OCBC GLOBAL OUTLOOK 2018

OCBC Bank

Navigating trade tensions and market uncertainties

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The recent month has been a test of investors' ability to stay sanguine on growth and financial markets in the face of heightened trade tensions. What has been clear is that the US administration will continue to ratchet up the noise and threat levels against China and other major trading partners for a wide spectrum of industries and products in order to extract some concessions in the name of "fair trade". China, the European Union (EU), Canada and Mexico, amongst others, are also threatening or responding with retaliatory measures. The second stage of the US-Sino trade war is likely to extend into the investment rules sphere, with the US Committee on Foreign Investments likely getting greater powers. This comes at a point when the global growth momentum is about to decelerate (not end!) into the second half of 2018, partly due to base effects and partly due to the peaking of global manufacturing cycles. While an outright full-scale global trade war is not imminent yet, still the contagion into business sentiments, financial condition tightening and roiling financial markets are a heady mixture at a juncture when growth tailwinds are fading.

Fund flows have turned amid the de-risking pressure, which has been exerting itself in the Emerging Markets (EM) sphere. Asia has not been unscathed, especially since China appears to be facing the brunt of the protectionist measures from the US. While growth will likely sustain into the second half of the year, nevertheless the spectre of a trade war, encouraged by the US' sabre-rattling of 10-25% tariffs on an additional US$200 billion of imports from China and 25% tariffs on car imports from the EU for instance, has prompted many market watchers to mark down their growth expectations ahead. We had already cautioned at our 2018 global growth outlook that the upside data surprises will fade into 2H18, and it is increasingly apparent that manufacturing PMIs have already peaked. The fact that China has begun turning the fiscal and monetary policy spigots to support domestic growth is telling of how the tide has turned.

The global monetary policy landscape has also evolved since the start of the year. The US Federal Reserve (FOMC) had subtly upgraded its median dot plot from a finely balanced 3 rate hikes this year to 4 in the recent June meeting. What we think will likely transpire is that the FOMC will proceed to hike for the third time in September 2018, and keep the option (not a sure bet in our view) open for a fourth hike in December 2018, depending on how things go. The variance of rate hike expectations is also considerably wider for 2019, suggesting significant flexibility of options out into next year. In contrast, the European Central Bank (ECB) has announced that it will end its asset purchase program by end-2018, but sent a fairly dovish signal that it would only initiate its first rate hike after the summer of 2019 as economic indicators in the Eurozone, especially the German economy, portends a growth slowdown. The Bank of Japan (BOJ) was again the laggard, with no pre-emptive intentions to exit monetary policy stimulus in the near-term.

Outside of the G3, the monetary policy normalization bandwagon has gotten more populated, partly due to central banks wanting to be pre-emptive and fend off domestic currency pressures amongst others. Asia's growth cycle also appears mid-cycle. However, with headline and core inflation recovering but still mostly subdued below most major central bank's target zones, there is no room for heroes either, especially with the trade war headwinds. With OPEC's recent decision to increase output, we also do not see a significant uptick in crude oil prices from the current US$65-70 per barrel beyond US$75 per barrel in 2019. It is also interesting to note that worsening trade rhetoric has so far capped the 10-year US Treasury bond yield from retesting its 3.11% high last seen on 17 May 2018.

With the rising USD and US interest rate story, we see the current market volatility in EM assets as only the start. After the initial broad-brush selling, we suspect that the differentiation will start on the basis of liquidity conditions – those able to access USD and local liquidity will ride the 2H18 choppy market conditions in a more resilient fashion that others. The growth synchronisation theme that dominated most of 2017 and to a certain extent the 1H18 has started to fade. Buckle up for a bumpier ride ahead as trade flashpoints continue to surface, notwithstanding the expected summer stupor and World Cup fever.

OCBC Asia GDP, CPI and Policy Rate Forecasts

GDP					
% chg year-on-year	**2015**	**2016**	**2017**	**2018F**	**2019F**
US	2.6	1.6	2.3	2.8	2.4
Euro-zone	2.0	1.8	2.5	2.2	1.9
Japan	1.1	1.0	1.7	1.1	1.0
United Kingdom	2.2	1.8	1.8	1.4	1.6
New Zealand	3.2	3.6	3.1	2.9	3.0
Australia	2.4	2.5	2.8	2.8	2.8
China	6.9	6.7	6.9	6.5	6.4
Hong Kong	2.4	2.0	3.8	3.6	2.7
Taiwan	0.8	1.4	2.9	2.6	2.5
Indonesia	4.9	5.0	5.1	5.1	5.3
Malaysia	5.0	4.2	5.9	5.5	5.0
Philippines	6.1	6.9	6.7	6.7	6.5
Singapore	2.0	2.0	3.6	3.0	2.7
South Korea	2.8	2.8	2.9	3.0	3.0
Thailand	2.9	3.2	3.9	4.2	3.8
Vietnam	6.7	6.2	6.8	6.6	6.5

Inflation					
% chg year-on-year	**2015**	**2016**	**2017**	**2018F**	**2019F**
US	0.1	1.3	2.1	2.5	2.2
Euro-zone	0.0	0.3	1.8	1.6	1.6
Japan	0.8	-0.1	0.5	1.0	1.0
United Kingdom	0.0	0.7	2.7	2.5	2.1
New Zealand	0.3	0.6	1.9	1.8	2.0
Australia	1.5	1.3	1.9	2.2	2.3
China	1.4	2.0	1.6	1.8	2.2
Hong Kong	3.0	2.4	1.5	2.2	2.3
Taiwan	-0.3	1.4	0.6	1.5	1.5
Indonesia	6.4	3.5	3.8	3.5	3.9
Malaysia	2.1	2.1	3.9	2.6	2.5
Philippines	1.4	1.8	2.9	4.4	3.5
Singapore	-0.5	-0.5	0.6	0.5	1.5
South Korea	0.7	1.3	1.9	1.7	2.0
Thailand	-0.9	0.2	0.7	1.5	1.5
Vietnam	0.6	4.7	2.6	3.8	3.8

Central Bank Policy Rate					
	2015	**2016**	**2017**	**2018F**	**2019F**
US Fed Funds rate	0.50%	0.75%	1.50%	2.50%	3.25%
ECB refinance rate	5.00%	0.00%	0.00%	0.25%	0.75%
BOJ overnight rate	0.00%	-0.10%	-0.10%	-0.10%	0.00%
BOE base rate	0.50%	0.25%	0.50%	0.75%	1.25%
RBNZ cash rate	2.50%	1.75%	1.75%	1.75%	2.25%
RBA cash target rate	2.00%	1.50%	1.50%	1.75%	2.25%
China lending rate	4.35%	4.35%	4.35%	4.35%	4.35%
CBRC discount rate	1.63%	1.38%	1.38%	1.38%	1.63%
Hong Kong base rate	1.63%	1.38%	1.75%	2.75%	3.50%
BI reference rate	7.50%	4.75%	4.25%	5.75%	6.50%
BNM overnight rate	3.25%	3.00%	3.00%	3.25%	3.50%
BSP overnight reverse repo	4.00%	3.00%	3.00%	3.75%	4.00%
Singapore 3-month SIBOR	1.19%	0.97%	1.50%	1.81%	2.33%
BOK target overnight call	1.50%	1.25%	1.50%	1.50%	1.75%
BOT repurchase rate	1.50%	1.50%	1.50%	1.75%	2.00%
SBV base rate	9.00%	9.00%	9.00%	9.00%	9.00%

Source: OCBC Bank

Contents

CHINA

China turns more flexible

The Chinese economy kicked off 2018 on a strong footing with the economy growing by 6.8% on the back of global recovery story. Industrial production growth reaccelerated to 7.0% yoy in April from 6.2% yoy in December 2017 as the manufacturing sectors continued to benefit from the extended momentum of global recovery.

Although the external factors remain supportive, notwithstanding the looming US-China trade tension, China's growth is losing momentum domestically. Both retail sales and fixed asset investment decelerated at a more than expected pace in May. The deceleration of retail sales may be attributable to one-off events such as the postponement of car purchase in anticipation of tariff cut in July. However, the deceleration of investment is more structural due to China's persistent de-leverage campaign.

From financial de-leverage to structural de-leverage

Since 2018, the focus of China's de-leverage campaign has been shifted from financial de-leverage in 2017 to structural de-leverage mainly targeting at local government and SOEs financing. In addition, China stepped up to tighten its supervision on private public partnership program (PPP) to clamp down on potential misuse of the system. This has led to the significant slowdown in infrastructure investment.

On a positive note, China's de-leveraging efforts have started to bear the fruit. China's aggregate social financing unexpectedly collapsed to CNY760.8 billion in May, although new Yuan loans still rose in line with market expectations by CNY1.15 trillion as funding demand continued to shift from off-balance sheet items to on-balance sheet. The traditional off-balance sheet channels including entrusted loans, trust loans and banker's acceptances shrank by CNY421.5 billion in May due to de-leverage measures, the largest decline on record.

Slowdown ahead

We expect the Chinese economy to slow down in the coming quarters for three reasons. First, one of the unintended consequence of its de-leveraging efforts is eventual drag to real economic growth. The weighted average loan interest rate has increased to 5.96% in March, up 22bps from 2017. In addition, 9.94% more loans in the first quarter have been priced above the benchmark interest rate.

Second, the infrastructure investment is expected to slow down further as a result of the tightening in PPP and local government financing, which will continue to weigh down China's growth outlook.

Third, with the looming trade war, the contribution from external demand is likely to diminish. One of the key reasons why the Chinese economy outperformed in 2017 is because of strong support from external demand. Without the 0.6% contribution from net export, China is unlikely to achieve its stellar 6.8% growth in 2017.

As a result of higher funding costs, slower investment growth and diminishing support from net export, we expect China's growth to slow down to about 6.5% in 2018.

Prolonged trade tension

China's incremental financial market opening and reform in the past few months as well as China's compromise and pledge to import more US goods failed to stop Trump Administration from escalating the trade tension. The trade war will officially kick off from 6 July should both sides fail to find a last minute solution. We think the market should not underestimate the risk of trade war as Trump's unpredictable approach has managed to rally the animal spirits in the US and awakened China hawks. It has become politically acceptable in the US to take a tougher approach against China. This may give the US an advantage in the near term in negotiation. Nevertheless, in the medium term, it is forcing China to retaliate, which may further escalate the tensions. Although the direct impact of tariff on initial US$34 billion products is likely to be limited, the contagion and spillover effects may lead to higher volatility in the market. As such, we think market should closely monitor the development of bilateral trade negotiations ahead of the US midterm election in November, which could be the most important risk for China in the second half of 2018.

More flexible policies

Against this backdrop, China's policy has been more flexible. We expect China to expedite its plan to boost its domestic demand via proactive fiscal policies and flexible monetary policy to counter the negative impact of trade war.

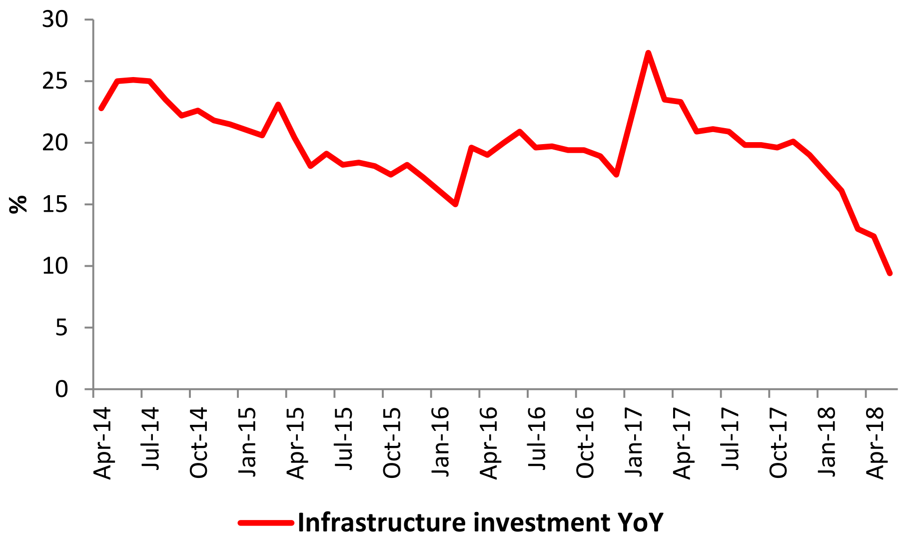
Since early June, China has switched to a more stimulative mode. On the monetary front, the PBoC announced to expand the MLF collateral to include AA rated credit bond as well as some SME loans to ease credit risk. In addition, PBoC injected a higher than expected CNY663 billion in longer term liquidity in June via the 1-year MLF to replace the maturing CNY259.5 billion MLFs. This is also the largest single month liquidity injection since December 2016. Meanwhile, China also announced the fresh round of targeted reserve requirement ratio cut to inject about CNY700 billion liquidity. We think China will continue to use both the MLF and RRR cut to strike the balance between financial stability and structural de-leverage.

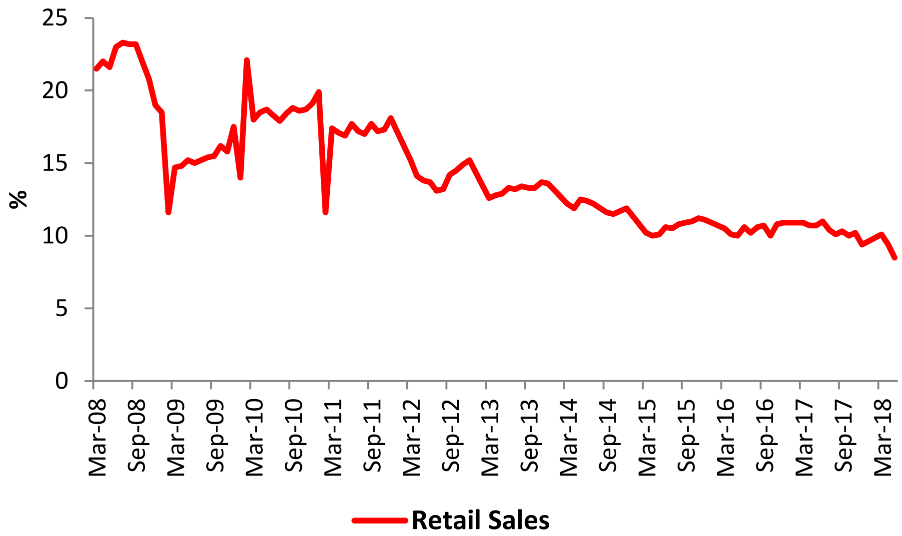
One of the bright spots in China is that its fiscal revenue growth remains strong, above nominal GDP growth. This will give China room to stimulate the economy and counter the impact of trade war via proactive fiscal policies. China's Ministry of Finance has proposed to cut income tax for individual in June. The minimum threshold for personal income tax will be raised to CNY5000 per month from currently CNY3500 per month pending on People's Congress' approval. This is equivalent to about CNY250-300 billion in fiscal stimulus.

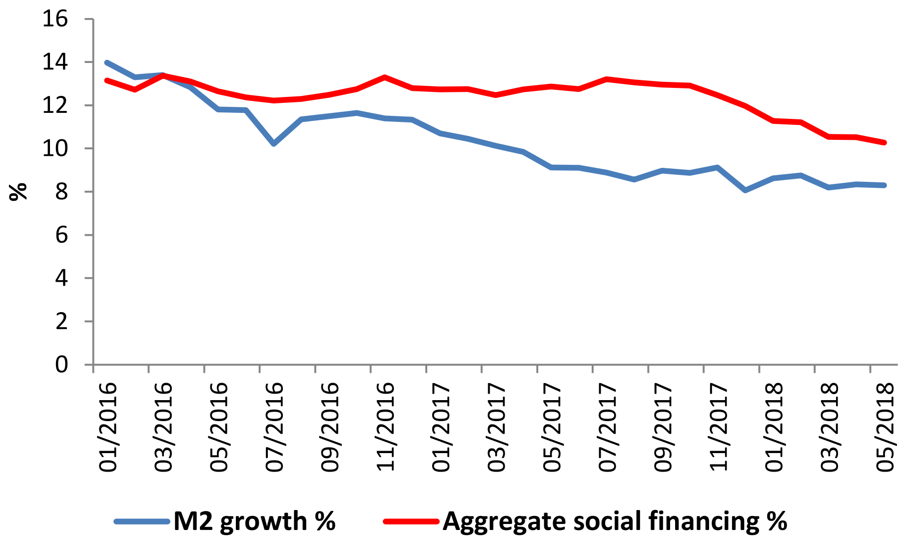
As mentioned by Vice Premier Liu He many times that China will be committed to defend its bottom line of no systemic financial risk. We think China will remain flexible in the second half to safeguard against thisrisk. As such, the risk of systemic crisis is likely to be contained for now.

Mild depreciation of RMB is acceptable

China's RMB has weakened significantly against the dollar recently as market believes China may use currency depreciation as a tool to alleviate pressure from the trade war. The recent rapid depreciation against the dollar was mainly driven by corporate flows ahead of dividend payments. There are recent signs that China may intervene to slow the pace of depreciation, however, we think PBoC has no intention to stop RMB appreciation as the RMB index remains high and a slightly weaker Yuan is helpful to alleviate the pressure on Chinese exporters arising from the looming trade war.







Source: OCBC Bank, Bloomberg

HONG KONG

Surprised on the upside

Economic growth continued to surprise on the upside. As US-Sino trade conflicts and local rate hike prospects have not yet materialized, the Hong Kong economy continued to benefit from stronger external and internal demand. On the one hand, synchronized global growth together with a weaker HKD has boosted the city's exports of goods and inbound tourism. On the other hand, local consumption has strengthened amid positive salary prospects and the wealth effect from the burgeoning housing market. Expansionary fiscal policy has boosted government spending and public investment. Given the strong growth momentum in 1H18, we upgrade our forecast for 2018 GDP growth from 2.9% to 3.6%. In the medium term however, we are wary of two potential downside risks. First, higher domestic interest rate may materialise in 2H18. Gradual increases in local rates could moderately weigh down the wealth effect and hurt local consumer sentiments. Second, should US-China trade tensions escalate, it may take a toll on Hong Kong's trade sector.

A weaker HKD is good for exports

In 1H18, HKD tumbled to the weak end of the peg for the first time since 2005. Due to the peg to the greenback, HKD followed USD to fall against major currencies. As compared to the end of 2016, USD/HKD rose 1.2% while the dollar index dropped 8%. Since HKD's weakness was a result of US-China yield differential rather than drastic capital outflows, it has been favorable for the economy. **On one hand, a weaker HKD combined with strong external demand has supported the trade sector.** As the US-China trade conflict has not yet materialized, HK's trade activities remained resilient on synchronized global growth. Exports of goods grew by 5.2% yoy in 1Q18, the strongest pace since the 3Q17. As the entire electronic value chain in Asia continues to benefit from global recovery, HK's exports of electrical machinery, telecommunications and sound recording, office machines and automatic data processing machines, which accounts for 66% of total exports, increased 12% yoy in 1Q18.

On the other hand, HKD's weakness together with Asia's sustained economic growth has buoyed tourism activities. Exports of travel services expanded remarkably by 11.8% yoy as total visitor arrivals increased 9.6% yoy during the first quarter of 2018. The revival of the tourism sector is also reflected in the four consecutive months of double-digit growth in sales of jewelry, clocks and watches.

Moving ahead, any rally in the HKD is expected to be moderate due to the still wide US-HK yield differential. Also, we expect the recent bout of USD strength to be short-lived. As such, a relatively weak HKD as well as the resilient global recovery could continue to lend support to HK's exports of goods and services.

Sanguine local sentiment to boost the economy

Apart from strong external demand, the sanguine local sentiment has also contributed to the robust economic growth. Specifically, private consumption advanced 8.6% yoy in 1Q18, the fastest pace since the third quarter of 2011. This was mainly due to the wealth effect from the burgeoning housing market.

The housing price index hit a record high for the eighteenth consecutive month and advanced 7% YTD in April.

With the unemployment rate at an over twenty-year low and salary prospects getting more positive, the tight labour market has also boosted consumer sentiment. In the coming quarters, the local economy will likely continue to benefit from sustained global growth, and we expect the labour market to stay tight. If this is the case, we may see a faster wage growth pace, which would in turn bode well for local consumption.

Elsewhere, an expansionary fiscal policy drove government consumption up by 3.9% yoy in 1Q18. With the government's efforts to ease the housing shortage, public investments in building and construction also advanced 9.0% yoy in the first quarter. These uptrends are expected to sustain into the coming quarters. As such, we upgrade our forecast for 2018 GDP growth from 2.9% to 3.6%.

Watch out for the downside risks

In the medium term, however, we are wary of downside risks from trade conflicts as well as possible rate hikes. **In terms of trade conflicts,** Trump's flip-flops on US-Chinese trade relations have increased the uncertainty for HK's trade sector. The sector's contribution to HK's economy reached 18% in 2016. Exports to China and US accounted for 62.2% of total exports while imports from these two regions took up 51.8% of total imports in 2017. As Trump trade protectionism aims at China's high-tech industry. HK's trade activities which are concentrated in the shipping of high-tech products could take a hit should the tensions escalate.

On the local interest rates front, we expect HK's banking system to kick off the rate hike cycle this year along with the uptrend in HIBOR. Global central banks may also start to tighten their monetary policy from late 2018. If this is the case, we may see a correction in both housing market and stock market amid capital outflows and higher borrowing costs. This could reduce the wealth effect and soften the growth of household spending.

Higher borrowing costs may discourage companies' spending patterns. Private investment growth decelerated from 9.6% yoy in 4Q17 to 5.1% yoy in 1Q18. In fact, loans for use in HK (excluding trade finance) have seen double-digit annual growth for fifteen straight months. However, loans to building and construction, property development and investment as well as household debt (including mortgage) represented 55% of total loans for use in HK (excluding trade finance). Higher interest rates will likely hit property market, mortgage demand as well as loan demand from property developers.

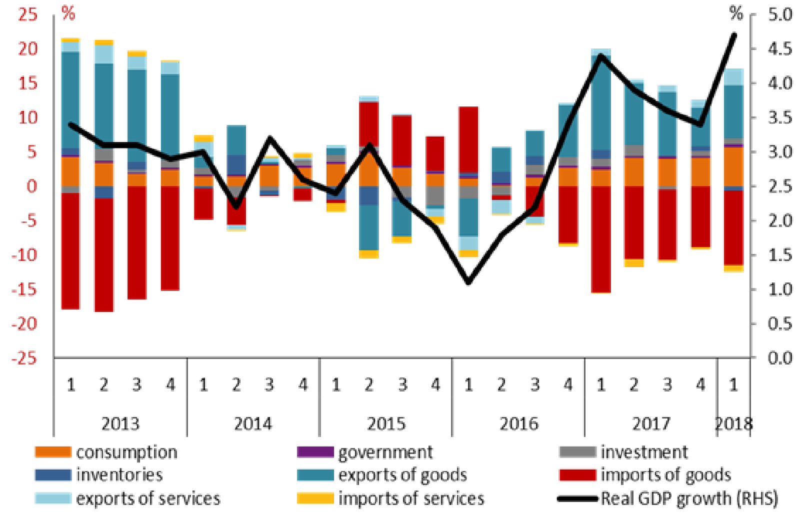
Limited downside for the housing market

Lately, we do see some signs of a slowdown in the housing market. May's housing transaction volume dropped for the third consecutive month by 4% yoy (-16.9% mom) to 5522 units. The annual growth of secondary home price index slid for two months in a row from February's 16.2% to April's 13.9%. Approved mortgage loans fell 5.6% mom in April. The slowdown was probably due to factors including higher borrowing costs, a volatile stock market and an expected increase in new home supply. In 2017, over 70% of housing transactions involved residential mortgages, while more than 90% of mortgage loans have been priced with reference to one-month HIBOR. The uptrend in HIBOR might have scared off some prospective homebuyers or encouraged them to wait for a correction in housing market. In the second half of this year, we expect banking system to raise the prime rate. This could further weigh on housing market sentiments and tame the demand for prime rate-based mortgage loans offered by property developers. Worse still, any stock market correction due to global monetary tightening could add downward risks to the housing market.

