Markets Index Q4 2009



HSBC

The world's local bank

Stephen King

Emerging market growth accelerates in Q4 to strongest since late 2007

07 January 2010

China continues to play pivotal role in leading global economic recovery

While the Western nations are still struggling to post a meaningful economic recovery, the emerging economies are going from strength to strength. Our latest Emerging Markets Index, complied by Markit, provides further evidence of a robust recovery in economic activity in the emerging world. In the final quarter of 2009, the overall output index rose to 56.1, up from 55.3 in the third quarter and a trough of 43.8 a year ago. This is the strongest reading since late 2007.

These latest gains offer yet more support to our long-held view that the global economic recovery is crucially-dependent on the health or otherwise of the emerging nations. In the West, the majority of economies are still in intensive care, unable to deliver any degree of self-sustaining momentum. For the emerging world, it's a different story: employment is picking up, the order backlog is on the rise, exports have bounced back and business expectations in the service sector are increasingly positive.

What are the secrets of emerging market success? Part of the story, undoubtedly, is the increasingly-pivotal role of China in the world economy. HSBC now expects GDP in China to expand at a 9.5% rate in 2010 after an 8.5% gain in 2009. For an economy long thought to be ultimately dependent on US consumer demand, this is a remarkable result.

China has clearly benefited from an enormous domestic stimulus in the form of easy credit and heavy infrastructure spending. Admittedly, not all of this will be sustained. The latest data, however, suggest that China's expansion is gradually becoming more broadly based. This is hardly surprising. China continues to offer some of the lowest labour costs in the world. The renewed rebound in Chinese exports says more about the super-competitive nature of Chinese industry, and its rising share of world trade, than it does about any serious recovery in consumer demand in the Western world.

China's rebound has triggered a substantial further increase in the quantity of inputs purchased by Chinese manufacturers, triggering higher global commodity prices. This process has turned the world economy on its head. Previous economic downswings in the Western world were typically associated with collapsing commodity prices, hitting the export earnings of emerging nations. The result was often a nasty collapse in activity within the emerging world. The most obvious example is undoubtedly the Latin American debt crisis between 1982 and 1984.

China's strength has greatly reduced the risks faced by other

emerging nations in the light of Western recession. While commodity prices have dropped from the heights reached in 2008, they are, for the most part, still remarkably high compared with levels seen earlier in the decade. Their buoyancy has a lot to do with China's economic development. With relatively low per capita incomes, incremental Chinese growth is much more commodity-intensive than is growth in the service-dominated Western world. A swing in the source of global growth away from the West and towards China will, other things equal, keep commodity prices elevated, thereby bolstering the export earnings of other emerging nations. This process also supports so-called "south-south" trade within the emerging world.

The latest EMI readings are remarkably consistent with a China-centric world economy. The evidence of a broad-based recovery in economic activity across the emerging nations has been accompanied by a return of price pressures. Both input and output prices are on the rise, although the recovery in input prices – raw materials of one sort or another – has been far more extensive. Price gains have little to do with economic growth in the Western world: economic activity in North America and Western Europe fell off a cliff in the second half of 2008 and the first half of 2009. Even with some modest signs of recovery in recent months, it's near-enough impossible to argue that the rise in commodity prices is being driven by the West, other than via the indirect impact of very low interest rates.

In truth, commodity price gains have made life a lot more difficult for Western economies. An old-fashioned commodity price collapse was a neat way for Western nations to export their pain to countries elsewhere in the world. This mechanism no longer works. By supporting commodity prices, China's success provides a degree of economic insulation for other emerging nations. Higher raw materials prices, in turn, make a Western economic recovery that much more difficult by eating away at spending power in Western commodity-importing nations.

For policymakers in the emerging world, there are a number of key "takeaways" from the fourth quarter 2009 release. Although the results are mostly positive, the rate of improvement in economic activity has slowed relative to the more robust gains seen earlier in 2009. Frankly, this is not surprising: the initial bounce from an economic trough often overstates the underlying pace of economic growth.

This is not just a story about a lack of demand. There is also, it seems, a lack of supply, reflected in rising order backlogs and higher prices. Unlike countries in the developed world, many emerging nations suffered only modest losses in economic activity during the crisis. In many cases, these losses have now been reversed. Rapid gains in demand, allied with relatively-inelastic supply, are now beginning to translate into higher inflation pressures.

It's unlikely that higher inflation will prove to be a major short-term threat but the latest EMI survey suggests that price pressures need to be monitored closely. After all, only two years ago, many emerging nations found themselves needing to cope with the reality of much higher food prices, a key part of the inflation process. Attempts by individual nations to insulate their people from rising food prices led to heightened international tensions and growing protectionist pressures. Inflation is an economic evil for lots of different reasons but, in the emerging world, the biggest concern is inflation's impact on the distribution of income, with the poorest in society suffering the most.

Rising inflationary pressures will also re-open policy dilemmas which, during the earlier slump, had faded from view. With US interest rates very low, capital is likely to flow out of the US and into the emerging nations. Rapid exchange rate appreciation is one obvious response but, for commodity-producing nations, this can all-too-easily destroy competitiveness in other, non-commodity-producing, industries, even if inflation is brought to heel. Another response would be to raise interest rates behind a barricade of capital controls, in an attempt to tighten domestic monetary conditions without having to accept a substantial exchange rate increase. A third response would simply be to reduce inflation via fiscal policy, through tax increases, public spending cuts, or subsidies on life's necessities. None of these options is ideal. Policy uncertainties are, therefore, likely to persist in the months to come. In the meantime, the emerging nations continue to be in the driving seat of the global economy.

Stephen King
Group Chief Economist

HSBC Emerging Markets Index

Emerging market growth hits two-year high in Q4.

Key findings:

- Output and new orders rose in Q4 at fastest rates since late 2007.
- Exports show largest gain for nearly five years as global trade revives.
- Employment expands to meet rising backlogs.
- Prices rise in line with stronger demand.

