Economics
Markets
Strategy

4Q 2014

DBS Group Research
September 11, 2014

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Economic forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2011	2012	2013	2014f	2015f	2011	2012	2013	2014f	2015f
US	1.6	2.3	2.2	1.9	2.6	3.1	2.1	1.5	1.7	1.9
Japan	-0.5	1.4	1.5	1.2	1.0	-0.3	0.0	0.4	2.9	1.5
Eurozone	1.6	-0.7	-0.4	0.6	0.9	2.7	2.5	1.3	0.5	0.8
Indonesia	6.5	6.2	5.8	5.4	5.9	5.3	4.0	6.4	6.0	5.8
Malaysia	5.1	5.6	4.7	5.9	5.2	3.2	1.7	2.1	3.0	3.2
Philippines	3.6	6.8	7.2	6.4	6.4	4.7	3.2	2.9	4.4	4.1
Singapore	6.0	1.9	3.9	3.0	3.6	5.2	4.6	2.4	1.5	2.8
Thailand	0.1	6.4	2.9	1.6	4.0	3.8	3.0	2.2	2.1	3.3
Vietnam	5.9	5.0	5.4	5.4	5.7	18.6	9.3	6.6	4.8	5.8
China	9.3	7.7	7.7	7.5	7.5	5.4	2.6	2.6	2.7	3.2
Hong Kong	4.9	1.5	2.9	2.6	3.0	5.3	4.1	4.3	4.4	4.5
Taiwan	4.2	1.5	2.1	3.5	3.7	1.4	1.9	0.8	1.4	1.3
Korea	3.7	2.3	3.0	3.5	3.8	4.0	2.2	1.3	1.5	2.5
India*	6.7	4.5	4.7	6.1	6.6	9.0	7.4	9.5	8.1	7.0

* India data & forecasts refer to fiscal years beginning April; prior to 2013.

Source: CEIC and DBS Research

Policy and exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	4Q14	1Q15	2Q15	3Q15	current	4Q14	1Q15	2Q15	3Q15
US	0.25	0.25	0.25	0.25	0.25	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	106.9	105	106	108	109
Eurozone	0.05	0.05	0.05	0.05	0.05	1.292	1.28	1.27	1.26	1.25
Indonesia	7.50	7.50	7.50	7.50	7.50	11,823	11,750	11,750	11,750	11,750
Malaysia	3.25	3.50	3.50	3.50	3.50	3.20	3.20	3.18	3.17	3.16
Philippines	3.75	4.00	4.00	4.00	4.25	43.9	43.3	43.1	42.9	42.7
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.26	1.26	1.25	1.24	1.23
Thailand	2.00	2.00	2.00	2.00	2.25	32.2	32.3	32.1	32.0	31.9
Vietnam^	6.50	6.50	6.50	6.50	6.50	21,205	21,200	21,200	21,200	21,200
China*	6.00	6.00	6.00	6.00	6.00	6.13	6.10	6.07	6.04	6.01
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.75	7.76	7.76	7.76	7.76
Taiwan	1.88	1.88	2.00	2.13	2.25	30.0	29.6	29.5	29.4	29.3
Korea	2.25	2.25	2.25	2.50	2.75	1036	1025	1020	1015	1010
India	8.00	8.00	8.00	8.00	8.00	60.8	61.3	61.6	61.9	62.3

^ prime rate; * 1-yr lending rate

Source: Bloomberg and DBS Group Research

Interest rate forecasts

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

		11-Sep-14	4Q14	1Q15	2Q15	3Q15
US	3m Libor	0.23	0.30	0.30	0.30	0.40
	2Y	0.57	0.70	0.85	1.05	1.35
	10Y	2.54	2.70	3.00	3.20	3.40
	10Y-2Y	197	200	215	215	205
Japan	3m Tibor	0.21	0.25	0.25	0.25	0.25
Eurozone	3m Euribor	0.09	0.20	0.20	0.20	0.20
Indonesia	3m Jibor	8.12	8.00	8.00	8.00	8.00
	2Y	7.49	7.60	7.80	8.00	8.00
	10Y	8.14	8.25	8.50	8.50	8.50
	10Y-2Y	65	65	70	50	50
Malaysia	3m Klibor	3.73	3.75	3.75	3.75	3.75
	3Y	3.60	3.70	3.70	3.80	3.80
	10Y	4.01	4.00	4.10	4.20	4.20
	10Y-3Y	41	30	40	40	40
Philippines	3m PHP ref rate	1.31	1.50	2.00	2.50	2.50
	2Y	2.95	3.20	3.40	3.40	3.50
	10Y	4.43	4.50	4.50	4.50	4.60
	10Y-2Y	148	130	110	110	110
Singapore	3m Sibor	0.41	0.40	0.40	0.40	0.45
	2Y	0.53	0.70	0.88	0.98	1.03
	10Y	2.44	2.50	2.55	2.65	2.70
	10Y-2Y	191	180	168	167	167
Thailand	3m Bibor	2.18	2.20	2.20	2.20	2.45
	2Y	2.43	2.50	2.60	2.80	2.70
	10Y	3.69	3.80	4.00	4.20	4.20
	10Y-2Y	126	130	140	140	150
China	1 yr Lending rate	6.00	6.00	6.00	6.00	6.00
	2Y	3.92	3.90	4.00	4.00	4.00
	10Y	4.30	4.30	4.40	4.50	4.50
	10Y-2Y	38	40	40	50	50
Hong Kong	3m Hibor	0.36	0.40	0.40	0.40	0.50
	2Y	0.43	0.60	0.75	0.95	1.25
	10Y	1.98	2.05	2.15	2.35	2.50
	10Y-2Y	155	145	140	140	125
Taiwan	3M CP	0.80	0.80	0.88	0.96	1.04
	2Y	0.60	0.65	0.70	0.75	0.80
	10Y	1.71	1.65	1.70	1.70	1.70
	10Y-2Y	111	100	100	95	90
Korea	3m CD	2.35	2.40	2.40	2.65	2.90
	3Y	2.51	2.50	2.60	2.80	3.00
	10Y	3.07	3.10	3.20	3.30	3.40
	10Y-3Y	56	60	60	50	40
India	3m Mibor	8.91	9.00	9.00	9.00	9.00
	2Y	8.46	8.50	8.60	8.60	8.60
	10Y	8.54	8.55	8.65	8.65	8.65
	10Y-2Y	8	5	5	5	5

Source: Bloomberg and DBS Group Research

5 years down, 5 to go?

One should call a spade a spade: it's been an awful year so far for global growth. The US delivered 1% growth in the first six months of the year, half the pace of the past five years. Europe's Core-3 countries – GE, FR and IT – shrank in the first six months of the year. It's not the periphery that's faltering there today, it's the core. Japan's economy shrank by 0.7% in the first six months of the year. Why does everything seem to be going the wrong way? Is it ever gonna change?

It could be a while. It's been 5 years since the launch of QE in the US. During that time, growth has averaged 2% and inflation has gone down, not up. Why is this, with so much money being 'injected' into the economy? Because the money never went into the economy. It went straight into the Fed's basement in the form of excess reserves. Banks don't want to lend it into the economy and no one wants to borrow anyway. Consumers are still paying back the 10-year build-up of debt and leverage that finally collapsed in 2008. Producers still face significant excess capacity. Good progress has been made on both fronts but at the current pace it could take another 5-6 years for households to and producers to eliminate their respective overhangs.

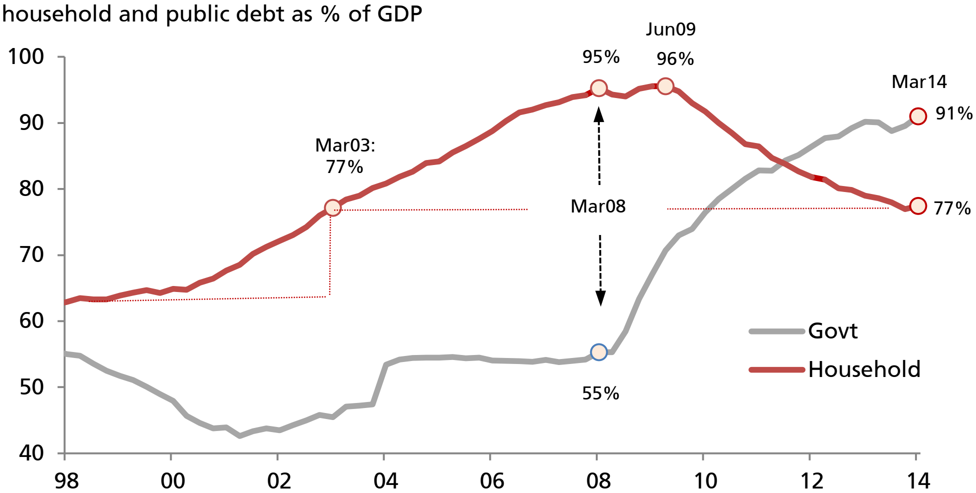
Europe? When Draghi 'saved the euro' two years ago he did it by chasing financial market speculators out the picture. That was critical but it was only half the problem. The real economy problem – competitiveness differentials – was the bigger problem. And chasing speculators away was never going to solve it. Trouble was bound to return. It has.

With Core-3 growth negative in the first half of 2014 and inflation rapidly approaching zero, the ECB has cut interest rates further and initiated a bond buying program that resembles QE in all but name. Will it work? Probably no better or worse than it did in the US. You can lead a horse to water but Europe's don't seem any more inclined to drink than America's.

If monetary policy can't fix the real economy, the question remains: how long will it take Europe to regain competitiveness? Most reckon several more years at least. Ironically perhaps, falling inflation is Draghi's friend, not his enemy. Falling prices

US – non-financial sector leverage

household and public debt as % of GDP



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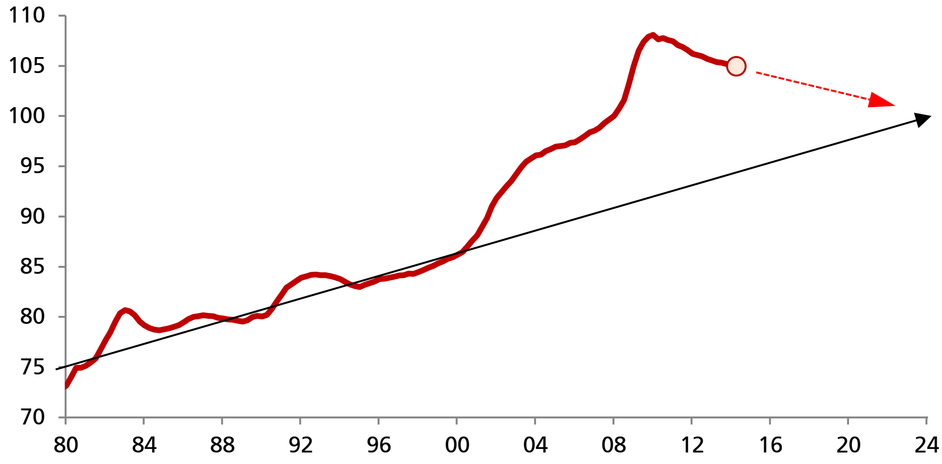
US – K stock per worker

1Q08=100, 09P



relative to your neighbor's is the very definition of a competitiveness gain. The more Draghi succeeds in keeping inflation up, the longer it takes Europe to recover.

A weaker euro would help. It wouldn't help Greece export to Germany but it doesn't have to. The beauty of international trade and finance is that Greece can sell anywhere in the world and use the money to repay what it owes Germany. Thank goodness debt reduction in the periphery doesn't rely on greater German demand, like so many have claimed. Germany creates a Germany every 50 years. Asia creates a Germany every 3.5 years. If anyone's incremental demand is going to save the euro, it's Asia's.

The trouble with a weaker euro, or course, is a weaker yen. Everyone wants a weaker currency and that's impossible. It's risky too. What goes around comes around and the circle can turn vicious in a hurry. Currency depreciation isn't a viable strategy for restoring structural competitiveness when more than one country is trying to do it. You have to do it the hard way, by raising productivity and lowering wages. One could easily imagine it taking Europe another 5-6 years to accomplish this.

Japan is trickier. Abenomics lifted sentiment temporarily but growth over the past year has been zero and structural change / reform is just as elusive as before. At least things are moving in the right direction in the US and Europe. It's harder to say the same for Japan.

And Asia? What's different here? India it seems! At least for the moment. Sentiment is high following the election of Modi as prime minister. The stock market is up by 27% this year and 2Q GDP growth surged by more than 10% (QoQ, saar). If the honeymoon is to last, Modi needs to deliver structural change, just like Europe and Japan (see "India" below). The lesson from Abenomics is one must strike while the iron is hot. Talk on the ground of it "realistically" taking Modi two years to show results is disconcerting. Sentiment could sour long before that.

The clock is ticking. In India as it is in Japan, Europe, China, the US ...

David Carbon, for

DBS Group Research

September 11, 2014

Is it ever gonna change?

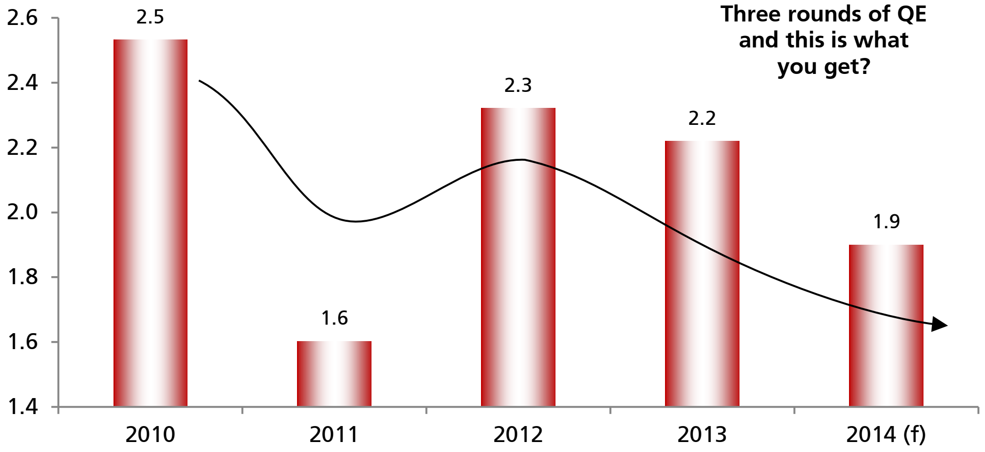
- **The US delivered 1% growth in the first six months of the year, half the pace of the past five years**
- **Europe's Core-3 countries – GE, FR and IT – shrank in the first six months of the year. It's not the periphery that's faltering there today, it's the core**
- **Japan's economy shrank at 0.4% pace in the first six months of the year. It's delivered zero growth over the past four quarters**
- **Why does everything seem to be going the wrong way?**
- **Is it ever gonna change?**

Every year since 2009, Fed officials and markets alike have thought "this would be the year" for recovery. In some sense, they were right – the US economy has been recovering steadily for five years. But what they really meant was that "this would be the year" growth ratcheted up to long-run average or even faster – as it's always done coming out of recession – and slack in labor markets and production capacity would quickly dissipate.

Every year, though, these expectations proved too optimistic. Growth in 2010 and 2011 averaged only 2.1%, barely two-thirds the 30-year average of 3%. Growth in 2012 was only slightly higher at 2.3%. Last year it fell back to 2.2%. Not a good showing and this year it's worse: full year growth appears headed back below 2%. Only sequential expansions of 3.5% (QoQ, saar) in Q3 and Q4 would prevent that from happening and the monthly data flow (discussed below) don't suggest any such reprieve is on the cards. In the 5.25 years since QE began, growth has averaged 2% per year and this year the economy will probably undershoot that mark rather than overshoot it. It's recovery Jim – honest – but not like we've ever known it.

US – GDP growth

% full year growth



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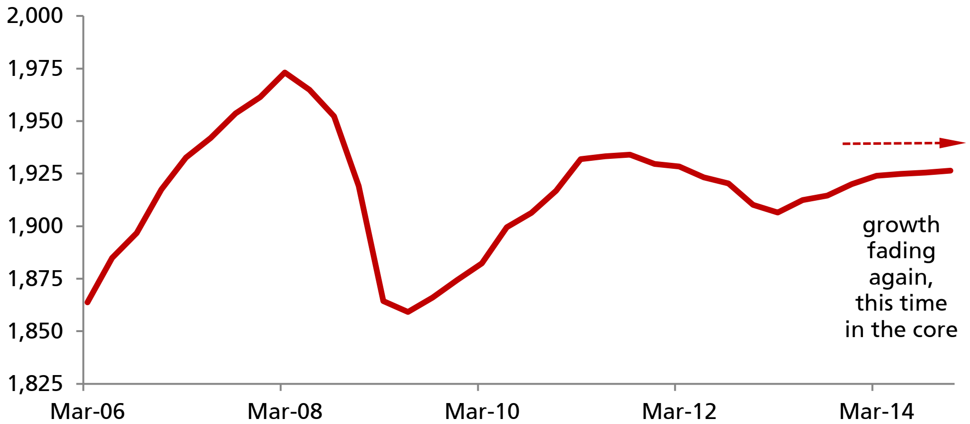
ECONOMICS

Eurozone – GDP

EUR bn, 00P



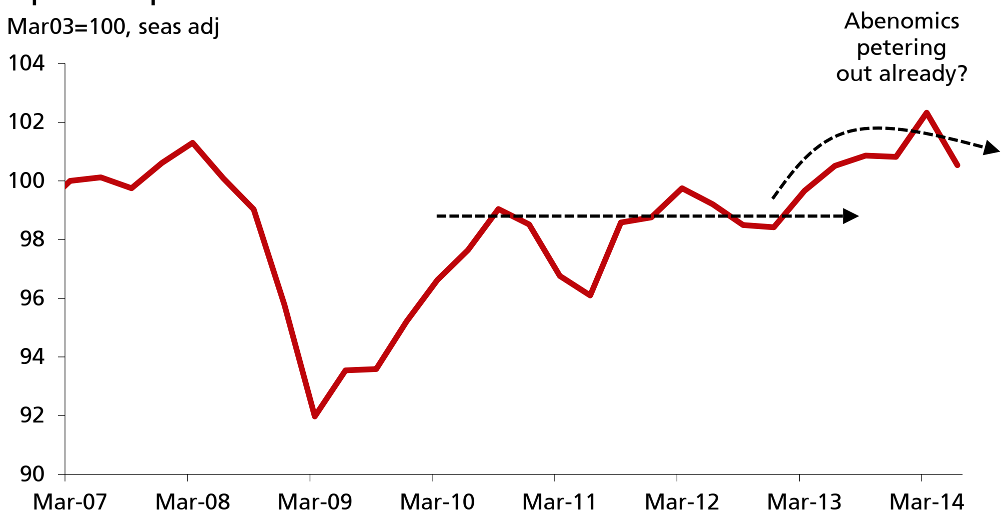
Europe's double dip recession risks becoming a triple

In Europe, things are worse. Growth there for the past 5.25 years has averaged 0.6%, thanks to a second recession following the global financial crisis of 07/08. Most thought Europe had finally exited the second downturn a year ago (chart above) but now the core, rather than the periphery (where all the debt problems were centered back in 2011) is in trouble. Germany shrank by 0.8% (QoQ, saar) in Q2. Italy shrank by the same. France ran sideways. Compounded by an already weak first quarter, growth in Europe's Core-3 countries has been zero for the six months of the year. The ECB is now pursuing a quantitative easing (QE) program in all but name and is a whisker away from dropping that formality as well – just as the Fed is getting out of the business. QE is unlikely to prove any more effective there than it was in the US and Europe seems destined once again to be a drag on the rest of the world, including Asia, for the indefinite future.

And Japan? For a couple of quarters back in 2013, it rode a wave of positive sentiment emanating from Abenomics. No longer. The all-important "third arrow" – structural reform – never materialized, sentiment faded again and growth in the first half of this year has fallen back into negative territory. Yes, the consumption tax distorted Q2 growth downward but only by what it distorted Q1 upward. Net out the volatility and you're left with negative growth for the first half of the year and zero growth for the past full year. Like in the US and Europe, things seem to be slowing, not picking up.

Japan - GDP path

Mar03=100, seas adj



Japan's growth over the past 4 quarters has been zero

Asia continues to generate its own demand that drives its own growth. This year, growth should rise to 6.25%

Begging the question: Is it ever gonna change? Yes, as we explain below. But only very slowly in the US and Europe and in Japan the answer will continue to depend on whether the third-arrow is ever fired, just as it has been for the past 24 years. In the meantime, the Raggedy-Ann picture of the G3 that has prevailed for the past five years will persist. Plainly it bodes no better for Asia today than it has since 2008.

Mercifully, Asia continues to grow its own demand as it has for the past five years and this continues to fuel 6-plus percent GDP growth. China's downshift to 7.5% growth a couple years back means that Asia-10 potential is now about 6.25% so one shouldn't expect more than this going forward, save for cyclical / temporary overheating. Certainly nothing is overheating at the moment, though it is nice to see India kicking up some dust once again. Sentiment is high following the election of Modi as prime minister, the stock market is up 27% year-to-date and second quarter GDP grew by 10% (QoQ, saar). We've upped our full year forecast for India's growth to 6.1% from 5.5%, which will help lift Asia-10 GDP growth overall to 6.25% from 6.1% last year and 6% in 2012.

In Asia at least, things are moving in the right direction. Why is the G3 having so much trouble? Will things ever change? Yes, but slowly.

US – the short and the long of it

Thanks to bitter cold weather, the economy contracted by 2% (QoQ, saar) in the first quarter. For some reason, many believe the 4.2% rebound in the second quarter made up for that loss and that Q2 growth is the shape of things to come.

It didn't and it isn't. After a 2% contraction, 4% growth is lousy. It leaves year-to-date growth at 1%, half the pace of the past five years.

If 4% growth persisted then things would be okay. That's not on the cards. Consumption fell by 0.2% (MoM, sa) in July and notwithstanding a spurt in July auto sales appears headed for quarterly growth of 1.5% (QoQ, saar). That's a big step down from last quarter's 2.5% and barely higher than the 1.2% registered in Q1. This leaves our best estimate for 3Q GDP growth at 1.9% – and even that depends on a big improvement in the trade balance (table below).

Faster consumption growth is necessary if GDP growth is to accelerate. Unfortunately, the best that can be said for consumption is that cold weather losses sustained earlier in the year have been recouped. Take retail sales for example, growth has settled back into its trend range of 3.25%-3.5% YoY before

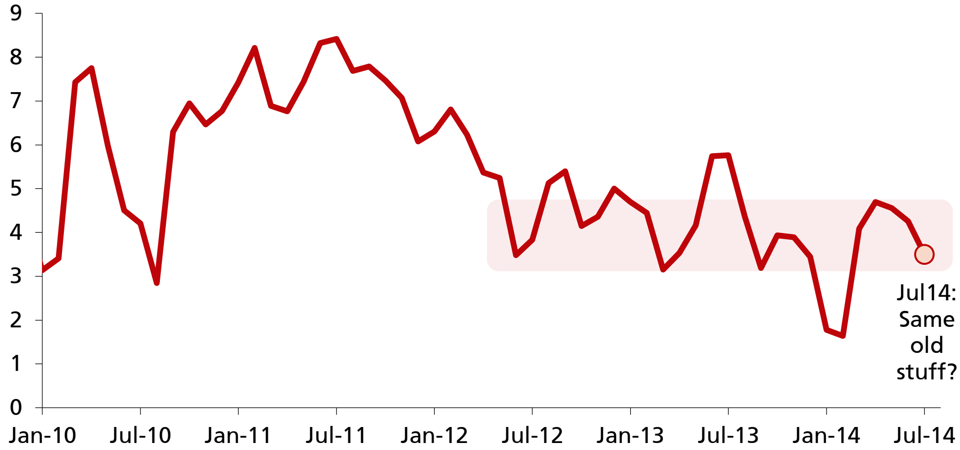
US GDP growth

				2013	-- 2014 --				--- 2015 ---	
	2013	2014(f)	2015(f)	Q4	Q1	Q2	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)
Output & Demand										
Real GDP*	2.2	1.9	2.5	3.5	-2.1	4.2	1.9	2.6	2.4	2.5
Private consumption	2.4	2.1	2.2	3.7	1.2	2.5	1.5	2.2	2.3	2.4
Business investment	3.0	5.7	5.5	10.4	1.6	8.4	6.0	5.0	5.0	5.0
Residential construction	11.9	1.7	5.1	-8.5	-5.3	7.2	6.0	4.0	5.0	5.0
Government spending	-2.0	-0.6	0.2	-3.8	-0.8	1.4	0.2	0.2	0.0	0.0
Exports (G&S)	3.0	3.2	5.5	10.0	-9.2	10.1	4.6	6.8	4.8	4.8
Imports (G&S)	1.1	3.7	3.9	1.3	2.2	11.0	0.0	4.0	4.0	4.0
Net exports ($bn, 09P, ar)	-420	-445	-430	-384	-447	-464	-440	-430	-430	-430
Stocks (chg, $bn, 09P, ar)	64	57	55	82	35	84	55	55	55	55
Contribution to GDP (pct pts)										
Domestic final sales (C+FI+G)	2.0	2.1	2.4	2.8	0.7	3.2	2.0	2.3	2.4	2.5
Net exports	0.2	-0.2	0.1	1.0	-1.6	-0.4	0.6	0.2	0.0	0.0
Inventories	0.0	0.0	0.0	-0.3	-1.2	1.2	-0.7	0.0	0.0	0.0

* % period on period at seas adj annualized rate, unless otherwise specified

US - retail sales growth

% YoY



Consumption has recovered from the cold weather at the start of the year. But that's all – weak trend growth remains

adjusting for inflation. But knock off 1.5 to 1.75 percentage points for inflation and you're looking at real sales growth of a little under 2%, just what you're seeing in the total consumption series in the GDP accounts. Importantly, no sign of acceleration is evident.

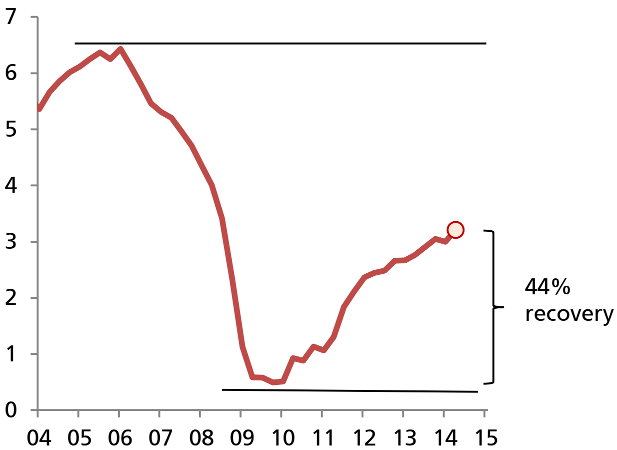
Capital overhang and the sorry state of investment

Weak consumption begets weak investment. After netting out depreciation, private fixed investment has risen to about 3% of GDP from 0.5% at the bottom of the crisis (chart below left). But it used to account for 6% of GDP or more, which means that less than half the ground lost during the meltdown has been recouped – five years after hitting bottom. In absolute dollar terms (chart below right), private fixed investment has yet to return to pre-crisis levels, some six years after the fact.

Weak investment means weak capital stock growth and it's the latter that gives – or used to give us – our rising incomes: the more machines and factories one has to work with, the more time one can spend 'on the beach' instead of in the office.

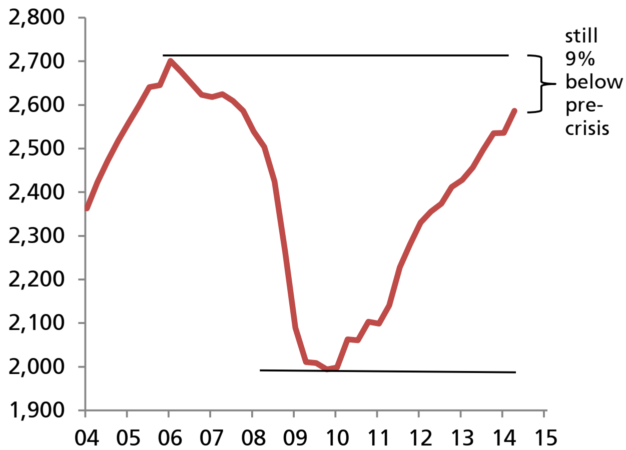
US – net private fixed investment as % of GDP

percent per year



US – private fixed investment

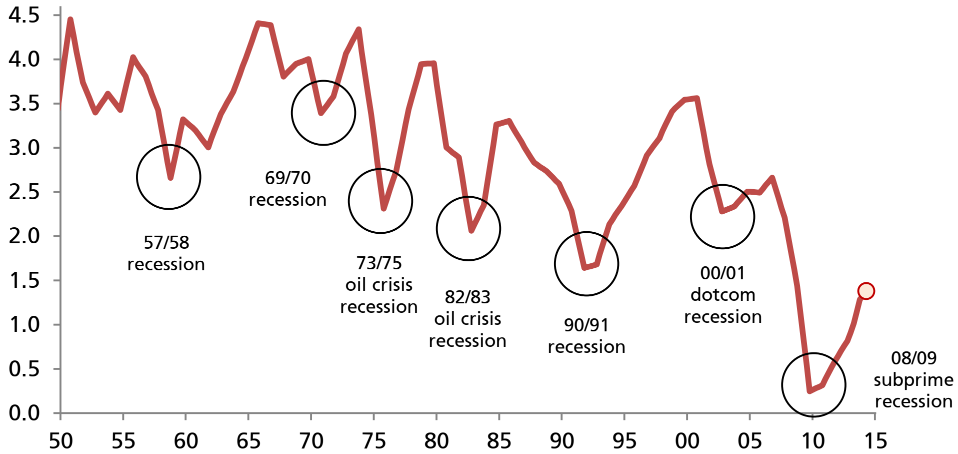
USD bn, 09P, saar



After 4 years of 'recovery', capital stock growth remains slower than the slowest point in any of the previous six recessions

US – capital stock growth

% YoY



The capital stock today is growing more slowly than at any time in the past 50 years, save only for the most recent collapse (chart above). That's a remarkable statistic / statement that bears repeating – after four years of 'recovery', current capital stock growth of 1.5% is slower than the slowest point ever reached in any of the past six recessions.

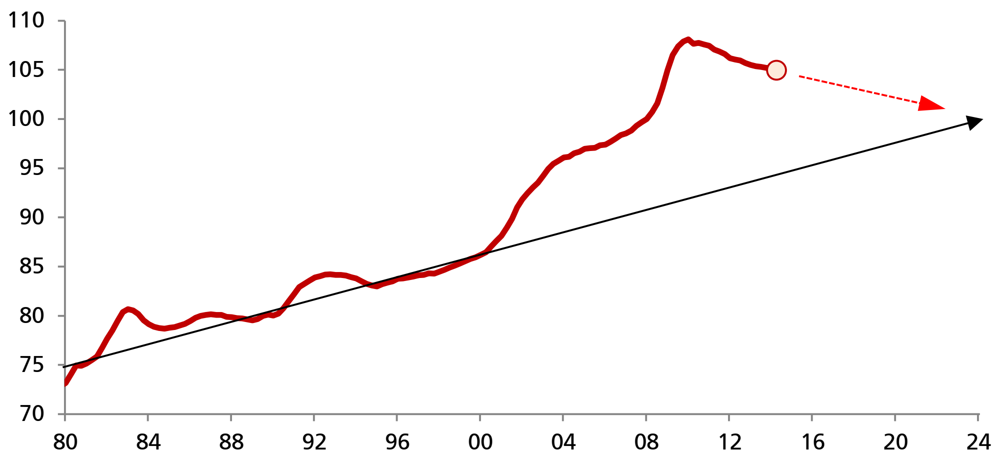
One might think, therefore, that the economy is starved for capital goods – that workers are being forced to share desks and computers and floor space and so on. That might also explain why hiring remains so weak – there's no point adding workers if there's no equipment to go with them.

In fact, though, the opposite is true – workers are swimming in a pool of excess capital. When Lehman Brothers collapsed, the capital labor ratio shot up and a large overhang remains (chart below). This 'capital overhang' explains why investment has been so weak. Until the excess has been absorbed, investment demand seems likely to remain weak. At the current pace of normalization, that could take another 6-7 years.

It could take 6-7 more years to absorb the capital overhang

US – K stock per worker

1Q08=100, 09P



Import demand -- the sum of all things

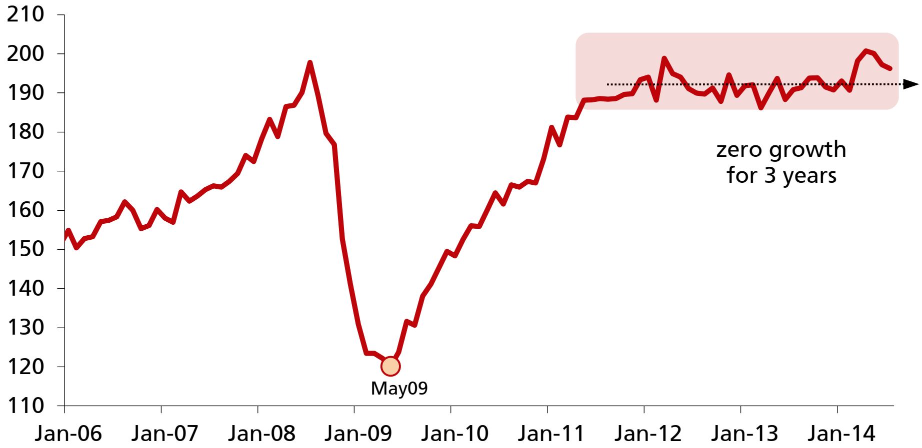
Imports are an excellent gauge of overall demand because they are the sum of all things: final and intermediate goods, raw materials, consumer and producer demand – the whole kit and kaboodle. What do imports say about the state of US demand?

Nothing good. They perked up a little bit in March but have contracted in the four months since. The broader picture remains clear: imports haven't grown by more than a couple of dollars for the past 2.5 years.

Imports are the sum of all things. They tell a clear story

US - imports

US$bn/mth, sa, BoP basis



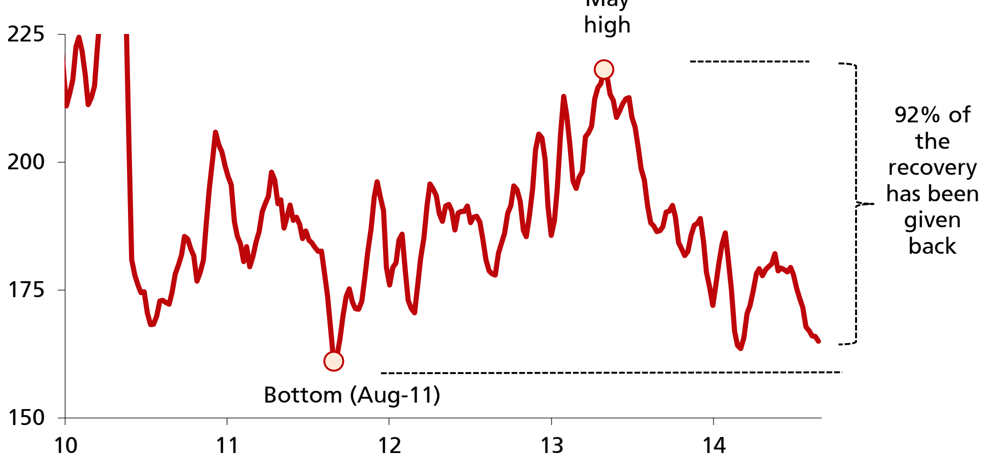
Housing demand

Housing used to be the symbol of recovery. Between early-2011 and early-2013, construction and home sales grew at a 20% trend pace. Prices rose at 12%-14% trend pace. That has all come to an end.

When the Fed started talking about tapering in mid-2013, mortgage rates jumped by 100 basis points and all forms of housing activity came to a stand-still. Since

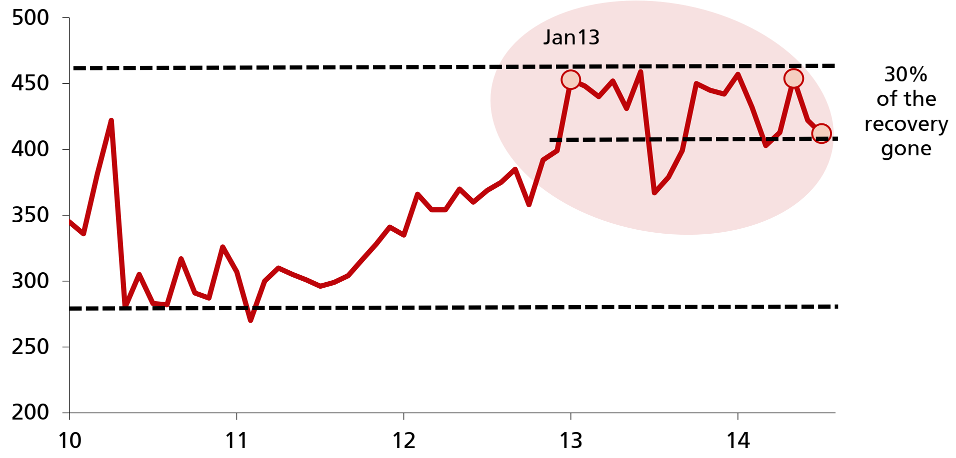
US - mortgage applications for purchase

Aug90=100, sa, 4wma



US – new home sales

thous/mth, saar



The good news is under the hood: households are paying down old debt

May-2013, mortgage applications – the first step in home ownership for everyone except hedge funds – have collapsed. They are now only 2.9% higher than at the very nadir of the crisis. Put differently, 92% of the two year recovery in mortgage applications has evaporated (chart at bottom of previous page).

New home sales aren't faring quite as poorly but almost (chart above). They stopped growing back in early-2013 and as of July have given back 30% of their two year recovery. Given that they lag mortgage applications, the outlook for sales and construction is precarious at best. Housing has been the biggest risk to the broader outlook for the past 18 months and it remains so today.

One plus one

Put it all together and our best estimate for third quarter GDP growth comes to 1.9% (QoQ, saar). This would leave the first three quarters' average growth at 1.3%. A fatter 2.6% outcome is expected in 4Q, which would lift average GDP growth for the 4 quarters ending December to 1.7%. Considering that growth has averaged 2% for the past five years, it's hard to say things are 'finally picking up'. It's hard to say they're even moving in the right direction.

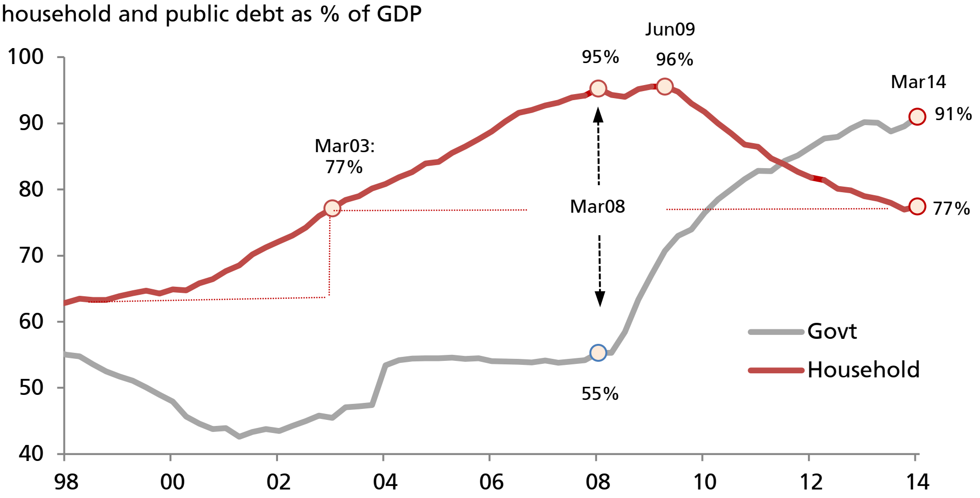
Is it ever gonna change?

It might not look like it on the surface but under the hood things are moving in the right direction. With consumption the ultimate driver of economic growth, the repair of household balance sheets is the most important gauge of recovery. The news here is good: the 10-year build up of debt and leverage that blew up in 2008 is quietly being brought back into line. Since mid-2009, household debt has been cut to 77% of GDP from a peak of 96% (chart top of next page). Nothing is more important for sustained recovery, however slow it may seem to be proceeding.

At 77% of GDP, half of the run-up in leverage has now been unwound. While unambiguously good, no one knows the magic number where consumption might start to accelerate again. It's possible that 77% is "low enough" and consumers might start spending more freely next week. But it's equally possible that households might want to get back to where they were before all the trouble began. If so, that would imply a 60% leverage ratio before consumption growth picked up. At the current pace of unwinding, that would take another 6-7 years.

US – non-financial sector leverage

household and public debt as % of GDP



Nothing is more important to sustained recovery and an eventual pick up than the repair of household balance sheets

The bottom line? Solid progress is being made on what is the most important determinant of sustained recovery and an eventual pick up in growth. But there is no magic number that signals a return to faster growth. Anyone who claims otherwise is selling snake oil.

Other measures of recovery

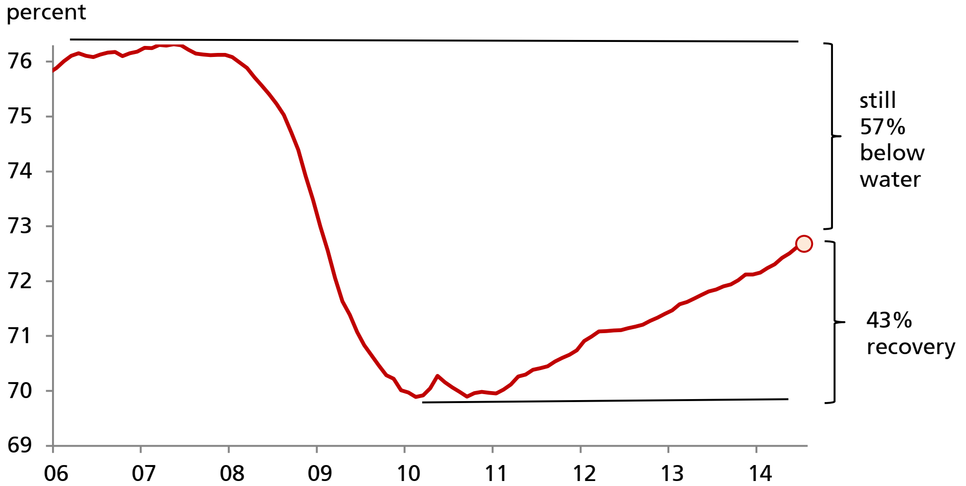
Household balances suggest it could be another 6-7 years before growth picks up. The capital overhang discussed above does too.

What about labor markets? How much slack / excess capacity remains there? That depends on who you talk to. Some claim that the unemployment rate, now down to 6.1%, means that slack is almost gone and it's time for the Fed to start raising interest rates.

Fed Chair Yellen, though, thinks otherwise At the Fed's Jackson Hole conference two weeks ago (which was all about labor markets) she discussed four measures of slack that explain why the unemployment rate is unreliable and why officials need to consider a wide variety of indicators before making judgements about unemployment / excess labor in the economy.

US – nonfarm payrolls as % of working age population

percent



After four years of 'recovery' labor markets have recouped less than half their losses of 2008/09

Do household balance sheets, a capital overhang and labor market slack make for a vicious triangle? Maybe not vicious, but certainly difficult

Our favorite measure (chart at bottom of previous page) may be the simplest. It is the proportion of working-age Americans who have a job. As one would expect, the fraction fell sharply after the collapse of Lehman Brothers in Sep-08. Four years later, less than half those losses have been recouped. Some ten million workers remain unemployed by this gauge. At the current pace of recovery, full employment won't be reached until 2021/2022, with clear / downward implications for inflation and consumption / economic growth in the meantime.

A vicious triangle?

An unholy trinity of household balance sheets (debt overhang), excess capacity (capital overhang) and labor market slack all point to another 6-7 years before growth returns to normal. Is this a vicious triangle? Not really. Negative feedback loops are impeding growth but things _are_ moving in the right direction. Recovery _is_ proceeding. It's just that it's been painfully slow for the past five years and it seems likely to remain that way for 6-7 more. In that sense, it's vicious enough.

What about Europe and Japan?

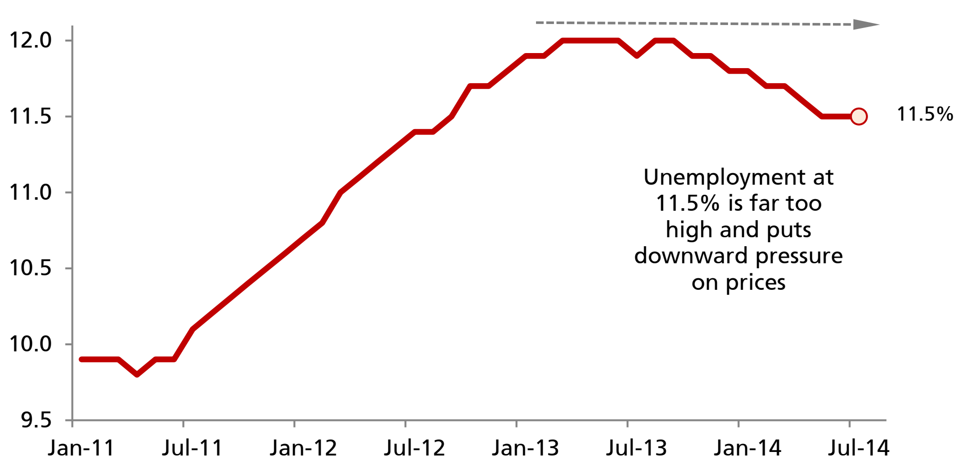
When ECB president Draghi 'saved the euro' two years ago he did it by chasing speculators out of the picture. Financial market pressure was acute, even critical, but it was always just half the problem. The real economy problem – a lack of competitiveness in many European countries – was, no surprise, the real problem. Dispatching the speculators relieved financial market pressure but did nothing to raise competitiveness / fix real economies. Trouble was bound to return. It has.

Output in Germany and Italy fell in the second quarter and ran sideways in France. Added to an already weak first quarter, output in the Core-3 countries fell by 0.1% (QoQ, saar) over the first six months of the year. Recession in other words. With unemployment still high and inflation falling ever closer toward zero (chart below), the ECB has cut interest rates to the bone (and/or further into negative territory) and begun a private sector bond purchase program that resembles QE in all but name.

Will it work? The Fed's experience suggests not. Five years of QE went hand in hand with 2% GDP growth and inflation that went down, not up. The main reason QE didn't do anything is because banks never put the funds into the economy, they left them the Fed's basement in the form of excess reserves. The metaphor of the Fed "injecting" money into the economy was always a false one. A better phrase is "you can lead a horse to water but you can't make him drink." Europe's horses seem no more inclined to drink than America's.

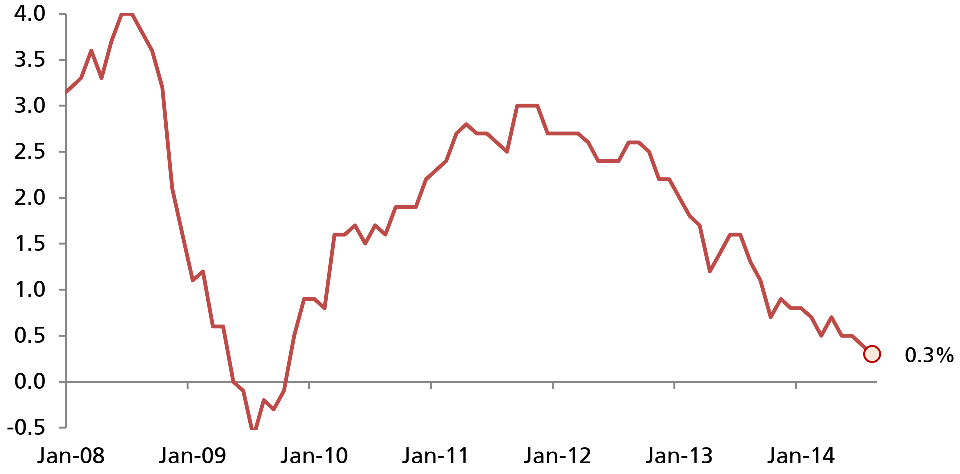
Eurozone – unemployment rate

%, sa



Eurozone – CPI inflation

% YoY, 3mma



Ironically, falling inflation is Draghi's friend, not his enemy

If monetary policy can't fix the real economy, the question remains: how long will it take Europe to regain competitiveness? Most reckon several more years at least. Ironically perhaps, falling inflation is Draghi's friend, not his enemy, so long as a vicious circle can be avoided. Falling prices relative to your neighbor's is the very definition of competitiveness gains. The more Draghi succeeds in keeping inflation up, the longer it takes Europe to recover.

It's a Catch-22. But a weaker currency and demand from the rest of the world can help. If the euro falls by 7% against the dollar, as it has since March of this year, that's just as good for exports as your inflation rate run 1 percentage point below that of your trading partners' for 7 years! It wouldn't help Greece sell exports to Germany but so what? The idea that the fate of the euro rested on Germany creating more demand to buy peripheral Europe's exports and thus lower its debt was always a false one.

At any realistic growth rate it would probably take Germany 50 years to double in size – to create a new Germany. Asia creates a Germany every 3.5 years

For starters, Germany was never capable of growing fast enough. If it grew at 2% per year, it would double in size – create a new Germany – in 35 years. The good news, as we have explained many times, is that the Asia-10 creates a Germany every 3.5 years [1]. If anyone is going to create the demand that saves the euro it is Asia, not Germany. Which works just fine. The great thing about international trade and finance is Greece doesn't have to sell exports to Germany to pay back its German debt. It can export anywhere in the world and pay Germany with the proceeds.

The caveat here – and it's a big one – is that currency depreciation is a zero sum game. Draghi wants to lower the euro by 20%; Kuroda wants to lower the yen by 20%. Pretty soon Yellen will want to lower the value of the dollar by 20% too and we're all back at Square-1. Currency depreciation always assumes your neighbor doesn't follow suit and that's risky. It's not a good long-run strategy for regaining competitiveness. Europe is probably going to need several more years to return to normal, just like the US.

Japan is trickier. Abenomics lifted sentiment and growth for several quarters in 2013. But the third arrow (structural reform) never materialized and sentiment has faded again. In the first six months of the year, GDP shrank by 0.7% (annualized). Growth for the past year has been zero.

Whether the third arrow will ever materialize is a fair question. It's been 24 years since the bubble blew and many thought Abe was finally the real deal. But the lack of significant reform and zero growth over the past four quarters doesn't suggest anything lasting is in the offing. Recovery may be slow in the US and Europe but at least things are moving in the right direction. It's not clear one can say that about Japan.

Asia is as Asia does

In 2014, Asia will drive its own growth, just as it has for the past six years. Going forward, that is unlikely to ever change

Where does all this leave Asia? Just where it has been for the past five years – driving its own growth, with its own demand, to the tune, this year, of 6.25%.

Six and a quarter percent growth may seem slow and it is compared to a few years back. But China has slowed, as most are aware, and it's a permanent / structural downshift. Given this, 6.25% growth in the Asia-10 overall is probably the new normal, for now anyway. Growth will slow further as the years go by.

That doesn't mean Asia's growing dominance in the global economy will fade. On the contrary, it will accelerate. Even with slower GDP growth, the time it takes Asia to "put a Germany on the map" will grow shorter and shorter. Asia will add three Eurozones to the global economy over the next 25 years [2]. As one might expect and as we explain in great detail on our Asian Insights website, that will bring profound changes to the global economy [3].

This note began by asking, "Is it ever gonna change?" From this latter perspective, the answer can only be: "It already is. Big time."

Notes:

[1] See for example "Asia: Gamechangers", 5May14.

[2] Ibid.

[3] www.dbs.com/insights

Sources:

Except where noted, data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts and transformations).