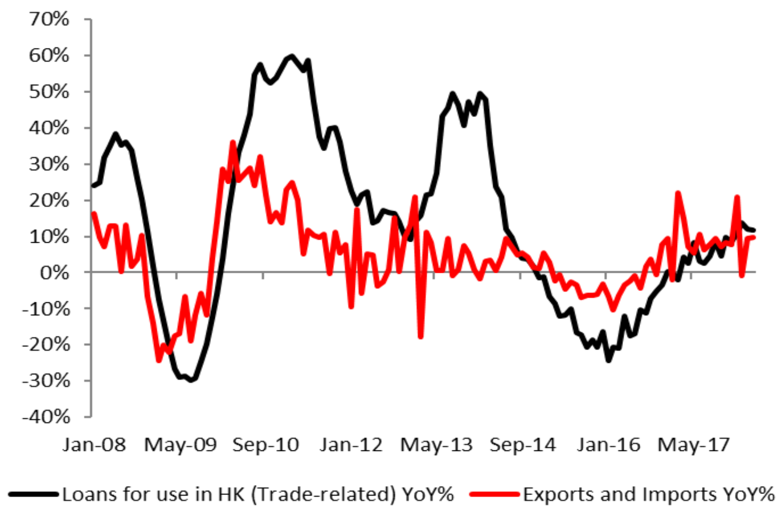
Nevertheless, the downside for the housing market tends to be limited amid a structural imbalance between home supply and demand. **On the demand side,** firstly, it is expected that nearly 50% of primary home transaction will not involve mortgage loans this year. Affluent investors whose housing demand is much less sensitive to interest rate changes could continue to support the market. Secondly, huge pent-up housing demand could help to cap the downside for the housing market. The growth of domestic households accelerated from an average of 1.2% during 2008-2016 to 1.4% in 2017. However, owner-occupiers as a proportion of total number of domestic households only marked 49.2% in 2017, down from an average of 52% during 2008-2016 due to the increasing unaffordability of private flats. Worse still, the average waiting time for general applicants for public housing increased from 4.7 years to 5.1 years.

On the supply side, first, property developers may choose to sell their new project at a slow pace in anticipation of a weakening housing market. Second, the residential land price, as well as the development and construction cost, has been increasing gradually, which means that any room for housing prices to drop is shrinking. Third, new home supply has been increasing at a subdued pace. In 1Q18, housing completions and housing starts decreased by 72% yoy and 68% yoy respectively. The government's effort to ease housing shortage may not pay off any time soon. All in all, we expect secondary housing price growth to slow down gradually from 14% yoy in April to 3% by end of this year.

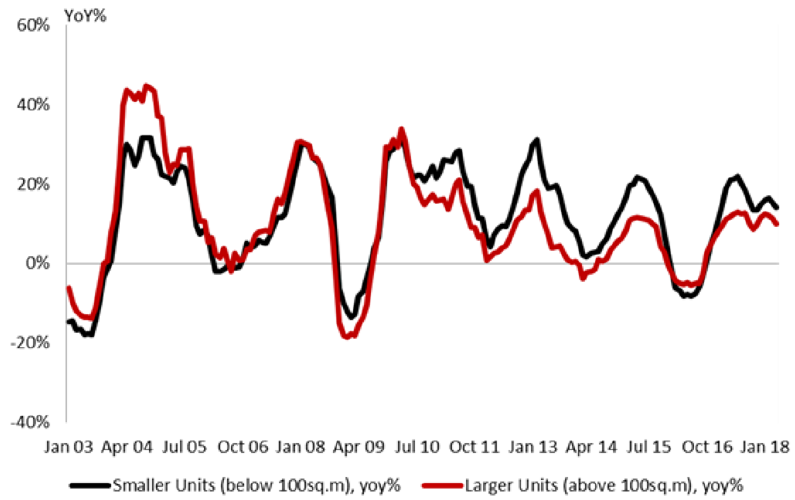
Hong Kong GDP Growth



HK Trade Activities & Trade Finance



Residential Property Price Growth



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

INDONESIA

It is not deja-vu

Tumbling IDR, weaker than expected growth, large pull out of capital funds and off cycle Bank Indonesia (BI) policy meetings, it all looks like a repeat of 2013 or 2015 one more time again. Some say history repeats itself and we should take lessons from the past. However, there are many reasons to believe that this isn't the same Indonesia. Domestically, this is a stronger Indonesia than before even if there are external pressures.

To begin with, the current account deficit for Indonesia is still much smaller at -2.04% of GDP as of 1Q 2018. Compare this to the taper tantrum period where Q3 2013 current account deficit went as high as -3.61% of GDP. Furthermore, the drivers of the deficit now compared to a couple of years back are very different. The deficit back in 2013 was heavily driven by a decline in commodities export revenues whilst the deficit today could potentially be linked to the rise in FDI (see chart 1 and chart 2). If we look at the trade data of Indonesia, export growth has been very strong throughout 2017 and into the beginning of 2018 (see chart 3) whilst back in 2013 and 2015, it was in mainly in negative growth territory. Imports have also been high through 2017 and into the beginning in 2018 (see chart 3). Back in 2013 and 2015, this number was in the negative growth territory.

In addition to this, inflation this time is at a much more manageable level compared to before. The latest May headline inflation was at 3.23% yoy and well within the target range of Bank Indonesia's $\pm$ 3.5% range. In 2015, headline inflation hit as high as 7.26% yoy during the year and averaged 6.4% for the entire year. As for 2013, it hit levels as high as 8.18% yoy and similarly averaged 6.4% for the whole year. The freezing of fuel and electricity prices have also likely helped in moderating inflation.

Although 1Q 2018 growth grew slower than expected at 5.06% yoy but this is still a healthy level. The slower growth was mainly due to once again sluggish household consumption growth at 4.95% yoy, which was below the five year average of 5.0%. It continues to remain a puzzle as to why consumption growth is not picking up in Indonesia despite inflation coming in at a manageable average level of 3.3% in 1Q 2018. The consumer confidence index was also high at 121.6 in March (a number above 100 indicates optimism). However, the bright spot for Indonesia is that investment growth remains strong at 7.95% yoy (4Q 2017: 7.3% yoy). Gross fixed capital formation (GFCF) in machinery & equipment continued to grow strongly at 23.7% yoy (4Q 2017: 22.31% yoy) providing support to the development of the manufacturing sector. GFCF in buildings & structures was still strong at 6.16% yoy (4Q 2017: 6.68% yoy) possibly supported by infrastructure investment.

We still believe that Indonesia's economy will expand by 5.1% yoy for the entire 2018. We remain optimistic at this point that household consumption has a chance of picking up on top of a more contained level of inflation, stable labour market conditions and government spending ahead of upcoming elections. The pressure on the IDR will slowly reduce as BI is now going to be more pre-emptive in raising rates. Investment growth will continue to remain robust as overall GDP growth performance can still be deemed as strong. The manufacturing PMI also rose to a 23 month high in May of 51.7 with the degree of optimism also at three-month high, reflecting expected improvements in demand and planned company expansions. The central bank has also talked of introducing macro-prudential measures to ease financing and develop financial marketing deepening. However, there may be some risks to investment growth arising from uncertainty surrounding the upcoming elections where some potential investors may adopt a wait-and-see approach. Similarly, there is a risk that household consumption growth continues to disappoint.

On the interest rate front, the new Governor Perry Warjiyo has made it clear that Bank Indonesia will be “pre-emptive, front-loading and ahead-of-the-curve”, clearly signalling a more hawkish stance as it attempts to stabilize the IDR. Near-term USD strength doesn’t immediately show signs of slowing and we will continue to have to watch closely regarding the strength of US economic data. Any subsequent BI hike would depend on the Fed delivering four hikes this year.

This is definitely a different Indonesia in 2018 compared to the past. On relative terms, domestic pressures are much less than before, even if external pressure persists. Compared to 2013 and 2015, the current account deficit is narrower, the headline inflation rate is lower and growth rates are stronger. The central bank also has a much higher level of reserves. However, going forward, the Indonesian government though will still be meandering through a delicate situation as it balances between growth and stability.

Chart 1: Current account deficit, %

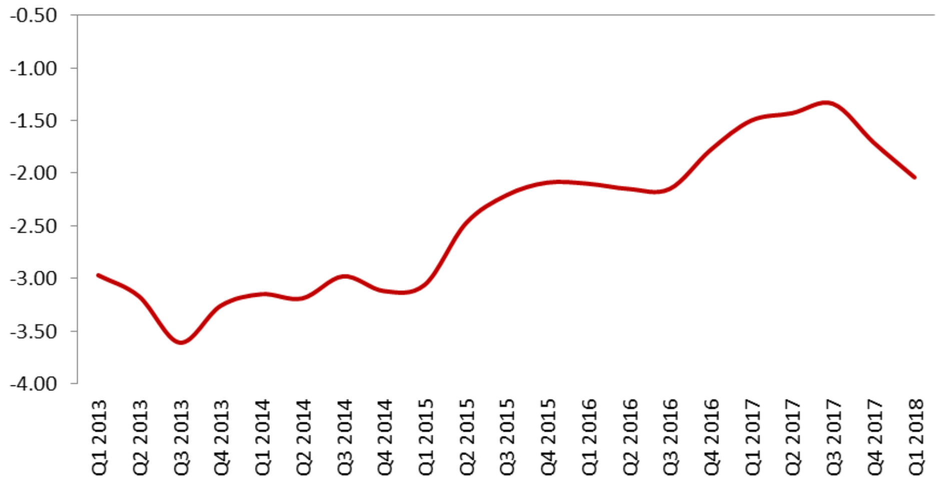


Chart 2: FDI, US$bn

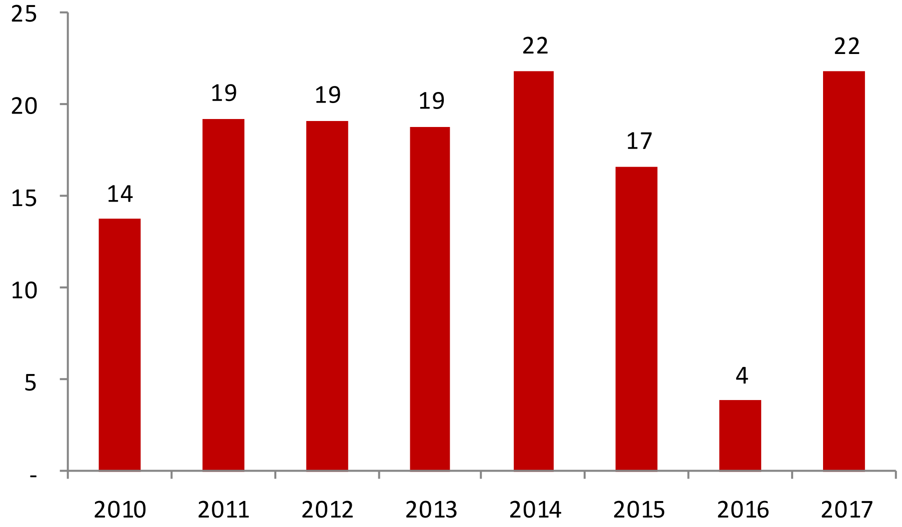
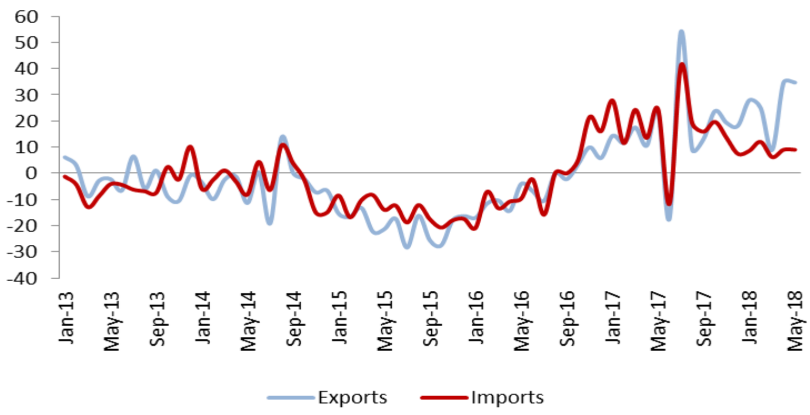


Chart 3: Exports and Imports Growth, %



Source: CEIC, Reuters, OCBC Bank

KOREA

A cautionary tale

What's good initially may serve as a hurdle henceforth

Korea, like many neighbouring Asian economies, saw a huge positive export and manufacturing turn-around throughout the most of 2017. As recent as October 2017, Korea exports grew at a strong 35% year-on-year, clocking nine months of consecutive double-digit export growth and at its fastest pace since January 2011. Similarly, manufacturers also saw a rosy period with industrial production growth clocking a strong eleven months of consecutive expansion into September 2017 and marking the longest expansion streak since its 30-month consecutive expansion seen back in Dec 2011. The relatively rosier economic backdrop then have also injected positive spill-over effects into its domestic economy, as seen from a healthier labour market as unemployment dipped to its seventh month low of 3.5% in July 2017, while private consumption accelerated to its fastest pace in seven quarters to 3.4% y/y at 4Q17. To that end, the relatively rosier economic prints and potentially higher rates in other developed economies gave the Bank of Korea (BOK) enough ammunition to pre-emptively raise its base rate by 25 basis points to 1.50% in late 2017.

But what seems to be a strong end to 2017 appears to give 2018 a formidable high base hurdle. In a rather quick turn of circumstances, the first signs of moderation came as early as March with Korea's manufacturing Purchasing Manager's Index (PMI) falling below its 50.0 mark, suggesting deterioration in manufacturing optimism then. Export growth surprisingly contracted into April (-1.5% y/y, vs market estimate of +3.3%), while overall 1Q18 growth disappointed at 2.8% y/y, well below its 10-year average of 3.3%. Further signs of moderation were seen into late May seen from poorer manufacturing PMI which consistently printed below its 50.0 handle for three consecutive months, while unemployment rate rose back to its 4.0% handle.

To fully illustrate Korea's moderating growth, one would need to look no further than its recent disappointing 1Q18 growth print and its details. Growth remains specific in selected industries, suggesting that the recovery is not broad-based: across industries. The manufacturing sector rebounded by 1.9% q/q (up from -1.7%) led by the increased production of machinery and equipment, while construction activities encouragingly picked up by 3.3% q/q buttressed by the increased construction in both residential and non-residential projects. However, growth in the services sector remains lacklustre at a mere 0.9% q/q, with cultural/other services (+4.0%) & finance/insurance activities (+2.8%) shouldering the bulk of it while the rest of the services sector slowed to sub-2.0% q/q growth. By expenditure, exports rebounded 4.4% q/q, up from -5.3% in the previous quarter suggesting that growth in Asia's fourth largest economy remains underpinned by the uptick in global trade activities, although the April export contraction does threaten this optimistic outlook. Lacklustre private consumption growth over the same period were seen as well, suggesting that the uptick in exports and manufacturing activities have not been fully translated into Korea's labour market and spending power.

Three potential growth drags into 2018

The moderation in growth indicators are observably stark to-date, seemingly so vivid that the recent BOK monetary policy statement was relatively softer compared to its April's rhetoric. The policy-makers were quick to recognise relative weakness across Asia's emerging market space, citing that "some emerging market economies with weak external soundness have shown instability, as capital outflows from them have increased". However, in Korea's domestic environment, the statement highlighted that "employment conditions have been sluggish", shifting their language from merely "recovery in employment conditions has slowed" while removing its previous positive tone over "improvements (seen) in household income conditions" in their April statement. In a nutshell, the central bank cites potential growth drags including (1) monetary policy normalisation in major economies, (2) trade protectionism and (3) the uncertainties surrounding the direction of the US government's economic policies.

While these concerns do sound relevant and pertinent in explaining the relative slowdown seen of late, they remain isolated to exogenously-driven factors. As a matter of fact, Korea's domestic economy is also showing signs of moderation; we identify three domestically-related drags that Korea may see: (1) elevated household debt levels, (2) structural unemployment environment and (3) persistently weak manufacturing confidence. Importantly as well, net foreign equity investment in Korea has seen three consecutive months of outflows into April 2018, suggesting that foreign investors remain concerned over N. Korea-centric geopolitical uncertainties.

The rise in household debt as a percentage of GDP is particularly worrying and is a symptom that BOK governor Lee has repeatedly pointed out in his recent statements. In fact, Korea's household debt to GDP rose to a 84.1% high in 1Q18, up from 56.4% back in 2004. The International Monetary Fund (IMF) has cited that household debt "may raise the likelihood of a financial crisis and could lead to lower growth", while "there is a trade-off between the short-term benefits of rising household debt to growth and its medium-term costs to macroeconomic and financial stability". In short, the tenet of economics highlights the benefits to growth in the short-term as household finances consumption through incurring higher debts. However, households would increasingly face medium-term debt burdens especially through higher interest rates, which in turn curbs future consumption and overall GDP growth.

With the higher household debt seen into 1Q18, the uptick in domestic consumption seen during the same period suggest to us two important aspects: one, higher consumption has largely been fuelled by debt, and two, the trend of consumption growth is likely not unsustainable in the long-run. Moreover, household debt burdens are exacerbated by higher policy-rates by developed economies, in which BOK would need to eventually account for in order to pursue macroeconomic stability and reduce the risk of capital flight especially if rate differentials widen further. Even so, the ballooning debt is also accompanied by a relatively weaker labour market seen into 4M18, as unemployment levels rose back to its 4.0% handle, suggesting that the relatively softer external environment has quickly translated into redundancies in Korea's labour market.

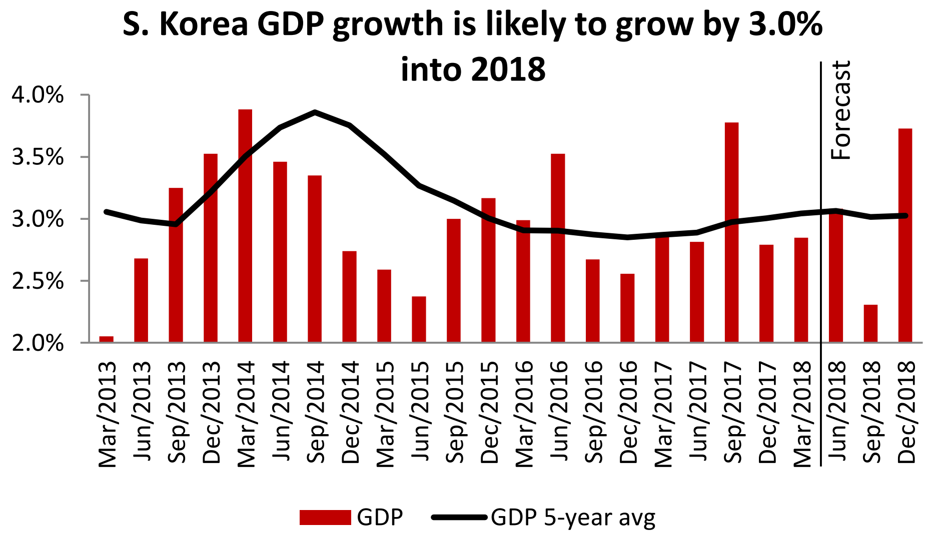
Lastly, the persistently weak manufacturing and services confidence seen since 2011 highlights the relative pessimism felt in the Korean economy. Recent survey results show that manufacturers were particularly worried about domestic consumption patterns and uncertain global economic conditions. The pessimism is likely also led by the slowing trade growth seen into early 2018, and could slow further given the high-base growth seen in 2017.

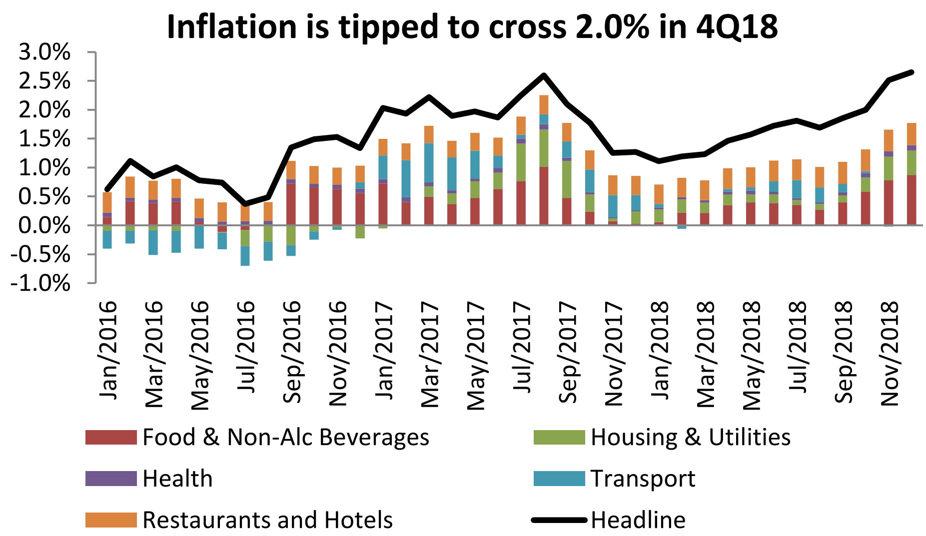
Fiscal plans are still much needed

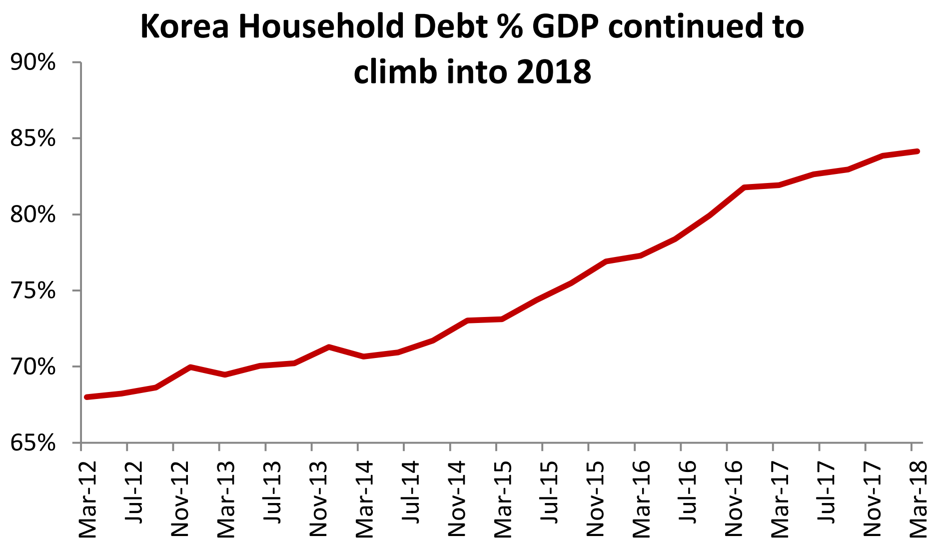
The possibility for further growth moderation, coupled with policy-makers' somewhat reluctance to raise rates given the uncomfortably high household debts does raise the question over potential economic stimulus should headwinds fortify. Meanwhile, the uneasiness over the pick-up in unemployment levels can also give further downside risk to both domestic consumption and growth into the medium-term ahead. To that end, investors can find relief from Korea's KRW4 trillion ($3.8 billion) supplementary budget in hope to boost business subsidies to help cut the country's high youth unemployment. Or as President Moon puts it, "An extra budget to add jobs for young Koreans is inevitable."

