



Economics Markets Strategy

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Economic forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2010	2011	2012	2013f	2014f	2010	2011	2012	2013f	2014f
US	2.5	1.8	2.8	1.4	2.1	1.6	3.1	2.1	1.6	2.0
Japan	4.5	-0.6	2.0	1.8	0.9	-0.7	-0.3	0.0	0.3	2.4
Eurozone	1.9	1.6	-0.5	-0.4	0.5	1.6	2.7	2.5	1.5	1.4
Indonesia	6.1	6.5	6.2	5.8	6.0	5.1	5.4	4.3	7.4	7.3
Malaysia	7.2	5.1	5.6	4.3	5.2	1.7	3.2	1.7	2.1	3.0
Philippines	7.3	3.6	6.8	7.0	6.7	3.8	4.8	3.1	3.1	4.0
Singapore	14.8	5.2	1.3	2.9	3.5	2.8	5.2	4.6	2.5	3.2
Thailand	7.8	0.1	6.4	4.0	5.2	3.3	3.8	3.0	2.4	3.5
Vietnam	6.8	5.9	5.0	5.3	5.7	9.2	18.6	9.3	6.7	6.8
China	10.3	9.3	7.8	7.5	7.5	3.3	5.4	2.6	3.5	3.5
Hong Kong	7.0	4.9	1.5	3.5	4.0	2.4	5.3	4.1	4.5	3.5
Taiwan	10.7	4.1	1.3	2.6	3.3	1.0	1.4	1.9	0.8	1.1
Korea	6.2	3.6	2.0	2.8	3.5	2.9	4.0	2.2	1.3	2.8
India*	8.4	6.5	5.0	4.3	5.0	9.6	8.9	7.4	6.1	6.8

* India data & forecasts refer to fiscal years beginning April; inflation is WPI

Source: CEIC and DBS Research

Policy and exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	4Q13	1Q14	2Q14	3Q14	current	4Q13	1Q14	2Q14	3Q14
US	0.25	0.25	0.25	0.25	0.25
Japan	0.10	0.10	0.10	0.10	0.10	99.5	102	103	104	106
Eurozone	0.50	0.50	0.50	0.50	0.50	1.330	1.32	1.33	1.34	1.35
Indonesia	7.00	7.00	7.00	7.00	7.00	11,300	11,150	11,200	11,250	11,300
Malaysia	3.00	3.00	3.00	3.00	3.00	3.27	3.31	3.29	3.28	3.26
Philippines	3.50	3.50	3.50	3.75	4.00	43.8	44.0	43.8	43.6	43.4
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.27	1.25	1.23	1.22	1.21
Thailand	2.50	2.50	2.50	2.75	3.00	31.7	32.2	32.1	32.0	31.9
Vietnam^	7.00	7.00	7.00	7.00	7.00	21,114	21,310	21,340	21,380	21,410
China*	6.00	6.25	6.25	6.50	6.50	6.12	6.09	6.06	6.03	6.00
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.75	7.76	7.76	7.76	7.76
Taiwan	1.88	1.88	1.88	2.00	2.13	29.7	29.5	29.4	29.3	29.2
Korea	2.50	2.50	2.50	2.75	2.75	1085	1075	1070	1065	1060
India	7.25	7.25	7.25	7.25	7.25	63.6	64.1	64.4	64.8	65.1

^ prime rate; * 1-yr lending rate

Source: Bloomberg and DBS Group Research

Interest Rate Forecasts

%, eop, govt bond yield for 2Y and 10Y, spread in bps

		11-Sep-13	4Q13	1Q14	2Q14	3Q14
US	3m Libor	0.25	0.30	0.30	0.30	0.30
	2Y	0.44	0.78	0.98	1.17	1.17
	10Y	2.91	3.00	3.30	3.70	4.00
	10Y-2Y	247	222	232	253	283
Japan	3m Tibor	0.23	0.25	0.25	0.25	0.25
Eurozone	3m Euribor	0.22	0.19	0.19	0.19	0.19
Indonesia	3m Jibor	6.77	7.00	7.00	7.00	7.00
	2Y	7.86	7.80	8.00	8.00	8.00
	10Y	8.76	8.75	9.00	9.00	9.25
	10Y-2Y	90	95	100	100	125
Malaysia	3m Klibor	3.20	3.25	3.25	3.25	3.25
	3Y	3.41	3.50	3.50	3.50	3.50
	10Y	3.88	4.10	4.20	4.30	4.40
	10Y-3Y	47	60	70	80	90
Philippines	3m PHP ref rate	0.59	1.00	1.50	2.00	2.50
	2Y	3.05	3.25	3.25	3.50	3.75
	10Y	3.76	4.25	4.50	4.75	5.00
	10Y-2Y	71	100	125	125	125
Singapore	3m Sibor	0.37	0.35	0.35	0.35	0.35
	2Y	0.25	0.50	0.70	0.91	0.91
	10Y	2.66	2.80	2.87	2.90	2.94
	10Y-2Y	241	230	217	199	203
Thailand	3m Bibor	2.60	2.60	2.60	2.85	3.10
	2Y	2.92	3.00	3.00	3.25	3.50
	10Y	4.33	4.50	4.75	5.00	5.00
	10Y-2Y	141	150	175	175	150
China	1 yr Lending rate	6.00	6.25	6.25	6.50	6.50
	2Y	3.88	3.88	4.00	4.00	4.00
	10Y	4.07	4.25	4.50	4.50	4.50
	10Y-2Y	19	37	50	50	50
Hong Kong	3m Hibor	0.39	0.40	0.40	0.40	0.40
	2Y	0.42	0.58	0.88	1.07	1.27
	10Y	2.46	2.60	2.90	3.30	3.60
	10Y-2Y	204	202	202	223	233
Taiwan	3M CP	0.85	0.80	0.88	1.00	1.13
	2Y	0.73	0.90	0.90	0.90	1.00
	10Y	1.71	1.80	1.90	2.00	2.00
	10Y-2Y	98	90	100	110	100
Korea	3m CD	2.66	2.70	2.70	2.95	2.95
	3Y	2.93	3.00	3.25	3.50	3.50
	10Y	3.63	3.75	4.00	4.25	4.25
	10Y-3Y	70	75	75	75	75
India	3m Mibor	11.59	8.00	8.00	8.00	8.00
	2Y	9.19	8.60	8.00	8.00	8.00
	10Y	8.39	8.60	8.10	8.10	8.10
	10Y-2Y	-80	0	10	10	10

Source: Bloomberg and DBS Group Research

Three steps forward ...

Capital flows have always been a two-way affair. When sentiment is strong, inflows push you up the mountain. When it's weak, they drag you out to sea. The fact that Western central banks put interest rates on the floor five years ago and kept them there has only amplified the action – first inward, as Asia's V-shaped recovery took off in 2009 and 2010 and then outward, as the EU debt crisis erupted in 2011 and, more recently, as fears over Fed tapering have grown.

We estimate that in the two quarters ending June, some US\$138bn flowed out of the Asia-8. Is that a lot? Surprisingly, no. Two years ago, \$152bn flowed out when the European debt crisis erupted. When Lehman collapsed five years ago, \$350bn left the region, 2.5x more than the current 'exodus'. QE and its tapering make a sexy story but the fact is today's outflows rank only third in the standings, and that's just in the past five years.

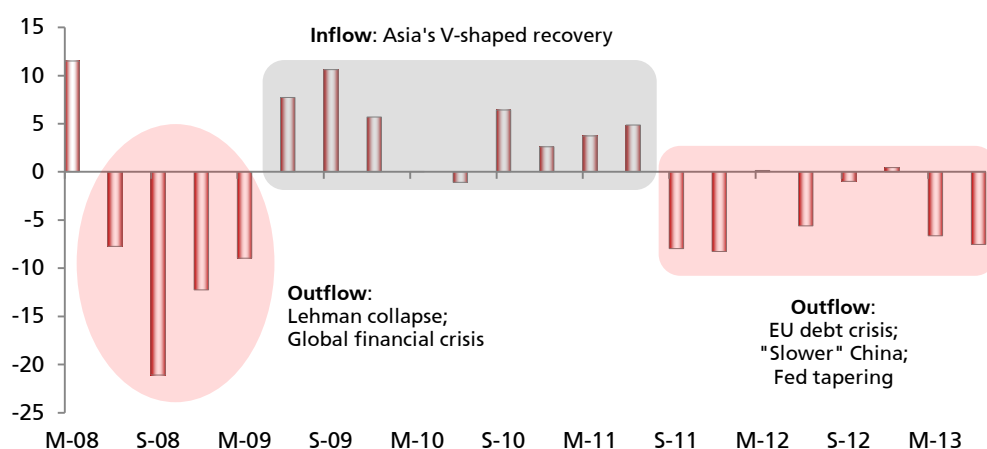
If all of this money is flowing out of the region, when does Asia run dry? It doesn't. Today's outflows underscore the fact that there have always been two types of inflow: short-run 'hot' money flows arbitraging differential rates and returns, and longer-term inflows seeking to profit from Asia's strong growth. The hot money is now going home – or at least this week it is. The long-term money is staying put. And the long-term money is the bigger force.

Since the dotcom / hi-tech downturn ended in 2001, some \$2.4 trillion of capital has flowed into the Asia-10. About \$500bn flowed out temporarily in 2008/09 and another \$300bn has flowed out since September 2011. Net, net, that's \$1.6trn of long-term capital that has stayed in Asia, riding out the various global crises of the past 12 years. Three steps forward, one step back – for every dollar that comes in, 66 cents stay for the long haul. As capital flows go, that's a pretty good signal-to-noise ratio.

Why is so much money coming to Asia? That's easy. Asia is where the world's growth is being generated. And businesses want to be where the growth is. Think about it:

Asia 8 – capital inflow/outflow

BoP capital acct surplus/deficit as % of GDP



Asia and the US are now about the same size – GDP in both regions is roughly \$16 trn. If the US grows at a 2.5% rate, it generates \$400bn of new demand each year. But Asia grows at a 6.25% pace, maybe a bit faster. It generates \$1000bn of new demand every year. If you're a businessman, do you want to invest where demand is growing by 4 cents per year or where it's growing by 10 cents per year?

Extend the thought to Europe. Many are encouraged by the fact that Germany returned to positive growth in the second quarter. That's good news and a good reason to invest there. But put it in perspective. If Germany grew at a 1.5% rate for the next 47 years – a feat few think it will accomplish – it would double in size. It would 'add' a new Germany to Europe's economic map by 2060. Asia, by contrast, 'adds' a new Germany every 4 years, right here in Asia. Five years hence, it will take only 3.5 years for Asia to add a Germany. By 2060, Asia will have put about 25 Germanys on the economic map. Pretty staggering.

This is why long-term capital will continue to flow to Asia. Businesses and investors want to be where the growth is. Inflows will continue to flip-flop in the short-run and yes, Asia will make plenty of mistakes – the West has no monopoly on that. But the shift in economic gravity is the biggest structural change underway in the global economy today. Structural inflows will remain, and grow, long after today's hot and sexy but ultimately short-term outflows have become a footnote to the bigger picture.

David Carbon, for
DBS Group Research
September 12, 2013

Asia-vu 3: are we there yet?

- Capital outflow, collapsing currencies: is Asia headed back to 1997?
- Absolutely. It's been headed there for five years
- But it's not 1997 yet
- Most of Asia continues to run external surpluses. India and Indonesia are exceptions. Both have work to do
- Domestic leverage is at or below trend in most of Asia. China isn't the furthest above trend, Singapore is
- Asia's reserves are at an all-time high; external debt is at an all-time low
- Asia-vu is five years away at least. Recent outflows are cyclical, related to the Fed/QE. Structural inflows are larger and will continue for a long time. Whether 1997 comes again will depend on policy

Current account deficits, capital outflow, collapsing currencies – is Asia headed for 1997 all over again?

Absolutely. We've been charting Asia's progress toward 1997 for five years and it's closer than ever [1]. The good news is, we're not there yet – 1997 is five years away, maybe more. There are some problems – mostly in India and, to a lesser extent, Indonesia – but recent outflows reflect jitters over Fed/QE tapering, not structural problems in the region more broadly. QE was never going to last; the inflows it spawned were never going to stay. Longer-term structural inflows – always the bigger if less sexy force than QE – will stay, and grow. Asia will continue to move forward to the past.

Nomenclature

References to economic regions in this report follow these conventions:

Asia-10: CH, HK, TW, KR, SG, MY, TH, ID, PH, IN

Asia-9: A10 less IN

Asia-8: A10 less IN, CH

Asean-5: SG, MY, TH, ID, PH

Asia Big3: CH, IN, ID

Crisis-4: TH, MY, ID, KR

Greater China: CH, HK, TW

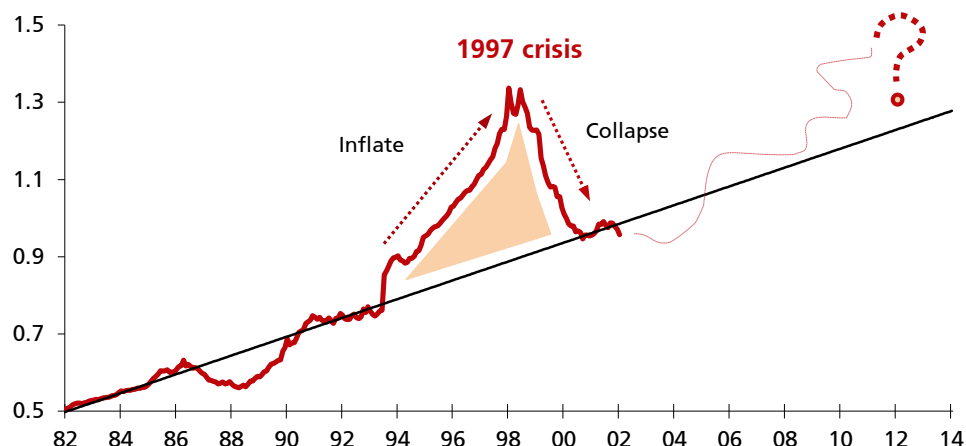
G4: US, EU, JP, A10

G3: US, EU, JP

EU: EU17

Asia – financial sector leverage leading to 1997 crisis

domestic credit relative to GDP, simple avg, Asean 5, KR, HK



If that sounds ominous, it shouldn't. A few years ago, everyone said global rebalancing was necessary – Asia needed to stop running surpluses and the West needed to cut its deficits. That is now happening and, with the important exception of India, that's pretty much all that's happening – it's a benign and welcome development. Asia, as a developing region, is *supposed* to be running deficits, not surpluses. It's supposed to be borrowing from the rich countries, not lending to them.

And for those international investors who wish emerging market countries didn't run deficits, they need to realize this is a contradiction in terms. The only reason emerging markets need foreign money in the first place is to run a deficit. No deficit; no need for foreign cash; no opportunity for the EM investor to earn 'above average' returns. It's that straightforward.

How Asia's march back to 1997 ends remains an open question. A crisis isn't predetermined – it depends on policy and on not letting things – leverage mainly – get out of hand. If leverage and other policies remain appropriate, the cycle doesn't have to be a cycle – one could run north forever. Asia might not see 1997 until 2027, if then.

But first things first. We're already talking about the end game when we should be charting the progression towards it. Only when the points are plotted can one declare 'here is where Asia sits today'.

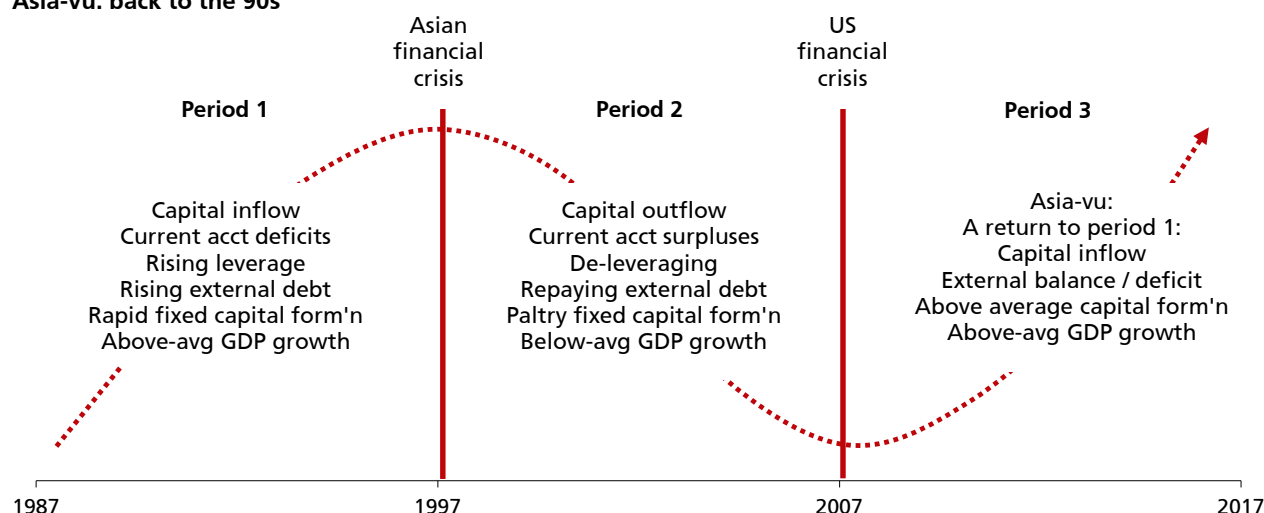
What made 1997?

We've used the stylized chart below to help us lay the groundwork before [2]. It's a thirty year picture divided into three parts: the decade leading up to 1997; the decade between 1997 and 2007 and the decade following 2007, which may or may not lead back to 1997 in 2017.

Decade 1: 1987-1997

The ten years leading up to the 1997 financial crisis were archetypical of excess. Most countries ran large current account deficits that sometimes rose as high as 10% of GDP (Malaysia in 1995). Capital inflows into the region were strong, however – they more than financed the external deficits and put a lot of upward pressure on currencies and downward pressure on interest rates. Domestic leverage rose sharply (see chart on page 1) along with all the foreign borrowing. Gross fixed capital formation soared and GDP growth averaged 8% per year between 1987 and 1996. In Thailand, Indonesia and Malaysia – three of the 'Crisis-4' countries – growth averaged 9% per year for 9 years.

Asia-vu: back to the 90s



The only reason to accept foreign money is to run a deficit

Decade 2: 1997-2007

It was a great run but, as most are aware, it all came to an end in the summer of 1997. Most of Asia – with the notable exceptions of Singapore and China – spent the next 10 years unwinding the excesses of the previous 10 years. Capital left the region. Currencies dropped. Interest rates rose. Current accounts soared to surplus from deficit and, for the most part, stayed there. Asia used its surpluses to pay back the foreign debt (and other liabilities) it had built up over the previous 10 years.

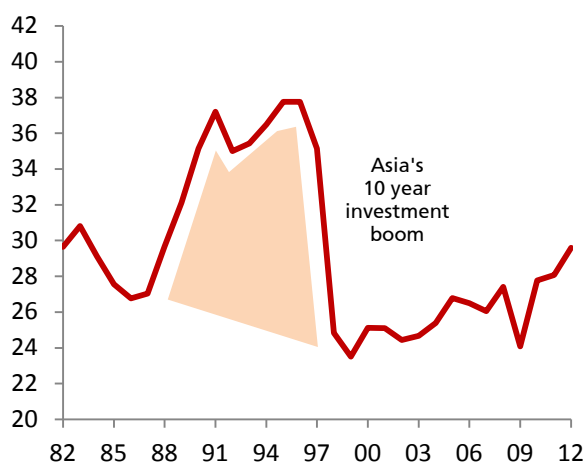
Of course the downside to paying off old debt is that you don't have money left over to buy new things, like capital equipment. Investment in the post-97 decade dropped to a shadow of its former self (chart below left). In the Asean-5, for example, investment growth that averaged 12% per year between 1987 and 1996 dropped to less than 2% between 1997 and 2007.

Low investment means low growth, full stop. More than anything else, this is what kept Asia's GDP growth between 4-5% in the post-crisis decade when it had been twice as high in the pre-97 decade (chart below right).

Referring back to the stylized Asia-vu chart on p2, it is clear that the post-97 decade was in most regards the equal-and-opposite reaction to the pre-crisis decade – an unwinding of all that came before. Ten years up, ten years down. What now?

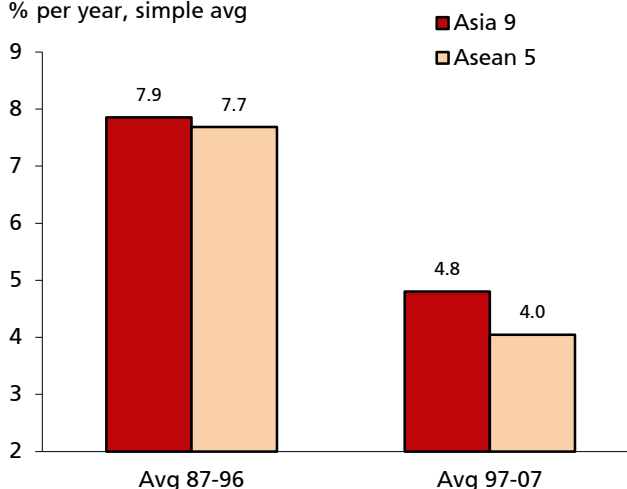
Asia crisis-4 – investment to GDP ratios

percent, simple avg, TH, MY, ID, KR



Asia – GDP growth

% per year, simple avg



Decade 3: Asia-vu

We have argued for some time that the ten years following the global financial crisis would, for Asia, look a lot like the ten years leading up to the 97 crisis – that is, the regional landscape would once again be characterized by capital inflow, a move toward external deficit from surplus, rising leverage, rising investment and faster GDP growth.

Are we there yet? Is it 1997 all over again? The short answer is no, Asia is not on the cusp of another 1997. Most of the region, in fact, remains far away. If one plots the relevant points – the deficits, the leverage, the reserves, the debt, the investment, the inflows and outflows – the picture that emerges is clear: Asia has several years to go before it's 1997 again. Several countries have moved closer to 1997 than others, however, in important ways. Let's consider the data.

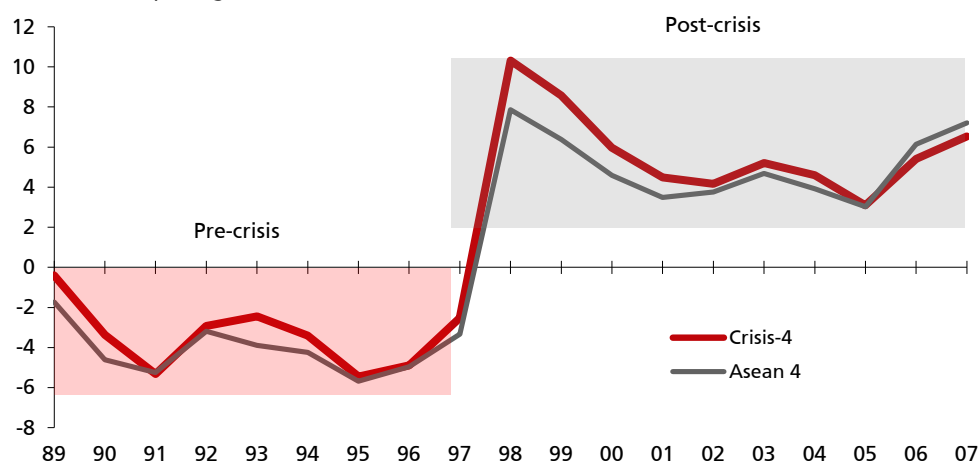
Current accounts

Current account deficits are surely the most emblematic feature of Asia's pre-crisis period. Deficits in the Crisis-4 countries (TH, MY, ID, KR) averaged 4-5% of GDP for nearly a decade. In 1995, Malaysia ran a full year deficit of 9% of GDP; Thailand ran 8% deficits in 1995 and 1996. That changed overnight, however, when the bottom fell out in 1997. Deficits became surpluses instantly and they were maintained for the next 10 years (chart below).

In 1997, Asia deficits turned to surpluses overnight. Most countries have remained in surplus ever since

Asia – current account balance

% of GDP, simple avg

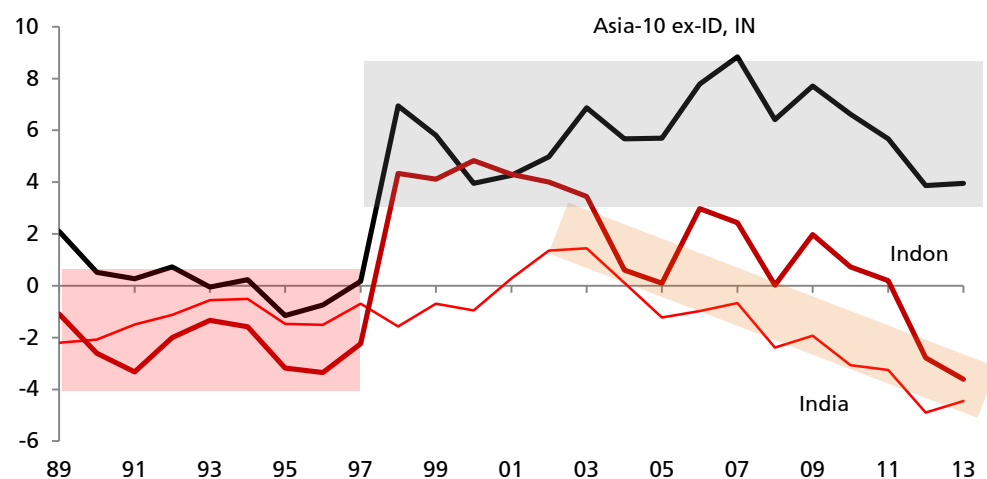


How is Asia faring today? Except for India and Indonesia, not very differently (chart below). Surpluses have fallen from 8% of GDP in 2007 to about 4% today. That's a significant decline – and it owes more to strong growth in Asia than to weak growth in the G3 [3]. But a 4% surplus is still a substantial one and, from this perspective, Asia overall remains far away from 1997. (See Appendix I for country detail).

That said, India and Indonesia need to be monitored. External balances of both countries have trended south for the past 10 years, with India running deficits in most of them (chart below). India's current account deficit has averaged nearly 5% of GDP for the past two years and officials have some serious structural work to do (see "IN: short-term focus, longer-term perils", 19Aug).

Asia – current account balance

% of GDP, simple avg



Indonesia's deficit is more cyclical. It has fallen to 3% of GDP but only recently and we reckon some modest adjustments in policy would be enough to put it on a sustainable footing (see "TH, ID, PH: Roadmap to 2020", 18Jun). As discussed above, there's no reason to pursue an outright surplus – a deficit of 1.5-2.5% of GDP is probably in both Indonesia's and foreign investors' interests.

External debt

Sixteen years of current account surpluses have turned most Asian countries into net-creditors to the world

Sixteen years of surpluses either gets you a pretty big foreign bank account or pays down a lot of old debt. In China's case, it's the former. In the rest of Asia – the part that got into trouble in 1997 – it's the latter. Net external debt (total less holdings of foreign exchange reserves) fell sharply in the decade following the 97 crisis. By 2009, most Asian countries had become net creditors to the outside world rather than net debtors (charts below and Appendix II).

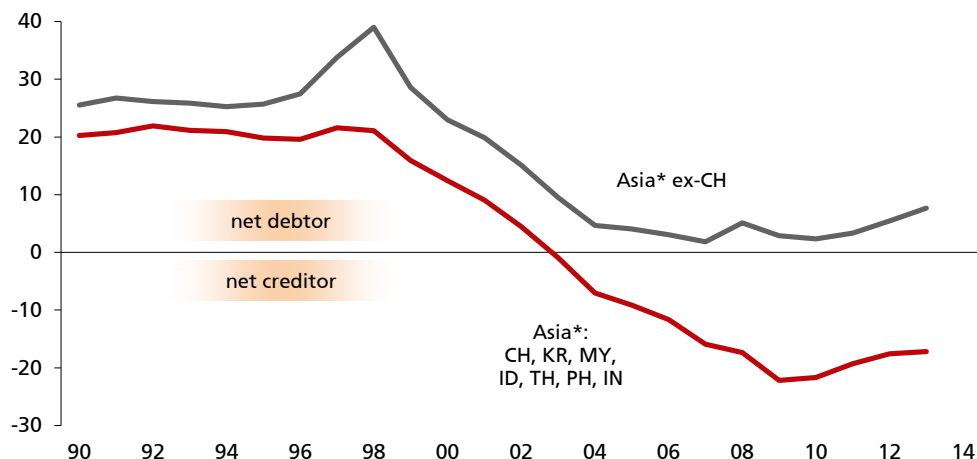
Thailand, for example, had a net external debt equivalent to 67% of GDP in 1997; today it's a net creditor to the tune of 9% of GDP. Malaysia's net debt was 27% of GDP in 1997; today it's a 4% of GDP creditor. Even the Philippines is a net creditor today (1% of GDP) compared red ink equal to 45% of GDP back in 1997.

Countries that remain net debtors have made much progress too. Indonesia's 14 years of surpluses have lowered its net debt from 57% of GDP in 1997 to 20% today. Korea's surpluses have cut its net external debt to 7% of GDP from 29% back in 1997.

Sixteen years of surpluses add up. From an external debt / country risk perspective, Asia is miles away from 1997 [4]. If one had to put a marker on it, the region looks more like 1988 today than 1997 – it's reflating but slowly and the road to Asia-vu is a long one.

Asia – net foreign debt as % of GDP

ext debt (public + priv) less FX reserves as % of GDP



Gross fixed capital formation

Rapid and/or 'over' investment is a big part of most economic crises, including Asia's in 1997. Capital floods in, buildings (most notably) go up, some can't be rented, investors can't be repaid, everyone runs for the exit, hoping not to be the last out the door. Asia's 10 year investment boom ended abruptly in 1997 (charts below). How have things fared since? Is Asia 'over-investing' again?

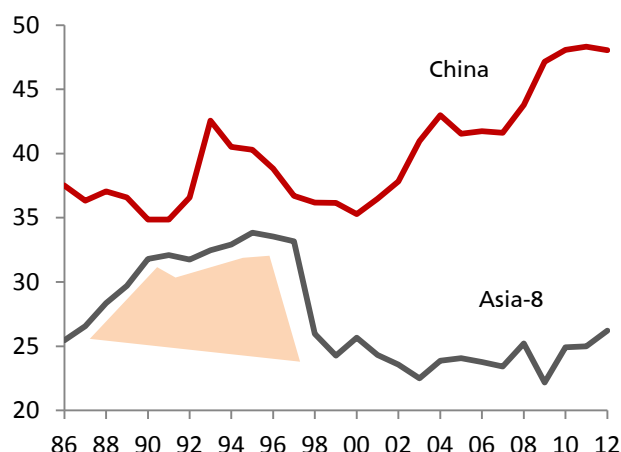
Except for China, decidedly not. Between 1997 and 2007, investment ratios ran flat as a pancake. Like external debt, investment has ticked up modestly since

2007 but, as the charts below make plain, most of Asia remains as far away from 1997 from an investment perspective as it does from an external debt perspective.

China of course is the exception. Investment as a share of GDP has continued to rise from 35% of GDP in 1980 to 48% today. Does this put China on the cusp of 1997 moment?

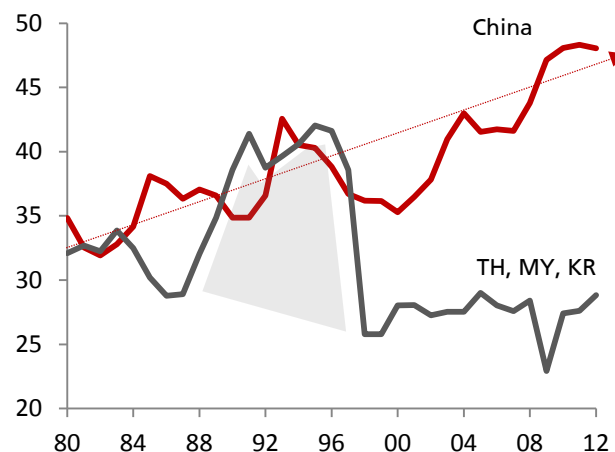
Asia – investment to GDP ratios

percent, simple avg



Asia – investment to GDP ratios

percent, simple avg



It might were it not for a couple of mitigating factors. The first is that while 48% is high, how one gets there surely matters as much as the height itself. Thailand, Malaysia and Korea all jumped to 44% in the early 90s but they did it almost overnight. China's ratio is higher than this but the rise occurred over a 35 year period, not a 2 year period. Indigestion must depend in large part on how fast dinner is consumed.

Second, the authorities in China are aware of the risks and are undertaking reforms to address them. Property development has been restrained. Industries where over capacity is most acute – steel, aluminum, cement, paper – have been ordered to scale back. The GDP growth target has been lowered to 7.5% and for the first time in a long time it appears to be a real target rather than a lower bound. If China has been approaching 1997, the authorities have been pursuing structural changes to ensure it doesn't get there [5].

Domestic credit relatives

Leverage and domestic credit doesn't have to come from foreign inflows. That's what drove Asia's bubble in the early-90s but domestic monetary authorities can inflate economies just as easily as inflows can. Whatever the source, how does the overall credit / leverage picture in Asia look relative to 1997?

Like the other variables mentioned above, pretty muted. Domestic credit [6] relative to GDP is running on or below trend throughout most of the region (table at top of next page). Back in 1997, leverage in most Asian countries in the region had risen two standard deviations or more above trend (see Appendix IV).

Interestingly, given all the hoopla surrounding loan growth there, China's leverage isn't far above trend (chart bottom left of next page). Even including the so-called shadow banking sector, outstanding credit relative to GDP lies only 1.2 standard deviations above trend [7]. Stolid, safe Singapore, by contrast, is where leverage has run furthest amuck. Loans extended by domestic banking units now stand 2.1 standard deviations above trend, a 4-unit swing since 2006 (chart below right). Singapore in 1997 looks almost sleepy by comparison.

China's investment to GDP ratio is high. But it got where it is over a 35 year period, not a 2 year period like Asia in the 90s

Asia 10 domestic credit / leverage

Financial sector loans as a percentage of GDP

	--- Loans:GDP ratio ---				Stdev from trend	Growth rate in loan:GDP ratio		
	1986 %	2000 %	2013 %	change 1986-2013 pct pts	2013 units	1986-00 % / yr	2000-13 % / yr	1986-13 % / yr
China (Formal sector)	72	101	125	53	0.0	2.4	1.7	2.1
China (Formal+Shadow)	73	108	168	95	1.2	2.8	3.5	3.1
Hong Kong	78	124	168	90	0.3	3.3	2.4	2.9
Singapore (DBUs)	78	93	131	54	2.1	1.3	2.7	2.0
Singapore (DBU+ACU)	286	188	261	-25	1.9	-2.9	2.6	-0.3
Korea	39	52	86	47	-1.5	2.0	4.0	3.0
Taiwan	65	142	153	88	-1.0	5.7	0.6	3.2
Malaysia	66	82	121	55	0.4	1.5	3.1	2.3
Thailand	54	92	101	47	0.2	3.9	0.7	2.4
Indonesia	20	20	34	14	0.6	0.0	4.3	2.0
Philippines	18	45	34	16	-0.8	6.8	-2.3	2.3
India	19	23	51	32	0.3	1.3	6.3	3.7

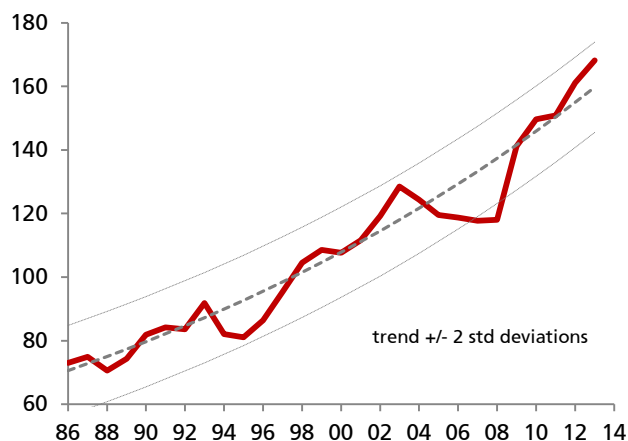
Of course no single statistic (like standard deviations from trend) can fully describe the leverage situation and associated risks. Singapore's leverage lies the most number of standard deviations above trend; Taiwan's ratio is the second highest in absolute terms. China's ratio has risen by the most number of percentage points since 1986 (95 points) but India's leverage ratio has grown the fastest in percentage terms (and Singapore's the slowest). Pick your poison, there's something for everyone.

This kind of mixed picture shows why it is so difficult to gauge whether a bubble exists and / or when it might blow. We have always regarded standard deviations from trend as the most useful indicator but anyone who has ever drawn a trend line knows how subjective that exercise can be and, at the same time, how useless an 'objective' computer-generated trend line can be. The best any investor or regulator can do is look at everything and err on the side of caution. The good news is, most in Asia have done so since 1997.

A final point here is worth noting. To the extent that China's leverage has run too high and financial stress were to lead to capital flight, the direction would likely

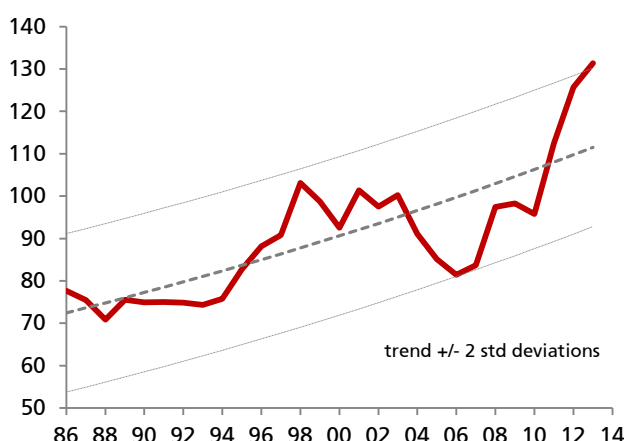
CH – domestic credit as % of GDP

percent, formal sector + shadow banking



SG – domestic credit as % of GDP

percent, Dom Banking Units



be the opposite of what occurred in 1997. Back then, Asia's precrisis borrowing turned to outward flight when foreign investors realized that not everyone would get out whole. China, by contrast, hasn't been borrowing from the rest of the world for the past ten years, it has been lending to it. Were China to run into trouble, the 'sucking sound' of capital flows would likely be inward, not outward, as companies and officials pulled home foreign funds to patch local holes.

Capital inflow and outflow [8]

If Asia isn't on the verge of another 1997, why then is capital leaving the region? The answer is, most of it isn't. Most of the inflows into Asia over the past decade have been long-term / structural flows coming from investors and businesses seeking to capitalize on Asia's strong growth – and they have stayed put. Since 2001, some US\$2.4 trn of capital has flowed into Asia. About \$500bn flowed out temporarily in 2008 and another \$300bn has flowed out since September 2011. That leaves net inflows of \$1.6trn since 2001, or about 2% of GDP, on average, during the period. That's not chump change.

Some of the inflows since 2008 of course have been short-term in nature, arbitraging the difference between local rates and returns and those of Western countries where growth was weak and where central banks had cut interest rates to zero. These cyclical inflows are now reversing course. The world is once again in 'risk-off' mode, this time over fears of Fed tapering of its third quantitative easing program and the fallout it could potentially bring to asset prices.

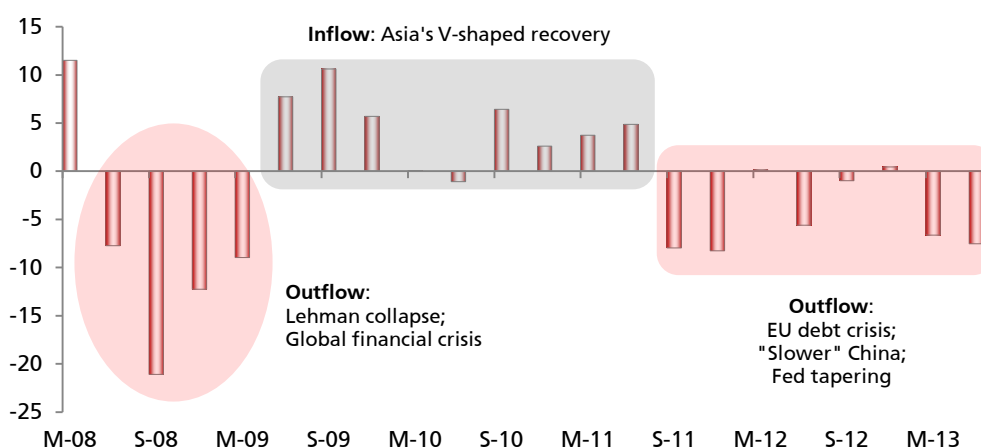
Two points to make here. First, as the chart below clearly shows, outflows aren't only, or even mainly about the Fed and QE3. Asia's outflows (and slower growth) began a full two years ago – way back in September 2011 when the EU debt crisis erupted in earnest. In the second half of 2011, outflows averaged 8% of GDP, comparable to that which followed the collapse of Lehman Brothers in Sep 2008. Even after QE3 began, nine months later in Sep12, capital continued to flow out of Asia, not in. Outflows have recently reaccelerated but worries about Fed tapering are simply the latest in a string of 'risk-off' events that includes the EU debt crisis and concerns about a hard landing in China.

The bigger point to make is that the short-term money that flowed into Asia on the back of low interest rates in the West was always going to be just that: short-term. The US was always going to recover, its monetary policy was always going to return to normal. Inflows borne of cyclical weakness in the G3 were always going to reverse at some point. That point appears increasingly to be now.

Two-thirds of Asia's inflows are long-term flows and they are staying put. Short-run inflows were always destined to become outflows eventually

Asia 8 – capital inflow/outflow

BoP capital acct surplus/deficit as % of GDP



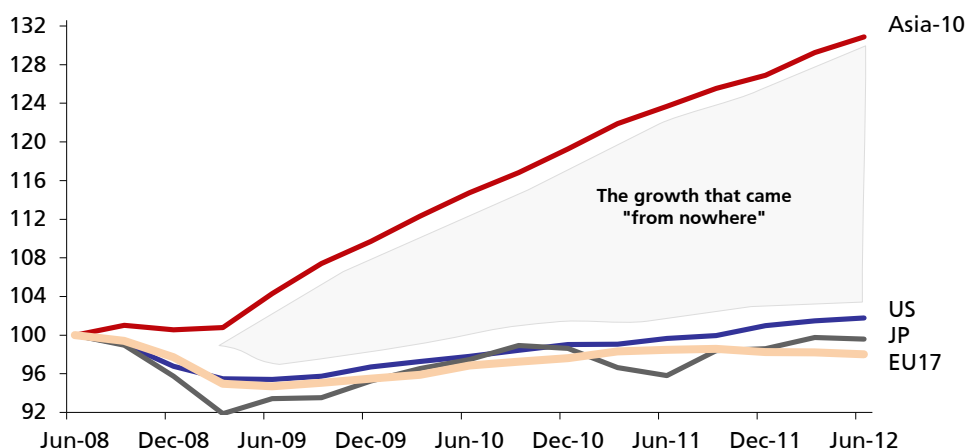
Why will Asia continue to receive long-term inflows? Because Asia is where the world's growth is being generated

Longer-term inflows

The biggest point of all to make is that long-term inflows will remain. And grow. If there is one thing that the global financial crisis has made clear, it is that Asia is where the world's growth – its new demand – is being generated. In the four years following the collapse of Lehman Brothers, the US grew not one iota. Ditto for Japan. Ditto for Europe. Asia, meanwhile, continued to grow at almost its long-run average pace, 'adding' an entire Germany to the Asian economic map in the process. Even at today's slower growth pace for China (7.5%) and the region more generally (6%), Asia will continue to add a new Germany to the region every four years. Five years from now, with even slower growth (but a larger base), it will take Asia only 3.5 years to put a new Germany on the map.

Real global GDP

2Q08=100, seas adj



This kind of demand growth is what makes businesses want to invest in Asia. This kind of demand growth is what has brought long-term capital into the region and what will keep it flowing in in the years ahead. It's not rocket science – businesses want to go where the growth is. And increasingly that is Asia.

Is Asia headed for 1997 again? Yes. Is it there yet? No. China and Singapore have some work to do on financial sector leverage. Indonesia has some work to do on the current account. India has work to do on many fronts. But the region as a whole remains far away from 1997 in 2013. Capital inflows will continue to push it forward to the past for several more years, if not for considerably longer.

Notes:

[1] See "Asia-vu", DBS Quarterly Economics-Markets-Strategy, 15Jun07; "Asia-vu (2): back to the '90s", DBS Quarterly EMS, 17Sep09; "Two decades down, one to go" Finance Asia, 4Jun10 (<http://www.financeasia.com/News/174362,two-decades-down-one-to-go.aspx>); "Where have all the surpluses gone?", DBS Quarterly EMS, 14Jun12.

[2] Ibid.

[3] "Where have all the surpluses gone?", DBS Quarterly EMS, 14Jun12.

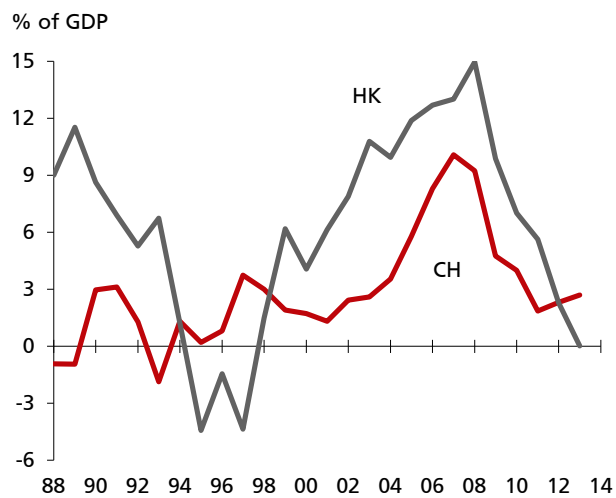
- [4] Moreover, it is clear that most of the criticism Asia used to receive from Western countries for running surpluses and contributing to 'global imbalances' was unwarranted. Asia wasn't creating new imbalances, it was addressing / unwinding old ones.
- [5] See "New drivers, new risks: The impact of a slower China on regional economies and currencies", 2 August 2013.
- [6] Domestic credit is defined as financial sector loans to the local private sector. In the case of shadow banking in China, it includes estimates of loans made by trust companies, brokerage firms and other small lenders and financial guarantors. Estimates are taken from the US Federal Reserve ("Shadow Banking in China" Expanding Scale, Evolving Structure", Federal Reserve Bank of San Francisco, April 2013.)
- [7] See "Shadow Banking in China" Expanding Scale, Evolving Structure", Federal Reserve Bank of San Francisco, April 2013.
- [8] Capital inflows here are defined / calculated simply as the difference between an increase in foreign reserves and the current account surplus – e.g., a \$1 rise in foreign reserves accompanied by \$1 current account deficit implies capital inflows of \$2.

Sources:

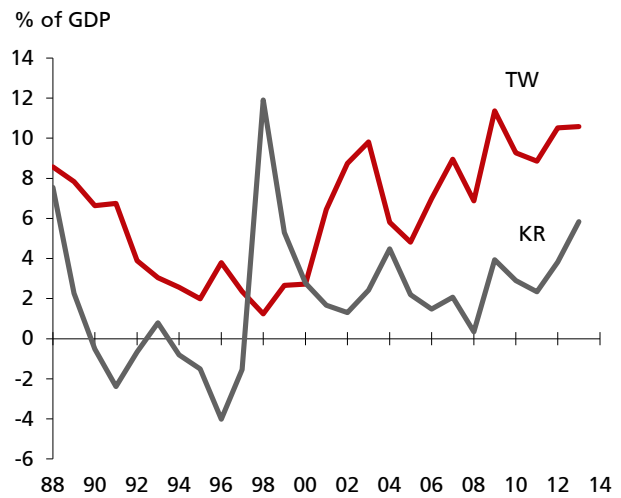
Except where noted, data for all charts and tables are from CEIC Data, Bloomberg, IIF (external debt) and DBS Group Research (forecasts and transformations).

