

Asia's Growth Intermission

Friday, July 05, 2013

Asian economies had a bumpy ride in the first half of 2013

After a euphoric first quarter, market optimism and consumer confidence have taken a nose-dive, especially towards the end of the second quarter. The catalysts for the rethink appear to be twofold, namely the threat of a twin withdrawal of liquidity by the US FOMC as well as China's PBoC amidst the domestic self-engineered liquidity squeeze. It is clear from the recent export, manufacturing and PMI data releases that Asian economies are being caught in the whirlwind of tepid global demand conditions, and while domestic demand will continue to provide a buffer, the headline growth momentum is inevitably slowing.

While we are not pessimistic about Asian economies and are still penciling in a very modest recovery going into the second half of the year, the odds appear to be somewhat stacked against a growth outperformance for Asian economies. Moreover, with the US economy gaining some traction, lifting the broad USD and also longer-dated US Treasury bond yields, it is precautionary to expect some capital outflow and liquidity reversal from the region, which may dampen Asian asset market performance as well.

Financial markets have seen a kneejerk reaction, possibly an over-reaction, to QE tapering concerns

The Fed-ECB-BOJ nexus remains in flux – the Fed is well-positioned to be the first major central bank to exit Quantitative Easing (QE), whereas the other major central banks like ECB, BOE and BOJ are clearly well-entrenched in the dovish camp. For instance, ECB president Draghi just pledged to keep interest rates at a record low for “an extended period of time” while new BOE governor Carney said that the “implied rise in the expected future path of Bank Rate was not warranted by the recent developments in the domestic economy” and the MPC will assess “adopting some form of forward guidance, including the possible use of intermediate thresholds” which “would have an important bearing on the Committee’s policy discussions in August”. Draghi also reiterated his openness to reducing interest rates further and/or other unconventional measures. He was also reticent on whether “an extended period of time” meant a 12-18 month period. Hence, while the ECB’s newly adopted language sounds familiar to that of the FOMC and will be based on economic variables like inflation, growth and credit growth, it is important to distinguish it in that it has no timetable guidance or precise policy targets (unlike the Fed’s 6.5% unemployment rate for instance).

Similarly, the BOE statement also signaled its discomfort that “market interest rates have risen sharply internationally and asset prices have been volatile”. For the UK economy “there have been further signs that a recovery is in train, although it remains weak by historical standards and a degree of slack is expected to persist for some time”, and while inflation “is set to rise further in the near term...further out, inflation should fall back towards the 2% target as external price pressures fade and a revival in productivity growth curbs domestic cost pressures”. Therefore, the MPC

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“voted to maintain the size of its programme of asset purchases financed by the issuance of central bank reserves at £375 billion” and “maintain Bank Rate at 0.5%”. In addition, China’s new leadership is clearly signaling that its reform agenda takes priority over growth. Japan too, is counting on unprecedented monetary easing to achieve the BOJ’s 2% inflation target within two years and reflate the stagnant economy.

H2 is likely to remain a potentially tricky adjustment period amid QE tapering

Our assumed time-frame is that the Fed will begin to taper QE3, likely in September, and possibly to the tune of up to half of the current US\$85b monthly purchases, and halt completely by mid-2014 assuming that the economic data continues to hold up, especially on the US housing and labor market front. However, actual interest rates remain a distant prospect and could only materialize in early 2015. Nevertheless, any short-term pullback in longer-dated bond yields mark a good opportunity to hedge interest rate exposure against the clear risks of further upward pressure on rates going forward. Along the same theme, the allure of QE tapering is likely to benefit the USD and continue exert its influence on Asian currencies. With the narrowing of longer-tenor bond yield differentials, and dwindling FX reserves for some Asian economies, local currency government bonds could also lose their shine in the current environment.

Without the strong China story and strong Asian growth outperformance, it could be challenging to see global asset allocation continuing to favour this part of the world in the near term. As such, while we remain constructive on risk in the second half of 2013, we remain slightly cautious on Asian risk assets in the near-term as investors adjust to the inflection point for the US economy and USD-denominated markets.

Regional economies will feel the effects from the Chinese growth cooling

The rolling over of many Asian manufacturing PMIs, especially China’s, a moderation in import growth amid softening domestic demand, and growing signs of a retreat of foreign interest in Asian equity and local currency bond markets suggest little impetus for a strong growth recovery story in the second half of the year. 2013 full-year GDP growth forecast continue to be pared back, starting with China, but we think the growth downgrades will likely fade in the third quarter.

Policy levers are in place to lean against the global headwinds, but Asian ex-Japan policymakers appear hesitant to deploy aggressively at this juncture

A moderation in investment growth momentum is clearly evident in Asia, especially for economies like Malaysia and Thailand that have witnessed a robust spike in investment last year. Yet, domestic consumption growth in the region looks to have remained robust driven by the positive structural demographic factors, and this would help to offset some of the moderation in investment, which in some ways could be a bitter pill to swallow anyway, given that some overheating risks have appeared in some countries. At the same time, the moderation in investment growth has also led to reduced pressure on domestic inflation throughout the region. Except for in Indonesia where the recent fuel price hike has triggered a spike in domestic inflation, we continue to see inflationary pressures remaining manageable across the region, and indeed there have been some downside pressure in several economies.

As it is then, growth-inflation dynamics within the region have not come to a stage that will push for any immediate actions from the regional authorities. On the fiscal policy front, this could be something that is positive in nature, provided that the regional governments will shift their focus towards medium-term targets. Some encouraging developments have been observed on this front, and indeed, the fact that Chinese authorities are less concerned about short-term growth trend could actually translate to be an important pillar for longer-term growth sustainability in the region. On the monetary policy front, given the imminent policy normalization in the US, we believe that some Asian central banks may need to follow suit in due course. Indeed, the recent string of macro-prudential measures adopted in Singapore indicates the decisive policy need to tackle domestic asset inflation. While previously some central banks had been worried about excessive speculative inflows in their domestic bourses, the regional market carnage witnessed in June was a game changer. It is likely to have shifted the focus towards financial market stabilization in the near-term, particularly considering the potentially damaging impact on growth from excessive volatility in financial markets.

OCBC Asia GDP, CPI and Policy Rate Forecasts

GDP					
% chg year-on-year	2009	2010	2011	2012	2013F
US	-3.5	3.0	1.7	2.2	1.9
Euro-zone	-4.4	2.0	1.5	-0.6	-0.6
Japan	-5.5	4.5	-0.8	2.0	1.8
United Kingdom	-4.0	1.8	1.0	0.3	0.9
New Zealand	0.3	0.9	1.3	3.2	2.7
Australia	1.4	2.6	2.4	3.6	2.5
China	9.2	10.4	9.3	7.8	7.7
Hong Kong	-2.5	6.8	4.9	1.5	3.0
Taiwan	-1.8	10.8	4.1	1.3	2.5
Indonesia	4.6	6.2	6.5	6.2	6.3
Malaysia	-1.5	7.4	5.1	5.6	5.0
Philippines	1.1	7.6	3.6	6.8	6.1
Singapore	-0.9	14.9	5.3	1.3	2.0
South Korea	0.3	6.3	3.7	2.0	2.5
Thailand	-2.3	7.8	0.1	6.5	4.8
Vietnam	5.3	6.8	5.9	5.0	5.0

Inflation					
% chg year-on-year	2009	2010	2011	2012	2013F
US	-0.4	1.6	3.2	2.1	1.5
Euro-zone	0.3	1.6	2.7	2.5	1.5
Japan	-1.3	-0.7	-0.3	0.0	0.1
United Kingdom	2.2	3.3	4.5	2.8	2.7
New Zealand	2.2	2.3	4.1	1.1	1.5
Australia	1.8	2.9	3.3	1.8	2.4
China	-0.7	3.3	5.4	2.7	2.3
Hong Kong	0.5	2.4	5.3	4.1	4.2
Taiwan	-0.9	1.0	1.4	1.9	1.3
Indonesia	4.9	5.1	5.4	4.3	7.2
Malaysia	0.7	1.7	3.2	1.7	2.7
Philippines	4.3	3.8	4.7	3.1	3.0
Singapore	0.6	2.8	5.2	4.6	2.8
South Korea	2.8	3.0	4.0	2.2	1.7
Thailand	-0.8	3.3	3.8	3.0	3.1
Vietnam	6.5	9.2	18.6	9.3	7.2

Central Bank Policy Rate					
Central Bank Policy Rate	As at	As at	As at	As at	Forecast at
	end 2009	end 2010	end 2011	end 2012	end 2013
US Fed Funds rate	0-0.25%	0-0.25%	0-0.25%	0-0.25%	0-0.25%
ECB refinance rate	1.00%	1.00%	1.00%	0.50%	0.50%
BOJ overnight rate	0.10%	0.10%	0.10%	0.10%	0.10%
BOE base rate	0.50%	0.50%	0.50%	0.50%	0.50%
RBNZ cash rate	2.50%	2.50%	2.50%	2.50%	2.50%
RBA cash target rate	3.75%	4.25%	4.25%	3.00%	2.75%
China lending rate	5.31%	5.81%	6.56%	6.00%	6.00%
CBRC discount rate	1.25%	1.63%	1.88%	1.88%	1.88%
Hong Kong base rate	0.50%	0.50%	0.50%	0.50%	0.50%
BI reference rate	6.50%	6.50%	6.00%	5.75%	6.25%
BNM overnight rate	2.00%	2.75%	3.00%	3.00%	3.00%
BSP overnight reverse repo	4.00%	4.00%	4.50%	4.00%	3.50%
Singapore 3-month SIBOR	0.75%	0.44%	0.38%	0.38%	0.39%
BOK target overnight call	2.00%	2.50%	3.25%	3.00%	3.25%
BOT repurchase rate	1.25%	2.00%	3.25%	3.00%	2.75%
SBV base rate	8.00%	9.00%	9.00%	9.00%	9.00%

Source: OCBC

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Growth dynamics remained challenging in H1 2013

Growth dynamics remained challenging in H1 2013 amid a tepid global economy

The Singapore economy grew by a tepid 0.2% yoy (+1.8% qoq saar) in the first quarter, as the manufacturing sector contracted 6.8% yoy (-12.3% qoq saar). In contrast, the key growth pillars were the services sector (+2.7% yoy and 7.9% qoq saar), backed by robust growth in financial & insurance sector (+10.5% yoy and 50.6% qoq saar), and the construction sector (+7.3% yoy and 16.5% qoq saar) which saw a boost from private sector building activities. While the economic signals remain mixed in the second quarter, with some signs of stabilization in the domestic electronics sector and a pickup in the biomedical cluster, the Singapore's economy is unlikely to pick up significant speed in the second half of the year. Recent haze conditions may also slightly complicate the recovery process. Our Q2 GDP growth forecast is 2.2% yoy (+11% qoq saar).

