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Markets
Strategy

3Q 2015

DBS Group Research

11 June 2015

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Economic forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2012	2013	2014	2015f	2016f	2012	2013	2014	2015f	2016f
US	2.3	2.2	2.4	2.2	2.5	2.1	1.5	1.6	0.9	1.7
Japan	1.7	1.6	-0.1	1.1	1.0	0.0	0.4	2.7	1.0	0.8
Eurozone	-0.7	-0.4	0.9	1.0	1.3	2.5	1.3	0.4	0.4	1.1
Indonesia	6.0	5.6	5.0	5.1	5.5	4.0	6.4	6.4	6.4	5.7
Malaysia	5.6	4.7	6.0	4.9	5.0	1.7	2.1	3.1	2.1	3.0
Philippines	6.7	7.1	6.1	6.0	6.2	3.2	2.9	4.2	2.5	3.7
Singapore	3.4	4.4	2.9	3.2	3.5	4.6	2.4	1.0	-0.1	1.3
Thailand	7.3	2.8	0.9	3.2	4.5	3.0	2.2	1.9	-0.2	2.0
Vietnam	5.0	5.4	6.0	6.0	6.2	9.3	6.6	4.1	1.3	3.5
China	7.7	7.7	7.4	7.0	6.8	2.6	2.6	2.0	1.8	2.2
Hong Kong	1.7	2.9	2.3	2.5	3.0	4.1	4.3	4.4	3.7	3.5
Taiwan	2.1	2.2	3.8	3.4	3.5	1.9	0.8	1.2	-0.2	1.2
Korea	2.3	2.9	3.3	3.0	3.5	2.2	1.3	1.3	0.8	2.1
India*	5.1	6.9	7.3	7.6	8.3	7.4	9.5	6.0	5.6	5.9

* India data & forecasts refer to fiscal years beginning April; prior to 2013.

Source: CEIC and DBS Research

Policy and exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	3Q15	4Q15	1Q16	2Q16	current	3Q15	4Q15	1Q16	2Q16
US	0.25	0.25	0.50	0.75	1.00	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	123.4	125	126	127	128
Eurozone	0.05	0.05	0.05	0.05	0.05	1.127	1.08	1.05	1.02	0.99
Indonesia	7.50	7.50	7.50	7.50	7.50	13,306	13,460	13,660	13,870	14,080
Malaysia	3.25	3.25	3.25	3.25	3.25	3.75	3.74	3.76	3.78	3.80
Philippines	4.00	4.00	4.00	4.25	4.25	45.1	45.3	45.4	45.4	45.5
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.35	1.36	1.38	1.40	1.42
Thailand	1.50	1.50	1.50	1.50	1.75	33.7	33.7	33.8	34.0	34.1
Vietnam^	6.50	6.00	6.00	6.00	6.00	21,798	21,781	21,781	21,781	21,781
China*	5.10	4.85	4.60	4.60	4.60	6.21	6.24	6.26	6.28	6.30
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.75	7.77	7.77	7.78	7.79
Taiwan	1.88	1.88	1.88	1.88	1.88	30.9	32.0	32.2	32.4	32.6
Korea	1.50	1.50	1.50	1.75	1.75	1109	1133	1147	1161	1175
India	7.25	7.25	7.25	7.25	7.25	64.0	64.6	65.6	66.7	67.8

^ 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-Jun-15	3Q15	4Q15	1Q16	2Q16
US	3m Libor	0.29	0.40	0.70	0.95	1.20
	2Y	0.73	0.90	1.15	1.40	1.60
	10Y	2.48	2.40	2.60	2.70	2.80
	10Y-2Y	176	150	145	130	120
Japan	3m Tibor	0.17	0.20	0.20	0.20	0.20
Eurozone	3m Euribor	-0.01	0.00	0.00	0.00	0.00
Indonesia	3m Jibor	6.92	7.00	7.00	7.00	7.00
	2Y	8.27	8.00	8.10	8.20	8.30
	10Y	8.66	8.60	8.70	8.80	8.80
	10Y-2Y	39	60	60	60	50
Malaysia	3m Klibor	3.69	3.70	3.70	3.70	3.70
	3Y	3.33	3.30	3.40	3.50	3.60
	10Y	4.11	4.10	4.20	4.30	4.30
	10Y-3Y	77	80	80	80	70
Philippines	3m PHP ref rate	2.31	2.50	2.75	3.00	3.00
	2Y	3.40	3.50	3.60	3.70	3.80
	10Y	4.36	4.40	4.60	4.80	4.80
	10Y-2Y	96	90	100	110	100
Singapore	3m Sibor	0.83	0.90	1.00	1.15	1.25
	2Y	1.09	1.10	1.30	1.50	1.70
	10Y	2.77	2.70	2.80	2.85	2.85
	10Y-2Y	168	160	150	135	115
Thailand	3m Bibor	1.66	1.70	1.70	1.70	1.95
	2Y	1.49	1.60	1.60	1.60	1.80
	10Y	3.06	2.90	3.00	3.10	3.20
	10Y-2Y	156	130	140	150	140
China	1 yr Lending rate	5.10	4.85	4.60	4.60	4.60
	2Y	2.28	2.50	2.60	2.70	2.80
	10Y	3.59	3.60	3.70	3.80	3.90
	10Y-2Y	131	110	110	110	110
Hong Kong	3m Hibor	0.39	0.50	0.70	0.95	1.20
	2Y	0.49	0.60	0.85	1.10	1.30
	10Y	1.42	1.65	1.90	2.05	2.20
	10Y-2Y	93	105	105	95	90
Taiwan	3M Taibor	0.88	0.88	0.88	0.88	0.88
	2Y	0.66	0.65	0.65	0.65	0.80
	10Y	1.56	1.53	1.60	1.65	1.65
	10Y-2Y	90	88	95	100	85
Korea	3m CD	1.80	1.55	1.55	1.80	1.80
	3Y	1.78	1.70	1.85	2.00	2.15
	10Y	2.47	2.50	2.60	2.70	2.80
	10Y-3Y	69	80	75	70	65
India	3m Mibor	7.95	8.10	8.10	8.10	8.10
	2Y	7.88	7.80	8.00	8.25	8.25
	10Y	7.83	7.80	8.00	8.25	8.25
	10Y-2Y	-14	0	0	0	0

Source: Bloomberg and DBS Group Research

Bringing investment home

Asia's investment growth has slowed to a crawl. That's bad because saving and investing is what gives you – anyone – faster growth and higher incomes. Double-digit savings and investment rates underwrote 7% per-capita income growth in Asia for decades. At that rate, wages and salaries double every 10 years. Millions of Asian kids today can look forward to a standard of living 4 to 6 times higher than their grand-parents enjoyed. And it's mostly because their grand-parents (and parents) saved and invested all they could.

It ought to be a huge concern then that real investment growth in Asia has slowed from an 11% pace in 2008 to 6.5% on average in 2009/10, 5% in 2012, 4% in 2013 and below 3% in 2014. Either this gets turned around or the Asia growth story ends.

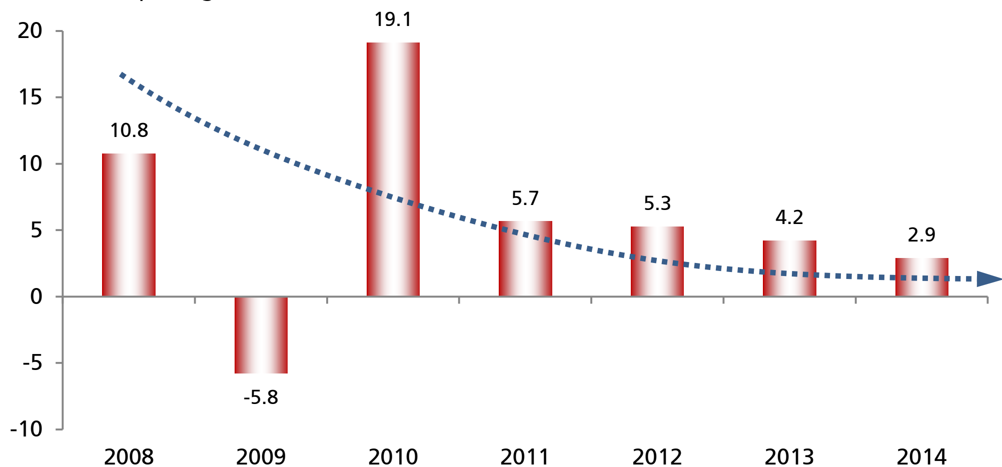
Some say it already has. China has slowed sharply and the market mantra is there's too much saving and investing in China, not too little. Don't believe it. Singapore has saved and invested more than China for fifty years and has nothing but one of the highest incomes in the world to show for it. China could do worse than to mimic this.

For most Asian countries, including China and Singapore, the issue isn't how to guard against 'over-investment'. It's how to arrest its slide. Sub-3% growth in real fixed capital formation won't deliver the GDP growth Asia needs to lift incomes and keep populations employed. What to do?

Is China's new Asian Infrastructure Investment Bank (AIIB) the answer? Unfortunately, no, the numbers are too small. If the AIIB raised all of the $100bn it hopes to and disbursed it all over the next three years, it could lift Asia's investment by an extra 0.4%. That's not zero but it may as well be.

The real problem, though, isn't a lack of funds, but precisely the opposite. All Asian countries, save for India and Indonesia, run current account surpluses and have done since 1998. Surpluses mean you're lending to the rest of the world (or paying down old debts). If you're lending to the rest of the world, you don't need to borrow funds from the AIIB. If you're lending to the rest of the world, you don't need to borrow funds from anyone.

Asia 10 – real investment growth



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But if Asia is lending to the rest of the world, it's immediately clear how to raise investment at home: stop lending, start borrowing. Stop running surpluses, start running deficits. Stop investing in US Treasuries and start investing at home, where the income-lifting capital equipment and infrastructure is desperately needed.

Run deficits? Sounds a bit heretical. Foreign lenders, rating agencies and local officials would all object. But it's not heresy, it's Finance 101. Higher income, capital abundant countries are supposed to lend to lower income / capital scare countries, not vice-versa. Foreign lenders earn a higher return than what's available at home; local borrowers can invest more than local savings otherwise allow. Everyone wins.

Too much borrowing is dangerous of course. After all, the reason deficits are anathema to so many is they led to the Asian crisis of 1997/98. But that was 18 years ago when deficits were 10% of GDP in some countries for a good many years. The surpluses run ever since have cut net foreign debt in the Crisis-4 countries (TH, KR, MY, ID) to 11% of GDP from 60% back in 1998. It's time to let go.

Would eliminating surpluses really matter to Asia's investment equation? Yes, greatly. On average, Asia-10 countries have run surpluses of 6% of GDP since 1998. Last year, the average surplus was 5% of GDP. Asia is sending 5%-6% of its real output abroad every year when it could be investing it at home instead. If modest deficits of 2%-3% of GDP were run, domestic investment could be 7-8 percentage points of GDP higher than it currently is. That's a boatload of dollars that could be building Asia's infrastructure, raising Asia's growth and lifting Asian incomes.

But mindsets have to change for this to occur. Officials, rating agencies and foreign investors need to let go of 1997. Until they do, no amount of funding from an AIIB or other institution will succeed in raising domestic investment in the region. Some say you can't squeeze blood from a turnip. It's just as hard to push water into a fire hydrant.

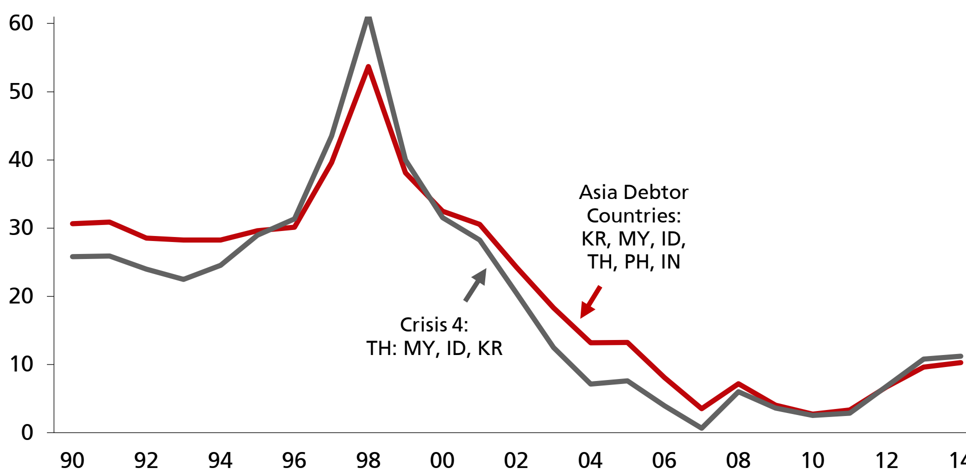
David Carbon, for

DBS Group Research

June 11, 2015

Asia – net foreign debt as % of GDP

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



Asia: arresting the Great Investment Slowdown

- **Asia's investment growth has slowed to a crawl**
- **Some of the slowdown owes to falling savings rates that typically accompany rising incomes. But investment has slowed far more than higher incomes alone can explain**
- **If the slowdown is not arrested and turned north again, incomes and employment will suffer**
- **China's new AIIB won't turn the tide. It's far too small**
- **The real problem is Asia's current account surpluses. Asians are lending, not borrowing – investing abroad rather than at home**
- **Some good old-fashioned deficits are what the region needs. It's not heresy, it's Finance 101. But mindsets will have to change if deficits (and greater domestic investment) are to return to Asia**

Asia's investment growth has slowed to a crawl. After averaging 15% per year for decades, real investment growth in the Asia-10 has slowed from an 11-odd percent pace in 2008, to 6.5%, on average, in 2009/10, 5% in 2012, 4% in 2013 and below 3% in 2014. The drop isn't just about China, where many would say a slowdown is overdue. These figures are simple averages of the Asia-10, so tiny Singapore counts just as much as the massive mainland.

Savings and investment have been key to the growth equation in Asia since 1950 as indeed they are everywhere. Higher incomes tomorrow can only come from sacrificed consumption today. With few exceptions, the more you save, the faster you grow. So far, Asia's GDP growth hasn't suffered much. In simple average terms

Nomenclature

References to economic regions in this report adhere to the following conventions:

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

Asia-9: A10 less CH

Asia-8: A10 less IN, CH

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

Asia Big3: CH, IN, ID

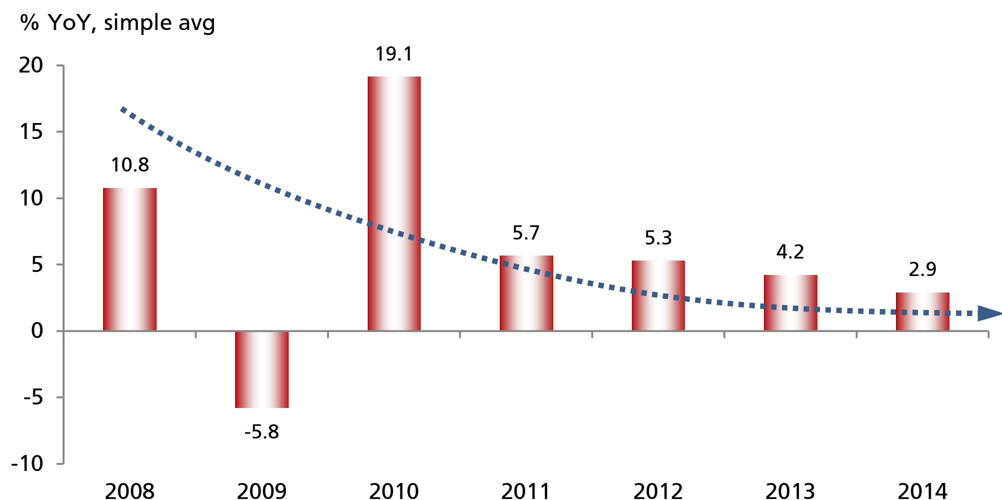
G4: US, EU, JP, A10

G3: US, EU. JP

EU: EU18

Asia 10 – real investment growth

% YoY, simple avg



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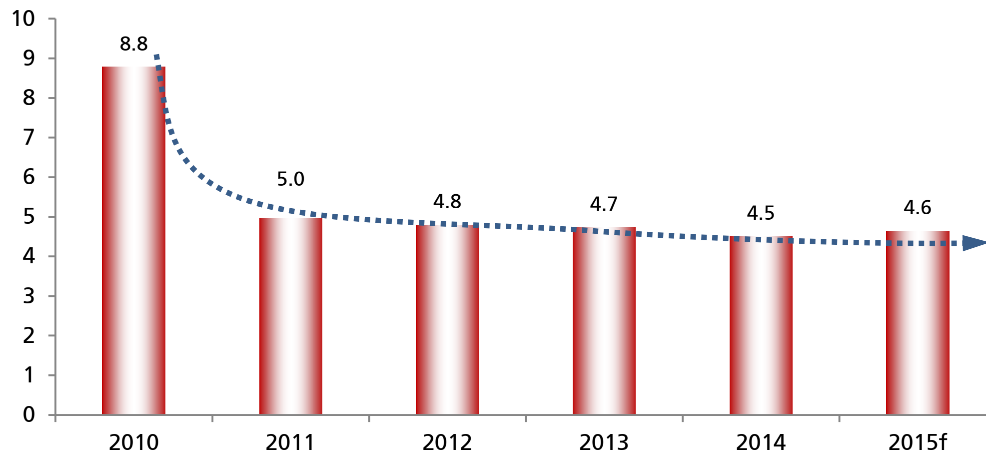
Asia10 – GDP growth

% YoY, simple avg



(again to avoid heavily biasing the picture with China), growth has run between 4.5%-4.75% for the past four years [1]. But it won't stay there if investment doesn't stabilize soon. Output, incomes and employment will all take a hit. How do you arrest Asia's great investment slowdown? How do you turn it around?

If investment doesn't pick up, growth will fall. Incomes may too

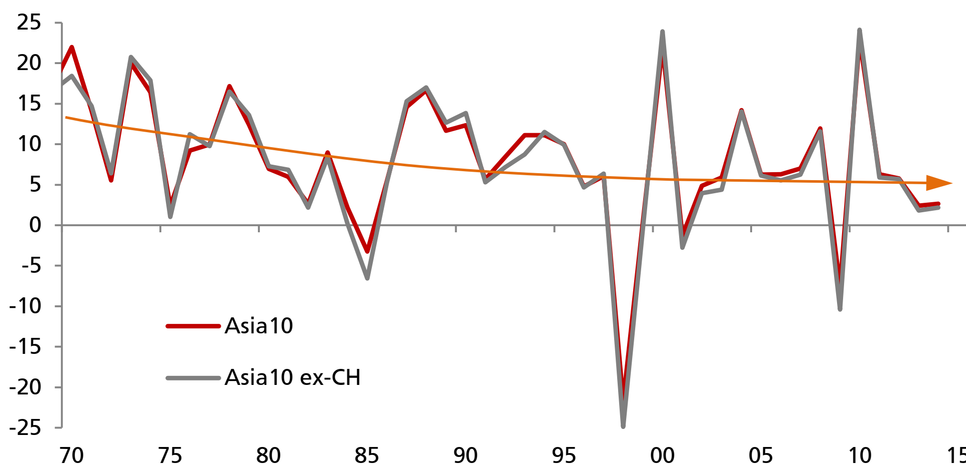
Of structures and cycles

Alas, a big part of the answer is, you don't. As discussed below, much of the great investment slowdown is 'structural' – owing to the steady rise in incomes over the past few decades. To this extent (but no further), slower investment is good news, not bad.

It's no surprise then that Hong Kong, Korea and Taiwan – Asia's three highest income countries after Singapore – have experienced the most marked slowing in investment (charts at top of next page). China and India, at the lower end of the income spectrum, haven't experienced much if any slowdown in trend investment growth. Most would agree this makes sense for India, where per-capita income

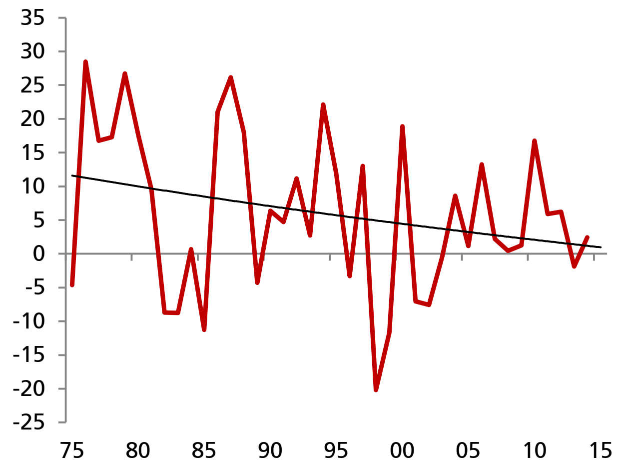
Asia-10 – real investment growth

% YoY, Gross Fixed Capital Formation, simple avg

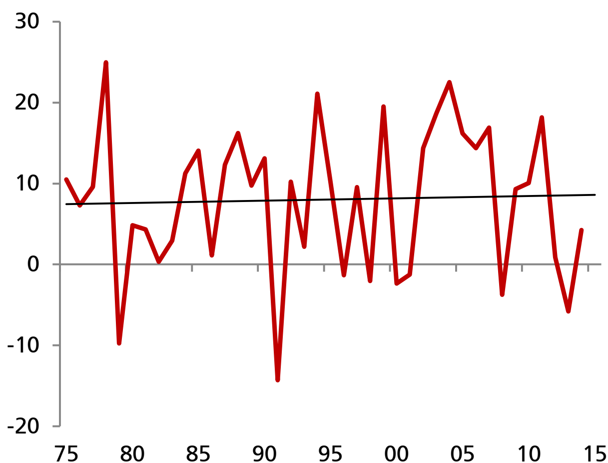


Korea – real investment growth
% YoY, GFCF

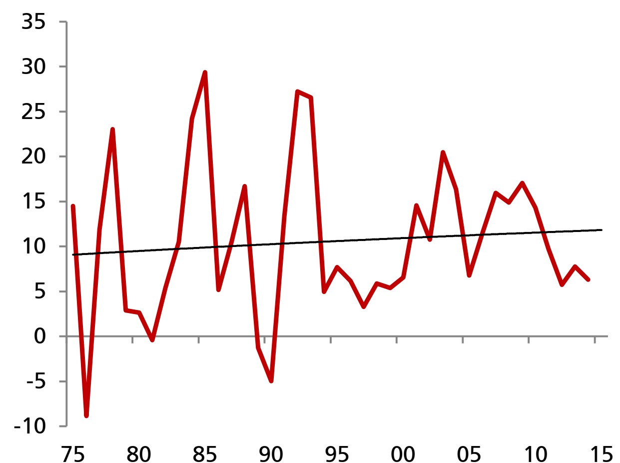
Hong Kong – real investment growth
% YoY, GFCF



India – real investment growth
% YoY, GFCF



China – real investment growth
% YoY, GFCF



is Asia's lowest at USD1,700 (chart at top next page). But even after years of fast growth, China's income remains low by Asian standards at $7,600 per person and, from this perspective, the recent 'slowdown' could prove to be more cyclical than structural. In the event, it hasn't been especially large to begin with (chart above right). (See also Appendix I for additional Asia-10 investment growth charts).

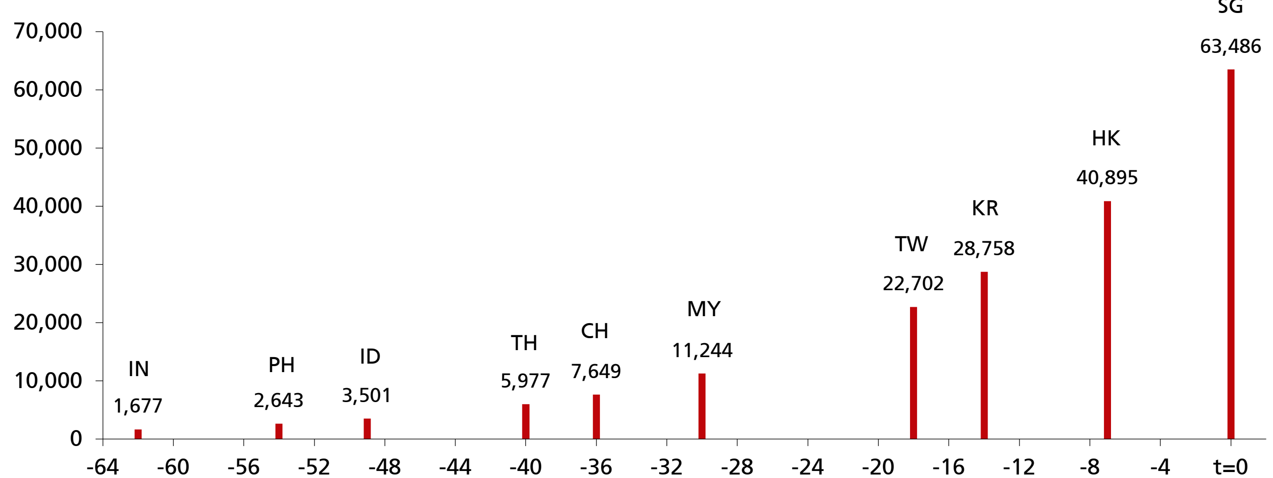
Why does investment slow?

Why does investment slow when incomes go up? The main reason is people save less / consume more. And at the end of the day saving and investment are one and the same. It doesn't start out that way of course. At *very* low incomes, the opposite is true. At very low incomes most economies are agrarian based and most of what gets produced, by necessity, gets consumed. But if you can scrimp and save a bit, the surplus can be invested in better seeds or capital equipment – productivity and incomes jump sharply. This allows more saving and more investment. A virtuous circle ensues.

But as incomes continue to rise, two things happen. The returns from more machinery or fertilizer, say, grow smaller. The second 'tractor' doesn't bring the

Asia – per capita GDP timeline

USD per person in 2014 and number of years required to reach Singapore pci (assuming 6% pci growth rate)



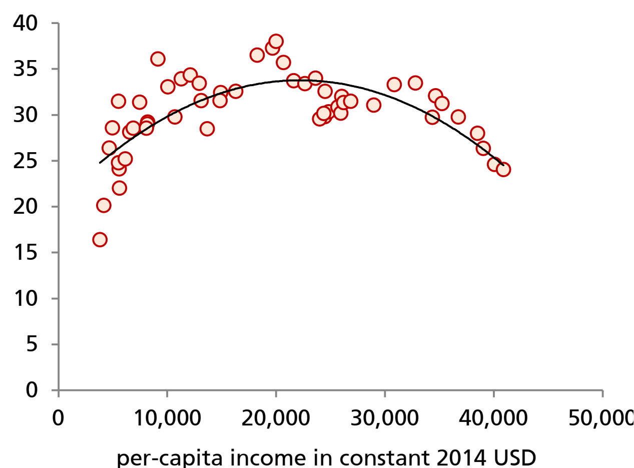
same bang as the first; the third even less, and so on. All countries find it increasingly difficult to lift productivity the higher it already is. This is the technical, supply-side of the equation: returns to saving fall.

The second thing that happens is on the softer, demand side: people themselves change. As incomes go up, most want to enjoy the fruits of their labor. Another dollar in the bank becomes less attractive than a new dress, a night on the town, a trip to Spain. Falling returns from saving and a rising preference for consumption join hands and bring a reduction in savings as a proportion of income [2]. Less savings means less investment.

U-shaped savings rates are seen virtually everywhere, eventually [3]. Hong Kong's saving rate (below left) peaked when incomes hit US$20,000 in today's prices. The same is true for the US and Japan (top of next page). Malaysia's saving rate (below right) turned south when incomes reached a much lower $8000 per person – thankfully the rate itself remains a very high 35% of GDP. The same occurred in Thailand (see additional plots in Appendix II).

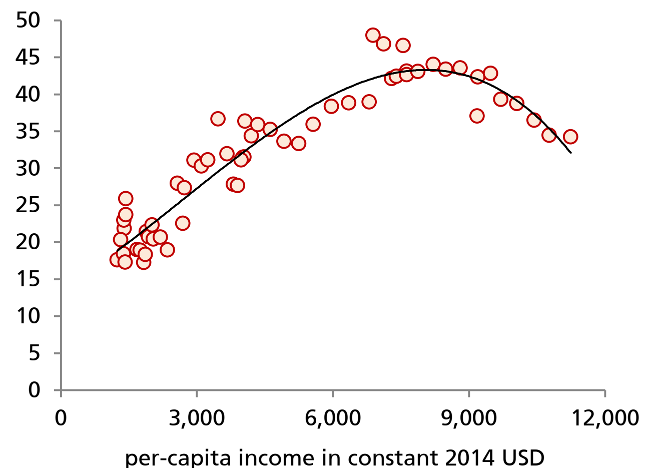
Hong Kong – saving / GDP and per-capita income

Saving / GDP (%)

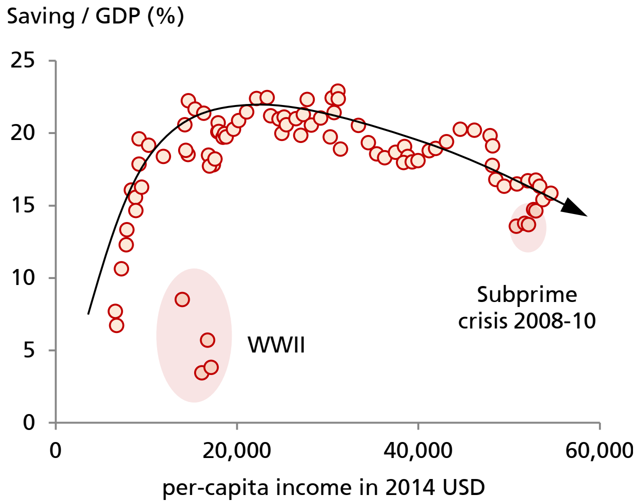


Malaysia – saving / GDP and per-capita income

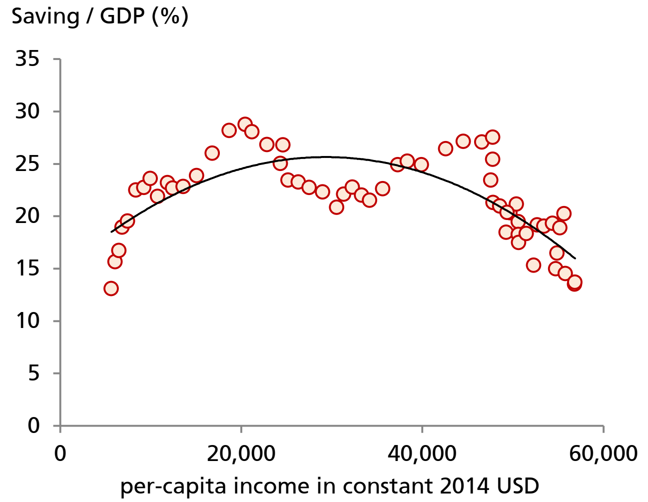
Saving / GDP (%)



US – saving / GDP and income (1929-2014)



Japan – saving / GDP and per-capita income



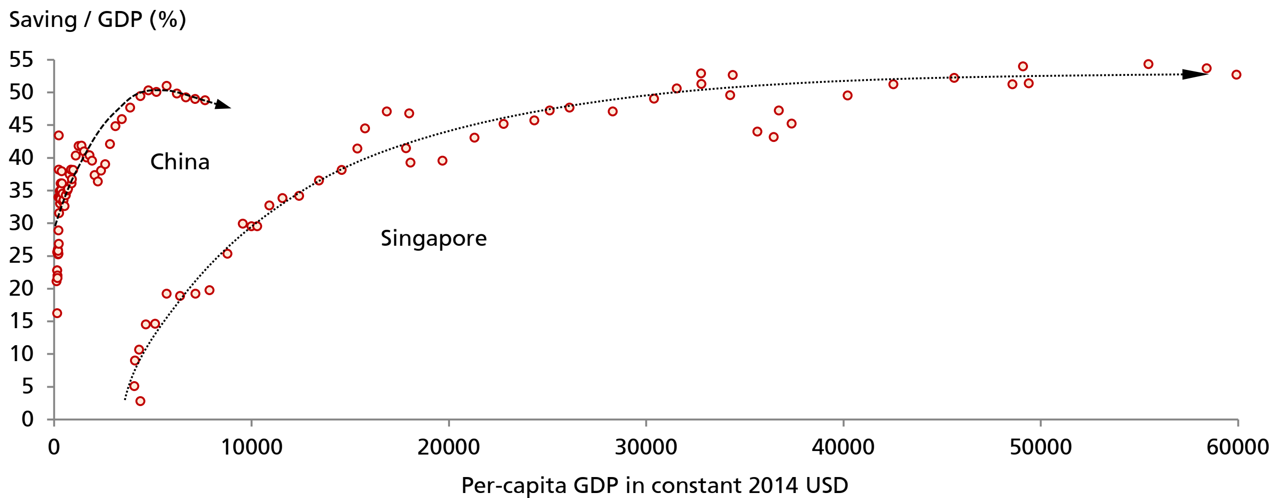
Over-investment? Or poor investment?

The experiences of China and Singapore are interesting and instructive (chart below). China is often accused of 'over-investing' – it saves too much and consumes too little, or so it is said. Saving and investment close to 50% of GDP can only lead to the kind of debt trouble that China seems to be in today. A greater consumption share in GDP 'is needed'.

But is it really? Singapore saves and invests just as much as China – and it's done so for 30 years – but nobody accuses Singapore of macro mismanagement. On the contrary, Singapore rightfully receives kudos all the time for its growth record. What gives? Why is Singapore a hero; China a reprobate?

Whatever it is, it has nothing to do with 'over-investment'. Fifty percent of GDP is fifty percent of GDP whether it's China's or Singapore's. China may have invested poorly, as most countries do from time to time. But that's different. Even China's infamous 'ghost towns' – built but not yet occupied cities – are, at worst, an example of poor investment, not over-investment. Any technocrat could have used the money spent on the ghost town to build something more immediately

China and Singapore – saving / GDP and per-capita income



beneficial to society and have been praised for his efforts. Which isn't to say that 'immediately beneficial' is the most important criteria to judge investments by. A 7% growth rate, like China's, means a lot of things that look strange today look less so tomorrow. Singapore's 4th and 5th terminals at Changi airport come to mind.

Four quick points: First, roads always go nowhere when you build them. It's what happens later that counts. Second, over-investment from a national / macro perspective isn't a well-defined term; it's nigh impossible to induce. If poor investment is the worry, call it poor investment.

Third, a high consumption share in GDP is not something to strive for, as if having one provides some sort of macro benefit, like 'sustainability'. Singapore has sustained a saving / investment ratio of 50% of GDP for decades and has little to show for it but one of the highest incomes in the world. Falling savings rates *tend* to occur as incomes go up. But the process isn't set in stone and when it occurs it occurs naturally. Most importantly, there's nothing good or bad about it. If a country prefers to work 12 hours a day and save half of it for a better life tomorrow, wonderful. If a country prefers a lower 'income' in return for cleaner air and more time at the beach, wonderful too. Consumption, saving and investment shares in GDP are choices, not exam grades.

Singapore has saved and invested 50% of GDP for decades and has nothing to show for it but one of the highest income levels in the world

Finally, judging by relative income levels, Singapore's experience and China's vast undeveloped inland areas, it could well take another 50 years before China's investment rate starts to fall. And the country could well be better off for it than were it to pursue greater consumption today.

Arresting the slide in investment

For most Asian countries, including China and Singapore, the issue isn't how to guard against 'over-investment', it's how do you arrest its slide of the past few years? Asia-10 growth in real fixed capital formation has fallen below 3% per year (chart page 1) and that simply won't sustain the kind of GDP growth needed to raise incomes and employ growing populations.

Enter China's new Asian Infrastructure Investment Bank (AIIB) – might that turn the tide? Unfortunately no, and not because Japan and the US remain petulantly reluctant to join. The AIIB aims to raise $100bn for regional investment projects, which simply isn't a large amount of money. In 2014, Asia-10 gross fixed capital formation amounted to US$6,700bn. If the AIIB raised and then dispersed all $100bn of its funds over the next three years – a highly unlikely event – it could finance an additional 0.4% of Asia-10 investment over and above what is already likely to occur on that time frame. That's better than nothing but not by much. The AIIB's significance is more political than economic [4].

Some good old-fashioned red ink is what the region needs

Asia's current account surpluses have to go

There's a bigger reason why the AIIB is unlikely to lift investment in Asia: all the Asia-10 countries, save for India and Indonesia, are running current account surpluses and have been for the past 18 years. Why does that make the AIIB irrelevant? Because if you're running C/A surpluses, you're lending to the rest of the world. You don't need to borrow funds from the AIIB if you're a lender yourself. You don't need to borrow funds from *anyone* if you're a lender yourself.

But if Asia has been lending to the rest of the world for the past 18 years, it's immediately clear how to raise investment at home: stop lending and start borrowing. Stop running C/A surpluses and start running C/A deficits. Stop investing in US Treasuries and start investing domestically, where the income-lifting capital equipment and infrastructure is needed.

Run current account deficits? Sounds pretty heretical. To most, it is. Foreign investors wouldn't like it. Rating agencies wouldn't like it. Local officials wouldn't like it. It's unanimous.

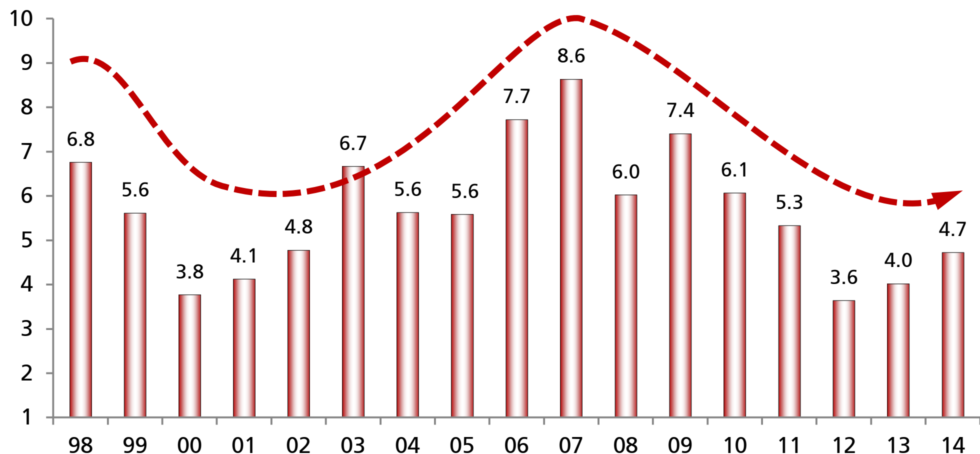
And unanimously wrong. Running deficits in Asia isn't heretical. It's Finance 101. It's the way things are *supposed* to be. Higher income / capital abundant countries are supposed to lend to lower income / capital scarce countries, not vice-versa. The foreign lender earns a higher return than he can at home; the local borrower can invest more than his own savings will allow. And – most importantly – everyone's incomes go up more than they otherwise would. It's a handshaking deal that benefits both sides of the borrower/lender equation. Why rating agencies, officials and Boston fund managers see heresy in this is anyone's guess but for the sake of higher incomes of everyone involved, mindsets need to change. Emerging economies are supposed to be borrowers, not lenders.

A current account swing equivalent to 6% of GDP would bring boat-loads of needed domestic invest-ment to the region

But what kind of money are we talking about here? Would moving from surplus to deficit really make much of a difference to Asia's investment equation? Yes it would – a very large difference. On average, Asia-10 countries have run C/A surpluses to the tune of 6% of GDP every year since 1998. That means they have lent 6% of their income to foreign countries every year for the past 18 years. They could have been investing that much at home instead.

Asia 10 – current account surplus

% of GDP, simple average



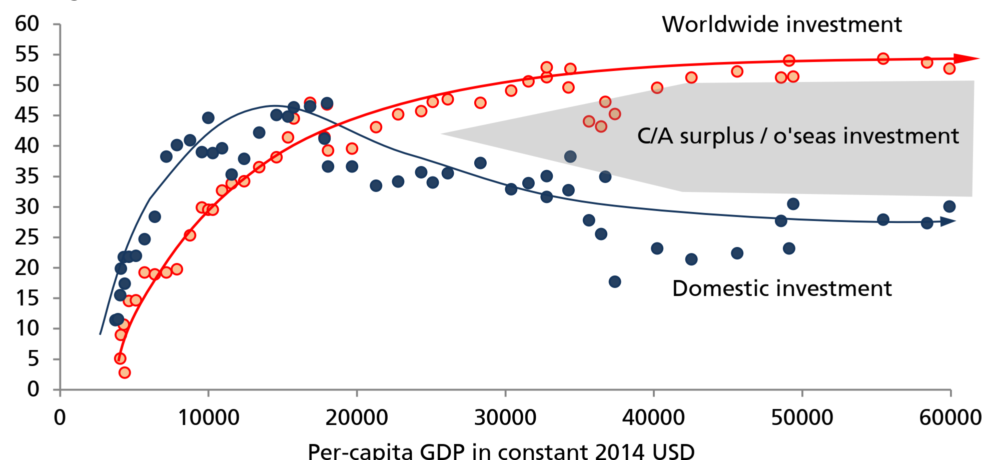
And that's without any red ink. If they ran deficits of 2%-3% of GDP, domestic investment could be 8%-9% of GDP higher than it currently is. That's a boatload of investment dollars that could be improving Asia's infrastructure, raising Asia's growth rates and lifting Asian incomes. To be sure, the 2%-3% deficit represents borrowing and returns on those funds go the foreigner. But the 2%-3% rise in the capital stock each year lifts labor productivity and wages too, and that portion stays at home. Again, it's a handshaking deal.

Asia-vu?

Too much borrowing is dangerous of course. After all, the reason deficits are anathema to foreign investors, public officials and ratings agencies alike is because too much borrowing led to the Asian financial crisis of 1997/98. But that was 18 years ago and deficits back then were 10% of GDP in some countries for a good many years. It's time to let go.

Who would benefit in Asia by a swing to deficit? Everyone, save, as mentioned, for India and Indonesia, where deficits of 2%-3% of GDP are already being run. Malaysia would benefit greatly, as domestic investment has fallen sharply and it runs a current account surplus of 5%-6% of GDP. Korea and Taiwan run surpluses

Singapore – saving and domestic investment shares in GDP and per-capita income



of 6% and 12% of GDP respectively and few would argue that those economies couldn't use more local investment.

Singapore might benefit more than most (chart above). It is grappling with below-normal GDP and productivity growth and has been attempting to raise both with a significant restructuring exercise that is now entering its fifth year. Results have been mixed. Singapore is a high income country and so, by the logic outlined above, ought to be lending abroad. But its current account surplus was 19% of GDP in 2014 and has averaged 20% of GDP since 2010! With productivity growth negative in 2014, it's hard to argue that some of that 19% of GDP current account surplus couldn't be spent on domestic investment instead of overseas investment, helping raise domestic productivity and incomes in the process.

The Asian Financial Crisis was 18 years ago. It's time to move on. Mindsets must change

A brighter future

Asia's incomes continue to rise and slower investment is a natural part of that process. But investment growth has slowed to below 3% per year and that won't sustain the GDP growth that Asia is accustomed to and needs to keep incomes rising and populations employed. Current account surpluses are standing in the way of greater domestic investment in all Asian countries save for Indonesia and India. A swing to modest 2%-3% of GDP deficits could lift investment in the region by 8-9 percentage points of GDP – a huge amount.

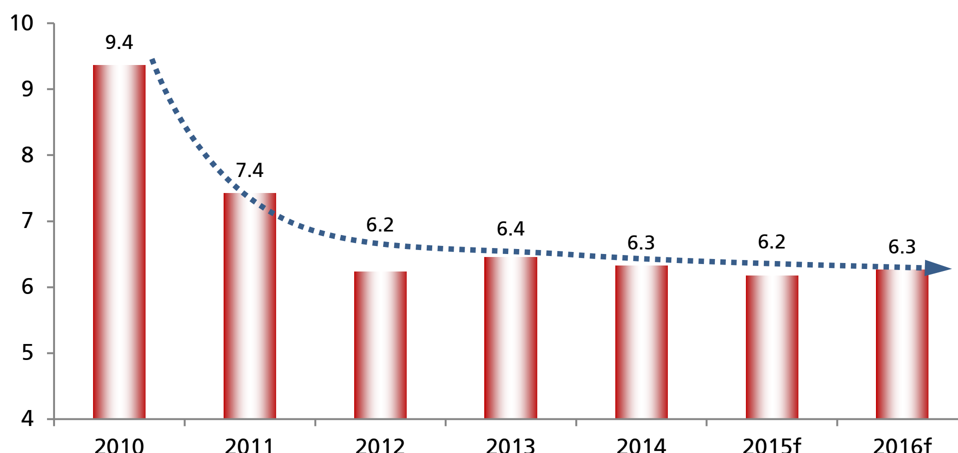
But mindsets have to change for this to occur. Officials, ratings agencies and fund managers all need to let go of 1997. Everybody wins when capital abundant investors lend to capital scare borrowers. Everyone loses when the opposite occurs, as it is today. Periodic crises shouldn't mean you throw the baby out with the bath water. Until the much-needed shift in mindset occurs, no amount of funding from an AIIB or other institution will succeed in lifting domestic investment in the region. Some say you can't squeeze blood from a turnip. It's just as hard to shovel water into a fire hydrant.

Notes:

[1] Weighted average growth has also remained stable for the past four years at about a 6.25% growth rate (chart below). The lion's share of China's slowdown came in 2011.

Asia10 – GDP growth

% YoY, wtd avg



[2] Demographics may also play a role. As individuals age, they begin to work less and ultimately dis-save. If a country overall is aging, savings rates will tend to fall.

[3] See also: "Asia: U-shaped consumption paths and non-discretionary spending", 17Jan14.

[4] Nor is China's $50bn AIIB commitment particularly significant. In today's dollars, China's trade surplus of the past five years amounts to about US$1,250bn, most of which has been invested in US Treasuries and German Bunds. Shifting $50bn of that into regional infrastructure is plainly less momentous than it sounds.