Appendix I: Current account balances

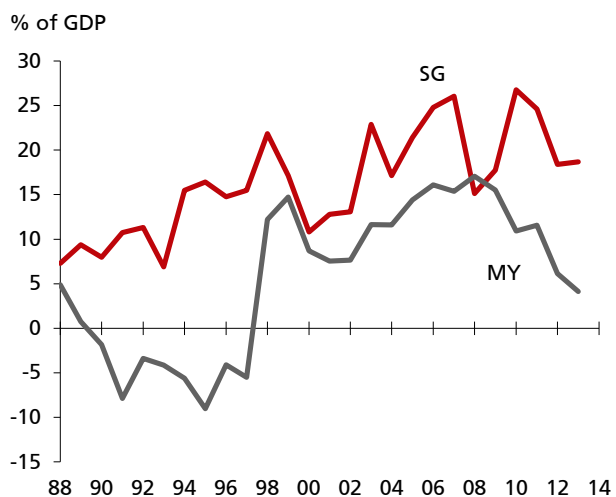
Asia – current account balance



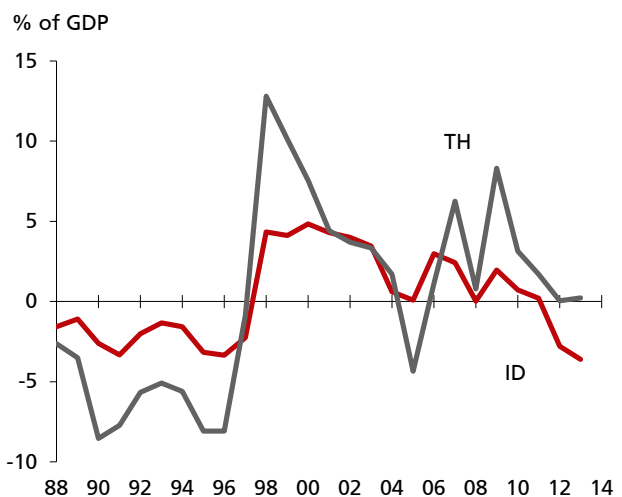
Asia – current account balance



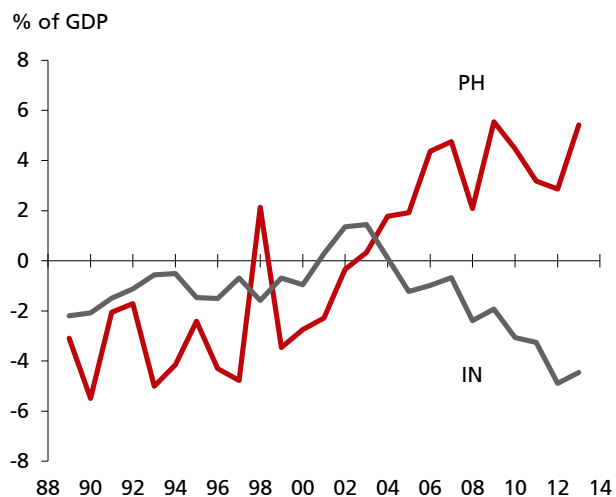
Asia – current account balance



Asia – current account balance



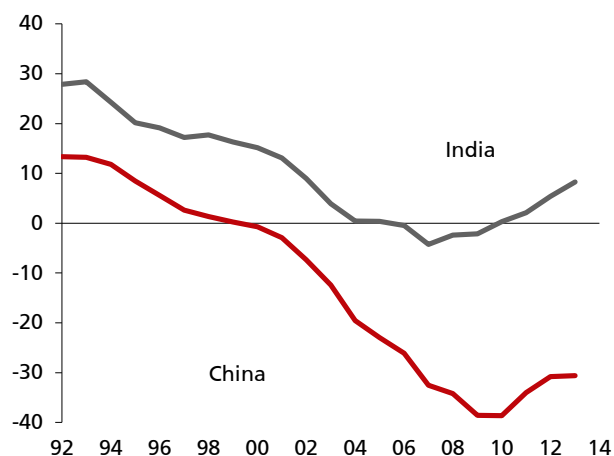
Asia – current account balance



Appendix II: Net external debt

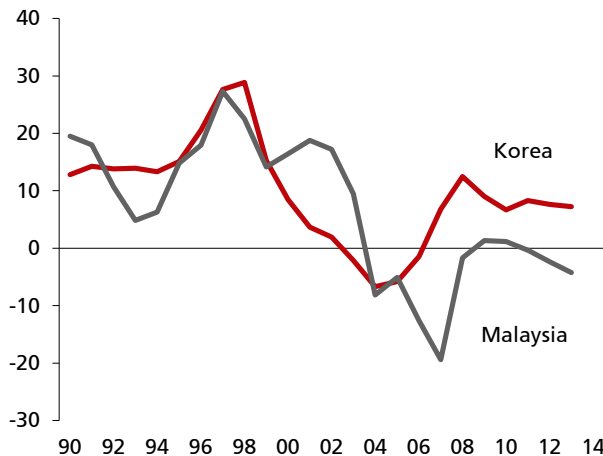
Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP



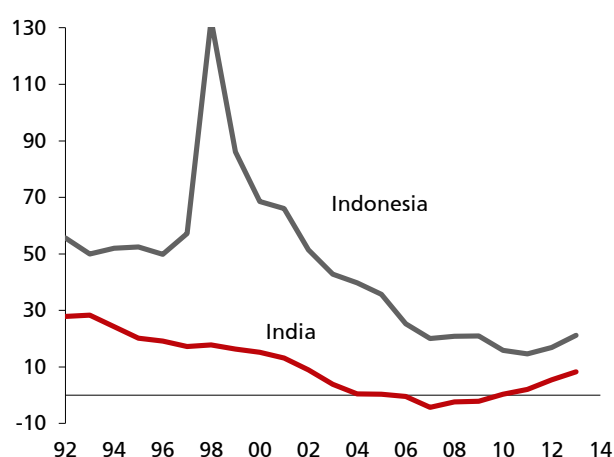
Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP



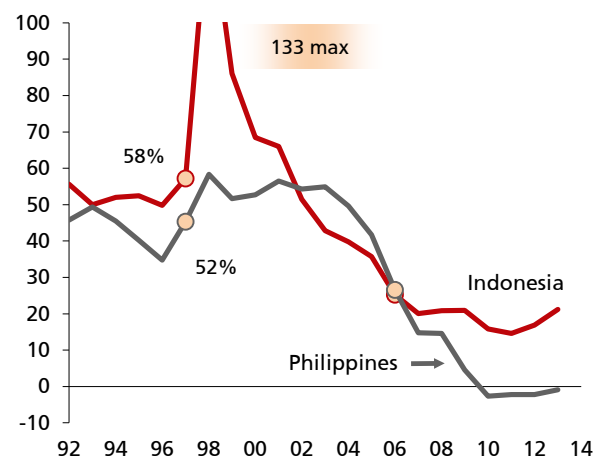
Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP



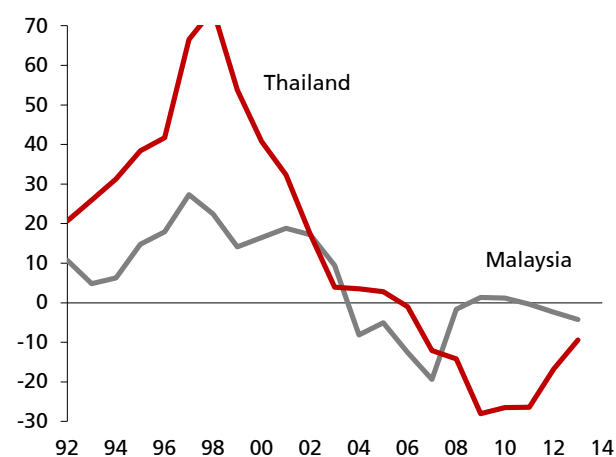
Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP



Asia – net foreign debt as % of GDP

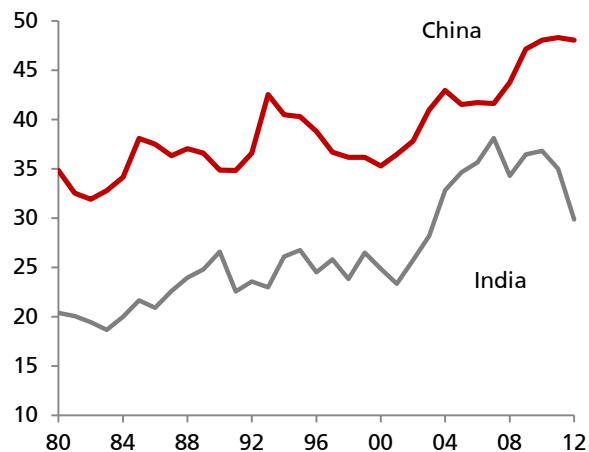
ext debt less reserves as % of GDP



Appendix III: Gross fixed capital formation

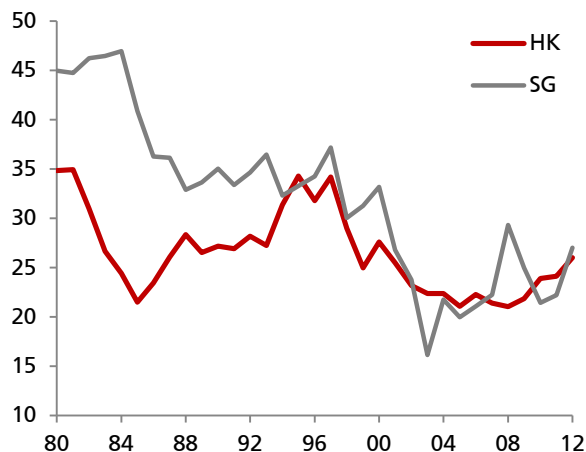
Asia – investment to GDP

percent, GFCF



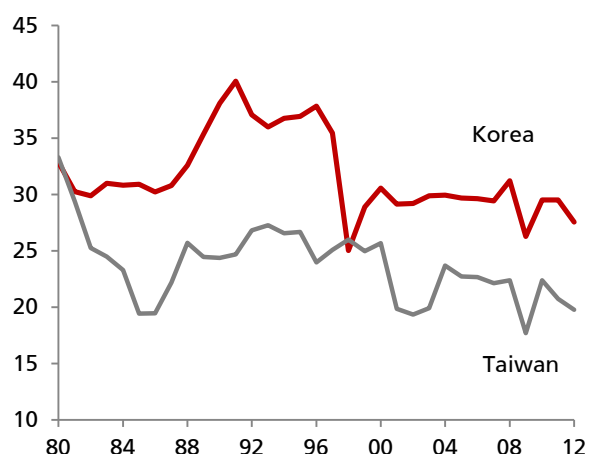
Asia – investment to GDP

percent, GFCF



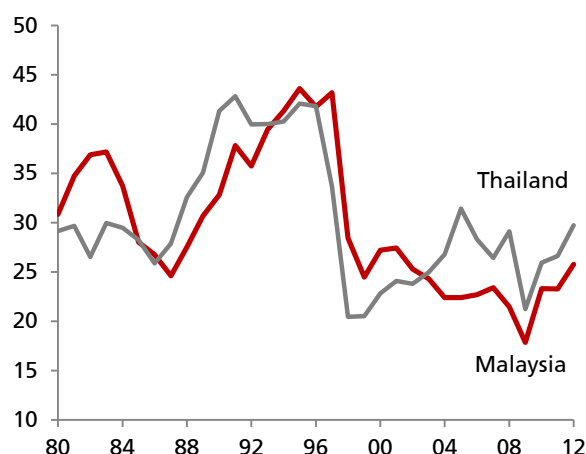
Asia – investment to GDP

percent, GFCF



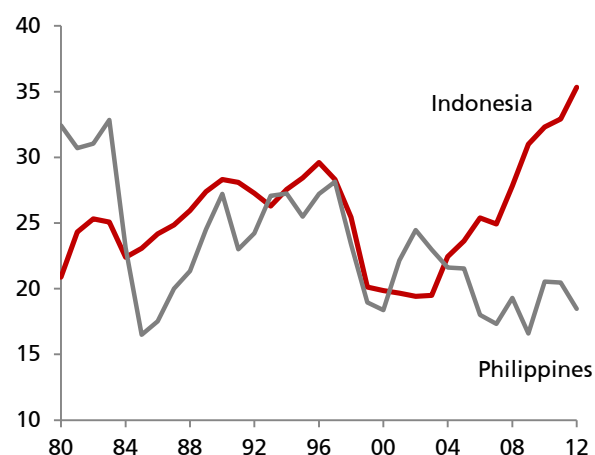
Asia – investment to GDP

percent, GFCF



Asia – investment to GDP

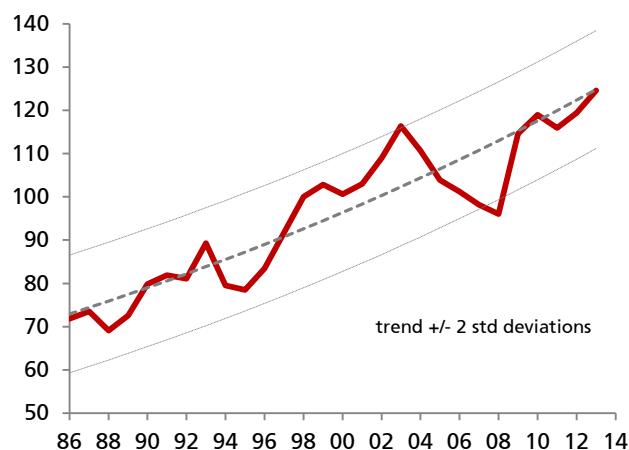
percent, GFCF



Appendix IV: Domestic credit relatives

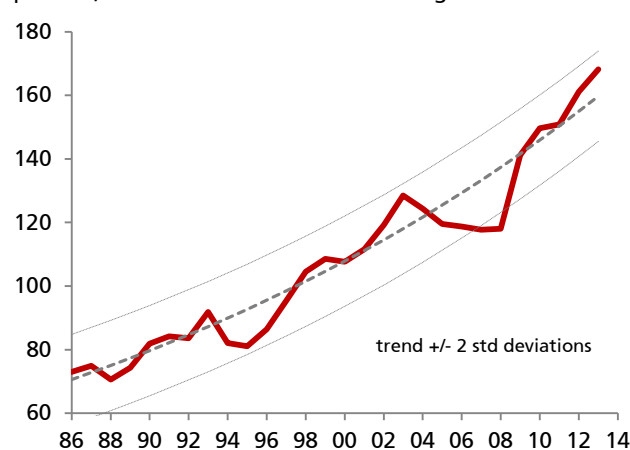
CH – domestic credit as % of GDP

percent, formal sector



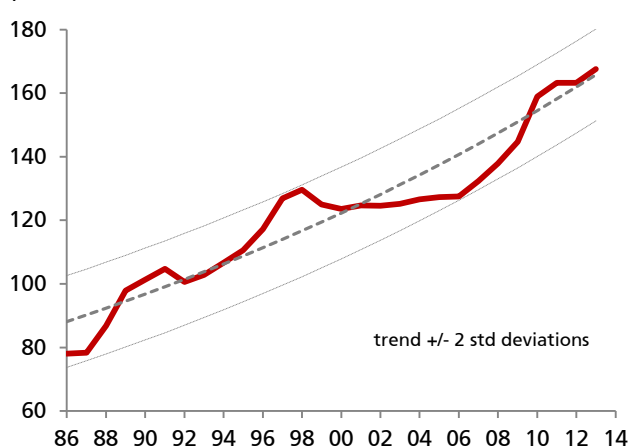
CH – domestic credit as % of GDP

percent, formal sector + shadow banking



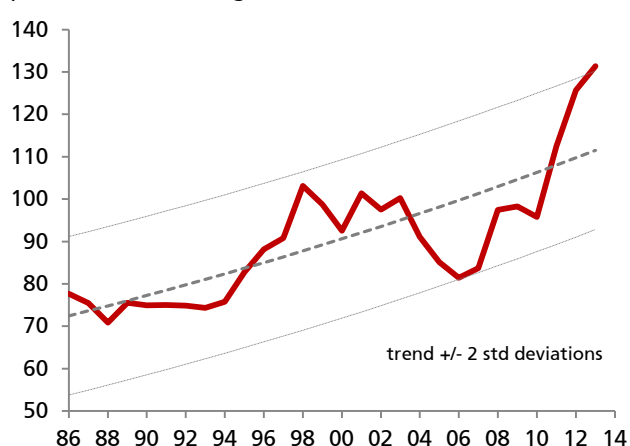
HK – domestic credit as % of GDP

percent



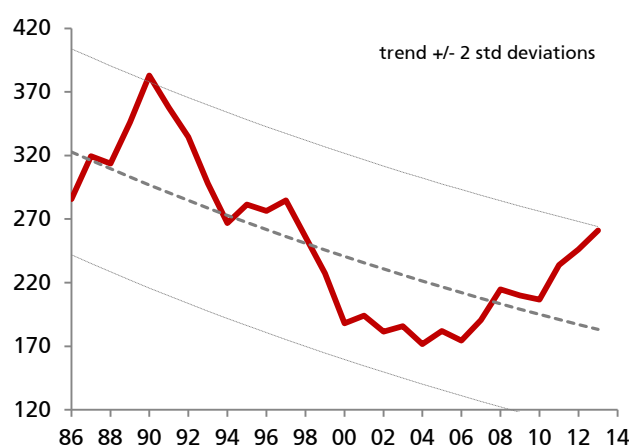
SG – domestic credit as % of GDP

percent, Dom Banking Units



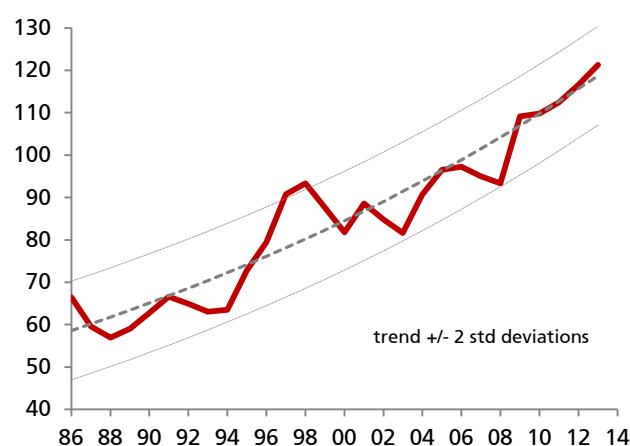
SG – domestic credit as % of GDP

percent, DBU + ACU



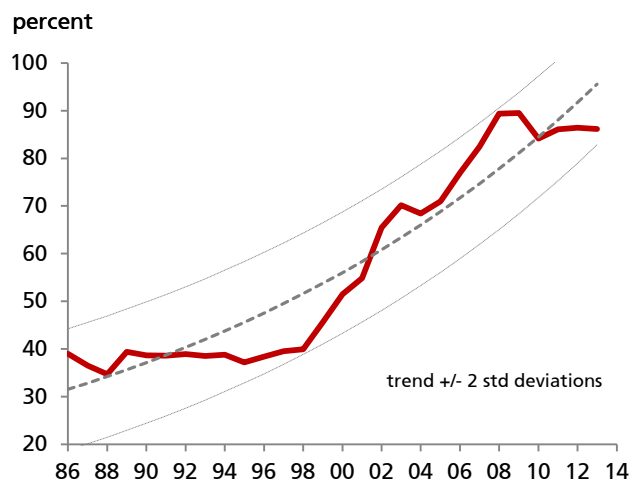
MY – domestic credit as % of GDP

percent

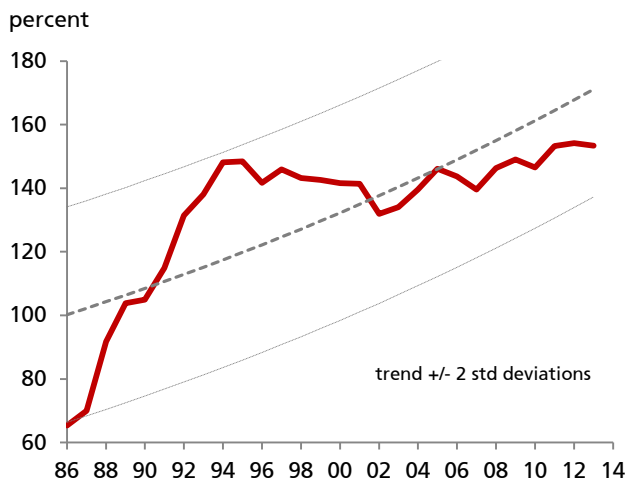


Appendix IV: Domestic credit relatives (cont'd)

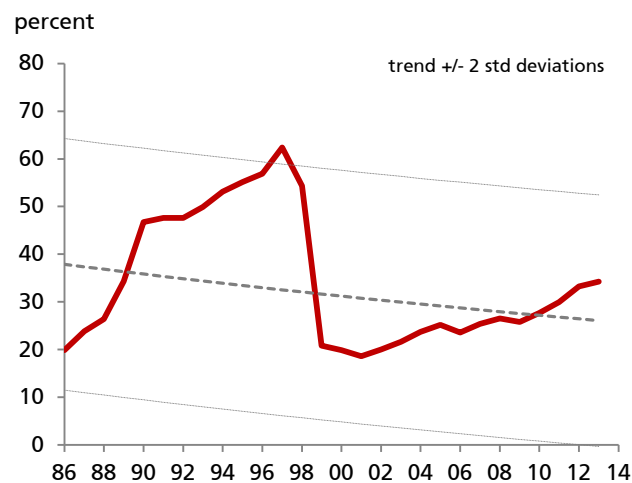
KR – domestic credit as % of GDP



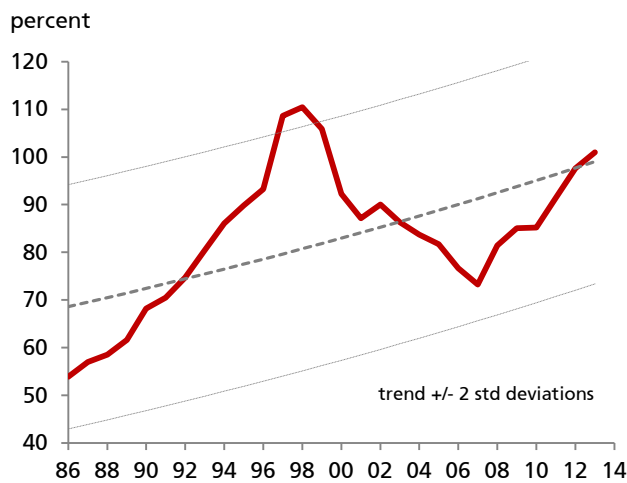
TW – domestic credit as % of GDP



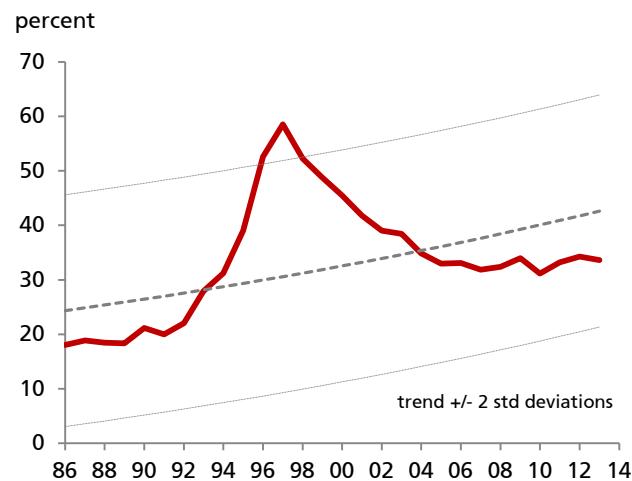
ID – domestic credit as % of GDP



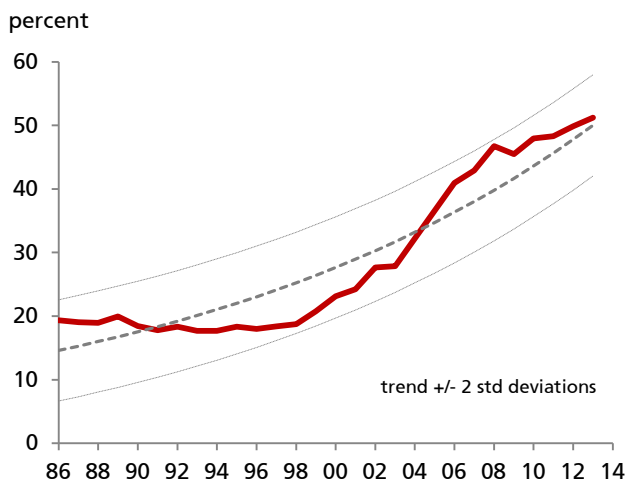
TH – domestic credit as % of GDP



PH – domestic credit as % of GDP



IN – domestic credit as % of GDP



Appendix V: Domestic credit growth summary

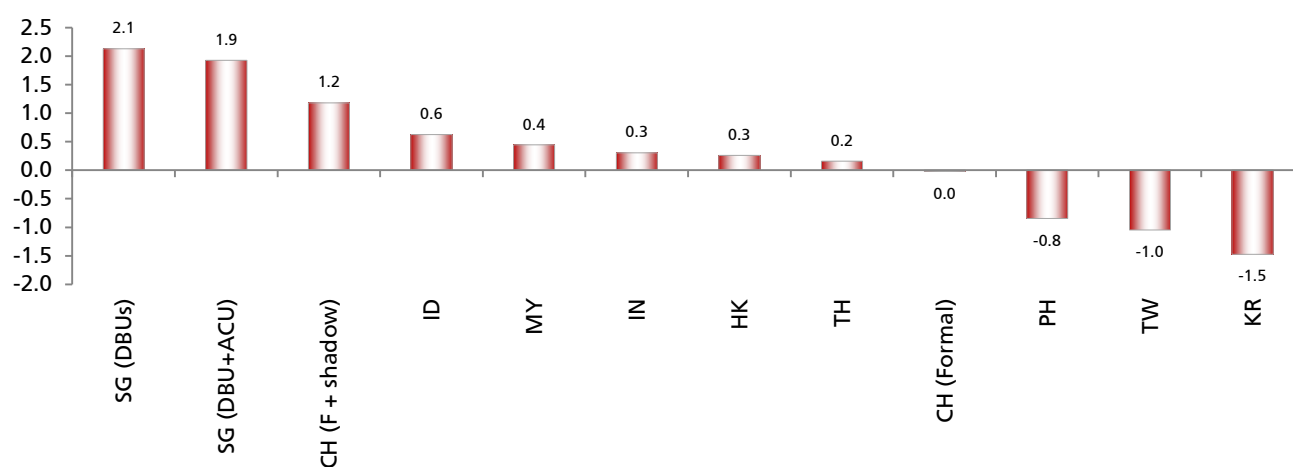
Asia 10 domestic credit / leverage

Financial sector loans as a percentage of GDP

	--- Loans to GDP ratio ---				Stdev from trend	Growth rate in loans to GDP ratio		
	1986 %	2000 %	2013 %	change 1986-2013 pct pts		1986-00 % / yr	2000-13 % / yr	1986-13 % / yr
China (Formal sector)	72	101	125	53	0.0	2.4	1.7	2.1
China (Formal+Shadow)	73	108	168	95	1.2	2.8	3.5	3.1
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Singapore (DBU+ACU)	286	188	261	-25	1.9	-2.9	2.6	-0.3
Korea	39	52	86	47	-1.5	2.0	4.0	3.0
Taiwan	65	142	153	88	-1.0	5.7	0.6	3.2
Malaysia	66	82	121	55	0.4	1.5	3.1	2.3
Thailand	54	92	101	47	0.2	3.9	0.7	2.4
Indonesia	20	20	34	14	0.6	0.0	4.3	2.0
Philippines	18	45	34	16	-0.8	6.8	-2.3	2.3
India	19	23	51	32	0.3	1.3	6.3	3.7

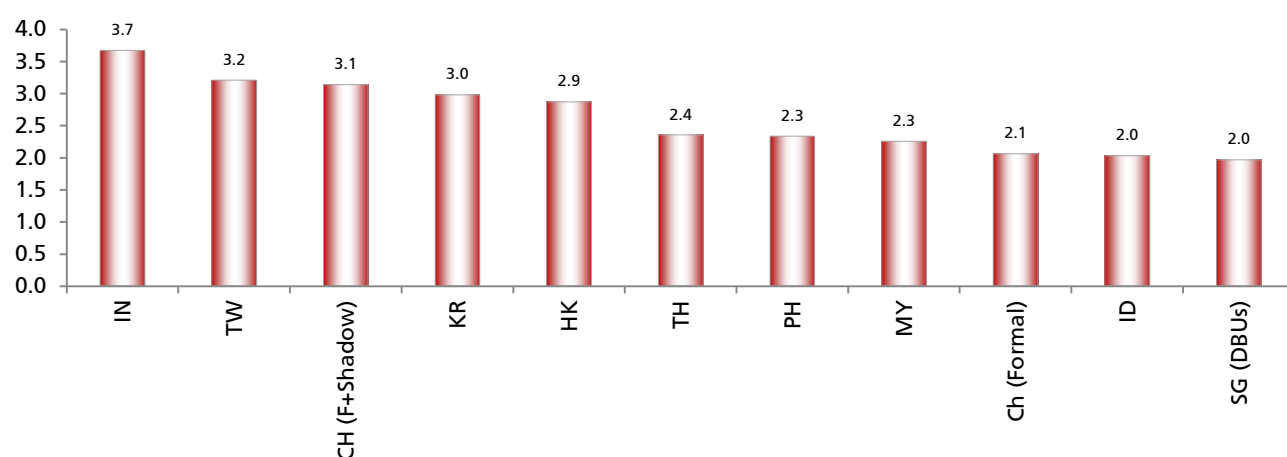
Asia10 – financial sector leverage, std deviations above trend

loans as % of GDP, std deviations above/below trend



Asia10 – financial sector leverage growth

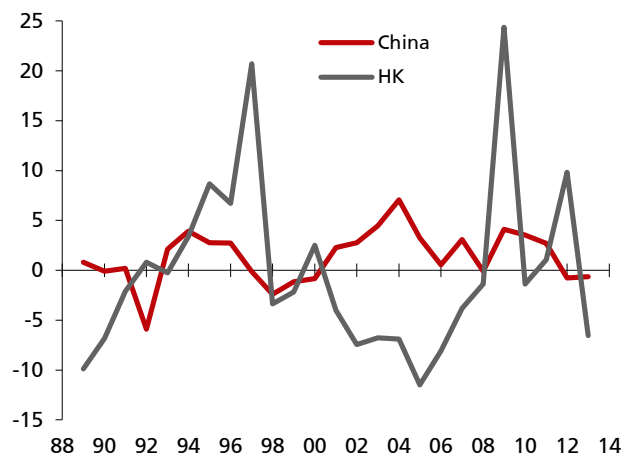
loans as % of GDP, avg growth per year, 2000-2013



Appendix VI: Capital account balances

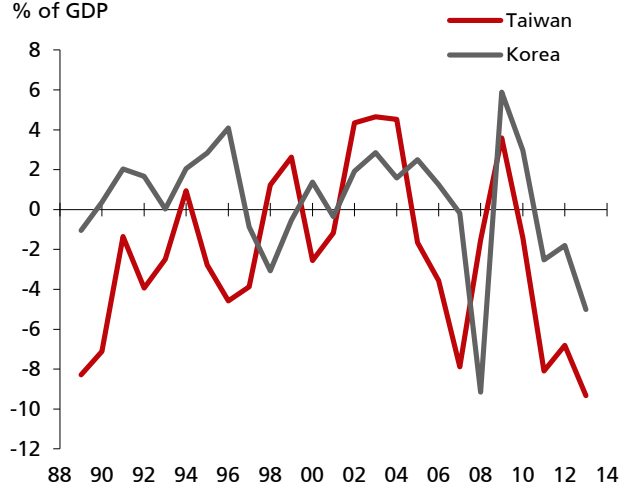
Asia – financial account balance

% of GDP



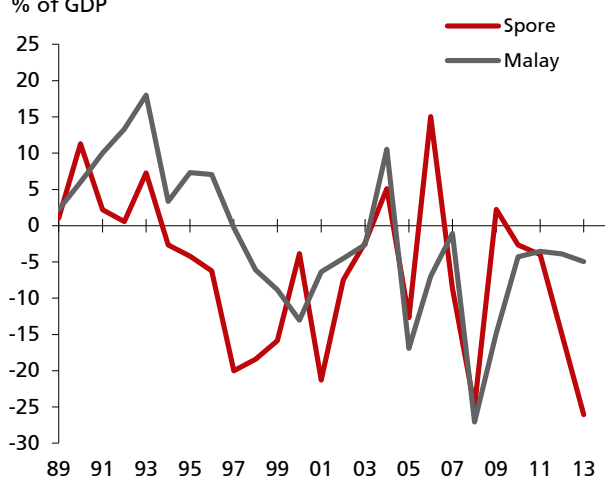
Asia – financial account balance

% of GDP



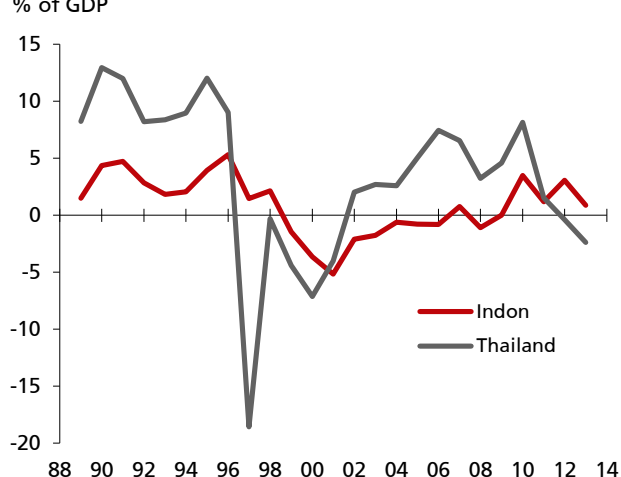
Asia – financial account balance

% of GDP



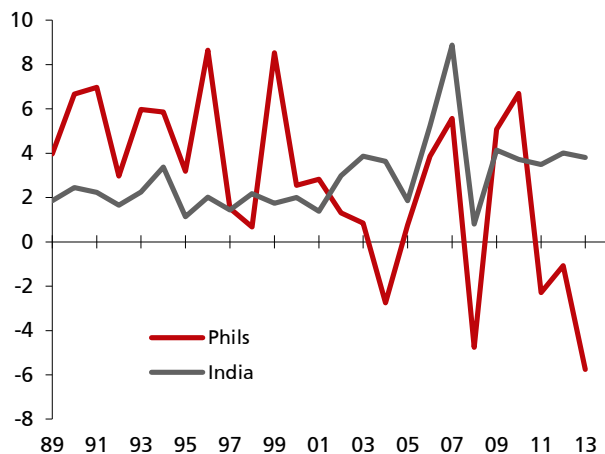
Asia – financial account balance

% of GDP



Asia – financial account balance

% of GDP



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FX: Volatility, not crisis

Asia: Volatility has risen on Fed tapering fears

Asia is not headed towards another 1997/98 crisis; this is a case of jitters

Sentiment is stabilizing and indeed turning cautiously optimistic with the modest improvement in the global economy

CNY: Set to appreciate again

HKD: Wary of peg speculation

TWD: Stable, resilient

KRW: Confident but in no hurry to appreciate

SGD: Back on the “historical” appreciation path

MYR: Adjusted for fiscal weakness

THB: More cautious than optimistic

IDR: No relief until the current account improves

PHP: Weaker despite good fundamentals

INR: Oversold and stabilizing

VND: Look for another small drop

USD: Buy the rumor, sell the fact

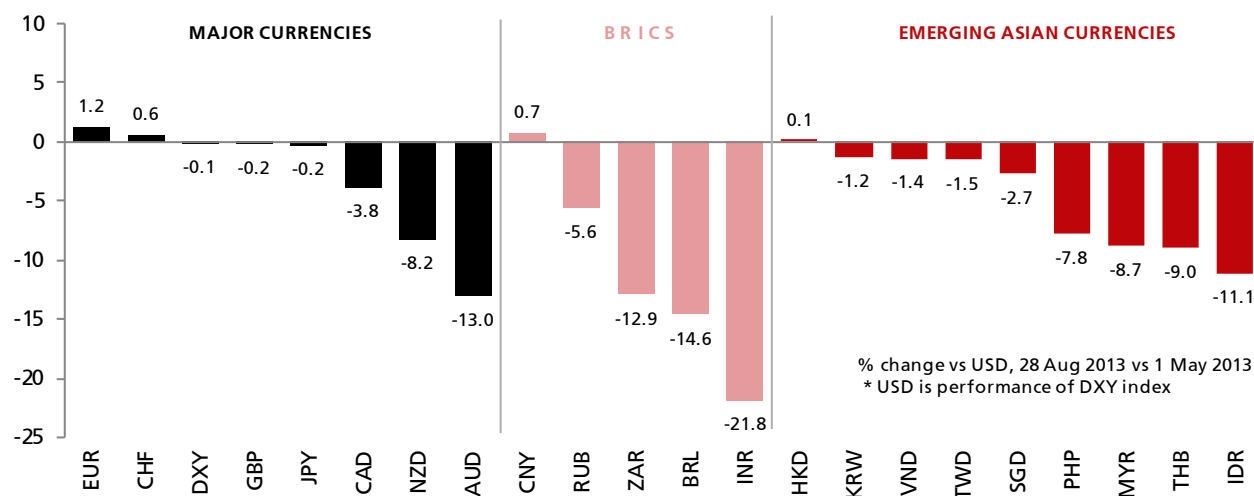
JPY: Towards flatter depreciation

EUR: Appreciation defies sceptics

AUD: New government brings hope

NZD: Still seen hiking before Fed

The May-August fallout on currencies from the Fed's plan to wind down QE3



Currency forecasts

	11-Sep	4Q13	1Q14	2Q14	3Q14	4Q14
EUR /usd	1.3309	1.32	1.33	1.34	1.35	1.36
Previous		1.32	1.34	1.35	1.36	1.37
Consensus		1.28	1.27	1.26	1.27	1.25
usd/ JPY	99.85	102	103	104	106	107
Previous		102	104	105	106	107
Consensus		103	105	106	108	110
usd/ CNY	6.1183	6.09	6.06	6.03	6.00	5.97
Previous		6.06	6.03	6.00	5.98	5.96
Consensus		6.12	6.10	6.08	6.07	6.05
usd/ HKD	7.7541	7.76	7.76	7.76	7.76	7.76
Previous		7.78	7.79	7.80	7.80	7.80
Consensus		7.76	7.77	7.77	7.76	7.77
usd/ KRW	1085.8	1075	1070	1065	1060	1055
Previous		1080	1060	1040	1030	1020
Consensus		1127	1130	1123	1105	1107
usd/ TWD	29.629	29.5	29.4	29.3	29.2	29.0
Previous		29.4	29.2	28.9	28.8	28.7
Consensus		30.1	30.2	30.1	30.0	29.8
usd/ SGD	1.2660	1.25	1.23	1.22	1.21	1.20
Previous		1.23	1.21	1.19	1.18	1.17
Consensus		1.28	1.29	1.28	1.26	1.26
usd/ MYR	3.2580	3.31	3.29	3.28	3.26	3.25
Previous		2.99	2.96	2.94	2.93	2.92
Consensus		3.30	3.27	3.26	3.28	3.22
usd/ THB	31.960	32.2	32.1	32.0	31.9	31.8
Previous		29.8	29.7	29.6	29.5	29.4
Consensus		32.0	32.0	32.1	32.0	31.7
usd/ IDR	11330	11150	11200	11250	11300	11350
Previous		9800	9750	9700	9650	9600
Consensus		11200	11200	11083	11200	10700
usd/ PHP	43.610	43.8	43.6	43.4	43.2	42.9
Previous		41.0	40.5	40.0	39.8	39.6
Consensus		44.0	43.8	43.5	43.5	43.2
usd/ INR	63.380	64.1	64.4	64.8	65.1	65.4
Previous		56.6	57.0	57.4	57.6	57.8
Consensus		64.0	63.8	62.0	62.1	61.8
usd/ VND	21110	21310	21340	21380	21410	21450
Previous		21200	21300	21400	21450	21500
Consensus		21350	21400	21500	21900	21450
AUD /usd	0.9328	0.95	0.97	0.99	1.01	1.03
Previous		1.00	1.02	1.04	1.05	1.06
Consensus		0.89	0.88	0.87	0.88	0.88
NZD /usd	0.8078	0.81	0.82	0.83	0.84	0.85
Previous		0.82	0.84	0.86	0.87	0.88
Consensus		0.78	0.77	0.76	0.78	0.76

DBS forecasts in red. Consensus are median forecasts collated by Bloomberg as at Sep 11, 2013

The myth of “higher US bond yields, higher USD”

Expectations that the Fed’s tapering plans would bring a strong US dollar did not materialize. The benchmark DXY (USD) index, which measures the performance of the USD against other major currencies was, in reality, trapped in a wide range between 80.60 and 84.60. In the past couple of months, the DXY fell back to the floor of this range even whilst the 10-year US bond yield rose towards 3.00%. What went wrong? Nothing actually. This was exactly what happened during the start of QE1 and QE2.

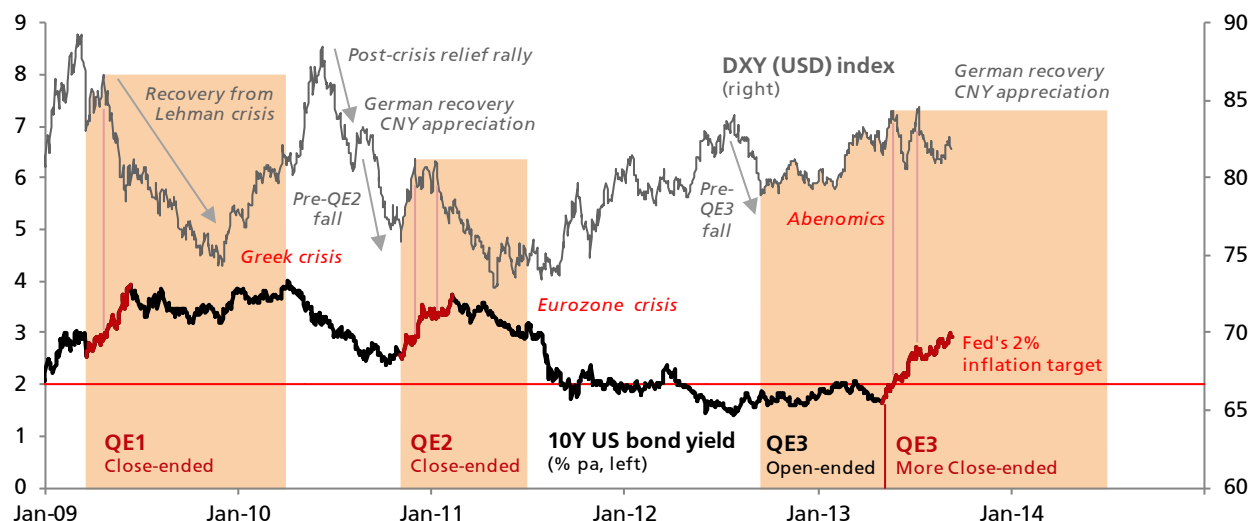
Markets missed two things regarding QE3. First, the Fed’s third asset purchase program was open-ended and did not have specific end-dates like QE1 and QE2. Second, unlike the first two QEs, US 10Y bond yields were not above, but below the Fed’s 2% inflation target. Both differences could be attributed to the severity of the Eurozone crisis. Let us not forget, the Euro was facing break-up risks until European Central Bank (ECB) President Mario Draghi pledged in late July 2012 to “do whatever it takes” to stand behind the single currency. This was followed by the Fed’s open-ended QE3 in September 2012. A flight to safety in bonds and QE3 were the two reasons for record low US bond yields.

It was probably no coincidence that the first whispers of tapering from Fed officials emerged in the first quarter this year. Apart from US equities rising towards their all-time highs, the housing sector was also recovering on the back of negative real mortgage rates. As Fed officials became more concerned about excessive risk taking in US asset markets, they became less ambiguous about their plans to wind down QE3.

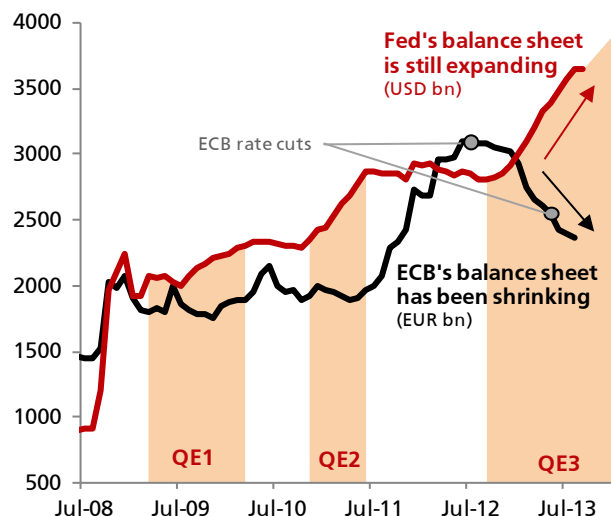
The Fed probably resorted to communication to make QE3 less open-ended, and to prompt markets to return long bond yields above inflation again. The Fed probably also needed a more friendly global economy before actually reducing its asset purchases. Hence, it should not come as a surprise why the taper in September, if it proceeds, is coming only after the Eurozone reported an end to its six-quarter recession and with worries of a China hard landing receding.

From here, we should pay close attention to the German recovery and the Chinese yuan resuming its appreciation. They were instrumental in leading the DXY (USD) index lower after the end of the first Greek crisis in 2010/11, for the remainder of the QE2. A broad global recovery was also responsible for a lower USD during QE1 after the initial run-up in US long bond yields. Based on the Fed’s current timetable, and economic assumptions, QE3 will be around until mid-2014. QE3 will become truly close-ended only when the Fed removes the phrase “to increase or reduce asset purchases” that it inserted into the FOMC statement on May 1.

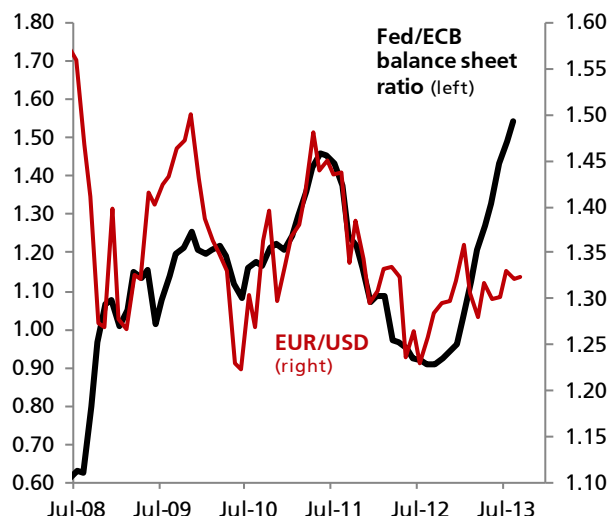
In reality, USD falls when US long bond yields rise – watch out for German recovery & CNY appreciation



In reality, which central bank is printing more?



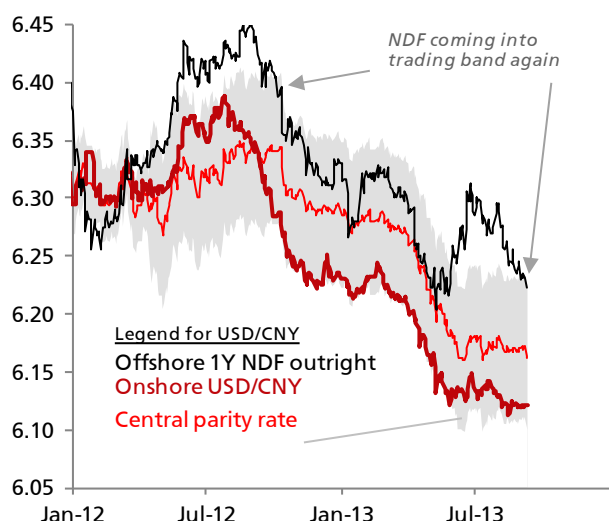
Fed vs ECB policy favors higher EUR/USD



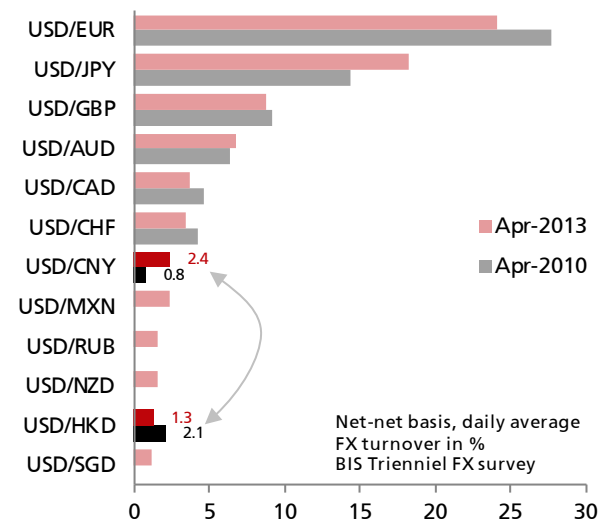
The market was frustrated that EUR/USD did not fall to 1.25 despite Fed taper vs ECB rate cut expectations. First, the Fed is still expanding its balance sheet even after it tapers asset purchase by the expected USD 10-20bn from its current pace of USD 85bn a month. Second, the ECB's balance sheet has been shrinking in spite of the past two rate cuts. In fact, the ratio of Fed's balance sheet vs that of the ECB has now surpassed the last high seen in mid-2011. Back then, EUR/USD was higher around 1.48 compared to 1.32 today. It was also interesting that Eurozone exited recession with a shrinking ECB balance sheet. But this was also due to Eurozone relaxing on fiscal austerity on lower government borrowing costs. The US economy, on the other hand, has been relying on QE3 to help offset the fiscal drag from tax hikes and the sequestration.

We believe that China may be ready to resume its appreciation again. The offshore non-deliverable forward (NDF) market is less worried about a hardlanding in China's economy. This is evident in the 1Y NDF outright for USD/CNY coming back into the $\pm 1\%$ official trading band. When this happened about the same time last year, China started to lower its central parity rate again. The Commerce Ministry recently announced that it expected trade to rebound again. When the central parity rate stopped falling in June/July, the Commerce Ministry warned of difficult trade conditions.

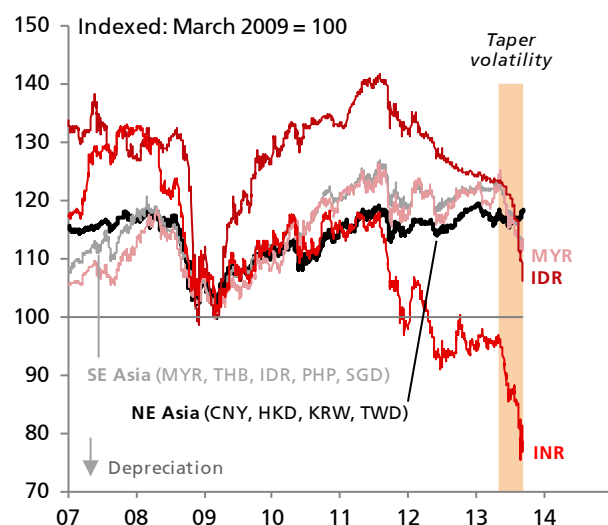
China to resume CNY appreciation again



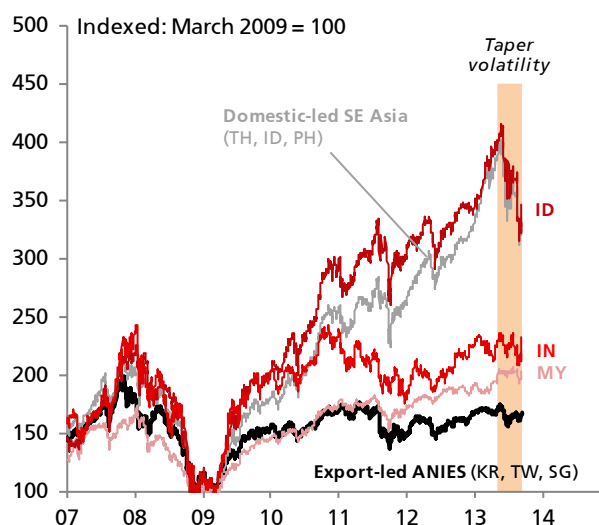
CNY moving up as an international currency



Asian currencies before/after 2008 global crisis



Asian equities before/after 2008 global crisis

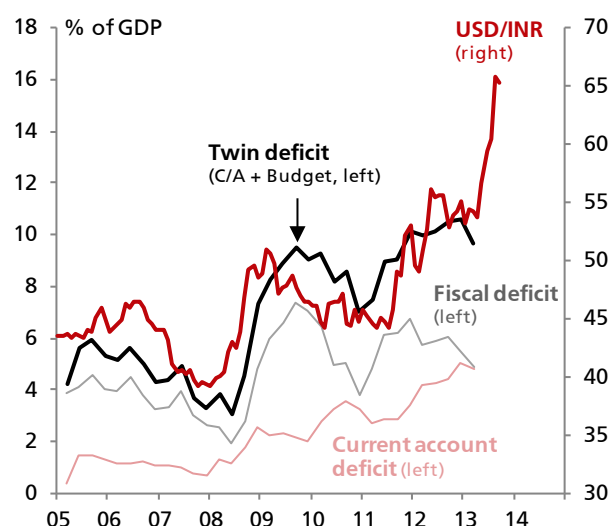


Fears that Asia was headed for another 1997/98 crisis were exaggerated

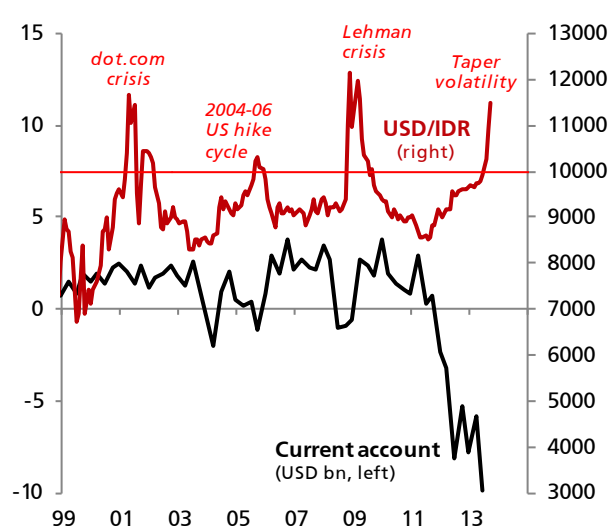
The volatility triggered by Fed tapering fears in Asia ex Japan were more country specific than region-wide. The hardest hit currencies were the South and Southeast Asian currencies characterised by wide current account and/or fiscal deficits, falling foreign reserves and disappointing growth. Conversely, the Northeast Asian currencies were comparatively more stable, supported by record high foreign reserves, strong current account surpluses, and optimism that growth was bottoming out. Unlike their SE Asian peers, stock markets in NE Asia did not rise to record highs after the 2008 global crisis. Hence, NE Asia was more resilient to SE Asia to the volatility in emerging markets triggered by the Fed's plan to taper asset purchases.

For the worst-hit Indian rupee, its problems should not be wholly blamed on the taper-led volatility. Throughout the 2011/12 Eurozone crisis, policymakers struggled in vain to support growth constrained by wide twin current account and fiscal deficits. Truth was, India had already resorted to expansive fiscal and monetary policies to support growth via domestic demand during the 2008/09 global crisis. With rating agencies demanding fiscal responsibility to safeguard its investment-grade debt rating, India lowered interest rates support growth. The rupee was left bearing the burden of adjustment for the widening savings-investment gap. It was under these

Indian rupee selling is overdone



IDR needs current account to stop worsening



circumstances that the rupee entered into a crisis during the volatile May-August period. Despite this, we reckoned that the rupee was oversold by late August. The correlation between the exchange rate and its combined current account and fiscal deficits suggest that USD/INR should be below, and not above, 60. Although USD/INR has come off its 68.85 high on August 28 to 63.84 on September 10, it is too early to conclude that the worst was over. Past experiences suggest that after a blowout, currencies tend to enter into a period of consolidation rather than reverse its fortunes.

The other embattled currency was the Indonesian rupiah, which had not been able to reverse its depreciation because of the current account deficits that emerged during the Eurozone crisis. Unlike India, rating agencies had been more lenient with Indonesia. This should not come as a surprise. Indonesia cut fuel subsidies to improve its fiscal position, and hiked rates and tolerated rupiah depreciation to address its current account deficit. Even so, these measures must demonstrate progress in improving the savings-investment gap. Without this, USD/IDR's uptrend will merely flatten instead of repeating its post-Asian crisis experiences of falling below 10,000 again on the back of a better global economy and a weak USD.

Unlike some market participants, we do not see the Malaysian ringgit in the same light as the rupee or the rupiah. While the depreciation was blamed on weak fiscal finances, we have always recognized the ringgit as a managed float whose value is kept closely aligned to its Southeast Asia peers.

Collectively, these pockets of weakness were sufficient to raise some alarm bells that Asia might be headed for another 1997/98 crisis. Doomsayers drew parallels between the post-2008 crisis landscape and the 1990s. Both cycles started with a US housing crisis/recession, followed by a crisis in Europe, and strong capital inflows that propelled Southeast Asian equities to record highs. From this point forward, there are many cases of mistaken identities. For example, Abe's weak yen today was more like the Chinese yuan devaluation in 1993/94 than the one that ushered in the strong USD policy in 1995. The Fed's upcoming taper that was responsible for the recent global bond sell-off is continuously mistaken as the 1994/95 US rate hike cycle that sparked a bond crisis. By the way, the USD collapsed during the 1994/95 US hike cycle.

Fortunately, Asia's fate today is tied to China still playing its global rebalancing role, just as region was linked to Japan in the 1990s. Japan could not continue its rebalancing role in 1995 because its stock market/property problems finally found their way into its banking sector. It was no coincidence that America adopted a strong USD policy in the same year that Japan asked the G7 for help to end the yen's appreciation. While Asian crisis may not be around the corner, the recent market volatility should be taken as a serious wake-up call for Asia to strengthen their balance sheets with structural reforms.

