Economics
Markets
Strategy

2Q 2015

DBS Group Research
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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	2.6	2.4	2.1	1.5	1.6	1.2	1.7
Japan	1.8	1.6	0.0	1.3	1.0	0.0	0.4	2.7	1.0	0.8
Eurozone	-0.7	-0.4	0.9	0.9	1.2	2.5	1.3	0.4	0.2	1.1
Indonesia	6.0	5.6	5.0	5.5	5.7	4.0	6.4	6.4	6.0	5.5
Malaysia	5.6	4.7	6.0	4.9	5.0	1.7	2.1	3.1	3.4	3.0
Philippines	6.8	7.2	6.1	6.3	6.0	3.2	2.9	4.2	3.2	3.8
Singapore	3.4	4.4	2.9	3.2	3.5	4.6	2.4	1.0	0.4	1.3
Thailand	6.4	2.9	0.7	3.6	4.3	3.0	2.2	1.9	0.8	2.8
Vietnam	5.0	5.4	6.0	6.0	6.2	9.3	6.6	4.1	1.9	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	1.5	2.9	2.6	2.8	3.0	4.1	4.3	4.4	3.7	3.5
Taiwan	2.1	2.2	3.7	3.7	3.5	1.9	0.8	1.2	0.3	0.9
Korea	2.3	3.0	3.3	3.4	3.7	2.2	1.3	1.3	1.3	2.0
India*	5.1	6.9	7.4	7.8	8.3	7.4	9.5	6.4	5.6	5.8

* 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	2Q15	3Q15	4Q15	1Q16	current	2Q15	3Q15	4Q15	1Q16
US	0.25	0.25	0.25	0.50	0.75	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	121.3	121	122	123	124
Eurozone	0.05	0.05	0.05	0.05	0.05	1.054	1.08	1.06	1.04	1.02
Indonesia	7.50	7.50	7.50	7.50	7.50	13,170	13,250	13,460	13,660	13,870
Malaysia	3.25	3.25	3.25	3.25	3.25	3.68	3.67	3.69	3.71	3.73
Philippines	4.00	4.00	4.00	4.00	4.25	44.3	45.2	45.3	45.4	45.4
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.38	1.38	1.39	1.40	1.41
Thailand	1.75	1.75	1.75	1.75	2.00	32.9	33.0	33.2	33.3	33.5
Vietnam^	6.50	5.50	5.00	5.00	5.00	21,368	21,350	21,350	21,350	21,350
China*	5.35	5.10	5.10	5.10	5.10	6.26	6.30	6.33	6.36	6.39
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.76	7.76	7.77	7.77	7.78
Taiwan	1.88	1.88	1.88	1.88	2.00	31.6	31.8	32.0	32.2	32.4
Korea	1.75	1.50	1.50	1.50	1.75	1126	1118	1133	1147	1161
India	7.50	7.25	7.25	7.25	7.25	62.5	63.6	64.6	65.6	66.7

^ 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-Mar-15	2Q15	3Q15	4Q15	1Q16
US	3m Libor	0.27	0.30	0.40	0.70	0.95
	2Y	0.68	1.00	1.25	1.50	1.70
	10Y	2.10	2.20	2.40	2.60	2.70
	10Y-2Y	142	120	115	110	100
Japan	3m Tibor	0.17	0.20	0.20	0.20	0.20
Eurozone	3m Euribor	0.03	0.10	0.10	0.10	0.10
Indonesia	3m Jibor	6.80	7.00	7.00	7.00	7.00
	2Y	7.19	7.00	7.20	7.40	7.60
	10Y	7.78	7.60	7.80	8.00	8.20
	10Y-2Y	58	60	60	60	60
Malaysia	3m Klibor	3.77	3.70	3.70	3.70	3.70
	3Y	3.42	3.50	3.60	3.70	3.80
	10Y	3.98	4.10	4.20	4.30	4.30
	10Y-3Y	57	60	60	60	50
Philippines	3m PHP ref rate	2.32	2.25	2.50	2.75	3.00
	2Y	3.09	3.10	3.20	3.30	3.40
	10Y	4.06	4.00	4.20	4.40	4.60
	10Y-2Y	97	90	100	110	120
Singapore	3m Sibor	0.88	0.70	0.70	0.85	1.05
	2Y	1.19	1.20	1.40	1.60	1.80
	10Y	2.45	2.35	2.50	2.70	2.75
	10Y-2Y	125	115	110	110	95
Thailand	3m Bibor	2.17	1.90	1.90	1.90	2.15
	2Y	1.92	2.00	2.00	2.10	2.20
	10Y	2.71	2.60	2.70	2.80	2.90
	10Y-2Y	78	60	70	70	70
China	1 yr Lending rate	5.35	5.10	5.10	5.10	5.10
	2Y	3.23	3.10	3.20	3.30	3.40
	10Y	3.52	3.60	3.70	3.80	3.80
	10Y-2Y	29	50	50	50	40
Hong Kong	3m Hibor	0.39	0.40	0.50	0.70	0.95
	2Y	0.53	0.70	0.95	1.20	1.40
	10Y	1.42	1.70	2.00	2.30	2.40
	10Y-2Y	89	100	105	110	100
Taiwan	3M Taibor	0.88	0.88	0.88	0.88	0.96
	2Y	0.64	0.65	0.65	0.65	0.80
	10Y	1.62	1.65	1.65	1.65	1.70
	10Y-2Y	98	100	100	100	90
Korea	3m CD	1.94	1.70	1.70	1.70	1.95
	3Y	1.91	2.00	2.00	2.15	2.30
	10Y	2.32	2.40	2.50	2.60	2.70
	10Y-3Y	41	40	50	45	40
India	3m Mibor	8.56	8.10	8.10	8.10	8.10
	2Y	7.85	7.50	7.75	8.00	8.25
	10Y	7.76	7.60	7.80	8.00	8.25
	10Y-2Y	-14	10	5	0	0

Source: Bloomberg and DBS Group Research

Swimming down the middle

Expectations of rate liftoff in the US juxtaposed against ongoing / fresh QE in Japan and Europe have wrought havoc in global currency markets. Since July, the euro and the yen have both fallen by some 20% against the greenback. Caught in this veritable tsunami, where have Asia's currencies swum? Right down the middle, mostly, just as one would have hoped. They've fallen against the dollar and risen against the euro and yen and in so doing have maintained a modicum of stability in very choppy seas.

Truth be told, most Asian currencies haven't swum 'right' down the middle. Most have clung more to dollar than they should have. Measured against a simple basket of dollars, euros and yen, all of Asia's currencies, save for the ringgit, have appreciated by 2.5%-12% since July. This isn't necessarily, or even generally, a good thing.

On the brighter side – and in a complete reversal from the 'Taper Tantrums' of 2H13 – India and Indonesia are experiencing inflows, over and above that needed to finance current account deficits. 'Excess' inflows are pushing currencies and FX reserves north. Compared to July, the rupiah has appreciated by 2.5% against the tri-currency basket and Indonesia's reserves have risen by US$4bn. The rupee is up by 9% and India's reserves have risen by $14bn.

In other countries, however, outflows have been the order of the day and central banks have spent a good portion of their reserves keeping currencies strong. Since July, China's reserves have fallen by US$150 billion, thanks mainly to 'keeping up with the Joneses'. The CNY has barely fallen against the dollar and has thus appreciated by 11.4% against the tri-currency basket. Singapore's reserves have fallen by US$34bn since July – counting spot and forward holdings, as the IMF says one should – the quid pro quo of keeping the Sing dollar on its appreciation path. In six short months, reserves have fallen by the equivalent of 11% of a full year's GDP. Little wonder the central bank eased back on the appreciation path in late-January. Further easing will be necessary if reserves don't stop falling.

But it's not just China and Singapore where reserves are being spent propping up currencies. Thailand, Malaysia, Taiwan and the Philippines have all spent the equivalent of 1%-4% of a full year's GDP over the past six months supporting exchange rates.

The question is, for what? Growth in the region is 6.2% – pedestrian at best. Inflation is falling hard and fast; in Singapore it is negative.

Asia – FX appreciation since July 2014
% appreciation, 3d avg ending 6Mar15 relative to Jul14 mth avg

	CNY	HKD	KRW	TWD	IDR	SGD	MYR	PHP	THB	INR	A10	A9	A Big 3	Asean
vs USD	-1.1	-0.1	-7.1	-4.6	-9.1	-8.7	-11.7	-1.5	-0.8	-2.8	-4.8	-5.2	-4.4	-6.4
vs JPY	16.3	17.5	9.2	12.1	6.9	7.3	3.8	15.8	16.6	14.2	11.9	11.4	12.4	10.0
vs EUR	19.6	20.9	12.4	15.4	10.0	10.4	6.8	19.2	20.0	17.5	15.2	14.7	15.7	13.2
vs Tri ccy	11.4	12.5	4.6	7.4	2.4	2.8	-0.6	10.9	11.7	9.4	7.2	6.7	7.7	5.4

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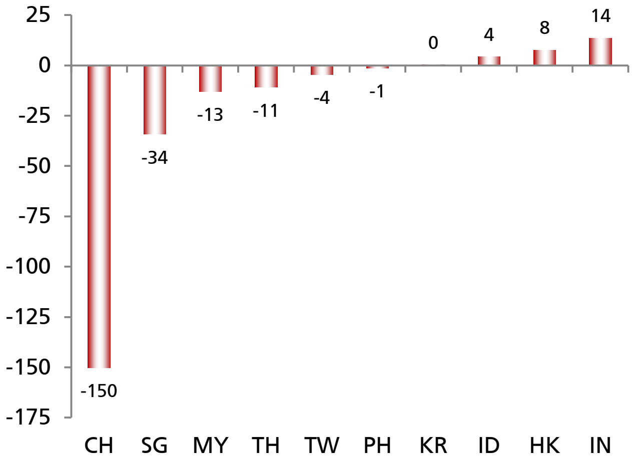
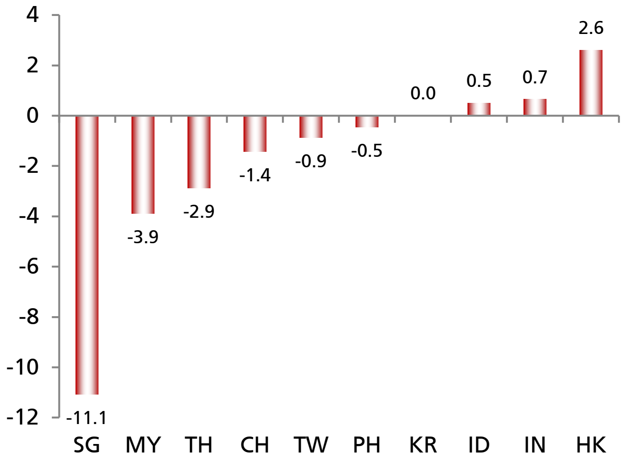
Asia – change in foreign reserves, past 6 months

USDbn, Jun14-Dec14, spot plus forward holdings



Asia – change in foreign reserves, past 6 months

% of GDP, Jun14-Dec14, spot plus forward holdings



Too-strong currencies are at least as big a driver of falling inflation regionally as the drop in oil prices. Think about it: imports account for 20%-35% of GDP in Asia, much more in Singapore and Hong Kong. Oil imports account for 1%-6% of GDP. An 8% currency appreciation on imports worth 25% of GDP puts the equivalent of 2 percentage points of GDP of downward pressure on prices. A 60% drop in oil prices on imports of 3% of GDP brings only 180 points of downward price pressure. Currencies matter.

Most of Asia is now in easing mode, in spite of widespread expectations of Fed hikes later this year. There is no reason that part of this easing should not take the form of weaker currencies rather than lower interest rates. Especially when too-strong currencies are behind much of the need to ease in the first place. Swimming down the middle is always good policy. Asia could take better aim.

David Carbon, for

DBS Group Research

March 12, 2015

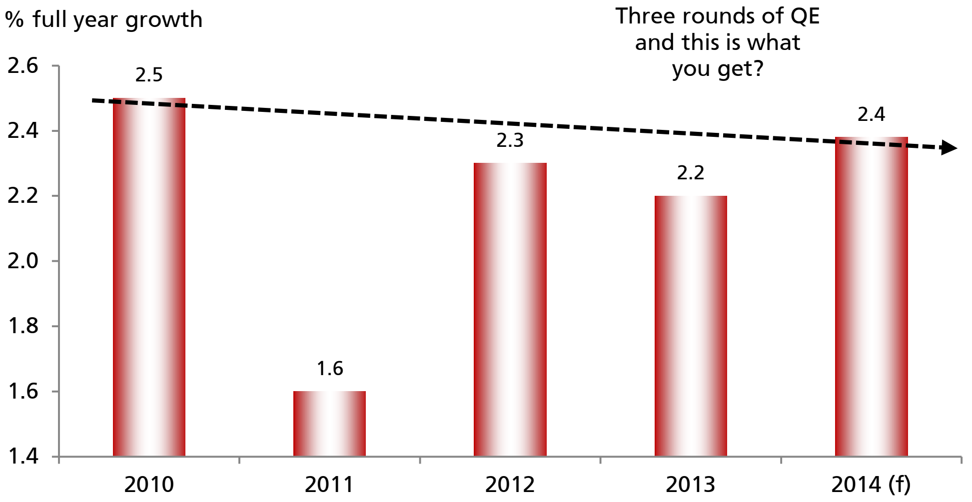
The real divergence in the global economy

- **The US isn't doing any better than it has for the past five years. Europe and Japan aren't doing any worse**
- **Divergence? Not as far as real economies are concerned. And where they go, monetary policy usually follows**
- **Asia continues to grind out 6.2% growth per year. That creates a Germany every 3.5 years. That's the real divergence in the global economy. It's the biggest thing going on today**
- **Asia's demand will help drive oil prices back to $100/bbl, probably by year-end**
- **Asia's currencies have strengthened too much against a simple basket of dollars, euros and yen. This is putting downward pressure on both growth and inflation. Such self-inflicted wounds are unnecessary**

Markets are being driven by perceived 'divergence' between the US, on one hand, and Europe and Japan on the other. The US is taking off; Europe and Japan are headed over the cliff. The Fed is about to hike interest rates; the BoJ and ECB are pursuing new / additional QE policies that will 'inject large amounts of liquidity into their economies'.

Most of this divergence is imagined, not real. The US isn't doing much better than it has for the past five years; Europe and Japan aren't doing much worse. The Fed may be on the cusp of hiking rates but the data continue to suggest there is no need to be and, if it does pull the trigger later this year, odds are it will proceed much more slowly afterwards than it ever has in the past. Meanwhile, the ECB

US – GDP growth



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and BoJ may expand their balance sheets further but that doesn't mean they are 'injecting' so much as nickel into their economies. Unless banks lend the money they receive into their economies, all is for naught. The Fed delivered three rounds of QE over six years and growth never accelerated. US inflation has been falling for three years and no, most of this has absolutely nothing to do with oil (more on this below). Ninety percent of the QE money the Fed 'injected' into the economy went nowhere but into the Fed's basement in the form of excess reserves. Banks prefer to leave it there than to lend it into the economy.

The Fed delivered three rounds of QE over six years. Growth has yet to accelerate; inflation is still falling

The situation is no different at other central banks, which is why many, including the ECB, now pursue negative interest rate policies. They charge private banks to leave funds there, in the hope that they will lend them into the economy instead.

Japan offers the clearest example of the impotence of QE. Over the past 20 years the BoJ's balance sheet has risen to 65% of GDP (compared to the Fed's 25% and the ECB's 21%). Is pushing it to 85% or 95% of GDP, as the BoJ intends, going to do the trick? Of course not. If the money doesn't go into the economy, another 200% of balance sheet expansion won't accomplish anything. You can lead a horse to water but you can't make him drink.

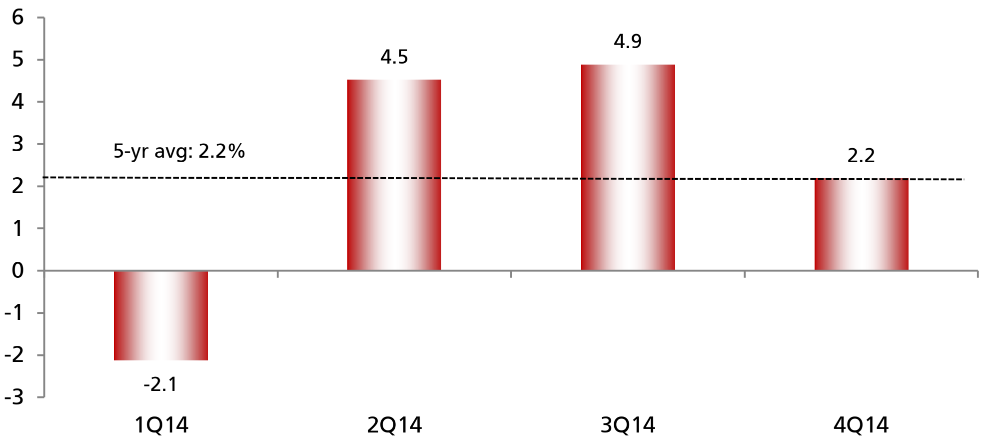
Where does that leave things? The US is still grinding ahead at a 2.25% pace, just as it has for the past five years. Europe and Japan are still grinding ahead at a 0.75%-1% pace, just as they have for the past five years. QE doesn't inject any liquidity anywhere. And the Fed, if it tightens at all, will proceed more slowly than it ever has in the past. Divergence? Not really. Not here.

The real divergence is in Asia. Not in the sense that it is all-of-a-sudden accelerating. It's not. It will grow at about a 6.25% pace in 2015. Like in the G3, just about what it's done for the past five years too. The divergence comes in what that 6.25% growth puts on the table. At that growth rate, Asia 'adds' a Germany to the world's economic map every 3.5 years. Look around – Asia has already grown nearly two Germanys since Lehman Brothers collapsed in 2008.

That's the real divergence in the global economy. And it will only widen in the years ahead. It's a big deal with big implications for oil prices, capital flows, middle class consumption, urbanization, pretty much anything you can think of. It's the biggest structural change going on in the global economy today. But we've talked about this a lot before so we won't dwell on it here [1]. We'll make a couple of points

US – GDP growth in 2014

% (QoQ, saar)



about oil prices and currencies but this report will mainly focus on the short-term cyclical divergence between the US, Japan and Europe. Or, rather, it's nonexistence.

United States

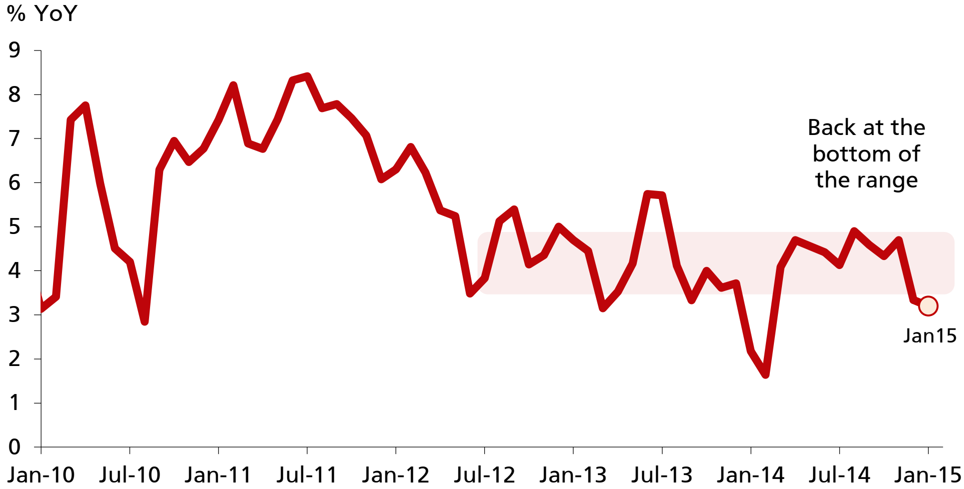
4.7% GDP growth in Q2 and Q3 wasn't strength per se, it was pay-back for the 2.1% contraction in Q1. Everyone seems to have forgotten this

Since hitting bottom in 2009, US growth has averaged 2.2% per year. Importantly for the 'divergence' theory, it's not accelerating (chart at bottom of page 6). Yes, growth in Q2 and Q3 of 2014 averaged 4.7% (QoQ, saar). But that wasn't strength per se, it was 'payback' for the bitter cold weather and the 2.1% contraction it caused in Q1 (chart at bottom of page 7). Temporary drop; temporary rebound. End of story. What happens next? Exactly what you would expect: 4Q growth drops back to 2.2%, right where it's been for the past five years. Surprise? Not at all.

That's GDP in its quarterly and annual forms. Do the higher frequency data show something better? Unfortunately, no.

Retail sales growth continues to run at 3.5%-4.5% on-year pace, just as it has since mid-2012. That's not a bad pace – nor is 2.2% GDP growth for that matter – the point here is simply that this is where we've been for 2.5 years. There is no sign of acceleration anywhere. In fact, the last two data points (Dec14 and Jan15) are on the low side of trend, not the high side. And for on-year growth, that's really-and-

US - retail sales growth

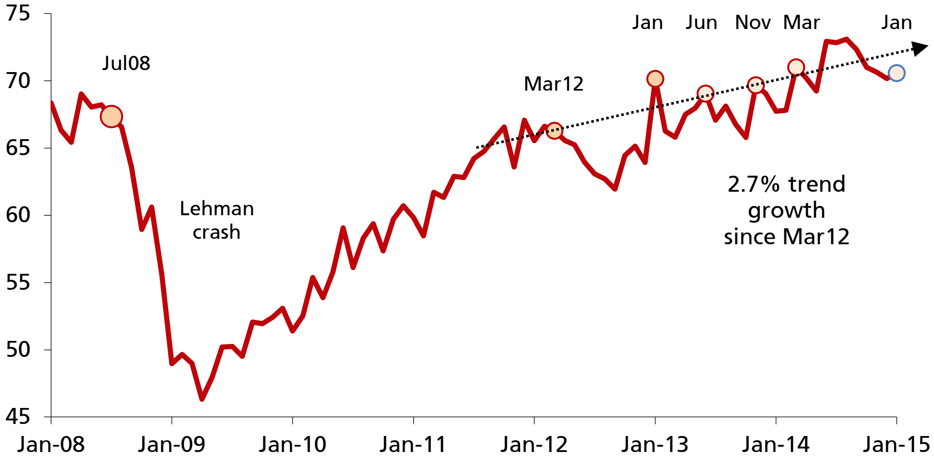


truly low because January's sales are being compared to Jan14, when cold weather had pushed them off a cliff. Growth ought to look abnormally high, not low.

Investment? Take a look at core capital goods orders at the top of the next page. You'll see the Lehman Brothers crash in Sep08, the recovery starting in mid-09 and, in early-2012 a sharp turn to the right towards more 'normal' growth. Normal might not be the right word – growth has been pretty slow since March 2012. You can't read it straight from the chart but the fact is trend growth has been a lowly 2.7% for the past three years. Two point seven percent growth for something as important as US core capital expenditures is very low – depreciation alone runs between 5%-8% for most of the equipment represented here, maybe more.

US – core capital goods orders

US$bn/mth, seas adj, non-def K goods, ex-aircraft



Core capital goods orders have been growing at a 2.7% pace for nearly 3 years. Capital depreciation rates are 2 to 3 times higher

Plainly, there's no evidence of strong demand in the investment space. As with retail sales, there is no evidence of acceleration anywhere. And once again, the past two months have been below trend rather than above it.

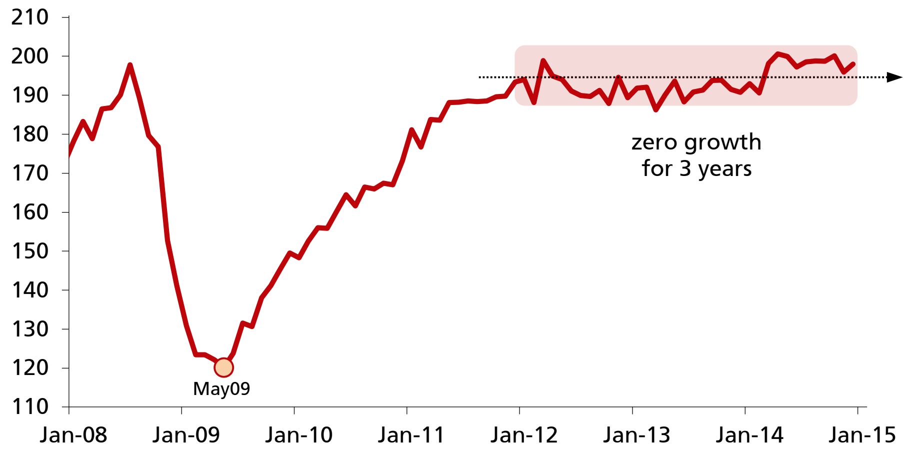
Imports are a great proxy for demand conditions overall – and especially relevant if anyone thinks the US is going to be pulling others along. Imports are the sum of all things – the kitchen sink, consumer goods, producer goods, final goods, intermediates, raw materials – you name it, it's in there. And if the US is going to be pulling the world along, they'd better be headed up. Are they?

Unfortunately, no. US imports haven't grown by more than a dollar in three years. That's not low growth, it's no growth. The US is not going to be pulling anyone along at that pace. And once again, this is the way it's been for three years.

What about job creation? Everyone's excited about the nonfarm payrolls and how much better things are today than not so long ago. But has job creation really

US - imports

US$bn/mth, sa, goods, BoP basis

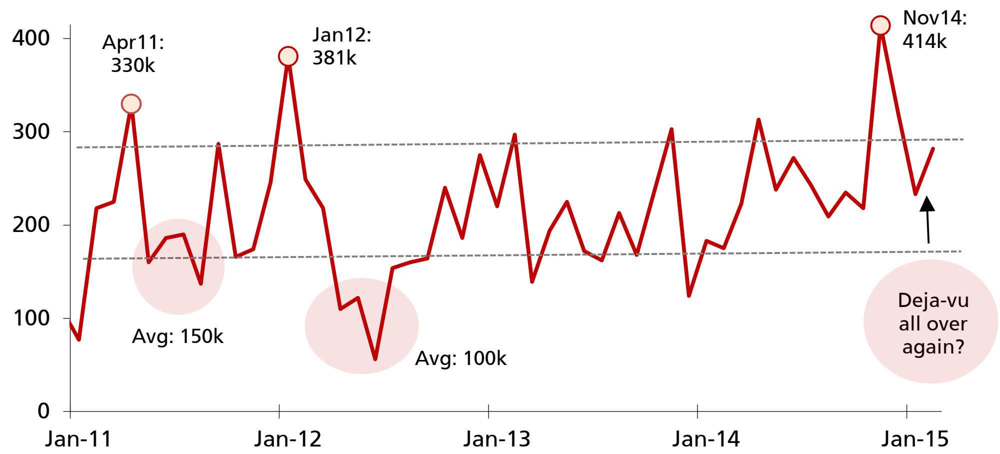


improved? You decide. Take a look at private sector payrolls since 2011 in the chart below. Do you see any change in trend? We don't. We see some good numbers in Nov14. But we've seen some good numbers before, like in early-2011 and early-2012. And every time they've looked great in the past, they've crashed hard soon thereafter. Don't look now but the latest 'good news' is starting to look like deja-vu all over again.

Do you see any change in trend in nonfarm payrolls? Be honest

US - private sector nonfarm payrolls

private sector NFP x1000, sa



Recovery is occurring. It's for real. But it's still painfully slow

None of this is to say the US isn't recovering. It is. It's just that it's not accelerating like so many seem to believe. Growth remains steady. And painfully slow.

Take the nonfarm payrolls mentioned above once again. Since January 2011, job growth has averaged 208k per month overall and 214k per month in the private sector. That may be a 'solid' number given the US (and everybody else) just went through the biggest crisis in 100 years but how much have labor markets recovered? That's a different question with a different answer.

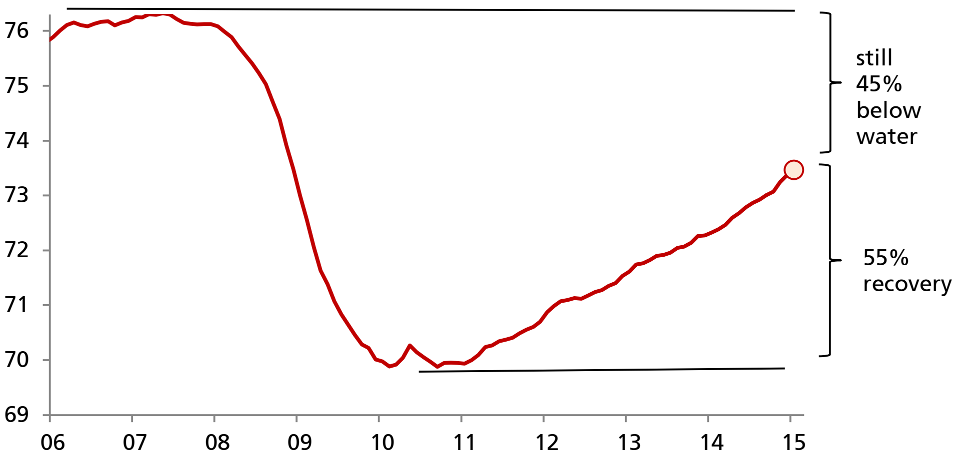
The usual measure of recovery is the unemployment rate, which has fallen, officially anyway, to 5.7%. That's not far from the 5%-5.5% that many consider to be 'full-employment'. But nobody knows if the 5.7% is real or not. Fed Chair Yellen expressed her doubts last August when, at Jackson Hole, she proclaimed 19 other indicators still pointed to much unemployed labor. The labor force participation rate is, give or take a tenth of a percentage point, at its lowest since 1977. Is that because people have given up looking for jobs and dropped out of the labor force (implying a useless statistic)? Or is it because Americans are aging / retiring? The answer remains unclear.

We think the best measure of labor market recovery is simply the fraction of working age Americans who hold a job. This takes the retiree question out of the picture. And what does this gauge say?

That recovery is proceeding, just like Fed officials say. It has to be recovering if 214k nonfarm jobs are being created every month. But the population continues to grow too. The goal post is moving. Bottom line? The proportion of working-age Americans who hold a job has recovered 55% of the ground lost since the 2008 collapse of Lehman Brothers (chart below).

US – nonfarm payrolls as % of working age population

percent



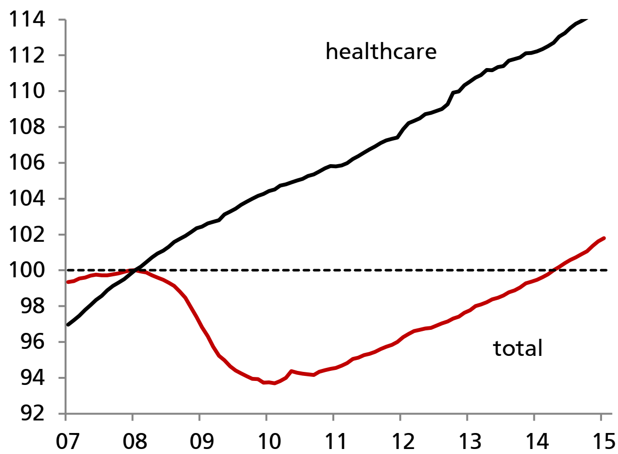
The proportion of Americans with jobs has recovered one-half of the ground lost in 2008/09

That's definite progress. Maybe even solid progress. But it's not especially rapid progress. Five years after the economy hit bottom, the US has recovered only a little more than half the ground lost during the crisis. At this pace, it would take another four years for labor markets to fully recover. It could take another four years for consumption growth and inflation to revert to normal too.

Sadly, even this picture overstates the amount of labor market recovery. That's because many of the jobs created over the past 5 years have been in healthcare. Those jobs kept rising all through the crisis (chart at right). Is that bad? Of course not. Healthcare jobs are among the most valuable in any society but their steady rise is a structural issue, not a cyclical one. If you want to see how much true cyclical recovery there has been from the cyclical downturn, you need to remove them from the picture. When you do, you find that the labor market has recovered only 45% of the ground it lost in 2008 rather than 55%. Five years after hitting bottom, labor markets have recovered less than half their cyclical losses.

US – nonfarm payrolls

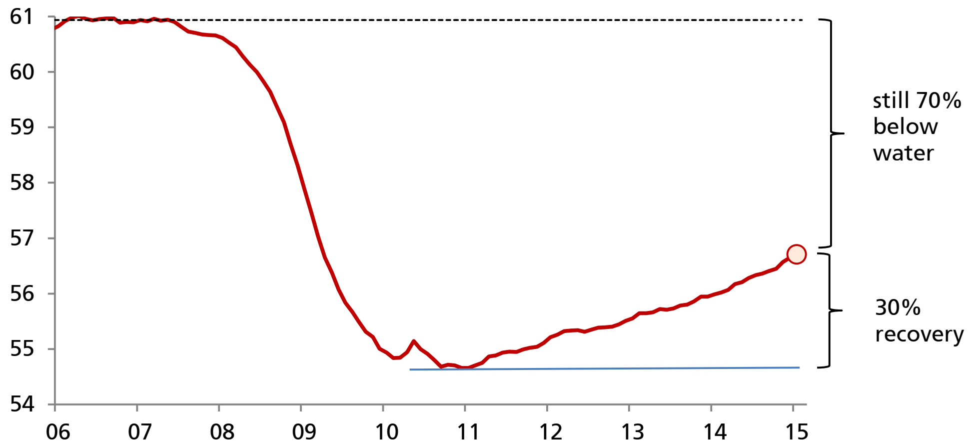
Jan08=100, sa



It gets worse. Many new jobs have been part-time and/or restaurant jobs – dishwashers, cooks, waitresses and so on – taken up by people qualified for more productive work. If you remove part-time and restaurant workers from the picture, labor market recovery drops to a distressing 30% (chart below). Five years after hitting bottom, the US is less than one-third of the way back to 'normal'. Even with 214k nonfarm jobs being created every month. Progress is real. But really slow.

US – nonfarm payrolls as % of working age population

percent, ex-part time, restaurant and healthcare



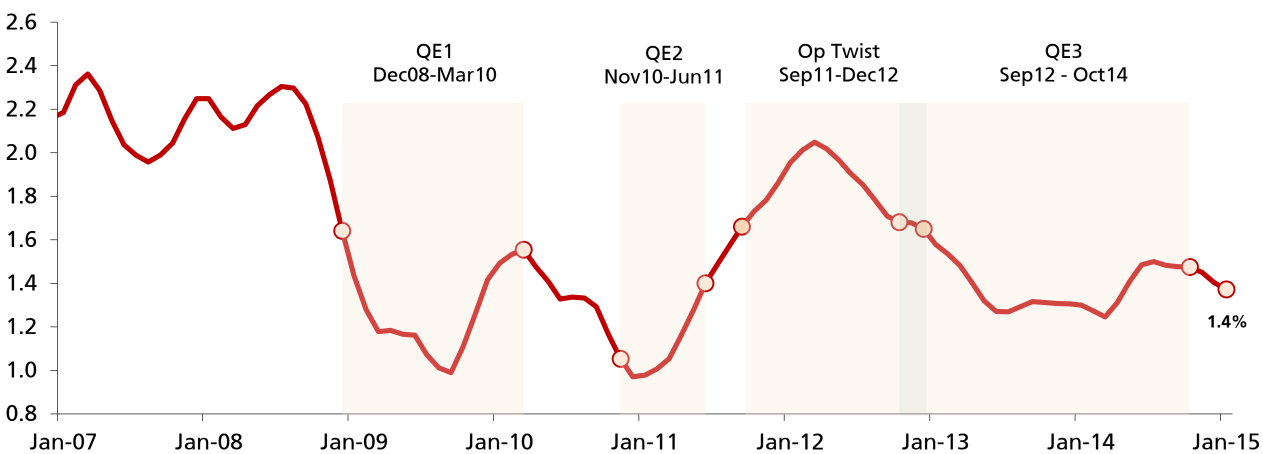
Outright deflation in 17%of the economy

Plainly, the data aren't screaming for rate hikes. But the Fed has to be forward-looking. It has to watch for signs of rising inflation. Are there any? No. On the contrary, core PCE inflation – the Fed's favored gauge – has been falling for three years (chart below).

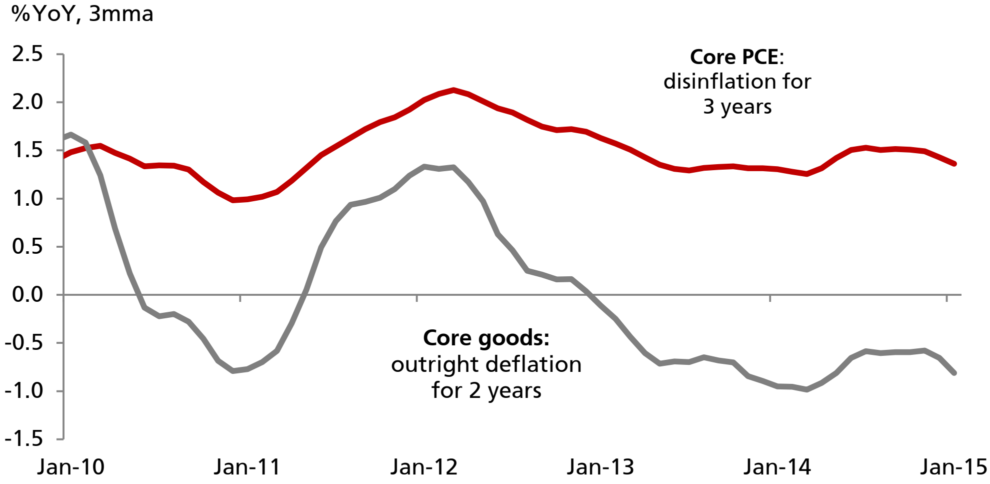
The Fed's explanation of this is nonsense. The Fed says falling inflation is due to low oil prices, which have fallen by 50% over the past 8 months. But core PCE deflation has been falling for three years, not six months, and it doesn't have any oil in it to begin with.

US - core PCE inflation

% YoY, 3mma



US – core PCE deflator inflation



One quarter of the Fed's favorite inflation gauge has been showing outright deflation for two full years. Why hasn't the Fed mentioned this?

The real reason core PCE inflation has been falling for three years is that 26% of that core – the goods portion – has been in outright deflation for two of them. Not low inflation, not disinflation – outright deflation is occurring in more than one-quarter of the Fed's favorite gauge. Strange that the Fed hasn't picked up on this. Inflation is half their job and this is the index they put above all others.

Is deflation in just an item or two distorting the whole picture? No. Over and above energy – because we're talking about the core now – auto prices are down by one percent from a year ago. Clothing prices are down by 1% from a year ago.

US – PCE deflator inflation / deflation

% YoY

	Jan 2015	Jan 2015 3mma	Share in total consumption (%)	Share in GDP (%)
Overall PCE	0.2	0.7		70
Core (ex-food, energy)	1.3	1.3	87	61
Goods	-3.7	-2.3	33	23
Nondurable goods	-3.7	-1.7	22	16
Durable goods	-2.8	-2.7	11	7.6
Goods (ex-food, energy)	-1.0	-0.9	23	16
Energy (Motor veh & HH fuel)	-33	-21	3.3	2.3
Motor vehicles	-0.9	-0.8	3.8	2.6
Clothing	-0.8	-0.6	3.1	2.1
Household furniture & appliances	-3.5	-3.3	2.4	1.7
HH furniture	-2.4	-2.3	1.4	1.0
HH appliances	-5.2	-4.8	1.0	0.7
AV / Photo / Computer	-7.6	-7.4	1.8	1.3
AV	-8.8	-8.7	0.9	0.6
Photo equip	-7.0	-5.7	0.04	0.0
Info tech	-6.4	-6.0	0.9	0.6
Computer hardware / tablets	-9.9	-9.3	0.5	0.3
Computer software	-1.8	-1.5	0.4	0.3
Smartphones, calculators	-10.6	-10.4	0.02	0.01
Jewelry	-2.5	-3.4	0.7	0.5

Household furniture and appliance prices are down by 2.4% and 5.2% from a year ago. TVs prices are down by 9% YoY. Computers are down by 10%. Smartphones, 11%. Jewelry, 3%. Even software prices are down by some 2% YoY.

It's a lot of falling prices. And it adds up. The goods chunk of the core PCE deflator represents 17% of GDP and prices are falling at an average rate of 1% YoY.

It's not oil. It's not 6 months. It's 17% of GDP (over and above oil) and its outright deflation for two years. And, to our knowledge, the Fed hasn't mentioned it once.

Why is this? We don't know. Officials appear to be too busy telling markets that interest rates at zero is not normal. No argument there. It isn't normal. But two years of deflation in one-sixth of the economy – over and above oil – isn't normal either.

Japan and the Eurozone aren't faring any worse than they have for the past five years. There's no 'divergence' from this angle

Juxtaposed against the non-accelerating growth in the real economy, falling prices are another reason to expect that, if the Fed does decide to pull the trigger on rates later this year, it probably won't move very far or very rapidly thereafter.

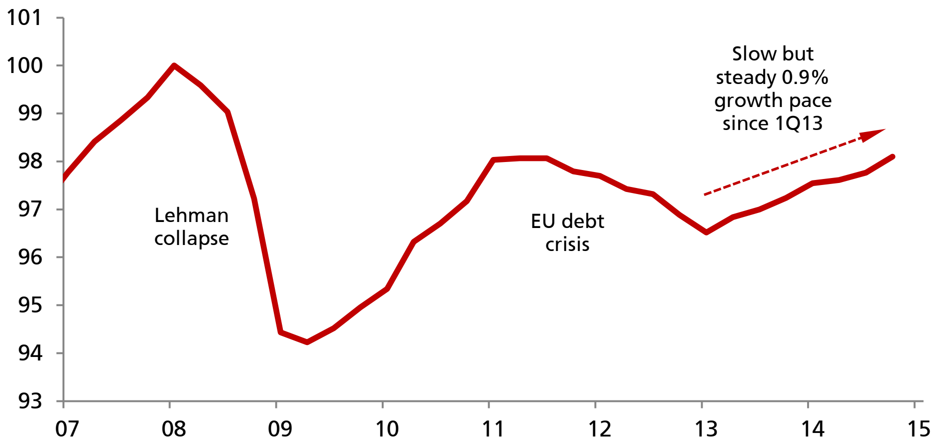
Divergence in the global economy? Not from the US side.

Europe and Japan

If the US isn't headed off to the moon, neither are Europe or Japan headed off the cliff. After drifting down to 0.3% (QoQ, saar) in the second quarter of 2014, Eurozone GDP expanded by 0.6% and 1.4% in the third and fourth quarters. Full year growth came to 0.9% and we expect the same in 2015. Draghi was right to pursue QE but only in the sense that central bank governors are not supposed to throw up their hands and do nothing when growth is this slow and inflation is falling. That doesn't mean QE will prove any more effective in Europe than it did in the US over the past six years or in Japan over the past 20. In fact, it almost surely will not.

Eurozone – GDP

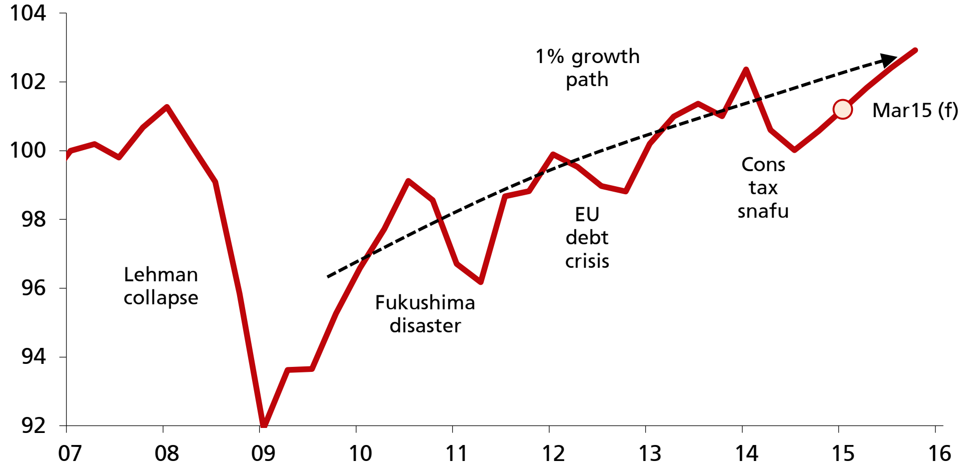
Mar08=100, sa, 2010P



In Japan, industrial production hit bottom in Aug14 and has run sharply northward ever since. It's been a tough six years for Japan but, economically anyway, no tougher than in the Eurozone. Through the ups and downs of the Fukushima disaster in 2011, the European debt crisis in 2011/12 and the consumption tax snafu in 2014, Japan continues to cling to a 1% growth path (chart at top of next page). We expect 1.3% full year growth in 2015. Like in Europe and the US, QE from the central bank was never going to deliver real growth or higher inflation. Only a third arrow from Abe's quiver (aimed at structural change) might accomplish that. Sadly, the odds of it appearing seem to grow slimmer by the month.

Japan - GDP

Mar03=100, seas adj



What divergence?

Put it together. The US continues to run at a 2.25% pace; Japan and Europe continue to run a 1%-odd pace. All three regions are doing just about what they've done for the past five years.

Divergence? Not so much. At least in the real economies. And where they go, monetary policies usually follow.

Asia

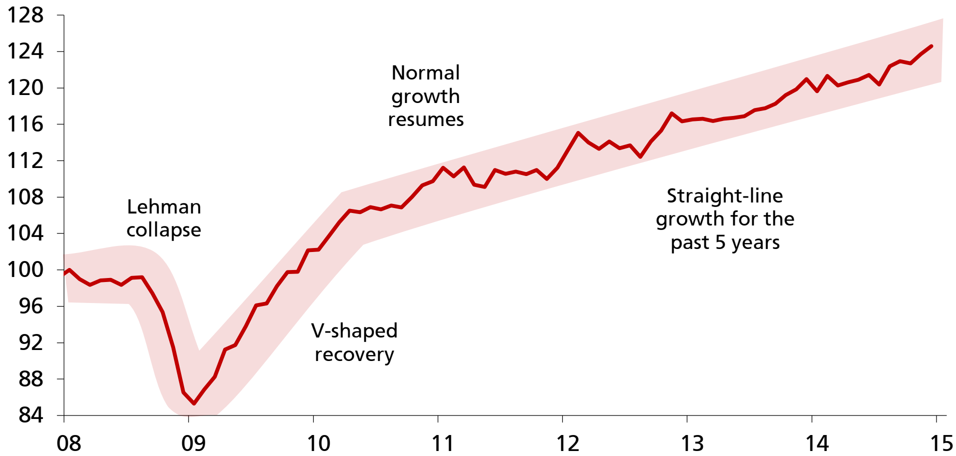
Asia continues to grow at the 6.25% pace it has for the past four years

In contrast to popular opinion, Asia isn't growing slower and slower. It double-clutch-downshifted four years ago, thanks mainly to China, and has run at a 6.2% - 6.5% pace ever since. This year, we expect 6.3% GDP growth in the Asia-10, essentially unchanged from the 6.4% growth in 2014 and 2013, and the 6.2% registered in 2012.

Asia's stable trajectory can be clearly seen in the high frequency plots of industrial production and exports as well. On the supply side, industrial production has long been the best single indicator of cyclical ups and downs. In the chart below, the

Asia 10 - industrial production

Jan08=100, seas adj, ex-TH



plunge following the collapse of Lehman Brothers is easily seen, as is V-shaped recovery that took hold in early-2009. The upward portion of the 'V' was never going to last and took its inevitable turn to the right in early-2010.

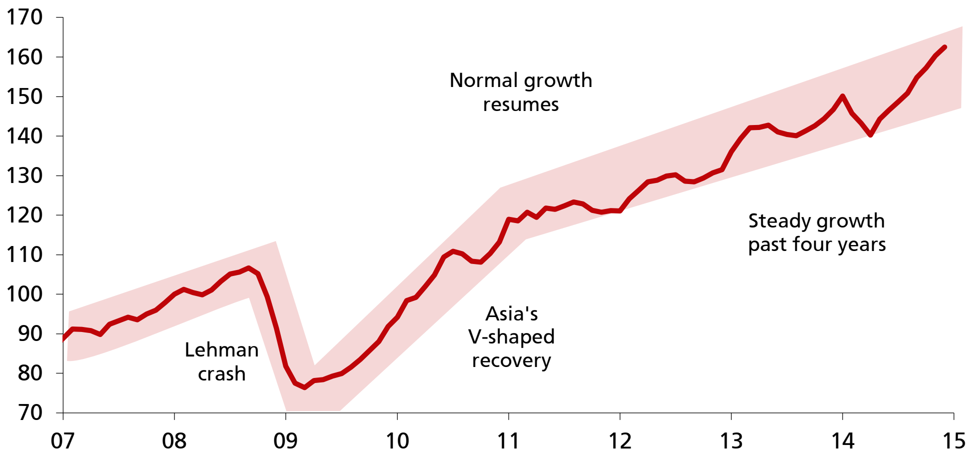
Ever since, it's been straight line IP growth for the Asia-10. The zigs and zags seen in the chart will often reveal sharp swings in growth rates on quarter-by-quarter basis. But that's a forest-vs-trees problem. Look at the broader picture and you see immediately that there has been no change in trend over the past five years.

Ditto for exports, where the 'square-root' path is seen just as clearly. Asia's V-shaped export recovery turned to the right in early-2011 and has run a 7-odd percent growth path ever since. How do you get 7% export growth in Asia when, as we showed above, US imports haven't grown by more than a dollar in 2.5 years? By trading with regional neighbors. Asia's domestic demand is powering Asia's growth; intra-regional trade continues to rise.

How are Asia's exports rising when US imports are not? Asia is trading with Asia

Asia 10 – exports

Jan08=100, sa, 3mma, avg USD, EUR and JPY terms



The real divergence

The four key regions of the world – Asia, the US, Europe and Japan – all continue to grow at a pace largely unchanged from the past 4-5 years. Any divergence in real economies – especially as between the US on one hand and Europe/Japan on the other – is purely imagined. Divergence in monetary policies is, therefore, likely to prove less eventful than most imagine as well.

The real divergence in the global economy continues to be that between Asia and the G3 – the US, Japan and Europe. As noted above, it's not that Asia is speeding up – far from it. The divergence lies in Asia's vastly higher growth rate – 6.25% compared to 2.25% for the US and 1-odd percent for Europe and Japan – and what that implies for the dollar amount of new demand that Asia puts on the global table each year vis-a-vis the G3. Those dollars are the very definition of global growth and Asia is generating far more of them than any other region of the world.

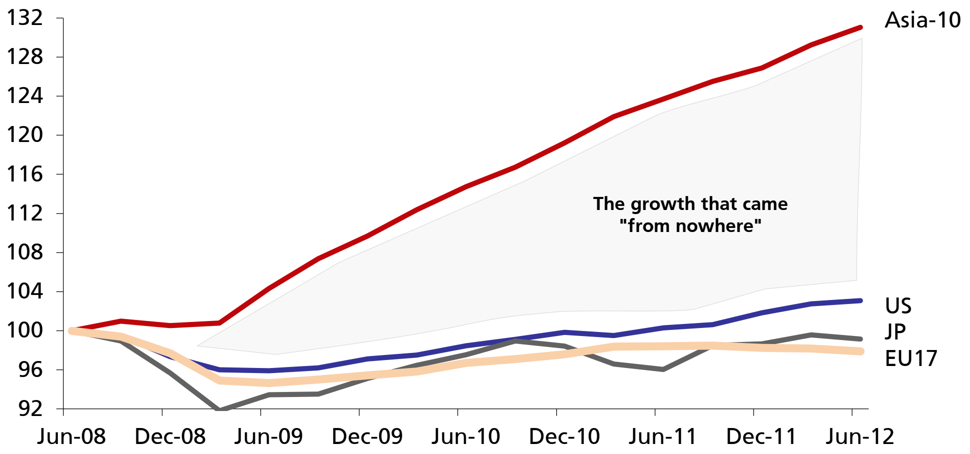
We've talked about this often before and we won't rehearse it all here. The fast facts are that Asia puts 2.5x as much new demand on the global table each year as the US does. How's that? Simple. In terms of size, the Asia-10 is every bit as large as the US – both regions have a GDP of some \$16trn. But Asia grows at a 6.25% rate; the US at a 2.5% rate (if it's lucky). The new demand that Asia creates in a given year (\$16trn x 6.25%) comes to \$1000bn; that generated by the US comes to \$400bn (\$16 trn x 2.5%). In short, for every dollar of new demand the US puts on the global stage, Asia puts up \$2.50.

