Economics and Macro Strategy

DBS 2019-20 Outlook

Fading Momentum

Group Research

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Outlook 2019-20

- *Has the cycle peaked, with China and US slowdown ahead? Have we reached peak USD, peak rates, peak growth, and peak earnings? Will an asset market correction upend the US monetary policy normalisation cycle? How much of a toll would the trade wars take? Will declining oil prices help emerging markets, offsetting likely downside to income and investment in the commodity space? Where do we see pockets of fiscal support? Which elections are potential game changers?*

- *We address these questions in our 2019-20 Outlook, covering 13 countries (G3+Asia10) and 4 asset classes. Faced with fading momentum, the best one can expect from the global economy is an orderly slowdown, helped by prudent policy calibration. Ongoing slowdown in China and late cycle dynamics in the US will direct asset prices, in our view. Staying long USD, short duration, and cautious about equities and credits are strategies for next year, but as 2019 progresses, markets will begin to price in a slowdown scenario, taking steam away from the USD and rates. All of this will keep volatility high, in our view.*

- *There are some potential positives for Asia: (i) low oil prices will help keep inflation down and ease BOP pressure, softening policy tightening bias; (ii) asset market sell-off from 2018 may bring back value-seeking investors; (iii) as the realisation that using China as an exporting hub is going to be challenging going forward sets in, ASEAN economies may see trade diversion-related investment; and (iv) in some economies, fiscal policy will likely be eased (China, India, Indonesia, and the Philippines).*

- *Key risks to this scenario are: (i) strong wage pressure pushing up rates in the US, strengthening the USD, tightening dollar liquidity, causing funding distress worldwide and (ii) China-US conflict hurting investment, tipping the world toward a sharply lower growth trajectory.*

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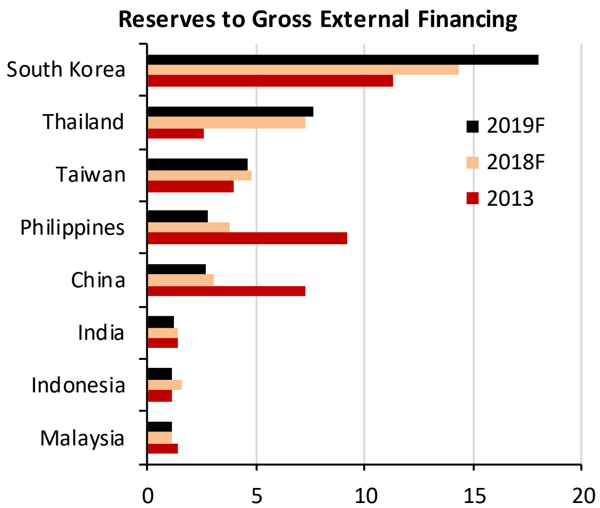
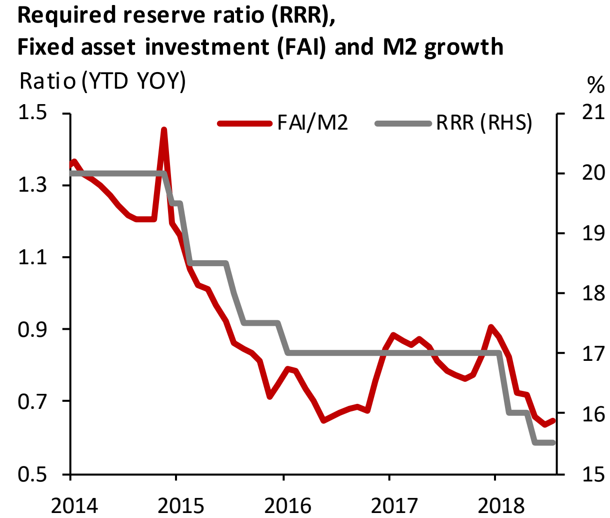
Even as oil prices decline, a few key Asian economies will face formidable funding needs next year



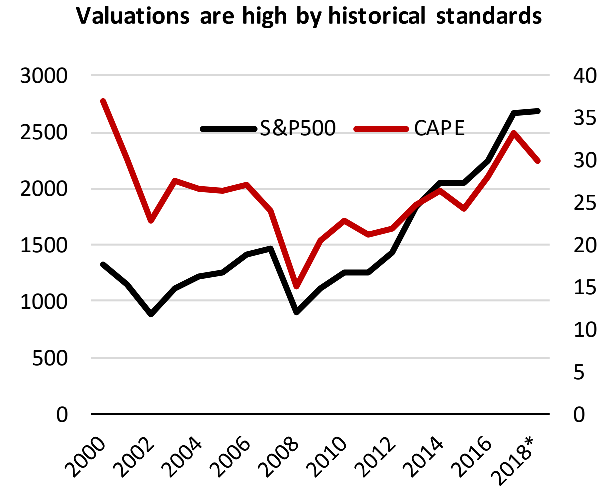
Source: World Bank, DBS Group Research. The ratio is calculated with gross FX reserves in the numerator and gross external funding needs (current account plus external debt due next year) in the denominator

Policy efficacy appears to be weakening in China, especially when seen from the perspective of investment in response to monetary easing



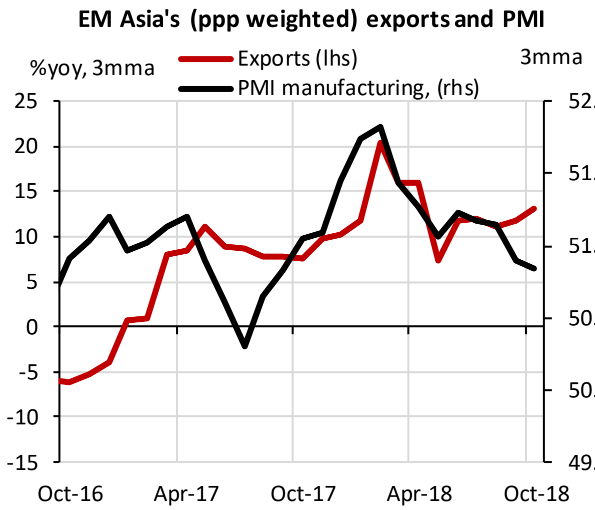
Source: Bloomberg, DBS Group Research. The ratio is calculated with real growth of investment in the numerator and real M2 growth in the denominator

The US equity market correction in recent months is insignificant by historical standards, while valuation remains high



Source: Bloomberg, DBS Group Research. Year-end figures; end-Nov for 2018. Shiller PE ratio for the S&P 500 is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio (CAPE)

Trade tensions and a weakening tech cycle have pushed down regional PMIs; exports will likely follow in the new year



Source: CEIC, DBS Group Research. Both quantities are aggregated by using IMF's GDP (ppp) weights of the following countries: Mainland China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan POC, and Thailand

Four key charts

Overview: Fading Momentum

A year ago, we called our annual outlook “Strong Tailwind,” suggesting that the growth momentum from 2017 was going to spill over to 2018. But we also cautioned that for asset markets, the Goldilocks 2017 was going to be a tough act to follow.

Indeed, **global growth looks slated to be on course for a tad above 3.5% this year**, despite concerns about trade and pockets of geopolitical instability. Asset markets, however, have lost momentum as the year has progressed, spooked by higher rates, slowing earnings growth, and marginally tighter liquidity. The sharp sell-off since October reflects souring sentiments and growing uncertainty about the outlook, with no end in sight with respect to trade wars, European politics, and tension in the middle-east. Add to this ongoing demand slowdown in China and Europe, as well as likely slowing of the US economy in the coming quarters, it would be reasonable to argue that peak growth in this cycle has already been reached.

But peak growth does not yet mean peak USD or peak US rates, in our view. With unemployment well below 4%, wages growing at 3%+, inflation at 2%+, and growth, despite slower compared to 2018, at a comfortable 2.5%, the US Federal Reserve will find it hard to pause from its quarterly rate hike path, in our view. This will leave some room for further USD strengthening and rates rising. We also believe that asset markets would have to correct much more before a Fed relent materialises.

The shadow of China-US strife will loom through 2019-20, even if some trade deal is reached. The US has taken a hard stance on pushing back on China’s rise in the technology and military sphere, something that will persist even if tariff wars abate. This will likely alter the regional investment landscape, with some eventual upside for some ASEAN economies as they benefit from trade diversion, but in the near term there will major casualty as far as investment is concerned.

An all-out trade war, with 25% tariff on all Chinese exports to the US, could readily tip the global economy toward a recession and cause major sell-off in asset markets. By 2020, US growth could go below 1% and China’s below 5% in this scenario.

A sliver lining is declining oil prices, with a substantial supply-demand imbalance that could well last a few quarters. We think that eventually supply will be cut back and US-Iran tensions will push oil back up, but for the time being, that would be a source of much-needed relief for large oil importers in India and Indonesia.

Long vols has been a winning trading strategy this year, and we think that will likely be the case in 2019-20. Even if a slowdown appears on the horizon, relatively tighter G3 liquidity will keep pressure on rates and credit, in our view.

2019 would see fiscal policy accommodation in a few major EM economies, led by China. As the Chinese authorities see money multipliers falling, they will put more emphasis on fiscal support. Faced with general election related considerations, one ought to expect a rise in public and private expenditure increases in India and Indonesia as well.

Are elections good or bad for markets in emerging markets? Our research suggests that as long as they are not sources of major surprises, elections are associated with only mild changes in economic trajectory. India’s parliamentary elections or Indonesia’s presidential elections will command many headlines in 2019, we are sure, but we will not expect any major change in the direction of either economies post elections, regardless of outcome.