Malaysia keeps MYR close to SE Asia average



Parallels with the 1990s – similarities & differences

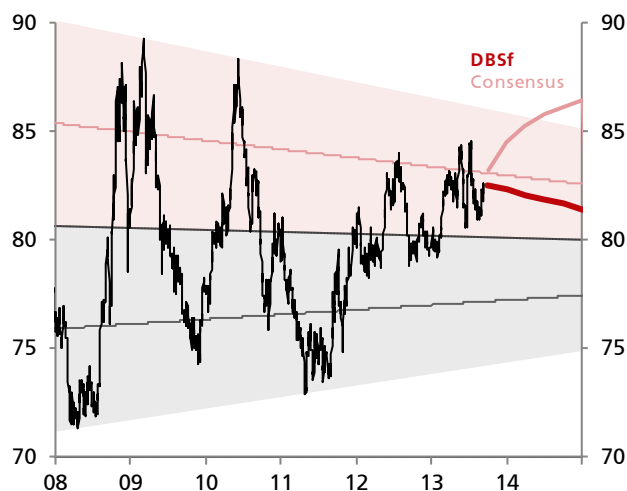
Event	1990s	Today
US housing crisis & recession	Early 1990s S&L crisis	✓ 2008/09 Subprime crisis
European crisis	1992 ERM crisis	✓ 2011/12 Eurozone crisis
Southeast Asia equity bull run	1993 record highs	✓ 2013 record highs
Major Asian FX weakens by choice	1993/94 CNY devaluation	✓ 2012/13 Weak JPY (Abe)
US monetary tightening	1994/95 Fed rate hike cycle Weak USD/bond crisis	* 2013 Fed taper Not rate hike
Global rebalancing partner in Asia	Japan End strong JPY in 1995 Banking crisis	* China CNY still appreciating Reforms/restructuring
Strong USD policy	1995-2001	* US wants trade to create jobs
Asian crisis	1997/98	*

US dollar

USD faces downside risks if Fed taper turns out to be a “buy rumor, sell fact” event

When Fed’s plan to wind down QE3 first took root in May, there was much optimism and enthusiasm that this would herald a strong USD uptrend heralding America’s exit from its five year-old crisis. Three to four months later, the USD, as measured by the DXY index, had not been able to break out of its prison between 80.60 and 84.60. The USD had more success against the emerging market currencies with its reversal of capital flows story. That is, until US stocks also succumbed to acute volatility in emerging markets in August. By this time, uncertainties emerged across multiple policy fronts. Discomfort has increased that former Treasury Secretary Larry Summers may succeed Ben Bernanke as Fed Chairman when the latter’s term ends in January 2014. With the current fiscal year ending on September 30, the White House and Congress are running out of time to lift the federal debt ceiling. Lastly, President Barack Obama’s push for military action against the Syria for using chemical weapons may lead to either more geopolitical uncertainties or him becoming a lame duck president. Against this background, the Fed’s tapering, if it chooses to proceed, is becoming viewed as a marred exercise.

DXY index – caught between USD bulls and bears



DXY index	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	81.762	82.3	82.1	81.9	81.7
Previous		80.0	79.6	79.2	79.0
Consensus		84.5	85.3	85.8	84.7
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.25	0.25	0.25	0.25	0.25
Previous		0.25	0.25	0.25	0.25
Consensus		0.25	0.25	0.25	0.25

Euro

Fed tapering threat balanced by shrinking ECB balance sheet and Eurozone recovery hopes

EUR/USD was remarkably stable between 1.2750 and 1.3400 in 2Q13 and 3Q13. This frustrated the USD bulls who championed the Fed’s “hawkish” plan to wind down QE3. This coupled with the European Central Bank’s (ECB) dovish forward guidance also explained why consensus favored a lower EUR/USD at 1.25 in the next 12 months. In reality, the ECB’s balance sheet has been shrinking when tail risks started to ameliorate over the Eurozone crisis in 2H12. Conversely, the Fed’s balance sheet has been expanding after QE3 started in September 2012. By July, the Fed/ECB balance sheet ratio has risen back to April 2011 levels when EUR/USD was higher at 1.48. Assuming that the first taper takes place as expected in September 2013, the fact remains that Fed’s balance sheet will continue to expand until QE3 is fully unwound. Meanwhile, EUR was also supported by the Eurozone economy finally exiting its six-quarter recession. Despite the relief, EU policymakers and the ECB recognized the need to deepen and broaden the recovery beyond Germany and the UK with supportive fiscal and monetary stances. This will be important to keep the EUR resilient during the wind down of QE3.

EUR/USD – moving into recovery zone



EUR /usd	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	1.3309	1.32	1.33	1.34	1.35
Previous		1.32	1.34	1.35	1.36
Consensus		1.28	1.27	1.26	1.27
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.50	0.50	0.50	0.50	0.50
Previous		0.50	0.50	0.50	0.50
Consensus		0.50	0.50	0.50	0.50

Japanese yen

USD/JPY uptrend intact, but the gradient is likely to stay flat ahead of next year's sales tax hike

PM Shinzo Abe is set to make a final decision on October 7 to proceed with the two-stage sales tax hike. Under the tax law passed last year, the sales tax will first increase to 8% from 5% in April 2014, and next to 10% in October 2015. Encouraged by the reflationary effects of Abenomics, the Japanese public supports the sales tax as necessary to address the country's huge debt stock and maintain confidence in Japanese government bonds (JGBs). Nonetheless, Japan Inc wants the government to consider a small fiscal stimulus to offset the expected hit on consumer spending. The finance ministry will decide by end-2013 if it needs to compile an extra budget. To encourage the Abe government to establish and strengthen its fiscal discipline credentials, the Bank of Japan (BOJ) reassured that it will not hesitate, if necessary, to provide more monetary stimulus to safeguard the recovery. In turn, this has raised hopes amongst JPY bears that the BOJ may ease again next year. Except that CPI inflation has increased strongly to +0.7% YoY in July from its bottom at -0.9% in March, after the BOJ's surprisingly aggressive QE (now known as the Kuroda bazooka) in April.

USD/JPY – uptrend turns square-root



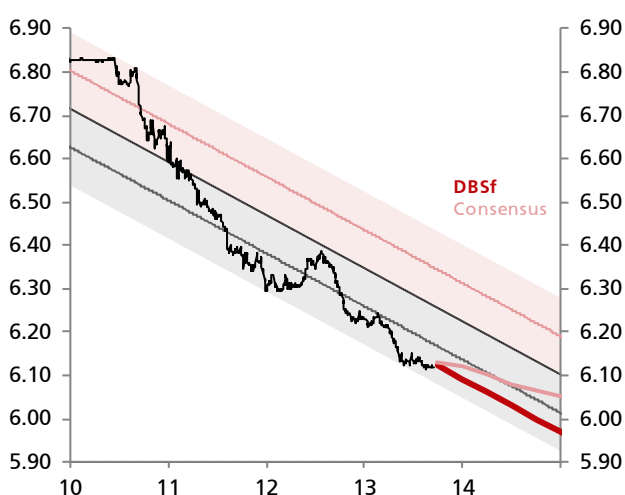
usd/ JPY	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	99.85	102	103	104	106
Previous		102	104	105	106
Consensus		103	105	106	108
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.10	0.10	0.10	0.10	0.10
Previous		0.10	0.10	0.10	0.10
Consensus		0.10	0.10	0.10	0.10

Chinese yuan

Looking for CNY appreciation to resume from its pause that started in June/July

Owing to emerging market volatility from the Fed's plan to wind down QE3, China stopped lowering the central parity for USD/CNY in June. Since then, the official fixing has been kept flat in a range mostly between 6.16 and 6.18. Interestingly, despite the stable exchange rate, other markets were becoming less worried about a hard landing in the economy, thanks to the upside surprises in recent data. The approval of the Shanghai Free Trade Zone in July also sent an important signal that China was quickening the loosening of capital controls. In the offshore non-deliverable forward (NDF) market, the 1-year outright has returned into the official +/-1% trading band for USD/CNY. The Shanghai Composite Index has been recovering steadily after the sharp sell-off in May/June. Looking ahead, China may resume lowering the central parity. When the exchange rate turned stable in June/July, the Commerce Ministry warned that the strong CNY would hit exports and that trade conditions looked more difficult in 2H13. Earlier this month, the Commerce Ministry turned optimistic about a trade rebound in the coming months. Enough said.

USD/CNY – resuming its downtrend



usd/ CNY	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	6.1183	6.09	6.06	6.03	6.00
Previous		6.06	6.03	6.00	5.98
Consensus		6.12	6.10	6.08	6.07
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	6.00	6.25	6.25	6.50	6.50
Previous		6.25	6.25	6.25	6.25
Consensus		6.00	6.00	6.00	6.00

Hong Kong dollar

Will there be a repeat of last year's speculation against the HKD peg in 4Q13?

According to the BIS Triennial FX Survey issued in September, the CNY has, in the past three years, overtaken the HKD to become one of the world's ten most traded currencies. Between the Aprils of 2013 and 2010, the share of turnover in USD/CNY increased to 2.1% from 0.8%, while that of USD/HKD fell to 1.3% from 2.1%. Earlier in June, the Hong Kong Monetary Authority (HKMA) reported that the daily average trading volume in CNY in the territory also surpassed that of the HKD, for the very first time in May. Meanwhile, China's State Council approved in July to establish the Shanghai Free Trade Zone. This was an important signal that China was moving forward to increase the capital account convertibility of the CNY. In the non-deliverable forward market, the 1-year outright for USD/CNY has returned into the official $\pm 1\%$ trading band. The last time this happened in 4Q12, the HKMA had to defend the HKD peg vs the USD, especially when China resumed the CNY's appreciation. Hence, it should not come as a surprise why USD/HKD is not straying far from the floor of its 7.75-7.85 convertibility band in spite of the volatility in emerging markets.

USD/HKD – staying close to floor of band



usd/ HKD	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	7.7541	7.76	7.76	7.76	7.76
Previous		7.78	7.79	7.80	7.80
Consensus		7.76	7.77	7.77	7.76
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.38	0.40	0.40	0.40	0.40
Previous		0.40	0.40	0.40	0.40
Consensus		0.41	0.43	0.46	0.47

Taiwan dollar

TWD to maintain a modest appreciation along the mid of its post-2008 crisis price channel

The resilience and stability of the TWD to the volatility in emerging markets should not come as a surprise. Unlike its Southeast Asian peers, the Taiwan stock market did not rise to record highs after the 2008 global crisis. Hence, it did not fall victim to the reversal of capital flows triggered by the Fed's intention to taper asset purchases. Against the woes of deficit-led emerging currencies, the TWD was comparatively attractive from record high foreign reserves and current account surpluses. Even so, policymakers are not about to let the TWD appreciate strongly. The official 2013 growth forecast was recently lowered in mid-August to 2.31% from an earlier estimate of 2.40%. Ironically, Taiwan's current account surpluses reflected weak demand in both its external and domestic sectors. Hence, expansionary fiscal policies were needed to support overall growth in the past few years. But the scope to continue this is narrowing with government debt now covering on the legal limit set at 40.6% of GDP. Encouraging private sector investment will not be easy either because of the attraction of China.

USD/TWD – favoring a neutral downtrend



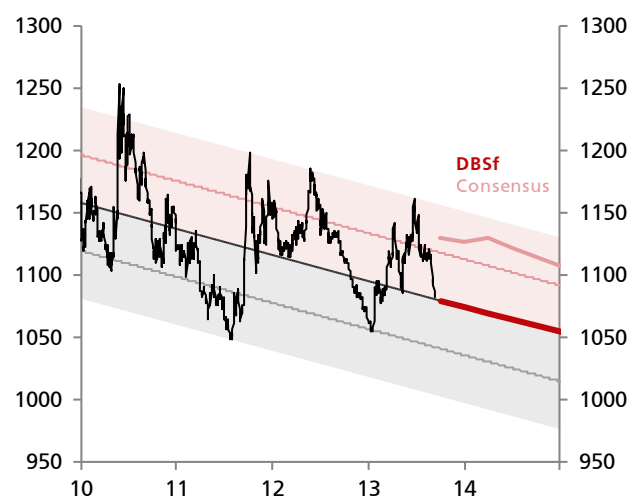
usd/ TWD	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	29.629	29.5	29.4	29.3	29.2
Previous		29.4	29.2	28.9	28.8
Consensus		30.1	30.2	30.1	30.0
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	1.88	1.88	1.88	2.00	2.13
Previous		1.88	2.00	2.13	2.13
Consensus		1.88	1.88	2.00	2.13

Korean won

KRW modest appreciation intact, confident that the economy has turned the corner

Bucking the trend, the KRW was the only Asian currency, apart from the CNY, that appreciated during the volatility in emerging markets. With current account surpluses and foreign reserves rising to record highs, and short-term external debt falling to six-year lows, the KRW was less vulnerable to the Fed's plan to wind down QE3. Unlike the deficit-led Asian countries in trouble today, Korea did not boost domestic demand and let growth slow with the global economy. This was a prudent decision because commercial and specialized banks were still lowering loan/deposit ratios from its peak of 135.6 in 3Q08 to 117.6 in 1Q13. While fiscal spending helped to cushion the slowdown, central government debt only rose modestly to 34% of GDP in 1Q13 vs 32% in 2010. Looking ahead, the trade-dependent Korean economy is starting to turn the corner with the global economy. On a seasonally-adjusted QoQ basis, real GDP growth has been rising steadily for the third straight quarter to 1.1% in 2Q13 from 0% in 3Q12. The Bank of Korea is optimistic that the economy bottomed at 2.0% last year, and set to meet its 2.8% target for 2013, before improving to 4.0% next year.

USD/KRW – no hurry to rush into lower half



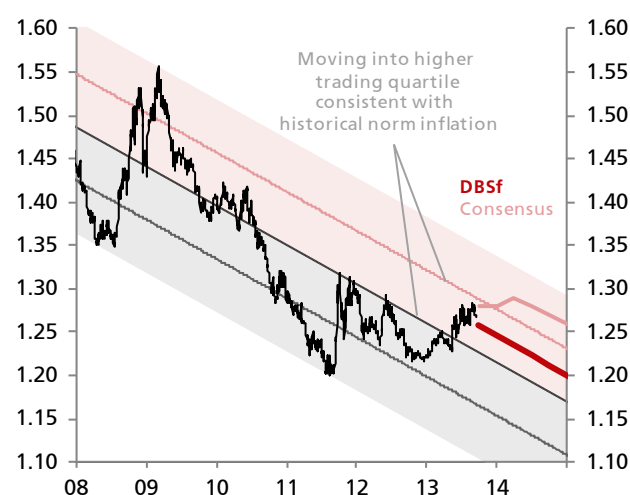
usd/ KRW	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	1085.8	1075	1070	1065	1060
Previous		1080	1060	1040	1030
Consensus		1127	1130	1123	1105
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	2.50	2.50	2.50	2.75	2.75
Previous		2.50	2.75	2.75	2.75
Consensus		2.50	2.50	2.50	2.63

Singapore dollar

USD/SGD returned to the upper half of its price channel on inflation easing to historical norm

Since 2004, Singapore's appreciating exchange rate policy was best reflected by USD/SGD falling in a wide descending price channel. USD/SGD moved and stayed in the lower half of the channel whenever the Monetary Authority of Singapore (MAS) turned vigilant against inflation. For example, 2007 and 2008 were years of record high oil prices. Inflation was elevated during 2010-12 when capital inflows fueled asset inflation in Asia, in spite of slowing growth during the Eurozone crisis. In this regard, USD/SGD's recent move back into the upper half of the channel was consistent with inflation easing to its historical norm of 2-3%. This, however, did not imply that the authority would ease its modest and gradual appreciation policy stance at the upcoming SGD policy review in October. Despite market volatility in emerging markets, the government turned more confident on the economy. Real GDP growth bounced to 3.8% YoY in 2Q13 from 0.2% in the previous quarter. The 2013 official growth forecast was subsequently upgraded to 2.5-3.5% from 1-3% previously. Our expectation for USD/SGD to fall below 1.25 in the next 12 months is premised on a better global recovery next year.

USD/SGD – into a "historical norm" quartile



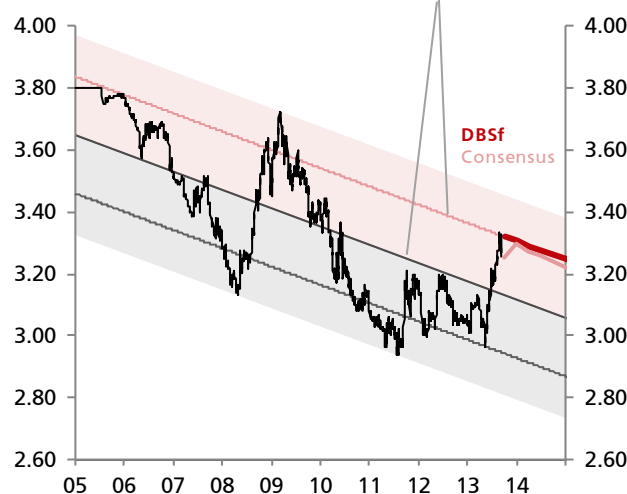
usd/ SGD	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	1.2660	1.25	1.23	1.22	1.21
Previous		1.23	1.21	1.19	1.18
Consensus		1.28	1.29	1.28	1.26
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.37	0.35	0.35	0.35	0.35
Previous		0.35	0.35	0.35	0.35
Consensus		0.39	0.39	0.40	0.40

Malaysian ringgit

MYR's longer-term appreciation trend is intact, albeit at weaker adjusted levels

USD/MYR returned into the upper half of its post-2005 descending price channel in 3Q13. The MYR's sharp 12.7% depreciation during May-August was attributed to emerging market volatility from the Fed's plan to taper asset purchases. On the domestic front, the government is coming under more pressure from rating agencies to address their fiscal concerns and safeguard its sovereign debt rating. To keep its economy growing above 5% after the 2008 global crisis, Malaysia ran budget deficits in excess of 4% of GDP, and government debt rose to 53.8% of GDP in 2012 from 39.8% in 2008. The reliance on domestic demand to offset the weak external sector also eroded its impressive current account surplus from a high 17.1% of GDP in 2008 to 2.4% in 1H13. Hence, the budget announcement in October will be an important opportunity for the government to demonstrate its resolve to improve fiscal finances. Despite its fiscal challenges, we do not view Malaysia in the same light as India and Indonesia. Malaysia's international liquidity position is stronger. Unlike these two countries, foreign reserves are higher, and not lower, than total external debt in Malaysia.

USD/MYR – moving down in a higher quartile



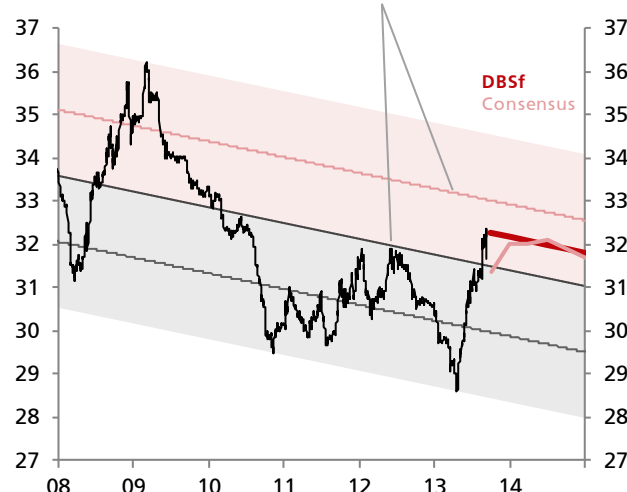
usd/ MYR	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	3.2580	3.31	3.29	3.28	3.26
Previous		2.99	2.96	2.94	2.93
Consensus		3.30	3.27	3.26	3.28
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	3.00	3.00	3.00	3.00	3.00
Previous		3.00	3.00	3.00	3.00
Consensus		3.00	3.13	3.13	3.25

Thai baht

We are more cautious and less optimistic than consensus over the THB's recovery prospects

The THB was not spared from volatility in emerging markets due to Fed tapering worries. Like most Southeast Asian currencies, it returned all gains from the post-Eurozone crisis recovery in 2H12. It did not matter that Fitch upgraded its sovereign debt rating by one notch to BBB+ in March. By end-August, USD/THB returned into the upper half of its post-2008 crisis price channel. This was in line with the mild technical recession in 2Q13 and the near 4-year low inflation that led the Bank of Thailand (BOT) to trim its benchmark interest rate by 25 bps to 2.50% in May. Due to high household debt, the central bank has been resisting the Ministry of Finance's push for more rate cuts. Both the BOT and MOF have been content to let the exchange rate find its appropriate level for exports to become competitive again. For now, the THB has weakened as much as during the 2004-06 US rate hike cycle. Its recovery pace will depend on the government's strategy to revive growth, which focuses on flood management projects worth THB 350bn, and a THB 2.0trn infrastructure programme over the next seven years.

USD/THB – moving into a higher quartile



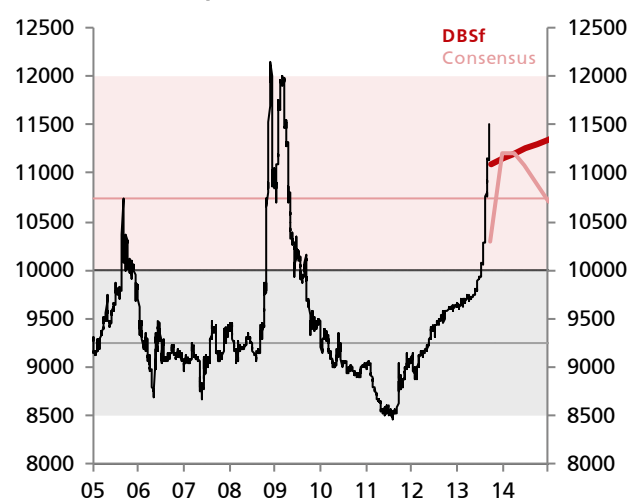
usd/ THB	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	31.960	32.2	32.1	32.0	31.9
Previous		29.8	29.7	29.6	29.5
Consensus		32.0	32.0	32.1	31.4
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	2.50	2.50	2.50	2.75	3.00
Previous		2.50	2.50	2.75	2.75
Consensus		2.50	2.50	2.63	2.75

Indonesian rupiah

USD/IDR still needs to narrow its current account deficit to reverse its rise above 10,000

USD/IDR bottomed in August 2011, the same month the USD lost one of its triple-A debt rating. The Eurozone crisis started the next month. To win its investment-grade sovereign debt ratings by Moody's in December 2011, and Fitch in January 2012, Indonesia had to keep growth above 6%. To maintain fiscal discipline, Indonesia boosted domestic demand via rate cuts to offset the weakness in exports. Unfortunately, this also resulted in persistent current account deficits from 4Q11. While this kept the IDR weak, its depreciation was modest, tempered by rising Jakarta stocks, foreign investments in IDR-denominated bonds and currency interventions. This ended in May this year when Fed tapering fears emerged and fueled the reversal of capital out of emerging markets. Unlike India, rating agencies were more lenient with Indonesia because it cut fuel subsidies to aid its fiscal position, and hiked rates and tolerated currency depreciation to address the savings-investment gap. But these measures need to narrow the current account deficit for USD/IDR to repeat its post-Asian crisis experiences of falling below 10,000 again on the back of a better global economy and a weaker USD.

USD/IDR – to keep above 11000 first



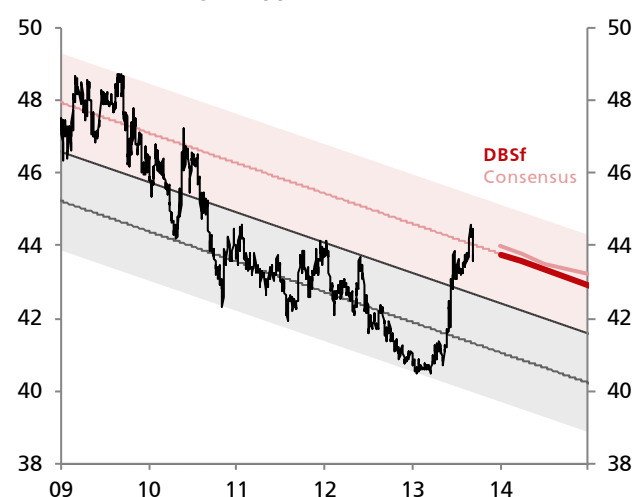
usd/ IDR	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	11330	11150	11200	11250	11300
Previous		9800	9750	9700	9650
Consensus		11200	11200	11083	11200
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	7.00	7.00	7.00	7.00	7.00
Previous		5.75	6.00	6.25	6.25
Consensus		7.13	7.13	7.25	7.25

Philippine peso

PHP is supported by its strong fundamentals in spite of the recent sell-off

The PHP was not spared from capital outflows from emerging markets in May-August despite its relatively stronger fundamentals. At its worst point in August, the stock market was down almost 25% from its all-time high in May. This was in spite of solid real GDP growth of more than 7% for four straight quarters into 2Q13. The IMF reckoned that the government would achieve the top end of its 6-7% official growth target this year. Inflation fell to a four-year low of 2.5% YoY in July. Unlike Indonesia or India, the Philippines has a solid international liquidity position. Despite trade deficits, services surpluses and overseas foreign worker remittances have kept the current account in surplus position. Import cover was highest in the region at 16.7 months in June. Foreign reserves were, as at 1Q13, more than 8 times that of short-term external debt. It was, therefore, understandable why, in spite of the market volatility, Moody's put the country's sovereign debt rating on review for an upgrade. Moody's is the only rating agency yet to award the Philippines an investment-grade debt rating. Standard & Poor's and Fitch have already done so in February and March respectively.

USD/PHP – falling in upper half of channel



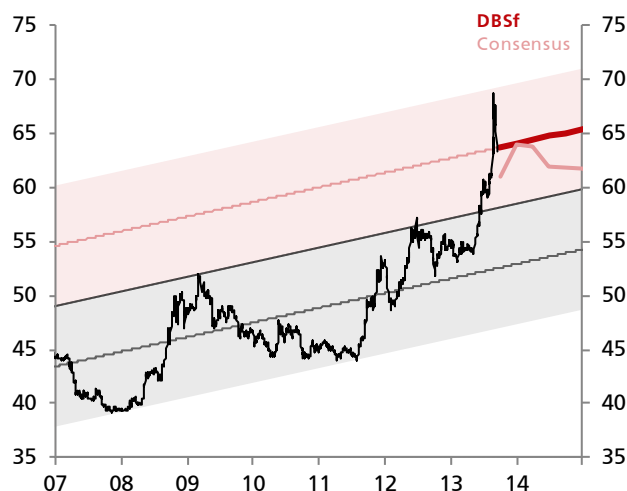
usd/ PHP	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	43.610	44.0	43.8	43.6	43.4
Previous		41.0	40.5	40.0	39.8
Consensus		44.0	43.8	43.5	43.5
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	3.50	3.50	3.50	3.75	4.00
Previous		3.50	3.75	3.75	3.75
Consensus		3.50	3.63	3.75	3.88

Indian rupee

The oversold INR may start to consolidate in the upper half of its new and wider price channel

The INR depreciated by 8.1% in August, its worst monthly fall since March 1993 (-16.9%) and July 1991 (-17.5%). INR consolidated for 20 months after July 1991, and 30 months after March 1993, before it fell again. For now, the INR looks oversold. Until this year's sell-off, USD/INR had been fluctuating with its combined current account and fiscal deficits. By this measure, USD/INR should be closer to 50-60 instead of 65-70. This risk premium reflected the struggle faced by policymakers to address India's macroeconomic imbalances. Since the Eurozone crisis, India tried in vain to prevent growth from slowing to 4.4% YoY in 2Q13 from 9.9% in 1Q11. Fiscal discipline had to be maintained to safeguard its investment-grade debt rating already under negative watch. Lowering interest rates only served to imperil a weak exchange rate already under pressure from current account deficit woes and Fed tapering worries. That said, the new central bank governor, Raghuram Rajan, is sending the right signals that he will provide the leadership to revive confidence in the INR by pushing for more financial liberalization and pro-active structural reforms.

USD/INR – stabilizing in a higher channel



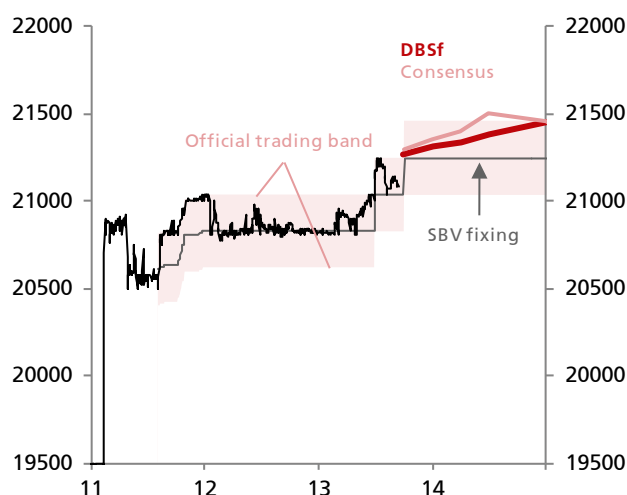
usd/ INR	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	63.380	64.1	64.4	64.8	65.1
Previous		56.6	57.0	57.4	57.6
Consensus		64.0	63.8	62.0	62.1
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	7.25	7.25	7.25	7.25	7.25
Previous		7.00	7.00	7.00	7.00
Consensus		7.13	7.00	7.00	7.00

Vietnam dong

The prospect for another 1% devaluation cannot be totally discounted

The State Bank of Vietnam (SBV) devalued the VND by 1% on June 27, two months after its governor said that the VND will not be devalued by more than 2% this year. Back then, economists urged a 4% devaluation to help exports. The June decision was probably due to the return of a USD 1.2bn trade deficit in 2Q13. Although the deficit returned to a small USD 79mn surplus in the first two months of 3Q13, this may not last. Export growth slowed to 12.7% YoY in July-August from 14.6% and 19.2% in 2Q13 and 1Q13 respectively. Against this background, domestic demand will need to pick up the slack in the external sector to achieve the official 5.4% growth target after the 4.9% YoY expansion in 1H13. Imports have already rebounded by 18.2% YoY in January-August from 7.9% in 2012. With inflation starting to rise from its low, the IMF does not want the SBV to ease policy and focus on structural reforms. Rating agencies have not lowered their guard against problem loans at Vietnam banks. Hence, our forecast reflects the prospect for another 1% devaluation, and a preference for spot USD/VND to continue trading in the upper half of the official +/-1% trading band.

USD/VND – scope for another 1% devaluation



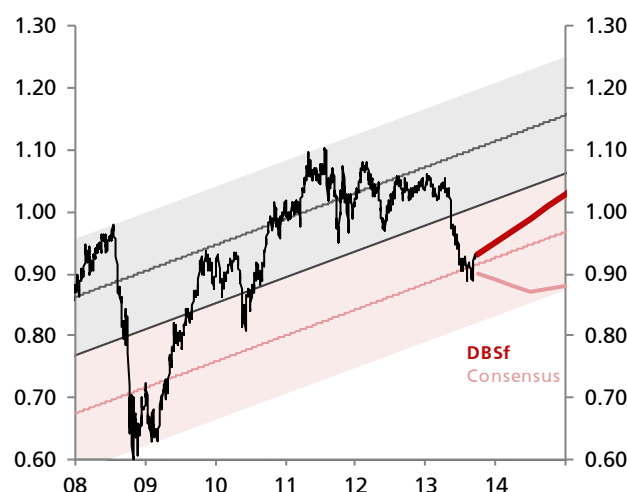
usd/ VND	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	21110	21310	21340	21380	21410
Previous		21200	21300	21400	21450
Consensus		21350	21400	21500	n.a.
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	7.00	7.00	7.00	7.00	7.00
Previous		7.00	7.00	7.00	7.00
Consensus		n.a.	n.a.	n.a.	n.a.

Australian dollar

AUD/USD likely to have bottomed at 0.8846, and looking at a modest recovery

The factors responsible for the AUD's collapse from near 1.06 in April to 0.88 in early August may be starting to reverse. The conservative opposition Liberal-National coalition swept the election on September 7. Businesses welcomed the pledge by PM-elect Tony Abbott to reverse the policies of the outgoing Labor government blamed for eroding Australia's competitiveness. These included scrapping the unpopular carbon emission and mining taxes. The incoming government is also more business-friendly and reform-oriented, with its plans to reboot the mining sector, cut corporate taxes and deregulate the economy. With Australia assuming the G20 chair next year, Abbott supports the group's stance that exchange rates should be market-determined. That said, the Abbott government still lacks a majority in the Senate until elections in July 2014. Nonetheless, the Australian economy may be bottoming out, especially now that China has turned more positive on trade and its economy. Hence, the Reserve Bank of Australia may need to reconsider its option to keep the door open for another rate cut, and its bias for more weakness in the AUD.

AUD/USD – stable before recovering lost ground



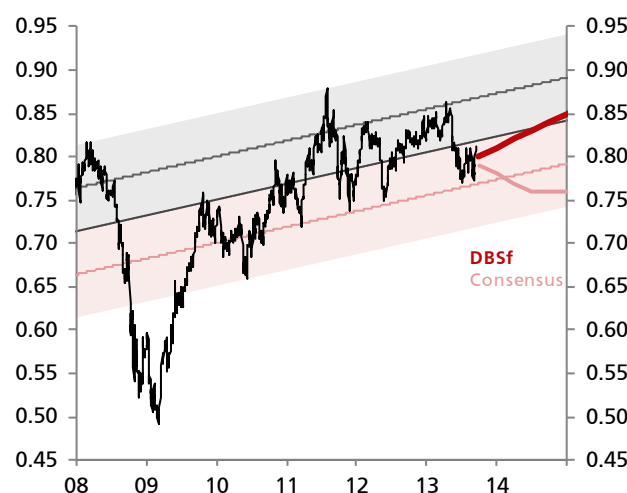
AUD /usd	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.9328	0.95	0.97	0.99	1.01
Previous		1.00	1.02	1.04	1.05
Consensus		0.89	0.88	0.87	0.88
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	2.50	2.50	2.50	2.50	2.50
Previous		2.75	2.75	2.75	2.75
Consensus		2.38	2.38	2.38	2.38

New Zealand dollar

NZD/USD supported by improving economy and rising inflation fuelling rate hike expectations

The Reserve Bank of New Zealand (RBNZ) has pledged to keep its policy rate unchanged at 2.50% for the rest of 2013. In the interim, the central bank has resorted to macroprudential regulatory tools to cool its hot property sector. Despite this, the RBNZ is still expected to start hiking rates early next year and bring rates above 3.00% in 2014. Although inflation was 0.7% YoY in 2Q13, and below the RBNZ's 1-3% target band, 2-year inflation expectation bottomed at 2.36% in 3Q13, its first increase since 2Q11. With July services and manufacturing indices starting 3Q13 on a strong note, real GDP growth has scope to rise above 3% YoY again in 2H13 after a disappointing 2.4% in 1Q13. If so, the RBNZ is seen hiking rates before its US counterpart. This will help offset some of the depreciation suffered during the volatile May-August period from Fed tapering fears. On the other hand, the NZD's recovery is also likely to be limited. The RBNZ remains vigilant against excessive NZD appreciation. Although the government is fiscally responsible, the trade and current account deficits are likely to stay wide from an economic recovery led by domestic demand.

NZD/USD – stabilizing and moving higher



NZD /usd	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	0.8078	0.81	0.82	0.83	0.84
Previous		0.82	0.84	0.86	0.87
Consensus		0.78	0.77	0.76	0.78
Policy, %	11-Sep	4Q13	1Q14	2Q14	3Q14
Revised	2.50	2.50	2.75	3.00	3.25
Previous		2.50	2.75	3.00	3.25
Consensus		2.63	2.75	3.00	3.13

Yield: Normalization

- US: Having adjusted sharply since late May, the USD rates market is no longer overly complacent about interest rate risk. Further increases in bond yields and swap rates are likely if the Fed tapers asset purchases before year-end
- SG: The intermediate segment of the swap curve has already steepened in anticipation of US rate hikes in the coming 2-3 years. However, the 1Y SGD swap rate is likely to remain anchored near current levels for the coming 12 months
- HK: With the implied yield on the Dec-15 Fed Funds futures hovering way below 2%. 2Y UST and 2Y EFN yields are likely to price in US rate hike expectations more aggressively. All eyes will be on the timing of Fed tapering
- KR: While the lackluster domestic economy demands lower rates, upward pressure arising from rising US rates are clearly dominant. Front-end swap rates are likely to hover above the 3M CD rate in the coming months
- TW: Curve steepening in the 1Y/3Y segment of the swap curve is likely to continue as the 3Y TWD swap rate continues to rise on the back of upward pressure from US interest rates.
- TH: With domestic growth losing momentum over the past two quarters, monetary policy is likely to remain accommodative. Interbank rates are likely to stay low, anchoring the front end of the THB swap curve around current levels
- MY: While external balances have deteriorated over the past few years, the current account is still on track to register a surplus in 2013. Upward pressure on MYR rates are unlikely to be on the same scale as India's or Indonesia's
- ID: Monetary policy is being tightened. With the current account deficit continuing to widen in 2Q, worries about external funding will persist. Interbank rates are likely to head higher in the medium term driven by tighter liquidity conditions and higher FASBI deposit rates
- PH: Liquidity conditions remain the dominant factor explaining why market rates remain low relative to policy rates. These conditions are expected to persist, keeping the 3M interbank reference rate low
- IN: Managing the twin deficits in a more difficult external funding environment is proving to be a challenge. Interbank rates and bond yields have already spiked sharply and are likely to stay elevated for the short term. Beyond the coming quarters, however, liquidity conditions should improve, leading to a fall in government bond yields
- CH: The engineered liquidity squeeze is over. However, term premia are likely to remain high amid uncertainty about future liquidity conditions. As such, short-term market rates are likely to stay elevated in the coming months

US: Yield curve normalization in progress

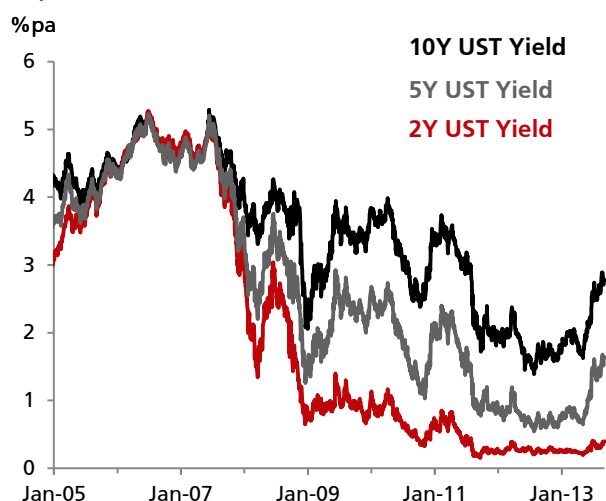
The Treasury yield curve normalization since late May was swift. 10Y UST yields rose close to 3% from 1.6% in the beginning of May. With 2Y yields rising by a much smaller magnitude, the 2Y/10Y spread rose to 250bps, from 143bps over the same time period. 75% of the spread widening can be explained by steepening in the 2Y/5Y segment of the yield curve, while the remaining 25% can be attributed to steepening in the 5Y/10Y segment of the yield curve. In short, the bond market is no longer overly complacent about interest rate risk. Further increases in treasury yields are likely if the Fed tapers asset purchases before year-end.

The withdrawal of extremely accommodative monetary policy in the US is a multi-step process. The first step was the phasing out of calendar-based guidance in favor of threshold-based guidance (linking the Fed funds rate to unemployment and inflation) in December. The second step took place in May when the Fed hinted that tapering is imminent, triggering the rise in long-term rates. Markets are now discounting the prospect of Fed tapering and further increases in long-end rates can only take place if the Fed confirms that plans for monetary stimulus removal remain intact. Subsequently, markets would be looking at the next step in the monetary tightening cycle, rate hikes. With Fed tapering looming on the market's radar, the front end of the yield curve is likely to start discounting the probability of rate hikes in 2015, pushing longer-end rates higher.

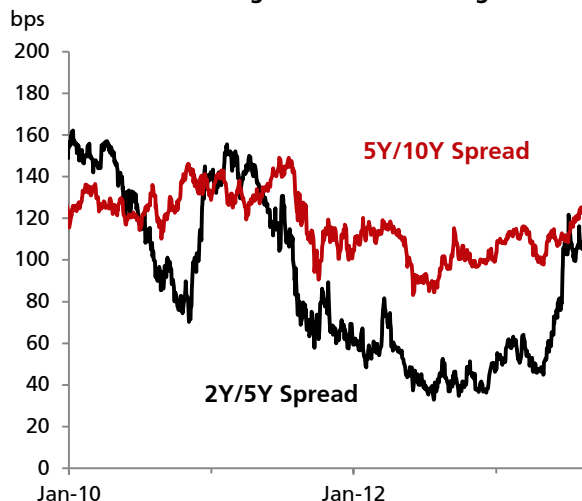
Mixed US data of late have not dissuaded the market from more aggressively pushing UST yields higher. However, the timing of Fed tapering and rate hikes is not set in stone, and weakening data in housing is a source of concern. As mortgage rates rise in tandem with 10-year treasury yields, some impact on housing is inevitable and new home sales have stalled. With the market and consensus expecting tapering in September, the risk lies with persistent weakness in US data that could force the Fed to delay tapering to a later part of this year. However, this would not change the medium term market view that less Fed accommodation is to be expected over the coming few years. While bond yields would likely take a breather under this scenario, yields are still headed higher over the medium term.

We expect yields on US Treasuries to rise. Yields in the 2Y sector are likely to end 2Q14 near 1.2% and yields in the 10Y sector are likely to end 2Q14 near 3.7%

2Y, 5Y & 10Y UST Yield



UST Curve - 2Y/5Y Segment vs 5Y/10Y Segment



Singapore: Short-term rates staying low

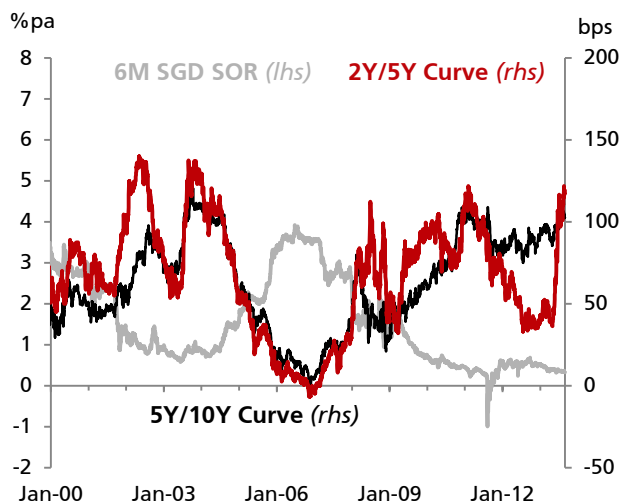
Tracking the yield curve normalization process in the US, SGS yields have headed higher over the past few months. Effectively, 10Y SGS yields are already at levels last seen in early 2011, just before the Fed anchored the entire US yield curve lower with calendar-based guidance on the fed funds rate. Notably, the 2Y/10Y spread has also widened to 230bps, from 120 bps in the early part of May. With a significant portion of adjustment already done in 10Y SGS yields, further increases in SGS yields will depend on Fed policy actions in the coming few months.

In swaps, the 6M SOR (which serves as the floating leg fixing index for SGD swaps) is likely to hover between 0.3-0.4% through the coming 12-month period. Upward adjustments in the 6M SOR will occur only when the US rate hike cycle becomes imminent, an event that is unlikely to take place in 2014. The 10Y SGD swap rate is trading close to our current fair value calculations of above 2.50% (defined as the 10Y USD swap rate less the spread between 6M Libor and 6M SOR). As 10Y USD swap rates head towards 4.0% in 1H14, 10Y SGD swap rates are expected to rise above 3% (the midpoint between our fair value measurement and the regression between 10Y USD swap rates and 10Y SGD swap rates).

Hong Kong: Watch 2Y EFN yields

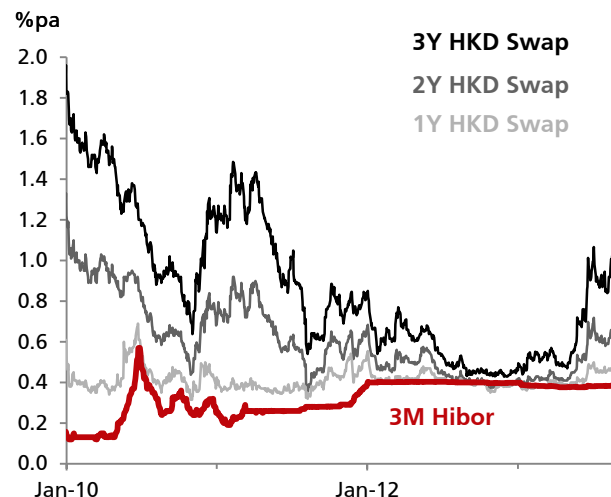
Longer-term HKD swap rates have tracked USD swap rates higher over the past months, with most of the pressure coming from the intermediate sector of the swap curve. Notably, the 2Y/5Y segment of the HKD swap curve steepened by 79bps in the four months from May to August. This compares with a 25bps increase in the 5Y/10Y segment. As a result, the 2Y/5Y segment of the swap curve is now steeper than the 5Y/10Y segment of the swap curve. This should remain the case in the coming months as the USD rates market is likely to discount more Fed rate hikes for 2015. As the front end of the USD swap curve steepens to discount a steeper forward path for 3M USD Libor, the front end of the HKD swap curve will steepen to discount at steeper forward path for 3M Hibor. With the Dec-15 Fed Funds futures still hovering well below 2%, markets are going to increasingly price in Fed rate hike expectations into the 2Y sector of the USD swap curve. As 2Y USD swap rates head above 1% in mid-2014, so would 2Y HKD rates. Three-month Hibor itself (which serves as the floating leg fixing index of HKD swaps), is expected to hover between 0.3-0.4% in the coming 12-month period. Impetus for higher 3M Hibor is unlikely as the Fed is not expected to hike rates in 2014.

2Y/5Y Curve vs 5Y/10Y Curve in Swaps



- The intermediate sector of the SGD swap curve has already tracked the USD swap curve higher as US rate hikes get priced in
- We expect yields on benchmark Singapore government securities to rise. Yields in the 2Y sector are likely to end 2Q14 near 0.9% and yields in the 10Y sector are likely to end 2Q14 near 2.9%

1Y, 2Y & 3Y HKD Swap Rates vs 3M Hibor



- With the implied yield on Dec-15 Fed Funds futures still far below 2%, 2Y HKD swap rates are likely to begin aggressively pricing in potential US rate hikes in 2015.
- We expect yields on Hong Kong's benchmark Exchange Fund Notes to rise. Yields in the 2Y sector are likely to end 2Q14 near 1.1% and yields in the 10Y sector are likely to end 2Q14 near 3.3%

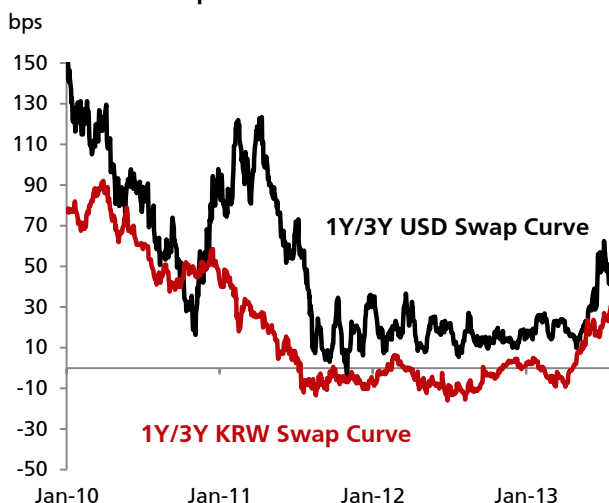
Korea: Pulled in different directions

Since the Bank of Korea (BOK) cut the policy rate by 25bps to 2.50% on May 9, short-end swap rates have been heading steadily higher. Moreover, short-end swap rates have consistently stayed above the 3-month CD rate, a configuration not seen since mid-2011, when the Fed provided calendar-based guidance on the Fed Funds rate. Two opposing factors, the state of the Korean economy (justifying loose monetary policy) and rising interest rates in the US are at play here, so far, the latter is clearly dominant. Speculation of potential Fed tapering in the coming months has led to rapid steepening in the USD swap curve. Notably, the 1Y/3Y USD swap curve spread widened to 50bps from just 15bps (a 35bps change) in the beginning of May, and this has translated into upward pressure on Asian swap rates including Korea. Over the same time period, the 1Y/3Y KRW swap spread increased to 23bps from a negative spread of 8bps (a 31bps change). The high correlation between Korean rates and US rates is not surprising as Asian central banks have to maintain a level of interest rate differential against US rates to reduce exchange rate volatility and draw in sufficient USD liquidity into the financial system. As such, we think that short-end KRW swap rates are likely to stay above the CD rate in the coming months.

Taiwan: Heading higher gradually

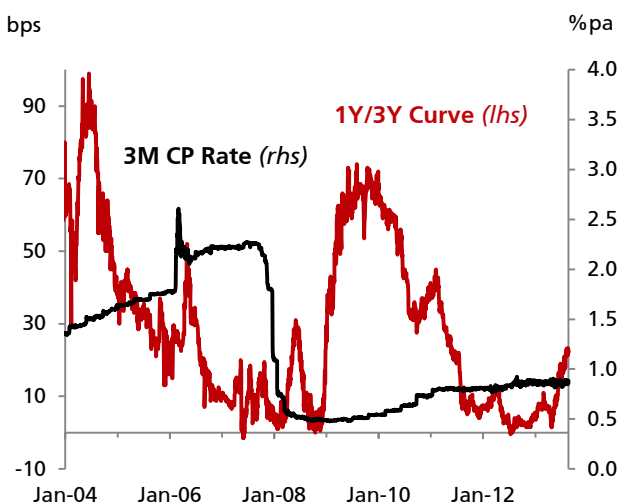
The 1Y/3Y segment of the TWD swap curve has been flat through the 10 months ending early May, but hints of Fed tapering have driven TWD swap rates higher since late May. The front end of the swap curve (1Y/3Y segment) has steepened to 22bps from just 2bps in the early part of May and further steepening towards 40bps is likely in the coming months. Most of the steepening is likely to take place through higher 3Y swap rates as upward pressure is expected to persist on the back of rising USD interest rates. The 1Y TWD swap rate, on the other hand, is not expected to rise significantly from current levels. Fundamentally, domestic liquidity is abundant given rising current account surpluses over the past few years. Moreover, the amount of certificate of deposits (issued by the central bank) outstanding remains elevated in the past few months, indicating the central bank has plenty of room to inject liquidity into the financial system if needed. With no signs of economic overheating and low inflation levels, there is also no impetus for the central bank to tighten domestic liquidity conditions. As such, the 3-month commercial paper rate (which serves as the floating leg of TWD swaps) is likely to stay low in the immediate few quarters, anchoring 1Y swap rates.

KRW & USD Swap Curves



- KRW swap rates have already risen significantly since early May. Further increases are likely as the US embarks on the withdrawal of monetary stimulus
- We expect yields on benchmark Korean Treasury Bonds to rise. Yields in the 3Y sector are likely to end 2Q14 near 3.50% and yields in the 10Y sector are likely to end 2Q14 near 4.25%

1Y/3Y Curve vs 3M CP Rate



- Domestic liquidity driven by sizable current account surplus will help to moderate swap rate increases as the US embarks on the withdrawal of monetary stimulus
- We expect yields on benchmark Taiwan government bonds to rise. Yields in the 2Y sector are likely to end 2Q14 near 0.9% and yields in the 10Y sector are likely to end 2Q14 near 2.0%

Thailand: Close correlation with US rates

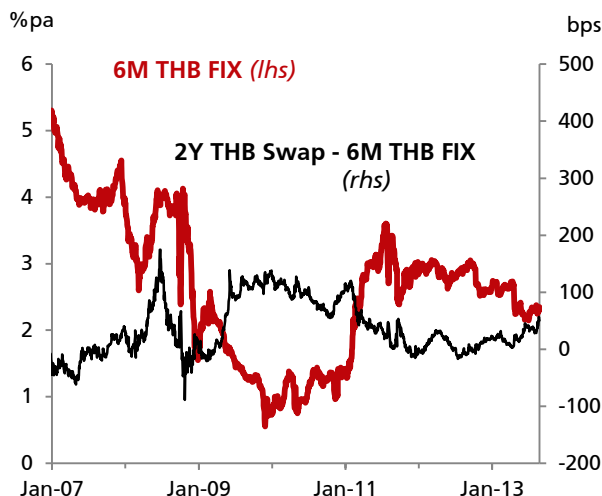
THB swap rates have tracked US swap rates higher over the past 3 months. However, the magnitude of the change in front-end THB swap curve (1Y & 2Y swap rates) has been relatively small. Notably, 1Y and 2Y THB swap rates have risen by just 9bps and 14bps respectively since end-May. While there has historically been a high correlation between US and THB swap rates, we think that domestic factors may be more dominant for the front-end of the THB swap curve in the short term. The trajectory of the FX-implied 6M THB FIX (which serves as the floating leg of onshore THB swaps) broadly depends on the policy rate direction and onshore liquidity in the domestic financial system. Over the course of the next four quarters, policy rates are likely to stay low to support the domestic economy as growth momentum further eased from 1Q (GDP contracted by 0.3% QoQ sa in 2Q). Moreover, there is no pressing need to raise policy rates to curb inflation (inflation edged down to 2.0% YoY in July) or to manage external imbalances. Externally, an improvement in the global economy should also result in an improvement in domestic liquidity via higher export values and portfolio inflows. Both of these suggest that upward pressure on front-end swap rates (1Y & 2Y) are likely to be more muted than they otherwise would have been (given likely upward pressure from rising US interest rates).

