

2017 Global Themes

Thursday, January 05, 2017

Half a year ago in our 2H16 outlook report, we anticipated that the only certainty would be more anticipated market volatility and economic uncertainties for the second half of 2016, and that policy divergence and China-centric risks would remain predominant. At least on those counts, the 2017 outlook will likely continue to trade on familiar themes. However, one game-changer could be US president-elect Trump with his unorthodox campaign promises. With the prospect of a reflationary US economy, and a potentially more hawkish FOMC, the USD has taken flight. This in turn may be the trigger for the unwinding of the carry trade that has largely been in vogue since the Global Financial Crisis. The trickle of capital outflow from Emerging Markets (EM), including Asia, started in 2H16, and may pick up momentum in 2017. For now, there are too many moving parts to forecast with much precision on the growth and market outlooks for Asia. Our best guess is that the Asian economies will manage the growth transition with a few potential speed bumps as monetary (and in selected cases the fiscal as well) space is somewhat constrained as the global inflation story is turning higher amid the FOMC rate hikes.

Trump's wildcard on trade and China are potentially disruptive to markets

Just like how traditional industries and companies have been facing disruptive technologies, the potential for global growth and financial market confidence to be disrupted by potential trade measures from a Trump administration. With the slowdown of many once fast-growing emerging economies including China (remember the acronym "BRIC"?), global trade growth has decelerated in recent years, which the IMF attributed to a combination of cyclical and structural factors. More disconcerting is the World Trade Organisation's (WTO) prognosis that 2017 global trade growth would average between 1.8-3.1% (previously 3.6%), with the range of estimates to "reflect the increasingly uncertain relationship between trade and output growth". This is a mild consolidation from 2016's 1.7% growth forecast which would mark the worst performance since the Global Financial Crisis. Moreover this forecast was prior to Trump's election win and discounts the protectionist measures which are on the rise.

No longer taking globalization and trade growth for granted.

Since China joined the WTO in 2001, its meteoric rise as an economic power has been the tide that lifted all boats in Asia. With the economic transition story for the Chinese economy, and the persistent economic drag from the Global Financial Crisis, Asian economies have found the pre-crisis growth levels more challenging to achieve. In addition, the anchor provided by the Chinese RMB for Asian currencies has been eroded as market sentiments and expectations have also reversed. With the expected demise of the Trans-Pacific Partnership (TPP) in a Trump era, it remains to be seen if regional initiatives like the "One Belt, One Road" and the Regional Comprehensive Economic Partnership (RCEP) will take flight. So far, the economic payoffs from the Asean Economic Community have also been relatively muted.

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Over in Europe, the Brexit referendum last June has cast a dark shadow over EU integration. It is still unclear how and when UK will trigger Article 50 and the form that exit negotiations will take. With immigration issues still on the boil, the upcoming Netherlands, French and German elections may also throw up some potential nail-biting excitement.

Asian markets are no longer carried away, but increasingly left to swim on their own merits.

With idiosyncratic domestic challenges such as ageing population, economic restructuring and growing income inequality issues, the Asian economic landscape is also rapidly evolving. Assuming that the US economy and USD strength continues to gain altitude in 2017, the portfolio allocation away from EM assets to DM assets could pick up speed. In the ensuing rush for the exit door towards end-2016 as far as more fickle capital flows are concerned, it is unsurprising then that this could turn out to be the Achilles heel for EM, especially Asia. The pressure is hence on for Asian economies to reinforce their economic moats and strengthen the basis for medium-term sustainable growth by undertaking structural reform and promoting productivity growth and innovation.

China remains a key risk with a L-shaped recovery and myriad policy challenges

China continues to tighten capital controls amid persistent market concerns about RMB weakness. The once formidable FX reserves of near US\$4 trillion has been eroded to around the US\$3 trillion handle, albeit still very substantial by any absolute parameters. Nevertheless, the recent volatility in the money and bond markets onshore, coupled with generally bearish RMB market sentiments have added pressure on policymakers to manage the capital outflow and pace of RMB depreciation. Managing financial risks is an increasing policy focus in 2017, as highlighted by the Central Economic Working Conference in December 2016. The bumpy adjustment process for China entails further inherent market volatility for the rest of Asia. The main trade implications that an antagonistic Trump administration would have on the Chinese economy are examined in a subsequent thematic piece. While we anticipate China will avoid a hard land, nevertheless, its GDP growth rate will continue to slow.

Up, up and away for Asian rates? Not so fast!

With the resurgent USD and the steepening of the US yield curve, the prospects for Asian interest rate easing look less stellar. The rate cuts implemented in 2016 by various Asian central banks look to be mostly done. We tip BI, BNM etc to remain on hold for the foreseeable future, awaiting the FOMC rate hikes to come this year, as well as the inflation uptick due to more supportive oil prices. Asian policymakers are likely to tread a delicate balance between supporting domestic growth and finding policy space amid externally-driven pressures on currencies and interest rates.

OCBC Asia GDP, CPI and Policy Rate Forecasts

GDP						
% chg year-on-year	2013	2014	2015	2016F	2017F	2018F
US	1.7	2.4	2.6	1.6	2.2	2.3
Euro-zone	-0.3	1.2	2.0	1.6	1.4	1.5
Japan	2.0	0.3	1.2	0.9	1.0	0.9
United Kingdom	1.9	3.1	2.2	2.0	1.2	1.3
New Zealand	2.1	2.9	3.1	3.1	2.9	2.6
Australia	2.1	2.8	2.4	2.4	2.6	2.7
China	7.8	7.3	6.9	6.7	6.4	6.0
Hong Kong	3.1	2.7	2.4	1.4	1.9	2.5
Taiwan	2.2	4.0	0.7	1.2	2.0	2.2
Indonesia	5.6	5.0	4.8	5.0	5.2	5.4
Malaysia	4.7	6.0	5.0	4.2	4.2	4.2
Philippines	7.1	6.2	6.3	6.9	6.3	6.5
Singapore	4.7	3.3	2.0	1.8	1.5	2.0
South Korea	2.9	3.3	2.6	2.7	2.6	2.6
Thailand	2.8	0.8	2.8	3.2	3.2	3.4
Vietnam	5.4	6.0	6.7	6.2	6.7	6.5

Inflation						
% chg year-on-year	2013	2014	2015	2016F	2017F	2018F
US	1.5	1.6	0.1	1.3	2.3	2.4
Euro-zone	1.4	0.4	0.0	0.2	1.3	1.5
Japan	0.4	2.7	0.8	-0.2	0.6	1.0
United Kingdom	2.6	1.5	0.0	0.6	2.4	2.5
New Zealand	1.2	1.2	0.3	0.6	1.7	1.9
Australia	2.5	2.5	1.5	1.3	2.0	2.2
China	2.6	2.0	1.4	2.0	2.2	2.5
Hong Kong	4.3	4.4	3.0	2.5	2.2	2.6
Taiwan	0.8	1.2	-0.3	1.3	1.4	1.5
Indonesia	6.4	6.4	6.4	3.5	4.3	4.4
Malaysia	2.1	3.2	2.1	2.2	2.8	2.9
Philippines	2.9	4.2	1.4	1.7	2.9	3.0
Singapore	2.4	1.0	-0.5	-0.4	1.0	1.5
South Korea	1.3	1.3	0.7	1.3	1.6	2.0
Thailand	2.2	1.9	-0.9	0.2	1.5	1.8
Vietnam	6.0	1.8	0.6	4.7	3.8	4.0

Central Bank Policy Rate (%)						
	2013	2014	2015	2016	2017F	2018F
US Fed Funds rate	0.25	0.25	0.50	0.75	1.25	1.75
ECB refinance rate	0.25	0.05	0.05	0.00	0.00	0.00
BOJ policy rate	0.10	0.10	0.10	-0.10	-0.10	-0.10
BOE base rate	0.50	0.50	0.50	0.25	0.25	0.25
RBNZ cash rate	2.50	3.50	2.50	1.75	1.75	1.75
RBA cash target rate	2.50	2.50	2.00	1.50	1.50	1.50
China 1yr lending rate	6.00	5.60	4.35	4.35	4.35	4.35
Hong Kong base rate	0.50	0.50	0.75	1.00	1.50	2.00
CBRC discount rate	1.88	1.88	1.63	1.38	1.38	1.63
BI rate*	7.50	7.75	7.50	6.50	4.75	5.00
BNM overnight rate	2.99	3.23	3.05	3.00	3.00	3.25
BSP overnight reverse repo	3.50	4.00	4.00	3.00	3.00	3.25
Singapore 3-month SIBOR	0.40	0.46	1.19	0.97	1.50	1.95
BOK target overnight call	2.50	2.00	1.50	1.25	1.50	1.75
BOT repurchase rate	2.25	2.00	1.50	1.50	1.75	2.00
SBV base rate	9.00	9.00	9.00	9.00	9.00	9.00
* Indonesia changed to 7 day repo from 3Q16.						

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Walking a thin line

Despite a weak start, the Chinese economy has shown signs of stabilization since the second half of 2016. The official Purchasing Manager Index (PMI) recovered from a low of 49 in February to 51.7 in November 2016. In addition, private confidence returned after hitting the bottom in July, with the private sector investment reaccelerating to 3.1% yoy in the first eleven months of 2016, up from a mere 2.1% seen during January to July 2016. The recovery since the second half of 2016, despite the external black swan events such as Brexit and US Presidential Election, can be attributed to three factors in our view: (1) booming property market, (2) easing monetary policy and (3) proactive fiscal policy.

The recovery continues in the last quarter of 2016 with the industrial profits growth accelerating to 14.5% in November. It is almost certain that China will achieve its 2016 growth target of 6.5% - 7.0%. We expect growth to end 2016 at 6.7%. However, the excessive reliance of the economy on the property market and easing monetary policy led to the concerns on asset bubble creation in both property and bond markets.

Since 4Q 2016, China's policy makers have tightened the grip in both markets to reduce leverage. On the property front, most tier-1 and tier-2 cities announced two rounds of tightening measures in early October and late November respectively to curb speculative demand, thus resulting in a significant fall in property transaction volumes. On the bond front, the People's Bank of China (PBoC) also started to replace the short end liquidity via net withdrawal from open market operation with more expensive medium term liquidity via MLF injection. As a result, bond prices have declined since late October with 10-year government bond yield spiking from a low of 2.7% to a high of 3.4% in December. The rapid correction in the bond market also exposed counterparty risk after one Chinese Security company defaulted on its bond transaction via the so-called entrusted bond holding agreement. This incident also exacerbated the recent bond market turmoil, resulting in the trigger of circuit breaker of bond futures for the first time on 19 December. However, the decision from the Security Company to take the responsibility for the loss following the intervention from the top regulators has calmed the market sentiments. This prevented the incident from developing into a full blown crisis.

Containing the financial risk

Looking ahead, containing financial risk will be the key task for China in 2017 as mentioned during the latest Central Economic Working Conference. As such, we expect a tight bias to remain in both property and bond markets to promote further de-leveraging in order to pursue a more sustainable growth in the future.

Less accommodative monetary policy

In order to contain the financial risk, one of the key changes for 2017 will be the monetary policy stance. In the latest Central Economic Working Conference, China has changed its monetary policy tone to "*prudent and neutral*" from merely "*prudent*". This sounds quite similar at a first glance. However, after reading between the lines, i

clearly suggests a tighter bias monetary policy framework – little is said regarding flexible policy nor the lowering of funding cost. Given that 2017 is likely to kick off with higher inflationary expectations, a relatively stabilizing growth prospect and concerns about asset bubbles, we expect monetary policy to remain on a tight bias. The overall funding costs for 2017 are unlikely to go back to the low levels seen in 2016.

A lower growth expected in 2017

Back to the growth story, to recap, the stable growth in 2016 was mainly supported by three factors including booming property market, easing monetary policy and proactive fiscal policy. The change of focus to contain asset bubbles in 2017 shows that the economy is likely to find less support from the property market and monetary policy. As such, the risk for the growth in 2017 is clearly on the downside. Chinese policy makers have increasingly shown higher tolerance for a slower growth. In the latest Central Economic Working Conference, the statement omitted the sentence “maintaining growth in a reasonable range”. This shows that China is likely to drop its hard growth target, such as 6.5%-7.0% range for 2017.

In addition, the protectionism tone from President-elect Trump's economic team has also created uncertainties for China's trade prospect. However, we think the impact may not be so significant based on two reasons. First, we think the hurdle for Trump to name China as the currency manipulator is very high. Second, the upgrade of value chain means that China could be less vulnerable to the trade war if any. We will discuss these issues in detail in the thematic piece below.

Despite less support from the property and monetary policy, fiscal policy will remain proactive, which should provide the floor for growth. As such, we expect the growth to slow at a marginal pace to about 6.4% in 2017.

Reforms will be key

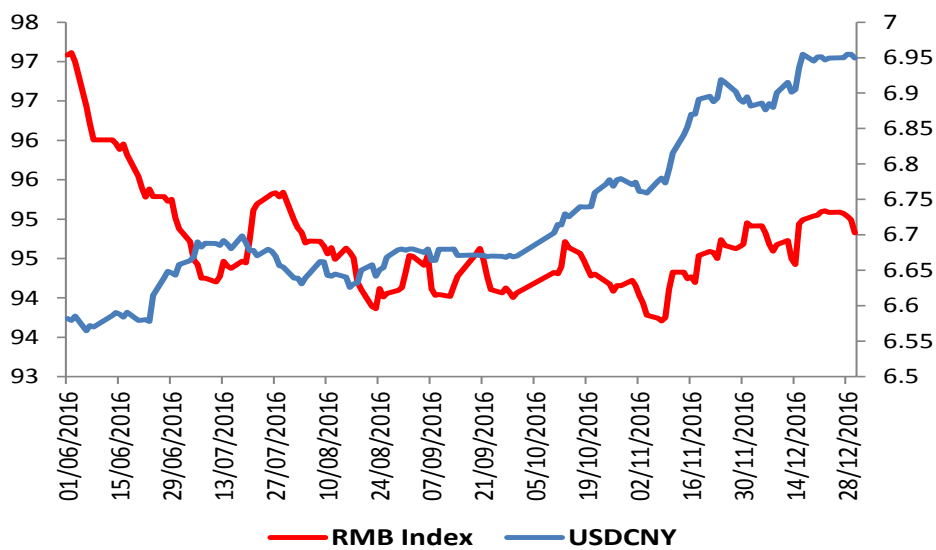
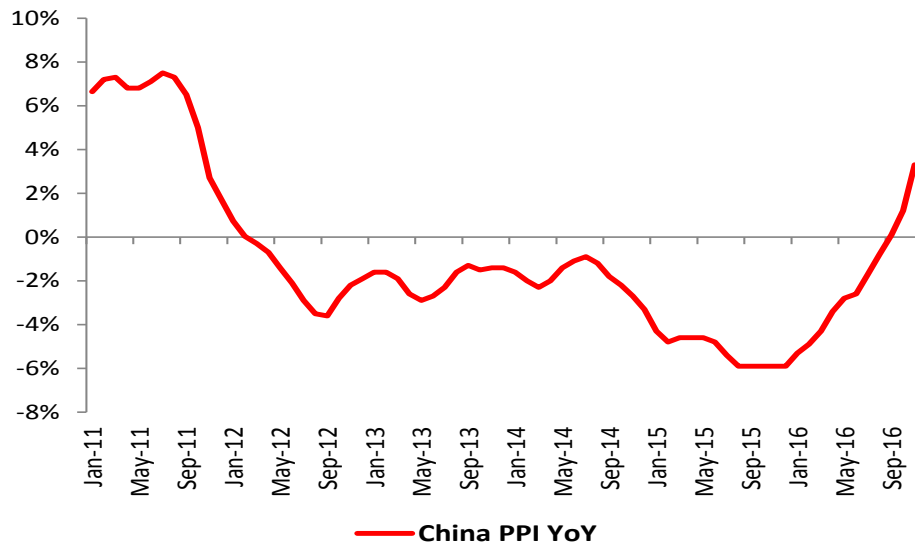
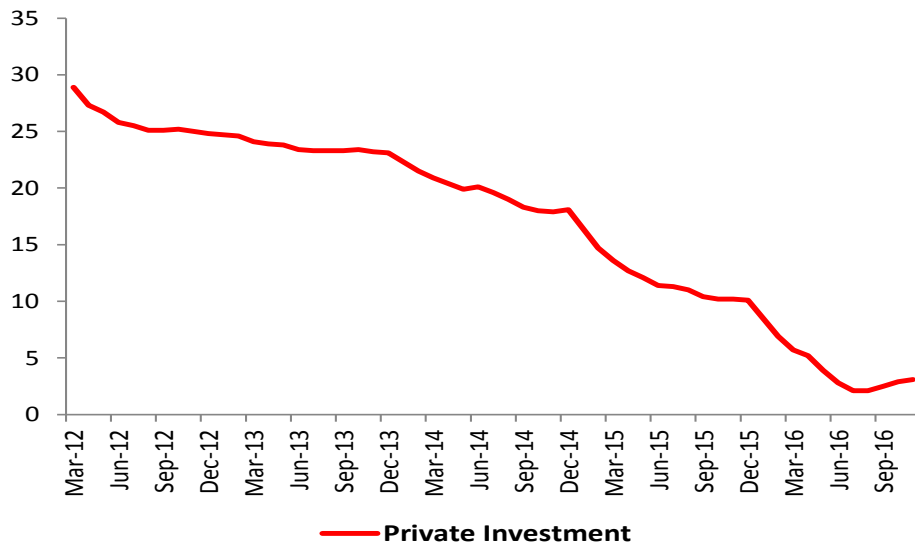
Tightening measures in the property market, bond market or even currency market are never meant to be the panacea. They will only buy time for China to eventually roll out reforms to solve the root problem. Given that Chinese policy makers are likely to downplay the role of growth target, we think China may be more serious about reforms. As such, four areas are to be watched including (1) supply side reform including the on-going de-capacity, de-leverage and de-stock efforts; (2) supply side reform for agriculture sectors, (3) supporting the real economy such as those in the competitive manufacturing sector and (4) promoting the healthy development of property market, which may include land and tax reforms.

