OCBC TREASURY RESEARCH

OCBC 2021 GLOBAL OUTLOOK

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2021 Outlook: A New Era with Covid Vaccines on the Horizon?

A new dawn in 2021?
Photo credits: OCBC Treasury Research

2020 has been a tumultuous year, with the Covid pandemic wrecking havoc across the global economy and exacting a heavy toll both in terms of fatalities and also livelihoods. While the global economy has emerged from the Great Lockdown situation in the second quarter of 2020 with the sharpest slump seen in many years, synchronised monetary and fiscal policy support including significant government transfers has been forthcoming which helped to head off some of the worst economic effects of the pandemic. Industries like aviation and hospitality-related ones have been decimated and is still fighting for survival. Recovery will likely take many quarters if not years. This is notwithstanding the V-shaped bounce seen in the third quarter of 2020 as the re-opening of economies saw economic activity rebound from extremely low levels.

However, resurgent waves of Covid infections since then have prompted some countries to slow down their re-opening and reinstate partial or localised lockdowns. While China's recovery as the First-In-First-Out from the Covid crisis appears to be well underway, other major economies have not been so fortunate to recover back to pre-pandemic levels amid setbacks due to the ongoing spread of Covid infections. High-frequency activity indicators also point to a levelling off in terms of growth momentum, apart from manufacturing activity which has been leading the recovery story. Productivity has also generally taken a hit during the lockdown periods, albeit the adoption of remote working and data-enabled services may drive different changes in production, distribution and payment systems.

Moreover, the shape of the downturn triggered by Covid-19 is different from previous crises – the scale of disruptions to the services sector, and also global supply chains will continue to have ricocheting impact on the form of foreign direct investments, portfolio flows and investment decisions well beyond the potential lifespan of the Covid-induced recession. Still, financial markets have been forward-looking and risk appetite has been quick to capitalise on the cheap money, ample liquidity and the policy put option provided by major central banks that they will do whatever it takes to ward off further downward market spirals amid a disinflationary environment. Policymakers had been very innovative and provided unprecedented support in the sheer scale of asset purchase programs, lending facilities, emergency programs, loan moratoriums, and other temporary lifelines including credit to affected firms and workers to mitigate the Covid fallout. In addition, negative interest rates have become more widely discussed and some forms of debt monetisation even accepted as a temporary fix in the interim.

From the depths of recession in 2020 to growth in 2021, albeit an uneven one.

A slow and uneven recovery for the global economy appears to be in store as the baseline scenario, barring a quick fix through the quick materialisation of a vaccine. In the best case scenario, a vaccine which is highly effective is widely deployed within a rapid period of time. At this juncture, there appears to be many promising vaccine candidates from Pfizer, Moderna and AstraZeneca, which could potentially see a quick roll-out in the US, and elsewhere. Assuming no vaccine nationalism, even then, the assumed lift to both business and consumer confidence have to happen for the nascent economic recovery to take root and a synchronised upturn to develop. As such, the IMF is tipping 2021 global GDP growth at 5.2%, after shrinking 4.4% in 2020 which is slightly less severe than initial projections during the depths of the second quarter slump and also a far cry from the 2.8% growth seen back in 2019 despite the US-China trade tensions. Poverty and inequality, in particular, have suffered an acute setback due to the K-shaped recovery post-Covid which meant that low-income households and non-PMET workers including gig and informal workers were most vulnerable to the economic recession. Unemployment rates may remain elevated for longer, even as interest rates remain lower for longer.

The structural changes brought about by work-from-home arrangements, safe distancing and other hygiene measures, coupled with the prevalence of online shopping, reshoring and global supply chain shifts, as well as ESG issues may mean that the post-Covid world will be fundamentally different. At some point in 2020 and beyond, policymakers will also have to contemplate the fiscal sustainability of their support programs and recalibrate the duration and quantum of the emergency support, even if low inflation outlook and inflation expectations imply monetary policy accommodation can remain intact to ward off downside risks. Downside risks, as articulated by many central bankers, remain formidable. First, the resurgent Covid outbreaks continue to weigh on external demand and growth.

Second, premature or mis-calibration in the withdrawal of policy support could engender risk-off bouts of market volatility and affect business and consumer confidence about the viability of the recovery story. Third, tightening of financial conditions and/or liquidity and debt insolvencies may trip up leveraged corporate and households, deplete bank capital buffers, constrain credit and potentially see a negative vicious cycle for financial markets. Last but not least, geopolitical uncertainties have not fully dissipated. US-China tensions and strategic competition may last beyond the Trump administration even if the US President-elect Biden is more orthodox in his approach towards global trade. The potential bifurcation of technology standards and platforms also remains a real risk.

The glass remains half-full, but that's good enough for financial markets!

This is not to say that we're bearish on 2021 growth prospects, but the optimism has to come with a dose of realistic caution. Bearing in mind that financial markets, whether equities, credit or commodities, have had a fairly good run year-to-date in 2020, the hurdle for further exceptional outperformance in 2021 is set at a relatively high bar. Fostering new growth opportunities, collaborating in open and free trade (for instance, the recently signed RCEP for a start), speeding up the transition to a low-carbon economy and other cleaner technologies, investing in retraining and reskilling workers, boosting productivity growth and promoting inclusivity, managing sovereign and corporate debt overhangs, and strengthening our resilience towards calamitous health crises, amongst others, will help to relieve the potential economic scarring of the Covid pandemic, but remain formidable medium-term challenges for the road ahead. For now, there is light at the end of what appears to be a very long and dark Covid tunnel, and the financial markets are quick to celebrate that prospect.

GDP Growth Rates

% CHANGE YOY	2018	2019	2020F	2021F	2022F
US	2.9	2.2	-3.7	4.0	3.0
Eurozone	2.3	1.7	-7.8	4.2	3.0
Japan	0.3	0.7	-5.5	3.6	1.6
United Kingdom	1.3	1.5	-11.0	11.0	3.1
New Zealand	3.2	2.2	-4.0	3.6	3.5
Australia	2.7	1.8	-3.6	3.1	3.0
China	6.7	6.1	2.0	9.2	5.6
Hong Kong	2.9	-1.2	-6.0	4.3	2.1
Taiwan	2.7	2.7	2.4	3.3	2.1
Indonesia	5.2	5.0	-2.0	5.2	5.2
Malaysia	4.7	4.3	-5.1	6.0	4.3
Philippines	6.2	5.9	-8.3	3.2	6.5
Singapore	3.4	0.7	-6.1	5.0	3.0
South Korea	2.7	2.0	-1.1	3.0	2.4
Thailand	4.2	2.4	-7.8	3.2	3.7
Myanmar	6.4	6.5	2.0	5.7	6.5
Vietnam	7.1	7.0	1.6	6.7	6.6

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

Inflation Rates

% CHANGE YOY	2018	2019	2020F	2021F	2022F
US	2.4	1.8	1.2	1.7	1.8
Eurozone	2.2	1.4	0.3	1.0	1.3
Japan	1.0	0.5	-0.6	0.4	0.7
United Kingdom	2.5	1.8	0.6	2.1	2.0
New Zealand	1.6	1.6	1.6	0.9	1.0
Australia	1.9	1.6	0.5	1.5	1.2
China	2.1	2.9	2.6	1.5	2.2
Hong Kong	2.4	2.9	0.4	1.5	1.9
Taiwan	1.5	0.5	-0.1	1.0	1.1
Indonesia	3.3	2.7	1.0	3.2	3.3
Malaysia	1.0	0.7	-1.0	1.5	1.6
Philippines	5.2	2.5	2.3	2.8	3.0
Singapore	0.4	0.6	-0.3	0.6	1.2
South Korea	1.5	0.4	0.4	1.0	1.2
Thailand	1.1	0.7	-0.9	1.0	0.6
Myanmar	5.9	8.6	6.1	6.2	6.2
Vietnam	3.5	2.8	3.4	3.5	3.6

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

Central Bank Policy Rates

BENCHMARK RATE %	2018	2019	2020F	2021F	2022F
US Fed Funds Rate	2.25-2.50	1.50-1.75	0.00-0.25	0.00-0.25	0.00-0.25
ECB Deposit Facility Rate	-0.40	-0.50	-0.50	-0.50	-0.50
BOJ Overnight Rate	-0.10	-0.10	-0.10	-0.10	-0.10
BOE Base Rate	0.75	0.75	0.10	0.10	0.10
RBNZ Cash Rate	1.75	1.00	0.25	0.00	0.00
RBA Cash Target Rate	1.50	0.75	0.10	0.10	0.10
China Loan Prime Rate (1 year)	4.31	4.15	3.85	3.85	3.65
CBRC Discount Rate	1.375	1.375	1.125	1.125	1.125
Hong Kong Base Rate	2.75	2.00	0.50	0.50	0.50
BI Reference Rate	6.00	5.00	3.50	3.75	4.25
BNM Overnight Rate	3.25	3.00	1.75	1.50	1.75
BSP Overnight Reverse Repo	4.75	4.00	2.00	1.50	1.75
Singapore 3-Month SIBOR	1.89	1.77	0.44	0.47	0.50
BOK Target Overnight Call	1.75	1.25	0.50	0.50	0.75
BOT Repurchase Rate	1.75	1.25	0.50	0.50	0.50

Source: Bloomberg, CEIC. IMF, OCBC Bank Estimates

Contents

A New Chapter

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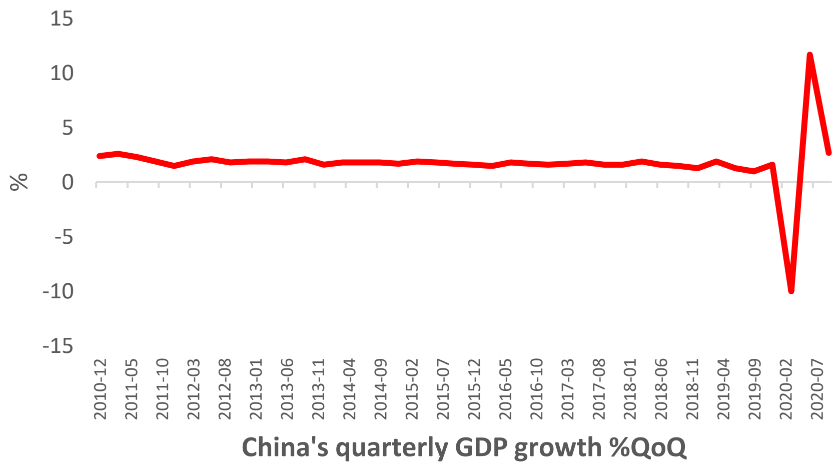
- China's economy has returned its to pre-pandemic level.
- The economic growth is expected to accelerate to 9.2% in 2021 from about 2% in 2020 on the back of resilient external demand and improving domestic demand.
- Long term US-China rivalry will continue but the higher predictability of Biden Administration may reduce the tail risk in the near term.
- China's dual circulation strategy does not mean more inward looking. Economic opening will remain intact.
- There is limited room for additional easing. With focus shifting back to de-leveraging, the rates market may remain volatile.
- We prefer to buy RMB to hedge against the uncertainty in the rates market.

The Chinese economy demonstrated a strong post-pandemic V-shape recovery in 2020 thanks to China's effective virus containment measures with the economy growing by 0.7% yoy in the first three quarters. This confirms that the Chinese economy has returned to pre-pandemic level.

Chart 1: The Chinese economy expanded by another 3.2% on quarter in 3Q.



Source: OCBC, Wind, Bloomberg

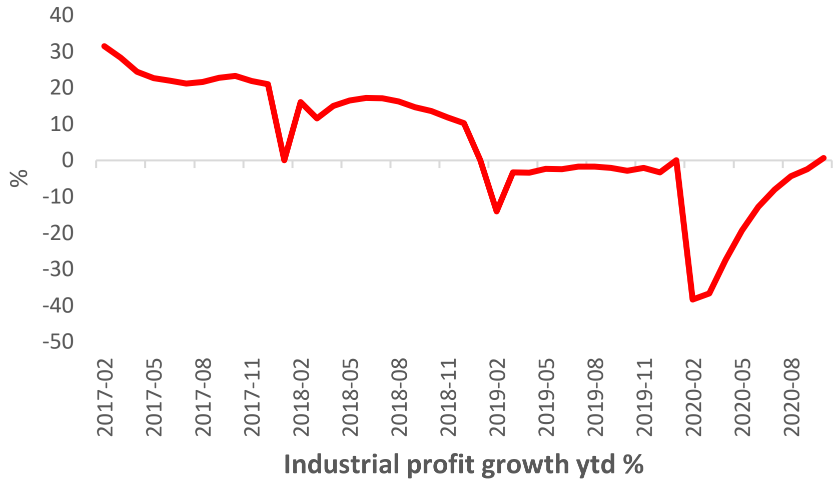
Capital formation remained the key counter cyclical factor, bringing up growth by 3.1% in the first three quarters, offsetting the 2.5% drag from consumption. External demand remained supportive, contributing 0.1% to China's growth in the first three quarters as China had played a role as the last resort of global supplier against a worldwide lockdown.

Looking ahead, we expect Chinese recovery to accelerate on the back of improving domestic demand and the still resilient external demand. China's manufacturing PMI and non-manufacturing PMI both rose to the highest in 2020, signalling solid momentum of Chinese economy. We expect China's growth to accelerate to around 6% yoy in 4Q 2020. This will translate to about an annual growth of 2% in 2020, making China the only major economy delivering growth this year.

Meanwhile, we revise up our 2021 growth forecast to 9.2% from 8.2% previously for three reasons. First and most importantly, the positive development of Covid-19 vaccine globally is expected to yield positive surprise to Chinese economy. Both US and UK have announced that it will make vaccines available to their residents from December 2020. We think there is high chance that vaccines will be rolled out to the public in advanced economies in the first half of 2021. However, most people in emerging markets may still need to wait for a bit longer towards the end of 2021 for vaccination due to constraints from vaccine production capacity and transportation. The earlier return to normalcy in developed markets may create a mismatch between demand and supply when most of alternative production centres in the world are still struggling to fight the virus. The only country which may fill the gap is China. As such, we think China could be one of the key beneficiaries of the earlier than expected rollout of vaccine, which will further underpin China's recovery in the first half of 2021.

Secondly, the companies' improving profitability is expected to continue to support China's recovery of domestic demand. China's industrial profit jumped by 28.2% yoy in October. For the first ten months, industrial profit grew by 0.7% yoy, the first growth since 2019. This also reinforces the view that the Chinese companies' profitability has returned to pre-pandemic level. We expect private consumption to become key contribution factor to China's growth in 2021.

Chart 2: Industrial profit has returned to pre-pandemic level as well



Source: Bloomberg, Wind, OCBC Bank

Thirdly, the base effect is expected to help as well. Overall, we expect the Chinese economy to deliver an astonishing 13% growth in the first half of 2021.

Challenges remain

Despite the upbeat outlook in 2021, we think challenges remain including the long-term rivalry between US and China and the implications of supply chain shift.

President-elect Joe Biden's victory is a short-term relief to China, which may end the extreme unpredictability under Trump Administration. Nevertheless, the outgoing Trump Administration's escalation of bilateral tension in the last two months of Trump's Presidency may create a high hurdle for the incoming Biden Administration to normalize its relationship with China. In addition, after four year's ruling of populism, it has been a bipartisan new normal to be tough on China. As such, we see low probability of significant improvement of bilateral relationship under Biden Administration though Biden's higher predictability is likely to reduce any potential tail risk.

We think the Biden Administration's view about Taiwan holds the key in the coming years for bilateral relationship as China is unlikely to compromise its core national interest. Taiwan issue will remain a key geopolitical risk that market cannot ignore.

Meanwhile, with the global economy returning to normalcy in the coming years on the back of positive development of vaccine in 2021, we expect "China plus one strategy" to reaccelerate. Most countries will try to reduce their reliance on one single country. As such, the return of supply chain shift may create new challenges for Chinese economy. We will discuss this issue separately in our special piece.

Supply side reform still holds the key

To offset the negative impact of ongoing uncertainties such as rising geopolitical tensions and the trend of deglobalization, China has promoted its dual circulation strategy since the first half of 2020 with domestic circulation being the mainstay and the domestic and international circulations reinforcing each other.

Although dual circulation is a demand side story, the key to achieve it should mainly come from the supply side. As mentioned by Vice Premier Liu He in his article in late November, deepening structural reform will be the main storyline for the 14th five-year plan while technology innovation will be the fundamental driver. China will pursue the path of creating demand via successful supply side reform in its dual circulation strategy.

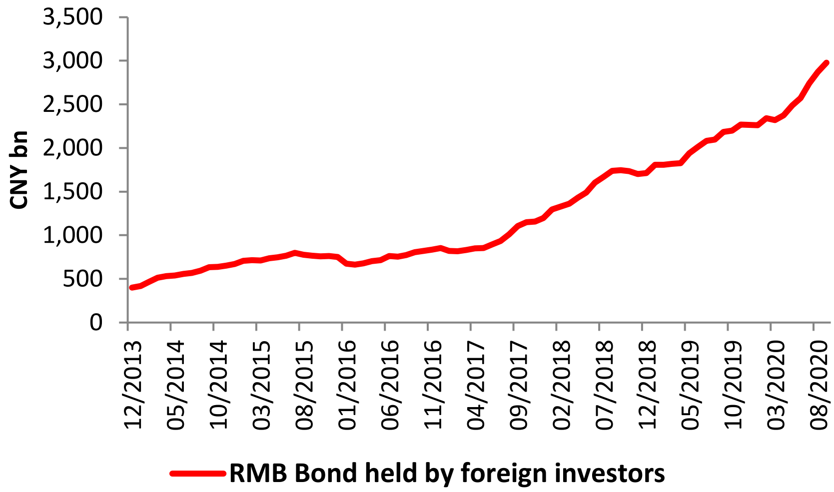
The reform of six important production factors including labour, land, capital, technology, data and entrepreneurship will dictate China's path for the next decade. As such, we will pay more attention to those production factors reform. That is why we are still bullish on China's equity market as China's determination to increase share of direct financing is part of China's capital reform. Should the reform be successful, it will energize China's equity market.

Economic opening intact

China's promotion of its dual circulation strategy does not mean China will become more inward looking. Instead, we think China will continue to seek wider, broader and deeper economic opening to promote the globalisation.

Despite the rising concerns about economic decoupling between US and China this year, the financial connection between China and the rest of the world has not been derailed. Foreign investors continued to increase their holdings in China's onshore RMB assets. We expect this trend to continue into 2021 on the back of favourable yield differential.

Chart 3: Increasing interests in onshore RMB bonds by foreign investors



Source: Bloomberg, Wind, OCBC Bank

In addition, China will also broaden its outflow channels to allow Chinese investors to increase their participation in global financial market. China's currency regulator announced in late November that China will broaden its trial of Qualified Domestic Limited Partnership (QDLP) to meet the demand for global asset allocation from domestic investors. The broadening of outflow channels is likely to be positive for global assets.

Limited room for easing

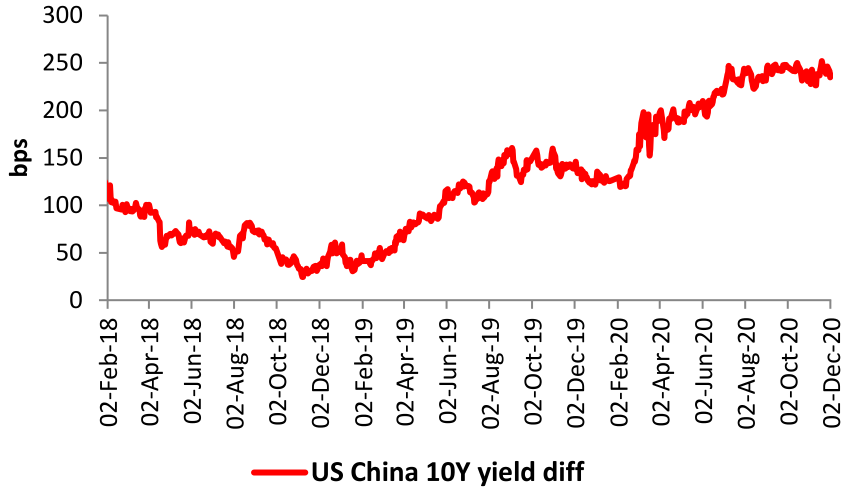
Since late April 2020, China has kept its new benchmark interest rate Loan Prime Rate (LPR) unchanged after China emerged from the lockdown. China's central bank has mentioned several times that China treasures the room for traditional monetary policy and China wants to save the ammunition of traditional interest rate cut for rainy day.

Given Chinese economy has returned to pre-pandemic level, we think China's focus is shifting away from supporting growth to keeping leverage ratio in check. As such, we think China is likely to keep its LPR unchanged in the foreseeable future.

Although China's CPI is expected to fall further in the coming months and is expected to start 2021 with negative reading, the deflationary number is unlikely to change the PBoC's decision making as the decline of CPI is mainly the result of falling pork prices and base effect. Former PBoC Governor Zhou Xiaochuan in late November called for the revamp of inflation by factoring in asset prices as well as the cost of public services. This implies that the PBoC is unlikely to react to pork price driven deflation given that China's asset prices including property market prices and equity prices continued to appreciate in 2020.

Overall, we expect China to maintain its benchmark LPR rate unchanged in 2021. This suggests that China's risk-free rates such as government bond yields may remain elevated in the near term.

Chart 4: The yield differential between China and US remains elevated



Source: Bloomberg, Wind, OCBC Bank

Upbeat view on RMB remains unchanged

RMB has outperformed in 2020 against both dollar and its major trading partners despite the escalation of US-China tension with RMB has gained more than 6% against the US dollar as of end November. The strong RMB was mainly attributable to three factors including China's first in first out recovery, the widening current account surplus and favorable yield differential between China and US. We expect those factors will continue to underpin RMB in 2021.

In addition, given China's increasing focus on independency of monetary policy as mentioned in the latest 3Q monetary policy report, it will gradually loosen its tight control on currency volatility. This means that China will have higher tolerance for the possible overshoot of RMB in the near term. We expect RMB index to trend higher in 2021 to test 98. For the USDCNY, we think it may test 6.30 in 2021.

Signs of Recovery

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- Economic recession showed signs of easing. First, 3Q GDP's decline narrowed notably. Second, the economic indicators for October affirm that the recovery remains on track.
- Both trade and financial sectors may remain the bright spots for 2021 as the growing regional trade activities and the flush global liquidity will likely continue to give a boost.
- The outlook of the retail, F&B, tourism-related and transportation sectors hinges on the Covid-19 development and the timing of border re-opening.
- Property market may continue to paint a mixed picture with commercial property market and residential property market likely to show different growth trajectories.
- We tip a recession of around 6% for 2020 and a growth of 3%-5% for 2021 depending on when an effective vaccine will be widely available.

