EYE ON ASIAN ECONOMIES

ASIAN ECONOMICS RESEARCH

CLSA

4Q19

September 2019

The end of the American upturn

At the 2019 Investors' Forum we argued that US data were increasingly suggestive of an economy in the last year of its economic upswing. This *Eye on Asian Economies* moves this forecast to our central case and investigates what a shallow US recession will mean for AxJ economies.

In consequence we have cut our Asian growth forecasts by 0.5ppts in both 2019 and 2020. This means that we are 0.2ppts below consensus for this year and 0.6ppts below consensus for 2020. In most countries this is the automatic consequence of world trade, already weaker than at any point since 2009, slowing further. But we have downgraded our forecasts for India because the credit cycle shows no sign of picking up, and China because monthly data are soft and economic stimulus, though visible, is gradual.

Inflation is falling in most countries (though the pace of decline is easing). Inflationary pressures, such as they are, have been isolated and caused by supply disruptions. Thus, African swine fever in China has elevated food prices and the attack on Saudi Arabia has boosted oil prices. These are growth-negative. Policymakers will ignore them as a source of inflation. And they are temporary. We expect 2020 inflation to be lower than 2019 across the board aside from tax effects (Japan and Malaysia) and erratics (Thailand).

In consequence monetary easing, which started in force in 3Q19, will continue. Monetary policy has been loosened in the US and Eurozone and in eight of the eleven AxJ countries we forecast. Rate cuts will continue, in the G3 and in Asia, in 4Q19 and 2020. Monetary policy will not boost investment. But aggressive US easing will keep financial conditions loose and help an early recovery in 2021.

Real GDP growth

	2018	2019E	2020F	2021F
USA	2.9	2.2	1.0	2.2
Eurozone	1.9	1.0	0.7	1.5
Japan	0.8	0.7	0.3	0.7
Australia	2.7	1.9	2.2	2.5
China	6.6	6.3	6.0	5.8
Hong Kong	3.0	(0.7)	(0.5)	2.5
India[1]	6.6	5.7	6.7	7.1
Indonesia	5.2	5.2	5.2	5.4
Korea	2.7	2.0	1.9	2.7
Malaysia	4.7	4.4	3.1	3.6
Philippines	6.2	5.9	6.0	6.0
Singapore	3.1	0.6	1.0	1.5
Taiwan	2.6	2.3	1.3	1.6
Thailand	4.1	2.8	2.6	3.1

[1] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

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Executive summary

We move a shallow US recession to our central case

In the last quarter markets have become increasingly worried that a US slowdown is imminent. The concerns are justified. US data look increasingly typical of an economy entering the final year of its upswing. Critically, business confidence and profits have fallen. We move a shallow US recession to our central case for 2020.

Weakness elsewhere means that the global economy is reliant on the US

The problem is that weakness elsewhere means that the global economy is reliant on the US to drive growth. World trade growth has already fallen to the lowest level since the Global Financial Crisis on the US economy slowing from 3%-plus growth in mid-2018 to 2% today. Europe cannot provide an offset as it, itself, is export driven. So is Japan. So too are most emerging economies be they commodity producers or manufacturers. Internally-driven emerging markets are the exception and India, a big one, is weak. This leaves China. China could offset the effects of slower US growth if it chose to. But it will not. Beijing's target is to maintain full employment. It does not have to accelerate growth to do this. China's full employment growth rate is slowing.

We have cut our 2020 growth forecasts

We have cut our 2020 growth forecasts for those AxJ economies that are export driven. China can maintain full employment in 2020 by growing at 6% and this is our forecast. India's FY20 growth will disappoint. Modi's corporate tax cuts are bold but will take time to gain traction. India's recovery will be postponed to late 2020.

Ubiquitous monetary easing

When world trade growth is below 2¾%, commodity prices tend to fall. World trade growth has been below this level for nearly a year, and we expect commodity prices, notwithstanding geopolitical risks, to soften. This, and a general drift lower in core inflation, means that inflationary pressures are minimal. Disinflation will remain dominant for the foreseeable future. This allows monetary policy to be pre-emptive to keep financial conditions accommodative. Monetary easing has already started in the US and Europe and in eight of the eleven AxJ countries we forecast. It will become all but ubiquitous in coming months.

Period of unilateral USD strength is coming to an end

US growth dropping below trend means that the Fed will cut four times next year. This is not yet discounted. When it is, the USD will weaken. This soft-USD phase will be over by mid-2020; but we are increasingly optimistic that the long period of unilateral USD strength is coming to an end.

Our 2020 growth estimates are 0.5ppts down on three months ago

CLSA real GDP growth forecasts

%YoY	2017	2018	2019E	2020F	2021F
US	2.4	2.9	2.2	1.0	2.2
Europe	2.6	1.9	1.0	0.7	1.5
Japan	1.9	0.8	0.7	0.3	0.7
Australia	2.4	2.7	1.9	2.2	2.5
China	6.8	6.6	6.3	6.0	5.8
Hong Kong	3.8	3.0	(0.7)	(0.5)	2.5
India[1]	6.9	6.6	5.7	6.7	7.1
Indonesia	5.1	5.2	5.2	5.2	5.4
Korea	3.2	2.7	2.0	1.9	2.7
Malaysia	5.7	4.7	4.4	3.1	3.6
Philippines	6.7	6.2	5.9	6.0	6.0
Singapore	3.7	3.1	0.6	1.0	1.5
Taiwan	3.1	2.6	2.3	1.3	1.6
Thailand	4.0	4.1	2.8	2.6	3.1

[1] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

Concern about an imminent world recession has risen

10-2yr spreads turned negative in August

After declining sharply after the July Fed meeting

A precipitous fall in developed-economy bond yields

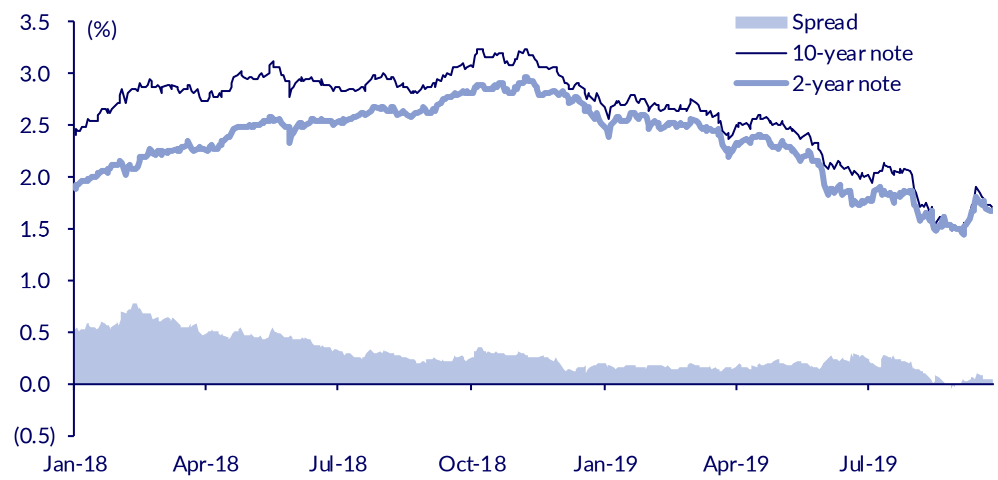
The end of the American upturn

Financial market confidence about the world economy has deteriorated in the last quarter. The latest Bank of America survey of fund managers reported 34% as saying that a global recession was likely in the next year. This percentage compares with only 6% in April. It is the highest proportion since October 2011.

Debt markets confirm the pessimism. The failure of the Fed to deliver more than 25bp at its July meeting caused the 10-2 year spread to turn negative, for the first time since 2007, in August. Heightened trade war fears have kept the spread close to zero: Figure 1.

Figure 1

US 10-2yr Treasury yield spread

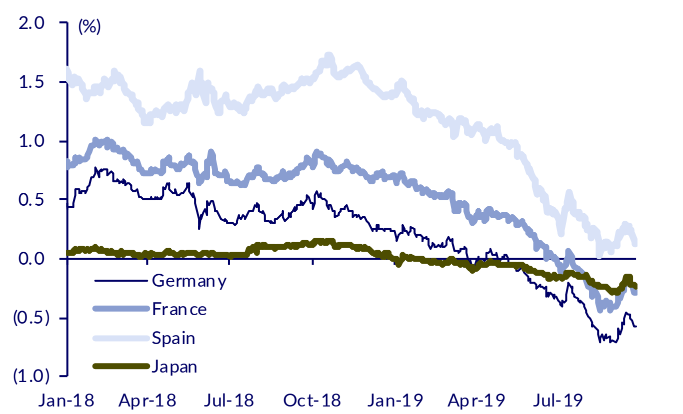


Source: CLSA, Bloomberg

The same period has seen a precipitous fall in developed-economy bond yields. At time of writing 10-year German Bunds are -0.58%; 10-year French OATs -0.29%. Spain a former high-yield member of the Eurozone periphery is again approaching a zero 10-year yield. Ten-year JGBs have pushed through the bottom of the +/- 20bp corridor that the Bank of Japan maintains as a target. However, they are now far from remarkable: Figure 2.

Figure 2

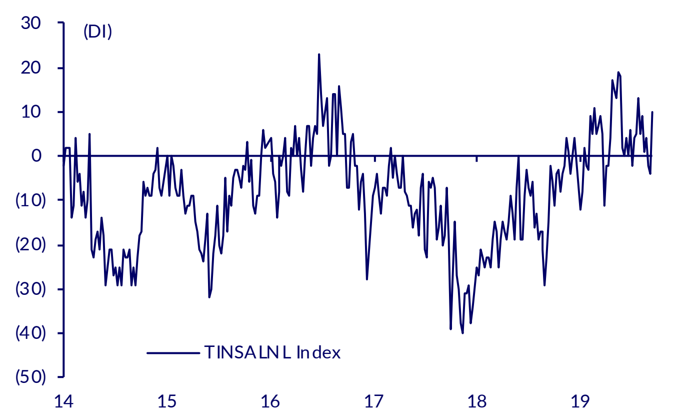
Ten-year non-US government bond yields (%)



Source: CLSA, Bloomberg

Figure 3

JP Morgan Treasury client net longs index



Source: CLSA, Bloomberg

Investors remain super bullish on bonds

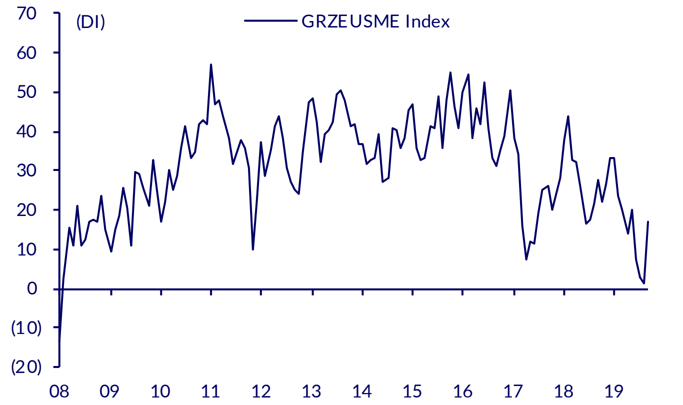
Despite the collapse in yields the BofAML survey reports that the investor view on bonds was the most bullish since 2008. This is supported by JP Morgan's survey of active client Treasury net longs: Figure 3.

And bearish on equities

The mirror of this is that investors are bearish on equities. ZEW's expectations surveys for both the Dow Jones (Figure 4) and the Stoxx 50 (Figure 5) fell to post Global Financial Crisis (GFC) lows over summer. They have retreated but the trend remains negative: Figure 4-5.

Figure 4

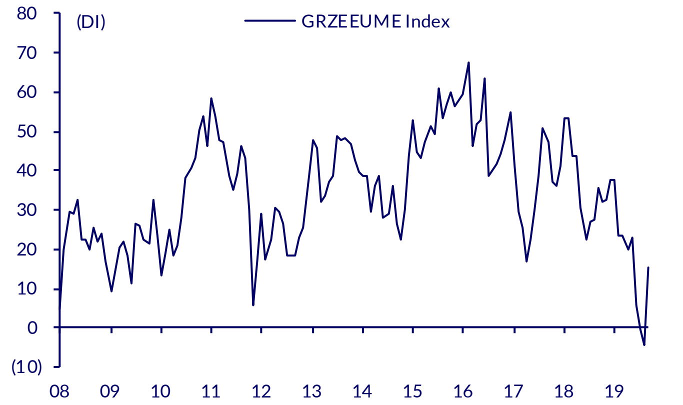
ZEW US Dow Jones market expectations index



Source: CLSA, Bloomberg

Figure 5

ZEW Eurozone STOXX 50 market expectations index



Source: CLSA, Bloomberg

Even on a bearish world view bonds are vulnerable to correction

Irrespective of what happens next to global growth and inflation, fixed income markets are vulnerable to further correction. The world economy is facing clear headwinds and these will get worse. Disinflationary forces will strengthen. Interest rates will be cut. But this is more than discounted. We expect bond yields to rise into the end of the year. Only after some profit taking will they take another leg lower.

This view is despite a bearish world outlook for 2020

The argument that bonds are still overbought should not be construed as indication that we think broader market concerns that the cycle is approaching its end are unjustified. On the contrary, this *EoAE* reduces our expectations for world trade growth in 2020. **We now see a full year contraction of 1% in global trade volumes.**

For the first time we are concerned that the US upswing is coming to an end

This is not *quite* a world synchronised recession as China will continue to protect a narrow corridor around its full employment growth trajectory (see p40). But it will not be that far from it. Eurozone growth is unlikely to be able to decouple from weak exports (see pp15-16). Commodity exporters will remain under pressure until commodity prices bottom. Most critically, for the first time we are concerned that the US upswing is coming to an end (see pp9-15 below).

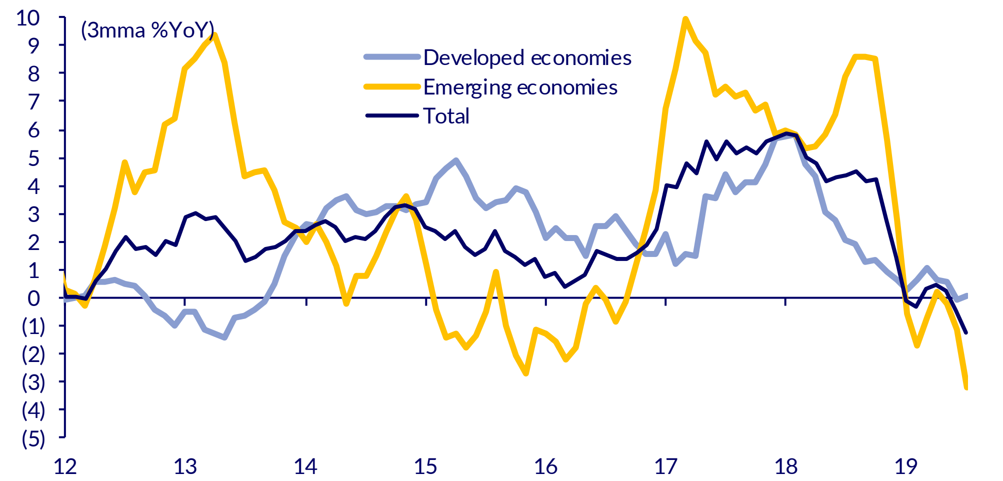
Slower US growth has pulled word trade growth to a new post-GFC low

The importance of the US to global growth is visible in current data. World trade volume growth is off its start-year lows but the trend is still downwards: Figure 6. In the three months to July global demand growth was -1.2% YoY. The geographical breakdown of weakness is broad. Demand from all developed economies is weak but it is the US where, in the last six months, the slowdown is most conspicuous: Figure 7. The US is not in recession; however, the contribution to world demand growth from other regions is anaemic. Therefore the normalisation of US growth, as the late-cycle Republican fiscal stimulus has dropped out of the data, has pulled world trade growth down to a new post-GFC low.

The downward trend has reasserted after a 2Q rebound

Figure 6

World trade volume growth (3mma %YoY)



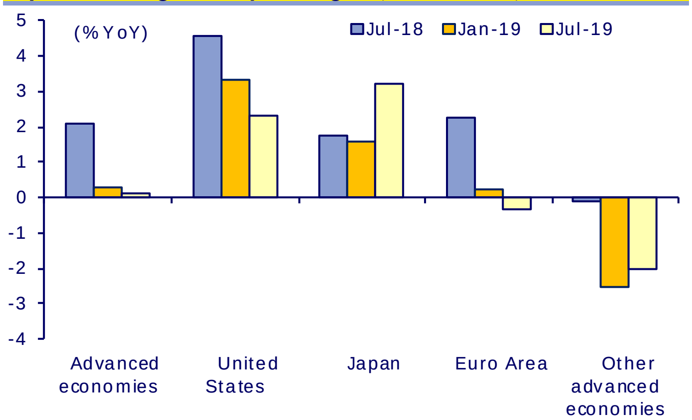
Source: CLSA, cpb.nl

Smaller Asian countries are growing below trend

In emerging markets Asia dominates: Figure 8. This remains a China-centric slowdown (the CPB data started to identify China separately a couple of months ago). The comparison with six and (even) twelve months ago is distorted by an inventory cycle, caused by the staged introduction of US tariffs. But we judge that inventory cycle has now completed. Today what you see is what you get in terms of what Asian trade reveals about final demand patterns. And this is a weak picture. China's growth, by historical standards is low; additionally in some key products – most importantly autos – we see a structural decline in income elasticity as market penetration increases and markets mature. Smaller trade-driven Asian countries are now growing below trend, their output gaps will widen in coming months.

Figure 7

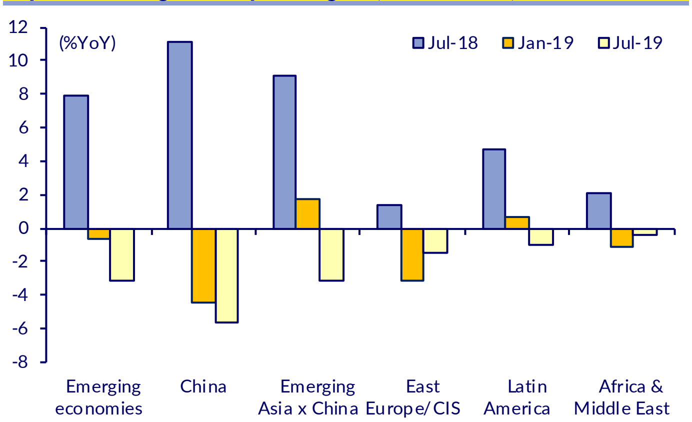
Import volume growth by DM region (3mma %YoY)



Source: CLSA, cpb.nl

Figure 8

Import volume growth by EM region (3mma %YoY)



Source: CLSA, cpb.nl

Globally, manufacturing continues to deteriorate

Manufacturing trends are strongly correlated with trade and manufacturing PMIs provide an alternate and slightly more up-to-date presentation of the same fact. Globally, manufacturing continues to deteriorate. At 49.3, JP Morgan's global manufacturing PMI set a new post-Global Financial Crisis low in July. The August recovery is minimal: Figure 9.

Germany and its supply chains are weakest

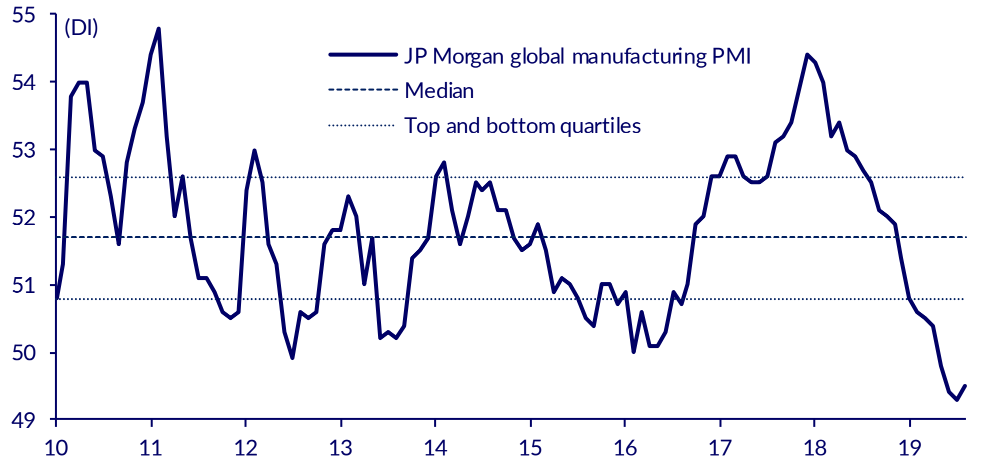
In absolute terms the most cyclical, manufacturing and export-driven economies are (as would be expected) the weakest: Figure 10. That is the German-centric northern European supply chains. In Asia, only Taiwan is comparable. As with trade

49.3 in July was a post-GFC low

however, the weakness is shifting to include the US. From the end-2017 peak, European economies' manufacturing PMIs have declined the most but US-centric indicators have increasingly participated since 3Q18. Consider the chart below, which shows the Markit manufacturing PMIs for Taiwan and Germany with the US, and Canada: Figure 11.

Figure 9

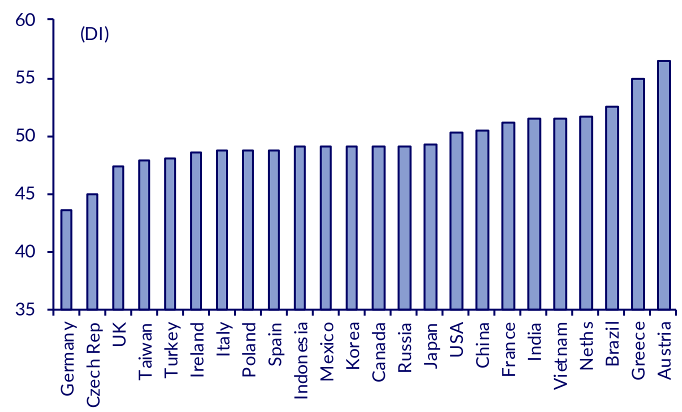
JP Morgan global manufacturing PMI



Source: CLSA, Markit Economics Ltd

Figure 10

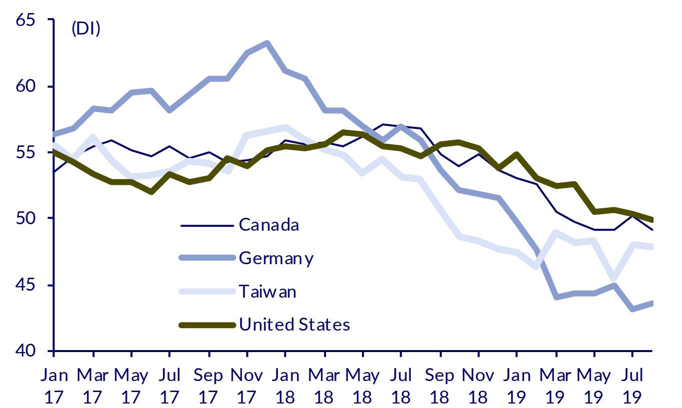
Markit manufacturing PMIs August



Source: CLSA, Markit Economics Ltd

Figure 11

Markit manufacturing PMIs US-centric vs China-EZ centric



Source: CLSA, Markit Economics Ltd

Broader weakness is pulling the aggregate downwards

The 'delta' in a global forecast has begun to shift from the weakness of China and (to the extent that China's auto demand has been a swing factor) Europe to the US. In absolute terms, US manufacturing remains much stronger than manufacturing in Europe but it is now decelerating. And, with other regions with little prospect of accelerating, any additional drag is damaging.

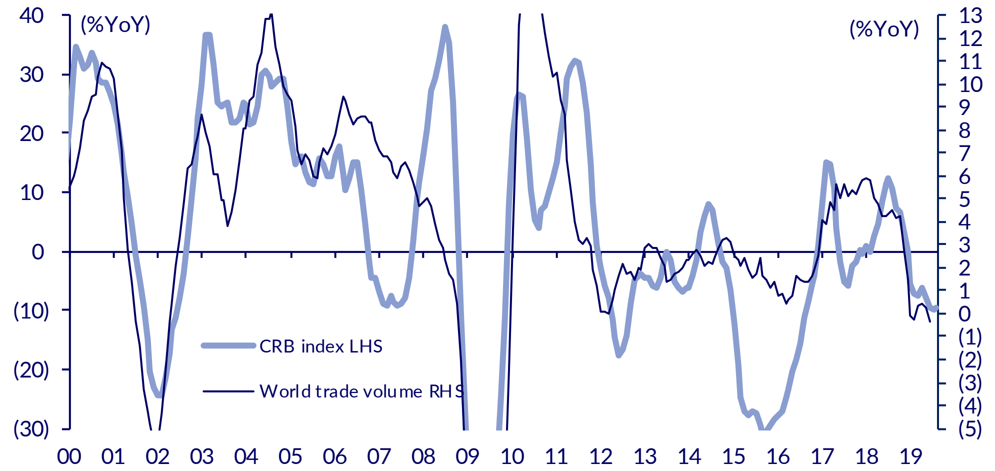
Allowing disinflationary forces to strengthen

As the slowdown in trade and manufacturing has broadened overall world trade has weakened and allowed disinflationary forces to strengthen. Historically it takes world trade growth of 2¾% to keep commodity prices stable: Figure 12. World trade growth has been below this level for more than nine months. From first principles we, therefore, expect commodity prices to fall.

