ECONOMICS BRIEFING

number 03

DBS Asian Insights

DBS Group Research • September 2013

Changing Gears

The Impact of a Slower China

DBS

04 **Overview**
What's Behind the Slowdown?
The Changing Nature of China's Growth
Winners and Losers

07 **Manufacturing**
Exports Make a Comeback
Opportunities Remain
China's Auto Market Resilience

12 **Tourism**
Visitor Arrivals Remain Resilient
Chinese Still Spending Abroad

17 **Property**
Normalizing the Property Market
Impact on Property Developers

20 **Commodities**
Extended Down-cycle
Selective Rebound Potential

24 **Currencies**
Policy Priorities
Asian Currencies

27 **Economic Indicators**
GDP & Inflation Forecasts
Policy & Exchange Rate Forecasts

Changing Gears

The Impact of a Slower China

David Carbon
Chief Economist
davidcarbon@dbs.com

Philip Wee
Senior Currency Economist
philipwee@dbs.com

Chris Leung
Senior Economist
chrisleung@dbs.com

Irvin Seah
Economist
irvinseah@dbs.com

Ma Tieying
Economist
matieying@dbs.com

Eugene Leow
Economist
eugeneleow@dbs.com

Radhika Rao
Economist
radhikarao@dbs.com

Joanne Goh
Regional Equity Strategist
joannegohsc@dbs.com

Herbert Hui
Analyst
herbert_hui@hk.dbsvickers.com

Executive Summary

China's economy is at a turning point. The government's plans to reduce the economic reliance on exports and low-cost labor, and a new emphasis on consumption and the private sector as drivers of growth, will have significant ramifications not only for China's citizens and businesses, but also for its regional and global trading partners.

While the end of the decades-long era of double digit growth has had a visible impact on demand for products such as hard commodities, the moderation and broader structural reforms within China will have a more nuanced impact on other sectors of the Asian economy. In a sign that the world's second-largest economy is stabilizing, China's manufacturing has picked up steam, which is good news for Asian exports. And while tourist arrivals in other Asian countries are not accelerating, they continue to climb higher despite the slowdown. Meanwhile, the outlook for Asia's property market remains cloudy, with property prices in China continuing to soar even as the economy slows.

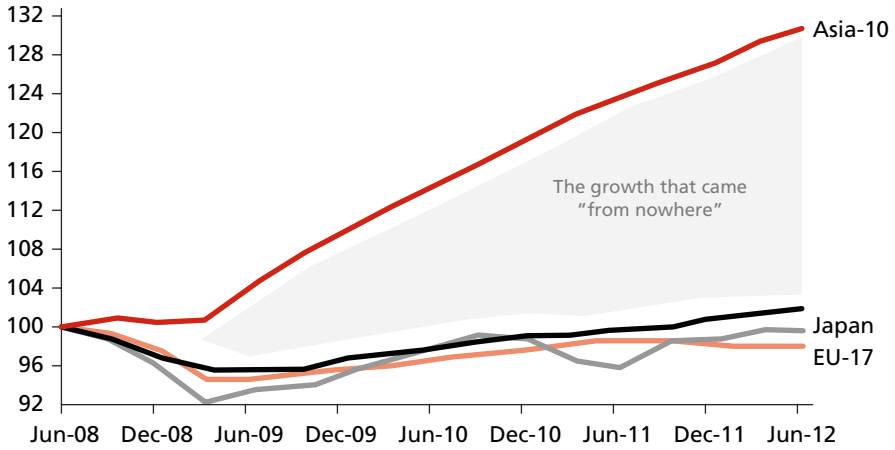
Investments in mature Asian real estate markets may take a hit. Finally, despite slower growth prospects, the yuan remains relatively stable.

It is a mixed outlook that will have an uneven impact on Asia. While mature exporting economies of Northeast Asia have a deeply coupled relationship with China's growth, developing economies in Southeast Asia have been somewhat slower in tapping Chinese demand for some goods and services and hence still have room to grow in some sectors. Nonetheless, China's engineered slowdown to support more sustainable growth will continue, and the rest of Asia stands to benefit from the long-term gains, provided it can ride out the short-term pains.

Overview

China's emergence as a global economic force has taken place at a much faster pace than most people imagined. Before the onset of the global financial crisis in 2008, most observers believed Asia's growth was intractably linked to the US consumer and that if she ever died, so too would Asia. History has proven them wrong: in the four years that followed the collapse of Bear Stearns in June 2008, the economies of the US, Japan and Europe went nowhere. Meanwhile, Asia's economic expansion over this period is the same size as the entire German economy, and China accounted for 70% of this addition.

1 Real global GDP
2Q08=100, seas adj



New normal

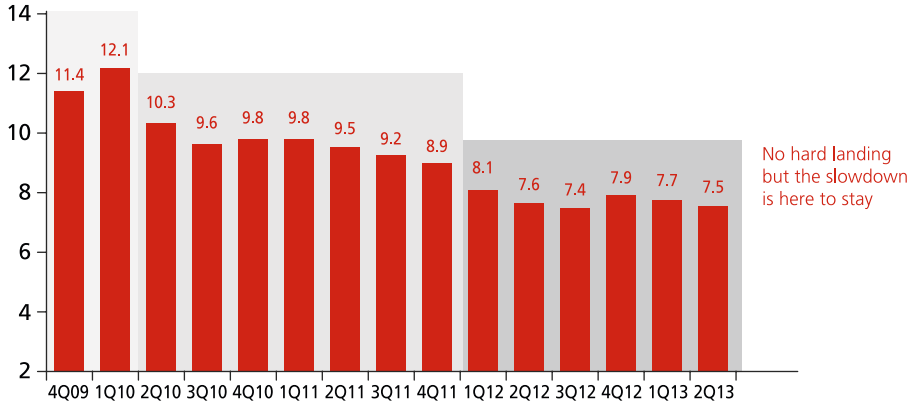
China's role as a new driver of global demand raises an important question: what happens to both the Asian and global economies when China decelerates and sub-double-digit growth becomes the "new normal"? This question is no longer academic: since the start of 2012, China has indeed slowed considerably. China's double-digit growth was a storied and persistent feature of the three decades of development that followed the brave new economic reforms of the early 1980s. The transition to single-digit growth took place in 2010 and 2011 and growth has averaged 7.6% since early-2012. Many have wondered about the risk of a "hard landing", an event that would, by definition, have severe repercussions across the region.

No hard landing

The good news is a hard landing seems ever more unlikely as time goes by. Not only did growth run at 7.6% for five consecutive quarters, but much of the slowdown has been intentionally engineered, as the new leadership clears the decks and overhauls the engines for the next growth phase.

The bad news is most of the slowdown seems likely to be permanent. The "next" growth phase was made necessary precisely because the old one had run out of steam. And growth phases run progressively slower as countries mature.

2 China - GDP growth
% YoY



If China wants to grow as fast as it possibly can, it needs to tear down the walls, gut the rot and restructure the beams

What's Behind the Slowdown?

China's slowdown has in large part been intentionally engineered by the authorities, which is the main reason we believe a hard landing seems unlikely. Why would the authorities want slower growth?

New value proposition

It's not so much that they want it – no one does – it's a matter of accepting the inevitable. Economies slow as they mature. When you're young and importing loads of technology and knowledge from abroad, productivity grows rapidly. If you don't charge much for your output, GDP also grows quickly. But as wages and incomes rise, and as countries move ever closer to the edge of existing technological capability, the ability to make big jumps fades. Productivity and GDP growth slow. It's the economic facts of life for any developing country: a high income US or Japan cannot grow as fast as a Vietnam or a China, even when they are doing all the right things.

If China wants to grow as fast as it possibly can, it needs to tear down the walls, gut the rot and restructure the beams. It needs to figure out what the country one rung above it on the technological ladder is doing and try to do it better and cheaper. China needs to quickly take the cake of the guy above because the guy one rung below it is trying to take China's. It's not graceful and it's not optional – it's move up or move out.

Plainly, fiscal and monetary policies cannot gut the rot and restructure the beams. They can postpone the inevitable, but in the meantime productivity growth and potential GDP continue to fall, not rise. This is why the authorities have refrained from offering short-term stimulus: it's counterproductive when the economy needs an overhaul.