Economic recession showed signs of easing

First, 3Q GDP's decline narrowed notably to -3.5% yoy from -9% yoy in 2Q. A combination of low base effect, stimulus measures, China's economic recovery and the re-opening of global economy helped to partially offset the impact of virus resurgence during July and August. Second, the economic indicators for October affirm that the recovery remains on track. In particular, the Purchasing Manager Index for the private sector rose to 49.8, the highest since March 2018. The decline of retail sales narrowed to -8.8% yoy, the mildest drop since June 2019. Also, housing price index rose for the second consecutive month by 0.7% yoy.

The bright spots of 2021

During the third quarter, exports of goods and exports of financial services increased by 3.9% yoy and 2.5% yoy respectively despite the local virus resurgence and the economic recession. Moving into 2021, we expect both trade and financial sectors to remain the bright spots for 2021.

On the trade sector front, trade with Taiwan and Vietnam advanced by 18.9% yoy and 16.5% yoy despite the decline of 4.9% yoy in total trade during the first ten months of 2020. By commodities, trade of electrical machinery, telecommunications equipment and office machines accounted for 67.4% of total trade. Taken all together, it suggests that Hong Kong continued to play a role as the key re-export port during the course of supply chain shift, owing to the prevalence of "China+1" strategy and its preferential corporate tax. In the 2020 Policy Address, the Hong Kong government also reiterated its interest in joining the RCEP which has been recently signed by 15 countries including China. Going forward, Hong Kong's trade and logistics sector may continue to gain traction on the back of China's solid recovery and the accelerating regionalization.

For the financial sector, there are two major breakthroughs. First, the IPO market has been hot with 99 companies getting listed in Hong Kong. In total, as much as HK$213.8 billion has been raised during the first three quarters of 2020. Together with the southbound equity inflows, the IPO rush has led to strong Hong Kong dollar demand and pushed up the aggregate balance (a gauge of interbank liquidity) to a record high. Though Ant Group's mega IPO was suspended unexpectedly, the IPO pipeline remains resilient with a raft of companies including Baidu and the other US-listed Chinese firms probably lining up for Hong Kong listing. In the medium term, the Hong Kong Exchange may shorten the IPO settlement process from 5 business days to as little as 1 business day in 2Q 2021. This may further increase the competitiveness of Hong Kong's IPO market by increasing the efficiency and reducing market risk through digitalization.

Second, on top of the stock and bond connect schemes, ETF connect was launched in October with four "feeder" ETFs beginning trading in Shenzhen and Hong Kong. Meanwhile, the loss-making biotechnology companies listed in Hong Kong and the stocks listed on the Mainland Sci-Tech Innovation Board will be included into the stock connect scheme. The wealth management connect is in the pipeline as well. With Greater Bay Area (GBA) being the test field for cross-border financial integration, more connect schemes could be expected to start here to help increase the offshore RMB liquidity. In addition, within the GBA, channels for cross-border RMB flows may be expanded to include not only trade settlement, payment and investment but also interbank funding. This will in turn help to enhance Hong Kong's role as an international financial centre, the major offshore RMB centre and the key gateway connecting Mainland China and the rest of the world.

Chart 1: Trade with Taiwan and Vietnam was strong

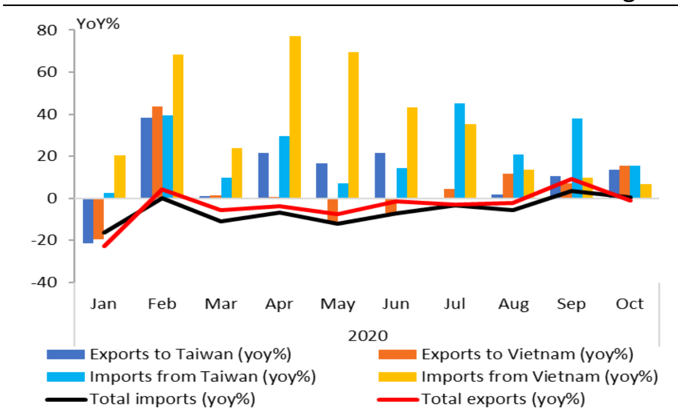
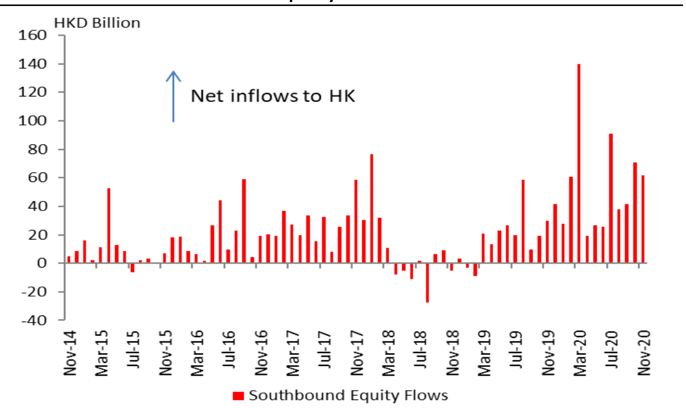


Chart 2: Southbound equity flows under stock connect



Source: HK Census and Statistics Department, Bloomberg, OCBCWH

The hardest-hit sectors are still fraught with uncertainties

Several rounds of relief measures as well as the easing of travel restrictions helped to alleviate the pressure on the hardest-hit sectors including tourism, hospitality, F&B, retail trade and transportation. However, we remain wary of the downside risks. First, due the fourth wave of Covid-19, the government delayed the launch of travel bubble with Singapore and tightened social distancing measures. Unless the local pandemic is brought under control in a short run, the hardest-hit sectors may lose some momentum in the fourth quarter. Second, even if global pandemic is well contained, virus concerns may remain intact before an effective vaccine is widely available and in turn hinder the rebound of local consumption and inbound tourism. Finally, the hardest-hit sectors may lose some financial supports amid the gradual expiry of the relief measures including the Employment Support Scheme (ESS).

A weakening labour market could weigh on the hardest-hit sectors as well. As Cathay Pacific, a local airline, announced a cut of about 5300 jobs in Hong Kong, some companies in the retail trade and F&B sectors also have layoff plans after the ESS ends. As such, the labour market looks set to weaken further. Even if the unemployment does not worsen much further, we are still concerned about the elevated underemployment across the hardest hit sectors and the weakening wage prospect. This would then fall into a vicious cycle as a weakening labour market would weigh on the local consumption which has been the main driver of the hardest-hit sectors' growth during pandemic.

Taken all together, we think the outlook of the hardest-hit sectors still hinges on the Covid-19 development and the timing of border re-opening.

Property market may continue to paint a mixed picture

Like the hardest-hit sectors, the commercial property market may regain some momentum once an effective vaccine is widely available. Adding to the upward pressure is the government's abolishment of the Doubled Ad Valorem Stamp and the hike of the LTV ratio of mortgage on the non-residential properties. However, the outlook is still not promising as it is facing a risk that the demand may never return to the pre-virus levels due to the increasing flexibility of work arrangement and the prevalence of online shopping. For office property market, some banks in Hong Kong announced that they will allow some staff to work from home permanently. As such, the vacancy rate of Grade-A office in Central which rose to 6% in August, the highest in nearly 15 years, may remain elevated going forward. For the retail property market, the vacancy rate in the five core areas may stay elevated as well after increasing to a new high in October.

In comparison, the residential property market has been much more resilient with housing price index rising 0.4% YTD as of October. This was mainly attributable to lower borrowing costs, strong pent-up demand, and prospect of insufficient supply. On the supply front, the government said that it is still confident in meeting the 10-year public housing supply target and plans to increase the public and transitional housing supply in the short to medium term. However, whether the government could deliver the plan of increasing housing supply remains uncertain especially given the disruption from Covid-19. Notably, the housing construction dropped by 20% yoy to 11600 units during the first three quarters, much lower than the government's expectation of 20,854 units. All in all, we expect the prospect

Chart 3: Unemployment rate by sector

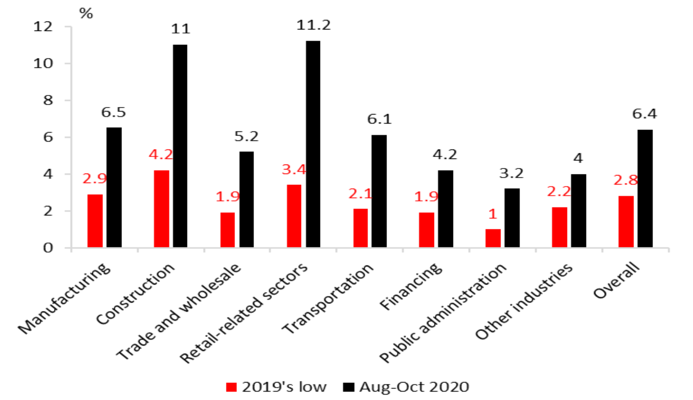
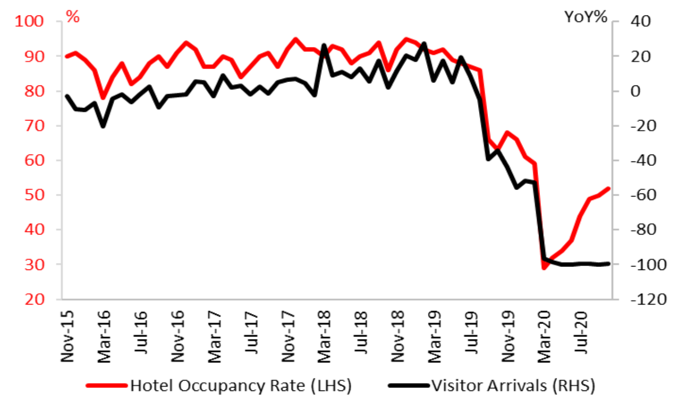


Chart 4: Tourism and hospitality were hit hardest



Source: HK Census and Statistics Department, OCBCWH

Chart 5: Housing transaction and price

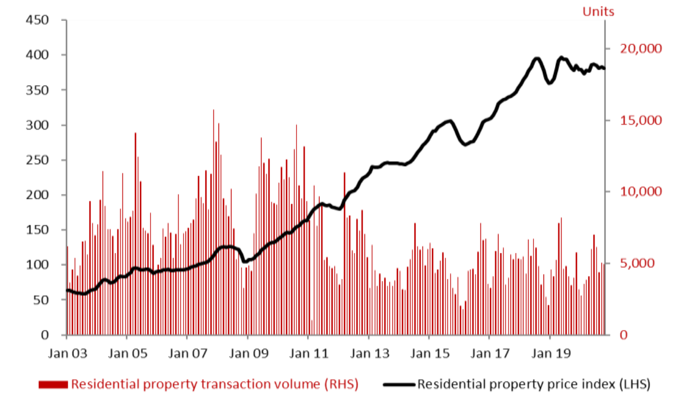
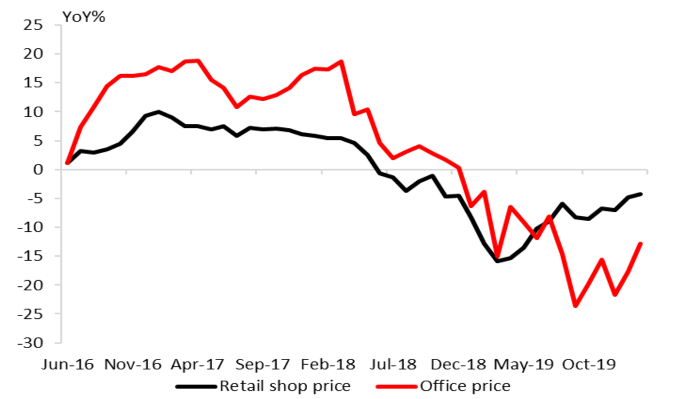


Chart 6: Commercial property price



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

In conclusion, we expect the economic recession to slow down further in 4Q. However, we remain wary of some downside risks including the virus resurgence in Europe and US, the domestic fourth wave of Covid-19 and the tightening of social distancing measures in Hong Kong, the persistent pandemic uncertainty, and the expiry of Employment Support Scheme.

On a positive note, a strong expansion could be expected during 1H 2021 given the low base effect. Some favourable factors could also help, including China's continued solid recovery, the expected easing of US-China trade tension, the prospect of an effective vaccine, and the flush global liquidity. On the flip side, government expenditure may not see significant growth next year given the potential gradual unwinding of stimulus measures. In conclusion, we tip a recession of about 6% for 2020 and an expansion of 3%-5% in 2021 depending on the vaccine development and the timing of border re-opening. Meanwhile, the government estimates an economic contraction of 6.1% yoy for 2020, as compared to the expected decline of 6%-8% in August.

Hinging on the Shots

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Ahmad Enver

Unlike some of its neighbours, Indonesia has shied away from adopting nationwide lockdowns to battle the pandemic outbreak this year. Instead, different local governments have adopted different set of restrictions. The capital city of Jakarta has adopted, on and off, varying degrees of the so-called large-scale social restrictions, or PSBB as it is known in Bahasa, for instance.

Given that cases have remained broadly on the uptick through the year – coupled with the perceived lack of large-scale testing – such a strategy has had its fair share of detractors. There are concerns, for one, that the authorities may be betting too heavily on the availability and wide dissemination of vaccines to turn things around.

To be sure, the government should be lauded for having been proactive in securing supplies of vaccines from various sources. Indonesia is in line for at least 4 vaccines that are in late-stage trials, which put the country second in Asia and on par with Japan and India in terms of secured access, according to Bloomberg.

However, even though the supply may already be in the pipeline, it might still take a while for the vaccines to be rolled out enough for Indonesia to reach the magical herd immunity level. For one, Indonesia's earlier plan to roll out vaccination as soon as November 2020 using vaccines from China had to be postponed because results from Phase 3 trial take longer than expected to pan out.

Leading Researchers	Method	Orders by Indonesia	Latest Status
Oxford University (UK) / AstraZeneca (UK)	Viral Vector	**100 million doses**. To be sent in Mar/Apr21 then gradually through the year.	Phase 3 trial results announced on Nov 23, with an average efficacy of 70%. Mixed dosage (Half-dose, followed by a full dose 28 days later) see higher efficacy of 90%, but results dogged by concerns of small sample size (of just 2741).
Pfizer (US) / BioNTech (Germany)	mRNA	*(None so far)*	Further analysis of Phase 3 trial results announced on Nov 18. Vaccine shown to be 95% effective, with 170 cases confirmed. US FDA to meet on Dec 10 to decide on authorization. Reports suggest that UK regulator may approve the vaccine this week and to launch vaccination on Dec 1.
Moderna (US)	mRNA	*(None so far)*	Announced on Nov 16 that its the vaccine was 94.5% effective, with 95 cases confirmed. Awaiting US FDA approval. Compared to Pfizer, Moderna's vaccine is said to involve less onerous distribution logistics; stable at normal fridge temperature vs. requiring deep-freeze.
Novavax (US)	Bioengineered Spike Proteins	**30 million doses.**	Launched Phase 3 trial on Sep 24 in the UK; where it plans to recruit 10k volunteers. Up to 400 participants will also be vaccinated against the seasonal flu; to determine the safety of getting both.
Sinovac (China) / Butantan (Brazil)	Inactivated Virus	1.5 million doses in Nov20, another 1.5mn in Dec. Remainder of **a total of 85mn doses** through 2021.	On Jul 3, Brazil's regulator approved the start of volunteer recruitment for its Phase 3 trial. Sinovac is conducting Phase 3 trials in Indonesia and Bangladesh as well. Indonesia's drug regulator BPOM said that, if results are good, an emergency use authorization may be granted by end Jan21.
Sinopharm (China)	Inactivated Virus	**5 million doses** to be sent in Nov 2020, then **another 10 million** in December.	China had begun to inject medical workers and other high-risk groups with this vaccine in July. Sinopharm launched its first Phase 3 trial among 15k volunteers in the UAE, and will also do so in Peru and Bahrain. Phase 3 trial outcome is said to be due in Mar21.
CanSino (China)	Viral Vector	**100,000 doses** to be sent in Nov 2020. **15-20mn doses** expected in 2021.	Started running Phase 3 trials in a number of countries including Saudi Arabia, Pakistan and Russia. China's military had approved the vaccine on June 25 for a year as a "specially needed drug" in an unprecedented move.
Merah Putih (Indonesia)	Recombinant Protein	Domestic production; To supply **57.6mn doses.**	Developed by onshore Eijkman Institute for Molecular Biology. Expected to complete trials in 2021 and to start production in 2022.

Source: OCBC, Bloomberg, RAPS, National Geographic, Jakarta Post, Jakarta Globe, KataData.

On the flip side, even though Indonesia is on the list of countries that would eventually receive AstraZeneca's vaccine, recent news flow suggesting that the company may have to re-conduct its Phase 3 trial due to questions including on the small-sample size of its previous one, mean that the roll-out may not take place anytime soon as well.

That is a pity given that, compared to the other vaccines which had announced successful Phase 3 results such as Pfizer/BioNTech and Moderna ones, AstraZeneca's vaccine would have been lot more suitable for Indonesia given that it can be stored in normal fridge temperature rather than a deep-freeze requirement that would have been too taxing on Indonesia's logistical infrastructure.

All in all, the vaccine-related challenges faced thus far show that Indonesia's strategy on depending on the shots to put an end to the pandemic spread remains a high risk one. To a great extent, the economic outlook in 2021 would thus depend on whether it would be a successful bet as well. As our baseline expectation has it, we see growth coming in at around 5.2% yoy in 2021. While that marks a significant improvement from the -2.0% yoy that we are likely to see in 2020, it nevertheless signals a relatively subdued pace of sequential growth uptick rather than a sharp one.

Our view is coloured by how the growth momentum had remained weak in Q3 2020 and the fact that higher frequency indicators such as consumer confidence and retail sales are still stuck in rather lacklustre mode going into the end of 2020. These would likely portend a still-soft momentum going into the new year.

One key hindrance to a more forceful uptick in growth momentum has been the slow pace of fiscal disbursement.

As of November 2nd, the government has only disbursed 52.8% of its IDR 695tn (USD48bn) stimulus package. While that marks an improvement from the 45.8% of total package as of end-September, the pace of disbursement remains squarely on the slow side. Moreover, it is unlikely to accelerate exponentially, as well, with the head of the national economic recovery task force, Budi Sadikin, already saying that the government expects just another IDR100tn of disbursement in Q4.

While much has been done to make sure the fiscal funds are there, including pushing the envelope on what is traditionally accepted as the most prudent separation of fiscal and monetary policies by allowing direct debt monetization by Bank Indonesia, the bottleneck on the disbursement of such funds remains an acute issue.

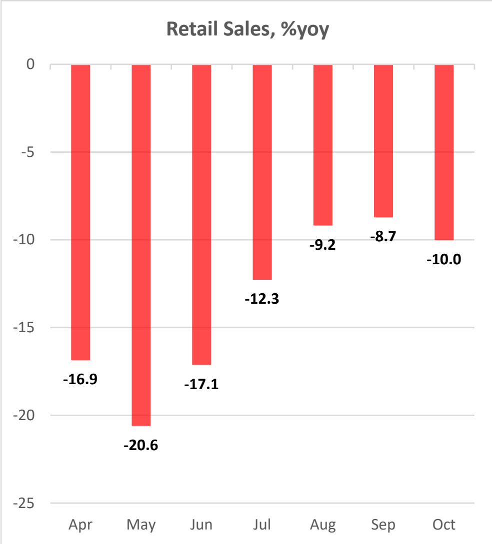
At a time when other economic engines such as private consumption, business investment and overseas demand are all just starting to try and gain tractions, the onus has been left on the government to spend and bolster the economy as a whole.

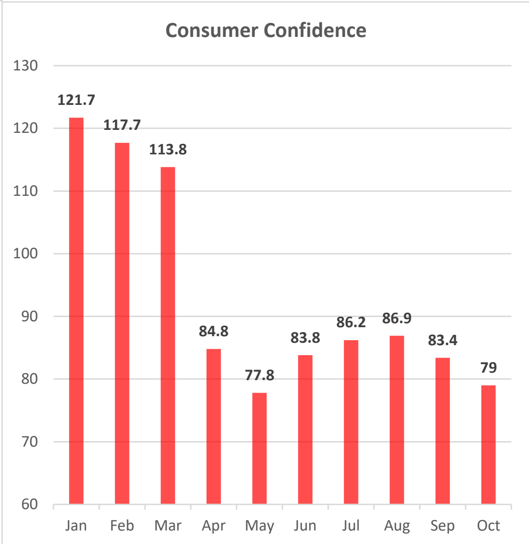
However, zooming into the Q3 GDP data breakdown, while it is true that the net contribution of government spending to the overall headline GDP growth has increased to 0.72ppt, compared to a net negative contribution of more than 0.5ppt in Q2, it has not been enough to tip the scale that much back then – and, from the look of things, into Q4 as well.

The fact that growth momentum remains weak presents itself if we look at private consumption, long a crucial component of Indonesia's economy.

The good news is that the private spending has picked up pace on a relative basis from Q2. Compared to a net drag of nearly 3ppt on headline growth then, the latest data shows a drag of 2.17ppt.

The not-so-good news is that the scale of the improvement proved to be a lot less than what we had anticipated and what the higher frequency indicators such as retail sales surveys and car sales have suggested. This signals a still-weak momentum in private consumption recovery into Q4.





Source: Bloomberg, OCBC Bank.

It does not help that unemployment has picked up and will likely pose another headwind to Q4 numbers. The statistics agency has just announced that the unemployment rate has gone up to 7.07% as of August, compared to 5.23% a year before that. As many as 2.56mn Indonesians are said to have lost their jobs due to the pandemic.

Looking beyond that, the softness in private consumption looks to remain an issue in the rest of 2020 and into 2021. We saw considerable downtick still in the pace of imports of consumption goods in October, for instance. It appears that, with or without forceful lockdown measures by the authorities, Indonesian consumers have decided to hold their purse-strings tight, either because of financial considerations that prevent them from spending or health concerns that keep them at home rather than going out to shop and eat.

Elsewhere, business investment activities have shown anaemic recovery too, still presenting a net drag of 2.11ppt to headline growth, albeit a relative improvement form the -2.72ppt contribution in Q2. Meanwhile, while net exports proved to be a big contributor to headline growth at 1.71ppt, it was really driven more by the heavy pullback of imports – in keeping with the lack of domestic private and business consumption demand – than anything else.

Altogether, the -3.49% yoy growth presents a disappointing print for the Indonesia's economic recovery hope. The weak momentum in private consumption uptick, in particular, offers a tricky outlook for Q4. We are revising down our Q4 GDP growth expectation from -1% to -2% yoy, taking in the lack of forceful recovery momentum and still-slow pace of fiscal disbursement. With that, the full-year GDP growth looks to us to be at -2%. This would be the first full-year recession the country has experienced since 1998.

