OCBC GLOBAL OUTLOOK 2019

OCBC Bank

A brave new world in 2019

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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

Benign growth but choppy financial markets seen in 2018, but will this repeat in 2019?

If we can allow ourselves a pat on the back, we have been quite prescient in calling a year ago that the benign global macro-economic picture in 2018 does not necessarily imply a smooth ride for financial markets. In fact, 2018 marked a roller-coaster ride for both traditional assets (equities and bonds) as well as non-traditional assets like bitcoin. Looking ahead, the key uncertainties that swayed market sentiments over course of 2018 included the Trump-Kim meeting, the ongoing Brexit negotiations, the EM rout, the fear of an overly hawkish FOMC (albeit now replaced by more dovish interpretations for 2019), ECB's policy direction (after halting monthly asset purchases from end-2018) and BOJ's "stealth tapering", China's policy dilemma amid external trade tensions (mainly US-induced) and a global growth cycle that has matured and may have peaked.

Asian growth to see a relatively smooth glide path from 2018 to 2019.

Asian economies' year-to-date performance has been relatively resilient, albeit decelerating into 3Q18. With 2018 growth prospects largely in the bag, the IMF forecasts for 2019 GDP growth also looks fairly benign and telegraphs a modest slowdown story. The global economy is tipped to see 3.7% in 2019, the same as 2018, while major economies will see slightly slower growth eg. 2.5% for the US, 1.9% for EU and 6.2% for China. The economic fundamentals for ASEAN remain robust, but trade war concerns continue to linger and weigh on 2019 growth prospects given both the US and China are key export markets. Coupled with higher US interest rates, this could further pressure currencies of countries with weaker external positions, namely Indonesia and the Philippines. On average, ASEAN economies are tipped to expand by 4.9% in 2019.

The same old risks of trade tensions, geopolitical uncertainties and other grey rhinos in financial markets.

The US-China trade war has escalated in 2H18 only for US president Trump and Chinese president Xi to hit the pause button at the sidelines of the G20 meeting. China basically intends to resume purchases of American soybeans soon (to the tune of between 5-8 million tons) and cut tariffs on US car imports from 40% to 15%, but further challenges may lie ahead with meeting demands for "structural changes" to China's economic model by 1 March. The uncertainties surrounding the arrest of Huawei's CFO, Japan being the latest US ally to ban Huawei equipment and the US' record bilateral trade deficit with China in November 2018 could remain thorns in the side. US-China tech cold war.

Elsewhere, the Brexit deal remains elusive and is nearing endgame with the 29 March 2019 deadline, notwithstanding the EU agreement on the backstop insurance and UK PM May recently surviving a vote of no confidence. Elsewhere in Europe, the Italy remains under pressure to revise its budget proposal to avert the European Commission's wrath, while European banks are contemplating the end of ECB support and rising funding costs into 2019. Over in Asia, Japan also plans to hike its sales tax to 10% come October 2019. The surprise election outcome in Malaysia in May 2018 had left market watchers somewhat skeptical of the reliability of polls, especially ahead of upcoming elections in Thailand and Indonesia. In typical business fashion, some firms may adopt a temporary "wait-and-see" attitude to capex spending and hiring, especially given the externalities of the US-China trade war.

Clearer signs of inflation coming back were foiled by the recent oil price dip.

Crude oil prices hit an air pocket towards end-2018. They had likely peaked in October 2018, aided by US' sanctions on Iran. Still, global supply has risen and OPEC is pumping well over 33 million barrels a day in November. Note US' oil production had surpassed Russia and Saudi Arabia in September to become the world's top oil producer. The 6 December OPEC meeting promised production cuts of 1.2 million barrels a day, but the IEA opined it's too early to tell if the global over-supply may sustain into next year given that stocks have been building and US share production may scale up. IEA had slashed its forecast for new oil supplies from non-OPEC countries by 22% to 1.5 million barrels per day due to lower Russia and Canada output. Going forward, inflation in 2019 is likely to be supported by higher global oil prices and still resilient domestic economic activity. ASEAN inflation is likely to average 3.0% yoy in 2019, higher than the 2.6% for 2018.

Global liquidity may continue to be restrained into 2019

Monetary policy normalisation has become the norm, with many Emerging countries also jumping on the bandwagon of interest rate hikes to offset the compression of yield differentials against the US. The European Central Bank (ECB) has also halted its monthly asset purchases in December 2018 and stands on the cusp of contemplating its maiden rate hike for this cycle sometime in the summer of 2019. Meanwhile, BOJ remains again the laggard notwithstanding market speculation of stealth tapering as well. While the global monetary policy dial has started to move away from very accommodative settings, nevertheless it likely remains a long-drawn process. Major central banks still sound somewhat cautious going out into 2019, with the ECB being a case in point. When asked about the outlook risks, ECB's Draghi warned of "continuing confidence with increasing caution" and hinted that the guidance for the timing of the first rate hike is "both date contingent and it's also state contingent, namely depending on the situation of the economy". Note that the December 2018 Eurosystem staff macroeconomic projections for the euro area had been revised slightly lower to 1.9% in 2018 and 1.7% in 2019. In particular, Germany's IFO Institute has pared its growth forecasts to 1.5% for 2018 which will ease further to 1.1% in 2019, down from the earlier forecasts of 1.9% for both years, albeit it tips growth to reaccelerate to 1.6% in 2020 amid the headwinds of auto industry problems, trade conflicts and Brexit uncertainties.

Global growth brakes to apply from 2019, with US economy potentially running out of steam in 2020? Not inconceivable in our view.

What is clear is that the global synchronised growth story that propelled risk assets higher has come to the end of its current run. While recession prospects for the US, Eurozone, UK and Japan vary between 15-30% depending on who you ask, nevertheless the inexorably flattening yield curves and now already partially inverted US yield curve have poured cold water on further policy normalisation going ahead. Delving into 2019, the question remains on what is potentially the straw that breaks the camel's back? Will it be protectionism? For now, the spillovers into the global economy has been somewhat limited by the frontloading of goods ahead of the US-China tariffs, but may take a larger dent out of the global economy in 2019. Will it be an overly hawkish Fed who shifts the monetary gear from normalisation into a restrictive setting? This also appears to be somewhat retracted by recent Fed rhetoric that suggest policymakers are cognizant of the risks to step too hard on the brake when the global economy is already decelerating and the US economy is likely to come off its fiscal sugar rush. Will it be the Chinese economy stumbling amid the myriad of policy challenges of supporting growth, deleveraging and containing financial, housing and credit risks? All these factors remain headwinds to be grappled with in the short-term.

Geopolitical risks will likely remain speedbumps (no different from 2018).
As it turns out, the US midterm elections in November 2018 saw the loss of the House of Representatives to the Democrats, but as at this juncture, barring more investigations into President Trump, there has not been any material impact on its economic and foreign policy yet. Some of the risk events in 2019 to take note of include upcoming general elections in Thailand and Indonesia, and changes in central bank leadership for the ECB for instance. With US president Trump's continued criticism of the FOMC's rate hike intentions and Powell's leadership, a potential change in the Fed chairmanship is also not fully out of the arena of imagination down the road (albeit it is not the baseline scenario for now), whether it's Powell throwing in the towel (aka Mattis-style resignation) or an actual replacement.

China's economic transition and deleveraging remains challenging.
As the ongoing US-China trade war has demonstrated, there are no easy solutions here even with the 90-day truce struck at end-November on the sidelines of the G20 summit. The US administration continues to call for wide-ranging structural and economic reform on issues spanning Intellectual Property, 5G, hi-tech (AI and advanced manufacturing), industrial policy, and liberalising more sectors to foreign participation and investments. With the 40th anniversary of Deng Xiaoping's "reform and Opening Up', Chinese president Xi is expected to address criticism of his Belt and Road Initiative, "Made in China 2025" ambitions, and more assertive presence on the global stage. Central bank policy has shifted to one of policy accommodation, while the economic agenda remains one of mitigating financial risk, pollution and poverty will continue while stabilizing employment, finance, trade, foreign investment and market confidence. Policymakers are also prioritizing "unwavering" support for the private sector. The private sector generates 60% of the nation's output, 70% of technological innovation and 90% of new jobs, according to economic advisor Liu He. On balance, 2019 likely remains a challenging year for China as policymakers navigating the policy tightrope between sustaining GDP growth, deleveraging, downside external risks from trade tensions and protectionism, and financial sector risks. A further growth deceleration remains on the cards, with the key question being one of the pace of slowdown and the risk of policy mis-steps.

Implications for financial markets: belt up, cut through the noise levels and focus on the data.
As the FOMC contemplates a pause near the broad range of neutral interest rates, data monitoring becomes even more critical. This could contribute to a rapidly evolving market view of data dependency and what constitutes neutral for them. Given that the global investor climate has turned decidedly more cautious, it appears that tactical trades would be more opportunistic and likely more short-term in nature. Clear directional trades and outsized returns may become more elusive. However, if

we are indeed standing near the cusp for global monetary policy shifting from outright hawkish to a inflection point of sorts, whether it's for a temporary pause or for a more dovish tilt into 2020, there will be opportunities for investments so stay tuned.

Our take on your 10 burning questions

1. Is the Fed due for a pause?

Going by the economic data, 3Q18 GDP growth was very strong at 3.4% qoq annualised, driven by healthy consumption and manufacturing and non-manufacturing ISM remains near cycle-highs, albeit there is some housing market softness. On the labour market front, nonfarm payrolls are still robust (204k for the last 12 months and 170k for the last three months) and the unemployment rate continues to hold at a low 3.7% without much incipient signs of wage inflation. More importantly, core PCE inflation is edging towards but remains short of its 2% target. Hence a gradual rate hike trajectory remains intact. However, given the recent market volatility, especially with the S&P500 testing a bear market correction, notwithstanding the Fed's preference to ignore short-term market gyrations as noise, nevertheless coupled with the flatness of the yield curve, this may give the Fed room for a pause. With the addition of the word "some" to the phrase of "further gradual increases" in the December 2018 FOMC statement, this suggests a limited number of rate hikes remain in our view. We think two rather than three rate hikes are now likely in 2019, but emphasise that we're essentially back to data dependency ie if wage inflation accelerates further amid still resilient growth in 2019, there is little to stop the FOMC from doing a third hike if the data warrants it.

2. Where is the US-China trade war heading to in 2019?

The latest concessions made by China including large purchases of agriculture products, lower tariffs for US auto imports and a revamp of China's "Made in China 2025" plan to allow more foreign access to China's high-tech manufacturing sector are positive for sentiment. However, most concessions reported by media are not really ground-breaking in our view. It just rolled back some of the retaliation measures. As such, it could be still too early to lower our guard. With Trump's re-election campaign starting in 2019, the key question about the progress of US-China trade tension is that whether a trade deal with China is good for Trump's re-election campaign or not. This could well depend on other parameters such as the Mueller investigation, US economy or the equity market performance etc. As such, we see the outcome of US-China trade talk still binary.

3. What are the USD prospects for 2019?

Despite the US economic outperformance standing on an increasingly narrow base, we think this should be sufficient to sustain overall USD strength into the beginning of 2019. Nevertheless, continue to expect mixed outcomes across the major pairs, given the myriad of idiosyncratic drivers pulling the majors in different directions. Deeper into 2019, the weakening fundamentals should make broad USD prospects considerably murkier. The Fed's hiking cycle should enter its last legs by mid-2019. This should give the other major central banks the opportunity to catch up to the Fed in terms of policy normalization, and therefore putting the USD on the back seat on a structural perspective. The risk to this view is that the expected pause by the Fed collides with a sharper, more protracted downturn in the economic momentum. In this context, expect the other major central banks to under-deliver on their potential rate hikes and the typical countercyclical properties of the USD to kick in.

4. Will oil prices fall further in 2019?

Oil prices have tumbled by almost 40% as of mid-December since the peak in early October. OPEC's decision for OPEC+ to cut oil production by a total of 1.2 million barrels per day from January 2019 failed to support market either. The sharp reversal of sentiment in the past two months was mainly the result of oversupply fear as well as a rethink of demand factors amid the economic slowdown in China and Europe. Those factors will continue to dominate the oil market into 2019. On the demand front, given crude oil is a growth-related commodity, the uncertainty from the US-China trade war may continue to dampen demand. However, given the global economic slowdown in 2019 is likely to be marginal in our baseline scenario; we think the movement of oil prices should be more of a function of a supply story rather than a demand story in 2019. On supply, support from the waiver of Iranian sanction is likely transient. In addition, we expect Saudi Arabia and Russia to cut enough production from the current peak to support prices, which should provide floor to the oil prices. However, the shale production in the US, which has exceeded 8 million barrels per day, could remain the wild card for global oil volatility. We expect shale producers to continue production despite the weak oil prices due to pressure to repay debt. All in all, commitment from Saudi Arabia and Russia may support the oil prices to rebound to US$55-60 range, but any meaningful rebound could be capped by shale production.

5. Will we see reforms in the World Trade Organisation's policies?
The WTO's Special and Differential Treatment (SDT) for certain developing countries is losing its relevance after 23 years of WTO's establishment. Proposed reforms include stricter SDT provided to developing countries, reduction of domestic subsidy, and regulations on dumping activity used to support domestic industry. The implication of these are downward pressures on the China equity market for affected sectors, for example, the equity of Chinese solar industry plummeted after the government announced cuts in subsidies. Another challenging task faced by the WTO is its effectiveness in Intellectual Property (IP) protection. There have been pertinent accusations by US on China's IP theft and so far, we see no viable proposals in addressing this issue. To add on, one of Trump's sticking points in US-Sino trade tensions has been IP protection. We see the possibility of US firms halting their investments in China as "unlikely" given that China's markets remain a sweet spot for innovation and technological opportunities. If this issue is not addressed properly, it may affect the trade tensions further. The ineffectiveness of WTO in dispute settlement is another glaring issue to take notice of. The US has blocked the appointment of Appellate Body (AB). By Dec 2019, there will be only one judge left when the other two retire. This will significantly slow down the dispute settlement process, damaging WTO's major role in the multilateral trading system. A comprehensive amendment of the provisions of Dispute Settlement Understanding (DSU) to improve the interaction between AB and WTO members is required. However, the timeframe is a concern due to its complicated nature. We see little implications of this possible reform as the chances of it being implemented in 2019 is small.

6. Asian monetary policy convergence or divergence in 2019?
2018 marked a remarkable year of convergence in global monetary policy normalisation across both central banks in Developed and Emerging Economies. Around 43 central banks adjusted their monetary policy settings in 2018. The FOMC led the pace with a steady 25bps rate hike every quarter while unwinding its balance sheet, and the ECB also halted its monthly asset purchase in December 2018 and is considering a summer 2019 rate hike. Asia was no exception, but the dispersion was relatively wide - Bank Indonesia and BSP hiked a cumulative 175bps in 2018, while MAS tightened its S$NEER policy slope twice, whereas BNM was static after one 25bps hike in January 2018. China was the anomaly with a cumulative 250bps cut in its reserve ratio requirements (RRR) in a bid to support liquidity in the banking system. Gazing into the crystal ball for 2019, the external economic environment looks to be one of further moderation in momentum, coupled with likely exacerbated market volatility, which may drive a wedge further into the convergence of monetary policy trajectories. The game pin will be the FOMC in its less hawkish tilt which may suggest that an inflection point is near. So while 2017-2018 was a case of more central banks jumping onto the monetary policy normalisation bandwagon, the story may start to diverge more clearly from 2019 onwards, especially if a significant correction occurs in a major economy like the US.

7. Do Asian governments have sufficient fiscal space to stimulate growth?
As the global economy is at risk of a slowdown in 2019, it would naturally fall on governments to find ways to stimulate growth but the level of fiscal space varies among the different Asian governments with some ASEAN nations in particular having less space. Among the ASEAN-5, there is a split with Malaysia, Indonesia and the Philippines finding themselves increasingly constrained while Thailand and Singapore are in a more favourable position. Public debt levels for Malaysia are elevated with the Federal Government debt and contingency liabilities together standing at 68.4% of GDP in 2017, with the possibility that it would climb again for 2018. The issue of a twin deficit resulting in currency vulnerabilities on the other hand is a constraint for Indonesia and the Philippines. Meanwhile, Thailand's public debt stood at 41.72% of GDP, much lower than the 60% of GDP limit set in the sustainable fiscal framework, giving still plenty of space. Similarly, Singapore also has plenty of space having run sizable fiscal surpluses during better years aside

also having sizable national reserves. In North Asia, China would most likely run a fiscal deficit close to 3.0% in 2019 to create room for tax reform to unlock more domestic demand. For South Korea, the public debt remains low at 36.3% of GDP as of 2017 giving the government some leeway. As for Japan, good local appetite for government bonds with a low interest environment and subdued inflation eases the government borrowing situation to allow funding for stimuli programs.

8. Property cycle in key Asian cities

With the ongoing normalization of Fed's monetary policy, the red-hot Asian property markets start to face increasing downward pressure. The interest rates for both city states Hong Kong and Singapore have started to increase due to pass-through effect from higher US dollar funding costs. Hong Kong banks raised its prime rate in September 2018 for the first time since 2006 while Singapore's 3 month interbank lending rate SIBOR rose to 1.89% in December 2018, highest since global financial crisis. The expectation on higher interest rates is likely to dampen housing demand in both financial centres into 2019. In addition, both cities are also facing the similar challenges from higher supply. In Singapore, supply is expected to exceed demand with a flurry of launches planned in 2019-20 following the recent en-bloc fever, which could bring ~30,000 units to the market. In Hong Kong, the government will increase land supply for public housing development by land reclamation in next 20-30 years, studying on brownfield operations and introducing "Land Sharing Pilot Scheme". The higher supply together with weaker demand is likely to weigh down on price outlook in both cities. After adjusting for base effect, we expect Singapore housing price to fall by 2% while Hong Kong housing price may fall as much as 15% in 2019.

The demand story may be rosier in China thanks to falling interest rate due to easing monetary policy despite higher dollar interest rate. Meanwhile, the rising expectation on possible unwind of property tightening measures in some cities may also support the housing demand. On supply side, same as Singapore and Hong Kong, China is also facing the potential over supply challenge. Inventory is expected to increase in 2019 following the recent land shopping spree by developers in the middle of 2018. As such, we might see the price divergence in different cities to emerge again. Prices are expected to remain stable in tier-1 and tier-2 cities while prices in lower tier cities may fall.

Although we expect the housing market to lose momentum in 2019 in most Asian hotspots, any systematic risk to the banking sector looks unlikely in our view due to previous rounds of counter cyclical measures and macro prudential policies in place.

9. Will Malaysia face a ratings downgrade?

We believe any consideration for a ratings downgrade would probably only come in 2020 or after. The government itself has strongly committed to undertake various fiscal reforms and improve spending efficiency. For the 2019 budget, the government had implemented a zero-based budgeting approach and in particular, the expenditure on the supplies & services and the subsidies and social assistance categories are expected to fall by over 20%. The government will also additionally be looking to table a fiscal responsibility act, set up a debt management office and transition the government accounts to be on an accrual basis. The 2019 budget is augmented with an RM30bn special dividend from Petronas but according to Bloomberg, the cash and cash equivalents for the firm total around RM181bn as of 30th September 2018. If we took out the special dividend of RM30bn, the firm would still have RM151bn, which would make up 10% of GDP in 2019 (if we assume the government's growth forecast of 4.8% and 4.9% in 2018 and 2019 respectively). This compares to the government's projection of the fiscal deficit coming out at 3.4% of GDP in 2019. Going forward, it would be crucial though that we continue to monitor if the government's fiscal consolidation and reform exercises yield significant progress in 2019.

10. What challenges lie ahead after elections for Indonesia?

The country will be heading to polls in April 2019 to elect its president but the eventual winner will be facing quite a number of challenges ahead. Over the last few years, the country has faced the challenge of trying to strike a fine balance between raising growth rates and ensuring that inflation stays at a moderate level whilst also keeping the IDR volatility at a manageable level. This similarly will be no different in the future. Pushing growth rates high for the country beyond the estimated trend level of 5.0% can result in higher inflation. On the other hand, raising the country's growth potential through greater public and private investments can result in a higher fiscal deficit and current account deficit, the scenario of a worsening twin deficit. A worsening twin deficit would in turn increase the IDR volatility. The government has rolled out measures to reduce imports, limit the pace of infrastructure development, narrow the fiscal deficit in 2019 to 1.84% of GDP and targeted growth at 5.3% for 2019. All these appear very much as attempts by them to gradually move the country on a long term growth path that is a strong, sustainable and stable growth. Any future leadership would have to ensure a continued drive to be on such a trajectory.