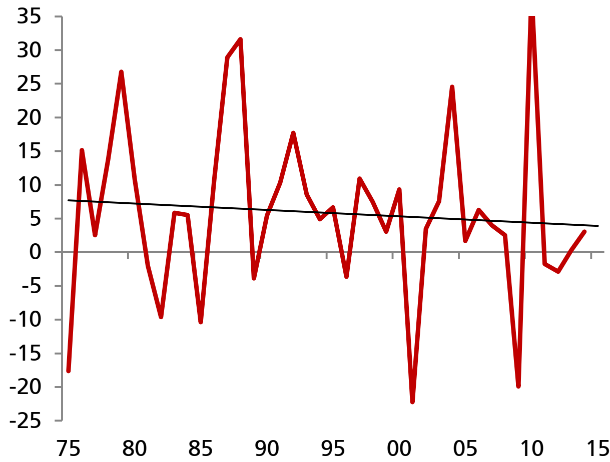
Sources:

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

Appendix I: real investment growth

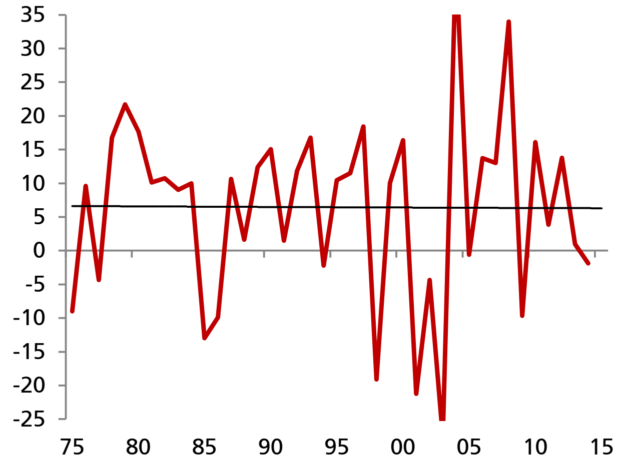
Taiwan – real investment growth

% YoY, GFCF



Singapore – real investment growth

% YoY, GFCF

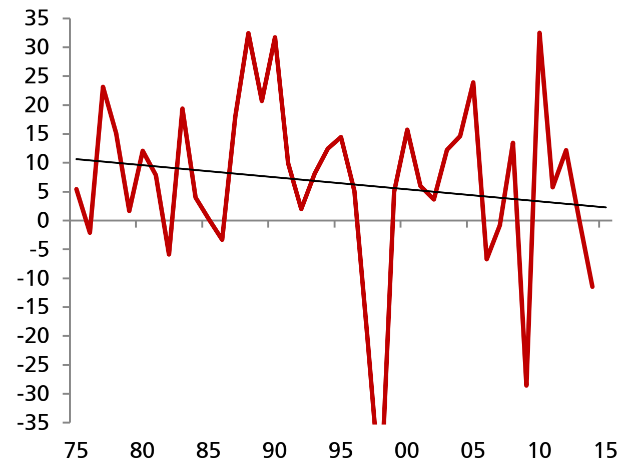


Malaysia – real investment growth

% YoY, GFCF

Thailand – real investment growth

% YoY, GFCF

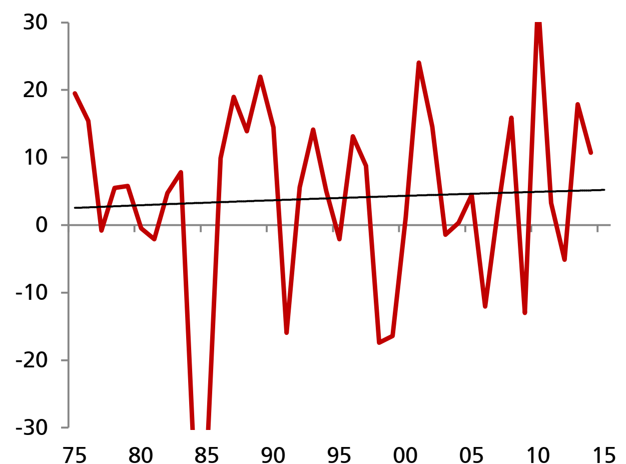


Indonesia – real investment growth

% YoY, GFCF

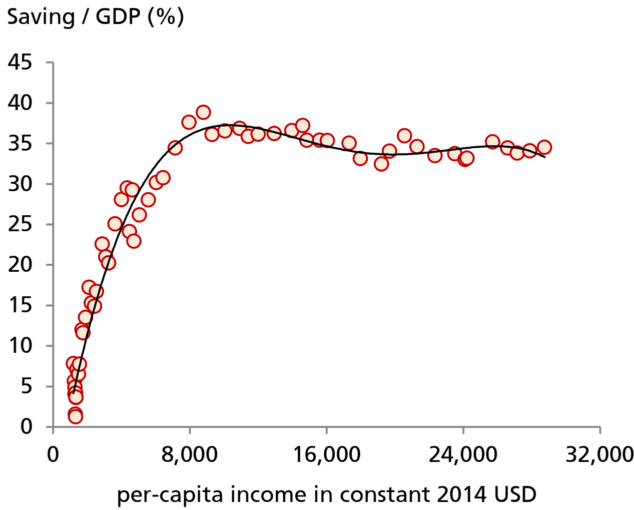
Philippines – real investment growth

% YoY, GFCF

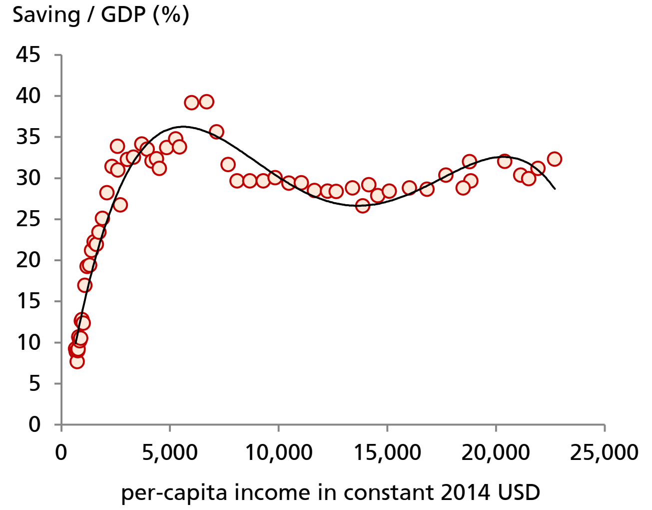


Appendix II: saving / GDP and per-capita income

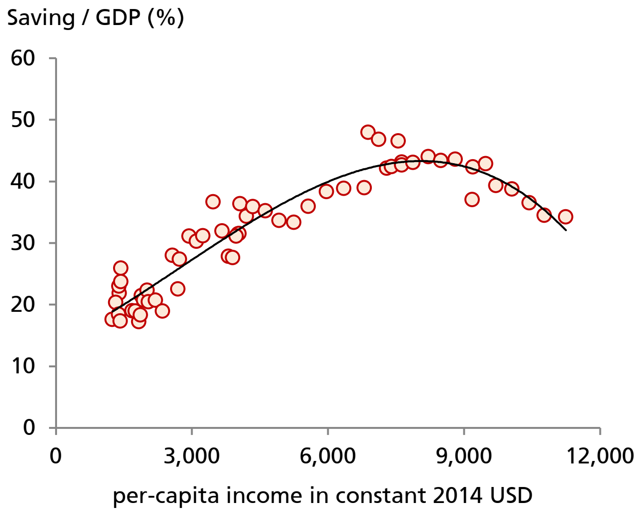
Korea – saving / GDP and per-capita income



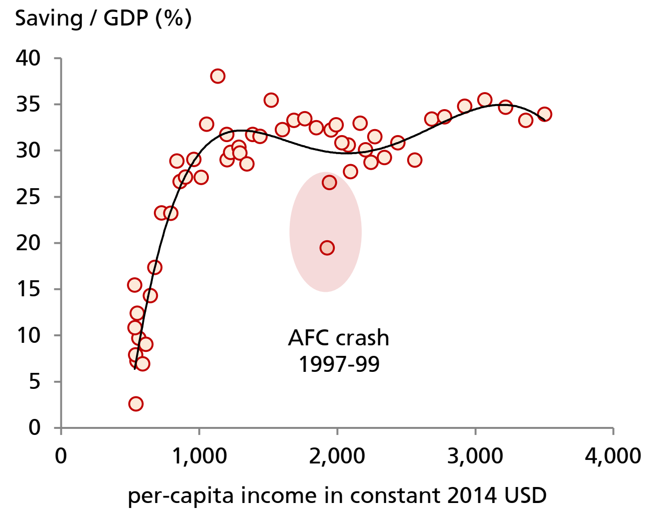
Taiwan – saving / GDP and per-capita income



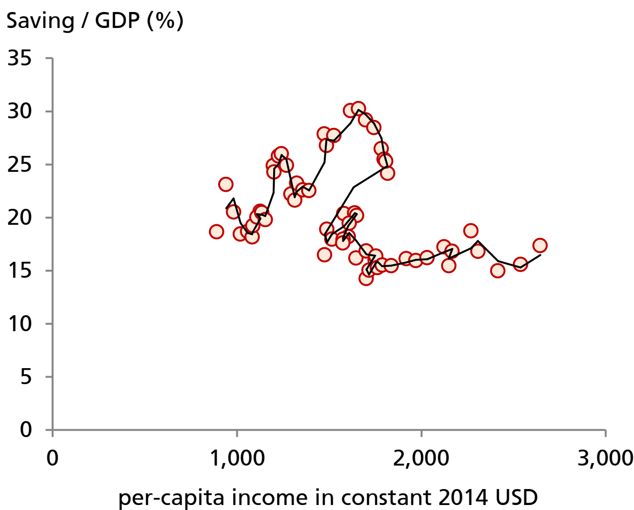
Thailand – saving / GDP and per-capita income



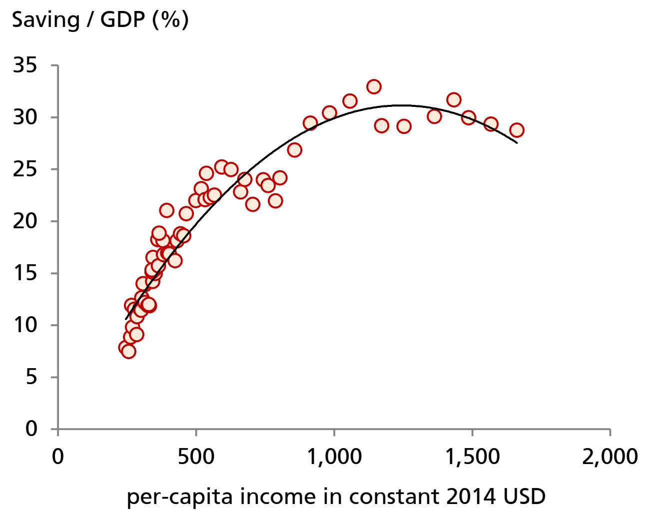
Indonesia – saving / GDP and per- capita income



Philippines – saving / GDP and per-capita income



India – saving / GDP and per-capita income



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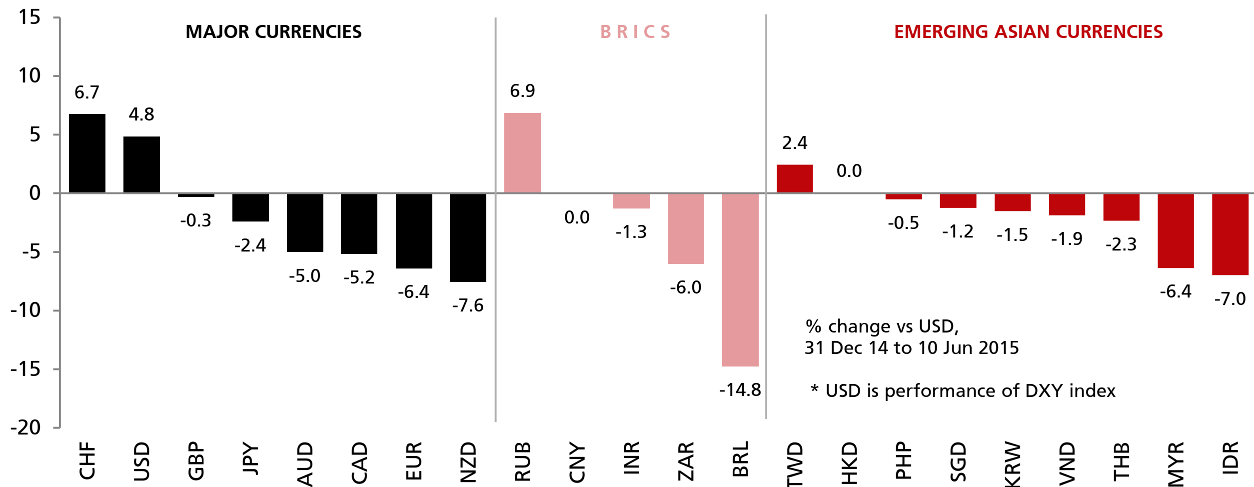
FX: tough times

Asia	Growth and trade slow; inflation falls
	The rest of the year is about rate cuts and currency depreciation
	Nervousness over US rates hikes in 2H15
	Lift-off expected by year-end
CNY	Stable with a bias toward weakness
HKD	More peg debate
TWD	No longer outperforming
KRW	Defensive
SGD	Uninspiring
MYR	Too many headwinds
THB	Weaker
IDR	Record low
PHP	Less optimistic
VND	Devalued again
INR	Rough weather
USD	Preparing for lift-off
EUR	QE to run till Sep-2016
JPY	2% inflation still eludes
AUD	Not out of the woods
NZD	Flip-flops

USD held on to gains by mid-2015



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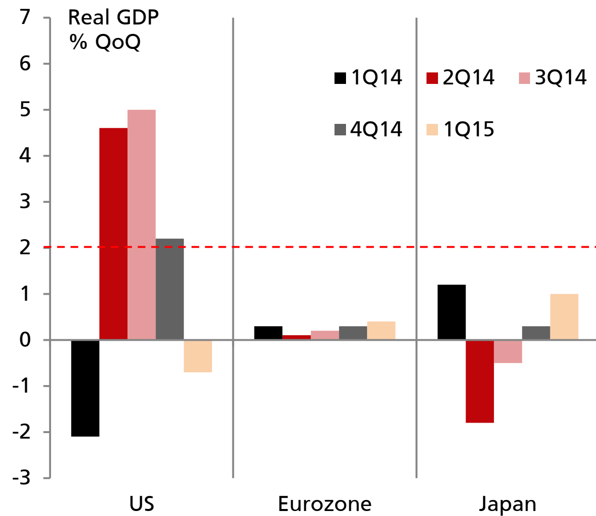
Currency forecasts

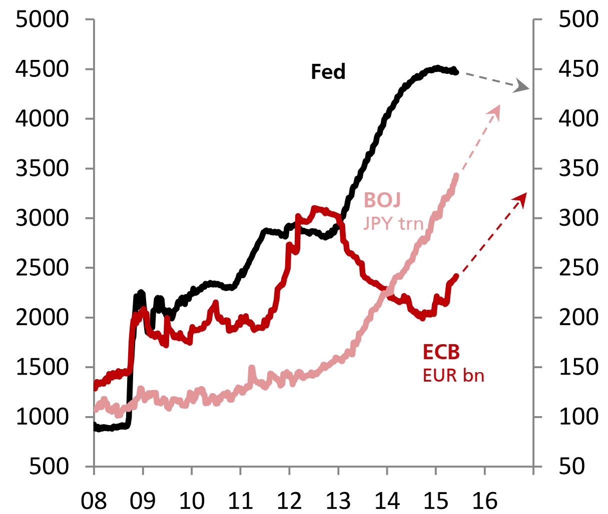
		10-Jun	3Q15	4Q15	1Q16	2Q16
EUR /usd		**1.1324**	**1.08**	**1.05**	**1.02**	**0.99**
	Previous		1.08	1.05	1.02	1.01
	Consensus		1.06	1.05	1.05	1.04
usd/ **JPY**		**122.65**	**125**	**126**	**127**	**128**
	Previous		122	123	124	125
	Consensus		125	125	126	128
usd/ **CNY**		**6.2061**	**6.24**	**6.26**	**6.28**	**6.30**
	Previous		6.33	6.36	6.39	6.40
	Consensus		6.20	6.19	6.19	6.20
usd/ **HKD**		**7.7524**	**7.77**	**7.77**	**7.78**	**7.79**
	Previous		7.77	7.77	7.78	7.79
	Consensus		7.77	7.76	7.77	7.78
usd/ **TWD**		**30.870**	**32.0**	**32.2**	**32.4**	**32.6**
	Previous		32.0	32.2	32.4	32.5
	Consensus		31.5	31.8	32.0	32.1
usd/ **KRW**		**1109.9**	**1133**	**1147**	**1161**	**1175**
	Previous		1133	1147	1161	1168
	Consensus		1120	1120	1132	1150
usd/ **SGD**		**1.3415**	**1.36**	**1.38**	**1.40**	**1.42**
	Previous		1.39	1.40	1.41	1.42
	Consensus		1.37	1.38	1.39	1.39
usd/ **MYR**		**3.7325**	**3.74**	**3.76**	**3.78**	**3.80**
	Previous		3.69	3.71	3.73	3.74
	Consensus		3.70	3.72	3.73	3.74
usd/ **THB**		**33.650**	**33.7**	**33.8**	**34.0**	**34.1**
	Previous		33.2	33.3	33.5	33.6
	Consensus		34.0	34.0	34.0	34.4
usd/ **IDR**		**13310**	**13460**	**13660**	**13870**	**14080**
	Previous		13460	13660	13870	13970
	Consensus		13425	13497	13618	13950
usd/ **PHP**		**44.980**	**45.3**	**45.4**	**45.4**	**45.5**
	Previous		45.3	45.4	45.4	45.5
	Consensus		45.2	45.4	45.6	45.9
usd/ **INR**		**63.8350**	**64.6**	**65.6**	**66.7**	**67.8**
	Previous		64.6	65.6	66.7	67.7
	Consensus		64.2	64.4	64.3	65.8
usd/ **VND**		**21775**	**21781**	**21781**	**21781**	**21781**
	Previous		21350	21350	21350	21350
	Consensus		21800	21867	22000	22000
AUD /usd		**0.7758**	**0.76**	**0.74**	**0.72**	**0.70**
	Previous		0.72	0.70	0.67	0.66
	Consensus		0.75	0.74	0.73	0.72
NZD /usd		**0.7207**	**0.70**	**0.68**	**0.66**	**0.65**
	Previous		0.70	0.68	0.66	0.65
	Consensus		0.71	0.70	0.69	0.70

DBS forecasts in red. Consensus are median forecasts collated by Bloomberg as at 10 Jun 2015

US economy unlikely to fall behind for long



Cen bank bal sheets – only US stopped expanding

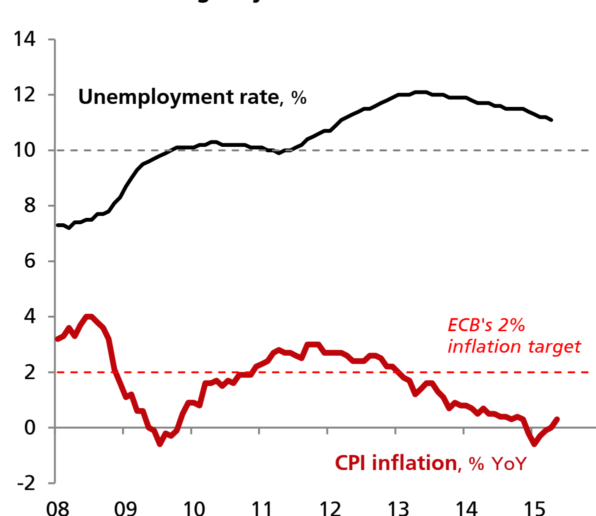


G3 currencies – completing monetary policy divergences

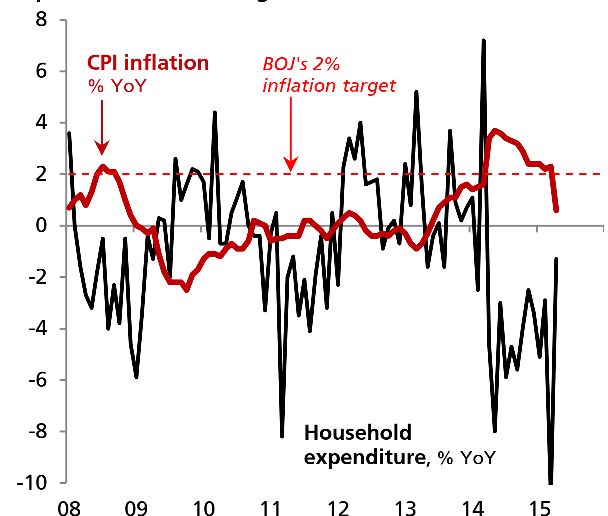
The greenback had not been able to make new highs ever since the DXY (USD) index peaked at 100.39 on 13 Mar. To a large extent, this was attributed to a disappointing US economy in 1Q15; real GDP contracted by 0.7% (QoQ, saar). Meanwhile, Eurozone growth improved while Japan further exited its technical recession. The DXY suffered a downward correction as an improved outlook for the Eurozone led to higher German bund yields and a stronger euro. This is unlikely to last.

The USD will resume its uptrend if the Fed hikes rates later this year as expected. Most officials and analysts, including DBS, believe the contraction in 1Q15 was temporary and growth will normalize from 2Q15. We expect 2.2% GDP growth this year, double that of Japan and the Eurozone. With the economy continuing to recover, most officials believe policy normalization will appropriate by year-end. The Fed has already ended its quantitative easing (QE) programs by tapering asset purchases from Dec 2013 to Oct 2014. According to Fed Vice Chairman Stanley Fischer, the pending rate hike cycle could last 3-4 years and bring the Fed Funds Rate to 3.25-4.00% by 2018.

Eurozone – a long way from sustainable inflation



Japan – still recovering from sales tax hike



10Y govt bond yields – only US is above 2%

Benchmark stock indices – US is still first out of crisis

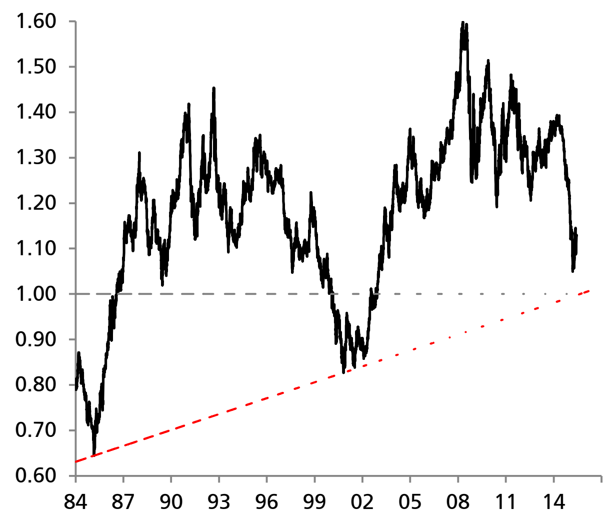
In Europe, the ECB remains far way from it's goal of 2% inflation, thanks in large part to the double-digit jobless rate there. Lest we forget, it took the Fed three rounds of QEs before US unemployment fell below 6% from 10%. While Eurozone stocks have outperformed their US counterparts recently, US equities are, on a bigger picture, well ahead of the Eurozone in exiting crisis. Hence, the ECB is expected to be more agenda driven, and less data dependent, in keeping QE running till Sep 2016 as scheduled.

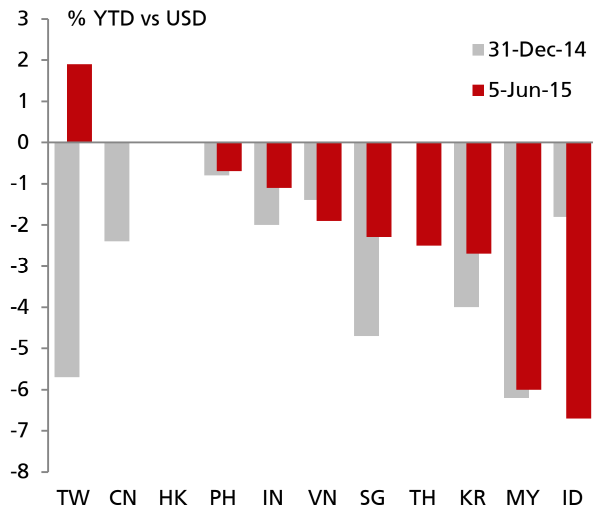
As for Japan, the return of growth does not bring the Bank of Japan (BOJ) any closer to achieving its 2% inflation target. In fact, household spending growth remains weak in negative territory. With the base effect wearing off from the first sales tax hike in Apr 2014, inflation has headed south quickly. The BOJ is likely to keep QE going into the second sales tax hike scheduled for Apr 2017.

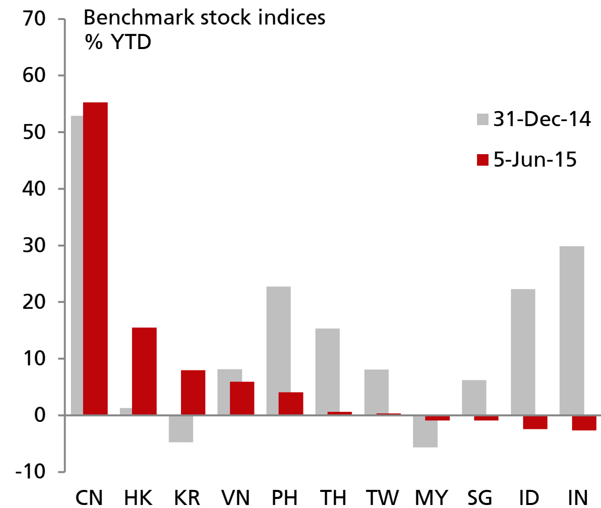
Overall, the Fed's balance sheet should continue to moderate even whilst those in the Eurozone and Japan expand. Having broken a multi-decade trendline in 2Q15, the risk of USD/JPY returning to its 2002 high cannot be discounted. EUR/USD also has scope to fall to a similar trendline currently located around parity.

USD/JPY breaks multi-decade trendline

EUR/USD – still looking at parity



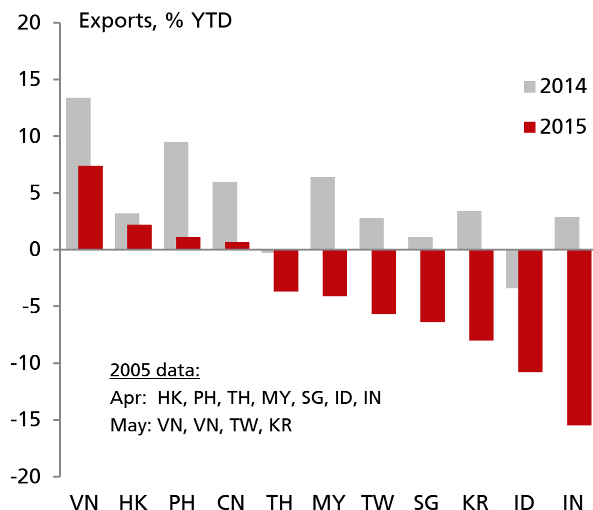


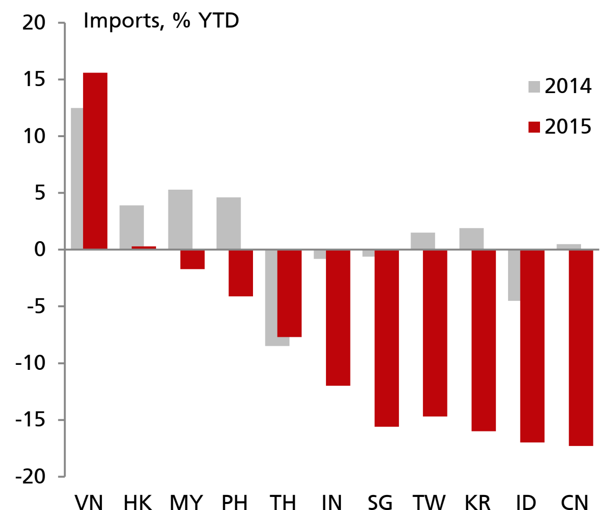


Asia ex-Japan currencies – 2015 is not looking good

With the exception of the Taiwan dollar, Chinese yuan and Hong Kong dollar, all Asia ex Japan (AXJ) currencies have, as at 5 Jun, depreciated this year. Unlike 2014, fundamentals have weakened in the region which was consistent with lacklustre performances in stock markets. China and Hong Kong equities bucked the dismal trend here, benefiting from the mainland's monetary easing and intensified efforts to internationalise the Chinese yuan and increase capital account convertibility. Even so, the Chinese yuan did not deviate far from its end-2014 level. Despite a wider trade surplus and impressive stock market, foreign reserves did not rise but fell, implying capital outflows from China.

Many AXJ countries are not expected to meet their official growth targets. Exports and imports have fallen sharply so far this year compared to moderate growth for the whole of last year. Unfortunately, the wider trade surpluses in some countries were not considered healthy because they did not result from exports rising at a faster pace than imports, but from imports falling faster than exports. In Vietnam, trade deficit deteriorated from weaker export growth and stronger import growth, which in turn, led to two devaluations in the Vietnam dong this year.





Asia's monetary policy – rate cuts (bps)

	Jan-15	Feb	Mar	Apr	May	Jun-15
ID	…	-25	…	…	…	…
IN	-25	…	-25	…	…	-25
HK	…	…	…	…	…	…
PH	…	…	…	…	…	…
MY	…	…	…	…	…	…
CN	…	…	-25	…	-25	…
VN	deval	…	…	…	deval	…
KR	…	…	-25	…	…	…
SG	flatten	…	…	Unch	…	…
TW	…	…	…	…	…	…
TH	…	…	-25	-25	…	…

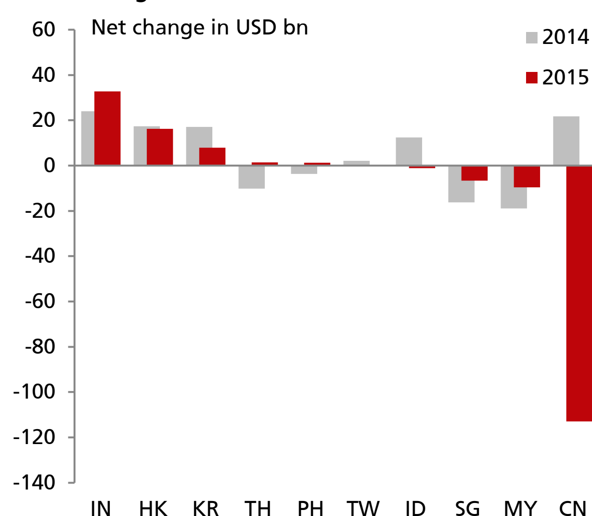
Asia's CPI disinflation (% YoY)

	2014	Jan-15	Feb	Mar	Apr	May
ID	6.4	7.0	6.3	6.4	6.8	7.2
IN	6.0	5.2	5.4	5.3	4.9	…
HK	4.4	4.1	4.6	4.5	2.8	…
PH	4.2	2.4	2.5	2.4	2.2	1.6
MY	3.1	1.0	0.1	0.9	1.8	…
CN	2.0	0.8	1.4	1.4	1.5	1.2
VN	4.1	0.9	0.3	0.9	1.0	1.0
KR	1.3	0.8	0.5	0.4	0.4	0.5
SG	1.0	-0.4	-0.3	-0.3	-0.5	…
TW	1.2	-0.9	-0.2	-0.6	-0.8	-0.7
TH	1.9	-0.4	-0.5	-0.6	-1.0	-1.3

With governments obligated to safeguard their sovereign debt ratings, many AXJ countries took advantage of the disinflationary environment to ease monetary policy to support growth instead. In this regard, monetary policy divergences were also evident in the region. No AXJ central bank is expected to join the US in hiking rates later this year. There was some speculation that Thailand's back-to-back rate cuts in Mar and Apr may also have sought to align the Thai baht to the weaker currencies in the region. With exports and inflation in negative territory, Taiwan may also become less tolerable in the Taiwan dollar bucking the region's depreciation. Close attention is also paid to the Philippine peso here.

The Indonesian rupiah and the Malaysian ringgit were the worst hit currencies this year. It did not matter that Indonesia was a net oil importer and Malaysia a net exporter, or that Fitch put Malaysia on negative watch while Standard & Poor's upgraded Indonesia's outlook. Both countries have weak international liquidity positions (large external debt vs low foreign reserves) that render their currencies vulnerable to the twin prospects of a stronger USD and higher US interest rates later this year. Not surprisingly, the Indian rupee was not spared from worries of a repeat of the emerging market volatility seen in 2013. Except that this time around, the twin deficit-led India has the worst performing export market.

Asia's foreign reserves



Asia's real GDP growth (% YoY)

	2013	2014	2Q14	3Q14	4Q14	1Q15
ID	5.6	5.0	5.0	4.9	5.0	4.7
IN	6.9	7.3	8.4	6.6	7.5	…
HK	3.1	2.5	2.0	2.9	2.4	2.1
PH	7.2	6.1	6.7	5.5	6.6	5.2
MY	4.7	6.0	6.5	5.6	5.7	5.6
CN	7.7	7.4	7.5	7.3	7.3	7.0
VN	5.4	6.0	5.2	5.6	6.0	6.0
KR	2.9	3.3	3.4	3.3	2.7	2.5
SG	4.4	3.0	2.3	2.8	2.1	2.6
TW	2.2	3.8	3.9	4.3	3.5	3.4
TH	2.9	0.7	0.9	1.0	2.1	3.0

Red denotes slowdown

US dollar

DXY has scope to push above 100 again if the Fed stays the course to lift rates later this year

The fate of the USD depends heavily on the Federal Reserve staying on schedule to lift rates later this year. According to Fed presidents from San Francisco and Cleveland, the Fed could act at any of the FOMC meetings from Jun to Dec. Fed Chair Janet Yellen, on 22 May, said that the 0.7% (QoQ, saar) contraction in 1Q15 GDP was transitory and expected the economy to recover thereafter. Some officials have argued it is better to raise rates "sooner and gradual" rather than "later and steeper". Fed Vice-Chairman Stanley Fischer indicated that the pending hike cycle could lead the Fed Funds rate to 3.25-4% in 2018. This suggests a gradual rate hike cycle of 1% per year over the next 3-4 years, compared to modest "2% over 2 years" during the 2004-06 hike cycle, and the aggressive "3% over 1 year" hike in 1994-95. Two things are important here for the USD. First, the Fed hike will complete the monetary divergences story. Second, the Fed hike cycle will be running alongside quantitative easing policies in Japan and the Eurozone well into the latter half of 2016. This should keep the USD firm against the basket of currencies in the DXY, namely, the EUR and JPY.

DXY index – upward bias intact

DXY	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**94.646**	**98.0**	**99.7**	**101.5**	**103.3**
Previous		99.6	100.9	102.1	102.6
Consensus		99.6	100.3	100.4	107.6

Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.25**	**0.25**	**0.50**	**0.75**	**1.00**
Previous		0.25	0.50	0.75	1.00
Consensus		0.45	0.70	1.00	1.25

Euro

EUR/USD is still biased down towards parity with Fed hikes outweighing Eurozone optimism

EUR/USD bottomed at 1.0456 on 16 Mar after the European Central Bank (ECB) launched its quantitative easing (QE) program on 6 Mar. Between 13 Apr and 15 May, EUR/USD rose from 1.0519 to 1.1466, during which the German 10Y bund yield surged to a high of 0.724% from its bottom of 0.075% on 20 Apr. On a relative basis, EUR/USD was underpinned by an improvement in Eurozone's growth to 0.4% QoQ in 1Q15 from 0.3% in the previous quarter, US growth slipped to -0.7% QoQ from +2.2% for the comparable period. The European Commission, on 5 May, upgraded its 2015 EU growth outlook to 1.8% from 1.7% previously. The ECB, on 3 Jun, upgraded its 2015 inflation forecast to +0.3% from 0% previously. In keeping its inflation outlook at 1.5% and 1.8% for 2016 and 2017, the ECB reminded markets that it still a long way from achieving its mandate to return inflation sustainably to 2%. In other words, the ECB reaffirmed that its QE program will run its course into Sep 2016. Meanwhile, senior Fed officials have since 22 May started to talk about lifting rates in Jun-Dec. If so, this has scope to push EUR/USD back down on monetary policy divergences.

EUR/USD – risks remain to the downside

EUR /usd	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1.1324**	**1.08**	**1.05**	**1.02**	**0.99**
Current		1.08	1.05	1.02	1.01
Consensus		1.06	1.05	1.05	1.04

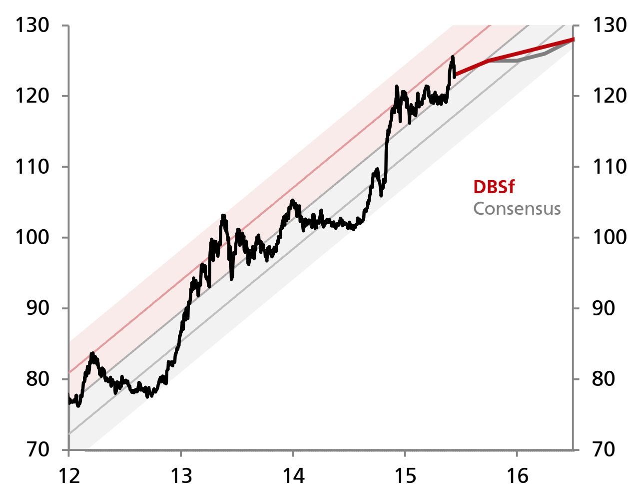
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.05**	**0.05**	**0.05**	**0.05**	**0.05**
Previous		0.05	0.05	0.05	0.05
Consensus		0.05	0.05	0.05	0.05

Japanese yen

USD/JPY breaks into higher ground above 125 on monetary policy divergences

USD/JPY was stable, mostly between 118 and 122 in Feb-May, before it depreciated sharply to 125.61 by 5 Jun, a level not seen since Jun 2002. Unlike the second half of last year, the JPY's depreciation was not driven by the Bank of Japan (BOJ) expanding its quantitative and qualitative easing (QQE) program in Oct 2014 in response to the technical recession in 2Q-3Q14. While real GDP growth has returned to positive territory, CPI inflation headed south to 0.6% in Apr15 from 3.7% in May14. As far as BOJ is concerned, QQE will remain in place for as long as necessary to return and sustain inflation to its 2% target. Neither can the weak JPY be explained by current account which posted its widest surplus since 2008. This coupled with the consistent moderation in foreign reserves suggested ongoing capital outflows from pension and institutional funds investing in assets overseas. Hence, the JPY's weakness is better explained by monetary policy divergences, namely from the Fed signalling its intentions to start hiking rates in Jun-Dec 2015. In Jan-May this year, the Fed's balance sheet shrank to $4.46 trillion from $4.50 trillion, while the BOJ's monetary base expanded to JPY304 trillion from JPY275 trillion.

USD/JPY – underpinned above 1.20



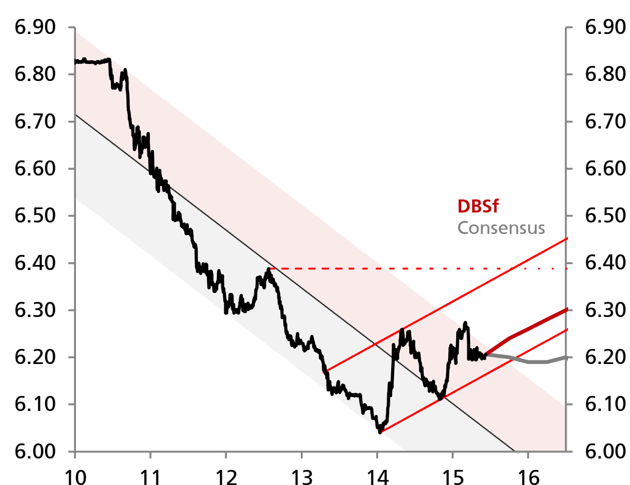
usd/ **JPY**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**122.65**	**125**	**126**	**127**	**128**
Previous		122	123	124	125
Consensus		125	125	126	128
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Previous		0.10	0.10	0.10	0.10
Consensus		0.10	0.10	0.10	0.10

Chinese yuan

USD/CNY has been stable but its upward bias will increase as CNY is used more overseas

The focus in China is on its strong stock rally and not on the CNY. By 5 Jun, the Shanghai Composite index rallied 55.3% since end-2014, driven by easy monetary policies to address the economic slowdown. Since last Nov, China has cut interest rates thrice by a total 90 bps to 5.10%, and lowered banks' reserve requirement ratio twice by a total 150 bps to 18.5%. With the launch of the deposit insurance system on 1 May, China is ready to remove the ceiling on deposit rates. Efforts to open the capital account have increased foreign participation in the domestic bond market. The above developments coupled with efforts to internationalise its currency should improve the CNY's bid to join the IMF's Special Drawing Right (SDR) this year. Success here, however, does not imply that the CNY will resume its one-way appreciation trend. In fact, both the spot and parity rates for USD/CNY have not deviated far from end-2014 the levels. To increase the use of the CNY overseas, especially for its regionalisation efforts (i.e. One Road, One Belt), will imply more outward direct investments from China. Not surprisingly, foreign reserves have dropped despite a wider current account surplus in 1Q15.

USD/CNY – underpinned above 6.20



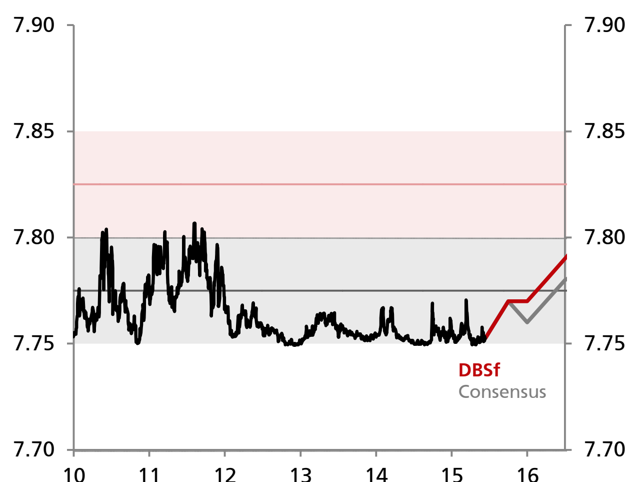
usd/ **CNY**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**6.2061**	**6.24**	**6.26**	**6.28**	**6.30**
Previous		6.33	6.36	6.39	6.40
Consensus		6.20	6.19	6.19	6.20
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**5.10**	**4.85**	**4.60**	**4.60**	**4.60**
Previous		5.10	5.10	5.10	5.10
Consensus		4.95	4.85	4.85	4.80

Hong Kong dollar

USD/HKD to lift off from the floor of its 7.75-7.85 convertibility band

The Hong Kong Monetary Authority (HKMA) intervened in mid-Apr to support the floor of its USD/HKD convertibility band between 7.75 and 7.85. This was around the period when Hong Kong stocks rallied strongly with their Shanghai counterparts. Apart from easing monetary policy, China also guided its USD/CNY parity rate down to 6.1079 from 6.1617 in Mar-May. Hong Kong is at an important crossroad where economies and policies in the US and China appeared to be headed in opposite directions. On the one hand, the HKD peg to the USD keeps HK rates tied to US rates that may start rising later this year. On the other hand, Hong Kong's stock market is more correlated with China, fuelled by easy monetary policy on the mainland. Inflows from the mainland had led Hong Kong to introduce more measures in Feb to cool the property bubble. Inflows were also evident in Hong Kong's record high foreign reserves vis-à-vis lower reserves in the rest of the region. With China opening its capital account and aiming to promote the CNY as a new international reserve currency, debate is also starting over whether it is time to consider shifting the peg from the USD to the CNY.

USD/HKD – to rise when US rates rise



usd/ **HKD**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**7.7524**	**7.77**	**7.77**	**7.78**	**7.79**
Previous		7.77	7.77	7.78	7.79
Consensus		7.77	7.76	7.77	7.78

Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.39**	**0.50**	**0.70**	**0.95**	**1.20**
Previous		0.50	0.70	0.95	1.20
Consensus		0.67	0.84	1.12	1.40

Taiwan dollar

USD/TWD likely to have bottomed and set to rise from the floor of its ascending price channel

The TWD has, for most of this year, bucked the depreciation pressures endured by other Asia ex Japan currencies. Initially, this did not appear to be a concern. The TAIEX stock index briefly rose and hit on 28 Apr, for the first time since Apr 2000, its psychological 10000 level. Thanks to an economy that outperformed its peers, Taiwan did not ease monetary policy like South Korea or Singapore. On a 12-month rolling basis, trade surpluses surged to new record highs. Unfortunately, this was not due to exports rising at a faster pace than imports, but from imports falling at a faster pace than exports. CPI inflation, in YoY terms, has been negative in every of the first four months of 2015. The government downgraded on 22 May, its 2015 economic growth outlook to 3.28% from 3.78%. The new forecast is lower than both the 3.37% and 3.50% achieved in 1Q15 and the whole of 2014 respectively. Not surprisingly, the TAIEX retreated sharply, by the first week of June, returned to the level it closed 2014 at. For export-led Taiwan, the exchange rate will probably matter more than interest rates for the economy. Hence, USD/TWD is also likely to realign itself to the higher USD in the region.

USD/TWD – to rebound after correction

usd/ **TWD**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**30.870**	**32.0**	**32.2**	**32.4**	**32.6**
Previous		32.0	32.2	32.4	32.5
Consensus		31.5	31.8	32.0	32.1

Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1.88**	**1.88**	**1.88**	**1.88**	**1.88**
Previous		1.88	2.00	2.00	2.00
Consensus		1.90	1.90	1.95	2.05

Korean won

USD/KRW sets its sights higher as growth, exports, inflation and rates fall

Apart from record high current account surpluses, nothing else is really going right for the KRW. Real GDP growth slowed for the fourth straight quarter to 2.5% YoY in 1Q15, its lowest showing since 1Q13. The Finance Ministry is expected to lower in late Jun, its 2015 official growth forecast from 3.8%. On the external front, exports contracted 10.9% YoY in May15, its worst performance since Aug09. Korea is also worried that the US rate hike later this year could lead capital to leave emerging markets into America, and strengthen the USD against the currencies of its competitors, especially the JPY. On the domestic front, Moody's warned that high household debt could crimp consumption expenditure and hurt growth. The Middle East Respiratory Syndrome (MERS) also emerged as a risk to domestic demand. Given the circumstances, the Bank of Korea is expected to cut rates a second time this year. The central bank will also decide in Sep whether to lower its inflation target range to 2-3% from the present 2.5-3.5%. CPI inflation first fell below 1% YoY in Dec14, and has since averaged 0.4-0.5% in Feb-May15. Core inflation eased to 2.0-2.1% in Mar-May15 from 2.4% in Jan15.

USD/KRW – turning up

usd/ KRW	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1110**	**1133**	**1147**	**1161**	**1175**
Previous		1133	1147	1161	1168
Consensus		1120	1120	1132	1150

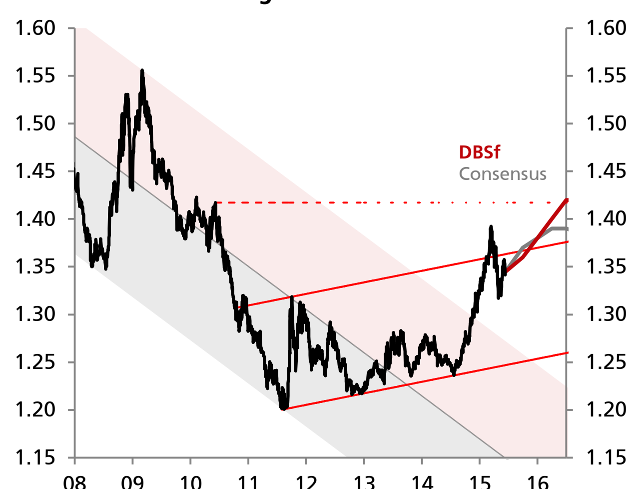
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1.75**	**1.50**	**1.50**	**1.50**	**1.75**
Previous		1.50	1.50	1.75	1.75
Consensus		1.60	1.60	1.65	1.75

Singapore dollar

USD/SGD is still set to return higher to 1.40 in the next 12 months

Final GDP turned out stronger at 2.6% YoY in 1Q15 vs the initial estimate of 2.1%. Yet, there is no urgency to reverse the unscheduled decision by the Monetary Authority of Singapore (MAS) on 28 Jan to flatten the slope of the SGD nominal effective exchange rate (NEER) policy band. CPI inflation fell to -0.5% YoY in May15, at the floor of the official inflation forecast of ±0.5% for 2015. More importantly, core inflation fell to 0.4% YoY in Apr, a level not seen since Mar10. Bank loans and advances slid to 0.5% YoY in Apr15, its slowest growth since Oct09. Industrial production fell to -8.7% YoY in Apr15, it worst performance since Feb13. Although non-oil domestic exports expanded 4.1% YoY in Jan-Apr15, total exports contracted 6.4%. Against these circumstances, the Ministry of Trade and Industry in May announced in May, that the Singapore economy would expand by a slower 2-4% average (vs 3-5% estimated previously) from now to 2020. As for USD/SGD, it will continue to fluctuate with the USD against its trade-weighted basket of currencies. The main risk in the rest of 2015 comes from the US rate hikes later this year boosting the USD globally.

USD/SGD – still looking at 1.40



usd/ SGD	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1.3415**	**1.36**	**1.38**	**1.40**	**1.42**
Previous		1.39	1.40	1.41	1.42
Consensus		1.37	1.38	1.39	1.39

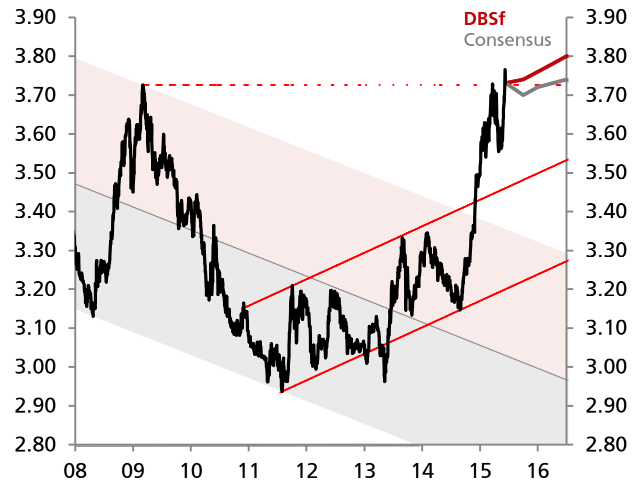
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.83**	**0.90**	**1.00**	**1.15**	**1.25**
Previous		0.70	0.85	1.05	1.15
Consensus		0.99	1.09	1.24	1.45

Malaysian ringgit

MYR is facing multiple headwinds from domestic and external fronts

The relief rally in the MYR led by a recovery in oil prices did not last long. USD/MYR fell from a high of 3.7290 on 20 Mar to a low of 3.5375 on 30 Apr but quickly rebounded to around 3.70 by early Jun. The KL Composite Index rallied 5.8% to a high of 1867.53 on 27 Apr before heading south. By the last week of May, the index had turned negative year-to-date. Investor confidence was hurt by the 1Malaysia Development Berhad's (1MDB) scandal where its MYR 42bn debt (2-3% of GDP) now posed as a contingent liability on a sovereign. This was the reason why, despite the recovery in oil prices, Fitch did not rescind its threat to downgrade Malaysia's A- sovereign debt rating. Sharing the same concern, Standard & Poor's is also paying attention to how 1MDB might impact the political and policy framework. This renders the MYR vulnerable if the US rate hikes in 2H15 materializes and takes the USD higher. Malaysia's short-term external debt was about 31% of GDP as at 1Q15 and 89% of foreign reserves. Since 2012, its current account surpluses were no longer more than 10% of GDP but below 4% in the past couple of years.

USD/MYR – supported at 2009 high



usd/ **MYR**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**3.7325**	**3.74**	**3.76**	**3.78**	**3.80**
Previous		3.69	3.71	3.73	3.74
Consensus		3.70	3.72	3.73	3.74

Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**3.25**	**3.25**	**3.25**	**3.25**	**3.25**
Previous		3.50	3.50	3.50	3.50
Consensus		3.20	3.20	3.25	3.25

Thai baht

USD/THB's uptrend resumes after it broke out of its 17-month prison between 31.74 and 33.13

The Bank of Thailand (BOT) cut rates twice by a total 50 bps to 1.50% this year. The Monetary Policy Committee was more convicted in the second cut on 29 Apr (5-2 votes) than the first one on 11 Mar (4-3 votes). CPI inflation first fell below 0% YoY in Jan15, and has since deepened to -1.27% in May15. Core inflation slipped below 1% in May15 for the first time since Dec13. Opinion has widened that 2015 will be a year of deflation for Thailand. Both business sentiment and consumer confidence indices have fallen sharply in recent months. Exports, industrial production and car sales have weakened. By end-May, the SET stock market index turned negative year-to-date, and continued to drift lower in Jun. Against this weak private sector background, this leaves the government and the central bank very little choice but to steer fiscal and monetary policies towards supporting growth. Not surprisingly, the second rate cut in May triggered USD/THB to break out of its 17-month consolidation between 31.74 and 33.13, and to rise to 33.74 in early Jun. This was also the first time since the 2008 global crisis that the THB depreciated more than 2.5% YoY vs USD.