The remainder of this publication is devoted to single page-each coverage (analysis and forecast) of 13 countries (G3+Asia10) and 4 asset classes (rates, FX, credit, and equities). We consider key forecasts and lay down the risks to our envisaged scenarios. We hope you will find the insights useful for your investment decisions.

Taimur Baig

Overview

US: Peak growth, but not peak FX/rates

	2017	2018F	2019F	2020F
Growth, yoy%, ave	2.3	3.0	2.5	1.5
Inflation, yoy%, eop	2.1	2.6	2.5	2.5
Core PCE inflation, yoy%, eop	1.6	2.0	2.4	2.0
Monetary policy rate, %, eop	1.50	2.50	3.50	3.50
USD per EUR, eop	1.16	1.12	1.10	1.15
10-year yield, %, eop	2.40	3.20	3.60	3.20

There is a lot of chatter about peak growth, peak earnings, and peak dollar heading into 2019. But near-term downsides to the US economy are still rather minimal, in our view. Labour market tightness, wage upside, fiscal support (farm subsidy and defence spending), and strong business sentiment will likely to keep growth comfortably in the 2.0-3.0% range next year. The chance of wage and inflation surprising on the upside is rising, but we don't see anything alarming in the pipeline. Fiscal slippage concerns are real, and the supply of treasuries has ballooned, but the gap between supply and demand does not appear glaring.

We therefore see 2019 growth remaining impressive by historical standards, averaging around 2.5% for the year, with core inflation nudging up toward 2.5%, keeping the USD strong, pushing the 10-year yield to over 3.5%, and allowing the Federal Reserve to keep hiking policy rates at the rate of one per quarter.

But a year from now, we expect conditions to become challenging along multiple dimensions:

- After two years of strong support, fiscal impulse will likely turn negative in 2020, as it will become progressively difficult to come up with further fiscal relaxation through legislative initiatives by then.

- China-US battles will likely transcend trade wars and spill over into geopolitical tension, but the key economic drag will stem from assorted uncertainties and cost increases associated with tariffs and other trade restriction measures.

- Given the prevailing tightness in the US labour market, wages will continue to rise through 2019, and the momentum could well last through the following year, even as growth begins to slow. The problem for the Fed would be that the level of output (not delta) and the prevailing wage/price dynamics will make it nearly impossible to ease policy in 2020.

- Finally, since a large number of US companies derive a bulk of their earnings from the rest of the world, external demand considerations will come into play sooner or later. Hurt by rising rates and tight USD liquidity, as well as difficulties around trade wars, growth in emerging markets will likely struggle, which will in turn spill back into weak international sales and profits for US companies by 2020.

It is hard to price this scenario; the yield curve would likely steepen in 2019 and then begin flattening in 2020; the USD would strengthen first and then soften; inflation will peak but remain uncomfortably high for the Fed.

What are the risks to this scenario? We think that chances of wages and inflation remaining benign, a scaling back of Fed policy normalisation if markets sell off (so-called "Powell Put"), or further fiscal support in the pipeline, are rather low. Clearly the ongoing volatility in the market and the downside to oil prices have raised expectations of a Fed relent, but we are disinclined to follow the herd.

Of course, if sentiments worsen sharply around trade wars, investment stagnation, China slowdown, and geopolitics (ranging from US to EU to the middle east), causing major unrest in the asset markets and hurting economic activity and financial stability, the Fed will come forward with support. The bar for such intervention is quite high, regardless of what the markets or the political establishment desires, in our view.

Taimur Baig

Eurozone: Shifting political and economic sands

	2017	2018F	2019F	2020F
Growth, yoy%, ave	2.5	1.9	1.8	1.8
Inflation, yoy%,	1.5	1.8	1.4	1.4
Core inflation, yoy%,	1.0	1.0	1.1	1.2
Currency, against USD, eop	1.16	1.12	1.10	1.15
Monetary policy rate, %, eop	0.0	0.0	0.0	0.5
10-year yield, %, eop	0.41	0.38	0.80	0.70

Markets are likely to be pre-occupied by shifting political and economic sands in 2019. Politics is likely to dominate the narrative in midst of rising far-right politics in the bloc's largest economies, Italy and Germany. In Germany, the electoral defeat of the ruling coalition partners in regional polls saw Chancellor Angela Merkel step down as the party chief and will not seek re-election when her political term ends in 2021. With dominant parties likely to take a backseat, the domestic landscape is likely to turn more fragmented and potentially threaten the stability of the biggest economy of the bloc.

Concurrently, the new government in Rome and the European Commission are still to reach a compromise on the former's spending plans and increase in fiscal/ debt ratios. Tensions might rise if the European Council launches an "Excessive Deficit Procedure" against Italy, which would require the government to provide a plan of corrective action to rein in its large public debt. Material fallout on the bond markets will necessitate the ECB's backstop, but the latter has reiterated that it will not get involved unless Rome officially seeks help.

Finally, in more than two years since the Brexit vote, there is little clarity on the terms of the UK-EU relationship after UK exits the bloc, as the March 2019 deadline looms.

2019 will also mark a crucial year on the institutional end, with a new head of the European Commission, election for the new European Parliament (May) and a new ECB Governor (October).

On growth, after a strong 2017, Eurozone lost momentum into 2018, which is likely to extend next year. From 2.3% YoY in H1, growth slowed to 1.7% in Q318. Nominal and negotiated wage growth improved in H218, though purchasing power was partly dented by high energy prices. Industrial production was dragged by slower manufacturing, utilities and mining activity, despite better capacity utilisation rates. Slowing construction activity is weighing on investment growth.

Temporary factors akin to disrupted car production in Germany due to stricter emissions regulations hurt growth, weighing on the bloc. France fared better, but Italy stagnated, making the latter's budget decisions even more tenuous. Considering risks to the outlook and global uncertainties on the trade front, we have lowered our 2018 forecast to 1.9% from 2.2% previously. Next year is pegged at a slower 1.8%.

Headline inflation has edged back towards the 2% target since June 2018. While this fulfils the policy mandate, rise in inflation is mainly due to cost-push forces i.e. energy prices (transport was the single biggest contributor to price increases) and utility costs. Core, meanwhile, continues to flatline, despite improving wages, which signals hesitation on the part of firms to pass on the burden of higher wages and, that the impact of a weak euro is still to reflect on imported/ tradable inflation.

Given this growth and inflation backdrop, policymakers see a lower need to maintain crisis-era policy. QE purchases are likely to cease by end-2018. Incoming signs of softness in growth indicators, however, suggest policy normalisation could be delayed. There is also a speculation that the ECB might consider another tranche of cheap financing program, under the TLTROs scheme (targeted long-term repurchase operation) to support growth and infuse liquidity (as the last round of LTROs mature in 2019). Rate hikes stand delayed beyond October 2019, possibly into 2020.

Radhika Rao

Japan: Stable politics to provide reform impetus

	2017	2018F	2019F	2020F
Growth, yoy%, ave	1.7	1.0	1.0	0.5
Inflation, yoy%, ave	0.5	1.0	1.1	1.6
Core inflation, yoy%, ave	0.5	0.9	1.1	1.6
Currency, vs USD, eop	113	114	116	112
Policy rate, %, eop	-0.1	-0.1	-0.1	0
10-year yield, %, eop	0.04	0.12	0.20	0.22

Prime Minister Shinzo Abe has been given another 3-year term as the Liberal Democratic Party's leader after winning the leadership election in September 2018. Meanwhile, he does not need to face the country's next lower house election until October 2021. A stable political environment will likely allow the authorities to continue pushing for the major policies under Abenomics in the next few years.

The government is set to raise the consumption tax to 10% from 8% in October 2019. The disruption impact on the economy is expected to be more moderate than during 2014 as the magnitude of consumption tax hike is smaller this time (2ppt vs 3ppt). Food and some other daily necessity items will be excluded to lessen the burdens on low-income households. Also, the counteracting measures will be stronger this time. The government is reportedly mulling a fiscal stimulus package worth JPY10tn to shore up domestic demand next year, including tax breaks for car purchases, shopping vouchers, and increases in public spending on infrastructures and disaster prevention. Finally, the private sector is relatively well positioned compared to in 2014. Base wage growth has picked up to 1% this year from -0.4% in 2014, while unemployment rate has fallen to 2.4% from 3.6%. Overall, we have penciled in a 0.5ppt decline in GDP growth and a 0.6ppt rise in inflation for 2019-2020. This compares to the 1.6ppt and 2.5ppt, respectively, in 2014.

Monetary policy is expected to remain loose in 2019. The Bank of Japan (BOJ) has tweaked the yield curve control policy this year, allowing the 10-year JGB yield to fluctuate in a slightly wider range around the 0% target (±0.2% vs ±0.1% previously). Given that the JGB yield curve remains flat and the pressure on banks' profits continues to loom, it is possible that the BOJ will further adjust policy technically to allow the long-term yields to move more flexibly in 2019. That said, any substantial policy changes (an end of the negative rate policy and outright hike in the long-term yield target) would only happen in 2H 2020 at the soonest. The BOJ would like to wait until after the 2019 consumption tax hike to ensure that the economy could fully recover from the disruptions and return to a sustained growth path. The BOJ would also want to ensure that deflation has been fully overcome and CPI will stay significantly above zero (e.g., 1%, if not the 2% target) in a stable manner.

External factors could pose risks to our baseline forecasts and need to be closely monitored. A rise in trade protectionism, further Fed tightening, and heightened emerging market volatility could dampen Japan's growth prospects, through weighing on exports and the overseas earnings of Japanese corporates.

To reduce trade conflicts and avoid the potential automobile tariffs imposed by the US, Japan has agreed to negotiate a bilateral trade agreement with the US. Yet, there is no consensus between the two sides regarding the concrete details, such as whether it will be a comprehensive free trade agreement and whether it should incorporate a clause to prevent competitive currency devaluation.