The Changing Nature of China's Growth

For the past 15 years, China has pursued a growth model centered largely on exports and investment, situated mainly along its Eastern seaboard. But wages have risen, productivity growth has fallen, much of the investment was wasteful and Eastern coastal areas have

China has to raise the importance of consumption as a driver of GDP and lower the importance of exports and investment

become heavily polluted. The new leadership believes that change is needed and the sooner the better.

China's to-do list of structural changes is wide and deep. On the macro side, key changes to the real economy include raising the importance of consumption as a driver of GDP and lowering the importance of exports and investment. Changes on the financial side include interest rate and currency liberalization, globalizing the renminbi and opening the capital account (which a globalized renminbi requires). Other chores include writing down bad debts in the financial sector, raising supervision of so-called shadow banks and reforming the tax code. These are all big changes that won't be accomplished easily or without risk.

Microeconomic changes include reducing the importance of state-owned enterprises (SOEs) in the economy and pension and healthcare reform. China's push to urbanize the population – aimed at raising the productivity of social investment – will be the biggest in history if it succeeds. From a sectoral perspective, capacity is to be cut in steel and other metals, concrete and paper in order to make way for more investment in airports, urban transport, shipping and energy.

3 Structural changes ahead for China

Macro changes		Micro changes
Real economy	Financial economy	
1. Raise consumption as a driver of GDP 2. Lower exports as a driver of GDP 3. Lower investment as a driver of GDP	1. Clean up bad debts 2. Interest rate liberalization 3. FX liberalization 4. Globalize the renminbi 5. Open capital account (implied by 4) 6. Raise supervision of shadow banks 7. Tax reform	1. Lessen role of state-owned enterprises in the economy 2. Pension / social security reform 3. Healthcare reform 4. Urbanization 5. Inland development versus coastal areas 6. Lower production capacity of steel, aluminum, other metals, concrete and paper 7. More private investment in airports, urban transit, energy and shipping 8. Allow more private capital in banking

Winners and Losers

All countries in Asia remain vulnerable to a slowdown in China: from joined-at-the-hip Hong Kong to increasingly integrated Taiwan; from high-tech Korea to Singapore, a financial and shipping hub, and the electronics and commodities producing countries of Thailand, Malaysia and Indonesia.

Mixed outlook

In this report, we highlight how the changes taking place in China will affect various industrial and financial sectors in the region. While mature economies in Northeast Asia have a deeply coupled relationship with China's growth, developing economies in Southeast Asia have been somewhat slower in tapping Chinese demand for goods and services and are hence coming off a lower base: some sectors, such as tourism, in these economies still have upside potential.

Manufacturing

Exports Make a Comeback

After a six-month contraction, China's external trade showed signs of stabilizing in July, easing fears of a slowdown in its economy. Moderate improvements in the major economies have helped lift export growth, with exports to the US increasing to 5.3% after falling 5.4% in June and exports to the EU rising to 2.8% after contracting 7.8% in June. The latest figures are also no longer distorted by false trade invoices designed to bypass the funds flow controls since the authority clamped down on such practices in May.

Resilience

These data flows are an encouraging sign for China's manufacturing, although the HSBC manufacturing purchasing managers' index (PMI) suggests that smaller-size enterprises may face credit constraints and did not see improvements in their operating conditions in July. Latest industrial production (IP) data also improved, jumping 9.7% from 8.9% in June. The stronger than expected output growth was led by construction and power as output in the cement, power, steel and non-ferrous industries reported particularly strong increases. The strong July economic data should support consensus forecast that China will grow by about 7.5% this year.

4 China's economic data

Figure in % year-on-year	July 2013, actual	Consensus estimate	June 2013, actual
Industrial production (IP)	9.7	8.9	8.9
Fixed asset investment (FAI)	20.1	20.0	19.3
Exports	5.1	2.0	-3.1
Imports	10.9	1.0	0.7
Consumer price index (CPI)	2.7	2.8	2.7
Producer price index (PPI)	-2.3	-2.1	-2.7
Retail sales	13.2	13.5	13.3
PV sales	13.5	n.a.	11.5

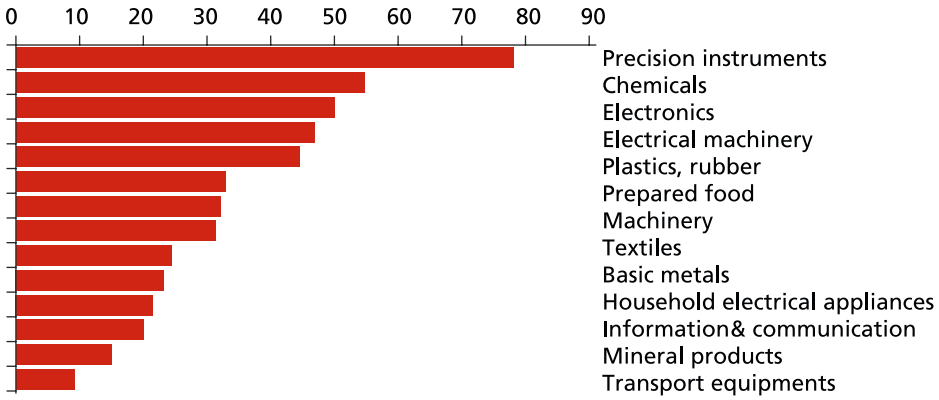
Sources: National Bureau of Statistics of China, Bloomberg Finance L.P., DBS Vickers

Taiwan

Asian economies are highly exposed to China's manufacturing sector, providing either raw materials or extra manufactured components into China's industrial processes. With China's 2014 GDP growth forecast cut to 7.5% from 8.5%, we have also lowered Taiwan's GDP forecast to 3.3% from 4.2% for next year. As Taiwan's economic reliance on China is high, it is susceptible to the risk of a more moderate growth in China. We expect the Taiwanese economy to recover in the second half of this year and return to potential growth in 2014, but a full recovery will be delayed if export demand from China remains tepid for an extended period.

Currently, exports to China and Hong Kong account for 40% of Taiwan's total exports. Even if measured by export orders, which is a better indicator of the source of final demand, China's share is large at 25%. Taiwanese firms sell not only consumer electronics to China, but also industrial electronics, precision instruments, machinery, chemicals and industrial materials such as plastics and rubber. The latter group will be vulnerable to the risk of a slowdown in China's fixed asset investment.

5 Taiwan's export dependence on China
% exports to China & HK/total exports



Mainland-based Taiwanese firms face chronic, supply-side cost pressures, such as increasingly expensive labor and land supply

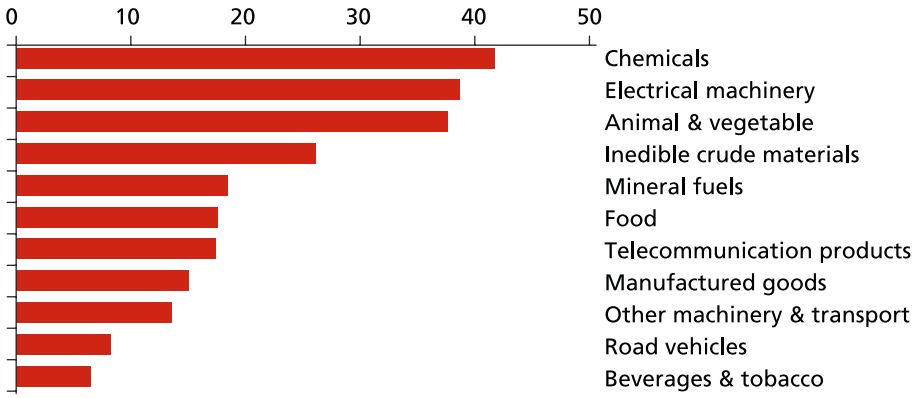
Many Taiwanese manufacturing firms have productions and operations on the mainland, with China accounting for almost 70% of Taiwan's total outward foreign direct investment (FDI) during the past decade. Apart from the short-term risk of slowing demand, these mainland-based Taiwanese firms are also facing chronic, supply-side cost pressures, such as increasingly expensive labor and land supply. Rising wages in China seems to be a secular trend, as the demographic dividend disappears and the Chinese government encourages higher wage growth to boost domestic consumption. In the long term, Taiwanese manufacturing firms will need to redefine their business model in China, targeting more at China's domestic consumer market and boosting productivity.

