OCBC GLOBAL OUTLOOK 2H 2019

Global 2H19 outlook: It never rains but pours!

Selena Ling, Head of Research and Strategy

Treasury Research
Tel: 6530-8384

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

GT Institutional Sales
Tel: 6349-1810

Parsing a volatile 1H 2019, it would be tempting to say that we have reached a fork in the road. First quarter growth momentum had been lacklustre, and the economic indicators in the second quarter have continued to suggest that light at the end of the tunnel, at least as far as the US-China trade and technology war and other geopolitical tensions, have yet to clearly materialised. A whole host of 2019 global growth forecast downgrades, whether from the IMF, World Bank, OECD, ADB, or the World Trade Organisation, suggest that the prospects for 2H 2019growth stabilisation and pick-up into the year-end may be dimming. That said, financial markets appear to be adopting a "bad news is good news" attitude, on the assumption of a Powell put, Draghi put, and for the other major central banks to follow suit.

Monetary policy accommodation has become fashionable again. With Fed chair Powell famously opining that prevention is better than cure at the June FOMC meeting, market doves have taken flight and the futures market is now pricing in 75bps by year-end and more to come in 2020. The dropping of the "patient" reference from the June FOMC statement was attributed to greater uncertainty from the trade war, rather than any US recessionary risk (notwithstanding the recent inversion of the 3-month to 10-year UST bond yield curve) or weakness in the US labour market conditions. Note that the median dots plot now reflect that 8 of the 17 FOMC members have pencilled in a cut by end-2019, with another 8 opting for no change and one in favour of hike. For 2020, 9 favour cut versus 8 in favour of a hold or hike. Indeed, political pressure may have well played a small role at least in the Fed's sudden pivot - Trump had consistently criticized Fed rate hikes and supposedly considered demoting Powell.

We believe that the Fed is likely to frontload a 25bps cut as early as July and 50-75bps before year-end as a precautionary move, but to factor in a further series of rate cuts into 2020 would require a further deterioration of the US economic fundamentals. Of course, the tepid inflationary environment does provide leeway for partially reversing the series of nine 25bp rate hikes that have been implemented since the end of 2015. While recent US-Iran tensions have lifted crude oil prices, nevertheless it is not expected to be a run-away risk or likely to remain elevated for a sustained period of time.

Actually the broad risks are largely familiar to that half a year ago when we published our 2019 Global Outlook, whereby heightened uncertainties from the protracted US-China trade war have contributed to market gyrations and business trepidation. We had earlier warned that global growth brakes would apply from 2019 onwards, with the US economy potentially running out of steam in 2020. In that context, the fact that the US Federal Reserve has now turned tail and is signalling an imminent bias suggests that the risks have loomed larger in the past few months. Throw into the murky mix, geopolitical risks such as Iran (sabre-rattling amid new US sanctions on the Iranian leader and eight senior military personnel) and North Korea (with US president Trump walking out of the Vietnam summit with Kim Jong Un), amongst others. True to form, US president Trump remains a confusing figure for market watchers to figure out what is the end-game, judging by his tweets about Plan B for China, and preferring Mario Draghi to Jay Powell as Fed chair etc. Fresh from the G20 summit in Osaka over 28-29 June, there is now another temporary ceasefire for fresh tariffs as the US and China head back to the negotiating table for further talks. For now at least, China has committed to buy more US goods and Trump will allow US companies to supply Huawei, albeit White House advisor Kudlow warned that the latter was not being granted a “general amnesty”. In addition, there was a nice photo-op and handshake between US president Trump and North Korean leader Kim Jong Un, which has also led to increased expectations that negotiations for the latter’s denuclearization will restart. However, we have seen this story before, and the question is how long-lasting the truce will be and if there will be a final agreement anytime soon.

China remains stuck between a big rock and a hard place in the near-term. China’s GDP growth had already been moderating in recent years amid the ongoing economic transformation away from an export-driven growth model to a more sustainable consumption-driven one, even before the US trade war started. The downside risks have been exacerbated by a multi-pronged US attack on trade, technology (aka Huawei and 5G), currency (US Treasury Department’s semi-annual FX report with an expanded monitoring watchlist that includes Singapore, Malaysia and Vietnam), etc. The co-mingling of non-tariff barriers, national security concerns, protection of intellectual property rights, fair treatment of foreign companies, removal of industrial subsidies, opening up of key sectors including services, all add up and potentially make a final trade deal harder to achieve. As such, the deployment of fiscal policy tools in China to mitigate the downside growth is likely to be accompanied by a similar monetary policy tilt to come. While China’s central bank has been actively employing innovative monetary policy options to inject liquidity and ease funding conditions for smaller brokerages and security firms, we cannot fully discount the possibility of traditional options such as Reserve Requirement Ratio (RRR) cuts to come as well. Even if the Chinese economy manages to pull off 2019 GDP growth above the key 6% handle this year, the next few years will remain challenging.

For Asian economies, the US-China trade war and China slowdown pose the greatest immediate downside risks, while the medium-term risks from technology and digital disruption remain very real. Earlier hopes of trade front-loading ahead of US-China tariffs and beneficial trade diversion effects have mostly faded. The one reality that businesses seem to be waking up to is that a slower China will mean a slower Asia. Even Vietnam, which appeared to be the main beneficiary from the diversion of US imports from China, may still face increased scrutiny from the US Treasury Department on the currency manipulation front for running a significant current account and bilateral trade surplus with the US. That said, the silver lining is that private consumption in many Asian economies remain resilient and underpinned by healthy domestic labour market conditions. Despite the manufacturing and trade slowdown, domestic demand is playing a key role in buffering the overall growth slowdown. For Singapore, the risk of a technical recession going into 2H19 and the potential for the full-year 2019 GDP growth forecast to be downgraded to the region of 0.5-1.5% yoy is not insignificant, which also has implications for the monetary policy decision in October.

Elsewhere, the clearest prediction we had on the Brexit rigmarole was the departure of the then-PM Theresa May, which has now come to pass. Boris Johnson and Jeremy Hunt are now engaging in brinksmanship and squabbling over the possibility of a no-deal Brexit even as the clock ticks closer to the 31 October deadline. In reality, a no-deal Brexit will likely trigger a parliamentary crisis, if not potentially outright market and/or economic chaos. However, investors have come round to the view that it will not pose a systemic risk to the global financial system.

If we are indeed on the cusp of lower interest rates and a softer USD, the implications for investors and corporates are clear. Focus less on the economic data for now and watch what central banks are telegraphing and intending to do. This will drive near-term market directionality. Be wary of sudden market sentiment shifts and do not assume that market presumptions (eg. at least 75bps of Fed rate cuts by year-end) are cast in stone, but are instead very much dependent on the flow of the day, whether in terms of economic data, geopolitical leanings or political pressure. Be opportunistic in your hedging and investment decisions. While we do think the current dovish-policy fuelled market optimism still has a little more room to run until the Fed actually starts to cut rates, nevertheless, the UST bond yield curve suggests that a lot of it has already been discounted. Hence the risk going into 4Q19 and 2020 is that market hopes for a whole cycle of rate cuts significantly more than 50bps of Fed cuts may end in disappointment. This is especially for Emerging Markets including Asia where the monetary policy space could be somewhat limited as they had not been as aggressive as the Fed in normalizing monetary policy last year, with the exceptions of Indonesia and India.

OCBC Economic Outlook: At a Glance

		GDP	Inflation	Central Bank Rate (Year-end)
Developed	**United States** The Fed has turned dovish and may embark on a rate easing cycle from Q3 onwards.	2017: 2.2% 2018: 2.9% 2019F: 2.3% 2020F: 1.9%	2017: 2.1% 2018: 2.4% 2019F: 2.0% 2020F: 2.7%	2017: 1.25-1.50% 2018: 2.25-2.50% 2019F: 1.50-1.75% 2020F: 1.50-1.75%
	Eurozone Draghi says that the ECB has further stimuli ammunition if conditions warrant further monetary easing.	2017: 2.4% 2018: 1.8% 2019F: 1.3% 2020F:1.5%	2017: 1.5% 2018: 1.8% 2019F: 1.3% 2020F: 1.6%	2017: 0.00% 2018: 0.00% 2019F: 0.00% 2020F: 0.00%
	Japan Watch for further trade attrition between US and Japan, which may result in Japan automotive tariffs.	2017: 1.9% 2018: 0.8% 2019F: 1.0% 2020F: 0.5%	2017: 0.5% 2018: 1.0% 2019F: 1.1% 2020F: 1.5%	2017: -0.10% 2018: -0.10% 2019F: -0.10% 2020F: -0.10%
	United Kingdom UK to elect a new PM in mid-July, with Boris Johnson in the front seat. Brexit deadline on 31 October.	2017: 1.8% 2018: 1.4% 2019F: 1.2% 2020F:1.4%	2017: 2.7% 2018: 2.5% 2019F: 1.8% 2020F: 2.0%	2017: 0.50% 2018: 0.75% 2019F: 0.75% 2020F: 0.75%
	Australia Two rate cuts have already been done in 1H; expect more rate reductions if disappointing data continues.	2017: 2.4% 2018: 2.8% 2019F: 2.1% 2020F:2.8%	2017: 2.0% 2018: 2.0% 2019F: 2.0% 2020F: 2.3%	2017: 1.50% 2018: 1.50% 2019F: 1.00% 2020F: 1.00%
Asia-Pacific	**India** With the BJP winning a clear majority and the RBI appearing dovish, expect growth to be favourable.	2017: 7.2% 2018: 7.1% 2019F: 7.3% 2020F: 7.5%	2017: 3.6% 2018: 3.5% 2019F: 3.9% 2020F: 4.2%	2017: 6.00% 2018: 6.50% 2019F: 5.50% 2020F: 5.50%
	South Korea Faltering electronic exports and external macro headwinds may prompt BoK to cut rates by Q4.	2017: 3.1% 2018: 2.7% 2019F: 1.8% 2020F: 2.4%	2017: 1.9% 2018: 1.5% 2019F: 1.0% 2020F: 1.5%	2017: 1.50% 2018: 1.75% 2019F: 1.50% 2020F: 1.50%
	Taiwan Economic growth likely to take a hit as US-China tensions to dampen demand for local electronic exports.	2017: 3.1% 2018: 2.6% 2019F: 2.0% 2020F: 2.0%	2017: 1.1% 2018: 1.5% 2019F: 0.9% 2020F: 1.1%	2017: 1.375% 2018: 1.375% 2019F: 1.375% 2020F: 1.375%
ASEAN	**Myanmar** Continued uncertainty over the withdrawal of preferential trade status by the EU may dampen investments.	2017: 6.8% 2018: 2.1% 2019F: 6.4% 2020F: 6.6%	2017: 4.0% 2018: 3.5% 2019F: 3.9% 2020F: 6.7%	2017:10.00% 2018: 10.00% 2019F: 10.00% 2020F:10.00%
	Philippines Growth may accelerate in 2H as mid-term election results boost chances of infrastructure development policies.	2017: 6.7% 2018: 6.2% 2019F: 6.0% 2020F: 6.2%	2017: 2.9% 2018: 5.2% 2019F: 2.9% 2020F: 3.3%	2017: 3.00% 2018: 4.75% 2019F: 3.75% 2020F: 3.00%
	Thailand Growth may come under increasing pressure on fragmented parliament, slower tourist arrivals, falling exports.	2017: 4.0% 2018: 4.1% 2019F: 3.4% 2020F: 3.5%	2017: 0.7% 2018: 1.1% 2019F: 1.0% 2020F: 1.2%	2017: 1.50% 2018: 1.75% 2019F: 1.50% 2020F: 1.50%
	Vietnam The economy is likely to experience a redirection of trade flows into the country from the US-China trade war.	2017: 6.8% 2018: 7.1% 2019F: 6.5% 2020F: 6.5%	2017: 3.5% 2018: 3.5% 2019F: 3.1% 2020F: 3.3%	2017: 6.25% 2018: 6.25% 2019F: 6.25% 2020F: 6.25%

Source: IMF, Bloomberg, CEIC and OCBC Bank

OCBC Asia GDP, CPI and Policy Rate Forecasts

GDP					
% chg year-on-year	**2016**	**2017**	**2018**	**2019F**	**2020F**
US	1.6	2.2	2.9	2.3	1.9
Euro-zone	2.0	2.4	1.8	1.3	1.5
Japan	0.6	1.9	0.8	1.0	0.5
United Kingdom	1.8	1.8	1.4	1.2	1.4
New Zealand	4.2	2.6	3.0	2.5	2.9
Australia	2.8	2.4	2.8	2.1	2.8
China	6.7	6.8	6.6	6.2	6.0
Hong Kong	2.2	3.8	3.0	2.1	2.1
Taiwan	1.5	3.1	2.6	2.1	2.0
Indonesia	5.0	5.1	5.2	5.1	5.4
Malaysia	4.2	5.9	4.7	4.4	4.3
Philippines	6.9	6.7	6.2	6.0	6.2
Singapore	2.8	3.9	3.2	1.3	2.0
South Korea	2.9	3.1	2.7	2.0	2.4
Thailand	3.4	4.0	4.1	3.4	3.5
Myanmar	5.9	6.8	2.1	6.4	6.6
Vietnam	6.2	6.8	7.1	6.5	6.5

Inflation					
% chg year-on-year	**2016**	**2017**	**2018**	**2019F**	**2020F**
US	1.3	2.1	2.4	2.0	2.7
Euro-zone	0.2	1.5	1.8	1.3	1.6
Japan	-0.1	0.5	1.0	1.1	1.5
United Kingdom	0.7	2.7	2.5	1.8	2.0
New Zealand	0.6	1.9	1.6	2.0	1.9
Australia	1.3	2.0	2.0	2.0	2.3
China	2.0	1.6	2.1	2.2	2.4
Hong Kong	2.4	1.5	2.4	2.4	2.1
Taiwan	1.0	1.1	1.5	0.8	1.1
Indonesia	3.5	3.8	3.2	3.2	3.4
Malaysia	2.1	3.8	1.0	1.3	2.5
Philippines	1.3	2.9	5.2	2.9	3.3
Singapore	-0.5	0.6	0.4	0.8	1.5
South Korea	1.0	1.9	1.5	0.8	1.5
Thailand	0.2	0.7	1.1	1.0	1.2
Myanmar	6.8	4.0	3.5	3.9	6.7

Central Bank Policy Rate					
	2016	**2017**	**2018**	**2019F**	**2020F**
US Fed Funds rate	0.50%-0.75%	1.25%-1.50%	2.25%-2.50%	1.50%-1.75%	1.50%-1.75%
ECB refinance rate	0.00%	0.00%	0.00%	0.00%	0.00%
BOJ overnight rate	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
BOE base rate	0.25%	0.50%	0.75%	0.75%	0.75%
RBNZ cash rate	1.75%	1.75%	1.75%	1.25%	1.25%
RBA cash target rate	1.50%	1.50%	1.50%	1.00%	1.00%
China lending rate	4.35%	4.35%	4.35%	4.35%	4.10%
CBRC discount rate	1.375%	1.375%	1.375%	1.375%	1.375%
Hong Kong base rate	1.00%	1.75%	2.75%	2.00%	2.00%
BI reference rate	4.75%	4.25%	6.00%	5.50%	4.75%
BNM overnight rate	3.00%	3.00%	3.25%	3.00%	3.00%
BSP overnight reverse repo	3.00%	3.00%	4.75%	3.75%	3.00%
Singapore 3-month SIBOR	0.97%	1.50%	1.89%	1.98%	2.05%
BOK target overnight call	1.25%	1.50%	1.75%	1.50%	1.50%
BOT repurchase rate	1.50%	1.50%	1.75%	1.50%	1.50%
CBM domestic rate	10.0%	10.0%	10.0%	10.0%	10.0%
SBV refinancing rate	6.50%	6.25%	6.25%	6.25%	6.25%

Source: OCBC Bank

Contents

Country Outlook

Thematic Pieces

CHINA

The Balancing Game

Tommy Xie, Head of Greater China Research

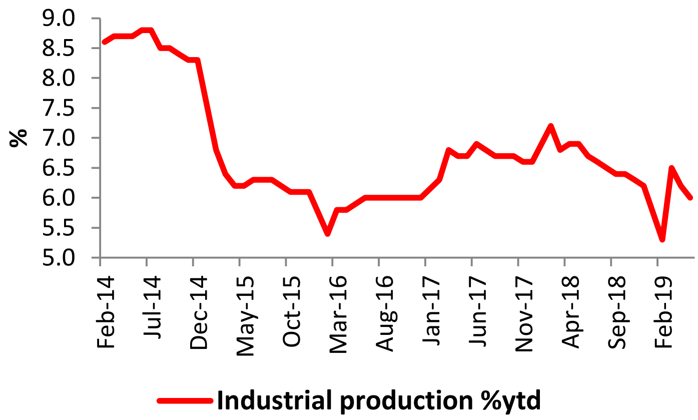
Summary View

- The weak economic activities seen in 1H19 was mainly the result of rising uncertainty from the US-China trade war and the unexpected shift of domestic monetary policy from easing to neutral from April onwards.
- China still prefers utilizing innovative measures to handle domestic challenges so as to strike a balance between structural de-leveraging and growth.
- China could eventually turn back to traditional monetary easing to supply the bond issuance.

China's green shoots story proved to be short-lived as economic activities slowed again in April and May. The country's industrial production slowed down to 5% yoy in May, the lowest on record. The deceleration in the second quarter was mainly the result of two factors, including rising uncertainty from the re-escalation of US-China trade war and the unexpected shift of China's monetary policy stance from easing to neutral in April, as authorities attempted to strike a balance between structural de-leveraging and growth.

Three domestic challenges for China…

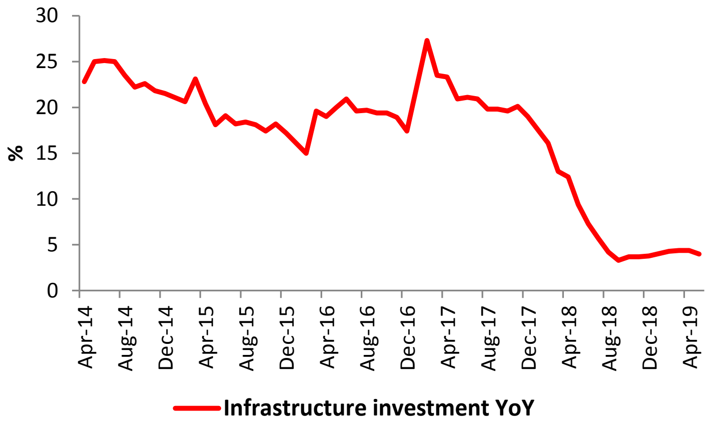
In 1H 2019, the Chinese economy faced three new challenges domestically, which were a still prudent monetary policy; proactive but experimental fiscal policy; and liquidity shock from the trial to break the implicit guarantee. This is in addition to the rising uncertainty from the US-China trade war.



Experimental fiscal policy

Since the beginning of 2019, China has announced massive tax cuts to stimulate the economy, ranging from income tax cut, value-added tax cut (effective from 1 April) and social contribution rate cut (effective from 1 May). The total tax cut, which is estimated to be CNY2 trillion, is the first experimental fiscal stimulus in that it does not rely on infrastructure investment. However, the boost from the tax cut to the economy is not as fast as the usual investment-driven fiscal stimulus.

The further deceleration of infrastructure investment to 4% in the first five months from 4.4% in the first four months was a disappointment. This was mainly due to the funding constraints for the local government.



Experimental bank takeover

Ripple effects from Baoshang bank takeover lasted longer than expected

Meanwhile, China's central bank and banking regulator jointly announced in late May to take over the troubled Baoshang bank due to several credit events. This marked the first state takeover in about two decades. Despite the reassurance from the regulators that the takeover is a one-off event, the ripple effect from the Baoshang incident lasted longer than expected. Smaller lenders and non-bank financial institutions were locked out of the funding market although overall market liquidity remains abundant. This raised some concerns that the snowball effect from the Baoshang incident may hit the real economy should the demand from the largest corporate bond buyers, namely the non-bank financial institutions disappear.

The structural liquidity issues arising from the Baoshang incident and slower transmissions from the tax cut may require more support from monetary easing. However, it seems the PBoC is still reluctant to act despite global central banks having entered a new round of an easing cycle. Instead, China is still relying more on innovative policy to support domestic growth.

China still prefers innovative measures to handle economic challenges.

On liquidity, China's central bank stepped up its support in June to calm down the market via guaranteeing the issuance of certificate of deposit by one of the smaller lenders through the Credit Risk Mitigation Warrant as well as increasing the re-discount and SLF quota for smaller banks by an aggregate CNY300 billion. Meanwhile, the PBoC and security regulator CSRC were reported to host a meeting with six big banks and a few big security brokerages to ease the structural liquidity pressure faced by non-bank financial institutions since the takeover of Baoshang bank. Big banks are encouraged to lend to big security brokers, which will play a bridging role to support funding demand from the smaller non-bank financial institutions.

For the Chinese economy, China unveiled a new guidance to support the issuance of local government special purpose bonds in June. Proceeds from the issuance of special purpose bonds will be allowed to be used as seed capital for major projects. Meanwhile, local government funding vehicles are also allowed to renegotiate the financing terms with financial institutions to support the existing projects and contain the risk. We think it may help address the funding concerns of the local government, which may boost infrastructure investment in 2H2019.

There is also talk that China's Ministry of Finance that China may increase its quota for local government bond issuance in 2H2019. As such, there is a risk that China's bond supply may increase. Historically, China's fiscal stimulus via bond issuance usually goes hand in hand with easing monetary policy. Even though China has relied mostly on the innovative policies to strike the balance between structural de-leveraging and growth, we think in the medium term China may eventually turn to traditional monetary easing, such as RRR cuts.

However, China may turn back to traditional monetary easing eventually.

The US-China trade war remains a wild card. It is difficult to quantify the impact at the current juncture. Nevertheless, we think President Trump has made two strategic mistakes on the impact of the US-China trade war. This includes assuming that China is paying for most of the tariffs and that manufacturing activities will move back to the US. Our conversation with Chinese manufacturers suggest that US importers may need to share a portion of the tariffs cost, while the latest survey from the American Chamber of Commerce in China showed that few US manufacturers plan to move back to the US. Overall, we think there is the risk that President Trump may have overestimated the impact of the trade war on the Chinese economy, while underestimating the impact on the US. Our best guess is that a further escalation of the US – China trade war could result in Chinese GDP being slashed by as much as 0.6-1%, though this is not in our base case scenario.

To conclude, we think the large variety of policy tools together with China's window guidance is likely to contain the liquidity risk. Without the further escalation of US-China trade war, we expect the Chinese economy is on track to achieve about 6.2% growth in 2019.

On monetary policy, although the PBoC remains prudent, we think China may eventually turn back to traditional monetary easing such as RRR cuts to support the increasing bond issuance.

HONG KONG

Fraught With Uncertainties

Carie Li, Economist

Summary View

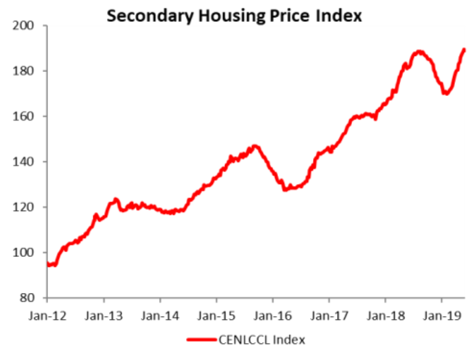
- Market sentiments were once upbeat amid three positive factors including major central banks' dovish stance, China's stimulus measures and the resumed trade talk between US and China. With the re-escalation of the trade war, consumer/ investor sentiment will likely remain subdued especially given the resultant correction in risky asset prices.
- Lingering trade war concerns and weakening external demand could continue to drag down goods exports. Also, services exports may stay muted as unfavourable factors such as a weaker RMB, stock market correction and rising concerns about the global outlook may overshadow the favourable factors.
- As for the other two crucial industries, the banking sector may see weakness in both internal and external loan demand amid trade war risks while the housing market frenzy may calm soon on increasing short-term supply, negative wealth effects and the limited downside of mortgage rates.
- In conclusion, HK's economic outlook will hinge on the trade war development and the efforts of China to prop up growth. Should US-China trade talks go on well and China unveil more stimulus measures, we expect HK's GDP growth to reach 2.1% in 2019. Otherwise, it is possible for the growth to soften further.