Facing the challenging economic environment, Bank Indonesia has lately started to cut its policy rate again. While its MPC statement and press conference on Nov 19th played up the sense that economic growth has solidified lately on both global and domestic fronts, it is probably best to see what they do rather than hear what they say. In that meeting, it cut the 7-day reverse repo policy rate after leaving it unchanged for a few months.

Source: Bloomberg, OCBC Bank

Abutting the portion announcing the cut of BI policy rate by 25bps to 3.75%, the statement noted that the decision has been made "considering inflation expectation that remains low, external stability that is preserved, and as a follow-up step to quicken the pace of national economic recovery."

That inflation is low has been a mainstay throughout this year and not just now and is unlikely to be a trigger on its own. The external stability portion is indeed a necessary precondition (and fulfilled given the Rupiah stability recently), but it was the euphemistically expressed third point that really tipped the balance.

Indeed, as we see it, the miss in the Q3 GDP print would be a gamechanger to BI's policy mix; stepping away from just focusing on quantitative easing to bringing back policy rate cuts due to the weak growth momentum. While BI's wording today does not spell it out as clearly, the need to do what it can to try and improve the growth momentum is evident from its decision to cut rate.

Now that it has started easing rates again, the natural thing will thus be to wonder if they will do it again and again in subsequent meetings. To us, once again is probably enough; we see just one more rate cut bringing the 7-day reverse repo rate to 3.5%. If market conditions continue to be as favourable as the last few weeks ahead of the next meeting on December 17th, then BI would be keen to use the momentum to deliver that next cut.

Will it go beyond that? If there is any lesson to be had in 2020, a year that has thrown so many assumptions and preconceived notions in the bins, it is to never say never. As a baseline expectation, however, we do not expect BI to cut rate beyond 3.5%, in large part because of the continuing need to anchor yield differentials and secure fund inflows. For one, having seen the US 10-year yield with the capacity to test 1.0% rather easily during the choppy sessions of post-US election, BI would much rather play safe.

Likely Strong Rebound

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- The worst is over for Macau's economy as the local pandemic has been almost contained and a travel bubble has been established with Mainland China.
- However, for the two-pillar industries of tourism and gaming, the recovery may remain slow before an effective vaccine is widely available.
- In addition, we will closely monitor the possible revamp of regulation on the gaming sector ahead of the casino license renewal as Chinese government has cracked down on cross-border gambling.
- We expect the GDP to contract by about 54% yoy in 2020. Given the very low base effect, a strong rebound of over 60% yoy in GDP growth looks likely in 2021.

The worst is over

As Macau's local pandemic has been almost contained, Mainland China had resumed visa approvals to Macau in phases since July and fully opened the border in late September. As a result, both tourism and gaming activities have rebounded strongly with visitor arrivals surging by 686% during July to October and gaming revenue more than tripled during September to October.

This was also reflected in the narrowed decline of exports of gaming services (-93.6% yoy) and other tourism services (-87.9% yoy) in the third quarter. With the gradual recovery of the two-pillar industries of tourism and gaming as well as the rebound in local consumer/business sentiments, the economic recession eased slightly. Growth rate has improved relatively from -68% yoy in 2Q to -63.8% yoy in 3Q.

The recovery may remain slow until a vaccine is widely available

Both visitor arrivals (-81.9% yoy in October) and gaming revenue (-72.5% yoy in October) continued to see notable year-on-year decline.

Tourism sector's recovery has been slow due to several reasons. First, the processing of Mainland China's visa approvals to Macau has been slow. Second, Mainlanders have remained cautious about cross-border travel amid lingering virus concerns. Third, the limited availability of transportation also remains a constraint. Finally, though China has shown a strong economic recovery, the recovery has been imbalanced. For fresh graduates and migrant workers, job uncertainty remains a concern.

Taken all together, the slow recovery of the inbound tourism led to the sluggishness in the mass-market segment where revenue dropped for the third consecutive quarter, by 94% yoy in 3Q. On the other hand, VIP segment, whose revenue was down for the seventh consecutive quarter by 92.5% yoy in 3Q, may find it hard to regain traction as junket operators have been hit hard by the liquidity crunch resulted from subdued inbound tourism and China's crackdown on cross-border gambling.

In conclusion, we expect gaming revenue to only recover to about 50% of the pre-virus level by end of this year. Gaming revenue, which fell 81.4% yoy during the first ten months of this year, may fall around 80% yoy for 2020. Moving into 2021, gaming revenue may more than double amid a low base but may not return to 2019's level yet. The government estimates that gaming revenue will only reach MOP130 billion in 2021, or 55.5% lower than the level of 2019.

Watch out for the possible revamp of regulation on casinos after 2022

According to the 2021 Policy Address, the government hinted that the regulation on casino operation may be revamped next year depending on public opinion. As the Chinese government has cracked down on cross-border gambling, whether this will be reflected in the new regulation and have long-term impact on the gaming sector will be closely watched.

Chart 1: Gross gaming revenue

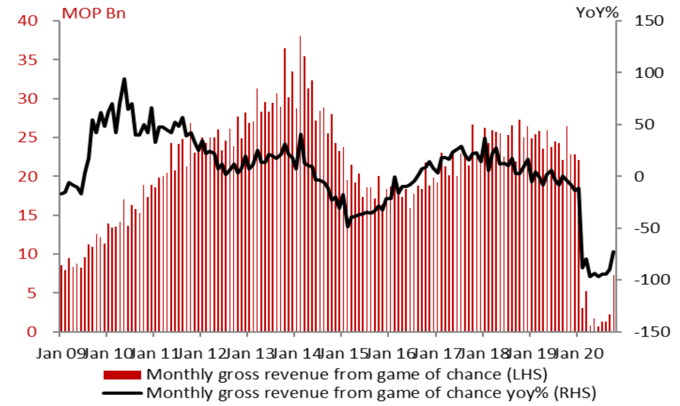
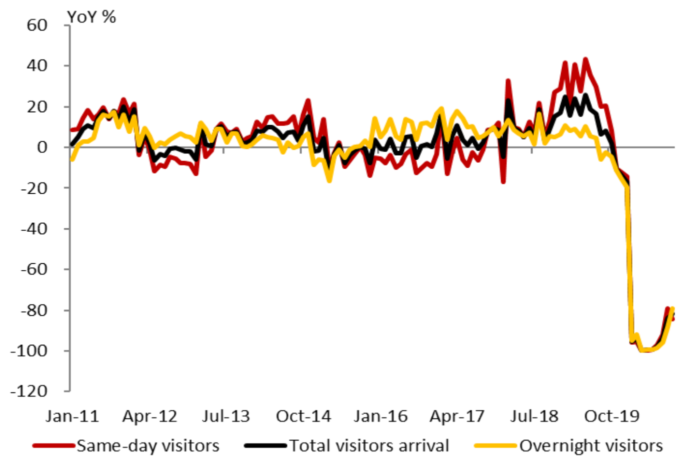


Chart 2: Visitor arrivals



Source: DICJ, DSEC, OCBCWH

Macau

Chart 3: Components Contribution to Real GDP Growth

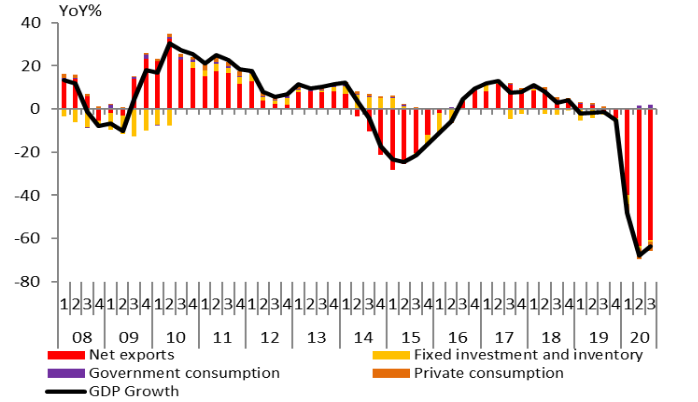
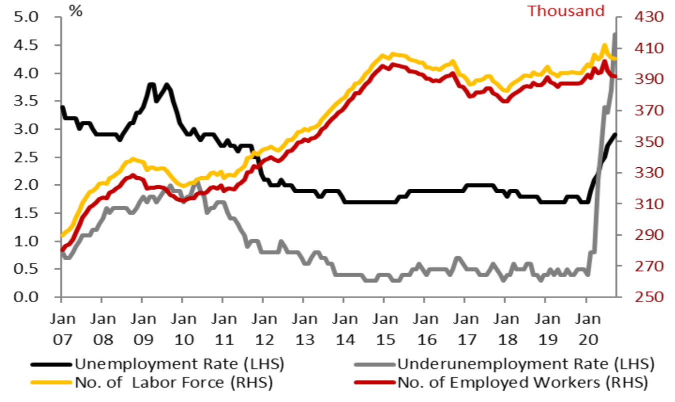


Chart 4: Unemployment rate is rising



Source: DSEC, OCBCWH

The housing market is recovering albeit with limited upside

On the back of easing economic recession, the housing market also regained some momentum. In particular, average housing price (MOP101,333/square meter) and housing transaction volume (612 deals) were up by 0.2% and 7.4% on monthly basis respectively in September. During the same month, approved residential mortgage loans surged by 38.3% mom or 82.6% yoy to MOP6.8 billion. On top of the economic recovery, some other factors have also supported the housing market. First, local borrowing costs stayed low amid flush liquidity. Second, the medium-term supply looks set to remain scarce, especially given that construction activities were disrupted by Covid-19 outbreak. Notably, housing start dropped by another 65% yoy to 109 units in the first three quarters of 2020, after declining for four consecutive years.

Going forward, the housing market may remain supported by the prospect of low interest rate and the limited housing supply. However, the upside of the housing market may be limited. First, the economic recovery may be a bumpy ride. Second, the labour market outlook may remain sluggish amid the slow economic recovery as overall unemployment rate rose to the highest since late 2010 and median wage plunged by 11.8% yoy in 3Q. Third, after the government implemented supportive measures for several years, most of the potential first-home buyers, who have made up around 80% of total local homebuyers since March 2018, may have already entered the market. Finally, the housing control measures may continue to weigh down on speculative demand as local homebuyers who owned more than one flat represented merely 1.4% of total local homebuyers in September.

All in all, we expect the average home price (-3.9% YTD as of September) may drop up to 5% by end of this year and rebound by up to 5% in 2021.

Chart 5: Housing market rebounded

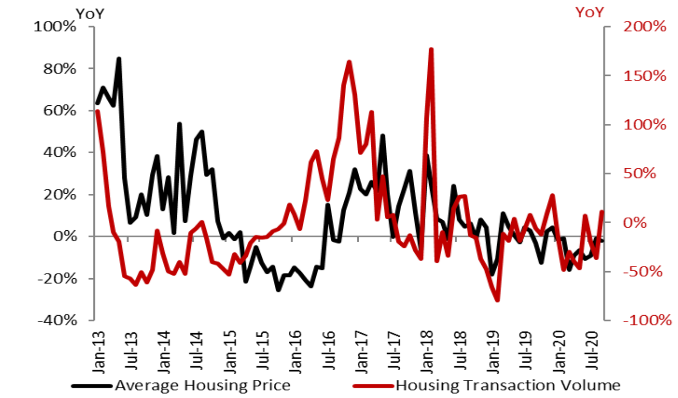
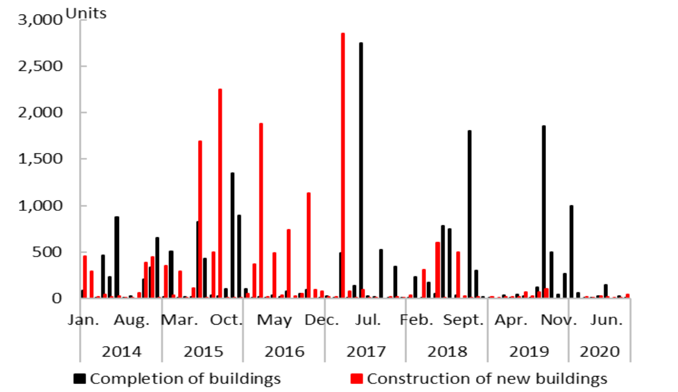


Chart 6: Housing starts continued to decline



In conclusion, we expect the two-pillar industries of tourism and gaming to keep regaining momentum on the back of the gradual border re-opening. However, the recovery may be slow until an effective vaccine is widely available. As such, we tip a record GDP contraction of about 54% yoy for 2020 whereas the government estimates a recession of 60.9% yoy for this year.

On a positive note, even though the government income plunged by 66% yoy and the government expenditure surged by 20% yoy during the first three quarters, the basic reserves and excess reserves remained healthy, at an aggregate sum of 139% of 2019's GDP as of end-September. The sizeable fiscal reserves allow the government to keep the spending on social welfare unchanged despite the reduced total expenditure. As such, it may continue to support consumer sentiment. Hence, together with the government's proposed increase in infrastructure investment, the low base from 2020 and the vaccine hopes, there may be strong rebound in the economic growth next year. We expect an expansion of over 60% yoy while the government is expecting a double-digit growth for 2021 GDP.

Conditional Recovery

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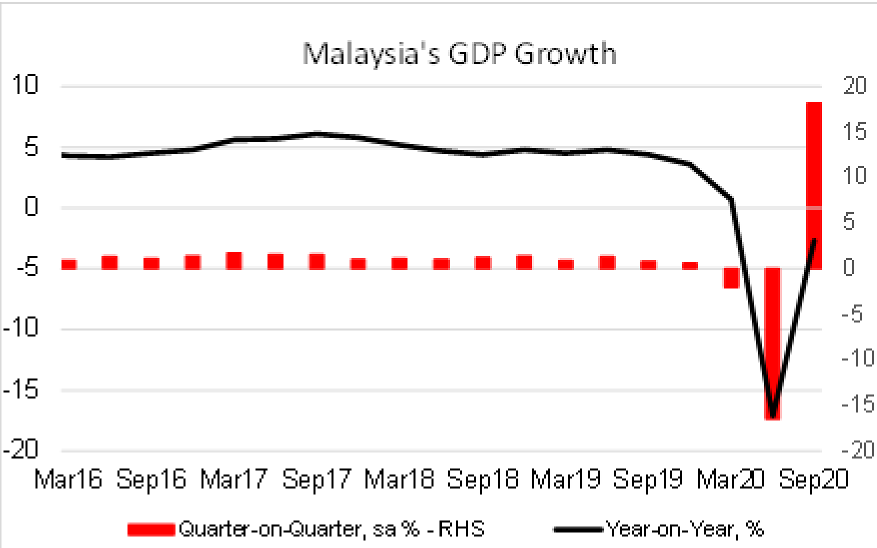
The year 2020 has been a tough one for most but would feel especially so for Malaysia. Not only has it had to deal with the coronavirus pandemic like other countries, Malaysia has also been hit a particularly heavy bout of political uncertainties. Both factors have conspired to weigh on the economy, so much so that we project the economy to shrink by 5.1% for the year.

Looking ahead, the silver lining is that the positive vaccine development would kindle hope for better odds in humanity's fight against the coronavirus scourge – and start to limit its economic impact. However, the new year may not offer any antidote to the political afflictions on Malaysia yet. This could limit the speed at which the economy can recover in 2021.

Before we delve deeper into what may lie ahead, it is worthwhile to take a look at how 2020 economic numbers have transpired thus far, not least to get a sense of how the momentum might or might not carry on into 2021.

With that in mind, let's look more closely at the latest official GDP print that we have thus far, which is in Q3. At a negative growth rate of 2.7% yoy, the Malaysia's Q3 GDP data bear the imprint of an economy that is still suffering considerably from the pandemic effects. However, it did come better than the -4.0% rate that we and the market had expected. Moreover, the Q3 headline number marked a strong sequential uptick of 18.2% on a seasonally adjusted basis, a sharp U-turn from the 16.5% contraction suffered in Q2.

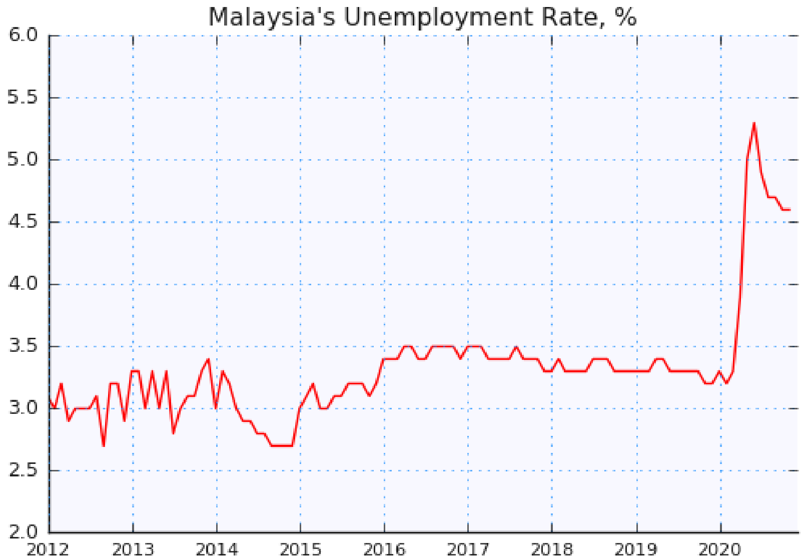


Source: *CEIC, Bloomberg, OCBC Bank*

Looking at the some of the key subcomponents, the substantial recovery in Q3 would not have been possible without a requisite uptick in private consumption, which has been playing an increasingly important role.

To that end, after dropping by a hefty 18.5% yoy in Q2, private consumption rebounded considerably in Q3, with a growth rate of -2.7% yoy. Rather than pulling down the overall headline growth substantially, by nearly 11 percentage points in Q2, the category now subtracts just 1.2ppt in Q3.

The relatively robust recovery in consumption tallies with the relative improvement in employment picture that we have seen for Malaysia in Q3. While the latest unemployment rate of 4.6% as of September is still high compared to 3.2% at the start of the year, it has nonetheless shown an encouraging improvement when compared to the high 5.3% of May this year at the height of the crisis.



Source: CEIC, Bloomberg, OCBC Bank.

Encouraging signs of recovery can be seen in investment activities, as well. In normal times, that sentence would have easily been a careless typo if we judge from the fact that the category is still contracting by as much as 11.6% yoy and contributing a net -2.64ppt to headline growth. However, in the current extraordinary climate, any relative positive movement itself is laudable. The same category saw deep slump of nearly 29% yoy and pushing headline growth by over 7ppt in Q2, for one.

A similar set of dynamics can be seen in exports. It is undeniable that its performance still bears damage from the blows of the pandemic – pushing down headline growth by nearly 3ppt for instance – but, again, on a relative basis compared to Q2 (whereby it dragged down growth by nearly 14ppt), the outturn for exports in Q3 have improved massively.

Indeed, on a sectoral basis, the exports-dependent manufacturing sector has even started to grow in yoy terms, by 3.3% in Q3 compared to -18.3% in Q2. As Bank Negara emphasized in its press release accompanying the GDP data release, “Improvements in growth were seen across most economic sectors, particularly in the manufacturing sector, which turned positive following strong E&E production activity.”

In short, so far so good from the Q3 prints. What does it entail for the economy in Q4 and into next year, however?

At the broad level, the momentum bodes well for the recovery. In particular, the uptick in export-oriented manufacturing activities should help to reinforce the improvement in employment outlook, which would in turn allow the private consumption to continue rebounding.

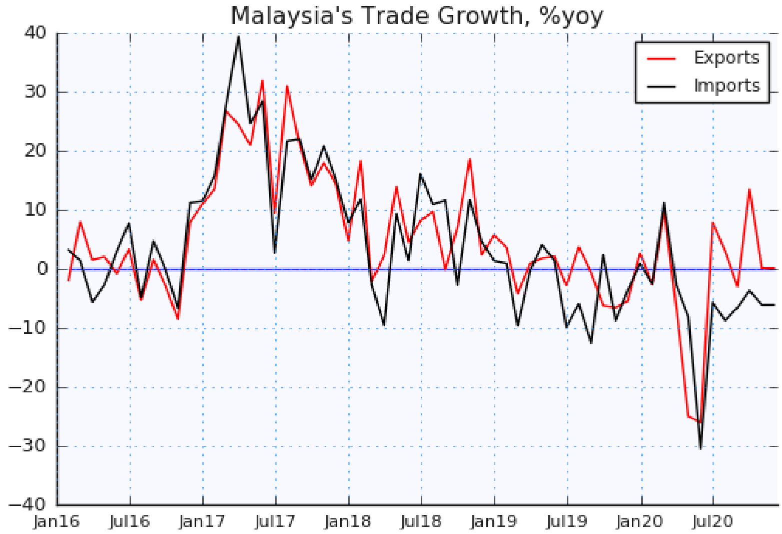
That’s the good news. The less-rosy reality, however, is that the resurgence of pandemic on the ground would dent the pace of recovery in Q4. While the restriction orders are a lot less stringent than in Q2, the psychological factor at play remains there and would curtail private consumption recovery. The silver lining is that the bulk of economic activities – including manufacturing facilities – have stayed largely untouched. Our baseline expectation is thus for growth to come in at -1.5% yoy in Q4, marking some improvement from Q3 but at a less robust pace of recovery than before. Hence, for the year as a whole, growth would likely come in at around -5.1% yoy.

For 2021 itself, the potential arrival and dissemination of workable vaccine in Malaysia represent a substantial upside risk. While the exact timing of a rollout – and how long it would take before the magical herd immunity is reached – would remain unclear in the near term, the psychological effect on consumers might start to be felt more keenly throughout the year.

To be sure, it will still be a fairly challenging outlook for labour market overall, which would continue to present a drag to private consumption recovery. However, we are of the view that the worst should be behind us now, as we can see from the more recent stabilization in unemployment. Alongside the continued recovery in the economy overall, and some more resilient sectors like manufacturing specifically, we ought to see some relative improvement in the year ahead.

Thus far, we have seen an encouraging pace of recovery in Malaysia’s exports sector. While the September data may yet to capture the full effect of the latest uptick in virus outbreak, the scale of the upside surprise (+13.6% yoy, fastest in 2 years) tells us that the manufacturing sector (which can remain open during the CMCO) has exhibited considerable strength, and should help to counter the hit on consumer and business confidence. To that end, the sub-sector of electronics exports appears to have been driving the uptick as well, benefiting from the recovery in tech cycle and also stocking-up activities.

