2020 Global Outlook:
Stay Nimble in the Year of the Rat

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Monetary policy accommodation saved the day in 2H19 when the global growth prospects was sinking relatively fast under the weight of a myriad of headwinds including the escalating US-China trade and tech war, China's continued economic slowdown, Brexit concerns and other geopolitical risks such as the situation in Hong Kong. The US Federal Reserve started the party rolling with the first of its three rate cuts in August, followed by September and October of 2019 as part of its mid-cycle adjustments before taking a breather on "insurance" easing. The European Central Bank (ECB) launched its bazooka package of cutting its deposit rate to -0.5% on 12 September and resumed its quantitative easing with EUR20bn monthly asset purchases, but also attracted some dissension among members.

Standing in the last month of 2019, however, the hurdle to further global monetary policy easing has been raised. The Fed is now in pause mode. Reserve Bank of Australia (RBA) Governor Philip Lowe also hinted that the interest rate floor may be at 0.25% following which quantitative easing (QE) in the form of government bond purchases may be launched, but emphasised that this is unlikely in the near-term. This "low for longer" interest rate environment also contributed to the IMF's Financial Stability Review warning of potential side effects including threats to investment funds, insurers and some real estate markets. China stands out from the crowd with a slew of recent counter-cyclical easing measures.

The policy tilt is also increasingly shifting from being centred on monetary policy accommodation to fiscal policy. In his parting words, previous ECB president Mario Draghi had called for fiscal policy "to do its part". Closer to home, after MAS delivered the expected S$NEER slope flattening in mid-October, the playbook now turns to potential fiscal stimulus at the 2020 Budget even as the anticipated 2019 growth forecast of 0.7% yoy may give way to a modest improvement of 1-2% yoy in 2020.

However, the market nuancing has shifted for the 2020 growth outlook from one of outright doom and gloom to a slightly less bearish prognosis, notwithstanding the persistent wax and wane of global trade tensions. If anything, US president Trump is now threatening he has no deadline and may wait until after the 2020 elections to reach a trade deal with China, while the passage of legislation such as the Hong Kong bill and potential sanctions on Chinese government officials responsible for the human rights violations may prompt retaliation from China. Nevertheless, the IMF forecast is for global growth prospects to improve modestly from around 3% in 2019 to 3.4% in 2020, even though major economies like the United States and China are still likely to see a further deceleration.

Financial markets are likely to stay in flux in 1H 2020 even as investors grapple with economic green shoots in the form of recent macroeconomic stabilization and modest improvements in the global and regional manufacturing Purchasing Managers Indices. The recent improvements seen in the Asian manufacturing PMIs in November, especially for China, but with the notable exceptions of Thailand and Philippines, have fuelled market hopes for a more stable if not improved Asian growth prospects in 2020. Our view is that given the US-China trade negotiations have been one step forward and one step back, the trajectory is not smooth sailing yet and it is possible that after the seasonal Christmas orders, we may see a bit of a slowdown again in 1Q20. At this juncture, we do not expect a sharp V-sharp recovery for manufacturing or trade growth.

The challenges that we see going ahead into 2020 still remain formidable. The ongoing impeachment probe against US president Trump is likely to contribute to higher noise levels in the interim, especially given that 2020 will be an election year as well. Tariff man Trump also remains actively on the prowl with recent reinstatement of the steel and aluminium on Argentina and Brazil, as well as proposed tariffs on around $2.4b of French products in retaliation to its digital revenue tax and exploring similar probes against Austria, Italy and Turkey. US Commerce Secretary Ross also opined that tariffs on China will rise if a trade deal is not struck, so the scheduled 15 December tariff tranche against China will be one key milestone to watch if it will proceed or be postponed.

As far as the US Fed is concerned, whether they stop at three or four cuts, does it really matter? The Fed is on hold for now and we think they may only cut in 1Q20 if US data remains tepid or weaken further into 2020, but there may be some reluctance to cut rates in an election year notwithstanding Trump's clarion calls for the Fed to always do more. Liquidity provision will likely be more important. The Fed is already supplying term repo offerings across the year-end and liquidity support may be forthcoming until the Fed has finished its review of some areas in the existing supervision of the regulatory framework that Quarles alluded to as having created some incentives that contributed to the recent repo market issues.

We see the ECB's focus for now to revolve around a strategy review instead of fresh monetary policy stimulus at this stage. ECB policymakers may review their current inflation target of "below but close to 2%", but even adjusting it to 2% over the medium term may not see immediate implications. This suggests that the next policy meeting on 12 December will not see any adjustments to its policy settings, but instead will grapple with big picture issues like the clarification of the symmetrical approach to the inflation target, a soft coordination between monetary policy and financial stability tools, and climate change.

We need to stay nimble to navigate volatile financial markets in the Year of the Rat even with macroeconomic stabilization. **Regional economic prospects may still orbit around China into 2020.** China will likely still have its hands full managing the growth transition with both external (US trade, tech and other tensions) and domestic policy challenges (including labour and asset market stability, and Hong Kong developments). Assuming that global monetary policy accommodation will slow to a trickle but not stall completely and some extent of fiscal stimulus may be forthcoming, with market players increasingly inured to the back-and-forth of US-China trade dynamics, this should impart some element of positivity to start 2020 but we would caution against market exuberance. The low-for-longer interest rate environment may be punctuated by bouts of reconsideration, but should imply a generally conducive regime for bond markets. While credit valuations remain tight, end-investor liquidity continues to search for a home to be put to work, and the tightening bias in credit spreads looks unlikely to be unwound anytime soon.

Last but not least, medium-term growth drivers like Environmental, Social and Governance (ESG) parameters will likely play an increasingly important role in the global marketplace, so we have also included a thematic piece as an introductory ESG report. Happy reading!

GDP Growth Rates

% CHANGE YOY	2017	2018	2019F	2020F	2021F
US	2.4	2.9	2.2	1.7	1.8
Euro-zone	2.5	1.9	1.2	1.1	1.3
Japan	1.9	0.8	0.9	0.3	0.7
United Kingdom	1.8	1.4	1.2	1.1	1.5
New Zealand	2.6	2.8	2.5	2.4	2.6
Australia	2.4	2.7	1.7	2.3	2.5
China	6.8	6.6	6.1	6.0	5.8
Hong Kong	3.8	3.0	-1.1	1.1	1.5
Taiwan	3.1	2.6	2.0	1.9	2.2
Indonesia	5.1	5.2	5.1	5.2	5.3
Malaysia	5.7	4.7	4.6	4.2	4.2
Philippines	6.7	6.2	5.9	6.2	6.3
Singapore	3.9	3.2	0.6	1.5	1.5
South Korea	3.2	2.7	2.0	2.2	2.3
Thailand	4.0	4.1	2.7	2.9	3.2
Myanmar	6.3	6.8	6.6	6.7	6.7
Vietnam	6.8	7.1	6.9	6.6	6.7

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

Inflation Rates

% CHANGE YOY	2017	2018	2019F	2020F	2021F
US	2.1	2.4	1.5	1.9	2.0
Euro-zone	1.5	1.8	1.2	1.0	1.5
Japan	0.5	1.0	1.0	1.3	0.7
United Kingdom	2.7	2.5	1.8	1.9	2.0
New Zealand	1.9	1.6	1.4	1.9	2.0
Australia	2.0	2.0	1.6	1.8	2.0
China	1.6	2.1	2.8	2.4	2.1
Hong Kong	1.5	2.4	2.6	2.2	2.0
Taiwan	1.1	1.5	0.8	1.1	1.2
Indonesia	3.8	3.2	3.2	3.3	3.4
Malaysia	3.8	1.0	0.8	1.5	1.5
Philippines	2.9	5.2	1.5	2.6	3.4
Singapore	0.6	0.4	0.6	1.1	1.2
South Korea	1.9	1.5	0.5	0.9	1.6
Thailand	0.7	1.1	0.7	0.6	1.0
Myanmar	4.0	3.5	7.8	6.7	6.5
Vietnam	3.5	3.5	3.6	3.7	3.8

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

Central Bank Policy Rates

BENCHMARK RATE %	2017	2018	2019F	2020F	2021F
US Fed Funds Rate	1.25-1.50	2.25-2.50	1.50-1.75	1.25-1.50	1.25-1.50
ECB Deposit Facility Rate	-0.40	-0.40	-0.50	-0.50	-0.50
BOJ Overnight Rate	-0.10	-0.10	-0.10	-0.10	-0.10
BOE Base Rate	0.50	0.75	0.75	0.75	1.00
RBNZ Cash Rate	1.75	1.75	0.75	0.75	0.75
RBA Cash Target Rate	1.50	1.50	0.75	0.25	0.50
China Lending Rate	4.35	4.35	4.35	4.10	3.85
CBRC Discount Rate	1.375	1.375	1.350	1.350	1.350
Hong Kong Base Rate	1.75	2.75	2.00	1.75	1.75
BI Reference Rate	4.25	6.00	5.00	4.50	5.00
BNM Overnight Rate	3.00	3.25	3.00	2.50	2.50
BSP Overnight Reverse Repo	3.00	4.75	4.00	3.50	3.50
Singapore 3-Month SIBOR	1.50	1.89	1.76	1.60	1.52
BOK Target Overnight Call	1.50	1.75	1.25	1.25	1.25
BOT Repurchase Rate	1.50	1.75	1.25	1.25	1.25

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

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More Committed to Support Growth

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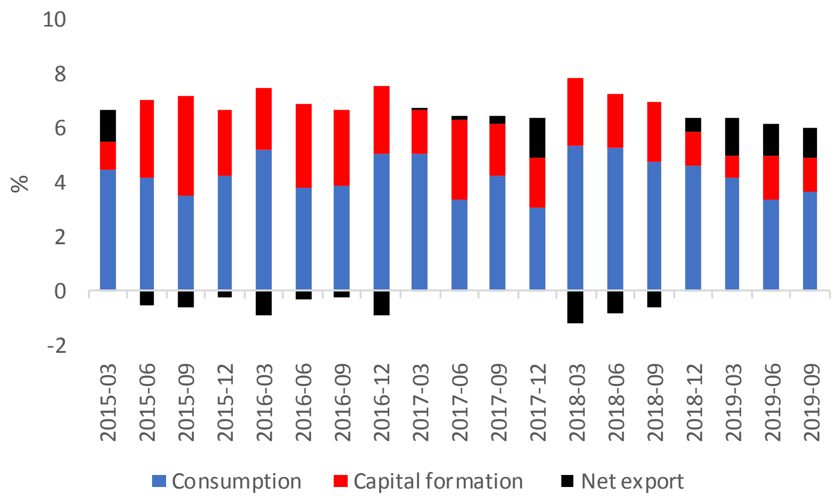
- China has unveiled three pillars to support growth. Manufacturing investment and infrastructure investment may have bottomed out although property investment is expected to slow down. Car sales are also expected to recover.
- Counter cyclical easing will be a keyword for 2020. Fiscal policy will still play a leading role, but RRR and LPR cuts are still expected. However, it is not the start of an easing cycle.
- A phase one trade deal with the US is still expected.

The Chinese economy decelerated to 6.2% yoy in the first three quarters of 2019 from 6.6% yoy in 2018. The slowdown was not surprising against the backdrop of a global economic slowdown and rising uncertainty from US-China trade war and geopolitical tensions. Consumption remained a key driver which contributed 60.5% to China's GDP growth in the first three quarters.

Three confusions seen in 2019

First, net export of goods and services was actually the key driver to growth in 2019 despite the trade war. Net export contributed 19.6% to China's GDP growth in the first three quarters, the highest since China published the breakdown data from 2009. The surprisingly strong support from the net export was mainly because the decline of import growth was much bigger than export growth slump. China's export of goods fell by 0.2% in the first ten months of 2019 due to the escalation of trade war and global economic slowdown. However, China's import of goods fell by 5.1% yoy in the same period. China's falling demand also weighed down the growth prospect for the region.

Chart 1: Net export contributed positively to China's growth in 2019



Second, capital formation was the weakest link in 2019. In the first three quarters of 2019, capital formation only contributed about 19.8% to China's growth, marginally higher than net exports. China's investment growth in manufacturing sector and infrastructure sector only grew by 2.5% yoy and 3.4% yoy in the first three quarters respectively, much lower than the 7.9% nominal GDP growth in the same period. This was not usual in the past decade given Chinese growth model was mainly export and investment oriented.

The widening divergence between manufacturing and infrastructure investment growth and nominal GDP growth may be partially attributable to China's shift of growth model to being more consumption driven. This is an encouraging sign for Chinese economy. However, the magnitude of the decline was more worrying, as it may lead to a sharper than expected growth slowdown ahead.

Chart 2: Both manufacturing and infrastructure investment growth were lower than nominal GDP growth

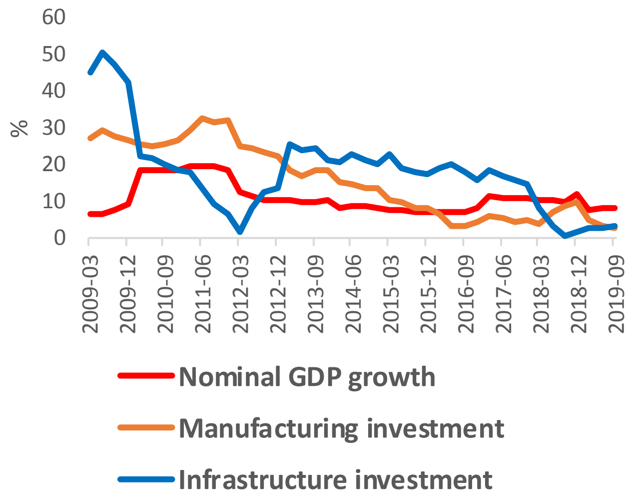
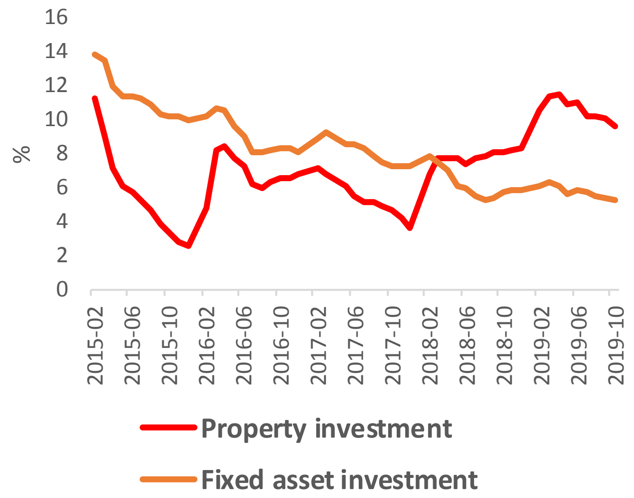


Chart 3: Property investment remained resilient despite tightening measures



Third, the property market was more resilient than expected. China's property investment growth decelerated gradually to October's 10.3% yoy. Despite all the property tightening measures, the double-digit growth in property investment helped to partially offset the weak manufacturing and infrastructure investment.

Three pillars to support growth

After the further escalation of US-China trade war in August, China has stepped up its policy supports for growth. Since early September 2019, the State Council announced more detailed measures to support growth via three pillars including conventional monetary easing, counter cyclical measures and measures to boost consumption. On consumption, China unveiled 20 measures to stabilize expectation and boost confidence in consumption by promoting car sales and environmentally friendly electronic products. China is expected to gradually ease or remove the restrictions on car sales as well as encourage local government to support the sales of new energy cars.

Counter cyclical policy support is the key theme

Fiscal policy has played a leading role in driving China's counter cyclical movement. In early September, China's state council confirmed that China will approve some of 2020 local government special bond quota earlier to support infrastructure investment. Meanwhile, China also allowed local government special bonds to be used as capital for infrastructure investment. In November, China loosened the rule again to lower the minimum capital for infrastructure projects.

On monetary policy, although China vowed to keep its prudent monetary policy intact, China has been more willing to lower key interest rates in name of bringing down the funding costs. Since November, China has lowered its key MLF rate, reverse repo rate other than LPR. We are not convinced that China has entered a monetary easing cycle due to constraints from financial risks, property prices as well as rising consumer inflation. However, we think there is still room for China to further support the growth via easing monetary policy under the framework of counter cyclical measures. We expect China to cut RRR further to lower the funding costs to the real economy as well as to lower the credit spread, which may eventually translate to a further decline of LPR in the coming months.

Chart 4: China cut its 1-year MLF rate

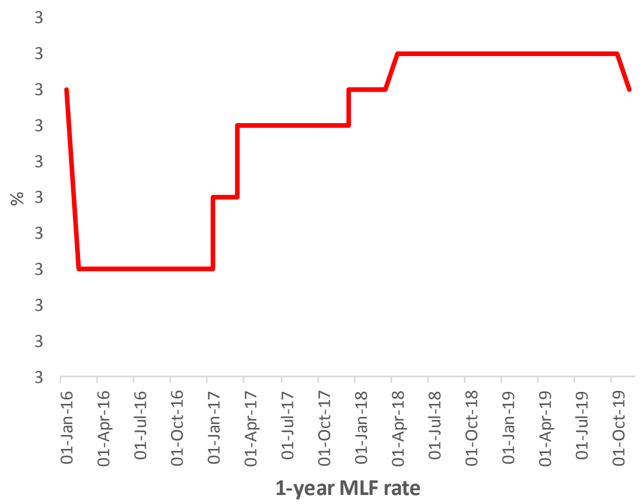
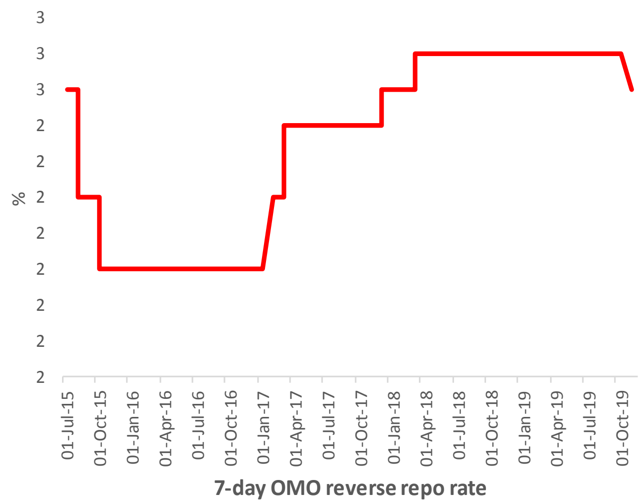


Chart 5: China cut its 7-day reverse repo rate



Will China loosen its property tightening measures?

Market got excited in late November after China cut its 5-year LPR fixing rate for the first time since August. Meanwhile, PBoC advisor Ma Jun also said that local government should have space to tailor property policies to the local situation. As market usually takes 5-year LPR as official attitude towards the property market, together with Ma Jun's comments, the move fuelled some speculations that whether China will loosen its property measures.

We think the room for China to loosen its property tightening measures nationwide is limited given the rapid increase of China's household leverage ratio. According to the latest estimates by PBoC, China's household debt to GDP ratio has climbed to 60.4% in 2018, much higher than the 52.6% estimated by BIS. In coastal areas such as Zhejiang province and Shanghai, the household debt to GDP ratio has exceeded 80%. As such, we doubt China will roll back tightening measures especially in the coastal areas. However, the huge variance of household leverage ratio in each province (eg, household leverage ratio in Shanxi province is 50% lower than that in Zhejiang province) suggests that China may fine tune its property policies in those provinces with low household leverage ratio.

6% growth in 2020 is still possible

Looking ahead, we expect China's property investment to slow down further as a result of falling land acquisition. Nevertheless, the rising investment in central and western China may partly offset the decelerating investment growth in highly regulated eastern area. On a positive note, we think China's manufacturing investment has bottomed out. Meanwhile, we expect China's infrastructure investment growth to pick up gradually on the back of those counter cyclical measures. The stabilization in manufacturing investment and recovering infrastructure investment are likely to offset the deceleration of property investment in 2020, which may bring the fixed asset investment growth back to 6-7% range.

Chart 6: Falling land acquisition

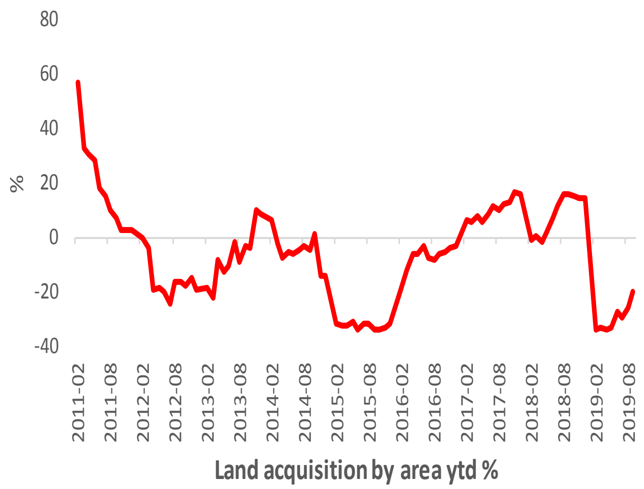
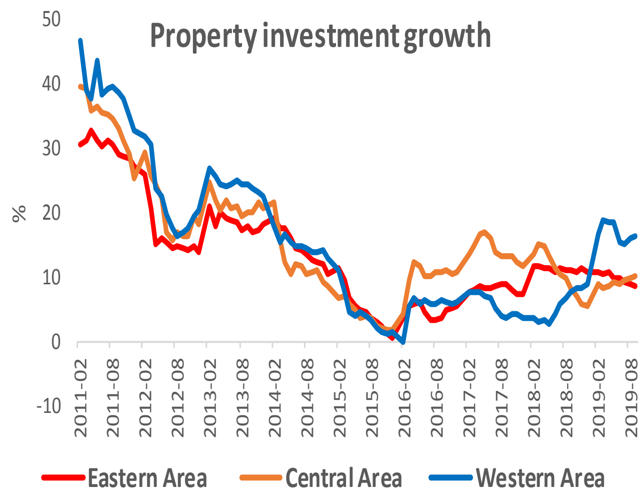


Chart 7: Variance helps



On consumption, there are also signs that car sales may have bottomed out. Although industrial profit for car manufacturers continued to contract in October, the magnitude of decline has narrowed. Given China's car sales accounted for about 30% total retail sales, we think the stabilization of car sales will help support retail sales in 2020.

Watch out for the progress of US-China trade talks

We expect both sides to reach a phase one deal soon. Although the road to a comprehensive trade deal remains bumpy, we think the chance for further escalation may be low in 2020 as a stable growth prospect for the US economy is important for President Trump to fight for his re-election.

To conclude, we expect the Chinese economy to grow by about 6% in 2020 thanks to supportive fiscal policy and more flexible monetary policy assuming there is no further escalation of the trade war.

Hong Kong

The Double Whammy

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- Trade war continued to hit the trade sector while local political development has weighed heavily on the retail, tourism, hotel, catering and transport sectors. The internal and external headwinds combined have further dented consumer and business sentiments. As a result, the economy has slipped into a technical recession in the third quarter and is set to remain sluggish in the coming quarters.
- Due to rising concerns about the labour market and economic outlook, elevated local rates and increasing short-term supply, housing prices have retraced lower from the record high seen in June. That said, the prospects of lower borrowing costs and the relaxation of mortgage rules appeared to have given a renewed boost to the housing market. Therefore, home prices may be able to show up to 5% yoy growth by end-2019.
- Elsewhere, the financial market has felt a milder pain as the stock market has rebounded on an improvement of risk appetite and both HKD and aggregate balance have been relatively stable, signalling little sign of massive outflows. That said, banks' funding pressure will likely remain high when there are large IPOs or seasonal factors, despite the cut in CCyB ratio by HKMA and the cut of HKD savings deposit rates by commercial banks. Given global headwinds, we expect total loans to see single-digit growth this year and next year.
- In conclusion, the economic outlook will hinge on the development of the trade war and local political development, both of which however show no sign of resolution at this juncture. As such, despite a reduction in global economic risks, global monetary easing, local fiscal stimulus and a low base for 4Q, a full-year recession in 2019 looks highly inevitable. We downgrade our 2019 GDP growth forecast to -1.1% and expect the growth to remain muted at 1.1% for 2020.

A challenging start sets the stage for a technical recession in 3Q

Existing tariffs, the global economic slowdown and a high base amid front-loading activities during July to October 2018 have led exports (-9.2% yoy) and imports (-11.5% yoy) to drop for the twelfth and eleventh consecutive month respectively in October.

On top of the trade war, a series of demonstrations in Hong Kong triggered by the extradition bill since early June have added downward pressure to the already weak economic growth. As social incidents have continued escalating, over twenty countries have issued travel warnings for Hong Kong or warned their citizens of the risk of violence in Hong Kong. This coupled with the global economic slowdown and a relatively strong HKD especially against the RMB has hit hard on the tourism-related sectors. After registering a strong 13.9% yoy growth in inbound visitors during 1H19, total visitor arrivals and Mainland visitors both decreased for the third consecutive month in September respectively by 34.2% yoy and 25.1% yoy. Hotel occupancy rate tumbled by 28 percentage points yoy to 66% in August. Worse still, retail sales (over 40% contributed by tourists) dropped by the most since the record in August and fell for an eighth consecutive month by 18.3% yoy in September as the trade war and social unrest have hit consumption, from both locals and visitors, and affected the normal operation of department stores. A strong HKD especially against the RMB has further suppressed visitor spending which accounted for 40% of retail sales.

Apart from the tourism- and consumption-related sectors, the transport sector also felt the pain from the social unrest. With fewer tourists willing to visit Hong Kong and more households reluctant to go out, airport passenger traffic (-12.9% yoy in October) and the passenger traffic of other transport modes (MTR traffic dropped to an over three-year low in August) dropped notably.

Chart 1: Trade growth tumbled

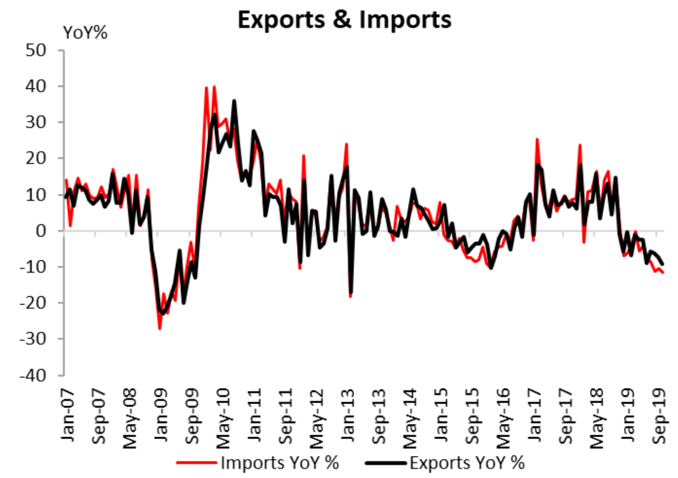
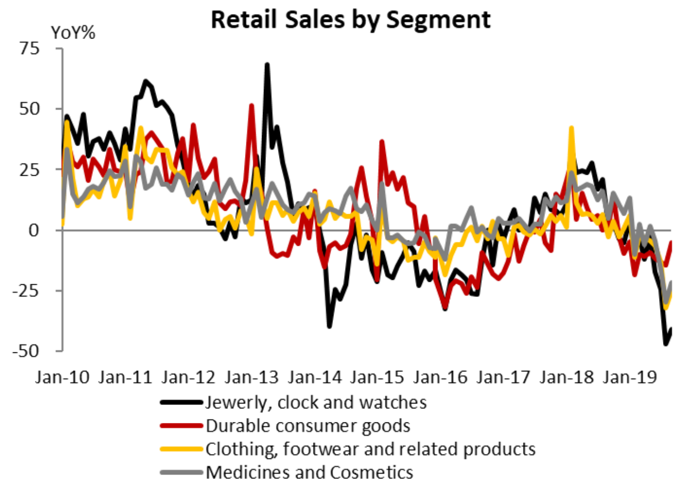


Chart 2: Retail sales were hit badly



Source: HK Census, OCBCWH

On the housing market front, the property price index dropped for the fourth straight month by 0.69% yoy in October while housing transaction volume decreased for the fifth straight month by 5.7% yoy to 4001 deals in October amid sour investment sentiments on external and internal uncertainties. The front-loading of new project launched with sweeteners in anticipation of vacancy bill implementation has also added downward pressure to the housing prices.