Market sentiments were once upbeat

Market sentiments improved notably in 1Q 2019, supported by three positive factors. First, since early this year, major central banks followed the Fed to shift their stance from hawkish/neutral to dovish. This helped to ease concerns about tightening liquidity across the globe. Second, China rolled out universal monetary easing and larger-than-expect tax cut to prop up the growth. As such, China's economy showed some green shoots in March. Third, the US-China trade talks went well and was close to reaching a deal.

Improved market sentiments in 1Q19 boosted both the stock market and the property market.

These three positive factors drove the Hang Seng Index up to the highest since mid-2018 in April. The resultant wealth effect together with the eased concerns about local rate hikes and renewed worries about decreased housing affordability fuelled a new round of housing frenzy. After a brief correction in late 2018, housing transaction volume rose for the second consecutive month by 18% yoy to 7,822 deals (the highest since Sept 2016) in April 2019. Also, Centaline Property Centa-City Leading Index which tracks secondary private housing prices rose 8.6% ytd to an all-time high as of 26th May.



Source: Bloomberg, OCBCWH

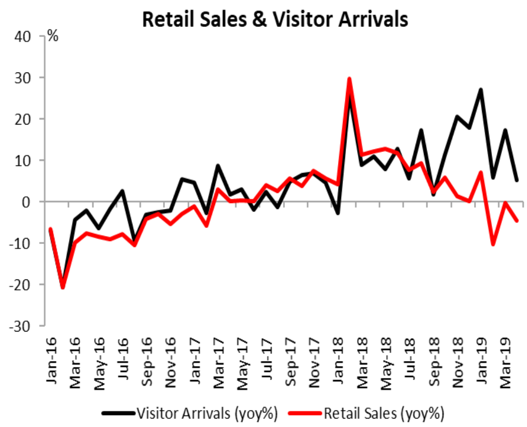
Internal demand remained subdued

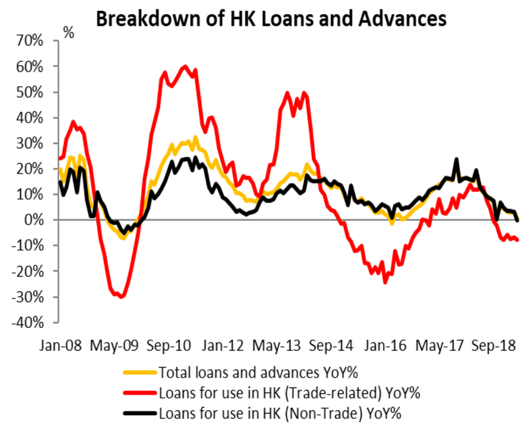
Private consumption, fixed investment and local loan demand remained subdued amid global economic slowdown and lingering trade war risks.

Though risky assets prices rallied significantly, consumption and fixed investment remained sluggish amid external uncertainties. Private consumption growth decelerated notably from 2.7% yoy in 4Q 2018 to 0.1% yoy in 1Q 2019 while fixed investment decreased for the second straight quarter by 7% yoy. As global economic growth continued to show signs of a slowdown and the US-China talks did not made any material progress, consumer and investor sentiments remained cautious.

Similarly, inbound tourists have been cautious about spending due to a strong HKD (or a weak RMB), faltering global growth outlook and lingering trade war risks. In fact, visitor arrivals increased by 13.9% yoy in the first four months of 2019 on the back of the infrastructure improvement including the opening of the high-speed rail and Hong Kong-Zhuhai-Macau Bridge. However, retail sales dropped by 1.2% yoy in 1Q 2019. Specifically, the sales of clothing & footwear (-2.6% yoy) and jewellery & watches (-11.4% yoy) all continued to drop.

On the other hand, due to concerns about external uncertainties, local loan demand continued to soften. The growth in HK's total loans and advances (HK$10 trillion) decelerated to the weakest since June 2016 at 0.5% yoy in April 2019. Trade finance dropped for the eighth straight month by 7.8% yoy to HK$484 billion due to weak trading activities on soft external demand. Loans for use in HK (excluding trade finance) dropped for the first time since January 2019 by 0.1% yoy to HK$6.5 trillion.





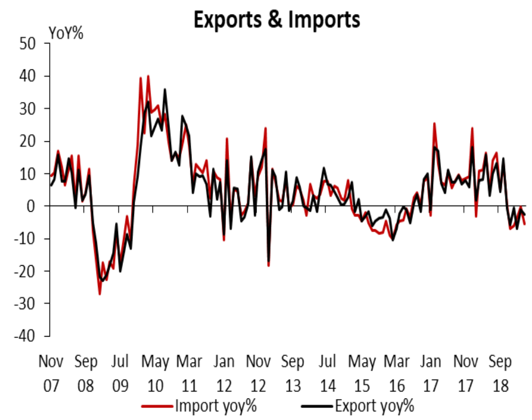
Source: HK Census and Statistics Department, HKMA, OCBCWH

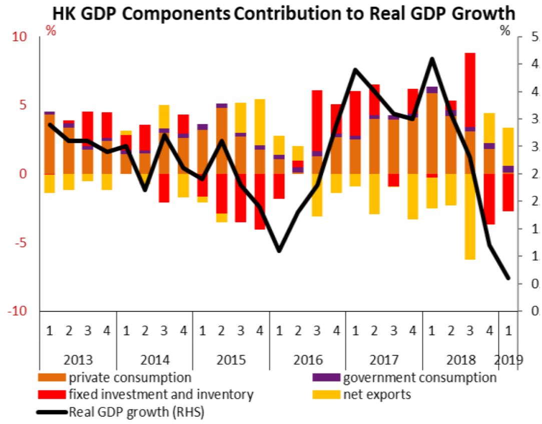
External demand continued to weaken

Weak external demand and lingering trade war risks continued to weigh down HK's trade activities.

Due to the persistent trade war risks and weak external demand, the trade sector took a hard hit. Exports fell for the sixth consecutive month by 2.6% yoy while imports dropped for the fifth month in a row by 5.5% yoy in April. Exports to major trading partners including China (-5.2% yoy), the USA (-10.6% yoy), India (-25.7% yoy), Japan (-5.5% yoy), Taiwan (-14.9% yoy) and Vietnam (-3.3% yoy) all decreased during the first four months of 2019. This confirms that China's stimulus failed to revive global demand while the US-China trade war continued to materialize. Over the first four months of 2019, container throughput of HK's port dropped by 7.6% yoy to 5.99 million TEU, ranking the eighth (as compared to the 7th last year) among the world's major ports.

Amid subdued internal demand, weak external demand and high base effect, GDP growth decelerated to the weakest level since 3Q 2009 at 0.6% yoy in 1Q 2019. Going forward, HK's economic outlook may continue to be fraught with uncertainties.



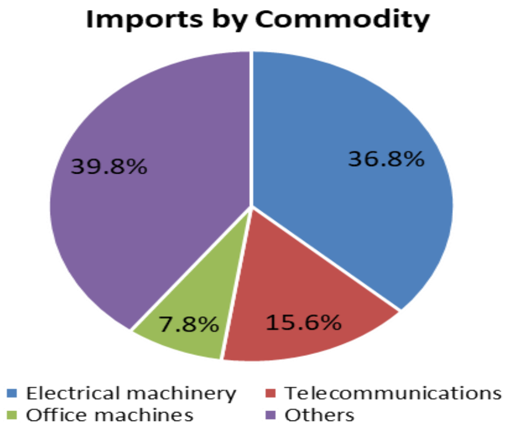


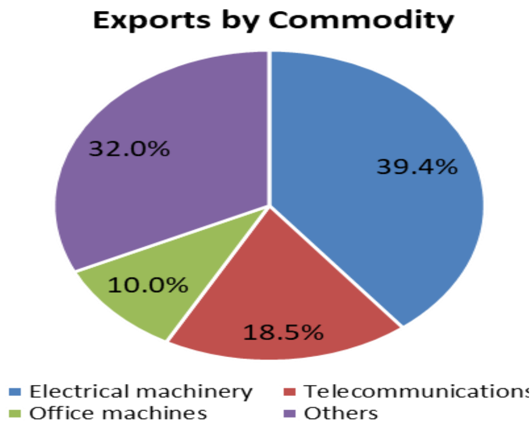
Source: HK Census and Statistics Department, OCBCWH

Trade sector is succumbed to external headwinds

Re-escalation of US-China trade war and the start of a tech war may further hurt HK's trade activities and dent consumption sentiment.

The trade activities may stay weak as the US-China trade war escalation is set to put a lid on global economic recovery and hit global demand. More notably, with the trade war turning into technology war, Asia's whole electronic value chain may take a harder hit. The same would be true to HK's trade sector which focuses mainly on the high-tech products. Exports and imports of electrical machinery, telecommunications and office machines took over 68% of total exports and 60% of total imports respectively in Apr. In conclusion, we expect exports and imports will see around 0% growth in 2019. Should US-China trade war escalate, HK's trade activities are likely to weaken further.





Source: HK Census and Statistics Department, OCBCWH

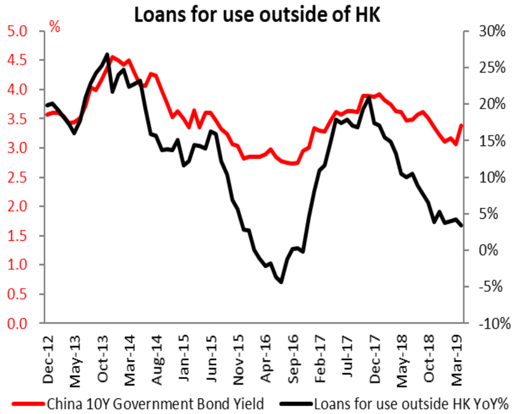
Retail sector may fail to benefit from resilient tourism

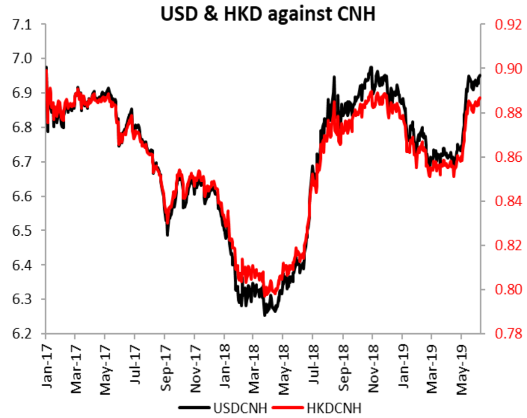
The holiday effect combined with infrastructure improvement may lend some support to HK's inbound tourism and sales of low-end products. Despite the US and China announcing a trade war ceasefire and agreeing to resume talks, lingering trade war risks and global economic slowdown may keep local consumption and visitor spending subdued with the retail sector likely to remain sluggish over the coming months.

Banking system is facing double whammy

The banking system may see weakening loan demand at home and from Mainland China.

Internally, given that the US-China trade tensions re-escalated in early May, we are wary of further contraction in trade finance in the coming months. Also, the heightened uncertainties about growth outlook amid trade war risks could further weigh down other local loan demand. Externally though, a stabilizing RMB and a wider USD-RMB yield differential would make offshore financing increasingly attractive to Mainland companies. However, the rising reliance of offshore direct financing and the multiple headwinds at home and abroad may constrain the growth in loans for use outside of HK. In conclusion, we expect total loan growth to remain subdued and only see low single-digit growth in 2019.



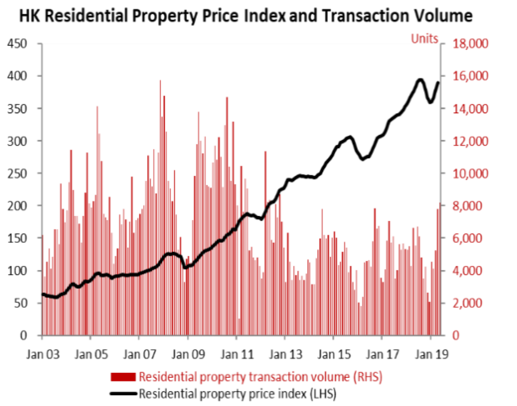


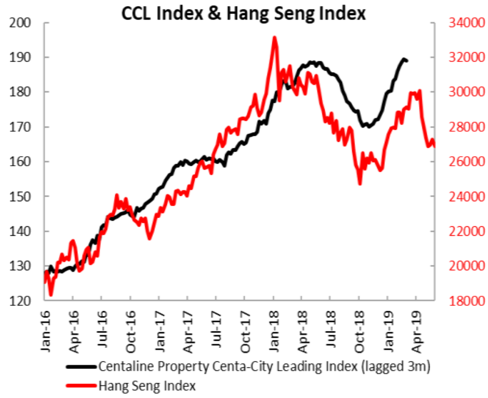
Source: HKMA, Bloomberg, OCBCWH

The renewed housing frenzy may calm soon

The renewed housing frenzy may calm soon amid several unfavorable factors.

Despite the recent rebound in the property market, we believe that the market's growth will slow down due to several unfavourable factors. First, investor sentiment might have been dented by trade war escalation and the resultant negative wealth effect (the Hang Seng Index having dropped by over 10% in May). This has already prompted some buyers to walk away from the purchase of new homes lately. Second, there will be around 5,000 units of public housing available in mid-2019 while property developers may bring forward the launch of new projects to avoid the upcoming vacancy tax. This suggests increasing short-term supply, which has propelled some homeowners to lower the offering prices lately. Third, even though the chance of prime rate hike is slim this year, the downside for mortgage rates seems limited due to the decrease in the aggregate balance. The one-month HIBOR has hovered above 1.5% since mid-March. As housing prices already went up by 10.4% ytd as of May 2019, we revise our forecast for housing price growth to 8% yoy for 2019. However, should US-China trade tensions further escalate, housing prices will likely see a milder growth this year.





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

We expect HK's 2019 growth to slow to 2.1% yoy.

In conclusion, though the US and China have agreed on a trade truce, the lingering trade war risks and the existing tariff may continue to be a drag on Hong Kong's exports while keeping the household spending and corporate investment cautious. Going forward, HK's economic outlook will hinge on the trade war development and the efforts of China to prop up growth. Should the US-China trade talks go well and China unveil more stimulus measures, we expect HK's GDP growth to reach 2.1% yoy in 2019. Otherwise, it is possible for growth to soften further.

INDONESIA

So What Now After Elections?

Alan Lau, Economist

- We downgrade 2019 growth from 5.3% yoy to 5.1% yoy after a potentially slower 1H 2019 than expected.
- 2019 headline inflation is likely to be at 3.2% yoy and comfortably within Bank Indonesia's (BI) target range of 2.5% - 4.5%.
- We believe BI should begin cutting the benchmark rate starting in 3Q 2019 by 25bps with our expectation of 50bps of rate cuts in 2019.
- Jokowi's second term is likely to be focused on building long term foundations and may not see a significant boost in growth from current levels of around 5.0%.

After months of campaigning, the Presidential race ends with Jokowi having achieved a big margin of victory of around 11% against his rival Prabowo. This though was widely expected and the election itself was deemed in a way quite "uneventful". With the election race now over, the focus moves back to the economy.

Growth likely to remain stable

We downgrade our 2019 growth forecast from 5.3% yoy to 5.1% yoy.

The country has so far had a slow start to 2019 with growth decelerating to 5.07% yoy for 1Q 2019 from 5.18% yoy in 4Q 2018. Household consumption growth slowed to 5.01% yoy (4Q 2018: 5.08% yoy) despite expectations of the election campaign supporting spending on the ground although consumption by "non-profit institutions serving households" did pick-up. Meanwhile, gross fixed capital formation (GFCF) grew at a weaker pace of 5.03% yoy (4Q 2018: 6.01% yoy) but this could have been due to concerns regarding political uncertainty. Net exports were a positive contributor to growth although overall trade volume fell.

Headline inflation likely to be at 3.2% yoy and comfortably within BI's target range.

However, moving into the second quarter, we expect to see growth pick-up to 5.2% yoy as household consumption will likely rise due to the festive season. GFCF may probably see higher growth as political uncertainty recedes. However, net exports could likely be a drag amid the subdued global trade environment. For 2H 2019, there are few reasons to expect growth to accelerate further. At this point, we are not expecting that any additional stimulus packages can be fully implemented this year. Hence, given the challenge of catching up after a slower 1Q 2019 and potentially overall slower 1H 2019, we are downgrading our entire 2019 growth forecast from 5.3% yoy to 5.1% yoy. As a note, the country's economic growth as a whole may not be too affected by the ongoing US – China trade war compared to other ASEAN peers given that exports are a much smaller share of GDP relative to them.

Inflation is not a constraint for monetary policy

The 1Q 2019 headline inflation averaged 2.62% which brought it close to the bottom of Bank Indonesia's (BI) range of 2.5% - 4.5%. However, for 2Q 2019, it has ticked up higher to average at 3.14% yoy amid a faster increase in food prices. We expect food prices to continue to rise and drive headline inflation higher for the rest of this year. Rising airfare prices can also risk feeding into higher inflation although the government is working to keep the cost of air travel down. Meanwhile, the continued freezing of fuel and electricity prices should help cap inflation levels. Overall, we see the entire 2019 headline inflation to be at 3.2% yoy

Trade deficit is likely to persist

Expect a monthly trade deficit to persist and the current account deficit to be at 2.5% - 3.0%.

We see it likely that a trade deficit may continue in the near term, with exports possibly going to be affected by the slower global trade environment amid ongoing trade tensions. Growth in imports meanwhile may likely be capped by government import control measures such as prioritizing crude oil usage for domestic demand or implementing the B20 policy. In terms of the current account deficit, we see that it may come out in the range of 2.5% - 3.0% of GDP.

Firmer IDR opens window of opportunity for BI

A firmer IDR should provide the window of opportunity for BI to cut.

Interest in high yielding Asian bonds has risen since early June as a global easing cycle primarily led by the Fed sets in. This in turn has provided support for a firmer IDR and we believe that the currency would likely remain in the range of 14,000 – 14,500 against the USD for the rest of this year with a stronger likelihood to be at the bottom end of this range. Hence, we see it likely that BI may begin cutting as early as 3Q 2019 by at least 25bps and we are expecting a total of 50bps of rate cuts in 2019. After all, Perry Warjiyo has said that rate cuts are a “matter of time”. For further analysis on a BI rate cut, please refer to our thematic piece: *Why has BI not cut?*

Jokowi’s second term would more likely focus on long-term development

We are expecting Jokowi to continue to push ahead with his infrastructure plan as he works to improve connectivity throughout Indonesia. Other measures that he may consider undertaking include improving tax compliance to help increase revenue to strengthen the fiscal situation. He would also probably focus on developing human capital in addition to driving the development of export oriented industries. However, we see that most of these goals would be more long-term in nature.

Don’t expect a pickup in growth from current levels in Jokowi’s second term as he lays the foundation for the longer term instead.

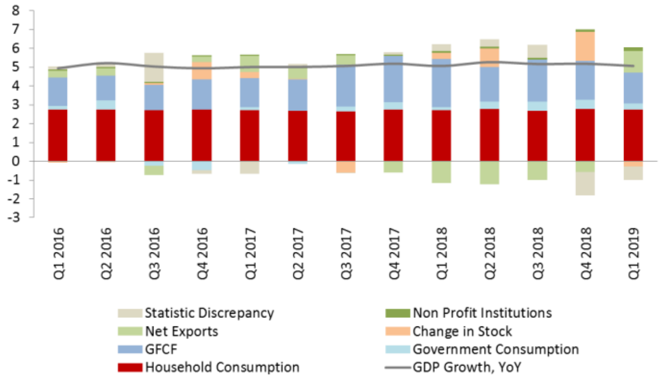
Recently, Finance Minister Sri Mulyani has said that plans for a “super deductible tax" incentive, that allows a company to deduct its taxes at double the amount it invests in skills training and triple the size of its investment in research and development, will soon be issued. According to news reports, the government has also recently announced some tax cut measures to boost investment and economy growth including the income tax for infrastructure – related securities being lowered to 5% from 15% and price threshold at which luxury sales tax (at 20%) applied to houses and apartments being raised to Rp30bn from Rp20bn for landed property and Rp10bn for an apartment respectively. The government is also reportedly studying a proposal to cut the corporate tax rate from 25% to 20%. Whether these tax cuts would lead to any increase in investment in the economy is difficult to judge given that investment itself also depends upon various other factors such as the level of infrastructure.

Steady Indonesia ahead?

Expect a stable second half but watch out for rate cuts and announcements on new development plans.

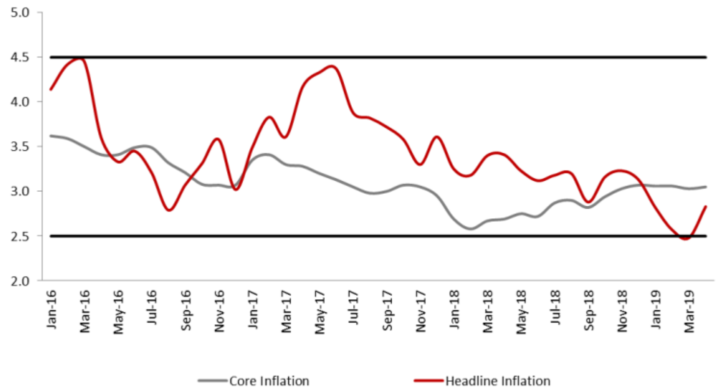
Overall, we expect that Indonesia’s economy would continue to exhibit stability into 2H 2019. There are limited signs at this point of any significant disruptions to the country’s economic fundamentals in 2019. However, do look out for BI easing in the next few months. Also, watch out for possible Jokowi announcements on any new development plan.

Chart 1: Contributors to GDP Growth, % yoy



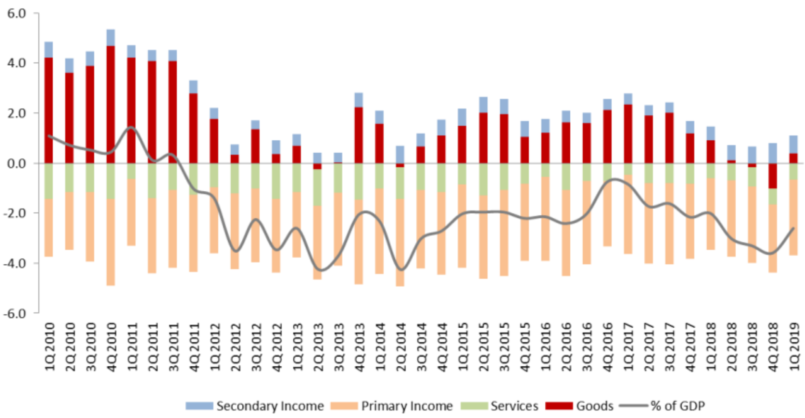
Source: CEIC, Bloomberg and OCBC

Chart 2: Headline and Core Inflation, % yoy



Source: CEIC, Bloomberg and OCBC

Chart 3: Contributors to Current Account Surplus/Deficit, % of GDP



Source: CEIC, Bloomberg and OCBC

MACAU

Faltering Growth Outlook Despite Resilient Tourism

Carie Li, Economist

Summary View

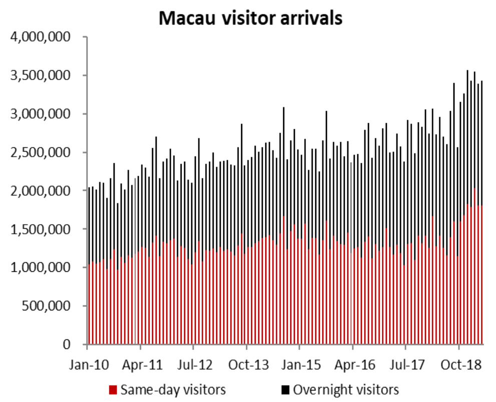
- Infrastructure improvement has lent strong support to Macau's inbound tourism by mainly boosting the same-day tourism. Combined with China's stabilization, a rebound in RMB, wealth effect from stock rally and holiday effect, these favourable factors also allowed overnight visitors to show stronger growth in March and April.
- However, neither the gaming activities nor the retail sector benefited much from the resilient inbound tourism as inbound tourists have been cautious about spending due to lingering global uncertainties.
- Though the casino operators' effort to increase non-gaming elements paid off with a rising percentage share of mass-market revenue, this failed to offset the sharp slump in revenue from high-rollers fuelled by mounting policy risks.
- Given the lingering trade war risks, the renewed downward pressure on China's growth will likely further weigh on the gaming and retail sectors.
- Though housing market regained some momentum in 1Q19, the momentum may fade soon amid negative wealth effect, housing control measures and the diminishing effect of supportive measures.
- In a nutshell, we expect GDP growth will slow down to around 0% in 2019.

