HSBC Emerging Markets Index

Q4 2010

HSBC

The world's local bank

Stephen King

Uptick in emerging market growth but inflation provides sting in the tail

10 January 2011

Emerging nations re-accelerate

The HSBC Emerging Markets Index (EMI) for the fourth quarter of 2010 shows that economic growth in the emerging world accelerated at the end of last year following a temporary lull in the third quarter. Although not quite back to the highs recorded earlier in 2010, the Q4 reading of 55.7, up from 54.2 in the third quarter, confirms that the emerging nations continue to expand at a pace well ahead of the developed world.

The pick-up in activity was mostly associated with a broad-based rebound in manufacturing output, driven primarily by improvements in China, Israel, Poland and Turkey and helped along by big gains in new orders. There was also a welcome rebound in services activity in Russia although, for the most part, there was little change in the pace of growth in services activity in the quarter. Export activity showed modest signs of improvement but remained well down on the very elevated pace seen in the early stages of 2010.

Inflation is becoming a major worry

The sting in the tail comes from inflation. Not since the food and energy scares seen in the early months of 2008 have the cost and price components of the EMI risen to such worrying levels. Admittedly, input prices were rising more quickly than output prices in the fourth quarter, suggesting a squeeze on margins or wages or, alternatively, an offsetting improvement in productivity. There can be no doubt, however, that inflationary pressures are building rapidly. Whether policymakers in the emerging world can tame inflation is one of the big issues for investors to confront in 2011.

The contrast between the excessive buoyancy of the emerging world and the ongoing weakness of the developed world could not be starker. As Chinese and Indian inflation rates have risen, so US inflation rates have dropped. Can these divergent trends continue? And, if they do so, what are the implications for the global economy?

Those with debts and those without

To understand what's happening, it's worth starting with debt. There's too much of it in the West and, by past standards, not a lot of it in the emerging world. In a bid to kick-start their economies, Western policymakers have delivered increasingly unconventional policies, culminating with the Federal Reserve's decision to launch "QE2" (so-called quantitative easing via the purchase of Treasuries) in a bid to offer more monetary stimulus in a world of zero interest rates.

Yet, so far, the effects of this stimulus have been felt more in the debt-lite emerging world than in the debt-heavy developed world. With many emerging nations linking their currencies to the US dollar, monetary decisions reached by the Federal Reserve have both local and global consequences. And, because the emerging nations aren't facing the same debt headwinds, they have ended up expanding rapidly even as Western nations have licked their financial wounds.

Higher commodity prices

With the Federal Reserve busily printing dollars and the emerging nations growing so quickly, commodity prices have risen rapidly. Some commodities, particularly precious metals, are obvious hedges against a falling dollar. Others are in heavy demand in the emerging world – most obviously, China – reflecting rapid growth in nations with low per capita incomes which, inevitably, have big ambitions for infrastructure development. The hospitals, airports, roads, railways and bridges which, nowadays, are taken for granted in the developed world are still being built in the emerging world. And, as consumers in emerging nations begin to enjoy higher living standards, they gradually shift to meat- and dairy-based diets, thereby increasing the demand for grain (feeding humans via animals is a very inefficient process).

For the emerging nations, these developments are both a blessing and a curse. Many emerging nations are commodity producers: the more commodity prices rise, the higher export incomes become, leading in turn to a faster pace of economic growth. At the same time, with low average per capita incomes, rising food and energy prices lead to greater poverty and rising income inequality. The challenge, then, is to deliver a rapid pace of economic growth without letting inflation get out of control.

How to deal with overheating

One seemingly-attractive answer is to raise interest rates and disengage from the US dollar. Certainly, US policymakers are keen on this approach. Yet there are also significant risks. Brazil, for example, has allowed the real to appreciate significantly in recent years. Yet despite the theoretical benefits of a stronger currency – downward pressure on domestic costs and lower import prices – Brazilian inflation has been uncomfortably high. And the currency's strength has led to a significant loss in competitiveness for Brazilian manufacturing industry.

China also finds itself in a quandary. While a rise in the renminbi might temporarily alleviate domestic inflationary pressures, it would also lead to major losses in renmimbi terms on China's holdings of Treasuries and other US assets. And Japan's experience in the late-1980s – when huge gains in the value of the yen coincided with the build up of an unsustainable domestic bubble – has left many Chinese policymakers lukewarm about the benefits of currency appreciation.

So what else can emerging nations do? The alternatives to higher interest rates and currency appreciation are many and varied. At the macroeconomic level, tighter fiscal policy could be used to offset relatively loose monetary conditions. Yet this is precisely what many Asian nations delivered in the mid-1990s with mostly dismal results: although many countries ran budget surpluses, they nevertheless succumbed to financial excesses culminating in the Asian crisis of 1997 and 1998.

More likely, then, are policies designed to "throw sand in the works." If the US and other Western economies are engaged in quantitative easing, perhaps emerging nations can mop up the effects on their own economies with the use of "quantitative tightening". Already, policymakers are moving down this path. With its dollar peg, Hong Kong is countering monetary excess with raised collateral requirements for

property loans, thereby reducing the demand for credit. China, amongst others, is raising reserve requirements for banks in an attempt to limit the supply of credit. And many emerging nations are now either using, or thinking about, capital controls, the financial equivalents of dams designed to keep excess liquidity at bay. Indeed, in contrast to the 1990s, capital controls now have the IMF's blessing.

Admittedly, many of these policies are experimental and there is no way of knowing whether they will ultimately be successful. They are, however, a direct consequence of attempts by Western nations to fix their own problems by turning to the printing press. It is difficult to blame emerging nations for using unconventional policies when the West is playing the same game as well. Still, the emerging nations are, on the whole, in a happier position than Western nations: better to have a bit too much growth with a modest build up of inflationary pressures than to have too little growth, too much unemployment and the threat of outright deflation.

The long-term story

Although the EMI offers a reading only of current and near-future developments, it continues to highlight the relative outperformance of the emerging world. A reading of 50 for the composite index is consistent with GDP growth in the emerging world of around 5.5% whereas the equivalent reading for the developed world is consistent with stagnation. Put another way, the structural growth rate in the emerging world around which the EMI provides cyclical information is significantly higher than in the developed world. In a good year, developed economies might expand at a rate of 2.5% but emerging economies could easily expand at around 7.5%.

Part of this exceptionally rapid growth can be put down to "catch-up". After all, for much of the 20th Century, emerging nations often found themselves in the economic equivalent of the deep-freeze: with capital relatively immobile and many nations under the yoke of repressive regimes, it simply wasn't possible for them to flourish. With economic and political connections being re-established, emerging economies have been able to catch up for decades, even centuries, of lost (or denied) opportunities.

A new golden age?

But there is now more to this story. We have now entered a new phase of world trade growth in which emerging nations are increasingly trading with each other. This could potentially prove to be another economic "golden age", an emerging market version of the extended period of rapid growth seen in the developed world in the 1950s and 1960s, when tariffs fell and international trade blossomed. Even today, tariffs between emerging nations are still very high. If emerging nations can work together to remove these tariffs, we could witness an explosion of world trade on a truly momentous scale. With China increasingly trading with Brazil, India with the Middle East and Sub-Saharan Africa with China, the importance of the US consumer as a key influence on global economic activity would, over time, slowly decline.

Indeed, change is already under way. In 2000, at the peak of the technology bubble, developed nations contributed two-thirds of the 6% growth in investment spending. In 2010, of the likely 10% increase in investment spending, more than four-fifths will come from the emerging world, with China playing a dominant role. And although we don't yet have complete figures, it's likely that Chinese households contributed as much as US households to global consumer spending growth, a remarkable achievement given China's position just a decade ago. This is a true revolution, with the world economy undergoing a radical transformation.

Of course, plenty of things can go wrong. Higher food prices threaten the unedifying spectacle of "food wars" and a retreat into protectionism. Climate change is likely to disrupt water supplies and, hence, lead to food shortages in parts of the emerging world. Border conflicts in many parts of the emerging world have not been satisfactorily resolved. As emerging nations seek to increase their influence in other parts of the world – whether to gain access to raw materials or to take ownership of key assets – tensions with the developed world may increase. Rising income inequality could lead to internal political tensions.

For the time being, however, emerging nations are enjoying their place in the economic sun. And with the Emerging Market Index now confirming that the softening in the third quarter of 2010 was no more than a temporary lull, the chances of continued economic expansion remain high. The main near term threat comes from inflation. We shall, of course, be using the EMI to gauge whether policymakers succeed in bringing those inflationary pressures under control.