Recovery gains strength as output growth hits two-year high

The HSBC Emerging Markets Index (EMI) rose to 56.1 in Q4 from 55.3 in Q3, signalling the strongest quarterly increase in emerging market manufacturing and services output since the final quarter of 2007. The index has exceeded 50.0 (indicating an expansion of output) in each of the past three quarters, with the rate of increase accelerating over this period as the recovery from the contractions seen around the turn of the year continued. However, the 0.8 index-points gain in the EMI in Q4 was considerably weaker than the 4.6 rise seen in Q3, suggesting some moderation in the speed at which the recovery process accelerated during the final quarter of 2009.

The EMI is based on 19 manufacturing and service sector PMI (Purchasing Managers' Index) surveys conducted across 14 emerging markets to provide the earliest and most reliable indication of economic trends.

The headline "EMI" series tracks changes in output and is complemented by a series of sub-indices, which show that the improved output trend has been driven by rising demand and exports. Firms have also taken on additional staff in response to an unprecedented rise in backlogs of work. Price pressures have meanwhile developed alongside the pick up in demand: the survey data show an increase in prices charged for goods and services, with rates often raised to offset higher input costs.

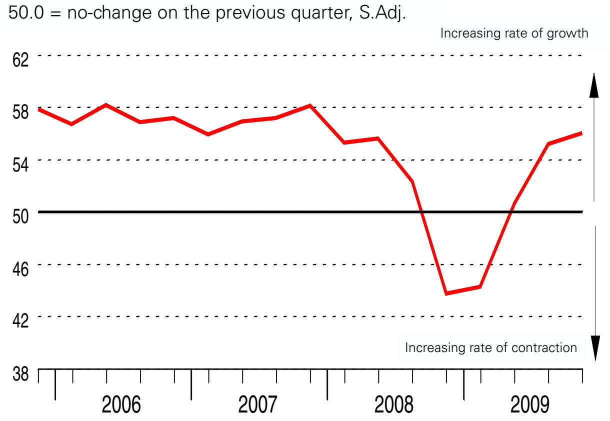
Broad-based upturn across manufacturing and services

The upturn was broad-based across both emerging market services and manufacturing, although the latter reported the faster rate of increase. Manufacturers saw the strongest growth of both output and new orders for two years – with exports showing the largest quarterly gain for nearly five years – while growth of services activity was the best since Q2 2008.

However, the rate of expansion of service sector activity improved only marginally on that seen in Q3, and incoming new business in the service sector rose at a fractionally weaker rate than Q3. This suggests a very slight loss of momentum, but it should be noted that services have had less ground to recover in terms of business levels, having experienced a shallower recession than manufacturing. Looking at the four largest countries in the emerging world, China continued to report the fastest growth in Q4, despite registering a slower rate of

EMI (all-sector output)

50.0 = no-change on the previous quarter, S.Adj.



BRIC (all-sector output)

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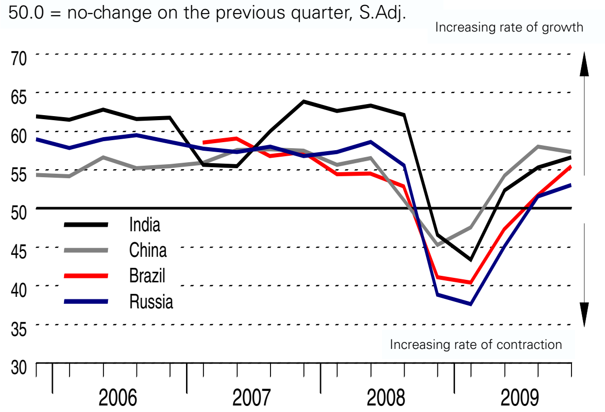

expansion since Q3. This reflected an easing of service sector growth. Chinese manufacturing output, in contrast, accelerated to hit a near-record high. India saw only slightly weaker growth than China as, like Brazil and Russia, growth accelerated in Q4. Russia posted the weakest growth but nonetheless registered its largest rise in overall activity since Q3 2008.

Employment growth gathers pace

Emerging market employment increased for the second successive quarter, with the rate of job creation rising to a two-year high in Q4. Manufacturers reported a stronger increase in employment than services, but had also seen far greater job shedding during the downturn earlier in the year. While services saw the largest rise in employment since Q3 2008, the increase in manufacturing was the fastest for five-and-a-half years.

China led employment growth, with job creation reaching a record high, followed by Brazil. A more modest rise was seen in India. In contrast, employment continued to fall in Russia, highlighting the extent to which Russia and other central (and eastern) European countries, such as Poland and the Czech Republic are lagging behind in the global recovery.

Employment growth reflected the need to expand capacity in line with rising demand. This shortfall of capacity was indicated by outstanding business posting the first noteworthy increase in the series history, rising – albeit modestly – for the first time in two years. The increase in backlogs was largely focused on the manufacturing sector, and was particularly evident in China.

Capacity constraints were also signalled by a lengthening of supplier delivery times in Q4, with longer lead-times attributed to a combination of rising demand (purchasing of raw materials by emerging market manufacturers rose at the fastest rate for two years) and low inventory levels at suppliers.

Output prices rise as firms pass on higher costs

Inflationary pressures continued to build in Q4, in part reflecting improved pricing power of suppliers amid rising demand for goods and services. Input costs rose at the steepest rate for five quarters, led by higher raw material prices in the manufacturing sector. Subsequently, firms sought to pass on higher costs to customers, causing charges to increase at the fastest rate for over a year. However, the rise was only modest due to intense competition and price-conscious customers.

Outlook improves

The survey also paints an encouraging picture of prospects for 2010. In manufacturing, the ratio of new orders to unsold inventory rose to a near-record high, suggesting output will need to continue to rise to satisfy demand. Meanwhile, service sector companies' expectations about the coming year improved to show the highest optimism for a year-and-a-half.