Korea

Korea also has a significant trade and investment exposure to China. A possible slowdown in the Chinese economy will inevitably engender some negative knock-on effects for Korea. We project the Korean economy to grow 2.8% this year and 4.0% next year, assuming a recovery in external demand from the second half of 2013. Alongside lowering China's GDP forecast in 2014, we have also cut the forecast for Korea to 3.5%.

About 20% of Korea's total outward FDI went to China during the past decade. Its manufacturing industry, particularly chemicals, electronics and crude materials, will be adversely impacted by a slowdown in China. Exports to China account for 25% of Korea's total exports, or 30% if shipments via Hong Kong are included. Even assuming that only one

6 Korea's export dependence on China
% exports to China/total exports



half of exports to China and Hong Kong are retained for domestic use and the other one half is processing trade, Korea's export exposure to China is significant, at about 15%.

Other manufacturing sectors that have small trade connections with China could also have significant business exposure to the Chinese market, as production lines have been relocated to the mainland and the process of materials procurement, production and distribution has been localized.

Opportunities Remain

From a long-term perspective, we believe Korean manufacturing firms will maintain their competitiveness in the Chinese market, with the timely adjustment of their business strategy to cope with the structural transition in the Chinese economy. Korea's FDI investment in China is moving towards value-added high tech industries, as well as inland provinces with a large consumer market and relatively strong growth potential. Samsung Electronics, for instance, invested US$7 billion in Xi'an city last year to build a memory chip plant in China's west region, the company's largest-ever overseas investment case.

Moreover, during President Park Geun-hye's visit to Beijing in June this year where she met with China's President Xi Jinping, the two sides agreed to strengthen cooperation in green energy, high tech and services trade. Park has also promised to encourage more Korean companies to invest in China's inland provinces in the future.

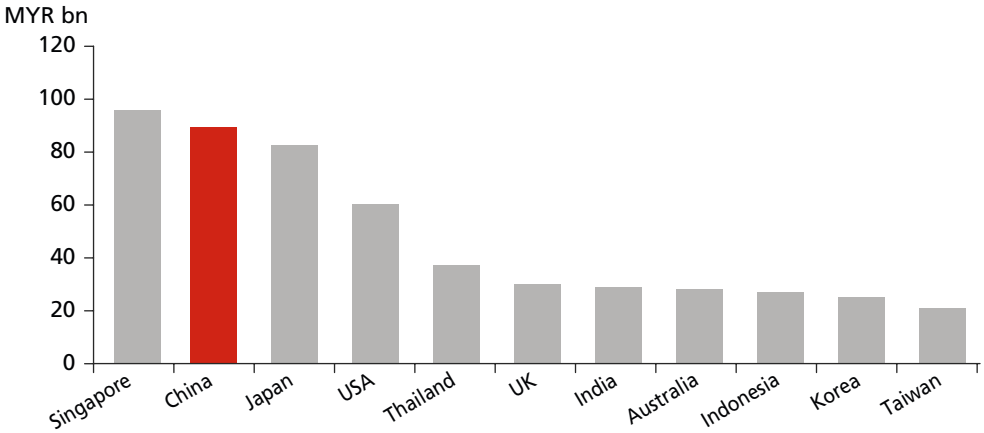
Malaysia

In Malaysia, a slowdown in demand from China will hit key exports including electronics components, transport equipment and palm oil, as well as more broadly across the manufacturing sector. China is Malaysia's second largest export market, accounting for about 12.6% of total export share in 2012, up from just 3.1% in 2000.

Singapore

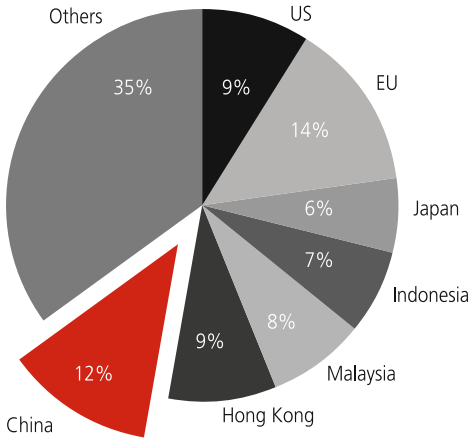
As a small and open economy that is increasingly tied to China, Singapore's exports – and in turn the manufacturing sector – will be hit the hardest if China's policymakers are aiming

7 Malaysia's exports to key markets (2012)

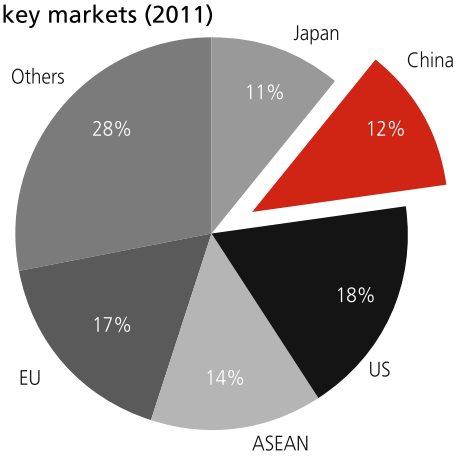


for slower growth. Excluding the European Union, China is Singapore's second largest non-oil domestic export (NODX) market, accounting for 11.8% of total NODX, or S$21 billion, a significant increase from S$4.1 billion or 3.6% in 2000. Key export products include high-end electronics products and components (e.g. integrated circuits), chemical and petrochemical products.

8 Singapore's non-oil domestic export share (2012)



9 Vietnam's exports share by key markets (2011)



Vietnam

China is also one of the top export destinations for Vietnam, and a moderation in demand from China will impact its export driven sectors such as agriculture, textile and electronics manufacturing. In 2011, Vietnam's exports to China amounted to US$11.1 billion and accounted for about 12% of total exports.

India

However, it is a different scenario with India, the world's second most populous country. India's economy is domestically driven, and its relatively small trade exposure to China should mean a limited impact from slower growth in China. Consumption accounts for more than 70% of India's overall output, with net external trade accounting for less than a quarter.

But on a net bilateral basis, China is India's biggest supplier and has consistently run a trade surplus with its South Asian counterpart. Exports to China along with Hong Kong account for 9.2% of India's total merchandise exports, based on an average of the past three years. Over half of these shipments are made up of iron ore, copper, mineral fuels and textiles (primarily cotton), which are typically driven by the manufacturing, infrastructure and construction industries. A China slowdown could hit India's growth prospects as demand for these is likely to slip further in the next two years.

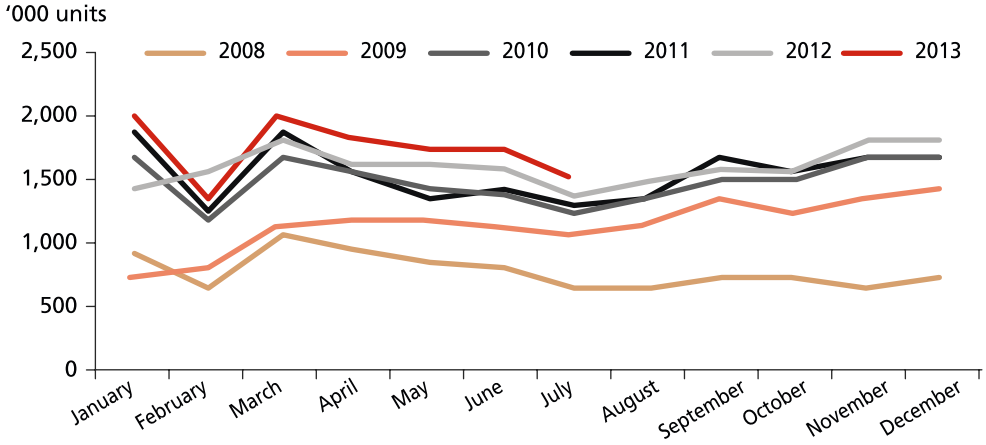
China's Auto Market Resilience

Until July, we considered the global growth proxies and domestic secular growth sectors as the top performing sectors. As sales growth has stopped decelerating since July, we can expect profit margins to start turning around.