Current world trade growth implies falling commodity prices

Figure 12

World trade volume growth and commodity prices (3mma %YoY)



Source: CLSA, cpb.nl, Bloomberg

The Abqaiq attack does not reverse the supply-demand fundamentals, which are weak

The surge in political risk premium and artificial contraction in supply caused by the attack on Saudi Arabia's Abqaiq oil processing plant pushed oil prices from USD60/bbl to (disregarding the initial spike) around USD65/bbl. However, though market prices remain firm, the sensitivity of the oil market to speculation about when Saudi production will restart suggests that the underlying supply-demand dynamics are fragile. Given the weakness of global trade and manufacturing, this is unsurprising. Our oil price forecasts assume that the Saudi commentary, that the bulk of production disruption will be solved by the end of September, is largely correct. This will allow the weakness of global demand growth to return to the focus. As data weaken we expect the oil price to drop back to the mid-50s by year-end.

We cut our commodity price forecasts from three months ago

Our global forecast means that bearish price action for commodities will continue. Figure 13 shows our commodity price forecasts for the coming two years. We see continued weakness this year extending through 2020. Precious metals will be the exception. They will be well supported in the first half given the performance we expect from Treasuries.

Figure 13

Commodity price forecasts

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
Oil (Brent) (p/e)	66.9	53.8	55.0	42.0	45.0	55.0	45.0	42.0	42.0
Oil (Brent) (average)	54.8	71.7	63.0	50.0	43.0	59.0	50.0	43.5	42.0
CRB index (p/e)	193.9	169.8	170.0	155.0	155.0	170.0	160.0	152.0	152.0
FAO food index (p/e)	169.1	161.9	170.0	165.0	165.0	170.0	168.0	166.0	165.0
Gold (p/e)	1,304	1,283	1,570	1,500	1,500	1,570	1,700	1,700	1,600

Source: CLSA, Bloomberg

This feeds back into weak demand for manufactures from commodity producers

Weaker commodity prices mean that the export receipts of commodity exporting regions will be pressured. 2020 will therefore see continued squeeze on emerging markets' contribution to world trade growth bringing more regions into line with (and contributing to) soft conditions in manufacturing-driven economies. As we have flagged in the past, there is also the issue of international USD lending concentrated in the resource sector requiring refinance. This has the potential to add to financial stress in the US.

Even if international credit markets remain well behaved the cumulative effect of slowing US growth, continued weak growth in Europe, a contained Chinese stimulus and weak export receipts in both manufactured good exporters and commodity exporters means slower world trade. Hence our expectation that world trade in CY2020 growth will be negative (for the first time since the GFC).

Monetary policy can be loosened early because of the absence of inflation

The capacity of the world economy to reaccelerate requires one or more of these cycles to bottom or a policy response to be put into place. Monetary policy has been quick to act and, in the absence of inflation, central banks will continue to act aggressively to prevent financial conditions from tightening. So far, this has been only partially successful if measured against the post-GFC average. However, the sharp hardening in financial conditions typical in previous recessions should be avoided. This should be a shallow downturn in most countries. **Our negative world trade forecast for 2020 is because it represents an interruption to growth in a *broad range* of countries rather than because the recessions in each are severe.**

World trade growth will start to recover in 2021

A first look into growth in 2021 sees world trade starting to recover. Geographically this will come from the effectiveness of counter-cyclical monetary policy in the US. We are less optimistic that monetary policy will be successful in stimulating growth or inflation in Europe (pp15-17), smaller Asian countries (pp28-29) and Japan (pp18-20). As commodity prices recover, emerging market demand for manufactures should start to pick up. China will act as a dampening force. It will be successful in keeping GDP growth close to its full employment growth trajectory but that trajectory itself is gradually declining (p40) and therefore China should not be expected to be a global reflation force either in 2020 or 2021. Equally, and counter to the typical market fears, it should not be considered a global growth risk.

US growth: The end of the upturn

The upswing was 123 months old in September

As of September, the US economic upswing is 123 months long. The previous post-war record (1991 to 2001) ended (using NBER recession data) after 120 months: Figure 14.

Figure 14

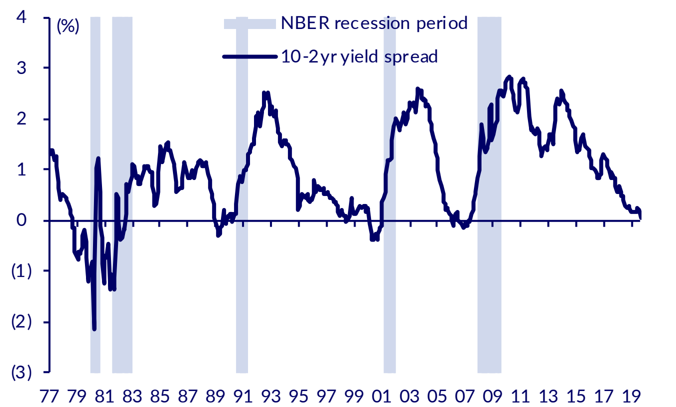
Post-War NBER cycle durations

Expansion starts	Expansion ends	Expansion length (mths)	Prev recession length (mths)
na	Feb-45	80	na
Oct-45	Nov-48	37	8
Oct-49	Jul-53	45	11
May-54	Aug-57	39	10
Apr-58	Apr-60	24	8
Feb-61	Dec-69	106	10
Nov-70	Nov-73	36	11
Mar-75	Jan-80	58	16
Jul-80	Jul-81	12	6
Nov-82	Jul-90	92	16
Mar-91	Mar-01	120	8
Nov-01	Dec-07	73	8
Jun-09	na	122	18

Source: CLSA, NBER, Bloomberg

Figure 15

US 10 – 2-year Treasury spread vs NBER recession periods



Source: CLSA, NBER, Bloomberg

The yield curve inverted in August

One defining difference of this cycle is that financial markets seem acutely aware of the risks. Equity and debt markets have been "looking for recession" for at least a year. This contrasts with previous business cycles in which warning flags were overcome by strong risk appetite. Thus, the Treasury curve inverted for the first time in this cycle in August (Figure 1 and 15). For context, the inversion is only just visible in the month-average chart shown as Figure 15. But the fact that it has happened is worthy of comment. Figure 15 shows that curve inversion has proven a reliable lead indicator in the past.

This has been a reliable lead indicator in the past

- Curve inverted Sep 1978: 16 months lead; Recession started Jan 1980.
- Curve inverted Sep 1980: 10 months lead; Recession started July 1981.
- Curve inverted Jan 1989: 18 months lead; Recession started Jul 1990.
- Curve inverted Feb 2001: 13 months lead; Recession started Mar 2001.
- Curve inverted Jun 2006: 18 month lead; Recession started Nov 2007 (the curve inverted temporarily in Feb-Mar 2006 take this as the signal the lead is 22 months).

The markets clearly do not think that the Fed will cut fast enough

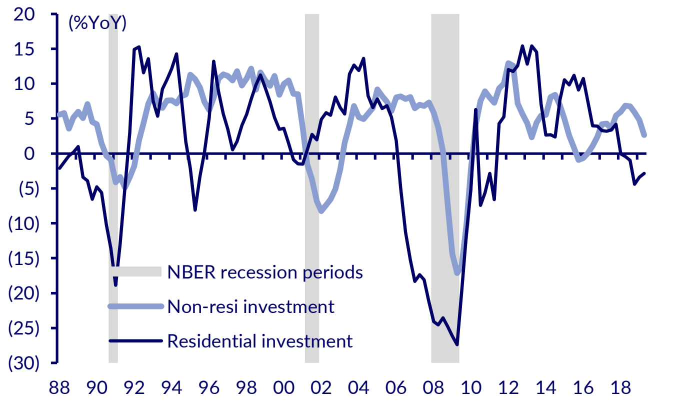
Yield curve inversions are caused by the long end of the curve discounting rates being cut combined with the demand for safe haven assets as recession worries rise. The disinversion is caused by rate cuts being delivered. Obviously, the Fed has now started to cut rates. The historical precedent is that it does so insufficiently quickly to prevent recession. The bond market reaction to the July FOMC and September FOMC meetings show this to be the markets' interpretation today. This is becoming our view also.

Facilities investment is now contracting

Certainly growth in the US is narrow. Figure 16 shows that residential investment has started to contract. Non-residential investment is slowing. In contrast, private consumption remains robust both numerically (PCE rose at a 4.3% QoQ saar in 2Q) but also in that big-ticket items were exceptionally strong (durable goods +12.9% QoQ saar, vehicles +15.9% QoQ saar): Figure 17.

Figure 16

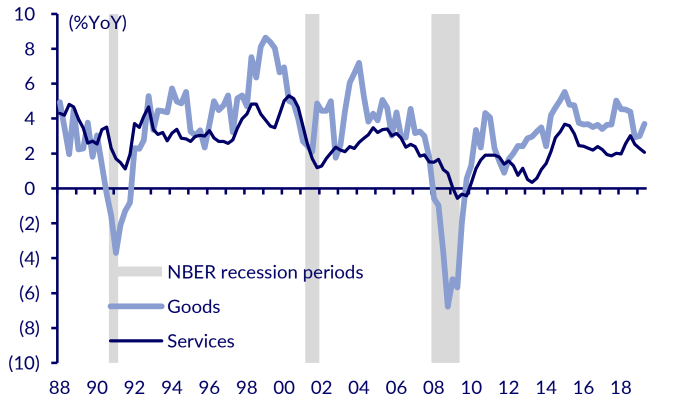
Gross private domestic investment (%YoY)



Source: CLSA, NBER, Bloomberg

Figure 17

Private consumer spending (%YoY)



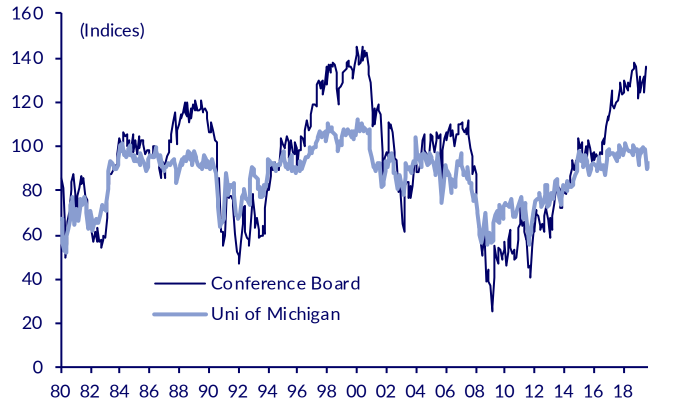
Source: CLSA, NBER, Bloomberg

The consumption outlook remains strong

The bull case for the US is that consumer spending continues to propel growth fuelled by very high confidence measures (Figure 18) and good employment growth (Figure 19). However, average weekly and hourly earnings remain softer than fully compatible with this narrative and indeed average weekly earnings have been declining in the last twelve months: Figure 20.

Figure 18

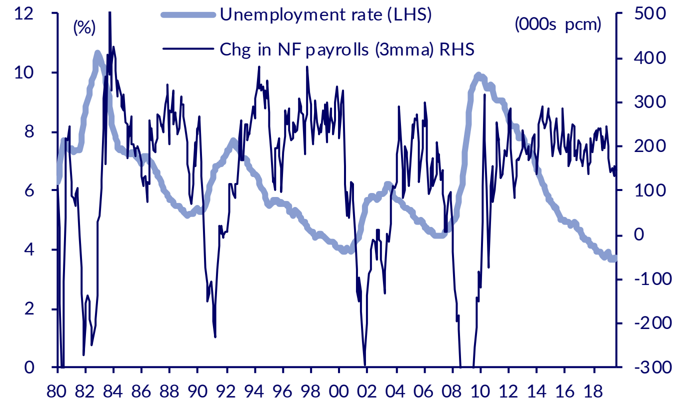
Consumer confidence measures



Source: CLSA, Bloomberg

Figure 19

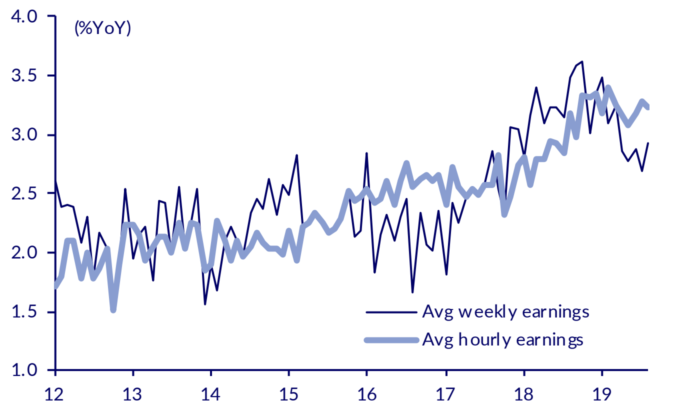
Change in non-farm payrolls and unemployment rate



Source: CLSA, Bloomberg

Figure 20

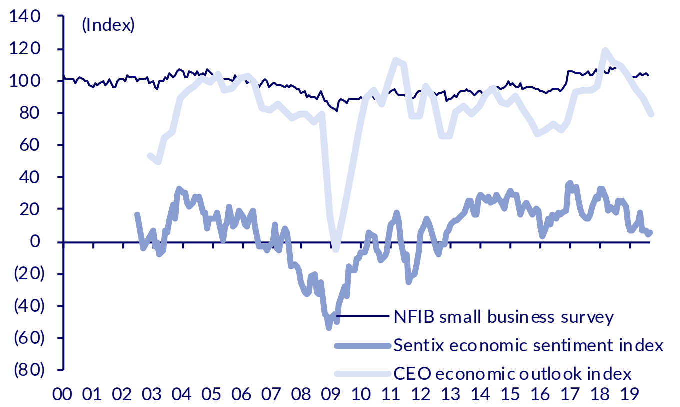
US private wage growth measures (%YoY)



Source: CLSA, CEIC

Figure 21

Business confidence indicators



Source: CLSA, Bloomberg

Business confidence is well off peak levels

A strong labour market and consumer spending give momentum to an economic cycle. But it is the investment and hiring decisions of businesses that are causal. US business confidence measures remain above long-run averages, but they are well down from their peak in response to President Trump's continued moves to impose tariffs on China. Indeed business confidence is close to levels that, in previous cycles, have presaged recession: Figure 21. However it is evidence that profits are, at the whole economy level, declining, which provides powerful support to worries that the US business cycle upswing is approaching its end.

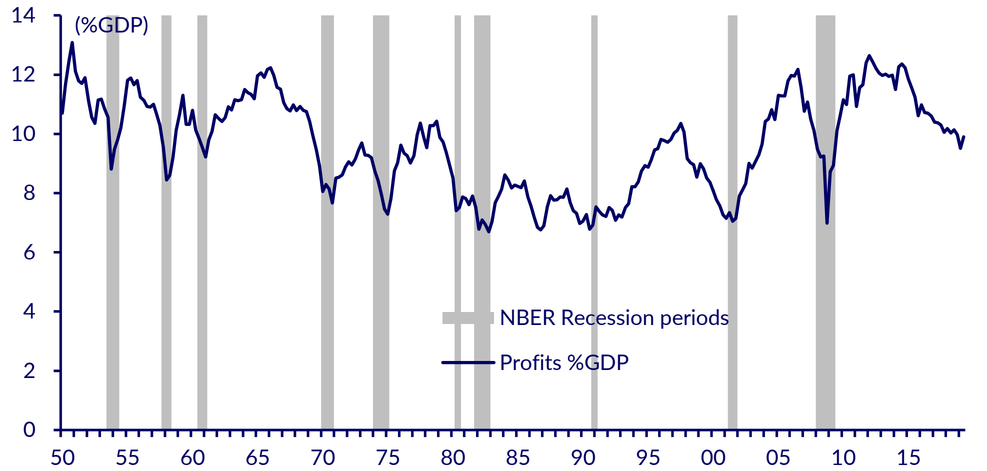
Profits fall as a precursor to recession

Profits as a share of GDP provide a good indicator of a business cycle's age. In the early years of an upswing profits expand faster than wages and property income (rent or interest) as factors of production are underutilised. As full employment of property, capital and resources approaches growth of factor incomes outstrips that of corporate profits. Profits as a share of GDP therefore fall. Businesses start progressively to miss their own earnings targets and react by curtailing investment and hiring plans. Thus the cyclical downturn starts. It becomes self-reinforcing. As business revenues come under pressure relative to fixed costs profits fall further to trough (as a percent of GDP) at the heart of a recession.

Corporate profits falling as a proportion of GDP from 2014

Figure 22

Corporate profits (incl IVA and CCA) % GDP



Source: CLSA, NBER, BEA, Bloomberg

The profits decline is of comparable magnitude to previous cycles

Three months ago we were able to write that US profits in this cycle were not sending a clear warning. The monotonic decline in profits that presaged recession periods in previous cycles was not present. However, revisions to historical data mean that this is no longer true. Figure 22 shows the profits cycle alongside recession periods as defined by the NBER. Post revision this cycle looks much more typical in that profits as a share of GDP peaked early in the cycle (at 12.6% in 1Q12) and have been declining consistently from 3Q14. The profits share of GDP is now 2.7ppts down from its cycle high. This is a comparable magnitude of decline to previous business cycles.

This cycle now appears much more typical than it did three months ago

The dates quoted above make it clear that a fall in the profits share is an advance lead indicator. It does not mean that an immediate cyclical downturn should be expected. In many respects (relevant to profits) this has been a unique cycle. Wages have not accelerated to the extent expected; low inflation has allowed interest rates and bond yields to be lower than usual. Spare capacity has persisted in the international economy because, post-GFC, decorrelation of growth cycles has been the rule rather than the exception. However, the fact remains that the **behaviour of profits now looks much more typical of previous cycles as a cyclical downturn approaches.**

We cut our 2020 US growth forecast to 1%

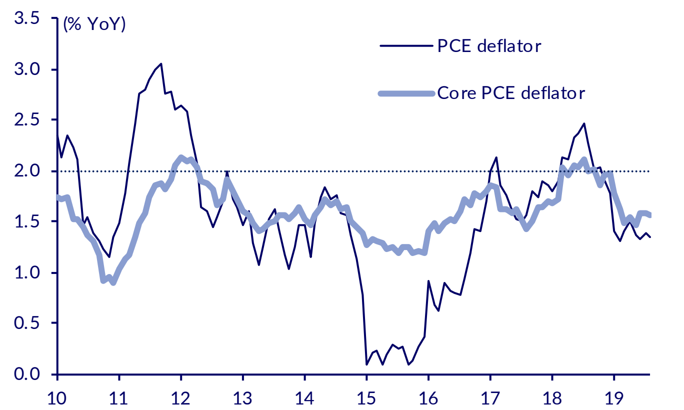
Our 2020 growth forecast already included a temporary slowdown as last effects of the Republican fiscal stimulus dropped from the data. Our central case now shifts from this proving a temporary interruption to it contributing to a nascent cyclical downturn. **We reduce our 2020 US growth forecast to 1% (0.8ppts below today's consensus).**

This represents a short and shallow US recession

By historical standards this will be a short and shallow US recession. Unemployment will rise but by no more than 1-1½ppts trough to peak. Wage data are likely to remain flat. If the US could be considered in isolation, it would be shallower still. However, though external weakness matters less to the US forecast than the behaviour of its domestic corporates, it is not completely insulated. US manufacturing will be weak in 2020. Given Trump's mercantilist tendencies and the presidential election cycle, this matters from a political standpoint as much as an economic one.

Figure 23

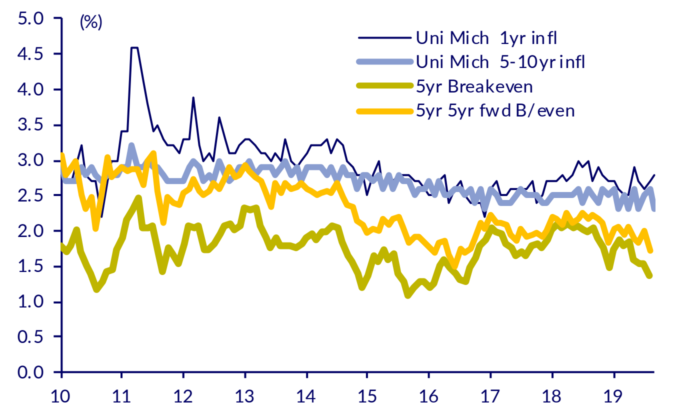
PCE and core PCE inflation (%YoY)



Source: CLSA, Bloomberg

Figure 24

Inflation expectations



Source: CLSA, Bloomberg

Inflationary pressure stays muted on this forecast

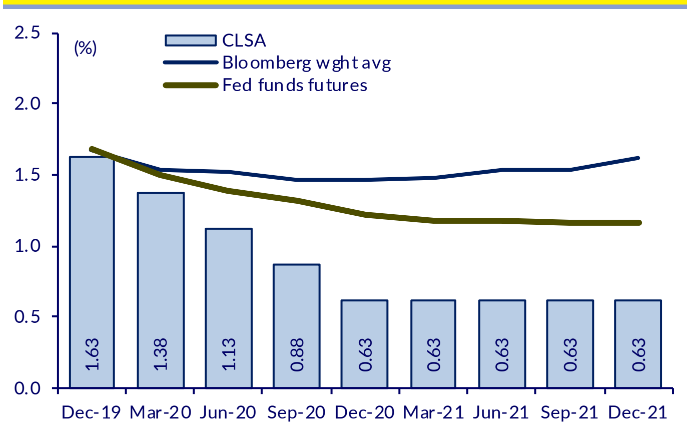
Inflationary pressure stays muted on this forecast. Both headline and core PCE deflator are already well below the Fed's 2% inflation mandate that from the June FOMC statement has been explicitly "symmetric": Figure 23. Both the global and the US outlook argue that this will continue. We expect inflation to remain around 1½% through 2020. Survey-based inflation expectations are lagging and significantly higher than bond market-derived measures (Figure 24). They are likely to fall as low inflation persists and Main Street economic confidence weakens.

Rates cut by 25bp in September and December

The July tone of the July and September FOMC meetings suggest that the Fed is mindful of the need to contain over-aggressive rate cut expectations. But at Jackson Hole Powell demonstrated clear concern about the threat that escalation in the Trade War represented to growth. Most importantly inflation, at worst, presents no obstacle to monetary policy being eased to try and protect financial conditions and, while the interpretation of the mandate remains symmetric, is an active argument for rate to be cut. Accordingly, we shift our expectations for Fed policy. Following the cuts in July and September, we expect the Fed to steer expectations away from an October cut. However, we do expect rates to be reduced in December. This will take the ceiling of the Fed funds target rate corridor to 1.75% by the end of the year: Figure 25.

Figure 25

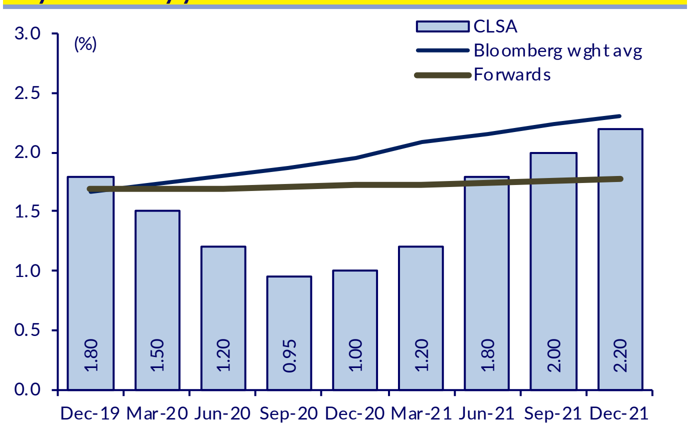
Fed funds forecast: CLSA vs The Street



Note: Futures and median as at 24 September
Source: CLSA, Bloomberg

Figure 26

10-year Treasury yield forecast: CLSA vs The Street



Note: Forwards as at 24 September
Source: CLSA, Bloomberg

4x 25bp rate cuts in 2020

Our growth expectation for 2020 is well below the Fed's central tendency forecast (1.8-2.2% YoY 4Q20/4Q19 from the September FOMC meeting). Building this into our forecasts implies a significantly lower interest rate trajectory either than contained in the "Dots" chart (still >2%) or Fed funds futures and forwards. We assume four 25bp reductions taking the Fed funds target to a 0.50-0.75% range by December: Figure 25.