If external risks escalate, growth outlook falls short of expectations by a wide margin, and deflation pressure resurfaces, we would expect the authorities to recalibrate fiscal and monetary policies, including postponing the scheduled consumption tax hike and keeping rates low across the curve for an extended period.

Ma Tieying

Japan

Rates: Past peak pain

Global monetary conditions are likely to get tighter in 2019, **marking a third year of higher DM rates.** The US, Eurozone, and Japan should see interest rates continue to grind higher as their respective central banks continue to / or signal commitment to withdraw monetary stimuli. However, the pace of tightening differs between the Fed, the European Central Bank (ECB) and the Bank of Japan (BOJ). We think that the bulk of the tightening will still be delivered by the Fed in 2019 while the BOJ would continue to taper. Meanwhile, the ECB will be on pause, prepping for a hike only in 2020.

With US GDP growth running above 3% for two consecutive quarters, YoY CPI still hovering above 2% and the unemployment rate plumbing new lows, further rate hikes are needed, Trump's criticism of the Fed notwithstanding. Tightness in the labour market is translating into higher wages. We suspect that the market (currently pricing in one hike for 2019) is underestimating core inflation risks and Fed hike risks.

Meanwhile, **the ECB has committed to cease asset purchases by end-2018**. Unfortunately, this has not translated in meaningfully higher German yields as we had thought earlier. Considering elevated political risks (European Parliamentary elections are due in May) and depressed economic activity in the Eurozone, rate hikes are probable only in 2020.

The BOJ has been loosening control of the yield curve and will likely continue to do so in 2019. Policy making has evolved with the 10Y yield now allowed to fluctuate with a 20bps spread around zero. In practise, 0.2% acts as a ceiling for yields, beyond which, the BOJ would step in with JGB purchases. The BOJ's balance sheet is now expanding at about JPY1.8tn/month (3mma), down from around JPY2.9tn in early 2018. If this pace of stimulus withdrawal persists, the BOJ could stop asset purchases within the next 1-2 years.

By end-2019, the US tightening cycle will likely end in the coming quarters, passing on the rate hike baton to the ECB and possibly the BOJ in 2020.

Asia

As USD rates edge up, Asia policy rates will be dragged higher again, but peak pain is probably behind us. Asia rates in the higher-yielding economies have already adjusted significantly (real rates are high in Indonesia and India) over the past few quarters as complacency gets worked out of the system. This sets the stage for a more modest hike cycle for the twin deficit economies in 2019 even as we see the Fed hikes continue. Even if yields rise in these economies, local currency govvies (with much higher absolute yields) may be attractive from a total return perspective.

Malaysia, Thailand, Korea and Taiwan are lagging peers in the monetary policy cycle. Korea and Taiwan have well-supported external balances and are likely to face headwinds from trade. There is little scope for policy rates (we have a token hike for Korea by the end of this year) or govvie yields to rise even if USD rates get meaningfully higher in 2019. For Malaysia, we expect yields to be broadly steady with the central bank facing inertia in either direction. Oil prices remain a key risk and we suspect that the curve would steepen if prices fell much lower. Meanwhile, the THB curve is already pricing in a modest rate hike cycle as the central bank turns modestly more hawkish.

Lastly, policy settings are going to stay accommodative in China through 2019. We have assumed that liquidity would be kept ample (more RRR cuts could be in the offing) to cushion downside from the ongoing trade war with the US. That said, we think that longer-term govvie yields may be rangebound with yields already low in absolute and relative (compared to the US) terms.

Eugene Leow

Currencies: USD stomping higher into 2019

The US Dollar Index (DXY) positioned to rise above 100 in 2019 on relatively stronger fundamentals. The US economy is set to outperform its Developed Market (DM) peers for a second straight year in 2019. The Fed Funds rate, together with the UST 10-year bond yield, will become more restrictive above 3% in 2019. The Fed's balance sheet is on track to narrow to less than 20% of GDP compared to 40% in the Eurozone and 100% in Japan.

Softer growth and hard politics will drive the euro below 1.10. Eurozone's growth will stay subdued below 2% for a second straight year in 2019. The European Central Bank is more likely to lift rates in early 2020 instead of late 2019. Italy's zero growth will steel Rome's resolve to defend its expansionary fiscal spending plans and oppose Brussels' pressure to respect EU fiscal rules. The single unity of the EU will come into question when far-right parties increase their representation at the European Parliament elections in May 2019.

The British pound will fall towards the 1.20 low seen after the 2016 Brexit referendum. Brexit is no longer about a deal or no deal but evolving into an existential crisis regarding the kingdom's unity. Fractious politics have prevented the prime minister May from bringing together all parties – Tory Brexiters and Remainers, Northern Ireland and Scotland – to support the withdrawal agreement negotiated between Downing Street and Brussels. A smooth and orderly Brexit is no longer guaranteed.

A weaker 115-120 range awaits the Japanese yen. The top priority in Japan has shifted from beating inflation to supporting the economy. Real GDP growth in 2019 is expected to slip, for the first time since 2016, below 1%. The Abe administration is considering a JPY10t stimulus package to offset the hike in sales tax to 10% from 8% in October 2019. A shock from trade war will delay the sales tax for a third time, with the Bank of Japan putting aside its stimulus exit plan in favour of more easing.

The Chinese yuan will weaken past 7 to pre-GFC levels. The People's Bank of China is looking for "grey rhino" financial risks – highly obvious yet ignored threats – to resurface in 2019. Trade tensions have led to the slowest growth since the Global Financial Crisis and its first current account deficit since 1993. Debt rating agencies have been vigilant against more corporate debt defaults and hidden local government debt. It will be more challenging to cushion growth from more trade tensions (especially if Trump imposes tariffs on the remainder USD267bn of Chinese goods) via domestic demand while maintaining financial stability. Apart from more fiscal stimulus – which widens the budget deficit – look for further cuts in the reserve requirement ratio and interest rates.

The return to an appreciation stance has not and will not stop the Singapore dollar's depreciation against the USD. Singapore has an exchange rate policy that aligns USD/SGD to the greenback's trends against DM and Emerging Asian currencies. This was best illustrated by USD/SGD's rise to 1.38 despite the return of the SGD policy to a modest and gradual appreciation stance in April.

Looking ahead, we see more DM currency weakness on domestic factors. **Emerging Asia currencies will carry last year's baggage** – a stronger US dollar, rising US rates, tighter credit/financial conditions, trade tensions and global growth risks – **into 2019**. Asia's three weakest currencies – the Indian rupee, Indonesian rupiah and the Philippine peso – have yet to break free from their current account/fiscal deficits. The healthy external surplus positions of Asia's resilient currencies – the Thai baht and South Korean won – have also started to narrow alongside slower growth. **Two pivotal risks – large capital outflows and private/sovereign debt rating downgrades – will loom over the region.** Positioned at the upper limit of its 4%-wide policy band against external uncertainties, the risk-reward scenario favours a weaker SGD past 1.40 in 2019.

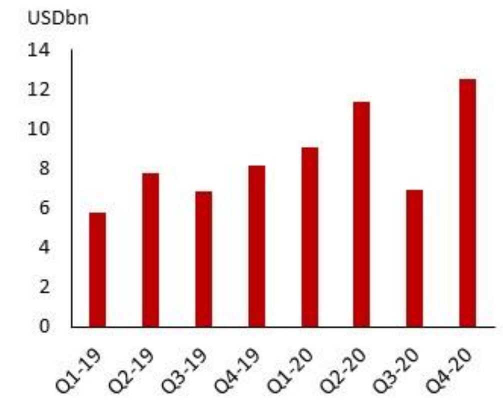
Philip Wee

Credit: Mind the downside

We see 2019 as a muddle through year with no conviction or catalyst for a sharp spread movement in in either direction, barring major global events (e.g. geopolitical). Apart from potential changes in Fed expectations, a key driver of the market this year would be China, with its wall of maturities in the high yield (HY) space, with implications for both secondary market and credit events.

We recommend focusing more on managing downside risks with returns accruing largely from coupon carry. We prefer high grade (HG) over HY credits given the improved valuations in the HG space and fewer fundamental concerns. We recommend short duration (<5Y) to mitigate rising interest rates, at least till mid-2019, when we expect most of the UST yield increase to happen. Selected BB bonds and subordinated debt offer yield pick-up opportunities, but we are cautious on single B names given rising credit events.

Chinese HY wall of maturities (offshore bonds)



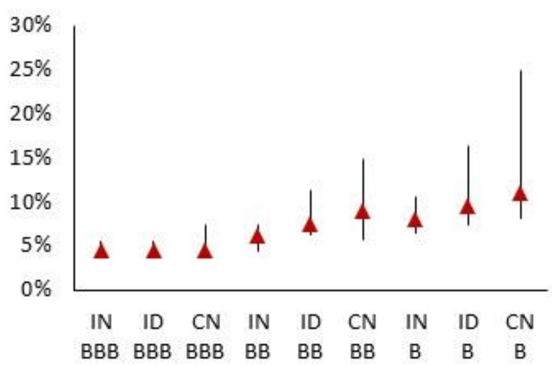
Source: Bloomberg, DBS

China's maturity wall will be key focus: around USD29bn of sub-investment grade and unrated offshore bonds mature in 2019, followed by USD40bn in 2020 (Bloomberg data). This has two implications 1. Credit stress: The median debt/EBITDA of Chinese HY/unrated issuers with 2019-20 bond maturities is over 11x and interest cover ratio is around 1.8x (Bloomberg data). LGFVs/regional government owned entities partially explain the high leverage. This, will likely, raise refinancing concerns in several cases (around 20% of bonds due in 2019 and 30% in 2020 trade at yields of over 15% reflecting this stress). 2. Repricing of secondary market: We are likely to continue to see issuers price well wide of secondary in order to get deals done, weakening secondary market prices.