Financial sector has been resilient despite the social unrest

Though social tension continues, the financial market appears to have been rather calm. For the banking system, total loans and advances grew at a faster pace by 7% yoy in October. On the deposits front, HKD deposits rebounded soon by 0.44% mom in October as IPO activities grew and commercial banks lifted HKD fixed deposit rates during the month. In terms of the stock market, after sliding briefly in August due to the escalation of US-China trade war and local political turmoil, Hong Kong's stock market rebounded on improvements in global risk appetite. As a result, several large IPOs including AB InBev returned successively from September. With regard to the money and FX market, though the prolonged protests have sparked concerns about potential capital outflows and resulted in several rounds of funding squeeze in Hong Kong, the market has been increasingly calm, as a stable HKD and aggregate balance as well as the retracement of HIBORs from July's high suggest no massive outflows so far.

Chart 3: Property price index

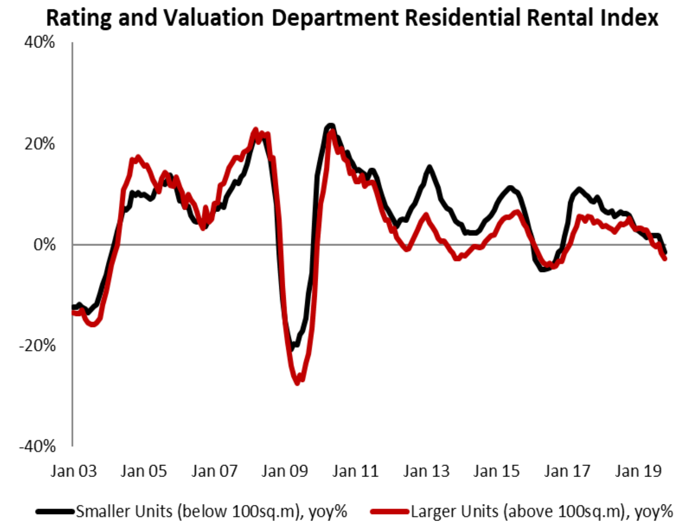
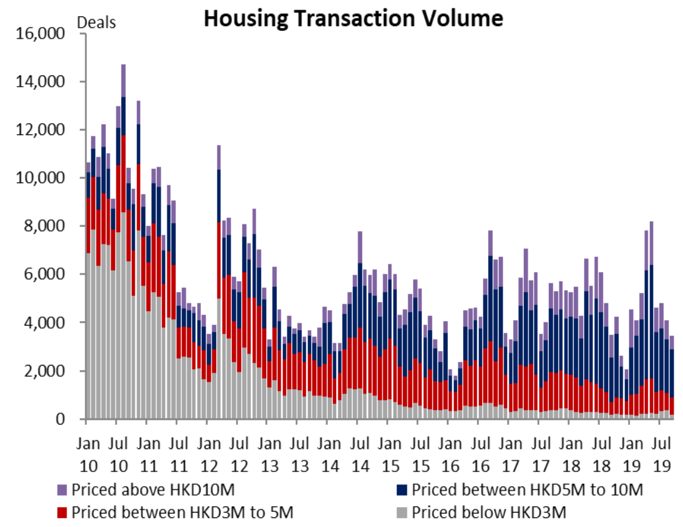


Chart 4: housing transaction volume



Source: Hong Kong Valuation Rating and Valuation Department, Land Registry, OCBCWH

Due to the double whammy which hit hard on private consumption and fixed investment (taking up about 90% of total GDP), Hong Kong's economy has slipped into a technical recession in 3Q as widely expected while contracting more than anticipated by 2.9% yoy, the largest decline since 2Q 2009.

Chart 5: HK GDP contribution

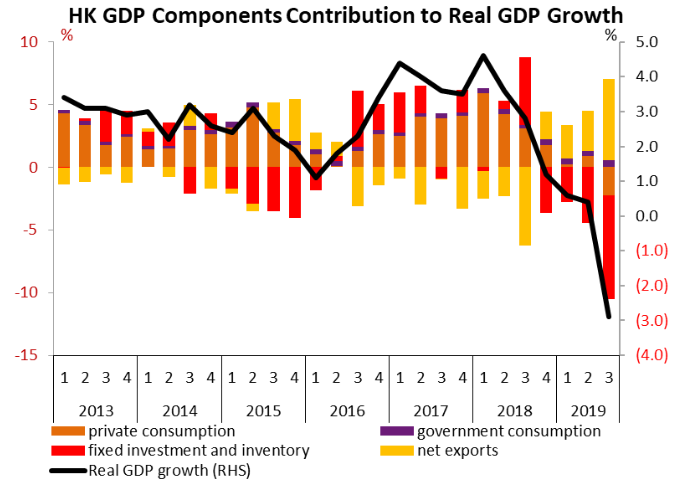
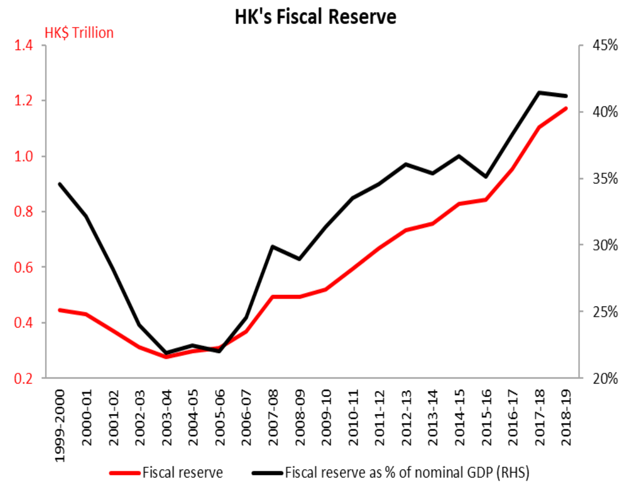


Chart 6: HK's fiscal reserve



Source: HK Census, OCBCWH

Economic outlook is still challenging

1)Trade sector

Even though high base effect will abate from November and trade talk between the US and China has shown signs of progress, trade activities may still stay sluggish due to existing tariffs, potential new tariffs, sluggish demand at home and abroad as well as the largely affected electronic value chain in Asia. We hold onto our view that both exports (-4.6% yoy during the first nine months) and imports (-6.5% yoy during the first nine months) will register single digit decrease for 2019 as a whole.

Next year, whether the trade sector will rebound hinges mainly on the development of the US-China trade war. Should the US-China trade negotiations show further improvement, adding on the low base this year and the early signs of global economic stabilization, we could expect some moderate rebound in Hong Kong's trading activities in 2020.

However, any rebound could be derailed should the US deprive Hong Kong of the status of separate customs territory and the right to import sensitive technologies from the US. Though Hong Kong's exports to US merely took up 7.1% of its total exports and domestic exports represented only 1% of total exports, it is still a concern as other countries could be prompted to amend their policy with Hong Kong and in turn cause long-term shock to Hong Kong's trade sector. More notably, the Hong Kong port could also take a long-term hit as it has mainly shipped high-tech products (taking up 66.1% of total trade in Hong Kong) and already weakened amid fierce competition from Mainland China's ports.

Chart 7: HK imports breakdown

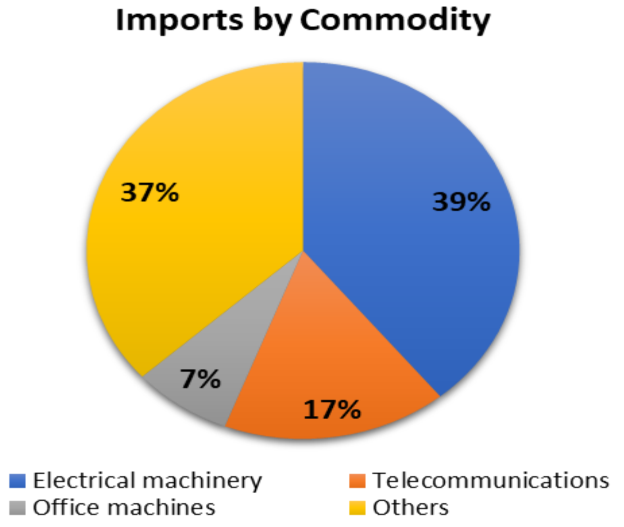
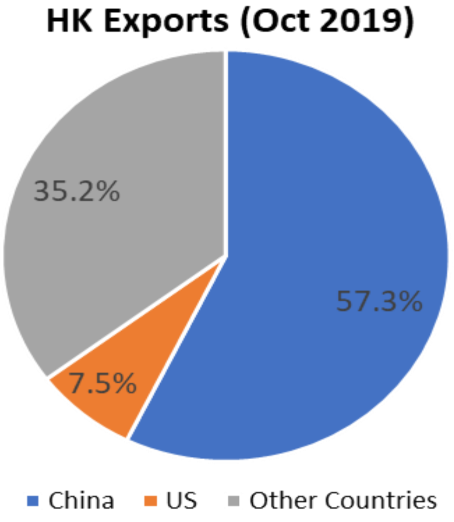


Chart 8: HK exports breakdown



Source: HK Census, OCBCWH

2) Tourism- and consumption-related sectors

Given ongoing protests and relatively strong HKD, we expect retail, hotel, tourism, catering and transport sectors to continue weakening in the near term. We believe that retail sales will drop about 10% this year and will remain subdued next year. This will highly likely result in further weakness in the retail sector's unemployment (recently rose to the highest since 2017 at over 4%) as well as the retail shop market (retail shop rental rose by 0.3% yoy and price dropped by 12.5% yoy in September).

Though the government has unveiled a slew of measures to support the SMEs especially the tourism and transport sectors, the measures may not be able to reverse the downturn of the sectors hit hard by social unrest. Whether the tourism- and consumption-related sectors could regain momentum next year will still depend on the political development.

3) Banking sector

Though the local social unrest has a relatively milder impact on the banking system, banks have been experiencing high funding pressures as the HKD loan-to-deposit ratio surged to the highest since March 2002 at 90.6% while the ratio of HKD CASA deposits dropped to the lowest since January 2009 at 55% in September.

Though HKMA cut CCyB ratio by 50bps to inject HK$200-300 billion liquidity while some commercial banks cut the HKD savings deposit rates by 12.5bps to nearly 0%, banks may still have to scramble for HKD funds when there are seasonal factors or large IPOs. These catalysts include increased competition from eight virtual banks, low aggregate balance and uneven distribution of HKD liquidity among the banking system. As such, the net-interest-margin for banks especially the larger ones may narrow moderately.

Chart 9: HK deposits

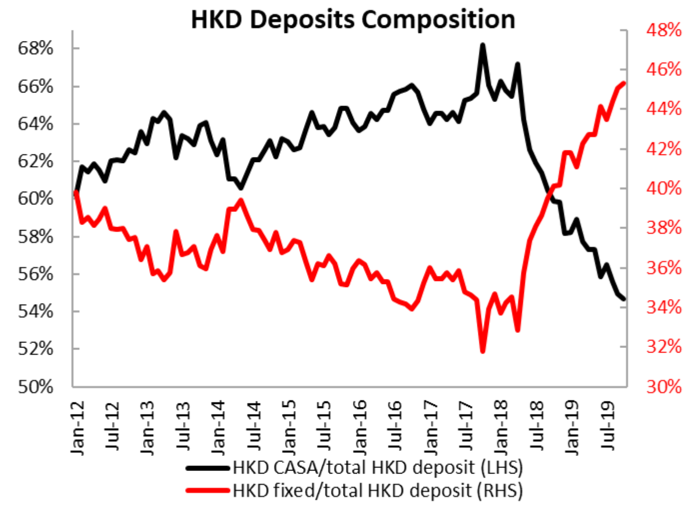
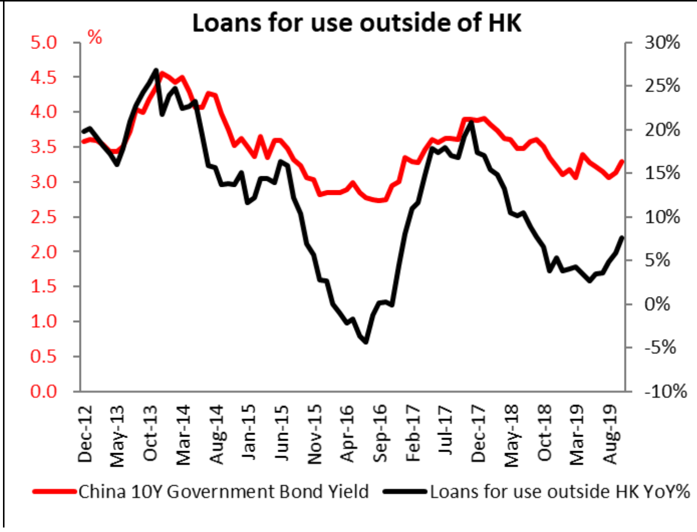


Chart 10: Loan used outside HK



Source: HKMA, OCBCWH

On the loan growth front, internally, local loan demand may remain sluggish amid challenging economic outlook. That said, the relaxation of mortgage rules for first-home buyers coupled with a positive outcome of US-China trade talks may help to partially offset the impact of local social unrest on local loan demand. Externally, the growth of loans for use outside of Hong Kong may not strengthen much further as Mainland companies may prefer to borrow at home given flushed liquidity while overseas M&A activities have reduced. All in all, we expect total loans to show low single-digit growth in both 2019 and 2020.

4) Housing market to regain short-term momentum

In the near term, the housing market will likely regain some momentum thanks to the prospects of lower borrowing costs and the loosening mortgage rules on first-home buyers as the latter has unleashed some pent-up demand. We expect the transaction volume of private flats priced at HK$5-10 million (which took up 56.6% of total transaction volume) to rebound. Meanwhile, despite multiple headwinds, housing prices (+5.9% YTD as of September) may be able to show a growth of up to 5% yoy by end-2019.

Nevertheless, the long-term housing market outlook still hinges on the outlook of economy, labour market and housing/land supply. First, the labour market outlook is worsening with unemployment rate expected to go up further. This could make the near-term rebound in the housing market fragile. Second, Hong Kong's economy is facing a double whammy from trade war and local social unrest, both of which remain present and could continue to weigh on growth. Third, the government has been less than effective in increasing land and public housing supply while vacancy tax could deter developers from building private housing (housing construction fell 11.6% yoy during the first quarters of 2019). Should the imbalance between long-term supply and demand persist, we still believe that any housing market correction will be well capped.

Chart 11: Interest rate came off again

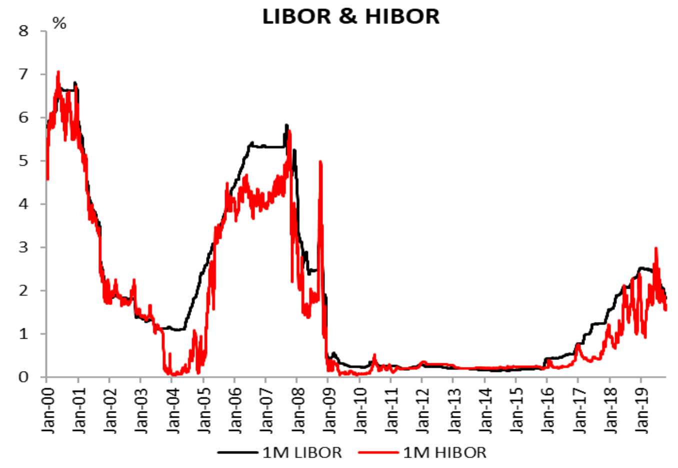
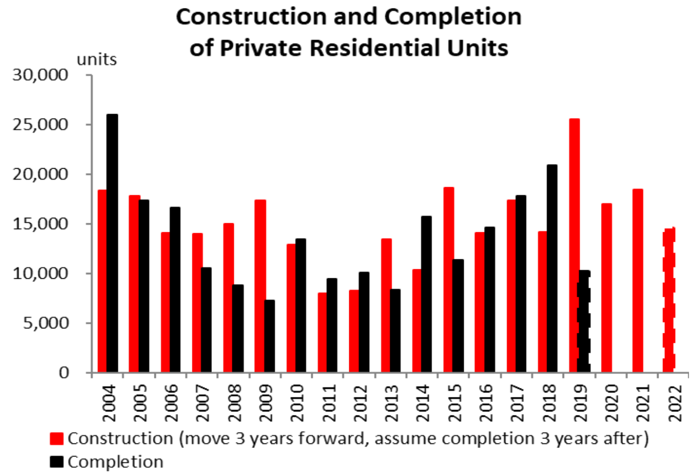


Chart 12: Imbalance persists



Source: HK Rating and Valuation Department, Land Registry, Bloomberg, OCBCWH

In conclusion, since August, the government has rolled out more than HK$20 billion worth of off-cycle relief measures to help households, SMEs and sectors that have been grappling with the political development. This, combined with a low base for 4Q, reduction in global risks as well as global monetary easing, may allow 4Q's economic contraction to be milder than in 3Q. However, unless the trade war and the protests come to an end, the economic growth may not be able to reverse the downtrend any time soon as trade, retail, catering, tourism, hotel and transport sectors would likely remain weak while consumer and investment sentiment may remain soft. As 3Q's contraction was more severe than expected and the economy has contracted by 0.7% yoy during the first three quarters, a full-year recession now looks inevitable for 2019. We downgrade our 2019 GDP growth forecast to -1.1% and expect the growth to remain muted at 1.1% for 2020.

On the other hand, the raft of relief measures would likely lead to the first fiscal deficit since the 2003/04 fiscal year for the 2019/20 fiscal year. That said, the strong fiscal reserve could still allow the government to continue rolling out relief measures to mitigate the impact of the trade war and political development.

Hugging Five

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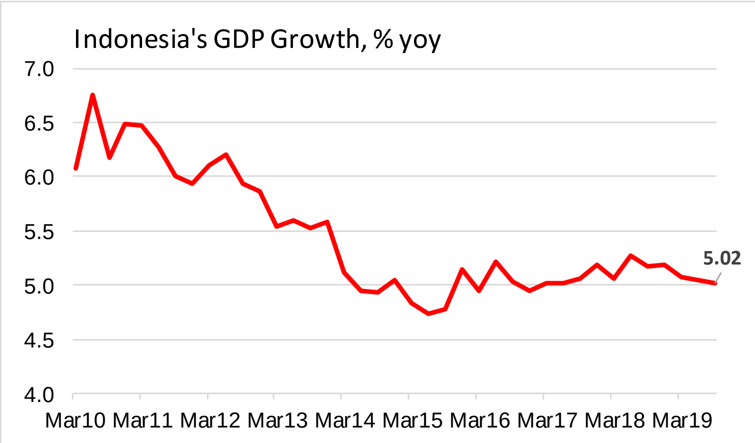
- Stability is likely to remain the operative word when it comes to Indonesia's economic prospects in the coming year, with GDP growth expected to remain close to 5% and inflation at 3.3% yoy.
- Details from recent GDP prints suggest that while private consumption remains the key contributor to overall growth, its momentum has slowed, necessitating support from other engines, including investment.
- To attract FDI investment, the new cabinet has to focus on labour reforms. Meanwhile, Bank Indonesia is likely to retain a dovish bias in 2020, with some opportunistic rate cuts depending on global situation.

Shortfall of stability

When it comes to economic data and perhaps life in general, there is value in stability, since you know what to expect and can plan accordingly.

Indeed, the most recent GDP print of Q3 2019 print – at 5.02% yoy – marks the 22nd consecutive quarter that the growth rate can be rounded to 5% flat.



Source: OCBC, Bloomberg.

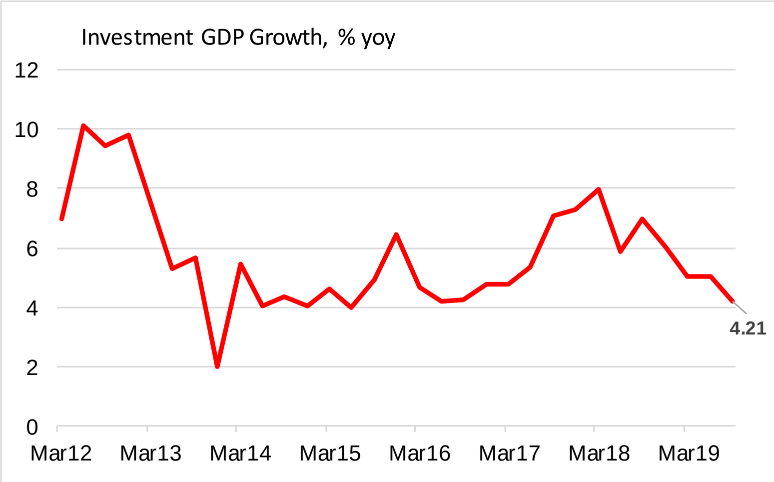
Viewed against a global environment besotted with this fear or that, and some of the regional peers where recession risk is a clear and present danger, Indonesia's economic stability is an unqualified plus, to be sure.

However, set against the backdrop of how Indonesia is still some ways from fulfilling its full potential, the wait for a more forceful uptick in growth rate may inadvertently test patience.

Chastened by the gap between actual growth outturns and the 7% growth rate target that he had envisioned in his first term, President Jokowi has nonetheless shown no sign of giving up.

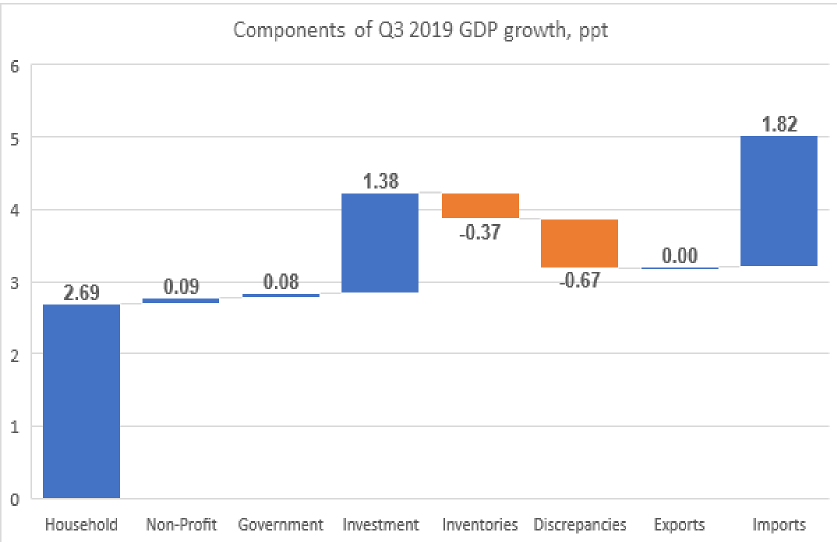
In the speech marking the inauguration of his second term recently, he envisaged that by 2045 – Indonesia's centenary as an independent republic – it would not only become a developed economy but will be the world's fourth largest economic entity worth $7 trillion.

To have a chance of turning that dream into reality, however, Indonesia needs to fire up its investment engine. Unfortunately, latest data shows that this may remain a tough goal to realize.



Source: OCBC, Bloomberg

At 4.21% in year-on-year terms, investment growth in Q3 2019 is the lowest since mid-2016. The slowdown is also evident when we look at the contribution to overall headline GDP growth that comes from investment activities, declining for the fifth consecutive quarter to 1.38 percentage points (ppt) in Q3, compared to 2.24ppt the same period a year ago.



Source: OCBC, Bloomberg

For Jokowi's second (and last) presidential term, boosting investment should be at the front and centre of the agenda. Of utmost importance will be tackling the labour rigidity that has tied Indonesia's hands in trying to welcome more labour-intensive FDI, in particular. In the immediate forecast period of 2020, we expect investment growth to contribute an average of 1.25 percentage points to headline GDP. This marks a slight pick-up but not yet forceful enough to push the headline higher.

Meanwhile, as grateful as Indonesia should be to the steadiness of private consumption as the 'anchor tenant' of growth stability, the fact of the matter is that a diverse set of contributors makes for a more balanced growth model. Already, the contribution of household consumption to overall headline GDP has softened to 2.69ppt in Q3 2019, from 2.77ppt in the prior quarter. We see the lagged effects of BI's 2019 round of rate cuts and still-robust employment to form a supporting floor for private consumption in 2020, with headline contributions of 2.75ppt on average.

On the trade front, given what has been happening on tariff concerns, it is hard to expect significant contribution from exports. For good measure, and somewhat poetically, the growth contribution from exports came in at 0.0ppt in Q3, albeit an improvement from the -0.38ppt in Q2. Interestingly, from the trade front, it is the imports which contributed significantly to growth: courtesy of its heavy shrinkage year-on-year, imports contributed as much as 1.8ppt to headline GDP growth. The dependence on further imports shrinkage to make up for slowing exports contribution is not sustainable, however. Unless global trade flows pick up sizably, this would remain a volatile contributor to growth in 2020.

Overall, given the steadiness of the headline data, policymakers are unlikely to shift gears too dramatically from what they have already telegraphed to the market. Our sense is that Bank Indonesia – having cut rates by 100bps already this year – will shift towards a mini-pause mode in the near term. It would want to assess the impact of their loosening thus far, especially with the implementation of macroprudential policies on housing and vehicle loans in December in mind and the 50bps relaxation of reserve requirement ratio effective in January 2020 in mind. Towards the middle of the year, however, if the global situation *allows* for it (via relative Rupiah stability) and indeed *calls* for it (via continued trade uncertainties), BI might reach for further easing of up to 2 interest rate cuts.

Meanwhile, fiscal tap may be relatively loosened in Q4 2019 and into 2020, with Finance Minister Sri Mulyani already telegraphing a looser fiscal stance that is likely to see deficit printing close to 2.2% of GDP for 2019, rather than the sub-2% expected before.

In terms of near-term growth outlook, it should not come as a surprise that more of the same is to be expected, with 5.0-5.2% average growth rate for 2020 being our baseline expectations.

Growth to Remain Weak

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- GDP contracted for the third consecutive quarter in 3Q19 due to the continuous plunge in fixed investment and the external headwinds which have weighed heavily on the exports of services. Although infrastructure improvement and holiday effects have lent strong support to same-day tourism, overall tourism growth has still been constrained by a strong MOP, China's economic slowdown and the spill-overs of Hong Kong's social unrest. On top of this, overnight tourism has been hit further by the lack of new entertainment project openings and the high accommodation costs.
- Despite the resilient mass-market segment on the back of steady tourism growth, gross gaming revenue growth has softened as high-roller demand has been dented by China's economic slowdown, policy risk regarding anti-money laundering and a strong MOP. We expect gross gaming revenue to drop by 2% in 2019 and fall by another 2% in 2020. The retail sector has been subdued amid weak local and visitor consumption which may continue to weigh and drag down the retail shop market. The housing market has also shown signs of slowdown from mid-2019 and the downtrend may persist given a bleak economic outlook, housing control measures and diminishing effect of housing supportive measures. That said, any correction of housing market may be capped by scarce home supply and prospects of lower borrowing costs.
- Moving forward, mounting uncertainties could continue to hit exports of goods and services while denting consume and business sentiments. Adding on a possibly further plunge in private investment, a full-year recession looks inevitable for 2019. Hopefully, the new government will roll out more fiscal stimulus to help ease the downside growth risk. In a nutshell, we downgrade 2019 GDP forecast to -3.0% but expect GDP to grow 2.0% in 2020.

Macau has contracted for three consecutive quarters in 2019.

GDP growth contracted for the third consecutive quarter by 4.5% yoy in 3Q. Fixed investment plunged for the sixth consecutive quarter by 8.5% yoy in 3Q, given the lack of mega entertainment and housing projects under construction and a high base effect. Meanwhile, exports of gaming services and other tourism services also fell by 4.2% yoy and 12.4% yoy respectively in 3Q as a strong MOP especially against the RMB combined with China's economic slowdown have hurt VIP gaming, overnight tourism and tourist spending.