As a gauge of the health of economic-sensitive domestic sectors, the Chinese auto market remained in a steady growth pace during the low seasons with underlying demand still healthy as passenger vehicle sales rose by 10.5% on-year to 1.24 million units, slightly better than June's 9.3% expansion. Based on seasonal patterns, passenger vehicle sales should pick up sharply from September.

Most auto dealers stocks have struggled since the beginning of the year as investors focused primarily on cash flow and earnings quality. On the other hand, leading auto makers with strong earnings momentum have performed better than expected, including Chongqing Changan and Great Wall Motor. Although Geely Auto has a relatively short operating history in the export and SUV segments, the firm sold a total of 34,000 units of vehicles in July, around 20% more than the same period last year, achieving 53% of its 2013 target.

10 Total vehicle sales in China (monthly)



Source: CEIC

Tourism

Higher incomes have led to a boom in Chinese tourism abroad, raising revenues throughout Asia. While a sustained slowdown in the Chinese economy will inevitably have ripple effects on Asia's tourism sector, China's incomes continue to go up, and so will tourism.

Uneven impact

However, the impact will be unevenly felt across the region. A slower China will hit Hong Kong's tourism industry the hardest, followed by Thailand and Taiwan, as growth in these countries are more highly dependent on tourism and Chinese tourists. Singapore and Korea are close behind, with broadly similar exposures. Malaysia gains much from tourism, which contributes 7% to GDP, but it's not a popular destination for mainland Chinese. The same goes for Indonesia, the Philippines and especially India.

Hong Kong

Despite reports of falling Chinese tourist numbers in mature Asian countries, Hong Kong's tourist arrivals from China still reached 35 million last year, implying a growth rate of 20%. However, when China's GDP growth dipped to 7.4% in the third quarter of 2012, retail sales growth of popular tourist items in Hong Kong dropped to 2.2%, compared with 11.1% in the second quarter. And as worries about China's growth return, it is likely that tourist spending will disappoint again. In April, falling gold prices sent mainland tourists on a shopping spree for the precious metal, masking the underlying weakness in spending power. Headline retail

A sustained slowdown in the Chinese economy will have ripple effects on Asia's tourism sector, but China's incomes continue to go up, and so will tourism

11 Asia – Tourism contribution to GDP and China exposure (2012)

	(1) Tourism contribution to GDP (%)	(2) China arrivals as % of total visitor arrivals	(3)=(1)*(2) China exposure
China	2.6	n.a.	n.a.
Hong Kong	8.0	72.0	576
Thailand	7.3	12.5	91
Taiwan	2.5	35.4	89
Singapore	5.2	12.0	62
Korea	2.1	25.5	54
Japan	2.1	17.1	36
Malaysia*	7.0	3.3*	23
Indonesia	3.0	7.5	23
Philippines	2.0	7.0	14
United States	2.8	1.7	5
India	2.0	2.3	5

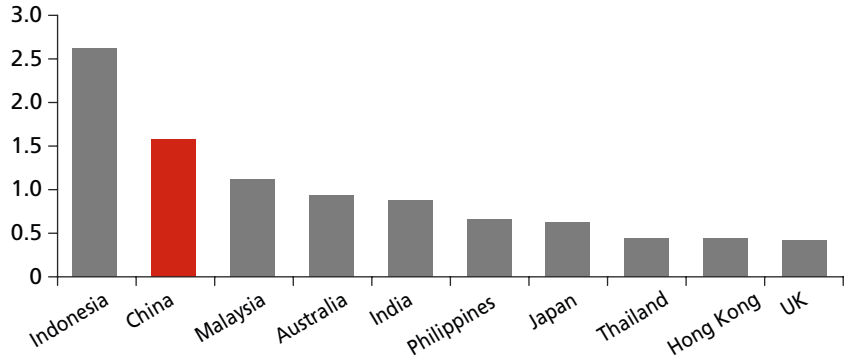
Source: World Travel and Tourism Council
* 2007

sales values rose 20.7% that month, up from 9.8% in March. This did not last. In May, retail sales growth retreated to 12.9%. In the September quarter, we project only high single-digit growth for retail sales values to reflect weaker tourist and locals' spending.

Singapore

Singapore has profited tremendously from Chinese tourists. China is now Singapore's second largest tourism market and it is also one of the fastest growing. Total tourist arrivals from the mainland registered 1.6 million in 2011 and it has been growing at a rapid pace of 14.4% per annum compared to the industry-wide average of 5.9% over the last decade. But the novelty effect may be waning for Chinese tourists. To offset this, more tourist attractions have been created and packaged tours to Singapore now include other Southeast Asian destinations. If Chinese tourist arrivals decline, the effect will be felt across the entire tourism value chain from the hotels to retail outlets, casinos as well as the F&B businesses.

12 **Total tourist arrivals in Singapore by country (2011)**
Million, persons



Taiwan

Taiwan's tourism trade with China has been rapidly growing since it relaxed visa requirements for mainland visitors in 2008. Chinese travellers currently account for 35% of tourist arrivals in Taiwan, and this is set to increase now that the daily quota of Chinese tourists has been increased to 7,000 from an initial 3,000 and extended to 26 Chinese cities from the previous three. We expect tourism and tourism-related services sectors to maintain solid growth this year and the next, with Taiwan being a new travel destination for most mainland residents.

Korea

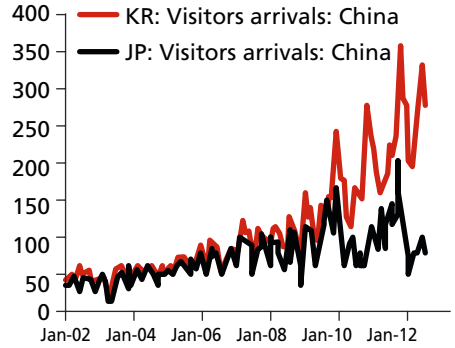
We also think Korea's tourism sector will continue to hold up well in the event of a China slowdown. In 2012, China accounted for 25% of total tourist arrivals in Korea, the second largest source country for Korea's tourism. As political and cultural ties strengthen between Korea and China, and relations between Japan and China remain in a troubled state, Chinese consumers will increasingly see Korea as an alternative travel destination to Japan. In the first quarter, the number of Chinese tourists visiting Korea surged strongly, while Japan saw a decrease in Chinese visitors despite the yen depreciation.

Malaysia

It is a generally similar picture in Southeast Asia. Although a slower Chinese economy will not pose significant risks to Malaysia, some impact will be felt in the externally-oriented sectors. Among the services industries, Malaysia's tourism industry will probably be the worst affected if Chinese tourist arrivals decline. As it stands, the growth rate of overall tourist arrivals in

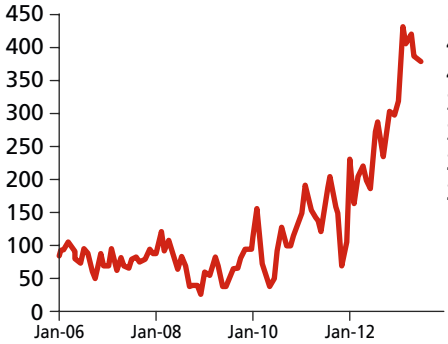
13

Chinese visitor arrivals in Korea and Japan
Thou, persons



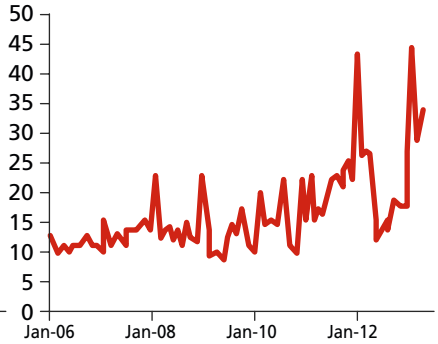
14

Chinese visitor arrivals in Thailand
Thou, persons



15

Chinese visitor arrivals in the Philippines
Thou, persons



Malaysia has been moderating over the last three years. Even the increase in tourist arrivals from Asia has been easing. Chinese tourist arrivals have bucked the trend, however, clocking double-digit growth for the last three years. In 2012, tourist arrivals from China rose by 24.7% from the previous year.