Value in HG after 2018 spread widening: for example, Indian and Indonesian quasi-sovereigns have issued 10Y bonds at spreads of 230-250bp during the year, on average around 40-50 bp wider than 2017 and at levels close to those last seen in 2012-13, despite fundamentals being largely unchanged year on year. A recent Indian quasi-sovereign printed a 10Y deal at a spread of 310bp, compared to 235bp and 160bp for its own deals in August 2018 and November 2017 respectively. We see value in such HG deals, especially as there are fewer fundamental issues in this space.

Indian and Indonesian HY relatively expensive: while there are selective opportunities, generally Indian and Indonesian HY trade on the expensive side (see figure below) given the almost absence of meaningful supply. However, given the stronger technicals, we expect the better-quality names (BBs) to hold up better. Indian and Indonesian credits also face less credit stress compared to Chinese issuers, as seen in the lower dispersion of single B yields. That said, short dated (~2Y) BB Chinese paper is a pocket of value (e.g. established BB property developers at over 7% for a 2-3Y paper).

Median yield and dispersion of 3-5Y USD bonds



IN=India; ID=Indonesia; CN=China
Source: Bloomberg, DBS

Neel Gopalakrishnan

Credit

Equities: Cautious but opportunistic

We remain cautious but opportunistic on Asia markets. A strong USD, weak Asia currencies, and higher US interest rates are major headwinds for Asia markets. However, given how low valuations are, and seeing how excessive pessimism has prevailed, we believe upside risks are there for markets. Investors are urged to watch for volatility, be defensive and keep cash to deploy when opportunities arise.

With the recent sell-off, Asia ex-Japan is now near one standard deviation below average. This is the level at which it used to bounce around at times of market stress. We think there is good support for markets at this level by long-term investors looking for value. We recommend stocks with earnings visibility and yield plays with growth to ride out the volatility.

There are also cash levels waiting to be deployed. According to an EPFR survey, as of end-October, cash levels among Asia ex-Japan funds had reached an all-time high since 2011! Almost at capitulation level, we believe pessimism is at its extreme among investors. There are hence bullets for the markets to stage a rebound once some of the uncertainties are resolved. For instance, a relief rally triggered by easing trade tension or a less hawkish Fed could present attractive trading opportunities. Investors should maintain a list of bombed out value plays in the event this scenario plays out.

Our current preferred markets are China and Singapore. The investment case for China-related equities listed in Hong Kong remains opportunistic, in our view. With low valuations, policy stimulus, and doors for trade talks which are still open, we believe there are upside risks to the market. While it may be too early to talk about re-leveraging in China, some degree of de-regulation could take place and benefit a lot of the sectors in the same manner these sectors were negatively affected in 2018. Key sectoral picks in China include the Chinese insurers, banks, Internet, telco equipment, healthcare and education, which are supported by long-term policy goals. Likewise, **we believe long-term investors can find value in Singapore,** as it is one of the cheapest markets in terms of price-earnings ratio and dividend yield.

We believe there is upside risk for the ASEAN region as major pressure points could turn favourable. The potential topping of the USD, bottoming oil price, pause in interest rate hikes, and peaking of US bond yields, could see prices skewed to the upside, and ASEAN markets are typically sensitive to such factors. Common investment themes in the region include government spending, resilient domestic demand, and how companies can benefit from the ASEAN Economic Community (AEC). Thailand and Indonesia will hold elections in the first half of next year and domestic sentiments can be positive. **We look for inflation to peak in the Philippines as a major catalyst for the market.** Most preferred market among emerging ASEAN is Thailand, and least preferred Malaysia.

We believe investors will still be attracted to Korea as this is the cheapest market. Improving China relationship is a major catalyst for the market**.**

Taiwan and India are likely to underperform the region. Taiwan remains the slowest-growing economy in the Asia ex-Japan region into 2019. Despite the recovery in exports (which are now waning), domestic demand has stayed relatively lacklustre amid the weakness in public confidence, and the lack of strong policy stimuli. We have an Underweight in India for now and look for signs of low oil price and inflation to prevail to turn more positive in the market.

Asia market recommendations for Q1 2019

Overweight	Neutral	Underweight
China / HK	Philippines	Taiwan
Singapore	Indonesia	India
Thailand	Malaysia	
	Korea	

Joanne Goh

Equities

China: Fiscal to the rescue?

	2017	2018F	2019F	2020F
Growth, yoy%, ave	6.9	6.6	6.2	6.0
Inflation, yoy%, ave	1.6	2.1	2.3	2.3
Currency, vs USD, eop	6.51	7.00	7.10	6.90
Policy rate, %, eop	4.35	4.35	4.35	4.35
10-year yield, %, eop	3.90	3.70	3.30	3.30

High Frequency indicators suggested economic resilience hitherto. Export growth has held up well. Shipment to the US even accelerated in 2H18 despite escalating trade tensions. US President Trump's decision to delay executing 25% tariff on Chinese exports until January 2019 clearly hurried US importers to fill inventories. But plunging PMI export orders indicates those front-loading activities are over. Exports are set for a notable fall in 1Q2019. Mainland firms are struggling with shrinking orders. A weakening CNY also raise the costs of imported materials. Industrial profit growth will fall, while the continued crackdown on shadow finance will mitigate credit growth.

The service sector, which is less cyclical than the industrial sector, will eventually be impacted. Companies are scaling back capex and hiring due to uncertainty ahead. Consumer will become more conservative on discretionary spending. In fact, soaring property prices have been ramping up household indebtedness. A greater proportion of disposable income goes to service mortgage repayment. A recent spike in rental costs across tier-one cities has created difficulties for younger urbanites, a key consumer group of the country.

While the plan for sweeping personal tax cuts may buttress consumer sentiment somewhat, the direct impact is expected to be modest. The cuts are estimated to lift headline GDP growth by 0.2%, which is insufficient to offset the negative impact arising from Sino-US trade tensions.

More fiscal support is likely. Import tariff reductions on nearly 1,500 consumer products in July were encouraging. Easing the trade war pain further requires reducing corporate income taxes and social security premiums alongside raising tax rebates for exporters.

Given the ongoing de-risking campaign, it is hard to envision another wave of infrastructure stimulus. Still, tax cuts alone will drive budget deficit higher. The actual deficit ratio is projected to rise to 3.8% in 2019 from 3.6% this year.

Monetary policy will continue to remain accommodative. Bank's reserve requirements were slashed four times this year to encourage lending. PBOC has been engineering a sharp decline in interbank rates via open market operations. They will have to bring reverse repo rate down more to alleviate pressure on corporate balance sheets.

Heightening risk aversion however mitigates the intended effectiveness of monetary policy. Smaller companies have difficulties in securing loans even at higher borrowing costs. The deterioration of corporate cash flow is evident by the recent collapse in M1 growth. **Further reserve requirement reduction is likely, in our view.**

CPI is projected to edge up to 2.3% in 2019 from 2.1% in 2018. Rising food prices will continue to put upward pressure on the headline. Pork price inflation, which carries hefty influence in the CPI basket, is on the rise due to the ongoing outbreak of African swine fever. On top of tariff, the weakening CNY are pushing up import prices.

Yet we see some offsetting factors that will keep inflation on the low side. Health cost inflation, which had surged in recent years after the relaxation of price controls on public medical services, is set to decline. Tighter property curbs will depress home prices and rentals. Monetary policy bias can therefore remain comfortably on the easing side.

Chris Leung and Nathan Chow

Hong Kong: Softening growth and asset markets

	2017	2018F	2019F	2020F
Growth, yoy%, ave	3.8	3.3	2.5	2.0
Inflation, yoy%, ave	1.5	2.5	2.7	2.5
Currency, vs USD, eop	7.81	7.85	7.83	7.79
Policy rate, %, eop	1.75	2.75	3.75	3.75
10-year yield, %, eop	1.75	2.60	2.75	2.75

Increasing external headwinds

Trade performance is expected to drift down in 2019 due to intensifying Sino-US trade tension. China and the US are Hong Kong's top two export destinations. Exports to China and the US accounted respectively for 79.1% and 12.4% of Hong Kong's GDP. If China and the US impose tariffs on each other on Jan 1st 19, it will hurt Hong Kong's re-exports performance. By then, those front-loading activities to avoid tariffs are finished. The contraction in trade finance points to sluggish trade performance ahead. Exports of services will be negatively impacted as well. Cross-border financial activities will continue to decelerate, spilling over onto travel services and visitor spending.

Softening domestic demand and asset markets

The sharp fall in the Hang Seng Index will translate into negative wealth effect and moderate domestic consumption (60% of GDP). Despite a 20-year low jobless rate of 2.8%, the demand for labour, of which 11.6% comes from the import/export trade and wholesale sectors, is set to weaken.

The property market will cool down further after 48 months of stellar growth around 50%. The Centa-city Leading Index registered a 3.2% decline since end-July. The contracting building and construction and cost of ownership transfer component of GDP also reflects such pessimism.

The confidence of Hong Kong's businesses in China, particularly in the Greater Bay Area, has been hurt by the escalation in trade tensions. Hong Kong is the largest source of realised foreign direct investment for China (53.1% share in 2017), especially in the Guangdong province (63.8% share in 2016). Meanwhile, Guangdong's exports accounted for 51.7% of its GDP in 2017, well above the national average of 18.6%. Pressures on the property market could rise if unfavourable business conditions prompt owners to liquidate their holdings.