Currency

RMB has weakened against the dollar by more than 6.5% in 2016. The current fixing mechanism launched in the beginning of 2016 has helped contain the concern about the one-time devaluation. However, it failed to address the concern about the gradual depreciation. In order to slow down the pace of depreciation and manage market sentiment, China has chosen capital control to manage outflows. This may slow down capital outflows. However it also created pent-up demand for foreign currencies. As such, we think RMB may weaken further against the dollar in 2017. The pace of depreciation in 2017 will depend on the outlook of the US dollar. Based on the framework of currency basket, we think the USDCNY may go higher to 7.1-7.2 should the EURUSD break the parity as a result of political risk in 2017.

Risk

We have always asserted that the current fixing mechanism is trapped in a path of gradual depreciation. RMB policy risk could be one of the risks in 2017. Given that FX reserve may fall below the US\$3 trillion handle anytime soon, China may have to choose between capital control and a more flexible currency. In order to slow down the decline of FX reserves, China may have to scale down intervention efforts. We think the chance for China to eventually allow a freer floating currency cannot be ruled out in 2017. Should China loosen its control on currency volatility, there is the risk for the USDCNY to overshoot. However, this could be the only way to clean up the pent-up demand for the greenback. Given China is still running a sizable current account surplus; we think RMB may be able to recoup some losses after the overshoot.



Succumb to Global Uncertainties

The economy appeared to be more resilient than expected and expanded by 1.9% yoy in 3Q. The improvement was attributed to pick-up in the private consumption (+1.2% qoq) on upbeat market sentiment. In addition, investment ended four quarters of negative growth and rose by 6% yoy. Moreover, exports grew steadily by 1.9% yoy. However, the economic outlook remains subpar as global uncertainties may hurt the crucial trade sector. Also, a stronger HKD and China's slowdown are likely to continue denting tourist consumption. The resultant weakness in the retail sector may cloud the labor market. As a result, jobless rate, which stabilizes at an over two-year high of 3.4, will likely rise further and hurt local sentiment. In all, we expect 1.9% yoy of economic growth for 2017, following a 1.4% expansion in 2016.

Tourism and retail sectors to remain weak

As the downtrend of inbound tourism appeared to ease slightly, decline in total retail sales value narrowed from -10.5% yoy over 1H to -4.1% yoy in October. The sales value of jewelry and watches also dropped at a much milder pace by 0.1% yoy amid the effect of low basis. However, the tourism and retail sectors are expected to continue their downward cycle as a stronger HKD may dent tourist spending.

Amid weak tourism activities and sluggish luxury consumption, unemployment rate in retail sector printed 5.2% in October, higher than the average of 4.7% in 2015. In the near term, the employment of retail sector is likely to sag. Combined with correction in the housing and stock markets, local consumers are expected to remain cautious. Therefore, private consumption expenditure may remain hobbled by a benign outlook of the labor market (+1.2% yoy in 3Q v.s. the increase of 4.7% yoy in 2015).

Due to gloomy prospect for the retail sector, retail shop market may tumble further after the retail shop rentals and prices fell by 3.9% yoy and 10.3% yoy respectively in September. As such, more rental concession by the landlord and higher vacancy rate in core business district are expected.

Trade sector faces uncertainties

Exports declined in October by 1.8% yoy, after registering growth in the previous two months. The decrease was broad-based due to muted external demand. Moreover, loan to finance visible trade slumped by 0.6% mom in October amid sagging trade activity. Looking ahead, given US President-elect's unfriendly stance on China's trade, HK's trade sector may be hit as 56% of total exports were of China origin while 9.3% were from US. On a positive note, as Trans-Pacific Partnership (TPP) is dead, major economies begin to eye on the Regional Comprehensive Economic Partnership (RCEP) and China's "One Road One Belt" strategy. Should the member countries reach an agreement on the RCEP, it may be a boost to HK's trade activity.

Elsewhere, huge gap between the trade data from China and HK has revealed the persistent pressure of capital outflow from Mainland via fake invoices. Though the gap has been narrowing, China may continue to tighten its capital control given the lingering angst of a weaker Yuan.

Residential property market to see renewed correction

On the housing market front, low interest rates, tight supply and investment from Mainland China together pushed overall residential property price up for the first time in the past 10 months, jumping 0.5% yoy in October. Housing transaction volume also rose for the fourth straight month to 6,793 units in November. However, the housing market looks set to brace for a renewed correction as the new cooling measure may hit the investment demand for smaller flats and suppress the supply in secondary market. Should the Fed accelerate its rate hike pace, higher borrowing costs could further curb housing demand. Therefore, total transaction volume is expected to slump by around 50% from the current level in 1Q 2017. Housing prices may also retreat by 5% to 10% yoy in 2017 as a result. Nonetheless, a flatter rate hike path of the Fed and strong demand from Mainland investors may translate into smaller downward risks on housing prices.

With regard to housing supply, private housing starts rose by 17.34% yoy in the first nine months. As such, annual supply of private residential units during 2016 to 2018 is expected to reach around 15,600 units, up from the five-year average of around 11,397 units in 2010 to 2014. However, new home completion has missed expectation in 2016. If developers continue to slow down the construction pace amid tepid housing market outlook, tight supply may be another factor limiting the downside of housing prices.

Financial sector and the RMB internationalization

Like the sectors mentioned above, the crucial financial sector is also facing external headwinds, especially those from Mainland China. Specifically, offshore RMB deposits shrank by 22.4% yoy for the 14th straight month in October as CNH depreciated by over 5% in 2016. Looking ahead, RMB may remain dampened given (1) China's economic slowdown amidst the government's control on property market, and (2) persistent capital outflow amid policy divergence. In this case, lower demand for RMB asset means that RMB liquidity pool in HK will continue to shrink. In addition, China strengthened control on capital account, signaling a halt in RMB internationalization. As a result, tighter RMB liquidity in the offshore market could risk a further slowdown in development of Dim Sum Bond market.

On the other hand, tight RMB liquidity in HK will narrow the gap between CNH and CNY and reduce the opportunities of carry trade. Adding on cheaper borrowing costs in Mainland China, loans for use outside HK are expected to see more downside (-1.5% mom in October). Despite the launch of debt-to-equity swap, high credit risk of Mainland enterprises also keeps banks in HK reluctant to approve loans to them.

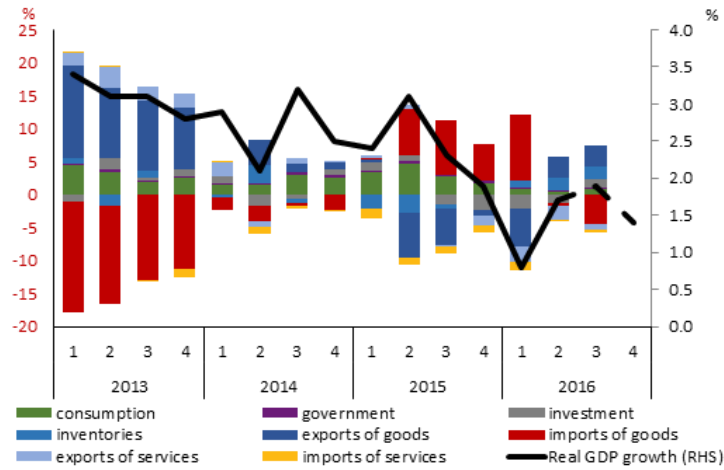
On a positive note, the depreciation risks of the Yuan have urged onshore investors to shift capital across the border and bring some RMB liquidity to HK. The launch of Shenzhen-Hong Kong Stock Connect in early December just provides another way for Mainland investors to tap the offshore market. In the medium term, should China push ahead RMB internationalization by launching bond link and the like, job and business opportunities will increase across HK's financial sector, amid higher need for brokerage and asset management from Mainland investors. As a result, improvement in the crucial financial sector could help weather some headwinds faced by the economy.

Furthermore, the One Belt One Road plan is expected to boost offshore trade settlement in RMB and use of RMB as investment currency. This will also underpin the RMB internationalization. As a result, Hong Kong, as the main bridge to connect China and foreign markets, may see its role enhanced.

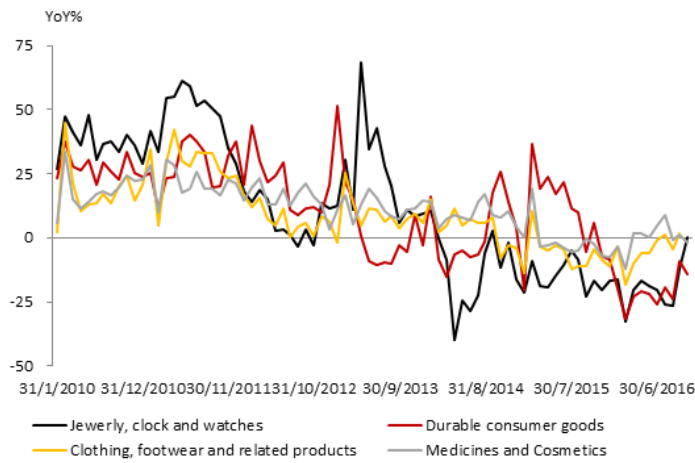
Will HKD sustain its strength?

Due to the linked exchange rate system, the HKD has moved in tandem with the stronger USD despite a weaker economy. However, given the sour outlook and pressure of capital outflows on Trump Tantrum, whether HKD is able to sustain its strength is open to question. Capital inflows from Mainland China and an expected gradual rate hike pace of the Fed may allow the HKD to fall at a moderate pace with 7.80 being a crucial resistance. Still, any steeper increase in US rates is likely to push both HIBOR and USDHKD up. Nevertheless, we believe that aggregate balance in the banking system will be adequate to defend the HKD from facing renewed risks of de-peg.

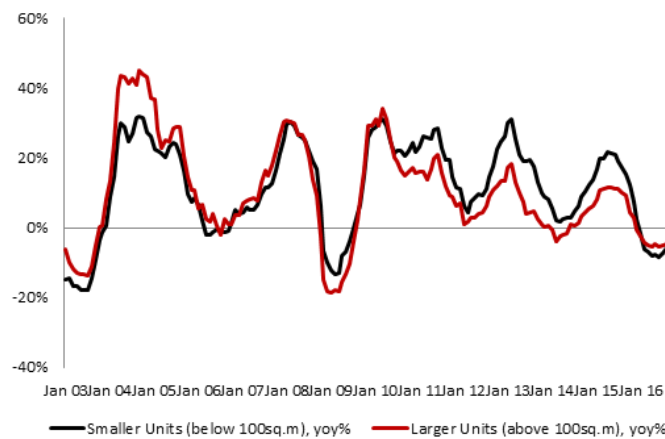
Hong Kong GDP Growth



Retail Sales Growth by Categories



Residential Property Price



Source: Land Registry, Census and Statistics Department

Important Inroads

At the start of 2016, after we peered into the crystal ball and thought about the outlook for the Indonesian economy in 2016, we thought that it can indeed do better than the 4.8%yoy growth that was clocked in 2015, even if not by a whole lot.

As we start to gaze into the outlook for 2017, the same steady-as-she-goes pace of growth pick-up still looks to us to be the most likely scenario. Indeed, we see a good chance that GDP growth for Indonesia to be at 5.2% yoy next year, compared to 2016's growth that is probably going to clock around 5.0%.

At first glance, such growth rates are not exactly exciting. This is especially so, when compared to talks of 7% growth rate that President Jokowi floated when he first came into office in late 2014. It is also markedly lower than the 6.0-6.5% growth rate that the Indonesian economy used to clock just a few years ago.

However, if we take a step back and notice how much the overall global growth outlook has shifted, we would better realise the true value of the Indonesian growth story. For instance, even at a seemingly humdrum growth rate of 5%, Indonesia would still likely be among the Top 5 best performing economies in Asia this year.

At a time when the developed countries are struggling with low-for-longer growth rates and some of its commodities-dependent emerging market peers such as Brazil and South Africa are facing an unhelpful combination of tepid economy and toxic politics, the very fact that Indonesia could still buck the odds and achieve steady growth should not go unnoticed by businesses looking for opportunities in our region.

On this front, the key role played by Indonesia's consumers as a ballast to counter global volatility is worth bearing in mind. To be sure, commodities slowdown has hurt spending power in some regions, particularly among those who live in the commodities-producing regions in the islands of Sumatra and Kalimantan. At the nationwide level, however, things are looking relatively encouraging, with household consumption holding rather steady at around 5.0%yoy growth.

In the near term, such steady private consumption growth might see some challenges. In particular, the success of the government's tax amnesty program – which has already seen at least IDR4035tn of assets declared, more than the lofty official target of IDR4000tn – has an unintended consequence of draining liquidity from households. This is because the amnesty participants had to fork out at least 2% of their declared assets to pay the tax office, as part of the deal of coming in clean for their past tax malfeasance. Such enthusiasm inevitably caused a bit of a squeeze on household spending power, at least in the near term, and would curb the chances of any significant improvement in private consumption just yet.

The issue of potential soft patch in the next quarter or two has also received attention from policymakers. In particular, Bank Indonesia has been busy cutting its policy rates in an attempt to ensure a smooth provision of liquidity in the banking system. Already,

in 2016, the central bank has eased its policy rate by as much as 6 times or an aggregate of 150 basis points, in order to nudge down the bank rates. While the average deposit rate has declined by more than 100 basis points thus far, it appears that lending rate has dropped less enthusiastically.

While the central bank was signalling a continued easing stance at some point, it has since adopted a more cautious tone, courtesy of bouts of global markets volatility especially post-Trump election. It now appears to be positioning for other ways of boosting credit growth, rather than engineering further cuts in its policy rate that might be deemed to be risking its currency stability too much. Hence, the more likely actions for BI will be to reach for further loosening of macro-prudential measures and some tinkering of regulatory framework such as a relaxation of reserve requirement rules for banks.

Hence, despite the lower likelihood for policy rate cuts, we believe that the policy environment will remain one that is supportive of growth, especially on the domestic consumption front. This is especially more so, if we consider the fact that the fiscal policy would also retain a broadly supportive role.

In particular, the government continues to put its money where its mouth is when it comes to infrastructure spending, with as much as IDR300tn allocated for infrastructure expenditure in the 2017 budget. This goes to show that, despite the legal restriction in which the government is forbidden to run a budget deficit that exceeds 3% of GDP, it has managed to find wiggle room within the limited space and to prioritize spending for important infrastructure spending, rather than squandering it on expensive-and-unproductive fuel subsidies like before.

When it comes to policy measures to support growth, apart from the fiscal measures and monetary policy easing mentioned earlier, the Indonesian government has also been busy undertaking structural reforms.

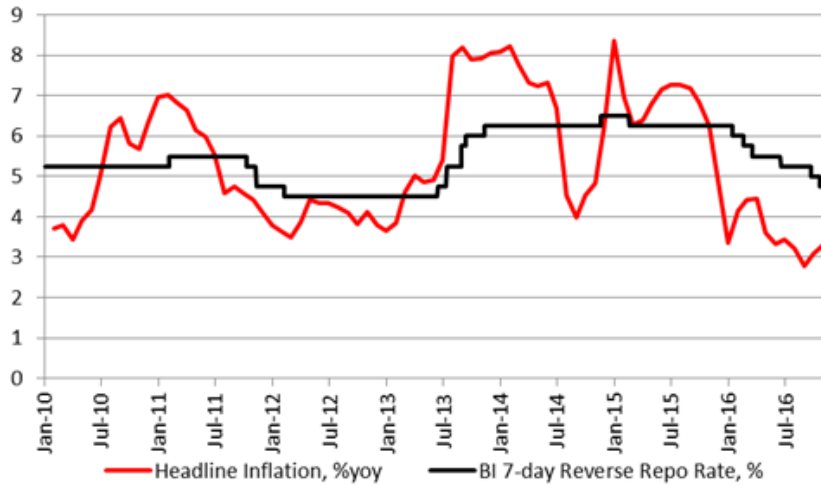
Indeed, since he took over as the Coordinating Minister for Economic Affairs in August 2015, Darmin Nasution has been spearheading a series of economic reform packages – at its 13th edition last and counting – that aim to cut the bureaucratic red tape faced by foreign investors. While businesses are awaiting clearer implementation of these broad-level reforms, the packages have nevertheless signalled the government's seriousness in pursuing reforms to offer a more enticing environment for investors.