Orders and exports

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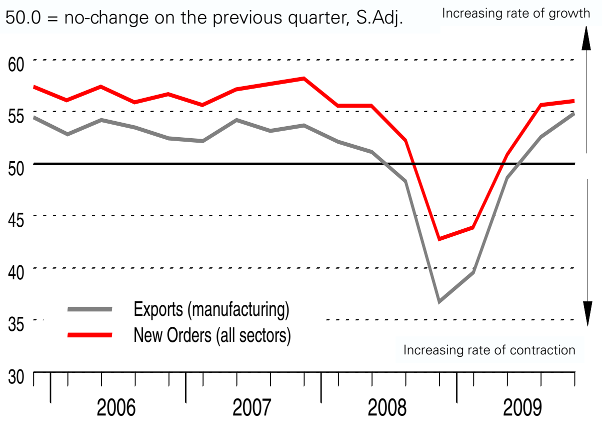

Employment and backlogs of work

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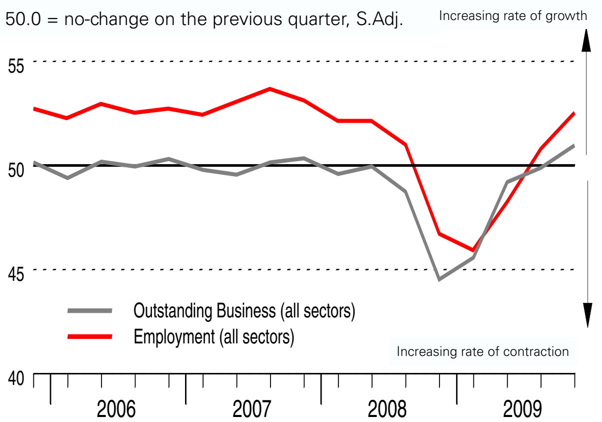

Input and output prices

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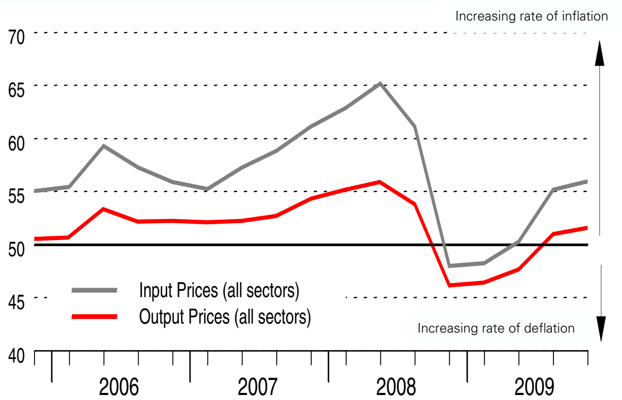

Output

Output growth hits two-year high.

The combined output of emerging market manufacturing and services rose at the fastest pace for two years in Q4. The latest improvement constitutes a further recovery of output from the steep declines recorded in Q4 2008 and Q1 2009, with output having now risen for three consecutive quarters.

Manufacturing output expanded at the fastest rate for two years, outpacing growth of services activity by a modest margin. Services grew at the steepest rate since Q2 2008. Of the largest emerging nations, China recorded the strongest increase in output (despite being among only a small number of emerging countries to see slower growth than Q3), followed closely by India and Brazil. Russia also saw output growth accelerate but again, like other central and eastern European countries, at a relatively modest pace.

Output by sector

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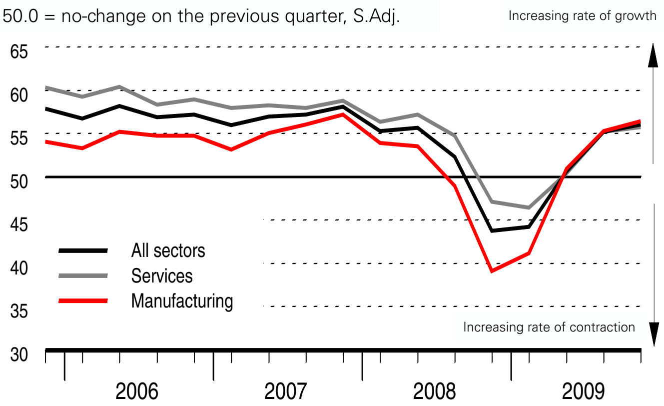

Output in BRIC countries (all sectors)

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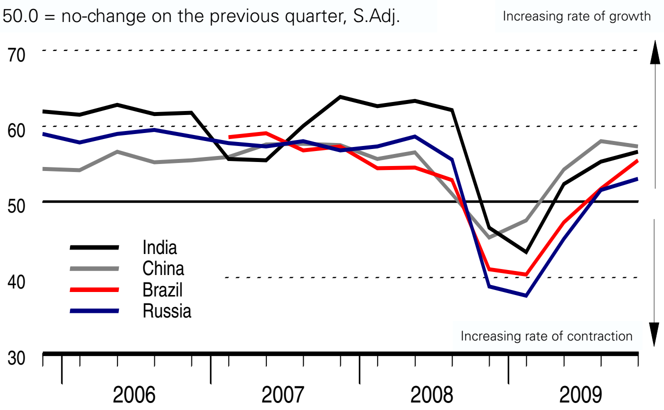

New Business

Growth of new orders gains further traction in Q4, led by manufacturing.

Growth of new orders across emerging markets gathered further momentum in Q4, with the rate of expansion increasing slightly on that seen in Q3 to reach a two-year peak. Manufacturers saw growth of new orders accelerate compared to Q3, while growth of service sector new business eased marginally. Nevertheless, both sectors recorded robust rates of expansion, signalling a broad-based upturn in demand.

All countries saw a rise in new orders in Q4. Looking at the largest emerging nations, China recorded the fastest rate of increase, although a survey–record rate of manufacturing order book expansion was partly offset by slower growth of services. Brazil and India also saw robust growth of demand, with the rate of expansion accelerating on Q3 in both cases. In stark contrast, only a weak rise was again seen in Russia.