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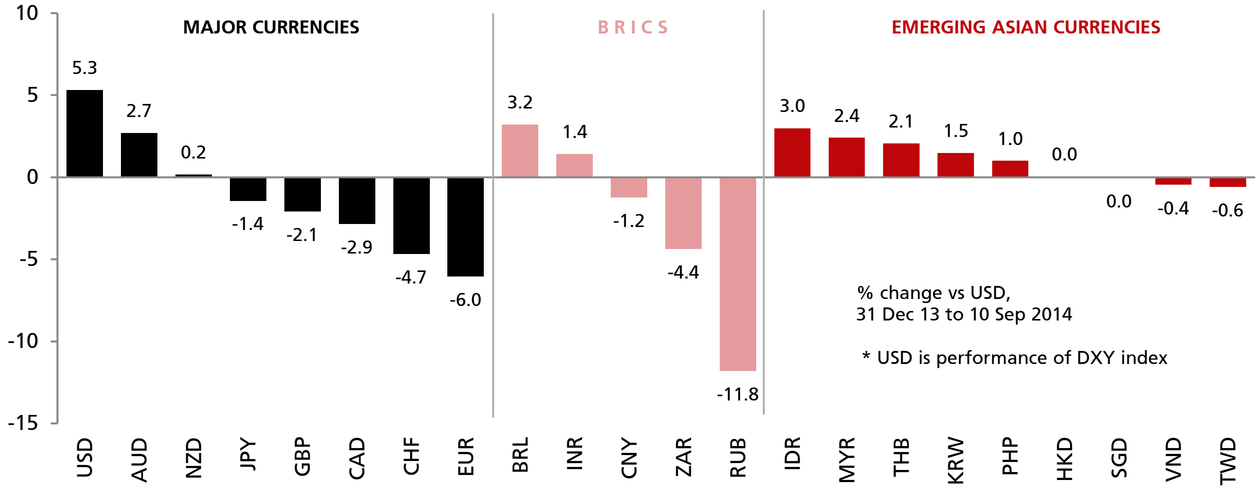
FX: Defensive

Asia	USD is the strongest G3 currency
	Fed hike expectation vs QE odds in Eurozone and Japan
	Global recovery intact despite weakness in Eurozone and Japan
	Optimism in Asia more evident in stocks than currencies
	Reform theme emerging in Asia
CNY	Appreciation pace to moderate
HKD	Interventions again
TWD	Fundamentally sound
KRW	Favoring consolidation
SGD	No strength from basket
MYR	Time for a pause
THB	Growth focus returns
IDR	Stability not secure
PHP	Slow recovery
VND	Targeting FDI
INR	Reform hopes vs Fed hike fears
USD	Relatively stronger
EUR	Under-estimated Draghi
JPY	Bears return
AUD	Stable like RBA
NZD	Hurt by RBNZ pause

Currencies in 2014 – America up, Europe down, Asia stable to firm



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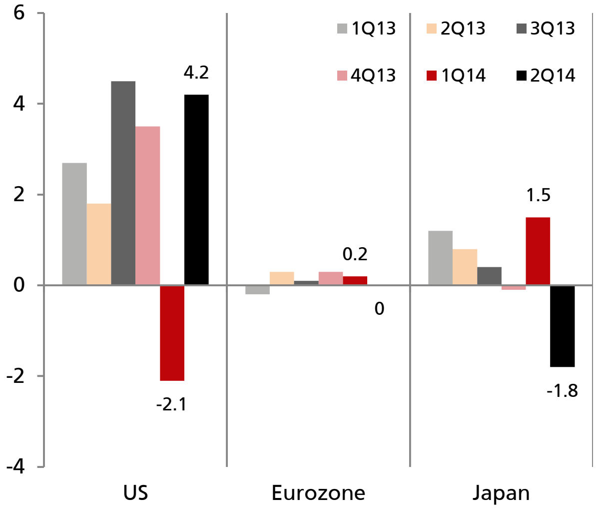
Currency forecasts

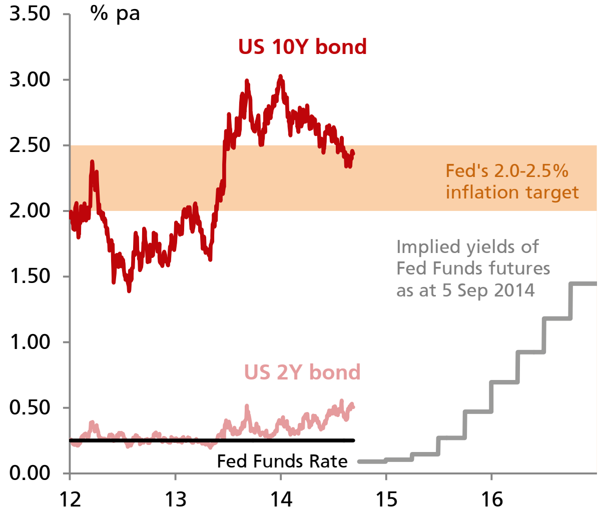
		10-Sep	4Q14	1Q15	2Q15	3Q15	4Q15
EUR /usd		**1.2916**	**1.28**	**1.27**	**1.26**	**1.25**	**1.24**
	Previous		1.38	1.39	1.40	1.41	1.42
	Consensus		1.30	1.30	1.28	1.27	1.26
usd/ **JPY**		**106.82**	**105**	**106**	**108**	**109**	**110**
	Previous		103	104	108	108	108
	Consensus		105	107	108	110	110
usd/ **CNY**		**6.1284**	**6.10**	**6.07**	**6.04**	**6.01**	**5.98**
	Previous		6.07	6.00	5.97	5.93	5.89
	Consensus		6.13	6.10	6.09	6.10	6.00
usd/ **HKD**		**7.7506**	**7.76**	**7.76**	**7.76**	**7.76**	**7.76**
	Previous		7.76	7.76	7.76	7.76	7.76
	Consensus		7.75	7.76	7.76	7.76	7.77
usd/ **TWD**		**29.990**	**29.6**	**29.5**	**29.4**	**29.3**	**29.1**
	Previous		29.6	29.5	29.4	29.3	29.1
	Consensus		29.9	29.8	29.9	29.4	30.0
usd/ **KRW**		**1033.7**	**1025**	**1020**	**1015**	**1010**	**1005**
	Previous		995	990	985	980	975
	Consensus		1017	1018	1010	1001	1005
usd/ **SGD**		**1.2632**	**1.26**	**1.25**	**1.24**	**1.23**	**1.22**
	Previous		1.22	1.21	1.20	1.19	1.18
	Consensus		1.26	1.27	1.27	1.26	1.28
usd/ **MYR**		**3.2000**	**3.20**	**3.18**	**3.17**	**3.16**	**3.14**
	Previous		3.15	3.14	3.12	3.11	3.09
	Consensus		3.20	3.23	3.25	3.18	3.20
usd/ **THB**		**32.185**	**32.3**	**32.1**	**32.0**	**31.9**	**31.8**
	Previous		32.6	32.5	32.4	32.2	32.1
	Consensus		32.5	32.8	33.0	32.5	33.5
usd/ **IDR**		**11830**	**11750**	**11750**	**11750**	**11750**	**11750**
	Previous		11500	11500	11500	11500	11500
	Consensus		11800	12000	12036	11901	12000
usd/ **PHP**		**43.930**	**43.3**	**43.1**	**42.9**	**42.7**	**42.4**
	Previous		42.9	42.7	42.5	42.3	42.1
	Consensus		44.0	44.0	43.8	43.5	44.0
usd/ **INR**		**60.940**	**61.3**	**61.6**	**61.9**	**62.3**	**62.6**
	Previous		62.6	63.0	63.3	63.7	64.0
	Consensus		60.0	60.1	60.5	60.5	61.0
usd/ **VND**		**21170**	**21200**	**21200**	**21200**	**21200**	**21200**
	Previous		21450	21480	21520	21560	21590
	Consensus		21325	21300	21400	21450	21500
AUD /usd		**0.9154**	**0.90**	**0.90**	**0.90**	**0.91**	**0.91**
	Previous		0.97	0.98	0.99	1.00	1.01
	Consensus		0.92	0.90	0.90	0.91	0.88
NZD /usd		**0.8220**	**0.82**	**0.82**	**0.83**	**0.83**	**0.84**
	Previous		0.87	0.87	0.88	0.88	0.88
	Consensus		0.84	0.83	0.82	0.84	0.80

DBS forecasts in red. Consensus are median forecasts collated by Bloomberg as at 10 Sep 2014

Real GDP growth, % QoQ saar



US bond markets see benign Fed hike outlook



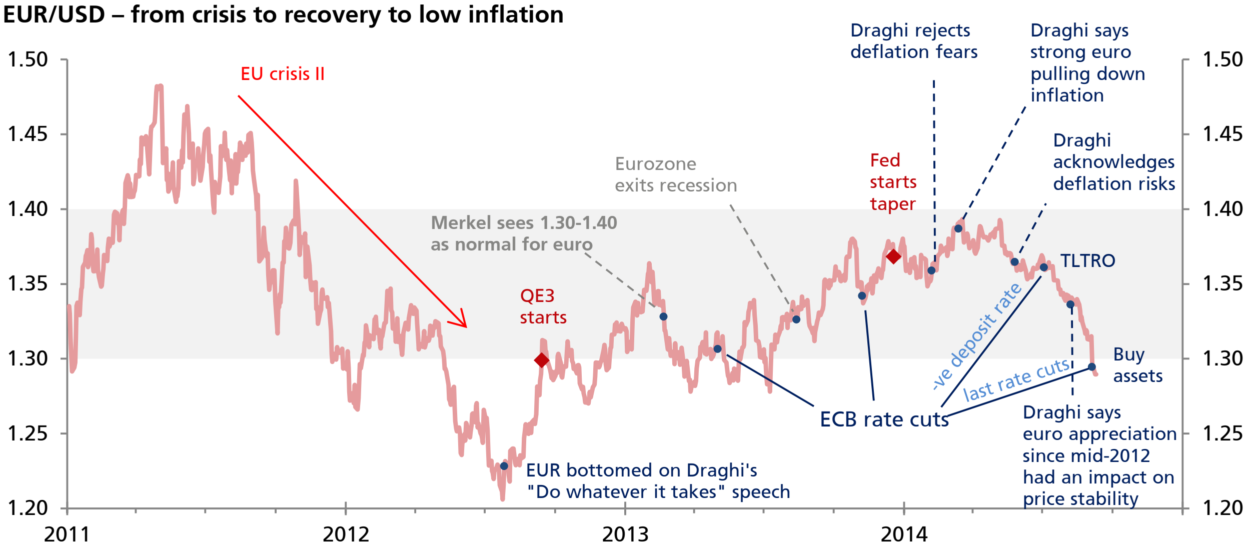
G3 currencies – balance sheet war

Unless the US economy stumbles again, the US dollar is expected to remain strong against its G3 counterparts – the Euro and the Japanese yen. The US economy rebounded in 2Q14 after an expected contraction in 1Q14. According to the US interest rate futures market, the US rate hike cycle is expected to start in 2H15, with the Fed Funds Rate reaching 1.50% by end-2016. The Fed's balance sheet is likely to stop expanding after it completes tapering asset purchases in October. Fed Chair Janet Yellen and her predecessor, Ben Bernanke, opined that there was no need for the Fed to shrink its balance sheet even whilst it normalizes monetary policy.

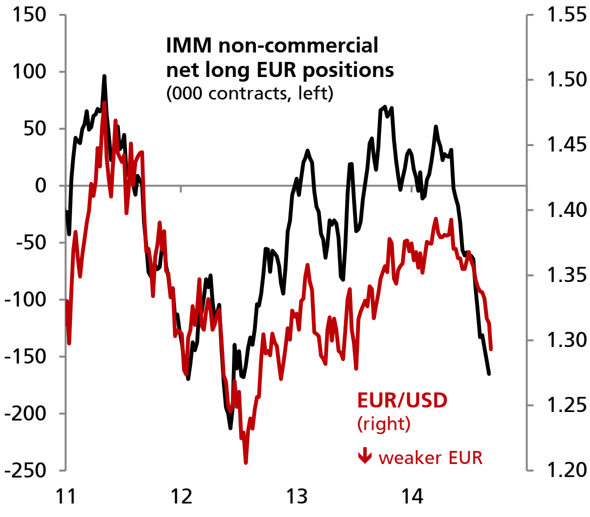
In the Eurozone, growth evaporated in 2Q14, while CPI inflation fell to 0.3% YoY in Aug14, to its lowest level since Oct09. Confidence was also hurt by geopolitical risks from the Ukraine/Russia crisis. The initial monetary measures announced by the European Central Bank (ECB) in June were aimed at fighting disinflation, with the second round of measures in September targeted at pre-empting deflation. The ECB expects these measures to expand its balance sheet.

While the rate cuts in September were said to be the last, the ECB has kept the door open for quantitative easing measures if growth and inflation fail to recover in the quarters, and worst, fall into negative territory. The ECB blames the euro's strength

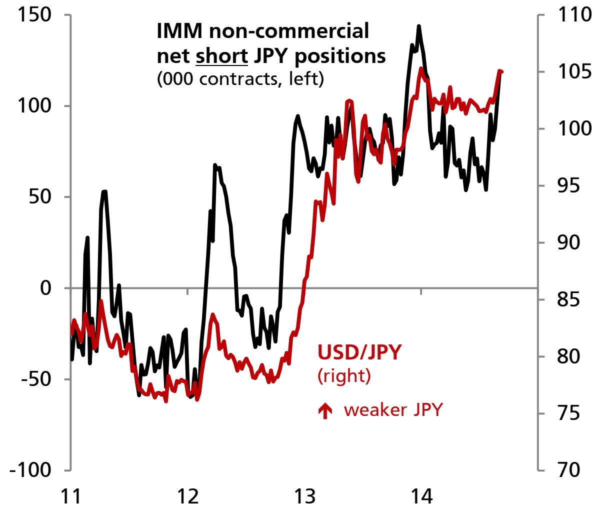
EUR/USD – from crisis to recovery to low inflation



Speculators are very short the euro



Speculators rebuilding short JPY positions

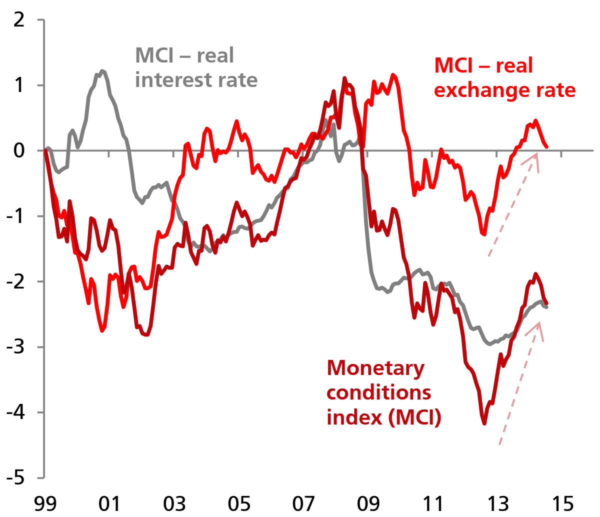


since mid-2012 for tightening monetary conditions and hurting the Eurozone's fragile recovery. Until optimism returns to the Eurozone, EUR/USD is expected to remain below 1.30 with a downside bias towards 1.25.

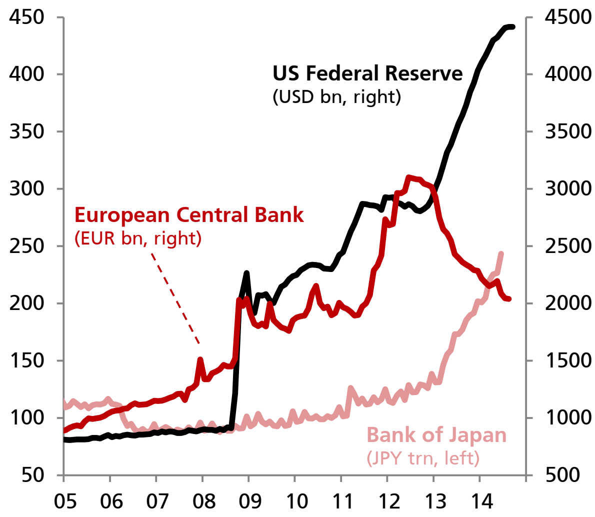
In Japan, growth plunged in 2Q15 after the sales tax was hiked to 8% from 5% on 1 April. PM Shinzo Abe will, after reviewing the economy's performance in 3Q14, decide around end-2014 whether to proceed with the second sales tax hike to 10% in October 2015. The Bank of Japan (BOJ) will also need to review its monetary base target by end-2014. Close attention is also paid to public and private pension funds as they shift from investing in domestic bonds to equities and overseas assets. USD/JPY is likely to have entered into a new and higher trading range between 105 and 110.

In summary, the Fed's balance sheet is expected to stop expanding. The ECB's balance sheet is set to stop contracting and expand on the TLTROs and the asset purchases coming in the rest of the year. The door remains open for the BOJ to keep expanding its balance sheet. Against this background, speculators have increased their bearish bets against the euro and the yen. That said, this quarter had also an important lesson. These speculative positions could quickly adjust should US and Eurozone/ Japan data switch places again.

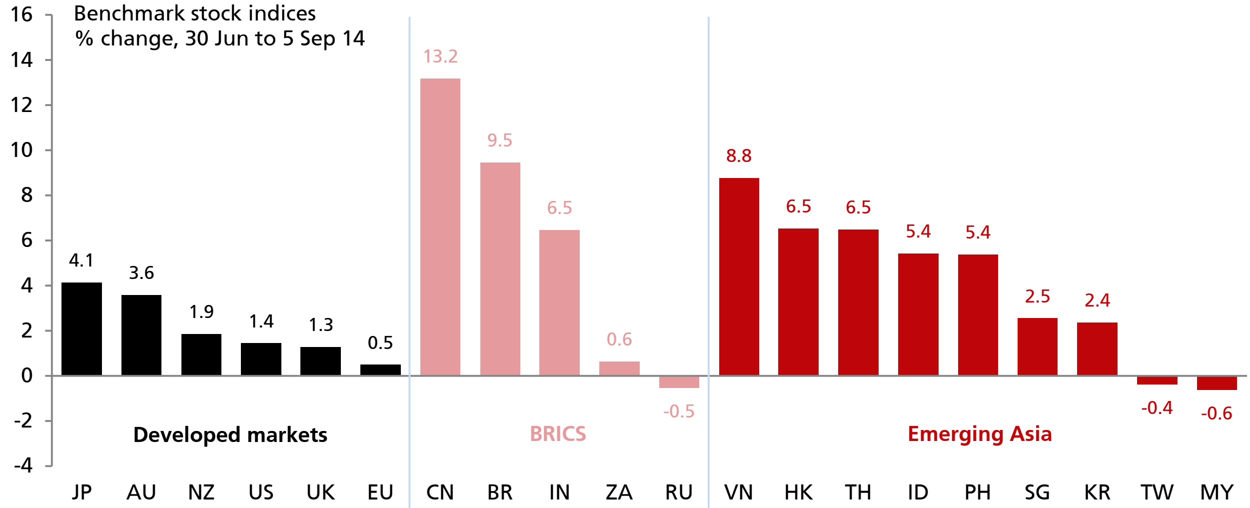
Strong euro blamed for tighter monetary conditions



G3 central bank balance sheets



Equities in 3Q14 – emerging markets continued to lead developed markets



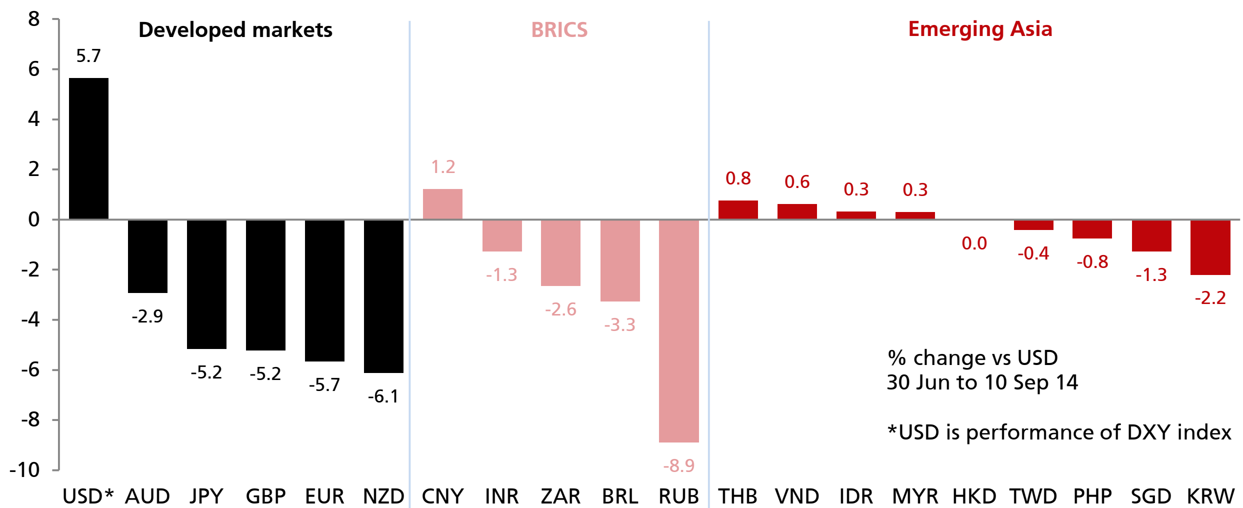
Emerging Asia – more optimism in stocks than currencies

Emerging Asian markets fared better than developed markets in 3Q14. This was, however, reflected more by their bullish stock markets than by their exchange rates. Owing to growth uncertainties in big economies like Eurozone and Japan, domestic-led Southeast Asian markets performed better than their export-led counterparts in Korea, Taiwan and Singapore. This divergence was also apparent on the monetary policy front. For example, the Malaysian ringgit appreciated ahead of its rate hike in July, while the Korean won depreciated into its rate cut in August.

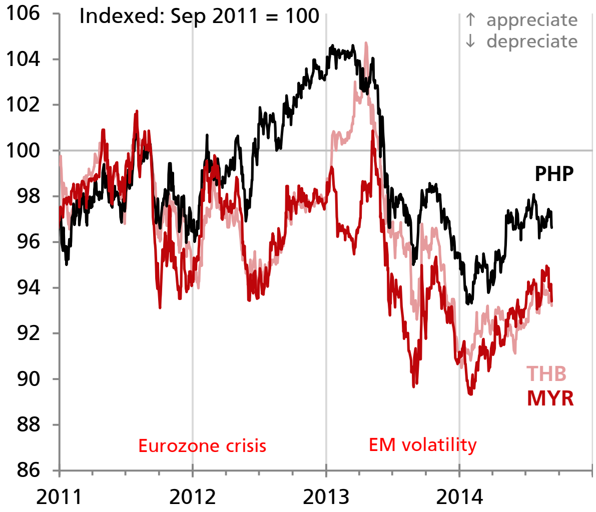
China and Hong Kong equities were buoyed by the launch of the Shanghai-Hong Kong Stock Connect program in September. The People's Bank of China (PBOC) was hardly seen in the markets and allowed both the CNY and CNH to appreciate past the official parity (fixing) rate. Meanwhile, the Hong Kong Monetary Authority (HKMA) intervened frequently from July to support HKD peg to the USD, at the floor of its 7.75-7.85 convertibility band.

Reform also emerged as a major theme starting with India and Indonesia electing pro-reform and business-friendly leaders at their elections this year. In Korea, the Ministry of Finance and the Bank of Korea have started to coordinate fiscal and monetary policies to revitalize domestic demand. With the Japanese yen weakening

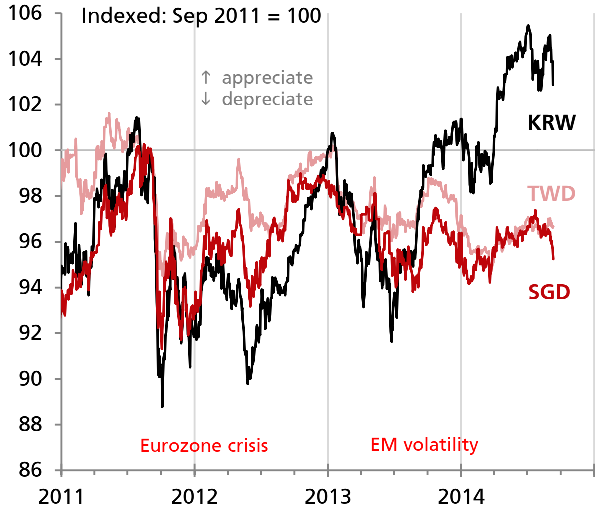
Currencies in 3Q14 – USD firmer against in developed markets, mixed in Asia ex Japan



Domestic-led Southeast Asian currencies



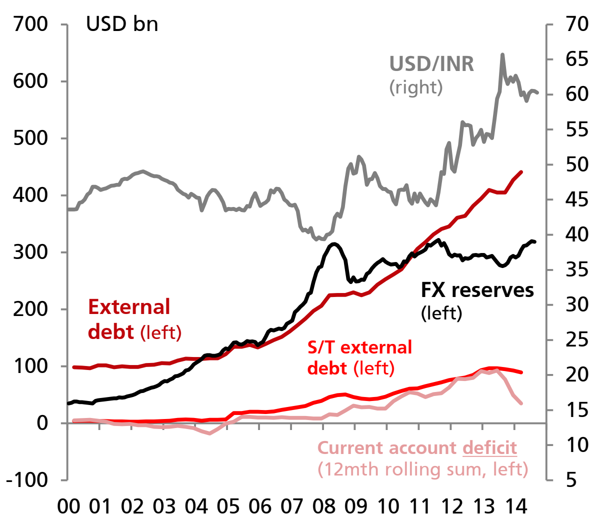
Export-led & surplus Asian currencies



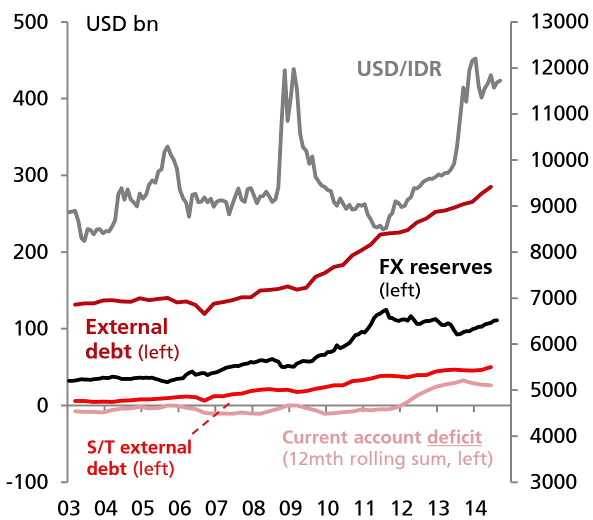
again, Korean policymakers have become less tolerant with won appreciation. In Thailand, the King approved a military-led functioning cabinet tasked with reviving the economy. Having improved macroeconomic stability, Vietnam is permitting foreign direct investment (FDI) enterprises to, with effect from 25 September, open FDI capital accounts in VND. On a positive note, these countries have a common goal to lift economic growth in their countries. Yet, there is little room for complacency. Last year's emerging market volatility demonstrated that capital inflows can quickly turn into outflows when stock markets fall, and the US starts paving the way for higher rates. Put simply, while foreign reserves have improved in countries like India and Indonesia, their external debt did not stop rising.

Conversely, there are also countries like China and Singapore who favor slower growth to carry out reforms and restructuring in their economies. China is considering lowering its 2015 growth target to 7%. Aiming to reduce its reliance on foreign workers, Singapore indicated a willingness to tolerate a slower 3% growth rate as long as growth was driven by productivity and contributed to social stability. This, however, does not mean that either country will abandon their appreciating exchange rate policies. On the contrary, the yuan has become a more international currency over the past couple of years, while Singapore overtook Tokyo to become the world third largest foreign exchange rate centre.

India's external positions – more stable, not strong



Indonesia – external positions still vulnerable

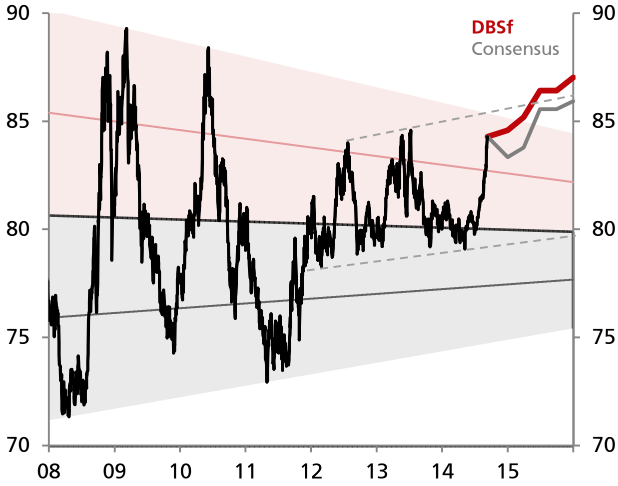


US dollar

USD looks good against EUR, JPY and GBP as the world's top reserve currency

The DXY (USD) index appreciated to 84.5 from below 80 in July-September. The DXY's rise did not come entirely from a stronger USD, but also from weaknesses in its basket of currencies. Its resurgence started when the US economy rebounded in 2Q14 from a shockingly weak 1Q14, while growth evaporated in the Eurozone and plunged in Japan. Against this background, it was no longer a zero probability for the Fed to bring forward its plan to hike rates in 2H15. Neither was it implausible for the Eurozone and Japan to implement quantitative easing measures in late 2014 or early 2015 if their economies failed to pick up from 3Q14. Hence, speculators renewed their bearish bets against the euro and the yen. They also pared their bullish British pound bets. Against a weaker Eurozone outlook, and Scotland contemplating self-rule, speculators were no longer sure that the Bank of England would hike before the US next year. Overall, the third quarter was about the USD overtaking the EUR, JPY and GBP to become the world's top reserve currency again. To continue doing so, there should be no negative surprises from the US economy to turn the Fed dovish again.

DXY index – surprising on the upside



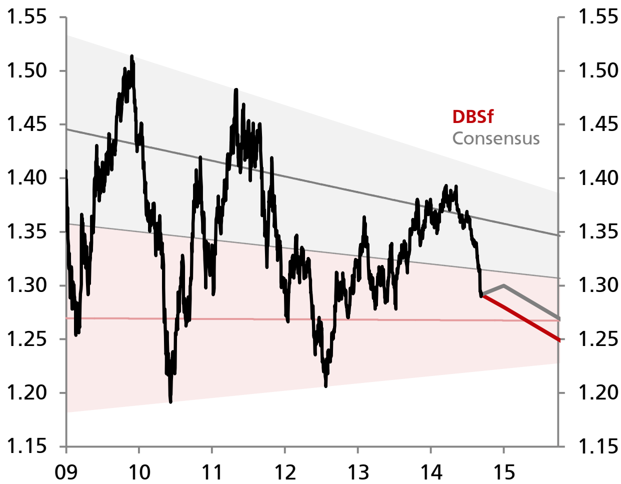
DXY	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**84.283**	**84.6**	**85.2**	**85.8**	**86.4**
Previous		79.1	78.8	78.5	78.2
Consensus		81.9	83.3	83.8	84.8
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Previous		0.25	0.25	0.25	0.25
Consensus		0.25	0.25	0.25	0.25

Euro

Draghi pushes EUR lower to keep the Eurozone recovery alive

EUR/USD fell from 1.40 to 1.30 between 8 May and 4 September. European Central Bank (ECB) President Mario Draghi blamed the strong euro for tightening monetary conditions, hurting the fragile recovery and threatening to send the Eurozone into deflation. The first set of measures to fight disinflation were announced at the ECB meeting on 5 June. The refi rate was cut to 0.15% from 0.25%, the deposit facility rate to minus 0.10% from 0%, and its marginal lending facility to 0.40% from 0.75%. The ECB would also conduct two targeted long-term refinancing operations (TLTROs) in September and December. With Eurozone growth evaporating in 2Q14, and inflation continuing to head south to 0.3%, more measures were announced at the ECB meeting on 4 September. The refi, deposit and main lending rates were further cut to 0.05%, -0.20% and 0.30% respectively. To augment the TLTROs, the ECB would also start in October, to buy asset backed securities and covered bonds. While euro negative in the short-term, these are also pro-active and pro-growth stimulus. Hence, they should be euro positive when they start to yield the desired results for the economy.

EUR/USD – guided lower by dovish ECB



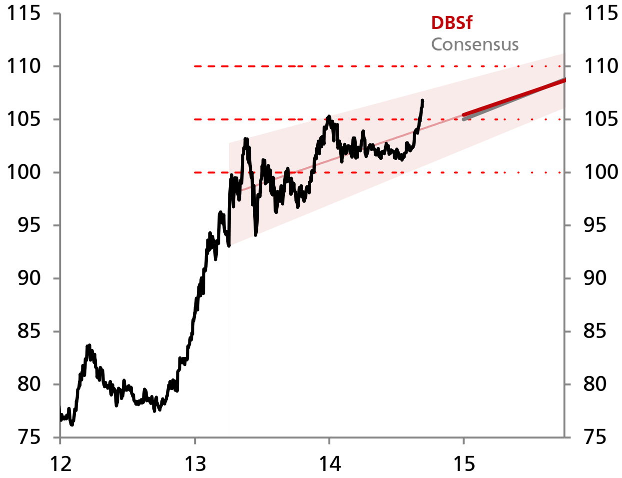
EUR /usd	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**1.2916**	**1.28**	**1.27**	**1.26**	**1.25**
Previous		1.38	1.39	1.40	1.41
Consensus		1.30	1.30	1.28	1.27
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.05**	**0.05**	**0.05**	**0.05**	**0.05**
Previous		0.15	0.15	0.15	0.15
Consensus		0.13	0.13	0.13	0.13

Japanese yen

USD/JPY uptrend intact, with scope to move into higher 105-110 range in the next 6-12 months

Speculators started to reinstate their weak JPY bets in July, and propelled USD/JPY to 105 from 101 over the next two months. Japan's real economy contracted 6.8% (QoQ saar) in 2Q14 after the sales tax was hiked to 8% from 5% on 1 April. This contrasted sharply with 6.1% expansion in 1Q14 from the pre-tax spending rush. PM Shinzo Abe will decide whether to proceed with the second sales tax hike to 10% scheduled for October 2015 after reviewing the economy's performance in 3Q14. Japan will release the preliminary estimate for this number on 17 November. The Bank of Japan (BOJ) will also need to review its quantitative and qualitative (QQE) program, which has so far, only set a monetary base target till the end of 2014. The Japanese Government Bond (JGB) market believes that the BOJ will need to continue to QQE to lift and anchor inflation expectations at 2%. By end-August, the 10Y JGB yield was back at 0.50%, around the lows when QQE was launched in April 2013. There will also be an urgency to reform the Government Pension Investment Fund (GPIF), to shift its allocation from bonds to Japanese stocks and overseas assets.

USD/JPY – moving into a higher 105-110 range



usd/ JPY	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**106.82**	**105**	**106**	**108**	**109**
Previous		103	104	108	108
Consensus		105	107	108	110

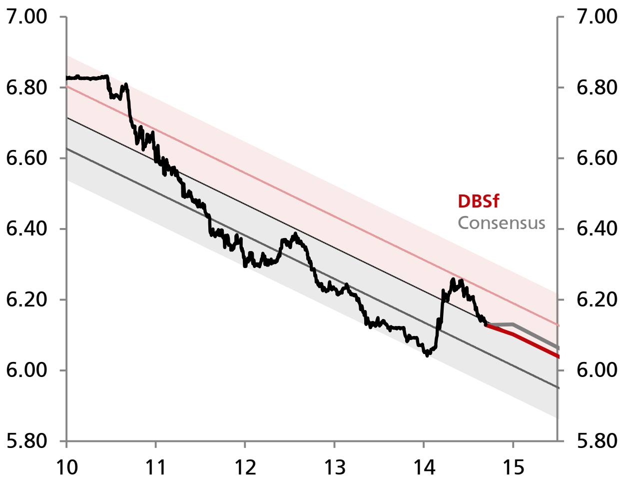
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Previous		0.10	0.10	0.10	0.10
Consensus		0.10	0.10	0.10	0.10

Chinese yuan

We remain cautious and mindful that the CNY has become a two-way exchange rate

After its shock 3.6% depreciation in January-April, the CNY appreciated 2.0% vs USD in May-August. Export growth rebounded to 14.5% YoY in Jul14, a sharp contrast from its -18.1% reading in Feb14. The trade surplus hit a new all-time high of $47.3bn in Jul14. Shanghai stocks rose more than 14% from its low in July ahead of the establishment of the Shanghai-Hong Kong Stock Connect program. Despite the optimism, we remain cautious. USD/CNY fell into the lower half of its official trading band despite a stable parity (also the mid) rate kept between 6.1443 and 6.1710. The Commerce Ministry warned on 18 August that it may not achieve this year's 7.5% growth target for trade. Inflation had been below its official 2.6-3.5% target throughout this year. The central bank has decided to give itself two years to free up interest rates. This will provide scope to ease monetary policy to achieve this year's 7.5% growth target. Yet, China may also seek a lower 7% growth target in 2015 to pursue reforms. Looking ahead, pay more attention to the parity. If China does not guide it lower to 6.0969 by end-2014, this will be first year that the CNY has officially depreciated.

USD/CNY – appreciation pace to slow



usd/ CNY	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**6.1284**	**6.10**	**6.07**	**6.04**	**6.01**
Previous		6.07	6.00	5.97	5.93
Consensus		6.13	6.10	6.09	6.10

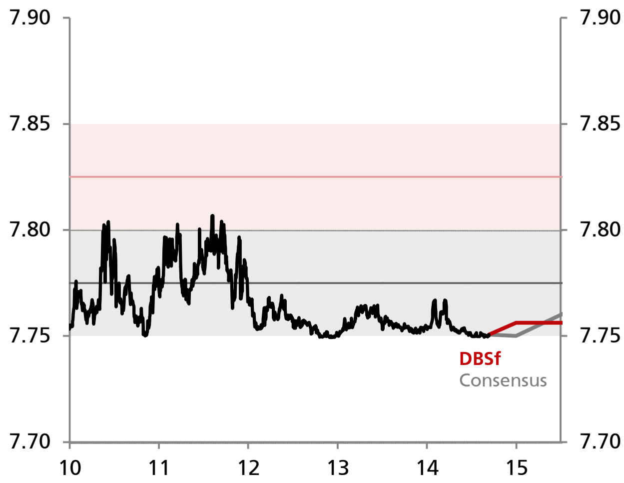
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**6.00**	**6.00**	**6.00**	**6.00**	**6.00**
Previous		6.00	6.00	6.00	6.00
Consensus		5.88	5.88	6.00	6.00

Hong Kong dollar

HKMA intervenes again to support HKD peg against USD

During the first half of 3Q14, the Hong Kong Monetary Authority (HKMA) was pre-occupied with defending the lower limit of the 7.75-7.85 convertibility band for USD/HKD. HKMA deputy chief executive Peter Pang offered, in late July, four reasons for the HKD strength during this period. First, mainland-based companies made large dividend payments to HK shareholders during the summer earning season. Second, there was a rise in cross-border deal activities. Third, there was precautionary demand by banks for the half-yearly close. Fourth, investors were positioning ahead of the scheduled launch of the Shanghai-HK Stock Connect. There was also speculation that Russian companies shifted cash into HKD in response to the US/EU sanctions to punish their country over the Ukraine crisis. The IMF Article IV review in May generally affirmed that Linked Exchange Rate System remained the best arrangement for HK. While the CNY has become a more international currency in the past two years, the USD is still considered the most relevant anchor currency to a financial centre like HK because it is still the most used currency in the world.

USD/HKD – floor supported by HKMA



usd/ **HKD**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**7.7506**	**7.76**	**7.76**	**7.76**	**7.76**
Previous		7.76	7.76	7.76	7.76
Consensus		7.75	7.76	7.76	7.76
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.36**	**0.40**	**0.40**	**0.40**	**0.50**
Previous		0.40	0.40	0.50	0.50
Consensus		0.42	0.48	0.58	0.89

Taiwan dollar

USD/TWD to move steadily and gradually lower in a tight 29-30 range

USD/TWD has been stable between 28.9 and 30.7 after the Eurozone crisis erupted in September 2011. Many factors suggest that the currency pair should be closer to the floor of this range. Taiwan's economic recovery is gaining traction. Real GDP growth expected to hit 3.5% this year, its fastest since 2011. The labor market is tightening. The unemployment rate has been below 4.0% (saar) since May14, a positive trend not seen since 2005-08. The Ministry of Labor is looking to hike the monthly minimum wage by 3.8% next year, which will be the largest increase in over three years. CPI inflation has been above 1.6% (YoY) since Mar14 after languishing below 1.0% for 10 straight months. With the policy discount rate unchanged at 1.875% since June 2011, the central bank will have to consider hiking rates to keep real rates positive. Not surprisingly, the TAIEX stock index hit in July, its highest level since October 2007. With a current account surplus of more than 10% of GDP, and foreign reserves that keep rising to new all-time highs since Nov12, it would not be unreasonable for USD/TWD to eventually extend its fall below 28.9 either.

USD/TWD – stable to lower

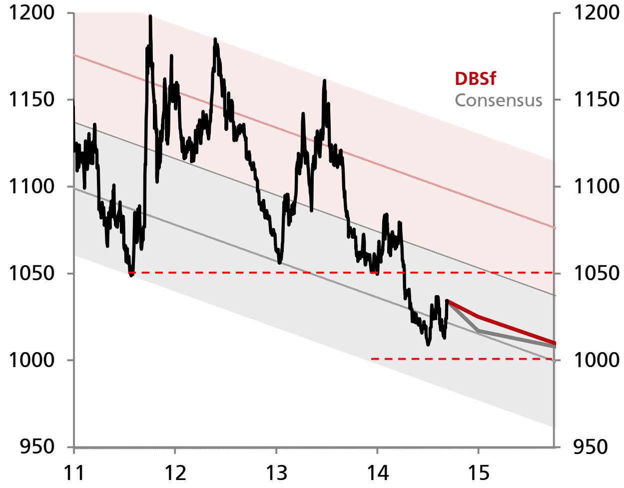
usd/ **TWD**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**29.990**	**29.6**	**29.5**	**29.4**	**29.3**
Previous		29.6	29.5	29.4	29.3
Consensus		29.9	29.8	29.9	29.4
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**1.88**	**1.88**	**2.00**	**2.13**	**2.25**
Previous		2.00	2.13	2.25	2.25
Consensus		2.00	2.00	2.13	2.13

Korean won

Stable KRW desired to complement pro-growth fiscal and monetary policies

USD/KRW has been consolidating between 1012 and 1041 after it fell to a low of 1008 from a high of 1090 in February-July. The third quarter was characterized by the finance ministry and the central bank coordinating fiscal and monetary policies to revitalize the Korean economy. The new economic team led by Finance Minister Choi Kyung-hwan announced a fiscal stimulus package on 24 July. Apart from more fiscal spending in 2H14 and easier mortgage financing rules, there were tax incentives to encourage companies to put their cash reserves to work. The Bank of Korea (BOK), on 14 August, followed with a 25bps cut in its 7D repo rate to 2.25%. The BOK indicated that rate hikes, if any, would only come later next year. Policymakers also favored a stable exchange rate,and signaled intolerance for more KRW appreciation, especially against a weaker Japanese yen. With the above policies aimed at mobilizing savings to boost investment, Korea's solid current account surpluses are likely to moderate. Also, record high foreign reserves were recently accompanied by rising short-term external debt. Overall, the stage is set for the KRW to moderate its appreciation pace.

USD/KRW – consolidation with downside bias



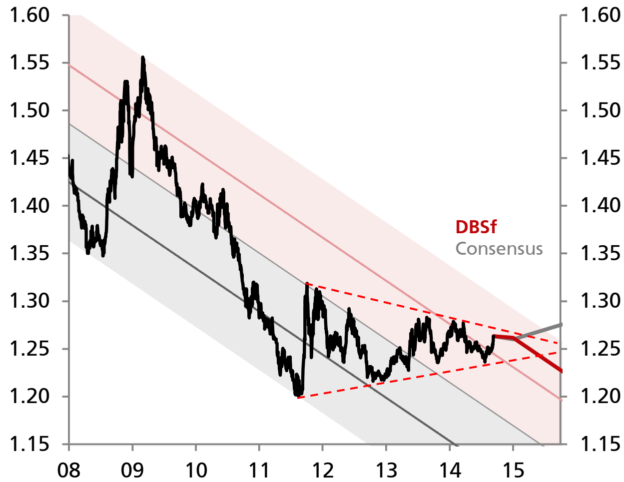
usd/ **KRW**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**1034.1**	**1025**	**1020**	**1015**	**1010**
Previous		995	990	985	980
Consensus		1017	1018	1010	1001
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**2.25**	**2.25**	**2.25**	**2.50**	**2.75**
Previous		3.00	3.00	3.00	3.00
Consensus		2.25	2.25	2.38	2.50

Singapore dollar

USD/SGD has been range-bound since 2011 despite Singapore's appreciation policy

On 24 July, the Monetary Authority of Singapore narrowed its 2014 inflation forecast to 1.5-2.0% from 1.5-2.5% previously. The real economy also disappointed by slowing to 2.4% (YoY) in 2Q14 from 4.8-5.0% in the previous three quarters. Even so, the MAS is unlikely to abandon, at its October policy review, its stance to appreciate the SGD nominal effective exchange rate (NEER) policy band at a modest and gradual pace. Although CPI inflation slowed to 1.2% (YoY) in Jul14 from an average 2.7% in 2Q14, core inflation remained above 2% in the past 8 out of 9 months ending Jul14. The MAS believes that economic restructuring in Singapore will keep core inflation above its historical average of 2% over the next few years. The central bank also expects the economy to do better in 2H14, and sees full-year growth at 2-4% this year. In the end, one thing has not changed. Despite the appreciation policy, USD/SGD has not been able to break out of its broad 1.20-1.30 range established since 2011. Due to a desynchronized global economy, the USD has not been able to establish a firm trend against the exchange rates of Singapore's major trading partners.

USD/SGD – still in a symmetrical triangle



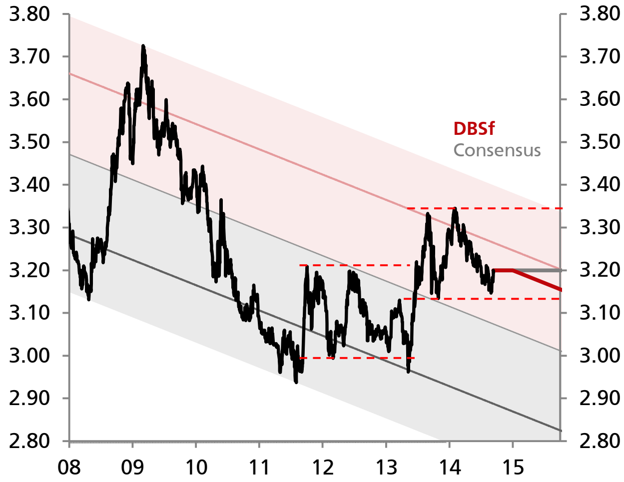
usd/ **SGD**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**1.2632**	**1.26**	**1.25**	**1.24**	**1.23**
Previous		1.22	1.21	1.20	1.19
Consensus		1.26	1.27	1.27	1.26
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.41**	**0.40**	**0.40**	**0.42**	**0.45**
Previous		0.40	0.40	0.43	0.43
Consensus		0.42	0.40	0.42	0.59

Malaysian ringgit

MYR appreciation is due for pause after its strong rally in February-August

Amongst the Southeast Asian currencies, the MYR recovered best from last year's emerging market volatility. The MYR appreciated 6.5% in February-August, during which USD/MYR fell from a high of 3.3460 to a low of 3.1410. Malaysia was the only Asian country that hiked before the Fed. After its first 25bps hike to 3.25% on 10 July, Bank Negara Malaysia (BNM) is expected to raise its overnight policy rate a second time to 3.50% later this year. Apart from China and the Philippines, Malaysia was the only other East Asian country to boast a growth rate of more than 6.0% in 1H14. The stock market also rose to record highs this year. Not surprisingly, CPI inflation stayed stubbornly above 3.0% (YoY) since Dec13. With the government looking to set the goods and services tax at 6% in April 2015, BNM expects inflation to stay within 3-4% in 2014 before stabilizing towards 3% in 2016. Through the consumer tax, the government is targeting a balanced budget by 2020. Meanwhile, the current account surplus has been comfortably above $10bn every quarter since 3Q13. Even so, USD/MYR has a history of staying supported, once it hits the floor of its broad consolidative trading range.

USD/MYR – to consolidate after hitting 3.15 floor



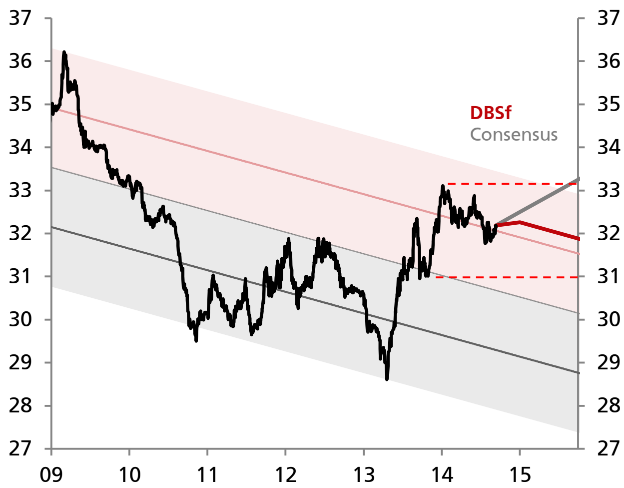
usd/ **MYR**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**3.2000**	**3.20**	**3.18**	**3.17**	**3.16**
Previous		3.15	3.14	3.12	3.11
Consensus		3.20	3.23	3.25	3.18
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**3.25**	**3.50**	**3.50**	**3.50**	**3.50**
Previous		3.00	3.00	3.00	3.00
Consensus		3.38	3.50	3.50	3.50

Thai baht

Post-martial law THB stable and looking forward to better growth prospects

Contrary to initial fears, Thai equities and the THB did not fall after the military imposed martial law on 22 May. Since then, the SET index rose 11% by end-August, while the THB appreciated 1.9% vs the USD. Effectively, Thai equities recovered 80% of their losses incurred during last year's emerging market volatility. The THB's recovery rate was less impressive at 26%. Although the current account reported surpluses every quarter since 2Q13, they were marred by intermittent monthly deficits. This coupled with the flattish recovery in foreign reserves suggested a domestic driven Thai stock rally. Looking ahead, fiscal and monetary policies are looking to complement each other to support growth. King Bhumibol endorsed, on 25 August, military junta leader Prayuth Chan-Ocha as prime minister. Two days later, Bank of Thailand (BOT) Governor Prasarn Trairatvorakul said that a functioning and potentially high spending government may be in place. With fiscal policy returning to support growth, Prasarn was optimistic that the economy may have bottomed out in 2Q14. The challenge ahead will be to persuade the private sector and foreign investors to join in the rebuilding process.

USD/THB – off the peak, but no hurry to rush down



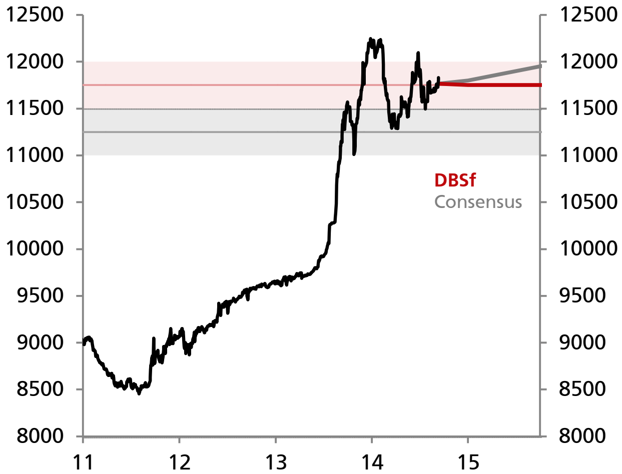
usd/ **THB**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**32.185**	**32.3**	**32.1**	**32.0**	**31.9**
Previous		32.6	32.5	32.4	32.2
Consensus		32.5	32.8	33.0	32.5
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**2.00**	**2.00**	**2.00**	**2.00**	**2.25**
Previous		2.00	2.00	2.25	2.25
Consensus		2.00	2.13	2.25	2.25

Indonesian rupiah

The foundation of IDR stability this year still needs strengthening

Attempts by USD/IDR to rise above 12000 were short-lived this year. Like India, Indonesian stocks rallied when popular Jokowi Widodo won the presidential election in July. By end-August, Indonesian stocks were up 20.2% YTD vs 3-8% in US equities. Externally, the US monetary policy outlook was benign in spite of the Fed tapering asset purchases. Foreign investors increased their holdings of IDR-denominated government bonds to IDR 434trn in Aug14 from IDR 324trn in Dec13. Foreign reserves increased to $111bn in Jul14 after it reclaimed the $100bn mark in Jan14. Conversely, USD/IDR could not break below 11250 either, and was still well above the sub-10000 levels seen before last year's EM volatility. Indonesia's trade and current account data remained volatile. After narrowing to 2.0% of GDP in 1Q14 from 4.5% in 2Q13, the current account deficit ballooned to 4.3% of GDP again in 2Q14. Real GDP growth fell to 5.12% (YoY) in 2Q14, its slowest pace since 3Q09. CPI inflation slid to 3.99% (YoY) in Aug14, from its 8.22% high in Jan14, a low not seen since Jan13. Bank Indonesia, however, did not cut rates, and remained wary that Fed hike fears could trigger capital outflows again.

USD/IDR – still struggling at the top



usd/ IDR	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	11822	11750	11750	11750	11750
Previous		11500	11500	11500	11500
Consensus		11800	12000	12036	11901

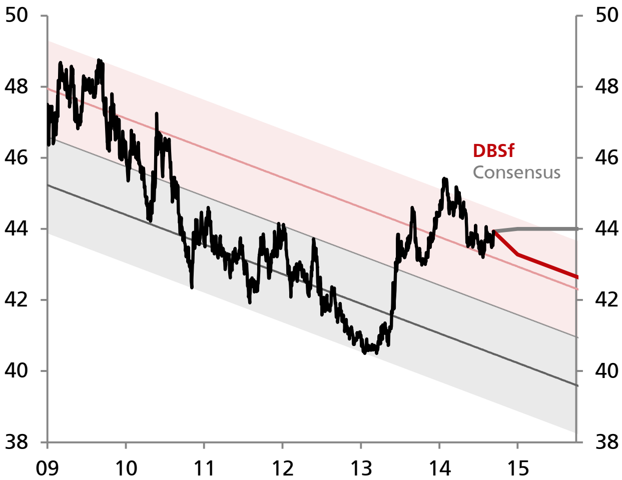
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	7.50	7.50	7.50	7.50	7.50
Previous		7.50	7.50	7.50	7.50
Consensus		7.50	7.50	7.50	7.63

Philippine peso

PHP recovered from emerging market volatility but at a slower pace than equities

The recovery of the Philippines from last year's emerging market volatility was reflected more in its stock market than its exchange rate. At their strongest levels in August, the stock index and the PHP respectively, recovered 88% and 51% of their losses incurred between May 2013 and February 2014. The Philippines was one of three East Asian countries that achieved a better growth rate above 6.0% (YoY) in 2Q14. Foreign investor confidence received a boost in May when Standard & Poor's lifted the Philippine long-term foreign debt rating by one notch to BB. Against this constructive background, CPI inflation increased to an average 4.3% (YoY) in the first seven months, which was in the stronger half of its official 3-5% target for 2014. Bangko Sentral ng Pilipinas (BSP) hiked its policy rate by 25bps to 3.75% on 31 July. With BSP looking to moderate inflation to 2-4% in 2015, and return real rates to positive territory, consensus expects rates to further rise to 4.25% by 3Q15. Despite growth averaging 6.0% in 1H14, the government still wants to achieve its 2014 growth target of 6.5-7.5%. Interestingly, investors believe that there is ample room for fiscal spending to help out here.