USD/THB – upper half of price channel

usd/ **THB**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**33.650**	**33.7**	**33.8**	**34.0**	**34.1**
Previous		33.2	33.3	33.5	33.6
Consensus		34.0	34.0	34.0	34.4

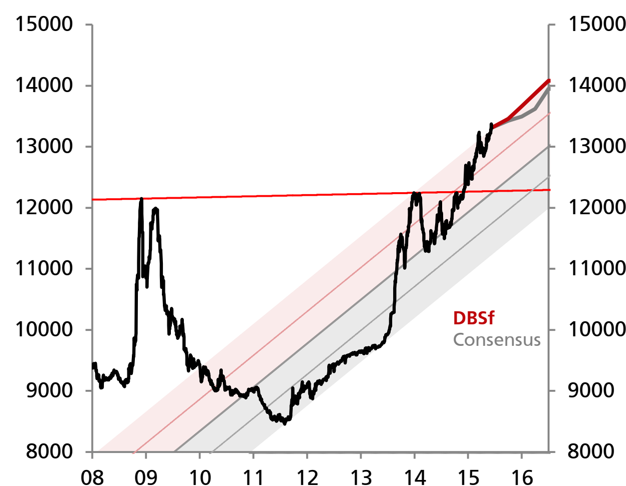
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**1.50**	**1.50**	**1.50**	**1.50**	**1.75**
Previous		1.75	1.75	2.00	2.00
Consensus		1.45	1.45	1.55	1.65

Indonesian rupiah

USD/IDR broke and is likely to stay above its psychological 13000 level

The depreciation trend of the IDR remains intact. With trade performing worse than last year, Indonesia will find it challenging to reverse slowing economic growth while maintaining macroeconomic stability. Real GDP growth slowed to 4.71% YoY in 1Q15, below 5% for the first time since 3Q09. By 5 Jun, Jakarta stocks were down 2.4% for the year on a lack of clarity on how the government will achieve this year's 5.7% growth target. Fiscally, Indonesia is required by law to keep the budget deficit under 3% of GDP. Bank Indonesia is not about to cut rates a second time this year. Expecting the US to hike rates later this year, BI wants to maintain a tight bias in monetary policy. Inflation was still high near-7% and yet to return to its official 3-5% target. BI also wants to suppress the current account deficit at 2.5-3.0% of GDP this year. Instead, BI will selectively loosen credit standards on mortgage and auto loans. To help stabilize the IDR, BI will from 1 Jul, ban the use of foreign currencies in domestic transactions on non-cash transactions. The earlier ban on cash transactions in Jul 2011 did not stop the IDR depreciation.

USD/IDR – 13000-14000 range



usd/ **IDR**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**13310**	**13460**	**13660**	**13870**	**14080**
Previous		13460	13660	13870	13970
Consensus		13425	13497	13618	13950

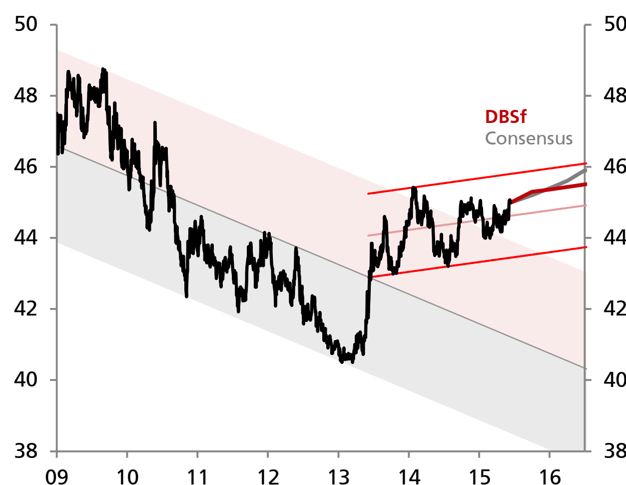
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**7.50**	**7.50**	**7.50**	**7.50**	**7.50**
Previous		7.50	7.50	7.50	7.50
Consensus		7.45	7.35	7.30	7.20

Philippine peso

Time to reassess if markets are overly optimistic about the PHP

USD/PHP has been stable mostly in a 44-45 range since Sep 2014. Apart from being the fastest growing economy in Southeast Asia, the Philippines also boasted a record high stock market. Lately, there were more disappointments than upside surprises. When the PHISIX peaked at 8127.48 on 10 Apr, it was up 12.4% for the year. Since then, it fell to a low of 7469 on 28 May, the same day real GDP growth slowed to a 3-year low of 5.2% YoY in 1Q15. Despite weaker-than-expected data, the government did not abandon its goal to lift growth to 7-8% in 2015. This will depend mostly on a sharp increase in government spending in 2H15, before the election ban takes effect ahead the 2016 presidential elections. Believing that liquidity is ample to support growth, the central bank is likely to keep its policy rate unchanged at 4% for the rest of the year. Although CPI rose 2.2% YoY in Apr15, its slowest gains since Aug13, inflation remained within the official 2-4% target. As for depending on exports on growth, the PHP will find increasingly it hard to ignore the depreciation in other Asian currencies. USD/PHP may well be thinking about breaking above 44-45 later this year.

USD/PHP – firmer in upper channel



usd/ **PHP**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**44.980**	**45.3**	**45.4**	**45.4**	**45.5**
Previous		45.3	45.4	45.4	45.5
Consensus		45.2	45.4	45.6	45.9

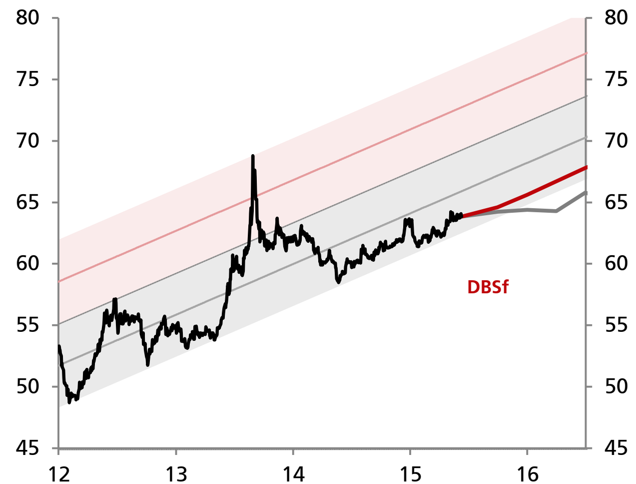
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**4.00**	**4.00**	**4.00**	**4.25**	**4.25**
Previous		4.00	4.00	4.25	4.25
Consensus		4.00	4.05	4.20	4.25

Indian rupee

INR is still depreciating within a price channel, headed for rough weather

We have not changed our view for the INR to keep depreciating in a price channel. The Bombay Sensex index has been struggling after it hit a new record high of 29095 in mid-Apr, and was down 2.7% year-to-date as at 5 Jun. The Reserve Bank of India (RBI) lowered interest rates thrice this year on 2 Jun, 3 Mar and 15 Jan. The repo rate was reduced by a total 75 bps to 7.25% with the door left open for another cut later this year. Despite the high 7.5% YoY GDP growth in 1Q15, the RBI believes that that the economy was still operating below potential with a negative output gap. Externally, exports contracted 14.2% YoY in Jan-Apr15 vs 7.1% growth in calendar year 2014. Domestically, India is bracing for a second year of drought. Monsoon rainfall is estimated to be worse at 88% of the 50-year average of 89cm in Jun-Sep, vs the 93% predicted earlier in Apr. Together, weak exports and deficient precipitation have led the government to expect a wider current account deficit of 1.6-1.7% of GDP for FY ending Mar16. INR could be headed for some rough weather ahead especially if the US hikes rates later this year.

USD/INR – rising in lowest quartile of channel



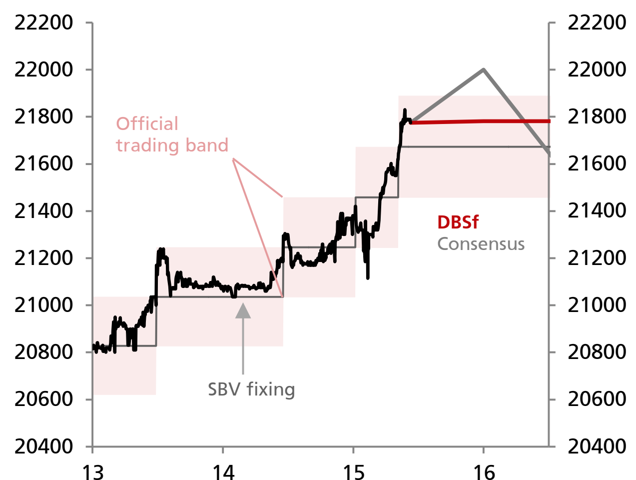
usd/ **INR**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**63.835**	**64.6**	**65.6**	**66.7**	**67.8**
Previous		64.6	65.6	66.7	67.7
Consensus		64.2	64.4	64.3	65.8
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**7.25**	**7.25**	**7.25**	**7.25**	**7.25**
Previous		7.25	7.25	7.25	7.25
Consensus		7.20	7.15	7.10	7.05

Vietnam dong

The VND is no longer as strong as it was 6-12 months ago

The State Bank of Vietnam (SBV) devalued the VND twice this year. The mid-point of the official USD/VND trading band was first raised by 1% to 21458 on 7 Jan. This was aimed at keeping the exchange rage aligned to the USD's broad-based appreciation globally. The second decision to lift the mid-point by 1% to 21673 on 7 May was not a positive one. The trade deficit deteriorated sharply to $3.47bn in the first five months of 2015 compared with a $803bn surplus for the whole of 2014. Export growth slipped to 7.3% YTD in Jan-May15. Without any improvement here, 2015 could well be the first year since 2009 that exports did post double-digit growth. Until export growth falls below 0%, and/or inflation starts rearing its ugly head, it is still premature to conclude that Vietnam's macroeconomic stability is short-lived. Even so, there is no room for policymakers to be complacent. Trading above its official trading band, spot USD/VND is not taking the SBV at face value that it would not devalue the VND a third time this year. We take a more neutral stance and keep our USD/VND forecast in the upper half of its trading band.

USD/VND – stable despite devaluation



usd/ **VND**	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**21775**	**21781**	**21781**	**21781**	**21781**
Previous		21350	21350	21350	21350
Consensus		21800	21867	22000	22000
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**6.50**	**6.00**	**6.00**	**6.00**	**6.00**
Previous		5.00	5.00	5.00	5.00
Consensus		n.a.	n.a.	n.a.	n.a.

Australian dollar

AUD/USD is still seen closing the year below and not above 0.75

The AUD is still not out of the woods despite some stability returning to commodity prices. The Reserve Bank of Australia (RBA) cut its cash target rate twice, on 5 May and 3 Feb, this year by a total 50 bps to a record low of 2.00%. Real GDP growth decelerated four straight quarters to 2.3% YoY in 1Q15 from 2.9% in 1Q14. CPI inflation slowed more dramatically to 1.3% YoY in 1Q15 from 3.0% in 2Q14. The Organisation for Economic Cooperation and Development (OCED) and the International Monetary Fund (IMF) have become concerned that the RBA's push to lower rates may worsen the housing bubble in an economy with the world's highest household debt-to-income ratio. Doubts remain if the Treasury had been too optimistic in its 2.1% of GDP budget deficit projection for FY ending Jun16. Due to weaker terms of trade from low commodity prices, the trade deficit widened to AUD 3.9bn in Apr15, the worst on record. Totalling AUD 7.8bn in the first four months, the deficit is likely to more than double the AUD 9.1bn gap seen for the whole of 2014. Look for the RBA to keep jawboning the AUD weaker on a trade-weighted basis.

AUD/USD – still high relative to global trends

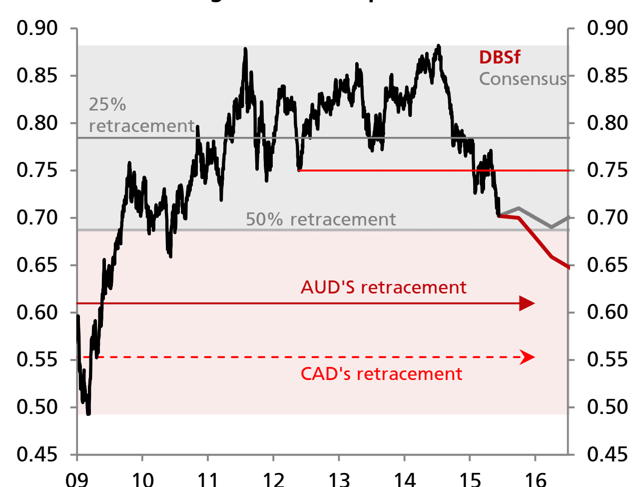
AUD /usd	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.7758**	**0.76**	**0.74**	**0.72**	**0.70**
Previous		0.72	0.70	0.67	0.66
Consensus		0.75	0.74	0.73	0.72
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**
Previous		2.00	2.00	2.00	2.00
Consensus		2.00	1.95	1.95	1.95

New Zealand dollar

NZD becomes vulnerable on flip flops in monetary and fiscal policies

The fortunes of the NZD turned sour after the Reserve Bank of New Zealand (RBNZ) opened, on 30 Apr, the door to cut rates if demand weakened and inflation slowed. During its earlier meeting on 29 Jan, the RBNZ had already abandoned its rate hike bias in favour of a steady rate stance. The RBNZ is facing a challenge to achieve its official inflation target of 1-3% this year. For the second straight quarter, CPI inflation declined to -0.3% QoQ in 1Q15 from -0.2 in 4Q15. The finance ministry, on 21 May, broke its promise to deliver a budget surplus in the current financial year. The blame fell on a tax revenue shortfall from a slower economy and weak inflation. New Zealand is also facing challenges from global dairy costs falling to 5-year lows on slower demand from China and an increase in supply from Europe. With the finance ministry still looking at a budget surplus in the next FY, don't expect more fiscal spending to support growth. Instead, the RBNZ is now considering taking back one or more of the four rate hikes it delivered last year. In turn, this would meet the RBNZ's desire to correct the excessive strength of the NZD on a trade-weighted basis.

NZD/USD – too high relative to peers

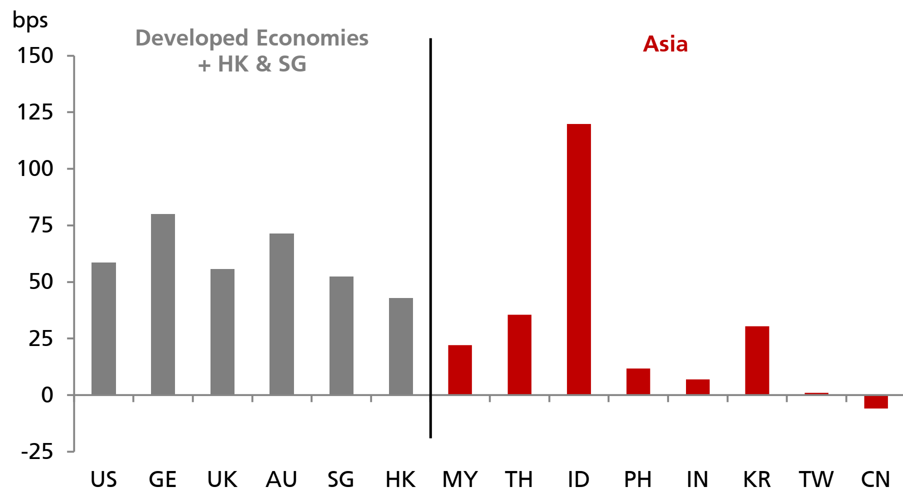


NZD /usd	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**0.7207**	**0.70**	**0.68**	**0.66**	**0.65**
Previous		0.70	0.68	0.66	0.65
Consensus		0.71	0.70	0.69	0.70
Policy, %	10-Jun	3Q15	4Q15	1Q16	2Q16
Revised	**3.50**	**3.00**	**3.00**	**3.00**	**3.00**
Previous		3.50	3.50	3.50	3.50
Consensus		3.35	3.30	3.45	3.65

Yield: the selloff begins

US	Liftoff in long-term developed market sovereign yields has begun
	The next leg up will be driven by Fed hike expectations
	The market appears to be underpricing interest rate risks in the intermediate segment of the UST curve
	Greek funding remains an near-term risk
Asia	Asian sovereign bonds have fared better than most through the recent volatility
	Bear-steepening is expected as most central banks are likely to keep policy loose
SG	High relative to the US
HK	Hibors not budging yet
KR	Easy monetary policy
TW	Unruffled
TH	Pessimism
MY	Steepening
ID	Adjustment in progress
PH	3M rate has normalized
IN	Monetary easing complete
CH	Vulnerable to inflation

Change in 10Y Government Bond Yields since 1 April



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US: The selloff begins

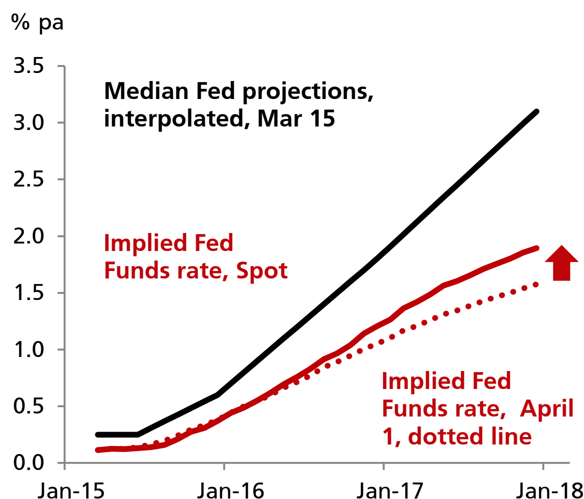
Liftoff in long-term developed market yields has occurred. Average 10Y government bond yield for G7 economies (10Y G7) have risen by 64 bps since the beginning of April. This is comparable to the taper tantrums seen in mid-2013. Back then, hints of tapering drove 10Y UST yields 100 bps higher in the span of two months, and triggered a massive selloff across global bonds. This time, 10Y German Bund yields rose by 90 bps in the span of two months, and led the rout in global sovereign bonds. 10Y UST yields rose by 55 bps over the same time period.

We reckon that 10Y G7 yields have room to head higher over the next few quarters, but uncertainty on Greece is an immediate concern. Greece has opted to defer all of its June repayments (totaling EUR 1.6bn) to the end of the month. With funds running out, a failure to unlock funding could trigger default and Greece's exit from the Eurozone. Grexit fears are likely to weigh on sentiment, keeping UST and German Bund yields lower than they otherwise would have been.

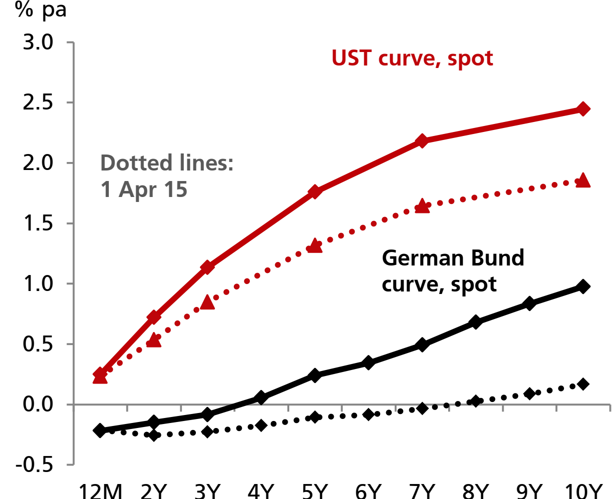
Our core scenario assumes that a solution would be found and that Greece would avoid a default. This would pave the way for resumption in long-term rate normalization. Alternatively, even if a Greek default occurs, we think that spillover unto the other peripheral economies should be limited. Some short-term pain is likely to be felt through the risk channels but these should stabilize thereafter. Ongoing quantitative easing by the European Central Bank (ECB) should help cushion any strains in Italian, Spanish and Portuguese government bonds. In this case, UST and German Bund yields would be lower for longer, but improving global growth should still lift yields towards the end of the year.

The market is likely to refocus on the global economic fundamentals and the liftoff of the Fed Funds rate once the Greek issue blows over. In this regard, normalization in long-term UST yields is well underway. The market is also more accurately pricing in interest rate risks over the coming few years. Using the 1% real yield compensation that investors demand for holding 10Y USTs as a guide, 10Y UST yields should be trading between as 2.5-3.0% as US inflation heads towards the 1.5-2.0% range. With 10Y UST yields at 2.44%, 80 bps higher than the low in Jan, we reckon that more than half of the adjustment is done.

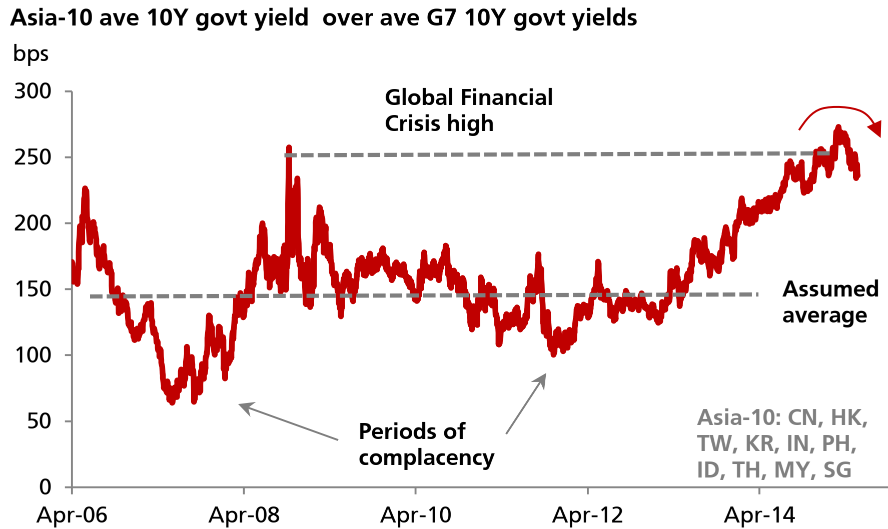
Fed Funds Rate: Implied & Fed projections



UST vs German Bund Curve



Asia-10 ave 10Y govt yield over ave G7 10Y govt yields



Meanwhile, Fed funds futures are gravitating towards a more aggressive rate hike profile for 2016 and 2017 even as the timing of the liftoff remains stuck in the end 2015/early 2016 period. The implied Fed funds rate for end-2016 and end-2017 rose to 1.21% and 1.90% respectively, compared to 0.96% and 1.52% in mid-April. The market is likely to be more convinced of the Fed's conviction to raise rates later this year. Notably, even after steepening in the 1Y/3Y segment of the USD swap curve, the rate hike pace priced into the market is still significantly less than half of what is seen in the previous rate hike cycle (2004/06 rate hikes took place at 25bps/meeting, 200bps a year pace).

Asian government bonds sold off during the recent bond tantrums. On average, Asia government bonds performed better their developed market counterparts. When global sovereign yields fell in the five quarters ending 1Q15, Asia yields did not fall as much. As such, the yield spread of Asian government bonds over their developed market counterparts serves as a cushion through the recent bond rout. Compared to the beginning of Apr, the average 10Y government bond yield for Asia-10 economies (10Y Asia-10) rose by 31 bps. IDgov bonds stood out as the worst performer against the economies we track. Much of this can be attributed to overly compressed spreads (relative to USTs) in the early part of this year. Spreads have since normalized.

On the whole, we suspect longer-term G7 and Asian government bond yields would still be under upward pressure in the coming quarters. Greek concerns are likely to stall, but not derail this process. Initially, bear steepening is likely in Asian government bond curves as frontend yields are anchored by loose monetary policy. Subsequently, when Fed hikes become imminent, upward pressure would be more pronounced in the intermediate segment of global sovereign curves.

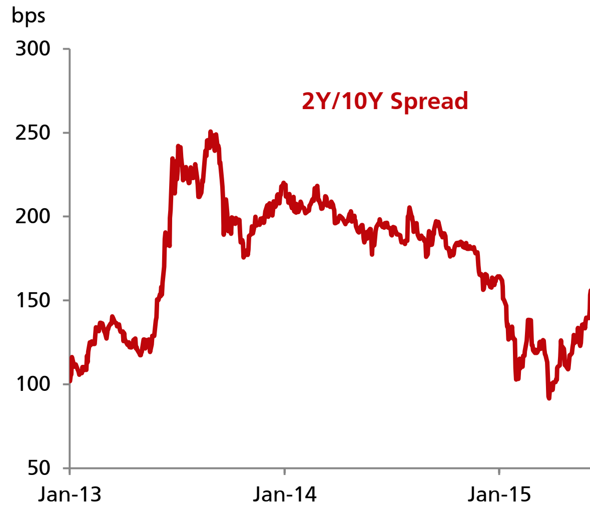
We expect yields on US Treasuries to rise. By mid-2016, yields in the 2Y sector are likely to reach 1.60% while the 10Y sector edges to 2.80%.

Singapore: High relative to the US

USD strength and the prospect of eventual Fed hikes in the coming quarters remain the dominant themes dictating where SGD rates are heading. While USD strength did wane temporarily in 2Q, allowing short-term Sibor and SOR to fall, upward pressure on SGD rates has reasserted over the past few weeks. As the market speculates on further USD strength, 3M SGD forward points are elevated by historical standards (trading at the upper band of the 20-30 points range), keeping SORs high relative to Libors of similar tenors. We expect this premium to dissipate over the coming few quarters after USD strength runs its course.

The 2Y/10Y segment of the SGD swap curve has steepened to 150bps, in line with the USD swap curve. Much of this has got to do with the sharp selloff in German Bunds that triggered the recent global sovereign bond tantrums. Rates in the intermediate sector (2Y-5Y) are more accurately reflecting interest rate risks, but still remain too dovish. We suspect that curve flattening in the 5Y/10Y segment of the SGD swap curve would take place once the Fed funds rate start to head north. As USD rates grind higher, SGD rates are likely to follow with a smaller magnitude.

SGS Curve - 2Y/10Y Segment



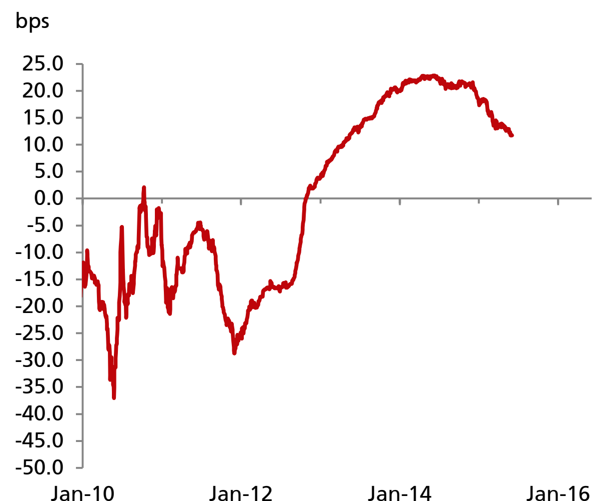
- *The premium of short-term SGD rates over USD rates has kept the SGD swap rates elevated. This premium is likely to fade in the coming quarters*
- *We expect 2Y and 10Y SGD yields to reach 1.70% and 2.85% respectively by mid-2016*

Hong Kong: Hibors not budging much yet

The front end of the HKD interest rate swap curve has been generally higher than the comparable segment of the USD swap curve. This is due largely to the fact that 3M Hibor has been above 3M Libor since 4Q12. As the 3M Libor and the 3M Hibor are the floating leg fixings of their respective swaps, any premium in 3M Hibor directly feeds into fron-tend HKD swap rates. However, this premium is set to fade in the coming quarters.

3M, 6M and 12M Hibors have largely been stable over the past few years. In recent months, as the market prepares for eventual Fed hikes, 3M, 6M and 12M Libors have started to rise. As such, the 12M Hibor/12M Libor spread has narrowed to 9bps, from a peak of 34bps in mid-2014. This spread is likely to continue narrowing and will likely turn negative within two quarters. Similar developments can be seen in the 3M Hibor/3M Libor spread. However, with the market not anticipating imminent Fed hikes, the spread compression has been more muted. When Fed normalization is well underway, we think that HKD rates should trade below USD rates. This is already the case for HKgov yields relative to UST yields of similar tenor.

12M Hibor/12M Libor Spread



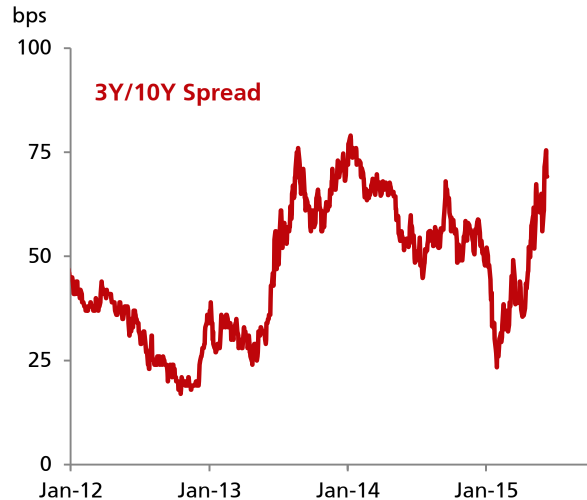
- *HKD rates should trade below USD rates of similar tenor when Fed normalization is underway, an event that is likely in the coming quarters*
- *We expect yields on 2Y and 10Y Exchange Fund yields to reach 1.30% and 2.20% respectively by end-2015*

Korea: Easy monetary policy

While monetary policy is likely to be kept easy, longer-term KTB yields have already started to selloff. Much of this can be attributed to the German Bund-led tantrums that took place through Apr/May and resulted in a 50 bps upward adjustment in 10Y KTB yields. Investors appear generally wary of duration risks given the volatility in G7 sovereign bonds. As 10Y UST and German Bund yields settle near this year's high, 10Y KTB yields are also biased to the upside.

Meanwhile, the economic picture is mixed. While domestic demand appears to be holding up amid a housing recovery, the external sector continues to languish as yen weakness remains a sticky issue. The outbreak of Middle East Respiratory Syndrome (MERs) also threatens the economy. Accommodative monetary policy is likely to keep the shorter-term KTB yields low. From a supply and demand perspective, 10Y KTBs are also facing increasing competition in the form of mortgage-backed debt issued by the Korea Housing Finance Corporation (a state-owned company). These reasons point to stronger upward pressure on the longer-term yields, keeping the KTB curve steep for the foreseeable future.

KTB Curve - 3Y/10Y Segment



• *Monetary policy is likely to be kept easy as external headwinds persist. The KTB curve is likely to stay steep*

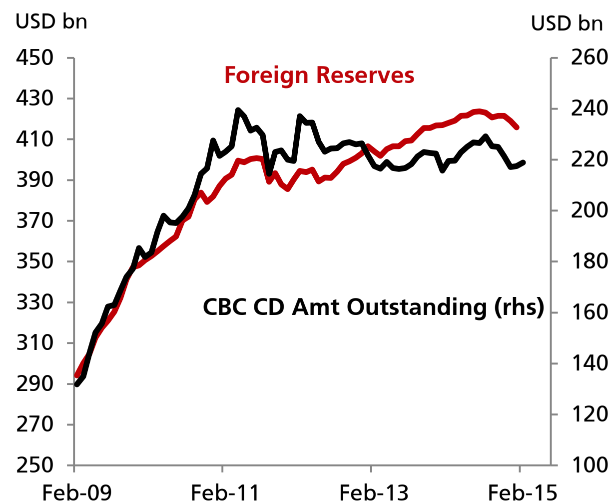
• *We expect 3Y and 10Y Korean Treasury Bond yields to rise to 2.15% and 2.80% respectively by mid-2016*

Taiwan: Unruffled

TWgov bonds were unruffled by the German Bund-led tantrums that occurred in Apr/May. While most sovereign yields across the globe are still higher than levels seen in early Apr, 10Y TWgov yields have retraced the move. This is not surprising considering that Taiwan still runs a large current account surplus that cushions TWD rates from fluctuations in global yields. Liquidity is also kept ample as the amount of outstanding CDs issued by the central bank fell in line with a decline in foreign reserves.

While we see TWgov yields higher (in line with global yields) in the coming quarters, the magnitude is likely to be restrained. As noted previously, TWgov yields are one of the least sensitive to movements in UST yields. Moreover, recent economic data including industrial production, export orders and PMI have been soft. Expectations of monetary tightening have also been pushed further back. No rate hikes are expected through to mid-2016. We expect 10Y TWgov yields to head towards 1.65% (top of the trading range) in the coming quarters. Upward impetus on 2Y TWgov yields is likely to be even more muted.

CBC Amt Outstanding & Foreign Reserves



• *There is no rush to tighten monetary policy given that inflation is low. No rate hikes are expected over our forecast horizon*

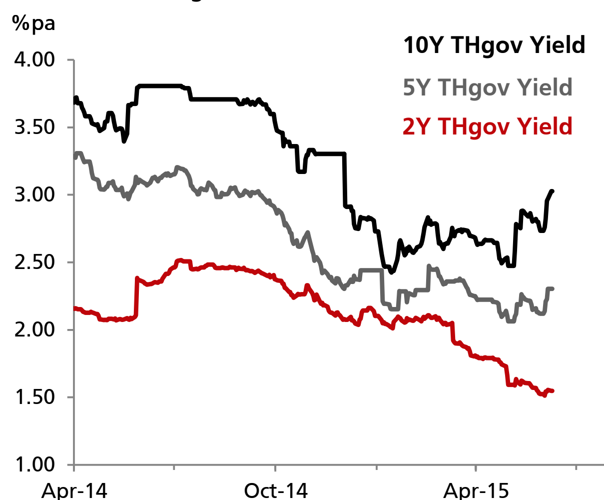
• *We expect the 2Y and 10Y government bond yields to rise to 0.80% and 1.65% respectively by mid-2016*

Thailand: Economic pessimism

Short-term THgov bonds are likely stay resilient even if developed market yields head north. Economic growth has been sub-par since the military coup a year ago. Household debt overhang, weak investment and lackluster external demand have combined to drag down headline growth. With easy monetary policy seemingly ineffective in driving growth, much depends on the ability of the government to push through with fiscal spending in the second half of the year. Meanwhile, core inflation is trending down while headline inflation has been in negative territory since Jan15. As such, we think that that depressed THgov yields are accurately reflecting economic pessimism.

While there would be upward pressure on THgov yields as developed market yields head higher, we think the magnitude could be relatively muted. Through the German-Bund led tantrums in 2Q15, 10Y THgov yields rose by a relatively muted 34 bps since the beginning of Apr. Weak export demand did not stop the current account balance from heading towards 4% of GDP in 1Q15, suggesting that external funding risks are minimal. We expect the THgov curve to stay steep in the coming quarters with the Bank of Thailand (BoT) unlikely to begin the tightening cycle anytime soon.

2Y, 5Y & 10Y THgov Yield



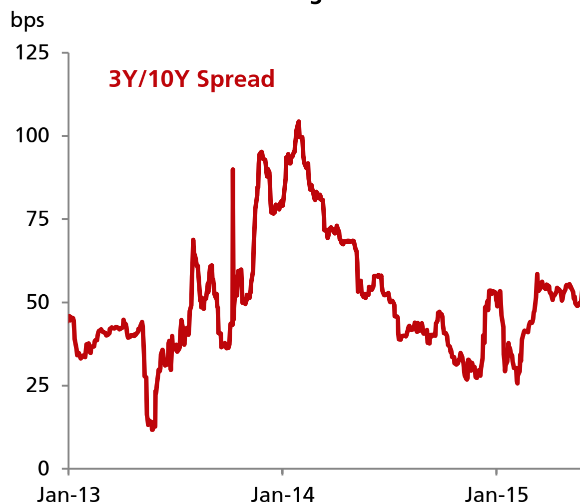
- *Short-term THgov yields are likely to stay stable as rate hikes are not imminent. However, longer-term yields should track global yields higher*
- *We expect 2Y and 10Y Thailand government bond yields to rise to 1.8% and 3.2% respectively by mid-2016*

Malaysia: Steepening

The announcement in late May that USD 1bn (provided by companies controlled by the Abu Dhabi government) would be injected to the troubled 1Malaysia Development Bhd (1MDB, a state development fund) did not fully allay concerns on refinancing risks. Malaysia's 5Y credit default swap (CDS) spreads, while down from the peak of 151bps in January, are still elevated at 131bps. It is also unclear if delays in resolving this issue would lead to a wider political fracas. Contingent liability issues and worries about the budget position are key reasons weighing on the ringgit and MGSs

External factors are also a key factor impacting on market sentiment. Through the bond market tantrums in April, MGS securities performed relatively well as oil prices continued to climb. However, as WTI crude failed to decisively break above USD 60/bbl, 10Y MGS yields have been edging higher. Worries about the high level of short-term external debt also rendered MYR assets more vulnerable as developed market yields headed north.10Y MGS yields spiked by 20bps in the first two months of Jun while shorter-tenor MGSs are less impacted. We see scope for the 3Y/10Y segment of the curve to steepen as front-end rates remain anchored.

MY Gov Curve - 3Y/10Y Segment



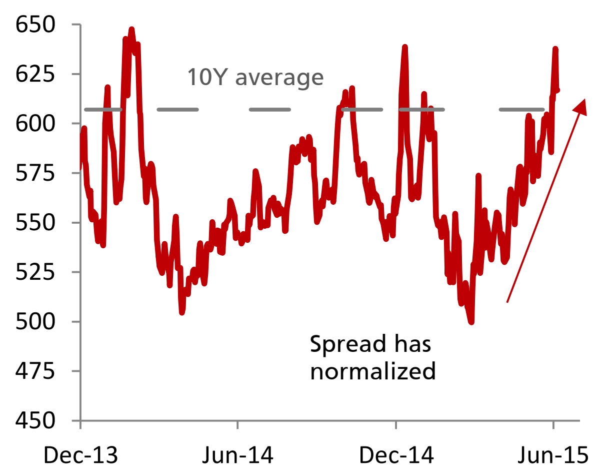
- *Long-term MGSs are likely to rise, in line with global yields. Meanwhile, high levels of short-term external debt remains a concern*
- *We expect 2Y and 5Y Malaysian government securities yields to rise to 3.60% and 4.30% respectively by mid-2016*

Indonesia: Adjustment in progress

We thought that spreads of IDgov bonds over USTs of similar tenor were too compressed in the beginning of the year given Indonesia's still-sizable current account deficit and elevated foreign ownership of IDgov bonds. This view played out as IDgov bonds fared poorly in the recent sovereign bond selloff with 2Y and 10Y yields up by 100 bps and 120 bps respectively since the beginning of Apr. Meanwhile, shorter-term rates were less impacted, with the 3M Jibor up by barely 3 bps over the same time period.

Slowing growth has prompted speculation that Bank Indonesia (BI) may ease policy further. We disagree and see the policy rate staying stable over our forecast horizon. A rate cut could exacerbate pressure on the rupiah and on IDgov bonds in a period when financial market volatility is high. On the whole, we think that 10Y IDgov yields yield spreads over 10Y UST yields has largely normalized. However, in the short term, further spread widening cannot be discounted as the rout in global bonds and persistent rupiah weakness impact on investor confidence.

10Y IDgov Yield spread over 10Y UST Yield



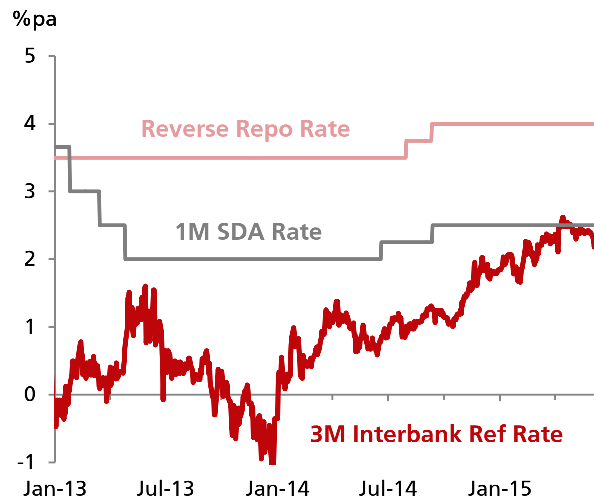
- *Given high foreign ownership of IDgov bonds, we are wary that interest rate normalization in the US could spark risk aversion in the market*
- *We expect 2Y and 10Y Indonesian government bond yields to reach 8.30% and 8.80% respectively by mid-2016*

Philippines: 3M rate has normalized

The FX-implied 3M PHP interbank reference rate has now normalized and is hovering around the special deposit account (SDA) rate. Further upside in the absence of a rate hike cycle is unlikely. The increase in the 3M PHP forward points to 0.24 from -0.1 in late 2013 was the key driver behind the sharply higher 3M PHP rate. PHP forward points now better reflect interest rate differentials between the Philippines and the US. As forward points increased, the 3M PHP interbank reference rate rose from -1.1% to 2.4%.

This trend in rising FX forward points over the past few quarters is not limited to the Philippines. Other economies in the region also saw similar developments as the market reacts to eventual Fed hikes via a stronger USD. Under such circumstances, FX-implied rates in the region are likely to stay elevated for several quarters until the period of USD strength runs its course. We expect the 3M PHP interbank reference rate to hover around 2-2.5% through to the end of the year as Bangko Sentral ng Pilipinas (BSP) keeps policy rates steady. Upward pressure would be more apparent in 1H16 when BSP raises the policy rate.

Policy Rates & 3M Interbank Reference Rate



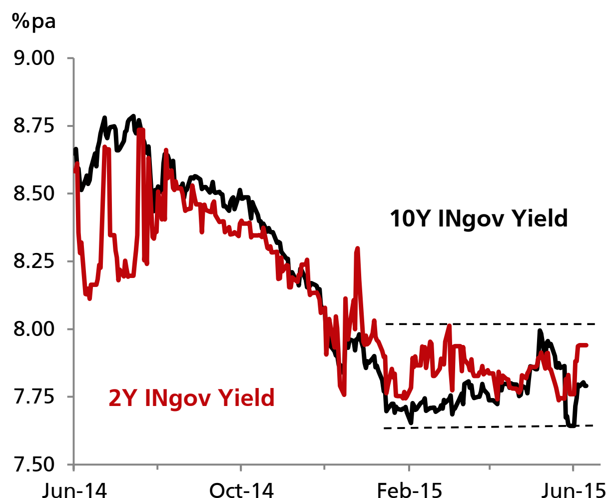
- *With USD strength becoming a dominant theme, the FX-implied 3M PHP interbank rate has risen significantly over the past few months*
- *We expect 2Y and 10Y Philippine government bond yields to reach 3.30% and 4.40% respectively by mid-2016*

India: Monetary easing is done

Monetary easing by the Reserve Bank of India (RBI) is likely done. Domestically, the threat of a weak monsoon on food price inflation is likely to stay the RBI's hand even as disinflationary trends persist. Externally, the window for monetary easing is fast closing as worries about Fed hikes drive global bond yields higher. While we had initially thought that rate cuts would benefit INgov bonds, the positive spillover has been limited. The two rate cuts this year only benefitted the very front of the INgov curve with 1Y yields dropping by 50 bps since the beginning of the year.

Comparatively, 2Y INgov yields have largely been rangebound between 7.75-8.00% while 10Y INgov yields have been hovering between 7.64-8.00%. In the absence of further rate cuts, INgov yields are biased to the upside in the coming quarters. Through the global bond tantrums over the past few months, INgov bonds have been relatively stable compared to their emerging market counterparts. Much of this stability can likely be attributed to the narrow current account deficit, an improvement which developed in large part due to depressed oil prices. However, if oil prices push higher, external funding concerns would likely to weigh on INgov bonds.

2Y & 10Y INgov Yield



• *Upward impetus on Indian government bond yields is likely with no further rate cuts over our forecast horizon.*

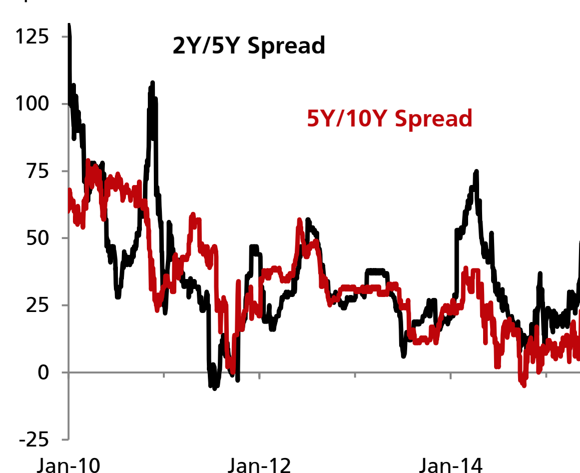
• *We expect both the 2Y and 10Y Indian government bond yield to rise to 8.25% by mid-2016*

China: Vulnerable to inflation pickup

Incremental monetary easing by the People's Bank of China (PBoC) has had the desired impact on market interest rates over the past year. 2Y and 10Y CNgov yields are down by 120 bps and 50 bps respectively since mid-2014. Meanwhile, the 7D repo rate is hovering around the lows (2%) registered in the past four years. While further easing is certainly possible given the still-weak economic data of late, we think that downside may be limited as market rates are no longer high relative to inflation. In any case, further easing should have greater impact on short-term rates.

The cumulative stimuli thus far are significant and the local government debt swap program (converting debt from local government financing vehicles to municipal bonds) should lift confidence for the economy going forward. Under such conditions, a turnaround in sentiment should lift longer-term CNY rates (see "The rise in global yields: where to now?", 25 May 2015). Since then, 10Y CNgov yields have risen by 17 bps. With the 2Y/10Y CNgov spread already at 110 bps (levels not seen since early-2014), further spread widening appears unlikely in the short term. A rebound in inflation expectations should put more upward pressure in the intermediate segment of the CNgov curve.

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



• *Policy stimuli have been incrementally added over the past year. Any signs of a bottom in the economic cycle should send Chinese government bond yields higher*

• *We expect 2Y and 10Y Chinese government bond yields to rise to 2.80% and 3.90% respectively by mid-2016*

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

		11-Jun-15	3Q15	4Q15	1Q16	2Q16
US	3m Libor	0.29	0.40	0.70	0.95	1.20
	2Y	0.73	0.90	1.15	1.40	1.60
	10Y	2.48	2.40	2.60	2.70	2.80
	10Y-2Y	176	150	145	130	120
Japan	3m Tibor	0.17	0.20	0.20	0.20	0.20
Eurozone	3m Euribor	-0.01	0.00	0.00	0.00	0.00
Indonesia	3m Jibor	6.92	7.00	7.00	7.00	7.00
	2Y	8.27	8.00	8.10	8.20	8.30
	10Y	8.66	8.60	8.70	8.80	8.80
	10Y-2Y	39	60	60	60	50
Malaysia	3m Klibor	3.69	3.70	3.70	3.70	3.70
	3Y	3.33	3.30	3.40	3.50	3.60
	10Y	4.11	4.10	4.20	4.30	4.30
	10Y-3Y	77	80	80	80	70
Philippines	3m PHP ref rate	2.31	2.50	2.75	3.00	3.00
	2Y	3.40	3.50	3.60	3.70	3.80
	10Y	4.36	4.40	4.60	4.80	4.80
	10Y-2Y	96	90	100	110	100
Singapore	3m Sibor	0.83	0.90	1.00	1.15	1.25
	2Y	1.09	1.10	1.30	1.50	1.70
	10Y	2.77	2.70	2.80	2.85	2.85
	10Y-2Y	168	160	150	135	115
Thailand	3m Bibor	1.66	1.70	1.70	1.70	1.95
	2Y	1.49	1.60	1.60	1.60	1.80
	10Y	3.06	2.90	3.00	3.10	3.20
	10Y-2Y	156	130	140	150	140
China	1 yr Lending rate	5.10	4.85	4.60	4.60	4.60
	2Y	2.28	2.50	2.60	2.70	2.80
	10Y	3.59	3.60	3.70	3.80	3.90
	10Y-2Y	131	110	110	110	110
Hong Kong	3m Hibor	0.39	0.50	0.70	0.95	1.20
	2Y	0.49	0.60	0.85	1.10	1.30
	10Y	1.42	1.65	1.90	2.05	2.20
	10Y-2Y	93	105	105	95	90
Taiwan	3M Taibor	0.88	0.88	0.88	0.88	0.88
	2Y	0.66	0.65	0.65	0.65	0.80
	10Y	1.56	1.53	1.60	1.65	1.65
	10Y-2Y	90	88	95	100	85
Korea	3m CD	1.80	1.55	1.55	1.80	1.80
	3Y	1.78	1.70	1.85	2.00	2.15
	10Y	2.47	2.50	2.60	2.70	2.80
	10Y-3Y	69	80	75	70	65
India	3m Mibor	7.95	8.10	8.10	8.10	8.10
	2Y	7.88	7.80	8.00	8.25	8.25
	10Y	7.83	7.80	8.00	8.25	8.25
	10Y-2Y	-14	0	0	0	0

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CNH: linking domestic and global markets

- **China has approved 32 foreign institutions to invest in the domestic bond market**
- **QDII2 allows mainland households to invest in various asset classes overseas**
- **Via the Shenzhen-Hong Kong Stock Connect, foreign investors will be able to trade the new economy companies**

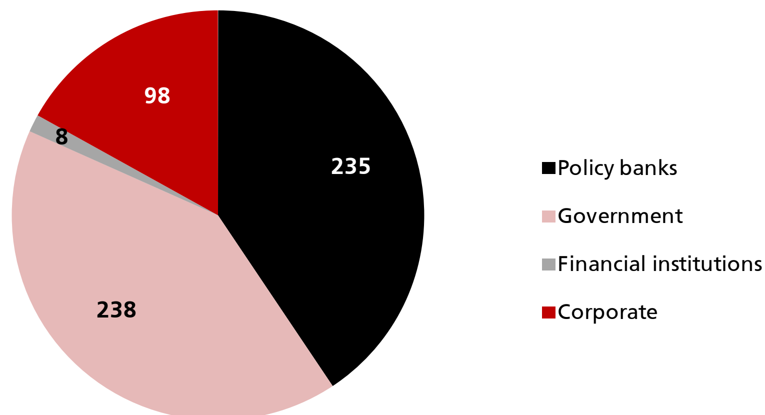
QFII/RQFII expansion

In a bid to have the yuan included in the IMF's SDR currency basket, Beijing has quickened the pace of capital account liberalization by linking domestic and global markets. In May, China approved 32 foreign institutions to invest in its domestic bond market worth USD 5.9 tn, mainly via the QFII (Qualified Foreign Institutional Investor) and RQFII (Renminbi Qualified Foreign Institutional Investor) schemes.