But the fall in property prices is manageable. The resilient job market has kept the delinquency ratio of mortgage loans outstanding for more than 6 months (0.01%), and the share of private co-financing scheme among total mortgage value (1.7%) low. Both global and local interest rates have remained low by historical standards. Although the prime rate may rise 5 more times from now, it is significantly below the peak (10.25%) seen in 1997.

Rigidity of land policy will also keep upward pressure on private housing prices. The authority proposed to raise the ratio between public and private housing of new land supply from 6:4 to 7:3. Building purpose of 9 pieces of private property land will be changed to public housing. Also, the deterioration in the demand-supply balance will not cease until 2019. The first phase of the proposed the new 1,700-hectare reclamation project is projected to complete by 2032. Assuming this 20-year plan can satisfy housing demand for 1.1mn people as per the Policy Address, the newly-built artificial islands can only meet the demand of the immigrants from China (150 immigrants x 365 days x 20 years). More land is required to fulfil the demand from local natural events (e.g. marriage and birth-death).

Inflation at bay

In 2019, robust economic conditions seen in the past 21 months will slow down due to external headwinds. Local labour cost will moderate accordingly. Softening housing market will drag private rental cost down the road. Yet, food price may accelerate to the widespread of pig disease. Upward adjustment in public housing rentals will also play a role in upholding the headline price pressure. CPI for 2019 is projected to be flat at 2.7%.

Samuel Tse

India: Risk catalysts subside

	2017*	2018F	2019F	2020F
Real GDP growth, yoy%, ave	7.1	6.7	7.1	7.4
Inflation, yoy%,	4.5	3.6	4.0	4.2
Core inflation, yoy%,	4.8	4.7	6.0	5.4
Currency, against USD, eop	65.9	65.0	74.0	76.5
Monetary policy rate, %, eop	6.25	6.00	6.50	7.00
10-year yield, %, eop	6.80	7.60	8.00	8.20

*Year ending March 2017

Indian rupee and bonds were amongst the hardest hit in Asia this year, despite better defences vs 2013. **Nerves stabilised in 4Q18 as risk catalysts ease, providing reprieve to the domestic markets.**

Real growth is likely to witness a cyclical slowdown into 2019, while still emerging as the fastest in the region. The correction in oil prices and a stable rupee are timely, helping to cushion the slowdown at the margin. Rural demand (farm sector) is still to materially improve, as inferred from lower tractor and two-wheeler sales, along with tight financing conditions and weaker trade balance (due to a tougher global demand backdrop). Fiscal impulse will be negative as weak revenues necessitate a cut in expenditure. However, contrary to expectations of a big miss, the FY19 union budget target of -3.3% of GDP might be overshot by a small -0.1-0.2%, in our view. States might miss the FRBM threshold of -3% of GDP for a fourth consecutive year on higher revenue expenditure. Barring a sharp lift in GST revenues in FY20 and subsequent pick-up in tax to GDP ratios, the fiscal math might be a constrain in FY20 as well.

On the supply-side, the financial sector is faring better as deposit and credit growth improve, though the liquidity/ regulatory squeeze on non-banks will hurt credit availability down the line.

We expect FY19 real GDP to expand 7.1% YoY tempering our earlier forecast of 7.4%. FY20 is seen at a faster 7.4%, assuming the drag from weaker agricultural prices and income ease, along with favourable base effects from mid-2019.

Inflation continues to surprise on the downside. FY19 is tracking an average of 4.2% YoY in first seven months of the year, higher than FY18's 3.6%, but sequential trends are undershooting historical averages. Bulk of this weakness emanates from low food costs, with little material boost from MSPs (Minimum Support Prices), suggesting procurement of crops have not kept pace. While positive for inflation, a prolonged phase of weak food/ farm prices trigger concern over the negative repercussions for agricultural incomes and rural demand. Notwithstanding the lagged pass-through of a weak rupee and firm oil prices, inflation might register 4% rise, on target in FY19. FY20 inflation is seen at 4.2%, factoring in a modest increase in food inflation on pro-farm support measures and steady commodity prices.

Expectations for rising inflation and rate hikes have been pared, with real rates at elevated levels. This provides the RBI the leeway to hold rates unchanged in FY19 (here). The likelihood and scale of policy tightening risks in FY20 hinge on external developments, particularly rupee and oil.

External balances will, meanwhile, receive some relief as global oil prices ease (>30% between October and November 2018) and foreign portfolio outflows slow. Noting a lagged impact on imported purchases, FY19 CA deficit is likely to be close to -2.7% of GDP, before easing to -2.0-2.3% in FY20. Slower FDI flows and to-date portfolio outflows will be a drag on the FY19 financial account, pushing the basic balance of payments i.e. CAD and FDI, to negative. Subject to global risks, FY20 deficit is expected to narrow.

State polls in November-December kickstart a busy political period, until the April-May 2019 general elections. For the markets, politics poses a short-term hurdle, with corporate earnings, growth, the rate environment and global triggers still the dominant long-term drivers for the broader market direction.

Radhika Rao

Indonesia: Elections to boost sentiments

	2017	2018F	2019F	2020F
Growth, yoy%, ave	5.1	5.1	5.2	5.1
Inflation, yoy%, ave	3.8	3.2	3.8	3.6
Currency, vs USD, eop	13,496	14,800	15,600	15,200
Policy rate, %, eop	4.25	6.0	6.5	6.5
10-year yield, %, eop	6.3	8.1	8.8	8.4

Indonesians will elect President, Vice President, as well as national and regional legislatures next year. We see this election as a catalyst of growth (from consumption side) or, at least, a neutral rather than a drag on growth since political stability is intact. One of the reasons is because Jokowi's running mate is an Islamic figure from the largest Muslim Organization, *Nahdatul Ulama.* This has shifted the campaign tone out of sectarian politics, which has recently dominated several regional elections. The change might increase confidence of better political stability during election period.

Despite strong external headwinds, Indonesia is growing around its potential rate, supported mainly by public infrastructure projects. Even though improved tax compliance effort has affected disposable incomes, consumption growth was quite robust, thanks to stable inflation. The biggest drag to growth came from the trade balance. As a net oil importer, higher oil price has widened the current account deficit, while, concurrently, commodity prices in Indonesia's export basket softened. Beyond this cyclical issue, the current account deficit in Indonesia will persist as long as saving-investment gap remains negative.

From the fiscal side, the overall stance is contractionary. However, we believe that the growth could benefit from expenditure impulse as more spending is allocated towards higher short-run multiplier spending (including the spending for subsidies and regional transfers). Despite the government's strong commitment for fiscal sustainability and budget transparency, below-the-line risk such as fuel price subsidy through a state-owned energy enterprise, Pertamina, might pose an additional fiscal risk should oil price rise again.

Even though we expect public investment will remain robust in 2019, private investment might yet start to kick in. Construction state-owned enterprises are having solid orderbook backlog that might extend to 2022 (assuming the same rate of project implementation rate), assuring a stable public investment next year. The wait-and-see behaviour of private investors, normal during election year, may cease and the government continuous effort to improve the investment climate might start to have an impact. For instance, wider coverage of tax holiday/incentive and relaxation of investment negative list, which was announced as the 16th economic policy package early this month, could be helpful.

We think growth might pick up to 5.2% in 2019 supported mainly by election-transitory boost to consumption. Growth may slide back to 5.1% in 2020 in the face of stronger external headwinds.

Inflation has been benign in 2018 due to the combination of stable rice price and fixed retail fuel price. Yet, we still think that the government might need to adjust domestic retail fuel price to catch up with the economical price even if oil price eased to $60/bbl. We think inflation might inch toward 4% in 2019 and ease back to 3.6% in 2020 barring further supply side disruption.

Bank Indonesia (BI) has shown its commitment to be pre-emptive and ahead of the curve this year. BI's hawkish tone will likely not change in 2019, especially as inflation risk is expected to be high and balance of payment pressures could remain elevated. We see flat policy rate throughout 2020 barring global shocks or any significant downfall on domestic growth.

Masyita Crystallin

Malaysia: Risks to growth and fiscal

	2017	2018F	2019F	2020F
Growth, yoy%, ave	5.9	4.7	4.5	4.2
Inflation, yoy%, ave	3.8	1.1	2.5	1.6
Core inflation, yoy%, ave	2.3	1.0	1.6	0.9
Currency, vs USD, eop	4.06	4.20	4.25	4.15
Policy rate, %, eop	3.00	3.25	3.25	3.00
10-year yield, %, eop	3.91	4.20	4.30	4.25

The economy started strongly, but growth quickly fizzled out in the second and third quarters of 2018. GDP growth in the third quarter moderated to 4.4% YoY (6.7% QoQ saar), from 5.4% in the first quarter. Private consumption remains the key contributor as consumers have loosened their purse strings amid an improving labour market and lower consumption tax. However, investment growth remains lacklustre as several high-profile projects were put on the back-burner following the fiscal rationalisation by the new government. The biggest drag came from export, as sales fell by 0.8% in the quarter. This has led to a sharp drop in net exports (-7.5%) even though imports have also moderated.

Indeed, external headwinds are picking up amid the rising trade protectionism and an ongoing downcycle in global electronics demand. Trade disputes between the US and China, and the normalization of global interest rates are expected to take a toll on the outlook. We expect GDP growth to slow down to 4.5% in 2019 and 4.2% in 2020. This is down from our forecast of 4.7% in 2018.