This is how Asia managed, in the four years between mid-2008 and mid-2012, to do what everyone said was impossible: to grow by 7.25% per year – an almost average rate back then – while the US, Japan and Europe went nowhere (chart below). The dollars of growth Asia generated in those four years amounted to the entire GDP of Germany. Fascinating, as Mr Spock would have said. In the middle of the biggest crisis in 100 years, Asia put an entire Germany on the map, right here in Asia, and it did it with no help from the US, Europe or Japan.

Asia has slowed since then of course. Even so, it doesn't take 4 years for Asia to 'grow' a Germany any more. Today, it takes only 3.5 years. Five years from now, it will take only 3 years. Asia will continue to slow in the years ahead. Nevertheless, the time it takes to put a Germany on the map will grow shorter and shorter. Today,

Real global GDP

2Q08=100, seas adj



Asia 'adds' a Germany to the world's economic map every 3.5 years, right here in Asia

Asia is 2.5x the driver of global growth the US is. That multiple will grow rapidly in the years ahead.

Two points: First, this is the global divergence that matters. It's the biggest structural change underway in the global economy today. Forget the US vs Japan and Europe. That will be gone in a month, maybe two. The big stuff is Asia vs the rest of the world. It's here now and it's here to stay.

Second, the implications of this divergence run in all directions, including for the price of oil, a topic to which we now turn.

Oil

The 60% drop in the price of crude over the past 8 months – now 40% after a significant rebound – never and still doesn't make sense from many angles. It was, for example, the second-sharpest drop in history, surpassed only by the plunge during the global financial crisis of 2008/09. Is the global economy imploding like it was in late-2008? No. It's sure not booming but the bust came long ago.

Moreover, the gap between supply and demand that ostensibly drove the plunge amounted to a 1 million barrel/day surge in US shale oil production and a 750 thousand bbl/day drop in demand from Europe and Japan. That 1.75 million bbl/day gap amounts to a very small 2% of total global supply and demand (see "Global crude: low for long?", 19Jan15). How does a 2% gap in supply and demand drive a 60% drop in price? No one has an answer, just like no one predicted the price plunge in the first place.

We reckon it has mainly to do with financial markets amplifying / leveraging the modest shifts in fundamentals many times over in the quest for yield. But when prices move this far without fundamental underpinnings, they often move back just as quickly. Brent crude prices have already "V-bounded" by 35% since hitting a $45/bbl bottom in mid-January. And, as discussed in more detail in the note cited above, we suspect they will continue north over the remainder of the year.

Everyone overlooked Asia's ability to generate demand in 2008-2012. Most continue to overlook Asia today when they think about oil prices

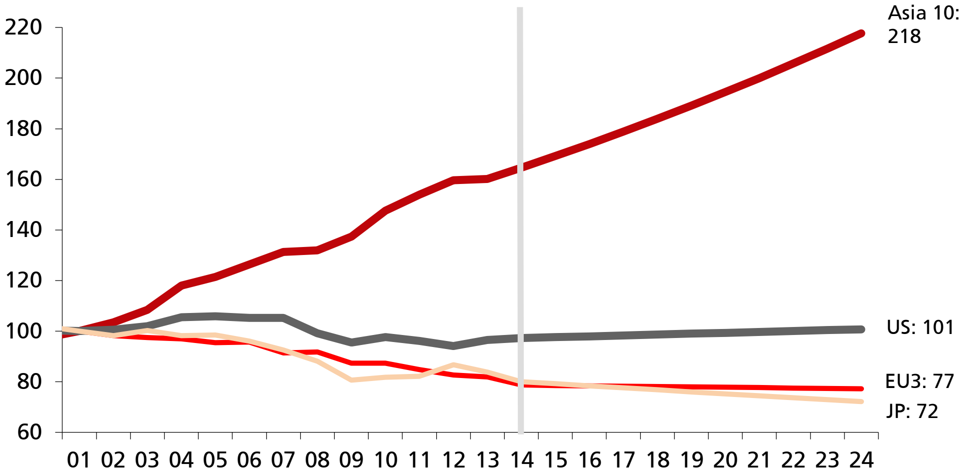
In the very short-run, this is because both the boost in shale supply and the drop in demand from Europe and Japan seen in 2014 are unlikely to be repeated this year. That eliminates most of the supply-demand gap right there. Add to this the expected growth in Asian demand in 2015 – some 650 thousand bbl/day – and excess supply could easily turn to excess demand by the end of this year. A V-bound would be expected from this angle as well.

But it's over the next 2-3 years – and far more so the further out one looks – where the fundamentals of Asian demand growth really swamp whatever supply-demand gaps might have existed in 2014. Have a look at the chart of G4 oil consumption below. It looks almost identical to the chart of G4 GDP shown on the previous page. In fact it is almost identical, except that it's oil demand you're looking at and it begins 10 years earlier and ends 10 years later than the chart of GDP.

But the story and the message are the same. Demand from the US, Europe and Japan has run sideways to downward for the past 14 years. In Asia, it's gone nowhere but up. That will all continue. In the G3, comparatively low GDP growth and continued efficiency gains mean crude demand will continue to run sideways-to-downwards. In Asia, faster GDP growth and rising incomes mean crude demand will continue to soar (if by less than GDP growth). Asia is already the largest consumer of crude in the G4; by 2024 Asia will consume more than the US, Europe and Japan combined (chart at top of next page).

Global petroleum consumption

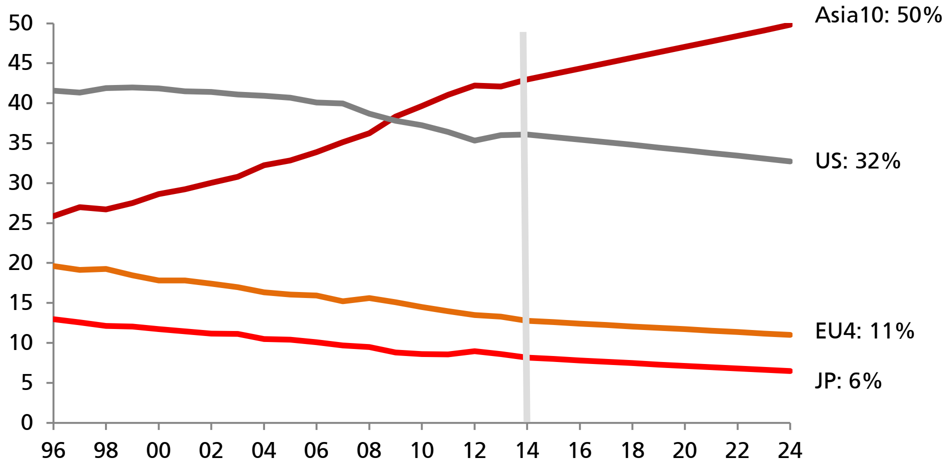
bbls/ year, 2001=100



It's truly strange that nobody predicted the drop in crude prices and now nobody predicts they will go back up. Did we know nothing about oil before prices fell? If the answer is yes, what makes us think we know anything now? If we did know something about oil before prices plunged, then shouldn't we expect them to rise again fairly quickly?

Global petroleum consumption shares

percent share in total G4 consumption



In 10 more years, Asia will consume more petroleum than the US, Europe and Japan combined

Still, most don't. What are people missing? The biggest thing, we think, is Asian demand. Just as everyone overlooked Asia's ability to create a Germany in 2008-2012 – indeed most argued it was impossible – everyone seems to be overlooking Asia's ability to generate crude oil demand today.

Fool me once, shame on you. Fool me twice...

We reckon Asia's demand growth should eliminate the supply-demand mismatch in a year's time, if not sooner. Prices would then reasonably be expected to return to the $100/bbl averaged over the past three years. But if financial markets begin to sense $100 oil in a year's time, they would put prices there today. After all, compared to today's Brent price of $61/bbl, that would bring a 40% return. Nobody expects that from equities or anything else. One more reason why crude could go back up just as quickly as it fell.

Divergence and currency policy

Divergence between the US and Japan/Europe is a myth but maybe that's why it's taken on mythical proportions anyway. Sentiment is often self-fulfilling in the short-term and the implications are most evident in currency markets.

Since July of 2014, QE and expectations thereof in Europe and Japan have pushed the yen and euro down by 20% against the dollar. With the dollar soaring and the euro and yen tanking, where have Asia's currencies swum? Right down the middle, mostly, just as one would have hoped. They have fallen against the dollar but risen against the euro and yen and, in so doing, have maintained a modicum of stability amidst very stormy seas.

Truth be told, most Asian currencies haven't swum 'right' down the middle. Most have clung to the dollar more than they should have. Measured against a simple basket of dollars, euros and yen, all of Asia's currencies, save for the ringgit, have appreciated by 2.5%-12% since July (table below). This isn't necessarily, or even generally, a good thing.

On the brighter side, inflows into India and Indonesia – over and above that needed to finance current account deficits – have pushed currencies and FX reserves north. Compared to July, the rupiah has appreciated by 2.5% against the tri-currency

Asia – FX appreciation since July 2014
% appreciation, 3d avg ending 6Mar15 relative to Jul14 mth avg

	CNY	HKD	KRW	TWD	IDR	SGD	MYR	PHP	THB	INR	A10	A9	A Big 3	Asean
vs USD	-1.1	-0.1	-7.1	-4.6	-9.1	-8.7	-11.7	-1.5	-0.8	-2.8	-4.8	-5.2	-4.4	-6.4
vs JPY	16.3	17.5	9.2	12.1	6.9	7.3	3.8	15.8	16.6	14.2	11.9	11.4	12.4	10.0
vs EUR	19.6	20.9	12.4	15.4	10.0	10.4	6.8	19.2	20.0	17.5	15.2	14.7	15.7	13.2
vs Tri ccy	11.4	12.5	4.6	7.4	2.4	2.8	-0.6	10.9	11.7	9.4	7.2	6.7	7.7	5.4

basket and Indonesia's reserves have risen by US$4bn. The rupee is up by 9% and India's reserves have risen by $14bn.

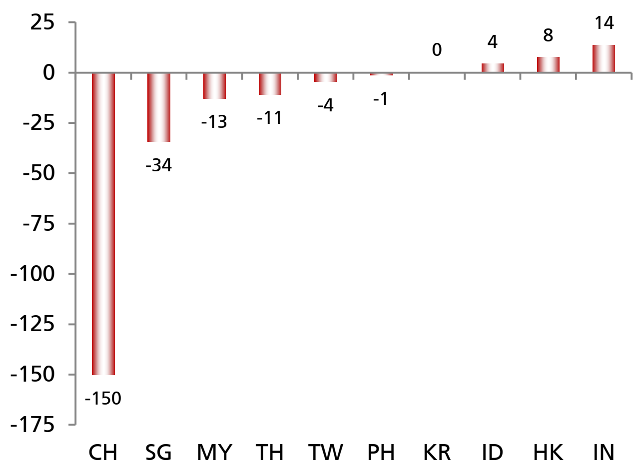
In other countries, however, outflows have been the order of the day and central banks have spent a good portion of their reserves keeping currencies strong. Since July, China's reserves have fallen by US$150 billion, thanks mainly to 'keeping up with the Joneses'. The CNY has barely fallen against the dollar and has thus appreciated by 11.4% against the tri-currency basket. Singapore's reserves have fallen by US$34bn since July – counting spot and forward holdings, as the IMF says one should – the quid pro quo of keeping the Sing dollar on its appreciation path. In six short months, reserves have fallen by the equivalent of 11% of a full year's GDP. Little wonder the central bank eased back on the appreciation path in late-January. Further easing will be necessary if reserves don't stop falling.

But it's not just China and Singapore where reserves are being spent propping up currencies. Thailand, Malaysia, Taiwan and the Philippines have all spent the equivalent of 1%-4% of a full year's GDP just over the past six months supporting exchange rates.

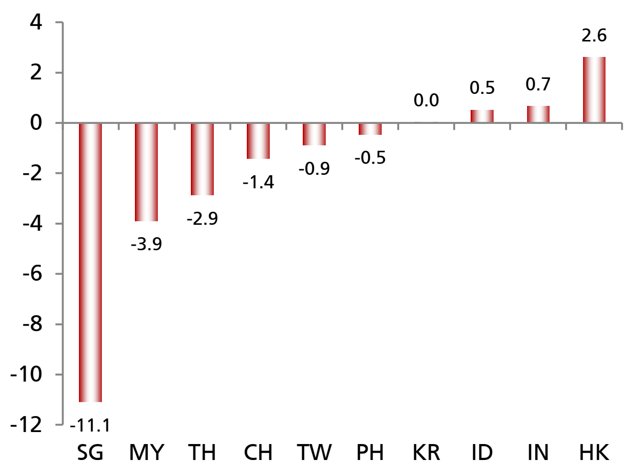
The question is, for what? Growth in the region is 6.2% – pedestrian at best. Inflation is falling hard and fast; in Singapore it is negative.

Too-strong currencies are at least as big a driver of falling inflation regionally as the drop in oil prices. Think about it: imports account for 20%-35% of GDP in Asia, much more in Singapore and Hong Kong. Oil imports account for 1%-6% of GDP. An 8% currency appreciation on imports worth 25% of GDP puts the equivalent of 2 percentage points of GDP of downward pressure on prices. A 60% drop in oil prices on imports of 3% of GDP brings only 180 points of downward price pressure. Currencies matter.

Asia – change in foreign reserves, past 6 months
USDbn, Jun14-Dec14, spot plus forward holdings



Asia – change in foreign reserves, past 6 months
% of GDP, Jun14-Dec14, spot plus forward holdings



In a complete reversal of the 'Taper Tantrum' of 2H13, India and Indonesia are being blessed today with inflows that more than finance their current account deficits. Unexpectedly, they face the classical 'nice problem to have'.

Much the rest of Asia appears to be delivering self-inflicted wounds, holding currencies stronger than necessary. Notwithstanding widespread expectations of Fed tightening later this year, most countries in the region have moved into monetary easing mode. There is no reason that part of that easing should not take the form of weaker currencies rather than lower interest rates. Especially when too-strong currencies underlie much of the need to ease in the first place.

One quarter down...

There's no reason why easing in Asia should not take the form of weaker currencies rather than lower interest rates. Especially when it is too-strong currencies that underlie much of the need to ease in the first place

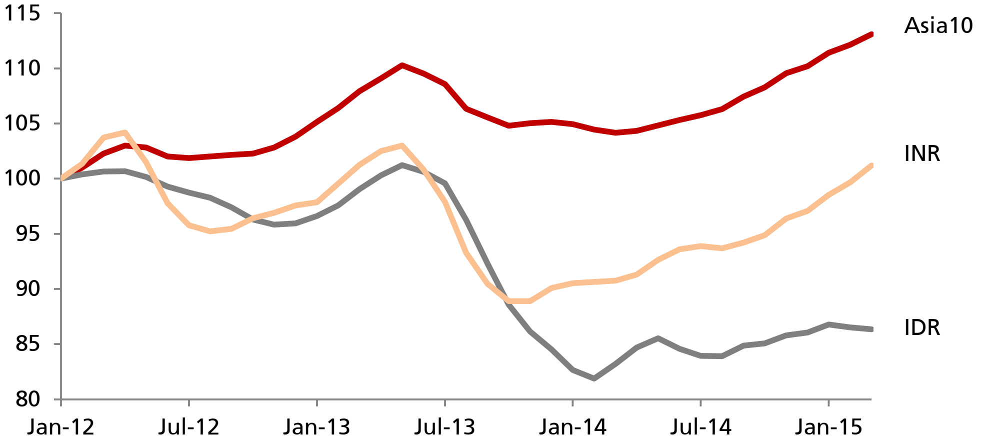
2015 has started off fast. Where do we find ourselves? Just about where we've been for the past four years, whether you're in the US, Europe, Japan or Asia. Real economies are running on the same keel – rising at a 1% pace in Europe and Japan, a 2.25% pace in the US and a 6.25% pace in Asia. On the monetary policy front, the BoJ is pursuing QE, but it's been doing that for twenty years. The ECB is again expanding its balance sheet but it won't be doing any more good there than it did in Japan or the US. The US has ended six years and three rounds of QE with no apparent impact on growth and inflation still falling. One quarter of the Fed's favorite index – the core PCE deflator – has been in outright deflation for two full years. Slow, steady growth and still-falling inflation are two good reasons why the Fed might want to delay raising interest rates. If it does go ahead and pull the trigger later this year, there is every reason to believe it won't get very far afterwards. Divergence? If you say so.

And Asia – once again we come to the conclusion that it will continue to drive its own growth this year and beyond. The 6.25% growth pace we expect in 2015 will be a fourth in a row. At that rate, Asia puts a Germany on the map every 3.5 years. That is the global divergence that matters. It's the biggest thing going on in the global economy today. Most missed it in 2008. We ignore it again at our loss, perhaps our peril.

In spite of this growth force, Asia is shooting itself in the foot by holding currencies too strong. Most of Asia is in easing mode made necessary in part by central banks' unwillingness to allow currencies to absorb more of the large swings in the dollar, euro and yen. Swimming down the middle is always good policy. Asia could aim a little better.

Asia – currency values vs tri-ccy (USD, JPY, EUR)

Jan12=100, incr= appr'n, 3mma



Sources:

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

Notes:

[1] For a short summary, see "Asia: gamechangers", May 5, 2014.

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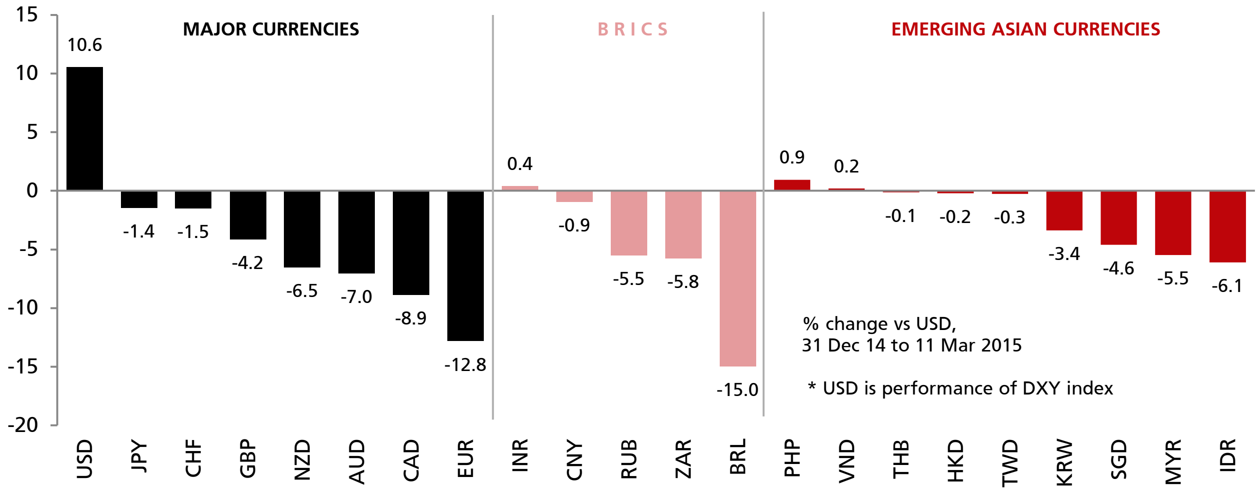
FX: mighty USD

Asia	**USD is underpinned by monetary policy divergences**
	Past half-year was mostly about QEs in Eurozone and Japan
	Rest of 2015 will be about looming Fed hikes
	Asian currencies weaker vs USD, but appreciated on NEER
CNY	**Easing again**
HKD	**Monitoring financial stability**
TWD	**Better growth, weaker politics**
KRW	**Multiple headwinds**
SGD	**Slower trade-weighted appreciation**
MYR	**Rating downgrade risk**
THB	**Not that resilient**
IDR	**Weakness returns**
PHP	**Sound but not immune**
VND	**Stable despite devaluation**
INR	**Not bucking strong USD**
USD	**Fed hikes looming**
EUR	**Parity on QE**
JPY	**Weak on BOJ and Fed**
AUD	**Dovish and overvalued**
NZD	**Very overvalued**

USD started year 2015 on a strong note



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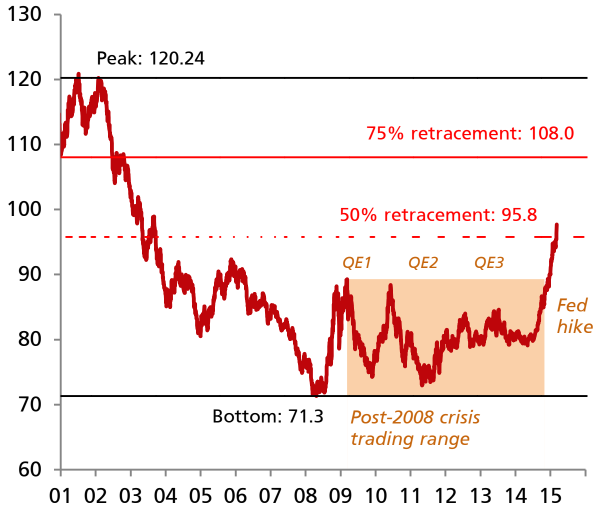
Currency forecasts

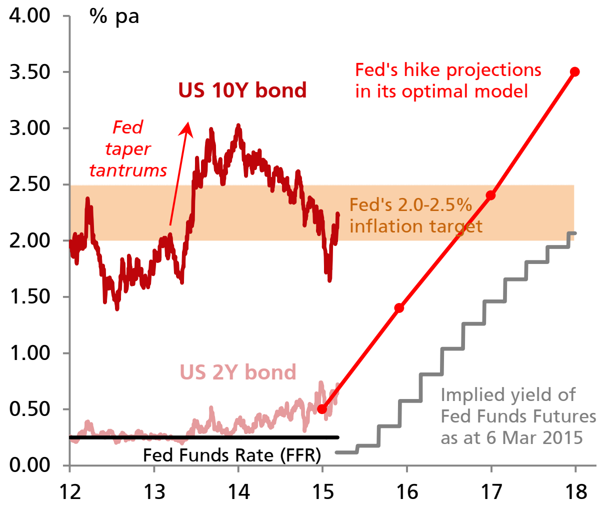
		11-Mar	2Q15	3Q15	4Q15	1Q16
EUR /usd		**1.0545**	**1.08**	**1.06**	**1.04**	**1.02**
	Previous		1.12	1.11	1.10	1.10
	Consensus		1.10	1.08	1.08	1.08
usd/ **JPY**		**121.44**	**121**	**122**	**123**	**124**
	Previous		122	123	124	125
	Consensus		122	124	125	125
usd/ **CNY**		**6.2623**	**6.30**	**6.33**	**6.36**	**6.39**
	Previous		6.25	6.20	6.15	6.15
	Consensus		6.24	6.22	6.20	6.18
usd/ **HKD**		**7.7706**	**7.76**	**7.77**	**7.77**	**7.78**
	Previous		7.77	7.77	7.78	7.77
	Consensus		7.76	7.76	7.76	7.76
usd/ **TWD**		**31.703**	**31.8**	**32.0**	**32.2**	**32.4**
	Previous		31.5	31.7	31.8	31.7
	Consensus		32.0	32.0	32.2	32.0
usd/ **KRW**		**1131**	**1118**	**1133**	**1147**	**1161**
	Previous		1130	1140	1150	1145
	Consensus		1120	1130	1135	1140
usd/ **SGD**		**1.3886**	**1.38**	**1.39**	**1.40**	**1.41**
	Previous		1.34	1.35	1.36	1.36
	Consensus		1.37	1.38	1.38	1.38
usd/ **MYR**		**3.6970**	**3.67**	**3.69**	**3.71**	**3.73**
	Previous		3.64	3.66	3.68	3.67
	Consensus		3.66	3.66	3.67	3.65
usd/ **THB**		**32.900**	**33.0**	**33.2**	**33.3**	**33.5**
	Previous		33.3	33.4	33.6	33.5
	Consensus		33.1	33.2	33.7	33.7
usd/ **IDR**		**13186**	**13250**	**13460**	**13660**	**13870**
	Previous		12550	12725	12900	12850
	Consensus		13000	13000	13086	13058
usd/ **PHP**		**44.330**	**45.2**	**45.3**	**45.4**	**45.4**
	Previous		45.2	45.3	45.4	45.3
	Consensus		45.0	45.2	45.4	45.5
usd/ **INR**		**62.780**	**63.6**	**64.6**	**65.6**	**66.7**
	Previous		64.4	65.5	66.5	66.0
	Consensus		62.8	63.0	63.0	63.1
usd/ **VND**		**21325**	**21350**	**21350**	**21350**	**21350**
	Previous		21250	21250	21250	21250
	Consensus		21517	21575	21650	21638
AUD /usd		**0.7593**	**0.75**	**0.72**	**0.70**	**0.67**
	Previous		0.80	0.78	0.76	0.77
	Consensus		0.76	0.75	0.75	0.75
NZD /usd		**0.7288**	**0.72**	**0.70**	**0.68**	**0.66**
	Previous		0.73	0.72	0.70	0.71
	Consensus		0.73	0.72	0.71	0.71

DBS forecasts in red. Consensus are median forecasts collated by Bloomberg as at 11 Mar 2015

DXY (USD) index – from crisis to recovery



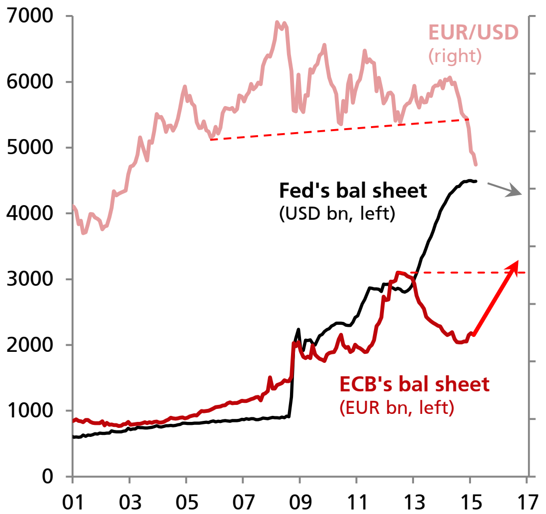
Are markets underestimating Fed hikes?



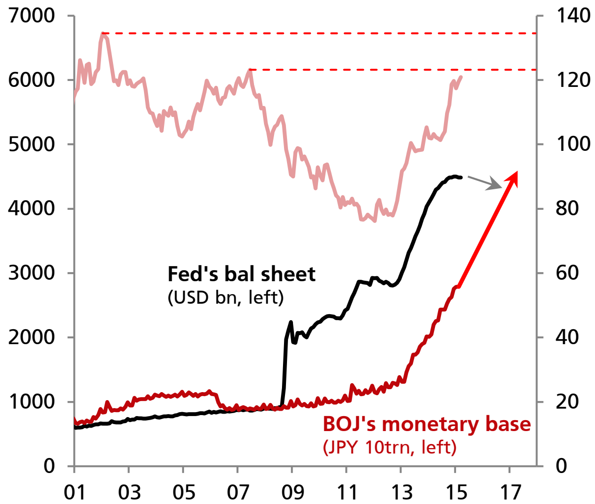
G3 currencies – mighty USD

The USD is expected to sustain its uptrend over the next couple of years on divergent monetary policies. The most significant development in 1Q15 was the European Central Bank's (ECB) success in pushing through quantitative easing (QE) to fight deflation. Lasting from Mar 2015 to Sep 2016, the program would expand the ECB's balance sheet to a new high. The Bank of Japan (BOJ) had earlier launched a second round of QE last Oct and is likely to keep expanding its balance sheet to record highs into its scheduled second sales tax hike in Apr 2017. Conversely, the US Federal Reserve's balance sheet has stopped expanding after its last taper in Oct, which effectively ended QE3. Exiting its crisis, the Fed is keen to further normalize monetary policy by hiking interest rates later this year. Here, markets risk underestimating the Fed's intentions to return real interest rates to positive territory. According to the Fed's optimal study, the Fed Funds Rate should return to 3-4% by 2017, above the Fed's 2-2.5% inflation target. In summary, QEs in Japan and the Eurozone were mostly responsible for leading the benchmark DXY (USD) index out of its post-crisis range. Having recovered more than half of its losses from the last weak USD cycle in 2002-08, the DXY has scope to extend its recovery on the approaching Fed hike cycle.

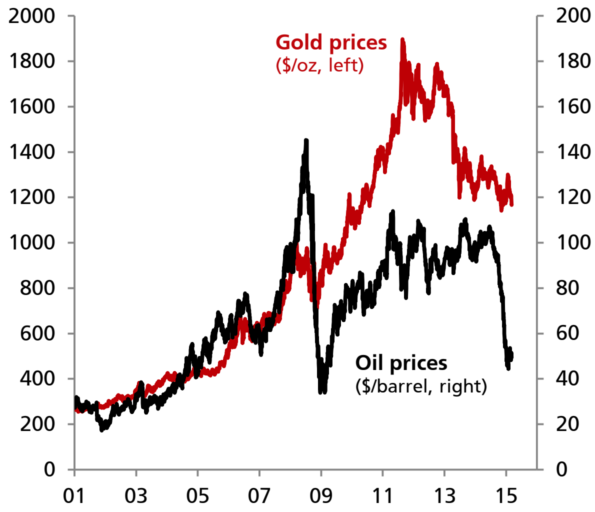
ECB's balance sheet to expand till Sep 2016



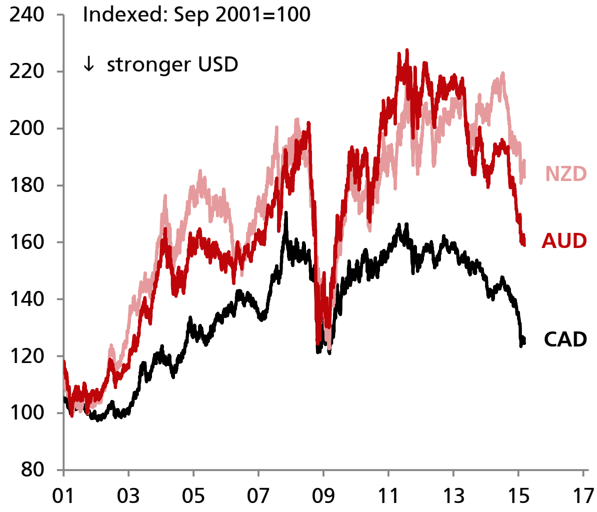
BOJ's monetary base to expand till Apr 2017



Black gold slides, yellow gold lacking lustre



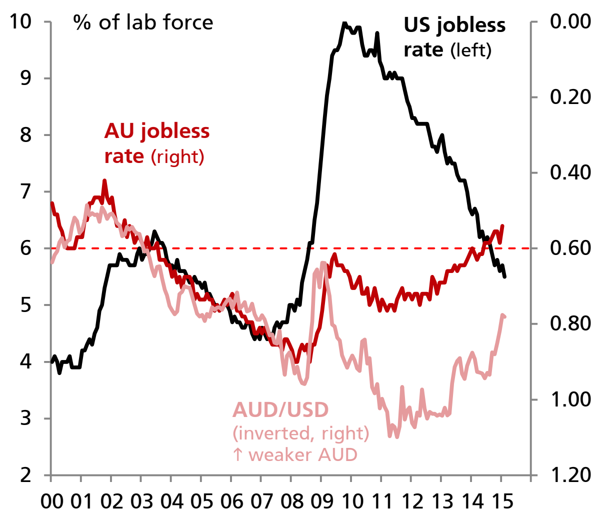
NZD & AUD – room to catch-up with CAD



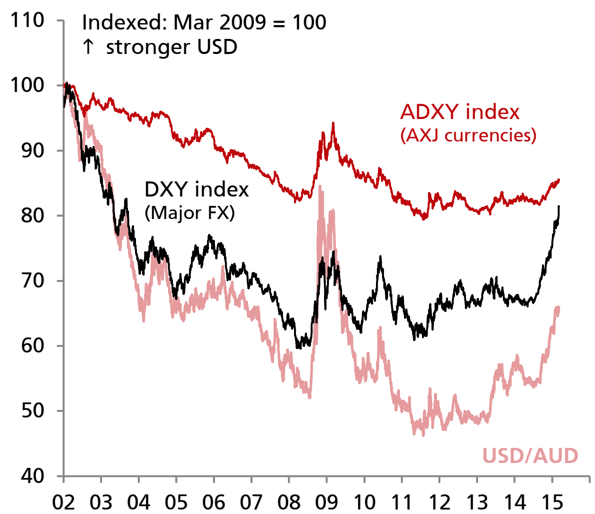
Commodity currencies – more payback

The outlook for commodity and commodity currencies first turned negative when the USD started to recover its status as the world's leading reserve currency. America's exit from its crisis was first heralded by the Fed tapering asset purchases to end QE3. This first sell-off in commodity currencies in 2013 was led by the plunge in gold prices during the Fed taper tantrums. Demand for commodities was, meanwhile, dampened by the lopsided world economy. Before Abenomics turned up, Japan was mired in deflation. Eurozone twice entered into crisis and China slowed down from its economic restructuring. Against this background, oil prices collapsed in 2H14 from an oversupply in crude and led Canada and Australia to cut rates, and New Zealand to abandon its rate hike bias. Not surprisingly, NZD is considered most overvalued on indexed basis, compared to AUD and CAD. On a relative value basis, AUD lost its premium against the USD when the US jobless rate fell below 6%, even as Australia's rose above 6%. With the USD strong globally, Australia and New Zealand consider their exchange rates overvalued. Both central banks have become more vocal and pro-active in seeking more depreciation in their currencies, not only against the USD, but also on a trade-weighted basis.

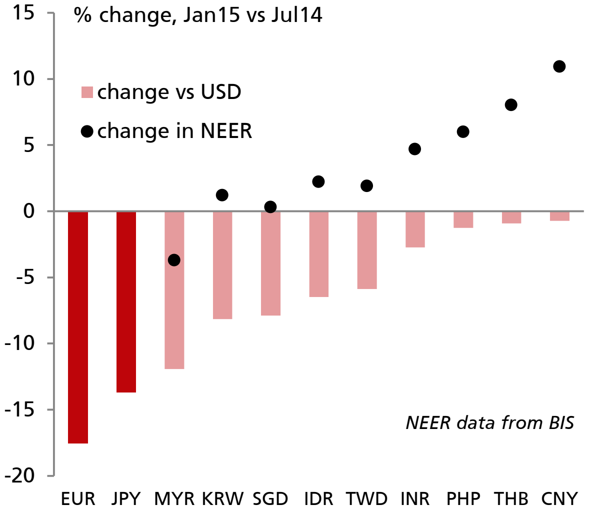
Relative value – US jobless rate < 6% vs AU > 6%



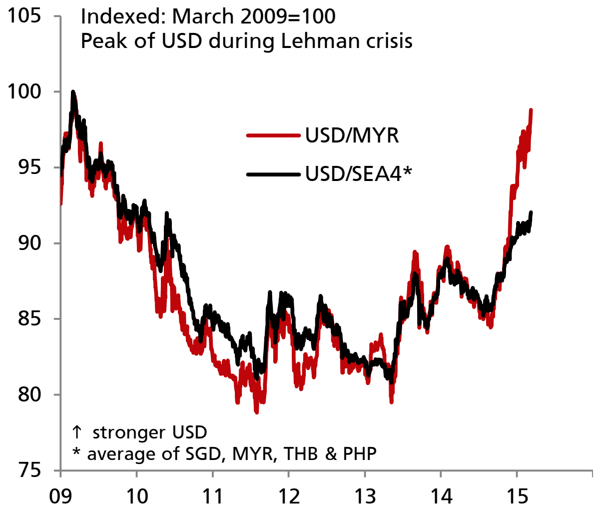
Why RBA thinks AUD is overvalued



Asian currencies – down vs USD but up on NEER



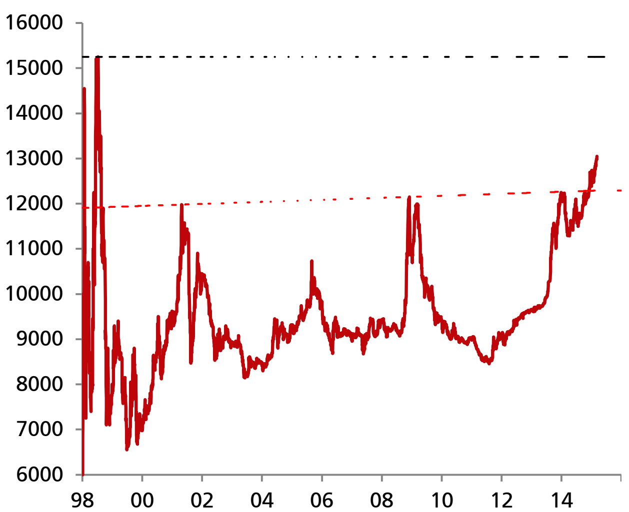
MYR – weaker than Southeast Asian peers



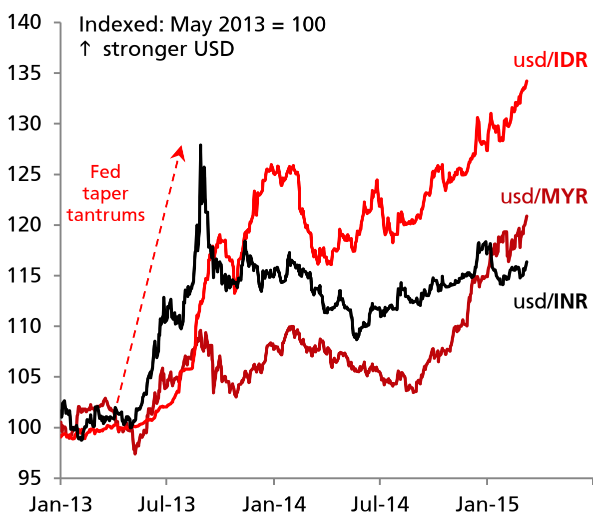
Asia ex Japan – down vs USD, up on NEER

Although Asia ex Japan (AXJ) currencies depreciated against the USD, most have actually appreciated on nominal effective exchange rate (NEER) basis. This was attributed to the sharp depreciation in major currencies, namely the euro and the Japanese yen since mid-2014. The Malaysian ringgit (MYR) stood out as the weakest AXJ currency which was best reflected by the break in its tight correlation with Southeast Asian currencies.The shock on the MYR from the plunge in oil prices was worse than the 12% depreciation experienced during emerging market (EM) volatility in May13-Jan14. By early Mar15, USD/MYR was more than 10% above the peak hit during EM volatility. To a lesser extent, the same was also seen for USD/IDR which rose to new highs not seen since the 1997/98 Asian crisis. Despite record high stock markets on reform hopes from newly-elected leaders, the Indonesian rupiah and the Indian rupee have not been able to buck the globally strong USD trend. Although India and Indonesia benefitted from lower oil import bills, both countries want to bring growth rates higher and have surprised with interest rate cuts. With the US expected to hike rates later this year, this should continue to keep the USD on its upward trajectory, not only against these RRR currencies, but also other AXJ currencies.

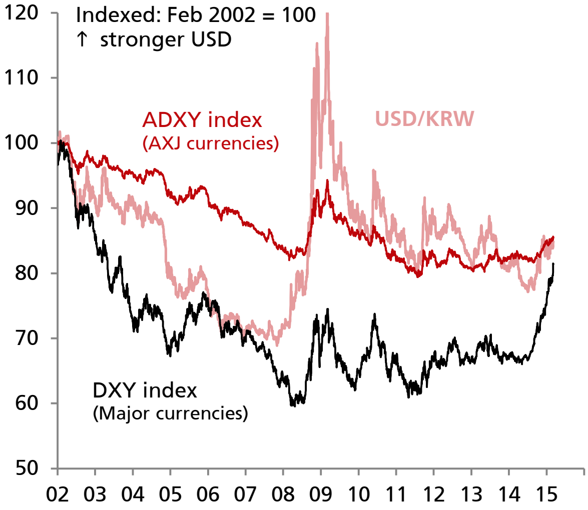
USD/IDR broke above post-Asian crisis highs



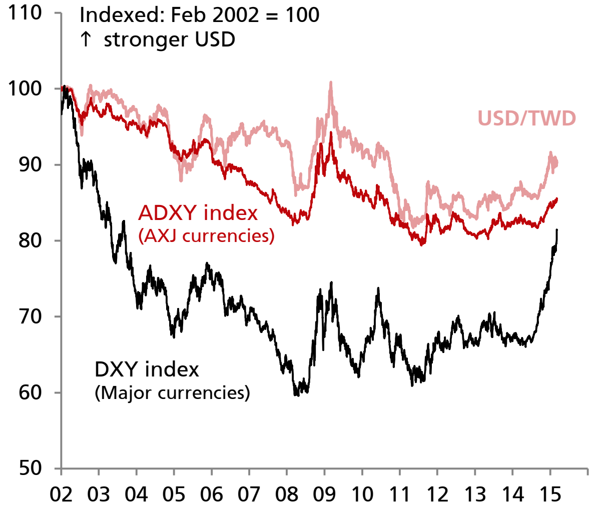
RRR currencies – bracing for US rate hikes



KRW – watching DXY (JPY & EUR) closely



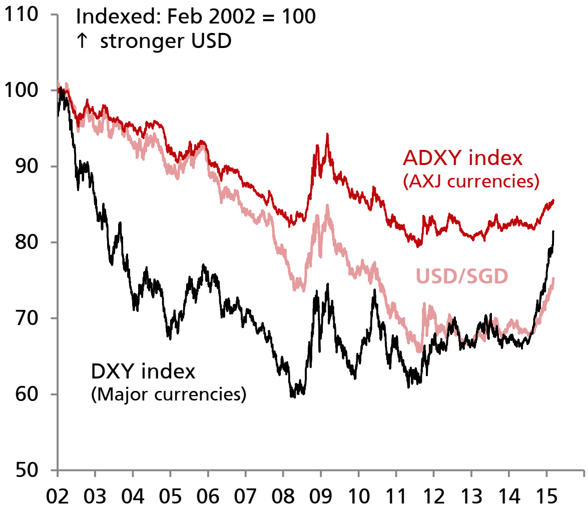
TWD – not overvalued for sure



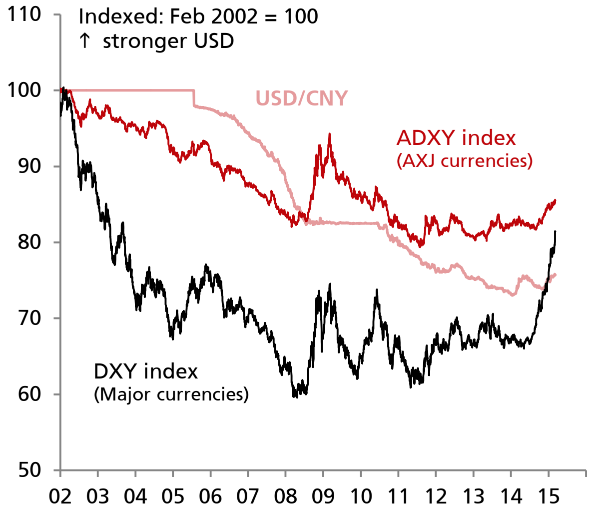
Asia ex Japan currencies – realigning to a higher USD

To gauge how the strong USD impacted AXJ currencies, we compare their perfomances against the benchmark Major (DXY) and Asian (ADXY) currency indices. During the last weak USD cycle in 2002-08, it was clear that, on an indexed basis, major currencies appreciated more than their AXJ counterparts. Hence, the QE policies of Japan and the Eurozone could be viewed as correcting excessive strength in the yen and euro as opposed to targeting weaker exchange rates or promoting currency wars. After the 2008 global financial crisis, export-led Korea and Taiwan kept their exchange rates competitive and close to the ADXY, in spite of record high foreign reserves and current account surpluses. Global rebalancing efforts were, instead, led by the the Singapore dollar and the Chinese yuan via appreciating exchange rate policies. Unfortunately, this could not be sustained after the DXY reversed its downtrend in mid-2014. Since then, the DXY has been rising aggressively, and set to converge with the ADXY. Singapore responded by slowing its appreciating exchange rate policy in Jan, ahead of its scheduled policy review in Apr. China has since Nov, cut rates twice, lowered its reserve requirement ratio, and gradually lifted its USD/CNY parity rate. Despite efforts to let their currencies realign to a higher USD, these four countries have only succeeded in slowing the trade-weighted appreciation in their exchange rates.

SGD – following USD higher



CNY – no incentive to appreciate

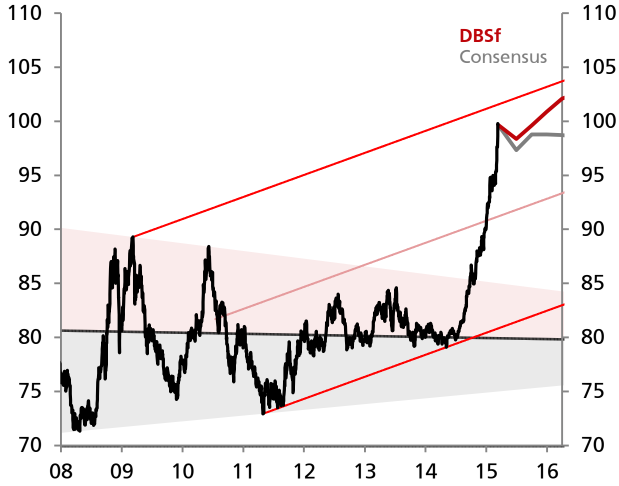


US dollar

DXY hit a 12-year high on G3 monetary policy divergences

The benchmark DXY (USD) index ascended to 97.726 on 6 Mar, its highest level since Sep 2003. Effectively, DXY has recovered more than 50% of its losses incurred during the last weak USD cycle between 2002 and 2008. DXY was also well above the 72.7-89.6 range seen during QE1, 2 and 3 under the Fed. This marked America's exit from the 2008 global financial crisis. Even so, the DXY's surge since mid-2014 was also attributed to monetary policy divergences in the G3 economies. Just as the Fed's last taper ended QE3 last Oct, Japan shocked with QQE2 in the same month in response to its technical recession, while Eurozone started QE in Mar this year to fight deflation. Looking ahead, this trend is likely to endure over the next two years. Eurozone's QE is scheduled to end by Sep 2016 while Japan's QQE2 is expected to last till its second sales tax hike due in Apr 2017. As for the US rate hike cycle expected to start later this year, the Fed's goal is to normalize monetary policy by returning real rates to positive territory. Currently at 0-0.25%, and below the Fed's 2-2.5% inflation outlook target, Fed Funds Rate would only reach 3-4% by 2016-17.

DXY index – emerged from 2008 crisis



DXY	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	99.795	98.4	99.6	100.9	102.1
Previous		86.0	86.6	87.2	87.8
Consensus		97.3	98.8	98.8	98.7

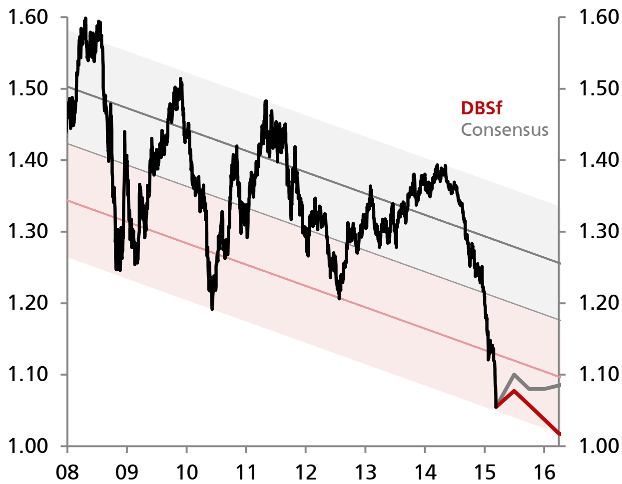
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	0.25	0.25	0.25	0.50	0.75
Previous		0.25	0.25	0.50	0.75
Consensus		0.35	0.60	0.90	1.25

Euro

EUR/USD moving towards parity on ECB QE and Fed hikes expectations

EUR/USD started 2015 below 1.20 on signs that the European Central Bank (ECB) was moving closer towards quantitative easing (QE). EUR/USD fell below 1.15 on 22 Jan when the ECB announced that it would implement QE in March, and broke below 1.10 just before QE was launched on 9 Mar. Between 8 May 2014 and 6 Mar 2015, EUR/USD depreciated 23% from a high of 1.3992 to 1.0840. More importantly, the currency pair is well below the 1.1875 low seen during the PIGS crisis in May 2010, and the 1.2040 low during the Eurozone crisis in Jul 2012. It is important to recognize that the weakness of the euro since May 2014 is not driven by another crisis but the result of an intended policy decision to ease monetary conditions via a depreciation in the real exchange rate. Looking ahead, the next push for EUR/USD to fall towards parity would need to come from US rate hikes expected to start later this year. The currency pair should remain weak over the medium-term from an ECB balance sheet expanding to a new record high vs a Fed balance sheet shrinking from its all-time high. And this monetary policy divergence is scheduled to last into 2016.

EUR/USD – moving towards parity



EUR /usd	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	1.0545	1.08	1.06	1.04	1.02
Current		1.12	1.11	1.10	1.10
Consensus		1.10	1.08	1.08	1.08

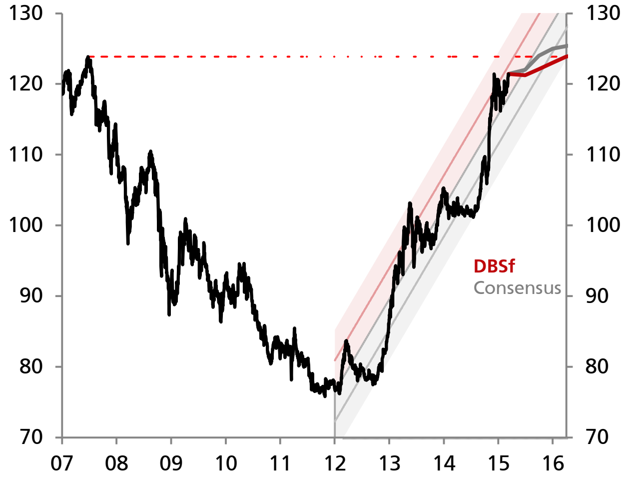
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	0.05	0.05	0.05	0.05	0.05
Previous		0.05	0.05	0.05	0.05
Consensus		0.05	0.05	0.05	0.05

Japanese yen

USD/JPY eyeing Fed hike to move higher again, but upside may be limited at around 124

USD/JPY surged from 101 to 122 in 2H14, into and after the Bank of Japan's (BOJ) second qualitative and quantitative easing (QQE2) on 31 Oct. After the ruling Liberal Democratic Party led by PM Shinzo Abe won the snap election on 14 Dec, USD/JPY has been consolidating mostly between 116 and 121. The same price action was also witnessed in 2013. USD/JPY raced to 103 from 77 in Oct13-May14, into and after QQE1 in Apr 2013. Thereafter, it consolidated between 96 and 101, before it rose again to 105 in 4Q13 ahead of the first Fed taper in Dec14. If history repeats itself, USD/JPY is likely to rise again into the first Fed hike expected later this year. This time around, most see the next ceiling for USD/JPY around the 124 high set in mid-2007. Despite the similarities, Japan's leaders and policymakers are facing new and different challenges today. With Japan emerging slowly from a technical recession amidst a rout in global oil prices, doubts remain over BOJ's ability to meet its 2% inflation target. Fiscal reforms have been in doubt after the second sales tax hike was pushed out to Apr 2017 from Oct 2015. Finally, political scandals appeared to have returned to plague Abe and his ministers.