OCBC Asia GDP, CPI and Policy Rate Forecasts

GDP					
% chg year-on-year	**2016**	**2017**	**2018F**	**2019F**	**2020F**
US	1.6	2.3	2.9	2.6	1.9
Euro-zone	1.9	2.4	1.9	1.6	1.5
Japan	0.6	1.9	0.9	0.9	0.6
United Kingdom	1.8	1.8	1.3	1.5	1.6
New Zealand	4.2	2.6	2.8	2.8	2.6
Australia	2.8	2.4	3.0	2.8	2.7
China	6.7	6.9	6.6	6.2	6.0
Hong Kong	2.2	3.8	3.7	2.7	2.4
Taiwan	1.5	3.1	2.6	2.3	2.2
Indonesia	5.0	5.1	5.2	5.3	5.2
Malaysia	4.2	5.9	4.5	4.4	4.2
Philippines	6.9	6.7	6.2	6.1	6.1
Singapore	2.4	3.6	3.4	2.7	2.5
South Korea	2.9	3.1	2.6	2.5	2.5
Thailand	3.3	3.9	4.3	3.9	3.8
Vietnam	6.2	6.8	7.1	6.6	6.5

Inflation					
% chg year-on-year	**2016**	**2017**	**2018F**	**2019F**	**2020F**
US	1.3	2.1	2.4	2.2	2.2
Euro-zone	0.2	1.5	1.8	1.7	1.7
Japan	-0.1	0.5	1.0	1.1	1.4
United Kingdom	0.7	2.7	2.5	2.1	2.0
New Zealand	0.6	1.9	1.6	2.0	2.0
Australia	1.3	1.9	2.0	2.2	2.3
China	2.0	1.6	2.2	2.4	2.5
Hong Kong	2.4	1.5	2.3	2.4	2.1
Taiwan	1.4	0.6	1.5	1.2	1.3
Indonesia	3.5	3.8	3.2	3.5	3.6
Malaysia	2.1	3.9	1.1	2.0	2.3
Philippines	1.3	2.9	5.2	4.2	3.5
Singapore	-0.5	0.6	0.4	1.3	1.5
South Korea	1.0	1.9	1.6	1.8	2.0
Thailand	0.2	0.7	1.2	1.4	1.5
Vietnam	4.7	2.6	3.5	4.0	3.9

Central Bank Policy Rate					
	2016	**2017**	**2018F**	**2019F**	**2020F**
US Fed Funds rate	0.75%	1.50%	2.50%	3.00%	3.25%
ECB refinance rate	0.00%	0.00%	0.00%	0.25%	0.50%
BOJ overnight rate	-0.10%	-0.10%	-0.10%	-0.10%	-0.05%
BOE base rate	0.25%	0.50%	0.75%	1.00%	1.25%
RBNZ cash rate	1.75%	1.75%	1.75%	1.75%	2.00%
RBA cash target rate	1.50%	1.50%	1.50%	1.50%	1.75%
China lending rate	4.35%	4.35%	4.35%	4.35%	4.35%
CBRC discount rate	1.38%	1.38%	1.38%	1.38%	1.38%
Hong Kong base rate	1.00%	1.75%	2.75%	3.25%	3.50%
BI reference rate	4.75%	4.25%	6.00%	6.50%	6.00%
BNM overnight rate	3.00%	3.00%	3.25%	3.25%	3.25%
BSP overnight reverse repo	3.00%	3.00%	4.75%	5.25%	5.25%
Singapore 3-month SIBOR	0.97%	1.50%	1.90%	2.33%	2.85%
BOK target overnight call	1.25%	1.50%	1.75%	2.00%	2.00%
BOT repurchase rate	1.50%	1.50%	1.75%	1.75%	1.75%
SBV base rate	9.00%	9.00%	6.25%	6.50%	6.50%

Source: OCBC Bank

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Country Outlook

Thematic Pieces

CHINA

A binary outcome

The Chinese economy decelerated in 2018 as widely expected. The slowdown was initially the result of China's efforts to lower the leverage ratio as part of its campaign to contain financial risk. However, the slowdown accelerated in the second half of 2018 due to weaker sentiment arising from the escalation of US-China trade war. The Chinese economy decelerated to 6.5%yoy in 3Q from 6.8% in the first half and is expected to slow down further to about 6.3% in 4Q.

The impact of trade war on Chinese economy is still limited for now due to two reasons. First, as the tariff was rolled out in phases by the Trump Administration, Chinese exporters have front loaded some of its exports to the US to beat the deadline. This actually led to a stronger export growth with China's total exports growing by 11.3% yoy in the first eleven months. Second, China has stepped up its support via easing monetary policy and proactive fiscal policy to counter the negative impact on exporters. Since September, China has announced to raise the export tax rebate twice. Total export tax rebate as of end November hit a new high of CNY1.35 trillion and is expected to reach CNY1.5 trillion in 2018. This helps partially alleviate the pain from exporters hit by higher tariff.

Domestically, China has cut its reserve requirement ratio (RRR) for most banks by 250bps in 2018. Although part of liquidity from the RRR cut was used to redeem the medium term lending facility (MLF), total outstanding of MLFs still went up year-to-date, which is a sign of easing monetary policy. As a result, China's funding costs have fallen across the board from its peak. For example, China's 10-year bond yield fell by more than 50bps while China's 3m SHIBOR declined by more than 170bps. Although the transmission mechanism from money market to real economy is not so smooth, the real economy still benefited from the overall easing tone as the weighted average funding costs for corporate fell slightly by 3bps to 5.94%.

Looking ahead, we think there is still room for China to ease its monetary policy as PBoC is not concerned about the inflation risk and liquidity trap. In its 3Q monetary policy report, PBoC argues that the decline of excessive reserves placed by banks with the central bank shows that the liquidity has been channelled to the real economy. We also agree with PBoC's assessment on inflation as inflationary pressure is likely to be capped by potential falling demand due to rising external uncertainties. Meanwhile, the increasing domestic supply of goods as manufacturers shift their product offerings from export to domestic trade due to trade war may also cap the price pressure domestically. Overall, we expect China's CPI to stay below 2.5% in 2019. Given the inflation risk and liquidity trap are unlikely to be the constraints, we expect more monetary easing from PBoC such as additional RRR cut.

As the recent November economic data missed market forecasts, the expectation for possible interest rate cut has heightened. Meanwhile, PBoC Governor Yi Gang's comments that the central bank is moving away from a quantity based policy to a price based target also further fuelled the speculation of a possible benchmark interest rate cut. Nevertheless, we think the chance of interest rate cut is still low for two reasons. First, the interest rate cut may send a wrong signal to the market as it deviates from China's intended path of de-leverage. In the latest politburo meeting in December, China's top makers reiterated to continue China's three economic battles including financial risk, poverty and pollution in 2019. This shows that China policymakers is trying to downplay the market speculation that China would go back to the old path of excessive stimulus in 2019 amid the US-China trade war and the global growth slowdown. As such, we think China will still try to strike the balance between ensuring stable growth and containing financial risk. Therefore, we think an interest rate cut may not be a good option against this backdrop. Second, the heightening interest rate cut is also negative for RMB which has been under pressure due to US-China trade war. Despite the recent correction of US yields across the curve, we expect the US yields to recover in 2019 due to the rising US Fed fund rate. As such, the narrowing interest rate differential as a result of China's rate cut may cause unnecessary currency volatility, which could dampen financial stability. Based on rationale above, we expect China may deliver its easing monetary policy via further RRR cut rather than an interest rate cut in 2019.

For 2019, the main focus is likely to be the fiscal stimulus. China's tax revenue has grown strongly in 2018 at a double digit pace despite the slowing GDP growth. This argues for more tax reform to lower the burden for businesses. We think China's tax reform could be one of the key reforms in 2019. In addition, there is also a chance that China may announce a higher fiscal deficit target above 3% in 2019. Overall, a more proactive fiscal policy next year is likely to alleviate the impact of external uncertainties on China.

Risks

Domestically, China's property market has been resilient despite the toughest tightening measures in place in 2018. We observed quite an interesting divergence this year. This round of slowdown is actually associated with a low housing inventory rather than high inventory in the past few mini-cycles. This was mainly due to China's systematic plan to revamp the shanty towns on the back of the central bank's longer term cheap funding via Pledged Supplementary Lending (PSL). The rebound of inventory in lower tier cities recently suggests that the China's property market may slow in 2019. However, given the still resilient property investments amid the ongoing revamp of shanty town projects and the low interest rate environment, we think property market is unlikely to be the main drag on Chinese growth in 2019. We will discuss about the property market in details in our thematic piece.

The largest tail risk in 2019 still lies on the external factor in our view, mainly the US-China trade war. The latest concessions made by China including a large purchase of agriculture products, lower tariff for US auto imports and revamp of China's "Made in China 2025" plan allow more foreign access to China's high-tech manufacturing sector are positive for sentiment. However, it is still too early to call that the recent 90-day truce will continue. With Trump's re-election campaign starting in 2019, the key question about the progress of US-China trade war is whether a trade deal with China or a tough stance on China is good for Trump's re-election campaign. This could well depend on other parameters such as the Mueller investigation, the US economy or US equity market performance etc. As such, we see the outcome of US-China trade talk as still binary. Should the US-China trade war pause longer, we see a good chance for China to grow by about 6.3% in 2018. Alternatively, China's growth may slip below 6% to around 5.8% even with the support from more proactive fiscal policy.

HONG KONG

Facing multiple headwinds

Economic growth has been slowing down since 2Q18. GDP growth reached a two-year low of 2.9% yoy in 3Q18 with both private consumption and exports of services weakening. Since late September, the economy has been facing multiple headwinds including China's slowdown, higher borrowing costs as well as US-China trade war. These headwinds are expected to hurt business and consumer sentiments, weigh down loan demand, suppress trade activities and soften inbound tourism. With all the pillar sectors losing growth momentum, we are wary of a further economic slowdown in the coming quarters. On a positive note, the government promises to increase public housing supply in the 2019 Policy Address. This may translate into stronger public investments and help to ease some downside risks on the economic growth. All in all, we revise our forecast on 2018 GDP growth from 3.6% yoy to 3.4% yoy and expect that the growth will slow further to 2.7% yoy in 2019.

Headwind 1: First local rate hike since 2006

Back in September when bets on prime rate hike, quarter-end seasonality effects and IPOs tightened HKD liquidity, HIBOR surged to the higher levels since 2008. As such, all major banks in Hong Kong lifted HKD fixed-deposit rates to scramble for HKD funding. Consequently, the whole banking system was facing funding pressure. In addition, the pressure on mortgage net interest margin was growing as over 80% of approved mortgage loans have been priced with the one-month HIBOR benchmark and the mortgage rates have been capped by prime rate. Against this backdrop, all commercial banks were propelled to raise the prime rate for the first time since 2006. Though the magnitude of rate hike was relatively small and varied from one bank to another, the move itself did kick start a new prime rate hike cycle and raised the concerns about much higher interest rates going forward. Therefore, loan growth, consumer sentiment and housing demand has started to weaken from September. Furthermore, during a rate hike cycle, a correction of both stock market and property market is highly likely. This would in turn reduce wealth effect, hurt investor sentiments and soften loan demand.

Headwind 2: Trade war is set to be prolonged.

The US and China have agreed on a trade war truce for 90 days after the Trump-Xi meeting during G20 summit. Nonetheless, should negotiations fail after 90 days, the US may raise the tariff from March 2019. As the trade war risks have not abated yet, we expect Hong Kong's trade activities to remain muted in the near term and potentially take a hard hit should trade war escalate. Besides, fears of the prolonged trade war will dent business and consumer sentiments. Should Asia's economic outlook be clouded by the trade war, adding on China's slowdown and a strong HKD, inbound tourism and tourist spending will also face downward pressure.

Headwind 3: China's economy has been decelerating

A combination of trade war concerns and the previous de-leveraging campaign has weighed down China's economy. Though China continued unveiling supportive measures to ease downside risks on growth, economic growth is expected to slow down further should US-China trade war continue. Given the tight relationship between Hong Kong and China in terms of trade, tourism, businesses, finance and so on, China's slowdown will undoubtedly cloud Hong Kong's economic outlook.

Key pillar industries are losing momentum amid these headwinds
As for the banking sector, total loans and advances dropped for the fourth consecutive month by 0.2% mom in October 2018. Trade finance dipped for the second consecutive month by 2% yoy to HK$481 billion in October, the lowest since April 2017. Loans for use in HK (excluding trade finance), which accounted for 65% of total loans and advances, increased at the slowest pace since January 2010 by 0.3% yoy to HK$6.29 trillion. Despite HIBOR retracing lower, the continued slowdown in loans growth reflects weaker loan demand amid a housing market correction and a stock market rout. The escalation of US-China trade war from late September also continued to dent corporate sentiments and in turn hit local loan demand. Externally, loans for use outside of HK increased by 6.5% yoy (weakest since December 2016) to HK$2.9 trillion in October, the lowest since February 2018. As Chinese authorities stepped up efforts to support the financing needs of the private sector, Mainland companies might have shown lower interests in overseas financing. The rising interest rates and exchange rates of HKD and USD might have also deterred Mainland companies from offshore funding. As such, we expect loan growth to decelerate further in the coming months and probably even dip into the negative territory in the medium term.

With regard to the trade sector, exports and imports advanced respectively by 14.6% yoy and 13.1% yoy in October 2018. The notable growth could be attributed to a relatively low base in October 2017 and the front-loading of trade activities before the US raised the tariff on Chinese imports from 10% to 25% in January 2019. Nevertheless, we doubt the sustainability of such a strong growth number. Though the US agreed to put the tariff hike plan on hold after the Trump-Xi meeting, the current 10% tariff would still slow down trade growth albeit at a moderate pace. After the 90 days of the trade truce, a tariff hike is still possible if there is no deal reached. As such, we are wary of any renewed trade war which may weigh on global economic outlook, in turn weakening global demand and putting a lid on Hong Kong's trade growth. More notably, the US may continue to target China's high-tech industries. In October, the imports of "electrical machinery, apparatus and appliances, and electrical parts thereof" and "telecommunications and sound recording and reproducing apparatus and equipment" accounted for 55% of total imports while the exports of these two commodities represented 60% of total overseas shipments. If the trade war turns to technology war, Hong Kong's trade sector which mainly ships high-tech products would inevitably take a hit.

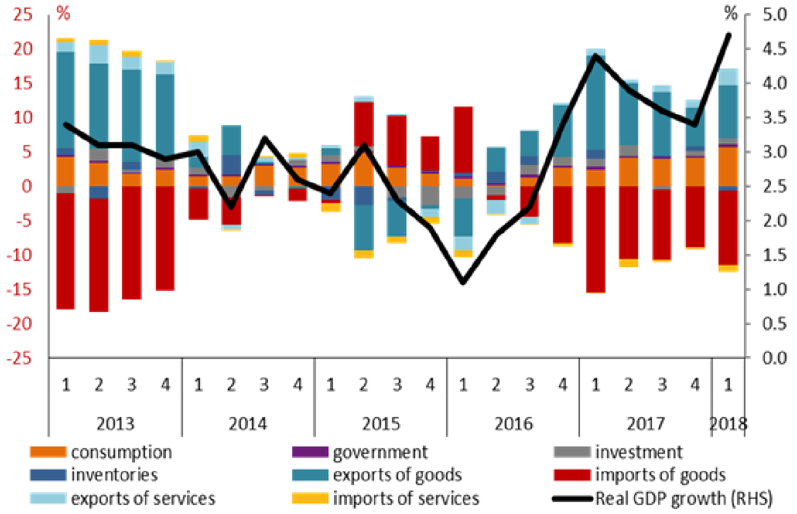
On retail sector front, growth in HK retail sales value rebounded from the lowest since June 2017 of 2.4% yoy to 5.9% yoy in October?. Nonetheless, it is still much weaker than the average monthly growth of 10.8% yoy during the first ten months of 2018. the growth decelerated to 2.4% yoy in September 2018, the weakest since June 2017. The sales of food, alcoholic drinks and tobacco and those of goods in supermarkets both declined for the first time since January 2018. This reflects muted local consumer sentiments probably due to the lower wealth effect on property market and stock market corrections. With local economic outlook clouded by monetary tightening and trade war, weakening prospects of salary growth may also dent local consumption. On the other hand, sales of consumer durable goods increased notably by 14.3% yoy (the fastest since April 2018), partially due to the golden week holiday and the opening of HK high-speed rail. Nevertheless, tourist spending appeared to have been muted as sales of jewellery, watches and clocks merely grew by 3.3% yoy. Though improved infrastructure could lend some support to the tourism activities, a stronger HKD, China's slowdown as well as Asia's sluggish economic outlook may continue to weigh down tourist spending. We expect total retail sales to increase by around 8% in 2018 and to see single-digit negative growth in 2019.

Last but not the least, in terms of the property sector, total housing transaction volume tumbled for the third straight month by 53.7% yoy to 2635 deals (lowest since March 2016) in November. Approved new residential mortgage loans slid by 4.6% mom in October to the lowest since December 2017.

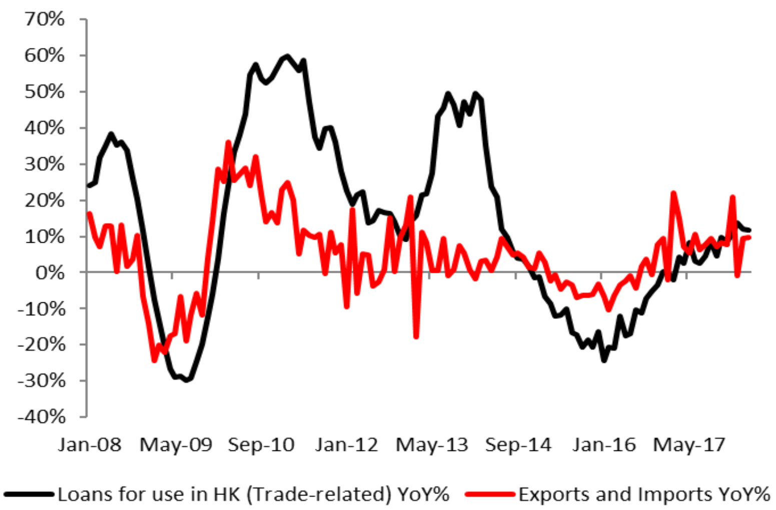
Though property developers offered sweeteners, the primary housing transaction volume continued to tumble. Worse still, the residential property price index dropped for the third consecutive month by 0.5% mom in October and was down by 2.1% from the all-time high. In the secondary market, home sellers have increasingly lowered their offering prices, normally by 10% to 20%, in an effort to find a potential buyer. The disappointing data prints clearly point to weakening housing sentiments due to several unfavorable factors including lower wealth effect, fear of rising interest rates, weakening salary prospects, softer housing demand from Mainland investors as well as expectations of increasing public housing supply. Hence, housing transaction may remain sluggish while housing prices may drop around 15% by end-2019 from the record high.

In conclusion, with all key pillar industries gradually losing momentum, Hong Kong's economy may slow down further in the coming quarters. On a positive note, the 2019 policy address delivered the Hong Kong government's promise to increase public housing supply which may translate into stronger public investments. This may help to ease some downside risks to the economy. We have revised our forecast on 2018 GDP growth from 3.6% yoy to 3.4% yoy and expect the growth will slow further to 2.7% yoy in 2019.

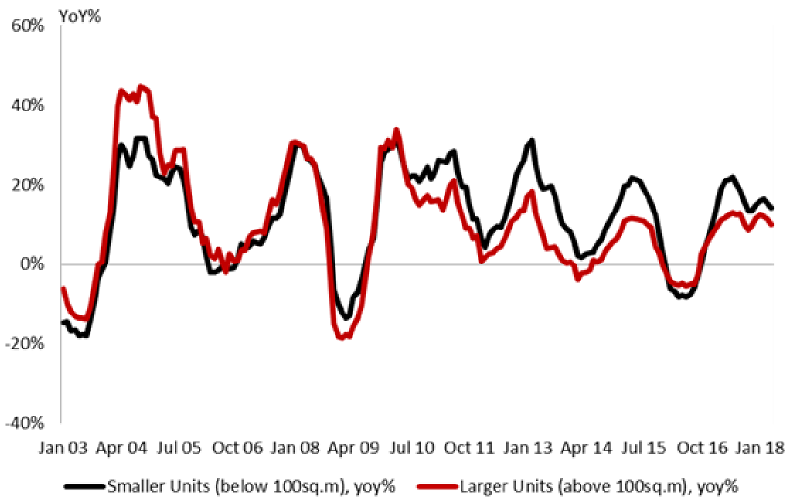
Hong Kong GDP Growth



HK Trade Activities & Trade Finance



Residential Property Price Growth



Source: Census and Statistics Department, Rating and Valuation Department, HKMA

INDONESIA

A mixed 2018 but be positive about 2019

2018 was again another rollercoaster year for Indonesia's financial markets, but growth was relatively composed. The currency depreciated to above 15,000 against the USD, the lowest since the Asian Financial Currency amid unfavourable external factors. However, the decline has been rather gradual and there has been some stabilisation back below the 15,000 handle towards the end of 2018. Meanwhile, GDP growth so far in 2018 has remained around the 5.0% level which is close to 2017 and not too far above potential growth which in turn helps to keep inflation in check. Indeed, inflation has so far remained moderate and we expect it to come out at around 3.2% yoy for 2018. The current account deficit may have widened but the government has been quick to react.

Going into 2019, we are expecting the situation to remain stable. The IDR may face some initial volatility early in the year but it should end the year much stronger as the USD strength turns. Growth is also likely to remain stable at 5.3% yoy. The government is also looking to narrow the fiscal deficit to 1.84% of GDP in 2019. The current account would probably narrow as the government measures come into full force. Any potential political uncertainty should recede after the presidential elections in April 2019.

Stable and robust growth

For the first three quarters of 2018, growth has remained fairly stable in the range of 5.00 – 5.30%. Consumption has been the main driver with the rate of growth going above 5.00% for both the second and third quarter of 2018. However, the silver lining in 2018 has been that investment growth has remained strong starting from a pick–up that begun towards the end of 2017. Government consumption has also been stronger in both the second and third quarter. We see growth in the fourth quarter should remain stable at 5.2% yoy without any significant changes. Hence, we expect overall growth in 2018 to probably average 5.2% yoy.

Going into 2019, consumption will probably remain the main driver growth amid support from increased expenditure building up to the presidential elections, increased government hand outs and moderate inflation at around 3.5% yoy. However, rising interest rates could eventually weigh down on consumption. Investment growth should still remain robust especially once any political uncertainty recedes. Government consumption is expected to strengthen especially if disbursement continues to remain effective. Recent government consumption data has shown that expenditure has become more robust (see chart 3). Our 2019 growth forecast of 5.3% yoy is above our estimates of trend growth at 5.0% and therefore, it may be prudent for the government to try to keep growth at such levels so as to avoid an overheating of the economy.

Narrowing the fiscal gap

The government is looking to strengthen their level of fiscal discipline as they work to narrow the fiscal deficit for 2019 to 1.84% of GDP. The assumptions for the budget are reasonable as they expect the IDR to average at 15,000 against the USD and growth to come out at 5.3% yoy in 2019. They also see the crude oil price to be at US$70 per barrel. Despite the fiscal deficit narrowing, the budget is not actually one of consolidation but in fact one of higher spending as overall expenses is expected to actually rise by 11% yoy whilst as a percentage of GDP, it may increase from 15.5% to 16.4%. However, the government will also work to raise revenue from 13.3% of GDP to 14.4% of GDP. Overall, this represents a step in the right fiscal direction as the government will now be increasing revenue to make available more cash for development.