Stephen King

Group Chief Economist

HSBC Emerging Markets Index

Emerging market growth quickens in Q4 led by rebound in manufacturing. Price pressures intensify.

Key findings:
- Both emerging market output and new business rise at faster rates in Q4.
- Export order growth quickens but remains slower than Q1 peak.
- Input cost inflation hits two-and-half year high amid supply chain bottlenecks.
- Service sector business optimism dips to near-record low.

Emerging market growth gathers momentum in Q4

The HSBC Emerging Markets Index (EMI), a quarterly indicator derived from the PMI surveys, showed that emerging market growth quickened in Q4. The index rose to 55.7, from a five-quarter low of 54.2 in the preceding quarter, and was above the long-run series average of 54.7. Nonetheless, the pace of expansion remained slower than rates recorded in Q4 2009 and H1 2010.

The EMI is based on 21 PMI (Purchasing Managers' Index) surveys conducted across 16 emerging markets and provides the earliest and most reliable indication of economic trends.

The uptick in emerging market growth primarily reflected a rebound in manufacturing activity, as service sector growth held steady in the final quarter. Rates of expansion were almost identical across both sectors, with output expanding at a fractionally faster pace in manufacturing.

Emerging Asia diverges; Eastern Europe strengthens

Manufacturing output rose across Eastern Europe, with the Czech Republic, Poland and Turkey (series-record expansion) all recording substantial rates of growth in Q4.

Meanwhile, divergent trends across Emerging Asia manufacturing were apparent in the final quarter. Both China and India recorded sharp and accelerated rates of expansion that were the fastest in three quarters. In contrast, manufacturing output growth was only marginal in Taiwan and stagnated in South Korea.

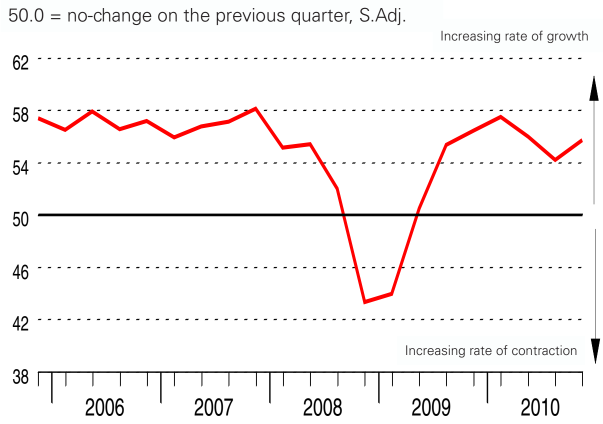
The performance of emerging market manufacturers improved in line with an uptick in new export order growth, which quickened from only a marginal pace of expansion seen in Q3. However, export growth was still down on rates seen during H1 2010. Of the big-four emerging markets, India recorded by far the strongest increase in new export business. China recorded modest growth (fastest in three quarters), but falling exports were indicated in Brazil and Russia.

Service sector growth holds steady, but optimism dips

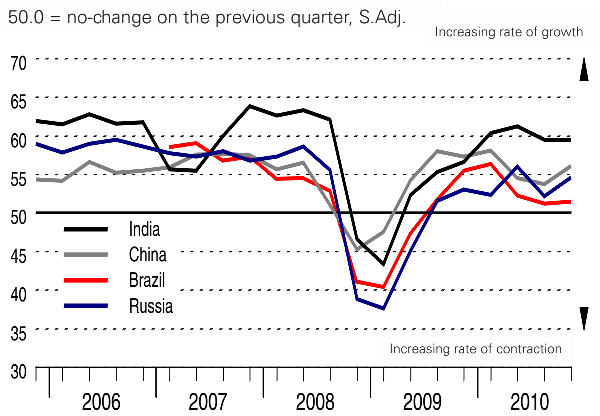
In the emerging market service sector, activity growth remained substantial in India, despite easing to a four-quarter low. China also recorded a slowdown in output growth (eight-quarter low). Conversely, Russia saw a strong acceleration in growth, following only a slight rise in activity during the preceding quarter. Despite quickening to a three-quarter high, Brazilian service sector growth remained modest in Q4.

The outlook for service sector activity darkened somewhat in Q4, with business optimism dipping to the second-lowest in the

EMI (all-sector output)



BRIC (all-sector output)



series history. Sentiment in China and Brazil fell to series-record lows, while Indian service providers were the least optimistic about future activity levels in six quarters. Russia, in contrast, recorded an improvement in business confidence, with the degree of optimism broadly in line with the long-run trend.

Input price inflation surges

On the prices front, input cost inflation quickened to the fastest since Q2 2008, when global commodity prices peaked before plummeting amid the fallout from the global financial crisis. The input prices index climbed almost six points from the previous quarter, highlighting the rapid build up of inflationary pressures across the emerging world. Manufacturers felt the brunt of higher purchasing costs in Q4, with input cost inflation hitting a ten-quarter high. Service providers recorded a much slower rise in average input prices than manufacturers, but the pace of inflation was still the fastest since Q3 2008.

Supply chain delays persist

Strong input cost inflation across the emerging world reflects two trends in particular. First, commodity prices have surged in line with economic recovery and loose monetary policy in the US. Second, low stock holdings at suppliers have led to widespread delivery delays, meaning suppliers have been able to hike charges. According to the EMI data for Q4, the average time taken by suppliers to deliver inputs to manufacturers lengthened at the fourth-fastest rate in the series history.

Of the big-four emerging markets, India recorded a series record pace of delivery time lengthening, while both China and Russia registered near record rates. In contrast, Brazil saw average vendor performance deteriorate at the slowest rate for five quarters.

Firms passed on higher costs to clients

Emerging market firms passed on rapidly rising input costs to clients through increased output charges in Q4. At the composite level, the rate at which companies raised their charges was the fastest since Q2 2008, predominately reflecting a near record rate of output price inflation across the manufacturing sector. Service providers also hiked their tariffs at an accelerated rate in Q4, albeit at a much slower pace than in manufacturing.

Job creation continues

Emerging market employment rose in Q4, with rates of job creation across manufacturing and services broadly similar to those seen in Q3. At the composite level, staffing levels increased across all big-four emerging markets in the final quarter, with rates of growth holding relatively steady in China, Brazil and India. Russia saw renewed employment growth in Q4, with rates of expansion broadly similar across both manufacturing and services.

On average, companies were able to satisfy robust growth of new orders, as backlogs of work rose only marginally in Q4. However, this followed a fall in Q3, suggesting that an element of capacity pressure built across the emerging world in the final quarter. Outstanding business growth was centred on the manufacturing sector in Q4, as services saw a stagnation of work-in-hand.

Orders and exports

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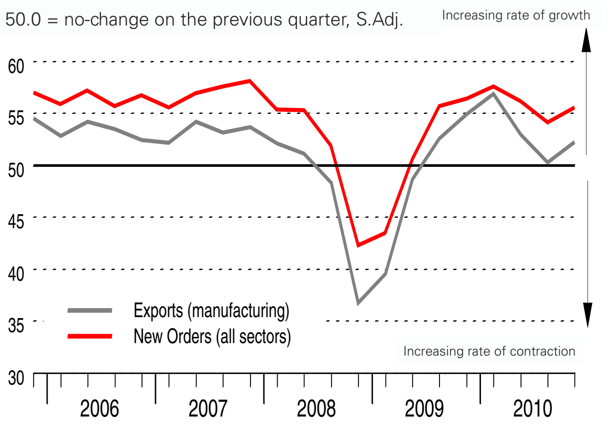

Employment and backlogs of work

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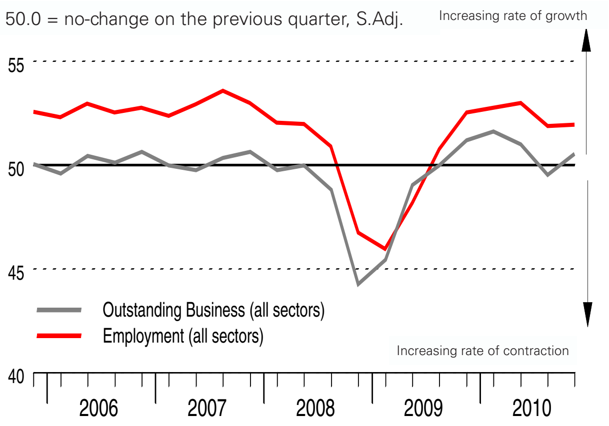

Input and output prices

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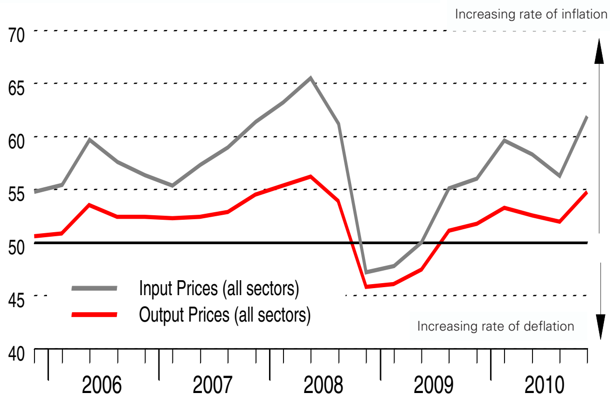

Output

Emerging market activity rose at a marked and accelerated pace in Q4.