Thailand

In Thailand, a more moderate pace of export and tourism-related growth lies ahead for the country as China's growth slows. Tourist arrivals from China rose by 260% from 2005 to 2012, accounting for 18.6% of the increase in total tourist arrivals over the period. Despite the slowing Chinese economic growth, China's policy push towards consumption and the rising Chinese middle class will likely ensure that Chinese tourists to Thailand continue to increase in the coming years. Moreover, Thailand is a relatively new destination for Chinese tourists, and it stands to benefit from further growth if it can successfully promote its tourism sector to the Chinese. More importantly, there has been no correlation between GDP growth and Chinese visitor arrivals to Thailand. Notably, as China's GDP growth cooled through the last five to six quarters, tourist arrivals to Thailand continued to spike up, reaching an all-time high of 420,000 visitors in February.

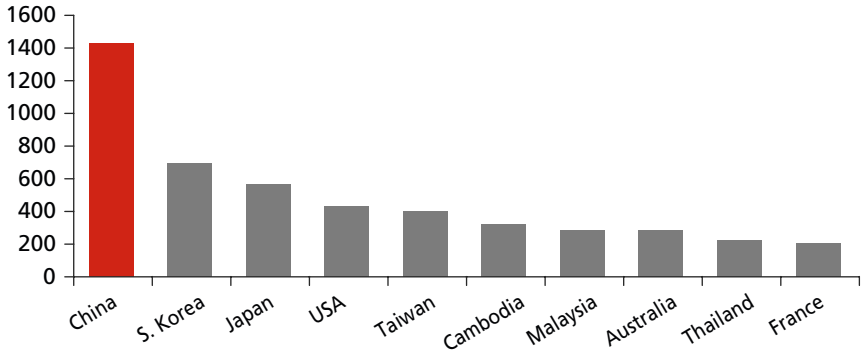
Philippines

For the Philippines, visitor arrivals from China will likely remain resilient even as China rebalances away from investment-led growth. There has been a surge in Chinese visitor arrivals to the Philippines over the past three years. While territorial disputes between the two sides led to a dip in Chinese visitor numbers in 2012, arrivals have since recovered. The uptrend in Chinese visitor arrivals is expected to continue with the moderating of China's headline growth likely driven by slower investment rather than consumption.

Vietnam

Vietnam's tourism is highly dependent on China, its top market, and moderation in tourist arrivals from China will impact the entire tourism industry. In 2012, tourist arrivals from China totaled 1.4 million, twice as many as South Korean tourists, its second largest market.

16 Tourist arrivals in Vietnam (2012)
Thou, persons



Japan

However, the macro impact of China's slowdown on Japan's tourism should be limited, with tourism as a percentage of GDP being negligible, at only 0.2%. China is Japan's third largest source country for tourism (after Korea and Taiwan), contributing 17% to the total number of tourist arrivals last year.

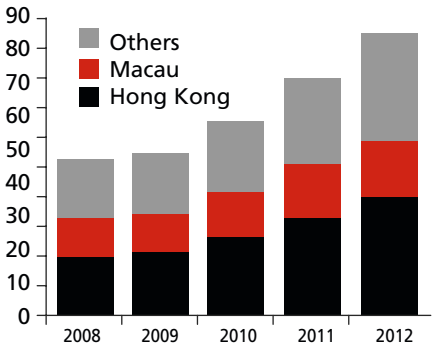
About 95 million Chinese tourists are expected to travel out of the country in 2013, an increase of about 12 million from last year

Tourist arrivals from China have fallen sharply since late last year (down 26.4% on-year during the January to March period) as a result of the territorial disputes and worsening diplomatic relations. Further tourism weakness, therefore, appears limited. In addition, the yen's depreciation since the end of 2012 is expected to continue to help Japan's tourism in the next year, with a time lag. Tourist arrivals from other countries such as Korea and Taiwan have surged strongly in the first five months of 2013 (38.1% year-on-year and 45.4% year-on-year, respectively).

Chinese Still Spending Abroad

With China at the center of the region's growth story, a slowdown there could affect growth in Asia's tourism industry. While the growth of outbound tourists from China has probably

17 Total outbound Chinese tourists, and those to Hong Kong, Macau
Million, persons



Sources: CEIC, DBS

passed the peak, the absolute numbers remain sizable. About 95 million Chinese tourists are expected to travel out of the country this year, an increase of about 12 million from last year.

Asian gaming

Across Asia, the gaming industry is increasingly becoming an important thrust of tourism. While Chinese tourists continue to flock to Macau, Asia's gambling capital, China is also a big player in Singapore's casino market, accounting for about half of Genting Singapore's VIP revenue. The region's gaming industry may be affected by slower Chinese tourist arrivals, but our analysis of Chinese outbound tourists shows that it has not been impacted by the slowdown.

18 ASEAN stocks with exposure to China

Sector/Company	Market	Revenue exposure in China (%)	Comments
Gaming			
Genting Singapore	Singapore	~25%	Estimated to contribute about half of VIP revenue. Risk of potential increase in debt provision as gaming debts are not enforceable in China. Resorts World Singapore can leverage on Genting Group's strength in ASEAN VIP segment to mitigate impact
Genting	Malaysia	11%	China contributes about half of Genting Singapore's VIP revenue (~25% of overall revenue). In turn, Genting Singapore makes up 42% of Genting Berhad's revenue

Source: DBS Vickers

Property

Normalizing the Property Market

The property sector in the Chinese context exists in two distinct segments: the domestic property market and the external property market, which is heavily focused on Asian property outside China.

The domestic property market is subject to at-times brutal but necessary policy decisions to regulate investment in housing and the wider financial sector. As China adjusts its policies to promote more sustainable growth, the series of measures implemented so far, including the frugality campaign and cooling measures to curb property prices, have generally worked well.

Policy limitations

But there are concerns that the austerity drive in the world's second largest economy may go too far, particularly after the central bank recently allowed interbank liquidity to become extremely tight. The strategy is to keep the status quo on monetary policy and to inject liquidity through central bank operations when needed. While interbank rates have already normalized, bank lending will likely remain cautious for the remainder of the year.

Despite this, there are few tangible signs of system-wide distress in either the property market or financial sector. China's broad money supply growth in 2013 remained steady at 14.1% on-year in the first half, which is still above the 13% annual target, while new loans grew by 14.0%, which is generally healthy and does not suggest economy-wide illiquidity.

The current state of the macroeconomy suggests real economic activities will pick up slowly. Cutting interest rates to reduce borrowing costs, as some are speculating, will only reinforce the root cause of the problem as lower rates encourage people to chase higher yields and helps the proliferation of wealth management products. Besides, lowering benchmark rates may not necessarily translate into lower funding costs for the final borrowers.

Interest rate liberalization needs to quicken so that banks have more freedom to determine deposit and lending rates. This is the most challenging part and requires careful planning given the numerous stakeholders involved.

Interest rate liberalization needs to quicken so that banks have more freedom to determine deposit and lending rates

Separately, China's central bank in its 2013 financial stability report released in August said that it was ready to set up a deposit insurance system as early as this year, and we envision an upward bias in domestic interest rates once reform kicks in.

Elevated asset prices and slower economic growth will prevail as long as quantitative easing floods the world with liquidity. Striking a balance between two contrasting policy objectives requires in-depth diagnostics within appropriate contexts.

Hong Kong

Hong Kong is one of the world's most expensive real estate markets but the euphoria has since worn off following rounds of government intervention, with property prices down 1.4% from the peak in March 2013. As special taxes discourage investment from foreigners, the share of mainland Chinese buyers has dropped to 5.0% in the first quarter, from 10.7% in the same period last year. In the luxury market, the share plunged to 11.1% in the first quarter, from 33.1% a year ago.

We expect even less mainlander participation as the Chinese economy continues to moderate, though it is unlikely to trigger a property market collapse

While residential property prices in Hong Kong are still up 5.3% from end-2012, the outlook is clouded by China's slowdown and more flats launched by developers in the second half. Moreover, residential property transactions have fallen 32.7% on-year in the first quarter.