More hikes in 2019 by Bank Indonesia (BI) is a possibility

At this point, we believe BI would likely undertake at least two hikes of 25bps for 2019. Growth may also be above trend and therefore, this provides some space for the hikes. Fed rhetoric has also become increasingly less hawkish and hinting strongly at a slowdown in the rate hikes from the current pace of 25bps every quarter in 2018 for the year ahead. BI has also reiterated that they would be “pre-emptive” and “ahead of the curve” in 2019 as they work to ensure IDR stability. The IDR could potentially face a more volatile period from February to April in the build-up to the presidential elections, but should stabilise once political uncertainty recedes.

Government measures to stabilize the IDR

The government has also unveiled a slew of measures in 2018 to stabilize the currency. Most of the measures are mainly focused on narrowing the current account deficit. Such measures include but are not limited to delaying power projects, implementing the B20 biodiesel measure, buying up the export quotas of private oil companies via Pertamina and etc. The central bank has also launched a domestic non-deliverable forward in 2018 that would be settled in local currency. The latest trade data though appears to be mixed at this point. The November trade shows that the growth of raw materials imports remains elevated at 15.6% yoy whilst growth of consumer goods imports still stands at 6.8% yoy. However, imports of capital goods have declined by 2.1% yoy. More time would probably still have to pass before the full effect of the measures sets in.

Presidential elections – who will win?

The 2019 election will see a rerun of President Jokowi facing off against Prabowo Subianto. Jokowi’s election platform highlights nine missions that include improving human development, improving government service and raising economic competitiveness among other items. Prabowo’s platform, titled “Fair and Prosperous Indonesia” is also looking at similar areas. Currently, at this point all major polls are showing that Jokowi is leading against Prabowo (see chart 4).

2019 would probably be a solid growth year for the country

The numbers for 2019 suggest another unspectacular year but actually point to the right direction. Growth remains on track and policy measures appear to be in the right direction. The government continues to work to narrow the fiscal deficit whilst having also already unveiled a slew of measures to try to narrow the current account deficit. This serious effort to address the twin deficits issue should hopefully help to bring more stability to the IDR. Both presidential candidates are also committed to drive hard at infrastructure development if they are elected. Hence, there is every reason to be positive going forward as the country puts in place policies to address short term vulnerabilities and set itself on a long term path of strong, sustainable and stable growth.

Chart 1: Contributors to GDP Growth, % yoy

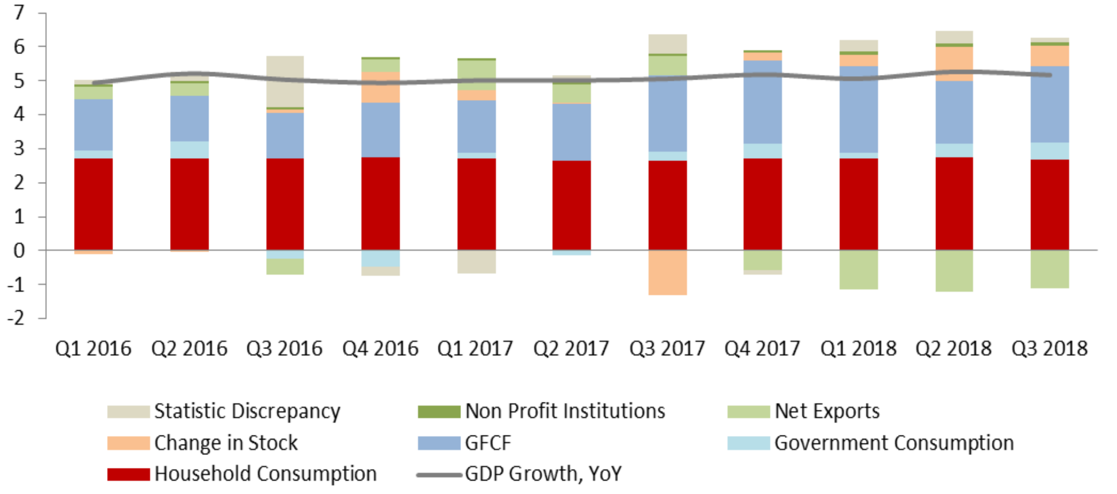
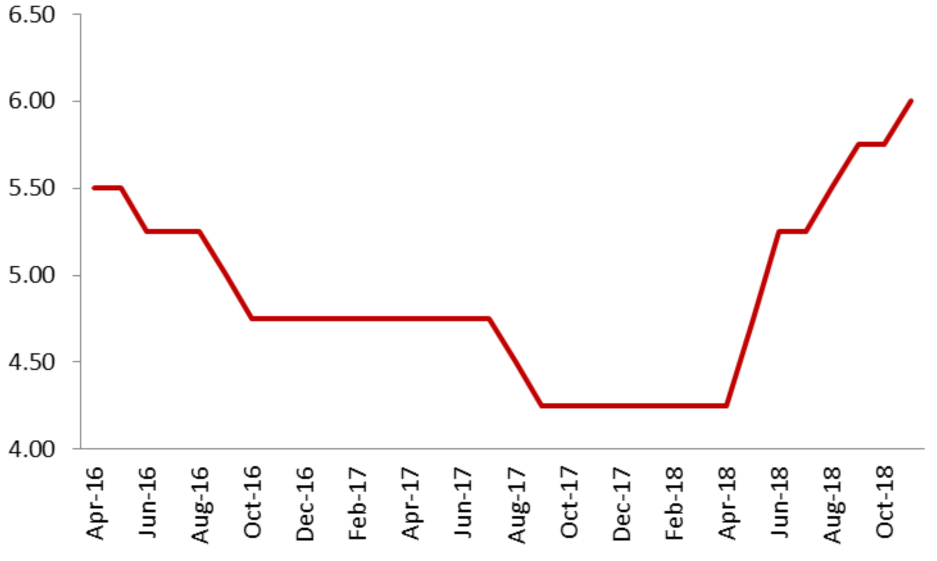


Chart 2: Bank Indonesia Benchmark Interest Rate, %



Source: Bloomberg, CEIC, BI, BPS and OCBC

Chart 3: Investment, Household Consumption and Government Consumption Growth, % yoy

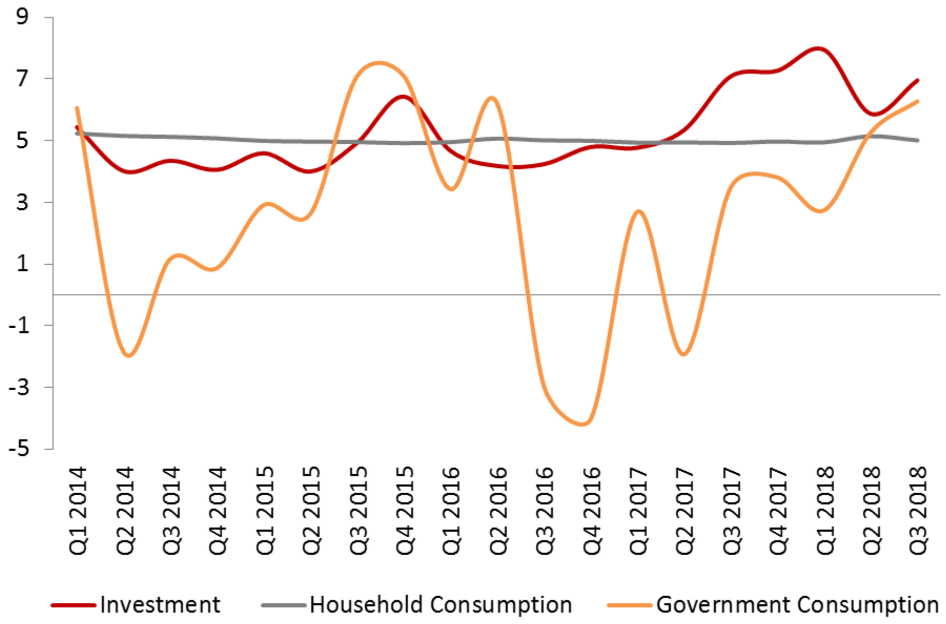
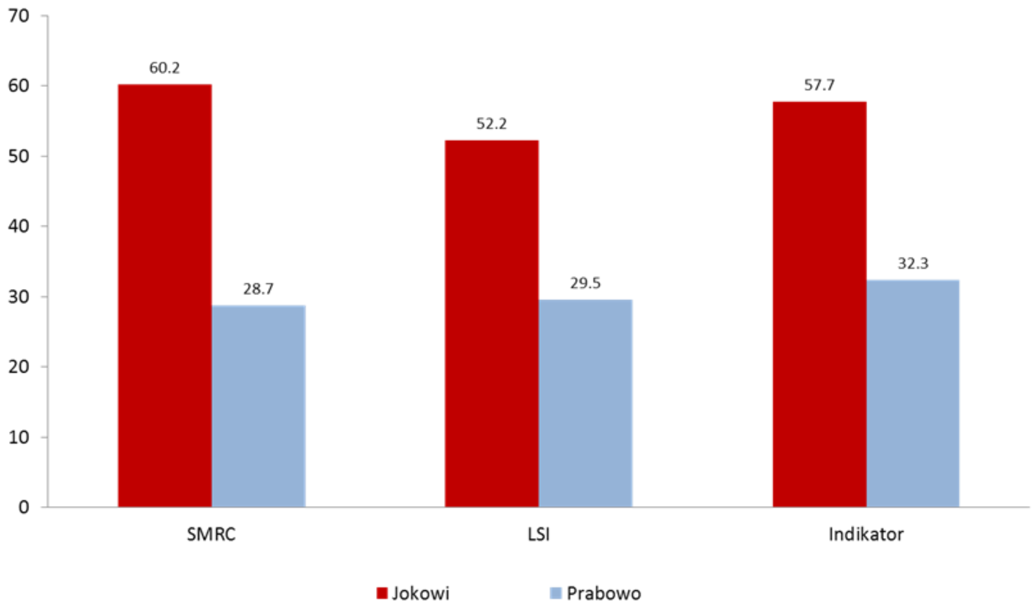


Chart 4: Polling of Indonesia Presidential Candidates



Source: CEIC, Various websites including polling and news sites, OCBC

MACAU

Hit from China's slowdown

Macau's economy has become increasingly adaptable as a result of China's ongoing anti-corruption campaign, thanks to the government's efforts in infrastructure improvement and casino operators' development of non-gaming businesses. Instead of over-reliance on VIP gaming, Macau's economy has gained momentum increasingly from recreational gaming and tourism activities. However, tourism and gaming, which are traditional services sectors, are still vulnerable to external shocks. As such, with China's economy slowing down gradually and the trade war looming over Asia's economic outlook, Macau's growth softened notably from 5.9% yoy in 2Q18 to 1.6% yoy in 3Q18, the weakest level since 2Q16.

During the first ten months of 2018, total visitor arrivals increased by 8.4% yoy, supported by the opening of a new mega project and Asia's benign economic growth. As such, exports of other tourism services grew for the ninth consecutive quarter by 11.4% yoy in 3Q18. Due to the resilient tourism activities, mass-market revenue registered double-digit growth for the fourth consecutive quarter and was up by 20.5% yoy in 3Q18.

Infrastructure improvement to only lend limited support to the gambling hub

With the long-awaited Hong Kong-Zhuhai-Macau Bridge started operation from late October, market players increasingly expects that infrastructure improvement will give boost to the slowing tourism and gaming sectors of Macau.

However, the new bridge only lured low-end package tourists and same-day visitors (+13.2% yoy) in October. Though Mainland tourists continued to grow, the number of tourists from Taiwan edged lower for the second straight month by 3.9% yoy while that from South Korea slid for the seventh consecutive month by 25.2% yoy in October. Worse still, overnight visitors' growth decelerated from 8.4% yoy during January-August to 7.5% yoy during January-October. The share of overnight visitors dropped from 55% in September to 49.1% in October, the lowest since February. Taken all together, it suggests that Macau's attractiveness to overnight visitors might have been waning probably due to some headwinds including a stronger MOP, China's slowdown and the increasing uncertainty over Asia's economic outlook economic outlook.

Moving ahead, as we expect the greenback to remain resilient till 2Q19, a stronger MOP against major currencies may continue to weigh on inbound tourism, tourist spending and gaming demand. Should the US-China trade war become a prolonged war and China's supportive measures turn out to be ineffective, the economic outlook of Asia including China will continue to weaken and in turn weigh down Macau's tourism and its gaming sector. In this case, recent infrastructure improvement linking Macau to Zhuhai and Hong Kong is unlikely to lend much support to either tourism or gaming activities.

Consequently, we expect the growth in tourism and retail sales to slow down in the coming quarters. During the third quarter of 2018, retail sales grew at the slowest pace since 2Q17 to 12.8% yoy while the sales of watches, clocks and jewellery also increased at the weakest rate since 3Q16 by 2.6% yoy. Meanwhile, gross gaming revenue is expected to expand by about 13% in 2018 but also slow to 2%-5% in 2019.

Economy growth to remain subdued

In a nutshell, we expect economic growth to remain subdued in the coming quarters. First, despite support from improved infrastructure, the tourism sector and the mass-market gaming could still slow down amid a stronger MOP, China's slowdown and Asia's muted economic outlook. Second, the VIP segment of the gaming sector is likely to be hit by China's slowdown, policy risks and higher borrowing costs. Third, the prolonged trade war may weigh down trade activities (exports of goods dropped by 8.8% yoy, the first decline since 4Q16) as well as consumer sentiment (private consumption growth softened from 5.9% yoy in 2Q18 to 4.1% yoy in 3Q18). Fourth, investment growth could stay sluggish amid the gradual completion of mega entertainment and infrastructure projects (private construction investment plummeted by 20.6% yoy while public construction tumbled by 45.7% yoy).

On a positive note, the government's plan to increase investment in infrastructure may provide a floor to the contraction of investments. In addition, with median monthly wage rising by 6.7% yoy in 3Q, private consumption may continue to grow albeit at a moderate pace. Hence, we expect GDP to grow by 5% yoy in 2018, but soften to 2%-3% yoy in 2019.

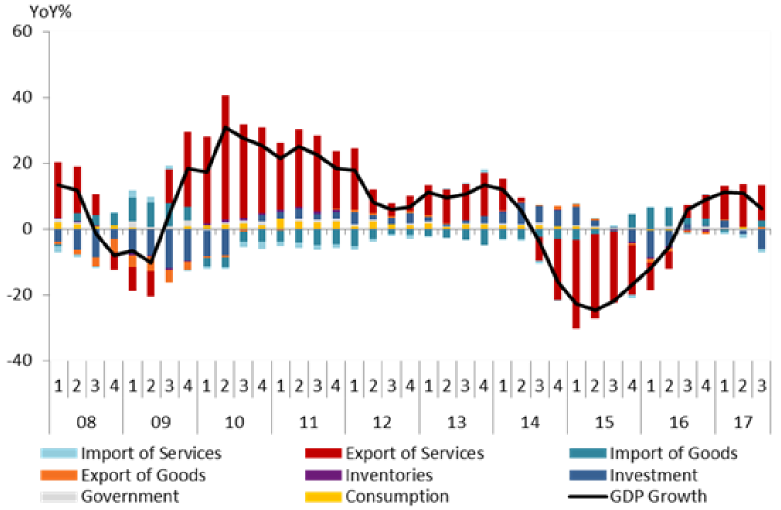
Housing market correction is likely but with limited downside

Housing transaction volumes dropped by 12.6% yoy or 29.9% mom to 581 deals in September, the lowest since February 2017. Due to the thin volume, housing prices might have been inflated. Average housing price rose for the fourth consecutive month by 6.3% yoy to MOP106,819/square meter. As supportive measures allow first-home local buyers (who took up 77.5% of total housing transaction in September) to borrow up to 90% of total property value, approved new residential mortgage surged by 244% yoy to a multi-year high of MOP9.67 billion in September.

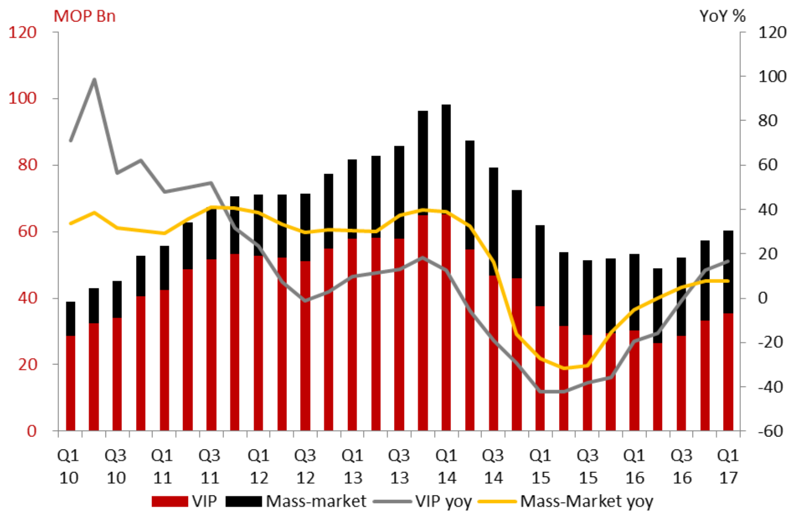
Moving ahead, we still expect housing transaction to remain sluggish and housing prices growth to soften due to several unfavourable factors. First, the wealth effect is subsiding amid stock market correction. Second, the tightened housing measures from this February have deterred speculative demand. Non-first-home local buyers only represented 22.5% of total housing transaction in September, much lower than 67.6% in February. Third, with all commercial banks kicking start the prime rate hike cycle in September, concerns about higher borrowing costs would suppress housing demand.

However, the downside for the housing market is likely to be capped due to two factors. First, supportive measures and the tight labor market may continue to prompt some potential homebuyers to enter the market. Second, housing supply has been increasing at a very slow pace with housing completion and housing start sliding 49% yoy and 52% yoy during the first nine months of this year. Housing prices growth may print 10% yoy by end of 2018 and 0%-5% yoy by end of 2019.

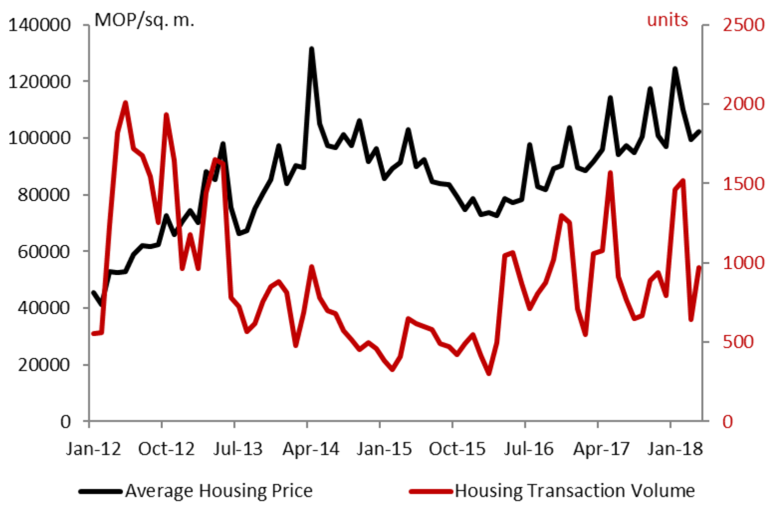
Macau GDP Growth



Macau Gaming Revenue by Segment



Macau Residential Property Market



Source: DSEC, DICJ, Financial Services Bureau

MALAYSIA

A transitional 2019 ahead

It has been a year of change for Malaysia as the elections in early May saw an end to the decades' old rule of Barisan Nasional to be replaced by Pakatan Harapan. Since taking office, Pakatan has been busy working to undertake fiscal reforms whilst at the same time, they have also reviewed the 11th Malaysia Plan to increase the focus on spreading growth throughout the country.

This year though has so far proven to be challenging for Malaysia as growth has slowed consecutively quarter after quarter. We see growth coming out at 4.5% yoy for 2018 but then to subsequently slow to 4.4% yoy for 2019. The government has also announced that the fiscal deficit for 2018 will be at 3.7% of GDP before moderating to 3.4% of GDP for 2019. The MYR has seen substantial weakening this year and despite dropping below 4.00 against the USD early in 2018, it hovers well above the 4.00 mark coming to the end of the year. Going into 2019, the government will now be facing a dual challenge of keeping the fiscal deficit in check and trying to sustain growth.

Challenges of growth

After a strong start in the first quarter for 2018 at 5.4%, growth subsequently slowed to 4.5% and 4.4% for 2Q 2018 and 3Q 2018 respectively amid supply shocks for both the LNG and palm oil sector. LNG production has been affected due to pipeline issues whilst crude palm oil output saw a weaker second quarter. Petronas has recently tried to assure that the Kebangan gas field will return to full capacity by August 2019. However, going into the final quarter, lower commodity prices can risk dampening the outlook even if production pick-up. Consumption would probably slow in the final quarter as consumers had likely frontloaded expenditure in the second and third quarter given the tax holiday. Hence, our expectations for slower growth at 4.5% yoy for 2018.

As mentioned, we see growth slowing to 4.4% yoy for 2019 amid the likelihood that global growth could weaken which in turn would result in subdued trade growth. Consumption would probably remain the main driver of Malaysia's GDP growth given stable labour market conditions, moderate inflation and continued government hand-outs (albeit reduced). Public consumption may slow as the government works to undertake fiscal consolidation. There are however upsides such as if LNG production pick-ups significantly, this could help elevate growth given the low base in 2018, although there is a possibility that lower commodity prices can offset gains (given that LNG prices are linked to oil prices). Also, the ongoing trade tensions between the US and China could see some production relocating to Malaysia and provide some lift to the economy although this still has to materialise. The government would also be returning the owed GST (goods and service tax) and income tax refunds which could help stimulate the economy although we believe that the effect would be limited given that it mainly goes to corporates whose appetite to invest would probably depend on their outlook of the economy.

Keeping the fiscal deficit at bay

Amid this weaker outlook, the government may be dealing with a challenging fiscal situation given the replacement of GST with SST (sales and service tax) and the need to return outstanding tax refunds. As mentioned, the government sees that the fiscal deficit will be at 3.7% of GDP in 2018 before moderating to 3.4% in 2019 and then subsequently 3.0% in 2020. In the medium term, they see it moderating to 2.5% of GDP. The previous administration had forecasted.

sees that the fiscal deficit to be at 2.8% of GDP in 2018 and to achieve a balanced budget by 2020. The current government though believes that it would be able to lower costs given the implementation of zero-based budgeting and open tenders. Furthermore, the government is looking to source for additional revenue such as raising the real property gains tax, stamp duty and gaming duties. New taxes such as a tax on online services imported by Malaysian businesses would also be introduced. Petronas will also be providing a special dividend of RM30bn to the government in 2019 which the latter claims will be used to fund the pay back of the owed tax refunds. Despite these fiscal developments, the rating agencies have still not changed their sovereign rating of Malaysia, but Moody's has downgraded the outlook of Petronas from stable to negative. Moody's though was the only agency to rate Petronas above the sovereign. Looking ahead, the fiscal situation would still have to be closely watched in 2019.