An increase in emerging markets output was signalled for a seventh successive quarter in Q4. Although remaining below Q1's peak, the rate of growth also accelerated from Q3's five-quarter low and was above the series average.

Manufacturing output and service sector activity increased at broadly similar rates in Q4. Production in manufacturing accelerated sharply from Q3, with growth the steepest since Q1's series peak. For services, the rate of expansion was marginally higher than Q3's one-year low.

India remained a key contributor to overall growth, registering the sharpest rises in manufacturing and services output. China saw a marked acceleration in manufacturing output growth, but a slower rise in services activity. Brazil registered a modest output rise, while Russian growth accelerated to a solid pace.

Output by sector

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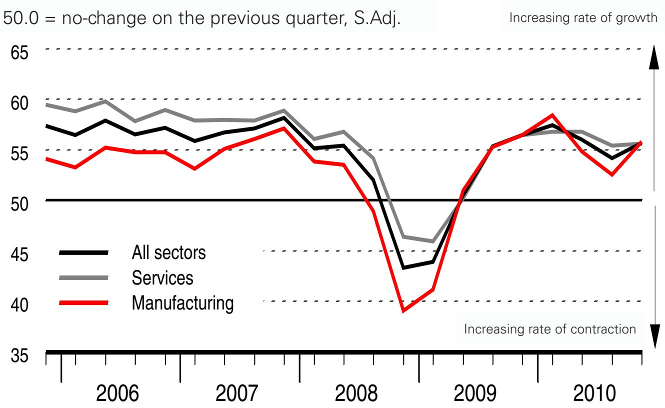

Output in BRIC countries (all sectors)

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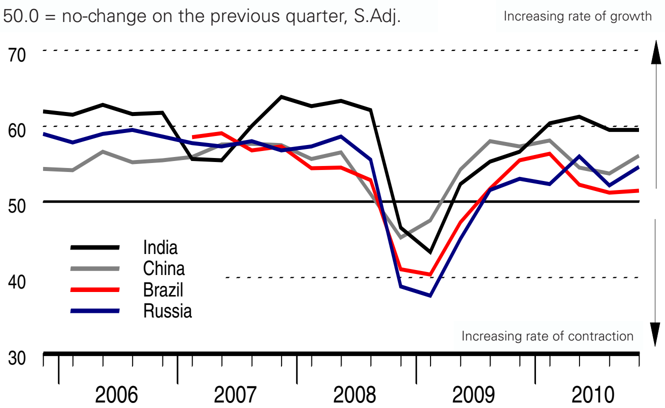

New Business

Incoming new orders continued to increase at a robust rate in the final quarter of 2010.

In line with the trend for business activity, levels of incoming new business rose at a stronger pace than during Q3, with the rate of growth robust and above the series average.

Having diverged in Q3, rates of growth in the manufacturing and service sectors were broadly similar in the final quarter. Growth of new orders in manufacturing was the strongest for three quarters. The rate of expansion of service sector new business improved slightly on Q3's five-quarter low and remained marked.

China and India saw marked new business growth, with both countries enjoying strong contributions from their manufacturing sectors. Russia saw a solid increase in new business, while growth in Brazil remained modest as a strong currency continued to undermine export trade.

New business by sector

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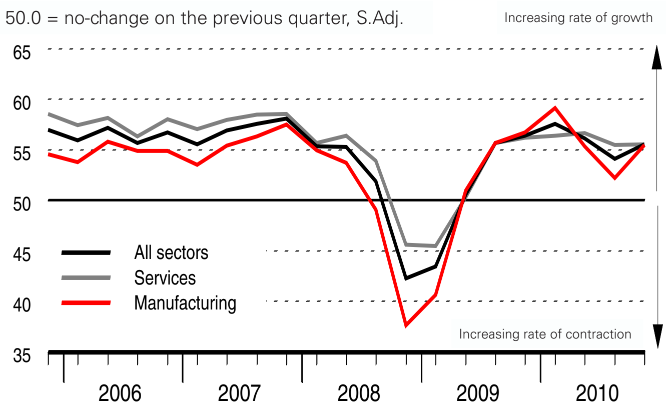

New business in BRIC countries (all sectors)

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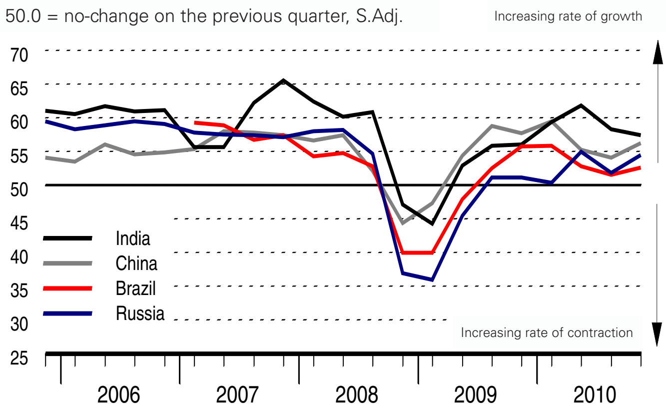

Outstanding Business

China and India lead modest overall increase in business outstanding.

Having fallen marginally in the previous quarter, backlogs of work outstanding increased for the third time in 2010 during Q4.

Overall growth of outstanding business was led by manufacturing, where capacity pressures were more evident than in services (which signalled no change in backlogs since Q3). Levels of work outstanding in manufacturing have now risen for six successive quarters, although the rate of growth remained only modest during Q4.

Backlogs increased in both China and India (primarily reflective of rising work outstanding in respective manufacturing sectors). There was a slight fall in outstanding business in Brazil, and a steep contraction in Russia as backlogs at manufacturers fell at the fastest pace in nearly two years.

Outstanding business by sector

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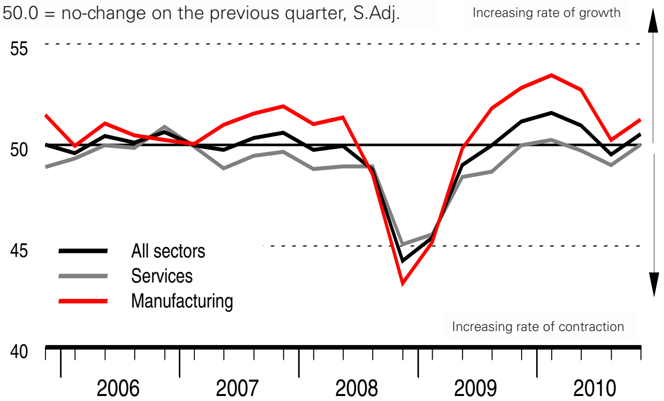

Outstanding business in BRIC countries (all sectors)

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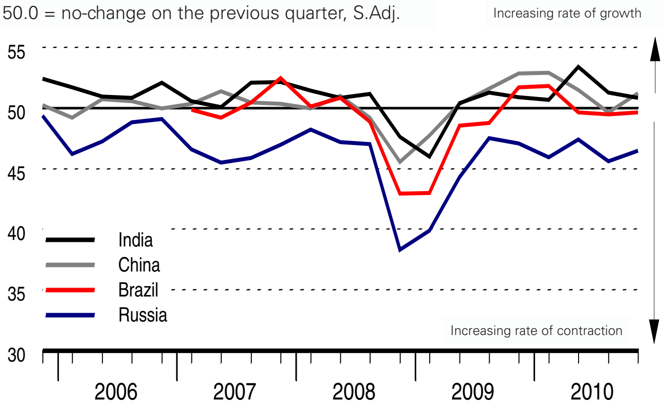

Employment

Growth of employment improved slightly in Q4 2010.