USD/JPY – back to 2007 high



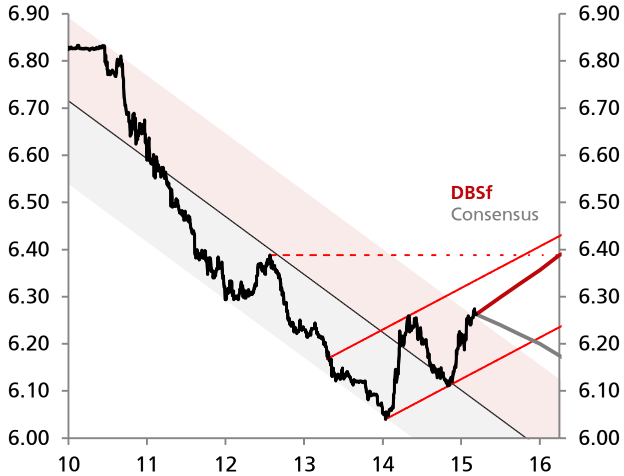
usd/ JPY	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**121.44**	**121**	**122**	**123**	**124**
Previous		122	123	124	125
Consensus		122	124	125	125
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Previous		0.10	0.10	0.10	0.10
Consensus		0.10	0.10	0.10	0.10

Chinese yuan

As China turns dovish on monetary policies, CNY keeps a weak tone against the USD

For the first time since 2012, the People's Bank of China (PBOC) cut the 1Y lending rate by 40bps to 5.60% on 21 Nov 2014. Less than a month later, the official parity rate for USD/CNY bottomed at 6.1137 on 17 Dec. Since then, the PBOC has been guiding parity higher by 0.7% to 6.1543 as at 3 Mar 2015. During this period, the banks' reserve requirement ratio (RRR) was lowered by 50bps to 19.5% on 4 Feb, while the lending rate was cut a second time on 1 Mar by 25bps to 5.35%. These dovish policy moves were supported by disappointing data. CPI inflation fell to 0.8% YoY in Jan15, below 1% for the first time since 2009. Export growth returned into negative territory in Jan15 after eight months of expansion. Despite a wider current account surplus last year, foreign reserves fell in 2H14. The real economy expanded 7.4% in 2014, its slowest growth rate in 24 years. China lowered its 2015 growth target to 7% from 7.5%. Against this background, markets have been keeping onshore USD/CNY and offshore USD/CNH rates at the upper side of the official trading band. Looking ahead, China is expected to ease rates and RRR again, and possibly widen the trading band too.

USD/CNY – not bucking globally strong USD



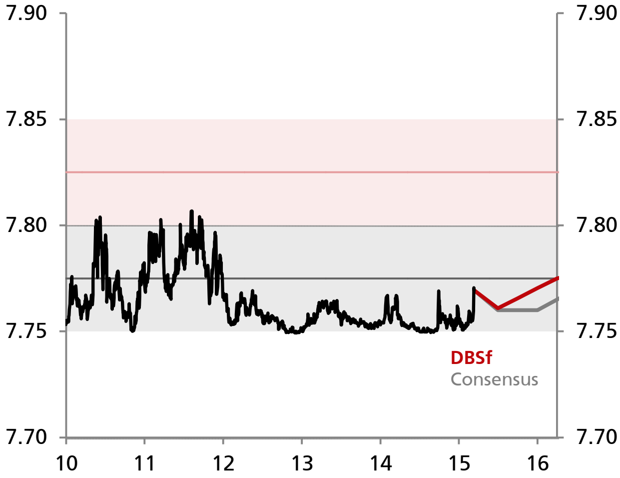
usd/ CNY	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**6.2623**	**6.30**	**6.33**	**6.36**	**6.39**
Previous		6.25	6.20	6.15	6.15
Consensus		6.24	6.22	6.20	6.18
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**5.35**	**5.10**	**5.10**	**5.10**	**5.10**
Previous		5.35	5.35	5.35	5.35
Consensus		5.15	5.10	5.10	5.05

Hong Kong dollar

USD/HKD to rise when the US starts to hike rates later this year

There was no speculation that Hong Kong would shift its HKD peg from the USD to the CNY, and understandably so. The USD is strong globally and against Asian currencies, including the CNY. In reality, the foreign exchange market was pre-occupied with the depreciation of the CNY in the offshore markets. By 6 Mar, USD/CNH and the 1Y outright non-deliverable forward (NDF) for USD/CNY was respectively, 0.1% and 2.0%, above the official trading band in the mainland. Unlike previous years, the Hong Kong Monetary Authority (HKMA) did not intervene to support the floor of the 7.75-7.85 convertibility band for USD/HKD. Instead, the central bank was probably more concerned the health of its financial centre. Hong Kong is caught between rate cuts and more capital account convertibility in China, and liquidity and credit risk from the looming US rate hike cycle. With residential property prices having risen another 13% in 2014, the HKMA announced on 27 Feb more credit tightening measures to safeguard the financial system from the heated sector. During the last US rate hike cycle in 2004-06, USD/HKD rose to 7.80 or the mid of its 7.75-7.85 convertibility band.

USD/HKD – moving off its floor



usd/ **HKD**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**7.7706**	**7.76**	**7.77**	**7.77**	**7.78**
Previous		7.77	7.77	7.78	7.77
Consensus		7.76	7.76	7.76	7.76
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**0.39**	**0.40**	**0.50**	**0.70**	**0.95**
Previous		0.40	0.50	0.70	0.95
Consensus		0.57	0.72	0.90	1.18

Taiwan dollar

While currently favored by fundamentals, TWD is uncertain about its political future

TWD was the most resilient currency within the Asian NIEs (Newly Industrialized Economies). Since mid-Oct14, Taiwan equities have been consistently outperforming their peers too. Taiwan was the fastest growing economy (3.5%) in 2014 compared to South Korea (3.3%), Singapore (3.0%) and Hong Kong (2.3%), a lead that it is likely to be preserved in 2015. The government, on 16 Feb, upgraded its 2015 growth outlook to 3.78% from 3.50% previously. With export growth seen paltry at 1.02%, growth is expected to be driven by strong domestic demand. Ironically, this was not reflected by its dovish outlook for imports (-1.02%) and inflation (0.26%). Conversely, the above growth optimism was not shared by businesses who have started to worry that an unfavorable outcome at the 2016 presidential elections may strain cross-strait relations. According to a poll conducted by Want Want China Times Media Group in late Feb, 57% of the voters favored the pro-independent opposition Democratic Progressive Party (DPP) to win the election. Hence, the TWD cannot afford to neglect its role to maintain export competitiveness and price stability in a strong USD environment.

USD/TWD – rising back to 2010 high

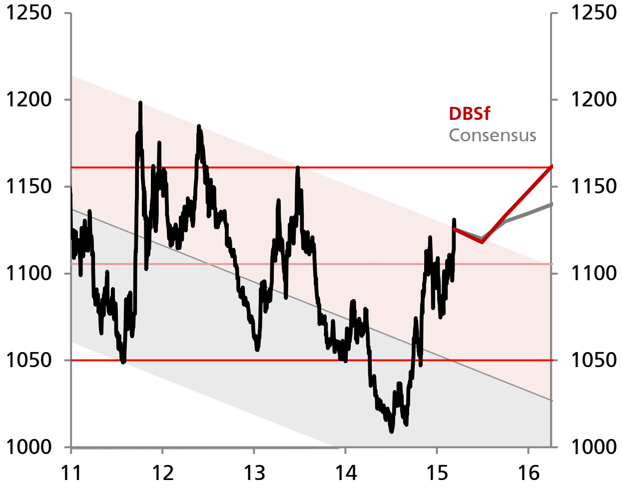
usd/ **TWD**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**31.703**	**31.8**	**32.0**	**32.2**	**32.4**
Previous		31.5	31.7	31.8	31.7
Consensus		32.0	32.0	32.2	32.0
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**1.88**	**1.88**	**1.88**	**1.88**	**2.00**
Previous		1.88	1.88	2.00	2.00
Consensus		1.70	1.75	1.80	1.85

Korean won

KRW is facing multiple headwinds, externally and domestically

Export-led Korea has been closely monitoring the KRW against the weak JPY after the Bank of Japan shocked with QQE2 on 31 Oct last year. This year, Korea is also worried that the European Central Bank's move to launch QE in 1Q15 may weaken euro and hurt its exports to Eurozone. Neither did it help that GDP growth slowed for the third straight quarter to 2.7% YoY in 4Q14 from 3.9% in 1Q14. Effectively, the economy was now performing below its potential growth rate, which the BOK estimated to be 3.5%. This was probably why the BOK cut rates in Aug and Oct last year, and in Mar this year. Looking ahead, the BOK could once again lower its policy rate again in 2Q15. CPI inflation fell to 0.5% YoY in Feb15, a 16-year low. At 2.3% YoY in Feb15, core inflation was also below the BOK's 2.5-3.5% inflation target. Even so, BOK was wary that the rate cuts may have led housing lending growth to exceed its expectations. During his report to parliament in Feb, BOK Governor Lee Ju-yeol told lawmakers that foreign reserves may be mobilised to address threats to financial stability from further falls in the JPY and commodity prices, as well as US rate hikes expected later in the year.

USD/KRW – tracking weaker JPY & EUR



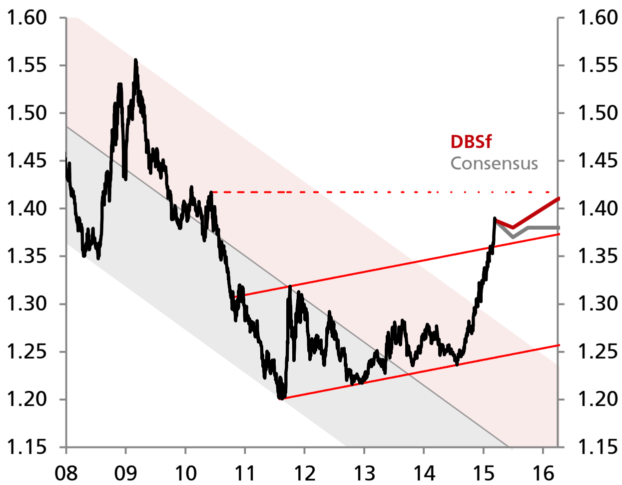
usd/ **KRW**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**1131**	**1118**	**1133**	**1147**	**1161**
Previous		1130	1140	1150	1145
Consensus		1120	1130	1135	1140
Policy, %	12-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**1.75**	**1.50**	**1.50**	**1.50**	**1.75**
Previous		1.75	1.75	2.00	2.00
Consensus		1.80	1.80	1.85	1.95

Singapore dollar

Tone remains strong for USD/SGD to keep rising towards 1.40

The Monetary Authority of Singapore (MAS), on 28 Jan, eased the appreciation pace of the SGD nominal effective exchange rate (NEER) policy band. The decision took markets by surprise because it came ahead of the scheduled semi-annual policy review in April. Inflation was cited as the reason for the policy change. The central bank downgraded its 2015 inflation outlook to between -0.5% and +0.5% from 0.5-1.5% previously. CPI inflation first turned negative in Nov14 and was last at -0.4% YoY in Jan15. Overall, 1Q15 was best characterised by the SGD NEER depreciating from the mid to the floor of its policy band. According to our model, this represented a 2% depreciation in the SGD on a trade-weighted basis. With the market looking for the MAS to ease again in April, USD/SGD has been above 1.35 since early February. We reckon that the policy band could be re-centered lower (our base scenario) or widened to manage volatility from Fed hikes later in the year propelling the USD higher globally. That said, the risk of the appreciation policy turning neutral cannot be totally discounted, especially if deflation starts to rear its ugly head and force another downgrade in the inflation outlook.

USD/SGD – rising back to 2010 high



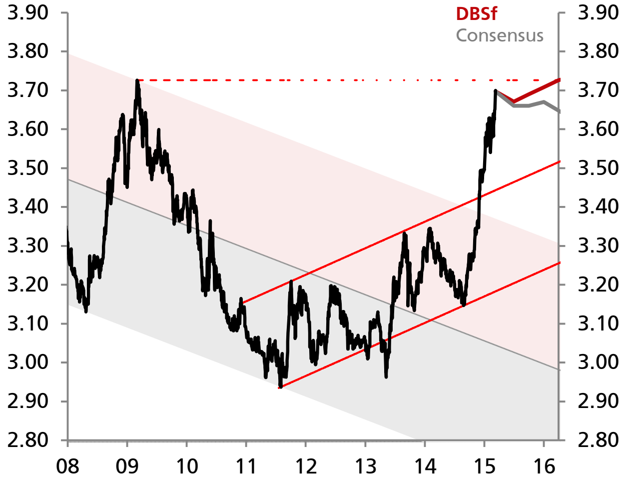
usd/ **SGD**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**1.3886**	**1.38**	**1.39**	**1.40**	**1.41**
Previous		1.34	1.35	1.36	1.36
Consensus		1.37	1.38	1.38	1.38
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**0.88**	**0.70**	**0.70**	**0.85**	**1.05**
Previous		0.42	0.45	0.60	0.75
Consensus		0.78	0.87	0.99	1.08

Malaysian ringgit

Having slipped on oil in 2014, MYR is vulnerable to Fed hikes expected in 2015

MYR was the worst performing emerging Asian currency in 2014, and the second weakest in 1Q15. The sharp sell-off in the MYR started in Aug 2014 on the global oil rout. As a net oil exporter, Malaysia suffered from lower oil and gas revenues. The government, on 20 Jan, downgraded its budget targets announced last Oct, which assumed an oil price of $100/barrel. With oil prices halved today, the 2015 growth outlook was lowered to 4.5-5.5% from its previous estimate of 5-6%. The goal to further narrow its fiscal deficit to 3% of GDP was abandoned with the target raised to 3.2%. Linking its sovereign credit worthiness to public finances, Fitch warned that it may downgrade Malaysia's debt rating during its review in 1H15. Another concern is external debt, which was redefined to include holdings of MYR-denominated debt by foreigners. Over the past few years, short-term external debt has been rising and converging with falling foreign reserves, amidst narrowing current account surpluses. Against this background, the MYR is not immune to US rate hikes expected to start later this year. The risk remains for USD/MYR to trend higher to and above 3.70.

USD/MYR – back to 2009 high



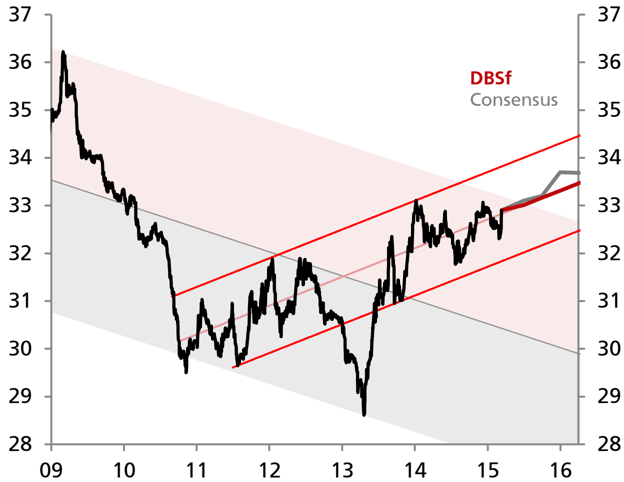
usd/ **MYR**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**3.6970**	**3.67**	**3.69**	**3.71**	**3.73**
Previous		3.64	3.66	3.68	3.67
Consensus		3.66	3.66	3.67	3.65
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**3.25**	**3.25**	**3.25**	**3.25**	**3.25**
Previous		3.50	3.50	3.50	3.50
Consensus		3.25	3.25	3.25	3.30

Thai baht

THB is not as resilient as it looks; USD/THB is likely to return above 33 eventually

THB was the top performing Asian currency in 2015. As of 4 Mar, THB appreciated 1.6% YTD vs USD, even whilst other emerging Asian currencies depreciated by an average 3.8%. Real GDP growth rebounded to 2.3% YoY in 4Q14 from -0.5% in 1Q14. In turn, Thai stocks rose towards the record highs seen in early 2013. As a net oil importer, Thailand benefitted from lower oil prices. Current account deficits have, since Oct14, reversed into strong surpluses with a record high of $5.5bn posted in Dec14. While this was attributed to a smaller oil import bill, exports continued to languish. In the first two months of 2015, the fall in inflation into negative territory was also accompanied by a retreat in consumer sentiment. Not surprisingly, business sentiment remained cautious, worried about low domestic spending and the lacklustre global economy. Against this uninspiring background, the THB, on a nominal effective exchange rate (NEER) basis, would need to shed some of its sharp 9.3% appreciation accumulated between May14 and Feb15. The central bank may also need to consider lowering interest rates to augment efforts to meet the 4% growth target set for this year.

USD/THB – uptrend still intact



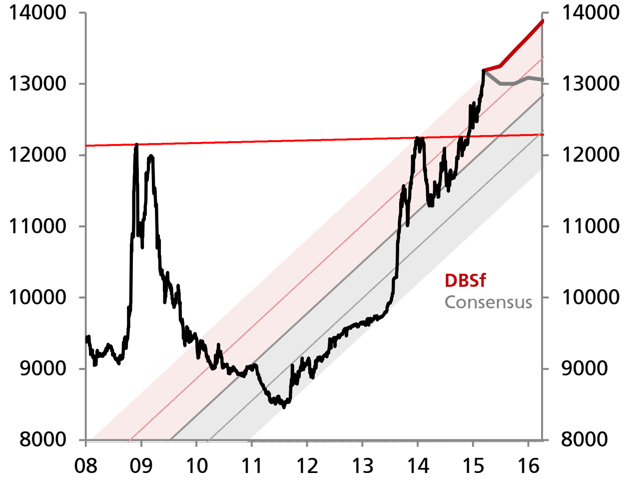
usd/ **THB**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**32.900**	**33.0**	**33.2**	**33.3**	**33.5**
Previous		33.3	33.4	33.6	33.5
Consensus		33.1	33.2	33.7	33.7
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**1.75**	**1.75**	**1.75**	**1.75**	**2.00**
Previous		2.00	2.00	2.00	2.00
Consensus		1.85	1.85	1.90	2.00

Indonesian rupiah

USD/IDR above 13000, uptrend intact

Indonesia's aspiration to achieve its growth targets would probably eclipse its desire for exchange rate stability. President Jokowi wants to lift growth to 7% during his five-year term. The immediate challenge this year will be to revive growth to 5.7% from a five-year low of 5.03% last year. On the fiscal front, fuel subsidies were cut to free up funds for more spending in infrastructure. On the monetary front, Bank Indonesia (BI) surprised with a rate cut on 17 Feb after CPI inflation fell to 6.29% YoY in Feb15 from a high of 8.36% in Dec14. The president signaled a desire for another rate cut if inflation falls further below 5%. This has weakened the IDR on two counts. First, global currency markets favor a strong USD because Fed hikes are seen starting later this year. Second, no thanks to Eurozone and Japan, countries with dovish monetary policies are seen favoring weaker currencies. Neither does it help that the current account deficit is expected to widen to 3.3-3.5% of GDP this year. During the EM volatility in May13-Jan14, the IDR only stabilized after the deficit narrowed to less than 2%. With the private sector discouraged from accumulating more external debt, this presents a challenge to deliver a stable IDR to attract investments.

USD/IDR – new post-crisis highs



usd/ IDR	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**13186**	**13250**	**13460**	**13660**	**13870**
Previous		12550	12725	12900	12850
Consensus		13000	13000	13086	13058

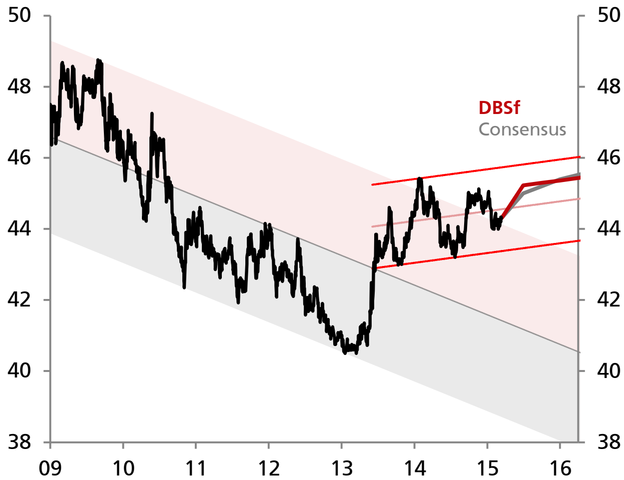
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**7.50**	**7.50**	**7.50**	**7.50**	**7.50**
Previous		7.75	7.75	7.75	7.75
Consensus		7.30	7.30	7.30	7.20

Philippine peso

USD/PHP has been stable around 45 despite global currency volatility

PHP remained one of the most stable currency, underpinned by favorable fundamentals. Since 2012, the Philippines had been the second fastest growing Asian country after China. Ironically, the country also reported the highest jobless rate in the region. Fortunately, this turned out to be a blessing in disguise. Remittances by Philippine workers overseas have not only helped boost domestic demand at home, they have also ensured a healthy international liquidity position. In contrast to many Southeast Asian countries, the country's foreign reserves exceeded gross external debt while current account surpluses matched short-term external debt. For the third straight year, the Philippines was rewarded in 2014 with sovereign debt rating upgrades by all three international rating agencies – Moody's, Standard & Poor's and Fitch. Not surprisingly, the Philippine markets found favor with foreign investors. Apart from Philippine stocks posting new record highs this year, the PHP had been stable despite market volatility from unpredictable central banks in the rest of the world. Barring unforeseen shocks, the PHP is well-positioned to weather the US rate hike expected to start later in the year.

USD/PHP – mild uptrend



usd/ PHP	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**44.330**	**45.2**	**45.3**	**45.4**	**45.4**
Previous		45.2	45.3	45.4	45.3
Consensus		45.0	45.2	45.4	45.5

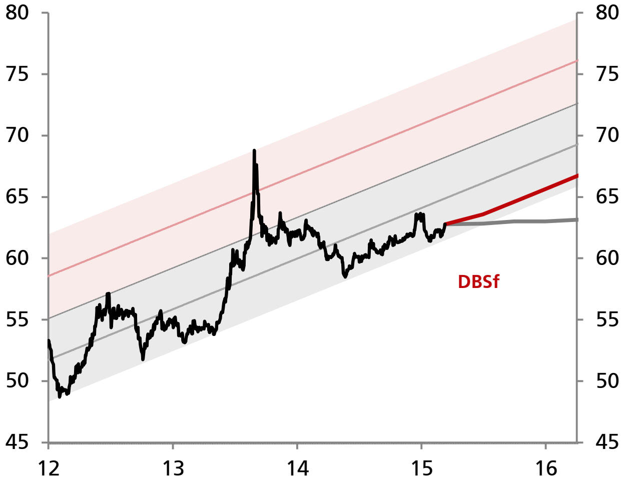
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**4.00**	**4.00**	**4.00**	**4.00**	**4.25**
Previous		4.00	4.25	4.25	4.25
Consensus		4.00	4.05	4.15	4.25

Indian rupee

Optimism in INR is reflected via trade-weighted appreciation and not against the USD

INR started 2015 on a firm note but could not extend its appreciation beyond Jan. USD/INR fell from 63.620 to 61.290 in 6-28 Jan, but has since, been consolidating between 61.555 and 62.460. On the domestic front, sentiment has improved. Indian equities continued to rise to new record highs on reform hopes and supportive policies to lift growth. On the former, there is optimism over the "Make in India" initiative to establish India as a global manufacuring hub. The finance ministry and the Reserve Bank of India (RBI) signed a monetary policy framework to set at inflation target of 4% and keep it within 2% either side of the target. Budget 2015/16 announced on 28 Feb was aimed at boosting growth and infrastructure which RBI Governor Raghuram Rajan believed would help India become a powerhouse in the world. RBI played its part with two surprise inter-meeting rate cuts on 15 Jan and 4 Mar. As for the exchange rate, INR is still held ransom to external factors. USD/INR should continue to rise on the globally strong USD trend from QEs in Eurozone/Japan vs Fed hikes later this year. Instead, optimism in the INR is best reflected, on a relative value basis, in its trade-weighted appreciation.

USD/INR – still crawling higher



usd/ **INR**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**62.780**	**63.6**	**64.6**	**65.6**	**66.7**
Previous		64.4	65.5	66.5	66.0
Consensus		62.8	63.0	63.0	63.1

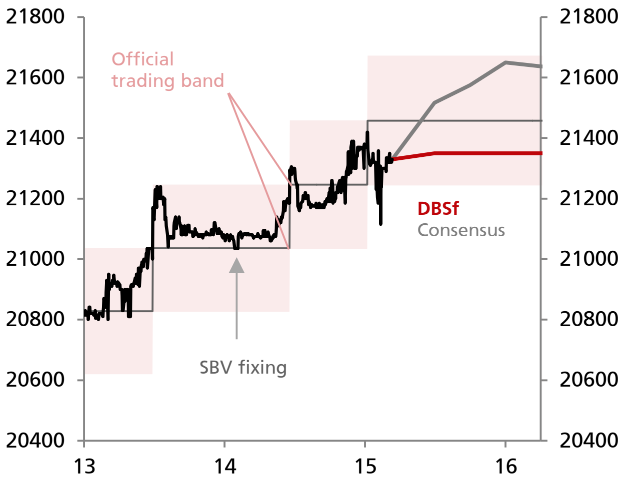
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**7.50**	**7.25**	**7.25**	**7.25**	**7.25**
Previous		7.50	7.50	7.50	7.50
Consensus		7.30	7.20	7.15	7.10

Vietnam dong

VND stable in a strong USD environment

VND dong is stable. USD/VND remained in the lower half of its official trading band after the VND was devalued on 7 Jan. The State Bank of Vietnam (SBV) lifted the mid-point of the USD/VND trading band by 1% to 21458. The mid was previously lifted by 1% to 21246 in June. The devaluations do not imply weakness but recognition by policymakers to keep the exchange rate aligned to the globally strong USD environment. In reality, Vietnam is no longer experiencing the macroeconomic imbalances – double-digit inflation and chronic trade deficits – that plagued the VND after the 2008 global crisis. Instead, CPI inflation eased to 0.34% YoY in Feb14 while a trade surplus of $2.14bn surplus was reported in 2014. In 2H14, Moody's and Fitch upgraded Vietnam's sovereign debt rating by a notch to "B1" and "BB-" respectively. Against this favorable landscape, SBV sees room to lower interest rates by 100-150bps this year. This would complement the government's pro-investment policy and help the economy to return growth above 6% this year. Unlike most of its Asian peers, Vietnam's growth has improved in the past three years to 5.98% in 2014 from 5.42% in 2013 and 5.25% in 2012.

USD/VND – stable despite devaluation



usd/ **VND**	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**21325**	**21350**	**21350**	**21350**	**21350**
Previous		21250	21250	21250	21250
Consensus		21517	21575	21650	21638

Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**6.50**	**5.50**	**5.00**	**5.00**	**5.00**
Previous		6.00	6.00	6.00	6.00
Consensus		n.a.	n.a.	n.a.	n.a.

Australian dollar

AUD/USD to fall towards 0.70

The AUD remains fundamentally weak. The Reserve Bank of Australia (RBA) has not only abandoned its steady rate bias, but also cut its cash target rate by 25bps to a record low of 2.25% on 3 Feb. A week later, on 10 Feb, the central bank downgraded its 2015 outlook for the Australian economy. Real GDP growth is now expected to average 1.75-2.75% this year instead of 2-3% previously. CPI inflation is expected to average 1.25% in 1H15 instead of 1.5-2.5% before. RBA Governor Glenn Stevens told parliament on 13 Feb that the economy was not expanding fast enough to stop the jobless rate from climbing higher. The unemployment rate has, after it bottomed at 4.9% in Dec10, been ascending over the past four years to 6.4% in Jan15. Externally, the AUD also faced competitive headwinds from a globally strong USD against Asian currencies; the region buys more than 70% of Australia's exports. The plunge in oil prices since mid-2014 also hammered other commodity currencies such as the CAD and NZD. Canada surprised with a rate cut in Jan while New Zealand abandoned its rate hike bias in favor of a steady rate stance. Against this background, the RBA still sees a need for the AUD to depreciate, not just against the USD, but also on a trade-weighted basis.

AUD/USD – still high relative to global trends

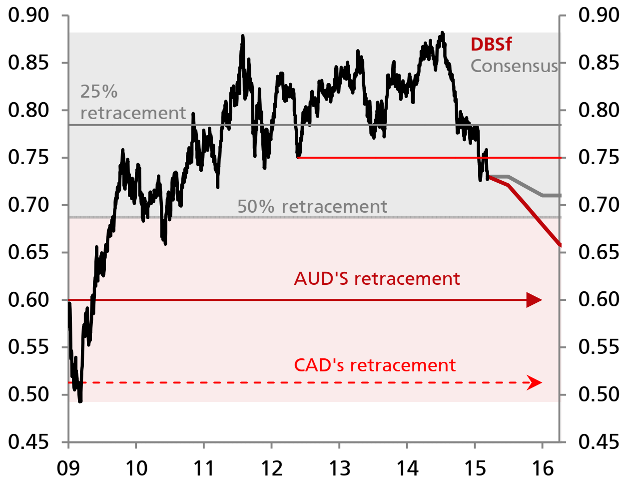
AUD /usd	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**0.7593**	**0.75**	**0.72**	**0.70**	**0.67**
Previous		0.80	0.78	0.76	0.77
Consensus		0.76	0.75	0.75	0.75
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**2.25**	**2.00**	**2.00**	**2.00**	**2.00**
Previous		2.50	2.50	2.50	2.50
Consensus		2.00	2.00	2.00	2.10

New Zealand dollar

NZD is unjustifiably high and need to realign itself to the weaknesses of its peers

Unlike its counterparts in Canada and Australia, the Reserve Bank of New Zealand (RBNZ) did not cut rates this year. Even so, the RBNZ did abandon its rate hike bias in favor of a steady rate stance at its monetary policy meeting on 29 Jan. The door was left open for the next move to be a cut as much as it was for a hike. The policy shift could be attributed to CPI inflation falling to 0.8% YoY in 4Q14, below the RBNZ's 1-3% target range for the first time since 2Q13. RBNZ reckoned that inflation could turn negative and stay below its target range throughout 2015. According to the latest RBNZ survey released on 24 Feb, 2Y inflation expectations eased to 1.80% from 2.06% its previous reading last Nov. Not surprisingly, both the 2Y and 10Y government bond yields are below the 3.50% policy rate. Hence, consensus may be too optimistic in expecting the RBNZ to hike rates in 1Q16. With rates on hold for an extended period of time, RBNZ is likely to focus on the NZD which it considers unjustifiably high. Both AUD and CAD have returned 72% and 95% of their post-2008 crisis gains. Put simply, NZD/USD should be below and not above 0.70 and closer to its peers on an indexed basis.

NZD/USD – too high relative to peers

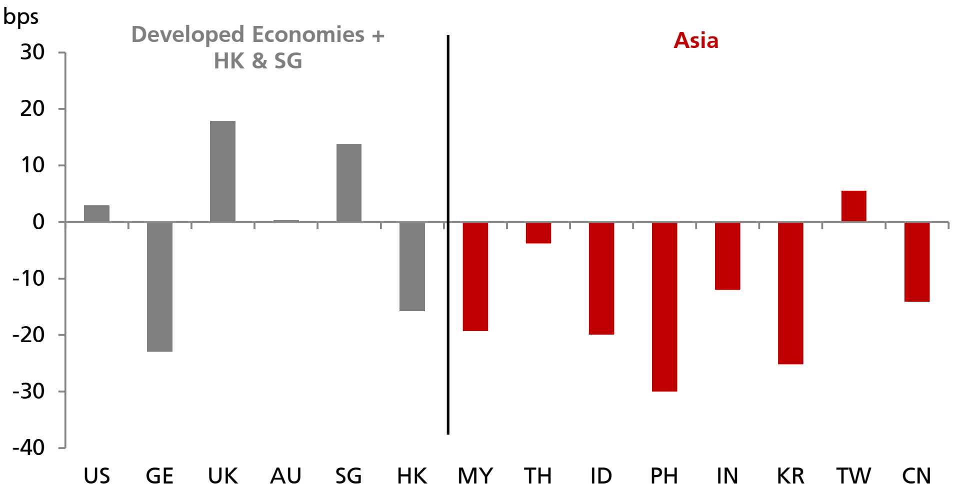


NZD /usd	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**0.7288**	**0.72**	**0.70**	**0.68**	**0.66**
Previous		0.73	0.72	0.70	0.71
Consensus		0.73	0.72	0.71	0.71
Policy, %	11-Mar	2Q15	3Q15	4Q15	1Q16
Revised	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**
Previous		3.50	3.50	3.75	3.75
Consensus		3.50	3.50	3.55	3.75

Yield: turning point

US	Strong momentum in US job numbers have prompted the market to price in an eventual Fed tightening
	Quantitative easing by the European Central Bank is already priced into the market
	Stabilizing oil prices have allowed inflation expectations in the US and EZ to bottom out
Asia	Asian government bond yields will remain under upward pressure as USD rates normalize higher
	However, the magnitude of change is likely to be muted compared to the taper tantrums of mid-2013
SG	Currency pressures
HK	Low relative to the US
KR	Sensitive to USD rates
TW	Lacking direction
TH	Speculation of further easing
MY	Stable yields, weak ringgit
ID	A one-off cut
PH	Sweet spot
IN	Another rate cut coming
CH	Easing mode

Change in 10Y Government Bond Yields since end-2014



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US: Turning point

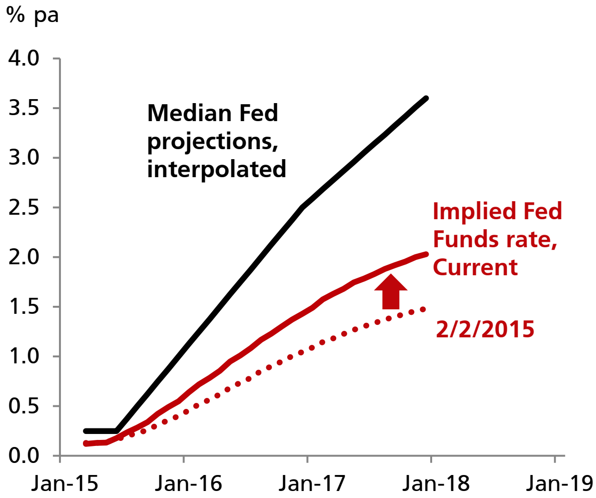
In 1Q15, there was a wave of central bank easing across the globe. The European Central Bank (ECB) announced quantitative easing (QE), China cut its benchmark 1Y deposit rate by 25bps to 5.35% while India cut its repo rate by a cumulative 50bps to 7.5%. Depressed oil prices and the resultant decline in headline CPI has opened the opportunity for central banks to be more accommodative even as eventual Fed normalization draws closer. As the current wave of monetary easing fades and oil prices stabilize, the market is likely to focus on the timing and pace of Fed hikes. Interest rates in the US and Asia are generally biased higher over the next few quarters.

Three key factors suggest that long-term rates may be bottoming out. Firstly, QE by the ECB is anticipated and largely priced into the Eurozone sovereign yields. Notably, 10Y German Bund yields are now languishing at 0.3% (similar levels to Japan) with much of the curve (1Y-5Y) already in negative territory. While there remains room for further spread compression in the peripherals' paper relative to German Bunds, by and large, room for German yields to head lower is likely limited. Moreover, the bounce in oil prices and the announcement of QE have had a stabilizing impact on Eurozone inflation expectations. If German Bund yields stop falling, a key reason driving UST yields lower in 2014 would be diminished.

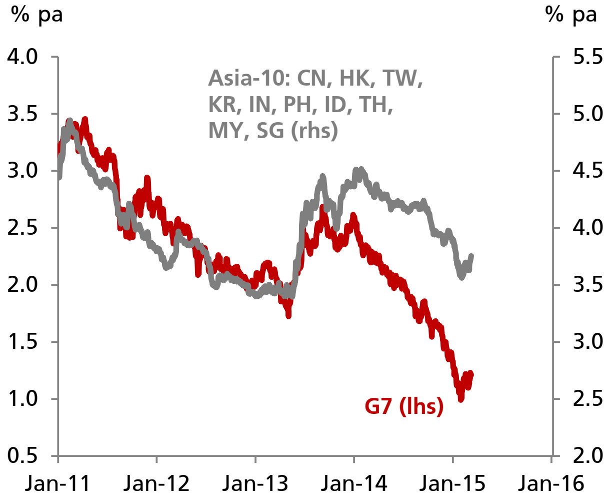
Secondly, WTI prices are now 15% higher than the low seen in late-January and appears to be holding up around the USD 50/bbl level. While some volatility is expected to persist, the bulk of the down move is likely over. This is important as oil was the single largest factor driving down long-term UST yields in December and January. Correlations between US inflation expectations, US CPI and oil prices at elevated levels. The bounce in oil has eased downward pressure on UST yields. 10Y UST yields at 2.14%, are some 50bps higher than the low registered in January.

Thirdly, USD interest rates are still not adequately reflecting interest rates risks as we draw closer into the US monetary normalization cycle. There continues to be a sizable gap between what Fed officials project for the Fed funds rate and what the market reflects. With the market still implying a hike pace that is less than half that seen in the previous rate hike cycle (the Fed hiked by 25bp per meeting in the tightening cycle from 2004/06), we think the market remains too complacent in the intermediate segment of the UST curve. The same can be said for longer-term UST

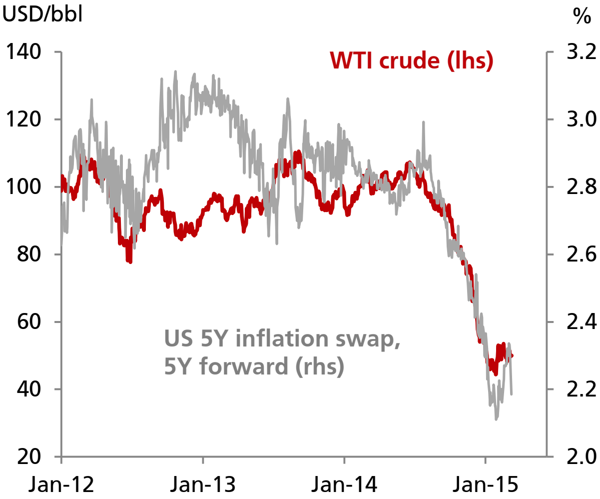
Fed Funds rate: Implied & Fed projections



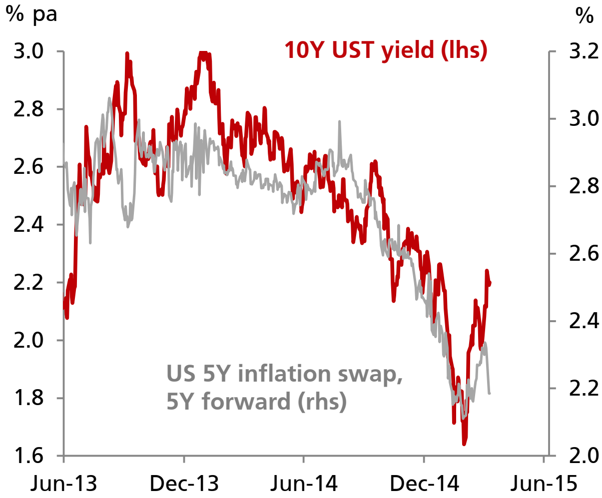
Ave 10Y Govt Yield: Asia-10 & G7



WTI crude prices & inflation expectations



10Y UST yield & inflation expectations



yields. While distortions from ECB's QE and the sizable balance sheet of the Fed will keep long-term UST yields lower than they otherwise would have been, further normalization in 10Y UST yields towards the 2.5-3.0% range is likely.

Against the backdrop, the window for Asian central banks (China is an exception) to ease monetary policy further is likely to close over the next few months. This is predicated on the assumption that policy makers would be concerned about stability in their respective currencies and government bonds. On a more positive note, Asian government bond yields have adjusted during the taper-tantrums of mid-2013. Even as developed market yields pushed new lows over the past year, Asian yields have declined by a smaller magnitude. As such, it is likely that Asian yields in general should also rise by a comparable or smaller magnitude relative to UST yields over our forecast horizon. For China, rates remain heavily dependent on expectations of growth. With deflation risks still weighing, it is not clear that a government bond yields have found a bottom just yet.

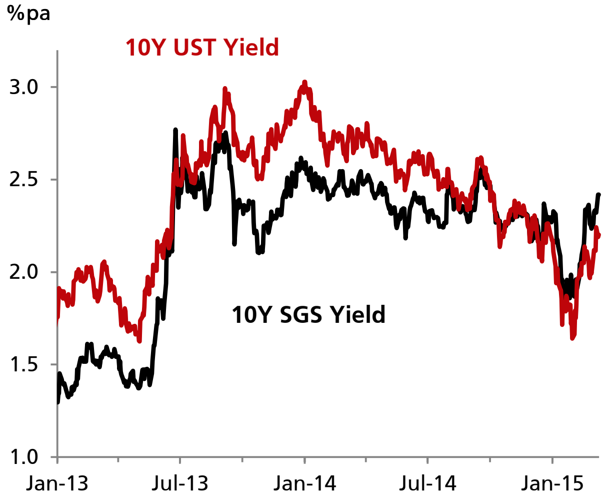
We expect yields on US Treasuries to rise. By end-2015, yields in the 2Y sector are likely to reach 1.50% while the 10Y sector is edges to 2.60%.

Singapore: Currency pressures

3M Sibor and 3M SOR have remained elevated relative to 3M Libor over the past few weeks. Initial signs of this decoupling took place in late 2014 when 3M SOR came under upward pressure. The premium of SGD rates over USD rates extends beyond the short term. SGS yields (2Y, 5Y and 10Y) are now also higher than USD yields of comparable tenor. This development is an anomaly considering that USD rates have been higher than SGD rates for the most part of the past 15 years.

Much of this phenomenon is likely due to market speculation of further SGD weakness relative to the USD. Notably, the Monetary Authority of Singapore (MAS) flattened the SGD nominal effective exchange rate (S$NEER) appreciation path at a surprise intermeeting move in late January. Speculation of further easing at the upcoming biannual monetary policy meeting in April has been a key reason why SGD rates stay elevated. In any case, short-term SGD rates should still track USD rates closely over a longer term. Sustained pressure on short-term SGD rates should only materialize when the Fed hike cycle starts, an event that is likely to take place only in 2H15.

10Y SGS Yield & 10Y UST Yield



• *Worries about excessive USD strength in the lead up to Fed tightening is keeping the spread of UST yields over SGS yields narrow*

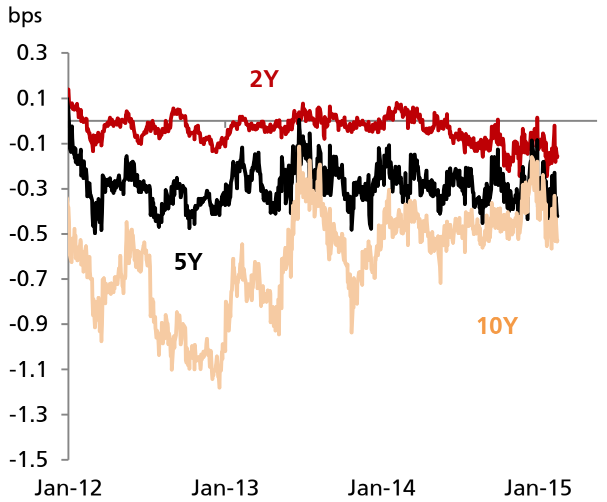
• *We expect benchmark SGS yields to rise. 2Y and 10Y yields are likely reach 1.60% and 2.70% respectively by end-2015*

Hong Kong: Low relative to the US

5Y HKgov yields have largely traded at a stable spread (negative) relative to UST yields of similar tenor over the past three years. However, the same cannot be said for 2Y and 10Y HKgov bonds. The spread in the 2Y segment has slipped deeper into negative territory while the spread in the 10Y segment has generally narrowed (become less negative). The behavior of spreads suggests that investors of HKgov bonds prefer shorter duration (2Y) bonds over longer tenor 10Y bonds. This could be due to increasing wariness that the Fed may start to normalize interest rates in 2H15.

We suspect that these spreads (HKgov yields less UST yields) are likely to narrow slightly (become less negative) when the Fed eventually hike interest rates. During the taper tantrums of mid-2013, spread compression was the sharpest in the 10Y segment, followed by the 5Y segment as the market wrongly brought forward Fed hike expectations. This time round, while we think that spread compression is likely to occur the moment Fed displays clearer forward guidance on the timing of rate hikes, the magnitude of change is likely to be significantly smaller. Meanwhile, with exchange rate risks and credit risks unlikely to be key, HKgov yields are likely to stay below UST yields.

HKgov bond yield less UST yield



• *On a historical basis, Hibors are high relative to Libors. Upward movements in Hibors are likely to be muted at the start of the Fed tightening cycle*

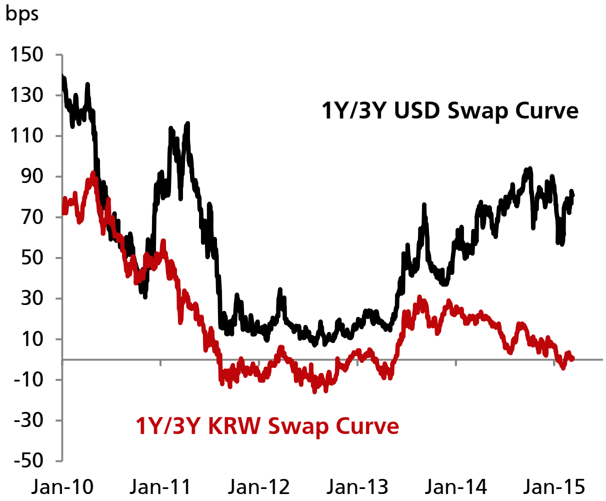
• *We expect yields on Hong Kong's benchmark Exchange Fund Notes to rise. 2Y and 10Y yields are likely reach 1.20% and 2.30% respectively by end-2015*

Korea: Sensitive to USD rates

The decoupling of slope steepness in the KRW and USD swap curve has persisted. Traditionally, the 1Y/3Y segments of both curves have been highly correlated as the Bank of Korea (BoK) sought to maintain interest rate differentials between KRW rates and USD rates. This correlation broke down when the Bank of Japan (BOJ) embarked on multiple rounds of aggressive quantitative easing since the end of 2012. With the KRW up by about 50% compared to the JPY in a relatively short time, the markets remained concerned about Korea's export competitiveness.

Even as the market has inferred that the BOK is willing to keep monetary policy loose, KRW rates are still highly sensitive to USD market rates. Notably, as USD swap rates bounced from end-January lows, there was a corresponding spike in KRW swap rates. While the impact has since petered out in the frontend KRW swap rates, backend swap rates stayed high. Currently, the market still sees a better than even chance of a 25bps rate cut (in line with our view) within the coming year. Meanwhile, intermediate to long-term KRW swaps rates should track USD swap rates higher.

KRW & USD Swap Curves



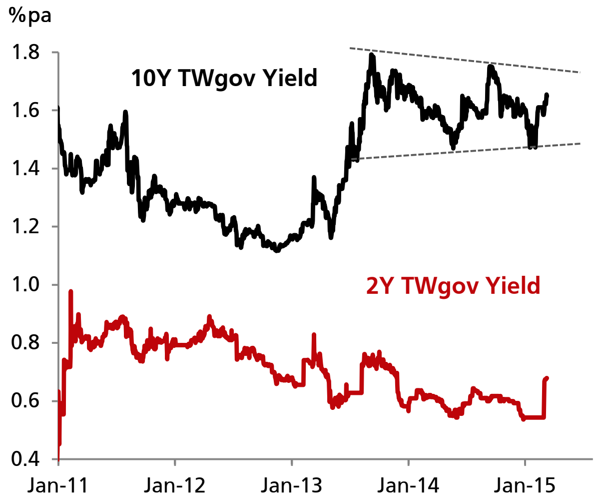
- *While there is a case to be made for further rate cuts, rising USD rates are likely to restrain the magnitude of further easing.*
- *We expect yields on benchmark Korean Treasury Bonds to rise. 3Y and 10Y yields are likely reach 2.15% and 2.60% respectively by end-2015*

Taiwan: Lacking direction

Lacking an overriding catalyst, TWgov yields are likely to stay range-bound for the coming few months. Since the taper tantrum in mid-2013, 10Y TWgov yields have been hovering between 1.50-1.75%, while 2Y TWgov yields have actually been drifting lower. Fundamentally, the economy registered full-year 2014 growth of 3.7% (the fastest pace in three years) and is on track to grow by 3.78% in 2015 (according to the statistical agency). Despite this backdrop of strong economic growth, inflation has been contained on the back of depressed oil prices.

As the current sweet-spot period of strong growth/low inflation is expected to continue through to end-2015, the market is less likely to be concerned about monetary policy changes. External funding is also not a worry with liquidity conditions likely to remain flush. Notably, even as the export outlook is likely to moderate in 2015, low oil prices are expected to keep the current account surpluses sizable. Changes in developed market yields would thus have a much more muted impact on TWgov yields. Against this backdrop, we project 10Y TWgov yields to drift towards the top of its trading range (1.75%) towards the end of the year.

2Y & 10Y TWgov Yield



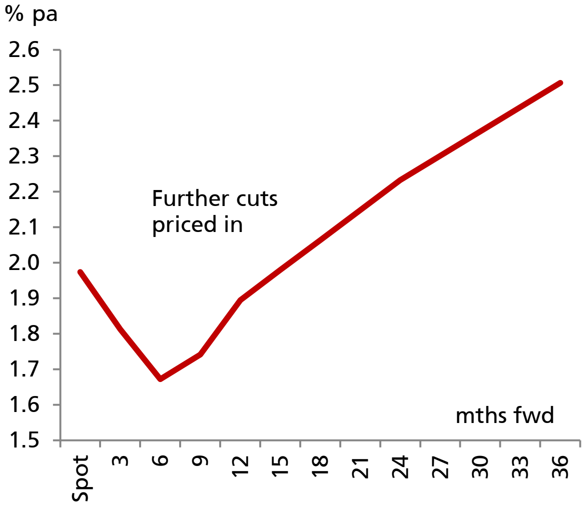
- *There is no rush to tighten monetary policy given that inflation is low. The first hike is now projected to take place in 1Q16*
- *We expect yields on benchmark Taiwan government bonds to rise. 2Y and 10Y yields are likely reach 0.65% and 1.65% respectively by end-2015*

Thailand: Speculation of further easing

Short-term THB swap rates may be too aggressive in pricing in rate cut expectations over the next six months. The implied 6M THB FIX, 6M forward, is now at 1.60%, almost 30bps lower than spot. The market is pricing in at least 25bps worth of rate cuts with an outside chance of 50bps within the next six months. Coming off after a 25bps rate cut by the Bank of Thailand (BoT) to 1.75% on March 11, the market may be too dovish compared to our core scenario that the policy rate would be kept on hold at 1.75% for the rest of 2015.

In the short term, speculation on further monetary easing is likely to persist, keeping THB swap rates low. This is understandable if the market continues to focus on weak growth/inflation dynamics and the still high real policy rate (2.25%). However, against the backdrop of rising USD interest rates, caution is warranted to ensure external funding and currency stability. Moreover, high household debt could also deter further monetary loosening. We expect longer-term THB swap rates to rise as USD swap rates normalize higher. Shorter-term THB swap rates are set to follow with a lag.