H2 growth is likely to see modest improvement from H1 2013 to the 3% yoy handle

Our full-year 2013 growth forecast remains at 2% growth forecast as we see leading and cyclical indicators are pointing higher, suggesting that H2 growth is likely to see a stronger 3.3% yoy range as well. Although it is unlikely that the financial services sector could maintain its 50% qoq clip into Q2, we expect it will remain an important driver for the services sector if global risk appetite and market sentiments continue to sustain in line with the global economic recovery. The official growth forecast is at 1-3%, with MTI indicating that the economy is expected to improve gradually in the year.

Recent haze is unlikely to make a big dent in Q2 GDP growth

The recent hazy conditions may have had a temporary negative impact on the tourist-related activities, but is likely to be limited. Based on estimates from the 1994 haze episode, where there was negligible impact on exports and industrial productions, but F&B fell by around 9.4% and visitor arrivals were 3.1% lower on a monthly average basis, while health-related expenditure rose by 1.9%. Using these estimates as a very rough proxy, while recognizing that there are key differences between the severity of the haze (since PSI then was only 226) and we do not know how long this current haze conditions will last, it is possible that the monthly cost estimates of the current haze episode could be between \$50-100m for F&B and \$60m for tourism while health-related expenditure could increase by around \$15m. This is equivalent to only 0.05% of our GDP.

Singapore's competitive rankings have slipped amid sluggish growth and elevated inflation

Singapore remained in 2nd place behind Switzerland for the WEF Global Competitiveness Report for 2012-2013, but slipped from 4th to 5th position for the IMD World Competitiveness Yearbook 2013 ranking, behind the US, Switzerland, Hong Kong and Sweden. Singapore was also ranked the 8th most innovative among 142 economies surveyed by business school Insead for the Global

Innovation Index 2013, which is 5 places lower than the 3rd position last year.

Productivity improvements are expected to deliver a fresh growth impetus

Labour productivity continued to contract by 3.7% yoy in Q1 2013, after shrinking by 2.6% on-year in 2012, following a 1.3% on-year improvement in 2011. While the Economic Strategies Committee (ESC) report in February 2010 had called for a shift to productivity-driven growth involving a qualitative transformation of the Singapore economy, three years have passed but the journey to a productivity-driven domestic workforce and growth remains challenging. In fact, Singaporeans work extremely long hours but have less to show for it than other high-earning countries in Southeast Asia, according to the ICAEW's Economic Insight: Southeast Asia report. Given the recent Budgetary policy enhancements to promote productivity, especially for the SMEs, we expect that the coming quarters and years may start to see the pay offs from the investments.

The domestic labour market looks set to remain tight, given Q1 unemployment rate was 1.9%, amid ongoing foreign manpower policy curbs. Hiring intentions remain robust, with more employers in Singapore planning to hire additional workers (+5.5% 48.7%) in Q3, the highest since Q4 2011, while fewer plan to reduce their staff number (-2.5% points to 2.7%) in Q3, according to the latest Hudson Report: Employment Trends which surveyed 337 Singapore employers in May 2013. The main beneficiaries are likely to be manufacturing and industrial, where 50.9% intend to hire more staff this quarter, followed by IT&T (50.6%) and consumer (42.5%). In addition, contracting in the banking and financial services sector is also increasingly robust (+18.1% points), with employers seeking to satisfy headcount needs through temporary resources. In particular, risk control, risk management and compliance roles were said to be in high demand.

Inflation is moderating as macro-prudential measures cap domestic asset prices

CPI inflation has averaged between 1.5-1.6% for April and May, down from the 4% seen in Q1, aided mainly by the drop in private road transport, namely COE premiums following the February curbs on car loans, and coupled with the property cooling measures in January 2013 which included up to 7% ABSD. Category B COE premiums have fallen from a high of \$96,210 in early January to around \$77,110 for the latest July tender, after touching a low of \$58,090 in mid-March 2013. Meanwhile, crude oil prices have also been well contained at around US\$95 per barrel, given tepid global demand conditions amid high oil production levels due to US shale oil innovation,

The official headline inflation forecast for 2013 is 3-4%, with core inflation at 1.5-2.5%. Our CPI and core inflation forecasts for this year are 2.8% yoy and 2.2% yoy respectively, which will mark a significant moderation from 2012's 4.6% yoy headline and 2.6% yoy core inflation.

Domestic property market potentially faces challenging months ahead

Going forward, with the introduction of the Total Debt Servicing Ratio (TDSR) framework on 28 June which has addressed some loopholes after the property market shown signs of revival in May (private residential home prices accelerated to 0.8% qoq in Q2 2013), we anticipate that the demand for property purchases and mortgage loan may be dampened, especially for buyers with existing properties and/or other debt liabilities. A slowdown in volumes and potentially more price

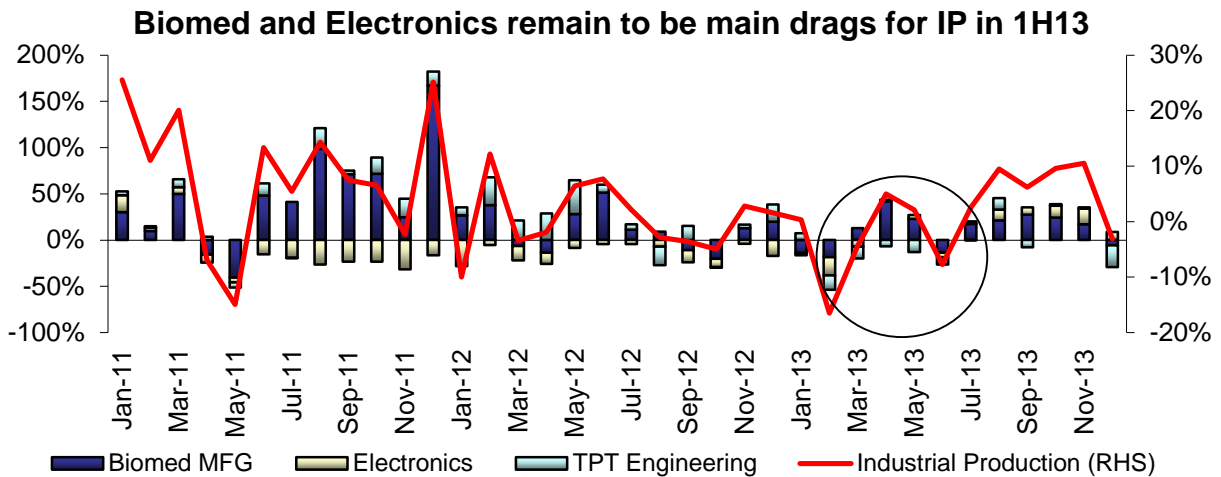
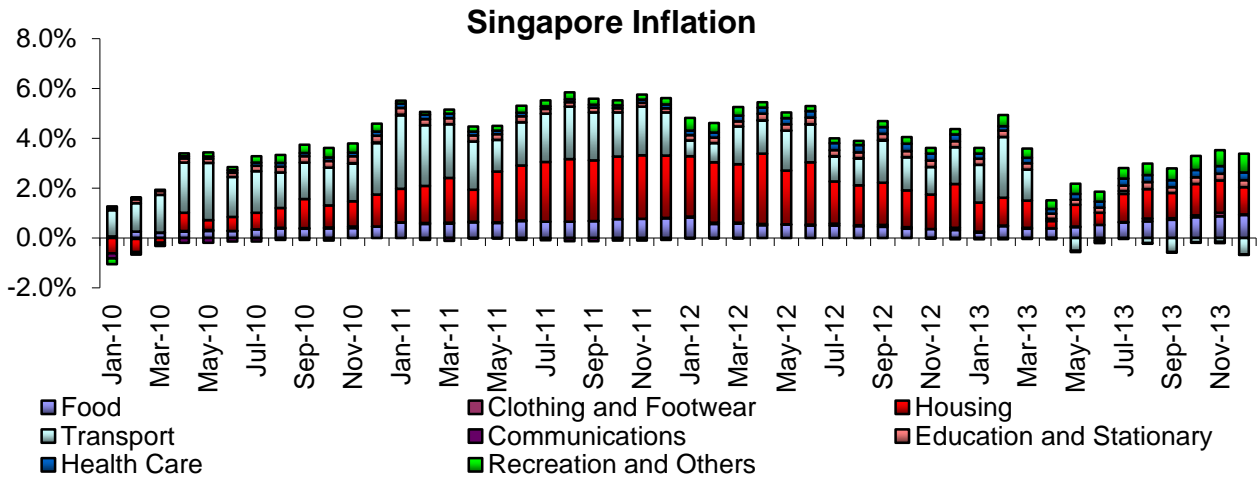
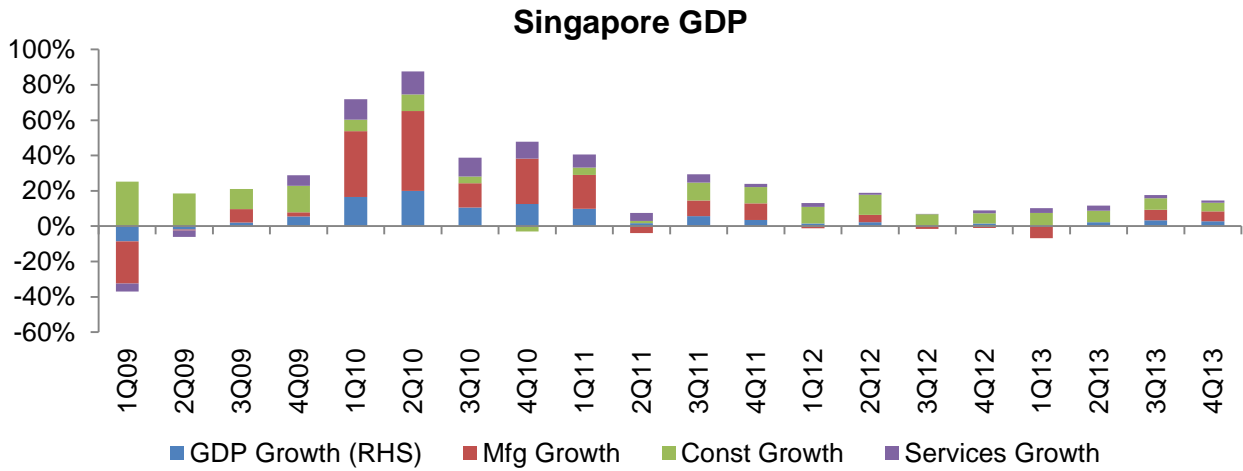
discounts could emerge in the months ahead. The TDSR rules are wide-encompassing and fairly prescriptive, market players may adopt a wait-and-see attitude first. While June may see an uptick in the processing of mortgage loans, we believe that pace of growth of housing loans will likely moderate from the 15.9% yoy seen in the first five months of this year.