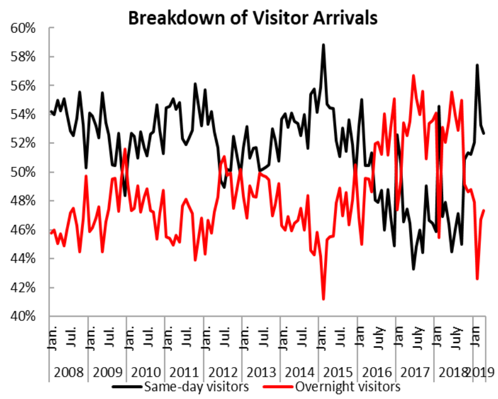
Infrastructure improvement lent strong support to tourism

The tourism sector has benefited from infrastructure improvement whilst also benefiting from short-lived support from China's stabilization and the RMB's rebound in March and April.

During the first four months of 2019, total visitor arrivals increased by 19.9% yoy. Same-day visitors saw double-digit yearly growth for the seventh consecutive month in April and rose sharply by 31.9% yoy over the first four months. By source of visitors, those from Mainland China grew by 21% yoy while those from Hong Kong rose notably by 23.6% yoy during January to April. This drove the visitors from the Greater Bay Area (HK visitors taking up 41.1%) up by 20.5% yoy over the same period. By mode of transport, visitor arrivals by land, which accounted for 73.6% of total visitor arrivals, surged by 48.5% yoy during the first four months of 2019 with 20% coming via the Hong Kong-Zhuhai-Macau Bridge. This confirms that the infrastructure improvement continued to support Macau's inbound tourism.

On the other hand, overnight visitors grew by 8.3% yoy during the first four months with the percentage share of overnight visitors rebounded from a four-year low of 42.6% in Feb to 47.3% in Apr while the average length of stay of overnight visitors rebounded from 2.1% (a level last seen since Apr 2018) in Feb to 2.2 days in Apr. This may be attributed to seasonal factors, wealth effect from stock market rally, the slight rebound in RMB and China's economic stabilization during Mar and Apr.





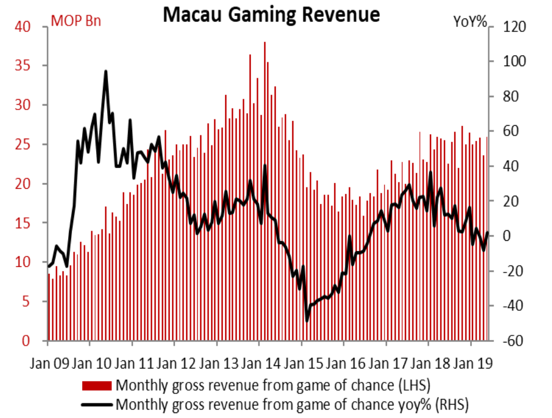
Source: Macau DSEC, OCBCWH

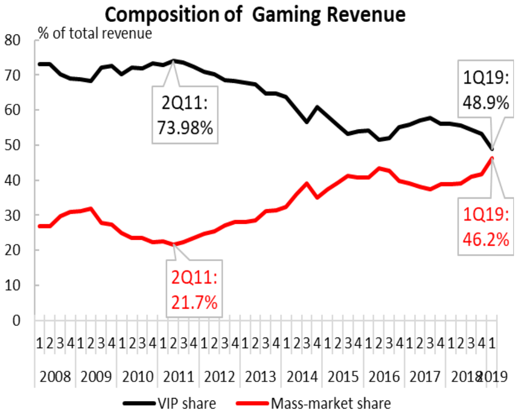
Gaming and retail sectors continued to lose momentum

Gaming and retail sectors may remain sluggish due to mounting policy risks, cautious visitors' consumption and rising concerns about the trade war.

Owing to the resilient tourism activities, mass-market revenue registered double-digit growth for the sixth consecutive quarter and was up by 18.4% yoy in 1Q 2019. The percentage share of mass-market revenue surged to a record high of 46.2% in 1Q 2019. However, due to the low profitability of mass-market segment, the strength of this segment failed to offset the weakness of the high-roller segment. The revenue from the VIP segment dropped for the first time since 3Q 2016 by 13.4% yoy in 1Q 2019 amid mounting policy risks. In terms of policy risks, first, the new tobacco control law was implemented from 1st January 2019. Second, China's crackdown on illegal FX activities may have limited high-rollers' funding.

As a result, total gaming revenue tumbled by 0.5% yoy in 1Q 2019, driving the growth in the export of services down by 0.3% yoy in 1Q 2018, the first decline since 2Q 2016.

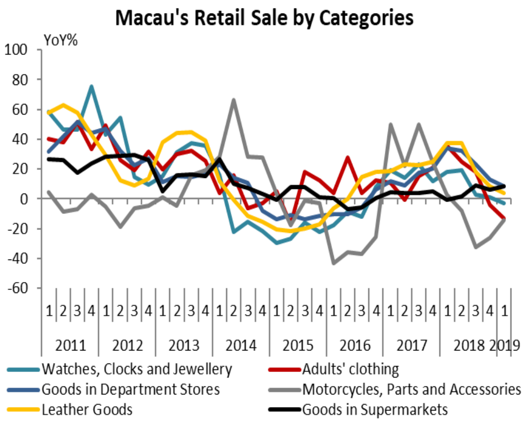


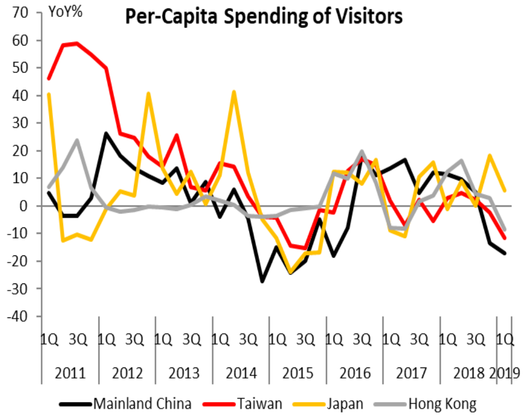


Source: Macau DICJ, OCBCWH

On a positive note, official data shows that visitor arrivals during the Labour Day holiday rose by 37% yoy with those from Mainland China jumping 42.7% yoy. This suggests that mass-market segment might have had a good start in 2Q 2019. However, after the holiday effect abates, we are wary of a possible slowdown in tourism growth amid the renewed downward pressure on the RMB and the weakening global economic outlook following the re-escalation of the US-China trade war. On the other hand, without much more new mega projects to attract tourists, the high cost of staying overnight may impede overnight visitors who have made major contribution to Macau's gaming and retail growth from re-visiting the gambling hub.

On the retail front, sales dropped by 2% yoy in 1Q 2019, the first decline since 3Q 2016. The sales of watches, clocks and jewellery (taking up 20.9% of total retail sales) and those of adults' clothing (representing 12.4% of total retail sales) decreased by 3% yoy and 12.9% yoy respectively. This indicates that visitor spending remained muted due to external uncertainties. Indeed, the per-capita spending of visitors slid for the second consecutive quarter by 14.9% yoy in 1Q 2019. Per-capita spending of visitors from Mainland China, Taiwan and Hong Kong fell by 17.2% yoy, 11.7% yoy and 8.5% yoy respectively. With the escalation of the US-China trade war weighing heavily on Asian currencies and global economic growth, together with the negative wealth effect from the stock market correction, Macau's retail sector will likely remain sluggish in the coming quarters.





Source: Macau DSEC, OCBCWH

In a nutshell, we remain cautious about the gaming sector's outlook and revise our forecast for gaming growth from 2%-5% to around 0% for 2019. Meanwhile, retail sales growth is expected to remain subdued.

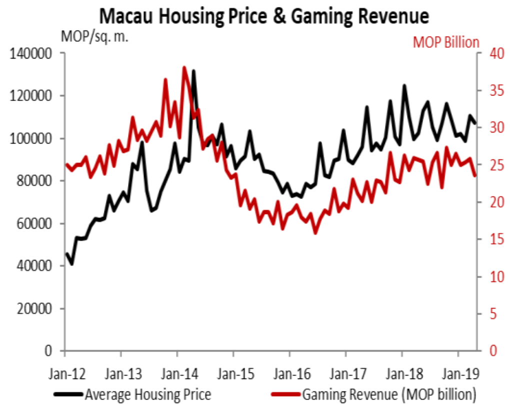
Housing market's upside may be capped

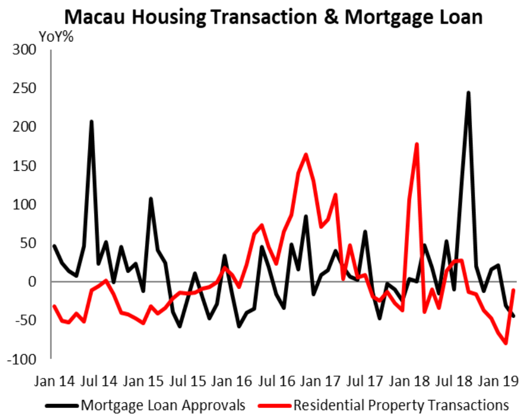
The housing market's upside may be capped by the negative wealth effect, housing control measures and diminishing effect of supportive measures.

On the housing market front, average housing price rose by 13.8% ytd to MOP110,424/square meter as of March. During the same month, housing transaction volume rose by 83.3% mom to 572 deals while approved new residential mortgage loans surged by 85.8% mom to MOP3.38 billion. The rebound in housing market was mainly due to the abated seasonality, the positive wealth effect from the stock market rally, developers' sweeteners, eased concerns about higher interest rates and the measure supporting first-home local buyers (taking up 82.2% of total local buyers in March).

Nevertheless, on a year-on-year basis, housing transaction volume and approved new residential mortgage loans continued to drop by 11.2% yoy and 44.5% yoy respectively in March. This signals that investor sentiment remained cautious against faltering economic growth outlook. Also, the housing control measures continued to curb speculative demand. The percentage share of local buyers holding more than one residential property out of total local buyers stayed low at 4.2%.

Moving ahead, though the housing market may continue to be supported by the eased concerns about local rate hikes, supportive measures and limited supply (housing completion and start decreased by 86% yoy and 89% yoy respectively in 1Q 2019), the market's upside may be capped by several unfavourable factors. First, external headwinds including global economic slowdown and renewed US-China trade tensions may dent investor sentiment and erase wealth effect. Second, the house cooling measures could continue to take effect. Third, the effect of measures supporting first-home local buyers may subside gradually. All in all, we expect total housing transaction volume to decrease year-on-year in 2019. Average housing price will likely hover in the range of MOP100,000/square meter to MOP110,000/square meter.



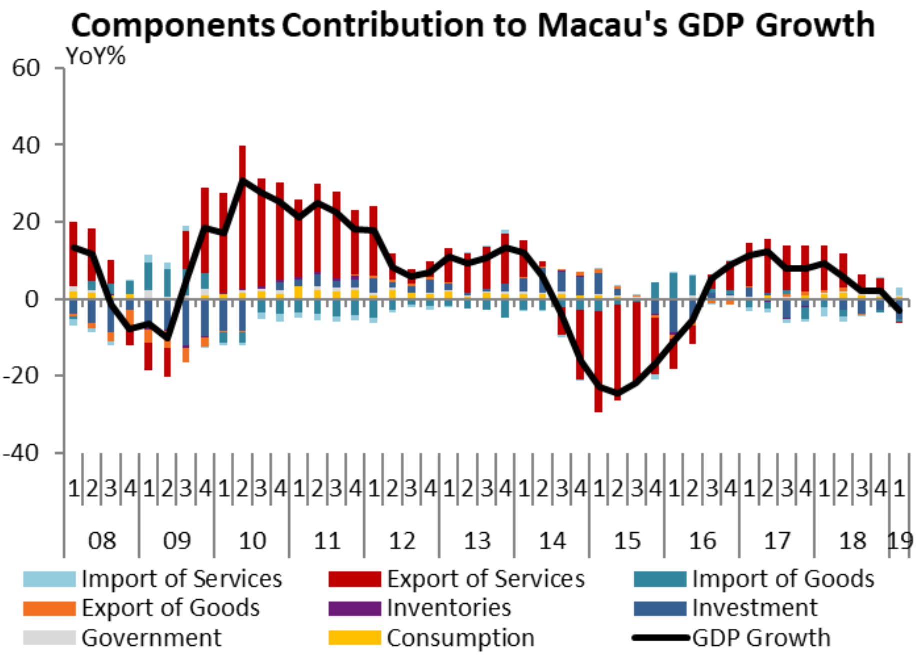


Source: AMCM, Macau DSEC, Macau Financial Services Bureau, OCBCWH

We downgrade Macau's 2019 growth outlook from 2%-3% to 0%.

Conclusion: GDP growth may decelerate further this year

The economic growth is feeling the pain from the global growth slowdown, lingering trade war risks, strong MOP and mounting policy risks. As such, we are concerned about the weakening outlook of the crucial gaming sector. Worse still, it is possible for the tourism growth to slow down amid external uncertainties. Furthermore, the trade war re-escalation may hurt trade activities (exports of goods dropped by 1.8% yoy in 1Q 2019) and consumer sentiment (private consumption growth softened to the lowest since 3Q 2017 at 2.1% yoy in 1Q 2019). Finally, soft private investments (construction investment continued to plunge by 37.5% yoy in 1Q 2019) may remain a drag on economic growth as only a few new mega entertainment projects remain uncompleted. Taken together, we downgrade Macau's 2019 growth forecast from 2%-3% to around 0% in 2019.



Source: Macau DSEC, OCBCWH

MALAYSIA

Challenging Second Half Ahead

Alan Lau, Economist

- Growth is likely to remain subdued in 2H 2019 and we stick to our full year 2019 growth forecast at 4.4% yoy amid a weak global economy.
- We expect 2019 headline inflation to be at 1.3% yoy but if the targeted fuel subsidy scheme is not rolled out soon, it is likely to drop below 1.0% yoy.
- BNM's May 2019 cut of 25bps appears one and done at this point but stay vigilant of further easing if growth slides significantly from current levels.
- Lookout for MYR risks related to the FTSE Russell decision in September 2019 on the potential of Malaysian bonds exclusion from the World Government Bond Index.
- We believe any reassessment of the fiscal situation by rating agencies would probably happen in 2020 or later.

In May, Pakatan Harapan marked its first year anniversary in government but pollsters Merdeka Center found that the government's approval rating stood at a mere 39% as of March 2019, compared to 79% in May 2018. However, it has not been an easy 1H 2019 for Malaysia as the country's small open economy faced the headwinds of slowing global growth and rising trade tensions.

Expect slow growth still…

Expect a subdued 2H 2019 with our expectations for 2019 growth to be at 4.4% yoy.

Indeed, growth has slowed for the country with 1Q 2019 GDP expanding at 4.5% yoy, lower than the previous quarter at 4.7% yoy. Investment fell by 3.5% yoy possibly due to business concerns on the economic environment and the ongoing government consolidation. Sectorial wise, mining and quarrying recorded a decline in output by 2.1% yoy amid production weaknesses that it has been facing since last year. Private consumption continued to be the engine growth, expanding at 7.6% yoy. Net exports were still a positive contributor to growth although absolute trade volumes were lower. Moving forward, it is difficult to see growth picking up significantly from current levels for the rest of 2019 as the global economic situation continues to deteriorate amid the ongoing trade tensions between the US and China. As a whole, we continue to expect that the entire 2019 GDP growth to be at 4.4% yoy. However, the government did recently announce that the East Coast Rail Link (ECRL) and Bandar Malaysia development would carry on and these projects could provide a boost to the economy. That said, there are still not a lot of details regarding the start time of these projects/developments and hence, it is difficult to factor in the effect they would have on the economy at this point.

A pick-up in inflation depends on the fuel subsidy regime

Headline inflation expected at 1.3% yoy but at risk of falling below 1.0% yoy if the targeted fuel subsidy mechanism is not introduced soon.

Meanwhile, on headline CPI, the first quarter saw on average a deflation at 0.3% yoy. The deflation occurred for the first two months of the quarter before March saw positive, albeit subdued at 0.2% yoy. Headline inflation was also moderate at 0.2% yoy in April and May. The low level of price increases have been due to the effects of one-off government policies such as the change in the tax regime, the lowering of broadband prices and the capping of fuel prices. The effects of the first two should gradually wear off going into 2H 2019 but the continued impact of the cap on fuel prices is uncertain. The government has talked of introducing a targeted fuel subsidy scheme by July, where by subsidies would only be provided to certain social groups although the details of the program is still not clear. This program compares to the current blanket fuel subsidies scheme for all groups. If the scheme isn't rolled out sooner, headline inflation risks falling below 1.0%. At this point in time, we still stick with our headline inflation forecast for 2019 at 1.3% yoy. Core inflation at the same time is likely to remain benign.

+Watch out for MYR risks

Watch closely the FTSE Russell decision in Sept 2019 on Malaysian bond inclusion in the WGBI.

On the currency front, the USDMYR has edged higher so far this year amid both external and ringgit-specific factors. Some market concerns had revolved around FTSE Russell considering downgrading Malaysian government bonds market accessibility levels, which may result in Malaysia being consequently dropped from the World Government Bond Index (WGBI). Bank Negara Malaysia (BNM) though has rolled out a number of measures to address these concerns. A final decision by FTSE Russell is expected to be reached in September 2019.

Remain vigilant of further monetary easing

Be vigilant for further easing if growth slides down significantly.

Regarding BNM, further rate cuts this year after the May decision to slash by 25bps does not appear on the horizon just yet. The tone of the May monetary policy statement does not appear to indicate further easing for this year too. The central bank had said that "the adjustment" was "intended to preserve the degree of monetary accommodativeness" and also only simply stated that "the MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth and inflation". That said, if the global economic situation significantly slides downwards especially given the ongoing trade tensions, we believe that further easing by the central bank may still be on the table to provide the boost to the economy.

What else should we watch out for?

Any reassessment in the fiscal situation may only come in 2020 or later.

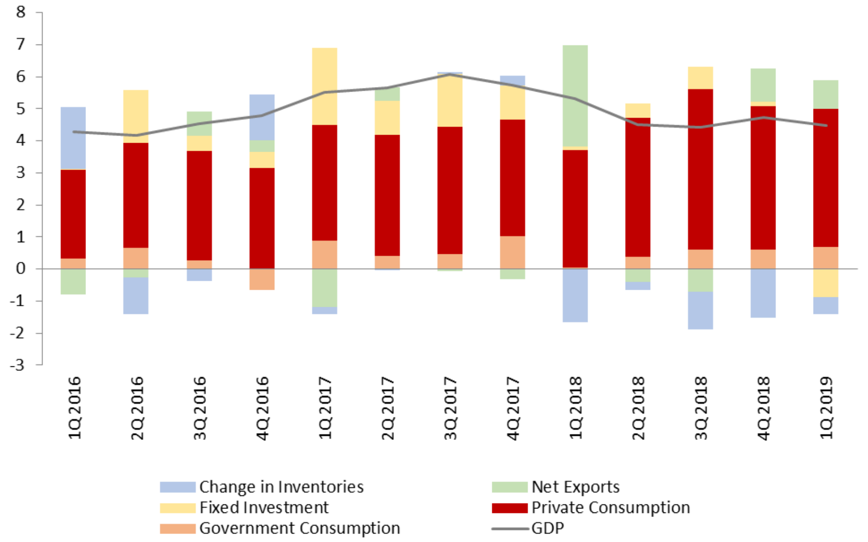
There remains a need to continue to monitor the fiscal situation closely. Brent prices have risen significantly from lows in December of around $50 per barrel and ongoing trade tensions as well as the US–Iran tensions can affect commodity prices. The government may also incur additional expenses even though they have been working at try and to meet their expenditure reduction goals. The budget deficit for 1Q 2019 was reportedly at 2.0% of GDP. Finance Minister Lim Guan Eng recently pointed out that the government would not be introducing new taxes in the 2020 budget and "if there are, it is just a follow up of what we have announced in 2019 budget." Recently, Moody's had downgraded PETRONAS' credit rating to A2 from A1 as they highlighted that the "company's ties to the sovereign create potential for government interference that may have a negative impact on the company's business profile or cash flow". In our view, any major reassessment of the sovereign credit ratings may only come in 2020 or later.

Expect challenges ahead

It will be a challenging 2H 2019.

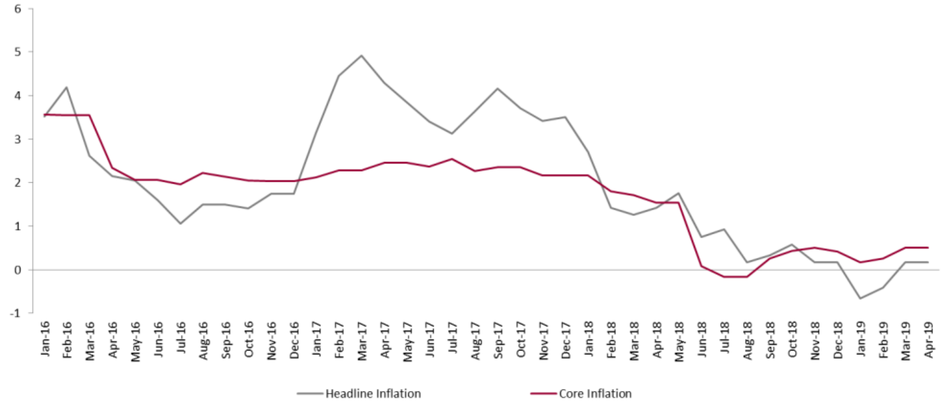
Overall, 2H 2019 would not be easy for Malaysia. Just like any other open Asian economies that are facing setbacks due to the weak global environment, Malaysia may continue to face headwinds in the form of slowing growth and heightened volatility across asset markets including for currency and bonds.

Chart 1: Contributors to GDP Growth, % yoy



Source: CEIC, Bloomberg and OCBC

Chart 2: Headline and Core Inflation, % yoy



Source: CEIC, Bloomberg and OCBC

Cloudy skies ahead for Myanmar

Summary View

- Spillovers from a slowdown in China may dim export prospects.
- The Companies Law beginning Aug 2018 is expected to increase FDI.
- Credit and liquidity squeezes are expected in the short-term as the central bank introduces new prudential regulations.
- EU's potential withdrawal of preferential trade status is a key risk to Myanmar's exports.

Near-term outlook: external headwinds expected

The near-term economic outlook has weakened with rising risks to stability. 2017/2018 saw a rebound in growth, with a recovery in exports and agriculture as the main drivers. However, a weakening external environment, notably spillovers from a slowdown in China, may dim short-term export prospects for Myanmar. China is Myanmar's largest export destination and source of FDI inflows. Separately, Myanmar is also a net importer of petroleum products, leaving the country vulnerable to rising energy costs. Oil prices have eased in June, but a sharp increase not unlike Q1 2019 this year may reoccur if OPEC tightens more than expected.

Myanmar economy expected to pick up on increased FDI.

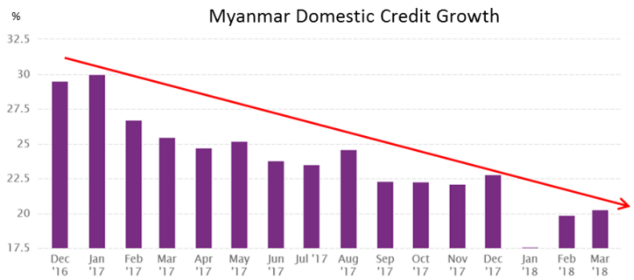
Despite external headwinds from the US-China trade war, Myanmar's economy is still expected to gain steam. Real GDP growth is forecast higher at 6.4% in FY2019 versus an expected 6.2% in 2018, according to IMF estimates. The acceleration of growth is predicated on the assumption that foreign investment is expected to improve, with Myanmar opening up to more avenues of FDI as evident from the implementation of the Companies Law. The law, which is in force as of 1 August 2018, allows local companies to have foreign ownership of up to 35% without being considered a foreign company, hence are not subjected to restrictions under the Myanmar Investment Law. This increases the attractiveness of local companies to foreign investors; conversely, it also gives local firms more flexibility to tap into foreign capital.