This implies a weaker USD around the turn of the year

Therefore, while the Fed is simply delivering rate reductions already discounted for this year, our 2020 rate cut forecast is more aggressive than the Street. This suggests that there is scope for USD weakness most likely in the tail end of this year or early 2020.

Followed by a move below 1% yield

As we flag above the aggressive fall in long-dated bond yields in recent months appears, even on a low inflation, low growth forecast, excessive. We therefore forecast a period in which 10-year yields rise. It will happen sooner rather than later (early 4Q) and will be only temporary. The interest rate growth and inflation forecasts we detail above imply that 10-year Treasury yields will fall in 2020. For the first time post-Global Financial Crisis we expect 10-year Treasury yields to move below 1%: Figure 26.

President-Fed tension to remain high

This forecast is aggressive but we doubt that it will satisfy President Trump. Tension between Powell and Trump will therefore remain high. The Fed is independent and presidential invective is unlikely to shift its rate decisions. But, while the USD remains strong, the continued weakness of manufacturing and perceived reluctance of the Fed to act raises the risk that the Treasury try unilaterally to weaken the USD.

Intervention against the USD: could happen, won't work

We discussed the risk of USD intervention in our *Infofax Special* on 12 August (**Won't work, could well happen**). Our view remains unchanged. The probability of Treasury intervention is far more than a tail risk, we guesstimate around a 30% probability. However, it will not be supported by US' trading partners and will not have a lasting effect on the USD unless the Fed cuts more aggressively than the market expects. A softer USD appears in our forecast therefore only in 2020 and independently of Treasury intervention.

We assume no fiscal stimulus as Democrats control the House

From Trump's perspective, the slowdown we expect in 2020 raises political risk. It will be accompanied by increased invective against the central bank and suggests a more, rather than less, bellicose stance in international trade negotiations (see p22). We do not however include countercyclical fiscal policy in our US forecast. Trump has expressed interest in cutting taxes but what can be done by executive order is small. And we see little chance of a Trump stimulus securing Democrat support in the House of Representatives.

We assume Trump is re-elected but trade wars will persist irrespective of who is president

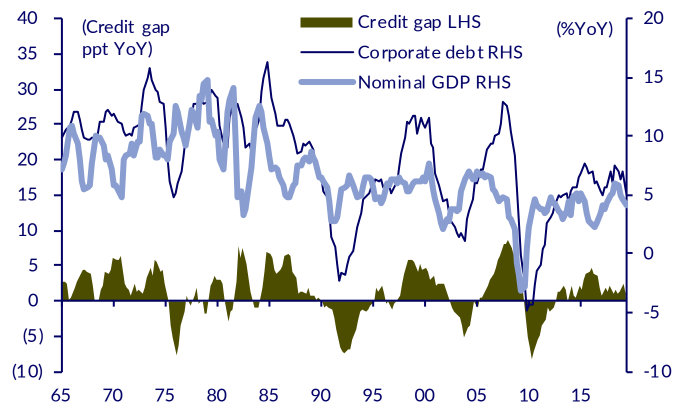
At this early stage, our working assumption is that Trump be reappointed in November 2020. In one respect, it matters less than might be expected: the Trade War. The Overton Window has shifted in US-China relations and trade tensions will remain high irrespective of who secures the White House.

Counter to market fears balance sheet risk is lower than in previous cycles

In our forecast 2020 sees a shallow recession in the US. It feeds back through weak trade but the US is not an export-driven economy. And early central bank policy should help minimise the inevitable pro-cyclical tightening of financial conditions. Most importantly, balance sheet risk is lower than at comparable points in previous cycles. Although there has been a loosening of credit standards through the upswing and corporate debt levels have risen this has been muted compared with previous cycles (Figure 27 shows the YoY growth in domestic non-financial corporate liabilities and nominal GDP growth – the "credit gap" between the two is small). The household sector is by historical standards actively undergeared (Figure 28: total household borrowing vs nominal GDP growth – the "credit gap" is entirely absent).

Figure 27

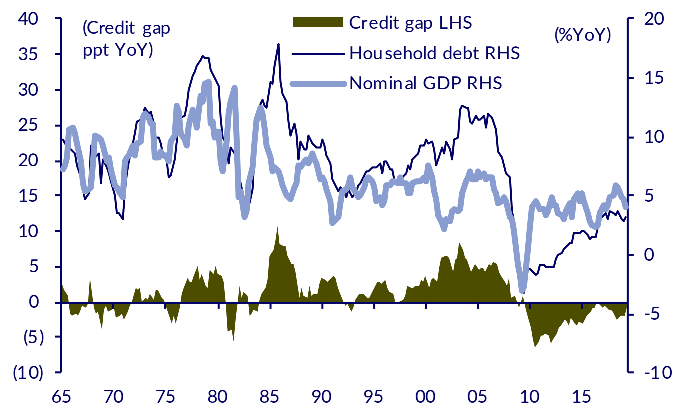
Non-fin corporate liabilities growth vs nominal GDP growth



Source: CLSA, Federal Reserve, CEIC

Figure 28

Household liabilities growth vs nominal GDP growth



Source: CLSA, Federal Reserve, CEIC

This allows an early recovery: 2¼% GDP growth in 2021

The absence of a financial overhang implies that this downturn will be short. A first look at 2021 growth therefore sees the quarterly profile accelerate through the year. Calendar year average growth will be around 2¼%. In anticipation, 10-year yields should rise ahead of the end of Fed tightening. This is USD currency positive suggesting a reversion to USD outperformance in 2021.

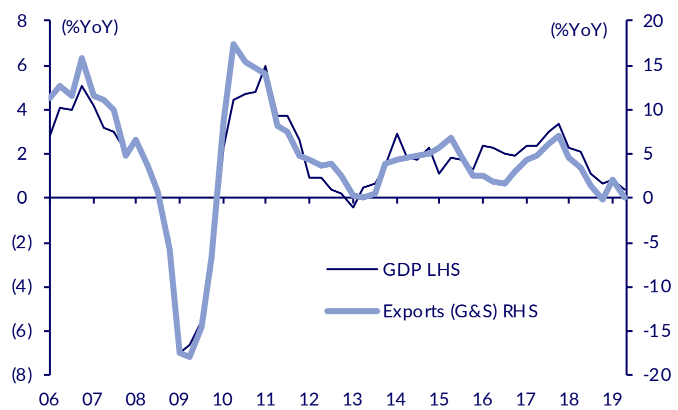
EZ growth: Exposed to a world trade slowdown

The export-driven core of the Eurozone has been hit by weak world trade

The export-driven core of the Eurozone has been badly affected by weak world trade. Germany posted negative GDP growth in 2Q as the weakness of its manufacturing industry more than outweighed its robust domestic economy: Figure 29.

Figure 29

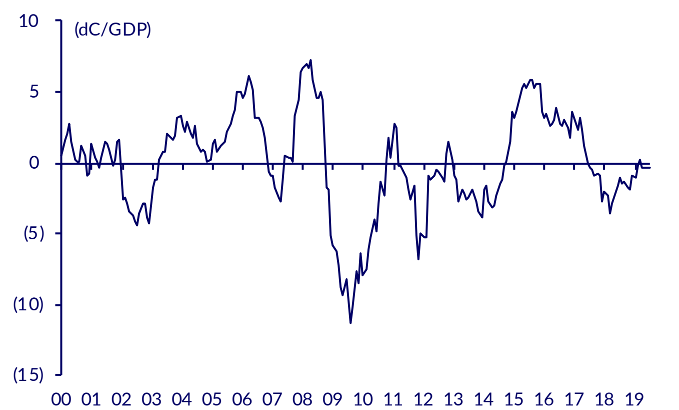
German real export and GDP growth



Source: CLSA, CEIC

Figure 30

Eurozone credit impulse



Source: CLSA, Bloomberg

An early-cycle credit impulse helped the EZ in 2015

As we argued six months ago (see *EoAE* 2Q19 **Stall Speed**) the Eurozone outperformed during the last significant world trade slowdown (in 2015) only by virtue of it receiving an early-cycle, and unsustainable, positive credit impulse as it emerged from the degearing forced by the Eurozone sovereign debt crisis. The slowdown in external trade in 2018 was reinforced by Eurozone credit impulse turning negative: Figure 30.

Eurozone growth forecast cut to 0.7% for 2020

Fiscal stimulus remains verboten in the core by institutionalised fiscal conservatism and in the periphery by the restrictions of the Stability and Growth Pact. We cut our growth estimate for the Eurozone this year to 1% in the last *EoAE*, notwithstanding the weakness of 2Q numbers we would be disappointed were full year growth to come in below this level in 2019 (the consensus growth forecast has fallen from 1.2% at the time of the 3Q *EoAE* to 1.1% today). However, our expectation that a cyclical slowdown in the US will push world trade growth in 2020 negative affects our Eurozone forecast. **We cut our base case forecast for Eurozone growth in 2020 to 0.7%; this is 0.4ppts below consensus and 0.4ppts below our forecasts from three months ago.**

Meaning the fall in unemployment halts

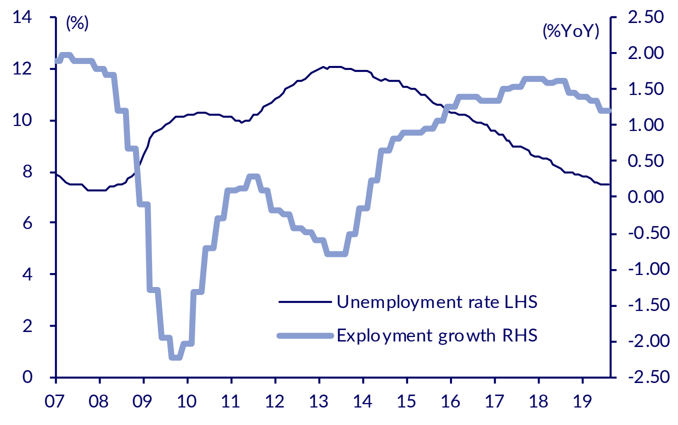
Even though the Eurozone is slow growth economy, this forecast is below trend. This has two immediate implications. The first is that we expect the improvement in the Eurozone labour market to pause. As a lagging economic indicator, Eurozone unemployment continues to decline but this is likely to stop in 2020. Employment growth has already started to decline: Figure 31. Given the importance of consumer spending to Eurozone GDP growth this represents a problem.

And disinflationary pressures grow

The second is that inflationary pressures, already weak, will decline further: Figure 32. Output gap models have not worked well post-GFC. However, it is hard to make a logical case for anything but lower inflation given current data, our expectation that growth slow in 2020, an anticipated decline in global commodity prices (see Figure 13) and a weaker USD in early 2020. We expect the headline CPI to fall to around 0.7% YoY in mid-2020. Core inflation will be a little higher at 0.9%.

Figure 31

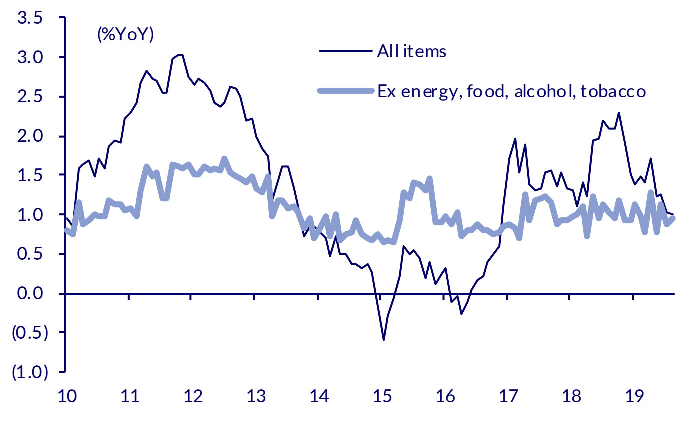
Eurozone labour market indicators



Source: CLSA, CEIC

Figure 32

Eurozone inflation



Source: CLSA, CEIC

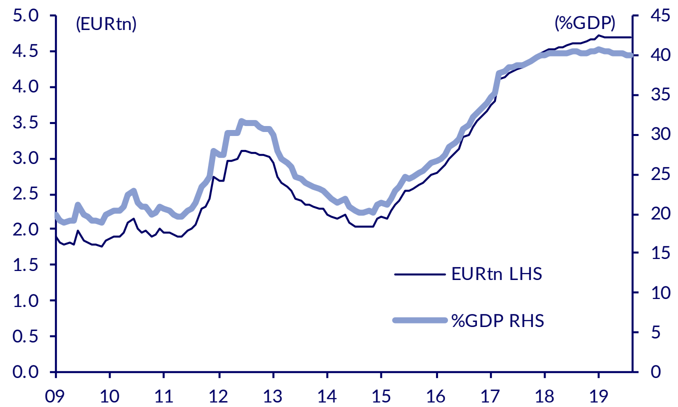
The ECB cut rates by 0.1ppts at its September meeting. We anticipate that a further 10bp cut in the policy rate is possible but the criticism that negative reserve deposit rates are a counterproductive “tax” on banks suggests that -0.6% (reached around end-1Q20) will prove the lower bound for the ECB policy rate.

QE to be restarted in 2020

Continued economic weakness in 2020 will be countered by the ECB increasing the pace of quantitative easing. This initially has been restarted at a tentative pace of EUR20bn per month. The new ECB president, Christine Lagarde, will have to work to keep the conservative members of the ECB council on board. But Germany is facing a severe economic slowdown and we expect that Bundesbank opposition to more QE will soften as the USD depreciates versus the EUR in 1H20. We expect that the ECB's asset purchase program will expand to EUR30bn per month in 1H2020 and stay at this level (growth data will improve but inflation will stay low) to the end of 2021: Figure 34.

Figure 33

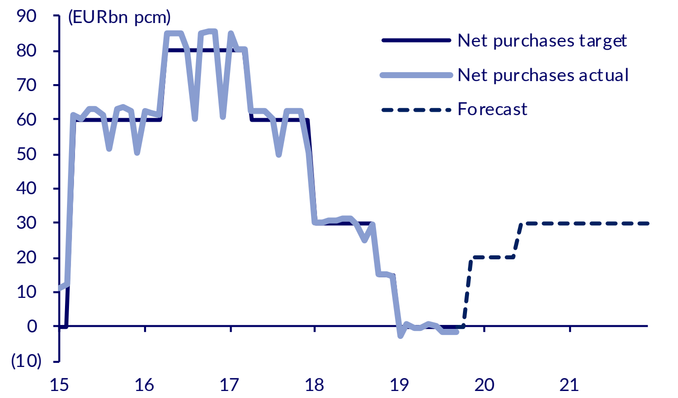
ECB balance sheet



Source: CLSA, Bloomberg

Figure 34

ECB Asset Purchase Program net monthly purchases



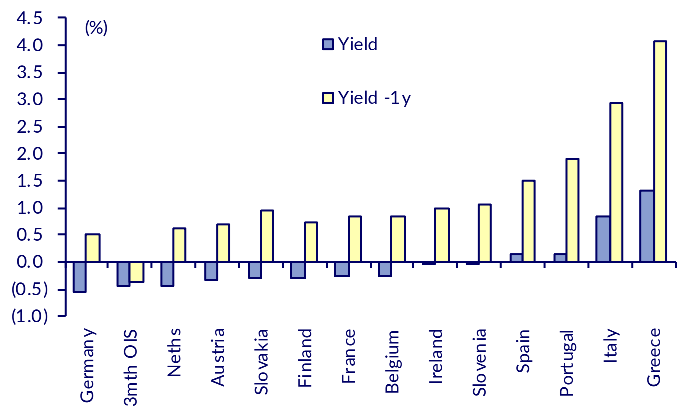
Source: CLSA, Bloomberg

Sovereign credit spread compression in the Eurozone in 2020

The exceptional push negative for Eurozone bond yields over summer is excessive even given a weak growth and inflation outlook: Figure 35. We expect some profit taking in the coming quarter. Funding costs for Eurozone bonds will fall by around 20bp on our forecast. It is hard therefore to forecast significantly lower yields for long-dated core Eurozone bonds than prevailed at the end of August. However, we would expect the resumption of ECB buying and the reassurance of low money market rates to continue to compress sovereign risk premia: Figure 36. At current yields fiscal sustainability, even for indebted Eurozone countries, is unproblematic. This, plus a relatively quiet political calendar in 2020, suggests that Eurozone breakup risk concerns will be low despite weak GDP growth.

Figure 35

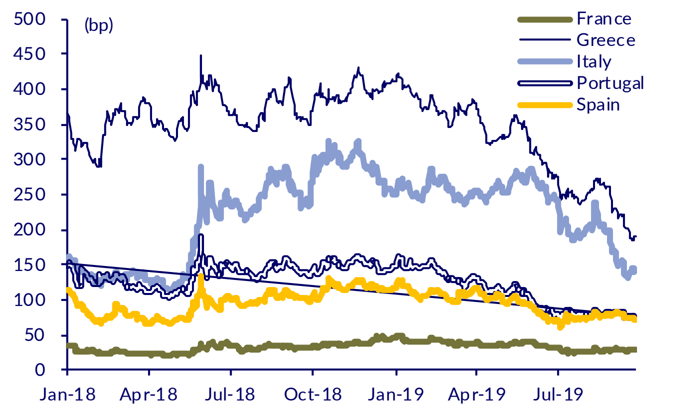
10-year EUR bond yields



Source: CLSA, Bloomberg

Figure 36

EUR sovereign bond spreads over 10yr German Bunds



Source: CLSA, Bloomberg

Modest EUR outperformance in 1H20

To end-2019 we expect the EUR vs the USD to stay soft though concerns about the risk of (US) Treasury intervention will cap USD gains. In 2020, however, an interest rate differential argument favours the EUR. We see it modestly outperforming the USD in 1H20 despite the weakness of Eurozone growth. This will be an additional source of concern for the ECB.

EZ growth will accelerate in 2021 but lag the US

Like all large export driven economies, the Eurozone is a source of instability in the world economy. Weak exports cause weak GDP growth, which feeds into weak import demand. This is a momentum generating process. Thus although we expect that global growth will start to recover in 2021 the Eurozone upturn will lag that in the US. We expect Eurozone growth of 1½% in 2021.

Japan: Sales tax increase going ahead

Japan struggles in a low world growth environment ...

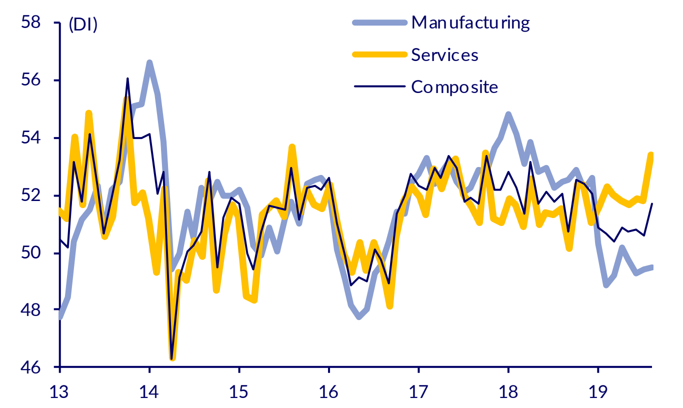
Our Eurozone forecast condenses to weak exports generating weak GDP growth, monetary policy maxed out and able to offer little stimulus and fiscal policy constrained. The same is true of Japan. Historically GDP growth has been 86% correlated with world trade growth and the government has confirmed that consumption tax, presently 8% will be raised to 10% on 1 October. The front loading of purchases that precedes such pre-announced tax increases has boosted monthly indicators (Figure 37 shows the Markit PMIs). However, it will not persist. As CLSA's Japan strategist, Nicholas Smith wrote on 21 August (**The VAT hike goof & what comes next**) the compressions of real wages caused by previous sales tax hikes have taken several years to reverse: Figure 38.

... the last thing it needs is fiscal tightening

We judge the decision to raise the sales tax to be a mistake. The IMF estimates that without mitigating measures the 2019 and 2020 fiscal stance is contractionary by 0.7% and 0.6% of GDP respectively as the effects of the 2018 supplementary budget fade and the October consumption tax increase comes into play (Article IV consultation Nov 2018).

Figure 37

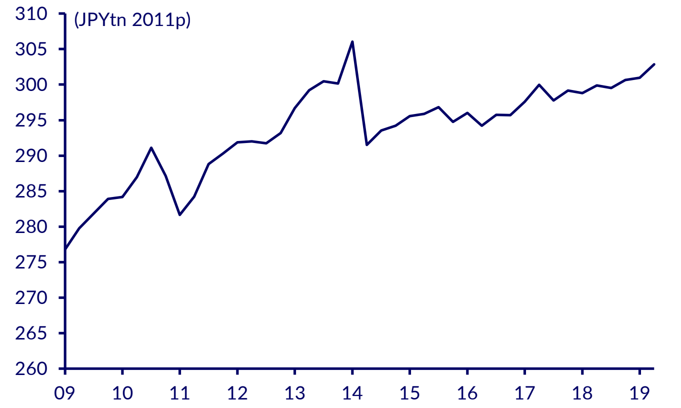
Markit Economics PMIs



Source: CLSA, Markit Economics Ltd

Figure 38

Real private consumption (saar)



Source: CLSA, CEIC

2020 growth forecast cut to 0.3%

If world trade growth remained around current levels Japan would be able to achieve the ¾% growth estimate for 2019 and the ½% growth forecast for 2020 we made in the 3Q19 *EoAE*. This year in fact is turning out a little better than we expected and, as we noted three months ago, Abenomics has raised Japan's productivity growth and the trajectory of its GDP deflator (which in the absence of any reform would be even lower). These numbers included an assumed 1 October sales tax rise so they do not require downgrading for this reason. But slower world growth in 2020 will squeeze Japan. We cut our growth forecast to ¼%. At this level, technical recession is possible.

Ex-sales tax effects inflation to remain low, but stable

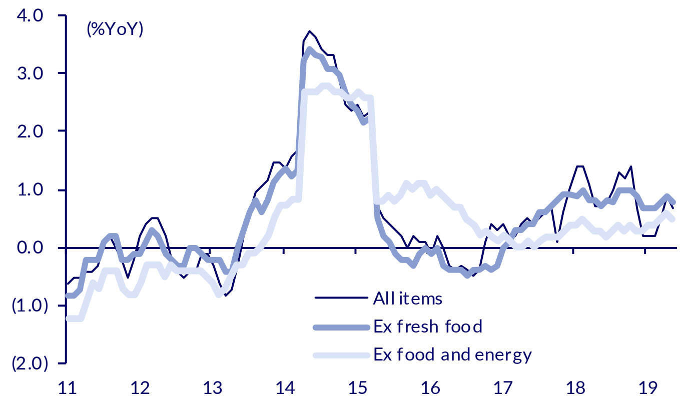
Japan's labour market remains very tight. However, this forecast is below trend and implies that labour market data will start to soften. They are unlikely to do so quickly enough to exert a disinflationary force on the economy however. Japan has been the exception in recent months in that its core inflation rate, though extremely low, has not been declining. We expect that excluding tax effects inflation will stay around current levels through 2020, Figure 39, that is a little over 0.5%. The tax rise will push this to around 2% before it drops out in October 2020.

Yield curve control has made JGBs underperformers

The ex-tax figure is what matters to monetary policy. The Bank of Japan has disregarded sales tax effects as temporary in the past and will again (its inflation target requires inflation to exceed 2% in a "stable manner"). However low inflation is no longer uniquely Japanese. Nor is extreme monetary policy nor negative yields. On the contrary price action in debt markets over summer have left the 10-year JGB looking conventional. Yields are negative, but not as negative as in core Europe. The Bank of Japan's yield curve control anchors 10-year yields at zero +/-20bp. Though 10-year JGBs have broken through the bottom of this range this has made them underperformers: Figure 40 and Figure 2 above.