Indeed, such determined policy reform momentum will be the most precious item that Indonesia can have in the coming years, as it continues to wean off its dependence on commodities as a source of growth, towards boosting the contribution of manufacturing sector to the economy. It is early days yet in the grand scheme of things, but it looks to us that, into the third year of his administration now, President Jokowi's government has made some important inroads into making that transformation process a successful one.

GDP Growth



Policy Rate



Loans Growth



Source: CEIC, Reuters, OCBC Bank

Cautiously Optimistic

Even though the worst is over, Macau's economy is unlikely to go back to its glory days. As the gaming slump abates on recovering tourism activities, the economy advanced for the first time since 2Q 2014, up by 4.0% yoy in 3Q. Growth should be supported given favourable domestic policies amid a global recovery that should positively affect the gaming and tourism sectors. For fiscal year 2017, the government plans to increase expenditure by 12.0% despite the estimated 0.3% decline in revenue. Therefore, though fewer projects are scheduled to be completed in 2017, the buoyant government investment and expenditure on fiscal stimulus would help to compensate the benign private investment. Private consumption, however, will probably fly at a low altitude as the boost from lower inflation is thwarted by a stagnant wage growth. In all, the GDP is expected to contract by about 5.0% yoy in 2016. For 2017, a 3.0 - 5.0% growth is expected from the low 2016 base.

Gaming sector is bracing for a healthier future

After 26 months of consecutive decline, gross gaming revenue (GGR) registered its first annual growth in August. After that, the effect of Mid-Autumn Festival and National Day Holiday combined with two new hotel openings brought more leisure gamblers to town. This has fuelled the expansion of mass market segment, thereby cancelling out the drag from a shrinking VIP segment. Till 3Q, the lower-end segment accounted for 42.3% on average, up from the average of 39.6% last year. Premium-mass market, which is a new element, has also helped to lure some high-rollers who were once sidelined by the anti-corruption campaign. Consequently, gaming revenue from the mass market rose faster than expected in 3Q, up by 4.8% yoy.

However, amid lower profitability, the expanding mass market seems unlikely to bring the gaming sector back to its glory days. For the two casinos that opened in 3Q, the number of the tables allocated had to adhere to the government's 3.0% cap on the annual growth of tables. The combined effect from a weak growth in gaming tables and a lower minimum bet amount in mass market are expected to constrain the casinos' profitability. Despite this, the gaming sector is still bracing itself for a healthier future. With limited tables, casino operators have to allocate them more efficiently by moving the redundant tables from old casinos to new ones and also from VIP rooms to mass market. This will help to weather the subdued business environment and prevent the dilution of profits. Still, there are still concerns that the mass market segment's growth momentum will be unsustainable, should new projects become less attractive to tourists in the medium term.

Due to a low base, the decline in the VIP market revenue had narrowed significantly to -1.2% yoy in 3Q. It is said that junkets have resumed credit extension to high-stakes players and the rooms for the high rollers have re-opened for the first time in two years. Both factors may gradually bring VIP demand back. Nevertheless, the rebound in VIP business could be constrained by tighter regulation on junkets, smoking and money laundering. Despite that, as the VIP segment takes a less prior role, the impact of the corruption crackdown is abating.

On a positive note, the government has stated in the Policy Address 2017 to build more non-gaming elements in the gambling centres, hence the gaming sector is likely to benefit from the supportive policy. Adding on the effect of low base, we expect GGR to rise about 5.0% to 7.0% yoy to over MOP230 billion, higher than the government's forecast of MOP200 billion.

A new growth engine

An increasing number of visitors have brought growth tractions to the gaming, hotel and retail sectors. This makes the tourism sector the new growth engine for the gambling hub. With regards to the tourism activities, total visitor arrivals (+1.6% yoy) rose in four out of the past five months in October. The gains were mainly driven by fifteen straight months of growth in overnight visitors on subsequent new hotel openings since last May. Persistent room rate cuts amid fiercer competition have also boosted tourism activities. Clearly, the casino operators' effort to increase stake in non-gaming businesses has resulted in a structural change in the tourism sector, as the share of overnight visitors has surpassed 50% since June.

However, the sustainability of the new hotels' attractiveness is uncertain in the long term. Without natural wonders and diversified entertainment facilities, a mere slew of new resorts may not be able to sustain tourist re-visitation numbers, especially given limited choice of cheap accommodation and a stronger MOP. Any deceleration in the growth of tourists will pose renewed downward risks to the hotel sector amid the room glut. Nevertheless, the government's plan to develop budget hotels, theme parks and integrated shopping malls may provide new impetus for the tourism sector.

Due to the burgeoning growth in tourism activities, the retail sales' slump narrowed to -7.4% in 3Q. However, the number did not reflect the 17.3% yoy of robust gain in visitor spending per capita during the third quarter. Probably, visitors are generous in terms of spending on accommodation, but kept their purse strings tight regarding other items. Strong MOP and tepid income growth are likely to constrain tourist and local consumption respectively and thereby constrain the retail sector in the coming quarters.

Tepid local demand despite stable labour market

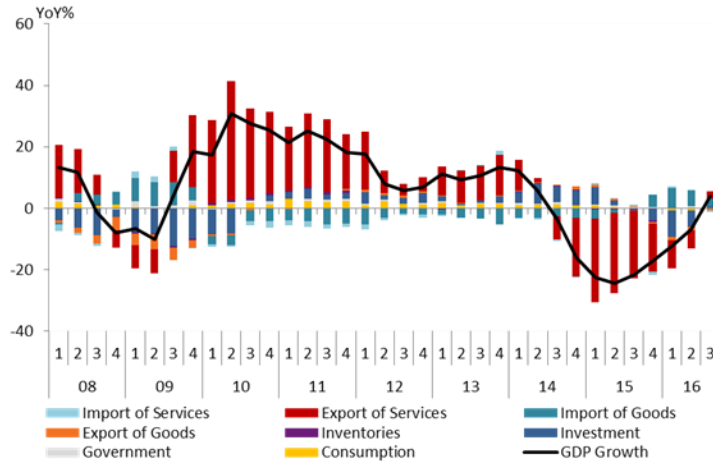
The jobless rate has stabilized at 1.9% since June-August 2015. However, the employment in different sectors was mixed. Labour redundancy continues to constrain the gaming sector's employment outlook despite an improvement in its business performance. A loose completion schedule of new mega projects in 2017 may also keep the hiring sentiment in construction sector muted. On the wholesale and retail sector front, after adding jobs to prepare for new shop openings in the mega projects, it cut jobs again due to the sluggish business environment. One bright spot has been the continuous job creation in the Hotels, Restaurants and similar sectors, but the pace could slow down going ahead. Despite the mixed picture of the labour market, the overall jobless rate is likely to stay low at around 2.0% amid tight labour supply.

In this case, a stable labour market, combined with lower inflation, seems bound to spur consumption and housing demand. However, given that the median monthly earnings have remained unchanged at MOP15,000 since 1Q 2015, households are likely to remain cautious about spending or home purchase.

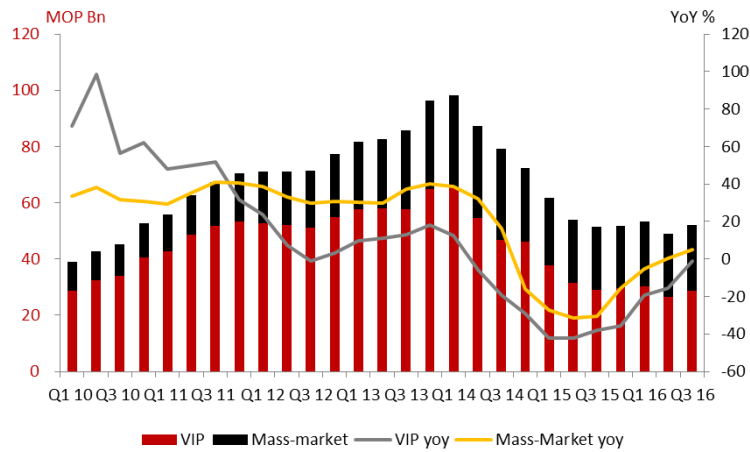
In fact, a stable labor market, upbeat sentiment and low borrowing costs have all helped to drive the housing transaction volume up for seven straight months. The decline of average housing price from the peak in 2014 has also softened from -44.7% in March to -37.9% yoy in September. However, due to the housing measures in place and fewer discounted flats available for sale, the housing market may not see much growth in the medium term. The boost from low borrowing costs may also wane as the Fed hiked rate on the back of Trump's fiscal stimulus.

On the supply side, the government plans to build around 12,600 public housing units in short-to-medium term. In addition, housing construction rose by 220.0% yoy and 20.0% yoy respectively in 2015 and during Jan-Aug 2016. This may expose the rebounding housing market to renewed downward pressure. Average housing price is expected to retreat by 5.0% to 10.0% on yearly basis over 2017.

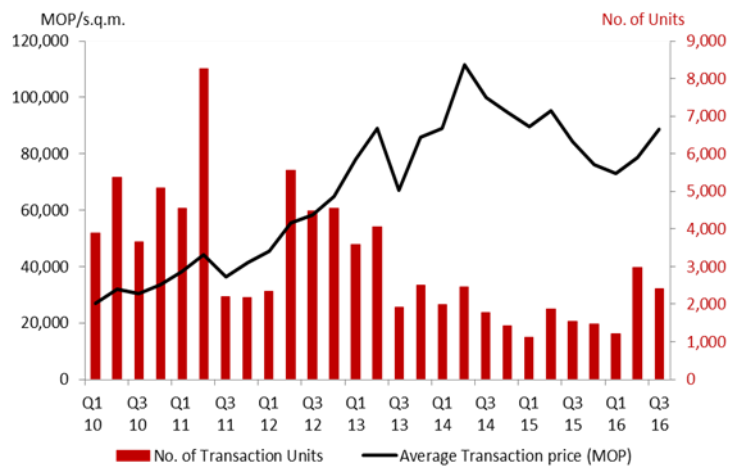
Impact of Gaming as Export of Services on Macau GDP



Macau Gaming Revenue By Segment



Macau Residential Property Market



Source: DSEC, DICJ

More Of The Same?

This time last year, as we penned down our thoughts about how Malaysia's economy will perform in 2016, we started with the following: "Things have been rough for the Malaysian economy," and that, "Looking into 2016, we see a good chance that things would at least stabilize, even if there is always the risk that the same factors which plagued the economy in 2015 may well rear their ugly heads again." Fast forward to the current point in time, and the same tenet largely still holds. For one, things have indeed been relatively rough, with global market jitters in the post-US election weeks affecting market sentiment towards emerging markets in general, and rekindle some concerns about Malaysia's idiosyncratic conditions in particular.

For instance, outside of Japanese Yen, Malaysian Ringgit was the worst performing currency in Asia for the period since Trump's elections until year-end. According to Bank Negara, the relatively pronounced impact in the currency market appears to have been exacerbated by influence from the offshore non-deliverable forward market. Because of that, the central bank, through the Financial Markets Committee, launched a series of initiatives to stabilize the market starting from early November 2016.

Among other things, it launched a fund manager hedging framework, which allows registered fund managers to actively manage the currency exposure of up to 25% of their invested portfolio onshore. Going by a December 28th statement, as many as 10 fund managers, consisting of both residents and non-residents, have registered with the central bank with a total asset under management of MYR41.8bn (~USD9.3bn). It added that "the disruptive influence from the non-deliverable forward market has also subsided." They pointed out that ringgit intraday movement has been averaging 90 points, lower compared to 228 points in November and a high of 600 points.

Moreover, the authorities also launched a new initiative to compel exporters to keep the majority of their export proceeds in the domestic currency, rather than leaving them in hard currencies such as USD. Under the new scheme, exporters could only maintain 25% of their export proceeds in foreign currencies, after accounting for up to 6-month forward projection of their loans and imports obligations. Going by the latest Bank Negara statement, December data indicated that around 57% of export proceeds have been reconverted for this purpose thus far. Overall, this is indicative of the kind of challenges that emerging markets face as we transition into a new year where some global factors look to be turning considerably less favourable.

Specifically, the fact that the US Federal Reserve has raised rates twice in this cycle, and looks to be positioning for relatively hawkish rate hikes of up to three times next year has brought pressure on previous EM darlings such as Malaysia that was the recipient of yield-seeking capital inflows. Despite the sell-off recently, foreigners still hold as much as 48.4% of Malaysia's MGS bonds as of end-November, making it relatively more vulnerable to any heightened risk of global capital outflows.

Curiously, the recent uptick in global oil price has also failed to boost MYR's appeal as much as one might have expected – perhaps pointing to the relative dominance of the global outflow concerns. On top of that, another big unknown in 2017 will be the impact of Donald Trump's presidency on global economy, especially when it comes to his blusters against global trade and relationship with China.

These are important factors to consider when we think about the outlook for Malaysia. Judging from BNM policy statement on November 23rd, it appears to us that the central bank too is trying to do just that. In what can be seen as an allusion to Trump's reflationary talks, BNM notes that "The prospect of a shift towards progressive use of fiscal policy in the developed economies could lead to a more balanced policy environment that would support growth going forward." Given the relative export dependence of Malaysia's economy, that aspect is obviously a good thing.

Still, this sunny-side up egg happens to have a burnt flipside. Specifically, the less savoury aspects of Trump's platform present significant risks to Malaysia, with the BNM policy statement adding that "there is uncertainty arising from risks of protectionism and financial market volatility." It remains anybody's guess but if the already-tepid global trade flows become further crimped next year due to tariffs or even threats of them, Malaysia would rank as one of the more highly impacted.

While Trump is a lot more likely to aim his salvos at the likes of China and Mexico than to Malaysia, it is wishful thinking to assume that the latter would escape unscathed from any protracted and broadened trade war.

Even if the importance of US as a trading partner to Malaysia has seen a structural decline over the past decade or so, a good 1 out of 10 dollars that Malaysia gets from exports is still coming directly out from American demand. Moreover, any impact on China's growth arising from its own bilateral trade skirmishes with the US, would have an indirect – but unfortunately not insignificant – impact on Malaysia's exports, as well.

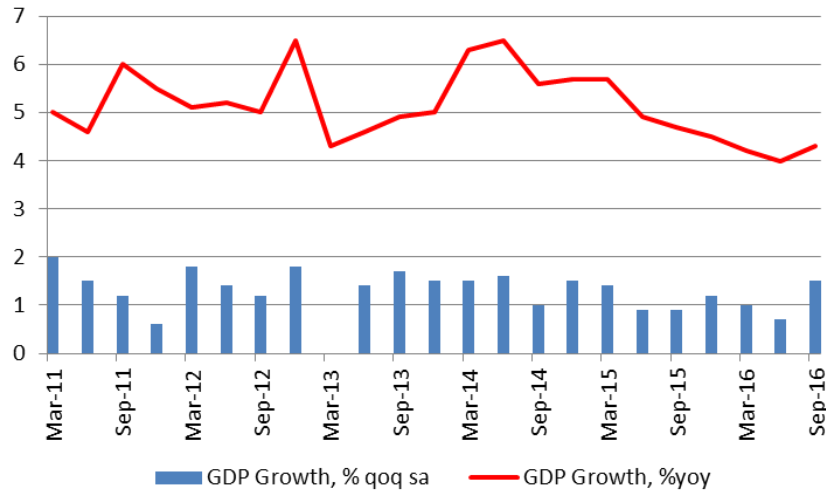
Hence, even as our baseline growth forecast for 2017 for Malaysia is relatively supportive at 4.2% yoy, roughly unchanged from 2016's growth figure, there is nonetheless a potential downside tilt. As much as Malaysia's domestic consumption has been holding up the overall growth, the fact of the matter is that it remains more export-dependent than some of its regional peers such as Indonesia.

With external risks on the rise, it would have been ideal if the BNM has the chance cut its policy rate further to give more oomph to domestic demand as a counterbalance. This is especially so, given that from a purely domestic angle, there is space given by the relatively low inflation. CPI headline inflation printed just 1.5% yoy in September and is projected by BNM to "remain relatively stable in 2017 given the environment of low global energy and commodity prices and generally subdued global inflation."