Tourism has been resilient

Despite the weakening economic growth, tourism has been resilient. Total visitor arrivals increased for the 21st straight month by 1.8% yoy in October as inbound tourism registered a strong growth of 11.5% yoy during the

Golden Week Holiday. Same-day tourism remained the main growth driver as its percentage share in total visitors stayed high at 54% and it has marked doubled-digit growth for 13 consecutive months. More notably, visitor arrivals by land continued to surge by 21.6% yoy with 14.2% travelling via Hong Kong-Zhuhai-Macau Bridge. This reinforces that infrastructure improvement has lent strong support to the same-day tourism.

In contrast, due to multiple headwinds, both overnight visitors and average hotel occupancy rate fell for the third straight month in October respectively by 4.8% yoy and 2.1% points yoy with the latter reaching the lowest level since May 2017 at 84.6%.

By visitor source, those from Hong Kong and China increased respectively by 11.5% yoy and 1.5% yoy, mainly due to holiday effects. Persistent protests in Hong Kong might have also encouraged residents in Hong Kong and Mainland China to visit Macau instead. Nevertheless, the prolonged social unrest in Hong Kong has deterred visitors from other major sources including South Korea (-28.1% yoy) and Japan (-34.9% yoy) as foreign tourists normally visit Hong Kong and Macau during the same trip.

Going ahead, even if infrastructure improvement continues to buoy the same-day tourism, overall tourism growth is expected to moderate due to a strong MOP, China's economic slowdown and the spill-overs of Hong Kong's social unrest. On top of this, overnight tourism may also remain suppressed by the lack of new entertainment project openings and the high accommodation costs. This may feed through to the catering, retail and gaming sectors.

Chart 1: Macau visitor arrivals

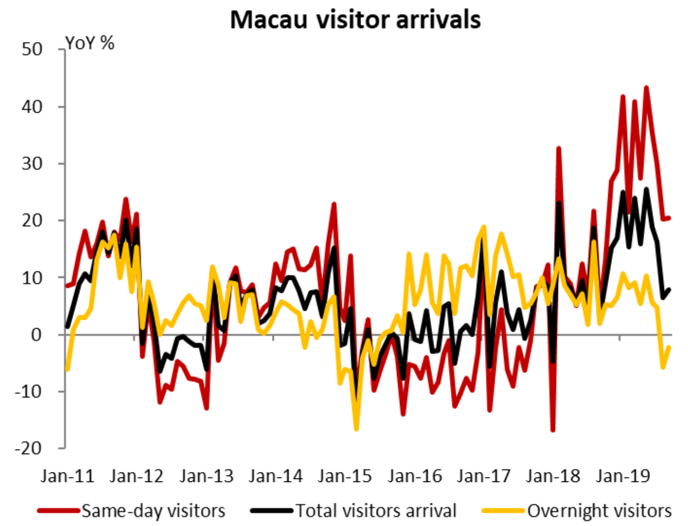
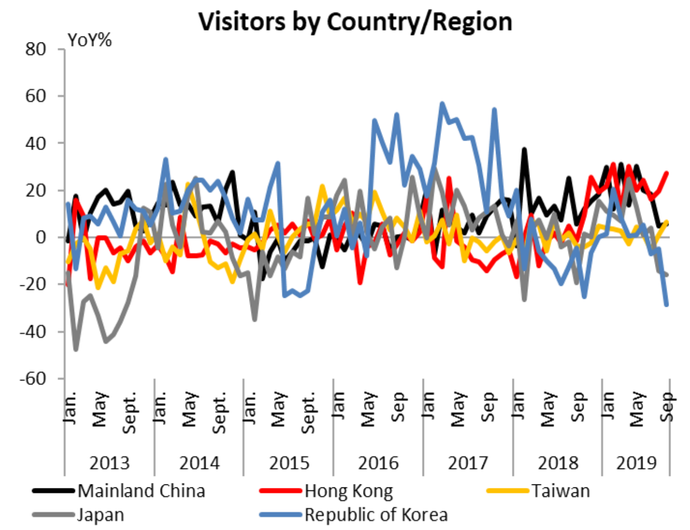


Chart 2: Visitors by country



Gaming sector remained sluggish despite resilient tourism

Gross gaming revenue decreased for the third consecutive quarter by 4.1% yoy in 3Q, the largest decline since 2Q 2016. This was mainly due to the weakness of VIP segment (-22.5% yoy) which offset the resilient growth of the mass-market segment (+18.7% yoy) on the back of steady tourism growth. With the significant contraction in high-roller demand amid China's economic slowdown, a weak RMB and anti-money laundering policies, the percentage share of VIP gaming revenue in gross gaming revenue fell to a record low of 43.9% in 3Q19.

Though the casino operators' efforts to diversify the gaming center from over-reliance on high-roller demand have paid off, the mass-market segment seems unlikely to bring the gaming sector back to the good old days, probably due to the relatively low gaming amount of leisure gamblers. Moving ahead, as we expect tourism growth to moderate, the growth of mass-market revenue may decelerate in 4Q19 while VIP gaming revenue could continue to drop amid multiple headwinds. In conclusion, gross gaming revenue (-1.8% yoy during the first ten months of 2019) is expected to fall by around 2% in 2019 and slide by another 2% in 2020.

Chart 3: Gaming sector remained sluggish

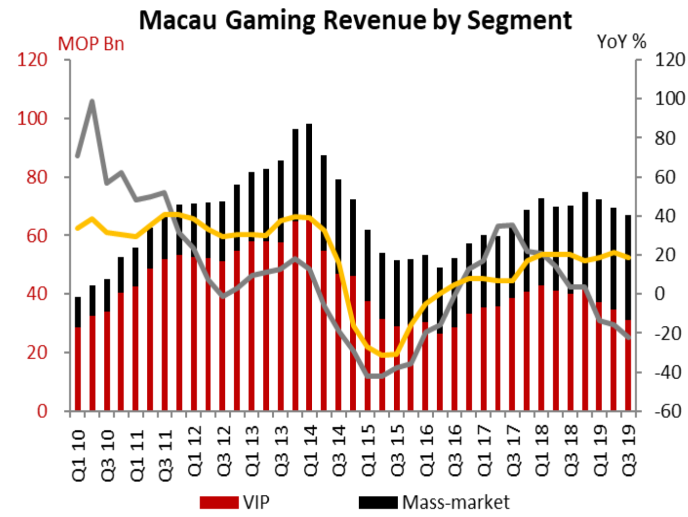
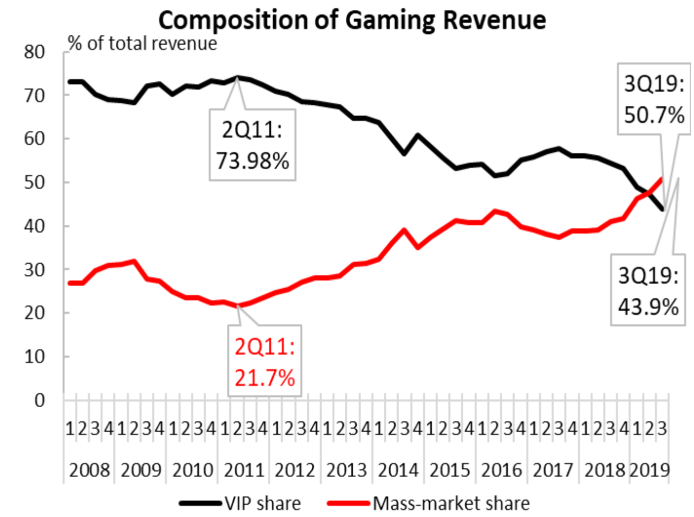


Chart 4: Share of mass market is rising



Retail sector has been subdued amid weak local and visitor consumption

Retail sales fell for the third consecutive quarter by 0.5% yoy in 3Q. The decline was mainly driven by the plunge in the sales of motor vehicles (-9.3% yoy) and adults' clothing (-18.1% yoy) amid weak visitor spending. The per-capita spending of visitors slid for the second consecutive quarter by 17.2% yoy in 3Q19, led by visitors from Mainland (-26.7% yoy), Taiwan (-21.7% yoy), Japan (-6.6% yoy) and Hong Kong -16.2% yoy). In addition, local households have been cautious about consumption with the sales of goods in supermarkets also slowing to 2% yoy in 3Q19. Looking ahead, local consumption may continue to be weighed down by the weakening economic outlook, the faltering labour market outlook (as the unemployment rate rose from a more than four-year low of 1.7% to 1.8%) and the prolonged trade war. Meanwhile, moderate tourism growth combined with a strong MOP, especially against the RMB, may continue to dent visitor spending. As such, both retail sales and the retail shop market look set to remain subdued in the coming quarters.

Chart 5: Retail sector has been subdued

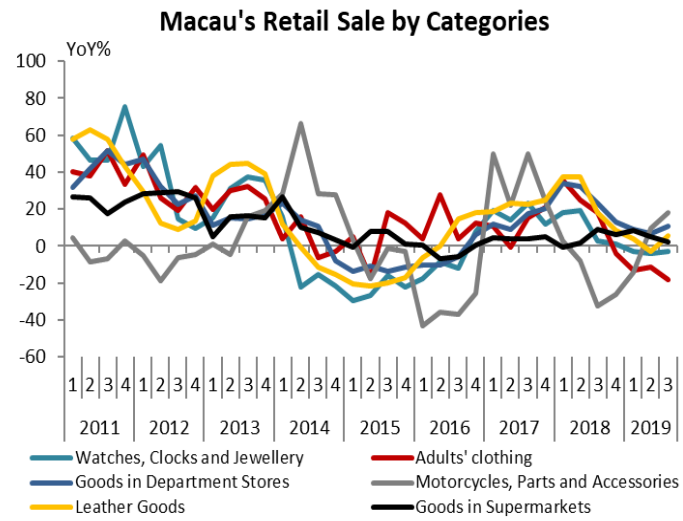
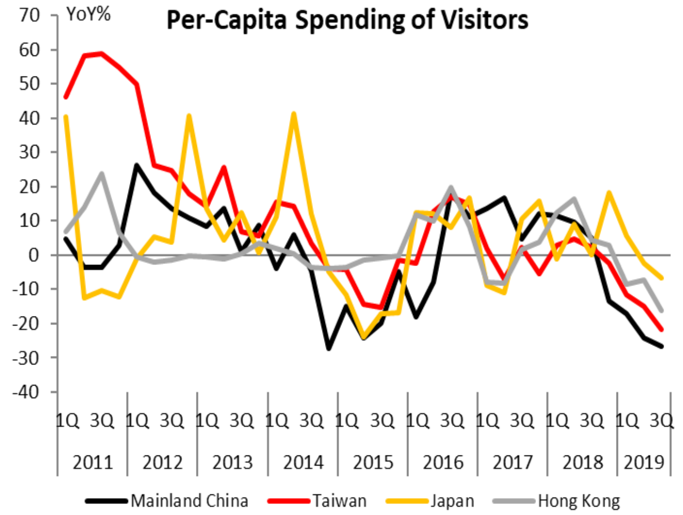


Chart 6: Falling spending power by visitors



Housing market has also shown signs of slowdown

The average housing price rebounded by 1.2% mom but dropped by 3.2% yoy to MOP103,436/square meter in September 2019. Approved new residential mortgage loans fell for the eighth consecutive month by 61.6% yoy to MOP3.7 billion while housing transaction volume plunged by 5.3% yoy to 550 deals (lowest since February 2019).

This illustrated that the housing market has slowed down from mid-2019 and could be attributed to the summer holiday effect, a bleak economic outlook, elevated local interest rates and the rising concerns about retrenchment. On top of these unfavourable factors, the housing control measures continued to take effect in suppressing speculative demand as local home buyers holding more than one property represented a mere 2.7% of total local buyers. Though the relaxation of mortgage rules from early 2018 for first-home local buyers (taking up 81.3% of total local buyers) has continued to buoy the housing market, the support is poised to wane gradually with more and more first-home local buyers having entered the market on the back of the new rules. Looking ahead, these factors will likely continue to weigh on the housing market. We expect housing transaction volume to fall gradually and housing prices (+2.2% YTD as of September) to drop 1.5% yoy by end of 2019.

In the medium term, however, any housing market correction may be capped by the scarce home supply and lower borrowing cost prospects. With global central banks actively easing monetary policy, we expect HKD rates to converge with USD rates gradually. On the supply front, housing starts continued to shrink by 79% yoy to merely 311 units during the first three quarters of this year. With more than 40% of the existing homes built more than 30 years ago, the condition of these flats is probably too poor to be considered by any prospective homebuyers. On a positive note, the Policy Address 2020 announced to resume the application for some 3000 economic housing units at the New Urban Zone A. Hopefully, the new government will take imminent action to further ease the housing supply shortage.

Chart 7: Signs of slowdown in housing market

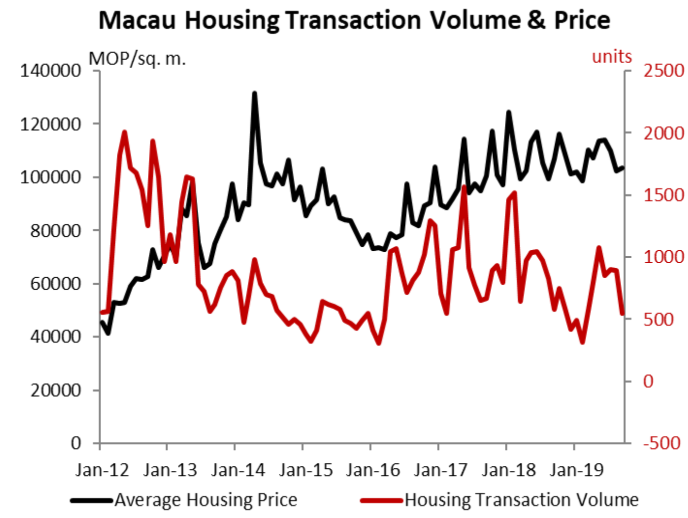
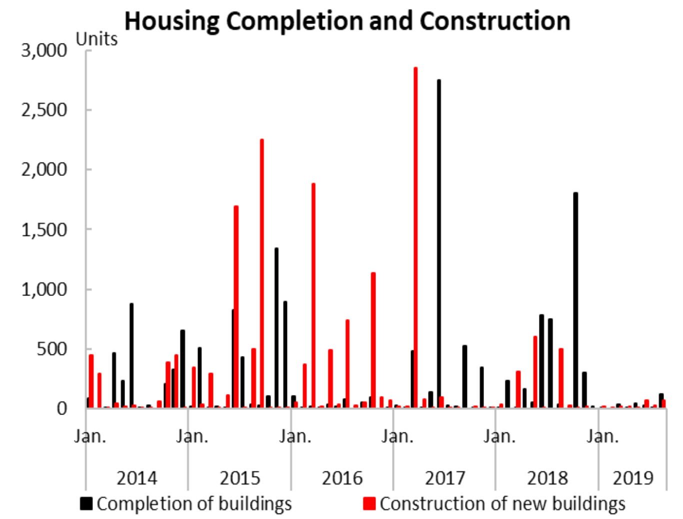


Chart 8: Scarce housing supply may be supportive



Full-year recession looks inevitable for 2019 but a modest 2020 rebound?

A full-year recession looks inevitable for 2019 amid mounting uncertainties which continue to hit exports of goods and services while denting consumer and business sentiments. Private investments may continue to plunge amid the lack of entertainment and housing projects under construction. As such, the new government will roll out more fiscal stimulus including cash handout, tax rebate and increase in public investment (+84.3% yoy in 3Q) to help ease downside growth risks. If this is the case, coupled with global monetary easing, the optimism about US-China trade talks and a low base from 2019, this may warrant a rebound in 2020's growth provided that external headwinds do not intensify. In a nutshell, we downgrade our 2019 GDP growth forecast to -3.0% and anticipate a modest rebound to 2.0% in 2020.

Mission Growth

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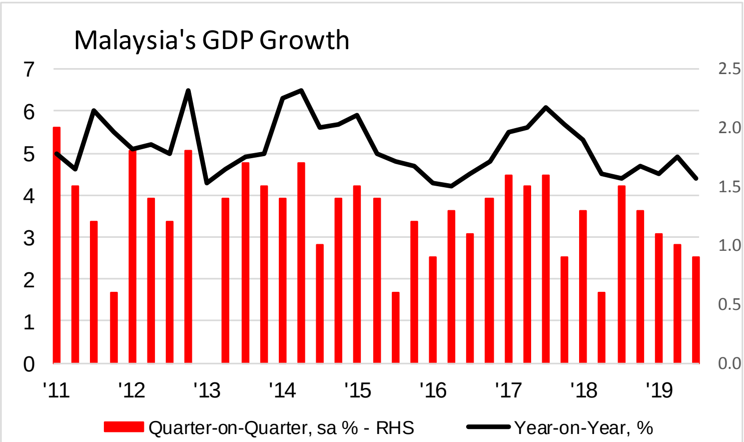
- They say 4.8%, but we think it will be closer to 4.2%. Here, we are referring to the 2020 GDP growth forecasts by the government and by us, respectively. A lot of stars must be aligned for the official target to be reached.
- Even though private consumption and government spending would help, we are ultimately less assured on exports and investments pick-up. Although FDI inflows have been encouraging, domestic business sentiment is less rosy, partly due to pockets of political uncertainties.
- If growth momentum does not pick up markedly, BNM appears ready to cut rate by up to 50bps by H1 2020 to help things out, given fairly limited fiscal ammunition.

Waiting for the momentum

Given the recent global uncertainties, for a medium-income economy like Malaysia to print a 4.4% yoy growth rate in Q3 2019 is not a bad thing at all and bodes well for the inherent resilience of its internal growth drivers.



Source: CEIC, Bloomberg, OCBC

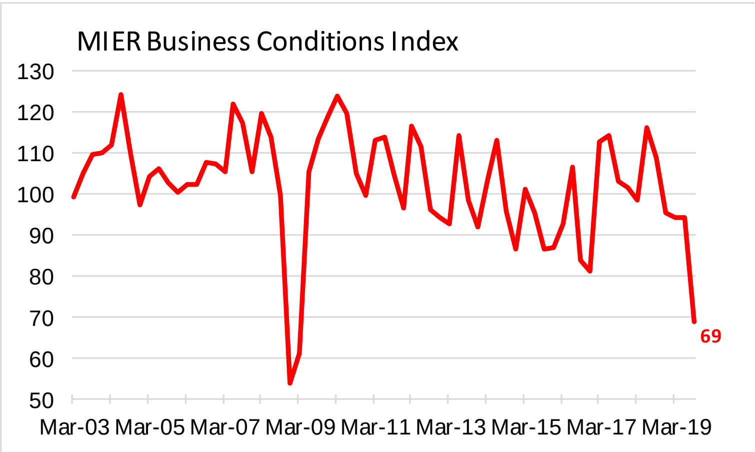
Even though it is by no means a poor set of data, the Q3 GDP release nonetheless shows some signals of a slowing sequential growth momentum that signals tougher roads ahead. On a seasonally adjusted basis, for instance, the quarter-on-quarter growth rate came in at 0.9%, the slowest momentum in over a year.

What's behind the relative slowdown?

The short gist of it is that helpful growth components of prior quarters turned less energetic, even as 'problematic' areas became even more so. To start with, even though private consumption which has been the anchoring overall GDP growth over the past year or so remains supportive, its growth has slowed in Q3. On a year-on-year basis, private consumption growth came in at 7.0% in Q3, but lower than 7.8% and the slowest since early 2018. In terms of its contribution to the headline 4.37% GDP growth, private consumption came in at 4.11 percentage points, compared to an average of 4.4ppt in the first half of this year.

Given that the tailwinds of GST removal from 2018 are now no longer with us, this should not come as a surprise, but nonetheless gives us a reminder that this big portion of growth contributor can no longer be counted on to pull the oars as hard as before. Hence, for 2020, we are expecting private consumption to contribute 3.5-4.0ppt to headline growth, still supportive but less fervently so.

Meanwhile, investment activities have declined significantly, pointing to the first challenge faced by the government in achieving its lofty growth target of 4.8% for 2020. In year-on-year terms, investment GDP grew by -3.72%, the deepest contraction this year. The slump pulled Q3 headline GDP growth down by 0.92ppt, compared to an average of half a percent deduction in H1. We had anticipated that a relatively strong FDI inflow of H1 would enjoy a strong enough momentum into Q3 to lift this portion of GDP up, but it appears that it might have been counteracted by still-lacklustre domestic investment activities.



Source: CEIC, Bloomberg, OCBC.

Indeed, for 2020, the fact that domestic business sentiment has been lacklustre may prove to be the main reason behind any shortfall in the government's effort to reach its 4.8% growth target. According to a recent survey by Malaysian Institute for Economic Research (MIER), business conditions have deteriorated in Q3 2019, to its lowest since 2008, citing sales pressure and a dip in domestic and external orders.

Elsewhere, while it is not surprising to see export activities being a net negative contributor to growth in the soft global environment, the fact that exports took headline growth down by 0.94ppt – as opposed to a flat contribution in H1 – may be an area that we need to increasingly look out for. In net trade terms, it took a heavy contraction in imports to negate the effect of the slump in exports. With imports contracting substantially by 3.26% yoy, it alone contributed two full percentage points to headline growth. That is to say, if imports have been flat instead of contracting by this amount, the overall GDP growth would have been 2.4% instead of 4.4% yoy.

A few areas from today's GDP prints continue to point to us that the most likely path for Malaysia's growth in 2020 remains one of downtick rather than the other way round. Instead of accelerating to 4.8% yoy that the government has targeted in its budget, we still see it slowing down to 4.2% instead, compared to what is likely to be 4.5% for the whole of this year.

At the broader level, the slowing sequential growth momentum as evidenced by the continually decreasing seasonally adjusted qoq rate is one factor to consider. The absence of new catalyst for private consumption is another. Elsewhere, while a relatively supportive fiscal stance should help, at just one-tenth of the economy, government consumption uptick in 2020 can only do so much, as evidenced by its minuscule 0.11ppt contribution to headline growth in today's Q3 GDP number.

Most importantly, as much as Malaysia's own domestic drivers can help buffer the impact, the global situation is still the biggest swing factor, with unavoidable impact on investment and trade. Even though Bank Negara appears to subscribe to the view that domestic growth remains largely favourable, it is still very much subjected to the ripple effects from global events.

Given the lack of strong countervailing domestic factors and the increasingly tricky negotiations between US and China trade representatives, BNM continues to be watchful. Already, Governor Shamsiah Yunus reminded markets today that the central bank under her watch is "not on a preset" course and will continue to monitor incoming data.

As much as we believe (and hope) that the baseline is for some US-China deal to come through such that central banks like BNM do not need to reach for the easing trigger in the immediate months ahead, it is very much still a day-by-day recalibration depending on news flow on the progress, if any, of the negotiations.

Indeed, should economic momentum threaten to bring growth significantly lower than the official target, the case for BNM to cut rates by up to 50bps in aggregate in H1 2020 would go up markedly.

Untapped Potential

- 2019 economic growth likely at 6.2% and expected to rebound higher to 6.3% in 2020.
- Liberalisation and reforms look set to continue boosting the economy.
- FDI flows and tourist arrivals from Asia set to remain robust.

GDP growth is likely to meet estimates in 2019.

Myanmar's 2020 economic outlook remains positive despite headwinds from a global trade slowdown. With the implementation of the Myanmar Sustainable Development Plan (MSDP) last August, the country aims for inclusive and transformational economic growth.

Accelerated reform implementation and liberalization of key sectors

With the implementation of the MDSP, Myanmar has been named one of the top 20 in the World Bank's list of most improved countries for ease of doing business. According to the World Bank's "Doing Business 2020" report, there are several key areas which allowed Myanmar to have jumped in the rankings:

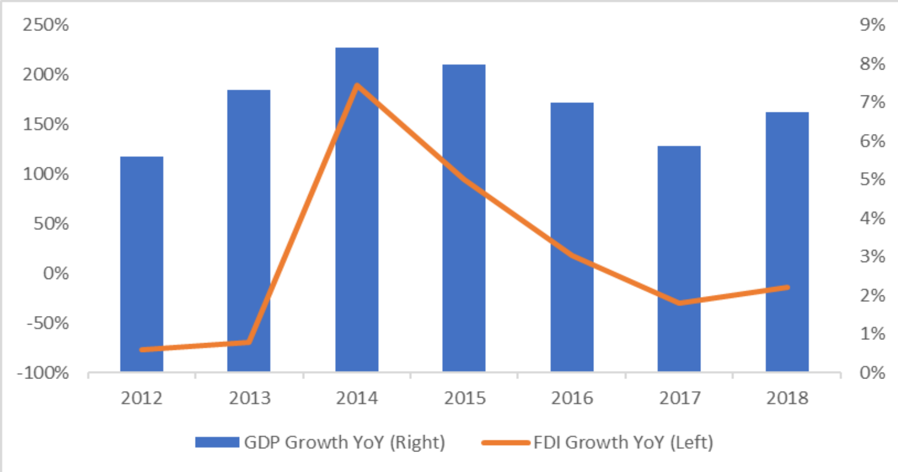
1. The government has been introducing more regulatory measures to ensure the quality of infrastructural projects, such as the stricter requirements for engineers and architects.
2. A series of rules to protect minority investors and enforce contracts was also put to legislation.
3. Establishment of an online platform to streamline the setting up of new businesses.

The accelerated reforms are expected to continue and will make Myanmar an increasingly attractive business destination, especially to multinationals looking to relocate their production out of China, given the US-China trade tensions.

Myanmar remains attractive to Asian investors

The FDI flows into Myanmar have increased over the year, after the government relaxed rules on foreign ownership in the manufacturing, wholesale & retail services, and the finance and insurance sectors. The improved regulation protecting foreign investors and stricter rules to ensure the quality of infrastructure also likely contributed to the rise in FDI in 2018.

Chart 1: Myanmar FDI inflows (USD mn)



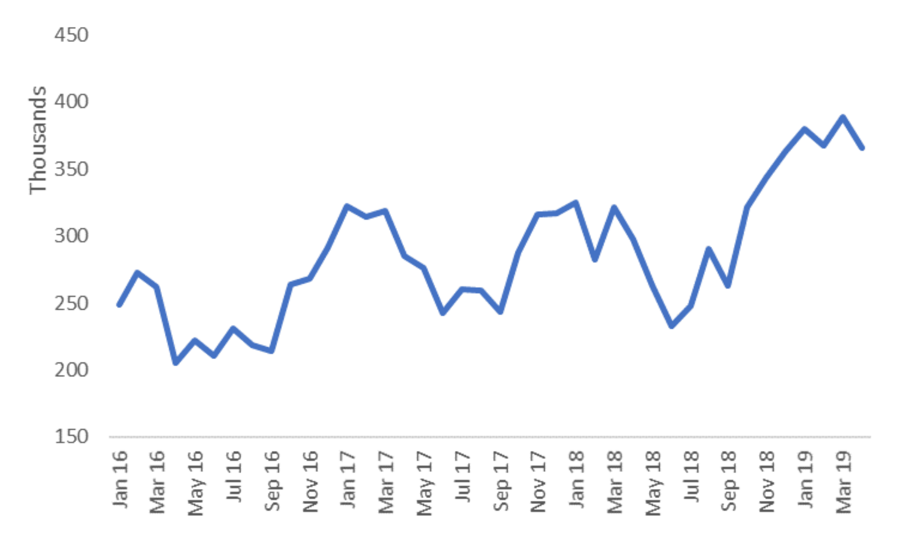
Source: CEIC, IMF, OCBC Bank

The bulk of the FDI inflows come from Asian investors, notably from China ($1.1bn), given that Myanmar is in a key strategic location with regards to the Belt-and-Road Initiative (BRI). The other large source of FDI is Singapore ($2.4bn). FDI was largely channelled into the Transport, Communications, and Manufacturing sectors. On this note, we see a possible uptick in the manufacturing activity in in the upcoming year.