We expect even less mainlander participation as the Chinese economy continues to moderate, though it is unlikely to trigger a property market collapse. The various stamp duties introduced by the government has already dampened investors' interests and property speculation is not rampant.

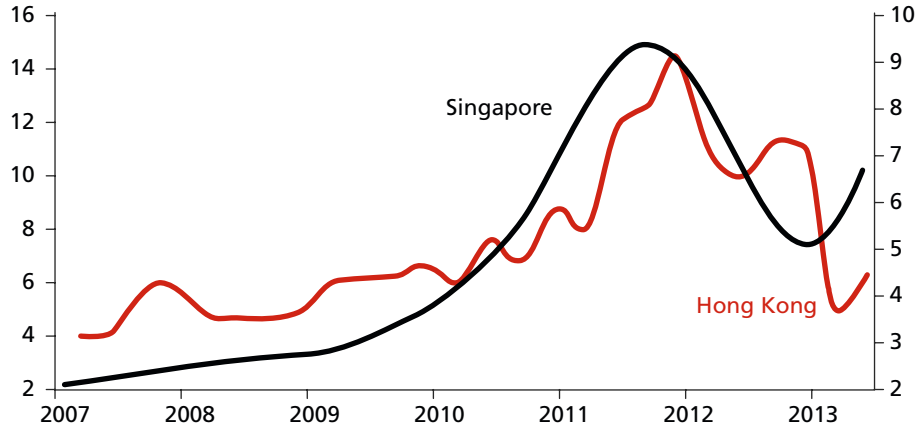
Singapore

Elsewhere, Singapore is likely to be impacted if China's moderating growth leads to a dip in property investments. Chinese buyers currently account for 5.2% of the total number of buyers in the property market.

Impact on Property Developers

There is a strong Chinese presence in property investments across Asia, and a slowdown in China will invariably impact potential investments. Property developers may be affected by slower sales, and gross margins could drop along with selling prices and land-banking potential.

19 PRC property buyers in Singapore and Hong Kong
% of total transaction volume



Sources: Centaline Property Agency, URA

China's slowdown has already affected Hong Kong and it is a similar trend in Singapore with Chinese nationals' property investment transactions showing a similar dip after peaking in 2011. Recent transactions, however, show a stable trend and pick up from 2012.

The distortion can be largely attributed to China's massive fiscal stimulus and liquidity injection in 2009/10, but the trend has since normalized. Domestic factors such as government policies and price levels are more important to Chinese investors than an economic slowdown.

20 ASEAN stocks with exposure to China

Sector/Company	Market	Revenue exposure in China (%)	Comments
Property developers			
CapitaLand	Singapore	24%	Residential sales continue to rise year-on-year due to a low base last year
Global Logistics Properties	Singapore	54%	The group continues to sign new rental leases with major companies, indicating that demand for logistics warehouse space remains relatively resilient
Keppel Land	Singapore	25-30%	Residential sales continue to rise year-on-year due to a low base last year
Ying Li	Singapore	100%	Chinese residential property developer
Rojana Industrial Park	Thailand	30%	Gross margin for condominiums in China will be squeezed due to the company's exit strategy (discount price, promotion)

Source: DBS Vickers

On the other hand, the low base of Chinese buyers in other ASEAN countries implies that the numbers can only grow over the years. In Malaysia, foreign buyers make up less than 2% of total transactions, but since the "My Second Home" scheme for foreign investors was enacted, the proportion of Chinese participants has been increasing over the last four years. Furthermore, Hong Kong and Chinese property developers are also making waves in other Southeast Asian countries.

Commodities

Extended Down-cycle

China's rapid urbanization in the past decades has fueled its appetite for natural resources. With the Asian dragon underpinning much of the demand for commodities in the global market, a brake on accelerated growth will be keenly felt in the commodities sector of resource-rich Asian economies that rely heavily on China for trade.

China accounted for more than 50% of the global consumption of coal and 12% of the overall consumption of energy/oil in 2012. With the government still working to boost consumption demand, much of the erstwhile demand has stemmed from the manufacturing, construction and trade-related sectors. But the momentum in these sectors has visibly slowed on the back of weaker growth as oil consumption moderated to 5% in 2011 and 4.8% last year. In addition, over-capacity and high stockpiles in China have depressed aluminum prices.

A slowdown in the Chinese economy had a moderate impact on Indonesia, with most of it coming from the pass-through of lower commodity prices onto external accounts

The specter of slowing global growth – especially one stemming from China – has resulted in global commodity prices easing off and weaker exports for key commodities such as coal, metals, petrochemicals and crude palm oil. While prices are bottoming out, there are fears that China's continued slowdown could drag the commodities down-cycle.

For ASEAN economies, commodities make up 39% and 60% of Malaysia's and Indonesia's total exports, respectively, while in Thailand, commodities have the largest sector representation in the stock market.

Indonesia

Indonesia's commodity prices have been unfavorable over the past four to five quarters. Coal, palm oil and industrial metal prices in particular have come down significantly and this has led to a deterioration of Indonesia's terms of trade. Coupled with robust investment-led domestic demand growth, the trade balance flipped from an average monthly surplus of US$2.2 billion in 2011 to an average trade deficit of US$400 million over the 12 months ended May. As a result, Indonesia's current account deficit remains sizable, averaging US$6.5 billion in the four quarters ended March.

Indonesia's growth is likely to be below potential due to policy constraints and lower commodity-related investment activity. As such, we have revised down our GDP growth forecast for 2013 and 2014 to 6.0% and 6.3%, respectively.

Thailand

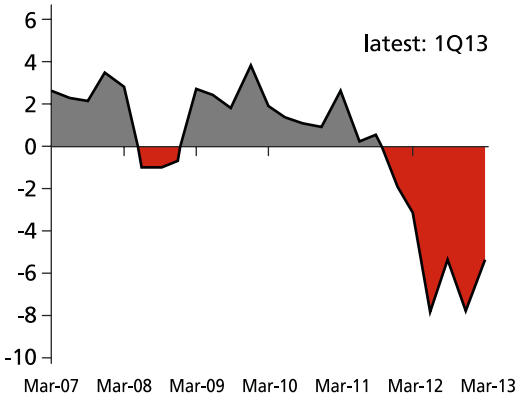
Thailand will also be affected as China's growth moderates, but some of this slowdown can be offset by a revival in the domestic economy as growth in the coming one to two years will be largely driven by consumer spending and public infrastructure spending. The slowing Chinese growth may indirectly lower inflationary pressures as commodity price increases stay muted. The central bank will be able to keep the policy rate low in the coming quarters to support investment growth and a low inflation environment is likely to help bolster consumer

spending. However, momentum in the domestic economy eased in the first quarter and public spending on infrastructure appears more likely to materialize in 2014.

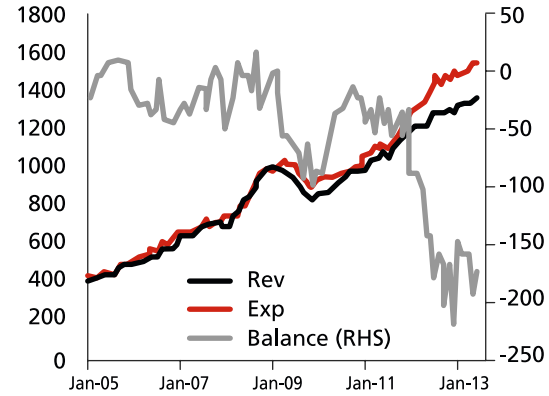
Philippines

Similarly in the Philippines, weaker external demand from slowing Chinese growth will not impact the economy much as growth is largely driven by domestic demand. More importantly, even if exports do not perform, policymakers have leeway to introduce stimulus if needed.

21 Indonesia's current account balance
USD bn



22 Indonesia's fiscal balance
IDR trn, rolling 12 mths



India

Meanwhile, in India, the iron ore and mineral fuel sectors were the hardest hit by moderating demand from China, pulled lower also by a fall in global commodity prices. Some negative feedback to other segments is also likely as Asia becomes increasingly important as a target market. Last year, more than half of India's exports were absorbed by the region.

At the other end, the bulk of India's imports constitute electrical and electronic products, mechanical and metallurgic, chemicals, and ceramics amongst others. Tepid growth in China will make the economy keener to sell to India rather than source from it, which may cause a further deterioration in India's bilateral trade balance.