6M THB FIX Spot & Implied



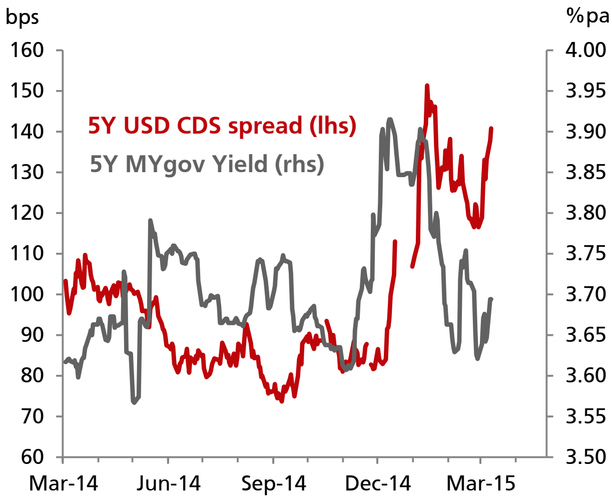
- *Speculation of further monetary easing will keep short-term THB swap rates low over the next few months*
- *We expect yields on benchmark Thailand government bonds to rise. 2Y and 10Y yields are likely reach 2.10% and 2.80% respectively by end-2015*

Malaysia: Stable yields, weak ringgit

The spike in MYgov bond yields (December to January) has receded. Part of this has got to do with the stabilizing of oil prices. Lower oil prices directly ease the buildup of pressure on the budget and on the current account, reducing risks of a deterioration in the twin deficits. Notably, the 5Y MYR credit default swap (CDS) spread has also fallen marginally to 140, from a peak of 152 in mid-January. Comparatively, MYgov bonds (3Y, 5Y & 10Y) have done much more, with prices back at early December levels.

The recovery in MYgov bonds despite still-elevated CDS spread levels suggests that other forces are at work. As highlighted previously, monetary policy across the globe remains highly accommodative. With developed market government bond yields still at low levels, this has helped cushioned upside on MYgov bond yields. Moreover, the authorities appear comfortable with letting the MYR weaken, thereby diffusing upward pressure on MYgov yields. However, lower MYgov yields should prove temporary. As developed market government bond yields bottom out, this should eventually lift MYgov yields in the second half of the year.

5Y MYgov yield & 5Y CDS spread



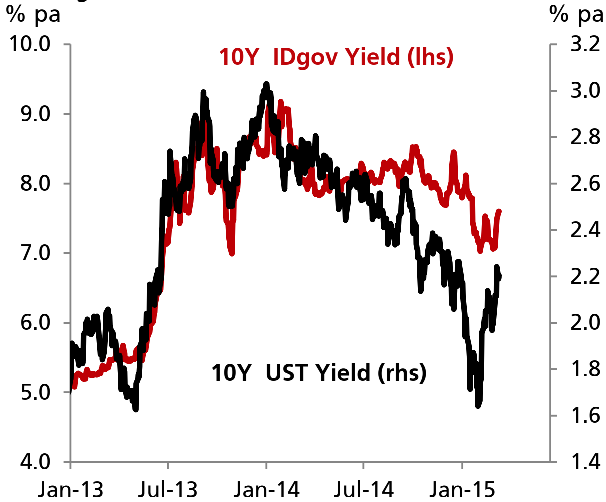
- *The authorities appear comfortable letting the MYR weaken. This should reduce upward pressure on MYgov yields even as UST yields head higher*
- *We expect yields on benchmark Malaysian government securities to rise.* **3Y** *and 10Y yields are likely reach 3.70% and 4.30% respectively by end-2015*

Indonesia: A one-off cut

The decision by Bank Indonesia (BI) to ease monetary policy in February is likely just a one-off. The latest 25bps reduction extended to both the BI policy rate and the Fasbi deposit rate, marking a change from the previous rate adjustment in November which left the Fasbi deposit rate untouched. As noted before, tweaks in the Fasbi deposit has direct implications on market rates whereas adjustments in the BI rate need not. 2Y and 10Y IDgov bond yields did revisit this year's low of 6.7% and 7.1% respectively but have since bounced.

We reiterate that IDgov yields are likely biased higher. Oil prices appear to have stabilized and more importantly, UST yields appear to have reversed their downtrend. 5Y and 10Y UST yields are now some 30-40bps higher than levels seen in end-Jan. In any case, reasons supporting overly low UST yields are becoming less compelling. Upward pressure on Asian government bond yields is likely to become apparent as UST yields normalize higher. Under these conditions, with no more BI rate cuts for the rest of the year, there is little reason for IDgov yields to head lower.

10Y IDgov Yield vs 10 Y 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*

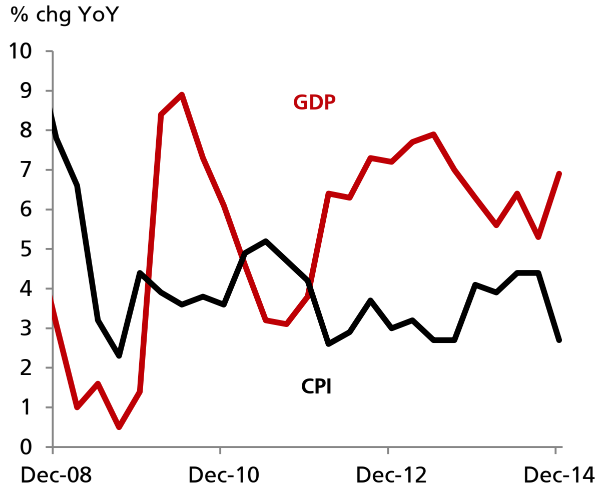
• *We expect yields on benchmark Indonesian government bonds to rise over a 1Y horizon. 2Y and 10Y yields are likely reach 7.40% and 8.00% respectively by end-2015*

Philippines: Sweet spot

Since the beginning of this year, 10Y PHgov yields have fallen by close to 40bps. This is about average when compared to other counterparts in Asia. Notably, this was a markedly better performance relative to 2014 when PHgov underperformed most other Asian and developed market sovereigns. Last year's underperformance was largely due to economic strength. GDP growth reached 6.1% when Asian economies faced moderation in economic activity. This also allowed Bangko Sentral ng Pilipinas (BSP) to hike the benchmark reverse repo rate by 50bps to 4%.

Monetary tightening and the increase in the 3M PHP reference rate (the market is implying greater PHP weakness versus the USD) have put some upward pressure on rates across the curve. However, the rapid fall in oil prices in 2H14 and yield decline in the developed markets (led largely by Eurozone sovereigns as speculation of quantitative easing mounted) provided a very positive backdrop for Asian government bonds. However, we think that PHgov bond yields are bottoming out amid a mix of stabilizing oil prices and tighter domestic monetary policy by the end of the 2015/early 2016.

PH: GDP & CPI



• *Growth/inflation dynamics suggests that the economy is in a sweet spot. Monetary tightening is projected only in 1Q16*

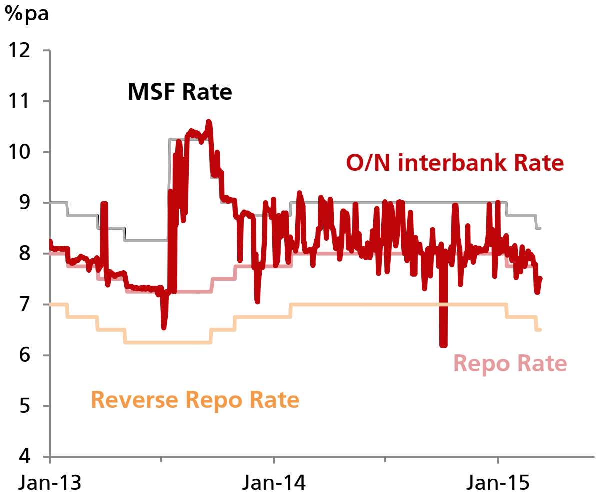
• *We expect yields on benchmark Philippine government bonds to rise. 2Y and 10Y yields are likely reach 3.30% and 4.40% respectively by end-2015*

India: Another rate cut coming

INR market rates are pricing in more monetary easing even after two intermeeting rate cuts (cumulative 50bps) that took place in 1Q. Notably, the forward space is implying another 68bps decline in the 3M INR interbank rate (from current spot of 8%) by the middle of the year. This is more aggressive than our forecast of another 25bps worth of rate cut. With INR swaps at these levels, receiving positions do not appear attractive. However, we still see value in short-term INgov bonds which have not seen yields fall sufficiently.

Notably, INgov bonds did not fully benefit from easy monetary policy across the developed world. In contrast to the 76bps fall in 10Y IDgov yields in January, 2Y INgov yields fell by only 22bps. Much of this is likely due to restrictions on foreign ownership of INgov securities, which have prevented yields from falling as much. However, a further 50bps cut in the repo rate should provide sufficient downward pressure to drive down yields in the front end of the INgov curve. We think that 2Y yields could push towards 7.5% by mid-2015 on tailwinds from low oil prices and further monetary easing.

Policy Rates, Bank Rates & Short Rates



• Sharply lower oil prices and declining inflation have provided room for INR market rates to head lower. 25 bps worth of policy rate cuts are likely to follow suit in 2Q15

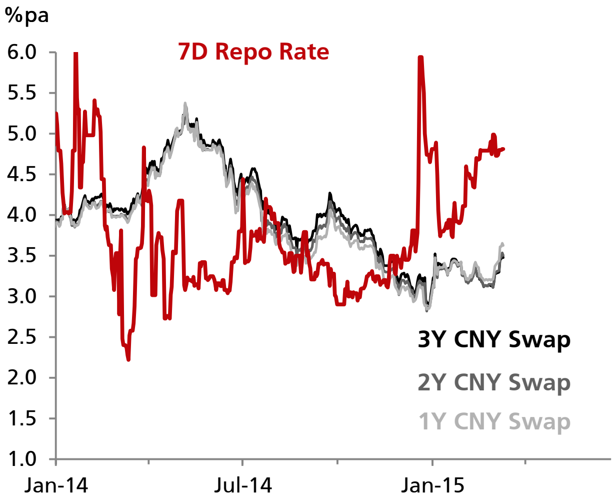
• We expect the Indian government yield curve to stay flat. 2Y and 10Y yields are both likely to reach 8.00% by end-2015

China: Easing mode

The divergence between the 7D repo rate (which serves as the floating leg fixing for CNY swaps) and frontend CNY swap rates continues. Since 4Q last year, the 7D repo rate has been steadily climbing, breaking out of its 2-4% range in December on regulatory (calculations of the loan-to-deposit ratio) concerns. However, even after this regulatory uncertainty has since been removed, the 7D repo has stayed persistently high, the seasonal increase in demand for cash in the Chinese New Year Period notwithstanding.

Comparatively, the 1Y CNY swap rate has been largely sideways since December while longer-term rates have actually been trending lower. With the 10Y CNY swap rate at 3.4%, the 7D/10Y segment of the curve has been inverted for over two months. We think that the 7D repo is too high. Policy makers have already taken steps (reserve requirement ratio cuts and lending rate cuts) to support credit growth and it is likely that more monetary easing will be forthcoming. These steps are necessary if the People's Bank of China (PBoC) intends to keep liquidity conditions ample as China enters into a period of smaller current account surpluses (slower liquidity expansion).

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



• The PBoC is likely to keep liquidity ample to support the economy. Short-term rates are likely to stay low

• We expect yields on benchmark Chinese government bonds to stay range-bound. 2Y and 10Y yields are likely reach 3.30% and 3.80% respectively by mid-2015

Interest rate forecasts

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

		11-Mar-15	2Q15	3Q15	4Q15	1Q16
US	3m Libor	0.27	0.30	0.40	0.70	0.95
	2Y	0.68	1.00	1.25	1.50	1.70
	10Y	2.10	2.20	2.40	2.60	2.70
	10Y-2Y	142	120	115	110	100
Japan	3m Tibor	0.17	0.20	0.20	0.20	0.20
Eurozone	3m Euribor	0.03	0.10	0.10	0.10	0.10
Indonesia	3m Jibor	6.80	7.00	7.00	7.00	7.00
	2Y	7.19	7.00	7.20	7.40	7.60
	10Y	7.78	7.60	7.80	8.00	8.20
	10Y-2Y	58	60	60	60	60
Malaysia	3m Klibor	3.77	3.70	3.70	3.70	3.70
	3Y	3.42	3.50	3.60	3.70	3.80
	10Y	3.98	4.10	4.20	4.30	4.30
	10Y-3Y	57	60	60	60	50
Philippines	3m PHP ref rate	2.32	2.25	2.50	2.75	3.00
	2Y	3.09	3.10	3.20	3.30	3.40
	10Y	4.06	4.00	4.20	4.40	4.60
	10Y-2Y	97	90	100	110	120
Singapore	3m Sibor	0.88	0.70	0.70	0.85	1.05
	2Y	1.19	1.20	1.40	1.60	1.80
	10Y	2.45	2.35	2.50	2.70	2.75
	10Y-2Y	125	115	110	110	95
Thailand	3m Bibor	2.17	1.90	1.90	1.90	2.15
	2Y	1.92	2.00	2.00	2.10	2.20
	10Y	2.71	2.60	2.70	2.80	2.90
	10Y-2Y	78	60	70	70	70
China	1 yr Lending rate	5.35	5.10	5.10	5.10	5.10
	2Y	3.23	3.10	3.20	3.30	3.40
	10Y	3.52	3.60	3.70	3.80	3.80
	10Y-2Y	29	50	50	50	40
Hong Kong	3m Hibor	0.39	0.40	0.50	0.70	0.95
	2Y	0.53	0.70	0.95	1.20	1.40
	10Y	1.42	1.70	2.00	2.30	2.40
	10Y-2Y	89	100	105	110	100
Taiwan	3M Taibor	0.88	0.88	0.88	0.88	0.96
	2Y	0.64	0.65	0.65	0.65	0.80
	10Y	1.62	1.65	1.65	1.65	1.70
	10Y-2Y	98	100	100	100	90
Korea	3m CD	1.94	1.70	1.70	1.70	1.95
	3Y	1.91	2.00	2.00	2.15	2.30
	10Y	2.32	2.40	2.50	2.60	2.70
	10Y-3Y	41	40	50	45	40
India	3m Mibor	8.56	8.10	8.10	8.10	8.10
	2Y	7.85	7.50	7.75	8.00	8.25
	10Y	7.76	7.60	7.80	8.00	8.25
	10Y-2Y	-14	10	5	0	0

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CNH: more free trade zones

- **To promote the pilot measures in Shanghai to other regions**
- **There is a significant potential in corporate banking business lines that generate fee-based income**
- **Unfortunately, high rates in the CNH market might dampen cross-border borrowing activities**

Foreign capital will remain as a prime driver behind quality growth despite the emerging trend of direct investment exceeding inflow of capital. To achieve that, policymakers will open up the economy further by establishing more Free Trade Zones (FTZ).

Establishing more FTZs

In Dec 2014, China's State Council approved the setup of three new FTZs in -- Guangdong, Fujian, and Tianjin -- with relaxed investment rules to speed up reforms. Specifically, the Guangdong FTZ, spanning an area of 116.2 sq km, covers Nansha new district in Guangzhou, Qianhai and Shekou districts in Shenzhen, and Hengqin district in Zhuhai. The Tianjin FTZ, which spans 119.9 sq km, encompasses Tianjin airport, Binhai New Area and Tianjin port. The Fujian FTZ, which spans 118.04 sq km, embraces parts of Pingtan, Xiamen and Fuzhou. Meanwhile, the Shanghai FTZ will be expanded from the current 28.78 sq km to 120.72 sq km after including Lujiazui, Zhangjiang and Jinqiao districts.

The inaugurations of the new FTZs are expected to be held in the second half of March, after the annual sessions of the National People's Congress and the National Committee of the Chinese People's Political Consultative Conference.

Promoting reform policies in a broader area

The creation of the Shanghai FTZ in Sep 2013 was recognized as a crucial economic reform initiated by China's new leadership. The FTZ expansion will test the reform policies in a broader area and also the feasibility to promote pilot measures in Shanghai to other regions. Some of the measures provide easier access to private capital and further open up the service sectors. One important breakthrough was the adoption of a "negative list" to ease the process of investment approvals inside the zone. As at Nov 2014, a total 14,000 new companies were set up. Among them, 2114 were overseas companies, 10 times the number in the previous year.

Thanks to the streamlined application procedures, outward investment accelerated in the zone as well. A total 160 overseas investment projects were completed by end-2014, with the total amount of foreign investment from Chinese companies reaching RMB 3.8bn. As mentioned in our earlier report, the adoption of a "Go Abroad" strategy by mainland companies is pivotal for China to achieve a more balanced BoP (balance of payment). Such a process allows mainland companies to broaden their business scope and transfer some excess capacity to foreign countries. This is indeed one of the policy aims of the "One Belt, One Road" initiatives (see "CNH: Going abroad", 10 Dec 2014).

Banks shifting focus to fee income

The Chinese companies' go-out strategy, alongside the growing presence of multinationals, attributes to the surging demand for cross-border products and services.

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The bilateral sweep pilot program, for instance, allows firms to connect previously segregated China cash pools to their treasury centers offshore. It enables them to maximize liquidity utilization, enhance intra-company financing, and reduce external borrowing costs. Such cross-border products and services also benefit Chinese banks. Amid the FTZ expansion, there will be a huge potential in corporate banking business lines such as cross-border cash pool management and international settlement, which generate fee-based income.

Cross-border transactions to grow

Another spotlight is the broader implementation of the free-trade account (FTA) system. The FTA system was first established in mid-2014. It allows yuan transactions for current account business, foreign direct investment, and cross-border borrowing for companies registered in the Shanghai FTZ. Hitherto, thirteen banks (including two foreign banks) in the zone have received approval to provide free-trade accounts to clients.

According to the authority, offshore loans obtained (mostly last year) by corporates in the zone totaled RMB 19.7bn, and the interest rate was 4.2 %. That compares favorably with the 1Y policy lending rate of 5.6% onshore during the same period. Since Feb 2015, a more flexible scheme has been applied. In particular, corporates can borrow a maximum of 2x their capital. The leverage ratio for FTZ incorporated banks are 5x their tier one capital. Meanwhile, borrowing entities are allowed to raise both yuan and foreign currencies funds under the FTA.

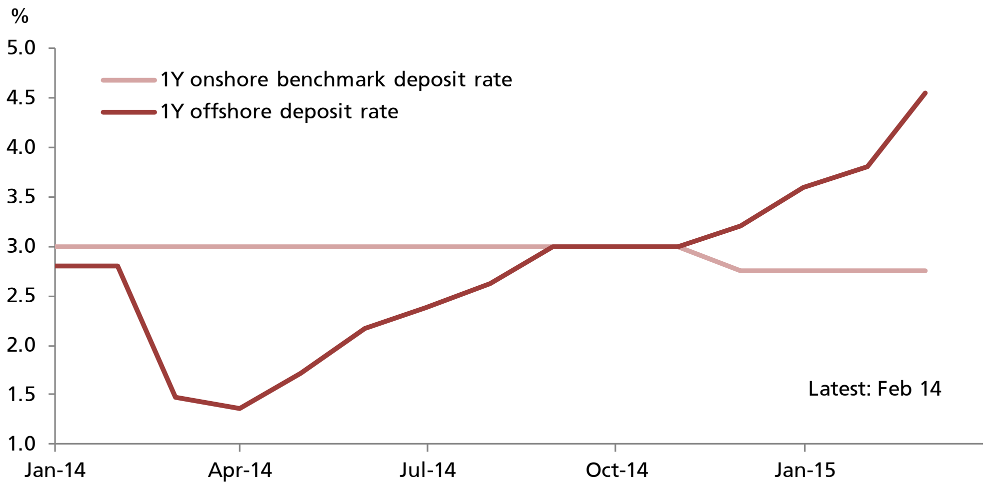
The addition of new FTZs in Guangdong, Fujian, and Tianjin will significantly allow more enterprises to tap the offshore market. The relatively low foreign currencies funding costs offshore will provide entities more options for their cost saving strategy. A modest demand for foreign currencies loans is therefore expected from mid-sized Chinese corporates that have no overseas subsidiaries. For yuan loans, however, some issues need to be addressed before the full impact can be felt.

Offshore yuan liquidity needs to be replenished

Since the kick-off of the Shanghai-Hong Kong Stock Connect program, RMB 109bn has been drained from HK's liquidity pool owing to stronger northbound versus southbound flows. This was equivalent to 11% of the city's yuan deposit base of RMB 981bn as of Jan 2015. There was also added pressure from the expansion of repatriation channels such as the Renminbi Qualified Foreign Institutional Investor (RQFII) program. These developments have sent offshore rates materially higher than onshore levels since 4Q14 (Chart 1) in spite of the liquidity measures by the Hong Kong Monetary Authority (HKMA) to help banks manage their yuan positions.

Regulators to address the offshore liquidity concern by broadening channels of yuan supply to the offshore market

Chart 1: Offshore rates higher than onshore levels since 4Q14

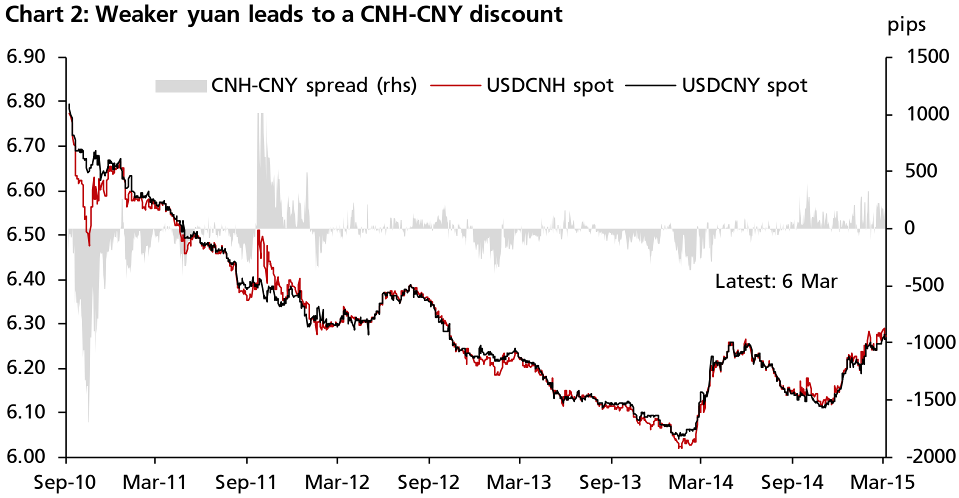


Compounding the situation is the weak currency outlook. In this quarterly report, DBS FX specialist has revised the year-end target for USD/CNY from 6.15 up to 6.36. A weaker yuan expectation is likely to lead to a prolonged CNH-CNY discount (Chart 2). This would consequently lower the current account yuan inflows to the offshore market, which have, so far, been the primary channel for CNH funding inflows.

Policy implications

Broadening channels of yuan supply to the offshore market is needed by increasing the variety of offshore investable assets for the mainland residents. By permitting offshore banks to tap into the onshore interbank market for funding is another wise strategy. Also, the HKMA could upgrade its yuan liquidity facility backed by its swap lines with the PBoC.

Chart 2: Weaker yuan leads to a CNH-CNY discount



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Asia equity: scaling the mighty USD wall

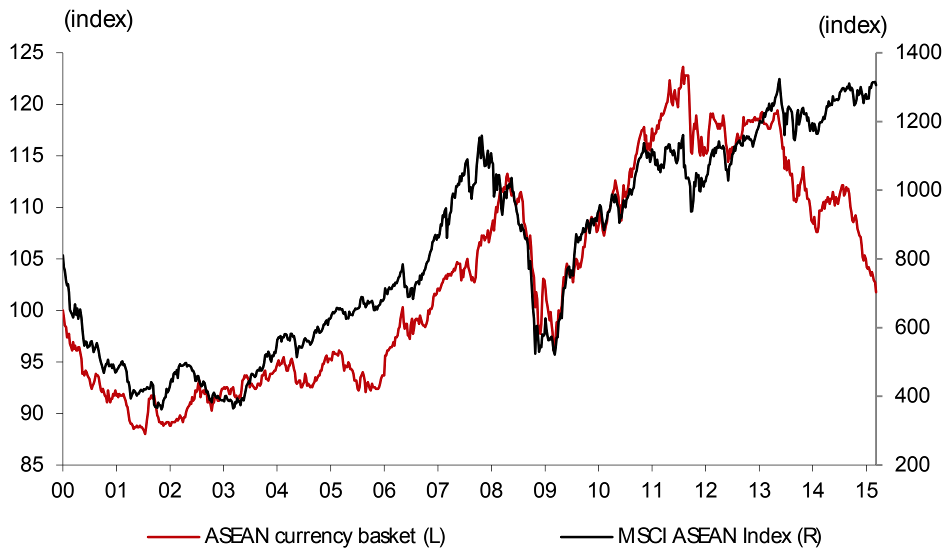
- **The divergence in equity and currency markets in Asia is an anomaly — Asian equities are likely to succumb to USD strength**
- **ASEAN markets are more vulnerable due to their higher sensitivities to US Fed hikes and weaker domestic currencies, as well as higher valuations —Thailand and Indonesia downgraded to Neutral**
- **The consolidation period will be shorter compared to the May13 "QE tapering tantrums" sell-off, and present a good opportunity to accumulate on weakness**

Asia equity markets are up 2.5% YTD as they continue to climb the wall of worry. With most indices nearing our year-end targets, we expect market trajectory to slow down in the coming quarter in view of the headwinds. Valuations, potential US interest rate hikes, and accelerating USD strength are likely to affect market volatility, especially for ASEAN markets.

Our house view remains that the US interest rate hike will be implemented towards year-end. However, markets being markets, are subject to fluctuations in expectations and "tightening tantrums", more so when economic data is not leading the markets in any direction.

Having said that, we view a near-term consolidation as a buying opportunity, as the external positions in most Asian countries have improved in the past few years.

Fig. 1: Asean currency basket vs MSCI Asean equity local index



Source: Datastream, DBS

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GDP Growth is intact, earnings downgrade to come

Except for Thailand, this quarter, DBS economists have largely placed their forecasts intact, with some minor upward revisions due to a better-than-expected 4Q results, lower oil price and rate cuts. We downgraded Thailand to Neutral in our last ASEAN monthly *(see "Watch valuations", 5 March 2015, Joanne Goh et all)*, in view of the growth disappointments.

We expect more downside to earnings growth however. Consensus earnings growth for MSCI Asia ex-Japan has been downgraded from 11% at end of last year to 9.5% currently. We expect more downgrades on the street, in view of the volatility in the currencies, oil price, interest rates and lower China growth.

Good opportunity to accumulate

In the event of a major sell-off, we believe it would be a good opportunity to accumulate on weakness. Asia markets should digest the US interest rate hike, just like the US tapering when it started in November in 2013, and ended one year later. During the May 2013 sell-off, markets in general, took more than one year to recover to their previous highs. We believe the healing period will be shorter this time around as the external positions are stronger, domestic liquidity is better, and most central banks are better prepared to tackle currency weakness as a result of portfolio flows by improving on capital control measures and communiqué.

Our house view remains that the US interest rate hike will be implemented towards year-end. However, markets being markets, are subject to fluctuations in expectations and "tightening tantrums", more so when economic data is not leading the markets in any direction.

USD strength is here to stay

The increasing divergence in global monetary policies is prompting currency forecasters to favour an even stronger USD appreciation path. DBS currency strategist expects the USD to sustain its uptrend over the next couple of years as it begins to raise rates.

DBS currency strategist believes markets could have underestimated the Fed's intentions to return real interest rates to positive territory. According to the Fed's optimal study, the Fed Funds Rate should return to 3-4% by 2017, above the Fed's 2-2.5% inflation target.

While QEs in Japan and the Eurozone were mostly responsible for leading the benchmark DXY (USD) index out of its post-crisis range, going forward, the DXY has scope to extend its recovery on the approaching Fed hike cycle.

Volatility from Asian currencies

Asia ex-Japan currencies have weakened YTD vis-a-vis the USD but has strengthened against major currencies like the Euro and the Yen due to the sharp depreciation in the latter two. Unlike in 2005 when the Chinese RMB embarked on an appreciation trend, China is seemingly favouring a depreciation policy now. There is hence even less incentive for Asia to buck the globally strong USD trend.

In Q2 we look to more volatility in Asia equities markets as their currencies re-align to a higher USD. The markets which are more sensitive to local currency weakening are the five ASEAN markets and India. The relative sizes of portfolio flows vs trade flows, and external position and reserves have made them more vulnerable to outflows triggered by a weak currency.

Potential US interest rate hikes

Market's "tightening tantrums" have begun, triggered by a better than expected jobs report and an increased speculation that the Fed would remove "patient" from its statement at next week's FOMC meeting on 18 Mar. In May 2013 when the market was experiencing "tapering tantrums", Asia markets were down 17% from the high in USS terms, with the worst hit markets being Indonesia (-36%), India (-30%), Thailand (-28%) and Philippines (-28%). And indeed the TIPs markets have yet to re-visit their previous highs in USD terms.

The statistical sensitivity of US Fed funds interest rate hikes to Asia equity markets is not as strong as the market reactions, however. We believe these are merely knee-jerk reactions, and an excuse to take profit after the market had rallied on low rates before. Hence, market valuations and prior fund inflows have to taken into consideration for analysis in this context.

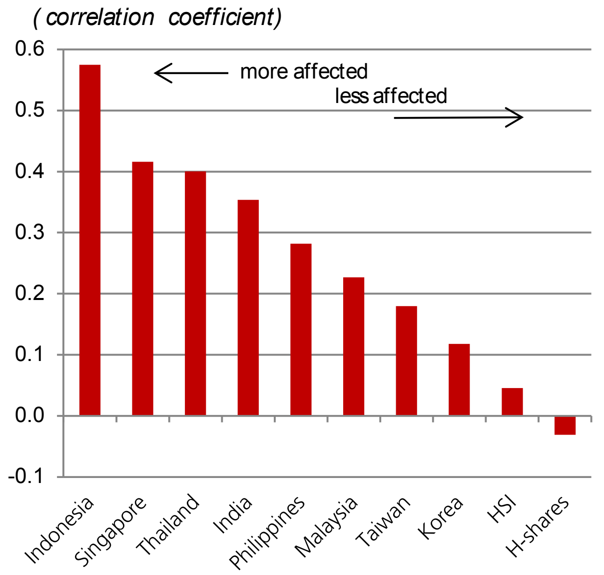
Nonetheless, the ranking of the correlation coefficient suggests that Singapore, Indonesia, Thailand and Hong Kong will be affected the most in a interest rate hike environment. In Singapore and Hong Kong, interbank rates tend to move in tandem with the US short rates, which explains the higher correlation. Thailand and Indonesia used to enjoy strong fund flows which tend to reverse during US rate hikes.

This time round, Singapore's SIBOR has already moved ahead from 0.3125% to 0.88%, while Thailand had hardly any significant fund inflows since the political coup in 2014. Implications on these two markets may be different now.

US interest rate hikes may be delayed, however

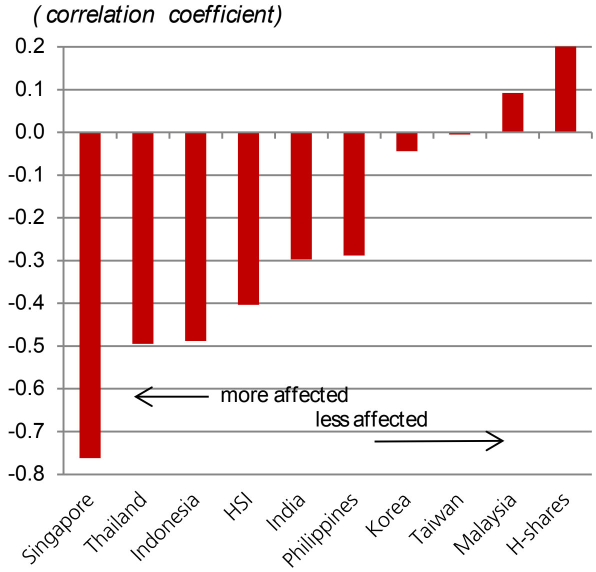
Whether US will eventually hike rates in June still remains an uncertainty. As DBS chief economist argued, there is no acceleration seen in US economic growth and 4Q14 just brings back the broader US picture back to normal average of 2.3% since 2012. Fed rhetoric increasingly focuses on a June or September liftoff. To our eye, there are clear reasons why it might want to delay. The real economy continues to struggle, real wage growth has been near zero for two years and inflation continues

Fig. 2: Ranking of Asia markets' sensitivity to domestic currency weakness



Source: Datastream, DBS

Fig. 3: Ranking of Asia markets' sensitivity to US Fed funds rate hikes



Source: Datastream, DBS

to fall. And indeed, the Fed's favorite inflation — the core PCE deflator, has been falling for three years, not six months. If the Fed does go ahead and raise rates later this year, there is every reason to believe it won't get too far, too fast thereafter. *(See "US: no acceleration", David Carbon, Economics-Markets-Strategy Q215, 12Mar)*

18 March remained the D-day to watch if global currencies and markets could have a temporary relief from the sharp USD appreciation volatility. The likely scenario will be for Fed to remove the word "patient" from the minutes but still sounds dovish, hence suggesting nothing new. Volatility would be here to stay until Fed finally raise rates.

Regardless investors should be prepared for the dollar's ascent and eventual US interest rate hikes. The VIX index needs to be monitored if investors are too complacent on this.

Rise in bond yields

We believe the US 10-year bond yield rates may be bottoming out as the highly anticipated QE has been carried out, oil price has recovered from its low (indicating the inflationary expectations may have bottomed), and the beginning of the US rate hike cycle is drawing closer.

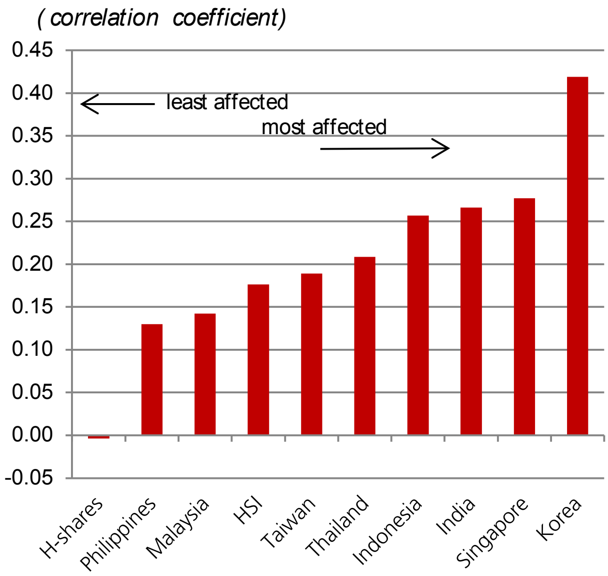
Simultaneously, a rise in bond yields interest rates would generally be interpreted as a strengthening in the US economy is underway, in which case will benefit export economies. Indeed, most Asian markets have positive correlation with a rising US bond yield environment, with Singapore, Korea and Taiwan having the highest correlations. Hong Kong H-shares are fairly insensitive to US bond yields.

Investors should however be cautious of sectors which use bond yields as the valuation benchmarks, such as the REITS sector, and those with exposure to high yield bonds.

Valuations

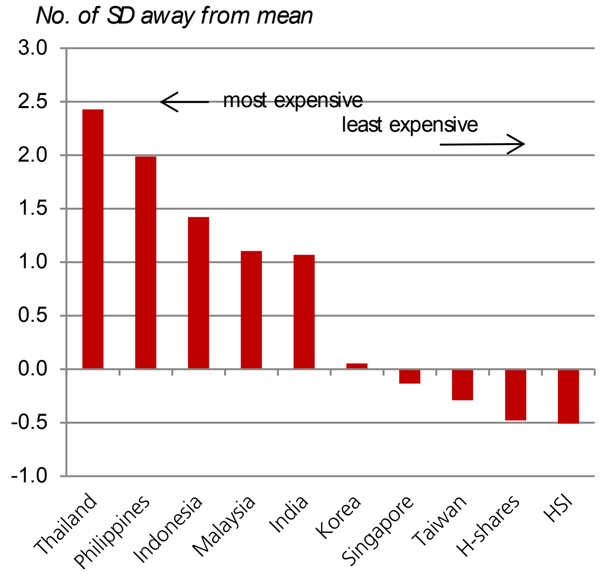
Asia ex-Japan markets is now trading in line with average valuations in terms of 12-month forward PE but not for ASEAN markets, except for Singapore, which trade

Fig. 4: Ranking of Asia markets' sensitivity to rising US bond yields



Source: Datastream, DBS

Fig. 5: Ranking of Asia markets' 12-month forward PE valuations



Source: Datastream, IBES, DBS

at more than +1SD. The cheapest markets are still Hong Kong's HSI and MSCI China, while Thailand is the most expensive. Markets have generally ignored valuations this year due to the positive sentiments driven by strong global liquidity outlook in the beginning of the year. We believe investors will focus on valuations now, in view of the macro headwinds of rising interest rates and weak currencies, making markets such as ASEAN and India more susceptible to profit taking.

Asset allocation

The theme behind our asset allocation this quarter is to mainly hedge against changes in expectations on US interest rate hikes. The event risk stemming from the March 18 Fed meeting is high, in our view, and investors should not ignore this as markets have been complacent about US interest rate hikes and currency weakness in Asia YTD. During the EM market volatility in May13-Jan14, Asean markets were shocked down 15% on the equities and 13% on the currencies.

The recovery period will probably be shorter this time round. We are maintaining most markets as Neutral, as the odds are even. We prefer Hong Kong / China to ASEAN as it is immune to the US currency and rate hike uncertainty and hence, it is an Overweight for us. Malaysia is an Underweight due to currency weakness concerns stemming from its fundamental weakness.

Our key views and sensitivity to the various headwinds of US interest rate hikes and weak currencies for the respective markets are discussed in the following section. Our market recommendations are as follows:

Overweight: China / Hong Kong

Underweight: Malaysia

Neutral: Singapore, India, Taiwan, Korea, Indonesia, Thailand, MSCI Hong Kong

Fig. 6: Summary of overall ranking (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
Singapore	2	1	9	7	4.75
Malaysia	6	9	3	4	5.5
India	4	5	8	5	5.5
HSI	9	4	4	10	6.75
Taiwan	7	8	5	8	7
H-shares	10	10	1	9	7.5
Korea	8	7	10	6	7.75

Source: Datastream, IBES, DBS

Fig. 7: 2013 EM sell-off — high to low correction

	Local idx from Hi-Lo	Currency from Hi-Lo	USD terms *
Indonesia	-24%	-22%	-36%
India	-16%	-23%	-30%
Philippines	-22%	-9%	-29%
Thailand	-22%	-13%	-28%
H-shares	-27%	-3%	-27%
Korea	-14%	-10%	-21%
HSI	-18%	0%	-18%
Singapore	-13%	-5%	-16%
Malaysia	-14%	-11%	-16%
Taiwan	-12%	-4%	-12%

Source: Datastream, DBS. Notes: 1) Index high and low in 2013 only. Singapore STI hit another low in 2014. 2) USD terms based on local index in USD. 3) Do not tally with currency weakness due to different dates of high and low for the index and the currency respectively

Market Views

China / Hong Kong (Overweight)

DBSVickers Hong Kong / China strategist believes the market will take a breather in 2Q due to multiple headwinds. Negative earnings revisions are also persisting longer than expected due to factors such as RMB weakness, implications of the gaming sector disappointments on the deep impact of the anti-corruption drive, prolonged oil price weakness, as well as interest rates cuts on Banks' margins.

During the National People's Congress in early March, Premier Li Keqiang highlighted 2015 targets and reform plans for China. While GDP growth has been lowered to 7%, strong focus is being put on higher quality growth, and demonstrating commitment to gradual reforms. We believe the markets will focus on these reform sectors in Q2.

Outflows emanating from RMB weakness will be less compared to other ASEAN markets. The market is not as sensitive to rising US bond yields or Fed fund hikes. In terms of valuations, China / Hong Kong are the two cheapest markets. Our Overweight on China / Hong Kong is from a defensive stance as it will be less affected by these macro uncertainty.

MSCI Hong Kong is a Neutral as the local Hong Kong shares will be affected by US interest rate hikes as HIBOR moves in tandem with US short rates. Weak local sentiments from high property prices and street protests, and slowdown in tourists arrival will continue to affect consumption trend. The gaming sector will take some time before it recovers.

Singapore (Neutral)

Near term, the uncertainty lies in the Singapore currency which has weakened 4.9% since the beginning of the year, and the Singapore interbank rate which has jumped 2.8 times (from 0.3125% to 0.88%). Being an open economy, this uncertainty is detrimental to the flows expected against a strong global liquidity backdrop. Statistically Singapore remains one of the most vulnerable markets to a weakening SGD and Fed rate hikes. The risk emanating from US fed fund rake hikes, which will prolong the USD strengthening and a spike up further in interbank rates, cannot be ignored.

Meanwhile, the latest PMI dipped further, with declines in key sub-indexes such as new orders, new export orders and production output. Inventory levels have started to pile up and production activities have eased — all suggesting a weak outlook ahead for the manufacturing sector. All hopes are pinned on the US recovery when Europe and China are still struggling with growth.

We believe the domestic stocks should continue to be favoured in this environment. Based on the recent budget announcement, handouts totalling S$848m are expected to spur consumer spending, with consumer staples being key beneficiaries, as the bulk goes to the aged and the low income group. The Singapore government has extended most of the expiring tax incentives and concessions for REITs in the 2015 budget, for five years to March 2020.

Banks which are net lenders in the interbank market will benefit from the increased SIBOR rate. However, overall loan growth is expected to slow with a slower nominal growth and increased lending rate.

We maintain our Neutral outlook on the Singapore market with a year-end target of 3600.

Indonesia (Downgrade to Neutral)

JCI reached a new high this quarter following an unexpected 25bps rate cut by Bank Indonesia. Foreign inflows were strong both in the bond and equity markets till one week ago. Bond yields fell 7.8% to 7.1% and foreign ownership reached 40%, while equity P/E valuations were driven to 15.5x.

Despite the strong flows, the rupiah has depreciated 5.7% YTD. JCI in USD terms was thus down 1.1%. DBS currency strategist is forecasting rupiah weakening by 5% to 13660 by year-end. On a USD-adjusted return basis, our target return for JCI will be less than 5% for the year. We are thus downgrading the market to Neutral in view of this currency uncertainty.

We believe the big question for Indonesia equities is whether they will still be subject to fund outflows when the US starts hiking interest rates as in past instances. The most recent occurrence was during EM volatility in May13-Jan14, when the US Fed signaled the beginning of its QE tapering. The JCI dropped 30% and the rupiah depreciated 15% within a 3-month period. This time around, the odds are quite fair when uncertainty looms on whether BI will cut rates further or whether the US will eventually hike rates this year. To err on the safe side, we prefer to be Neutral on the market. Nevertheless, against a backdrop of depreciating Asia currencies amid USD strengthening, we believe the rupiah cannot escape the fate of further depreciation to be in line with region.

The re-rating that we are looking for in Indonesia is unlikely to happen in such a risk- adverse environment. We are lowering Indonesia's PE target towards 14.6x PE, which is +1SD. This will put the year-end JCI target at 5700.

Compared to May 2013, Indonesia's current account deficit has narrowed from as high as 4.2% of GDP to about 3% of GDP currently. Additionally, by removing most fuel subsidies, and thus helping to lower the value of oil imports, the government has also made its fiscal deficit less sensitive to dollar swings. Moreover, a string of policy measures and interest rate hikes have been taken to support the rupiah.

We are recommending investors to look out for opportunity to buy on weakness in Indonesia. The government under Jokowi is growth and reform oriented as can be seen from the policies so far. While earnings are not going to be strong this year, the reform should pave the way for better governance and transparency in doing business and therefore achieve a higher level of potential growth in the future by attracting more FDIs. A potential ratings upgrade by S&P would give inflows a big boost.

Investors should look toward rupiah stability as a signpost to overweight the market again. We believe the market should recover quite briefly after the initial sell-off.

Thailand (Neutral)

We downgraded Thailand to Neutral in our last ASEAN monthly *(see "Watch valuations", 5 March 2015, Joanne Goh et all)*, on growth concerns. Domestic demand is still weak which needs fiscal spending and stimulus boost.

However private consumption growth will likely fall below potential and investments may not pick up if export outlook continue to be sluggish. It remains to be seen if government disbursements can pick up in view of the red tape. Agricultural produce may also be affected by the potential drought, thereby affected farmers consumption spending, The SET index remains stuck at below 1600. Trading activity was mainly driven by domestic liquidity rotating among the leading sectors and small caps.

The Thai baht has strengthened vs other Asian currencies, hurting export competitiveness when external environment remains weak. Markets are starting to price in rate cuts which implies that THB is likely to weaken in line with other currencies. However, whether rate cuts will spur growth remains uncertain as Bank of Thailand has repeatedly refused to acknowledge this by resisting rate cuts and putting more emphasis on fiscal policies to boost growth. This suggests that policy options may be limited to boost growth recovery and could disappoint once again.

We continue to recommend the selective play strategy, given that the market still lacks key drivers amid the gloomy macro picture. Any further market weakness would be an opportunity to accumulate key stocks for long-term investment.

Malaysia (Underweight)

Malaysia will be subject to portfolio outflows if its fundamentals deteriorate further. Sentiment has dipped in 2014 amid rising inflation as the government tightens its belt on subsidies and kept a tight lid on credit growth. With oil prices falling 50% since the peak, it has not only hurt Malaysia's exports but also the government's finances, prompting the ratings agencies to revise their outlook on Malaysia to negative.

The market is trading at 16.4x, which is more expensive than its regional peers. We believe there are more downside to earnings growth, given weak sentiments. The Malaysian ringgit has depreciated 15% since June last year after experiencing USD38bil of bond outflows and USD2.2bil of equity outflows. Foreign bond holdings stood at 32% as of end-September which remains vulnerable.

On the macro front, we believe there is downside risk to our growth forecast of 5.2% for 2015, given the weak external environment and commodity prices. Malaysia has been standing pat on its monetary policies while much of the easing has been effected by default via its weak currency. Conversely, export competitiveness could be achieved in its electronics and other non-commodity exports.

Philippines (Neutral)

The PSEi has gained 500 points this year to register a 6.1% gain YTD. 4Q14 GDP data released in January did not disappoint - growth exceeded expectations at 6.9% in the quarter (vs. 5.9% consensus estimate), taking full-year 2014 GDP growth to 6.1%. Furthermore, inflation has continued to ease in January, to 2.4% from 2.7% the month before. Sentiment has been positive since, as low oil prices are expected to support the country's growth. Lower inflation should also spur consumption, and give the BSP less headroom to raise interest rates.

Valuations are likely to remain lofty, given the outlook for stronger macro data. The low inflation and oil price backdrop will trigger growth this year – supporting higher multiples. However, in the latter part of the year, a strong US$, Fed rate hike, and uncertainty over the upcoming presidential elections will become major risks.

We are maintaining Philippines at Neutral.

Korea (Neutral)

We continue to see KOSPI trapped in a range of 1900-2100. 2014 has been a reform year for Korea but it remains to be seen if that will translate into a P/E re-rating for Korea in the short run. The government has aimed to boost domestic demand by making fundamental changes to household income growth. Some of these measures include encouraging corporates to increase dividend payouts and boosting property prices. However, KOSPI remains highly sensitive to economic and earnings growth where outlook is uncertain, in our view.

Korea's exports had been sluggish where a strong won vs yen was the easy target to blame. With Samsung's output accounting for close to 17% of Korea's GDP, the increasing competition faced by Samsung from Apple and China's handset manufacturers does not paint a rosy picture ahead for Korea. Until there is a strong commitment by Korea's Chaebols towards restructuring, the deep cyclical sectors such as shipbuilding, steel, petrochemicals, and manufacturing will continue to de-rate in an economy facing a potential dis-inflationary spiral.

With China now being Korea's biggest export market, accounting for 25% of Korea's total trade, improving trade relationship with China is a key driver for Korea's exports. In an important development on the policy front, Korea and China signed a provisional free trade agreement at the end of February. China will remove tariffs on 71% of its products imported from Korea over the next 10 years. Korea also registered strong growth in Chinese tourist arrivals in 2014. We believe the KOSPI could be more sensitive to China's growth indicators than before, reacting to China's PMI data and monetary policies.

BoK has pointed out that the won has become slightly overvalued on the REER basis, and that there are downside risks on growth recovery this year. DBS' economist believes there is room for one rate cut this year, while household debt has increased recently to uncomfortable levels.

Short-term drivers for KOSPI to stay in the range includes: 1) Stable global growth; 2) Potential interest rate cuts; 3) Consumption boost from lower oil prices and inflation, as well as government fiscal measures; 4) Bright spots in new economic sectors such as internet, media and cosmetic products; and 5) Bottoming outlook for Samsung Electronics.

We are maintaining our Neutral recommendation for Korea. The market has high positive correlation with rising US bond yields, according to our sensitivity analysis.

Taiwan (Neutral)

The Taiwan stock market returned 2.5% YTD in line with the region. As the region grapple with volatility on currency and US tightening tantrums, Taiwan remained fairly immune to fund outflows. Like Korea, impact of rising US bond yields on Taiwan is positive as it signals US economy is strengthening, and should lift Taiwan's exports growth.

There are high hopes that the Apple effect can be extended into this year with the launch of the i-watch, but it remains to be seen as the i-watch has a lower demand volume than the i-phone. Indeed, Taiwan's electronics exports expanded strongly last year, but we believe it could prove to be a cyclical surge. Key trade negotiations with China are expected to be delayed until after the elections, which implies that the economy is unlikely to receive a significant boost from cross-straits relations in the meantime.

DBS' economist forecasts a 3.7% GDP growth in 2015 which is the same as last year's. Taiwan's domestic demand could gain further traction this year, on the back of a set of favourable factors – falling unemployment, rising wages, low oil prices and low interest rates. Inflation is expected to fall to 0.3% this year, giving Taiwan much room to maintain a neutral monetary stance despite strong liquidity.

In terms of external balance, Taiwan stands out as having one of the strongest in the region and could display its defensiveness against a backdrop of USD strengthening and rate hike scenario. We maintain our Neutral stance on Taiwan, the wild card being the presidential elections campaign which will begin in the middle of the year. Domestic demand may receive another boost.

India (Neutral)

Sentiments in India received another boost from the budget as more growth-oriented measures are being announced. RBI has also issued another inter-meeting interest rate cut. We are maintaining India as Neutral as it is trading towards its 5-year historical high of 18x P/E. The market has gained 40% since the beginning of 2014 on elections, reforms, positive policy signals, rate cuts and data revisions. With all these having been largely priced in for the time being, we believe that real improvement in the economy and corporate earnings growth matter more to the market now. While trumping on the growth front, investors may have to scale back their expectations on the fiscal front. The rupee has finally weakened against a backdrop of weakening Asia currencies, an anomaly when the currency was still strengthening after two rounds of rate cuts. Considering India's twin deficits, and huge inflows YTD, INR should still be held ransom to external factors.

Consensus is forecasting 8%, 16% and 18% earnings growth respectively for 2014-2016. Direct uplift to earnings growth could come most likely from corporate tax cuts, and other measures would probably need a longer time to see real benefits. Recovery in growth confidence has yet to be reflected in any of the leading indicators like a pick-up in investments or earnings revisions. DBS' economist is maintaining a GDP growth forecast of 7.8% for 2015 just yet, but the government does have an aggressive GDP growth forecast towards 8-8.5%, and driving India towards being a world powerhouse.

We believe the sentiments towards India should still be positive after this round of volatility and are maintaining our Neutral stance on India.

CN: new exchange rate management

- **Exchange rate management has changed compared to previous episodes of economic crises**
- **It is no longer realistic to assume absolute rigidity of the RMB exchange rate in the face of external shocks**
- **Exchange rate policy has to share the burden of cushioning the slowdown due to restraints on fiscal and monetary policy**
- **Exchange rate management shall remain cautious. RMB fluctuations will be measured in magnitude**

No inconvertible currency has captured as much spotlight as the RMB. Foreign investors have become more pessimistic about China's economy lately because GDP growth is likely to decelerate further to 7% in 2015 from 7.4% in 2014, and disinflation in both the CPI and PPI has deepened.