Relaxed visa rules lead the increase in tourist arrivals

Following the relaxation of visa rules for Japan, South Korea and China in August 2018 last year, tourist arrivals in Myanmar have seen a clear uptick, increasing as much as 30.1% in February 2019. The government is now looking to attract more Western tourists by using the same strategy with European nations, which accounted for only 10% of tourist arrivals in 2018, according to the Central Statistical Organisation (CSO) in Myanmar.

Chart 2: Myanmar Monthly Tourist Arrivals

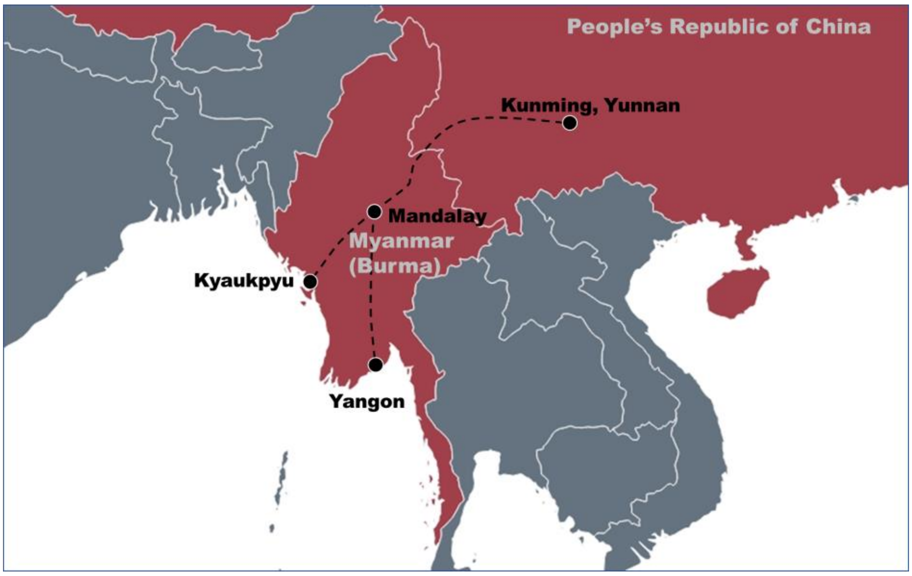


Source: CEIC, OCBC Bank

Strategic geographical location provides opportunities

Sitting between inland China and the Indian Ocean, a trade route running through Myanmar from China has the potential to allow Chinese trade flows to bypass the Strait of Malacca. This led to the proposal of the China-Myanmar Economic Corridor in September 2017, stretching from China's Yunnan to Mandalay in central Myanmar, to Yangon and Rakhine in the southeast and southwest regions of Myanmar respectively.

Figure 1: China-Myanmar Economic Corridor



Source: Visme, OCBC Bank

Negotiations between Myanmar and China with regards to their shared economic corridor have made slow progress. Comparatively, the China-Pakistan Economic Corridor (CPEC) has had more than 50 agreements signed, worth in excess of $46 bn, in contrast to less than $2bn in Myanmar. If Myanmar and China can find a way to resolve issues regarding fears of a debt trap, in addition to environmental and sustainability concerns, the potential for further development and foreign investment into Myanmar will be significant.

Domestic issues regarding the Rohingyas remain a downside risk

Myanmar's alleged issues with the treatment of the Rohingya people have sparked condemnation from the West. Notably, the European Union is considering the revocation of Myanmar's status under the Generalised Scheme of Preferences (GSP), which reduces import duties for goods from Myanmar. This would hit Myanmar's garment industry, which accounted for 24% of all its exports in 2018. Escalation of this issue might also affect the tourism sector and result in lower FDI inflows into the country.

Investment sentiment in 2020 dependent on Rohingya hearing

Myanmar's economic potential remains largely untapped as the recent liberalization of its market continues at a gradual pace. Policies like the MDSP are likely to boost the appeal of Myanmar as a destination of investment flows and trade growth in 2020 and beyond. The current Rohingya crisis, however, may prove to be a stumbling block in the near term, as Myanmar's economy is in its infancy and will continue to require trade preferences from the EU and other major partners. The Myanmar government, led by Aung San Suu Kyi, is currently contesting a lawsuit of alleged genocide at the International Court of Justice; until a clear resolution over this issue is received, it is likely investors will adopt a more cautious stance in diverting funds into Myanmar.

Full Steam Ahead for Duterte's Projects in 2020

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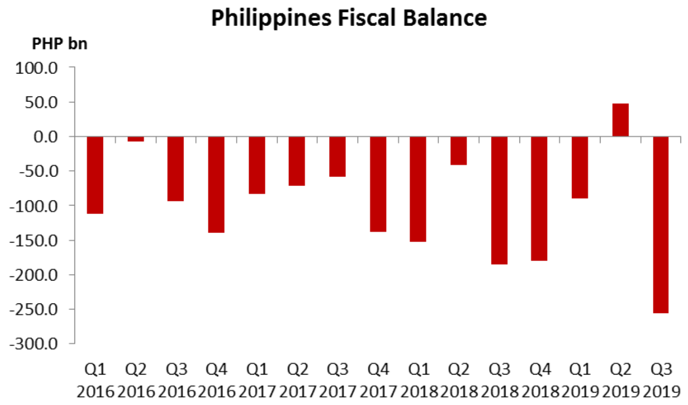
- The fiscal deficit is likely to widen in 2020, with evidence in 2H suggesting that the slowdown in fiscal spending is behind the country.
- Package 2 of the tax reforms are likely to arrive next year, but a repeat of 2018's inflation scenario is unlikely given that alcohol and tobacco have a smaller composition of the CPI.
- The BSP may cut the benchmark rate and RRR twice in 2020.

Fiscal deficit to widen further in 2020

The fiscal deficit in 3Q19 widened to PHP256bn, the largest on record. Despite government revenue increasing 11.3% yoy, expenditure rose at a faster pace of 17.0% in that quarter, with all expenditure segments posting increases yoy. This suggests that the slowdown in fiscal spending in 1H19 is now behind the Philippines, especially after President Duterte strengthened his hold on the Senate after the mid-term elections. In particular, the Duterte administration now looks determined to play catch-up on public spending after delays in 1H, with the sharp increase in Q3 hinting of further disbursements on infrastructure projects in the year ahead.



Source: Bloomberg, CEIC, OCBC Bank

On a 12-month rolling basis, the fiscal deficit still represents a manageable level as a percentage of nominal GDP. As of September 2019, the fiscal deficit is 2.6% of GDP whereas there were higher deficit-to-GDP levels recorded in September 2018 (3.0%) and December 2018 (3.2%). This suggests that there may still be policy space for more aggressive capital expenditure from the government, which we think is highly likely given the expected backload in spending.

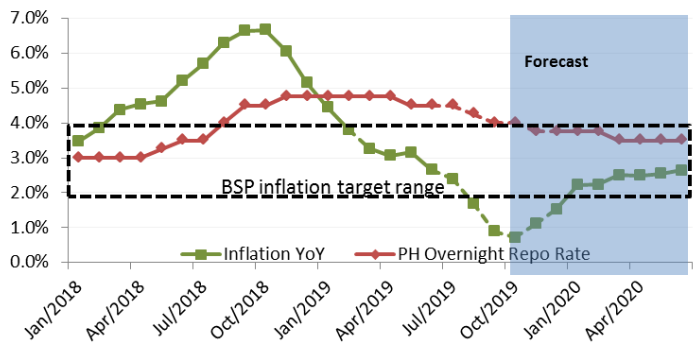
Package 2 of tax reforms to be completed in 2020

The Department of Finance has said that it plans to implement all of the government's tax plans before the end of 2020. Package 2+ (sin tax) is likely to begin next year, with higher excise taxes to be placed on tobacco and alcohol, while package 2 (lowering of corporate income tax rates from 30% to 20%) had its first Senate hearing conducted in September 2019. Package 2+ has sparked concerns that a repeat of the runaway inflation in 2018 as a result of package 1 (TRAIN programme) may be likely. The sharp increase in inflation, however, is unlikely to happen in our opinion. Firstly, the TRAIN programme targeted oil, automobile, tobacco and sweetened beverage excise taxes – components which form a sizeable portion of the CPI. For example, the transport basket alone, which was targeted during package 1, makes up 8% of the CPI; package 2 targets mainly the alcohol and tobacco basket, which comprises 1.6% of the CPI. A repeat of 2018's inflation scenario thus looks unlikely.

BSP to cut benchmark rate and RRR twice in 2020

We expect the BSP to deliver two more 25bp rate cuts to its benchmark interest rate in 2020. The benchmark interest rate is likely to be lowered to 3.5% from 4.0%. How aggressive the cuts to the benchmark rate turn out to be is likely dependent on the resulting inflation from package 2+ as well as the external situation regarding the US-China trade war. As current inflation rates are relatively low and are residing at the bottom end of the BSP's inflation target range of 2-4%, we think the degree of rate cuts would therefore be highly dependent on domestic growth factors. Separately, we think the RRR is likely to be reduced by 200bp to 12%. Governor Benjamin Diokno has made clear of his intention to cut the RRR to single-digit by the end of his term in July 2023. With 400bp of the RRR cuts already implemented this year, the pace of RRR cuts in 2020 is expected to be slower. Bill issuances are likely to increase as a countermeasure to the expected RRR and interest rate cuts, chiefly to avoid runaway inflation.

PH Inflation and Benchmark Interest Rate



Source: CEIC, OCBC Bank

2020 GDP growth expected at 6.2% with headline inflation at 2.6%.

2019 GDP growth in the Philippines is expected to come in a shade below 6.0% at 5.9%, according to our forecast. Growth is expected to rebound in 2020 to 6.2%, with the increase in government expenditure and investments to drive economic growth next year. We expect the headline inflation rate in 2020 to average 2.6% next year.

Green Shoots or Stabilization?

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- After escaping a technical recession in 3Q19, the worst appears to be over. The Singapore economy may have bottomed in 2Q19, with some tentative signs of stabilization and marginal improvement in both the manufacturing and electronics sectors.
- Prospects for 2020 GDP growth tilt towards stabilization. We expect 2019 growth of 0.7% yoy to improve modestly to 1-2% yoy in 2020, which is in line with the official forecast of 0.5-2.5%.
- On the policy front, MAS has already eased monetary policy in October 2019 by flattening the S$NEER slope to around 0.5% pa, and market attention will turn to the upcoming 2020 Budget which is touted to be a pre-election budget.

After bottoming in 2Q19, GDP growth is likely to improve modestly into 2020.

Prospects for 2020 tilt towards stabilization: Our 2020 GDP growth forecast is 1-2% yoy with a midpoint of 1.5% yoy, but given the already very low base for NODX, we think NODX may print a slightly more positive 2-4% yoy if there is no further escalation of US-China trade tensions in the form of fresh tariffs/hikes. This is consistent with the official forecast range of 0.5-2.5% yoy growth in 2020, albeit their NODX growth forecast is less upbeat at 0-2% yoy, versus their forecast for 0.5-1.0% GDP growth and a 9.5-10% yoy NODX contraction (previously at a 8-9% yoy contraction in August) for 2019.

Headwinds remain familiar going into 2020 amid renewed worries about progress and the actual signing of the US-China Phase 1 trade deal. The November Fed minutes also revealed more knuckle-cracking concerns about downside risks to the economic outlook, which suggests that while the Fed is currently in pause and watch mode, this does not mean that another rate cut is completely off the table next year. Moreover, Brexit uncertainties remain. In summary, it is still too early to break out the champagne yet.

Given that 2019 growth will be a very low base, the 2020 growth range is likely to see a modest improvement to around 1-2% yoy assuming that the global trade tensions do not escalate further from here and the manufacturing and trade outlook sees a modicum of stabilization.

The same old risks for the S'pore economy are largely external.

The biggest risk remains the fragility of the external environment and the prospect of anaemic global growth amid the myriad of uncertainties pertaining to US-China tensions beyond trade, Brexit, China's slowdown, and geopolitical hotspots in Hong Kong etc which could continue to weigh on business and consumer confidence. With leading indicators like PMIs still suggesting that the global manufacturing slowdown is well-entrenched, it is of no surprise that central banks have pivoted to monetary policy easing. Still, the domestic labour market bears close monitoring as a further softening may warrant a more robust fiscal response from S'pore policymakers.

Inflation expectations are dovish in 2019 and may remain so in 2020.

MAS and MTI both continue to expect external inflation to remain benign ahead amid weak demand conditions and generally well-supplied food and oil commodity markets. However, they did note that crude oil prices could be volatile in the near-term to reflect geopolitical risks. Domestic inflation should, however, reflect softening labour market conditions and a lower wage growth trajectory as we head into 2020. Non-labour costs such as retail rents should also stay subdued, hence any cost pass-through to end-consumers would likely be constrained by the subdued macro-economic environment.

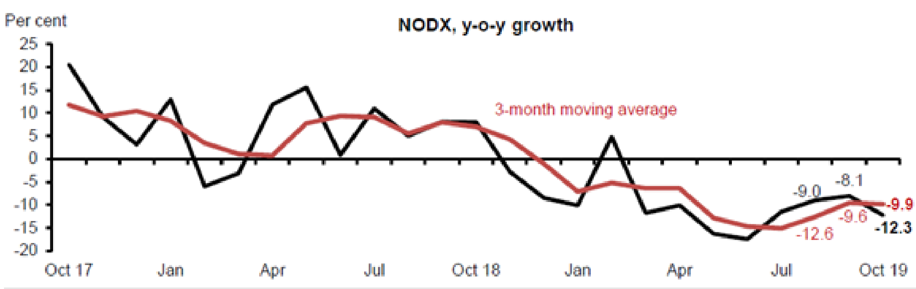
Our headline inflation is forecast at just above the 1% handle for 2020. This is consistent with MAS-MTI's headline inflation forecast of around 0.5-1.5% in 2020 as the negative contribution of imputed rentals to headline inflation dissipates. In addition, MAS-MTI tips core inflation to be at the average 0.5-1.5% next year. At this juncture, the domestic inflation picture remains dovish while the growth outlook still remains somewhat tepid in the near-term, which will likely keep MAS in stasis for now.

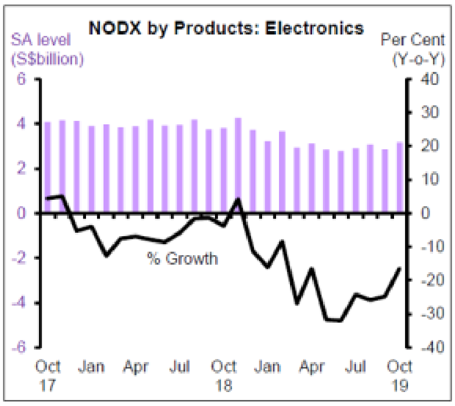
The NODX engine is still underperforming, but watch industrial production.

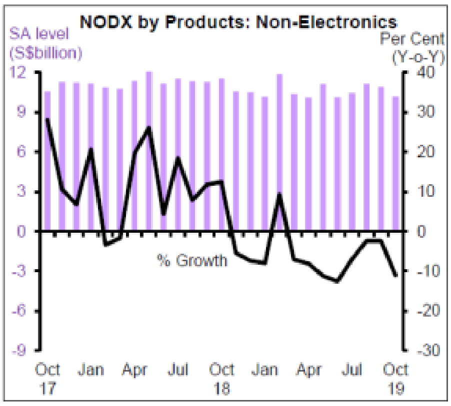
The US-China trade and tech war has clearly taken a toll. Electronics NODX has fallen 22.6% yoy to-date, with 10 double-digit declines recorded in the last 11 months with the exception of February 2019 (-8.4% yoy). Still, on absolute terms, electronics NODX had likely hit bottom around June this year and is showing some tentative signs of stabilization.

NODX to 9 of our top 10 NODX markets also fell in 2019 year-to-date, with the exception of the US (which rose marginally by 0.1% yoy year-to-date). At this juncture, market players are assuming and awaiting that the Phase 1 of the US-China trade deal will progress to an actual signing by Trump and Xi, which could pave the way for some stabilization in global demand conditions ahead in 2020.

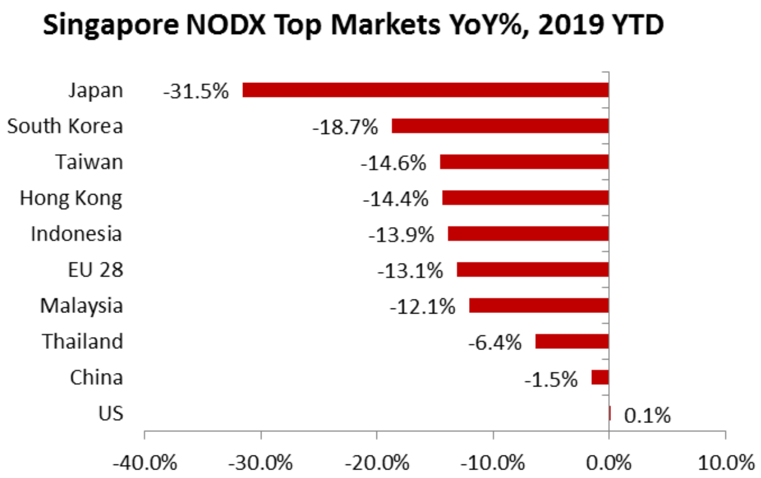
We anticipate that the NODX growth contraction could ease to -5.5% yoy in November and possibly revert to marginal but positive growth of 3.1% yoy in December to bring full-year 2019 NODX growth to -9.1% yoy. The latter would still be the worst NODX performance since 2009's -10.5% yoy reading and is a sharp slump from 2018's +4.2% yoy growth.







Source: Enterprise Singapore



Source: CEIC, OCBC Bank

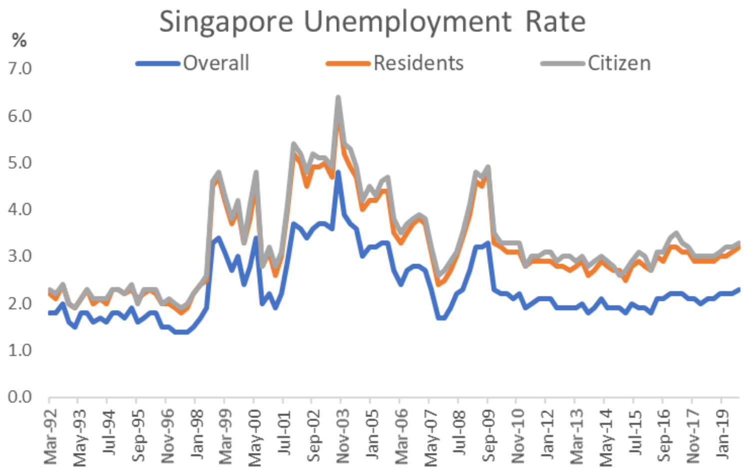
October industrial production surprised positively, recording the highest growth print since November 2018. Interestingly, the electronics cluster also eked out positive growth of 0.4% yoy, marking its first expansion after seven months of drought and reinforcing the view that the electronics sector may have bottomed mid-year and is beginning to see some green shoots.

The labour market remains resilient but may soften a tad more in 2020.

Spore's overall, resident and citizen unemployment rates rose to 2.3% (highest since 2009), 3.2% and 3.3% (both at 2-year highs) respectively in 3Q19. There appears to be some mismatch as unemployment rates rose even though there were still vacancies.

Total employment (excluding FDW) rose by 22.4k (+34% yoy) and was broad-based. Retrenchments rose 25% qoq to 2.9k in 3Q19 (3Q18: 2.86k), mainly services (66%). An estimated 74.7k residents (including 65k citizens) were unemployed in September. The unemployment rate may hover around the 2.3-2.5% in the interim, but should avoid the sharp spikes seen in the Global Financial Crisis (GFC) back in 2009.

In the advent of IoT and automation through technology such as AI, Singapore is expected to see the largest disruption in its workforce among ASEAN countries. Singapore may see a faster and more widespread digital transformation compared to its ASEAN peers, but major upskilling or reskilling needed for the labour force to stay relevant and fill new jobs created by Industry 4.0. This is likely to remain a key focus in the upcoming and future Budgets.

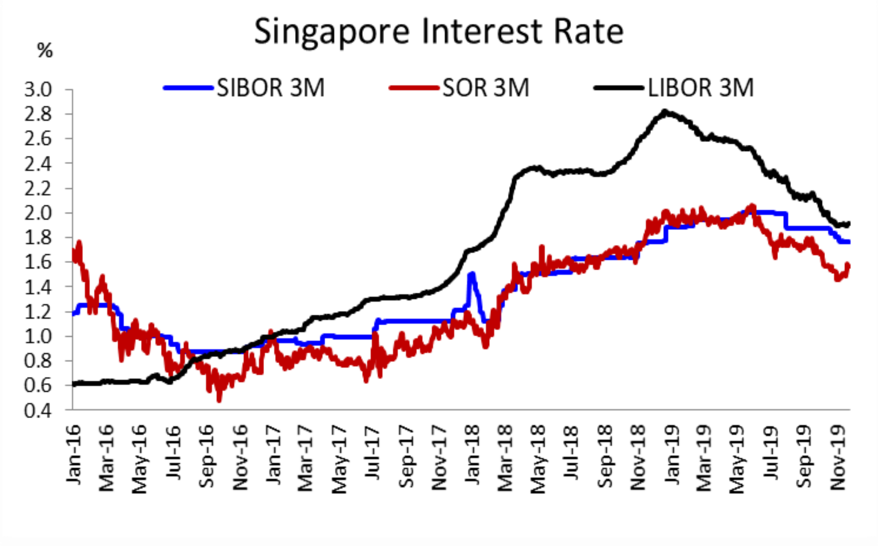


Source: CEIC, OCBC Bank

Whither the monetary and fiscal policy space: More to come?

Monetary policy setting has turned more accommodative. MAS has already eased monetary policy in October 2019 by flattening the S$NEER slope to around 0.5% pa. However, the SGD NEER remains supported despite the recent easing.

Domestic short-term interest rates are playing catch up to 3-month LIBOR. 3-month SOR collapsed to a year-to-date low of 1.45% in early November and is currently trading at 1.59% on 5 December. The 3-month SIBOR is also hovering near its year-to-date low of 1.76%. Our end-2020 forecast for 3M SOR and SIBOR are 1.38% and 1.60% respectively in anticipation that a lacklustre recovery in the global and domestic economy coupled with benign inflation expectations will not precipitate higher interest rates in the near-term.



More goodies at the upcoming pre-election 2020 "strong" Budget?

There is space for a stronger fiscal response at the upcoming 2020 Budget. Market attention is increasingly focused on what is touted to be a pre-election budget. Looking around the region, Japan has announced a stimulus package amounting to some JPY26 trillion, while Hong Kong has announced four waves of fiscal packages to mitigate the recession, and China's proactive fiscal policy support has also been forthcoming, and so on and so forth from South Korea, Thailand and India. Hence, Singapore will be in good company if it unleashes some fiscal boost as well.

A quick recap of the 2019 Budget highlights included the following:

- Merdeka Generation Package and greater healthcare assistance (CHAS etc).
- Bicentennial Bonus and Community Fund
- Financing for long-term infrastructure.
- Preparing for climate change.

In terms of what to expect for the 2020 Budget, our thoughts are as follows:

- Strong hint of a GST offset package is in the offing. Without a specific timeline on the actual implementation of the planned GST hike, it may be premature to speculate on the actual quantum of the GST offset package but the modalities are likely to be the usual GST vouchers etc. Focus will still be targeted at supporting low-income households and seniors.
- How to fund the $100b to combat climate change over 100 years? Will this be a steady drip of $1b per annum or a lump sum special transfer set aside in the 2020 Budget?
- How to assist displaced workers and SMEs ride out these challenging times? Maybe it is timely to top up the SkillsFuture scheme from the initial $500 per Singaporean and offer more work transition/facilitation programmes. For SMEs, greater assistance to help local companies in terms of enterprise capability building,

innovation and internationalisation efforts in light of the global trade tensions will be likely.

- Focus on medium-term priorities such as healthcare, education, security (including cybersecurity and food security), productivity improvements and environmental and financial sustainability.

Trade War Overhang Likely to Linger

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- Demand and supply in the electronics chain are likely to continue feeling the squeeze from the two trade wars South Korea is facing. Loss of jobs in manufacturing, presumably a result of stress in the exports sector, would likely lead to softening private consumption.
- South Korea's public debt to GDP ratio remains one of the lowest in the region and with the legislative elections next year, there might be more fiscal spending.
- We think the Bank of Korea (BOK) is unlikely to cut rates further in 2020 if US-China relations do not further deteriorate from here.

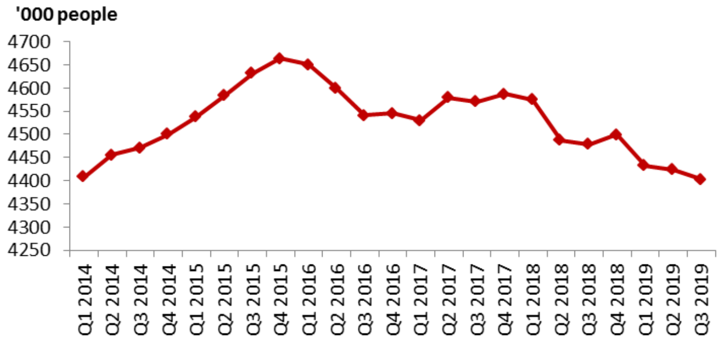
Growth to continue to stagger into 2020 as trade tensions linger

The South Korean economy, which traditionally serves as a bellwether for global trade flows, has been hard hit by tensions between the US and China in 2019. Adding to the mix of challenges was the Japan-South Korea tensions, which limited the supply of crucial raw inputs from Japan in South Korea's manufacturing of electronic products. Leaders from both Japan and South Korea apparently had a meeting during the ASEAN summit in November, but Japan officials had dismissed that as a brief conversation borne out of coincidence. With both demand (from China) and supply (from Japan) issues squeezing the all-important electronics sector in South Korea, the economic fallout on the country is likely to continue into 2020.

Manufacturing sector continues to shed jobs

A spill over from the US-China trade war onto the South Korean economy is the loss of jobs in the manufacturing sector, presumably linked to the automobile and electronic sectors. Since peaking at an average of 4.66mn workers in Q4 2015, manufacturers have shed about 260k jobs to average only 4.4mn jobs in Q3 2019. Poor external demand for manufactured goods and the hike in domestic minimum wages have contributed to the declining employment in the sector, which typically contributes about 16% of the total labour force.

South Korea Manufacturing Employment

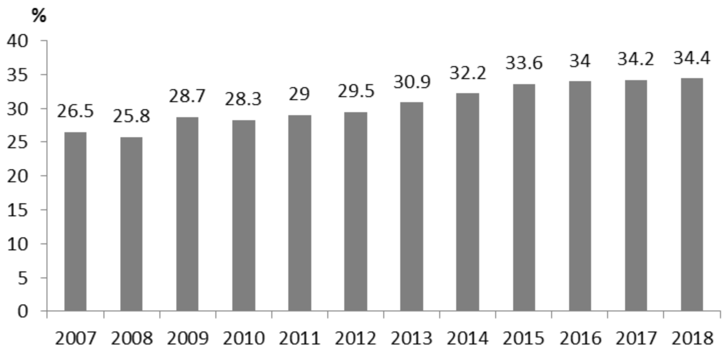


Source: CEIC, OCBC Bank

Expansionary budget in 2020

With monetary buffers running thin and South Korea facing a negative cyclical backdrop, the government has budgeted a 9.3% increase in fiscal expenditure in 2020. South Korea's government debt-to-GDP ratio stood at 34.4% in 2018 and ranks among one of the most conservative in the region. The Philippines and Thailand, for example, have their ratios around 40%. While we agree that years of prudence on debt loading should not be abandoned overnight, the current circumstances warrant a larger than normal expenditure. Initial headlines suggest that a substantial portion of the budget would be directed towards job creation and increasing self-reliance in key industries. We think welfare measures might be announced once the budget gains more clarity, especially with the legislative elections due in April 2020.