The new Pakatan Harapan government has tabled its first budget since coming into power. The focus is on institutional reforms, improving the standards of living, particularly for the lower income groups, as well as encouraging entrepreneurship. A slew of generous measures was introduced along with new tax initiatives to close an estimated fiscal gap of MYR24bn arising from the removal of the GST. Overall, the budget remains expansionary despite concerns regarding the ability to extract sufficient revenue. While this entails a significantly bigger budget deficit of 3.4% of nominal GDP in FY19, from a revised 3.7% in FY18, the government has demonstrated commitments toward fiscal sustainability. The fiscal deficit is projected to narrow to 3.0% of GDP by 2020. The medium-term plan is to reduce the fiscal deficit to 2.0%.

There are two key risks to the fiscal target forecast. Growth could potentially fall short of expectation amid an increasing challenging external environment, and there could be uncertainties on revenue flows, particularly given the higher dependence on oil-related revenues (31%). This could also potentially point to risks the government cutting back further on spending should revenue surprise on the downside.

Given the limitation on fiscal policy, monetary policy could potentially turn accommodative. Conditions in the external environment are expected to deteriorate heading into 2020, with risk of a US recession towards the tail-end of 2020. With higher global interest rates and weaker growth momentum, inflationary pressure will most likely remain benign. Though we expect inflation to rise to 2.5% in 2019, this comes mainly on the back of a low base this year (1.1%). Expectation is for headline CPI inflation to ease towards 1.6% in 2020, which could put in place the basis for a more accommodative monetary policy stance should weaker global demand affects growth significantly.

We expect the central bank to maintain stable monetary policy in 2019 but rhetoric could turn more dovish in 2020 as the need to meet the fiscal target limits the flexibility of fiscal policy. With that, although we expect the Overnight Policy Rate (OPR) to remain unchanged at 3.25% for 2019, we believe Bank Negara (Malaysia) will introduce pre-emptive easing, lowering OPR by 25bps to 3.00% in the third quarter of 2020.

Irvin Seah

Malaysia

Philippines: Still going strong

	2017	2018F	2019F	2020F
Growth, yoy%, ave	6.7	6.3	6.5	6.4
Inflation, yoy%, ave	2.9	5.3	4.7	3.8
Currency, vs USD, eop	49.9	53	55	54
Policy rate, %, eop	3.0	4.75	5.25	5.25
10-year yield, %, eop	5.7	7.4	7.9	7.7

Growth has decelerated this year, but the Philippines remains one of the fastest growing country in Asia. The main support to growth came from both public expenditure and infrastructure projects. Government's strong commitment to the Tax Reform for Acceleration and Inclusion (TRAIN) initiative bore fruits. The revenue generated from TRAIN was used for infrastructures development and direct transfers to support consumption of the lower income. Infrastructure related construction was the only sector that picked up recently.

The rise in inflation this year was partly related to tax reform (TRAIN) which involves higher excises tax for automobile, fuel products, tobacco and sugar-sweetened beverages, as well as higher oil and rice prices. The prospect of lower oil price on average next year would soften inflation. Yet, we think, in terms of inflation, it is no time to be complacent just yet. We estimate inflation will ease, but would stay above BSP target range at 4.7% in 2018 and ease to 3.8% in 2020.

Consumption has remained robust amidst the high inflation, partly due to tax cut as part of the TRAIN, which benefited wage earners with income less than PHP2mn. Given the resilience, and the prospect of inflation easing in the next two years, we believe consumption could grow even stronger.

From the fiscal side, government seems committed to keep an expansionary fiscal stance for the next two years. Further support from fiscal will depend also on whether TRAIN package 2 will be approved. Approval of the 2nd package might be more politically challenging as it aims to revamp the tax incentives system to counterbalance potential decrease in tax revenue. Despite being fiscal neutral, the second package could catalyse private sector development and hence investment further. We think, if the government follow through with the current reforms, it will address some supply side barriers to achieve higher potential growth.

Stronger external headwinds have widened current account deficit although support from remittances inflows is still strong. Weak global electronic demand dragged down Philippines electronic exports, accounting for 55% of total exports. While oil imports increased due to higher price this year. We think that balance of payment pressure will not go away next year despite softened oil price, for two reasons: firstly, global electronic demand might still be in the downcycle, secondly, capital goods imports for infrastructure projects might remain strong especially as the new "annual cash-based appropriations' budget starting in 2019 could speed up project implementation.

We expect real GDP growth to pick up to 6.5% in 2019 and moderate slightly to 6.4% in 2020 as global trade trends downward.

We see less option for monetary policy, as growth acceleration and fiscal expansion will put pressure on inflation from the demand side. In addition, being a late comer to hike rate this year, BSP still need to catch up to have competitive real rates amongst peers. Currently the real rates are still negative or close to zero. As such, even though inflation is expected to soften, it is likely to remain above BSP's upper limit. Hence, we pencil in another two rate hikes in 2019 and flat in 2020.

Masyita Crystallin

Singapore: Slowdown ahead

	2017	2018F	2019F	2020F
Growth, yoy%, ave	3.6	3.4	3.0	2.8
Inflation, yoy%, ave	0.6	0.7	1.8	1.5
Core inflation, yoy%, ave	1.5	1.6	1.7	1.4
Currency, vs USD, eop	1.34	1.40	1.42	1.38
10-year yield, %, eop	2.00	2.60	2.90	2.50

GDP growth for the third quarter saw a moderation to 2.2% YoY, from 4.1% previously. While this could be flagged out as a concern, it is largely due to the high base in the same period last year. On the margin, growth momentum improved to 3.0% QoQ saar, from a mere 1.0% in 2Q18. Besides the high base effect which weighed down on the year-on-year figures, the better sequential growth number nonetheless underscores some degree of resilience in the economy. That said, there are concerns regarding the risk aversion and faster than expected hikes in interest rates causing excessive volatilities in the financial markets, and property cooling measures weighing down on the business service (i.e., real estate) and construction sectors in the coming quarters.

On the export front, electronics cycle has peaked, and demand could be waning. Trade war could also add salt to wound. Although the trade diversion effect from the trade disputes between the US and China could benefit ASEAN, including Singapore, this would likely occur in the medium to longer term (see DBS article, "Singapore: Opportunity from the trade war" dated 1 Oct18). In the near term, a rebalancing of trade dynamics is emerging.

For example, non-oil domestic exports (NODX) to China fell by an average of 20.5% between Aug18 to Oct18 in contrast to 34.5% surge in sales to the US. Though this could suggest trade diversion in the making, the final net effect on Singapore would much depends on the relative contributions to overall export performance from these markets, as well as the product category. Nonetheless, we expect some drag on export performance in near term, and it should be manifested in the headline figures in the coming months.

Besides trade headwinds, global economic outlook is expected to be weighed down by tighter liquidity conditions. We expect more US Fed hikes in 2019, which will likely stoke repricing of financial market risks, thereby affecting business sentiments and investors' confidence. Such economic overcast will likely to persist beyond 2019. With these in mind, we see economic momentum to continue to moderate in the coming two years. GDP growth is expected to ease to 3.0% and 2.8% in 2019 and 2020, down from 3.4% this year.

With growth slowing, inflationary pressure should remain manageable. We expect both headline and core inflation to peak in 2019, and subsequently ease towards about 1.5% in 2020. While core inflation should remain stable in the near term, the all item CPI series is expected to rise to 1.8% in 2019, from 0.7% this year. This largely stems from a low base effect due to declines in car prices arising from the supply glut in the secondary car market. Barring any supply side shock in the external environment, inflationary pressure should otherwise remain subdued amid a slow growth scenario.

The Monetary Authority of Singapore (MAS) is, barring global shocks, likely to keep normalizing monetary policy in 2019. The scope for more normalization is also reflected by the rise in the Sing dollar nominal effective exchange rate (SGD NEER) to the top of its policy band. The Singapore dollar policy was first returned to a modest and gradual appreciation stance in April 2018 with a slight increase in the policy band. This followed by a similar back-to-back adjustment in October. According to our model, the slope has yet to return to the appreciation pace seen before the first easing in January 2015.

Irvin Seah

South Korea: Policy support at play

	2017	2018F	2019F	2020F
Growth, yoy%, ave	3.1	2.7	2.6	2.4
Inflation, yoy%, ave	1.9	1.6	1.7	1.6
Core inflation, yoy%, ave	1.5	1.2	1.6	1.6
Currency, vs USD, eop	1067	1140	1180	1140
Policy rate, %, eop	1.50	1.75	1.75	1.75
10-year yield, %, eop	2.47	2.30	2.50	2.30

The economy is estimated to have grown 2.7% this year, on the back of the continued recovery in exports and increase in government spending. We expect GDP growth to slow slightly to 2.6% in 2019.

Exports outlook faces some headwinds. The US-China trade tensions this year have not hurt the supply chain in South Korea. But the negative spillover effects would become more notable in 2019. It remains possible that the US's tariffs on the USD200bn Chinese exports will be raised further to 25% next year. It also can't be ruled out that the US will move further to impose tariffs on the remaining USD267bn Chinese exports.

Trade conflicts also happen between South Korea and the US. South Korea has received exemptions from the US on steel tariffs this year, by making compromises to revise the KORUS FTA (doubling a cap on the number of automobiles imported from the US). This, however, does not guarantee that it can be exempted by the US on the new automobile tariffs that Trump has threatened to impose.

The risk of capital outflows bears watching. The KRW markets have stayed resilient during the Fed tightening and EM volatility this year, thanks to the country's strong foreign reserve coverage and solid current account balance. Foreign inflows into KRW bonds remained buoyant in the first ten months of 2018 (KRW13.7tn), offsetting the outflows in the equity market (6.8tn). Outflow pressures may increase next year, considering that the KRW-USD negative rate differentials will widen further to more than 100bps and the outlook for GDP growth/corporate earnings will weaken.