In terms of investment activities, 2021 should mark a year of improvement from a dismal 2020, rather than an upsurge. The latest data show that for the H1 2020, Malaysia has gathered only $8.6bn worth of FDI, compared to 23.3bn in H1 of 2019, and 31.7bn for the whole of 2019. Given the pandemic and the political uncertainties, that should not come as particularly surprising.



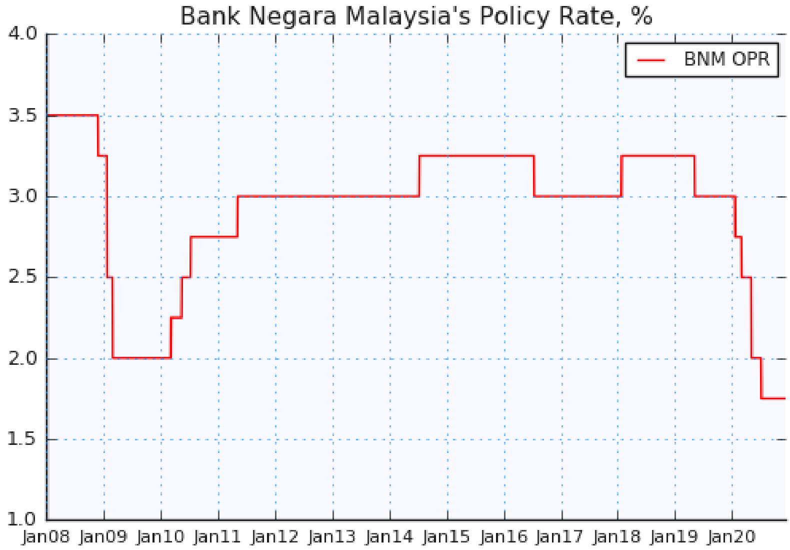
Source: CEIC, Bloomberg, OCBC Bank

While there is hope that FDI flows would improve alongside global economic recovery in 2021, we are unlikely to see headline numbers beating 2019's intake just yet due to lingering reservations by businesses to commit to longer-term investments amid a climate of political uncertainties. Moreover, in the tail risk scenario whereby the pandemic resurgence stretches on, it would act as another deterrent for any would-be FDI investors into Malaysia.

On the flip side, it must be said that Malaysia would continue to be a beneficiary of two intermingling structural trends. One is the move to shift manufacturing facilities out of China due to geopolitical considerations. Another is the uptick in demand for high-tech products due to the stocking up of semiconductors and demand from the work-from-home crowd during the pandemic. On both fronts, the specific tech-oriented FDI flows should benefit Malaysia, especially within the established tech clusters such as Penang area. These supporting factors should help to put a floor on FDI numbers in 2021.

Overall, we see enough improvement in various components of the economy for the GDP growth to come in at around 6.0% yoy, a respectable rate of recovery, albeit not a roaring one. In terms of monetary policy reaction, there is still some chance of further OPR cuts in 2021, but only by a relatively constrained 25bps or maximum of 50bps.

The central bank has sounded rather sanguine on growth outlook, opting to focus on 2021 recovery ahead rather than the likely immediate soft patch caused by domestic virus resurgence and also lingering global lockdown risks. Given that monetary policy acts with a lag, that appears to make sense. Still, if economic activities do soften in the coming months – despite expectation of a more solid recovery thereafter in 2021 – BNM might come in with a cut to help secure market confidence. Overall, while it has left the door open for further rate cuts, it does not sound like a central bank that sees the need for major actions, including on large-scale asset purchases ala its regional peers such as Bank Indonesia.



Source: OCBC, Bloomberg, CEIC.

Nationwide lockdown Forthcoming

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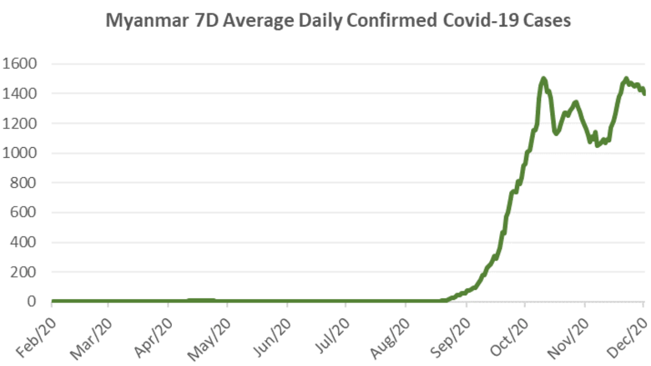
- Virus count surges and may prompt a nationwide lockdown.
- Manufacturing and tourism sector set to remain subdued until H2 2021.
- GDP growth in 2021 estimated at 5.7% yoy, but may see further downward revision if a nationwide lockdown is imposed.

Second wave of virus

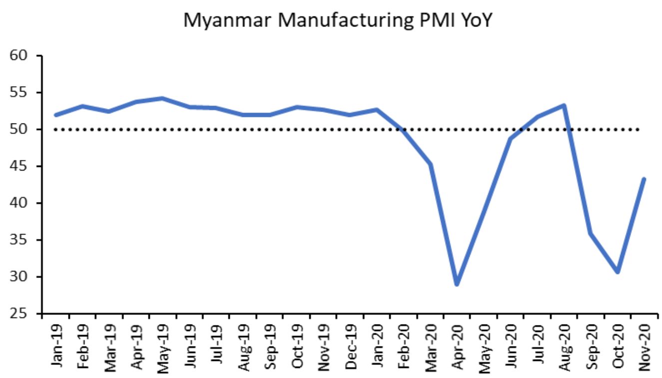
Myanmar is currently battling a surge in coronavirus cases. Despite the government's imposition of stay-at-home orders in the mid-south region since August, cases have continued to climb rapidly. With a limited testing capacity and an increasingly overwhelmed health system, a national lockdown may be forthcoming as Myanmar grapples to contain the spread.

We estimate Myanmar's GDP growth in 2021 at 5.7% yoy, which may be subjected to further downside revisions if the country is unable to contain the current virus contagion. Even at 5.7% yoy, however, the country's economic growth is still lower than the usual 6-7% yoy growth that it is normally accustomed to.



Source: WHO, John Hopkins University, OCBC Bank

Weakening conditions

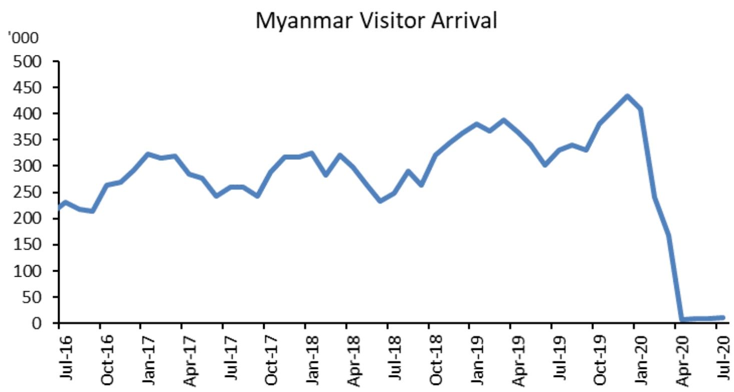


Source: OCBC, Bloomberg

Myanmar's manufacturing was impacted heavily by the latest round of travel restriction measures imposed in August. Output and new orders remain soft amid factory closures and subdued demand conditions. Meanwhile, employment has dipped due to the accelerated rate of job losses. With the virus spread showing no signs of abating, containment measures are unlikely to be lifted in the coming weeks, which could result in economic output dipping further. Consequently, we expect the return to pre-pandemic levels may be protracted and this could weigh on the manufacturing sector in 2021.

We expect Myanmar's PMI to return to expansion territory only when a vaccine becomes widely available. Due to infrastructure and logistic challenges, however, we expect Myanmar dissemination of the vaccine to its population to take longer than other Asian peers. Hence, the return of Myanmar's PMI to expansion territory may only come in H2 2021.

Tourism and travel industry likely to remain subdued



Source: Bloomberg.OCBC

Tourism in Myanmar has grown rapidly in recent years as a result of the government's investment and efforts. With the expansion of the sector, it has created jobs and business opportunities for its people. Tourism receipts have grown from USD1.97bn in 2017 to USD2.82bn in 2019, which contributed about 6.7% to the nation's GDP in 2019.

The emergence of the pandemic and the closure of international borders have resulted in a 65% yoy decline in tourist arrivals from January to July 2020. With the rising Covid cases, Myanmar has extended restriction on all international and domestic commercial air travel services until 31 December 2020. Given the current trajectory of the virus, however, we expect this restriction to extend into Q1 2021. Consequently, we expect the tourism sector to remain subdued in H1 2021 before rebounding in H2, barring any significant virus resurgence.

Myanmar

Strong rebound in 2021

Myanmar is projected to grow 2.0% yoy in 2020, its slowest pace on record, before rebounding to 5.7% yoy in 2021 on the back of strengthening textile, oil & gas and agriculture exports. In 2020, the Central Bank of Myanmar has cut its policy rate thrice, totalling 300bps, to 7.0%. Even then, we see sizeable monetary space for further rate cuts if necessary. We expect the central bank to further reduce its key rate in 2021 if the daily virus count stays above 1000 and the Myanmar government orders a nationwide lockdown.

Rate Cut Cycle may not be Over Yet

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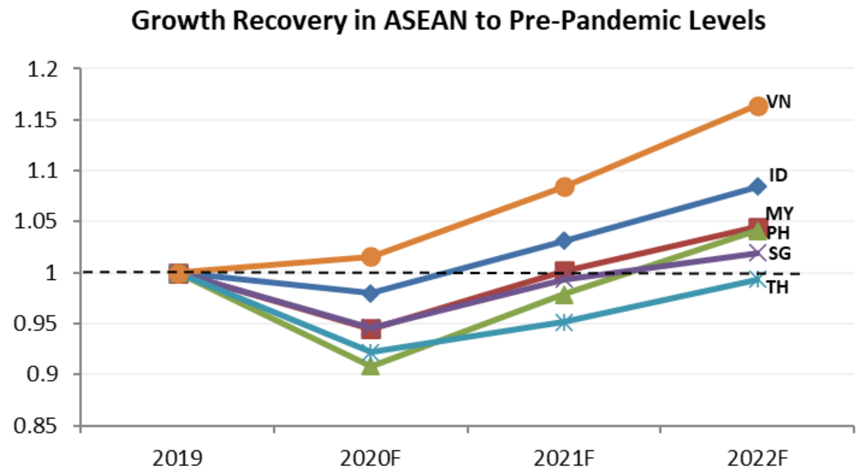
- Philippines GDP growth in 2021 estimated at 3.2% yoy.
- Current account balance to return to deficit in 2021.
- BSP has space to further ease monetary conditions, if needed.

The Philippines was the worst economic performer in 2020 in the region owing to the numerous lockdowns the country had to endure, particularly in Manila city. While we expect an economic growth of 7.8% in 2021, this would effectively mean the country would have to wait till mid-2022 to recover to pre-pandemic levels.

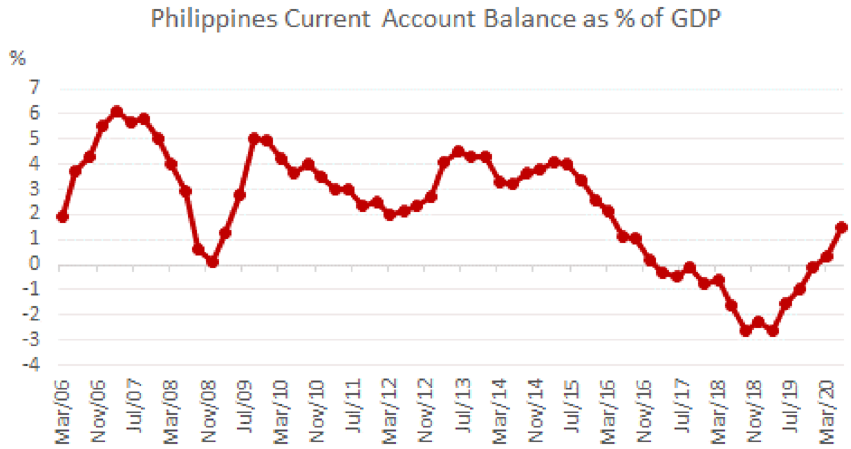


Source: IMF, OCBC Bank Estimates

The prioritization of economic recovery is likely to take centre-stage next year. In our opinion, this means that the BSP may be willing to allow inflation to creep towards its upper target band of 4%. With inflation just slightly above the mid-point at 2.6% in October 2020, we thus see scope for the BSP to continue supporting the economy via expansionary monetary policies. To that end, we think the rate cut cycle in the Philippines has yet to conclude, unlike other Asian peers. With the key interest rate presently at 2.0%, there is still ample monetary buffer and we think the BSP may yet reduce the key rate to 1.5% if necessary, especially if growth falters.

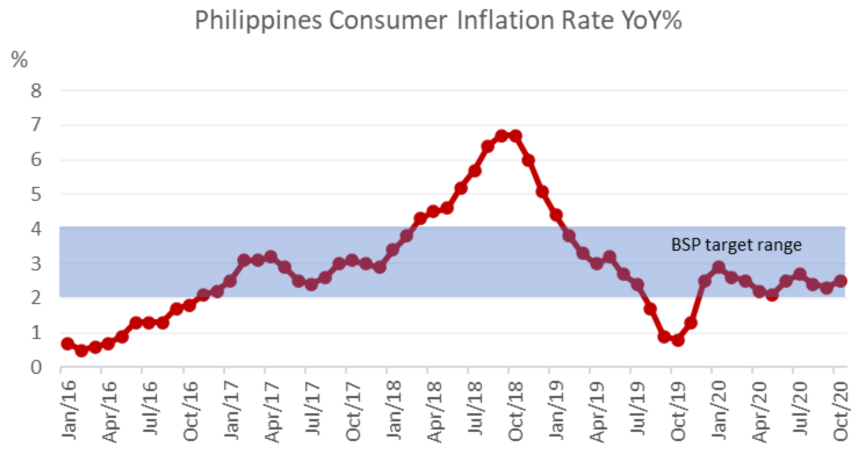
BSP Governor Benjamin Diokno is also likely to continue reducing the RRR, as part of his key objective to bring down said rate to “single-digit” before his term ends in 2023. With the RRR presently at 12.0%, we expect the BSP to reduce the RRR by 200bp to 10.0% by end 2021. This would also help to boost lending activity and stimulate economic recovery within the Philippines.

Higher oil prices would potentially be a headwind for the Philippines' economic recovery. Higher energy import costs would lead to higher consumer inflation rates, which may limit the degree of monetary accommodation the BSP could afford. It would also further deepen the current account deficit of the country. The current account balance in Q2 2020 rose to $5.4bn but we expect that to be temporal and the country to post current account deficits in 2021 and 2022. Too deep a current account deficit might spark the same degree of capital outflows witnessed in 2018, which in turn may result in delays of President Duterte's economic reforms.



Source: Bloomberg, OCBC Bank

As such, we expect the asset performance of the Philippines, especially the peso, to be moderately reliant on oil prices next year. If oil prices rise too high and too quickly, the increased expectations of inflation and current account deficit may bring about swift capital outflows.



Source: Bloomberg, OCBC Bank

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Positioning for a Post-Covid World

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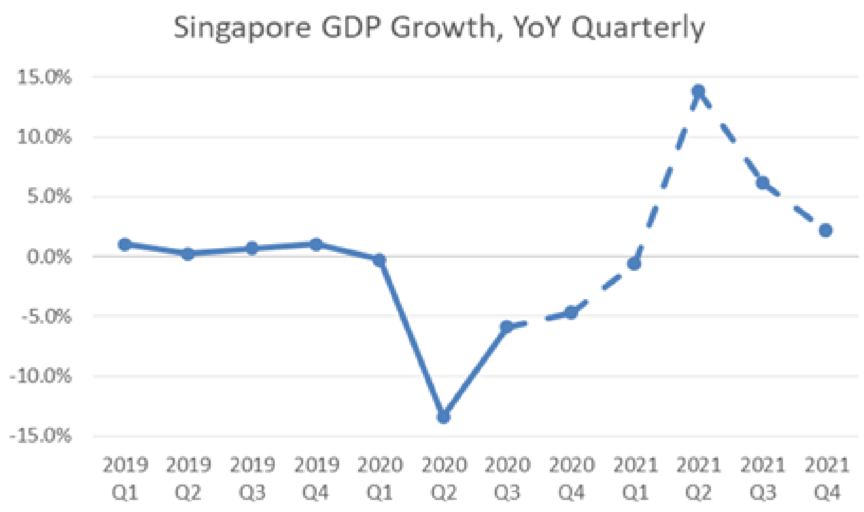
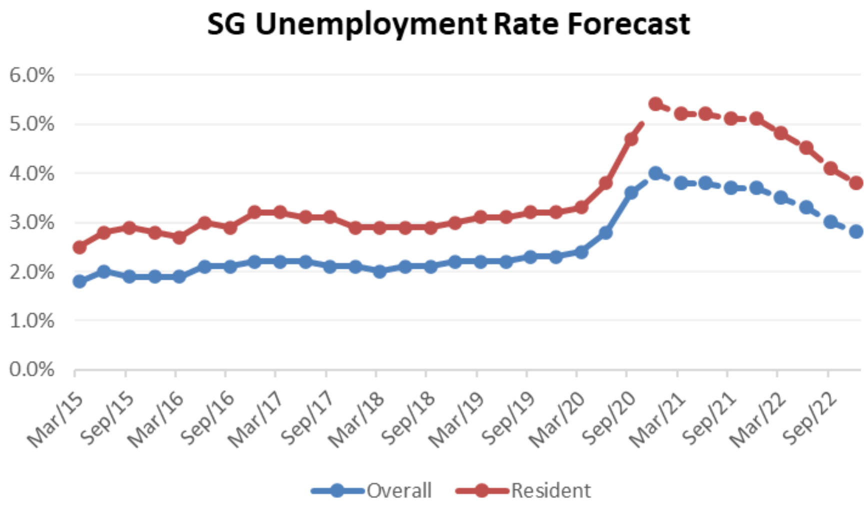
- **Singapore has seen a very sharp slump in the first half of 2020 due to the Covid pandemic.** While 2Q20 growth appears to be the trough and 3Q20 saw an improvement post-Circuit Breaker, nevertheless full-year 2020 GDP growth is still likely to contract by between 6.5% to 6.0% yoy.
- **Singapore may see growth rebound to 4-6% in 2021**, given the low 2020 base and rising market optimism that vaccine deployment will cement the global recovery prospects.
- **Policy accommodation is likely to remain intact, at least in early 2021**, given the soft growth and labour market, unchallenging inflation, and concerns about the K-shaped recovery which has affected the non-PMETs and lower-income workers more.
- **Fiscal policy is likely to be extended through an expansionary Budget 2021**, whilst monetary policy, with a current neutral S$NEER slope, is also likely to stay for longer against a backdrop of a very easy global monetary policy environment.

The worst is over, but it's a potentially long challenging road ahead

The imposition of the Circuit Breaker from 7 April to 1 June 2020 after the global Covid pandemic landed on Singapore's shores, coupled with the sharp stalling of the global economy due to the pandemic, meant a sudden slump in S'pore's growth momentum. Notably, the S'pore economy saw a less severe contraction of 5.8% yoy in 3Q20 compared to the -13.3% yoy decline seen in 2Q20, but rose 9.2% on a quarter-on-quarter seasonally-adjusted basis.



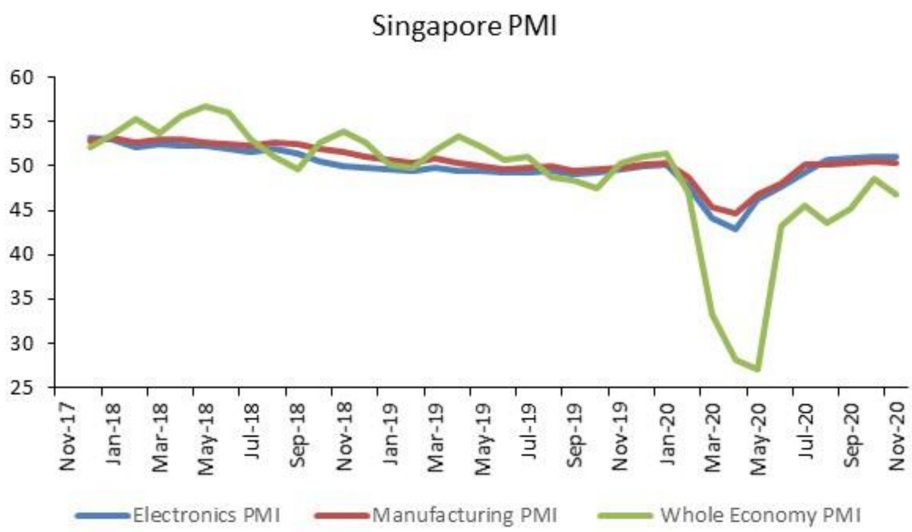
Source: CEIC, OCBC Bank



Source: CEIC, OCBC Bank

Manufacturing driving the recovery, but a K-shaped recovery is apparent.

The phased resumption of activities was propelled by the manufacturing sector that expanded 10.0% yoy in 3Q20, led by electronics, biomedical manufacturing and precision engineering clusters. This was driven by strong global demand for semiconductors and semiconductor equipment from the 5G market, data centres and cloud services. In contrast, the construction sector continued to shrink by 46.6% yoy in 3Q20, extending the 60.0% yoy slump in 2Q20. The services sector also continued to reflect the continued slump in air and water transport, continued plunge in international visitor arrivals, soft demand for wholesale & retail trade, as well as weakness in the business services segments, albeit the information & communications and finance & insurance sectors fared better amid resilient demand for enterprise IT solutions and financial market volatility.



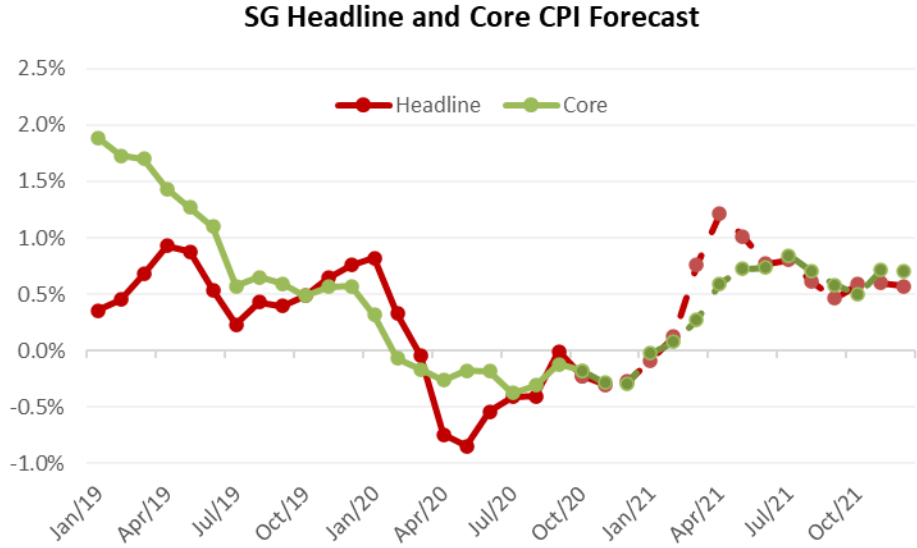
Source: CEIC, Bloomberg, OCBC Bank

2020 will still mark the worst recession since independence

For the full-year of 2020, MTI expects a contraction of 6.5% to 6.0% yoy, amid the weak external demand conditions and ongoing global travel restrictions, as well as dampened consumer sentiments and safe-distancing capacity constraints. Among the three key engines, only manufacturing is expanding currently, aided by the electronics and biomedical cluster, whereas construction and services remain mired in negative growth. This picture is unlikely to change in 4Q20.