Bank Negara Malaysia (BNM) likely to stay pat

We opine that BNM may stay pat in 2019. Likely slower growth would mean that the central bank would want to avoid a rate hike if possible whilst the risk of a weak MYR would make a cut unfavourable. Inflation would also remain moderate at 2.0% for 2019, thus relieving the central bank of any pressure to raise rates. At this point, we see that holding the rate would be the most likely course of action for them, although we won't rule out a cut if economic conditions turn south. If there is pressure for a rate cut, it would probably come in 2H2019 as we believe that US economic outperformance should eventually dissipate and therefore provide some relief for EM currencies including the MYR. However, in the interim there may still be some volatility given the continued uncertainty in the ongoing trade negotiations between China and the US in the near-term.

Ride out 2019 first…….

As a small open economy, it will not be an easy year ahead for Malaysia given the global slowdown and the risk of worsening trade tensions. At the same time, the government is working to improve the public financial situation through various reforms. Therefore, it is best to view 2019 as the necessary year of transition amid unfavourable external uncertainty.

Chart 1: Contributors to GDP Growth, % yoy

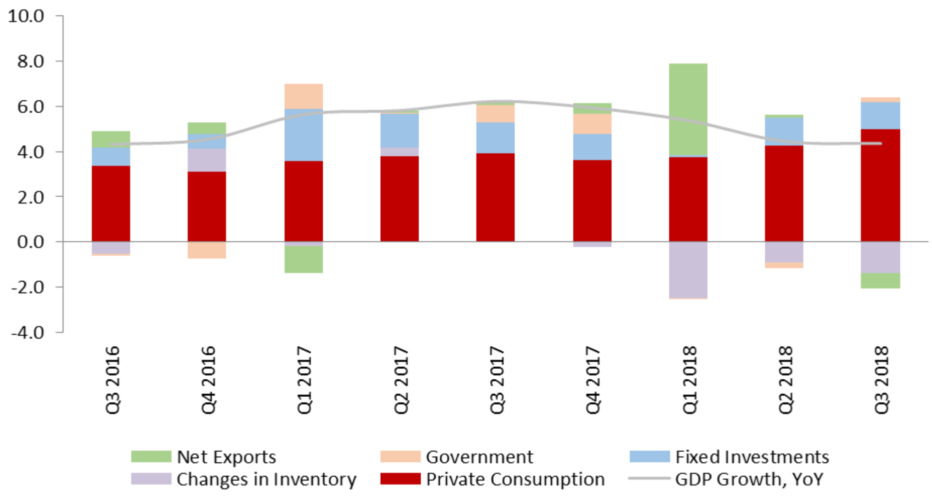
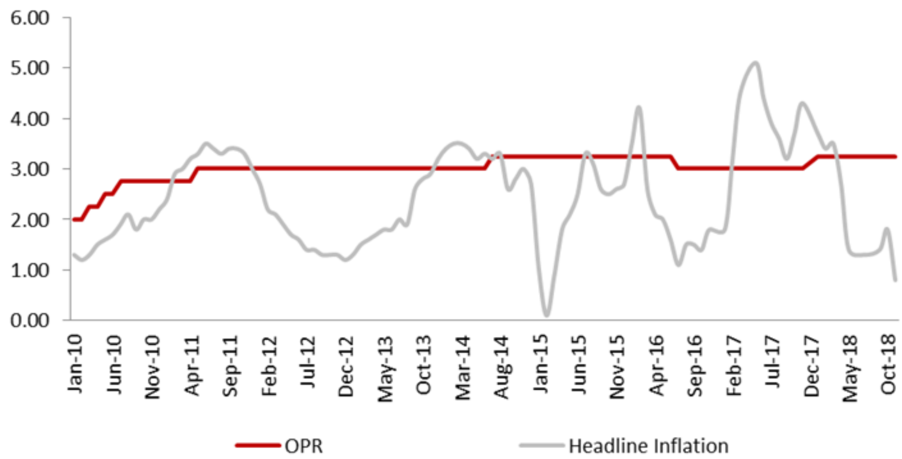


Chart 2: BNM OPR (%) and Inflation Rate (% yoy)



Source: OCBC, CEIC, BNM, Bloomberg, Department of Statistics Malaysia

MYANMAR

Long-Term Resilience

A year after the conflict in Rakhine State broke out, Myanmar is still struggling to resolve fundamental concerns relating to basic human rights as well as the repatriation and recovery of refugees who fled to Bangladesh. Global economic prospects are increasingly gloomy as uncertainty over trade rises. However, not all hope is lost for Myanmar. With the recent policy changes and investments in infrastructure from the Belt and Road Initiative (BRI), Myanmar is forecasted to enjoy a robust economic growth from a regional and global standpoint.

GDP growth: Moderate yet robust

Global economic prospects have darkened amid the escalating US-China trade tensions and the global GDP growth is forecasted to grow at a moderate pace of 2.9% in 2018 as compared to 3% in 2019. Moving into 2019 with a potentially more volatile global trade environment, Myanmar's 6.2% forecasted economic growth for 2019 is regarded to be robust.

Fiscal Outlook: Execution and sustainability challenges

The budgeted fiscal deficit was 5.8% in 2017/18, but the actual was below the target at 2.7%. Since 2013/14, the top 10 spending ministries did not fully spend the allocated budget. The consistently underspent budget reflects budget execution challenges. The approved budget deficit increased for 2018/19 to 6.0% but given the inefficiency in budget execution, the actual deficit is predicted to be lower at 4.0%.

Between 2016/17 to 2017/18, government revenue dropped from 18.2% to 16.5%. Government revenue, as a share of GDP, has been declining and is expected to further decline by 1% in 2018/19. The dwindling percentage of revenue to GDP is a result of both the decline in revenue of the State Economic Enterprise (SEE) and the Union Government (UG). SEEs suffer from a decline in competiveness in an increasingly competitive market while UG bears the brunt of the fall in oil and gas royalty payments. Thus, the consolidated government revenue is predicted to further decline.

Government expenditure between 2016/17 and 2017/18, as a share of GDP, fell from 20.9% to 19.2% due to limited spending capacity. Considering the consistently underspent capital budget, the 2018/19 budget allocated more funding towards capital spending, namely in the education, health and energy sectors. Capital expenditure is budgeted to increase to 6.0% in 2018/19 from 4.3% in 2017/18 while recurrent expenditure remains relatively stagnant. With the new budget, government expenditure is predicted to increase.

Declining government revenue and increasing expenditure are projected in 2018/19. Hence, the fiscal deficit is forecasted to grow. Fiscal sustainability is a concern given Myanmar's inflationary pressures.

Monetary Policy: Inflation to accelerate

In August 2018, inflation soared to 8.2% year-on-year, the highest increase in two years. To curb inflation, the government started to restrict direct central bank financing and paid for the fiscal deficit through issuing domestic treasury bills and bonds instead. Direct Central Bank financing fell from 51% in 2016/17 to 19% in 2017/18, which is ahead of the 20% target by 2019/20. In the same period, the Treasury bills and bonds financing increased from 49% to 81%. The change in the main financing source for the government deficit helps the Central Bank better manage monetary aggregates growth, which is critical to price stability.

Despite reducing the reliance on Central Bank to finance the budget deficit, inflation is projected to climb from 5.5% in 2017/18 to 8.8% in 2018/19. Exchange rate pass-through and increasing food prices are the main drivers of expected inflation. From August to October 2018, the kyat depreciated substantially by 18% against the USD. The Federal Reserve is on a sustained policy normalization path, which coupled with Myanmar's persistent current account deficit, saw the kyat facing strong depreciation pressure. Food and beverage form close to 60% of Myanmar's Consumer Price Index. Seasonal flooding and the sharp depreciation of kyat resulted in an increase in the price of rice and cooking oil between April and August 2018 as compared to the same period in 2017, by 11.4% and 10.1% respectively. Given global inflationary factors and the characteristics of Myanmar's economy, inflation is expected to continue climbing in 2019.

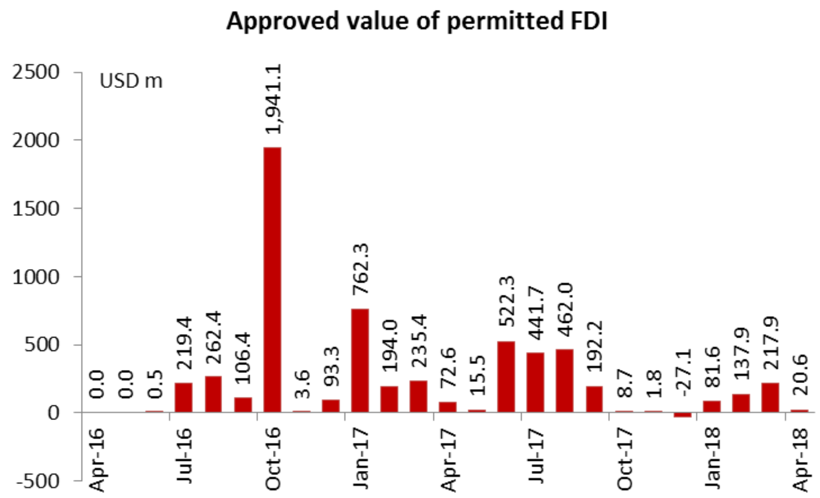
Policy reform: Effective implementation can boost investments

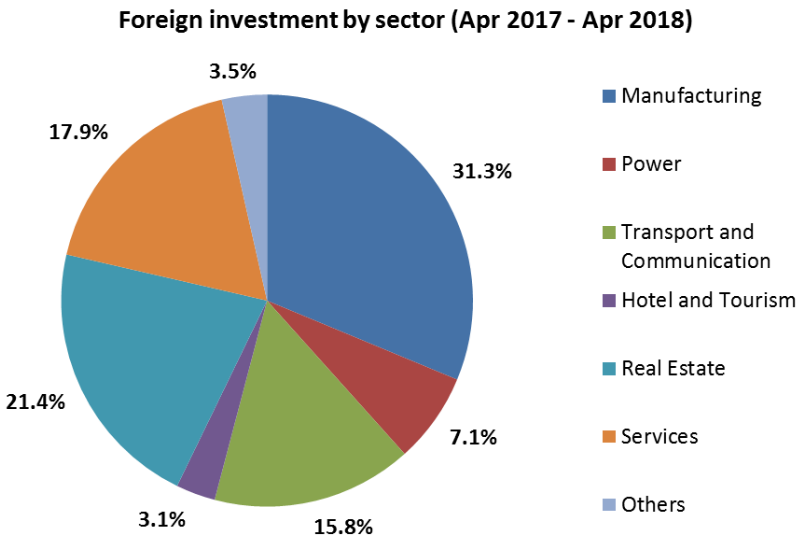
In a bid to attract Foreign Direct Investment (FDI), the Ministry of Commerce has removed the restrictions on foreigners to engage in retail and wholesale businesses from May 2018. Since August 2018, the new Myanmar Companies Law was in place. The law permits foreign ownership in local companies up to 35%. These reforms were expected to improve efficiency in Myanmar, through the promotion of competition.

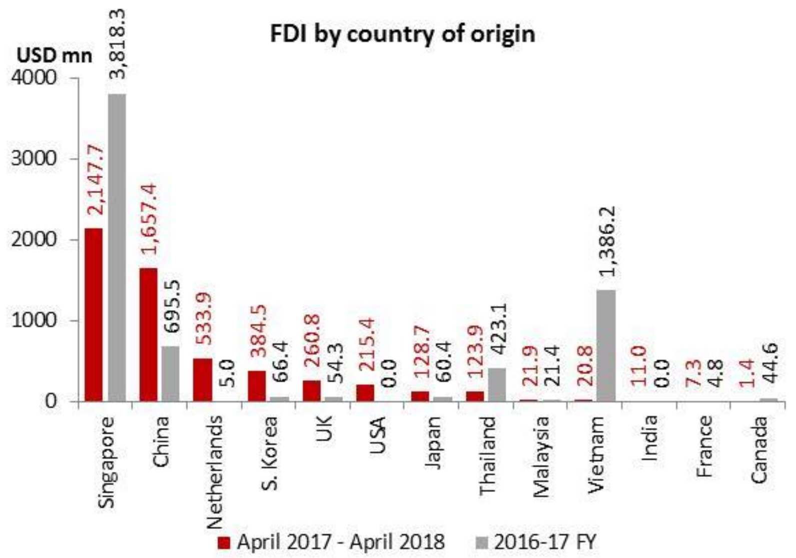
As part of China's BRI, Myanmar and China signed a framework agreement on November 8, 2018. The agreement includes an investment of $1.3 billion for the Kyaukphyu deep-sea port project's first phase of implementation. The cost of the project, projected to be in four phases, is estimated to be $7 billion. The second BRI project includes the construction of the Muse-Mandalay railway line. These BRI projects can help to improve connectivity within Myanmar and with the region, and have the potential to achieve positive spillover effects on trade opportunities if barriers on trade facilitation are overcome.

Conclusion: Window of opportunity

In a less favourable global economic environment, Myanmar faces higher macroeconomic volatility. Triggered by global factors, the Kyat depreciated steeply. Coupled with higher food prices, inflation is soaring. However, Myanmar may be on the road to recovery. Moving forward, the government begins to diversify their financial sources in an attempt to nip inflation in the bud. New opportunities are expected to emerge with the recent policy reforms, which includes the liberalization of foreign investments in Myanmar. FDI is expected to grow with the execution of BRI related projects. Overall, Myanmar is still projected to experience a robust recovery, despite the global slowdown in trade looming in the background.







Source: Bloomberg, CEIC, OCBC Bank

PHILIPPINES

Driving growth in the face of a global slowdown

2018 has not been an easy year for the Philippines as the government had to deal with the challenges of slowing growth, elevated inflation, widening current account deficit and a volatile PHP amid global uncertainties. In the face of all this, the government has continued to push ahead with its “build, build, build” program to transform the country’s infrastructure. Inflation had hit 6.7% in October, the highest since 2009, before easing for the first time in eleven months to 6.0% in November. This though exceeds the central bank’s annual inflation target of 2-4% until 2020. The BSP’s inflation forecast is for 3.5% in 2019 and 3.3% in 2020. Going into 2019, the Philippines may again be navigating difficult waters amid the risk of a global slowdown and further protectionist sentiments setting in. The BSP will also probably feel the pressure to continue to raise interest rates as they try to rein in inflation. Overall, we tip GDP growth at 6.2% yoy for 2018 before slowing marginally to 6.1% yoy in 2019.

Weakening external sector may continue to weigh in

Private consumption continued to be a key driver of growth so far in 2018 with the first half of the year seeing higher growth although it has slowed to 5.2% yoy for the 3Q 2018. However, the economy continues to mainly be supported in 2018 by high government expenditure and investments as the current administrative pushes ahead with the “build, build, build” program to develop the country’s infrastructure. Net exports though have significantly weighed on the economy as exports growth slowed amid a growth moderation in electronics components. Meanwhile, imports growth continues to be driven by strong private consumption and the infrastructure spending of the government.

For 2019, the Philippines economy will continue to remain supported by the heavy public spending and strong investment growth as the government drives ahead with the implementation of the infrastructure programs. Private consumption would probably remain strong supported by continued inflows of remittances and a steady labour market although there are inflation risks. Export growth is likely to continue to remain slow amid a global slowdown.

Fiscal deficit as the government pushes ahead with development

The fiscal deficit is expected to continue in the range of 2.5 – 3.0% given the ambitious infrastructure push. However, in the short term, tax reforms could probably help bolster revenue. That said, the level of actual spending will really depend upon the level of progress made on the infrastructure projects. The budget may also face some downside risk from increased expenditure due to the reconstruction of Marawi or additional security spending.

BSP likely to tighten further in 2019

For 2018, the central bank has increased the benchmark rate by about 175bps since May as they attempt to rein in on inflation and stabilize the PHP. Furthermore, US interest rate normalization, strong US economic performance and the trade war had weighed on the PHP, given that the Philippine runs twin deficits. In fact, BSP has forecast that the current account deficit will widen further to 2.3% of GDP in 2019 (the most since 2001), which may underscore the pressure on the PHP. President Duterte’s 9 trillion peso infrastructure plan is likely to keep imports elevated and pressure the current account deficit. Going forward into 2019, we expect the BSP to undertake further tightening in the 1H 2019 as they try to bring back inflation into their 2 – 4% target range.

2019 would likely not be an easy year

Going into next year, the Philippines will continue to face the challenge of a slowdown in global economic activity and trade. The PHP as mentioned would remain vulnerable given that the country is in a twin deficit situation. Inflation should recede slightly if commodity prices remain weak and food supply improves although pressures may come from the economy growing above trend. Overall, it would be no easy year for the Philippines in 2019.

Chart 1: Contributors to GDP Growth, % yoy

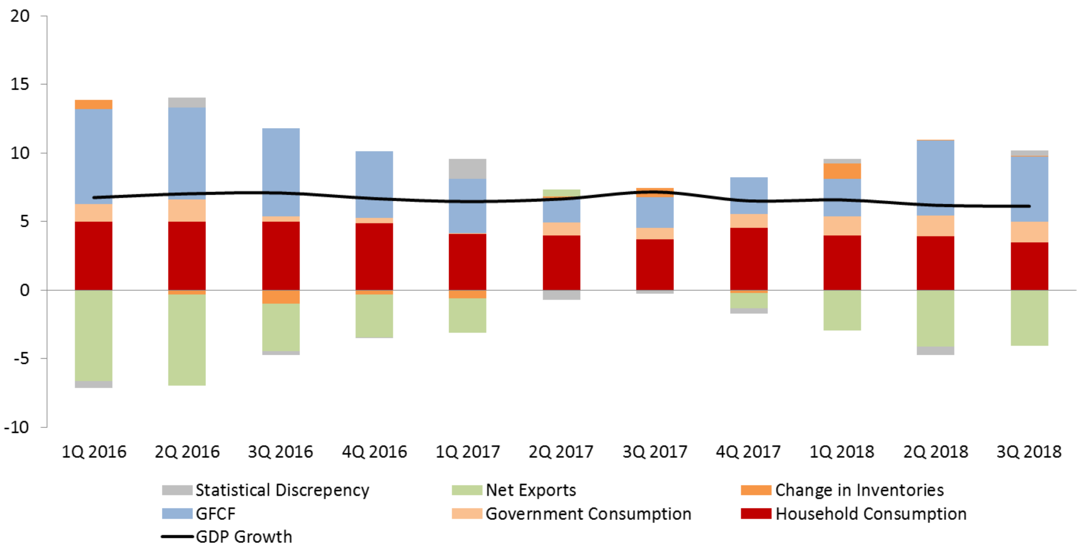
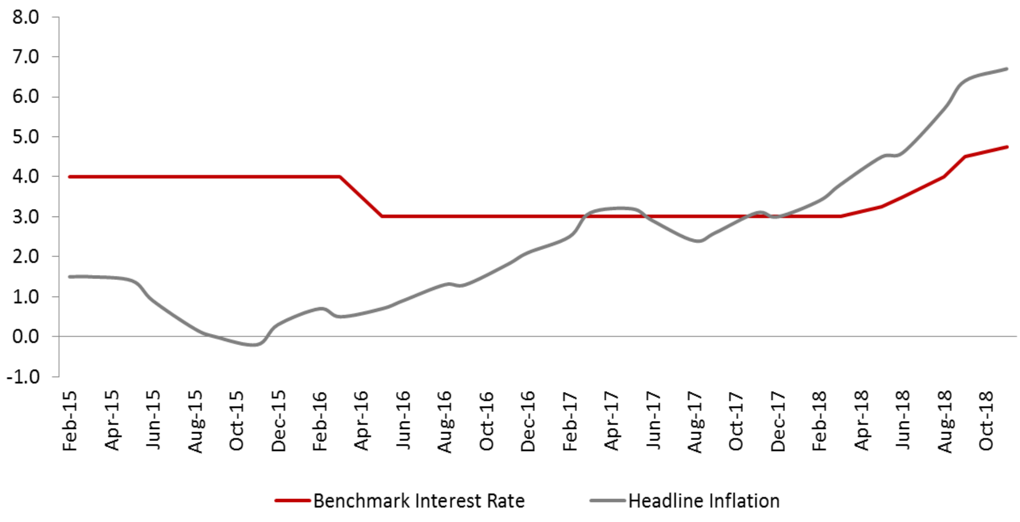


Chart 2: BSP Benchmark Interest Rate (LHS), % and Inflation Rate (RHS), % yoy



Source: Bloomberg, CEIC, OCBC

SINGAPORE

More changes afoot for 2019

2018 GDP growth has exceeded expectations, mainly due to a fairly resilient manufacturing performance.

Despite much ado about the slowing global manufacturing cycle, especially for electronics and further exacerbated by fears about the escalating US-China trade war, 2018 has turned out to be relatively benign in terms of overall GDP growth. Manufacturing growth was stellar in 1H18 (1Q18: 10.8% yoy and 2Q18: 10.7% yoy versus 2017 full-year growth of 10.1%) and decelerated in 3Q18 to 3.5% yoy, but remained the main outperformer for the year. Services growth also began 2018 on a strong note with 4.0% yoy in 1Q18 before decelerating to 2+% for 2Q-3Q18 as momentum moderated for finance & insurance, information & communications, whereas accommodation & food services picked up speed.