On top of the Companies Law, economic reforms include standardizing FDI applications and implementation procedures. From October 2018 to January 2019, FDI approvals jumped to $1.5 billion from $832m a year earlier. The signs of revival in FDI approvals may imply an increase in foreign investor interest.

Tighter macroprudential measures may limit credit growth

Credit and liquidity might face problems from stricter regulations.

Restructuring in the banking sector are starting to be reflected in the economy. In 2017, the Central Bank of Myanmar (CBM) introduced new prudential regulations that limit banks' ability to extend credit. Through stricter treatment of non-performing loans and an increase in minimum capital requirements, there are expectations of a squeeze in credit and liquidity in the economy, as credit growth had already tumbled from 30% in Jan 2017 to 18% in Jan 2018. The deleveraging may not only result in a tightening of credit, but may also exert pressure on banks' profitability.

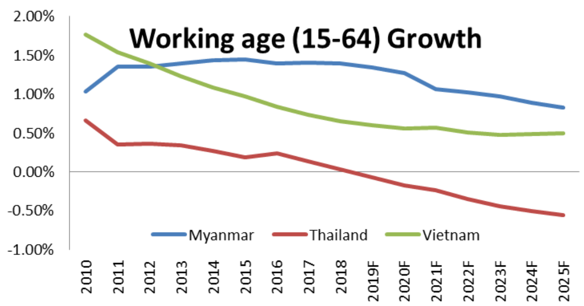


Source: CEIC, OCBC Bank

Long-term outlook: supported by a growing demographic dividend and a strategic location

Growing population and geographical advantage to provide opportunities.

Myanmar's working-age population has been expanding in recent years and is expected to persist longer than its neighbours. Its long-term prospects are also lifted by being located between the global growth engines of China and India. The China-Myanmar Economic Corridor, part of Chinese's Belt and Road initiative, involves several infrastructure projects including the Kyaukphyu Deep Sea Port. The agreement also included a pipeline delivering natural oil and gas to China's Kunming from Myanmar's Rakhine. The upgraded Sittwe port will increase facilitation of cargo transshipment when construction of the India-Myanmar-Thailand Trilateral Highway is completed. These infrastructure projects provide career opportunities for the growing labour force.



Source: The World Bank, OCBC Bank

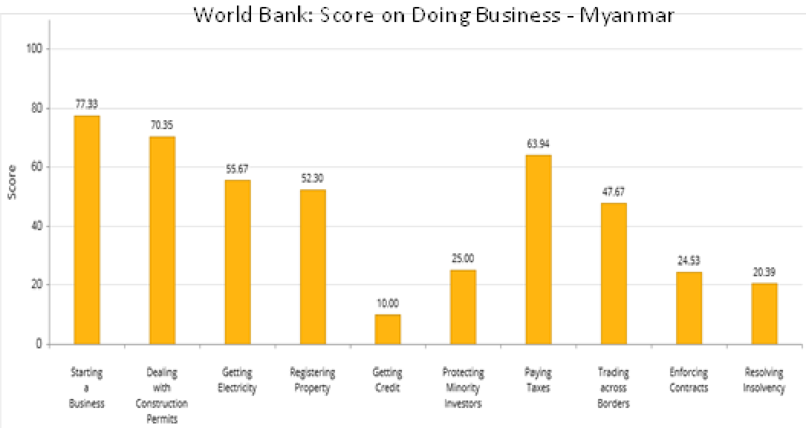
EU's potential withdrawal of preferential trade status

Myanmar is part of the EU's Generalized System of Preferences (GSP), and the scheme grants Myanmar's goods duty-free and quota-free access to the EU market. As of 2018, nearly 14% of Myanmar's exports go to EU countries. The EU Trade Commissioner announced last year that the EU is considering withdrawing Myanmar's preferential trade status on human rights concerns over the Rohingya crisis, which may erode investor confidence and increase risk to exports.

Growing population and geographical advantage to provide opportunities.

Acceleration in the development strategy reforms

Acceleration of its development strategy reforms is needed to boost the investment appeal of Myanmar. The Myanmar Sustainable Development Plan, 2018–2030; National Education Strategic Plan, 2016–2021; Myanmar National Health Plan, 2017–2021; and Myanmar National Social Protection Strategic Plan, 2014 are a few of the policies in the pipeline that could give a boost to Myanmar as a more attractive investment hub. This may help to offset the external pressures from the EU's potential withdrawal of preferential trade status as well as the US-China tensions.



Source: World Bank, OCBC

PHILIPPINES

Reasons For Optimism in 2H

Howie Lee, Economist

Summary View

- We estimate 2019 growth in the Philippines at 6.0% yoy, in-line with official estimates of 6% - 7%.
- With President Duterte commanding a super-majority of Senate, important economic reforms such as the “Build, Build, Build” programme should be pushed through before the end of the year.
- BSP is likely to continue its dovish rhetoric – we now think the BSP will conduct a total of four rate cuts of 25bp each this year.
- Import binge likely to continue, weighing further on the current account deficit – remains a hotbed for capital outflows not unlike 2018.

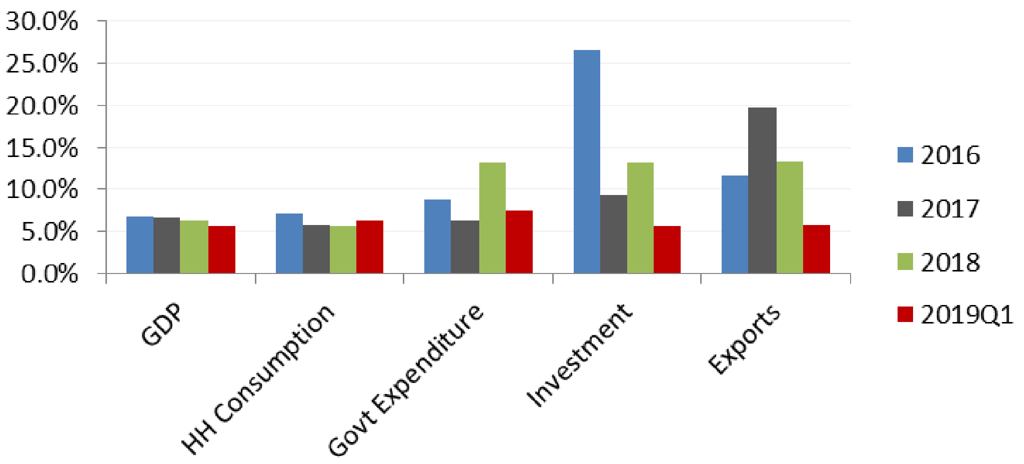
Expect growth to pick up in 2H 2019

We expect full-year growth for the Philippines to clock 6.0%.

1Q 2019 GDP for the Philippines came in at 5.6% yoy, with drags in growth being broad-based but especially pronounced in investments and exports. Despite the 4-year low growth rate, there are reasons to be optimistic over the growth rate in 2H 2019. We estimate that growth in 1Q 2019 would have been 6.2% yoy instead if the budget had been passed by 1Q 2019, with NEDA Director-General Ernesto Pernia even calling for 6.6% yoy growth without budget delays. With Pernia cautioning that government consumption is not expected to recover until 2H 2019, we expect a back-loading of fiscal spending in 3Q 2019 and 4Q 2019 to make up the spending gaps in 1H 2019, with the caveat that the budget would be approved by 2Q 2019.The approval looks a likely proposition, now that President Duterte has more support in the Senate following his success in the mid-term elections.

We expect the Philippines to eventually clock a growth rate of 6.0% yoy in 2019, in-line with official estimates of 6-7%.

Philippines GDP Expenditure YoY Growth

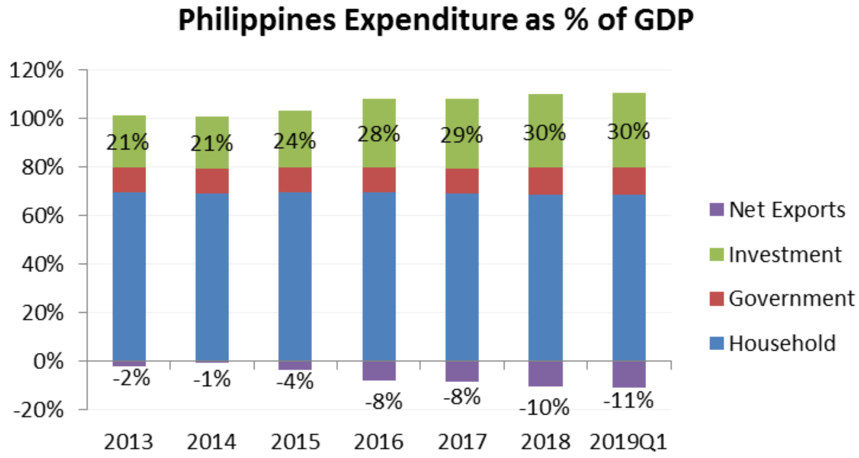


Source: CEIC, OCBC Bank

Domestic growth drivers to insulate US-China fallout

Share of investment in PH GDP as increased.

The evolvement of the Philippines economy has resulted in an increasing share of investments in the country's GDP makeup while taking on a larger share of net imports. Investments are likely to further garner pace as the country's "Build, Build, Build" programme materialises, aided further by lower borrowing costs as the BSP embarks on its policy to reduce benchmark interest rates and the reserve requirement ratio (RRR). The country's position as a net importer of goods, mostly as a result of demand for construction materials towards its infrastructure programmes, means it is less vulnerable to the US-China fallout than other export-oriented economies in the region. Household consumption will likely continue to provide a stable base for growth.

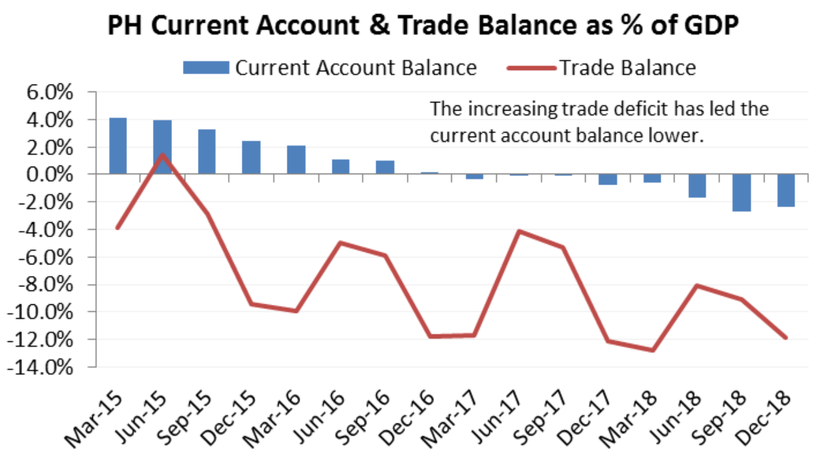


Source: CEIC, OCBC Bank

Current account deficit may leave capital vulnerable

Import demand for infrastructure construction may drive a deeper CA deficit.

Strong domestic demand – in the form of higher demand for goods towards the infrastructure-building programmes – is likely to result in the continuation of a widening current account (CA) deficit via higher imports. Exports, especially the electronics segment, are expected to suffer as global supply chains reverberate on the ensuing US-China tensions. As imports continue to outpace exports, the widening current account deficit potentially leaves the door open for a repeat of 2018's capital outflows. We think that is a highly unlikely event this year, especially with expectations of an impending US rate cut and Philippines' inflation coming off consistently.

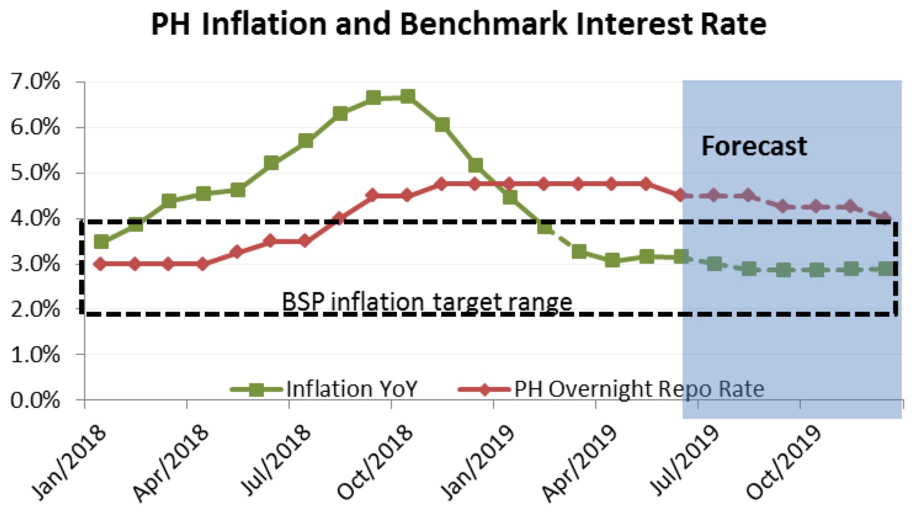


Source: CEIC, Bloomberg, OCBC Bank

Inflation may end the year at 2.9% in 2019, by our estimates.

Inflation likely to stay below 4%

Assuming that Brent prices do not escalate to prices of $80/bbl and beyond, we expect inflation to remain within BSP's target range of 2-4%. Despite the increase in May's CPI to 3.2% yoy from 3.0% yoy in April, we note that the CPI base becomes structurally higher beginning June as the year on year effects of the TRAIN programme recede. Stable inflation levels and the pledges of infrastructure programmes have attracted capital inflows back into the country, despite the dovish stance from the BSP. We forecast inflation in the country to end the year at 2.9% yoy and average 3.1% yoy in 2019.



Source: CEIC, OCBC Bank

We expect BSP to perform two more rate cuts this year, assuming inflation levels remain stable.

BSP may cut rates twice more

The BSP has already performed one rate cut in May as inflation continues to trend downwards. Led by dovish governor Benjamin Diokno, we expect the BSP to enact two more 25bp rate cuts for the rest of 2019 – once each in 3Q 2019 and 4Q 2019. Higher inflationary pressures may come in the form of agricultural prices, as China sources for US alternatives and El Nino starts to wreck damage on crop output. Nevertheless, we do not expect inflation returning to sub-4% levels as long as crude remains stable at current levels. This ought to give BSP the space to conduct more monetary easing as they seek to undo the 175bp hike from last year. We also expect another 100bp cut in the RRR.

SINGAPORE

Headwinds to slow the Singapore economy further

Selena Ling, Head of Research and Strategy

- After a robust 2018, Singapore's GDP growth slowed to 1.2% yoy in the first quarter of 2019.
- Economic indicators remain weak in 2Q19. Industrial production contracted more than expected by 2.4% yoy (-0.7% mom sa) in May.
- Business confidence may have unwound somewhat since US and China called off trade negotiations. Both manufacturing and non-manufacturing PMIs have softened again in June.
- Inflationary pressures remain benign at this juncture. Our full-year headline and core inflation forecasts remain at 1.0% and 1.5% yoy respectively.
- With downside risk for 2Q19 GDP growth spilling over to 2H19, we have shaded down our full-year 2019 growth forecast to 1.3% yoy.

Downside risks to Singapore's economic growth have increased.

After a robust 2018, Singapore's GDP growth slowed to 1.2% yoy in the first quarter of 2019, weighed down by a lacklustre manufacturing sector amid the global electronics demand weakness. Meanwhile, the domestic construction sectors staged a comeback while services growth momentum continued to chug along, underpinning the local jobs market. Policy settings have room to be loosened slightly if the global and domestic growth prospects continue to deteriorate, especially since major central banks including the US Federal Reserve and European Central Bank amongst others have already pivoted to a more dovish bias. The Monetary Authority of Singapore (MAS) had kept its monetary policy settings static in April 2019, after steepening the S$NEER slope twice in April and October 2018. However, the official 2019 GDP growth forecast has been narrowed to the lower end of its initial 1.5-3.5% range, suggesting that risks are tilted to the downside. The FY2019 Budget also saw an expansionary fiscal policy stance, with a planned $3.5 billion fiscal deficit (-0.7% of GDP) compared to the $2.1 billion fiscal surplus (0.4% of GDP) for FY2018. In addition, there is still ample dry powder in the form of some $15.6 billion of accumulated overall surpluses.

Most economic indicators suggest lacklustre growth momentum heading into 2H 2019.

The economic indicators suggest that growth momentum likely remained lacklustre. Bank loans growth had moderated to just 1.4% yoy (flat on-month) in April, down from 2.2% yoy in March, and marking the slowest growth pace seen since November 2016. The main drag came from consumer loans, particularly housing loans that contracted for a third consecutive month in April. Meanwhile, business loans also moderated, with greater business caution in loans to manufacturers and financial institutions. On the consumer front, confidence also remained tepid, with retail sales declining for the second straight month by 1.8% yoy, weighed down by soft motor vehicles sales (-1.1% yoy) in April. On the external trade front, non-oil domestic exports also slumped by 15.9% yoy in May, the largest drop since February 2013, due to electronics exports which declined by 31.4% yoy (the biggest decrease since 2009), and reflecting demand weakness across Singapore's NODX trading partners such as China (-23.3% yoy), Malaysia (-14.7%) and EU 28 (-10.0% yoy) amongst others.

Soft electronics demand continues to weigh on Singapore's GDP growth.

Industrial production contracted more than expected by 2.4% yoy (-0.7% mom sa) in May. This is also a reversal of the April improvement which saw industrial output expand by 0.1% yoy (+2.1% mom sa), but in line with the weak regional industrial production data seen out of China, Taiwan and Thailand, and is a probably a reflection of the lacklustre global growth and demand prospects amid the heightened trade war uncertainties. In particular, electronics continued to underperform, declining by 10.8% yoy due to the drag from computer peripherals (-17.0% yoy), semiconductors (-11.7% yoy) and data storage (-10.4% yoy)

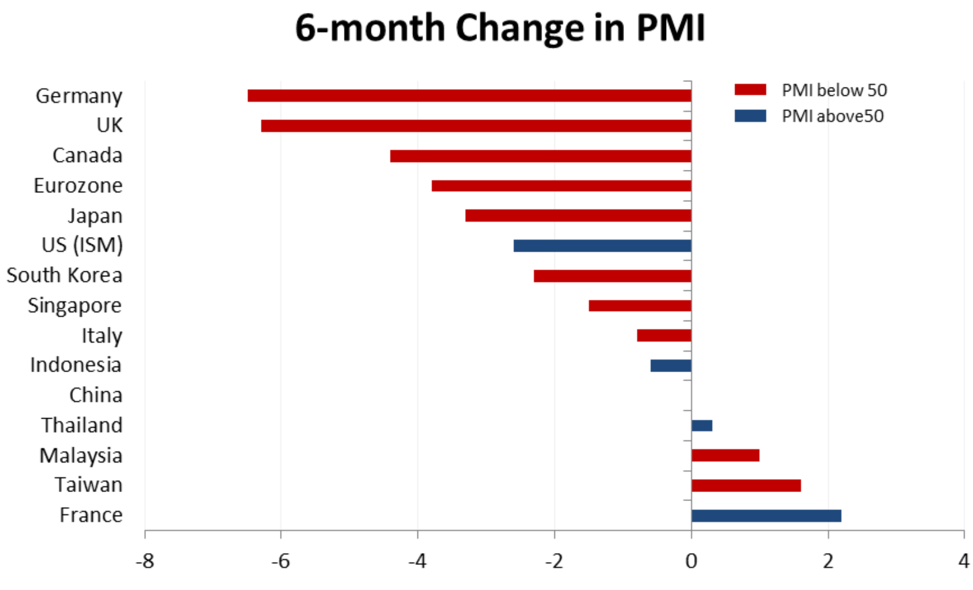
Similarly, precision engineering output also shrank 4.7% yoy in May, weighed down by the machinery & systems segment (-16.6% yoy) due to refrigeration systems, process control equipment and semiconductor-related equipment. This suggests that the electronics industry is not out of the woods yet, and the US-China trade war coupled with Huawei issues may continue to exert a dampening effect on global electronics demand.

Business sentiments have declined since the re-escalation of US-China trade tensions in May.

Business confidence may have unwound somewhat since US and China called off trade negotiations. Earlier business expectations surveys for the manufacturing and services sectors surveys had suggested that 1Q19 could have been the bottom for the Singapore economy and showed a slight uptick in corporate sentiments for 2Q-3Q19. That said, the most optimistic within the service industries were information & communications (+18%, notably in computer programming & consultancy services software publishing services and web portal services), finance & insurance (+9%, especially fund management and insurance), wholesale trade (+9%, particularly for machinery & equipment and petroleum & petroleum products), while the most bearish were retail trade (-14% post year-end and festive season), transport & storage (-14%, weighed down by air transport segment) and F&B services (-9%). Hiring intentions were fairly muted, with only a net weighted 2% of service firms anticipating an increase in hiring activity for 2Q19, mainly in recreation, community & personal services (+10%), information & communications (+8%) and wholesale trade (+2%). Meanwhile, manufacturing sentiments were the most upbeat for the transport engineering cluster (+16%, led by the marine & offshore engineering segment amid a modest uptick in demand for oil & gas-field equipment, as well as the ship repair and commercial airline repair), followed by the biomedical manufacturing (+2%), whilst the most bearish were the general manufacturing (-6%, dragged down by the F&B & tobacco, and demand for print jobs and construction materials), precision engineering (-3%) and electronics (-1%) due to softening demand for semiconductors and semiconductor-related equipment.

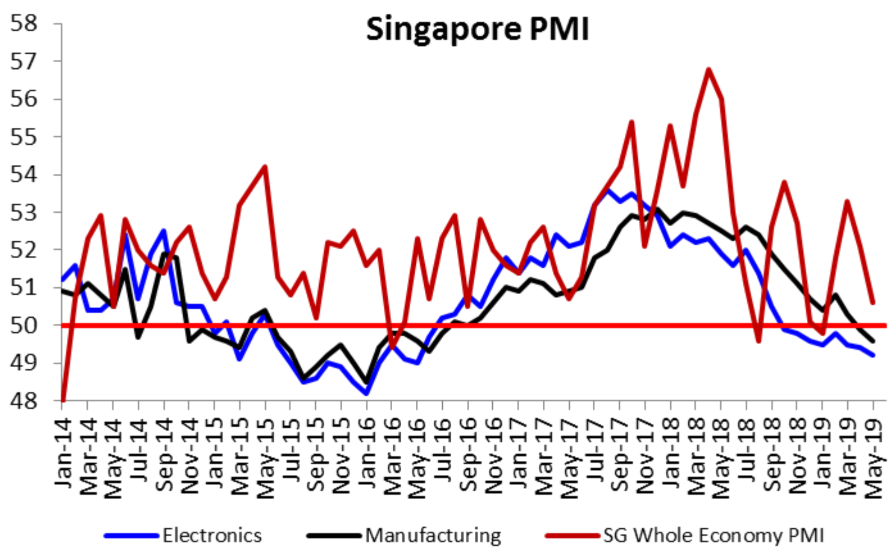
The manufacturing PMI in June has now contracted for two consecutive months.

The manufacturing PMI slipped 0.3 points to 49.6 in June, marking its second straight month of contraction due to the drag from first-time contractions in new orders, factory output, inventory and employment gauges amid the heightened trade tensions. Meanwhile, the electronics PMI also decline by 0.2 points to 49.2 in June, registering its eighth consecutive month of contraction as new orders, new exports, factory output, inventory and employment gauges remained depressed. Note that the electronics order backlog index has now contracted for fourteen continuous months. While the soft global electronics demand theme has been apparent for many months, the broad-based weakness as reflected in the sudden first-time contractions seen in many of the sub-gauges within the manufacturing PMI suggest that the other non-electronics manufacturing industries may also be feeling the heat from the US-China trade tensions and business confidence is gradually being eroded. Coupled with the uptick in input prices for both the manufacturing and electronics, demand conditions have turned increasingly challenging for the months ahead. This is already being reflected in the worsening slow payments in 2Q19, according to the SCCB report. This suggests that 3Q19 domestic manufacturing growth momentum may not be out of the woods yet despite the temporary truce for fresh US tariffs on China.