More pressure on the back-end of the SGS bond yield curve with QE tapering

During the June de-risking bout, sparked by the feared liquidity withdrawal from the FOMC and PBoC, longer-dated SGS bond yields have begun adjusting higher. If the FOMC delivers on the QE3 tapering before year-end, it would be logical that the US Treasury bond market will continue to see position adjustments. Our view is that assuming that the US housing and labor market continues to recover and improve, the most likely timing is for the FOMC to begin tapering its asset purchase program in Q3 around September and halt completely by mid-2014, and the Fed may be sufficiently emboldened to contemplate the first rate hike in early 2015. As such, the SGS yield curve should also continue to normalize in the second half of 2013, especially given the new 20-year SGS bond issue scheduled on 2 September.

Monetary policy stance remains appropriate for now

The MAS maintained its modest and gradual appreciation stance for the SGD NEER policy band, with no change to the slope and width of the policy band, as well as the level at which it is centred, in April, citing it to be appropriate for containing inflationary pressures, anchoring inflation expectations, and facilitating the restructuring of the economy towards sustainable growth. Given the resurgent broad USD amid QE tapering expectations, our year-end USD-SGD forecast is 1.2743. Our 3-month SIBOR forecast is 0.39%, close to the current 0.37% as of 3 July 2013.



Source: CEIC, OCBC Bank

Reform rather than growth is the key focus

Chinese economy decelerated to 7.7% yoy in Q12013 from 7.9% yoy in Q42012 due to weaker than expected consumption and investment following the aggressive clampdown on corruption and recreational activity using public funds under the new leadership. The recovery lost the steam in the second quarter with the leading indicator HSBC PMI fell further to 48.2 in June from 49.2 in May and 50.4 in April, indicating both weak domestic demand and external demand.

Less responsive to credit expansion

Two big problems that concern China's new leadership emerged in the first half including less responsive of China's economy to credit expansion and inflated export data. Chinese recovery remained sluggish in the first half of the year despite China's credit expanded at a much stronger than expected pace with total social financing surged by 52% yoy in the first five months. The inefficiency in credit transmission mechanism has raised concerns over China's growth prospect.

On the trade data front, China's export grew by more than 18% yoy in Q1 despite still weak external demand. In particular exports to Hong Kong spiked to an unusual high level. The investigation led by Chinese regulators uncovered the fake trade activities focusing on cross border arbitrage. This significantly inflated China's trade data with Commerce Ministry estimated that trade data was inflated by US\$75bn in the first four months of this year.

Reform rather than growth is the key focus

The root of current inefficiency in Chinese economy is the long term structural problem faced by China (such as SOE dominated economy, less liberalized interest rate market and capital account etc). As a result of falling return in investment in real economy, more private capital flew into the shadow banking system to pursue higher return to offset the falling return from the real economy. This further dampened the efficiency of China's credit transmission mechanism. As such, the new leadership has clearly signaled that reform rather than growth is the key focus for this year.

Ever since the new leadership sworn in, Chinese regulators have announced a few new rules to cap the investment of wealth management products in shadow banking products and clamp down on fake trade. The latest battle ground shifts to interbank market with the central bank engineered liquidity squeeze aimed to press the banks to deleverage.

Chinese style liquidity squeeze is not the start of financial crisis

The spike of interbank rate in June is not rare in history, however, the level of tightness is unusual. It was mainly due to the combination of regular factors and ad hoc factors. China's liquidity squeeze started from the end May due to usual seasonal patterns such as corporate tax payment by end May, pre-holiday demand, reserve requirement check and half-year end balance sheet dressing. Meanwhile, the slowdown in capital inflows as a result of clampdown on fake trade and illegal cross border arbitrage and PBoC's harsh stance to tight the interbank market

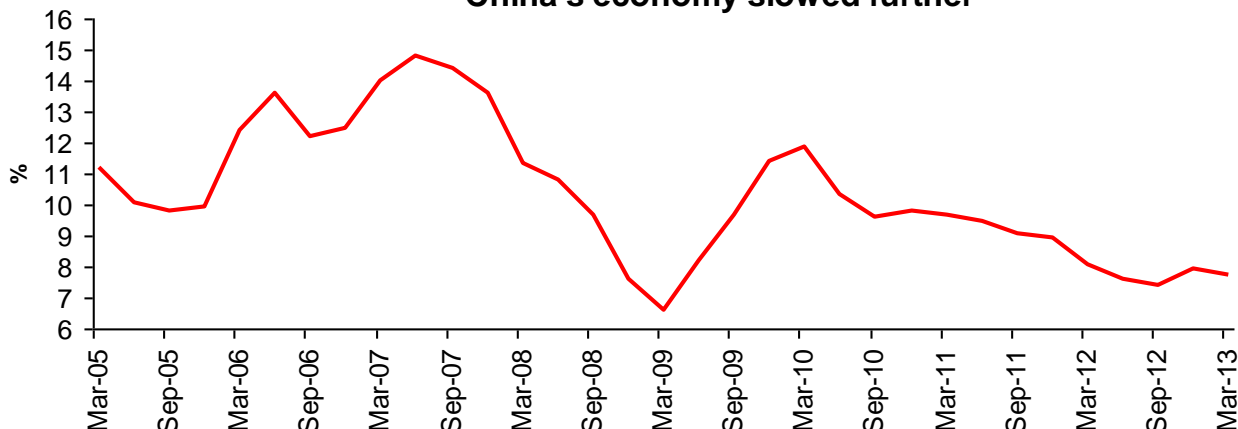
exaggerated the volatility in China's money market.

The liquidity situation worsened after China came back from the dragon boat festival as a result of policy confusion when central bank signaled it would continue to withdraw liquidity through open market operation instead of injecting liquidity as hoped by most market players. The hawkish tone signaled clearly central bank is uncomfortable with the rapid rise of leverage ratio by banks. The overnight interbank borrowing rate hit as high as 30% on 20 June. The messy situation in the interbank market quickly spread beyond the banking sector, triggered the massive sell-off of the equity market in both China and Asia. As a result, China's central bank eventually stepped in and announced it has injected the liquidity to some financial institutions via targeted injection to calm the market down despite the central bank still think that total liquidity is at a reasonable level. Ever since PBoC released its statement on 25 June, the interbank borrowing costs have fallen significantly. The interbank rates are expected to keep normalizing.

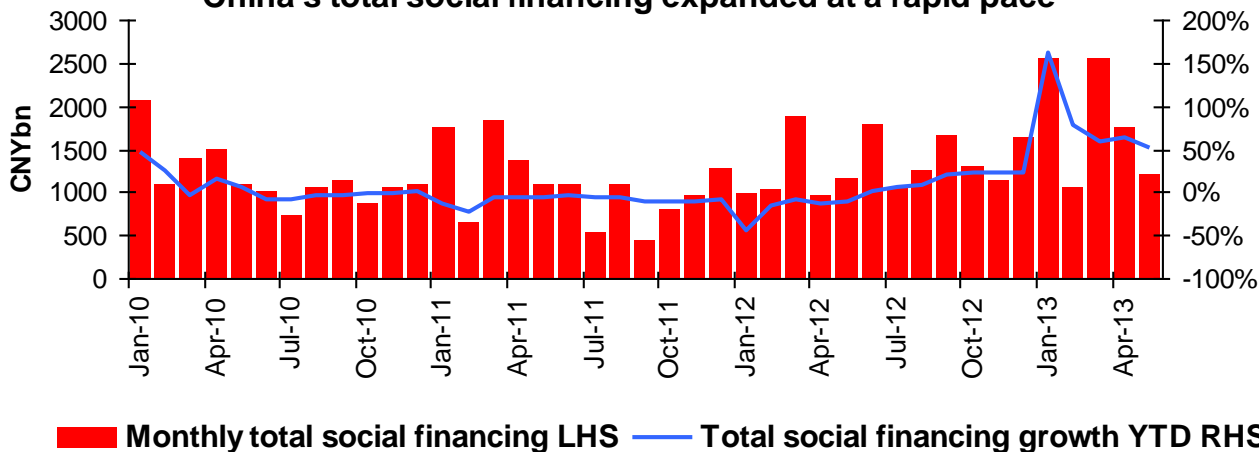
We believe the systemic risk is remote due to three reasons. First, China's 20% legal reserve requirement ratio (RRR) will provide enough buffers to liquidity squeeze (PBoC is sitting on nearly CNY20tn cash reserve). Meanwhile, Chinese banks still hold proper excessive reserve at CNY1.5tn as mentioned by CBRC head Shang Fuling. Second, China's banking system has the one of the lowest LDR ratio in Asia at 67.7% by end May. Third, Chinese central bank has reassured to maintain money market stability. We think the liquidity squeeze is likely to end before mid-July. And the imminent hard landing scenario is unlikely.

Nevertheless, the extended period of liquidity squeeze will lead to dislocation in financial market, which in turn will hurt growth. As such, we expect that Chinese economic prospect in the second half is likely to be affected by the current liquidity squeeze due to two reasons. First, Chinese new leadership has signaled clearly they have much higher tolerance for slower growth. As such, China will continue their reform practice to curb shadow banking activity, which may slow the growth down further. Second, Chinese banks may be more cautious on managing their liquidity after the current drama, which may slow the credit expansion in the second half. As such, we revised down our GDP forecast for 2013 to 7.7% from previously 8% to reflect the possible deleverage activity in both interbank and shadow banking sectors.

China's economy slowed further

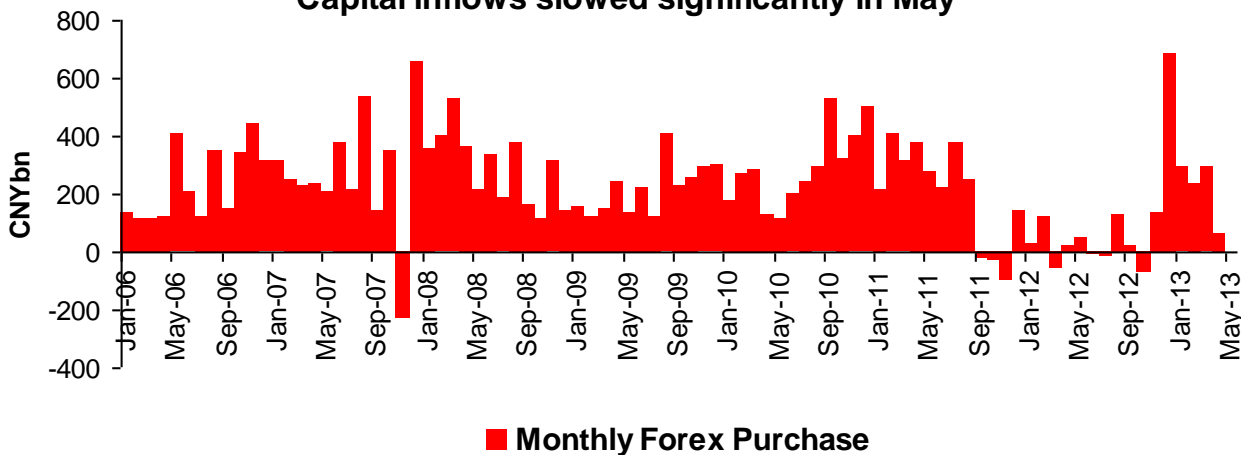


China's total social financing expanded at a rapid pace



■ Monthly total social financing LHS — Total social financing growth YTD RHS

Capital inflows slowed significantly in May



■ Monthly Forex Purchase

Source: CEIC, OCBC Bank

Exports to remain a drag

We have previously downgraded our 2013 GDP growth forecast for Malaysia from 5.4% yoy to 5.0% yoy after the disappointing performance in Q1. While the domestic economy, especially investment, has continued to remain robust so far in the year, Malaysia's export growth remains under pressure from soft commodity prices and the prevailing sluggish state of the global economy. The recent weakening of the MYR may help to support export demand going forward but we don't expect to see a significant recovery in Malaysia's export growth until closer to the year-end. As such, a repeat of the stellar growth performance in 2012 is unlikely to be seen.