Figure 39

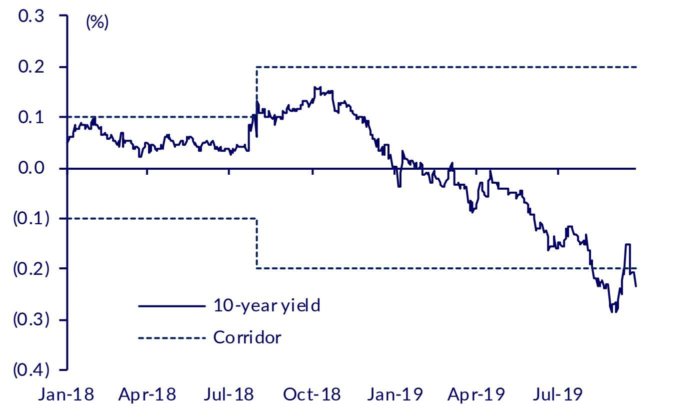
Headline and core inflation (%YoY)



Source: CLSA, CEIC

Figure 40

10-year JGB yield



Source: CLSA, Bloomberg

The delivery of looser monetary policy in more and more central banks will require a policy response from the Bank of Japan. And, although there is little credibility in the 2%-plus inflation target (and its demise is recurrently forecast), we see little sign of the Bank of Japan moving to anything else. Monetary policy should therefore be biased towards further loosening.

We expect a shift lower for the 10yr's target band

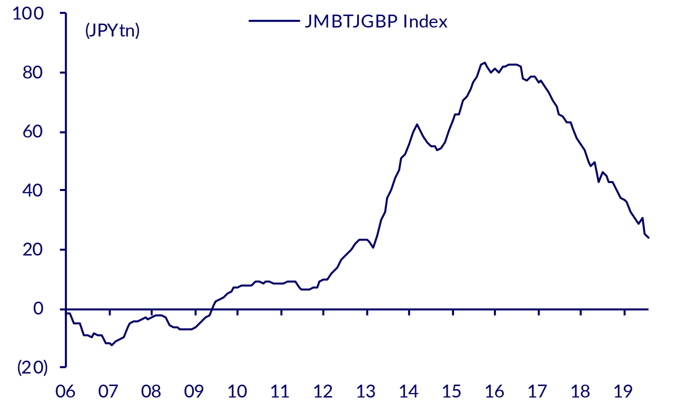
The most that we expect the Bank of Japan to do is adjust the bottom end of the band within which the 10-year is targeted to allow yields to fall below -20bp. We assume a shift from +20bp to -20bp to +20bp to -40bp. This will require only a small acceleration in the rate of Bank of Japan buying which in recent months has fallen: Figure 41. Certainly, a return to the pace seen in 2016 will not be required.

JPY will continue to outperform

Monetary easing in Japan will have little impact on growth. Nor will it match the Fed. Unlike the EUR, the JPY has attractions of a safe haven currency. This will keep it well bid independently of relative interest rates. We expect modest JPY outperformance this year. With the weaker USD we expect for early 2020, the JPY will continue to outperform: Figure 42.

Figure 41

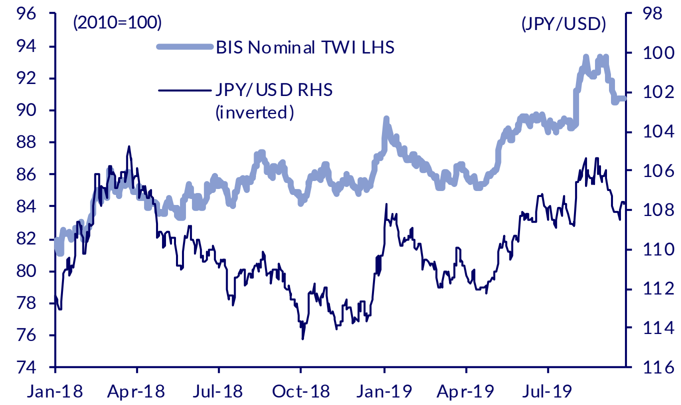
BoJ JGB net purchase rate



Source: CLSA, Bloomberg

Figure 42

JPY/USD and JPY trade-weighted index



Source: CLSA, Bloomberg

2021 growth around 0.7%

Our 2020 forecast of 0.3% includes a boost from Olympic construction and from the one off boost to service exports as the games commence. This will be a one off. We expect Japanese growth to strengthen in 2021 as world trade starts to recover but it is likely to lag. For the moment, we assume 2021 growth around 0.7%.

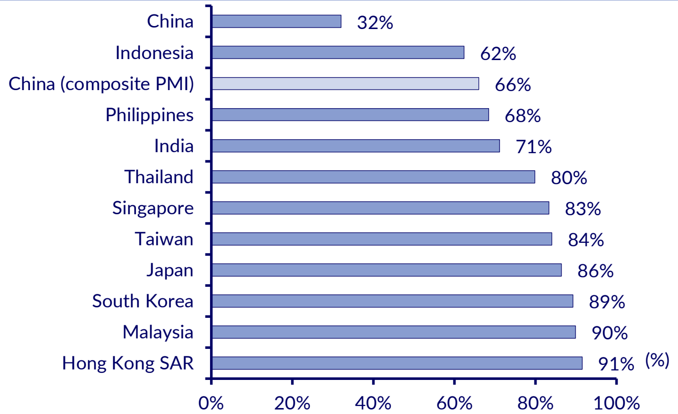
China and the Trade War: Tensions continue, trend growth slows

China represents a much-needed dampening force to the world cycle

Despite markets' concerns about China tail risk economy, while policy remains dually focussed on avoiding imbalances and maintaining full employment China provides a much-needed dampening force to the world cycle. Export weakness in Europe and Japan weaken growth and thus depress world trade further by slowing imports. Over the last ten years China's GDP growth has been only 32% correlated with world trade, lower than any other country we forecast: Figure 43.

Figure 43

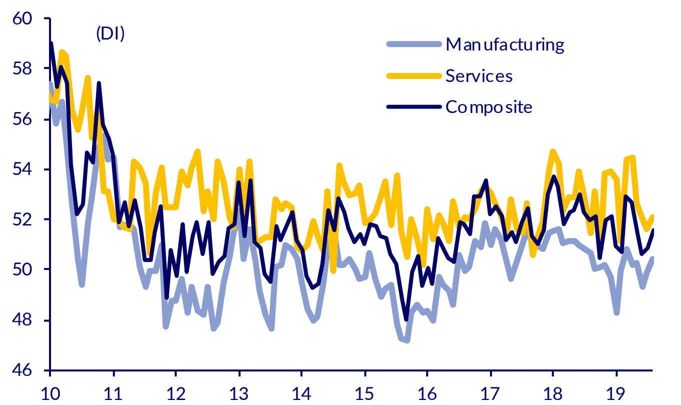
GDP correlation with world trade growth



Source: CLSA, CEIC, Markit Economics Ltd

Figure 44

Markit PMI



Source: CLSA, Markit Economics Ltd

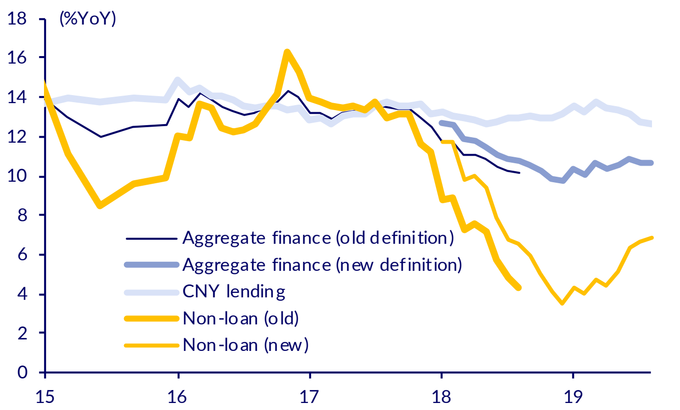
This correlation is subject to the criticism that China's GDP growth are manipulated. In particular the low correlation reflects the official data showing no economic slowdown in 2015 when most China commentators and the urgency of government stimulus, indicate that the economy was close to a hard landing. Recalculate the correlation with the Markit composite PMI, our favoured whole-economy activity index and a number that we do trust, and the importance of world trade to China's growth rises to 66%. This is not enough to reverse the argument. In China, policy rather than external conditions, matter most for growth.

Markit's composite PMI is above 2015 levels

This is borne out by recent readings of the Markit PMIs: Figure 44. Manufacturing is weak but the overall volatility of the index is low by other countries' standards (and note China's standing in Figure 10 above). The services and the composite PMIs are considerably stronger. The composite PMI is well above its 2015 trough as it has been at all points in the past 18 months despite market fears about Chinese growth. This conclusion vindicates economic policy, which remains reactive, triaged and gradual.

Figure 45

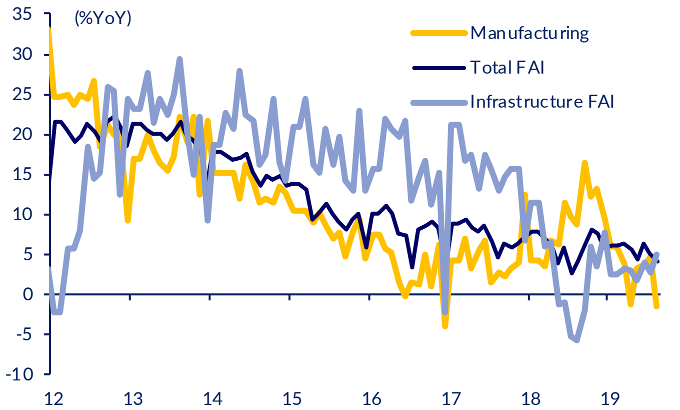
Aggregate finance growth (%YoY)



Source: CLSA, CEIC

Figure 46

Fixed asset investment %YoY



Source: CLSA, Markit Economics Ltd

Faith in Beijing's ability to manage growth has risen

While global growth fears have risen in the last quarter, concerns about China's economy weakening have been quite muted. This is despite the trade war continuing to escalate and indicates a degree of market conviction that China's policy will remain committed to keeping growth close to full employment.

2019 growth estimate cut to 6.3% because of the soft start to 3Q

That said, most July economic statistics were weaker than expected and 2Q GDP data were published at 6.2% YoY (1.6% QoQ). Credit is accelerating but slowly and bank lending growth has been weakening since the start of the year suggesting a dysfunctional credit multiplier: Figure 45. Most aggregate finance components have been weak with the exception of local government special bond issuance. This continues to accelerate and the revealed preference of policymakers is pivoting towards promoting infrastructure spending (see the China country forecast section on pp37-40 for more of this). This is sensible given the headwinds facing private businesses and export-facing manufacturing in particular. **We reduce our 2019 growth estimate to 6.3% because of the soft start to 3Q.** This still represents a decorrelated forecast.

6% growth in 2020

Next year will be slower. Trend growth is slowing and although China will use countercyclical policy to prevent an output gap from opening it will not accelerate its economic growth to benefit the rest of the world economy. **We expect growth around 6.0% in 2020, essentially tracking the full employment trajectory but slightly weaker than 2019.** China will therefore not contribute to the world trade slowdown but neither will it act as an offset to weaker US growth.

And 5.8% in 2021

Further slowdown should be expected in 2021 and for the same reason. Given demographics, China's full employment growth trajectory is slowing by around 0.2ppts per annum. This suggests that China's growth target can fall below 6% in 2021 without threatening higher unemployment. Financial markets however are likely to take this as an additional global risk.

The trade war continues to escalate

The trade war continues to escalate

Trump threatened a 10% tariff on the remainder of China's export to the US at the start of August. China's retaliation caused the president to add an additional 5ppts to existing tariffs (25% to 30%) and to the 10% tariffs (now 15%) due to start on 1 September and 15 December.

However talks are back on track

Since then the optics have become more positive. First Trump, on the request of Liu He, shifted the date at which US tariffs rise by 5ppts from China's National Day, 1 October, to 15 October as a gesture of goodwill. Second China has indicated that it is encouraging companies to buy US products including soybeans and pork. It has indicated that various US agricultural products, including soybean, pork and other farm goods will be exempt from additional trade war tariffs. Mid-level trade talks resumed in September with the thirteenth round of high-level talks scheduled to take place in Washington in October.

Rudd expects a deal before year-end

Speaking at the 26th Investors' Forum in Hong Kong, Kevin Rudd, former Australian prime minister and expert on the Chinese polity, argued that such steps would be important signposts towards a deal being signed before the end of the year. He expects this because a deal is in both sides' economic interests and that, otherwise, both the US and Chinese economies would suffer.

However a deal will not preclude future tensions, nor will it see tariffs rolled back

We agree with the economic analysis however the question is whether the economic imperative is sufficient not only to push both sides to come to a trade agreement but adhere to it such that the agreement has long-term meaning. Here we remain sceptical. Financial markets have tended to look for an agreement with the premise that if secured the trade war would be over. The reality, as demonstrated by Trump's willingness to threaten Mexico with tariffs after the US-Mexico-Canada agreement had been struck, is that for the US side at least tariffs remain an on-the-table weapon irrespective of whether an agreement has been made or not. We continue to think that the political cycle in the US plus the fact that other Republican candidates and likely Democrat candidates all now favour a more confrontational stance with respect to China, makes any truce reached between Trump and Xi highly unstable. Accordingly while we hope that Rudd is correct our assumption in forming a world trade forecast is to assume that tariffs remain in place and that tensions remain high. Any risk-on period following an agreement should be "rented rather than bought".

Siloization of technology to continue

Additionally continued siloization of US technology should be expected. Huawei will continue to be the most obvious target but not the only one. The risk that more Chinese manufacturers find their access to US technologies restricted will rise as the presidential election approaches.

And China is responding to increase self-reliance

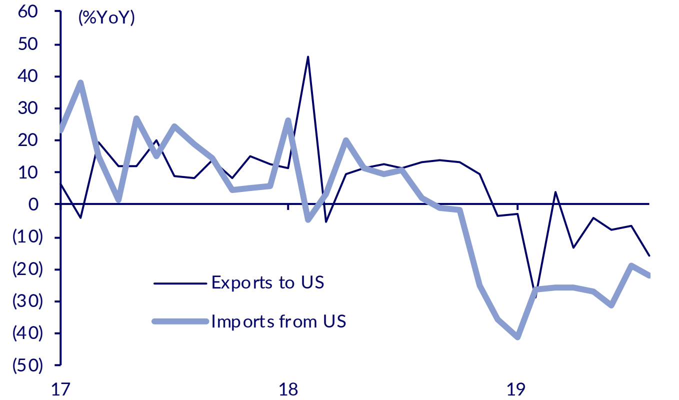
US technology restrictions are also bringing a response. Chinese companies are likely to be aggressive in sourcing alternatives. Korea and Taiwan's high tech industries will be obvious beneficiaries. China is also likely to increase its efforts to develop local rivals to established technologies and standards. For a small country this would be economically irrational but China has the scale and international reach to create genuine challengers to western alternatives.

US exports to China have slowed more than China's exports to the US

With tariffs in play for more than a year their impact on trade patterns can start to be determined. As we wrote in the *Infofax Daily* on 22 August (**Who's winning the war?**) the change in China's export growth to the US (2018 +11%, year to July 2019 -8% YoY) is smaller than the change in US exports to China (2018 0% YoY, 1M-7M19 -28% YoY): Figure 47. This is perhaps understandable given the nature of the products the two countries trade. Agricultural and energy products have a higher price elasticity than semi or finished manufactures particularly given the scale of global production that China represents (see *EoAE* 2Q19 **Groundhog year** p20). Recent work by "Bloomberg Economics" supports the argument that the US is finding it more difficult to source alternatives to Chinese exports (and therefore is finding them supply constrained) than China is finding it difficult to find alternatives to US products (**Global Insight: 700k data points reveal China trade war edge** 28 August). Certainly both sides of China-US trade have slowed significantly faster than China's trade with the EU, Figure 48, from being in a state of approximate parity a year ago even though US aggregate import growth is stronger than that of Europe.

Figure 47

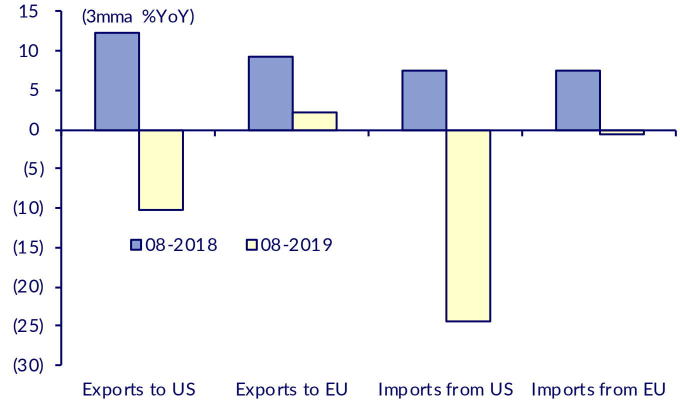
China's trade with the US: exports versus imports



Source: CLSA, CEIC

Figure 48

China's exports and imports

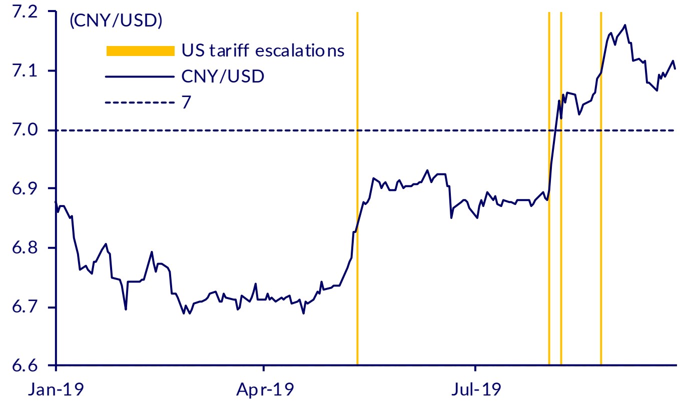


Source: CLSA, CEIC

This highlights the economic irrationality of a trade war. However, the US-China trade war has always been a political as much as an economic construct. Faced with weaker economic growth we fear that increased mercantilism will be a natural response for President Trump.

Figure 49

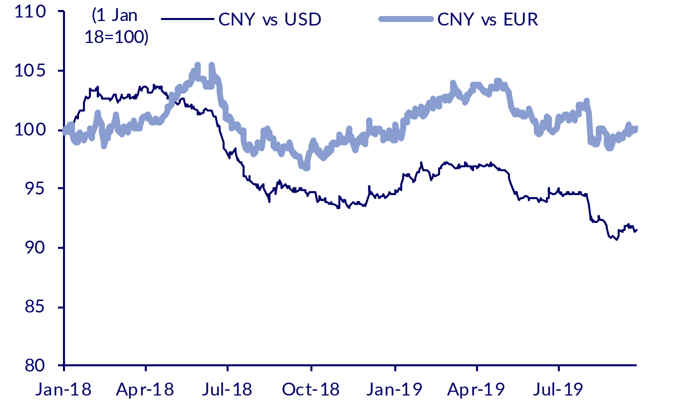
CNY/USD



Note: 10 May: US tranche II tariffs rise from 10% to 25%, 1 Aug: Trump announces tariffs to be imposed on remaining Chinese exports, 23 Aug: Trump threatens additional 5ppts on US tariffs
Source: CLSA, Bloomberg

Figure 50

USD/CNY and EUR/CNY exchange rate indices



Source: CLSA, Bloomberg

CNY/USD target CNY7.30/USD

The natural response to a tariff threat is to allow the currency to depreciate: Figure 49. As the tensions between China and the US have been worse, the currency depreciation has been faster than we expected when the CNY was first allowed to trade through CNY7/USD and we shift our end-2019 CNY/USD forecast to CNY7.30/USD. The USD has been unilaterally strong over this period. In the last 12-months the CNY has moved sideways versus the EUR: Figure 50.

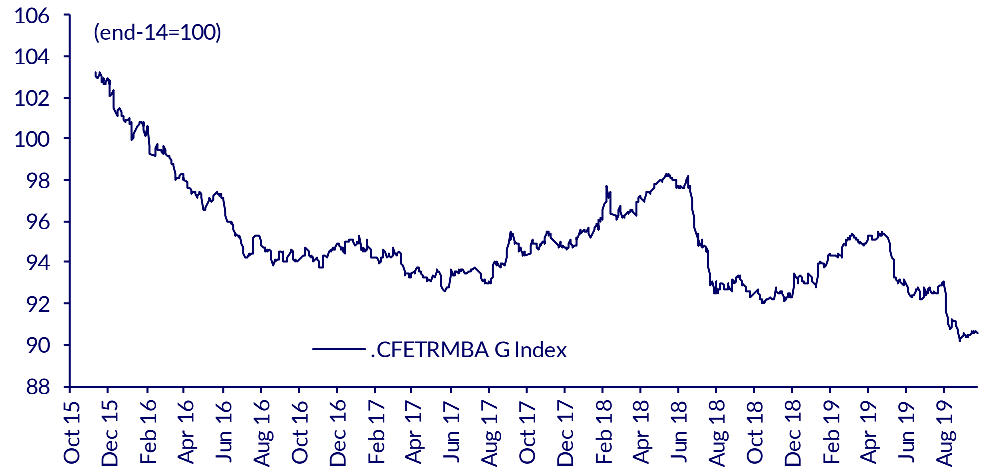
The CNY has been a weak currency in trade-weighted terms

In trade-weighted terms, the scale of depreciation seen in the last four months is now approaching the depreciation in May and June 2018: Figure 51. Indeed, it is noteworthy that the CNY has been in a depreciating trade-weighted channel since the PBoC policy focus shifted towards the trade-weighted index in late 2015.

Which we expect to continue

Figure 51

CFETS CNY trade-weighted index



Source: CLSA, Bloomberg

Given the likely weakness of the Chinese balance of payments, this will continue. However, the softer tone we expect for the USD in early 2020 will help the CNY. We expect a temporary re-appreciation back towards CNY7/USD though a move through this key psychological level looks unlikely.

Asian growth: The 2020 consensus to come down

Internally-driven economies as well as export-driven ones have seen growth weaken

World trade and manufacturing are already weaker than in 2015 and Asian economies, with the exceptions of India, Indonesia and Philippines have large manufacturing sectors. It is therefore unsurprising that Asian growth data in the last three months have been disappointing. There are exceptions. Korea, Malaysia and Taiwan all reported better than expected 2Q GDP growth (typically for domestic reasons). But, it is sobering that Asia's internally-driven economies, where the effects of external conditions are least important, have also been weak.

We are less optimistic than three months ago on India

Thus, we are much less optimistic than three months ago on India. Empirically construction, investment and credit are tightly correlated and, though the government is to be applauded in launching a bold reform of corporate taxes, the point at which credit recovers and growth shifts above trend seems more distant today than it did twelve months ago. Monthly data to August have been soft and we fear that FY20 GDP growth will be below 6%.

2019 growth estimates down an average of 0.5ppts

In aggregate, our 2019 growth estimates are down an (unweighted) average of 0.5ppts. This reflects large cuts in our numbers for Hong Kong and India and smaller downgrades for Thailand (data remain dire), Australia (largely housekeeping after 2Q19 GDP) and China. The last, of course, qualitatively, punches above its small (0.1ppt) size. China's current activity data are softer than we expected approaching the 1 October holiday. However, first, they are less weak than Chinese data were in 2015 and, second, policy is increasingly focussed on infrastructure spending funded by local government bond issuance. This should prove a reliable countercyclical stimulus at the expense of higher indebtedness and increasing the role of state direction in the economy.