This prompted the official GDP growth forecast to be narrowed from earlier 2.5-3.5% yoy to 3-3.5% yoy upon the release of the revised 3Q18 GDP growth estimates. This is in line with our expectations for 3.4% yoy. With the first three quarters already standing at a relatively robust 3.6% yoy, any moderation in 4Q18 is likely to be accommodated as outward-oriented sectors like manufacturing and finance & insurance should continue to expand by at a more modest pace. The choice of a 1.5-3.5% forecast range is also appropriately neutral compared to say a hypothetical 2-4% (which would imply 2019 upside risks beyond the upper limit of the 3-3.5% growth range in 2018) or even 1-3% (whereby the lower floor would herald a more immediate downshift in momentum from here). The latest MAS Survey of Professional Forecasters Survey (SPF) also tipped 4Q18 GDP growth at 2.4% yoy and 2019 growth at 2.6% yoy (range: 2.5-2.9%) which is a marginal downgrade from the 2.7% forecast in the previous survey three months ago.

We see 2019, especially 2H19, as potentially posing a more challenging growth trajectory, mainly arising from the expected US growth moderation (note that fiscal stimulus will fade and monetary policy is tightening further, potentially to neutral or slight beyond neutral settings), while weaker demand conditions in the global semiconductor cycle and moderation in growth in key markets including ASEAN may dampen activity in wholesale trade, transportation & storage and finance & insurance sectors. Note IESingapore also revised its 2018 NODX forecast to 5.5-6.0%, but tips 2019 at 0-2% yoy. The external demand outlook is likely to be slightly weaker in 2019, with the manufacturing sector to see a more modest expansion. The often cited downside growth risks stem from a further escalation of trade conflicts and a faster-than-expected tightening of global financial conditions, and are not new per se. However, the full impact of these two familiar headwinds may have reached a turning point and potentially subside into 2019.

What poses the biggest upside and downside risks to the 2019 macroeconomic backdrop?

Unsurprisingly, the downside risks identified for the Singapore economy going ahead are trade protectionism (100% of respondents versus 89% three months ago), higher interest rates (41% versus 37%) and China slowdown (41% versus 37%) given that the MAS SPF was conducted prior to the 90-day ceasefire agreement for US-China trade tensions. Interestingly, the perceived upside risks were easing trade tensions (47% versus 37%), US monetary policy (29%) and regional trade and investment (29%). Towards December 2018, the key turning points for financial markets were twofold in our view, namely that the US-China have called a 90-day ceasefire agreement on fresh tariffs pending negotiations and that the Fed rhetoric has also turned somewhat more cautious, particularly from Fed chair Powell amid US president Trump's criticism of the Fed's rate hike strategy, with the latest being his comment that "I think that would be foolish, but what can I say". If the US-China trade war de-escalates further into 2019 and/or the Fed contemplates a pause in its quarterly rate hike cycle, this could prove to be tailwinds for market sentiments if not the global economy.

Domestic sentiments have peaked and may continue to soften into 2019.
Both the manufacturing and electronics Purchasing Managers Indices (PMIs) likely peaked at 53.0 in March 2018 and 53.6 in September 2017 respectively for the current cycle. They have eased to 51.5 and 49.9 (contraction territory for the first time since July 2016) respectively in November 2018. Still, the Nikkei Singapore PMI continued to pull higher for a third straight month from 52.6 in October to a 5-month high of 53.8 in November 2018, suggesting that the private sector was benefiting from a favourable demand environment due to new contract wins, promotional work and improved market conditions, especially from the Asia-Pacific region. Input buying also rose at the sharpest rate since April, which coupled with supply chain pressures, contributed to higher purchasing prices. Adding to this pressure was a sharp hike in staff costs amid reports of higher commission and overtime pay outs which consequently prompted firms to raise prices at an accelerated rate. At this juncture, it is unclear how upbeat the private sector economy may sustain into 1H19.

The labour market remains a domestic anchor of stability.
The overall unemployment rate has ticked slightly higher to 2.1% in 3Q18, despite the employment surging 16,700 workers (excluding foreign domestic workers) which is more than double the 6,500 in 2Q18 and marked the highest since 4Q14. However, hiring conditions may soften slightly going ahead. The ratio of job vacancies to unemployed persons has dipped from 1.10 in 2Q18 to 1.05 in 3Q18, while labour turnover has also eased in terms of both recruitment and resignation rates over the course of 2018 and this could suggest some caution in hiring intentions. The re-entry rate for retrenched residents within six months also declined over the quarter, due to those previously employed in clerical and production & related jobs. Job opportunities remain concentrated the services sector and mainly in key higher-skilled industries such as professional services, information & communications, community, social and personal services, and financial & insurance services. Employment prospects saw notable improvement for PMETs which had accounted for the bulk of the increase (+7,600) in job vacancies for 1Q-3Q18, with the remainder (+2,600) from non-PMETs, namely construction (+1,900). While short-term wage inflation is likely to be sustained, nevertheless the dispersion across sectors may differ.

Still watching for inflation, especially core inflation for now.
In our 2018 outlook, we had highlighted that "the domestic inflation trajectory remains contained" as "external inflation sources also generally remain benign, despite the uptick in global crude oil prices" and "there are no broad-based increases in demand-led price pressures". To recap, our view one year ago was that "the window remains open for MAS to adjust its policy stance in 2018 (either April or October) even if core inflation remains stable in the 1-2% range for 2018, namely because monetary policy operates with a long time lag and policymakers prefer to be pre-emptive rather than reactive" and "the move should be seen as a normalisation of sorts to adjust the neutral SGD NEER policy band to a modest appreciation slope which is likely to be at a more gradual gradient than pre-GFC (ie. <2% appreciation p.a.)". True enough, core inflation has been relatively well-behaved this year and is expected not to deviate from around the 1.7% yoy handle for 2018. MAS also proceeded to normalise the S$NEER by twice steepening the gradient from neutral settings.

Official rhetoric suggested since then there has been no change to the official inflation projections from October monetary policy statement (MPS). This suggests that recent incoming economic indicators have not tilted the balance as far as the official comfort zones are concerned. Still, the headline and MAS core inflation are expected to climb to 1.3% yoy and 1.8% yoy respectively in 2019, compared to 0.5% and 1.7% respectively from the 2018 forecasts according to the latest MAS SPF. Our crude oil price view, despite the volatility in 2018, remains fairly benign into end-2019 at US$65 and US$70 per barrel for WTI and Brent respectively. However, given Singapore's reliance on trade, it is susceptible to imported inflation from its trading partners as Singapore run trade deficits with both China and US who are among the top three trading partners. Notwithstanding the current 90-day hiatus on fresh tariffs pending US-China negotiations, a worse-case scenario (albeit of a lower probability now) where US escalates to 25% tariffs on all US$505 billion of Chinese imports could spillover and impact Singapore's headline inflation.

In addition, the domestic inflation angle cannot be discounted completely. Overall unit labour cost has climbed from -0.6% a year ago to +1.6% in 3Q18, and given the relative resilience of the domestic labour market and slower productivity growth (value added per worker rose at a more muted 1.2% in 3Q18 versus 5.9% yoy a year ago), this bears watching going out into 2019 should the tight labour market conditions feed into wage inflation and in turn to consumer prices.

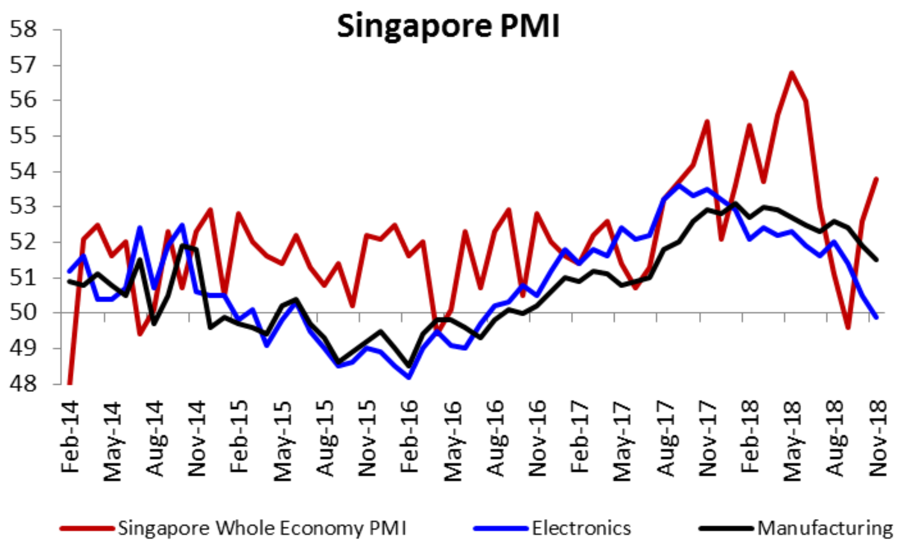
2019 Budget expectations – a continuation from the 2018 budgetary themes?

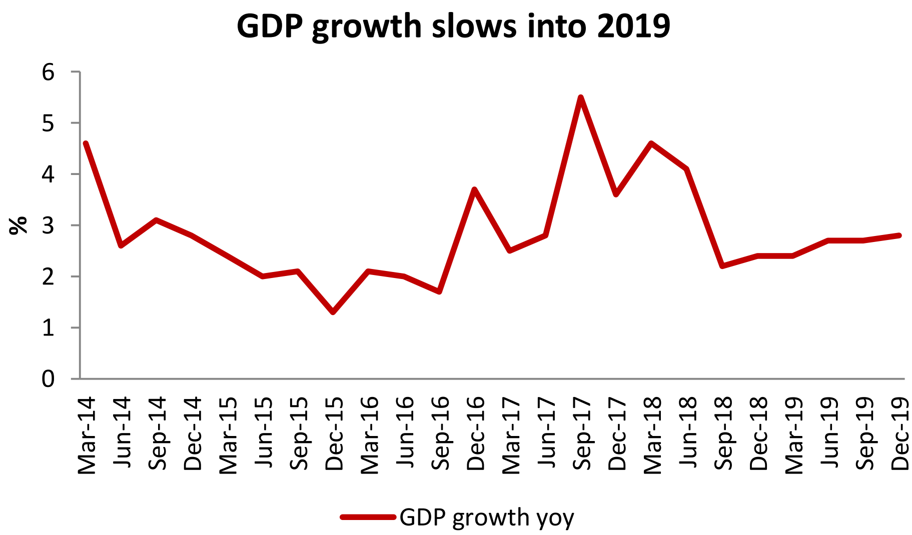
Given that elections may come earlier than expected and there are no clear signs of significant overheating in the Singapore economy, fiscal policy settings in the 2019 Budget are unlikely to be overly restrictive either. PM Lee has hinted that the Cabinet reshuffle will be announced sometime after the 2019 Budget. Finance Minister Heng had said in an interview with Bloomberg that "our priority areas remain for economic restructuring" and "the other big area is looking at infrastructure development" with urbanization being a major trend in Asia. He also opined that "we should not be planning on the basis of just year to year, but we need to take a longer-view of some of our needs". Our view is that the major budgetary themes will not deviate too much from the 2018 schemes to support continuing education and training including SkillsFuture, capability building, especially for SMEs and digitalisation, enhancing productivity and innovation, and broadening the social and community support schemes for education, healthcare and special needs, while emphasizing the need for medium-term fiscal sustainability. The 2018 budget had planned for a small deficit of $0.6 billion.

Whither interest rates and MAS monetary policy settings in 2019?

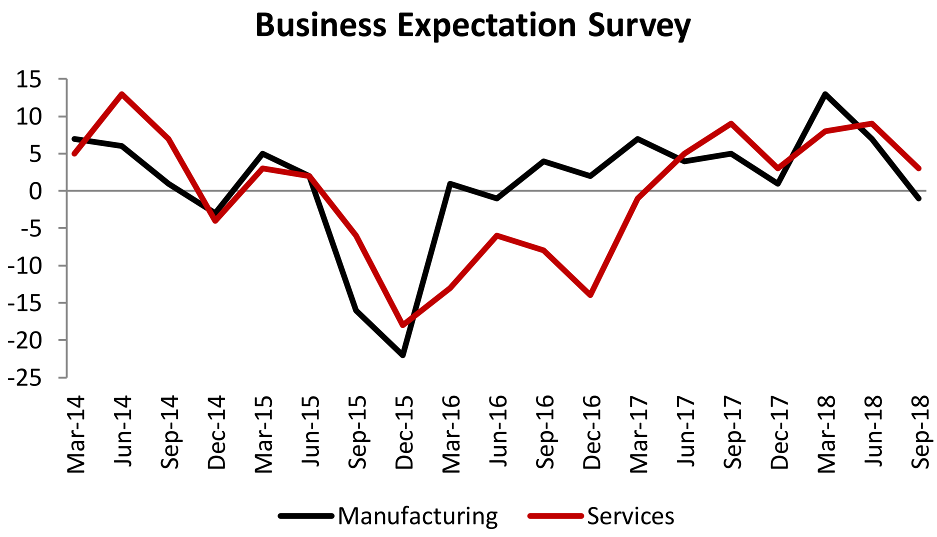
Going forward, we expect local rates to continue to play catch-up to the USD rates, notwithstanding that the MAS has already tightened monetary policy twice this year. We tip the 3-month SIBOR and SOR to ascend further to around 2.3% region by end-2019, up from 1.77% and 1.93% respectively on 13 December 2018. This is predicated on the FOMC delivering another two to three hikes in 2019. In comparison, the MAS SPF also tips the 3-month SIBOR to end 2018 at 1.85% (a tad higher than the 1.81% expected three months ago) and to climb higher to 2.31% by end-2019.

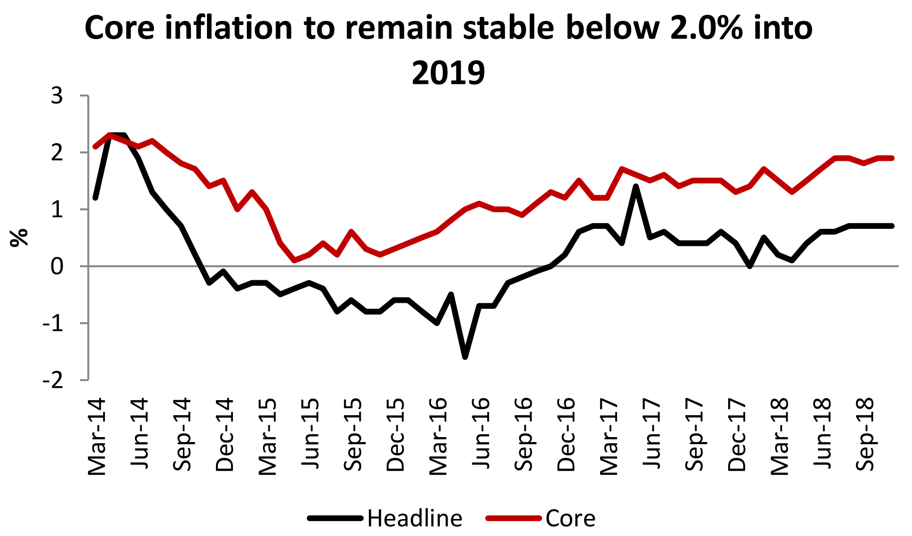
MAS may remain on a tightening bias given the inflation dynamics that will play into 2019 on the back of administrative prices adjustments (eg. public transport fares) and the tightening domestic labour market (given no short-term plans to lift foreign worker curbs and a still elevated wage growth trajectory), but the timing between the April and October 2019 MPS remains fluid at this juncture.





Source: Bloomberg, OCBC Bank





Source: Bloomberg, OCBC Bank

TAIWAN

The local election result could be positive for growth

The Taiwanese economy remained resilient in the first half of 2018 growing by 3.2% yoy on the back of steady domestic demand and supportive external demand. However, the economy decelerated to 2.27% in 3Q as a result of high base effect and negative contribution from the external demand was partly attributed to the spill over effect from the escalating US-China trade war. Private consumption decelerated to 1.8% yoy in 3Q from 2.4% yoy in the first half. Although gross capital formation rebounded in 3Q up by 5.4% fastest growth since 4Q 2013, the sharp decline of net export weighed down the economic growth in 3Q. The external uncertainty is likely to drag the growth down further in 4Q even though private consumption may stabilize around 1.8%. As such, we expect 4Q growth to slow further to below 2%. For the whole year of 2018, Taiwan's growth is likely to decelerate from 3.07% in 2017 to about 2.6%.

Looking ahead, private consumption is expected to remain stable in 2019 for two reasons despite the negative wealth effect from the recent sharp correction of equity market. First, the recent sharp decline of oil prices is likely to boost demand for durable goods. Second, although consumer confidence softened due to weaker global outlook, the steady wage growth may provide the floor to the consumption growth. As such, we expect private consumption growth to stay above 2% in 2019.

Capital formation could be another supporting factor to growth in 2019. The landslide victory of opposition KMT in the latest nine-in-one local election has sent the warning signal to the current Tsai Administration. We think this may be one of the catalysts for President Tsai to roll out more fiscal measures in 2019 to support the domestic economy ahead of the Presidential election in early 2020. Meanwhile, Taiwan's increasing engagement in foreign direct investment and relocation of some Taiwanese operation from Mainland China back to Taiwan suggest that capital formation is likely to stay robust in 2019.

Against the backdrop of stable inflation and capital formation, the outlook of Taiwan's economy will hinge on the global outlook as well as the development of US-China trade war. Given the global economy is expected to slow down in 2019 and uncertainty about the US-China trade war remains despite the 90-day truce, we expect Taiwan's international trade to slow down significantly. The impact of trade war on the regional supply chain is expected to be prolonged. This may have lasting impact on Taiwan's economic growth. Overall, we expect Taiwan's growth to slow down slightly in 2019 to about 2.4% from estimated 2.6% in 2018.

"Politics and economic should not mix"

The victory of KMT in the latest nine-in-one local election raised the hopes that the cross straits relationship may turn warmer again. In particular, the rejection of the referendum by majority Taiwanese to change the name from Chinese Taipei to Taiwan for the upcoming Tokyo Olympics removed an imminent risk for the escalation of cross straits tension.

The victory of KMT candidate Han Guo-yu in Kaohsiung, a DPP stronghold, has attracted global interest. His slogan to make Kaohsiung the richest municipal city in Taiwan and his latest support to Taiwan's bread master Wu Pao-chun who caught in the cross fire between Chinese netizens and Taiwanese netizens on 1992 consensus are a welcome sign that Taiwanese local leaders are likely to focus more on the economic development rather than politics. As mentioned by Mr. Han that politics and economics should not mix. His ambition to develop the regional economy is positive for the growth outlook in our view. The latest news shows that Kaohsiung's tourism industry has benefited from Mr. Han's victory with a high hotel occupation rate for the year-end being reported.

The hype to disconnect the politics from economy may bring some medium term supports to Taiwan's growth in 2019.

THAILAND

A mediocre year ahead?

As her major ASEAN peers embarked on a tightening path in 2018, the Bank of Thailand (BoT) initially bucked the trend and stood out as the exception holding out its benchmark rate at 1.50% throughout most of 2018 as the economy grew on a steady path. Inflation had remained subdued and up until November, it only averaged 1.13% whilst the THB had weakened much less than other regional currencies. Growth had also been strong during the first half of the year before a slowdown in the third quarter. Eventually, though, the central bank made a move to hike in December 2018 given concerns about financial vulnerabilities.

Going into 2019, just like for other open ASEAN economies, it may not be a straightforward year for Thailand. The global economy looks set to take a less positive direction next year and Thailand without doubt would be affected. The country would also be facing elections next year that are expected to be held in February and thus add to some political uncertainty.

Expect slower growth

Growth in 2018 started off strongly at 4.9% yoy in 1Q 2018 before slowing to 4.6% yoy in 2Q 2018 and 3.3% in 3Q 2018. Private consumption was the main driver of growth as it accelerated over the three quarters from 3.7% yoy for 1Q 2018 to 4.5% yoy for 2Q 2018 and 5.0% yoy for 3Q 2018 with consumer confidence being stronger than the previous year. Meanwhile, government consumption has been more stable in 2018 and grew at around 2.0% for the first three quarters. Exports grew strongly in the first half of the year but experienced a decline in the third quarter as deliveries to China slumped. However, investment growth was strong and stable throughout 2018 in the range of 3.0 – 4.0%. For the entire year in 2018, we still though see that growth would most probably average 4.3% yoy despite the recent slowdown.

Going forward into 2019, we have to be more wary of the external sector amid slower global growth and escalating trade tensions. Investment may continue to be supported strongly by government infrastructure projects although private investment could eventually pick up once any election-related political uncertainty recedes. Private consumption, however, on the hand may also still be weighed down by elevated household debt levels and weak wage growth. Overall, we see growth for 2019 coming out at 3.9% yoy.

BoT likely to hold for 2019

The BoT as expected undertook a 25bps hike in December as they look to try to "curb financial stability risks and to start building policy space". As a note, the household debt stood at 77.5% of GDP as of end 2Q 2018. However, they also appeared at the same time to be rather neutral. The central bank had mentioned that "prolonged low policy rate had contributed to the economy expanding at the level consistent with its potential and the inflation rate". Hence, at this point, we don't anticipate any further rate hikes in 2019.

Fiscal space is still available

The fiscal deficit is expected to be lower at 2.8% of GDP for 2018 and to further narrow to 2.5% of GDP for 2019. However, the government still has sufficient fiscal space even if the budget was to remain expansionary. Public debt to GDP stood at 41.72% of GDP as of

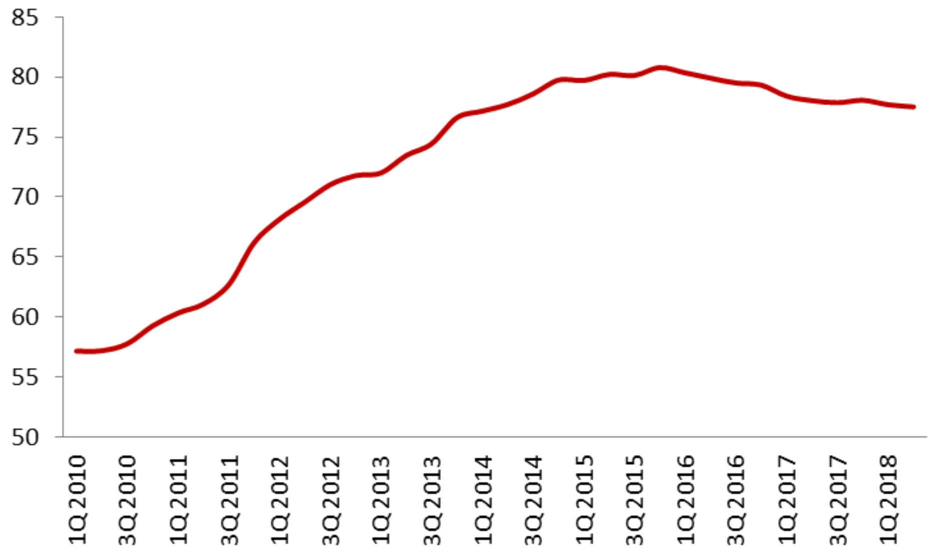
October 2018 (as reported by the government) and it is still well below the 60% of GDP limit as set in the sustainable fiscal framework. Hence, there is still plenty of fiscal space for the government to increase investment if it wished to, albeit they had previously stated that they are aiming to keep the public debt to GDP ratio at no more than 50%.