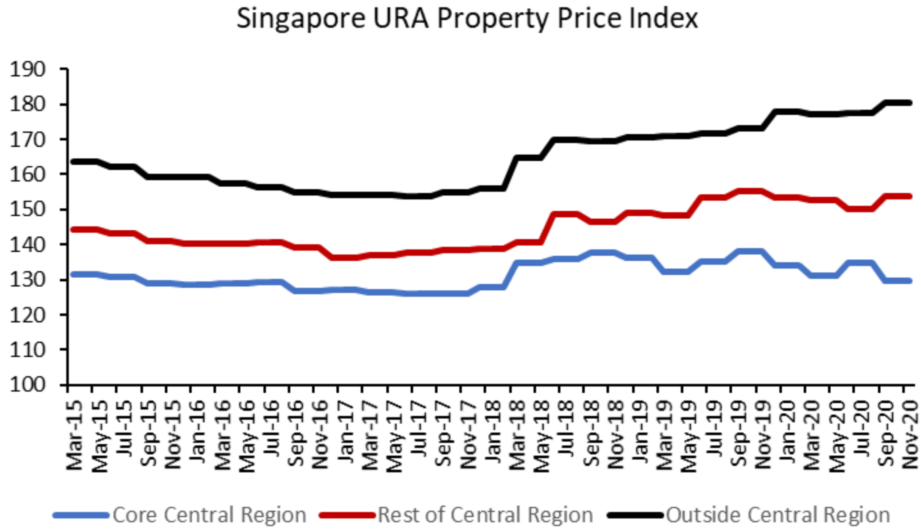
The 2021 recovery will be very vaccine-dependent

After an extremely low base in 2020, 2021 is likely to usher in a growth bounce to 4-6% yoy, but will be highly dependent on the global economic recovery and the state of Covid containment both globally and domestically. On the external front, while China has made significant headway as the First-In-First-Out of the Covid crisis, other major economies like the US and Eurozone are still experiencing resurgent waves of Covid infections that is driving localised lockdowns and tightening of safe management measures that will inevitably impact consumer demand and dampen or delay their recovery trajectory. ASEAN may benefit from the "China plus one" strategy and the global supply chain shifts, but are also vulnerable to idiosyncratic risks including subsequent Covid waves and domestic political uncertainties. As such, a gradual and uneven recovery path, with many major economies not returning to pre-Covid levels until end-2021 may continue to weigh on both business and consumer confidence in the near-term. In addition, there is growing concern about any premature withdrawal of policy accommodation as the recovery gets underway, which could impede any nascent improvements.



Source: CEIC, OCBC Bank

On the domestic front, the growth recovery will be driven by three fronts, trade-related services should benefit from a global pickup, especially in wholesale trade and water transport. ICT and finance & insurance will likely remain healthy, amid ongoing demand for IT and digital solutions, and payment processing services respectively. Second, a Covid vaccine deployment will likely encourage the re-opening of international borders and a return of international travels, which could support the recovery of the aviation- and tourism-related sectors including accommodation and hospitality-related industries. In tandem, retail trade and F&B services should also see an improvement from their current dire state. Last but not least, the construction sector should also gradually recover from the very dampened activity levels in 2020, notwithstanding the safe management measures and hygiene factors imply a return to pre-Covid levels is still some distance away.



Source: Bloomberg, OCBC Bank

Policy accommodation to stay as the path of least resistance, but may be recalibrated in line with the recovery story

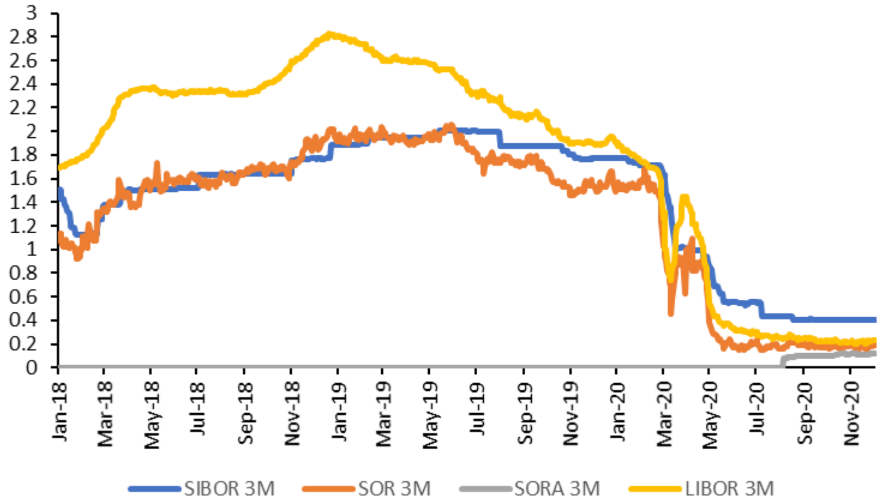
Like the rest of the world, both fiscal and monetary policy accommodation have been on tap to combat the Covid crisis and its economic spillovers. Fiscal policy stimulus has been on a unprecedented basis in 2020, with nearly $100b expended in four budgets, amounting to around 20% of GDP and warranting $52b of draws on past reserves. Key initiatives in the form of the Jobs Support Scheme, rental and other assistance, and loan moratoriums just to name a few, have been critical to shore up the Covid hit to the S'pore economy in the near-term. Looking ahead, while the Budget 2021 is likely to remain expansionary, the scale is likely to be more modest given the high bar set in 2020.

Protecting jobs and livelihoods are likely to remain a key priority, but positioning for the post-Covid future through digital transformation, encouraging new growth areas and industries will be instrumental to ensuring S'pore's economic competitiveness going ahead.

Monetary policy has been set on an accommodative path with the S$NEER sloped at a zero appreciation bias and this is likely to remain appropriate out to the April 2021 monetary policy review. Both headline and core inflation remain in slight negative territory in 2020, but should recover into slightly positive territory in 2021. Given that inflation expectations remain well-anchored, there is no urgency to tweak the monetary policy settings in the short-term. Moreover, major central banks including the FOMC, ECB, BOE and BOK continue to telegraph their willingness to continue to do whatever it takes to ensure economic stability and ward off financial market risks. This erring on the side of caution has become the mantra for many key central banks, and it would be difficult to find one that would risk prematurely withdrawing policy support given the high level of uncertainties surrounding the world economy and Covid. While central bankers would sporadically warn of the excessive private sector indebtedness and the risk of asset bubbles arising from loose monetary conditions, they would likely adjust their liquidity operations rather than risk prematurely hiking interest rates at this juncture.

Short-term interest rates to remain low for longer as well

Short-term interest rates like the SIBOR and SOR have fallen in tandem with the LIBOR amid the depressed economic conditions and ample liquidity, given the major central banks' commitment to keep monetary policy accommodative until the economic recovery is stabilised and a Covid vaccine has materialised. With the FOMC pledging to keep its Fed Fund rate near zero through 2023, the front-end of the USD yield curve should remain anchored and there is a high correlation that domestic interest rates should also stay low for longer. The transition to SORA is underway and it is unlikely to deviate too much either in the interim.



Source: Bloomberg, OCBC Bank

In conclusion, the S'pore economy is likely to ride the global recovery wave and see a nice growth bounce to 4-6% yoy growth in 2021. However, the K-shaped recovery has exacted a heavy toll on non-PMETs, low-income households and SMEs with fewer resources to cope with the Covid crisis. Looking ahead, policy accommodation is likely to tilt towards being more targeted and calibrated, but the structural changes arising from the global supply chain shifts, the China plus one strategy, and the digital disruption are going to continue to exert and S'pore is not immune to these changes.

Fiscal muscle to do the Heavy-lifting

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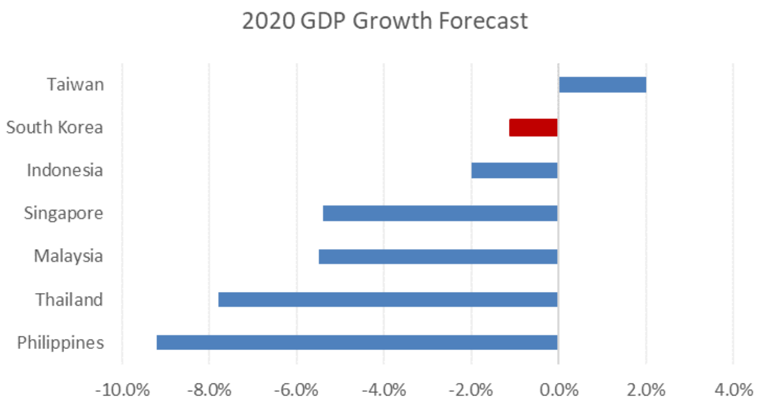
- South Korea's GDP growth in 2021 estimated at 3.0% yoy
- China's economy recovery to lift South Korea's exports prospects
- Outsized FY21 budget to diminish the need for further monetary easing by BoK

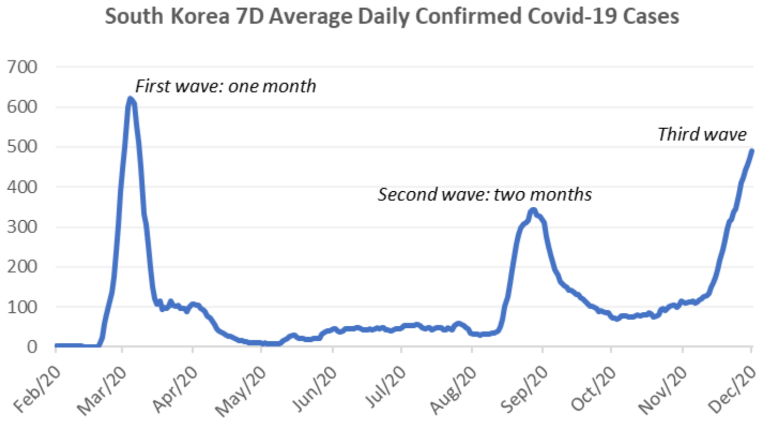
South Korea is expected to post one of the smallest growth contractions among Asian peers in 2020, with the economy of Taiwan likely the closest rival. With a GDP growth contraction of 1.1% yoy expected in 2020, the South Korean economy has clearly outperformed in this pandemic relative to Asian peers, especially when one considers the likes of Thailand and the Philippines which are enduring GDP contractions of more than 8% yoy.

We expect the South Korean economy to expand 3.0% yoy in 2021, which suggests that the country would have returned to pre-pandemic levels by the middle of 2021.



Source: IMF, Bloomberg, CEIC, OCBC Bank Estimates

The recent surge in Covid cases – amounting to 500 cases a day at time of writing – provides some cause for concern for the economic recovery in 2021. However, South Korea has demonstrated its ability to contain the virus outbreak on multiple occasions and we do not expect the latest episode to endure beyond three months, as demonstrated in the previous two waves.



Source: WHO, John Hopkins University, OCBC Bank

China's continued economic recovery will likely be the biggest tailwind for South Korea's economic growth in 2021. Already, we see South Korea posting positive export growth in late 2020, and this is expected to persist as domestic demand from China translates into better export prospects for the region. The new normal of work-from-home, resumption of a broad 5G rollout globally and the return of appetite for automobiles are all set to benefit South Korea's manufacturing outlook. Additionally, South Korea is a key supplier of petrochemicals and aviation fuel, both of which may see a rebound in demand as the availability of a vaccine kickstarts travelling activity.

Source: Bloomberg, OCBC Bank

The budget deficit in 2021 is expected at 5.4% of GDP (or 109.7tn won), which is comparable to 2020's 5-6% after four additional supplementary budgets. Hence, we view 2021's budget deficit as significantly large, considering that the budget is 8.5% higher than pandemic-struck 2020 and that the economic prospects of 2021 is expected to be markedly improved to last year. If approved by parliament, it would be a strong boost to the country's economic growth recovery, in addition to the supporting factors already listed above.

This would mean that the need for the BoK to continue in its monetary easing policies is heavily diminished in 2021. For a while now, we have determined that the BoK has already reached the end of its rate cut cycle and this view is unlikely to change next year. We expect the BoK to prioritise the provision of liquidity, but further rate cuts are probably unnecessary at this stage.

The Best of Two Worlds

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- Taiwan is one of the only few economies in the world this year to show positive growth in every quarter of 2020
- The economy continues to benefit from tech cycles, strong investment and effective virus containment measures.
- Domestic demand is likely to pick up in 2021.
- No urgency for central bank to act. We expect CBC to keep rates unchanged in 2021 at 1.125%.
- As Taiwan is left out of RCEP, long term challenge from rising export competitiveness means Taiwan need to seek more free trade agreements.

The Taiwanese economy grew by 2.26% yoy in the first three quarters of 2020. Although it was the slowest growth in four years, it has outperformed most of its peers in the region. In addition, after an upward revision of its second quarter GDP growth to 0.35% yoy from the previously estimated contraction of 0.58% yoy, Taiwan and Vietnam are the only two major economies in the world managed to show positive growth in every quarter of 2020 so far during the global pandemic.

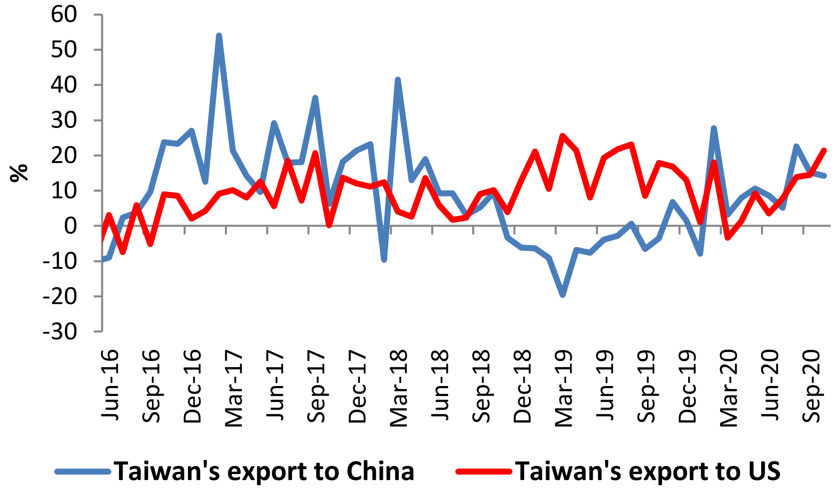
The stronger than expected performance of Taiwanese economy in 2020 was mainly attributable to three factors.

First, Taiwanese exporters benefitted from both the pandemic and US-China tensions. As a technology leader in the semiconductor and ICT sector, Taiwanese tech players ride on the surging global demand for technology products due to the emerging trend of work-from-home arrangements. Meanwhile, the substitution effect amid escalating US-China tensions also underpins Taiwan's exports. Taiwan's exporters have enjoyed the best of two worlds with exports to both mainland China and US rising by average 10.7% yoy and 8.7% yoy respectively in the first ten months of 2020 despite the contraction in global trade. As such, the contribution from net exports of goods and service to GDP growth has reached a remarkable 1.82% in the first three quarters of 2020.

Second, the effective government containment measures and strong individual social responsibility has helped Taiwan to contain the spread of virus in an earlier stage. Taiwan is one of the only few economies that have not imposed any internal lockdown measures so far. As such, the direct impact of Covid-19 on domestic economy is limited.

Third, the development of 5G and offshore wind power was barely affected by Covid-19, and resilient fixed investments continued to support economic growth. The contribution from capital formation to GDP growth was at 1.2% in the first three quarters of 2020.

Chart 1: Taiwan's exports to both mainland China and US remained strong

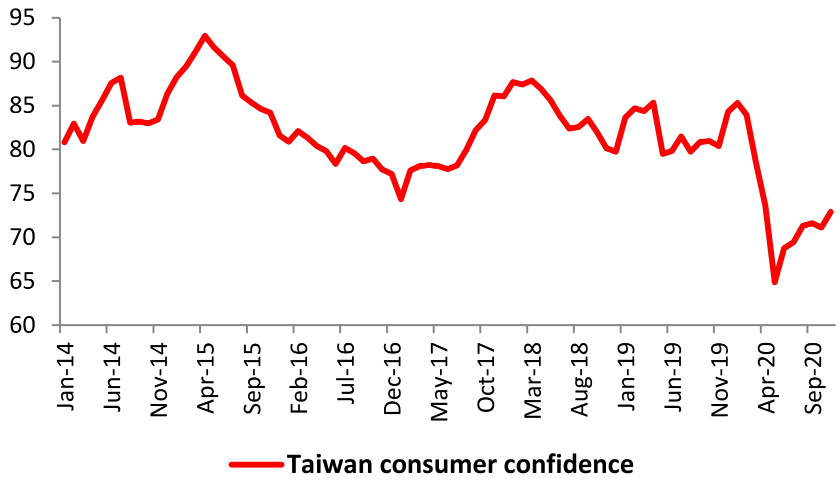


Source: Bloomberg, Wind, OCBC Bank

Not surprisingly, domestic private consumption has been the key drag to the economy this year due to global travel restrictions and local social distancing policies. Private consumption dragged down GDP growth by 1.48% in the first three quarters of 2020. Nevertheless, the contraction of private consumption has narrowed since the second half of 2020 thanks to government stimulus measures, such as the triple stimulus voucher scheme, the promotion of domestic travel and job support scheme.

Taiwan's job market continued to improve with unemployment rate falling to 3.77% in October from the peak of 4.16% in May. Looking ahead, with the resumption of domestic economic activities, the labor market is likely to improve further in the coming months, although the rebound of tourism and service sectors is expected to be modest as cross-border tourism remained restricted.

Chart 2: Taiwan's consumer confidence recovered from the low

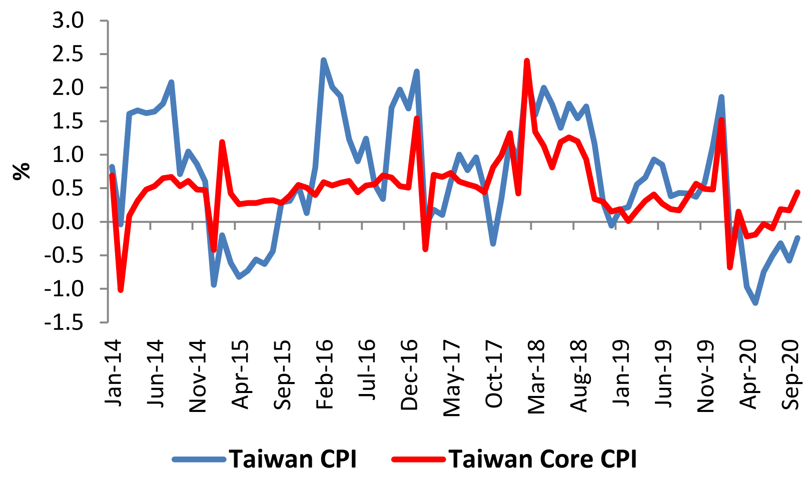


Source: Bloomberg, Wind, OCBC Bank

On a positive note, Taiwan has not reported any local transmitted Covid-19 case for more than 200 days. Although consumer spending may continue to take a hit from global pandemic, we expect Taiwanese economy to emerge earlier than most of its Asian peers despite the recent resurgence of virus globally. Therefore, we expect Taiwanese economy to grow by about 2.4% yoy in 2020. The strong momentum of external demand is expected to sustain into 2021. In addition, with the recovery of domestic demand, we expect Taiwan's growth to accelerate to about 3.3% in 2021.

Despite the resilient growth, Taiwan's inflation remained low with headline CPI reading being in negative territory for nine consecutive months. The decline was partially due to lower oil prices. The divergent performance between growth and inflation shows that there is no urgency for the central bank to act now. Taiwan's central bank (CBC) has kept its benchmark interest rate unchanged at 1.125% for two quarters after the 25bps reduction in March despite a globally coordinated monetary policy easing.

Chart 3: Taiwan's consumer inflation remained low



Source: Bloomberg, Wind, OCBC Bank

Given inflation is expected to return to positive territory in 2021 and the growth recovery is expected to continue, we do not see reasons for central bank to lower its interest rate from here. However, as the Fed is expected to keep its interest rate low for at least next three years, there is no urgency for CBC to hike either as the timeline of rolling out the Covid-19 vaccine to the general public in most of developing markets remains uncertain. As such, we expect CBC to keep its benchmark interest rate unchanged at 1.125% in 2021.

Geopolitical risk has been a regular risk event monitored by the market since the Tsai Administration took over in 2016 but has never materialized. Instead, the Taiwanese economy has managed to weather the rising US-China tension and the rapid deteriorating cross straits relationship relatively well in the past few years.

Nevertheless, given mainland China's ruling party has deleted the word "peaceful" in front of the unification phrase in reference to Taiwan in official speeches this year so as to leave all the policy options open, the geopolitical risk could be much more real in the coming years. On a positive note, the higher predictability of incoming Biden Administration may reduce the tail risk in the near term. However, we will continue to monitor whether Taiwan will become the front line of battleground for US-China long term rivalry.

Other than geopolitical risks, Taiwan's export competitiveness may also face a challenge after being left out of the newly minted the Regional Comprehensive Economic Partnership (RCEP). The increasing trade linkages between mainland China and Japan and South Korea means more competition for Taiwanese products.

Although Taiwan's Finance Minister said that 70% of Taiwanese shipments to RCEP markets have already been exempted from tariffs, Taiwan may still need to actively seek more free trade agreements to reduce the indirect impact of the RCEP. This also means that further openness of domestic market seems to be unavoidable.