Limits to downside

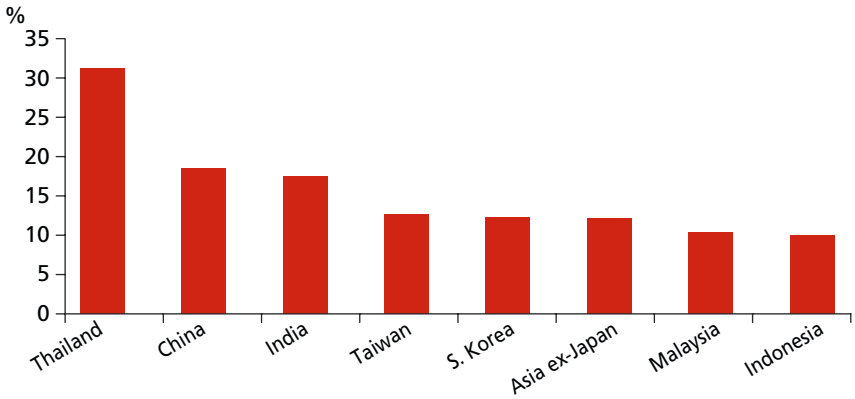
The connection between strong demand for commodities from China to satisfy its investment requirements and a subsequent run-up in prices is well-documented. Therefore, a moderation in demand for energy, minerals and non-ferrous metals and impact on commodity prices would be a positive development for India's inflation trajectory and external imbalances.

To be sure, while some moderation in commodity prices can be anticipated, the structural changes in China will still involve a multi-year shift towards urbanization and infrastructure development, and can potentially reverse the downshift in prices.

Selective Rebound Potential

It is too early to get excited about macrosensitive stocks in China's financials and materials sectors, but the oil/gas, cement and engineering/construction sectors still have meaningful rebound potential. Among ASEAN countries, companies from the coal/metals, industrials and consumption sectors that have big footprints in China could also be impacted if demand from China wanes.

23 Commodity sector weightings in selected Asian stock market



Source: IBES, Datastream, DBS

24 China/Hong Kong sector performance

August 9, 2013	1-month	3-month	6-month	12-month	Year-to-date	Versus year-end 2009	Versus year-end 2011	Full-year 2012
Energy including coal								
Coal	18.6	(17.0)	(29.3)	(27.4)	(34.5)	(47.5)	(35.7)	(1.8)
Oil & gas	2.0	(12.1)	(14.7)	(8.4)	(18.1)	1.2	(6.6)	14.1
Oil services & equipment	16.8	0.8	5.6	53.3	9.6	86.3	56.0	42.2
Construction, industrials and transportation								
Steel, aluminium & copper	17.0	(11.4)	(24.1)	(16.3)	(25.0)	(61.5)	(18.4)	8.8

Sources: Thomson Reuters, DBS Vickers

On the hard commodities front, Indonesia continues to face weaker demand from China, its biggest buyer of coal. Harum Energy (with a 44% revenue exposure to China), is one of Indonesia's largest coal producers, but it struggles with weak pricing despite selling higher-quality coal.

Singapore's Wilmar, though highly exposed to China, should not face headwinds amid weakening demand from the mainland as its earnings contribution from China has already fallen by half in 2012 compared with three years prior. Thailand's largest agribusiness company, Charoen Pokphand (CP) Foods, also has strong ties to China, but any impact from a slowdown

in China should be limited given its operations in consumer staples. In Malaysia, while Sime Darby has a limited direct exposure to China, its motor, ports and heavy equipment segments are directly exposed to China's economic activities.

25 ASEAN stocks with exposure to China

Sector/Company	Market	Revenue exposure in China (%)	Comments
Coal, metals			
BANPU	Thailand	10%	China is a major coal importer; slowdown will reduce coal consumption
Adaro Energy	Indonesia	5%	No material impact on volume but pricing is a concern
Indo Tambangraya Megah (ITMG)	Indonesia	26%	ITMG sells higher calorific value coal, more resilient demand
Harum Energy	Indonesia	44%	Despite selling higher calorific value coal, weak pricing is an issue
Tambang Batubara	Indonesia	14%	Most output is sold to the domestic market, but some export to China
Aneka Tambang	Indonesia	<20%	Exports nickel ore
PT Timah	Indonesia	<20%	Exports tin to China
Consumption			
Wilmar	Singapore	49%	Unlikely to drop further as earnings before interest and taxes (EBIT) contribution has already fallen from 43% in 2009 to 21% in 2012
CP Foods (CPF)	Thailand	30%	CPF has feed operations in China under CPP. Given its staple products, the slowdown should have limited impact
Industrials			
Noble Group	Singapore	8%	Already affected by China slowdown in the previous year
Sime Darby	Malaysia	20%	Its motor, ports and heavy equipment segments are directly exposed to China's economic activities. Half of the motor EBIT comes from China/HK market (around 7% of EBIT). But the industrial segment in Australia and plantations will feel the direct impact of weak coal and crude palm oil prices

Currencies

One of the biggest questions about China's economic transition is the future of its currency, the renminbi. That the renminbi will inevitably become a more liberalized and global currency is generally accepted by both market participants and China's policymakers. The main debate centers on how much and how fast China opens its currency up to international market forces. Such reforms over the past decade have been measured and gradual and authorities are yet to announce a more definitive roadmap for currency liberalization.

Policy Priorities

In the more immediate-term, stabilizing China's currency markets is likely to be a greater priority for authorities ahead of any major currency reforms. While worries about an economic hard landing were reflected in price action seen in the offshore non-deliverable forward (NDF) market in May, both the onshore and offshore renminbi markets have been more sanguine about slower growth, staying close to the floor of the official trading band. These rates were stable despite intense market volatility from worries about the Federal Reserve tapering, and a self-inflicted credit crunch that pummeled Chinese stocks to four-year lows.

The fact that the central parity has been kept to a narrower band this year suggests that stability and minimizing volatility in the exchange rate are higher priorities

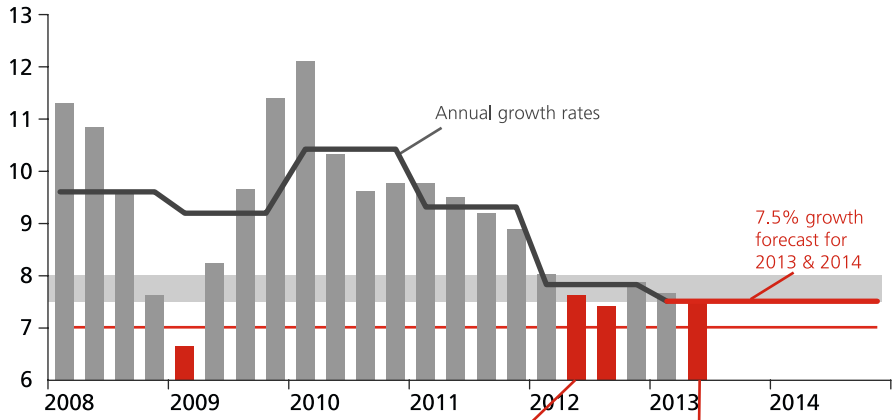
In our assessment, China is once again flattening the US dollar-yuan band, a strategy it has adopted since the 2008 crisis to cope with market volatility and a higher US dollar versus Asia ex-Japan currencies. We do not subscribe to the view that China is considering devaluing the yuan to cope with slower growth prospects. The fact that the central parity has been kept to a narrower band this year suggests that stability and minimizing volatility in the exchange rate are higher priorities. The last thing Asia needs now is China adding to capital flight worries. Moreover, the Chinese government has reaffirmed its commitment to achieve the official 7.5% growth target for 2013. This will, in the short-term, provide an important support and assuage earlier fears that growth could fall below 7.0% in the second half of this year.

China still needs to provide more clarity on its longer-term growth targets. Its new leaders are expected to unveil their economic and financial reform plans at the upcoming Communist Party meeting in October.