Still, beyond fiscal stimulus to aid Korea's domestic economy, the risk of moderation in exports into 2H18 and increasing debt burdens by households does inject headline growth risk for Korea into the rest of this year. Importantly, recent domestic consumption growth seen into 4Q17 was supported by increasing household indebtedness, while business confidence remains weak to-date. All-in-all, the recent softer-than-usual statement by the central bank signals to us a subtle shift away from the somewhat positive tone seen in 2017.

With 1Q18 GDP growth falling short of the government full-year growth target of 3.0%, it is vital to look for more signs pertaining to growth momentum into the rest of 2Q18, though we admit that recent incoming data has been less rosy than before. As such, while we still keep our growth and inflation forecasts at 3.0% and 1.7%, respectively, we opine that the hurdle for BOK to hike rates before 2018 is up has been building up. As such, we keep our outlook for BOK to stay pat at 1.50% for the year ahead.







Source: CEIC, Bloomberg, OCBC Bank

MACAU

A more solid recovery

The gambling hub's economic recovery has proved to be more solid than the past. This was mainly attributed to the synchronized global recovery as well as the efforts to diversify the local economy away from over-reliance on gaming elements. In 1Q18, GDP advanced 9.2% yoy, marking the seventh consecutive quarter of positive growth. With the opening of new hotels and casinos over the past two years, inbound tourism has improved by leaps and bounds. This has brought casual gamblers to the gambling hub and reduced the gaming sector's reliance on high-rollers. As such, exports of gaming services and other tourism services increased by 16.5% yoy and 19.6% yoy respectively. Owing to the revival of pillar industries including tourism and gaming and a slew of new project openings, hiring sentiments remained upbeat. The resultant tight labour market and positive salary prospects together drove private consumption up at the fastest pace since 1Q15 by 4.8% yoy. Besides, government investment in fixed assets jumped by 132.5% yoy as a raft of infrastructure projects has been under construction. In the coming quarters, we will see infrastructure improvement (including Hong Kong-Zhuhai-Macau bridge) and the opening of a new wave of mega entertainment projects. Against this backdrop, the economy is expected to continue benefiting from strong external and internal demand. If this is the case, even with an unfavourable base effect, Macau's GDP could still expand by 7% this year.

Cautiously optimistic about the gaming sector

Gaming revenue unexpectedly increased 20.1% yoy over the first four months of 2018. This round of gaming growth is led by both casual gamblers and high-rollers, which makes it different from the past. Date back to 2005-2013, the gaming sector relied heavily on the VIP segment with VIP revenue accounting for roughly 70% of total gaming revenue. With a raft of new mega entertainment projects opening one by one since 2016, tourism activities have revived strongly on the back of Asia's resilient growth. Over the first four months of this year, total visitor arrivals increased 8.4% yoy. The number of overnight visitors climbed for the 28th straight month by 9.3% yoy in April. Hotel guests grew for the 33rd consecutive month by 7.6% yoy while hotel occupancy rate rose 2.8 percentage points to 88.9% in April. Zooming in, over 50% of the total visitors from Mainland (54%), Japan (63%) and South Korea (62%) stayed overnight. This reinforces our view that a new wave of mega projects openings has buoyed the tourism sectors and in turn lent strong support to the mass-market segment of the casinos. As a result, the mass-market's contribution to gross gaming revenue edged higher by 10 percentage points to about 40% over the past few years.

Moving forward, any further improvement in inbound tourism will bring more recreational gamblers to the city. Therefore, the mass-market's contribution to total gaming revenue is expected to increase gradually. In contrast, the support from VIP segment could wane should policy risks escalate. Lately, two commercial banks in Macau were reported to have removed the UnionPay machines from either pawnshops or jewellery shops around casinos. This raises concern that policy risks related to anti-money laundering are looming over the gaming sector. In addition, the expected increase in borrowing costs could impede junket operators from extending credit to high-rollers. Once the support from high-rollers abates, gaming growth driven mainly by mass market could be slower than that bolstered by both VIP and mass segments. Furthermore, the whole gaming sector may see its growth slowdown over the third quarter of this year as the World Cup is set to distract some gambling demand away from casinos. All in all, we hold onto our view that gaming revenue growth will slow down to 10%-15% in 2018.

Retail sector to sustain growth momentum

Apart from the gaming sector, the retail sector also benefited from the revival of tourism. Coupled with the sustained growth of Asia, a weaker MOP has also helped to bring more tourists to the gambling hub by increasing their purchasing power. Total spending of visitors rose for the seventh consecutive quarter by 22% yoy in 1Q18. Local consumption also has been elevated on the back of faster wage growth as median monthly employment earnings rose for the second straight quarter by 6.67% yoy to MOP16,000 in 1Q18. As such, retail sales jumped at the strongest pace since 4Q13 by 25.7% yoy in 1Q18. The sales of watches, clocks & jewellery, which represented 21.1% of total retail sales, advanced 17.87% yoy. Sales of goods in department stores (+33.8% yoy), adults' clothing (+36.5% yoy) and leather goods (+37.1% yoy), which combined accounted for 43% of total retail sales, all grew significantly. Hence, the retail sector outlook has improved and the retail shop market has rebounded notably. The transaction volume and value of retail shops edged higher by 22.4% yoy and 84.4% yoy respectively in 1Q18. We expect retail sector and retail shop market to sustain their growth tractions in the rest of 2018. This may in turn give a boost to the domestic economy.

Housing market is facing new control measures

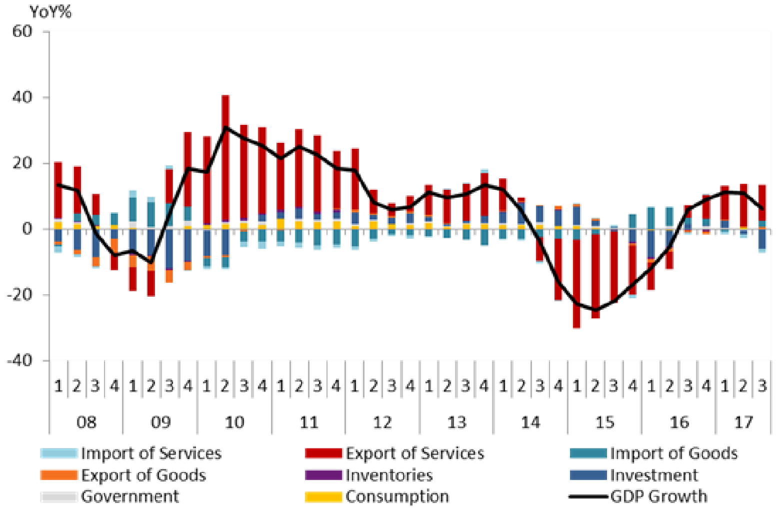
On the back of the sanguine economic outlook and persistently low borrowing costs, housing market sentiments had been upbeat over the first two months of this year. As a result, housing transaction volume surged by 138% yoy during the period. However, following the implementation of new property control measures, the housing market has been somewhat affected. Specifically, housing transactions decreased for the second consecutive month by 10% yoy to 973 deals in April, even though the average housing price advanced for the fourth straight month and rose by 5.6% YTD to MOP 102,439/square meter in April.

In early February, the government unveiled three new measures to control the property market. First, the exemption of vacant residential property tax is cancelled. Second, on top of the existing stamp duty, buyers of second homes have to pay additional 5% of the property value and those of a third property and above will need to pay an addition of 10%. The removal of exemption of vacant residential property tax and the additional stamp duty on second-home buyers have curbed housing demand and reduced secondary home supply. As a result, housing transactions are expected to remain sluggish in the coming months.

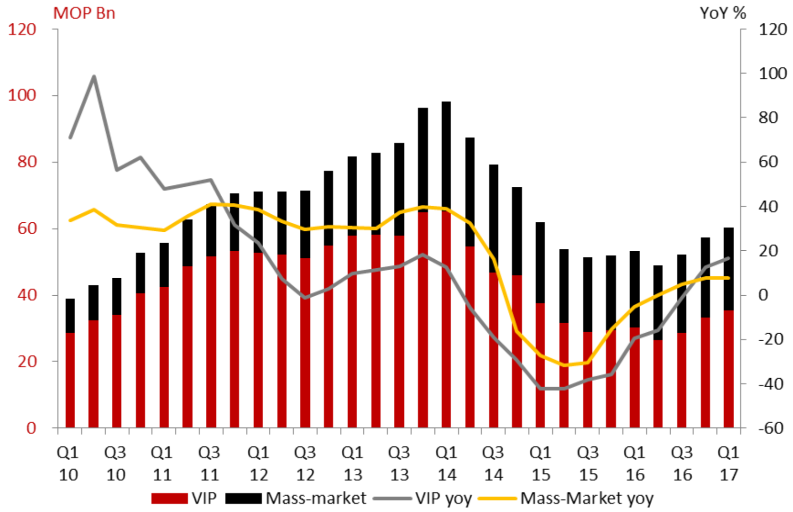
Third, first-home buyers aged between 21 and 44 who hold Macao identity cards are allowed to apply for a mortgage with loan-to-value ratio up to 90%. As such, pent-up demand has translated into resilient housing prices and notable growth in mortgage loans. Data shows that over 80% of the transactions involved first-time local homebuyers. Approved new mortgage loans rose 133.9% mom to MOP 6.08 billion in March.

Moving forward, the buoyant economic outlook and tight labor market are expected to accelerate wage growth. This could encourage first-home buyers to enter the market. On the supply front, housing completion decreased by 20% yoy to 415 units while housing start fell by 89% yoy to 338 units over the first four months of 2018. The scarce home supply combined with strong demand from first-home buyers will likely elevate housing prices. We expect housing prices to advance 8%-10% yoy by end of this year. However, higher borrowing costs and potential stock market correction may limit the upside for housing prices.

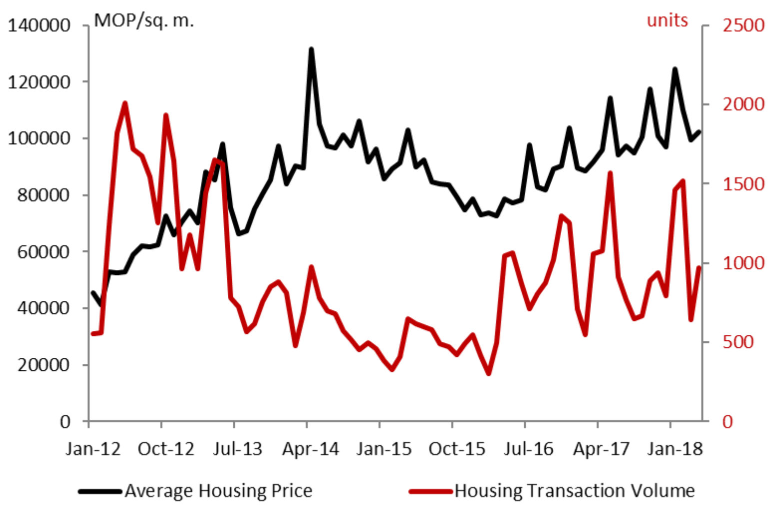
Macau GDP Growth



Macau Gaming Revenue by Segment



Macau Residential Property Market



Source: DSEC, DICJ, Financial Services Bureau

MALAYSIA

New government, new direction

It has been a big first half of the year for Malaysia with a first ever historic change of government from the incumbent Barisan Nasional (BN) to Pakatan Harapan (PH). The 92 year old Mahathir Mohamad is back at the helm as the 7th Prime Minister and shows no signs of slowing or exhaustion. If anything, we are seeing the that new government has been quick at work to deliver on some of its first 100 days promises and undertake reforms that it has talked about for years. A Council of Elders has been created to oversee the delivery of these first 100 days promises.

Economically, growth for 1Q 2018 was still strong albeit slower at 5.4% yoy. It was below the median consensus growth forecast at 5.6% yoy but only slightly above our own forecast of 5.3% yoy. Private consumption was once again the main anchor of growth, expanding at 6.9% yoy. Trade growth was more subdued with exports growing at 3.7% yoy and imports declining at 2.0% yoy. Investment growth disappointed at 0.1% yoy mainly due to a decline in government investment by 1.0% yoy.

Going forward, it is fairly obvious that one would primarily have to watch closely how the fiscal plans of the new government shape up. The new government has already brought down the GST to 0% and they will be looking to reintroduce the sales and service tax (SST) in September. They have also already cancelled the Kuala Lumpur – Singapore high speed rail and the MRT line 3. The Ministry of Finance has announced that they will be targeting to cut a total of RM10bn from the budget this year. The cuts will cover projects that were awarded through direct negotiation or limited tender, non-essential operating expenditures such as consulting services, allocations to mega projects and other items that include special projects under the Internal Coordination Unit (ICU). The government is also incurring additional expenses related to a Hari Raya special assistance to lower ranked civil servants and a petrol price stabilization program. However, the government has announced that it will be continuing ahead with the East Coast Rail Line (ECRL) and the Tun Razak Exchange (TRX). With regards to the former, Finance Minister Lim Guan Eng has said, “It doesn’t really make sense to just scrap it because we’ve already paid RM20 billion”. As for the TRX, the government has said that they would have to pay RM3.5bn in compensation if they were to cancel it. With all this in mind, it would be crucial to watch closely as to the extent to which the government can continue to review other major projects such as the Pan-Borneo Highwat. Also, there is also a risk that the government could take on additional expenditure especially in relation to other manifesto promises.

Regardless, at this point, we still keep our growth forecast at 5.5% yoy for 2018. We see that private consumption has the potential to strengthen further due to items such as government handouts and civil service assistances/bonuses already paid out or to be paid out by both the previous and current government. As the dust settles, investment should also pick up during the remainder of the year. The global economic situation also remains healthy for the year-to-date. However, this optimism can be tempered by announcements regarding changes of major infrastructure projects.

On the interest rate front, we believe that it is very likely that BNM would keep the OPR on hold at 3.25% for the rest of the year. With growth at 5.4% yoy in 1Q 2018, the situation would not favour for the central bank to raise rates for at least the next few months as BNM had after all forecasted for growth in 2018 to fall in the range of 5.5% - 6.0% this year. The government has also appointed Nor Shamsiah Mohd Yunus as the new governor of BNM. However, this would unlikely see a change in the monetary policy stance given the new governor's background as a career central banker at BNM.

There will probably also be more policy clarity after the full cabinet is sworn in on the 2nd July 2018. The works minister would be announced on that day and it would be crucial to look out for any future announcements regarding the Pan-Borneo highway from the new minister. It would also be of interest to watch closely how the new government would set trade policy following the unveiling of the new trade minister on that day too.

Despite the many recent changes, Malaysia remains one of Asia's most stable economies and we still expect strong and steady growth for this year. However, going forward, we will have to continue to watch closely how the new government policies unfold and in particular, the subsequent effects that these policies could have on the government's fiscal situation.

Chart 1: Contributors to GDP growth, %

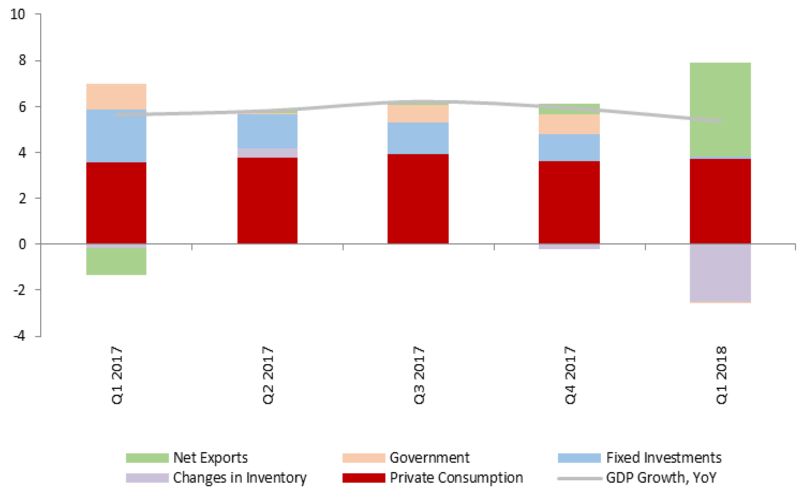
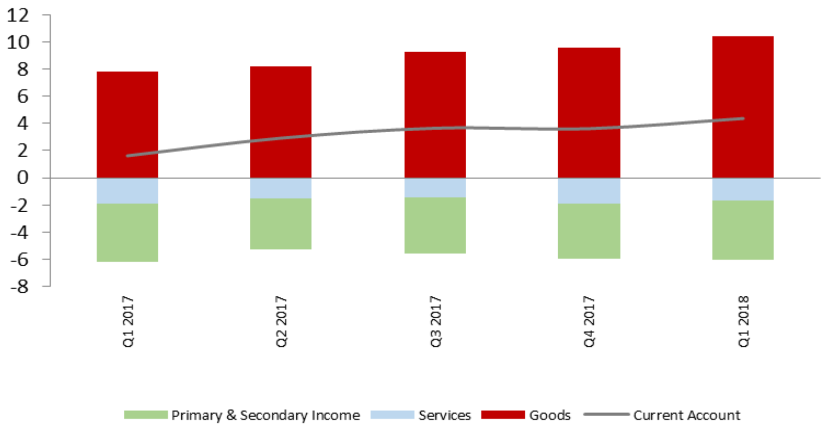


Chart 2: Current account and components percentage of GDP, %



Source: CEIC, Department of Statistics Malaysia, OCBC Bank

MYANMAR

Opportunities amidst change

In the 2018 Global Outlook, we noted a number of distractions that beset Myanmar, and urged readers to look pass them to focus on the positive developments. Since then, the situation has broadly improved. In truth, however, many of the distractions continue to simmer on with limited signs of a full resolution. Investors in Myanmar generally take the long view, and the saving grace is that the long-term outlook remains positive. In the near term, changes in the legislative and regulatory fronts may give rise to business opportunities for corporates.

Foreign investment environment: Worst may be over
From a bigger perspective, a myriad of political issues has reduced the attractiveness of Myanmar as an investment destination in 4Q 2017. However, the worst of foreign investor sentiments may have passed. The approved value of foreign direct investments (FDI) by permitted enterprises saw a 52.0% quarter-on-quarter growth in 1Q 2018. Singapore alone accounted for around 47.0% of all FDI in 1Q2018. This shows that Singaporean corporates remain convinced of the Myanmar story despite the challenges. Having said that, note that total approved FDI is about US$1bn lower fiscal year-to-date (note the extension of FY2017/18 due to shift in fiscal year) from April 2017 to March 2018, compared to FY2016/17 (running from April 2016 to March 2017). Moving forward, a temporary slowdown in FDI may be expected as Myanmar undergoes a transition to shift the fiscal year to Oct-Sep, as opposed to the current Apr-Mar. Taxation and other complications may keep foreign investors away, although we do not expect any structural impediments in the long run.

From a sector perspective, we note that there is an emphasis on investments in manufacturing. Despite the decline in overall FDI between April 2017 and March 2018, approved foreign investments into the manufacturing sector actually increased from US$1.17bn in FY2016/17 to USD$1.77bn in the same period between 2017 and 2018, which is a 50% increase. This highlights the government’s strategic shift towards labour-intensive, export-oriented manufacturing industries. Moving forward, as Myanmar continues its path towards industrialization, one may expect further investments into the transport and infrastructure sectors.

Many new opportunities should arise in the manufacturing, transport and infrastructure sectors. As in most emerging countries, the government’s policy priorities will drive business opportunities. Potential investors should keep a close look at recent legislative and regulatory changes to identify investment opportunities. We outline two such changes here.

Education: A unique opportunity
Following a relaxation of rules surrounding foreign investment into educational services sector in April 2018, this may be the next growth area for Singaporean investment into Myanmar. Foreign investors are now permitted to contribute 100% of the capital investment needed to establish a private school for basic education, technical and vocational training, higher education, and any other educational service as designated by the Myanmar Ministry of Education.

This scope effectively covers the entire education spectrum.

Broadly speaking, this is a move in the right direction for Myanmar, as education and training are the keys towards a stronger labour force, and thereafter, faster social and economic development. Singaporean corporates are in a uniquely strong position to assist in this respect. The Singapore education system is built upon a strong bilingual foundation, and often ranks top in international rankings for Mathematics and Science. Thus, the Singapore education brand-name delivers both international repute and desirable attributes in the current climate. Singaporean education programmes have been popular overseas, with the education-related corporates are well-experienced in exporting private education services in the region. Therefore, there is a strategic match in terms of Myanmar's demand and Singapore's expertise in this area.

Note that the Singapore brand-name is already present in the Myanmar education and training landscape. The Singapore-Myanmar Vocational Training Institute (SMVTI) launched in 2016 has its curriculum planned by the Singapore Institute of Technical Education, and will see its 6th intake in June 2018. In November 2017, the Institute of Singapore Chartered Accountants (ISCA) also penned a memorandum of understanding with the Myanmar Institute of Certified Public Accountants (MICPA) to raise the accounting profession towards internationally accepted standards and norms. These instances show that a Singaporean touch in the education sector is very much welcomed.

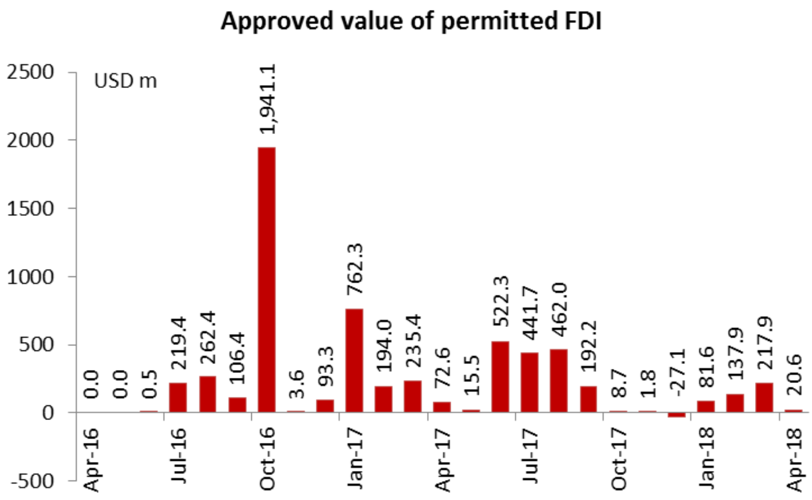
Infrastructure: Always in demand

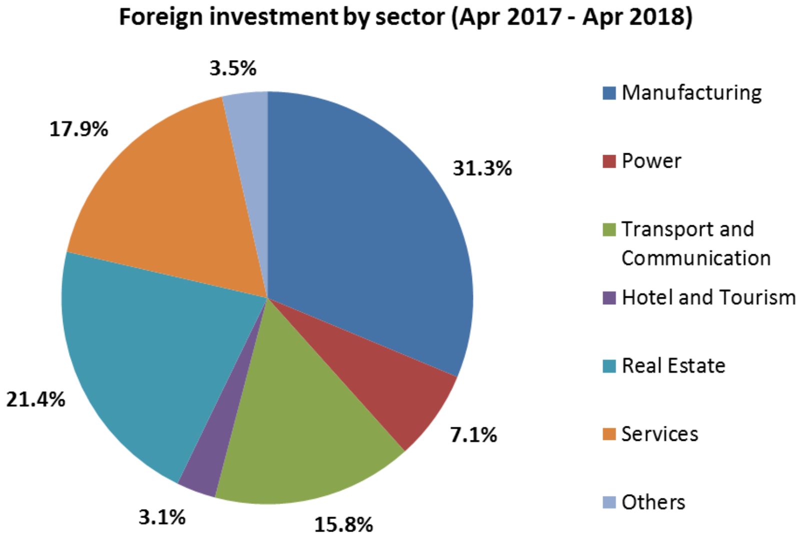
Another opportunity is in infrastructure development. Infrastructure will always be in demand in a developing country like Myanmar, and the recent Yangon Myothit project is too large to overlook. A new development company, the New Yangon Development Company (NYDC), was formed by the Yangon Regional Government to oversee the development of the new city, Yangon Myothit, spanning about 14,000 acres towards the south-west of the existing Yangon city. Moving forward, the new city would complement the existing Yangon city by easing the traffic congestion and providing the housing needs for the growing population.