The changing macroeconomic landscape has already prompted China to cut interest rates and reserve requirement ratios. The RMB is also allowed to weaken slightly. The consensus is that China will not tolerate large depreciation of its currency. This is evidenced by PBOC's repeated intervention in the foreign exchange market of late. A historical review of exchange rate behavior during several periods of economic crisis reveals that China's exchange rate management has changed.

China kept the RMB/USD exchange rate stable during previous crisis episodes

Asian currencies tumbled across-the-board in 1998 at the height of the Asian Financial Crisis. Many predicted the RMB would follow their paths as China's export growth dived to just 0.5% in 1998 from 21% in 1997. Yet the RMB was kept stable under the guidance of Zhu Rongji. Even so, Chinese exports remained competitive as labor costs in China were very low. China did not resort to exchange rate depreciation to stimulate growth even though exports accounted for about 20% of GDP.

Although the increment of foreign reserves slowed, China was not under any pressure to raise interest rates to defend the currency. Back then, capital flows from portfolio investments were almost non-existent due to capital account inconvertibility. Proactive fiscal policy and monetary policy were utilized immediately to stimulate economic growth. At that time, the function of the exchange rate policy was mainly to anchor expectations to support stability in the market. Bear in mind that the China's status back then was nowhere close to the status in 2015. China's economy, measured in terms of nominal GDP was only USD 1 trillion in 1998, one-tenth of the size in 2014.

China did not devalue its exchange rate to arrest the decline in export growth in subsequent economic crises either. The onslaught of the Global Financial Crisis, which saw export growth plunge from 17.4% in 2008 to -16.0% in 2009, did not prompt China to devalue the currency. Instead, China halted the appreciation of the RMB that began in 2005 and kept the RMB stable against the USD in a very nar-

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row range for almost two years. When the European sovereign debt crisis dragged down exports growth to the European Union from 14.4% in 2011 to -6.2% in 2012 (China's exports to EU accounted for 16.3% of total exports at the time), the RMB was allowed to appreciate by 1% that year. Once again, the exchange rate was not employed to boost growth but was used to anchor expectations and instill confidence in China's economic performance. After mapping the behavior of RMB at each episode of external driven economic crisis in the past 15 years and across two different leaderships (Table 1), one may conclude that the RMB would remain stable amid externally driven crises.

The exchange rate was used to anchor expectations and instill confidence

Table 1: Behavior of RMB amid export growth decline

	Asian Financial Crisis
1997	21.0%
1998	0.5%
Swing	20.5%
RMB appreciation	0.0%
	Tech Bubble Burst in the US
2000	27.9%
2001	6.8%
Swing	21.1%
RMB appreciation	0.0%
	Global Financial Crisis
2008	17.4%
2009	-16.0%
Swing	33.4%
RMB appreciation	0.0%
	European Sovereign Debt Crisis
2011	20.3%
2012	7.9%
Swing	12.4%
RMB appreciation	1.0%
	Current Situation
2013	7.8%
2014	6.0%
Swing	1.8%
RMB appreciation	-2.4%

Change in exchange rate management

A turning point came in 1Q14 when the PBOC engineered RMB depreciation to alter expectations that the RMB was a one-way bet. Although the RMB stabilized somewhat by 3Q14, an interest rate cut in November triggered market expectations of RMB depreciation in 2015. Indeed, the RMB continued to weaken in 1Q15.

It is puzzling why China allowed RMB to depreciate even in the absence of an external crisis. This is a clear divergence from exchange rate management in past crises. There are several possible explanations:

China allowed RMB to depreciate even in the absence of an external crisis

(1) Exchange rate depreciation is being allowed to shoulder the burden of cushioning the economic slowdown. The legacy of debt left by the credit binge in the aftermath of the Global Financial Crisis imposed tremendous restraints on fiscal and monetary policy. Private sector domestic credit as a share of GDP was 140% at the

end of 2013 compared to just 98% at the end of 2007. Meanwhile, M2 as a share of GDP rose to 193% by the end of 2014 versus 151% at the end of 2007. Monetary loosening, in particular, has been executed in a very cautious manner since Xi's leadership took helm. In contrast, fiscal/monetary responses were much more aggressive as debt levels were much more manageable prior 2008.

(2) Many currencies are depreciating against the USD including the majors as central banks have been engaging in new rounds of quantitative easing which weakens their currencies. As a result, the RMB appreciated 6.2% against other currencies in trade-weighted terms in 2014. Moreover, China's cost of labor had risen substantially since its entry into the World Trade Organization (WTO). The average hourly compensation for manufacturing employees in China almost tripled from USD 0.6 in 2002 to USD 1.74 in 2009. Such developments do not augur well for domestic industries already surviving on thin margins amid a fragile external environment.

China does not intend to orchestrate a V-shaped rebound through RMB depreciation

(3) What's different in the latest episode is that the Chinese government has already made a commitment to increase exchange rate flexibility. A more market-determined exchange rate mechanism is part of China's package of financial reforms. In March 2014, the RMB trading band was widened from 1% to 2%. Under the current depreciation episode, China is merely allowing the currency to respond to market forces, keeping its word on its commitment.

Conclusion

The mentality behind exchange rate management has clearly changed under the Xi-Li leadership. As long as the constraints on fiscal and monetary policy remain, a weaker exchange rate will be allowed to cushion downside growth risks. However, China did not intend to orchestrate a V-shaped rebound through RMB depreciation and so the magnitude of exchange rate fluctuations will be small. The significance is really about demonstrating commitment to gradual structural reforms, i.e., the exchange rate will be increasingly market-based. It is no longer realistic to assume the exchange rate will be kept stable in the face of unforeseen external economic shocks – or even amid a self-engineered economic slowdown – even though history suggests otherwise.

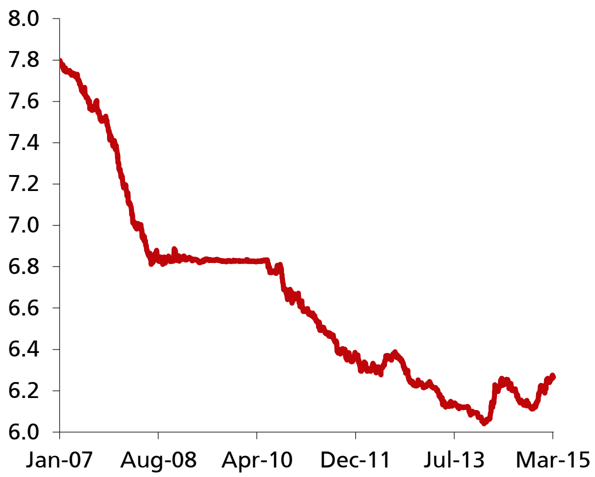
China Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real GDP growth	7.4	7.0	6.8	7.3	7.2	7.1	6.9	6.9	6.8
GDP by expenditure: current price									
Private consumption	12.0	13.0	13.5	12.0	12.6	12.8	13.4	13.3	13.5
Government consumption	12.0	12.5	12.5	12.0	12.5	12.5	12.5	12.5	12.5
Urban FAI growth (ytd)	15.7	15.0	14.5	15.7	15.4	15.3	15.2	15.0	14.8
Retail sales - consumer goods	10.3	13.0	13.0	10.3	12.3	12.8	13.3	13.4	13.0
External									
Exports (USD bn)	2,343	2,478	2,670	646	507	605	676	690	543
- % YoY	6	6	8	9	3	6	7	7	7
Imports (USD bn)	1,960	2,053	2,213	496	478	503	541	532	512
- % YoY	1	5	8	-2	1	4	7	7	7
Trade balance (USD bn)	383	425	457	150	29	102	135	159	30
Current account balance (USD bn)	214	298	321	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	2.1	2.7	2.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	3,843	4,266	4,719	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (USD bn, YTD)	120	126	132	120	33	66	92	126	35
Inflation & money									
CPI inflation	2.0	1.8	2.2	1.5	1.2	1.7	2.0	2.1	2.2
RPI inflation	1.0	0.9	1.0	0.7	0.6	0.9	1.0	1.0	1.1
M1 growth	3.2	6.5	6.5	3.2	6.2	6.3	6.2	6.0	6.1
M2 growth	12.2	12.0	12.0	12.2	12.3	12.5	12.4	12.0	12.2
Other									
Nominal GDP (USD bn)	10,331	10,842	11,749	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-1.8	-2.0	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

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

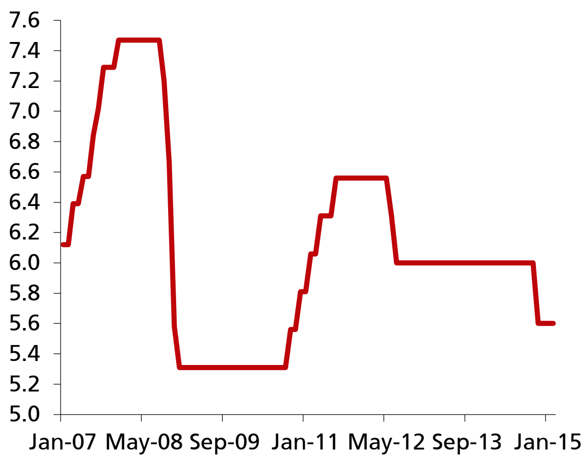
CN - nominal exchange rate

CNY per USD



CN – policy rate

%, 1-yr lending rate



HK: opportunities

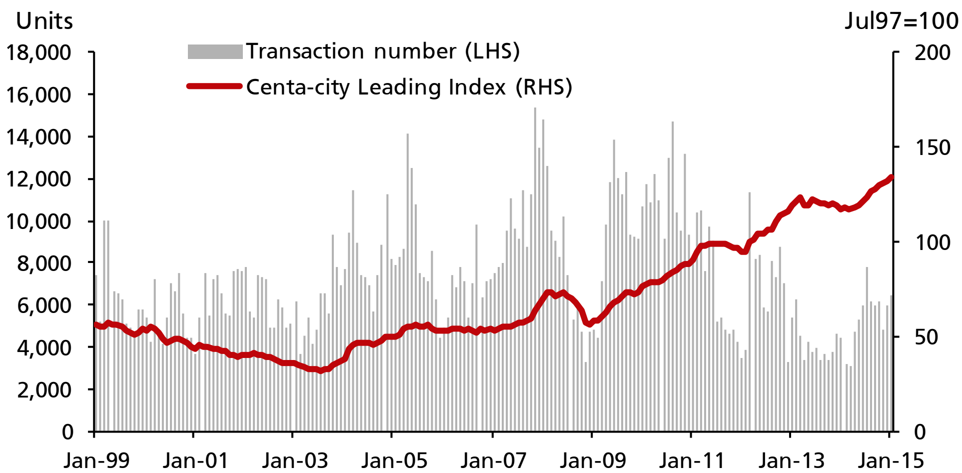
- **Crucial factors supporting the multi-year property price rally – ultra low interest rates and strong end-user demand – remain unchanged**
- **Contrary to our expectations, the government did not beef up one-off relief measures that would lower consumer prices**
- **Thus, CPI projections for 2015 are revised upwards to 3.7% from 3.4% previously**
- **GDP growth projection for 2015 lifted to 2.8% from 2.3% previously due to stimulus measures in the Budget**
- **Hong Kong is well placed to seize opportunities from "One Belt One Road", and lift its long run growth rate**

Housing market fundamentals remain unchanged

The government, together with the Hong Kong Monetary Authority (HKMA), imposed new administrative controls on the property market in March. The loan-value ratio for residential properties valued at less than HKD 7mn would be capped at 60%, down from a range of 60%-70% previously. In addition, lending rules on additional mortgage finance was tightened. The debt service ratio – which banks use to assess mortgage applicants – will be applied not only to mortgage loans from banks but to total liability, that is, mortgage loans from banks plus other sources of mortgage financing (e.g., those offered by developers).

Home prices will likely take a breather for one to two months before rising further on thin transaction volumes. Administrative measures introduced in the past two years have increased the cost of transactions and encouraged home owners to hold onto their properties. In turn, this left little room for price negotiation between buyers and sellers, and led to lower transaction volumes. The impact on prices is less clear. The increase in prices was unabated amid multiple rounds of administrative measures and there is no reason why the most recent round will be different. Crucial factors supporting the multi-year price rally (Chart 1) – ultra low interest rates

Chart 1: Residential property market



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and strong end-user demand – have not changed. Meanwhile, residential rentals are set to increase at a quicker pace from potential buyers adopting a wait-and-see stance. Apart from a slew of administrative measures, these buyers have been deterred by high housing prices or more stringent mortgage requirements (Chart 2).

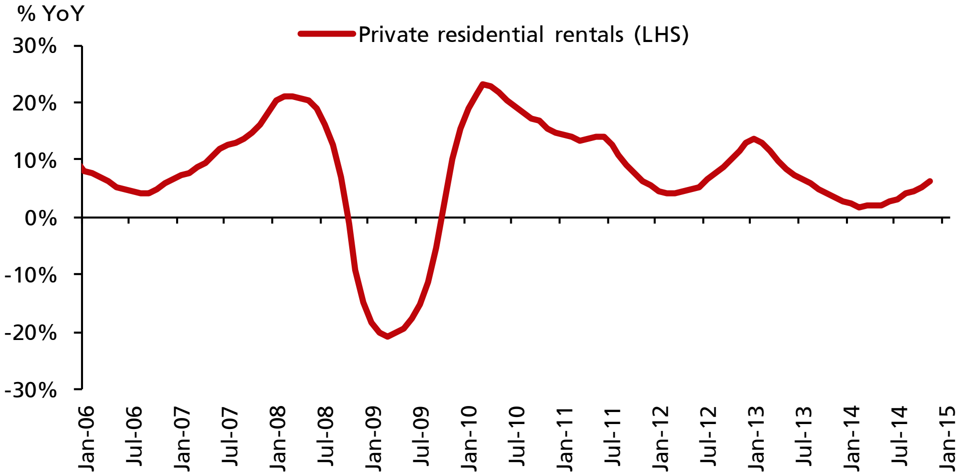
Inflation forecast lifted

Residential property prices rebounded strongly in 2H14, and the pace of price increase accelerated in 1Q15. There is also room for further price increases. As changes in housing rents are reflected in the CPI with a time lag of six to nine months, the CPI housing component is likely to stay elevated throughout the year. As housing is a major component of Hong Kong's CPI, this will lift headline inflation.

Contrary to our expectations, the government did not beef up the types of one-off relief measures that would lower consumer prices. Save for two quarters of rates waivers – which were raised to $2,500 from $1,500, other price-impacting measures remained the same. As in the previous Budget, only one month of rental waivers for public housing was offered, and no electricity subsidies were offered. We previously projected the CPI is likely to be lower in 2H15 due to additional government relief measures. In light of the recent Budget announcement, we would adjust CPI projections upwards to 3.7% for the full year of 2015 (previous projection: 3.4%), compared with 4.4% for 2014. The government is projecting 3.5% headline CPI inflation in 2015.

We would adjust CPI projections upwards to 3.7% for 2015

Chart 2: Housing rentals



GDP forecast lifted on Budget measures

The FY15/16 Budget was unveiled in February. The FY14/15 budget surplus leaped to HKD 63.8bn, up from HKD 12.0bn in FY13/14, mainly as a result of an unexpected increase in stamp duties.

Amid economic malaise and mounting social discontent over skyrocketing property prices, the government distributed multiple sweeteners. The middle class stands to benefit the most. Salaries tax, tax under personal assessment and profits tax will be reduced by 75%, subject to a ceiling HKD 20,000, an increase from HKD 10,000 last year. Child tax allowances will be increased from HKD 70,000 to HKD 100,000 per child. Meanwhile, two quarters of rates waivers will be maintained, capped at HKD 2,500 per quarter. Relief measures for the needy, aged and disabled include two months' extra allowance, and one month's rent will be waived for public housing tenants. Relief measures totaled HKD 34bn, up from about HKD 20bn last year.

These measures are timely and appropriate as Hong Kong continues to face headwinds from an economic slowdown on the mainland and a tough external environment. Such measures, alongside positive wealth effects from more bullish equity and property markets, will bolster private consumption in 2015. The increase in

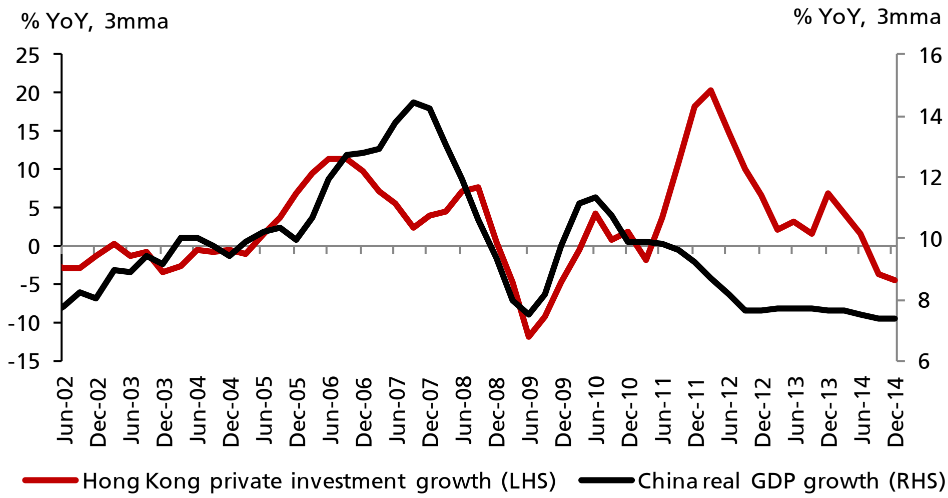
We are projecting 2.8% GDP growth in 2015

budget sweeteners would lift private consumption growth, and lift headline GDP by approximately 0.5% from our previous estimates. We are projecting 2.8% GDP growth in 2015, versus 2.3% in 2014. The government is projecting 1%-3% growth in 2015.

The outlook for private investment and external trade will remain bleak. 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, mainland structural reforms will elevate risks. As such, Hong Kong enterprises' China-related business expansion and capital expenditures should slow in response. We anticipate Hong Kong private investment growth to be slow, as was the case in 2014.

Net exports will contribute little, if at all, to headline growth. Export growth to major markets is a mixed bag. Exports to ASEAN and USA fared exceptionally well in the latest three months (Nov-Jan), growing 14.7% and 3.4% respectively. In contrast, exports to Japan and the EU dipped into the negatives, contracting 11.6% and 2.1% respectively. Exports to China had barely grown. This pattern is expected to continue into the first half of 2015, and low single-digit export growth is expected.

Chart 3: Hong Kong private investment growth vs. China GDP growth



Seizing opportunities in "One Belt One Road"

The One Belt One Road initiative is high on the Chinese government's agenda and is possibly one of the biggest projects in the coming decade and beyond. China will establish a $40bn Silk Road Fund to support infrastructure investments in countries covered in the initiative, and an Asian Infrastructure Investment Bank (AIIB) has been proposed in which 21 countries have already signed up to join. A strategic framework is yet to be finalized, and details of implementation are possibly still being drafted.

As the project is still in its infancy, now is the time for Hong Kong to pitch in with new ideas and capture a first mover advantage. Hong Kong has a natural advantage, given its geographical proximity to China and established trade and financial ties. In addition, as unparalleled port infrastructure and efficient logistics systems are already in place, Hong Kong can meaningfully contribute to the Maritime Silk Road initiative in a short period of time.

To capture this window of opportunity, the government may work with the private sector, particularly with businesses in the professional services and logistics sectors to conjure up suggestions. The HKSAR government may then proactively liaise with the Chinese government to reach cooperative outcomes.

Meanwhile, Hong Kong must continue to lift its competitiveness by implementing the proposals outlined in this year's and last year's Budget. Some of these include: promoting the liberalization of trade in services between Hong Kong and Guangdong, supporting the development of a three-runway system, formalizing the blueprint for railway development, and nurturing and attracting human capital.

Hong Kong needs new growth catalysts

The significance of One Belt One Road should not be underestimated. If Hong Kong proactively supports the initiative and rides on its success, it could provide a palpable boost to Hong Kong's GDP growth in the long run. Opportunities of this kind are direly needed as Hong Kong's GDP growth has slipped below the ten year average of 3.9% for three consecutive years already. The government is projecting long run GDP growth to average just 3.5% annually from 2016 to 2019, and a structural budget deficit could arise in just six years' time under the current growth and demographic trajectory.

A sustainable boost to future GDP growth from One Belt One Road will ease constraints on future government expenditures – imperative in light of demographic challenges in Hong Kong, provide ample employment opportunities and lift future competitiveness.

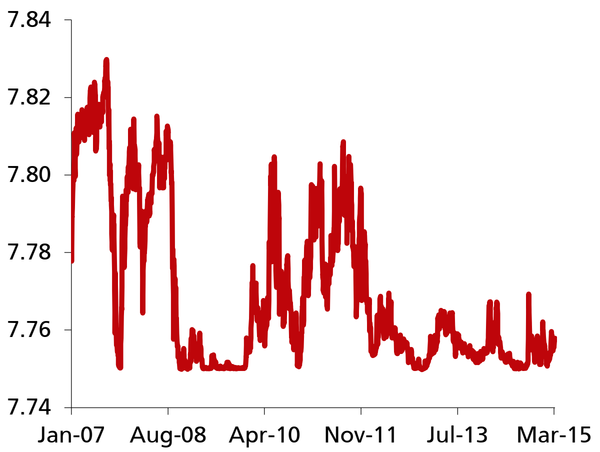
Hong Kong Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP growth (12P)	2.3	2.8	3.0	2.2	1.5	3.8	3.8	2.3	2.5
Private consumption	2.7	5.7	6.4	3.8	1.7	7.2	7.3	6.4	5.7
Government consumption	3.1	3.0	3.0	3.3	3.0	3.0	3.0	3.0	3.0
Investment (GDFCF)	-0.3	2.0	3.0	4.0	1.5	1.5	2.5	2.5	3.0
Exports of goods and services	0.9	2.8	5.4	0.3	-0.4	2.1	4.6	4.6	5.1
Imports of goods and services	1.1	3.5	6.4	1.2	-0.5	2.6	5.7	5.7	6.4
Net exports (HKD bn)	-6	-40	-54	-5	1	-33	11	-20	-13
External (nominal)									
Merch exports (USD bn)	474	488	520	125	107	119	131	131	114
- % YoY	8	4	8	1	2	3	4	5	7
Merch imports (USD bn)	544	566	601	146	124	139	149	154	131
- % YoY	9	4	7	3	2	4	5	6	6
Trade balance^ (USD bn)	-70	-78	-81	-21	-17	-20	-18	-23	-17
Current acct balance (USD bn)	0.4	-18.7	-22.4	-	-	-	-	-	-
% of GDP	0.1	-6.1	-6.9	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	331	354	376	-	-	-	-	-	-
Inflation									
CPI inflation	4.4	3.7	3.5	5.1	4.1	4.5	3.5	2.6	3.0
Other									
Nominal GDP (USD bn)	290	306	324	-	-	-	-	-	-
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

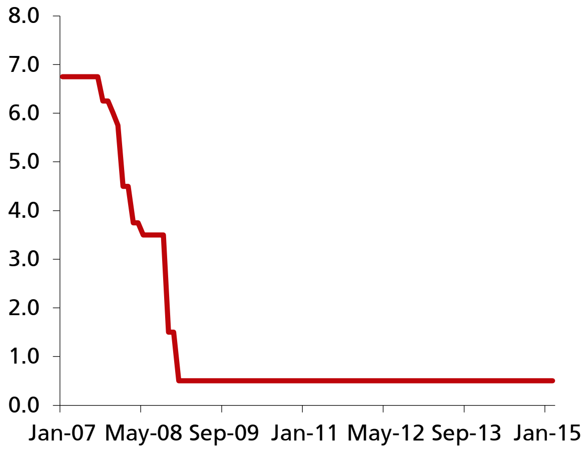
HK - nominal exchange rate

HKD per USD



HK – policy rate

%, base rate



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TW: policy on hold

- **Despite the recent wave of monetary easing across Asia, Taiwan's central bank is likely to stay on hold**
- **The export sector is doing relatively well, growth is on course and competitiveness is not a big worry**
- **Inflation is falling faster-than-expected due to the collapse in oil prices. But domestic demand is picking up**
- **GDP growth is expected to remain stable at 3.7% this year**
- **Inflation is estimated to be virtually 0% this year before inching up in 2016**
- **Political uncertainties in the run-up to 2016 elections bear watching**

Growth forecast unchanged

The economy has continued to recover at a steady pace. Real GDP registered 4.8% (QoQ saar) in 4Q14, a similar rate of expansion compared to 4.4% in 3Q14. Exports growth eased to 4.0% after a strong rise to 9.6% in the previous quarter. Offsetting this was a synchronous fall in imports growth from 14.5% to -2.0%. Net exports, as a result, remained a major contributor to GDP growth in 4Q14. Equally important was the component of private consumption expenditures (PCE). On the quarter-on-quarter basis, PCE growth remained solid in 4Q14, at 2.6%.

We maintain the forecast that GDP growth will be stable at 3.7% this year. Exports growth is expected to moderate. Essentially, electronics exports may not be able to repeat their surge seen in 2H14, which was driven by the unusually strong sales of Apple's new smartphone products. The Jan-Feb15 exports data were distorted by the Chinese New Year and the fluctuations in global commodity prices. A better gauge would be export orders, which are less influenced by the holiday effects, and reported in both value and volume terms. Judging from the orders data, exports demand has come off the peak, while still holding at high levels (Chart 1).

Chart 1: Export orders

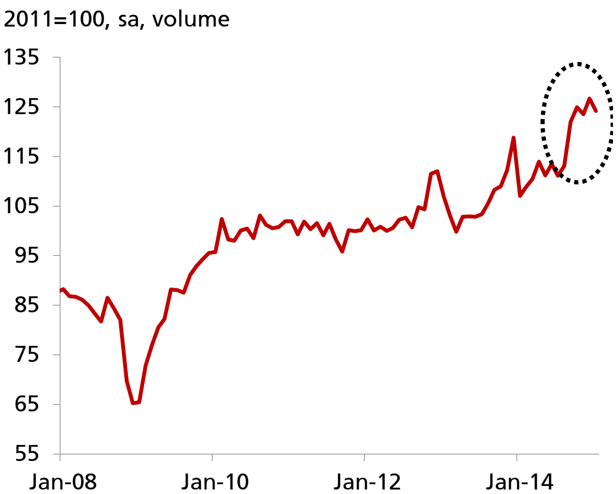
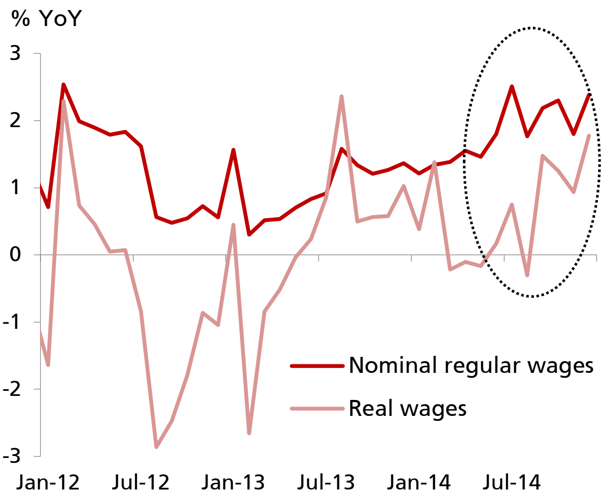


Chart 2: Wages growth



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Domestic demand is expected to pick up in the coming quarters and play a bigger role in driving growth. Consumers should be more willing to loosen purse strings, in the context of declining fuel prices, improving employment/income conditions, and persistently low financing costs. Noticeably, the inflation-adjusted real wage growth has begun to creep up since 4Q14, thanks to the fall in oil prices and the rise in nominal wages (Chart 2). Meanwhile, the consumer confidence index, which dropped temporarily in 2H14 due to the fallout of a food safety crisis, has bounced back in Dec14 and continued to move upward at the start of this year.

Consumer spending to pick up on the back of higher real wages

Inflation far lower than expected

Indeed, inflation has fallen sharply due to the collapse in global oil prices, which turned out to be the biggest surprise on the macro front. Headline CPI dropped to an average of -0.6% (YoY) in Jan-Feb15, down from 0.8% in 4Q14 (Chart 3). Core CPI also slowed to 1.2% from 1.5% during the same period.

As a major revision compared to one quarter ago, we now forecast inflation to fall to 0.3% this year from 1.2% in 2014, instead of staying stable at 1.0%. The embedded assumption here is that oil prices (Brent) will average USD 58 this year, 40% lower than the $99 in 2014. In case that the pass-through effects of low oil prices exceed estimates, full-year inflation numbers would be negative.

Negative CPI figures do not mean deflation. GDP deflator – a broader measure of prices in the economy – is exhibiting an upward trend (Chart 4). Behind this is the improvement in the terms of trade, helped by the decline in energy import prices. The implications for the medium-term income and prices outlook are positive.

Negative CPI figures don't mean deflation

We do not believe deflation is a risk in Taiwan. GDP growth is running close to the potential rate, capacity utilization is high and the labour market conditions are tight. The 3.7% growth for GDP predicted this year is not far from the historical average of 4% witnessed in the recent decade. The seasonally-adjusted jobless rate, which stands at 3.8% presently, is on par with the levels prior to the global financial crisis in 2007. As capacity tightens amidst a pickup in wage growth, demand-side price pressures will likely surface over time.

Policy on hold

Taiwan's central bank (CBC) has kept the benchmark discount rate unchanged at 1.875% during the latest meeting in Dec14. Given the high correlation between Taiwan's and US's interest rate cycle in the past, market expectations are high that the CBC will follow the Fed to raise rates as the next policy step. However, with monetary easing spreading across Asia since the end of last year, the expectations for rate hikes in Taiwan have also started to ebb (Chart 5).

Chart 3: CPI inflation

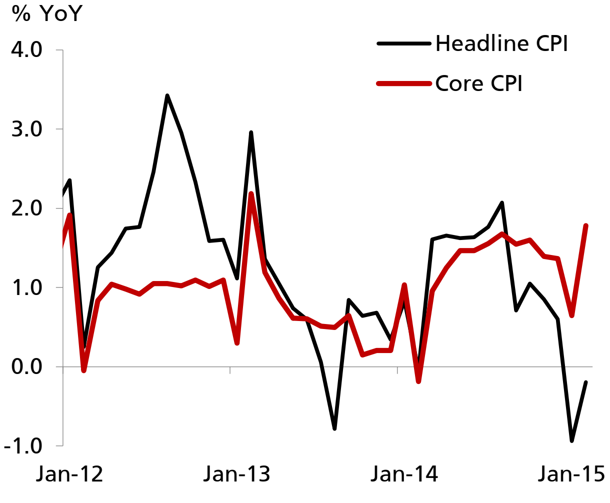
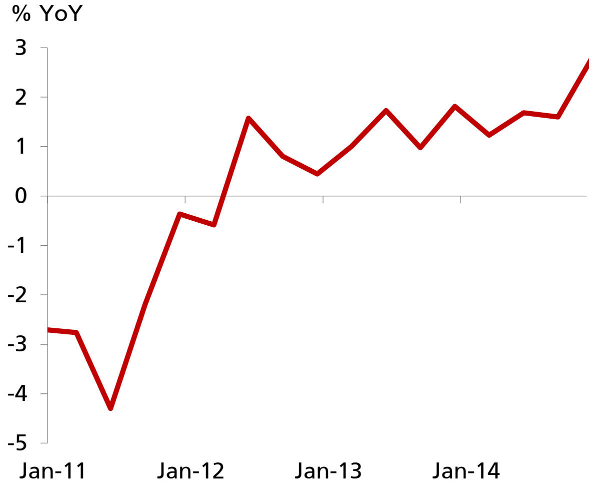


Chart 4: GDP deflator



The biggest determinant of monetary policy is the growth and inflation dynamics in the domestic economy. In Taiwan, the rapid slowdown in inflation should have removed the urgency to hike rates in the near term. On the other hand, steady growth also means little pressure for the CBC to cut rates to stimulate the economy. Therefore, we forecast the CBC to hold the policy discount rate at 1.875% throughout this year before raising it to 2.00% in 1Q16.

Steady rates, weaker currency

In the FX market, expectations have increased for the TWD to depreciate, against the backdrop of a broadly strong USD worldwide (Chart 6). From the perspective of funds flows, there are indeed reasons to expect some weakness in the TWD ahead. Domestic capital outflows have the potential to increase, due to very low TWD rates, rise in USD yields, and the government's policy deregulations (lifers' investment in Formosa bonds has been excluded from the overseas investment cap since last year). An increase in capital outflows will likely negate the benefits of cheaper oil prices on the balance of payments.

From the policymakers' perspective, a weaker TWD would also be favored as it is the best way to contain disinflation, the sources of which mainly came from the fall in import prices. Verbal and actual interventions would be employed by the central bank to guide the USD/TWD to higher levels. Cutting interest rates to aggressively weaken the TWD remains unlikely, however. Exports are still doing relatively well in Taiwan and trade competitiveness should not be a big worry.

Political uncertainties and reform slowdown

In contrast with the stability on economic front, the political environment is uncertain and complicated. The ruling KMT party suffered a landslide defeat during the local elections last November. It is widely expected that the KMT will face an uphill battle during the two crucial elections in 1H 2016 – presidential and parliamentary elections. The reshuffling of political power and deployment of election strategy will likely dominate the KMT's agenda this year. This implies a possible slowdown in formulating and implementing the long-term economic policies.

Importantly, the Taiwanese public is resisting trade liberalization – a key component of the KMT's long-term policies. Debate is heating up regarding whether to pursue deeper economic integrations with China, with concerns mounting about the potential consequences of industrial relocations, job losses and funds outflows. The ratification of a services trade agreement with China has been put on hold for one year. Without addressing public concerns over China's "magnet effect", it would prove difficult for the KMT to push through any China-related trade deals in the parliament. No breakthrough is expected in cross-strait economic relations in the rest of this year.

Chart 5: Short-term market interest rates

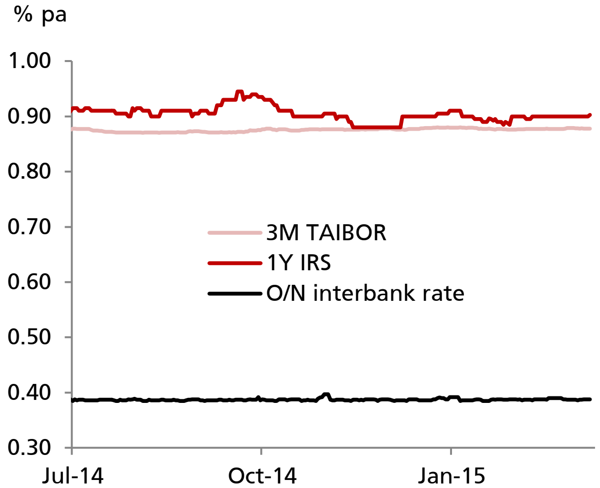
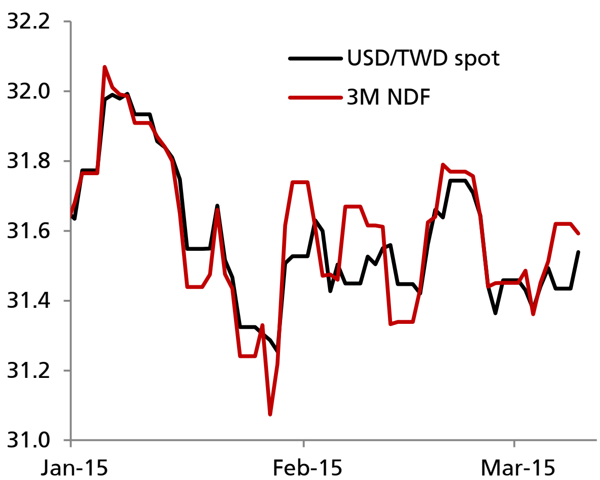


Chart 6: TWD exchange rates



Taiwan Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP growth	3.7	3.7	3.5	3.3	3.6	3.8	3.7	3.6	3.8
Private consumption	3.0	3.0	2.7	2.4	3.4	3.0	2.8	2.8	2.7
Government consumption	3.4	2.3	1.6	3.1	0.9	3.1	2.4	2.6	1.1
Gross fixed capital formation	1.7	1.7	1.6	-0.4	2.3	1.9	1.2	1.6	1.6
Net exports (TWDbn, 11P)	1326	1567	1814	462	246	381	429	511	298
Exports (% YoY)	5.7	5.2	4.9	5.7	6.2	5.7	4.4	4.6	4.7
Imports (% YoY)	5.4	3.5	3.3	4.9	4.9	4.5	1.2	3.5	3.1
External (nominal)									
Merch exports (USDbn)	314	314	332	79	71	81	81	82	78
- % chg	2.7	0.1	5.7	0.5	-3.0	0.6	-0.7	3.3	10.2
Merch imports (USDbn)	274	263	287	66	58	67	69	70	68
- % chg	1.6	-3.9	9.0	-3.2	-13.4	-5.1	-2.7	5.7	16.6
Trade balance (USD bn)	40	51	45	13	13	14	12	12	11
Current account balance (USD bn)	65	76	70	-	-	-	-	-	-
% of GDP	12.3	14.1	12.6	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	419	423	428	-	-	-	-	-	-
Inflation									
CPI inflation	1.2	0.3	0.9	0.8	-0.6	-0.5	0.4	1.7	1.7
Other									
Nominal GDP (USDbn)	531	533	542	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Fiscal balance (% of GDP)	-0.5	-0.3	-0.5	-	-	-	-	-	-

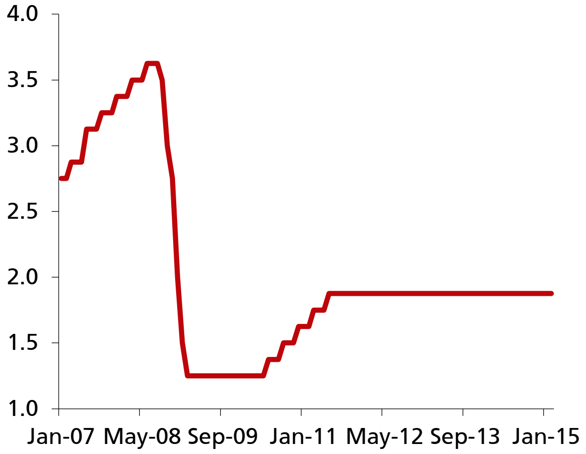
* % growth, year-on-year, unless otherwise specified

TW - nominal exchange rate

TWD per USD

TW – policy rate

%, rediscount rate



KR: an unsatisfactory recovery

- Recovery is weaker than expected as the exports sector faces head-winds
- Growth is projected to be 3.4% this year, barely changed from 3.3% in 2014
- Inflation is estimated to be 1.3%, with the risks skewed to the downside
- Rate cuts will remain a macro theme for 2015
- Looking for a stronger recovery in domestic demand in 2Q-4Q, aided by lower oil prices, faster loans growth and increase in public spending
- Attention will be given to the Korea-China FTA later this year

Growth below potential

Recovery appears fragile in Korea and the momentum is weaker than expected. GDP growth has exhibited a volatile pattern, falling to 1.5% (QoQ saar) in 4Q14 after a temporary rebound to 3.7% in 3Q14. The monthly output data, which are a good predictor for GDP, deteriorated at the start of this year, suggesting weak growth outcomes in 1Q15 (Chart 1). Thankfully, the leading composite index, PMI and business sentiment have begun to improve on a broad basis. This still flags the possibility of a stronger recovery down the road, probably from 2Q15 onwards.

We maintain the forecast that the economy will grow 3.4% this year, barely changed from 3.3% in 2014. This sort of growth rate should be considered as unsatisfactory. In the past decade, growth has averaged 4% per year. Even factoring in a structural decline in GDP growth after the 2008 global financial crisis, the new normal of growth should be 3.5%-3.8% in Korea, according to most academic estimates.

An important explanation is that exports have been underperforming. In the key electronics sector, the market share of Korean smartphone makers has declined significantly in 2014 (Chart 2). Rising competition came from the Chinese and US

Chart 1: Output data

sa, 2010=100

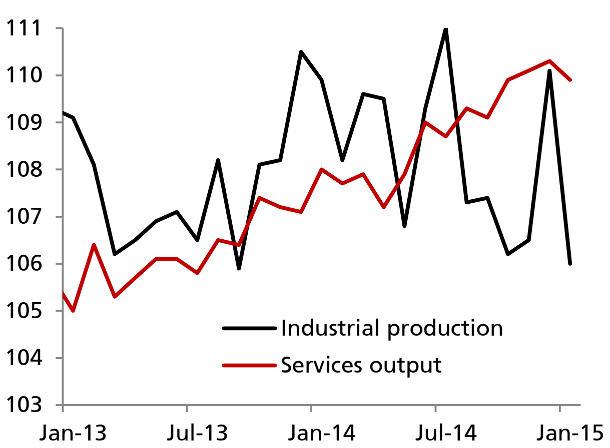
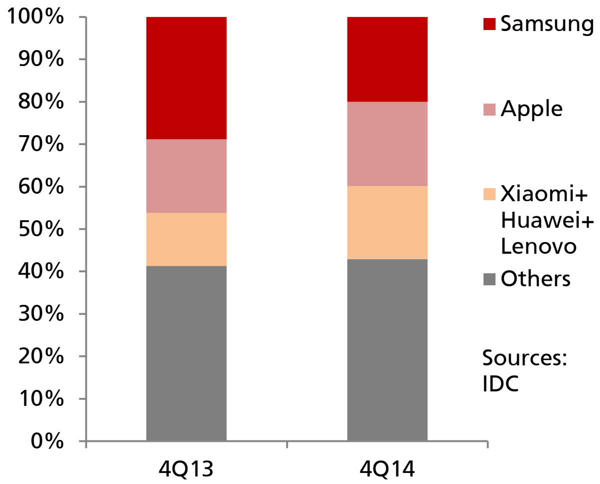


Chart 2: Smartphone vendor market share



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KOREA

counterparts, which have moved forward in terms of technology upgrade and product innovation. Given the deterioration in competitiveness and only a modest recovery in global demand, the near-term outlook for exports remains lacklustre.

Domestic demand to pick up

Domestic demand will have to shoulder the burden to support growth against this backdrop. Thankfully, the situation here is improving. Credit growth has started to accelerate after the central bank delivered two rate cuts in 2H14 (Chart 3). Meanwhile, an expansionary budget for 2015 has been approved by the parliament as scheduled. Government expenditures will be boosted by KRW 19.6trn (5.5% YoY) this year, with more funds allocated to improve social welfare and lower the costs of living for working class people. Considering the benefits of low oil prices in addition to the accommodative monetary policy and expansionary fiscal policy, there are sufficient reasons to expect a faster recovery in domestic demand this year.

Inflation below target

Inflation has remained very low amid the weak economic recovery, fueling the concerns over deflation risks. On the surface, headline CPI dropped slightly to 0.7% (YoY) in Jan-Feb15 from 1.0% in 4Q14. And core CPI rose to 2.3% from 1.7%. Excluding the distortion impact of tobacco tax hike, however, headline inflation has fallen to virtually 0% and core inflation has slipped to 1.6% (Chart 4).

The supply side factors – the collapse in global oil prices – have played a key part in explaining the fall in CPI numbers. Still, it is undeniable that the demand-side inflation is also subdued in the domestic economy. With GDP growth running below the potential, the output gap has remained slightly negative and spare capacity has continued to linger. Capacity utilization in the manufacturing sector stayed at subnormal levels as of Jan15. In the labour market, the unemployment rate remained a notch higher than its levels prior to the 2008 financial crisis (Chart 5).

Compared to three month ago, we have made significant revisions to the inflation forecast. CPI growth is now expected to average 1.3% this year, instead of the earlier estimate of 1.7%. This will make it the fourth consecutive year for inflation numbers to undershoot the central bank's target, which is currently set at 2.5%-3.5%.

The BOK maintains an easing bias

The Bank of Korea (BOK) is expected to maintain an easing bias on monetary policy, against the backdrop of low inflation and a subpar GDP growth. Indeed, the BOK has trimmed its growth and inflation forecasts at January's meeting, and said in the statement that "the negative output gap in the domestic economy will persist for

Chart 3: Bank loans growth

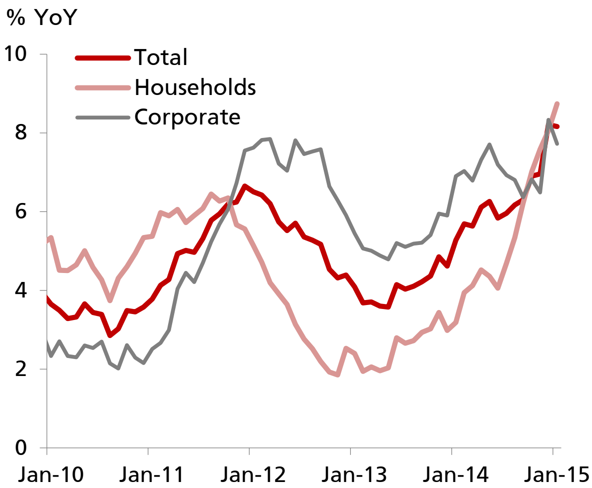
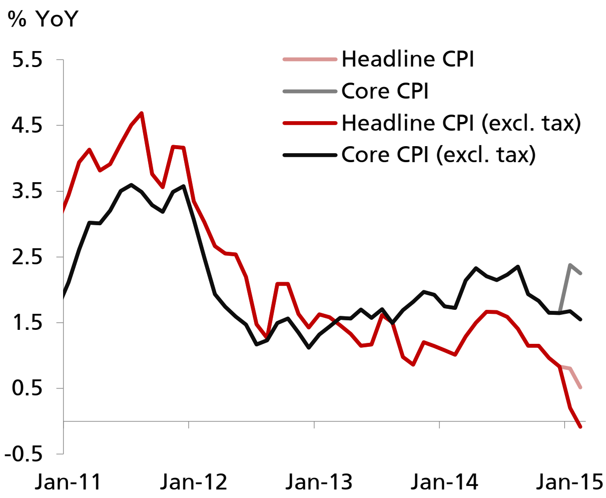


Chart 4: CPI inflation



a considerable time". This was a downgrade compared to the previous phrase that "the negative output gap will gradually narrow going forward". In March, the BOK further downgraded the assessment, saying that "the continuation of negative output gap will be longer than had been anticipated".

Admittedly, the hurdles for rate cuts are now higher than in 2014. Bank loans growth has risen strongly since 2H14, triggering concerns about household over-leverage. With the side effects of rate cuts becoming apparent, the BOK will have to take a prudent approach going forward and refrain from aggressive moves.

Aggressive easing is unlikely

On the FX policy, the easing bias is also clear. The BOK has increased its USD buying in Jan15, as inferred from the change in foreign reserves adjusted by the FX valuation effects (Chart 6). Some government officials recently mentioned the possibility of relaxing FX rules later this year, such as cutting bank levies on FX borrowings and revising the limits on FX forward. This should be seen as a precautionary measure in response to the risk of large capital outflows caused by US rate hikes. It doesn't represent the intention of encouraging capital inflows.

Korea-China FTA under limelight

In addition to monetary policy, another interesting thing to watch is the development in trade and investment ties between Korea and China. The two countries have signed a provisional free trade agreement (FTA) in Feb15, and promised to formalize it within the first half of this year. Under the agreement, China will completely remove tariffs on 71% of its products imported from Korea over the next 10 years, and lift this ratio to 91% in 20 years. Meanwhile, China will also reduce the market access barriers for Korean firms to do business in its territory, including in the fast-growing services industry such as e-commerce, finance, and telecommunication.

Korea's petrochemical, precision instrument and services sectors are expected to benefit the most from this FTA. Given the exclusion of many agricultural items, the resistance from Korean farming group – traditionally a strong opponent against free trade – should be limited. There is a good chance that the pact will receive parliamentary approval by the end of this year and take effect in 2016.

After the Korea-China FTA is implemented, the size of external trade covered by FTA will account for more than 70% of Korea's total trade, up from 55% currently. Expanding the free trade network has positive meanings for the country's long-term growth outlook. It also provides an opportunity for Korea to explore its potential as an international trade and business hub, catching up with the higher-income peers like Singapore and Hong Kong. On expectations of a stronger recovery in the medium- to long- term, we forecast GDP growth to rise to 3.7% in 2016.