We have cut the 2020 forecasts by 0.5ppts also

Figure 52

CLSA GDP forecasts relative to 3Q19 Eye on Asian Economies

(%YoY)	2017	2018	2019E	2020F	2021F	*Chg in CLSA f'cast in last qtr* 2019	2020
USA	2.4	2.9	2.2	1.0	2.2	*(0.3)*	*(0.5)*
Eurozone	2.6	1.9	1.0	0.7	1.5	*0.0*	*(0.4)*
Japan	1.9	0.8	0.7	0.3	0.7	*0.0*	*(0.2)*
Australia	2.4	2.7	1.9	2.2	2.5	*(0.1)*	*(0.1)*
China	6.8	6.6	6.3	6.0	5.8	*(0.1)*	*(0.2)*
Hong Kong	3.8	3.0	(0.7)	(0.5)	2.5	*(2.3)*	*(1.9)*
India[1]	6.9	6.6	5.7	6.7	7.1	*(1.7)*	*(0.9)*
Indonesia	5.1	5.2	5.2	5.2	5.4	*0.0*	*0.0*
Korea	3.2	2.7	2.0	1.9	2.7	*0.0*	*(0.3)*
Malaysia	5.7	4.7	4.4	3.1	3.6	*0.3*	*(0.1)*
Philippines	6.7	6.2	5.9	6.0	6.0	*0.0*	*0.0*
Singapore	3.7	3.1	0.6	1.0	1.5	*(1.4)*	*(1.2)*
Taiwan	3.1	2.6	2.3	1.3	1.6	*0.3*	*(0.6)*
Thailand	4.0	4.1	2.8	2.6	3.1	*(0.4)*	*(0.5)*

[1] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

The weak external environment is the primary reason for all but three of the downgrades

Figure 52 summarises the changes that we have made to our forecasts in the last three months. The cut in our US forecast is causal. As we flag above (see pp9-15) though 1% US GDP growth in 2020 is a shallow recession, there is insufficient strength in the rest of the world economy for it not to pull global growth further negative. While Korea and Taiwan published better than expected 2Q19 numbers both are strongly trade correlated and negative multiplier effects from export weakness will accumulate the longer global trade contracts. We have cut the 2020 forecast for all the countries that we model save the Philippines and Indonesia (unchanged). The weak external environment is the primary reason for all but three of the downgrades:

China: Trend growth is slowing

- **China:** The government policy reaction to weak 2019 data remains relatively gradual. This suggests increased tolerance of slow growth. And the pace of growth required to maintain full employment is ¼ppt lower in 2020 than it was in 2019. We assume an "around 6%" official growth target achieved by continuing to use infrastructure investment countercyclically.

India: Tax reform positive, credit environment negative

- **India:** The positive effect of Modi's corporate tax reforms are more visible in our FY21/2020 forecast. However, we assume that credit growth remains subdued until the second half of the fiscal year and this contains GDP growth below 7%.

Hong Kong: Protests reinforce extant economic slowdown

- **Hong Kong:** Investment was collapsing before the protests. Resident consumption should recover as the protests abate. However, we assume that visitor arrivals from Mainland China will take longer to revert to normal levels. A larger government stimulus package should be expected centered on residential and infrastructure construction but the first-year effects of these will be muted.

We are below consensus for 2020

Though financial market pessimism about global growth has, over summer, been high this has not yet permeated into regional forecasts. Our 2020 forecasts are below consensus in all countries aside from Japan (in line) and Indonesia (0.1ppts above consensus). Consensus surveys are inevitably lagging. As US data weaken in late 2019 expectations, first for US growth and then subsequently global growth, will be cut.

And expect the consensus to be cut in coming months

Figure 53

CLSA GDP forecasts relative to consensus

(%YoY)	2017	2018	2019E	2020F	2021F	*CLSA-consensus*	
						2019	*2020*
USA	2.4	2.9	2.2	1.0	2.2	(0.1)	(0.7)
Eurozone	2.6	1.9	1.0	0.7	1.5	(0.1)	(0.4)
Japan	1.9	0.8	0.7	0.3	0.7	(0.2)	0.0
Australia	2.4	2.7	1.9	2.2	2.5	0.0	(0.3)
China	6.8	6.6	6.3	6.0	5.8	0.1	(0.0)
Hong Kong	3.8	3.0	(0.7)	(0.5)	2.5	(1.4)	(2.1)
India[1]	6.9	6.6	5.7	6.7	7.1	(1.0)	(0.3)
Indonesia	5.1	5.2	5.2	5.2	5.4	0.2	0.1
Korea	3.2	2.7	2.0	1.9	2.7	0.0	(0.3)
Malaysia	5.7	4.7	4.4	3.1	3.6	(0.1)	(1.2)
Philippines	6.7	6.2	5.9	6.0	6.0	0.0	(0.2)
Singapore	3.7	3.1	0.6	1.0	1.5	(0.1)	(0.7)
Taiwan	3.1	2.6	2.3	1.3	1.6	0.3	(0.7)
Thailand	4.0	4.1	2.8	2.6	3.1	(0.2)	(0.7)

[1] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

2021 should see growth recovering

A shallow US recession with a return to above-trend US growth means a better outlook for 2021. This is most visible in the US forecast. Other countries will lag as multiplier effects smear the weakness in the 2020 forecast into 2021. But, by the second half of 2021 most countries will be growing above trend and output gaps that developed in 2020 will be being closed.

But China's trend-tracking growth trajectory can slow further

China is the exception. Its policy of micro-managing the business cycle to prevent an output gap emerging gives it a low-amplitude business cycle. It also means that China will not act as an offset to slower growth in other regions (successfully *preventing* an output gap emerging negates the need to accelerate growth above trend). China's full employment growth trajectory will drop to 5¾% in 2021 and we expect that the government growth target will be a 5.5-6.0% growth range. Financial market reaction to China, for the first time, targeting growth under 6% is likely to be poor.

Asian inflation: Bobbling along the bottom

Inflation continues to drift lower

Inflation in the last quarter has continued to edge lower though the pace of decline has become more moderate: Figure 54 shows latest inflation rates compared with six and twelve months ago. Figure 55 does the same for core inflation.

ASF assumed to dissipate after the Chinese New Year

The drift lower for headline inflation excludes China and Hong Kong whose inflation continues to be driven higher by African swine fever. This will keep headline inflation rates elevated to the 2020 Chinese New Year. After this point, we have assumed that pork prices start to mean revert. Even if the reversion is incomplete, this will generate very low inflation rates in late 2020 and early 2021.

Figure 54

Headline inflation rates August 2019

%YoY and ppts	Aug-19	Feb-19	Aug-18	chg on 6mth	chg on 12mth
Australia	1.6	1.8	2.1	*(0.2)*	*(0.5)*
China	2.8	1.5	2.3	*1.3*	*0.5*
Hong Kong	3.5	2.6	2.6	*0.9*	*1.0*
India	3.2	2.6	3.7	*0.6*	*(0.5)*
Indonesia	3.3	2.6	3.2	*0.8*	*0.1*
Korea	0.0	0.5	1.4	*(0.5)*	*(1.5)*
Malaysia	1.5	(0.4)	0.2	*1.9*	*1.3*
Philippines	0.0	3.8	6.4	*(3.8)*	*(6.4)*
Singapore	0.5	0.5	0.7	*0.0*	*(0.3)*
Taiwan	0.4	0.2	1.5	*0.2*	*(1.1)*
Thailand	0.5	0.7	1.6	*(0.2)*	*(1.1)*

Source: CLSA, CEIC

Figure 55

Core inflation rates August 2019

%YoY and ppts	Aug-19	Feb-19	Aug-18	chg on 6mth	chg on 12mth
Australia	1.5	1.7	1.6	*(0.2)*	*(0.1)*
China	1.5	1.8	2.0	*(0.3)*	*(0.5)*
Hong Kong	2.5	2.5	2.1	*(0.0)*	*0.4*
India	4.0	5.1	5.7	*(1.1)*	*(1.7)*
Indonesia	3.2	3.1	2.9	*0.1*	*0.3*
Korea	0.8	1.1	1.0	*(0.3)*	*(0.2)*
Malaysia	2.0	0.3	(0.2)	*1.7*	*2.1*
Philippines	0.0	3.9	4.8	*(3.9)*	*(4.8)*
Singapore	0.8	1.5	1.9	*(0.8)*	*(1.1)*
Taiwan	0.4	0.3	1.4	*0.1*	*(1.0)*
Thailand	0.5	0.6	0.7	*(0.1)*	*(0.3)*

Source: CLSA, CEIC

We have observed the dominance of disinflationary forces for some time and there are few changes to our 2019 inflation estimates: Figure 56. Where there are changes they are housekeeping, monthly outcomes having been higher or lower than our models suggested.

Only small changes to our 2019 inflation estimates

Figure 56

CLSA inflation forecasts relative to 3Q19 Eye on Asian Economies

(%YoY)	2017	2018	2019E	2020F	2021F	*Chg in CLSA f'cast in last qtr* 2019	2020
USA[1]	1.8	2.1	1.5	1.5	1.8	*(0.1)*	*(0.2)*
Eurozone	1.5	1.8	1.2	0.8	1.3	*0.1*	*(0.2)*
Japan	0.5	1.0	0.8	1.5	1.0	*(0.1)*	*0.2*
Australia	2.0	2.0	1.3	1.3	1.9	*0.2*	*0.3*
China	1.6	2.1	2.6	1.6	1.3	*(0.1)*	*(0.9)*
Hong Kong	1.5	2.4	2.8	1.8	0.7	*0.2*	*(0.4)*
India[2]	3.6	3.4	3.3	3.2	3.3	*(0.1)*	*(0.4)*
Indonesia	3.8	3.2	3.0	2.6	2.8	*0.2*	*0.0*
Korea	1.9	1.5	0.7	0.5	1.0	*0.0*	*(0.3)*
Malaysia	3.8	1.0	0.8	1.3	1.9	*0.0*	*0.0*
Philippines	2.9	5.2	2.4	2.3	2.8	*(0.3)*	*(0.4)*
Singapore	0.6	0.4	0.6	0.5	0.5	*0.0*	*0.0*
Taiwan	0.6	1.3	0.7	0.2	0.8	*0.0*	*(0.1)*
Thailand	0.7	1.1	0.7	1.4	1.5	*(0.2)*	*(0.1)*

[1] PCE deflator, [2] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

But lower growth and commodity prices mean cuts in our 2020 inflation forecasts

There is a more substantive change for 2020. Compared with three months ago we have reduced our growth forecasts and this implies increased downward pressure on core inflation rates. In addition, we have cut our oil and commodity price forecasts (on the back of weaker global growth) which means additional downward pressure on headline inflation. Our 2020 inflation forecasts are 0.2ppts down on the 3Q19 *EoAE*. The outsized reduction in the China inflation forecast primarily reflects the pork price effect that we outline above.

Our forecast sees inflation lower in 2020; the median analyst sees it higher

An absence of inflation is absolutely a consensus in financial markets. However, the median inflation economist forecast for 2020 on Bloomberg remains relatively high. Indeed the median forecast for 2020 is higher than the 2019 estimate for all AxJ countries but China and Hong Kong. On our forecasts 2020 inflation will be lower or unchanged from 2019 inflation in all but Malaysia (this year is reduced by a tax effect) and Thailand (where some very low early-2019 inflation prints mean a positive base effect in early-2020). Our forecasts relative to consensus are shown below. On average, we are 0.6ppts lower for 2020: Figure 57. As with growth, we expect that consensus inflation forecasts will be cut quickly at the start of next year.

The consensus forecast for 2020 is too high and will fall

Figure 57

CLSA inflation forecasts relative to consensus

(%YoY)	2017	2018	2019E	2020F	2021F	*CLSA-consensus*	
						2019	***2020***
USA[1]	1.8	2.1	1.5	1.5	1.8	*0.0*	*(0.4)*
Eurozone	1.5	1.8	1.2	0.8	1.3	*0.0*	*(0.5)*
Japan	0.5	1.0	0.8	1.5	1.0	*0.1*	*0.5*
Australia	2.0	2.0	1.3	1.3	1.9	*(0.3)*	*(0.7)*
China	1.6	2.1	2.6	1.6	1.3	*0.2*	*(0.7)*
Hong Kong	1.5	2.4	2.8	1.8	0.7	*0.3*	*(0.4)*
India[2]	3.6	3.4	3.3	3.2	3.3	*(0.4)*	*(0.8)*
Indonesia	3.8	3.2	3.0	2.6	2.8	*(0.2)*	*(0.9)*
Korea	1.9	1.5	0.7	0.5	1.0	*0.1*	*(0.8)*
Malaysia	3.8	1.0	0.8	1.3	1.9	*(0.1)*	*(0.7)*
Philippines	2.9	5.2	2.4	2.3	2.8	*(0.6)*	*(0.9)*
Singapore	0.6	0.4	0.6	0.5	0.5	*(0.1)*	*(0.6)*
Taiwan	0.6	1.3	0.7	0.2	0.8	*(0.2)*	*(0.9)*
Thailand	0.7	1.1	0.7	1.4	1.5	*(0.2)*	*0.4*

[1] PCE deflator, [2] Fiscal year starting April of captioned calendar year.
Source: CLSA, CEIC, Bloomberg

Inflation will be slow to accelerate in 2021

Inflation will be slow to accelerate in 2021 even though global growth should be picking up. Output gaps will initially be slow to close. Commodity prices should start to rise relatively early in the recovery cycle and feed into headline inflation, but core inflation will be more lagged. And the acceleration in inflation will be from very low starting points. On our forecast 2021 inflation in AxJ will be below the 2% "price stability" level in all countries but India, Indonesia and the Philippines. In no country will it be high enough to require monetary policy to be tightened early in the recovery cycle.

Monetary policy: Easing becomes ubiquitous

The easing cycle has started with a vengeance

Since the publication of the 3Q19 *Eye on Asian Economies* the US and the Eurozone have cut rates (and the Eurozone restarted quantitative easing). In AxJ policy rates have been cut in seven countries and RRR has been cut in China.

Rate cuts will become all but ubiquitous

Looking forward rate cuts will become all but ubiquitous. Including money market rates driven by USD rates, every AxJ economy we forecast other than Taiwan (where the central bank favours fiscal expansion) will see rates lower in the remaining months of this year. This includes China. The People's Bank of China chose not to reduce rates pre-emptively ahead of the September Fed cut. However, we find it hard to imagine that in a global environment of lower rates the PBoC will stand aside.

Only Taiwan will not ease monetary policy in 2020

Figure 58

Policy rate forecasts

	End-2017	End-2018	Current	End-2019	End-2020	End-2021
USA[1]	1.38	2.38	**1.88**	1.63	0.63	0.63
Eurozone[2]	(0.40)	(0.40)	**(0.50)**	(0.50)	(0.60)	(0.60)
Japan[2]	(0.10)	(0.10)	**(0.10)**	(0.10)	(0.10)	(0.10)
Australia	1.50	1.50	**1.00**	0.75	0.50	0.50
China	3.00	2.64	**2.62**	2.40	2.00	2.00
Hong Kong	1.31	2.33	**2.29**	1.95	0.85	0.97
India[3]	6.00	6.25	**5.40**	4.65	4.40	4.40
Indonesia	4.25	6.00	**5.25**	5.00	4.25	4.25
Korea	1.50	1.75	**1.50**	1.25	0.75	0.75
Malaysia	3.00	3.25	**3.00**	2.75	2.00	2.00
Philippines	3.00	4.75	**4.00**	4.00	3.50	3.50
Singapore	1.50	1.89	**1.88**	1.65	1.00	1.12
Taiwan	1.38	1.38	**1.38**	1.38	1.38	1.38
Thailand	1.50	1.75	**1.50**	1.25	1.00	1.00

[1] Mid-point of Fed funds upper and lower bounds; [2] Overnight reserve deposit rate; [3] Fiscal year starting April of captioned calendar year. Source: CLSA, Bloomberg

The BoJ easing will be via yield curve control

As Figure 58 shows, we expect that rate cuts will continue into 2020 with again only Taiwan the exception. The Bank of Japan will not cut policy rates but we do expect it to allow 10-year JGB yields to move below -0.2%.

7-day interbank repo rate at 2% in China end-2020

Again our 2020 forecast makes no exception for China. An environment in which the US Fed funds rate is taken below 1%, the USD is soft (in 1H20, see below) and other Asian countries are cutting rates means that we expect that the PBoC will guide money market rates lower. Our end-2020 forecast for the 7-day interbank repo rate is 2%. Though this seems extremely aggressive, the risk is that we are being too conservative.

1ppt off rates in Indonesia and India

It is, however, India and Indonesia, whose policy rates today are highest, where we see the greatest capacity for rates to be cut aggressively. Taking our 2019 and 2020 forecasts together, both countries will cut rates by 100bp from current levels.

Policy-driven asset inflation cycle will continue

As we argued three months ago (3Q19 *EoAE* p30), we do not believe that monetary policy will be effective at cushioning Asian economies from the effects of slower global growth unless, at the same time, broader government policy stimulates investment in non-cyclical sectors. It is therefore encouraging that the last three months have seen a more proactive approach to fiscal stimulus starting to appear in the region. Korea's draft 2020 budget and India's corporate tax cuts (which should be considered countercyclical as well as supply-side reform) stand out here but, so too, does China's increased focus on infrastructure investment. More generally, over-reliance on monetary stimulus is undesirable and is likely to be limited in its ability to stimulate business investment given the weakness of global growth. Instead velocity of circulation will fall as liquidity stays pooled in financial assets.

No tightening in 2021

The flat inflation trajectory we expect for 2021 will allow central banks to keep monetary conditions accommodative. In no country do we expect policy rates to rise before the end of 2021.

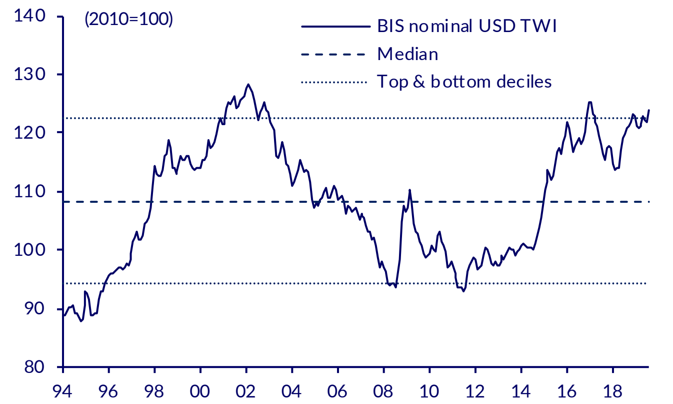
> **Weaker USD in early 2020**

Exchange rates: Some (temporary) USD softness

As we flag in the US commentary above, though Fed rate cut expectations are aggressive for this year, rate expectations for 2020 are not. The USD is, against most measures expensive (Figures 59 and 60 show long run charts of the nominal and real USD trade-weighted indices). We therefore expect that the USD will weaken in early 2020 as the forward curve shifts down in recognition of weaker US growth.

Figure 59

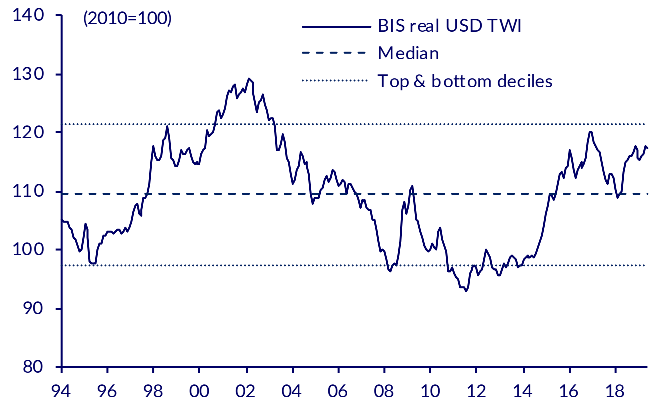
USD trade-weighted index: nominal



Source: CLSA, BIS, Bloomberg

Figure 60

USD trade-weighted index: real



Source: CLSA, BIS, Bloomberg

Disappointing US economic data have the potential to extend this into the second quarter and it is visible in the end-1Q20 and end-2Q20 forecasts shown in Figure 61.

Figure 61

Currency forecasts

Period end	2017	2018	2019F	2020F	2021F	Coming 12 months by quarter			
						4Q19F	1Q20F	2Q20F	3Q20F
USD/EUR	1.20	1.15	1.07	1.15	1.10	1.07	1.15	1.20	1.17
JPY/USD	112.7	109.7	104.0	100.0	105.0	104.0	101.0	100.0	100.0
USD/GBP	1.35	1.28	1.20	1.30	1.30	1.20	1.25	1.30	1.30
USD/AUD	0.78	0.70	0.65	0.70	0.75	0.65	0.67	0.70	0.70
CNY/USD	6.51	6.87	7.30	7.30	7.30	7.30	7.20	7.10	7.20
HKD/USD	7.81	7.83	7.84	7.83	7.82	7.84	7.84	7.83	7.83
INR/USD	63.93	69.79	72.00	70.00	69.00	72.00	71.00	70.00	70.00
IDR/USD	13,548	14,481	14,325	14,700	15,000	14,325	14,450	14,517	14,600
KRW/USD	1,067	1,116	1,250	1,160	1,100	1,250	1,200	1,180	1,180
MYR/USD	4.06	4.14	4.23	4.34	4.38	4.23	4.25	4.28	4.31
PHP/USD	49.92	52.72	52.60	53.90	55.00	52.60	53.00	53.34	53.60
SGD/USD	1.34	1.36	1.42	1.37	1.42	1.42	1.37	1.33	1.35
TWD/USD	29.95	30.59	32.00	32.00	32.00	32.00	31.50	31.00	31.50
THB/USD	32.67	32.71	30.90	31.50	31.75	30.90	31.00	31.10	31.30

Source: CLSA, Bloomberg

> **We do not expect the soft-USD period to persist past mid-year**

We do not expect the soft-USD period to persist past mid-year. Even at the trough of the US rate cycle, US Treasuries represent high-yield assets relative to peers that offer a comparable risk profile. Thus, we anticipate that the USD will restrengthen in 2H20 though the JPY's safe haven status will offer it insulation.

We are cautious on AxJ currencies to end-2019

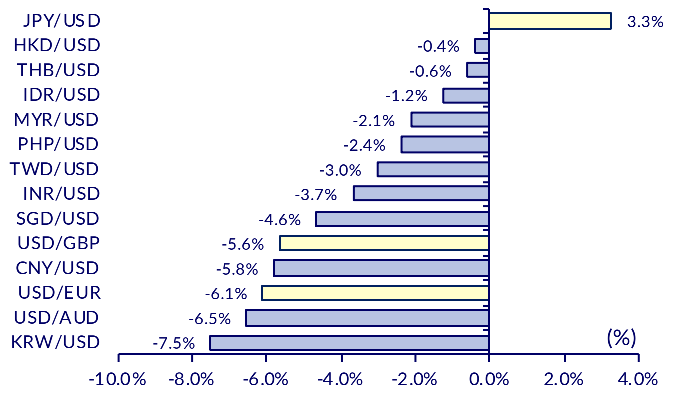
This strong-USD, weak-USD, strong-USD profile is visible in our AxJ currency forecasts also. For 2019 we are cautious. Figure 62 shows the end-2019 forecasts compared with the end-September spot rate. The combination of

- Aversion to "trade warrant" assets (KRW).
- Anticipated monetary easing (AUD, SGD).
- Scepticism about a US-China trade deal (CNY, TWD, KRW).

Catches most AxJ currencies somewhere.

Figure 62

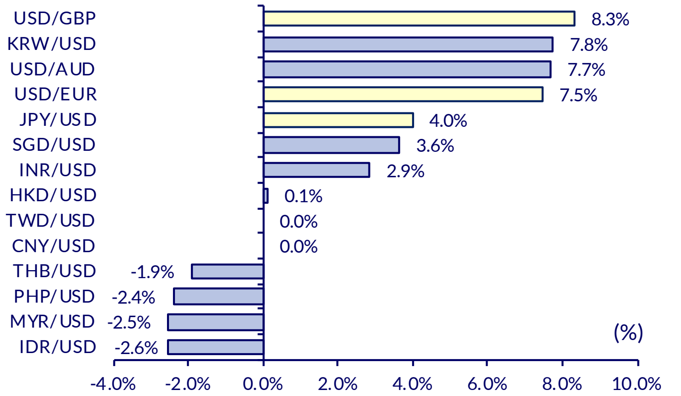
End-2019 forecast appreciation/(depreciation) from spot



Note: Spot rates at 26 September
Source: CLSA, Bloomberg

Figure 63

End-2020 forecast appreciation/(depreciation) from end 2019



Source: CLSA

But see them stronger by mid-2020

We expect that nearly all AxJ currencies will be stronger by the middle of next year. However, as with developed-economy counters, we do not expect this strength to persist. In particular, the erosion of currency support means that we expect the CNY to be a weak currency. We anticipate that it will slip towards CNY7.30/USD in the remainder of 2019; appreciate to CNY7.10/USD by mid-2020 but have slipped back to CNY7.30/USD by end-2020. This represents a regional headwind.

In 2H20 Asian currencies can start to decouple from a soft CNY

However, it is a headwind that we expect some Asian currencies to be able to overcome. The INR remains favoured even though we have brought our 2020 growth forecast down. But, it is KRW and AUD that we favour most. And, despite their differences, it is for the same basic reason. The early rate cuts this year mean that the Aussie economy will bottom soonest. Korean growth is more reflexive but financial markets are quick to identify any potential inflexion in world trade and Korean assets are favoured in anticipation of recovery. This includes the KRW and turns the weakest AxJ currency we forecast for 2019 into the strongest in 2020.