Investment remains the main driver of growth

The domestic economy has remained robust so far this year. Investment growth continued to be strong, at 13.2% yoy in Q1 2013, supported by strong growth in both private and public investment at 10.9% yoy and 17.3% yoy respectively. Despite earlier concerns that political uncertainties might have weighed on investment growth in the country, the Q1 GDP data indicated that Malaysia's longer-term growth potential has been the more important driving factor of domestic growth. The government's commitment to deliver the targets embedded in the Economic Transformation Program remains firmly in place, and we expect the frontloading of infrastructure projects to sustain economic growth towards the year-end. This is also evident from the fact that monthly imports of capital goods continue to suggest sustained demand for infrastructure-related goods.

The spill over impact from Malaysia's robust investment growth since last year would continue to be the underlying support for private consumption, whose growth is likely to sustain at more than 7.5% this year. As we have noted at the start of the year, private consumption growth is an important pillar for Malaysia to ensure sustainable growth in the medium-term. While pre-election spending is likely to have played a part, we have been rather encouraged by the improvement seen in customer sentiment and the still fairly healthy employment conditions seen so far this year. Despite the fact that the manufacturing sector remains weighed by a sluggish external demand, manufacturing payrolls have continued to surge higher at about 6-8% this year. Expect to see unemployment remaining circa 3% this year.

Nevertheless, the recent fall in trade balance, with surplus coming in at a 16-year low in April, is an indication of the sharp divergence between the domestic and external economic momentum. The current pace of investment growth is clearly unsustainable as there are early signs that the domestic economy maybe starting to overheat, as reflected in our Financial Conditions Index. This much is also evident by the fact that net exports was the main drag to growth so far this year, despite exports chalking some sequential quarterly growth in the same period. On this front, we also note that overall loan growth has moderated throughout H1 2013, falling to about 10% yoy currently from about 12% yoy last year while working capital loan growth has also fallen quite markedly to below 3% yoy currently after reaching as high as 10% yoy last year.

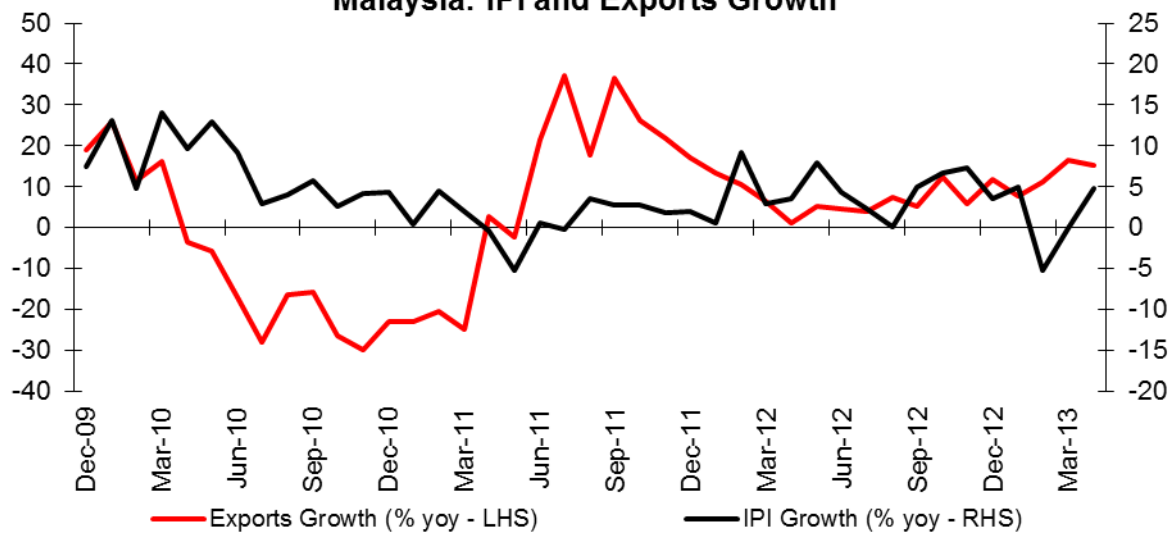
Medium-term fiscal consolidation plans are in the offing

The Budget 2014 announcement in late October will be important to monitor as we will get more clarity as to what kind of other investment projects will be launched into 2014. The limelight, however, will also fall on the fiscal consolidation plans of the government especially considering the persistent words of caution from various rating agencies. Malaysia's fiscal debt is relatively high when compared to most countries in EM-Asia and also when compared to countries with A- or BBB+ rated countries. Not only has fiscal deficit been inching higher, but it is also rather disconcerting to see that both ratios of expenditures/tax revenues and subsidies/development expenditures have been rising rather markedly. On the revenue front, raising corporate tax rate may not be a viable option but presumably, more can be done to raise individual tax revenues and it will be interesting to see if the government will be mulling over plans to introduce the GST once again.

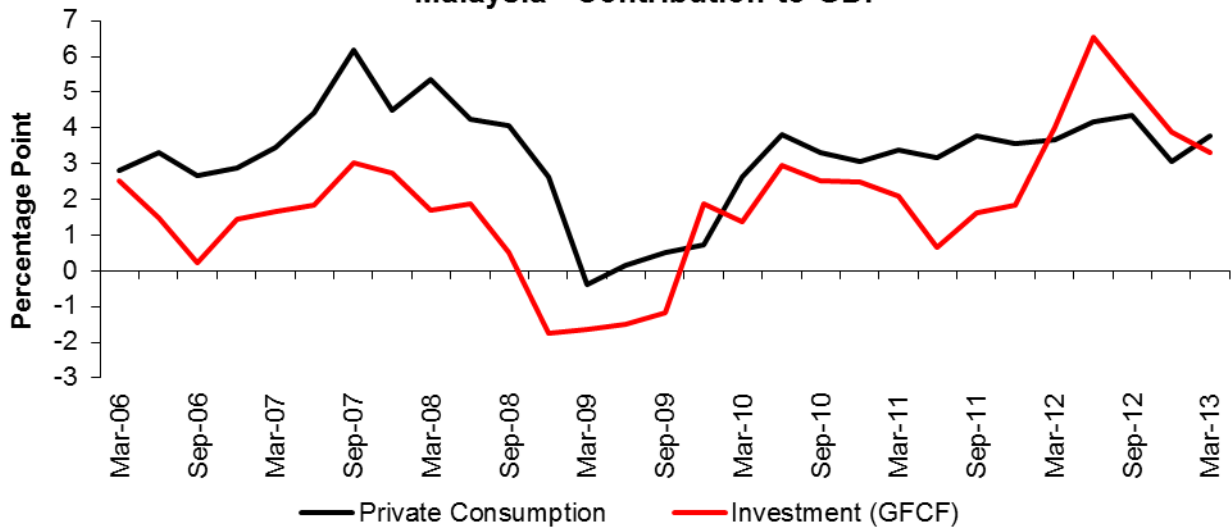
Inflation is on the rise but expect stable OPR

Should there be some fiscal consolidation steps, either on the revenue or expenditure front, we think that there will be some impact on inflation in the economy. Inflationary pressures have ticked up in H1 2013 but at a slower pace from what we had expected earlier this year. A combination of low base effects, rising prices and supply-side pressures from rising wages is likely to mean that inflation will inch back towards 3% at the year-end with our current forecast pencilling in 2.7% yoy average for the full year. Against this backdrop, it is unlikely that the BNM will lower its interest rate unless we see a slump in growth momentum going forward. The implicit official tolerance of a strong MYR since last year has been partly driven by the need to support domestic demand, particularly to bolster investment growth in the economy but this only means that there is some potential room for the authorities to provide some monetary stimulus on the currency front, particularly considering the downside risks to growth stemming from the lacklustre external demand.

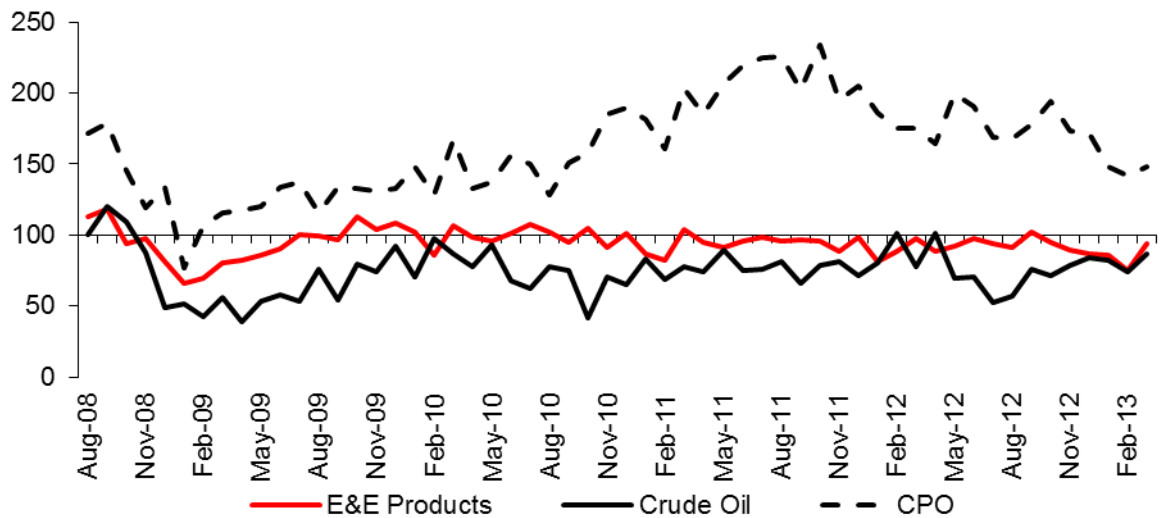
Malaysia: IPI and Exports Growth



Malaysia - Contribution to GDP



Value of Main Exports (Jan 2008 = 100)



Source: CEIC, OCBC Bank

Plenty of potential and challenges alike

The rather disappointing Q1 GDP growth has indicated signs of moderation in the domestic economy, particularly in investment growth where the impact of a weaker IDR is likely to have played a part. Private consumption growth, however, remains strong in the economy and we also expect to see only marginal impact from the recent fuel price and BI rate hikes on the prospect of private consumption going forward. This is likely to be the key driver of Indonesia's growth towards the year-end, especially noting the anticipated increase in election-related spending ahead of 2014. We forecast GDP growth to come in at 6.3% yoy in 2013 while inflation may now average 7.2% yoy in the year following the recent fuel price hike. Given the sustained drag from the trade account as well as the recent global market turbulence, we continue to see downside risks to our 2013 GDP growth projection at this juncture.