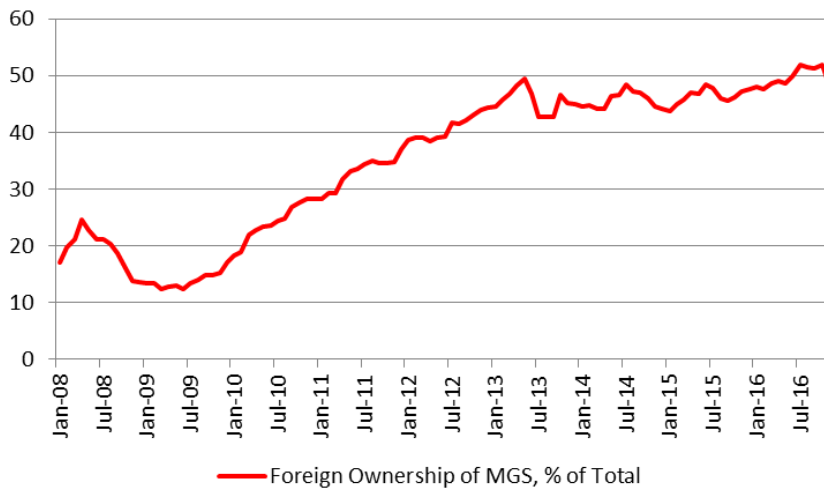
Still, even if talking about the demise of globalization seems to be a new cottage industry, we still live in an inter-connected world at this point, where policymakers have to keep global, and not just domestic, factors in mind. Hence, in such an unsettled global environment, even if Bank Negara feels that it has the space given by domestic factors to ease further, it is probably wise refrain from doing so for now.

That holding pattern, lamentably, might have to take place for a while more. And unless there is clarity on the global markets environment, we think there is a higher likelihood now than before that Bank Negara will have to keep its Overnight Policy Rate unchanged at 3.0% for the whole of 2017.

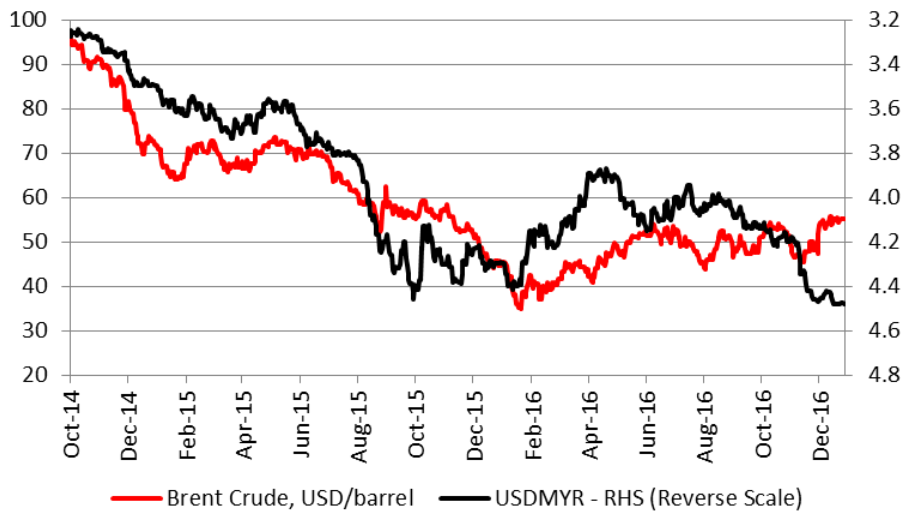
GDP Growth



Foreign Ownership of Bonds



Oil Price and MYR



Weight of Expectations

In our Global Mid-year Outlook published in July 2016, we communicated a message of cautious optimism on Myanmar. We revisit this theme, and examine the state of play between caution and optimism as we look into 2017.

Optimism was the prevailing sentiment amongst locals and interested foreigners at the start of 2016. How can it not be? Myanmar has enjoyed 5 years of rapid growth since economic reforms took place in 2011. The National League of Democracy (NLD) and its leader, Aung San Suu Kyi, were to finally take power in April, representing the hopes of locals in a new era of democracy. For interested foreigners, this confluence of positives raised expectations for new opportunities in Asia's last frontier economy. However, as the year passed, optimism was tempered by a note of caution on the ground. The challenge of transition and governance has proved to be formidable, and has had a real impact on the economy.

Caution: Transition pains take their toll

One would have expected that optimism will carry the Myanmar economy as foreign investors flood into the scene. The reality was much more sombre. Economic growth has been slower than envisaged in the first 6 months of FY2016-17. The Planning Minister, Kyaw Win, attributed this to the "challenges of the transition". Many of these challenges are playing out at the government agency level, and in the policy climate in the business and investment scene. This creates a sense of wariness that prevents foreign businesses from converting their interest and optimism into actual investment. Peering into foreign direct investment (FDI) data, we find another indication of this caution. The government aimed to attract US\$6b of FDI in the current fiscal year. As at 31 October 2016, Myanmar saw inflows of approximately US\$3.2b in foreign investments. However, the data appear to be skewed by outsized flows in October. Excluding October, total investments amounted to just US\$1.2b in 6 months, a far cry from the target.

Into 2017, we should expect these transition issues to persist, but alleviate over time. For one, greater policy clarity will be forthcoming as we expect the by-laws of the new Myanmar Investment Law to be released. Early indications suggest that labour-intensive manufacturing and physical infrastructure projects will obtain priority, and incentives will be awarded through a tiered tax exemption structure. Greater challenges will be in the quality of policy execution and the consistency in regulatory enforcement. However, these issues are a function of the institutional capacity of the government, and that will take time to develop.

Optimism: Lifting of US sanctions, restoration of GSP benefits

The lifting of US sanctions and the restoration of Myanmar's position under the US Generalised System of Preferences (GSP) scheme are sources of optimism going into 2017. With the sanctions lifted, all Myanmar individuals and entities listed on the Specially Designated National and Blocked Persons List (SDN List) will be removed, and restrictions on banking and financial transactions lifted. This move allows US businesses to deal with Myanmar corporates with much fewer restrictions. Exports will

also enjoy preferential tariff rates as a result of the re-entry into the GSP scheme. This should give a boost to the export sector.

An encouraging precedent can be found in 2013, when Myanmar was included in the European Union's (EU) GSP scheme. Post-inclusion, exports to the EU grew at a CAGR of 33.0% from €162m in 2012 to €675m in 2015. To achieve even half of this result in terms of trade with the US would be a significant boost to the Myanmar economy. However, we remain conservative in our hopes. The fact remains that economic ties between Myanmar and the US has been largely negligible due to prolonged sanctions. Corporates on both sides will need time to familiarize. Thus, one should not expect trade or investment from the US to spike in the short term.

Thankfully, positive signs have already been observed in selected industries. For example, the garment industry is poised to benefit. The garment industry is one of the areas where Myanmar possesses distinct advantages – low labour costs and relatively youthful demographics. Indeed, the garment industry has been growing rapidly since 2011, with the total export value of garments reaching US\$1.01b, accounting for 8.8% of the country's total exports, in 2014. This is more than double that of the 2010 level of US\$484m. In addition, it has also benefited significantly from the inclusion of Myanmar into the EU's GSP scheme. Post-inclusion, garment exports to EU rocketed from €112m in 2012 to €423m in 2015, accounting for 62.3% of all exports to the EU and more than half of all garment exports.

At the corporate level, the presence of European apparel brands, such as H&M and Adidas, operating in and sourcing from Myanmar will help inspire confidence among the American labels. A key deterrent is the relatively weak labour rights record, which may occasionally lead to public relations issues in Western countries. However, with the new government active in reviewing labour rights and industrial relations, the situation should improve over time, and encourage more fashion labels from the US to set up shop in Myanmar.

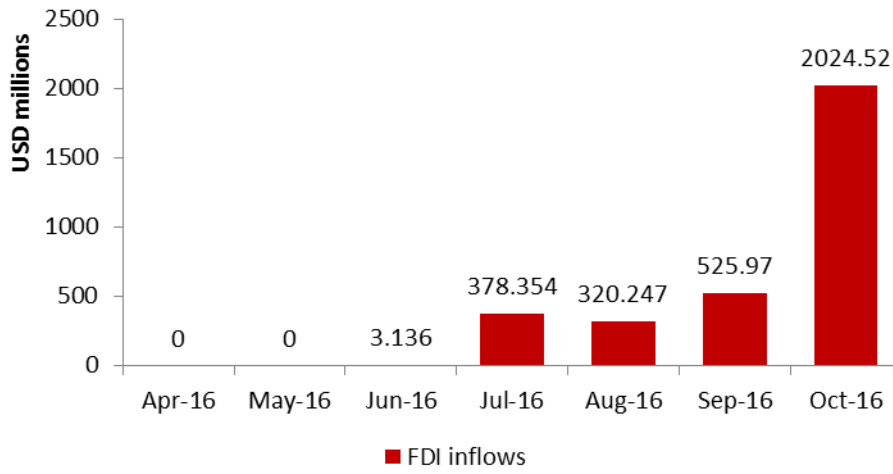
Conclusion: Finely balanced

As with all frontier economies, caution and optimism will be locked in a multi-year struggle, with the edge tilting to either side depending on the times and policies. At this point, the optimism that was observed at the start of 2016 appears to be dosed with a fair share of caution. The net result, it seems, is finely balanced.

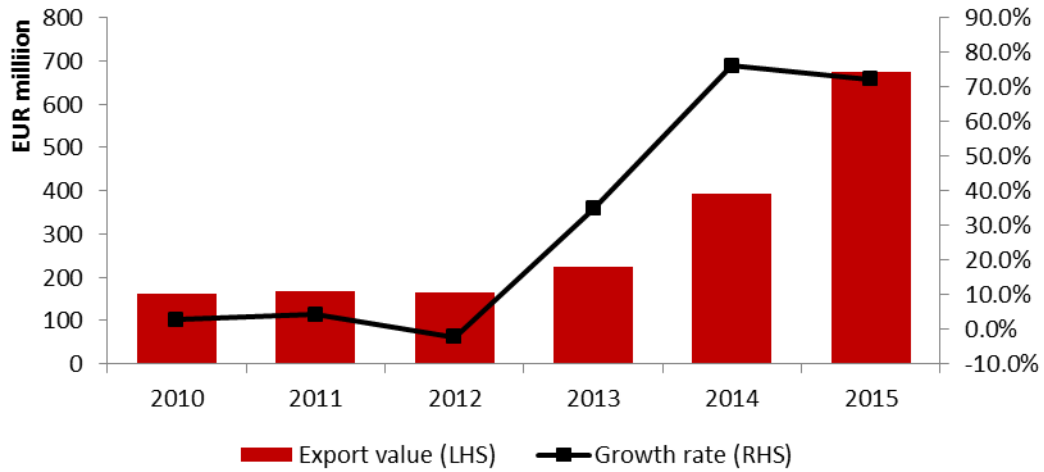
Overall, we are heartened by the willingness of the government to acknowledge their weaknesses, and note the increased efforts by the government to engage with the business community. We view this as a positive engendering trust amongst the business community. At the same time, while the US government has lifted its prohibitive hand on economic relationships between the two countries, private businesses may still be reluctant to engage. Both sides will need time to discover and familiarize. These are issues that can only be alleviated by building trust over time, and cannot be overcome with a stroke of the presidential pen.

Many of the transition pains will remain in play going into 2017. Undoubtedly, this will continue to take its toll and may result in growth coming in a notch lower, at the 7-7.5% range. In the mid-term horizon, we continue to expect that Myanmar has the potential to grow at a pace between 8-8.5%.

FDI track record in FY2016-2017



Myanmar export to EU



Garment trade in Myanmar



The economic side is gradually turning

The 2H16 growth cues start out soft but manufacturing, particularly electronics have shown recent signs of life. November industrial production rose 11.9% yoy, its fastest pace since March 2014, led by electronics (+24.2% yoy) and pharmaceuticals (+34.8% yoy) which more than offset weakness in other beleaguered sectors like the offshore & marine sector. This was also mirrored in the November NODX which rebounded strongly by 11.5% yoy (+13.1% mom sa) as electronics exports recovered 3.5% yoy (previously -6.0% yoy). It therefore came as no big surprise that the Singapore economy expanded a better than expected 1.8% yoy (+9.1% qoq saar) based on advance estimates of 4Q16 growth. This meant a technical recession was avoided. Note the earlier three quarters of GDP growth were also revised higher, lifting the full-year GDP growth to 1.8%, which is still a slowdown from 2015's 2.0% yoy and the slowest since 2009.

Singapore's manufacturing PMI rose for the second straight month by 0.4 points to 50.6 in Dec16, which is the highest print since Nov14 (at 51.8). New orders, new export orders, production and inventories gauges saw improvements into the end of 2016, which should bode well for 1Q17 manufacturing momentum. This came after the upside surprise in the 4Q16 flash print for manufacturing at +6.5% yoy (+14.6% qoq saar), which is the strongest bounce since 1Q14, and contribute to the 4Q16 GDP growth at a stronger-than-anticipated +1.8% yoy (+9.1% qoq saar). Similarly, the electronics PMI also rose 0.7 points to 51.2 in Dec, after easing slightly in Nov (-0.3 points), which also marked the strongest reading since Oct15. The improvement was also driven by an uptick in new orders, new export orders, production and inventory gauges. In particular, demand for OLED displays, dual-lens cameras, fingerprint technology and touch screens could remain key drivers in 2017.

The tide is gradually turning for 2017, with the long-awaited domestic manufacturing recovery finally taking root at +2.3% yoy for 2016 vis-à-vis -5.2% yoy in 2015. The key outperformer was manufacturing which rose 6.5% yoy (+14.6% qoq saar) in 4Q16, which marked the strongest yoy quarter since 1Q14 and a sharp bounce from the 8.1% qoq saar contraction in 3Q16, driven by the electronics and biomedical clusters. The services sector also saw its growth momentum pick up to +0.6% yoy (+9.4% qoq saar) in 4Q16, which is an improvement from the three straight quarters of sequential slowdown previously. Support came from "other services industries", transportation & storage and business services sectors. Construction, on the other hand, declined for the second consecutive quarter by 2.8% yoy (-4.7% qoq saar), weighed down by private sector construction activities as cooling measures and cautious market sentiments persisted, especially with the FOMC hiking US interest rates in December 2016 and telegraphing a more hawkish rate hike trajectory for 2017.

Nonetheless, the 2017 outlook remains tentative, with GDP growth likely still rangebound at around 1-2%. This is at the lower end of the official forecast of 1-3%. The key uncertainties in our view remain the Trump presidency potentially having spillover effects for global trade, China's continued slowdown with the 19th party congress due later this year, and heightened market volatility, especially on the currency and interest rate front, potentially weighing on corporate and consumer confidence.

Domestic inflation is likely to pick up gradually into 2017, alongside higher commodity prices. Our forecast is for headline and MAS core inflation to print at +1.0% yoy and +1.6% respectively this year. November CPI flatlined on-year, after 24 straight months of contraction. Headline inflation fell 0.6% yoy for the first eleven months of 2016, which is close to the official inflation forecast. Notably, MAS core inflation accelerated to 1.3% yoy in November 2016, with the January-November averaging +0.9% yoy as well. The 2017 inflation outlook remains modestly tilted to the upside, especially with crude oil prices holding above the US\$50 handle per barrel. The familiar drags from the three key segments, namely housing & utilities, private road transport, and communications, are gradually subsiding.