Asian forecast summary

Real GDP growth (%YoY) (average)	2018	2019E	2020F	2021F
Australia	2.7	1.9	2.2	2.5
China	6.6	6.3	6.0	5.8
Hong Kong	3.0	(0.7)	(0.5)	2.5
India[1]	6.6	5.7	6.7	7.1
Indonesia	5.2	5.2	5.2	5.4
Korea	2.7	2.0	1.9	2.7
Malaysia	4.7	4.4	3.1	3.6
Philippines	6.2	5.9	6.0	6.0
Singapore	3.1	0.6	1.0	1.5
Taiwan	2.6	2.3	1.3	1.6
Thailand	4.1	2.8	2.6	3.1

Inflation (%YoY) (average)	2018	2019E	2020F	2021F
Australia	2.0	1.3	1.3	1.9
China	2.1	2.6	1.6	1.3
Hong Kong	2.4	2.8	1.8	0.7
India[1]	3.4	3.3	3.2	3.3
Indonesia	3.2	3.0	2.6	2.8
Korea	1.5	0.7	0.5	1.0
Malaysia	1.0	0.8	1.3	1.9
Philippines	5.2	2.4	2.3	2.8
Singapore	0.4	0.6	0.5	0.5
Taiwan	1.3	0.7	0.2	0.8
Thailand	1.1	0.7	1.4	1.5

Current account balance (USD bn) (total)	2018	2019E	2020F	2021F
Australia	(29.7)	(21.8)	(42.3)	(49.2)
China	49.1	66.4	38.7	(20.6)
Hong Kong	15.6	12.4	5.1	8.0
India[1]	(57.2)	(57.6)	(85.3)	(97.2)
Indonesia	(31.0)	(35.0)	(38.4)	(43.0)
Korea	76.4	54.9	53.6	83.7
Malaysia	7.6	11.5	5.2	2.4
Philippines	(8.7)	(6.8)	(10.4)	(12.4)
Singapore	65.1	59.0	51.2	60.0
Taiwan	72.0	68.0	63.2	56.6
Thailand	32.4	30.3	26.9	21.6

Current account balance (%GDP) (average)	2018	2019E	2020F	2021F
Australia	(2.1)	(1.6)	(3.1)	(3.2)
China	0.4	0.5	0.3	(0.1)
Hong Kong	4.3	3.3	1.3	2.1
India[1]	(2.1)	(2.0)	(2.7)	(2.8)
Indonesia	(3.0)	(3.1)	(3.2)	(3.4)
Korea	4.4	3.3	3.2	4.6
Malaysia	2.1	3.2	1.4	0.6
Philippines	(2.6)	(1.9)	(2.7)	(3.1)
Singapore	17.9	16.3	13.9	16.5
Taiwan	12.1	11.7	10.9	9.8
Thailand	6.4	5.6	4.7	3.7

Exchange rates (vs USD) (y/e)	2018	2019F	2020F	2021F
Australia[2]	0.70	0.65	0.70	0.75
China	6.87	7.30	7.30	7.30
Hong Kong	7.83	7.84	7.83	7.82
India[1]	69.17	71.00	70.00	69.00
Indonesia	14,481	14,325	14,700	15,000
Korea	1,116	1,250	1,160	1,100
Malaysia	4.14	4.23	4.34	4.38
Philippines	52.72	52.60	53.90	55.00
Singapore	1.36	1.42	1.37	1.42
Taiwan	30.59	32.00	32.00	32.00
Thailand	32.71	30.90	31.50	31.75

Policy rates (%) (y/e)	2018	2019F	2020F	2021F
Australia	1.50	0.75	0.50	0.50
China	2.64	2.40	2.00	2.00
Hong Kong	2.33	1.95	0.85	0.97
India[1]	6.25	4.65	4.40	4.40
Indonesia	6.00	5.00	4.25	4.25
Korea	1.75	1.25	0.75	0.75
Malaysia	3.25	2.75	2.00	2.00
Philippines	4.75	4.00	3.50	3.50
Singapore	1.89	1.65	1.00	1.12
Taiwan	1.375	1.375	1.375	1.375
Thailand	1.75	1.25	1.00	1.00

[1] Fiscal year starting April of captioned calendar year; [2] Rates are quoted in USD/AUD. Source: CLSA

CLSA

Australia

EoAE Forecasts - 4Q19

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First out

- 2Q growth was expected to be soft and was. More importantly it showed the dependence of Australian growth on the consumer, which is a flawed growth driver.
- The RBA recognises this and, with inflation low, will seek to shrink the output gap to boost wages. Rate cuts will also help real estate and keep consumer credit sweet.
- Growth will move back above 2% in 2020. Progress will initially be modest but markets will see the end of easing first in Australia. This means that the AUD will appreciate.

Decent

Australian GDP growth was in line with expectation in 2Q at 0.5% QoQ and 1.4% YoY (1Q: 0.5% QoQ and 1.7% YoY). This was the lowest YoY growth rate since June 2003 but a weak figure had been discounted and, because sequential QoQ growth was well above the YoY change (which was depressed by the very weak quarters of 3Q18 and 4Q18), was interpreted as historical. Overall the market consensus was that the number was decent and that 2Q would be the trough of the growth cycle. The Aussie bond market likes to discount rate cuts. But the in-line 2Q outcome removed some of the negative tail risk and thus some of the more extreme monetary policy forecasts.

Consumption dependent

This is not to say that the release was strong. On the contrary it confirmed the headwinds facing the Aussie economy. Aggregate fixed capital formation contracted QoQ for the fourth consecutive quarter with QoQ falls in residential and non-residential construction offsetting a rise in facilities investment. This plus a (likely erratic) negative contribution to growth from inventory liquidation meant that domestic demand growth was weak (0.2% QoQ).

The qualitative assessment from the 2Q data was that the Australian economy continues to be reliant on consumer spending as its main driver. Household consumption rose by 0.4% QoQ sa in 2Q (1Q: 0.3% QoQ sa). However, this growth driver is flawed. Consumer spending might be the primary source of current growth but its pace is lacklustre compared with historical norms.

Debt, wages, property

Three issues are critical. First, the labour market has been slackening since the start of the year. Unemployment has risen back above 5% (5.3% in August, 4.9% in February). Employment growth continues but the mix has become skewed from full time workers to part time. Hourly wage growth, which was rising but remained low

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	2.1	2.6	2.5	2.8	2.4	2.7	1.9	2.2	2.5
Domestic demand (contr. to growth)	0.3	1.2	1.2	2.0	2.8	2.9	0.7	2.4	2.5
Nominal GDP growth	3.5	2.9	1.7	3.9	6.0	5.0	3.4	2.5	3.5
Consumer prices (y/e)	2.6	1.7	1.7	1.4	2.0	1.8	1.1	1.4	1.8
Cash target rate (% y/e)	2.50	2.50	2.00	1.50	1.50	1.50	0.75	0.50	0.50
USD/AUD (y/e)	0.89	0.82	0.73	0.72	0.78	0.70	0.65	0.70	0.75
Money supply M1 (y/e)	14.7	11.7	13.9	8.3	9.0	2.4	13.8	8.2	8.0
Current account balance (USD bn)	(51.1)	(45.4)	(57.0)	(41.1)	(35.8)	(29.7)	(21.8)	(42.3)	(49.2)
- as a % of nominal GDP	(3.4)	(3.1)	(4.6)	(3.3)	(2.5)	(2.1)	(1.6)	(3.1)	(3.2)
General gov't balance (% GDP)	(1.5)	(2.7)	(2.5)	(2.3)	(2.0)	(0.3)	0.1	0.4	0.4

Note: % YoY rates unless otherwise stated. Source: ABS, RBA, OECD in absolute terms while unemployment was falling, looks to have topped out. In its last policy statement the Reserve Bank observed that: *A further gradual lift in wages growth would be a welcome development. Taken together, recent labour market outcomes suggest that the Australian economy can sustain lower rates of unemployment and underemployment*. We agree with this judgement. Second, household debt levels are high and the household savings ratio has already fallen significantly. Measured against previous cycles there is scope for savings to fall further (the ratio was periodically negative between 2000 and 2006). Whether it would be desirable for this to happen is a moot point but delinquency rates presently are low and debt servicing problems appear isolated. But this does point to a vulnerability if the labour market slackens more significantly and it also increases the potential fallout from the third issue: the residential property market.

Real estate prices in the first half of the year were soft as the correction in prices that started in 2017 continued. This weighs on expenditure directly, turnover falls in declining property markets impacting replacement cycles for consumer durables, and indirectly via negative wealth effects and sentiment. Recent news suggests that this drag is starting to abate with the last monetary policy statement flagging that conditions in urban housing markets had started to stabilise. In particular prices in the bellwether markets of Sydney and Melbourne have begun to increase. Other urban markets lag, but the pace of decline is improving.

Running the economy hot

Australia is a high income economy with high levels of property ownership and debt (predominantly floating rate) and a mature consumer credit market. Monetary policy thus has the potential to be a highly effective countercyclical tool. Indeed the Reserve Bank acknowledges that its cash rate cuts in June and July (having been largely passed through) have loosened domestic financial conditions. Looser lending restrictions, effective in July (banks no longer have to stress test a customer's ability to pay with an assumed interest rate of 7%) should also help monetary policy be intermediated into private sector credit.

The June and July rate cuts will not be the last in this cycle. The governor's statement at the August meeting, when rates were left unchanged, noted that: *Together, the recent data on wages, prices, output and unemployment suggest that there was more spare capacity in the economy than had previously been recognised. They also suggest that, like a number of other countries, Australia can sustain lower rates of unemployment and underemployment without running inflation risks*.

We allow for one further rate cut this year (meetings are in October, November and December; we favour the November meeting when the next full Statement on Monetary policy will be published). With a further cut, to a terminal forecast of 0.5%, early in 2020.

GDP growth forecasts

RBA	
Updated:	Aug
2019:	2.0
Consensus	
Updated:	Sep
2019:	1.9
CLSA	
2019:	1.9

The CLSA difference

GDP growth

- This year is recognised as weak by ourselves, the consensus and the RBA. Next year is universally seen stronger as interest rate cuts take effect. We are below the consensus of 2.5% due to our world view.

Inflation

- Inflation is suppressed and, on our currency and commodity price forecasts, will remain so. The consensus has inflation 1.6% this year and 2.0% in 2020. We think both numbers too high.

Interest rates & exchange rate

- An October cut is now seen as likely, certainly there is room for one more before year end. And another in early 2020 but, thereafter, the big story will be firmer growth. This is AUD supportive.

Australia by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	2.4	2.6	1.6	2.1	2.4
Public consumption	3.9	4.1	5.1	3.6	3.2
GFCF	3.5	2.5	(2.8)	1.4	2.1
Domestic demand (contr. to growth)	2.8	2.9	0.7	2.4	2.5
Exports, goods & services	3.7	4.9	3.4	2.7	2.0
Imports, goods & services	7.8	4.1	(1.1)	2.7	2.0
Real GDP growth	**2.4**	**2.7**	**1.9**	**2.2**	**2.5**
Prices					
Consumer prices (y/e)	2.0	1.8	1.1	1.4	1.8
Consumer prices (average)	2.0	2.0	1.3	1.3	1.9
Producer prices (y/e)	2.3	3.6	0.5	0.7	0.8
Currency & interest rates					
USD/AUD (y/e)	0.78	0.70	0.65	0.70	0.75
USD/AUD (average)	0.77	0.75	0.70	0.69	0.73
Cash target rate (% y/e)	1.50	1.50	0.75	0.50	0.50
Average mortgage rate (% y/e)	5.28	5.36	5.15	4.75	5.00
External sector					
Exports (USD, % YoY)	20.0	11.3	(2.1)	(4.6)	4.7
Imports (USD, % YoY)	11.2	7.0	(4.8)	0.4	0.0
Trade balance (USD bn)	10.5	21.1	27.0	14.6	13.5
Current account balance (USD bn)	(35.8)	(29.7)	(21.8)	(42.3)	(49.2)
- as a % of nominal GDP	(2.5)	(2.1)	(1.6)	(3.1)	(3.2)
FDI (USD bn)	39.2	62.3	45.1	52.8	59.0
CA + net FDI (% GDP)	0.3	2.3	1.7	0.8	0.6
External debt (net, USD bn)	791.5	770.9	754.1	860.9	922.4
Debt service ratio (% exports)	6.0	5.8	5.3	5.6	6.5
International reserves (USD bn, y/e)	66.6	53.9	42.2	52.6	62.5
Money supply					
Money supply M1 (y/e)	9.0	2.4	13.8	8.2	8.0
Money supply M3 (y/e)	4.5	2.4	3.9	3.7	3.6
Private sector credit (y/e)	5.2	4.7	3.3	3.8	5.5
Private sector credit (% GDP)	152.0	150.7	151.6	153.2	156.0
Government sector					
General gov't balance (% GDP)	(2.0)	(0.3)	0.1	0.4	0.4
General gov't debt (% GDP, y/e)	43.9	42.1	40.0	40.2	40.2
Nominal GDP					
Nominal GDP (USD bn)	1,386.8	1,418.2	1,370.4	1,381.6	1,528.9
Nominal GDP per capita (USD)	56,378	56,747	54,022	53,660	58,502
Nominal GDP (AUD bn)	1,808.3	1,899.0	1,963.7	2,011.9	2,082.3
Nominal GDP (AUD, % YoY)	6.0	5.0	3.4	2.5	3.5
Other data					
Industrial production	1.1	3.4	0.3	1.0	2.0
Retail sales	2.7	3.0	3.1	3.4	3.7
Unemployment (% y/e)	5.5	5.0	5.1	5.1	5.0
Population (millions)	24.6	25.0	25.4	25.7	26.1

Note: % YoY rates unless otherwise stated. Fiscal deficit estimates are for the fiscal year ending in June. eg, 2015/16 is under 2016. Source: ABS, RBA, OECD

Near term outlook sees PCE soft on sluggish wage growth, negative wealth effects and high debt levels.

We do not expect mining capex to accelerate in a soft commodity price environment; facilities investment upturn therefore pushed to 2021. Resi construction also soft in the near term.

As elsewhere the inflation outlook is soft...

...recognised by the central bank which is happy to cut rates further in the interests of improving wage growth.

Commodity price assumptions imply a terms of trade loss...

...but we think that the worst is over for the AUD. Monetary policy will bottom sooner than elsewhere.

Definition change in mid-2019 for M1.

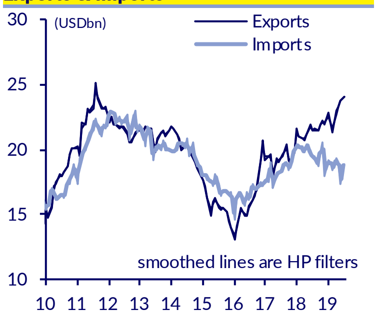
Credit growth to remain subdued until real estate cycle strengthens.

Fiscal position to continue to improve.

Terms of trade loss implies a very low 2020 GDP deflator.

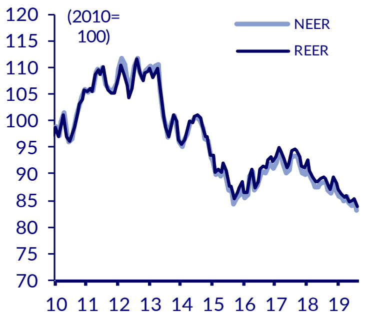
The labour market's move towards full employment has come to a halt. The presence of slack in the labour market implies that wage growth will remain subdued in 2019 and 2020.

Exports & imports



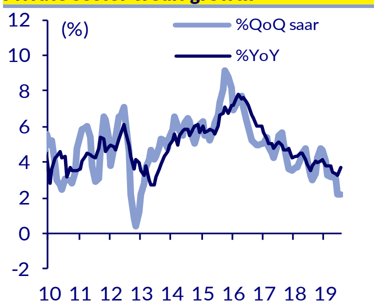
Source: CEIC, CLSA

AUD NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

That should prove sufficient. Though the Reserve Bank will remain vigilant to any signs of a cyclical slowdown in China, particularly in the context of a continuing trade war, we expect China to successfully achieve its objective of tracking the full employment growth trajectory. The weaker commodity prices that we anticipate for late 2019 and 2020 imply a terms of trade squeeze for Australia but in the absence of significant currency weakness this will remain concentrated in the mining sector rather than impacting the economy more generally.

AUD weakness is on its last legs

This segues to the currency outlook. As noted the Australian money markets have been quick to recognise the prospect for lower rates (Aussie government bonds are no longer "high yield") and combined with concerns about China's growth and the trade wars, the AUD has been a weak currency. It has declined from a little over USD0.80/AUD in early 2018 to USD0.67/AUD in August. At time of writing it is a little above this level but the trend is still downwards.

As the chart to the left shows, this is far from just a "strong USD". The AUD has been a weak currency in 2018 and 2019 in trade-weighted terms also. The combination of our global and Australian forecasts suggests that this will continue a while longer. We expect the AUD to have slipped to around USD0.65/AUD by the end of 2019.

That should however be it. We see the AUD stronger in 2020. A weaker USD is the first part of this forecast. Evidence that the US is slipping into a period of below-trend growth will see USD interest rate support decline rapidly early in 2020. On the other hand Australia, which has been growing below trend in 2019, should be starting to accelerate. As the effects of interest rate cuts accumulate residential real estate and credit growth should improve, albeit tentatively at first. Discretionary consumer spending should support a modest acceleration in private consumption in 2020 (we expect 2.1% YoY growth in PCE) and again in 2021 (for 2.4% YoY growth in PCE). Facilities investment will remain suppressed but interest rate sensitive activity should start to improve. Growth will move above 2% in 2020. Our forecast of 2.2% is below consensus thanks to global forces but still implies that the output gap starts to close. This will be more visible in 2021 when we anticipate GDP growth of 2.5%.

Australia is therefore the first country we forecast where financial markets will recognise that the monetary easing cycle has come to an end. The RBA need not be aggressive and inflation on our forecast remains ultra-low. Our end-2021 cash rate forecast therefore sees it unchanged but the yield curve will steepen earlier in Australia than elsewhere in anticipation of recovery. This implies a stronger AUD.

This should propel the AUD higher even when the USD has stopped depreciating. We see a move back to USD0.70/AUD by end-2020 and further to USD0.75/AUD in 2021. These are modest gains to be sure (commodity prices and the CNY are both soft on our forecast) but they are sufficient to mark the Aussie as an outperformer.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
USD/AUD	0.72	0.78	0.70	0.65	0.70	0.75	0.65	0.67	0.70
JPY 100/AUD	84.2	88.0	76.8	67.6	70.0	78.8	67.6	67.7	70.0
GBP/AUD	0.58	0.58	0.55	0.54	0.54	0.58	0.54	0.54	0.54
EUR/AUD	0.68	0.65	0.61	0.61	0.61	0.68	0.61	0.58	0.58
Memo: USD/EUR	1.05	1.20	1.15	1.07	1.15	1.10	1.07	1.15	1.20
Memo: JPY/USD	117.0	112.7	109.7	104.0	100.0	105.0	104.0	101.0	100.0

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Infrastructure uplift

- **Activity data remain soft and manufacturers are reluctant to invest but the increase in infrastructure is starting (just) to become visible in FAI data.**
- **RRR has been cut and will be cut further. Money market rates are firm but we have no doubt that China will participate in the rate cuts we see internationally.**
- **Growth this year has to be around 6¼% to keep full employment. But trend growth is slowing every year. We see 6% growth in 2020 and a 5.5-6.0% growth target for 2021.**

Ebb continues, response starts

Last quarter we flagged soft 2Q data and anticipated that government policy would become more expansionary to ensure a better 3Q outcome. Monthly data remain disappointing. However the policy response has started to become more visible. It is centred in infrastructure spending funded by local government special bond issuance. To date it is mainly the issuance which is visible. However August did see investment by China's infrastructure industries accelerate, though only by a small amount: 4.9% YoY in August compared with 2.7% YoY in July.

The last few months have seen growth headwinds intensify. President Trump imposed tariffs on China's remaining exports to the US on 1 August and raised the rate to 15% (from 10%) alongside an additional 5ppts on other US tariffs on 23 August. Since this low point, news has become better. First Trump postponed tariffs being imposed on PCs and smartphones (China's two biggest consumer goods exports to the US) to 15 December to shield US consumers in the critical pre-Christmas and back to school shopping periods. Second he pushed the date at which existing tariffs were to rise from 1 October to 15 October. Official news agencies have announced that China will resume purchases of US farm products including soybeans and pork. These steps are encouraging in that they signal both sides are moving back towards the table after an acrimonious few months. We are sceptical that a lasting deal is imminent (see below) but the progress is positive. Chinese manufacturing does not need more headwind.

More infrastructure, more debt

Because it is already clearly suffering from the deceleration in global trade. This is visible in manufacturing activity and trade data. But it is also visible in manufacturing investment, which is weak. Credit growth, aside from local government special bond issuance, is weak. Anecdotal evidence is that private businesses are risk averse and reluctant to invest. This suggests that further stimulus will remain focussed on infrastructure.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	7.8	7.3	6.9	6.7	6.8	6.6	6.3	6.0	5.8
Domestic demand (contr. to growth)	7.9	7.0	7.0	7.3	6.2	7.2	6.7	6.5	6.4
Nominal GDP growth	10.1	8.1	7.0	7.9	10.9	9.7	8.7	7.5	7.3
Consumer prices (y/e)	2.5	1.5	1.6	2.1	1.8	1.9	3.0	0.3	1.7
7-day interbank repo rate (% y/e)	5.10	4.20	2.49	2.60	3.00	2.64	2.40	2.00	2.00
CNY/USD (y/e)	6.05	6.21	6.49	6.95	6.51	6.87	7.30	7.30	7.30
Money supply M2 (y/e)	13.6	12.2	13.3	11.3	8.1	8.1	8.7	8.1	7.3
Current account balance (USD bn)	148.2	236.0	304.2	202.2	164.9	49.1	66.4	38.7	(20.6)
- as a % of nominal GDP	1.5	2.3	2.8	1.8	1.4	0.4	0.5	0.3	(0.1)
General gov't balance (% GDP)	(2.0)	(2.1)	(2.4)	(2.9)	(2.9)	(2.6)	(3.0)	(3.0)	(3.0)

Note: % YoY rates unless otherwise stated. Source: IMF, World Bank, China Economic News, CEIC

The IMF's Article IV consultation on China has caused concern about China's fiscal position. The IMF quotes an "augmented" fiscal deficit of 11.2% of GDP rising to 12.7% this year. Augmented government debt is estimated at 72.7% of GDP end-2018 rising to 80.1% at end-19. Certainly the official general government deficit and debt figures are incomplete, they exclude the special bonds that form the funding for the infrastructure acceleration. The IMF is to be applauded in attempting to include contingent liabilities (the main things "augmenting" debt are LGFVs and government guided and special construction bonds). However the inference that this is a massive risk is mistaken. Indeed the IMF is more concerned with bank lending and the strength of bank capital than excessive government borrowing. China's government borrowing is in CNY and government debt, locally funded, rarely causes financial crises. However the extent of borrowing does underline that the marginal efficiency of credit is low. Deploying infrastructure spending as a countercyclical tool will be effective in supporting growth but it necessarily is a debt-intensive strategy.

Expensive pork hides disinflationary forces

Pork prices are still rising and public dissatisfaction is increasing. The meat category of the CPI is up 30.9% YoY (pork alone 46.7% YoY). Food price hikes because of supply-side shocks are equivalent to a tax. They compress real incomes and discretionary spending. For this reason they are growth negative and the optimal monetary policy response is either to ignore them (as transitory) or consider them as risks that warrant easing if they start to hurt growth.

Specifically pork inflation will not prevent monetary policy from being loosened even if it takes inflation above previously sensitive levels. In fact we do not think that this will happen (though it will come close). We expect inflation to just exceed 3% around end-2019 and stay around this level to end 1Q20. Thereafter it will start to fall. By end-2020 inflation will be very low due to high base effects. This temporary dip will be equally unimportant to monetary policy.

Core inflation is declining. This is a global rather than China-specific phenomenon and points to the speed with which disinflationary forces have accelerated as world growth has slowed. This is also visible in China's PPI. This turned negative YoY for the first time since 2016 in June and was -0.8% YoY in August. As in 2015 negative PPI is concentrated in upstream, typically heavy industrial, sectors. Falling prices in these industries in 2014 and 2015 caused concerns about credit quality as these sectors, historically, have had high debt levels. The terms of trade loss as heavy industrial goods prices fell in line with global commodity prices contributed to recession in China's northern provinces in 2015. PPI will continue to decline on a YoY basis on our global commodity price forecasts. This is a growth headwind. However, supply-side reform has reduced the credit risk. Smaller private sector firms have left the industry. State owned producers lack pricing power but they do not represent a systemic risk.