Source: Bloomberg, OCBC Bank

Singapore PMI slipped to 50.6 in June versus 52.1 in May and a sharp retreat from the five-month high of 53.3 in April. Output, new business and employment gauges saw softer growth, while forward looking gauges like buying activity was reduced for the sixth straight month and business confidence slid to its lowest since March 2017 amid expectations of a more challenging economic conditions ahead, albeit the work backlog gauge rose amid greater supply chain pressures and new business from abroad rebounded into expansion after May's notable decline. Meanwhile, hiring rose mildly in June, but some industries saw headcount reductions. Cost pressures rose in June, with prices paid for purchased items rising at a faster pace, and labour expenses also increasing but at a slower pace.

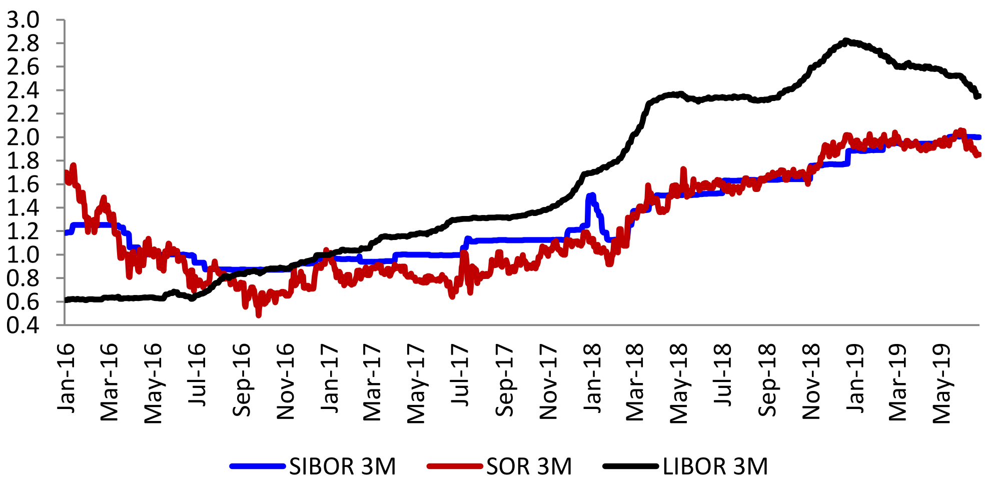


Inflationary pressures continue to remain benign at this juncture.

Inflationary pressures remain benign at this juncture. Headline inflation unexpectedly accelerated to 0.9% yoy in May, up from 0.8% yoy in April and marking the highest yoy print since May 2017 (+1.4% yoy). The key price drivers were domestic in nature, namely education (+2.6% yoy, as tuition fees & other fees jumped 2.6% yoy), recreation & culture (+2.3% yoy, amid higher holiday expenses which climbed 4.3% yoy), transport (+1.6% yoy, across both public and private road transport costs which rose 2.5% and 1.5% yoy respectively), healthcare (+1.4% yoy, mainly in medical & dental treatments) and food prices (+1.4% yoy), which more than offset the lower prices in communications (-1.1% yoy), clothing & footwear (-0.9% yoy) and housing & utilities (-0.7% yoy). The headline inflation for January to May 2019 averaged 0.6% yoy, which is more than double the 0.2% yoy print for the same period last year. That said, it is still currently at the lower end of official 0.5-1.5% headline inflation forecast for this year.

However, core inflation remained stable and was unchanged at +1.3% yoy for the second month in May and flat on-month. This brought the first five months' core inflation reading to average 1.5% yoy, which is on par with the same period last year. Note this is also comfortably within the official 1-2% core inflation forecast for 2019. Notably, the liberalisation of the Open Electricity Market and cheaper electricity tariffs had helped to contain core inflation.

Looking ahead, the inflation rhetoric is unlikely to deviate significantly going into the October monetary policy meeting, notwithstanding indications that private road transport costs could pick up slightly this year vis-à-vis last year and accommodation costs are still likely to decline at a slower pace in 2019. Essentially the dampened global growth prospects, coupled with the lingering US-China trade uncertainties which are manifesting in the manufacturing and electronics PMIs, are likely to keep even any potential hint of hawkish intentions under a lid for the interim. Moreover, given the recent dovish pivot by the US Federal Reserve, the European Central Bank and the Reserve Bank of Australia amongst others in late June, the pendulum has swung clearer in favour of more rather than less monetary policy accommodation.



Our full-year headline and core inflation forecasts remain at 1.0% and 1.5% yoy respectively. Headline inflation is tipped to rise faster at 1.3% yoy due to higher COE premiums and oil prices. The recent pullback in COE premiums, if sustained, should imply the yoy spike in private road transport costs could start to fade by 4Q19. However, domestic core inflationary pressures remain stable for now, and firm labour market conditions are not spilling over into untoward wage intentions.

We see limited upside to SOR and SIBOR in the short-term.

Overall liquidity conditions have tightened since July 2018, with a rise in both S$NEER and S$SIBOR. SIBOR AND SOR have not retraced as much as LIBOR even though market participants have priced in the FOMC's more dovish stance. In particular, the 3-month SIBOR remains remarkably stable around the 2% handle, even though the 3-month SOR has retraced from a recent high of 2.06% at end-May to around 1.84% currently. We see limited upside to 3-month SIBOR and SOR from here, and SOR may continue to diverge from SIBOR as it tracks LIBOR lower.

There is potential downside risk to our current 2Q19 GDP growth forecast of 1.1% yoy, given that manufacturing output has declined for two out of the five months year-to-date and the June 2018 base looks challenging with another on-year contraction in industrial production likely on the cards. As the macro environment remains murky for now, Singapore as a small open economy will be susceptible to any further downshift in global growth momentum, even as we wait and watch if the temporary truce on fresh US tariffs on China and the resumption of US-China trade talks will eventually result in a lasting trade agreement.

Risks of a technical recession have increased.

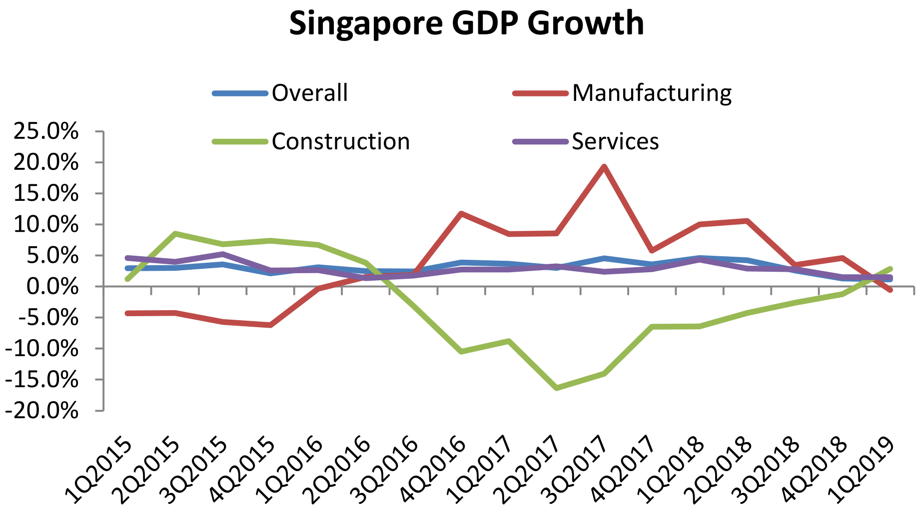
Risk of a technical recession cannot be discounted. At the recent release of the MAS annual report, MAS noted that the current 1.5.-2.5% full-year growth forecast is under review and suggested that 2Q19 GDP growth could be lower than in 1Q19. Since the narrowing of the original 1.5-3.5% official growth forecast to the lower half of the range at 1.5-2.5% was quite recent, the stated intention to review the forecast again clearly reflects how the external macro-environment has deteriorated since May. If the official forecast revision comes to pass, it is can be anyone's guess of 0.5-1.5% or 1-2% yoy, as the earlier baseline scenario that 2H19 will see some stabilization in growth from a tepid 1H19 may be in jeopardy. The US-China trade war remains first and foremost the key risk for the global and Singapore economy, with a real risk of deeper and more widespread disruptions to global/regional supply chains, handicapping firms from their capex and hiring plans, and worsening business and consumer confidence. Our revised 2019 growth forecast is 1.3% yoy (range 0.5-1.5%).

October's policy meeting will be likely weighed against stable core inflation and deteriorating economic fundamentals.

Decision time is coming up at the upcoming October policy meeting. Globally, major central banks like the FOMC and ECB have pivoted to a more dovish stance, whilst other central banks in Asia like RBI, BSP amongst others have begun easing monetary policy. Given the decelerating global growth and trade momentum, the dilemma for central banks that had normalised monetary policy in 2018 is when to start to unwind some of the earlier tightening. This will also be a challenge for the upcoming October policy decision. Should incoming economic data continue to deteriorate, the probability of taking back some of the earlier 2018 monetary policy tightening is not insignificant, but this has to be weighed against core inflation prospects playing out into 2020-2021. Separately, MAS also noted it has been in active dialogue with the US Treasury regarding the role of FX intervention operations within Singapore's monetary policy framework, but opined that Singapore's inclusion in the US Treasury Report has no direct consequences for the economy or the conduct of MAS' monetary policy.

We downgrade full-year 2019 growth forecast to 0.5-1.5% yoy.

We downgrade our full-year 2019 growth forecast for 0.5%-1.5% yoy. With 1Q19 GDP growth off to a slow start and 2Q19 growth momentum likely to disappoint, the stabilization hopes for 2H19 may have to be pushed further out. The drag remains mainly on the external front as Enterprise Singapore has cut its 2019 NODX growth forecast from 0% to -2%. Our NODX growth forecast for 2019 is -5 to -8% yoy. Nevertheless, there remains ample fiscal ammunition and definite space for some policy stimulus if needed.


Singapore GDP Growth
Overall
Manufacturing
Construction
Services
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
1Q2015
2Q2015
3Q2015
4Q2015
1Q2016
2Q2016
3Q2016
4Q2016
1Q2017
2Q2017
3Q2017
4Q2017
1Q2018
2Q2018
3Q2018
4Q2018
1Q2019

SOUTH KOREA

Caught in the US-China crossfire

Howie Lee, Economist

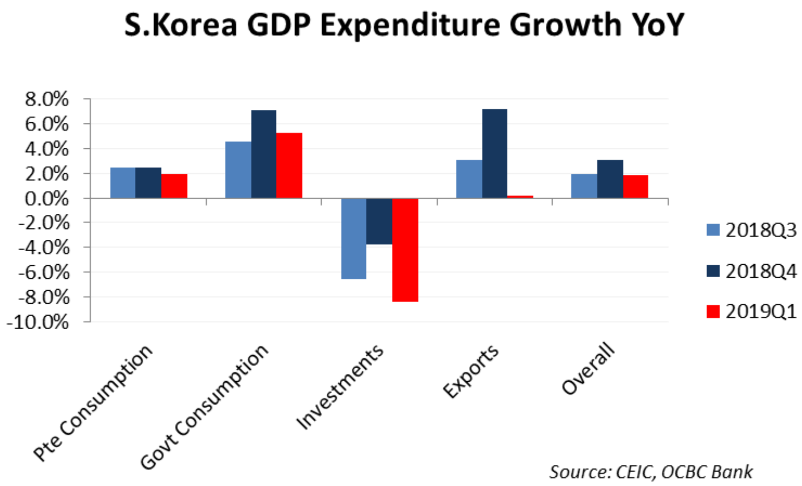
Summary View

- The US' ban on suppliers to Huawei is likely to further dampen demand for electronics in a sector already seeing a cyclical downturn.
- Exports have clocked sixth consecutive year-on-year declines and we expect the trend to persist into 2H 2019 on electronics weakness.
- Lower oil prices should ease pressure on the current account (CA) balance, but its effects on inflation may be countered by higher minimum wages.
- We think the BoK may cut rates late in the year, but they may leave it late into the year to allow room for a pickup (albeit unlikely) in economic activity.

Slowest GDP growth since 2009

Slowdown in electronics demand likely to add a drag on growth.

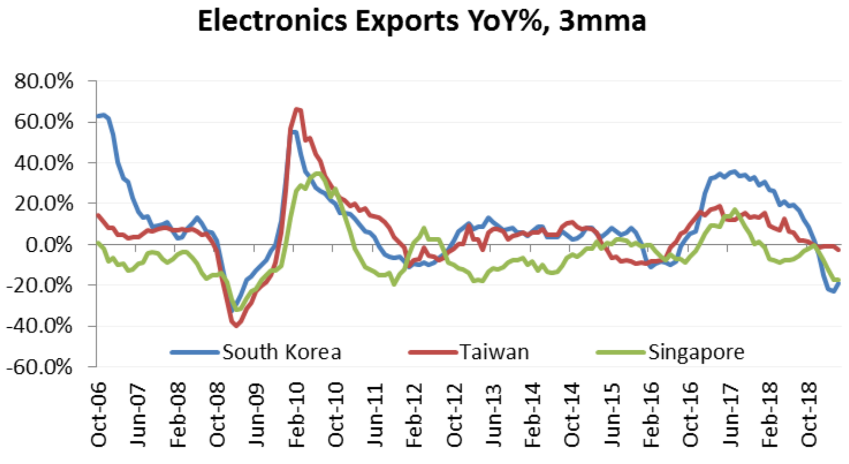
Poor electronic demand and its resulting secondary effects capped Q1 growth in South Korea to its slowest since the Global Financial Crisis (GFC). The economy grew 1.7% yoy and contracted -0.4% on a qoq SA basis – both measures are the lowest since Q3 2009 (+0.9% yoy) and Q4 2008 (-3.3% qoq) respectively. Weaknesses in growth were broad-based but were especially pronounced in exports and investments. The lack of demand in chips was a major factor for the drop in private investment in the electronic sectors, while the construction sector saw a -27% qoq drop in investments, presumably due to a sharp decline in government investment. The Bank of Korea's (BoK) downgraded forecast of 2.5% yoy for 2019 still seems a tad too overstretched in our opinion, given that the estimate was made before tensions between the US and China re-escalated. We expect South Korea GDP to come in at 1.8% yoy for full-year 2019 as the trade tensions take its toll on the electronic sector.



Electronics to feel the heat

Electronics are already facing a cyclical downturn and now has to contend with the Huawei ban.

The ban on Huawei came at a time when the electronics sector was already facing a cyclical downturn. The likes of South Korea, Taiwan and Singapore, all of which are heavily involved in electronics manufacturing and exporting, are likely to see growth dampened via its electronics trade. The latest ban on Huawei is likely to further crimp demand on electronic products ranging from integrated circuits to solid state disks (SSDs) and microchip packages (MCPs). DRAM prices have already been in decline and we expect the trend to continue.

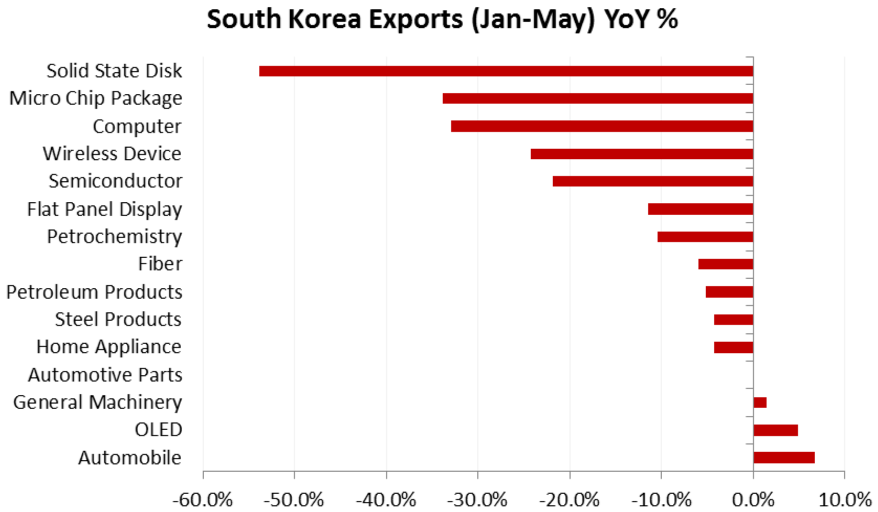


Source: CEIC, OCBC Bank

Short-term gains will likely give way to long-term pain if the US-China trade war drags out.

In the first five months of 2019, South Korean exports slid by an aggregate of -7.4% yoy. SSDs (-53.8%), MCPs (-33.8%) and ICs (-21.9%) led the way in contractions, while wireless communication devices (-24.3%) and mobile phone parts (-34.2%) also contributed to the downturn. In the short-term, we expect Huawei to increase purchases of electronic parts from South Korea, Taiwan and Singapore but the long-term effects of the US-China tensions is likely to result in a net negative demand for goods from China. Any form of uptick in South Korean electronics demand is therefore likely to prove temporary.

.

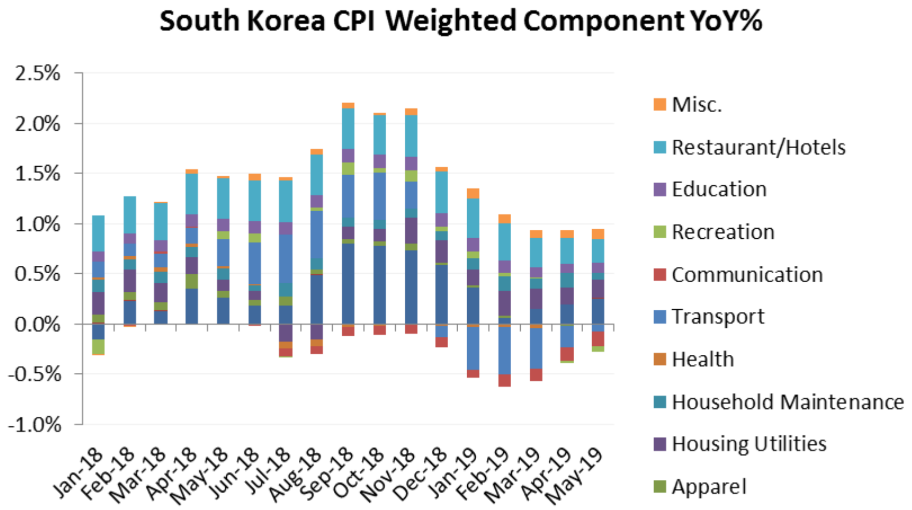


Source: CEIC, OCBC Bank

Inflation expected to remain below 2%

We expect South Korea inflation to average 0.8% through 2019.

The BoK expects 2019 inflation rate at 1.1% yoy, with Governor Lee Ju-Yeol stating in early May that “the inflation rate will (soon) climb above the 1% level.” We think that the markets should not read too much into that statement for several reasons. Firstly, the BoK has been trying to defend its position in keeping rates constant – anchoring expectations of a climbing inflation rate (although still below the target of 2%) is a counter-measure against rate cut pressures. Secondly, at time of statement, Brent was still trading above $70/bbl and the US has not reignited the trade war with China – to expect higher import-led inflation was a natural cyclical effect. Finally, the CPI base from June to August is relatively low and if Brent continues to trade above $70/bbl, the 1% inflation level would have been relative easy to meet. With Brent prices having collapsed in the meantime, we think the pass through from the higher minimum wages would likely be negated by lower oil prices. We forecast the full year 2019 South Korea inflation rate at 0.8% yoy.



Source: CEIC, OCBC Bank

The BoK may cut rates once this year but likely to leave it late

BoK members have displayed signs of dovishness recently.

The May meeting saw one member dissenting for a more dovish monetary stance. More recently, Governor Lee Ju-Yeol appeared to have been more dovish, saying the central bank should "act appropriately as the uncertainty has risen sharply" and that "inflation has remained far below its target level", in a speech commemorating the BoK's 69th anniversary. With the Fed now displaying a relatively high inclination to cut rates before the end of 2019, the hurdle for the BoK to follow suit has likely reduced.

We think the BoK may leave its rate cut cycle late in 2019, but may easily reverse that expectations if the macro environment improves.

We think there is an increasing possibility that the BoK may cut rates once late this year. Firstly, despite weakening growth prospects, domestic financial stability still weighs heavily within the BoK; we expect the central bank to be one of the last-movers regionally in rate reductions, possibly holding out for a recovery in data. Secondly, at 1.75%, the BoK has little room for rate reduction and they may want to preserve its ammunition, especially if we assume that fiscal stimulus may be limited next year as semiconductor tax revenues fall. Relative to other regional central banks, however, we still believe the hurdle for the BoK to reduce rates remain one of the highest – an improvement in the macroeconomic environment, especially if US-China relations thaw and semiconductor exports start to improve, may easily push back our expectations from a rate cut to a rate hold.

TAIWAN

Not all bad news

Tommy Xie, Head of Greater China Research

Summary View

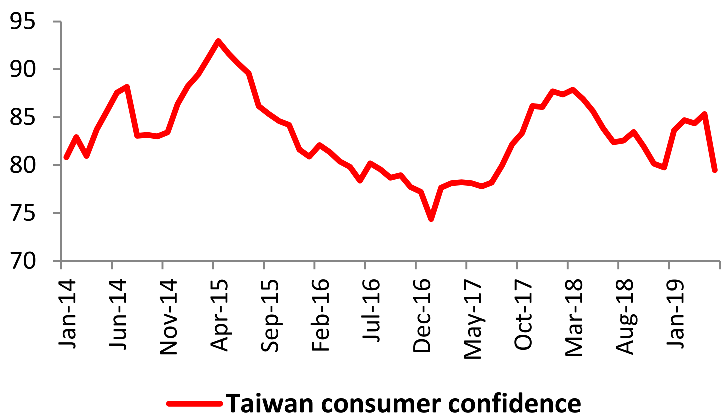
- The Taiwanese economy had a weak start in 2019 due to weak consumption and uncertainty from the US-China trade war.
- Taiwan's exports suffered from the supply chain disruption.
- However, Taiwan benefitted from the substitution effect from the trade war as US importers sourced from alternative sources as well as relocation back to Taiwan by Taiwanese manufactures.
- Private investment is the bright spot. We expect growth to stay above 2% yoy for 2019.
- We expect interest rate to remain intact in 2019 despite muted inflation.

The Taiwanese economy decelerated in the first quarter to 1.7% yoy, the lowest since 2Q 2016. The slowdown was the result of three factors including weak consumption, the uncertainty from the US-China trade war and global slowdown, as well as the high base effect (the economy grew by 3.2% yoy in 1Q 2018).

Sluggish domestic demand

Private consumption is expected to remain sluggish.

Private consumption growth slowed down to 1.32% yoy in the first quarter, down from average 2% growth in 2018. Despite the still-tight labor market, the uncertainty arising from the US-China trade tension weighed down Taiwan's consumer sentiment. The private consumption is expected to remain sluggish in the coming months due to softening consumer confidence, which fell to 79.48 in May, down from 85.33 in April. The consumer confidence in equity investment collapsed to 60.60 from 96.40 probably due to fragile outlook on equity as a result of the re-escalation of US-China trade war in May. Although Taiwan's equity market rallied by more than 10% year to date, concerns remain about the negative wealth effect due to uncertainty may continue to dampen Taiwan's private consumption.



External demand remains uncertain

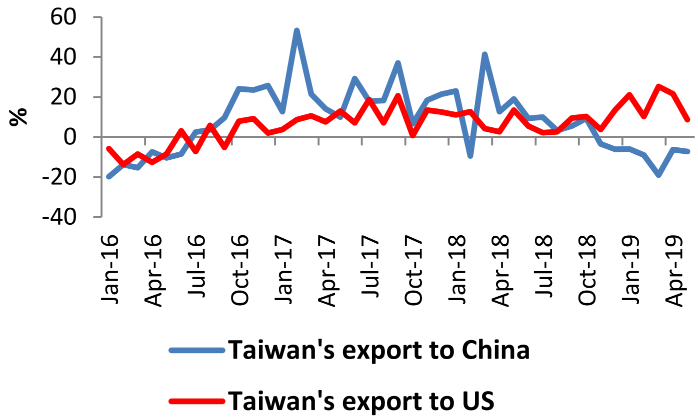
Taiwan was affected by supply chain disruption.

Taiwan's export growth has fallen for the seven consecutive months since November 2018 as the regional supply chain has been disrupted by the escalation of US-China trade war. Taiwan's exports to mainland China declined by 10.15% yoy in the first five months of 2019 after growing by 8.7% yoy in 2018.