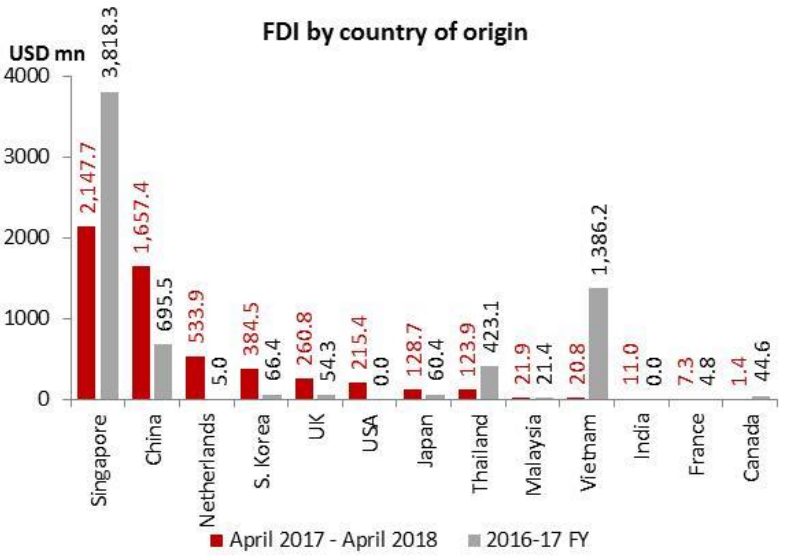
The initial phase of the development will focus on infrastructure projects, estimated to cost US$1bn in total. Basic transportation infrastructure, such as bridges and roads, will need to be built or upgraded. Following that, new investment will be required for industrial zones, electricity generation and distribution, water treatment plants and other critical infrastructure. As it stands, the development projects within Yangon Myothit may largely take the form of Public Private Partnerships (PPP) with the Yangon Regional Government. This structure may reduce the inherent risks for foreign corporates entering Myanmar, and prove to be attractive to the foreign investors. Moreover, the procurement process is expected to feature the "NYDC Challenge Model", an adaptation of internationally recognized Swiss Challenge procurement method. This method allows third parties to make counter-offers, thereby encouraging transparency and reducing the chances of inflated project costs. Note also, that the former Singapore foreign minister, George Yeo, is an independent director at the NYDC.

Conclusion: Opportunities amidst change

The investment climate in Myanmar will remain challenging over the near term. Social and political issues will continue to dominate international media, and perhaps distract from the economic issues and opportunities. However, the worst may have passed, and FDI have returned in a modest fashion. Moving forward, there may be a quiet period for foreign investment due to the administrative confusion over the shift in fiscal year, although this should be sorted out in time to come. New opportunities will show itself to discerning corporates will are willing to invest effort in understanding the legislative and regulatory changes. Overall, we continue to view Myanmar as an attractive proposition for corporates who have a long term horizon.







Source: Bloomberg, CEIC, OCBC Bank

PHILIPPINES

"Build, Build, Build" for a stronger economy

The Philippines, with a GDP growth rate at 6.8% in 1Q 2018, is the second fastest expanding economy in Southeast Asia, after Cambodia. This pace is not expected to ease up over the near term, with full-year growth forecasts coming in at 6.7% for 2018 and 2019. A key plank to sustain this rate of growth is the Duterte administration's massive infrastructure programme, dubbed the "Build Build Build" initiative, aimed at bridging the infrastructure gap and improving local business environment in the long term.

Philippines' expansionary fiscal policy boosts GDP growth

The "Build Build Build" initiative consists of total 75 flagship projects. In 2018 alone, the overall infrastructure programme was allocated of US$22bn, equivalent to 5% of GDP. Known as the most ambitious infrastructure programme in the history, the initiative consists of six airports, nine railways, three bus rapid transits, four seaports, and 32 new roads and bridges. The government intends to spend more than US$160bn over the next five years. The successful implementation of the initiative will provide the foundations of robust growth in the Philippines in the medium term.

One of the key projects to note is the New Clark City (NCC), which aims to develop the Philippines' next metropolis amidst an abundant green, high-tech and disaster-resilient landscape. Located just 100 kilometres away from Metro Manila, the NCC will cover an area of 9,450 hectares. Given its advantageous location close to Metro Manila, it has the potential to greatly reduce the traffic and congestion in Metro Manila as businesses and economic activity is diverted from the capital. Envisaged to be the next economic hub in the Philippines, it is expected to contribute PHP1.57tn to the GDP annually.

While the initiative looks positive on paper, the implementation has proven to be a significant challenge. The funding remains a critical issue. As it stands, the initiative is expected to be funded by the additional tax revenue collected from a series of tax reforms, as well as Official Development Assistance from Japan and China.

70% of newly-raised tax revenues, estimated at US$38 billion over the next five years, will be set aside for initiative. The first tax reform bill, dubbed the Tax Reform for Acceleration and Inclusion (TRAIN), aimed to raise revenues from petroleum products, automobiles and sugar-sweetened beverages, while lowering personal income taxes. Although it successfully made it pass the Congress, the final version of the bill delivered a reduced amount of tax revenues. This sets a difficult precedent for future tax reforms, which are still works in progress. Whether they will have a smooth journey through Congress is still an open question.

Meanwhile, the other funding source, soft loans and grants from China and Japan, will remain geopolitically sensitive, and not so straightforward to negotiate. For one, dependence on China for funds may involve concessions on other fronts, which could face domestic opposition.

Job creation remains key

The Department of Finance projects that the "Build Build Build" initiative is expected to create 1.7 million jobs by 2022. At this juncture, the unemployment rate is near its historic lows, with the latest print coming in at 5.3%. However, the strong headline statistic masks a problem of underemployment, as the new jobs created consist mainly of lowly skilled jobs in the service sector, with the vacancies filled by workers from the agricultural sector. The value-add is limited, thus resulting in stagnant wages. Nevertheless, Philippines' economy is likely to benefit in the long run from a shrinking poverty population and narrowing income inequality.

Expanding price pressures is a concern

On a flip side, a fiscal expansion may not sit well at a time of growing price pressures. Investors may want to pay close attention to headline inflation, which hit 4.6% in May 2018. Note that this is above the upper tolerance level of 4.0% inflation target set by the Bangko Sentral Ng Pilipinas (BSP), and at a five-year high. As it stands, an elevated level of crude oil prices may add further upward price pressures. Second-round impacts may push inflation further, if wage demands increase in light of the higher prices. Indeed, the central bank has hiked the policy rate twice in this latest cycle of tightening, to 3.50%. We expect the hawkish trajectory of the BSP to persist into 2019. Governor Nestor Espenilla has said policymakers are prepared to take futher action as needed.

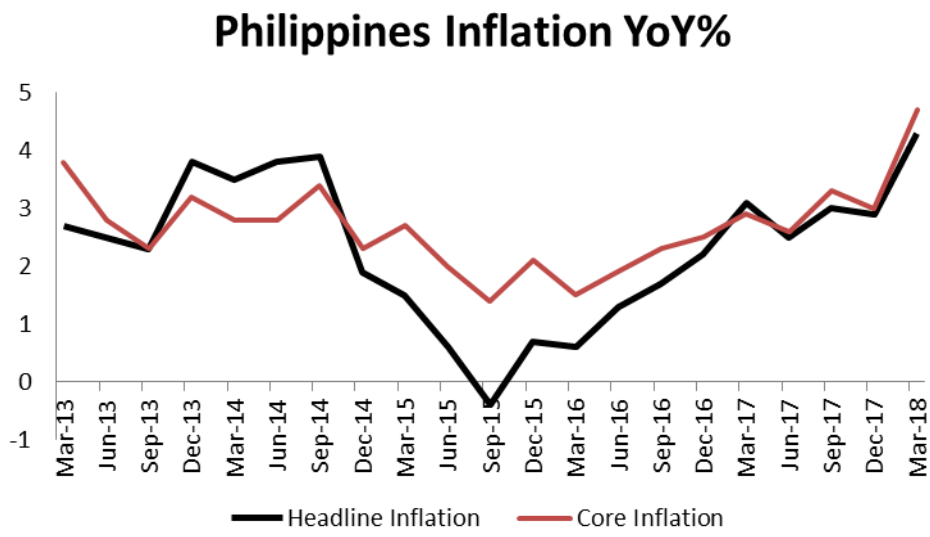
Note, however, that the PHP is not likely to react to the higher policy rates and the hawkish BSP. Fundamentally, the negative pressure on the PHP is driven by persistent equity outflows, which in turn, are driven more by global cues than domestic factors. At this stage, given the Philippines' reliance on imports, persistent PHP weakness does not bode well for inflation prospects. Overall, we do expect the headline inflation rate to persist above the BSP's upper tolerance band in 2018, before easing in 2019.

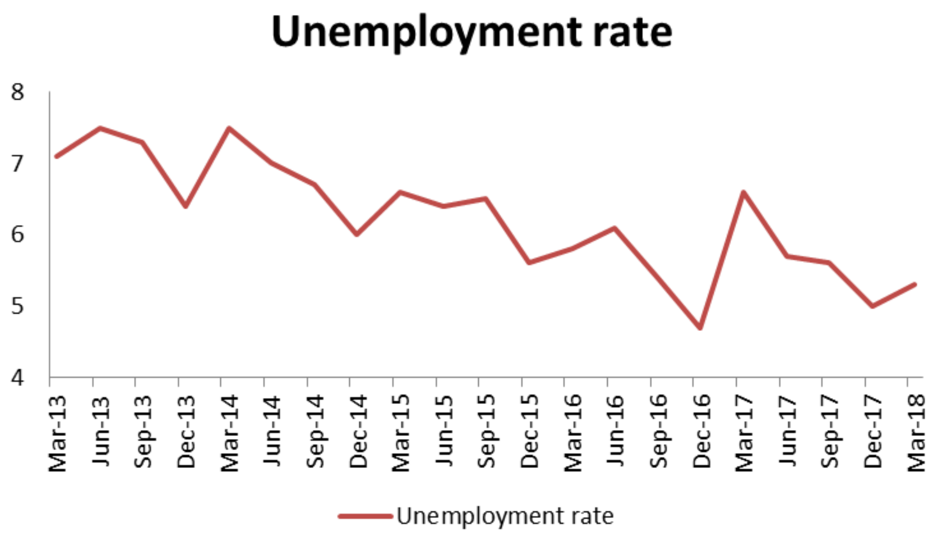
Philippines' outlook raised to "Positive" from "Stable"

S&P has revised the Philippines' credit outlook to a "Positive", from "Stable" earlier this year. Improvements on the policymaking front that may contribute to better public finances and more sustained growth in the coming quarters were cited as the reason for the revision. The ratings agency further suggested that a potential upgrade in Philippines' credit rating from its current "BBB" level may be on tap if improvements continue to be made.

Conclusion: Positive economic outlook in medium and long term

Overall, deepening price pressures and the depreciation of the PHP may dominate headlines in near term. However, the "Build, Build, Build" initiative provides a blueprint towards stronger economic fundamentals in the Philippines. Nevertheless, the implementation of such a major project will inevitably run into speed-bumps from time to time, albeit the government is likely to persist on this vision, , and methodically pick off issues that stand in the way.





Source: Bloomberg, OCBC Bank

SINGAPORE

Greater policy confidence amid broadening growth engines

The Singapore economy expanded by a stronger-than-expected 4.4% yoy in 1Q18, beating the 3.8% median growth forecast tipped in the March survey of the MAS Professional Forecasters Survey (PFS). That said, the consensus outlook for 2018 growth remains unchanged at 3.2% yoy between the June and the March PFS editions. This was likely due to the recognition that manufacturing, specifically the electronics momentum, was moderating, partly due to a high base in 2017, albeit sector data suggested that non-electronics, notably pharmaceuticals, were picking up some of the slack in recent months. Moreover, the looming shadow of global trade tensions, particularly the US-Sino tit-for-tat tariff skirmishes, may weigh on regional trade activity and economic optimism in the near-term. This was clearly articulated in the top 3 potential risks to the Singapore economy in the June PFS which flagged trade protectionism (84% versus 88% three months ago) and higher interest rates (47% versus 17% three months ago) as key downside risks, whereas upside risks were the property market (47% versus 41% three months ago) and the electronics sector & tech cycle (37% versus 47% three months ago).

At the sector level, the outperformers for 2H2018 are likely to continue to be Finance & Insurance (as market volatility and reallocation of portfolios drive funds flow) and Wholesale & Retail Trade (amid the improving tourism picture and the steady but not spectacular domestic private consumption health). The laggard is likely to remain the construction sector whose underperformance for last year and the year-to-date is likely to drag on a little further, albeit there are hopes for a bottoming by year-end or early 2019. In addition, the recent US-North Korean summit on 12 June may have brought many intangible benefits to registering Singapore in the global media landscape.

Manufacturing firms remain in a sweet spot. A weighted 13% of manufacturers tip a favourable outlook for April-September 2018, with all clusters upbeat. The most upbeat was the precision engineering cluster (+39% versus +36% a quarter ago), led by the machinery & systems segment amid sustained demand for semiconductor-related equipment, whereas the precision modules & components segment is anticipating a slight weakening due to rising material costs. This was followed by the electronics cluster (+14% versus -10% a quarter ago) amid sustained global chip demand and the expected pick up in export demand for other electronic modules & components. The biomedical (10% versus +4% a quarter ago, led by higher export demand for both pharmaceuticals and medical technology) and transport engineering (+9% versus +5% a quarter ago, amid rising aircraft engineer repair orders in the aerospace segment and even the marine & offshore engineering segment is tipping a marginal improvement with the higher crude oil prices) clusters are also anticipating better business prospects for the next six months.

While the output expectations for 2Q18 jumped to +24%, up from +10% a quarter ago, nevertheless, the optimism is not likely to translate into employment gains. A net weighted 4% plan to hire fewer workers in 2Q18 (up from 3% in 1Q18), due to the drag from the transport engineering cluster, especially the marine & offshore engineering segment. That said, a weighted 77% of manufacturers reported no limiting factors for export orders in 2Q18, with only 19% that faced export constraints citing price competition from overseas competitors and the economic and political conditions abroad as most important factors.

On the trade front, non-oil domestic exports (NODX) has improved after a soft patch in February-March 2018. This brought the NODX growth to 6.2% yoy growth in the first five months of this year which is a moderation from the 9.3% yoy seen during January-May 2017. As electronics exports continued to disappoint by contracting 7.8% yoy in May, partly due to the high base last year, the NODX outperformance was led by non-electronics (26.2% yoy versus 19.6% in April) amid pharmaceuticals which grew by 32.1% yoy. In particular, ICs, parts of PCs and diodes & transistor exports were a drag in May, and this weak streak in electronics may sustain in the coming months. Given the recent hardening of US trade measures against China, we anticipate that electronics NODX in the region, especially for China and South Korea, may continue to drag.

The improvement in business confidence had also widened from manufacturing to the services sectors. Services firms had also turned more upbeat with a net weighted 8% anticipating more favourable conditions as well for 2Q-3Q18, reversing the more cautious outlook a quarter ago (+3% in 1Q18 versus +9% in 4Q17). The most optimistic segments were financial & insurance (+16% amid the improvement in the global economy), wholesale trade (+10% amid higher demand for machinery, equipment & supplies), real estate (+9% due to improved sentiments among real estate developers and firms managing residential, commercial & industrial properties), recreation, community & personal services or RCPS (+8% amid higher demand for healthcare services), whereas retail trade remained the most downcast (-19% which is worse than the -5% a quarter ago) followed by accommodation (-7% which is a dramatic improvement from the -23% a quarter ago) and food & beverage services (-6% which is similar to the print a quarter ago) after the year-end holiday and 1Q18 festive period. Notably, there were only 3 negative segments in the services survey in 2Q18 versus 5 bearish segments a quarter ago, which reinforces our view that the domestic engines of growth has broadened.

The services sector is likely to continue to support domestic employment in the S'pore economy. A net weighted 3% of services firms expect to increase hiring activity for 2Q18, up from 1% a quarter ago. The improvements in services firms' hiring intentions were led by the financial & insurance (+15% which is unchanged from a quarter ago), business services (+9% which is a significant turnaround from -4% a quarter ago) and RCPS (+4% which is actually a pullback from the +8% seen a quarter ago).

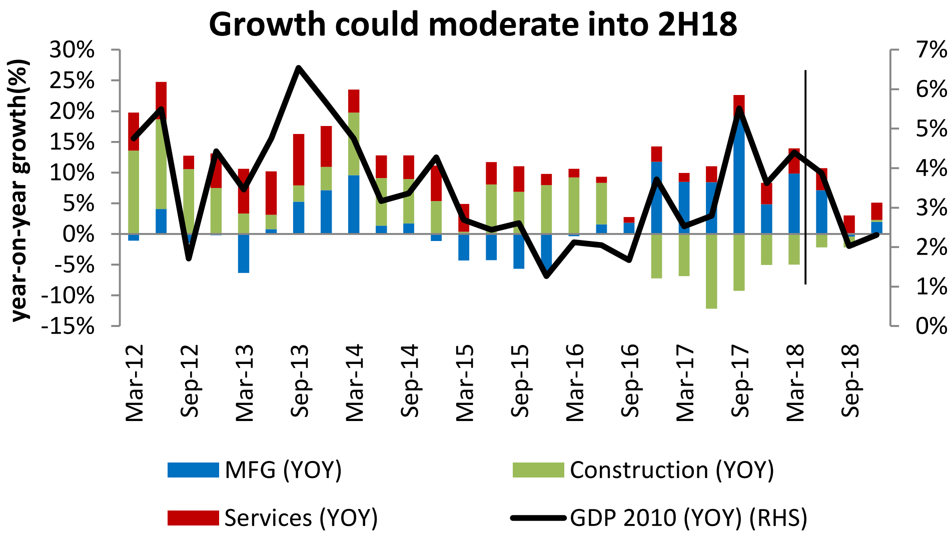
The labour market has stabilised given the sustained expansion in economic activity. Both resident unemployment and retrenchments declined, while job vacancies and total employment rose. Jobs growth in services sectors (like Community, Social & Personal Services, Financial Services & Insurance Services, InfoComms & Media, Transportation & Storage and Professional Services) helped to offset declines in Work Permit Holders in the Construction and Marine Shipyard industries. The job vacancies to unemployed ratio also improved from 0.92 in December 2017 to 1.04 in March, crossing the 1x mark for the first time since March 2016 (1.05). Looking ahead, the domestic overall unemployment rate is likely to remain stable around 2.0% this year, after retreating slightly from 2.1% in December 2017 to 2.0% in March 2018. However, domestic labour demand may remain uneven across sectors amidst the ongoing economic restructuring efforts and as hiring remains cautious in selelcted industries like Construction and Marine Shipyards. The benign headline unemployment rate may also mask PMET-specific challenges, especially after retrenchment or long-term unemployed in areas like mismatches in wage expetations and obsolete skillsets. That said, the Career Support Programme (CSP) and Professional Conversion Programmes (PCPs) have shown some momentum to assist them. Meanwhile, the Singapore economy is facing structural challenges like an ageing population, technological disruptions and keener global competition.

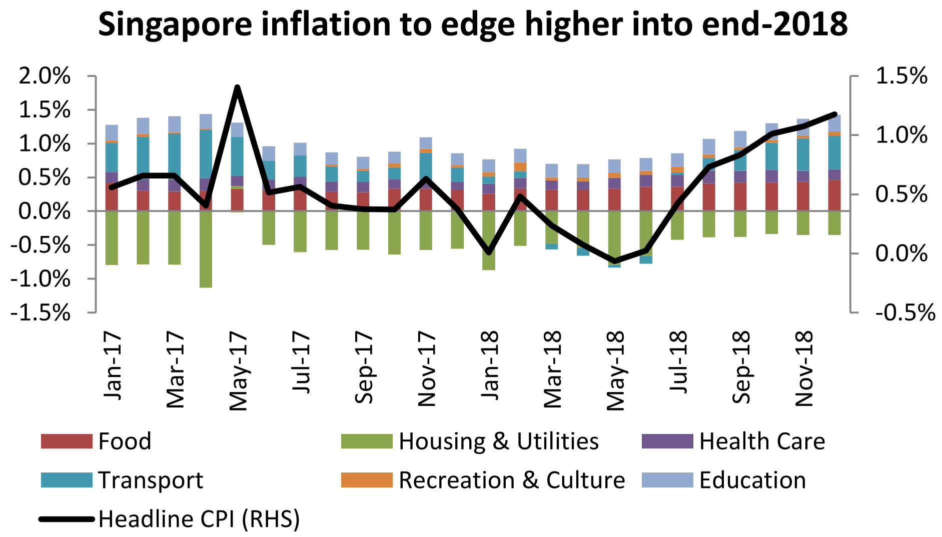
On the inflation front, the data remains very benign for now. The official headline and core inflation forecast remains at 0.5-1.5% and the upper half of 1-2% respectively for 2018, whilst our house forecast stands at 0.5% and 1.5%, versus the median headline and core inflation expectations for this year stand at 0.8% (down from 1.0% in March PFS) and 1.6% respectively. We tip WTI and Brent crude oil prices at US$65 and US$70 per barrel by end-2018, implying little further upside risk in the near-term.