South Korea Government Debt to GDP Ratio



Source: CEIC, OCBC Bank

Bank of Korea to stand pat on interest rates

We think the Bank of Korea is likely to stand pat on its interest rate decisions in 2020, especially with the benchmark rate already at a record low of 1.25%. However, we also note that the central bank is highly likely to be data dependent, particularly in response to the inflation path, export prospects, and the two trade wars that the economy finds itself embroiled in, directly or indirectly. Governor Lee Ju-Yeol has hinted that he would prefer fiscal policies to do the heavy lifting, remarking before parliament that rate cuts have a diminishing effect on stimulating the economy and "fiscal policy can be more effective." Additionally, the Bank of Korea remains concerned with the high levels of household debt, which would serve as an additional hurdle for the central bank to continue pursuing looser monetary policies. We see the possibility that the Bank of Korea may conduct one more rate cut in 2020 to leave the benchmark rate at 1.00%, but beyond that might be a tall order.

We see 2020 growth at 2.2% with inflation at 0.9% yoy.

We forecast South Korea's economic growth in 2020 at 2.2% yoy, a slight improvement from our expectations of 1.8% in 2019. A combination of low base effects, aggressive fiscal expenditure and optimism that US-China relations will not dive further south is our main driver for the uptick in growth projections. Separately, we expect the headline inflation rate to creep higher to 0.9% mainly due to low base effects. Import-led demand is expected to remain soft while we do not expect crude oil prices to rise materially in 2020. Both factors combined are likely to add a cap to price gains in the economy.

Muddling Through the Trade War

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- Domestic demand remained resilient. Against the external headwinds, Taiwan's economy benefited from order transfers, stronger-than-expected Taiwanese overseas businesses repatriation and industrial and economic remodelling and upgrading.
- The state of the cross-straits relationship is still crucial to sentiment in 2020.
- Central bank is expected to keep its prudent monetary policy unchanged.

The Taiwanese economy unexpectedly accelerated further to 2.91% yoy in the third quarter of 2019, despite protracted global trade conflicts and the global growth slowdown. Taiwan's growth in the first three quarters of 2019 can be mainly attributed to the stronger than expected investment repatriation effects and order transfer effects due to US-China trade war.

Domestic demand is expected to improve further

Private consumption accelerated from 1.55% yoy in 2Q to 1.96% yoy in 3Q 2019. Meanwhile, the consumer confidence index returned to the level above 80 (80.97) in September, compared to 79.48 in May, partially driven by the August announcement about the increase of minimum wage TWD 23100 to TWD 23800 which would take effect in January 2020.

Although the prospect of wage growth might help to bolster domestic consumption, we expect that the overall consumption sentiment is likely to remain sluggish due to the concerns over potential shocks in the labour market as a result of lingering US-China trade war risks and tightening tourism permits by China. The job opportunity index, which is a sub-index of consumer confidence index, dropped to 87.6 in October from 100.9 a year ago.

Fixed capital formation was the bright spot in 2019 despite a contraction in the 3Q which was mainly driven by decline in inventory and high base effect. Fixed investment grew at a stronger pace at 4.78% yoy for the first three quarters of 2019 amid the return of overseas Taiwanese business. According to official data, there were more than 140 Taiwanese enterprises returning to the island, with the investment amount more than TWD 600 billion. It is expected that more than 50000 job opportunities would be created. Clearly, the return of Taiwanese businesses might lend support to the economic growth of Taiwan, at least in two aspects. Firstly, labour demands would be enhanced as enterprises would seek for talents to satisfy domestic business needs. As a result, it might speed up the wage growth further and tighten domestic labour market. Secondly, the return of Taiwanese enterprises might also induce positive knock-on effect driving up the demands for other sectors, including construction, financial services industry and raw material supply.

In short, we expect that the domestic demand would improve further in the first half of 2020. Despite the multiple external headwinds might continue to dent overall sentiments, the robust labour market, the positive prospect of wage growth and stronger fixed investment might help to boost the domestic demands.

External headwinds are not all negative

Taiwan's trade performance was not immune from the rising geopolitical risks including the US-China trade war and Japan South Korea dispute, as the year-on-year export growth contracted for ten months out of twelve months since Nov 2018. The cumulative amount of export orders fell by 6.1% yoy during the first three quarters of 2019.

Although the road to a complete trade deal between US and China remains bumpy, we think the negative impact of trade war on Taiwan could be limited for two reasons.

Firstly, the effect of order transfers. In the first three quarters of 2019, the decline of Taiwan's exports was softer than other major trading hubs of Asia, including HK, South Korea and Singapore. Moreover, the exports to US and South Korea picked up by 17.7% yoy and 8.3% yoy respectively for the first three quarters of 2019. This suggests that parts of the export orders have been transferred to Taiwan because the Island has not been involved in trade conflicts directly and Taiwan possesses strong capacity to provide semiconductor technology which could satisfy the material shortage encountered by South Korea.

Chart 1: Taiwan's export orders

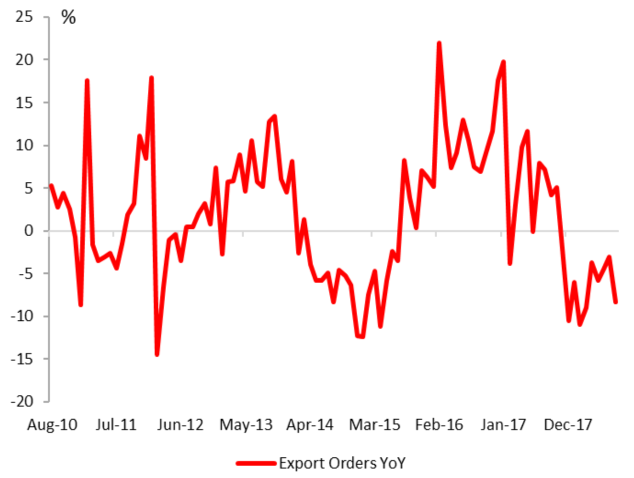
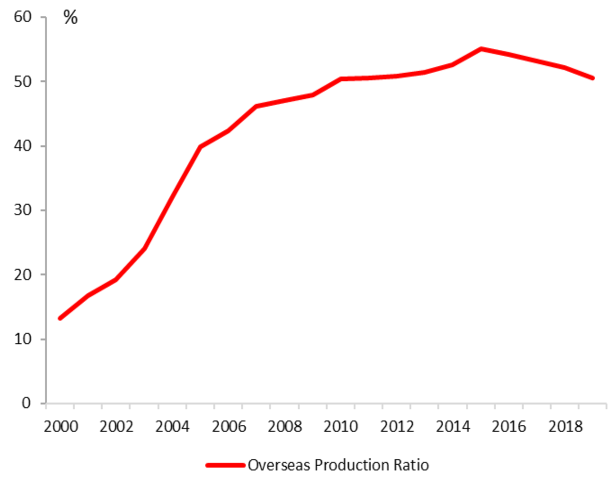


Chart 2: Overseas production ratio fell



Secondly, trade war risks have changed the business and economic models of Taiwan. In the past, Taiwan's manufacturing runs on the model of "receive orders in Taiwan, produce goods in China, ship products to overseas". As a result of the lingering trade conflicts, the return of Taiwanese businesses to invest in Taiwan might help to remodel and upgrade the domestic production chain, especially for the advanced manufacturing industry such as semiconductors. According to the Department of Statistics of the Ministry of Economic Affairs, the overseas production ratio dropped to 51.2% during the first three quarters of 2019, compared to 52.1% in the whole 2018. In fact, some well-known brands like Foxconn Technology Group, Inventec Corp., Quanta Computer Inc. and Compal Electronics Inc. have set up new factories or increased the domestic investment in Taiwan.

The positive effects of order transfer helped to ease the shocks of trade war. According to the Governor of CBC Yang Chin-long, the impact of order transfer would persist at least until 2020. We expect the performance of exports might improve in 2020 amid low base effect and order transfer effect. Nevertheless, external headwinds including the trade war risks and global macroeconomic performance might remain crucial variables.

Cross-Strait relationship is still crucial in 2020

Visitor arrival from mainland China tumbled recently after China tightened individual travel permits to Taiwan. According to the survey conducted by the travel industry, the number of mainland visitors is expected to reduce by 1 million by the end of 2019. Thanks to the TWD 4.6 billion relief measures supported by government, including the wave of visa fee and cash coupons for night market, it might help to relieve the negative impact on the tourism-related sector and retail sector arising from the tense relationship between Taiwan and China.

In addition, Taiwan's Presidential election, which is scheduled to be held on 11 January 2020, will be a key focus next year. The ruling party DPP's position on the Hong Kong unrest in its campaign may complicate the China-Taiwan bilateral relationship going forwards.

Prudent monetary policy stance remains unchanged

Taiwan's central bank revised the 2019 GDP growth forecast up from 2.06% to 2.4% as CBC expected that the economic growth in the second half of 2019 would be stronger than the first half of this year amid two favourable factors. First, the government's proactive stimulus polices might help to bolster the domestic consumption sentiments. Second, the rising overseas Taiwanese businesses repatriation might help to speed up private investments. Despite the prospect of further wage enhancement this year, the uncertain global outlook, lower oil price forecast and moderate domestic demand might cap the upside for inflationary risks.

In a nutshell, the economic growth and inflationary pressure for 2020 is likely to remain modest. Therefore, CBC would continue to keep a prudent monetary policy in order to achieve the target of price stabilization and economic and financial growth. We expect that the CBC would keep its benchmark rate unchanged in the first half of 2020. For the second half of 2020, it would depend on the domestic economic performance and external environment.

Chart 3: muted inflationary pressure

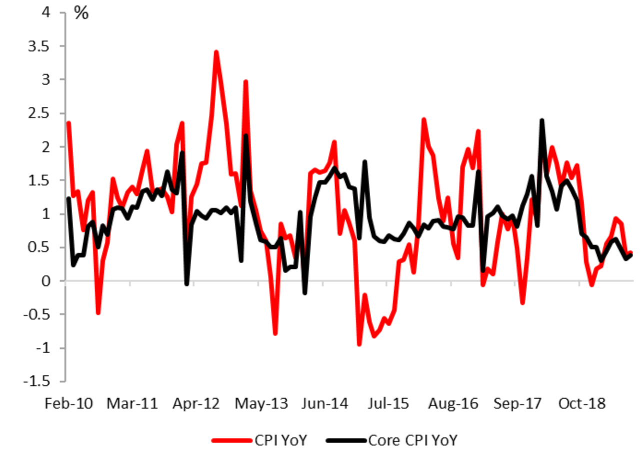
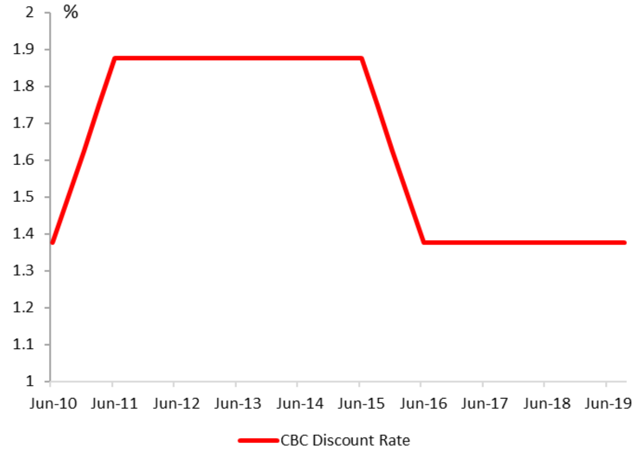


Chart 2: prudent monetary policy remains



To conclude, despite the enduring external headwinds, we expect that the GDP growth will stand above 2.3% yoy in 2019 and 2.4% yoy in 2020 on the back of support from order transfer, stronger-than-expected Taiwanese overseas businesses repatriation and industrial and economic re-modelling and upgrading. Nevertheless, the 2020 President Election, US-China trade war risks and the subdued global economic outlook might remain the key uncertainties in 2020. CPI inflation is likely to pick up by from 0.5% in the first ten months of 2019 to 0.7% for the first half of 2020, reflecting a modest price growth. On the back of moderate economic growth and inflationary pressure, we expect the CBC to maintain its prudent easing monetary policy stance unchanged at least until the first half of 2020.

Fiscal Spending Key to Stimulating Thailand's 2020 Growth

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- Soft import demand from falling household consumption, on top of continued fund inflows, are trapping Thai exports in a downward spiral. The strong baht and the US-China trade war have also hurt tourism prospects in Thailand, although there is evidence that tourism is rebounding.
- The Finance Ministry has repeatedly said that it stands ready to unveil more fiscal stimulus if needed, even though it is already planning a record 2.2tn baht budget for 2020.
- We think the BoT is likely done with its rate reduction cycle for now, although the central bank has said 1.25% may not be its lower interest rate bound.

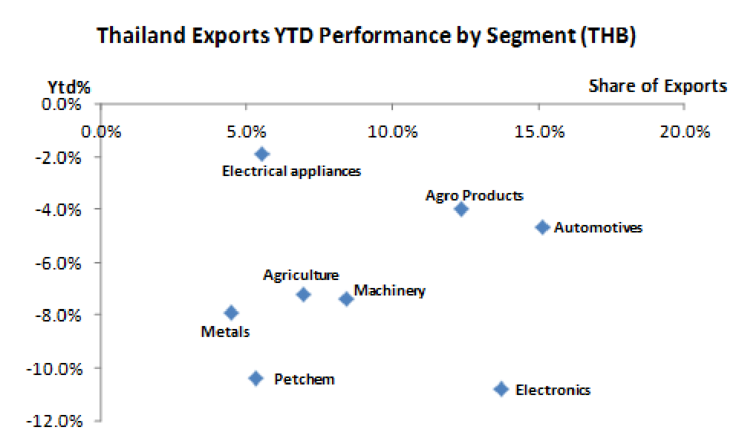
Thailand's self-reinforcing economic conundrum

Thailand's vicious self-reinforcing cycle looks like there is no end in sight until external growth picks up. To summarise the economic situation of Thailand:

- The US-China trade war has led consistent contractions in the exports sector. Manufacturing has suffered, like every other manufacturing-reliant economy in the world.
- Domestically, Thailand is faced with two main problems. The first is poor local consumption, with the high household debt levels a main challenge. The second is the delays related to the budget and infrastructure spending due to this year's elections.
- The net effect is Thailand continues to run a current account surplus on top of sluggish domestic consumption. The current account surplus, in addition to sizeable foreign reserves (40% of GDP), has resulted in the Thai baht being seen as a regional safe haven currency, especially within Southeast Asia.
- As Thailand attracts fund inflows due to its regional safe haven status, the baht continues to appreciate. The strong currency adds to the export woes, with tourism (viewed as services exports) taking a particular hit.
- To top it off, Thailand is at risk of being placed on the US watchlist of currency manipulators. Their trade preferences with the US have already been removed as of Q4 2019.
- The Bank of Thailand therefore finds itself limited on two fronts. First, high household debt deters them from aggressive monetary stimulus for fear of rocking financial stability. Secondly, the risk of being placed on the US Treasury watchlist of currency manipulators may have resulted in the BOT adopting more caution in implementing aggressive monetary easing policies.

Exports and tourism hurting on external deterioration and strong THB

The export sector, especially within manufacturing, has been hard hit due to slowing demand externally as well as a strong baht. In particular, the electronics sector, which is the second largest segment in Thailand's export market, has faced the most severe downturn in demand, with a contraction of 10.8% (measured in baht terms) in the first 9 months of 2019. The weakness in the electronics sector is not limited to Thailand alone. The large electronic-manufacturing economies have all faced slowing growth concerns due to a slowdown in demand for smartphones and PCs. Other areas of notable trade slowdown in Thailand include automobiles (-4.7%), petrochemicals (-10.4%), agro-products (-4.0%) and machinery (-7.4%), measured in baht. These five segments make up 55% of Thailand's exports in 2019.



Source: CEIC, OCBC Bank

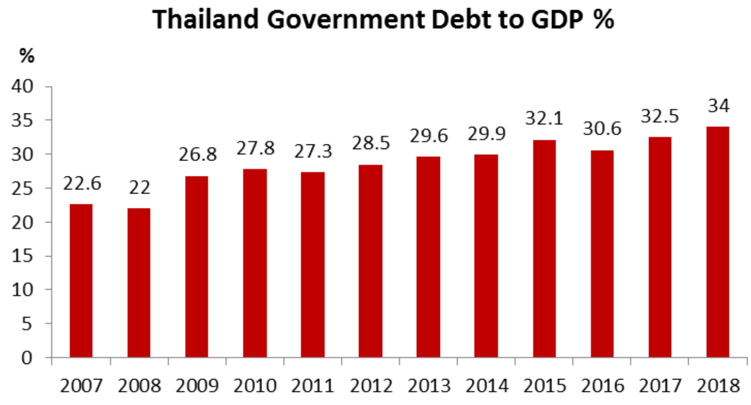
Tourism in Thailand has seen a notable slowdown as well. We forecast full-year 2019 total tourist arrivals at 39.6mn visitors, a growth rate of 3.7% yoy which is the slowest since 2014. There appears to be a bottoming out in the decline of tourists in Q3, which boasted a growth rate of 7.2% yoy. That statistic, however, may have been slightly skewed by low base effects from a year ago, where Chinese tourists to Thailand plummeted in light of the Phuket ferry incident. We forecast total Chinese arrivals in Thailand to have grown 2.7% yoy this year which is a marked decline from the 7.4% yoy increase in 2018.

Source: CEIC, OCBC Bank

Both sectors are expected to pick up if the external growth situation, especially within China, improves. To that extent, a more comprehensive trade deal than the phase one would be needed to instil business confidence back in China, encourage the Chinese to consume, invest and import more. Without that return of confidence, it is difficult to see marked improvements in Thailand's exports and tourism sectors next year.

Fiscal policy to take the reins in 2020

With the monetary buffer in Thailand running thin, attention now turns to the Thai government to implement more expansionary fiscal policies to stimulate growth in the economy. In August, the cabinet has already approved a 316bn baht programme that sought to increase credit lines to SMEs, provide loans to drought-stricken farmers in the north and boost the tourism sector via rebates. In October, the cabinet has approved the 2020 budget of 3.2tn baht in its first hearing. This budget is set to be implemented in February 2020 at earliest, given that a second reading on the budget is due in January 2020. With public debt to GDP at 34% as at December 2018, we think that the government can afford to roll out more fiscal stimulus programmes, with the threshold of 60% public debt-to-GDP ratio set in the Fiscal Responsibility Act still a considerable gap away. The 2020 budget of 3.2tn baht is also just 6.7% more than 2019's budget of 3.0tn baht, and is not viewed as overly aggressive. In November, finance minister Uttama Savanayana has also said that the government is ready to implement more economic stimulus if necessary, which suggests that the 2020 expenditure might eventually exceed the 3.2tn baht target.

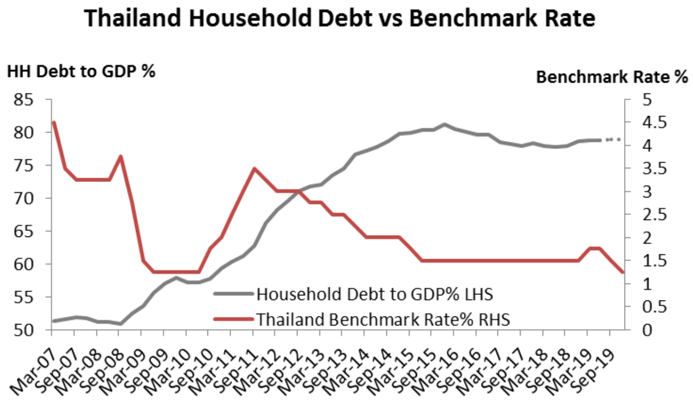


Source: CEIC, OCBC Bank

Bank of Thailand turns its attention to capital outflows

The benchmark interest rate in Thailand now stands at 1.25%, and is likely to close 2019 at that level. This is a joint record-low interest rate that was last seen during the 2009 GFC. In light of the persistently high household debt levels, the apparent negligible impact on the baht after two rate cuts, as well as possible concerns over being placed on the US Treasury watchlist of currency manipulation, have likely raised the hurdle for further rate reductions from here.

In the November meeting, some key measures were brought forward to facilitate capital outflows as the Bank of Thailand looks to tame the baht's appreciation. We think the measures announced are likely to have a limited impact on the baht, as we are still expecting Thailand to run a healthy current account surplus in 2020. More policies are expected to be forthcoming, however, if the baht strength remains elevated.



Source: Bloomberg, CEIC, OCBC Bank

2020 GDP growth expected at 2.9% with inflation at 0.6% yoy.

We estimate full-year 2020 GDP growth at 2.9%, which is little changed from the 2.7% that we are forecasting for 2019. The magnitude of growth rebound will likely be highly dependent on the pace and depth of the US-China trade agreement, if at all. Expansionary fiscal policies are also likely to play a key role in Thailand's growth next year, although the well-documented concerns of the gridlocked parliament may result in some project delays. The RCEP free-trade agreements should help to alleviate some stress off Thailand's embattled export sector, although we are less hopeful that the long-running negotiations over the China-backed high-speed railway from Bangkok to the Laos border may see a conclusion before the end of 2019. We see 2020 inflation at 0.6% yoy, slightly lower than this year's 0.7%, as we expect the continued strength of the baht to keep import costs low.

At the Crossroads of Shifting Supply Chains

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- Vietnam is set for a record high FDI in 2019, driven primarily by investments from China (including Hong Kong). FDI has been largely flowing into Vietnam's manufacturing sector.
- Vietnam may be a victim of its own success if the US begins to target the economy due to Chinese manufacturing spillovers.
- Growth may rebound next year if there is no further deceleration in US-China relations.

Resilient exports as Vietnam sees more FDI inflows.

Vietnam has largely demonstrated resilience for most of 2019 as consensus largely pointed to the economy as the biggest beneficiary of the US-China trade war. The economy's export growth of 8.3% year-to-date, while not as stellar as previous years, is still in expansion territory, a statistic that other export-dependent economies in the region particularly Singapore, Thailand and South Korea were unable to boast of. This growth rate, however, would be the economy's slowest pace of export expansion since the 2009 GFC.

Source: CEIC, OCBC Bank

FDIs have also continued to display higher inflows yoy, led largely by funds from China (including Hong Kong). To-date in October, funds flowing in from China have almost tripled yoy, rising from $1.4bn last October to $3.8bn this year. China also looks set to be the biggest foreign investor of Vietnam this year, overtaking the likes of South Korea, Japan and Singapore. China normally accounts for 5-10% of Vietnam's FDI, but to-date the country already comprises 12.9% of Vietnam's foreign investments, overshadowing South Korea (9.5%), Singapore (6.3%) and Japan (5.6%).

Composition of FDI by Country				
Country	**2016**	**2017**	**2018**	**2019***
China (incl HK)	9.7%	6.0%	6.6%	12.9%
Japan	3.6%	21.6%	18.6%	5.6%
South Korea	22.6%	11.1%	10.3%	9.5%
Singapore	6.5%	10.5%	4.0%	6.3%

** as of October 2019*

Source: CEIC, OCBC Bank

The disbursement ratio of FDI in Vietnam has also seen improvements in 2019. Vietnam has typically faced challenges with a low disbursement ratio of FDI as foreign investors presumably lay a larger upfront investment capital to qualify for incentives. The disbursement ratio in October stood at 55.6%, an improvement over 2017 (50.3%) and 2018 (54.1%). Manufacturing has increased its stranglehold over the foreign funds, with the sector now possessing 68% of total FDI.

FDI Flows into Vietnam Industries (USD $bn)					
	2015	**2016**	**2017**	**2018**	**2019***
Total	22.8	24.4	35.9	35.5	29.1
Manufacturing	15.2	15.5	15.9	16.6	19.8
Real Estate Activities	2.4	1.7	3.1	6.6	3.0
Commerce	0.5	1.9	2.4	3.7	2.0
Electricity, Gas, Aircon	2.8	0.1	8.4	1.6	0.8
Scientific Technology	0.3	0.9	1.0	2.1	1.2
Construction	0.7	0.6	1.1	1.2	0.7

** as of October 2019*

Source: CEIC, OCBC Bank

Both the export and FDI pictures suggest that there has been a relocation of supply chains, especially from the Chinese manufacturing scene, into Vietnam. The manufactured goods are then exported for consumption to foreign markets. At first glance, Vietnam appears to have been a beneficiary of the US-China trade war. But as the slowing global trade growth suggests, while Vietnam may have benefited from the substitution effect of relocating supply chains, it is not invulnerable to the lowered wealth effects that the trade war has plunged the global economy into.

High on US watchlist

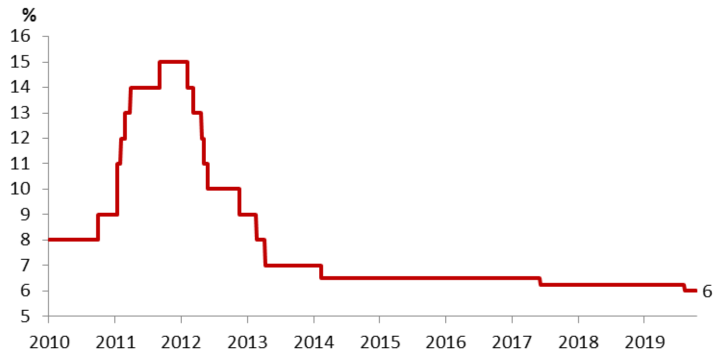
Vietnam entered the US watchlist of currency manipulators in the US Treasury's May 2019 report. With a trade surplus of $39.5bn and a current account surplus of 2.4% at end-2018, it is in excess of the thresholds of $20bn and 2% set by the US respectively. While being on the watchlist does not warrant any penalties, it will still likely rattle investment confidence. Furthermore, as China can testify, the US can label any country a currency manipulator even if not all three requirements are met. Vietnam is in the thick of the crossfire as the country is viewed as hosting relocated Chinese production facilities with the hope to circumvent the increased tariffs via exporting from Vietnam. In some ways, Vietnam may find itself a victim of its own success if it continues to attract FDI from China while increasing its share of exports to the US.

Criteria	Previous Threshold	New Threshold	Vietnam
Trade surplus with the US	$20bn	$20bn	$39.5bn
Large current account surplus	3% of GDP	2% of GDP	2.4%
Intervention in FX market	8 of 12 months	6 of 12 months	NA

SBV has started cutting interest rates

The State Bank of Vietnam ("SBV") has cut its benchmark policy rate to 6% in September 2019 for the first time in more than two years. Given the easing cycles that global central banks have embarked on, it is perhaps not surprising to see the SBV follow suit. The SBV has also lowered other key interest rates, including lowering the limit on interest rates for dong deposits with maturities of 1-6% from 5.5% to 5%. The lending rate for short-term loans was also lowered to 6% from 6.5%. Both the private and public debt levels of Vietnam are relatively low compared to regional peers. Private debt to GDP is estimated at 56.1% and public debt to GDP at 49.2% by the Ministry of Finance which is one of the lowest among ASEAN 6 economies. Inflation also remains favourably low and the economy shows no signs of overheating. There still appears to be room for further rate cuts to support growth if there is a necessity, given the relatively subdued inflation and debt levels.

Vietnam Benchmark Refinance Rate %



Growth to accelerate in 2020

Vietnam is poised to be one of the top performers in the ASEAN region again next year, with a growth rate of 6.5% as estimated by the IMF. While it may have benefited from the relocation of supply chains in this trade war, Vietnam's next challenge comes in upgrading its technological infrastructure to continue holding onto its current elevated status as a rising manufacturing hub. The country boasts one of the cheapest manufacturing labour wages in the region but China's manufacturing scene has turned increasingly complex and sophisticated. Vietnam needs to do more than offer good geographical proximity and low labour costs – the push for technological improvements must continue if it is to fully absorb the spillovers from China in the current climate.