GDP growth forecasts	
Government	
Updated:	Mar
2019:	6.0-6.5
Consensus	
Updated:	Sep
2019:	6.2
CLSA	
2019:	6.3

The CLSA difference

GDP growth

- It's remarkable that in a summer of global growth worries & trade war escalations that concerns about China's growth have been muted. It's not because of good data, we edge our f/cast down.

Inflation

- ASF is raising inflation forecasts. We agree. However, fears that it will be a block on monetary easing are wrong; the PBoC will look through ASF as a non-recurrent cost pressure.

Interest rates & exchange rate

- The consensus has the CNY weaker to year-end but stronger in 2020 and 2021. This implies an expectation of easing trade tensions. We disagree and see the CNY weak. Also BoP support is falling.

China by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	6.5	9.1	8.9	8.8	8.7
Public consumption	10.0	10.5	10.0	9.0	8.0
GFCF	4.4	4.9	4.5	4.2	4.0
Domestic demand (contr. to growth)	6.2	7.2	6.7	6.5	6.4
Exports, goods & services	7.4	5.5	0.0	0.0	2.0
Imports, goods & services	9.5	7.0	(2.0)	1.0	4.0
Real GDP growth	**6.8**	**6.6**	**6.3**	**6.0**	**5.8**
Prices					
Consumer prices (y/e)	1.8	1.9	3.0	0.3	1.7
Consumer prices (average)	1.6	2.1	2.6	1.6	1.3
Producer prices (y/e)	4.9	0.9	(0.3)	(2.3)	1.7
Currency & interest rates					
CNY/USD (y/e)	6.51	6.87	7.30	7.30	7.30
CNY/USD (average)	6.76	6.62	6.97	7.20	7.30
7-day interbank repo rate (% y/e)	3.00	2.64	2.40	2.00	2.00
10-year gov't bond yield (% y/e)	3.90	3.31	2.95	2.45	2.45
External sector					
Exports (USD, %YoY)	11.4	9.1	1.0	0.0	2.0
Imports (USD, %YoY)	16.0	16.2	(1.0)	0.0	4.0
Trade balance (USD bn)	476.1	395.1	439.5	439.5	408.2
Current account balance (USD bn)	164.9	49.1	66.4	38.7	(20.6)
- as a % of nominal GDP	1.4	0.4	0.5	0.3	(0.1)
FDI (USD bn)	66.3	107.4	32.2	5.0	10.0
CA + net FDI (% GDP)	1.9	1.2	0.7	0.3	(0.1)
External debt (total, USD bn)	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% exports)	n.a.	n.a.	n.a.	n.a.	n.a.
International reserves (USD bn, y/e)	3,140.0	3,072.7	3,121.3	3,115.0	3,054.4
Money supply					
Money supply M1 (y/e)	11.8	1.5	4.7	5.7	7.3
Money supply M2 (y/e)	8.1	8.1	8.7	8.1	7.3
TSF (net change CNYtn)	22.4	19.3	23.4	25.3	25.1
TSF (y/e)	13.4	9.8	11.6	11.3	10.1
TSF (% GDP)	222.8	223.0	229.0	237.0	243.0
Government sector					
General gov't balance (% GDP)	(2.9)	(2.6)	(3.0)	(3.0)	(3.0)
Nominal GDP					
Nominal GDP (USD bn)	12,150	13,600	14,035	14,617	15,475
Nominal GDP per capita (USD)	8,741	9,746	10,023	10,402	10,975
Nominal GDP (CNY bn)	82,075	90,031	97,860	105,241	112,968
Nominal GDP (CNY, %YoY)	10.9	9.7	8.7	7.5	7.3
Other data					
Industrial production	6.6	6.2	4.5	4.3	4.7
Retail sales	10.2	9.1	8.8	7.7	7.3
Unemployment (% y/e)	5.0	4.9	5.1	5.0	5.0
Population (millions)	1,390	1,395	1,400	1,405	1,410

Note: % YoY rates unless otherwise stated.
Source: IMF, World Bank, China Economic News, CEIC

Weak retail sales figures notwithstanding, the economy is rebalancing from investment to consumption. All forecast years have C growing faster than GDP.

Investment is being used countercyclically, but this is infrastructure capex being used to offset weak manufacturing and private-sector capex not a 2009-style boost.

The objective is to track the full employment growth rate as closely as possible. We think that Beijing will succeed. But the full employment growth rate itself is slowing.

ASF to take inflation over 3%. The base effect, as pork prices normalise in 2H20 and 1H21, is responsible for the ultra-low end-2020 figure.

PPI is already negative as heavy industrial prices fall in line with global commodity prices.

We are pessimists on the US-China trade war and thus see CNY as a weak currency. Additionally the BoP is weak.

Neither the boost to inflation nor the base effect will matter for monetary policy. China will cut rates in an environment where everybody else is.

Trend decline in current account surplus is basically because China's social contract means that it grows faster than the rest of the world.

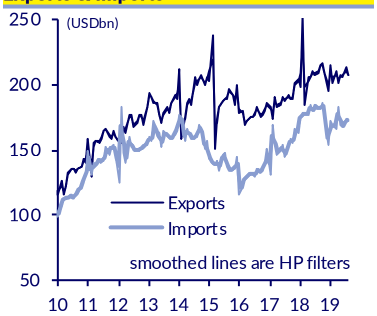
No evidence that a weaker CNY is causing momentum based capital outflows.

Using infrastructure countercyclically is a credit-intensive way of stabilising the economy. Crisis concerns are overdone, this is local currency government debt. Worries about the marginal efficiency of credit are more justified.

The IMF's augmented deficit figures are more than 3x this number. We stick to the government published figures for consistency and comparability with other countries.

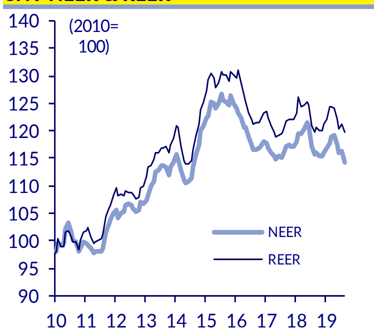
Low PPI inflation suggests low nominal growth.

Exports & imports



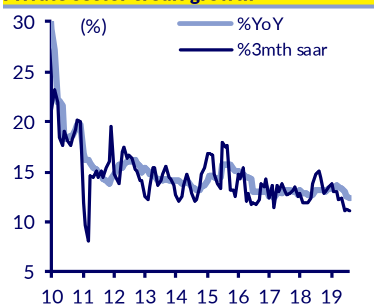
Source: CEIC, CLSA

CNY NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

Monetary easing: Participating in ubiquity

Particularly in a lower rate environment. The People's Bank of China cut the RRR for large banks from 13.5% to 13.0% in September (small banks 11.5% to 11%). The PBOC however failed to cut its medium term lending (MLF) rate from 3.3% ahead of the widely discounted cut from the Fed and short-dated interbank rates have been sticky around 2.6-2.7% (we use RP07 as benchmark). However in the close to ubiquitous easing environment we expect in the coming 12 months China will participate. Because the bulk of wholesale funding in China is conducted at shorter tenors we focus on the 7-day rate; we see it at 2.4% for end-19 with around 2% possible for end-2020. However we would be surprised if the PBoC did not reduce the MLF rate as a signal before the end of the year. At least two more RRR cuts will be needed across all bank sizes.

The currency outlook of a trade war pessimist

The CNY was allowed to depreciate through CNY7/USD in response to Trump's threat to impose tariffs on China's remaining products. Optimism that talks are restarting has allowed it to appreciate back towards CNY7.10/USD. We remain sceptical that the current more constructive tone will prevail in the face of deteriorating US growth and a persistent US-China trade imbalance. Consequently we see the CNY weaker. Our end-2019 target is CNY7.30/USD.

Thereafter a softer USD should support some CNY outperformance, but only temporarily. By mid-2020 we expect CNY to be back under pressure as Trump (facing an election in a slow growth environment) ratchets up US-China trade tension for political reasons. We see this risk as high even if an agreement is signed (see Mexico for example). Our advice is to "rent" any CNY rallies; by end-2020 we see the CNY back at CNY7.30/USD.

Growth to track trend

This year's growth outcome, thanks to infrastructure spending, will be in the middle of the 6-6.5% target range. Looking to 2020 the first question is "what the target will be?" We assume a target of "about 6%" and our growth forecast is that this, again, will be achieved. This expectation is based on the fact that China's full-employment growth trajectory is slowing because of its aging population. Academic assessments, using supply side models, suggest that full employment growth is falling by around ¼% per annum. China needs to grow by around 6¼% this year to keep the economy close to full employment. For 2020 the required growth rate drops to 6%. For 2021 a number around 5¾% will be sufficient and our growth forecast drops accordingly. This can be achieved with a 5.5-6.0% growth target. To react negatively to this target would be to mistake the objective of maintaining full employment without excessive stimulus with policy failure. Markets will worry about a China slowdown nonetheless.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
CNY/USD	6.51	6.87	7.30	7.30	7.30	7.30	7.20	7.10	7.20
CNY/JPY 100	5.77	6.26	7.02	7.30	6.95	7.02	7.13	7.10	7.20
CNY/GBP	8.79	8.76	8.76	9.49	9.49	8.76	9.00	9.23	9.36
CNY/EUR	7.81	7.88	7.81	8.40	8.03	7.81	8.28	8.52	8.42
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

Hong Kong

EoAE Forecasts - 4Q19

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Shock to the core

- **The economic fallout of the protests has reinforced a growth slowdown that was underway before the demonstrations. Tourism and consumption hardest hit.**
- **Negative GDP growth in both 2019 and 2020. Carry-over from 2H19 is huge. The government will introduce a sizeable stimulus package in the 2020-21 budget.**
- **The protests have not caused any large-scale capital flight or weakening of the HKD. Next year US rate cuts will help guide HIBOR lower.**

Chief Executive's concession not enough to stop protests
The political crisis triggered by the extradition bill has deteriorated since the publication of the 3Q19 *Eye on Asian Economies*. The intensity of clashes between protestors and the police has escalated drastically over the summer. Carrie Lam, Hong Kong's Chief Executive, offered formally to withdraw the extradition bill on 4 September. The concession, however, has not ended the unrest. The protest movement has widened from the initial demand for the abandonment of the extradition bill to demands for an independent inquiry into alleged policy brutality and demands for greater democracy.

Market reactions to the turmoil
While protests intensified over the past three months, volatility in the HKD/USD exchange rate has been moderate. Between the start of July and mid-August there was about 0.8% depreciation in the HKD against the USD, but the HKD has not fallen to the HKD7.85/USD lower limit of the trading band and the HKMA has had no need to intervene to defend the peg. The mild depreciation suggests the absence of large scale capital outflows. The HKD strengthened in September to HKD7.829/USD, moving further away from the weak-side convertibility undertaking.

Tighter interbank liquidity has driven HIBOR higher since March while USD rates have eased since the start of the year on rate cut expectations. As a result, the HIBOR-USD LIBOR spread turned from negative to positive in June (with a brief reversal around mid-July). It is currently +20bp. The premium of HIBOR to USD LIBOR helps generate inflows supporting the HKD; that the premium remains moderate shows that the market is not pricing in a significant probability of the HKD peg being abandoned.

The Hang Seng Index dropped by 12% between mid-July and mid-August. It has since rebounded and although it has not recovered all the losses, the stock market has been fairly resilient in the past three months.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	3.1	2.8	2.4	2.2	3.8	3.0	(0.7)	(0.5)	2.5
Domestic demand (contr. to growth)	3.9	2.8	1.4	2.5	5.0	4.4	(2.6)	1.3	3.3
Nominal GDP growth	5.0	5.7	6.2	3.9	6.9	6.8	2.0	1.3	3.3
Consumer prices (y/e)	4.3	4.9	2.3	1.2	1.7	2.6	3.1	0.6	0.9
3-month HIBOR (% y/e)	0.38	0.38	0.39	1.02	1.31	2.33	1.95	0.85	0.97
HKD/USD (y/e)	7.75	7.75	7.75	7.76	7.81	7.83	7.84	7.83	7.82
Money supply M1 (y/e)	9.7	13.1	15.4	12.3	9.8	(0.4)	4.8	6.7	3.7
Current account balance (USD bn)	4.2	4.1	10.3	12.7	15.9	15.6	12.4	5.1	8.0
- as a % of nominal GDP	1.5	1.4	3.3	4.0	4.6	4.3	3.3	1.3	2.1
General gov't balance (% GDP)[1]	1.1	3.8	0.6	4.6	5.9	2.5	(0.3)	(5.0)	(2.5)

Note: % YoY rates unless otherwise stated. [1] Fiscal year starting April. Source: CEIC, CLSA estimates, HKSAR government

That said, there are genuine concerns whether the current crisis has exposed long-term risks of the Hong Kong economy. This is reflected in rating cuts by two credit ratings agencies. Fitch downgraded Hong Kong's long-term foreign-currency issuer default rating from "AA+" to "AA" and its outlook from stable to negative on 6 September. Ten days later Moody's downgraded the outlook for Hong Kong's sovereign rating from stable to negative but kept the rating unchanged (Aa2). According to the ratings agencies, the downgrades stemmed from increasing concerns about the autonomy of Hong Kong's institutions and the governing capacity by the government.

Economic impacts of the protests

The current protests are more economically damaging than the Umbrella Movement in 2014. Confrontations between protestors and the police are more prolonged, frequent, widespread and violent. We also believe that the impacts of current demonstrations are more extensive than SARS in 2003. SARS was a large demand shock but the damage was temporary. The quick and large rebound in tourist arrivals and retail sales in 3Q03, following the launch of the Individual Visit Scheme for Mainland travellers in July, meant that the hit on the economy was short-lived.

Prior to the protests, the Hong Kong economy had already been slowing due to a weak global trade environment. Investment and external trade were the main drag on 2Q growth. In 3Q, we expect a sharp drop in exports of services, where inbound tourism is counted in the national accounts. Sentiment towards Hong Kong of potential Chinese visitors has deteriorated significantly since mid-July, when Mainland media began coverage of the Hong Kong protests. Based on media reports and July visitor statistics, we expect a 40% QoQ (sa) decline in tourist arrivals in 3Q, which contributes to a 10% QoQ contraction in service export volumes. For 4Q, we expect no growth in tourist arrivals.

Private consumption is also affected. Households have reduced going out for shopping and dining. Shops are closed on days when protests are planned. We expect private consumption volume to decline by 5% QoQ seasonally adjusted in 3Q and to rise by 3% QoQ in 4Q. These adjustments have reduced our forecast for 2019 annual private consumption growth to -1.1% from 2.2% printed in the 3Q19 *EoAE*.

Given Hong Kong's flexible labour market and the nature of employment in the industries affected second-round effects have been quick to appear. The headline unemployment rate was 2.9% in August, a historical low. However, employment in accommodation and food services and retail, the two sectors most depressed by the fall in tourists, showed an abrupt drop in July and the drop deepened in August. We expect the unemployment rate to rise to 3.7% by the end of 4Q, although we note that this is still lower than that in the post-GFC period and during SARS. An ageing population is helping keep the unemployment rate down.

GDP growth forecasts

Government	
Updated:	Aug
2019:	0-1
Consensus	
Updated:	Sep
2019:	0.7
CLSA	
2019:	-0.7

The CLSA difference

GDP growth

- The consensus forecast is outdated. The government expects a recession in 2H19. GDP growth will struggle until mid-2020 when consumption and goods exports begin to pick up.

Inflation

- Downward pressure on inflation from weak domestic demand and a slow property market. Food inflation however is likely to stay high as imported pork prices continue to accelerate.

Interest rates & exchange rate

- The closing of the spread between HKD and USD rates has helped limit depreciation of the HKD. Price action suggests the probability attached by the markets to a de-peg is low. We agree.

Consumption will have plunged in 3Q19 but will recover quicker than tourism and investment. Some upside risk in 2020 if the government gives a large cash handout in the policy address.

Hong Kong in numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	5.6	5.5	(1.1)	2.2	3.5
Public consumption	2.8	4.2	4.9	7.6	5.2
GFCF	2.9	2.0	(9.4)	(3.6)	1.1
Domestic demand (contr. to growth)	5.0	4.4	(2.6)	1.3	3.3
Exports, goods & services	5.9	3.8	(4.3)	(1.3)	1.9
Imports, goods & services	6.6	4.6	(5.3)	(0.3)	2.4
Real GDP growth	**3.8**	**3.0**	**(0.7)**	**(0.5)**	**2.5**
Prices					
Consumer prices (y/e)	1.7	2.6	3.1	0.6	0.9
Consumer prices (average)	1.5	2.4	2.8	1.8	0.7
Currency & interest rates					
HKD/USD (y/e)	7.81	7.83	7.84	7.83	7.82
HKD/USD (average)	7.79	7.84	7.84	7.83	7.83
3-month HIBOR (% y/e)	1.31	2.33	1.95	0.85	0.97
External sector					
Domestic exports (USD, % YoY)	1.5	5.2	(0.9)	(2.9)	0.2
Re-exports (USD, % YoY)	7.8	6.9	(3.3)	0.4	2.3
Exports (USD, % YoY)	7.6	6.9	(3.3)	0.3	2.3
Imports (USD, % YoY)	8.3	7.9	(5.7)	(0.7)	2.8
Trade balance (USD bn)	(61.9)	(71.8)	(54.9)	(49.2)	(52.2)
Current account balance (USD bn)	15.9	15.6	12.4	5.1	8.0
- as a % of nominal GDP	4.6	4.3	3.3	1.3	2.1
FDI (USD bn)	24.0	30.5	7.9	1.9	8.3
CA + net FDI (% GDP)	11.7	12.7	5.5	1.8	4.2
International reserves (USD bn, y/e)	431.4	424.7	438.3	418.8	422.9
Money supply					
Money supply M1 (y/e)	9.8	(0.4)	4.8	6.7	3.7
Money supply M2 (y/e)	10.0	4.3	1.5	(2.0)	2.0
HKD bank lending (y/e)	19.7	8.9	4.4	0.8	6.8
HKD bank lending (% GDP)	201.2	205.2	210.0	209.0	216.0
Government sector					
General gov't balance (% GDP)[1]	5.9	2.5	(0.3)	(5.0)	(2.5)
Nominal GDP					
Nominal GDP (USD bn)	341.8	362.8	370.1	375.0	388.1
Nominal GDP per capita (USD)	46,113	48,467	49,187	49,591	51,075
Nominal GDP (HKD bn)	2,663.8	2,843.6	2,901.2	2,937.5	3,035.7
Nominal GDP (HKD, % YoY)	6.9	6.8	2.0	1.3	3.3
Other data					
Visitor arrivals	3.2	11.4	(13.2)	(19.4)	20.7
Retail sales	2.3	8.7	(17.2)	(11.7)	15.5
Unemployment (% y/e)	3.0	2.8	3.7	4.0	3.7
Population (millions)	7.4	7.5	7.5	7.6	7.6

Note: % YoY rates unless otherwise stated. [1] Fiscal year starting April.
Source: CEIC, CLSA estimates, HK government.

The government may announce more construction plans for public housing in the October policy address but the impact on investment will only be reflected in a few years' time.

We expect moderate recovery in goods exports towards end-2020.

Two years of negative growth but recession shallower than the GFC.

Food (pork) inflation will remain elevated for most of 2020, but CPI in services and private rental will be depressed by slower labour market and property market.

Fed rate cuts mean USD rates to fall further in 2020. Keeping a small positive spread over USD LIBOR, HIBOR will fall.

The HKMA lowered the Base Rate by 25bp following the Fed move on 18 September as an automatic adjustment under the rule-based Currency Board system.

The HIBOR-USD LIBOR premium helps contain capital outflows.

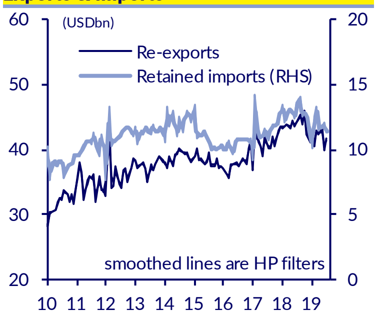
Loan growth will slow further on weak economic growth and a cooling property market.

Slow property transactions will hit government revenue. More tax cuts and cash handouts will be announced.

Tourism is the worst hit sector. It will be depressed for most of 2020. How fast the recovery depends on Beijing's stance.

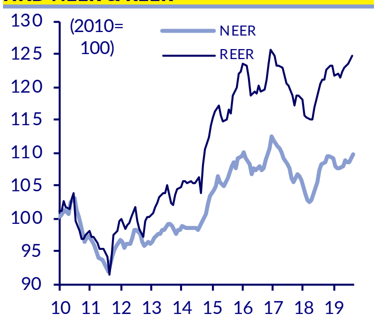
A steep increase is likely in 4Q19 in hotels and food and beverage sectors.

Exports & imports



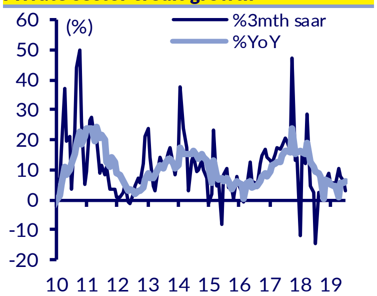
Source: CEIC, CLSA

HKD NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

Hong Kong has been on an investment downturn since 4Q18. Most infrastructure projects have been completed and private investment spending has been lacklustre. In the midst of protests, investment projects that are already in the pipeline for the next one or two months are likely to continue but plans in the next few quarters may be postponed or scrapped as political uncertainty weakens business confidence. Rolling in the plunge in investment in 2Q (-11.6% YoY), our GFCF growth estimate for 2019 was lowered to -9.4% from -2.4% from three months ago.

The contraction in both external and domestic demand in 2H19 is estimated to give rise to a 1.9% YoY decline in real GDP. With the 0.5% growth in 1H, our full-year GDP growth estimate is cut to -0.7% from 1.6% published in the 3Q19 *EoAE*.

A mild recovery in 2H20

We expect tourism to remain very weak for nine to twelve more months. Visitor arrivals from Mainland China will be especially weak given the public opinion backlash. We have pencilled in some return in tourist numbers and a moderate increase in the export volume of travel services in 4Q20. However, on a YoY terms, services exports volume will still fall by 10% in 2020. How fast tourism recovers depends on whether and when Beijing greenlights the return of Chinese tourists to Hong Kong.

Resident consumption, on the other hand, is likely to rebound faster than tourism and investment when the protests subside. We expect that private consumption will rise sequentially starting from 4Q19 but the YoY growth rates will only turn positive in 2Q20 or 3Q20. On a low base for comparison, private consumption is expected to increase by 5.3% in 2H20. Our 2020 PCE growth forecast is 2.2% growth following a 1.1% contraction in 2019.

In mid-August, the financial secretary, Paul Chan, announced a stimulus package worth HKD19.1bn (USD2.4bn), equivalent to 0.7% of 2018 GDP. This is small compared to the stimulus package of HKD70bn (USD8.9bn, 4.2% of GDP) in the 2008/09 budget, a countercyclical policy response to the GFC. We expect the Chief Executive to announce a large stimulus package in her policy address in October. While the administration is known to be fiscally conservative, given the severity of the current political crisis and economic dislocation, we expect a package at least the same size as that in the 2008/09 budget. With the fall in fiscal revenue and the increase in fiscal expenditure, the government will run a budget deficit of 5% of GDP in 2020 and another one of 2.5% in 2021. Abundant reserves accumulated in previous years give the government sufficient fiscal room to run a deficit for two years.

We expect goods exports to improve at a gradual pace through 2020 with the base effect becoming easier. However, fixed investment will remain subdued unless the government announces new infrastructure projects. Even these will have their main economic impact beyond 2021. In the next two years, the government will try to play a larger role in the economy given the significant loss of confidence among the private sector.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
HKD/USD	7.81	7.83	7.84	7.83	7.82	7.84	7.84	7.83	7.83
HKD/JPY 100	6.93	7.14	7.54	7.83	7.45	7.54	7.76	7.83	7.83
HKD/GBP	10.56	9.99	9.41	10.18	10.17	9.41	9.80	10.18	10.18
HKD/EUR	9.38	8.98	8.39	9.00	8.60	8.39	9.02	9.40	9.16
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

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Delayed reward for bold reform

- **Slashing corporate taxes combines bold supply-side reform with a Keynesian fiscal boost. The initial growth benefit will be modest; the long-term gain is potentially great.**
- **There has been a substantial recapitalisation of the state banks but the system is not fixed; there is not yet effective monetary transmission through the banking sector.**
- **RBI has been explicit in arguing that the benign inflation outlook provides headroom for continued monetary easing in order to close the negative output gap.**

Corporate tax cuts: the boldest reform since the GST

September saw the Modi government introduce its most important supply-side reform since the introduction of the GST. Corporate taxes have been cut dramatically, from 34.3% to 21.2%. For newly established manufacturing companies the effective rate is 17%, the same as Singapore.