USD/PHP – trending lower slowly



usd/ PHP	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	43.930	43.3	43.1	42.9	42.7
Previous		42.9	42.7	42.5	42.3
Consensus		44.0	44.0	43.8	43.5

Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	3.50	4.00	4.00	4.00	4.25
Previous		4.00	4.00	4.00	4.00
Consensus		4.00	4.00	4.13	4.25

Indian rupee

INR is out of crisis, but is still more stable than positive, and not invulnerable to Fed hike fears

By the elections in May this year, the INR had recovered 70% of its depreciation incurred during last year's emerging market volatility. The INR's initial recovery from oversold levels in September-October 2013 was about restoring policy credibility. This coincided with the appointment of Raghuram Rajan as Reserve Bank of India (RBI) Governor. The INR's second recovery in February-May this year was about reform hopes. Indian equities were euphoric ahead of pro-business Narendra Modi's historic victory at the May elections. Despite the post-election stock market continuing to rise to new record highs, the INR stopped appreciating. From its low of 58.33 in May, USD/INR has risen and stayed above 60 since mid-July. Like it or not, the INR bore the brunt of last year's sell-off in emerging markets. It remains to be seen if the new government can fulfill its reform promises, return the economy to its potential growth path without double-digit inflation and wide fiscal and current account deficits. While foreign reserves have recovered to above $300bn again, total external debt also rose and was larger at $441bn as at Mar14. Put simply, the INR is still vulnerable to Fed hike fears.

USD/INR – stable after Modi optimism

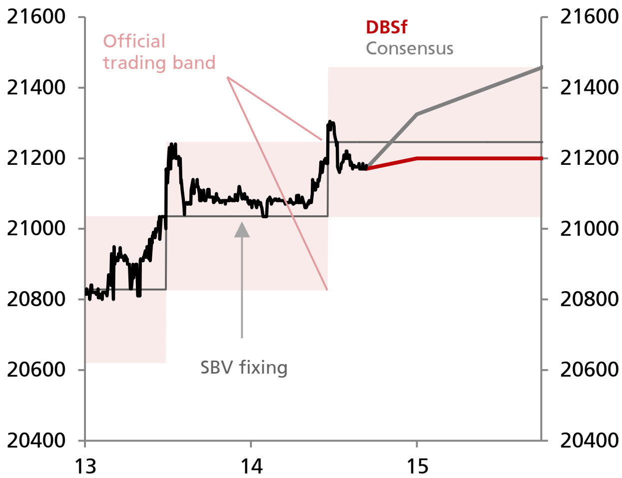
usd/ **INR**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**60.940**	**61.3**	**61.6**	**61.9**	**62.3**
Previous		62.6	63.0	63.3	63.7
Consensus		60.0	60.1	60.5	60.5
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**8.00**	**8.00**	**8.00**	**8.00**	**8.00**
Previous		8.00	8.00	8.00	8.00
Consensus		8.00	7.88	7.75	7.75

Vietnam dong

Post-devaluation VND finds support from more macroeconomic stability and less political tensions

The State Bank of Vietnam (SBV) devalued the dong on 19 June; the mid-point of its official USD/VND trading band was lifted by 1% to 21,246. The mid-point was previously increased by a similar 1% to 21,035 in June 2013. While spot USD/VND also traded higher, it did not stay above the mid-point this time around. Why? Tensions between Vietnam and China have eased, with both sides working to mend the ties strained in 2Q14. Vietnam equities fully recovered their losses incurred in April-May, and advanced to their highest level since March 2008. SBV reported in July that foreign reserves reached a record high of USD 35bn vs USD 24bn at end-2012. Looking ahead, investors were also encouraged that the government, having restored macro-economic stability, was now reportedly moving to lift the average growth rate to 6.5-7.0% for the 2016-2020 period. Real GDP growth averaged 5.8% in 2010-13. For a start, the SBV issued in August, a new decree permitting foreign direct investment (FDI) enterprises to, with effect from 25 September, open FDI capital accounts in VND. Moody's upgraded on 29 July, Vietnam's sovereign debt rating by one notch to B1.

USD/VND – stable just below its fixing



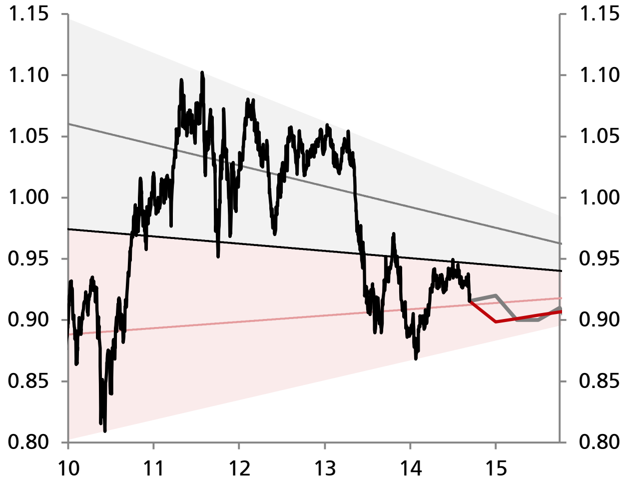
usd/ **VND**	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**21170**	**21200**	**21200**	**21200**	**21200**
Previous		21450	21480	21520	21560
Consensus		21325	21300	21400	21450
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**6.50**	**6.50**	**6.50**	**6.50**	**6.50**
Previous		7.00	7.00	7.00	0.00
Consensus		n.a.	n.a.	n.a.	n.a.

Australian dollar

AUD has been moving with the RBA's monetary policy stances

Most of the Oz's appreciation this year took place in January-April, during which AUD/USD rose 9.3% to 0.9461 from 0.8658. Since then, AUD/USD has been consolidating in a wide range, mostly between 0.9200 and 0.9450. Interestingly, this was also the period when speculators added long AUD positions. They believed that it was a question of "not if, but when" the Reserve Bank of Australia (RBA) would join its New Zealand counterpart in raising rates next year. Ironically, the Australian interest rate markets did not share their optimism, and were instead, paring rate hike bets. The implied yield for 90D bank bills maturing in Dec15 eased to 2.69% from 3.43% in April-July, while the 10Y government bond yield eased to 3.28% from 4.18%. These rates have converged lower towards the RBA cash target rate which has been unchanged at 2.50% since August 2013. The rate markets are probably closer to the truth than the speculators. The AUD's recovery earlier this year was triggered by the RBA abandoning its easing stance. Since then, the AUD has been stable with the RBA consistently pushing its steady rate mantra. To take profit, speculators need the RBA to signal its intentions to hike rates.

AUD/USD – no rush for RBA to hike rates



AUD /usd	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.9154**	**0.90**	**0.90**	**0.90**	**0.91**
Previous		0.97	0.98	0.99	1.00
Consensus		0.92	0.90	0.90	0.91

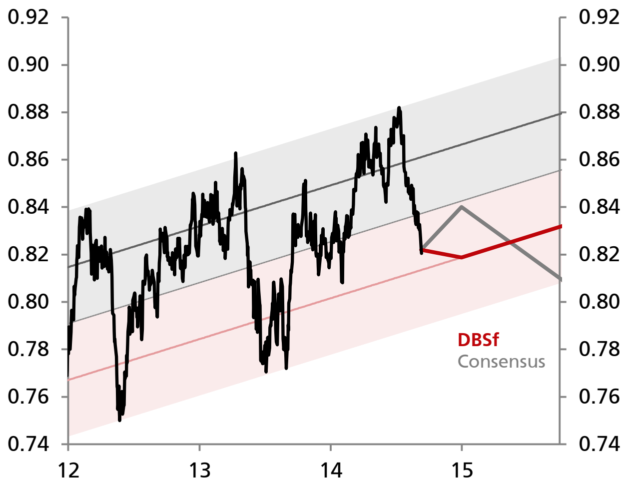
Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**2.50**	**2.50**	**2.50**	**2.50**	**2.75**
Previous		2.50	2.50	2.50	2.50
Consensus		2.50	2.63	2.75	2.88

New Zealand dollar

Profit-taking hit NZD hard after RBNZ signalled a pause in its hike cycle

NZD/USD appreciated 9.8% in February-July to a high of 0.8835 from a low of 0.8048. This coincided with the four rate hikes by the Reserve Bank of New Zealand (RBNZ) in March-July, during which the official cash rate (OCR) was lifted by a cumulative 100bps to 3.50%. This coupled with a benign Fed monetary policy outlook, attracted many speculators to bet on a stronger NZD. Since then, the NZD returned about 2/3 of these gains by end-August. Why? With the Fed signaling the last taper in October, markets have started thinking about the Fed's plan to normalize US monetary policy next year. The RBNZ announced, at its July meeting, a pause in its rate hike cycle. From the first hike to end-August, the 10Y government bond yield eased to 4.57% to 4.07%, which in turn, compressed its spread against the OCR to 57bps from 207bps. Similarly, the implied yield on the 3M NZ bills futures maturing in Dec15 fell with the 10Y yield to 4.01% from 4.47%. The NZ markets agreed with the RBNZ that a pause was needed to assess the impact of the four hikes on the economy. Put simply, consensus may be too premature in expecting the RBNZ to further lift the OCR to 4.50% by end-2015.

NZD/USD – tumbled on RBNZ pause



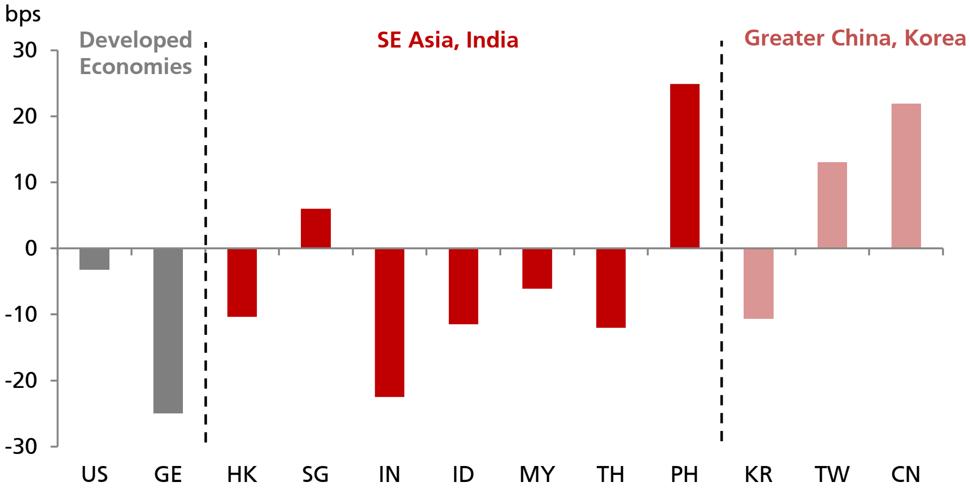
NZD /usd	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**0.8220**	**0.82**	**0.82**	**0.83**	**0.83**
Previous		0.87	0.87	0.88	0.88
Consensus		0.84	0.83	0.82	0.84

Policy, %	10-Sep	4Q14	1Q15	2Q15	3Q15
Revised	**3.50**	**3.50**	**3.50**	**3.75**	**4.00**
Previous		3.50	3.50	3.50	3.50
Consensus		3.63	4.00	4.13	4.38

Yield: Watch the front-end

US	The ECB is just as important as the Fed
	As EZ gov yields bottom out, LT UST yields can rise again
	Persistently low EZ rates will limit rise of UST yields
	Fed hike speculation is likely to intensify as taper ends
	2Y-5Y US rates appear to be too low
SG	SGS yields are high relative to USTs
HK	Status quo for Hibors
KR	Re-steepening in the frontend of swap curve
TW	Swap spreads to widen
TH	Post-coup optimism is sufficient to lift swap rates
MY	LT MGS yields are low despite tightening
ID	Reforms need to be delivered
PH	Building price pressures point to higher yields
IN	Not easy to lower rates
CH	Slowdown worries to keep ST rates low

Change in 10Y Government Bond Yields since mid-2014



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US: ECB is as important as the Fed

Developments in the Eurozone are just as important as the Fed when it comes to projecting USD market rates. Over the past few months, the collapse of inflation and inflation expectations in the Eurozone helped to drive German Bund yields to record lows. As 10Y German Bund yields dropped by 95bps (to 0.96%) since beg-2014, 10Y UST yields also fell by 50bps (to 2.50%) as investors find the yield advantage offered by USTs to be increasingly attractive.

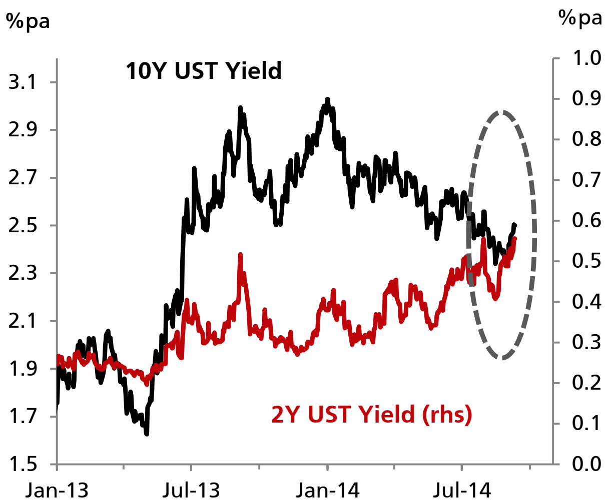
The downward distortion to long-term UST yields is likely to persist as the Eurozone struggles with weak growth and low inflation. The European Central Bank (ECB) has already cut policy rates twice this year and is effectively already at the zero-bound. Targeted long-term refinancing operations (TLTROs) and asset purchases (covered bonds and asset-backed securities) are also imminent. As rates in the Eurozone look likely to stay low for an extended period, long-term UST yields are going to be lower than they otherwise would have been.

However, we think that yields in the Eurozone have likely stabilized. In which case, downward pressure on UST yields arising from declining German Bund yields should also dissipate. Barring an escalation in geopolitical risks or a shock to the US economy, the impending end of quantitative easing by the Fed suggests that long-term UST yields have room to head higher in the coming quarters.

Meanwhile, speculation of eventual rate hikes in the US is likely to intensify in the coming months. Currently, the market (Fed Funds futures and USD swap curve) is pricing in a very mild upcoming tightening cycle relative to Fed projections and to the previous rate hike cycle in 2004-2006. The implied fed funds rate for end-2015 is at 0.6% while the implied Fed funds rate for end-2016 is at 1.6%. By contrast, FOMC participants on average anticipate the fed funds target rate to reach 1% by end-2015 and around 2.5% by end-2016. Moreover, the market does not expect the Fed to raise the Fed funds rate to its longer-run projection of 3.75-4.00% even after ten years. Compared to the previous rate hike cycle where the Fed hiked by 25bps every meeting, the market is pricing in only 12.5bps of hikes per meeting in 2016 and an even smaller magnitude per meeting in 2017.

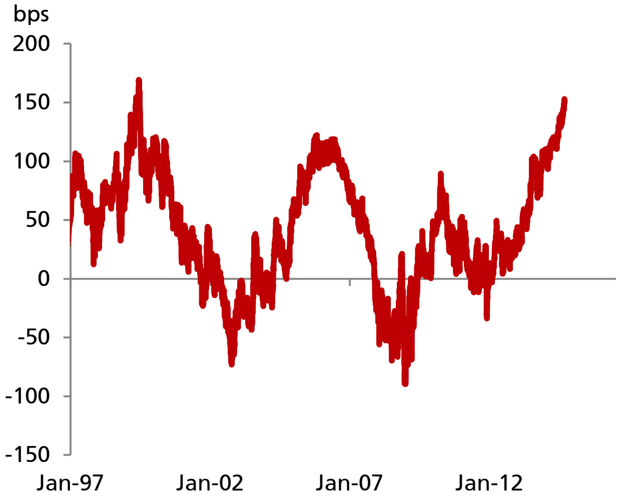
Clearly, the market is not convinced of the Fed's ability and/or willingness to raise short-term interest rates. Much of this has got to do with persistent growth worries on the US economy and on potential spillover from geopolitical risks. Structurally,

2Y & 10Y UST Yield

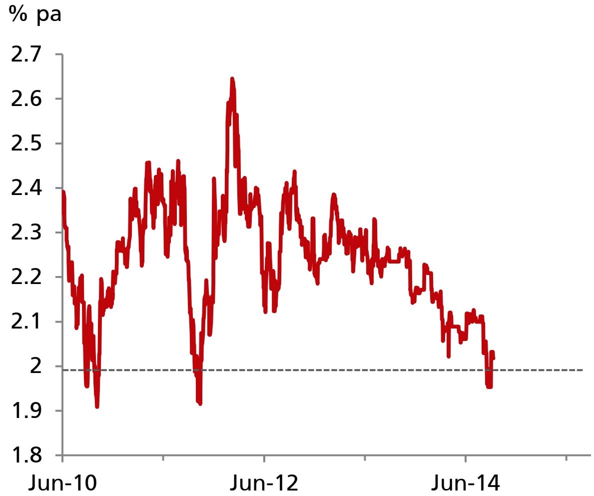


UST Curve - 2Y/10Y Segment

10Y UST yield spread over 10Y German Bund



5Y EUR inflation swap rate, 5Y forward



there are also concerns that weaker longer-run growth, inflation and debt dynamics would limit any increase in short-term USD rates. Being mindful that intermediate-term rates ran too high in 2010/11(prior to the Eurozone crisis when the market was speculating on US rate increases), it is not surprising that the market has been heavily discounting Fed projections.

Given how low rates are in the intermediate segment of the USD swap curve, we think that risks are tilted to the upside. When the Fed provides greater clarity on the timing of rate hikes, we suspect that intermediate-term USD rates (2Y-5Y) may be most vulnerable to an upward adjustment.

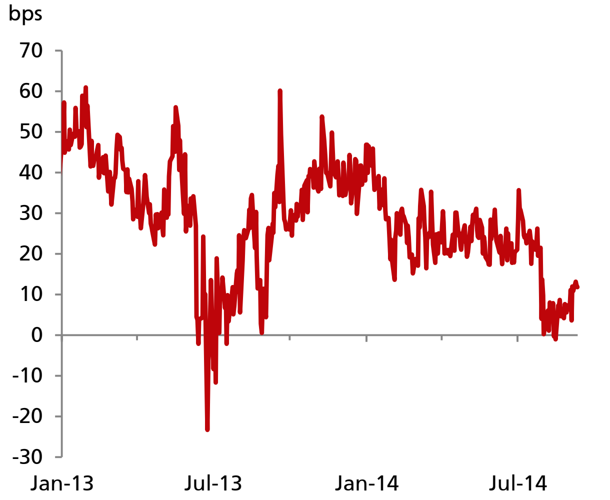
We expect yields on US Treasuries to rise. By mid-2015, yields in the 2Y sector are likely to reach 1.1% while yields in the 10Y sectors are likely to reach 3.2%.

Singapore: SGS yields are high relative to USTs

On a historical basis, 10Y SGS yields are high relative to 10Y UST yields. Over the past three years, the median spread of 10Y UST yield over 10Y SGS yield stood at 30bps. During the period of financial market stress in mid-2013 when the Fed first hinted of tapering, the yield spread turned negative as USTs benefit from its global safe haven status. More recently, the yield spread has compressed sharply to just 10bps as the prospect of weak growth/low inflation in the Eurozone pushed down long-term UST yields through this year even as long-term SGS yields remained largely stable.

Barring a financial shock, the yield spread is unlikely to stay compressed for long and should normalize towards 20-30bps. In the coming quarters, Fed rate hike speculation is likely to intensify. If yields in the Eurozone also bottom out, upward pressure is likely to materialize on long-term USTs and SGSs yields. However, given the outperformance of USTs relative to SGSs in recent quarters, we think that the upward adjustment in UST yields is likely to be larger than SGS yields. Upward pressure on both UST and SGS yields are likely to become more visible once the Fed gives a clearer timeframe for eventual rate hikes.

Spread of 10Y UST over 10Y SGS



• *The spread on 10Y SGS yields over 10Y UST yields are likely to normalize as easy monetary policy in the Eurozone gets fully discounted*

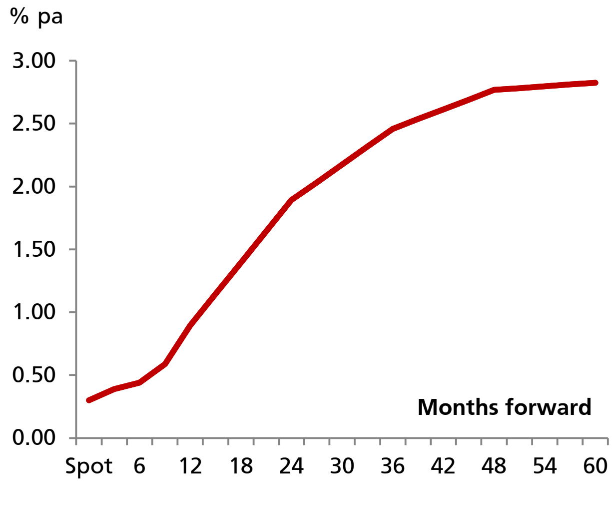
• *We expect benchmark SGS yields to rise. 2Y and 10Y yields are likely reach 1.00% and 2.65% respectively by mid-2015*

Hong Kong: Status quo for Hibors

As speculation on US rate hikes intensify in the coming quarters, the forward path of short-term Hibors and Libors are likely to have an upward bias. However, when the Fed eventually raises its policy rate(s), the impact is likely to be stronger on Libors relative to Hibors. Notably, the period over the past two years when Hibors were consistently higher than Libors is an anomaly. This development only came about because the Fed utilized forward guidance and quantitative easing to lower USD market rates. These measures nudged down Libors from early 2012 levels, but Hibors were essential unchanged.

Already at higher levels relative to Libors, Hibors are likely to be sticky heading upwards in the lead up to eventual Fed tightening. Instead, we are more likely to see Libors creep up even as Hibors remain relatively stable in the immediate few months (the assumption lies with the fact that some US monetary tightening have been priced into the market and there would not be any major disruptions to global financial markets when US rate hikes actually occur). Implied rates from USD and HKD swap curves indicate that the 3M Libor would head above 3M Hibor only after a year's time.

3M Hibor: Spot & Implied



• *On a historical basis, HIbors are high relative to Libors. Upward movements in Hibors are likely to be muted at the start of the Fed tightening cycle*

• *We expect yields on Hong Kong's benchmark Exchange Fund Notes to rise. 2Y and 10Y yields are likely reach 1.00% and 2.40% respectively by mid-2015*

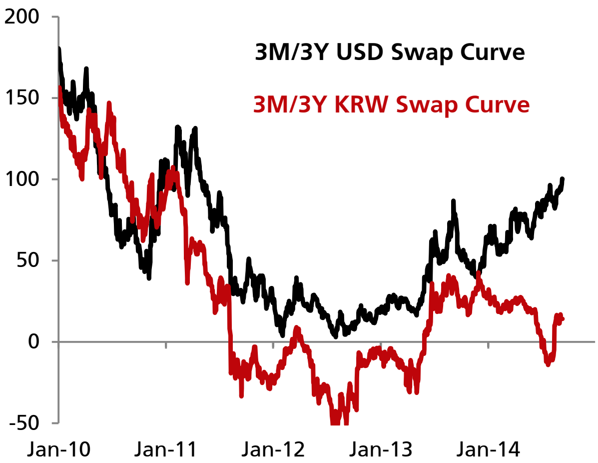
Korea: Re-steepening in the frontend

The disconnect between the 3M/3Y segments of the KRW and USD swap curves is likely to prove temporary. Historically, the slope steepness of the two curves has been highly correlated as the Bank of Korea (BoK) acted to maintain short-term interest rate differentials with USD rates. However, a slowdown in the economy prompted the BoK to cut its policy rate by 25bps. With increasing signs of a turnaround in the economy in 3Q, the rate cut should not be seen as the start of an easing cycle. The market is in line with our view with the 1Y KRW swap rate hugging close to the 3M CD rate.

With a broad range of indicators already showing an upswing in economic activity, the market may be too dovish on rates in the intermediate segment of the KRW swap curve. As the economic recovery gathers traction, the 3Y KRW swap rate to tick back up towards 2.9% (levels seen just before the Ferry disaster in April), steepening the 3M/3Y segment of the swap curve within the next few months. Externally, intensifying Fed rate hike speculation should also put upward pressure on 3Y KRW swap rates. Accordingly, the gap in 3M/3Y slope steepness between the KRW and USD swap curve should narrow.

KRW & USD Swap Curves

bps



• *The Ferry disaster in April prompted the central bank to cut the policy rate. But this is not the start of an easing cycle*

• *We expect yields on benchmark Korean Treasury Bonds to rise. 3Y and 10Y yields are likely reach 2.80% and 3.30% respectively by mid-2015*

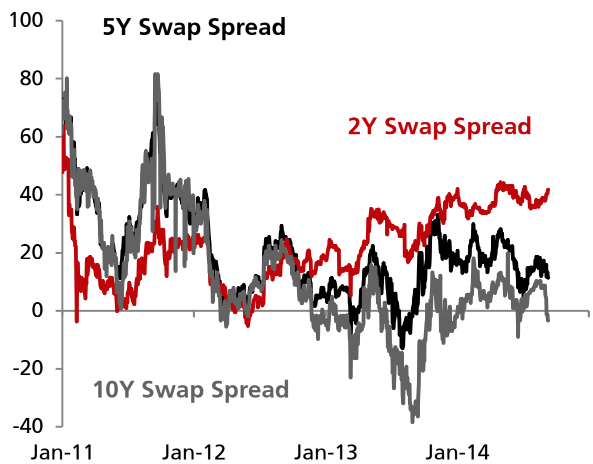
Taiwan: Swap spreads to widen

TWD swap spreads (defined as TWD swap rates less TWgov bond yields of similar tenor) have room to widen in the coming quarters. TWD swap rates and TWgov bond yields are likely to come under upward pressure as the economy shows increasing signs of picking up. Notably, the turnaround in manufacturing has been striking with the August PMI hitting an all-time high of 56.1. Strengthening economic activity and accompanying inflationary pressures are likely to stoke rate hike expectations, lifting TWD market rates in the coming quarters.

However, abundant liquidity conditions should also depress TWD market rates, but the impact on TWgov yields is likely to be stronger. With the current account surplus still pushing new highs, liquidity in the financial system has to be soaked up by existing instruments including TWgov bonds. However, the government has stuck to fiscal consolidation and bond issuances are projected to be scaled down to TWD 236bn in 2015 from TWD 277bn this year. Favorable supply and demand conditions are likely to provide support for TWgov bonds even as investors consider rising price pressures on the horizon.

2Y, 5Y, 10Y Swap Spread

bps



• *Abundant liquidity conditions suggest that an increase in the policy rate would only lead to a small increase in the 3M CD rate*

• *We expect yields on benchmark Taiwan government bonds to rise. 2Y and 10Y yields are likely reach 0.75% and 1.70% respectively by mid-2015*

Thailand: Post-coup optimism

Since the military coup in May 22, the THB swap curve has embarked on a parallel shift higher, driven largely by an upward adjustment in the 6M THB FIX (which serves as the floating leg fixing of THB swaps). The market has clearly assessed that the coup has brought about stability (at least in the short term) and reduced the probability of further monetary easing. Notably, the 6M THB FIX and the 1Y THB swap are once again hugging close to the policy rate (2%).

This is in line with our view that the policy rate is likely to be kept steady for the next four quarters. Notably, while high frequency indicators (industrial production and business sentiment) suggest that economic conditions remain challenging, an improvement in the economic outlook is sufficient to raise growth/inflation expectations. Some optimism has been raised with the authorities indicating a willingness to proceed with big-ticket infrastructure spending with THB 150bn set aside for FY 2014/15 (Oct-Sep). Assuming that political stability is maintained, upward pressure on the 2Y THB swap rates are likely to going to be greater than 10Y THB swap rates over the medium term.

1Y, 2Y & 3Y THB Swap Rates vs 6M THB FIX

• *While optimism has returned since the military coup, rate hikes are not imminent as the authorities try to revive growth*

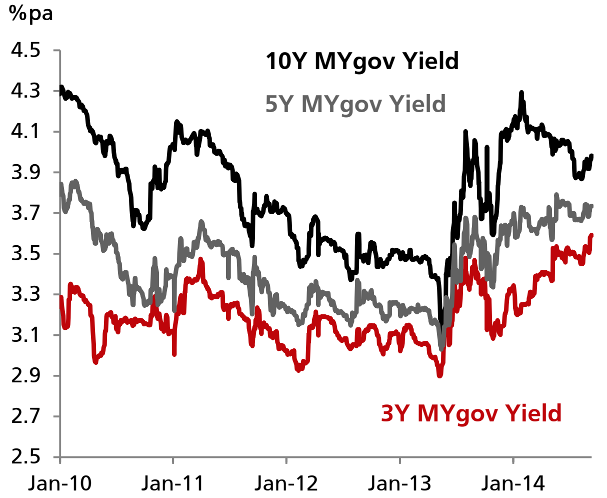
• *We expect yields on benchmark Thailand government bonds to rise. 2Y and 10Y yields are likely reach 2.80% and 4.20% respectively by mid-2015*

Malaysia: Yields are low despite tightening

The monetary policy tightening cycle by Bank Negara Malaysia (BNM) has been fully expected by the market with the 3M Klibor on an uptrend since April. BNM has since hiked the policy rate by 25bps to 3.25% in July. Inferring from Klibors of different maturities, the current rate hike cycle is likely to be short with the market only pricing in another 25bps worth of hikes by the end of 2014. Notably, the premium of 3M Klibor over 1M Klibor stands at 46bps but the incremental premium tapers off sharply for Klibors with longer maturities.

The Malaysian economy has consistently surprised on the upside this year as GDP growth topped 6% YoY in 1H. Concomitantly, price pressures are also high by historical standards. Headline CPI has been above 3% (YoY) in recent months compared to an average of 1.9% over the past five years. Moreover, tightening is also likely to be driven by the need to manage high household leverage and preempt risks of higher short-term USD interest rates. Meanwhile, long-term MGS yields are low relative to BNM's policy stance. This distortion is likely to persist as long as long-term yields in the Eurozone and the US stay low.

3Y, 5Y & 10Y MY Gov Yield



• *The current tightening cycle is likely to be short with just another 25bps worth of hikes projected to take place by the end of the year*

• *We expect yields on benchmark Malaysian government securities to rise. 3Y and 10Y yields are likely reach 3.80% and 4.20% respectively by mid-2015*

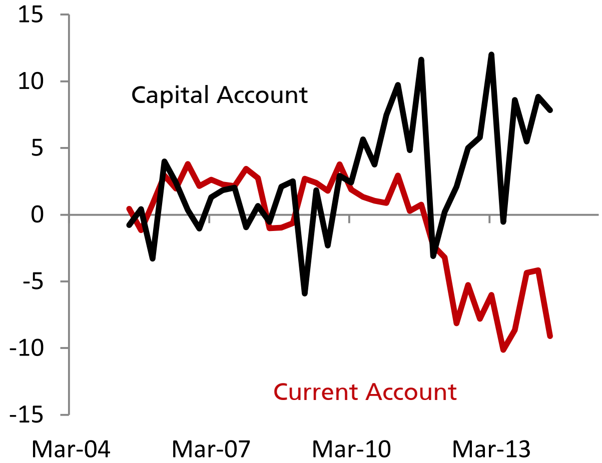
Indonesia: Reforms need to be delivered

Foreign investors have returned to IDgov bonds in a big way. By July, the cumulative foreign ownership of IDgov bonds for 2014 reached IDR 94trn, surpassing the full-year record of IDR 110.4trn in 2010 (foreign ownership of IDgov bonds amount to 37% of the total outstanding. Part of the reason stems from declining 10Y UST yields over the course of year. Investors chasing higher returns would have found 10Y IDgov yields to be attractive. The other part of the reason can be attributed to optimism for reforms under the new president Jokowi Widodo.

Critical in the coming few months is the prospect of fuel subsidy cuts. From a rates perspective, the relevance of fuel subsidy cuts do not relate to the ability of the government to repay its debts (as government debt to GDP is low). Instead, a fuel subsidy cut may be the most direct way to reduce external funding pressures in the event that short-term USD rates start to increase. Notably, while moderating GDP growth has stabilized the current account balance, the deficit remains wide at 3.2% of GDP in 2Q. Market expectations are high and disappointment on reforms is a key risk.

Current Account & Capital Account

USD bn, qrtly



• Foreign ownership of IDgov bonds have pushed to new highs. However, risks from the still-sizable current account deficit bear watching

• We expect yields on benchmark Indonesian government bonds to rise. 2Y and 10Y yields are likely reach 8.00% and 8.50% respectively by mid-2015

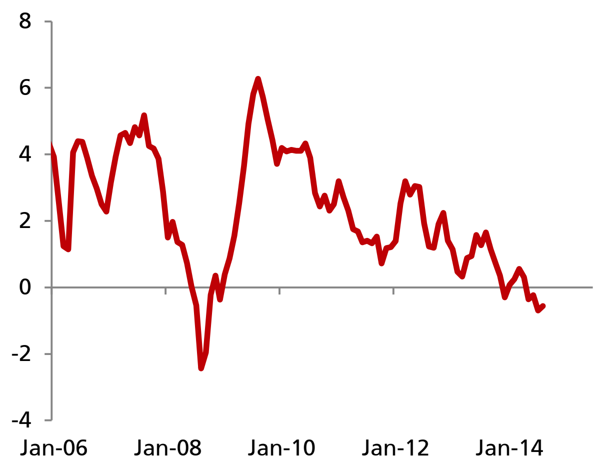
Philippines: Building price pressures

Bangko Sentral ng Pilipinas (BSP) is already embarking on a tightening bias with the special deposit account (SDA) rate raised to 2.25% and the effective reserve requirement ratio (RRR) raised by 2%-pt this year. The reverse repo rate was also raised by 25bps to 3.75% in July. While PHgov bond yields have already adjusted higher over the past year on the back of Fed tapering (2Y and 10Y yields are near the top of their respective trading ranges), we suspect that the market may be underestimating potential price pressures in the coming months.

Notably, headline CPI has already crept towards 5.0% (YoY) in July since bottoming out at 2.1% in August last year. Moreover, loan growth has been accelerating, reaching a 3-year high of 20.4% (YoY) in July. With the loan-to-deposit ratio indicating plenty of room for credit creation, persistently high loan growth levels and the concomitant surge in money supply risk inflation levels that are above the BSP's comfort zone (3-5%). Relative to inflation, 10Y PHgov bonds are also experiencing negative real yields. From a risk-to-reward perspective, 10Y PHgov bonds remain unattractive, especially when further monetary tightening is on the horizon.

PH: 10Y PHgov yield less YoY CPI

%-pt



• Growth/inflation dynamics suggest that further tightening is in store. PHgov yields are too low relative to current inflation levels

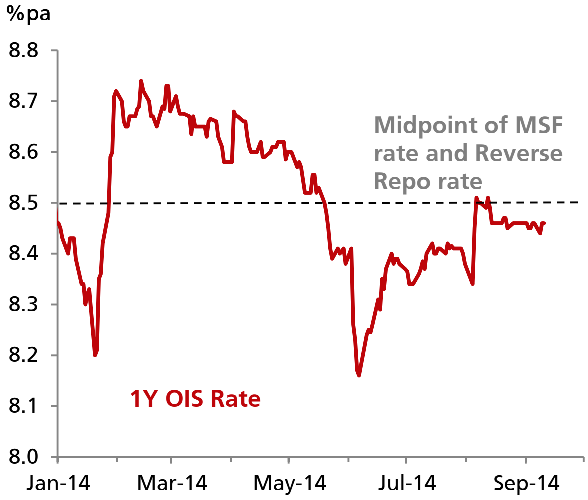
• We expect yields on benchmark Philippine government bonds to rise. 2Y and 10Y yields are likely reach 3.40% and 4.50% respectively by mid-2015

India: Not easy to lower rates

1Y INR overnight indexed swap (OIS) rates have pared back optimism on rate cut expectations over the next year, but remain too dovish with respect to where rates would be in two years' time. Market expectations for the economy under the leadership of newly elected Prime Minister Narendra Modi have been high. In the rates space, front-end OIS rates dipped to a low of 8.16% in June before rebounding back to 8.46% as the Reserve Bank of India (RBI) stuck to a balanced policy outlook in the past two monetary policy meetings.

The 1Y INR swap rate is now trading in line with our view that the Reverse Repo rate and the Marginal Standing Facility (MSF) rate will be kept on hold over the next four quarters. Implicitly, the 3M INR interbank rate is expected to hover around 8.5% (the midpoint of the MSF rate and the Reverse Repo rate). However, the implied 3M INR interbank rate in two years' time remains too low relative to what the market is implying for 3M Libor. If economic growth picks up as we expect, the concomitant increase in price pressures and current account deficits is likely to restraint monetary easing. Externally, the prospect of Fed rate hikes should also limit room for monetary easing.

1Y INR OIS Rate



• *It will not be easy for short-term INR rates to head lower if market speculation of Fed hikes intensify in the coming months*

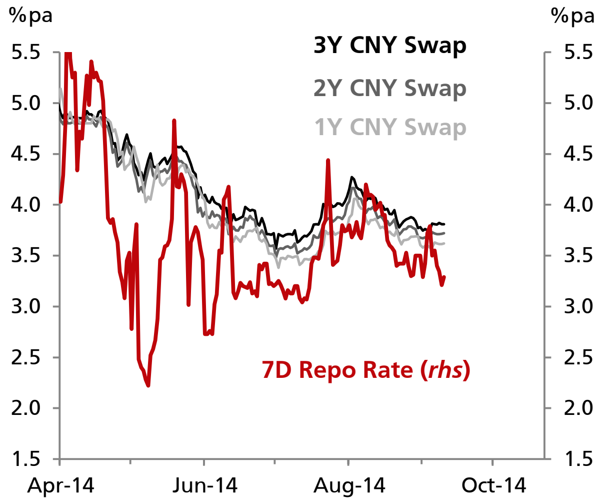
• *We expect yields on benchmark Indian government bonds to stay range-bound. 2Y and 10Y yields are likely reach 8.60% and 8.65% respectively by mid-2015*

China: Slowdown worries to keep rates low

Frontend CNY swap rates (1Y, 2Y and 3Y) are likely to be driven by two key forces in the immediate few months. Firstly, downward pressure on CNY swaps is likely to persist as long as concerns linger about the economy. Notably, a host of high frequency data including total aggregate financing disappointed for July, suggesting that the authorities would at least keep short-term interest rates low to support the economy. The 7D repo rate is therefore expected to remain in the 3-4% range, limiting any rise in front-end CNY swap rates.

Secondly, weak data has also prompted speculation that that the authorities would embark on further stimulus. In which case, expectations of higher growth/inflation in the coming quarters may lift frontend CNY swap rates, relative to the 7D repo rate. The spread between the 1Y CNY swap rate over the 7D repo rate has actually widened over the past few weeks. At this point, we maintain that large scale stimulus (either monetary to fiscal) appears unlikely as the authorities guide China towards sustainable growth. As such, the spread of 1Y CNY swap rate over the 7D repo rate is only likely to widen significantly when economic indicators show signs of stabilization.

1Y, 2Y & 3Y CNY Swap Rates vs 7D Repo Rate



• *The PBoC is likely to keep liquidity ample to support the economy. Short-term rates are likely to stay low*

• *We expect yields on benchmark Chinese government bonds to stay range-bound. 2Y and 10Y yields are likely reach 4.00% and 4.50% respectively by mid-2015*

Interest rate forecasts

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

		11-Sep-14	4Q14	1Q15	2Q15	3Q15
US	3m Libor	0.23	0.30	0.30	0.30	0.40
	2Y	0.57	0.70	0.85	1.05	1.35
	10Y	2.54	2.70	3.00	3.20	3.40
	10Y-2Y	197	200	215	215	205
Japan	3m Tibor	0.21	0.25	0.25	0.25	0.25
Eurozone	3m Euribor	0.09	0.20	0.20	0.20	0.20
Indonesia	3m Jibor	8.12	8.00	8.00	8.00	8.00
	2Y	7.49	7.60	7.80	8.00	8.00
	10Y	8.14	8.25	8.50	8.50	8.50
	10Y-2Y	65	65	70	50	50
Malaysia	3m Klibor	3.73	3.75	3.75	3.75	3.75
	3Y	3.60	3.70	3.70	3.80	3.80
	10Y	4.01	4.00	4.10	4.20	4.20
	10Y-3Y	41	30	40	40	40
Philippines	3m PHP ref rate	1.31	1.50	2.00	2.50	2.50
	2Y	2.95	3.20	3.40	3.40	3.50
	10Y	4.43	4.50	4.50	4.50	4.60
	10Y-2Y	148	130	110	110	110
Singapore	3m Sibor	0.41	0.40	0.40	0.40	0.45
	2Y	0.53	0.70	0.88	0.98	1.03
	10Y	2.44	2.50	2.55	2.65	2.70
	10Y-2Y	191	180	168	167	167
Thailand	3m Bibor	2.18	2.20	2.20	2.20	2.45
	2Y	2.43	2.50	2.60	2.80	2.70
	10Y	3.69	3.80	4.00	4.20	4.20
	10Y-2Y	126	130	140	140	150
China	1 yr Lending rate	6.00	6.00	6.00	6.00	6.00
	2Y	3.92	3.90	4.00	4.00	4.00
	10Y	4.30	4.30	4.40	4.50	4.50
	10Y-2Y	38	40	40	50	50
Hong Kong	3m Hibor	0.36	0.40	0.40	0.40	0.50
	2Y	0.43	0.60	0.75	0.95	1.25
	10Y	1.98	2.05	2.15	2.35	2.50
	10Y-2Y	155	145	140	140	125
Taiwan	3M CP	0.80	0.80	0.88	0.96	1.04
	2Y	0.60	0.65	0.70	0.75	0.80
	10Y	1.71	1.65	1.70	1.70	1.70
	10Y-2Y	111	100	100	95	90
Korea	3m CD	2.35	2.40	2.40	2.65	2.90
	3Y	2.51	2.50	2.60	2.80	3.00
	10Y	3.07	3.10	3.20	3.30	3.40
	10Y-3Y	56	60	60	50	40
India	3m Mibor	8.91	9.00	9.00	9.00	9.00
	2Y	8.46	8.50	8.60	8.60	8.60
	10Y	8.54	8.55	8.65	8.65	8.65
	10Y-2Y	8	5	5	5	5

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CNH: Marching ahead

- **PBoC accelerated the appointment of offshore yuan clearing banks**
- **The pace of RQFII expansion has also picked up**
- **Shanghai-Hong Kong Stock Connect to kick off in October**

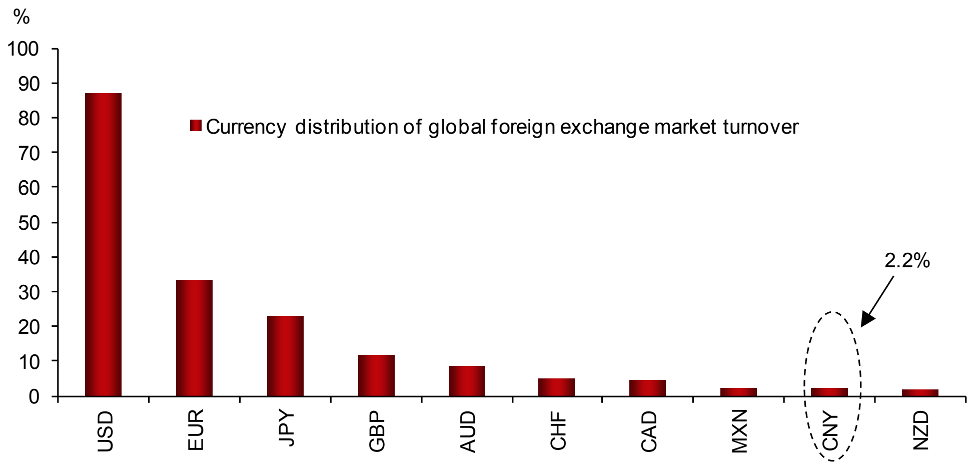
Beijing's efforts to promote yuan usage outside the Asian time zone are delivering fruit. Between July 2013 and July 2014, European direct yuan payments with China and Hong Kong increased by 105%. London saw the largest increase, with a 123% growth; followed by France (+43.5%), Germany (+116%), and Luxembourg (+41.9%). While Greater China remains the major trading partner in yuan for most of these European hubs, there was a noticeable shift in business for some countries. For example, Luxembourg witnessed an increasing share of "purely offshore flows" – trades with no Greater China leg. That underlies a deeper implication in the scope of RMB internationalization.

Increasing share of "purely offshore flows"

A major criterion of an international currency is that the currency is frequently used in transactions among non-residents, or so-called "third-party" settlements. The US dollar (USD) is the main currency fulfilling this criterion. Examples are the quotation and payment of financial products and real estate in some countries using the USD, and the use of the USD by tourists in countries that is not the legal tender.

Another important criterion is the extent of the currency being used in the denomination and invoicing of international trade. It is a well-known fact that the USD takes the lion's share of global trade. This happens even for trades which do not involve the US either as a buyer or as a seller. According to the 2013 Bank of International Settlement (BIS) survey, the USD was involved in 87% of all transactions in the foreign exchange market. Given that the yuan currently accounts for a mere 2.2%, it has a long way to go (Chart 1).

Chart 1: Most traded currencies by value



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More clearing lines

Amid the recent flurry of yuan clearing bank establishments, nevertheless, an increasing share of "purely offshore flows" should be seen going forward. Five out of nine clearing banks were appointed in the past few months in London, Frankfurt, Paris, Luxembourg, and Seoul. Meanwhile, the central banks of Australia and China are working together on potential yuan clearing arrangements in Sydney. Dubai, the second largest emirate in the United Arab Emirates (UAE), is also reportedly on the way to becoming a yuan hub for the Middle East.

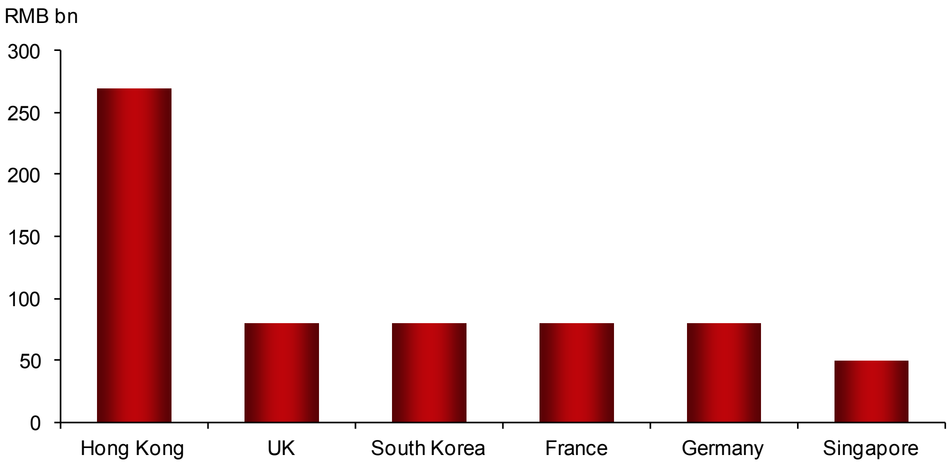
Presently, most of the yuan trade relies on infrastructure in Hong Kong and Singapore. Luxembourg, for instance, has been getting access to yuan liquidity via BoC Hong Kong and ICBC Singapore. And according to the HKMA's Real Time Gross Settlement system, the cross-border settlement between Hong Kong and the mainland accounted for only 10% of the daily yuan settlement, with the remaining 90% being "purely offshore". That implies most of the transactions are occurring between Hong Kong and overseas markets, and/or among overseas markets via Hong Kong. Such strong offshore demand bodes well for the growth of yuan business globally as more clearing platforms are set up.

Expanding RQFII

RQFII quota doubled to 640bn from 320bn last year

While yuan clearing banks serve a practical purpose in facilitating transactions (i.e. cash management, remittance, trade servicing, and FX hedging), yuan-denominated investment products satisfy needs for portfolio diversification. In this regard, China recently granted a RMB 80bn RQFII quota each to Germany and South Korea, in addition to the existing RMB 480bn quota allocated to Hong Kong, Singapore, France, and the UK (Chart 2).

Chart 2: Total RQFII quota



Launched in 2011, the RQFII scheme allows offshore institutional investors to invest in the mainland's securities markets, including stocks, bonds and money market instruments. Compared with the USD-denominated QFII program, RQFII has far fewer restrictions on investment targets and cross-border yuan movement. Its quota has therefore been taken up quickly. In just three years after its launch, the total quota approved has reached RMB 258bn. In comparison, the outstanding amount under QFII, which was launched in 2002, stood at USD 58bn.

Mutual market access connections

In addition to institutional investors, a new program will soon be available to individual investors. Through the Shanghai-Hong Kong Stock Connect, which is scheduled to kick off in October, offshore investors will be able to trade all the constituents of the SSE 180 Index and SSE 380 Index, and shares of all SSE-listed companies which have issued both A shares and H shares (see "CNH: "Through-train" coming, 15 Apr 2014).

SH-HK Stock Connect paves the way for future mutual market access connections

As yuan-denominated equities become more accessible, the offshore demand for yuan-denominated structured products is expected to surge. As such, the yuan use for offshore investment settlement purposes can be further promoted. This is an important development to increase capital account convertibility in the yuan.

The Shanghai-Hong Kong Stock Connect paves the way for future mutual market access connections with other exchanges such as the Shenzhen Stock Exchange. There is also the potential to extend mutual links to exchanges that list other asset classes including fixed income, futures and options, and other derivatives. In sum, the Shanghai-Hong Kong Stock Connect is a historical landmark. Its implementation will have a significant impact on Asia's economy as well as the global financial markets.

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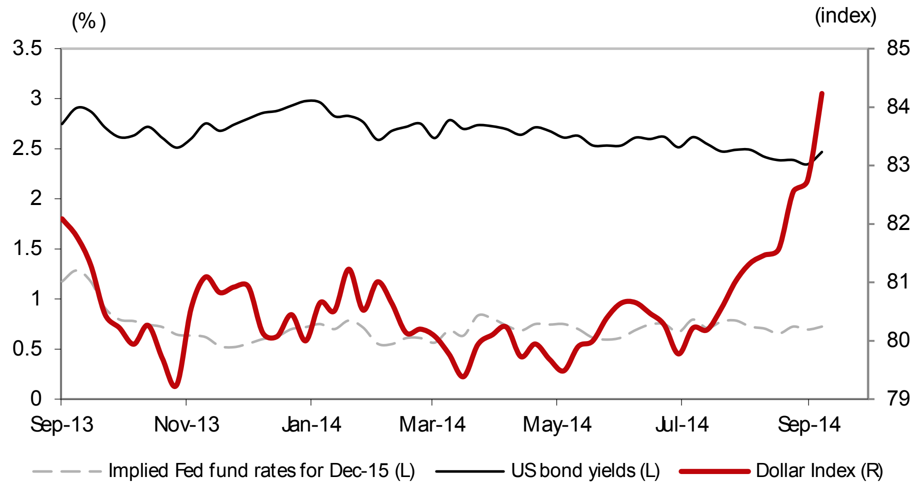
Asia equity: Domestic safety, global perils

- **Expect volatility ahead as markets are perplexed by the Fed's QE exit and ECB's QE entry**
- **Supportive government policies make investing in Asia safe – buy on weakness**
- **Re-rating to continue in China, Thailand and Indonesia – maintain overweight**

Asia equities returned 5% during the quarter, driving the total gains for the year to 8.5%. Improving global data, reasonable valuations, and a pragmatic Fed calendar has supported modest gains in a low volatility environment. Gains were uneven across Asia, but well intended. India and the TIPs markets — last year's crisis-hit countries attempted to revisit their previous high after more than a year, while greater China markets recovered as China's growth was seen as stabilising. Meanwhile, South Korea, Singapore and Malaysia underperformed.

We believe Asia equities can continue to perform in the coming quarter, as domestic factors reign, but external macro uncertainties may rise in the near term, where global risk appetite may be more important to watch. The complete lifting of US quantitative easing will affect bond yields, USD direction, and the perception on the US economic outlook, while the easing of tensions in Ukraine and the Middle East are likely to spike up bond yields as well. Meanwhile recessionary risk in Europe is rising and a dovish ECB may push down further the Euro and European bond yields. That said, a change of winds could render these factors in the other direction. On balance, risk appetite should improve on the margin as investors look to uncertainty being removed.

Fig. 1: Global risk factors on watch



Source: Datastream

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ASIA EQUITY

Economic recovery has been patchy in most Asian economies but a major slowdown has been avoided, thanks to supportive government policies. We believe investors can rely on these policies to nurture the still nascent recovery. In Thailand, the interim government is likely to approve more budget spending and in Indonesia, an unavoidable fuel subsidy cut is likely to be accompanied by measures to boost domestic sentiments with reform measures. More government spending can also be hoped for in Philippines in 2H, next year in Singapore as it celebrates its 50th National Day, and Malaysia's ETP to be on schedule amid weak domestic sentiments. Domestic sentiments are improving in Korea due to government making a push after the confidence-dampening ferry disaster; and the launch of iPhone 6 should bode well for Taiwan's electronics sector. Supportive policies are expected to continue in China for the government to achieve its 7.5% GDP target amid a soft recovery. Near term, the mutual market access between Shanghai and Hong Kong is the first test to China's capital liberalisation effort which is likely to see more forthcoming newsflow. All said, domestic investors should feel optimistic on the recovery going into next year.