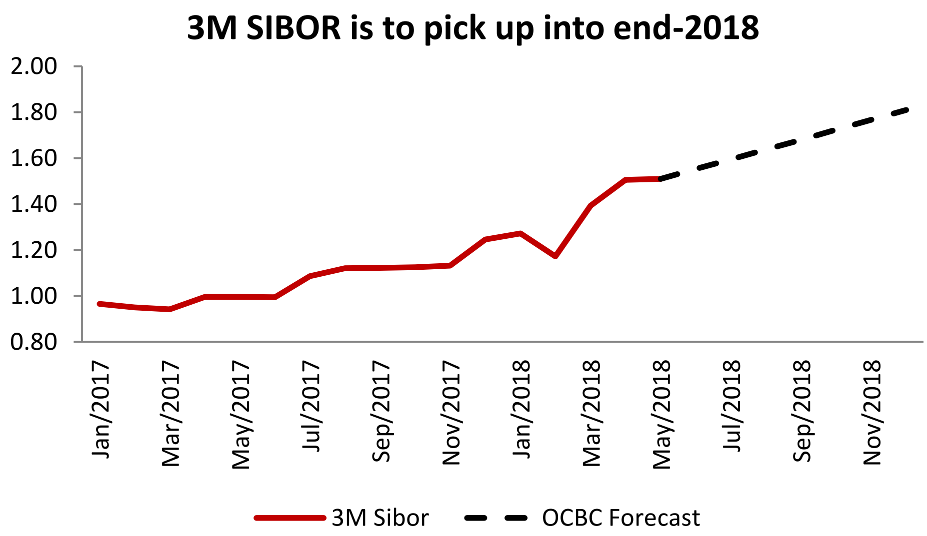
Interest rates and bank loan activity. The median 3-month SIBOR forecast has been hiked from 1.65% at the March PFS to 1.8% for the June PFS. Our forecast for the 3-month SIBOR and SOR have also been upgraded to 1.81% and 1.9% respectively, taking into account the slightly more hawkish slant in the June FOMC median dots plot from three to four hikes this year. That said, we do not expect that the rising domestic interest rates to materially impact the housing market outlook in the near-term. Due to the recent enbloc fever, more than 7,000 units have been taken out of the private residential market since 2017, which should in turn support the resale market. However, when developers start to launch the enbloc site projects, this may again tilt the supply-demand balance into 2019, so some caution may be warranted further out.

For monetary policy, MAS decided in April 2018 to increase slightly the slope of the S$NEER policy band, from zero percent previously, with no change to the width of the policy band and the level at which it is centred. MAS cited this “measured adjustment” as taking into account the uncertainty in macroeconomic outcomes presented by ongoing trade tensions, and also as consistent with a modest and gradual appreciation path of the S$NEER policy band that will ensure medium-term price stability. While MAS will continue to closely monitor economic developments, the increased policy confidence arose from its expectation that the Singapore economy should continue on a steady expansion path in 2018 and core Inflation is likely to rise gradually over the course of 2018 and into 2019. In particular, domestic sources of inflation are expected to rise gradually in 2018, in line with consumer services prices as domestic demand picks up amid further improvements in resident employment that supports a faster pace of wage growth. MAS currently tips core inflation to come in within the upper half of the 1–2% forecast range, which suggests the window for a further normalisation of monetary policy at the October 2018 MPS remains open.

In summary, the 2019 economic outlook for the Singapore economy remains relatively intact at this juncture, notwithstanding the swirling US-Sino trade tensions that are likely to sustain beyond 2H18. The June PFS is calling for a slight retreat to around 2.8% GDP growth for next year, unchanged from the March PFS. We also think a 2-4% growth forecast range remains reasonable for now. The growth engines are unlikely to alter significantly over the next 6-12 months. However, the key to watch would be the inflation picture, given that oil prices are currently hovering around US$60-70 per barrel range, but may see some upside risk to US$75-80 per barrel into 2019.







Source: Bloomberg, CEIC, OCBC Bank

TAIWAN

More balanced growth

The Taiwanese economy ended 2017 on a strong footing with 2.9% yoy growth which was the fastest since 2014. The stronger than expected growth in 2017 was mainly attributable to resilient external demand thanks to upward cycle for electronic products. Total net exports in real terms grew by 31% yoy in 2017, accounting for almost 70% of total growth in 2017.

The strong growth momentum sustained in the first quarter of 2018 with the economy growing by 3.02% yoy, albeit decelerating slightly from 3.42% yoy in 4Q 2017, as external demand remained supportive. In addition, domestic demand has started to pick up. Contribution of capital formation to economic growth turned positive in the first quarter as private investment recovered as a result of upbeat external demand and increasing government expenditure.

Looking ahead, the growth drivers for Taiwanese economy in 2018 is likely to be expanded from external demand to a more balanced twin engines model including both domestic demand and external demand. Domestically, private consumption is expected to remain resilient, thanks to solid job market and wealth effects from the equity market. Taiwan's unemployment rate fell to 3.63% in May, the lowest since 2001. Wage growth accelerated to 4.37% yoy in the first four months of 2018, up from 2.5% in 2017, which should provide support to private consumption. In addition, Taiwan's equity market outperformed in the first half of year, despite the recent correction in Asia due to rising US dollar and concerns about a looming US-China trade war, Taiwan's benchmark index still gained about 2.4% year-to-date. The positive wealth effect from equity market may also add to optimism in private consumption.

In addition to consumption, we expect the contribution from private investment to turn positive in 2018 for three reasons. First, despite the strong recovery in 2017, capex failed to pick up as investors still took a wait-and-see approach. The sustainable global recovery in early 2018 may give private companies more confidence to increase their capex. Second, the increasing FDI inflows to set up research and development centres in Taiwan by global high-tech firms may also support investment growth this year. Third, increasing government expenditure may also add optimism to private sector.

Externally, although the contribution from external demand is likely to decline in the coming quarters due to high base effect, we expect net exports to continue to contribute positively to growth in 2018 as there is no sign that Taiwan's trade has been disrupted by the looming US-China trade war. Taiwan's export growth remained strong in May with 14.2% yoy growth. In addition, export orders growth also reaccelerated to 11.7% in May after decelerating to 3.1% in March. In particular, export orders for electronic products recovered to 14.1% yoy in May. This signalled that Taiwan's export is likely to remain strong in the coming months. Although we reckon that the contribution from net export is unlikely to be as significant as that in 2017 due to the base effect and uncertainties arising from global trade tension, the external demand is expected to remain a driving force for economic growth.

Overall, we expect the Taiwanese economy to gain support from both domestic demand and external demand. However, as a result of base effect and rising downside risks for export due to looming global trade tension, we expect economic growth to decelerate gradually. We expect 2Q growth to remain intact at around 3%, however, the GDP growth is projected to slow down to below 2.5% in the second half of 2018. For the whole of 2018, we expect Taiwan's economy to grow by 2.6%.

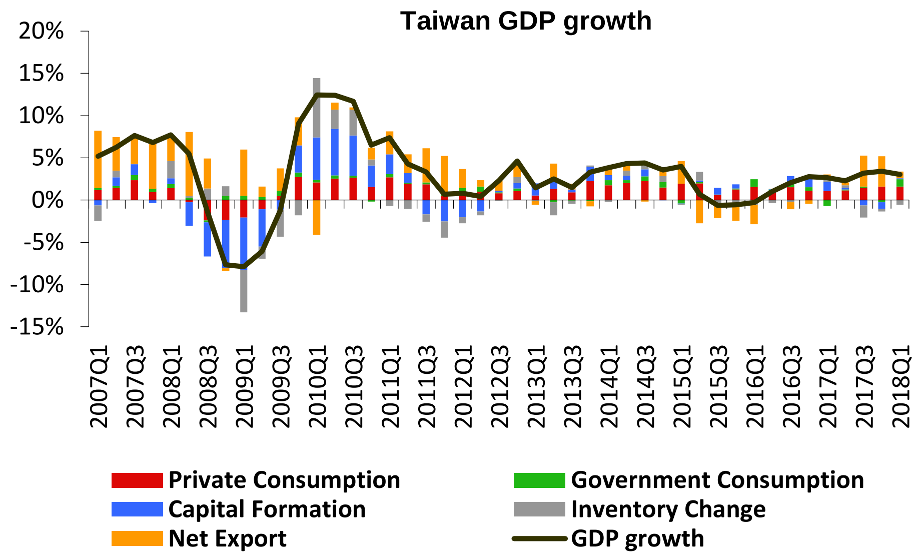
Watch out for inflation

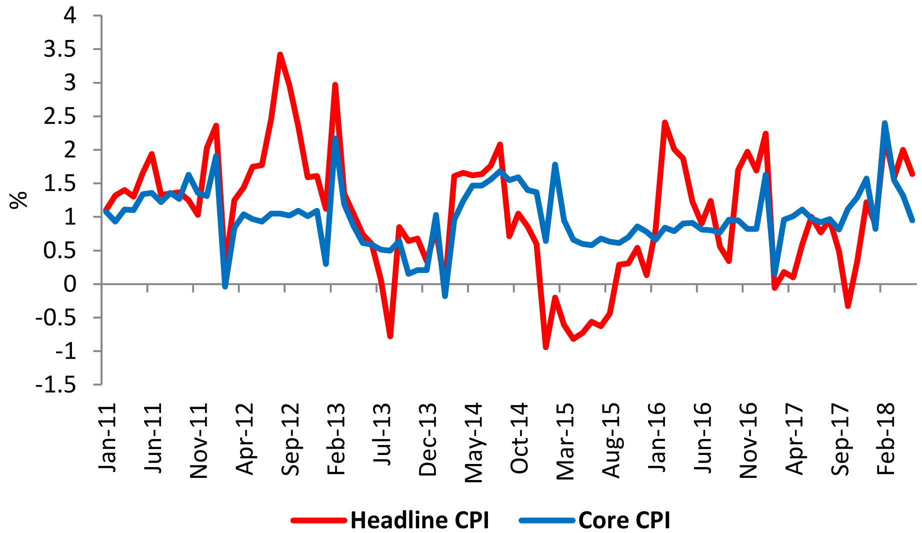
Taiwan's consumer prices moved up to 1.5-2% range in the first five month from 0.5%-1% range in 2017 as a result of higher oil prices and food prices. However, the increase of price pressure is not only restricted to headline inflation and core inflation also picked up. Against the backdrop of tight job market, core inflation is likely to remain supported by steady wage growth. The latest toilet paper rush in February shows that Taiwan is not immune to the rising raw material prices. Given oil prices are expected to stay above US$70 dollar per barrel on average this year as the real production hike by OPEC is unlikely to match the increase of demand, we expect inflationary pressures to remain. We revised our 2018 inflation forecast to 1.5% from 1.2%.

Central bank remains dovish

Taiwan's central bank held its interest rate unchanged as expected in June despite rising inflationary pressure and a hawkish Fed. We think there is no urgency for the CBC to hike this year for three reasons. First, the inflationary pressure is expected to be contained. As mentioned by newly appointed central bank Governor Yang Chin-long, a rise of inflation below 2% is still acceptable. As Taiwan's CPI is projected to stay below 2% in 2018, this is unlikely to be the rate hike catalyst this year. Second, the recent depreciation of Taiwan dollar is still mild as compared to other weaker counterparties in Asia such as Indonesia, India and Philippines. There is no urgency for the CBC to hike interest rate to maintain interest rate differentials to support the currency, given still soild economic fundamentals. Third, the potential spill-over effect from the looming US-China trade war via supply-chain linkages may also keep the central bank cautious on rates.

Moreover, Governor Yang's belief that the central bank does not necessarily achieve effects via surprising monetary policy signals that central bank is likely to follow its script. As long as CPI stays below 2% on average, we see low risks of a rate hike in 2018. As such, our next rate hike forecast has been postponed to early 2019.





Source: Bloomberg, CEIC, OCBC Bank

THAILAND

Remembering the old lesson learnt

When Veerathai Santiprabhob took over Bank of Thailand's helm as the new central bank governor in 2015, he likely knew the daunting task ahead of him and his team. As a former economist in the International Monetary Fund (IMF) as well as a part of the Finance Ministry's policy research institute during the Asian Financial Crisis in 1998, he saw first-hand how mounting debt levels and deteriorating international confidence could quickly sink an economy into an economic crisis. A veteran policy-maker who had the experience in manoeuvring two major crises in 1998 and 2008, it cannot be more apt for him to sound out that "one old lesson re-learned in the global financial crisis is that high levels of debt can be dangerous".

High debt levels can indeed be a key area of concern and have the potential to erode both domestic and international confidence. This issue can be quickly exacerbated when debt accumulates higher in the midst of a higher interest rate environment. Encouragingly, Thailand's debt levels have been improving into 2018. Public debt, defined as the government's debt burden issued in order to finance the country's growth and development, has edged lower to 41.0% of its nominal gross domestic product (GDP), down from 2016's 44% handle. Comparing this with public debt levels seen in the US (82.3% of GDP), Germany (45.1%) and Malaysia (52.5%), Thailand's public debt still appears relatively manageable.

However, the uncomfortably high household debt at 77.5% of GDP as of 4Q17 remains a key concern for policy makers. Though household debt levels as a percentage of GDP has continued to edge lower from its 80.8% peak back in Dec 2015, policy-makers in the Bank of Thailand remained cognizant that "household debt remained elevated" while "private consumption growth remained moderate". A recent eye-boggling statistic released by the University of the Thai Chamber of Commerce (UTCC) highlighted that 96% of a sample of 1,194 survey respondents whose income is lower than THB15,000 per month are in debt, and the average debt per household has grown to THB137,988, the highest level in 10 years. Even more so, actual debt levels are hard to compute, given that 35% of total debt are sourced from loan sharks at an average interest rate of 20% per month (versus an interest rate of 10.6% per year from recognised money lenders). Given the severity of the debt burden, about 85.4% of the respondents have defaulted on debt repayments over the period March 2017 – April 2018.

Tying this back to Thailand's economic outlook, the high household debt level, should it persist into 2018, serves as an alarming warning signal. High household indebtedness can drag on overall domestic consumption growth, as households face a worrying decline in disposable income given their need to finance an increasing amount of debt. Thailand is already experiencing lower private consumption levels as a percentage of GDP, reinforcing Bank of Thailand's concern that "the economic recovery had yet to benefit household income and employment in a broad-based manner". Moreover, high household debt levels may be exacerbated should interest rates in Thailand rise, a scenario we cannot fully discount as interest rates especially in developed economies climb higher into 2H18.

Oil prices, inflation and impact on growth

Inflation had surprised higher, on the back of higher energy and food prices. Given the rally in oil prices, the price of diesel in Thailand spiked as well owing to the lack of subsidies, which means that consumers are to bear the brunt of the price increase. Note that the Energy Ministry has announced its intent to cap diesel prices at not more than THB30/litre, as well as subsidising 50% of any price increases during this period of higher oil price. This signals the return of energy subsidies in Thailand after it was lifted post 2014 after the junta took over the government.

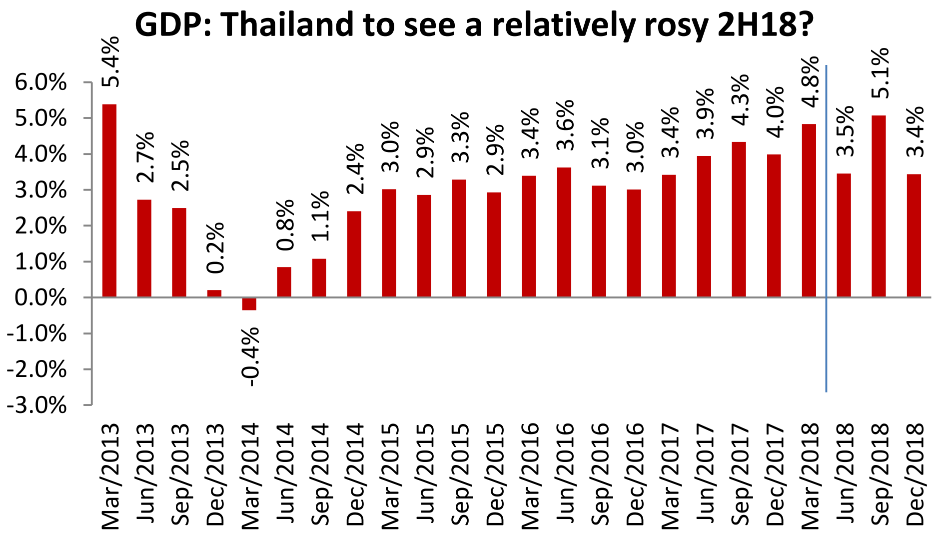
Indeed, the rise in global oil prices can have a negative knock-on effect on Thailand’s economic growth as well. DPM Somkid commented that rising oil prices seen to-date is unlikely to hinder Thailand’s economic growth, though highlighting the government’s need to ease the potential price impact especially on low income earners. However, Thailand’s National Economic and Social Development Board (NESDB) highlighted that higher prices can present a challenge to growth, noting that key raw materials such as rubber and plastics will grow invariably, and underlined that the department’s growth outlook is “based on the oil price averaging $60 - $70 per barrel”.

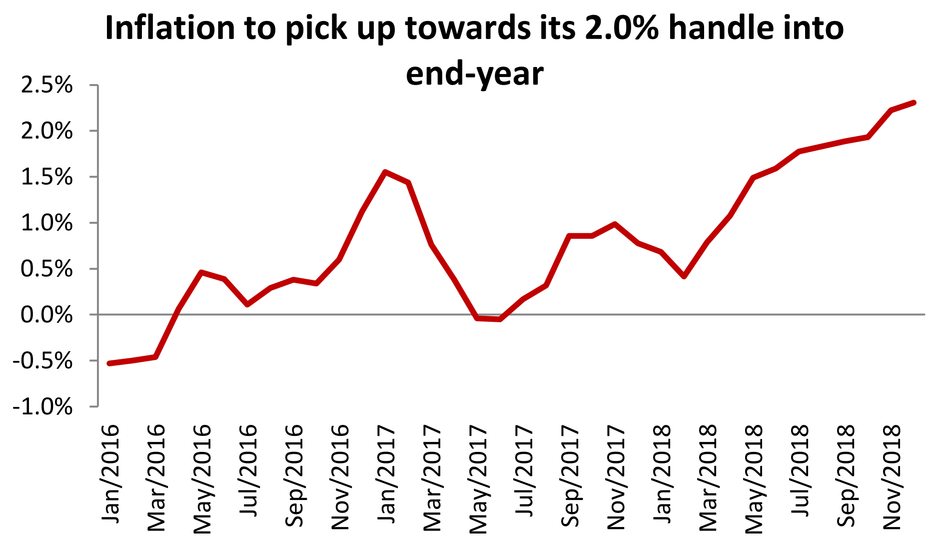
Still, Thailand’s 1Q18 growth surprised on the upside at 4.8% y/y, up from 4.0% (+0.5% qoqsa) in the previous quarter. The better-than-expected growth print suggests that its growth outlook remains stable for now, though we observed that several growth drivers seen in 1Q are likely to be seasonal and may not sustain into the year ahead. These drivers include the exceptional growth in the agriculture sector (+6.5% y/y) given favourable weather conditions, as well as the strong public sector investment (+4.0% y/y) as projects entered into their construction phase. Moreover, a markedly higher growth base will be observed as we approach 2H18, given the strong growth and export numbers seen in 2H17.

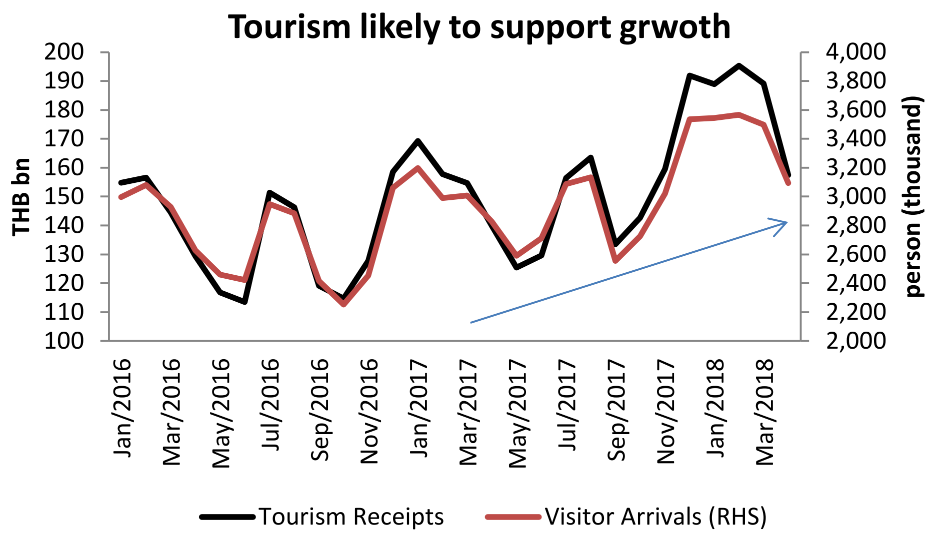
Outlook is stable, but watch out!

To that end, we pencil Thailand’s full-year growth at 4.2%, at the lower end of NESDB’s call of between 4.2% - 4.7%. Should our projection come to pass, it will mark Thailand’s fastest annual growth since 2012. Drivers of growth including manufacturing, trade and tourism will be the mainstays into the year, owing to their strong momentum already seen at the start of 2018. With the favourable economic backdrop, the improving environment has already benefited Thailand’s labour market to-date, and should eventually translate into higher income levels and employment conditions. Elsewhere, with higher interest rates already seen in developed economies, we pencil the Bank of Thailand to inject a one-time 25 basis point hike to its benchmark rate towards the end of this year.

Still, we recognise the onset of growth moderation in Asia as a general phenomenon, with Thailand’s growth numbers already showing similar tell-tale signs as well amid a high 2H17 base year. It’s hardly the fault of Thailand’s economic fundamentals really, given that a falling tide descends all ships. Thailand’s economic standing remains solid, notwithstanding the moderation on the back of rising economic confidence and stable currency, while debt levels appears to be improving despite being elevated.







Source: CEIC, OCBC Bank

VIETNAM

All is well

Economic growth surged to a ten-year high of 6.8% in 2017 on the back of strong industrial growth as well as improved domestic consumption. Similarly, Vietnam's economy surged 7.4% in 1Q18 to see its strongest first quarter GDP growth in a decade. While growth is expected to stay relatively strong into the near future as Vietnam remains an investment and manufacturing hotspot with private consumption supporting further growth, the brisk pace 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. Furthermore, with trade tensions seemingly casting a dark shadow on the global economic outlook, supply chain dynamics may be recalibrated and this could pose a downside risk for the middle kingdom's economic growth going forward. Meanwhile, inflation came in at 3.9% yoy in May 2018 on the back of higher oil prices, although it still falls within the National Assembly's target of 4.0%.

On the whole, the Vietnamese economy remains supported by strong fundamentals even as the economy shifts up the value chain, away from lower-end goods towards more export oriented manufacturing with a focus on the domestic economy. As foreign firms increasingly move their facilities into the country to take advantage of Vietnam's demographic advantages and trade openness, huge opportunities exist in the market for both existing players and potential new market entrants.

The country is in a sweet spot

Data flow suggests firm activity for the economy entering into 2H18. The sharp acceleration in economic growth reflects solid external demand that is bolstering the manufacturing and export sector. The country's industrial production rose 7.1% yoy in May '18 with manufacturing growing 9.1% yoy. The stellar performance seen in the first half was likely due to favourable base effects as seen from the Samsung saga back in 1Q17 when the company announced a recall of the Note 7. With Samsung products accounting for almost 25% of Vietnamese exports, being stung by the Note 7 fiasco definitely took a toll on export numbers.

The country has grown to become a manufacturing hotspot amongst its regional peers on the back of its cheap and large labour force as well as geographical advantages given its proximity to major trade routes. There has been an increase in the pace in which the country adopts more services that are engaged in the manufacturing sector, a clear shift in focus towards higher value add products. The upswing in the Vietnamese economy will provide added avenue for the country to remain a popular investment destination amongst foreign investors as well. Investments are now moving away from the agricultural and mining sectors and up the value chain into manufacturing, wholesale and retail trade investments. In 1Q18, the services and manufacturing sector accounted for 60.0% of the Vietnamese economy, a pick up from the previous quarter (56.2% in 4Q17). Furthermore, the recent Fitch's credit rating upgrade of Vietnam from "BB-" to "BB" came at a time when emerging economies in Asia were facing worries about capital outflows and this should support further foreign inflows into the Vietnamese economy going forward.