New business by sector

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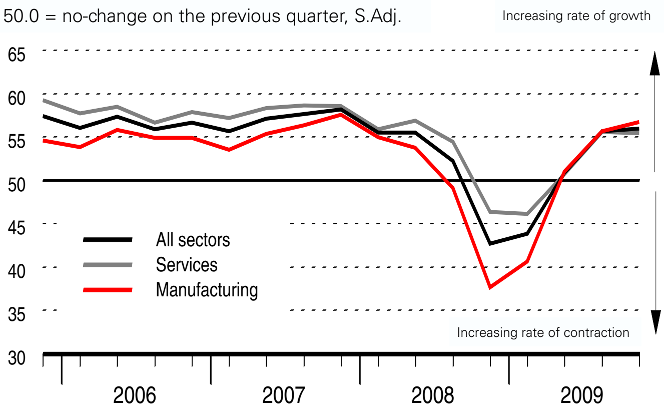

New business in BRIC countries (all sectors)

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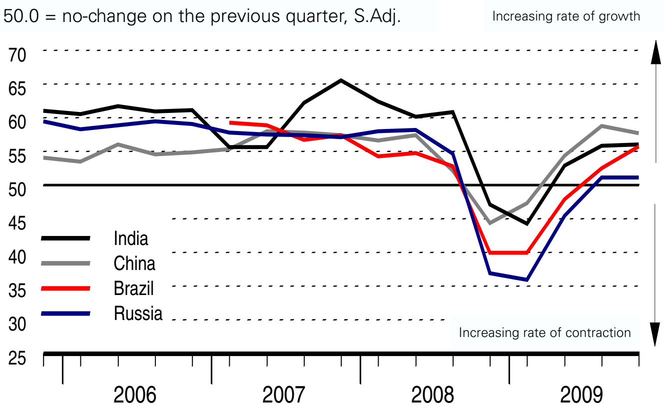

Outstanding Business

Backlogs show largest rise in series history.

Backlogs of work rose in Q4, registering the only noteworthy increase in the series history. The increase – although still only modest – represents a considerable turnaround since the start of the year, when backlogs were falling sharply. The amount of outstanding work rose in Q4 largely as a result of companies being unable to adjust output to match the increase in demand, especially in manufacturing.

Manufacturers reported the second successive quarterly rise in backlogs, with the rate of increase rising to the fastest since Q1 2005. Taiwan, China and Brazil reported particularly large increases. Service sector backlogs fell in Q4, but only at a marginal rate that was the slowest since Q1 2007. A rise in service sector backlogs in India was countered by slight falls in China and Brazil and a larger decline in Russia.

Outstanding business by sector

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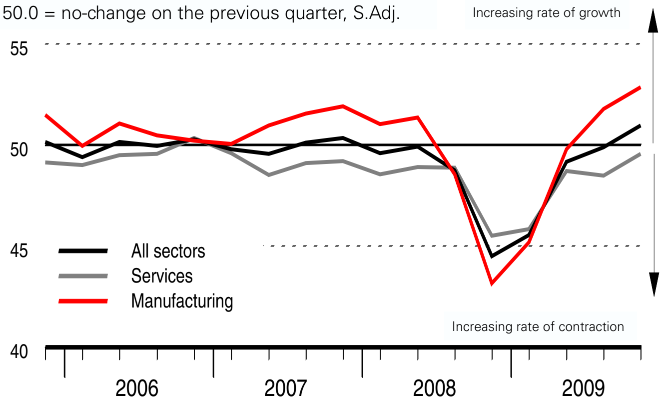

Outstanding business in BRIC countries (all sectors)

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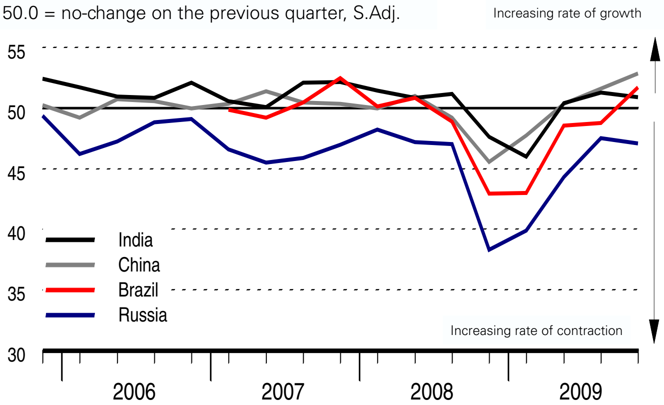

Employment

Job creation strongest for two years.

Emerging market employment rose for the second quarter running in Q4, with the rate of job creation building on the modest pace seen in Q3 to hit a two-year peak.

Manufacturing jobs were created at a slightly faster rate than service sector positions, the former seeing the strongest gain since Q2 2004 while service sector companies reported the largest rise since Q3 2008.

Data signalled that China reported the fastest employment growth of the major emerging market nations, registering a survey record high, followed by Brazil. India reported more modest growth (though still saw the best gain in over a year). However, a further fall was recorded in Russia, albeit the smallest since job shedding began in the final quarter of 2008.

Employment by sector

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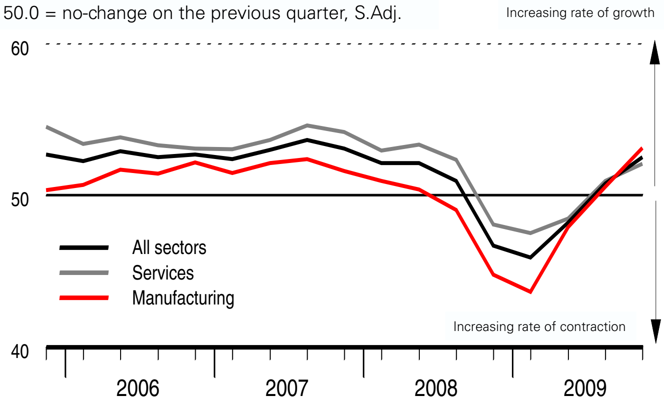