Not a walk in the park

Just like any other open and trade-dependent economy, Thailand would naturally find its growth vulnerable in 2019 to an anticipated global slowdown and escalating trade tensions. However, the country's economic fundamentals generally remain strong with a still solid current account surplus, manageable fiscal deficit, low public debt to GDP ratio and adequate level of foreign reserves. The central bank is also appearing to keep a close eye on the household debt situation. The major key event for next year would obviously be the elections and how policies would eventually turn out after it, but we do not see any significant downside growth risks at this juncture.

Chart 1: GDP Growth Rate, % yoy

Chart 2: Household Debt as % of GDP



Source: Bloomberg, CEIC, OCBC Bank

VIETNAM

Manufacturers' alternative rock

As ASEAN football champion, with an outlook upgrade for the banks by Moody's, and also the top destination in Asia for manufacturers seeking shelter from the US-Sino trade tariffs – Vietnam definitely has a lot to celebrate toward the end of the year entering 2019.

Although growth somewhat moderated into the second and third quarter of 2018 as compared to a remarkable 7.5% in 1Q18, it is by no means disappointing given the global backdrop of heightened trade tensions surrounding the export-oriented nation, with both quarters posting GDP growth of 6.7% and 6.9% on-year respectively. Vietnam's 2018 growth is now poised to exceed the government's target of 6.7%, on the back of strong domestic demand, higher exports and FDI, according to the Head of General Statistics Office Nguyen Bich Lam. Earlier in December, Prime Minister Nguyen Xuan Phuc also told investors at the annual Vietnam Business Forum (VBF) 2018 in Hanoi to expect the nation's 2018 GDP growth to be around 7%, which is ahead of most countries in Asia. Meanwhile, headline consumer price inflation rose to as high as 4.67% in June, then swiftly dipped below the government's 4% target all the way to 3.46% in November, with oil prices likely to continue swaying figures going into 2019.

Amidst the ongoing US-China trade war rattling global commerce, Vietnam is appearing to emerge as a winner rising above the chaos. For producers in China seeking safer ground away from the US-Sino trade tariffs, many have chosen Vietnam as their preferred alternative, with its relative cost savings and proximity to China compared to its other Asian peers proving to be practical selling points for the star economy in the ASEAN region. Total pledged foreign direct investment for 2018 is estimated at US$35.46b, down a marginal 1.2% yoy from the previous year, according to the Foreign Investment Agency under the Ministry of Planning and Investment.

Earlier in the year, we thought that the brisk pace of growth that was set last year will be difficult to replicate in view of an expected moderation in China and the difficulties in pushing through with the country's state-owned enterprise (SOE) reforms. Both concerns have proven to hold true to expectations, but the relocation of production lines by manufacturers out from China to circumvent US tariffs has blessed Vietnam's economy more than initially expected in its capacity as a regional manufacturing hub.

To that end, we now see Vietnam's overall GDP growth coming close to 7.1% for the year 2018, with its stellar manufacturing PMI performance thus far in this quarter on top of three quarters of growth already in the bag, and a 6.6% growth for 2019.

Trade tariffs – not a story of the Asian supply chain victim

Nearly half a year on since the implementation of the first tranche of US-China trade tariffs, talks of "Disruption to the global supply chain", "Asia to be hit first", "Manufacturers to shift production" have seemingly played out accordingly on the surface. Textile, electronics and consumer good factories in China that are unable to bear the burden of the duties slapped onto their products have had no choice but to seek cheaper bases elsewhere, while Asian economies reliant on trade known to be bellwethers for the manufacturing industry such as Taiwan, South Korea and

Malaysia have seen their PMIs and exports slow or even slip into contractionary territory in the fourth quarter of the year.

With a manufacturing slowdown story being told across the region, Vietnam's show of divergence versus its peers underpins its strength as a regional manufacturing hotspot, with firms seeking to switch over from China to evade tariffs adding to the bonanza. The recalibration of supply chain dynamics looks poised to continue serving as an upside to the manufacturing sector as producers pursue opportunities in substitute countries for production shifting.
The allure of Vietnam as a top destination in Asia for producers switching out of China stems from its provision of a readily available labour force that is more affordable across an assortment of key industries and its geographical proximity to China, which also places the nation in position to further reap the benefits of the accessibility to extensive commerce routes.

The shift in focus toward higher value-add products yet having its roots in the traditional economy enables Vietnam to engage across a broad range of the assembly line, just in time to cater to the surging demand of producers who are strongly considering and implementing plant relocations out from China. At a recent business forum in Hanoi, the prime minister referred to Vietnam as the "big workshop" of the world as a "fulcrum" for transnational companies, further propelling the nation's manufacturing capabilities into the international spotlight.

Trade representatives from other Asian countries appear to agree. The Japan External Trade Organisation (JETRO) Chief Representative in Ho Chi Minh City Takimoto Koji expressed keen interest in preserving and expanding their investment in Vietnam on behalf of 70% of current investors. He also shared that Japan was Vietnam's largest foreign direct investor in 2017, with a record amount of USD 9.11bn, and cited the nation's growing yet affordable youth workforce as a leading factor in enticing overseas firms to boost investment in the Vietnamese economy. According to the World Bank, Vietnam's labour force stands at about 57.5 million, as compared to 15.4 million in Malaysia and 44.6 million in the Philippines, providing a larger pool for manufacturers to choose from for different segments of the production line, cementing the case for production shifting to Vietnam.

Foreign firms with production plants in China, including retailers from US where the tariffs are being initiated from, are exercising foresight by seeking other host countries to diversify supplies and hedge against potential escalations on the tariff narrative which may affect goods that are still unscathed by the US-Sino clash. In the garment industry, SWIMAX International JSC, a supplier for US department store Target based in Vietnam, saw a surge in orders starting from the beginning of this year. Chairman Ngo Quang Thoa attributed the boom to the trade war, and expects the firm's exports to the US to rise by up to 20% by the end of 2018. Walmart furniture supplier Phu Tai Corp. is strategizing for a forecasted upswing in exports to the US for this year and the next due to buyers switching out from China. Even luxury goods, a traditional stronghold of the Chinese manufacturing market, is not spared from production flight, with Coach's parent company Tapestry ramping up activity in Vietnam while trimming operations in the middle kingdom.

Looking ahead, the recognition of Vietnam's ascendency in the manufacturing industry across Asia will likely continue to prop the nation on a propitious footing to reap the benefits of production switching in the near term at least, spurring exports and growth opportunities at a time when many of its peers will find it tough to envisage a similar scenario.

Beyond the trade war – not betting it all on the turning tides

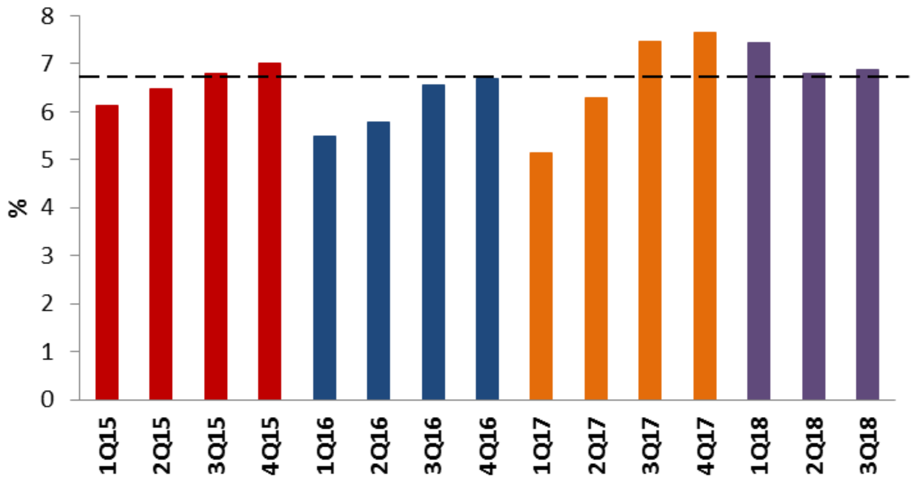
Vietnam is not betting it all on the turning tides stemming from the US-China trade war to buoy its economy. The government has been actively pursuing negotiations with other nations and blocs across the globe to galvanise its economy, including the finalisation of a free trade agreement (FTA) with EU earlier in June. The FTA will eliminate over 99% of all tariffs between the two economies, with machinery, textiles and chemicals among the traded goods that will be able to gain from the deal. In addition to freer trade, EU firms will also be among the traded goods that will be able to gain from the deal. In addition to freer trade, EU firms will also be able to bid for public contracts with Vietnamese ministries and key state-owned enterprises (SOEs), which is expected to drive bilateral investments moving forward. We expect EU's emphasis on sustainable development of labour, environmental and civil rights, which come hand-in-hand with the FTA, to be a source of future utility for Vietnam in light of the prominence of impact investing. Vietnam will welcome a boost in investor confidence on the back of EU's acknowledgement of the nation's headway in moving up the ranks of the emerging markets via the ratification of the FTA.

Meanwhile, private sector investment is turning up the heat on the competitiveness of domestic corporations, which could promote competency in services if the expansions are able to boost the efficiency of firms' business operations and consumer marketing. A recent major merger and acquisition (M&A) activity in the Vietnamese retail space would be Vingroup's investment in Fivimart, which has seen all of the latter's stores renamed to VinMart, reflecting the growing dominance of the group's retail arm VinCommerce in the supermarket business. Upcoming M&A activities in 2019 would be key to watch as an indicator of business sentiment, with several high profile deals such as Vietnam Airlines' planned listing on the Ho Chi Minh City Stock Exchange tipped to take place in the first quarter, and the pace of ongoing privatisation of state-owned enterprises (SOEs) expected to pick up next year with improved online access to reduce regulations and taxation issues.

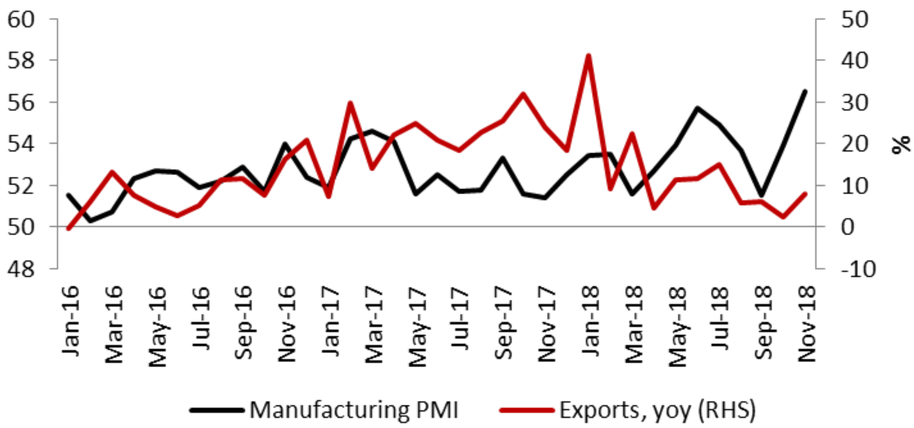
Conclusion

A favourable geographical location, sufficiently prepared manufacturing capacity and progressive domestic reforms to foster business growth will posit Vietnam to weather ongoing trade tensions and provide an avenue to create a sustainable expansionary path. Nielsen and the Conference Board jointly ranked Vietnam second globally in terms of consumer confidence in their 3Q18 report, reinforcing the potential for private consumption as a pillar of growth entering 2019. We now see Vietnam's overall GDP growth coming close to 7.1% for the year 2018, with its stellar manufacturing PMI performance thus far in this quarter on top of three quarters of growth already in the bag, and extending to a 6.6% growth for 2019. Heading toward the new year, financial technology growth in the banking sector, trade war developments which may see benefits for Vietnam wane if the rhetoric were to worsen beyond market expectations, and progress on the openness of trade and investments space amidst structural reforms will be pivotal in guiding the nation's trajectory in the coming year.

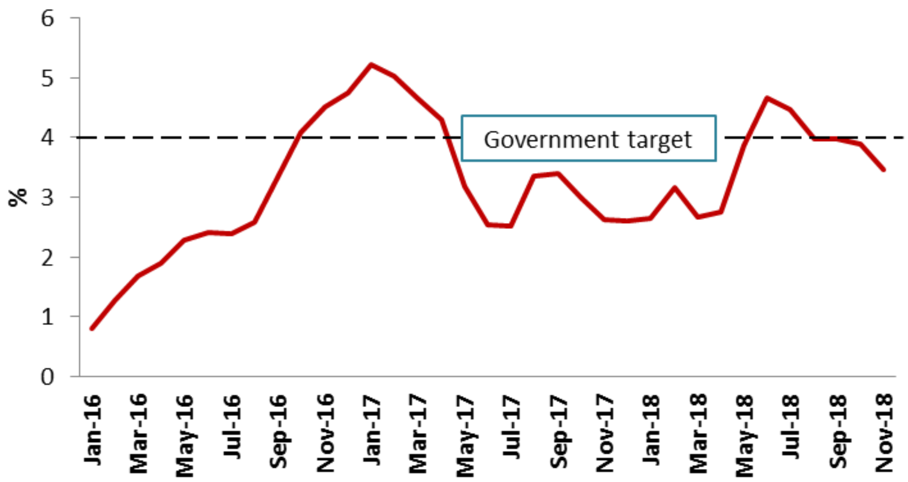
2018 growth poised to exceed 6.7% goal



2018 manufacturing and export activity both in expansionary territory



Inflation slipped below government target of 4%



Source: Bloomberg, OCBC Bank

CHINA PROPERTY

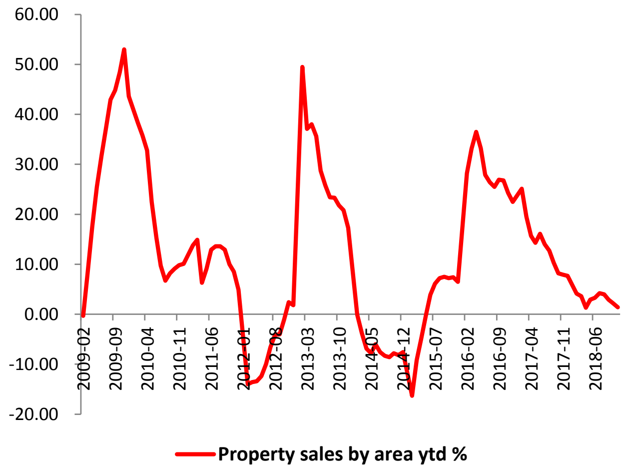
Not the weakest link yet

Highlights:

- China's property market has slowed since the announcement of the "toughest tightening measures" in September 2016.
- The slowdown is different from the past cycle as it is associated with low inventory.
- The strong land acquisition may continue to support investments. The property market is unlikely to be the main drag on Chinese growth in 2019

Since September 2016, China has announced a fresh round of property tightening measures as 19 cities introduced various measures to cool down the property market during the golden week holiday in 2016. In addition, in its 2016 Central Economic Working Conference in December, China also unveiled its property slogan that "Housing is for living not for speculation". Ever since then, the property fever started to taper off and property sales slowed down significantly. Property sales by area slowed down significantly with the growth rate decelerating from 22.5% in 2016 to only 2.2% in the first ten months of 2018.

Chart 1: Sales decelerated due to property tightening measures



Source: Wind, OCBC

Despite the prolonged property tightening measures, weaker domestic growth and rising external uncertainties, the concern that China's property market could be one of the key drags on growth in 2018 proved to be wrong. China's fixed asset investment in property sector reaccelerated to 8.1% yoy in the first ten months of 2018 from 3.6% yoy in 2017, although China's headline fixed asset investment slowed down to 5.7% yoy in the same period from 7.2% yoy in 2017. Meanwhile, China's housing prices continued to rise albeit at a more gradual pace led by the prices in the lower-tier cities.

Chart 2: Property investment reaccelerated in 2018

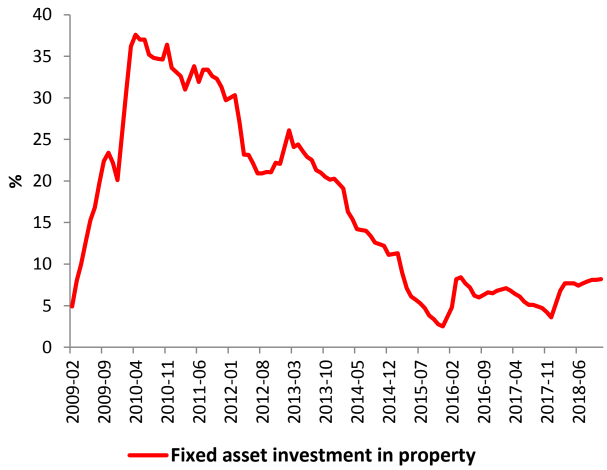
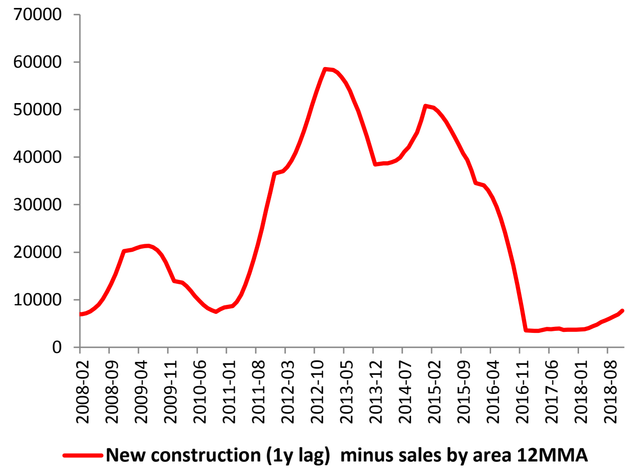


Chart 3: Inventory remains low despite slowdown



Source: Wind, OCBC

An interesting divergence

In previous property mini-cycles in China, slower growth usually led to higher inventory that in turn held developers back from more land acquisition, this round of slowdown is actually associated with low inventory. This is probably the first time in the past decade that we saw an interesting combination of slower growth but low inventory.

The cause of sales and inventory divergence is mainly attributable to China's plan to revamp the shanty town. China's central bank PBoC set up a new financing tool called the Pledged Supplemental Lending (PSL) in April 2014 to financially support the revamp of shanty town. China has revamped 18.15 million units of shanty town in 2015-2017 and is expected to revamp another 15 million from 2018-2020. The outstanding PSL amount increased by CNY635 billion 2017 and another CNY649 billion in the first 11 months of 2018.

The cash payout from the revamp of shanty towns has created fresh demand for housing. Given the tightening measures in tier-1 and tier-2 cities, the cash payout spilled over to demand in the lower tier cities, thus driving up the housing prices in tier-3 and tier-4 cities.

As a result of falling inventory in the lower tier cities, developers continued to acquire land aggressively despite a tight funding environment in the first half of 2018 amid China's de-leverage campaign. The land acquisition cost increased by 63.4% yoy in the first ten months of 2018.

Slowing but supportive factors remain

Looking ahead, the supply-demand matrix affecting the housing market may have started to change. The support from the revamp of shanty town is likely to diminish after the government announced to limit the cash payout ratio. In fact, we have seen the rebound of inventory level in the past few months. We expect the inventory to go up further in the coming months due to the limited cash payout.

Nevertheless, we think the housing market is unlikely to be the black swan for Chinese economy in 2019 for three reasons. First, the surging land acquisition in 2018 suggests that the property investment is likely to remain steady in 2019. Second, since mid-2018, China has eased its monetary policy and driven down the interest rates. Unlike the Hong Kong property market which faces the risk of rising interest rate, the falling interest rate environment in China is likely to provide a buffer to the growth slowdown in China. Third, the latest politburo meeting on 31 Oct did not mention the property market. It is the first time for the past one and half years that the property topic was excluded in the major meeting and this suggests that China is unlikely to tighten its property market further in 2019 as the property market is now expected to play a role of stabilizer to counter the impact of rising uncertainties from the US-China trade war.

Overall, we expect China's property market to slow further in 2019. The rising inventory in lower-tier cities suggest that the housing prices in lower tier cities may face renewed downward pressures. However, given the still resilient property investment amid the ongoing revamp of shanty town projects and low interest rate environment, we think the property market is unlikely to be the main drag on Chinese growth in 2019.

Chart 4: Strong appetite for land acquisition despite slowdown

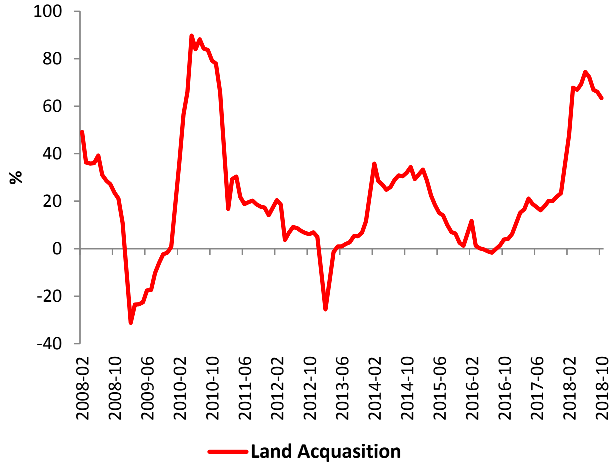
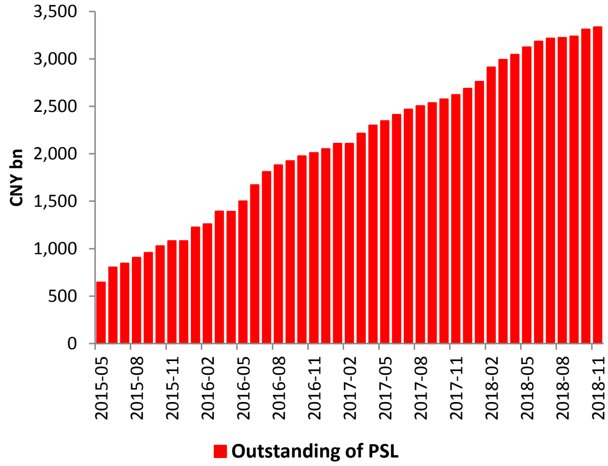


Chart 5: PSL continued to go higher supporting the initiative to revamp the shanty town



Source: Wind, OCBC

CHINA SPECIAL

China's POEs funding difficulty: The road ahead

The Chinese economy has decelerated in the past year. The official manufacturing PMI has dropped to the lowest level since July 2016, with significant softening in both new order index and new export order index. The risks of the US-China trade war might be only able to explain a part of China's economic dilemma. From the internal perspective, the loss of growth momentum in China may also be attributed to the operating difficulties encountered by private owned enterprises (POEs).