QFII and RQFII are the two major channels accessing the onshore capital market (both stocks and bonds). Although the QFII program has grown slowly since its inception in 2002, it received a significant boost last year from rapid and sizable approvals. Meanwhile, the quota on the newer RQFII program, which was launched in late 2011, has quickly increased to a sizable RMB 360 bn.

The room for further expansion is ample. As of Mar 2015, offshore institutions held RMB 579 bn (USD 93 bn) China's interbank bonds (Chart 1). That is equivalent to roughly 2% of domestic bonds outstanding. This contrasts starkly with the situation of most major economies and some of the major emerging markets. In particular, foreigners' bond holdings account for 65%, 50%, and 25% of domestic bond

Chart 1: China bond holding by offshore entities (RMB bn)



Note: excludes exchange-traded bonds

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outstanding in Australia, US, and Russia respectively. Hence, if the RMB continues growing as a reserve currency, further access to domestic markets is needed. The increased participation of foreign investors, private and official alike, always reinforces the development of the mainland bond market.

QDII2 to kick off

Capital account liberalization is all about two-way flows. To facilitate outward flows, China plans to launch the Qualified Domestic Individual Investor (QDII2) pilot program. It will initially be kicked-off in six cities: Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou. Individuals with at least RMB 1 mn in financial assets are eligible to participate. QDII2 would be wider in scope than the Shanghai-Hong Kong Stock Connect program, which is mainly focused on guiding mainland investors into stocks related to China. QDII2, on the other hand, will allow them to invest directly in overseas property, equity, and bond markets.

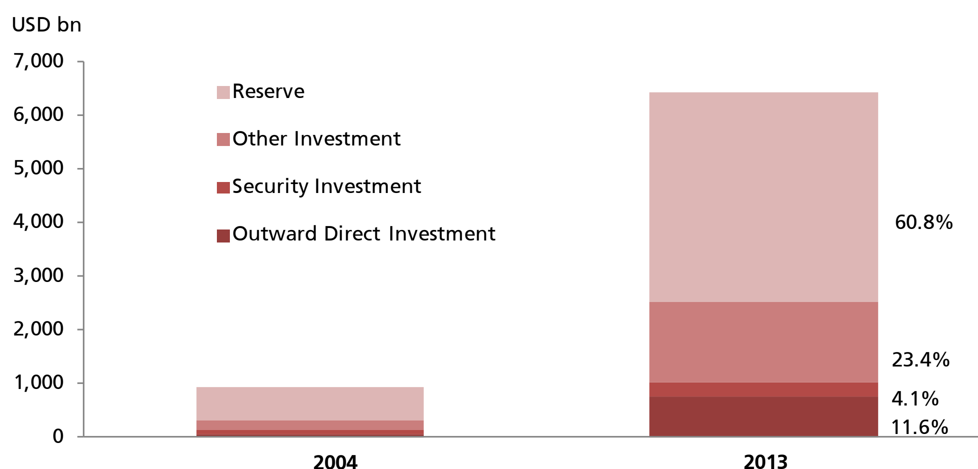
Guiding more outflows is key to China achieving a more balanced IIP

Liberalization on this front will have a global impact, given the size of the country's wealth. According to the latest statistics, the financial assets of Chinese households exceeded RMB 100 tn, of which 40% are parked in cash and deposits with low yields in real terms. In sharp contrast, US households' deposits only account for 15% of financial assets. Removals of restrictions on outflows allow Chinese households to diversify their large pools of savings by investing in overseas assets.

From a macro perspective, guiding more outflows is crucial for China in achieving a more balanced international investment positions (IIP) (see "CNH: To break fresh ground in 2015", 17 Nov 2014). Evidenced by a five-fold surge in IIP, China's financial integration into the world economy progressed rapidly over the past decade. But the country's external assets are heavily skewed towards official reserves, which currently accounts for 61% of total assets. Portfolio investment and outward direct investment are still underdeveloped with tiny shares of 4.1% and 11.6% respectively (Chart 2).

Given that the mainland runs a current account surplus (i.e. excess savings), the low accumulation of external assets is an indicator of "trapped" savings in the domestic economy. The excess savings could cause large speculative flows into real estate or other assets. To some extent, the ongoing disinflation suggests much of China's liquidity is spent speculatively on existing assets. Since these assets already exist, they can be purchased (and repurchased) without adding directly to GDP. An effective way of solving this would be a higher degree of international diversification for mainland private capital.

Chart 2: Security investment and ODI still underdeveloped



Mutual market access and others

Aside from the "Q" programs, mutual market access has become another spotlight. It is expected that the landmark Stock Connect scheme linking Hong Kong with Shanghai to be extended to Shenzhen in the second half of this year. Seen as China's equivalent of the Nasdaq, the Shenzhen market is home to Chinese companies in sectors including technology, pharmaceuticals, and clean energy.

The new stock connect link would therefore allow foreign investors to trade the so-called new economy companies via the Hong Kong exchange. Separately, a long-awaited scheme to allow funds domiciled in Hong Kong and China to be sold in each others' market will be launched in July. Meanwhile, China pushed ahead efforts to link its domestic markets with global peers by launching a joint venture in Germany to provide a wide range of yuan-denominated products to European investors. The latest move is a bold attempt to expand the yuan's footprint beyond Asia.

Near term, the mainland authorities will likely further facilitate access to the Chinese capital markets by overseas institutional investors. Efforts will also be made to facilitate the international use of the yuan by removing unnecessary policy barriers and providing the necessary infrastructure. The aim is to further promote capital account liberalization and make the yuan a freely usable currency – a major criterion of a SDR currency.

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Asia equity: Fed fear

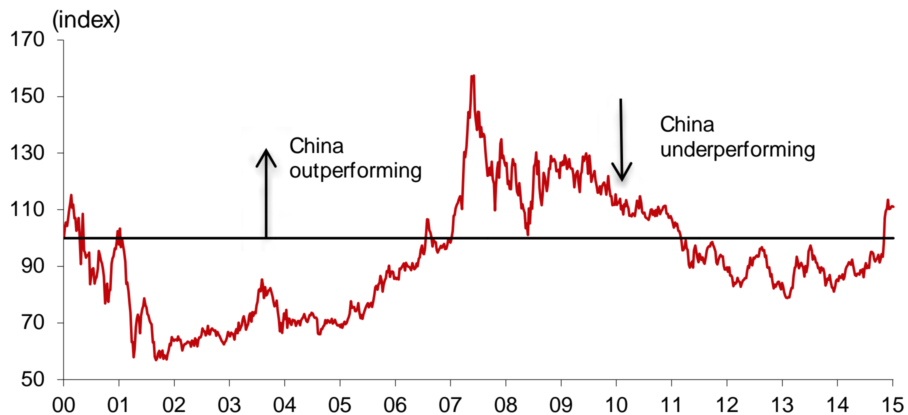
- **Prolonged uncertainty over Greece's bailout negotiations and US interest rate hikes pose the greatest challenge to risk appetite**
- **The China rally still has legs but speed bumps are likely; H-shares and HSI to benefit from China flows and potential China MSCI re-weighting**
- **Emerging ASEAN and India mostly impacted by US rate hikes and slow growth; we have downgraded Indonesia and India to Underweight, sell into rebounds**
- **Taiwan, Korea, Thailand, Philippines and Singapore should be resilient in the current environment**

Markets have become volatile in June, and corrected decisively after the latest US job report, as though trying to price in a Fed rate hike in the upcoming June 17 meeting. The disconnect between economic fundamentals and stock market valuations is a major concern, especially in the US and China. Investors are also fearing that Fed rate hike may be a policy mistake when the global economy isn't ready. Uncertainties on Greece bailout negotiations in the near term with a possible "Grexit" are also giving the thumbs down to markets. We are cautious in 2H15.

Making good out of the bad, we recommend staying invested in China / Hong Kong. Acrophobia? The P/E market valuation is still 26% away from the previous high, before when it corrected in line with the rest of the global equities on US subprime and commodity bust. We recommend staying Neutral in China and Overweight in H-shares and Hong Kong shares which stand to benefit from eventual MSCI re-weighting.

Emerging ASEAN continues to face uncertainty over US rate hikes while experiencing a more acute growth slowdown than the rest of the region. Much of it was due to a slow pick-up in investment growth needed to offset the worse than expected export

Fig. 1: MSCI China vs MSCI ASEAN, in local currency terms, June '00 — June '15



Source: Datastream

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slowdown. The strong US dollar trend is posing another threat to ASEAN currencies, adding a new paradigm of currency and outflow risks to these markets. We stay underweight on ASEAN and expect more downside to these markets until the first rate hike occurs.

Asia markets trade on their own

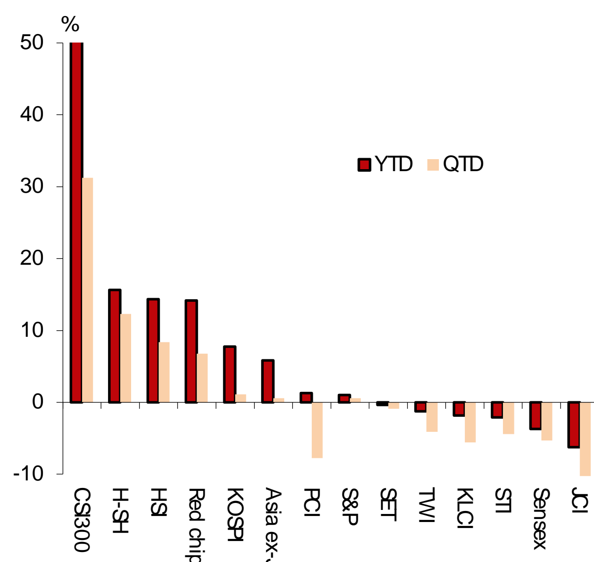
MSCI Asia ex-Japan has recorded a 5.6% return YTD but the market performance was highly polarised. Only Hong Kong and China indices managed to outperform with a whopping 13% return, Korea performed in line while all other markets underperformed the region. Taiwan, Malaysia, Singapore, Indonesia and India all posted negative YTD returns.

Asia had navigated through the first half of the year in a sea of uncertainties — oil prices falling more than 50%, China rally which is up 50%, a strengthening USD, and Fed rate hike chatter since the beginning of the year. As a result, there was a shift in fund flows away from ASEAN as they were deemed to be more affected by these macro factors.

The uncertainty over US recovery has also impacted the other two major Asia markets – Taiwan and Korea – which should benefit from a US recovery. Korea has fared better between these two due to cheaper valuations, higher leverage to China's growth, and an easing stance by the central bank.

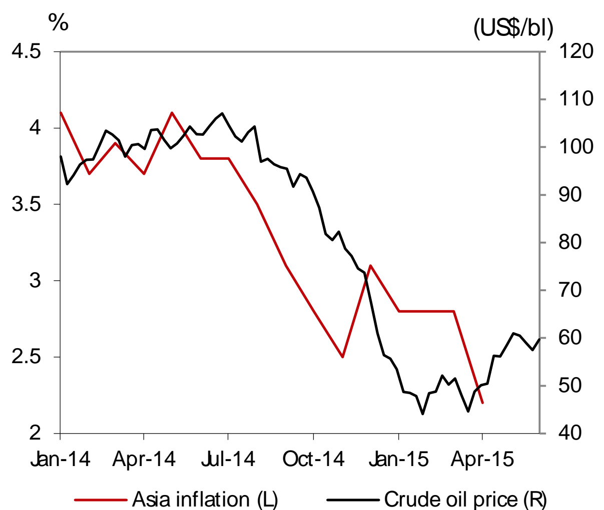
India succumbed to profit taking one year on after Modi's government took over as reality sets in on its reform execution. Lower oil price has aided India's inflation and allowed the central bank to cut rates three times so far this year and propelled the Sensex to an all-time high above 30000 in 1Q. Like India, Philippines has also benefitted from lower oil price, driving inflation down to an all-time low. The

Fig. 2: Asia market performance highly polarised



Source: Datastream, DBS

Fig. 3: Asia inflation bottomed out with oil price



Source: Datastream, DBS

PCOMP touched a historical high in April before giving in to profit taking. These two are the most expensive markets in Asia (ex-China). India traded at 18.3x PE at its high, while Philippines traded at 20.5x.

Factors to watch out for in 2H

With most of the factors expected to persist in the second half, we believe 3Q will likely be a cautious quarter as dark clouds blow over, with uncertainty extending to the 4Q, depending on the developments. Our watch list in 2H would be:

1. Oil price hovering at current levels
2. US Fed funds rate hikes in 4Q
3. China rally
4. Growth downgrades
5. "Grexit"

Impact of lower oil price not felt in Asia

The growth dividend from lower oil prices in Asia was lower than expected. We reckon there may be too much optimism in the first place. The negative impact is mostly on tax revenue shortfall thus resulting in negative sentiments in general before the benefits can be felt.

For instance, Singapore was quick to raise fuel tax in its budget early this year, while Indonesia is unlikely to meet its revenue and hence spending target, casting a gloom in the growth outlook. Malaysia scaled down its budget spend and cut other forms of subsidies to offset the lower oil price revenue.

Thailand also suffered because 16% of SET's market cap made up of oil-related sector, resulting in a poor showing for the SET index. The same goes for Singapore's extensive listing of offshore marine stocks, all of which badly missed estimates in the latest round of earnings reports, while more bad news is yet to come.

Philippines has turned out to be the eventual winner as its inflation has fallen to a historical low due to lower oil prices. Indeed inflation has fallen throughout the region, some even recording dis-inflation. Now that oil price has recovered 50% from the low, inflation in these countries has likely hit the bottom, thus complicating the monetary easing stance by most central banks. There is thus less room for Asia markets to cut rates in the second half of the year.

Barring base effects on the oil price, a weaker currency, US Fed rate hikes, bottoming inflation expectations, and whether further rate cuts will have any positive impact on growth are the major considerations against further rate cuts. In India, the weak monsoon is a risk to food prices and CPI inflation could overshoot the RBI's 2-6% target, leaving further rate cuts, three thus far, off the table. Meanwhile, Thailand's current policy rate is just 25bps higher than its all-time low of 1.25% in 2009 at the depth of the financial crisis. Compared to then, the current GDP growth looks robust.

We expect oil price to hover at current levels. While optimism on benefits of lower oil price has been tapered, some of the negative effects have yet to be reflected. These include the news flows on the oil & gas-related sector, fiscal budget shortfall in Indonesia, India and Malaysia, and bottoming inflation expectations in most Asia countries which render monetary support no more a policy option.

Fed fears

The markets have also been dealing with US Fed rate hike uncertainty since the beginning of the year. Most Asia markets hit all-time highs earlier in the year as rate hike expectations faded when US inflation fell due to lower oil prices. However, the Fed funds futures have rate hike now firmly in place by end of the year at 0.33% and 1.1% by end of next year, following the better wage and payroll numbers in May.

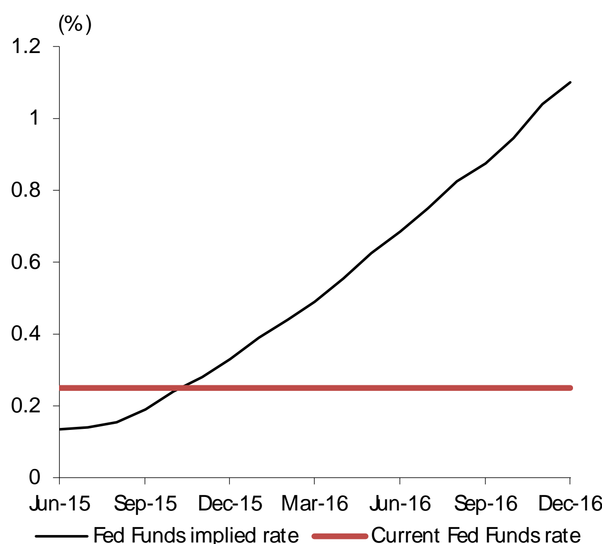
Indeed the manner in which the equity and bond markets have been correcting after the May job report is as if they are trying to price in a rate hike on June 17 Fed meeting, or to the effect that Fed will signal a rate hike soon. To this extent, any dovish signals by the Fed will stage a rebound in these markets.

DBS chief economist continues to believe that Fed rate hike will be implemented late this year. A rebound in Q2 and Q3 GDP growth is generally expected after a contraction of 0.7% in Q1. We have lowered our full year forecast to 2.2%, which is two ticks down from last year's. Core PCE inflation – the Fed's favoured gauge – fell to 1.3% YoY in April from 1.4% in March. It remains to be seen how Fed can justify a lift-off with such uncooperative data. However, judging by the rhetoric, the Fed really wants to get rates off the ground soon.

Several Fed officials have raised the notion that interest rate normalisation is either an "early and gradual one", or a "delayed and steeper one". While on the other hand, some, including the IMF, have urged the rate hikes to be delayed till next year. Whatever it is, we believe Asia markets will face significant pressure at the lift-off for fear of policy mistakes which could stifle the still nascent global recovery.

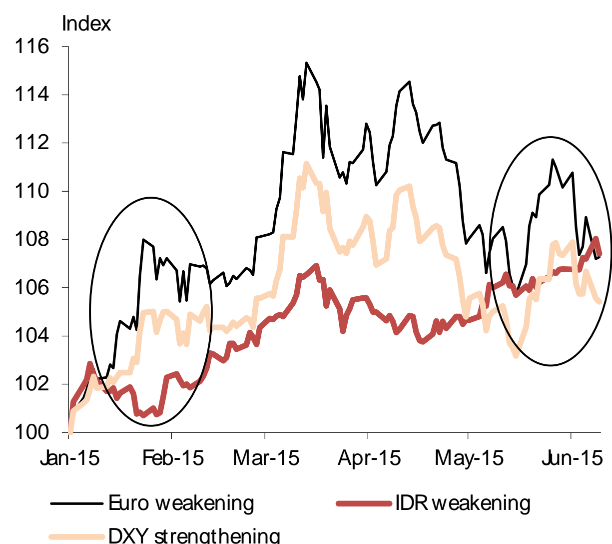
Like the QE "tapering tantrums" in 2013, Asia EM markets and currencies suffer major setbacks throughout this year as the region grapples with "tightening tantrums". Taiwan, Malaysia, Singapore, Indonesia and India all posted negative YTD returns. The uncertainty over bond yield spreads, currencies and fund flows led us to believe that the rout is not going to be over until the rate hikes have concluded.

Fig. 4: Implied fed funds rates from fed funds future



Source: Bloomberg, DBS. As at June 10

Fig. 5: Asia currency weakness more in line with dollar strengthening trend this time round



Source: Datastream, DBS

USD strengthening adds to Asia currency woes

Earlier in the year, ASEAN currencies had been relatively resilient in a bout of currency weakness against USD. Central banks then allowed their currencies to depreciate, fearing that their competitiveness may be eroded if their currencies remain strong on a NEER basis. Growth which are below expectations are also prompting central banks to mull cutting rates to boost growth. Lately the resumption of the USD strengthening trend, driven by US rate hike expectations, drove another round of weakness in ASEAN currencies.

With the twin prospects of higher USD rates and a stronger USD, ASEAN currencies remain vulnerable. The Indian rupee, Indonesian rupiah and Malaysian ringgit are considered the most vulnerable due to their high foreign debt levels. The Malaysian ringgit also stopped drawing support from the recovery in oil prices amidst rumours of a leadership rift in the ruling party. The Thai baht has weakened sharply of late, especially after the Bank of Thailand cut rates yet again to support growth and relaxed capital controls on outflows.

The Singapore dollar recovered half of the losses it incurred during Jul14-Mar15 after the Monetary Authority of Singapore (MAS) maintained its appreciating exchange rate policy on 14 Apr. But the depreciating trend has resumed. DBS currency strategist sees the USD/ SGD at 1.41 by 2Q16.

US and Asia bond yields heading higher

10Y German Bund yields rose by 90bps in the span of two months lifting other global bond yields over the same period. DBS fixed income strategist believes that the liftoff in long-term developed market yields has occurred, with room to head higher over the next few quarters. The market is likely to refocus on the global economic fundamentals and the liftoff of the Fed Funds rate once the Greek issue blows over. 10Y UST yields should be trading between as 2.5-3.0% as US inflation heads towards the 1.5-2.0% range. Asian government bonds sold off through the recent bond tantrums, but yields will still be under upward pressure in line with the developed market bonds.

(For details, see 3Q Economics-Markets-Strategy, "Yield: the sell-off begins", 11June)

Fig. 6: Summary of overall ranking of Asia markets sensitivities to various macro factors (1 = most negatively affected)

	Domestic currency weakness	Fed funds rate hikes	Rising US bond yields	Valns	Avg
Thailand	3	2	6	1	3
Indonesia	1	3	7	3	3.5
Philippines	5	6	2	2	3.75
India	4	5	8	4	5.25
Singapore	2	1	9	10	5.5
Malaysia	6	9	3	5	5.75
HSI	9	4	4	8	6.25
H-shares	10	10	1	6	6.75
Taiwan	7	8	5	9	7.25
Korea	8	7	10	7	8

Source: Datastream, IBES, DBS. *Refer to 2Q Asia equity strategy: "Scaling the mighty USD wall", 11Mar2015, for ranking methodology.*

Fig. 7: Current MSCI Emerging markets weightings and proforma with 5% and full China 'A' inclusion

Country	Current weight	Partial inclusion at 5%	Potential full inclusion
China	25.3%	30.0%	43.6%
Korea	14.6%	13.7%	11.0%
Taiwan	13.0%	12.1%	9.8%
S. Africa	7.4%	6.9%	5.6%
Brazil	7.3%	6.8%	5.5%
India	7.0%	6.5%	5.2%
Mexico	4.6%	4.3%	3.5%
Russia	3.9%	3.7%	3.0%
Others	17.0%	15.9%	12.8%

Source: MSCI

China rally

China A shares rallied another 50% in 1H this year after returning 63% in 2H last year. The talk of more monetary easing, deregulation in cross-border capital flows, and the potential inclusion of China 'A' shares in MSCI benchmark indices have gotten the market excited. The potential upside in unleashing Chinese liquidity into the Hong Kong bourse has also lifted the Hong Kong market which trades at deep discounts to their 'A' share counterparts.

For the rest of Asia, the China rally implies funds are attracted to China / Hong Kong for potentially better returns. MSCI's raising of China benchmark weights would also squeeze the weights of other markets and hence trigger outflows from them.

The negative impact of weak domestic currencies, US Fed fund hikes, rising US bond yields and higher valuations in other markets had already placed the rest of Asia in a vulnerable position *(see 2Q Asia equity strategy: "Scaling the mighty USD wall", 11Mar2015)*. With a bigger benchmark weight, fund flows will naturally be attracted to China / Hong Kong, thus sustaining the rally in our view, and ASEAN markets will continue to underperform.

At the time of writing, MSCI has postponed the decision to include 'A shares in the benchmark until the 'A' share market is more "ready". According to MSCI's announcement made, it will work with the Chinese regulators for its "readiness", and may include it any time, and need not wait for next year's review.

The announcement doe not change our views on China as we believe that MSCI inclusion is a matter of time. Indeed we should be hearing more newsflow on stock market de-regulations, and issues such as better transparency and accessibility will be dealt with. More views are discussed in the China market section.

Weak GDP growth

1Q GDP growth has generally disappointed when high hopes on an infrastructure spending boost failed to materialise. Delays are now expected in Thailand and Indonesia's government spending amid a sharper slowdown in consumption and exports. We believe weak growth will drag on for some time. Consumer and business sentiments have continued to fall in most Asian countries. Currency volatility is likely to delay investment decisions. Further growth downgrades to the economies are likely in our view.

"Grexit"

Hopes are high that there will be a longer term solution to Greece's bailout impasse which has dragged on since 2010 but markets are getting impatient each day. With Greek's GDP down almost a quarter since 2009, Athens' resistance to further austerity is high. DBS economist explores few possibilities in the bailout negotiations *(see "Greece: the clock is ticking, 4 May)*. Between a compromise and a default, it seems chaos cannot be avoided. Athens' cash crunch is likely to turn acute over the next two months, and markets are likely to be highly volatile while awaiting the outcome.

Asset allocation

The theme behind our asset allocation this quarter is to be defensive against the factors in our 2H watch list. China and Hong Kong remain isolated as they continue to be driven by Chinese liquidity which has potential to be unleashed further in 2H. As valuation may be a little too high for comfort, we stay Neutral in China, recommending clients to tread cautiously. We believe that the CSI300 is likely to re-touch its all-time high in 2H but volatility is going to be high. We recommend that investors who wish to participate in the China rally should consider the Hong Kong listed H-shares and HSI for better risk-reward.

Emerging ASEAN and India are mostly impacted by US rate hikes and growth slowdown. We are downgrading Indonesia and India to Underweight and recommend selling into the rebound. We continue to maintain Malaysia as Underweight.

Taiwan, Korea, Thailand, Philippines and Singapore should be resilient after the recent correction. These countries have positive current account balance and have low foreign debts. Domestic sentiments, save for Thailand, are also fairing better than the other markets.

We identify Thailand and Korea as two countries which are most leveraged to China. Both Korea and Thailand's tourism sector have benefited strongly from China tourist arrivals. Chinese tourists now account for 45% of Korea's tourist arrivals, and 16% of Thailand's, and are still growing.

Besides China exports now account for 22% of Korea's total exports. An expected recovery in China from 3Q onwards should help arrest the slowdown in Korea's exports in our view. Thailand is also turning to China to support the infrastructure projects. A US$12billion rail project has already been inked.

Our key views for the respective markets are discussed in the following section. Our market recommendations are as follows:

Overweight: Hong Kong, H-shares

Underweight: Malaysia, Indonesia, India

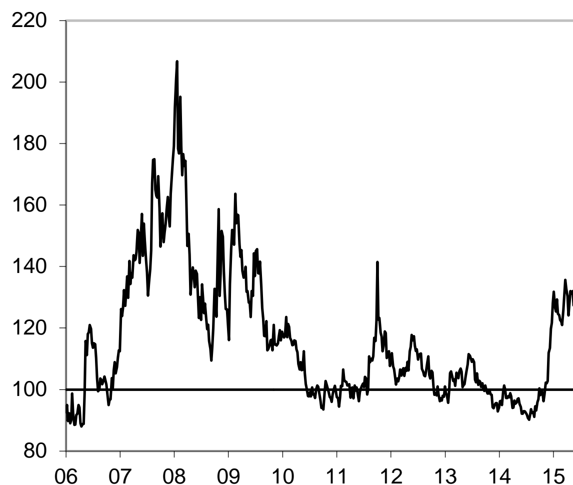
Neutral: Singapore, Taiwan, Korea, Thailand, Philippines, China 'A', MSCI Hong Kong

Market views

China / Hong Kong ('A' shares Neutral, HSI and H-shares Overweight)

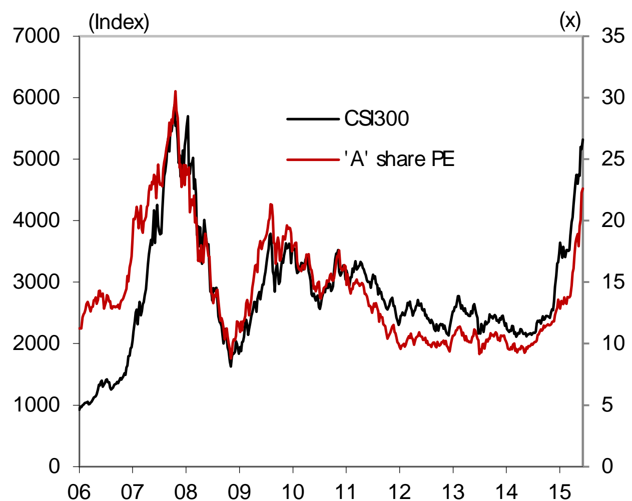
We are still positive on the China rally but believe that the market could be overheated in the near term and volatility could be high, rendering risk / reward unfavourable. Chinese equities have de-rated steadily since 2010. Compared to the previous rally in 2006/07, 'A' shares were up 264% and PE valuations reached 31x. We believe there is still some legs for the Chinese shares to go. The Chinese shares

Fig. 8: AH premium



Source: Datastream

Fig. 9: 'A' shares 12-month forward PE vs CSI300



Source: Datastream

are probably going to hit a new high, but volatility is going to be high as well. Lack of fresh leads going forward will subject the market to profit taking at the same time when regulatory risks for authorities to stem the euphoria are rising. We downgrade China 'A' to Neutral.

We recommend that investors who wish to participate in the China rally should consider the H-shares for better risk-reward. Both retail and institutional investors should start to take an interest in H-shares as they are on average 22% cheaper than 'A' shares. Firstly, China Securities Regulatory Commission has given the green light to China mutual funds to invest in Hong Kong through stock connect. Secondly, after the potential inclusion of 'A' shares in MSCI China, institutional investors may be better off raising the weights for the corresponding 'H' shares as they are cheaper. We have recently seen more China funds being launched, and SH-HK liquidity picking up.

Macro fundamentals are not that great for the general market but the future looks promising. Latest macro indicators show no signs of recovery in China, leading us to believe that more monetary easing and supportive policies will be in place. Several reforms are ongoing which includes the financial sector reforms for the eventual liberalisation of capital markets domestically and internationally. The groundwork has been done on work report initiatives this year to rejuvenate investment growth, especially in manufacturing focusing on the high-end sectors. The 2015 work plan also includes pollution control, SOE reform, price liberalisation to encourage consumption in healthcare, information goods and leisure. The "one belt, one road" plan, in conjunction with the newly established AIIB initiated by China, will also help lift investment growth in the region.

At time of writing, MSCI has decided not to include 'A' shares in this review, but may include them "anytime" once they are ready after they work with the authorities on some of investor concerns. Key issues to be addressed are transparency and more streamlined approach needed on quota allocation, capital mobility and beneficial ownership.

We expect the 'A' share market to cool down on the back of the news, but this does not derail the positive story on China. The Hong Kong market has been lackluster since May. A cooling off in 'A' share may induce bargain hunting in Hong Kong by pent up China liquidity. We expect Hong Kong and China equities to resume rallying in 2H15.

China's liquidity environment is still favorable and alternative investment classes still have low appeal. Judging from latest macro indicators, the PBOC will continue to keep monetary policy loose and we expect more rate cuts to come. Meanwhile, there are also several potential catalysts in 2H15, such as the announcement of Shenzhen-HK stock connect and upgrades to stock connect quotas. Both of these will help with A-share inclusion into MSCI down the road.

Singapore (Neutral)

Despite the Singapore market having underperformed MSCI Asia ex-Japan this year, the Singapore market still trades at a PE premium of 6% to the region. Growth downgrades regained their momentum after 1Q earnings result as the earnings from oil & gas and commodity sectors dragged. At the same time, global risk appetite should be weak as investors remain concerned about the impact of Greece bailout talks in the near term and US rate hike in the medium term. We believe the Singapore market is unlikely to re-rate and will stay close to its historical PE range.

Indeed, Singapore's PE has de-rated over the years, in line with its potential GDP growth which has come off over the years. The government expects GDP growth to average 2-4% in the coming years till 2020, from the forecast of 3-5% made five years ago. Until Singapore sees a breakthrough in its restructuring efforts, its PE will remain trapped.

1Q GDP came in at 2.6% YoY which is better than the advanced estimates. Still, a weak export and manufacturing growth will continue to weigh down on the outlook for Singapore. Coupled with pressure from domestic restructuring and risk of higher interest rate, business confidence affecting companies' willingness to invest are likely to have a spill-over effect on the overall GDP growth this year.

The bright spot has been in domestic consumption lifted by an almost still full employment, and government's inclusive policies in healthcare, wages and welfare system have kept ground sentiments relatively buoyant.

Under this environment, the Singapore market is likely to be swayed by global market sentiments. In particular, stocks deriving earnings domestically should outperform the international stocks. Our Singapore strategist recommends Overweight positions in Banks, Property and Transport sectors for a Singapore portfolio.

We maintain our Neutral stance on Singapore in a Asia ex-Japan portfolio as Singapore should be more resilient than its ASEAN counterparts on its response to US rate hikes.

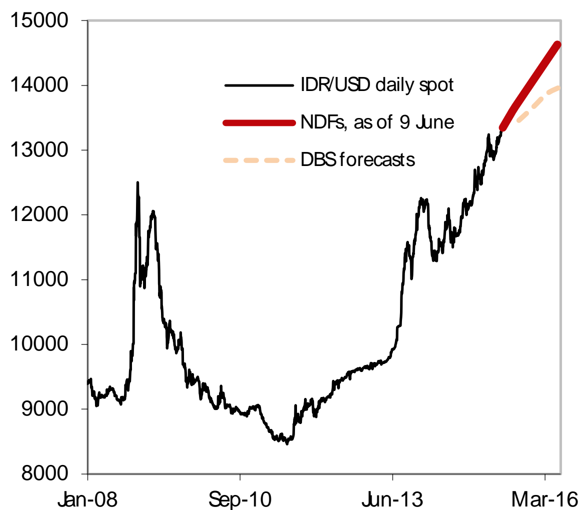
Indonesia (Underweight)

It is quite unlikely that Rupiah will break away from the weak rupiah-weak equities phenomenon chain. With the USD set to regain its strength, we believe IDR remains vulnerable. We are downgrading the market to Underweight with a revised forecast of 4700, implying a 5% downside from current levels. As the US Fed funds rate hikes draw near, we believe the market will have another leg down.

Indonesia bond yields have nudged up 120 bps since April this year and is now close to 8.7%. Adjustment in the bond market is still on-going in our view. Outflows to the bond market YTD April was negative US$130m compared to US$1bn inflows in 2014. Note that corresponding inflow during Jan –April 13 was US$208 followed by an outflow of US$130m in May–Dec 13 and bond yield spiked up to 9%. We believe the bond market is expecting more currency weakness. The 12-month NDF is at 14655. More bond outflows can be expected.

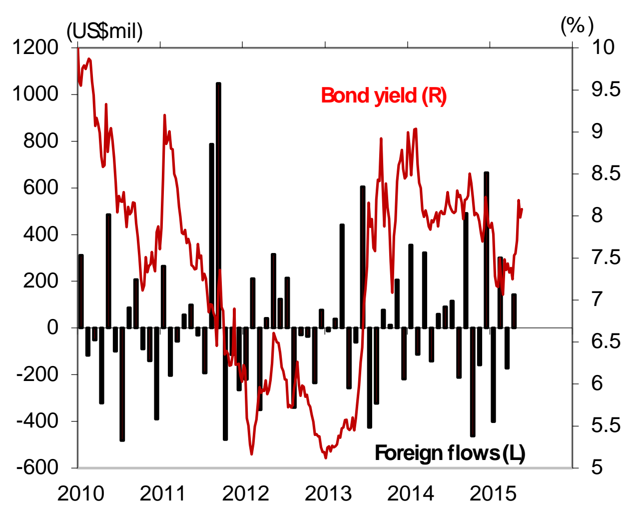
Growth has slowed. 1QGDP came in at 4.7% which is significantly below our/ consensus forecasts. DBS has lowered its full-year growth estimates to 5.1% and 5.5% for 2015 and 2016 respectively. Meanwhile, consensus is forecasting 5.4%. A consistent across-the-street forecasts below 5% would render a de-rating for the

Fig. 10: Indonesia IDR forecast



Source: Datastream, DBS

Fig. 11: Indonesia bond foreign flows vs bond yields



Source: Bloomberg, Datastream

Indonesia market, in our view. Our concerns are on export slowdown and delay in investment spending. Our feedback loop indicates that local corporates have more mixed to negative views on Jokowi's reform plan. Until we see a major breakthrough in investment growth after the festive season, we believe the market will be ripe for a de-rating if growth continues to disappoint.

Earnings growth has dropped further from 10% in the beginning of the year to 5% currently. We believe there is still downside risks to growth nearer to 0% on average as investment activities slow down. The consumer sector should be more resilient in the near term as the festive season approaches.

Given Indonesia's relatively low public debt level, we believe the government has room to run a bigger fiscal deficit to support GDP growth next year. Execution risk, however looms. Targeting a potential upgrade by next year, we believe Indonesia will work towards reforms and improving quality of spending, i.e. infrastructure spending will be accelerated. With China's AIIB and Japan levelling up the funding for Infrastructure spending in the region, we should see Indonesia making progress on that front. We will be looking for opportunity to re-look at Indonesia again when there are signs of an investment-led pick up, and when fed fears dissipated.

Malaysia (Underweight)

We maintain our Underweight view on Malaysia. The easing of the USD and gains in crude oil in recent weeks have been beneficial for the Malaysian equity market and MYR. Nonetheless, corporate earnings outlook remains weak as a weaker MYR and the GST implementation will translate into higher operating costs and weaker domestic demand. This will become more apparent from 2Q15 onwards.

For Malaysia, policy options to spur growth remain limited as fiscal policy is in a consolidation mode as oil revenues fall. Monetary policy is also constrained by high household debt and ringgit depreciation *(see "MY: limited options", 29Apr)*.

Negative newsflow will limit further upside in Malaysia. These include 1) potential rating downgrade; 2) negative earnings revisions, especially from the Banks and Plantations sector; 3) budget shortfall; and 4) 1MDB saga.

While domestic funds may be supportive of the market, we believe the bond market may need more support this time round should there be a rating downgrade. Foreigners now hold close to 44% of domestic currency bonds, which are at risk of foreign outflow and further ringgit depreciation should the rating downgrade materialises.

We maintain our Underweight stance on Malaysia.

Thailand (Underweight)

Net foreign equity inflows to date in Thailand has been quite muted, suggesting foreign investors were less than enthusiastic in the market both ways. One year on after the military government took over, while there is stability in most aspects of the economy, domestic sentiments have yet to pick up in a sustainable manner.

The external environment has been unfavourable globally and Thailand exports have weakened in line with the rest of Asia. It is thus important for Thailand to boost its domestic demand. Plans and budget have been drawn up but the pace of implementation has been slow. However we believe things should pick up in the second half as both consumption and investments are likely to gain traction in 2H15. Investment growth may peak in 3Q15, as the government goes full-speed on its budget spending during the last quarter of the 2015 fiscal year. Private consumption growth may return to its pre-crisis trend by the year-end. These are supportive factors for a stronger recovery into 2016.

Thailand maintains a positive current account balance, and healthy import ratio. Like it or not, it is due to a weak import growth. Current account (C/A) recorded a

surplus of USD 8bn, or about 8% of GDP, in 1Q15. While some narrowing is likely to be seen towards the year-end, full-year C/A surplus may be in excess of 4% of GDP, highest since 2009. This is strengthening Thailand's external position and thus its currency outlook as far as impact of US rate hikes is concerned.

The new found political stability in Thailand is mostly reflected in its tourism sector. Tourist arrivals have rebound strongly and we expect the trend to continue. Niche exports sector riding on the weak Baht and US recovery theme such as Electronics and Autos sector are also some of the key themes which should continue to do well. The Construction sector shall also benefit from an investment boost and China's infrastructure foray into Thailand. Earnings growth forecast in Thailand is less disappointing than the other Asean markets.

We maintain our Neutral stance on the market despite the global macro headwinds. We like the stable market environment which will benefit from a stronger economic recovery in 2016, notwithstanding a general elections now being planned for in early 2016.

Philippines (Neutral)

1Q15 GDP growth came in at 5.2% (YoY) which was well below market expectations of 6.6%. In line with the region, net exports proved to be a bigger drag than what we have expected, taking away 1.8%-pt from overall GDP growth, most since 3Q13. Fiscal spending also came in at a disappointing 4.8% in the quarter, slower than the 5-year average of 6% growth. DBS economist now expects GDP growth to come in at 6.0% and 6.2% in 2015 and 2016 respectively — slight adjustments from our previous forecasts of 6.3% and 6.0%.

MSCI Philippines trades at 18.5x 12-month forward earnings after the recent correction. GDP growth is unlikely to deviate too much from 6% as long as private consumption and investments remain robust and there are good reasons to expect these conditions to sustain. CPI inflation is currently trending below 3%. Foreign worker remittances are still set to hit a record-high of USD25bn this year. And the government's infrastructure overhaul is ongoing.

Growing at 6%, Philippines is still one of the fastest growing economies in Asia. We maintain our Neutral stance on the market.

Korea (Neutral)

Thanks to the loosening of monetary and credit policies since last year, consumer sentiment has improved in Korea. Consumer confidence index climbed to a half-year high of 105 in May and private consumption growth has been the bright spot in the economy amid a slump in exports. GDP should still remain below BoK's target as the economy is still highly dependent on export growth. The government is focused on reviving economic growth and DBS economist believes there is still room for one more rate cut this year.

Korea joined the Asian Infrastructure Investment Bank (AIIB) in April as one of the founding members. Korea is likely to play a significant role in AIIB, given its large size and experience in participating infrastructure / construction works abroad. Construction services take up nearly 20% share of Korea's total exports of services. By boosting outward investment growth, this should help offset the lower domestic growth which is constrained by high debt levels and deteriorating demographics. Improving trade flows and export demand should follow *(see "What will the AIIB mean for Korea?", 19May).*

The market is the cheapest in Asia and several sectors bear a bottoming outlook which are poised for recovery once the global growth environment improves. The

export outlook is not that bleak with Korea being more outward looking and improving its trade position in Asia.

We are reiterating our Buy call in Samsung electronics, an index heavyweight, believing that market concerns may be overdone. The company is expected to deliver strong operating profit of KRW7.57tn (+27% QoQ) in 2Q15 contrary to market concerns. Bit growth and margins all look optimistic for semiconductor business, as both its DRAM and NAND growth should outpace the market, boosted by official sales of Galaxy S6 that includes a large number of DRAM and NAND, along with robust sales of iPhone that has high NAND loadings. Supply disruption of Galaxy S6 should ease from June. The company may record lower than expected net profit due to higher corporate tax rates.

China is an important economic partner with Korea and improving ties with China is a key driver for Korea's economic rebound. Chinese tourists accounts for 45% of total tourism arrivals to Korea. Following the recent MERS outbreak in Korea, the negative impact of a decline in Chinese visitors is likely to be apparent, which will be directly felt by the retail trade, accommodation and transport services sectors, among others.

However, DBS economist notes that compared to the threat of MERS, the economy faces bigger slowdown risks stemming from the weakness in exports. The manufacturing data have deteriorated broadly in Apr-May, increasing the possibility that the 2Q GDP will fall short of expectations and the full-year growth will miss the 3% mark. With exports to China accounting for 25% of Korea's exports, we believe a revival in the Chinese economy is a major driver for Korea's growth.

We are maintaining Korea as Neutral and believe the KOSPI can stay at the upper end of the trading range. A breakout above the range is likely if the impact of MERS turns out to be short-lived, and the Chinese economy show strong signs of recovery in 3Q.

Taiwan (Neutral)

Taiwan will probably enter a period of growth slowdown, but yet not enough to prompt any monetary actions just yet. The slowdown in recent manufacturing activities has weighed on economic growth in 1Q and it now looks like that growth has fallen below trend levels in 2Q. Official statistics agency has just cut its GDP growth forecast for 2015, from 3.8% to 3.3%, while DBS has a 3.4% forecast. Risk of further downgrades cannot be ruled out.

Earnings growth are becoming anaemic – below 10% for the next three years. It is difficult to envisage strong earnings recovery without a corresponding tech cycle recovery or a strong US recovery. Meanwhile, politics are likely to complicate cross-straits policies and Taiwan is unlikely to benefit from China's stimulus plans.

As Taiwan enters the ex-dividend season in 3Q, Taiex can probably rebound after the recent correction, supported by dividend yield of close to 2.8%, with some SOEs earning more than 5% yield. Our concerns are on accelerating negative earnings revision trend as GDP growth slows; and the unlikelihood of Taiwan-Shanghai connect which the market is trying to price in. Opportunities exist among sectors leveraged to US recovery, including electronics auto parts, companies exposed to Apple parts supply chain, sportswear and equipment.

The biggest wild card is Presidential elections next year. The governing party has the tendency to support market with liquidity to lift sentiments.

We are maintaining Taiwan as Neutral in 3Q supported by dividend yields.

India (Underweight)

The probably last rate cut for the year has left Investors pondering what would be

the next good news for India. Amid enthusiasm in Modi's reforms, the Sensex hit 30000 earlier in the year aided by US$42bn of foreign inflows YTD. Helping things along was the central bank's 75-bps rate cuts this year, as inflation fell alongside lower oil and food prices. With the honeymoon period now over, it's time for the new government to deliver before disappointments set in *(See "India: time to deliver", 21 May 2015).*

The strategy team believes India should not be spared from a general slowdown in the global environment. Recent export growth dropped for a fifth straight month, factory output slowed to a five-month low and bad loans at banks are estimated to rise to the highest since 2001. Domestic vehicle sales rose 1.9% in April compared with a 7% increase a year earlier. On the inflation front, central bank chief Rajan has cited the possibility of a weak monsoon, rising oil prices and a volatile external environment clouding the inflation outlook and rate cuts may have to pause for some time.

All said, without execution on the reform, India's growth is likely to drift along with the rest of the Asia economies as they succumb to export weakness. Gross value added — a component of GDP watched closely by the central bank — gained 6.1% versus an estimated 7%.

Near term, exasperated investors could shift allocation from India towards China where investors are still underweight. Chinese valuations exceeded India's for the first time but Hong Kong shares still remain reasonably valued.

We are reducing India to Underweight.

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CN: what's lies in the emperor's mind?

- **The absence of sharp currency depreciation, large scale fiscal stimulus and only modest monetary easing all suggest the government's acceptable level of GDP growth could be lower than what the market expects**
- **The relative lack of stimulus is intended to achieve structural objectives such as reducing overcapacity and imposing more stringent discipline on investment decisions**
- **The government has chosen to ease minimally to let the economy decelerate in an orderly manner**

Historically, hard times in China were characterised by slower GDP growth pushing lending rates down. As Chart 1 shows, this occurred during the 1997/98 Asian financial crisis and the 2008/09 Global financial crisis. It's happening again today. This, however, does not mean more aggressive monetary easing coming down the pipe.