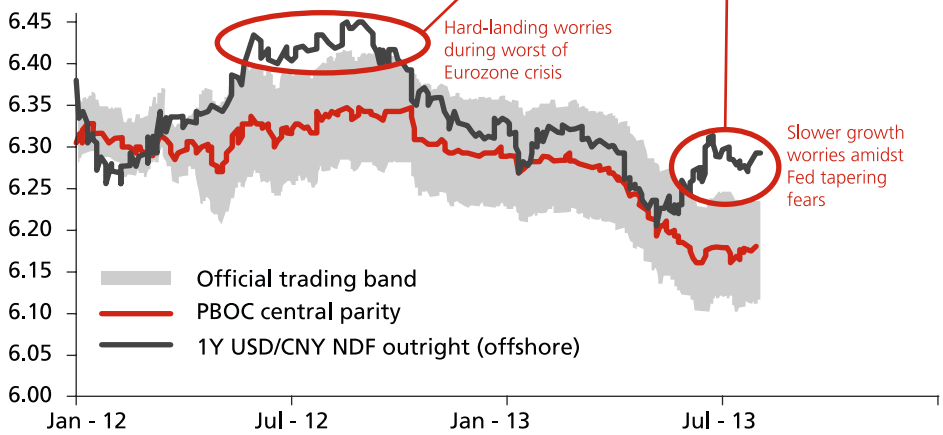
Asian Currencies

While the outlook for Asian currencies rests in large part on the Federal Reserve's policy deliberations over time, China's economic prospects also remain crucial. The US dollar had been the main beneficiary of market volatility in global currency markets so far this year. This started with a weak Japanese yen that triggered currency war fears in the first quarter, and later by Fed tapering fears in May-July. Between the two factors, it was the Fed that returned the US dollar to the top of its post-crisis trading ranges. This was

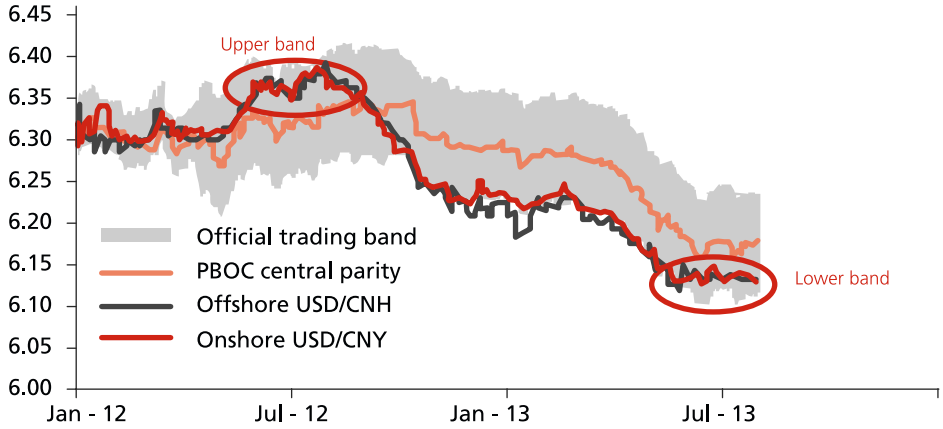
26 Pain threshold for China's economic growth
Real GDP, % YoY



27 NDF market is worried about slow China again
USD/CNY



28 Onshore CNY & offshore CNH are calmer
USD/CNY

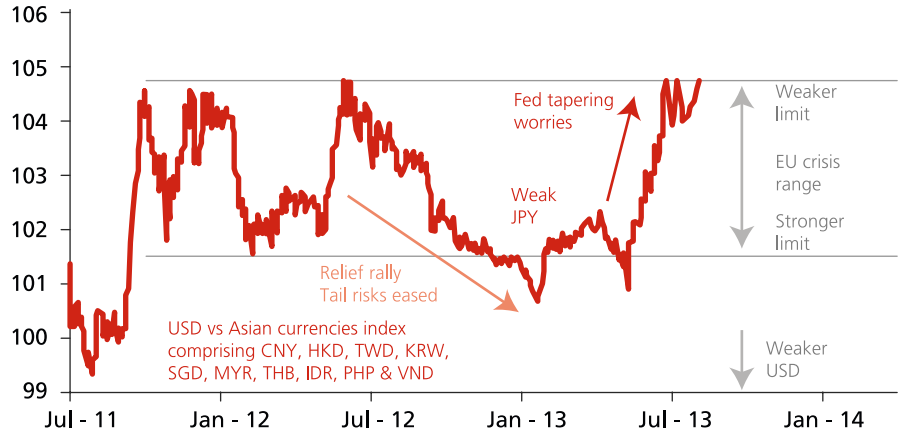


probably the reason why China moved towards a stable yuan in late June.

Since the 2008 crisis, the US dollar has fluctuated within a wide range against the major currencies. This was easily attributed to the deleveraging taking place in both the US and the Eurozone. Against the Asia ex-Japan currencies, the US dollar has also been trapped in a range after the Eurozone crisis erupted in September 2011.

It's our view that markets have overreacted to the Fed's intentions to taper quantitative easing. We took comfort in the US dollar's retreat from the top of its range against the growth-sensitive export-led Asian Newly Industrializing Economies currencies. Nonetheless, the market volatility did reveal the vulnerability of Southeast Asia to a reversal of capital flows from a withdrawal in Fed stimulus. Assuming there are no more distractions that could delay the global recovery story such as a China hard landing, we expect the US dollar to start returning its gains.

29 Asia ex-Japan currencies - still range bound after EU crisis
Indexed: 1 Sep 2011 = 100



Sources: IBES, Datastream, DBS

Economic Indicators

GDP & Inflation Forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2010	2011	2012	2013f	2014f	2010	2011	2012	2013f	2014f
US	3.0	1.8	2.2	1.4	2.3	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	0.0	2.0
Eurozone	1.9	1.6	-0.5	-0.6	0.1	1.6	2.7	2.5	1.5	1.9
Indonesia	6.1	6.5	6.2	6.0	6.3	5.1	5.4	4.3	6.7	6.4
Malaysia	7.2	5.1	5.6	5.0	5.2	1.7	3.2	1.7	2.0	2.4
Philippines	7.3	3.6	6.8	6.4	6.0	3.8	4.8	3.1	3.1	4.0
Singapore	14.8	5.2	1.3	2.5	3.5	2.8	5.2	4.6	2.8	3.6
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	1.0	1.3
Korea	6.2	3.6	2.0	2.8	3.5	2.9	4.0	2.2	1.5	2.9
India*	8.4	6.5	5.0	5.2	5.8	9.6	8.9	7.4	6.7	7.0

* India data & forecasts refer to fiscal years beginning April; inflation is WPI
Source: CEIC and DBS Research

Policy & Exchange Rate Forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	3Q13	4Q13	1Q14	2Q14	current	3Q13	4Q13	1Q14	2Q14
US	0.25	0.25	0.25	0.25	0.25	…	…	…	…	…
Japan	0.10	0.10	0.10	0.10	0.10	98.4	100	102	104	105
Eurozone	0.50	0.50	0.50	0.50	0.50	1.324	1.31	1.32	1.34	1.35
Indonesia	7.00	7.00	7.00	7.00	7.00	10,935	9,850	9,800	9,750	9,700
Malaysia	3.00	3.00	3.00	3.00	3.00	3.30	3.02	2.99	2.96	2.94
Philippines	3.50	3.50	3.50	3.75	4.00	44.7	41.5	41.0	40.5	40.0
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.27	1.24	1.23	1.21	1.19
Thailand	2.50	2.50	2.50	2.50	2.75	32.1	29.9	29.8	29.7	29.6
Vietnam^	7.00	7.00	7.00	7.00	7.00	21,155	21,100	21,200	21,300	21,400
China*	6.00	6.00	6.25	6.25	6.50	6.12	6.09	6.06	6.03	6.00
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.76	7.77	7.78	7.79	7.80
Taiwan	1.88	1.88	1.88	1.88	2.00	30.0	29.6	29.4	29.2	28.9
Korea	2.50	2.50	2.50	2.50	2.75	1110	1100	1080	1060	1040
India	7.25	7.25	7.25	7.25	7.25	66.6	56.2	56.6	57.0	57.4

^ prime rate; * 1-yr lending rate

Disclaimers and Important Notices

www.dbs.com