China's Digital Currency: Not a Game Changer

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- The problem statements for Libra and China's digital currency DCEP are different. The introduction of Libra may have accelerated China's plan to issue its own digital currency. The purpose of China's DCEP is to replace M0.
- DCEP is a legal tender backed 1:1 by China's sovereign currency RMB. Given that holders of DCEP will not receive interest and financial institutions will place 100% reserve with the central bank, we think the impact of DCEP on monetary policy is very limited.
- In the longer run, it helps to reinforce China's ambition to internationalize Yuan.

Since social media giant Facebook introduced its cryptocurrency Libra in June 2019, the topic of digital currency has dominated global headlines. In order to lobby for the support from the US regulators, Mr Zuckerberg, CEO of Facebook, warned that it could lead to China overtaking the US in global influence should the Libra project be blocked by the US Congress. Meanwhile, he also said China is moving quickly to launch a similar idea in the coming months.

China's central bank has started its own digital project called "Digital Currency Electronic Payment" (DCEP) since 2014. Western experts may not be aware that their lobby efforts to market Libra using China fear factor actually accelerated China's plan to issue its own digital currency. Just like people in US are worried about the impact of China's digital currency, China is also concerned about the progress of Libra as the exclusion of RMB in Libra's reserve assets may weaken RMB's position in international stage and dampen China's ambition to internationalize its currency.

In August 2019, PBoC's director of digital currency research institute said "China is almost ready to launch its own sovereign digital currency". Meanwhile, in early September 2019, it was reported that China has begun the closed loop test of its DCEP. Although PBoC Governor Yi Gang poured the cold water in late September saying there is no detailed timetable for the launch, it was widely believed that China may be the first country to launch the digital currency.

Problem statements for Libra and DCEP are different

Although both Libra and China's DCEP shared the similar idea of digital currency, the motivation to create both digital currencies is different. Libra was designed to improve financial inclusion via providing a stable currency built on a secure blockchain which create more access to better and cheaper financial service for billions of un-bankable people in the world. However, this is not the main problem statement faced by Chinese society as digital payment has been widely used in both city and rural areas in

China via the platforms of WeChat Pay and Alipay. For China's case, the DCEP was mainly designed to replace M0, which will reduce the cost of circulation of banknotes and coins.

Features of China's DCEP

Based on the current clues, China's planned DECP has at least five important features.

First, China's DCEP will operate in a "two-tier" issuance system with China's central bank will issue the digital currency to authorized financial institutions and general public will receive or exchange their digital currency from those institutions. In order to ensure there will not be any excessive supply of money, participating financial institutions will deposit 100% reserve requirement with the central bank. As such, **China's DCEP will be legal tender backed 1:1 by China's sovereign currency RMB.**

The adoption of two-tier issuance system has at least two benefits. First, PBoC can leverage on commercial bank's advanced IT system to help distribute the digital currency. Second, unlike one-tier system which central bank will issue the digital currency directly to retailers, the two-tier system will help avoid the situation that customers moved the deposits away from the commercial banks to central bank's digital currency due to central bank's high credit rating. The two-tier system will be important to ensure financial stability.

Second, China will not pay interest to the holders of DCEP in the early stage. This suggests that DCEP will not be a competitor to bank deposits and it will mainly be an alternative payment tool, which may challenge the payment platform such as wechat pay and Alipay.

Third, in terms of privacy issue, China's DCEP will run under the framework of "controllable anonymity" similar to Libra. The system offers similar anonymity of physical banknotes and coins to users. PBoC also said the regulator will not seek full control of the information of the general public. In addition, PBoC senior officials said that the regulator will protect privacy "as long as you are not making any crimes".

Unlike Libra, China's DCEP will adhere to centralised management. This will give China's regulator a good balance between "controllable anonymity" and anti-money laundering. Given the digital transaction will generate a permanent record, this will help lower the costs for KYC and AML.

Fourth, China's DCEP can be sent offline. The payment could be point to point even without the internet. This will make the payment more convenient as compared to the current payment system.

Fifth, on underlying technology, there will not be any pre-determined technology path. The participating financial institutions can freely choose whether they want to use blockchain technology or traditional accounting system to distribute the digital currency. Then the digital currency will be dispersed by commercial banks through digital wallets.

Meanwhile, China has no plan to create a smart contract function for its DCEP as it may deviate from the original purpose to replace the physical banknotes and coins. In economics, the main functions of money are as a medium of exchange, a store of value and a standard of payment. There is no administrative function for money. As such, China's digital currency will inherit the original functions of money to support its legitimacy.

Table: Key Features of China's DCEP	
Purpose of DECP	To replace physical notes and coins to lower the circulation cost and make the circulation more efficient.
Operating issuance system	"Two-tier" system: Central bank will not issue the digital currency directly to the public to ensure financial stability.
Interest rate	No interest paid to holders
Credit	Backed by sovereign credit
Privacy	Controllable anonymity
Centralized or decentralized	DCEP is centralized
Technology	Partially powered by blockchain. Commercial banks can choose freely how they want to distribute the currency.
Smart Contract	No smart contract feature
Payment	Can be sent offline with additional feature of point-to-point transfer even without the internet.

In conclusion, China's DCEP is a legal tender backed 1:1 by China's sovereign currency RMB. Given holders of DCEP will not receive interest and financial institutions will place 100% reserve with the central bank, we think the impact of DCEP on monetary policy is very limited. In the initial stage, the DCEP will be mainly used to replace M0 and payment will be mainly restricted domestically, the impact on global financial market is also limited. In the longer run, should more countries be willing to hold DCEP, this may help reinforce China's ambition to international its currency.

Global Supply Chain: Shortened and More Regional

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- Global supply chain shifts are usually driven by the motivations of cost minimization and overseas market expansion.
- We think the current shift in supply chains was mainly driven by three factors including cost concerns, tariff factors as well as non-tariff factors such as technology change and consumer demand changes.
- The rise of regionalization may be irreversible regardless of the development of US-China trade talk.

Since the Second World War, the international trade has transited from the vertical division of labour to horizontal division of labour (mixed mode also included) as a result of rising globalization, the well-recognized concept of comparative advantage and more convenient transportation etc. In tandem with economic development and technological change, the shifts in global supply chain have been clearly observed during the past decades.

A Review of Global Supply Chain Shifts

Global supply chain shifts are usually driven by the motivations of cost minimization and overseas market expansion. We have witnessed 5 major shifts since industrial revolution.

Firstly, since the mid-19th century, the United Kingdom has become a "world factory" after the industrial revolution. From early 20th century, the UK has gradually shifted industrial and supply chain to the US due to rising demands for cheap resources and overseas market expansion. The technology has been introduced to US gradually. This helped the US become a top industrial country.

Secondly, during the cold war era, the US has provided technological supports to Japan and West Germany. For example, US had strengthened the technological transfers to Japan to satisfy the demand for war goods during Korean war. Those helped rebuild Japan and Germany's industrial capabilities.

Thirdly, as the size of domestic market of Japan has been limited with insufficient resources available, Japan has transferred the parts of industrial chain to Hong Kong, Taiwan, Singapore and South Korea, mainly focused on labour intensive manufacturing industries. This led to the rise of four "Asian tigers".

Fourthly, with rising costs in "Asian Tigers", investors have continued to seek new overseas markets with cheap labour and resources. China has managed to capture this opportunity after the successful "reform and opening", which eventually transformed China to be the world factory until now. The prior experiences showed that the shift of global supply chain and industrial transfer were mainly driven by cost concern and market expansion in peaceful periods.

The fifth industrial transfer has kick-started since 2012, driven by more complicated factors. Same as previous few rounds of shifts, manufacturers have started to look inward into China's western area as well as outside China due to rapidly rising labour costs in the coastal areas. However, the shift has accelerated after the outbreak of US-China trade war since 2018 as well as rising trade tensions globally such as Japan-South Korea trade dispute.

Overall, we think the current shift of supply chains was mainly driven by three factors including cost concern, tariff factors as well as non-tariff factors such as technology change and consumer demand changes.

First, rising costs amid trade protectionism has accelerated the shift of supply chain outside of China. The production costs of China have increased persistently since "Reform and Opening". Specifically, the average yearly wages in manufacturing sector have increased by 135% to CNY 72088 in 2018, compared to 2010. The US-China trade war emerged since Mar 2018, with more than USD 470 billion imported goods being tariffed by both sides. In order to dodge the tariffs, in addition to the concerns over increasing production costs, it has speeded up the process to shift manufacturing production bases from China to other emerging markets, including Taiwan, Vietnam and Thailand. In fact, it has been observed that some multinational companies, including Fitbit, Samsung, Sony, Google and Apple has announced to transfer all or parts of production lines from China to other countries, especially for those tariff-related products. On the flip side, Vietnam has seemed to be one of the biggest winners under the prolonged US-China trade war. Specially, the GDP grew by nearly 7% yoy for the first three quarters of 2019, registering the biggest gain in nine years. The exports of Vietnam recorded positive year-on-year growth for 17 months out of 18 months since the outbreak of US-China trade war. Meanwhile, the FDI grew by 3.1% yoy to USD 26.16 billion for the first three quarters of 2019. Specifically, more than 69% of total funding (USD 18.09 billion) has invested in machining and manufacturing sector. The data suggests that the US-China trade war has expedited the shift of "low-end" manufacturing and textiles manufacturing away from China to other emerging markets amid cost minimization and tariff evasion intentions.

Chart 1: Labour costs in China has risen rapidly

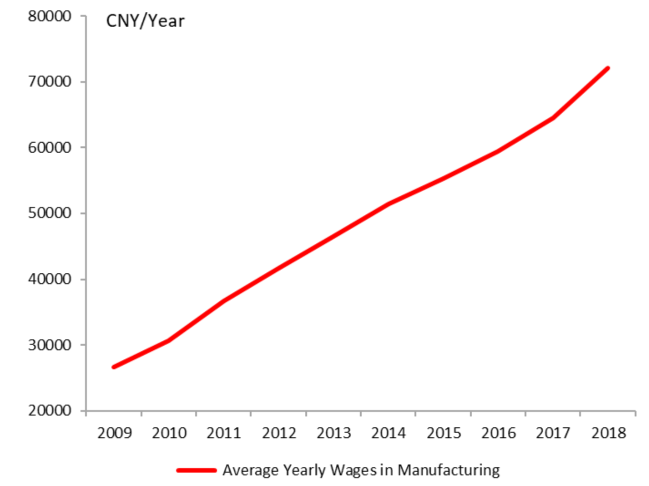
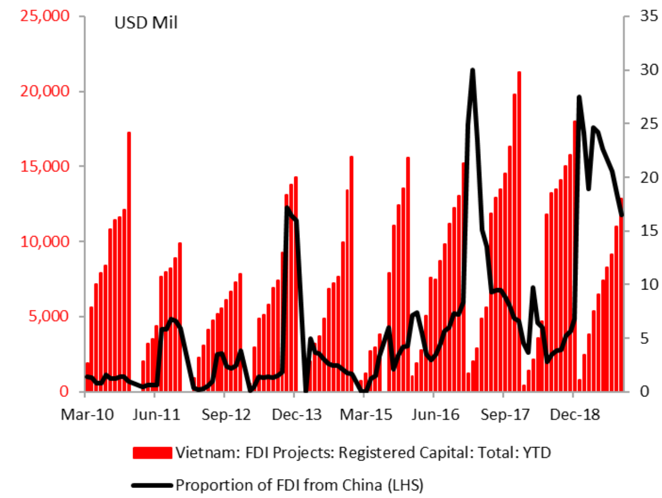


Chart 2: Vietnam is the next beneficiary



Secondly, a localization of supply chains was re-established as a result of rising protectionism. From the case study of Taiwan, affected by the concerns over tariffs, more Taiwanese businesses have decided to return to the island. According to official data, there have been more than 140 Taiwanese enterprises repatriating to the island, with the investment amount more than TWD 600 billion. With more returning Taiwanese businesses, it has helped to upgrade its domestic production chain, particularly in high-tech industries like semiconductors, which might improve its business and economic model in the longer term. In fact, some well-known brands liked Foxconn Technology Group, Inventec Corp., Quanta Computer Inc. and Compal Electronics Inc. have set up new factories or increased the investment in Taiwan.

A snapshot on Taiwanese Enterprise's Return (As of the end of October)	
Number of Enterprises return	More than 140 Taiwanese enterprises
Investment amount	TWD 623.6 billion
Employment Creation	More than 52000
Industry	Manufacturing and High-End Manufacturing Industry
Example	Foxconn Technology Group, Inventec Corp., Quanta Computer Inc. and Compal Electronics Inc.

On the other hand, with the escalating Japan and South Korea trade conflict previously, Japan had restricted the exports of some essential materials of semiconductor to South Korea. As the semiconductor industry of South Korea has highly relied on Japanese suppliers, it has caused tremendous shocks to the high-tech manufacturing sector of South Korea. 93.7% of Fluorinated Polyimide, 91.9% of Photoresist and 43.9% of Hydrogen Fluoride, which are the core materials for the semiconductor production and imported from Japan during the first five months of 2019 have been included in the export prohibited list since July 2019. This has consequently strengthened South Korea government's consciousness of autonomous development and production. According to the data, South Korea government has planned to invest USD 6.5 billion for R&D and production purposes to boost localized production process for 80 strategic commodities within seven years, aiming at stabilizing the supply chain of semiconductor, display and parts of automotive.

Thirdly, the trend of shortening supply chain has emerged due to a supply chain optimization strategy driven by both tariff factor and non-tariff factor. With the lingering US-China trade war, some multinational firms have established regional or localized production bases serving the specific market to avoid tariffs. For example, Adidas has started to change the manufacturing landscapes in the last four years, with "manufactured in China" goods target only for China market. The move is not only from tax perspective but from diversification perspective as well.

For the non-tariff factor, technological advancement has helped to replace parts of low-skill-intensive tasks. For example, the widely use of 3D-printing and automation production has helped perform those reduplicative tasks with lower costs. Therefore, firms have been needed to build up overseas production bases due to cost concerns. Meanwhile, some firms believed that shorter supply chain (or localized production chain) has been critical to quickly respond to the changes in consumer demand due to rising demand for customized products. For example, General Electric has re-established its production base (Appliance Park) in Kentucky and changed its business model to be vertical integration, meaning that design, production and assembly are taking place in the same production site. Strong flexibility to respond to the change in market demand and to minimize time costs of communication with overseas production bases have been the major advantages. Meanwhile, General Electric has set up the position of "Business Quality Manager", covering the issues of production, sales and service assurance, in order to achieve "zero distance to consumers".

Regionalization could be the new normal

Moving forward, although we believe globalization trend is unlikely to change drastically in the near term, but the rise of regionalization may be irreversible regardless of the development of US-China trade talk. First, protectionism seems to be on the rise gradually. Countries like China and South Korea are likely to increase the control and development over core or sensitive technologies and may establish more localized industrial chains to stabilize the supply after experiencing negative impacts driven by recent trade conflicts. Second, technological development, including 3D printing and automation, might help to replace low-skill-intensive tasks effectively, which trim the importance of the horizontal division of labour. Third, alongside with more efficient information flow and rising demand for customized products, localized production which can minimize transportation required and have more flexibility to cater for the changing consumer pattern and demand, might be a sound solution in the longer term.

No Sign of Massive Outflows

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- Since the start of 2H19, a combination of local unrest, US-China trade war and RMB's depreciation have weighed heavily on the already weak economy of Hong Kong and fuelled concerns about capital outflows from the financial hub. Real time indicators showed no signs of significant capital outflows. USDHKD has never touched 7.85 since May while the aggregate balance has stabilized at HK$54 billion since early April. HKD liquidity has also been relatively ample with USDHKD forward swap curve returning to discount levels and HIBOR retreating from July's highs. Furthermore, southbound equity inflows under stock connect also helped to ease the outflow risks of Hong Kong.
- Though Fitch downgraded Hong Kong's sovereign rating while Fitch and Moody's both lowered Hong Kong's rating outlook to negative, this has barely affected the funding costs of either Hong Kong's companies or government. As long as there is no structural change to Hong Kong's status as an international financial hub with separate customs territory, independent regulatory system and free capital flows, we believe that outflow risks will remain contained.
- Even if there are hypothetically substantial outflows driving USDHKD to 7.85, Hong Kong's sizeable foreign exchange reserve and strong fiscal reserves imply they can defend the currency peg system well.

Although the scale of protests has de-escalated somewhat after Hong Kong's local district legislative election in late November, tension remains relatively elevated. The protests have continued at this juncture. This coupled with the prolonged trade war and RMB's depreciation has weighed heavily on the already weak economy of Hong Kong.

For the past few months, there have been widespread concerns about capital flight from Hong Kong especially after Hong Kong reported a month-on-month decline of HKD deposits in August. For the August's change in HKD deposits, it was partially due to the less buoyant fund-raising activities in August compared to July, as stated by the HKMA. In the meantime, USD deposits (excluding those placed by HKMA's exchange fund) and RMB deposits rose by 0.2% mom and 4.6% mom respectively. Instead of selling HKD assets and shifting the capital cross the border, most of the investors seemed to have merely transferred their HKD deposits to RMB or USD deposits. This was probably due to the less attractive yield of HKD and increased concern about capital outflows which could threaten the currency peg system. Similarly, rather than defending the HKD amid any massive capital exodus, the HKMA's move to place USD deposits with commercial banks was more of a pre-emptive action to prepare for any possible surge in USD demand.

Real-time indicators have also shown no sign of significant outflows

In order to investigate whether there are significant capital outflows, we have looked at four high frequency indicators.

First, USDHKD spot. Back in July, a combination of concentrated dividend payment, AB InBev's IPO and worries about outflows together once tightened the HKD liquidity with 1M HIBOR soaring to the highest since 2008 at 2.99%. This forced the market players to unwind their short HKD positions and drove USDHKD spot down to 7.7827. Then the suspension of the extradition bill and the withdrawal of AB InBev's IPO helped to ease HKD liquidity and encouraged the return of carry trade, bringing USDHKD spot up from July's low. That said, the currency pair has not touched 7.85 since May despite an escalation in unrest.

Chart 1: USDHK and yield differential

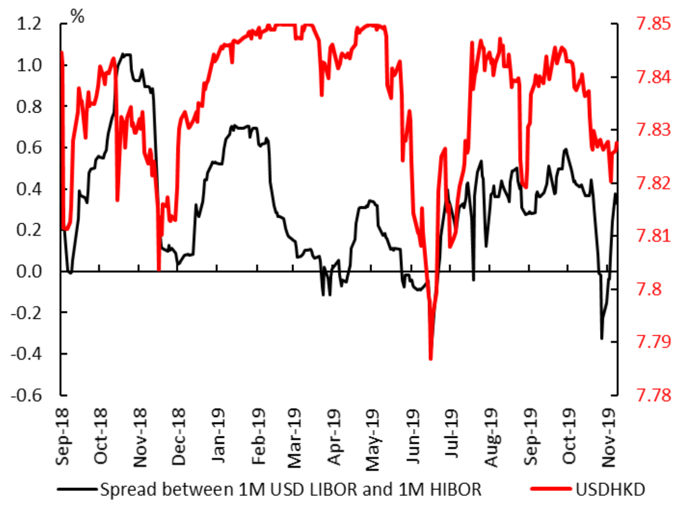
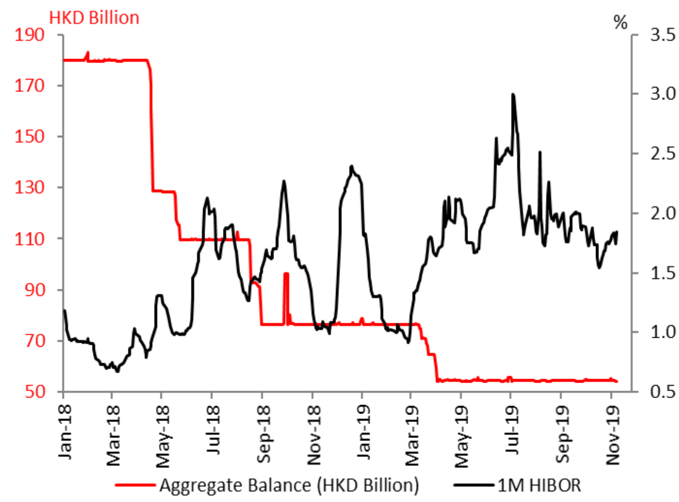


Chart 2: Aggregate balance



Second, aggregate balance. As the excess reserve parked by commercial banks at the HKMA and a gauge of interbank liquidity, the aggregate balance has shrunk by 69.8% since last April as USDHKD spot continually touched 7.85 and triggered HKMA intervention. However, since USDHKD spot has stayed well below 7.85, the aggregate balance has stabilized at HK$54 billion since April.

Third, USDHKD forward swap points, which reflect market's expectation of the USD-HKD yield differential. On one hand, Fed's rate cuts have pushed down USD rates. On the other hand, HKD rates have been slightly elevated amid low aggregate balance, uneven distribution of HKD liquidity among banking system, outflow concerns, large IPOs, seasonal factors and virtual banks' upcoming soft launches. As such, bets on inverting USD-HKD yield differential in the long term once drove forward swap points up to premium levels.

Nevertheless, market players have refrained from pushing the longer-end of the forward swap curve to the previous highs (such as +230 in December 2016 and +700 in January 2016). Also, the uptrend of the short-end normally did not last for more than one week. Rather, the short-end liquidity always managed to turn flushed again after the brief tightness.

With the announcement by Hong Kong's Chief Executive Carrie Lam to withdraw the extradition bill on 4 September, the 12-month forward swap points even collapsed from +115 down to par while the short-end of the swap curve edged down to deeper discount levels. Lately, when there is no large IPO or seasonal factors, the USDHKD forward swap curve have mostly traded at discount levels despite ongoing protests. This reinforces our view that the previous jump in USDHKD forward swap points were attributed mainly to concerns about outflows rather than an actual capital exodus.

Chart 3: HKD 12m forward points

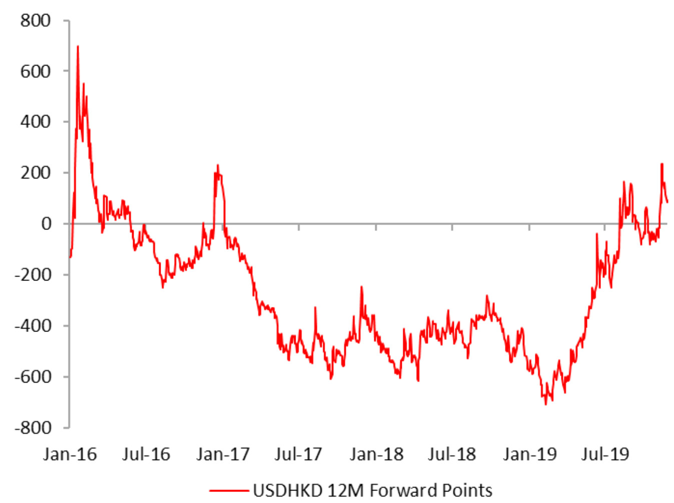
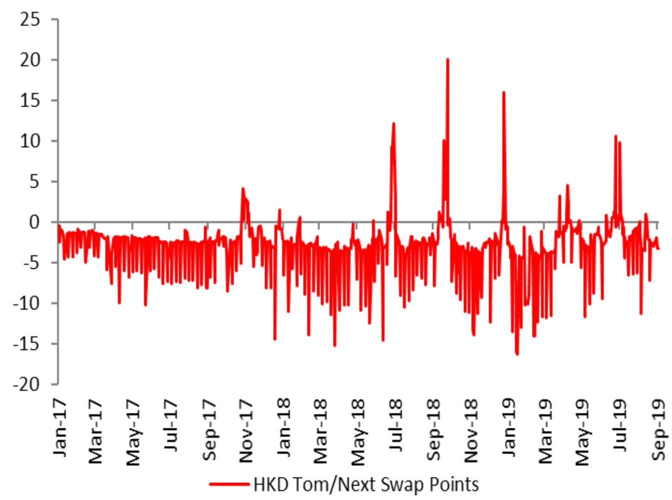


Chart 4: HKD TN forward points



Fourth, southbound equity flows under stock connect. Due to the increasing needs of Mainland investors to hedge against RMB depreciation risks and the attractive valuation of H-shares, southbound equity flows have registered net inflows for ninth consecutive months till November 2019 with the amount exceeding HK$215 billion. According to the HKEX, overseas investors (excluding Mainland investors) took up 29.5% and Mainland investors represented 11.6% of the market trading value in Hong Kong stock market in 2018, as compared to 31.6% and 8.6% respectively in 2016. The continuous inflows from Mainland China might have helped to offset some outflows by other foreign investors.

Chart 5: Hang Seng China AH Premium Index

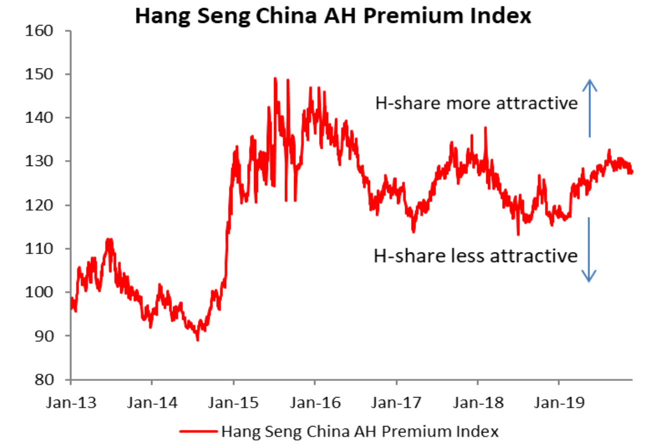
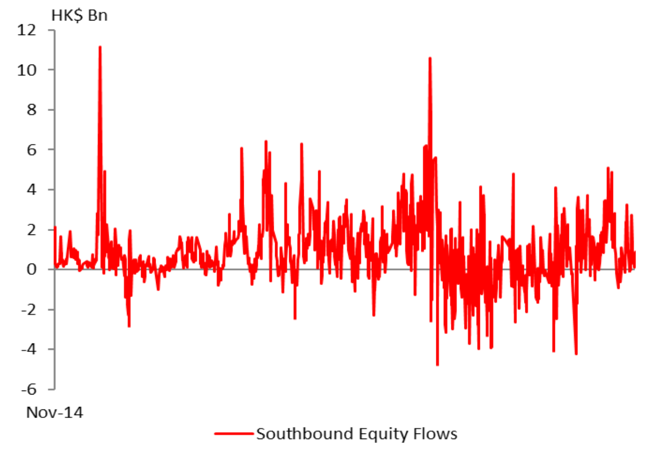


Chart 6: Southbound equity flows



Outflow risks to be contained

Due to the persistent protests, Fitch downgraded Hong Kong's sovereign rating for the first time since 1995 from AA+ to AA with a negative outlook while Moody's lowered the rating outlook from stable to negative. In contrast, S&P affirmed Hong Kong's sovereign rating and rating outlook, citing healthy reserves. As Hong Kong's rating is relatively high and the main buyers of HKD bonds are local banks or insurers, the rating downgrade has barely affected the funding costs of Hong Kong's government or companies.

The enactment of HK Human Rights bill in late November complicated the macro backdrop for Hong Kong as market is waiting for China's threatened retaliation. The US Secretary of State will be required to review whether Hong Kong is autonomous enough from China to justify its special trading status under the US-Hong Kong Policy Act. Our base case is that there will not be any structural change to Hong Kong's status as an international financial hub with separate customs territory, independent regulatory system and free capital flows. If this is the case, outflow risks will remain contained, especially given global monetary easing has prompted global investors to hunt for yields. Hong Kong's healthy reserves have also reinforced investors' confidence in its financial market.

De-pegging risk is not in sight either

Even if there are hypothetical substantial outflows pushing USDHKD to 7.85, the sizeable foreign exchange reserve and the strong fiscal reserve will allow the HKMA to defend the currency peg system well. Specifically, the HKMA's foreign exchange reserve has increased by 141% to US$440.6 billion during December 2008 to October 2019, representing 2.1 times the monetary base or 47% of Hong Kong dollar M2 (as of September 2019).