Private consumption likely to remain resilient despite recent fuel price hike

The government's recent fuel price hike (45% price increase in petrol and 22% price increase in diesel) is crucial in keeping fiscal deficit below 3% of GDP and also in helping to improve the trade account, at least on the margin, given that the bulk of Indonesia's trade deficit in the past 9 months has been driven by its oil balance. We think that this move, coupled with the anticipated monetary tightening by the BI, is positive for Indonesia's risk profile and should be an underlying support to sentiment on the IDR, barring any broad-based USD strength in global markets. As such, the fuel price hike could indeed trigger some positive wealth impact despite the presumed negative direct impact on purchasing power. Indeed, learning from the experiences of 2005 and 2008, we also think that any impact on domestic growth from the fuel price hike alone is likely to be of little significance, especially considering the steep increase in inflation it is set to cause. Note also that private consumption has remained robust in H2 2012 despite reports of fuel prices being doubled in black markets formed in various cities that faced a shortage in subsidized fuel.

The cash compensation program for the poor would help to offset some drag on consumption growth as well, particularly given that the marginal propensity of consumption is highest in this segment of the population. Additionally, we expect pre-election spending to also prop up private consumption growth in H2-2013. As witnessed in the 2004 and 2008 elections, private consumption growth tends to start accelerating 2 quarters prior to the legislative elections, with average growth reaching 5.8% yoy in such periods (private consumption growth was recorded at 5.1% yoy in Q1). This time is unlikely to be different especially since the campaigning period is likely to be rather heated considering the widely open race in 2013. We expect private consumption to chalk at least 5% yoy overall growth this year, which should be sufficient to keep overall GDP growth coming in at 6% yoy.

Moderation in investment is the one key concern

While we had factored in a moderation in investment going into 2013, the pace at which investment growth has been falling was rather disconcerting in Q1. This is

especially noting that in the same period, bank loan growth has remained fairly strong at about 23% yoy, which indicates that the fall in investment was unlikely to be a consequence of policy direction. Imports of capital goods are likely to have been falling by about 15% in the year-to-date and this is certainly a negative sign of investment growth prospect for the year. We think that this weakness in investment growth may now sustain in H2 especially considering the recent weakening in the IDR and also the fact that commodity export earnings would have remained soft in H1, given that the mining sector has remained under pressure. We have now downgraded our full-year forecast for investment growth to about 5-6%, which would make it the lowest level since 2007 (except for 2009 when the data was distorted due to the 2008-09 crisis).

Indications so far this year suggest that while total FDI for the year may come in below last year's record high, the total FDI may remain modest and continue to be close to the USD 20bn figure. Concerns over policy risks and the recent S&P downgrade of Indonesia's sovereign rating outlook from "positive" to "stable" are likely to affect on investors' appetite, although the extent is likely to be limited considering that Indonesia's long-term growth potential remains robust amidst its growing middle class. Furthermore, we also think that the implementation of the fuel price hike would tend to ease concerns over policy risks, especially noting the fact that the government managed to pull this through despite having the election just less than a year away.

External demand continues to be a drag

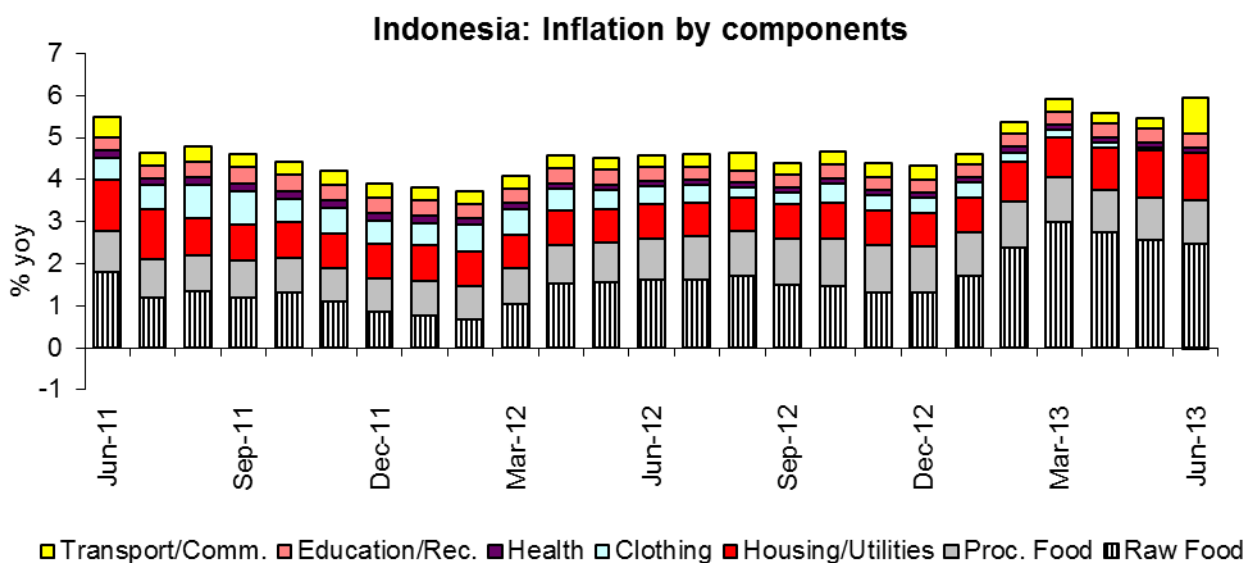
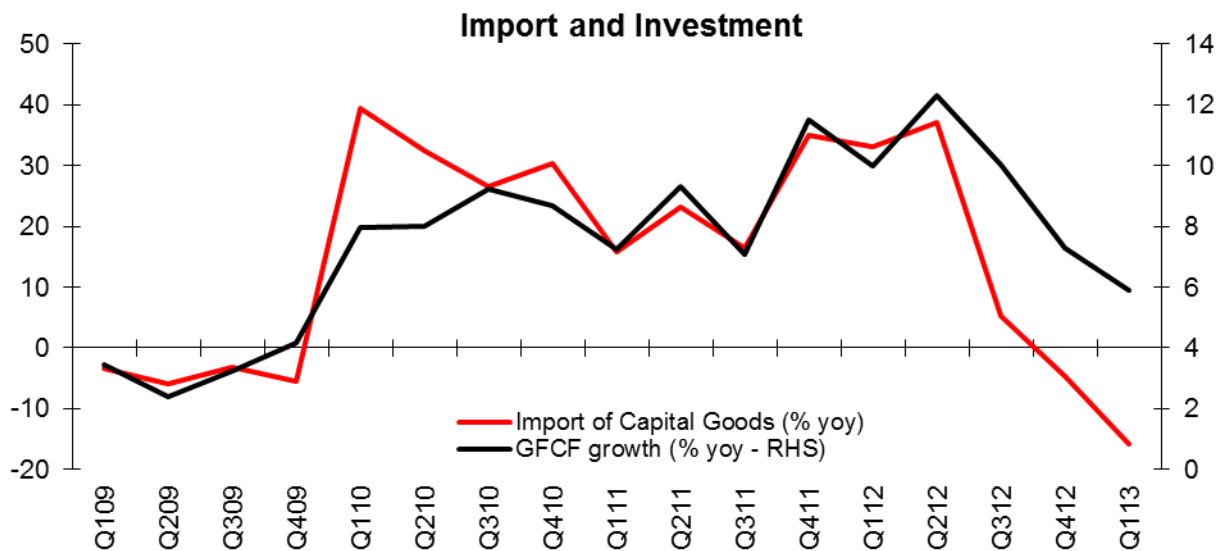
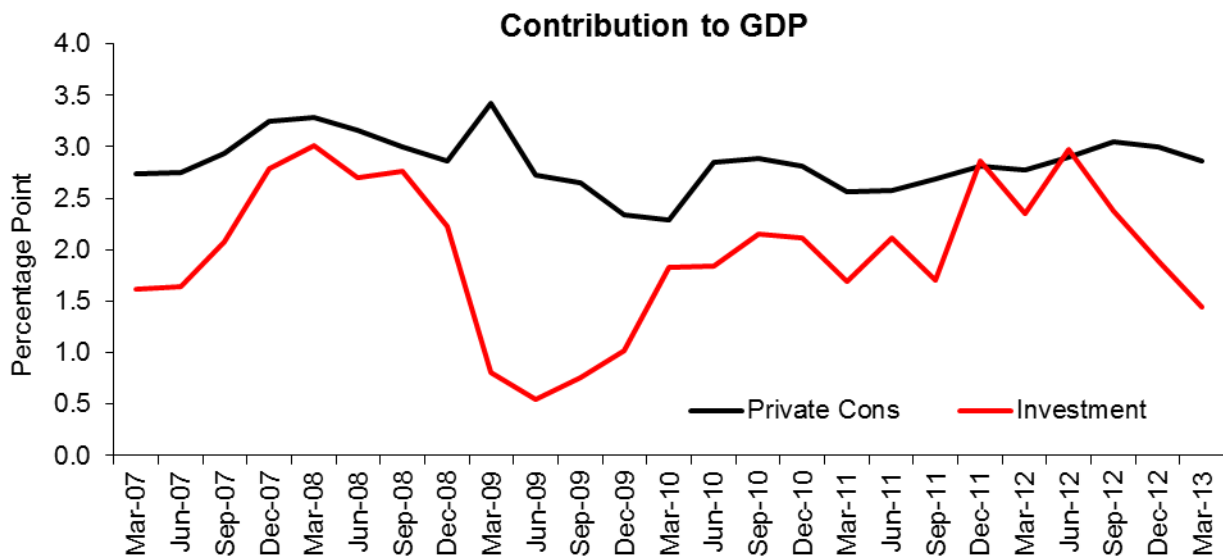
Export growth is likely to remain weak in Q3 especially given the still sluggish global demand and the sustained weakness in commodity prices. Furthermore, recent disruptions in Freeport's mine would also assure that external shipments may remain weak for now. More importantly, as we have highlighted in our 2013 outlook, Indonesia's export growth could remain lackluster, given that productivity in the manufacturing sector has been on a sustained decline driven by over-investment in the commodity sector in recent years. While concerted efforts have been taken to develop downstream industries in the commodity sector, the considerable time lag means that overall export values will remain weighed by the current string of export restrictions, such as taxes on CPO exports.