It is possible that the leadership's acceptable level of growth is lower than the 7% market consensus. Unlike past economic slowdowns, this one is not driven by exogenous shocks but self-imposed, characterized chiefly by an intensifying anti-corruption program. In addition, to pave the way for a more sustainable growth path, China is seeking to rebalance its economy away from excessive, inefficient investments towards private consumption. Fixed asset investment, which accounted for more than 50% of GDP, has been allowed to fall at a staggering pace ever since Xi Jinping became president (Chart 2). To smooth out the business cycle, the People's Bank of China (PBoC) has cut interest rates by 90 bps and the reserve requirement ratio by 150bps since Nov 2014. Despite the downward pressure on growth, the magnitude and speed of cuts were smaller and slower than previous episodes. For

Chart 1: Nominal lending rate vs. nominal GDP growth

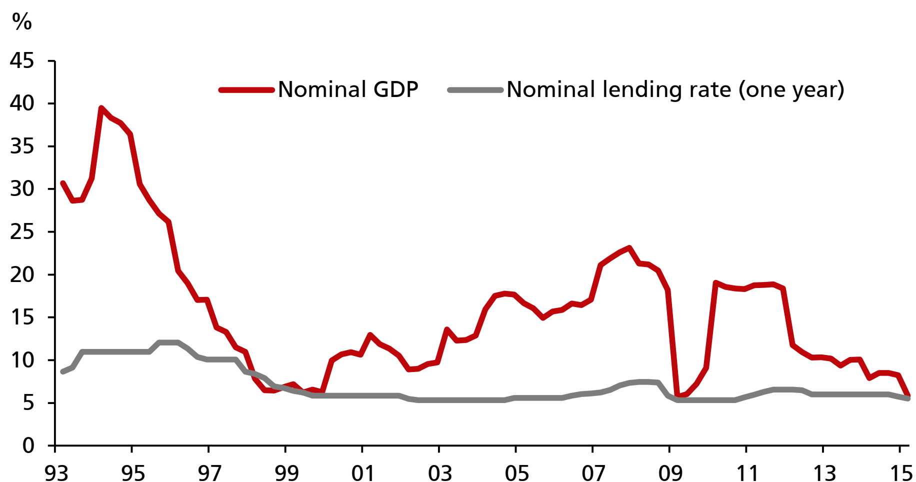

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Chart 2: Fixed asset investment

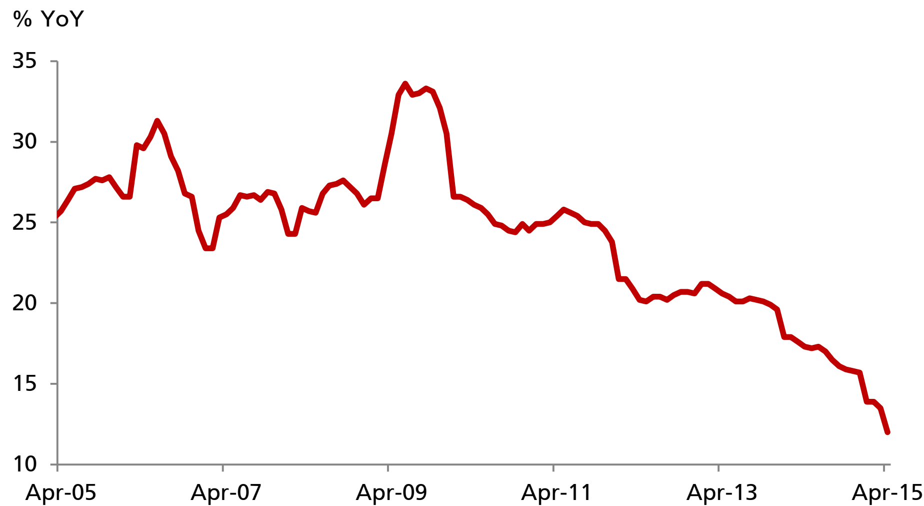
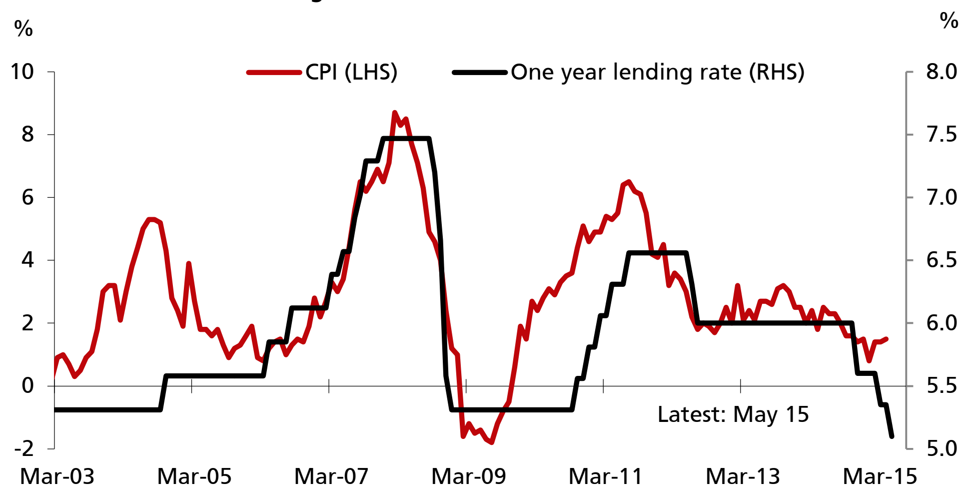


Chart 3: Benchmark lending rate and CPI



example, the benchmark lending and deposit rates were cut aggressively by 144 bps and 180 bps respectively in Oct 1997 after GDP growth fell from 9.7% in the 4Q96 to 8.0% in 3Q97. PBoC lowered the RRR from 13% to 8% in one move in Mar 1998 when GDP growth was 7.2%. Today, the RRR is higher at 18.5%. The monetary easing since last Nov was not considered aggressive because the incremental liquidity released from RRR cuts has merely offset capital outflows (Chart 3).

PBoC has cut interest rates by 90bps and the RRR by 150bps since Nov 2014

The pace of loosening is dictated by structural constraints which include debt. Total social financing as a share of GDP in 2014 was 204%, compared with 125% in 2008, and 109% in 2002. For sure, cutting rates could alleviate the interest burden of debt ridden entities and buy them some time to clean up their books. On the other hand, loosening too much may revive the credit-driven growth model. This dilemma has forced policymakers to proceed cautiously with monetary loosening. In addition, cutting interest rates can no longer stimulate the economy as effectively as before. China's present problem is not insufficient liquidity; M2 growth is 5.8% higher than nominal GDP growth in 1Q15. The challenge is minimizing the misallocation of capital. China's financing is dominated by bank lending by large state-owned banks to large SOEs, and direct financing is minimal. Thus, China's dominant strategy is to

buttress growth momentum with minimal loosening. An implicit objective could well be the fact that policymakers would like to stress test the capacity of SOEs to weather current economic malaises. Difficult times force enterprises to increase their efficiency in order to survive. Those that cannot will have to go through the natural economic course of sector consolidation. The key risk of this strategy is to manage an orderly economic slowdown without igniting any systematic risks in the financial system. It has worked well so far.

New fiscal tactics

The new practice of fiscal spending targets specific areas with long term strategic goals in mind

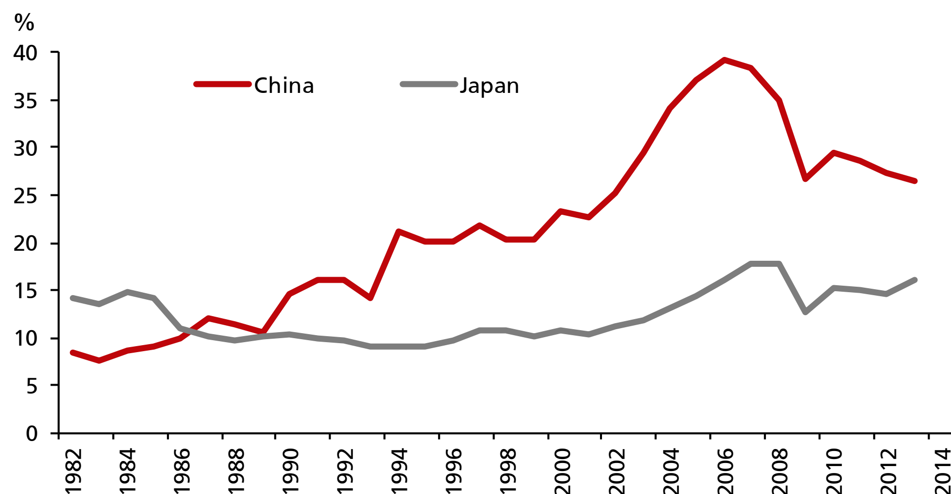
To complement its current monetary management, China has also changed its fiscal strategy. In 2015, the PBoC injected USD 32bn and USD 30bn respectively into state-owned policy banks – China Development Bank (CDB) and Export-Import Bank of China (EXIM) – through loan-equity swaps. The PBoC is now the second largest shareholder in the CDB and the biggest shareholder of EXIM. This is an extension of conventional fiscal policy where local governments spend money directly to stimulate the economy. The experiences in 2009 clearly showed much of the CNY 4trn fiscal stimulus had gone haywire and left a legacy of overcapacity and debt overhang. The new practice of fiscal spending targets specific areas with long term strategic goals in mind. While this improves the quality of growth, it will have less immediate impact on headline growth.

The PBoC also purportedly lowered the lending rate on loans to CDB through Pledged Supplementary Lending (PSL) with duration of 3-5 years to 3.1% from 4.5% a year ago. The idea is to encourage long term infrastructure spending based on better risk assessment and better allocation of capital via designated policy banks. CDB earmarked at least CNY 590bn for infrastructure projects in 2015, up 44.4%% from CNY 409bn in 2014. It will provide at least CNY 400bn in loans to support the renovation of shanty towns, CNY 100bn for railway projects and CNY 90bn for water infrastructure projects. These amounts are lower than those spent in 2008/2009.

Exchange rate policy

As far as exchange rate policy is concerned, the Chinese government has not followed the path of sharp currency depreciation like Japan to boost exports in spite of higher nominal exports of goods and services/GDP ratio at 24.6% compared to Japan's 15.2% in 2014 (Chart 4). The spot CNY exchange rate was flat compared to year-end 2014 levels. To compare, the yen depreciated by 4.5% during the same period. In fact, the RMB has been appreciating against many currencies. It appreci-

Chart 4: Nominal exports of goods and services/GDP



ated by 3.2% YTD in real Effective Exchange Rate (REER) terms. Competitive currency devaluation does not make strategic sense. China is campaigning for the IMF to include the RMB into its Special Drawing Rights (SDR) this year. If successful, this would lead more central banks and international institutions to embrace the internationalisation of the RMB. The Chinese government is probably more concerned about longer term agendas – such as economic rebalancing and RMB internationalization – than short term export competitiveness. This explains why trade related policies that facilitate rebalancing are being pushed.

Competitive currency devaluation does not make strategic sense

Reducing import tariffs to boost domestic consumption

Starting from 1 Jun, the Ministry of Finance would cut import tariffs on 14 categories of popular consumer items in order to increase foreign goods imports and to boost domestic consumption. Duties on goods such as garments and shoes were cut by an average of 50%. Import tariffs on cosmetics will fall to 2% from 5% previously and duties on diapers will be reduced to 2% from 7.5%. More duty free shops will be opened, and consumption taxes will likely to be adjusted downward as well. This is an intelligent move as Chinese outbound tourism spending – encouraged by sharp currency depreciation elsewhere – increased by 28% YoY to USD 165bn in 2014. Attracting some of this spending back home could boost domestic consumption. We anticipate more cuts on a wider variety of items going forward.

Policy is geared towards the long-term

Monetary, fiscal and exchange rate policies are all steered towards achieving China's long term goals. There is a great chasm between market expectations for more stimulus and actual policy orientation. The market believes that China's policy stimulus is behind the curve, not realizing the possibility that policymakers may be willing to accept growth lower than 7%. Judging by policy execution hitherto, this is possible. There is room to loosen more but policymakers have chosen not to. For instance, the government could have completely removed restrictions on the purchase of second homes nationwide, but they did not. The pace of monetary loosening has also been slower than previous episodes.

Policymakers may be willing to accept growth lower than 7%

Striking a balance between maintaining short-term growth and achieving long-term structural objectives is difficult. More often than not, governments seem to choose the former over the latter. China is different. The government is willing to sacrifice short-term growth. As such, the market should brace for more downside risk on headline growth. More strident doomsayers will emerge. Yet, we have shown that a holistic, longer-term perspective gives reason to be optimistic.

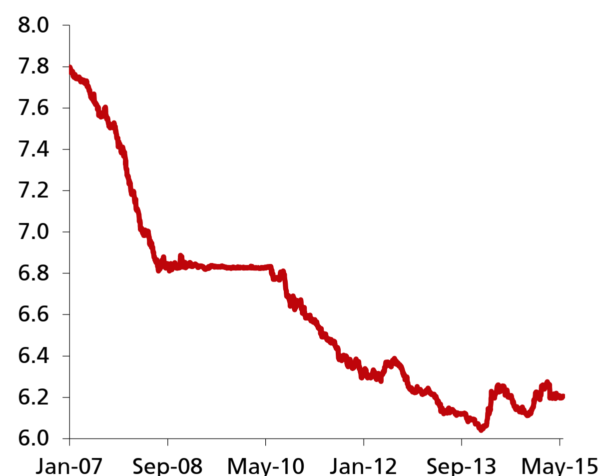
China Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real GDP growth	7.4	7.0	6.8	7.0	6.8	7.1	7.1	6.8	6.8
GDP by expenditure: current price									
Private consumption	9.9	12.5	10.5	12.3	12.5	12.6	12.7	10.5	10.5
Government consumption	6.8	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Urban FAI growth (ytd)	15.7	13.5	13.5	13.5	13.0	13.3	13.5	13.5	13.5
Retail sales - consumer goods	12.0	11.0	10.5	10.2	10.8	11.5	11.5	10.5	10.5
External									
Exports (USD bn)	2,342	2,485	2,678	514	604	676	690	550	650
- % YoY	6	6	8	5	6	7	7	7	8
Imports (USD bn)	1,959	1,965	2,119	390	503	541	531	418	541
- % YoY	0	0	8	-18	4	7	7	7	8
Trade balance (USD bn)	383	520	559	124	102	135	159	132	110
Current account balance (USD bn)	220	342	368	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	2.1	3.1	3.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	3,843	4,311	4,810	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (USD bn, YTD)	120	126	132	35	65	89	122	36	66
Inflation & money									
CPI inflation	2.0	1.8	2.2	1.2	1.7	2.0	2.1	2.2	2.2
RPI inflation	1.0	0.4	0.7	-0.2	0.5	0.6	0.7	0.7	0.7
M1 growth	3.2	6.5	6.5	5.8	5.9	6.0	6.0	6.0	6.0
M2 growth	12.2	12.0	12.0	11.6	11.8	12.0	12.0	12.0	12.0
Other									
Nominal GDP (USD bn)	10,331	11,015	12,169	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.1	-2.0	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

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

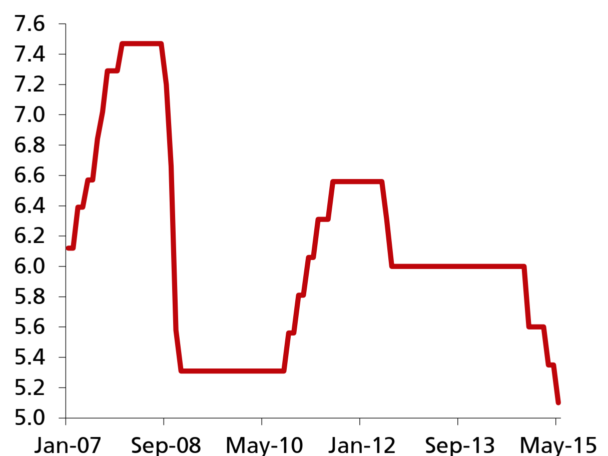
CN - nominal exchange rate

CNY per USD



CN – policy rate

%, 1-yr lending rate



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HK: red flags up, white flags down

- **The retail sector faces new headwinds. Multiple entry permits for Shenzhen residents are no longer issued and import tariffs for consumer goods are slashed on mainland China**
- **The status of Hong Kong as a prime shopping destination may fall unless businesses formulate new strategies**
- **Positive wealth effects should bolster locals' spending and provide some respite to retailers**
- **Residential property prices have room to rise further**

Retail sector faces multiple headwinds

The retail sector continues to be troubled by multiple challenges. China's slowdown and the anti-corruption drive are continuing. Economic weaknesses in Europe and Japan and the depreciation of their currencies relative to HKD cuts tourist spending in Hong Kong and encourage locals to buy overseas. In the first four months of 2015, Chinese tourist arrivals to Hong Kong grew only by 6.1% YoY. By contrast, Japan and Korea enjoyed tourist growth from China of 99% and 31%.

As a result of the ongoing anti-corruption campaign, the luxury retail sector has taken the hardest hit. Sales of jewellery and watches have been contracting year-on-year for 13 consecutive months. Because the slowdown has been prolonged, we expect demand for labor in prime shopping locations – particularly street shops selling luxury goods – to fall in 2015.

Looking ahead, Hong Kong mass-market retailers will face new structural challenges. In April, the Chinese government has ceased issuing multiple (unlimited) entry permits into Hong Kong for Shenzhen residents. The impact will be increasingly felt as issued permits expire. Starting from June, China will slash import tariffs on consumer goods including skincare products, western-style clothes and diapers by an average of 50%. As an example, a pair of imported running shoes, priced at 600 yuan, will become about 60 yuan cheaper after the tax cut. In light of huge cost savings, mainland consumers may develop new shopping habits over time and reduce visits to Hong Kong.

Burdened with high rental and labor costs, Hong Kong retailers have little room to slash prices. Staying competitive would require adaptive business strategies. For example, those stores targeting mainland customers may want to refocus on local customers. Others may cut costs by relocating to cheaper locations.

Political events are also casting a shadow on the retail sector. According to the Travel Industry Council, the number of mainland tour groups visiting Hong Kong over the Easter holidays dropped by 20% following protests targeting cross-border parallel traders in recent months. Such events may have long term repercussions on Hong Kong's tourism industry. As mainland tourists shun visiting Hong Kong and select other tourist destinations, they may form new travel habits. Coupled with new developments on the mainland, such as the increase in the number of duty-

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free shopping malls, the status of Hong Kong as a prime shopping destination may erode over time. We project total retail sales values to grow 2.0% in 2015 (-2.3% YTD), vs. -0.2% in 2014 and the five-year trend growth of 12.7%.

The overall retail labor market should remain steady for now. Locals' spending growth shall stay resilient due to positive wealth effects from better equity and property markets, offsetting some of impact of lower tourist spending (locals' spending accounts for more than 60% of total retail sales). In addition, retail sector employment does not respond immediately to temporary dips in the sector.

Retail sales growth of only 2.0% expected this year

The government's 2Q15 Quarterly Business Tendency Survey indicated that 95% of respondents in the retail sector expect their employment to increase or remain unchanged in 2Q15 compared with 1Q15. That said, we are not ruling out sporadic layoffs in those shops bearing the brunt of recent developments, such as small-sized stores catering to mainland tourists or even parallel traders, e.g., pharmacies.

Residential property market to be resilient

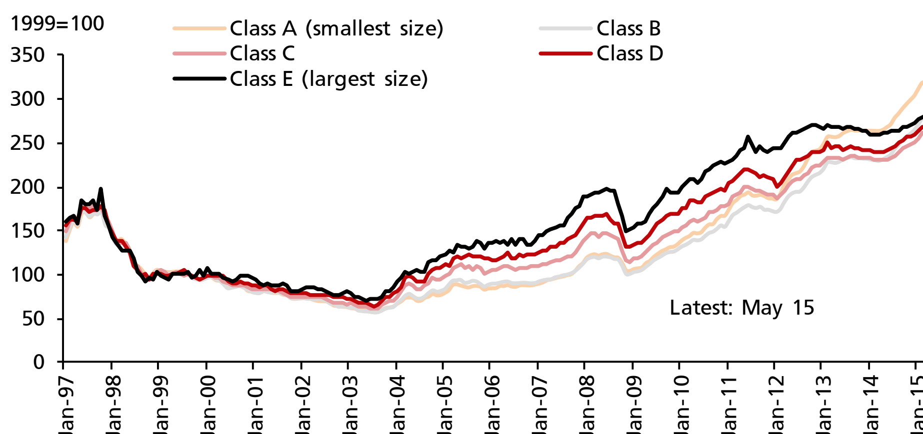
The residential property market made a strong comeback recently. Prices increased 7.2% to-date (May) and rentals fell slightly by 0.9% YTD. Pent-up demand from last year, when homebuyers were uncertain about the outlook for interest rates and adopted a "wait-and-see" approach, is being released. The surge in property transactions and prices after relaxation of Double Stamp Duty (DSD) rules last May is further testimony to strong demand.

Administrative measures introduced in the past two years have increased the cost of transactions, encouraged home owners to hold onto their properties and left little room for price negotiation, thereby lowering transaction volumes. The impact on prices is less clear (Chart 1). The increase in prices was unabated amid multiple rounds of administrative measures. Crucial factors supporting the years-long price rally – ultra low interest rates and strong end-user demand – have not changed. Meanwhile, residential rentals are set to regain upward momentum as potential buyers continue their wait-and-see stance amid a slew of administrative measures, or are deterred by high housing prices or more stringent mortgage requirements.

Prices increased 7.2% YTD

Prices have room to increase further within this year. Full-employment conditions lend support to the property market. End-user demand is strong and supply is still relatively constrained. The market has already digested the possibility of near-term US rate hikes. The impact of actual rate hikes on the Hong Kong property market depends on 1) the timing of the rate hikes – whether it coincides with a large increase in HK's housing supply; and 2) the speed and magnitude of rate hikes. In our view, the first US rate hike will happen in 4Q15, and the rate of increase would be gradual.

Chart 1: Residential property prices (Rating and Valuation Dept)



Government relief measures cloud inflation outlook

Residential property prices rebounded strongly in 2H14, and accelerated in 1Q15. Private rental growth (YoY) has been trekking up consistently since April 2014, with just a small retreat in recent months due to an influx of small-sized homes in the primary market. However, this is expected to be temporary. The general uptrend would be captured in the CPI this year, as rentals growth enters the CPI with at least six months time lag. This partly explains why the housing component averaged 8.2% in 1Q15, much higher than headline CPI of 4.4%. Despite a continual rise in rents, housing inflation is expected to be a few percentage points lower in 2Q and 3Q due to the base effect of government rate waivers. The government will waive rates in April-September 2015, subject to a ceiling of $2,500 per tenent per quarter. This is higher than the $1,500 waiver applied to the same period in 2014.

Electricity, water and gas inflation will also be noticeably lower in the second half of the year due to a very high base in 2014 caused by the timing of government subsidies. In the second half of last year, CPI inflation for electricity, water and gas was lifted by the cessation of electricity subsidies (CPI for this component averaged more than 20% in 2H14 compared to 4.5% in 1H14). To reflect this impact, we lower our full-year headline CPI projection to 3.2%.

Positive wealth effects to keep growth steady

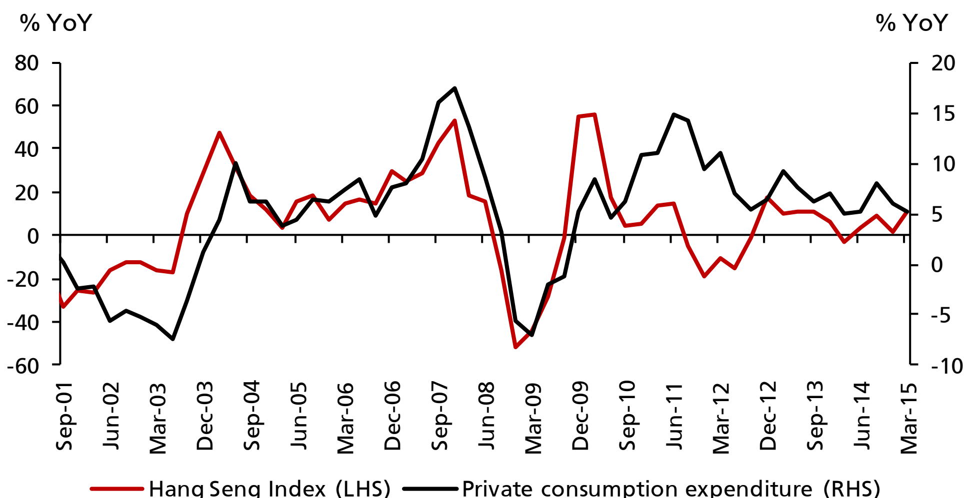
Wealth effects from more bullish equity and property markets should support private consumption

Budget sweeteners and positive wealth effects from more bullish equity and property markets will bolster private consumption in 2015 (Chart 2). The Hang Seng Index has leapt about 15% YTD. We maintain our 2.8% GDP growth projection for 2015, versus 2.3% in 2014. The government is projecting 1%-3% growth in 2015.

The outlook for private investment and external trade remains gloomy. Hong Kong's private investment is positively correlated with China's economic performance. China's slowdown has been protracted (annual real GDP growth dipped below 8.0% since 2012), and economic growth is set to slow further to about 7.0% this year from 7.4% in 2014. Meanwhile, it takes time for reform dividends to show, and structural reforms elevate uncertainty. As such, Hong Kong enterprises' China-related business expansion and capital expenditures should slow in response. We anticipate Hong Kong private investment to grow at a modest pace.

Net exports will contribute little, if at all, to headline growth. Nominal net exports have fallen by 11.7% YTD. Export growth to major markets is mixed. Exports to ASEAN and US fared exceptionally well in the first four months of the year, growing 15.2% and 6.0% respectively. In contrast, exports to Japan and the EU dipped into red, contracting 5.7% and 0.9% respectively. Compared to 4Q14, the contraction

Chart 2: Private consumption expenditure versus the Hang Seng Index



has lessened. Exports to China have merely grown by 1.1%. Export growth will continue to be polarized across key markets into the second half of 2015. We expect exports growth to the US to hold up, while exports to emerging markets may taper off slightly. According to IIF, average GDP growth across emerging markets fell to 1.6% over Feb-Apr versus 1.9% in the previous three months, and confidence is at post-crisis lows across the emerging world. In light of the fragile external environment, we are projecting low single-digit export growth in 2H 2015.

We lower our GDP growth projections for 2015 to 2.5% from 2.8% previously

As Hong Kong continues to face headwinds from a deepening economic slowdown on the mainland and a tough external environment, we lower our GDP growth projections for 2015 to 2.5% from 2.8% previously.

Looking ahead: tough luck for retail

The environment is extremely challenging for the retail sector, and this raises a question about Hong Kong's employment situation. In any case, unemployment is a lagging indicator, and it will be a while before we see a rise in the retail unemployment rate. However, it is unrealistic to expect that the sector can escape unscathed from the economic malaise. Challenges coming from all fronts – both structural and cyclical – have already made it harder to do business than before. This may translate into lower monetary rewards, tougher demands on workers and the occasional shop going out of business.

It is not the time to wave the white flag yet. Hong Kong's retail sector prides itself in product variety and quality. During this difficult period, businesses will have to devise innovative strategies to attract and retain customers. There is only so much the government can do to stimulate consumption and promote tourism. Fending for themselves is retailers' best bet.

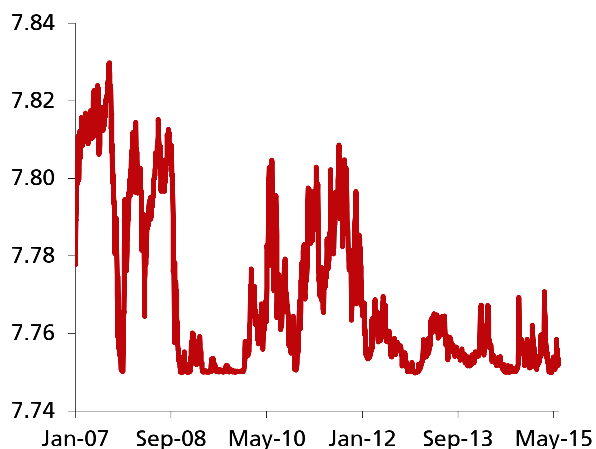
Hong Kong Economic Indicators

	2014	2015f	2016f	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth (13P)	2.5	2.5	3.0	2.1	2.4	2.5	3.1	2.6	2.9
Private consumption	3.2	4.7	6.1	3.5	4.9	5.1	5.3	5.5	5.3
Government consumption	3.0	3.5	3.0	3.5	3.5	3.5	3.5	3.0	3.0
Investment (GDFCF)	-0.2	4.6	3.0	7.3	4.2	3.9	3.6	3.0	3.0
Exports of goods and services	0.8	3.3	5.4	0.2	2.2	5.2	5.1	4.9	5.8
Imports of goods and services	1.0	3.9	6.4	0.5	2.8	6.4	5.6	6.2	5.8
Net exports (HKD bn)	6	-26	-42	-2	-31	14	-7	-18	-43
External (nominal)									
Merch exports (USD bn)	474	489	520	108	119	131	131	114	127
- % YoY	3	4	8	2	3	4	5	7	7
Merch imports (USD bn)	544	565	599	123	139	149	154	130	127
- % YoY	4	4	7	1	4	5	6	6	6
Trade balance^ (USD bn)	-70	-76	-79	-15	-20	-18	-23	-16	0
Current acct balance (USD bn)	0.4	-16.4	-18.3	-	-	-	-	-	-
% of GDP	0.1	-5.4	-5.7	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	329	344	359	-	-	-	-	-	-
Inflation									
CPI inflation	4.4	3.2	3.0	4.4	3.3	2.7	2.3	2.5	3.0
Other									
Nominal GDP (USD bn)	291	306	323	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3

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

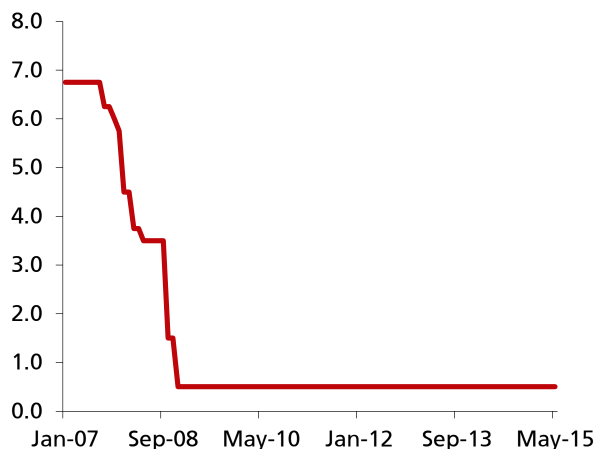
HK - nominal exchange rate

HKD per USD



HK – policy rate

%, base rate



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TW: downside risks

- **Downside risks to growth have increased**
- **Exports are losing steam thanks mainly to China**
- **The property market is cooling due to tighter policy**
- **The central bank is likely to guide the USD/TWD higher to support exports. But a cut in interest rates is unlikely**
- **The correction in property market was self-induced. The government will keep a tight rein on property ahead of the 2016 elections**

Growth was tepid in 1Q at 3.5% (YoY) or 2.7% (QoQ saar) (Chart 1). The main driver was net exports (falling imports). Domestic investment and government consumption both deteriorated in 1Q. Private consumption was the only component that held steady. We have cut our full-year GDP forecast to 3.4% from 3.7% previously.

Downside risks may be underestimated

Risks remain tilted to the downside. The weakness in April data – export orders, exports, industrial production and PMI – points to more downside potential in 2Q15 (Chart 2). We assume a significant rebound in 2H15 but if this fails to materialize our full-year forecast of 3.4% will be missed.

Demand from China has weakened and will likely remain subdued for some time. The recent easing of macro policies by Chinese authorities could help to arrest a further slide in investment and consumption growth there. Demand for foreign goods, however, would only start to increase after the excess capacity in China's domestic manufacturing sector is largely absorbed.

Just when the exports are losing steam, Taiwan's property market – an important driver of domestic demand – is cooling as well. Property prices have fallen since

Chart 1: GDP growth slowing

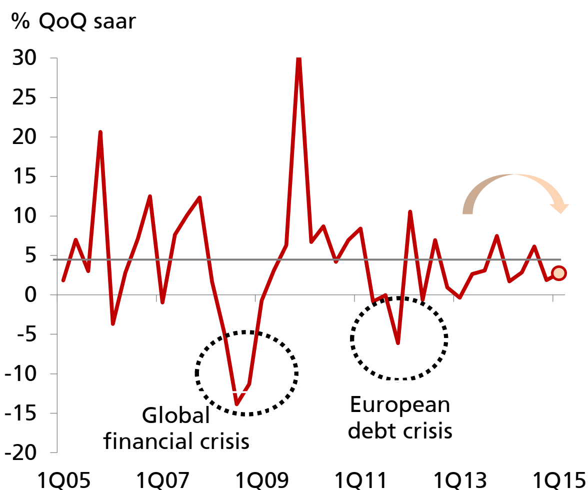
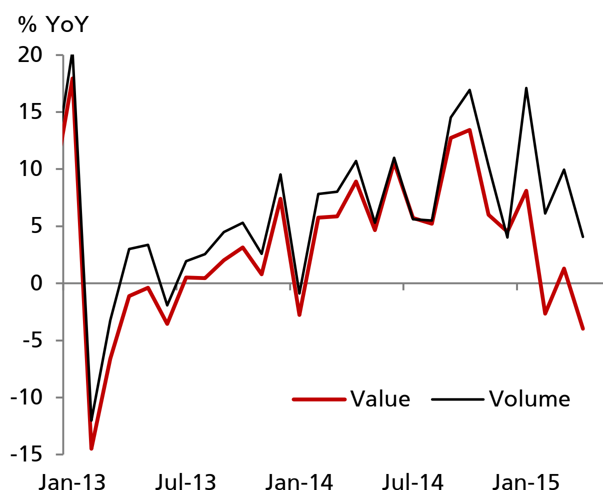


Chart 2: Export orders growth slowing



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late last year, along with the gradual slowdown in bank lending growth (Chart 3-4). The several rounds of credit policy tightening by the central bank (aimed at curbing property prices) have had the desired effects. Meanwhile, the government introduced in May a 15%-45% capital gains tax on property transactions (to replace the existing luxury tax), which further dampened the investment sentiment in the property market.

High property prices, albeit a common phenomenon in the region, have been criticized in Taiwan as a fault of government policies in recent years ever since the KMT party took power in 2008. The younger generation, in particular, has showed strong dissatisfaction about the rocketing property prices, which made it increasingly difficult for them to own homes. With the 2016 elections approaching, the authorities would be under pressure to keep a tight rein on property prices ahead, in an attempt to reduce the wealth gap, improve public livelihood and obtain the voters' support.

A temporary slowdown, not a downturn

The labor market should remain stable

Whilst a growth slowdown appears very likely for 2Q, a more important question is whether the slowdown is temporary or indicative of a trend. If it is a one-quarter phenomenon, the labour market will remain stable in 2H15, providing support to consumption and domestic demand. Conversely, if GDP growth remains subpar for two quarters or longer, job and income conditions would deteriorate, exerting pressures on the domestic sector and leading to a broad-based economic downturn.

We are leaning towards the view that slowdown will be temporary. Externally, our core scenario remains that the global economy is on the recovery path. Thanks to the upcoming release of new mobile products by US tech firms this summer/autumn, exports demand for electronics components is expected to bounce back in 2H15.

Domestically, the ongoing correction in the property market should not be a major concern. The correction has been very mild so far. And importantly, it was self-imposed rather than driven by external factors. In the event of a sharper-than-expected decline in the property market, the central bank could relax the credit control measures to cushion the impact.

Policy fine-tuning expected

A temporary economic slowdown is expected to trigger a fine-tuning of macro policies. Taiwan's central bank (CBC) is likely to guide the USD/TWD rate higher via interventions and moral suasions, and slow the process of absorbing excess liquidity via issuing CDs during open market operations.

Chart 3: Housing prices came off the peak

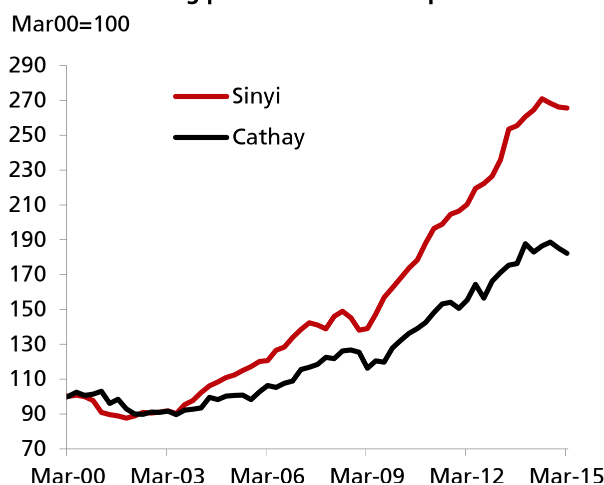
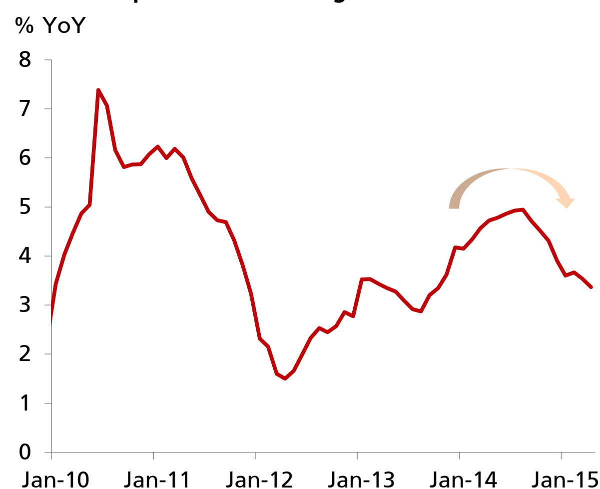


Chart 4: Expansion in housing loans moderated



We maintain the view that the CBC will hold the key rate steady at 1.875% in the rest of 2015. Historically, the CBC adjusts rates only when major economic swings occur. It raised rates in 2010-11, when Taiwan emerged from the global financial crisis. The tightening process paused in 2011-14, due to the European debt crisis and China's slowdown. Holding the view that the domestic economy remained in a recovery phase despite the temporary slowdown in growth, the CBC has refrained from making a policy U-turn to cut rates during this period. Today's situation will likely play out as it did in 2011-14. The central bank will refrain from rate cuts unless it suspects that recovery is seriously disrupted.

Monetary policy is sufficiently accom-modative

Moreover, monetary policy is already accommodative. The overnight interbank rate, currently at 0.39%, is below the core inflation rate of 0.6%. M2 money growth is running at 6.5% (YoY), at the upper end of the CBC's target range of 2.5-6.5% (Chart 5). Admittedly, the TWD has appreciated against many of the trade partners' currencies this year. Measured on a REER basis, however, the TWD has remained undervalued compared to its long-term value (Chart 6). The implication is that trade competitiveness remains intact despite a strong TWD, thanks to relatively low domestic inflation.

On the fiscal policy front, we expect the government to focus on the issue of income distributions, in a bid to reduce social inequality and obtain public support ahead of the 2016 elections. Increasing government expenditures via a supplementary budget is unlikely amid the constraints of public debt ceilings.

Watching the election campaigns

The next presidential and parliamentary elections will both be held in January 2016. Election campaigns will be in focus in the next half a year. The ruling KMT party is struggling to find a high profile presidential candidate. In contrast, the nominee from the opposition DPP party is currently leading all the possible candidates in the media polls.

It is widely known that the DPP takes a conservative stance on the cross-strait issues. The KMT has a relatively open attitude. But it is also facing obstacles to push for new initiatives to strengthen economic ties with the mainland, in light of growing misunderstanding about its China policies amongst the Taiwanese public. The progress of cross-strait trade and investment liberalization has already slowed in the past one year and is likely to remain sluggish in the near future.

Chart 5: Money supply growth

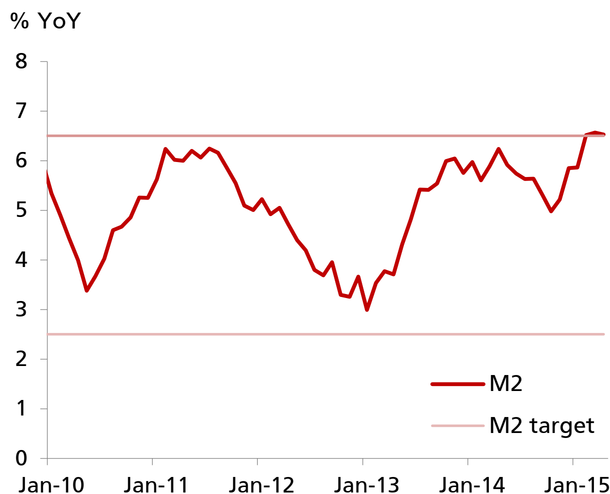
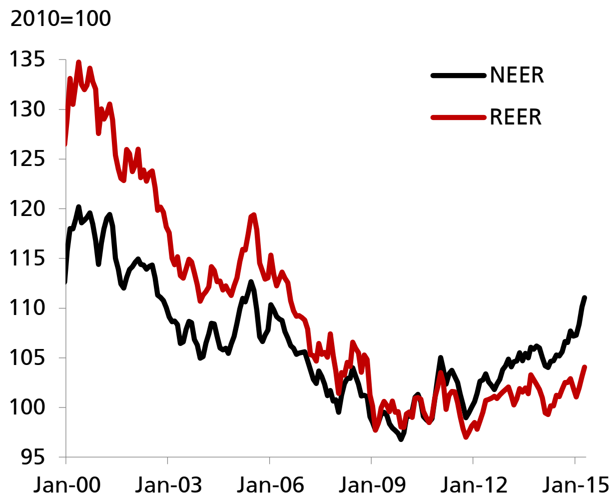


Chart 6: TWD effective exchange rates



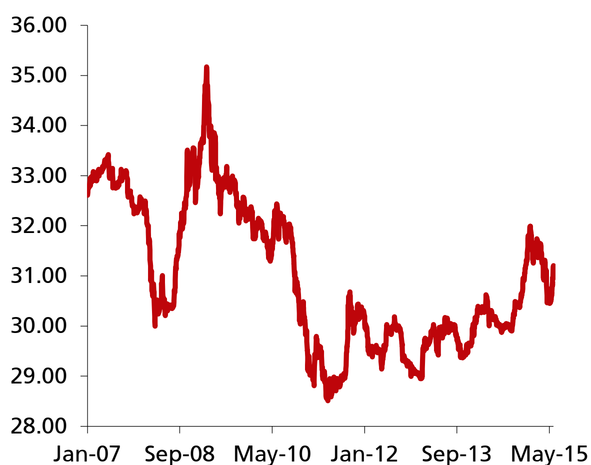
Taiwan Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth	3.8	3.4	3.5	3.4	3.3	3.0	3.7	3.7	3.6
Private consumption	3.0	2.4	2.6	2.5	2.3	2.4	2.5	2.6	2.6
Government consumption	3.7	0.5	2.0	-2.2	1.8	1.1	1.1	3.2	1.6
Gross fixed capital formation	1.8	0.7	2.6	0.4	1.0	0.6	0.8	3.3	2.4
Net exports (TWDbn, 11P)	1318	1652	1857	298	405	412	538	325	458
Exports (% YoY)	5.9	4.7	4.9	5.9	5.1	3.9	3.9	4.6	4.8
Imports (% YoY)	5.7	2.0	3.7	2.5	2.8	1.3	1.4	4.1	3.4
External (nominal)									
Merch exports (USDbn)	314	299	319	70	74	76	79	75	81
- % chg	2.7	-4.6	6.6	-4.2	-7.6	-6.0	-0.7	6.5	10.0
Merch imports (USDbn)	274	241	269	57	59	62	63	60	69
- % chg	1.5	-12.0	11.8	-15.0	-15.4	-12.7	-4.7	6.0	16.7
Trade balance (USD bn)	40	58	49	13	14	14	16	15	12
Current account balance (USD bn)	65	82	74	-	-	-	-	-	-
% of GDP	12.3	15.3	13.5	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	419	423	427	-	-	-	-	-	-
Inflation									
CPI inflation	1.2	-0.2	1.2	-0.6	-0.7	-0.3	0.6	1.6	1.4
Other									
Nominal GDP (USDbn)	531	538	543	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.8	3.8	3.8	3.7	3.8	3.8	3.8	3.8	3.8
Fiscal balance (% of GDP)	-0.8	-0.7	-0.9	-	-	-	-	-	-

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

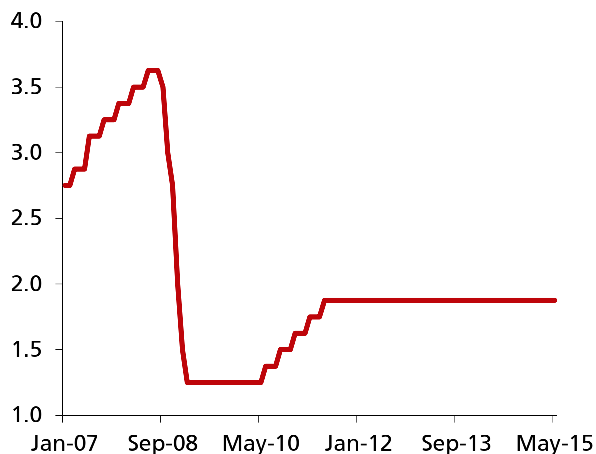
TW - nominal exchange rate

TWD per USD



TW – policy rate

%, rediscount rate



KR: external drag remains

- **Exports are deteriorating further, offsetting a recovery in domestic consumption**
- **The recent MERS outbreak also threatens the outlook**
- **GDP growth could fall below 3% this year**
- **Pressure is rising for economic stimulus**

The economy continues to grow at a moderate pace. Growth of 3.3% (QoQ, saar) beat expectations in 1Q15. But it came after a very weak fourth quarter. The past four quarters of growth have averaged only, 2.4%, well below the trend pace of 4% (Chart 1).

A divergence has emerged between exports and domestic demand. The quarter-on-quarter growth of goods and services exports was approximately 0% in 1Q15. By contrast, private consumption growth picked up to 2.5% from 1.9% in the preceding quarter. Gross fixed capital formation bounced back to 17%, reversing the 11% decline in the prior quarter.

We have lowered our GDP forecasts and now look for 3.0% growth this year and 3.5% for 2016.

Exports remain a drag

Exports have been a drag on growth for some time. The situation appears to be worsening rather than improving. The trade, manufacturing production and PMI data have deteriorated further in Apr-May (Chart 2). Many expect that exports demand will pick up in 2H15 as the US economy will regain momentum after being disrupted by temporary factors in 1Q, and the Chinese economy will also rebound as policy stimuli start to take effect. But the data out of US and China have remained

Chart 1: GDP growth still below trend

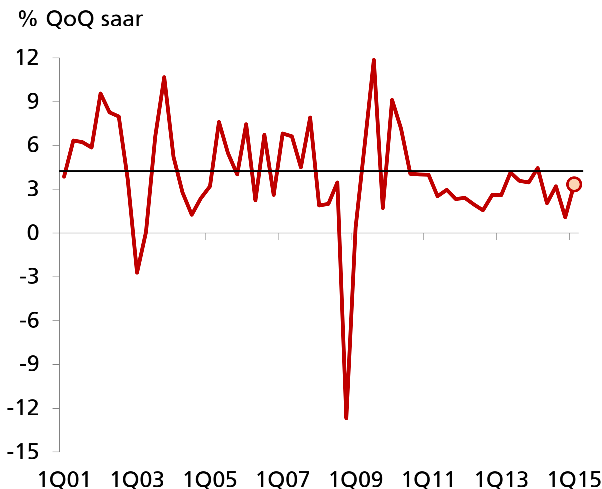
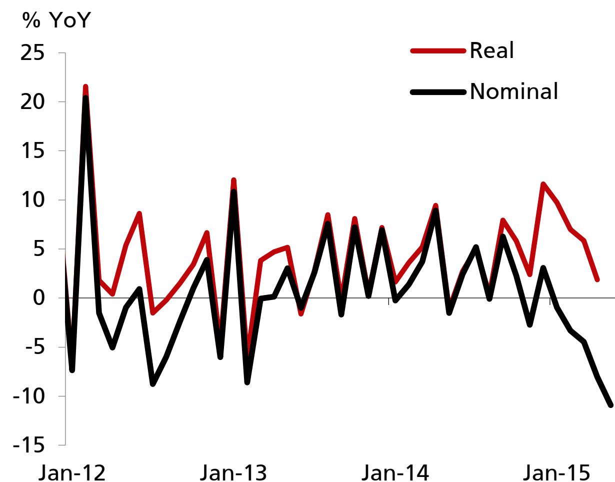


Chart 2: Exports deteriorating



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uninspiring so far. Whether 2H performance in these two economies will match expectations remains to be seen.

At the sectoral level, some had been optimistic about the outlook for electronics exports. Samsung's new flagship smartphones, which were launched in April, received positive response from consumers initially. More recent news, however, suggest that their full-month sales results still failed to break the records of predecessors. Indeed, competition has become increasingly intense in the smartphone sector due to maturing technology, falling costs and a saturated market. Whether Korean tech firms are able to restore competitiveness and regain market shares this year remains a question mark.

…offsetting recovery in domestic demand

Consumption and investment picked up, driven by the property market

Domestic demand should have continued to recover in early-2Q, as evidenced by the uptick in retail sales, consumer confidence and construction orders in April/May. Thanks to the central bank's rate cuts and relaxation of household borrowing rules, credit and property markets have entered a cyclical upturn since 2H14. Bank loan growth accelerated to 8.4% (YoY) in 1Q15 from 6-7% in 3Q-4Q14, led by the expansion in home mortgage loans (Chart 3). Property transactions registered double-digit growth for three successive quarters. Housing prices have also been rising (Chart 4). Recovery in the credit and property markets should benefit both the real estate and the financial sectors and provide a lift to consumption and investment growth.

But income and employment growth has remained suppressed, due to the knock-on effect of sluggish exports. Wage growth registered 3.8% (YoY) in 1Q15, far lower than the long-term average of 6%. The seasonally-adjusted jobless rate stood at 3.8% in Apr-May, notably higher than 3.0% seen before the global financial crisis in 2008. The softness in labour market conditions will likely restrict the pace of domestic consumption recovery in the near term.

In addition, the recent outbreak of Middle East Respiratory Syndrome (MERS) has raised the risk of a delay in domestic demand recovery. The number of trip cancellations by foreign tourists has surged since the beginning of June. Domestic consumer sentiment also appeared to have weakened. How seriously consumer spending will be hit really depends on how risks of contagion are contained going forward. The potential impact of MERS on consumption and domestic demand hasn't been factored into our GDP forecasts.

Chart 3: Bank lending growth accelerating

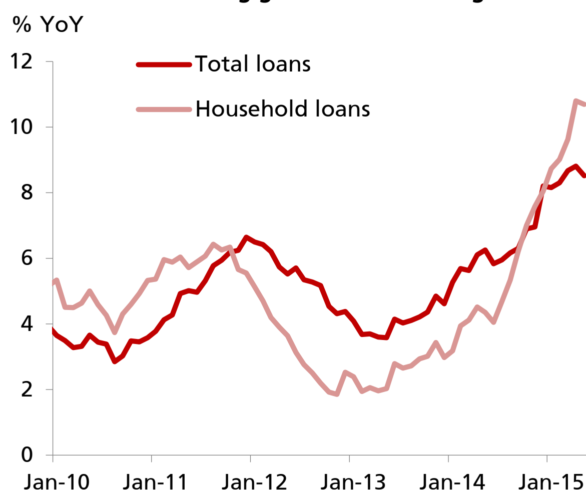
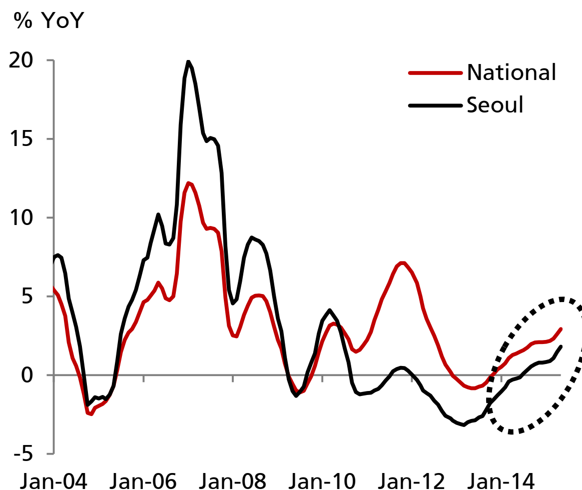


Chart 4: Housing prices bottoming out



Policy easing remains an option

The recovery in bank lending and property market activities should reduce the urgency for the authorities to further loosen policies. Given the sluggishness in exports and the threat of MERS, however, growth could fall below 3% this year.