Chart 5: Unemployment rate

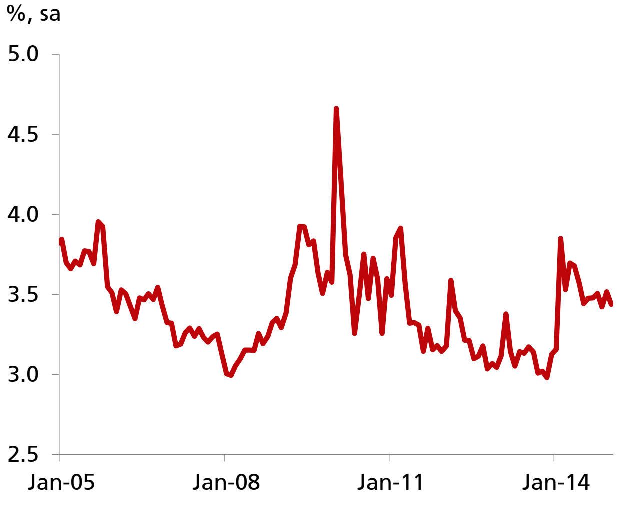
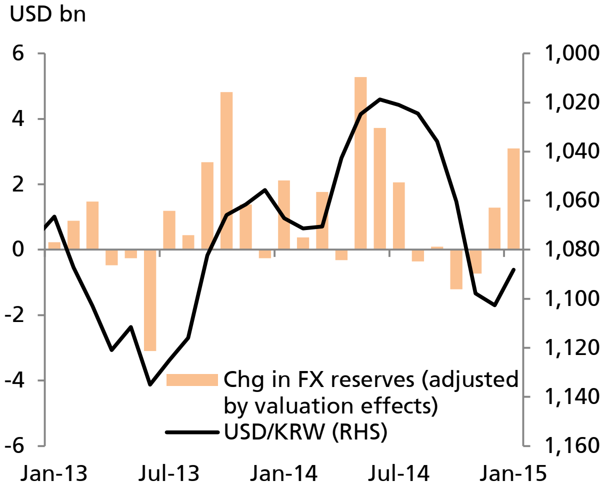


Chart 6: Change in FX reserves vs. KRW



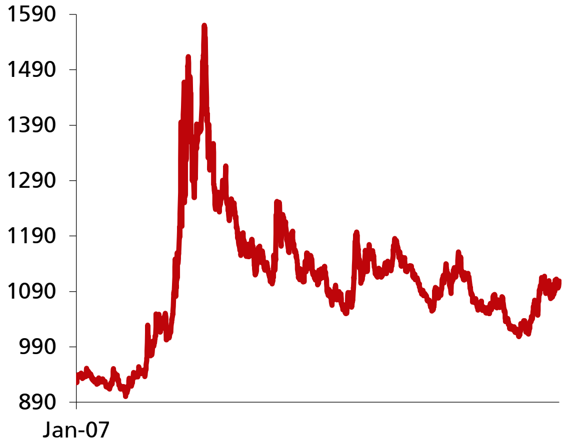
Korea Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP (2010P)	3.3	3.4	3.7	2.7	2.8	3.3	3.3	4.0	3.9
Private consumption	1.7	2.6	2.6	1.4	2.0	3.0	2.6	2.8	2.6
Government consumption	2.8	4.7	3.5	3.1	4.7	5.9	4.1	4.1	3.5
Gross fixed capital formation	3.3	3.0	2.9	0.9	1.4	2.4	1.9	5.8	3.0
Net exports (KRW trn)	101	108	126	30	15	29	29	35	19
Exports	2.8	3.0	6.1	0.8	0.8	0.5	4.3	6.1	6.1
Imports	2.0	2.4	4.6	-0.8	1.1	1.1	2.8	4.6	4.6
External (nominal)									
Merch exports (USD bn)	573	573	613	148	135	146	142	149	141
- % YoY	2.3	0.0	7.0	0.9	-1.9	0.3	0.4	1.1	4.8
Merch imports (USD bn)	526	497	551	129	113	120	126	138	139
- % YoY	1.9	-5.4	10.8	-2.8	-14.8	-8.6	-4.9	6.9	23.6
Trade balance (USD bn)	47	76	62	18	22	26	16	11	2
Current account balance (USD bn)	89	111	98	-	-	-	-	-	-
% of GDP	6.3	8.1	7.0	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	364	388	401	-	-	-	-	-	-
Inflation									
CPI inflation	1.3	1.3	2.0	1.0	0.7	0.9	1.4	2.1	2.2
Other									
Nominal GDP (USD bn)	1,406	1,366	1388	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.5	3.4	3.3	3.5	3.6	3.4	3.4	3.4	3.5
Fiscal balance (% of GDP)	-2.2	-2.5	-2.4	-	-	-	-	-	-

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

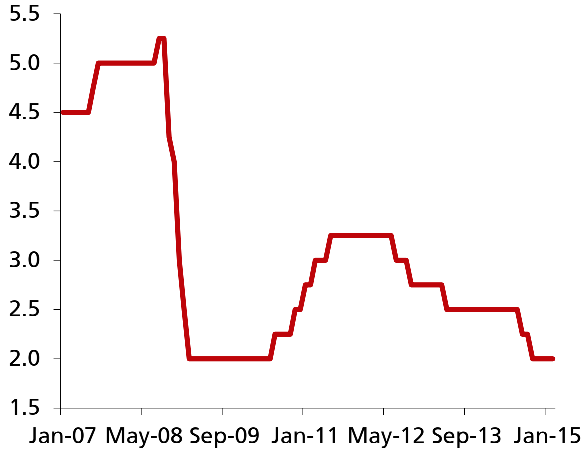
KR - nominal exchange rate

KWR per USD



KR – policy rate

%, target rate



IN: looking up

- **New GDP numbers need to still earn the authorities' trust. FY15/16 GDP growth is likely to average 7.8% on cyclical rebound**
- **Easing inflation paves the way for rate cuts, but scale hinges on assessment of potential growth levels and US Fed rate hike concerns**
- **Twin deficits are no longer a flash-point. Delay in fiscal consolidation goalposts push back rating/ outlook upgrades**
- **Strong rupee appreciation against its trading partners to be a cause of concern**

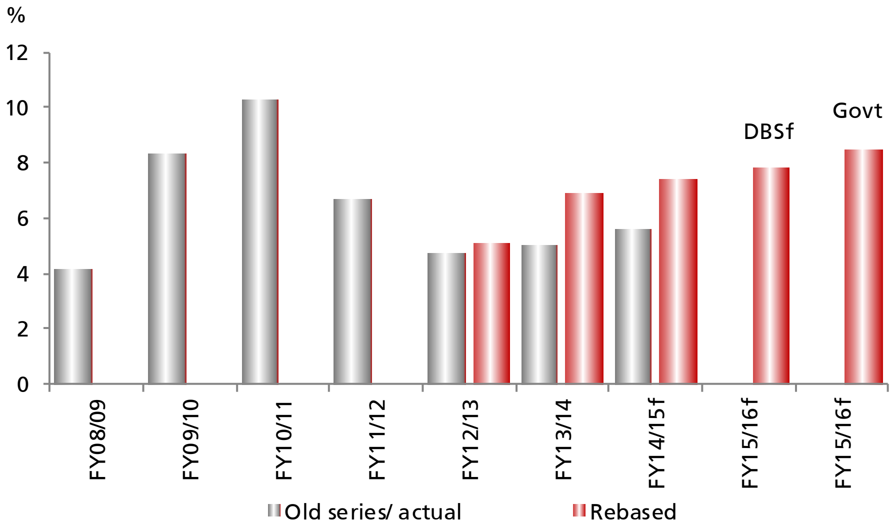
New GDP numbers need to earn trust

Recent revisions to the past GDP numbers continue to confound. To recall, FY12/13 GDP growth (market prices) was revised to 5.1% (vs 4.7% earlier) and FY13/14 to 6.9% (vs prev 5%). FY14/15 is estimated at 7.4% (Chart 1). These sharp revisions and limited anecdotal series have made it difficult for the authorities to gauge the economy's potential growth to draw inferences for monetary/ fiscal stance. To this end, the new GDP growth numbers have to still earn the trust of the Finance Ministry and the Reserve Bank of India (RBI).

Given the only modest upturn in high-frequency indicators and spare capacity in the economy, there is reason to believe that the output gap has not filled as yet. Incorporating the new data series, our growth estimate is at a sub-consensus 7.8% in FY15/16 on the back of a cyclical recovery.

Gradual pick-up in capex from hastened clearances of stalled projects, positive real rates and low inflation environment are expected to underpin activity. Private consumption spending is likely to register modest improvement, with fixed capital formation to rise 5.5% this year from 3.5% average in the last two. Low crude prices and correction in gold demand will keep a lid on import demand (offsetting higher investment-led purchases), improving the net exports position.

Chart 1: Rebasing exercise pushes up GDP growth



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Sector breakdown is likely to see agricultural output recover in FY15/16, on the assumption of a normal monsoon. Industrial sector strength under the new series remains at odds with the subdued corporate earnings and production trends that are stabilising around 2-3% mark. Nonetheless, positive sentiments, PMIs, rebound in auto sales and slight pick-up in capacity utilisation point to a modest rebound. Services sector meanwhile is likely to remain apace at 10% YoY next year.

Inflation eases …

Even as growth is on a gradual upturn, inflation continues to ease (Chart 2). From 9.5% in FY13/14, consumer price index (CPI) inflation slowed to 5.1% (rebased series) by January 2015, helped by low crude prices, limited impact from below normal rains, a small rise in minimum support prices and subdued rural wage growth. Pipeline risks are also in check with WPI inflation in red for the past two months. These factors and price sensitivity to crude prices point to the likelihood that FY15/16 CPI inflation will average 5.6%, below the RBI target of 6% by January 2016.

Inflation risks can't be dismissed, especially due to doubts over durability of softer commodity prices

Further out, inflation is unlikely to be a source of concern, but risks can't be entirely dismissed. Durability of the softer commodity run is still in doubt. Any swift reversal in crude prices might play havoc with expectations, more so as petrol and diesel prices are now market-determined (see "India: falling oil prices – good or bad" 19Jan15 and "Global crude: low for long?" 19Jan15).

Secondly, unfavourable weather conditions and seasonal spurt in food prices (Chart 3) might disrupt the disinflationary impact, requiring sustained efforts to ease supply-side pressures. Finally, uncertainty over the strength in rains, recent increases in indirect taxes/freight charges and an expansionary fiscal stance are also risks to reckon with. The likelihood that the output gap has not narrowed fully keeps the door open for cuts, albeit not aggressively.

… paves way for rate cuts, albeit not aggressively

With inflation off the boil and expected to stay below the RBI's early 2016 target at 6%, the room for rate cuts remains open. The RBI has undertaken two off-cycle rate cuts in January and March. These demonstrated the central bank's confidence in the evolving inflation outlook and correction in the households' inflation expectations. Despite the slight overshoot in fiscal targets, the RBI endorsed the government's move to rationalise subsidies and re-channel savings towards higher capital expenditure.

Chart 2: Inflation expectations (IE) ease

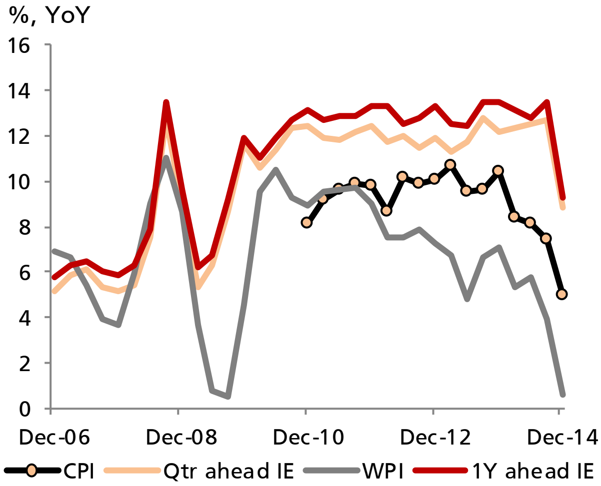
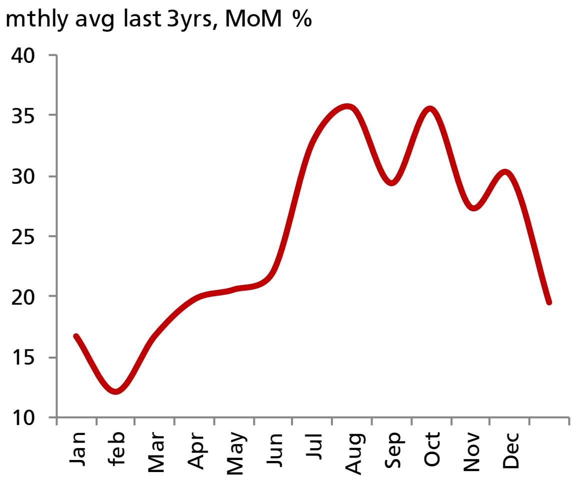


Chart 3: Average movts in commonly used vegs



On fundamentals, room for rate cuts is narrow. But INR gains cause discomfort

Of the 75bps worth cuts we had expected this year, 50bp have already been delivered and the remaining 25bp is likely by June. The window for further rate cuts stands to narrow as recovery takes hold, potential inflation risks emerge and as markets re-assess US Fed rate hike risks. Here we assume the central bank prefers to preserve trade competitiveness and hence will prefer to ease monetary conditions through a cheaper currency rather than lower rates.

New monetary policy framework is an important development

The move to formalise the monetary policy framework between the RBI and government is a positive development. Inflation-targeting has been adopted as main policy objective, with the goal at +/-2% of 4% from FY16/17 onwards. Formation of a monetary policy committee is on the cards, though details are scant.

The government's explicit involvement is an important first. Earlier without the government's official buy-in, the central bank was solely responsible for ensuring price stability. Lack of a common ground often led an expansionary fiscal policy to dilute the effectiveness of a tight monetary policy stance. The new framework will therefore make both parties accountable, with the government required to exercise fiscal discipline and ease supply-side bottlenecks to keep inflation in control.

Further out, focus is on the make-up of the policy committee, especially the extent of RBI representation. A government's active role in such a committee might undermine the central bank's independence and result in a conflict of interests in terms of broader economic priorities. To that extent, the central bank should prudently have a bigger say in policy decisions. We'll wait to see the nuances, which could be outlined later this year.

Twin deficits well in control

Direction of oil prices to dictate FY15/16 current account gap

Relief from a lower crude import bill and passage of a spurt in gold purchases led the 1Q-3Q FY14/15 current account deficit (CAD) to -1.8% of GDP. This marks a notable improvement from the recent peak at -5% in the Jun13 quarter. A small deficit or near balance is likely in the Mar15 quarter, leaving FY14/15 CAD at a comfortable -1.3% of GDP from -1.7% the year before (Chart 5).

Direction of oil prices will be an important determinant for the scale of improvement in next year's current account deficit. A rebound in oil prices (see the feature article in this quarterly issue) will marginally widen the deficit to -1.4% of GDP, working with the assumption that higher oil imports and rise in investment-related purchases

Chart 4: Monetary policy framework gets govt nod

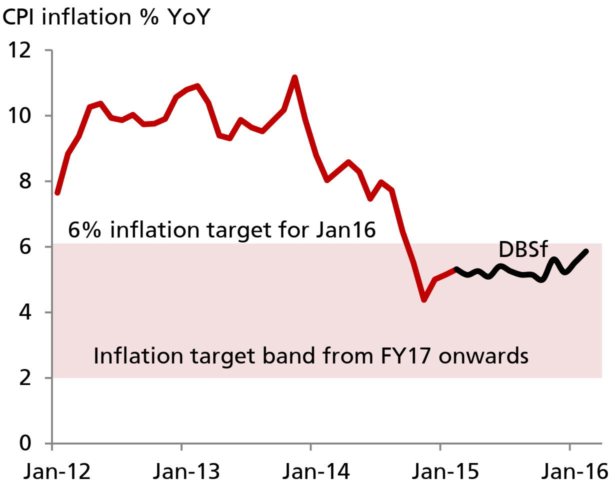
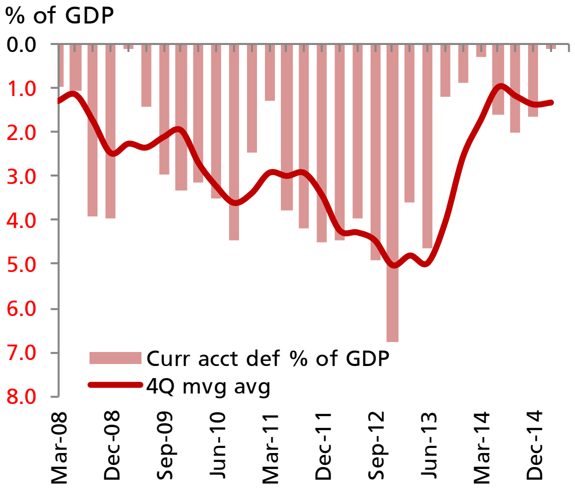


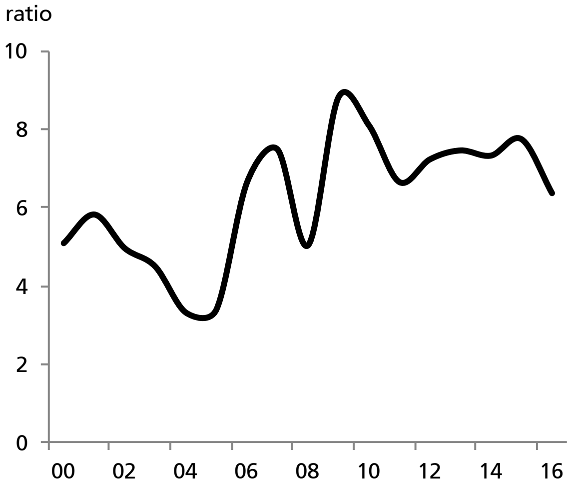
Chart 5: Current account worries in the backburner



(capital and project goods) underpin import growth. The gap could narrow to -0.5 to -1% of GDP in FY15/16 if oil prices stay muted at USD 50-60pb.

Narrower current account gap and strong capital inflows have underpinned the balance of payments position and underscore that India's external balances are no longer a flash-point.

Chart 6: Revenue to capital expd ratio to improve



On the fiscal end, modest increase in the FY15/16 fiscal deficit to -3.9% of GDP from -3.6% improves the credibility of the fiscal math (see "India budget: growth trumps fiscal goals", 2Mar15). The government also affirmed its commitment to fiscal consolidation, whilst delaying the -3.0% target by a year to FY18. Renewed focus on higher public spending (better expenditure mix - see Chart 6) especially infrastructure projects is positive for growth.

Rating agencies to take a sober view on fiscal metrics

The rating agencies and markets will however continue to take a sober view toward any hypothetical upgrade and monitor the fiscal targets and whether they are met over the medium-term.

Rupee strength vs trading partners is a source of concern

Strong equity and capital inflows continue to push the Indian rupee higher against the dollar, creating a fresh headache for the RBI. After the cumulative USD 42bn inflows last year, another USD 8bn has flown into the equity and debt markets so far this year. This has seen the rupee emerge as a front-runner against the other EM currencies, but sharp gains have been kept in check due to the authorities' active presence.

RBI's net dollar purchases in the spot market jumped to USD 12bn in Jan, highest in seven years. In fact, the central bank has been a net buyer in the past ten out of thirteen months, intervening both in the spot and forwards market. Over the past six months, about USD 26bn has been mopped up in the spot market, alongside USD 50bn in the forwards space, according to official data.

The authorities' preference to restrain strength in the rupee (vs dollar) is justified on two counts. Firstly, on fundamentals, letting the currency to appreciate strongly on the back of purely capital inflows, rather than a strong trade surplus or durable investment flows, is ill-advised.

Secondly, while rupee's gains against the dollar are measured, the currency has surged against its trading partners. On the inflation-adjusted real effective exchange rate (REER) basis, the INR is up more than 11% since early 2014. Composition of the REER basket explains the dichotomy. The rupee is up 21% against the EUR, 12% against the JPY since last year. Against the yuan, rupee is up ~2%.

Hence, to retain its trade competitiveness, the Indian authorities are likely to prefer keeping in-sync with the regional currency movements. In addition, with markets now re-assessing the risks of US rate hikes, the RBI will be keen to build cushion against any deterioration in the external environment. Hence, helped by the broader dollar up move, the RBI could grow tolerant of measured rupee weakness (see Currency section for in-house INR View).

India Economic Indicators

	14/15f	15/16f	16/17f	3Q15	4Q15f	1Q16f	2Q16f	3Q16f	4Q16f
Real output (11/12P)									
GDP growth*	7.4	7.8	8.3	7.5	7.5	7.6	7.8	7.7	8.0
Agriculture	1.4	1.9	3.0	-0.4	0.4	1.0	2.0	2.0	2.5
Industry (incl constrn)	5.9	6.3	7.0	3.9	7.6	6.0	6.0	6.5	6.5
Services	10.7	10.8	11.0	13.5	10.5	10.5	10.5	11.0	11.0
Construction	4.5	3.5	5.0	1.7	4.0	3.0	3.0	4.0	4.0
External (nominal)									
Merch exports (USD bn)	310	330	340	77	73	78	82	85	85
- % YoY	-1.3	6.4	6.1	-1.0	-11.4	-1.0	1.1	10.0	16.4
Merch imports (USD bn)	450	480	500	117	99	110	120	125	125
- % YoY	-0.1	6.8	8.3	7.5	-10.9	-2.9	-0.5	7.2	26.3
Trade balance (USD bn)	-140	-150	-160	-39	-26	-32	-38	-40	-40
Current a/c balance (USD bn)	-24	-31	-37	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)	6.4	5.6	5.8	5.0	5.3	5.2	5.2	5.6	6.5
Other									
Nominal GDP (USD tn)	2.1	2.3	2.5	na	na	na	na	na	na
Fiscal balance (% of GDP)	-4.1	-3.9	-3.5	na	na	na	na	na	na

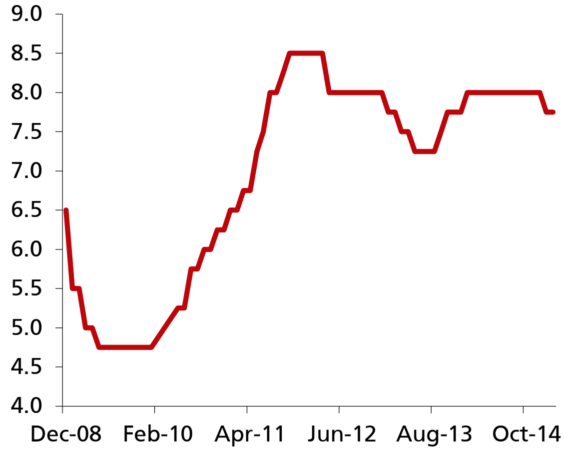
% change year-on-year, unless otherwise specified
Annual and quarterly data refers to fiscal years beginning April of calendar year.
* GDP growth stands for Real GDP; breakdown is under GVA (Gross Valued Added) series

IN - nominal exchange rate

INR per USD

IN – policy rate

% repo rate



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ID: gentle recovery

- **GDP growth is likely to come in around 5.5% this year on the back of the anticipated increase in fiscal spending**
- **A weak rupiah, however, means downside risks for domestic GDP growth**
- **Average CPI inflation is likely to be around 6% in 2015 but don't expect significant downward adjustment in inflationary expectations ahead**
- **Bank Indonesia is likely to keep its key policy rate unchanged but seems to be increasingly tolerant of a weak rupiah against the dollar**

GDP growth is likely to come in around 5.5% this year [1], on the back of the anticipated increase in fiscal spending. Private consumption growth has moderated slightly but remains as the underlying driver for GDP growth. Investment growth is likely to tick up higher, but a weak rupiah means some downside risks to our forecast.

Bank Indonesia (BI) is likely to keep its policy rate steady while at the same time tolerate some rupiah weakness against the dollar. Part of this tolerance for a weaker rupiah is the need to further narrow the current account (C/A) deficit.

Modest recovery in domestic demand

Private consumption growth moderated in 4Q14 but continued to trend a decent 5% and still contributed about 55% of overall GDP growth in the period (Chart 1). Lower fuel prices have lifted sentiment among consumers, following the sharp drop in Nov14 when the government raised its subsidised fuel prices.

We have yet to see any significant spike in consumption data so far this year. While the retail sales index ticked up slightly in January, auto and motor cycle sales remained soft. Imports collapsed in January, led by consumer goods, suggesting that the weak rupiah has continued to be a drag. It is imperative to note, however, that stable core inflation indicates that underlying demand remains resilient.

Chart 1: Private consumption still the underlying support for GDP growth
YoY, %-pt contribution

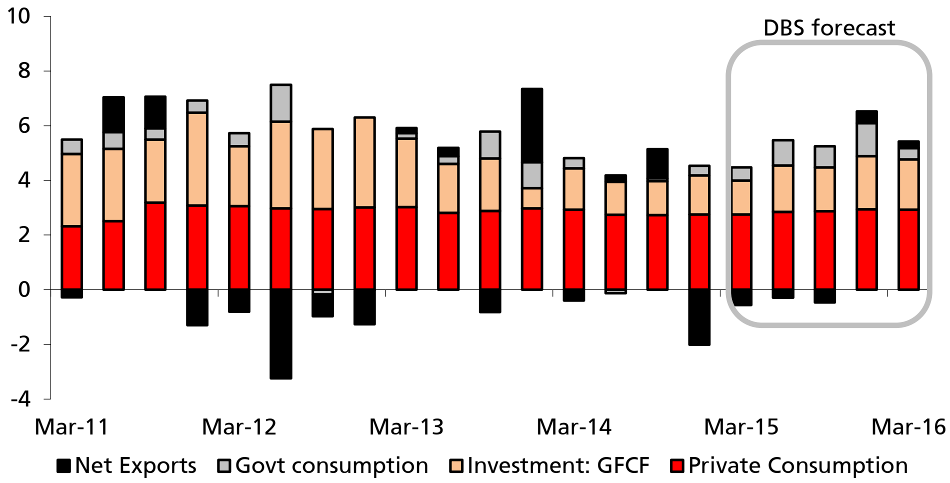

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Chart 2: Liquidity conditions to improve

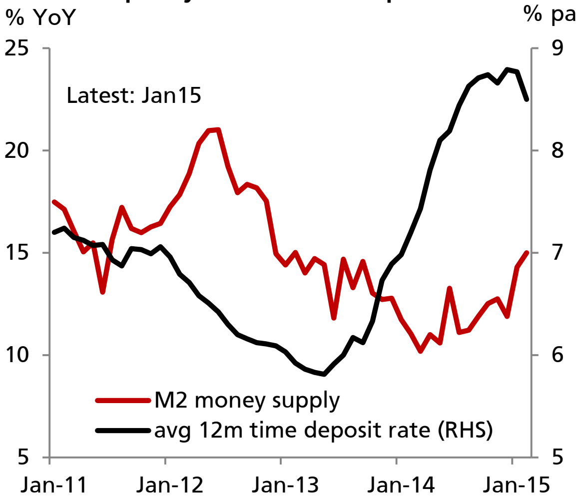
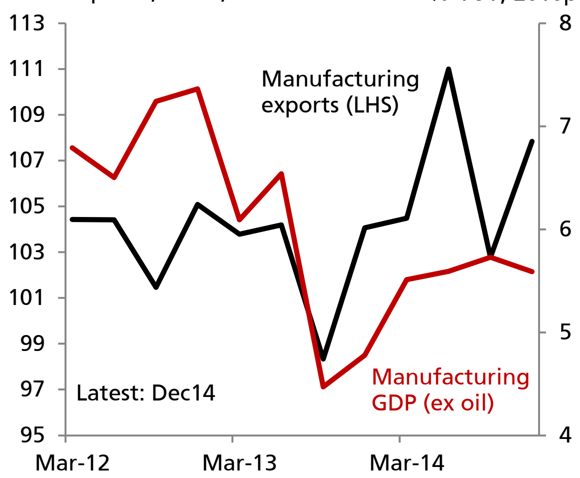


Chart 3: Manufacturing in the economy



How fast investment growth recovers going forward will have a direct impact on household demand. A mild recovery in investment growth, back to around 5-5.5% is likely this year, after the 4.5% average in the past two years. Downward pressure on lending rates, improved liquidity in the financial system (Chart 2) and the government's expansionary fiscal plans will help to anchor the pace of the recovery.

Government's delivery is key

The pace of fiscal disbursement is crucial

The main game changer this year comes from the fiscal front. A record-high 20% of this year's budget is meant for capital expenditure. Regional developments are crucial and there are signs of the government's strong intent on this front. Among others, the government has lowered cement prices and pushed for greater financing from banks in rural areas. We see little risks on the fiscal position, given the relatively low public debt level.

The pace of fiscal disbursement matters though and it remains to be seen if the government's short-term plans can materialize. While the government aims to complete all project tender exercises by March, nothing has made the headlines so far this year. Separately, a one-stop platform for new business permits is underway, under the authority of the state investment agency. Still, we believe that the government needs to liberalize more sectors before a significant increase in foreign direct investment (FDI) is evident.

Stronger manufacturing will be a huge plus

No significant recovery is expected for exports this year. Indeed, some downside risks persist amid weak commodity prices. It is encouraging to note the slight recovery in the exports of manufactured goods. On annual basis, exports of manufactured goods are currently growing at around 5% pace, compared to practically zero growth in 2012-2013. As a result, manufacturing GDP growth has inched up to about 5.5% pace currently, from about 4.5% at the end of 2013 (Chart 3).

Modest export growth in manufacturing but more need to be seen

Growth in the manufacturing sector has the potential to grow an annual pace of about 8% in the medium-term. Stronger export growth will definitely be a plus. We are unlikely to see export growth nearing the double-digit territory anytime soon, however, given the current state of the global economy. Relative productivity level has also been a drag, noting that several neighbouring countries (see the Philippines, for example) have seen much stronger growth in their own manufacturing sector. This is definitely one issue that the current government would want to tackle but don't expect any quick results on this front.

Chart 4: Inflationary pressures remain

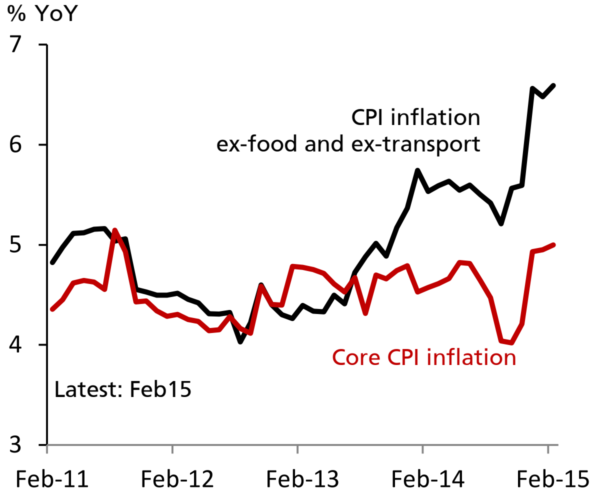
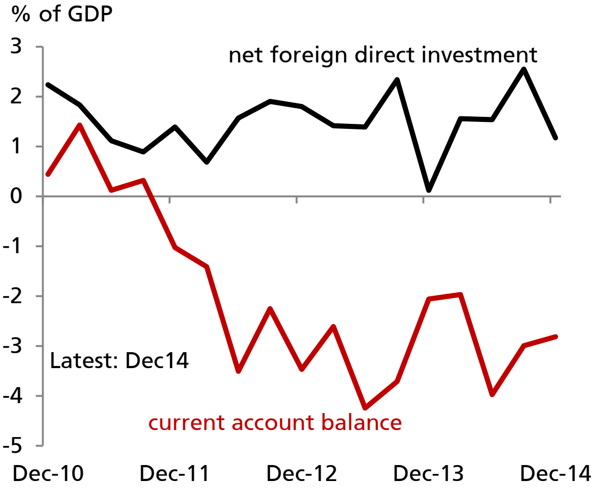


Chart 5: Still need to narrow C/A deficit



CPI inflation to average 6% this year

Don't expect significant downward adjustment in inflationary expectations

Average CPI inflation is likely to be around 6% in 2015 but risks are tilted towards the upside. Lower crude oil price has triggered disinflationary pressures in the transport and raw food components of the CPI basket. Excluding these 2 components, CPI inflation is currently still trending higher (Chart 4).

Don't expect significant downward adjustment in inflationary expectations ahead. Major retailers have not revised their prices despite lower fuel prices, as evident from the steady inflation in processed food and clothing components of the CPI. Adjustment in toll prices and the recent rice shortage have put some near-term pressure on CPI inflation. More importantly, imported inflationary risks persist given the weak rupiah tone.

BI to maintain key policy rate steady but tolerant of weak rupiah

BI's surprise cut in February was not the start of an aggressive policy easing cycle. Rather, it was to undo the 25bps rate hike delivered in November. Current account (C/A) deficit is likely to come in at 2.9% of GDP this year. While the central bank seems to be more comfortable with the C/A deficit hovering around 3% now, we continue to think that a more sustainable level is around the 2% mark (Chart 5).

BI to keep its key policy rate steady

The central bank seems to be increasingly tolerant of a weaker rupiah against the dollar. Given the dominance of the strong USD theme this year, BI seems to be fairly comfortable about the rupiah prospect, as long as it remains fairly stable on an effective exchange rate basis. A weaker rupiah is meant to push for stronger pick-up in manufacturing exports.

Risks

A close monitoring of the rupiah is warranted. Excessive weakness of the rupiah may actually turn into a structural drag for GDP growth potential in the medium-term, given the potential adverse impact on investment growth. Following the surprise rate cut in February, market's confidence on BI's policy credibility seems to have affected the rupiah rather markedly.

Some political risks continue to lurk at the background. The on-going tussle between the police force and the corruption eradication commission (KPK) has been affecting the public perception of the new government.

Notes:

[1] Based on the newly-introduced GDP series, with 2010 as the base year

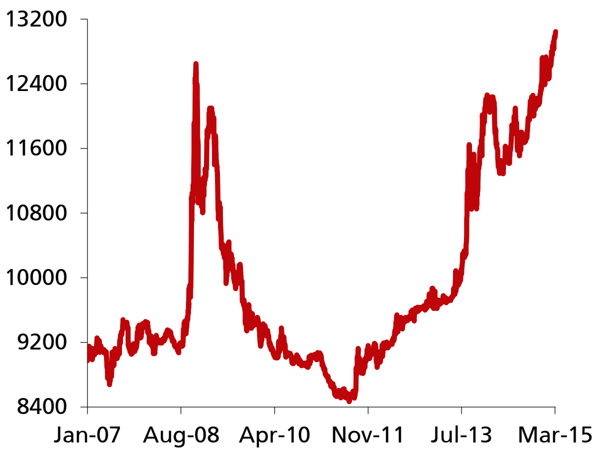
Indonesia Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
Real GDP growth	5.0	5.5	5.7	5.0	5.4	5.4	5.6	5.6	5.6
Private consumption	5.1	5.2	5.3	5.0	5.0	5.3	5.3	5.3	5.4
Government consumption	2.0	9.8	6.0	2.8	7.6	11.5	9.4	10.0	6.4
Gross fixed capital formation	4.1	5.0	5.6	4.3	3.9	5.3	5	5.8	5.8
Net exports (IDRtrn, 10P)	58.0	40.0	33.0	10	11	-8	17	20	16
Exports	1.0	2.1	4.4	-4.5	-0.9	1.4	2.0	5.9	5.1
Imports	2.2	3.1	4.9	3.2	1.5	2.6	4.2	4.2	4.2
External									
Merch exports (USDbn)	176	173	185	44	41	42	43	47	45
- % chg	-3.4	-1.7	6.9	-10.2	-6.8	-6.7	-2.3	6.8	9.8
Merch imports (USDbn)	178	179	189	44	39	46	48	46	44
- % chg	-4.5	0.4	5.7	-4.3	-9.3	-2.1	9.1	4.5	12.8
Merch trade balance (USD bn)	-2	-6	-4	0	2	-4	-5	1	1
Current account bal (USD bn)	-26	-26	-25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-2.9	-2.9	-2.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	112	114	116	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation (average)	6.4	6.0	5.5	6.5	6.5	6.5	6.3	4.4	3.6
Other									
Nominal GDP (USDbn) **	888	890	915	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.5	-2.3	-2.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified
Starting this quarterly, we use the new GDP series with 2010 as the base year

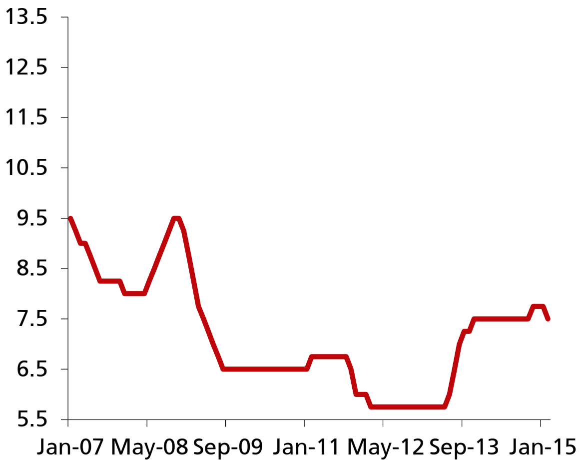
ID - nominal exchange rate

IDR per USD



ID – policy rate

BI rate



MY: buckling down

- **Strong GDP growth of 6.0% was recorded for 2014 but that will likely slow to 4.9% in 2015**
- **Drag from the external front will remain a challenge and domestic growth will also moderate on fiscal consolidation**
- **Inflation will rise marginally to 3.4% in 2015, as lower oil prices offset the GST effects**
- **Bank Negara will likely maintain the Overnight Policy Rate at 3.25% for the rest of the year**

The economy raced to a strong finish in 2014. Headline GDP rose by 5.8% (YoY) in 4Q14, significantly higher than market expectations (Chart 1). On the margin, growth momentum accelerated to 6.5% (QoQ, saar), from 4.3% previously. Overall, the economy grew by 6.0% in 2014, the fastest annual growth rate since 2010.

Domestic demand the key driver of growth

Domestic demand continued to be the key driver of growth (Chart 2). Growth was supported by a faster pace of private investment (11.2% YoY, from 6.8% in 3Q14) and robust expansion in consumption (7.8% YoY, from 6.7% in 3Q14). Strong capital spending in the manufacturing and services sectors drove private investment while stable labour market condition and continued wage growth have boosted consumer spending.

Meanwhile, government spending has moderated while public investment has continued to decline. This came on the back of measures to consolidate developmental expenditure to reduce the overall fiscal deficit, as the government embarks on its fiscal consolidation.

But the main drag came from the external front. Export growth moderated to 1.5% (YoY) in 4Q14, from 2.8% previously while imports growth accelerated by 0.4%-pt to 2.6%. This has led to a sharp decline in net exports of 9.8%. In fact, net exports have shaved off 0.8%-pt of the overall GDP growth.

Chart 1: A strong finish in 2014

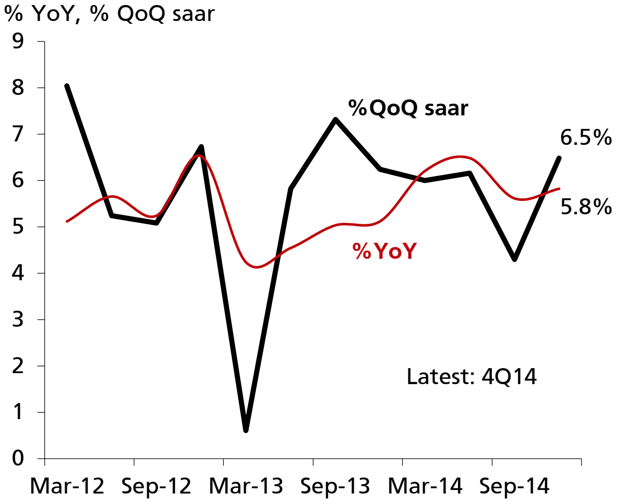


Chart 2: Domestic demand driving up growth

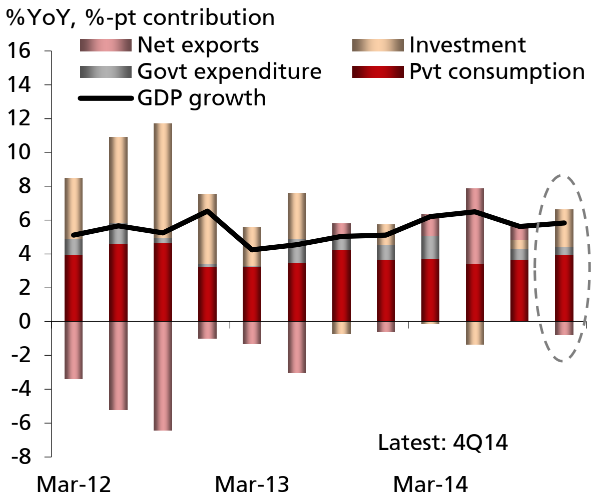


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Chart 3: PMIs mostly down

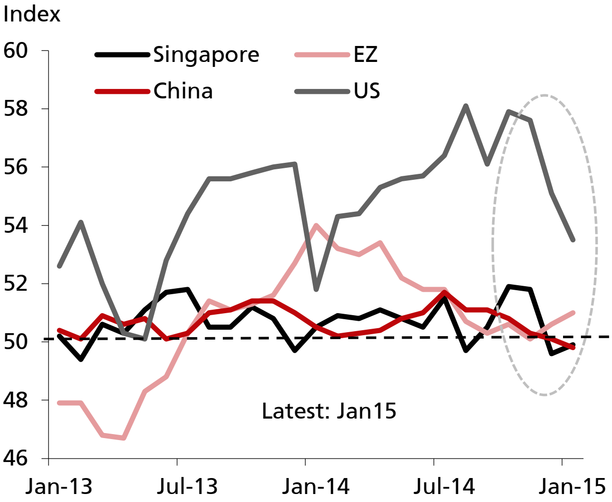
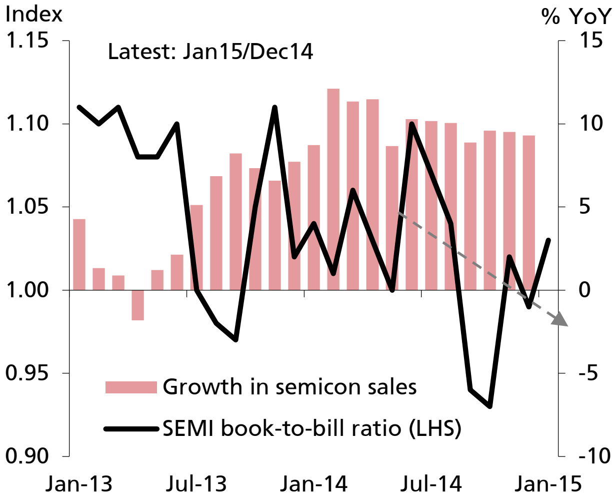


Chart 4: Electronics cycle looking dicey



Growth momentum set to ease

Going forward, while the economy remains on a steady growth path, growth momentum will likely ease amid uncertainties in the global economy and domestic constraints. The recovery in the US has been uneven. High frequency data remains mixed and fourth quarter GDP growth has been revised downwards. Separately, though Japan and the Eurozone are out of recession, significant structural impediments remain and outlook is still bleak. And China will be growing slower as well. Over-capacity there in previous years will take time to digest.

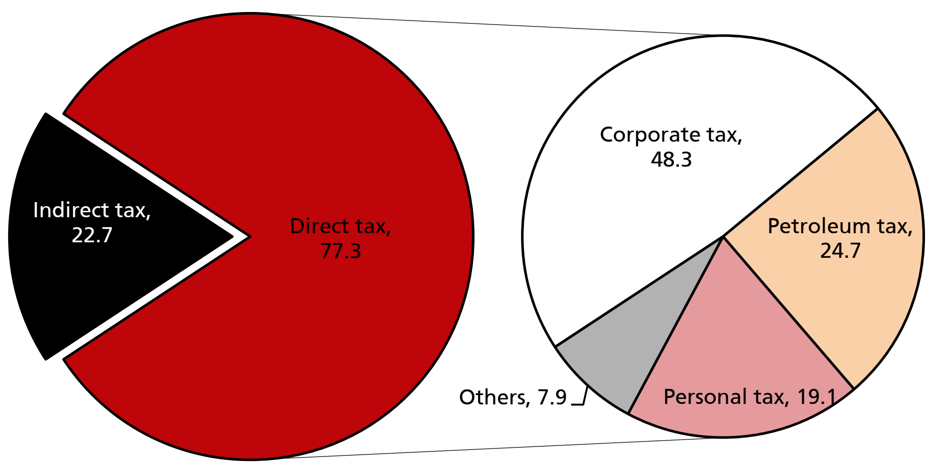
For the quarters ahead, Malaysia's export growth will remain modest against the backdrop of a weak external demand. The PMIs of key export markets have mostly fallen (Chart 3). In addition, electronics cycle appears dicey with the SEMI book-to-bill ratio having fallen back to near parity level and global semiconductor sales growth moderated (Chart 4).

Low oil price a double-edge sword

The fall in oil prices is another pain point for oil exporting countries like Malaysia. It will be a drag on government spending and private investment. While oil prices appear to have bottomed and have picked up slightly over the past one month, it is nevertheless still about 50% lower compared to Jul14.

With the sharp fall in oil prices, the assumed price of USD 100 per barrel used in the 2015 Budget was no longer realistic. Malaysia depends heavily on direct taxes (Chart 5). And petroleum tax revenues account for about 25% of the total direct tax revenues. The potential deterioration in the tax revenue collections had prompted

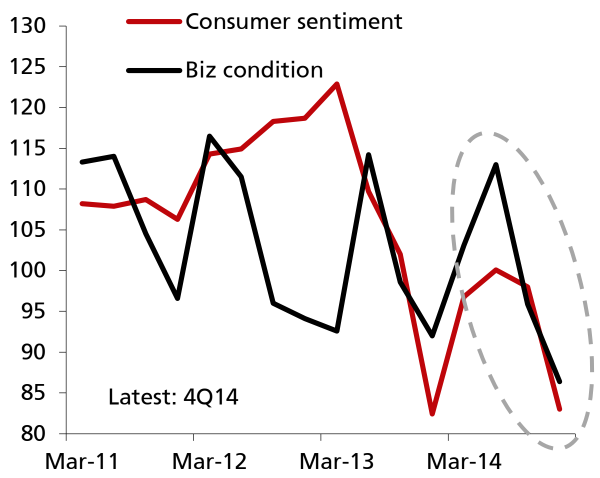
Chart 5: Federal government tax revenue composition (%), 2013



Prime Minister Najib to announce a MYR 5.5bn cut in fiscal spending in January to shove up the fiscal position amid plummeting oil prices.

Moreover, investment activity will also moderate given the cut back in oil and gas capex spending. This is especially so considering the shaky investor confidence (Chart 6). Likewise, consumer sentiments haven't been encouraging too. While consumers may front-load spending ahead of the GST introduction, consumption will likely ease thereafter given the spike in prices.

Chart 6: Sentiments have moderated sharply



Given the uncertain external environment and domestic fiscal constraints, we revise down our 2015 GDP growth forecast to 4.9%, down from 5.2% previously. Such subdued growth momentum is likely to persist into 2016, when GDP growth is likely to average 5.0%.

Bank Negara to stand pat for the rest of the year

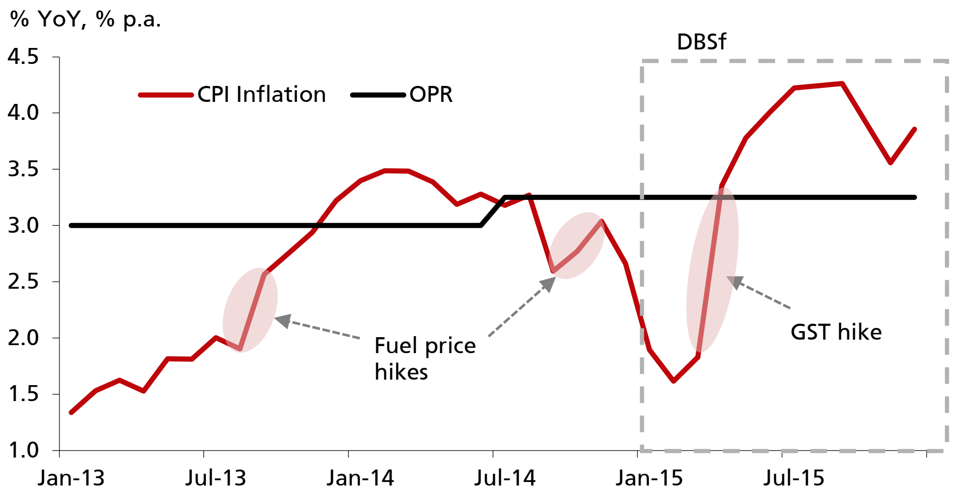
Bank Negara (Malaysia) is expected to keep the Overnight Policy Rate (OPR) at 3.25% for the course of the year despite the anticipated spike in inflation after the introduction of the GST in April (Chart 7).

Plainly, inflation and growth dynamics have shifted. Headline inflation readings for the past few months have persistently fell below expectation. Effects of the hikes in pump prices in last October have eased substantially on the back of the sharp fall in oil prices. Juxtaposed with the slower growth outlook, chance is high that the central bank will keep policy on steady keel.

Inflation forecast lowered

While the introduction of the GST will likely drive inflation higher, the effect is expected to be blunted by the GST offset package and low energy prices. Full-year inflation is now expected to average 3.4%, down from our previous forecast of 4.2%. Going forward, inflation should ease to 3.0% in 2016, once the GST effects subside.

Chart 7: Inflation and monetary policy outlook



Malaysia Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP growth	6.0	4.9	5.0	5.8	5.4	4.8	4.9	4.6	4.6
Private consumption	7.1	6.0	6.4	7.8	6.4	5.8	5.8	6.0	5.6
Government consumption	4.4	3.5	6.2	2.7	2.5	3.0	2.8	5.0	4.8
Gross fixed capital formation	4.7	4.4	5.6	4.3	4.2	4.0	4.2	5.2	5.0
Exports	5.1	3.5	5.0	1.5	2.6	3.2	3.6	4.7	4.7
Imports	3.9	5.2	6.2	2.6	3.5	6.4	5.3	5.7	6.0
External (nominal)									
Exports (USD bn)	237	218	226	58	53	55	55	55	54
Imports (USD bn)	211	190	192	51	46	48	48	48	47
Trade balance (USD bn)	26	28	33	6	7	7	6	7	8
Current account bal (USD bn)	15	17	19	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	5	5	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	3.4	3.0	2.8	1.8	3.7	4.2	3.8	4.4
Other									
Nominal GDP (USDbn)	327	354	382	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-3.5	-3.2	-2.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

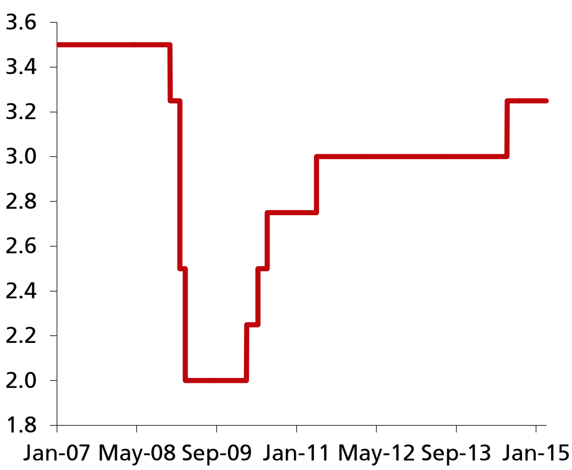
- % growth, year-on-year, unless otherwise specified

MY - nominal exchange rate

MYR per USD

MY – policy rate

%, OPR



TH: slower than expected

- **The recovery in the domestic economy is slower than anticipated. Expect GDP growth at 3.6% in 2015**
- **It is important to see the government getting its act together, for recovery in the private sector is still in its early phase**
- **Despite sluggish exports, current account surplus is expected to persist, supportive of sentiment on the baht**
- **The Bank of Thailand surprised with a 25bps rate cut in March against a falling CPI inflation outlook**

The recovery is underway, albeit at a slower than anticipated pace. Private investment growth may have bottomed out but still early in the recovery phase (Chart 1). Fiscal disbursement has been disappointing though. More disconcertingly, falling core inflation suggests that underlying private consumption is still lackluster. With export growth unlikely to make much of a difference this year, we now expect overall GDP growth at 3.6% in 2015.

Bank of Thailand (BOT) delivered a surprise 25bps rate cut in March, as CPI inflation is set to average below 1% this year. The decision is mainly taken to lay the ground for a stronger recovery in 2016 as the rate cut may not do much to boost domestic demand in the near-term. Further easing is unlikely.

Domestic demand still weak

There have been little signs of a strong pick-up in domestic demand. The private consumption index has been moving sideways. A similar picture is seen in retail sales of durable goods, suggesting that underlying demand is still weak (Chart 2). Import growth remains soft, despite the baht holding its ground against the dollar in recent months. Following a disappointing 4Q15, private consumption growth is still some way off from the pre-2013 crisis trajectory (Chart 3, next page).