Second, the government's constant push towards more open trade and business policies bodes well for the economy. For instance, the country's readiness to remain in the Trans-Pacific Partnership trade deal (TPP-11) despite America pulling out of the deal as well as the recent signing of the EU-Vietnam Free Trade Agreement in June this year underpins the government's commitment towards a more open market. Additionally, this makes Vietnam the only country amongst ASEAN countries, aside from Singapore, to hold a free trade agreement with the EU. Furthermore, Vietnam has continued to see steady improvement in the World Bank's Doing Business index over the years. Of note, the country is currently ranked 68, finding itself above the regional average as well as ahead of regional peers such as Indonesia, Philippines and Laos.

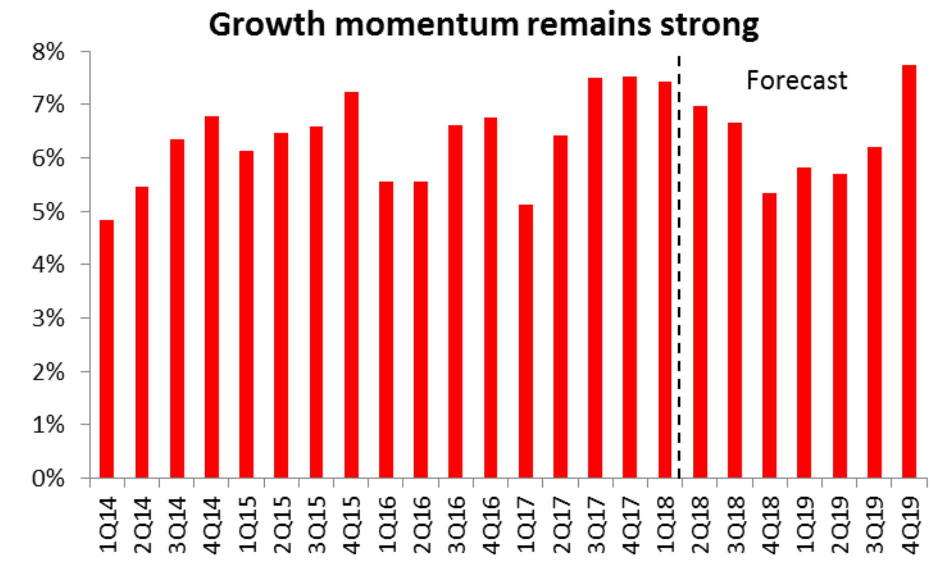
Last, the Vietnamese economy's favourable demographics have laid the foundation in driving private consumption further. Given Vietnam's increasingly affluent middle-income population, a growing educated workforce as well as its golden population structure, where 45% of the population is currently under 30 years of age, the country is in a sweet spot for further expansion in private consumption to underpin further growth. According to the World Bank, more than 50mn of the Vietnamese population is projected to join the global middle class by 2035. As these middle class consumers come to enjoy a better quality of living, they are expected to develop a stronger appetite for imported and branded goods. Inevitably, this will create a host of business and economic opportunities for the region.

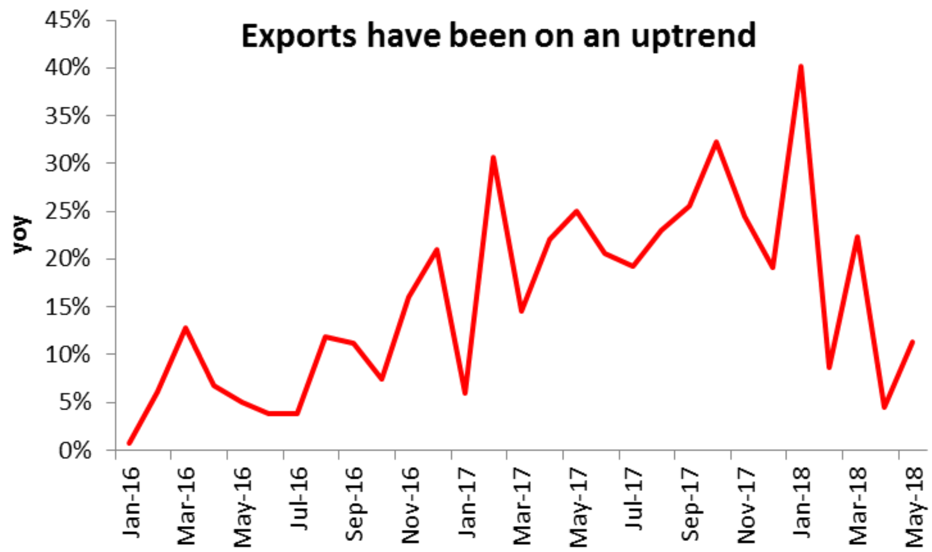
Beware of trade tensions – a blessing in disguise?
However, there still remain imminent downside risks that could cast a shadow on the sanguine outlook. For one, the mounting trade tensions which have continued to dominate headlines could posit to drag the country's stellar growth down. In May 2018, Vietnamese exports rose 7.1% yoy, up from April's 4.7%. Furthermore, with the increasing amount of foreign direct investments that the country has seen over the years, it is no doubt that the country has slowly found itself increasingly integrated into the global supply chain. For instance in recent years, the country has attracted several investors such as Samsung, LG Electronics and Intel to move their manufacturing facilities over to Vietnam. Hence, the country's increasing involvement in supply chains stand to be a double edged sword for Vietnam on the back of the economy's relatively open nature. Looking on the bright side however, there is a possibility that with the increasing amount of tariffs being slapped on Chinese products, there could be a recalibration of trade flows between China and its trading partners. Chinese companies may move some production lines to neighbouring emerging markets to book its trade with the US under other countries. As such, it may benefit Vietnam as a regional manufacturing hub.

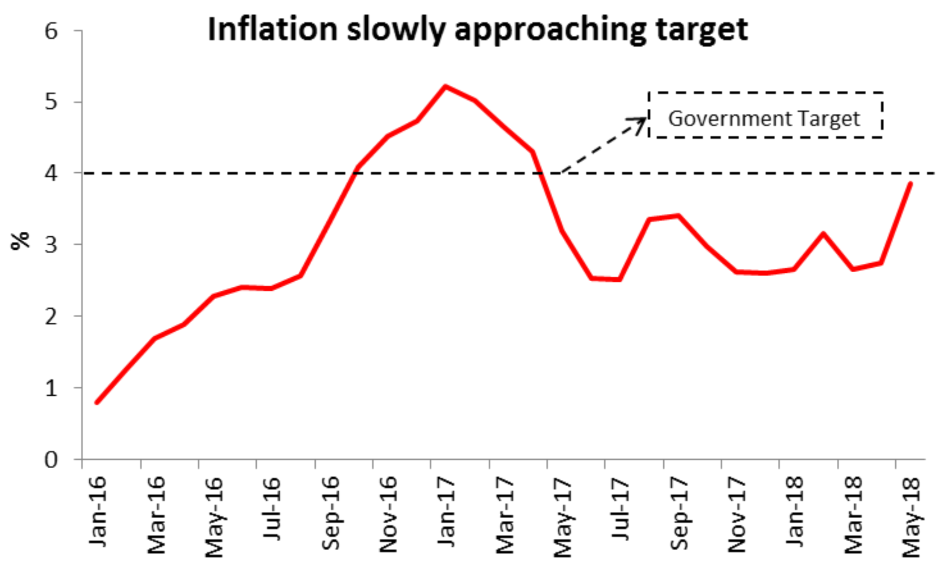
Additionally, the slow pace of SOE reforms continues to pose a drag on the economy. It is no doubt that the Vietnamese economy has continuously worked towards improving its efforts to overhaul the country's relatively less efficient SOEs. Ever since the country's liberalization in the 1980s, the government has continuously been working towards boosting SOE equitisation as a form of attracting foreign companies to improve competitiveness and steer the economy towards further expansion. In recent years, the government has stepped up efforts to divest state-owned enterprises, through initial public offerings and stake sales. Unfortunately, Vietnam's lack of transparency and small sales percentage of SOEs have hampered investor sentiments. In 2017, the government released a list containing plans to divest 406 SOEs by 2020, with 135 scheduled for 2017 alone. However, this goal has not been met, with only 69 SOEs being equitized in 2017. Most notably however, the 53.59% stake sale (worth $4.8bn according to the Ministry of Industry and Trade) of the Saigon Beer Alcohol Beverage Corp, also known as Sabeco, to Thai Beverage - a Thai conglomerate, is the first major step in a long-delayed divestment plan to speed up the liberalisation of the country's economy. Additionally, in order to step up the privatisation process, the government established a committee on 5 Feb 2018, the Committee for State Capital Management, to consolidate control over assets in firms managed by different ministries, where vested interests have often played a major role in delaying equitisation plans. Should the government continue to improve the pace in which such reforms take place, the economy should see less downside risks stemming from domestic factors.

Conclusion

In a nutshell, Vietnam started off the year on a strong footing. The economy is converging on many strengths, combining both domestic and foreign factors, supported by investment flows, improvements in the manufacturing sector as well as banking on the country's increasingly affluent middle-class income population, in order to create a sustainable expansionary path. To that end, we believe Vietnam's overall GDP growth for 2018 to come close to 6.6%, slightly below the government's official target of 6.7%. While the outlook posits to be generally favourable, there are clearly both domestic and external risks that could dampen growth. The highly open economy is likely to be exposed to external factors amidst the mounting trade tensions. Hence, one should not take for granted the current economic upswing and instead focus on deepening and accelerating structural reforms to lift the country's growth potential further.







Source: Bloomberg, CEIC, OCBC Bank

GLOBAL SPECIAL

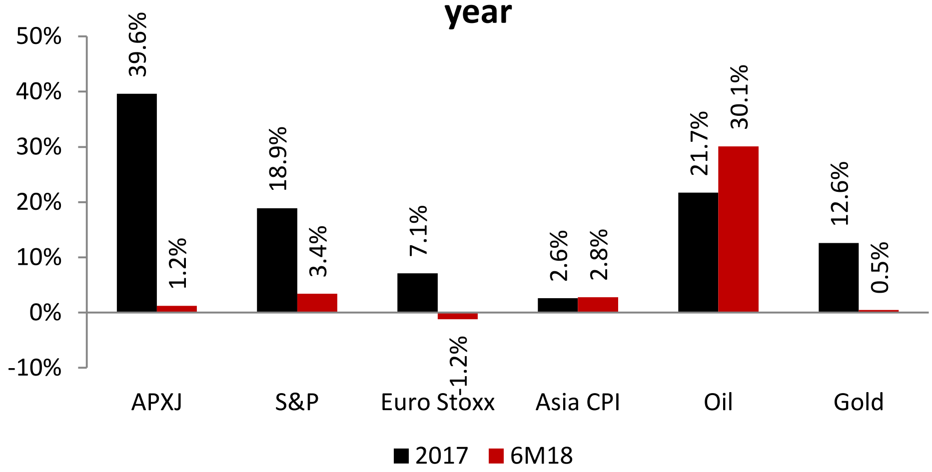
US-led inflation risk and the many implications

Where is Goldilocks?

The phrase "not-too-hot, not-too-cold" has been a popular way to describe the global economy in 2017. Referencing the popular children folktale relating to our main female protagonist and her ideal state of habitation, a goldilocks economy describes an economy that is not so "hot" in fuelling inflation, nor too "cold" in depressing risk appetite. In a nutshell, the economy is seen to be operating in a well-balanced state in which there is economic growth but little inflation to worry about.

Indeed, this was largely seen in how global growth trended into 2017. Last year alone, global growth expanded to 3.76%, the highest growth print since 2011. The positive risk appetite also spurred asset prices: Asia Pacific (ex-Japan) equities rallied almost 40%, with the S&P and Euro Stoxx50 gaining 18.9% and 7.1%, respectively. Inflation rate in Asia also fell to its 2009 levels at 2.2% as food and oil prices declined.

Chart 1: How asset prices moved in a goldilocks year

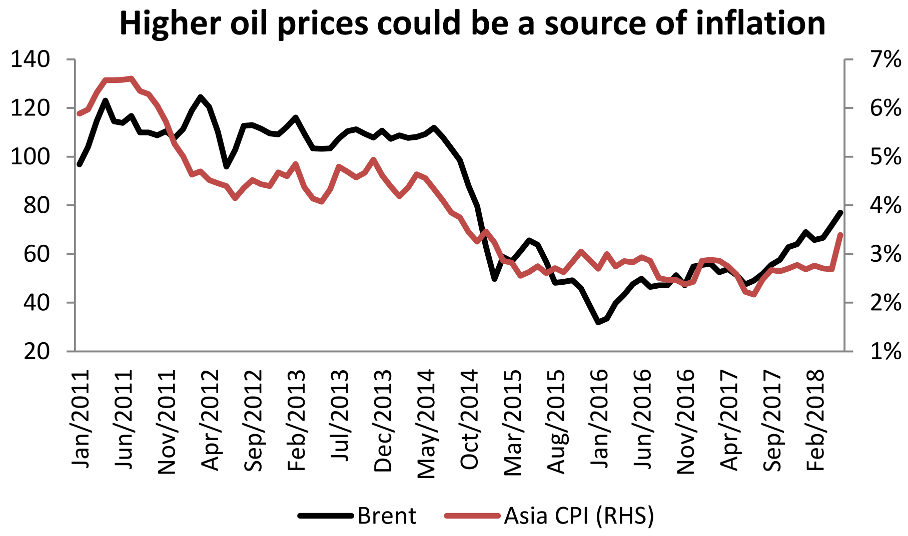


Source: Bloomberg, CEIC, OCBC Bank

However, current global economic fundamentals look different. While empirical data shows a strong risk-on year in 2017, rallies in asset prices were markedly milder in the first six months of this year amid arguably stronger inflationary pressures and more recently trade war concerns. This raises key questions as to whether the goldilocks' phenomenon, which led risk appetite in the last year, had faded on higher inflation and interest rates concerns.

US-led inflation pressures and the widening rate differentials

Higher inflationary pressures are seen to-date, albeit from low prints seen in the past years as oil prices recovered. Notably, Brent oil rallied 21.7% yoy in 2017, and another 30.1% in the first six months of this year. Elsewhere, the UN Food and Agricultural World Food Price Index has rallied from 149.3 to 176.2 in May 2018, suggesting higher commodity prices may eventually elevate global inflationary pressures. Inflation in Asia has risen to 3.2% in its latest May reading, likely on higher commodity prices seen to-date as well as a lower 2017 base print.

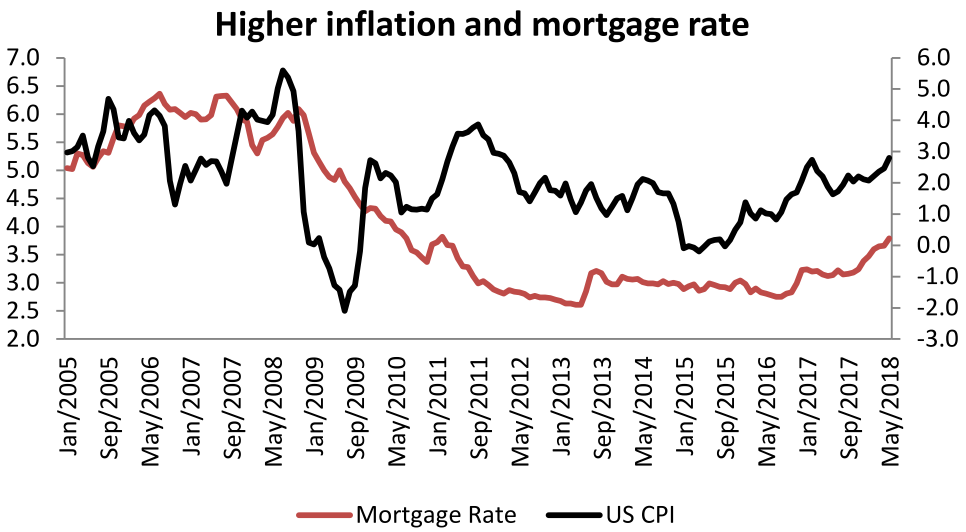


Source: CEIC, OCBC Bank

Still, market-watchers could perceive that inflationary pressures especially in Asia remain manageable to-date, although US-led inflation has recently risen above the Fed's 2.0% mandate. Note that the US FOMC has embarked on its rate hike cycle since 2015, and has hiked seven times over the past three years. The immediate implication due to a rising US interest rate is the widening rate differentials between US-Asia, which had fuelled a recent fund outflow phenomenon out of the Emerging Markets (EM) to US shores. Consequently, Asian currencies to-date have depreciated broadly against the US, leading central banks including Bank Indonesia and Bank of Korea to raise rates in attempt to stem currency depreciation and outflows, rather than as a response to uncomfortable inflation risks.

This opens a new can of worms perhaps, especially when monetary normalisation seen to-date is made despite the moderating growth prospects and benign inflation environment. Higher interest rates in theory serve as a response to curb an overheating economy and unhealthy speculation, both which remain almost non-existent to date. Rather, the higher rates already seen in many Asian economies including Singapore, Malaysia, Indonesia, South Korea, India and Philippines can depress growth prospect, and dissuade risk appetite. Moreover, the higher interest rates will also lead to higher cost of borrowing for both businesses and consumers, while serving to limit consumer spending given a likely increase in the savings rate of return.

Elsewhere, the higher inflation and interest rates would have a profound effect on household debts. Asian economies especially China, Thailand, Malaysia, Indonesia and Vietnam have increasingly higher household debt burdens into 2018. The higher household debt levels are exacerbated by the slow growth in household income and stronger inflationary pressures, which could in turn pressure households to accumulate higher debts to sustain spending power. Higher interest rates in these economies then, will likely worsen debt serviceability by both households and businesses, which in turn require delicate policy-manoeuvres to tackle this issue.



Source: CEIC, OCBC Bank

Whither inflation and interest rates into the future?

Asia's inflation climate will likely remain manageable especially given the rising interest rate environment. Higher consumer prices already seen to-date are a general reaction to better growth-related factors and risk appetite seen into this year. Moreover, inflation pressures have also been driven by the uncomfortably higher oil prices, suggesting that future price movements would be driven by how oil prices could move into year-end.

Fundamentally, our WTI and Brent oil price outlook remains bearish at year-end expectation of $65/bbl and $70/bbl, respectively. We remain uncomfortable over the recent high energy prices, as the drivers for the rally were driven by geopolitical factors, including market-watchers' pricing-in of a potential shortfall in Iranian and Venezuelan oil supplies. More recently, crude oil prices have remain range-bound as market-watchers monitor the upcoming OPEC meeting on the 22nd June. We note that these geopolitical factors, by historical standards, are likely to be short-lived, while oil supplies can potentially see further upside risks following higher US and OPEC oil production into 2H18. Note that US rig counts continue to accumulate into 2018, suggesting the US oil production will likely climb further.

Regardless, the tightening labour market and anticipated stronger inflation pressures seen in 1H18 have persuaded US policy-makers to raise policy rates higher, and may consequently pressure Asia's interest rates higher into the second half of 2018. Moreover, widening interest rate differentials between US-EM could exacerbate fund outflows out of EM Asia.

While some consolation may be seen should oil prices and inflation pressures fade lower into the second half, the higher interest rate climate is already seen to-date may serve to tighten monetary conditions further should policy-makers persist in their efforts to stem fund outflows out of Asia. Rising Asia interest rates especially during growth moderation and tame inflation pressures may dampen growth, raise lending and borrowing costs, and limit risk appetite.

GEOPOLITICAL SPECIAL

Who will benefit from the Korea peace treaty?

The high-stakes Trump-Kim meeting in Singapore in June marked the first step to officially end the Korea war. Although whether the US will lift the economic sanctions depends on the progress of North Korea's denuclearization, the "indefinite" suspension of US's military exercises with South Korea and the return of war remains by North Korea show that the bilateral relationship between US and North Korea may have entered a new chapter.

Should the economic sanctions be lifted and North Korea adopt a similar reform and opening up approach as China did 40 years ago, we see a high chance that the North Korea economy may boom given its strategic location, favourable demographics and rich natural resources. In addition, the whole region may also benefit economically in one way or another.

In this article, we will discuss four possible implications of the North Korea Peace Treaty from perspective of South Korea, China, commodity as well as Singapore.

Since 1990s, both North Korea and South Korea have tried to fix their relationship, which reached its peak in 2007 after both sides signed the agreement "Declaration on the Advancement of South-North Korean Relations, Peace and Prosperity" following the former South Korean President Roh Moo-hyun's visit to Pyongyang. In December 2007, the freight rail services between South Korea's Munsan and North Korea's Bongdong was reopened, ending a 56-years suspension of railway linkages between two countries. Meanwhile, the 2007 agreement also laid out the plan for transportation linkages including the repairs of Gaeseong-Sinuiju railroad and the Gaeseong-Pyongyang expressway for joint use.

In April 2018, the Panmunjom Declaration for Peace, Prosperity and Unification of the Korean Peninsula adopted by both North and South Korea leaders reiterated the plan to implement the projects previously agreed in the 2007 Agreement with the first step towards connection and modernization of the railways and roads on the eastern transportation corridor as well as between Seoul and Sinuiju.

Should the Peace Treaty progress as planned, we expect South Korea to work together with North Korea to establish three special economic zones including the west coast zone linking Seoul to Sinuiju to China for industries and logistics, the east coast zone integrating South Korea with Russia for energy and the border area between North and South for tourism.

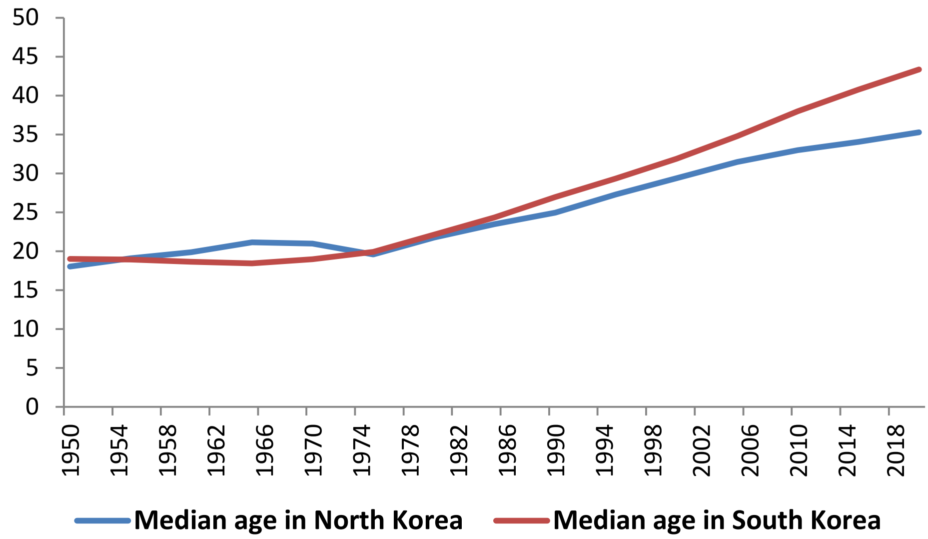
Source: Google Images, charting & words by OCBC Bank

Impact on South Korea

Against this backdrop, we think South Korea is likely to benefit the most from the Korea Peace dividend via access to highly disciplined North Korea labour, favourable demographics in North Korea and improved railway linkages to continent.