Having said that, some investors may still be concerned that the foreign exchange reserve is insufficient to cover the Hong Kong dollar M2 or the equity holdings of foreign investors (excluding Mainland investors). With regard to Hong Kong dollar M2, it takes into account short-term loans which may not cause capital outflows arising from concerns about exchange rate and interest rate risks. In other words, using M2 may overestimate the pressure of capital flight. More importantly, 47% is indeed much higher than the 20% required for a country/region with a fixed exchange rate system. In terms of the equity holdings of foreign investors (excluding

Mainland investors), though these represented around US$1 trillion of Hong Kong stock market turnover in 2018, margin trading might have been involved and therefore the equity holdings may not exactly reflect the possible equity outflows by foreign investors (excluding Mainland investors). Also, such potential outflows may be partially offset by the resilient equity inflows by Mainland investors.

On the other hand, the fiscal balance has consecutively registered a surplus since 2004-05 while the fiscal surplus to GDP ratio has remained resilient and averaged at 3% during 2004/05 – 2018/19. Though several rounds of off-cycle relief measures which were rolled out lately may lead to the first fiscal deficit in 15 years for the 2019/20 fiscal year, fiscal reserve will likely still remain strong above HK$1 trillion.

Chart 7: HK's FX reserve

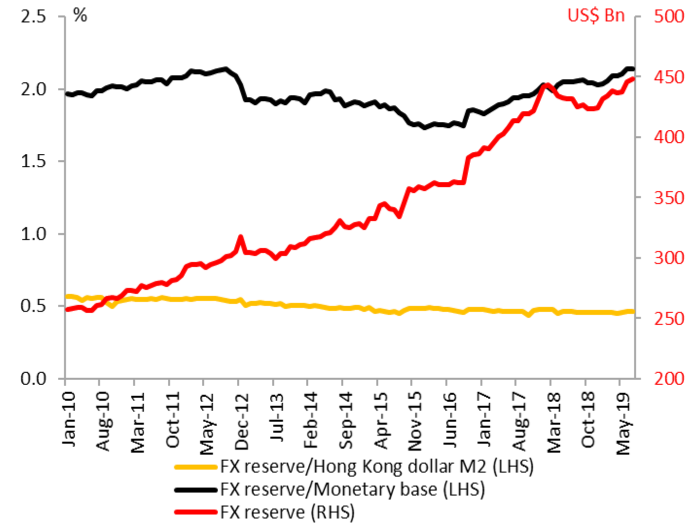
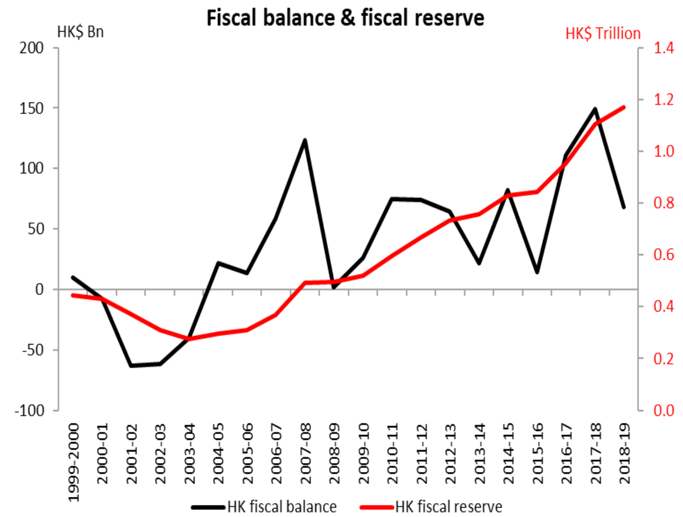


Chart 8: Fiscal balance remained resilient



In conclusion, Hong Kong will be able to maintain the existing currency peg system in the foreseeable future. In the medium term, we also see a low possibility of HKD pegging with RMB instead of the USD. HKMA's former chief Norman Chan has clearly pointed out four conditions to be met before they consider pegging the HKD with the RMB. First, the RMB should be fully convertible. Second, capital account should be totally opened up. Third, there should be a financial market with sufficient depth and width that enables the Exchange Fund to hold assets to support Hong Kong's monetary base. Fourth, the economic cycle of Mainland China and Hong Kong should be synchronized. Except the fourth condition, the other three conditions are still far away from being met. As such, as a small economy and an international financial centre, it may still be more appropriate to peg the HKD with USD at this stage.

Getting Real: A Deeper Look at Indonesia's GDP Data

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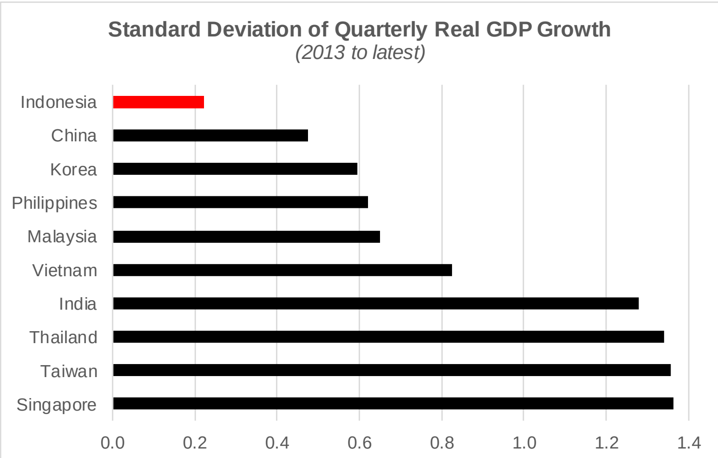
- Given the steadiness of Indonesia's GDP data in recent years – which have hugged close to 5% for 22 quarters running – questions have been asked about the quality of the data gathering and collation.
- We take a closer look here and find that the stability of the headline GDP prints in real terms owe primarily to the netting out of the volatility in the corresponding nominal and deflator components of the GDP data.
- In short, the issue with Indonesia's GDP is not so much that it has been doctored, but more about how it is performing below-potential due to investment shortfall.

Deviation Deficiency

As alluded to in the 2020 outlook segment on Indonesia, the most recent GDP print of 5.02% yoy in Q3, coming very close to Q2's 5.05% and Q1's 5.07%, has invited questions about Indonesia's macroeconomic data quality.

At a cursory level, a comparison with data of its regional peers does show an inclination for Indonesia's real GDP growth rate to be stable. Looking at the standard deviation of GDP growth rates from 2013 to the latest available prints, for instance, the one for Indonesia is easily the lowest at just over 0.2, compared to an average of close to 1.0 for its major Asian neighbours.

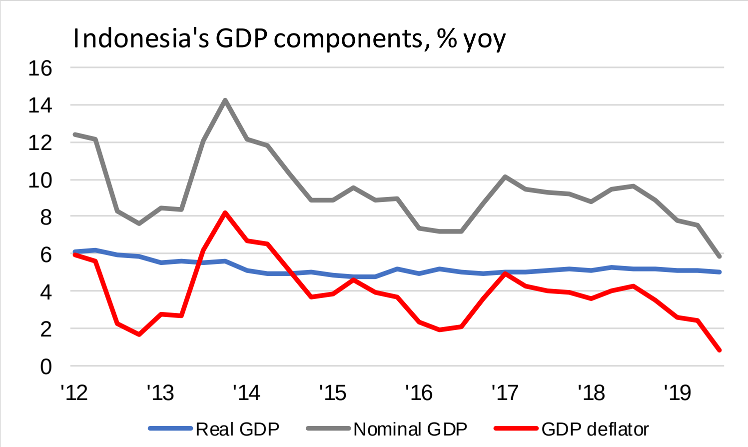


Source: OCBC, Bloomberg.

To be sure, given that Indonesia's economy is a lot less beholden to the ups and downs of global trade flows, the lower volatility of its GDP prints is to be expected. Indeed, it is not surprising to see Taiwan and Singapore having the highest growth volatility during the period, given their export dependence. Still, purely on this metric alone, Indonesia's GDP volatility stands out considerably at the low end of the spectrum.

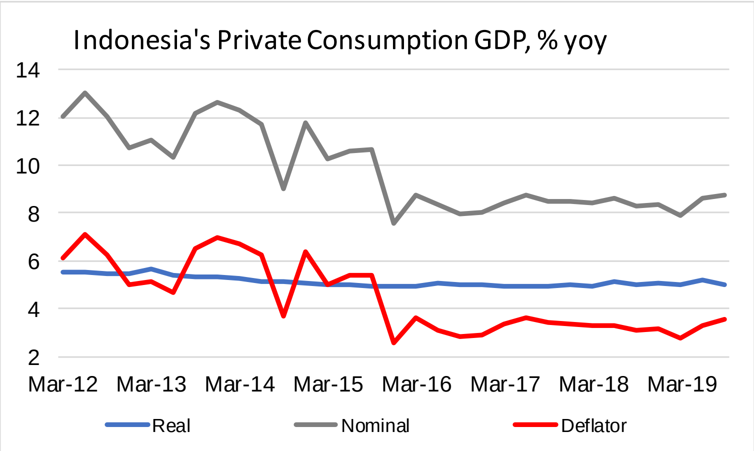
What lies behind the relative stability of its GDP prints and should we be all riled up about the data quality?

Here, we start by looking at how real GDP prints are derived to begin with. Although real GDP is what we usually focus on, as it strips away the price inflation effect over time and allows for cross-period comparability, the data is constructed from two separate series. First comes nominal GDP, which is a measure of the economy on current price terms. The second is the GDP deflator, which is analogous to inflation, but tracks a different basket of goods depending on the components of the GDP. Deflating the nominal GDP by, well, the GDP deflator gives us the real GDP prints.



Source: OCBC, Bloomberg.

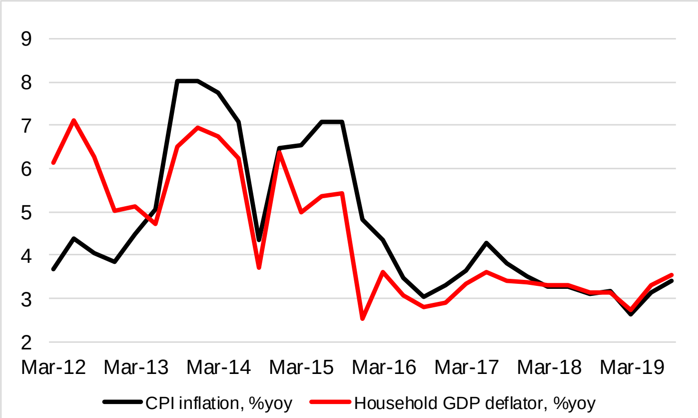
From the chart above, it is telling that even though the real GDP prints have been flatlining, both nominal GDP and GDP deflator series have been gyrating in sharp contrast. Moreover, the trajectories of the latter two series appear to be very much in sync. Not only do they move a lot more, they do so in a concerted fashion. The net effect of which is that the two sets of volatile numbers cancel each other out, resulting in a stable series over the period that is the real GDP print that we know of.



Source: OCBC, Bloomberg.

When we zoom in on a key component of headline GDP, that is the private consumption which comprises more than 55% of the economy, a similar dynamic can be seen, although even the nominal consumption GDP has been less volatile than before as well.

Indeed, in nominal terms, consumption has come down markedly to around 8-9% range since 2016, compared to 10-12% growth in the years prior – contributing to the sense that the economy has slowed down more markedly than the official numbers suggest. What is missing from this narrative, however, is the understanding that there has also been a considerable decrease in the consumption GDP deflator component, which mirrors the fact that Indonesia's CPI inflation has been largely contained. This has acted to negate the nominal consumption slowdown in recent years, and brought about the stability in real consumption numbers.



Source: OCBC, Bloomberg.

Overall, our sense is that the stability of the headline GDP and consumption GDP numbers in Indonesia can be explained by a deeper look at the underlying dynamics between nominal and deflator terms and does not arise from supposed chicanery.

There is indeed an issue to be had with the stability of Indonesia's GDP. However, it has less to do with unfounded accusations of data manipulation and a lot more to do with how Indonesia can do so much better with its potential by boosting investment, as detailed in the accompanying Indonesian outlook piece.

The Great Disjoint: What Oil is Telling Us About the Global Economy

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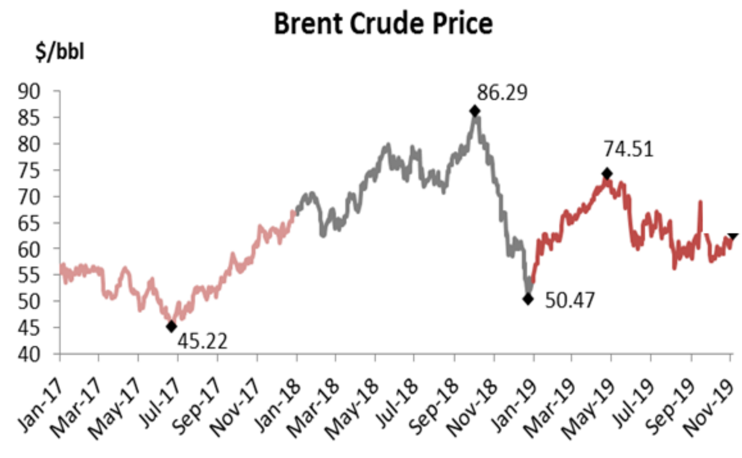
- Unlike equity and credit trends, oil prices have remained muted in 2H 2019. Brent prices have struggled to break above its 2019 average; meanwhile the S&P 500 index is setting record highs.
- Contracting PMIs, poor Chinese consumption of diesel and subdued refinery margins show the depth of slowdown globally.
- Whereas crude oil continues to reflect consumption sluggishness, equities and credit trends have benefited from a global rate cut cycle.

Oil prices in 2019

Brent went on a promising start at the start of 2019. Having collapsed from $86.29/bbl to $50.47/bbl within two months at the end of 2018 due to the US-China trade war, prices got a lift from OPEC+ agreeing to reduce oil supplies. Brent went on a rally and nearly tested $75/bbl in May, as the oil market took bullish cues from the (then) trade truce and a supply deficit.



Source: Bloomberg, OCBC Bank

The re-escalation of the US-China conflict, however, marked a structural shift in financial markets. Fed Chair Jerome Powell appeared to have lacked conviction in reducing interest rates before May. By the end of May, the probability of a rate cut in the July FOMC meeting had risen to about 40% and then further to almost 100% by the end of June. With the Fed leading the way in interest rate cuts, the momentum soon spilled over to central banks around the world, if they hadn't already began reducing their benchmark interest rates.

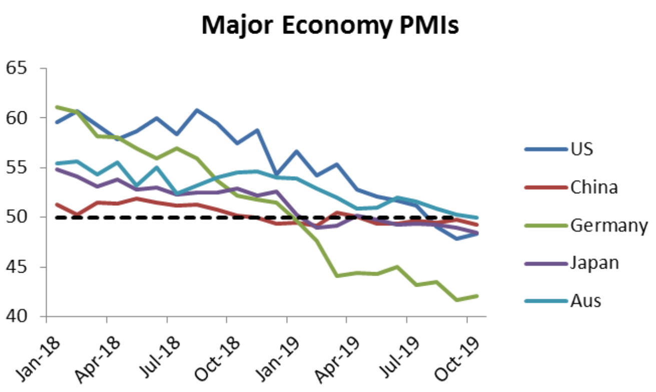
At around the same time, Brent prices declined from its high of $74.51/bbl to a low of $56.23/bbl in early August – a decline of almost 25% from peak to trough. In the same time the S&P 500 index has rebounded and setting new record highs while high-yield credit spreads have tightened and threatening to clock a new year to-date low, Brent has remained lacklustre, lacking the impetus to even break above its 2019 average levels.

Source: Bloomberg, OCBC Bank

The question, therefore, is why has the oil market showed such a huge disjoint with the equity and credit spread markets, when all three are traditionally expected to move along in tandem?

The US-China trade war has hurt manufacturing

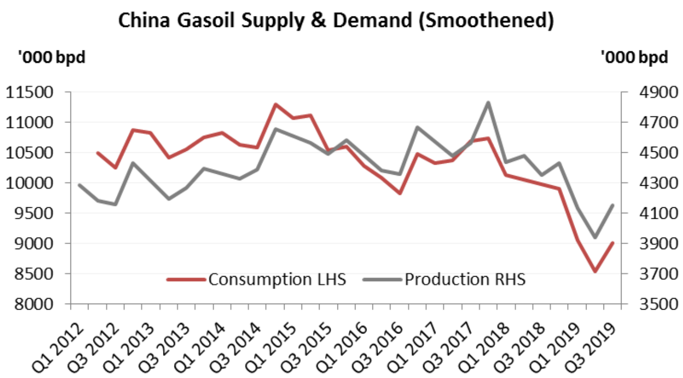
Globally, manufacturing activity has taken a huge hit. PMIs across the globe have deteriorated in the past twelve months. Both the developed and developing markets' PMIs have largely shown contractions, with those in Asia bearing a larger brunt of the slowdown. The US ISM manufacturing PMI sunk below 50 in August and has remained below the threshold since then. Germany's PMI dipped below 50 in January; Japan followed suit one month later. In Asia, demand for electronics fell further as the Huawei issue added further gloom to an industry already facing a slowdown in smartphone and PC consumption.



The lack of growth in world trade volume also shows how consumption demand across the world has waned. The CPB World Trade Volume Index shows a decline of 0.3% yoy in world trade volume in the first eight months of 2019. If this persists, it will be the first full-year contraction in global trading activity since the 2009 financial crisis.

China's weakening demand for oil shows the extent of slowdown

A look at China's diesel consumption shows how manufacturing activity has slowed within the country. Diesel demand – the fuel of choice for most industrials and factories – has dropped sharply since Q4 2018. The decline in diesel consumption has also led to a drop in supply of gasoil in the country, as the market seeks to correct itself. Despite the decline from both sides, the supply deficit of gasoil in China remains one of the lowest in years, at about 4.5 to 5.0 mbpd. This means the need to import crude oil or diesel from other countries would have declined, leading to suppressed crude oil prices globally.



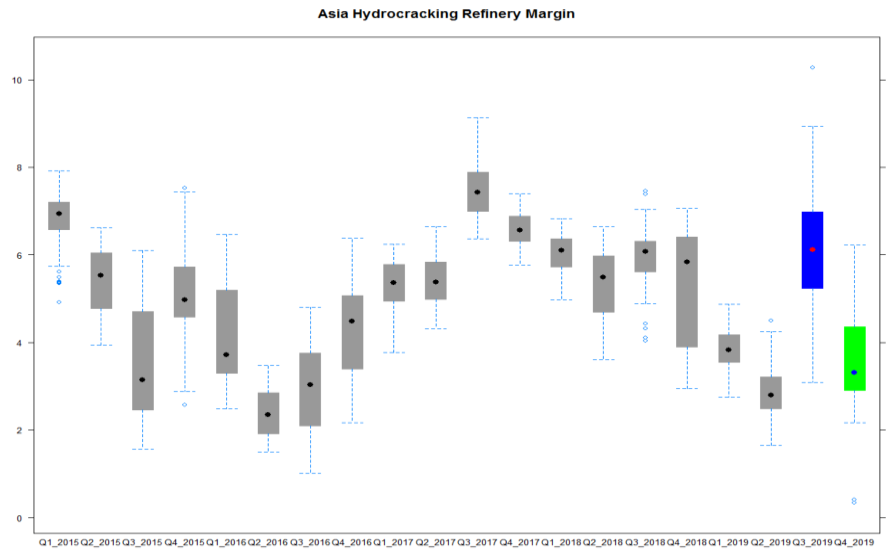
Source: Bloomberg, OCBC Bank

The lack of diesel consumption in China ties in with the observation that PMIs across the world have waned, and China, as the world's most important manufacturing hub, has demanded lesser quantities of gasoil to power its industries.

Refinery margins lend further credence of weakening global consumption

Suppressed refinery margins in Asia also depict the extent of weakening consumption worldwide. A sharp uptick in refinery margins to $6.13/bbl sparked hopes that consumption demand is returning to the market, which in turn would have raised prices of refined oil products. However, in Q4, the margins have sunk back to $3.13/bbl, similar to the profits that Q1 and Q2 have witnessed of $3.83/bbl and $2.86/bbl respectively. Why then, did the margins of Q3 spiked so drastically?

One explanation is the volatility of prices observed in fuel oil, whose crack margins swung from as high as $5/bbl to as low as -$15/bbl. With IMO 2020 around the corner, fuel oil was widely expected to see some volatility in demand as we approached the end of 2019. With fuel oil crack margins now stabilised at a depressed rate of -$20/bbl, refinery margins have followed suit by returning to $3.13/bbl.



Putting the pieces together

The contraction in global PMIs, the lack of Chinese diesel demand and the relatively low hydrocracking margins show that there is a decline in consumption of goods globally. This explains why Brent prices have struggled to even break above its 2019 average levels, despite a global supply deficit in the oil market when the Iranian sanctions are taken into account.

That leads us back to our very first question – why is there such a disjoint in oil prices compared to the record high S&P 500 index and the tightening of credit spreads? The answer lies in the interest rate reductions conducted by central banks across the world. As global economic growth stutters, central banks across the world have cut interest rates. This has prompted a search for yield among market participants, who in the face of ever declining yields (and even negative interest rates) are moving up the risk ladder to search for higher yields. This has caused credit spreads to tighten and dividend yields to fall.

Oil, however, is less sensitive to interest rate movements and hence not displayed the same level of exuberance shown in equity and credit markets. Its sluggishness this year strongly suggests that global economic slowdown is not out of the woods yet, despite the strong showing in equities and high-yield bonds.

Conclusion: oil needs to move higher for economic recovery confirmation

Assuming that the supply side of the equation remains largely stable in 2020, a pickup in oil prices, together with the rallying financial indices, will suggest that a more sustainable global economic recovery is underway. A breakthrough in US-China trade talks might prove to be a useful catalyst in sparking this recovery. If Brent prices can meaningfully return above $70/bbl, we think it may signal that the global demand is back on track; at current levels, Brent prices suggests that a lot more needs to be overcome globally to satisfy the current output gap.

A Primer on ESG Investment

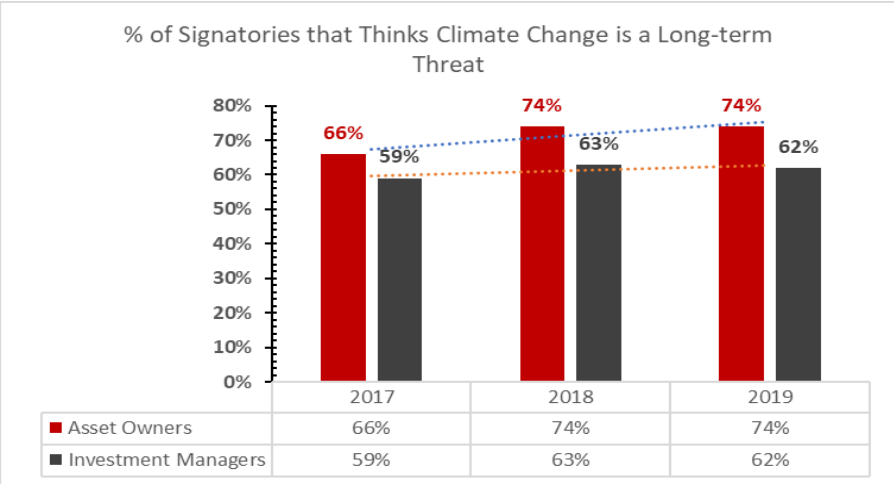
Global Treasury Research

- ESG = Environment + Social Responsibility + Governance. Here we provide a summary understanding of the MSCI ESG Rating and MSCI ESG Leaders Index.
- AUM with the ESG concept is growing rapidly. Asia ranked the first in terms of growth. We provide a quick scan of ESG in Asia.
- The importance of ESG in relation to changes in the global investment environment.

ESG = Environment + Social Responsibility + Governance

In 2006, Goldman Sachs published a research report that, for the first time, introduced the concept of ESG investment. ESG is the acronym for Environment, Social responsibility and Governance. ESG investment refers to the integration of the unconventional analysis for environment, social responsibility and governance, on top of traditional fundamental analysis for macro-economics, industry growth potential, corporate financial indicators and profitability, into the investment decision framework.

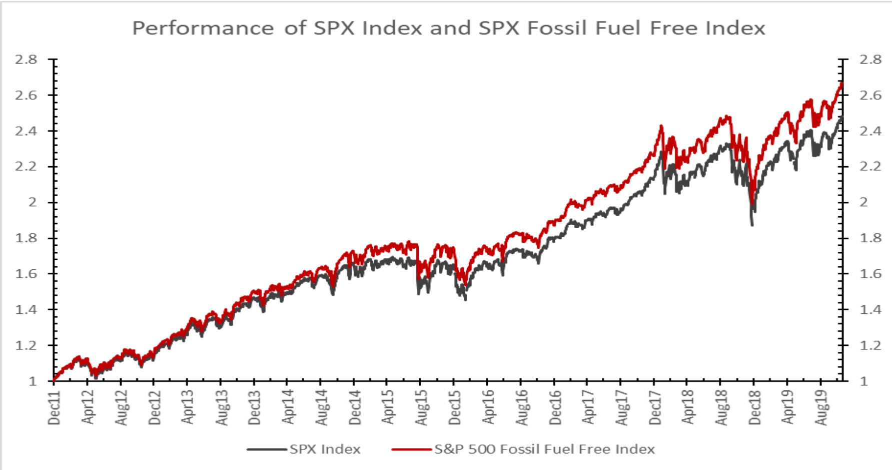
Environment involves analysis related to climate change, nuclear energy and sustainability. Started from North Europe, many pension funds and insurance institutes worldwide are including a project's or a company's impacts on climate change as a factor of analysis in their investment decision framework.



Source: UN PRI, OCBC Bank

With the depletion of non-renewable resources, production of companies or projects that are dependent on non-renewable resources may be adversely affected in the future. Their return to investors may be negatively impacted as well. Therefore, more investors have started to include environmental sustainability into their investment decision making processes.

For example, fossil fuel (non-renewable and detrimental for climate change) dependent industries are becoming less attractive to assets owners and investment managers.



Source: Bloomberg, OCBC Bank

Social responsibility refers to human rights, consumer protection, diversity and animal welfare, among others. ESG investors believe that companies which recruit talents from different environments with diverse backgrounds are more likely to find suitable talents for their job positions, which in turn allow these companies to enjoy greater returns on their investments in labour.

Employee human rights include employees' personal safety, health well-being, welfare and the employees' impacts on the broader society. Companies that pay attention to employee human rights tend to have their employees working more efficiently.

In recent years, the number of litigation cases related to consumer damages is growing. The litigation process is usually time-consuming and it drains a company's or a project's resource, as well as its brand image and good will. The minor benefits gained from "cheating" the consumers do not justify the costs of these unlawful acts under the tightening regulations on consumer protection. Thus, consumer protection has gradually become a main factor that investors consider in their investment decision process.

Governance refers to management structure, employee relations, executive and employee compensations. The relationship between the board of directors and the company's management, the relationship between employees and the company, the company's salary incentive mechanism and a fair compensation system, all have important impacts on the long term success of a company or a project.

MSCI ESG Rating and MSCI ESG Leaders Index

MSCI has an ESG rating system for the underlying equities of the MSCI Index.