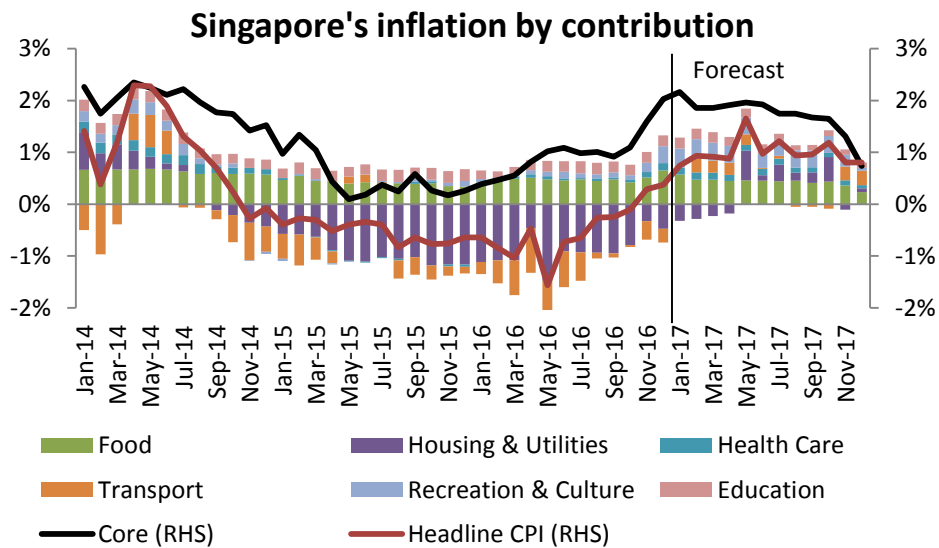
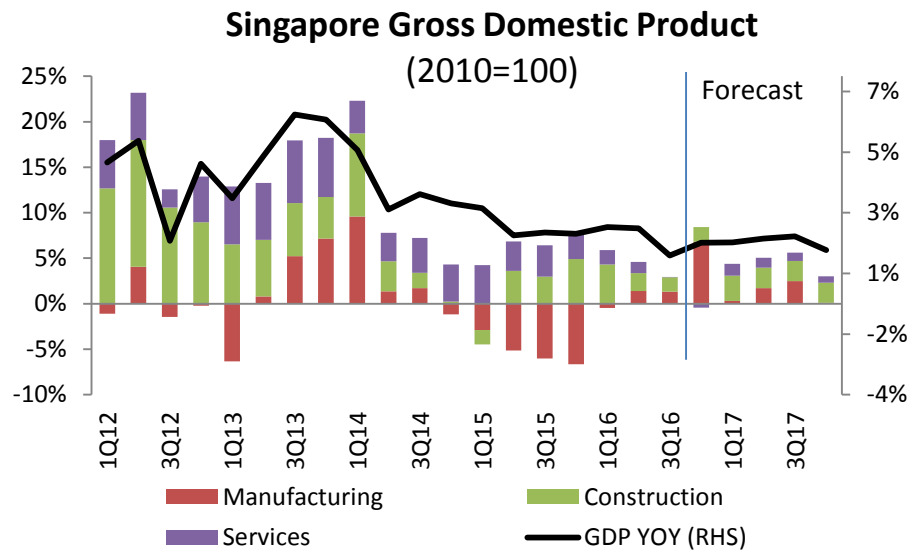
Domestic short-term interest rates have bottomed in the second half and could edge higher in 2017. While our sneaky suspicion remains that the FOMC could again over-promise and under-deliver on its rate hike expectations (ie. undershoot the three 25bp rate hikes outlined in its median dots graph), the bias is still on for the 3-month SIBOR and SOR to climb towards the 1.5%-1.55% region respectively as the year progresses, up from the near 1% handle currently. This, coupled with the intact cooling measures, could continue to put a dampener on the private residential property market - note URA private home prices fell for 13th straight quarter by a less severe 0.4% qoq in 4Q16, bringing 2016 to -3% (down for 3rd straight year).

Still bank loans growth has also likely bottomed. Notwithstanding the recent turnaround in short-term interest rates towards end-16, bank loans growth accelerated for the 2nd month to +1.1% yoy in Nov (+0.04% mom) after 12 straight months of contraction. Business loans rose 0.7% mom (-0.2% yoy) while consumer loans rose 0.06% mom (+3.0% yoy). Loans improved for general commerce (+2.9% mom), transport (+1.2% mom), business services (+2.4% mom) and housing/bridging loans (+0.6% mom). We tip 2017 bank loans at grow 1% yoy, which will be a significant improvement for the -1% yoy seen for Jan-Nov16. This is predicated on a gradual rather than abrupt interest rate adjustment path.

Nevertheless, the upward pressure in domestic short-term interest rates come at a potentially tricky juncture as the domestic labour market has already shown signs of softening. Layoffs in the first nine months of 2016 rose 34% on-year to 13,730, albeit still below the 21,210 seen in 2009. While the 3Q16 unemployment rate was unchanged at 2.1%, we could see further easing in labour market conditions in 2017. The Manpower survey for 1Q17 suggested that the net employment outlook was unchanged at 8%, with the most optimistic sectors being finance/insurance/real estate (15% versus 22% a quarter ago), followed by transportation/utilities (13% versus 6%), and manufacturing (9% versus 7%), whereas the most pessimistic sector was the wholesale/retail trade (-3% versus 0%). Notably, some softening in hiring intentions were also visible for the services sector (9% versus 16%) and even public admin/education (8% versus 10%) which had been key supports for the job market to-date.

Domestic confidence may continue to ease amid the myriad external and domestic challenges. The SBF-DP SME sentiment index has hit a record of 49.8 in 4Q16, marking the first time it dipped below 50 in its 7-year history. Notably 5 of the 6 industries, with the exception of Business Services, saw a negative outlook for 1H17. The National Business Survey for 2016/2017 also highlighted that businesses expect rough waters in 2017, with 63% saying that economic climate worsened in 2016, and 48% believing that 2017 will be even worse. The key challenges they flagged remain operating costs and manpower issues. As such, companies are looking for measures to assist with manpower issues and lower government compliance costs

The wish-list for the upcoming FY17 Budget (due for release on 20 February) may continue to grow given the potential double-whammy of rising interest rates and a still sluggish economic environment. However, given that the Singapore economy is neither in a technical nor outright recession, the policymakers may prefer to take a calibrated approach and not pull out all the big guns yet. While we think fiscal policy can be more accommodative, with a modest deficit penciled in for FY 17, the lift to the domestic economy is likely to be limited given the import leakages. Similarly, the Committee for Future Economy (CFE) may focus more on medium-term strategic thrusts like building corporate capabilities, innovation and skillsets to support future growth industries.



Source: Bloomberg, OCBC Bank

Slow and Steady

Steady ship in rocky waters

Global economic conditions proved to be very rocky in the year 2016 – numerous political events shook investor sentiments from starkly unexpected results especially that of Britain's vote to leave the European Union. Moreover, global economics was plagued by the sudden slow-down in its external environment, owing to the slowdown in China's trade numbers and the very low oil price. Elsewhere, the rise of inward-looking and protectionist policies had invariably gave market-watchers another reason to fret; these policies may lend more pessimism into 2017 particularly in the areas of external trade and overall confidence in time to come.

Many Asian economies suffered negative repercussions owing to the said drivers, including Thailand. Thailand in fact had faced pockets of negative trade prints throughout 2016, largely owing to lower commodity prices such as rice, rubber and sugar, but also in its industry component where contractions in electronic exports and vehicles were observed as well. However, Thailand can boast of one strength that many Asian economies do not have: its stellar appeal for tourism arrivals, which directly contributes tourism spending and its exports in services activities. The fervor in propping up economic performance by government spending, including that of key public infrastructure projects including transportation systems has also given investors another reason to cheer and stay invested in Thailand. Elsewhere, its relatively sizable domestic market will serve as a cushion against potential economic shocks.

These are the reasons that Thailand should see similar growth patterns into 2017, even when uncertainties continue to prevail. Still, Thailand is still very much veined into the bloodstream of the global economy; sustained slowdown in trade especially if oil prices remain low amid a potential breakdown of trade pacts including the Trans-Pacific Partnership agreement. In our view, Thailand's economic growth in 2016 is very likely to print around 3.2 – 3.3%, a remarkable level even during these uncertain times. Growth is likely to print marginally better in the next year, potentially at 3.3 – 3.7% clip depending on how trade and tourism perform into 2017.

Three strong pillars, two otherwise

Throughout the test of time, Thailand has always boasted of three key pillars: (1) its infrastructure spending which gives further economic support to overall growth, (2) unfaltering tourism arrivals even in the midst of political/social distress, and (3) strong private investment growth given its emerging economy status and relatively healthy growth potential.

Going into details, we are comforted as well by Thailand's recent data in 3Q16: Thailand's private consumption has expanded at an acceptable clip of 3.5% in 3Q16, supported by higher agricultural production and farm income, as well as spending in durable goods such as passenger cars (+11.0%) and motorcycles (+17.8%). The increase in durable goods spending is extremely comforting, as it clearly reflects better income levels and overall consumer confidence in the health of the economy, as reflected in the consumer confidence index of 62.3 (up from 61.1 in the previous quarter). Tourism arrivals also aided in this print, as consumption growth was also supported by the increase in VAT in hotel and restaurant spending. All-in-all, tourism receipts in 3Q16 printed a whopping 17.1% growth (THB447.71bn), with the number of tourism arrivals growing by a similar clip of 13.1% (8.23 million persons). Lastly, value of projects applied for investment rose by 22.7% (THB65.4bn) while those approved recorded 50.2% (THB380bn), suggesting continued interest by both domestic and foreign investors.

Despite these pillars, Thailand has since seen the crumbling of two traditional pillars that once aided growth; specifically, the goals of "facilitating export growth acceleration" and "assisting farmers" as stated by the National Economic and Social Development Board (NESDB) may see further hiccups into 2017.

Recent data reflecting poor trade numbers, amid sustained uncertainties into 2017's trade environment, does raise concerns on Thailand's external environment. Exports of goods did print a positive growth rate in 3Q16, its first expansion in seven quarters. Nevertheless, export volume remained in contraction territories, led by declines in agricultural export products. The negative spillover into its manufacturing sector is observed as well, given that the growth in the manufacturing sector that has 30 – 60% export share, has declined by a worrying 4.1% in 3Q16. Elsewhere, while we are comforted by Thailand's efforts to alleviate farmers' income levels seen especially from state loans to rice farmers, there still persist the structural problem of overproduction given the reluctance (and inability perhaps) of farmers to switch their traditional farming expertise to other forms of produce.

Revisiting politics again

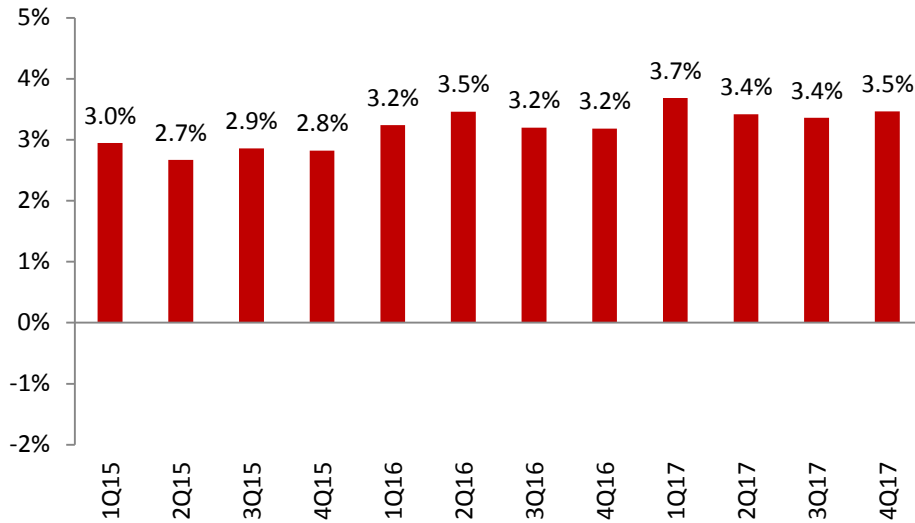
Amidst many political events in the global arena, Thailand's very own political arena has been a focal point through the last two years owing to military takeovers and outbreaks of civil unrests and dragging growth. Still, ever since the referendum on military-drafted constitution, which clocked 61% in approval vote by the public, there have been no signs of unrests. At least from the eyes of the market-watchers, the vote for the constitution is a proclamation of trust that the constitution will restore stable, clean politics as claimed, and the overall public's desire for political stability.

Into 2017, should the roadmap be adhered to, Thailand would also see its very own general election then. Though in-depth details surrounding the election are not known at this time, the election might be a test of political stability, and public confidence, owing to the fact that past elections had been hot grounds for civil unrests.

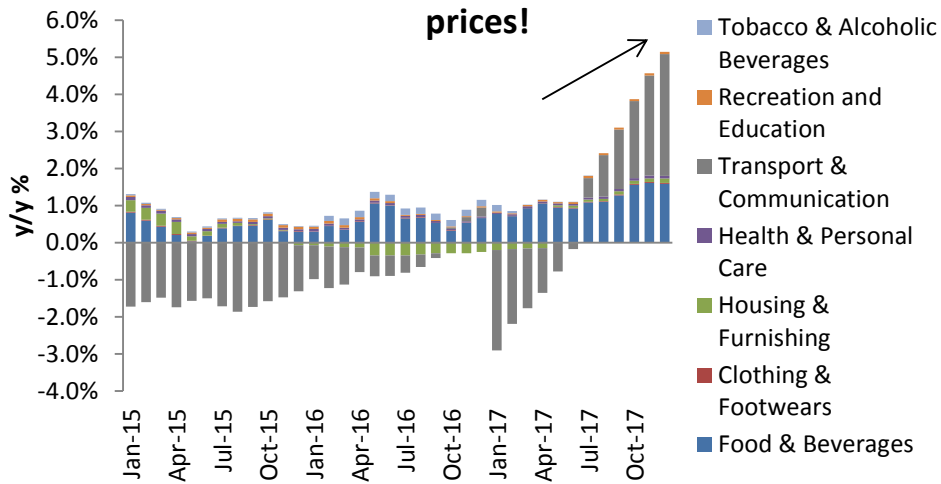
Growth outlook into 2017

Given Thailand's strong fundamentals seen in its tourism industry, domestic consumption and investment trends, growth is likely to be marginally better at around 3.3 – 3.5% in 2017, in line with NESDB's projection of 3.0 – 4.0% growth, though downside risk may persist especially if the external environment stays lacklustre. Elsewhere, with potentially higher oil prices, headline inflation is likely to pick up to 1.5% in 2017 as well. Moreover, even in the face of downside risk, Thailand still enjoys both monetary and fiscal space to support economic growth; the Bank of Thailand has persistently left interest rate unchanged at 1.50% in an effort of preserving monetary space, an endeavor that may prove useful should growth turn south. Should the adverse not come to pass, the central bank may well raise rates marginally by 25bps in the later part of 2017 on grounds of limiting interest rate divergences amid positive growth prospects.

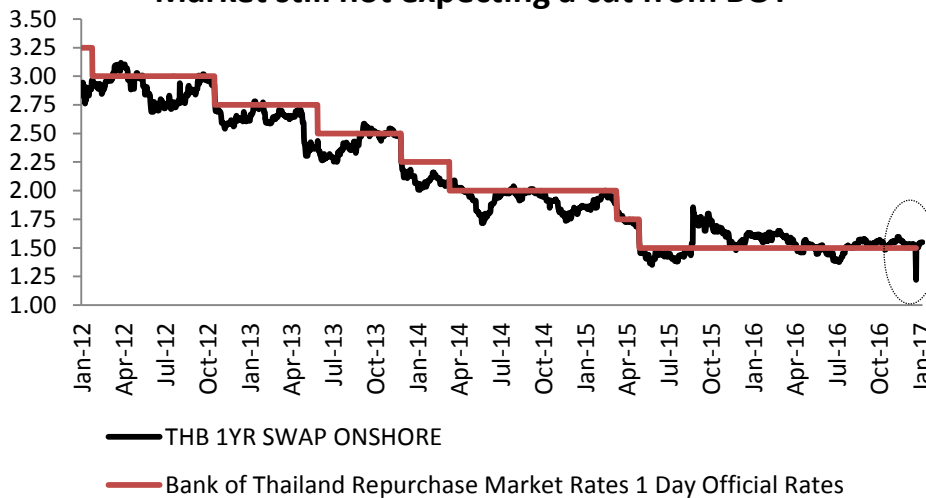
Headline GDP



Thailand inflation: Watch out for higher oil prices!



Market still not expecting a cut from BOT



Source: OCBC Bank, Bloomberg

What to expect next?

The target is high and challenging

The second half of 2016 saw the State Bank of Vietnam (SBV) trimming its growth target from 6.7% to a lower range of 6.2-6.5%. Similarly, the Asian Development Bank followed suit, downgrading its full year 2016 forecast for the Southeast Asian country from 6.7% to 6.0%. Despite the dampening outlook, Vietnam still grew at a healthy 6.4% in 3Q16, coming just a notch behind China's GDP of 6.7% in the same quarter. As we dive deeper into Vietnam's numbers, a mild recovery in agriculture production into 2H16 can be observed, especially after the sector delivered a disappointing production due to unfavourable weather conditions in the first half of the year.

For 2016 to achieve a full-year growth of 6.2-6.5%, the economy has to expand by at least 7.1-7.3% in the last quarter of the year. Despite Vietnam being an outperformer in EM-Asia, we tip that 4Q16 GDP will come in at 6.3%, thus averaging full-year growth to reach 6.0% and missing the official forecast given the high base effect in 4Q15 amid a hampered agriculture industry seen given poor weather conditions. Still, we find comfort in a healthy set of indications; year-to-date export growth have already clocked 7.5%, in line with latest government's target of 8.0%, while credit growth is likely to print 17.8% in 2016, according to latest government projections, Just as how Prime Minister Nguyen Xuan Phuc has put it, "The (GDP) target is high and challenging..."