Malaysia: Signs of vulnerability

Fundamentally, Malaysia's external imbalances have deteriorated, with the current account surplus falling to MYR 2.6bn in 2Q, from a peak of MYR 28.3bn in 3Q11. Much of this can be attributed to robust domestic demand propping up imports while exports stayed lackluster over the past two years. Another point of vulnerability lies with the elevated level of local currency government debt held by foreign investors (32% as of 1Q13, compared to 13% in 4Q09 of total outstanding bonds). In a more difficult funding environment, portfolio outflows would put upward pressure on rates. Notably, upward pressure from rising US interest rates have already pushed front-end MYR swap rates sharply higher since late May, to levels last seen in August 2011

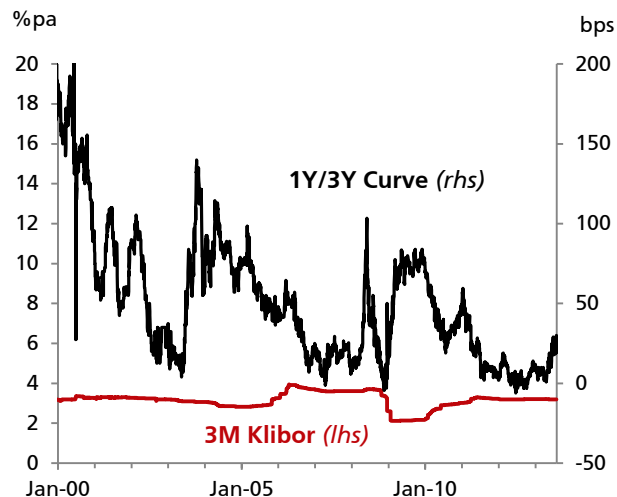
While there are signs of vulnerability regarding external funding, Malaysia's fundamentals are clearly stronger than India's or Indonesia's. Malaysia is still likely to run an annual current account surplus (albeit diminished) this year, compared to a likely deficit in excess of 3% of GDP for Indonesia and India. Upward pressure on short term MYR rates is unlikely to be of the same magnitude as these current account deficit economies. As such, there is scope for the 1Y/3Y segment of the MYR swap curve to continue steepening,

2Y Swap Rates vs 6M THB FIX



- Given the high correlation between US and TH rates, it is not surprising that THB swap rates have tracked USD rates higher over the last few months.
- We expect yields on benchmark Thailand government bonds to rise. Yields in the 2Y sector are likely to end 2Q14 near 3.25% and yields in the 10Y sector are likely to end 2Q14 near 5.00%

1Y/3Y Curve vs 3M Klibor



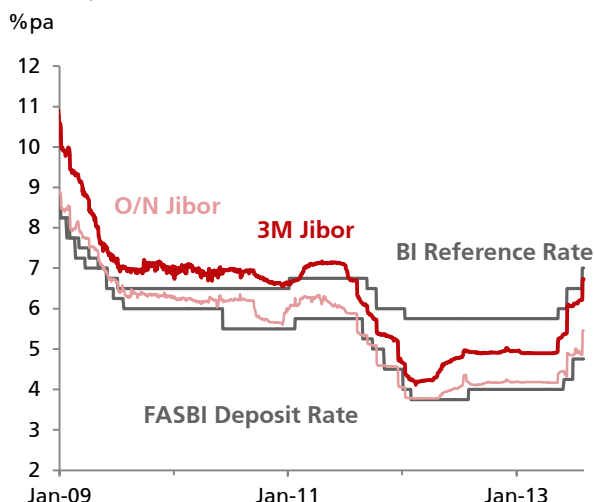
- While external imbalances have deteriorated, Malaysia's fundamentals are clearly much stronger than India's or Indonesia's.
- We expect yields on benchmark Malaysian government securities to rise. Yields in the 3Y sector are likely to end 2Q14 near 3.5% and yields in the 10Y sector are likely to end 2Q14 near 4.3%

Indonesia: Tightening

Upward pressure on bond yields and interbank rates are likely to persist as Bank Indonesia (BI) maintains its tightening stance over the medium term. Over the past two months, BI hiked both the FASBI deposit rate and the policy rate by a cumulative 125bps, frontloading monetary tightening in response to higher inflation driven by the fuel price hike in late June. Notably, the hikes in interest rates is also a step in the right direction as the authorities tackle the widening current account deficit. With inflation pushing higher and the trade balance still under pressure, we believe that monetary tightening is not over. Another 25bps worth of FASBI deposit rate hikes have been penciled into our forecast, taking the rate to 5.50% by the end of the year.

From a longer term perspective, the spread between 3M JIBOR and the BI is at the narrowest point since late-2011. This is driven by a combination expectations of tighter monetary policy, increased term premia and a deterioration of domestic IDR liquidity conditions. An improvement in the global economy could draw in foreign inflows and improve domestic liquidity conditions. However, on balance, domestic liquidity conditions are unlikely to be as ample as during 2011. Overall, 3M Jibor is likely to head higher over the medium term.

BI Policy Rates & Jibor Interbank Rates



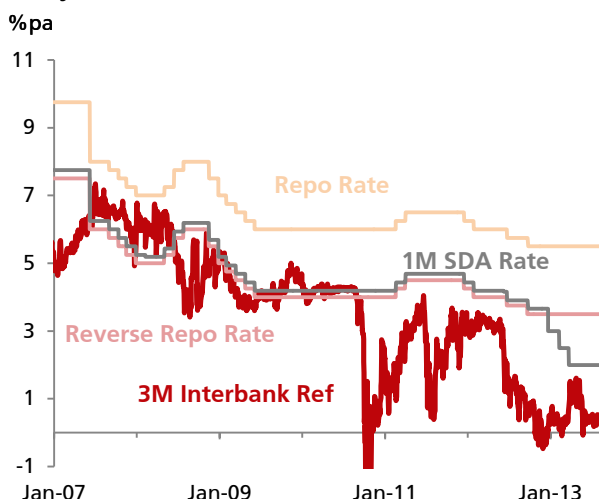
- With the current account widening to a record of USD 9.8bn in 2Q, the need to manage external imbalances implies tighter monetary policy over the medium term

- We expect yields on benchmark Indonesian government bonds to rise. Yields in the 2Y sector are likely to end 2Q14 near 8% and yields in the 10Y sector are likely to end 2Q14 near 9%

Philippines: Liquidity cushion

Liquidity in the financial system is sizable and short-term rates are likely to stay low even in the event of moderate portfolio outflows. Liquidity in the financial system can be gauged by the level of funds placed in the special deposit accounts (SDAs) and by the loan-to-deposit ratio. As of May, there are still PHP 1.7trn in the SDAs and the loan-to-deposit ratio for universal and commercial banks stood at 66.4%. Moreover, the current account remains in a firm surplus position through the lackluster external environment over the past two years. For the most part of the period since 2011, the FX-implied 3M interbank reference rate has been significantly below the SDA rate as FX forwards do not reflect the full change in USD/PHP as implied by interest rate differentials. During the recent period of capital outflows, the 3M interbank reference rate only rose briefly (moving closer in alignment with interest rate differentials) in June and has since subsided. Favorable currency dynamics in the forward space and ample liquidity should reduce upward pressure on the 3M interbank reference rate and front end PHP swap rates stemming from US interest rates heading up. With credit growth staying moderate and inflation staying low, Bangko Sentral ng Pilipinas (BSP) is unlikely to tighten liquidity or raise policy rates anytime soon.

Policy Rates & 3M Interbank Reference Rate Rate



- The accumulated liquidity in the financial system and current account surpluses suggest that the 3M interbank reference rate is likely to stay low, hovering between 0 and 2% in the coming months.

- We expect yields on benchmark Philippine government bonds to rise. Yields in the 2Y sector are likely to end 2Q14 near 3.50% and yields in the 10Y sector are likely to end 2Q14 near 4.75%

India: Tight liquidity

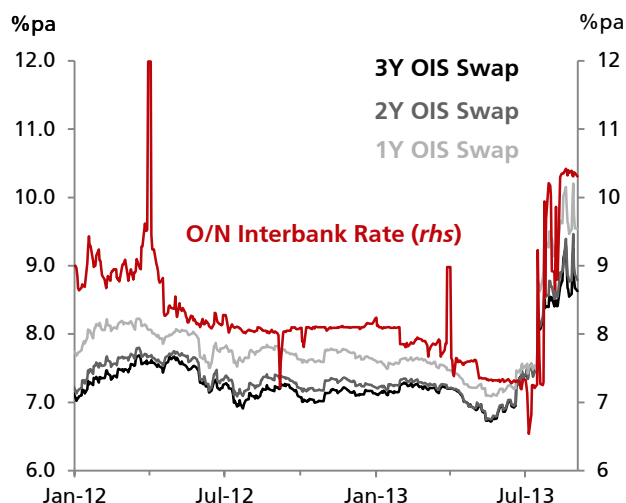
The domestic liquidity environment has been tight over the last few months and the Reserve Bank of India (RBI) further tightened INR liquidity by raising both the Marginal Standing Facility (MSF) rate and the Bank rate by 200bps to 10.25% on July 15. A limit of INR 750bn has also been set for Repo based borrowing. The limit was subsequently reduced to 0.5% of each bank's net demand & time liabilities. The overnight interbank rate, which has been hugging close to the repo rate in the preceding months, immediately shot towards the MSF rate. For most part of the last four weeks, the overnight interbank rate has been hovering in the upper half of the range between the MSF rate and the Repo rate.

The important thing to note is that the monetary authorities are engineering the liquidity squeeze and elevated interbank rates are expected to persist in the short term. Notably, the current account deficit remains a worry and the rupee slipped to new lows before staging a small recovery. The front end of the swap curve is implying that interbank rates are likely to stay elevated for the next 1-2 years. Notably, 1Y and 2Y OIS swaps have risen by 250bps (to 9.75%) and 200bps (to 8.97%) respectively since early June and are at levels not seen since mid-2008 (prior to the full-blown global financial crisis).

China: Liquidity squeeze over

Front-end onshore swap rates (1Y, 2Y & 3Y) are likely to hover in ranges over the coming months. The June liquidity squeeze is over. After hitting a peak of 10.8% on June 20, the 7-day repo rate (which serves as the floating leg fixing index of onshore swaps) is back below 5%. A temporary surge in the repo rate of that magnitude is not a unique occurrence. In the episodes of Jun-2011 and Dec-2011, 3-month Shibor and front-end CNY swap rates (1Y, 2Y & 3Y) stayed elevated for a few months (relatively to the period preceding the liquidity squeeze). We think that concerns about policy uncertainty and variable liquidity conditions will persist for some time that should keep term premia high. While the recent episode of tight liquidity and those in 2011 are associated with different 'objectives,' market participants are concerned that liquidity conditions in the banking system could tighten again. Notably, policy actions to tighten liquidity in 2011 were responses to rising property prices amid signs of overheating in the domestic economy. In contrast, the most recent episode of liquidity tightening was aimed at encouraging banks to maintain "stable and appropriate" credit growth. Notably, People's Bank of China (PBoC) governor Zhou Xiaochuan indicated on August 19 that the economic growth rate is robust. On balance, we think market rates are biased towards the upside.

IN: 1Y, 2Y & 3Y OIS Rates vs O/N Interbank Rate



• *Dealing with the twin deficits in a difficult funding environment implies that interest rates are likely to be elevated in the short term.*

• *We expect yields on benchmark Indian government bonds to fall as excessively tight liquidity eases in the coming quarters. Yields in the 2Y sector are likely to end 2Q14 near 8.0% and yields in the 10Y sector are likely to end 2Q14 near 8.1%*

1Y, 2Y & 3Y CNY Swap Rates vs 7D Repo Rate



• *The liquidity squeeze in June is over. However, concerns about policy uncertainty and liquidity conditions are likely to keep term premia high.*

• *We expect yields on benchmark Chinese government bonds to rise. Yields in the 2Y sector are likely to end 2Q14 near 4.0% and yields in the 10Y sector are likely to end 2Q14 near 4.5%*

Interest rate forecasts

%, eop, govt bond yield for 2Y and 10Y, spread bps

		11-Sep-13	4Q13	1Q14	2Q14	3Q14
US	3m Libor	0.25	0.30	0.30	0.30	0.30
	2Y	0.44	0.78	0.98	1.17	1.17
	10Y	2.91	3.00	3.30	3.70	4.00
	10Y-2Y	247	222	232	253	283
Japan	3m Tibor	0.23	0.25	0.25	0.25	0.25
Eurozone	3m Euribor	0.22	0.19	0.19	0.19	0.19
Indonesia	3m Jibor	6.77	7.00	7.00	7.00	7.00
	2Y	7.86	7.80	8.00	8.00	8.00
	10Y	8.76	8.75	9.00	9.00	9.25
	10Y-2Y	90	95	100	100	125
Malaysia	3m Klibor	3.20	3.25	3.25	3.25	3.25
	3Y	3.41	3.50	3.50	3.50	3.50
	10Y	3.88	4.10	4.20	4.30	4.40
	10Y-3Y	47	60	70	80	90
Philippines	3m PHP ref rate	0.59	1.00	1.50	2.00	2.50
	2Y	3.05	3.25	3.25	3.50	3.75
	10Y	3.76	4.25	4.50	4.75	5.00
	10Y-2Y	71	100	125	125	125
Singapore	3m Sibor	0.37	0.35	0.35	0.35	0.35
	2Y	0.25	0.50	0.70	0.91	0.91
	10Y	2.66	2.80	2.87	2.90	2.94
	10Y-2Y	241	230	217	199	203
Thailand	3m Bibor	2.60	2.60	2.60	2.85	3.10
	2Y	2.92	3.00	3.00	3.25	3.50
	10Y	4.33	4.50	4.75	5.00	5.00
	10Y-2Y	141	150	175	175	150
China	1 yr Lending rate	6.00	6.25	6.25	6.50	6.50
	2Y	3.88	3.88	4.00	4.00	4.00
	10Y	4.07	4.25	4.50	4.50	4.50
	10Y-2Y	19	37	50	50	50
Hong Kong	3m Hibor	0.39	0.40	0.40	0.40	0.40
	2Y	0.42	0.58	0.88	1.07	1.27
	10Y	2.46	2.60	2.90	3.30	3.60
	10Y-2Y	204	202	202	223	233
Taiwan	3M CP	0.85	0.80	0.88	1.00	1.13
	2Y	0.73	0.90	0.90	0.90	1.00
	10Y	1.71	1.80	1.90	2.00	2.00
	10Y-2Y	98	90	100	110	100
Korea	3m CD	2.66	2.70	2.70	2.95	2.95
	3Y	2.93	3.00	3.25	3.50	3.50
	10Y	3.63	3.75	4.00	4.25	4.25
	10Y-3Y	70	75	75	75	75
India	3m Mibor	11.59	8.00	8.00	8.00	8.00
	2Y	9.19	8.60	8.00	8.00	8.00
	10Y	8.39	8.60	8.10	8.10	8.10
	10Y-2Y	-80	0	10	10	10

CNH: Milestone reached but long journey remains

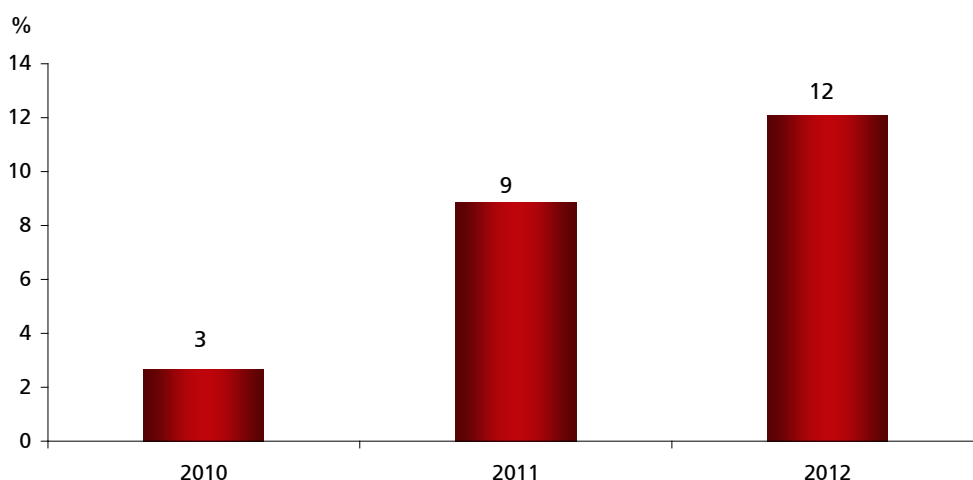
- RMB for the first time joined the league of the most-traded global currencies
- But it is still underrepresented when compared to the size of the China's economy
- Continuous efforts are needed to move RMB further up the ranks as a

Efforts to globalize the renminbi (RMB) reached a milestone when the currency joined the league of the most-traded currencies for the first time. According to the Bank for International Settlements' (BIS) latest report on foreign-exchange turnover, daily trading in RMB has tripled over the past three years to USD120 bn. This makes the RMB the ninth most actively traded currency in 2013, with a share of 2.2% in global FX volumes. The RMB ranked 17th (with a share of 0.9%) in the last survey conducted in 2010.

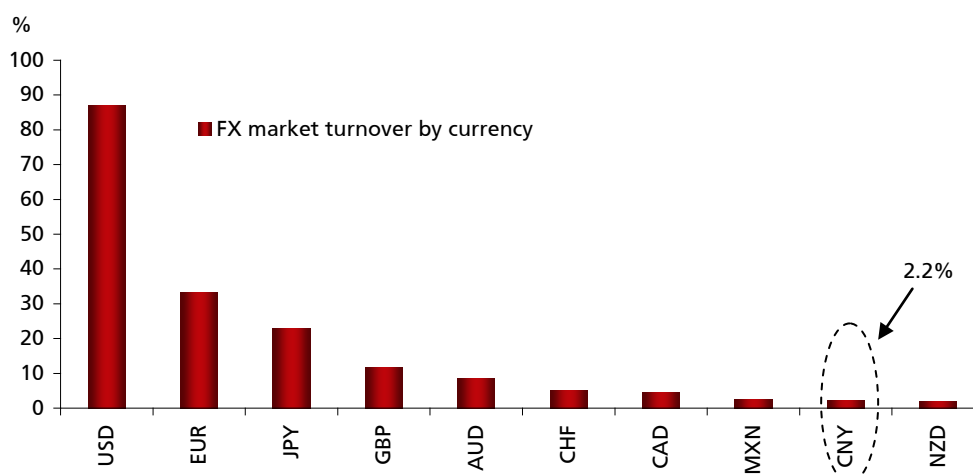
The ninth-most-actively-traded currency

The notable improvement highlights the flexibility foreign firms can gain by using RMB. For corporations that trade with China, the use of RMB can lower their FX costs and risks. They can also enjoy the price discounts offered by some mainland companies. Since Chinese exporters usually raise prices on foreign currency transactions as a cushion for potential FX fluctuations, it is estimated that overseas importers paying in RMB could save 2-3% on their invoices. The combination of factors has led to a six-fold surge in RMB-settled trade in the past three years (Chart 1).

Chart 1: RMB trade settlement to China's total trade



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Chart 2: The RMB joins the league of the most-traded currencies


Continuous policy initiatives

Having said that, the RMB is still underrepresented when compared to the size of the China's economy. Currently, China represents around 11% of global GDP (2nd largest economy) and more than 10% of world trade (largest trading country). But the RMB's share in global FX volumes is significantly lowered than that of the USD (87%), the most-used currency for global transaction (Chart 2). Continuous efforts are therefore desired to move RMB further up the ranks as a global payments currency.

Trade channel

In July, the People's Bank of China (PBoC) announced a series of measures aimed at simplifying RMB cross-border transactions. Based on the basis of 'know your customer', 'know your business,' and 'due diligence', banks in the mainland can process RMB cross-border trade settlement for their corporate clients before verifying the documentary proof of underlying trade transactions. The streamlined process increases the efficiency in handling RMB-denominated trades.

Meanwhile, the PBoC has also approved a new scheme — gross-in/gross-out arrangement — to make it easier for a European Fortune 500 company with substantial sales in China to manage its RMB holdings. Before the new model was introduced, the company had to process multiple cross-border RMB payments separately for regulatory oversight, resulting in transaction costs and a lack of central monitoring. Some domestic banks were also being frustrated since settling trade separately had been both time-consuming and labor intensive. Under the new scheme, the company can consolidate all incoming RMB transactions made in different time periods into a single transaction; as well as all outgoing RMB payments into another. This centralized approach to cash management significantly reduces the exchange rate exposure and optimizes liquidity management for the company. It also sets a precedent for other foreign corporates to adopt the RMB in international trade.

The PBoC announced a series of measures aimed at simplifying RMB cross-border transactions

Portfolio investment channel

Progress has also been made on loosening controls on cross-border investment. In August, the State Administration of Foreign Exchange (SAFE) simplified rules on the QDII (Qualified Domestic Institutional Investor) scheme, including allowing investors to choose the currencies they want to use for cross-border fund remittance and no longer requiring the regulator's approval on FX purchases/sales. After the deregulation, China fund managers will see more flexibility in designing QDII portfolio. Off-shore RMB investable products such as dim sum bonds could also be benefitted. For

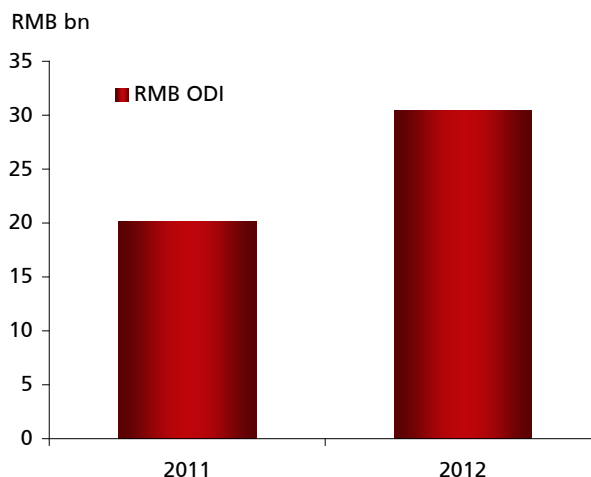
instance, mainland investors might be particularly interested in high yield names such as property developers as Chinese property firms have been banned from issuing onshore.

Direct investment channel

Beijing is also keen to boost offshore RMB liquidity by encouraging more RMB use in outward direct investment (ODI). On the back of policy relaxation, such as raising thresholds for project amounts subject to approval and simplifying application procedures, RMB-settled ODI surged 50% last year (Chart 3). The growing share of private investment can also be seen as a result of preferential policy supports. In 2012, outward investment made by non-SOEs accounted for 9.5% of China's ODI, a significant rise from 4% in 2010.

More encouragingly, the US has recently committed to maintain an open and fair investment environment for Chinese investors. If realized, this represents an important breakthrough for China's ODI. In the past, Chinese direct investment was often viewed with suspicion because it was dominated by SOEs. These were considered a threat to competitive markets and, occasionally, to national security. Consequently, though China was the largest investor in developing economies in 2010 and 2011, it represents less than 2% of the US's total stock of inward investment. According to the Heritage Foundation, China has ploughed about USD50 billion into the US during 2005-2012. But over USD200 billion-worth of potential deals have fallen through due to political opposition and regulatory obstacles. Political obstacles mainly targeted large M&A deals in sensitive industries, such as oil and gas, infrastructure, and high-tech industries (i.e., CNOOC's failed bid for Unocal in 2005; Huawei's unsuccessful attempts to acquire 3Com in 2008 and 3Leaf in 2010). Apparently, China's ODI would be greater if the US was to become more hospitable towards mainland investment. This will also facilitate the growth in RMB ODI as the application procedure is virtually the same for RMB-settled and USD-settled investments.

Chart 3: RMB ODI surged 50% in 2012

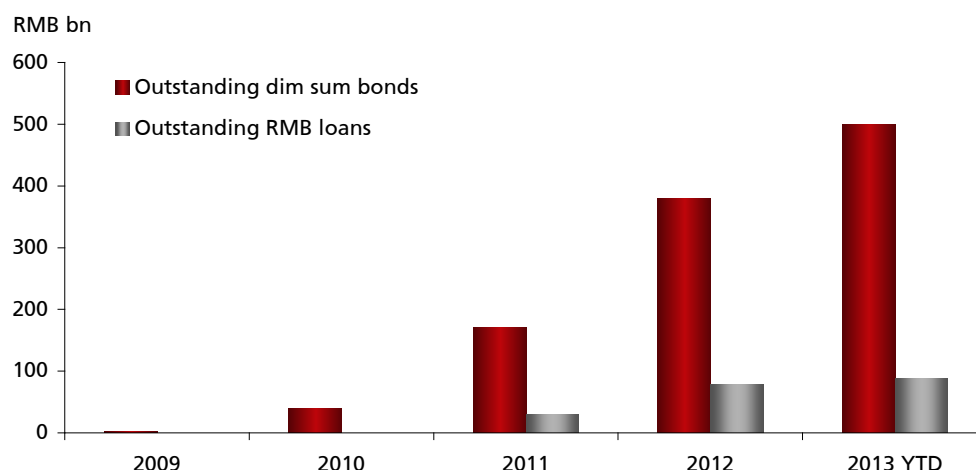


China's ODI would be greater if the US was to become more hospitable towards mainland investment

Cross-border RMB flows channel

As part of the steps toward a convertible RMB, the development of the Qianhai economic zone has been emphasized on cross-border RMB flows. Hereto, fifteen Hong Kong banks were authorized to offer a combined RMB2 bn of loans for Qianhai companies. Such cross-border RMB lending scheme provides Hong Kong banks a new attractive avenue for RMB fund investments; the growth of which has far been lagging behind that of other offshore RMB products. For instance, the total outstanding RMB loans in Hong Kong merely amounted to RMB88 bn, compared with the dim sum bond market's RMB500 bn (Chart 4).

The limited size of RMB-settled business for Hong Kong companies is a major factor that attributes to the weak RMB loan growth, according to a survey constituted to the DBS RMB Index for Winning Enterprises (DRIVE). Cross-border lending is thus essential in improving the demand and yield on the Hong Kong's RMB deposit; and subsequently the offshore RMB circulation. In July and August, three land auctions (14 million sq ft GFA) were held in the zone, which signals that Qianhai has already

Chart 4: Hong Kong RMB financing


entered into an expansion phase. Given the anticipated surge in business activity, Qianhai has assigned up to 200 million sq ft GFA for office space usage. Stronger demand for cross-border loans is therefore expected going forward.

Conclusion

China's efforts to internationalize the RMB have been warmly welcomed by the corporate sectors and global investors, indicating enormous demand for the RMB as a trade settlement and investment currency. As such channels broaden and deepen, coupled with the ongoing expansion of offshore RMB hubs, the RMB is set to move up the ranks further as a global currency. The likelihood of RMB to become one of the top five most traded currencies is high in the next BIS's report to be published in 2016.

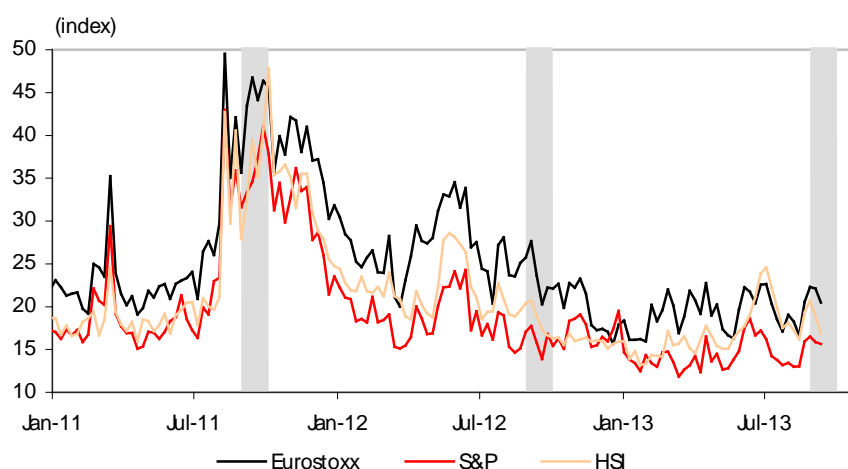
Asia equity: Embrace the volatility

- It's no time for risk, as headwinds are expected to strengthen in September
- Although Asia markets have corrected, a series of major events could trigger more volatility ahead
- The beginning of QE tapering could remove some uncertainty, but markets need to adjust and anticipate the Fed's next move
- Buy on weakness in ASEAN markets, as markets had over-discounted fears for another 1997/98-styled currency crisis brewing

September is historically the worst month for US stocks. Investors should not ignore the mid-month FOMC meeting as a potential pain inflictor this year. While the consensus is looking for the start of tapering, it pays to be guarded on any potential wild cards in what the Fed chairman will say at the post-meeting conference. Now that 10-year bond yields have almost touched the 3% threshold, investors will focus next on how fast the Fed wants short rates to normalise, even if it is going to be 2-3 years later.

Complacency in Europe, Japan and US could also be threatened with the German elections, tax changes in Japan, and US budget debates, which are all happening in the September month. Adding to the mine fields are the rising military tensions with Syria, nomination of the new Fed chief, and the fragile global recovery. We believe any rally is unsustainable and investors should lighten on risk in September. In our view, there will be better buying opportunities post-FOMC meeting, and investors should focus on the ASEAN markets, where the worst will be deemed over by October.

Fig. 1: Eurostoxx, S&P and HSI volatility index — too much complacency in markets



Source: Bloomberg. Shaded bars are September months

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Sell on rumour, buy on news?

The main event for the month will be the FOMC meeting on September 18, when the Federal Reserve will decide if it proceeds with a “cautious tapering” in its asset purchases. The Fed is expected to decrease purchases by USD10-20bn from its current level of USD85bn a month. As both equity and bond markets have corrected in advance, many wonder if the event will be a “buy on news” opportunity.

Although the start of QE tapering should remove some uncertainty, we believe markets will still have a lot of adjustments to make and will try to anticipate Fed’s next move. The scale of the tapering, whether it will be on Treasuries or MBS, and the impact on both yields and the housing market; and when investors will completely wean off from the QE, are all questions that investors will want to hear answers from the Fed chairman in the same post-meeting conference. Importantly, it remains to be seen if Bernanke will make use of the opportunity to shape investors’ expectations on the level of normalised FOMC rates and by when it will reach that level. It could be a nasty surprise as current Fed funds futures are still pricing in high probability that fed funds rate won’t move in 2014. A normalised fed funds rate could be at 2.5% if inflation does get back to 2%, which means rate hikes at consecutive meetings when Fed’s threshold-based guidance is reached. (Fig. 2)

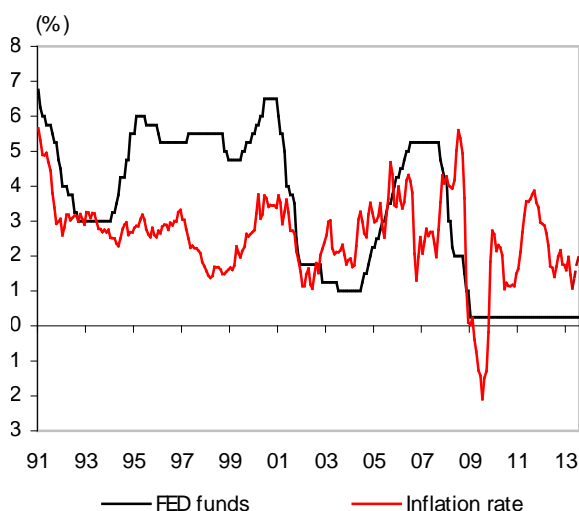
We recommend investors to be cautious ahead of the FOMC meeting in September.

ASEAN needs time and data to stabilise

Focus will turn to the Fed in ASEAN markets’ trading after fears invoked by funds unwinding and currency free-fall. Nonetheless, the Asian currency volatilities expose a need for more reforms and restructuring, with little room for complacency in the region. ASEAN central banks have addressed concerns on their problems, but data releases in the upcoming months need to show that these measures are working.

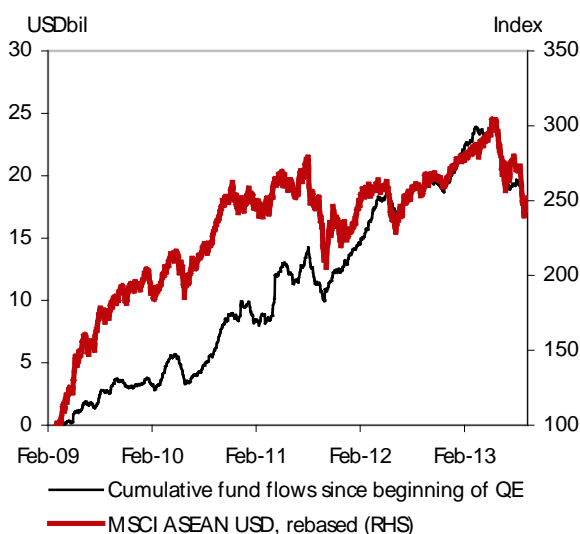
Specifically, we look for inflation data and rate hikes to peak in Indonesia; Thailand GDP in 3Q to confirm the recession is temporary; Malaysia budget announcements to be less restrictive on growth but yet prudent. Our calculations show that foreign inflows since the launch of QE in Mar-09 are only about 30% into unwinding (Fig. 3). This will be the main stumbling block to a near term market recovery, especially with focus turning to QE tapering in September.

Fig. 2: US Fed funds rate and CPI inflation — less Fed accommodation is to be expected



Source: Datastream

Fig. 3: Foreign inflows and ASEAN index moving in tandem since Feb09



Source: Bloomberg, Datastream, DBS

China surprised in 3Q but sustainable V-shaped recovery unlikely

The Hong Kong market outperformed ASEAN which was hit by currency woes in 3Q. Sentiments in Hong Kong / China were also lifted by China's better than expected PMIs (which rose above 50) and export numbers, and a lower than expected inflation which lifted hope for government stimulus. (Fig. 4)

China's PMI may have recovered modestly but it is unlikely to stage a V-shaped recovery in our view. PMI survey details show that some inventory re-stocking may need to come through, but export orders are not improving fast enough to have a sustained re-stocking. The strong loan growth recorded in the past few months is not sustainable (August number was below expectations) as the central government remained guarded on the build up of excessive credit growth and NPLs. Unless there's a pick-up in fixed asset investments which currently remained low by historical standards at 20.3%, we believe that the headline GDP is unlikely to surprise on the upside. A PMI of 50-52 is more consistent with our GDP forecast of 7.5%, which we believe that the government will likely maintain for "sustained and healthy" growth.

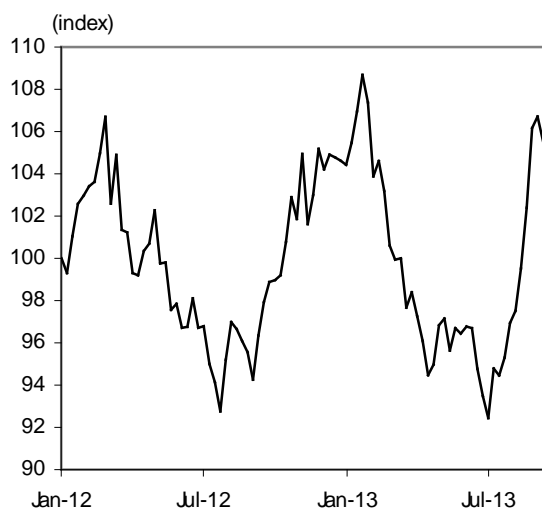
Fixed asset investments will be focused on the railway, water treatment and environmental sectors. The development of trade free zones in Shanghai and Guangzhou are still in the planning stage and could have many implications for China's sustainable growth model and political power structure in our view. Benefits are unlikely to be felt in the near term.

We believe funds outflow from ASEAN favouring Hong Kong / China was tactical for a few reasons. 1) 1H underperformance in Hong Kong / China vs ASEAN; 2) China's GDP disappointments in 1H where downgrades in expectations had stabilised; 3) pegged HKD currency which is not subject to contagion risks from the ASEAN currency crisis.

ASEAN returning to stability - buy on weakness

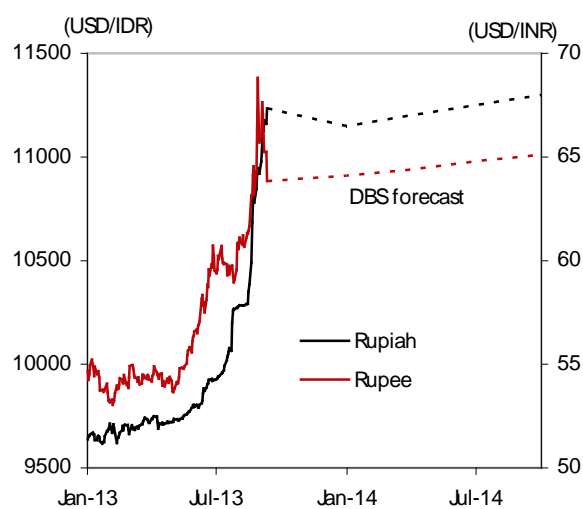
With ASEAN markets already corrected, we believe that some stability may be returning to emerging market currencies, hence the equity markets. (Fig. 5). Central

Fig. 4: Hang Seng Index vs MSCI South-east Asia Index relative performance



Source: Datastream, DBS

Fig. 5: Asian currencies returning to stability



Source: Datastream, DBS

banks in India and Indonesia are staying vigilant pending the Fed's QE tapering decision due on Sep18, risks of further currency depreciation, and the pressure to hike rates. Markets are giving the new RBI governor the benefit of doubt that he can help arrest the INR depreciation with bold reform measures. Indonesia's latest foreign reserves number suggest that foreign fund outflow may have past the peak in this round of risk aversion.

The passing of FOMC meeting will provide short-term relief to markets but pressure points will need to ease in these ASEAN markets before investors can be convinced that the worst is over and that it takes time for currencies to stabilise. Our best gauge in timing is October, as we discuss some of the pressure points in the section below.

It is unlikely for China's PMI to consistently surprise on the upside, and coupled with the stabilisation of ASEAN currencies, we believe China may not outperform ASEAN again in 4Q. We are maintaining our neutral stance on Hong Kong / China, and recommend investors to buy ASEAN on weakness, as we believe the worst will be over for ASEAN markets by October.

ASEAN on the mend

Since the start of the market turmoil in July, many central banks in Asia have taken measures to address problems that their economies are facing. These measures may eliminate investor concerns for further downside risks in these markets, but eventually the improvements must be reflected in the economic numbers. Generally policy makers are prioritising economic stability over a faster pace of economic growth, and downside risks to growth projections exist. Over the course of past one month we have downgraded 2013 GDP growth for Thailand, Indonesia and Malaysia. (Fig. 6)

Indonesia

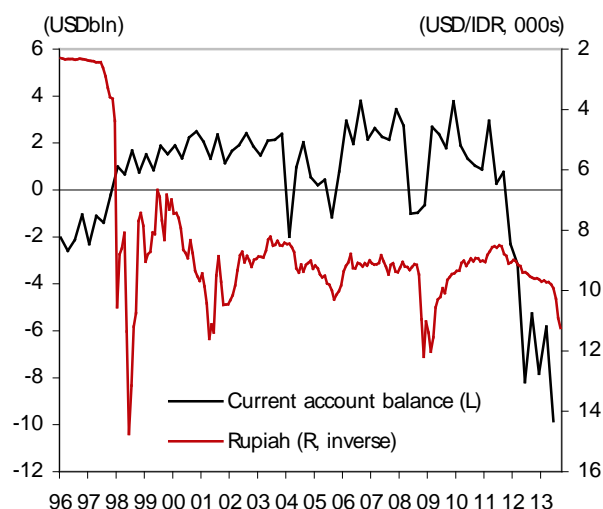
In Indonesia, BI has taken several measures to pre-empt further falls on the rupiah, including hiking rates by another 50 bps, and introducing bi-monthly policy meetings to react swiftly to market conditions. With the possibility of inflation rising and

Fig. 6: 2013F GDP growth forecast revisions since last quarter

	Forecast last Qtr 2013f	Current forecast 2013f	
Indonesia	6.3	5.8	↓
Malaysia	5.0	4.3	↓
Philippines	6.4	7.0	↑
Singapore	2.5	2.9	↑
Thailand	5.0	4.0	↓
China	8.0	7.5	↓
Hong Kong	4.0	3.5	↓
Taiwan	2.6	2.6	=
Korea	2.8	2.8	=
India*	5.7	5.2	↓
ASEAN 5	5.0	4.8	↓
ASA 10	4.8	4.6	↓

Source: DBS. Arrows denote revisions since last quarter.

Fig. 7: Indonesia current account balance vs rupiah



Source: Datastream, DBS

staying above 9% for the rest of the year, the strategy team believes that further rate hikes may be needed. The current account deficit may not widen further but is unlikely to improve in our view, considering the still weak outlook for commodities. (Fig. 7). The rupiah may still be under pressure unless there are further rate hikes. Investors may want to see possible shocks from higher inflation, current account and the foreign reserves. Reported inflation and foreign reserves as of August were better than expectations, while trade balance had fared worse than expectations.

Indonesia's foreign reserves maintained at US\$93 billion in August, after dropping from the high of US\$103 billion in May. The fear that foreign reserves will be depleted to defend the currency on foreign outflows was eased. Foreign fund outflows was the most intense in June with about US\$2 billion sold in bonds and equities respectively. We believe foreign outflows has past its peak.

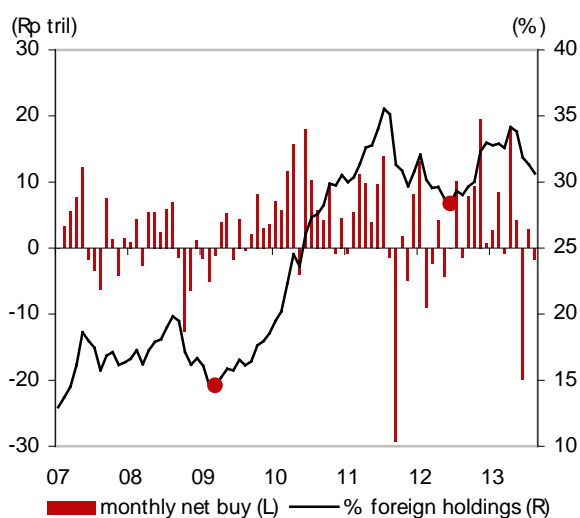
Investors are concerned about potential foreign bond outflows in Indonesia, which could subject the markets to high interest rates risk. To be sure, foreign bond holdings has stayed sideways in the last two years and did not experience large outflows during the Eurozone crisis. (Fig. 8). The Indonesia / US bond yield spreads are the most attractive in the region, and should remain so for foreign investors, especially with the current USD/IDR level. We see Indonesia LT bond yields rising to 9.25% and US LT bond yields to 4% by 3Q14.

Thailand

Thailand is technically in recession after two quarters of negative growth. Concerns are whether the recession will drag to the next quarter and what measures the government will take to boost growth. Some overhang on PCE growth is likely to occur as the Bank of Thailand (BoT) keeps an eye on household credit levels and ensures that these loans stay moderate.

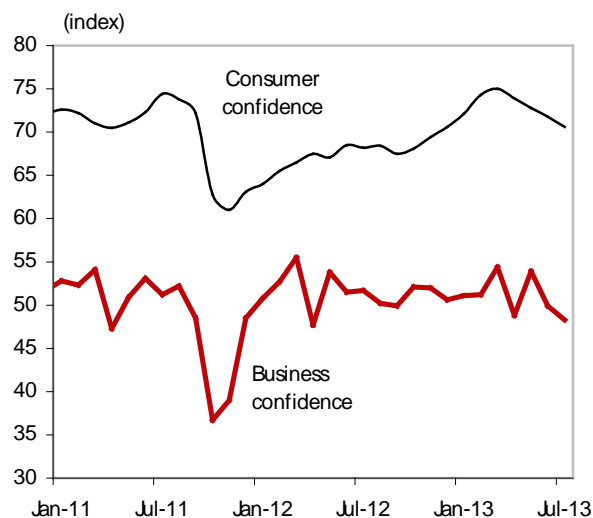
At the same time, public investments remain weak. Short of an announcement of a sizable stimulus package, and yet a prudent one, market sentiment is likely to remain weak. Further delays in the royal endorsement of the Budget Bill and government projects are expected. In its third revision, Thai's Finance Ministry forecasts the 2013 GDP growth rate at 3.8-4.0%, down from 4.0-5.0% forecasted in June.

Fig. 8: Indonesia govt securities held by non-residents — % of total vs monthly net buys



Source: CEIC, DBS

Fig. 9: Thailand consumer and business confidence — down but not out



Source: Datastream, DBS

Unlike India or Indonesia, Thailand's external balance is strong and reversal of capital flows due to QE unwinding should not be as worrisome. Thailand is likely to keep policy rates low to support the domestic economy amid falling inflation. Domestic liquidity should thus remain abundant. Thailand is the most liquid market in ASEAN in terms of average daily trading value with domestic participation rate close to 75%. We believe that once domestic confidence resumes, the Thai market should resume its upward momentum. (Fig. 9)

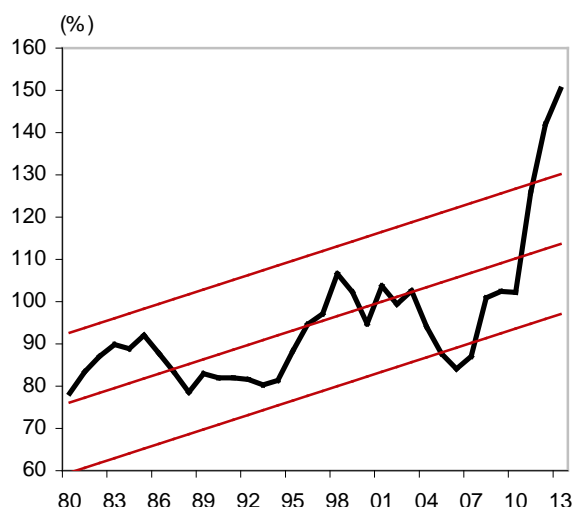
Valuations in Thailand is cheap after the correction. Potential catalyst for upgrade is the resumption of infrastructure spending without any political hindrance, which we will be watching for closely. Meanwhile key themes for 4Q are beneficiaries of a weak baht and rising oil price.

Singapore

In Singapore, higher US bond yields have kept investors on the sidelines as the de-risking trend continues. Singapore's debt has built up due to low interest rates in the last two years, and has been the most rapid in the region, thus making the economy the most vulnerable to higher interest rates among all ASEAN economies. While rates on the long end are rising, short rates have yet to move. Attention will turn to when the FOMC hikes rates (Singapore rates closely follow this trend), when QE tapering starts. The government may have to continue to tighten on property measures, credit growth, foreign labour policies and the currencies to stay prudent. Meanwhile, weak regional currencies and economies are dampening the earnings outlook for a number of Singapore stocks exposed to the region. We see further downside risks to earnings growth for next year. (Fig. 10, 11)

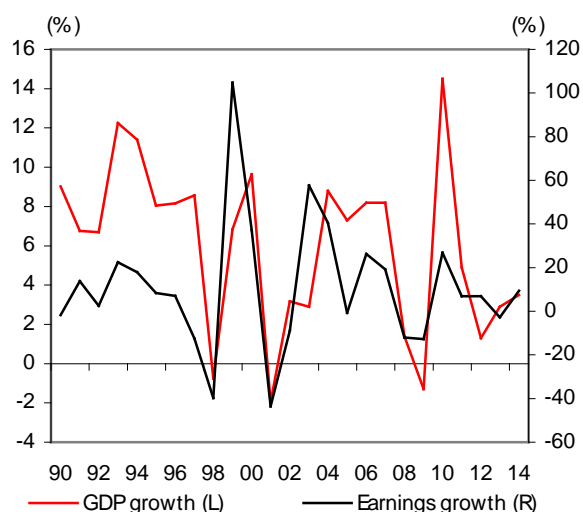
Negative impact of QE tapering will be mainly from rising interest rates. The wild card, however, is the upside surprise for externally driven cyclical stocks as the global recovery is being confirmed; or the reverse if FED decides to delay it. China demand slowdown is also misconstrued for many Singapore stocks with China exposure, and should thus benefit from improving sentiments in China. Stocks with South Asia exposure should also find relief after the stabilisation of the currencies. But investors should look out for impact of demand slowdown from these markets.

Fig. 10: Singapore loans and advances to GDP — policy tightening bias needs to be in place



Source: CEIC, DBS. Bands are average and standard deviation lines.

Fig. 11: Singapore annual GDP and earnings growth



Source: CEIC, Datastream, IBES, DBS

Malaysia

Malaysia's ETP mid-year briefing highlighted that projects with high multiplier and low import content will be accelerated while the opposite will be rescheduled. This is seen as a prelude to the upcoming 2014 budget announcement on 25 Oct, where measures to improve finances may be announced. Higher taxes and cuts in subsidies, and delays in projects are all likely to result in slower growth going forward. We have downgraded 2013 GDP from 5% to 4.3%. Earnings growth is now -5%.

Although Malaysia has been a defensive market because of the low foreign ownership in the equity market, the foreign holding in its bond market has almost tripled since the GFC, to as high as Indonesia's. Its fiscal position has also worsened to near 5% deficit. The Malaysia ringgit suffered sell-off together with the regional currencies, and the equity market was also affected. We believe investors have over-reacted to fears of the region heading to another currency crisis, in this instance, putting Malaysia in the same category as INR or IDR. (Fig. 12)

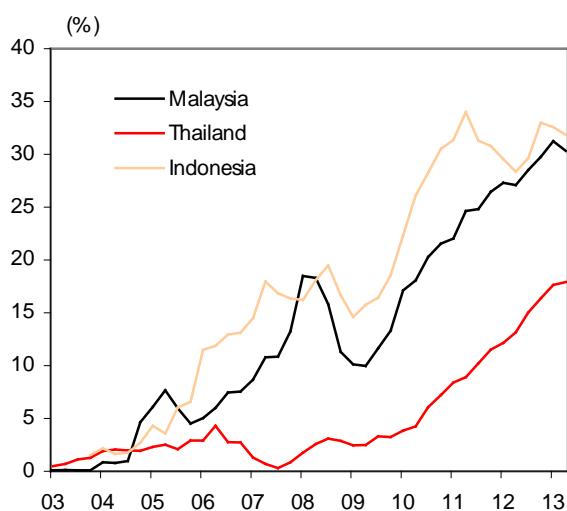
In response to the "so-called" crisis now, Malaysia planned a tightening path to delay infrastructure projects, cut subsidies, and may start a consumption tax to contain the budget deficit and bolster a shrinking current-account surplus. While these measures are likely to lead to slower growth, investor confidence had gained on these prudent measures. This is in sharp contrast to the policy response then in 1997/98 Asian financial crisis when Malaysia devalued the ringgit, raised interest rates sharply, and imposed capital controls. Importantly there are more policy options now than before that central banks can use to handle a crisis. To begin with, Malaysia isn't in a current account deficit position compared to pre-1998.

Nevertheless, we have downgraded the market to underweight on account of its expensive valuations and growth risks. (Fig. 13)

Philippines

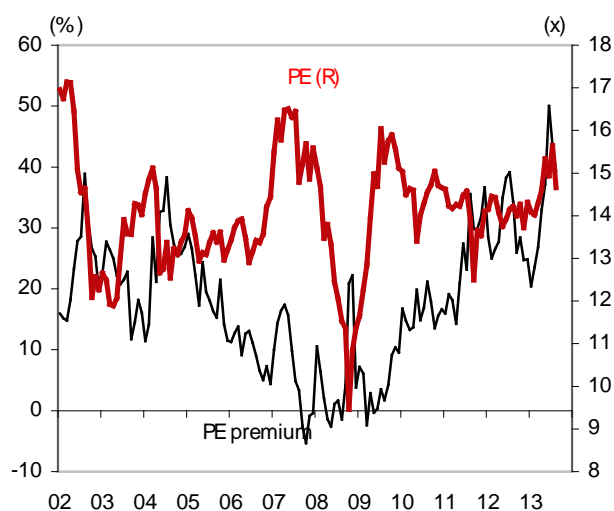
Philippines had the most inflows into the market in the last two years, which drove the PE multiple from 14x in 2012 to 20x during most part of 2013. With the regional markets in turmoil, it is difficult to assume that the Philippines market will be

Fig. 12: Foreign bond holdings — Thailand, Indonesia, Malaysia



Source: CEIC, DBS

Fig. 13: Malaysia P/E premium relative to the region



Source: CEIC, DBS

spared, no matter how strong its external balance is. But once markets stabilise after the sell-off, we believe Philippines will rebound strongly. As the country pursues a strategy focusing on stability over growth, we are unlikely to see a lift in its potential GDP growth of 5%. The strong growth it is currently enjoying is an exception rather than the norm, with the success of the PPP projects a potential wild card.

The benign inflation and low rates environment has been conducive for the domestic economy. Remittances and BPO services remained resilient in the last two years throughout the global soft patch and these have helped to prop up private consumption. The consumer sector remains to be one of our favourites. We recommend buying on dips for large consumer plays. In addition to the constructive industry outlook, the bigger consumer names should not be hit by rising yields given the deleveraging exercise in the last six to 12 months, low debt profiles and strong operating cash flows.

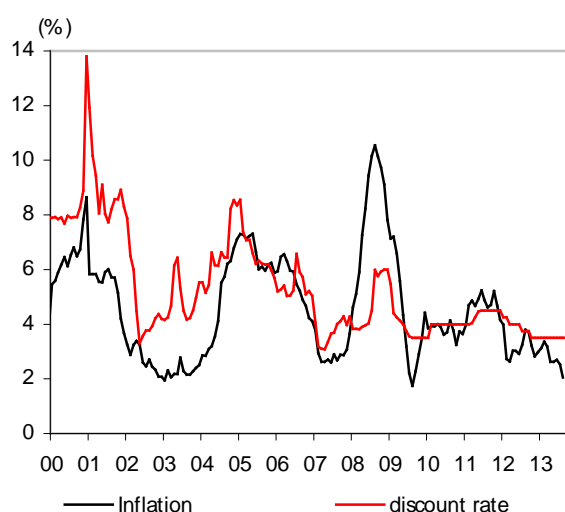
The banking sector should also be key beneficiaries of the positive economic prospects. Strong GDP growth and ample liquidity in the system should translate to benefits for the economy and for banks in general. We prefer exposure to larger banks.

ASEAN cyclical outflow about to end

ASEAN markets bore the brunt of the sell-off in QE tapering talks. This owes much to its fundamental strength which had been driving the region's outperformance and attracting a larger proportion of foreign inflows. One of the worst case scenarios, which we are vigilant against, is that ASEAN's four years of equity inflows (since the beginning of QE) may be wiped out when QE starts tapering.

In the past four years since the launch of QE in Mar-09, Thailand, Indonesia and Philippines have attracted US\$24.5bln of inflows before the May sell-off. Outflows since May 22 (beginning of "tapering" sell-off) amounted to US\$7.1bln and markets were down 15%, on average. Investors, who expect all liquidity from QE to be unwound, would like to see another US\$17.4bln of outflow, translating to a further c. 37% market downside, assuming there is a hypothetical relationship between fund flows and market performance.