The finance minister reiterated in May that the government will stick to an expansionary fiscal policy this year. The central bank also prioritizes the goal of supporting economic growth, as explicitly said in its latest policy statement in May. Indeed, macro policies have been loosened progressively in the last few years since the current administration took power in 2013. GDP growth fell below the 3% mark to 2.9% in 2013. This obliged the government to unveil a supplementary budget worth KRW 17.3trn and prompted the central bank to cut rates by 25bps. Last year, there was no extra budgetary support. But the BOK slashed rates further by 50bps. GDP growth picked up mildly to 3.3% as a result.

This year, both the finance ministry and the central bank expect growth to surpass 3%, close to last year's 3.3%. A supplementary budget is deemed as unnecessary under this macro assumption. The central bank cut rates by only 25bps as of May. Going forward, if the risk becomes more serious that GDP growth will fall below 3% this year, the authorities would find it necessary to add stimulus – preparing a supplementary budget and/or further cutting rates (note: the BOK indeed cut rates by another 25bps on the day when this report was released).

Market volatility has increased

Volatility has increased in financial markets. Foreign inflows into the stock market have been rising since Moody's upgraded Korea's sovereign rating outlook to "positive" in April. Long-term bond yields, however, have come off the bottom, driven by the surge in global bond yields (Chart 5). The USD/KRW rate has fluctuated in a wide range of 1070-1130 during the past 2-3 months.

Going forward, market expectations for US interest rates will continue to influence the Korean bond and FX markets. But the risk of a sharp rise in KRW bond yields or sharp depreciation of the won should still be low. This considers the strength of Korea's external liquidity position and improvement in its sovereign credit profile.

In fact, the BOK would like to tolerate some weakness in the won. On trade weighted basis, the won actually has appreciated this year and risen above the long-term average levels (Chart 6). To policymakers, excessive currency strength should be a bigger concern than currency weakness, especially given the ongoing weakness in exports that has weighed on the overall growth outlook.

Chart 5: Market interest rates

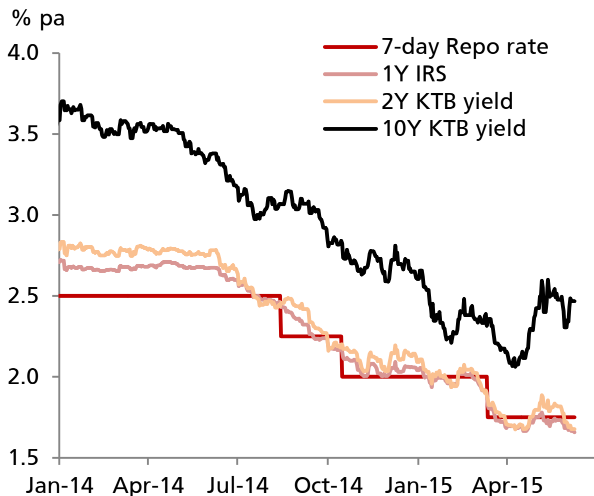
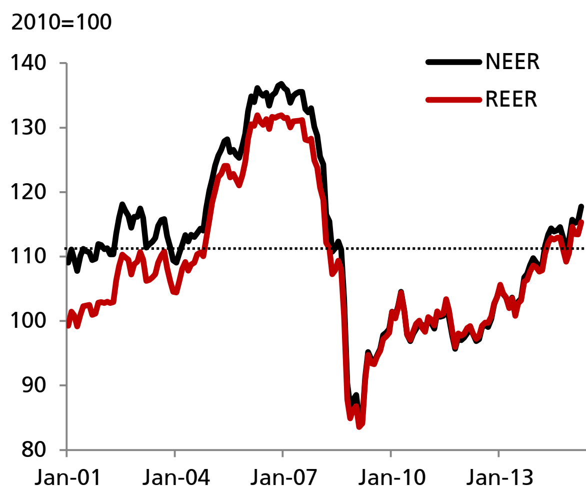


Chart 6: KRW effective exchange rates



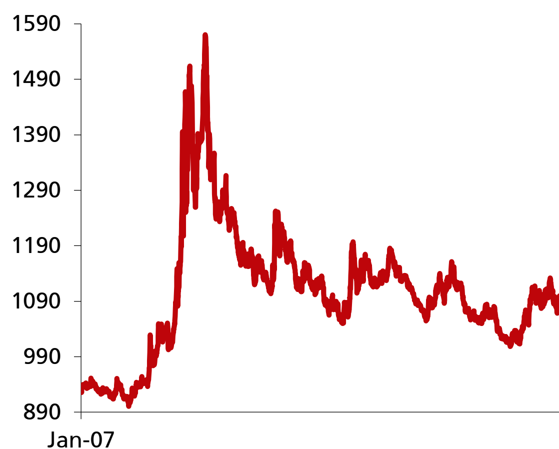
Korea Economic Indicators

	2014	2015f	2016f	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP (2010P)	3.3	3.0	3.5	2.5	2.7	2.9	3.7	3.6	3.5
Private consumption	1.8	2.4	2.8	1.5	2.6	2.5	2.7	2.8	2.8
Government consumption	2.8	3.8	3.7	3.1	4.4	3.4	4.3	4.8	3.8
Gross fixed capital formation	3.1	3.4	2.8	2.4	2.2	2.5	6.2	2.8	2.8
Net exports (KRW trn)	99	102	117	12	28	28	33	17	32
Exports	2.8	2.3	4.7	0.1	0.9	3.7	4.4	5.4	4.5
Imports	2.1	2.3	3.2	1.9	1.4	2.9	3.0	3.2	3.2
External (nominal)									
Merch exports (USD bn)	573	539	578	133	133	132	140	133	149
- % YoY	2.3	-5.9	7.2	-2.9	-8.7	-7.0	-5.0	-0.1	11.7
Merch imports (USD bn)	526	462	516	112	111	117	123	124	129
- % YoY	1.9	-12.1	11.9	-15.5	-15.5	-12.2	-5.3	11.2	16.8
Trade balance (USD bn)	47	77	61	22	22	15	18	9	19
Current account balance (USD bn)	89	112	97	-	-	-	-	-	-
% of GDP	6.3	8.3	7.0	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	364	384	393	-	-	-	-	-	-
Inflation									
CPI inflation	1.3	0.8	2.1	0.6	0.5	0.9	1.4	2.1	2.2
Other									
Nominal GDP (USD bn)	1,410	1,388	1396	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.5	3.5	3.4	3.7	3.7	3.5	3.5	3.6	3.5
Fiscal balance (% of GDP)	-2.0	-2.3	-2.2	-	-	-	-	-	-

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

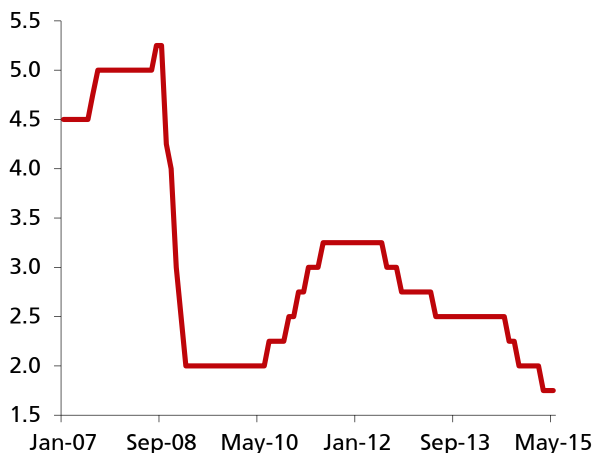
KR - nominal exchange rate

KWR per USD



KR – policy rate

%, target rate



IN: speed-bumps

- **Growth and reform hit speed-bumps this quarter**
- **We cut our FY15/16 growth forecast to 7.6% from 7.8% on weak rural wage growth and slow investment**
- **A weak monsoon is a risk to growth and inflation**
- **Easing inflation is driven by cyclical rather than structural drivers. The RBI will hold rates steady in 2H15**

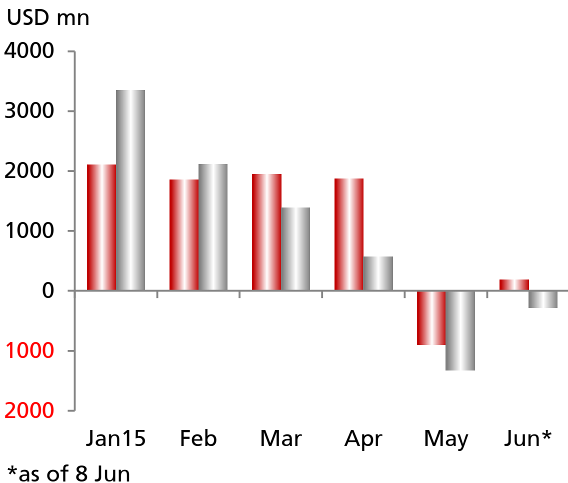
The government has generated much enthusiasm on the Indian economy in the past year, raising expectations for structural reform and faster growth. While policy makers get some of the credit, favourable externals – low commodity prices and ample liquidity – have also helped.

Optimism not misplaced but recovery will be gradual

The pace of macro improvement and progress on reforms has, however, hit a speed-bump. This has led to concerns over excessive optimism on the economy, and domestic financial markets have pared gains. Foreign portfolio flows have moderated through the year, slipping into the red in May (Chart 1). A host of triggers has led to this bout of weakness, including unexpected tax demands, regional fund rebalancing and tepid macro data. We expect growth to pick-up hereon though overtly-bullish expectations need to be tempered.

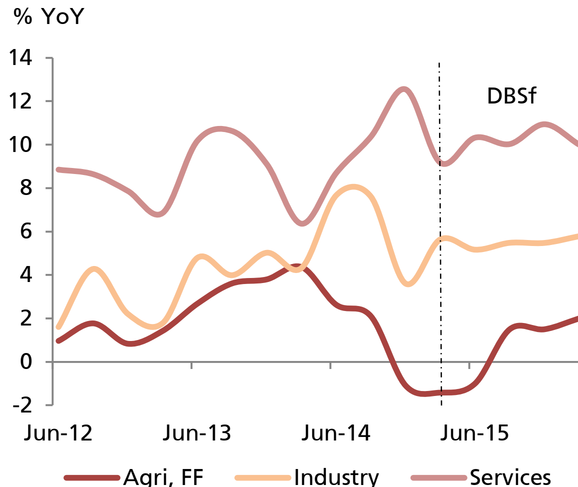
Real GDP growth rose 7.3% in the year ending Mar15 (FY14/15), based on the new GDP series. Domestic demand was the main pillar of support for growth and we expect this to sustain. However, a slower than anticipated pick-up in the investment cycle, especially private sector spending, and moderating rural incomes may weigh on growth. That said, higher public spending should revive the investment cycle, helped also by unclogging of stalled projects and easier financial conditions.

Chart 1: Foreign portfolio inflows pull back



*as of 8 Jun

Chart 2: GDP growth - sectors



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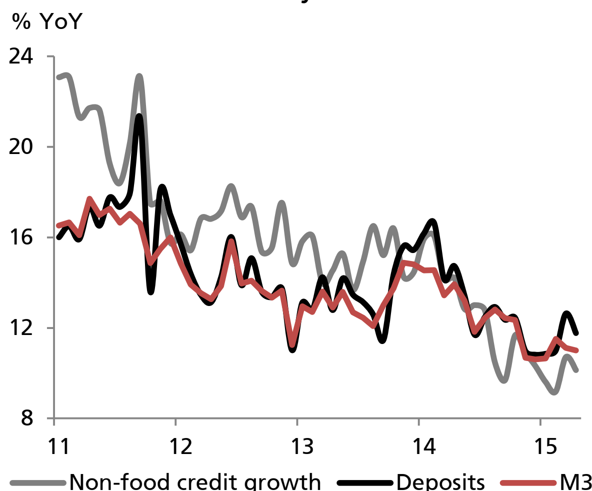
In light of these, we lower our real GDP growth for FY15/16 to 7.6% from 7.8% earlier. A return above 8% is likely in FY16/17.

On the supply-side, we assume a normal monsoon this fiscal year (Chart 2, previous page). Base effects will prop agri growth to 1.1% from 0.2% in FY14/15. Drought is a risk however (see "IN: weak monsoon a risk"; 08Jun15).

Chart 3: Credit metrics stay weak



Concurrently, manufacturing growth should remain steady at 7% and should offset subdued consumer goods output and electricity generation. Service sector is likely to maintain a healthy 10% pace on higher trade, communication and financial sector activity.

Meanwhile, the new GDP series continue to face skepticism, given the disconnect between strong headline growth and underwhelming high frequency indicators. The authorities, including the RBI, are likely to refer to the other lead indicators, including credit metrics (Chart 3), PMIs, non-oil non-gold imports and core industries output, to capture the growth trend. Additionally, there is still a need for historical numbers of the new series to better understand potential growth levels.

Moderation in inflation is more cyclical than structural

Always an Achilles heel, inflation has eased significantly in the past year. Over half of the deceleration owes to food prices. Pipeline price pressures have also been subdued as WPI inflation slipped into the red, back in Nov14, and then registered a record low -2.7% in Apr15. The fuel price index accounts for less than a fifth of price basket but is responsible for bulk of the deceleration of headline WPI.

The moderation in inflation is driven predominantly by cyclical factors rather than structural improvements. Minimum support price for farm produce was raised by a

Chart 4: Estimated CPI trajectory vs targets

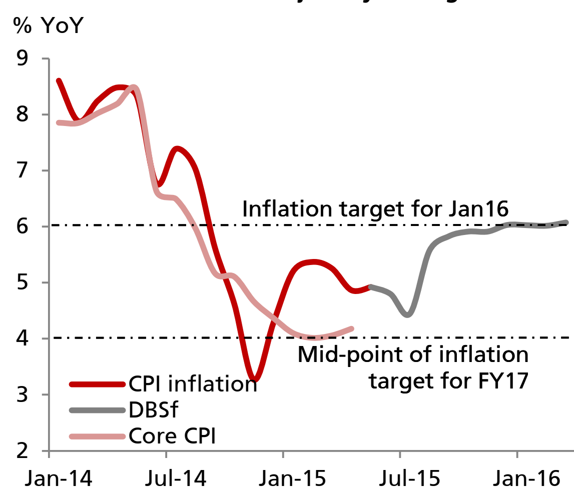
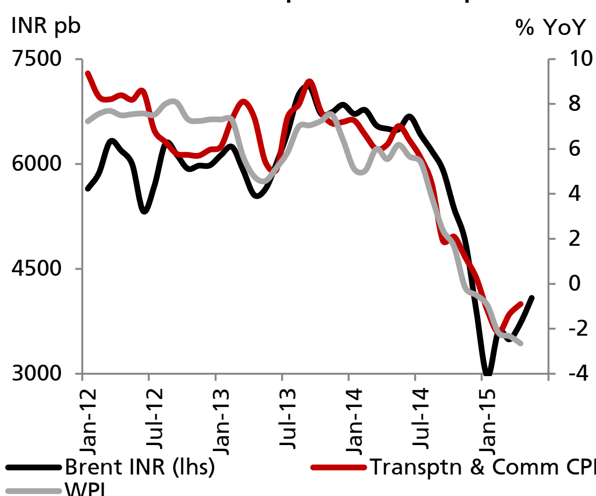


Chart 5: Reversal in fuel prices a risk for prices



moderate 4% (paddy and wheat) last year from 11% the previous year. Commodity prices have also pulled back, alongside a stable rupee. Global farm commodity prices have been benign, evidenced by the 18% decline in UN FAO food index since 2014. The government also undertook short-term measures like expand the essential commodities act, release extra stock of food grains, discourage hoarding and black-marketing activities etc.

Yet there is a risk that part of this disinflationary trend might reverse course if any of the above factors turn unfavorable. If monsoon disappoints by a wide margin, apart from the risk of higher food prices, minimum support prices might also be raised by a greater extent to support rural incomes.

Global oil prices have edged off lows since Jan, with the rupee losing ground since last month (Chart 5, previous page). In addition to these risks, unless supply-side constraints are eased by improving agri productivity, smoothen supply chain inefficiencies and logistical constraints, the recent pullback in inflation will be considered cyclical and not long-lasting.

As things stand, we expect FY15/16 inflation to rise 5.6%, with the near-term trend to see inflation ease until Aug beyond which base effects get adverse and push prints towards 6% by end-year.

Rates trajectory to be data-dependent

The RBI lowered its policy rates by a cumulative 75bps to 7.25% between Jan-Jun15. Despite the likelihood that inflation readings will stay below 5% until Aug15 due to base effects, the central bank adopted a cautious stance at its June review. Key risks that are likely to influence policy direction over the next two-three quarters include: a) below-normal southwest monsoon; b) direction of crude prices; c) volatility in global financial markets.

In its early-June update, the Indian Meteorological agency (IMD) estimated that Jun- Sep rains will only reach 88% of the long period average (LPA) vs April's estimate of 93% (Chart 6). In terms of spatial distribution, north-west and central parts of the country are likely to be the worst hit, with 8% shortfall seen in July and 10% in August.

As highlighted above, downturn in inflation is more cyclical than structural and in case monsoon disappoints, inflation readings could breach the upper-end of the central bank's 2-6% CPI target.

Chart 6: Rainfall deficiency in Jun-Sep vs normal

Source: IMD, DBS Group research

Crude prices have also held on to recent gains and are likely to prompt gradual adjustments in domestic retail prices. Finally, US rate hike risks remain on the table despite the soft data patch in 1Q. Considering these risks, the central bank is likely to remain on hold until end-2015. Likelihood of higher public spending to kickstart the capex cycle and need to step-up fiscal support to compensate a weak agricultural sector (if monsoon disappoint) will also deter the central bank from loosening policy reins too aggressively.

Reform agenda – progress to be gradual

While growth makes a gradual comeback, return to a high growth plane depends on the pace with which reforms are implemented. The agenda over the past year has been broad-based but incremental. While the groundwork for crucial reforms is complete, the more difficult phase of implementation will be under watch in the quarters ahead.

Which reforms will take priority? Foremost, it is crucial to gain consent of various stakeholders on the land acquisition bill and get it passed through the two parliamentary houses. July's parliamentary session will be key in this respect. The land acquisition bill is important to unclog existing projects and encourage greenfield commitments.

Secondly, infrastructure gaps need to be plugged. Big-ticket projects like the industrial corridors, Bharat Mala, Sagar Mala, National investment and manufacturing zones etc, have been planned. Funding requirements for such projects are enormous and involve long gestation periods. With the private sector still cleaning up its balance sheets, foreign collaboration is needed to help bridge some of the funding gap.

Next, the Goods and Services tax (GST) needs to be pushed through, with contentious issues like state compensation, exclusion of specific product lines and revenue neutral rates yet to be resolved. Expectations are that this is rolled out in some form by Apr16.

Finally, the agricultural / rural sector needs support after successive weak harvests. Rather than extending subsidies or raising support prices, focus is on efforts to improve farm productivity through mechanisation, irrigation, efficient warehousing facilities and establishing a nationwide agriculture market.

In sum

The Indian economy is headed in the right direction but expectations should be tempered. Compared to last year, foreign portfolio inflows are likely to slow, as the reform agenda enters the crucial implementation stage. The to-do list is long and will take more than a year or two to complete.

India Economic Indicators

	14/15f	15/16f	16/17f	4Q15f	1Q16f	2Q16f	3Q16f	4Q16f	1Q17f
Real output (11/12P)									
GDP growth*	7.3	7.6	8.3	7.5	7.5	7.8	7.9	7.2	7.8
Agriculture	0.2	1.0	2.0	-1.4	-1.0	1.5	1.5	2.0	2.0
Industry (incl constrn)	6.1	5.5	6.8	5.6	5.2	5.2	5.7	5.9	6.8
Services	10.6	10.0	10.0	9.2	10.3	10.0	10.9	10.0	10.4
Construction	4.8	3.0	5.0	1.4	2.0	3.0	3.0	3.5	3.5
External (nominal)									
Merch exports (USD bn)	308	310	330	70	70	80	80	80	85.0
- % YoY	-1.5	0.5	6.5	-15.1	-11.6	-1.0	2.1	14.1	13.3
Merch imports (USD bn)	447	460	492	96	100	115	120	125	130.0
- % YoY	0.0	2.8	7.0	-13.6	-11.6	-4.8	2.2	30.0	30.0
Trade balance (USD bn)	-139	-150	-162	-26	-30	-35	-40	-45	-45
Current a/c balance (USD bn)	-28	-31	-40	na	na	na	na	na	na
% of GDP	-1.3	-1.4	-1.5	na	na	na	na	na	na
Foreign reserves(USD bn, eop)	340	360	380	na	na	na	na	na	na
Inflation									
CPI inflation (% YoY)	6.0	5.6	5.9	5.3	4.8	5.3	6.0	6.1	6.1
Other									
Nominal GDP (USD tn)	2.1	2.3	2.5	na	na	na	na	na	na
Fiscal balance (% of GDP)	-4.0	-3.9	-3.5	na	na	na	na	na	na

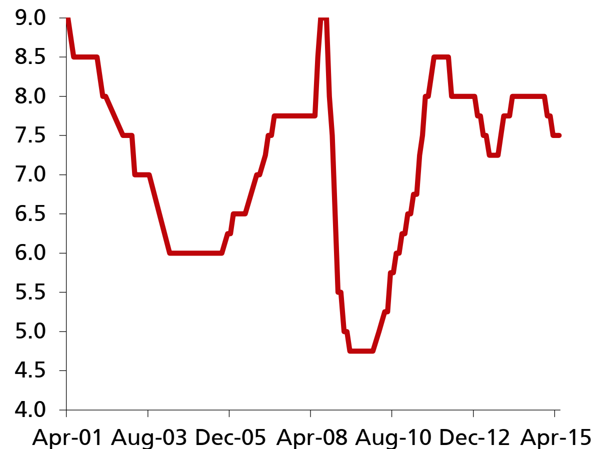
% change year-on-year, unless otherwise specified
Annual and quarterly data refers to fiscal years beginning April of calendar year.
* GDP growth stands for Real GDP; breakdown is under GVA (Gross Valued Added) series

IN - nominal exchange rate

INR per USD

IN – policy rate

% repo rate



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ID: under pressure

- **Further moderation in GDP growth can't be ruled out**
- **Private consumption, while still relatively strong, has been easing**
- **The budget deficit target of 1.9% of GDP seems too rosy considering the need to support growth**
- **But Bank Indonesia is likely to maintain its tight policy bias, given the need for financial stability at this juncture**

GDP growth eased to 4.7% (YoY) in 1Q15, the slowest since 3Q09. Further moderation can't be ruled out and the government is under pressure to arrest the slowdown. The authorities are committed to accelerate fiscal spending in 2H15, after the disappointing pace so far in the year. Investment growth may inch higher by year-end. Private consumption growth is likely to remain around 5%. We expect growth at 5.1% and 5.5% in 2015 and 2016 but downside risks remain.

Despite slowing GDP growth, Bank Indonesia (BI) is likely to keep its tight policy bias. Some inflationary risks have resurfaced in recent months and we now see CPI inflation averaging 6.4% this year, similar to the past two years. Additionally, although some improvements have been made, external funding concerns persist.

Downside risks to GDP growth outlook

A relatively young population and a rising middle-income class remain as the structural, long-term drivers behind the consumption story. Personal consumption growth continues to grind along at 5%, maintaining the average pace for the past ten years. This resilience is not to be taken for granted though. Private consumption growth has been softening since 2012-13, while having to shoulder a higher proportion of overall GDP growth in the economy (Chart 1).

Chart 1: Private consumption is increasingly important to GDP growth

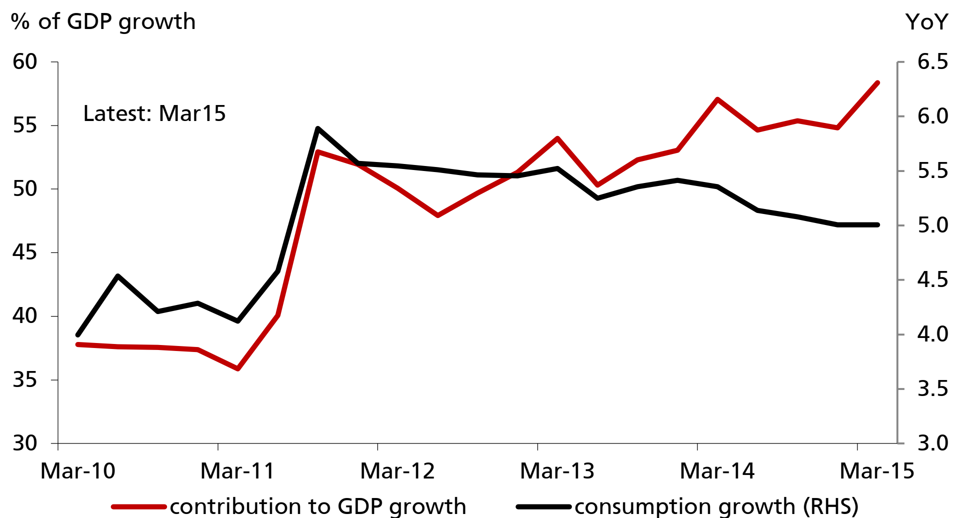

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Chart 2: Worrying signs from auto sales

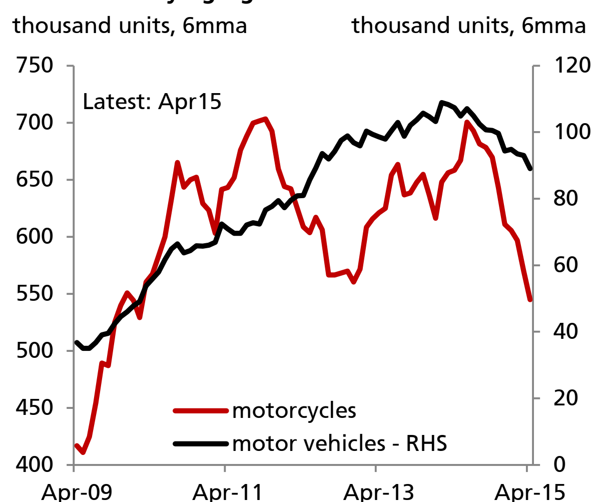
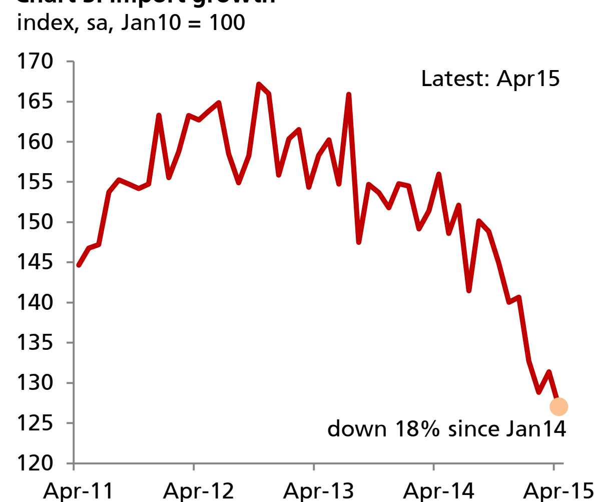


Chart 3: Import growth



Some of the high frequency data still suggest a modest consumption ahead. Retail sales continue to grow circa 15%. Income growth is likely to remain decent at around 10%. Core inflation is stable at 5%. But other signs are disconcerting. Up until April, auto sales were down by 16% (YoY); two wheel vehicle sales fell by 21% (Chart 2). Total imports have fallen by nearly 20% since Jan14 (Chart 3).

Exports will provide little boost to consumption growth this year. We expect them to fall by 4.4% this year, worse than the 3.4% drop last year. Weak commodity prices continue to weigh on revenues, given that coal and palm oil products make up a quarter of total exports. It is also important to note that GDP growth was slowest in commodity-intensive regions like Kalimantan, which recorded a mere 1% in 1Q15.

Investment growth is lackluster, at around 4% currently. A weak rupiah and poor sentiment continue to undermine the recovery in private investment. More importantly, the pace of fiscal spending has disappointed. At 2.2% (YoY) in Q1, government consumption growth was even slower than in 4Q14.

More aggressive fiscal policy will help

Fiscal deficit targets below 2% of GDP are too rosy

The last time GDP growth fell below 5% in 2009, the government ramped up its spending significantly. Government consumption grew 11% in 2009 and its contribution to GDP growth rose to a full 1%-pt. While acceleration of fiscal spending is likely in 2H15, full-year government consumption growth may only reach around 6%, at best.

The government has set an overly-optimistic tax collection target for this year. A 30% jump in tax collection is difficult to achieve given the slowing GDP growth. It is also high by historical standards, double than the average in the past ten years. Up to May, tax collection was only a third of the entire year's target. Full-year fiscal revenues may only reach 90% of the target.

The current budget deficit targets of 1.9% (of GDP) for 2015 and 2016 seem to be too conservative, considering the need to help arrest the slowdown in GDP growth. Even with a 2.5% (of GDP) fiscal deficit, the government still needs to lower its planned expenditures by some 2% of GDP this year.

More importantly, the project implementation phase continues to frustrate. Key projects which were supposed to start in April, including the first power project in Central Java, have been delayed due to red-tape and land disputes.

Chart 4: Foreign reserves / s-t ext debt
ratio, quarterly data

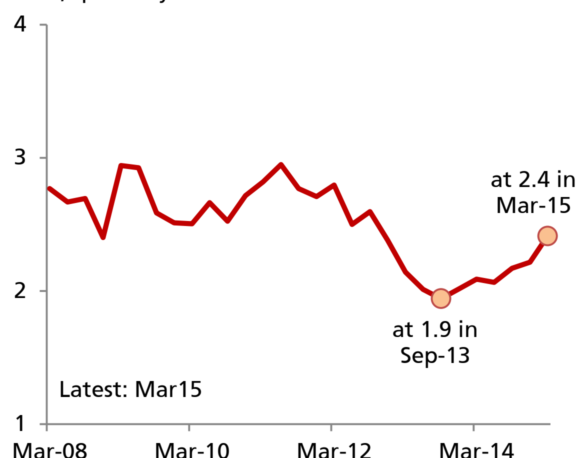
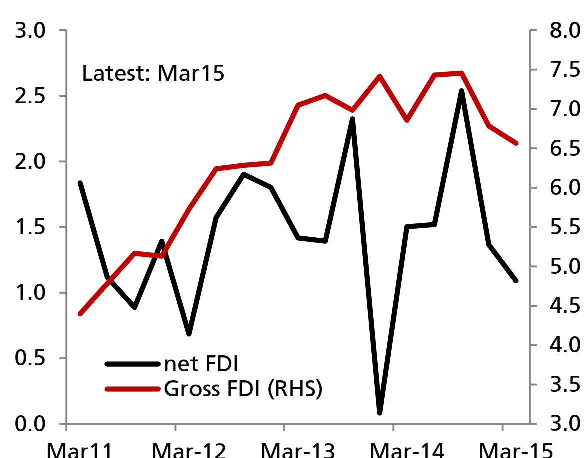


Chart 5: Foreign direct investment into Indonesia
% of GDP USD bn



Bank Indonesia to maintain cautious stance

Current account deficit not a problem if FDI rises

There have been some notable improvements concerning external financing risks. External debts are still rising but the pace of growth has eased. Total external debts grew 7.6% (YoY) in 1Q15, slower than the average of 10.3% seen in 2014. Short-term external debts have continued to moderate, and foreign reserves coverage is now at its highest point since mid-2012 (Chart 4).

Meanwhile, current account (C/A) deficit narrowed to 1.8% of GDP in 1Q15, on the back of the USD 2.5bn trade surplus in the period. Yet, bulk of this was caused by a slump in imports rather than a surge in exports. An increase in fiscal spending and some revival in investment growth mean that C/A deficit may rise again towards the year-end. We look for C/A deficit to come in at 2.7% of GDP this year, a slight improvement over the actual 2.9% reading last year.

BI is likely to maintain a cautious stance. The central bank will continue to watch external debt issuance and encourage currency hedging by local corporates. We remain of the view that a more sustainable C/A deficit is about 2% of GDP, based on net foreign direct investment (FDI) flows recorded in the economy. It is also worth highlighting that gross FDI has eased in 1Q15 (Chart 5). If this moderation continues, it would prompt more market concern.

Monetary policy boost through non-rate measures

BI to maintain a tight policy bias

CPI inflation is back in excess of 7% and likely to peak during the Ramadan/Eid period in June-July before inching lower again towards the year-end. Yet, weak sentiment on the rupiah is likely to support underlying inflationary expectations. Anticipation of higher fuel prices after July also means upside risks to prices across the board. We now expect CPI inflation to average 6.4% this year, up from our previous forecast of 6%. Even if CPI inflation may slip below 5% by Dec15, it will only prove to be one-off, given the high base effects from last year.

Expect BI to maintain its tight policy bias. While there is a need to support growth, BI prefers to do this through non-rate measures. BI has loosened rules concerning property mortgages, auto loans as well as limits for loan-to-deposit ratios among commercial banks. The central bank also continues to tolerate a weak rupiah, as long as it remains relatively stable on an effective exchange rate basis.

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

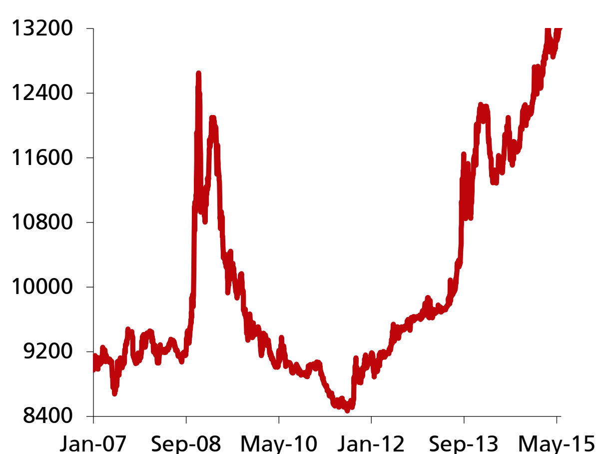
Indonesia Economic Indicators

	2014	2015f	2016f	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f	2Q15f
Real output and demand									
Real GDP growth (10P)	5.0	5.1	5.5	4.7	5.0	5.3	5.3	5.7	5.5
Private consumption	5.1	5.2	5.3	5.0	5.3	5.3	5.3	5.4	5.3
Government consumption	2.0	5.6	5.9	2.2	5.9	6.1	6.7	7.3	8.4
Gross fixed capital formation	4.1	5.3	5.7	4.4	5.8	5.5	5.3	5.9	5.2
Net exports (IDRtrn, 10P)	58	122	118	30	12	37	41	36	10
Exports	1.0	2.5	4.4	-0.5	1.8	2.3	6.3	5.1	4.1
Imports	2.2	-0.6	4.9	-2.2	-1.3	0.5	0.5	4.2	5.0
External									
Merch exports (USDbn)	176	168	181	39	41	42	46	44	45
- % chg	-3.4	-4.4	6.5	-11.4	-8.9	-4.5	4.5	12.8	9.8
Merch imports (USDbn)	178	165	174	37	42	44	42	40	44
- % chg	-4.5	-7.4	5.7	-14.0	-10.6	0.0	-4.5	8.1	4.8
Merch trade balance (USD bn)	-2	3	7	2	-1	-2	4	4	1
Current account bal (USD bn)	-26	-24	-24	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-2.9	-2.7	-2.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	112	113	118	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation (average)	6.4	6.4	5.7	6.5	7.1	7.0	5.3	4.5	5.1
Other									
Nominal GDP (USDbn) **	888	895	920	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.5	-2.5	-2.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

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

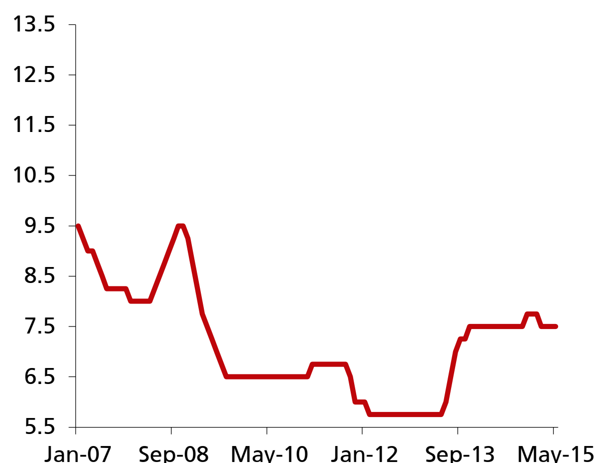
ID - nominal exchange rate

IDR per USD



ID – policy rate

BI rate



MY: treading water

- **Growth eased in 1Q15 due to exports**
- **Domestic demand remains resilient but post-GST consumption growth is set to moderate**
- **GDP growth remains on track to meet our forecast of 4.9% in 2015 and 5.0% in 2016**
- **Inflation should fall to 2.1% in 2015 as the GST inflationary impact is significantly less than expected**
- **Bank Negara will keep the policy rate at 3.25%**

GDP grew by 5.6% (YoY) in the first quarter (Chart 1), marginally slower than the 5.7% pace in 4Q14. Sequentially, momentum eased to 4.7% (QoQ saar), from a robust 7.3% previously. Domestic demand remains resilient; the external sector continues to be a drag.

External drag, domestic resilience

Export sales fell by 0.6% (YoY) in the quarter, from an expansion of 1.9% previously. A fall in oil prices and the general weakness in global demand has weighed down on export performance. This is against the backdrop of a slowdown in China and the tepid recovery in the developed economies (Chart 2).

Nonetheless, growth remained supported by a healthy expansion in private investment and robust domestic consumption. Strong capital spending in the manufacturing and services sectors continue to drive private investment despite the cut back in oil and gas capex spending due to the low oil prices.

Pre-GST purchases have also boosted private consumption. Consumption surged by 8.8% (YoY), up from an already healthy pace of 7.6% in the previous quarter.

Chart 1: Modest slowdown in 1Q15

% YoY, % QoQ saar

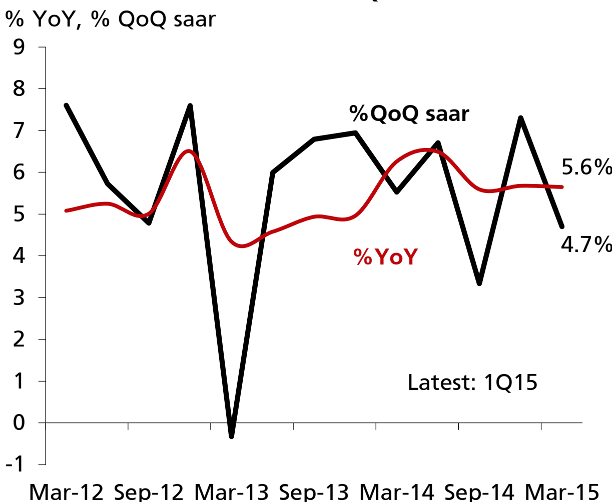
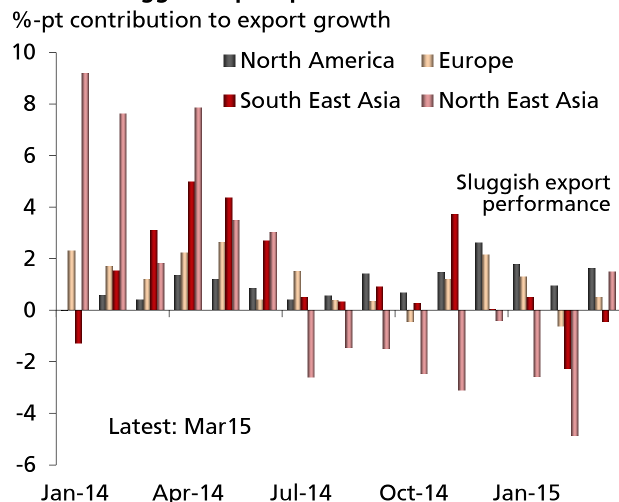


Chart 2: Sluggish export performance

%-pt contribution to export growth



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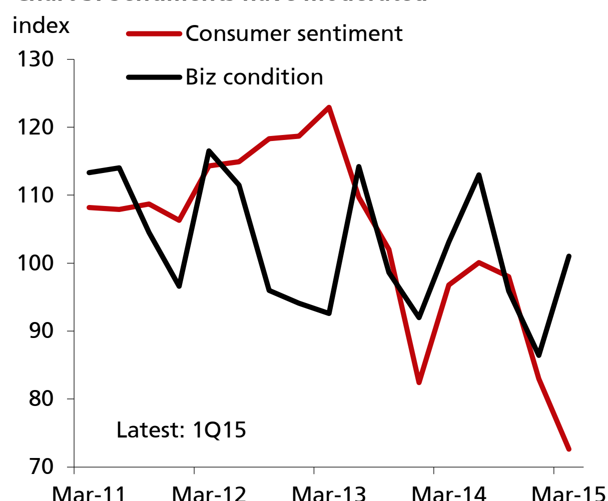
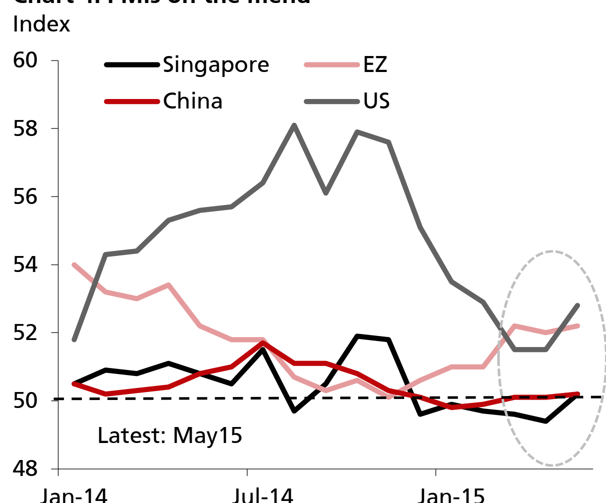




Beyond the front-loading ahead of the GST, stable labour market conditions and continued wage growth have underscored consumer sentiments. That said, the GST hike is bound to impact consumption growth. Moreover, consumer sentiment is cooling (Chart 3). Slower consumption growth ahead is likely.

This should be partially offset by steady disbursement of investment spending. Investment is expected to be led by capital spending in export-oriented industries, the services sector as well as for infrastructure development projects. Development projects tied to the Economic Transformation Programme will remain key drivers.

Net exports will likely continue to weigh down on overall GDP growth. The structural challenges in Eurozone will limit the upside from the region. Sluggish recovery in the US and potential normalisation of monetary policy by the Fed will remain a concern. Slower growth in China will further dent the outlook.

That said, there have been blips of a bottoming out and potentially a turnaround in global business cycle. Recent PMIs of Malaysia's key markets are on the mend (Chart 4). Hopes will be pinned on a gradual improvement in global demand, henceforth providing the much needed jab in the arm on the external front. Otherwise, existing uncertainties in the external environment and marginally slower domestic growth will imply a full-year GDP growth of 4.9% and potentially 5.0% in 2016.

Lower inflation despite the GST

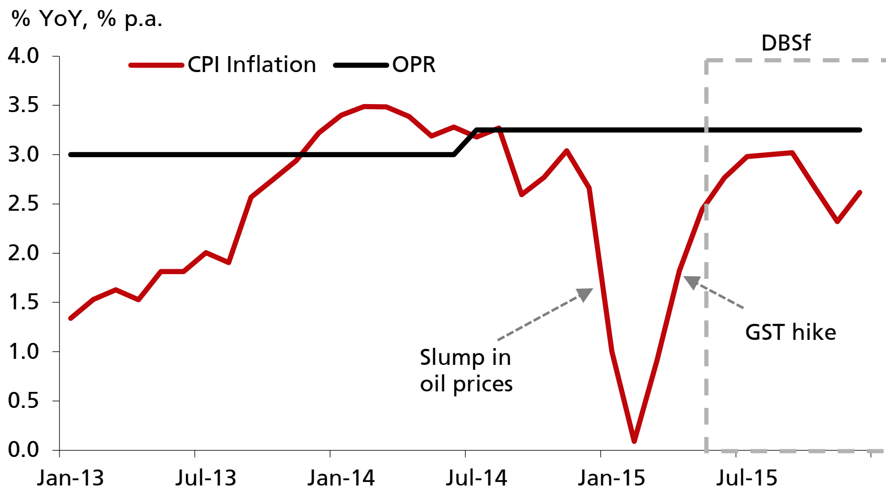
Inflationary impact of GST muted

The Goods and Services Tax (GST) was introduced in April and the direct impact on headline inflation was fairly muted. CPI inflation rose to 1.8% (YoY) in April, up from 0.9% previously. The pass-through effect of the 6% tax hike is significantly less than our earlier expectation of a 1.5%-pt increase in the headline CPI inflation.

One key reason for the benign inflationary impact is that many basic food and fuel items, and other essential services have been exempted. Moreover, the GST in effect has replaced the sales and services taxes (SST), which carry fairly high tax rates of between 5-10%. Given the swap in taxation approach, prices for some items have in fact fallen. Based on official estimates, prices probably fell for 56% of goods and services in the CPI (up to 4.1%) while 38% of items will experience price hikes (of less than 5.8%).

Lastly, the GST offset package is also significant. To help the mid and lower-income households cope, the government has announced cash handouts and relief measures. Personal and corporate tax rates have also been lowered. So, despite some expected temporary effect on inflation, the overall GST impact was muted by the substantial exemption list, the offset package and the mere swapping of taxation approach.

Chart 5: Inflation and monetary policy outlook



More importantly, the main reason for the benign inflation outlook is low energy prices. Sharp decline in global oil prices in the second half of last year has been the main driver of the disinflationary pressures. Barring a sharp rebound in oil prices in the coming months, full-year inflation is expected to register 2.1%, down significantly from our earlier forecast of 3.4%.

Inflation forecast for 2015 lowered to 2.1%

Risks of second order price effect and a pick-up in inflation expectations remain. Bank Negara remains vigilant on inflation by keeping policy rate steady in the most recent meeting in May. Beyond underlying fundamentals, monetary policy is also weighed down by domestic and external factors. Unlike many regional central banks where falling domestic inflation has prompted loosening in monetary policy to support growth, Malaysia, however, has little room to manoeuver in this regards (see "MY: limited options" dated 29 Apr15). Expect the central bank to hold policy rate steady at 3.25% in the coming quarters.

Planning ahead

The 11th Malaysia Plan (11MP) was unveiled by Prime Minister Najib recently. The five-year plan essentially laid out some of the hard targets for the economy in the coming years as well as the broad strategies necessary to achieve them. Overall GDP growth is projected to average 5-6% over the next five year, driven mainly by healthy expansion of consumption (6.4% per annum) and private investment (9.4% per annum). This is expected to bring about an average 7.9% annual rise in gross national income (GNI) per capita from 2016 to 2020.

Importantly, policymakers expect the GST to bolster its fiscal position. Revenue is projected to rise by about 7.9% per annum. Reliance on oil-related revenues is targeted to fall from 21.5% (of total tax revenue) in 2015 to 15.5% by 2020. While both developmental and operating expenditure will rise, the government expects overall fiscal deficit to fall to 0.6% (of GDP) in 2020, from 3.2% in 2015.

In addition, government debt is estimated to moderate to 43.5% of GDP by 2020, down from existing 53.3%. Rating agencies will be keeping a keen eye on the steps to be taken in achieving this objective given that this has been in the radar over the past years. Lastly, inflation is expected to average 2.5-3.0% in the coming years.

While the growth target is in line with Malaysia's underlying growth fundamentals, one needs to consider the fact that some of her key trading partners are undergoing their own domestic reforms. Growth momentum in key markets such as Singapore and China has moderated and will remain slow in the coming years. This will have spill-over effects on Malaysia's growth prospects.