Muted Economic Revival in 2021

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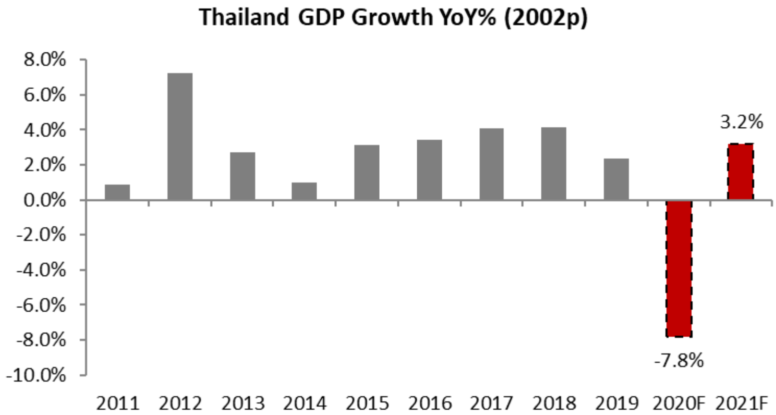
- Thailand GDP growth in 2021 estimated at 3.2% yoy.
- Current account to remain in surplus in 2021.
- BoT is likely to have reached the end of its rate cut cycle.

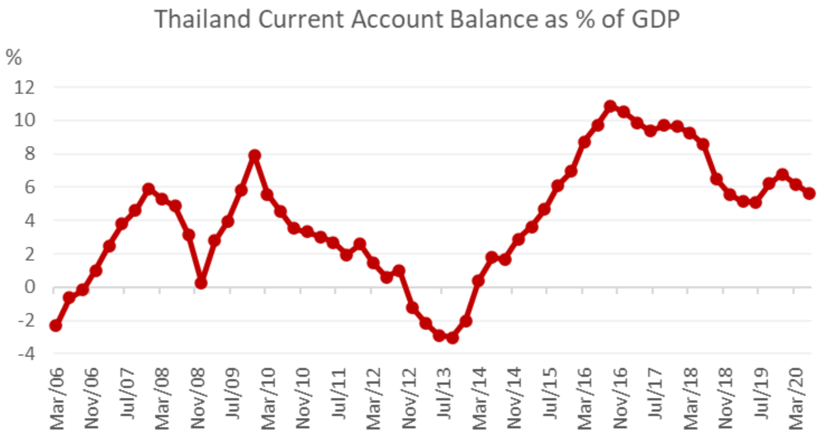
We expect Thailand to post a growth of 3.2% yoy in 2021. This assumes a moderate revival in tourism of almost twice that of 2020 and the wide dissemination of a vaccine by H2 2021. We assume that Thailand can keep its Covid cases in the current very low levels from now till the wide availability of a vaccine.



Source: CEIC, OCBC Bank Estimates

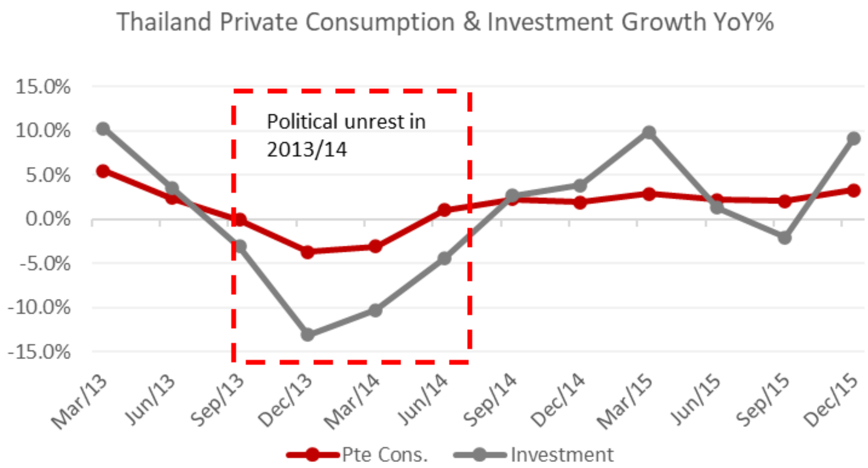
The 2021 economic revival in Thailand is likely to be muted due to two factors. Firstly, its reliance on tourism means its recovery path is less certain relative to other Asian peers. Secondly, it continues to grapple with political uncertainty in the country, which could hamper private consumption and the return of tourism. As such, we expect the pace of government borrowing and fiscal support to continue at its current pace in 2021. The FY21 budget is expected at a deficit of 623bn baht. However, more than half of 2020's 1tn baht emergency fund has yet to been approved and disbursed. If that is added to the FY21 budget, the fiscal support next year may eventually turn out to be greater than 1tn baht.

We expect the current account balance to remain in surplus in 2021, albeit smaller than what was seen in 2020. Our house view is for gold prices to peak in H1 2021, which would lead to lower gold exports next year. Higher oil prices would add pressure on imports, while a recovery in domestic demand could drive imports higher as well. This could ease the pressure on the BoT in its persistence to weaken the baht in a bid to support exports.



Source: Bloomberg, OCBC Bank

The obvious black swan in Thailand's economic recovery would be its political uncertainty. Until we see a clear political party backing one of the pro-royalist or pro-democracy group, we do not expect the current unrest to result in violence. This is markedly different from the Red and Yellow Shirt protests back in 2013/14, which caused tourism and private consumption to take a deep dive. In the context of 2021, tourism is already virtually a miniscule fraction of what Thailand is accustomed to while the lack of violence has resulted in minimal disruption among domestic consumption. We expect this equilibrium, albeit uneasy, to continue through 2021.



Source: CEIC, OCBC Bank

We also expect Thailand to have reached the end of its rate cut cycle for now, assuming the political situation does not take a sharp turn for the worse. The BoT has signalled its intention to tame the baht strength via capital controls, rather than reducing the benchmark lending rate. With the gradual recovery in the global economy, we expect the pressure on BoT to continue in its intervention to abate. The key lending rate is expected to remain at 0.50% through 2021 and possibly for 2022 as well.

Recovery Supported by Exports

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Assisted by
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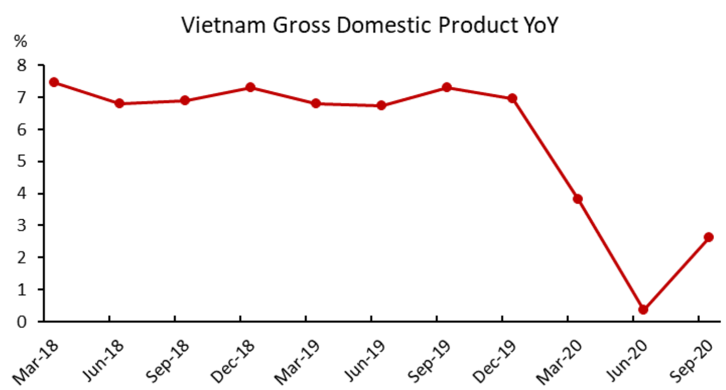
- Export-led growth is likely to remain intact.
- Trade policy risk is a growing headwind.
- Recovery is poised to be one of the strongest among ASEAN peers.

Covid-19 under control

Vietnam's handling of the coronavirus has been largely successful. To date, Vietnam has recorded a total of 1,321 infections with 35 deaths and zero community cases for 84 consecutive days. Swift implementation of containment measures along with effective testing, tracing and quarantining system has enabled Vietnam to contain sporadic small outbreaks before it could be developed into a widespread community transmission. With the virus under control, restriction measures have been eased further in the second half of 2020.

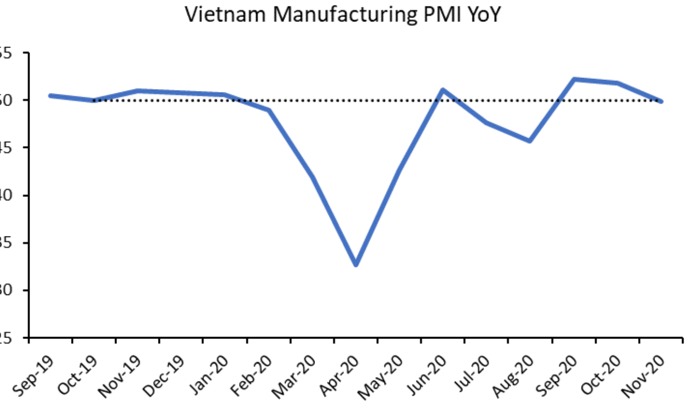
Our base assumption is for Vietnam to be able to maintain this containment of the virus into 2021, which will provide the economy a stable platform for a strong recovery of 6.7% yoy next year.

Domestic conditions are picking up



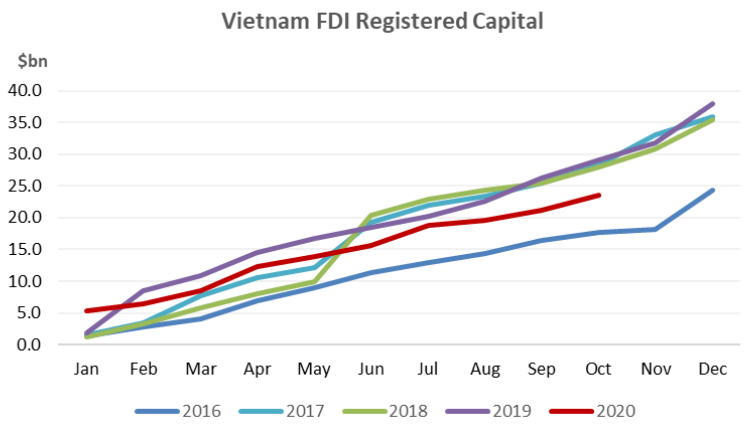
Source: Bloomberg, OCBC Bank

The Vietnamese economy has thus far been supported by exports, which reported five consecutive months of positive yoy growth since July 2020. The continued shift in the global supply chain from China to Vietnam, particularly in electronic products and machinery, will likely add additional steam to the export growth momentum in 2021.



Source: Bloomberg, OCBC Bank

Meanwhile, Vietnam's manufacturing PMI recorded two consecutive months of expansion in September and October, although it unexpectedly fell back into contraction in November. The dip was partly due to a fall in output, following the landfall of Typhoon Molave, which resulted in flooding in certain areas. We expect this contraction to be temporary and factory production to consequently return to normal operations. We expect an increase in orders from an increasing number of companies looking to shift their assembly lines from China to Vietnam in 2021, which will likely boost production and bode well for the manufacturing sector next year. Hence, we expect the PMI to stay above 50 for most of 2021.



Source: Bloomberg, OCBC Bank

Vietnam's foreign direct investment (FDI) slumped this year as the pandemic dampened investment opportunities in EM markets. As of October 2020, FDI into Vietnam amounted to $23.5bn, which is almost 20% lower compared to the past three-year average at the same stage. The main sectors attracting the bulk of FDI inflows were manufacturing and processing followed by real estate. The nation's swift recovery will likely boost investor's confidence and we expect 2021 FDI inflows into Vietnam to recover back to 2019 levels.

SBV likely to remain accommodative

The State Bank of Vietnam (SBV) is likely to remain accommodative in its monetary policy to support economic recovery in 2021. The SBV has already cut its policy rate thrice this year by a total of 200bps to 4.0%. While we do not rule out further monetary easing measures from SBV in 2021, albeit that would be heavily contingent on the availability and timing of a vaccine. At 4.0%, however, Vietnam possesses an enviable absolute level offer that few Asian peers can boast of and could cut its key rate further if necessary.

Leading the ASEAN recovery

We project 2021 growth at 6.7% yoy, a sharp increase from the 2.5% yoy growth slated in 2020. The rolling out of vaccine programmes across the globe in 2021 could see external trade conditions recovering at an accelerated pace. In tandem with the reallocation of global supply chain and the possible early reopening of international borders, Vietnam's recovery is poised to remain robust and resilient going into 2021.

Vaccines: A Tale of Two Tail Risks

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This time last year, if you were to read any report or article suggesting that the coming year would bring a pandemic so deadly and so widespread that governments across the world would mandate their populations to stay at home for months on end – at the cost of deep economic recessions and painful job losses – you would be forgiven to have dismissed it as a quack story and, quite understandably, paid little heed to it.

Alas, that is precisely what has transpired in 2020; the mother of all tail risks that has manifested itself so concretely. Indeed, one lesson we ought to learn from the tumultuous year might be to never say never, when it comes to wondering what events might take place.

Even as we would have a positive view of relatively steady economic recovery as a baseline, it is worthwhile to let our minds wander a little and think more broadly on some of the outlier scenarios. These are events that may be unlikely to occur, but if they do, they could bring tremendous repercussions.

Given how the year 2020 has been dominated by the pandemic to say the least, our perception of what tail risks might lurk around the corner in 2021 would inadvertently be coloured by the same frame of mind as well. Here, let's zoom in on some of the potential outlier scenarios that might be brought on by vaccines.

To be sure, given the recent positive news regarding the Phase 3 trial results of some vaccines – from research firms Pfizer/BioNTech, Moderna and AstraZeneca – the discovery of vaccine itself can no longer count as a tail risk in and of its own. Moreover, it appears that expectation that these vaccines can start to be rolled out to at least some segments of some countries such as the US by Summer 2021 can now be considered mainstream, as well.

Instead, the tail risks could manifest in other ways, on both positive and negative ends.

On the positive side, there is a scenario whereby more vaccine candidates clear the Phase 3 trial hurdles, such that the availability and speed at which vaccines can be rolled out become less of an issue.

Thus far, the results from the three candidates which have finished their Phase 3 trials are broadly encouraging. Indeed, Pfizer/BioNTech and Moderna look set to clear the emergency authorization needed and may well be administering their first shots by the end of 2020. Meanwhile, even though AstraZeneca's results appear encouraging too, the reported small samples and some errors in the exercise have resulted in the announcement of a larger repeat trial – which means that widespread adoption of its vaccine may not take place anytime soon.

If we were to have a positive surprise on the timing and scope of the vaccine rollout, it would thus be left to the remaining candidates that are in Phase 3 trials.

To that end, a number of vaccines spearheaded by China's medical research institutions are the more likely candidates. Sinovac, for instance, has been conducting trials in Brazil, Bangladesh and Indonesia. Indeed, according to the regulators in Indonesia, the results of Sinovac's trials are due in January 2021.

If the vaccine is proven to be efficacious, it would allow for a relatively rapid roll-out, including in Indonesia whose government has pre-ordered a total of 85mn doses to be delivered throughout 2021. For a country that has been besieged by seemingly relentless infections uptick like Indonesia, if the vaccine is proven to be effective and safe, its rollout could, quite literally, be a booster shot to confidence.

Outside of Sinovac, some other key vaccines include those from Sinopharm and CanSino who are busy conducting Phase 3 trials as well – with whom Indonesia has struck pre-order agreements too. Apart from these names that are spearheaded by China-based research institutions, another vaccine that warrants attention will be the one from US-based Novavax, which had launched its Phase 3 trial in the UK in September.

Overall, when it comes to vaccine successes, the more will feel ever the merrier, because of the daunting tasks in vaccinating billions and billions of human populations against the new-but-very-real threat. Not only would the successful trials allow for the demand to be fulfilled in terms of quantity more quickly, the variety of vaccines – not least in how they can be stored for distribution – would be important too.

Already, among the trio of successful vaccine candidates, the deep freeze requirement for Pfizer/BioNTech has effectively ruled out its deployment for most developing countries due to infrastructure shortfall. While AstraZeneca's one requires only the 'simple' supporting infrastructure of refrigerator temperature, its lower efficacy and trial concerns present some issues to the rollout. Hence, what would be needed for a more even vaccination rollout across the world will thus be a vaccine that can give a lot (in terms of effective protection against the virus) but demands relatively little (in terms of storage needs). Finding that 'sweet spot' vaccine could thus present a significant positive tail risk in 2021.

Now, on the flip side, if such a vaccine cannot be found readily, we might well inch towards a negative tail risk scenario. If trials after trials of the remaining Phase 3 vaccines show low efficacy rate or indeed cause harmful side effects, then the world runs the risk of splitting into a have-versus-have-nots of vaccines, that might have tremendous economic and market implications.

Here, imagine a situation where developed countries are able to roll out rapid vaccinations of their population using shots from Moderna and Pfizer – because they have not only secured the supplies but also possess the supporting infrastructure to distribute them across their countries. Economic activities can thus resume readily there, resulting in a considerable uptick in consumer and business confidence. That is, a boom scenario.

Now, couple that by imagining the flipside situation for much of developing nations. On one hand, they are left out of the cold of the supplies of vaccines that work. On the other hand, those vaccines that they thought they already pre-ordered, if at all, turn out to be flops; ineffective at best, harmful at worst. While their export activities might receive some fillip from selling to the newly voracious (and vaccinated) consumers of the rich world, the domestic portions of their economies remain bedevilled by coronavirus scourge. Their growth prospects would thus remain in relative doldrums, even as they watch their developed counterparts rebound sharply.

Moreover, the dichotomy in economic growth could come at a time when global policy setting starts to shift away from the ultra-accommodative end of the spectrum in 2020. As the economies of the developed world recover sharply, the need for overt policy support would become less and less apparent. On top of that, the need to counter inflationary pressure could become more and more palpable. The net effect would be a dial-back of expected support from both monetary and fiscal policy fronts.

From the perspective of emerging markets, any talk of reduced appetite for monetary policy among the developed world's central banks – especially the Fed – would be especially concerning. This is not to say that the deployment of vaccine would automatically result in the Fed hurrying to raise rates.

However, if the experience of 2013 Taper Tantrum – when the-then Fed chair Ben Bernanke merely suggested the reduction in the pace of its asset purchases – is any guide, it may not take much of a shift in policy stance for market to react massively. Coming at a time when inflows into emerging markets have been on a sharp uptick, any reversal would feel especially acute. Couple that with the situation where their economies have yet to recover, any financial market turmoil could be especially damaging.

To be sure, this is by no means a baseline scenario in our view, but merely a mental exercise in the spirit of casting the horizons for tail risks. Moreover, to some extent, the probability of the negative tail risk – of economic and financial sufferings due to a wide divergence in the speed of vaccine rolle-out – can be further reduced through a global collaborative efforts. Already, the COVAX initiative that ropes in 172 countries and multiple vaccine candidates to try and remedy the 'vaccine inequality' goes some ways to reduce that risk. Still, at a time when politicians will be compelled to take care of their own people first, it is a tail risk to keep mind as we enter 2021.

Biden's First Hundred Days

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Speak Softly, but remind the world that America still carries a big stick

Come January 20th Joseph Biden will become the 46th President of the United States, helping to bring to end what might have been one of the most unpredictable Oval Office policymaking platforms that has kept the world and markets on edge over the last four years.

It may be useful to imagine Joe Biden's ascendancy as a 'return to the norm presidency;' one that hopes to replicate his successes in supporting America's economic recovery from the 2008 financial crisis and build on Barrack Obama's wider policy ambitions that were cut short at the end of 2016.

At a broad level, we expect the incoming administration to adopt; (1) an aggressive approach to the Coronavirus pandemic, (2) an incremental, accommodative and pragmatic approach to the economy and jobs support, and (3) a resolute but stable approach to Foreign Policy.

The key to their success will be determined by their ability to compromise with the Republican leadership. That is, to find common ground that has thus far eluded the Democratic leadership under Nancy Pelosi and the Republicans that are helmed by Mitch McConnell and Donald Trump the past two years.

Currently, we expect a split government as the Republicans maintain their majority in the Senate. This is the first time since 1988 that a president will begin his first term without control of both the House and Senate. Effectively, this denies him a political 'honeymoon period' and diminishes the likelihood of significant policy successes in his first 100 days.

Having said that, the former Vice President may yet outperform expectations despite the divided Congress. Between choices of compromise and gridlock, Biden and his transition team have already stated their willingness to compromise to keep the wheels of the US government running in this critical period.

Back to Paris

Biden and his team look poised to hit the ground running on Day One. Already, the incoming administration has reportedly drafted a series of executive orders and declarations that are ready to be rolled out on inauguration day. It is a jam-packed list that includes measures to rejoin the World Health Organisation and the Paris Climate Accords, for instance.

As a sign of the seriousness of its environmental agenda, Biden's administration is likely to declare an intention achieve Net-Zero Carbon Emission standard in the next few decades (following in the stead of China, S. Korea, the UK and Japan). Moreover, Biden will likely seek to revoke and supersede over 20 of Trump's executive orders regarding the relaxation of environmental standards.

This includes requiring public companies to disclose climate change related financial risks and greenhouse gas emissions in their operations.

Focus Here

While bringing the US back to the fore of environmental protection is laudable, there is no question as to what would preoccupy the Biden administration front-and-centre when it assumes power: Covid-19 crisis.

They will have to prioritise battling the coronavirus pandemic upfront, to prevent the third wave from spiraling further out of control. As governors are forced to reimpose lockdowns nationwide and the number of coronavirus cases continues to soar, Biden is likely to immediately take measures that go further than the Trump administration. These would include establishing unified federal guidelines on countermeasures, coordinating lockdowns and travel restrictions between states. His team might oversee purchases and deployment of medical and PPE equipment to support the front-line healthcare workers and general infrastructure. The hiring of contact tracers might take place at a wider scale as well, helping to create more jobs in the process.

Most importantly, Biden will have to oversee a rapid distribution of vaccines throughout the country when they come through. While he might well drop the moniker of Operation Warp Speed, Biden will nonetheless have to proceed at a rapid pace in facilitating what would be an unprecedented rollout of vaccines.

The difficulties are not merely in terms of production bottlenecks and logistical headaches, Biden and his team would have to overcome vaccine skepticism among corners of the population which may cut across political lines as well. Without widespread adoption, achieving a herd immunity – estimated to require anywhere between 75-95% vaccination of the population – will be a tall order.

Resuscitating Growth

Apart from dealing with the coronavirus crisis, doing all he can to resuscitate economic growth cannot be too far below in Biden's agenda too.

One big unknown between now and the start of his term is whether there will be any stopgap fiscal stimulus to help the US economy tide through what is likely to be soft patch given the ongoing virus resurgence and pockets of lockdown measures.

While a group of bipartisan senators have come up with a new proposal worth USD908bn in early December – reinjecting some optimism for a fiscal stimulus to the market – whether the initiative will take root or not remains an open question. It is worth bearing in mind that the previous bipartisan proposal died due to the lack of buy-ins from the leadership of both parties. Thus far, there have been few suggestions that this time round would be any different.

Indeed, both parties might well want to adopt a wait-and-see attitude during the interim period. The Republicans might be reluctant to boost the economy, only to hand a "good" economy over to the incoming administration. On the flipside, the Democrats might argue that they will have a freer hand in shaping the details of the stimulus package under a Biden administration.

Beyond the nearer-term stimulus focus, markets will be on the lookout for how Biden intends to pursue his broader economic agenda. This includes his Made-in-America initiative that seeks to hasten development in clean energy technology. Figures amounting to USD400bn in procurement and 300bn in R&D have been floated previously.