Fig. 14: Philippines policy rate and inflation rate



Source: Datastream

Fig. 15: Cumulative fund flow since Mar 2009, Thailand, Indonesia, Philippines

US\$bln	Thailand	Indonesia	Philippines	Total
Inflows till May 22	6,949	11,356	7,288	24,547
Outflows since May22	4,125	3,519	534	7,132
Remaining amount	2,825	7,837	6,754	17,415
% of total	41%	69%	93%	71%

Source: Bloomberg, DBS. Data as of 10Sep.

Among the ASEAN markets, Philippines will have the most to unwind, while Thailand has 41% and Indonesia is only about 30+% into the process of unwinding.

But one has to bear in mind that 1) QE tapering is neither QE exit nor unwinding; 2) the current crisis is not heading towards a 1997/98 financial crisis; and 3) if inflows into the region were half structural and half cyclical, the outflows due to FED / QE is about to end soon.

For more discussion on why we don't think the current sell-off is leading towards 1997/98 Asia financial crisis, see *"Asia-vu 3: are we there yet?"*, David Carbon, 5 September 2013.

Earnings growth and valuations

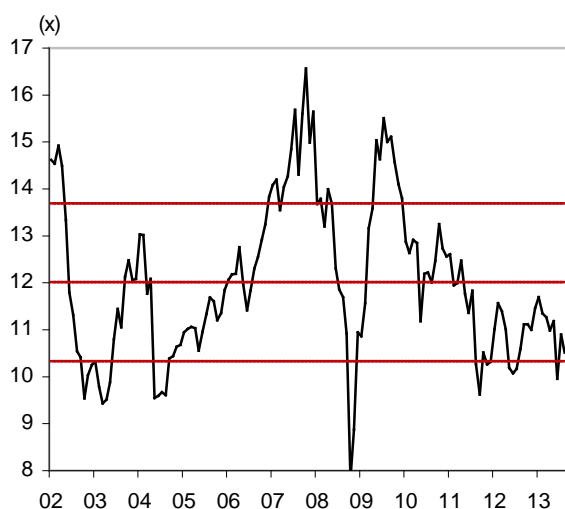
Downside risks to growth

The consensus is expecting 12.7% earnings growth for the region in 2013 and 2014, which we believe there are downside risks. Adjustments into weaker currencies, high interest rates, and slower economic growth are likely. Fed tapering fears and volatility in Asian currencies have exposed a need for more reforms and restructuring, with little room for complacency in the region. The government may have to roll in measures to restrict domestic demand growth, such as restricting imports, hiking interest rates, embracing weak currencies to boost export competitiveness, and tightening credit growth to rein in financial imprudence. Domestic sectors are likely to be negatively impacted more than the export sectors.

Asia PE valuations near -1SD

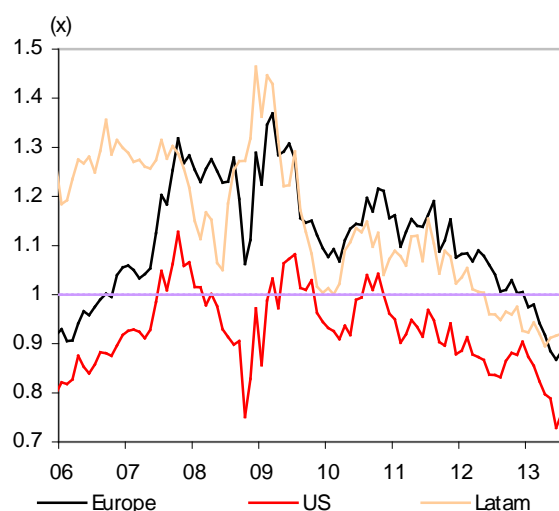
Asia valuations have come off to approach -1SD at 10.5x 12-month forward PE, and the region is now cheaper than US, Europe, and Latam on an absolute basis. (Fig. 16,17). We expect the region's underperformance against the developed markets to come to a halt once growth downgrades have stabilised. The wild card is China, where GDP growth expectations have been brought down to 7.5%, and China has indeed started to perform since 3Q. The outperformance will be sustainable if there is growth surprise emerging from the country.

Fig. 16: Asia ex-Japan 12-month forward P/E valuations



Source: Datastream, IBES, DBS

Fig. 17: Asia ex-Japan P/E valuations relative to US, Europe and Latam



Source: Datastream, IBES, DBS

Valuations in Indonesia have fallen to around 11.6x (where it used to trade around 14x), after the market had corrected by 16% since May 22. Indonesia 10-year bond yields have risen to 9%, and the rupiah to 11235. We expect bond yields at 9.25%, and rupiah at 11300 by end of Q3 next year. All said we believe that most of the negatives have been priced in the market and recommend investors to buy on weakness. As mentioned in previous section, further downside for the market could be derived from worse than expected higher inflation, widening current account deficit, and a more aggressive QE tapering calendar by the FED.

Markets in China / Hong Kong and Korea remain at below 10x and could be deemed attractive from PE perspective. However both markets had outperformed in 3Q. China / Hong Kong markets could be subjected to disappointments later as we believe that a v-shaped recovery in China is unlikely. Korea stands to benefit the most from a US recovery. Pending the QE tapering decision, the wild card is a delay which will suggest that the US economy is still weak. We are keeping China / Hong Kong as neutral, and Korea / Taiwan as underweight for now.

ASEAN looks oversold to us. We recommend accumulating ASEAN on weakness.

As discussed in *"US: ISMs tease", David Carbon, 12 Sep 2013*, there remains a possibility QE could be delayed when US growth is still weak.

Our current neutrals are on China/Hong Kong, Singapore, Indonesia and Thailand; underweight on Malaysia, Korea, Taiwan and India. Philippines is our only overweight market. On balance we are high in cash levels for better risk/reward buying opportunity after the FOMC meeting.

If our base case scenario of modest QE tapering, and a commitment to low FED rates until 2015 plays out in the September FOMC meeting, we will be looking for opportunities in Indonesia, Thailand, and Korea once the uncertainty is cleared. Asia should perform in line with the developed markets as growth downgrades stabilised.

Fig. 18: Regional countries P/E and earnings growth forecasts

	10-yr Avg	-1SD	P/E(x)			Earnings Growth (%)			Current Recommendation
			2012	2013F	2014F	2012	2013F	2014F	
Hong Kong									
HSI	13.0	10.5	11.4	10.3	9.6	-1.6	9.9	7.1	Neutral
MSCI China	12.0	9.1	10.1	9.2	8.4	1.1	9.7	9.6	Neutral
MSCI HK	15.7	13.8	16.7	15.2	13.8	-11.0	9.8	10.2	Neutral
China 'A'	14.7	10.5	13.8	11.5	10.0	-0.2	18.5	15.0	Neutral
Singapore	13.9	12.3	13.6	14.0	12.8	6.9	-2.7	9.4	Neutral
Korea	9.5	8.0	10.6	9.2	7.8	7.3	17.0	18.3	Underweight
Taiwan	13.8	10.4	19.0	14.2	12.8	2.3	33.7	10.7	Underweight
India	14.9	12.3	14.7	13.5	11.6	10.6	8.5	16.7	Underweight
Malaysia	14.1	12.9	15.6	15.6	14.3	15.6	-0.4	9.2	Underweight
Thailand	10.4	9.2	13.5	11.7	10.3	17.6	15.2	13.9	Neutral
Indonesia	11.8	9.5	14.4	12.9	11.1	-0.1	11.4	16.3	Neutral
Philippines	14.0	11.8	19.7	18.2	16.9	13.8	8.2	8.1	Overweight
Asia ex-Japan	12.1	10.5	12.8	11.4	10.1	3.2	12.7	12.7	Neutral vs DM
US	14.0	12.3	15.9	14.9	13.5	6.1	6.2	10.6	
Japan*	16.2	12.4	22.0	14.0	12.8	30.4	63.7	9.3	
Europe	12.0	10.0	nmf	13.4	11.9	-2.2	-0.6	12.5	
Developed mkts	13.5	11.7	15.6	14.5	13.1	3.2	7.5	10.7	
Emerging mkts	10.8	9.4	11.4	10.5	9.4	-2.0	8.8	11.9	

Source: IBES, Datastream, DBS. P/E valuations in italics bold are lower than 10-year average. Shaded cells are lower than -1SD.

CN: Soldiering on

- Prudent fiscal and monetary policy responses have helped to prevent growth from falling below 7.5%. Economic growth in 2H13 will remain around 7.5%
- The CNY will remain on a mild appreciation bias in spite of a challenging external environment. The benefits of keeping the status quo on exchange rate policy outweigh the costs
- Interest rate liberalization will likely proceed quickly in order to rationalize banks' lending decisions
- Conventional policy responses are not the right prescription for this cycle. Structural reform is the answer, but this usually constrains growth in the short-term

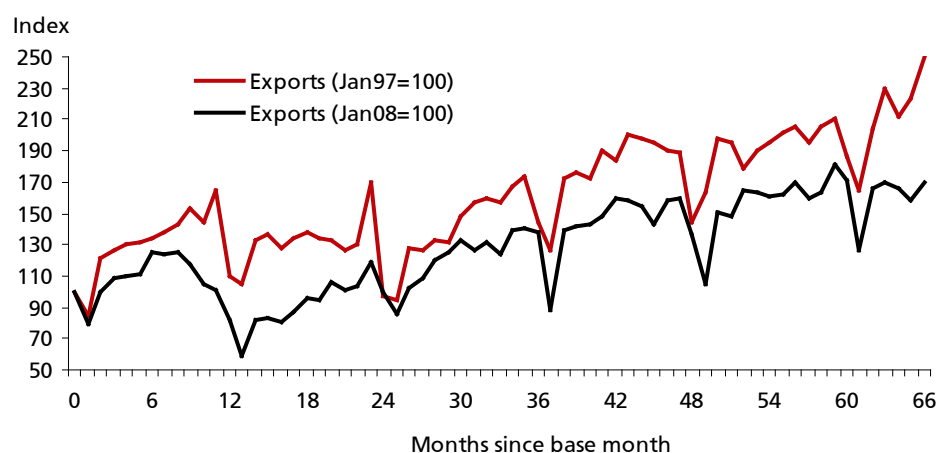
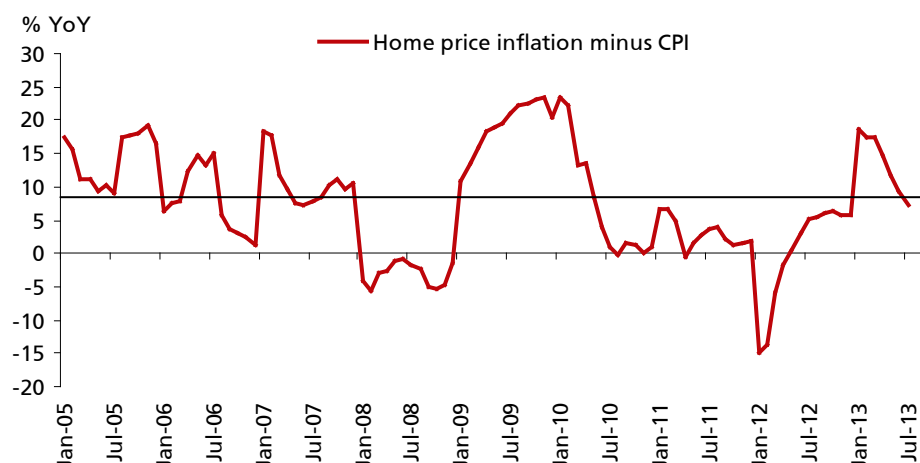
An analytical framework encapsulating a historical context is required to gauge China's medium-term economic outlook. Contrasting the past and the present allows us to better understand the present-day policy thinking. It is naive to assume that the recovery is on firm footing simply because a few economic figures improved recently. A more holistic approach is needed.

In the late-1990s, the country's situation was disastrous. China had double-digit non-performing loans (NPLs) and deflation. Despite aggressive rate cuts, fixed asset investment growth fell to single-digits amidst a liquidity trap. Massive unemployment resulted from the retrenchment of state-owned enterprises (SOEs) in 1997. Nowadays, China's NPL ratio and inflation rate are seemingly under control. Investment is still growing more than 20% from a year ago levels. Labor shortages are probably more prevalent than unemployment. While the facts look better, the situation is, in many aspects, more complicated than before (Table 1).

Table 1: Comparison between economic slowdown in the 90s and the present

	1990s	Recent round
Cause of slowdown	Domestic factors	External shock (The GFC)
Type of inflation	Product inflation	Asset inflation
Monetary policy response	Rate cut cycle (97-04)	Rate hike cycle (09-1H12)
Behavior of investment	Sharp fall in investment (single-digit growth over 99-00)	Slight fall in investment
Investment's contribution to growth	<40% of GDP growth	>50% of GDP growth
Level of NPL	Double-digit NPL (~20%) prior to state bank listing	NPL = 1%
Exchange rate	Remained constant	Mild appreciation per year

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Chart 1: China's export recovery path

Chart 2: Home price inflation vs. CPI


Policy flexibility is constrained

China's current exports recovery is lot weaker than after the 1997/98 Asian Financial Crisis (Chart 1). Five years after Lehman Brothers collapsed, China's exports to the EU are still falling year-on-year, while export growth to the US are at low single-digit rates. In terms of its contribution to GDP growth, net exports fell sharply from an average 37.7% in the 1990s to an average of 3.3% in the past decade. Hence, the case to alter the exchange rate policy to rescue exports is weak. Besides, policymakers have already built a strong foundation to internationalize the RMB. Allowing trend depreciation will trigger a confidence crisis. Therefore, China persisted in maintaining a mild appreciation in the yuan in spite of the weak external environment. As such, the RMB has been appreciating in the past few years.

Based on historical experiences, China should have cut interest rates in response to the low CPI inflation seen recently. We doubt that there will any rate cut down the road because the property market, and not the CPI, is the key anchor of inflation expectations (Chart 2). In particular, it is the pent-up demand in the property market after years of administrative controls that is adding to future inflationary risks. House prices rose an average of 6.7% YoY in July, up from 6.1% in June. In Guangzhou, price increases were higher at 17.2%. In the last down-cycle, it was possible

The CPI does not fully capture the price dynamics of the property market

Chart 3a: Monetary loosening in the 90s

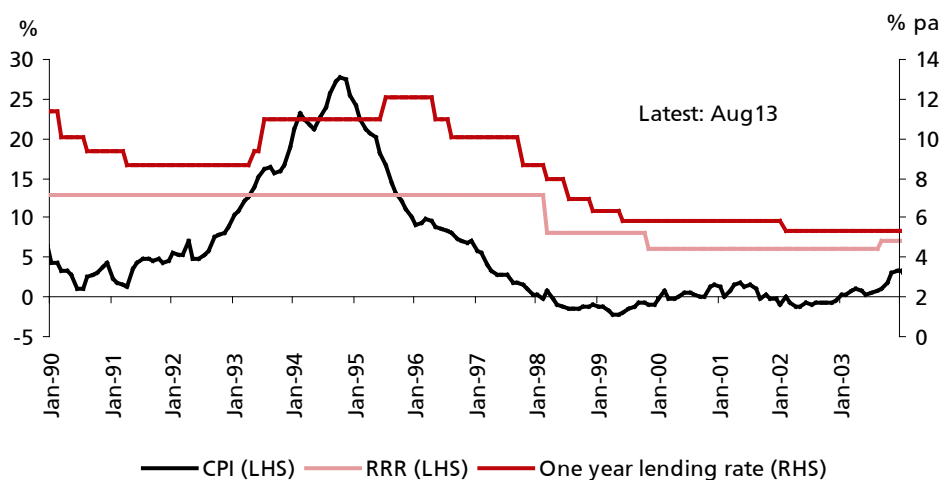
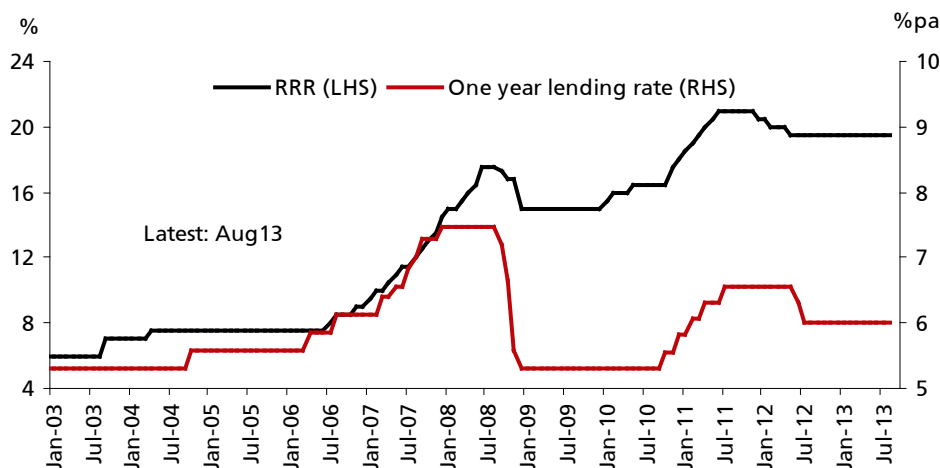


Chart 3b: Monetary policy in the past decade



for the PBOC to cut the one-year lending rate aggressively from its peak of 12.06% in 1995 to 5.31% in 2002; and to cut the reserve requirement ratio (RRR) from 13% to 6% in the same period (Chart 3a). The current situation warrants a more restrained policy response for fears of stoking asset inflation (Chart 3b). Unaffordable home prices is a huge source of social resentment. The government's firm hold on the property market for almost three years clearly shows they understand priorities.

Besides, further lowering interest rate cuts will encourage more yield-seeking behavior. Deposits rates, in real terms, have been negative or near-zero in the past few years. This has resulted in some people channeling their savings into the property market or wealth management products. Interest rate liberalization is the answer to this problem but that will compress banks' net interest margins especially once deposit rates are also liberalized. Such reforms also tend to be disinflationary and detrimental to short-term growth. What we now have is an economic slowdown alongside steady RMB appreciation and potentially higher interest rates stemming from interest rate liberalization. This seems very peculiar against conventional Keynesian economic wisdom.

With policy flexibility limited, maintaining investment growth has become a real challenge. China cannot afford a sharp drop in investment now for two reasons.

Even if there is policy support, it will be targeted at specific industries or projects

First, investment now accounts for over 50% of GDP growth compared to about 40% in the 1990s. Second, China cannot shift to a consumption-driven growth model within a short period of time. In turn, this has led to calls for fiscal responses to compensate the lack of monetary loosening. However, the National Development and Reform Commission (NDRC) has played down the idea of new stimulus packages, saying the country's economic growth is in a reasonable range. Premier Li Keqiang attested to this view in his recent article to the Financial Times. Even if there is policy support, it will be targeted at specific industries or projects. For example, the Agricultural Bank of China reportedly provided RMB 250 billion loans to the Shanghai government in August, purportedly to develop Disneyland and the Shanghai free trade zone. But this scale of support is not yet seen in other cities.

Fiscal policy support are limited this around. Sporadic reports of respective provinces investing here and there are everywhere but funding sources are often unknown. We do, however, know the government has recently encouraged more private capital participation in railway construction and operation, and expanded the local government bond self-issuance pilot scheme to cover four provinces and the cities of Shenzhen and Shanghai. However, funding from these sources are supplemental in nature. Only RMB 51.8 billion was raised from the local government bond pilot scheme over 2011-2012, and a 70 billion limit is set for 2013.

Some companies are using new loans to repay old loans

Local government debts are multiplying cancer cells

Problems in the state banking sector were nakedly revealed in the data in the 1990s. Prior to the listing of state-owned banks, the average NPL ratio of the four banks was more than 20% in 1997. As at 2Q13, the NPL ratio for commercial banks was only 1.0%, according to CBRC. This figure seems unbelievably low.

Worries about mounting local government debt and banks' asset quality are prevalent. The National Audit Office (NAO) puts local government debt levels at RMB 10.7 trillion at the end of 2010, which was equivalent to 26.7% of that year's GDP. Local governments' debt repayment abilities are questionable because many of the infrastructure projects initiated during the credit binge generate meager returns. NPL levels are still low partly because some companies are taking on new loans to repay old loans. Meanwhile, local government coffers are still being bolstered by land revenues, which rose 49.4% YoY for the first seven months of 2013. The NAO is currently conducting another round of auditing nationwide and the results is likely to be announced in October or November. This will provide Beijing a better understanding of the severity of the problem to better strategize a response plan to deal with the problem.

In the late 1990s, foreign reserves were mobilized to write-off the bad loans of Bank of China and China Construction bank before they were listed. Asset management companies (AMCs) were subsequently created to absorb RMB 1.4 trillion worth of bad loans from the five state-owned banks. Since then, only about 20% of bad loans have been recovered. Owing to the sheer size of the problem, the present debt problems are trickier to solve in spite of foreign reserves providing a war chest of well over USD 3.4 trillion. A 20% NPL ratio is equivalent to some USD 2.3 trillion in bad debt, and this does not include off-balance sheet debt. As of July 2013, shadow banking accounted for almost one-third of the stock of total social financing. This source of funding has grown amid the need to chase higher-yields as real deposit rates were near zero or negative in recent years, and was developed quickly without much needed soft infrastructure like proper risk management frameworks and detailed product and risk disclosures. Mobilizing foreign reserves to bail out local governments is also unwise because it sends the wrong message about moral hazard. In turn, this impede structural reform. As a result, this round's bailout, if needed, will be highly selective and require new solutions.

Using foreign reserves to bail out local governments is unwise because it creates moral hazard

Long term optimism in China

Back in the 1990s, problems in the economy also seemed insurmountable. Yet then-Premier Zhu Rongji managed to clean up the balance sheets of state-banks and engineered a spectacular strategic recovery by reforming SOEs and preparing China for entry into the WTO. By the same token, bad debts are unlikely to collapse the economic system but its mere existence constrains the economy's growth potential. The steady appreciation of the currency this around, together with an upward interest rate bias from interest rate liberalization, would also impede short-term growth. While prudent fiscal policy responses will ensure that GDP growth does not fall below the floor of 7.0%, a sustainable V-shaped rebound is also not expected in the short term. Another way to look at it is that China has no choice but to deepen structural reforms ranging from population policy, industrial policy, interest rate liberalization, capital account convertibility to the experimentation of free trade zones in different parts of the country. The new leadership is juggling these reforms simultaneously, and this is the foundation of our long-term optimism in China.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts are transformations).

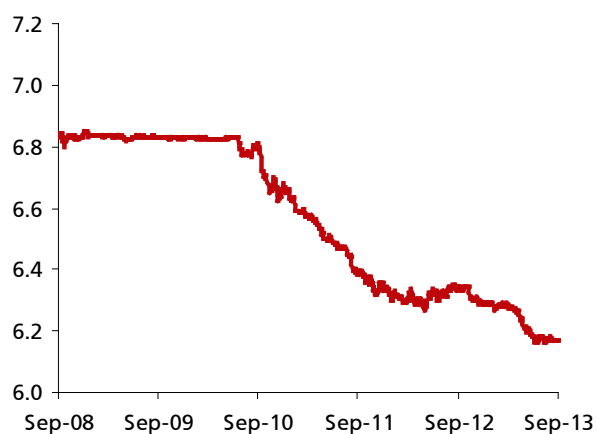
China Economic Indicators

	2012	2013f	2014f	2013	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real GDP growth	7.7	7.5	7.5	7.5	7.4	7.5	7.5	7.5	7.5
GDP by expenditure: current price									
Private consumption	11.5	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2
Government consumption	12.8	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Urban FAI growth (ytd)	20.6	21.0	21.0	20.1	21.0	21.0	21.0	21.0	21.0
Retail sales - consumer goods	14.3	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0
External									
Exports (USD bn)	2,049	2,246	2,516	544	590	604	570	609	660
- % YoY	8	10	12	4	9	9	12	12	12
Imports (USD bn)	1,818	1,976	2,193	478	512	517	518	531	568
- % YoY	4	9	11	5	11	10	11	11	11
Trade balance (USD bn)	230	270	322	66	78	86	52	78	92
Current account balance (USD bn)	193	262	312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	2.3	2.7	2.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	3,312	3,691	4,132	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (USD bn, YTD)	112	117	129	62	90	117	33	68	99
Inflation & money									
CPI inflation	2.7	2.8	3.5	2.4	3.0	3.2	3.5	3.5	3.5
RPI inflation	2.0	1.4	1.8	1.0	1.6	1.6	1.7	1.7	1.7
M1 growth	6.5	9.4	9.0	9.0	9.4	9.4	9.0	9.0	9.0
M2 growth	13.8	14.5	14.0	14.0	14.5	14.5	14.0	14.0	14.0
Other									
Nominal GDP (USD bn)	8,370	9,692	11,080	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-1.5	-2.0	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified

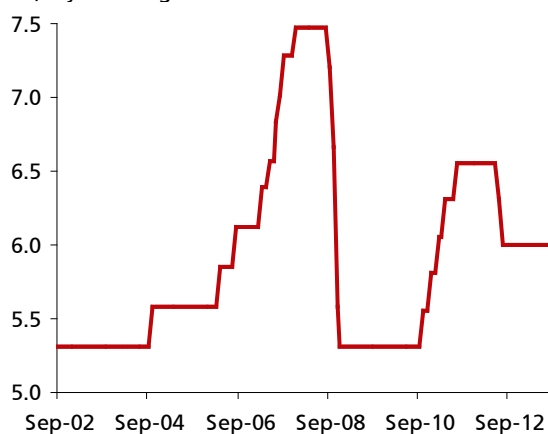
CN- nominal exchange rate

CNY per USD



CN- policy rate

%, 1-yr lending rate



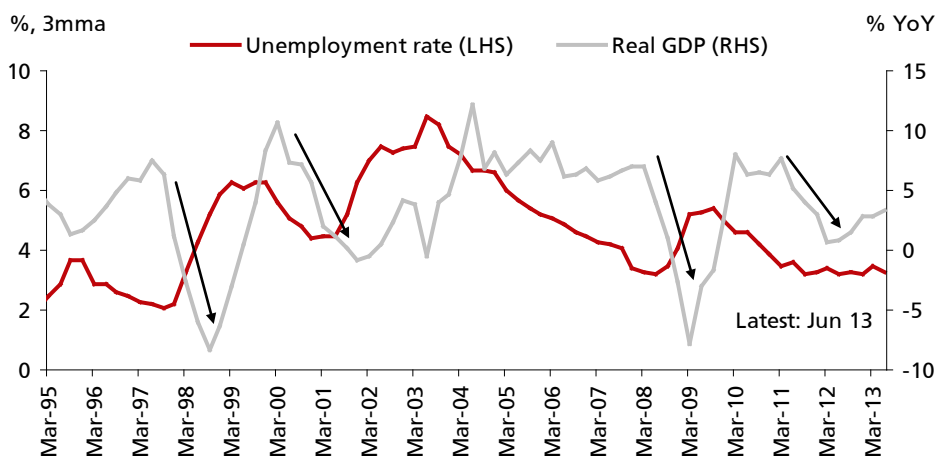
HK: Muddling along

- The unemployment rate has remained flat since July 2011 even though GDP growth has decelerated. Growth is no longer a good predictor of the unemployment rate
- Rather than looking at macroeconomic parameters like GDP and retail sales, employment surveys offer more accurate insights on the unemployment rate
- Private consumption is a major pillar of economic growth. However, it has fallen recently due to negative wealth effects. Trade data have improved for one month and it's too early to ascertain trend improvement
- Hong Kong should grow 3.5% this year

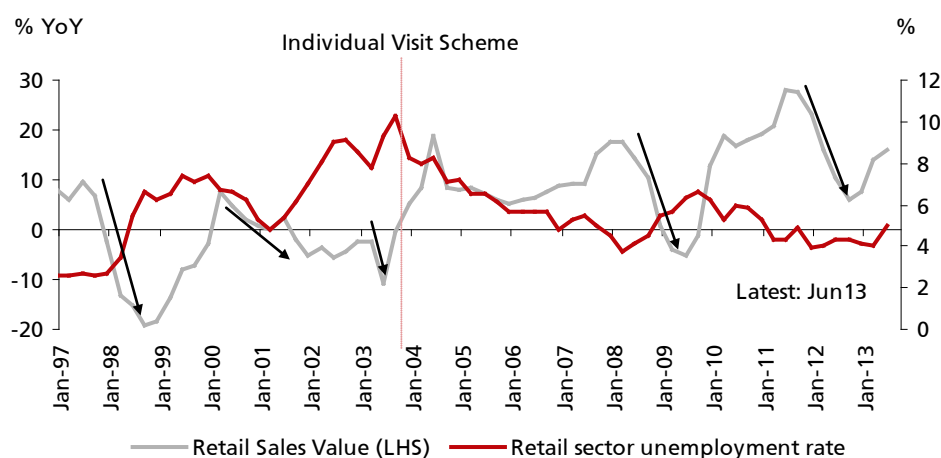
The unemployment rate has consistently stayed between 3.2% and 3.5% since July 2011 even though GDP growth has decelerated (Chart 1). To highlight this peculiar phenomenon, we zoom in on two sectors: retail and real estate.

In the retail sector, the unemployment rate behaved differently compared with previous cycles (Chart 2). In the past, the uptick of unemployment coincided with the drop in retail sales growth. But the unemployment rate practically stayed flat throughout 2H12 even when retail sales growth plummeted. This is probably attributable to the increasing influence of tourists on the retail sector. Although retail sales plunged in 2H12, tourist numbers did not - Chinese tourist arrivals grew 25.5% in 2H12 versus 22.7% in 1H12. If many people stop shopping altogether (e.g., in the midst of a Financial Crisis or epidemic), it will spark layoffs as workers become redundant. However, if shoppers remain active but are just spending less, retail employees are still required to serve these customers. This is especially true now as the influx of tourists generate high demands on retail employment.

Chart 1: Labor market remained tight despite growth deceleration



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Chart 2: Retail sector unemployment vs retail sales value growth


In addition, changing patterns of tourist consumption can also explain the relative stability of retail sector employment. For instance, Chinese tourists may visit high-end stores less amid an economic slowdown but spend more time shopping for personal products or clothing, increasing staffing needs in those stores.

In the real estate sector, the unemployment rate runs against intuition even more. The unemployment rate stood at 2.4% in 2Q13, the lowest since 4Q08, even though residential flat transactions have fallen by more than 30% YoY. As of May, there are 37,000 registered real estate agents in Hong Kong. But private flat transactions averaged just 3,852 per month over May- August, meaning more than nine agents were fighting for one transaction.

In comparison, when transactions averaged above 9,000 per month between 2Q09-2Q12, the sector's unemployment rate was 3.2%. The present low rate of unemployment is explainable: large agencies have decided to freeze headcount rather than layoff workers; discouraged agents went to find jobs in other industries; potential entrants into the industry may have been deterred by the dire prospects. Another reason is that real estate agents only account for about one-third of all real estate employees. Real estate developers have been busily launching projects recently, and these companies probably still demand a lot of labor.

A holistic approach to understanding unemployment

Retail sales and real estate used to be fairly good predictors of the unemployment rate. However, such parameters no longer shed much light on the direction of the unemployment rate. As cyclical demand-side factors cannot fully explain labor market tightness, we suspect supply-side factors are in force. Some sectors face chronic labor shortages regardless of the state of the economy. Demographic changes could be one behind this. For instance, the percentage of male employees aged below 50 have now decreased to 65% from 77% back in 2005, and this may have caused labor shortages in some sectors requiring intensive manual work. Of course, this is just one possible reason.

More important is the realization that there are limits to conventional macroeconomic wisdom when analyzing Hong Kong's labor market. Microeconomic factors are crucial to understanding hiring decisions and job seekers' aspirations, particularly at the industry level. Thus, it is worth tapping into the brains of industry specialists, and one way to do it is to pay more attention to employment surveys.

According to the latest Manpower Employment Outlook Survey, 18% of employers surveyed expected an increase in staffing levels in 3Q, with only 4% predicting a

The relationship between GDP and unemployment has weakened significantly

decrease. In the government's 3Q13 Business Tendency Survey, the net balance [1] across all industries increased over the previous quarter. The results of both surveys are consistent with the phenomenon that the labor market remained tight in spite of difficulties in the macroeconomic environment. All things considered, the unemployment rate is likely to stay between 3.3%-3.5% for the rest of the year.

Property prices are leveling-off but not falling

After rounds of government intervention, residential property prices are now 2.3% below the peak recorded in mid-March. However, they are still up 4.4% from year-end 2012. Last quarter, there were worries that China's economic slowdown, Fed tapering and more project launches by developers in the second half would hammer property prices. It turned out that prices held firm. The benchmark Centa-city Leading Index climbed three weeks in a row even amid more project launches, showing that pent-up demand is strong.

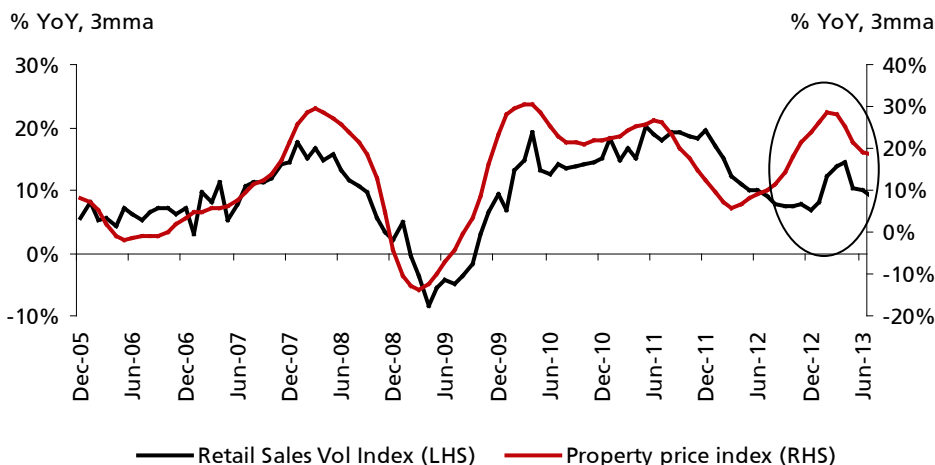
We do not expect new administrative measures this year as existing ones have effectively cooled the market. The Buyers' Stamp Duty (BSD) and Double Stamp Duty (DSD) have effectively stymied mainland investors. Besides, potential local buyers will likely be more prudent than one or two years ago as Fed tapering is now on the horizon. Yet, as end user demand remains strong, it is difficult for property prices to fall by more than 5% this year.

Private consumption growth has fallen

External trade numbers surprised on the upside lately. In July, Hong Kong's exports and imports rose 10.6% and 8.3% respectively, up from -0.2% and 1.4% in June. Nevertheless, improvement is nascent. Exports to Europe and the US have only been back to positive over the last one-two months, and exports to Japan is still in the red after falling for half a year (roughly one-quarter of Hong Kong's exports goes to the G3). On a three month moving average basis, exports to Asia – which accounts for about 70% of exports – decelerated from 9.4% in May to around 4.0% in both June and July. More importantly, higher export and import growth numbers does not necessarily mean better net export numbers. It is net exports that enter GDP calculations.

The more stable private consumption component (accounting for more than 60% of GDP) is presumably a more "dependable" pillar of growth. Unfortunately, the growth of locals' spending fell from 13.7% in 1Q to 9.9% in 2Q, and further to 7.1%

Chart 3: Locals' retail spending and the growth of property prices tracked well



Private consumption accounts for more than 60% of GDP

in July. It is expected to ease further in 4Q due to negative wealth effects stemming from milder property price growth (Chart 3). In fact, property price levels need not actually fall to erode consumer sentiment. In Hong Kong, people often gauge the health of the economy by the state of the property market, not GDP growth. The “feel good” factor has dissipated for both home owners and non-home owners, and this is feeding back negatively on domestic consumption. GDP growth momentum in 3Q and 4Q will likely be weakened as this key growth engine falters.

Mediocre at best

Private consumption is a key pillar of Hong Kong’s growth but it has lost steam since 2Q. Waning interest in the property market and China’s economic slowdown have hit consumer sentiment. In both 3Q and 4Q, private consumption growth will be mediocre at best, and so will real GDP growth. The nascent trade recovery is unlikely to change the bigger picture. Hong Kong is expected to grow 3.5% this year, lower than the trend growth of 4.5%.

Notes

- [1] Net balance is the difference between the percentage of respondents choosing “up” and that choosing “down”.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts are transformations).

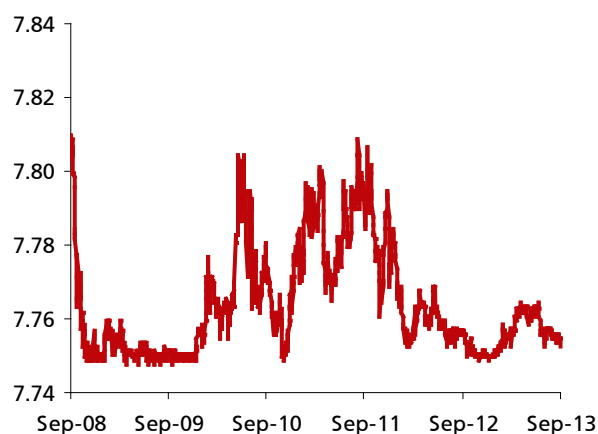
Hong Kong Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth (11P)	1.5	3.5	4.0	3.3	4.6	3.2	2.8	4.5	4.3
Private consumption	3.0	4.2	4.5	4.2	3.2	3.2	4.5	4.5	4.5
Government consumption	3.7	2.8	3.0	3.1	3.0	3.0	3.0	3.0	3.0
Investment (GDFCF)	9.4	3.3	4.4	6.9	4.4	4.4	4.4	4.4	4.4
Exports of goods and services	1.9	6.9	7.1	6.6	6.9	6.3	7.1	7.1	7.1
Imports of goods and services	2.8	7.2	7.3	6.7	7.0	6.5	7.3	7.3	7.3
Net exports (HKD bn)	38	30	25	-15	28	15	0	-18	28
External (nominal)									
Merch exports (USD bn)	443	462	502	111	124	123	115	123	134
- % YoY	3	4	9	2	7	5	11	12	8
Merch imports (USD bn)	531	520	620	128	135	138	131	148	156
- % YoY	4	3	10	4	3	2	11	16	15
Trade balance^ (USD bn)	-88	-58	-118	-18	-11	-15	-16	-25	-22
Current acct balance (USD bn)	3.5	6.9	3.2	-	-	-	-	-	-
% of GDP	1.3	2.5	1.1	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	317	308	317	-	-	-	-	-	-
Inflation									
CPI inflation	4.1	4.5	3.5	4.0	5.4	4.7	4.0	3.5	3.5
Other									
Nominal GDP (USD bn)	263	281	299	-	-	-	-	-	-
Unemployment rate (% , sa, eop)	3.3	3.4	3.4	3.5	3.4	3.4	3.4	3.4	3.4

* % change, year-on-year, unless otherwise specified
^ Balance on goods

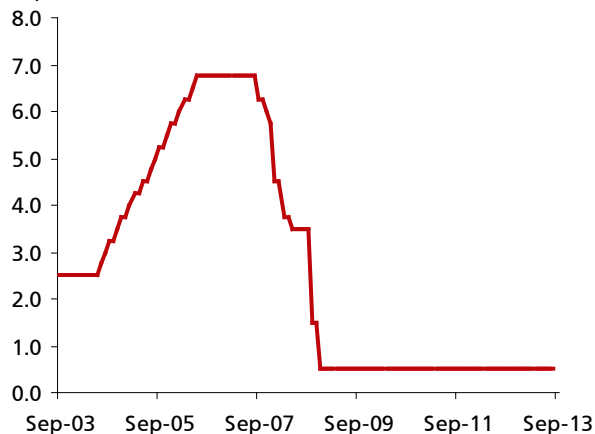
HK - nominal exchange rate

HKD per USD



HK - policy rate

%, base rate



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TW: Focusing on the long-term

- Taiwan is making continuous progress on trade and investment liberalization, which bodes well for its long-term economic prospects
- We forecast modest growth of 2.6% in 2013 and 3.3% in 2014, mainly reflecting a soft global outlook in the short term

Taiwan has adopted many measures since 2008 to liberalize economic relations with China, which could be seen as part of its structural reforms to achieve the long-term goals of boosting trade competitiveness and attracting investment. A number of new initiatives have been introduced in the past few months to promote trade and investment liberalization, not only with China, but also with global partners. As the reform progress is on track, the economy's long term outlook remains constructive.

Rapid expansion of services trade with China

Taiwan's services exports to China have grown strongly after 2008, especially reflected in tourism exports (Chart 1). The growth potential of tourism exports remains strong as the room of further deregulation is large. Taiwan recently announced in June to broaden the coverage of the individual visitor scheme for mainland Chinese tourists, and lift the daily quota imposed for Chinese visitors to 7,000 from 5,000. We estimate that the number of Chinese tourist arrivals will rise to 2.5mn this year from 2.0mn in 2012 (25% YoY). The related revenues are projected to increase to USD 4.6bn (1.0% of GDP) from USD 3.7bn (0.8% of GDP).

The prospects of financial services trade is also improving. Taiwanese banks have expanded branch networks in China since the cross-strait financial MOU was signed in 2009 (Chart 2). Earlier this year, the offshore RMB business has been launched in Taiwan. With the scale of RMB deposits in Taiwan's banking sector expanding rapidly towards CNY 100bn (Chart 3), Taiwan is getting closer to the goal of

Chart 1: Services exports growing strongly

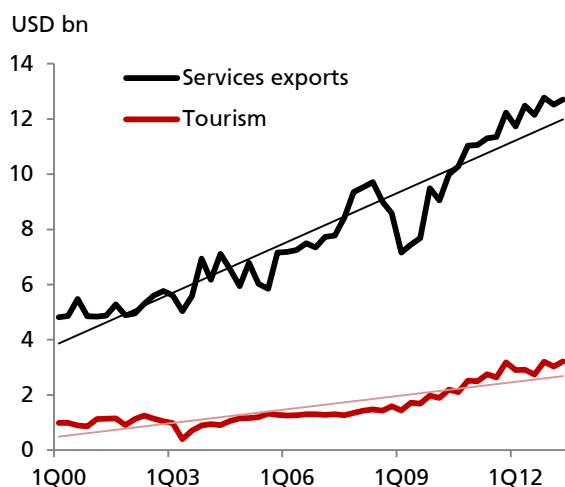
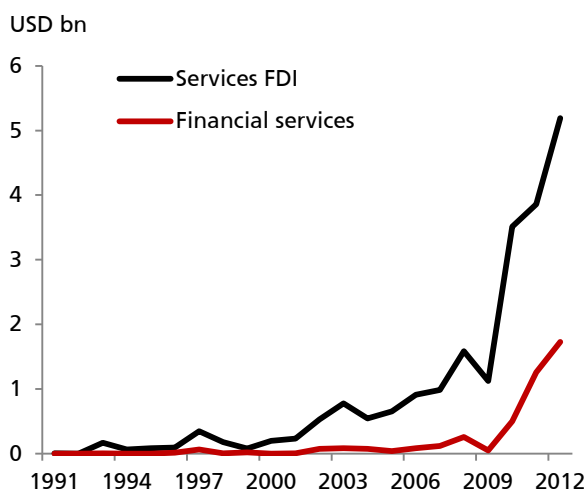


Chart 2: Taiwan boosted services FDI in China



building an offshore RMB market. Policies are already moving to foster the Formosa bond market. The credit rating requirement for the issuance of foreign currency corporate bonds has been removed in July. Further deregulations such as allowing Chinese firms to issue RMB bonds in Taiwan should be on the cards this or next year.

Looking ahead, services trade with China is expected to expand more broadly. The cross-strait services trade agreement has been signed in June, which offers Taiwanese firms preferential treatment in accessing China's services market in 80 areas. This is expected to further encourage Taiwanese firms to invest in China's services sector, which will in turn, drive the cross-strait services trade on a broader basis.

The prospect of financial services trade is improving

Improvement of cross-strait capital mobility

Another positive development is the improvement of cross-strait capital mobility. Taiwanese firms now have greater flexibility to invest / produce in Taiwan and export to China (rather than relocating to the mainland), thanks to the decline in transaction costs with China. According to the Ministry of Economic Affairs (MOEA), the domestic investment cases applied by Taiwanese firms with offshore operations reached a large TWD 210bn in 1H13 (1.5% of GDP).

On the other hand, China's investment in Taiwan is on the rise. FDI from China amounted to USD 217mn in 1H13, almost doubling from USD 122mn during the same period of last year (Chart 4). The MOEA is currently mulling plans to further ease the investment rules, including reviewing the requirement of "non-controlling stakes" imposed for Chinese firms investing in Taiwan's key technology sectors as shareholders (e.g., semiconductors and flat panels). A removal of such restrictions could substantially boost the interest of Chinese firms who are seeking for technology upgrade and R&D collaborations with foreign partners.

Strengthening ties with global partners

Furthermore, the scope of Taiwan's trade and investment liberalization is extending beyond China to global partners. An economic cooperation agreement with New Zealand was signed in July, the first free trade deal achieved with a foreign country that Taiwan doesn't have diplomatic relations. A quasi-FTA pact may also be signed with Singapore by the year end, according to media reports. This may encourage other countries and regions which have bilateral FTAs with China to study the feasibility of signing FTAs with Taiwan, such as the ASEAN, Chile and Switzerland.

Chart 3: RMB deposits in Taiwan increasing

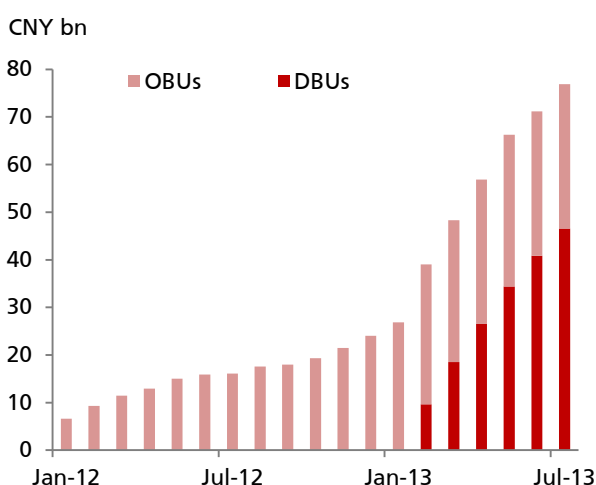
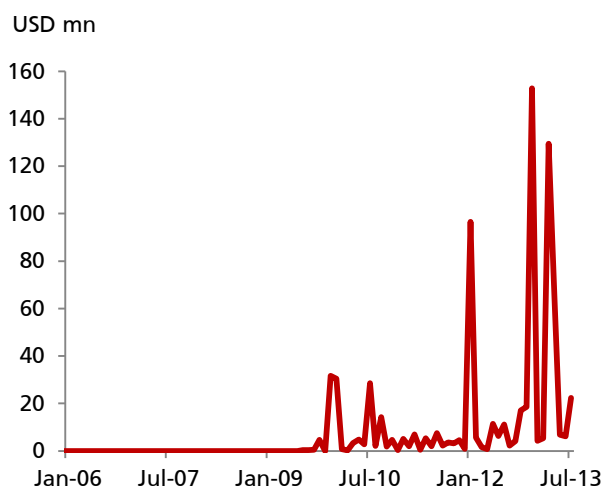


Chart 4: China's FDI in Taiwan started to grow



As an experimental platform of broad liberalization, establishing free economic pilot zones (FEPZs) has been proposed. The FEPZs will remove tariffs on exports and imports, offer tax incentives to FDI and streamline procedures for foreigners' residency. The first phase of the plan has started in five existing free trade port zones in August, focusing on four priority sectors including international medical services and logistics. The second phase, which contains more substantial deregulation measures and covers a wider range of industries and areas, is expected next year.

Lackluster growth in the short term

Domestic demand to be supported

In the short term, we expect GDP growth to remain soft at 2.6% this year and 3.3% next year (latest: 2.3% QoQ saar in 2Q, Chart 5). Export outlook remains lackluster due to risks in China and other emerging markets. But domestic demand should be supported by an accommodative monetary policy and a less restrictive fiscal policy.

The central bank (CBC) is expected to maintain rates low and unchanged for the rest of this year. Inflation has dropped to -0.4% YoY in July-August (Chart 6). With the output gap still negative, the demand-side price pressures are expected to remain muted in 2H13. The base effects for inflation will also be favorable in 2H13, as food prices surged strongly last summer / autumn due to bad weather.

A QE reduction by the US Fed is unlikely to cause significant liquidity tightening in Taiwan's markets. As the economy's current account balance is very robust and it didn't receive large foreign capital inflows during the previous QE episodes, the vulnerability to QE exit is considered to be low.

On fiscal policy, the government has relaxed the stance of tightening that it has pursued since last year. The MOEA recently decided to narrow the scope of the second-stage electricity price hike. As 80% of households won't be affected by the price hike, the impact on inflation and consumption should be only marginal.

Next year's fiscal policy will be slightly expansionary. In the 2014 budget proposal approved by the cabinet in August, central government expenditures will increase 1.7% next year, reversing the -1.6% decline this year. The deficit target is set at TWD 209.9bn (1.4% of GDP), larger than this year's TWD 174.4bn (1.2% of GDP).

The major uncertainties lie in the property market policy. Housing prices growth remained strong in 1H13 (Sinyi: 13.8% YoY, Cathay: 8.4%). A so-called luxury tax, which currently imposes a 10-15% sales tax on properties purchased not for self-use and sold within two years, is likely to be reviewed. Changes could include extending the taxation period, or introducing a levy on property buyers.

Chart 5: GDP growth still below trend

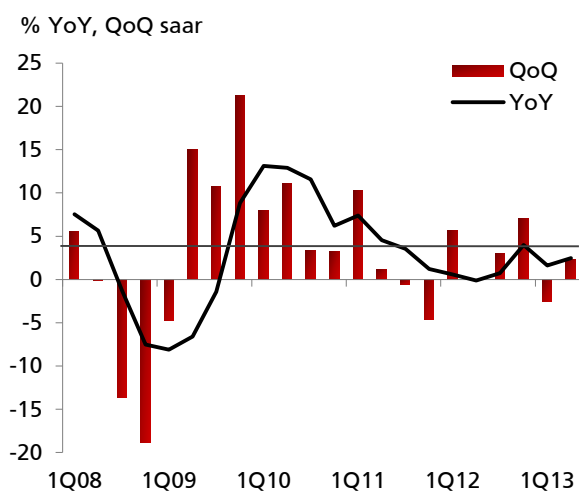
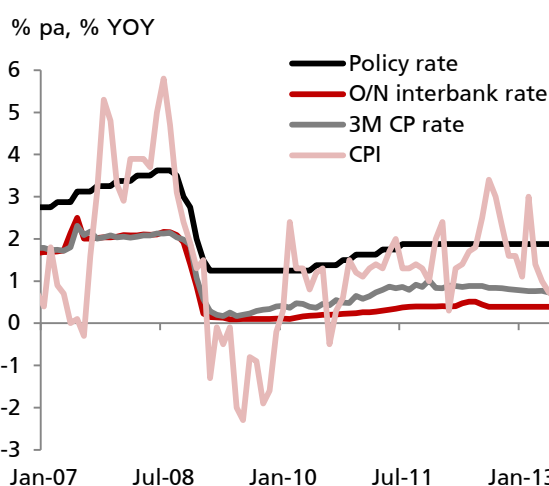


Chart 6: Interest rates remained low and stable



Taiwan Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth	1.3	2.6	3.3	2.5	3.2	3.0	3.7	4.0	3.2
Private consumption	1.5	1.3	2.1	1.7	1.6	1.8	2.4	1.7	2.2
Government consumption	0.5	0.7	0.6	-0.2	0.8	0.9	0	0.8	0.8
Gross fixed capital formation	-4.2	4.8	2.8	3.8	3.9	5.4	0.1	3.0	3.5
Net exports (TWDbn, 06P)	2911	3067	3355	746	781	899	728	814	847
Exports (% YoY)	0.1	4.7	6.1	5.2	4.1	4.4	5.3	6.1	6.3
Imports (% YoY)	-2.1	4.4	4.9	3.2	3.0	5.0	2.8	5.1	5.6
External (nominal)									
Merch exports (USDbn)	301	308	331	78	78	80	77	84	85
- % chg	-2.3	2.3	7.4	2.4	1.0	3.3	5.9	7.8	9.0
Merch imports (USDbn)	270	272	298	68	66	70	71	76	75
- % chg	-3.9	0.6	9.4	-3.5	-3.1	4.9	4.3	11.9	13.4
Trade balance (USD bn)	31	36	33	10	11	10	6	8	10
Current account balance (USD bn)	50	54	53	-	-	-	-	-	-
% of GDP	10.5	11.2	10.3	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	403	418	440	-	-	-	-	-	-
Inflation									
CPI inflation	1.9	0.8	1.1	0.8	-0.3	0.8	0.7	1.2	1.4
Other									
Nominal GDP (USDbn)	475	488	511	-	-	-	-	-	-
Unemployment rate (eop %, sa)	4.2	4.3	4.1	4.2	4.3	4.3	4.2	4.2	4.1
Fiscal balance (% of GDP)	-1.6	-1.6	-1.4	-	-	-	-	-	-

* % growth, year-on-year, unless otherwise specified

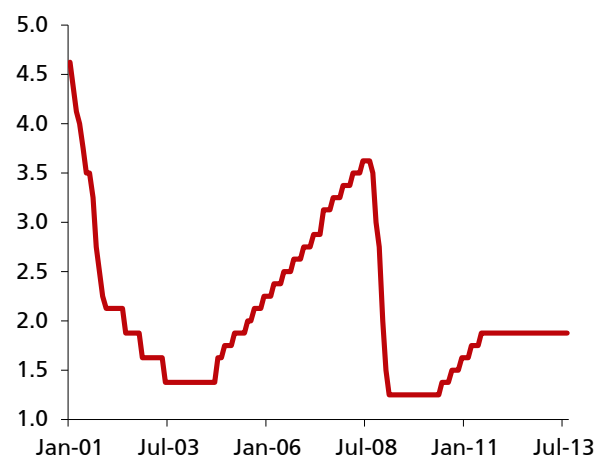
TW - nominal exchange rate

TWD per USD



TW – policy rate

%, rediscount rate



KR: Greater policy flexibility

- The prudent policies pursued after the 2008 global financial crisis have successfully lowered Korea's vulnerability to external liquidity shocks
- Policymakers now have greater leeway to focus on growth
- On the back of the modest easing of monetary, fiscal and property market policies, domestic demand is expected to improve in 2H13
- Considering a tepid outlook for exports, our 2013-2014 GDP forecasts are unchanged at 2.8% and 3.5% respectively

Korea implemented a series of prudent policies after the 2008 global financial crisis (GFC) to curb hot money inflows, strengthen external liquidity position and control the risks of domestic asset / credit bubbles. These efforts are paying off. Despite the recent bout of emerging market volatility caused by the fear of the Fed's QE tapering, Korea's financial markets have remained relatively stable. The improvement in financial stability gives policymakers the leeway to focus on supporting growth and fostering economic recovery.