Malaysia Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth	6.0	4.9	5.0	5.6	4.7	5.0	4.5	4.6	4.9
Private consumption	4.9	2.1	3.1	4.1	2.4	1.0	1.3	1.0	3.4
Government consumption	7.0	8.2	7.1	8.8	8.2	8.0	7.8	8.1	6.5
Gross fixed capital formation	4.8	5.6	5.6	7.9	4.0	5.4	5.2	5.0	5.6
Exports	5.2	1.1	3.7	-0.6	1.0	1.6	2.5	2.0	3.5
Imports	4.2	3.9	5.1	1.0	4.9	5.3	4.2	6.0	4.2
External (nominal)									
Exports (USD bn)	237	202	213	50	50	50	51	51	52
Imports (USD bn)	211	182	189	44	45	46	46	46	46
Trade balance (USD bn)	26	20	24	6	5	4	5	5	6
Current account bal (USD bn)	15	14	18	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	5	4	5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, yr-end)	117	111	119	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	3.1	2.1	3.0	0.7	2.3	3.0	2.5	4.3	2.9
Other									
Nominal GDP (USDbn)	327	350	382	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-3.5	-3.2	-3.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

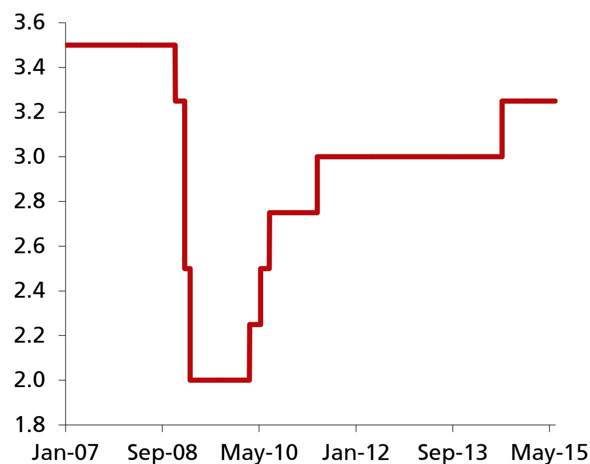
- % growth, year-on-year, unless otherwise specified

MY - nominal exchange rate

MYR per USD

MY – policy rate

%, OPR



TH: still struggling

- **We expect GDP growth of 3.2% in 2015, up from 0.9% in 2014**
- **A rebound in consumption is elusive and recent rate cuts may have little effect given that households continue to deleverage**
- **Manufacturing exports have been weak this year. Total (full year) exports could contract this year**
- **CPI inflation should return to 1.5% by year-end but negative inflation could linger**

Getting back to 4% GDP growth remains an uphill task. Exports are still running sideways. Private consumption growth has improved slightly but remains weak. After the spike in 1Q15, the economy needs public investment growth to remain strong. Expect GDP growth to come in at 3.2%, pretty much average growth for the past 4 quarters.

The Bank of Thailand (BoT) has already surprised with two 25bps rate cuts so far this year. Rates are at 1.50%, just above the record low of 1.25% in 2009. Compared to then, current 3% pace of GDP growth looks robust. We don't expect any further rate cut this year, although there are some risks of the BoT doing that to facilitate a softer baht.

Still looking for a stable footing

A strong recovery in consumption continues to elude (Chart 1). Consumer confidence has fallen from its highs of late-2014. It is not just sentiment. Retail sales have shrunk for 7 consecutive quarters, with durable goods down by the most. Motor vehicle sales are still falling in on-year terms though the pace has moderated. Overall, private consumption index has been stagnant since late-2013 (Chart 2).

Chart 1: Slow recovery in consumption

index, sa, Mar09=100

Chart 2: Consumption still running sideways

index, sa, Jan00=100 index, sa, Jan02=100

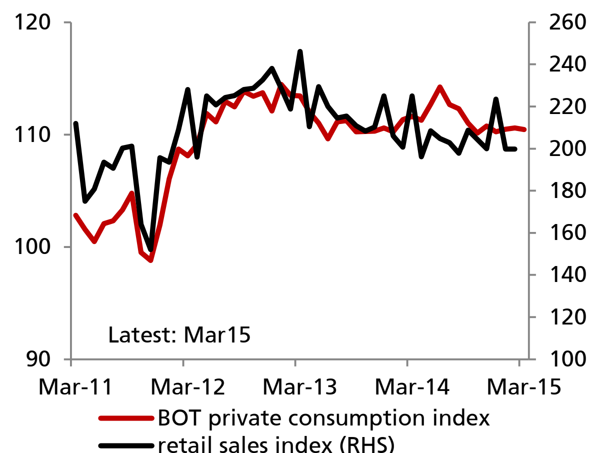


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Chart 3: Strong investment growth is crucial
index, sa, Mar09=100

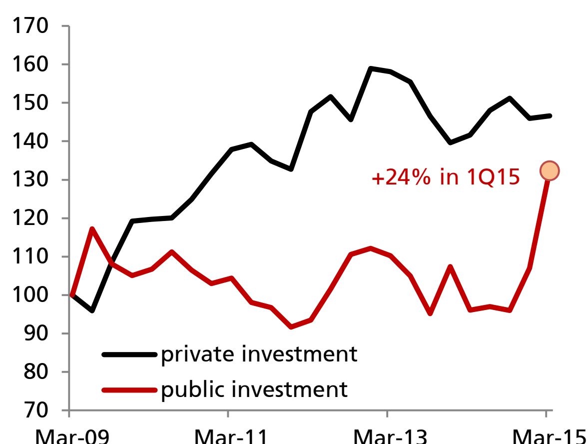


Chart 4: Risks of negative export growth this year
% MoM, sa, 6mma

Recent rate cuts may have little effect on domestic demand, given that households are still deleveraging. At this juncture, we think that only stronger income growth can spur stronger consumption. Yet, real income growth has actually fallen in 1Q15. Unless export growth returns to the double-digits, private consumption growth is set to remain circa 3-3.5% for a lot longer.

More aggressive fiscal policy could help. Public investment, about 20% of total investment, rose 24% (QoQ, sa) in 1Q15 (Chart 3). Up until May, the government is projected to have spent about 60% of its 2015 fiscal budget. Fiscal spending is likely to accelerate and may peak in 3Q15, the last quarter for the current fiscal year. Public investments need to continue playing catch-up with private investments.

Current discussions about FY2016 budget include plans to raise the budget deficit (nominal terms) by some 50% from this year's target and to lift investment spending to about 20% of total budget. It is important to note that the government's commitment on the economy has been there since last year. The pace of implementation has been slightly disappointing though.

Export growth may slip into the negative again this year

Exports of goods fell 4.7% (YoY) in 1Q15, more sharply even, than the 1.6% contraction in 4Q14. Manufacturing exports are down by some 2% up until April. Excluding the auto-sector, exports of manufacturing growth fared worse at -5%. A strong turnaround in export growth is unlikely in the near-term, as imports of intermediate goods continue to slump, at circa 10% pace currently (Chart 4).

Export growth has been flat for 3 years

Manufacturing exports make up close to 90% of total exports, and weakness here is disconcerting. We now expect overall export growth to be a mere 0.6% in 2015 and a contraction is possible.

Deflationary risks

Inflation continues to run further into the negative. Deflation is clearly evident in the transport component of the CPI, despite some recovery in oil prices. Inflation in the food and housing / furnishing components have also fallen further in 2Q15, making it likely that CPI inflation will remain in the negative for longer than previously expected. The drop in oil prices will fade from the on-year calculations in 3Q, however, and CPI inflation should return to 1.5% by year-end.

More importantly, core inflation has also continued to sink lower (Chart 5, next page). Core inflation is below 1% (YoY) once again for the first time since 3Q13. It is partly a reflection of the relative strength of the baht but mainly due to the weak

Chart 5: Inflation and the BoT rate

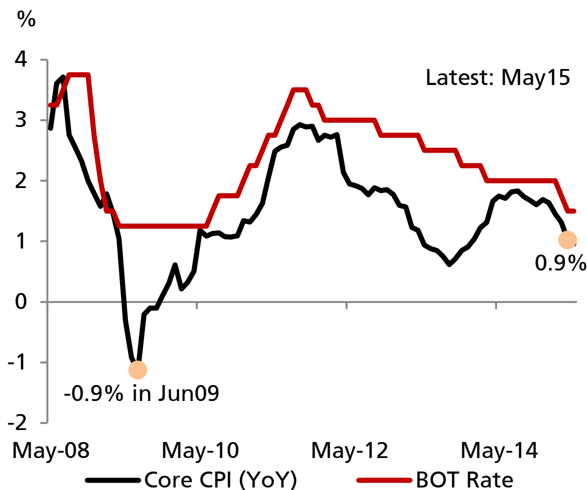
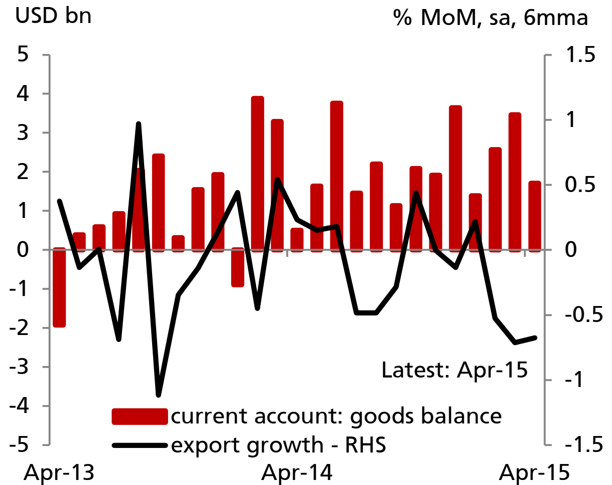


Chart 6: C/A surplus despite weak exports



underlying demand. Six months ago, we had thought core inflation will return to 2-2.5% by the year-end. Right now, even to stay at circa 1% is no longer a certainty.

Loose monetary policy to stay for now

Even if rate cuts may not do much to lift domestic demand, there are risks that the BoT may cut policy rates further to facilitate a softer currency. The central bank has made it clear that it wants to see the baht weaken, partly by easing restrictions on capital outflows back in April. That a weaker baht is meant to lift export growth is clear, but note that tepid export growth is also a reflection of global demand more than anything.

A weaker baht may help to lift export growth on the margins but unlikely to be enough to offset the slack in the economy. Furthermore, pushing for a weaker baht has been made difficult by the persistent current account (C/A) surplus. The C/A recorded a surplus of USD 8bn, or about 8% of GDP, in 1Q15. This is mainly due to weakness in imports though, as export growth remains tepid (Chart 6). While some narrowing is likely to be seen towards the year-end, full-year C/A surplus may still be in excess of 4% of GDP, highest since 2009.

BoT likely to keep rates steady but further cuts are possible

Falling core inflation does provide room for more rate cuts. It is important to note, however, that the last time the policy rate was at 1.25% (compared to 1.50% currently), it was in the depths of the global financial crisis of 2008/10. Compared to back then, today's 0.9% core inflation seems high.

We had earlier expected the BoT to start normalizing its monetary policy in 1Q16. The growth-inflation dynamics don't seem to suggest that this is likely now. The central bank is likely to maintain its policy rate steady at 1.5% until closer to mid-2016.

Risks

We remain watchful of the political situation in Thailand amid renewed tension surrounding the on-going case against former PM Yingluck for her role in the 2011 rice subsidy scheme. Meanwhile, a referendum will be held on the newly-drafted constitution, which is seen as necessary but may only delay the next elections, scheduled by end-2016.

Thailand Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth (02P)	0.9	3.2	4.5	3.0	3.1	3.5	3.3	4.4	4.9
Private consumption	0.6	2.4	3.6	2.4	2.1	2.5	2.4	2.9	3.4
Government consumption	2.8	5.1	5.7	2.5	2.5	8.8	6.0	6.1	6.2
Gross fixed capital formation	-2.8	5.0	6.0	10.7	6.6	5.3	9.1	3.8	4.4
Net exports (THBbn)	670	518	589	181	90	92	155	211	108
Exports	0.0	1.5	4.9	1.0	2.6	4.0	-1.0	3.5	5.6
Imports	-5.4	4.1	4.3	2.3	4.0	4.7	5.3	2.1	4.8
External									
Merch exports (USDbn)	228	228	240	53	55	60	60	58	58
- % YoY	0	1	5	-5	-2	3	3	8	6
Merch imports (USDbn)	228	223	234	52	53	58	60	55	58
- % YoY	-9	-2	5	-7	-7	-2	7	6	9
Trade balance (USD bn)	0	5	6	1	2	2	0	3	0
Current account balance (USD bn)	13	18	10	8	4	2	4	2	2
% of GDP	3.2	4.4	2.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	1.9	-0.2	2.0	-0.5	-1.0	-0.1	1.0	2.0	2.8
Other									
Nominal GDP (USDbn)	405	412	420	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate, %	0.8	0.8	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)**	-2.3	-3.0	-2.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

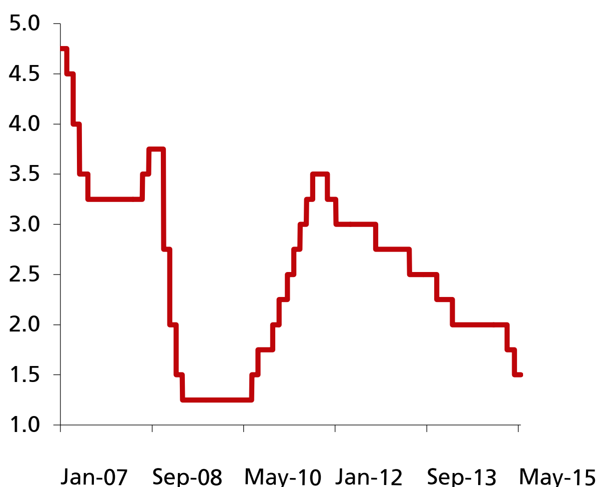
* % change, year-on-year, unless otherwise specified
** central government net lending/borrowing for fiscal year ending September of the calendar year
Starting this quarterly, we use the new GDP series with 2002 as the base year

TH - nominal exchange rate

THB per USD

TH – policy rate

%, 1-day RRP



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

SG: no celebration yet

- **Growth has moderated; inflation should fall further**
- **The outlook for manufacturing remains dicey and the labour crunch weighs on services**
- **GDP growth is on track to meet our forecast of 3.2% in 2015 and 3.5% in 2016. But downside risks remain**
- **Full year inflation will dip to -0.1% in 2015 before rising to 1.3% in 2016**

Singapore will celebrate its 50th year of independence in August. Despite the upbeat mood, the global environment and prospects for growth remain lackluster. Although GDP growth for 1Q15 was revised up to 2.6% (YoY) from 2.1%, momentum fell on a sequential basis to 3.2% (QoQ saar), from 4.9% in 4Q14 (Chart 1). Moreover, April industrial production fell sharply. For now, risks remain tilted toward the downside.

Manufacturing still looking dicey

Outlook for the manufacturing sector is still dotted with risks. Headline growth for the overall manufacturing sector moderated to -2.7% (YoY) in 1Q15, from an already weak -1.3% in the previous quarter. And industrial production growth for April has further confirmed the cloudy outlook, declining 8.7% YoY. This is the sharpest deceleration since Feb13 (Chart 2).

While production in the electronics cluster was up marginally by 1.2% YoY, it was over-written by a 28.6% plunge in biomedical output. Granted that the influence from the ever-volatile pharmaceutical cluster should be discounted but near term outlook for the overall manufacturing sector remains dicey from the NODX angle.

SG: Growth moderating
% YoY, % QoQ saar

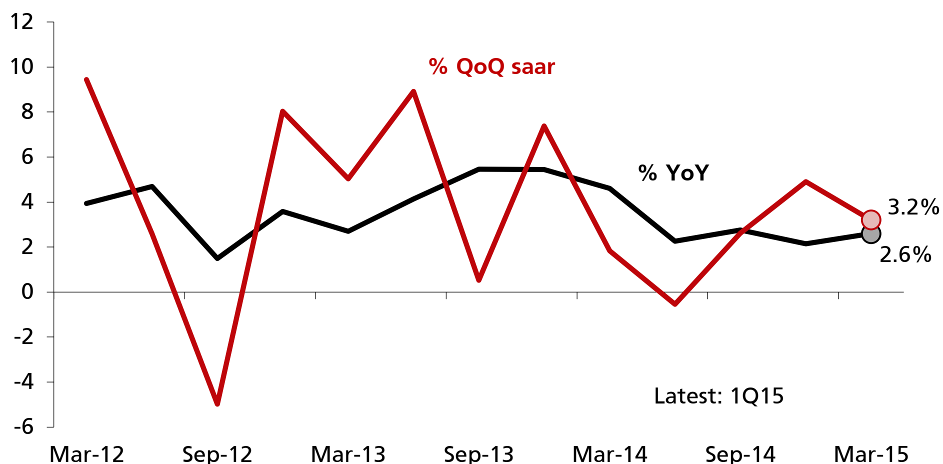


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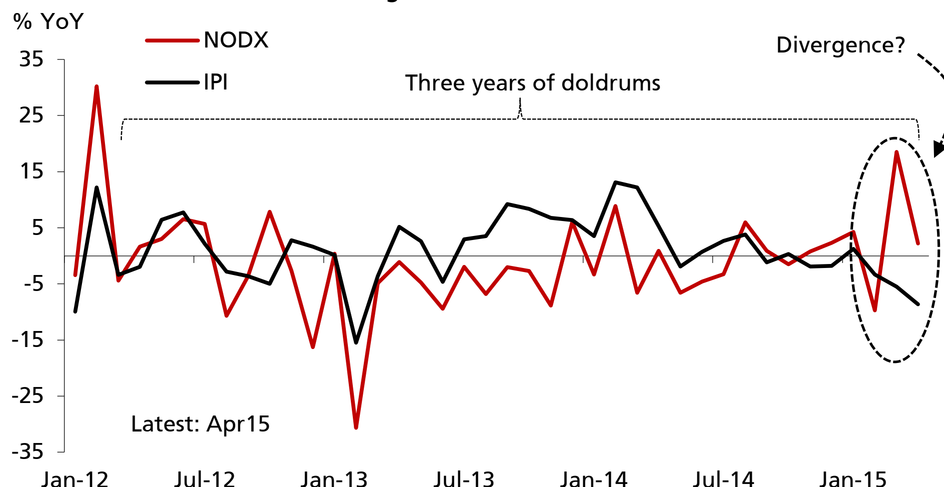
Chart 2: NODX and manufacturing in doldrums



It was a fall back to reality for non-oil domestic exports (NODX) in April. Headline growth moderated to just 2.2% YoY, following a stunning 18.5% surge in March (Chart 2). Sequentially, export sales fell by 8.7% (MoM, sa) compared to a 23.1% leap in March. Electronics exports is in doldrums (-3.8% YoY) while non-electronics NODX has picked up some of the slack.

This pullback shouldn't come as a surprise given the strong March NODX was driven by several one-off factors. Moreover, things could have looked a lot worse in April had it not been for (exports of) ships and boats, and aerospace products, which soared by 30 times and 3 times, respectively. These are very "lumpy" items which often distort the headline numbers.

Beyond the lumpy items, external demand hasn't improved significantly, which makes for sluggish export performance. In fact, barring any strong rebound in global outlook, NODX growth will likely slump once orders of these one-off items are fulfilled in the coming months.

But there are some glimmers of hope. Manufacturing PMI is finally back in expansion mode in May. The headline number has rebounded by 0.8pt to register 50.2, the first expansion in six months. The latest set of figures may suggest that the manufacturing sector could be on the mend. But much will still depend on global outlook, which thus far has remained uncertain.

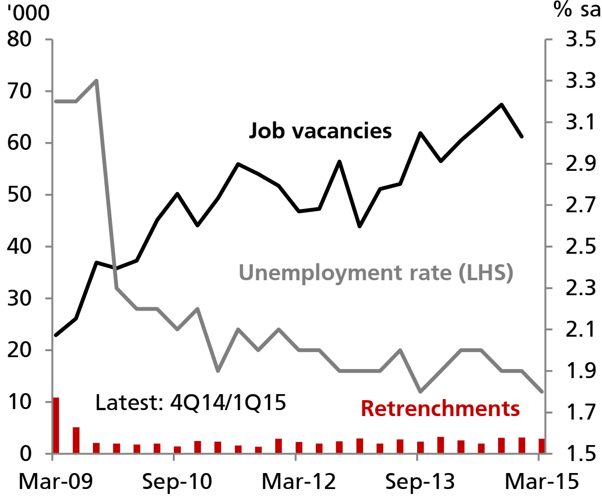
It's been three years of misery for manufacturers (Chart 2). Despite occasional uptick in global macro-data, general outlook appears half empty rather than half full from the manufacturing sector's perspective.

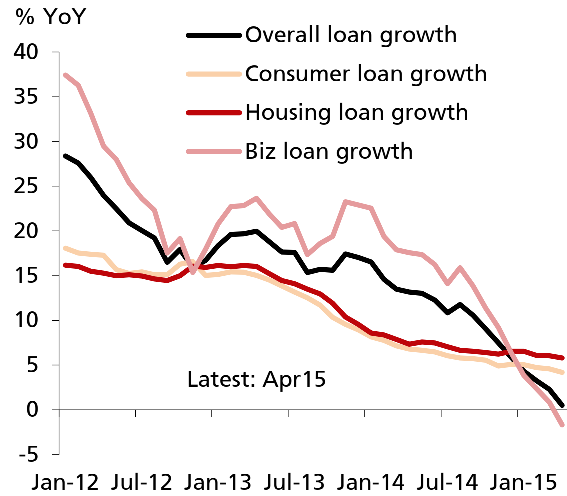
Labour crunch crimping services growth

Services growth set to moderate

Growth in services improved to 3.8% (YoY) in the quarter, up from 3.1% previously. Financial service remained in the driving seat with growth of 7.9% while wholesale and retail trade improved. But beyond a fairly rosy headline growth, performance of the services sector is expected to moderate in the coming quarters.

Companies are struggling with labour shortages due to years of tight foreign labour policies. While the foreign curbs were meant to lift labour productivity, distortions in the labor market have become apparent. Unemployment is already below the natural rate of 2.0% while vacancies have been rising (Chart 3). Employers are having great difficulties filling head-counts, limiting their ability to grow. As the labour crunch weighs on the sector, growth could moderate further in coming quarters.





Loan growth easing

Recent loan growth figures will provide a glimpse of what lies ahead. Total loans and advances moderated sharply to 0.5% (YoY) in Apr15, down from an already weak 2.3% previously (Chart 4). The main concern is that business loan growth dipped into the red, a first since the Lehman crisis.

This reflects significant downside risk to growth, particularly if such weakness persists in the coming months. Beyond the uncertain global outlook, pressure from domestic restructuring and risk of higher interest rate are weighing down on business confidence and affecting companies' willingness to invest.

Growth outlook remains uncertain

Overall growth outlook remains cloudy. Most notably, the divergence in monetary policies across key central banks around the world is creating uncertainty in the global economy. Such divergence will continue to impact the financial markets. Interest rate expectations will swing and currencies will be volatile. Confluence of these factors will have ripple effects on economic activities.

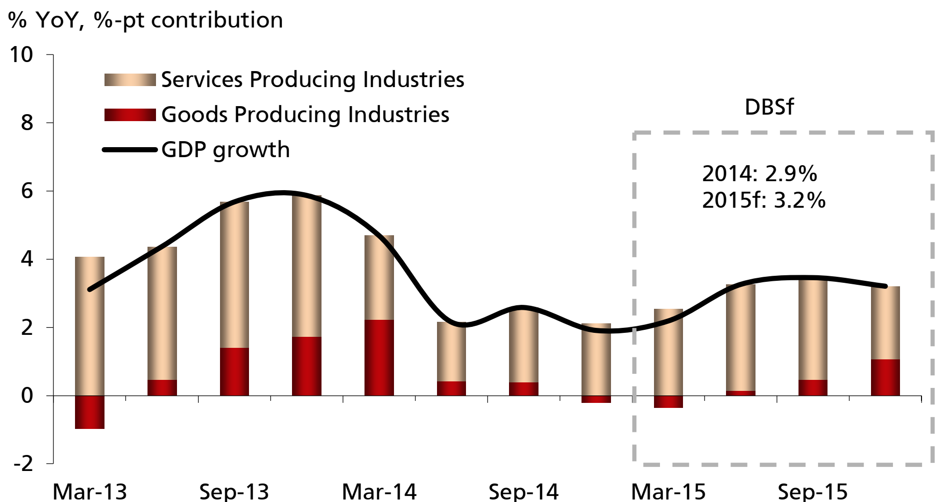
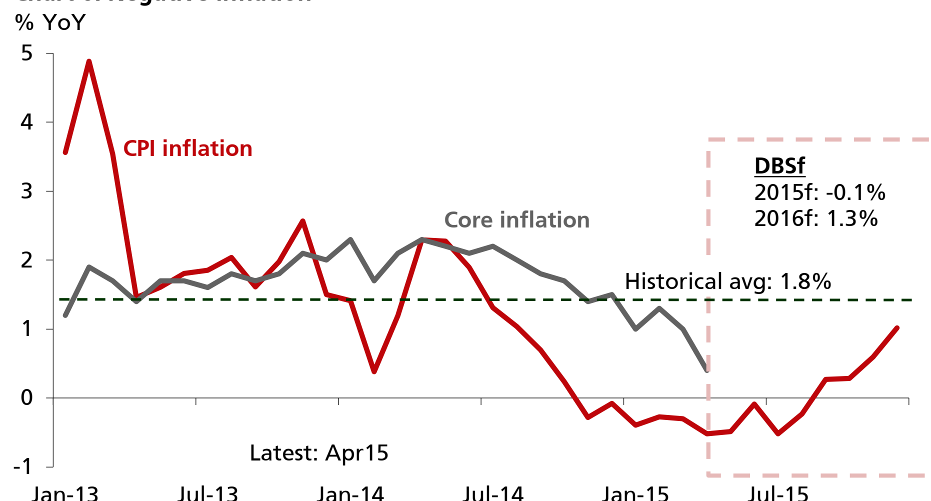


Chart 6: Negative inflation



Moreover, despite stronger GDP figures, European outlook is clouded with concerns over Greece's possible exit from the Eurozone. Data in the US remain mixed with recent downward revision in the growth figures. Though China's PMI jumped, growth momentum remains slow. Indeed, China slowdown is having a significant impact on Asia's growth prospects, including Singapore. While full year GDP growth is still expected to register 3.2% in 2015 and 3.5% in 2016, downside risk remains (Chart 5).

Negative inflation

Inflation will remain stuck in negative territory in the coming months. Latest April inflation registered -0.5% (YoY), down from -0.3% (Chart 4). The main drivers of the negative inflation have been housing, transport and healthcare. And these came on the back of low energy prices, a significantly lower-than-expected increase in wage growth, a cooling property market, as well as moderation in healthcare costs due to the introduction of the Pioneer Generation Package.

In addition, there could be more downward pressure on inflation going forward. The Land Transport Authority (LTA) announced last month that COE quotas for the second quarter, covering May to July will be increased by 42%. Note private transport cost accounts for about 11.7% of the CPI basket. Decline in the COE premiums will have significant impact on headline inflation.

Inflation to register -0.1% in 2015

Barring any significant uptick in oil prices, CPI inflation will stay in the negative level for a few more months. In fact, chance is high that full year inflation could fall below zero. We have lowered CPI inflation for 2015 to -0.1%, down from 0.4% previously. With growth momentum likely to remain subdued and global inflationary pressures tempered by potentially higher interest rates going forward, inflation for 2016 will remain benign at 1.3%.

While pressure on the Monetary Authority of Singapore (MAS) will undoubtedly rise with the persistently negative inflation, it pays to note that overall inflation for the year will still fall within the official forecast range of -0.5 to 0.5%. Earlier, the authority had surprised markets by maintaining status quo on the exchange rate policy in April despite market expectation for an easing. Unless growth or inflation surprises significantly on the downside, room for the central bank to ease monetary policy remains limited.

Singapore Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
Real GDP (00P)	2.9	3.2	3.5	2.6	3.4	3.6	3.3	3.2	3.3
Private consumption	2.5	2.5	2.8	2.8	2.5	2.3	2.2	2.5	2.7
Government consumption	1.7	4.9	5.8	4.7	3.5	5.8	5.5	6.0	5.0
Gross fixed investment	-1.9	1.3	2.4	2.6	0.0	1.0	1.6	1.7	2.3
Exports	2.2	3.1	2.7	4.7	2.3	2.4	2.9	1.4	2.8
Imports	1.5	1.4	2.8	-0.1	1.7	1.5	2.4	4.0	2.4
Real supply									
Manufacturing	2.6	0.7	4.3	-2.7	-1.1	1.6	5.1	4.2	4.7
Construction	3.0	4.0	3.5	3.1	8.1	3.3	1.8	3.0	2.0
Services	3.2	4.0	3.7	3.8	4.6	4.4	3.2	3.5	3.4
External (nominal)									
Non-oil domestic exports	-0.7	2.4	2.9	4.8	3.7	0.5	0.8	-2.0	2.7
Current account balance (USD bn)	59	61	62	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	19	19	19	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn)	257	251	260	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	1.0	-0.1	1.3	-0.3	-0.4	-0.2	0.6	1.2	1.5
Other									
Nominal GDP (USDbn)	308	318	334	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	2.0	1.9	2.0	1.8	1.8	1.9	1.9	2.0	2.0

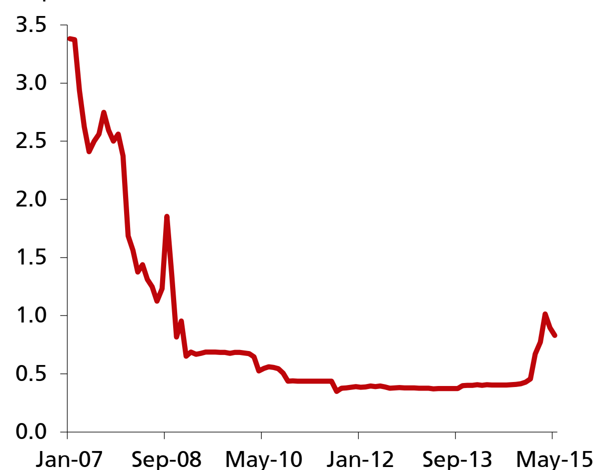
- % change, year-on-year, unless otherwise specified

SG - nominal exchange rate

SGD per USD

SG – 3mth SIBOR

% pa



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PH: cruising at six

- **Decent consumption and robust investment growth should deliver 6% GDP growth this year and next**
- **Improved competitiveness in manufacturing means exports of electronics continue to support overall export growth**
- **The slow pace of fiscal spending is a risk**
- **CPI inflation is well within the central bank's comfort zone**
- **Expect steady rates for the rest of the year**

The Philippines remain as one of the fastest growing economies in the region. Private consumption stays resilient. Investment growth is robust, offsetting the impact from slower export growth this year. Fiscal spending is a negative risk to GDP growth, however, given the increasingly high public scrutiny ahead of next year's elections. Expect GDP growth at 6.0% and 6.2% in 2015 and 2016 respectively.

CPI inflation is likely to come in at 2.5% this year. There are some upside risks going into 2016, given uncertainties over oil price trajectory as well as the anticipated impact from prolonged dry spells on food prices. Overall though, the Bangko Sentral ng Pilipinas (BSP) is comfortable with the current CPI inflation outlook. Coupled with the moderation seen in loan growth, expect stable rates for the rest of the year.

Domestic demand remains robust

The combined contribution from private consumption and investment growth has averaged 6% since 2012 (Chart 1). As long as private consumption and investment maintain its current growth trend, overall GDP growth is likely to come in circa 6%.

Chart 1: GDP growth likely to remain circa 6%
YoY, %-pt contribution

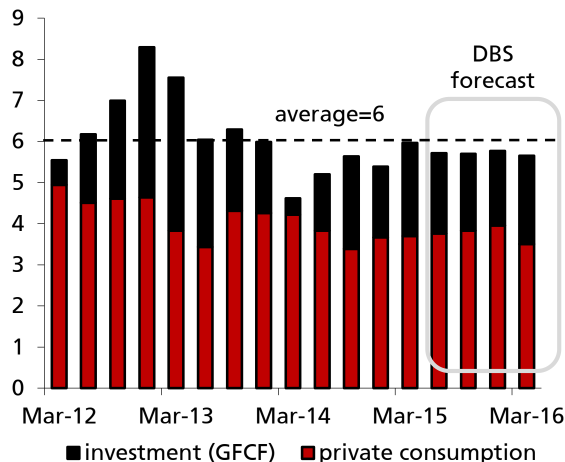

Chart 2: Non-food leading overall consumption
% YoY

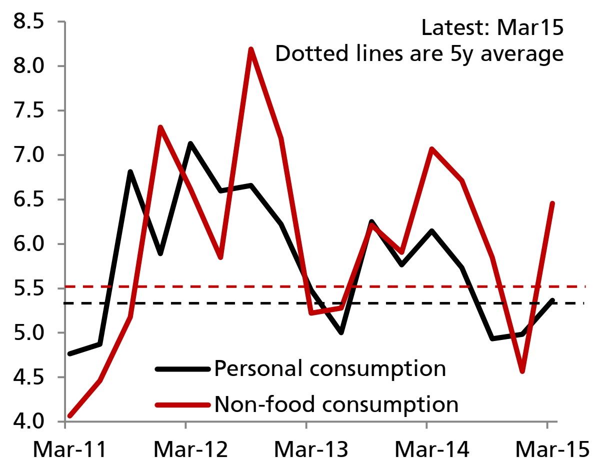

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Chart 3: Investment on durable equipment

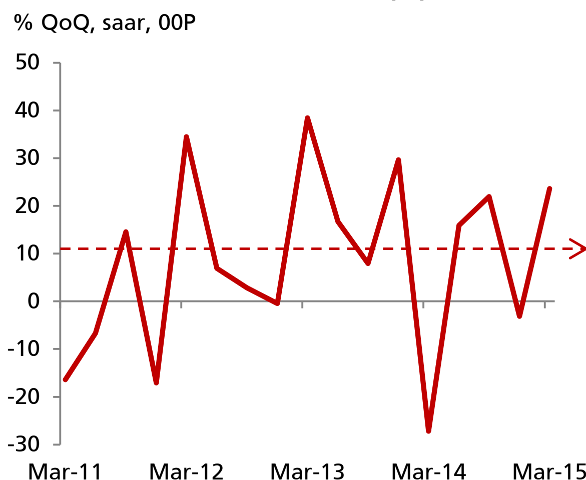
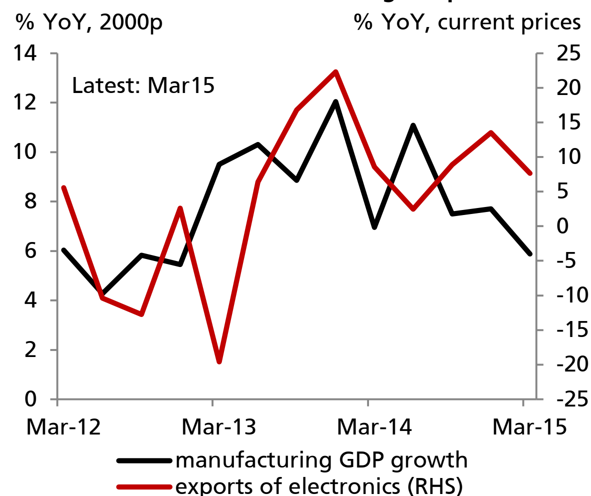


Chart 4: Growth in manufacturing is a plus



Private consumption is growing at a 6% pace, higher than its five-year average of 5.5%. Non-food consumption continues to lead (Chart 2). A combination of factors is likely to support consumption this year – manageable inflation, a resilient peso and strong foreign worker remittances. While growth of foreign worker remittances has moderated, they remain on track to hit a record-high USD 25bn this year.

Strong investment growth reinforces the consumption. Investment growth was robust at 10% (YoY) in 1Q15 and could have even been stronger if not for the marked fall in construction and de-stocking activities. After the strong bounce in 1Q15, average investment on machineries is growing at around 11% annual pace in the past 6 months, maintaining the trend seen in the past five years (Chart 3). Capital goods imports rose about 11% in the year-to-date. Capacity utilization remains high at over 80%. Given all these positive indicators, overall investment growth is likely to come in circa 9% this year, continuing its strong performance since 2011.

Moderation in exports

Imports of intermediate goods have moderated and exports are pretty much flat in the year-to-date. Total export growth is set to normalize this year to about 3%, hardly surprising given the robust, near double-digit, average growth over the past three years.

Nonetheless, we continue to see encouraging signs in the manufacturing sector. Exports of electronics managed to grow a modest 7% (YoY) in 1Q15 (Chart 4). To a certain extent, this indicates a positive structural shift in the economy. Productivity within the manufacturing sector has increased tremendously in recent years. Total foreign direct investment (FDI) reached a record high 2.2% of GDP last year and about 60% of it went into the manufacturing sector. The revitalization of the manufacturing sector has been one of the key positives for the Philippines in the past couple of years. Sustained strength in this sector will help take some burden off from services and construction.

Strong investment growth reinforces the resilience in consumption

Pace of fiscal spending is key

Whether GDP growth is going to come in at 6.5%, 6% or below 6% depends on the pace of fiscal spending ahead. Government consumption growth was disappointing in 1Q15 and proved to be the main drag for overall GDP growth. This is despite revenue growing a two year high of 18% (YoY) in the period (Chart 5, next page).

Part of the slowdown in fiscal spending is related to several controversies that came to light last year, including that of the government's disbursement acceleration

Chart 5: Strong revenue collection in 1Q15

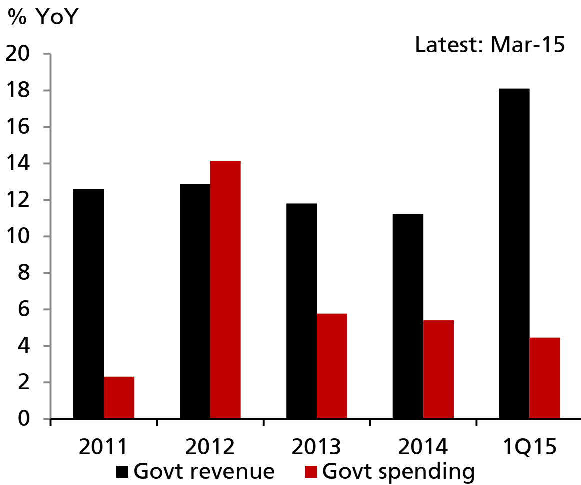
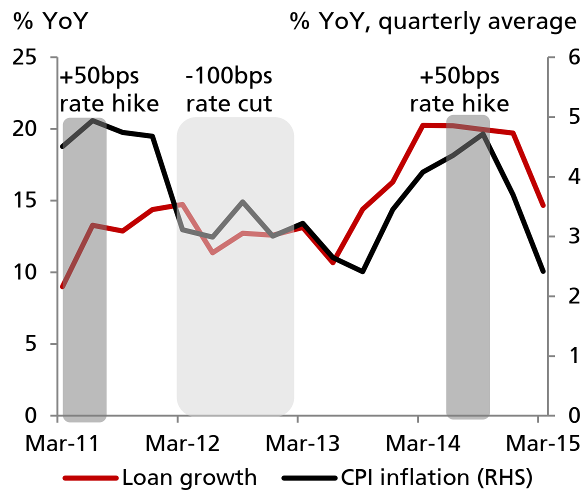


Chart 6: Loan growth moderates



program (DAP). Given the heightened public scrutiny, the pace of budget disbursement has slowed significantly compared to the first half of the Aquino administration.

The other difference this year has been the progress of the public-partnership program (PPP), whereby delays are increasingly becoming common. There is always a considerable time lag from the time a contract is signed and actual construction of the project starts. Several of the main projects due to be awarded this year have been pushed back to 2H15, which means that actual impact on the economy may only be seen in early-2016, at the earliest.

No reason to tinker with policy rates, for now

CPI inflation has continued to fall since Aug14, driven mainly by relatively lower oil prices this year. But crude oil price has risen in recent months and there are also risks on food prices due to the prolonged dry spells. Expect prices to slowly inch higher towards the year-end. CPI inflation may just have seen / near its bottom this year.

Expect steady rates to remain

Not that CPI inflation will trend near 4% again anytime soon though. Average CPI inflation for this year is likely to be in the lower-half of the central bank's 2-4% target. Coupled with a moderation in loan growth (about 15% currently, compared to 20% last year), the central bank is unlikely to further tighten its policy this year (Chart 6).

No strong reason for the BSP to loosen its policy in the near-term either. The government's 7% GDP growth target was always a long stretch to begin with. We reckon that the BSP is fairly comfortable with GDP growth staying circa 6%. In fact, the slowdown in construction seen in 1Q15 is an intended consequence from last year's aggressive tightening moves. Given that overall domestic demand looks fairly robust now, expect steady rates for the rest of the year.

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

Philippines Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
Real GDP growth	6.1	6.0	6.2	5.2	5.6	6.7	6.4	6.6	6.2
Private consumption	5.4	5.5	5.2	5.4	5.7	5.6	5.5	5.1	5.0
Government consumption	1.7	6.5	7.0	4.8	5.1	8.6	8.0	5.9	6.8
Gross fixed capital formation	6.8	9.0	8.1	10.1	9.9	8.5	8.3	9.2	7.6
Net exports (PHP bn, 00P)	-69	-159	-82	-69	41	-14	-117	-31	81
Exports	11.3	3.9	8.1	1.0	5.6	3.7	5.0	8.7	8.3
Imports	8.7	6.4	5.7	4.6	11.5	6.1	3.7	3.6	4.2
External (nominal)									
Merch exports (USD bn)	62	64	69	14	16	17	16	16	17
- % YoY	9	3	8	0	0	0	5	14	6
Merch imports (USD bn)	65	67	74	16	16	18	18	18	18
- % YoY	2	3	10	1	8	5	15	11	11
Merch trade balance (USD bn)	-3	-3	-5	-2	0	-1	-2	-2	-1
Current account balance (USD bn)	13	10	8	n.a	n.a	n.a	n.a	n.a	n.a
% of GDP	4.5	3.4	2.6	n.a	n.a	n.a	n.a	n.a	n.a
Foreign reserves, USD bn	80	81	82	n.a	n.a	n.a	n.a	n.a	n.a
Inflation									
CPI inflation	4.2	2.5	3.7	2.4	2.2	2.4	3.0	3.6	4.0
Other									
Nominal GDP (USD bn)	285	290	305	n.a	n.a	n.a	n.a	n.a	n.a
Budget deficit (% of GDP)	-0.9	-0.8	-1.5	n.a	n.a	n.a	n.a	n.a	n.a
Total external debt (USD bn)	58	58	57	n.a	n.a	n.a	n.a	n.a	n.a
Public sector (USD bn) **	43	43	43	n.a	n.a	n.a	n.a	n.a	n.a

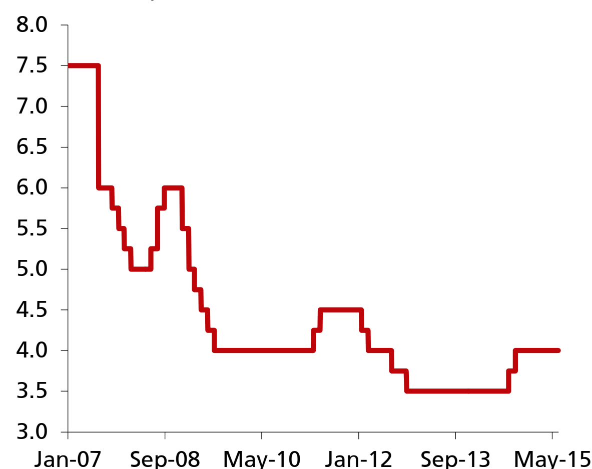
* % change, year-on-year, unless otherwise specified
** includes government, central bank and state-owned banks

PH - nominal exchange rate

PHP per USD

PH – policy rate

%, o/n rev repo



VN: brighter sparks

- **Growth remains steady; inflation has fallen to multi-year lows**
- **We expect 6% growth this year and next. Full year 2015 inflation will drop to 1.3%**
- **Although currency devaluation remains the preferred monetary policy tool, the central bank has some room for rate cuts**

The economy is back on the radar screens. Growth is hovering at potential while inflation is at multi-year lows. Except for the risk on the external balance, overall prospects for the economy are good.

Electronics boost

Vietnam was one of the fastest growing economies in Asia in 2014 (Chart 1). Growth hit 6.0% and has remained there in 1Q15. Manufacturing has been the key driver. Much of the improvement in the sector can be attributed to electronics. Electronics exports grew by 64% YoY in the first quarter (Chart 2). Although base effects play a part, structural shift in regional electronics supply chain is the main reason.

Vietnam has captured the market shares of some of its regional peers. The stunning growth in this sector lies in stark contrast to other Asian producers. For example, electronics exports from Singapore have fallen by some 35% over the past two years. During this period, Vietnam's electronics exports have tripled (Chart 2)!

Essentially, margin compression in the electronics industry has led to structural "hollowing out" in certain electronics segments in some countries. Manufacturers of some lower value added products in more established electronics producing countries were forced to relocate their production base to cheaper locations in order to maintain their profits. Beyond push factors, Vietnam's pro-FDI policies, cost advantages and a competitive labour force is a strong lure for manufacturers.

Chart 1: GDP growth for 2014

Annual GDP growth, %

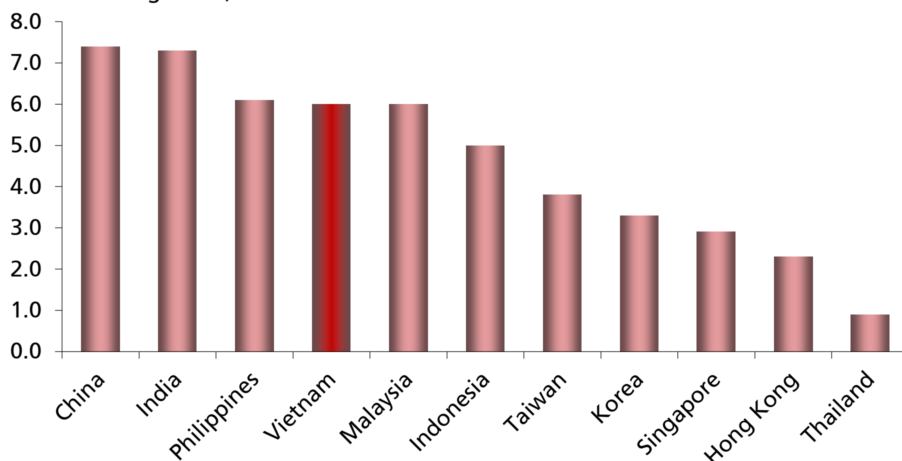


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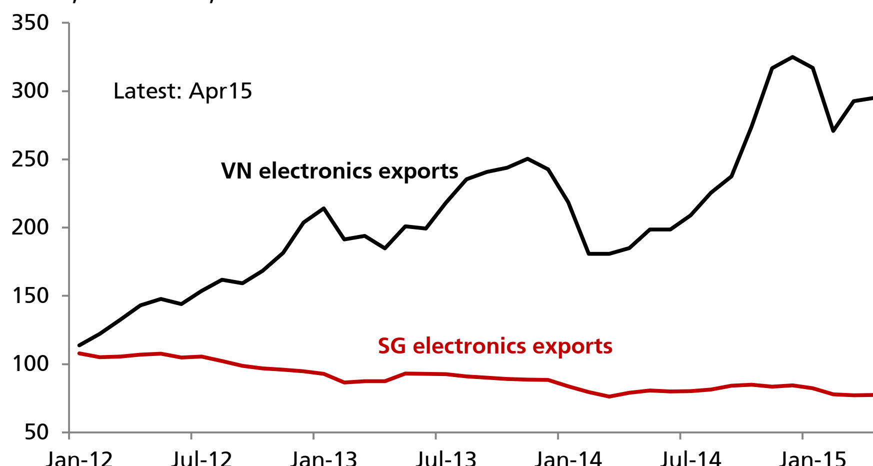
Chart 2: Singapore and Vietnam electronics exports



Against the backdrop of the "hollowing out" phenomenon in countries such as China, Singapore and Korea, FDIs into Vietnam in contrast, has picked up sharply in recent years. For example, Korean electronics giant, Samsung Electronics has announced late last year plans to invest USD 3bn in a new smartphone factory in Vietnam, alongside its existing USD 2bn plant.

Near-term prospects are bright for Vietnam's electronics industry. Apart from the slight moderation in April, the US SEMI book-to-bill ratio, a leading indicators for global electronics cycle, is reflecting an upswing in global electronics demand compared to mid last year (Chart 3). Expectations are high that strong electronics export sales will continue to lead the improvement on the external front and drive overall GDP growth going forward.

Hence, barring any significant negative growth shock in the global economy, Vietnam is on track to meet our full-year GDP forecast of a 6.0% in 2015 and 6.2% in 2016. That said, policymakers are even more upbeat about the country's growth outlook. The official growth target has been set at 6.2% in 2015 and 6.5% in 2016.