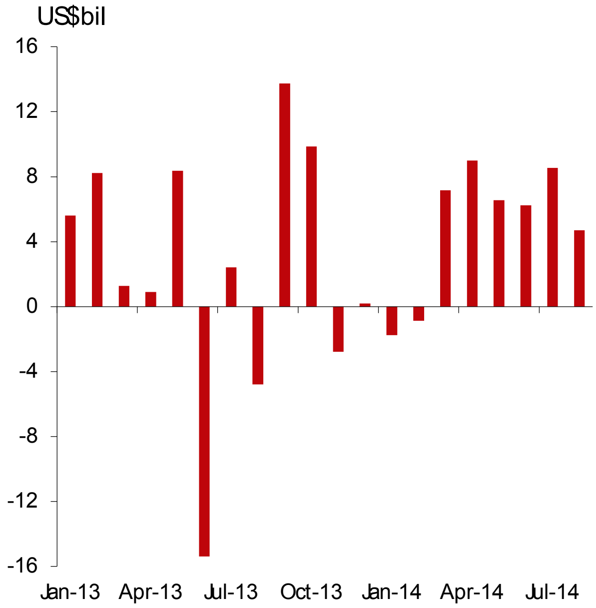
We believe inflows to the region should remain positive in the near term as we do not expect an imminent sell-off in emerging markets since the macroeconomic environment has been more stable and is likely to improve next year. Investors positioning for next year will be also be supportive of fund flows and market upside.

Fig. 2: Asia regional markets — GDP and earnings growth

	GDP growth			Earnings growth		
	2013	2014f	2015f	2013	2014f	2015f
US	2.2	1.9	**2.5**	6.4	**8.5**	**11.6**
Japan	1.5	1.2	1.0	73.8*	**6.9***	11.4*
Eurozone	-0.4	**0.6**	**0.9**	-5.8	**6.1**	**12.9**
G3	1.1	**1.2**	**1.5**	6.2	**7.2**	**11.4**
Indo	5.8	5.4	**5.9**	3.6	**10.1**	**12.6**
Malaysia	4.7	**5.9**	5.2	0.3	**1.6**	**10.3**
Philippine	7.2	6.4	**6.4**	8.8	6.6	**14.3**
Singapore	3.9	3.0	**3.6**	-4.0	**5.9**	**8.5**
Thailand	2.9	1.6	**4.0**	7.4	**9.8**	**12.6**
China	7.7	7.5	**7.5**	10.9	8.2	**10.6**
HK	2.9	2.6	**3.0**	8.3	**10.1**	3.9
Taiwan	2.1	**3.5**	**3.7**	36.9	19.8	8.7
Korea	3.0	**3.5**	**3.8**	-5.9	**12.4**	**14.0**
India*	4.7	**6.1**	**6.6**	7.1	**15.3**	**16.0**
ASEAN 5	4.9	4.5	**5.0**	3.2	**6.8**	**11.7**
ASIA 10	4.5	**4.6**	**5.0**	7.1	**12.6**	9.4
World	2.8	**2.9**	**2.9**	6.2	**7.2**	**11.4**

Source: IBES, DBS. Shaded cells shows reflect acceleration from previous year.

Fig. 3: Asia ex-Japan countries aggregate fund flows



Source: Bloomberg, Bursa, DBS. Includes fund flows for TH, ID, PH, KR,TW, ID, MY

The following section discusses our views on the various global regions. Growth continues to be very slow in the US, Europe and Japan, and China is downshifting to a 7.5% growth. The game changer is that Asia is now driving its own growth just as it had for the past few years. Save for some cyclical/overheating, probably in India, the structural growth story will continue to support the equity returns in Asia, and longer-term investors should continue to position themselves here. *(For details please refer to Economics-Markets-Strategy, "Is it ever gonna change?", David Carbon, 11Sep)*

US — the long and short of it

Things should be better in the second half in the US, but not tremendously. We expect growth of 1.9% (QoQ, saar) and 2.6% in Q3/Q4, which would still leave the 4-quarter average at 1.6%. That's better than the 1% seen in the first half but still far short of the 2% norm that has prevailed since mid-2009.

The vicious triangle of household balance sheets (debt overhang), excess capacity (capital overhang) and labour market slack all point to another 6-7 years before growth returns to normal.

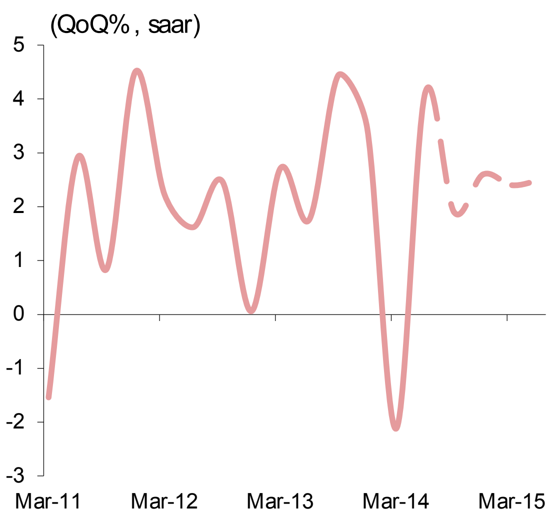
To be fair, recovery is ongoing. It's just that it's been painfully slow for the past five years. Over the past four years, household debt as a percentage of GDP has fallen to 77% from a peak of 97%. More than anything else, this will ensure that recovery continues and, at some point, gathers pace. But there's no magic number where consumption is bound to accelerate. Household debt loads were 60% of GDP before the recent run-up and if consumers decide that's the sort of debt they'd like to return to, it would take another 6-7 years to reach it at the current rate of unwinding.

Weak consumption begets weak investment. Lackadaisical investment is another reason for continued weak growth. Net investment remains at only 3% of GDP, barely half its 30-year average of 5%. Weak net investment means slow growth in the capital stock and it's the latter that gives us our higher productivity and income levels. Currently at 1.5% per year, capital stock growth – four years after hitting bottom – is still slower than the slowest point in any of the previous six recessions.

In the labour market, some ten million workers remain unemployed. At the current pace of recovery, full employment won't be reached until 2021/2022, with clear / downward implications for inflation and consumption / economic growth in the meantime.

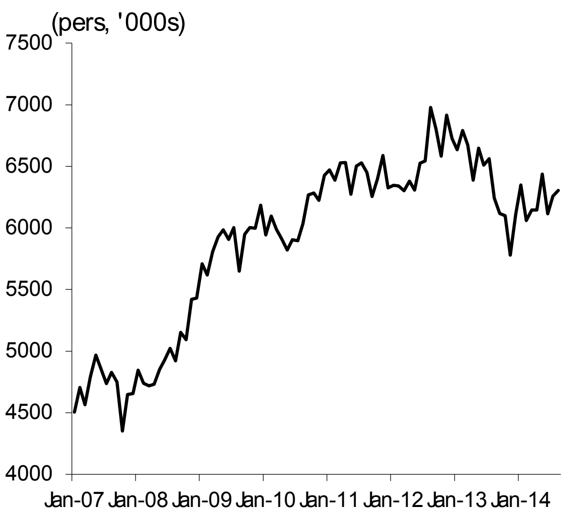
YTD, the US market has done as well as Asia's. The widened growth expectations between US and China (recovering US and weakening China) in the beginning of the year, and the better US 2Q growth number (+4% vs -2% in Q1) have driven hope that "this would be the year".

Fig. 4: US GDP growth — better 2H but still below 3%



Source: Datastream, DBS

Fig. 5: US labor force who wants a job



Source: Datastream

Every year, though, these expectations have proven to be too optimistic. Growth in 2010 and 2011 averaged only 2.1%, merely two-thirds the 30-year average of 3%. Growth in 2012 was only slightly higher at 2.3%. Last year it fell back to 2.2%. Not a good showing and this year it has been worse: full-year growth appears to be heading back below 2% and the monthly data flow doesn't suggest that such a reprieve is on the cards.

Nearly three-thirds of the year has now passed, and we expect the US to underperform Asia in the last quarter on account of 1) better growth in Asia; and 2) the widened valuation gap between the US/Asia.

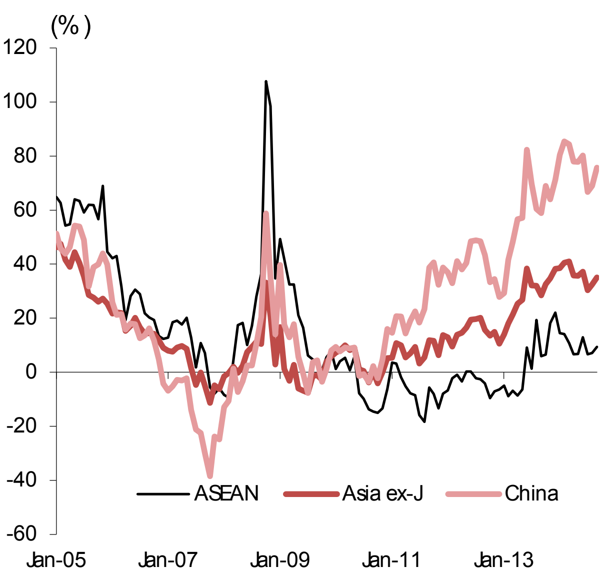
Europe

In Europe, things are worse. Growth there for the past 5.25 years has averaged only 0.6%, no thanks to a second recession following the global financial crisis of 07/08. Most thought Europe had finally exited the second downturn a year ago (chart above) but now the core, rather than the periphery (where all the debt problems were centred back in 2011), is in trouble. Germany's GDP shrank by 0.8% (QoQ, saar) in Q2, while Italy's shrank by the same margin, but France's ran sideways. Compounded by an already weak first quarter, growth in Europe's Core-3 countries has been zero for the first six months of the year. The ECB is now pursuing a quantitative easing (QE) programme in all but name and is a whisker away from dropping that formality as well – just as the Fed is getting out of the business. QE is unlikely to prove any more effective there than it was in the US, and Europe seems destined once again to be a drag on the rest of the world, including Asia, for the indefinite future.

Japan

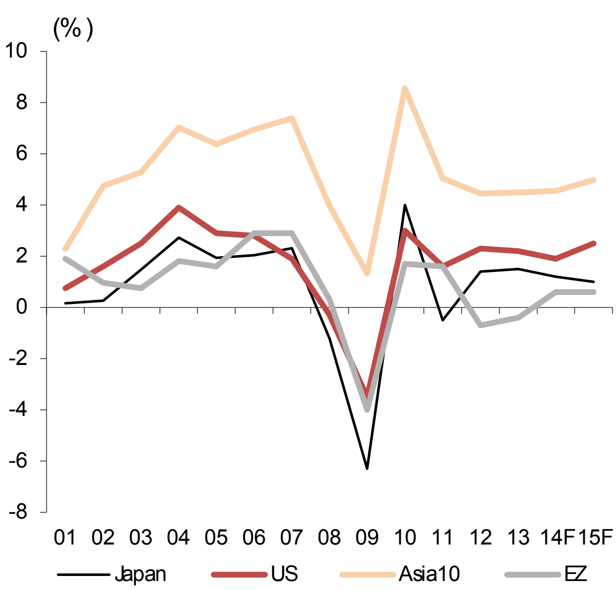
For a couple of quarters back in 2013, it rode on a wave of positive sentiments emanating from Abenomics. But not any longer. The all-important "third arrow" – structural reform – never materialised, sentiments faded again and growth in the first half of this year has fallen back into negative territory. Yes, the consumption tax distorted Q2 growth downwards but only by what it distorted Q1 upwards. Net out the volatility and you're left with negative growth for the first half of the year and zero growth for the past full year. Like in the US and Europe, things seem to be slowing, not picking up.

Fig. 6: US 12m forward PE premium to Asian markets



Source: Datastream, DBS

Fig. 7: Global regional GDP growth



Source: Datastream, DBS

China

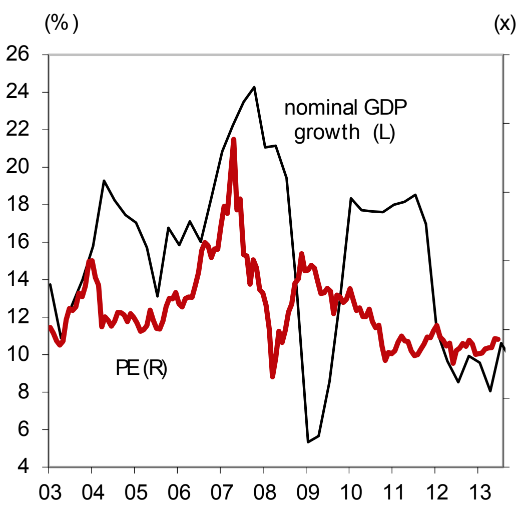
It remains debatable whether China's stock rally is sustainable. We belong to the positive camp and see upside towards our 26,300 index target by the end of this year. China has fared better than many other countries in many areas, in our view. Favourable demographics, stable growth, a "helicopter" government, and opening of financial markets and structural reforms should present a lot of opportunities for investors.

Skeptics have been concerned about potential systemic risks in the financial markets from a probable drop in property prices and the shadow banking system. But so far this year, the government has implemented several policies and reform measures to strengthen the financial system. A clearer regulatory framework to regulate the shadow banking system and internet financing activities will largely ease the overhang. Housing policy loosening together with a more stable macro outlook should also bring back confidence in the property market.

Undoubtedly, China has slowed down. The market is aware it is a permanent / structural downshift that will become the "new normal", a term repeatedly used by the new leadership to tone down expectations. Likewise, valuations have also de-rated from the high 20's multiples achieved in the mid-2000s when growth exceeded 10% to single-digit currently. The structural slowdown has largely been priced in, in our view.

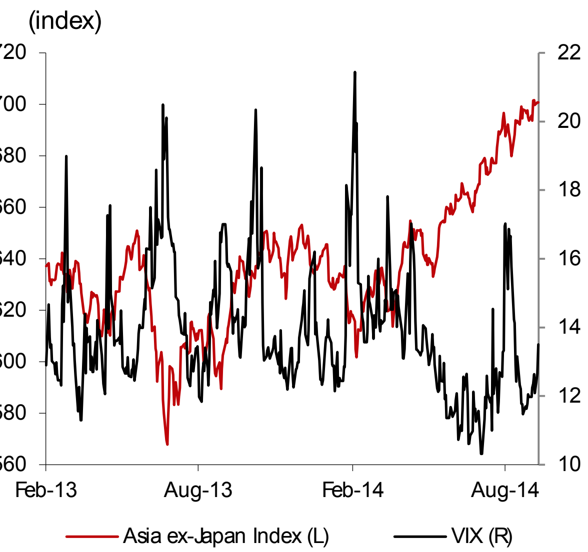
Trading at lower valuations than before and to the rest of the world, there is ample room for PE expansion should the headwinds from government policies turn into tailwinds. The Shanghai – Hong Kong mutual market access is going to be an experimental case on how the liberalisation of China's capital markets will take shape before China opens up its capital markets fully to the world. Armed with 7.5% growth compared to only about 1% in the rest of the world, investors will soon realise the market's full potential – the ability, together with the rest of Asia10, to create another Germany in 3.5 years, and three Eurozones over the next 25 years! And by that time, valuations will not be as attractive as they are now!

Fig. 8: China 12m fwd PE vs GDP growth



Source: Datastream, IBES, DBS

Fig. 9: VIX vs MSCI Asia ex-Japan Index



Source: Datastream

Volatility ahead

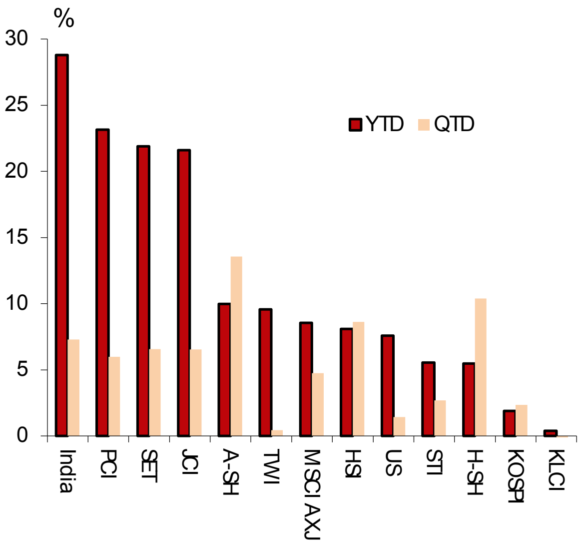
Against these expectations of a weaker growth in Eurozone and Japan vs US, and ECB/Japan's QE entry vs US QE exit, the two more direct implications for Asia are the direction of US dollar and the US bond yields, which can spook Asia market volatility in 4Q. By and large, during the year, AXJ exchange rates have been fairly stable to firm when the US is seen moving along a Goldilocks recovery. The US bond yields have headed down amid safe haven flows due to geopolitical unrests and declining Germany bond yields.

Renewed Fed hike expectations could be the trigger for higher volatility which has been complacently low for a long time. Our DBS fixed income strategist also believes that yields in the Eurozone have likely stabilised. In which case, downward pressure on UST yields arising from declining German Bund yields should also dissipate. Barring an escalation in geopolitical risks or a shock to the US economy, the impending end of quantitative easing by the Fed suggests that long-term UST yields have room to head higher in the coming quarters. The latter could spook the re-pricing of risk assets including Asia's emerging ASEAN markets in the 4Q. Although the macroeconomic conditions are a lot more stable when compared to last year, and the economies are more prepared to address a confidence crisis, their outperformance this year could drive investors to lock in profits before the year closes.

Asset allocation

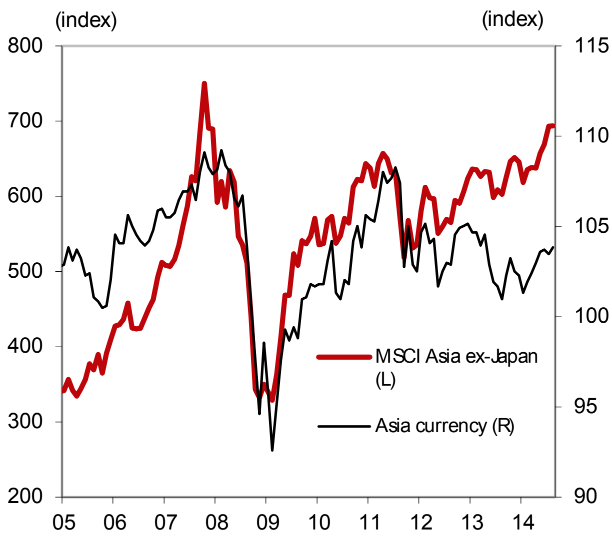
With the Fed set to fully wind down its QE3 program by October, we believe the focus will be on a rate hike. Speculation can quickly return, especially if data signals that the US economy is emerging strongly from its disappointing performance in the first half of this year. Hong Kong and Singapore remain most vulnerable to US interest rate hikes while most economies have their own rate hike cycle that is dependent on inflation outlook. Other markets may succumb to macro uncertainties arising from QE tapering such as higher bond yields and the prospects of a strengthening USD. Relative de-risking may lead to volatility in Asian markets in 4Q14.

Fig. 10: Asia regional markets — YTD and QTD performance



Source: Datastream, DBS

Fig. 11: Outlook for Asian markets is better with a strong currency



Source: Datastream, DBS

Keep an eye on global risk appetite in the near term. Now that the results season that reported lacklustre earnings is more or less over, investors will look to the global risk environment for direction. The complete lifting of US quantitative easing will affect bond yields, USD direction, and the perception on the economic outlook, while the easing of tensions in Ukraine and the Middle East are likely to spike up bond yields as well. Both should improve risk appetite, as some degree of uncertainty is removed.

Domestic investors are hopeful. Economic recovery has been patchy in most ASEAN economies but a major slowdown has been avoided, thanks to supportive government policies. We believe investors can rely on these policies to nurture the still nascent recovery. In Thailand, the interim government is likely to approve more budget spending and in Indonesia, an unavoidable fuel subsidy cut is likely to be accompanied by measures to boost domestic sentiments with reform measures. We can also hope for more government spending in Philippines in 2H, and next year in Singapore as it celebrate its 50th National Day, and Malaysia's ETP to be on schedule amid weak domestic sentiment.

Our asset allocation strategy is to focus on markets with long-term drivers for re-rating and to look beyond this year for stronger returns amid global macro uncertainties. These are China / Hong Kong, Thailand and Indonesia which we are overweight on. The focus on sectors will be assessing winners and losers of domestic recovery, interest rate sensitivity and margin squeeze.

The consolidation in Hong Kong/China in August is an opportunity to add positions in the market as it paves way for more market upside. We had raised our year-end targets for HSI to 26,300 and HSCEI to 12,400. The market's technical indicators are more palatable after the market consolidation in August. 1H14 earnings were generally upbeat, while earnings revisions have trended up. We also expect normalization in China's credit growth, more targeted policies, and a recovery in China property sales to be catalysts. Risks also seem lower given the latest ceasefire in Ukraine and Occupy Central movement's smaller scale. Some stocks in Hong Kong can benefit if trade sanctions between Russia and Europe worsen. Mutual market access (MMA) will kick off next month, and MMA will continue to be the focus, which could test HSI to its 2007 high when the QDII scheme was first introduced. We expect stocks that can benefit will continue to outperform in 4Q.

In Thailand, recovery amid a more stable political environment and reform progress will support Thailand's PE expansion into next year. We believe there are upside risks to growth forecasts. Positive momentum can hence be extended to sectors despite rich valuations.

It is worth noting that Hong Kong/China and Thailand are two markets that have potential of earnings recovery and possible earnings upside. 2Q14 earnings (1H14 for HK/China) were more positive than expected, leading to upgrades in earnings growth. The relative low valuations in these markets compared to the region will provide room for PE expansion.

Rumours of an imminent fuel subsidy cut had induced investors to take profit in Indonesia last month. In our view, fuel subsidy cuts, if well executed, will reflect Jokowi's commitment to reforms, and hence improve Indonesia's outlook for the next 10 years. The JCI could trade up to the 5300–6200 band, based on 13-15x PE, by end-2015. Although rising costs for companies will arise as a risk factor in Indonesia, there will still be sectors which will benefit from the subsidy cuts, such as Construction and Banks. Measures that offer better transparency in administrative procedures, a conducive business environment and clear policies are some of the reform measures that Jokowi can implement to offset rising costs, which would then lower the overall cost of doing business in Indonesia.

We maintain our Neutral stance for Korea and Taiwan. Near term, the exports outlook for Taiwan seems to be better with the launch of iphone 6, as Korea's Samsung may be under pressure. But domestic sentiment in Korea has recovered following the government's sentiment boosting measures. With US and China gradually recovering, we expect the economic growth to be sustained to support earnings going forward.

India is the best performing market YTD. India returned 29% YTD and 7% QTD. Positive momentum after the sweeping wins by the opposition party were carried forward to 2H. Economic growth forecasts have slowly been creeping up but this has yet to translate to earnings. The positive sentiment could continue to support the market, driving analysts to turn more positive on earnings forecasts. Until the first major disappointment which is unlikely in the near term, we are maintaining our Neutral call on the market. India now trades at 16x. Sensex may see some resistance at 28245, but this still translates to 3.5% return till the end of 2015.

Meanwhile, earnings growth in Malaysia and Philippines were below expectations. Given the lack of earnings growth to support the high valuations, we believe the market could be volatile on sensitivity to de-risking and growth prospects. We have both markets as Underweight. Singapore seems defensive. Short of any catalysts in the near term, we maintain Neutral on Singapore.

Our key views and investment ideas for the respective markets are discussed in the following section. Our market recommendations are:-

Overweight: China / Hong Kong, Thailand, Indonesia

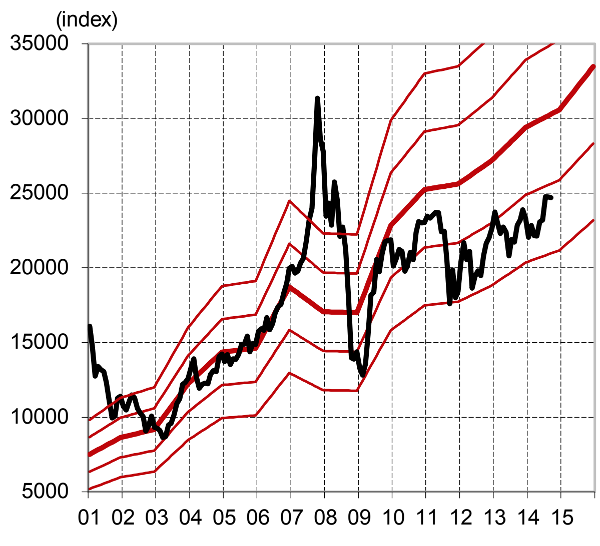
Underweight: Malaysia, Philippines

Neutral: Singapore, India, Taiwan, Korea

China / Hong Kong (Overweight)

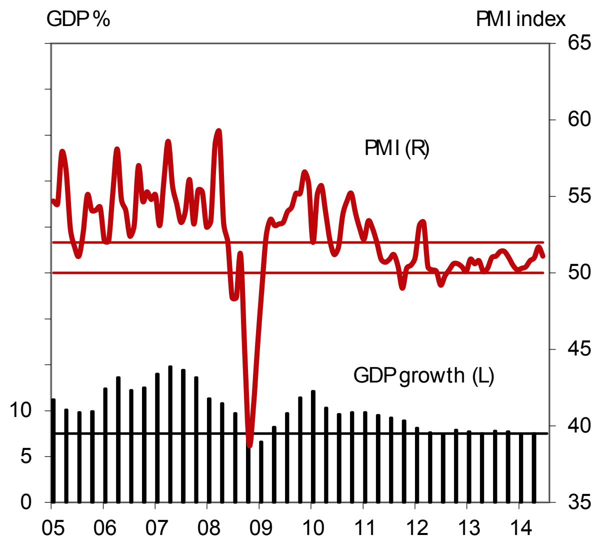
China A shares and the suite of Hang Seng indices returned in excess of 8% for the quarter, validating our call to raise the market to Overweight last quarter. We believe there is further upside as some of the overhangs improve.

Fig. 12: Hang Seng Index 7—18x PE bands



Source: Datastream, DBS. Line in bold red is the average.

Fig. 13: China PMI vs GDP growth



Source: Datastream, DBS

There were some concerns on the data front, and hence the sustainability of the rebound going forward. PMI was below expectations and loan growth slowed in July, and China property sales and prices have yet to recover despite easing some of the measures.

We believe there should be realistic expectations on economic growth and hence the PMI. The " new normal" growth, as stressed repeatedly by the Chinese leaders, should be one that is focused on the quality of growth and on changing the structure of the economy. GDP growth shall be maintained at 7.5% regardless, and hence PMI should range around 50-52.

Credit growth slowdown in July was a concern, as sharp deleveraging can derail macro recovery. We expect new bank loans to rebound in August, as we believe July's dip was primarily due to deposit seasonality and already high loan growth in June. Recent newsflow and comments from PBOC also point to new loans of around Rmb700bn in August, which should be reassuring for the market.

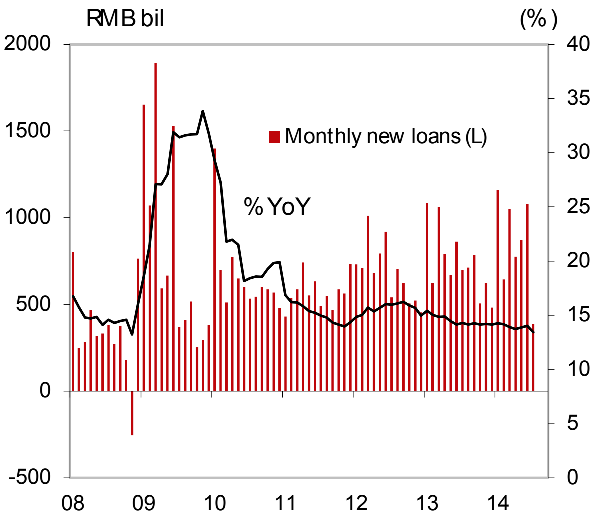
We also expect property sales will recover more meaningfully starting in September and October. In previous property cycles, sales started to recover 3-4 months after initial loosening measures. This year, HPF policies started to loosen in May and HPR policies were relaxed in late June. Therefore, our property team expects property sales to show a meaningful rebound in 4Q14 from 3Q14 levels.

There are three main catalysts to maintain the momentum in the China and Hong Kong markets in the following quarter.

1) Sino-Russia trade can increase if Europe-Russia relations deteriorate. We believe some Chinese companies can stand to benefit. Among imports from Europe and US to Russia, the largest sectors are machinery, autos, equipment, pharmaceuticals, plastics, optical and medical apparatus. Among these sectors, we believe likely Chinese beneficiaries to be within the machinery, autos, electronic equipment sectors, as China is already exporting sizeable amounts in these segments. Food is also another area that can see an increase in Sino-Russia trade.

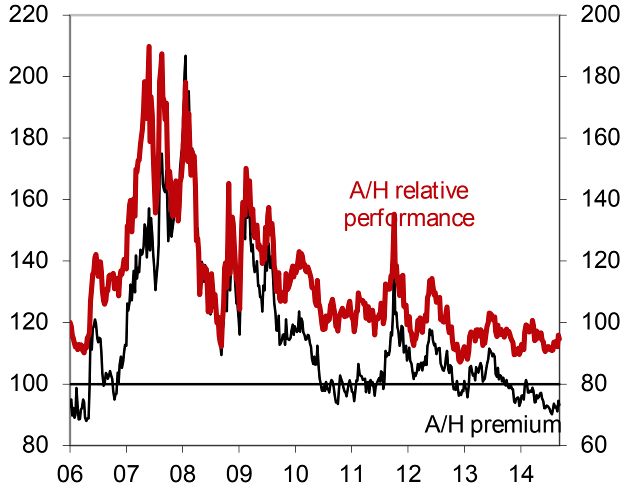
2) Mutual market access will kick off next month. We expect beneficiaries of mutual market access will continue to outperform. Beneficiaries fall into several

Fig. 14: China monthly new loans and loan growth



Source: Datastream, DBS

Fig. 15: Hang Seng AH premium Index vs A/H relative performance



Source: Datastream, DBS

clusters: a) companies that would benefit from the expected higher trading turnover and A-share market boost; b) H-shares trading at large discounts to A-shares; c) unique HK-listed plays, and d) A-share ETFs.

3) Mini-stimulus will underpin growth sustainability. We also expect policies around the targeted stimulus to stay. Infrastructure spending on railway and low cost housing, as well as gradual opening up of the capital markets are longer term restructuring plans which will continue to be in place. Meanwhile, SME credit and property market easing are near term stimulus to offset the negative sentiment from the government's tightening measures earlier on banking prudence, frugality and political in-struggle. We believe these measures may last for some time, together with some of the fine tuning policies being rolled out in the banking and property sectors.

The HSI is now trading at 11x forward PE, or 0.58 standard deviations above the 5 year mean of 10.5x. HSCEI's forward PE of 8x is still 0.84 standard deviations below mean. We believe these are attractive levels given potential positive earnings revisions. We maintain our year end HSI and HSCEI targets of 26,300 and 12,400, translating to 4.4% and 8.7% gains respectively.

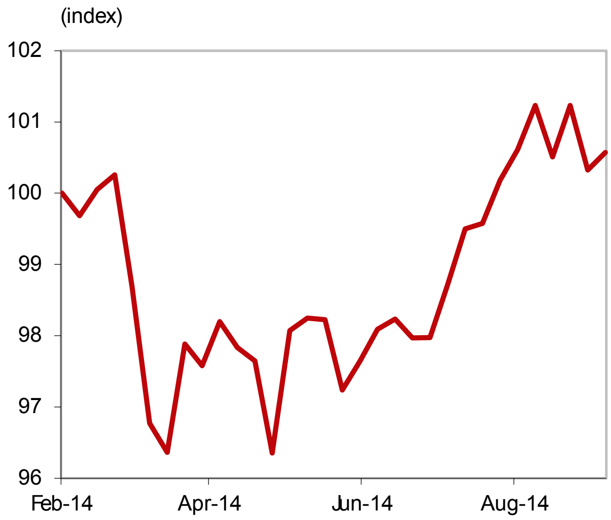
Singapore (Neutral)

The STI returned 3% for the quarter, underperforming the region's 5%. Monthly performance was mixed, reflecting a very challenging quarter driven by uncertainty in Ukraine/ Russia and the Middle East crisis, and a lacklustre earnings season which saw more misses than positive surprises. The good news is that the cut in earnings forecasts was marginal, and may suggest a halt to the earnings downward revision trend that has lasted for more than a year. The STI should remain well supported at current levels, and provide good bargain opportunities.

Three trends emerged on the earnings front:

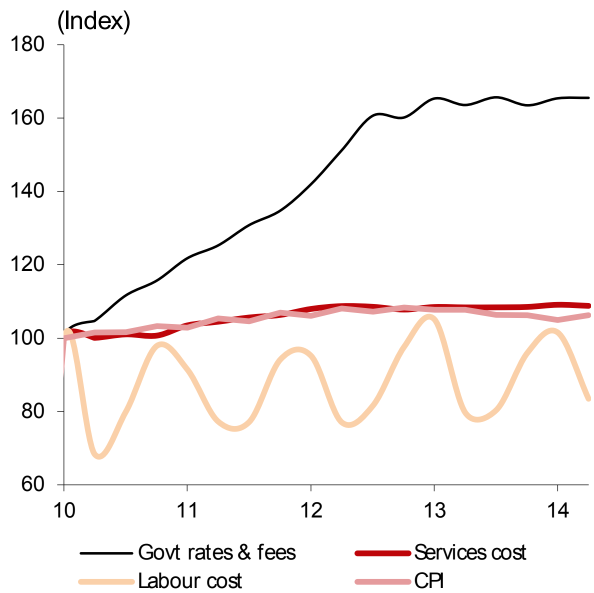
1) Banks shined again in 2Q, following a sterling 1Q performance. Low provisions, improving NIMs, higher trading and investment gains led to banks' growth. With a potential interest rate hike in 2015, we expect earnings to grow 11% in 2015 from 7.5% this year on improving NIMs.

Fig. 16: Singapoore Banks relative to STI



Source: Datastream, DBS

Fig. 17: Singapore costs of manufacturing



Source: Datastream, DBS

2) Singapore companies continue to be affected by the labour crunch that resulted from the government's foreign labour tightening policies. This has affected the labour intensive services and construction sectors.

The F&B, retail and hotel industries are among those affected. Challenges from rising rents, as well as labour cost and shortages are flagged. Meanwhile, foreign worker levies in the construction sector had just increased in July 2014 and will rise further in July 2015.We do not expect these cost pressures to abate anytime soon.

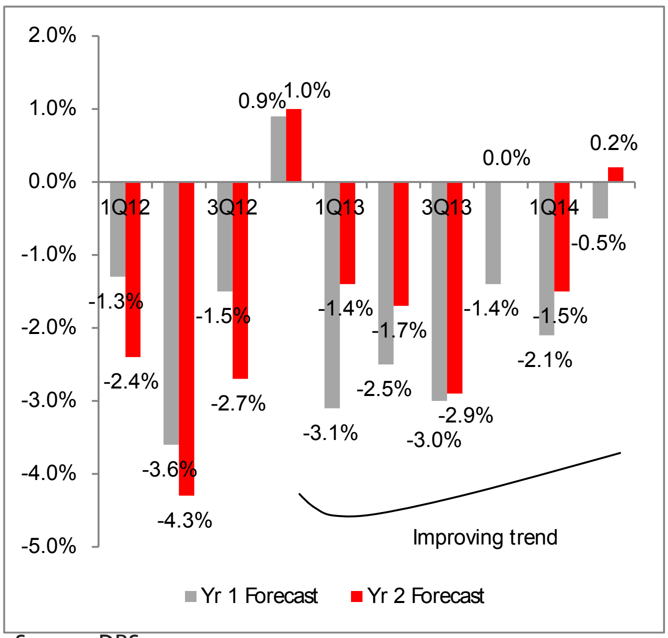
In addition to higher operating cost in Singapore, other challenges affecting margins and earnings are: a) currency volatility which would impact Singapore companies seeking global or regional exposure, b) higher raw material cost affecting consumer companies, although this should ease towards end-2014 as selected commodity prices such as CPO have peaked and are headed south, c) geopolitical risks affecting oil prices and d) strong SGD eroding the competitiveness of Singapore companies, affecting top-line growth.

As mounting cost pressures whittled down corporate earnings in general, we believe companies that are able to enhance or even defend margins will outperform. These would be companies (a) focused on product innovation and strong brand equity; b) with strong track records in project execution and achieving productivity gains; c) with strong positioning in a niche market; d) which have early mover advantage to tap on new market opportunities; and e) with efficiency in cost management.

3) Overall, the Industrials and Oil & Gas sectors, despite their underperformance this result season, are still expected to register strong growth going forward. We are expecting earnings for the Industrial sector to grow 21.8% and 17.3% for FY14F and FY15F, respectively.

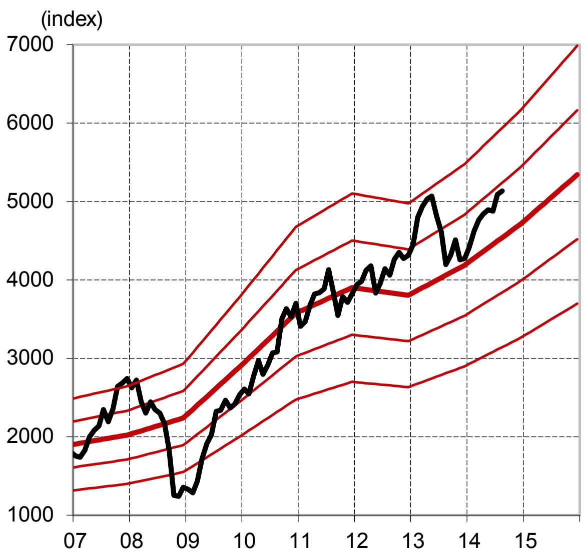
On the economic front, the Singapore economy grew 3.5% (YoY) in 1H14. For the full year we are expecting 3%, down from initial expectations of 4%. The downside risks had came from both exports and services, which are worrisome, as the latter is traditionally seen as the most stable engine of growth. At the same

Fig. 18: Singapoore earnings revision trend



Source: DBS

Fig. 19: Indonesia JCI 9 —17x PE Bands



Source: Datastream, IBES, DBS. Line in bold red is the average time, the recovery of the global economy has been sluggish and uneven so far this year. While expectations of a gradual recovery remain, recent data has proven to be quite mixed, and it is still early days to conclude that an upturn in the earnings revision trend is imminent. We believe the market will continue to trade range-bound until fresh drivers or more convincing trends come into sight.

Indonesia (Overweight)

Indonesia gained 7% in 3Q14, driven by positive developments in politics. The presidential election — the highlight of the year — has come to a close after the court declared Jokowi as Indonesia's new leader. We believe the case for re-rating of the Indonesian market is strong after Jokowi's presidential win and raised Indonesia to Overweight in August.

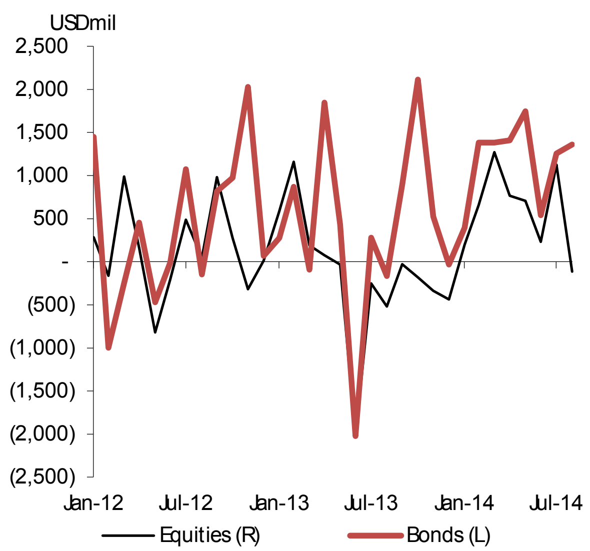
The market is inexpensive and a PE valuation range of 13-15x (average to +0.9SD) could lift the index to the 5300–6200 band by end-2015. Re-rating is likely to be supported by positive earnings outlook and reform policies. There are a few potential drivers in the near term:

1) Firstly, there could be possible swings of allegiance from Golkar/ Demokrat to Jokowi-JK's camp, thereby solidifying his political capability. This will make the reform process easier for Jokowi to implement.

2) New cabinet formed with technocrats, and with members who are seen to be able to push through reforms. The new government will take shape in October.

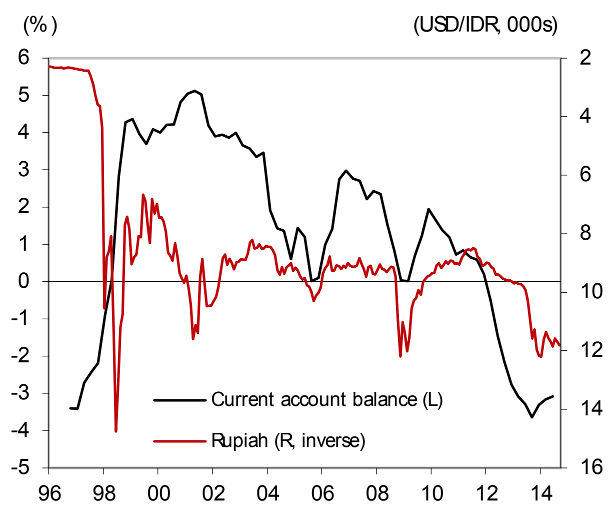
3) First fuel subsidy hike possibly this year. In our view, fuel subsidy cuts, if well executed, will reflect Jokowi's commitment to reforms, and hence improve Indonesia's outlook for the next 10 years. Fuel subsidy cuts in the past had only dampened consumer sentiment in the short term, but rising costs for companies will be a major concern. There will still be sectors which will benefit, such as Construction and Banks. Measures such as offering better transparency in administrative procedures, a conducive business environment and clear policies are some of the reform measures that Jokowi can implement to offset rising costs to bring the overall cost of doing business down in Indonesia.

Fig. 20: Indonesia net foreign portfolio flows



Source: CEIC, Bloomberg, Datastream, DBS

Fig. 21: Indonesia current account balancs vs rupiah



Source: Datastream, DBS

Foreign equity flows have reversed to net selling in August. But before this, Indonesia's inflows were already US$4.9bn for the year, the highest in its history. Several issues on the macroeconomic front still need to be addressed to instill longer term confidence in its currency, especially with the current account deficit. That said, the environment has been more stable than last year, and the rupiah at around 11800 currently is attractive in our view.

With the presidential election finally over, the market will be waiting for Jokowi's plans and future policies to be announced when he takes office on 20 October. The JCI does not look expensive at 13.8x FY15F earnings but it has outperformed most Asian indices YTD (up 20+%) except India, and has been hovering at the peak at the 5,200 level. Hence, JCI's upside potential could be limited until further catalysts are visible. But we remain optimistic of the long term outlook for the Indonesian market, and recommend investors to accumulate the big caps and reform beneficiaries in Indonesia for strong gains next year as the market re-rates.

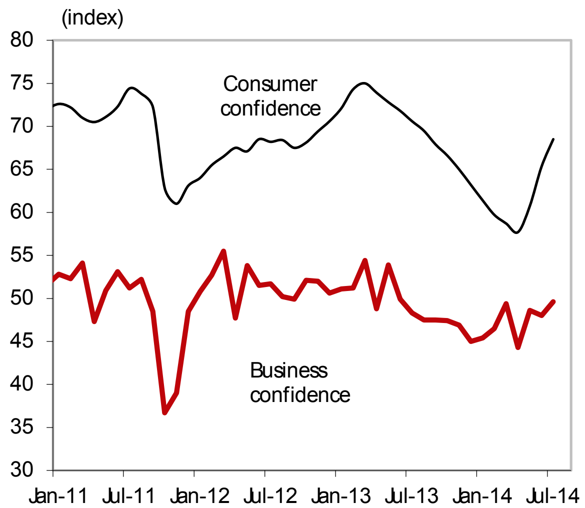
The key themes for Indonesia are:-

1) Impact of fuel price hike. We would be cautious towards several sectors which will be affected by fuel price hike, especially Consumer, Auto, Transportation and Manufacturing. Historically, these sectors tend to experience slower demand following a fuel price hike. In the Auto sector, 4W demand tends to drop for up to six months after a fuel price hike, while the Consumer and Manufacturing sectors must raise prices to offset incremental costs.

2) Earnings risk. Near term, there is still downside risk to earnings stemming from a slowing economy, fuel price hike, and weak 1H14 results. Investors should also be wary of valuation and foreign outflows. We recommend looking at inherently more resilient sectors — Property, Telecommunications and Offshore Marine Services.

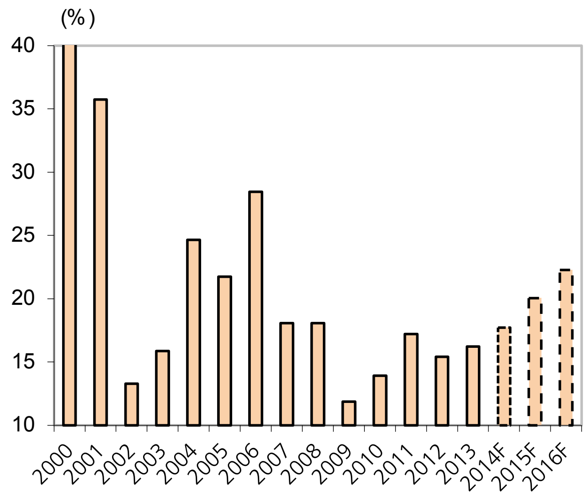
3) Long term reform beneficiaries. The Construction sector will also benefit if the next government deploys the fuel subsidy savings towards infrastructure projects. Other sectors including Healthcare, Oil & Gas, and Banks are also seen as potential sectors to benefit from the reforms.

Fig. 22: Thailand confidence indices



Source: Datastream, DBS

Fig. 23: Thailand market ROE



Source: Datastream, DBS

Thailand (Overweight)

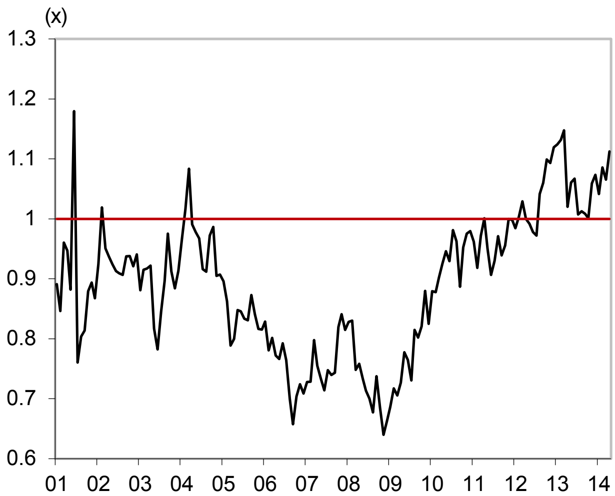
The Thai market rose another 6.6% in the quarter, taking YTD gains to 22%. We believe the market will continue to work itself towards the previous high given the relatively calmer political scene and the positive political developments so far. The roadmap to the next election is on track with the National Legislative Assembly (interim lawmaker) in place to review and clear pending laws. General Prayuth is now the PM of the interim government to ensure the reforms are carried out as planned.

Investors are now hoping for broad-based positive developments now that the interim government has been formed, especially with plans to revive the economy and ensure a sustainable recovery. Government spending in infrastructure, tourism and extension of tax cuts, together with low interest rates, are expected to bring about a revival in the economy. The private sector will put forward 139 legal draft bills and amendments. These laws will cover business promotions, trade facilitations, customs, urban planning, skilled labor, etc. The National Council for Peace and Order (NCPO) has a priority to accelerate law enforcement that is aimed at minimizing time and cost of doing business in Thailand, reducing corruption, and improving transparency.

We expect GDP growth to accelerate to 3.6% next year from 1.6% this year. But, this is still below the average GDP growth before the political crisis. We believe there is upside growth potential in Thailand, if the political reforms effectively address the deep political divide, leading to a successful election by end of next year. Investments should pick up as business confidence returns.

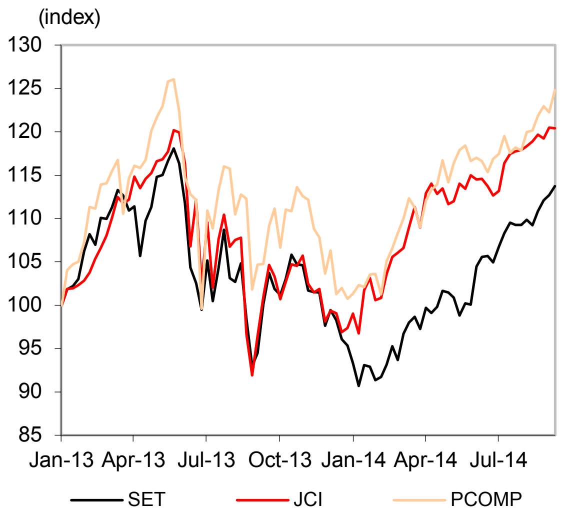
Although the recovery has been patchy so far, the halt in declines in GDP and earnings growth should help towards improving the economic environment hereon. Corporate earnings have been surprisingly resilient despite the poor political climate earlier when expectations were lower. We expect the reforms to provide upside surprises to the various sectors, following the appointment of the interim government, leading to better earnings outlook. For example, 2Q14 earnings of the major developers had exceeded analysts' estimates, reflecting improving consumer sentiment.

Fig. 24: Thailand PE relative to Asia ex-Japan



Source: IBES, Datastream, DBS

Fig. 25: SET, JCI, PCOMP — performance since 2013



Source: Datastream, DBS

The Thai market still lags Philippines and Indonesia in recovering to the previous highs and fund inflows are still marginally negative YTD, compared to historical high inflows to the former two markets. There are various sectors which should benefit from the reforms. The Property sector is expected to be in a bright spot amid improving domestic confidence and the low interest rate environment. Electronics is entering a seasonal peak in 3Q14, and key players will attract interest. Banking stocks will benefit from various economic components. Selected food companies could book windfall profits following the China food scandal and Russia's sanctions on European agricultural products, as buyers switch to buying from other countries such as Thailand. Sectors that are likely to remain weak are Automobile and Hire Purchase. The highlight of the reforms is expected to be the energy policy. General Prayuth is moving forward to end subsidies and move towards market pricing mechanisms.

We retain our Overweight recommendation for Thailand on earnings recovery and market re-rating potential.

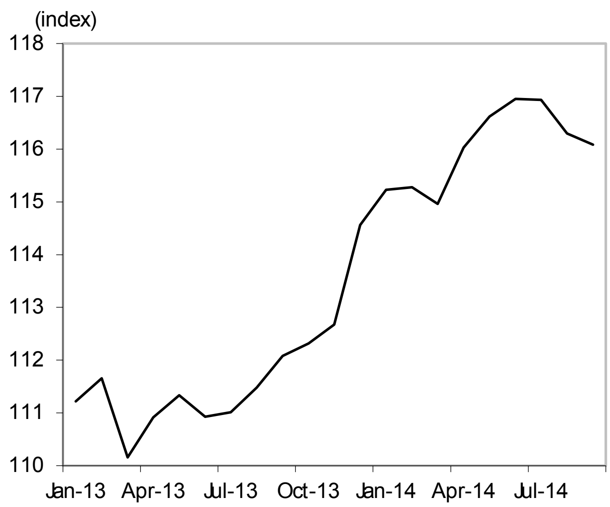
Malaysia (Underweight)

The KLCI was flat for the quarter and the year. The market was plagued by poor 2Q14 results, with 35% of stocks in DBS' universe reporting weaker-than-expected results compared to just 6% which had positive surprises. Aviation, Construction, Gaming, Glove, Media, Property and Telco sectors led the weak set of results. Hence, we have cut 2014-15 earnings for KLCI component stocks by about 2%. Earnings growth in 2014 is expected to moderate to 6.0% from 8.7% post-1Q14 results.

2Q14 GDP growth however beat expectations at 6.4% vs consensus estimate of 5.8%, and 6.2% in 1Q14. This was mainly driven by strong exports and investments, amid moderating growth in domestic consumption and imports. However we see risks that growth will slow in 2H given higher level of inflation further dampening consumer sentiment and the government's austerity drive to rein in the fiscal deficit.