The vulnerability to external liquidity shocks has decreased

The vulnerability of the balance of payments to external liquidity shocks has decreased significantly after 2008. This is manifested in several aspects. First, thanks to the government's macroprudential measures targeting at curbing banks' foreign currency borrowings, short-term external debt has declined sharply. The outstanding size of short-term foreign debt now stands at USD 120bn, almost 40% lower than the peak level of USD 190bn in 2008. This is in stark contrast to the debt accumulation in Southeast Asian countries in recent years (Chart 1).

Chart 1: Short-term external debt falling in Korea

% of foreign reserves

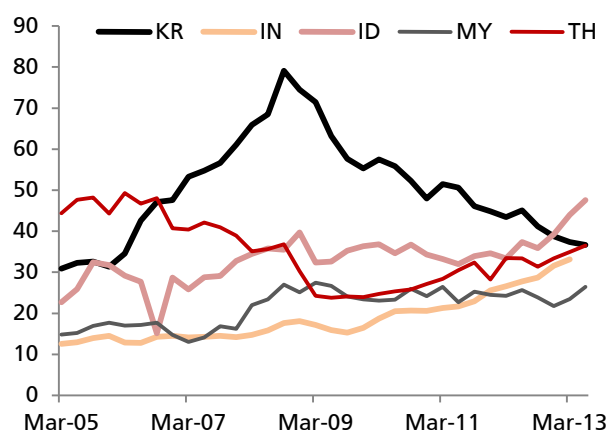
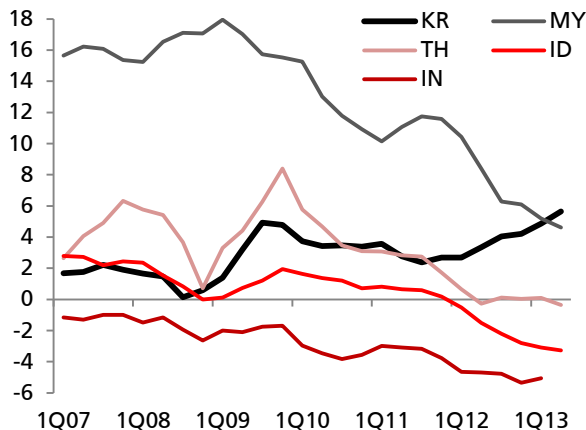


Chart 2: Current account strengthening in Korea

% of GDP



Second, the current account balance has returned to surplus after 2008. The KRW's large adjustment during the GFC has strengthened the export competitiveness of Korean companies and curbed overseas spending of Korean consumers. The current account surplus widened to 5% of GDP in 1H13, which compared favorably to the 0.3% bottom in 2008. This contrasted sharply with the current account deterioration in Southeast Asian countries in the last few years (Chart 2).

Thirdly, a large portion of foreign capital inflows into Korea has become long-term in nature. The share of long-term debt in gross external debt has risen to 70% from less than 50% in 2008, mostly from an increase of foreign investment in KRW government bonds. The low sovereign credit risk and favorable liquidity profile of KRW bonds have attracted the interest of foreign reserve managers pursuing reserve diversification. According to data from the finance ministry, about 40% of foreign holdings of KRW bonds come from global central banks nowadays, compared to less than 10% in 2008.

The participation of long-term investors well explains why foreign inflows into the KRW bonds have remained steady in the last few months, despite the general emerging market sell-off triggered by the Fed's plan to taper QE3 (Chart 3).

The KRW also showed resilience during this turbulent period, attributed to the improvement in the country's external position. During the period of capital flight from emerging markets between start-June and end-August, the KRW gained 1.8% versus the USD. This bucked the currency depreciation in Southeast Asia (12% in IDR, 5-6% in THB, MYR and PHP) and India (14% in INR).

Currency stability and low inflation provide policy flexibility

... provides leeway for policymakers to focus on growth

The Bank of Korea has sufficient flexibility to keep monetary policy accommodative because it did not face the capital outflows pressures that forced some emerging market central banks to raise interest rates to defend currencies. The BOK cut rates by 25bps earlier this year and is expected to maintain the benchmark rate low at 2.50% in the rest of 2013 and 1Q14 (Chart 4).

Meanwhile, currency stability has helped to contain inflation pressures in Korea and anchor inflation expectations. The latest CPI figure is 1.3% YoY, below the lower end of the BOK's target band of 2.5%-3.5%. Stripping the distortion from social welfare programs, actual inflation rate should be about 2.0%, which was still below the official target. From the perspective of inflation, the BOK also has enough leeway to maintain an accommodative policy stance and support economic growth.

Chart 3: Foreign investment in KRW bonds remained positive

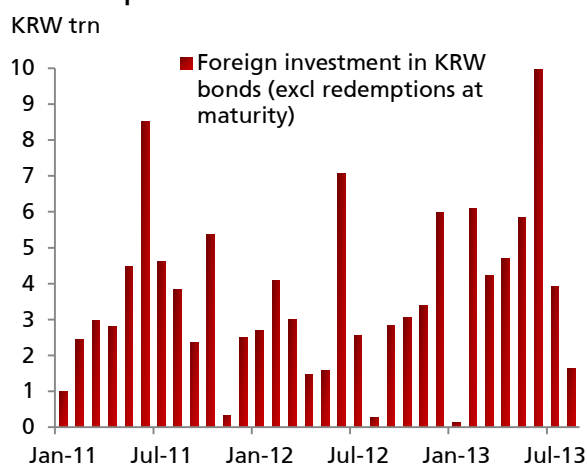
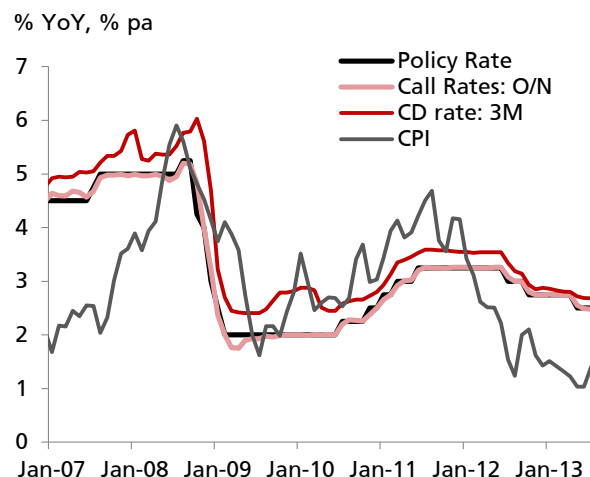


Chart 4: Interest rates remained low and stable



Government policies are already leaning towards growth. Apart from adding fiscal expenditures via the supplementary budget, policies are moving to revive the housing market. Housing prices growth averaged only 2.7% YoY in 2009-2012, a by-product of the government's tight regulations on financial institutions' mortgage loans and other household loans. The housing price-to-income ratio has fallen notably in recent years, which implies an improvement in home affordability and a potential recovery in fundamental demand (Chart 5).

Home transactions made a temporary rebound during several periods in 2011-2013, as the government periodically cut the real estate acquisition tax in attempt to stimulate the housing market. A new plan was announced recently in August to lower the acquisition tax to 1-3% from 2-4%. The reduction this time is permanent rather than temporary, which should have a greater and longer lasting impact on the property market activities.

Export outlook is tepid

The stronger growth of private consumption, government spending and construction investment has pushed up GDP growth to 4.5% (QoQ saar) in 2Q, the fastest over nine quarters (Chart 6). Thanks to the modest easing of monetary, fiscal and property market policies, domestic demand is likely to continue improving gradually in the next few quarters.

The export outlook remains tepid. Amongst the major economies, growth in the US and Japan appears steady, Europe is exiting recession, and China has showed some signs of bottoming-out. But a slew of uncertainties remain, including US federal debt ceiling, Japan's fiscal consolidation and China's shadow banking problem. Meanwhile, the slowdown risk in emerging economies has increased due to the turbulence in their financial markets. Korea's exports reported higher growth of 5.2% YoY in Jul-Aug, up from 0.8% in 2Q. This doesn't indicate a meaningful recovery, given the low base last year when European debt crisis deteriorated.

Meanwhile, overcapacity remains a problem in Korea's manufacturing sector. The average operation ratio of manufacturing firms stayed below trend, at 74% in July. The inventory-to-shipment ratio was relatively high, at 1.17. It will take some time for the excess capacity to be absorbed, unless export or domestic demand makes a strong recovery ahead. Taking into account a modest export outlook, we maintain our 2013-2014 GDP forecasts at subpar levels of 2.8% and 3.5% respectively.

No convincing signs yet of a turnaround in exports

Chart 5: Home affordability improved

Housing price to GDP ratio, 1Q01=100

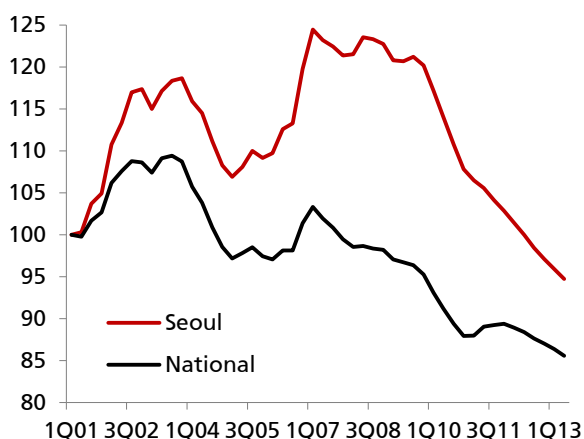
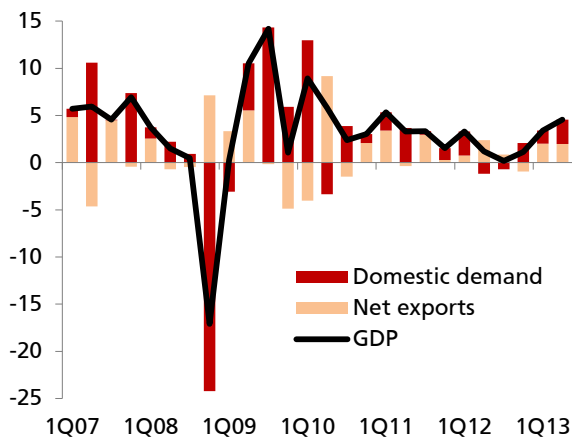


Chart 6: GDP growth rose on domestic demand

% QoQ saar, ppt



Korea Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP (05P)	2.0	2.8	3.5	2.3	3.2	3.9	3.9	3.5	3.4
Private consumption	1.7	1.6	2.5	1.8	1.7	1.5	2.6	2.4	2.4
Government consumption	3.9	3.3	3.8	3.8	3.5	4.6	4.4	3.0	3.5
Gross fixed capital formation	-1.7	2.7	1.6	2.9	4.3	6.4	2.9	1.1	1.4
Net exports (KRW trn)	104	117	134	30	30	34	26	34	34
Exports	4.2	5.7	7.6	5.7	5.3	8.0	7.0	7.2	7.7
Imports	2.5	4.2	5.9	4.7	4.1	6.2	5.2	5.7	6.1
External (nominal)									
Merch exports (USD bn)	548	566	625	141	141	149	143	161	157
- % YoY	-1.3	3.3	10.5	0.8	5.6	6.5	5.6	14.2	12.0
Merch imports (USD bn)	520	521	589	127	129	136	139	147	149
- % YoY	-0.9	0.3	12.9	-2.7	2.5	4.6	7.4	16.0	15.8
Trade balance (USD bn)	28	45	37	14	12	13	4	14	8
Current account balance (USD bn)	43	57	45	-	-	-	-	-	-
% of GDP	3.8	4.7	3.4	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	327	336	364	-	-	-	-	-	-
Inflation									
CPI inflation	2.2	1.3	2.8	1.1	1.3	1.4	2.1	2.9	3.1
Other									
Nominal GDP (USD bn)	1,131	1,210	1,332	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.0	3.2	3.1	3.2	3.2	3.2	3.4	3.1	3.1
Fiscal balance (% of GDP)	-1.4	-2.4	-1.7	-	-	-	-	-	-

* % change, year-on-year, unless otherwise specified

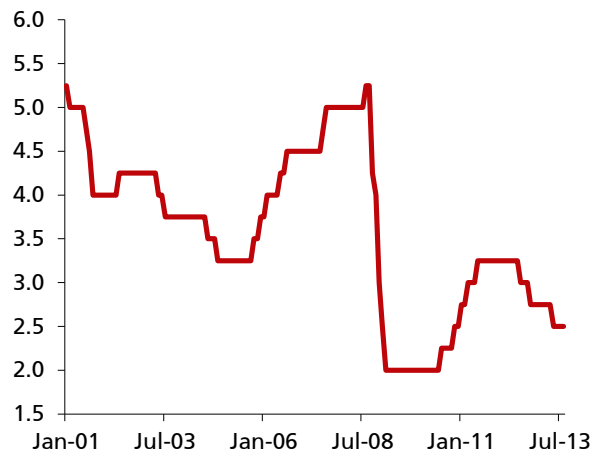
KR - nominal exchange rate

KWR per USD



KR – policy rate

%, target rate



IN: Uncertain times

- Outside of government spending and agriculture, little to support growth; GDP to slip below 5% in FY13/14
- Trade-off between fiscal consolidation and growth to ensue; latter likely to receive priority, but unlikely to help much
- Barring an intended sharp cutback in spending, fiscal targets at risk
- Monetary policy direction hinges on Fed QE deliberations and domestic inflation outlook; status quo on rates best way forward

Growth targets at risk

The modest upturn in 4Q FY12/13 (Jan-Mar13) growth proved to be a head-fake. Uncertainty in the rupee / financial markets since May13 and subsequent tightening in monetary conditions revived growth risks. These concerns were amplified by the release of the 1Q FY13/14 (Apr-Jun13) GDP at 4.4%, which was the weakest since Mar09 and down from FY12/13's 5.0%. The breakdown revealed that the sources of weakness were becoming broad-based, with sluggish industrial activity also percolating to the service sector.

The only two bright spots were agriculture and government spending, with support from these expected to extend through the year. Above-average monsoon rains should be positive for the winter crop and by extension rural incomes. Higher crop production will also address price pressures arising from supply shortages.

Focus meanwhile is centred at the other leg of support, i.e., fiscal expenditure. This component jumped 10.5% YoY fastest in six quarters in Apr-Jun13 and doubled from 4.2% rise last year. The sharp improvement is in contrast to sub-par activity in the other domestic demand sectors. Gross capital formation declined 1.2%, down from 3.2% rise in the last two years. Simultaneously, private consumption slowed notably to 1.6% compared with 4.0% last year and 2009-11 average of 8.0%.

Chart 1: GDP growth in a soft-patch



Looking ahead, apart from fiscal spending, there is unlikely to be a sharp recovery in consumption or investment activity, hence pointing to a correction in trend growth. On consumption, the high retail inflation (averaged 10% YoY in past six months), sluggish employment prospects and unfavourable credit rates could depress purchasing power. Lead indicators by way of PMIs and weak passenger car sales also signal such. It is of little wonder then that manufacturers look to scale back operations and meet demand through inventories. In particular, capital goods and consumer durables output have remained weak and the downtrend could become more pronounced in the quarters ahead on lack of policy initiatives. Thus, little interest in fresh capital expenditure ahead of the elections will keep this sector on a slow burner for the next 8-12 months.

On the external sector, the sensitivity between the currency and exports is not strong. Even if one overlooks that, the balance of trade only benefits from a weaker rupee with a considerable lag, and the pass-through could be reflected in the imports leg first. Hence the net exports position is unlikely to contribute significantly. Against this backdrop, we revise down our FY13/14 GDP forecast to 4.3% (vs. prev 5.2%) and FY14/15 to 5.0% (vs. 5.8%). Headline growth could be choked further if fiscal support is also withdrawn as the year progresses. In which case, GDP could slip below 4% (Chart 1).

Slowdown in growth is inevitable, with scale dependent on fiscal support

Trade-off between fiscal targets and growth

As the year progresses, the government is likely to face a trade-off between fiscal consolidation efforts and supporting growth. Both options carry inherent risks, but growth is likely to edge out austerity given that it is a pre-election year and there is limited headroom for monetary easing. Hence fiscal targets look set to be missed.

Government spending has been stepped up this fiscal year, abandoning last year's austerity efforts. Compared to a 4% drop between Jan-Mar13, total expenditures jumped 19% YoY in Apr-Jul13, outpacing the budgeted 16.4% (Chart 2). The strategy to cut-back on the Non-Plan spending was not adhered to, instead the productive Plan outlays fell 4% (vs. budgeted +29.4%). This compared unfavourably to the subdued 2.9% seasonally adjusted growth in gross tax revenues in the period. As highlighted in our focus piece ("IN: Down to fiscal support", 3 Sep13), if this above-budgeted pace of spending is pursued through the year and even if revenues recover strongly, the odds of an overshoot in the fiscal targets are high.

With growth on the skids, there is reason to be skeptical on the strength in fiscal revenues. Weak demand conditions and corporate margins under pressure could

Chart 2: Actuals vs Budgeted fiscal variables

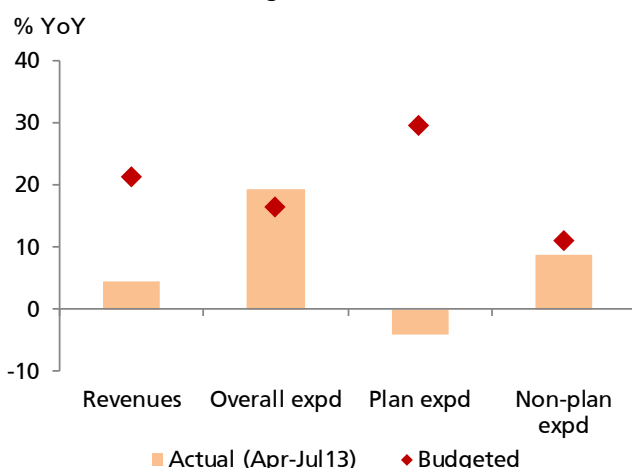
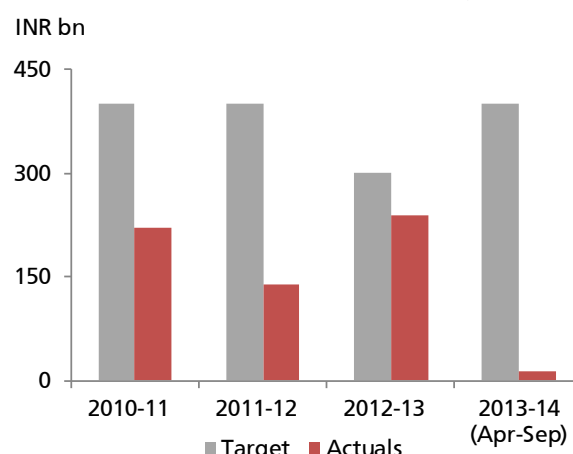


Chart 3: Divestments - case of missed targets



hurt tax receipts. As of 4Q FY12/13, sales growth of non-financial private sector companies continued to decelerate for six successive quarters, according to the RBI data. Indications are also not favourable for non-tax takeaways, primarily divestment receipts (Chart 3). As of Aug13, only 3% of the budgeted divestment proceeds have been raised, with the present difficult stock market conditions likely to depress valuations and investor interests.

Fiscal targets look set to be missed

In sum, while the revenue estimates will be difficult to meet, spending outlays stand to rise with the passage of the food security bill and likelihood of higher fuel allocations. As a base case, we retain our call for at least 50 percentage points jump in the fiscal deficit target to -5.3% of GDP. The only risk to this call is an intentional cutback in spending late in the year, in which case the targets might be met. But at the other end, growth will take a bigger-than-programmed hit.

Difficult to break new ground on monetary policy

While fiscal stimulus is underway, monetary conditions remain tight. The dovish start to 2013 fizzled away after the stark currency depreciation and financial instability since May. To address the latter, liquidity conditions were tightened through defacto cash reserve ratio increase and hike in the Marginal Facility Rate. Subsequent tweaks signalled the bias to keep short-term rates elevated and rein in long-term yields (Chart 4).

To a certain extent, the bout of financial markets instability was a crisis of confidence. Hence the new RBI Governor Raghuram Rajan stressed on the need for predictable and consistent communication, which led the rupee to stage a decent recovery. However, beyond the short-term positivity, the external drivers of the rupee weakness will continue to dictate the momentum. Monetary policy levers can address part of the malaise, with the resolution of the structural problems (namely fiscal / current account deficits and need to revive investment activity) still rests on the government. Approach of the elections will hinder prudent policymaking.

In terms of policy direction, we do not expect any change in the benchmark rate at the mid-Sep policy review. The mid-quarter monetary policy meeting was delayed to Sep 20, to not only provide the new head the time to settle in, but also help factor in any possible change in the Fed's QE tapering decision (on Sep 18). The course of action by the RBI also depends on the severity of the rupee depreciation in the interim along with the scale of QE tapering (or not). A delay in QE tapering will provide short-relief, but a sizable scaling back in asset purchases will pile pressure for an increase in the RBI's benchmark rates.

Chart 4: Weak INR hurts rate cut expectations

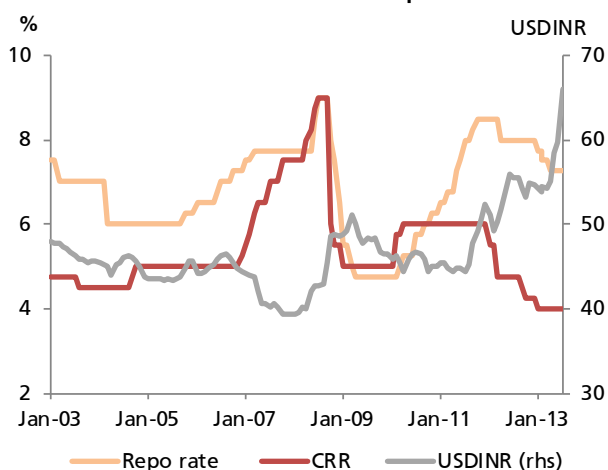
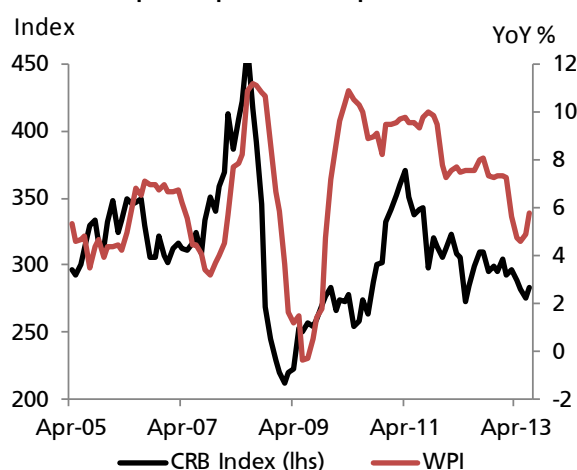


Chart 5: Imported pressures to provide floor



Inflation lurks in the background

Inflationary concerns have not received their due attention of late, drowned out by bigger headwinds - rupee, external imbalances and growth risks. That is not without reason as WPI inflation eased from FY12/13's 7.4% to 4.7-4.8% in Jun13. However, the easing trajectory was disrupted by the currency fall and rebound in oil prices on geopolitical worries. Early impact of these factors and food-related supply disruptions was reflected in Jul13, as the headline WPI shot up 100bps in just a month. CPI inflation witnessed a shallower pullback earlier and holds above 9.5%.

Two aspects will be of concern on this front. Firstly, demand destruction on the back of a tighter monetary policy has seen the core WPI (non-food manufacturing index used as a proxy) ease to three-year lows. Hence signs of a rebound in inflationary pressures despite subdued demand highlight that supply-side constraints are on the drivers' seat (Chart 5). In this regard, monetary policy is a blunt tool to address supply bottlenecks and thus pressure will build on the government to act.

Meanwhile, the weak rupee and upturn in global fuel prices have inflated the scale of underrecoveries for downstream companies. This triggered calls for an aggressive increase in the subsidised retail prices, but gradual moves may be preferred given the political sensitivity of the issue. Hence the fuel component will persistently reflect these increases, with the unadjusted component to show in the fiscal books. Further, manufacturers are likely to face higher input costs, but unable to pass-on the higher prices due to weak demand. Hence, pulling together all three aspects, we expect WPI inflation to head back above 6% mark by end-year.

Cost-push factors to underpin price pressures, as demand cools

Rating risks to linger

The government's ability to rein in the FY12/13 fiscal deficit to within target had comforted rating agencies. However, signs of trouble by way of currency depreciation, populist measures reviving fiscal concerns and deteriorating external metrics, have revived risks. With little room for monetary policy to assume a growth supportive role, fiscal spending has been stepped up to pick the slack. Simply put, the markets and rating agencies would have been more forgiving of fiscal slippage, if the higher disbursements were directed towards public infrastructures or industrial projects. However, as explained above this has not been the case.

In India's favour, external debt level to GDP is relatively less precarious at 20% of GDP, with short-debt making up about a third of FX reserves. However, there are few red flags – sufficiency of FX reserves to the overall external debt has been falling, along with a decline in the import cover. The net international investment position remained in red as of Mar13 and deficit widened by 20% on the year. And all this comes at a time when risks to growth are biased for further weakness. Looking ahead, a downgrade might not be imminent, but the impact should not be downplayed.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts are transformations).

India Economic Indicators

	12/13	13/14f	14/15f	1Q14	2Q14f	3Q14f	4Q14f	1Q15f	2Q15f
Real output (04/05P)									
GDP	5.0	4.3	5.0	4.4	4.3	4.4	4.2	4.3	4.8
Agriculture	1.9	3.0	3.5	1.9	2.8	3.0	3.4	2.8	2.8
Industry (ex constrn)	1.6	-1.0	2.0	-0.1	-1.0	-1.5	-1.5	1.0	1.0
Services	7.2	6.5	6.5	7.4	6.7	6.3	5.8	6.0	6.0
Construction	4.4	3.8	5.0	2.8	3.5	3.8	4.3	4.0	4.0
External (nominal)									
Merch exports (USD bn)	298	307	326	72	77	74	85	85	85
- % YoY	-2.5	3.0	5.0	-2.0	8.0	3.0	3.0	3.5	3.5
Merch imports (USD bn)	492	497	510	123	116	131	129	125	119
- % YoY	0.7	1.0	4.0	5.9	-5.3	-1.0	-2.0	2.0	5.0
Trade balance (USD bn)	-194	-190	-184	-51	-39	-57	-44	-40	-34
Current a/c balance (USD bn)	-88	-80	-78	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-4.8	-4.3	-4.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves(USD bn, eop)	292	270	290	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
WPI inflation (% YoY)	7.4	6.1	6.8	4.8	5.8	6.6	7.0	7.1	6.0
Other									
Nominal GDP (USD tn)	1.9	1.8	1.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-4.9	-5.3	-5.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change year-on-year, unless otherwise specified

** Annual and quarterly data refers to fiscal years beginning April of calendar year.

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ID: Tightening

- Our GDP projections for 2013 and 2014 has been revised down to 5.8% and 6.0% respectively
- Significantly tighter monetary policy implies that domestic economy growth would be slower. However, a more moderate pace of domestic demand growth also reduces external stability risks
- Nascent signs of recovery in the global economy should translate into better export numbers in the coming months, easing pressure on the current account

GDP moderated to 5.8% YoY in 2Q, marking the first time in 11 quarters that YoY growth dipped below 6%. A slowdown in gross fixed capital formation growth (4.7% YoY in 2Q, compared to an average of 9.9% in 2012) was the key reason behind slowing GDP growth as private consumption expenditure held steady. The economy has been facing headwinds over the past six quarters and these strains are starting to impact on headline growth. Notably, the prolonged period of depressed commodity prices have placed pressure on the external accounts and on the fiscal position. In order to ensure external and fiscal stability, monetary tightening and fiscal adjustments (subsidized fuel prices were raised by an average of 33% in late June) have been implemented by the authorities over the last few months.

Tighter monetary policy will inevitably be a drag on the domestic economy in the coming quarters, however, there are some nascent signs that the global economy is improving. Helped in part by base effects, moderation of import growth and an improvement in external demand, net exports contributed 2.0pct-pts to headline GDP growth in 2Q, up from 1.7pct-pt in 1Q. Comparatively, net exports deducted

Chart 1: A moderate pace of GDP growth ahead

YoY, %-pt contri

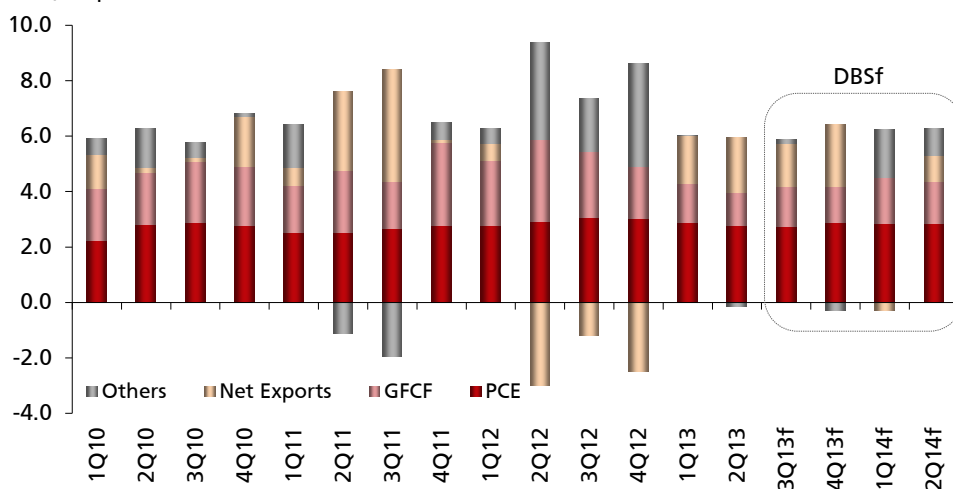
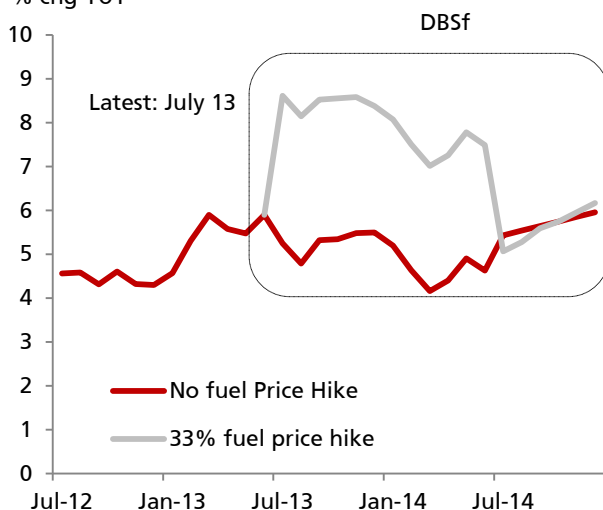
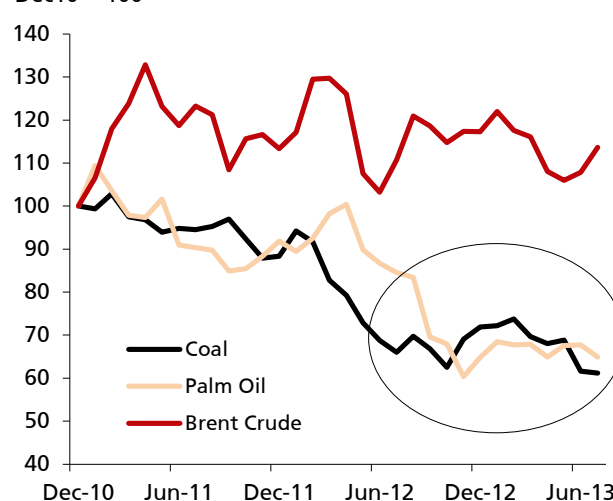


Chart 2: CPI trajectories

% chg YoY


Chart 3: Commodity prices

Dec10 = 100



an average of 1.5pct-pts a quarter in 2012. A gradual improvement in external demand in the coming quarters should help to bolster economic growth even as the domestic economy eases to a relatively slower growth pace (compared to 2011/12). For 2013 and 2014, we project GDP growth to reach 5.8% (down from 6.3% previously) and 6.0% (down from 6.5% previously) respectively.

Moderating domestic demand growth

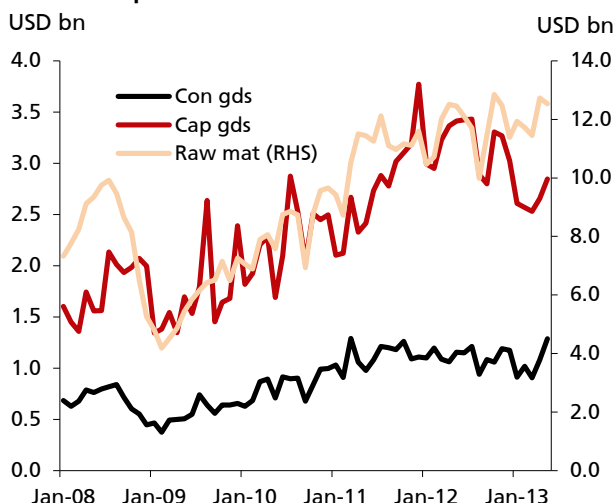
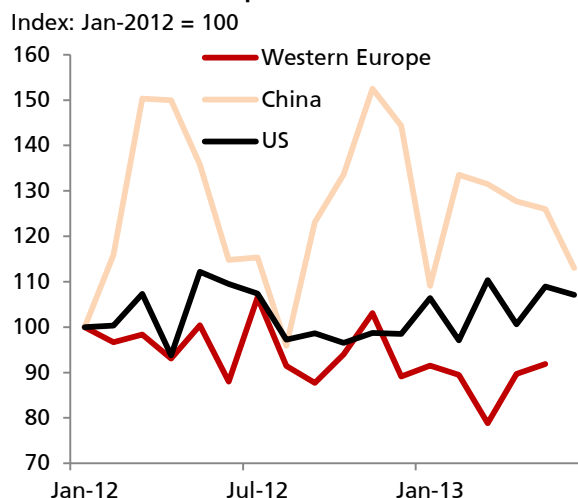
Domestic demand, or more specifically, investment growth has been slowing for the past several months. Part of the reason for the slowdown in investment is policy-engineered as the authorities already noticed overheating tendencies in the economy as manifested by the emergence of the current account (and trade) deficit in 2012. More stringent loan-to-value measures on property and vehicle loans have already been implemented since mid-2012. Coupled with weaker investor confidence amid a weakening rupiah, it is not surprising that investment slowed from the breakneck pace of growth last year.

On the surface, slower investment growth is negative for headline economic growth. However, slower economic growth also implies greater economic stability, which is exactly what the authorities are trying to achieve. To recap, robust domestic demand (leading to strong import growth) and lackluster commodity prices (weakening the terms of trade and export values) are two key reasons behind the widening current account deficit. While policy makers have no control over commodity prices (which depend largely on the state of the global economy), cooling the domestic economy will help to reduce imports. Notably, the import of capital goods have been declining in level terms from a peak of USD 3.8bn in December 2012 to a recent low of USD 2.5bn in March. Without this adjustment in imports, the current account deficit would have been significantly wider than the 4.4% of GDP registered in 2Q.

Slower but more stable growth

Tightening stance to be maintained

Bank Indonesia (BI) frontloaded monetary tightening over the last three months in response to the average 33% subsidized fuel price hike in late June. To be sure, the rate hikes does not have the desired impact on headline inflation, which spiked to 8.6% YoY in July (above what the authorities have been expecting). However, the rate hikes should help reduce the second round inflation effects from the fuel price

Chart 4: Imports

Chart 5: Non-ONG Exports


increase by moderating the pace of credit growth. Going forward, the relaxing of rules on food imports should also help to alleviate food price inflation in the coming months. Our inflation forecast has been lifted to 7.4% and 7.3% for 2013 and 2013 respectively.

That said, although sequential inflation is set to ease on the back of lower food prices and the post-Ramadan period, BI is still expected to maintain a tightening monetary policy stance. The current account deficit is still uncomfortably high (and the annual figure for 2013 is likely to be over 3% of GDP) and the rupiah remains on a weakening trajectory against the greenback. Needless to say, persistent rupiah weakness also erodes investor confidence and will stoke inflationary price pressures. With the external funding environment staying challenging amid speculation of less loose monetary policy in the US, higher domestic interest rates could be needed to draw in sufficient funding to service the current account deficit and reduce volatility in the rupiah. The FASBI deposit rate is expected to end the year at 5.50%, implying a cumulative increase of 175bps from the beginning of 2013.

A cyclical external uplift may be forthcoming

There are some nascent signs of improvement in the global economy. China's economic growth appears to have bottomed, the Eurozone crisis appears to have stabilized while the US economy continues to grind along. A breakdown of Indonesia's non-oil & gas (ONG) exports to these three regions reveals that shipments to China are still relatively weak. However, non-ONG exports to the US have been on a gentle uptrend since mid-2012 and exports to Europe have staged a rebound from the low in March. A global economic recovery would go a long way towards alleviating stress buildup on the external accounts. At this point, commodity prices remain unfavorable for Indonesia with oil prices having outperformed coal and palm oil over the past six quarters, weakening the terms of trade and the current account position. A recovery in external demand should also lift commodity prices, helping export volumes/values. Coupled with moderation in imports, the trade balance is likely to edge towards a surplus in an uneven fashion over the next few months. Under this scenario, external funding concerns are likely to ease somewhat, thereby reducing the need for BI to excessively tighten monetary policy.

An export rebound would ease external stability concerns

Indonesia Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Output and Demand									
Real GDP growth	6.2	5.8	6.0	5.8	5.8	5.8	5.7	5.9	6.2
Private consumption	5.3	5.0	5.1	5.1	4.8	4.9	4.9	5.0	5.2
Government consumption	1.2	1.8	5.9	2.1	1.0	2.9	7.7	7.0	4.8
Gross fixed capital formation	9.8	5.3	6.8	4.7	5.9	4.9	6.9	6.0	7.1
Net exports (IDRtrn, 00P)	240.8	288.6	313.2	62.2	79.6	69.4	81.4	68.9	87.6
Exports	2.0	5.3	7.0	4.8	6.5	6.4	5.5	6.4	9.0
Imports	6.7	1.9	9.0	0.6	4.0	2.8	5.7	5.3	8.7
External									
Merch exports (USDbn)	190	184	197	46	46	47	48	49	50
- % chg	-6.7	-3.3	7.3	-5.8	-0.4	-0.5	5.1	6.8	8.5
Merch imports (USDbn)**	192	189	207	47	47	48	50	51	53
- % chg	8.1	-1.2	9.2	-3.9	3.1	-3.1	8.7	5.0	12.0
Merch trade balance (USD bn)**	-2	-6	-10	-1	-1	-1	-2	-2	-3
Current account bal (USD bn)	-24	-30	-28	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-2.8	-3.2	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	113	90	95	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	4.3	7.4	7.3	5.6	9.1	9.6	8.7	8.7	5.8
Other									
Nominal GDP (USDbn)	871	921	988	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-1.8	-2.5	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified

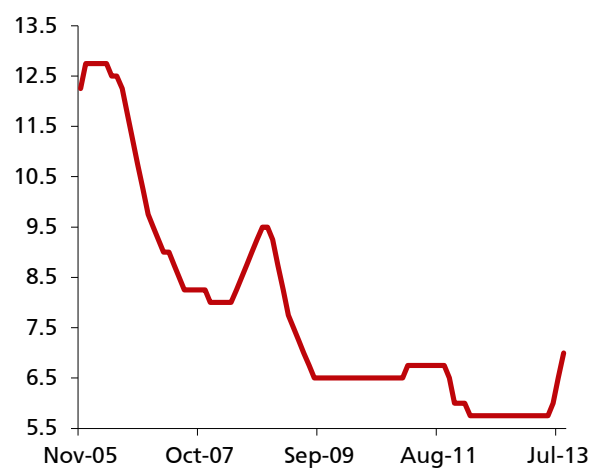
ID - nominal exchange rate

IDR per USD



ID – policy rate

BI rate



MY: Slower may be better

- Growth has surprised on the downside in 2Q13, after an already disappointing first quarter
- Full year GDP growth forecast for 2013 revised down to 4.3%; look for growth of 5.2% in 2014
- Inflation remains benign but should pick up on recent subsidy cuts
- Full year inflation should average 2.1% in 2013 and 3% in 2014
- Bank Negara will keep policy unchanged and allow the ringgit to adjust against the capital outflows

Soon after our previous quarterly report, “Expectation lowered”, in which we moderated our view on the outlook of the economy, almost everything start to crumble. Firstly, GDP growth in the second quarter fell short of expectation. Fiscal target appears unlikely to be met and the problems of falling trade and current account surpluses continue to cast a looming shadow of structural weaknesses.

Fitch then lowered Malaysia’s credit rating outlook to negative from stable due to lack of fiscal reform while the central bank has to cut the GDP growth forecast this year to 4.5-5.0%. Investors had enough, particularly after all the talk by the Fed on QE tapering and decided to pull the plugs. Capital outflows soon follow suit and the ringgit came under pressure thereafter.

Growth disappoints

Indeed, the last three month has been a struggle for Southeast Asia’s third largest economy. GDP growth in the second quarter came in below expectation at 4.3% YoY against the consensus forecast of 4.7%. While this still represents a sequential expansion of 5.0% QoQ saar, signs of weakness in the growth engines are beginning to surface (Chart 1).

Investment growth fell sharply to 6.0% YoY, down from 13.1% in 1Q13. Investors probably turned cautious amid risk of QE tapering while works on public developmental projects were moderated against concerns on fiscal health (Chart 2). In addition, net exports continued to be a major drag on growth given strong domestic demand. Import growth has remained relatively more resilient despite the sharp contraction in exports. And that put the pressure on the trade and current balances (see later section).

Chart 1: Growth below expectation in 2Q13

% YoY, % QoQ saar

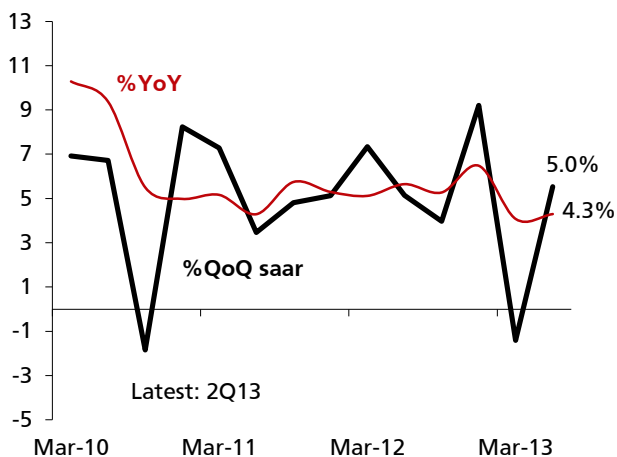
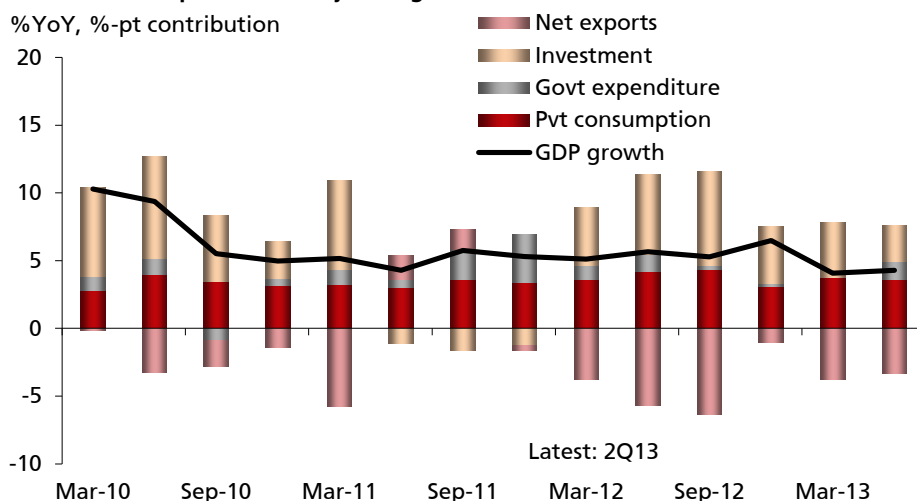


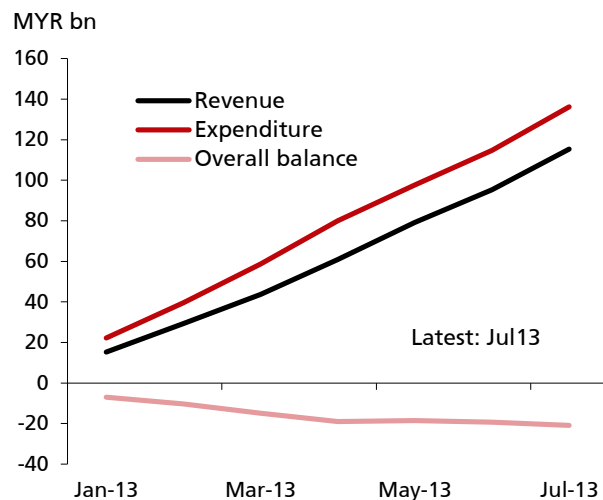
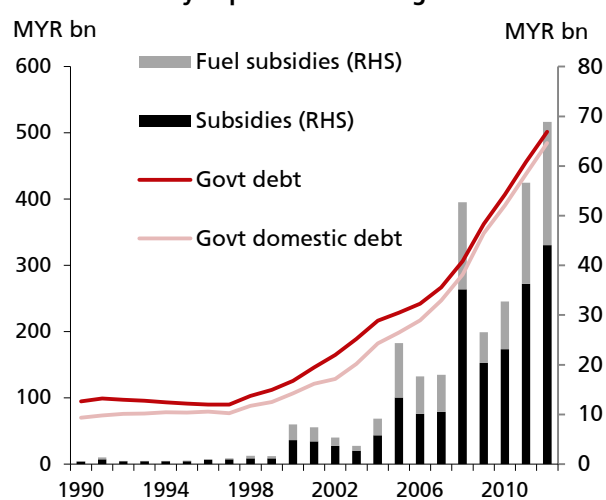
Chart 2: Net export still a major drag


Yet, consumption and government expenditure remained robust. Private consumption grew 7.2% YoY while government spending surged 11.1%. Juxtaposed with the under-performance in other aspects of GDP, this essentially hint of an overly accommodative fiscal policy.

Reining in the fiscal deterioration

Indeed, the fiscal condition has been a key flash point lately. Year-to-date, revenue collection has persistently fallen short of the expenditure and the gap has been widening (Chart 3). As a result, overall fiscal balance has continued to deteriorate. A narrow tax base, rapid increase in developmental expenditure from some of the mega projects in the Economic Transformation Programme, as well as generous handouts during the election period have strained the official coffers. Fiscal deficit could potentially come in at 4.5%, missing the target of 4.0% of nominal GDP this year.

The economy has been running large fiscal deficit for years and as a result, government debt has escalated to about MYR 502bn (53.3% of nominal GDP) in 2012 (Chart 4). Fitch has downgraded Malaysia's credit rating outlook to negative precisely due to that. One of the key pressure point came from the massive subsidy expenditure that has been escalating in recent years. And a large chunk of it is due

Chart 3: Fiscal deficit continues to widen

Chart 4: Subsidy expenditure driving debt level


A necessary step for fiscal sustainability

to the fuel subsidy component, which will likely reach at least MYR 24.8bn this year and account for about 56% of the total subsidy bills.

Hence, following a recent Fiscal Policy Committee meeting to shove up the fiscal position and to chart out the medium term direction for fiscal policy, the government announced cuts in the fuel subsidies. This is the first time in nearly two years whereby the fuel subsidies have been trimmed to keep the fiscal position in shape.

The government cut both Ron 95 petrol and diesel subsidies by MYR 0.20 per litre. This will raise the pump prices for RON95 petrol to MYR 2.10/litre and diesel to MYR 2.00/litre after the hike, up from MYR 1.90 and MYR 1.80 respectively. This latest move is expected to save about MYR 3.3bn per year as part of the crucial budget reforms.

Prime Minister Najib said the reductions were needed to trim the budget deficit and strengthen economic fundamentals to boost investor confidence. The financial markets of some Asian countries (including Malaysia) with high government debt and deteriorating external balances have come under pressure amid the anticipated QE tapering that spurs capital outflows from the region.

In addition, the Prime Minister also pointed out that part of the savings from the subsidy cut will be redirected to help fund handouts for the low incomes families to help them cope with the effects of higher fuel prices. Also, some developmental projects may be put on the back-burner with priority given to projects with low-import content and high-multiplier effects to reduce the strain on the external balance and the fiscal position. Lastly, chance of the introduction of the GST has increased again as this is widely pointed out as one of the measures to ensure longer term fiscal sustainability. We expect the GST to be announced in the upcoming FY 2014 budget.

It is a positive sign that the government is working on consolidating the fiscal position to ensure longer term fiscal sustainability. Re-calibrating the developmental project pipeline and cutting down on the fuel subsidies may help. Broadening the tax base to generate more tax revenue will be a boost. But the impact will manifest next year than this year. So the fiscal deficit will still undershoot the official target of 4.0% this year.

Preventing a fallout in external balance

The deteriorating trade surplus is another pain-point. Strong domestic demand has been driving up imports and with external demand remaining sluggish, the trade

Chart 5: Trade surplus falling persistently

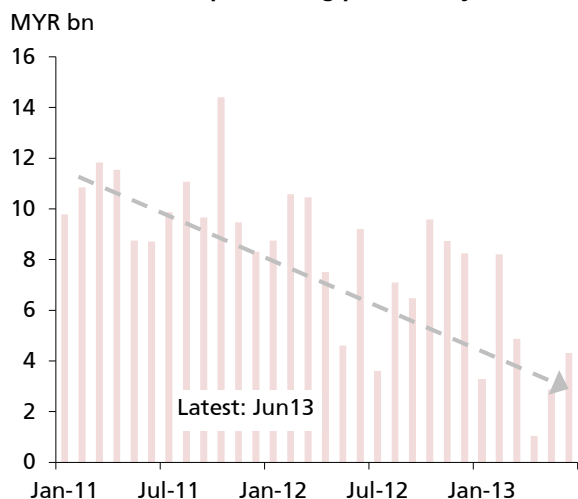
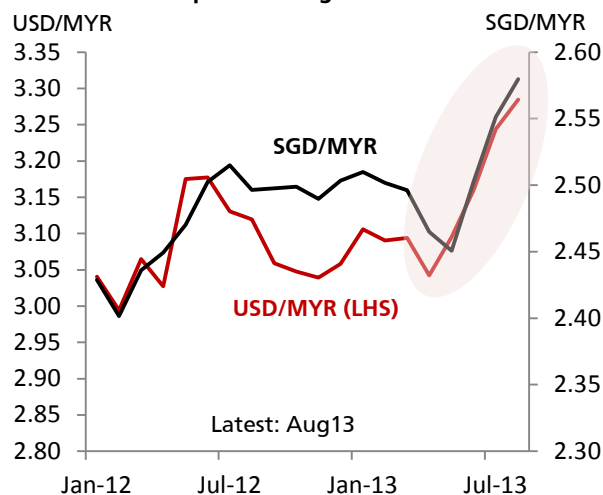


Chart 6: MYR depreciated against the USD and SGD



balance has been sliding over the last 3 years (Chart 5). Trade balance hit a multi-year low of MYR 1.0bn in April. Although it recovered to MYR 4.3bn in June, the risk of it turning into deficit remains. Domestic demand has been the biggest driver of growth keeping the economy afloat in recent years when global outlook has been dire. But that probably proved too much to bear on the external balance.

Weakness on the external balance, together with other fundamental gaps in the economy and outflows due to fears of QE tapering, are exerting pressure on the currency. Against the greenback, the MYR hit a three year low of 3.33 on 28 Aug13 (Chart 6). In fact, against the SGD, it registered a 15 year low of 2.60 on that same day.

Between interest rate and the exchange rate

To rectify this, either the exchange rate has to weaken further or the authority has to cool the domestic engines. As it is, it appears that the authority is happy to let the currency do the necessary adjustments and keeping the monetary policy on steady keel. We expect the central bank to maintain status quo on monetary policy and to maintain the Overnight Policy Rate at 3.00% for the next few quarters.

The concern is that hiking the policy rate could derail the current economic transformation and increase the government debt burden. Note the bulk of Malaysia's government debt is held by domestic holders. More importantly, monetary policy is a blunt tool. The policy rate can't adjust on a day-to-day basis much like the exchange rate. Hence, pressure on the ringgit will remain until external outlook picks up or somehow domestic demand cools by itself.