Even if Biden might be able to push through mandates for stronger fuel economy standards and caps on methane emissions via executive orders, his broader push for a "Green Infrastructure Program" might be harder to come by due to the likely split Congress. The transition to renewable energies has thus far been anathema to a number of Republican interest groups.

Less workable will be his stated agenda to increase the corporate tax rate from 21% to 28%, however. It is hard to imagine how the Republicans would go along with such a considerable hike at this point.

Is America Back?

Against the pressing need to focus on domestic issues such as the pandemic and economic growth, Biden's grander goal of restoring America's credibility as a power broker and stalwart of democratic ideals would likely have to take a backseat for some time. As seen in the recent G20 meeting, other world leaders may also be distracted with their own domestic situations/recoveries to meaningfully engage in Biden's multilateral ambitions.

However, this is not to say that foreign policy would not feature prominently in his first 100 days. If anything, the foreign policy sphere is traditionally an area where American presidents can function relatively unencumbered by domestic political constraints. It may not come at the top of his priority list, but it will be there.

To lead this charge, Biden has selected Anthony Blinken to be Secretary of State. Blinken has been a vocal supporter of global American leadership and advocates for a broad 'coalition-based approach' to tackling issues such as the rise of China, Russian aggression, and the Middle East Crisis. Although pragmatic and moderate in his approach to diplomacy, Blinken has recently alluded to a greater need for American interventionism where democratic values and norms are being subverted.

The first step will be a rapprochement with America's traditional western allies whose relations have been strained over the last four years; namely Australia, Canada, and the Western European nations.

There remain several trade disputes with key states that are likely to put Biden in a difficult position of choosing between American manufacturers and rapprochement: Boeing-Airbus dispute, aluminum and steel tariffs, as well as tensions over digital services taxes.

Regarding the Middle East, Biden has stated intentions to honor the Iran nuclear deal and return to the negotiating table – and Iran's measured response to the recent attack on its key nuclear scientist points to a similar intention. Under Biden, US is likely to adopt a multilateral approach, by working together with regional and global partners to resolve issues such as the Yemen and Syrian wars, and the stalled Israeli-Palestinian peace process.

Now, when it comes to China, Biden's administration's stance_may not represent a shift in substance or approach, but rather softening in style and process. Despite replacing sabre-rattling rhetoric with measured diplomatic overtures, the message is likely to remain the same. When all is said and done, China's rapid economic recovery and strategic ambitions will push Biden to maintain a firm stance on China.

In his first hundred days, President Biden will face decisions on existing tariff measures and export controls, as well as sanctions related to Hong Kong and Xinjiang. In order to alleviate pressure from Congress as well as pre-empt the escalation of hostilities, both sides may seek to engage in bilateral negotiations as early as possible.

On trade policies, Biden may look to reduce Trump-era tariffs but only gradually, to help preserve some leverage while engaging in negotiations with China on any new agreement that will likely take some time to strike. Meanwhile, export controls and the limiting of technological transfers (5G in particular) are likely to remain in place for the sake of 'National Security.'

Already, Biden has reportedly told the New York Times that he would leave the phase-one trade deal with China intact, as his team conducts a full review of America's policy toward China in consultation with key allies. This signals that Biden is unlikely to make major changes to the existing, Trump-era trade policy against China in his first 100 days, particularly when he is still going to be preoccupied with domestic pandemic and economic matters. However, how he reshapes the bilateral relationship will be one of the critical things to watch for Asia thereafter.

A Chinese Perspective on Supply Chain Shift

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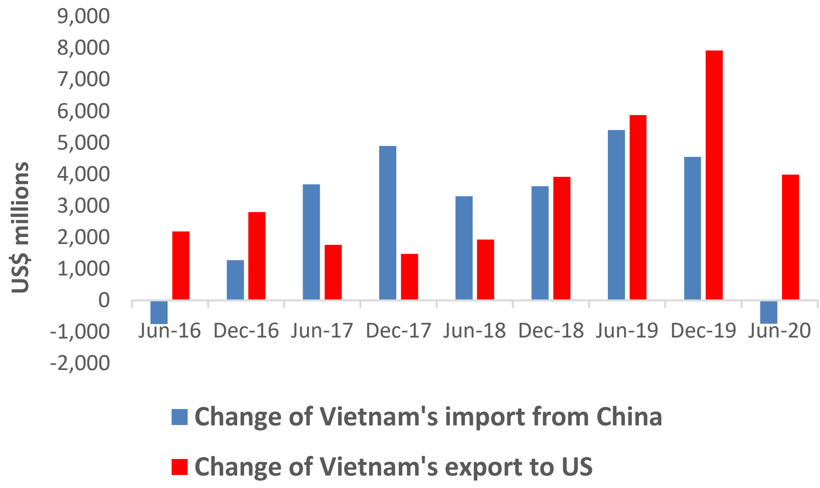
- A supply chain shift creates both challenges and opportunities for China. It helps to deepen its trade linkage with regional counterparties.
- ASEAN has been China's largest trading partner partially due to the supply chain shift.
- Although China may lose out on exports of final products to its regional competitors, it can still play an important role of an intermediate goods provider to the region.
- China's supply chain showed its strength during pandemic. We think China is likely to dominate the regional supply chain in the foreseeable future.
- When the world is moving towards carbon-neutral initiatives in the next few decades, the supply chain is no longer going to be about costs alone.
- This may be a new opportunity for China to consolidate its leadership in global supply chain via increasing its focus and investments in green supply chain.

Since the global financial crisis, the "China plus one strategy" has been discussed by multinational corporations from the perspective of benefit of diversification. The discussion heightened in 2015 because of rising costs in China and MNCs accelerated their implementations of the strategy in 2018 as a result of US-China trade war.

Although the supply chain shift out of China has been delayed by the global pandemic, we think the trend to reduce one's over reliance on a single trading partner is unlikely to be derailed.

Even Chinese companies have also relocated part of their lower-end manufacturing production to South East Asia for various reasons. As shown by chart 1 below, coincidently, the absolute changes of Vietnam's imports from China in the second half of 2018 and first half of 2019 were almost the same as the absolute changes of Vietnam's exports to the US. This was probably due to the increasing relabelling activities by Chinese companies to avoid the punitive tariffs due to the escalation of US-China trade war. The correlation has broken down since the second half of 2019 after the US tightened its certificates of origin.

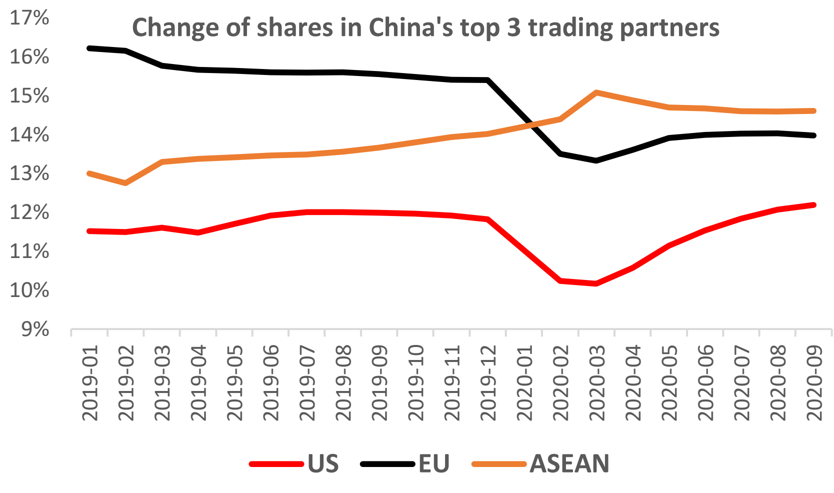
Chart 1: the possible relabelling activity at the start of trade war



Source: Bloomberg, Wind, OCBC Bank

Although the supply chain shift posed some challenges to China's status of global manufacturing hub, it also creates opportunity for China to deepen its trade linkage with ASEAN and South Asia to promote regionalization against the broader backdrop of deglobalization. Since the beginning of 2020, ASEAN has been China's largest trading partners, supplanting the EU. This was probably driven by the recent trend of supply chain shift to ASEAN with Vietnam being the key beneficiary from this wave of the shift.

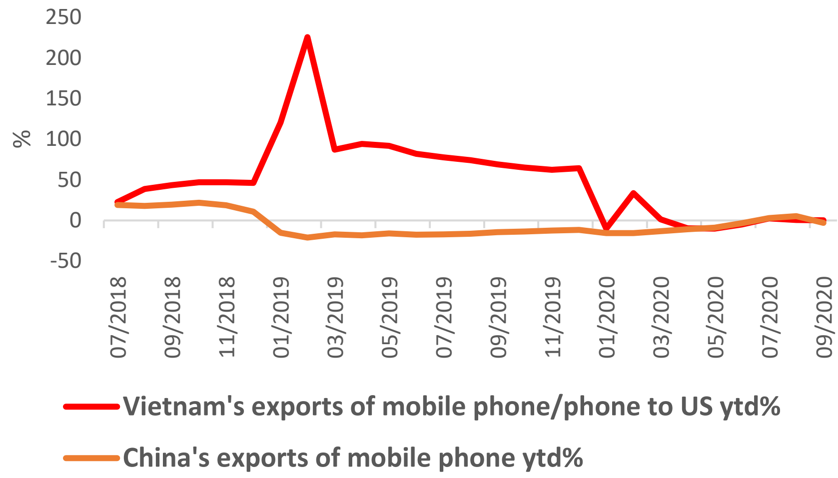
Chart 2: ASEAN has been China's largest trading partners since 2020



Source: Bloomberg, Wind, OCBC Bank

Across the sectors, we found that the changes are mainly on electronics supply chain. For example, China's exports of mobile phone, telephone and image video camera related products have been falling in the past few years while Vietnam's exports of those electronic products to the US have surged. This shows that the final demand for those electronic products has shifted to Vietnam.

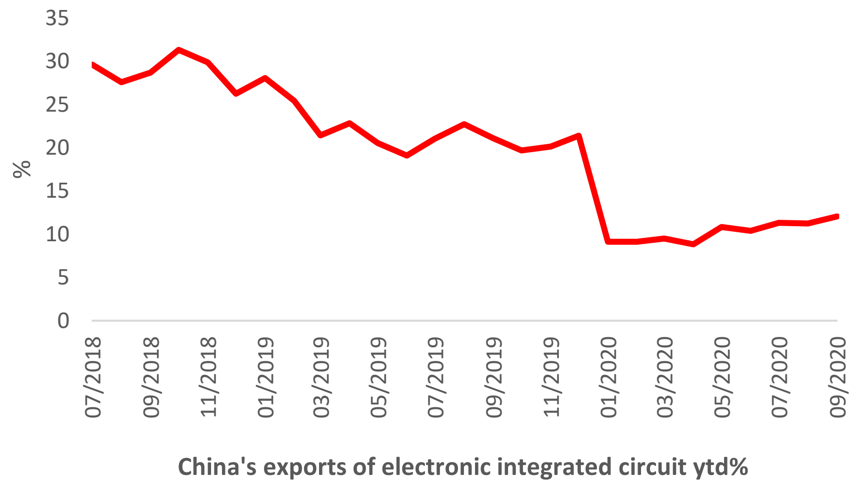
Chart 3: The supply chain shift is mainly on the electronic sector



Source: Bloomberg, Wind, OCBC Bank

Nevertheless, it is not all bad news for China. Although China may lose out on exports of final products to its regional competitors, it can still play an important role of intermediate goods provider to the region. For example, despite the weak global trade in the past two years, China's exports of various electronic integrated circuit, which are the inputs for electronic products, have grown strongly. The data from Chart 4 shows that the exports grew by 12.1% yoy in the first three quarters of 2020.

Chart 4: China's exports of electronic integrated circuits remained strong



Source: Bloomberg, Wind, OCBC Bank

In addition, the strong demand from Vietnam for China's machinery equipment, which could be due to the rising capex to build up its production capacity, also showed that the trend of supply chain shift will continue.

Pandemic demonstrated China's strong supply chain

Despite the recent shift, we think China is still likely to dominate the regional supply chain in the foreseeable future. The global pandemic has been the platform for China to showcase its supply chain capacity. For example, the recent transfer of textile orders back to China due to lockdown in India and other Asia countries demonstrated China's capability to be the global supplier of last resort.

In addition, the booming Chinese fast fashion brand such as Shein during the pandemic also presented an interesting example. One of the key reasons that the Chinese online fast fashion retailer can challenge dominant players like Zara, which revolutionised the fashion industry via fast response to the trends, is because of its strong supply chain management. China's effective supply chain together with big data analytics gives Chinese players an advantage in unveiling new design on a daily basis at a much lower cost.

When supply chain meets sustainability

China's President Xi announced in late September that China aims to be carbon neutral by 2060. Meanwhile, both South Korea and Japan also announced in October that they target to be carbon neutral by 2050.

Each node, link and process of the supply chain will drive the consumption of energy and the creation of waste, which will establish a carbon footprint impact on the environment. Given that one third of global greenhouse gas emission originates from trade-related transportation, a more centralized network will lessen the environmental footprints of any supply chain. This means that cost may no longer the only major consideration for the supply chain. The new parameter of carbon emissions will make supply chain shifts a more complex issue. This may be a new opportunity for China to consolidate its leadership in the global supply chain via increasing its focus and investment in green supply chain.

HKD Peg System: So Far So Good

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- From last year's social unrest to this year's US-China tensions, both have sparked concerns about potential capital exodus from Hong Kong from time to time. However, instead of capital flight, so far, we have seen very strong capital inflows.
- Three factors including free capital flow, common law system and HKD-USD peg system have made it hard for global investors to give up on Hong Kong's financial market.
- While political risks may still be looming, the currency peg system is expected to remain. First, the Basic Law states that Hong Kong dollar is the only legal tender in Hong Kong. Second, the government is determined to keep the peg system unchanged. Third, the government is financially capable of defending the peg system. Fourth, Mainland China will also lend support if necessary.
- In comparison to pegging to a currency basket or RMB, pegging to the USD is a better choice for Hong Kong which is a small economy, an international financial centre and the gateway for China's opening up.
- Since the USD-HKD peg system is likely to hold, HKD rates are expected to stay lower for longer in tandem with the US counterparts.

Concerns about capital exodus, but no real massive outflows

From last year's social unrest to this year's US-China tensions, both have sparked concerns about potential capital exodus from Hong Kong from time to time. However, instead of capital flight, so far, we have seen very strong capital inflows. This could be considered a confident vote for the Hong Kong market.

Normally, two indicators are used to gauge the capital flows of Hong Kong. First, the aggregate balance. Second, the total deposits. For the first indicator, it increased sharply from HK$54 billion in April to a record high of HK$457 billion in October. For the second indicator, it averaged 7.9% yoy during July to September, much stronger than the monthly average of 4.7% during January 2018 to September 2020. Back in 2009 when capital inflows were strong, both indicators also showed substantial increases.

Chart 1: Aggregate balance & HKD

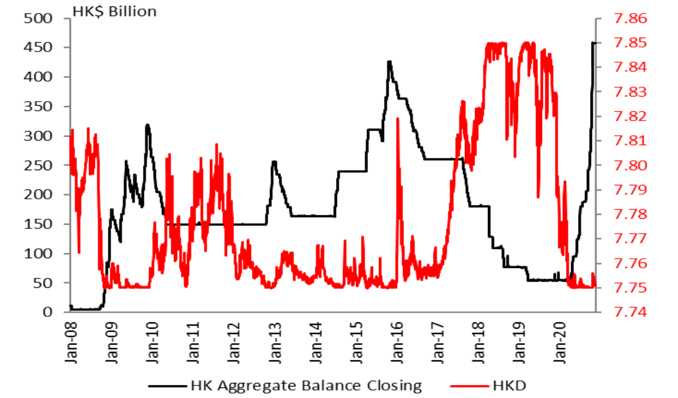
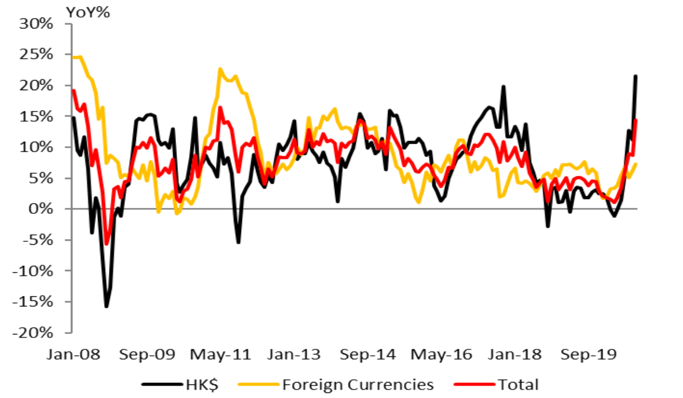


Chart 2: Deposits growth



Source: Bloomberg, HKMA, OCBCWH

Why are the investors still coming to Hong Kong?

Given the heightened political risks, why are investors still coming to Hong Kong? We think there are three factors that make it hard to give up on Hong Kong's financial market. First, the free capital flow. According to the Article 112 of the Basic Law, the Hong Kong dollar shall be freely convertible. This gives confidence for the investors who highly value the ease of funds repatriation. Second, the common law system. This system is applied in the other major financial markets such as the US, the UK, Singapore, Australia, New Zealand, etc. This reduces the investors' concerns about the difficulty of resolving potential disputes. Third, the HKD-USD peg system. The currency peg system is transparent and stable and therefore allows investors to save on hedging costs.

Looming political risks to be contained

Among all the three factors, the investors are normally more concerned about the stability of the currency peg system which has been challenged by the heightened political risks. Specifically, from last year's social unrest to this year's US sanctions, market has been concerned about the potential of massive outflows that could have intensified the de-pegging risk. Though massive capital outflows are unseen, the policy risks are still looming. By mid-December, the US Treasury is required to submit a report which proposes to sanction against those foreign financial institutions that have conducted significant businesses with the 10 sanctioned Hong Kong and Chinese officials. Moreover, there remain concerns that the US government may well impose further actions after the recent en masse resignation by opposition lawmakers in Hong Kong.

At this juncture, we still think it is unlikely for the US to cut Hong Kong off from the US clearing system or SWIFT as it will hurt the US' interest and is most probably not what a Biden administration wants given his support for multilateralism. More notably, it is much more difficult to attack the currency peg system by short selling Hong Kong stocks now than during Asian Financial Crisis as the stock market capitalization has increased by more than ten times during the period. Meanwhile, Mainland Chinese investors have become the major offshore investors in Hong Kong's stock market by representing 11.7% of the cash market trading value in 2018. The contribution may have increased given the continued southbound equity inflows under stock connects over the past few years. As such, the potential political risks look unlikely to be a real threat to the currency peg system at this juncture.

The solid grounds sustaining the peg system

The currency peg system is expected to remain stable given the entrenched legal basis. First, the Basic Law states that Hong Kong dollar is the legal tender in Hong Kong. This means that the local currency will not be replaced by the USD or RMB, or any other currency for that matter

Second, the government is determined to keep the peg system unchanged. Ever since its initiation on Oct 17, 1983, the HKD peg to the USD has survived a slew of crises from Asian financial crisis and global financial crisis to the current public health crisis. Given the resilience of the existing currency peg system, the government has reiterated that it has no intention to make any change.

Third, the government is financially capable of defending the peg system. Hong Kong's FX reserves ranked the seventh in the world and amounted to US$475 billion as of end-October which represents more than twice the city's monetary base and about 45% of HKD M2.

Fourth, even if the HKMA is running out of FX reserves, Mainland China will be there to help. Back in 1997, the governor of PBoC had already pledged to stand ready to assist in defending the peg system if so requested by the HKMA. This year, Hong Kong's Financial Secretary pointed out that the PBoC signed an US$100 billion currency swap agreement with HKMA in 2019, which reinforces the market's confidence in the currency peg system.

No better choice than pegging to the USD?

In comparison to linking to a currency basket or RMB, pegging to the USD is a better choice for Hong Kong.

First, as a small economy, Hong Kong relies heavily on exports of goods and services which are mostly settled in US dollar. It makes sense to peg to the USD. Second, to peg with a currency that is widely used across the globe (37.6% of cash transfers via SWIFT were performed in US dollar), it lays the foundation for an international financial market as the investors can reduce exposure to the risk of both exchange rate and interest rate. Third, as compared to a currency basket which needs to be fine-tuned from time to time, the Linked Exchange Rate System (LERS) is simple, stable and transparent, which reinforces the investors' confidence in holding the local currency in Hong Kong.

Finally, Hong Kong's role as the gateway for China's opening-up is irreplaceable at this juncture given the free capital flow and the common law system.

Since the currency peg system is also one of the major foundations that make Hong Kong's financial market flourish, it is arguably in China's interests to keep the LERS intact. More importantly, it is unrealistic at this stage to peg to the RMB, given its lack of full convertibility. Also, China's capital account is not totally liberalized while the financial market does not have sufficient depth and width that enables the Exchange Fund to hold assets to support Hong Kong's monetary base.

Implication to the HKD rates

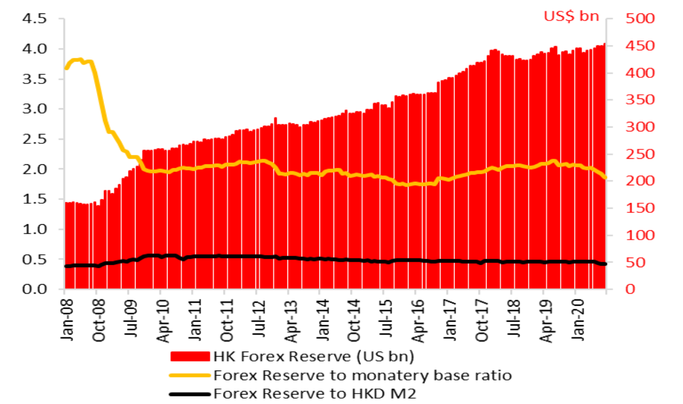
Since the USD-HKD peg system is likely to hold, HKD rates are expected to stay lower for longer in tandem with the US counterparts.

According to the impossible trinity, by choosing free capital movement and a fixed foreign exchange rate, the HKMA must give up on independent monetary policy. Therefore, whenever the Fed raises or cuts interest rates, even though HIBOR may not follow the trend immediately, the interest rate gap will narrow sooner or later, under the LERS. For example, after the Fed cut interest rate to historical low in March, the interest rate gap translated into strong capital inflows which finally pushed 1M HIBOR down below 1M LIBOR in November. Going forward, should the Fed keep rates unchanged near zero before end-2023, the new era of low rates in the world including Hong Kong is likely to be prolonged too. This will therefore give a boost to the financial market as well as the residential property market in Hong Kong.