Environmental			
Climate Change	**Natural Resources**	**Pollution and Waste**	**Environmental Opportunities**
1. Carbon Emissions 2. Product Carbon Footprint 3. Financing Environ-mental Impact 4. Climate Change Vulner-ability	1. Water Stress 2. Biodiversity and Land Use 3. Raw Material Sourcing	1. Toxic Emissions and Waste 2. Packaging Material and Waste 3. Electronic Waste	1. Opportunities in Clean Technologies 2. Opportunities in Green Building 3. Opportunities in Renewable Energy

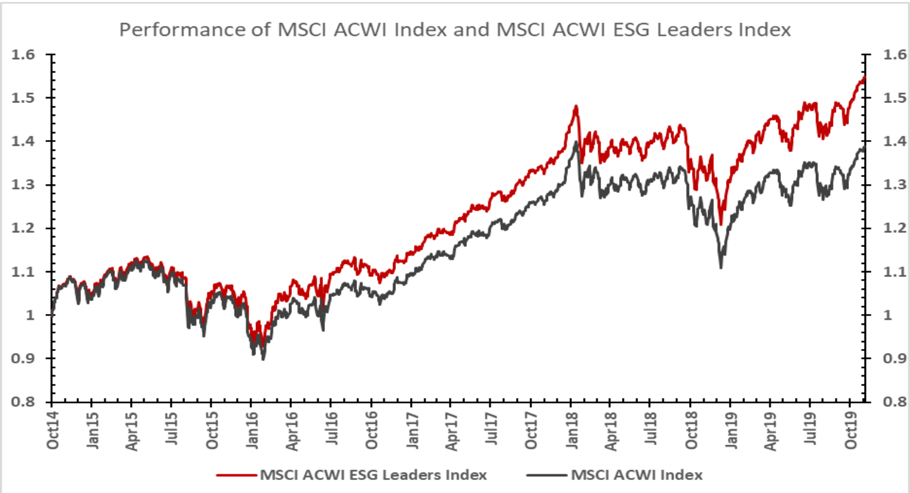
Social			
Human Capital	**Product Liability**	**Stakeholder Opposition**	**Social Opportunities**
1. Labour Manage-ment 2. Human Capital Develop-ment 3. Health and Safety 4. Supply Chain Labour Standards	1. Product Safety and Quality 2. Chemical Safety 3. Financial Product Safety 4. Privacy and Data Security 5. Responsible Investment 6. Health and Demographic Risk	1. Controver-sial Sourcing	1. Access to Communica-tions 2. Access to Finance 3. Access to healthcare 4. Opportunitie s in Health and Nutrition

Governance	
Corporate Governance	**Corporate Behavior**
1. Board Diversity	1. Business Ethics
2. Executive Pay	2. Anti-competitive Practices
3. Ownership and Control	3. Tax Transparency
4. Accounting	4. Corruption and Instability
S o	5. Financial System Instability

Source: MSCI, OCBC Bank

The underlying components of the MSCI index are being graded into 7 ranks ranging from "AAA" to "CCC" under this rating system. These equity names are further classified into "Laggard", "Average" and "Leader", with names under "Leader" being the better ESG-performers. Those that fall under "Leader" are grouped together to structure the MSCI ESG Leaders Index.

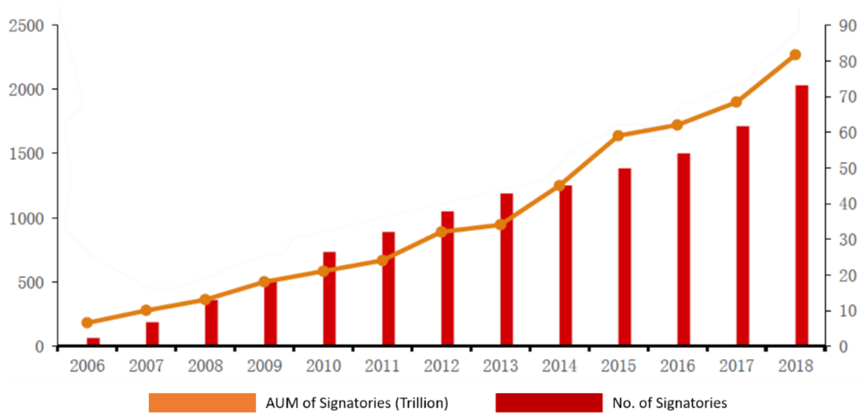
ESG investors believe that the inclusion of various ESG analysis factors helps to provide a more holistic interpretation of an investment opportunity's return and risk. To a certain extent, integrating ESG analysis factors into one's investment analysis framework may improve the performance of the investment portfolio.



Source: Bloomberg, OCBC Bank

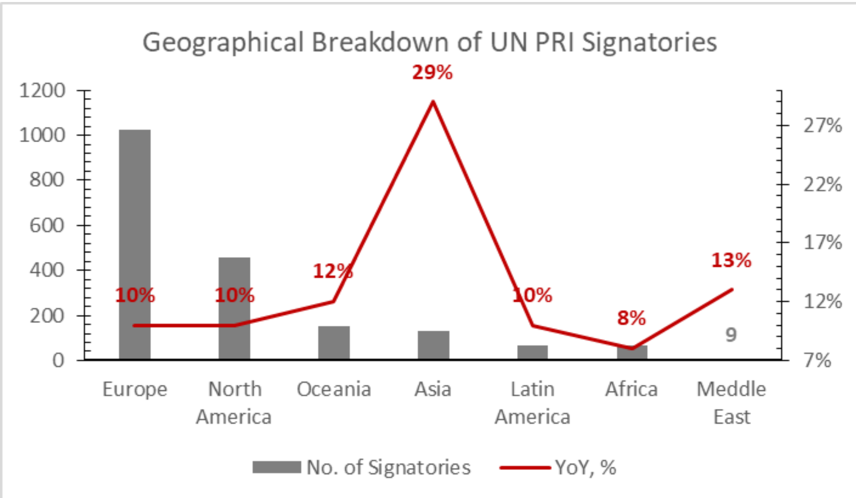
AUM under ESG concept growing rapidly

The concept of ESG investment has been trending globally since its introduction. In 2006, the United Nations Principles for Responsible Investment (UN PRI) was founded to encourage its signatories to include ESG analysis in their investment analysis frameworks. The number of signatories and their Asset Under Management (AUM) has been growing with fast and steady rates. In 2018, UN PRI has 2031 institutional signatories with a total AUM of about USD 81.7 Trillion.



Source: UN PRI, OCBC Bank

Among the signatories of UN PRI in 2018, Europe is ranked the first in terms of the total numbers of signatories, while Asia is ranked the first in terms of YoY growth rate of signatories.

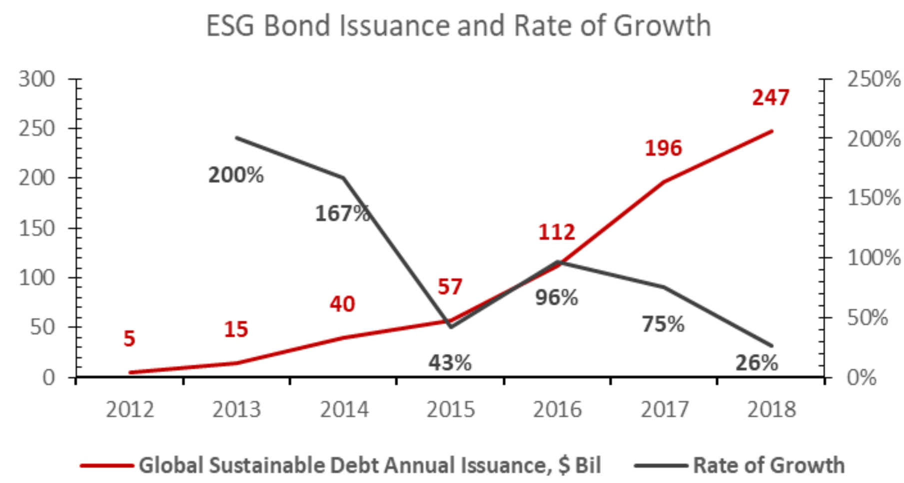


Source: UN PRI, OCBC Bank

In terms of asset class distribution, ESG-friendly equities and fixed income products have the same weightage of 39%. However, ESG-friendly infrastructure investment is ranked the lowest with a weightage of only about 1%.

Source: UN PRI, OCBC Bank

Notably, the number of green bonds, or sustainable bonds, issuances are growing with a fast pace.



Source: Bloomberg, OCBC Bank

Three factors signalling the importance of ESG

1)Asset owners' rising awareness of ESG

According to "Greater" Wealth Transfer – Capitalizing on the Intergenerational Shift in Wealth, $30 trillion of wealth will be transferred from the generation of Baby Boomers to the Millennials over the next few decades.

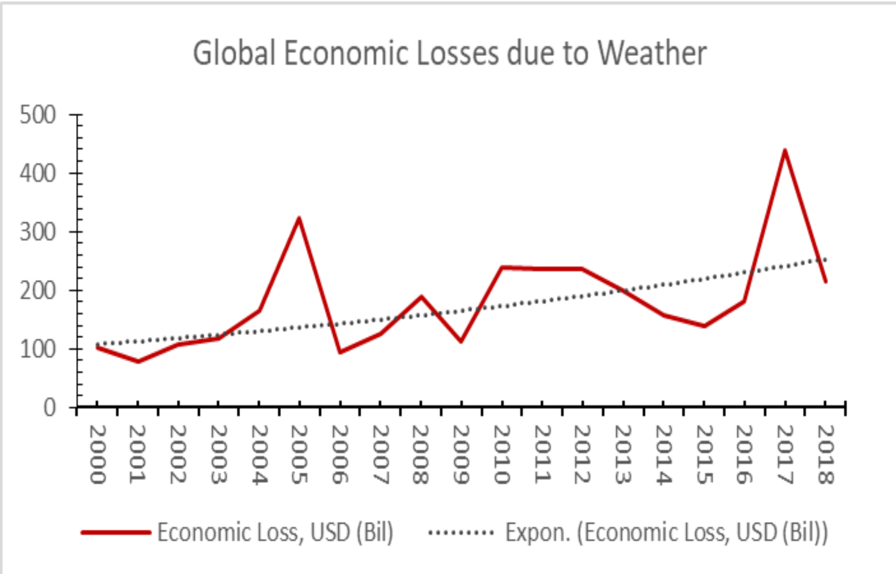
The Millennials generation has a relatively higher prioritization on ESG investing as they grew up in an era where education has placed increasing focus on ESG related issues. 67% of Millennials view that investments are ways to "express social, political and environmental value" and 90% of them would like to allocate more assets to responsible investments. Also, Millennial asset holders are reportedly twice more willing to invest in projects that solve social or environmental problems. According to Morgan Stanley Institute for Sustainable Investing - Sustainable Signals: The Individual Investor Perspective, 84% and 71% of Millennial and individual investors are interested in sustainable investing respectively.

Millennial asset owners also show a higher propensity in requesting their assets to be invested in ESG related projects, creating demand for green investment opportunities and green assets such as green bonds.

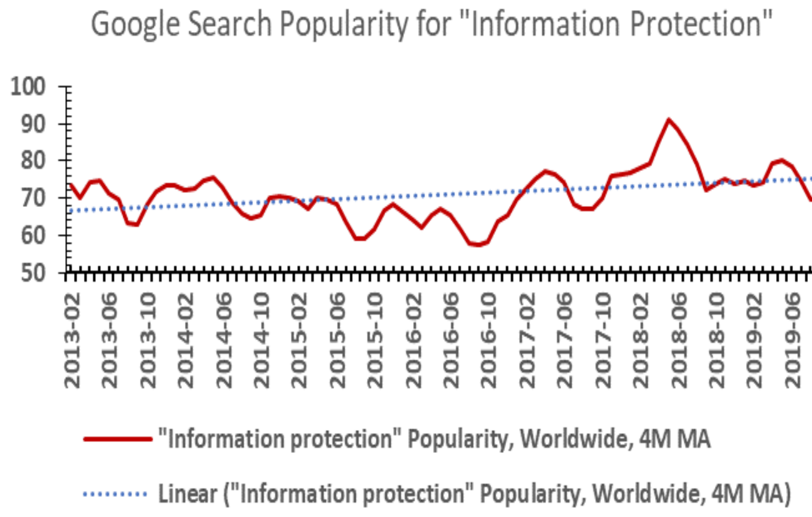
2) ESG-related issues are changing the business and investment horizon

Environment and sustainability related challenges, including environmental-related issues such as global warming and rising sea levels due to the Greenhouse Effect, changes in demographic patterns, tightening regulatory pressures, people's raising awareness in privacy protection, data security and human rights and employees' welfares, are playing gradually more important roles in economies globally. They are changing the context of how businesses operate. They are creating new risk variables that investors may not be able to model with the traditional fundamental analysis framework.

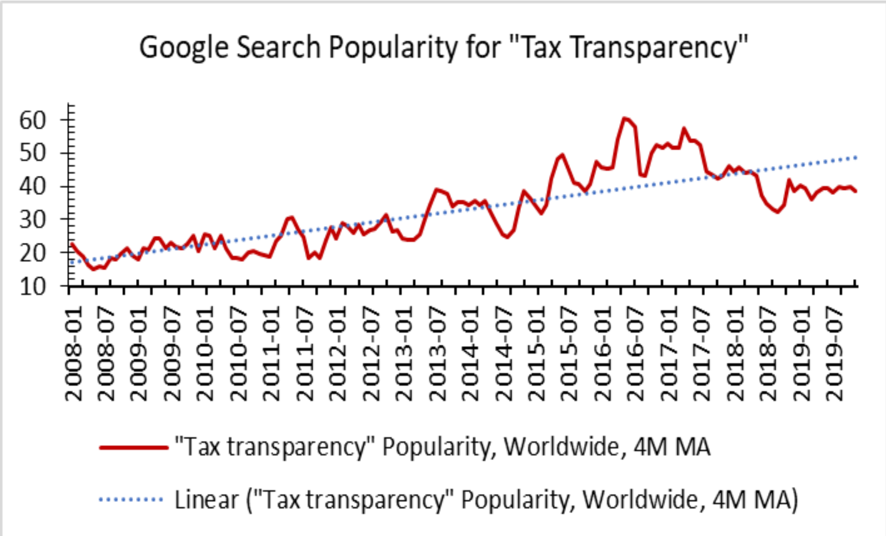
As ESG related issues are becoming more important in increasing the risks of investment opportunities, it is essential to introduce ESG factors into the traditional fundamental investment framework as new dimensions of analysis.



Source: Aon, OCBC



Source: Google Trends, OCBC Bank



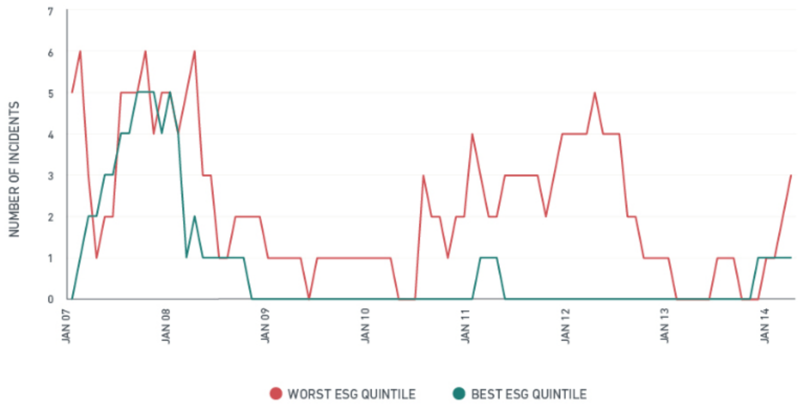
Source: Google Trends, OCBC Bank

3) Engaging ESG analysis helps factor out tail risks

Traditional fundamental analysis gauges the risk and return of an investment opportunity from the economic performances of the company, the industry and the macro-economy. Modelling tail risks or black-swan events in traditional fundamental analysis is normally challenging. It is believed that the integration of ESG analysis in investment decision process may help to reduce exposure to black swan events.

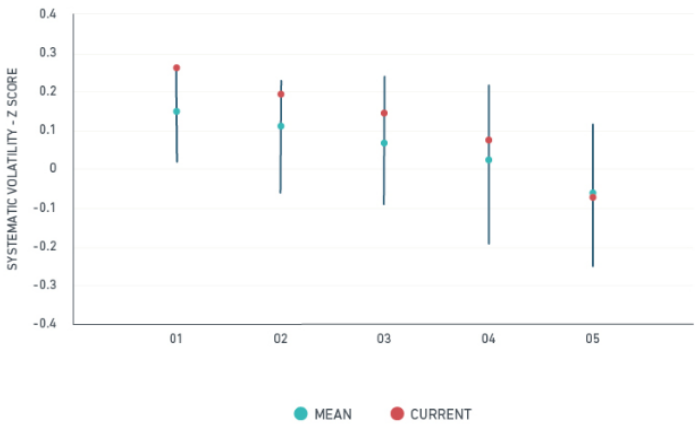
MSCI suggests that companies with better ESG practices may face less frequent large drawdowns in their share prices than those with relatively worse ESG practices. Also, companies with better ESG practices tend to have a lower systematic volatility, suggesting that they are exposed to fewer risks.

Large drawdown frequency of top vs. bottom ESG quintile



Source: MSCI

Systematic volatility of ESG quintiles

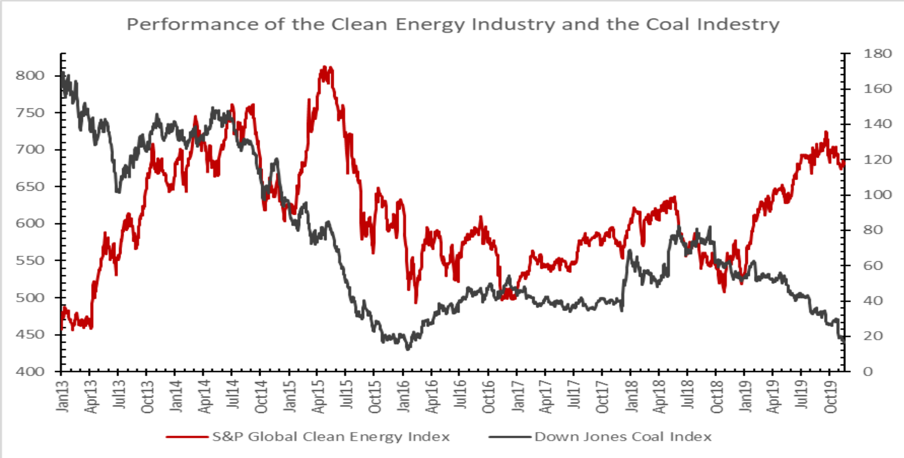


01 = worst 25% ESG quantile, 05 = best 25% ESG quantile

Source: MSCI

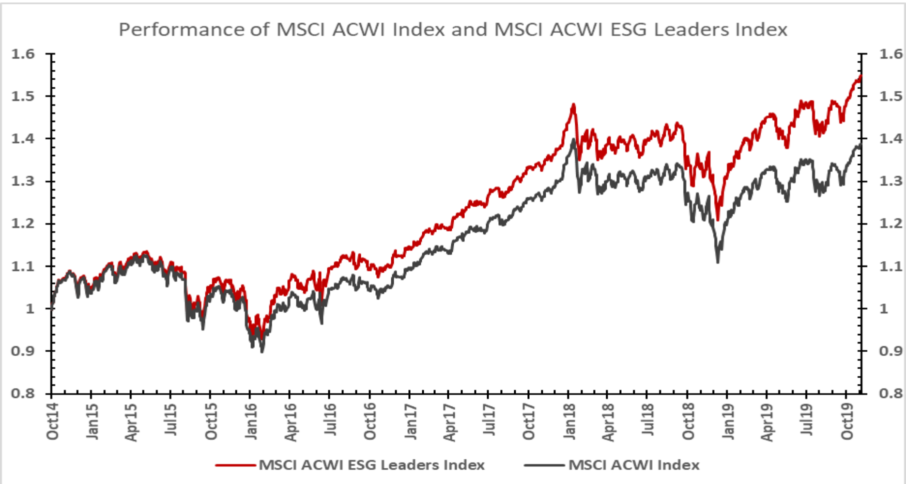
Investments with ESG considerations may have higher returns

In general, clean energy industries are expected to perform better than industries that are dependent on non-renewable energy (e.g. the coal industry).



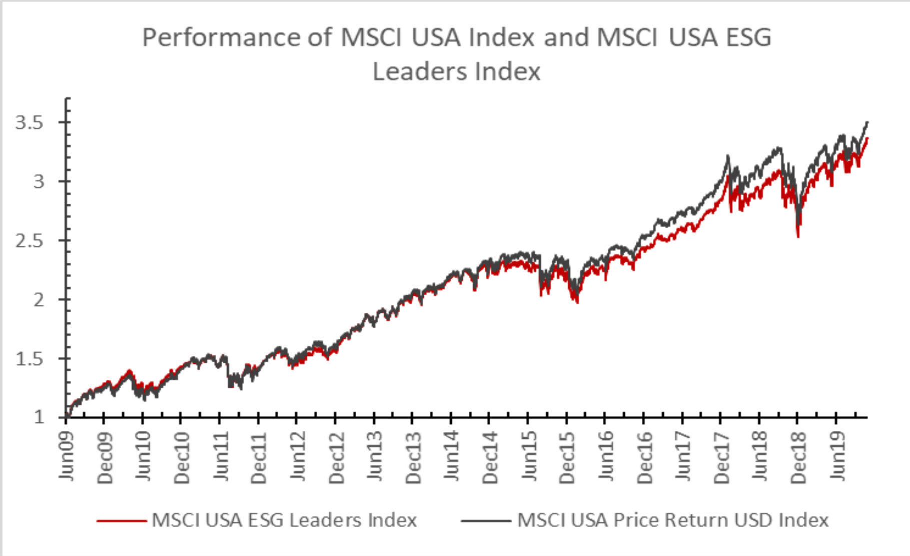
Source: Bloomberg, OCBC Bank

The MSCI indices suggest in equity market worldwide, investments that involve ESG factors as filtering parameters tend to perform better than investments that do not involve ESG analysis in the investment decision system.



Source: Bloomberg, OCBC Bank

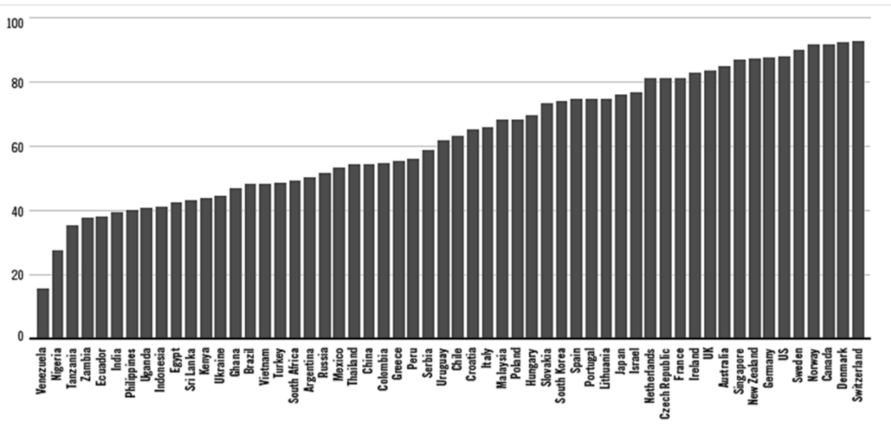
However, it is worth noting in the US market, an equity portfolio considering ESG factors has underperformed one without considering ESG factors. It reflects the maturity of the US equity market compared to other emerging markets to a certain extent. The concept of ESG investing is well-known by investors in developed markets. Thus, the alpha generation of ESG factors in developed markets tends to be less pronounced.



Source: Bloomberg, OCBC Bank

ESG in Asia

Templeton Global Macro ESG Index Score by Countries, Aug 2019



Source: Franklin Templeton

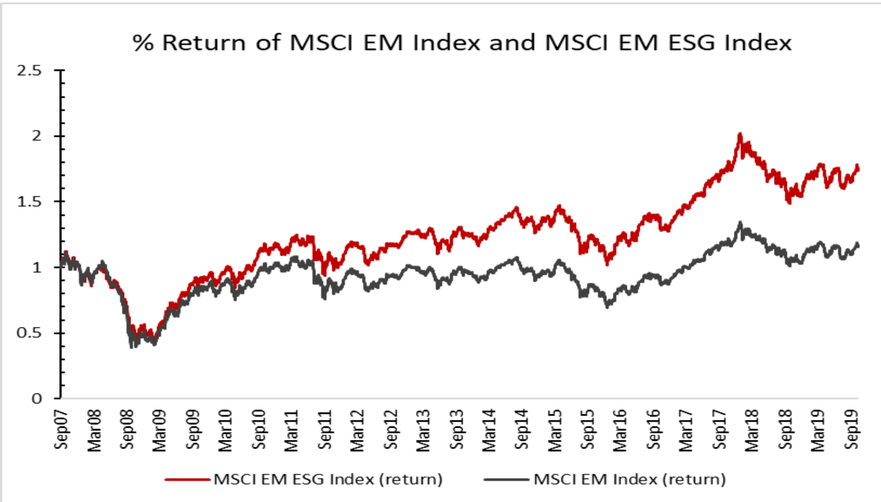
Developed countries are generally ranked higher in terms of ESG-friendly practices compared to developing countries. Nevertheless, emerging markets, especially Asia, are growing rapidly in the ESG space.

In Sep 2015, China mentioned of the need to establish a "green financial system" for the first time. *The China Green Finance Development Report (2018)* released in Nov 2019 states that China needs to continue its studies in theories of green finance, researches on more green financial policy tools and to encourage innovative green financial products in order to promote sustainable development in its financial system.

In 2018, 280 billion yuan of green bonds were issued in onshore China. According to PBoC, the balance of green credit facilities from banking institutions was 8.23 trillion yuan, a 16% YoY increase at the end of 2018. It accounts for 14.2% of the increase in loans for enterprises and other units in the same period.

However, ESG equity portfolios are underperforming in China despite outperforming in the boarder emerging market. It partially reflects the Zhongzheng Caitong (中证财通) ESG rating framework's ineffectiveness in filtering out companies that are truly ESG-positive.

Source: Wind, OCBC Bank

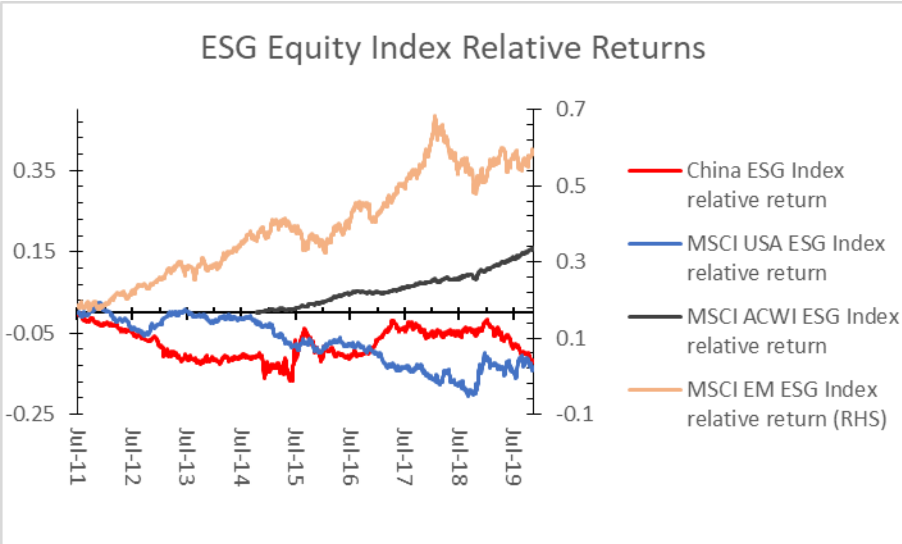


Source: Bloomberg, OCBC Bank

Conclusion

ESG analysis emphasise on an economy's long-term fundamentals. Thus, benefits from ESG analysis may only be realised given a significantly long time horizon. Nevertheless, ESG is becoming a trendy topic as the Millennial generation, who will be "inheriting" most of the assets in the world, are raising their awareness on ESG-related issues. ESG analysis is expected to provide some alpha ability by factoring out tail risks and black swan events, hence enabling investments in risky assets to produce better performance in the long run.

After equity portfolios include ESG as additional analysis factors, relative return (ESG index % return – ordinary index % return) of the EM market is significantly higher than the one of developed markets. ESG filtering in China, however, seems to have limited value-add, suggesting more work to be done by Chinese onshore ESG rating agencies.



Source: Bloomberg, OCBC Bank

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