Elsewhere, according to the National Assembly's Economic Commission, headline CPI is expected to end 2016 at 3.14% yoy, well below the government's target of 5.0%. Based on our forecast model, we expect inflation to come in a tad higher at 3.3% in 2016, largely due to a low base year in 2015 and higher oil prices seen at the end of the year. We project 2017 inflation to tick even higher to 3.8%, attributed to a potentially rosier global growth outlook and a rally in oil prices (forecast at end 2017: \$65/barrel)¹.

As we look into 2017, there are potential downside risks to Vietnam's economic growth. We present three key concerns in the external environment, be it from Trump's inward looking stance, China's slowdown or the rise of populism in EU.

Exports: Not all bright

Despite a set of healthy indicators, Vietnam is also victim to the weak external environment seen in most Asian countries, prompting the country to downgrade its export growth target from 10.0% to 8.0% in 2016. Into 2017, further downside risk to trade may persist given China's growth slowdown to our estimate of 6.2% in 2017 (2016: 6.7%), especially as China is Vietnam's second largest trading partner. Elsewhere, tough competition in the agro-forestry and fishery products from Thailand and India will also limit growth of the export industry. To exacerbate matters, currency depreciation seen across many Asian countries of late had pressured the competitiveness of Vietnam's exports.

¹ OCBC 2017 Commodities Outlook

All-in-all, Vietnam's status of an export-oriented economy, with exports accounting for 83.8% of GDP, the downside risk to its external environment tops our key concern for its economy.

On top of the relatively weaker export environment that Vietnam faced over the last year, the country may need to contend with further challenges especially in a post-Trump world. Indeed, the only certainty that the global trade has is, uncertainty. Given the US President-elect's past inward-looking rhetoric, the world might come to witness a rise in protectionism in time to come, hence contributing much uncertainty to an export-oriented Vietnam. With the TPP likely to be revoked once Trump takes office, Vietnam might see some setback in its plans to expand its export industry. Having signed the TPP in February with 12 other countries, Vietnam was initially hoping to see breakthroughs in its exports of textiles, garments, seafood and other products. Furthermore, the TPP was meant to knit the Asia-Pacific region into one free trade region, creating more business and FDI opportunities for Vietnam.

However on a brighter note, the Minister of Trade and Industry has reiterated Vietnam's commitment to integrate herself into the global world, with or without the TPP. In the case that TPP gets revoked, the good news is that Vietnam is still involved in various FTAs with trade partners like the European Union and Eurasia Economic Union. Furthermore, Vietnam can still take full opportunity of the Regional Comprehensive Economic Partnership (RCEP) with China and other ASEAN member states to promote and expand its trade industry.

Fiscal Deficit: Growing Risk

Another concern market-watchers may have, is the country's persistent budget deficit since 2003. In recent years, the deficit has been expanding, with no signs of improvement. In 2015 alone, the deficit has increased by 14% to take up 6.1% of the country's GDP. As we look into the spending part of the equation, Vietnam's recurrent expenditures was especially striking as it took up two-thirds of the government's annual spending. Recurrent expenditures include spending on security and defence, wages and salaries and other payments made by the government. To exacerbate this problem, Vietnam's involvement in the South China Sea might point to an increase in its defence spending for years to come. On the revenue side of the story, Vietnam has also proved to be incapable of matching its revenue to its spending. As Vietnam participates in an increasing number of FTAs which often require trade tariffs to be lowered, the country has been seeing a drop in its revenue from import and export duties. This decline is expected to trend into the future as Vietnam continues to promote free trade and open up its economy. Hence for Vietnam to turn things around, it is crucial for the country to work on its productivity level for more efficient spending, instead of discretionary spending.

Labour productivity: More improvements needed

In 2015, overall labour productivity growth increased by 6.4% yoy in terms of purchasing power parity basis. Despite seeing a healthy growth over the years, Vietnam's labour productivity level is still lagging behind other ASEAN countries. To meet the 7-8% growth target in 2020, Vietnam will have to see further improvements in its productivity growth. Since 1990, World Bank has continuously rated Vietnam's workforce as one of the least competitive one amongst both the ASEAN and Asian region. In a 2015 report, the World Bank has given a 3.39 score (out of 10) for Vietnam's productivity level, the lowest rating in 15 years. Vietnam's productivity level is now amongst the lowest tier in the ASEAN region, being only one-fifteenth than that of Singapore's and one-fifth of Malaysia's.

Furthermore, Vietnam is not immune to the issue of an increasing ageing population. In a report by World Bank, the country has an estimate of 7% of its population aged 65 years and over. This percentage is expected to double to 14% in 18 years. As a comparison, Indonesia will take 20 years to reach the 14% proportion, China will take 25 years and the US will take 69 years.

However, it is worth noting that Vietnam has already been working on these problems in its latest "Vietnam 2035 Report". The report, an initiative by the Vietnamese government and World Bank, has identified

“improving productivity” as one of the key focus for the country should they want to reach the upper-middle-income status. Some of the recommendations in the report include improving the efficiency of the agriculture sector and also the infrastructure of the country. The Minister of Planning and Investment has also suggested the country to move employees out of low value-added jobs in the agriculture sector into the manufacturing sector, in order to raise productivity.

Don't worry: Manufacturing is here to save the day

Still, the manufacturing sector remains an engine for growth. Industrial production has recorded a 7.6% yoy increase in 3Q16, as manufacturing led the gain with a double-digit growth. On top of this stellar performance, November's Nikkei PMI came in at an 18-month high of 54.0. For the last 3 years, Vietnam has mostly stayed in the above-50 territory, where 50 is the threshold that separates expansion from contraction.

The success in the manufacturing sector can be mainly attributed to two factors – low wages and an increase in FDI. In 2015, the average wage for workers in the manufacturing sector was at an estimate of US\$190/month. As a comparison, manufacturing workers in China, Vietnam's low cost competitor, earn an average of US\$257.82/month while workers in neighbouring countries like Thailand earn US\$347.75/month. The relatively low wages in Vietnam have made the country a top pick for foreign investors who are looking to relocate their business for cost saving purposes.

Apart from low wages, an increasingly open economy has also aided in the progress of Vietnam's manufacturing sector. To further boost the flow of FDI into the country, foreign investors are exempted from import duties on certain goods (like machineries and equipment that cannot be found in Vietnam) and most export duties. This has given a tremendous push to the textile and garment industry as FDI in the sector rose. In 2015 alone, the said industry has provided 2.5 million jobs in 6000 factories across the country.

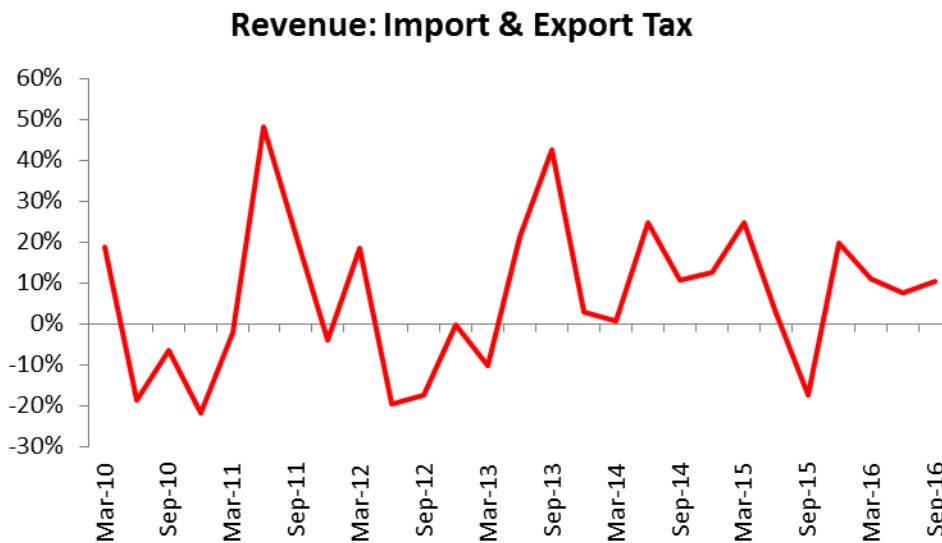
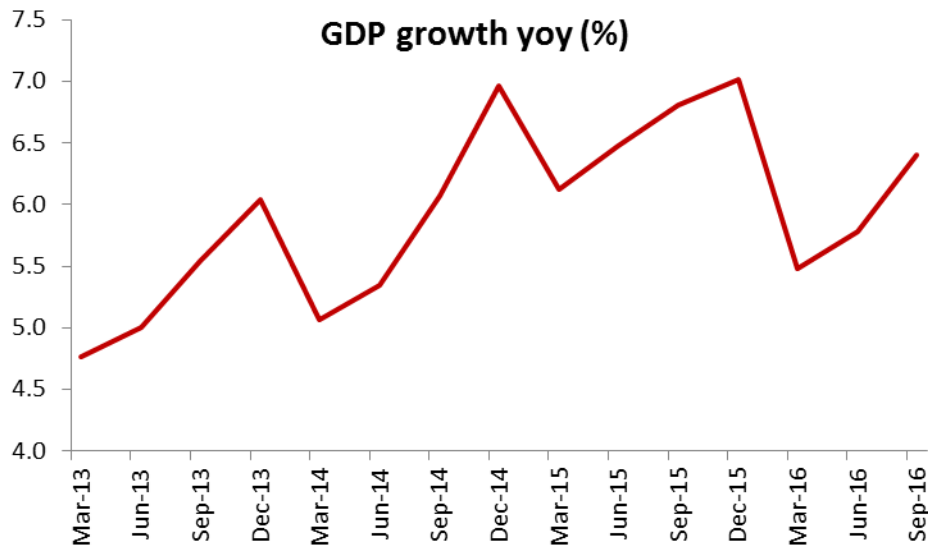
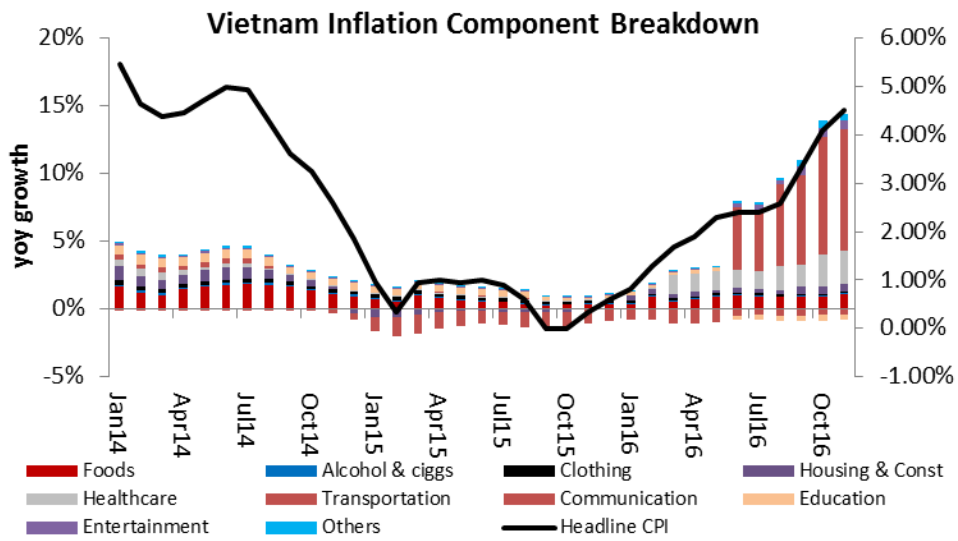
Notably, Vietnam has been making her step to venture out of low value-added production. More FDI can be seen moving towards the electronic industry while exports from the sector have also increased to US\$1.6billion in the first two months of 2016, according to Vietnam Customs. With electronics big players like Panasonic and Microsoft relocating to Vietnam, the electronic industry may be the next bright spot in Vietnam to look out for in time to come. With Vietnam's economic reforms and an increasingly stable political scene in the country, Vietnam might prove to be an appealing destination for foreign investors to relocate their manufacturing processes over to the export-oriented country.

What to expect next?

On the back of an uncertain global political economy, Vietnam may meet some hurdles in its route to promote trade and open up its economy. However, we opined that Vietnam's determination to integrate itself into the global economy is not going to be disheartened by the potential breakdown of the TPP and other geopolitical risks. Currently, Vietnam has 9 FTAs in effect, 1 FTA waiting to be enforced and 5 other FTAs that are in the negotiations phase. With all these agreements, we believe that the export industries will be spurred to greater heights, becoming one of the main pillars of support for the economy.

That said, to achieve the upper-middle-income status by 2035, Vietnam will no doubt have to work on its productivity and efficiency level as the country find ways to move out of low value-added industries.

In summary, it will be challenging for the economy to reach the government's growth target of 6.7% in 2017. To attain the target, the manufacturing sector has to continue to chug on. However, there might be some downside risks to the sector should US start turning inwards and away from Asia. Hence, we tip that the economy will grow between 6.2-6.5% in 2017, just shy of Vietnam's official target of 6.7%.



Source: Bloomberg, CEIC

The impact of trade protectionism on China

The appointment of Peter Navarro as the head of newly established National Trade Office shows that President Elect Trump’s “America First” is no longer a slogan but an attitude. The National Trade Office, which is dedicated to manufacturing within the White House for the first time, is expected to bring the US trade deficit down. Whether the new Trade Office will be equipped with real power or just a symbolic establishment remains to be seen. However, the new appointment of a hard core China hawk signals that some kind of increase in trade barriers for Chinese exporters is almost inevitable in 2017 under Trump administration. As such, we will discuss the impact of the possible trade protectionism on China in this report.

Not all bad news

The impact of Trump’s policy plan for the first 100 days is rather mixed in our view. In fact, Trump’s fiscal stimulus package and his plan to cut tax are positive for US growth. OECD became the first major multinational organization to revise the global growth up in late November after Trump’s promise to increase spending and cut taxes. We think the increase of aggregate demand as a result of Trump’s stimulus policies is likely to boost China’s exports. Without taking Trump’s protectionism into account, we actually expect China’s export in dollar term to grow by about 3.0% yoy in 2017 after an estimated 6.0% yoy decline in 2016.

Protectionism risk is real

Trump has vowed to withdraw from the 12-nation Trans-Pacific Partnership on day one of his presidency. Meanwhile, he is also determined to bring down the widening US’s trade deficit with China. According to data from US customs, the US’s trade deficit with China has widened to US\$366 billion in 2015, accounting for almost 48% of total US’s trade deficit. Meanwhile, the trade deficit with China as percentage of GDP rose to a record high of 2.03% in 2015. As such, it is not difficult to understand Trump’s motivation to reduce its import reliance on China.

Chart 1: US’s trade deficit with China continued to widen

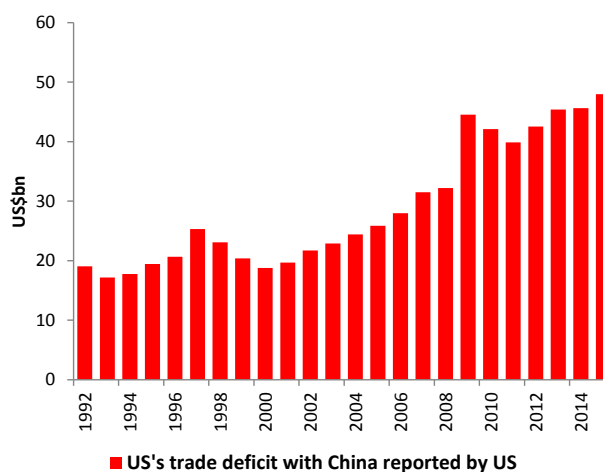


Chart 2: Trade deficit as a % of GDP also expanded

Source: Bloomberg, OCBC Bank

So far, the key threats from Trump to China include a 45% import tariff and to label China as a currency manipulator. Let's look at the currency manipulator first. We think the hurdle for Trump to name China as the currency manipulator is pretty high. According to the definition, the US Treasury is only allowed to name a country as the currency manipulator when a country meets all three criteria including 1) a large bilateral trade surplus with US, 2) large current account surplus with the rest of the world and 3) direct intervention in order to weaken currency. Given that China's current account surplus as percentage of GDP has fallen back to below 3% and recent intervention in the foreign exchange market has actually been to slow down the depreciation of RMB, China probably meets only one of the three criteria. As such, it is difficult for Trump to name China as the currency manipulator in our opinion.

Compared with the currency manipulator, a unilateral trade tariff is more likely. Although the extreme case of 45% tariff seems unlikely based on the current clue, the probability of 5-10% tariff on imports implemented via President executive action or as part of tax reform cannot be ruled out. This may create disruption to the bilateral trade.