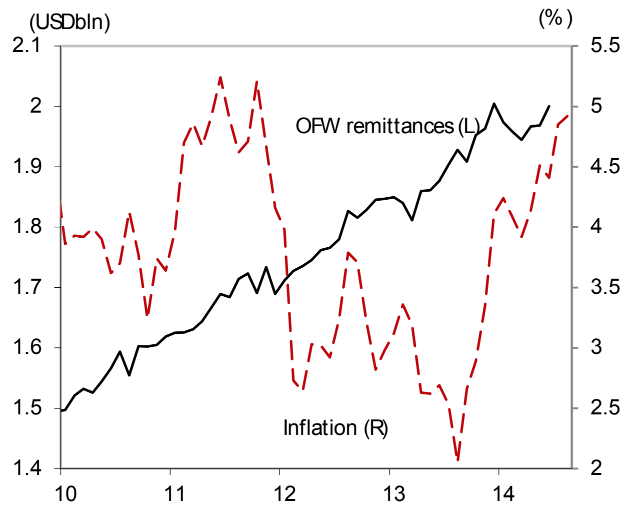
Malaysia's federal government will be tabling the 2015 national budget on 10 Oct. The focus will likely be on financial prudence in view of elevated levels of government and household debt. We expect subsidy rationalisation and utility tariff liberalisation to be the main measures used by the government to balance its books, while expanding its revenue sources at the same time. We also expect more clarity

Fig. 25: Malaysia KLCI 12--month fwd EPS



Source: IBES, Datastream, DBS

Fig. 26: Philippines OFC remittances vs inflation



Source: Datastream, DBS

on the implementation of Goods and Services Tax (GST) in April 2015. In view of cost-push inflation, the federal government may also continue to provide financial aid to the lower income group, albeit with a more targeted approach. Against such a backdrop, we expect domestic driven businesses to experience weaker demand and margin pressure in the near term.

With 2015 PE of 15.7x vs historical mean of 15.6x, valuation of Malaysian equities is not excessive but the poor earnings trend and domestic macro headwinds are likely to dampen equity performance in the near term. As such, we lower our end-2014 KLCI target to 1,860 from 1,910 while maintaining our target PE of 15.5x. Investors should also be mindful that the earnings yield gap (inverse of market PE minus risk-free return) has compressed to 2.0% which is close to -1SD of the mean. Unless earnings growth momentum picks up, equity PE de-rating will ensue once the interest yield curve steepens.

Corporate earnings disappointment remains the key risk to Malaysian equities amid cost-push inflation, dampening consumer sentiment, and slow household income growth. Against such a backdrop, we expect corporates with exposure to the domestic market to face earnings pressure from higher cost of doing business and/or slowdown in revenue growth. Corporates which rely on export markets may have to grapple with higher cost, but those with strong bargaining power may even be able to pass on the higher cost to customers.

As organic earnings growth becomes more challenging, alpha seeking investors would have to look for growth stocks which are driven by investment and/or M&As. The oil & gas and construction sectors fit this theme and we continue to overweight these sectors.

Philippines (Underweight)

The PSEi gained 5% in the quarter, driven mainly by better than expected 2Q GDP growth, and MSCI rebalancing which added significant weightings to PLDT. Inflation has stabilized after two rounds of hikes in policy rates and RRRs, driving hopes that an end to the tightening cycle may be near. Our assessment of GDP growth in the Philippine economy was upgraded to 6.5% for the full year vs 6.3% previously.

The strong economic growth came about despite slower investment growth. Domestic demand remains strong and exports had also become stronger. The economy is now growing c.6% (QoQ, saar) once again after the temporary slip in 1Q14, making it one of the highest among the TIP markets. Against a backdrop of positive sentiment, we expect the PCOMP to attempt the previous high achieved in May 2013. However we see near term risks to the market which may not make this uptrend sustainable. Philippine equities have moved in positive direction in recent months. Continued higher economic growth outlook and robust foreign inflows are generating medium-range momentum for Philippine equities. But, since equities are trading at historically rich valuations and 2Q14 reported earnings ranged from disappointing to unexciting, we prefer to tactically Underweight Philippine equity exposure on market strength.

The first round of foreign outflows was after the Fed's taper announcement. There are risks of capital outflows when the Fed lays down its groundwork for an interest rate hike in 4Q after QE tapering ends. A reality check on earnings delivery and complacency may inundate the market. Valuations are rich as the rise in equity prices has outpaced the growth in corporate earnings. Given lacklustre 1H14 earnings results, we see increasing scrutiny on the ability of companies to actually deliver on earnings and justify high valuations – resulting in volatile market returns. So far, the market's negative reactions towards rising inflation, monetary policy tightening, unexciting earnings season, and other risk events have been either muted or short-lived. We expect the high level of complacency to change, given high valuations and poor corporate earnings, making it unlikely for the market to continue to re-rate.

Taiwan (Neutral)

The Taiwan economy remains on a steady course of recovery, benefiting from the increase in global demand and the upturn in the electronics cycle. The moderate recovery is expected to continue into next year.

US and China combined had accounted for close to 50% of Taiwan's exports. This should be able to offset the downside risks from Japan and Europe, assuming a sustained recovery in US and China. With exports making up 73% of GDP, exports and associated investment demand should still play a major role in driving the GDP growth going forward.

Domestic sentiment has also been improving as reflected in the consumer confidence index, which almost reached the highs of 2011. Meanwhile, private consumption growth was stable at 2.5%, in line with the long-term trend. We see risk for the central bank to hike rates in December along with higher inflation and better GDP figures.

The Taiwan Weighted Index (TWI) reached its post-GFC crisis high level in July, rising 10% YTD but was flat during the quarter. PE valuation has been hovering at the historical average of 14x. We believe it will be challenging for the TWI to break out of it historical trading band as its index components are mainly cyclical stocks which are more sensitive to earnings and the global recovery. We are maintaining Taiwan market at Neutral. Drivers for the market include:-

1) Sustained economic recovery and corporate earnings growth could beat expectations We believe there is upside risk for earnings growth into 2015, which currently stands at 8.7%. GDP growth is expected to accelerate from 3.5% this year to 3.7% next year.

2) Correlation with the US market. Among Asian countries, Taiwan has the highest correlation with the US Nasdaq due to its large Tech exposure. We believe that the US market is likely to sustain its gains in 2H when interest rates continue to stay low amid a modest recovery scenario. We expect TWI to perform in line with the US, more so than the rest of the Asian markets.

3) Tech vs Non-Tech. The Technology sector has substantially outperformed the TWI YTD. We believe the rotation into non-Tech sectors should offer better upside on a risk reward basis, as the global recovery becomes more broad-based, especially with China's economic outlook stabilising. While still having positive vibes, the incline in the TWI may not be as strong as 1H this year as the non-Tech sector is more fragmented and smaller than the Tech sector.

4) November elections. Municipal elections to be held towards end of the year are a prelude to the presidential elections in 2016. Local politics are thus seen as a source of uncertainty towards the stock market.

5) Cross straits relationship. The approaching elections may see a flare-up in cross-straits relationship. While we believe that the Chinese government is unlikely to exert any provocations, local politicians may use it as a campaigning tool, thus providing uncertainty to the market.

6) Expectations of strong TWD. There are expectations that NTD will continue to strengthen alongside improving exports, strengthening current account balance, and rate hike expectations. This should bode well for liquidity flows, and hence sentiment towards the market.

(For details, see DBS Economics-Markets-Strategy 4Q14: "TW: A fuller recovery", Tieying Ma, 11Sep)

Korea (Neutral)

There is clear evidence that the Korean government is trying to prop up consumer and business sentiment, which have weakened due to the sunken ferry incident and the lack of progress seen in the reform proposals put forward by President Park. We believe the measures taken will be effective in augmenting the early signs of a rebound in the consumption and services sector, and recovery in global demand. We expect GDP growth to revert to the normal rate of 3-4% in 2H14, mirroring the recovery path witnessed in 2H13.

Some of these measures include: - 1) Bank of Korea has cut the benchmark repo rate by 25bps from 2.50% to 2.25% in August, in a one-off move to stem the fall in confidence. 2) A comprehensive economic stimulus plan was announced recently in July. Under the plan, the size of a SME lending program will be expanded and the administrative controls on mortgage loans (LTV, DTI ratios) will be relaxed, which represents quantitative easing of monetary/credit policy.

The visit by Chinese leader Xi Jinping to Korea in July also paves the way for a free trade agreement between the two countries, to be concluded by end of this year. The two sides have agreed to introduce direct trading between the South Korean won and the Chinese yuan, which will help reduce the pressure from the US dollar, as well as cut foreign exchange costs and boost bilateral investments. Korea's trades with China have now accounted for 20% of Korea's total trade (both imports and exports), and is bigger than US, Japan and EU combined.

Opportunities have also risen for Korea's services sector, especially with the deepening ties with China in the tourism and financials sectors. China tourists now account for 35% of tourists to Korea, and this has been growing at a double digit rate. Followings Xi's visit, about US$7bn worth of MOUs have been signed with Korean corporations, largely in property, casinos, gaming, media entertainment, fashion and bio-medical, as well as manufacturing and mining sectors. The setting up of a new Rmb clearing centre in Seoul, and the increased in investment quotas given to Korea should bode well for business opportunities for Korea's financial institutions.

Korea has proposed a tax on cash reserves on corporate balance sheets, in a bid to encourage higher dividend payouts by corporates. Benefits are seen in higher household income, as well as for individual investors to hold shares for longer period. KOSPI has failed to sustain above the 2100 level. Domestic market participation is relatively high in Korea, and there is constant redemption of equity mutual funds once the KOSPI reaches the 2000 resistance level.

PE valuations remain on the cheap side on a regional basis but have traded slightly above the 10-year average. For a sustainable re-rating, we need to see continuous improvement in domestic sentiment and corporate governance. At this juncture, we believe that the global cyclical uplift to drive better corporate earnings growth ahead, is still missing. DBS is forecasting global growth to be around 2.9%, with US projected to grow at 2.5% in 2015.

In considering the government's push to lift domestic sentiment, we believe Korea could hold on to its gains. Our preference is for the domestic sectors that will benefit from the government's economic stimulus measures. We are maintaining Korea at Neutral, with a view that KOSPI could trade higher towards 2200 in 4Q14.

(For details, see DBS Economics-Markets-Strategy 4Q14: "KR: Focusing on growth", Tieying Ma, 11Sep)

India (Neutral)

The Indian market has gained almost 30% YTD, making it the best performing market in Asia. Sentiment remains high post-elections amid hopes of forthcoming reform measures. However, we have yet to see any substantial upgrades in earnings or growth. For now we prefer to stay Neutral on the market. Although market valuations are high, the positive sentiments are too strong to fight against, and large disappointments aren't likely either.

We believe there are few trends that we need to be convinced of before turning bullish on the market.

Firstly, the WPI inflation has remained stable within the 5.0-6.0% range in the past six months and is likely to hover around the lower end of the band for the remaining part of the year. However, CPI inflation has bounced to 8% from 7.5%, driven by higher food prices. While food supplies largely depends on the monsoon season, a test for the effectiveness of the new government is whether the government can follow through with plans to avoid volatility in food prices, thus resulting in lower inflation.

Secondly, as a result of the falling WPI, expectations are high that RBI is likely to cut rates. However, we believe it will be difficult for inflation to fall further in a bottoming economy and RBI is likely to stay vigilant against eventual Fed hikes. The interest rate cycle is not likely to peak anytime.

Thirdly, there need to be timeline for plans on the reform process. In his speech on Independence Day, the Indian Prime Minister touched upon more reforms that are in the pipeline. Apart from social sector initiatives, the government is expected to pursue financial inclusion and replace the Planning Commission with a more effective institution. Ex- RBI central governor Bimal Jalan has been appointed to head the Expenditure management commission agency, to weed through the government's expenditure components. Beyond the announcements, clear timelines on implementation will be the key focus.

Fourthly, initial focus has been on addressing the government deficit. The new government surprised by maintaining a challenging FY15 fiscal deficit target of -4.1% of GDP, banking on optimistic tax revenue projections. The recent fall in fuel price, stable Rupee, and reform announcements have given hopes that the budget will be met. After belt-tightening in the earlier quarter, government spending rose 8% (YoY) during Apr-Jun, while Apr-May tax revenue receipts had accounted for less than 3% of the annual estimate. A mid-year scaling back in expenditure will be inevitable if targets remain out of reach.

The government is also pursuing a target that India's current account deficit (CAD) will narrow sharply to 1.7% of GDP in FY14/15 (Apr-Mar), from 4.8% in the previous fiscal year. We expect the deficit to widen to 2.5% in FY15/16 from higher non-oil imports and a possible relaxation in the strict gold import curbs. While this shortfall is still below the 4% pain threshold, a deficit still needs to be funded by capital inflows to avert a balance of payments crisis.

Taking all these into account, we believe India is heading in the right path towards restoring and maintaining macroeconomic stability. However, with tight monetary and fiscal policies expected to prevail this year and early next year, the scope of a swift turnaround towards 7% GDP growth is unlikely to materialise.

Currently, the Indian market trades at about 16x forward earnings which is above the average and near +1SD of its mean. We believe the market is a little stretched in terms of valuations, and has priced in a lot of positives, especially with the reform promises from the new government. Until we see progress on this front, and upgrades in growth expectations, we believe any market re-rating could be stalled. The first sign to watch is the evidence of a new investment cycle picking up.

We maintain Neutral weighting for India.

(For details, see DBS Economics-Markets-Strategy 4Q14: "IN: Positive momentum", Radhika Rao, 11Sep)

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CN: Institutional reforms marching on

- **Institutional reforms are deepening on all fronts**
- **The interplay between macro policies and micro reform imperatives are getting ever closer**
- **Provincial governments are finally permitted to issue bonds when certain conditions are met**

The market is still very much concerned about China's growth trajectory for the remainder for the year in spite of the fact that Beijing has adopted a new macroeconomic management philosophy for quite a while. Slower economic growth does not always justify broad-based fiscal/monetary loosening anymore, or else the People's Bank of China (PBOC) should have cut interest rates long ago as inflation fell and growth momentum dissipated.

The ups and downs of PMI and fixed asset investment (FAI) figures were usually used to draw up a bearish scenarios subsequently used to justify the need for more economic stimulus later. The falling economic figures could, however, well be a result of China cutting back overinvestment and overcapacity. This perspective is often understated. Tracking high frequency economic data only describes short term growth momentum but tells us nothing really deep about the progress of economic reforms.

SOE reforms are high on the agenda

Institutional reforms at the microeconomic level are required for sustainable growth, and so the interplay between microeconomic reform and macroeconomic management are getting closer and closer.

A case in point is China's recent response to stagnating economic growth in the Northeastern provinces (Heilongjiang was the worst performer with just 4.8% growth in 1H14). The government has opted to revive the region via state-owned enterprise (SOE) reforms – among a host of other microeconomic reforms – rather than purely loosening monetary policy. Such an approach reaffirms the leadership's determination to push through reforms in spite of economic slowdown. In a sense, economic stagnation is perhaps the best catalyst to advance reforms.

SOE reform, however, is an extremely complicated subject because institutions operating under different market structures require different solutions. In the past two months, SOEs reform imperatives can be broadly categorized into two major branches: (1) a gradual deregulation of energy prices; and (2) a trial hybrid ownership structure under the privatization label. The first places indirect pressure on SOEs to operate more efficiently. Gradual price liberalization has already taken place in sectors like oil, telecoms, tap water, electricity, and private hospitals. The second aims to increase the incentive to perform and improve the management structure by bringing in private investors.

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Recently, the State-owned Assets and Supervision and Administration Commission (SASAC) has announced a series of initiatives for reforming SOEs. China National Building Material Company and Sinopharm Group Company Limited will take the lead to accept private capital. In addition to these two companies, Xinxing Cathay International Group and China Energy Conservation and Environmental Protection Group are also given autonomous rights to senior management hiring, performance reviews and compensation management. Moreover, State Development and Investment Corporation and China National Cereals, Oils, and Foodstuffs Corporation will be reorganized to form state capital investment companies to hold the ownership rights of SOEs. These measures are bold because hybrid ownership is introduced for trial, for the very first time in thirty years. SASAC controlled 113 SOEs at the end of 2013 with total assets exceeding 160% of China's GDP.

Invigorating China's SOEs is easier said than done. According to the prevailing school of thought, changing the formal ownership structure of SOEs by attracting private capital would address present inefficiencies. We reckon this is only part of the story.

Both ownership structure and market structure determine SOE reform success

Empirical evidence in the past two decades suggests SOEs performed better when they were given the right incentive structure and are subjected to a certain degree of market competition. Opening SOEs to more private capital is only one of many steps to strengthen the incentive structure and to introduce a culture that champions on efficiency and profitability. The presence of market competition is also an important factor in determining the success of SOE reform. Mixed ownership may not achieve much in the absence of market competition and presence of regulated prices. What this means is that reforms in ownership structure must go hand-in-hand with the relaxation of entry barriers. The latter is difficult to achieve because sectors that are currently closed to private investors usually have strategic significance. Some other behemoth SOEs are natural monopolies, so inviting more competition may not be the way to go to increase efficiency.

SOE reforms are moving ahead already

The reform progress of mega-sized SOEs in strategic sectors is likely to be much slower than smaller, non-strategic SOEs that are already operating in a monopolistically competitive market structure. There are about 155,000 SOEs that are owned by local and central governments. Most are badly managed and run without the right incentives, resulting in dwindling profitability and low return on assets/equity. Relatively speaking, this group is much easier to privatize than the giant SOEs. Indeed, reform in this sphere is gaining traction in recent months because of the following factors: (1) Low market entry barriers, (2) They are concentrated in non-strategic sectors, and (3) Local governments are keen to offload them. According to the Economist Newspaper, the southern province of Guangdong held a meeting to offer stakes for sale in 50 SOEs. Meanwhile, the Shanghai government sold a 12% stake in Jin Jiang Hotel group to a local private equity firm and included stock option incentives for management executives. Specialists in China private equity should know the mechanics and the deal flows much better than anyone.

Another facet of institutional reform - fiscal reform

The standing committee of the National People's Congress amended the country's Budget Law to permit more local governments to raise funds for projects of public interest through bond issuance under approved quotas by the State Council. Proceeds of bond sales are forbidden to fund recurrent expenditure. They also cannot be used as credit guarantees for individuals and entities.

The Ministry of Finance (MOF) permitted Shanghai, Shenzhen, Guangdong, and Zhejiang to sell municipal bonds in 2011 as part of a trial program, followed by Shandong and Jiangsu in 2013. The trial was then expanded to Jiangxi, Ningxia region, Beijing, and Qingdao this year. MOF also began demanding disclosure of financial information and credit ratings in the application process. The trial runs were largely successful. The experiences strengthen the confidence of the central government to proceed further.

Local governments are now permitted to issue bonds

This is a major breakthrough. The Budget Law enacted in 1994 banned local governments from selling bonds, thereby forcing them raise funds through the establishment of financing vehicles. The raised funds are funneled into the property market, fueling asset inflation. The subsequent administrative measures launched against the rapid ascent of property prices a few years ago thus raised the alarm of gigantic debt burdens on local governments. Local government debts reached CNY 17.9trn (USD 2.9trn) in June 2013, of which almost 40% came from off-budget funding through financing vehicles. The latest reform should change the borrowing behavior of the local governments for good and force them to rationalize infrastructure spending in the future.

The next step is to overhaul the current tax sharing system because local governments are responsible for almost 80% of spending, but receive only 40% of tax revenue under the current tax-sharing system. As such, the Politburo of the Communist Party approved a general plan on June 30 to change the existing fiscal and tax system as part of the broad reform plan mapped out at the party's Third Plenum in November. The goal is to finish building a modern budget system by 2020, and simultaneously aimed to complete prioritized tasks by 2016.

Conclusion

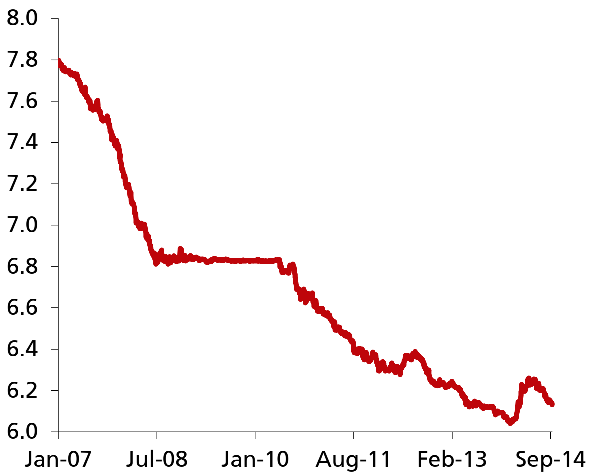
Microeconomic responses to macroeconomic slowdown will be a recurrent phenomenon going forward. It is clear that Beijing is firing the engine of reforms on all fronts ever since the Third Plenary in November 2013. The restraints on macro stimulus are wise, and the adoption of a targeted easing strategy avoids over-tightening, safeguarding GDP growth around 7.5%. The real deal ahead will be the actual execution of SOE reforms and restructuring of the fiscal/tax sharing system. Beijing has already chosen to perform major surgical work in numerous areas. What is certain that the leadership is determined to bring the country forward however the difficult the challenges are.

China Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real GDP growth	7.7	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
GDP by expenditure: current price									
Private consumption	12.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0
Government consumption	14.5	13.5	13.5	13.5	13.5	13.5	13.5	13.5	13.5
Urban FAI growth (ytd)	19.6	17.5	18.0	17.3	17.5	17.5	18.0	18.0	18.0
Retail sales - consumer goods	13.0	12.5	13.5	12.3	12.5	12.5	13.5	13.5	13.5
External									
Exports (USD bn)	2,209	2,334	2,568	571	618	654	540	628	680
- % YoY	8	6	10	5	10	10	10	10	10
Imports (USD bn)	1,950	2,055	2,261	485	546	550	517	528	595
- % YoY	7	5	10	2	9	9	9	9	9
Trade balance (USD bn)	259	279	307	86	72	104	23	100	84
Current account balance (USD bn	183	231	254	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	1.9	2.3	2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	3,612	3,966	4,350	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (USD bn, YTD)	118	123	130	63	93	123	33	66	98
Inflation & money									
CPI inflation	2.6	2.7	3.2	2.2	2.9	3.2	3.2	3.2	3.2
RPI inflation	1.4	1.3	1.6	1.1	1.4	1.6	1.6	1.6	1.6
M1 growth	9.3	9.5	9.5	8.9	8.8	8.8	8.5	8.5	8.5
M2 growth	14.3	14.5	14.0	14.7	14.5	14.5	14.0	14.0	14.0
Other									
Nominal GDP (USD bn)	9,396	10,161	11,337	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.1	-2.1	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

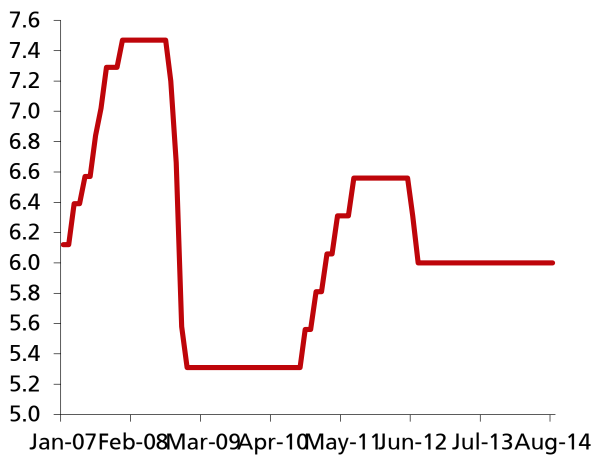
CN - nominal exchange rate

CNY per USD



CN – policy rate

%, 1-yr lending rate



HK: Humps and bumps

- China's slowdown has brought down Hong Kong's retail sales
- Unemployment concerns should not be overstated. The unemployment rate has decoupled from GDP growth in recent years and labor shortages are still prevalent
- In 2H, private consumption is expected to pick up on positive wealth effects. Private investment will remain the laggard as business transactions with mainland China shrink
- Mild reflation is expected on the back of rising rentals

China slowdown hits Hong Kong

Business conditions in Hong Kong have deteriorated as China's economy slowed. Indeed, PMIs dropped for five consecutive months to Jun14 as private sector activity cooled. Despite the slight improvement in Jul14, caution is still warranted because China is still in the midst of complicated structural reforms. China's slowdown also spilled over into Hong Kong's private investment (which fell by 5.6% YoY in 2Q) where machinery and equipment acquisition fell notably.

China's slowdown has pummeled Hong Kong's retail sales. Recent data show that the retail sector is suffering a more prolonged and heavier blow than expected (Chart 1). While tourist arrivals have generally held up, per-head tourist spending by mainland Chinese has decreased markedly (Chart 2) due to the ongoing anti-corruption campaign in China. Meanwhile, the Westpac MNI China Consumer Sentiment Indicator suggests that consumer sentiment further weakened to an all-time low in August.

Mediocre GDP growth outlook

We expect economic growth to fall below trend in the remainder of the year. The cyclical slowdown is primarily caused by lower growth in China and its subsequent impact on Hong Kong's private consumption and investment. In 2H14, private consumption is expected to pick up as better sentiment in the local property and equity markets bring on positive wealth effects. Private investment will remain the laggard GDP component as business transactions with mainland China shrink.

On the trade front, nominal merchandise exports grew 4.8% in 2Q14 versus 0.7% in 1Q14 as the US - a key export market - shook off weather woes. However, the export outlook is still murky. While US data has improved lately, China's domestic demand has been moderating on the back of structural reforms. Economic growth in the mainland will likely be capped in the medium-term without large-scale stimulus. EU and Japan economic data have surprised on the downside as well. On balance, global growth is still weak. In July, IMF has slashed its 2014 global growth forecast to 3.4% from 3.7%, which was lower than the 3.8% growth rate in 2H13. As such, Hong Kong's goods exports are unlikely to sharply rebound in 2H14. Services exports will likely fare worse as sluggish global growth continues to hamper inbound tourism.

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Chart 1: Tourist spending has dragged down total retail sales

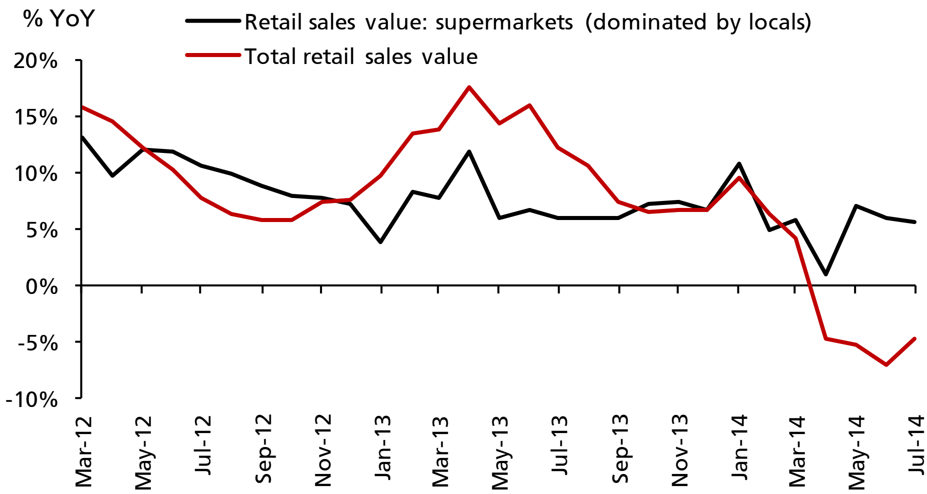
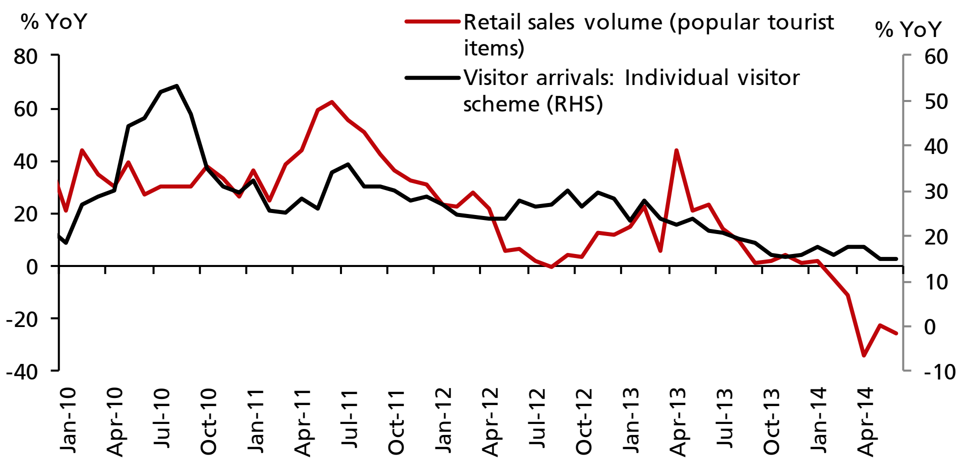


Chart 2: Retail sales volume no longer tracks Chinese tourist arrivals closely



Cautiously positive employment outlook

The unemployment rate has decoupled from GDP growth in recent years

The government's latest Quarterly Business Tendency Survey indicated that enterprises in the consumption-related sectors turned more cautious, which is consistent with lackluster retail sales performance. However, we are still cautiously positive on the employment outlook. Firstly, locals' spending growth should pick up soon on positive wealth effects; equity and property markets were looking up in 3Q14. This should somewhat offset the impact from dropping tourist spending and lend support to retail employment. Secondly, the government's survey indicated that the outlook for the financing and insurance, information and communications sectors remained sanguine. Finally, many sectors face chronic labor shortages despite the state of the economy. This is due to demographic factors, rather than cyclical factors. Generally speaking, the correlation between the unemployment rate and economic growth has decreased in recent years (see: The decoupling of growth and unemployment - 25 February 2014). Hence, absent severe economic shocks, we expect Hong Kong's unemployment rate to remain between 3.2%-3.5%.

Residential property market revival

Pend-up demand in the residential property market is being unleashed

The residential property market made a strong comeback recently. Prices increased 4.1% to-date in 3Q14, and are now 2.1% higher than the previous peak set in Mar13. Rentals also reached a historical high of $23.8 per square feet. This probably reflected pent-up demand from last year, when homebuyers were uncertain about the outlook for interest rates and adopted a "wait-and-see" approach. Actual Fed tapering has removed a lot of uncertainty and pent up demand is now being unleashed. The recent demand increase can also be attributed to the relaxation of Double Stamp Duty (DSD) rules in May which gave second-home buyers more time to sell their existing property without needing to pay stamp duty.

The question then, is whether prices have more room to go up. In the medium run (before 2016), prices have room to increase further. End-user demand is huge and supply is still relatively constrained. Besides, the government is unlikely to introduce new administrative measures in light of imminent US rate hikes, which act as a natural deterrent against short-term speculation. Finally, the market has already digested the possibility of near-term US rate hikes. Any "news" about the US further scaling back asset purchases or bringing rate hikes forward is old news and should have little marginal market impact.

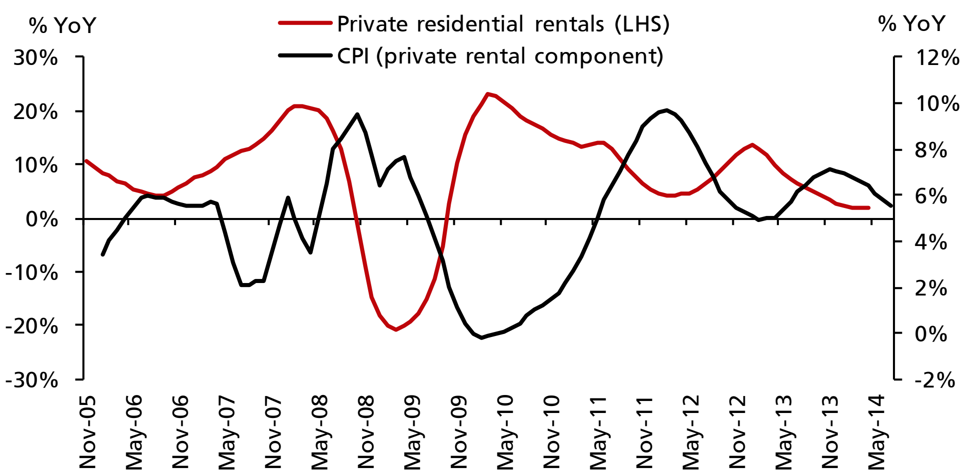
The office property market is, however, a lot bleaker. The number of office sales transactions in 1H14 was 23.7% lower than in 2H13, the lowest since 2H95. Transaction values fell 36.3% over the same period. While this is partly due to the DSD, we reckon the general slowdown of business volumes constrained demand for office space and also caused prices to fall.

Mild reflation

As rentals resume its climb, reflation is expected towards the end of the year

Hong Kong inflation softened in recent months on the back of disinflation in the housing and miscellaneous services components. Actual housing rentals are reflected in the CPI with a long time lag of six to nine months (Chart 3), meaning that recent disinflationary data largely reflected the property price correction in 2H13 which caused rentals growth to decelerate. The housing component of the CPI is expected to stop disinflating towards the end of this year to reflect the steadying of rental growth that began in 2Q14. In addition, the CPI will likely spike in Sep14 on base effects caused by distortions of government one-off relief measures such as rental waivers for public housing. As such, we project mild reflation in 2H14 from 3.9% in 1H14.

Chart 3: Housing rentals are reflected in the CPI with a lag



How strong is the economy?

Depending on who you are, the answer would be very different. The economy cannot be too bad in the eyes of the average Hong Konger – the unemployment rate is at historical lows, inflation is within reasonable ranges and asset prices are rising. Entrepreneurs, on the other hand, are finding it much harder to make money, especially from Chinese clients who tighten purse strings. We expect no significant economic events in Hong Kong in the latter half of this year. For better or worse, local politics will steal the limelight in the months ahead.

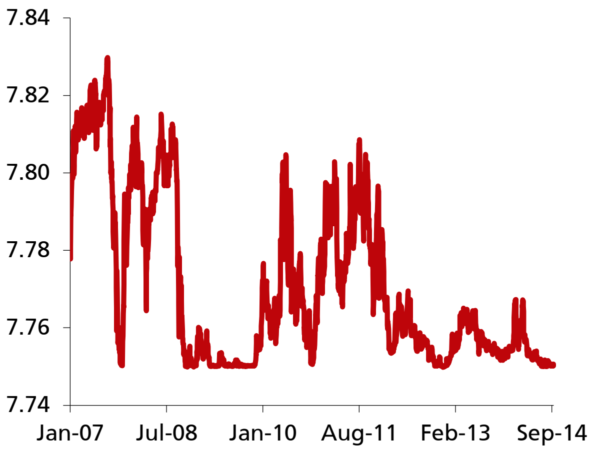
Hong Kong Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth (12P)	2.9	2.6	3.0	1.8	2.9	2.9	3.1	3.1	2.7
Private consumption	4.3	1.6	3.0	1.2	1.5	2.0	3.9	3.9	2.1
Government consumption	2.3	2.6	2.5	2.7	2.5	2.5	2.5	2.5	2.5
Investment (GDFCF)	3.3	1.0	3.0	-5.6	3.0	3.5	3.0	3.0	3.0
Exports of goods and services	6.4	4.0	6.6	1.4	4.7	8.3	5.7	7.9	6.9
Imports of goods and services	6.8	4.0	6.6	1.5	4.7	8.3	5.7	7.9	6.9
Net exports (HKD bn)	3	3	3	-24	21	6	-1	-26	23
External (nominal)									
Merch exports (USD bn)	459	480	511	116	127	131	112	123	136
- % YoY	4	5	7	5	7	7	7	7	7
Merch imports (USD bn)	524	549	585	134	144	150	129	142	153
- % YoY	4	5	7	5	7	7	7	7	7
Trade balance^ (USD bn)	-65	-69	-73	-18	-16	-19	-17	-19	-17
Current acct balance (USD bn)	2.9	-3.9	-2.1	-	-	-	-	-	-
% of GDP	1.0	-1.3	-0.7	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	311	324	337	-	-	-	-	-	-
Inflation									
CPI inflation	4.3	4.4	4.5	3.6	5.0	4.6	4.3	5.1	4.6
Other									
Nominal GDP (USD bn)	278	294	310	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	3.2	3.2	3.2	3.2	3.2	3.2	3.3	3.3	3.3

* % change, year-on-year, unless otherwise specified
^ Balance on goods

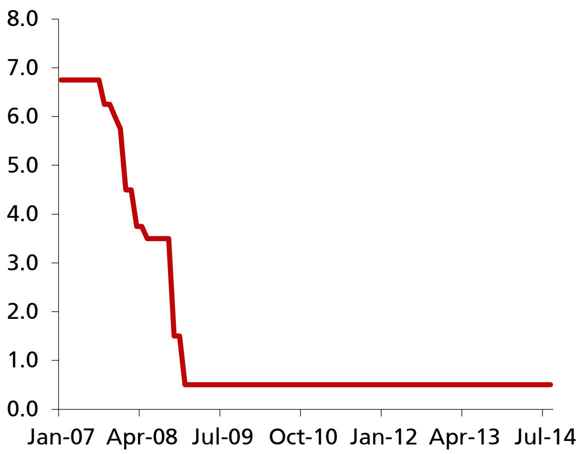
HK - nominal exchange rate

HKD per USD



HK – policy rate

%, base rate



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TW: A fuller recovery

- **A fuller recovery is underway. GDP growth is close to the long-term potential and jobless rate is close to the pre-GFC lows**
- **The central bank would like to ensure that recovery is full and sustainable before starting to hike rates**
- **Exports, especially electronics exports, are key to the short-term outlook**
- **The long-term prospects still depend on progress in free trade policies**

GDP forecasts upgraded

Recovery is gathering pace in Taiwan. GDP growth quickened to 3.7% (YoY) in 2Q from 3.2% in 1Q, the fastest rate over six quarters. On the quarter-on-quarter (saar) basis, growth was also impressive in 2Q, at 3.9% (Chart 1).

The Directorate General of Budget, Accounting and Statistics (DGBAS) upgraded its economic assessment in August, raising the 2014 GDP estimate to 3.41% from 2.98%. The DGBAS's view is that the economy will maintain a moderate recovery ahead and the annual GDP growth rate will rise further to 3.51% in 2015. Our forecasts stand close at 3.5% for 2014 and 3.7% for 2015. Compared to one quarter ago, we have lifted the 2014 growth estimate by 0.2ppt.

In the financial markets, the improvement of growth outlook has boosted investors' interest in risky assets. The TAIEX gained nearly 10% in the first eight months of this year, despite the correction in Jul-Aug triggered by the accident of Kaohsiung gas explosions. On the other hand, the TGB yields have risen across most segments since the mid of this year. The interest rate swap market has priced in a 12.5bps hike in the benchmark rate on the 12-month horizon.

Signs of a fuller recovery

Importantly, signs have emerged that a full-fledged economic recovery is on the way. The GDP growth of 3.7% in 2Q has approached the long-term growth average

Chart 1: GDP growth picking up

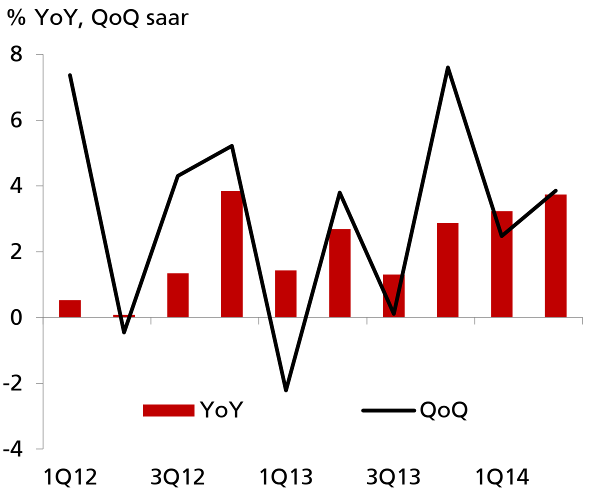
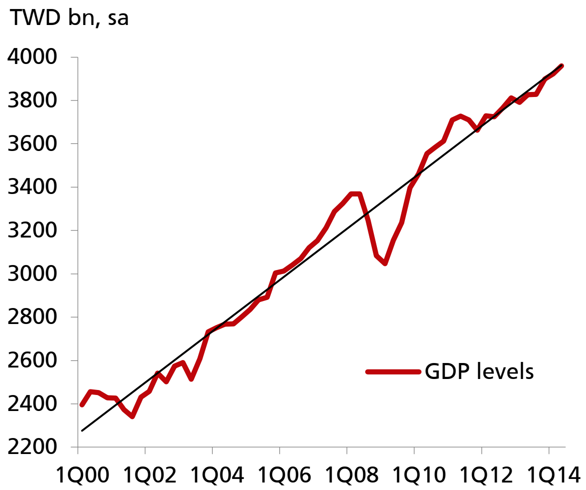


Chart 2: Output levels back to trend



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of 3.8% (2000-13). The negative output gap in the economy has almost evaporated (Chart 2). The unemployment rate, on the other hand, fell to 4.0% in July, fairly close to the pre-global financial crisis low of 3.9% (Chart 3). The slack in the labor market has been mostly absorbed.

Fiscal situation has also improved significantly, thanks to the recovery in tax revenues and the scaling-back of government expenditures. The central government's budget deficit narrowed to 0.9% of GDP in 2013, compared to the peak of 3.5% in 2009. Excluding debt repayments, the shortfall in the primary fiscal balance has already been eliminated. Accordingly, total public debt to GDP ratio fell for the first time over six years, to 48.5% in 2013 (Chart 4).

GDP, labor, fiscal data all suggest a fuller recovery

Gauging the timing of rate hikes

Taiwan's central bank held rates steady so far this year but tightened credit controls at its latest meeting in June. The loan-to-value ratios imposed on banks' lending to non-first home buyers and buyers of high-price properties were lowered further, aimed at cooling the property market. Targeted tightening was preferred over rate hikes to deal with property prices inflation, as economic recovery remained incomplete and consumer prices inflation remained relatively benign.

Going forward, a full-fledged economic recovery will give the central bank confidence to further remove monetary accommodation and begin to raise interest rates. An important precondition, in our view, is that GDP growth can stay at the potential levels of 3.5-4.0% for two consecutive quarters. This condition will be ripe by the end of this year, based on the official and our GDP growth forecasts.

What will really force the hand of the central bank will be a broad increase in price pressures. CPI inflation has risen to 1.9% (YoY) in Jul-Aug, not only surpassing its long-term average of 1.1% but also the one year time deposit rate of 1.36% (Chart 5). Stripping out the volatile food and energy prices, core inflation has also risen to an average of 1.6% in the last two months. The DGBAS forecasts that CPI growth will average 1.64% in 2014 and remain relatively high at 1.46% in 2015. From the perspective of managing inflation and inflation expectations, the central bank should be under significant pressures to hike rates over the next 12 months.

All in, we expect the central bank to raise the benchmark discount rate from 1Q 2015. Compared to the last quarterly report, our forecast of the first rate hike has been pushed back by one quarter. This mainly considers the near-term appreciation pressures on the TWD NEER, as a result of rising expectations about ECB/BOJ easing.

Chart 3: Jobless rate close to the pre-GFC lows

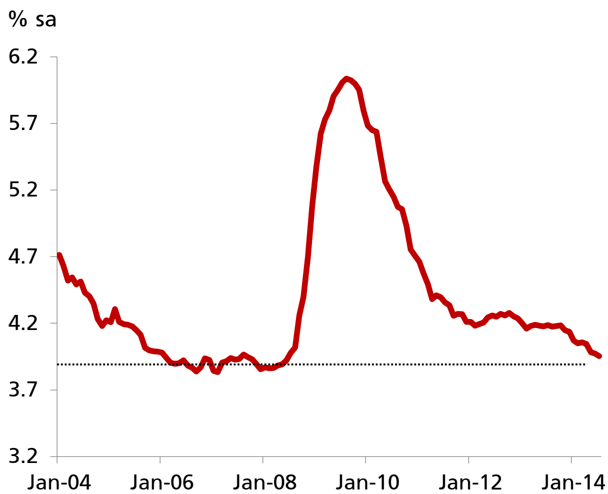
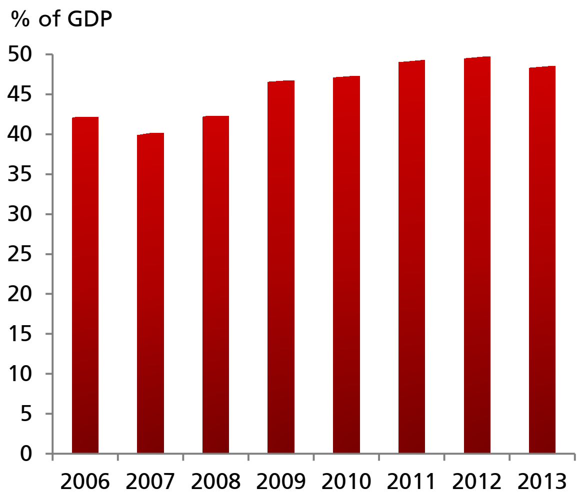


Chart 4: Public debt ratio stabilizing



Wild cards for the short term

A key assumption incorporated in our short-term economic forecasts is a rise in exports growth. The global electronics cycle is turning up, thanks to the release of new smartphone and other mobile products. Taiwanese contract manufacturers including Hon Hai and Pegatron, which supply components and assemble products for Apple, have received orders and started mass production of iPhone 6 since the beginning of 3Q. Judging from the 2012-13 experiences, the growth of Taiwan's electronics exports will likely accelerate in the second half of this year, before reaching a peak in the year end (Chart 6).

Electronics sales still depend on global demand

Ultimately, the performance of electronics exports will depend on the demand conditions in global markets. Uncertainties still linger. The US economy is maintaining a moderate recovery but Europe and Japan are re-deteriorating. Growth in China is also slowing. And it is unclear whether the Chinese authorities will be keen to boost the country's short-term growth momentum via new stimulus measures.

On the domestic front, the major risks in the short term are the possibility of a mini confidence crisis. Consumer confidence index has fallen notably in August, in the aftermath of the Kaohsiung gas explosion accident. A further drop is possible, given the outbreak of food safety scandals in September. The government's capabilities of crisis management will be tested and political noises can't be ruled out, at a sensitive time when a large-scale local election looms.

…and the long term

In the long term, economic reforms will be crucial for Taiwan to sustain growth momentum and maintain competitiveness. Promoting free trade has been the core strategy adopted by the current administration since President Ma Ying-jeou took office in 2008. Several landmark deals have been signed with China, Singapore and New Zealand to encourage the free flows of goods, services and capital.

Reform momentum stalled this year, however. Due to the increases in political pressures and public controversy, the services trade agreement signed with China failed to be ratified in Taiwan's parliament as originally scheduled. A breakthrough appears unlikely for the remainder of this year, considering that the government's agenda will be dominated by political issues ahead of the local election in November.

Competitiveness is a relative concept. Elsewhere in the region, the pace of trade cooperation and economic integration has continued to accelerate. South Korea, for instance, recently reached consensus with China to conclude the bilateral free trade negotiations by the end of this year. If without a renewed push for major reforms, the challenges facing Taiwan's long-term outlook would increase.

Chart 5: Real deposit rates turning negative

% pa, % YoY

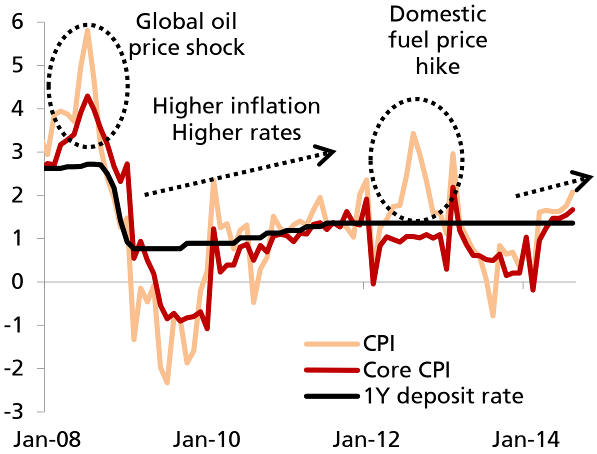
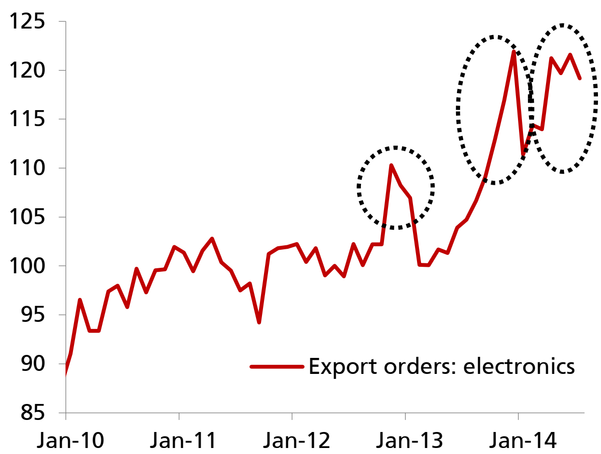


Chart 6: Electronics cycle peaking?

2011=100, sa, volume



Taiwan Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth	2.1	3.5	3.7	3.7	3.8	3.1	3.4	3.4	4.1
Private consumption	2.0	2.2	2.0	2.5	2.5	1.4	2.0	1.9	2.0
Government consumption	-0.3	1.0	0.8	1.0	1.6	1.6	0.6	0.8	0.8
Gross fixed capital formation	4.7	2.5	2.8	3.7	4.5	1.5	4.2	1.5	2.8
Net exports (TWDbn, 06P)	3022	3258	3559	788	837	940	756	863	915
Exports (% YoY)	3.8	4.8	5.5	4.4	6.1	4.7	5.4	5.5	5.5
Imports (% YoY)	3.9	3.7	4.1	3.8	5.5	3.5	4.2	4.1	4.1
External (nominal)									
Merch exports (USDbn)	305	320	346	80	82	84	81	88	88
- % chg	1.4	4.7	8.1	2.9	8.0	6.8	10.0	10.0	6.8
Merch imports (USDbn)	270	282	307	70	72	73	72	78	79
- % chg	-0.2	4.5	8.9	3.8	9.4	6.4	7.4	10.8	9.2
Trade balance (USD bn)	36	38	39	10	10	12	9	10	9
Current account balance (USD bn)	57	60	61	-	-	-	-	-	-
% of GDP	11.7	11.9	11.4	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	417	429	443	-	-	-	-	-	-
Inflation									
CPI inflation	0.8	1.4	1.3	1.6	1.7	1.6	1.4	1.1	1.3
Other									
Nominal GDP (USDbn)	491	509	538	-	-	-	-	-	-
Unemployment rate (eop %, sa)	4.1	4.0	3.9	4.0	4.0	4.0	4.0	4.0	3.9
Fiscal balance (% of GDP)	-0.9	-0.7	-0.5	-	-	-	-	-	-

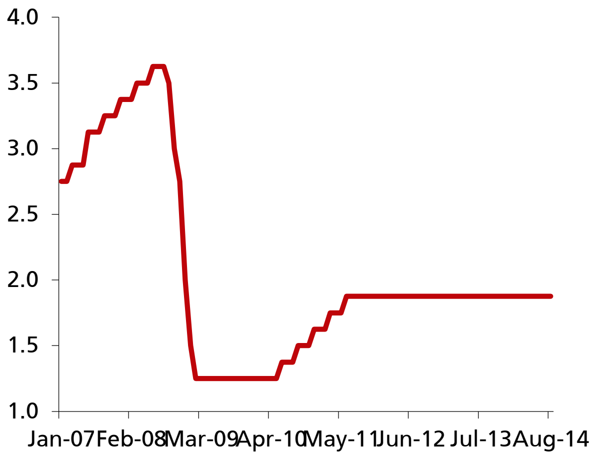
* % growth, year-on-year, unless otherwise specified

TW - nominal exchange rate

TWD per USD

TW – policy rate

%, rediscount rate



KR: Focusing on growth

- **Short-term growth outlook is improving, thanks to the easing of monetary, credit and fiscal policies**
- **GDP growth is expected to return to the 3-4% levels from 3Q onwards**
- **Household debt is a risk for the medium term. The BOK will closely monitor the debt trends and its next move would be a rate hike**
- **The government has the capabilities and willingness to push forward the long-term economic reforms**

A comprehensive stimulus package

The negative impact on the economy from the ferry disaster earlier this year was bigger than expected. Consumer and business sentiment has weakened markedly after the disaster, triggering a self-fulfilling slowdown in real economic activities. As a result of the deterioration in domestic demand especially consumption, GDP growth fell notably to 2.0% (QoQ, saar) in 2Q from 3.8% in 1Q (Chart 1).

In light of the unanticipated weakness in 2Q, the authorities downgraded their full-year economic assessment. The Bank of Korea (BOK) revised down GDP growth forecasts in July, trimming the 2014 and 2015 estimates respectively to 3.8% (from 4.0%) and 4.0% (from 4.2%).

In an attempt to revive sentiment and reinvigorate economic growth, a comprehensive set of stimulus policies has been adopted. The finance ministry unveiled a stimulus package in July, pledging to increase public spending by KRW 11.7trn and relax the rules imposed on financial institutions' home mortgage loans. The BOK also followed suit, cutting the base rate by 25bps in August.

Short-term growth outlook improves

The combination of credit easing, rate reduction and increased public spending is expected to provide adequate impetus to economic growth. We have been

Chart 1: GDP growth slowed in 2Q

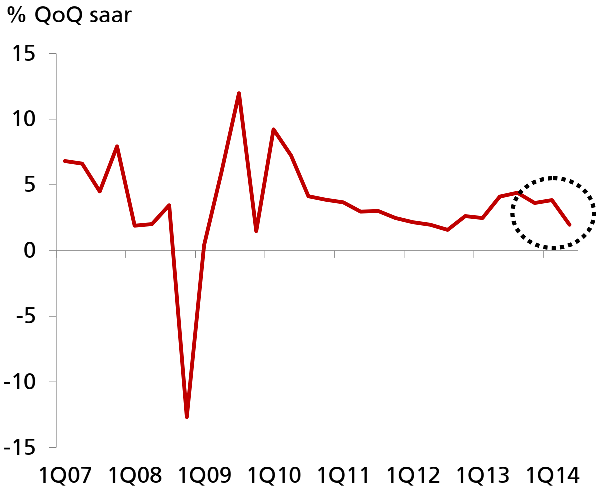
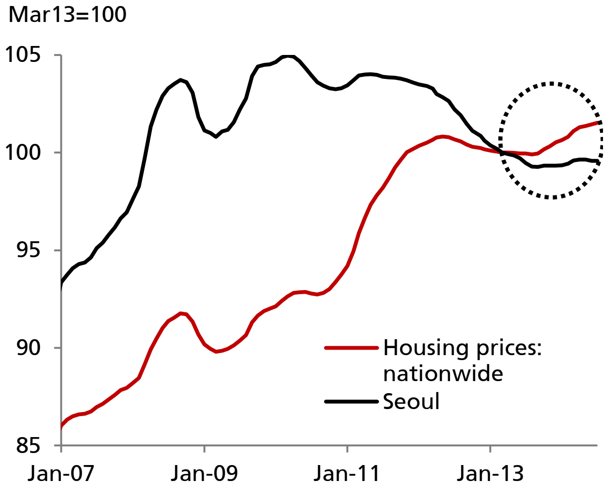


Chart 2: The property market bottoming out



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expecting a self-driven growth recovery in 2H as the impact on sentiment from the ferry disaster dissipates. The probability of a 2H recovery is now augmented, thanks to the stimulus measures proactively adopted by the authorities.