Employment in emerging markets increased for a sixth successive quarter in Q4 2010. Growth was up slightly on Q3's low, and remained broadly comparable to rates of expansion seen pre-global recession.

Service sector staffing levels continued to be raised at a faster pace than in manufacturing. In both sectors rates of expansion were lower than those seen in H1 2010 despite improving slightly since Q3.

China's service sector was a key driver of overall employment expansion despite growth easing slightly to a one-year low. Combined with a marginal expansion in manufacturing, China recorded the strongest composite payroll increase of the big-four emerging markets. Broadly similar modest rises in staffing levels were seen in Brazil, India and Russia.

Employment by sector

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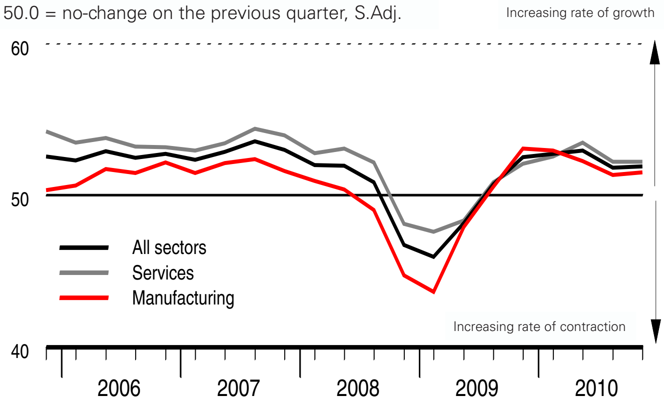

Employment in BRIC countries (all sectors)

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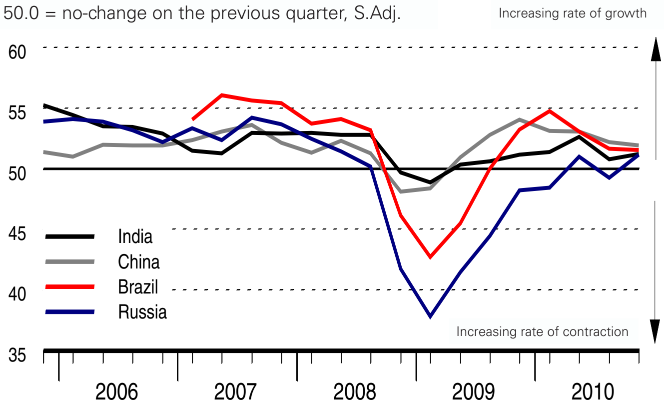

Input Prices

Steep acceleration of input price inflation registered in Q4 2010.

Input cost inflation jumped during Q4 2010 to a two-and-a-half year peak. Average input prices have now risen for six successive quarters.

Manufacturing input price inflation rose to the highest since Q2 2008, with the acceleration over the quarter the strongest in the survey history. Service sector input costs (which include wages and salaries, as well as bought-in goods and services, fuel, rents and utilities) rose to the greatest extent in nine quarters but to a much lesser degree than in manufacturing.

Rapid inflation was recorded in China's manufacturing sector and, at the composite level, the country recorded the strongest overall increase in costs. Russia saw a rapid rate of inflation, whereas Brazil registered a relatively modest increase in costs. Cost inflation in India remained marked.

Input prices by sector

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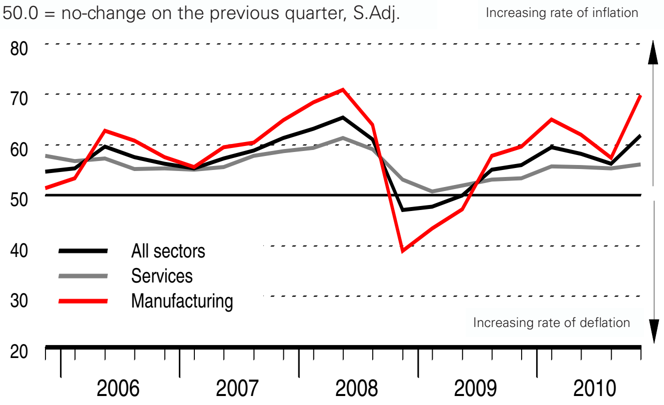

Input prices in BRIC countries (all sectors)

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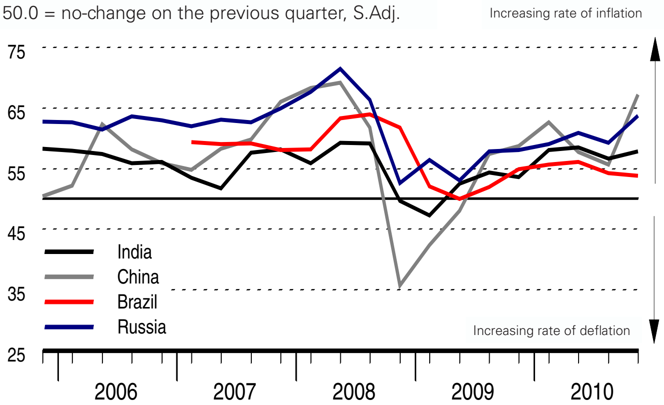

Output Prices

China leads acceleration of emerging markets output price inflation.

Having eased in the previous two quarters, average output price inflation in emerging markets accelerated during Q4 2010 to reach a two-and-a-half year peak.

Latest data marked the sixth successive quarter in which output charges have increased, and the latest round of inflation largely emanated from the manufacturing sector. Output prices here rose at the second strongest pace in the series history. In the service sector, output charges continued to increase at a modest pace that was only slightly faster than in Q3.

Of the big-four emerging markets, China recorded the strongest overall inflation (led by a surge in manufacturing input costs). Output charges rose at the strongest pace for over two years in Russia, while relatively modest increases were registered in Brazil and India.

Output prices by sector

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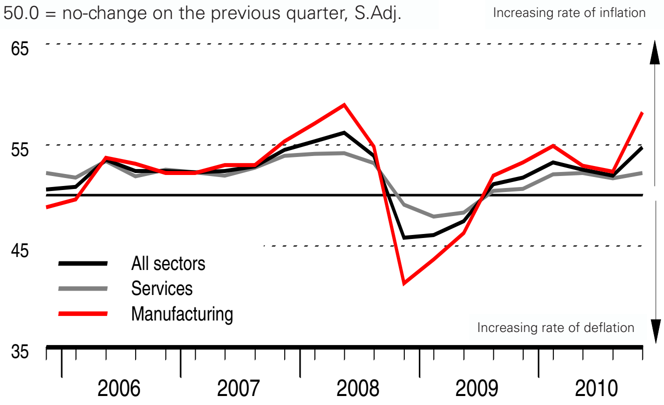

Output prices in BRIC countries (all sectors)

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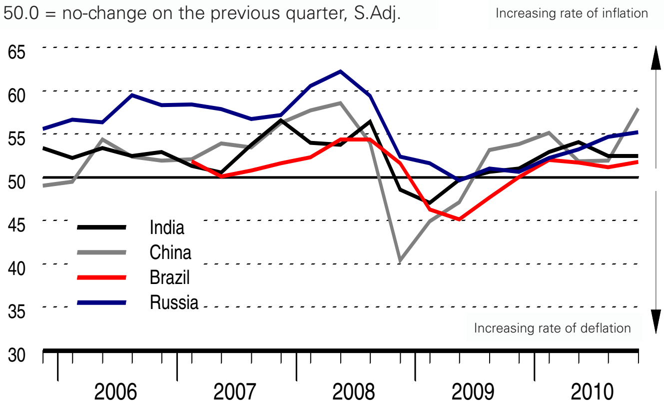

New Export Orders

New export order growth quickens, but remains slower than Q1 peak

New export business received by emerging market manufacturers rose for the sixth quarter running in the final quarter of 2010, with the rate of expansion quickening since Q3. Nonetheless, growth was still down on its Q1 peak, and slower than the pre-financial crisis average.

Of all emerging markets monitored by the survey, Israel recorded the most marked increase in new export business in Q4, while the Czech Republic, Poland and Turkey also saw growth.

New export orders rose in both China and India, with expansion in the latter much faster than in China. Unlike China, Indian export order growth returned to rates seen at the start of the year. Meanwhile, Brazil and Russia both recorded reductions in foreign order levels in Q4.