Chart 3: List of countries by foreign-exchange reserves

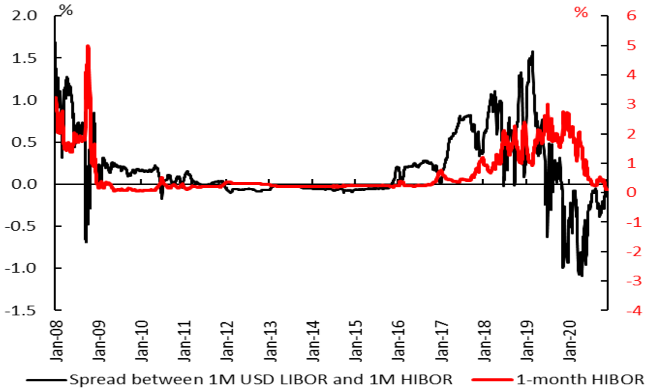
Rank	Country	Foreign exchange reserves (millions of US$)
1	China	3,266,286
2	Japan	1,389,779
3	Switzerland	1,015,321
4	Russia	584,900
5	India	572,771
6	Taiwan	501,240
7	Hong Kong	475,000
8	Saudi Arabia	447,500
9	South Korea	426,500
10	Brazil	354,546

Chart 4: HK's Foreign Exchange Reserve



Source: Wikipedia, Bloomberg, OCBCWH

Chart 5: HIBOR and LIIBOR converge in the medium to long term



Source: Bloomberg, HKMA, OCBCWH

Asset Inflation Expectations to Continue Fuelling Asset Prices Higher in 2021

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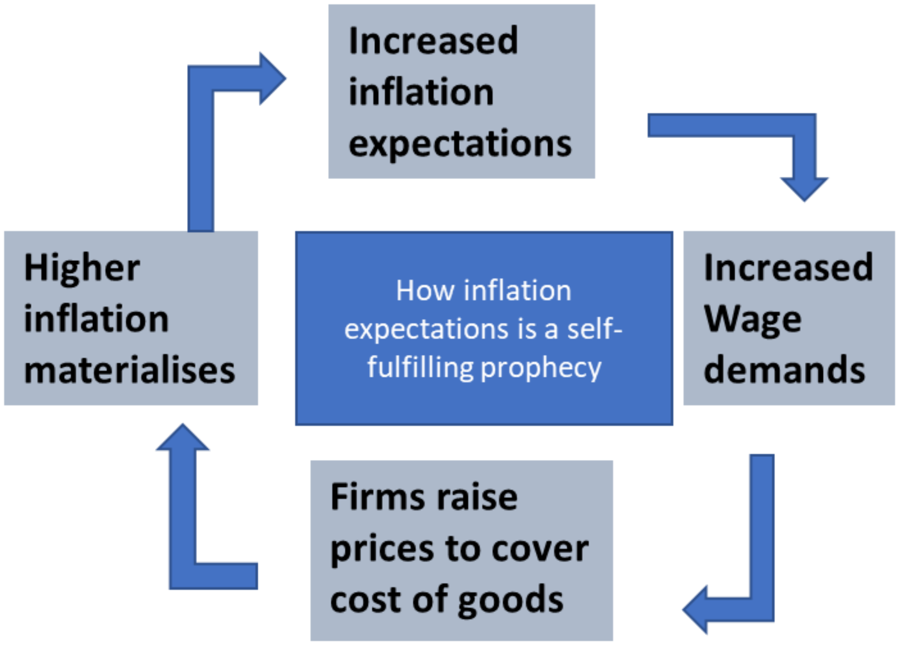
The 1970's and early 80's are remembered for two episodes of runaway inflation in the US. Many factors contrived to send inflation skyrocketing by the late 70's. While it is largely blamed on the spike in oil prices, many underestimated the concept of inflation expectation.

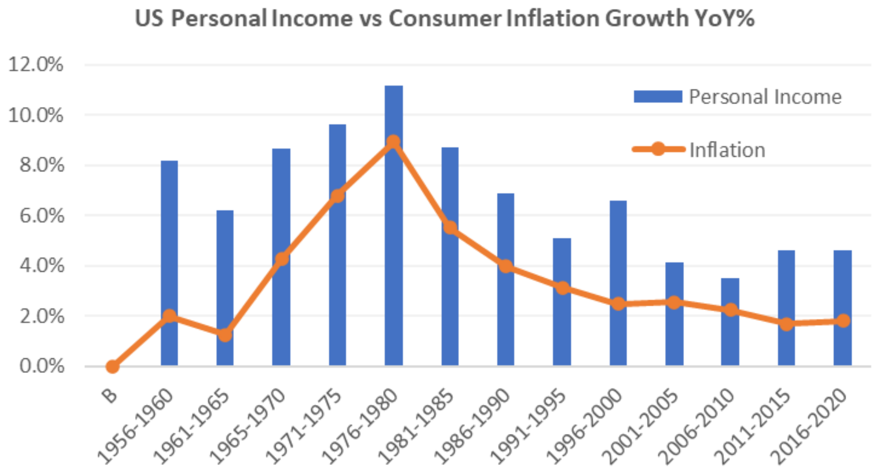
Simply speaking, if you expect prices to rise in future, you behave in a way that contributes to that prophecy. For example, if you expect the cost of living necessities to increase in a year's time, you would have a larger incentive to ask for a bigger pay increment from your employer. The employer, in turn, passes on the costs of higher wages into the selling price of his goods to make up, which ultimately translates into a higher costs of goods – exactly what the worker thought would have happened.



Source: OCBC Bank

Inflation expectations sounds easy as a concept, but in reality is extremely difficult to tame. It is particularly challenging to control because not only it is borne out of asymmetric information from the consumer, it has a direct impact to his standard of living. The consumer, in a bid to preserve his self-interest, acts in a manner to ensure his real wealth does not deteriorate, but in doing so, ends up fulfilling his own prophecy.

This was partly what happened in the 70's. One of the key contributors to runaway inflation then was the increasing wage demand of workers, notably among steel workers, which led to steel mills having to pass on the cost of higher wages into the cost of production.

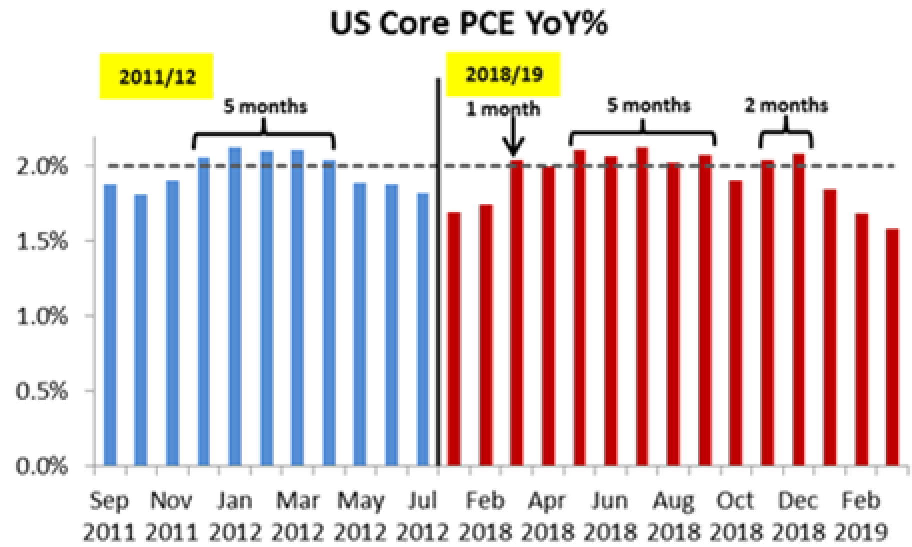


Source: Bloomberg, US Bureau of Labor Statistics, OCBC Bank

With rising inflation expectations, however, the remedy is still not out of reach. Raising interest rates to a point where it encourages saving and discourages spending (what we call delayed consumption) is normally the go-to solution. And because there is no upper limit to how high a central bank can raise interest rates – the sky is the limit here, really – it is relatively straightforward to arrest rising inflation expectations, albeit painful.

The opposite is true. To arrest a deflationary spiral, a central bank needs to cut interest rates.

In the past decade, central banks are mostly preoccupied with warding off deflationary pressures. We are seeing a seismic shift in thinking among the upper echelons of central banks, notably the US Federal Reserve, as top central bankers seek to stem economies from entering a deflationary tailspin. The Fed is now moving to a framework of average inflation targeting, which would implicitly suggest interest rates would stay low until consumer inflation averages 2%.



Source: Bloomberg, OCBC Bank

But back to our topic of inflation expectations – if there has been so much extra cash being pumped into the system in the past ten years (more so this year over the pandemic), why are we not seeing a rise in inflation?

The answer is we are seeing an increase in inflation – not in consumer prices, however, but in asset prices. The equity market is at an all-time high, while residential property prices are climbing. The excess liquidity has not resulted in organic growth, hence the funds are being channelled into existing assets.

Year	US GDP Growth	Shiller Home Price Index Change	S&P 500 Index Change
2008	-0.1%	-17.0%	-38.5%
2009	-2.5%	-3.1%	23.5%
2020F	-3.7%	6.3%	10.0%

Source: Bloomberg, US Federal Reserve, OCBC Bank

This concept of inflation expectations may be applied similarly on either consumer prices or asset prices. If inflation expectations on assets are high, then we may expect asset prices to continue increasing. In the past ten years, the S&P 500 index only ever had 2 separate years of losses. Inflation expectations on assets are so high that even through this pandemic, with consumer inflation falling to 0.1% yoy at its lowest in May, the S&P 500 index still managed to set record high after another this year.

Ordinarily, if it was the consumer inflation rate that was breaking new highs, the Fed would have stepped in to intervene. But is the Fed willing to arrest asset bubbles? It seems that most Fed officials agree that asset bubbles may be problematic, but are unwilling to do more than acknowledge their existence. Firstly, taming asset inflation requires the same remedy as dousing consumer inflation expectations – raising interest rates. That hurts the average guy on the street whose ownership of assets may be negligible to his wealth, and hence the marginal return on that policy may be muted. Secondly, with the amount of leverage in the US, asset inflation is a way to contain the economy's interest expense ratio and debt-to-asset ratio. Thirdly, arresting asset bubbles is normally seen as best left to banking supervision and regulation, but political red-tape delays the implementation of policies. Most importantly, the Fed and most other central banks have no mandate to control asset inflation.

Ultimately, the Fed will defend its actions as necessary to contain the economic fallout from the Covid pandemic. But we have seen from the 2008 subprime crisis that asset bubbles are best pricked before it gets too big. The Fed will do well to do more than just acknowledge the presence of the current asset bubble. But for as long as the market believes in the "Fed put", expect asset prices to continue rising – pandemic or otherwise.

ESG Follow Up: The Impact of Covid-19 on ESG Investment

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Environmental, Social and Governance ("ESG") integration has seen rapid growth at both the government and corporate level over the last few years. No longer merely considered a "trendy" topic, awareness of ESG factors has infiltrated investing at every level. Furthermore, while the COVID-19 pandemic has triggered a global economic downturn, it also has the potential to act as a catalyst for ESG agendas in 2021 and beyond. Between March and November 2020 over USD100bn worth of social and sustainability bonds were issued, with some parts of their proceeds used to respond to the COVID-19 crisis. This accounts for nearly a quarter of the value of green, social, sustainability and sustainability-linked bonds issued during the same period.

With an increasing number of firms embracing the notion of multiple stakeholders in their business models, we see three key ESG themes coming up in the post-COVID world, as we detail below.

Theme 1: An elevated priority on collective responsibility

The outbreak of COVID-19 coupled with mass demonstrations calling for social equality has encouraged governments and corporates to place an emphasis on the "S" or social element of ESG. While social factors have historically been more challenging to evaluate as compared to environmental and governance factors, we can expect to see a long-term increased focus on social issues or social responsibility on the government and corporate level that will sit aside to their documented commitments to environmental and governance issues. For example, issues such as human capital management, occupational, health and worker safety, supply chain transparency (such as labour practices of suppliers) and diversity policies have come to the forefront for many organizations. The onus also falls on investors and regulators to identify the business practices which best enable strong performance while improving material social issues for all stakeholders involved.

However, social responsibility is not just limited to governments and corporates within the traditional scope as mentioned above. We believe that social responsibility will increasingly expand to consumers in the context of the ever-relevant concern for the environment. The disruption of lives everywhere has not paused the climate crisis. Findings suggest that despite an unprecedented fall in human activity, the decrease in carbon emissions will be negligible in the long- run. With many governments initiating climate-related goals to accelerate the process of building a climate-resilient future, sustainable actions such as lowering carbon emissions are now regarded as a social norm in an increasing number of circles.

This intersection between the "E" and "S" of ESG could drive the concept of a collective responsibility across multiple levels for not just social issues, but environmental issues as well.

In 2020, changes in what consumers and corporates can bring have come from the top-down. In the third quarter alone, China, Japan and South Korea announced carbon neutral pledges. While the impact of China going carbon-neutral by 2050 is obvious because of its heft, countries such as South Korea can invoke tremendous change as well. The nation, which accounts for roughly 0.7% of the total world population, is currently the world's seventh largest carbon emitter, and its carbon pledge can persuade other heavy carbon-emitters to follow in its footsteps. While the U.S. has been lagging in climate-positive policies over the course of the last few years, President-elect Joe Biden's promise to re-join the Paris Agreement paints a more positive future for the current generation and the next than what was imagined a decade ago.

These fundamental changes in policy have resulted in the winds of change sweeping through a multitude of industries. For example, the automotive industry has gone through a massive upheaval in recent years, with carbon-neutral policies accelerating these changes. The rise of clean transport and electric vehicles ("EVs") in particular, with Chinese EV share prices soaring since the start of the year and Tesla's imminent entry into the S&P 500, indicates that the sector disruption is here to stay. Other large-scale changes in vital sectors such as renewables and agriculture have also emerged from the growing idea of social responsibility on all levels.

Theme 2: Supply chain disruption

Globalization as we know it today began in earnest in the 1970s and has resulted in exponential growth in trade and interconnected economies since. However, the pandemic has shown how susceptible these global supply chains are to disruptions. As a result, there has been a shift towards greater self-reliance and more digitalized supply chains.

There has also been a push for transparency from consumers who have been more conscious about not just the carbon footprint, but the labour standards within the supply chain. The International Labour Organization estimates that there are over 40mn people who currently work in slave-like conditions, with the textile industry being a major culprit. On the environmental front, firms tend to report their Scope 1 and 2 greenhouse gas emissions, which involve emissions from owned or controlled sources. However, calculating Scope 3 data requires companies to analyse indirect emissions from their supply chains, which tends to be more of a challenge. Hence, most corporates do not attempt to report Scope 3 emissions or have inconsistencies at best. For example, researchers from the University of Hamburg found low levels of consistency in Scope 3 data between the major data providers such as Bloomberg, Carbon Disclosure Project (CDP), MSCI and others.

Increased digitalization, transparency, and shorter supply chains can therefore have a positive impact on corporate ESG practices. Not only do they allow for a smaller carbon footprint, but enhanced supply chain visibility can assuage consumers' concerns while allowing companies to better understand their supplier networks. From the immediate standpoint of lower cost structures and informational edge, having a multitude of suppliers located in dispersed locations is advantageous for many companies. With the rise of ESG-centred focus, the longer-term fallout from not understanding the supplier network is becoming apparent to management teams. This means that increasingly, companies will also need to consider the merits of reshoring and scaling down on suppliers who are unable or unwilling to meet ESG standards. A shift to a greener supply chain may bring broad implications. For instance, Apple's commitment to have a 100% carbon-neutral supply chain by 2030 has resulted in Sony contemplating moving its manufacturing capabilities out of Japan given that the country lags in renewable energy infrastructure and policy when compared to other high income nations. Despite such disruptions, surveys have shown that in the long-run, consumers are often willing to pay more for sustainable products, and firms with sustainable business practices may gain a competitive advantage over their peers.

Theme 3: The standardization of ESG reporting and possible drawbacks of an overreliance on them

As the ESG investing field ramps up from a specialised and niche part of the investment universe in the 1960s (then known as socially responsible investing) to become mainstream in 2020, so has the adoption of ESG ratings. This development has allowed financial institutions to move into the ESG space quickly without building a deep bench. In the "buy versus build" decision, we have also observed at least three global data providers acquiring and taking control of ESG rating companies in 2020, growing their expertise by acquiring existing ESG rating providers rather than building expertise in house over a period of time.

As assets under management ("AUM") flow into ESG investments, the flow is being heavily – if not blindly –influenced into funds that base their investment decisions on particular ESG rating providers. While the pace of adoption was slower, this phenomenon has similar veins to rated bond markets where AUM deployment is heavily directed by ratings provided by bond rating agencies. For example, in the case of the Asiadollar market, AUM is heavily directed by ratings provided by three international rating agencies and two benchmark indices.

While this trend was perhaps inevitable, it is worth highlighting four potential issues which may come into the fore as asset owners take stock of what they are actually investing in and given the gravity of ESG risk (particularly climate change) and associated hurried pace towards mass ESG adoption:

- **Conflicting ratings where we find vastly different relative scores** between the main ESG rating providers. Such differences may be structural, as different methodologies result in different focus areas. For investors, this may mean that directing assets based on only one ESG rating provider and ignoring others may be overly simplistic. For one, it could unnecessarily exclude otherwise acceptable investment targets. Conversely, it could lead to ignoring of red flags in investment selection. To be sure, conflicting ratings do exist among the traditional bond rating agencies too. However, we find that with time-honed methodologies and experience with different credit cycles, discrepancy among these ratings tends to be narrower and therefore more predictive for its intended purposes.

- **Are ESG rating providers focusing on areas that matter to investor risk and returns?** There is yet no convergence over the quantum or type of information available to ESG rating providers, be it an industry-driven one such as the International Financial Reporting Standards ("IFRS") nor a regulatory-driven one such as stock market disclosure requirements, which affects the quality of information available to derive an ESG score, let alone the relativity of such a score across industry and geography. In our view, this means that following an ESG score without asking questions may result in ignoring tail risk. For example, both Rio Tinto and Westpac Banking Corp ("Westpac") were rated (and are still rated exemplarily) by widely followed ESG rating providers. However, both companies were engulfed in recent ESG issues that led to forced resignations at the C-suite. In the former's case, a social issue concerning cultural conservation had risked Rio Tinto of its continued shareholders support. In the latter's case, Westpac is facing AUD1.3bn (19% of its FY2019 net income) of regulatory fines on breaches due to insufficient internal controls and anti-money laundering activities.

- **Greenwashing gets exposed with implications to investment returns:** "Greenwashing" – the practice when an organisation spends more time marketing itself as green than being green is a main concern among ESG investors. In our view, this risk increasingly may affect returns for investors following the rush into ESG. In July 2020, an ESG fund favourite, an online fast fashion company called "boohoo", was found to have sweatshop working conditions within its supply chain. When the news came to light in July 2020, the company lost 49% of its share price over two days as investors scrambled to exit their investment. Prior to this, boohoo was rated at the second highest ESG rating. In our view, ESG risks are fundamentally influenced by the industry a company operates in and the geographies of its main business operations. With the fashion industry having a relatively poor track record in its ESG practices, finding out what boohoo was doing differently compared to its fashion peers would have led to better investment outcomes.

- **Substitution into ESG ETFs and ESG benchmark huggers?** From the trough in global equity markets on 23 March 2020 to 1 December 2020, the MSCI World ESG Leaders Index has reported a total return of 63.0% versus 65.4% for the MSCI World Index which does not filter out "bad" ESG companies. Over a five-year period, the MSCI World ESG Leaders Index and the non-ESG index both saw total returns of 72.6%. On quick glance, this is a vindication that investors "can do well by doing good". However, aside from the exclusion of Amazon from the MSCI World ESG Index, there is a noticeable overlap between the ESG index and the non-ESG index. 21.6% of the non-ESG MSCI World Index comprise of technology companies while 20.7% of the ESG friendly MSCI World ESG Index comprise of technology companies. On geography, both indices are dominated by US companies at 66.8% for MSCI World Index and 65.7% for MSCI World ESG Index. At some point, investors may be asking if they need to invest in both conventional funds and an ESG fund especially for their developed market allocation leading to a substitution effect among asset owners. Rather than concluding that companies with high ESG standards cause market outperformance, we are of the view that high performance companies care about ESG matters and are increasingly focused on integrating ESG into their business practices.

Shining the spotlight on Singapore

Since its independence in 1965, Singapore has placed an emphasis on being a clean and green city-state. Corporates have also aimed to be sustainable leaders; companies including CapitaLand Ltd, City Developments Ltd and Sembcorp Industries Ltd were included in the Dow Jones Sustainability Index in 2019. Being especially vulnerable to climate change, Singapore has implemented a multitude of sustainable measures as part of a commitment to be a leading ESG force in Southeast Asia. The policies are focused on green finance, sustainable infrastructure, as well as waste and water management.

In October, the country deployed its first ten fully electric double-decked buses for public transport. These buses will be a part of a fleet of 60 fully electric buses, which is expected to reduce carbon dioxide emissions by around 8,000 tonnes a year. Furthermore, the government plans to have all 5,800 public buses run on cleaner energy by 2040. Another clean energy initiative includes the Vehicular Emissions Scheme, which when coupled with the Electric Vehicle Early Adoption Incentive will afford cost savings of up to SGD45,000 for first-time electric vehicles (EVs) purchases. This will be the largest cash incentive for EVs globally, and the scheme will also increase surcharges for purchases of new vehicles, taxis and imported used cars.

Other benefits include an enhancement to the Water Efficiency Fund which took effect from November, where firms would receive funding up to SGD300,000 a month or up to 50 per cent of the installation cost of water-efficient equipment if they use more than 1,000 cubic metres of water a month. Firms will also obtain increased funding amounts for water saved, capped at SGD1mn per project.

On the financial side, MAS aims to launch its Green and Sustainability-Linked Loan Grant Scheme (GSLS) in January 2021, with a focus on supporting SMEs in obtaining green loans. The scheme will cover up to SGD100,000 of a borrower's expenses for validating the green and sustainability credentials of a loan. The GSLS will also provide financial incentives for banks to develop green loan frameworks. Meanwhile, Singapore's sovereign wealth fund, GIC, has signed up with three organizations, (1) Carbon Disclosure Project (CDP), (2) Climate Action 100+ and (3) the Asia Investor Group on Climate Change (AIGCC), as part of its commitment to place sustainability at the centre of its various investment strategies.

Conclusion

The path for ESG in 2021 has been cleared by the unfortunate COVID-19 pandemic. The event, among other paradigm-shifting ones that occurred this year, has given more impetus for consumers, corporates, and governments alike to become more socially responsible entities. With countries coming together with carbon-neutral goals, together with permanent disruptions to various industries, ESG is here to stay.

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