First, North Korea workers are known for being well-organized and highly educated. North Korea has implemented a nationwide 12-year compulsory education system, which is way above the global average of nine years. The high literacy level suggests that North Korea workers are one of the more competitive and competent labour forces in the world, which was proved by the prior experience in Gaeseong industrial park where tens of thousands of North Korea workers worked for South Korea private companies. Should the peace treaty progress, South Korea private sectors are likely to benefit significantly from North's organized and educated but cheap labour forces which earn less than 10% of South Korea workers' wages. This could make South Korea companies more competitive in the global stage.

Second, the latest data from United Nations showed that the median age in North Korea was 34 years in 2015, which is 6 years younger than that in South Korea. The young and cheap labour force is also likely to be a boost to South Korea's manufacturing sector. In addition, it may also support domestic demand in the Korea Peninsula in the longer run.



Source: CEIC, OCBC

Third and most importantly, the Korea Peace Treaty will allow South Korea to integrate to the Eurasia continent via railway. South Korea was officially admitted to the Organization for Cooperation of Railways (OSJD) in June 2018 after North Korea gave the green light. This will allow South Korea to take part in the operation of 280 thousand kilometres of railway lines across Eurasia via the Trans China Railway and Trans Siberian Railway. Via closer continental linkages, South Korea will benefit from two areas including transporting its goods to Europe via railways at significant faster speed and installing pipe gas from Russia to link the Korean Peninsula power grid to improve power efficiency and consumption.

Impact on China

China is also likely to benefit from South Korea's railway integration to the Eurasia continent as Northeast China will be the first contact point. As such, we think China is able to play a role to facilitate the logistics from Korean Peninsula to the rest of Eurasia continent. This could be the new growth driver to re-boost China's sluggish Northeast economy. The recent price jump of housing prices in Dandong, the largest border city facing North Korea's Sinujiu, likely reflects the optimism regarding the potential rebooting of China's Northeast economy.

In addition, the heavy industries such as steel in China's Northeast may also benefit from the potential high growth of North Korean economy. The reform and opening up of the North Korean economy is likely to boost the demand for steel products significantly. However, the poor refinery capacity and electricity shortages in North Korea signal that demand for steel is unlikely to be matched by domestic production. Given Northeast China's strategic location, we expect the steel companies in this region may benefit from the rising demand from North Korea.

Impact on commodities

It has been widely quoted by media that North Korea may sit on US$6-10 trillion of natural resources, according to estimates from a South Korea research centre in 2012. North Korea was also reported to have the world's largest rare earth reserve, which is crucial to the manufacture of high-tech products such as electronic products. In addition, North Korea is also rich in metals such as Zinc, Iron, and Magnesite. Although there is no official verification on North Korea's natural resources reserve, the trade fairs to bring in foreign investors in natural resources before the sanctions and the surge of trade between China and North Korea indirectly suggests that North Korea is indeed rich in natural resources. The return of North Korea to the global stage may thus reshape the global commodity market.

Impact on Singapore

Given Singapore's participation in the recent Trump-Kim summit, the city state may also benefit from the Korea Peace Treaty. North Korean leader Kim Jong Un has openly praised Singapore's economic development and hoped the country could learn from the country. This may give Singapore an edge to participate in North Korea's economic reforms and opening up. The participation in North Korea's special Economic zone in the east coast such as Rason and Wonsan Mt. Kumgang may give Singapore an advantage to link to the northern sea route, which has become increasingly important due to ice melting in Arctic as a result of global warming. The participation in the northern sea route could be important in 10-15 years' time for Singapore to stay relevant as a global shipping hub.

HONG KONG SPECIAL

This time it is different

Since late 2017, the Hong Kong Dollar (HKD) market has drawn global attention due to its increased volatility. In April, HKD fell to the weak end of the peg for the first time since 2005 when the range of 7.75-7.85 was introduced. Right after that, market panicked about a potentially fast capital flight and a de-peg of HKD from the greenback. However, capital outflows associated with a weak HKD turned out to be more manageable as the reason behind the HKD weakness is different from the past. Recent depreciation in HKD is mainly caused by a wide US-HK yield differential rather than external speculative pressure. Therefore, it barely had any impact on local market sentiments. However, a weaker HKD did translate into some upward risks for the local interest rates.

Since mid-April, the HKMA has bought a total of HK$70.35 billion to defend the currency peg system and reduced the aggregate balance down by 39% to HK$109.4 billion. Against the backdrop of reduced interbank liquidity, a slew of factors helped to push up the interbank rates. As a result, short HKD traders became more cautious than they were in April. Moving into the third quarter of this year, the revamp of IPO rules is set to bring more mega IPOs to the city. This would successively lock up money and keep the HIBOR elevated. Therefore, we may see very tight liquidity in 3Q18. We expect HIBOR to increase gradually with one-month and three-month HIBORs to test 2% and 2.25% respectively by end of this year. Given the continuous uptrend in HIBOR, commercial banks could continue to raise HKD fixed-deposit rates. Higher funding costs will likely prompt commercial banks to raise prime rate at least once this year by 25bps. However, in the medium term, as long as global liquidity remains flushed due to major central banks' general cautiousness about tightening, the US-HK yield differential is unlikely to close. Therefore, though we expect USD/HKD to retreat amid a narrower interest rate gap, the pair is still likely to hold up above 7.80 by end of 2018.

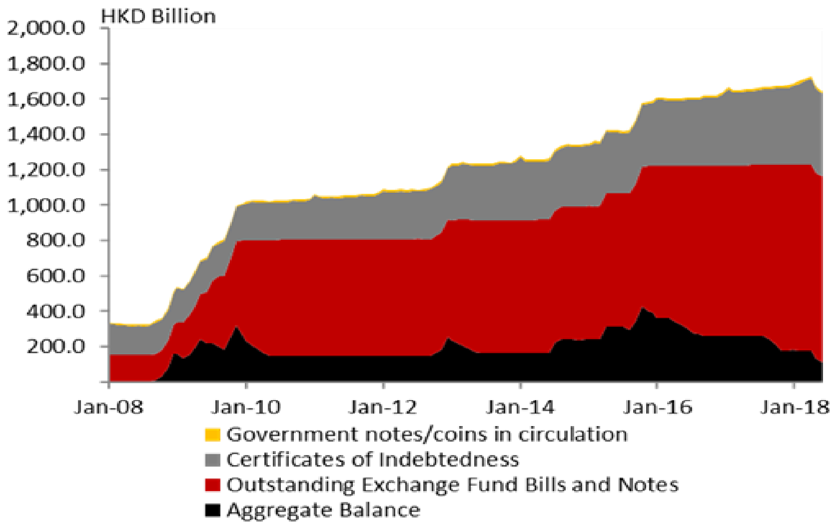
Liquidity has been piling up since 2008

Since 2008, global central banks have proactively printed money and injected large amount of liquidity into the market. As a result, hot money continued to flow into emerging markets including HK to search for higher yields. China's robust growth also encouraged Mainland investors to diversify their accumulated wealth by investing in overseas assets including HK properties, stocks and bonds.

The significant inflows to HK over the past decade have been reflected in three major indicators. First, the monetary base. Monetary base totalled HK$1644.1 billion (US$209 billion) as of May 2018, more than quadrupling from HK$320.6 billion as of December 2007. The monetary base comprises of 1) aggregate balance (HK$109.4 billion), 2) outstanding exchange fund bills and notes (HK$1050.7 billion), 3) certificates of indebtedness (HK$471.3 billion), and 4) government notes/coins in circulation (HK$12.7 billion). Normally, when capital inflows are too much to be absorbed by commercial banks, the three bank-note printing banks will print money and in turn increase the certificates of indebtedness. Since end of 2007, certificates of indebtedness nearly doubled.

If huge demand for HKD associated with capital inflows pushes HKD down to 7.75, it could trigger the HKMA to buy USD to defend the peg system. As a result, the aggregate balance will increase. With aggregate balance increasing rapidly, HKMA may issue additional Exchange Fund Bills and Notes (EFBNs) to mop up interbank liquidity. This is exactly what HKMA did over the past few years when aggregate balance was ballooning. Therefore, the combination of outstanding EFBNs and aggregate balance, which surged 677% since end of 2007, is a better indicator of capital inflows.

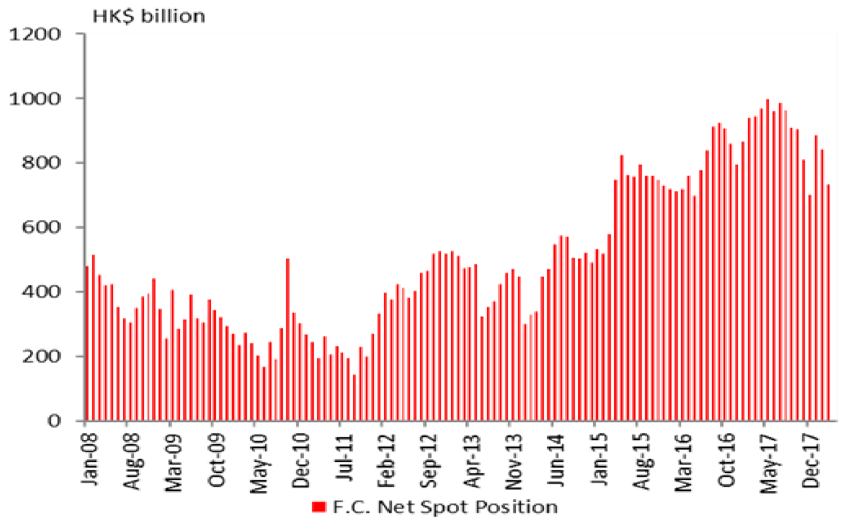
Chart 1: Monetary Base



Source: Bloomberg, OCBCWH

Second, commercial banks' foreign currency positions. Normally, commercial banks would try to meet the increasing HKD demand with their own FX positions. Net foreign currency spot positions of commercial banks rose 62.5% from HK$614.8 billion by end of 2007 to HK$999.2 billion as of May 2017 before sliding to HK$731.8 billion amid recent capital outflows.

Chart 2: Commercial Banks' F.C. Net Spot Position



Third, equity flows under stock connects. Since Mainland investors increasingly tapped HK stock market to diversify their investment portfolio, southbound net inflows under two stock connects totalled RMB 1.04 trillion during Nov 2014 to May 2018, outweighing the northbound net inflows of RMB 0.67 trillion during the same period.

Chart 3: Southbound equity flows

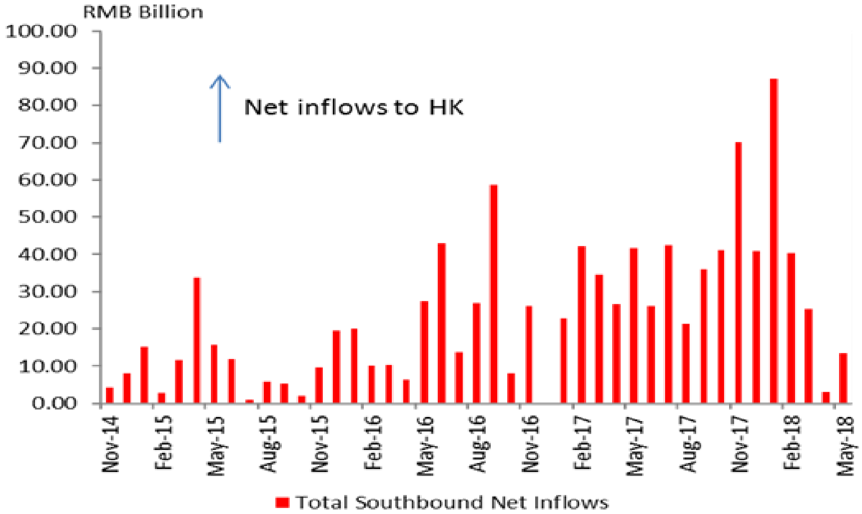
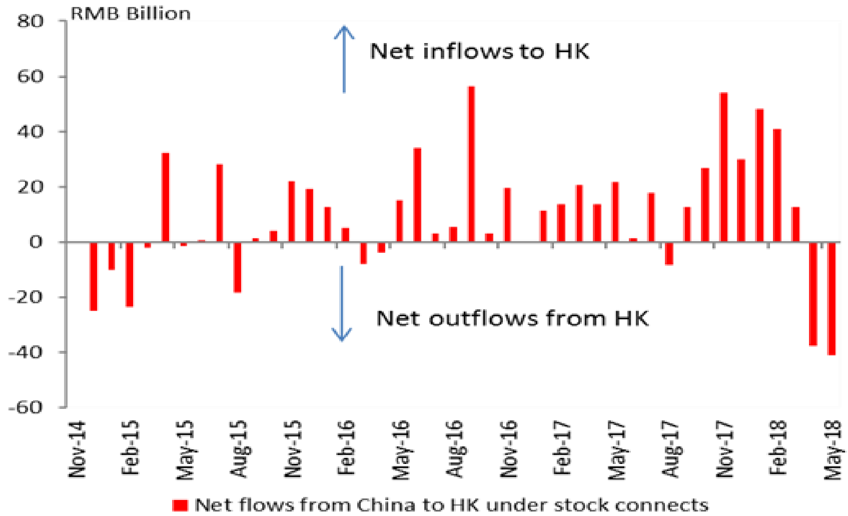


Chart 4: Net equity flows under stock connects



Source: HKMA, Bloomberg, OCBCWH

No more Soros, only carry trade

Due to ample liquidity and sound economic outlook, this round of HKD weakness is different from the past. During 1997 and 1998, foreign speculators aggressively bet on collapse of HK stock market and a de-peg of HKD from the greenback. Therefore, the HKMA was forced to take big moves and caused HIBOR to spike. This time, HK stock market is well supported by the strong fundamentals as well as resilient capital inflows. With little fundamental reasons to short HK stock market, carry trade activities have been the only major driver of HKD's weakness.

What is carry trade?

Carry trade normally shorts the lower yielding currency (HKD) for a higher yielding currency (USD). When the interest rate gap remains wide and the high yielding currency appreciates, the return of carry trade could be substantial. With regard to the yield differentials, the gap between one-month HIBOR and three-month HIBOR and their US counterparts respectively reached the 10-year high of 110.6bps and 117.9bps around 1Q18. In terms of the exchange rate, under the linked exchange rate system, HKD is only able to appreciate as much as 1.29% against the greenback, namely from 7.85 to 7.75. This suggests a limited loss from the high-yield currency's depreciation. Therefore, since market speculated that US-HK interest rate gap will remain wide due to HK's ample liquidity, the increasingly attractive carry trade easily pushed the USD/HKD up to 7.85.

Nonetheless, after HKMA intervened in the FX market and reduced the aggregate balance by nearly 40%, short HKD traders have become more and more cautious than they were in April. This in turn reduces the frequency of HKD touching the weak end of the peg.

Chart 5: US-HK yield differential & HKD

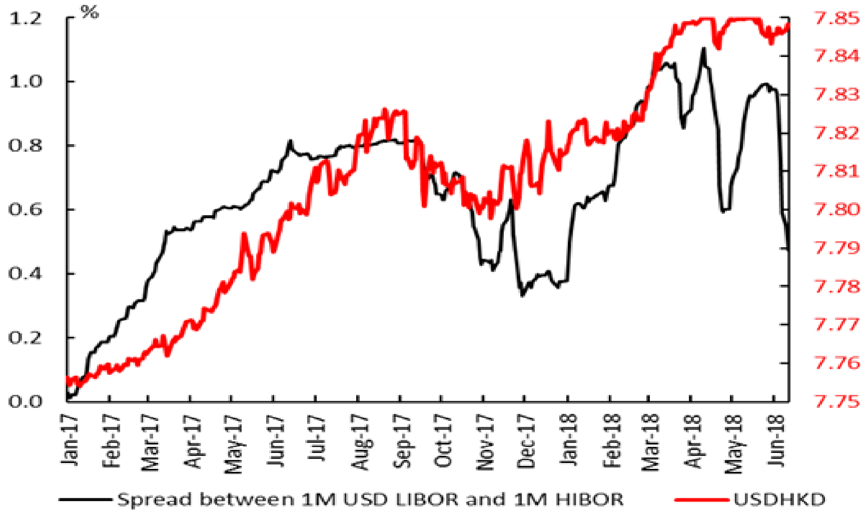
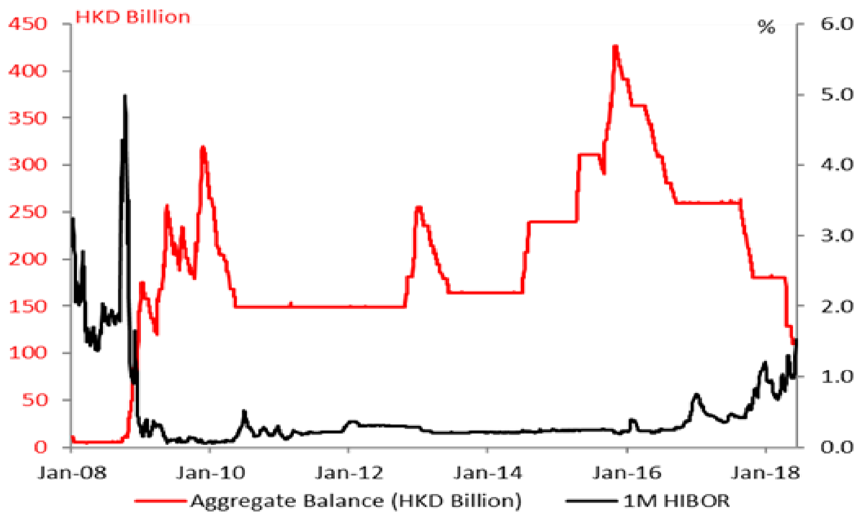


Chart 6: Lower aggregate balance & higher HIBOR



Source: Bloomberg, OCBCWH

All depends on the outlook of HIBOR

Moving forward, the timing of the prime rate hike, HKD's movement and the change of aggregate balance will all hinge on the outlook of HIBOR. As for HIBOR, it has surged throughout June due to market players' pre-positioning for half-year end and Xiaomi's IPO. Specifically, the one-month HIBOR moved up sharply from 1.02% as of 31 May to a 10-year high of 2.01% on 29 June. The three-month HIBOR also rose 32.6bps month-to-date to 2.096%. As a result, the spread of three-month HIBOR on its one-month peer narrowed from 78bps on 16 May to 8bps on 29 June.

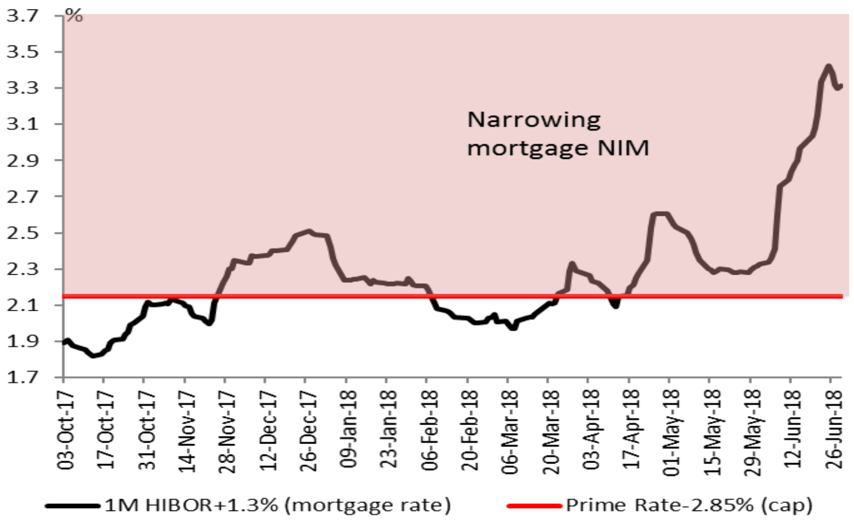
Moving into 3Q18, we expect HIBOR to remain elevated. First and foremost, after the revamp of IPO rules, Mainland companies including Xiaomi, China Tower, Meituan and Midea have actively applied to get listed in HK. Some even plan to raise US$10 billion. Even though market sentiments for IPOs could remain muted due to concerns about lingering US-China trade conflicts, the relatively large size of IPOs would still lock up substantial amount of liquidity. Second, the month-end effect could tighten the liquidity. Third, dividend payment flows would increase gradually in the coming months. HKD demand from Chinese companies listed in HK may peak in August and temporarily lock up some HKD liquidity. Therefore, we do not expect HIBOR to retreat significantly after month-end and Xiaomi's IPO. Instead, one-month HIBOR and three-month HIBOR may be able to find some support around 1.5% and 1.8% respectively in 3Q18.

However, unlike some emerging market countries running huge current account deficits, HK's sound fundamentals have helped to prevent a drastic capital exodus associated with prospective monetary tightening across developed countries. Given the lack of external speculative pressure, HK's liquidity conditions could loosen after the short-term factors abate, like mega IPOs, dividend payment flows and the month-end effect.

Ample front-end liquidity is possible to push USDHKD spot rate up to 7.85 once again. Any FX intervention of the HKMA would in turn reduce the aggregate balance from its current level of HK$109.4 billion. This may add to the Fed's rate hike expectations and the year-end effect in tightening the HKD liquidity in late 2018. Therefore, we expect one-month HIBOR and three-month HIBOR to rebound to 2% and 2.25% respectively by end of this year. Till the end of 2018, aggregate balance may drop at a manageable pace and stabilize between HK$50-HK$80 billion, while USD/HKD may retreat to 7.83.

With higher interbank HKD rates, commercial banks may continue to scramble for HKD fixed-deposits with higher rates, in an effort to ease the funding pressure. A combination of higher HIBOR and HKD fixed-deposit rate has pushed up the funding costs for commercial banks. However, HIBOR-based mortgage rates (one-month HIBOR plus 1.3%) remained capped by the prime cap (Prime rate minus 3.1%). This suggests that the net interest margin (NIM) on mortgage loans has been narrowing. As such, even though commercial banks stayed put right after Fed's June rate hike, we expect them to raise prime rate at least once by 25bps in 2018.

Chart 7: Suppressed mortgage NIM



Source: Bloomberg, OCBCWH

De-peg risk is not a concern

Looking ahead, the HIBOR and LIBOR gap is not expected to close and the HKD is unlikely to return to the strong side (7.75-7.80) until the capital outflow pressure intensifies on synchronized global monetary tightening. Nevertheless, even if capital exodus worsens and exacerbates the downward pressure on HKD, we think the de-peg risk is not a significant concern.

Sizeable foreign currency reserves and strong twin surpluses reflect strong fundamentals. According to the HKMA, official foreign currency reserve assets of Hong Kong amounted to US$432.1 billion at the end of May 2018, far outweighing the estimated US$130 billion inflows since Global Financial Crisis. Also, foreign currency reserve assets represent over two times the monetary base, or more than seven times the currency in circulation or about 45% of Hong Kong dollar M3. Meanwhile, the fiscal account to GDP ratio reached its highest since 2007/08 at 5.2% in 2017/18. The current account surplus to GDP ratio increased to 8.6% in 3Q 2017, the strongest since 1Q 2011. Notable improvements in HK's fundamentals will allow HK to maintain the linked exchange rate system in the medium term.