The real estate sector in particular, should receive a boost from the latest policy changes. The residential property market in Korea has already bottomed out and entered into an early phase of recovery since the end of 2013, thanks to the earlier round of policy adjustments that centered on tax cuts (Chart 2). A stronger recovery is expected for the remainder of this year and next year, taking into account the recent easing of mortgage lending rules and the reduction in interest costs.

The real estate sector will receive a boost

Based on the new rules, the loan-to-value ratio imposed on banks' mortgage lending will be lifted to 70%, a notable change compared to 50%-70% previously. The debt-to-income ratio will also be raised significantly to 60% from 50%-60%. In the meantime, the benchmark interest rate set by the BOK has been cut to 2.25%, close to the post-global financial crisis lows of 2.00% (Chart 3). The upcoming release of pent-up housing demand as a result of policy relaxation is expected to be strong, based on our assessment of the demographic and family trends, home ownership and valuation factors (see "Korea: housing recovery", 21 Aug).

The stimulus effects aside, intrinsic growth momentum in the economy should also be in place. Consumer spending is expected to recover naturally as the shocking impact of the ferry incident dissipates over time. Meanwhile, exports growth is expected to gather pace for the rest of this year, on the back of an improvement in global demand and a seasonal upturn in the electronics cycle. In all, we are confident that GDP growth will revert to the normal levels of 3.5-4.0% (QoQ, saar) in 2H. The full-year GDP growth is projected to be 3.5% in 2014 and 3.8% in 2015.

Positive data, shifts in expectations

The latest data could validate the view of 2H recovery. Consumption and services indicators have started to improve since the end of 2Q (Chart 4). This was followed by the positive turnaround in exports and manufacturing data in the beginning of 3Q (Chart 5).

In the financial markets, the 2Q growth slowdown and the expectations of monetary easing exerted downward pressures on bond yields and the KRW in July. Rate-cut expectations have subsided after the 25bps cut was actually delivered by the BOK in August. The negative spread between the 1-year IRS rate and the benchmark CD

Chart 3: Interest rates close to record lows

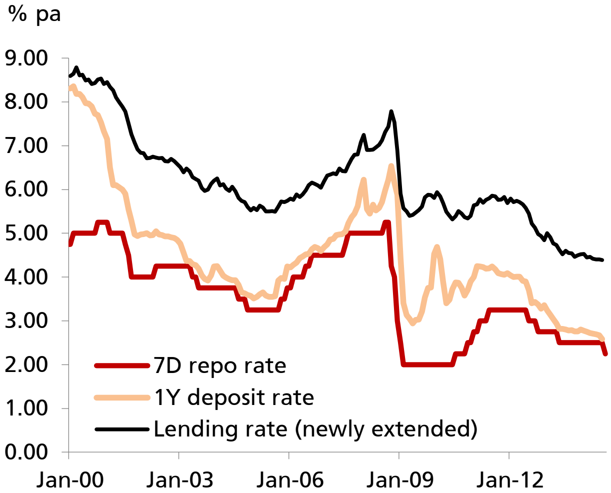
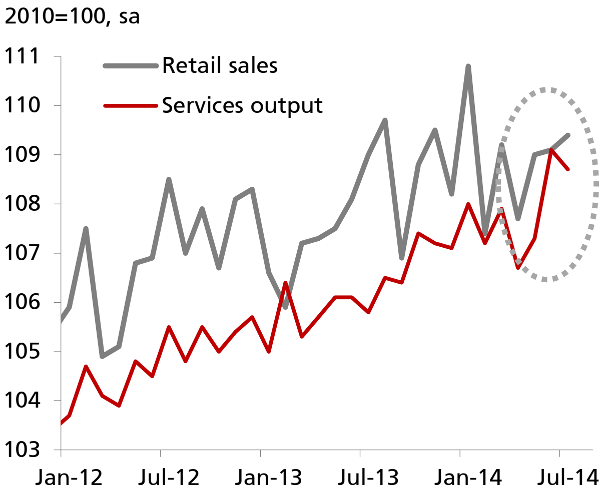


Chart 4: Consumption growth picking up



rate has disappeared since mid-August. The KTB yields have stopped falling and stabilized at low levels. On the other hand, interest in risky assets has returned as economic data improved and the expectations about growth recovery started to build. Foreigners' net investment in Korea equity market increased KRW 3.6trn in July and KRW 2.5trn in August, well above the 1H average of KRW 0.5trn.

Risks in the medium term

The loosening of monetary and credit policies bodes well for a recovery in the property market and the overall economy in the short term. The inherent risks are that the household debt ratio, which already stands high at 85% of GDP, could deteriorate further (Chart 6). Unsustainable debt and eventual default will put stress on banks' capital and liquidity, posing a threat to financial stability and long-term economic growth. The central bank will need to monitor closely the household debt growth trends, and adjust policies in a flexible and timely manner when risks increase. In our interest rate forecast, we expect the BOK to stay on hold during the rest of this year and begin to raise rates in 2Q 2015.

Long-term policies in the right direction

In order to minimize the debt default risks, boosting households' incomes and strengthening their debt repayment capabilities will be critical. As a step in the right direction, the government has pledged to improve the unbalanced income distributions between the corporate and household sectors when announcing its latest stimulus plan in July. Tax initiatives will be adopted to urge companies to reduce the accumulation of cash reserves, raise the wages for employees and/or distribute more dividends to investors.

Moreover, the government is pushing for reforms to directly boost the economy's long-term growth potential and lift national incomes. Promoting the development of the services industry and expanding the free trade networks are important components of the government's 3-year reform plan. In line with these objectives, Korea has reached consensus with China recently to conclude the bilateral free trade negotiations by the end of this year. The central banks of the two countries have also signed an agreement in July to establish the mechanism of KRW-CNY direct trading, which lays the foundation for Seoul to build an offshore yuan market and upgrade its financial services industry.

Note that the ruling Saenuri party has consolidated its control over the local government and the parliament, following the provincial/municipal election in June and the parliament by-election in July. There will be no major elections scheduled for the rest of this year and next year. A more stable political environment will allow the government to focus on the execution of economic policies.

Chart 5: Manufacturing data improving

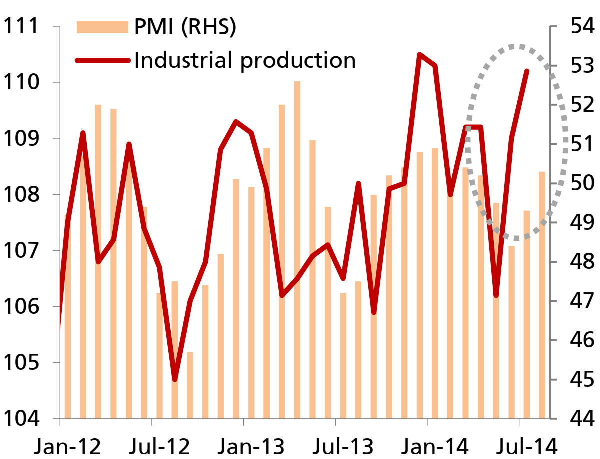
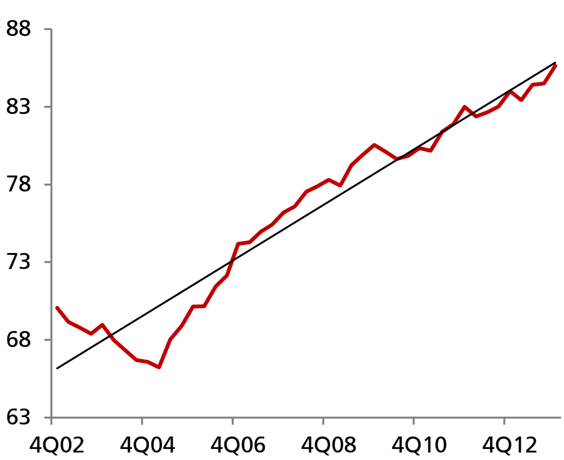


Chart 6: Household debt ratio deteriorating



Korea Economic Indicators

	2013	2014f	2015f	2Q14f	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP (2010P)	3.0	3.5	3.8	3.5	3.5	3.4	3.5	3.9	3.8
Private consumption	2.0	1.6	2.6	1.5	1.3	1.3	1.8	2.9	2.7
Government consumption	2.7	2.3	3.9	1.7	2.2	2.3	3.4	4.0	4.1
Gross fixed capital formation	4.2	3.9	2.4	3.4	2.8	4.0	1.5	2.5	2.6
Net exports (KRW trn)	93	112	133	30	30	36	20	34	36
Exports	4.3	5.6	7.8	3.7	6.8	7.2	7.7	7.7	7.8
Imports	1.6	3.6	6.0	2.7	4.8	3.3	5.7	6.2	6.1
External (nominal)									
Merch exports (USD bn)	560	579	629	146	142	153	145	162	157
- % YoY	2.1	3.4	8.7	3.2	4.1	4.4	5.3	10.9	10.4
Merch imports (USD bn)	516	536	587	131	133	140	141	147	147
- % YoY	-0.8	3.9	9.6	3.2	5.4	5.0	6.8	12.4	10.6
Trade balance (USD bn)	44	43	42	15	10	13	3	15	10
Current account balance (USD bn)	80	80	75	-	-	-	-	-	-
% of GDP	6.1	5.5	4.8	-	-	-	-	-	-
Foreign reserves (USD bn, eop)	346	378	412	-	-	-	-	-	-
Inflation									
CPI inflation	1.3	1.5	2.5	1.6	1.6	1.8	2.2	2.4	2.7
Other									
Nominal GDP (USD bn)	1,306	1,463	1,569	-	-	-	-	-	-
Unemployment rate (eop %, sa)	3.1	3.3	3.1	3.6	3.4	3.3	3.3	3.2	3.2
Fiscal balance (% of GDP)	-1.5	-1.4	-1.4	-	-	-	-	-	-

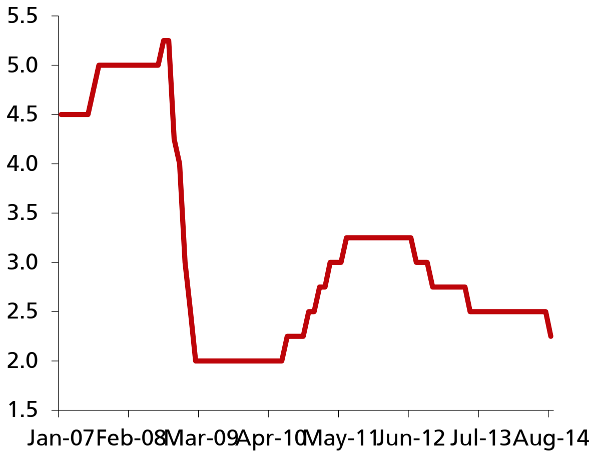
* % change, year-on-year, unless otherwise specified

KR - nominal exchange rate

KWR per USD

KR – policy rate

%, target rate



IN: Positive momentum

- **GDP growth is expected to hasten to 6.0-6.5% in FY15 and FY16 on an upturn in production and investment spending**
- **Recovery in aggregate demand and external risks will keep the RBI cautious. Repo rate to remain unchanged at 8% for rest of the year**
- **Current account deficit to widen to 2.2% of GDP on imports rebound. Fiscal deficit target to be met by mid-course corrective steps**
- **Rating agencies give the benefit of doubt to the government**

The Indian economy continues to ride on the positive momentum created by the pro-growth government, a credible central bank and macro stability. Apart from improving consumer and business sentiments, the strong rally in the equity markets has been taken as an indication of the improving confidence in the economy's prospects. Since Jan14, FII equity and debt inflows have totaled USD 13.6bn (vs. 20bn in 2013) and USD 18bn (vs. -USD 8.5bn in 2013) respectively.

Recovery underway

After stagnating at 4.5-4.8% for eight quarters, GDP growth accelerated to 5.7% YoY in the Jun quarter (1Q FY15). This was above consensus and fastest in over two years, reaffirming expectations that the economy has bottomed out and an upturn is likely in the quarters ahead.

In the Jun quarter, the marginal dip in farm output was offset by the strong recovery in the industrial (5.1% vs. 1.5% in the Mar quarter) and services (7.4% vs. 6.5%) sectors. This took non-agricultural growth to 5.2% YoY from 3.7% in the Mar quarter (Chart 1).

On the demand side, improvement was mainly led by a revival in domestic demand, primarily government spending and capital formation. Government spending jumped 8.8% in Apr-Jun (vs. -0.4% in the Mar quarter) accompanied by a 7.0% jump in gross capital formation (vs. -0.9%). Both the previous government and the new administration have accelerated project clearances since Jun13.

Chart 1: GDP ex-agri rebounds in Jun quarter

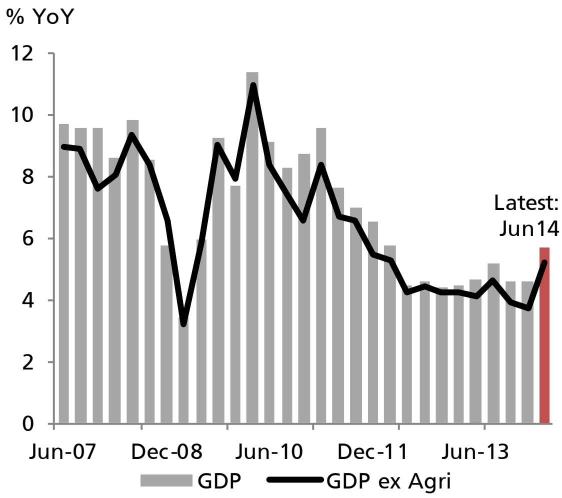
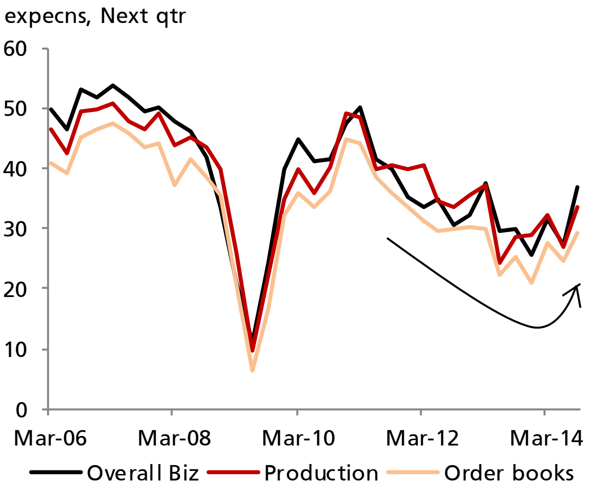


Chart 2: RBI Industrial outlook survey



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This was corroborated by the fall in the number of stalled projects to INR 1.04trn in first six months of 2014, down from INR 2.6trn in late-2013. Inventory drawdown and smaller contribution from net exports partly offset the rebound in growth.

We are optimistic on GDP growth rebound

We remain optimistic on the GDP growth trajectory this year and the next. The initial phase of the turnaround will involve a cyclical recovery through higher industrial production and clearances of existing projects. In the past year, the government's Project Monitoring Group has cleared over a third of the pending 438 projects, worth ~INR 5trn (USD 80bn).

There has also been an attempt to digitise various permits under the approval stage to hasten the process. In the meantime, the central bank's surveys have noted a revival in business confidence (Chart 2, previous page), with borrowing costs for high-grade corporates easing to three-quarter lows at last check.

Strong capital markets have opened avenues for corporates to raise funds to clean balance sheets and fund fresh interests. The revival in investment activity will perk service-related sector activities down the road, just as the government gets into a belt-tightening mode to meet fiscal targets.

In the Jun14 quarter, private consumption spending slowed to 5.6% YoY (vs. 8.2% prev quarter) reflecting weak rural demand on sub-par rainfall, sticky inflation and low positive real returns. We expect this component to benefit from a pick-up in industrial / service activities in 2H. A modest uptick in vehicle sales provides initial signs of a turnaround, but moderation in rural incomes might slow sales of two-wheelers.

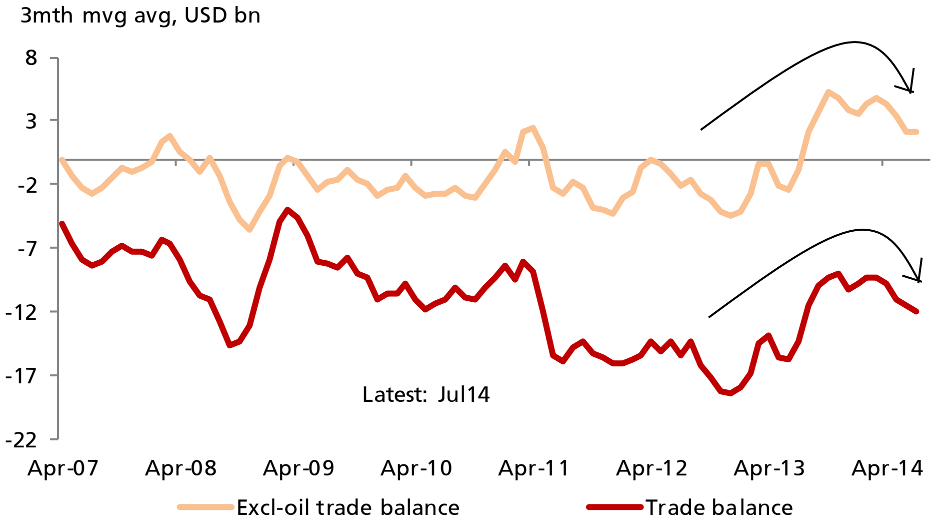
This mix of growth drivers prompts us to revise up our GDP projection to 6.1% in FY15 (from 5.5% prev) and 6.6% in FY16 (from 6.5% prev). The next leg of the recovery cycle will require fresh capex commitments by the private sector and an increase in capacity utilisation.

Main downside risks to our scenario arise from a slower revival in private sector participation and if the government's reform agenda were to lose steam. This will hurt the anticipated turnaround in domestic demand, not helped the least by an uncertain global demand backdrop. An overhang from tight monetary and fiscal policies could also dampen the pace of recovery.

Twin deficits – 1) Current account to widen modestly

There is likely to be some relief on the twin deficits i.e. current account (C/A) and fiscal imbalances this year. Our estimate is for the C/A deficit to widen marginally, but funding needs will be cushioned by the strong capital inflows.

Chart 3: Trade deficit re-widens on non-oil imports



Trends early in the year validate our expectations. Apr-Jun14 C/A deficit widened to -1.7% of GDP, after shrinking to -0.2% in the Mar quarter. Despite strong export growth of 10.6% YoY in Apr-Jun vs -1.5% in the same period last year, the C/A deficit widened on the back of a stronger recovery in imports (Chart 3, prev page). Non-oil non-gold imports, which are used as a proxy for domestic demand, rose 3.0% YoY.

Current account deficit to widen to -2.2% of GDP, fiscal gap to be met by spending cuts

For FY15, we expect the C/A deficit to widen marginally to -2.2% of GDP (vs. our previous forecast of -2.6%, and actual FY14's of -1.7%). A revival in investment spending and capex expansion plans are expected to buoy demand for imported inputs. At the time of writing, the court decision on mining operations is still pending. If the final ruling bans activity in all allocated mines, higher coal imports will be an additional strain on the trade account.

In the meantime, there has been no indication of cuts in the gold import duty, which suggests that the anticipated jump (apart from seasonal demand) in gold imports might not pan out. The balance of payments position should be comfortable at circa USD 40bn, up from USD 15bn last year.

Twin deficits – 2) Fiscal deficit target to be met, but quality in doubt

The new government retained the challenging -4.1% of GDP deficit target for FY15, banking on optimistic tax revenue projections. We expect this target to be met, but don't rule out a modest 0.1-0.2% of GDP overshoot.

The focus is on the ambitious divestment target (~USD 10bn) this year, which should offset the below-target tax collections. Recently, the cabinet approved stake sales in three big-ticket public-sector companies, due to hit the market in Sep/Oct. This will help tap the bullish market sentiments and positive valuations.

At the same time, if overall revenues fall short of budgeted estimates, a mid-course reduction in spending will be necessary to meet the deficit targets. Given last year's experience, the axe is likely to fall on capital expenditure, while subsidies prove stickier. Nonetheless, there might be some relief from lower food subsidies, as lack of preparedness amongst states to unveil the food security program could delay disbursements.

In this context, recommendations of the Expenditure committee led by former RBI Governor Bimal Jalan, will be important in weeding through unproductive spending items.

Some relief is also likely from the denominator effect i.e. GDP growth. Apart from the anticipated turnaround in growth, talks are that a more representative GDP series (to include informal sectors) may be introduced next year. This might also

Chart 4: Benchmark Repo rate to plateau at 8%

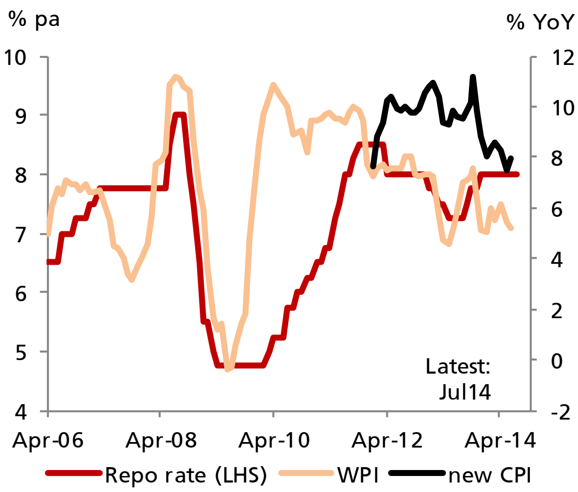
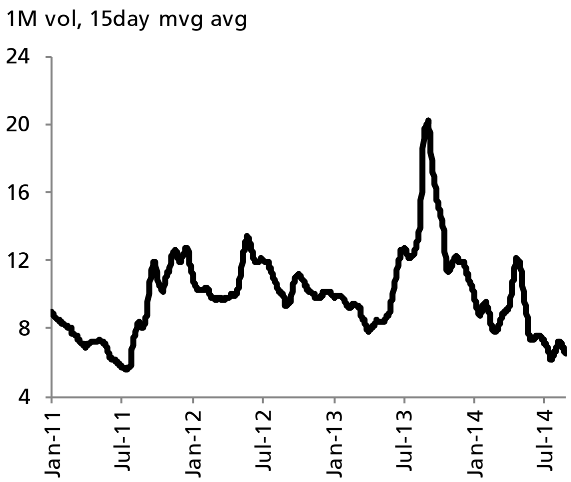


Chart 5: Low USDINR volatility



involve a new base year of 2011/12 vs. the present 2004/05 and boost the absolute (real) growth numbers.

Rating agencies, meanwhile, remain a patient lot and have given the benefit of doubt to the new government. A clear reform agenda and growth recovery might see Standard & Poor raise its rating outlook back to 'stable' from 'negative' in the latter part of this year but a rating upgrade is some distance away.

Policy rates to remain on hold through FY15

RBI to stay cautious

Relief on the twin deficits is underway and a turnaround in growth is expected to materialise over the next two years. CPI inflation has moderated from 11% YoY in Nov13 to 8% by Jul14 on a stable currency and contained commodity prices, notwithstanding the intermittent spikes on volatile perishable food items. The rainfall deficiency has narrowed considerably on the back of late rains in July-August (to <-15% from -48% in Jun).

Despite these favourable developments, the RBI will maintain a cautious stance and leave the Repo rate on hold this year. Concerns are bi-fold. Firstly, while the above factors will keep inflation close to the 8% nominal CPI target by Jan15, the RBI is wary of inflationary risks from higher aggregate demand in midst of supply-strapped conditions.

In addition, hurdles by way of unexpected jump in commodity prices, rupee volatility and sticky food prices also lower the prospect of premature rate cuts. Accordingly, the RBI has shifted focus to achieving 6% CPI by Jan16.

Secondly, the RBI aims to avoid volatility in the domestic financial markets from any reversal in the global accommodative monetary policy stance. This is reflected in the authority's active hand in the currency market to prevent the rupee from appreciating too fast on the back of hot money inflows. Keeping the rupee stable (Chart 5, previous page) ensures broader macro stability and signals that the policymakers are proactive in crisis-fighting, rather than reactive.

With the US Fed rate hike risks lingering in the backdrop, the RBI will see reason in maintaining the positive differentials between USTs and domestic rates. With these factors in mind, we expect the Repo to be held steady for rest of FY15 (Chart 4, previous page).

India Economic Indicators

	13/14	14/15f	15/16f	1Q15	2Q15f	3Q15f	4Q15f	1Q16f	2Q16f
Real output (04/05P)									
GDP	4.7	6.1	6.6	5.7	5.8	6.2	6.4	6.3	6.5
Agriculture	4.8	3.1	4.5	2.6	2.5	3.0	3.5	3.5	3.0
Industry (ex constrn)	1.5	5.0	5.8	5.3	4.8	4.9	5.3	5.5	6.0
Services	7.2	7.5	7.8	7.4	7.0	7.8	7.8	7.8	7.8
Construction	1.7	4.5	4.5	4.8	4.0	4.5	4.5	4.5	4.5
External (nominal)									
Merch exports (USD bn)	313	325	355	79	82	82	82	86	86
- % YoY	4.5	4.0	9.3	7.4	2.1	5.2	1.0	9.0	5.0
Merch imports (USD bn)	450	488	530	113	120	125	130	135	140
- % YoY	-8.0	9.1	8.6	-6.3	9.0	15.0	19.0	19.0	17.0
Trade balance (USD bn)	-137	-163	-175	-34	-38	-43	-48	-49	-54
Current a/c balance (USD bn)	-32	-45	-43	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-1.7	-2.2	-2.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves(USD bn, eop)	304	340	360	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation (% YoY)	9.5	8.1	7.0	8.1	7.9	7.7	8.4	7.9	7.1
Other									
Nominal GDP (USD tn)	1.9	2.0	2.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-4.5	-4.1	-3.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

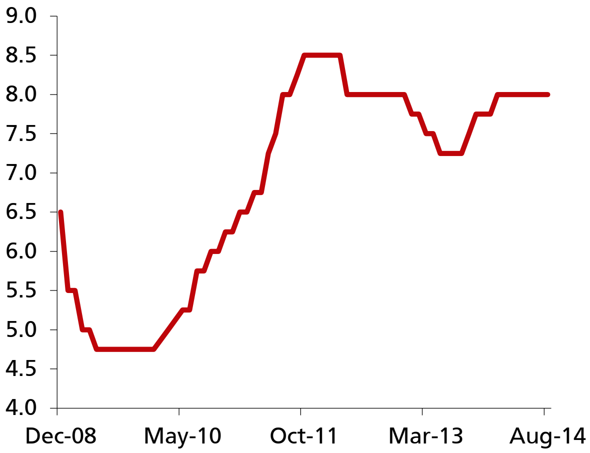
* % change year-on-year, unless otherwise specified
** Annual and quarterly data refers to fiscal years beginning April of calendar year.

IN - nominal exchange rate

INR per USD

IN – policy rate

% repo rate



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ID: A new beginning

- **Export growth is a drag and there is still no sign of a recovery in investment growth**
- **But private consumption remains a strong support to overall GDP growth and prospects are still encouraging going forward**
- **President-elect Joko Widodo takes office on October 20 and the new government is set to frontload its pro-growth policies**
- **One pressing task is to reduce fuel subsidy, which has contributed to the twin deficit in recent years**
- **Despite the anticipated fuel price hike by 2Q15, don't expect any shift in Bank Indonesia's monetary policy stance**

President-elect Joko Widodo takes office on October 20, facing plenty of challenges on the economic front. Growth has moderated and full-year GDP is likely to come in at 5.4% this year, lowest since 2009. Both the fiscal and current account are likely to remain in the deficit, at about 2.7% and 3.0% of GDP respectively.

The new government is set to frontload its pro-growth agenda, and thus, a recovery looks likely for 2015. One pressing task is to reduce fuel subsidy, which has contributed to the twin deficit in recent years. Look for a hike in the subsidized fuel price to be implemented by 2Q15. Don't expect any significant shift in Bank Indonesia's (BI) monetary policy stance, however, given that any impact is likely to be manageable.

Strong turnaround in exports unlikely

Export growth remains a drag on overall GDP growth (Chart 1). At the current pace, exports of goods and services are likely to be flat for the year. The rather lackluster performance in export growth throughout 1H14 partly indicates the weaker-than-expected recovery in global demand. Commodity prices especially that of coal and crude palm oil (CPO), continues to weigh on export receipts (Chart 2). Additionally, the impact of the mineral ore export restrictions also turned out to be more significant than we have previously expected.

Chart 1: Exports and investment a drag

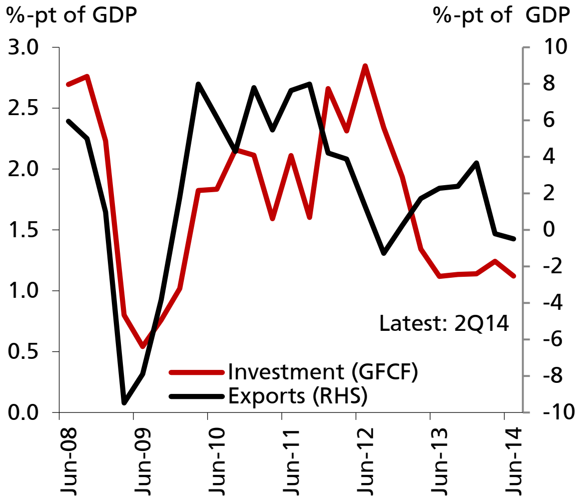

Chart 2: Coal and CPO exports lagging

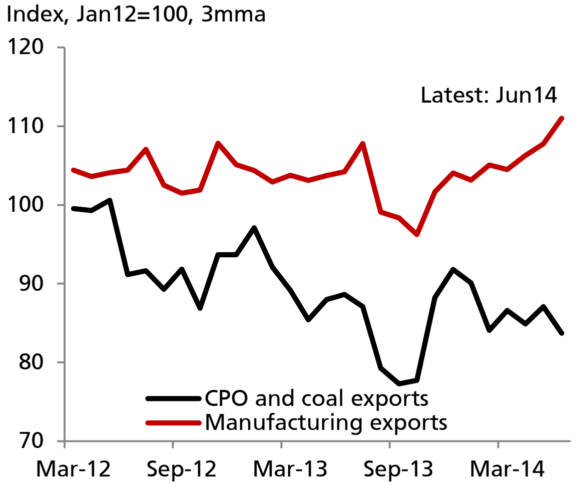

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Chart 3: No recovery in investment as yet

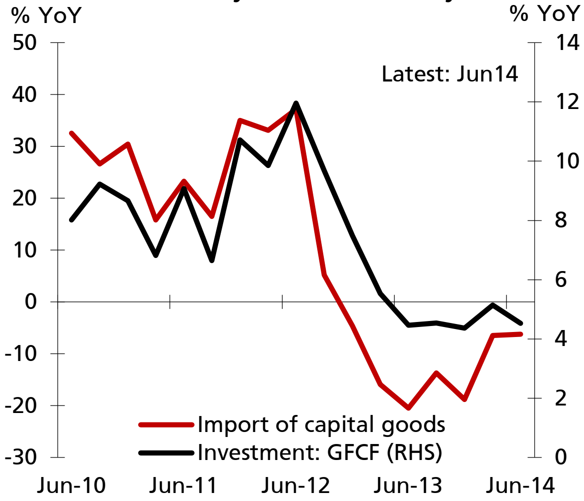
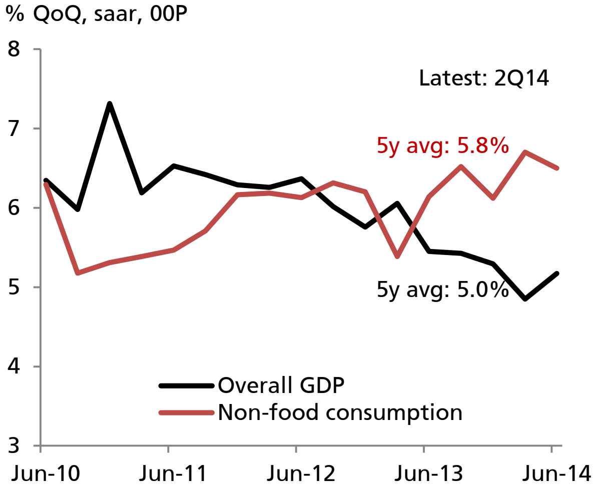


Chart 4: Consumption leading overall GDP growth



That said, the performance of manufacturing exports has been encouraging. At the current pace, this segment looks set to grow by about 5% in the year, marking a modest turnaround from the 3% fall in 2H13. And the latest Foreign Direct Investment (FDI) data is still indicative of strong investor interest in the sector. FDI into this sector accounts for about half of total FDI, well above the 20% recorded 4 years ago.

Manufacturing export growth has been encouraging

Delayed recovery in investment growth

Gross fixed capital formation (GFCF) grew by 4.5% (YoY) in 2Q14, unable to sustain the mild recovery seen in the previous two quarters (Chart 3). Sentiment among businesses is likely to have been weighed by the volatility in the rupiah in May-June and uncertainties ahead of the elections this year. Moreover, the tight monetary policy stance held by BI means that loan growth has continued to ease.

There is still no sign of a recovery in imports of capital goods either. Seasonally adjusted, imports of capital goods are still about 15% lower compared to early-2013. Sentiment among businesses is however likely to get a lift once the new government takes office. The political transition is now widely expected to be smooth, negating any lingering political uncertainties. An accelerated 2015 budget disbursement is also likely to help anchor the recovery in investment growth.

Resilient private consumption

Given the sustained weakness in export earnings and before a stronger recovery in investment can be witnessed, some moderation in private consumption is likely on the cards towards end-2014. Despite that, private consumption remains a strong pillar of the economy. And we are still likely to see private consumption growth circa 5.5% this year, sustaining the pace seen in recent years. Non-food consumption is currently growing at 6.5% pace, leading overall GDP growth in the process (Chart 4).

Private consumption to stay strong

Looking ahead, indicators remain encouraging (Chart 5, next page). The consumer confidence index is at its highest since end-2012 while price expectations have fallen quite significantly in recent months. Retail sales growth is still trending circa 15%. Additionally, plans to raise civil servants' pay in 2015 may also translate into similar adjustment in the private sector.

Impact from fuel price hike to be manageable

Reducing fuel subsidy is the first crucial policy on the agenda for the incoming government. Excessive subsidies have been weighing on both the fiscal and current account. At the current pace of fuel consumption, there is a high likelihood of fiscal deficit crossing the 3% (of GDP) mark, which is the current legal limit.

Chart 5: Positive outlook for consumption growth

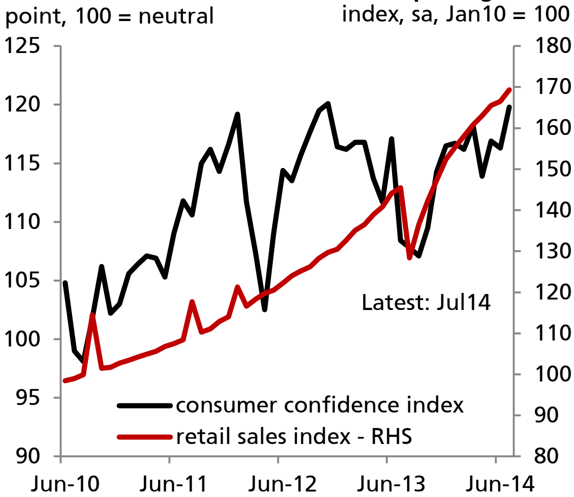
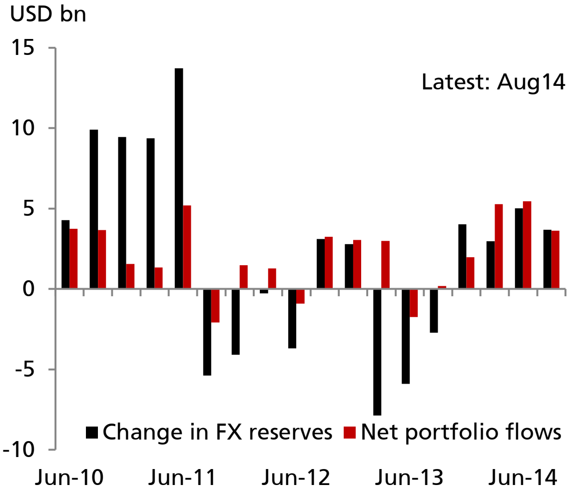


Chart 6: Foreign reserves and portfolio flows



The incoming government is planning to eliminate fuel subsidies gradually over the next 4 years. We expect the first subsidized fuel price hike to be delivered in early-2015 and, at this juncture, we pencil in a 20-30% adjustment. As with the case of 2013, the impact on consumption growth is likely to be muted.

Expect a 20-30% subsidized fuel price hike in early-2015

The impact on CPI inflation is likely to be sizeable but also temporary in nature. We look for CPI inflation to bounce back towards 7% (YoY) in middle-2015, from circa 5% in early-2015. Average CPI inflation for 2015 is still set to ease to 5.8% from a projected 6.0% this year.

Monetary policy focus is on financial market stability

With CPI inflation trajectory unlikely to be a problem, there could be some renewed pressure on BI to loosen its policy stance, especially given the easing GDP growth momentum. We remain of the view that BI will maintain its current policy stance and keep the BI rate stable at 7.5% this year.

Outlook on the current account balance will be the central bank's main policy focus. C/A deficit is likely to come in around 3% of GDP this year, with bulk of the pressure still from the oil & gas trade balance. Coupled with the anticipated fuel subsidy cut, a relatively stronger external demand in 2015 should help to narrow the C/A deficit further to circa 2.7% of GDP. Further narrowing of the C/A deficit is still warranted though. We remain of the view that C/A deficit of around 2% of GDP is more sustainable for the medium-term. Against this backdrop, we don't expect BI to shift away from its current policy stance.

BI rate to remain stable at 7.5%

Additionally, overall liquidity in the financial system is still supportive of GDP growth, especially considering the anticipated spike in fiscal spending in 2015. Going forward, strong portfolio inflows are likely to be neutralized by BI's accumulation of foreign reserves (Chart 6). Foreign reserves are up by USD 12bn in the year up to August, compared to the total USD 14bn net inflows recorded in equities and IDgov bonds. This is just an indication of BI trying to shore up its defenses against unpredictable financial market volatilities.

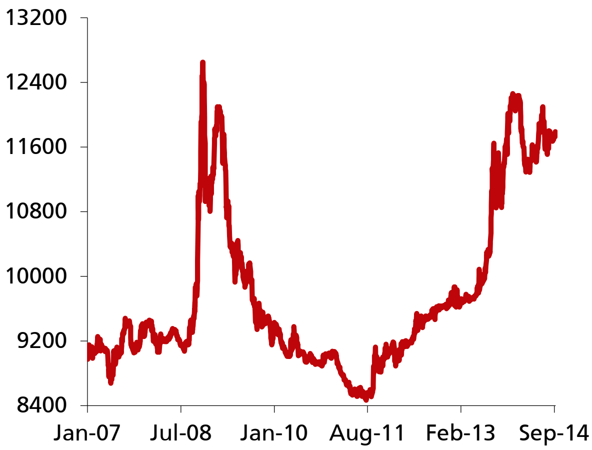
Indonesia Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
Real GDP growth	5.8	5.4	5.9	5.1	5.5	5.5	5.8	6.0	5.8
Private consumption	5.3	5.4	5.4	5.6	5.2	5.3	5.4	5.4	5.4
Government consumption	4.9	3.9	10.5	-0.8	3.4	7.8	10.0	14.1	14.1
Gross fixed capital formation	4.7	5.9	7.8	4.5	6.2	7.7	8.1	9.1	7.7
Net exports (IDRtrn, 00P)	295	307	319	72	79	79	84	78	79
Exports	5.3	1.1	7.1	-1.0	2.9	2.6	8.0	9.9	6.0
Imports	1.2	0.2	8.1	-5.0	1.7	4.5	8.1	10.3	7.5
External									
Merch exports (USDbn)	183	181	201	45	43	50	48	49	49
- % chg	-3.9	-0.1	11.2	-1.4	0.0	2.0	9.1	8.9	14.0
Merch imports (USDbn)	187	182	203	47	43	49	49	51	48
- % chg	-2.6	-2.7	12.1	-4.1	-6.5	6.5	14.0	8.5	11.6
Merch trade balance (USD bn)	-4	-2	-2	-2	0	1	-1	-2	1
Current account bal (USD bn)	-29	-26	-24	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	-3.3	-3.0	-2.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, eop)	99	110	116	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation (average) **	6.4	6.0	5.8	7.1	4.3	4.7	4.7	5.6	6.5
Other									
Nominal GDP (USDbn)	871	860	900	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-2.2	-2.7	-2.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified
** using the new CPI series with 2012 as the base year from here onwards

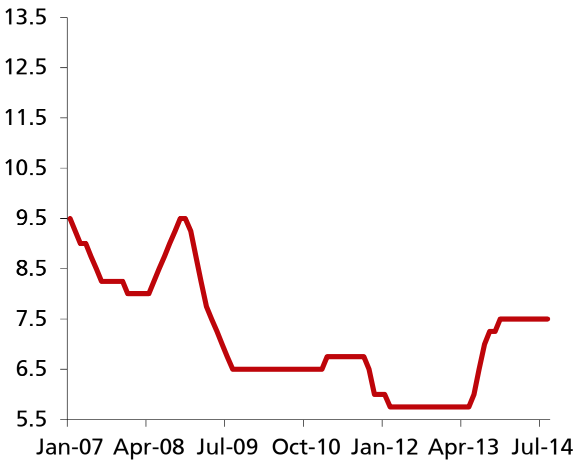
ID - nominal exchange rate

IDR per USD



ID – policy rate

BI rate



MY: Rebalancing

- **Strong growth in 1H14 has called for an upgrade in GDP growth forecasts for 2014 and 2015 to 5.9% and 5.2% respectively**
- **Inflation has been unusually high and upside risk remains with the introduction of the GST in Apr15**
- **Risk of financial imbalances calls for tighter monetary policy stance**

The economy was expected to undergo a soft braking as highlighted in our previous quarterly report in June. Since then, Bank Negara has introduced a 25bps rate hike in July, bringing the Overnight Policy Rate (OPR) to 3.25%. This is juxtaposed against a strong GDP showing in 2Q, higher than usual inflation and an unhealthy household leverage ratio.

Strong domestic growth

The economy expanded by 6.4% (YoY) in the second quarter. While this was higher than predicted, the story behind the numbers is in line with our expectation. The strongest lift came from the external front while domestic growth has remained healthy. On a sequential basis, growth momentum accelerated to 6.6% (QoQ, saar), up from 4.6% previously (Chart 1). Average growth for 1H14 now registers 6.3%, which essentially will require an upward adjustment in our full year GDP growth forecast to 5.9%, from 5.2% previously.

Domestic consumption has remained fairly robust (Chart 2). Private consumption growth recorded a healthy clip of 6.5% (YoY) despite the dampening effect of higher inflation. The healthy wage growth and the buoyant labour market have helped to loosen consumers' purse string. Unemployment rate dipped to a record low of 2.8% (sa) in 2Q, which boosted manufactured product sales (Chart 3).

Positive wealth effect from asset appreciation is another factor that will continue to underpin private consumption. Going forward, while higher interest rates may affect big ticket purchases marginally, private consumption is likely to stay resilient and may even pick up ahead of the introduction of the Goods and Services Tax (GST) on 1st April next year.

Chart 1: A strong 1H14 GDP performance

% YoY, % QoQ saar

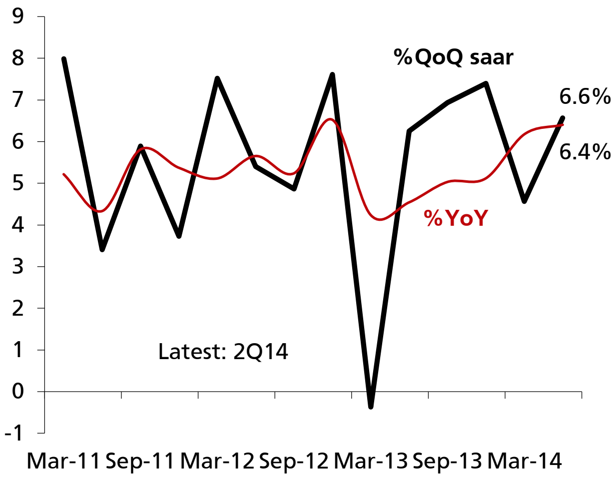


Chart 2: Stronger net exports and consumption

%YoY, %-pt contribution

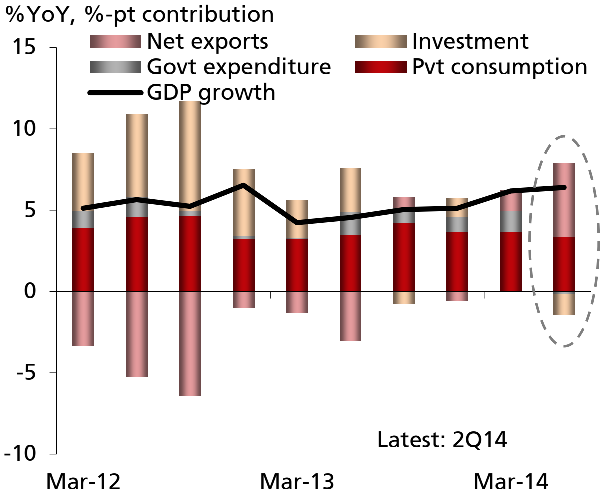


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Chart 3: Private consumption to stay buoyant

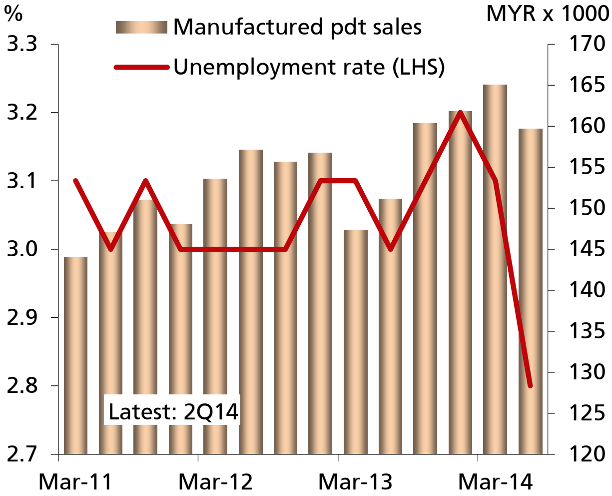
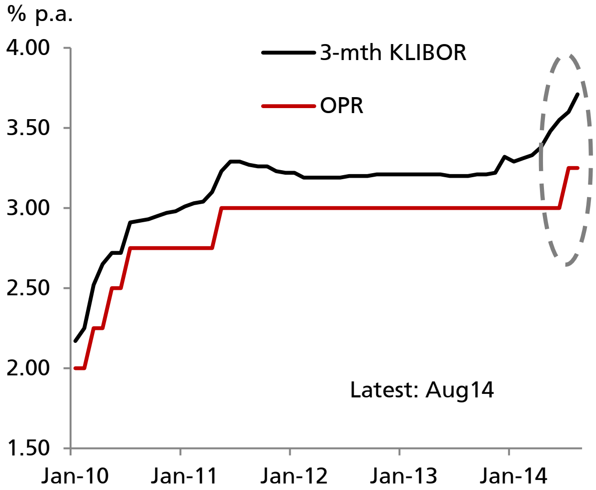


Chart 4: 3-mth KLIBOR and OPR



Investment growth rose to 7.2% (YoY) in 2Q, from 6.3% previously. Though a cut back in government infrastructure projects will imply slower disbursement of public investment, private sector investment has improved on better economic outlook. If not for a sharp drop in inventories, the contribution to GDP growth from the investment component would have been positive. Generally, investment sentiment has been sanguine.

Nonetheless, the key downside risk is higher interest rates. Though Bank Negara has raised the OPR by 25bps in July, expectation has pushed the 3mth KLIBOR higher by 14bps to 3.71% since the last policy meeting in July (Chart 4). Expect investment growth to moderate in the coming two quarters due to higher funding costs.

Robust external lift

The strongest lift came from the external front. Exports were up by 8.8% (YoY) in 2Q while imports have moderated to 3.9%. This essentially implies a strong contribution from the net export component. While partially due to base effect, impact of a pick-up in external demand and improvement in export competitiveness certainly has been manifested in the headline numbers (also Chart 2).

But there are signs of cooling on the external front. Though exports have grown by a solid 12.5% in the first half of the year compared to the same period last year, export growth and overall trade surplus have been easing in recent months (Chart

Chart 5: External demand set to ease

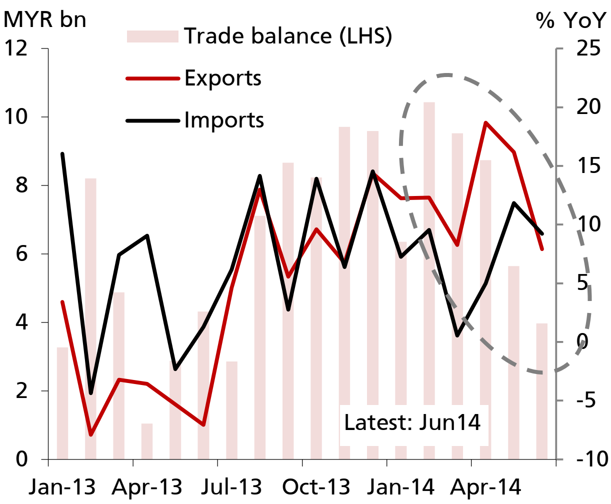
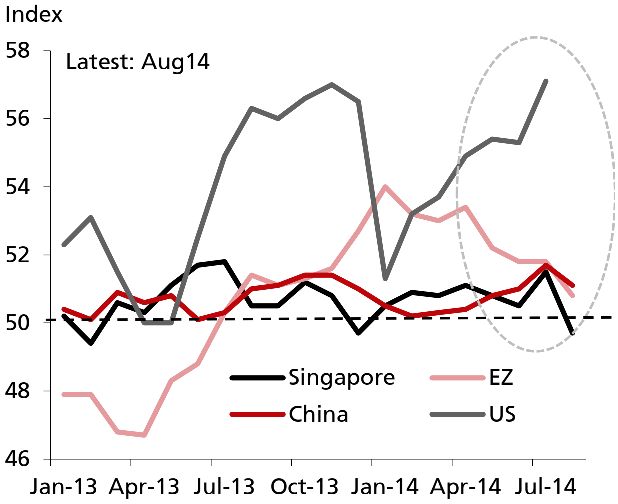


Chart 6: PMIs mostly down



5). In fact, apart from the US PMI, the PMIs of all key markets have moderated in recent months (Chart 6).

Slower growth ahead

The economy is off to a good start. The external environment remains conducive despite pockets of risks. The recovery in the US is in progress, albeit in a sluggish fashion. Europe is not entirely out of the woods with mixed signals from time to time. China is undergoing a soft landing but risks remain in its financial system. The outlook on external demand is expected to turn more tepid in the coming quarters.

Malaysia is entering a phase of rebalancing. Domestic growth will likely moderate on account of the effort to rein in fiscal deficit, introduction of indirect taxes and tighter monetary policy to deal with the risks of financial imbalances. These are necessary steps to ensure sustainable and balanced growth in the longer term.

Growth to register 5.9% in 2014

However, the strong showing in the first half has lifted the growth trajectory significantly. Even if the economy grows at a slower pace of 4.5-5.0% (QoQ, saar) over the next 2 quarters (versus 5.6% in 1H14), which is quite conservative, the YoY growth in 2H14 will register 5.5-5.6%. Juxtaposed with the 6.3% growth registered in 1H14, full year GDP growth is now expected to record 5.9%. But for 2015, growth momentum will continue to ease and the economy is expected to expand at a slower rate of 5.2%.

Inflation to dip in 4Q but tightening bias remains

Inflation clocked 3.2% (YoY) in July (Chart 7). This is about 70% higher than the five-year average of 1.9%. Though much of the price pressure is due to cuts in fuel subsidies and hikes in alcohol and tobacco taxes, the tight labour market, as well as the strong domestic growth make for higher demand pull inflation.