Tighter monetary policy as inflation jumps

We expect inflation to jump to an average of 7.2% yoy this year following the 45% petrol price and 22% diesel price increases in June, which is likely to cause price increases across the board. Expect to see double-digit inflation in the food, housing/utilities and transport components of the CPI. Additionally, seasonal inflationary impact from the upcoming Ramadan month and the start of the new school year will push inflationary expectations even higher in the economy, although the delayed fuel price hike has allowed some of these inflationary expectations to be priced in among local retailers.

In response, we expect BI to bring the BI rate to 6.25% and possibly even the 6.50% in H2 2013 before standing pat from then onwards. While it is clear to us that BI's surprise rate hikes in June (25bps for both BI and FASBI) were partly meant to boost confidence on the IDR, a tighter monetary policy direction is probably still warranted given that the central bank would want to avoid inflationary expectations from spiraling up further. This would also be in line with the central bank's aim to bring credit growth down to a more sustainable 15% level. We are also of the opinion that

BI will narrow the lower corridor between the FASBI and BI rates to possibly 125bps, which implies that another 75bps rate hikes are in the offing for the FASBI. We also expect BI to continue preventing excessive weakening of the IDR especially given the growth risks as explained above. Even if there have been renewed concerns over Indonesia's external liquidity problem, we remain of the view that current risks remain manageable given that current FX reserves still account for about 7 monthly import payments and more than double of current stock of short-term external debts.



Source: CEIC, OCBC

Watching monetary policy direction

The government has just revised its 2013 GDP growth forecast lower to 4-5% yoy as export growth is likely to remain weak amidst a lackluster global economy and further downside risks in China. Q1 GDP growth has also moderated to 5.3% yoy following the 6.5% overall growth penciled in 2012. Overall though, we maintain our current 2013 GDP growth forecast at 4.8% yoy as we expect the domestic economy to remain resilient while we also remain of the view that Thailand will benefit from the reflationary efforts currently underway in Japan. The strength of private consumption is crucial on this front and it is also imperative to see the direction of monetary policy trajectory going forward. The BOT is likely to refrain from cutting its key benchmark rate for the rest of the year, and in fact, we still think that a monetary policy tightening is imminent.

Moderation in investment is no reason to panic

The slower investment growth seen so far in H1 is not a reason to panic with regards to the country's growth outlook especially considering the high basis effects and the fact that we have also seen a spike in investment spending in H2 2012. This moderation in investment growth is likely to be a consequence of a smoothing behavior among local business following the spike witnessed in H2 2012, and does not necessarily signal a turn in confidence as yet particularly given the fact that business confidence has remained fairly high so far in H1. Indeed, with the current environment that is dominated by a tight labor market and a high capacity utilization rate, longer-term sustainability of growth would be at risk if investment growth were to remain in the double-digit territory close to the 2012 levels. Note that credit growth has remained robust, with overall M2 money supply growth likely to be around 11-12% this year, even higher than the 10.4% seen in 2012. After moderating slightly towards the end of last year, both leading and production indices have recovered significantly in H1 2013, suggesting that overall production in the economy is likely to remain supported going forward, barring another collapse in the global economy.

Manufacturing sector remains a crucial pillar of growth

The resilience of the Thai economy is also evident from the fact that its manufacturing sector has shown decent performance so far in the year. Manufacturing exports (7.0% yoy) had actually led overall export growth (4.3% yoy) in Q1 and this is very encouraging given that manufacturing takes up about 75% of overall export values in the economy and that it remains as the industry with the highest contribution to GDP in the period. We have also discussed previously that Japan's reflationary efforts, which tend to put some pressure on the JPY, may actually benefit Thailand given that Japanese exports are relatively complementary to Thai import needs, with strong anecdotal evidence seen in the automotive sector. Imports of intermediate goods are still chalking double-digit growth currently and we continue to take this as a strong sign of the generally encouraging picture we see among local businesses. More importantly, we continue to think that the high productivity in Thailand is the underlying factor that will spur strong recovery of its manufacturing export once the global economic recovery begins to pick up pace.

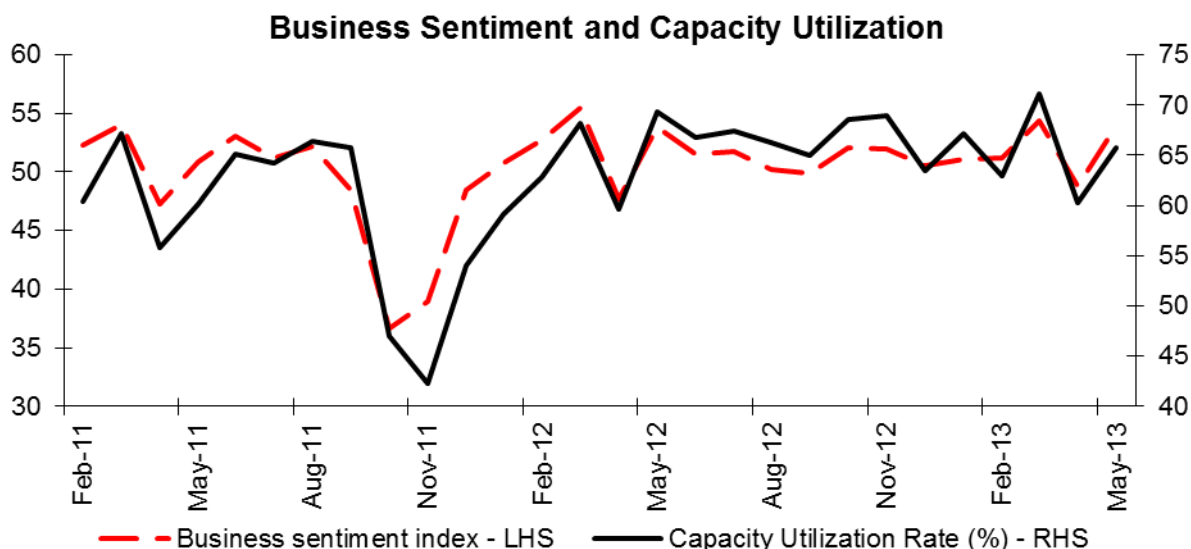
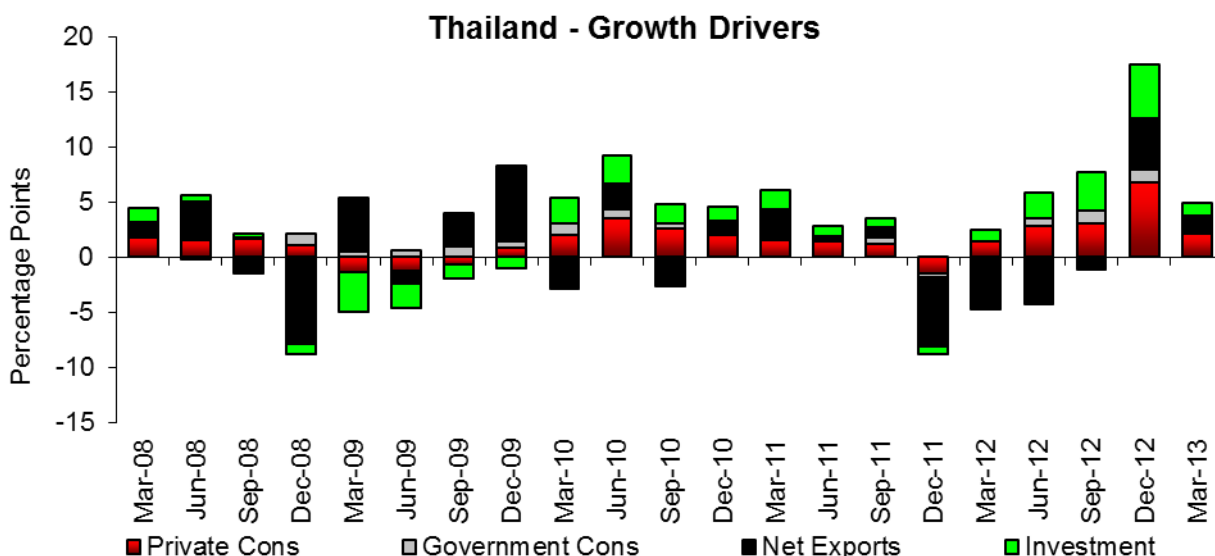
Awaiting a shift in fiscal policy focus

One limitation to the country's near-term growth potential is the fact that current capacity utilization is already hovering near record-highs and we think that the USD 65bn worth of infrastructure projects proposed earlier this year are crucial to bolster industrial production growth into 2014. On this front then, it is imperative to observe what the government will do regarding its fiscal spending going forward. The recent flip-flop on the rice intervention policy, in which the government announced a lowering of the buyback price to THB 12k/tonnes from THB 15k/tonnes only to reverse it within days, indicated that this highly controversial and populist policy is unlikely to be eliminated anytime soon. The rice buyback scheme is estimated to have cost the government about USD 4.5bn in 2011-12, and we estimate that this policy may prompt fiscal debt rising by as much as 1-2% of GDP this year, which means that there is presumably less fiscal room. If the government were to succeed rolling out its infrastructure projects this year, it would definitely signal a shift in focus towards more medium-term growth plans, which is a clear positive for the country's macro risk profile.

Loose monetary policy needs to end

Even if inflation numbers have come in soft so far in the year (average inflation at 2.8% yoy and average core inflation at 1.3% yoy), we remain of the opinion that inflation should inch higher towards the year end with our current forecast still penciling an average headline inflation at 3.1% yoy in the year. Based on our view, the BOT is unlikely to lower its benchmark rate any further and in fact the risk remains tilted towards a tighter policy stance at the year end. Concerns that a stronger THB may have an adverse impact on Thai export growth had partly driven the persistent calls for a BOT rate cut earlier this year, and thus, the recent weakening of the THB is likely to alleviate some pressure on the central bank for more rate cuts. The central bank has been broadly sanguine on its assessment on growth prospect in the longer-term and in fact has shown some concerns on the pace of loan growth, which remains circa 15% (with loan-deposit ratio still above 110% currently) Indeed, based on our estimates, financial conditions in Thailand have been excessively accommodative since last year, and further loosening of monetary policy may trigger longer-term risk in the economy.

Meanwhile, talks of possible capital controls in Thailand have pretty much died down in the past month, given the significant market selloff seen in June. The likelihood of the authorities to implement any capital control measures will depend on how the THB trajectory going forward, and again, the recent bout of USD strength has provided a breather for the authorities regarding this issue. In any case, we don't expect any draconian measure to be implemented by the authorities at this stage, given the haunting memory of the aftermath of the December 2006 decision.