Chart 8: Sizeable foreign currency reserves

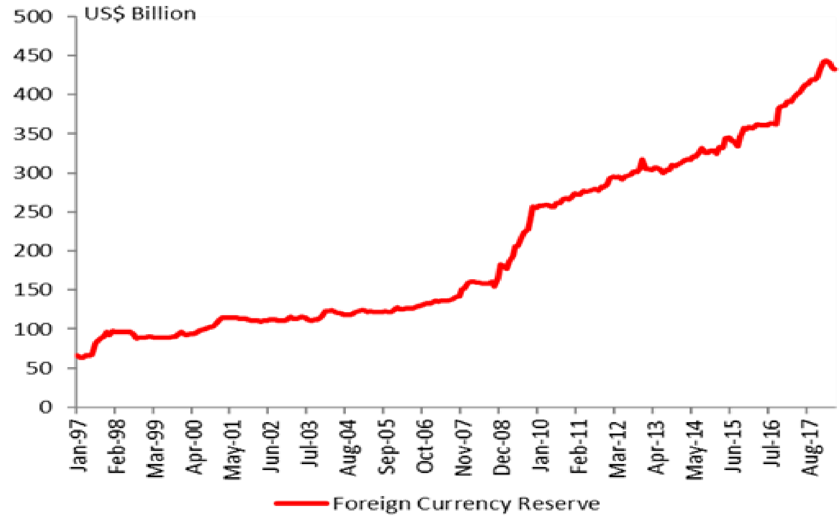
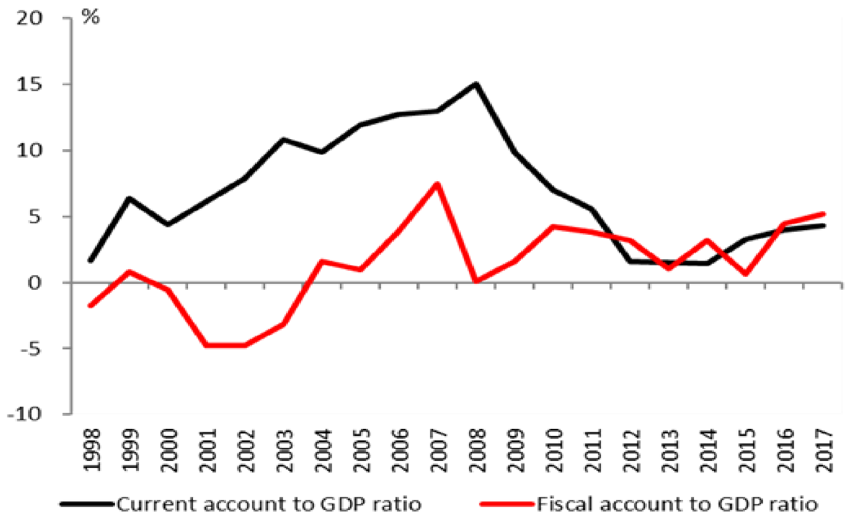


Chart 9: Strong twin surpluses



Source: HK Census and Statistics Department, Bloomberg, OCBCWH

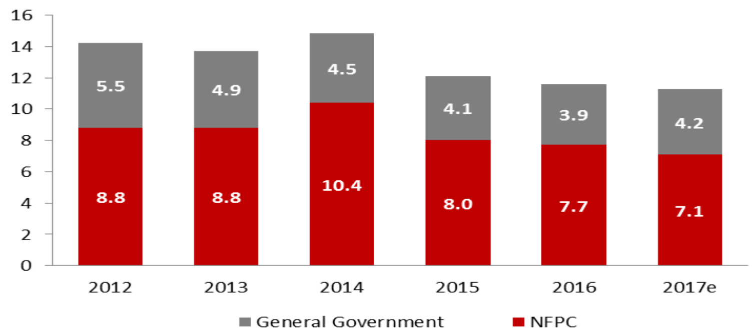
MALAYSIA SPECIAL

Journeying into the unfamiliar

Prior to Malaysia's historic May 9th election, it appeared that financial markets had not fully discounted the actual outcome. Immediately after the elections, many questions were raised about the future of key megaprojects and Chinese investments. Upon taking office, Pakatan Harapan (PH) was quick to act by postponing the Kuala Lumpur – Singapore High Speed Rail and shelving the Kuala Lumpur MRT Line 3. The government has though decided to press ahead with both the East Coast Rail Line (ECRL) and the Tun Razak Exchange (TRX). With all this in mind, it would be crucial to watch closely as to the extent to which the government can continue to review other major projects such as the Pan-Borneo Highway.

However, it would still be premature to assume too much until there is a clearer picture of the new government's fiscal plans. To note though, the new government has strongly stressed concerns about the level of the national debt as well as the need to drive through fiscal discipline. Interestingly also, government capital expenditure as a share of GDP has been on the decline (see chart 1).

Chart 1: Government capital expenditure as a share of GDP, %

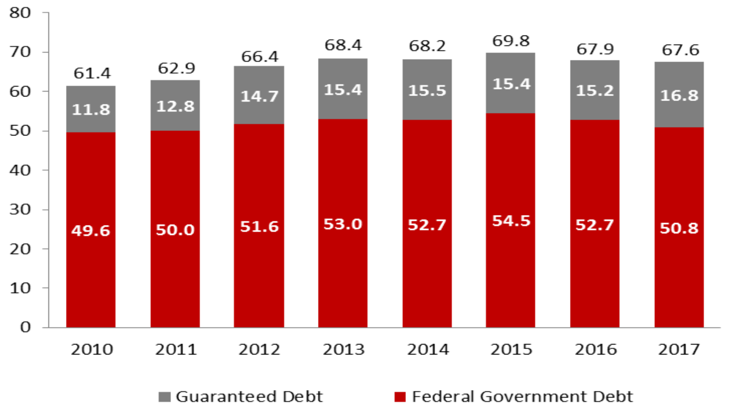


Source: CEIC, Ministry of Finance Malaysia and OCBC

Of debt and fiscal discipline

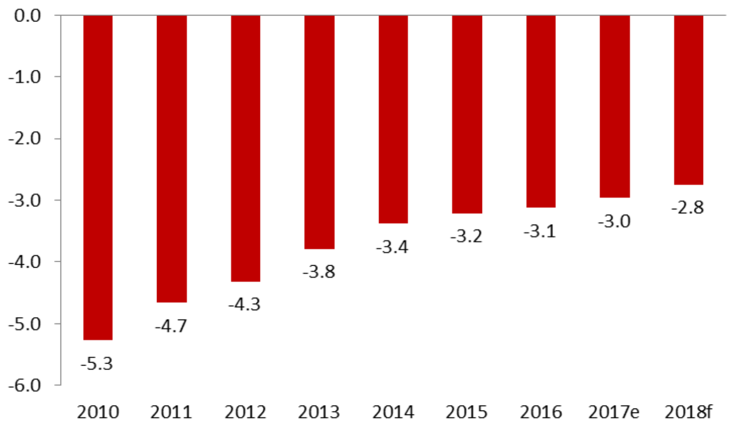
As mentioned, the new government has raised alarm over the country's debt situation. However, at this point, without enough details on the leases of the public private partnerships, we can only undertake an analysis on the Federal Government debt and the guaranteed debt based Bank Negara Malaysia (BNM) data. In 2017, the guaranteed debt as a percentage of GDP had risen and this offset the reduction in the Federal Government debt as a percentage of GDP (see chart 2). That said, this wasn't previously unknown and also only about 3.1% of Federal Government debt is foreign currency denominated as of end-2017. However, general expectations were that the fiscal deficit would decline as a percentage of GDP (see chart 3).

Chart 2: Federal Government debt and guaranteed debt as a percentage of GDP,%



Source: CEIC, BNM and OCBC

Chart 3: Fiscal Deficit as a percentage of GDP,%



Source: CEIC, Ministry of Finance Malaysia and OCBC

The challenge going forward is to continue to fulfil this expectation of further reduction in the fiscal deficit. Bringing down GST to zero percent is estimated by the Ministry of Finance to result in a revenue loss of RM21bn. Together with the Hari Raya special assistance program for lower-ranked civil servants and a petrol price stabilization program, there would be a total shortfall of RM24.7bn. The government has mentioned that this shortfall would be met by proceeds from the sales & services tax, higher dividends from government linked corporations, increase in corporate taxes receipts due to the rise in oil prices and an expenditure rationalization program of RM10bn. This assumes that the government doesn't introduce additional expenses this year but do note that the PH manifesto had also promised the abolishment of toll charges and an increased allocation to the Ministry of Health to 4% of GDP. However, these items are not part of the first 100 days promises of PH, albeit it remains to be seen whether the new government would wish to show progress in such areas within 2018.

Generally, there are some existing interesting trends to the budget to take into account. These include that salaries and pensions is estimated to have made up 46.6% of the operating expenditure in 2017 (see chart 4). Revenue as a share of GDP has also been on a declining trend (see chart 5). The PH manifesto has mentioned that PH would look into reviewing the personal income tax rate so that the burden towards the middle 40 percent (M40) can be reduced. Lim Guan Eng though has recently said "I am going to be a very, very unpopular finance minister" and "I have no money to give, I am cutting down".

Chart 4: Salaries and pensions as a percentage of operating expenditure, %

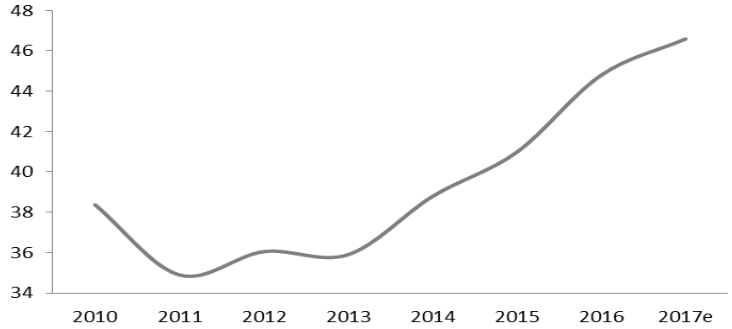
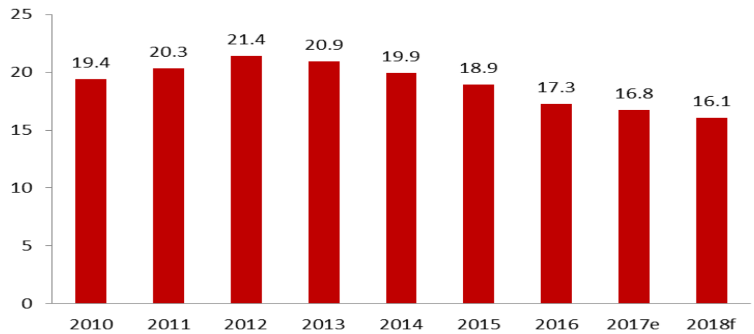


Chart 5: Revenue as a share of GDP, %



Source: CEIC, Ministry of Finance Malaysia and OCBC
Note: 2018 reflects the adjustment made by the new government

Whither trade agreements, China and foreign investments?

Investors will be watching how the new government handles sensitive bilateral relations with other key countries. PM Mahathir's comments on the Trans-Pacific Partnership were "it is important to take into consideration the level of development of a country" and "small, weaker economies must be given a chance to protect their products". PH did oppose the Trans-Pacific Partnership Agreement (TPPA) back when it was tabled in parliament. As it stands, the new government has only commented about reviewing the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

Regarding China, putting aside the concerns related to the major projects, Mahathir in his previous premiership appears to have previously engaged the country heavily. He made a total of seven official visits to China and during Malaysia's chairmanship of ASEAN in 1991, Beijing was granted observer status at an ASEAN ministerial meeting that year. Recently, Mahathir also completed a working visit to Japan as his first foreign visit since taking office. Mahathir has also always emphasized to "look east" and in particular to emulate the Japanese. Going forward, it would be interesting to watch how Malaysia will position itself between the two countries.

Mahathir's comments on foreign relations are rather measured right now. However, it would be interesting to see if Malaysia would try to take a bigger role to promote mutually beneficial regional cooperation. Mahathir has recently reiterated that he supports an East Asia Economic Caucus (EAEC).

The 11th Malaysia Plan and beyond

The plan is highly ambitious and broad-based with a focus on a wide range of items to be addressed from raising productivity to creating competitive cities. Fully implementing it would require an immense amount of resources. Minister of Economic Affairs Azmin Ali has already mentioned that the 11th Malaysia plan will also incorporate the goals of the new PH government. This would be made clearer during the tabling of the mid-term review of the plan in September. Some points of interest though from the manifesto include an emphasis to prepare Malaysian workers to face the challenges of Industrial Revolution 4.0 and that domestically, the government's main focus will be to develop SMEs. Going forward, it would be crucial for the government to have a focused and implementable economic plan.

Excitement and challenges

Malaysia has always been seen as a country of great growth potential. While any regime changes may bring along unfamiliarities and uncertainties, there is likely to be great opportunities as much as there would also be challenges.

TECHNOLOGY SPECIAL

The great debate: Technology the disruptor or enabler?

As discussed in our 2018 Global Outlook, amid the stagnating productivity and growth rates that we have seen over the years amongst major economies, policymakers expect the 4th Industrial Revolution and its technologies, including Artificial Intelligence (AI) and robotics, to drive future expansion. In particular, the digital economy can play a key role in fostering economic development by driving productivity growth and potentially provide a solution to the slowing growth rates of late.

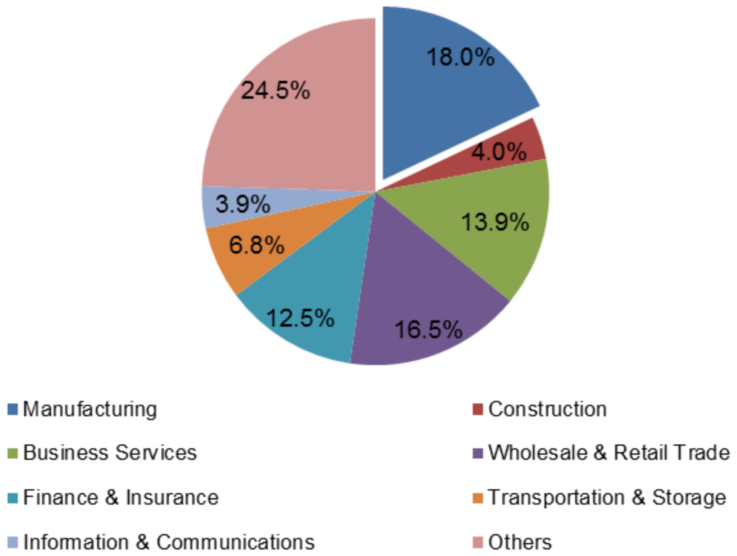
In Singapore, the Committee on the Future Economy (CFE) of Singapore is one of the latest growth strategies of the government to place technology as a top priority in encouraging growth. The government sees the importance of keeping up with trends and encouraging innovation as it steers the city state towards its vision of attaining a "Smart Nation" status. As mentioned by Prime Minister Lee Hsien Loong in as early as his 2016 National Day Rally "Old models are not working, new models are coming thick and fast, and we're having to adjust and to keep up, because of technology and globalisation. And the disruption will happen over and over again, relentlessly." Furthermore, when it comes to the degree of readiness to engage in digitalisation, Singapore emerges top of the leader board amongst many other major economies. For example, the city state continues to remain digitally ready amongst the world's top nations. Singapore, alongside with Australia and Sweden were recently ranked No.1 in the Economist Intelligence Unit's Technological Readiness Ranking for 2018-2022. The country moved up two spots from the same ranking list for 2013-2017. This only adds on to the plethora of lists that Singapore has topped with regards to it being digitally ready.

However, despite the various initiatives that have been pushed out by the government in trying to make Singapore the next digital powerhouse, the rise of digital technologies has also seen the disruption of existing business practices, exposing incumbents to competition and raising concerns about its impact on employment. By 2020, AI is projected to create 2.3 million new jobs worldwide while eliminating 1.8 million traditional jobs, according to research firm Gartner. This topic was once again addressed in global forums such as the World Economic Forum, G7 summit as well as in research papers by international institutions like the IMF, ADB and World Bank which highlighted that the development of technologies will disrupt jobs but usher in unprecedented new opportunities concurrently. While the technical development leads primarily to an efficiency enhancement in the production sectors, new creative and disruptive service models will revolutionise the service sector. This study delves further into the potential impact of the digital economy on Singapore and its various business sectors. In particular, we pay close attention to the city state's manufacturing sector, retail and services sector and finance sector as we believe that these are the main pillars that will spearhead growth via leveraging on technology's ever growing potential.

The manufacturing sector in Singapore continues to be a strong pillar of the economy. In 2017, manufacturing contributed 18% ($80.4bn) to the Singapore economy. Historically, from the first wave of industrialization leading up to the present, the manufacturing sector has always been on the frontier of technological advancements. By automating core manufacturing processes and harnessing the benefits of AI and machine learning technologies, this will aid manufacturers to maintain competitiveness.

The introduction of automated technology on the factory floor can boost efficiency and cost reductions as well as maintain or even improve the working conditions of employees, according to an Infosys report. For example, BMW in Germany has a self-driving Smart Transport Robot that travels the factory floor and sends out communication on any critical danger that it senses. In the same vein, firms in Singapore can adopt the use of such technology to lower costs, increase profitability and improve efficiency. Similar to what BMW has implemented, a network of sensors or mini bots embedded in factory floors would help firms to identify bottlenecks, reduce wastage and optimize production. Furthermore, given Singapore's status as a first-class shipping port, the deployment of sensors across the entire length of the supply chain to track shipments on a real-time basis would bode well for the manufacturing, export and logistic industries.

Manufacturing sector still a bedrock of the economy



Source: CEIC, Singstat, OCBC Bank

Looking towards the retail and services sector, we already see digital technologies being infused into our daily lives. Take e-commerce for example, global e-commerce sales reached $1.6trillion in 2016 and is expected to rise to $2.9trillion by 2021, a five-year compound annual growth rate (CAGR) of 12.3%. In most markets worldwide, online shopping sales are predicted to grow faster than overall sales, reinforcing the mounting pressure that traditional brick and mortar retailers have in rethinking their business models. Asia offers some of the largest and most attractive growth markets for e-commerce globally, with the region's online retail market set to be worth over $1.2trillion by 2021. Markets like Singapore and Hong Kong lead the pack, offering the level of logistics, consumer affluence and technological innovation required for the continued rapid development of e-commerce across all retail segments, while at the same time providing ideal springboards for international expansion.

The area we see the greatest potential for growth in e-commerce lies in value-added services, with companies seeking to differentiate themselves via customer service experience. For example, Amazon has been quick to recognise this, launching its Prime Now same-day in delivery service Singapore in July last year. Once again it is the country's high levels of urbanization and developed logistics resources that make such an offering possible. In another instance, Alibaba, a Chinese e-commerce giant, has a 14.4% stake in Singpost, which offers dedicated logistics and delivery services across South East Asia, a key area for expansion for the company. The collaboration provides the company with end-to-end delivery support, helping to overcome significant logistical hurdles in regional peers such as Indonesia, Philippines and Thailand. Similarly, Amazon chose the city state as its first entry point in Asia Pacific, providing an opportunity for further expansion in the region over the coming years. Today, Singaporeans are already familiar with buying and selling on Carousell and travelling by Grab for instance. More than 8 in 10 Singapore consumers have adopted e-payments and almost 3 in 5 Singapore merchants are accepting e-payments. The number of card payments in Singapore (both debit and credit) has grown nearly 35% between 2015 and 2017, and the volume of card-not-present payments (for example, using payment cards for online purchases) has nearly doubled during this period.

Digital payment solutions such as e-wallets over mobile devices have also flourished in Asia. Non-cash transactions in developed Asia-Pacific grew by 8.8% while that in Emerging Asia experienced 28.6% growth between 2015-2016, according to the 2017 World Payments Report by Capgemini. Digital payments in Asia are forecasted to grow annually at 16.4% to reach over USD 2.5 trillion per year in 2022, nearly half of the estimated global market of USD 5.4 trillion. In ASEAN, approximately one-third of FinTech companies are in the payments space, and this increases to 54% if you include money-transfer and remittance services, according to “The Rise of Fintech in China, 2016” study by EY and DBS. Nevertheless, China is clearly leading the way, with e-wallets accounting for 13% of consumer payments by value, according to Oliver Wyman’s “Winner-takes-all in battle for e-wallet supremacy, 2018”. Hence, there is huge potential for other Asian markets to play catch-up over time, especially with the convenience that these innovative systems convey. Singapore, as ASEAN chair this year, is leading the push for e-commerce growth in the region and streamline digital connectivity as well as lower operational barriers to entry. Google and Temasek estimated that e-commerce in ASEAN could amount to USD 88 billion in 2025 in their “e-economy SEA: Unlocking the $200 billion digital opportunity in Southeast Asia, 2016”.

In fact, across industries, companies are already leveraging on technology to enhance their businesses by automating repetitive tasks and improving efficiencies amongst other things. Bringing it closer to home, OCBC has continued to delve into the digital space by constantly implementing pilot programmes and initiatives to enhance customer experience as well as improve the functions of the bank. The bank is at the forefront of AI-powered voice banking in collaboration with Google, enabling customers to initiate a conversation about the bank’s services via the Google Assistant. This recent development complements other self-service digital channels such as AI-powered chatbot ‘Emma’, which was launched back in 2017, specialising in answering home and renovation loan queries on OCBC’s website. Additionally, the bank recently rolled out OCBC 360, a digital instant account-opening service for customers, without having to visit a branch physically. This further reinforces the bank’s commitment in making banking a seamless experience.

On the flip side however, the rapid development of such technologies and its pervasiveness in everyday life has received mixed reactions amongst the public. There are legitimate concerns about the future of jobs given technology’s impact - specifically, taking over roles which used to be performed by humans. In a study by Frey and Osborne (2013), it was found that roles in areas such as telemarketing, customer support, drivers, office clerks, retail salespersons and cashiers among others were most likely to be replaced by such technology. However, these roles have a few common underlying traits: 1) they are highly susceptible to automation, 2) the tasks involved are repetitive and 3) there is a high focus on manual efforts compared to one’s thought process. Thus, these technologies have so far taken over mostly well-defined routine tasks. Meanwhile, jobs that are least likely to be replaced by these advanced technologies include managerial roles, positions that require expertise and those that involve unpredictable physical work. Thus, even as some jobs are destroyed by the rise of the digital economy, new ones will always be created. For instance, OCBC launched the Future Smart Programme, a digital transformation programme, in May this year to ensure that employees would always be equipped with the highest level of digital proficiency to stay ahead of current trends.

With a thriving digital landscape, underpinned by its infrastructure and policy readiness, Singapore is fast becoming a hotspot for experimentation and innovation. Strong investments in digital infrastructure, a growing pool of IT expertise and a growing population that is mostly connected to the cloud also suggest that the country is making significant gains in the technological realm, with huge potential ahead of us. Hence, it is thus pivotal to view these technologies as an enabler rather than that of a disruptor. Without a doubt, the advent of technologies has brought about great disruption to both producers and consumers alike. For example, as digital payments continue to grow and flourish amid technological innovation in the financial sector, cyber hygiene and cyber-resilience has become increasingly important as well. However, if one is able to look past such hurdles and leverage on the many opportunities that such technologies bring about, we will be able to find ourselves ahead of the curve. Besides, the potential and beauty of ever evolving technology lies in doing things never done before.

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