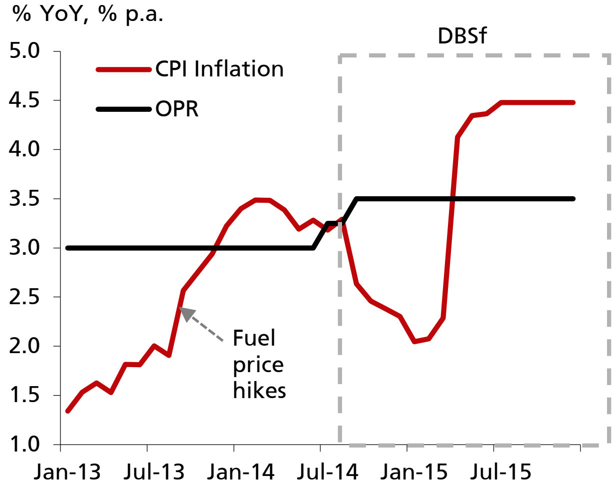
Yet, inflation has surprised on the downside over the past months and the headline number will probably ease on base effect in the coming months. As it is, CPI inflation will likely average 3.0% in 2014, down from our previous forecast of 3.5%. But expect a sharp spike up in CPI inflation prior and during the introduction of the 6% GST next April. Risks of opportunistic pricing behavior by retailers and second order price pressure cannot be discounted. Full year inflation for 2015 is expected to register 3.2%.

Apart from inflation, risk of domestic financial imbalances has been the key concern for Bank Negara. That was the main reason that prompted the 25bps rate hike in July. Household debt to GDP ratio has already risen to an unhealthy level of 86.8% in 2013 while the loan to deposit ratio has hit a multi-year high of 85.8% as of Jun14.

In short, leverage has continued to rise while liquidity condition within the domestic banking system is getting tighter. All these warrant a tighter monetary policy. For that, we expect the central bank to tap on the brake again, hiking the OPR by another 25bps in the forthcoming meeting in September.

Chart 7: Inflation and monetary policy outlook

% YoY, % p.a.



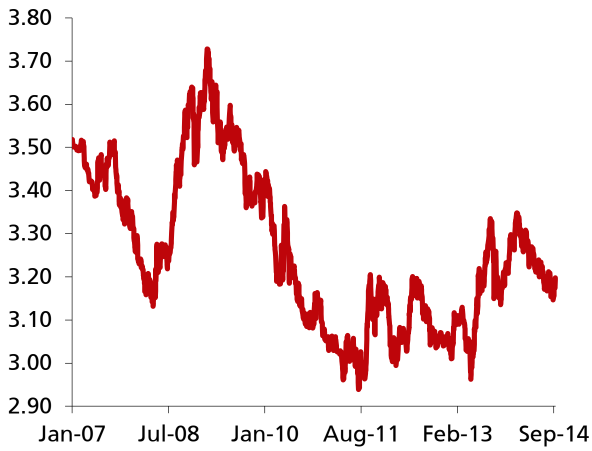
Malaysia Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth	4.7	5.9	5.2	6.4	5.9	5.3	5.3	5.0	5.1
Private consumption	7.2	6.5	6.3	6.5	5.8	6.5	6.3	6.3	6.4
Government consumption	6.3	5.3	4.5	-1.3	4.5	7.0	3.4	5.0	5.1
Gross fixed capital formation	8.5	6.0	5.7	7.2	4.5	6.2	6.0	5.4	5.9
Exports	0.6	6.4	4.4	8.8	5.0	4.2	4.5	3.0	4.5
Imports	2.0	6.2	6.2	3.9	6.8	6.9	6.3	7.0	5.5
External (nominal)									
Exports (USD bn)	229	245	246	60	61	65	62	62	65
Imports (USD bn)	206	222	230	55	57	60	58	58	61
Trade balance (USD bn)	22	23	16	6	4	4	4	4	4
Current account bal (USD bn)	13	13	14	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	3	4	4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn, yr-end)	140	148	158	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	2.1	3.0	3.2	3.3	3.0	2.4	2.1	3.5	3.7
Other									
Nominal GDP (USDbn)	313	341	369	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)	-4.0	-3.5	-3.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % growth, year-on-year, unless otherwise specified

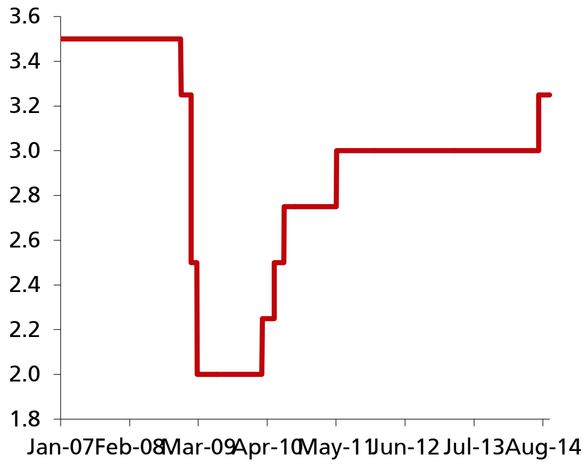
MY - nominal exchange rate

MYR per USD



MY – policy rate

%, OPR



TH: Early in the recovery

- GDP growth is no longer falling and improved confidence level is positive for the outlook on GDP growth going forward
- But there is still plenty of excess capacity in the economy, partly on the back of disappointing exports
- String of infrastructure projects is key to revive GDP growth momentum in the immediate-term
- CPI inflation to average 3.3% in 2015, well above the projected 2.1% this year
- Bank of Thailand (BOT) is likely to keep its policy rate stable at 2% until 3Q15 when we expect the normalization cycle to begin

GDP growth is no longer falling. Consumer and business confidence have been on the rise following the end of the political deadlock in May. The current government is set to accelerate its spending in 4Q14, with a string of infrastructure projects already lined up. That said, there is still plenty of excess capacity in the economy. Exports remain a drag. The speed of the recovery is also weighed by the current debt overhang among households. For now, we look for GDP growth to recover to 4.0% in 2015 from a projected 1.6% this year. It remains below 5.5% that the economy seems capable of in the medium-term.

Rising confidence is a positive start

Political risks have been subdued since the military government took control in May. The key economic posts in the newly established government under PM Prayuth are held by technocrats who also had cabinet posts after the 2006 coup.

Confidence on the economy has rebounded strongly since May, suggesting there are reasons to expect stronger domestic demand ahead (Chart 1). Consumer confidence came in at 80.1 as of August, its highest level in a year. Meanwhile, business sentiment currently sits just below the neutral 50 mark, also at its highest level in the past year. Essentially, confidence has now returned to its pre-political crisis levels.

Chart 1: Sharp rebound in confidence

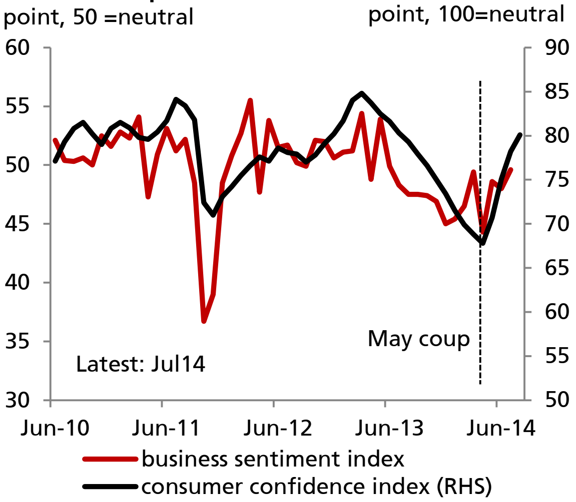


Chart 2: Domestic demand still weak

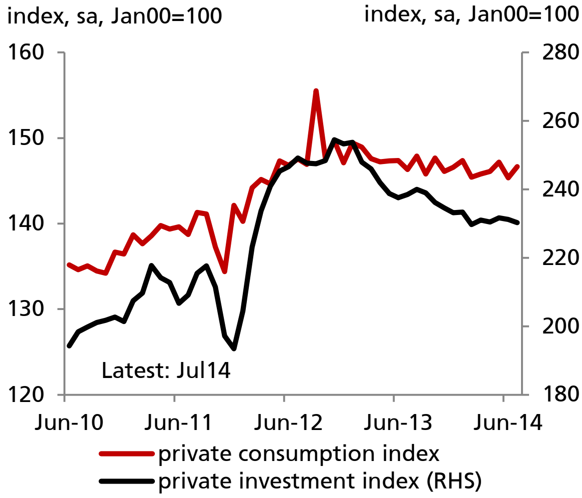


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Chart 3: Imports and retail sales

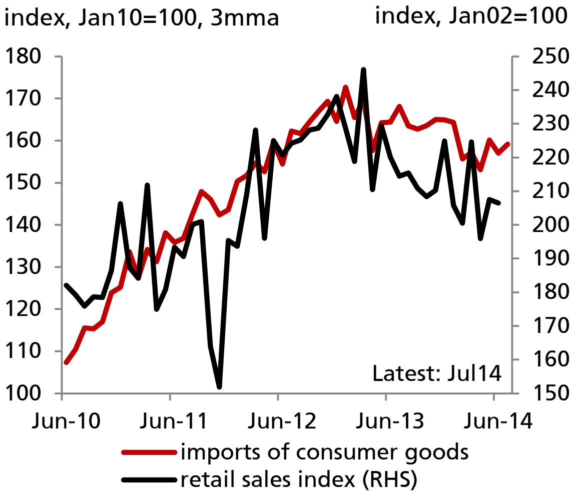
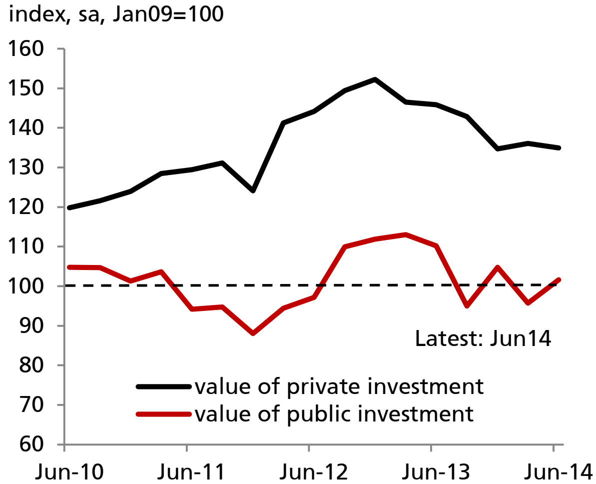


Chart 4: Public investment lagging



No doubt these are positive signs. The problem is that we are yet to see significant turnaround in the economy. Both the private consumption and private investment indices are yet to recover, suggesting that a weak domestic demand persists (Chart 2, previous page).

Still no significant turnaround in the economy

Imports of consumer goods have been pretty much flat while retail sales are still falling in recent months (Chart 3). Vehicle sales have also fallen by an average 30% (YoY) this year, just another sign that durable-goods consumption remains poor. While the government's cash handouts and special loans are likely to provide a temporary boost to private consumption growth, the on-going household deleveraging is likely to remain a limitation in the near-term.

Weak capacity utilization is the major concern

Stronger recovery in investments is also crucial. Total investments are about 13% lower than the amount seen in late-2012 and public investment has been stagnant in recent years (Chart 4).

But there is still plenty of excess capacity in the economy (Chart 5, next page). Capacity utilization is currently circa 60%, below the normal 65-67%. The bad news is that lackluster export growth persists. Exports shrank 0.4% in the year-to-date up until July, and we now expect exports to be pretty much flat for the full-year. As long as excess capacity remains in the picture, higher investment spending may not fully reach its potential in providing a boost to the economy.

Public investment to set the tone

At some point though, improved confidence is likely to translate into stronger domestic demand. And this will in turn help to get the economy back on the high gear. To sustain the improved confidence level, it is important to monitor the pace of fiscal spending going forward.

Plenty of excess capacity in the economy

The policy focus for the newly formed government under PM Prayuth is to boost public investment growth. Other than accelerating disbursements under the 2015 budget, which will be effective starting in October, the government is eyeing the THB 2.4tn infrastructure projects first introduced by PM Yingluck. At the initial stage, priority is given to a string of dual-track rail lines, worth some THB 900bn, or about 1/3 of the total value of the initial projects.

Inflation to recover

CPI inflation is trending circa 2% as we approach the year-end. This is driven by softening food and energy prices amidst the harvest season and sustained measures

Chart 5: Plenty of excess capacity on weak exports

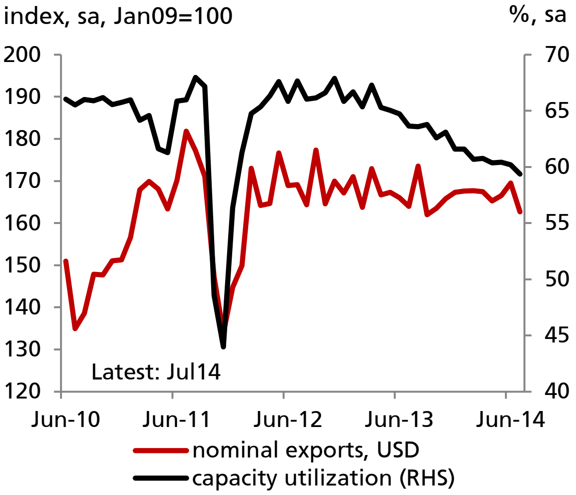
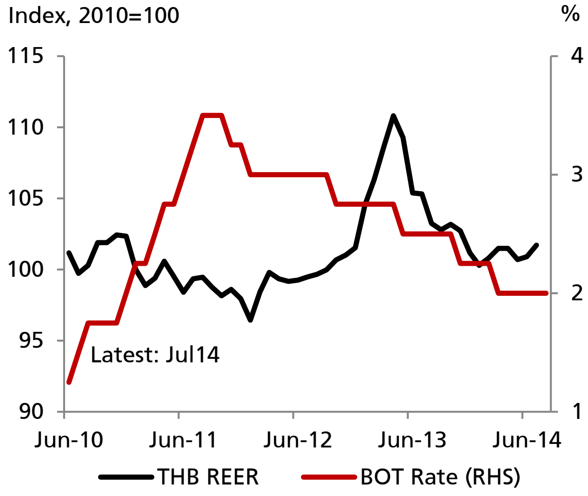


Chart 6: Accommodative policy persists



Underlying inflationary pressures persist

by the military government to keep rising prices in check. Average CPI inflation is likely to come in at 2.1% this year, lower than the 2.2% recorded for 2013.

Looking into 2015 though, there is still a good chance that CPI inflation may cross the 3% mark. Headline inflation is being kept in check due to the government's administrative measures and these are unlikely to go on forever. Indeed, potential energy subsidy cuts are currently being discussed. More importantly, underlying inflationary pressures remain prevalent, as evidenced by the slight upward trend in the core inflation reading.

Monetary policy normalization to start in the latter half of 2015

Expect the Bank of Thailand (BOT) to keep its policy rate at 2% for now. Prospects of a stronger GDP growth ahead and the gradual increase in CPI inflation means less reason for any further rate cuts going forward. The BOT is also unlikely to trim its interest rate just for the sake of pushing for a weaker baht. The terms of trade have been fairly supported in recent months. In fact, a stronger baht could potentially help to anchor the revival in investment growth.

Stable policy rate until 3Q15

Looking further ahead, some policy normalization is necessary. Monetary policy has been kept accommodative for some time now (Chart 6). Coupled with the fact that CPI inflation is likely to climb above 3% next year, persistently high household debt (in excess of 80% of GDP) is also likely to prompt the central bank to adjust its policy stance. Look for the BOT to start raising its policy rate in 3Q15, when we expect GDP growth to start trending back towards 5%.

Risks

No specific timeline has been set by PM Prayuth but fresh elections have been planned for end-2015. The jury is still out on the efficacy of the current government. This is especially true if we were to take historical precedence from the aftermath of the 2006 political coup. Thus far, the government's policy leaning seems to be reliant on short-term populist measures and public infrastructure projects to boost growth. Other goals such as an overhaul of the tax system and reforms in the energy sector will also be crucial to sustainable GDP growth in the medium-term. It is important to keep a close look on this front. Stay tuned.

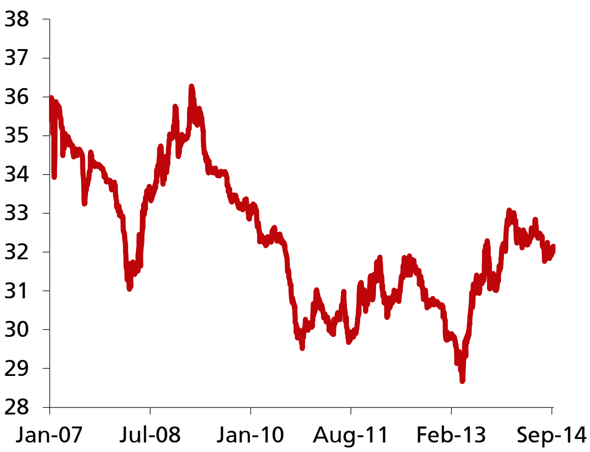
Thailand Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth (88P)	2.9	1.6	4.0	0.4	2.6	4.1	6.5	4.5	4.5
Private consumption	0.3	1.5	4.5	0.2	4.0	5.0	5.8	5.5	4.2
Government consumption	4.9	3.8	7.3	1.9	2.4	7.4	8.8	8.5	7.5
Gross fixed capital formation	-2.0	-1.0	4.0	-6.9	1.9	12.5	9.7	4.6	4.0
Net exports (THBbn)	742	837	792	191	187	195	227	161	200
Exports	4.2	0.1	5.5	-0.7	0.6	0.8	3.3	6.6	7.1
Imports	2.3	-3.1	8.6	-9.2	1.1	4.6	10.0	12.6	7.2
External									
Merch exports (USDbn)	229	228	245	56	59	56	59	60	64
- % YoY	0	0	7	0	0	-2	5	7	8
Merch imports (USDbn)	250	231	257	57	60	59	63	65	65
- % YoY	0	-8	11	-12	-2	0	13	14	8
Trade balance (USD bn)	-22	-3	-12	-1	-1	-3	-4	-5	-1
Current account balance (USD bn)	-2	9	3	1	-1	1	1	1	1
% of GDP	-0.8	2.2	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	2.2	2.1	3.3	2.5	2.1	2.0	2.5	3.3	3.7
Other									
Nominal GDP (USDbn)	388	380	400	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate, %	0.7	0.8	0.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal balance (% of GDP)**	-2.0	-3.0	-3.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* % change, year-on-year, unless otherwise specified
** central government net lending/borrowing for fiscal year ending September of the calendar year

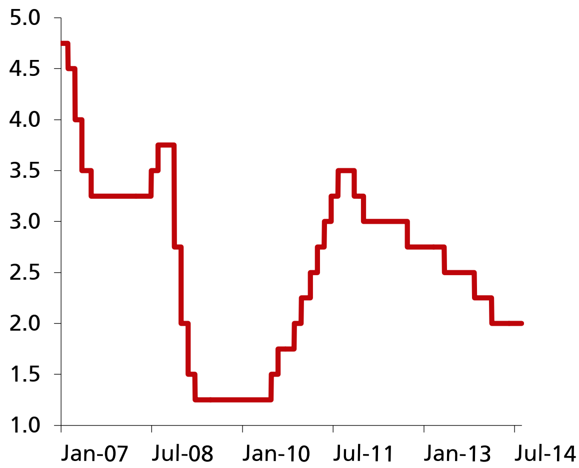
TH - nominal exchange rate

THB per USD



TH – policy rate

%, 1-day RRP



SG: Cloudy

- **GDP growth will stay below potential this year before improving marginally in 2015**
- **The external outlook remains tepid; domestic restructuring is still a drag**
- **Inflation has undershot expectation but set to rise in 2015**
- **MAS will maintain the existing Sing NEER appreciation stance**

The economy grew 2.4% (YoY) in the second quarter, a slower pace compared to 4.8% in the previous quarter. Sequentially, the economy has averted a contraction by posting a modest expansion of 0.1% (QoQ, saar) instead of a dip of 0.8% projected in the advanced estimates (Table 1).

Table 1: GDP growth by sectors

	2Q13	3Q13	4Q13	2013	1Q14	2Q14
Percentage change year-on-year						
Overall GDP	4.0	5.0	4.9	3.9	4.8	2.4
Manufacturing	0.8	5.3	7.0	1.7	9.9	1.5
Construction	6.1	5.6	7.3	6.1	6.4	4.4
Services producing	5.7	5.8	5.5	5.3	3.9	2.6
Quarter-on-quarter annualised growth rate, seasonally adjusted						
Overall GDP	10.2	0.7	6.9	3.9	1.8	0.1
Manufacturing	17.6	0.0	10.4	1.7	12.3	-15.2
Construction	9.8	6.7	10.6	6.1	-0.5	0.3
Services producing	10.0	0.6	7.1	5.3	-1.5	4.5

The trajectory of growth remains fairly unchanged from our long held expectation. An average sequential growth of about 3-4% in the next two quarters will ensure that full year GDP growth meets our target of 3.0%. In fact, the official 2014 GDP growth forecast has also been narrowed to 2.5-3.5%, from 2.0-4.0% previously.

Uncertainties in manufacturing

Tepid performance in manufacturing

The main lift in the second quarter came from a better-than-expected June industrial production output. Industrial production in June surprised on the upside. The headline number registered a marginal expansion of 0.4% (YoY) against consensus expectation of -0.9%.

The main driver on industrial production was the chemical cluster, specifically the petrochemical segment. Petrochemical output was up 23.2% (YoY), which lifted the overall chemical cluster by 10.5%. In fact, the petrochemical segment has been clocking double digit growth since December and such strong showing came mainly from a one-off increase in production capacity.

However, most of the key drivers over the last 8-12 months have ebbed (Chart 1). The offshore marine engineering cluster has dipped into contraction. Electronics is still in the doldrums whereas the pharmaceutical cluster, although had provided a crucial jab in the arm for the overall manufacturing sector in June and May, has remained mainly volatile. Moreover, while the US manufacturing PMI has risen higher, the PMIs from China and Europe have fallen (Chart 2). Singapore's own PMI has also dipped into contraction territory in August.

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Chart 1: Mixed manufacturing performance

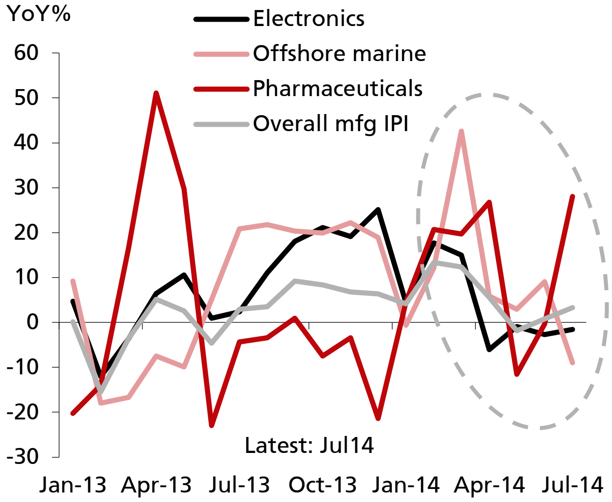
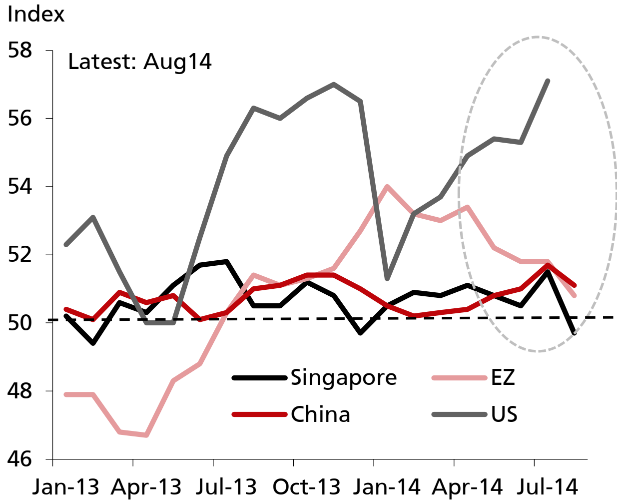


Chart 2: PMIs mostly down



Risk from exports

In addition, the losing streak in exports has continued. Headline non-oil domestic exports (NODX) for July shrank 3.3% (YoY). The key drag came from the electronics cluster. Electronics export sales have been in the slump for the last 24 months (Chart 3). The recent "firm specific" disruption to production capacity is adding salt into the wound.

Plainly, the economy is largely driven by external demand and export performance has a strong bearing on the nation's growth prospects. But as it is, NODX sales have been lacklustre. For the first six months, the total value of NODX is about 2.3% lower than in the same period last year. Risk is that NODX may post another year of contraction after a 6.0% drop in 2013. Note that NODX has never contracted by two consecutive years except during the global financial crisis in 2008-09, when sales were down by 7.9% and 10.6% respectively.

Moreover, while most expect a gradual improvement in global demand ahead, which will lift manufacturing activity, we do note that the manufacturing sector is weighed down by structural challenges. Domestic restructuring has resulted in a labour crunch, which is crimping export competitiveness and affecting the performance of exports and manufacturing. Such drag is already affecting GDP growth. Singapore is ultimately an export dependent economy. So if NODX continues to head south, growth will follow suit.

Chart 3: Slump in exports due to weakness in electronics

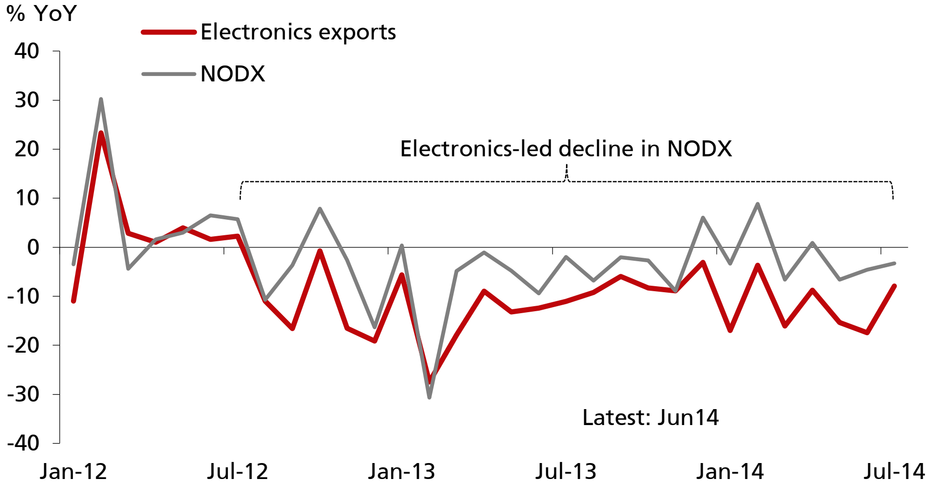


Chart 4: Labour crunch

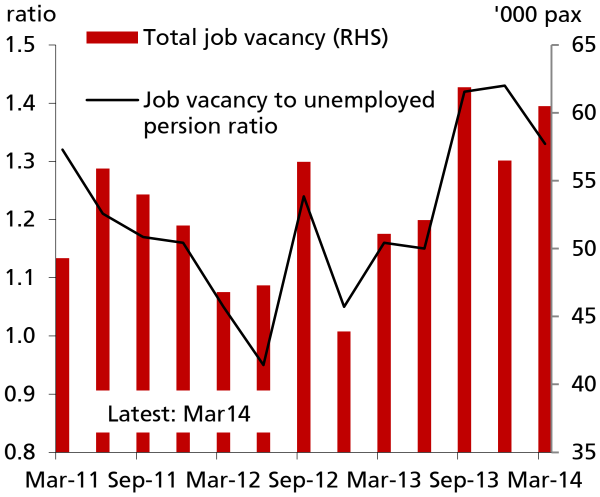
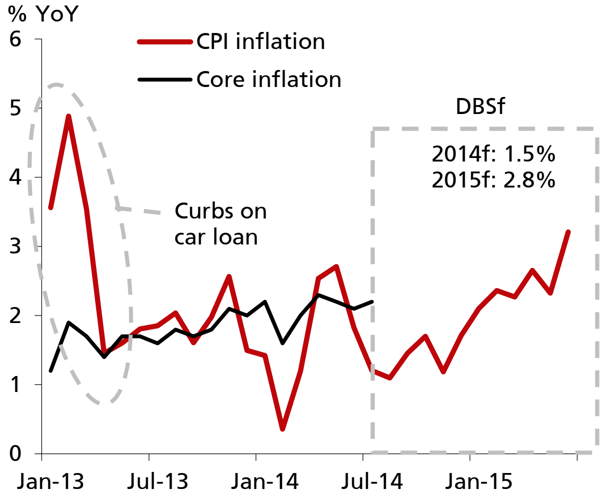


Chart 5: Inflation to pick up in 2015



Disappointment from services

But the main risk lies in the services sector. Traditionally the most stable engine of growth, the services sector has seen its growth momentum sliding in recent quarters. Growth slipped to 1.7% (YoY) in 2Q, down from 3.8% four quarters ago. The existing labour crunch due to curbs in foreign manpower has been taking a toll on this relatively more labour intensive sector. The total number of job vacancies in the economy registered 60,500 in 1Q, a rise of 18.4% from the same period last year (Chart 4). The ratio of job vacancy to unemployed person ratio has also spiked up to 1.33 in the first quarter, the highest since 4Q07. The labour market is extremely tight at present. As such, there is a risk that the services sector continues to slow in the coming quarters owing to the labour crunch.

Beyond the domestic structural drag, the external outlook is also a question. While expectation of a gradual recovery remains in place, recent data have been mixed. Demand from Asia and the West remains sluggish. Growth expectation for the US has been lowered. This is juxtaposed against a weak Eurozone and a slowdown in China. None of this bodes well for Singapore. Growth momentum going forward will be tepid. In sum, the economy continues to be weighed down by the domestic restructuring and external uncertainties. GDP growth is expected to average 3.0% in 2014 before improving marginally to 3.6% in 2015.

Inflation to pick up

Inflation set to rise in 2015

Headline inflation has remained low (1.2% YoY in July). But it doesn't reflect reality nor what lies ahead. Curbs in car loans last year and increase in COE quota over the past months have brought about decline in the COE premiums. With private transport cost having a high weightage of 11.7% in the CPI basket, it is no surprise that the headline CPI inflation readings have been benign.

But these are all policy-driven. Underlying cost pressure within the economy has been high. That explains why the core inflation reading has occasionally been higher than the headline number (Chart 5). Higher business costs due to wage pressure and rapid increase in rental have been passed on to consumers. And with both factors unlikely to ebb in the near term, inflation is set to rise in 2015. We have lowered our inflation forecast for 2014 to 1.5%, from 2.1% previously. However, inflation is expected to rise to 2.8% in 2015.

Inflation will be higher and growth is set to remain slow. But the Monetary Authority of Singapore is unlikely to change its policy stance as the downside risk to growth remains manageable. We expect the authority to maintain its current policy stance of a gradual appreciation of the Sing NEER in the upcoming review in October.

Singapore Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
Real GDP (00P)	3.9	3.0	3.6	2.4	3.0	2.0	2.8	3.5	4.0
Private consumption	2.6	1.6	2.2	1.3	1.6	1.5	1.8	2.0	2.4
Government consumption	9.8	3.2	5.3	15.4	4.5	2.6	4.0	6.0	5.0
Gross fixed investment	-1.9	-1.1	1.5	-1.8	-1.0	-0.7	1.0	1.7	1.0
Exports	3.6	4.0	3.5	2.5	3.5	2.9	3.5	3.2	3.7
Imports	3.1	3.2	3.2	1.7	2.4	3.2	3.0	3.2	3.2
Real supply									
Manufacturing	1.7	4.2	5.7	1.5	4.0	2.1	0.5	6.8	7.3
Construction	6.1	0.6	-0.1	4.4	-1.3	-6.1	-1.3	0.0	1.0
Services	5.3	3.0	3.4	2.6	3.3	2.4	3.9	3.1	3.3
External (nominal)									
Non-oil domestic exports	-6.0	-0.4	2.1	-3.4	-0.2	3.0	-1.7	5.6	2.2
Current account balance (USD bn)	54	54	56	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	19	18	18	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign reserves (USD bn)	273	280	290	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	2.4	1.5	2.8	2.4	1.3	1.5	2.2	2.7	3.3
Other									
Nominal GDP (USDbn)	287	296	315	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	1.9	2.1	2.4	2.0	2.0	2.1	2.2	2.3	2.4

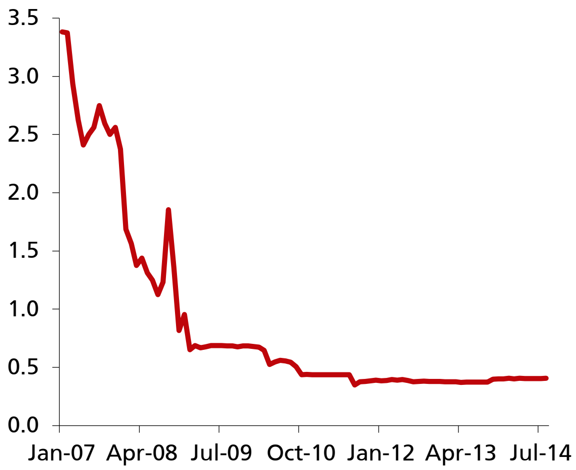
- % change, year-on-year, unless otherwise specified

SG - nominal exchange rate

SGD per USD

SG – 3mth SIBOR

% pa



PH: Strong for now

- GDP growth is likely to remain within the 6-7% range for 2014 and 2015
- Export growth remains supportive, led by the manufacturing sector. Contribution from net exports to remain positive for overall GDP growth
- Private consumption growth is resilient. Non-food consumption continues to lead overall consumption growth
- Underlying inflationary pressures are likely to persist and we expect CPI inflation to remain circa 4% in 2015
- Bulk of the adjustment in monetary policy has been delivered this year but further policy normalization is still forthcoming

We remain positive on the economy. Following the 6% recorded in 1H14, another 6-7% GDP growth is likely in 2014 and 2015. Investment growth has actually eased rather markedly in 2Q14, led by the public sector. This, however, was offset by strong exports in the period. Looking ahead, expect domestic demand to pick up. Fiscal spending is likely to accelerate going into 2015, following the temporary slump in 2Q14. Recent trend in exports remains encouraging. We have revised both our 2014 and 2015 GDP growth forecasts up slightly to 6.4% from 6.3% previously. Expect Bangko Sentral ng Pilipinas (BSP) to maintain its relatively tight policy stance.

Exports making a difference

Contribution from net exports to GDP growth came in at 4.2%-pt in 2Q14, highest since early-2012 (Chart 1). It is a sharp jump from the 1.2%-pt seen in the previous quarter and was the key driver that led GDP growth to 6.4% in 2Q14. The reason for this is two-fold. Export growth came in strong in the period. On the other hand, import growth moderated sharply, as a reflection of the significant pullback in fiscal spending.

But fiscal spending is likely to pick pace towards the year-end, as the government remains focused on the on-going infrastructure overhaul. The slowdown in April and May was likely to be temporary amidst the height of controversies regarding

Chart 1: Contribution to overall GDP growth

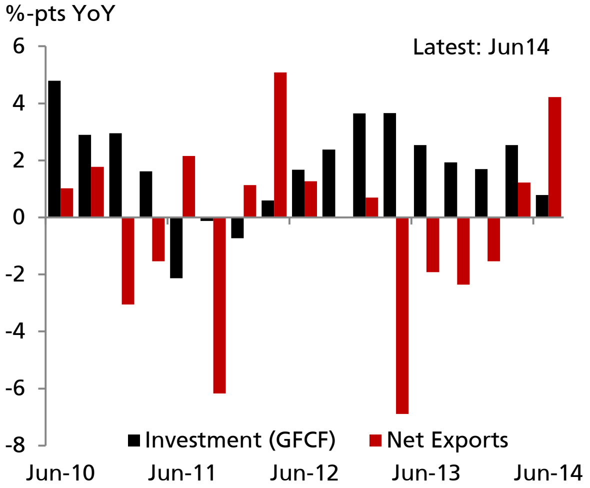


Chart 2: Fiscal spending rebounded in June

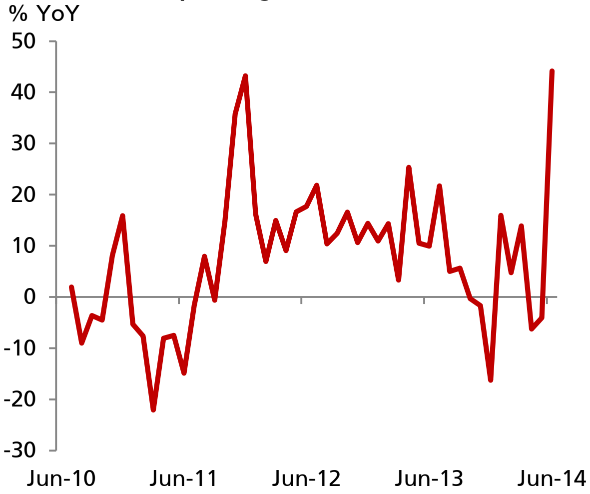


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Chart 3: Private consumption resilient

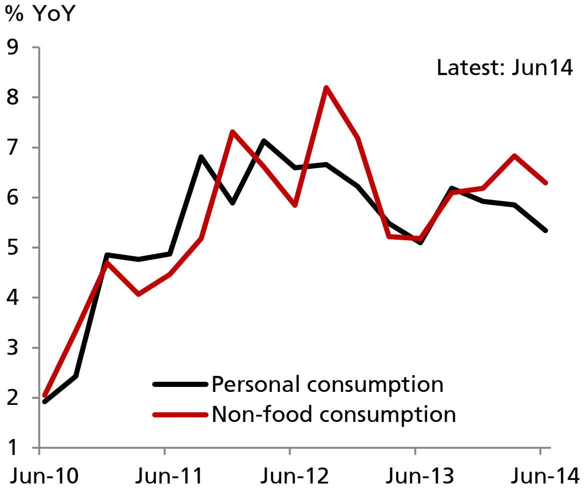
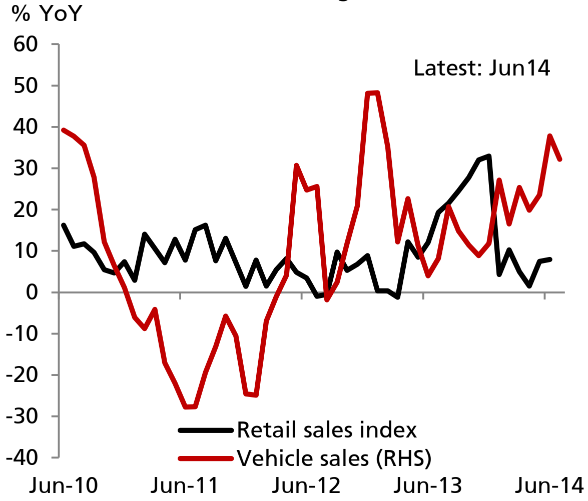


Chart 4: Robust vehicle sales growth



the Disbursement Acceleration Program (DAP). Indeed, fiscal spending jumped to 45% (YoY) in June again, after averaging a 5% (YoY) contraction in April and May (Chart 2, previous page).

While import growth is likely to recover alongside the bounce in domestic demand, contribution from net exports to overall GDP growth will remain positive. At the current pace, full-year export growth is likely to come in around 8-9% (YoY). Exports of manufactured goods did well in 2Q14, following a rather disappointing 1Q14. Exports of electronics and electrical components (E&E), which make up about 40% of total exports, are currently growing at about 5% pace similar to actual growth recorded in 2013.

Expect positive contribution from net exports to GDP growth this year

Domestic economy to remain strong

Domestic consumption growth has been resilient. Discretionary spending continues to lead overall consumption, with non-food consumption growth remaining steady above 6% (Chart 3). Up until July, retail sales growth is trending at 6% for the year, in line with the pace seen last year, while total vehicle sales are growing at a robust 20% pace (Chart 4).

The sustained strength in overseas foreign workers (OFW) remittances continues to provide a boost. While OFW remittances growth is likely to ease from 7.4% last year to about 5.5% this year, at an average of USD 2bn per month, the current trend remains supportive of overall private consumption growth.

With strong exports and consumption growth, it is hardly surprising to see decent momentum on the production end (Chart 5, next page). Industrial production has returned to double-digit growth in 2Q14, following the slow start to the year. At the current pace, average industrial production growth is likely to reach 7-8% for the year, up from 5.4% in 2013.

Inflation to remain supported at 4% into 2015

Look for resilient consumption growth to persist

Supply-side pressures have driven CPI inflation near 5% (YoY) in 3Q14. Food inflation is running at circa 8%, highest since early-2009. Upward pressure on utility charges also remains prevalent as we approach the year-end, although the recent easing in global crude oil prices may provide some relief on this front.

Looking ahead, underlying inflationary pressures are likely to persist given strong domestic demand. Indeed, core inflation is already trending circa 3.5% and likely to keep inflationary expectations up as we approach 2015. Expect CPI inflation to remain supported at around 4% in 2015.

Chart 5: Production growth sustained

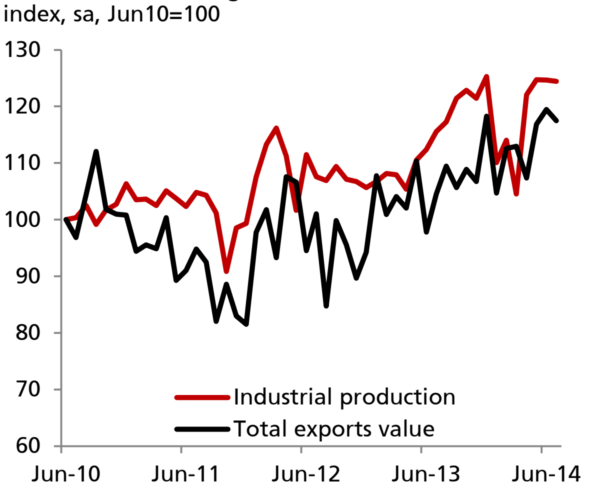
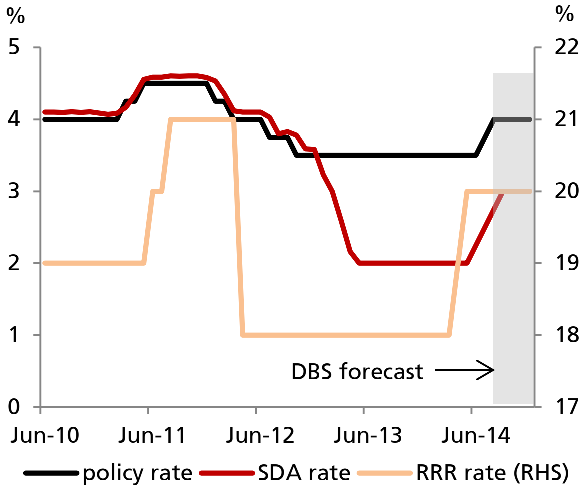


Chart 6: More tightening on the cards



Focus on long-term sustainability

Moderation in GDP growth is a result of policy normalization

BSP is focused on ensuring sustainable GDP growth in the longer-term, and thus, pushing for GDP growth to cross the 7% mark once again may not be that important in the near-term. Overheating risks are not glaring but not trivial either. At 5.5-6% trend, private consumption is above its long-term average growth of 4.5%. This is certainly positive but investment growth has also been running at double-digit pace in the past 3 years, well above its long-term average of 5.5%. And while GDP growth has averaged 6.8% in the past 10 quarters, real GDP per capita growth is slightly below 5%.

The next couple of years will be crucial. The government aims to double its infrastructure spending by 2016, as bulk of the projects under the public-private partnerships (PPP) is due to be completed by 2020. There are risks on the implementation phase, however, as already shown during the slump in fiscal spending in 2Q14. As far as financing is concerned, it remains to be seen if the government will indeed relax restrictions on foreign investments in the economy.

Further monetary policy normalization still warranted

For now, the BSP is likely to continue leaning towards a hawkish stance in 2015. Besides making an effort to manage inflationary expectations, the central bank remains concerned about excessive liquidity in the financial system. Loan growth, currently at 20% (YoY), is likely to moderate in 2015 but may remain above 15% amidst the sustained expansionary fiscal policy stance.

Further monetary policy normalization likely

Bulk of the adjustment in monetary policy has already been delivered this year (Chart 6). We expect the key policy rate and the Reserve Requirement Rate (RRR) at 4.0% and 20% respectively by end-2014, close to where they were in early-2012 when the BSP kick-started its loose monetary policy cycle. Further policy normalization may be done through the Special Deposit Account (SDA), which will also help the central bank's absorb excess liquidity in the banking system.

The road to 2016

Ahead of the national elections in 2016, it is important to monitor developments on the political front, given how these may affect the prospect of economic reforms. President Aquino has recently suggested the possibility of him extending his term, which will require an amendment in the constitution. In any case, there are also concerns that early campaigning ahead of 2016 may prove to be a disturbance in the running of the government. This may affect the pace of spending and revenue collection. Stay tuned on this front.

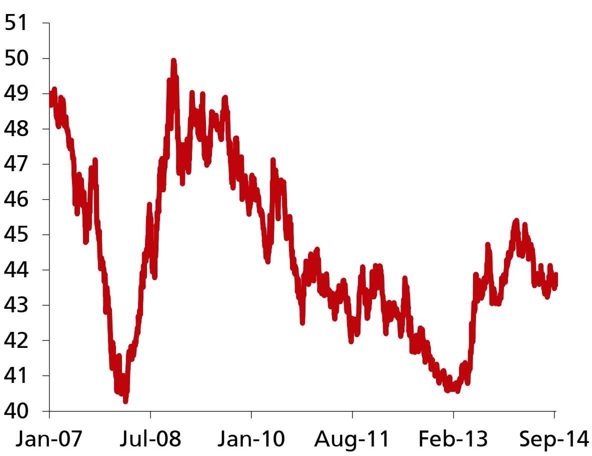
Philippines Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
Real GDP growth	7.2	6.4	6.4	6.4	6.9	6.9	5.9	5.6	6.8
Private consumption	5.7	5.3	5.5	5.3	5.5	5.3	5.2	5.6	5.8
Government consumption	7.7	3.2	9.5	0.0	2.8	10.2	9.3	9.6	9.5
Gross fixed capital formation	11.9	7.7	10.0	4.0	7.0	8.3	9.2	12.4	10.0
Net exports (PHP bn, 00P)	-150	43	108	114	41	-92	20	101	46
Exports	-1.1	9.3	10.0	10.3	4.6	9.6	9.9	10.3	9.0
Imports	5.4	2.7	8.2	1.4	-3.1	3.8	4.8	13.3	8.8
External (nominal)									
Merch exports (USD bn)	57	62	65	16	17	16	17	17	17
- % YoY	10	9	5	14	13	14	21	6	0
Merch imports (USD bn)	62	63	66	15	16	16	16	16	17
- % YoY	0	2	5	7	-6	0	0	7	6
Merch trade balance (USD bn)	-5	-1	-1	1	1	0	1	1	0
Current account balance (USD bn)	9	8	8	n.a	n.a	n.a	n.a	n.a	n.a
% of GDP	3.3	2.9	2.7	n.a	n.a	n.a	n.a	n.a	n.a
Foreign reserves, USD bn	83	80	82	n.a	n.a	n.a	n.a	n.a	n.a
Inflation									
CPI inflation	2.9	4.4	4.1	4.4	4.8	4.3	3.8	4.1	4.2
Other									
Nominal GDP (USD bn)	272	280	300	n.a	n.a	n.a	n.a	n.a	n.a
Budget deficit (% of GDP)	-1.4	-1.6	-1.8	n.a	n.a	n.a	n.a	n.a	n.a
Total external debt (USD bn)	59	58	58	n.a	n.a	n.a	n.a	n.a	n.a
Public sector (USD bn) **	41	41	41	n.a	n.a	n.a	n.a	n.a	n.a

* % change, year-on-year, unless otherwise specified
** includes government, central bank and state-owned banks

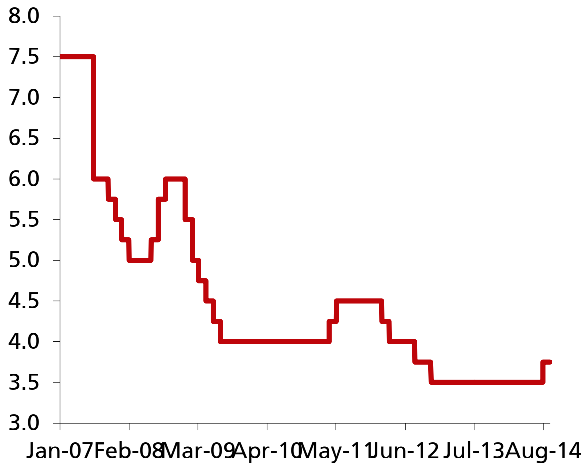
PH - nominal exchange rate

PHP per USD



PH – policy rate

%, o/n rev repo



VN: Balanced growth

- **Stable growth has taken hold and full year GDP growth is on track to meet our target of 5.4% and 5.7% in 2014 and 2015 respectively**
- **Inflation has remained benign but set to rise, averaging 4.8% this year and 5.8% in 2015**
- **The SBV will likely stand pat on monetary policy, keeping the benchmark refinance rate at 6.50% in the coming quarters**

Growth has improved amid weak domestic demand. GDP growth in the second quarter registered 5.5% (YoY), up slightly from 4.8% in the first quarter. The improvement came mainly from the external front.

Export boost

Export sales expanded about 13% in the first eight months compared to the same period last year. This has brought about a total trade surplus of about USD 1.1bn year-to-date (Chart 1). In fact, export demand has helped to offset the slack in domestic growth and boosted industrial activities (Chart 2). Except for the mining and quarrying sector, overall industrial production output has risen significantly over the last few months.

Yet, there are signs that such external boost may moderate going forward. The PMIs for most of the key export markets have dipped (Chart 3). Outlook for the key electronics cluster appears to run sideways in the coming months too. Leading indicators such as the SEMI book-to-bill ratio as well as the global semiconductor sales suggest that the electronics cycle may have peaked (Chart 4).

Nonetheless, barring any negative shock to the global economy, external demand will at worst moderate gradually. Overall trade surplus for the year is still on track to beat last year's USD 385mn.

Chart 1: Trade balance remains in surplus

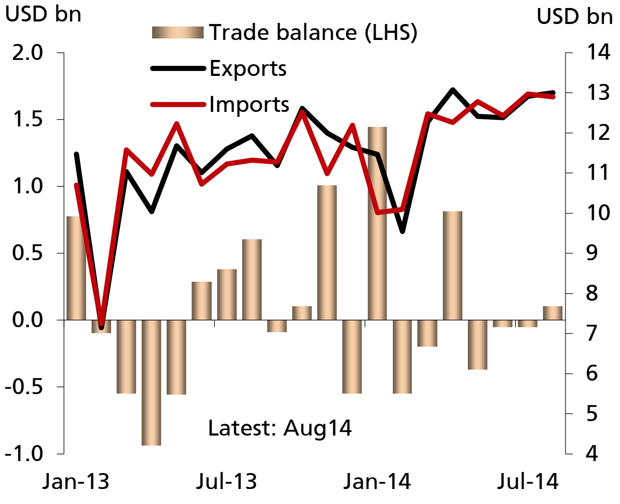


Chart 2: IPI mostly heading up

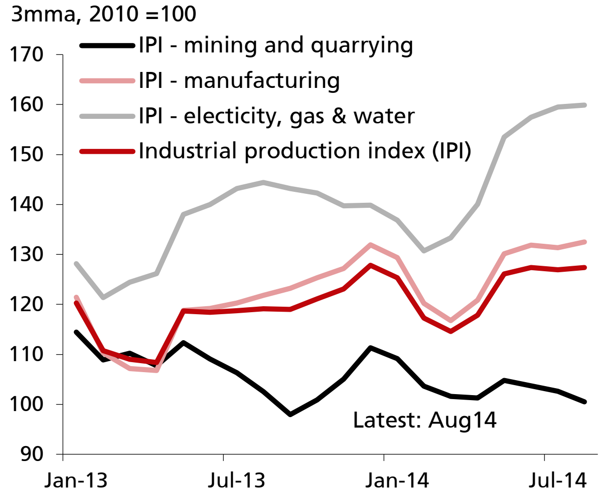


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Chart 3: PMIs mostly down

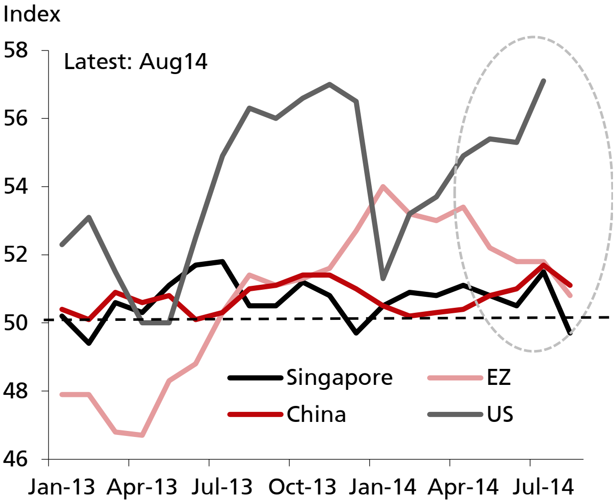
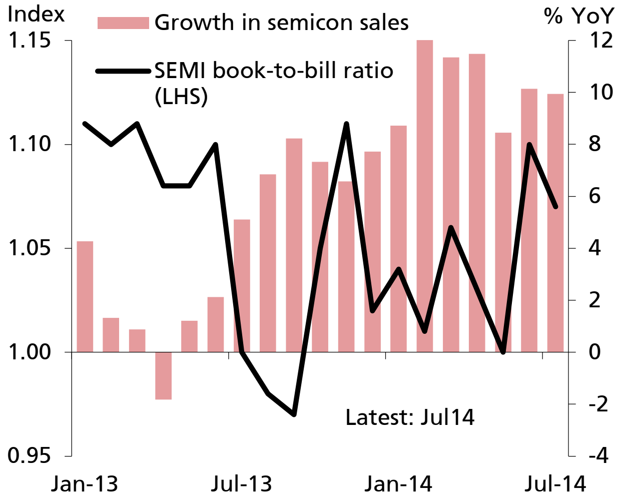


Chart 4: Electronics cycle has peaked



Domestic engines cooling

The domestic economy is not out of the woods. Retail sales growth has been easing as effects of the still fairly tight credit conditions have led to consumers tightening their purse strings (Chart 5). Reflecting the slower domestic demand, credit growth as of June this year registered an anemic pace of just 3.52% (YoY). While this is a marked improvement from a mere 0.01% as of end-March, it is nevertheless still far from this year's official target of 12-14% growth.