Chart 1: Manufacturing PMI

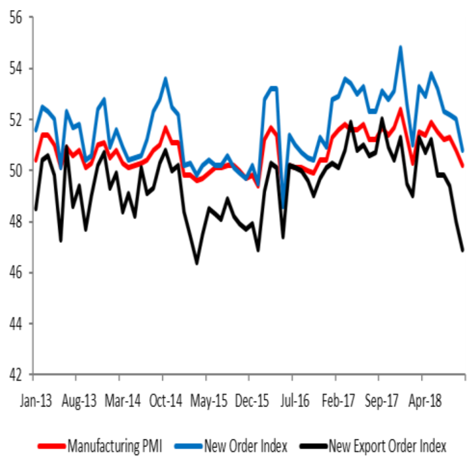
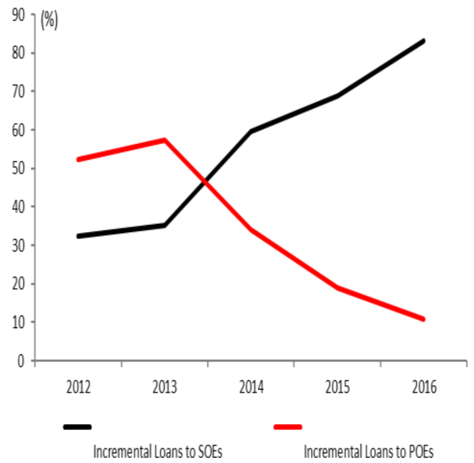


Chart 2: Proportion of Incremental Loans



Source: Wind, PBoC, OCBC

China's POEs have played an important role in different sections of Chinese economic system, including employment, innovations and tax revenue. As mentioned by PBoC Governor Yi Gang in June 2018, POEs have contributed more than 50% of tax revenue, 60% of GDP growth, 70%+ of innovative achievements and 80% of urban employment. Despite playing a significant role in China's economy, POEs have been facing some disadvantages in terms of seeking financial resources and operations. According to the data indicated by PBoC, the share of POEs' incremental loans to total incremental loans has been only 10.8% in 2016 while the share of state-owned enterprises (SOEs) has accounted for 82.2%. **In this article, we will review the cause of funding difficulties faced by POEs and discuss the road ahead.**

Financing difficulties was a rare phenomenon before 2008 for POEs were able to raise funds mainly through both traditional financial institutions and non-standard funding channels. Nevertheless, after the global financial crisis, the credit environment has changed gradually. In order to alleviate the negative shocks caused by financial crisis, the central government launched a 4 trillion-yuan stimulus plan to support the economic growth and trillions flew to both state owned enterprises and private owned enterprises. This in turn may have led to the excessive capacity problem eventually.

Nevertheless, it was still easy for POEs to access to funding before 2013. As suggested by the PBoC's data, the share of private enterprise's incremental loans to total incremental loans has accounted for more than half from 2012-2013. Nevertheless, the situation has deteriorated since 2013 as non-performing loan in

POEs rose significantly due to the excessive capacity problem, which is an unintended consequence of China's massive CNY4 trillion stimulus package. This led to a sharp withdrawal of bank's funding support for POEs. After suffering from the credit squeeze, private-owned enterprises have turned to raising funds through direct financing and non-standard financing channels. However, the clampdown on shadow banking in the past few years has further squeezed POE's funding capability. The years of mistrust and POEs' irrational investment amid mini-credit cycle in the past few years has worsened the funding difficulties faced by POEs. The vicious cycle has not been broken yet as of now.

Aiming to resolve the funding difficulties faced by private-owned enterprises, the Chinese government has launched a series of supportive policies since mid-October. Vice Premier Liu He has announced multiple auxiliary policies, including allowing insurance companies to invest in a good company as a long-term strategic investor and support the funding needs of private-owned companies via bond and equity financing. Subsequently, the top financial regulators of China have rolled out more "private-sector favouring" polices. Firstly, PBOC will increase the quotas for relending and rediscount by another 150 billion yuan on top of the 150 billion yuan of previous quotas announced in June to help the small companies with funding needs. Secondly, in order to give credit enhancements including credit risks mitigation tools to support private companies' bond issuance, the central bank will provide initial funding for specified institutions.

Marching to November, China's banking regulator stepped up its effort to support POEs' funding via unveiling the guidance on new "125" quantitative target. Although the announcement caused a backfiring due to concerns about possible rising NPLs, which forced CBIRC to clarify that the quantitative measure is not mandatory and banks' credit standard will not be intervened, it shows that China's regulators have paid more attention to solving the problem. **In addition, PBoC unveiled a new monetary policy tool targeted medium term lending facility (TMLF) on 19 Dec** just ahead of the December FOMC meeting. The new TMLF is created to support the funding needs from the small and private owned companies.

Without doubt, administrative polices indeed might help to resolve the funding difficulties of private firms in the short-term. In the longer run, in order to solve financing difficulties faced by private enterprises fundamentally, promoting further financial reform and liberalization should be the answer.

Firstly, carrying forward the interest rate liberalization and risk pricing marketization could be more effective and an essential means to address the financing problems. China's lending rates are still being constrained by the benchmark rate due to window guidance despite China has removed the ceiling for lending rate. As the credit risks of private firms have been normally higher than state-owned firms, without enough risk premiums, financial institutions have had less motivation to extend loans to private firms, leading to the funding difficulties of private firms. Therefore, the next stage reform may focus on pricing in the risk premium (? How to rephrase), which might enhance the incentives for the banks to provide loans to private enterprises.

Secondly, promoting "fair competition" for resources between private-owned enterprises and stated-owned enterprises could be another main reform orientation in the future, in order to prompt a more sustainable economic growth. In terms of market standing, greater efforts to ensure equal treatment received by the companies with different types of ownerships in the market could be useful. Support for private firms to ease financing barriers could also be included to a greater extent in the Marco Prudential Assessment Framework by providing more inducements for financial institutions to resolve the funding difficulties confronted by private enterprises. In fact, government have launched some relevant policies. For example, the scope of qualified collateral of the medium-term lending facility has been expanded to cover the loans for micro and small companies. The lenders to small and micro enterprises could enjoy expanded value-added tax exemption on loans to those firms with the quota increasing to 10 million yuan from 1 milion yuan.

Thirdly, encouraging further development on direct financing might be a more tenable method to ease the funding problems. An observation is that private firms might suffer more negative shocks during a period of financial deleverage, as financial institutions and commercial banks prefer to sell off risky? financial assets and call back the loans of private firms due to increased risk aversion. In addition, the feature of high turnover with small amount of private firms' financing pattern might increase the commercial bank's costs of risk management and discourage them from extending loans to private enterprises, especially the small and micro firms. Due to these structural reasons, it might be hard to reverse the private firm's funding problems through standard financing channels in the near term. Therefore, promoting direct financing might be an effective mean to help private firms to tackle the financing difficulties.

Meanwhile, direct financing might be a better fit for the interests of private enterprises. Firstly, the funding costs can be lowered in the absence of the participation of financial intermediates. Secondly, with the high degree of connection between the fund providers and business entity under direct financing, it might help to enhance the efficiency of fund allocation and the stability of long-term funds. Taken together, direct financing might improve the efficiency of the financial marketin China. According to the report of "2018 Credit Risks Condition and Outlook of Bond Market", the default rate of bond has been 0.45% and 0.56% in 2017 and the first five months of 2018 respectively, which is much lower than the nonperforming loan ratio of 1.9% in 2017(Wind data). Meanwhile, promoting equity financing might also help to fuel the impetus for the development and reform of China's equity market. That said, preventing systemic risks of financial market should remain the top priority of financial reform.

Fourthly, improving the efficiency of transition mechanism from liquidity to credit is also important for addressing the funding difficulties faced by private-owned firms. In retrospect, liquidity has been abundant following by several rounds of required reserve ratio cut and the supportive polices imposed by government. Nevertheless, the private-owned enterprises have still faced funding problems, which imply that the deficiency of credit system might be the crux behind, rather than just simply a problem of liquidity. Private firms have raised funds from non-standard funding channels and paid higher interest rates, as most of the traditional or standard financial institutions have preferred to extend loans to stated-owned enterprises amid risk aversion and the "implicit guarantee by government". This suggests that the "funding" channels have been less than effective to channel credit to the private sector even thoughthe central bank has provided incremental liquidity. Nevertheless, with more directional polices imposed by central bank, it might help to ease the dilemmas.

To conclude, funding difficulties faced by private-owned enterprises have been a common phenomenon in different economies amid the lack of collateral and rising risk aversion. Nevertheless, the unique market structure in China, with a significant proportion of stated-owned enterprises, has illustrated the dilemma of financial resource allocation. Indeed, the impacts of administrative measures to resolve private firm's financing difficulties may only be short-lived. In the medium-term, promoting financial market reform, including interest rate liberalization, "fair competition" for financial resources, intensifying development of direct financing and improving the efficiency of transition mechanism from liquidity to credit are still needed.

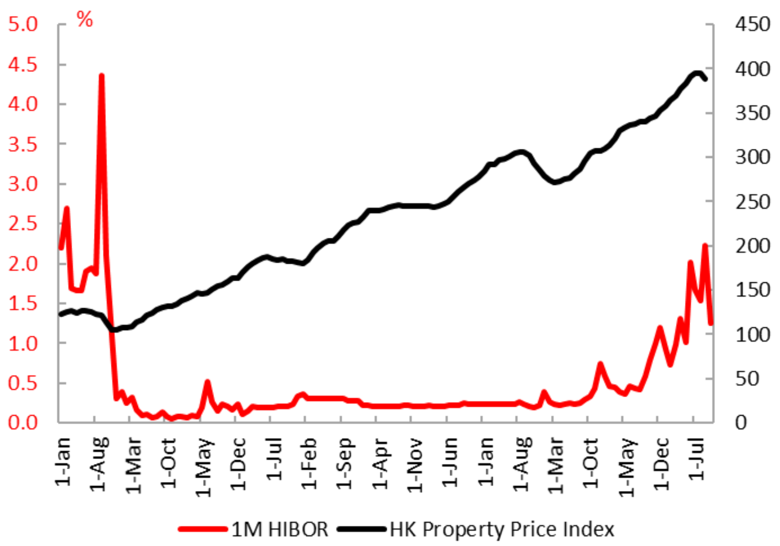
HONG KONG PROPERTY

Winter is coming

Since December 2015 when the Federal Reserve (Fed) firstly lifted fund rates in 2006, the Hong Kong Monetary Authority (HKMA) has closely followed the Fed's step to raise base rate. Nonetheless, Hong Kong continued to see huge capital inflows owing to its strong fundamentals, the still low USD rates and China's strong growth. As such, all banks in Hong Kong were not in any rush to raise local interest rates including the prime rate which is used to cap the mortgage rates.

As local rates continued to lag far behind their US counterparts, the low rate environment and buoyant market sentiments together boosted the housing market. The housing frenzy was then fuelled further by the slow increase in private and public housing supply. In July 2018, housing price index refreshed its record high for the 21st consecutive month and was up by 276.7% from the end of 2008.

Chart 1: Low Interest Rate and Record-high Housing Prices



Source: Bloomberg, OCBCWH

Housing market is cooling down

However, lately the overheated housing market has started to cool down. Specifically, total housing transaction volume tumbled for the third straight month by 53.7% yoy to 2635 deals (lowest since March 2016) in November. Approved new residential mortgage loans slid by 4.6% mom in October to the lowest since December 2017. Though property developers offered sweeteners, primary housing transaction volume continued to tumble. According to the data of Midland Realty (HK's real estate brokerage company), new home sales dropped to the lowest since 1Q16 in November. Worse still, the residential property price index dropped for the third consecutive month by 0.5% mom in October and was down by 2.1% from the all-time high. As at 2nd December, Centa-City Leading index, which tracks secondary housing prices, dipped for the tenth consecutive week to the lowest level since March 2018.

In the secondary market, more and more home sellers proactively cut their offering prices, normally by 10% to 20%, in an effort to find a potential buyer. Moving ahead, we expect the housing market to continue losing momentum given the following unfavourable factors

First, the prospects of higher interest rates may continue to weigh on housing demand. Due to higher HIBOR and HKD fixed deposit rates, Hong Kong's banking system raised its prime rate for the first time since 2006. In fact, the magnitude of prime rate hike in September was merely 12.5bps-25bps, which should have a limited impact on the housing market. Nonetheless, as the long-awaited rate hike cycle has finally started, market players increasingly feared higher borrowing costs ahead. Given the weakening economic outlook of Hong Kong and the gradual rate hike by the Fed, the rising capital outflow risk may push up HIBOR. We expect one-month HIBOR and three-month HIBOR to test 3.15% and 3.20% respectively by end of 2019. Should the Fed lift rates for three more times in 2019, commercial banks in Hong Kong may raise prime rate by about 50bps. With the prospect of higher interest rates, housing demand softened recently.

Second, lower wealth effect from the stock market could deter potential homebuyers. Back in October, when US-China trade war escalated and the Fed's Chair Powell unexpectedly opined a hawkish stance, global stock markets took a hard hit with Hang Seng Index tumbling by 10.1% in October. Lately, the Hang Seng Index has rebounded on news of the US-China trade war truce and the Fed's change in policy stance from hawkish to cautious. Nevertheless, we expect the Hong Kong's stock market to see limited upside as US's strong fundamentals could still warrant gradual rate hikes by the Fed in 2019 and US-China trade war risks have not fully abated yet.

Third, China's economic growth has been slowing down amid the US-China trade war and the previous deleveraging campaign. As a result, housing demand from Mainland investors appeared to have softened. The transaction volume of private homes valued over HK$10 million dropped for the third consecutive month by 59% yoy to the lowest since March 2016 at 477 deals in November 2018. Though the US and China have agreed on a trade war truce for 90 days, the possibility of tariff hike materialising in March 2019 cannot be ruled out, especially given both sides' conflicts over technology transfer and intellectual property. Should the trade war escalate again in 2019 or recent supportive measures fail to ease downside risk on China's economy, Mainland investors' interests in the overseas markets may weaken further.

Finally, the expectations of increasing public housing supply might have shifted the housing demand from private to public sector. Back in late June of 2018, the government unveiled three property control measures. First, the pricing of subsidized housing will be de-linked from private market rates and instead be linked to the median monthly income of the applicants. Second, public housing will be built on nearly nine prime sites originally reserved for private property projects. Third, a vacancy tax will be levied on primary residential properties that are unoccupied for more than six months. The tax will be set at 200% of the "rateable value" of the vacant property.

After that, the government announced more details about its plan to tackle the housing issues in its 2019 Policy Address. Specifically, the government plans to raise the public-to-private housing ratio. 70% of the housing units on government's newly developed land will be for public housing. On top of the existing public housing schemes, the government will increase land supply for public housing development by land reclamation in next 20-30 years, studying on brownfield operations and introducing "Land Sharing Pilot Scheme". In addition, the elderly will be encouraged to move into smaller public flats and vacate their larger public units. The revitalisation scheme for industrial buildings will also be reactivated to support the provision of transitional housing. Due to these measures, the less affluent households might have given up their plan of buying private flats and turn to the public sector. As such, we expect the smaller private flats (prices were down by 3.6% from the historical high in October) to see a deeper correction in the foreseeable future.

In a nutshell, we expect housing transaction to remain sluggish and overall housing price index to drop around 15% by end-2019 from the record high.

Will a property market correction lead to systematic risk?
As the overheated housing market started to cool down, market players increasingly fret that a property market correction will increase the systematic risks to the banking system.

Notably, loans for use in building, construction, property development and investment accounted for 55.2% of total GDP at end of 2017, much higher than the twenty-year average of 38.8% during 1998-2017. Besides, total household debt (nearly 70% in the form of mortgages) to GDP ratio rose to its record high at 71.2% at end of 2Q 2018, as compared to the twenty-year average of 59%. If taking mortgage loans provided by property developers (with higher loan-to-value ratio than bank mortgage loans) into account, the size of household debt would have been larger. According to the HKMA, mortgage loans offered by property developers expanded remarkably by 53% in 2017 though their size was only 2.6% of total bank mortgage loans.

The surge in indebtedness inevitably increased the debt service ratio. This makes Hong Kong vulnerable to higher interest rates and property market correction, which impairs the debt servicing capacity of property developers and households.

Early this year, BIS quarterly report pointed out that when property prices drop, property developers have to revalue their assets, which will limit their ability to take on new loans for new investments. Then developers, especially the small to medium ones, will have to sell their assets probably at a discount in an effort to deleverage. In the meantime, default risk from homebuyers who relied heavily on mortgage loans could also grow against the backdrop of higher interest rates, weaker economic growth and gradual housing market correction. If this is the case, banks' asset quality may worsen.

That said, we still believe the systematic risk related to the real estate sector will be well contained, given HKMA's macro-prudential measures and Hong Kong's strong fundamentals.

Specifically, HKMA has unveiled eight rounds of macro-prudential measures to decelerate bank lending to real estate activities. HKMA is also implementing the countercyclical capital buffer (CCyB) and increased the CCyB ratio from 1.25% to 1.875% with effect from 1 January 2018. Therefore, the banking system remains healthy. Specifically, the gross classified loan ratio reduced to 0.61% by the end of September 2018 from 0.85% as of end-2016. Also, as at the end of September 2018, the delinquency ratio of residential mortgage reached a record low of 0.02% for the third consecutive quarter. The average loan-to-value ratio of new mortgage loans approved further decreased to a record low of 44.6% in October 2018 from 50.8% in December 2016.

Furthermore, sizeable foreign currency reserves and strong twin surpluses reflect Hong Kong's strong fundamentals. According to the HKMA, official foreign currency reserve assets of Hong Kong amounted to USD423.1 billion in October 2018, far outweighing the estimated USD130 billion inflows since the Global Financial Crisis. The fiscal account surplus to GDP ratio reached its highest since 2007/08 at 5.2% in 2017/18. In addition, the current account has been running a surplus since 2Q 2014 with the surplus to GDP ratio marking 2.3% in 2Q 2018.

In conclusion, although we expect the housing market to continue to lose momentum in the coming years, any systematic risk to the banking sector looks unlikely to stem from the property market.