On a positive note, Taiwan benefited from the substitution effect of trade war as US importers

Taiwan also benefited from substitution effect.

sourced the products from alternative places to avoid the tariffs. Taiwan's exports to US jumped by 17.2% yoy in the first five months of 2019, the strongest growth since 2010. The substitution effect may provide a buffer to the loss of trade with mainland China. Taiwan's net exports only marginally dragged the growth down by 0.05% yoy in the first quarter. Taiwan's trade prospect this year will depend on the progress of trade talk. However, given the low base effect in 2H 2018, we expect Taiwan's net exports to support GDP growth in 2H 2019.



Private investment is the bright spot

Investment is the bright spot.

Despite the weak consumption, Taiwan's capital formation rebounded by 6.33% yoy in the first quarter, the strongest growth since 4Q 2013. Taiwan benefited from the supply chain diversification as Taiwanese manufacturers shifted their operations back to Taiwan from mainland China to avoid the tariffs. The strong imports of machines, which rose by 16.6% yoy up from only 0.16% yoy in 2018, showed that private CAPEX is likely to remain strong.

In addition, government spending is also likely to remain strong as the government is planning to roll out NT$230 billion infrastructure projects in 2019, double that in 2018. As such, we think the Taiwanese economy may find support from investments in 2019.

Against the backdrop of weak consumption, uncertain external demand and resilient investment, we expect Taiwan's economy to face more uncertainties. However, due to low base effects, we think Taiwan's GDP may re-accelerate in 2H 2019. For 2019, we expect Taiwan to grow by about 2.1% yoy, though it is lower than our beginning of the year forecast of 2.4% yoy.

Muted inflationary pressure

Taiwan's CPI grew only by 0.51% yoy in the first five months and core inflation rose by 0.22% yoy on average for the first five months. The weak growth prospect and falling oil prices are likely to cap inflationary expectation.

No rate cut is expected

No interest rate cut expected despite muted inflation.

Taiwan's central bank kept its benchmark interest rate unchanged in June as widely expected. Despite weak inflation numbers and the restart of the rate easing cycle by global major central banks, we expect Taiwan's central bank to hold rates constant for the rest of the year due to a possible growth recovery on the back of the low base effect.

VIETNAM

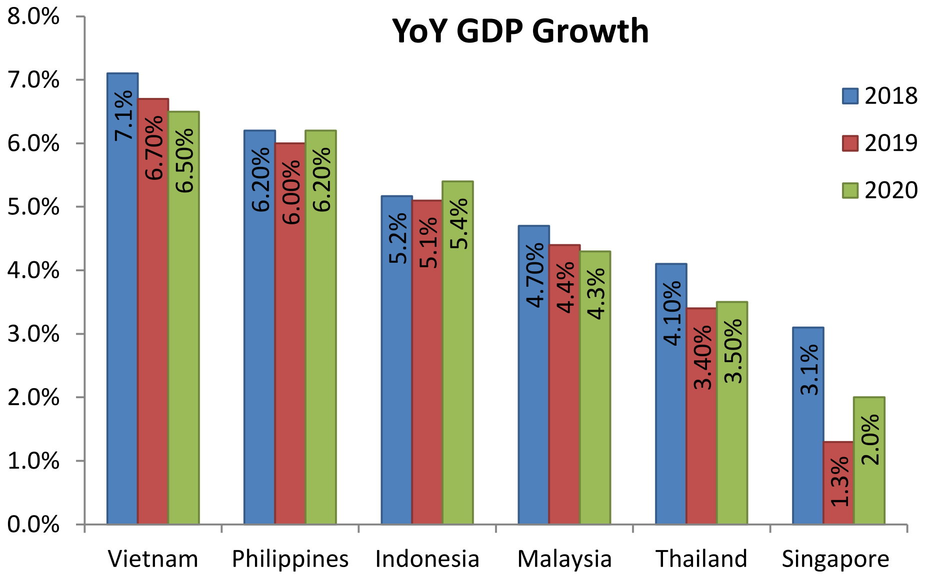
Young, vibrant Vietnam fights headwinds

Summary View

- GDP growth is expected to lead ASEAN countries, with private consensus at 6.6% (Bloomberg) and official forecasts at 6.8%.
- Vietnam is enjoying a redirection of trade flows from the US-China trade war, as supply chains look to relocate from China to avoid tariffs.
- The country is increasingly focused on macroeconomic stability, with a focus on improving infrastructure and business environment.
- Young & educated workforce, a strong private sector and supportive entrepreneurial environment highlights growth opportunity
- Downside risks include a slowdown in global trade and infrastructural red tape.

GDP growth is expected to lead ASEAN countries, with private consensus at 6.6% (Bloomberg) and official forecasts at 6.8%.

GDP growth is expected to lead other Asian economies.
The country is expected to see its growth momentum in 2019 ease slightly from about 7.1% to 6.6%. However, Vietnam's GDP growth is still expected to outpace the rest of the Asian economies. The young population, strong private sector and vibrant local entrepreneurial scene underpins the county's growth prospects, while the country's stable political scene provides a firm foundation for growth. Vietnam is also expected to be a beneficiary of the Sino-US trade tension. The confluence of these factors make Vietnam's outlook still bright even when considering the potential downturn in global economic activity.

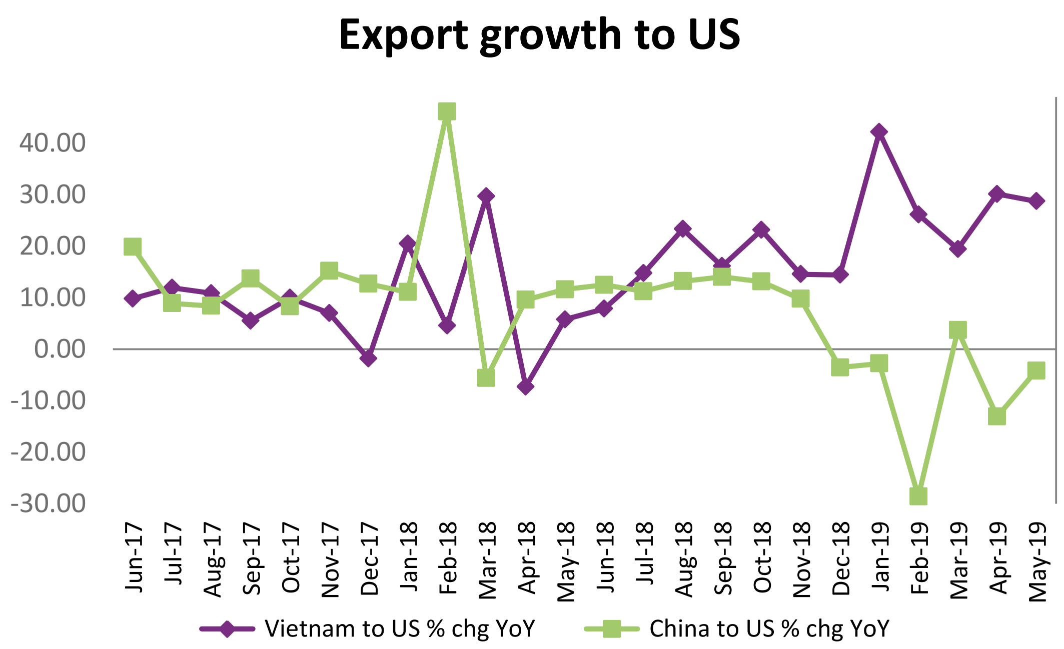


Sources: CEIC, IMF, Bloomberg, OCBC Bank

Services and manufacturing sectors are expected to prosper as trade flow is redirected from the US – China trade war.

Vietnam is enjoying a redirection of trade flows from the US-China trade war, as supply chains look to relocate from China to avoid tariffs.

The bulk of Vietnam's growth has come from the services (+13.3% YoY) and manufacturing (+7.6% YoY) industries, which combine to form 58% of Vietnam's total GDP. With companies trying to avoid the tariff hikes and limit downside risk of exposure to further escalation in the trade war, we may see a relocation of businesses and investment directed to Vietnam from China. Firstly, total exports to the US by Vietnam have seen a sharp growth since the trade war started. Exports to the US have also taken a larger proportion of Vietnam's total exports, having increased from 19.5% in 2018 to 22.5% in 2019 up to the month of May. Given the increased appeal of Vietnam as an alternative manufacturing and services destination to China, we expect the negativity spillover from the US-China tensions to be relatively muted compared to other ASEAN countries.



Source: CEIC Data

Increasing global integration and loosening entry restrictions to spur foreign capital inflows.

The country is increasingly focused on macroeconomic stability, with a focus on improving infrastructure and business environment.

Vietnam is opening up to other export markets by aggressively pursuing international trade agreements. It already has 11 signed FTAs currently in effect, 4 under negotiation and another 9 proposed or under study, according to Asian Development Bank. The government has also lifted restrictions on foreign ownership for listed firms in 2018, which should help increase the appeal of the nation as a FDI destination. Vietnam's Foreign Investment Agency reported that FDI in 2018 has reached $16.74bn, a four year high. The Vietnamese government has also been taking steps to improve the infrastructure in major industries, and appear to be open to improving legal framework in allowing better transparency and stronger Intellectual Property Rights (IPR) protection.

Stable and forward looking government promotes sustainable growth.

The government has recently signalled that it may start to encourage more FDI flows that promote technological advancement as it implements policies to move the country up the value chain. This prudence in policy is attractive for investors looking at longer term projects such as infrastructure and real estate, with the real estate sector seeing a surge in investment of 116% YoY in 2018 to US$6.6bn.

The government, recognising the need to drive domestic growth, has been trying to promote the private sector and entrepreneurial scene.

Multiple policies have been designed to support SMEs seeking business consultation services and venture incubators, as the government seeks to promote local businesses. The government is also looking at disinvesting state-owned enterprises which should increase efficiency and competitiveness in the economy. The government also acknowledges that there is a need to reform structural weaknesses in the business environment, especially in the banking and government sectors. The above measures should provide a boost to growth in the private sector, which accounts for 42% of the economy.

Slowdown in global demand for exports, infrastructural red tape and water shortages highlights downside risks.

With Vietnam expected to receive business relocations and redirected investment flows, the country may need to invest capital in upgrading infrastructure to keep up with demand. An example of infrastructure inefficiency is in water usage. Vietnam currently produces \$2 of GDP per cubic metre of water versus a global average of $\$19/m^3$. Approximately 8.1 million citizens in urban areas lack clean water supply and water outages are increasingly common, according to a government survey. Separately, the 2018 Provincial Competitiveness Index (PCI) report shows transparency, petty corruption at provincial levels, and slow administrative processes as the top three concerns of local respondents. Inefficiency in resource allocation may need to be reviewed for Vietnam to manage the increase in trade and business flows. The country had also been recently placed on the US currency manipulator watchlist by the US Treasury Department as its trade balance with the US hit \$40bn. Growth may take a severe hit if the US line their hawkish sights on Vietnam, like the recent imposing of more than 400% tariffs on Vietnamese steel imports into the country.

ASEAN SPECIAL

China's Economy Begets ASEAN Tech Changes

Howie Lee, Economist

Summary View

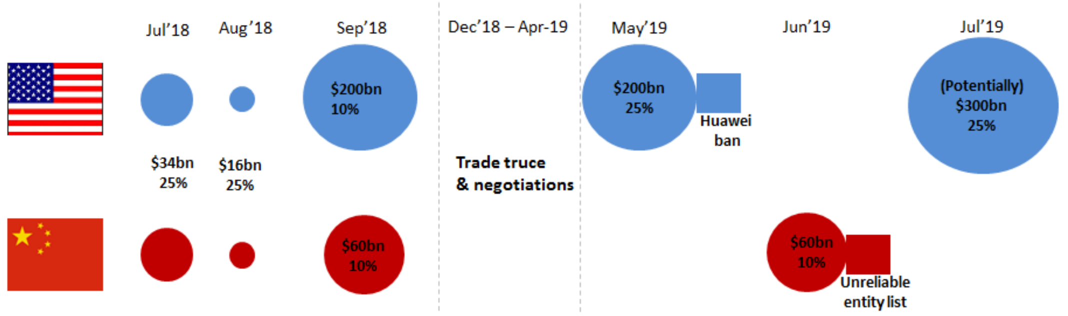
- The trade war is ultimately a race for tech superiority between the US and China.
- China's economy will eventually evolve into a consumption-driven model.
- As the Chinese economy matures, so will the complexity of import demands.
- ASEAN's heavy trade dependency on China means it needs to begin investing in human capital and ICT infrastructure to meet future needs.
- Singapore aside, most other ASEAN countries have much to catch up on tech progress.

Technology becomes increasingly important as trade barriers are erected.

Taking stock: US-China tension is ultimately a tech race

With US-China tensions coming to a head, it is probably important to take stock of a few important pointers. Firstly, the year-long dispute between the US and China has been more a race for technological superiority than a trade dispute. This is evident on three fronts – a) China has already agreed to wind down the trade balance with the US to near zero by 2024; b) most of the negotiations ultimately failed on tech transfer compromises; c) tech giant Huawei's inclusion into the direct line of fire is another US attempt to gain the upper-hand in the tech race. Secondly, two superpowers willing to sacrifice trade growth to maintain their slim lead in the tech race shows the importance each has attributed to the growing influence of digitisation. Third, businesses will increasingly have to turn to tech to get around trade barriers, as protectionism and a disdain for globalisation start to disrupt supply chains.

Timeline of US-China Tensions

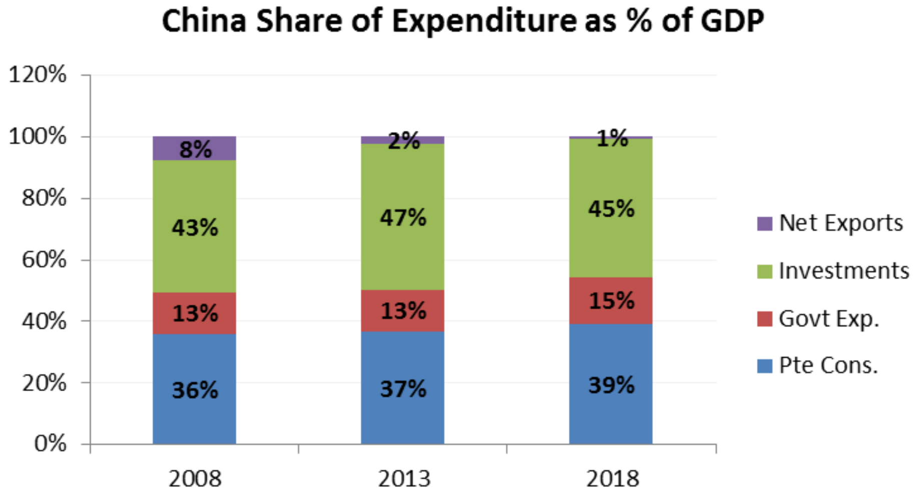


Source: Various; OCBC Bank

China's economy will evolve – with or without the trade war

As China's economy matures, it will begin to demand more complex intermediate and finished goods.

In the long term, China's economy will gradually have to evolve towards one that is domestic consumption driven rather than one that is export dependent, with investments expected to brige this gap in the medium term. This has been part of a long-term plan laid out by the government since the turn of the decade; the narrowing of net exports as a percentage of China's GDP has been a consistent trend. With the US now setting up trade barriers against China, the push towards a higher consumption-driven economy is likely to gather pace. In the interim, China continues to demand primary and intermediate goods in its manufacturing sector; but as the economy further matures, the demand for more complex imports will begin to grow.

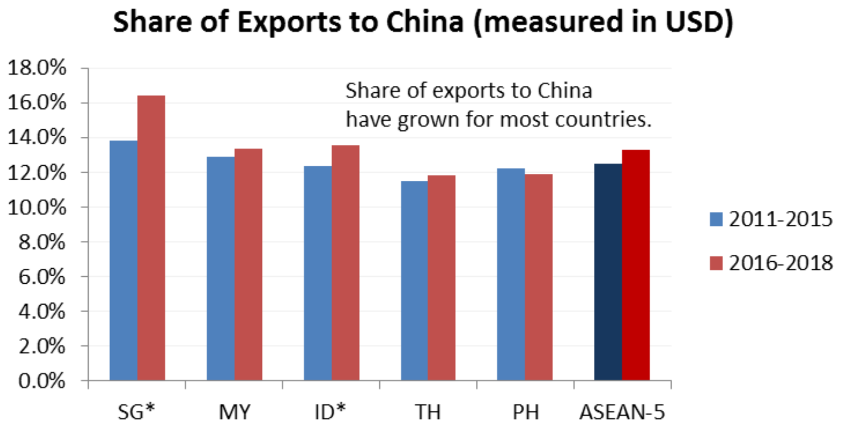


Source: CEIC, OCBC Bank

ASEAN trade dependency on China

ASEAN's trade dependency on China will likely increase in the future.

ASEAN is heavily dependent on Chinese import demand of regional goods. China ranks as the top export destination for most ASEAN-5 countries in 2018. While the trade dependency may not be as heavy as the likes of South Korea or Taiwan due to regional diversification, China ultimately serves as the end consumer for most of the supply chains in Southeast Asia. Collectively, 12.5% of ASEAN-5's exports may be attributed to China's demand; we expect this value to continue growing in the long-term as the Chinese economy matures and demands more intermediate-to-finished products

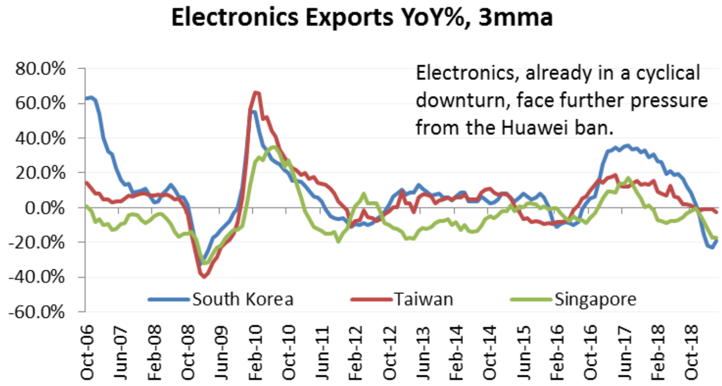


** non oil exports*
Source: CEIC, OCBC Bank

Regional electronics exports following China's import demand

Slump in regional electronics exports may be traced back to China's dip in demand.

An example of the region's trade dependence on China can be observed in the electronics sector. As demand for smartphones decline globally, so does the need for semiconductors and integrated circuits. Economies heavily dependent on electronic exports – Singapore, Taiwan and South Korea – have seen their export fortunes heavily dented by the lack of electronics demand from the Chinese this year. With China's push towards rolling out its 5G infrastructure in the near future, so would demand for electronic products is expected to rise. The booms and busts of the electronics cycle in this region is therefore closely related to Chinese import demand.



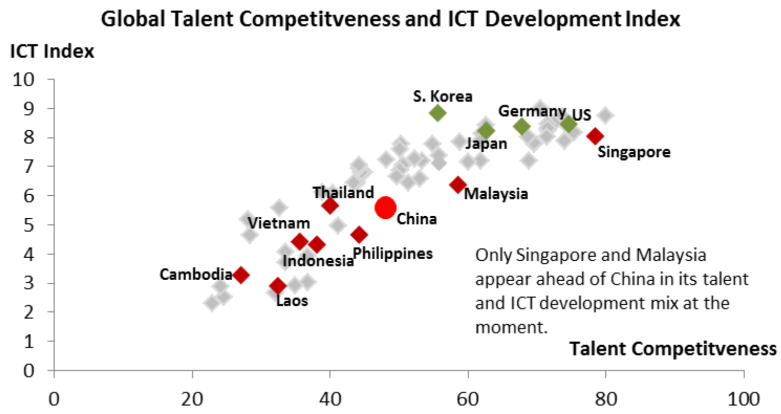
Source: CEIC, OCBC Bank

ASEAN needs to shift from labour dependency to technology

Investment in ICT infrastructure and human capital will be crucial in ramping up tech literacy in ASEAN.

The electronics story has set a clear example on the region's trade dependency on China. As China's economy continues to mature, labour-intensive manufacturing industries in ASEAN will see increasing difficulty in matching Chinese demand for more complex goods. The region must therefore begin to invest in capital –human and machinery – to shift from a labour-intensive manufacturing hub to one driven by technological know-how.

The development of information communication and technology (ICT) infrastructure is therefore critical for digitisation. Secure internet servers are critical for technology literacy– leaving Singapore out of the equation, less than 20% of ASEAN's population are online, according to a 2017 OECD report. Similarly, the skills that an economy demand will evolve as digitisation takes hold – at present, most of ASEAN has a lot to play catch-up on relative to China in terms of talent competitiveness and ICT development.



Source: INSEAD (2017), Intl Telecommunication Union (2018), OECD (2017), OCBC Bank

Conclusion

China's economy will eventually evolve into a consumption driven economy. ASEAN's trade dependency is expected to grow but as China's economy evolves, its demand for imports will likely turn increasingly complex. ASEAN will likely continue to supply goods and services to China but it will have to evolve together with China's economy. Labour-intensive economies will probably be phased out as technology-driven processes take centre stage. However, ASEAN's ICT development – aside from Singapore – leaves much to be improved. Most of ASEAN has to play catch-up in its digital know-how – investment in both human capital and ICT development will thus be critical.

BRI SPECIAL

Belt and Road initiative: Entering a New Phase

Tommy Xie, Head of Greater China Research

Summary View

- The 2nd Belt and Road Forum was a success. Inter-connectivity between China and BRI countries continue to deepen.
- China has worked to improve transparency to achieve the goal of sustainability.
- China also shows its flexibility in addressing the concerns about the debt trap. Lessons have been learnt from the past projects.
- For the next phase of BRI, China can do better via more comprehensive understanding about the BRI countries, effective communications with all stakeholders and promoting its soft power.

Interconnectivity continued to deepen between China and BRI countries.

China concluded its 2nd Belt and Road (BRI) Forum in April in Beijing. 38 head of states from different continents attended the forum while 150 countries sent their delegations to participate in the forum. Belt and Road (BRI) has become a true global brand despite rising hurdles due to rising protectionism, debt sustainability issues, and concerns about its environmental impact and local trickle down benefits. China has benefited from the increasing interconnectivity with BRI countries. Its exports to BRI countries increased by 7.8% yoy in the first quarter of 2019 despite China's total exports decelerating 3.7%. yoy. Meanwhile, the number of companies from BRI countries setting up offices in China continues to grow and was up by 35.4% in the first five months of 2019.

Improving Transparency

Sustainability is the key.

One of the key words from the 2nd BRI forum is sustainability. This includes debt sustainability and green sustainability. In order to achieve the goal of sustainability, China has worked hard to improve its collaboration with BRI countries in a more transparent and standardized way. China's Ministry of Finance published its debt sustainability framework for participating countries of the Belt and Road Initiative in both Chinese and English versions. The 15-page report will serve as a guiding principle for financial institutions of China and other BRI countries for their lending decisions, although the framework is not a mandatory policy tool. This is a good first step to help low income BRI countries avoid the so-called debt trap to ensure a more sustainable collaboration.

Addressing the concerns

In the middle of April, just ahead of the 2nd BRI forum, Malaysia announced that it has reached a new deal with China to resume the suspended East Coast Rail Link projects with the price tag being slashed by one third to RM44 billion from previously RM66 billion. Prime Minister Mahathir of Malaysia said the price reduction together with a joint venture to operate the rail line is a solution to solve Malaysia's concern about a potential debt trap. This new agreement appears to be a diplomatic victory for Prime Minister Mahathir. Meanwhile, the resumption of this mega project is also supportive to the Malaysian economy in terms of investments and job creation despite rising global uncertainties.

China shows its flexibility to address the concerns.

China's compromise to re-negotiate the contract shows China's flexibility in addressing the concerns of BRI countries. China's new strategy to hire more local workers and source more local material will deliver more local benefits for BRI countries.

However, on hindsight, the new agreement also led to two more questions. First, was the previous 2016 agreement, which was one third more costly, considered as unfair if the current deal is deemed as mutually beneficial by both countries? Clearly, we don't think China "bullied" Malaysia for its own advantage. Then it leads to the second question: Was there any political agenda behind China's agreement to such a big one-third price cut? It seems that either way China's previous BRI projects could also be thrown into question.

What can China do better?

Lessons learned.

This is the lesson that China probably can learn from the past. Under the current sustainability framework, other than improving transparency, we think there might be three areas China could improve to bring the BRI projects to the next phase for a "win-win" situation.

First, a comprehensive understanding about the BRI countries could be a critical first step to strike a more sustainable deal. This may require more intensive research on the respective countries comprising their macro, social, demographic, historical and political systems.