No change to policy rate in coming quarters

Inflation higher, growth slower

This most recent cuts in fuel subsidies is expected to weigh on domestic growth and stoke inflation in the coming months. In addition, the introduction of the GST will have a one off impact on inflation too. But as the fuel subsidy cut took effect from Sep13 and the GST will probably commence earliest in 2014, the inflation impact will manifest in 2014 and beyond. In addition, recent depreciation in ringgit may stoke imported inflation. But as external inflationary pressure remains benign, the risk of that happening is low.

Inflation averaged 1.7% for the first seven months of the year. On balance, it should come in a tad higher at 2.1% in 2013 before rising to 3.0% in 2014 (Chart 7). This is up from our previous forecasts of 2.0% and 2.4% respectively.

Chart 7: Inflation outlook

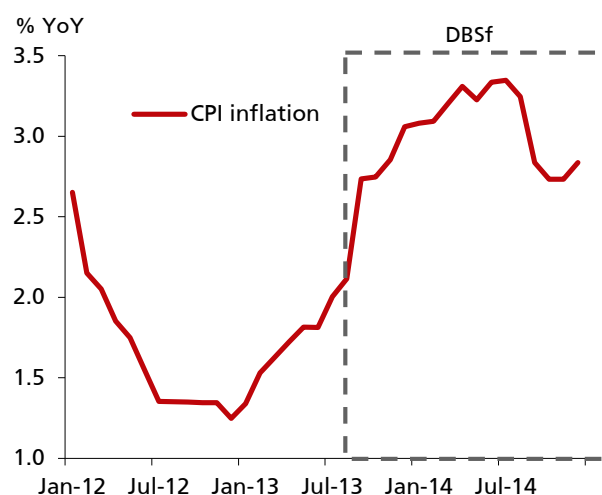
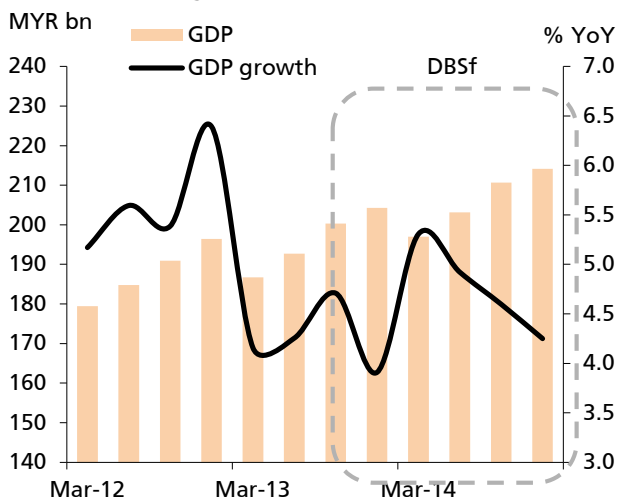


Chart 8: Slower growth ahead



Growth expectation lowered

GDP growth in the first half of the year has been below expectation. Going forward, the fiscal consolidation will surely dent domestic growth, the key driver of the economy for the last few years. With external demand unlikely to pick up significantly in the near term, full year GDP growth will most definitely undershoot. Further taking into account the downside risks from the conflict in Syria as well as the potential drag from QE tapering, full year GDP growth for the year is now projected to average 4.3%, down from 5.0% previously (Chart 8). Separately, GDP growth forecast for 2014 would have been lower than its current level of 5.2% if not for the low base this year.

Indeed, the government probably has to recognise the fact that growing slower could mean more sustainable growth and a better fiscal health in the longer term. Transforming the economy is important. But the pace has to be manageable without burning a hole in the coffer. This implies a more calibrated developmental spending and continued moderation in subsidies and fiscal consolidation. In short, the economy probably have to get accustomed to the new norm of slower growth and higher inflation in the coming years.

Malaysia Economic Indicators

	2012	2013f	2014f	2013	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth	5.6	4.3	5.2	4.3	4.8	4.0	5.6	5.4	5.0
Private consumption	7.7	7.0	5.7	7.2	7.1	6.2	5.0	5.5	5.8
Government consumption	5.0	4.8	5.8	11.1	5.0	3.5	6.2	4.5	5.0
Gross fixed capital formation	19.9	7.2	6.7	6.0	5.0	5.5	6.0	6.5	6.8
Exports	0.1	-1.9	4.4	-5.2	-3.0	1.0	3.6	4.1	5.0
Imports	4.5	0.6	4.1	-2.0	-3.0	4.0	-0.6	3.5	6.3
External (nominal)									
Exports (USD bn)	231	217	233	55	53	53	52	53	54
Imports (USD bn)	199	202	218	52	50	49	48	50	50
Trade balance (USD bn)	31	15	16	3	4	4	4	3	4
Current account bal (USD bn)	19	7	8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	6	2	2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, yr-end)	149	153	158	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	1.7	2.1	3.0	1.8	2.3	2.9	3.1	3.3	3.1
Other									
Nominal GDP (USDbn)	304	322	348	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-4.5	-4.5	-4.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % growth, year-on-year, unless otherwise specified

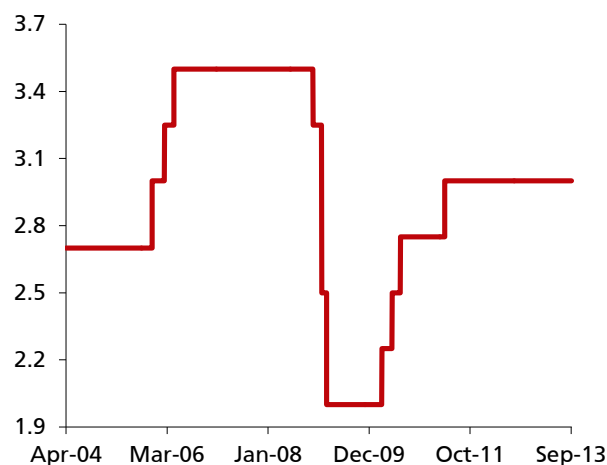
MY - nominal exchange rate

MYR per USD



MY – policy rate

%, OPR



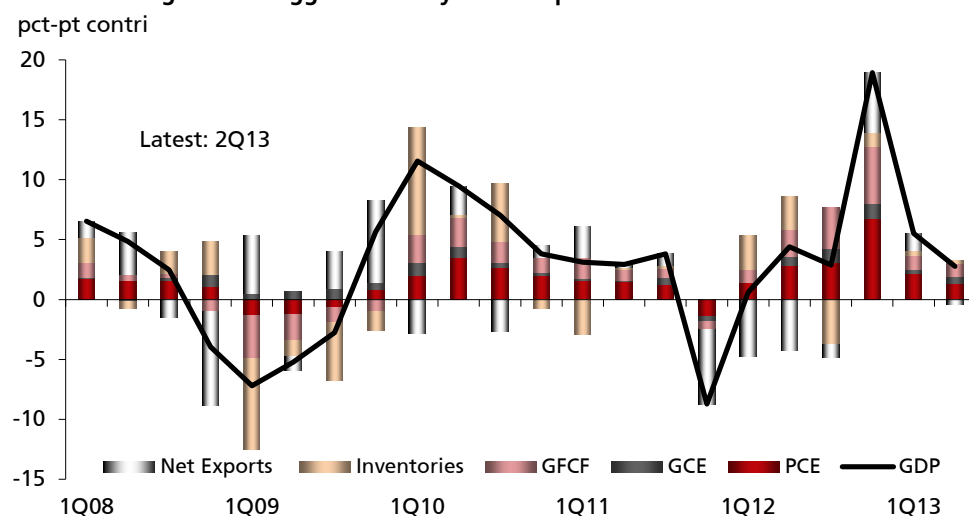
TH: Awaiting rebound

- Our GDP projections for 2013 and 2014 has been revised to 4.0% and 5.2% respectively. The revision comes largely on the back of delays in the THB 2.2trn infrastructure plan
- Elevated and rising levels of household debt is a concern and is likely to have a dampening impact on private consumption in the coming quarters
- There have been signs of deterioration in external balances, but monetary policy making is unlikely to be constrained as a result

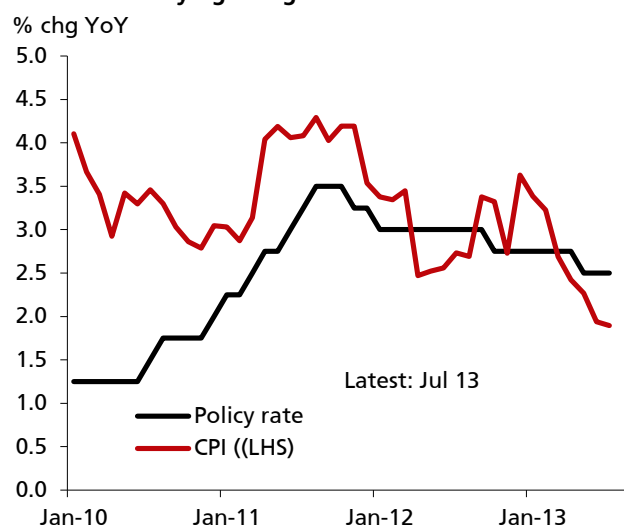
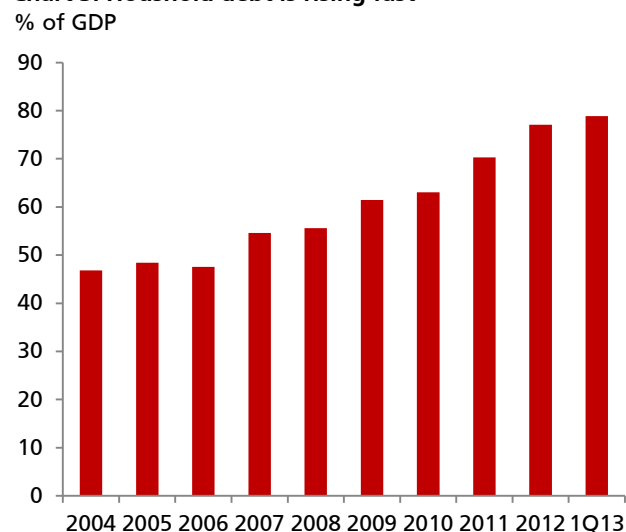
The economy entered into a technical recession as 2Q GDP contracted for the second consecutive quarter by 0.3% QoQ sa. In YoY terms, headline growth reached 2.8%, significantly below consensus expectations of a 3.3% expansion. There is no doubt that momentum has been lost over the first half of 2013 as some pro-growth policies that were in place in 2012 were unwound. The domestic economy has normalized accordingly. However, the biggest drag on growth came from the external front. Net exports deducted 0.4pct-pt to headline YoY growth in 2Q, compared to a contribution of 1.4pct-pt in the preceding quarter.

On the back of weaker-than-expected growth in 2Q and delays in the implementation of the THB 2.2trn infrastructure plan, we have downgraded our 2013 GDP forecast to 4.0%, from 4.6% previously. However, this implies that the ramp up in public investment will be a boost to growth next year and we maintain our GDP forecast at 5.2% for 2014. Notably, we do not believe that the drag from the external front is likely to persist and a gradual recovery is expected to take place in the coming months.

Chart 1: GDP growth dragged down by weak exports



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Chart 2: CPI staying benign

Chart 3: Household debt is rising fast


No near-term catalysts for the domestic economy

The domestic economy is posting a mixed picture but there are no immediate catalysts for a rapid pick up in domestic demand. Private consumption expenditure (PCE) contracted for two straight quarters and we suspect that this portion of GDP could underperform. PCE was provided with a temporary boost with the rice pledging scheme and the first car tax rebate scheme in full swing through 2012. The pro-growth policies (including generally low policy rates) adopted over the past few years have led to a significant increase in household debt. In fact, household debt to GDP has been on an ascending trend for the past six years. However, the rapid rise of household debt to 78% of GDP (as of 1Q13) from 63% in 2010 is a source of concern. Some overhang on PCE growth is likely to occur as the Bank of Thailand (BoT) keeps an eye on household credit levels and ensures that these loans stay moderate.

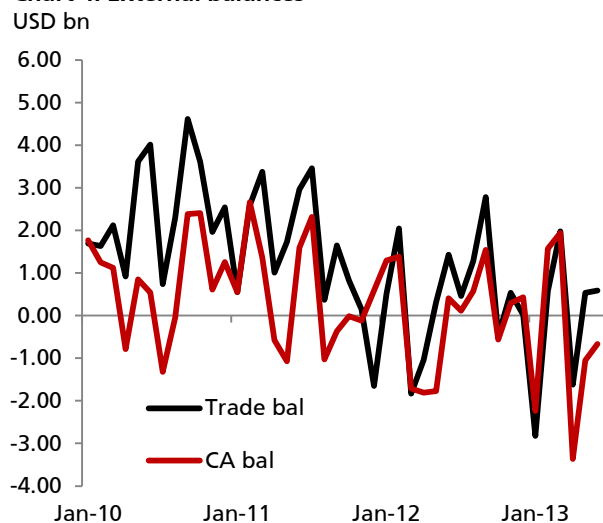
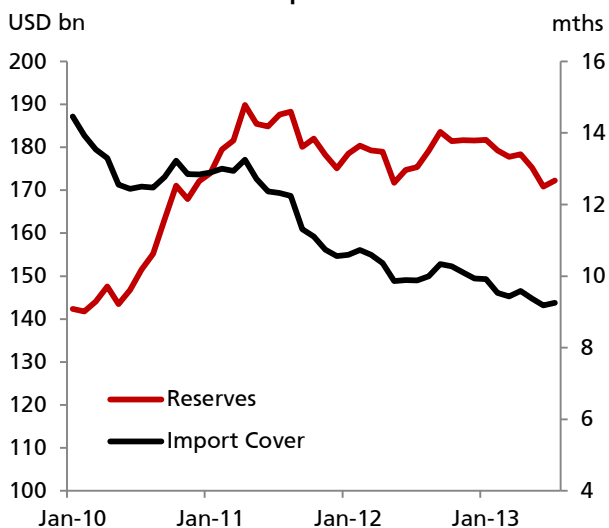
On the investment front, gross fixed capital formation (GFCF) growth rebounded by 1.8% QoQ sa in 2Q, taking back half of the contraction from the preceding quarter. A slowdown in private investment from the lofty levels of 2012 is inevitable as the post-flood reconstruction winds down. Initially, the tapering off of private investment is supposed to be offset by the increase in public investment in 2H. However, delays were inevitable when the Central Administrative Court ordered environmental impact assessment (EIA) and health impact assessments (HEIA) on the projects in late June. Given still weak public investment, GFCF growth is unlikely to outperform in the coming few months. Short of the announcement of a sizable stimulus package, the domestic economy is likely to grind along.

Meanwhile, monetary policy is likely to stay accommodative, but room for further rate cuts has become constrained. While GDP growth and inflation (1.9% YoY in July) have been heading south, elevated and rising levels of consumer debt remains a source of concern. As such, the policy rate is expected to be kept on hold in the short term as BoT also keeps an eye on volatile capital flows.

The bulk of infrastructure spending has been delayed

Assessing external stability risks

Driven in large part by Fed tapering fears, emerging market assets (including Thailand) have been sold down. Volatile capital flows have raised concerns about external funding for Asia especially since India and Indonesia (the two Asian countries with sizable current account deficits) have seen tremendous depreciatory pressure on their currencies. Thailand's current account surplus has been narrowing

Chart 4: External balances

Chart 5: FX reserves & import cover


from a peak of USD 22bn in 2009 down to USD 170mn in 2012. In 2Q13, the current account slipped into a deficit of USD 5.1bn and worries surfaced about further weakening of external accounts amid a difficult funding environment.

There have been some signs of deterioration. Foreign reserves have eased to USD 172mn, from USD 190bn in April 2011 and import cover has also fallen to 9 months, from 13 months over the same time period. Points of vulnerabilities also exist. For example, foreign ownership of local government bonds has increased to 18%, from 4% in mid-2010. However, it must be emphasized that foreign reserves are still at very high levels compared to external debt or imports.

On the whole, Thailand is not as vulnerable to external funding pressures (compared to Indonesia and India) as the current account is more likely to be in a balanced position, rather than in a structural deficit position. On the trade side, exports have gone sideways for the past three years and imports have caught up as domestic demand stayed resilient. As a result, the trade balance has been hovering around zero over the past year. It should not be overlooked that services exports have been growing strongly despite the lackluster global economy over the past few quarters. Assuming a gradual improvement in the global economy, the return of external demand should bolster exports. Domestically, the economy is likely to grind along and imports are likely to remain moderate (especially since public investment is only expected to pick up in mid-2014) for the coming few quarters. The current account is forecasted to register an annual deficit of 0.3% of GDP for 2013 and a surplus of 0.2% of GDP in 2014.

Monetary policy making is unlikely to be constrained by moderate capital outflows. Whereas defacto monetary tightening has already taken place in India and Indonesia (in response to external funding concerns), we believe that BoT can keep the policy rate low to support the economy in the coming quarters.

Monetary policy making is unlikely to be constrained

Thailand Economic Indicators

	2012	2013f	2014f	2Q13f	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth (88P)	6.4	4.0	5.2	2.8	4.3	3.4	4.9	5.7	4.3
Private consumption	6.7	2.0	4.5	2.4	1.1	0.1	4.0	3.4	4.9
Government consumption	7.5	3.2	4.7	5.8	0.8	3.7	10.6	2.2	2.5
Gross fixed capital formation	13.2	3.2	6.6	4.5	0.3	2.3	6.1	4.8	7.2
Net exports (THBbn)	660	742	794	130	188	219	215	159	184
Exports	3	4	4	3	3	2	-1	4	6
Imports	6	2	3	4	0	-3	-3	1	8
External									
Merch exports (USDbn)	226	231	263	56	58	61	63	65	67
- % YoY	3	2	14	-2	-2	8	12	17	15
Merch imports (USDbn)	219	229	257	56	57	59	61	63	66
- % YoY	8	5	12	0	5	5	8	12	15
Trade balance (USD bn)	7	2	6	0	1	2	2	2	1
Current account balance (USD bn)	0	0	4	-5	2	1	1	3	1
% of GDP	0.0	-0.1	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	3.0	2.4	3.5	2.2	1.9	2.3	2.6	3.9	4.0
Other									
Nominal GDP (USDbn)	366	401	450	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate, %	0.5	0.6	0.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)**	-2.9	-2.0	-1.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified

** Central govt cash balance for fiscal year ending September of the calendar year

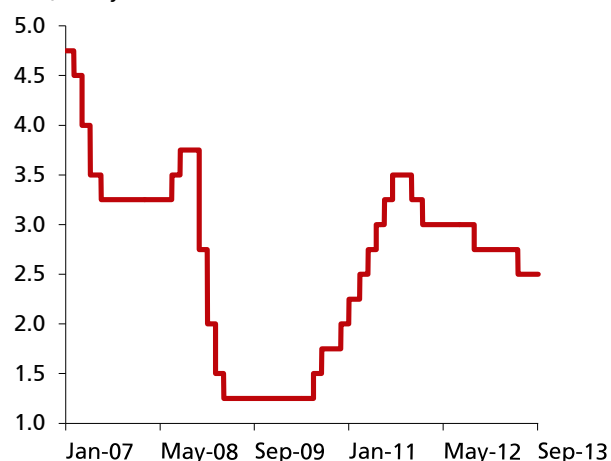
TH - nominal exchange rate

THB per USD



TH – policy rate

%, 1-day RRP



SG: Re-calibration

- 2Q growth was stronger than expected at 15.5% QoQ saar (3.8% YoY)
- This won't be maintained in Q3, especially in the manufacturing sector
- Look for full year growth of 2.9% in 2013 and 3.5% in 2014
- Inflation has eased. It should average 2.5% in 2013 and 3.2% in 2014
- Risks toward growth and inflation are balanced despite the depreciation in the SGD

The economy has surprised on the upside once again. Despite external headwinds, the headline number came in stronger than expected. The economy accelerated by 15.5% QoQ saar, up from a modest expansion of 1.7% in the previous quarter (Table 1). In year-on-year terms, that's a healthy 3.8% growth, from 0.2% in 1Q13. So for the first half of the year, the island state grew by 2.0% versus the same period last year. With this strong showing in the second quarter, the official forecast range has also been raised to 2.5-3.5%, up from 1-3% previously.

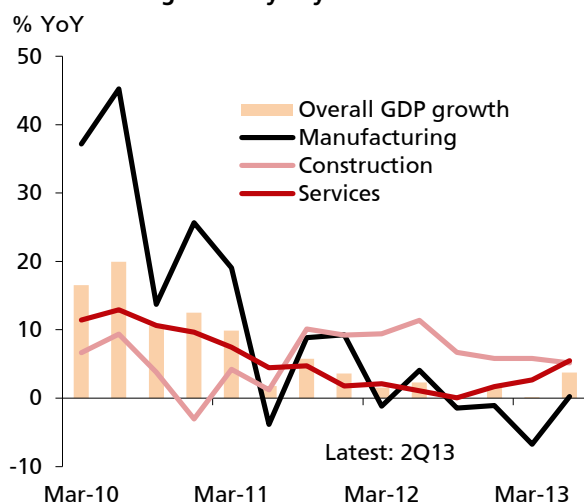
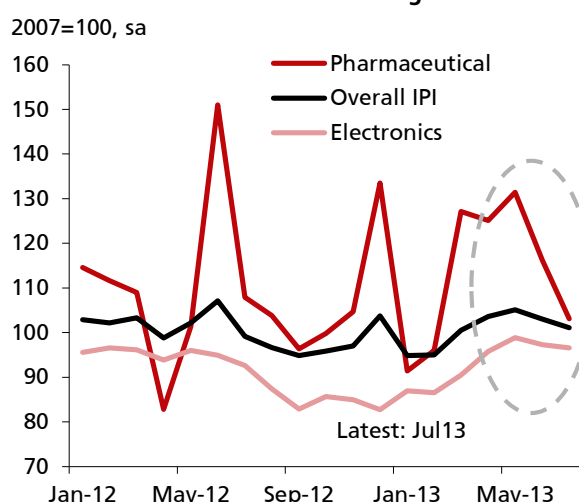
That's the nature of this economy. It's always volatile and often springs such surprises. More importantly, what led to this strong showing is a better than expected performance from the services sector. Although growth in the manufacturing sector was lacklustre at a mere 0.2%, the services has managed to pick up the slack (Chart 1).

Pullback in manufacturing

In addition, there are downside risks to the manufacturing sector in the coming months. Industrial production in recent months has fallen short of expectation. Unexpected downswing in the pharmaceutical cluster and the subdued growth in the electronics segment have brought about the disappointment. Though output grew 2.7% YoY in July, that's plainly based on the headline year-on-year numbers. In fact, industrial output has been on the slide for the last two months on a sequential basis (Chart 2). Industrial activity contracted by 1.9% in July, following a 2% drop in the previous month. In absolute level, both production output for key electronics and biomedical clusters were on the decline.

Table 1: GDP growth by sectors

	2Q12	3Q12	4Q12	2012	1Q13	2Q13
Percentage change year-on-year						
Overall GDP	2.3	0.0	1.5	1.3	0.2	3.8
Manufacturing	4.1	-1.4	-1.1	0.1	-6.7	0.2
Construction	11.4	6.7	5.8	8.2	5.8	5.1
Services producing	1.1	0.0	1.7	1.2	2.7	5.5
Quarter-on-quarter annualised growth rate, seasonally adjusted						
Overall GDP	0.1	-4.6	3.3	1.3	1.7	15.5
Manufacturing	-1.0	-16.6	3.1	0.1	-12.1	32.1
Construction	15.0	3.2	-3.9	8.2	10.3	11.2
Services producing	0.1	0.4	2.5	1.2	7.8	11.5

Chart 1: GDP growth by key sectors

Chart 2: Weakness in manufacturing


While the global economy continues to grind ahead with the current normalisation process, economic conditions are not picking up in a big way. This underscores the uncertainties that exist in the global economy at present. Growth in the manufacturing sector is expected to remain subdued against such a backdrop. Moreover, with China aiming for slower growth and key markets Malaysia and Indonesia struggling with capital outflows and drastic depreciation in their respective currencies, Singapore's exports and manufacturing performance will surely be affected. Expect a sharp pullback in manufacturing growth in 3Q13.

Growth to be driven by services

Despite the downside risk to the manufacturing growth in 3Q13, the services sector will likely pick up the slack. The sector grew by 5.5% YoY in the quarter, up significantly from 2.7% in 1Q13. A buoyant financial market and pick-up in intra-regional trade saw key segments such as the financial services, wholesale trade and the transportation services industries posting healthy growth. Tourism related industries also did well with the steady stream of tourist arrivals from the region.

Traditionally, the services sector is a stable and key engine of growth for the economy. Accounting for about 68% of GDP, improvement in the sector typically

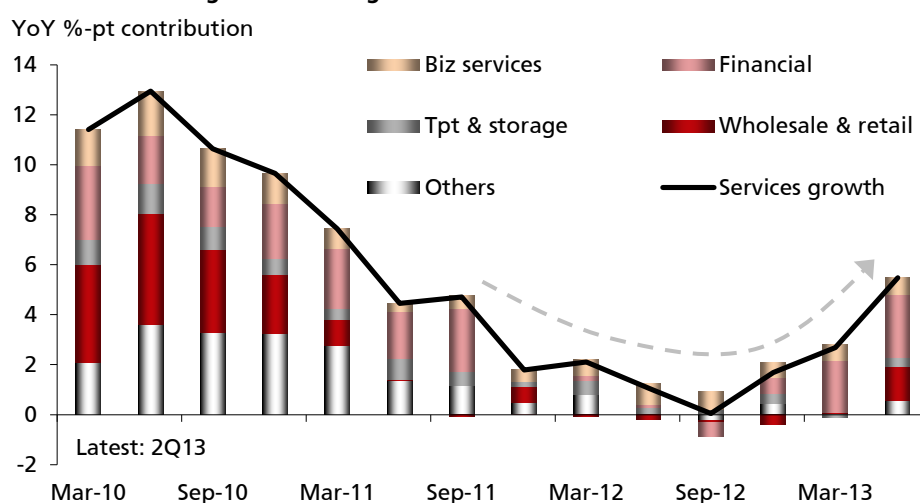
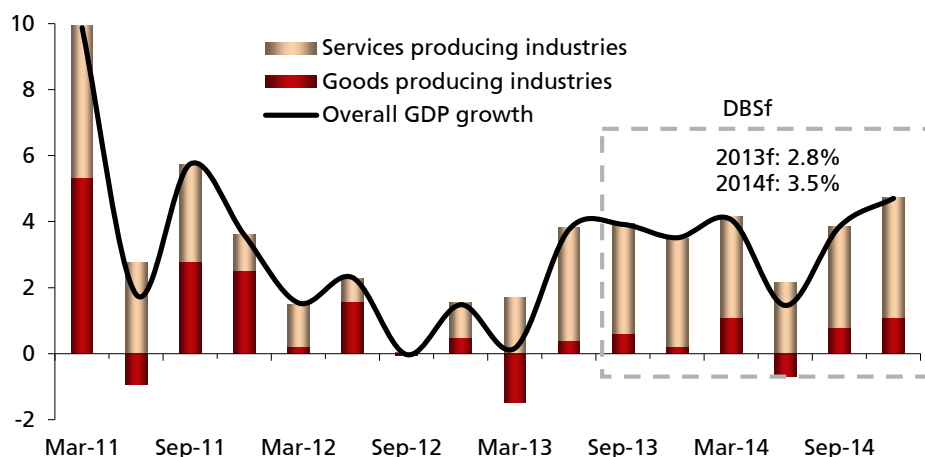
Chart 3: Services growth turning around


Chart 4: Growth to improve gradually

% YoY, %-pt contribution



Services picking up the slack

implies fairly healthy growth outlook for the broader economy. That is, if this sector turns, the entire economy will move along with it. Growth in this sector has already bottomed in 3Q12 and will likely continue to grind northward (Chart 3). This implies continued improvement in overall GDP growth as well.

Growth forecasts adjusted

The economy has bounced back stronger in the second quarter, and in the process, lifted the growth trajectory for this year significantly. To reflect this change, full year GDP growth for 2013 has been revised to 2.9%, from 2.5% previously (Chart 4). While GDP growth in the coming quarters will likely continue to improve gradually, there are risks down the road.

The recovery in the US will likely be tepid with overhanging QE tapering uncertainties and drag from the sequester cuts. Potential involvement in the Syria conflict is another flash point worth noting. On a separate note, Eurozone is technically out of recession. But growth momentum is expected to remain anaemic as the structural weakness in the region is unlikely to be resolved in the near term.

China is aiming for slower growth. The direct impact as well as a broader China-led Asia slowdown will certainly weigh down on Singapore's export and growth performance. Note that China is Singapore's largest export market and Asia accounts 71.6% of Singapore's total non-oil domestic exports in 2012. Moreover, recent capital outflows from the region and depreciation in the currencies of some neighbouring economies will surely affect Singapore's growth prospects indirectly.

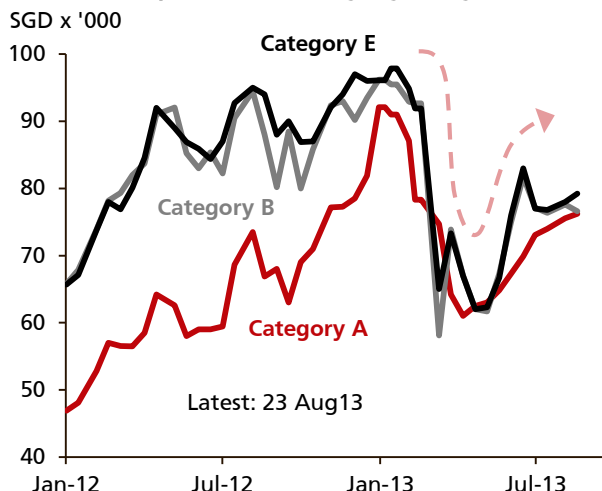
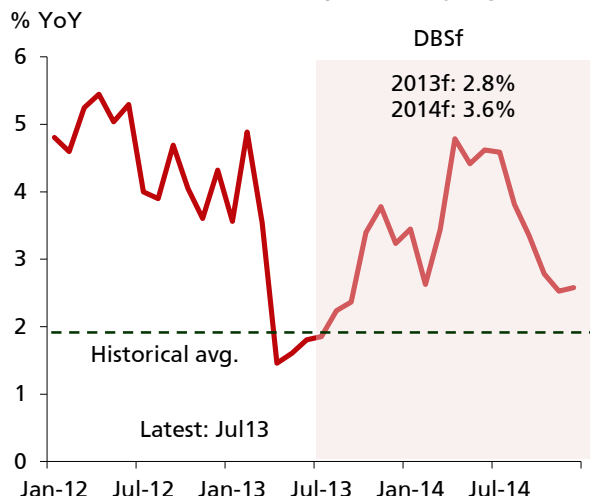
A slower Asia implies slower economic activity in Singapore. And the effect is more likely manifest from 4Q13 onwards. Hence, we expect growth to remain subdued at 3.5% in 2014.

Inflation lower but set to rise again

CPI inflation for July registered 1.9% YoY, up from 1.8% from the previous month. After the introduction of the curbs on car loans which sent the CEO premiums plummeting, inflation is inching close to the 2% mark and COE premiums are once again approaching the previous high (Chart 5). That is, the bounce back from COE premiums will be the key drivers of inflation in the coming months.

More importantly, we have highlighted that the policy change will have only a transient effect on headline inflation before the base effect lapse in twelve months

Higher inflation ahead

Chart 5: COE premiums inching higher again

Chart 6: Inflation to remain persistently high


time. With that, inflation is projected to breach the 4% mark by mid next year (Chart 6).

Moreover, the labour market remains tight, exerting significant wage pressure on businesses. Rental is still high and such cost push inflation will continue to dominate despite the absence of imported pressure. Indeed, domestic inflationary pressure is still strong and a lot has to do with the on-going restructuring. With that, full year inflation is expected to average 2.5% before rising to 3.2% in 2014.

MAS to stand pat despite depreciative pressure

Recent talk by the Fed on QE tapering has caused significant jitters in regional financial markets. Capital withdrew from some Asian economies, sending their currencies into a tailspin. India, Indonesia and Malaysia are the key affected economies due to some fundamental gaps in their economic structure.

As these are also some of the key trading partners for Singapore and the Monetary Authority of Singapore maintains its exchange rate policy against a basket of currencies, the Sing dollar was inevitably affected. The SGD depreciated against the

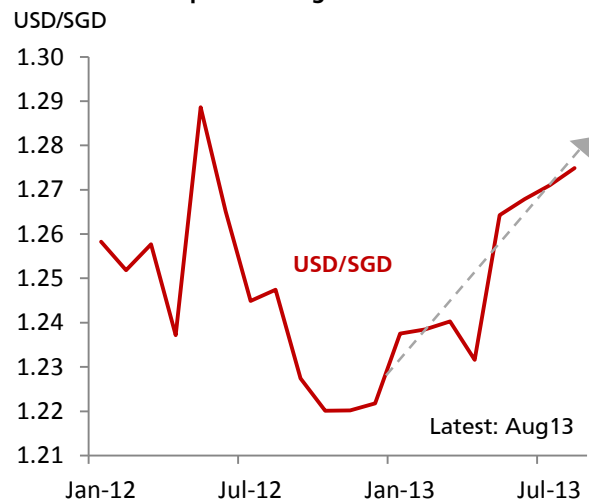
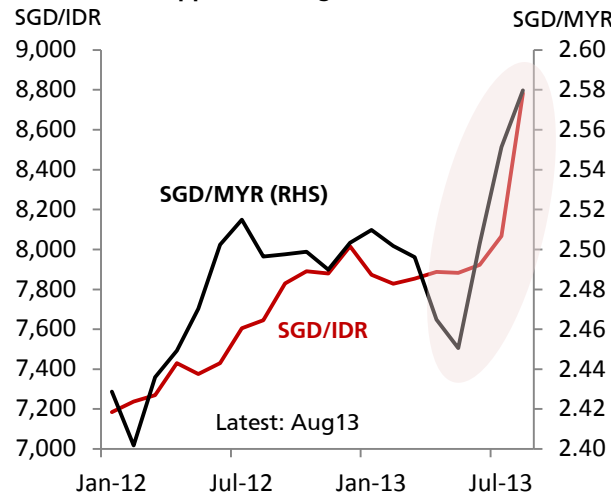
Chart 7: SGD depreciates against the USD

Chart 8: SGD appreciated against the MYR and IDR


Chart 9: DBS SGD NEER and policy band

Indexed: 1 Oct 10 = 100

**No change to MAS
policy**



greenback by about 4.3% but appreciated against the MYR and IDR by about 3.1% and 9.6% respectively since the start of the year (Chart 7 & 8).

With the latest round of exchange rate volatility, the Sing NEER dipped into the lower half of the policy band (Chart 9). We do not expect the central bank to tamper with the policy stance in the upcoming October policy review. The authority is more likely to continue with its appreciative stance and maintain the slope and width of the band. Despite the uncertainties pertaining to the growth outlook in the coming quarter, the MAS will have to stay vigilant on inflation next year. Sticking to status quo will allow policymakers to balance off the risks between inflation and growth in the coming quarters.

Singapore Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
Real GDP (00P)	1.3	2.9	3.5	3.8	4.0	3.7	4.3	1.7	3.7
Private consumption	2.2	2.6	3.1	2.7	3.0	3.3	3.2	3.0	3.0
Government consumption	-3.3	9.8	4.1	12.2	6.0	7.0	5.6	4.8	3.2
Gross fixed investment	7.4	-4.0	2.5	-3.8	-3.0	-3.2	2.0	2.3	2.7
Exports	0.3	2.3	4.3	3.1	4.7	5.5	5.4	4.0	4.1
Imports	3.2	0.8	4.0	2.9	2.0	0.9	3.6	4.1	4.2
Real supply									
Manufacturing	0.1	-1.1	0.8	0.2	1.2	0.8	2.7	-3.4	1.9
Construction	8.2	2.0	3.2	5.1	-0.7	-2.0	0.6	3.0	4.1
Services	1.2	4.7	4.4	5.5	5.3	5.2	4.8	3.4	4.3
External (nominal)									
Non-oil domestic exports	0.5	0.5	2.1	-5.0	4.1	16.6	4.0	6.8	2.8
Current account balance (USD bn)	51	54	57	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	18	18	18	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn)	259	272	281	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	4.6	2.5	3.2	1.6	1.7	2.4	2.2	4.1	3.7
Other									
Nominal GDP (USDbn)	277	292	312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (% , sa, eop)	2.0	2.2	2.5	2.0	2.1	2.2	2.3	2.4	2.4

- % change, year-on-year, unless otherwise specified

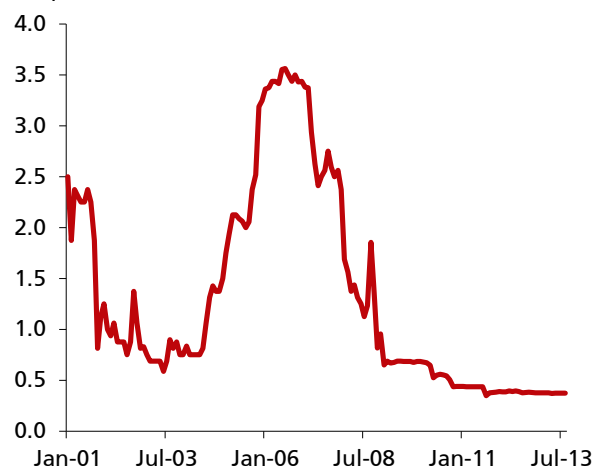
SG - nominal exchange rate

SGD per USD



SG - 3mth SIBOR

% pa



PH: SE Asia's fastest

- Our 2013 and 2014 GDP growth forecasts have been revised up to 7.0% and 6.7% respectively
- With no constraints on monetary policy, interest rates are likely to stay low, supporting continued momentum in the domestic economy
- Exports have been a drag on growth for the past few quarters, but a recovery is on the cards

The economy grew by 7.5% YoY in 2Q (1.7% QoQ sa), unchanged from the preceding quarter. The impressive growth rate was maintained despite significant external headwinds buffeting Asia, leading to several economies posting below-consensus growth numbers. Once again, the Philippine economy is the fastest growing in Southeast Asia. Momentum in the domestic economy is likely to be sustained in the coming quarters as policy rates remain low. Notably, the central bank is not constrained by external funding concerns or elevated levels of inflation.

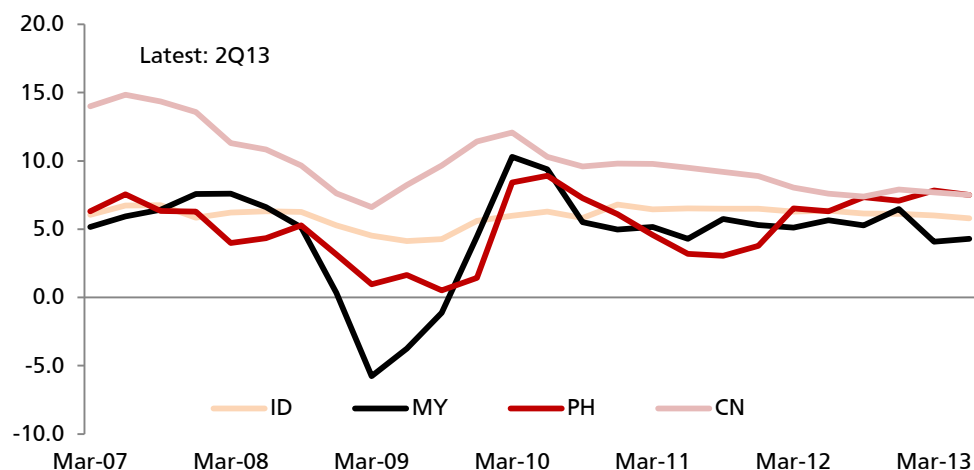
Externally, signs of stabilization in the Eurozone, and a nascent turnaround in the Chinese economy point to an improvement in exports in the coming months. On the back of robust 2Q GDP numbers and an improvement in the export outlook, we have lifted our GDP forecasts to 7.0% for 2013 (from 6.4% previously) and 6.7% for 2014 (from 6.0% previously).

It's all domestic demand

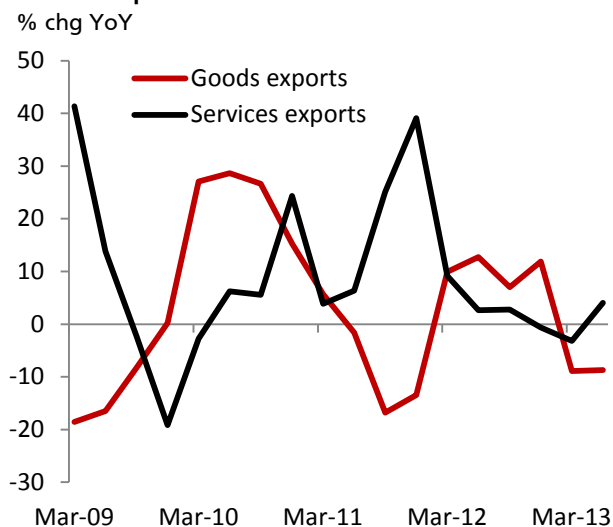
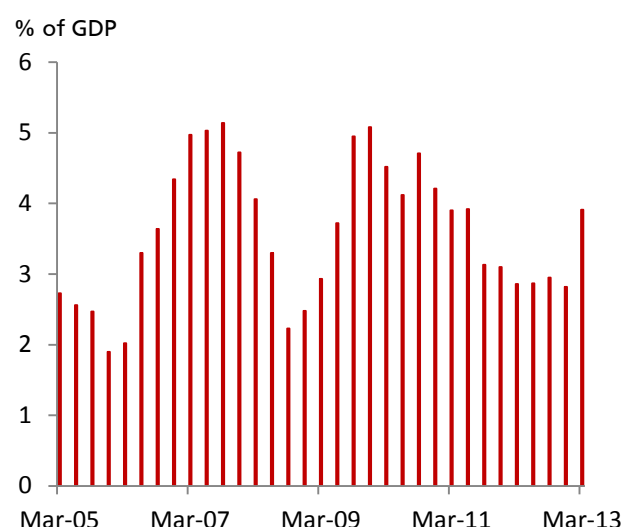
GDP growth was driven only by domestic demand over the past four quarters. Over the time period, net exports contributed an average of -1.9pct-pts (YoY terms), implying average domestic demand contribution of 9.2pct-pts per quarter. For 2Q, external demand was a drag to the tune of -2.0pct-pts, while domestic demand contributed the remaining 9.5%.

Chart 1: Selected Asian economies

Real GDP, % chg YoY



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Chart 2: Exports

Chart 3: Current account


The benign inflation and low rates environment has been conducive for the domestic economy. Other reasons also play a part. Firstly, remittances remained resilient through the global soft patch over the past few quarters and this has helped to prop up private consumption. Secondly, government spending has been elevated in the lead up to elections in mid-2013. Thirdly, investment sentiment has turned for the better with the current reform-minded administration in charge. It is not surprising that gross fixed capital formation (GFCF) growth has averaged 12.7% YoY in 1H13 and is likely to remain strong as the government bagged an investment grade for its sovereign rating for fiscal reforms, putting the economy firmly on foreign investors' radar screen.

With no external funding constraints (elaborated below), higher imports resulting from stronger domestic demand is not an issue. Going forward, domestic demand momentum is likely to be maintained even as government spending winds down post elections.

An export recovery on the cards

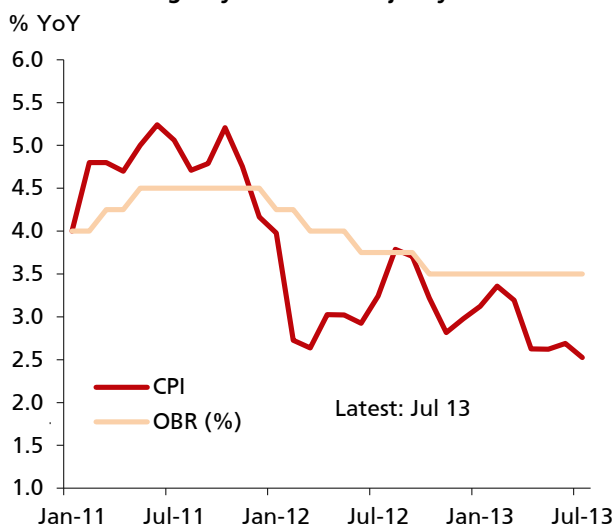
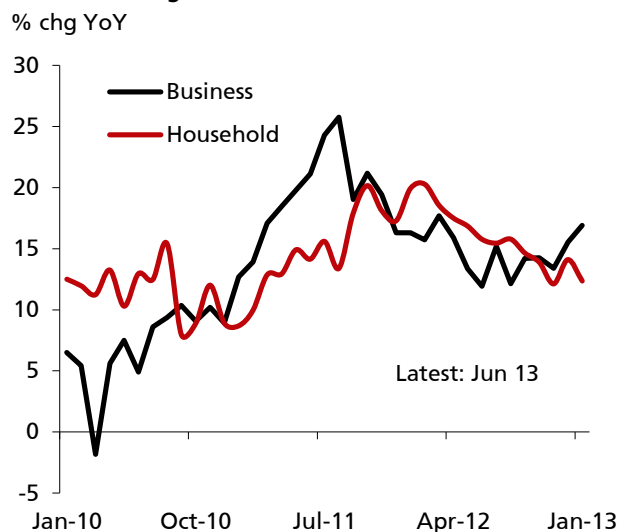
The lackluster global economy has weighed heavily on exports (in real terms) in 1H13. Notably, quarterly goods exports fell by an average of 8.8% YoY, while services exports rose by just 0.4% YoY. Comparatively, goods imports fell by only 1.6% YoY while services imports rose by 4.5% YoY. Imports have clearly outperformed on the back of the vibrant domestic economy.

In nominal level terms, however, nascent signs of recovery have appeared. Electronics manufacturing exports have headed higher over the past few months and are now 39% higher than the bottom in January. We think this rebound can be sustained with the global backdrop looking more positive. China's GDP growth has stabilized and PMI numbers have been recovering. The same can be said of the Eurozone, which exited recession in 2Q. With the US grinding along, external demand should recover in the coming months with, most of the impact showing in the early part of 2014.

An improvement in exports is on the cards

Monetary policy to stay accommodative

Monetary policy is not constrained and the overnight borrowing rate can stay low in the coming quarters. Most importantly, external balances are not pressured by

Chart 4: No urgency to hike rates just yet

Chart 5: Loan growth not excessive


speculation of Fed tapering. Over the past few months, Indonesia and India have been rocked by external funding concerns on account of their large current account deficits. Even countries running a balanced current account such as Thailand and Malaysia were affected. While asset prices in Philippine also took a tumble, external funding is not an issue for the economy given the current account is expected to remain in surplus position in excess of 2% of GDP this year. The sizable surplus has been maintained over the past six quarters even as exports went sideways and this was largely due to continued inflows from remittances.

From a price stability standpoint, there is again no urgency for the central bank to hike rates. Despite multiple quarters of strong GDP growth, inflation has been trending lower, reaching 2.5% in July. Stable food prices and depressed commodity prices have gone a long way towards keeping a lid on headline inflation. Barring an upward shock to these two components, a mild updrift in CPI is expected as the global recovery gains traction, eventually translating into higher commodity prices.

Meanwhile, credit aggregates have been showing moderate growth, averaging 14.3% YoY in 1H13. Acceleration in credit expansion is likely in the coming few quarters as enforcement of stricter access to the central bank's special deposit accounts (SDAs) start to take effect. The rotation out of SDAs into other financial instruments including deposits will manifest in the immediate few months, facilitating credit creation (and inflationary pressure) down the line.

We maintain that inflation will average 3.1% in 2013 before rising to 4.1% in 2014. Monetary tightening to regulate credit/inflation levels is likely to take place only in 2Q14.

Monetary tightening not needed just yet

Philippines Economic Indicators

	<u>2012</u>	<u>2013f</u>	<u>2014f</u>	<u>2Q13f</u>	<u>3Q13f</u>	<u>4Q13f</u>	<u>1Q14f</u>	<u>2Q14f</u>	<u>3Q14f</u>
Real output and demand									
Real GDP growth	6.6	7.0	6.7	7.5	6.8	6.3	6.7	6.9	7.1
Private consumption	6.6	5.6	5.9	5.2	5.4	6.2	5.8	6.8	5.8
Government consumption	12.2	14.7	3.5	17.0	14.3	13.6	7.2	0.6	3.0
Gross fixed capital formation	10.4	9.5	8.6	9.7	9.1	4.3	7.4	11.4	9.5
Net exports (PHP bn, 00P)	47.7	-70.0	-57.9	25.0	23.1	-113.1	-10.1	20.7	36.8
Exports	8.9	-5.1	4.9	-6.5	-1.1	-5.0	2.0	2.9	8.8
Imports	5.3	-1.2	4.4	-3.0	-1.4	-2.1	2.7	3.5	7.2
External (nominal)									
Merch exports (USD bn)	52.0	53.7	58.5	13.5	13.9	14.2	14.4	14.6	14.7
- % YoY	7.9	3.0	9.0	-2.7	4.1	18.4	19.2	7.7	5.8
Merch imports (USD bn)	61.7	60.8	68.1	15.3	15.3	15.9	16.6	16.9	17.2
- % YoY	2.7	-2.1	12.0	-0.1	-1.7	0.7	15.6	10.8	12.4
Merch trade balance (USD bn)	-10.0	-7.1	-9.6	-1.8	-1.4	-1.7	-2.2	-2.4	-2.5
Current account balance (USD bn)	8	7	7	n.a	n.a	n.a	n.a	n.a	n.a
% of GDP	2.8	2.6	1.9	n.a	n.a	n.a	n.a	n.a	n.a
Foreign reserves, USD bn	84	86	92	n.a	n.a	n.a	n.a	n.a	n.a
Inflation									
CPI inflation	3.1	3.1	4.0	2.8	2.9	3.4	3.8	4.3	5.3
Other									
Nominal GDP (USD bn)	250	279	323	n.a	n.a	n.a	n.a	n.a	n.a
Budget deficit (% of GDP)	-2.3	-2.5	-2.2	n.a	n.a	n.a	n.a	n.a	n.a
Govt external debt (USD bn)	48	48	48	n.a	n.a	n.a	n.a	n.a	n.a
% of GDP	19	17	16	n.a	n.a	n.a	n.a	n.a	n.a

* % change, year-on-year, unless otherwise specified

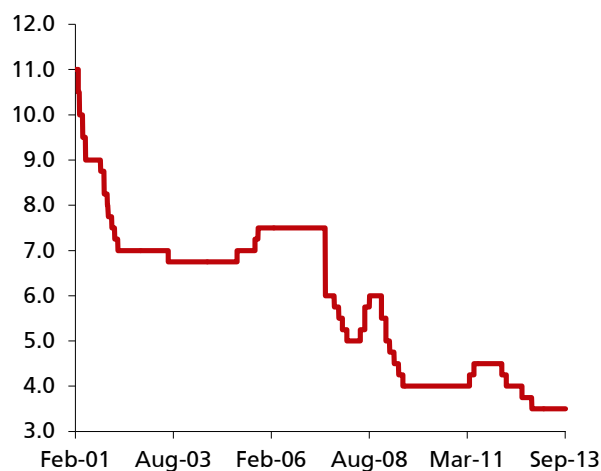
PH - nominal exchange rate

PHP per USD



PH – policy rate

%, o/n rev repo



VN: Regaining stability

- Growth has moderated while inflation has receded, prompting the central bank to end its monetary easing
- External balances, albeit lower, will remain in surplus
- Inflation remains on track to meet our forecasts of 6.7% and 6.8% for 2013 and 2014 respectively
- Growth forecasts remain unchanged at 5.3% for this year and 5.7% for 2014
- The State Bank of Vietnam will keep monetary policy steady

The State Bank of Vietnam (SBV) surprised the market with a devaluation of the official USD/VND by 1% to 21,036 and maintained the band within 1% from the official rate on 28 Jun13. That spooked the market, sending the VND spot to 21,243 despite reassurance by the central bank to stabilise the VND and to limit the extent of the depreciation in 2013 to about 2-3%. Nonetheless, the VND has managed to recover some lost ground amid the recent depreciation in the Asia currencies. It is currently trading at 21,140 at the point of this writing.

Improvement on the external balances

On hindsight, the devaluation was probably necessary. An aggressive rate cut cycle of about 800bps since early 2012 juxtaposed with concerns on the external balances warrant such an adjustment in the exchange rate. From a monetary policy perspective, the central bank has reached its limit on the interest rate front. The next policy option would then have to be the exchange rate. That said, we believe the downside risk to the currency will be manageable going forward. Stability is gradually taking hold again as policymakers persevere with this mantra in mind.