Source: CEIC, OCBC

Reforms in foreign investment restrictions eagerly awaited

The economy registered a stellar growth of 7.8% yoy in Q1, well above market forecasts and also stood as the highest growth in the region. This was all the more remarkable given that almost all Asian countries reported rather disappointing growth figures in the same period. On top of this, the sovereign credit rating upgrades and the favorable mid-term election results for President Aquino have continued to improve the outlook for the economy. The main challenge in our view is to see all the feel-good factors to translate into real increase in investment, and on this front, it remains questionable if the results of the May elections can indeed translate into reforms in foreign investment restrictions, which have been eagerly awaited. At this juncture though, the current strength in investment growth is enough to boost GDP growth to reach 6.1% yoy in 2013, well above our initial estimate of 5.3% yoy at the start of the year.

Robust investment growth to offset drag from external demand

Investment growth remained robust in the economy and we think this will have lasting impact in the domestic economy, providing the underlying boost to the economy. The prospect of investment growth is crucial to the overall growth outlook of the Philippines in the near-term, especially noting the fact that we continue to see excess capacity in the country, considering that the pace of investment boom in the Philippines is lagging the regional trend. Investment growth has accelerated further in H1 and this was rather broad-based, with bulk of the support coming in from specialized industrial machinery, indicating that capacity expansion remains prevalent in the economy. Note that this has taken place despite the recent moderation seen in industrial production, which may signal that the bulk of the support has come from the domestic economy, with contribution from the construction sector being the highest.

The construction sector has recorded a robust 38% yoy growth in terms of gross value-add in Q1, which is a record-high for the Philippines. While the current construction boom is likely to be near its peak, we are still encouraged by the fact that the typical spillover impact on the economy tend to last for 2-3 quarters, sustaining an overall support to the economy at times when external demand is likely to remain weak. Contribution from investment to overall economic growth currently stands at its highest level since 2010, negating the drag broadly seen from external demand.

Yet a moderation in growth is probably unavoidable

Part of the reasons that have sustained the strong investment growth in Q1 was the huge budget deficit for the period, which was likely triggered by a spike in pre-election government spending. Note that budget deficit has almost doubled in Q1, compared to Q1 2012, and this is not the typical pattern of government spending in the Philippines, where the government rarely frontloads bulk of its planned capital spending in the first quarter of the year. At this juncture, based on our estimates,

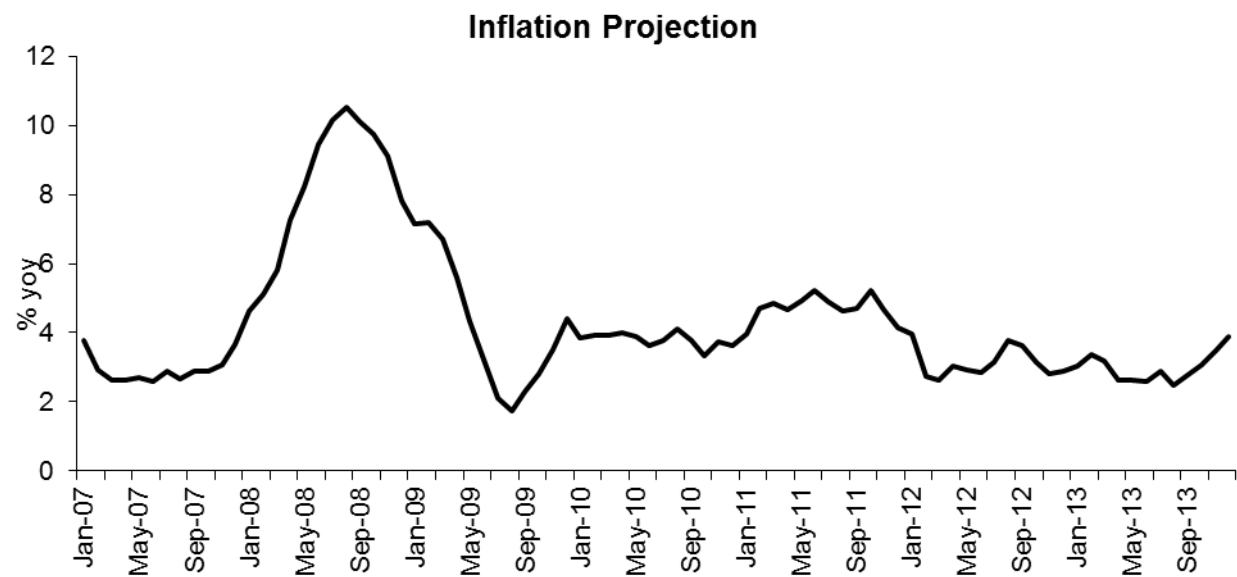
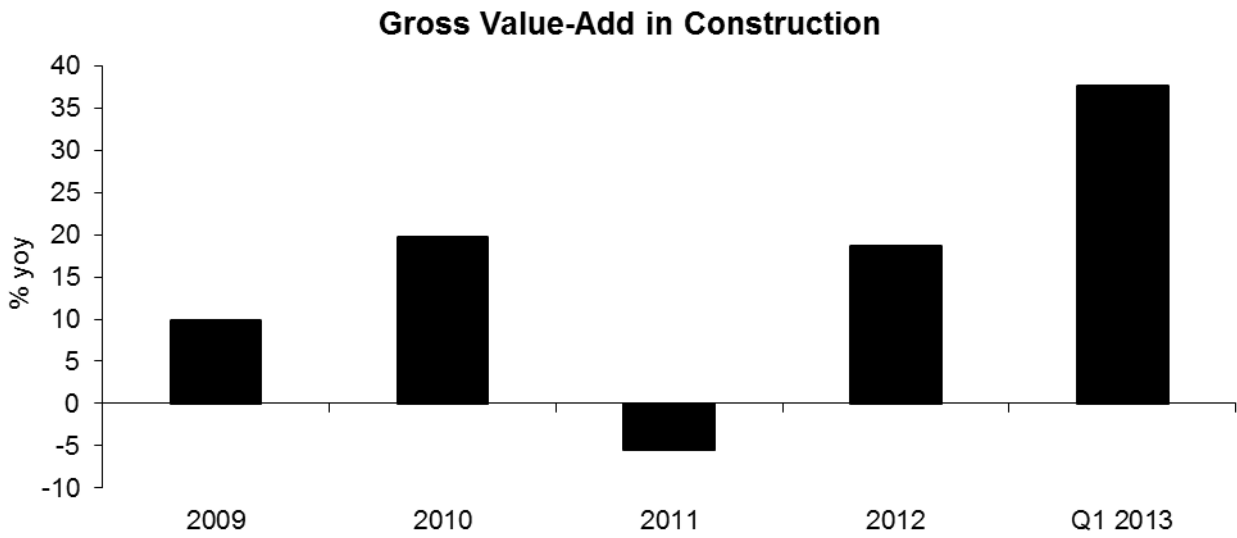
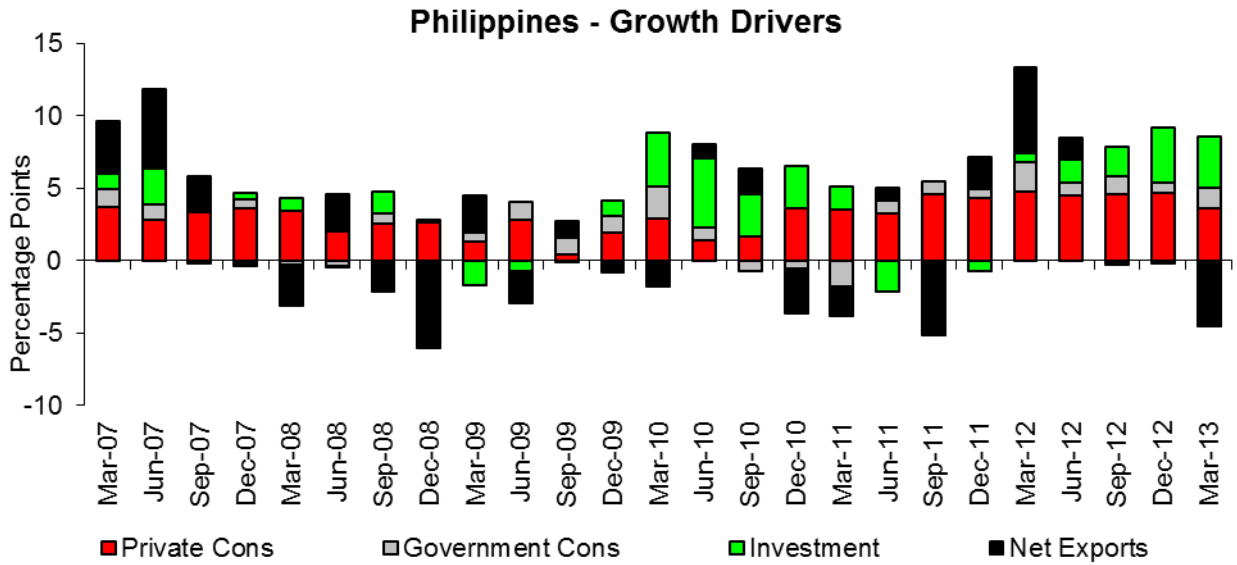
growth momentum will tend to moderate going forward, but no sharp slump is expected barring another hit to the global economy. Part of this anticipated moderation is positive in a way that it brings growth momentum to a more sustainable pace and avoids further overheating of the domestic economy. Indeed, some signs have begun to be more visible in Q1, as highlighted by the easing growth in private consumption despite the wealth effect from rising stock market equities, a stronger PHP as well as the sustained surge in government spending.

Monetary policy likely to be maintained stable

As far as monetary policy decision is concerned, the central bank is likely to be comfortable with the current growth performance. While inflation is also likely to remain with target for the year, we doubt that the BSP may want to trim its main policy rate going forward given the wrong signal that it may send amidst the broadly strong economic expansion. The recent weakening of the PHP and the market selloff in June has provided some room for the authorities, amidst earlier concerns of excessive capital inflows in the economy. Given that the interest rates paid to the Special Deposit Account are currently at record-low, we think that the risks are tilted towards the upside with regards to interest rate prospect going forward.

Longer-term growth prospect needs an extra boost

The favorable mid-term election results in May have continued to fuel anticipation that President Aquino and his administration may look to loosen restrictions on foreign investments in some key sectors in the economy. We have highlighted previously that one underlying limiting factor to our assessment on the Philippines is the fact that total FDI inflows have been extremely weak in recent years despite the influx of foreign money into the region. In fact, total FDI inflows in 2012 were recorded at only USD 2bn, less than 10% of total remittances recorded in the year.