Employment in BRIC countries (all sectors)

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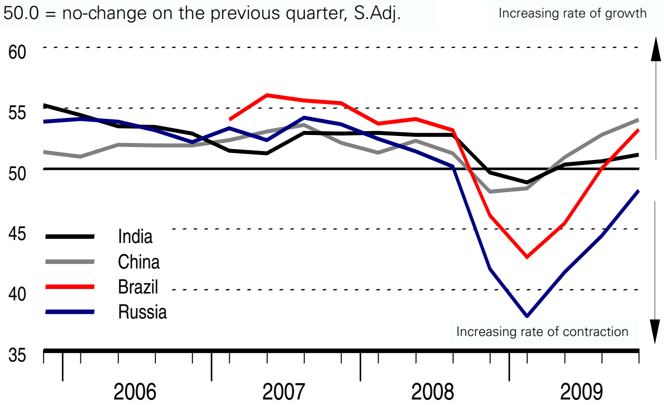

Input Prices

Input cost inflation gathers pace in Q4.

Average input costs in emerging manufacturing and service sectors rose in Q4 at the fastest rate since Q3 2008. Inflation has gathered pace throughout the second half of the year, reflecting rising commodity prices (notably oil) and improved pricing power among suppliers of both goods and services as demand has picked up.

Manufacturers' input prices rose particularly steeply in Q4, increasing at the fastest pace for five quarters. Service sector costs (which include wages and salaries as well as bought-in goods and services, fuel, rents and utilities) rose at a far more modest pace than manufacturing raw material prices (a rate unchanged on Q3), held down in part by low wage inflation.

Of the big-four emerging nations, costs rose most sharply in China and Russia while India saw the weakest rise.

Input prices by sector

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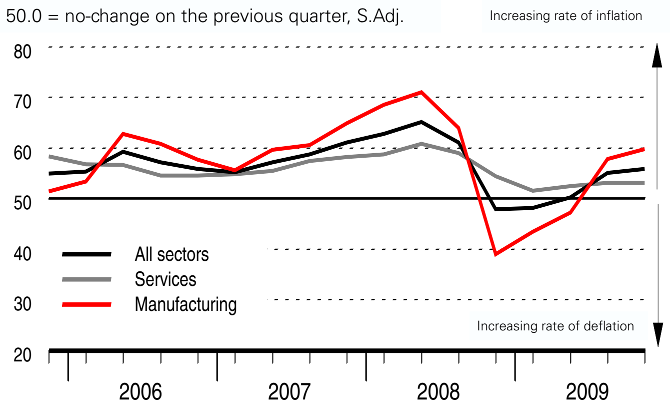

Input prices in BRIC countries (all sectors)

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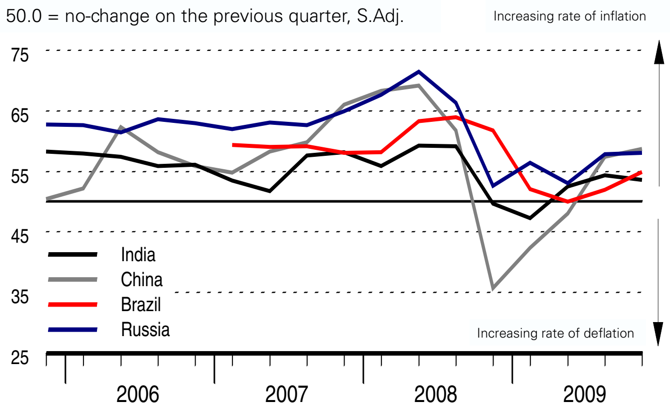

Output Prices

Prices charged rise to help offset increased costs.

Average prices charged rose for the second quarter in a row in Q4. The rise was only modest but was nonetheless the strongest since Q3 2008. This points to a further revival of pricing power, which had been severely eroded by weak demand earlier in the year, and it also reflects the need to pass on higher costs to customers, notably in manufacturing.

Manufacturers again reported a stronger rate of increase than service providers as prices were raised to compensate for higher raw material costs. However, the rate of inflation remained below that seen in mid-2008. Service charges rose only marginally in Q4, constrained by intense competition.

Of the largest emerging countries, China reported the strongest rise in charges for goods and services, with only very modest increases seen in the other countries.

Output prices by sector

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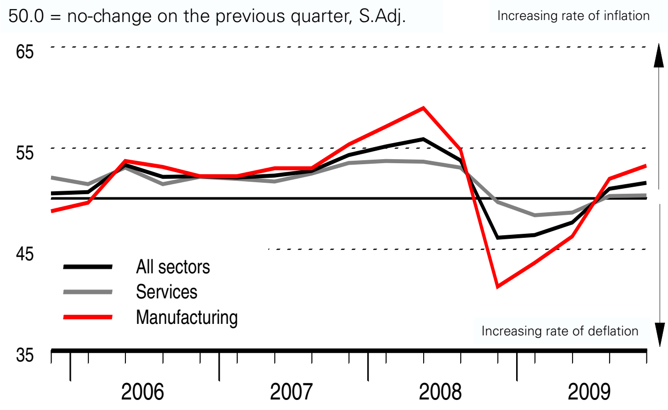

Output prices in BRIC countries (all sectors)

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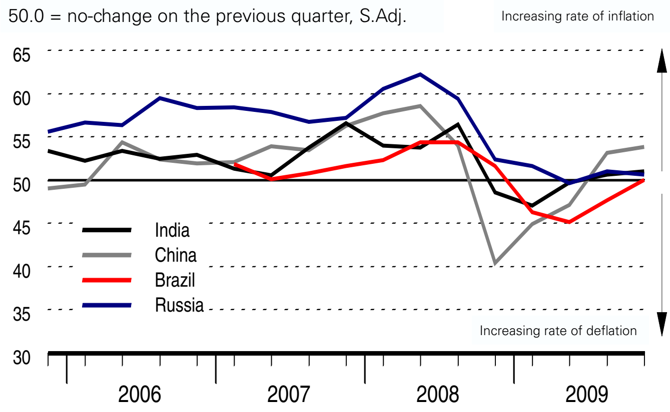


New Export Orders

Export revival gathers momentum in Q4.