Looking at the breakdown of US imports from China. The share of low value added manufacturing products, such as apparel, furniture and footwear, in US's imports from China has fallen steadily to about 31% in 2015 while share of imports of machinery and transport equipment has increased to 51% in 2015. Given the relatively thin margin and easy replacement, the imposition of trade tariff may have significant impact on this part of trade. Nevertheless, the tricky thing is that hiking the tariff on imports of low valued added manufacturing products from China and Mexico may not serve the purpose of bringing the jobs back to the US as the demand will simply be diverted to other low cost nation such as Vietnam. As such, we think it may be difficult to hike tariffs on only one or two countries. Should Trump's economic team apply the tariff to imports from other countries, this may help dilute the shock to Chinese exporters.

Chart 3: Imports of machinery and transport equipment from China has increased significantly

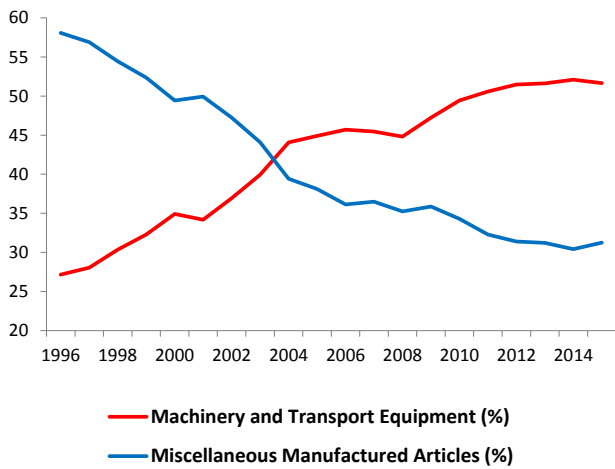
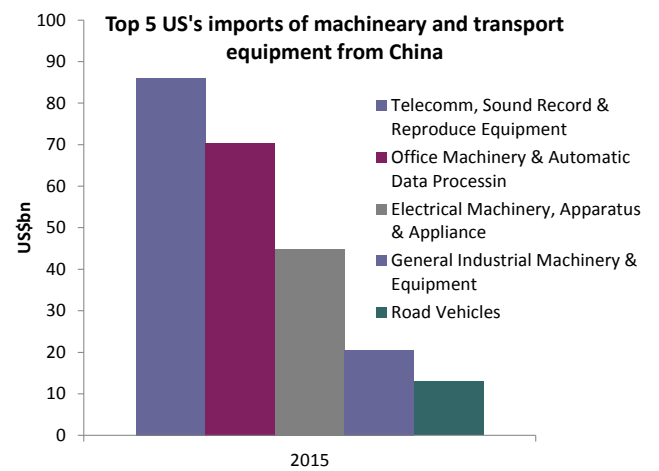


Chart 4: Top 5 US's imports of machinery and transport equipment from China.



The US's imports of machinery and transport equipment reached US\$248.9 billion in 2015; accounting for a quarter of US's demand. For the breakdown, US's top three imports of machinery equipment include 1) Telecomm, sound record and reproduce equipment, 2) office machinery and automatic data processing equipment and 3) Electrical machinery, apparatus and appliance. For the top 2 products, China has dominated the US market. The imports of telecomm, sound record and reproduce equipment from China took 54% of market share while the imports of office machinery and automatic data processing equipment took 60.4% of market share in 2015. This suggested that those products are not easy to be replaced. A tariff may run the risk of passing the cost to end consumers.

Chart 5: China accounted for quarter of US's imports of machinery and transport equipment

Shares in US imports of total machinery and transport equipment

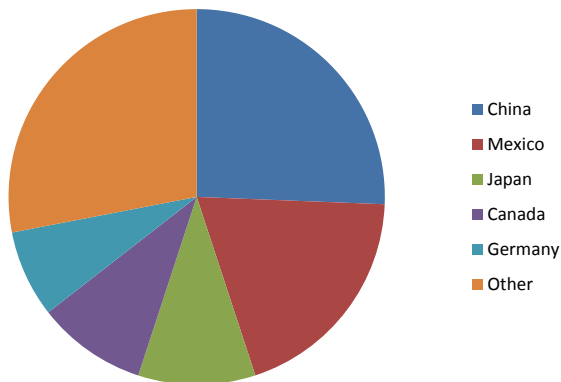


Chart 6: China dominated US's import of Telecomm, sound record and reproduce equipment

Share in US imports of Telecomm, Sound Record & Reproduce Equipment

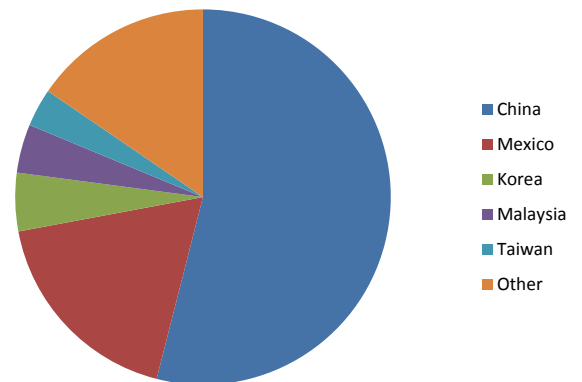
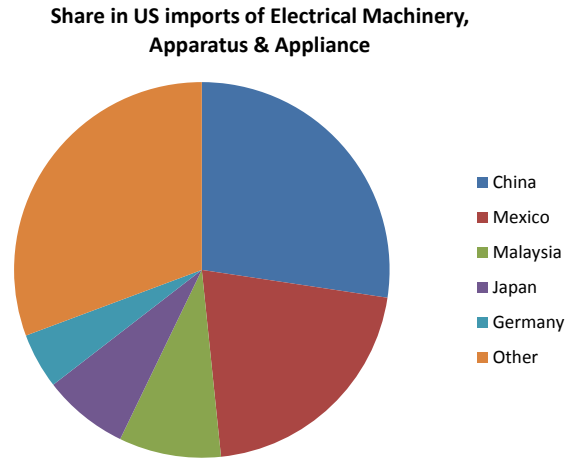
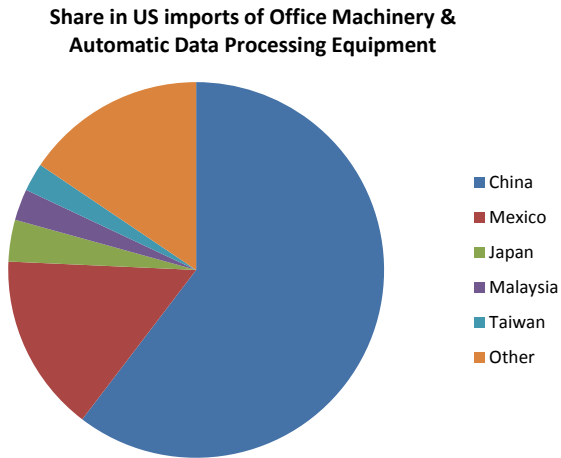


Chart 7: China dominated US’s imports of office machinery and auto data processing equipment

Chart 8: China accounted for slightly more than quarter of US’s imports of electrical machinery and appliance



To conclude, the declining share of those low valued products in China’s exports to US may suggest that China is less vulnerable to the trade war compared with before. In addition, the upgrade of value chain to more high value added machinery equipment also suggests that China may divert its exports to other part of the world to counter the impact of trade war with the US. As such, we estimate the net impact on China’s total exports could be less than 5%.

US ENERGY INDEPENDENCE

The prospect of energy independence

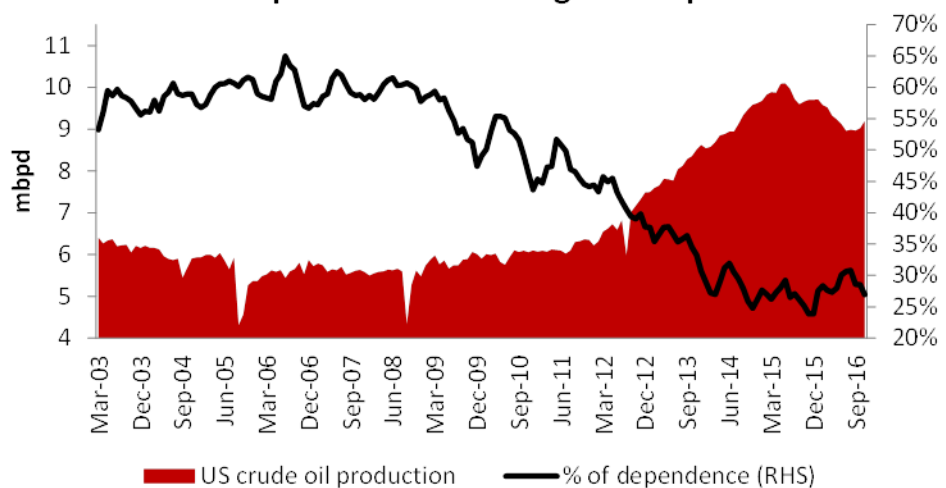
Political promise

In the lead up to the United States presidential election in November 2016, presidential candidate Hillary Clinton declared that the U.S. is “now, for the first time ever, energy independent.” This comment naturally generated headlines and raised eyebrows, thus leaving market-watchers wondering if the rise in oil production in recent years has indeed negated the country’s dependence on foreign oil supply. Our findings suggested that while the U.S. is indeed self-sufficient when pertaining to coal, natural gas and renewable energy sources, the net imports of petroleum from foreign countries were still equal to about 27% of oil-related consumption in November 2016.

Still, the level of reliance on foreign crude supplies has fallen sharply from 65% of total consumption seen ten years ago in 2006, as the shale oil and gas revolution has made the formerly idealistic goal of U.S. energy independence close to reality. Given the pace of production growth, the U.S. is likely to be a much smaller importer of oil in the future, in line with what President-elect Donald Trump’s promise to acquire “complete” independence from foreign sources of oil.

Still, the fact that the U.S. still relies on foreign crude oil supplies for roughly a quarter of domestic needs, or about half what Saudi Arabia is producing, remains daunting. Given the current pace of production growth, amid the relatively thirsty oil consumption patterns in the US, the prospect of energy independence can be achieved only by the rise of alternative energy, coupled with a substantial boost of domestic oil supply in the U.S. In our view, the path of ‘complete’ energy independence, reiterating what Donald Trump may be promising, may only be achieved beyond the year 2040, given the pace of oil production and the relatively sluggish advance of alternative energies.

US dependence on foreign oil imports



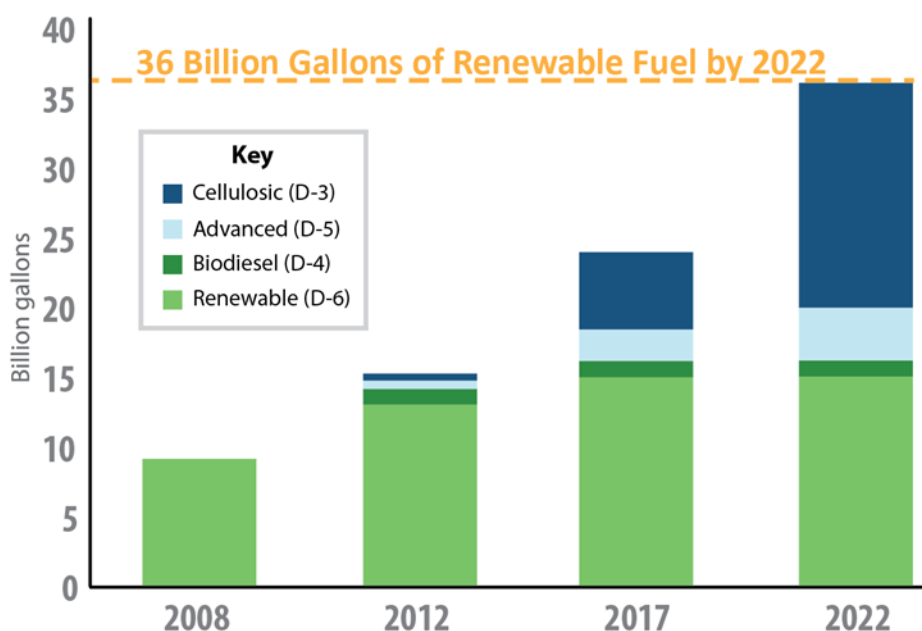
Source: Bloomberg, U.S. Energy Intelligence Agency, OCBC Bank

10 years since EISA

The goal towards energy independence had arguably taken concrete form with the Energy Independence and Security Act (EISA) of 2007, which aims to improve vehicle fuel economy, promote the supply of renewable alternative fuel sources, and eventually reduce U.S. dependence on petroleum.

Since then, the statistics pertaining to the pursuit of energy independence is astounding to begin with – U.S. oil production levels have leapt from 2010’s tepid 5.5 million barrels per day (bpd), to the historical high of 9.6 million bpd in 2015. Much of the increase is contributed by the shale oil production boom seen since 2010, with shale oil supply as a percentage of total U.S. oil production increasing to almost 60% in 2016, up from a mere 24% seen ten years ago. Into the year 2040, the U.S. Energy Intelligence Agency (EIA) forecasts that oil production will increase to 18 million bpd under its ‘High Oil and Gas Resource’ scenario, compared to 11 million bpd under its reference case. Still, under both scenarios, U.S. oil production is expected to rise gradually for many decades to come.

Congressional Volume Target for Renewable Fuel



Source: US Energy Intelligence Agency

Elsewhere, crude oil consumption has fallen since the enactment of EISA, with consumption falling from as high as 21 million bpd to roughly 19.6 million bpd averaged 2016 year-to-date. The fall, which also coincides with the global financial crisis, could have also been driven by other acts including the Renewable Fuel Standard Program (2007) which requires the use of renewable fuel to replace or reduce the consumption of petroleum-based transportation fuel, while aiming to blend a total of 36 billion gallons of renewable fuels with gasoline and diesel by 2022. Elsewhere, a law pertaining to fuel consumption, or as known as the Corporate Average Fuel Economy (CAFE) regulation, serves to increase the fuel economy of cars and light trucks, and will expand to phase 2 for medium and heavy duty vehicles in 2018 – 2027. This initiative is expected to reduce oil consumption of up to 2 billion barrels over the said ten years period while reducing carbon emission.

US crude oil consumption has fallen over the last ten years



Source: EIA, OCBC Bank

The move towards higher oil production and relatively lower oil consumption has eventually led to the ballooning of U.S. oil inventories: U.S. oil inventory levels have leapt-frogged by more than 160% to amount over 500 million barrels over the past ten years, in which ballooning inventories and the efforts of lobbyists persuaded the end of the 40-year U.S. crude oil export ban back in March 2016. The sudden surge in oil production seen ten years ago, subsequent ballooning of inventories, and eventual lifting of the U.S. crude oil export ban earlier this year is of no coincidence however; the move towards the goal of achieving energy independence was crafted under the Energy Independence and Security Act (EISA) in 2007, an endeavor to “move the United States toward greater energy independence and security”.²

The rise of alternative energy sources

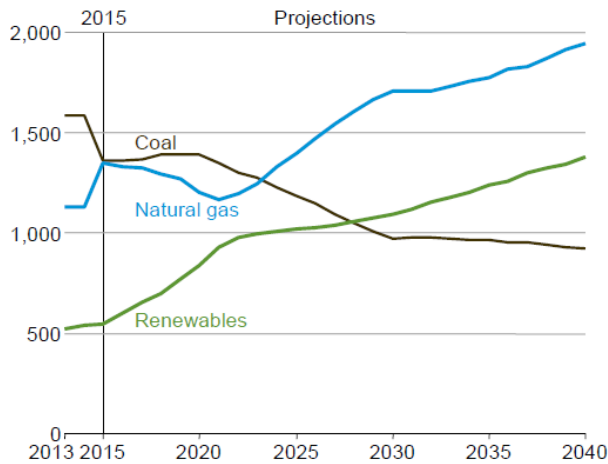
Still, the argument for energy independence is far broader than that of independence from foreign crude oil supplies; the promotion and subsequent use of alternative energy supplies can also effectively limit the consumption of traditional energy sources such as coal and fossil fuel.

Alongside the Energy Independence and Security Act back in 2007, the laws and regulation specifically in the U.S. Environmental Protection Agency’s Clean Power Plan (CPP) promotes efficient use of energy, and promotes the use of advanced technologies to reduce electricity generation mix. In a nut-shell, CPP mandates states to reduce carbon dioxide emissions from existing fossil fuel generators and the introduction of tax credits for wind and solar energy. According to estimates by the U.S. Energy Intelligence Agency (EIA), natural gas-fired electricity generation is expected to increase by 26% in 2030, and 44% in 2040, while generation from renewable energies to increase by 152% in 2040.