Chart 1: Private investment has bottomed out

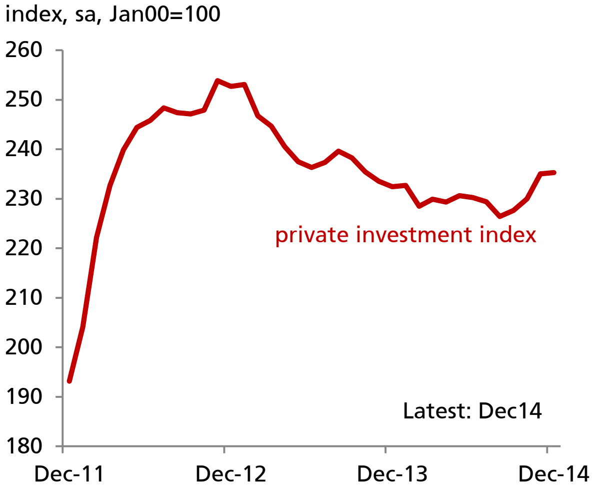


Chart 2: Domestic demand remains weak

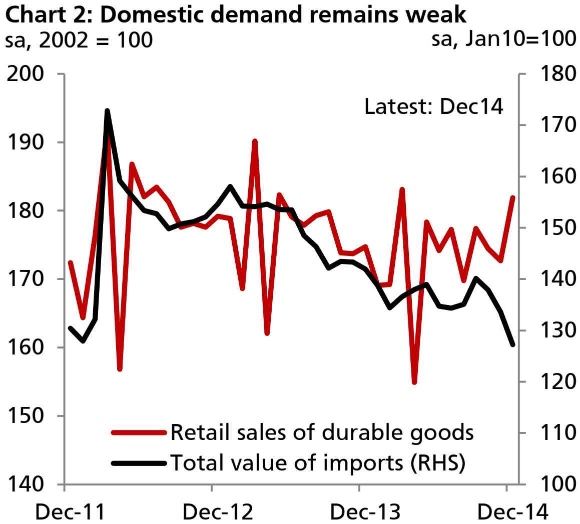


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Chart 3: Private consumption still below trend

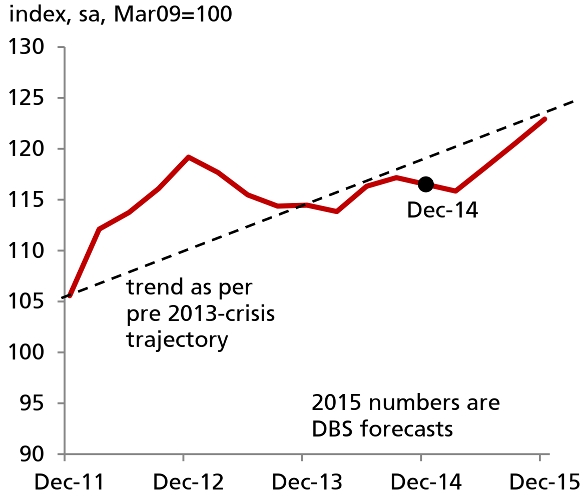
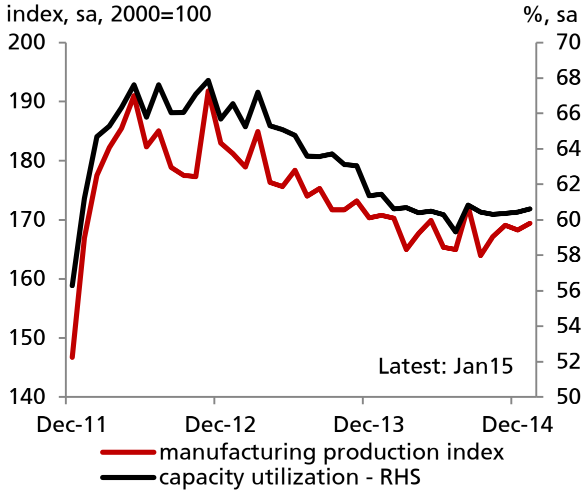


Chart 4: Weak manufacturing sector



The pace of fiscal disbursement has been slower than anticipated

Given all the excitement about government's projects this year, the pace of fiscal disbursement has been disappointing. Total government expenditure has actually fallen by some 4% (YoY) in 4Q14 (the first quarter of the FY15 budget) and no material pick-up is seen as yet so far this year. A ramp-up in fiscal spending is still in the offing later this year, but downside risks remain.

It is important to see the government getting its act together going forward, for public investment has also been moving sideways. About the only encouraging thing from the domestic economy at this juncture is the fact that private investment seems to have bottomed out. Overall investment (GFCF) growth is likely to return towards 5% this year, but given the contraction in the past two years, this is far from being a strong bounce.

Export growth below 5%

Weak domestic demand means plenty of slack in the economy. Capacity utilization remains around 60%, below its historical average of 65-68% during normal times (Chart 4). Manufacturing production had practically no growth in the past year. On seasonally adjusted terms, the current level of production is some 12% lower than where it was at the end of 2012. Manufacturing makes up 2/5 of the economy and we are unlikely to see a strong rally in GDP growth before witnessing a significant rebound in the sector.

Another pedestrian growth in the manufacturing sector is in the offing for this year, as export growth has been weak. Recent trade data indicates that imports of intermediate goods are still falling, not a good sign for the outlook on export growth (Chart 5, next page). We now expect goods exports to grow by a mere 3% this year. After 2 consecutive years of zero export growth, this amounts to be practically no growth at all for three years running.

Export growth is likely to come in a mere 3% this year

Despite anemic export growth, current account (C/A) surplus reached a multi-year high of 10.4% in 4Q14. The tourism sector had a strong end to 2014, which leads to a sharp surplus in the services component. Lower crude oil price has worked in favor of the goods trade balance, evidenced in the rising terms of trade. But the C/A surplus is also likely to persist due to the weak domestic demand. At an estimated 3.2% of GDP, the C/A balance is likely to continue supporting market sentiment on the baht.

Falling CPI inflation provides room for a rate cut

BOT surprised the markets with a 25bps rate cut in March, in a bid to boost confidence amid downside risks to GDP growth and falling CPI inflation. CPI inflation is set to undershoot target and we forecast it to average 0.8% in 2015. Slower-than-

Chart 5: Export growth not heading anywhere

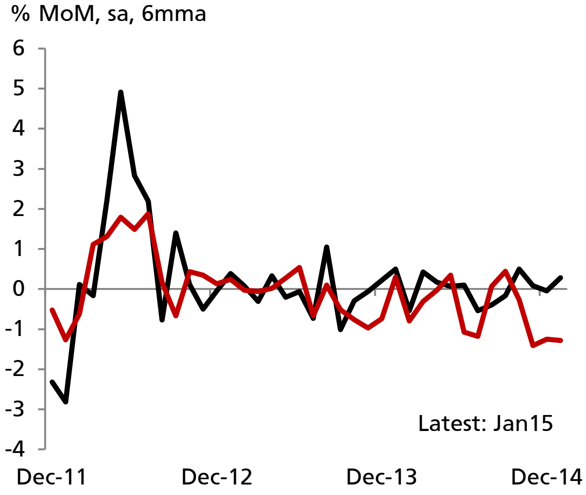
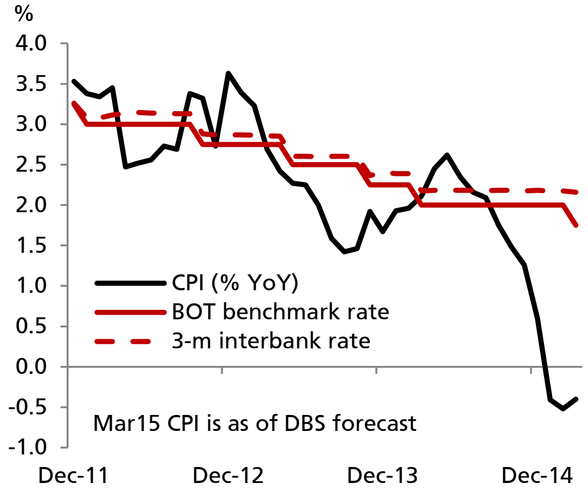


Chart 6: Real interest rate deeply in positive



expected GDP growth coupled with falling inflation leave the central bank with little choice but to cut its policy rate. Note that real interest rate is back in the positive, at about 2.5% currently (Chart 6), highest since 2009.

CPI inflation is set to undershoot official target by quite a margin

Deflationary risks have been dominant thus far in 2015. CPI inflation is set to average -0.4% (YoY) in 1Q15, lowest since 2009. Low crude oil price is the main factor, given that transport makes up a sizeable 25% of the overall CPI basket. Deflation in the transport component of the CPI is currently in its fifth consecutive month. It is quite likely that this trend will persist for the best part of 1H15, barring any sudden spike in crude oil price.

Yet, except for health services, all other components of the CPI basket have also witnessed some disinflation this year. At the current pace, core inflation is likely to average 1.4% this year, its slowest since the height of the political crisis in 2013. It suggests that underlying demand is shaky, although some impact from a relatively strong baht could also be at play.

We don't expect further policy easing by the BOT this year. There seems to be a preference to keep the baht relatively strong to help with the recovery in domestic demand. In any case, further weakness in the baht may not necessarily translate to a strong pick up in export growth, given the state of global demand. And more importantly, household debt remains a policy concern in the medium-term. The BOT will start to normalize its policy in early 2016.

Political stability is crucial for the tourism sector, one of the few bright stars in late-2014

Risks

The country is still under martial law for an indefinite period of time. There is no schedule as yet for the next general elections. While political stability persists under the current government, some security concerns have resurfaced in light of the recent impeachment and criminal charges given to former PM Yingluck. Recent bomb blasts have rocked Bangkok, and the Police had cautioned of possible follow-up attacks.

Besides the obvious risks on the government's policy efficacy, any surge in political noise will only hurt the tourism sector once again. Tourism was a key reason that prevented GDP growth slipping into the negative territory in 2014. After adjusting for seasonal effects, hotel occupancy rate was about 8% higher in 4Q14, compared to 4Q13-1Q14. Tourist arrivals rose about 10% in the same period. Given that tourism revenues make up about 10% of overall GDP, there is a significant downside risk on GDP growth in the near-term if political instability were to gain dominance again.

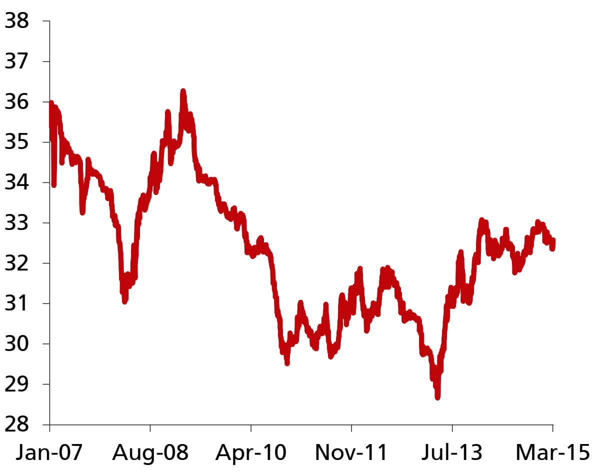
Thailand Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP growth (88P)	0.7	3.6	4.3	2.3	4.1	3.9	4.0	3.6	4.3
Private consumption	0.3	3.4	4.1	1.9	3.5	3.0	3.0	4.0	4.0
Government consumption	2.8	6.0	6.5	5.5	6.8	6.3	7.6	4.1	9.0
Gross fixed capital formation	-2.8	5.0	5.2	3.2	4.6	3.1	4.2	10.0	8.0
Net exports (THBbn)	886	938	925	269	288	210	210	230	262
Exports	0.0	7.0	4.1	4.9	7.4	8.5	9.7	2.7	2.0
Imports	-4.8	7.4	5.8	-0.3	6.9	8.1	5.4	9.2	6.3
External									
Merch exports (USDbn)	228	234	245	58	56	57	61	61	59
- % YoY	0	3	4	2	0	2	5	5	5
Merch imports (USDbn)	228	230	244	56	55	57	58	60	59
- % YoY	-9	1	7	-5	-2	0	-2	7	7
Trade balance (USD bn)	0	4	1	2	1	0	3	1	0
Current account balance (USD bn)	14	12	8	10	4	2	3	3	2
% of GDP	3.7	3.2	2.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	1.9	0.8	2.8	1.1	-0.4	0.1	1.0	2.2	3.4
Other									
Nominal GDP (USDbn)	374	380	390	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate, %	0.8	0.8	0.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)**	-2.5	-3.2	-2.8	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

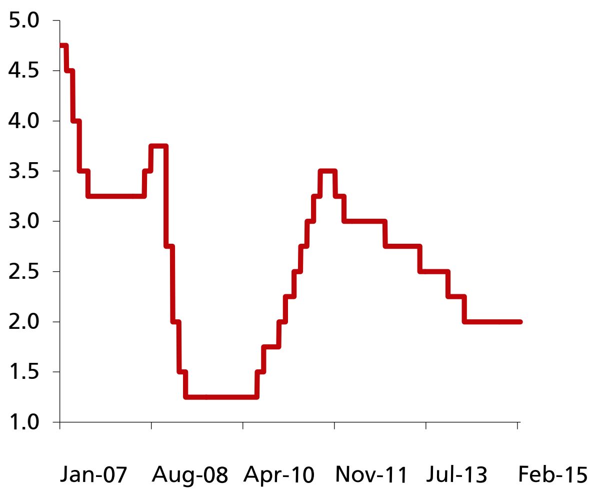
TH - nominal exchange rate

THB per USD



TH – policy rate

%, 1-day RRP



SG: dicey

- **Uncertainties in the external environment and domestic restructuring constraints imply subdued growth ahead**
- **GDP growth is expected to average 3.2% in 2015 and 3.5% in 2016**
- **Inflation will remain benign on low energy prices at 0.4% in 2015 and 1.3% in 2016**
- **Chance of further monetary policy easing by the MAS is rising given low inflation**

The economy grew by 2.1% (YoY) in 4Q14 (Table 1). On the margin, the economy exceeded market expectations with a healthy expansion of 4.9% (QoQ, saar). Full-year GDP growth for 2014 now reads 2.9%. This upward revision can be attributed to the better than expected showing in the manufacturing and services sectors.

Table 1: GDP growth by sectors

	2013	1Q14	2Q14	3Q14	4Q14	2014
Percentage change year-on-year						
Overall GDP	4.4	4.6	2.3	2.8	2.1	2.9
Manufacturing	1.7	9.6	1.3	1.7	-1.3	2.6
Construction	6.3	7.4	3.0	1.1	0.7	3.0
Services producing	6.1	3.7	2.6	3.3	3.1	3.2
Quarter-on-quarter annualised growth rate, seasonally adjusted						
Overall GDP	4.4	1.8	-0.5	2.6	4.9	2.9
Manufacturing	1.7	6.2	-9.3	0.9	-2.5	2.6
Construction	6.3	3.4	-3.0	0.7	2.2	3.0
Services producing	6.1	0.0	1.9	3.2	7.8	3.2

Patchy outlook for manufacturing growth ahead

Industrial production output figures for Oct-Dec14 were revised upward and with the adjustments, 4Q14 manufacturing growth now reports a contraction of 1.3% (YoY), compared to a decline of 2.0% assumed in the advance GDP estimates. This by itself has contributed an additional 0.2%-pt to the headline number.

Chart 1: End of NODX slump

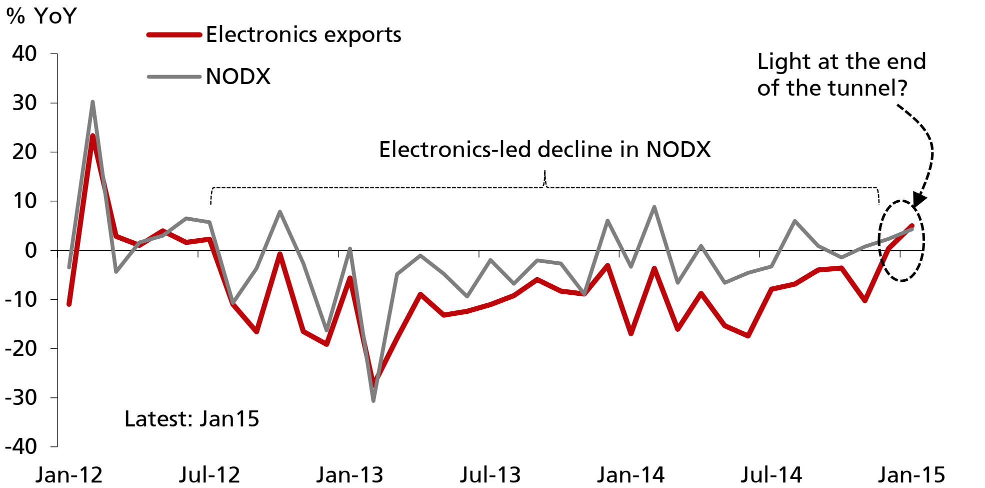


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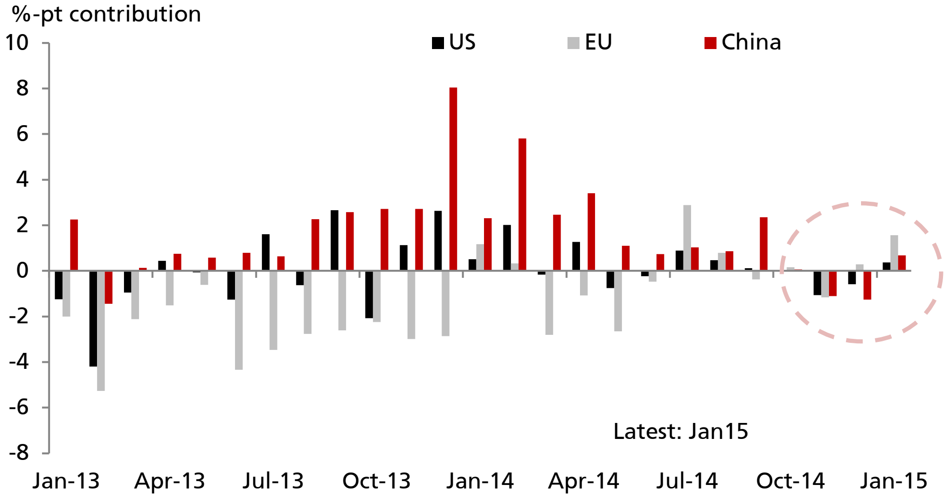
Chart 2: %-pt contribution to export growth



The improvement in the manufacturing sector is supported by the turnaround in non-oil domestic exports (NODX). Export sales are finally above water after a 28 months of doldrums (Chart 1, previous page), dragged down mainly by the weakness in electronics previously.

Uncertain outlook for manufacturing

However, there are risks ahead. The SEMI book-to-bill ratio, the leading indicator for global electronics cycle has fallen back to around parity level again. Global semiconductor sales growth had moderated to 9.3% (YoY) as of Dec14, compared to 10.2% in Jun14. Outlook for the manufacturing sector will remain tepid in the coming months as external headwinds remain strong. Pockets of downside risks in the global economy still exist. Exports to the top 3 markets - US, Eurozone and China - may have bottomed but signs of a pick-up remain elusive (Chart 2).

Unless the recovery in the US gains momentum, a slower growth in China this year and the placid outlook in the Eurozone, will continue to weigh down on the prospects for the manufacturing sector in the coming quarters.

Uneven improvement in service growth

The services sector grew 3.1% (YoY) in 4Q14, significantly faster than the 2.6% forecasted by the advance estimates. Growth was supported mainly by the finance and insurance sector, which recorded a growth pace of 10.3%. That translates into a stunning 36.2% surge on a QoQ saar basis. In fact, the financial services industry

Chart 3: Services growth driven mainly by financial services sector

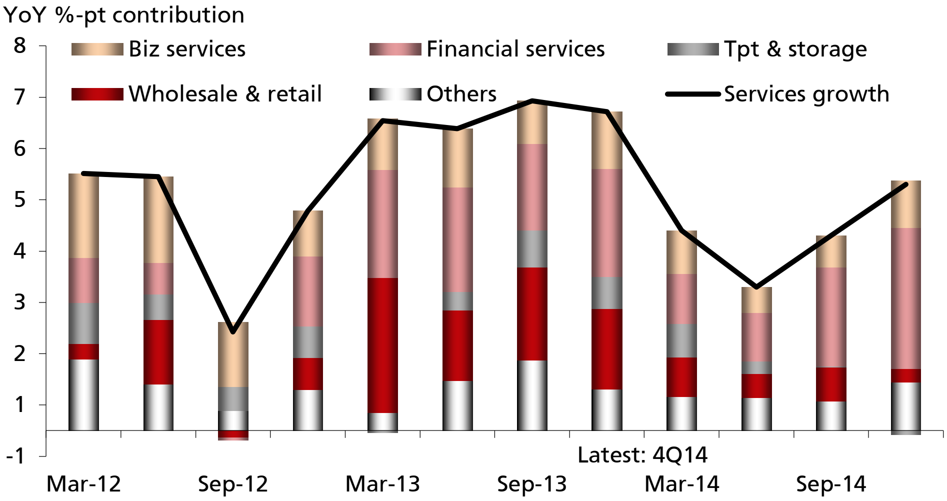


Chart 4: Business services growth

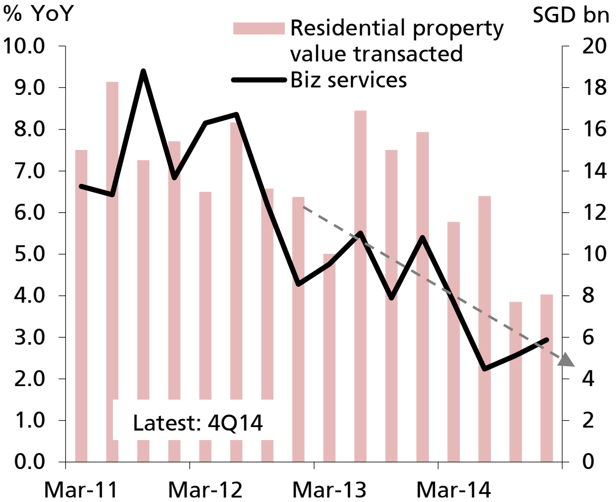
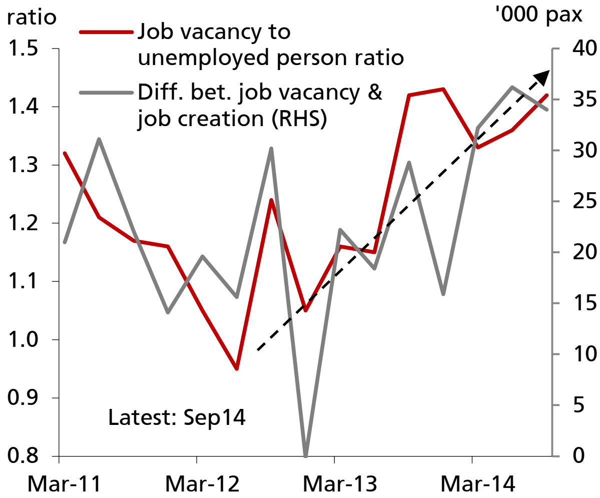


Chart 5: Labour crunch



alone accounted for about 57% of the total growth in the overall services sector. Performance in the other services industries has been less encouraging.

Going forward, externally oriented services sectors such as transportation and trading services will face headwinds amidst the challenging global economic environment. Business services will be weighed down by a cooling property market (Chart 4). Moreover, the labour market is expected to remain tight amid the restructuring process. Unemployment rate will remain low while vacancy rate will continue to escalate. The difference between job vacancy and job creation, a reflection of the labour market tightness, has already reached unprecedented level (Chart 5). The tight labour will remain the number one challenge for service providers in the quarters to come.

Subdued growth outlook ahead

Outlooks for the three key trading partners - China, Eurozone and Japan – are expected to remain dicey while the recovery in the US economy has been slow. Nothing in the external environment suggests an improvement in growth momentum in the near-term.

Growth still below potential

In fact, there are downward pressures on the GDP growth trajectory in the first quarter of the year, judging from the current global economic conditions. Overall GDP growth forecast for 2015 remains at 3.2% but we see downside risks.

For 2016, we expect growth momentum in the US to pick up while outlook in the Eurozone, Japan and China should stabilise. But potentially higher interest rates will crimp growth momentum in Asia and Singapore. A cautiously optimistic outlook will emerge and this makes for a subdued growth pace of 3.5%.

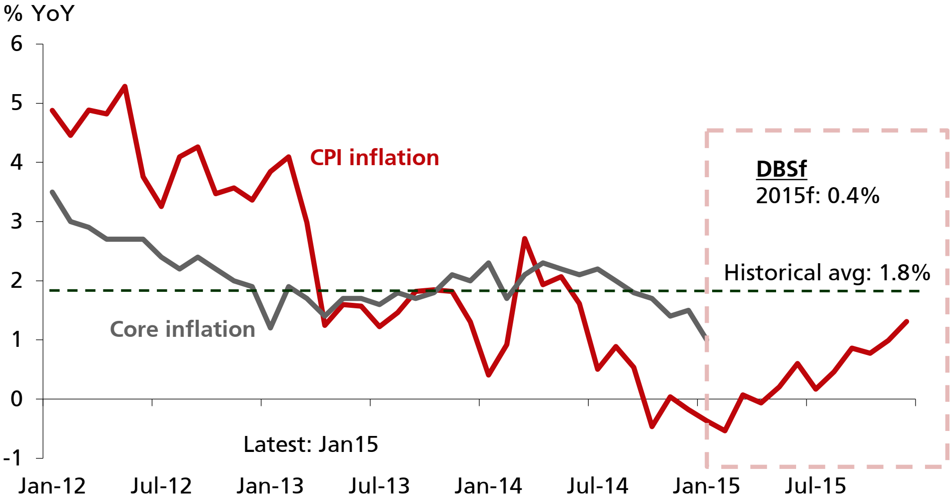
Inflation to remain benign

Inflation is expected to average 0.4% in 2015 (Chart 6, next page). Such benign inflation comes on the back of low energy prices, a significantly less 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.

Oil prices have fallen by about 50% over the past months. Being a net importer of oil, the island state will benefit significantly from a reduction in underlying costs, and henceforth inflation. As long as oil prices stay low, inflationary pressure within the domestic economy should remain muted.

Moreover, while the labour market has been tight, wage growth hasn't been as strong as anticipated. In fact, average nominal wage growth in 2014 has moderated to 2.6% (YoY), compared to 4.2% in 2013. The benign wage growth is expected

Chart 6: Benign inflation



to persist along with the sub-par growth of 3.2% this year. As a result, the pass-through effects on consumer prices will consequently be modest.

A cooling property market has further weighed down on inflation. Rental has been falling and is expected to continue on the downward trend amid risk of higher interest rates and a supply glut in the property market.

Lastly, the Pioneer Generation Package introduced by the government to alleviate the burden of healthcare costs for the elderly has lowered healthcare inflation. The sub-index has eased from an average increase of 3.5% (YoY) between Jan-Aug14 to just 1.8% over the past four months.

Inflation is declining on the compounded effects of the mixed bag of factors above. Not only is the base of the inflation trajectory for this year drastically reduced, the slope of this trajectory, in the form of sequential changes to prices, is likely to be significantly less than previously anticipated. Inflationary pressure, be it external or domestic, will stay relatively muted in the coming months.

Headline inflation will likely average -0.1% (YoY) in 1H15 before inching higher to 0.9% in 2H15. Overall inflation is expected to rise going forward to print 1.3% in 2016, partly on the back of the low base this year, higher energy prices and potentially stronger global growth.

Risk of further easing by MAS

Benign inflation suggests more easing pressure

The Monetary Authority of Singapore (MAS) surprised the market on 28 Jan15 with an announcement to flatten the slope of its appreciating Singapore dollar nominal effective exchange rate (SGD NEER) policy band. The decision was made in conjuncture to a downward revision in its inflation forecasts. Headline CPI inflation forecast for 2015 was lowered to between -0.5% and 0.5%, from 0.5-1.5% previously. The outlook for the core inflation was lowered to 0.5-1.5%, from 2-3% previously.

This is a rare off-scheduled policy move by the authority. While the MAS has brought its exchange rate policy closer to the general monetary easing stance seen in many countries globally, it still has a modest appreciation policy. With the SGD NEER now in the lower quartile of its band and flirting with the lower limit, chance of further easing is rising.

Much depend on the balance of risk between inflation and growth. And both are facing downside risk amid a sluggish external environment and global deflationary pressure. If inflation continues to remain stuck in negative level or growth turns out weaker than expected, the MAS could well re-centre the policy band lower or switch to a zero appreciation stance altogether.

Singapore Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
Real GDP (00P)	2.9	3.2	3.5	2.1	2.4	3.5	3.6	3.4	3.4
Private consumption	2.5	2.2	2.6	2.2	2.0	2.3	2.3	2.0	2.2
Government consumption	1.7	6.4	5.8	3.3	6.0	7.0	5.8	6.7	6.0
Gross fixed investment	-1.9	0.3	2.4	1.2	-1.4	0.0	1.0	1.6	1.7
Exports	2.2	2.1	3.0	0.2	2.0	2.0	1.8	2.5	2.5
Imports	1.5	1.5	2.4	0.5	0.9	1.5	1.3	2.3	2.4
Real supply									
Manufacturing	2.6	1.2	4.3	-1.3	-2.6	-0.6	2.1	5.6	4.5
Construction	3.0	1.1	3.5	0.7	0.3	5.0	0.4	-1.1	3.0
Services	3.2	4.3	3.7	3.1	4.1	4.9	4.8	3.5	3.5
External (nominal)									
Non-oil domestic exports	-0.7	1.5	2.5	0.5	2.2	2.2	0.0	1.7	0.2
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	0.4	1.3	-0.2	-0.2	0.2	0.5	1.0	1.2
Other									
Nominal GDP (USDbn)	308	319	334	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	2.0	2.1	2.0	1.9	2.0	2.0	2.1	2.1	2.0

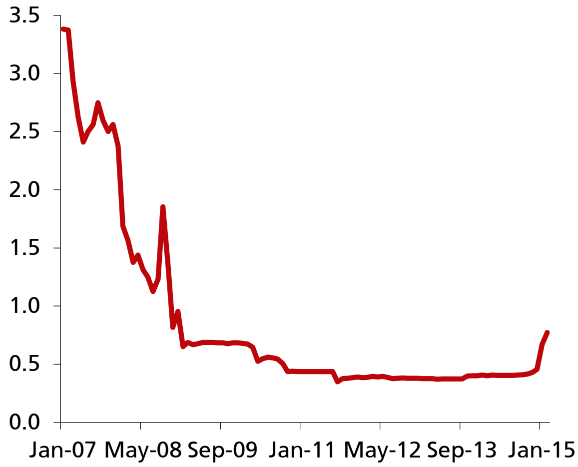
- % change, year-on-year, unless otherwise specified

SG - nominal exchange rate

SGD per USD

SG – 3mth SIBOR

% pa



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PH: staying strong

- **Fiscal spending ahead of next year's election will provide another layer of support for overall GDP growth**
- **Private consumption growth is steady circa 5.5% while investment growth remains strong at 8%. Expect GDP growth at 6.3% this year**
- **While export growth may moderate this year, the manufacturing sector will continue playing an important role**
- **Falling CPI inflation provides some room for the central bank to pause on its monetary policy tightening cycle**

Expect high fiscal spending to sustain this year, providing yet another layer of support in domestic demand. Bulk of the support still comes from the private sector though (Chart 1). Private consumption is resilient while investment growth will remain close to the double-digit territory. Some moderation in exports is likely following the robust growth over the past 2 years. Overall, expect GDP growth to come in at 6.3% this year.

The Bangko Sentral ng Pilipinas (BSP) remains concerned about liquidity in the financial system, even if some moderation is now visible. But lower than expected CPI inflation means there is room for the BSP to take a pause on its monetary policy normalization course.

Expansionary fiscal mode

A turnaround in government consumption at the year-end proved to be the difference for overall GDP growth last year (Chart 2). After putting restraints on fiscal spending for the best part of 2H14, the government has returned to spend at about 6% annual pace currently. Revenue collection is still growing at 12% pace, and thus, there is plenty of room for the government to continue boosting growth.

Infrastructure overhaul is still the key priority of the government. While many on-going private public partnership (PPP) projects appear to be behind schedule,

Chart 1: Steady domestic demand

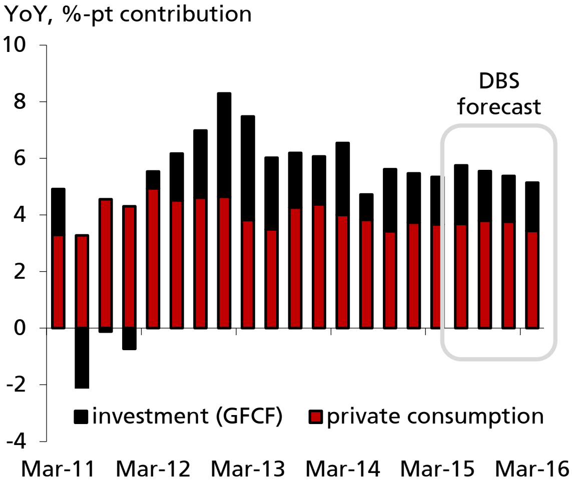

Chart 2: A turnaround in govt consumption

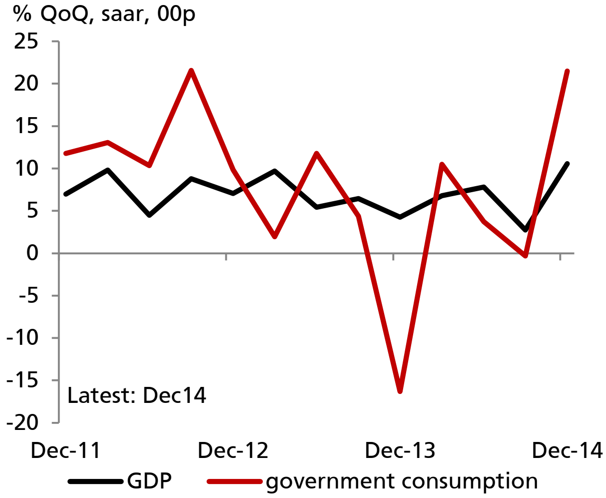

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Chart 3: Moderation in investment

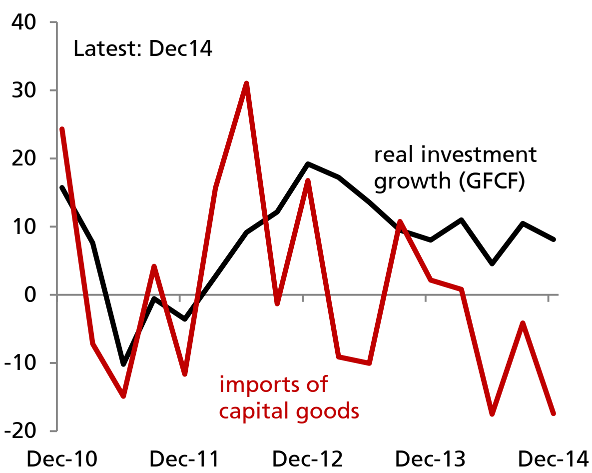
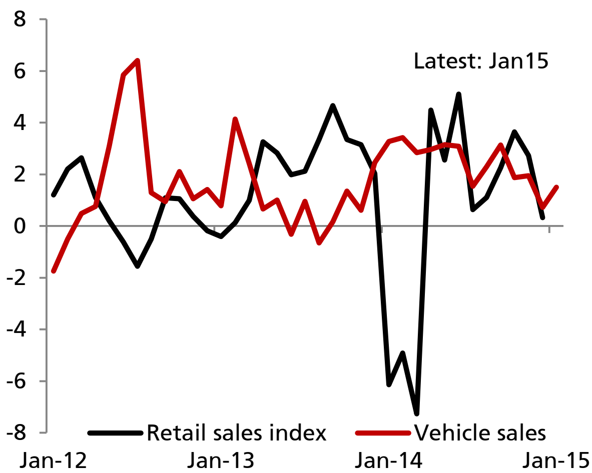


Chart 4: Steady consumption growth



interests for newly announced projects remain encouraging. Infrastructure development is crucial as the government aims to increase foreign direct investment (FDI) inflows. The government targets FDI to reach 3-5% of GDP in the next couple of years from an average of about 1% in the past 5 years.

On this front, some policy changes to enhance foreign direct investment (FDI) are currently being discussed. Among others, several changes in the pipeline may include new tax incentives for key sectors and revision to the negative investment list. A stronger mandate has also been given to the state investment agency, with new overseas trade representative offices set to be opened this year.

Look for possible policy changes to attract more foreign investors

Overall domestic demand stays strong

We estimate investment growth to remain strong at 8%, although this represents some moderation from recent years (Chart 3). Imports of capital goods have fallen quite markedly in 4Q14 despite a fairly stable peso, presumably due to some destocking. Since a strong outlook for demand persists, inventories are likely to pick-up again this year. Note that loan growth has only eased slightly in recent months, on the back of a tighter monetary policy.

Private consumption growth is steady at circa 5.5%. There is no reason to expect a shift from this trend for now. The high frequency data still suggests healthy consumption demand (Chart 4). Motor vehicles sales are growing at 15% pace per year. Retail sales growth has returned to its 10-12% pace, after witnessing a sharp fall in early-2014. Expect continued support as a result of positive multiplier effects from the sustained strength in services sector and a revitalized manufacturing sector.

Consumption is steady while investment growth remains strong

Strong inflows of overseas foreign remittances (OFW) are likely to remain prevalent. At the current trend, we expect total OFW to hit USD 25bn this year.

Some moderation in export growth

Goods export growth accelerated yet again in 2014, almost hitting the double-digit territory. Exports of electronic products rose 8% (YoY) in 2014, double the 4% expansion in 2013. Keeping up to this pace may be quite a task in 2015, given the high base effects and the general state of the global economy.

The manufacturing sector has been playing an increasingly important role in the economy. And it will continue to do that if not more. Growth in the sector has averaged 9% in the past 2 years, forming another pillar of support for the economy (Chart 5, next page). It also reduces the concentration risks stemming from an over-dependence of the services sector and an overheating construction sector. About 60% of foreign direct investment (FDI) projects approved in 2014 are in the manufacturing sector.

Chart 5: Growth in manufacturing is a plus

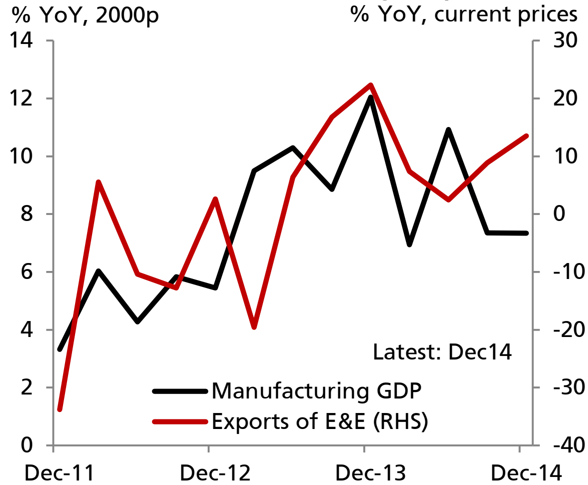
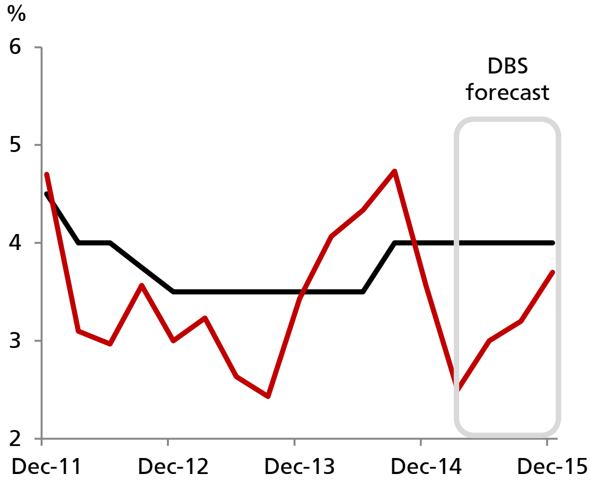


Chart 6: CPI inflation and policy rate



On FDI, we expect total FDI to potentially reach another record-high of about USD 6-8bn this year. The sustained focus on infrastructure projects is critical and, more importantly, further liberalization of the economy is likely to spur FDI inflows quite significantly. Coupled with the strong OFW inflows, expect the healthy external liquidity position to remain prevalent over the medium-term perspective.

Expect steady rates for now

CPI inflation is currently trending at 2.5% (YoY), sharply lower than the 4.5% pace six months ago. Lower crude oil price has led to deflation in the utilities and transport components of the CPI basket, which are the most sensitive to changes in crude oil prices. There are some upside risks on CPI inflation going forward, but we now forecast average CPI inflation to come in at 3.2% in 2015 (Chart 6), well within the BSP official target of 2-4%.

The rather sharp fall in CPI inflation is likely to convince the BSP to continue taking a pause in its policy tightening course though. This is especially given the string of policy loosening steps witnessed in the region so far this year. The central bank may adjust the rates on the Special Deposit Account (SDA) to absorb any spike in liquidity, but any move on the key policy rate is unlikely. Expect the overnight borrowing rate to remain steady at 4% for the rest of the year.

Overheating risks remain but BSP likely to keep rates steady this year

Overheating risks in the economy persist but the BSP is likely to be encouraged by the early impact from last year's tightening steps. Loan growth is moderating and broad money supply growth has eased to its lowest level since 2012. Growth in the construction sector, while still close to the double-digit level, has also moderated. Capacity utilization is at record-high, but this is mainly driven by the resurgence of the manufacturing sector.

Risks

The presidential election is due in 2016 and there are some concerns of policy continuity. On the fiscal position, revenue collection may come under pressure. There are also risks that protectionist interests may derail the efforts to boost FDI inflows. Political noise ahead of next year's election may affect government's efficacy and its push for stronger reforms. For now, we reckon that these risks are fairly limited.

Philippines Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
Real GDP growth	6.1	6.3	6.0	6.2	5.4	5.6	7.0	6.6	6.6
Private consumption	5.4	5.4	5.2	5.1	5.4	5.6	5.6	5.2	5.0
Government consumption	1.8	7.4	6.3	9.8	5.0	6.3	9.9	8.9	5.9
Gross fixed capital formation	8.6	8.0	7.1	8.1	6.9	10.7	8.0	7.4	6.9
Net exports (PHP bn, 00P)	31	16	12	-66	19	109	-3	-108	-8
Exports	12.1	6.2	6.6	15.5	9.4	8.4	3.7	3.5	4.5
Imports	5.9	6.7	6.7	5.3	4.3	8.8	5.5	8.4	7.9
External (nominal)									
Merch exports (USD bn)	62	64	71	15	15	16	17	16	17
- % YoY	9	3	11	9	8	2	-1	4	9
Merch imports (USD bn)	64	68	72	16	16	16	18	17	17
- % YoY	2	6	7	-2	1	8	5	10	6
Merch trade balance (USD bn)	-2	-4	-1	-1	-1	0	-1	-2	-1
Current account balance (USD bn)	10	7	8	n.a	n.a	n.a	n.a	n.a	n.a
% of GDP	3.5	2.4	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	3.2	3.8	3.6	2.5	3.0	3.2	3.7	4.0
Other									
Nominal GDP (USD bn)	285	295	305	n.a	n.a	n.a	n.a	n.a	n.a
Budget deficit (% of GDP)	-1.4	-1.0	-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) **	41	41	40	n.a	n.a	n.a	n.a	n.a	n.a

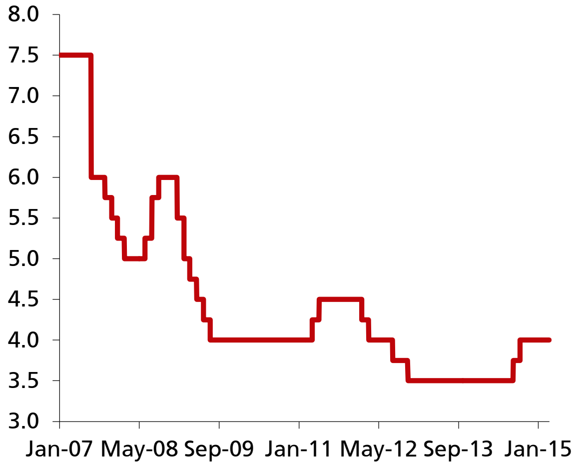
* % change, year-on-year, unless otherwise specified
** includes government, central bank and state-owned banks

PH - nominal exchange rate

PHP per USD

PH – policy rate

%, o/n rev repo



VN: oil effects

- **Fall in oil prices has driven inflation significantly lower and allowed the government to introduce reforms**
- **CPI inflation is now expected to average 1.9% this year, which will provide room for the central bank to ease monetary policy further**
- **GDP growth is projected to register 6.0% in 2015, driven by healthy exports and domestic growth**

Oil prices started falling around the middle of last year. To date, prices are still about 50% lower, although there has been a rebound since hitting bottom in January (Chart 1). Plummeting oil prices have significant effects on the economy, in terms of inflation, growth and monetary policy direction.

Oil driving inflation lower

The most direct pass-through effect of low oil prices goes into inflation. Headline number fell to 0.3% (YoY) in Feb15, the lowest since Nov01, in the aftermath of the Sep11 attack and post dot.com bust period. Most importantly, this was driven by the sharp plunge in transport inflation (Chart 2).

The transport and communication inflation index fell an unprecedented 15% (YoY) in Feb15, after having fallen by 10.4% in Jan15. The government has been slashing domestic pump prices repeatedly on the back of falling global oil prices. The Jan15 cut was the 13th consecutive fuel price cut since Jul14. The pump price of 92-RON gasoline, the most common fuel in Vietnam, has fallen by more than 30% to VND17,570 over the past months.

Indeed, the fall in pump prices amid plummeting global oil prices have lowered the entire inflation trajectory. Coupled with the disinflation in food, which registered -0.6% (YoY) in Feb15 despite the Tet New Year, overall inflation in 2015 is expected to be significantly lower than previously anticipated.

Chart 1: Oil prices plummeted

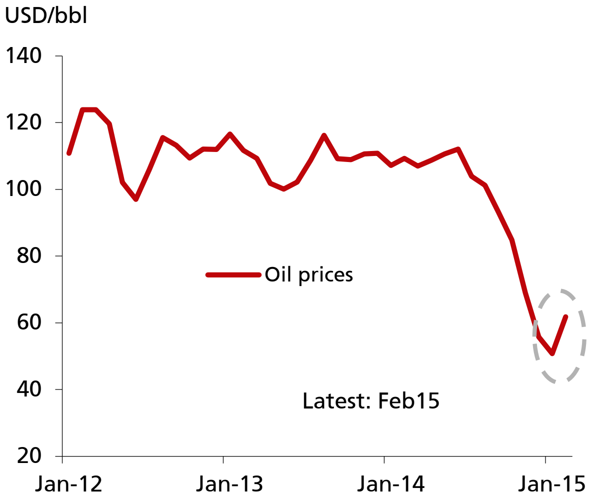


Chart 2: Transport inflation turned sharply negative

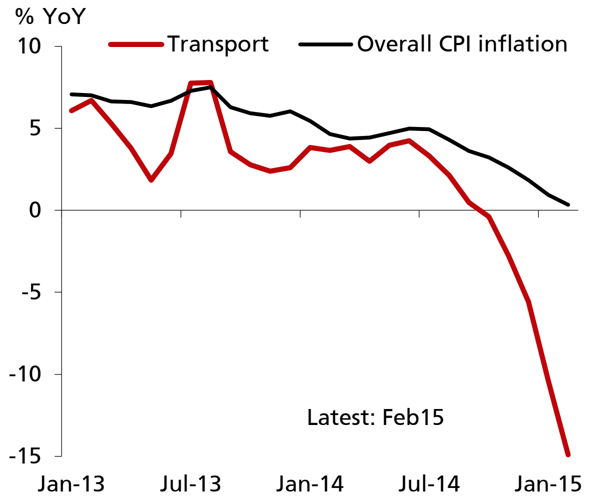


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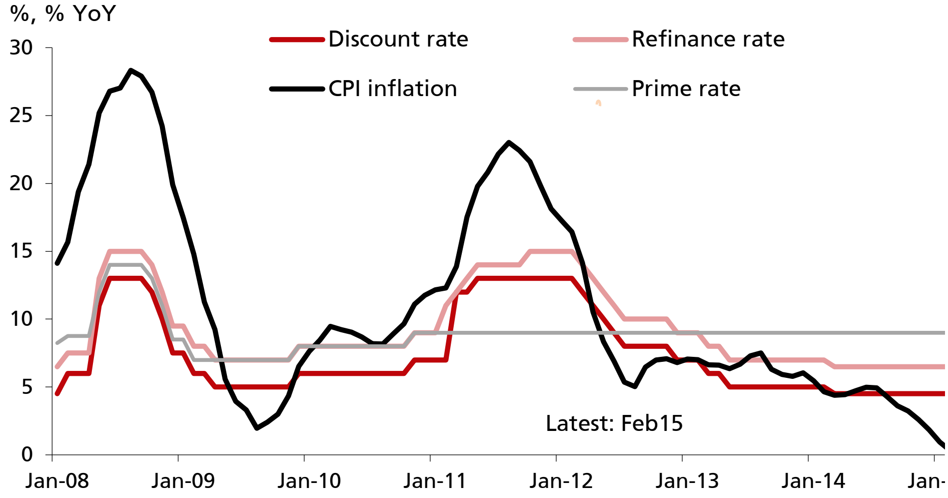
Chart 3: Inflation and monetary policy outlook



However, electricity prices are expected to increase by 9.5% in 2015, as the government is likely to take this window of low energy prices to cut electricity subsidies. The government may also tinker with other forms of subsidies, given that low fuel price is seen as a tax break for consumers.

Against this backdrop, we expect inflation to eventually pick up swiftly due to subsidy rationalisation. It could bounce back to above 1.5% level in the coming months before climbing above 3.0% going into 2016, on account of possible rebound in oil prices and stronger recovery in the global economy. CPI inflation for 2015 should average 1.9% before rising to 3.5% in 2016.

Monetary policy on easing bias

SBV to cut rates on benign inflation

The State Bank of Vietnam (SBV) is targeting 13-15% credit growth in 2015 to support its GDP growth goal of 6.2%. While the authority also aims to keep inflation below 5%, the final outcome on inflation could well fall short of their projection, thereby providing room for further monetary policy easing (Chart 3).

This is also underscored by the fact that many central banks around the world have already switched to an easing stance, in line with the global disinflationary pressure. Furthermore, monetary policy is traditionally tilted towards supporting economic growth in Vietnam.

Chart 4: Another year of trade surplus

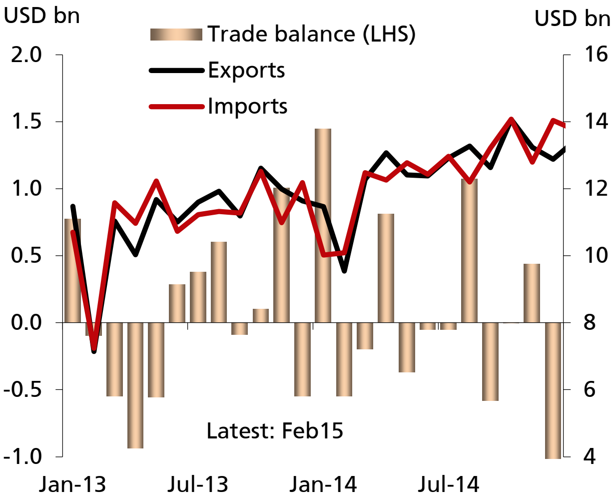


Chart 5: Electronics driving growth

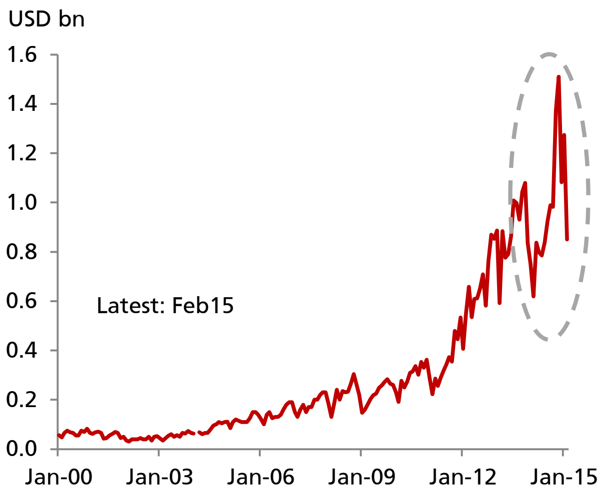


Chart 6: Electronics cycle looking dicey

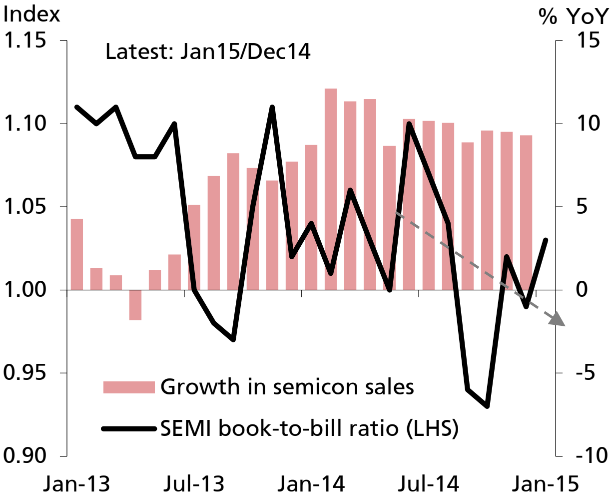
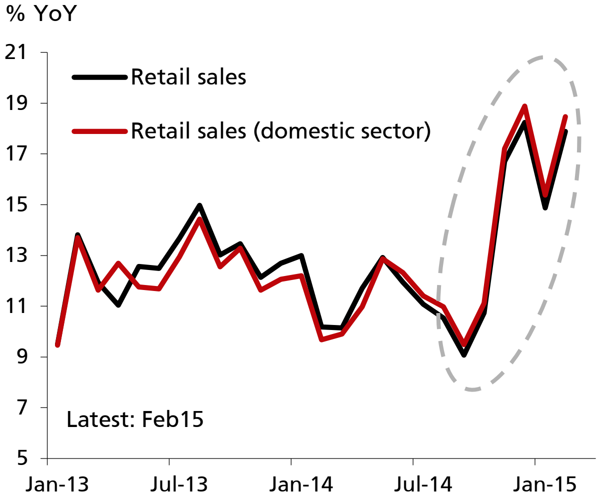


Chart 7: Domestic retail sales picked up strongly



In this regards, chances of further rate cuts are high. We now expect the SBV to cut the refinance rate by another 150bps over the course of the year. This is more than our earlier projection of just 50bps cut in 1Q15.