Manufacturing exports rose for the second successive quarter in Q4, staging a further recovery from the declines seen throughout the second half of 2008 and the first half of 2009. The latest increase in new export orders was the largest since Q1 2005, signalling a strong revival in emerging market trade flows.

Of the major emerging market nations, China saw the largest rise, with new export orders rising at the fastest pace since Q3 2004, followed by India, which posted the strongest increase for over a year. Only a marginal increase was reported by Brazilian manufacturers, though this represented the first improvement for two years. In contrast, Russian exports continued to fall, albeit at the slowest pace for over a year.

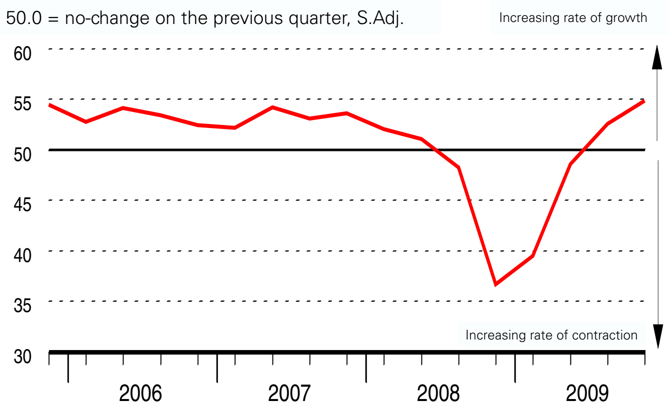
Quantity of Purchases

Purchasing activity growth near survey high in Q4.

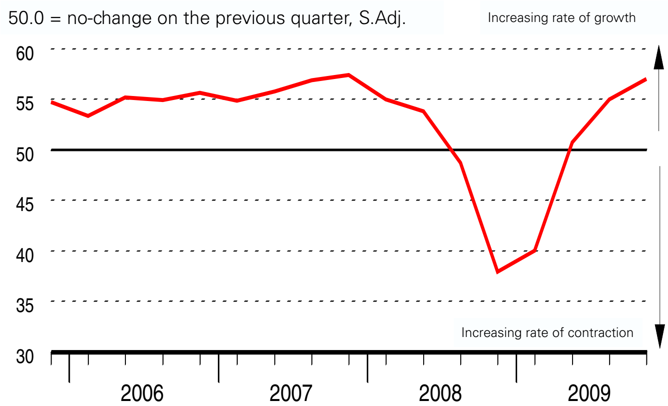
Manufacturers' purchases of inputs – including both commodities and manufactured inputs – rose strongly in Q4, up for the third consecutive quarter and showing one of the largest quarterly increases recorded by the survey. The rate of increase fell just short of the peak seen in the final quarter of 2007. Purchasing activity was raised to meet increased production needs and to rebuild depleted inventories, which had fallen sharply during the downturn.

All countries covered by the survey reported an increase in input buying by manufacturers, led by Taiwan and China, both of which saw increased rates of growth of purchasing (growth in China hit a series record high). Buying activity even returned to growth in the central and eastern European countries.

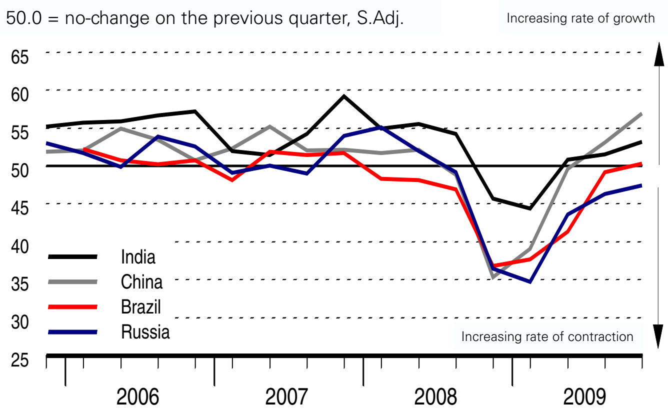
New export orders (manufacturing)



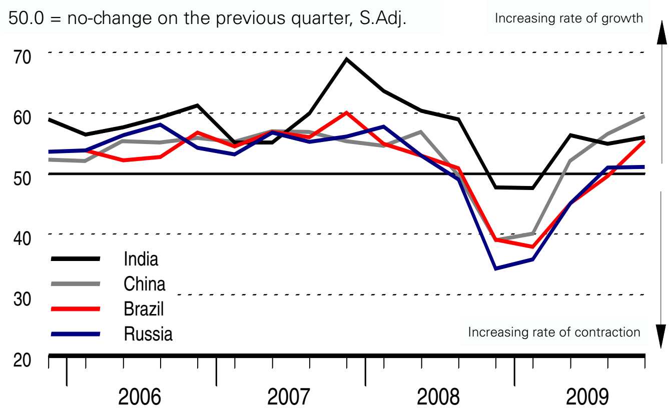
Quantity of purchases (manufacturing)



New export orders in BRIC countries (manufacturing)



Quantity of purchases in BRIC countries (manufacturing)



Stocks of Finished Goods

Finished goods stock kept low amid demand uncertainty.

Emerging market manufacturers' stocks of finished goods continued to decline in Q4, dropping at a pace similar to that seen in the previous two quarters but well below the survey record rate seen in Q1.

The widespread need to keep costs low encouraged manufacturing companies to keep inventory levels to a minimum, especially in the face of an uncertain outlook for demand.

However, the overall modest contraction of post-production inventories masked wide regional variations, with finished goods stock continuing to drop at a historically rapid pace in central and eastern Europe but falling much less severely in most Asian countries, with a marginal rise even reported in India.