Source: CEIC, OCBC Bank

Looking at the brighter side of things

Looking to the brighter side

Economic growth in the first half of 2013 has fallen short of market expectations, clocking a mere 4.9% yoy in 1H13, and is markedly slower than the lackluster 5.0% growth seen in 2012. The disappointing growth has also been reflected by downgrades from international bodies, with the IMF and the World Bank now expecting the economy to grow by a mere 5.2% and 5.3% respectively in 2013, down from their previous outlook of 5.8% and 5.5% earlier this year. However, looking at the brighter side of things, it is encouraging to see inflation falling to 6.7% in June vs our previous expectations of 9.7% for the year, suggesting that the central bank has more room for policy easing to encourage growth this year.

Our concerns however, remains the same: we continue to see the inefficient growth model, reflected by a weak banking system, heavily indebted state-owned enterprises, and the lack policy credibility and transparency as key risks for the economy this year. We stay pat on our GDP growth target of 5.0% this year, while expecting inflation to run tame at 7.2% over the same period. We also expect GDP to grow to 5.3% in 2014, underscoring the positivity to be seen from the recent structural reforms.

Recognition to rectify the bad debt plague is an encouraging sign

While it is necessary to be concerned over the weak banking system and amounting bad debt levels, we take comfort from the recent move by the government to accelerate banking reforms via the implementation of the Vietnam Asset Management Company (VAMC). A decree that will take effect on July 9, the VAMC is aimed to significantly reduce the bad debt levels in the economy via the purchase of such debt from financial institutions and replacing it with a 5-year zero coupon bond, which can be used as a collateral by the institutions to obtain refinancing funds. In essence, the VAMC scheme is an instrument for the financial institutions to swap their toxic debts for refinancing from the State Bank of Vietnam (SBV).

Non-performing loan (NPL) ratio has significantly fallen from 8.8% in 2011, to 4.5% at the end March-2013, but questions remain over the methodology of the classification, with international rating firms commenting that the NPL ratio could be as high as 15% if calculated by international standards. Despite the discrepancy in methodology, the recognition and concrete moves to rectify the bad debt issues in the economy is encouraging, and it serves as a viable first step to eventually remove this hindrance to a sustainable growth.

Look to the property market as a potential source of growth

In addition to the VAMC initiative, the state-owned Bank for Investment and Development of Vietnam (BIDV) has applied for VND 10 trillion from the SBV to support the social-housing segment of the property market, and will be the main lender for housing projects to the Housing and Urban Development Corporation (HUD) for the next three years. According to official plans, the HUD aims to complete 10,000 budget apartments through 2015. We opine that this programme will promote

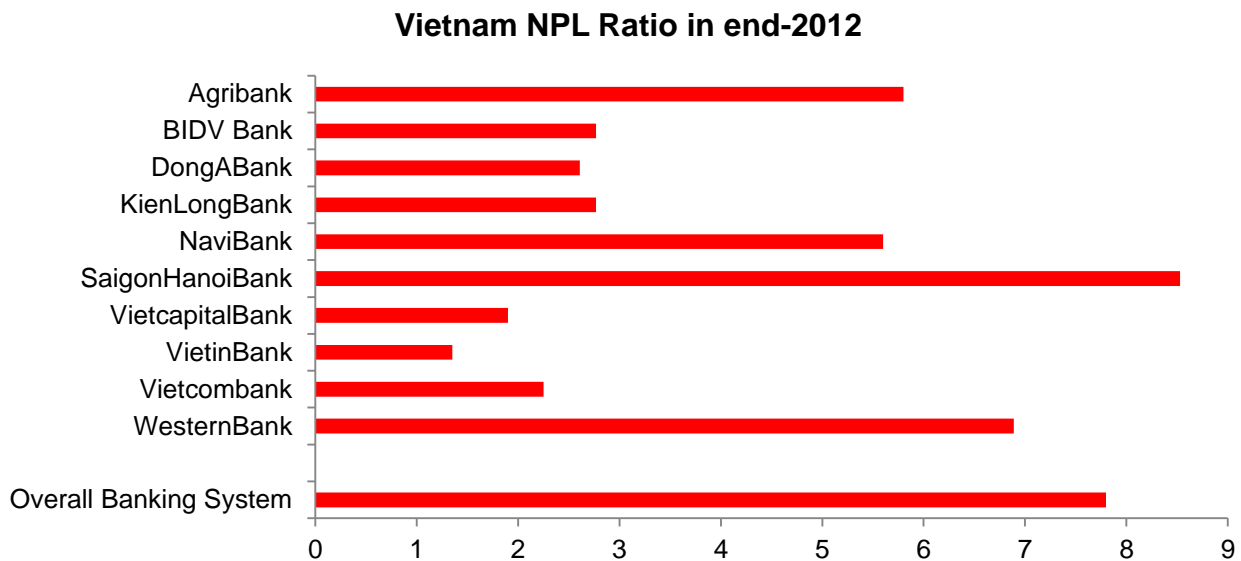
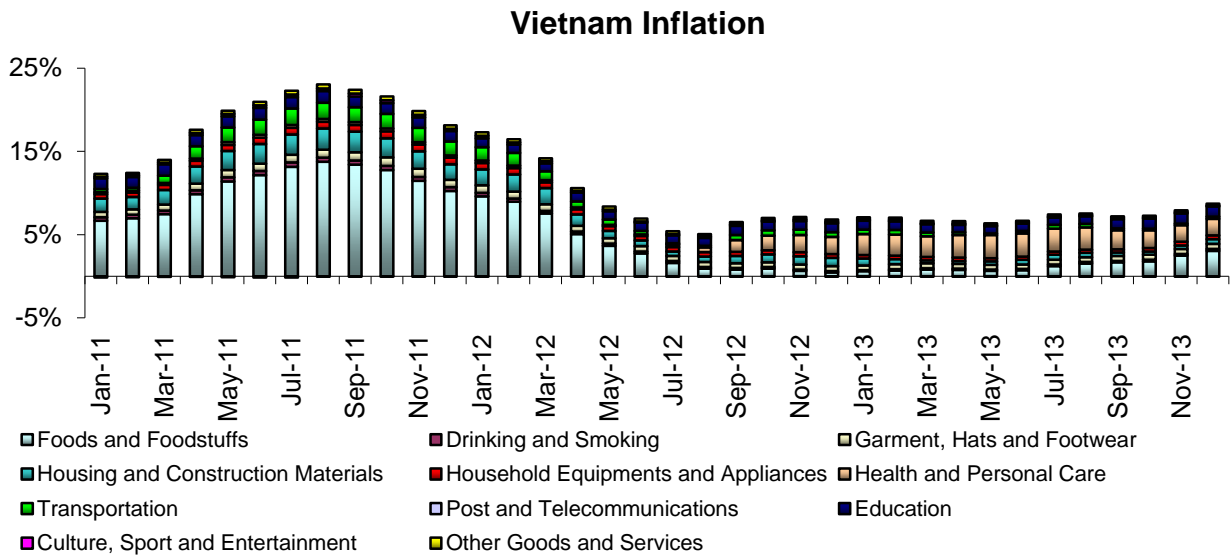
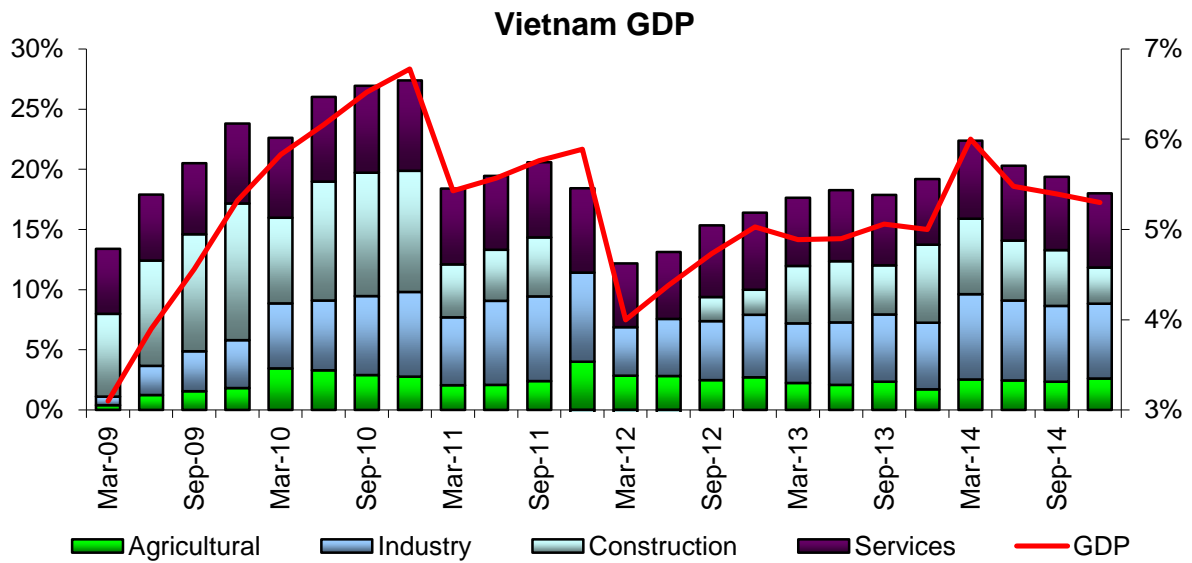
the real estate market in Vietnam, stimulating demand especially from the low-middle income earners, promote credit growth and eventually provide an additional growth engine for the domestic economy, as house buyers are able to obtain a maximum borrowing level equal to 85% of house value, with preferential rates at about 90% against the general lending interest rates of credit institutions.

More interest rates cuts on the cards, but beware

The move to promote credit growth and the recent rate cuts (such as discount rate, refinancing rate) by 100bps to a total of 800bps since the start of 2012 is hardly a concern given the tame inflationary pressures seen in the 1H13. Given the need to boost growth to official target of 5.5%, we opine the need for further rate cuts (presumably another 100bps for the year) to stimulate growth. We warn however, of the recent double-digit inflationary rate seen in 2011 and the futility of interest rate hikes then to tame the phenomenon. Do note that the inflation then was primarily fueled by the depreciation pressure of the VND, which saw a 7.3% devaluation then. As such, should inflationary pressures be promoted beyond acceptable levels at around 8.0%, we advise caution despite the above mentioned positives, as high inflationary pressures are a clear headwind against growth sustainability.

The importance for sustainable growth

All in all, the key to sustainable growth is not entirely dependent on short-term adjustments to monetary policy, but rather, the structural reforms needed to correct the toxic debt levels, inefficiencies of the state-owned enterprises and the lack of transparency to muster confidence from both international and domestic investors. While we take comfort from the recent structural reforms seen in the VAMC initiative, the prospect and effectiveness of such to reduce the NPL ratio is still in question.



Source: CEIC, Official Bank Statements, OCBC Bank

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