However, credit growth in the second half of the year tends to accelerate. Credit growth was 4.5% (YoY) in 1H13 but soared up to 12.5% by the end of the year. So it remains to be seen whether history will repeat itself again and much will depend on private consumption and investment growth in the coming few months.

But as it is, investment growth has been easing too. Apart from the effort to rein in the fiscal deficit, which has led to slower disbursement in developmental infrastructure projects and thus weaker construction growth, foreign direct investment (FDI) has moderated as well (Chart 6). Total FDI inflows in the first eight months of the year registered USD 7.2bn, still about 200mn short of the level in the same period last year.

Chart 5: Domestic retail sales softening

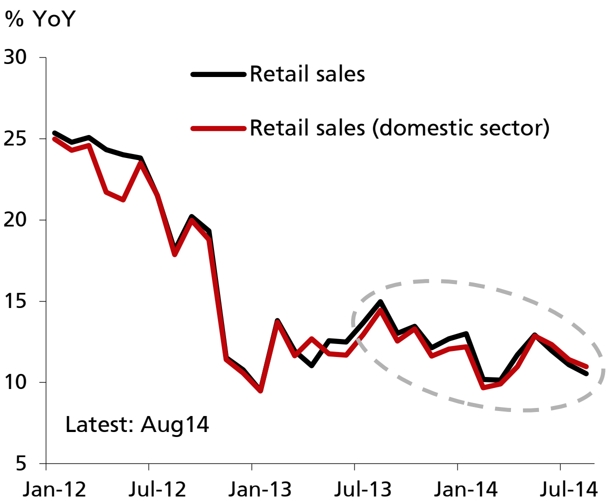


Chart 6: Lower FDIs year-to-date

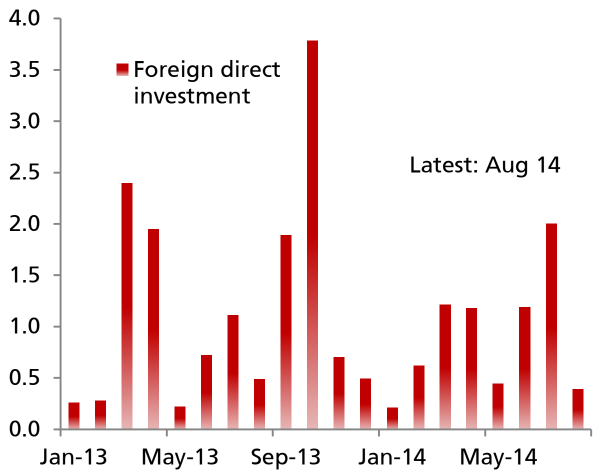
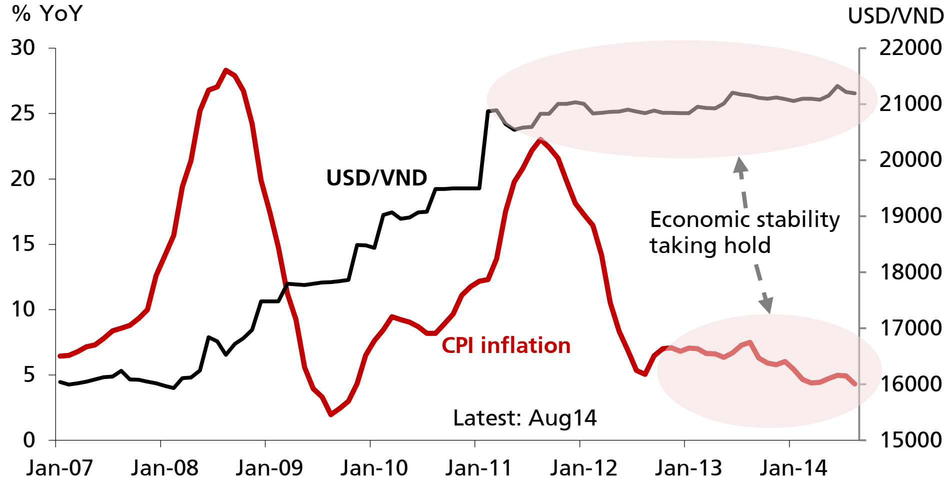


Chart 7: Stable outlook



Balanced growth

The economy remains firmly on a stable and sustainable economic development path despite slower growth. Such improved economic stability, evidenced by inflation and exchange rates, was recognized by Moody's, which upgraded Vietnam's sovereign credit rating to B1 recently in July (Chart 7). Going forward, growth will likely continue to be powered by external demand while domestic growth will be supported by the existing accommodative monetary policy, as well as additional stimulus spending by the state.

Outlook to remain stable

However, external headwinds may pick up. The Eurozone appears to be falling back into the doldrums. The recovery in the US is progressing, albeit in a sluggish pace. China's growth is holding up but the earlier East Sea spate with China has left a tinge of "after-taste" in term of economic relationship between these two neighbours.

Broadly, we expect GDP growth to pick up marginally to 5.7% (YoY) in the second half. This will meet our long held forecast of 5.4% growth for the full year. In 2015, GDP growth is expected to pick up to 5.7% on improved global outlook and a stable monetary policy stance.

Benign inflation, stable monetary policy

Due to soft domestic demand, demand-pull inflationary pressure is almost non-existent. The lack of global price pressure and a modest strengthening in the local currency have also helped to keep imported inflation at bay. The headline CPI inflation has been easing. Latest August CPI inflation registered 4.3% (YoY), compared to 7.5% twelve months ago. Indeed, the slowdown in domestic growth coupled with the easing in inflation are what prompted the State Bank of Vietnam to loosen monetary policy in March.

SBV to stand pat

While there is risk that the central bank may cut policy rate by another 50bps, it is rather limited. Inflation will likely pick up towards the end of the year. The price adjustments by the state in healthcare services (starting 1st August) and tuition fees, as well as the potential rise of gasoline and petrol prices due to further subsidy cuts will most certainly drive inflation higher.

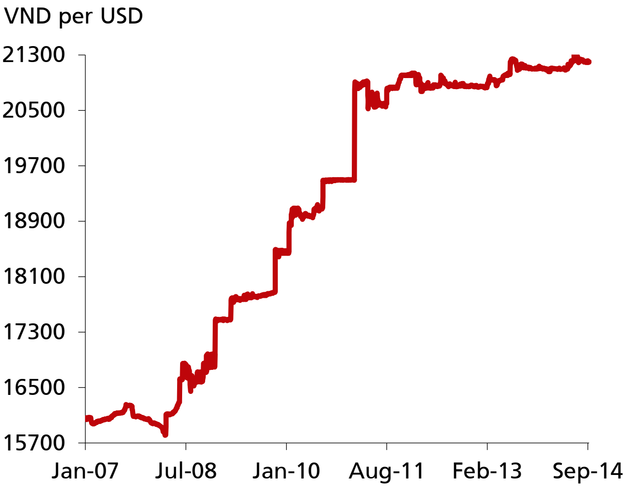
So despite the lower-than-expected inflation in 1H14, we are maintaining our inflation forecast for 2014 and 2015 at 4.8% and 5.8% respectively. Juxtaposed this with the expected steady improvement in GDP growth, the current policy rate of 6.50% appears appropriate. Monetary policy stance should remain status quo in the coming quarters.

Vietnam Economic Indicators

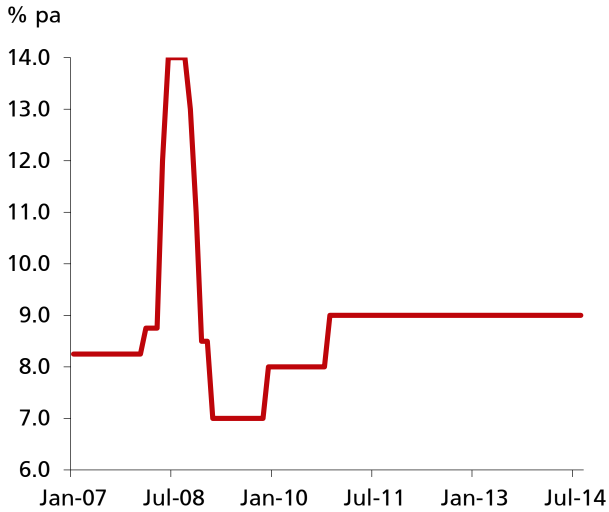
	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth	5.4	5.4	5.7	5.5	5.7	5.7	5.8	5.6	5.7
Real supply									
Agriculture & forestry	2.6	3.2	3.5	3.2	3.8	3.5	3.5	3.5	3.5
Industry	5.3	5.6	5.8	6.2	5.7	5.8	5.8	5.8	5.8
Construction	5.6	5.5	6.0	5.5	7.2	6.0	6.0	6.0	6.0
Services	6.5	6.2	6.5	6.1	6.3	6.5	6.5	6.5	6.5
External (nominal)									
Exports (USD bn)	133.3	148.4	151.7	37.9	38.2	39.0	36.6	41.6	42.0
Imports (USD bn)	132.9	147.6	150.8	37.5	38.3	39.3	35.8	41.2	42.1
Trade balance (USD bn)	0.4	0.8	0.9	0.4	0.0	-0.2	0.8	0.4	-0.1
Current account bal (USD bn)	5.3	8.3	8.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
% of GDP	3.4	4.4	3.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inflation									
CPI inflation	6.6	4.8	5.8	4.7	4.5	4.9	5.2	6.2	6.1
Other									
Nominal GDP (USDbn)	171	190	211	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%, sa, eop)	3.3	3.0	3.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

- % change, year-on-year, unless otherwise specified
- Figures may differ from official sources due to difference in reporting format

VN - nominal exchange rate



VN – prime interest rate



US: Back into the red

- **Job creation has not strengthened this year. It has softened**
- **Payrolls are down because growth is down**
- **Growth in the first six months of this year comes to 1%, half the pace of the past five years**
- **We expect growth of 1.9% (QoQ, saar) and 2.6% in Q3 and Q4. That would bring average growth over the past 4 quarters to 1.6%**
- **Given that growth has averaged 2% for the past five years, it's hard to say things are moving in the right direction**
- **Judging from the capital overhang, growth could remain slow for several more years**

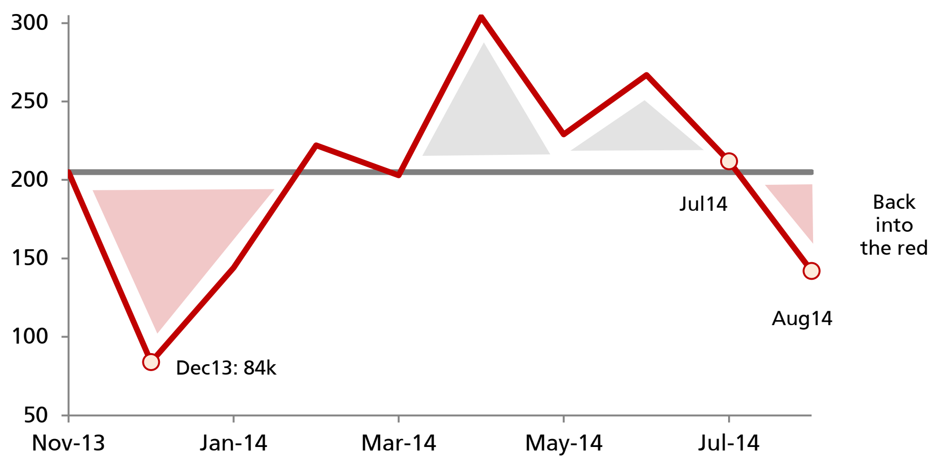
When Yellen spoke about labor markets at the Jackson Hole conference two weeks ago, the first thing she noted was the improvement in nonfarm payrolls – job growth had, at the time anyway, "averaged 230k per month in 2014 compared to 190k in 2012/2013". That wasn't a particularly relevant comparison, of course. It was a nod to her several more hawkish colleagues who are anxious to hike rates sooner rather than later – a (more than) generous tip of the hat and little more.

The relevant comparison, as everyone knew, was before and after December 2013, when payrolls plunged to 84k on the back of bitter cold weather. Payrolls had been averaging 204k through November, before crashing in December and January. So the real question was: had better numbers in April and June made up for those losses? Had job creation really improved?

The answer is, no. As noted, payrolls averaged 204k/month between Jan13-Nov13. From Dec13-Jul14, they averaged 208k. In short, all of better payrolls outcomes in

US – nonfarm payrolls

x1000 per month



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April and June were nothing but 'payback' for the exceptionally weak numbers in December and January. Trend growth before and since December 2013 had changed by an insignificant 4k – nothing.

Enter August. Payrolls grew by 142k, some 90k short of expectations. Relative to the 204k bogey that prevailed before the cold weather hit, payrolls fell 65k back into the red. Since November 2013, including the two bad months and the two good ones, payrolls have averaged 201k/month. Job creation has not improved. If one wants to split hairs, it has softened.

Job creation has not strengthened. It has softened

What goes around comes around

August payrolls might have been overstated to the downside but the idea that the broader economy is stronger than the payrolls suggest is wrong. GDP grew by 4.2% (QoQ, saar) in Q2 but that too was merely 'payback' for the 2% contraction in Q1. And it wasn't especially strong payback either. It left growth at 1% for the first six months of the year, half the pace of the past five years.

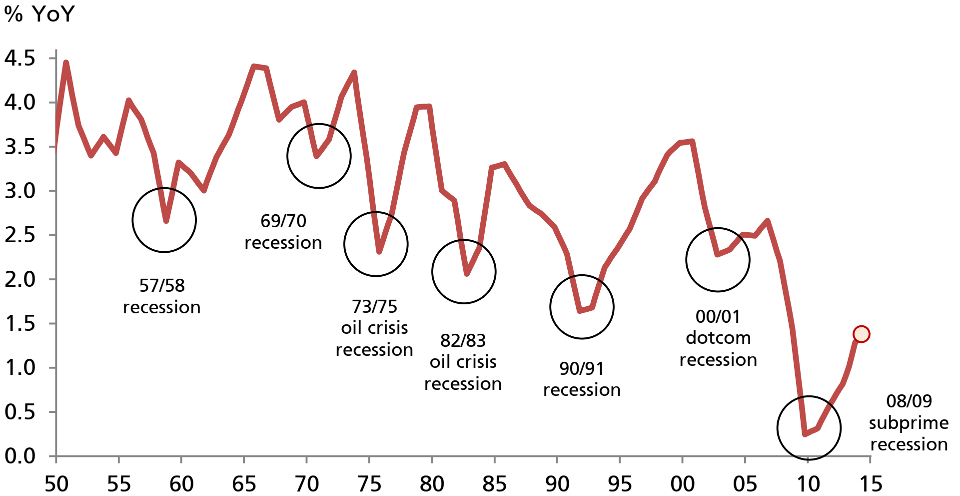
The question is, will 4% growth prevail in Q3 and Q4? And the answer is, it doesn't look that way. Consumption fell in July and, even with the spurt in auto sales in August, appears headed for quarterly growth of 1.5% (QoQ, saar). That's a big step down from last quarter's 2.5% growth and barely higher than the 1.2% registered in Q1. Average consumption growth of 1.7% for the past three quarters doesn't suggest any sort of acceleration is underway for the biggest demand component in the economy.

Capital overhang

Investment has been remarkably weak. Since Jan-2012, core capital goods shipments have grown at barely a 3% pace. After netting out depreciation, capital stock growth remains at only 1.5% per year. That's slower than the slowest growth registered in any of the previous six recessions – and it's been four years since the US hit bottom (chart below).

One might think, therefore, that the economy is starved for capital. One would be wrong. With so much firing and so little hiring since the crisis began, capital:labor ratios have jumped sharply above trend – labor is swimming in a pool of capital (chart at top of next page). The capital overhang is keeping investment and GDP growth slower than they otherwise would be. And at the current pace of absorption, it could well be another 6-7 years before the overhang is eliminated.

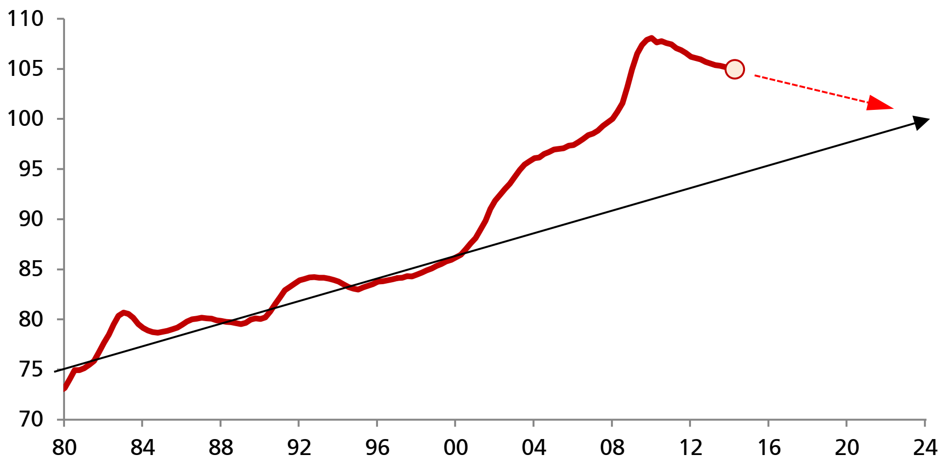
US – capital stock growth



A significant capital overhang remains

US – K stock per worker

1Q08=100, 09P



Housing remains the key risk

Mortgage applications have fallen sharply since May 2013 and are now only 2.9% higher than at the nadir of the crisis four years ago (chart below). Put differently, 92% of the two-year recovery in mortgage applications is now entirely gone. New home sales aren't faring quite as poorly but almost. They stopped growing back in early-2013 and as of July have handed back 30% of their two year recovery. Given that home sales and construction lag mortgage applications, the outlook for them can only be characterized as precarious. Housing has been the biggest risk to the outlook for the past 18 months and it remains so today.

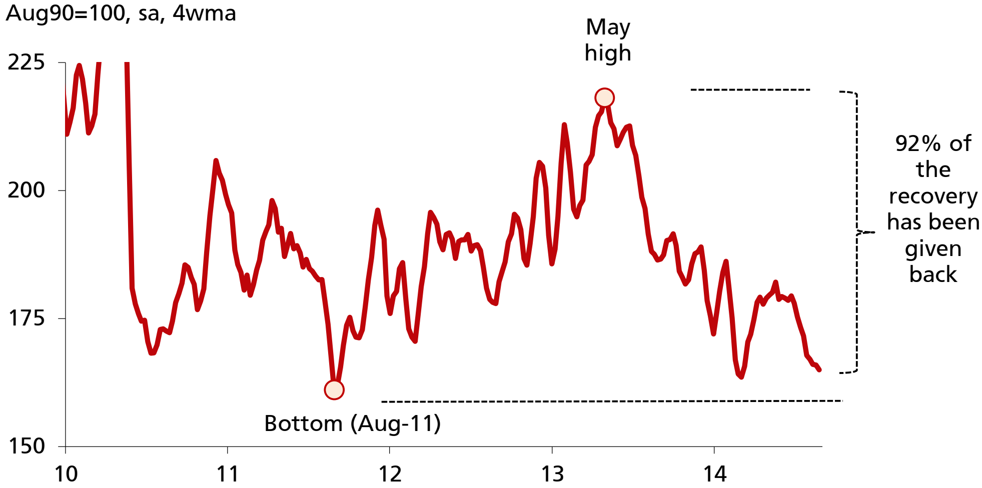
The bottom line for growth

Put it all together and our best estimate for third quarter GDP growth currently stands at 1.9% (QoQ, saar). That would bring this year's first three quarters' growth to 1.3% on average. A more generous 2.6% outcome in the fourth quarter would lift the 4-quarter average in GDP growth to 1.6%. Considering that growth has averaged 2% per year for the past five years, it's hard to say things are moving in the right direction.

Housing remains the key risk to the broader outlook

US - mortgage applications for purchase

Aug90=100, sa, 4wma



US Economic Indicators

	2013	2014(f)	2015(f)	Q1	-- 2014 -- Q2	Q3 (f)	Q4 (f)	--- 2015 --- Q1 (f)	Q2 (f)	Q3 (f)
Output & Demand										
Real GDP*	2.2	1.9	2.6	-2.1	4.2	1.9	2.6	2.5	2.5	2.7
Private consumption	2.4	2.1	2.2	1.2	2.5	1.5	2.2	2.3	2.4	2.5
Business investment	3.0	5.7	5.5	1.6	8.4	6.0	5.0	5.0	5.0	6.0
Residential construction	11.9	1.7	5.1	-5.3	7.2	6.0	4.0	5.0	5.0	5.0
Government spending	-2.0	-0.6	0.2	-0.8	1.4	0.2	0.2	0.0	0.0	0.0
Exports (G&S)	3.0	3.2	5.5	-9.2	10.1	4.6	6.8	4.8	4.8	4.8
Imports (G&S)	1.1	3.7	3.9	2.2	11.0	0.0	4.0	4.0	4.0	4.0
Net exports ($bn, 09P, ar)	-420	-445	-430	-447	-464	-440	-430	-430	-430	-430
Stocks (chg, $bn, 09P, ar)	64	57	60	35	84	55	55	60	60	60
Contribution to GDP (pct pts)										
Domestic final sales (C+FI+G)	2.0	2.1	2.4	0.7	3.2	2.0	2.3	2.4	2.5	2.7
Net exports	0.2	-0.2	0.1	-1.6	-0.4	0.6	0.2	0.0	0.0	0.0
Inventories	0.0	0.0	0.0	-1.2	1.2	-0.7	0.0	0.1	0.0	0.0
Inflation										
GDP deflator (% YoY, pd avg)	1.5	1.4	1.4							
CPI (% YoY, pd avg)	1.5	1.7	1.9	1.4	1.9	1.8	1.8	1.9	1.9	1.9
CPI core (% YoY, pd avg)	1.8	1.7	1.7	1.6	1.9	1.7	1.6	1.7	1.7	1.7
PCE core (% YoY, pd avg)	1.2	1.4	1.5	1.2	1.5	1.4	1.3	1.5	1.5	1.5
External accounts										
Current acct balance ($bn)	-379	-435	-452							
Current account (% of GDP)	-2.3	-2.5	-2.5							
Other										
Nominal GDP (US$ trn)	16.8	17.4	18.1							
Federal budget bal (% of GDP)	-4.1	-3.4	-3.2							
Nonfarm payrolls (000, pd avg)				190	267	180	200	210	220	220
Unemployment rate (%, pd avg)				6.7	6.2	6.2	6.2	6.1	6.1	6.0

* % period on period at seas adj annualized rate, unless otherwise specified

In this light, the drop in August payrolls to 142k isn't especially surprising. What goes around comes around. Unless and until GDP growth ticks back above 2% on a sustainable basis – a truly low bar to leap – payrolls should not be expected to rise back above the 201k/month they have now averaged since November 2013 or the 206k they have averaged since January 2013.

Several Fed officials are anxious to hike rates. It's a mystery why

Meanwhile, inflation continues to languish well below the Fed's 2% target. A 17% rise in oil prices between January and July raised inflation slightly during Q2 but with oil prices now in retreat inflation will soon follow. Unfortunately, the modest rise was never due to strong / strengthening demand.

Several Fed officials are anxious to hike rates. Given the softening in job creation, growth and inflation, it's a mystery why.

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

JP: Back to reality

- **Growth momentum has stalled after the sales tax hike; market enthusiasm about Abenomics is ebbing**
- **The government needs to finalize decisions on the next sales tax hike by Dec. A confirmation of the sales tax hike would be accompanied by a supplementary budget and corporate tax cuts**
- **The Bank of Japan is expected to extend the QQE program into 2015**

Bad data

Impact of sales tax hike bigger than expected

Japan's growth recovery has stalled after the government's hike of sales tax in April. GDP growth contracted sharply by 7.1% (QoQ, saar) in 2Q, a similar rate of decline as in 1Q11 when the economy was hit by the earthquake / tsunami disaster (Chart 1). Private consumption plunged as much as 19.0% in 2Q, which has exceeded the 13.2% decline witnessed during the first-ever sales tax hike in 2Q97.

Due to the lingering impact of the tax increase and the interruption of typhoon weather this summer, the economy has remained stagnant at the start of 3Q. The high frequency indicators, including retail sales, household spending and industrial production, remained flat in July (Chart 2).

Our GDP growth forecast for 2014 has been revised down to 1.2%, compared to 1.4% one quarter ago. Owing to technical reasons, we still look for a growth rebound to 2-3% (QoQ saar) in 3Q-4Q. Stripping out the quarterly volatility, the sequential growth in the four quarters of this year is expected to average just 1%. GDP growth is projected to stay at the 1% level in 2015.

Faltering confidence

Poor economic data have dampened investors' enthusiasm about Abenomics. The Nikkei moved sideways so far this year, failing to replicate its strong rise in 2013.

Chart 1: GDP growth fell sharply in 2Q

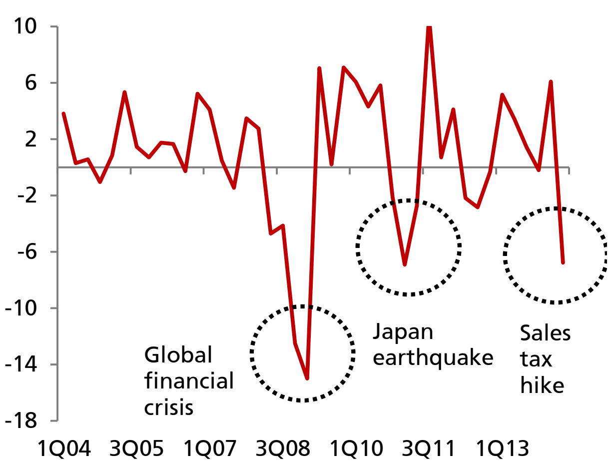
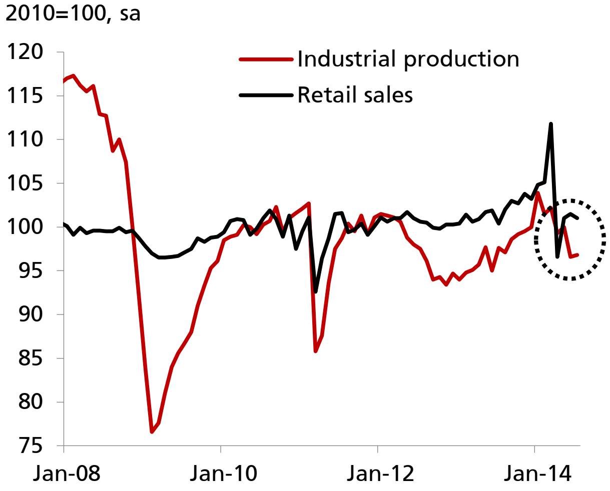


Chart 2: Output/consumption remained weak in July



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The Japanese yen was range bound against the US dollar in the first eight months of this year, at 100-105.

More recently, the USD/JPY rate rose above the 105 mark since the beginning of September, and the non-commercial net short positions in the JPY futures market increased again. This was mainly due to rising market expectations about the divergence in US's and Japan's monetary policies.

In the credit market, the lack of confidence was reflected in the prudence of lending / borrowing behavior. Bank loans growth registered 2.7% (YoY) in 1H14, barely changed compared to 2.6% in 2013. This is far lower than the pace of the BOJ's base money expansion in the last 1.5 years (about 40%, Chart 3).

Tougher decisions facing the government

Another sales tax hike is scheduled for 2015

The government will need to make a tough decision in December, regarding whether to raise the sales tax further in 2015. The hike of sales tax in April this year, from 5% to 8%, was only the first step of the government's medium-term plan of balancing budget deficits and fixing public finances. Based on the original plan, the sales tax rate will be lifted higher to 10% in October 2015.

Discussions regarding whether to go ahead with the next tax hike will heat up in the coming months. Our base case scenario is for the government to stick to the plan of raising sales tax in Oct15, in order to bolster investors' confidence in Japan's fiscal discipline and avoid jitters in the bond market. Official rhetoric on the economy currently remains very optimistic, which doesn't suggest the possibility of a policy U-turn in the near term.

The government and the central bank have both stressed that the 2Q GDP contraction was one-off and growth will bounce back resiliently in the second half of this year. The 3Q GDP – a crucial indicator watched by the government to make the tax decisions – is expected to show a technical rebound to 2-3% (QoQ saar). On the surface, economic data would still provide enough justifications for the fiscal hawks to argue for the next sales tax hike.

In order to prevent the economy from being hit hard again, the government is expected to prepare another supplementary budget (about JPY 3trn) and finalize the details of corporate tax cuts by the end of this year. To directly cushion the impact of sales tax hike, spending under the supplementary budget is expected to be allocated more towards the household sector this time.

Chart 3: Bank lending growth still subdued

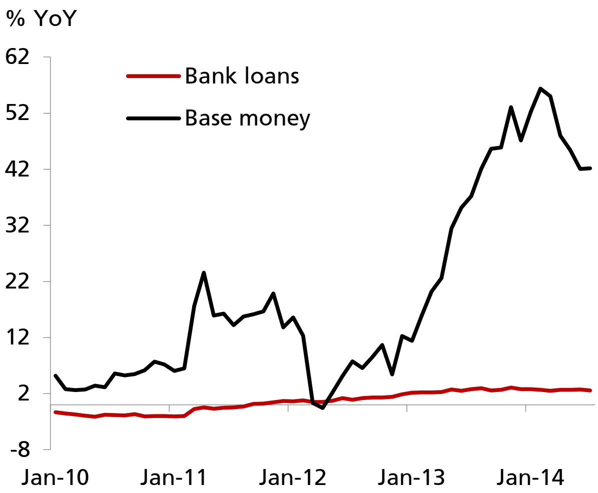
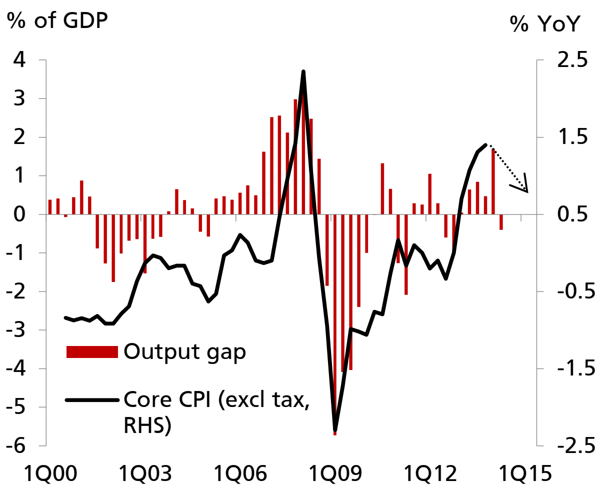


Chart 4: Inflation has peaked



Mounting pressures facing the BOJ

QQE expected to be extended

If the second sales tax hike were to be confirmed, pressures would also mount for the Bank of Japan (BOJ) to ease monetary policy to bolster economic growth. We expect the BOJ to firstly downgrade the GDP growth forecasts at its policy meeting in October. The BOJ's FY2014 growth estimate of 1.0%, which requires quarterly growth to rise to 5% (QoQ, saar) in 3Q-4Q, is too optimistic. A big revision to 0.5% is necessitated, in our view. Subsequently, the BOJ is expected to make a policy announcement by December's meeting, extending the QQE program into next year and specifying the base money target for end-2015.

Still, fresh easing measures are not expected in the near term. The BOJ's FY2014 inflation forecast of 1.3% (core, excluding sales tax) currently remains on track, although the FY2015 forecast of 1.9% is highly questionable. Wages growth, another important indicator monitored by the BOJ to evaluate the underlying price trends, has also picked up recently (2.6% YoY in July).

Our view is that inflation has peaked and will ease from 4Q onwards, reflecting the lagging effects of the deterioration of output gap after the sales tax hike (Chart 4). Growth of bonuses and other non-scheduled pays – the key contributors to total wages growth – may have peaked too (Chart 5). As such, we think the pressures facing the BOJ to make policy adjustments will become more acute in 2015.

Competitiveness remains a concern

The long-term economic outlook remains discouraging. Trade competitiveness is still a concern, due to the continuation of industrial hollowing-out and the erosion of technology advantage. Japan's electronics exports, for instance, persistently underperformed Taiwan's and Korea's in the last few years, in spite of the cyclical upturns in the global smartphone market (Chart 6).

Economic reforms remain slow. A new version of the long-term growth strategy – the 3rd arrow of Abenomics – was unveiled in June, which proposed corporate tax cuts and government pension funds reforms. In the crucial areas such as immigration and foreign investment access, changes were small and trivial.

A latest sign that Abe remains committed to reforms is the cabinet reshuffle conducted in September. A record number of female ministers were appointed, in line with the reform objectives of bringing more women into the workforce. Nonetheless, there is no guarantee that forceful reforms can be implemented after the cabinet reshuffle. Vested interest in the private sector and policy coordination at the local government level will need to be dealt with.

Chart 5: Wage growth may have peaked, too

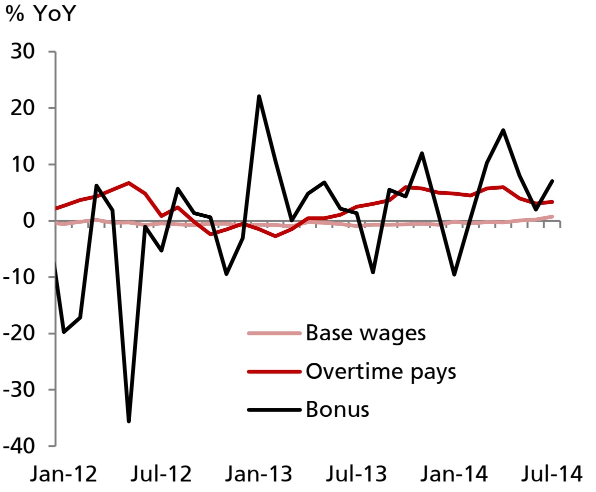
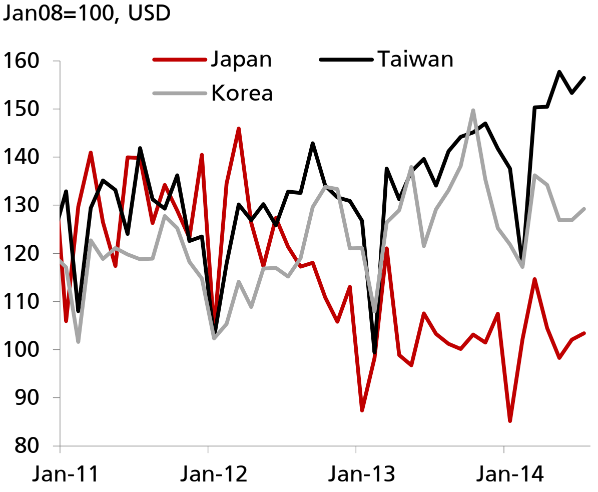


Chart 6: Japan's electronics exports underperformed



Japan Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth	1.5	1.2	1.0	-0.1	0.4	1.4	-0.1	2.0	2.1
Private consumption	2.0	-0.3	0.6	-2.6	-1.5	-0.5	-2.2	3.3	3.3
Government consumption	2.0	0.4	1.0	0.4	0.4	0.8	1.0	1.0	1.0
Private & public investment	2.4	4.1	-0.4	3.2	0.9	-0.2	-4.6	0.4	3.4
Net exports (JPYtrn, 05P)	8.0	8.6	9.4	2.7	2.4	2.3	2.2	2.7	1.8
Exports	1.6	7.4	3.1	5.4	7.1	7.7	2.0	3.4	3.4
Imports	3.4	7.3	2.5	5.9	5.6	3.2	-2.4	4.1	7.0
External (nominal)									
Merch exports (JPY trn)	70	72	76	18	18	19	18	19	19
- % YoY	9.5	3.0	5.9	0.1	3.1	2.5	5.4	7.9	5.5
Merch imports (JPY trn)	81	85	88	20	21	21	22	22	22
- % YoY	14.9	4.7	3.3	2.8	1.7	-2.1	-3.0	7.3	4.8
Merch trade balance (JPY trn)	-11	-13	-12	-3	-3	-3	-3	-3	-3
Current acct balance (USD bn)	33	14	32	-	-	-	-	-	-
% of GDP	0.7	0.3	0.7	-	-	-	-	-	-
Foreign reserves (USD bn)	1,267	1,286	1,288	-	-	-	-	-	-
Inflation									
CPI, % YoY	0.4	2.9	1.5	3.6	3.3	3.0	3.0	0.8	0.4
Other									
Nominal GDP (USD bn)	4,905	4,747	4,600	-	-	-	-	-	-
Unemployment rate (%, sa, eop)	3.8	4.0	3.8	3.7	3.8	4.0	3.9	3.9	3.8
Fiscal balance (% of GDP)	-8.5	-7.2	-6.3	-	-	-	-	-	-

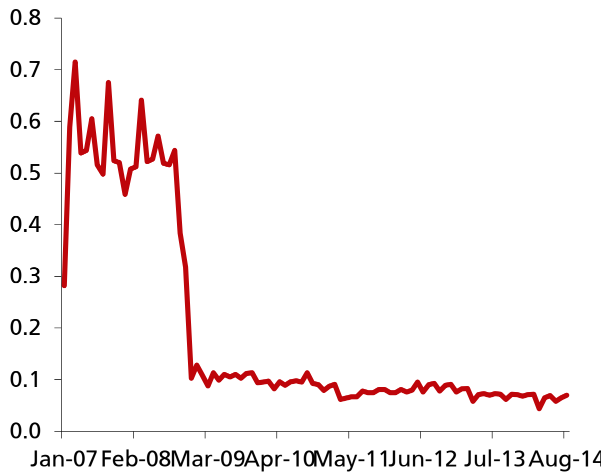
* % growth, year-on-year, unless otherwise specified

JP - nominal exchange rate

JPY per USD

JP – policy rate

%, call



EZ: Stagnates

- **We revise down our 2014 GDP growth estimate to 0.6% (prev: 0.9%). 2015 GDP seen recovering to 0.9%**
- **Inflation is likely to remain weak and below ECB target for this year and next at 0.5% and 0.8% respectively**
- **Focus on ECB calling for fiscal and structural support to spur growth, while inching towards quantitative easing**
- **Weak EUR to complement easier policy stance, but currency depreciation is a zero sum-game**

After a firm start to the year, the Eurozone economy came to a halt in 2Q. GDP growth was flat on the quarter, seasonally adjusted, and translated to 0.7% YoY. This took average 1H GDP to 0.1% (QoQ, sa), 0.8% YoY. As Chart 1 shows, on nominal terms the zone is smaller than its peak in 1H08 before the debt crisis surfaced. The OECD lead indicator (2-quarter lead) also corroborates the loss of growth momentum.

Growth to stay below 1.0% this year and the next

Worryingly, in 2Q it is not the periphery that underperformed, but the core member countries. German output contracted, while Italy slipped back into recession. At the same time, France was flat but Spain was a bright spot as it expanded 0.6% (QoQ, sa) in 2Q.

With the slowdown beginning to bite the core economies, the Eurozone looks set to wind-up on a sub-par note this year. On an aggregate level, high frequency indicators point to slowing household and capital spending in 2H. The unemployment rate has been edging down, but at a gingerly pace – half a percent improvement in ten months (see Chart 2, next page). This marks a one-fourth recovery to early-2011 levels, pointing to significant slack in the economy.

Chart 1: OECD lead indicator flatlines

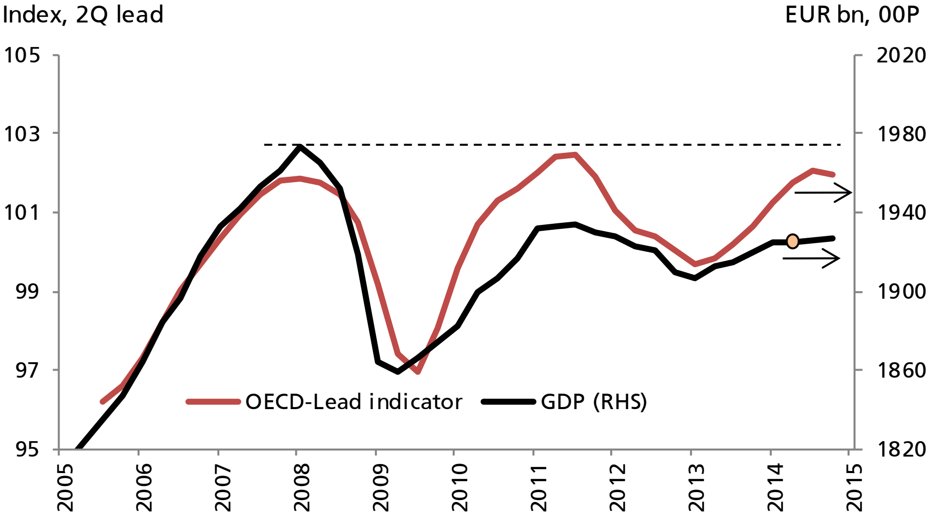


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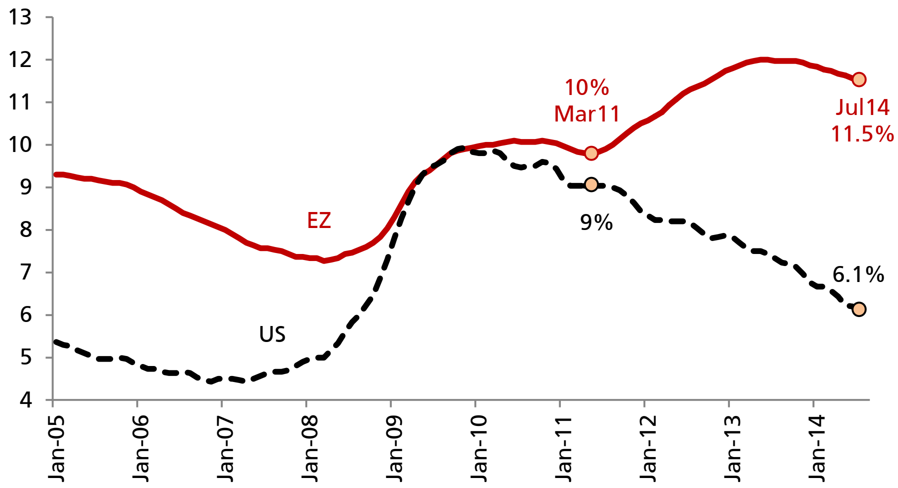
Chart 2: Eurozone unemployment rate eases at a snail's pace

%, 3MMA sa



Non-food retail sales failed to gain ground in 2Q after a strong start to the year, along with flat passenger car sales. Easing inflation, whilst a positive for real purchasing power, has fuelled deflationary concerns. Inflationary expectations have also been trending south, jolting the European Central Bank (ECB) to take action in September.

Loan growth to non-financial corporations remains weak, down -3.3% in 1H14, also accompanied by de-growth in household credit activity. Capacity utilisation rate is off the trough, but struggling to gain further ground from 79-80% vs 2006 high at 84%.

With domestic demand stagnating in 2H and the external sector weighed by gradual pick up in imports, we lower our growth estimates. We pencil in a flat (QoQ, sa) for 3Q and 4Q, which will translate to 0.6% growth this year (vs prev: 0.9%). 2015 GDP is seen recovering a touch to 0.9%.

ECB calls for sharing of the burden...

Shift in ECB's calls for fiscal policy sets the stage for eventual QE

While the ECB stands ready to support growth, we note an important shift in the central bank's language at the Jackson Hole speech. Departing from the past, ECB chief Mario Draghi called for fiscal policies to assume a flexible and pro-growth stance, while working within targets.

This, in our view, was an implicit acknowledgement that the fiscal austerity measures were diluting the easier monetary stance. In other words, weak aggregate demand was threatening the bank's price stability mandate, amid timid supply side pressures. A negative output gap has kept inflation low and led to a downward adjustment in inflationary expectations. To thwart this vicious cycle, member countries need to revive crucial structural reforms and possibly renegotiate fiscal targets during the annual exercise next year.

Interestingly, this shift in ECB's calls for fiscal policy to assume a more growth-supportive role also sets the stage for an eventual move towards sovereign asset purchases. The US Fed's and BOJ's QE journeys were also accompanied by accommodative fiscal policies.

... but has no luxury to sit still on policy

While calls for fiscal and structural support gain momentum in the background, the ECB does not have the luxury to sit on its hands. Dip in the Aug CPI to 0.3% YoY (vs. target at 2.0%) and falling inflationary expectations pushed the authorities to cut the main refinance rate by 10bps to 0.05% in Sep, lower deposit rate deeper in red and unveil plans to purchase asset-based securities (ABS) and covered bonds.

The latter marks the first step towards a private-sector quantitative easing (QE) exercise. The main intention behind these purchases and targeted long term refinancing operation (TLTROs) is to encourage credit activity and infuse liquidity through balance sheet expansion. In addition, as gleaned from the US Fed's and BOJ's experiences, the easier policy stance will also filter through currency depreciation (more below).

The tenor and other details of the ABS / covered bonds initiative are due next month. The ECB expects the TLTROs and private asset purchases to expand the bank's balance sheet by circa EUR 1trn from present EUR 2.02trn (back to '12 levels).

While the intentions are sound, the scale of purchases will be important to make a significant impact. Clearly, a program to purchase government bonds would have been more directed and sizeable given the outstanding pool of government securities of EUR 6trn. However, technical, political and legal hurdles of a sovereign QE are high, with the ECB seen buying time instead with private sector purchases.

June and September measures point to a busy 2H14

For the time being, measures announced in June and September point to a busy 2H14. The targeted long-term refinancing operations (TLTROs) are due to kick start in September, followed by the second tranche in December. In the interim, details on the ABS and covered bond purchases will be available in October. Towards the end-year, the ECB is due to release the asset quality reports on domestic banks, before taking over as the banking supervisor.

Final stop: QE

Back in 2012, the ECB's 'whatever it takes' drove out speculators, even though the Outright Monetary Transactions (OMT) measure remains unused till date. Since then, lower bond yields have allowed governments to borrow funds on favourable terms and even allowed a handful to exit bailout arrangements (eg Ireland, Portugal etc.).

Subsequent long tenor lending facilities and, more recently, policy rate cuts were tapped to address disinflation concerns. But weak demand continues to keep a lid on price pressures, feeding deflationary concerns. This led the ECB to unveil private asset purchases this month and the scope will be widened over the next few months to gauge if demand revives.

The ECB is near its end-game in terms of monetary policy measures. The central bank has kept the door open for sovereign bond purchases if recent measures fail to

Chart 3: Inflation vs benchmark rate

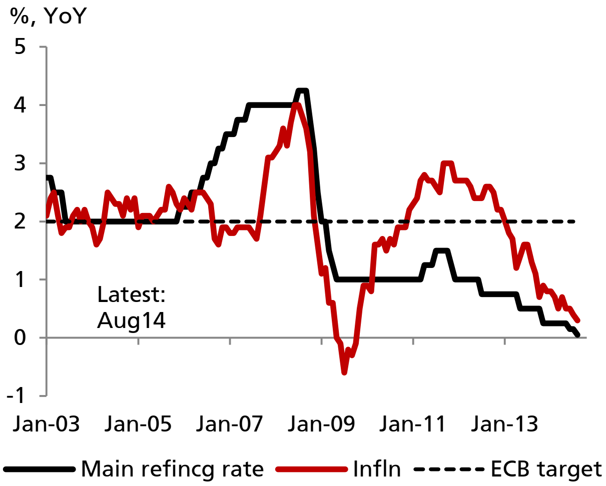
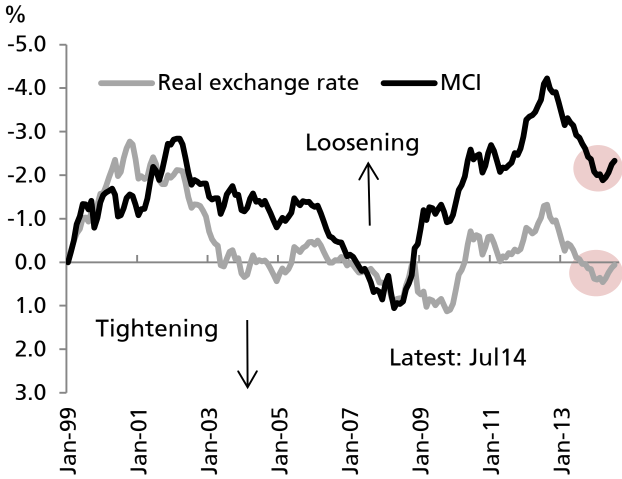


Chart 4: ECB Monetary conditions index



lift price pressures and economies slip back into recession. The odds of a quantitative easing exercise are, however, low this year.

Weak EUR to come handy

Currency depreciation a zero-sum game

Interestingly, even before full-scale QE has been tapped, the markets have shown faith in the ECB. Likelihood of a wider balance sheet has pushed the EUR/USD from 1.39+ at the start of the year to below 1.30. This reversal is also reflected in the ECB's monetary conditions index, leading to a de-facto easing of financial conditions (Chart 4, previous page).

On a broader scale, the divergence between the US Fed, which is at the cusp of completing its QE tapering exercise and possibly move towards rate hikes, vs. the ECB, which is in midst of a monetary easing cycle, have been dollar-supportive and weighed on the EUR.

Our in-house estimates (see FX section) are also for the EUR/USD to depreciate further over the next four quarters. The weak EUR will be a boost for the member countries' export competitiveness and feed prices through imported price pressures. But one should remember that currency depreciation is a zero-sum game. It won't be long before the neighbours play catch-up and negate the competitive advantage. Hence, implementing the crucial structural reforms through higher productivity, lower debt, and encouraging domestic demand are important to return to sustainable growth.

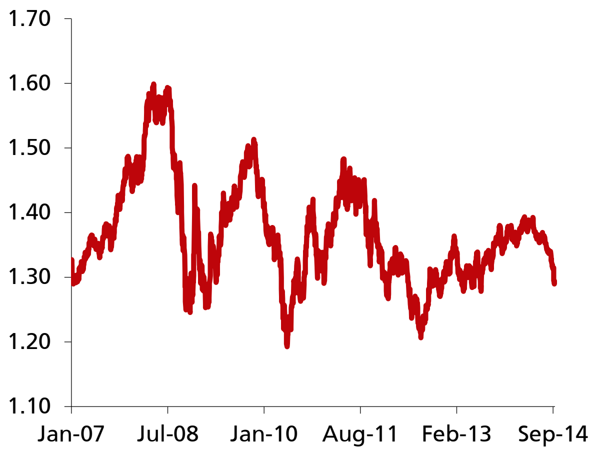
Eurozone Economic Indicators

	2013	2014f	2015f	2Q14	3Q14f	4Q14f	1Q15f	2Q15f	3Q15f
Real output and demand									
GDP growth (05P)	-0.4	0.6	0.9	1.0	0.6	0.3	0.5	0.8	1.0
Private consumption	-0.5	0.6	0.3	0.7	0.6	0.5	0.1	0.1	0.6
Government consumption	0.3	0.5	0.8	0.8	0.0	0.4	0.2	0.2	1.5
Gross capital formation	-2.7	0.9	2.3	1.3	0.8	-0.1	0.8	2.8	2.9
Net exports (EURbn)	361	360	390	90	91	93	100	100	95
Exports (G&S)	1.5	2.1	0.5	1.8	0.6	0.5	0.1	0.7	0.5
Imports (G&S)	0.4	2.3	-0.3	1.4	0.7	-0.8	-1.1	0.3	0.3
Contribution to GDP (pct pts)									
Domestic final sales (C+FI+G)	-0.8	0.6	0.8	na	na	na	na	na	na
Net exports	0.5	0.0	1.0	na	na	na	na	na	na
External accounts									
Current account (EUR bn)	231.0	200.0	170.0	na	na	na	na	na	na
% of GDP	2.4	2.1	1.7	na	na	na	na	na	na
Inflation									
HICP (harmonized, % YoY)	1.3	0.5	0.8	0.6	0.3	0.3	0.8	0.7	0.7
Other									
Nominal GDP (EUR trn)	9.6	9.7	9.8	na	na	na	na	na	na
Unemployment rate (%, sa, eop)	12.1	11.3	11.0	na	na	na	na	na	na

* % change, year-on-year

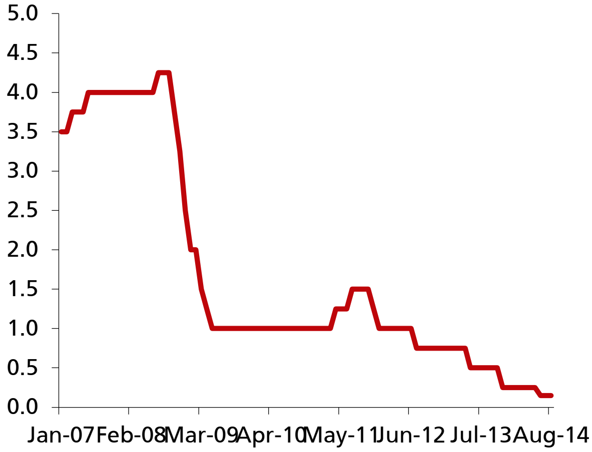
EZ - nominal exchange rate

USD per EUR



EZ – policy rate

%, refi rate



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