Stocks of finished goods (manufacturing)

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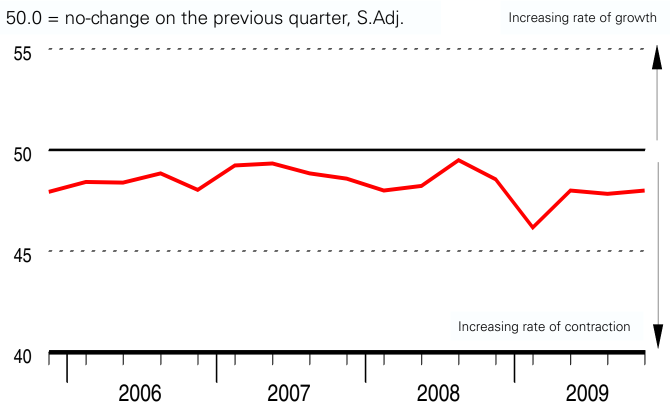

Stocks of finished goods in BRIC countries (manufacturing)

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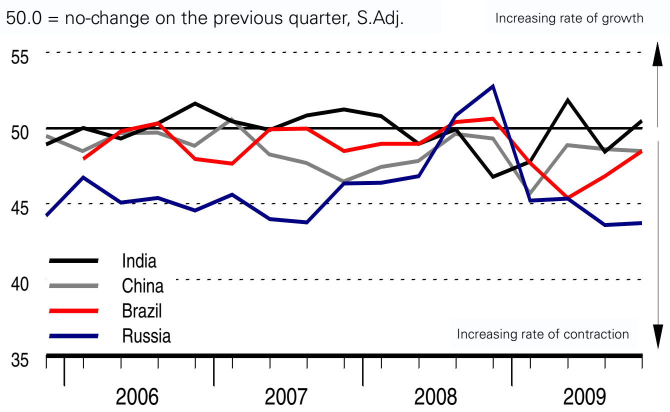

Stocks of Purchases

Stocks of purchases show smallest fall for two years.

Manufacturers' stocks of raw material purchases showed the smallest quarterly fall for two years in the final three months of 2009. At 49.2, the Index for Q4 was above the long-run average of the series (48.5) and signalled only a very modest cut in stock holdings.

Destocking peaked in Q1 amid widespread cost cutting, but has since eased sharply as the global recovery has progressed and order books have improved. Part of the drop in inventories in Q4 may be attributed to poor availability of supply rather than deliberate stock reduction.

Raw material stocks generally continued to fall in central and eastern Europe but were either largely unchanged or rose in Asia. China saw stocks increase (marginally) for the first time in two-and-a-half years.

Stocks of purchases (manufacturing)

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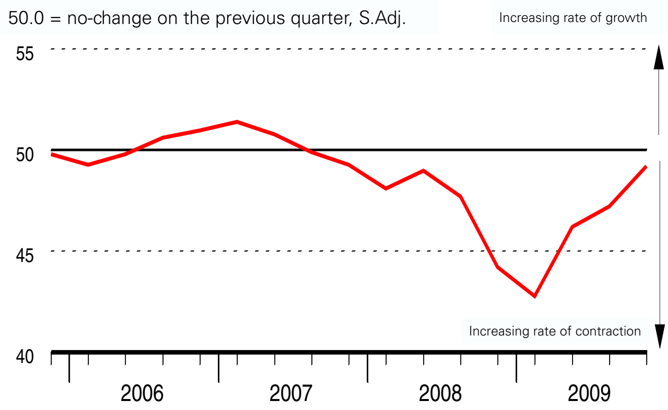

Stocks of purchases in BRIC countries (manufacturing)

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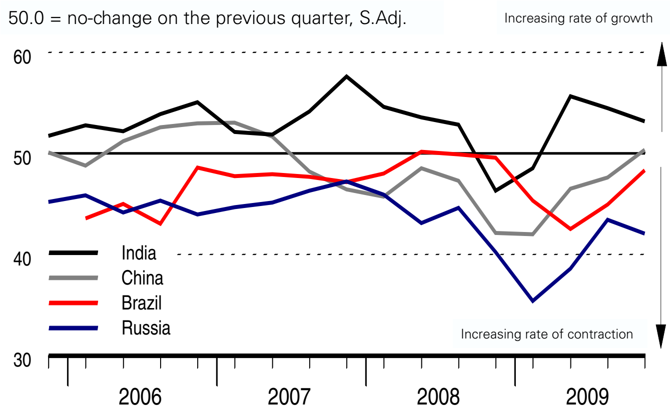

Suppliers' Delivery Times

Suppliers struggle to meet demand for raw materials in Q4.

Emerging market manufacturers reported that their average suppliers' delivery times lengthened for the second successive quarter in Q4. Prior to this period of slower lead times, average vendor performance had improved for three quarters in succession. The lengthening in Q4 was the greatest since Q3 of last year. Longer deliveries indicate the build up of capacity constraints, which have arisen due to the combination of rising demand for inputs from manufacturers and low inventory levels at suppliers.

Longer delivery times were widespread across the emerging world, occurring in Brazil, China, Russia, the Czech Republic, Poland and especially Taiwan, which saw by far the greatest lengthening of lead times of all countries surveyed.

Business Expectations

Service sector confidence recovers to pre-Lehman levels.

Optimism with regard to expected business activity levels in twelve months' time, asked only in the services PMI surveys, improved in Q4, rising to the most buoyant since the second quarter of last year, and therefore recovering the ground lost since the collapse of Lehman Brothers. Confidence hit an all-time low in the final quarter of 2008 but has since improved markedly over the course of 2009.

Q4 data signalled that confidence rose further in Brazil and Russia (hitting near-two year and three-year highs respectively), but held steady in India and dipped slightly in China. However, in all four countries monitored by the survey, business confidence was well above the lows seen around the turn of the year.