Chart 1: Percentage chg in Asian currencies. Jul-Aug

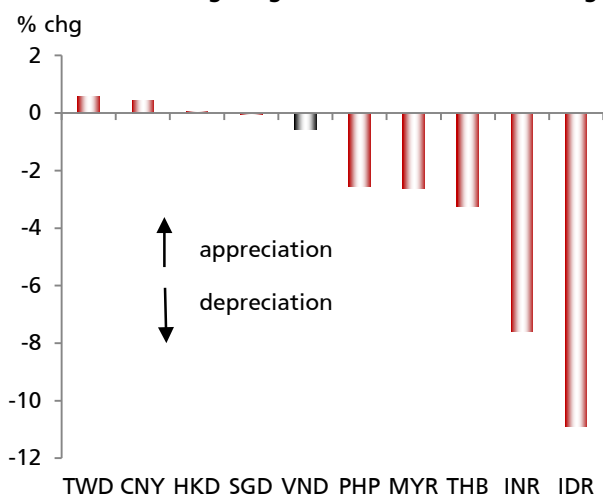


Chart 2: Trade def. improved amid weaker dong

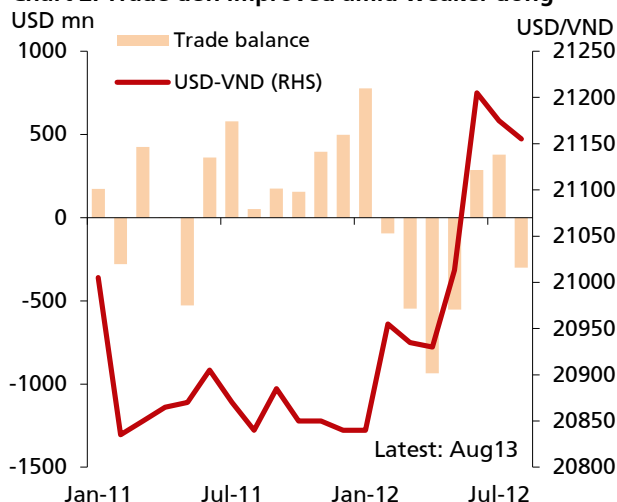
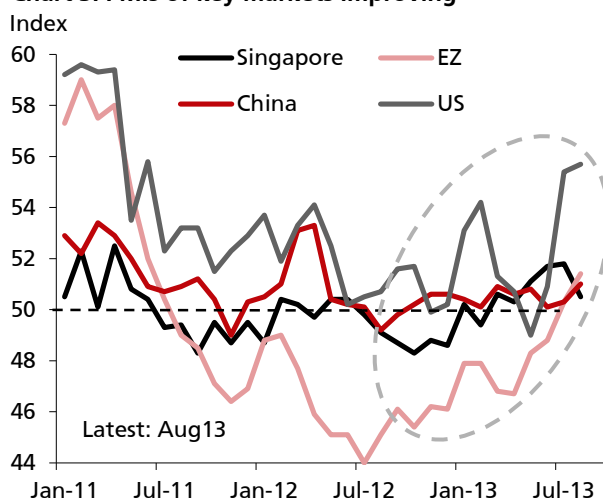
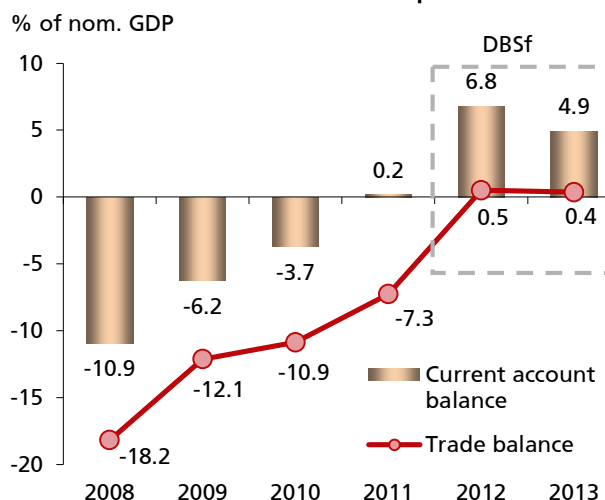


Chart 3: PMIs of key markets improving

Chart 4: External balance to remain positive


In fact, in the recent depreciation episode for Asia currencies, the VND is one of the least affected (Chart 1). While this is partly due to the fact that the VND is not a free floating currency and the authority exercises a certain degree of capital control to regulate outflows, the outperformance is also a reflection of confidence returning to the economy.

This is further buttressed by improvement on the external balance, in particular, the trade account. After four consecutive months of trade deficit, the trade balance turned into surplus in June-July (Chart 2). Though the account dipped into the red again in Aug13 and overall trade balance for the year is still in the deficit of about USD 578mn, the outlook on the trade account is expected to improve.

The PMIs of key export markets are improving (Chart 3). The Eurozone is technically out of recession. The US remains on this gradual recovery path. Though China is aiming for slower growth, the risk of hard-landing is remote. These makes for a steady improvement in the trade balance, which will also help to limit the depreciative pressure on the VND.

Trade balance to remain in surplus

We expect the economy to register a trade surplus of about USD 600mn this year, which should bring the current account surplus to about USD 8.6bn or 4.9% of nominal GDP (Chart 4).

Inflation to remain stable

CPI inflation increased to 7.50% YoY in August, up from 7.29% last month. On a sequential basis, consumer prices gained 0.83% MoM sa, reflecting increases in the overall food index, which account for 39.93% of the CPI basket. Hikes in fuel prices by about 2% on 17th July, the fourth of such hikes, also drove the housing and transport indices higher.

Vietnam is undergoing a fiscal consolidation exercise to ease the strain on the official coffers, particularly

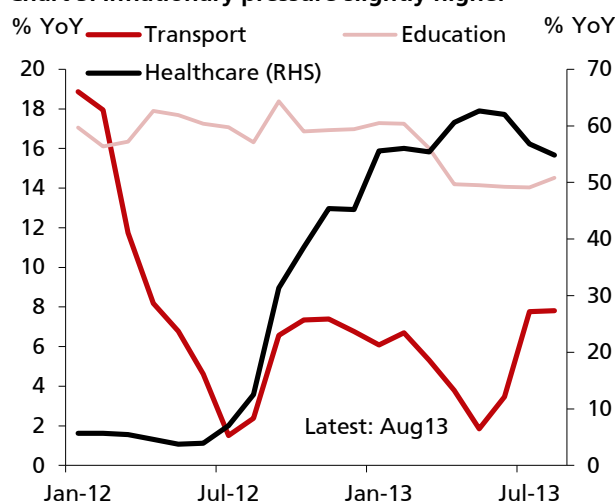
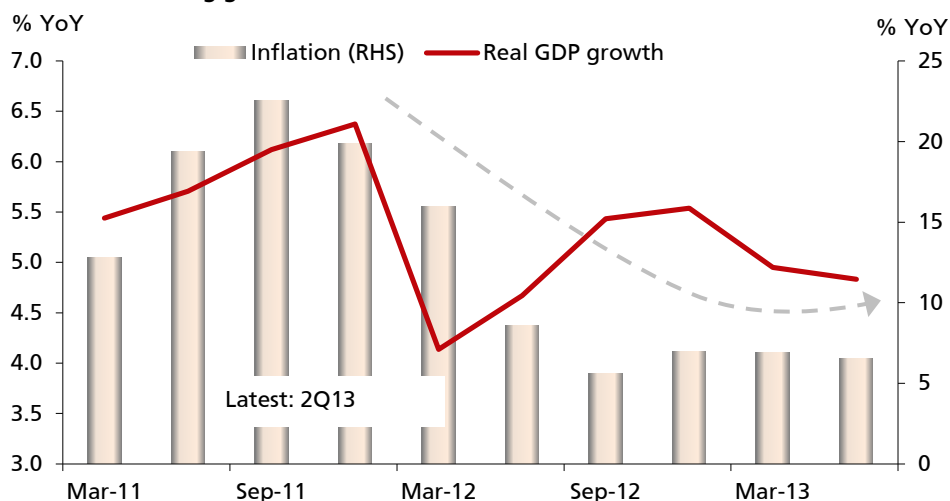
Chart 5: Inflationary pressure slightly higher


Chart 6: Balancing growth and inflation


Growth and inflation on track to meet projections

arising from a costly welfare subsidy programme. Both education and healthcare subsidies were shaved drastically in September last year, resulting in exceptionally high inflation in both sub-indices (Chart 5). Hence, the calibrated cuts in fuel subsidies this year is best viewed as part and parcel of near term fiscal rationalisation. Ultimately, the government still hope to achieve the fiscal deficit target of 4.8% of GDP although our view is that the final outcome will overshoot marginally to register 5.0%.

While the effort to shove up the fiscal position is encouraging, the risk on inflation should be closely watched. Transport, education and healthcare costs account for a total of 20.2% of the entire CPI basket. Though comparatively smaller to the food component, a spike up in these indices will surely affect the headline inflation. Yet, such policy effect should be transient and will not have a lasting impact on headline inflation as long as inflation expectations are anchored.

For now, inflation pressure remains manageable. We expect CPI inflation to ease modestly in the coming months on account of a favorable base effect. A drop to 6.0% in Sep13 is expected. On balance, full year inflation is still on track to meet our target of 6.7% in 2013 and 6.8% in 2014.

Striking the balance between growth and inflation

In the past, policymakers have often struggled to balance out the risk between growth and inflation. While there are still remaining concerns, particularly on the fiscal position, further devaluation and its associated inflationary impact, the economy appears to be finally striking a balance on both ends.

Though growth has been sluggish for the first half of the year (4.9%), inflation has finally receded and is stabilising (Chart 6). As long as policymakers continue to focus on consolidating the fiscal position, preventing deterioration on the external balances and keeping vigilance on inflation, economic stability will take firmer grip. Moreover, as global economic conditions improve, growth will most certainly pick up. For now, GDP growth remains on track to meet our expectation of 5.3% this year and 5.7% in 2014.

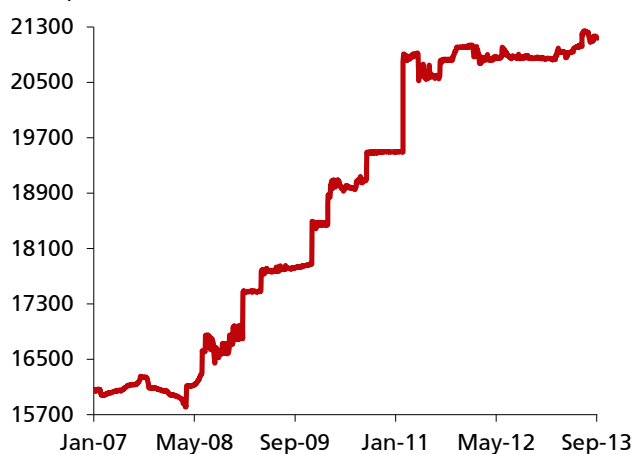
Vietnam Economic Indicators

	2012	2013f	2014f	2Q13f	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth	5.0	5.3	5.7	4.8	5.5	5.8	5.7	5.6	5.7
Real supply									
Agriculture & forestry	2.7	2.9	3.6	2.1	3.0	4.1	3.6	3.5	3.8
Industry	5.2	5.3	5.8	5.2	5.6	5.6	5.8	5.8	5.7
Construction	2.1	5.1	6.8	5.1	5.0	5.6	6.0	5.5	7.2
Services	6.4	6.1	6.3	5.9	6.3	6.5	6.3	6.3	6.3
External (nominal)									
Exports (USD bn)	114.4	131.5	144.5	32.7	33.7	35.4	33.8	36.1	36.8
Imports (USD bn)	112.4	130.8	143.1	33.9	33.6	33.8	33.6	37.7	36.3
Trade balance (USD bn)	2.0	0.6	1.4	-1.2	0.1	1.6	0.2	-1.6	0.4
Current account bal (USD bn)	10.6	8.6	9.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	6.8	4.9	5.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	9.3	6.7	6.8	6.6	6.9	6.3	6.5	7.6	7.2
Other									
Nominal GDP (USD bn)	156	174	192	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (% , sa, eop)	4.8	5.0	4.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % change, year-on-year, unless otherwise specified
- Figures may differ from official sources due to difference in reporting format

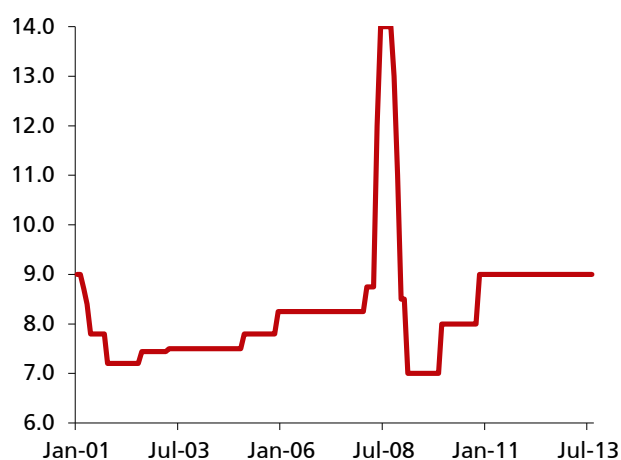
VN - nominal exchange rate

VND per USD



VN – prime interest rate

% pa



US: ISMs tease

- The ISMs have jumped but nothing else has
- Consumption growth has slowed to a 1% annualized rate; core capex is lower today than it was 16 months ago
- Where is the recovery everyone is talking about?
- Not in the labor market. Less than half the people who lost their jobs five years ago have them back again
- Housing is the key risk. Just the talk of tapering has sent interest rates sharply north and new home sales sharply south
- In the single month of July, one-third of the two year recovery in new home sales was wiped off the map

The ISM's – mnfg and services – have soared in the past two months. The service sector reading is now at 58.6, the highest since Jan05; the manufacturing version is back at 55.7, the highest in two years. Is the US off to the races?

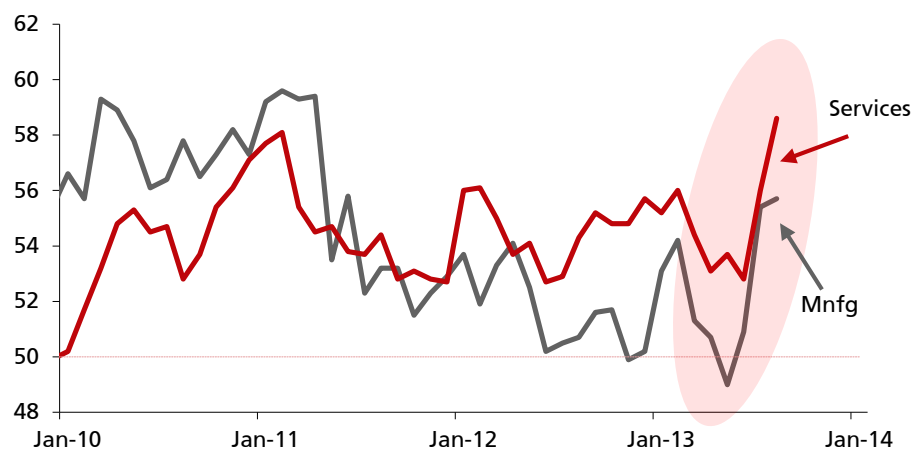
Probably not. The ISMs are not leading indicators, they are contemporaneous indicators at best. They are, for most intents and purposes, sentiment indicators that proxy the hard data. And the hard data itself doesn't look that good.

Industrial production, for example, didn't grow at all in July. It hasn't grown one iota in the past four months. How does that square with a jump in the ISM? It doesn't. The service sector ISM doesn't have a hard data equivalent on the supply side but the demand side data aren't shouting acceleration anywhere.

Consumption grew by 1.8% (QoQ, saar) in the second quarter, precisely what it's done for the past year. That's down from 2% on average over the past two years – a slowdown in other words. It gets worse closer to home. Over the past four months,

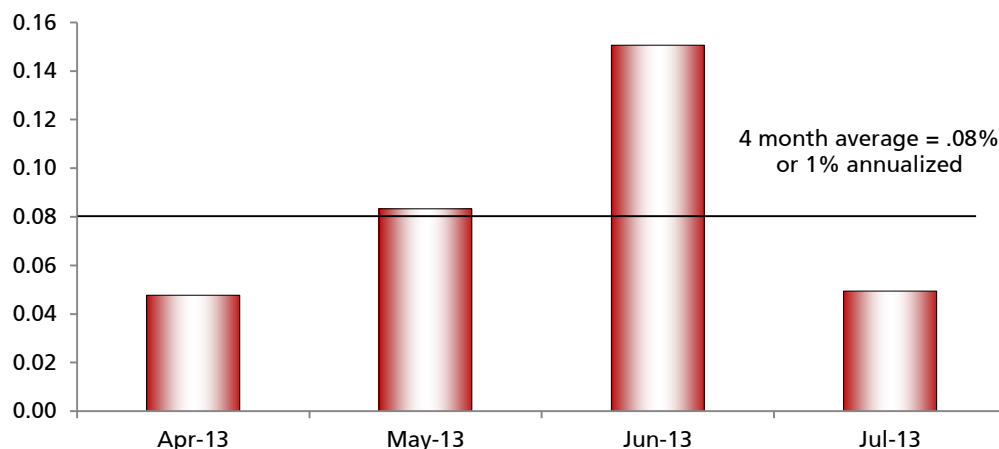
US – ISM surveys of manufacturing and non-manufacturing

Index, 50="neutral" (no growth)



US - real consumption growth

% MoM, sa, 09P



Consumption growth over the past 4 months has slowed to a 1% annualized rate

consumption growth has averaged but 0.08% per month, which compounds to less than 1% per year. Again: slower and slower, not faster and faster.

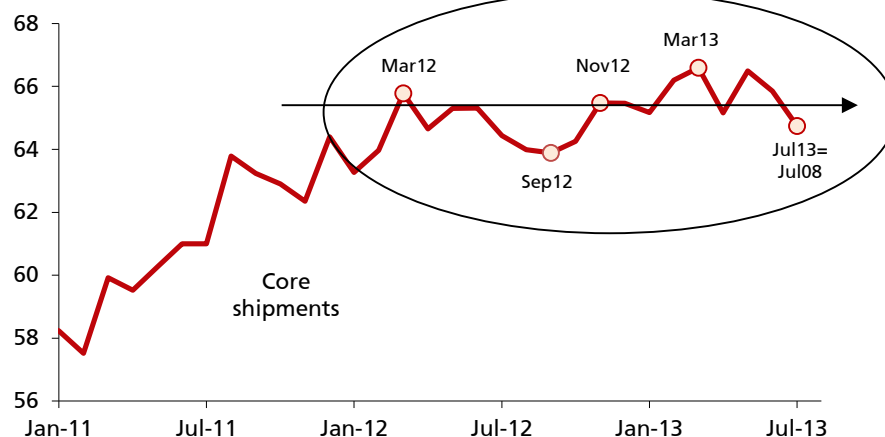
After consumption, investment is the most important demand category and, given that it's derived from consumption, it's no surprise that investment is flagging too. Core (non-defence, ex-aircraft) capital goods expenditures are running no higher than they were 16 months ago – zero growth for 5 quarters. And with consumption running even slower on the margin, odds are that capex will too before long.

Not for nothing has GDP growth disappointed in recent quarters. Yes, it popped by 2.5% (QoQ, saar) in the second quarter but growth has averaged a lowly 1.6% over the past four quarters and 1.3% over the past three.

What does Q3 hold in store? Given the monthly consumption profile shown above, Q3 consumption growth is likely to fall to 1.5% from 1.8% in Q2. We expect 2% growth in business investment and 6% growth in housing construction (discussed below). When government, inventories and trade are added to the mix, we reckon headline growth comes to only 0.6%. If we are correct, 4-quarter average GDP growth would fall to 1.1%, the slowest since Dec09.

US - core capital goods shipments

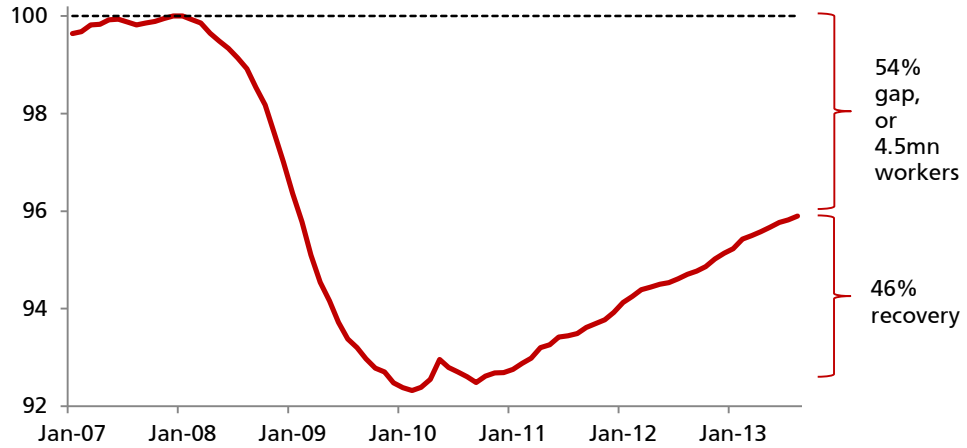
US\$bn/month, seas adj, non-def ex-aircraft



Core capex is lower today than it was 16 months ago

US – nonfarm payrolls, ex-restaurant, part-time, and healthcare

Jan08=100, sa



Less than half the people who lost their jobs in 2008/09 have them back again

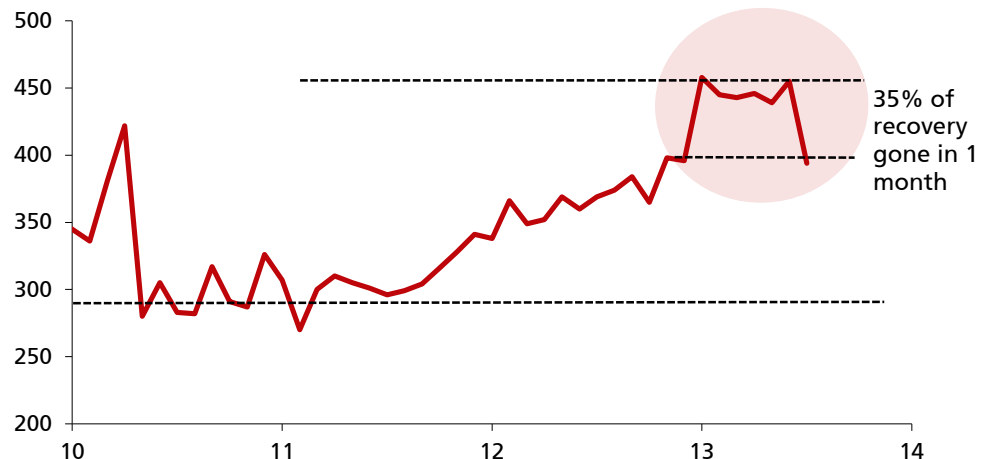
Labor markets

Most are now aware that the ‘improvement’ in the unemployment rate (currently 7.3%) over the past two years has come largely for the wrong reasons. In August, the labor force participation rate fell to a fresh 35-year low of 63.2%, highlighting the fact that large numbers of unemployed people are not being counted as such.

The issue isn’t just about properly counting the unemployed. The employment side of the equation, too, is much less rosy than appears on the surface. Much of the recovery in jobs is overstated by a rise in three sectors: healthcare, part-time jobs and restaurant workers. Healthcare workers were never laid off during the crisis; their numbers continued to grow, as they always do, in good times and bad. Such jobs are valuable and important but they greatly overstate the cyclical recovery. Restaurant and part-time workers do too. In the past six months, these two categories alone account for one of every three new jobs created in the economy. That’s not normal job growth; that’s people doing whatever it takes to put food on the table. If one removes these three sectors from the calculations, only 46% of the jobs lost in the 2008/09 downturn have been recovered five years after the fact. Such low

US – new home sales

thous, saar



In the single month of July, one-third of the two year recovery in the housing sector was wiped off the map

US Economic Indicators

	2012	2013(f)	2014(f)	Q1	--- 2013 ---				-- 2014 --		
					Q2	Q3 (f)	Q4 (f)		Q1 (f)	Q2 (f)	Q3 (f)
Output & Demand											
Real GDP*	2.8	1.4	2.1	1.1	2.5	0.6	2.0	2.1	2.5	2.7	
Private consumption	2.2	1.9	2.1	2.3	1.8	1.5	2.0	2.1	2.2	2.5	
Business investment	7.3	2.3	6.2	-4.6	4.4	2.0	6.0	6.0	8.0	8.0	
Residential construction	12.9	12.3	7.5	12.5	12.9	6.0	5.0	8.0	8.0	8.0	
Government spending	-1.0	-2.4	-1.2	-4.2	-0.9	-2.5	-1.0	-1.0	-1.0	-1.0	
Exports (G&S)	3.5	3.0	6.7	-1.3	8.6	7.1	6.5	6.5	6.5	6.5	
Imports (G&S)	2.2	2.2	6.1	0.6	7.0	6.0	6.0	6.0	6.0	6.0	
Net exports (\$bn, 05P, ar)	-431	-424	-437	-422	-422	-423	-427	-431	-435	-439	
Stocks (chg, \$bn, 05P, ar)	58	51	50	42.2	62.6	50.0	50.0	50.0	50.0	50.0	
Contribution to GDP (pct pts)											
Domestic final sales (C+FI+G)	2.5	1.4	2.2	0.5	1.9	1.0	2.1	2.3	2.6	2.8	
Net exports	0.1	0.0	-0.1	-0.3	0.0	0.0	-0.1	-0.1	-0.1	-0.1	
Inventories	0.2	0.0	0.0	0.9	0.5	-0.3	0.0	0.0	0.0	0.0	
Inflation											
GDP deflator (% YoY, pd avg)	1.2	1.6	1.8								
CPI (% YoY, pd avg)	2.1	1.6	2.0	1.7	1.4	1.6	1.6	1.8	2.0	2.0	
CPI core (% YoY, pd avg)	2.1	1.8	1.8	1.9	1.7	1.7	1.8	1.8	1.8	1.8	
PCE core (% YoY, pd avg)	1.8	1.4	1.6	1.5	1.2	1.3	1.4	1.5	1.5	1.6	
External accounts											
Current acct balance (\$bn)	-440	-489	-527								
Current account (% of GDP)	-2.7	-2.9	-3.0								
Other											
Nominal GDP (US\$ trn)	16.2	16.9	17.6								
Federal budget bal (% of GDP)	-6.5	-3.6	-3.8								
Nonfarm payrolls (000, pd avg)				182	145	160	175	180	185	190	
Unemployment rate (% , pd avg)				7.7	7.6	7.4	7.3	7.1	7.0	6.9	

* % period on period at seas adj annualized rate, unless otherwise specified

employment growth is likely to remain an important factor behind slow consumption growth and delay a return to normal monetary policy.

Risks

The biggest risk to the outlook is housing. Just the talk about Fed / QE tapering has sent interest rates, including mortgage rates, sharply north and mortgage applications sharply south. In July, new home sales fell by 13.4% from June levels. In that single month, one third of the two year recovery in the housing sector was wiped off the map. The risks to growth, consumer and market sentiment and central bank policy all lie first and foremost with housing. Any further declines in the months ahead could put Fed tapering – which has already been delayed by the weak August labor reports – on hold indefinitely.

Markets have a first Fed hike priced in for late-2014. The risk is that hikes come later, not sooner

JP: Tough choices

- Abenomics is facing challenges in pushing fiscal and structural reforms
- We expect a consumption tax hike next year
- GDP is expected to slow to 0.9% in 2014 from 1.8% this year from the trade-off between fiscal consolidation and economic growth
- On structural reforms, gradual and piecemeal changes are more likely than radical and comprehensive ones

The economic effects of the first two arrows of Abenomics – monetary policy easing and fiscal policy expansion – are immediate and significant. GDP growth has been boosted to 3-4% QoQ saar in 1Q and 2Q (Chart 1). Private consumption, investment, public spending and exports all increased in the past two quarters.

We expect GDP growth to stay strong at 2% QoQ saar in 2H13. Both domestic demand and exports should be supported in the next 2-3 quarters, taking into account the continued disbursement of supplementary budget and the lagging effects of yen depreciation.

Attentions turning to the third arrow – structural reforms

As the first two elements of Abenomics are already in place, market is now turning its attention to the third and the most crucial element – structural reforms. An outline of structural reforms was announced in June, which lacked bold and concrete measures and disappointed markets. Investors are now awaiting the 2nd part of the reform plan, which will be released this autumn.

Adopting structural reforms to directly boost the supply-side growth is crucial for Japan. The country's potential growth rate has fallen sharply over the past two decades, from more than 4.0% in the 1980s to less than 1.0% in the 2000s (Chart 2). The

Chart 1: GDP growth rose strongly in 1H13

% QoQ saar, ppt

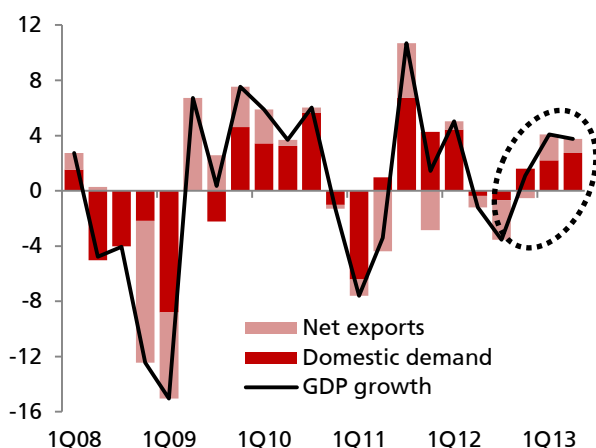
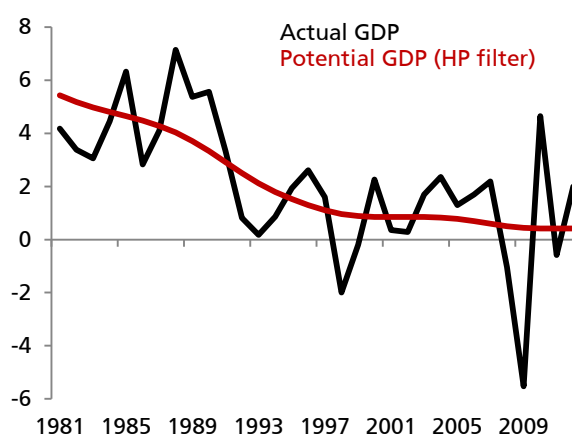


Chart 2: Potential growth fell sharply

% YoY



deterioration in demographics was not the only factor weighing on the economy. The growth of gross fixed capital formation also fell sharply from more than 5.0% in the 1980s to -1.8% in the 2000s. Meanwhile, the OECD estimated that growth in multiple factor productivity slowed from 3% to 1%. In light of the sharp and broad-based deterioration in input factors on all the fronts (labor, capital and productivity), full-fledged reforms are needed in Japan to reinvigorate its economy.

Pursuing comprehensive reforms is often controversial. For instance, the effective ways to boost investment and productivity include reducing the market access barriers for foreign investors (especially in the services sector), easing rules for starting new business, and improving the labor market flexibility. The short-term side effects are that some small companies might be squeezed out from increased competition, with some employees losing job security and/or benefits. Resistance from the vested interest groups could be strong.

Some other reform issues, such as boosting the labor participation rate of females and introducing immigration, would involve significant social changes. The existence of social pressures is another reason why we think gradual and piecemeal reforms are more likely than radical and comprehensive ones.

The centerpiece of the reform outline announced in June is trade liberalization. Japan has formally joined the Trans-Pacific Partnership (TPP) free trade talks in July. In the face of strong pressures from domestic farm lobby, however, Japan is insisting to maintain high tariffs on its agricultural imports during the TPP negotiation. On the other hand, Japan is seeking a tariff reduction on its automobile and other manufacturing exports to foreign countries. The half-hearted commitment to trade liberalization complicates the TPP negotiation process. It will be rather challenging for the 12 participating countries to meet the target of signing a pact within this year. The final TPP agreement, when achieved, might also be less comprehensive and less ambitious than initially envisioned.

Reforms face social pressures, as well as resistance from vested interest groups

... and fiscal reforms

Besides structural reforms, Japan's fiscal reform plan has also caught investors' attention. The government needs to make a final decision (by October) on whether to hike consumption tax next year. Based on the current schedule, consumption tax will be raised from 5% to 8% in April 2014, and then to 10% in October 2015. This is seen as an important step towards reducing fiscal deficit and fixing public finances.

Chart 3: GDP growth contracted in 1997 after the consumption tax hike

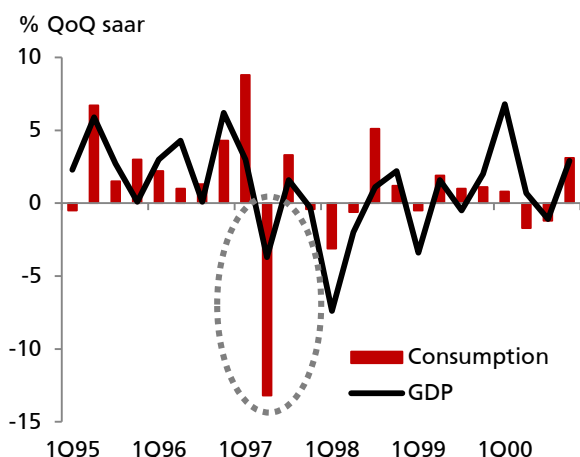
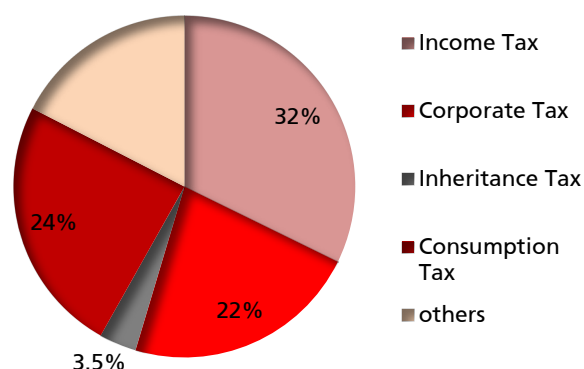


Chart 4: Composition of government tax revenues



A 3ppt consumption tax hike has been factored into our forecast

In the short-term, however, tax hikes will inevitably engender some negative impact on economic growth. Back in 1997 when the consumption tax was raised by 2ppt in April, GDP growth contracted sharply and immediately by -3.7% QoQ saar in 2Q. The economy slipped into a 3-quarter long recession in late-1997, when exports also started to deteriorate as a result of the Asian financial crisis (Chart 3). Based on past experiences, if the consumption tax is raised by 3ppt in April 2014, the annual GDP growth next year will likely be cut by one full percentage point. Hence, balancing the dual goals of fiscal consolidation and economic growth will be challenging.

Meanwhile, government decisions on corporate tax issues are also being watched closely. The business lobby is calling for a reduction in corporate tax rate towards the global average of 24% from the current level of 38%. Cutting tax, however, carries the risks of a loss in government revenues and a further deterioration in fiscal position. Corporate tax is a large source of government revenues in Japan, contributing as much as consumption tax (Chart 4). Lowering the corporate tax rate to 24% is estimated to cost the government JPY 4trn, which erodes the effects of a 2ppt hike in the consumption tax rate.

Moreover, there is no guarantee that a corporate tax cut will have long-lasting impact on investment and GDP growth. High tax is not the only factor hindering corporate investment in Japan. Inefficient government bureaucracy, policy discontinuity and restrictive labor market regulations are also problematic factors for doing business, according to various international surveys. A reduction in corporate tax, if it proceeds, should be complemented with a package of reform measures to improve the environment of doing business in Japan.

In our base case scenario, we expect the 3ppt consumption tax hike to be implemented in April 2014 as scheduled. Meanwhile, we expect the government to choose targeted and temporary tax breaks to boost corporate investment, rather than making a broad and permanent cut in the corporate tax rate. We have not factored in the possibility of additional spending in the FY2014 budget to cushion the impact of consumption tax hike.

What if it disappoints?

Delivering credible structural and fiscal reforms is crucial to preserve investor confidence about Japan's long term economic outlook. The financial markets are forward looking. The heightened volatility in the stock and currency markets in recent months suggests that investors have started to question the future effects of Abenomics, which so far has mainly relied on the short-term stimulus measures of monetary and fiscal policy easing.

Without reforms to restore competitiveness and address the deterioration of potential growth, Japan's recovery may lose momentum sooner or later and the Bank of Japan (BOJ) would face the pressure to ease further. This is against the global backdrop that the US's recovery is on track and the Fed is preparing to reduce QE and eventually normalize monetary policy. As a result of unfavorable growth and interest rate differentials, capital outflows from Japan could increase.

Fiscal reforms are also important. The consumption tax hike is recommended by the IMF. It is also viewed by international rating agencies as an important first step for Japan to restore its fiscal health. A delay or a moderation of consumption tax hike may undermine investor confidence over Japan's high debt. This is especially because the BOJ is now aggressively purchasing government bonds under the QQE program. Relaxing the target of fiscal consolidation would create perception of public debt monetization, which in turn, carries the distinct risks of pushing up government bond yields and undermining confidence in the currency.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts are transformations).

Japan Economic Indicators

	2012	2013f	2014f	2Q13f	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth	2.0	1.8	0.9	1.2	2.7	2.9	2.5	0.7	0.4
Private consumption	2.3	1.9	-0.3	1.8	2.5	2.4	2.5	-1.3	-1.3
Government consumption	2.4	1.6	1.7	1.8	1.8	1.6	2.0	1.6	1.6
Private & public investment	4.1	1.6	1.0	1.2	2.4	2.0	1.7	0.5	0.8
Net exports (JPYtrn, 05P)	9.0	10.0	12.0	2.6	2.7	2.7	2.7	3.0	3.2
Exports	-0.1	2.9	6.1	-0.3	5.7	10.1	7.4	5.7	5.7
Imports	5.4	1.8	4.2	0.8	1.5	4.6	4.6	4.1	4.1
External (nominal)									
Merch exports (JPY trn)	64	70	75	18	18	18	18	19	19
- % YoY	-2.7	9.2	7.2	7.1	13.1	15.9	9.6	6.5	6.7
Merch imports (JPY trn)	71	78	82	20	20	20	20	21	21
- % YoY	3.8	11.0	5.1	10.5	13.1	12.7	4.6	4.6	4.9
Merch trade balance (JPY trn)	-7	-9	-8	-2	-2	-2	-2	-2	-2
Current acct balance (USD bn)	60	58	63	-	-	-	-	-	-
% of GDP	1.0	1.2	1.4	-	-	-	-	-	-
Foreign reserves (USD bn)	1,268	1,257	1,239	-	-	-	-	-	-
Inflation									
CPI, % YoY	0	0.3	2.4	-0.3	0.9	1.0	1.1	3.5	2.6
Other									
Nominal GDP (USD bn)	5,962	4,961	4,620	-	-	-	-	-	-
Unemployment rate (% , sa, eop)	4.3	4.0	4.0	3.9	4.0	4.0	4.0	4.0	4.0
Fiscal balance (% of GDP)	-9.0	-8.0	-6.8	-	-	-	-	-	-

* % change, period-on-period, seas adj, unless otherwise specified

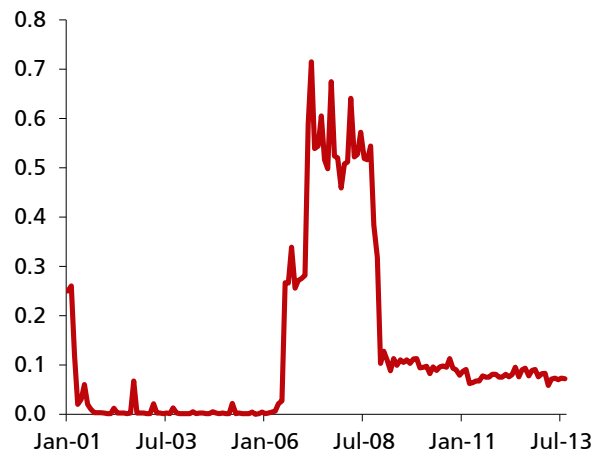
JP - nominal exchange rate

JPY per USD



JP - policy rate

%, call



EZ: Cautious optimism

- Growth is on a mend, but expectations of a V-shaped recovery are premature
- Developments in Greece in focus; highlights that growth is necessary for austerity to succeed
- Pressure to build on ECB to walk the dovish talk; bond yields have risen albeit not uniformly
- Despite the celebratory mood, progress on the banking union needs to be followed up

The mood has perceptibly changed in the Eurozone. Better-than-expected 2Q13 growth numbers and sustained improvement in the confidence indices have revived hopes for a stronger 2H13. The scale of contraction in 2Q headline GDP halved to -0.5% YoY vs the previous quarter. On seasonally adjusted basis, the region emerged from recession after six quarters, with output up +0.3% QoQ from average -0.2% last year (Chart 1).

Besides significant weakness in the investment activity, the other drivers of growth registered modest improvements. Household spending posted a smaller contraction of -0.9% in 1H13 (vs -1.4% in 2012) with government spending defying expectations to see flat growth in 1H (vs -0.6% in 2012). This was in contrast to -5.6% slump in gross capital formation, slipping away from -3.7% in 2012. In the meantime, the external sector did not look exciting. Along with the slippage in export growth, imports were also chipped away on the back of slower capital and consumption goods. Accordingly, net exports slowed to 1.6% in 1H (vs 3.6% last year).

Looking ahead, things are on a mend, though hopes for a V-shaped recovery could prove to be premature. Business and consumer confidence have sustained the upside momentum, with production activity also receiving a hand from restocking

Chart 1: GDP growth - stronger 2H13?

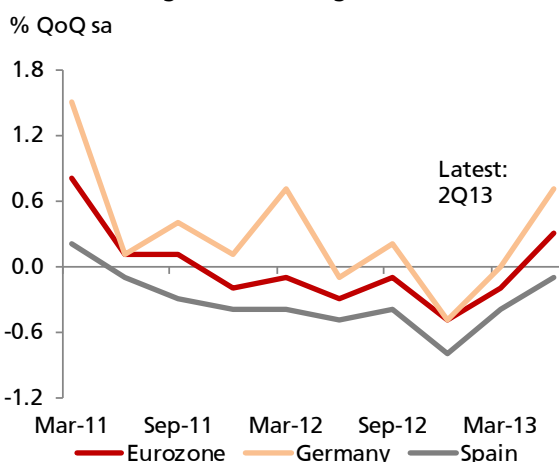
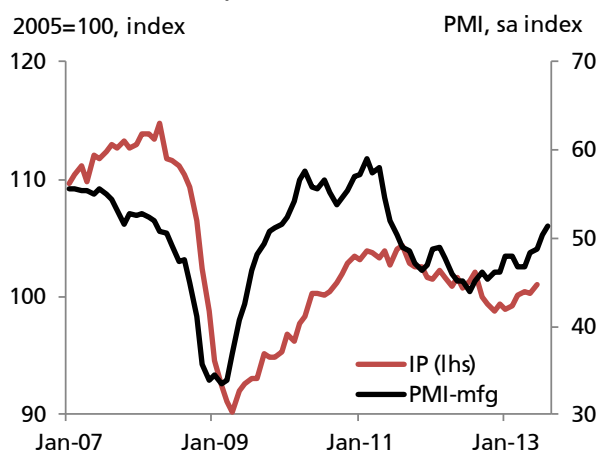


Chart 2: Production, PMIs on the mend



needs. PMI-manufacturing also staged a decent recovery to Jul-Aug13 average at 50.9, firmest in eight quarters and up from the bottom of the cycle at 45.1 in 3Q12 (Chart 2). While production has shown signs of recovery, drawing private sector interests in a significant fashion will be challenging amidst weak demand conditions, lack of public capex spending and tough credit standards. Household spending has benefited from manageable inflation and easy monetary policy, though remains hamstrung by high jobless rates which continues to erode purchasing power. Hence the early signs of an upturn in economic activity are likely to gain traction in rest of the year, but the pace will be gradual. Factoring in these factors and possibility of a firmer 2H, we revise our annual estimates to -0.4% for 2013 (up from -0.6% earlier) and +0.5% for 2014 (from 0.1%).

Growth to recover, but no quick rebound

There was more good news under the hood. Pick-up in 2Q growth was noted across the member countries, albeit by varied measure. While Germany, France and Portugal emerged from recession, output in Spain and Italy still fell but shallower contraction than previous quarter. This suggests that while things might have turned a corner on growth, the pace of recovery across the zone will be dictated by different levels of domestic debt, varied competitiveness, inflation and unemployment levels.

Developments in Greece are of interest in this regard as signs emerged of a possible third tranche of bailout funds to aid the economy to meet its 2014-16 debt obligations. While the ECB and Germany played down these expectations, a clearer image is likely to emerge after the German elections due in late-September. Despite the nuances, growth is necessary for austerity plans to succeed and the balance is more adversely tilted for Greece than most other member countries. The economy contracted -6.4% in 2011-12 before improving modestly to -5.3% in 1H13.

Simultaneously, government debt as a % of GDP has jumped from 148% last year to 160% by Mar13 (Chart 3). While there has been a focus to raise revenues, the state needs to undertake spending cuts to make meaningful progress on the debt side of the equation. However, the social costs of the austerity measures have been significant as headline unemployment rate runs at 27%, with the youth measure at above 60%. The Troika is scheduled to take stock of the current financing arrangement in Nov13 and will have to finalise further funding plans by mid-2014 when the existing arrangement draws to a close.

ECB in a tight spot

Signs of stabilization in incoming data have complicated policy direction for the ECB. Just as the central bank drums up its dovish forward guidance, short-term rates and

Chart 3: Greece - debt levels on the rise

as % of GDP

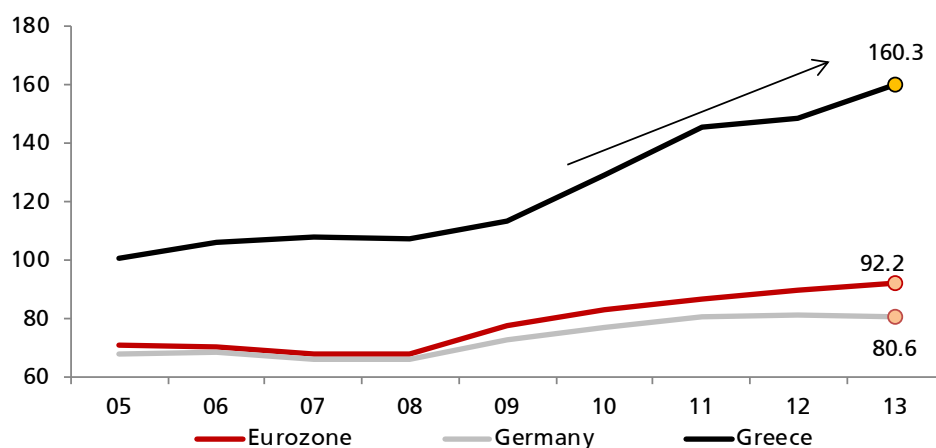
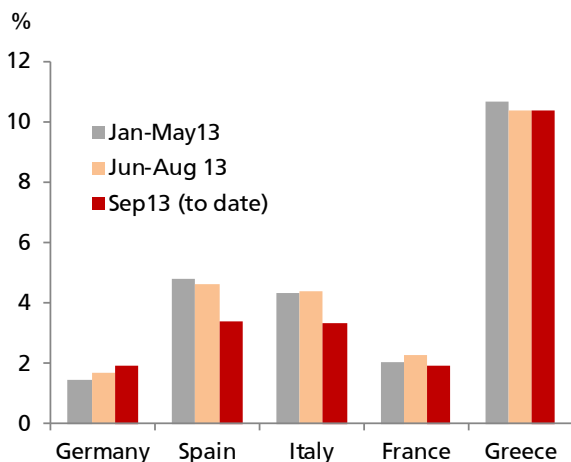
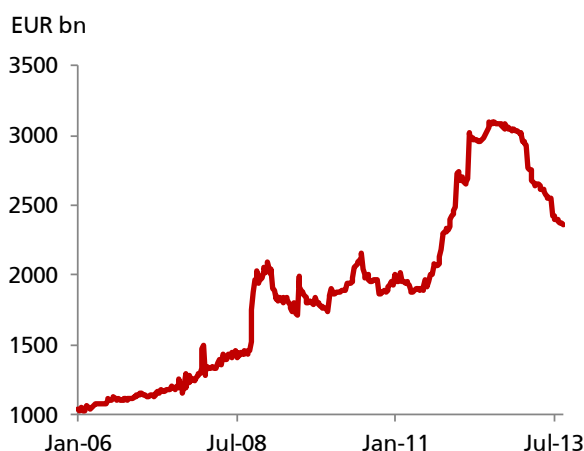


Chart 4: Movement in bond yields not uniform

Chart 5: ECB balance sheet narrows


bond yields have been inching up. The overnight EONIA averaged 0.09% between Jun-Aug13, up from 0.07% in Jan-May13. The rate briefly breached 0.10% on a few occasions since Jun13. In addition, the long-term bond yields have also inched up, but the uptick has not been uniform (Chart 4). The member countries where incoming data has supported the recovery agenda saw their rates inch up faster than the others. For instance, from 1.43% average in Jan-May13, Germany's 10-year yield inched up towards 2% in Sep13. This was in contrast to flattish movement in Greece's from 10.7% (Jan-May13) to 10.4% in Sep13.

A confluence of factors has distorted the linkage between rates and the central bank's guidance. Firstly, uncertainty over the Fed QE tapering exercise and the subsequent pressure to normalize rates has been the major driver of the uptick in the interbank and borrowing costs. With expectations on the rise for the asset purchases to be scaled back at the September FOMC, this might provide a floor to the Eurozone's rates. Secondly, liquidity conditions have been tightened by LTRO repayments. Excess liquidity has narrowed from EUR 800bn to EUR 250bn, closing in on the loosely mentioned EUR 200bn threshold. However, at the September review ECB President Draghi said he drew confidence from the shrinking excess liquidity which could be interpreted as narrowing of fragmentation risks. Hence the point at which the reduction in excess liquidity pushes short-term rates decisively higher and threaten the inflation outlook might be lowered, to possibly EUR 100bn. Likewise, the central bank's balance sheet has also narrowed by 21% (Chart 5).

Looking ahead, if the short-term rates continue to climb, the pressure on the central bank will build to back-up the dovish assurances with directed action. The first line of defence will be to cut the main refinancing rate further. A cut in the main refinancing rate could be accompanied by a reduction in the deposit facility rate to negative, a first for the zone. Secondly, collateral rules for loans extended to small and medium enterprises could be eased and more liquidity-enhancing measures like the LTROs. Finally, taking a leaf off US Fed's book, the ECB could also set economic thresholds that might provide the markets with a clearer framework of trigger points for a reversal in the policy bias. Understandably this will be a cumbersome exercise given the economically divergent member countries'. Nonetheless, this will provide the markets with clear thresholds for subsequent policy action.

In sum, the falling responsiveness of money and bond markets to the central bank's dovish stance might necessitate outright policy action. But the latter will be difficult to justify ahead of the German elections that are due in two weeks and gradual improvement in economic data. Status quo is likely for the year, with the ECB to

Confluence of factors has distorted linkage between rates and the ECB guidance

show their hand if the premature rise in the interbank rates are seen as a threat to the already weak loan growth and broader still-fluid growth conditions.

Structural reforms should not be abandoned

Despite the celebratory mood on the zone's growth prospects, eyes should not be off the ball. Talks of the banking and fiscal union had reached fever-pitch in midst of the 2011-12 crisis, with a follow-through imperative to prevent a revisit of the zone's break-away prospects and quell questions on the longevity of the common currency.

Of the two, plan to create a banking union has made some progress. A broad consensus was reached that the ECB will be the centralised agency under whom the Single Supervisory Mechanism (SSM) will be established. This could be made official around 3Q14. The next step is the establishment of the Single Resolution Mechanism (SRM), which covers the aspects of winding down the banks and funding the rescue process, which understandably has attracted divergent views from the Eurozone community.

The ECB and the European Commission have shown a preference for a common body to prevail through the process, though the bigger member countries' prefer these to be left with the national governments. While negotiations are ongoing, the progress should gain momentum after the German general elections. The resolution of the SRM will be followed by the zone-wide deposit guarantee. As an end-game, it is important to sever the linkage between the banking system and the sovereigns, which could set-off the negative feedback in the event of another financial crisis.

Progress on banking union important to break linkage between sovereigns and banks

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts are transformations).

Eurozone Economic Indicators

	2012	2013f	2014f	2Q13	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f
Real output and demand									
GDP growth (05P)	-0.5	-0.4	0.5	-0.5	-0.2	0.3	0.5	0.3	0.4
Private consumption	-1.4	-0.5	-0.2	-0.6	-0.4	0.1	0.2	0.0	-0.1
Government consumption	-0.6	-0.2	0.1	0.3	0.0	-0.4	0.1	-0.3	0.2
Gross capital formation	-3.7	-2.8	-0.9	-3.5	-1.6	-0.9	-0.2	-0.4	-0.4
Net exports (EURbn)	326	380	395	92	95	95	95	95	95
Exports (G&S)	2.7	1.8	3.0	0.7	0.7	3.4	5.0	3.3	2.6
Imports (G&S)	-1.0	3.0	2.0	-0.4	-0.2	3.0	4.1	2.7	2.3
Contribution to GDP (pct pts)									
Domestic final sales (C+FI+G)	-2.2	-1.0	0.1	-1.0	-0.5	-0.2	0.1	-0.2	-0.4
Net exports	1.7	0.6	0.4	0.6	0.5	0.3	0.6	0.4	0.3
External accounts									
Current account (EUR bn)	127.3	140.0	100.0	na	na	na	na	na	na
% of GDP	1.2	1.5	1.0	na	na	na	na	na	na
Inflation									
HICP (harmonized, % YoY)	2.5	1.5	1.4	1.4	1.5	1.5	1.5	1.5	1.5
Other									
Nominal GDP (EUR trn)	9.5	9.6	9.8	2.4	2.4	2.4	2.4	2.5	2.5
Unemployment rate (% sa, eop)	11.4	12.4	12.2	12.2	12.1	12.0	12.0	12.0	12.0

* % change, period-on-period, seas adj, annualised unless otherwise specified

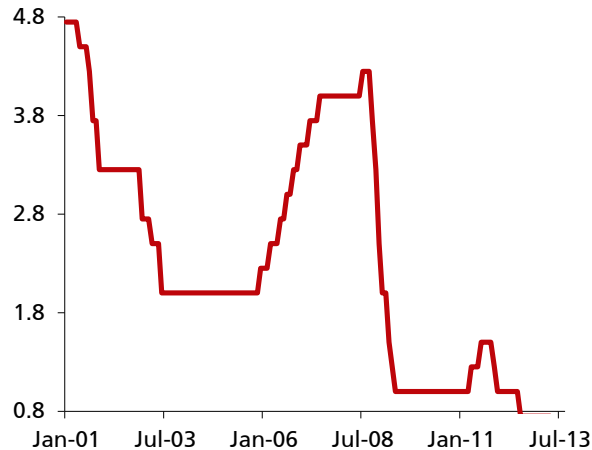
EZ - nominal exchange rate

USD per EUR



EZ – policy rate

%, refi rate



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