Chart 3: Electronics cycle improving

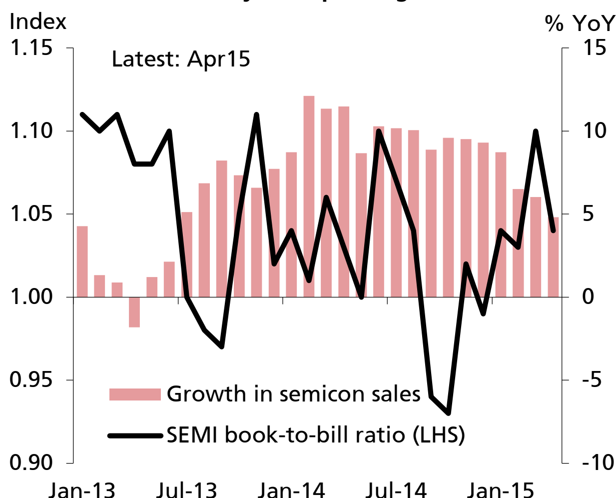


Chart 4: Risk on trade balance

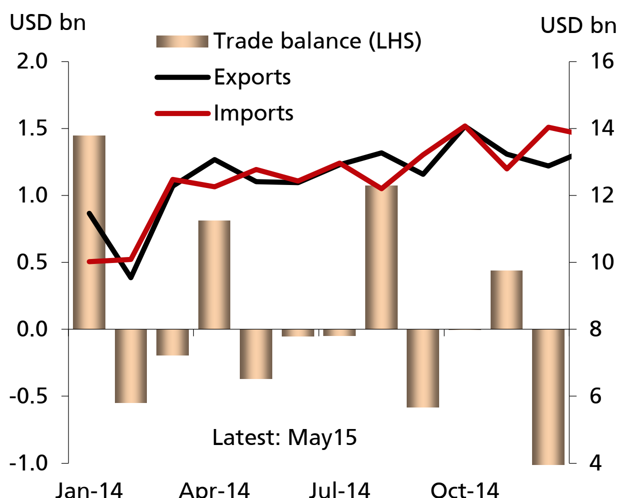


Chart 5: Dong devalued twice this year

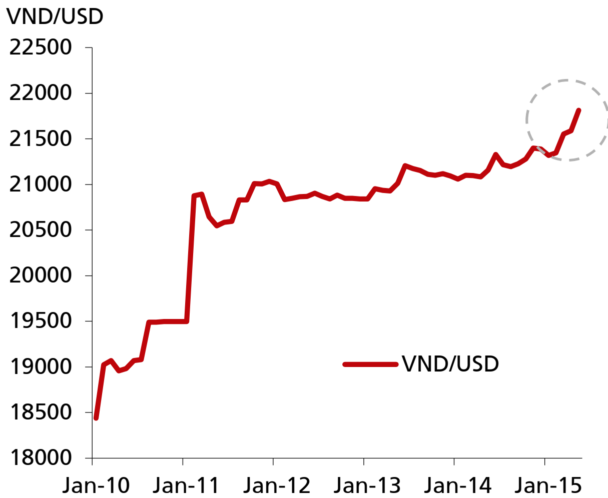
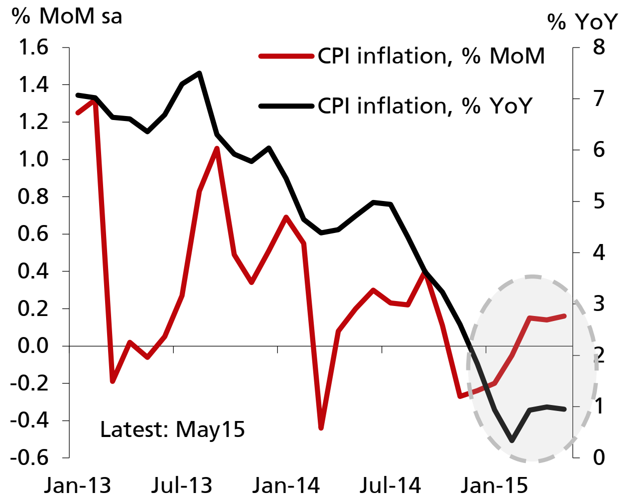


Chart 6: Inflation has bottomed



Downside risk on external balances

Risks reamin on the external front. Sluggish exports of agriculture products and commodities have weighed on overall export performance. Meanwhile, investment demand for imports has remained strong. Trade balances have deteriorated.

Overall trade balance as of May15 registered a cumulative deficit of about USD 3.0bn. In fact, the ballooning trade deficit is one of the key reasons that prompted the State Bank of Vietnam to devalue the dong in May, its second devaluation since the earlier bout in January (Chart 5).

Prices for agriculture products and commodities are expected to remain depressed due to weak demand. And this will consequently weigh down on the overall trade balance despite the strong showing in electronics. Overall trade balance for the year is now expected to register a deficit of USD 1.2bn, from USD 200mn previously.

Room for modest easing amid benign inflation

Inflation appears to have bottomed. After the steep decline from 5.0% (YoY) in Jun14, inflation has risen from the trough of 0.3% in February to register 1.0% in May (Chart 6). This is further supported by the third consecutive month of positive MoM change in the headline number. While inflation is expected to rise gradually in the coming months, full-year inflation will likely average 1.3% in 2015 before rising to 3.5% in 2016.

Inflation forecast for 2015 lowered to 1.3%

Such inflations remains inside the 5.0% target set by policymakers. Granted, the justification for a rate cut is less compelling than at the beginning of the year. But weakening domestic demand remains a concern. Retail sales growth has eased to 8.4% YoY in May, down from 14.9% in January. And overall loan growth of 4.0% in the first four months of the year is still a far cry from the 15%-17% target for this year. To revitalise domestic demand and to ensure that the full-year growth target is met, the SBV may be pressured to ease monetary policy further.

Indeed, though exports will provide the boost, weakening domestic demand will be a drag on overall GDP growth performance. The SBV has thus far preferred to devalue the dong to mitigate against the ballooning trade deficit and to preserve its foreign reserves. A more accommodative monetary policy amid a global disinflationary environment will not contradict the current policy direction. While we have since removed a 100bps rate cut for the second quarter, we have maintained the view for another 50bps cut in the third quarter of the year.

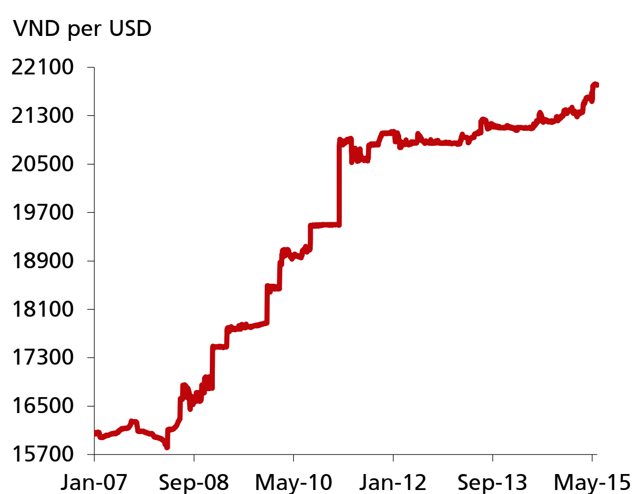
Vietnam Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth	6.0	6.0	6.2	6.0	5.9	6.1	5.8	5.9	6.0
Real supply									
Agriculture & forestry	3.5	2.9	3.1	2.1	3.2	3.3	3.0	3.2	2.8
Industry	7.2	7.6	7.3	9.0	7.0	7.2	7.1	6.6	7.5
Construction	7.1	6.1	7.5	4.4	7.0	6.8	6.0	7.0	7.6
Services	6.0	6.1	6.3	5.8	6.4	6.2	5.9	6.0	6.2
External (nominal)									
Exports (USD bn)	150.1	164.7	182.0	36.3	40.9	42.7	44.8	40.7	46.8
Imports (USD bn)	149.3	167.2	181.4	39.0	42.5	41.4	44.3	42.5	46.3
Trade balance (USD bn)	0.8	-2.5	0.6	-2.7	-1.6	1.3	0.5	-1.8	0.5
Current account bal (USD bn)	8.1	3.7	5.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	4.4	1.9	2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	4.1	1.3	3.5	0.7	1.0	1.3	2.3	3.4	3.8
Other									
Nominal GDP (USDbn)	186	200	220	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	3.4	3.0	2.8	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

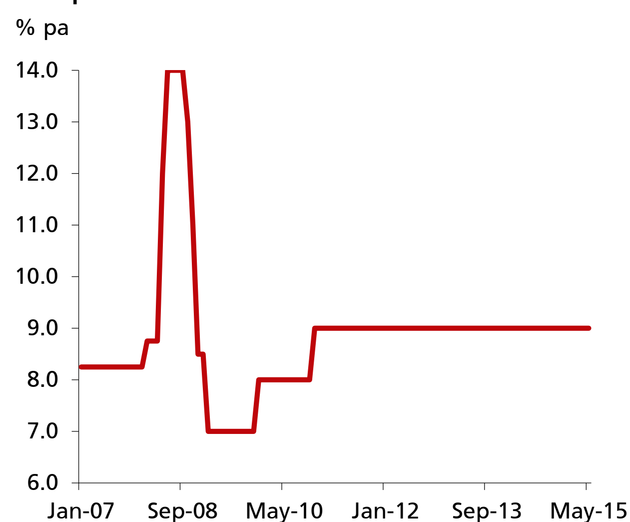
VN - nominal exchange rate

VND per USD



VN – prime interest rate

% pa



US: fifth time no charm

- **2Q GDP growth of 2.7% is expected. That's uncomfortably weak given the 0.7% contraction in Q1. It implies 1% average growth for the first six months of the year**
- **We have downgraded our full-year 2015 growth forecast to 2.2% from 2.6% previously. For a fifth year in a row, forecasters have had to throw out their overly-bullish expectations for the coming year**
- **The question isn't whether recovery continues. It does. The question people ought to be asking is, how much slack remains?**
- **Most Fed rhetoric continues to point to lift-off in late-2015**
- **But if core PCE inflation continues to drift lower, as it has for the past three years, the Fed will remain in wait-and-see mode**

Every December since 2010, markets have expected growth to accelerate towards 3% in the coming year. Each time, those expectations were tossed out the window by June. This year is no exception. First quarter GDP growth shrank by 0.7% (QoQ, saar) thanks mainly to weather- and strike-related distortions. But the data aren't bouncing back as they normally do after a 'technical' disruption, and they weren't very strong to begin with. Most, including DBS, expect only 2.7% growth in Q2, which would put average growth over the past 6 months at 1% and a not-much-better 1.4% over the past nine. We've little choice but to downgrade our 2015 forecast to 2.2% from 2.6% previously. Technically, that's a slowdown from last year's 2.4%. We don't really view it as such but the point remains: there hasn't been any pickup in growth since 2010. Six years of QE and growth hasn't accelerated one iota. Forecasters were fooled five years in a row. Quite a record.

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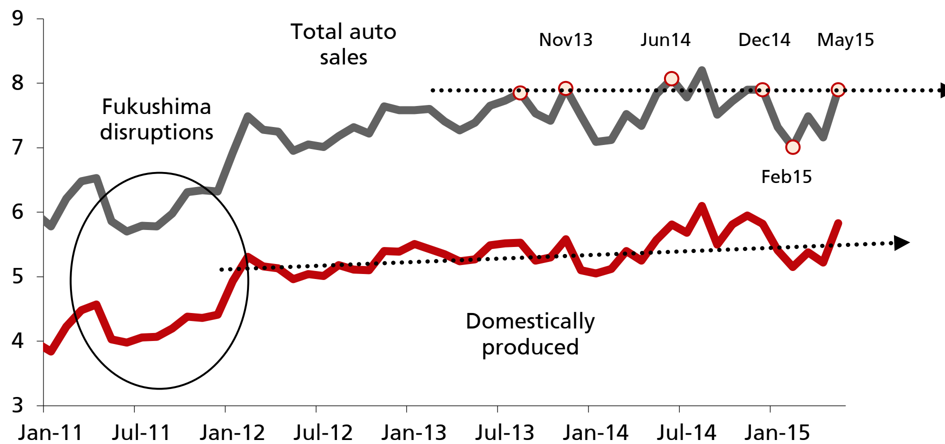
US - auto sales

mil units, saar



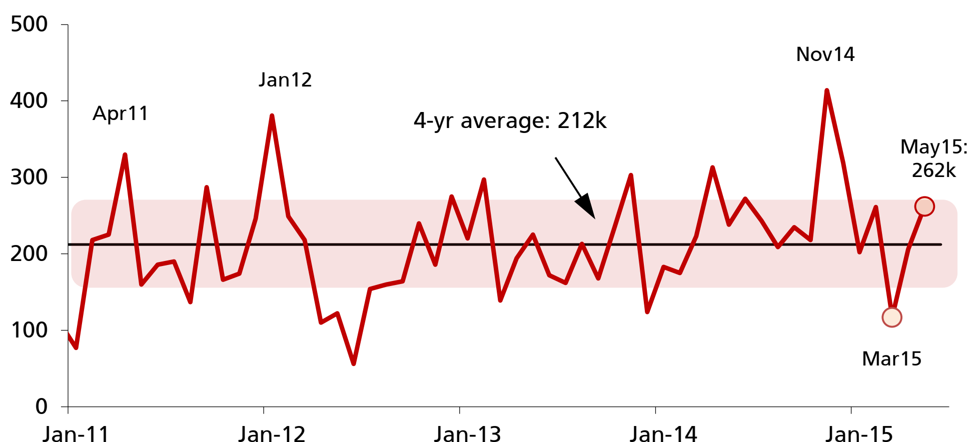
To be sure, the economy isn't doing any worse than it was before. Underneath the distortions of Q1 (and the payback we reckon will come over the remainder of the year), the economy continues to grind ahead at the 2.2% pace that it has for the past five years. Auto sales have recovered the ground they lost in Q1, even if they haven't made up for any of it. Retail sales have recovered their lost ground too (though again, no more). Consumption growth in Q2 is likely to hang close to 2% (QoQ, saar), only a tick or two below its five-year average. The service sector ISM (representing 80% of the economy) is still closer to 56 than to 55 and even the latter figure is a sturdy if not sporty one.

The question isn't whether recovery continues. It does. The question is, how much slack remains?

So recovery continues, lackluster though it is. Private sector nonfarm payrolls expanded by 262k in May, a good 50k higher than the 212k average of the past five years. Job growth certainly isn't taking off, like so many thought last year. But the 216k private sector jobs created each month since 2011 is solid growth that will

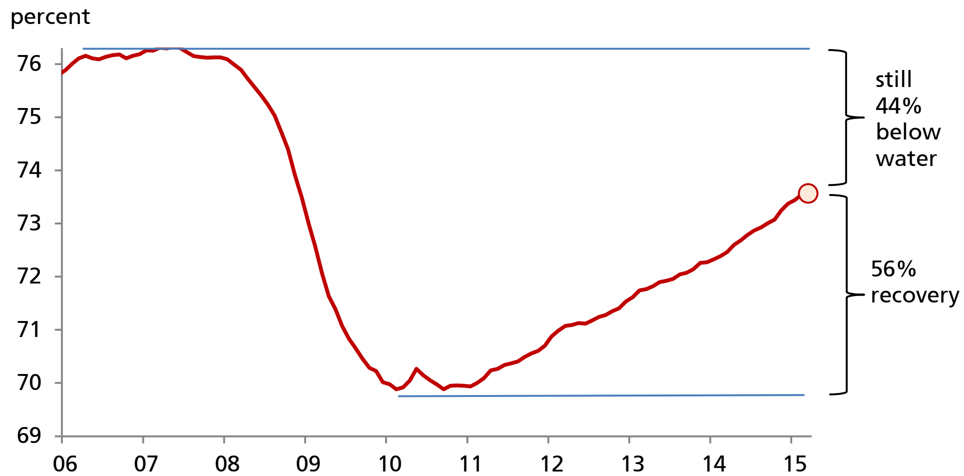
US - private sector nonfarm payrolls

private sector NFP x1000, sa



Even today, labor markets have recovered only half the ground lost during the crisis

US – nonfarm payrolls as % of working age population
percent



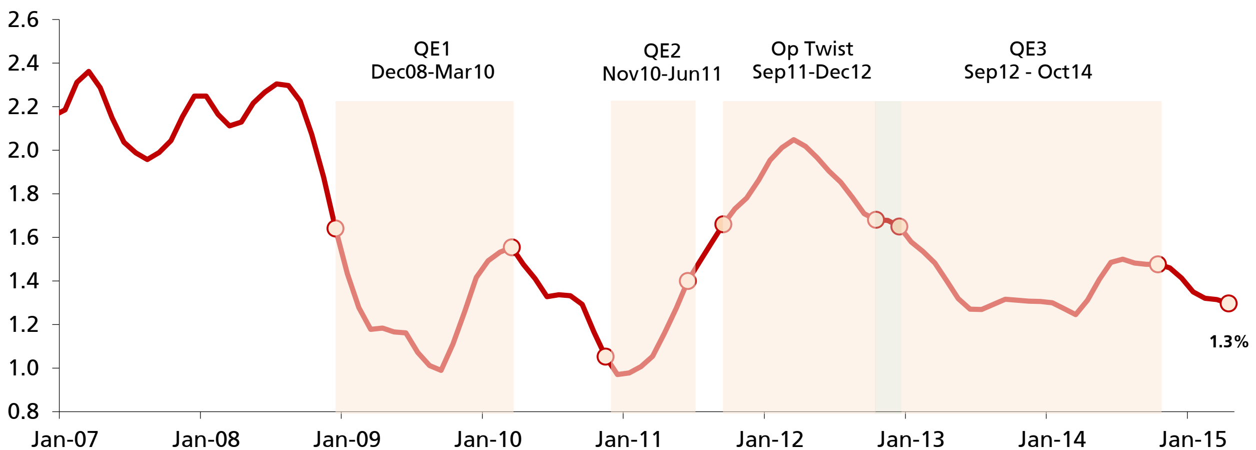
eventually bring labor markets back to normal. The trouble is, the working age population is growing by 130k-135k each month too, so the real unemployment rate isn't nearly as low or falling nearly as fast as the official one is (which crept back up to 5.5% in May).

Inflation and the Fed

The question for the Fed isn't whether recovery continues. It does. The question is, how much slack remains? It's not easy to gauge because so many people have dropped out of the labor force. To the extent this is due to discouraged workers giving up on their search for jobs, the official unemployment rate is meaningless. We think much slack remains. The proportion of working age Americans with jobs has recovered only about half the ground it lost during the downturn. At the current pace of recovery, it would take another 3-4 years before labor markets had fully recovered and inflation starts to rise.

With slack difficult to gauge, inflation itself will likely be the driver of Fed policy. Average wage growth rose to 2.3% on-year in May, two ticks higher than where it stood six months ago. If this were to continue north, it would eventually spill over into inflation more broadly. At the moment, however, just the opposite is occur-

US - core PCE inflation
% YoY, 3mma



US Economic Indicators

	2014	2015(f)	2016(f)	2014 Q4	--- 2015 --- Q1	Q2 (f)	Q3 (f)	Q4 (f)	2016 Q1 (f)	Q2 (f)
Output & Demand										
Real GDP*	2.4	2.2	2.5	2.2	-0.7	2.7	3.5	2.2	2.2	2.4
Private consumption	2.5	2.6	2.2	4.4	1.8	2.0	2.2	2.2	2.2	2.2
Business investment	6.3	3.0	5.2	4.7	-2.8	1.0	6.0	5.0	5.0	6.0
Residential construction	1.6	5.0	4.6	3.8	4.9	6.0	6.0	4.0	4.0	4.0
Government spending	-0.2	0.4	0.9	-1.9	-1.1	1.0	1.0	0.7	1.0	1.0
Exports (G&S)	3.2	2.4	3.3	4.5	-7.6	8.9	4.5	2.7	2.7	2.7
Imports (G&S)	4.0	3.5	2.2	10.4	5.6	-2.0	-1.0	3.0	3.0	3.0
Net exports ($bn, 09P, ar)	-453	-491	-478	-471	-548	-490	-460	-465	-470	-475
Stocks (chg, $bn, 09P, ar)	71	78	61	80	95	70	75	70	65	60
Contribution to GDP (pct pts)										
Domestic final sales (C+FI+G)	2.5	2.4	2.5	3.4	0.8	1.9	2.7	2.4	2.5	2.6
Net exports	-0.2	-0.2	0.1	-1.0	-1.9	1.4	0.7	-0.1	-0.1	-0.1
Inventories	0.0	0.0	-0.1	-0.1	0.4	-0.6	0.1	-0.1	-0.1	-0.1
Inflation										
GDP deflator (% YoY, pd avg)	1.4	1.3	1.3							
CPI (% YoY, pd avg)	1.6	0.9	1.7	1.2	-0.1	0.5	1.5	1.6	1.7	1.7
CPI core (% YoY, pd avg)	1.7	1.6	1.5	1.7	1.7	1.6	1.5	1.5	1.5	1.5
PCE core (% YoY, pd avg)	1.4	1.2	1.3	1.4	1.3	1.2	1.1	1.2	1.2	1.3
External accounts										
Current acct balance ($bn)	-410	-468	-505							
Current account (% of GDP)	-2.4	-2.6	-2.7							
Other										
Nominal GDP (US$ trn)	17.4	18.0	18.7							
Federal budget bal (% of GDP)	-2.8	-2.9	-2.9							
Nonfarm payrolls (000, pd avg)				324	195	227	220	220	220	220
Unemployment rate (%, pd avg)				5.7	5.6	5.5	5.5	5.4	5.3	5.2

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

ring. Core PCE inflation – the Fed's favored gauge – has fallen three ticks from where it stood 6 months ago. It is now running at 1.2% YoY, and moving away from the Fed's 2% target. While most rhetoric continues to point to a late-2015 lift-off, officially the Fed remains in data-dependent, wait-and-see mode. If core PCE inflation continues to drift lower – as it well could given the slack we think remains in labor markets – lift-off will be postponed.

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

JP: recovery is incomplete

- The post-tax hike recovery remains incomplete
- The good news is that wage growth is picking up, auguring well for demand and higher inflation
- But external risks remain. A slowdown in exports would create negative spillovers in the labour market
- The BOJ's 2% inflation target is too optimistic. Pressure will increase next year for monetary easing

The economy has returned to a recovery path after being disrupted by the sales tax hike last year. GDP growth registered 3.9% (QoQ, saar) in 1Q15, the second consecutive quarter in the positive and higher than 1.2% in 4Q14. Nonetheless, the cumulative growth in the last two quarters is still insufficient to offset the earlier contraction of 9% in 2Q-3Q14. Looking at the level of aggregate output, it remains lower than the level seen before the sales tax increase in the beginning of last year (Chart 1).

Likewise, the recovery in private consumption, which was hit the hardest by the tax hike last year, remains incomplete. Consumption growth registered a steady rate of 1.5% in the past three quarters ending 1Q15. This is far from enough to offset the double-digit contraction of 19% in 2Q14 (Chart 2). In fact, GDP growth in 1Q15 was mainly contributed by investment and inventory, which was in turn, driven by the increase in exports demand.

Domestic hopes vs. external uncertainties

We expect the economy to grow 1.1% in 2015 and 1.0% in 2016. A core assumption embedded in our forecasts is that the post-tax hike recovery in domestic demand

Chart 1: Output levels still lower than the peak

JPY trn, 2005p, sa

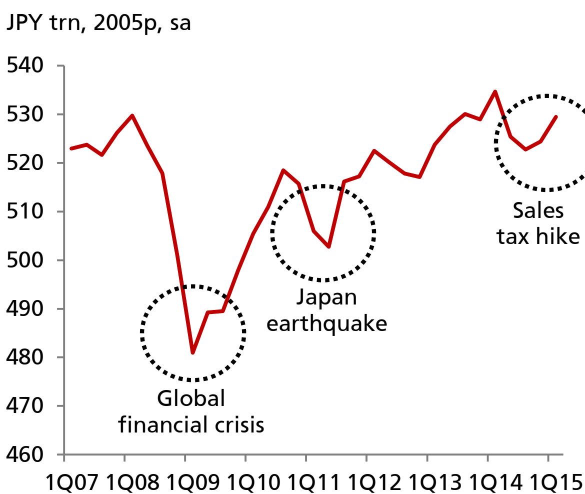
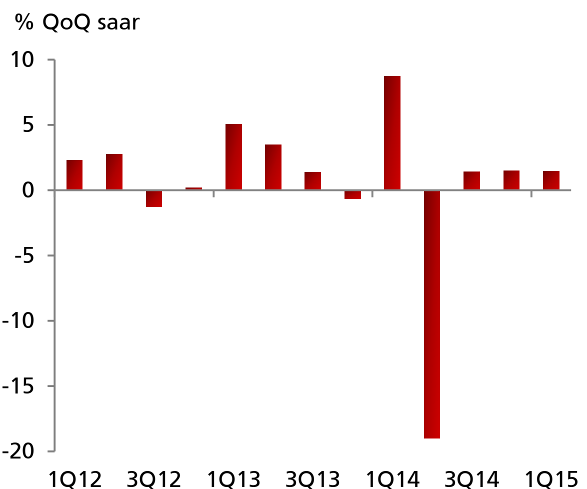


Chart 2: Consumption growth still weak

% QoQ saar



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gathers pace from 2Q15. Wage growth has picked up to 0.9% (YoY) in April from 0.2% in 1Q. Many corporates raised wages during the spring labour negotiations, partly due to government pressures. But tighter labour markets played a role as well. Real wage growth has risen to 0.3% in April from -2.0% in 1Q, thanks to lower inflation from the fading impact of the sales tax and a decline in oil prices (Chart 3).

Faster wage growth augurs well for domestic demand and an eventual rise in inflation. But risks remain. The global economy is facing more headwinds, given a faster-than-expected slowdown in China, weaker-than-expected recovery in the US, and heightened volatility in the FX and bond markets. If external demand were to deteriorate significantly ahead, it could offset the beneficial impact of a weak yen on Japan's exports and create negative spillovers in the labour market. Accordingly, the process of a wage-driven recovery in the domestic economy could be delayed.

The 2% inflation target remains distant

On the price front, we expect inflation to average 1.0% this year and 0.8% next year. While the BOJ projects a similar 0.8% for FY2015, the central bank is more optimistic about price outlook in the medium-term. As announced at April's policy meeting, the BOJ expects inflation to hit the 2% target next year, as early as the first half of FY2016.

At present, both headline and core CPI inflation are virtually 0% (Chart 4). We concur that demand-driven inflation may emerge over time, on the back of higher wage growth, a fuller recovery in domestic demand, and increase in inflation expectations. Nonetheless, the BOJ's forecast of 2% inflation still appears too sanguine. With wage growth running at just about 1%, demand-driven inflation is unlikely to exceed the 1% mark anytime soon. Stronger income growth and a faster recovery in consumption demand will be necessary to achieve the 2% inflation target.

Inflation is unlikely to exceed 1% anytime soon

Monetary policy still biased towards easing

The Bank of Japan maintained the pace of quantitative and qualitative easing at JPY 80trn (per annum) in the six meetings so far this year. According to the governor, further easing is not necessary for the time being. The economy is seen to be on the recovery path, the labor market is tight and inflation expectations are going up.

Given our less-than-sanguine view though, expect pressures to remain on the BOJ to add stimulus going forward in order to defend its policy target and maintain its credibility. Pressures will increase next year, when the timeline of achieving the 2% inflation target approaches (1H FY2016). In the event of a deterioration in exports

Chart 3: Wage growth picking up

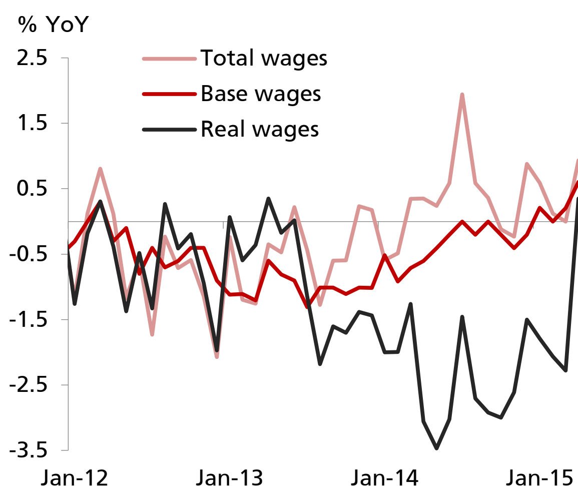
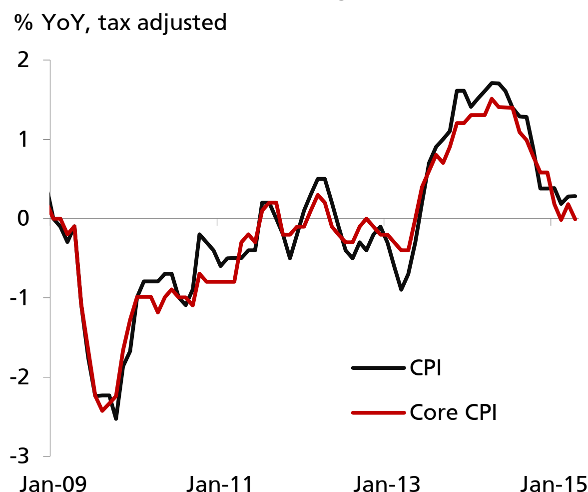


Chart 4: CPI inflation standing at 0%



that engenders negative impact on the labour market and drags the process of domestic demand recovery, the BOJ would be under pressure to add stimulus sooner rather than later.

The BOJ will face more pressure next year

Until there is a clear signal from the BOJ regarding its next policy move, the USD/JPY is likely to be dictated by market expectations about US interest rates to a large extent in the short term. USD/JPY consolidated in the 116-122 range up until May. But it broke this range and rose to 123-125 in the beginning of June, against the backdrop of the re-strengthening of the dollar (Chart 5).

Fiscal consolidation targets remain ambiguous

On the fiscal policy front, the progress of fiscal consolidation seems to have slowed since the government decided last year to postpone the second sales tax hike. While the primary fiscal balance has improved in 2014 thanks to the first sales tax hike, it remained in the deficit and the public debt-to-GDP ratio continued to climb (Chart 6).

Two rating agencies have turned more cautious about Japan's sovereign credit outlook, amid growing concerns about public debt sustainability and debt monetization. Fitch downgraded Japan's long-term foreign and local currency rating to A from A+ in April. Earlier, in December 2014, Moody's also cut Japan's rating by one notch, to A1 from Aa3.

Given mounting pressures from the rating agencies, the government has promised to prepare a new fiscal consolidation plan, which is set to be announced by end-June. According to the information available so far, the new plan will underscore the assumption of higher GDP growth, which automatically boosts the government's tax revenues. New tax hikes will be ruled out (except for the second sales tax hike that is now scheduled for 2017). A large cut in social welfare spending or medical spending will also be unlikely, due to pressures from pensioners and resistance from the medical industry.

A credible fiscal consolidation plan is really needed in order to avoid a further deterioration in Japan's sovereign credit profile and a loss in investors' confidence about the yen-denominated assets at some point in future. In this regard, how to achieve higher GDP growth in a sustainable manner so as to create permanent sources of tax revenues is the key question that remains to be answered.

Chart 5: The yen weakening further

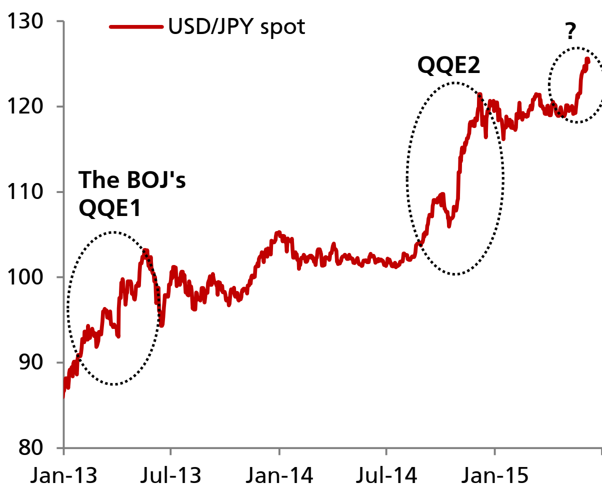
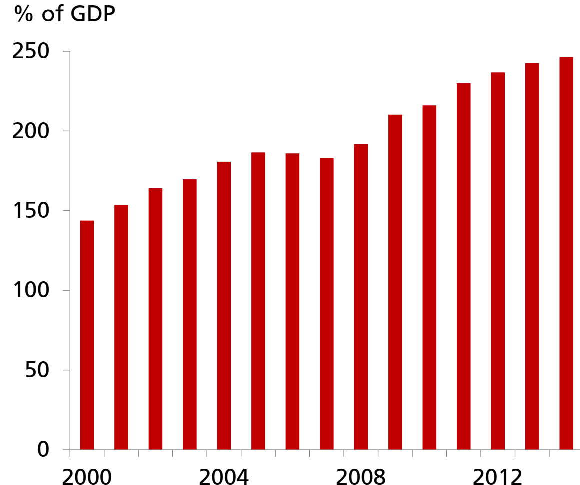


Chart 6: Public debt ratio continued to rise



Japan Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand									
GDP growth	-0.1	1.1	1.0	-0.9	1.4	2.1	2.0	1.3	0.9
Private consumption	-1.3	0.1	1.1	-4.1	1.5	1.5	1.6	1.4	1.2
Government consumption	0.2	0.7	0.8	0.8	0.7	0.7	0.7	0.8	0.8
Private & public investment	2.7	0.2	0.2	-3.3	1.3	1.8	1.6	0.1	0.2
Net exports (JPYtrn, 05P)	9.6	12.7	14.0	2.9	3.4	3.2	3.2	3.3	3.7
Exports	8.4	7.3	4.1	7.4	8.4	7.8	5.5	4.1	4.1
Imports	7.4	4.3	3.0	0.0	6.3	6.0	5.2	3.0	3.0
External (nominal)									
Merch exports (JPY trn)	73	79	83	19	19	20	21	20	21
- % YoY	4.8	7.6	5.7	9.3	9.5	7.8	4.7	5.7	7.3
Merch imports (JPY trn)	86	82	90	20	20	20	22	22	22
- % YoY	5.7	-4.2	9.8	-9.0	-2.8	-3.1	-1.1	7.9	11.8
Merch trade balance (JPY trn)	-13	-4	-7	-1	0	-1	-1	-2	-1
Current acct balance (USD bn)	25	96	65	-	-	-	-	-	-
% of GDP	0.5	2.4	1.6	-	-	-	-	-	-
Foreign reserves (USD bn)	1,261	1,267	1,241	-	-	-	-	-	-
Inflation									
CPI, % YoY	2.7	1.0	0.8	2.3	0.5	0.4	0.7	0.9	0.7
Other									
Nominal GDP (USD bn)	4,615	4,072	3,966	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Fiscal balance (% of GDP)	-6.8	-6.5	-6.2	-	-	-	-	-	-

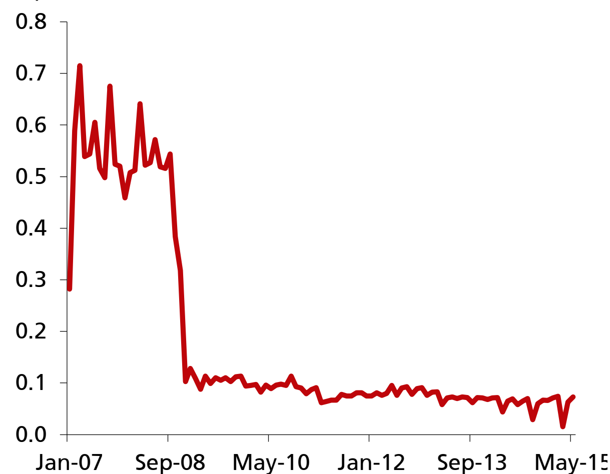
* % growth, year-on-year, unless otherwise specified

JP - nominal exchange rate

JPY per USD

JP – policy rate

%, call



EZ: cautious optimism

- **The Eurozone grew faster than the US and UK in 1Q15**
- **Domestic demand is off the trough and likely to lift 2015 GDP growth to 1%. 2016 growth should reach 1.3%**
- **Deflation risks are in check but inflation is nowhere in sight**
- **Rising bond yields and currency strength threaten to dilute QE's impact. The ECB will stay committed to QE purchases until Sep16**
- **Greece remains a risk**

Growth has improved and deflation fears have receded. The ECB's QE purchases have added to the optimism. But until the ECB is convinced that inflationary expectations have recovered, the output gap has narrowed and the reversal in inflation is demand-driven, we do not expect any change in the accommodative policy stance

Growth to improve gradually

The Eurozone economy expanded 1% YoY in 1Q15 (vs 4Q14's 0.9%), outpacing growth in the US and UK. Output is, however, still below pre-crisis highs (Chart 1). Amongst the core economies, Germany underperformed but the other three picked up the slack. France recovered to 0.7% YoY from a flat 4Q and Italy broke out of three consecutive quarters of decline to register a flat finish. Spain stayed at the top of the leader-board, expanding 2.6% (vs 2.0% in 4Q) while Greece slowed to 0.3% YoY from 1.3% in 4Q.

Domestic demand is on the mend, with 1Q private spending up at the fastest pace since Mar08. Falling prices buoyed real purchasing power, with retail sales (netting

Chart 1: GDP growth: Slow road to recovery

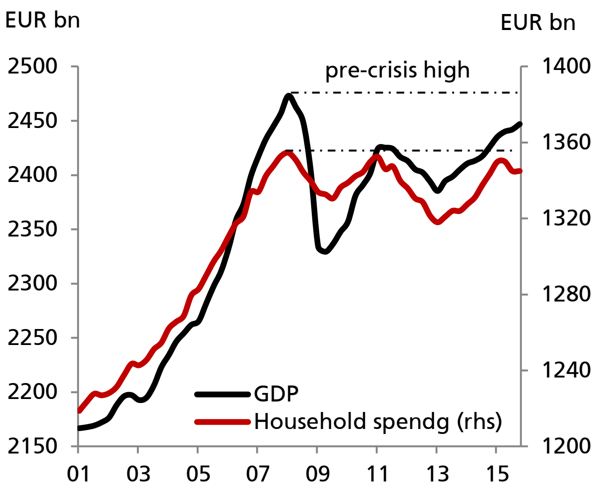
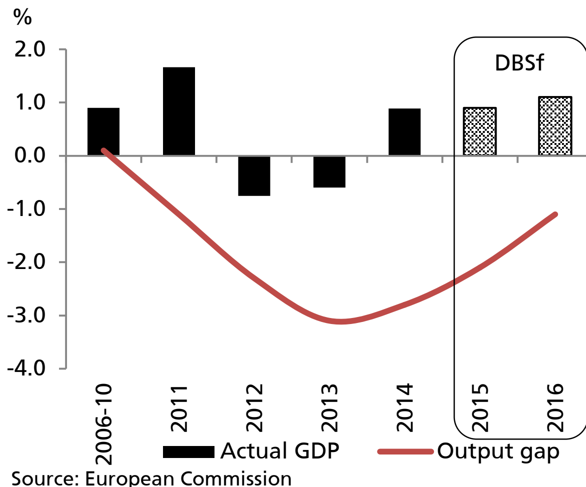


Chart 2: Output gap to narrow



Source: European Commission

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off inflation) up 2.7% YoY in 1Q15 from 4Q's 1.8%. Consumer and business surveys continue to improve notwithstanding the Greek overhang.

Industrial production growth inched up to 0.7% YoY in Jan-Feb15 from 4Q14's 0.3%. Manufacturing and service sector PMIs have stabilized above 50 (expansionary terrain), with credit growth to non-financial corporations declining at the slowest pace in over ten quarters. Notwithstanding the weak currency, the trade surplus narrowed in the first quarter.

Growth is likely to average 1.0% YoY (vs our previous estimate of 0.9%) this year and 1.3% in 2016. Domestic demand will be the main pillar of support as household spending improves on low inflation and an accommodative policy stance. But the pace of rise will be subdued as the jobless rate eases at a glacial pace and wage growth stagnates. Negotiated wages rose 1.5% in 1Q from 1.7% in 4Q14.

Businesses are likely to tap existing capacity to meet initial revival in demand, instead of stepping up operations or increasing headcount. Public sector investments will also go slow given the need to stick with fiscal consolidation and reforms in most member countries. Overall, even as the economy's output gap is narrowing, it has yet to return to pre-crisis levels (Chart 2).

Deflation risks wane but not out of the picture

After four successive months of decline, Eurozone inflation was flat in Apr and inched back to black in May at 0.3% YoY. The upturn was largely driven by food inflation which rose 1.2% in May, up from 0.3% in 1Q, while energy price inflation posted a shallower -5% YoY fall from 1Q's -7.7%. The highly-weighted service price inflation also ticked up to 1.3% in May from 1Q's 1.1%.

Price pressures have started to stabilize as PMI input/ output prices edge up and imported price pressures become less negative (Chart 3). Global commodity prices have also trimmed losses, with sharp EUR weakness to mark a floor for inflation prints. Financial market metrics of inflationary expectations (5Y5Y inflation indexed swaps) is also up from 1.5% in Jan15 to above 1.8% by Jun (Chart 4).

Inflation is likely to rise to 0.8% YoY by 4Q. Despite the upturn, inflation reamins far below the 2% target. Wage growth remains subdued in the midst of the gradual fall in the unemployment rate and significant slack in the system. Core inflation is off record lows, but tepid at 0.9% YoY.

Chart 3: Imported pressures/ input prices rebound

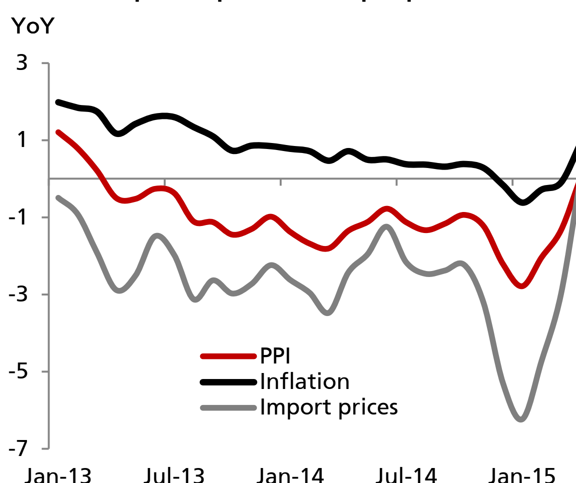
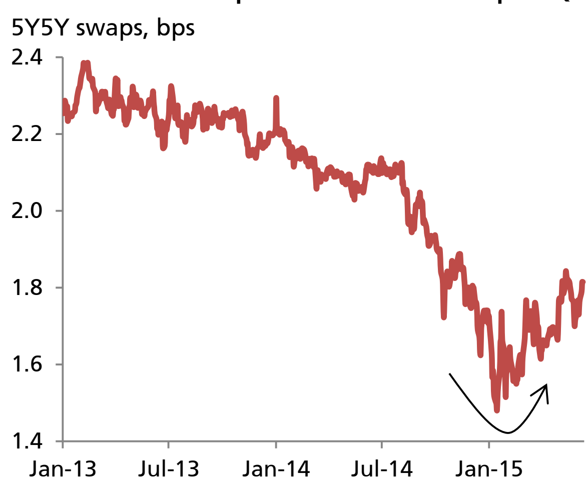


Chart 4: Inflation expectations bottom-out post QE



The confluence of a number of positive shocks like the weak euro, rebound in crude prices and lift to sentiment from ECB's asset purchases have added to the optimism. Reversal in any of these factors is still material risk.

ECB to stay the course with QE

Public and private sector asset purchases have lifted ECB's balance sheet to two-year highs. By end-May, government bond purchases stood at EUR 147bn, covered bonds at EUR 85bn and asset-backed securities at 7.2bn. If these purchases remain on track, ECB's balance sheet will be closer to a quarter of GDP by end-year and over 30% of GDP by end-2016 (Chart 5). This will see ECB's balance sheet close in on the US Fed but lag the BOJ by a wide margin, with the latter already at 60% of GDP.

Overall, the QE program is off to a positive start and its impact on the financial markets has been palatable. Expectations of asset purchases led the euro down 12% against the dollar by Mar15, while German 10y yields eased to a hair's breadth of turning negative.

Part of these gains have however reversed since April, as firm hard data and surveys out of the Eurozone raised concerns that the ECB might cut back on asset purchases sooner than expected. German yields, in particular, jumped 70-80bps off record lows and the euro is back above 1.10 versus the dollar from 1.05 lows.

Notably, the bulk of the benefits from asset purchases is felt through the bond markets, sentiments and currency channel, with the latter also evident in the ECB's monetary conditions index. With room for further rate cuts largely exhausted, much of the loosening in the domestic financial conditions is occurring through depreciating the euro (see FX section for our view on the EUR).

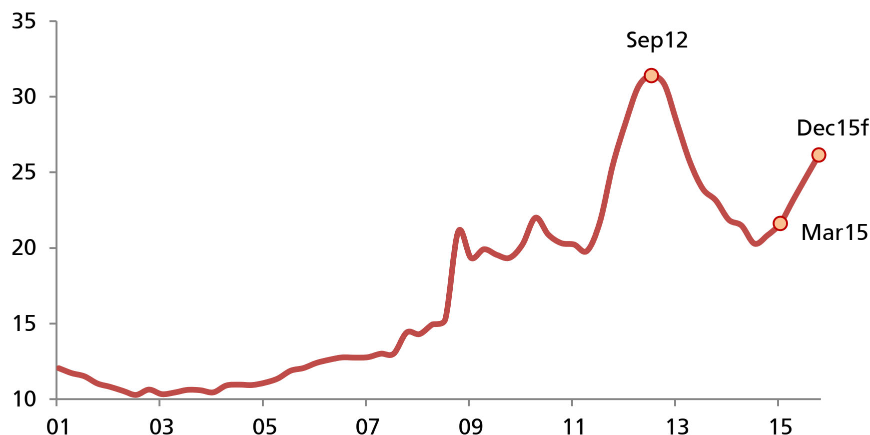
Hence, a sustained rebound in bond yields and a strong euro might dilute QE benefits. Thereby the ECB is likely to emphasize that while recovery is on track, the pace is far from comforting and inflation remains way below target. Asset purchases will stick to the original timetable and run until Sep16. There was also an indication that QE purchases will be frontloaded in May-Jun in anticipation of low liquidity during the holiday period in Jul-Aug. To compensate, purchases might be adjusted in Sep when liquidity picks up again.

Greece remains a risk

The deadlock between the Greek government and its creditors remains unresolved. Athens missed the first tranche of this month's repayment to the IMF, but has been given the leeway to combine the dues and pay by end-month.

Chart 5: Asset purchases underpin ECB balance sheet expansion

assets as % of GDP



Developments continue to warrant close attention. While the still-low bond yields, ECB's QE and broad positivity has lulled worries over Greece, any failure in bailout negotiations remains a key risk.

Athens' resistance to further austerity remains high and its various proposals have failed to convince creditors' of its commitment to reform. On the other hand, Eurozone members are unwilling to alter earlier conditions lest other indebted Eurozone members demand the same.

How will this end? The probability of an eleventh hour compromise between the Greek government and its creditors is high. Failing which, two things could happen: a) Greece defaults but stays in the Eurozone; b) extreme step of a Greek default and its return to the drachma. Fallout of the latter is unprecedented and hard to predict. Some believe Grexit would be beneficial for both parties. The remaining Eurozone members would ostensibly have greater cohesiveness. Greece would likely face a sharp downturn in the short run but, the argument goes, could avoid long-term stagnation with a devalued drachma.

All said, the manner in which the EU-Greece impasse is handled will set the precedent for other indebted Eurozone members. A hard-line stance may signal that no economy is "too big to fail". A soft-handed approach, on the other hand, would imply that there is sufficient flexibility to accommodate non-compliance.

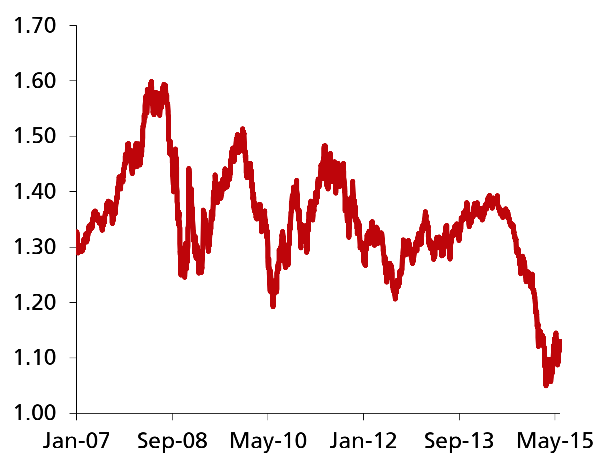
Whatever the outcome, hopes are high that it will involve a long-term solution rather than another interim deal. Greece needs a reform agenda it can digest and adhere to, lest it finds itself back in this situation one or two quarters down the road.

Eurozone Economic Indicators

	2014	2015f	2016f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output and demand (% YoY)									
GDP growth (05P)	0.9	1.0	1.3	1.0	1.1	1.0	0.9	1.1	1.0
Private consumption	1.0	0.9	1.2	1.7	1.4	0.6	0.1	0.8	1.1
Government consumption	0.6	0.5	1.1	1.1	0.5	0.3	0.1	0.7	1.2
Gross capital formation	1.2	0.7	1.4	0.8	0.3	0.5	0.1	0.8	1.9
Net exports (EUR bn)	389	406	420	91	100	105	110	105	105
Exports (G&S) (% YoY)	3.7	1.9	0.3	4.2	1.8	0.9	0.6	0.0	0.9
Imports (G&S) (% YoY)	4.0	1.6	0.0	5.1	1.9	0.1	-0.7	-1.4	0.5
Contribution to GDP (pct pts)									
Domestic demand	0.8	0.9	1.1	na	na	na	na	na	na
Net Exports	0.1	0.1	0.2	na	na	na	na	na	na
External accounts									
Current account (EUR bn)	240	220	200	na	na	na	na	na	na
% of GDP	2.3	2.2	2.0	na	na	na	na	na	na
Inflation									
HICP (harmonized, % YoY)	0.4	0.4	1.1	-0.3	0.2	0.8	0.8	1.6	1.0
Other									
Nominal GDP (EUR trn)	995	100	101	na	na	na	na	na	na
Unemployment rate (%, sa, eop)	11.6	11.3	11.0	na	na	na	na	na	na

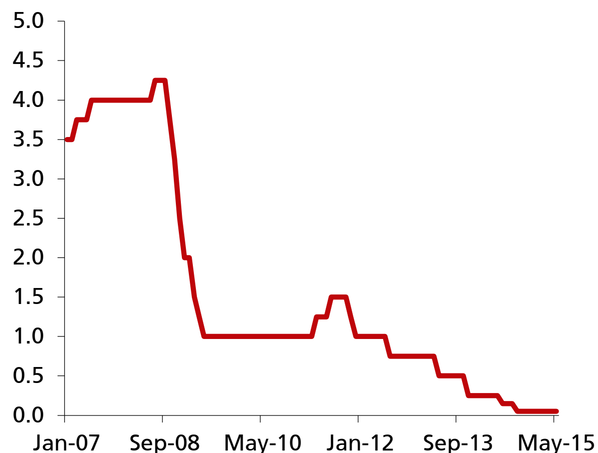
EZ - nominal exchange rate

USD per EUR



EZ – policy rate

%, refi rate



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