Export boost

The economy is expected to continue to enjoy improvement on the trade front. Overall trade surplus for 2014 came in smack in line with our forecast at about USD 800mn (Chart 4, previous page). Such rosy outlook should persist although trade balance may moderate on the back of increase in foreign investment, which could well drive capital imports significantly higher. Overall trade balance for 2015 is likely to register about USD 600mn.

Electronics exports will remain a key driver on the external front. Total electronics export sales rose by 7.4% to register a record USD 11.5bn in 2014 (Chart 5, previous page). With several more electronics plants expected to start production this year, the growth rate for electronics exports is likely to hit the double-digit territory.

However, there is downside risk in terms of the global electronics cycle. The SEMI book-to-bill ratio has dipped and is now hovering around the parity level again (Chart 6). Global semiconductor sales growth has moderated to 9.3% YoY in Dec14, down from 10.2% in mid-2014. If such trend continues, it could well imply potential easing in the global electronics cycle and that will surely put a dent on Vietnam's electronics ambition.

Healthy growth ahead

GDP growth of 6.0% in 2015

Beyond electronics, lower oil and gas prices will be supportive for growth, serving as an unofficial tax cut for both consumers and enterprises. This will be a boost for domestic consumption and investment.

In particular, retail sales have picked up strong in 4Q14 (Chart 7) and such robust performance will likely persist in 2015 considering the high chance of monetary easing and the fact that SBV is targeting for higher credit growth this year. Plainly, domestic growth will provide additional impetus to headline GDP on top of the boost from exports.

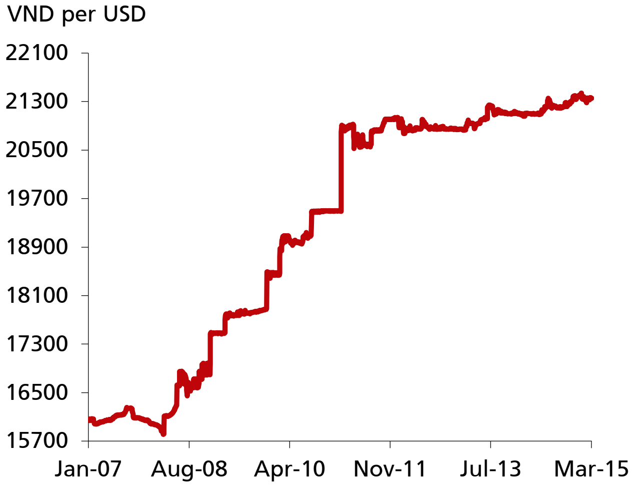
That said, global outlook is not exactly that rosy. While the recovery in the US remains in place, sluggish growth in the Eurozone and slowdown in China could well imply that overall growth performance may fall slightly short of SBV's target. We expect full-year growth to register 6.0% in 2015 and 6.2% in 2016. Nevertheless, this is still healthy growth and certainly more sustainable considering the roller-coaster ride that the economy has been through over the past years.

Vietnam Economic Indicators

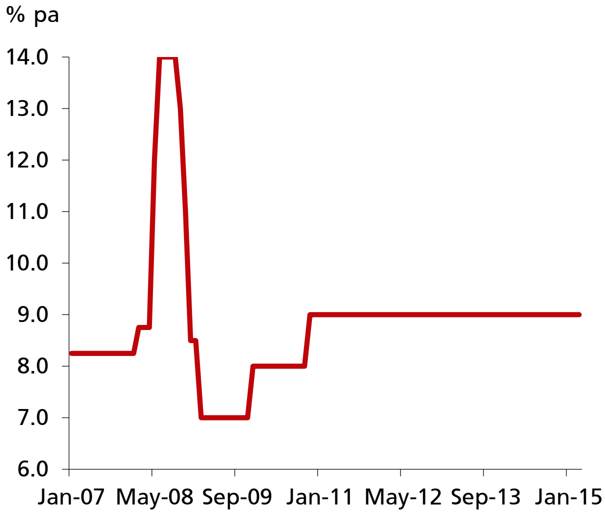
	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand									
GDP growth	6.0	6.0	6.2	6.8	6.1	5.9	6.0	5.9	5.9
Real supply									
Agriculture & forestry	3.3	3.2	3.1	4.7	3.1	3.2	3.3	3.0	3.2
Industry	6.9	7.0	7.4	8.7	6.8	7.0	7.2	7.1	6.9
Construction	6.5	6.7	7.7	8.4	6.6	7.0	6.8	6.5	7.5
Services	6.0	6.2	6.2	5.9	6.3	6.4	6.0	5.9	5.8
External (nominal)									
Exports (USD bn)	150.1	153.4	157.4	40.2	36.5	41.9	42.2	44.8	39.9
Imports (USD bn)	149.3	153.5	157.3	40.9	36.8	41.2	42.0	44.9	40.1
Trade balance (USD bn)	0.8	-0.2	0.1	-0.7	-0.3	0.7	0.2	0.0	-0.2
Current account bal (USD bn)	8.1	8.5	8.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	4.4	4.2	4.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	4.1	1.9	3.5	2.6	0.9	1.8	1.9	2.9	5.0
Other									
Nominal GDP (USDbn)	186	201	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



VN – prime interest rate



US: no acceleration

- **2.2% growth in 4Q14 brings the broader picture back to 'normal'**
- **4.7% avg growth in Q2 and Q3 wasn't strength per se, it was simply payback for the cold weather contraction in Q1**
- **Full year 2014 growth comes to 2.4%, not significantly different from the 2.3% averaged in 2012/13**
- **Growth in retail sales, core capex orders and imports has run unchanged for 2.5-3 years. There are no signs of acceleration anywhere**
- **One quarter of the Fed's favorite inflation gauge has been in outright deflation for two full years. Why hasn't the Fed mentioned this once?**
- **If the Fed does go ahead and raise rates later this year, there is every reason to believe it won't get too far, too fast thereafter**

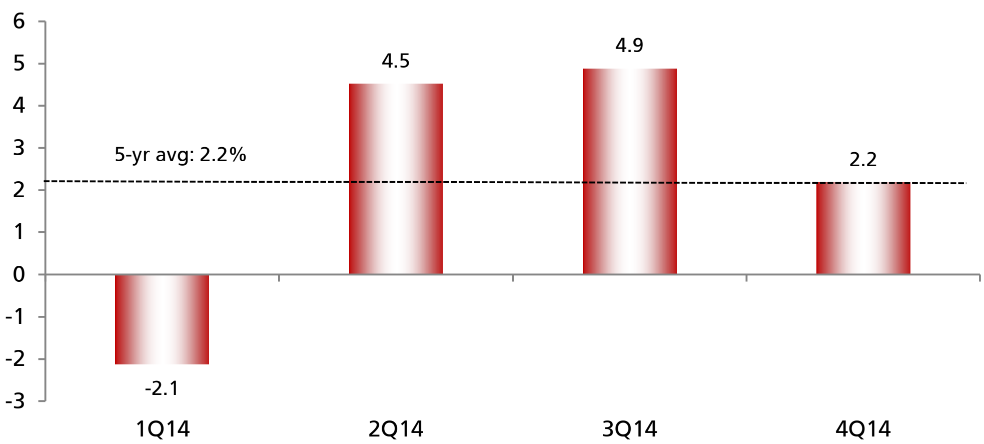
Fourth quarter GDP brought the broader growth picture back to reality. Most had forgotten that the strong growth in Q2 and Q3, (average 4.7% (QoQ, saar)), was not strength per se, it was payback for the bitter cold weather contraction in Q1. Technical drop, technical rebound, end of story. Growth returned to a 'normal' 2.2% in the fourth quarter, precisely equal to the 2.2% rate averaged for the past five years (chart below).

With that, full year 2014 growth came to 2.4%, not significantly different from the 2.3% outcome in 2012, the 2.2% outcome in 2013 or the 2.5% outcome back in 2010. Six years and three rounds of QE and that's the outcome: grudging, grinding growth that still fails to show much, if any, sign of acceleration. Divergence in the global economy? Not so much. At least not from the US side.

Do the higher frequency data offer any encouragement that the quarterly or annual data do not? Unfortunately, no.

US – GDP growth in 2014

% (QoQ, saar)



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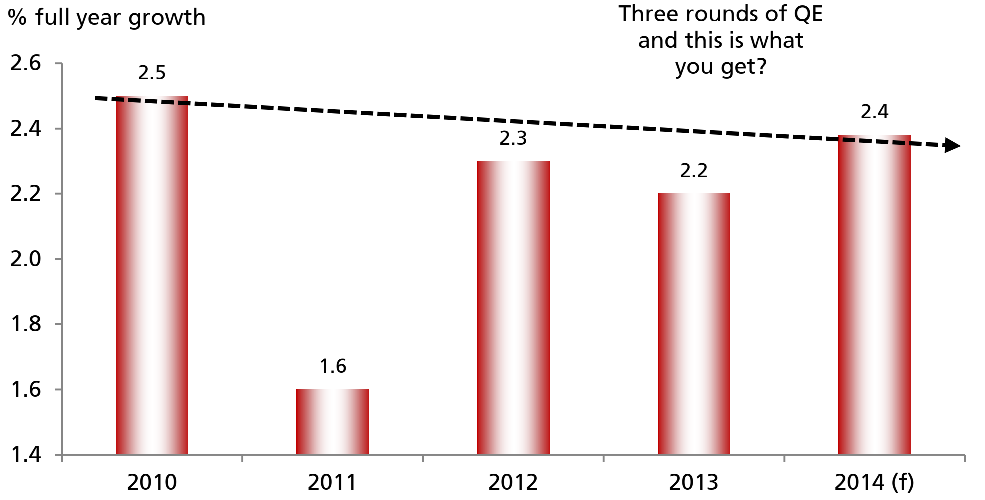
US – GDP growth

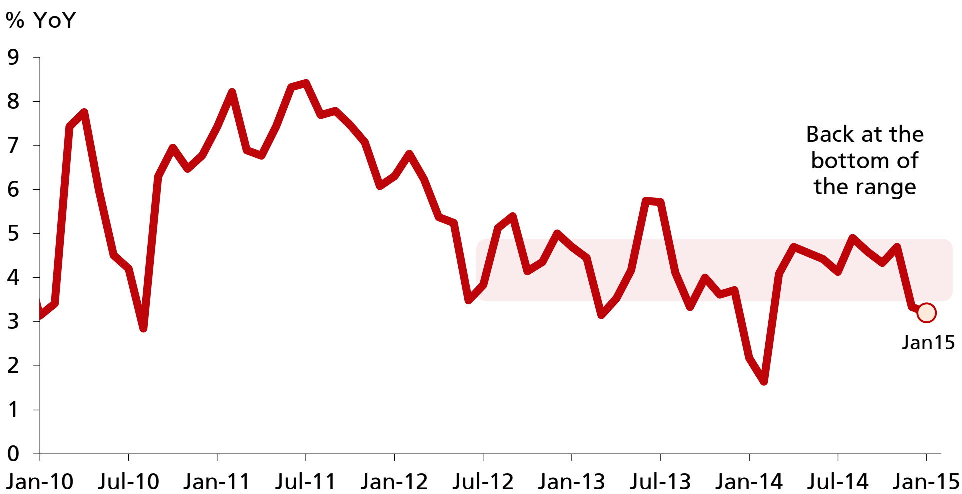


Retail sales (chart below) continue to grow at the 4% nominal pace that they have for the past three years. The last data point, Jan15, is on the low side of normal rather than the high side. Core capital expenditures (chart at top of next page) continue to rise at a 2.7% trend pace (nominal), unchanged from the past three years and barely high enough to offset capital depreciation rates of 5%-8%. Imports – the kitchen sink sum of all things: consumer goods, producer goods, final, intermediate and raw materials – continue to run sideways, displaying essentially zero growth for three full years (chart at bottom of next page). How, with such import growth, the US is supposed drive global growth once again remains a mystery.

Neither retail sales, nor core capex orders nor imports have shown any sign of acceleration for 2.5-3 years

Even the nonfarm payrolls, which everyone says have improved so much in recent months, don't show much, if any, change in trend. That sounds preposterous, we know, given what you read in the papers. But you be the judge. Take a look at private sector payrolls in the chart at the bottom of the next page. Do you see any change in trend? We don't either. We see some good numbers in Nov14, to be sure, but we've seen good numbers before. And every time we did – like in early-2011 and early-2012 – they were followed by very poor outcomes shortly thereafter. Don't look now but that latest surge looks like deja-vu all over again.

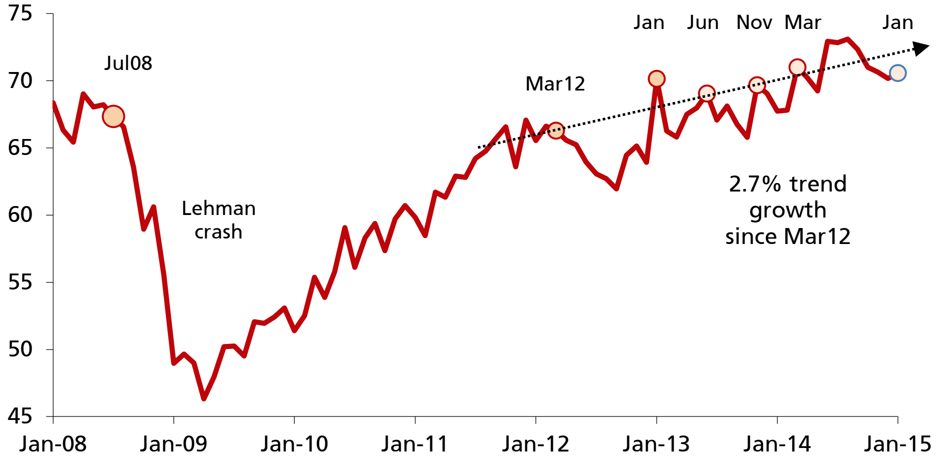
US - retail sales growth



Core capital goods orders have grown at a 2.7% pace for three years. Capital deprecia-tion rates are two to three times greater

US – core capital goods orders

US$bn/mth, seas adj, non-def K goods, ex-aircraft



Given all this, we continue to expect growth to run at a 2.25%-2.5% pace over the course of 2015 and into 2016, still very much in line with the past five years.

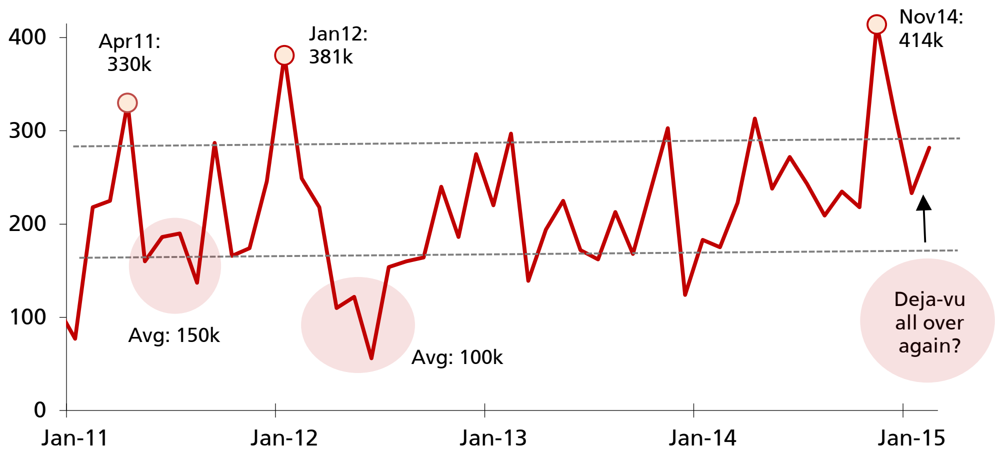
Inflation and the Fed

Fed rhetoric increasingly focuses on a June or September liftoff. To our eye, there are clear reasons why it might want to delay. The real economy continues to struggle, real wage growth has been near zero for two years and inflation continues to fall. The Fed says inflation is falling because oil prices have fallen over the past six months. This explanation doesn't square. The Fed's favorite inflation gauge is the core PCE deflator. It has been falling for three years, not six months, and there is no oil in it to begin with (chart next page).

The real reason core PCE inflation has been falling for three years is because 26% of it – the goods portion – has been experiencing outright deflation for two of them. Not low inflation, not disinflation. Outright deflation in one-quarter of the Fed's favorite index, for two full years. Strange that the Fed hasn't picked up this. Inflation is half their job and this is their favorite index. But to our knowledge, the Fed

US - private sector nonfarm payrolls

private sector NFP x1000, sa



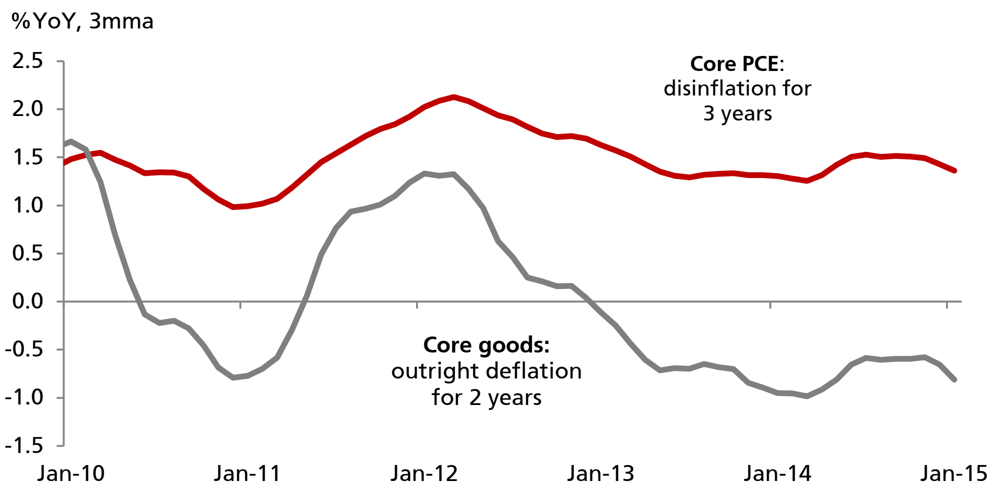
US Economic Indicators

	2014	2015(f)	2016(f)	-- 2014 -- Q3	Q4 (e)	Q1 (f)	--- 2015 --- Q2 (f)	Q3 (f)	Q4 (f)	2016 Q1 (f)
Output & Demand										
Real GDP*	2.4	2.6	2.4	5.0	2.2	1.9	2.1	2.2	2.1	2.4
Private consumption	2.5	2.7	2.2	3.2	4.2	2.2	2.1	2.2	2.2	2.2
Business investment	6.3	5.7	5.4	8.9	4.8	5.0	5.0	5.0	5.0	5.0
Residential construction	1.6	4.1	4.2	3.3	3.3	4.0	4.0	4.0	4.0	4.0
Government spending	-0.2	0.4	0.7	4.4	-1.8	0.1	0.1	0.1	0.1	1.0
Exports (G&S)	3.1	4.6	3.0	4.6	3.2	6.9	2.7	3.1	2.9	3.1
Imports (G&S)	4.0	4.3	3.0	-0.9	10.1	3.0	3.0	3.0	3.0	3.0
Net exports ($bn, 09P, ar)	-454	-466	-480	-431	-476	-460	-465	-468	-472	-475
Stocks (chg, $bn, 09P, ar)	73	54	50	82	88	55	55	55	50	50
Contribution to GDP (pct pts)										
Domestic final sales (C+FI+G)	2.5	2.8	2.5	4.2	3.3	2.3	2.2	2.3	2.3	2.5
Net exports	-0.2	-0.1	-0.1	0.7	-1.1	0.4	-0.1	-0.1	-0.1	-0.1
Inventories	0.1	-0.1	0.0	-0.1	0.2	-0.8	0.0	0.0	-0.1	0.0
Inflation										
GDP deflator (% YoY, pd avg)	1.6	1.7	1.7							
CPI (% YoY, pd avg)	1.6	1.2	1.7	1.8	1.2	0.8	1.0	1.5	1.5	1.6
CPI core (% YoY, pd avg)	1.8	1.5	1.5	1.8	1.7	1.6	1.5	1.4	1.5	1.5
PCE core (% YoY, pd avg)	1.4	1.2	1.4	1.5	1.4	1.3	1.2	1.1	1.2	1.3
External accounts										
Current acct balance ($bn)	-401	-470	-507							
Current account (% of GDP)	-2.3	-2.6	-2.7							
Other										
Nominal GDP (US$ trn)	17.4	18.1	18.8							
Federal budget bal (% of GDP)	-2.8	-3.0	-3.0							
Nonfarm payrolls (000, pd avg)				250	329	230	225	225	225	225
Unemployment rate (%, pd avg)				6.1	5.7	5.6	5.5	5.5	5.5	5.4

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

hasn't mentioned it once. If the Fed does decide to hike interest rates later this year, there is every reason to believe they won't go very far very fast thereafter.

US – core PCE deflator inflation



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

JP: out of recession

- **Recession is over and a modest recovery is underway**
- **GDP growth is projected to rise 1.3% in 2015, up from 0% in 2014**
- **The Bank of Japan is confident about the recovery outlook and is likely to maintain the current pace of quantitative easing**
- **Further easing can't be totally ruled out for 2H15 as inflation numbers may surprise on the downside later this year**
- **Political issues could distract attention as local elections approach**

Growth turning positive

The economy is finally returning to a growth path, after being dragged into a technical recession by a sales tax hike last year. Real GDP registered 1.5% (QoQ saar) in 4Q14, the first positive reading after two quarters of contraction in 2Q-3Q14 (Chart 1). Exports of goods and services grew strongly by 11.5%. Private consumption rose a modest 2.0%. The downturn in investment has also been arrested.

Our forecast remains for GDP growth to rise by 1.3% in 2015 from 0% in 2014. Domestic demand is expected to recover at a faster pace in the quarters ahead. Technically, the disruption impact of the sales tax hike, which was implemented one year ago in Apr14, will fully disappear from 2Q15 onwards. Meanwhile, the beneficial impact of oil price declines – which started since 4Q14 – should become apparent in 1H15 (considering the time lag of domestic prices adjustments).

Moreover, wage growth is likely to pick up slightly from 2Q15 when a major round of labour negotiations is completed. Corporate profits in the manufacturing and financial services sectors have increased strongly last year thanks to a weaker yen and a higher stock market. The labour unions are demanding higher pay rises for this year. And the government is also urging companies to share more profits with employees. Assuming a 1% rise in nominal wages this year, real wages will grow marginally in 2015 after contracting 2% in 2014 (Chart 2). A recovery in real wages

Chart 1: GDP growth

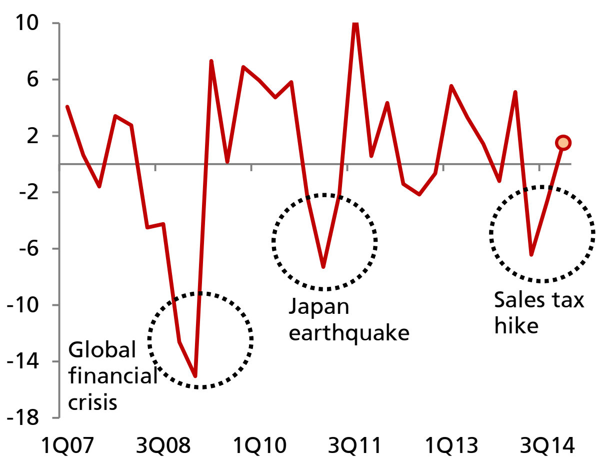
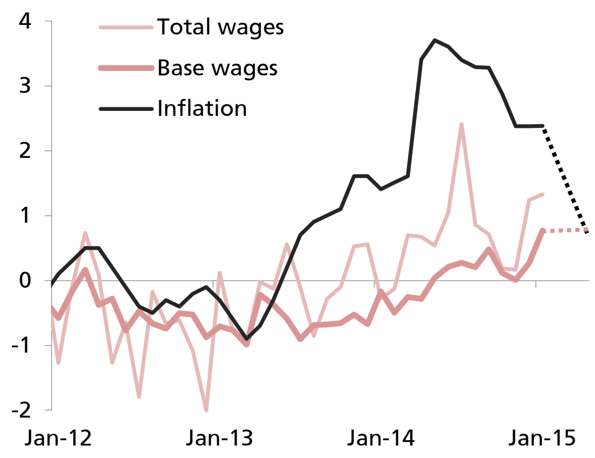


Chart 2: Wage growth vs. inflation



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will be important as it means a restoration of consumers' purchasing power and fundamental support to domestic demand.

Exports growth is expected to moderate on the other hand. The recent acceleration in exports was mainly driven by electronic components, which could be ascribed to the introduction of new smartphone models in the international markets. This might be a short-term, cyclical phenomenon.

Strong trade figures shouldn't be over-interpreted as a sign that Japanese exporters have gained competitiveness on the back of a cheap yen. In fact, the occupation rates of Japanese exports in major overseas markets have further declined in 2014 compared to 2013 (US: 5.7% vs. 6.1%, Europe: 3.2% vs. 3.4%). Optimism on the competitiveness of Japanese exports could be misplaced.

Inflation falling back to 0%

In contrary to the pickup in GDP growth, inflation numbers are exhibiting a downward trend. Headline CPI registered 2.4% (YoY) in Jan15, lower than the average of 2.5% in 4Q14. Excluding fresh food, core CPI has dropped notably to 2.2% from 2.6% (Chart 3). Further adjusted by the sales tax, headline and core inflation have fallen to merely 0.4% and 0.2% respectively in Jan15. The main reason was the slump in energy related prices, such as transport and public utilities fees. The non-energy items continued to see price hikes, reflecting the inflationary impact of a weak yen.

Negative CPI numbers are possible for 2H15

Compared to the research publications three months ago, we have cut the 2015 inflation forecast to 1.0%, down from 1.5% previously. Both the headline and core CPI numbers will likely hover in the range of 0-0.5% in the next three quarters, with the risks of turning slightly negative in 2H15.

Negative CPI figures (if appear) would spark the debate whether the economy is slipping back into a deflation trap. The risk of deflation shouldn't be exaggerated, in our view. With GDP growth reverting to the trend rate this year, the negative output gap is expected to be closed and excess capacity should dissipate. Meanwhile, the labour market has remained tight and the shortage of labor supply is acute. With the job-to-applicant ratio rising above the par levels, the unemployment rate has fallen to multiyear lows, and wage growth has showed some tentative signs of a pickup (Chart 4). All these suggest that the underlying trend is for prices to go up rather than down.

BOJ easing is possible, not probable

The Bank of Japan (BOJ) maintained the pace of quantitative and qualitative easing at JPY 80trn per annum at the two meetings so far this year. Repeatedly, the central bank said that the economy is recovering and inflation will rise in the medium term

Chart 3: CPI inflation

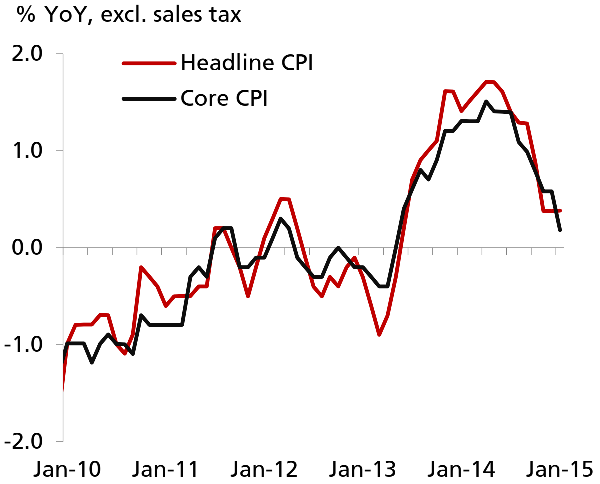
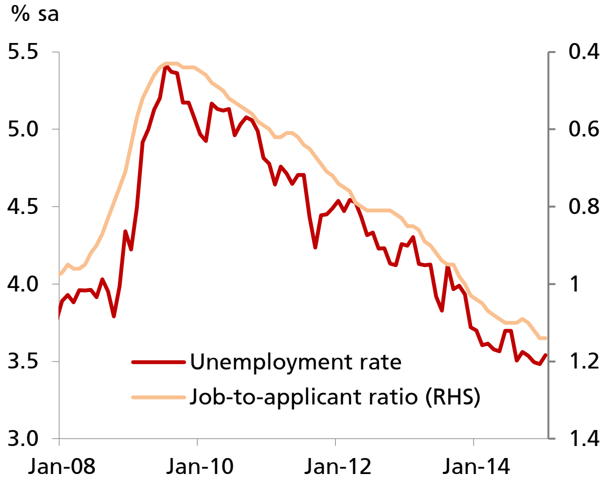


Chart 4: Labor market indicators



despite the short-term slowdown caused by oil price declines. Meanwhile, it has adopted a flexible approach in interpreting the timeframe of achieving the 2% inflation target, saying that inflation will hit 2% "in or around FY2015". That said, the BOJ also kept the door open for further easing, pledging to take more policy actions in future "when warranted". In the JPY markets, short-term interbank rates and swap rates have continued to dip in recent weeks, but the medium- to long-term bond yields have bounced back from the record lows (Chart 5).

A crucial factor will be the expected inflation rate

In our view, further policy easing is possible but not probable. If any, it will only come in 2H15 instead of 1H15. A crucial factor will be the expected inflation rate, which is closely watched by the BOJ as an indicator for the medium-term prices outlook. A recovering economy and rising wages should help to bolster public inflation expectations. On the flip side, a prolonged period of low oil prices and low actual inflation could negatively impact people's psychology. Risks will mount in 2H15 as the actual CPI may fall into the negative territory by then.

In the FX market, the USD/JPY rate stayed in a stable range of 115-120 in Jan-Feb15 before rising above 120 in early-March. There are enough reasons to expect a weaker yen ahead. Even without more stimuli from the BOJ, the policy divergence between the BOJ and the US Fed would be pronounced as the latter has ended QE and is poised to tighten balance sheet and hike interest rates (Chart 6). Compared to the European central bank that has just launched a new easing program, the BOJ will remain more aggressive in terms of the scale of balance sheet expansion.

Reforms remain slow and politics is a distraction

Regarding long-term policies, the focus is on tax reforms and public funds reforms at present. The government pension investment funds will be given more flexibility to invest in risky assets. The corporate tax rate will be cut from 34.6% to 32.1% in FY2015, and to 31.3% in FY2016. For more profound reforms such as immigration and labour market deregulations, there has been little progress hitherto.

Due to the lower house election last December, the ratification and implementation of economic policies have been postponed. The Diet, which resumed its first session after the election in Jan15, is facing a very busy agenda. Tasks include reviewing the annual budget for FY2015, approving the bill of cutting corporate tax, and formalizing the delay of the second-stage sales tax hike, among others.

Going forward, a nationwide wave of local government elections will be held soon in April. Issues like revitalizing the local economy and narrowing the regional gap would receive more attention in the coming months. Meanwhile, PM Abe is looking to amend the constitution on collective self-defense during the current Diet session. These political topics could turn out to be a distraction, dragging the progress of implementing long-term economic policies.

Chart 5: Market interest rates

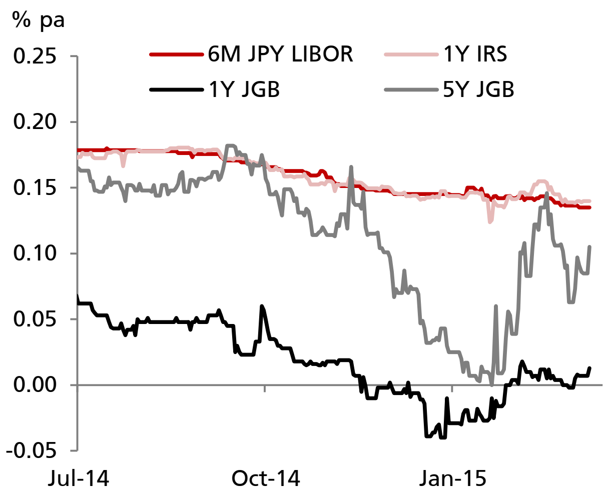
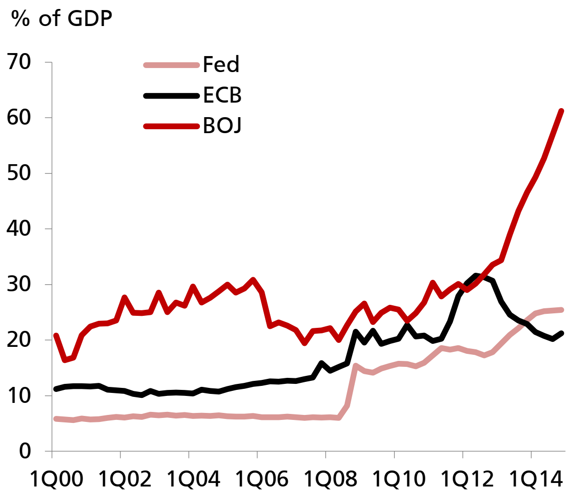


Chart 6: G3: Central banks' balance sheets



Japan Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16
Real output and demand									
GDP growth	0	1.3	1.0	-0.8	-1.2	1.5	2.5	2.3	1.8
Private consumption	-1.2	0.1	1.0	-2.2	-4.0	1.5	1.6	1.5	1.4
Government consumption	0.3	1.3	1.4	0.6	1.3	1.2	1.3	1.4	1.4
Private & public investment	2.7	-0.9	0.5	-1.6	-4.8	0	0.9	1.2	0.9
Net exports (JPYtrn, 05P)	9.5	13.1	14.9	2.9	3.0	3.5	3.3	3.3	3.4
Exports	8.2	5.9	4.9	10.9	5.2	6.8	6.5	4.9	4.9
Imports	7.2	2.2	3.5	3.8	-2.3	4.1	3.8	3.3	3.4
External (nominal)									
Merch exports (JPY trn)	73	84	87	20	20	21	21	22	21
- % YoY	4.8	14.5	3.9	9.1	16.6	18.8	14.7	8.8	13.8
Merch imports (JPY trn)	86	87	95	22	21	21	22	22	22
- % YoY	5.7	0.9	9.4	1.1	-4.4	6.3	2.5	0.4	13.5
Merch trade balance (JPY trn)	-13	-3	-8	-2	-1	0	-1	-1	-1
Current acct balance (USD bn)	25	103	61	-	-	-	-	-	-
% of GDP	0.5	2.5	1.5	-	-	-	-	-	-
Foreign reserves (USD bn)	1,261	1,274	1,245	-	-	-	-	-	-
Inflation									
CPI, % YoY	2.7	1.0	0.8	2.5	2.4	0.5	0.4	0.5	0.7
Other									
Nominal GDP (USD bn)	4,619	4,079	4,010	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Fiscal balance (% of GDP)	-6.8	-6.6	-6.4	-	-	-	-	-	-

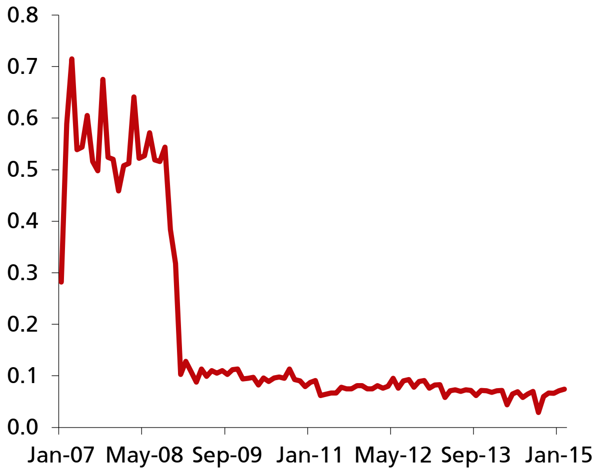
* % growth, year-on-year, unless otherwise specified

JP - nominal exchange rate

JPY per USD

JP – policy rate

%, call



EZ: stuck in low gear

- **Slow-paced recovery in domestic demand will keep growth at 0.9% in 2015, before edging past 1.0% next year**
- **Contingent on energy prices, inflation is expected to stabilise in 2H and rise a subdued 0.2% this year**
- **Monetary policy is focused on supporting growth through a weak real exchange rate and bond purchases**
- **Fiscal austerity needs to ease-up to give growth chance. Greek developments warrant attention**

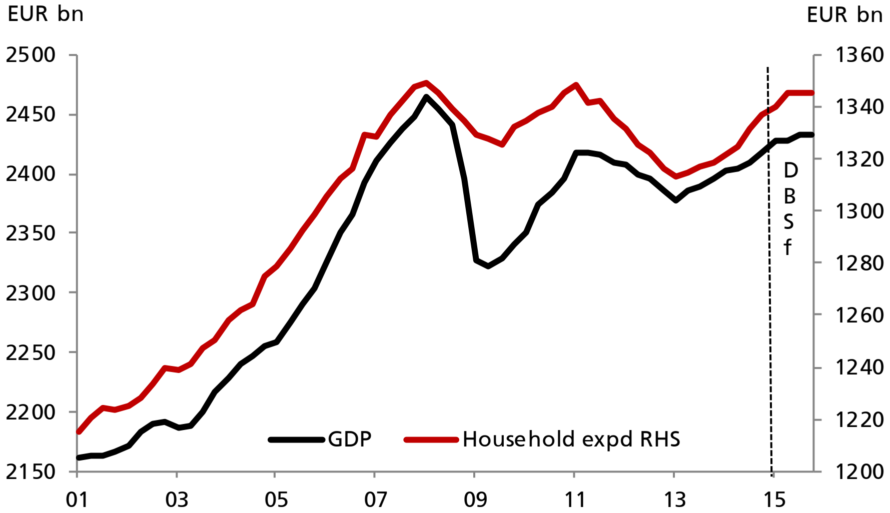
Growth to stabilise at weak levels

Activity in the Eurozone economy is getting off its back but it has been a slow process. GDP growth in 4Q14 stood at 0.9% YoY, or 0.3% (QoQ, sa), with full-year growth also at 0.9%. The pace of recovery briefly faltered in 1H14, with the slowdown percolating to the core economies just as the peripheral economies stabilised. Support from better domestic activity kicked in late last year, helped by Spain maintaining its strong-run and Germany rebounding from its soft-patch.

Into 2015, the Eurozone economy will be still far from firing on all cylinders. Household discretionary spending is looking up but weighed by the slow improvement in job creation and weak wage growth (Chart 1). After nearly doubling to its peak of 12% in mid-2013, the unemployment rate has retraced less than a fifth by early 2015.

Wage growth rose 1.8% YoY in the first three quarters of 2014 (latest available), less than half the pace of the pre-crisis period. This sluggishness is likely to extend this year, with consumption spending to rise 1.1% this year, little different from 2014.

Chart 1: GDP growth: Slow road to recovery



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Investment spending and industrial growth regained some ground by late-2014 and are likely to extend their recovery this year, though far from a V-shaped move. Weak credit activity and spare capacity belie hopes of a quick rebound, just as manufacturing and service PMIs tick up in January and February 2015 after hitting bottom in 3Q14. Industrial production also held its head above the water on the slight tick-up in capital and intermediate goods output.

We expect private sector activity to pick up albeit gradually as the ECB's QE program keeps a lid on financing costs and exports-oriented businesses benefit from the sharp euro depreciation. Imports growth – taken as a sum barometer of domestic activity – meanwhile remains subdued.

We maintain our sub-consensus call for GDP growth at 0.9% this year, as growth becomes better balanced. Private consumption spending will be supported by positive real rates and low inflation, while a pick-up in exports due to improved trade competitiveness is partly offset by investment-related imports.

We maintain our sub-consensus GDP growth estimate of 0.9%

Deflation risks still linger

Even as growth gets off its back, deflation risks continue to linger. Stark euro depreciation since mid-2014 failed to perk inflation amidst a weak commodity price environment. Worries over deflation heightened instead as tumbling energy prices pushed headline inflation to red in Dec14 and kept it in negative territory into early-2015 (Chart 2). Core inflation slowed to 0.6% in Jan-Feb15.

A modest bounce in the energy prices in February led to a shallower fall in the month's inflation print, which if sustained might lead 2H15 readings back to small positive. Notwithstanding the latter, our inflation estimate for 2015 remains subdued at 0.2% on the back of soft commodity prices, gradual narrowing in the output gap and weak wage growth.

Import and producer price indices have been in red for good part of last year, which is partly a reflection of low input prices but also weak demand. PMI price sub-indices also signaled that manufacturers resorted to price cuts to raise sales growth, eroding their operational margins.

Deflation concerns and a notable fall in the financial markets' metrics for inflationary expectations (Chart 3) led the European Central Bank (ECB) to announce quantitative easing. We are however doubtful of the purported lift to inflation, with much of

Chart 2: Broad-based disinflation

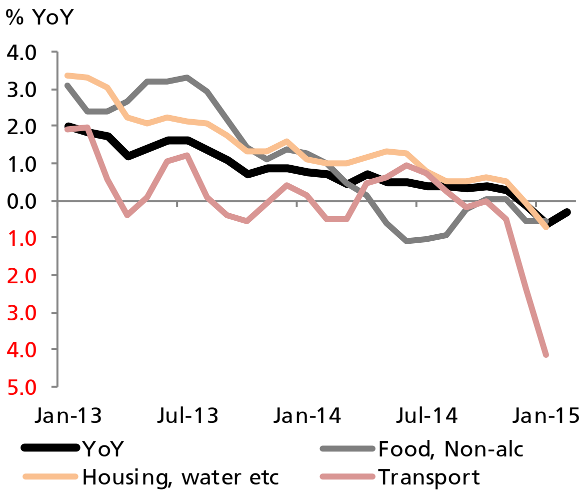
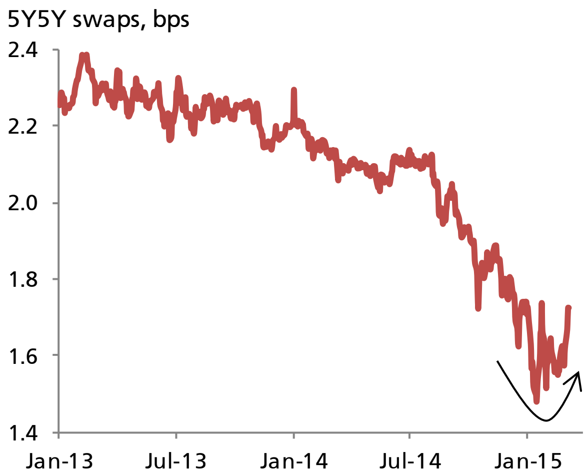
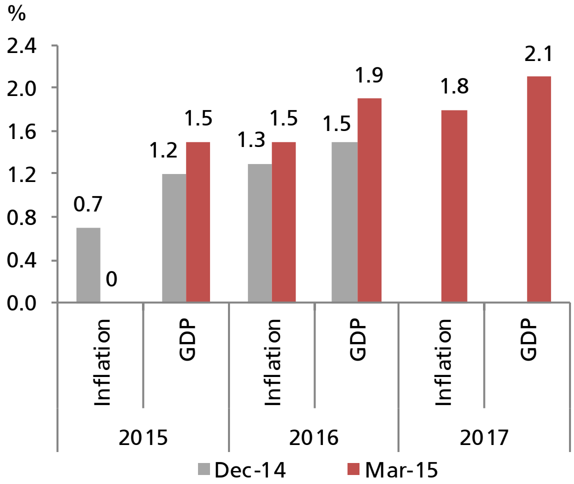


Chart 3: Inflation expectations bottom-out post QE



the pass-through only likely to occur through a weak currency. Looking ahead, base effects and gradual improvement in aggregate demand are expected to lift inflation to 1.1% next year, but still below the policy target.

Chart 4: Revisions in ECB staff forecasts



ECB focused on supporting growth through a weak real exchange rate and bond purchases

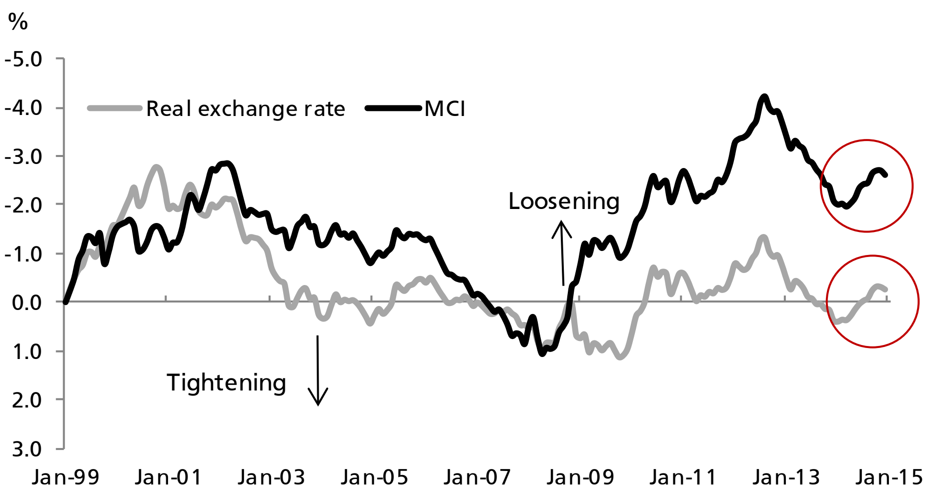
The European Central Bank (ECB) remains optimistic on the likely boost to growth and inflation from the private and public sector asset purchases. Accordingly, 2015 GDP growth staff projections were raised – 1.5% in 2015, 1.9% in 2016 and 2.1% in 2017 (Chart 4).

Low crude prices on the other hand led this year's inflation estimate down to 0% but expected to spring back to 1.5% in 2016 and 1.8% in 2017. Rebound in the composite PMIs, consumer/ business sentiment indicators and stabilisation in inflation expectations since early-2015 likely lent confidence to the ECB. There was also an underlying assurance that debt purchases could be extended beyond Sep16 if price targets are missed.

We however take a more cautious view on the impact of the quantitative easing program, beyond the initial boost to sentiments and asset markets.

Firstly, bond yields are already near record lows (despite a small rebound post Jan's QE announcement). Bulk of the impact thereby will be through the currency channel, which is also evident in the ECB's monetary conditions index (Chart 5). With the room for further rate cuts largely exhausted, much of the loosening in the domestic financial conditions is occurring through depreciating the euro real exchange rate (see FX section for our view on the EUR).

Chart 5: Monetary conditions index



Secondly, there is also considerable uncertainty over what and how the banks will deal with the QE-generated funds. A replay of the developments in the US, where banks parked bulk of the QE funds back with the Federal Reserve instead of lending it out to the real sector, will also hinder the effectiveness of ECB's purchases.

Finally, even if the bond purchases keep a check on the financing costs, this will only address part of the problem. Credit growth has been weak, not only due to higher rates but also weak demand. Domestic demand is yet to turn a corner, with the unemployment rate only down half a percent in the past year. Hence, QE is unlikely to be a panacea for growth and inflation trends.

Fiscal policy needs to play its part

Although the ECB has played its part to spur loan activity and growth, fiscal policy must also step forward to complement its efforts. While member countries need to lower their aggregate debt levels, the latter can't be undone drastically without taking a hard knock on growth. Unfortunately, the bailout terms call for more austerity and belt-tightening measures, which in turn hurts growth / raises unemployment and erodes revenue growth, setting off a vicious cycle.

To get these indebted economies back on the path of growth, the fiscal stranglehold needs to be loosened. However smaller goalposts along the way should be adhered to ensure the countries remain accountable. At the same time, surplus-led Eurozone economies with the fiscal room for more spending will be urged to do more to complement the ECB's efforts to fight deflation. Early progress is underway in this regard through the European Commission's investment fund and Germany's plans to step up infrastructure spending.

Overall, an accommodative monetary policy and lifting of fiscal austerity will provide the space for recovery to take hold. However without structural improvements, the upturn might not last for long.

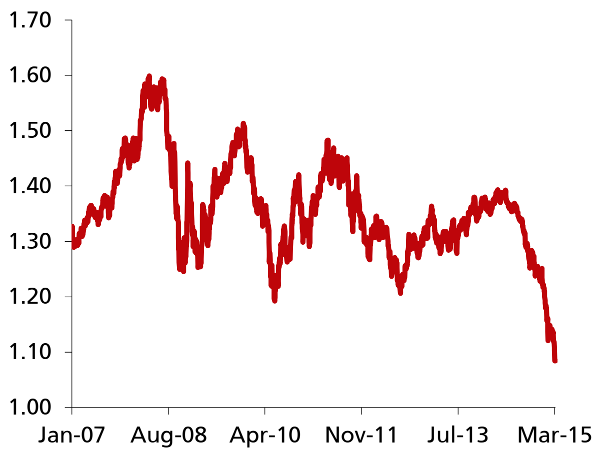
In this respect, developments in Greece should be monitored closely. Even as the bailout extension until June has helped both sides buy time, lack of a final agreement on further reform initiatives and dearth of other funding options might reignite concerns over the next couple of months.

Eurozone Economic Indicators

	2014	2015f	2016f	4Q14	1Q15f	2Q15f	3Q15f	4Q15f	1Q16f
Real output and demand (% YoY)									
GDP growth (05P)	0.9	0.9	1.2	0.9	1.0	1.0	1.0	0.7	0.9
Private consumption	1.0	1.1	1.1	1.4	1.4	1.5	1.0	0.6	1.1
Government consumption	0.7	0.3	0.9	0.8	0.6	0.5	0.2	0.1	0.4
Gross capital formation	1.0	0.3	1.6	0.3	0.0	0.5	0.5	0.1	1.1
Net exports (EUR bn)	404	395	395	105	100	95	95	95	100
Exports (G&S) (% YoY)	3.7	2.3	0.2	4.1	4.0	2.7	1.7	0.8	0.5
Imports (G&S) (% YoY)	3.8	2.8	0.1	4.0	4.3	3.5	1.8	1.4	0.5
Contribution to GDP (pct pts)									
Domestic demand	0.8	0.8	1.1	na	na	na	na	na	na
Net Exports	0.1	0.1	0.1	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	0.2	1.1	0.2	-0.5	0.0	0.6	0.7	1.6
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

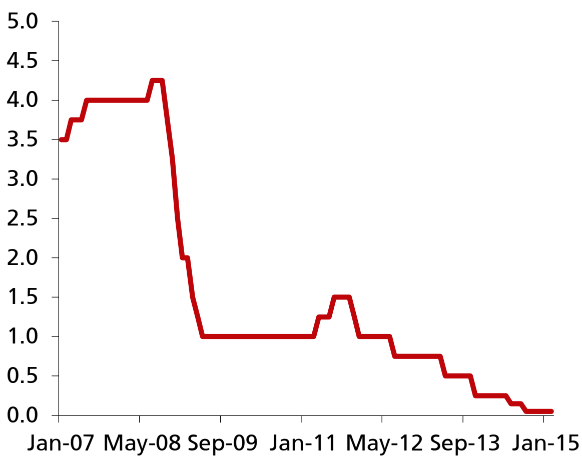
EZ - nominal exchange rate

USD per EUR



EZ – policy rate

%, refi rate



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