Suppliers' delivery times (manufacturing)

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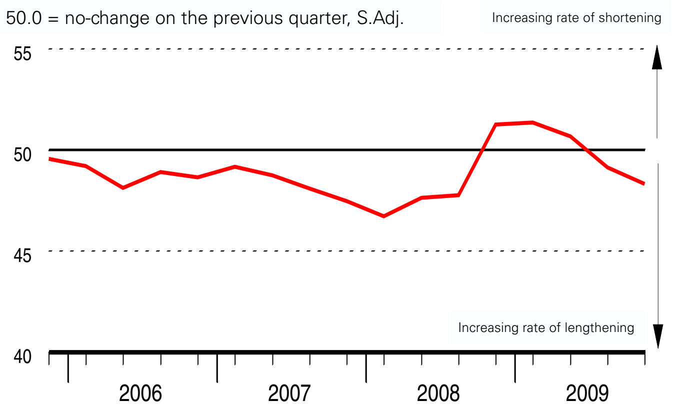
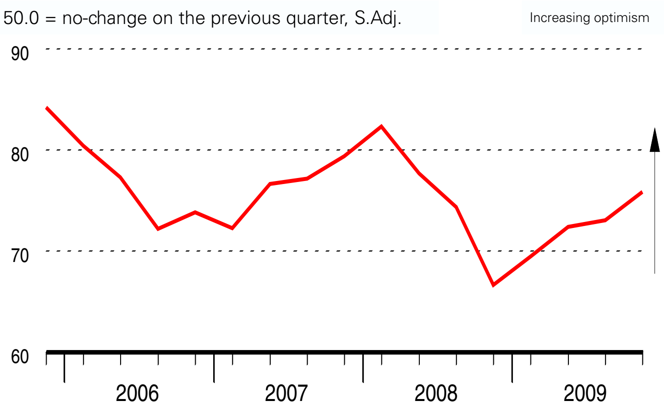


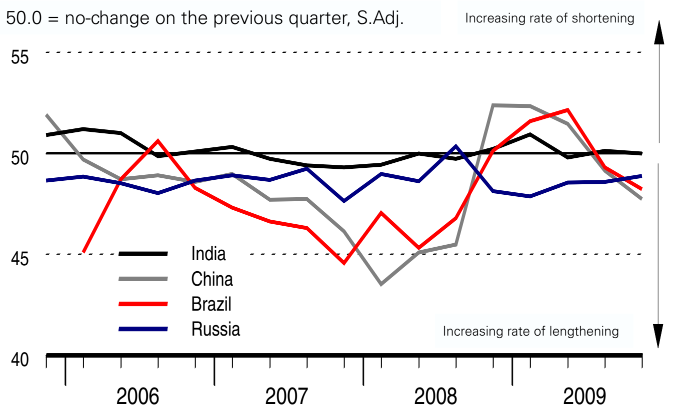
Business expectations (services)

50.0 = no-change on the previous quarter, S.Adj.



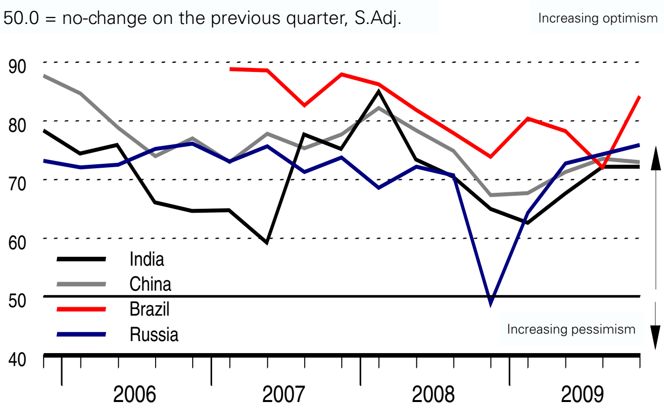
Suppliers' delivery times in BRIC countries (manufacturing)

50.0 = no-change on the previous quarter, S.Adj.



Business expectations in BRIC countries (services)

50.0 = no-change on the previous quarter, S.Adj.



Background Information

The Survey

The HSBC Emerging Markets Index (EMI) is a weighted composite indicator derived from national Purchasing Managers' Index (PMI) surveys in the emerging markets of Czech Republic, Hong Kong, Israel, Mexico, Poland, Singapore, South Africa, South Korea, Taiwan, Turkey and the increasingly important BRIC economies of Brazil, Russia, India and China. These surveys collectively track business conditions in over 5,000 reporting companies.

The Purchasing Managers' Index (PMI) surveys on which the EMI is based have become the most closely-watched business surveys in the world, with an unmatched reputation for accurately anticipating official data. The survey data are collected using identical methods in all countries, with survey panels stratified geographically and by International Standard Industrial Classification (ISIC) group, based on contributions to GDP.

Survey responses reflect the change, if any, in the current month compared to the previous month based on data collected mid-month. For each of the indicators, a 'diffusion' index is produced, which reflects the percentage of positive responses plus a half of those responding 'the same'. Diffusion indexes have the properties of leading indicators and are convenient summary measures showing the prevailing direction of change. An index reading above 50 indicates an overall increase in that variable, below 50 an overall decrease. All data are seasonally adjusted.

Data collected at the national level for manufacturing and services are then weighted together according to relative contributions to national or regional GDP to produce indicators at the national whole economy or aggregate emerging market level.

Data Sources

Country/Region	Producer:
Brazil	Markit
Russia	Markit
India	Markit
China	Markit
South Korea	Markit
Taiwan	Markit
Hong Kong	Markit
South Africa	BER
Singapore	SIPMM
Israel	IPLMA
Turkey	Markit
Poland	Markit
Czech Republic	Markit
Mexico	IMEF/HSBC

HSBC

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For further information please visit www.hsbc.com

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About Markit Economics

Markit Economics is a specialist compiler of business surveys and economic indices, including the Purchasing Managers' Index (PMI) series, which is now available for 26 countries and key regions including the Eurozone and BRIC. The PMIs have become the most closely watched business surveys in the world, favoured by central banks, financial markets and business decision makers for their ability to provide up-to-date, accurate and often unique monthly indicators of economic trends.

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