Second, China is usually good at building strong personal relationships with foreign leaders. However, this may not be enough amid the changing global geopolitical system and evolving domestic elections in the developing countries. As such, it may be important for China to engage not only with the ruling party but with the opposition party and local opinion leaders, as well to have a more comprehensive assessment on the feasibility of the projects.

Third, boosting soft power will also be helpful to enhance China's influence in the region, which may support China's BRI. The latest survey done by Singapore's ISEAS Yusof Ishak Institute in early 2019 showed that China's soft power penetration in Southeast Asia remained low. China remained one of the least preferred choices for higher education and tourism by ASEAN people even though Mandarin is considered as the second most important language after English in the region. Despite closer culture linkage, it may still take years for China to boost its influence of soft power. Usually the promotion of soft power is not driven by the State sector but by the private sector. For example, Chinese companies such as Huawei and Hai Di Lao have contributed to boost China's soft power in ASEAN with their high standard of quality and service. In the longer run, China's domestic reform to support private sector reforms is positive for promoting China's soft power.

To conclude, China's increasing cooperation with the region via BRI will help counter the impact of de-globalization. China has learned the lesson from the past. China's increasing shift to a more sustainable framework is mutually beneficial in our view.

GREATER CHINA SPECIAL

SME's Funding Difficulty of China and HK

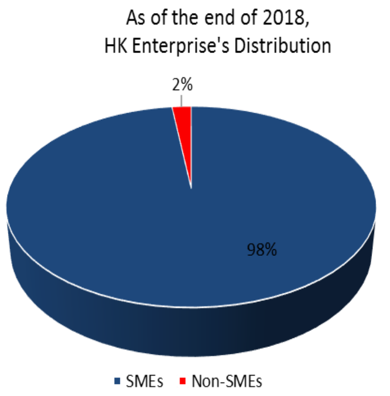
Dick Yu Sze Ngai, Economist

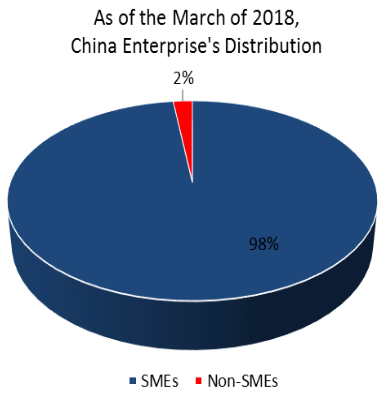
Summary View

- Small and medium sized-enterprises (SMEs)'s funding difficulty is a common phenomenon among different economies. Lack of collaterals and weaker commercial bank's risk preference on small-sized firms might be two major reasons.
- Funding support to the private sector has remained insufficient in China, especially for SMEs. Deteriorating commercial bank's risk appetite, the financial deleveraging campaign and more restrictive asset management rules may be due to some structural reasons.
- Nevertheless, SME funding difficulty has been insignificant in Hong Kong (HK). It might be supported by three main favourable factors, including flush liquidity, government supportive policies and commercial bank's better risk appetite to provide liquidity for SMEs.

Small and Medium Sized-Enterprises (SMEs)'s funding difficulty is a common phenomenon among different economies. Lack of collaterals and weaker commercial bank's risk preference on small-sized firms might be two major reasons. In this article, the funding conditions of China and Hong Kong and the causes behind will be discussed correspondingly.

The definition of SMEs between China and Hong Kong differ. China's definition takes the number of employees and sales volume into considerations while the number of employees is the only criteria for HK's official definition. Specifically, from the perspective of China, the definitions of different industries are mixed. For example, according to the official notice revised in 2017, industrial firms with less than 1000 employees and sales volume below 400 million yuan will be treated as SMEs. Among them, firms with more than 300 employees and sales volume not less than 20 million yuan will be defined as medium-sized firms. Otherwise, the firms are categorized as small and micro sized firms. On the flip side, Hong Kong's definition is simpler, compared to China's. Manufacturing enterprises with less than 100 employees and non-manufacturing enterprises with fewer than 50 employees are regarded as small and medium sized-enterprises.

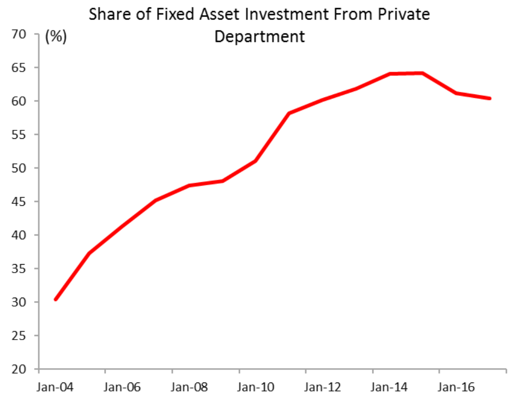


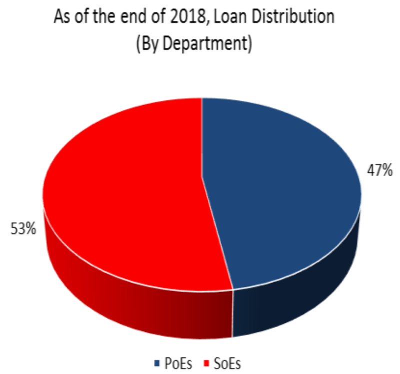


Source: SUCCESS, China Association of Small and Medium Enterprises, OCBC

Over a long period of time, private firms have made significant contributions to the economic development of China, with more than 60% of total fixed asset investment contributed by the private sector since early 2011. Nevertheless, as of the end of 2018, private-owned enterprise's (POEs) balance of loans recorded 42.9 trillion yuan, only accounting for 47.4% of total loan balance. **It shows that the funding support to the private sector has been insufficient.** After various top regulatory authorities, inducing People's Bank of China (PBoC), China Banking and Insurance Regulatory Commission (CBIRC) and the Ministry of Finance, have rolled out a series of supportive polices, CBIRC president Guo Shuqing stated that the average loan rate of 18 major commercial banks to small and medium-sized firms has dropped to 6.23% as end of 3Q 2018, 0.7% lower compared to 1Q 2018. **Despite that, it may still take a long time to a fundamental easing in private sector, especially for those small and micro firms.**

Funding supports to private department have remained insufficient in China.



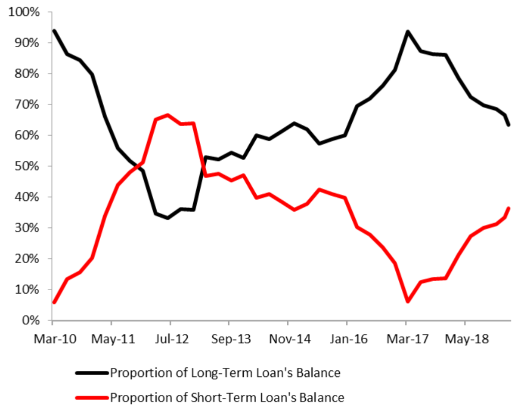


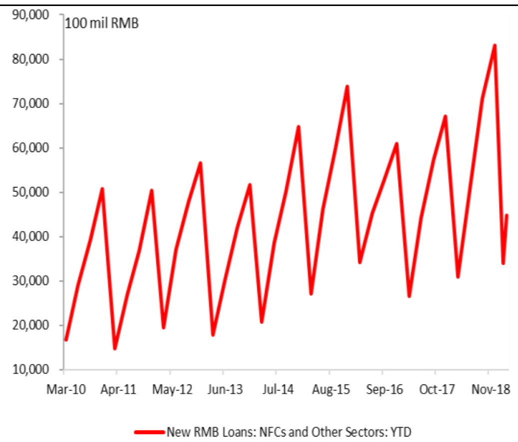
Source: Wind, OCBC

Without doubt, the lack of collaterals is a common factor, leading to small-sized private firms' funding difficulty in various economies. Nevertheless, the liquidity squeeze for small-sized private firms might be also attributed to other structural reasons in China.

Deteriorating commercial bank's risk appetite might be a key factor.

A first reason could be deteriorating risk appetite of commercial banks. Against the backdrop of an uncertain domestic economic outlook, banks' risk appetite could weaken. Given that somehow the concept of rigid redemption provided by government still exists, commercial banks have preferred to provide liquidity to state-owned enterprises (SOEs) rather than private firms due to risk aversion. Meanwhile, it is also observed that commercial banks have tended to provide short-dated loans rather than the medium to long term credits, due to decelerating domestic economic growth. As such, it has intensified the uncertainties small-sized private firms face in getting funding for long-term development and vitality.





Source: PBoC, Wind, OCBC

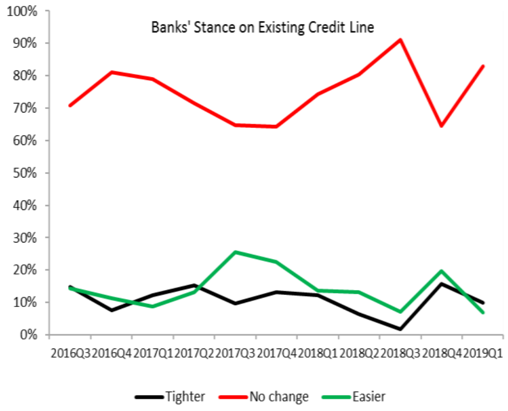
Financial deleveraging campaign and more restrictive asset management rules have intensified the funding difficulties faced by SMEs.

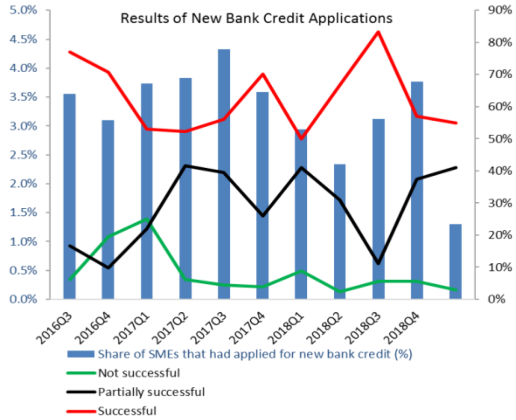
The second reason is that the "non-standard" funding channels were shut down by government amid the financial deleveraging campaign in previous years. Over a long period of time, as most of the small-sized private firms were basically unable to fulfil the requirements requested by "standard" funding channels, therefore, notes financing and "non-standard" financing have become important funding sources for small-sized private firms to acquire liquidity. After the "back door" was closed, they have to seek liquidity through "standard" funding channels, including seeking loans from commercial banks. Nevertheless, fulfilling those loan requirements still poses great challenges for small-sized private firms.

The third reason is that commercial banks have tended to keep more liquidity in order to fulfil the new regulations required given more restrictive asset management rules imposed by the government. Even though commercial banks obtained more liquidity due to monetary easing by the PBoC, they have remained cautious on extending credits to private firms.

SME funding difficulty has been less significant in HK.

Moving on to Hong Kong, SME's funding difficulty has been less significant, compared to the situation of China's small-sized private firms. According to a survey conducted by the Hong Kong Monetary Authority (HKMA) and the Hong Kong Productivity Council, it shows that the credit environment did not tighten in 2018 and early 2019, despite the rising concerns over a global economic slowdown and US-China trade war risks. On the one hand, the percentage of unsuccessful new bank credit applications dropped to 6% on average over 2018 and 3% during 1Q 2019, much lower than around 12% from 4Q 2016 to 4Q 2017, while the percentage of successful applications stabilized at 62% from 1Q 2018 to 1Q 2019 on average. On the other hand, only 9% of respondents reported that banks' stance on existing credit line turned tighter in 2018, 3.5% lower compared to the same period in 2017. Meanwhile, around 80% of respondents stated that the credit line remains unchanged from 1Q 2018 to 1Q 2019.





Source: HKMA, Hong Kong Productivity Council, OCBC

The credit environment in Hong Kong has generally been stable due to several reasons. Firstly, overall HKD liquidity has been kept "very flush", with a sizable monetary base and aggregate balance recording HKD 1.62 trillion and HKD 54.3 billion respectively in June. Ample HKD liquidity has prompted financial institutions to provide liquidity for SMEs.

Secondly, government and quasi-government corporations have provided multiple supportive measures in various categories to solve SMEs' funding difficulties. The Trade and Industry Department have launched an SME Loan Guarantee Scheme, to help SMEs meet working capital needs, and an SME Export Marketing Fund, to encourage them to expand their markets outside Hong Kong. Specifically, according to official data, the approved rate of SME loan guarantee schemes increased from 88.42% in 2013 to 91.2% as of the end of April 2019. In terms of quasi-government corporations, Hong Kong Mortgage Corporation Limited launched SME Financing Guarantee Scheme back on the 31 May 2012. As of May 2019, the cumulative approved rate of this program has been 88.8%, with an aggregate guaranteed amount of HKD 50,795.39 million approved.

Three main favourable factors, include flush liquidity, supportive government policies and commercial bank's better risk appetite improve liquidity for SMEs.

In other domains, the Innovation and Technology Commission has organized an enterprise support scheme to encourage the private sector to invest in research and development, while Cyberport manages a Cyberport Creative Micro Fund. **Thanks to the efforts made by public institutions, there has been significant progress in breaking down the financing barriers SMEs faced for loan acquisition.**

Thirdly, Hong Kong's SMEs have been less arduous to obtain credits from commercial banks, compared to the case in China. Similar to the situations in some developing economies, indirect financing has been the major funding channel of SMEs in HK. Supported by flush liquidity and better risk appetite due to public institution's guarantee, the SME credit environment has remained modest. In terms of loans from commercial banks, it can be separated into two categories for discussion, namely secured loans and unsecured loans. For secured loans, meaning that borrowers own some form of guarantee as collaterals (e.g. assets, deposits, etc), banks are usually willing to provide credit at lower interest rate due to lower risk. According to market information, the annual interest rate ceiling of most public institution's guaranteed plans have been capped by 10%.

In Hong Kong, SMEs could still be able to obtain loans from commercial banks, even though they do not own standard collaterals. For the banks with a more aggressive risk appetite, they provide unsecured loans to SMEs by charging a higher interest rate. Meanwhile, personal loans have seemed to be a possible alternative for SME's owners to acquire funding should the collaterals not be available. According to some public information, the annual interest rate of unsecured personal loans provided by commercial banks could be as low as 3%. Lower borrowing costs are also another relief for SMEs in Hong Kong.

Taking it together, the funding difficulty encountered by Hong Kong's small-sized firms has been less significant compared to that in China, mainly due to three reasons. Firstly, HKD's liquidity has been flush. Secondly, the borrowing cost in Hong Kong has been lower in general. Thirdly, commercial banks in Hong Kong have better risk appetite on extending loans to private firms, partly due to government and quasi-government corporations' guarantee. Nevertheless, to address the small-sized private firms' funding difficulty in China, improving financial institution's risk appetite to the private sector and buffering the shocks from financial reform will be crucial in the future.

HONG KONG SPECIAL

HKD Rates: Bracing for Higher Volatility

Carie Li, Economist

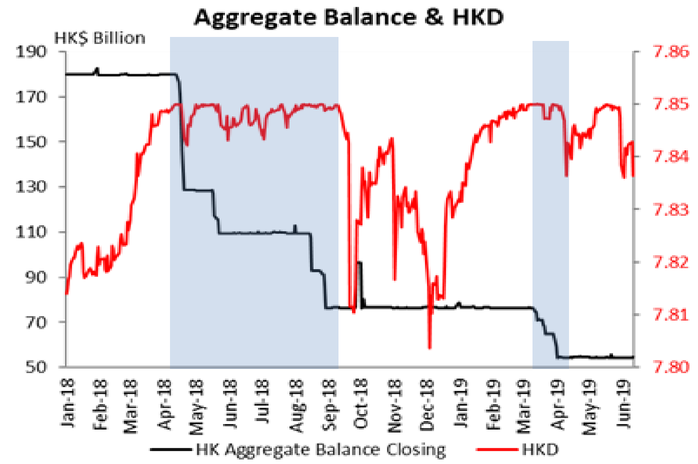
Summary View

- Due to a wide USD-HKD yield differential, the return of carry trade triggering HKMA intervention in March, which in turn pushed the aggregate balance down by 29% ytd.
- With the aggregate balance falling to the lowest since 2008 at HK$54.3billion, HKD interest rates and exchange rates braced for higher volatility as market players became increasingly sensitive to potential liquidity draining events. In 3Q 2019, a slew of seasonal factors and the potentially large IPOs (including Alibaba) may keep HKD rates elevated. Elsewhere, the eight virtual banks will start operation in late 2019 and will likely divert some deposits from the traditional banks with higher rates. This could also lend support to HKD rates.
- Given the elevated HKD rates and the suppressed USD LIBOR, the rising expectations of narrower USD-HKD interest differential may allow the USD-HKD to stay below 7.85 in the near term.
- Nevertheless, the upside for HKD rates may be limited given contained outflow risks, rising Fed cut expectations and sizeable FX reserve.
- After the seasonal and IPO effects abate, HKD rates may even come off. However, given the persistently compressed mortgage net interest margin and the low possibility of huge capital inflows, Hong Kong's (HK) banking system is not expected to cut its prime rate this year even if the Fed pushes ahead with rate cuts.
- With HKD rates likely to hover in the current range and external headwinds to continue denting sentiments, the growth of loans and housing market prices may slow down.

Wide yield differentials encouraged the return of carry trade

LIBOR-HIBOR spread widened to the highest since 2008 and drove HKD to frequently touched the weak end since early March.

After the 2018's year-end effect abated, HKD liquidity turned flushed. Meanwhile, major central banks gradually shifted to a dovish tone, easing the concerns about global monetary tightening. As such, capital inflows returned to emerging markets and helped to sustain the flushed HKD liquidity. In the absence of large IPOs, HIBOR dropped across the curve with 1M HIBOR falling below 1% for the first time since last November. 1M LIBOR-HIBOR spread widened to the highest since 2008 at 157.9bps as a result. This boosted carry trade activities and led the HKD to frequently touch the weak end of the currency peg since early March. As a result, the Hong Kong Monetary Authority (HKMA) directly intervened in the spot market to defend the currency peg for the first time since last August. This move pushed aggregate balance down by 29% within a month to HK$54.2billion, the lowest since 2008.



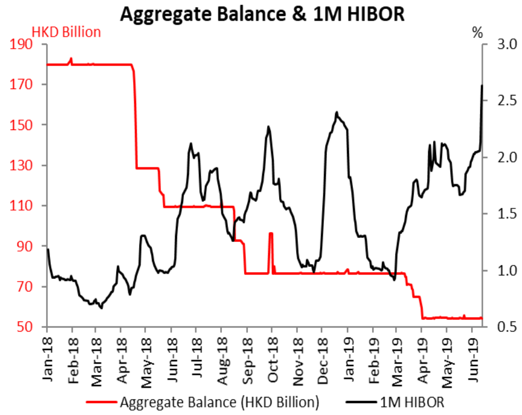
Source: Bloomberg, OCBCWH

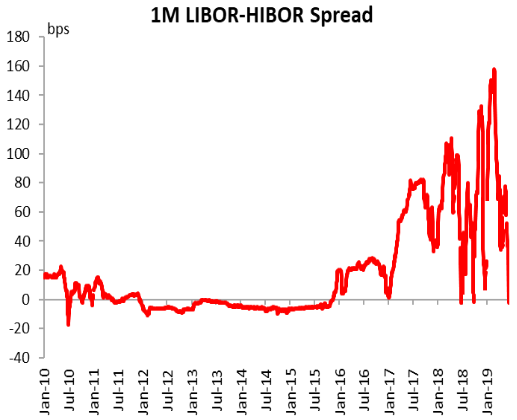
As aggregate balance fell sharply, the volatility of HIBOR increased significantly and sidelined carry trade.

Lower aggregate balance led to higher volatility of local rates

As the aggregate balance (a gauge of interbank liquidity) fell sharply from HK$179.3billion last April to HK$54.3billion in March, the volatility of HIBOR increased significantly as market players became increasingly sensitive to potential liquidity draining events such as quarter-end effects, large IPOs and any further HKMA intervention. As such, 1M HIBOR has fluctuated in a wide range of 1.14%-2.63% since March. Due to the high volatility of HIBOR, USD-HKD showed huge movement in the range of 7.8000-7.8500.

Lately, in anticipation of tighter liquidity on half-year end effect, concentrated dividend payment during June to July, large IPOs (Alibaba applied for a second listing in HK) and political risk, market players continued to hoard cash. This drove 1M HIBOR up to the highest since 2008 at 2.63%. In contrast, the aggressive factoring of Fed easing pushed USD LIBOR down gradually with 1M USD LIBOR falling to the lowest since last December at 2.4%. As a result, the narrowed USD-HKD yield differential drove USD-HKD down sharply from 7.8500 to as low as 7.7987.





Source: Bloomberg, OCBCWH

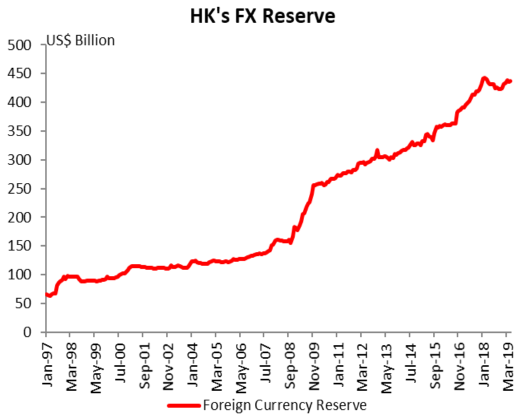
Rather than moving in one direction, HIBOR is expected to show two-way volatility in a range with limited downside and upside.

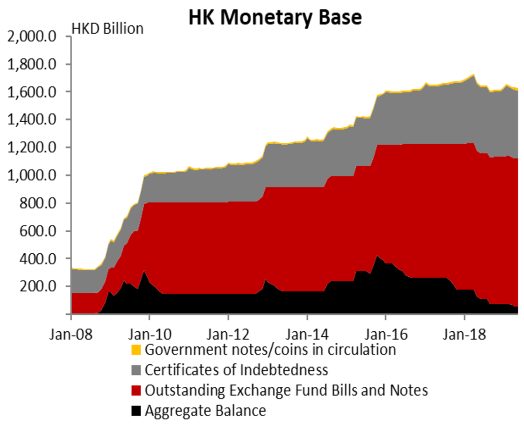
What to expect next?

With AB InBev's planned US$5bn IPO and Alibaba's planned US$10bn IPO likely to be launched in July or August, it may add onto the quarter-end effect in September and continue to tighten HKD liquidity even more after the concentrated dividend payments end in July. In this case, 1M or above tenor HIBORs may stay well above 1.5% in 3Q19. Adding on to the suppressed USD LIBOR, USD-HKD may not touch 7.85 or trigger any HKMA intervention over the coming months.

Nevertheless, after the seasonal factors and large IPO effect abate, HIBOR will likely come off again. However, given the suppressed USD LIBOR and the high volatility of HIBOR and HKD, carry trade players may stay cautious. As such, it looks difficult for USD-HKD to touch 7.85 again.

In a nutshell, rather than moving in one direction, HIBOR is expected to show two-way volatility in a range with limited downside and upside. For the downside, it will likely be capped by seasonal factors and potentially large IPOs. For the upside, it could also be capped by lowered USD LIBOR, contained outflow risks and sizeable FX reserve. HK's FX reserve totalled US$437.8billion or around HK$3.4trillion as of May, outweighing the HKMA's estimated inflows of HK$1trillion to HK since 2008 and more than two times the monetary base. If HKD liquidity gets too tight (like HIBOR persistently tops its USD counterpart), it is also possible for the HKMA to not roll over a portion of the maturing exchange fund bills and notes (totalled HK$1.07trillion) to calm the volatility in local rates. With HIBOR to hover in a range and USD LIBOR to come off, we expect USDHKD to hover mainly in the range of 7.80-7.85 for the rest of this year. As such, aggregate balance may hold around HK$50billion by end of this year.