Inflation will be less of a problem. The government's push for minimum wage hikes this year didn't trigger a sharp rise in inflation. Unemployment rate rebounded as companies reduced new hiring to offset the increase in wage costs. The labour market will likely remain soft in 2019 amidst a weaker prospect for GDP growth and corporate earnings. Meanwhile, oil price inflation will likely ease on the YoY basis thanks to the high base. We project that CPI will stay below the central bank's 2% target next year, at 1.7%.

Policy support will remain intact. The government has opted for fiscal policy expansion to support the economy in a pre-emptive manner. According to the 2019 budget proposal, government spending will increase by nearly 9% next year, the biggest since the 2008 global financial crisis. Budget focus is given to jobs, social welfares and education, which should help to bolster private consumption growth in 2019.

The Bank of Korea (BOK) is expected to keep monetary policy unchanged next year, striking a balance between the risk of a weaker macroeconomic outlook and that of rising capital outflows. While the BOK hiked rates by 25bps this year to contain property prices, we don't think asset inflation will be a bigger problem next year to necessitate further policy responses. Our forecast is for the benchmark rate to remain at 1.75% in 2019.

The adverse impact of the US-China trade war shouldn't be overestimated. South Korean manufacturers have already diversified overseas production bases from China to other emerging markets in recent years (e.g., Samsung and LG have expanded production facilities in Vietnam), which provides options for them to reroute trade and circumvent the US tariffs. Meanwhile, given the industry overlap with China, South Korea could possibly benefit from the trade diversion effects in certain sectors, such as plastics, rubber, metal, and transportation equipment, in our view.

Ma Tieying

Taiwan: Peak cycle

	2017	2018F	2019F	2020F
Growth, yoy%, ave	2.9	2.7	2.2	1.8
Inflation, yoy%, ave	0.6	1.5	1.0	1.0
Core inflation, yoy%, ave	1.0	1.2	0.7	1.0
Policy rate, %, eop	1.375	1.375	1.375	1.375

Taiwan's short-term economic cycle may have peaked after three consecutive years of recovery. We expect GDP growth to slow to 2.2% in 2019, down from 2.7% this year.

Export outlook faces multiple challenges. Global demand is expected to soften next year, due to slowing growth in China and other emerging markets and peak growth in the US. Despite positive catalysts from the new technology (IoT, AI, automotive electronics), weaker demand from the traditional 3C segments and decline in cryptocurrency-related chip demand cast shadows on the electronics outlook in the near term.

The adverse impact of the US-China trade war may also emerge next year. Taiwan's supply chain will be hurt modestly under our base case scenario, which assumes that the key consumer electronics products will continue to be excluded from the US's tariff lists against China. Trade disruption risks would increase if the US were to impose tariffs on the remaining USD267bn Chinese exports.

The indirect impact of rising global interest rates also bears watching. While Taiwan's external financing capabilities are strong, it does not mean it will be immune to the risks of Fed rate hikes and USD liquidity tightening. Higher USD financing costs could weigh on the growth prospects in emerging markets and thus Taiwan through the trade channel. Owing to growth concerns, the TAIEX saw USD4.7bn outflows during the global market jitters in October this year. Foreign ownership ratio has fallen from the peak but remains high at 39% presently.

Oil prices will be less of a worry. The rise in oil prices this year has not hurt the downstream consumers in Taiwan, as the state-owned Chinese Petroleum Corporation froze retail fuel prices in 4Q18. Thanks to the US's temporary waivers on Iran sanctions and a weaker demand outlook, oil prices are expected to stabilise in 2019. Taiwanese consumers will likely remain unscathed, even after domestic fuel prices return to the floating mechanism early next year.

There are policy options available to cope with the short-term external challenges. Government debt has fallen from the peak of 39% of GDP in 2012 to 36% in 2017, well below the legal ceiling of 50%. This provides sufficient space for the government to use fiscal measures to shore up the economy next year, if needed. Political motivations may also increase in the next one year, given that the ruling DPP party suffered a landslide defeat during the local elections in November 2018 and the next presidential election will arrive in January 2020.

Taiwan's central bank (CBC) has the room to keep monetary policy accommodative to support the economy. The CBC has refrained from hiking rates so far this year, in absence of serious pressure from consumer price inflation, asset price inflation, or capital outflows. Considering that CPI numbers have passed the peak and financial imbalances are not a glaring problem, we expect the CBC to continue keeping rates unchanged at 1.375% in 2019.

From a long-term point of view, the US-China trade war may not be a completely negative for Taiwan. In light of stricter US scrutiny on the IP/cybersecurity issues of Chinese products, global tech firms may look for alternative production bases in the region, including Taiwan. The China-based Taiwanese tech firms may also consider returning to Taiwan to invest. In the low-end manufacturing sectors, to avoid the US tariffs on Chinese products, Taiwanese firms will likely further diversify overseas production bases from China towards others emerging markets. This trend has been underway, thanks to the wage cost increases and structural transition in the Chinese economy in recent years.

Ma Tieying

Thailand: External headwinds and political noise

	2017	2018F	2019F	2020F
Growth, yoy%, ave	3.3	4.1	3.8	4.0
Inflation, yoy%,	0.7	1.1	1.4	1.5
Core inflation, yoy%,	0.6	0.6	0.7	0.7
Currency, against USD, eop	32.6	33.0	33.5	32.5
Monetary policy rate, %, eop	1.5	1.5	2.0	2.0
10-year yield, %, eop	2.60	2.90	3.00	2.80

The Thai baht was a favoured defensive trade in a volatile 2018, backed by an economy with relatively firm growth, strong current account surplus (~11% of GDP) and foreign bond inflows, even as interest in equities was less upbeat.

2019 is likely to be a more challenging year. Growth is likely to soften, with 3Q18 setting the stage for a lull period. The economy's two main engines - exports and tourism, are under a cloud. Export growth eased to 8.6% YoY in first ten months of 2018 vs 10% in 2017, accompanied by a 15% rise in imports. Trade surplus narrowed to USD8bn vs USD15bn in 2017, signalling a slower built up in this year's current account surplus. Demand conditions will be tougher in 2019 as US-China trade relations remain fraught, with a follow-up of protectionist policies to impact key Thai exports, including automobiles and manufacturing products. The US and China, cumulatively make up about a quarter of Thai exports. Concurrently, global growth is also likely to hit a speed-bump, led by Chinese growth at low-6% (according to our forecasts). The ASEAN 5 region, which is 15-16% of Thai exports is also facing slowdown risks, as a second derivative of easing China and global demand on the regional supply chain takes effect.

Tourism earnings weakened this year as a recent tragedy slowed the flow of visitors from China (a third of total). Efforts are underway to draw them back, along with diversifying to CMLV travelers, easing visa restrictions and encourage higher spending per trip from other nationalities to increase revenues. Slower tourist arrivals not only carry growth implications (sector accounts for ~12% of GDP) but is also likely to narrow the current account surplus to 9.5-10% of GDP in 2018 vs 11.2% in 2017. 2019 will edge down to 8% of GDP.

Stronger domestic drivers will be unable to offset weaker externals. Private consumption is expected to be stable, benefiting from modest improvement in farm incomes and populist fiscal measures. Public spending will get a tailwind from awarded infra projects, but pump-priming boost will slow after the February 2019 election. Export dependency of the manufacturing sector will be a strain, which will slow further improvement in the capacity utilization rate (currently ~70%). **From this year's forecast of 4.1% YoY, growth is likely to moderate to 3.8% in 2019.** This compares to NESDB's forecast at 4.2% and 2019 at 3.5-4.5%.

Inflation is near peak and is likely to trend lower in rest of this year and early next. Our forecast of 1.1% for 2018 and likely uptick to 1.6% next year due to base effects, will keep inflation at the weaker end of BOT's target range of 1-4%. Core inflation continues to hover at 0.7%, flat for the past six months. With global oil prices down more than 30% from year's highs and THB outperformance, imported inflationary risks are subdued.

More Bank of Thailand members have voted in favour of raising rates at recent meetings. The need to create a policy buffer for future contingencies (currently at 1.5%) and narrow the negative rate differential between Thai benchmark rates and the US, are justifications for the BOT's seemingly hawkish bias. Faced by the likelihood of slower growth in 2019 and subdued inflation suggest that the rate hiking cycle is likely to be frontloaded and shallow at best. Hikes, if delivered are likely to be completed by 1H19, with December's meeting also 'live' on this count. For rest of 2019 and 2020, we expect the BOT to stay on pause mode.

Radhika Rao

Vietnam: Beneficiary of trade wars?

	2017	2018F	2019F	2020F
Growth, yoy%, ave	6.8	6.9	6.6	6.3
Inflation, yoy%, ave	3.5	3.6	3.8	3.4
Core inflation, yoy%, ave	1.4	1.4	1.3	1.2
Currency, vs USD, eop	22425	23400	23500	23380
Policy rate, %, eop	6.25	6.25	6.25	5.75

Economic growth was exceptionally strong in 2018. Overall GDP growth registered 7.0% in the first nine months of the year. We reckon that overall GDP growth should surpass the official forecast of 6.7% to register 6.9%.

The export-oriented manufacturing sector was the star performers. Growth in the sector rose to 9% over the past three quarters, compared to 7.2% in the same period last year despite a moderation in export growth to about 15% in the first ten months of the year, from a full year average of 21.9%. Nonetheless, this sector should remain the key driver of growth as foreign direct investment in this sector has stayed strong, which will eventually translate into high production capacity.