Chart 2: First prime rate hike since 2006

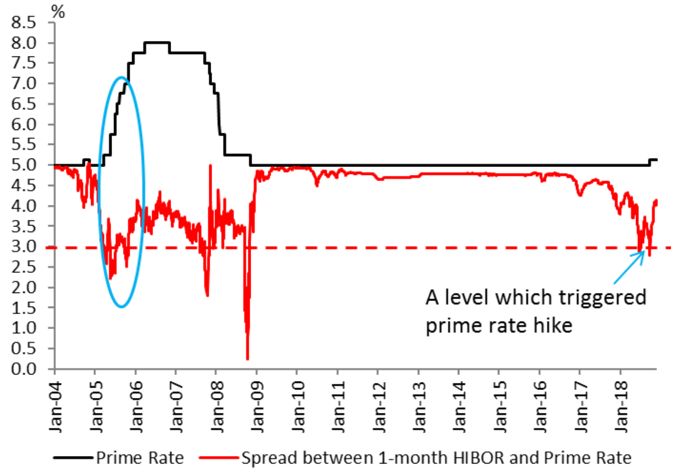


Chart 3: Lower wealth effect from stock market

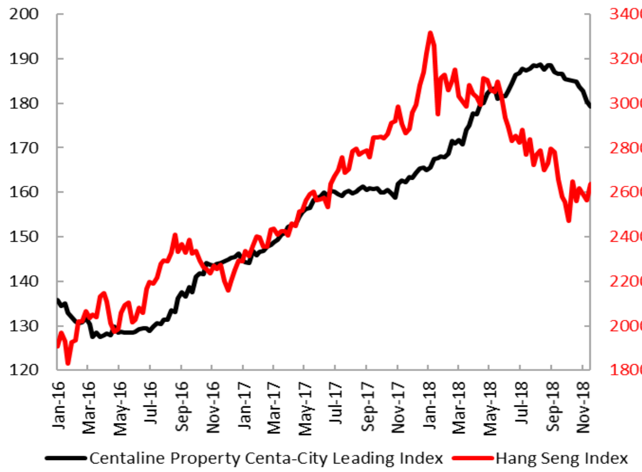


Chart 4: Decreasing demand for large flats

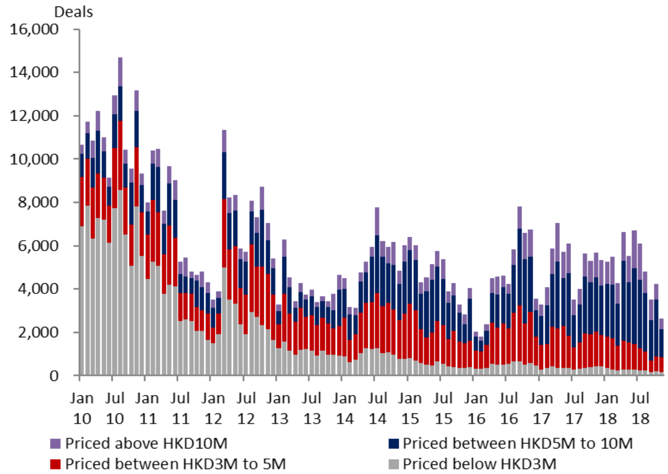


Chart 5: Increasing housing supply

Year	Public Housing Completions	Subsidized Sales Flat Completions	Private Domestic Completions	Total
2011	11,186	0	9,400	20,586
2012	13,114	0	10,100	23,214
2013	14,057	0	8,300	22,357
2014	9,938	0	15,700	25,638
2015	14,264	0	11,300	25,564
2016	11,276	3,017	14,600	28,893
2017	13,413	248	17,800	31,461
2018 (F)	20,500*	6,600*	18,130^	45,230
2019 (F)	13,800*	4,400*	20,371^	38,571
2020 (F)	11,300*	6,800*	20,233 (E)	38,333
2021 (F)	14,400*	5,400*	20,233 (E)	40,033
2022 (F)	12,900*	1,500*	20,233 (E)	34,633

Chart 6: Rising household debt

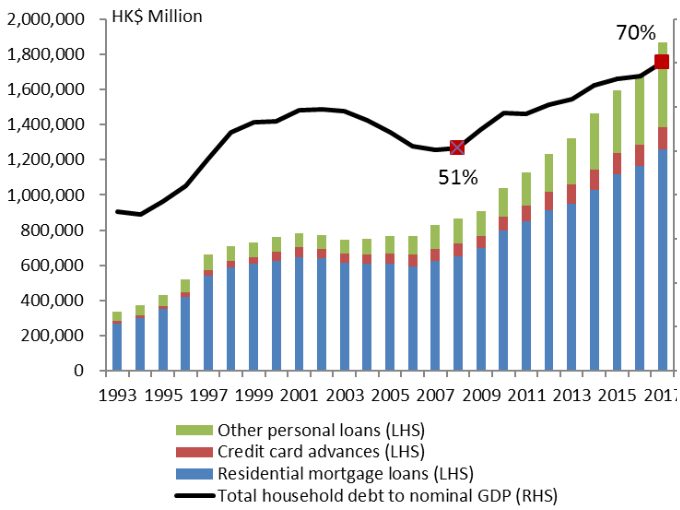
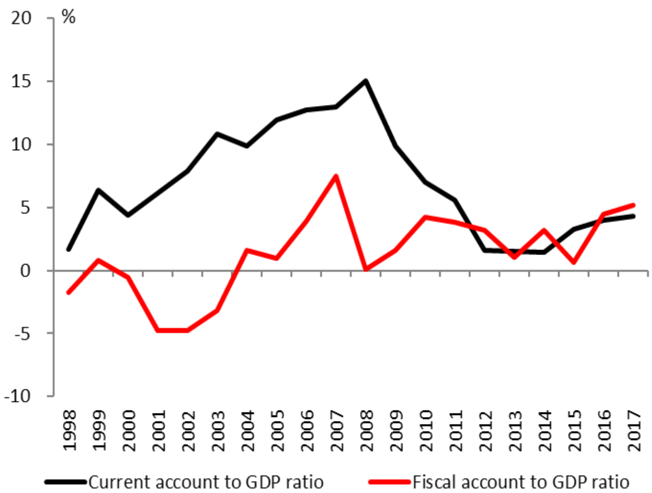


Chart 7: Strong fundamentals



Source: HKMA, Bloomberg, Hong Kong Census and Statistics Department, Rating and Valuation Department of Hong Kong and Housing Authority, Buildings Department, Transport and Housing Bureau, Land Registry, OCBCWH

MALASIA SPECIAL

Redrawing the fiscal map but is there sufficient time?

Almost immediately upon taking office, the new Pakatan Harapan (PH) government was quick to implement a major fiscal change by abolishing the GST as promised. Businesses and consumers were able to already enjoy a zero percent GST from 1st June 2018 onwards, even before the official repeal of the act had been passed. Abolishing the GST was a major campaign promise of PH to reduce the people's burden and after fulfilling this pledge, the new government found itself undertaking a major restructuring of the budget. However, since fulfilling the pledge, the government has also gone on to discover hidden financial commitments that include the tax refund, off-balance sheet development expenditures etc.

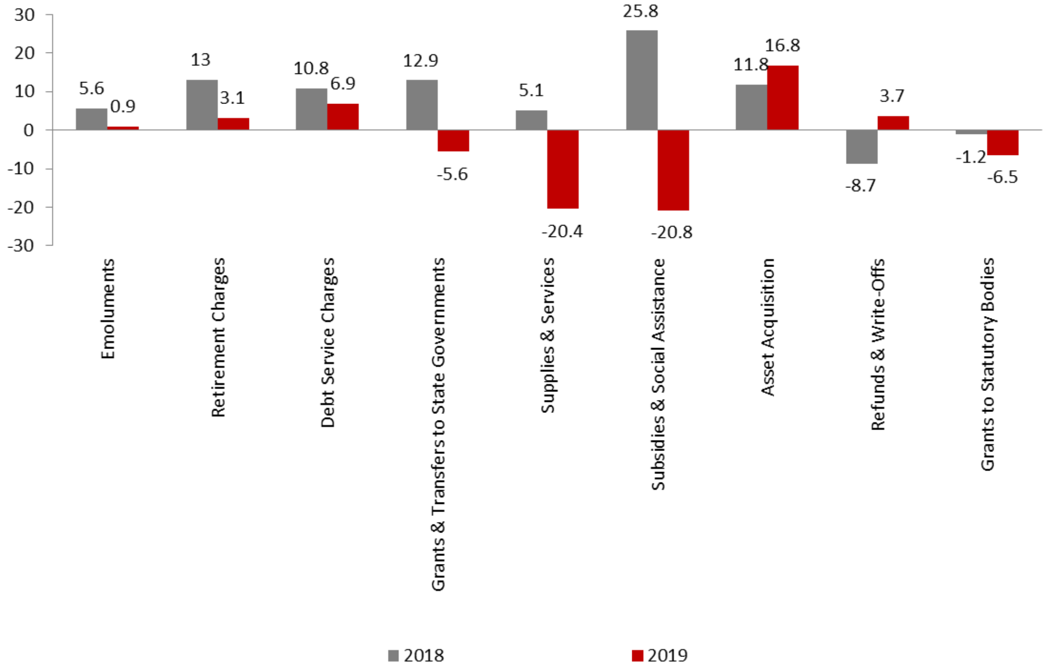
Subsequently, the government has announced that the budget deficit for 2018 will come out at 3.7% of GDP, an overshoot from the initial 2.8% GDP that had been expected. The budget deficit will then be narrowed to 3.4% of GDP in 2019, 3.0% of GDP in 2020 and 2.8% of GDP in 2021. In the medium term, the government expects that the fiscal deficit will be around 2.0% of GDP. The government assumes at the same time that GDP growth will come out at 4.8% yoy in 2018 and 4.9% yoy in 2019.

This piece will explore the current fiscal situation of the government, the fiscal vulnerabilities and medium-term fiscal sustainability.

Where is the government looking to achieve cuts?

The operating expenditure (OE) for 2019 will see a large increase but a major driving factor behind this is that the government has allocated RM37 billion for outstanding tax refunds. If this amount is taken out, the OE will actually see a decrease of about 5% from 2018. This reduction was mainly driven by lower expenditure in the supplies and services and subsidies and social assistance (see chart 1). In fact, the government is looking to achieve a large cut in these areas of over 20%. Regarding supplies and services, the government said that they had implemented a "zero-based" budgeting approach, whereby every expense is analysed based on whether it is needed and how much it would cost and hence, this had led to the reduction. They also said that the reclassification of items from this OE to the development expenditure (DE) had also supported the decline. Meanwhile, the government attributed the reduction in subsidies and social assistance to the reintroduction of a managed-float system for RON95 petrol and diesel (which would be running alongside a targeted fuel subsidy program) as well as a restructuring of cash hand outs. However, implementing a targeted fuel subsidy program may take time. There is a need to continue to monitor closely the government's progress in achieving these cuts. As a note, the government had initially targeted RM10bn of savings back in May for the 2018 budget, but the expected deficit for 2018 will now overshoot the initial target of 2.8% of GDP. At this juncture, it is unclear if the government has ruled out the need for a supplementary budget.

Chart 1: Change in spending for OE components, % yoy



Source: Ministry of Finance Malaysia and OCBC

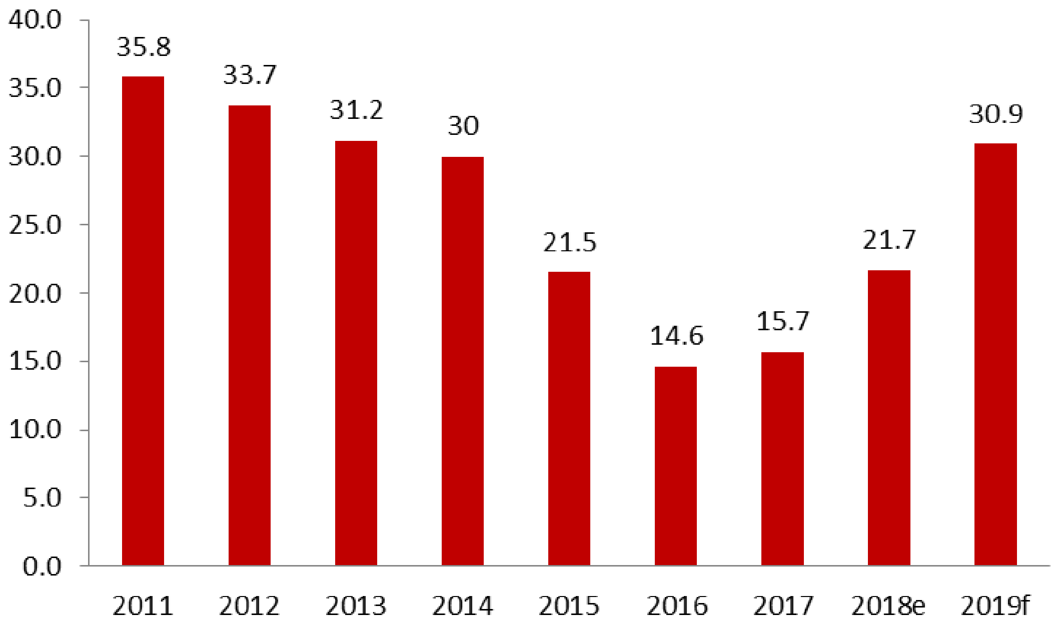
On the DE side, spending for 2019 is expected to remain broadly stable and only 0.4% lower than 2018. There will be a broad increase in expenditure across all subsectors, except the transport and trade and industry subsectors. These two subsectors will see a decrease in expenditure of over 10% from 2018. However, the transport and trade and industry subsectors still makes up a large share of total DE at 24.5% and 10.5% respectively. The housing subsector would see the largest increase in expenditure of all categories at 44% from 2018 although it makes up only a small share of total DE at 3%. The largest absolute increase will come from energy and public utilities subsector at RM1.2bn as the government works to expand public utilities coverage in rural areas. Overall, DE as a percentage of GDP remains small at 3.6%.

Increasing dependence on oil revenues

The budget for 2018 and 2019 saw a reversal in trends as oil related revenue will comprise an increasing share of the total revenue (see chart 2). In fact, the petroleum share of total revenue at 30.9% of total revenue is the highest it has been since 2013, when it was at 31.2% of the total revenue. However, if the Petronas special dividend is to be taken out, petroleum related revenue would still make up 19.5% of total revenue. Given the volatility of commodity prices, a heavy and increasing dependence on oil related revenues would not be fiscally ideal.

The revenue as a percentage of GDP is expected to rise in 2019 to 17.1% of GDP from 16.5% of GDP in 2018. However, if we did take out the special dividend of Petronas, the estimated revenue as a percentage of GDP is 15.1%. The tax revenue portion is rather low at 11.5% of GDP for 2019, which is also actually a decline from the government's estimate of 12.2% of GDP in 2018.

Chart 2: Oil revenue, % of total revenue



Source: Ministry of Finance Malaysia and OCBC

Implementing tax reforms will take time

In his budget speech for 2019, Finance Minister Lim Guan Eng had announced a range of potential taxes to be introduced in the coming or subsequent years in their attempt to raise revenue and increase the effectiveness of the tax system.

Among the new taxes to be introduced includes the online services tax. The Finance Minister had mentioned that foreign service providers would be required to be registered with the Royal Malaysian Customs, charge and remit the relevant service tax effective from 1st January 2020. Based on the World Bank report, Malaysia's Digital Economy – A New Driver of Development released in September 2018 , multiple steps still have to be taken before a digital tax can be implemented effectively in Malaysia. This includes that the country would need to engage in more cross border cooperation such as ratifying the multilateral instrument (MLI) – a mechanism to which will allow countries to update existing multilateral treaty provisions related to taxes. However, as it stands, 78 countries have signed the MLI, constituting 2/3 of the world population but the US has still not signed it. Hence, such a tax may still need time before it can be fully effectively implemented.

Aside that, the government is also looking to increase casino license fees and duties, raise the real properties gain tax and launch a special voluntary disclosure program among other changes. Going forward, it would be key to closely watch the government's progress in reforming the tax system so as to establish one that would effective in raising revenue in line with economic growth.

Can the global growth situation weigh in on the budget?

The government is expecting the country's growth to come out at 4.8% in 2018 and 4.9% in 2019. However, given the risk of slowing global growth, there is a possibility that Malaysia's growth could undershoot its target. Slower GDP growth would obviously mean that the budget deficit may come out wider than expected amid the possibility of lower than expected tax collections. Depending on how much growth is slower, this could theoretically result in the government having to increase social spending and/or introduce programs to stimulate growth. However, the government appears determined to show strong discipline in cutting expenditure at this point in time.

Does the government have contingency funds to tap on?

Cash and equivalents for Petronas stand at around RM181bn as of 30th September 2018, according to Bloomberg. The amount of cash and cash equivalents of Petronas (excluding the RM30bn for the special dividend to be paid out) we estimate could be around 10% of GDP in 2019 (based on government's forecast of 4.8% yoy growth in 2018 and 4.9% yoy in 2019), which compares to an expected budget deficit of 3.4% of GDP in 2019. The government can also potentially draw on additional dividends from various other sources such as from such as Khazanah, Bank Negara Malaysia (BNM) and various other government linked companies and agencies.

What did the government propose to improve fiscal management?

The government has proposed the following in the recent budget:

1. Setting up a debt management office that will have oversight over debt issuance by the Federal Government, statutory bodies and special purpose vehicles with the goal of managing it more effectively in a centralized manner.
2. Implement zero-based budgeting to improve cost efficiency and achieve higher savings.
3. Table a fiscal responsibility act by 2021 to avoid excessive spending that engenders mega debt.
4. Convert cash basis of accounting to accrual basis by 2021 to ensure full disclosure of the debts and liabilities.

Full effective implementation of these measures would generally require time and come in stages.

So how would the rating agencies react?

All three rating agencies of Moody's, S&P and Fitch have stayed pat since the Budget announcement. However, Moody's has downgraded Petronas' Outlook from stable to negative but it did rate it two notches above the sovereign previously. Fitch had rated it at the same level as the sovereign whilst S&P had put the LT local issuer credit rating one notch above the sovereign. Moody's has recently reaffirmed Malaysia's rating although it has recognized that "Malaysia's fiscal strength has weakened" and that "government debt will stay high for a long time" whilst also noting that "robust growth potential, notwithstanding a slowdown in the next few years, and deep domestic capital markets" together with "a solid institutional framework, including strong monetary policy effectiveness" would provide support for the credit profile. Fitch on the other hand has mentioned that the 2019 budget "raises risks to the fiscal outlook" but they also noted "the budget also contains measures to improve transparency and public debt management" whilst also noting that benefits related to the improvements in governance will take time to materialize". S&P has stated that "risks to Malaysia's fiscal and debt profiles remain elevated" but they "believe that the government's commitment to gradual fiscal consolidation is credible". Fitch sees that Malaysia's fiscal deficit will come out at 3.7% of GDP for both 2018 and 2019 whilst Moody's expects Malaysia's debt burden to rise to 52.8% of GDP and remain relatively stable thereafter. Overall, we believe that the rating agencies would probably not change the ratings and outlook for Malaysia before Budget 2020.

How are Malaysian government bonds performing?

The Malaysian government bond market has been relatively stable since the the Budget announcement (see chart 3). Foreign ownership in Malaysian government securities has also not changed much at the end of November after the budget release and has also been fairly stable since May (see chart 4). However, foreign ownership in Malaysian government securities are much lower than the peak seen back in 2016. Going forward, foreign ownership levels in the Malaysian government bonds could be more driven by external factors such as the developments regarding the US-China trade tensions and US economic performance, assuming that BNM continues to hold OPR steady in 2019.

Conclusion

In conclusion, he prospects of increased government fiscal deficits have not exactly rocked the financial markets. Aside from Moody's downgrade on the Petronas outlook, market reaction as a whole to the budget announcement has been rather muted. The government appears to have time to adjust fiscal policy and restructure the budget over the next one-two years. Overall, any major reassessment of the fiscal situation may come in 2020 or later.

Table 1: Malaysia sovereign ratings

Agency	Rating	Outlook
Standard & Poor's	A-	Stable
Moody's	A3	Stable
Fitch	A-	Stable

Table 2: Petronas ratings

Agency	Rating	Outlook
Standard & Poor's	A- (LT Foreign Issuer Credit) A (LT Local Issuer Credit)	Stable
Moody's	A1	Negative
Fitch	A-	Stable

Source: The Rating Agencies

Chart 3: 10 year, 5 year and year Malaysian government yields

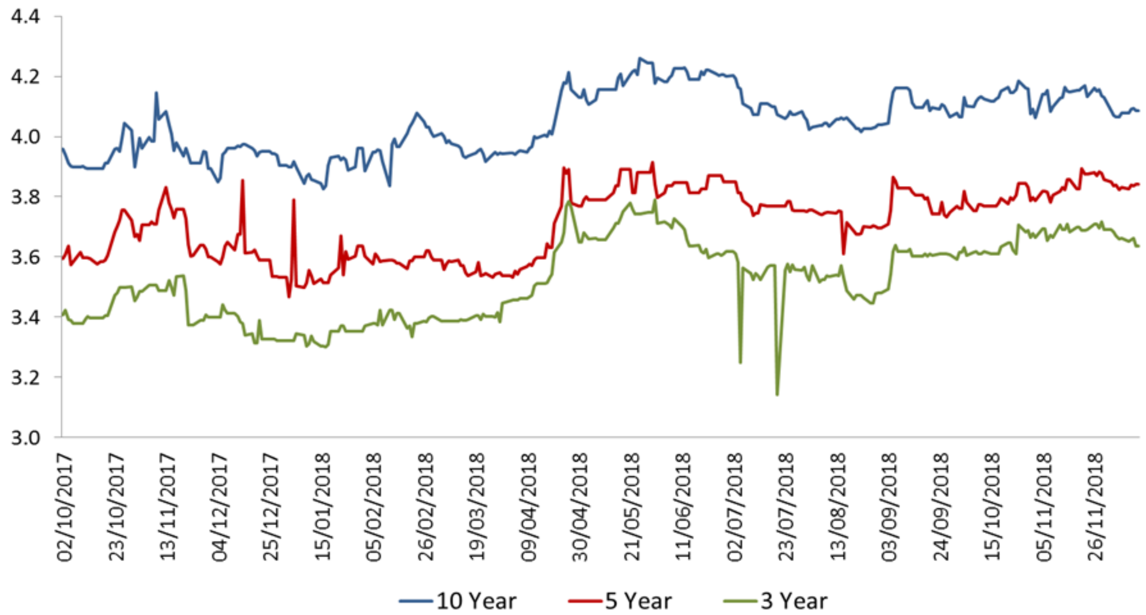
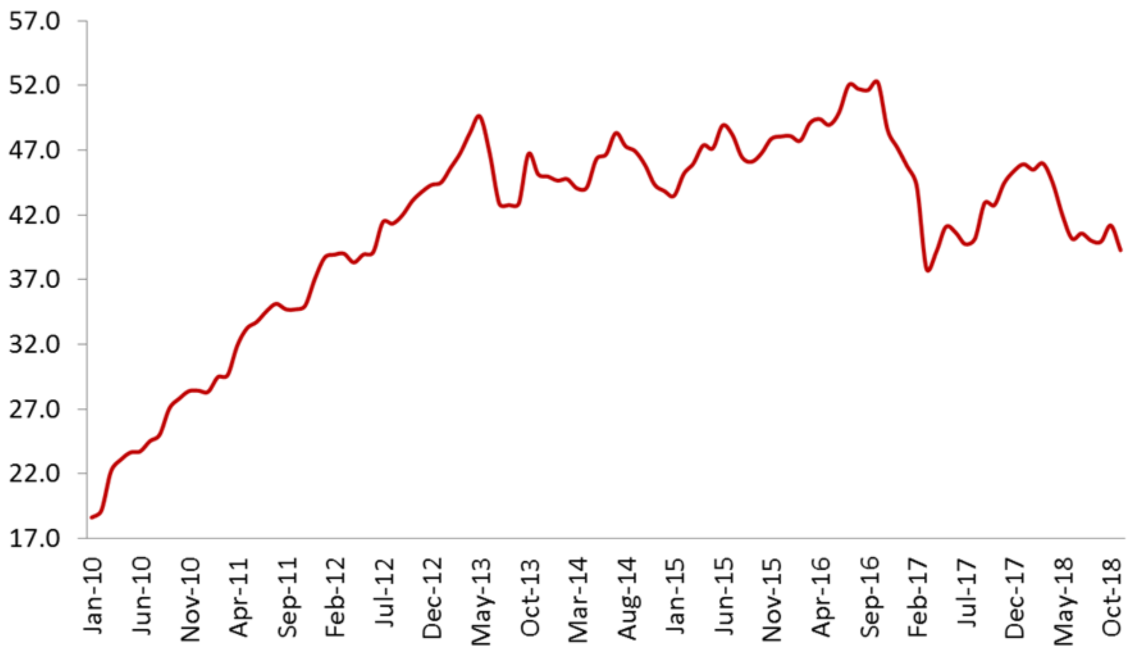


Chart 4: Foreign ownership of Malaysian government securities and Malaysian treasury bills, %



Source: CEIC, Bloomberg and OCBC

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	
Alan Lau		
AlanLau@ocbc.com		