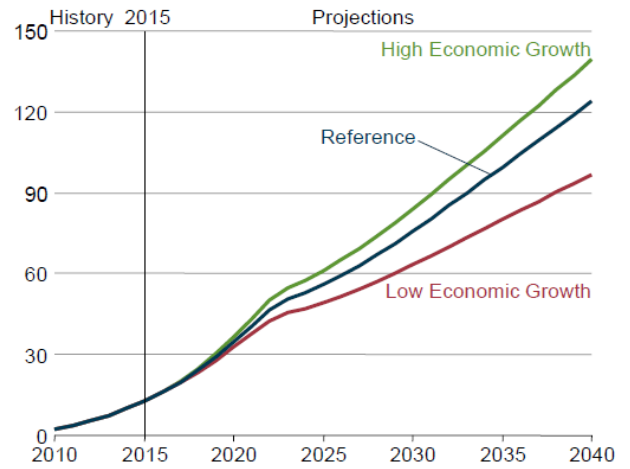
With the focus towards the use of natural gas, there is a direct impact on crude oil production. The production of energy from resources in shale gas and tight oil plays has grown over the years. Into the next couple of decades, the EIA estimates crude oil production to grow to 11.3 million bpd to 2040 on assumption that crude oil prices rises to more than \$130 per barrel then, which much of the gains from shale oil production at 7.1 million bpd (or 62.8% of total production) in 2040. As for natural gas, the increased production would, in EIA’s estimation, allow the U.S. to become a net exporter by 2029.

² Summary of the Energy Independence and Security Act (2007), <https://www.epa.gov/laws-regulations/summary-energy-independence-and-security-act>

Net electricity generation from coal, natural gas and renewables



Electricity Generation from solar power



Source: U.S. Energy Intelligence Agency (EIA) – Annual Energy Outlook 2016 report

Look beyond 2040

Despite the huge production gain seen over the years, US oil import reliance on some 27% of oil-related consumption still amounts to a sizable 5.0 million barrels a day. In order to achieve crude oil independence, the reliance on crude oil as a primary source for petroleum products, heating, and electricity production must decline as natural gas and renewable energy sources takes the front-stage. Fortunately, US consumption of petroleum and other liquids is expected to average 20 million bpd through 2040, amounting to a very small increase from today’s 19.65 million bpd. Should the U.S. manages to increase oil production to its estimate of 11.3 million bpd by 2040, total oil import reliance would fall to as low as 10%. Moreover, taking into account the likelihood for energy exports to accelerate, import reliance may be expunged, turning the U.S. to become a fully energy independent nation by then.

INDONESIA THEMATIC

Qualified Success

Call it a late bloomer. After what was a worryingly slow start, it was as if Indonesia's tax amnesty program received an adrenaline shot in late September 2016 and went on a heady upward rush.

At over IDR 4.1 quadrillion (~USD305bn) as of December 28th, 2016, total assets declared has surpassed the government's lofty target of IDR 4 quadrillion. Within that, onshore assets make up about 72% of the total. Tax take amounts to USD7.7bn, about 60% of the total targeted for tax proceeds of the amnesty program thus far.

The participation rate is unlikely to accelerate from here, as higher penalty rates kick in from January 2017 onward until the amnesty program ends on March 31st. Still, only the most diehard skeptics could claim that this program is no success. Indeed, to us, it marks the start of a silent paradigm shift that would change Indonesia's political economy dynamic for the better.

Looking back, the figure was chugging along unimpressively at first. The amnesty program was launched in late July 2016 but really became effective functionally only in early August. By late August, less than USD5bn of assets was declared, eking out but 1.4% of the government's USD308bn target. It prompted us to wonder if the government needed to tweak things more, including allowing for instalment payments of penalty rates, to make things more palatable for would-be participants

As it turns out, our cold sweat was for nothing.

The participation rate started to pick up pace in early weeks of September, and by the 16th of the month, nearly USD90bn was in. However, it was really over the past two weeks that the run-rate, well, ran up.



Source: Ministry of Finance, OCBC

Why the sudden heady rush? In some ways, the same reason why young school kids find a sudden urge to finish their homework – and that is the motivational power of deadlines.

Even though the program is open until March 2017, the penalty tax rates are the lowest at 2-4% as long as the participants slot their applications in by September 30th. While they can still participate later on, the rates go up to 5-10% if they wait further.

The magnitude of the uptick also alludes to the increasingly robust participation of the wealthier folks. Helped by active nudges by those in power – including over a dinner at the presidential palace last week that yielded a wealth of interesting group photos in the local media – the who's who of Indonesia's top business circle began to toe the line, declaring not only their verbal support but their hitherto neatly hidden assets, as well.

Such enthusiasm has trickled down too, with long lines of common folks forming at tax offices around the country. The logical thinking must have been that, if the supposedly politically connected big shots are throwing in the towel and joining the amnesty program, then perhaps it is wise to follow the current rather than be left vulnerable to waves of audits and punitive probes later on.

In aggregate, all these have added up to an impressive lot. At the time of writing, the total assets declared amount to IDR 4136 tn (~USD 305bn). The majority (72.4%) of it comes from onshore assets, followed by offshore assets that are opting to stay offshore (24.2%), and just 3.4% of offshore assets repatriating.

Among these figures, the fact that repatriation rate of the offshore assets is low will no doubt be snatched upon by skeptics out there to argue that the program has not been a success. We beg to differ, however. To begin with, there is the suspicion that some of the offshore assets might have been repatriated before the onset of the program, to avoid the three-year lock-up period. Given that the capital flow checks and controls would have been porous enough for the money to flow out to begin with – and thus as prone to undetected reshoring – that is not an inconceivable possibility. Moreover, we should not forget that, having been declared in black-and-white terms now, the still-offshore assets could eventually go back in formal ways depending on the risk-reward calculations of the owners. Ultimately, as we have said before, given the dire state of global returns, the appeal of investments in Indonesia would be standing out more and more in relative terms.

Overall, how would the recent uptick in tax amnesty participation affect the economy? In the near term, here are some of the things we are likely to see.

First of all, somewhat ironically, economic growth might take a breather. This is because the act of paying for the penalty tax rates – while arguably quite low – is going to drain liquidity from the population at large in the near term. Eventually, the money that the government has collected would of course flow back to the economy and it's a matter of left pocket vs. right pocket from the perspective of overall national accounts. Still, it takes time. After the initial dip, however, the fact that a lot of the asset owners have come clean would give them not just a sense of relief, but also the openness to make big ticket item purchases that they held back from doing when they feared getting the wrong kind of attention from tax authorities. The real game-changing element of this program is over the longer term, however. We have touched on the idea of how the amnesty initiative would be a boon to Indonesia's narrow tax base and less-than-developed financial sector before and will not dwell in lengths here.

What is worth thinking about too, and much less discussed thus far, is the notion that the tax amnesty would shift how the average Indonesian views the government-to-citizenry relationship.

In most advanced countries, citizens are used to paying taxes on their incomes and accept it as part of life – unless, of course, if you happen to be one particularly tax-savvy property magnate cheekily running for

top office to boot. They do, however, in return, expect accountability from the government in terms of how the money is spent. In various forms including through the ballot boxes and policy pressure groups, the citizens then engage in policy discussions and help to shape the priorities of the government, including on the fiscal front. This taxation-and-representation nexus is part and parcel of the maturing process of a democracy.

In Indonesia, that dynamic has been sorely missing thus far. While the democratic system has taken root and has indeed overseen a peaceful transition of power for over a decade now, it is not yet as enlivened by policy-oriented discussions as it could be. Though it is slowly changing, national and local elections appear to be still driven by personalities rather than policies. Now that more people will learn to pay taxes, for the first time perhaps, things should change for the better as Indonesians learn to demand a say in how their money is spent by the government. What it would then do is to ultimately form the basis for a more engaged citizenry, which would in turn force the politicians to battle one another not just in terms of popularity but also policy platform.

Such development would naturally take time, but one day, political scientists would look back at the tax amnesty program as a contributing factor to the development of a more robust democracy in Indonesia. That is also perhaps something positive to think about for Indonesians who have to now get used to the idea of paying taxes by the book.

Housing Market to Be Quiet

A slew of global uncertainties prompted the Fed to halt its rate hike cycle for most of this year. Therefore, banks in HK have been allowed to lower mortgage rates. Adding on property developers' offer of various sweeteners, investment demand has expanded. A more stable labor market than expected also fueled a rebound in end-user demand. Moreover, the spill-over effect of Mainland China's housing frenzy further helped reverse the downtrend in the property market. In anticipation of rising investment demand, the government tightened housing measures to cool the buying spree. This is followed by the increasing expectations of a faster rate hike pace by the Fed amid Trumponomics. As such, higher borrowing costs together with cooling measures are likely to hit the market. But the continuous capital flows from Mainland market and the loopholes of the cooling measures may ease some downward risks.

The first cooling measures since early 2015

Following the last round of tightening combined with heightened concern about Fed's rate hike since last December, residential property price retreated by 11.3% in March from the peak of last September. In addition, transaction volume dipped in February to the lowest since February 2011. However, slower rate hikes pace of the Fed, sweeteners offered by property developers and banks as well as the inflows from Mainland China together have put an end to the correction in housing market. Property price rebounded by 11.9% in October from March while transaction volume doubled in October from the same period last year.

As Chinese authorities unleashed home curbs since late September, this further prompted Mainland investors to buy homes in HK to diversify their portfolios, and in the meantime hedge against RMB risks. Moreover, given subdued corporate sentiment, banks are expected to continue competing for mortgage business before the interest rates catch up with those in the US probably around mid-2017. This is likely to further shore up local housing demand. As such, concern about increasing foreign and local investment demand urged the HK government to cool the buying spree. The government announced to raise the Ad Valorem Stamp Duty Rate to 15% regardless of the residential property value, effective as of 5 November. Only first-home buyers who are permanent residents can be exempted from the new levy

Impact varies on different groups of potential buyers

The new rule mainly dents the investment demand for small- to medium-size flats. For example, for local non-first-home buyers of small units priced at HKD4 million, the tax rate increases substantially from 4.5% to 15%. In comparison, levy on the buyers of larger units priced at or above HKD22 million rises from 8.5% to 15%.

In the meantime, homeowners will be reluctant to sell their property amid the expected decreasing demand and the increasing costs of buying a new home. Due to lower supply, the end-user demand for smaller units will hardly be met. Therefore, the secondary market is likely to be hobbled by the new cooling measure.

On the other hand, the government aims to block Mainland investors by the new

levy. After tightening, the range of tax rate on Mainland buyers moves up to 30%-50% from 23.5%-43.5%. For this group of buyers, however, the desperate need to diversify the portfolio and to hedge RMB risks takes priority over the higher levy, encouraging them to continue entering HK housing market. In addition, some property developers have offered to cut prices or absorb the 15% new tax to lure demand. Therefore, primary market will dominate.

Transaction volume to retreat

Based on historical data, during 2010 to 2015, transactions in the secondary market accounted for an average of 78.9% of total transactions. A shrinking secondary market will therefore translate into housing transaction slump. Additionally, in the three months after each of the last six rounds of tightening, the transaction volume dropped 46% on average. This indicates total transaction volume could plunge by around 50% from the current level in the coming quarter.

Only modest correction in housing prices

In terms of smaller flats, a combination of shrinking demand and tighter supply means that housing prices' correction may be moderate in the near term. With regard to larger residential units, the prices are likely to grow, albeit at a slower pace. Despite tightening measures, three supporting factors include continuous inflows from Mainland market, developers' sweeteners and the new rule's loopholes. Specifically, some investors buy homes under the name of their children who are first-home buyers. Others buy several flats under one agreement. Both cases could help to avoid the new levy, keeping some investors active in the market. Moreover, apart from Mainland buyers, China-based developers' scrambling for HK lands at unreasonably high premium also pushes up the luxury home prices.

In all, we expect a drop of 3% yoy in the average housing price over 2016. In addition, residential rental may hold up as some end-users turn to the rental market. Besides, investment demand may shift to non-residential property market, thereby adding upward risks to the market of car parking spaces and offices.

A mixed long-term picture

In the longer term, increasing new supply (+63% to 193,700 units during 2016-2020 from the past five years) may deepen the correction in home prices. Also, the prospect of the housing market hinges on the pace of Fed's rate hike. Nevertheless, Trump's victory makes the Fed's rate hike trajectory unpredictable at this point. On one hand, should Trump not start any trade war, fiscal stimulus is highly likely to spur growth and inflation. In this case, rates in HK will tick up in tandem with that in the US, thereby increasing the downward risks on the housing market. As such, property prices may fall by 5% to 10% yoy over 2017 as a whole and the transaction volume may shrink about 30% from end of this year.

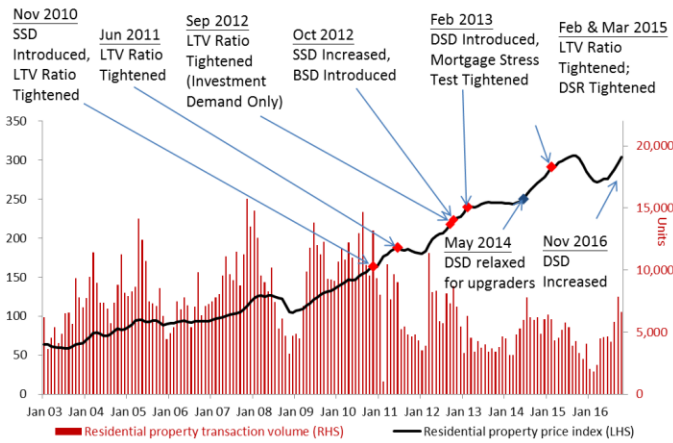
On the other hand, if Trump insists his stance on de-globalization, the rise of trade protectionism may risk a slowdown in the US's economic growth. Even without any trade war, possibility still exists that the US's economic growth on the back of the fiscal stimulus will be unable to offset the impact of a widening fiscal deficit. Any snap-back in the US's economic growth may propel the Fed to hold off on rate hikes. Relatively low rates could thereby help the HK's housing market to weather the impact of cooling measures.

It is not simply an undersupply story

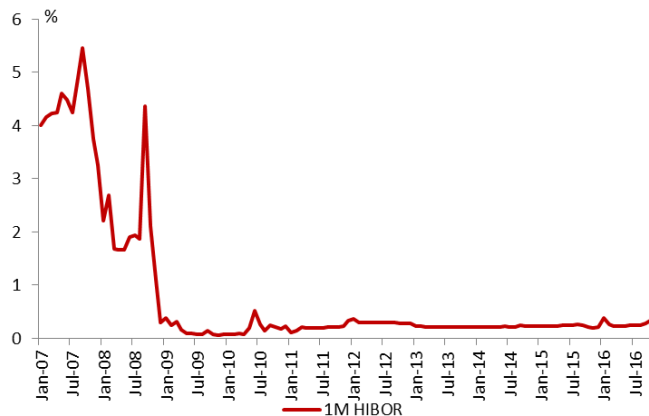
The housing issue in HK, however, is unlikely to be solved by a merely 10% fall in prices on the back of increasing supply, cooling measures or higher borrowing costs. Since Global Financial Crisis, the near zero interest rates has fuelled surge in household leverage. Total household debt rose significantly by 76% in September from end of 2008 and its share in GDP jumped from 51% in 2008 to 67% in 2015. Of the total household debt, residential mortgage loan accounts for 70%. Higher rates ahead mean household debt capacity is diminishing. Worse still, housing affordability in HK ranked the lowest across the globe, according to Demographia International Housing Affordability Survey. Therefore, simply deterring investment demand or adding private home supply does not necessarily help. Instead, the government could take Singapore as a reference and add housing supply mainly with subsidized flats. Meanwhile, the

government should also raise the maximum income and total net asset limits for these flats, in order to meet the huge end-user demand among the lower to middle class.

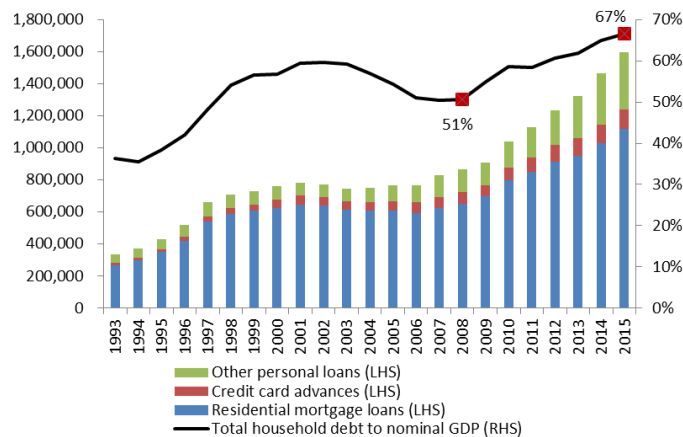
HK Residential Property Price Index and Transaction Volume



1-month HIBOR



HK Household Debt



Source: Bloomberg, HK Census and Statistic Department, HKMA

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