New export orders (manufacturing)

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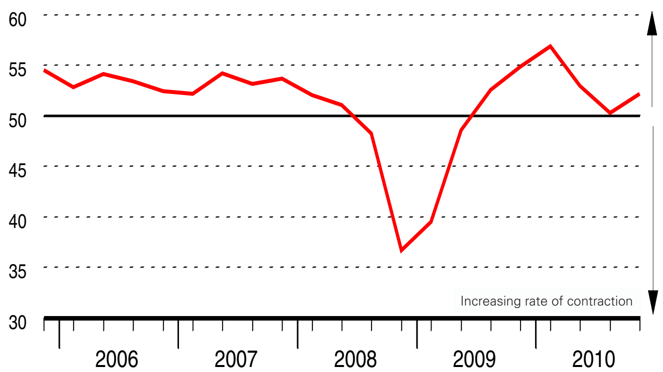

New export orders in BRIC countries (manufacturing)

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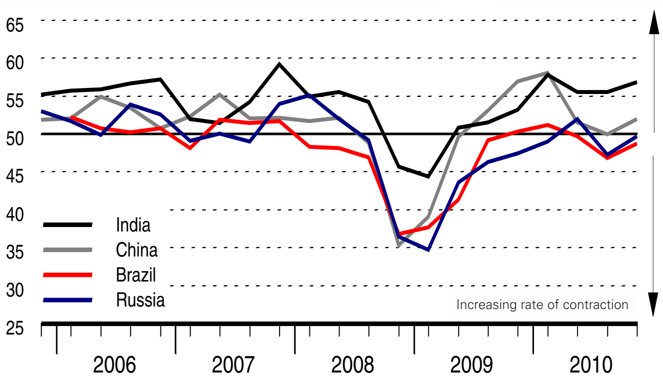

Quantity of Purchases

Purchasing growth hit three-quarter high in Q4.

Emerging market manufacturers recorded a further rise in purchasing in Q4, extending the current period of growth to seven quarters. The pace at which firms acquired inputs was marked, and accelerated to the fastest since Q1 2010. Growth of input buying primarily reflected a marked increase in new business and subsequent rise in production requirements.

Buying activity rose across three of the big-four emerging markets in Q4, with Brazil the exception. Here, purchasing fell for the second successive quarter. Russia recorded a moderate rise in input buying, but growth eased to a four-quarter low. Although China and India both registered strong growth of purchasing, rates of expansion headed in opposite directions. Purchasing growth accelerated sharply in China, but eased to a one-year low in India.

Quantity of purchases (manufacturing)

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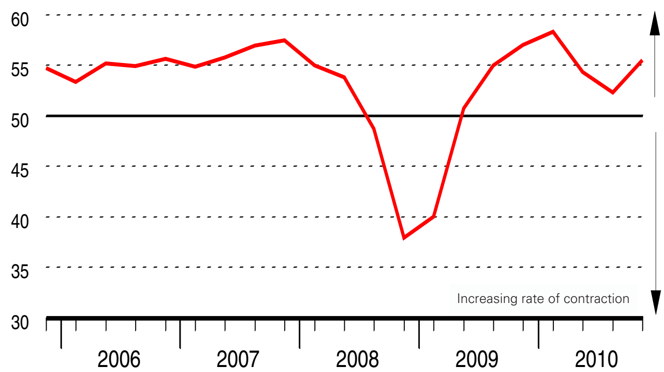

Quantity of purchases in BRIC countries (manufacturing)

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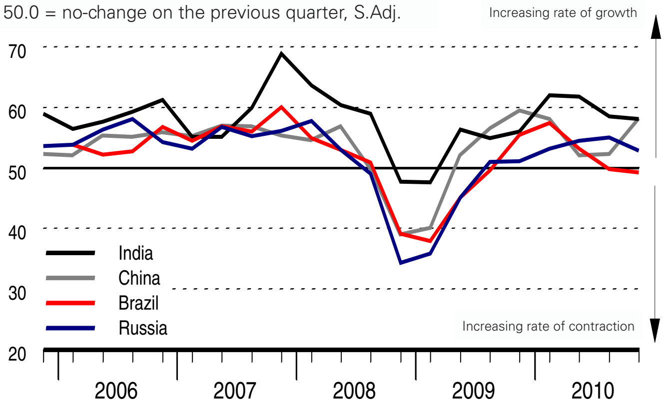

Stocks of Finished Goods

Sharpest rate of stock depletion in five quarters.

Finished goods holdings across the emerging world fell in the final quarter of 2010, as a greater volume of new orders were met directly from existing inventory. The pace of reduction was moderate, but still quickened to the joint second-fastest in the series history.

Stocks of post-production goods fell across nearly all emerging market manufacturers, with India and Singapore the two exceptions. China (fastest since Q1 2009), the Czech Republic, Poland, Russia (most marked in three quarters) and Turkey all recorded solid rates of stock depletion, although those seen in the Czech Republic and Poland were the slowest since Q4 2008. Modest declines were seen in Brazil, South Korea and Taiwan.

Stocks of finished goods (manufacturing)

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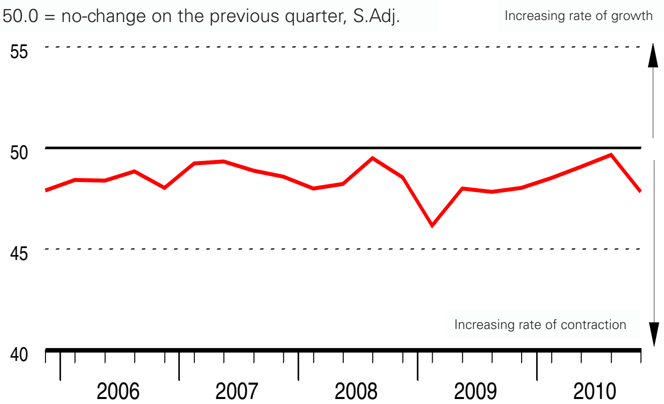

Stocks of finished goods in BRIC countries (manufacturing)

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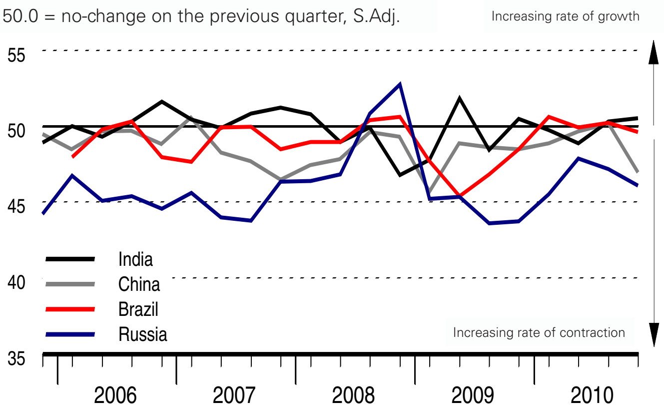


Stocks of Purchases

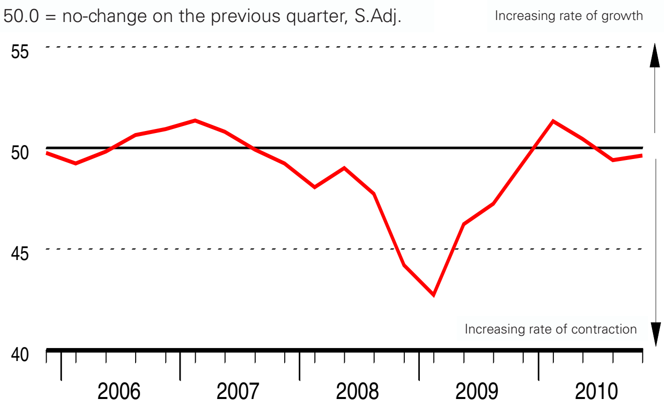
Pre-production inventories fell for second successive quarter.

Stocks of raw materials and semi-manufactured goods fell for the second quarter running in Q4, as firms utilised existing inventories due to delays in the supply chain. However, the rate of destocking was only marginal, and slightly slower than in Q3.

There were sharp variations by country/region. Russia recorded by far the sharpest rate of stock depletion in Q4, while inventory levels also fell in China (third in as many quarters) and Brazil (fastest in four quarters). Poland, Taiwan, South Korea and Israel all recorded reductions. In contrast, stocks were accumulated at substantial rates in India (third-fastest in the series history) and Saudi Arabia. Stock levels also rose in the Czech Republic, South Africa, Singapore and Mexico.