While we do expect external demand to ease steadily heading into 2019 and 2020 due to gradual normalization of global monetary policies, the risk on the external front in the near-term stems largely from the ongoing trade disputes between the US and China. Yet, despite the concerns regarding possible dilution of regional trade flows, which could adversely impact the outlook for Vietnam, we believe that Vietnam could become one of the countries in ASEAN that will likely benefit from the trade war. The country is well-positioned as an alternative to China for US importers seeking new sources, and for both global and Chinese companies looking to reshuffle their supply chains to a new low-cost destination. Such value proposition to investors could potentially help to mitigate some of the drag on growth arising from an increasingly challenging economic landscape.

Yet, the need for fiscal consolidation could imply slightly slower yet more sustainable growth ahead. Fiscal deficit remains elevated, at an estimated 6% in 2018, and government debt, though has moderated, is high (52.1%). We expect the authority to continue to invest in infrastructure and to build the capacity for growth but would take a more calibrated approach to balance the risk on the fiscal position in the coming years.

We expect overall GDP growth to ease to 6.6% in 2019, and subsequently to 6.3% in 2020. But the silver lining is that economic growth although slower, will be more sustainable and will increasingly be driven by productivity gains. Strong FDI flows into technology in recent years would augment domestic factors, resulting in better quality of growth. Early positive signs are already emerging. According to the National Assembly Economic Committee, labour productivity grew 6% last year, from the average 4.3% in the 2011-2015 period as a result of technological improvements.

Movement in oil prices was originally a risk factor on inflation but that has since been offset by the high base effect from earlier healthcare and education subsidy reforms. The expected fiscal consolidation ahead would also imply lesser domestic demand pull inflationary pressure. We reckon that inflation has peaked, and we foresee a more stable inflation outlook ahead. Overall CPI inflation should register 3.8% in 2019 and 3.4% in 2020, from 3.6% this year.

With a stable inflation and slower growth outlook, the SBV will most likely maintain a stable monetary policy in 2019. However, external risks could possibly compel the authority to support growth, particularly heading into 2020 where we expect global economic conditions to become even more challenging. On that, we reckon a slight easing bias in the medium term with two 25bps cuts in 1H20.

Irvin Seah

Growth, Inflation, Policy Rates & FX forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018f	2019f	2020f	2017	2018f	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	7.1	6.7	7.1	7.4	4.5	3.6	4.0	4.2
Indonesia	5.1	5.1	5.2	5.1	3.8	3.2	3.8	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.1	2.5	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.3	4.7	3.8
Singapore	3.6	3.4	3.0	2.8	0.6	0.7	1.8	1.5
South Korea	3.1	2.7	2.6	2.4	1.9	1.6	1.7	1.6
Taiwan	2.9	2.7	2.2	1.8	0.6	1.5	1.0	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.4	1.5
Vietnam	6.8	6.9	6.6	6.3	3.5	3.6	3.8	3.4
Eurozone	2.5	1.9	1.8	1.8	1.5	1.8	1.4	1.4
Japan	1.7	1.0	1.0	0.5	0.5	1.0	1.1	1.6
United States***	2.3	3.0	2.5	1.5	2.1	2.6	2.5	2.5

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.50	6.75	6.75	7.00	7.00	7.00	7.00	7.00
Indonesia	6.25	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.00	3.00
Philippines	5.00	5.25	5.25	5.25	5.25	5.25	5.25	5.25
Singapore**	2.10	2.30	2.55	2.70	2.70	2.70	2.70	2.70
South Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.25	0.25	0.50	0.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00
United States	2.75	3.00	3.25	3.50	3.50	3.50	3.50	3.50

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
China	7.10	7.20	7.15	7.10	7.05	7.00	6.95	6.90
Hong Kong	7.85	7.85	7.84	7.83	7.82	7.81	7.80	7.79
India	74.0	75.0	76.0	77.0	76.5	76.0	75.5	75.0
Indonesia	15000	15200	15400	15600	15500	15400	15300	15200
Malaysia	4.25	4.30	4.28	4.25	4.23	4.20	4.18	4.15
Philippines	53.5	54.0	54.5	55.0	54.8	54.5	54.3	54.0
Singapore	1.42	1.44	1.43	1.42	1.41	1.40	1.39	1.38
South Korea	1180	1200	1190	1180	1170	1160	1150	1140
Thailand	33.5	34.0	33.8	33.5	33.3	33.0	32.8	32.5
Vietnam	23500	23600	23550	23500	23470	23440	23410	23380
Australia	0.68	0.66	0.67	0.68	0.69	0.70	0.71	0.72
Eurozone	1.10	1.08	1.09	1.10	1.11	1.12	1.13	1.14
Japan	116	118	117	116	115	114	113	112
United Kingdom	1.26	1.24	1.23	1.22	1.23	1.24	1.25	1.26

Australia, Eurozone and United Kingdom are direct quotes

Forecasts

Rates Forecasts

		2019				2020			
		Q1	Q2	Q3	**Q4**	Q1	Q2	Q3	**Q4**
US	3m Libor	2.95	3.20	3.45	**3.70**	3.70	3.70	3.70	**3.70**
	2Y	3.05	3.20	3.35	**3.50**	3.50	3.50	3.50	**3.40**
	10Y	3.30	3.40	3.50	**3.60**	3.60	3.60	3.40	**3.20**
	10Y-2Y	25	20	15	**10**	10	10	-10	**-20**
Japan	3m Tibor	0.05	0.05	0.05	**0.05**	0.05	0.05	0.10	**0.10**
	2Y	-0.08	-0.05	-0.03	**0.00**	0.02	0.04	0.05	**0.05**
	10Y	0.14	0.16	0.18	**0.20**	0.20	0.20	0.22	**0.22**
	10Y-2Y	22	21	21	**20**	18	16	17	**17**
Eurozone	3m Euribor	-0.30	-0.30	-0.30	**-0.30**	-0.05	0.20	0.20	**0.20**
	2Y	-0.55	-0.40	-0.25	**-0.10**	0.05	0.15	0.15	**0.15**
	10Y	0.50	0.60	0.70	**0.80**	0.80	0.80	0.70	**0.70**
	10Y-2Y	105	100	95	**90**	75	65	55	**55**
Indonesia	3m Jibor	7.60	7.70	7.70	**7.70**	7.70	7.70	7.70	**7.70**
	2Y	7.60	7.70	7.70	**7.70**	7.70	7.70	7.70	**7.70**
	10Y	8.40	8.60	8.80	**8.80**	8.80	8.80	8.60	**8.40**
	10Y-2Y	80	90	110	**110**	110	110	90	**70**
Malaysia	3m Klibor	3.65	3.65	3.65	**3.65**	3.65	3.65	3.40	**3.40**
	3Y	3.75	3.75	3.75	**3.75**	3.75	3.75	3.60	**3.60**
	10Y	4.15	4.20	4.25	**4.30**	4.35	4.35	4.30	**4.25**
	10Y-3Y	40	45	50	**55**	60	60	70	**65**
Philippines	3m PHP ref rate	5.65	5.80	5.80	**5.80**	5.80	5.80	5.80	**5.80**
	2Y	6.85	6.90	6.90	**6.90**	6.90	6.90	6.90	**6.90**
	10Y	7.85	7.90	7.90	**7.90**	7.90	7.90	7.80	**7.70**
	10Y-2Y	100	100	100	**100**	100	100	90	**80**
Singapore	3m Sibor	2.10	2.30	2.55	**2.70**	2.70	2.70	2.70	**2.70**
	2Y	2.20	2.30	2.45	**2.50**	2.50	2.50	2.50	**2.40**
	10Y	2.70	2.75	2.80	**2.90**	2.90	2.90	2.70	**2.50**
	10Y-2Y	50	45	35	**40**	40	40	20	**10**
Thailand	3m Bibor	1.85	2.10	2.10	**2.10**	2.10	2.10	2.10	**2.10**
	2Y	2.00	2.25	2.25	**2.25**	2.25	2.25	2.25	**2.25**
	10Y	2.80	2.90	3.00	**3.00**	3.00	3.00	2.90	**2.80**
	10Y-2Y	80	65	75	**75**	75	75	65	**55**
China	1 yr Lending rate	4.35	4.35	4.35	**4.35**	4.35	4.35	4.35	**4.35**
	3Y	2.90	2.80	2.80	**2.80**	2.80	2.80	2.80	**2.80**
	10Y	3.30	3.20	3.25	**3.30**	3.40	3.50	3.40	**3.30**
	10Y-3Y	40	40	45	**50**	60	70	60	**50**
Hong Kong	3m Hibor	2.65	2.90	3.05	**3.20**	3.20	3.20	3.20	**3.20**
	2Y	2.60	2.85	3.00	**3.15**	3.15	3.15	3.15	**3.05**
	10Y	2.75	2.90	3.00	**3.15**	3.15	3.15	2.95	**2.75**
	10Y-2Y	15	5	0	**0**	0	0	-20	**-30**
Korea	3m CD	1.90	1.90	1.90	**1.90**	1.90	1.90	1.90	**1.90**
	3Y	2.10	2.15	2.20	**2.20**	2.20	2.20	2.15	**2.10**
	10Y	2.30	2.40	2.50	**2.50**	2.50	2.50	2.40	**2.30**
	10Y-3Y	20	25	30	**30**	30	30	25	**20**
India	3m Mibor	7.50	7.60	7.60	**7.70**	7.70	7.70	7.70	**7.70**
	2Y	7.40	7.50	7.50	**7.60**	7.60	7.60	7.60	**7.60**
	10Y	7.90	8.00	8.10	**8.20**	8.20	8.20	8.10	**8.00**
	10Y-2Y	50	50	60	**60**	60	60	50	**40**

%, eop, govt bond yield for 2Y and 10Y, spread bps

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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