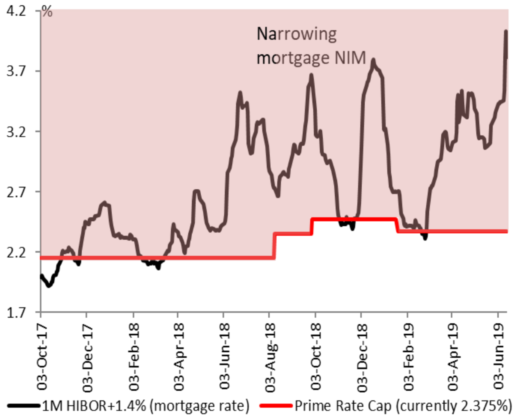


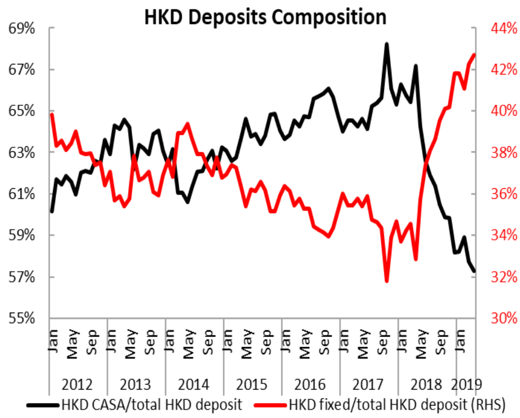
Source: HKMA, Bloomberg, OCBCWH

Will commercial banks change the prime rate?

HK's commercial banks are not expected to lift or cut prime rate this year despite the Fed's interest rate decision.

As HIBOR is expected to show limited upside while global central banks including the Fed are poised to cut rates together with muted loan demand, it seems unlikely for HK's banking system to lift the prime rate in the near term. Also, despite the Fed's rate decision, the commercial banks are not imminent to cut the prime rate any time soon due to several reasons. First, HK's banking system (only one hike by 12.5bps-25bps) lagged far behind the Fed (nine hikes by 225bps) on rate hikes. There is room for HK's banks to stay put. Second, since aggregate balance dropped to HK$54billion, HKD liquidity easily gets tight on seasonal factor or large IPOs. As such, the HIBOR-based mortgage rate (1M HIBOR plus 1.4%) have persistently topped its corresponding prime cap (Prime rate minus 3%) and compressed the mortgage net interest margin. This may make banks reluctant to cut the prime rate. Lately, some commercial bank even lifted the rate for re-mortgage. Third, as HIBOR has been elevated lately, commercial banks have raised fixed-deposit rates which drove the percentage share of HKD fixed deposits out of total HKD deposits to its highest since February 2009 at 42.7% as of May 2019. This suggests relatively high funding pressures in the near term. Fourth, if the Fed decides to cut rate this year, the decision is likely to be driven mainly by heightened trade tensions and further economic slowdown. Against this backdrop, HK seems unlikely to see substantial capital inflows. Nor will HIBOR be pushed down to previous years' lows.





Source: HKMA, Bloomberg, OCBCWH

Will virtual banks push up to traditional banks' funding costs?

The eight virtual banks may divert some deposits from the traditional banks but may only have limited impact on traditional banks' funding costs.

After launching the fintech supervisory sandbox 2.0 in late 2017 and the fast payment system in September 2018, the HKMA has granted a total of eight virtual bank licenses since March. These virtual banks include ZhongAn, SC Digital (backed by Standard Chartered, PCCW, HKT and Ctrip Financial), Livi VB (held by BOCHK, JD Digits and Jardines), WeLab, Ant SME Services (backed by Alibaba), Infinium (held by Tencent, ICBC Asia and HKEX), Insight Fintech (backed by Xiaomi) and Ping An OneConnect (held by Ping An). They will offer services including traditional deposit, loan and remittance within six to nine months from the date when the license was granted. As such, the number of licensed banks in Hong Kong increased from 152 to 160 as of April.

Going forward, digital banks are expected to divert some deposits from traditional banks due to several reasons. First, for the virtual banks, the minimum level of paid-in share capital is required to be at HK$300 million. The stringent requirement suggests that virtual banks have strong fundamentals. Second, like traditional banks, virtual banks will be regulated by HKMA and insured by Hong Kong Deposit Protection Board which will pay customers compensation up to a limit of HK$500,000 if the banks fail. Third, virtual banks do not have any minimum requirement for customers' account balance and barely charge any monthly fee or services fee. Fourth, the relatively low costs of running a virtual bank will likely allow the banks to offer higher deposit rates compared to that of traditional banks.

Assuming that the core capital adequacy ratio is 12% for the four virtual banks and their loan-to-deposit ratio reaches 75% (72.9% for traditional banks as of April 2019), more than 1% of the total deposits (HK$13.7trillion) could be lost by traditional banks.

Nonetheless, we believe that virtual banks will not add much upside risks to HKD rates as they may not divert much deposits from traditional banks. Reasons are as below. Firstly, as virtual banks may offer loans with lower rates to attract customers, concerns about compressed interest rate margins may prevent them from lifting deposit rates to an unreasonably high level. Secondly, with the focus being on the promotion of financial inclusion, the target customers of the virtual banks may be different from those of traditional banks which offer comprehensive services. Thirdly, traditional banks have taken various countermeasures such as scrapping fees and improving online banking services. Fourthly, for the older generation who are not very adapted to online services, they may still choose traditional banks.

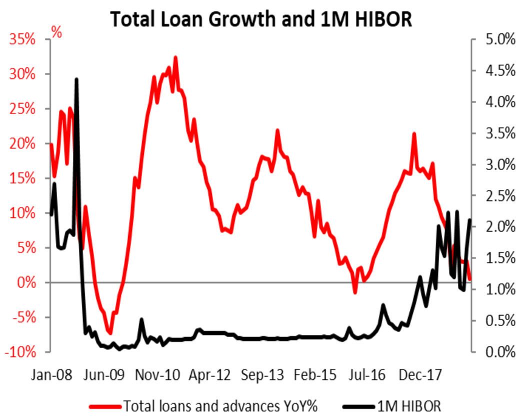
How will the volatility of HIBOR affect the economy?

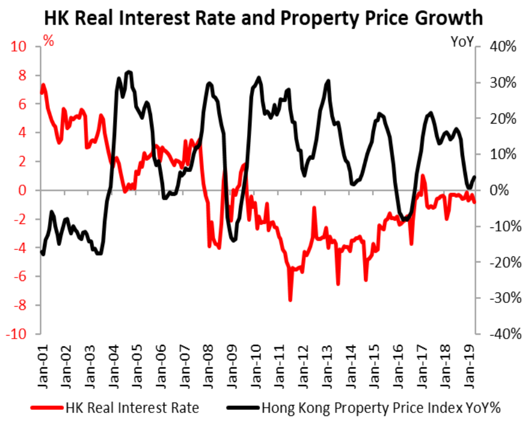
Early this year, the retreat in HIBOR and the shifting stance of Fed from hawkish to dovish eased market concerns about higher local borrowing costs. This was one of the major factors fueling the renewed housing frenzy and helping to stabilize total loan growth.

Due to the high volatility of HIBOR, it easily jumps on short-term liquidity draining factors. Combined with other unfavourable factors, the growth of local loans and housing market prices may slow.

Lately, with the shrinking aggregate balance contributing to higher volatility of HKD rates, HIBOR easily jumped to above 2% on short-term liquidity draining events. This combined with renewed trade war tensions may dent business sentiment and weigh down on loan demand.

Besides, the elevated HIBOR may limit the downside for mortgage rates. Specifically, over 80% of newly approved residential mortgage loans have been priced with reference to 1M HIBOR over the past five years with the mortgage rates subject to a prime rate cap. As we expect 1M HIBOR to remain range-bound above 1%, the mortgage rates (1M HIBOR plus 1.4%) may persistently top their prime rate cap (Prime rate minus 3%). If this is the case, it means that mortgage rates will remain equal to the prime rate cap. As mentioned above, we believe that the bank prime rate cuts are not imminent. This suggests that mortgage rates would stay relatively high at 2.375% (the normally used prime rate cap) or above. Elsewhere, HK's real interest rate (3M HIBOR minus CPI) has edged up gradually since 2011 and hovered just a tad below 0% lately, close to the highest level since 2009. Given the elevated local rates combined with other unfavorable factors including the negative wealth effect from stock market corrections, political risks and increasing short-term supply, we believe that the property market growth will slow down in the coming months.





Source: Bloomberg, OCBCWH

INDONESIA SPECIAL

Why has BI not cut?

Alan Lau, Economist

Friday, July 05, 2019

- Despite having hiked the benchmark rate by 175bps in 2018, Bank Indonesia (BI) has continued to stay on hold in 2019.
- Recent conditions though are in favour for BI to start cutting as a primarily Fed led global monetary easing cycle has provided support for a firmer IDR.
- Regardless, BI still decided to hold in June but we believe that they may still be awaiting more certainty of reduced capital outflows risks.
- The liquidity situation also doesn't appear to be immediately dire but BI has also been rolling out easing macro-prudential measures.
- Overall, we see BI may cut the benchmark rate by 25bps in 3Q 2019 as we believe a Fed cut is likely to happened in July 2019.

In the region, we have so far seen a number of the central banks already start to engage in an easing cycle. BNM, RBNZ and RBA have all cut their rates amid growth concerns whilst the BSP has already unwound some of its hikes from last year. However, Bank Indonesia (BI) has continued to stay static despite having hiked the most in the region in 2018 at 175bps together with the BSP. Governor Perry Warjiyo though has recently said that a rate cut is now a "matter of time". It appears almost clear that BI intends to cut but the timing is uncertain. The question now is why BI is still holding out on a cut. We believe that a few factors may be in play here, including that BI may want to get more certainty that the policy space has emerge. In this piece, we explore in more depth the factors driving BI's moves and divine the timing that they will most likely cut.

What are BI's concerns?

The current account deficit makes the IDR vulnerable but it shouldn't hinder BI from cutting if the external environment is favourable.

It is of no doubt that BI in the short–run is ultimately concerned with the IDR's volatility. However, the IDR appears more to be in a position of strength at this point of time. Since the start of June 2019, it has been relatively stable in the range of 14,000 – 14,350. Although Indonesia runs a current account deficit, such vulnerabilities in many respects are structural and long-term in nature. If anything, the current account deficit should only see a material change as the country's development evolves and there is less need for imported products. Hence, in the short run, BI would be expected to normally act when external conditions turn in their favour.

BI still held in June despite current favourable conditions

BI may possibly just be waiting to get more certainty of a Fed cut before acting similarly themselves.

As mentioned, the IDR has been firm since the start of June as it hovers in the range of 14,000 – 14,350. Furthermore, the Fed has turned increasingly dovish with the median 2020 dotplot now lower than the median 2019 dotplot. Market is also pricing in three Fed rate cuts this year with many believing that the first Fed cut could come in July 2019. Hence, it would have appeared favourable for BI to cut but they still decided to hold the benchmark rate at their June policy meeting.

A reason could simply be that BI just wanted to get more certainty of IDR stability. So far in 2019, the IDR did appear quite stable up until May. With an unexpected rise in trade tensions in May, the IDR, just like other Asian currencies began to see a sell off and even climbed above 14,400 against the USD. The strengthening of the IDR in June did provide some relief but who is to say that the Fed may still not suddenly move away from a dovish tilt and instead become neutral. After all, recent comments from Fed members did not give a clear indication that there is a unanimous agreement to undertake a cut so soon. Given such circumstance, BI could possibly just be extra cautious to wait for more certainty of a Fed cut to happen. If that is the case, BI may possibly not even move until a Fed cut happens.

Additionally, BI could be waiting to try to get a clearer picture on the risk of capital outflows of the repatriated tax amnesty funds. The funds itself reportedly stands at Rp147tn. This risk itself may be tied to the appetite for emerging market (EM) assets and Indonesia itself is traditionally a concerned high yield EM market. The first phase of the tax amnesty program itself had ended in September 2016 with a three year lock up period. In our view, we think it unlikely that BI would wait past September 2019 to ease and as long as they are sufficiently confident that the risks of capital outflows have receded, they would probably begin to move.

What about the trade war?

The outcome of the trade war itself shouldn't immediately be a factor to prevent a BI cut.

In some respects, some people may see that the big elephant in the room could be how the trade war progresses. BI may have just been waiting for the outcome of the Trump – Xi meeting at the G20 before deciding to move. Even if this is to be the case, we don't believe investors should be too concerned about whether the trade war situation can hinder further cuts. If there is an escalation in trade tensions, the global economic situation will gradually worsen making a Fed cut more likely and opening the space for BI to act similarly. In the flip case where both the US and China come to a "peace treaty", then, there would be an increasing risk appetite for EM assets, which in turn should give more support to the IDR and again, there would be the window of opportunity for BI to slash rates. However, in the scenario where the two sides continue to talk with no clear signs that a deal is going to happen, we still think the global rate easing cycle will carry on as the global economy is still expected to show signs of weakness. Hence, BI may probably still cut rates. As a whole, we don't see the trade war as an immediate decisive factor to stop an easing.

How about current domestic economic fundamentals?

The current domestic economic situation is no hindrance to a cut but neither does it create an urgency to ease so soon.

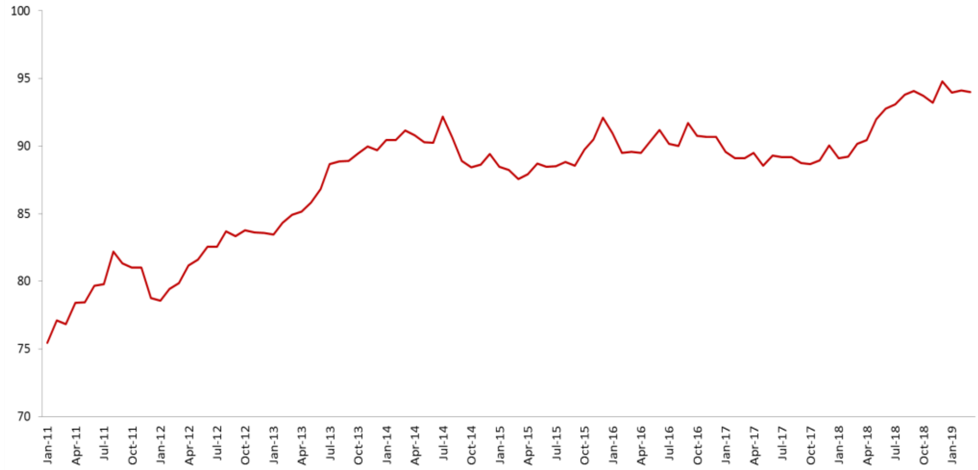
Given that Indonesia's economy is mainly domestically driven, the trade war is unlikely to have much impact on it. Growth continues to tick above 5.0% even if BI may be concerned about the "softness of the national economy". Headline inflation is likely to remain moderate and within BI's inflation target range of 2.5% - 4.5%, especially given the freeze on fuel and electricity prices. Hence, the domestic economic situation in our view is unlikely to create any urgency for BI to cut even though the growth softness means it is also not ideal to keep the benchmark rate high for too long.

Is time running out though as liquidity tightens?

The liquidity situation is not immediately dire but BI has also implemented measures to ease pressures.

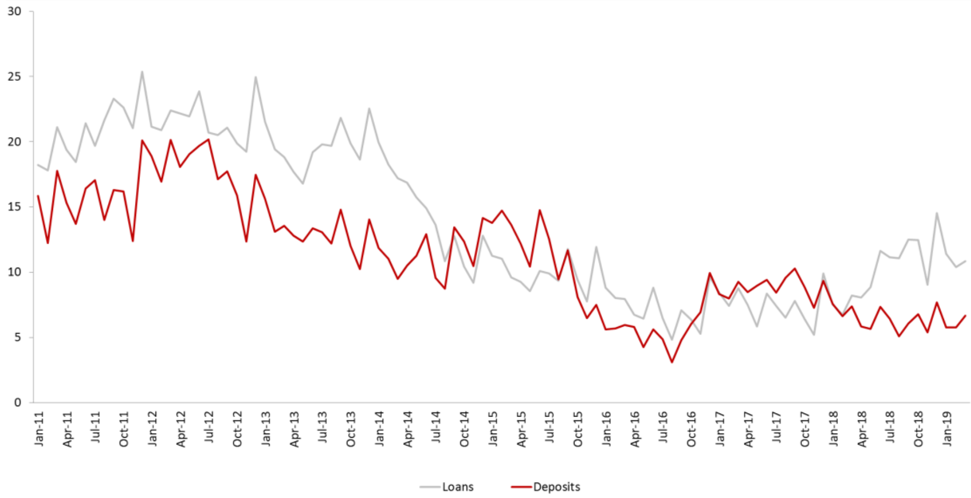
The first concern that arises regarding liquidity is related to the growth of loans and deposits. Over the last year or so, we have seen that deposit growth has been on a gradual downward trend (see chart 1). The loan growth in contrast has been on an upward trend but it started to come off in 2019 (see chart 1). The loan deposit ratio (LDR) has also been climbing, hitting 94% as of March 2019 (see chart 2), providing the first sign of a tightening liquidity situation.

Chart 1: Commercial Banks Third Party Deposit and Loan Growth, % yoy



Source: Bloomberg, CEIC and OCBC

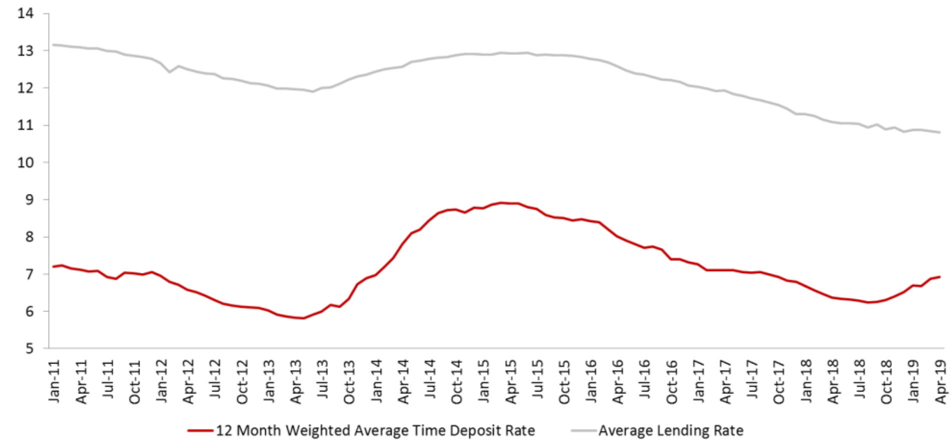
Chart 2: Commercial Banks Third Party Loan to Deposit Ratio (LDR), %



Source: Bloomberg, CEIC and OCBC

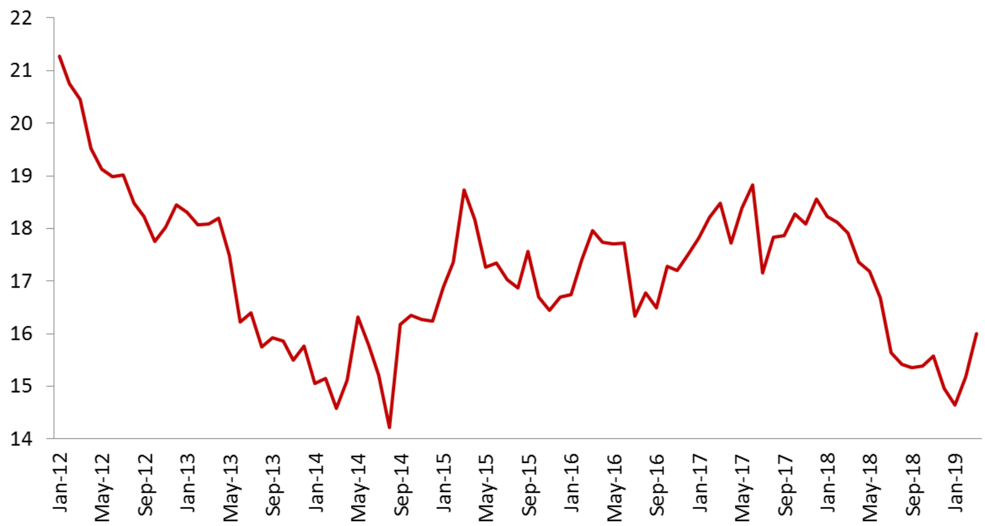
If we start to look at other measures such as the 12 month time deposit rate, we see that it has only started to climb since late 2018 after a period of decline (see chart 3). A few reasons could explain the earlier 2018 decline during a period of rate tightening. Among the reasons include the build-up of deposits in prior periods, drawing down of the liquid asset ratios or injections by BI. However, whatever the case may be, the recent rise in deposit rates are possibly pointing to tighter liquidity.

Chart 3: Deposit and Lending Interest Rate, %



Source: Bloomberg, CEIC and OCBC

Chart 4: Commercial Banks Liquid Asset Ratio, %

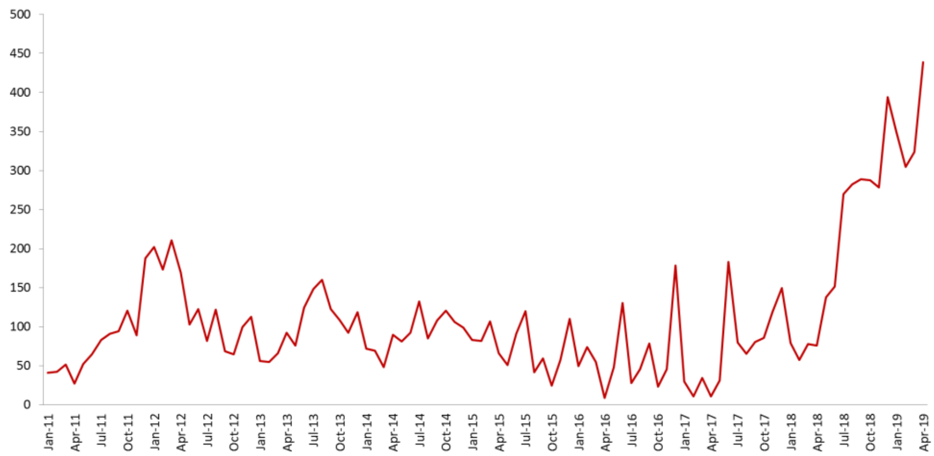


Source: Bloomberg, CEIC and OCBC

Meanwhile, we also see that the liquid asset ratio (see chart 4) has been on a decline throughout the entire 2018 amid the tightening. The usage of such assets may have helped address any liquidity shortage the banks could have been facing but the pace of decline also suggests that this source of funding was gradually drying up. However, it has risen recently though. That said, lending rates have been on the decline (see chart 3) even as loan growth has been coming off for 2019.

In terms of the excess liquidity in the commercial banking system, we see that although there was a period of decline between December 2018 to February 2019, it is still generally on an upward trend (see chart 6). However, this data does not reflect the possibility that smaller banks may be facing a liquidity squeeze whilst the bigger banks may have ample liquidity. The reserve requirement ratio (RRR) cut of 50bps though by BI should help alleviate the pressure on banks facing a squeeze.

Chart 5: Commercial Bank Excess Liquidity, Rp tn



Source: Bloomberg, CEIC and OCBC

As a whole, there are certain concerning signs regarding the liquidity situation that are emerging but the situation doesn't appear immediately dire. After all, BI has been vigilant of the liquidity situation.

A rate cut by BI in 3Q 2019 is increasingly likely in our view

We believe a 25bps cut is likely to come in 3Q 2019 whilst we expect 50bps of cuts by end 2019.

Overall, we believe that BI will likely cut the benchmark rate as early as 3Q 2019 by about 25bps. Our house view is that the Fed is likely to cut come July. Hence, this should clear the way for a BI easing to happen very soon. Furthermore, their concern on the growth softness also means that they are also unlikely to want to keep the benchmark rate at current levels for too long. Overall, we are expecting at least 50bps of cuts by the end of 2019.

OCBC Treasury Research		
Macro Research	**Credit Research**	**Wing Hang**
Selena Ling	**Andrew Wong**	**Carie Li**
LingSSSelena@ocbc.com	WongVKAM@ocbc.com	carierli@ocbcwh.com
Emmanuel Ng	**Ezien Hoo**	**Dick Yu Sze Ngai**
NgCYEmmanuel@ocbc.com	EzienHoo@ocbc.com	dicksnyu@ocbcwh.com
Tommy Xie Dongming	**Wong Hong Wei**	
XieD@ocbc.com	WongHongWei@ocbc.com	
Terence Wu	**Seow Zhi Qi**	
TerenceWu@ocbc.com	ZhiQiSeow@ocbc.com	
Howie Lee		
HowieLee@ocbc.com		
Alan Lau		
AlanLau@ocbc.com		