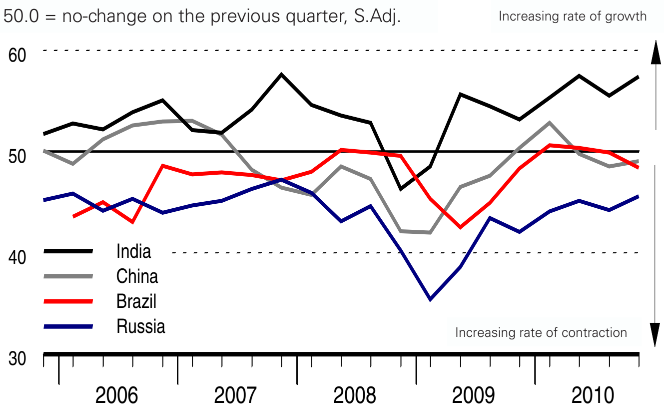
Stocks of purchases (manufacturing)

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



Stocks of purchases in BRIC countries (manufacturing)

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



Suppliers' Delivery Times

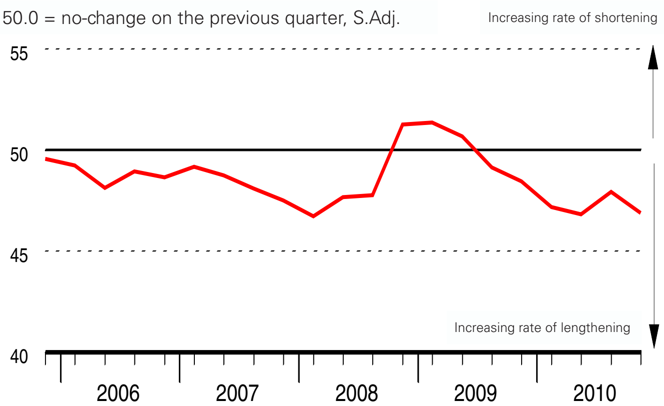
Lead times lengthened at the fourth-fastest rate in the series history.

The average time taken by suppliers to deliver inputs to emerging market manufacturers lengthened for the sixth quarter running in Q4. The rate of deterioration in vendor performance accelerated to the fourth-fastest since the start of the series in Q2 2004. Strong purchasing growth, coupled with limited stock at vendors, led to widespread shortages and delivery delays in Q4.

Average lead times lengthened across the majority of emerging markets monitored, with Saudi Arabia, South Africa, South Korea and UAE the exceptions. Of the big-four emerging markets, India reported a series record rate of decline in vendor performance. Near record rates of lead time lengthening were also seen in China and Russia. In contrast, Brazil recorded the slowest deterioration in supplier performance since Q3 2009.

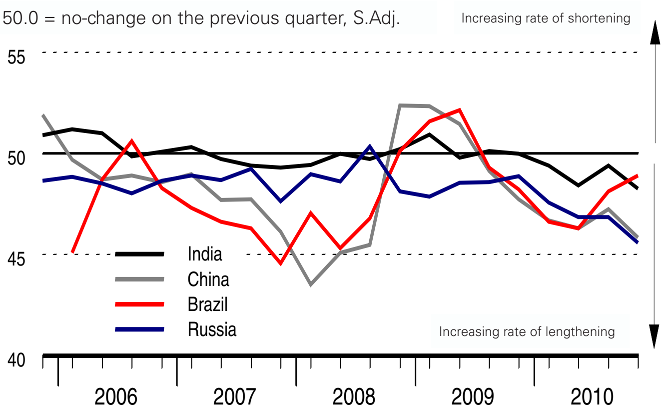
Suppliers' delivery times (manufacturing)

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

Business optimism the lowest since the height of the global recession.

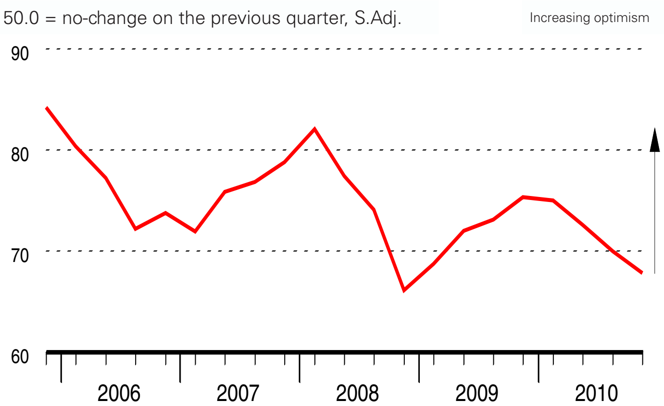
Emerging market service providers remained optimistic about the one-year outlook for business activity in Q4. However, the degree of optimism dipped to the lowest since Q4 2008, when the global recession was at its worst.

Chinese service providers were the least optimistic about future activity levels, with confidence hitting a series-record low in the final quarter. Brazil also saw positive sentiment dip to its lowest in the series history, while business optimism was the weakest for six quarters in India. In contrast, Russian service providers were more optimistic about the one-year business outlook than they were in Q3.

Degrees of positive sentiment were below long-run series averages across all emerging market service sectors monitored by the survey.

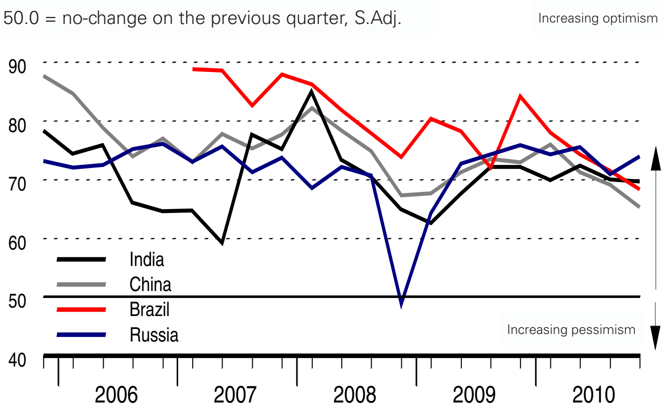
Business expectations (services)

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.



Economic Growth in 2010

Latest GDP data showed that economic trends continued to diverge in 2010. Having showed a worrying slowdown in the third quarter, economic growth picked up in both emerging markets and the developed world towards the end of the year. However, although the data have allayed fears of a hard landing for emerging economies and a double-dip recession in the West, rates of growth remain below those seen earlier in the year and set the scene for growth in 2011 to run below that seen in the years leading up to the recession.

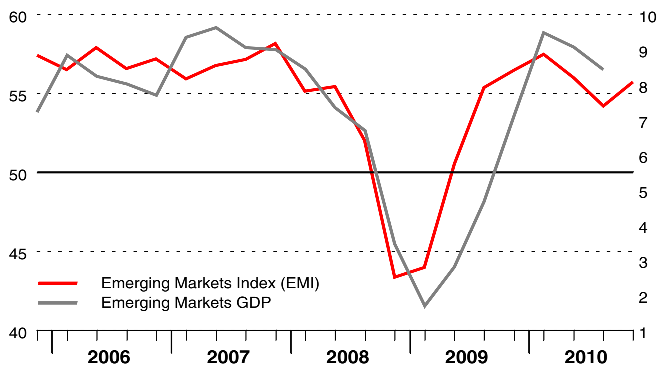
In emerging markets, the EMI points to GDP growth of 8% per annum in the final quarter of 2010, down from a 9.6% peak rate in Q1. Equivalent developed world PMI data ended up consistent with GDP rising at an annual rate of less than 2.0% in Q4 – down on the six-year high of 3.0% seen in Q3.

Delving deeper into the data, huge variations in national performance have been evident since the onset of the global recession in the third quarter of 2008, with emerging markets the clear winners in most cases. While all bar two developed countries (Switzerland and Canada) remain smaller in terms of gross domestic product (GDP) than their pre-recession peaks, many emerging markets have grown larger.

India and China are stand-outs, in that they did not experience recessions at all. Of those emerging markets which suffered recessions, Singapore, South Korea, Indonesia, Brazil and Turkey have all grown larger than their pre-recession peaks.

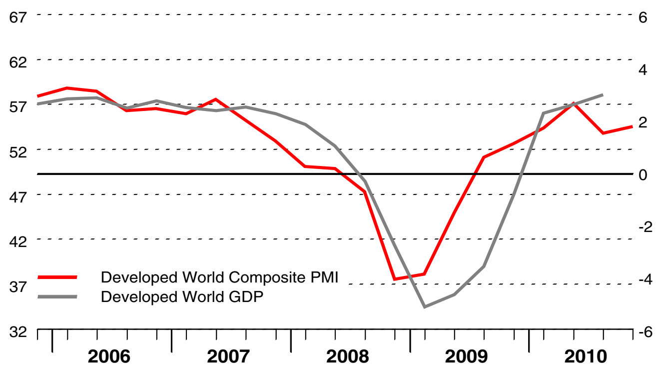
In comparison, many Western economies remain shadows of their former selves. Admittedly the largest countries have made good progress, with the US, Germany, Japan and the UK economies just 0.6%, 1.8%, 3.4% and 3.9% below their pre-recession peaks respectively, but this is nothing compared to some Eurozone countries. Greece is still technically in recession, and Ireland, Spain and Italy have recouped just 6%, 8% and 21% of lost GDP so far respectively.

Chart1: Emerging market GDP



Sources: HSBC, Markit.

Chart 2: Developed world GDP

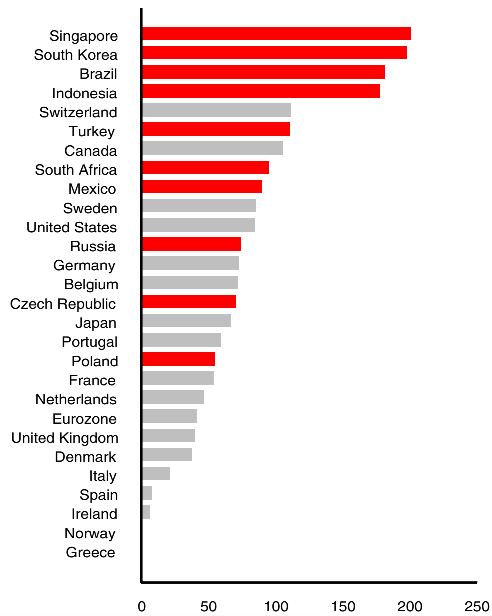


Sources: HSBC, Markit.

Please note that December PMI data are not included in the Q4 2010 average for the Developed World Composite PMI.

Chart 3: Recessions & recoveries – GDP data

Proportion of GDP lost in recession recouped by Q4 2010 (%)



Sources: HSBC, Markit.

Growth Drivers

Domestic and export demand factors have played important roles in explaining divergent national economic growth trends in 2010.

The EMI survey data show how domestic demand has helped prop up emerging market growth rates in 2010 while many developed countries have seen domestic demand hit by high unemployment, public sector spending cuts and deleveraging by indebted households.

The role played by domestic demand is illustrated in chart 5. Emerging markets have seen domestic demand outperform exports throughout 2010, while the opposite has been true for the developed world in the second half of the year.

EMI employment data illustrate that the domestic demand in emerging markets has been boosted relative to the developed world by stronger labour markets. However, there are signs that domestic demand in the developed world may soon start to pick up as a result of improving job market data (see chart 6).

Any strengthening of developed world labour markets of course usually bodes well for emerging market exporters. But this is no longer so clear-cut. EMI data show that emerging market producers have struggled in their export performance compared to developed countries in 2010. The EMI/PMI data show that only two of the top ten countries ranked by export growth in 2010 were emerging markets (India and the Czech Republic, the latter benefiting from its close ties to Germany). The Netherlands and the US led the table. The weakness of the US dollar and the euro were widely cited as key drivers of this resurgent export growth in the West, sparking cries of 'currency wars'.

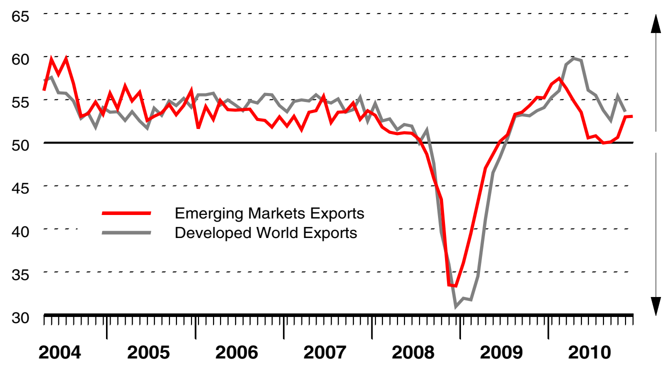
Countries/region ranked by export growth in Q4 2010

Sources: HSBC, Markit.

Please note that December PMI data are not included in the Q4 2010 averages for all Developed World PMIs.

Chart 4: Export trends

50.0 = no change on the previous month, S.Adj.

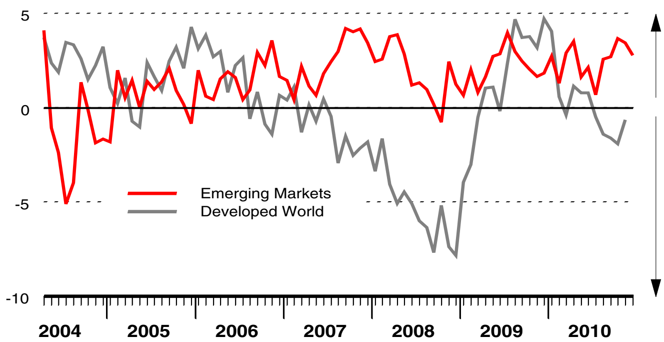


Sources: HSBC, Markit.

Chart 5: Domestic demand influence

PMI Total New Orders - New Export Orders Index

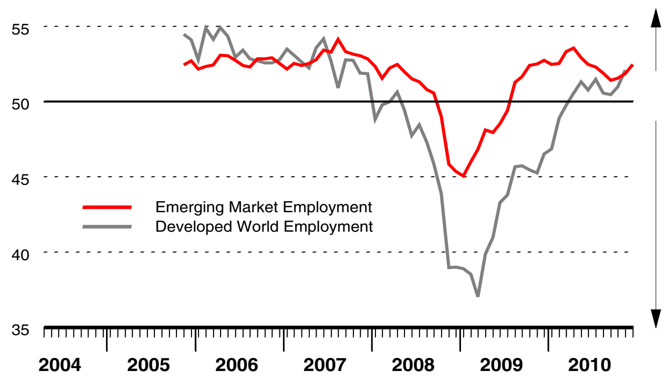
(readings above 50.0 indicate domestic demand rising faster than exports)



Sources: HSBC, Markit.

Chart 6: Employment

50.0 = no change on the previous month, S.Adj.



Sources: HSBC, Markit.

Please note that December 2010 PMI data are not included in the Developed World PMI series.

Regional Manufacturing Trends

Strong growth divergences have not just been evident between emerging and developed countries, but also across emerging markets themselves.

Chart 7 shows that Asia ex-Japan has seen particularly marked swings in manufacturing output, which was in turn driven largely by export trends. The region led the global recovery in late-2009 and early-2010 through its manufacturing rebound. Latin America and Eastern Europe followed close behind, but the latter struggled to enjoy the gains seen in other emerging regions in early-2010, largely due to subdued growth in Russia.

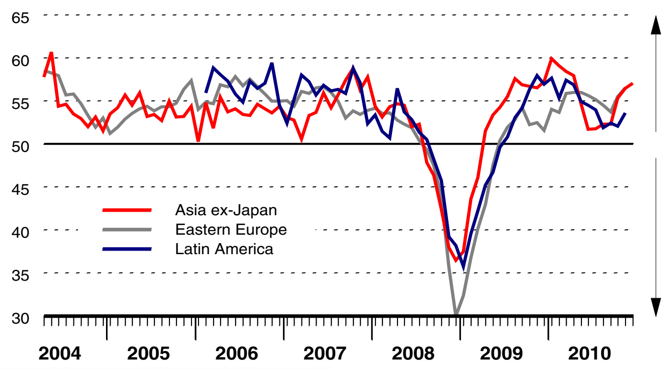
However, Eastern Europe has seen growth outperform other emerging regions in more recent months as exporters have increasingly benefited from buoyant demand for their exports from Germany, surveys for which were signalling near record output and employment growth in late-2010.

While Eastern Europe enjoyed strong demand from German customers, Asia and Latin America saw output growth weaken as exports suffered. Global trade flows slumped as the earlier boost from inventory rebuilding faded in late-2010, growth slowed in the G4 economies and exchange rates rose against the US dollar.

Employment trends have followed production trends over the past year, though the lag between Eastern Europe producers catching up with Asia ex-Japan in seeing a return to job creation (some ten months) was even greater than for output (just three months). However, by the end of the year, employment growth was surging higher in Eastern Europe.

Chart 7: EMI Output Index by region

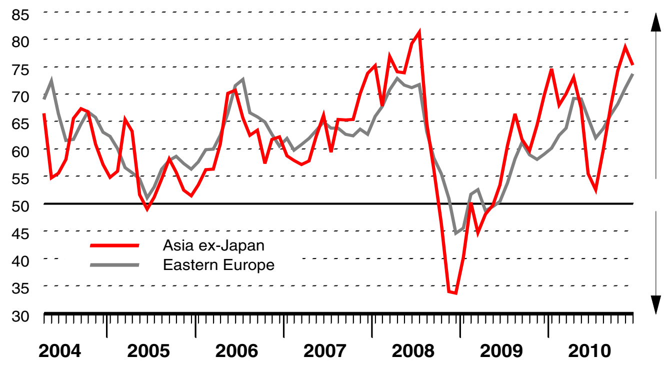
50.0 = no change on the previous month, S.Adj.



Sources: HSBC, Markit.

Chart 8: EMI Input Prices Index by region

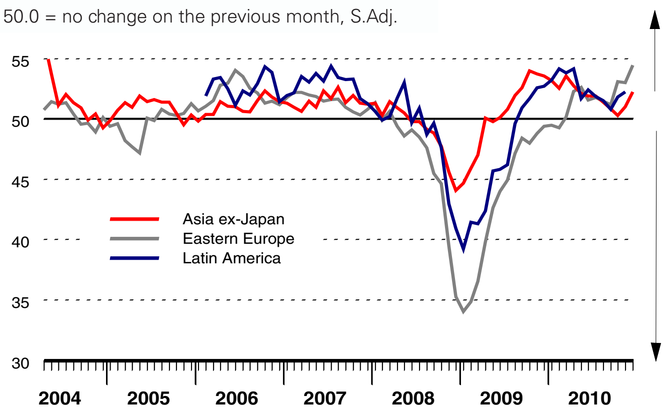
50.0 = no change on the previous month, S.Adj.



Sources: HSBC, Markit.

Chart 9: EMI Employment Index by region

50.0 = no change on the previous month, S.Adj.



Sources: HSBC, Markit.

Ex-Asia Japan: China, India, Singapore (excluding December data), South Korea, Taiwan, Turkey.
Eastern Europe: Czech Republic, Poland, Russia, Turkey.
Latin America: Brazil, Mexico (excluding December data).

Please note that Latin America PMI data are not compiled for December 2010, as Mexico figures for December were unavailable at the time of writing.

Emerging Markets – not the risky trade they once were

The EM/DM economic growth differential since the recession has been reflected in equity markets, which are closely correlated to EMI/PMI data*. Developed world equities lost 59% of their value in the recession, from peak to trough, compared with a larger 65% decline for emerging markets. However, since bottoming out, the developed world has seen a gain of 85% while a 152% leap has been recorded for emerging markets. This leaves emerging market equities at 87% of their pre-recession peak while the developed world has recouped just 76%.

Sovereign risk

However, perhaps the most important repercussion from the financial crisis has been the reassessment of sovereign risk. High budget deficits, household indebtedness, weak competitiveness and accompanying poor growth prospects have hampered the economic outlook for many developed countries, which will in turn make the task of reducing deficits even harder.

The cost of insuring against sovereign default in Western Europe is consequently now almost the same as for CEEMEA emerging markets. Moreover, of all the major countries for which data are available, the highest cost of insuring against default in 2010 was for Greece, followed by Ireland and then Spain. This is a big change from 2009, when the top five riskiest sovereigns were Turkey, Mexico, Russia, Brazil and South Korea, all of which also appeared in the top five in 2008.

Credit default swap spreads (basis points)

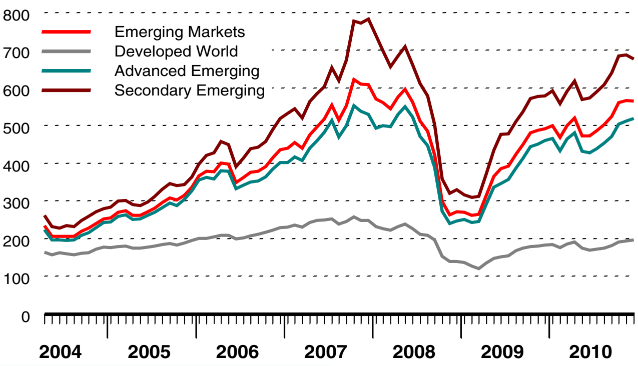
Countries ranked by highest cost of insuring against default in 2010 (annual average)

	2008	2009	2010
Greece	76	172	687
Ireland	55	197	293
Spain	47	93	202
Turkey	230	365	167
Italy	59	108	165
Russia	268	374	163
Poland	95	190	131
Mexico	167	239	123
Brazil	188	211	122
South Korea	163	202	102
Chile	101	133	81
Slovakia	64	106	79
China	91	115	73
UK	30	84	73
Japan	23	58	72
France	19	41	70
Netherlands	23	54	45
Germany	14	37	40
US	20	41	38
Denmark	31	58	37

**Both developed world PMI and Emerging markets EMI have an 85% correlation against annual changes in FTSE equity prices, and a 95% correlation with the dividend yield.*

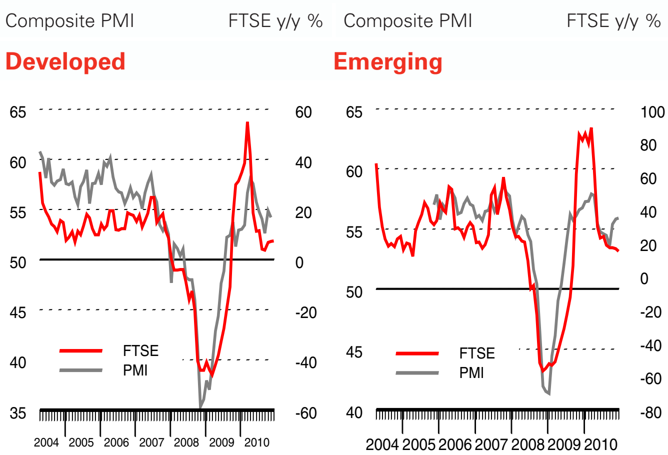
Chart 10: Equity markets

FTSE Index, monthly averages



Sources: FTSE, Ecowin.

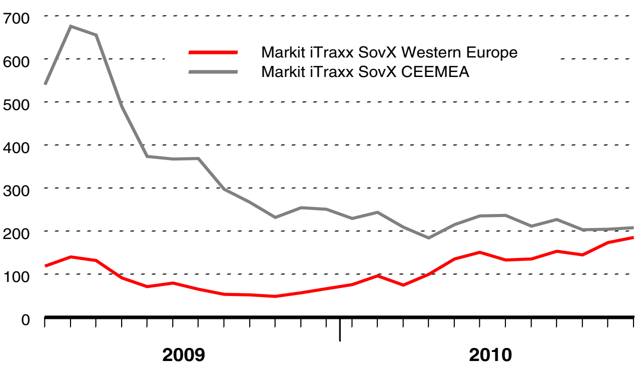
Charts 11 & 12: DM v EM PMIs and equities



Sources: HSBC, Markit, FTSE, Ecowin.

Charts 13: Sovereign credit markets

Spread, bps, monthly averages



Source: Markit.

Please note that December PMI data are not included in the Developed World PMI series. FTSE and Markit CDS data for December account for the period ending 21st December 2010.

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, UAE, Saudi Arabia and the increasingly important BRIC economies of Brazil, Russia, India and China. These surveys collectively track business conditions in over 5,800 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
UAE	Markit
Saudi Arabia	Markit

HSBC

Headquartered in London, HSBC is one of the largest banking and financial services organisations in the world. Its international network comprises some 8,000 offices in 87 countries and territories in Europe; Hong Kong; Rest of Asia-Pacific; the Middle East; North America and Latin America. With assets of US$2,418 billion at 30 June 2010, HSBC is one of the world's largest banking and financial services organisations. HSBC is marketed worldwide as 'the world's local bank'.

For further information please visit www.hsbc.com

About Markit

Markit is a leading, global financial information services company with over 1,900 employees. The company provides independent data, valuations and trade processing across all asset classes in order to enhance transparency, reduce risk and improve operational efficiency. Its client base includes the most significant institutional participants in the financial market place. For more information please see www.markit.com

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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