The intention is clearly to attract inward direct investment. In this respect it is worth noting that India is becoming a favoured location for manufacturing looking to diversify outside of China. See, for example, our *Infofax Special* on Taiwanese businesses (13 November 2018, pp6-7) which showed India to be the second largest destination (after Vietnam) for Taiwanese firms investment in 1Q-3Q 2018. This is an evolving shift suggesting that Modi's earlier reforms are gaining traction. But India also offers scale and a large (and rapidly growing) domestic market for consumer durables. After relative labour costs, market access consistently appears as the primary motive for inward FDI.

The corporate tax cuts also represent a substantial Keynesian fiscal loosening. They are costed at INR1.45tn; this is equivalent to ¾% of nominal GDP. Not all of these costs will accrue to central government. However, plugging them into our model raises the FY20 central government deficit from 3¾% of GDP to 4¼%.

While corporate tax cuts are clearly appropriate from a supply-side reform perspective they are less suited to a Keynesian counter-cyclical role. Companies often, particularly in adverse economic environments, have a low propensity to invest and a high propensity to save. And the corporate tax cuts have a powerful credit headwind to overcome if they are to accelerate Indian capital spending to any great extent. As we wrote in our *Special Report* **Gutsy Grasp** (5 September, pp5-7 and 22) private sector credit aggregates have been slowing since the start of the year. In theory and empirically it is hard to make a bull case for construction and investment picking up without accelerating bank credit growth.

Long-run history and forecast summary

	FY14	FY15	FY16	FY17	FY18	FY19	FY20E	FY21F	FY22F
Real GVA growth	6.1	7.2	8.0	7.9	6.9	6.6	5.7	6.7	7.1
Domestic demand (contr. to growth)	2.7	7.1	6.9	6.4	9.1	8.6	5.2	7.5	7.9
Nominal GDP growth	13.0	11.0	10.5	11.5	11.3	11.2	8.6	8.8	7.8
Consumer prices (y/e)	8.2	5.3	4.8	3.9	4.3	2.9	3.5	3.1	3.4
Repo rate (% y/e)	8.00	7.50	6.75	6.25	6.00	6.25	4.65	4.40	4.40
INR/USD (y/e)	60.1	62.6	66.3	64.8	65.0	69.2	71.0	70.0	69.0
Money supply M1 (y/e)	8.5	11.3	13.5	3.1	21.8	13.6	9.0	9.6	13.6
Current account balance (USD bn)	(32.3)	(26.8)	(22.1)	(14.4)	(48.7)	(57.2)	(57.6)	(85.3)	(97.2)
- as a % of nominal GDP	(1.7)	(1.3)	(1.0)	(0.6)	(1.8)	(2.1)	(2.0)	(2.7)	(2.8)
General gov't balance (% GDP)	(6.7)	(6.7)	(6.9)	(6.9)	(6.4)	(5.1)	(6.7)	(7.2)	(7.0)

Note: All figures % YoY growth rates, unless otherwise stated. All data refer to fiscal years ending March.
Source: Reserve Bank of India, CEIC, CLSA estimates

In consequence we expect the first year growth impact to be muted. The cuts are likely to add, on our estimate, around ¼% to FY20 GVA growth. This remains therefore under 6% (at 5¾% compared with the 5½% estimate in **Gutsy Grasp**). The boost should be about twice this in FY21 (where we now see growth around 6¾% assuming the credit system begins to operate).

Fiscal risk should not be overstated

A central government deficit in excess of 4% of GDP is not far from levels that, historically, have caused bond and currency markets problems. We do not anticipate that this will be the case this year for two reasons. First, the limited immediate boost to growth means that the impact on the current account should be small (in a national accounts framework a fall in government saving is offset by a rise in corporate saving rather than a rise in investment). This should contain any risk for the currency. A central government deficit over 4% accompanied by a significantly rising current account deficit would be problematic. However we are optimistic that the current account deficit can stay around 2%.

Second, the global environment. The weakness of Indian growth justifies an expansionary budgetary policy and the weakness of global growth eases the risks that such a policy represents in financial markets. World trade growth is already weaker than it has been since the Global Financial Crisis and on our forecast – which sees US growth (the US is the swing factor in the global forecast) decelerating into 2020 – will weaken further. In such an environment government funding requirements should be easily absorbed by financial markets hungry for yield. And weak growth makes us forecast that current oil price rises will soon go into reverse. India will be the most obvious beneficiary and this will further mitigate the risks of an expanding fiscal deficit.

High-octane monetary boost

The RBI started to ease in February 2019, lowering rates by a cumulative 110bp to 5.4% in August 2019. The RBI policy stance has continued to shift to growth preservation rather than (almost exclusively under the previous two RBI governors) balance sheet clean-up and risk minimisation.

RBI's August policy statement was explicit in arguing that the benign inflation outlook provides headroom for further policy action to close the negative output gap. Headline inflation was at 3.2% YoY and core inflation was at 4.2% in August 2019. We expect a 25bp rate cut in the December quarter and a further 75bp cut, to 4.4%, by June 2020.

The intermediation of lower policy rates into bank credit has so far been weak. The commercial banks cut their lending rates by 29bp compared with the RBI's 75bp cut between February and June 2019 and system loan growth has been slowing. Correcting this is now a policy focus. The finance minister has had an assurance

GDP growth forecasts

RBI	
Updated:	Aug
FY20 (GDP):	6.9
Consensus	
Updated:	Sep
FY20 (GDP):	6.7
CLSA	
FY20 (GVA):	5.7

The CLSA difference

GDP growth

- The RBI may wait until its October meeting to cut its 6.9% forecast for FY20 which is out of reach following the sharp slowdown in 1Q FY20. Ditto for the 6.7% consensus forecast.

Inflation

- RBI remains sanguine about the inflation outlook. We agree, with our average CPI forecast well below the middle of RBI's inflation target at 4%. Core inflation is also heading below 4%.

Interest rates & exchange rate

- Our forecast of multiple cuts into 2020 is conservative bearing in mind that it will leave the policy rate above 1% in real terms.

2Q19 consumption contraction will not mean revert in 3Q19, monthly indicators have been extremely weak.

Investment remained subdued in 2Q19. Again, monthly indicators suggest investment has remained sluggish in 3Q19. We are sceptical that capex will recover before credit.

The growth slowdown in 1Q19 and even sharper slowdown in 2Q19 have lowered our forecast. FY20 will be the fourth consecutive year of slowing GVA growth.

Inflation has been lower than expected; core is heading towards 4% YoY and headline is well below this level.

Portfolio and FDI inflows should be INR supportive despite a cyclically widening current account deficit.

RBI has been cutting rates aggressively and the low inflation outlook leaves space for this to continue.

Current account deficit will widen as GDP recovery starts.

But corporate tax cuts mitigate our criticism that not enough is being done to attract FDI. FDI surplus to increase progressively over time.

Credit growth failed to pick up despite the 110bp rate cut since February 2019. By FY22 though, credit will accelerate with improved transmission through the banking sector. This will be necessary for India to regain 7.1% trend GVA growth in FY22.

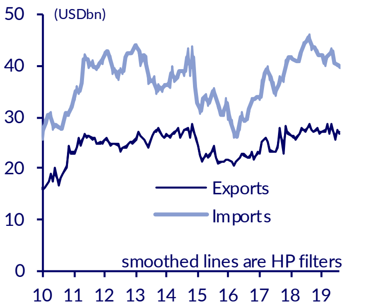
Including the corporate tax cuts (and lower nominal growth than assumed in the FY20 budget) will take this year's deficit to 4¼% of GDP. Firmer revenues to begin to contain the deficit next year. These figures assume no further significant fiscal stimuli.

India by numbers

	FY18	FY19	FY20E	FY21F	FY22F
Breakdown of real GDP					
Private consumption	7.4	8.1	4.1	7.2	7.6
Public consumption	15.0	9.2	9.0	9.0	7.7
GFCF	9.3	10.0	6.3	8.5	9.0
Domestic demand (contr. to growth)	9.1	8.6	5.2	7.5	7.9
Exports, goods & services	4.7	12.5	4.2	2.7	1.9
Imports, goods & services	17.6	15.4	3.3	5.6	5.3
Real GVA	**6.9**	**6.6**	**5.7**	**6.7**	**7.1**
Prices					
Consumer prices (y/e)	4.3	2.9	3.5	3.1	3.4
Consumer prices (average)	3.6	3.4	3.3	3.2	3.3
Currency & interest rates					
INR/USD (y/e)	65.04	69.17	71.00	70.00	69.00
INR/USD (average)	64.46	69.92	70.62	70.13	69.94
Repo rate (% y/e)	6.00	6.25	4.65	4.40	4.40
Reverse repo rate (% y/e)	5.75	6.00	4.40	4.15	4.15
External sector					
Exports (USD, %YoY)	10.3	9.1	6.4	1.6	1.3
Imports (USD, %YoY)	19.5	10.3	3.5	5.2	2.2
Trade balance (USD bn)	(160.0)	(180.3)	(176.9)	(199.3)	(206.7)
Current account balance (USD bn)	(48.7)	(57.2)	(57.6)	(85.3)	(97.2)
- as a % of nominal GDP	(1.8)	(2.1)	(2.0)	(2.7)	(2.8)
FDI (USD bn)	30.3	30.7	24.0	50.0	71.0
CA + net FDI (% GDP)	(0.7)	(1.0)	(1.1)	(1.1)	(0.8)
External debt (total, USD bn)	515.0	504.7	494.6	484.7	475.0
Debt service ratio (% exports)	9.4	8.8	8.0	7.6	8.1
International reserves (USD bn, y/e)	424.5	412.9	414.3	414.0	422.8
Money supply					
Money supply M1 (y/e)	21.8	13.6	9.0	9.6	13.6
Money supply M3 (y/e)	9.2	10.5	8.9	9.8	14.2
Private sector credit (y/e)	10.8	13.3	9.8	10.1	14.7
Private sector credit (% GDP)	55.0	56.0	56.7	57.3	61.0
Government sector					
Central gov't balance (% GDP)	(3.5)	(3.4)	(4.3)	(4.2)	(4.0)
General gov't balance (% GDP)	(6.4)	(5.1)	(6.7)	(7.2)	(7.0)
Central gov't debt (% GDP, y/e)	45.6	45.5	47.2	48.4	49.8
General gov't debt (% GDP, y/e)	69.0	68.7	71.5	74.3	77.2
Nominal GDP					
Nominal GDP (USD bn)	2,652.1	2,718.9	2,922.0	3,203.5	3,489.7
Nominal GDP per capita (USD)	2,018.2	2,045.8	2,174.7	2,358.3	2,541.0
Nominal GDP (INR bn)	170,950	190,102	206,426	224,629	242,061
Nominal GDP (INR, %YoY)	11.3	11.2	8.6	8.8	7.8
Other data					
Industrial production	4.4	3.8	3.4	4.0	4.3
Population (millions)	1,314	1,329	1,344	1,358	1,373

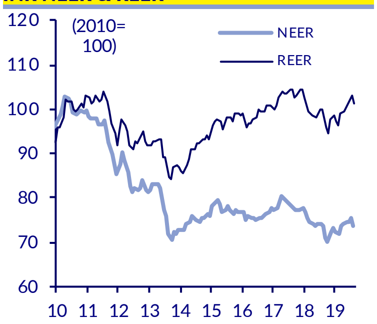
Note: All figures % YoY growth rates, unless otherwise stated. All data refer to fiscal years ending March.
Source: Reserve Bank of India, CEIC, CLSA estimates

Exports & imports



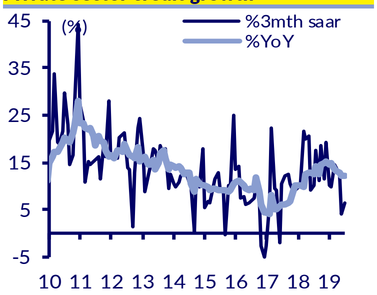
Source: CEIC, CLSA

INR NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

from the banks that they will pass on all RBI rate cuts to MCLR. This refers to the marginal cost of funds based lending rate which determines the minimum home loan rate of interest. The government will also establish a channel for enhanced credit provision to infrastructure and housing projects.

In real terms, the policy rate remains high, above 2%, considering that the investment cycle is not yet underway. On our inflation and interest rate projections, India's real policy rate will be at 1.2% at end-FY20 and 1.3% at end-FY21. The implication is that our interest rate forecast is conservative.

Inward FDI to rise as tax reform gains traction

India's large trade deficit largely reflects its structural energy trade deficit and the country's hearty appetite for gold. There is a substantial offset though, from the services surplus with IT software services revenues providing the largest contribution (around 3% of GDP in FY19). Overseas remittances are another positive offset, at 2.5-3% of GDP. Tourism receipts have potential but are currently low at around 1% of GDP. The aggregate services and transfers surplus will contain India's current account deficit at around 2% of GDP this year but rising investment will push the current account deficit wider in FY21 and FY22.

Gutsy Grasp was critical of both India and Indonesia for their efforts to encourage inward FDI. The corporate tax cuts reverse this assessment for India but the starting point is poor. Today net FDI in India provides inadequate cover for the current account deficit. Our currency outlook therefore remains cautious and we expect a move back to around INR72/USD by the end of this year. As GDP growth starts to recover the current account deficit will rise. However inward FDI should increase by a greater amount as the corporate tax reform gains traction (visible in the "adjusted resource gap" in the *By Numbers* table). India should also be a favoured destination for portfolio investment as its GDP growth starts to improve. We expect an INR70-72/USD range for 2020; moving to the high INR60s in 2021.

A controversial proposal has been to raise foreign capital through sovereign bond issuance which could provide over 10% of the annual financing requirement. This would be India's first foreign currency debt sale and has, unsurprisingly, sparked fierce criticism.

Risk and reward

The biggest risk factor is reform failure which would keep India growing below trend. Banking sector reform should ultimately aim to reduce significantly the state bank share of total banking assets. If not, the long term risk is that the state banks will need another round of recapitalisation, thereby diverting financial resources from more efficient spending. The huge upside to successful reform will be to reinforce the positive structural trends of rising urbanisation and an expanding middle class.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
INR/USD	63.93	69.79	72.00	70.00	69.00	72.00	71.00	70.00	70.00
INR/JPY 100	56.72	63.62	69.23	70.00	65.71	69.23	70.30	70.00	70.00
INR/GBP	86.38	89.01	86.40	91.00	89.70	86.40	88.75	91.00	91.00
INR/Euro	76.74	80.03	77.04	80.50	75.90	77.04	81.65	84.00	81.90
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

CLSA

Indonesia

EoAE Forecasts - 4Q19

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Jokowi's challenge: Delivering reform

- **Reform will be driven by economic necessity. Opening the economy to foreign investment is the best option for balance of payments and exchange rate stabilisation.**
- **Bank Indonesia has shifted to a bolder monetary easing stance. Lower rates will spur domestic demand but this is contingent on constructive policy signals for investment.**
- **The exchange rate will be shielded by sustained low inflation in Indonesia and declining interest rates in the US.**

Private investors trigger-shy

Reform in Indonesia is 'dawning'. The pressing need for structural change has been recognised but not yet implemented. Mr Jokowi, at the outset of his second term, has recognised the urgency to facilitate private investment, both domestic and foreign. This will be driven by economic necessity. Indonesia has to open its economy to foreign investment as the best option for balance of payments and exchange rate stabilisation (see *Special Report*, **Gutsy grasp: India and Indonesia tackle reform**, September 2019). Follow through implementation will take time delaying the onset of an investment upswing, notwithstanding lower interest rates following Bank Indonesia's shift to a looser monetary stance.

We estimate Indonesia's trend real GDP growth at 5.5%. Peak growth rates above 6% were recorded in the commodity boom cycle from 2007-2012. In the subsequent commodity down-cycle, growth decelerated to a 4.9% trough in 2015. There were green shoots of an investment upturn from 2Q17-3Q18 as infrastructure implementation, doggedly pursued by Mr Jokowi, started to gather pace. However, investment growth subsequently slowed as private investors remained side-lined. The investment contribution to GDP growth, which had been rising in 2017-18, fell in 1H19.

Private consumption fluctuation has been low amplitude, from 5.8% at the peak of the commodity cycle in 2012 to 4.8% at the trough in 2015. Growth may be understated since rapidly expanding E-commerce is not captured by official data. Early investment signals for 3Q19 were weak. The capital goods imports downtrend continued and bank credit growth slowed below 10% YoY.

The rebound in private investment, when it comes, will largely be in residential construction. Sluggish domestic cement sales have been a concern given that 75% of total investment is construction driven. Mortgage credit growth sent a weak signal for 3Q19. A revival in sentiment for increased private investment spending

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	5.6	5.0	4.9	5.0	5.1	5.2	5.2	5.2	5.4
Domestic demand (contr. to growth)	4.6	5.0	4.2	4.5	4.9	6.1	4.7	5.5	5.8
Nominal GDP growth	10.8	10.7	9.1	7.6	9.6	9.2	7.8	7.5	7.9
Consumer prices (y/e)	8.1	8.4	3.4	3.0	3.6	3.1	2.7	2.5	3.1
BI policy rate (% y/e)	7.50	7.75	7.50	4.75	4.25	6.00	5.00	4.25	4.25
IDR/USD (y/e)	12,189	12,440	13,795	13,436	13,548	14,481	14,325	14,700	15,000
Money supply M1 (y/e)	5.4	6.2	12.0	17.3	12.4	4.8	5.5	5.8	7.8
Current account balance (USD bn)	(29.1)	(27.5)	(17.5)	(17.0)	(16.2)	(31.0)	(35.0)	(38.4)	(43.0)
- as a % of nominal GDP	(3.2)	(3.1)	(2.1)	(1.8)	(1.6)	(3.0)	(3.1)	(3.2)	(3.4)
Public sector balance (% GDP)	(2.2)	(2.1)	(2.6)	(2.5)	(2.5)	(1.8)	(2.4)	(2.5)	(2.5)

Note: % YoY rates unless otherwise stated. Policy rate changed from 1-yr BI to 7-day repo rate effective August 2016.
Source: IMF, IFS, CEIC, CLSA estimates, Bank Indonesia, IIF

will be needed to lift real GDP growth from the sustained 5.2% pace that we forecast in 2020 to 5.4% in 2021.

Public infrastructure spending, with a budgeted 4.9% increase in 2020, will be relied on to support investment until the private sector comes on board. The increase will be lower than nominal GDP growth though, with an implicit reduction in public infrastructure spending to 2.4% of GDP (2019: 2.5% of GDP). Government financed SOEs have driven infrastructure but this is not sustainable. Encouragingly, Mr Jokowi has signalled a reduced role for over-leveraged SOEs by turning over the Patimban port development in West Java to private sector contractors. He has been urged to engage private companies for operation of the port which would boost efficiency in this notoriously inefficient sector.

Rising private investment growth will be essential for Indonesia to regain trend GDP growth of 5.5%. This will require that Mr Jokowi's intentions on facilitating investment, both domestic and foreign, are translated into actionable reforms. There has been a recent setback. Mr Jokowi has approved a parliamentary initiative that threatens to reduce the effectiveness of the anti-corruption commission (KPK) which will hamper efforts to improve governance in Indonesia.

Clawing back fiscal revenue

Fiscal concerns have been raised by a projected 0.9% of GDP tax revenue shortfall this year which would raise the fiscal deficit from the targeted 1.8% of GDP to 2.7% of GDP. Expenditure will need to be cut without reducing capital (infrastructure) spending, already compromised by energy, food and other subsidies. Premiums for the State Health Insurance agency will be doubled in order to contain the health care deficit.

With a low tax revenue base, among the lowest in the region at 10.3% of GDP, Indonesia needs to broaden the tax base and improve compliance (already benefiting from risk based audits and IT systems development). The tax office has received information on financial and nonfinancial assets held by Indonesians in Singapore and Hong Kong, through the Automatic Exchange of Information, since September 2018. Finance Minister Sri Mulyani, while concerned about moral hazard, is open to the idea of a second tax amnesty forming part of a broader tax reform including a corporate income tax cut from 25% to 20% by 2021-22.

Energy sector: Ripe for reform

Declining oil and gas production argue for energy sector reform. Following state-owned Pertamina's takeover of the Mahakam block from Total Energy Corp in December 2017, there was a 30% drop in production. However, Mr Jokowi may possibly be steering Indonesia away from resource nationalism. In August, the government extended ConocoPhillips' production-sharing contract for the Corridor natural gas block (Indonesia's second largest).

GDP growth forecasts	
Government (BI)	
Updated:	Aug
2019:	5.1
Consensus	
Updated:	Sep
2019:	5.0
CLSA	
2019:	5.2

The CLSA difference

GDP growth

- Our GDP growth forecast is slightly above that of BI and consensus. Our assumption is that positive policy signals will lift confidence in the private sector for higher investment.

Inflation

- In the global disinflationary environment, we forecast average inflation at 3% in 2019, the lower end of BI's 2.5-4.5% target range.

Interest rates & exchange rate

- BI has indicated a bolder easing stance. Sheltered by falling US interest rates, there is scope for another 100bp cut to 4.25% by end-2020 without destabilising the exchange rate.

Indonesia by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	5.0	5.1	5.3	5.3	5.4
Public consumption	2.1	4.8	5.0	5.0	5.0
GFCF	6.2	6.7	4.9	6.6	7.1
Domestic demand (contr. to growth)	4.9	6.1	4.7	5.5	5.8
Exports, goods & services	8.9	6.5	(2.5)	2.9	3.5
Imports, goods & services	8.1	12.0	(6.2)	4.6	5.6
Real GDP growth	**5.1**	**5.2**	**5.2**	**5.2**	**5.4**
Prices					
Consumer prices (y/e)	3.6	3.1	2.7	2.5	3.1
Consumer prices (average)	3.8	3.2	3.0	2.6	2.8
Producer prices (y/e)	3.1	3.0	1.6	(1.5)	0.5
Currency & interest rates					
IDR/USD (y/e)	13,548	14,481	14,325	14,700	15,000
IDR/USD (average)	13,406	14,276	14,260	14,520	14,840
BI policy rate (% y/e)	4.25	6.00	5.00	4.25	4.25
Base lending rate (% y/e)	10.68	10.34	9.80	9.20	9.00
External sector					
Exports (USD, % YoY)	16.9	7.0	(7.2)	2.0	3.6
Imports (USD, % YoY)	16.2	20.7	(6.1)	3.4	5.5
Trade balance (USD bn)	18.8	(0.4)	(2.4)	(4.8)	(8.3)
Current account balance (USD bn)	(16.2)	(31.0)	(35.0)	(38.4)	(43.0)
- as a % of nominal GDP	(1.6)	(3.0)	(3.1)	(3.2)	(3.4)
FDI (USD bn)	18.5	13.4	19.7	26.8	31.6
CA + net FDI (% GDP)	0.2	(1.7)	(1.4)	(1.0)	(0.9)
External debt (total, USD bn)	352.5	377.6	412.0	452.0	494.0
Gross external financing requirement % GDP	7.0	8.3	8.2	8.5	8.7
International reserves (USD bn, y/e)	130.2	120.7	125.4	123.9	123.0
Money supply					
Money supply M1 (y/e)	12.4	4.8	5.5	5.8	7.8
Money supply M2 (y/e)	8.3	6.3	7.0	7.6	9.0
Private sector credit (y/e)	8.2	11.7	10.2	10.8	12.0
Private sector credit (% GDP)	35.1	35.9	36.7	37.8	39.2
Government sector					
Public sector balance (% GDP)	(2.5)	(1.8)	(2.4)	(2.5)	(2.5)
Public sector debt (% GDP, y/e)	29.4	31.0	32.1	34.2	35.8
Nominal GDP					
Nominal GDP (USD bn)	1,013	1,039	1,121	1,184	1,250
Nominal GDP per capita (USD)	3,833	3,880	4,133	4,309	4,493
Nominal GDP (IDR tn)	13,587	14,837	15,990	17,191	18,557
Nominal GDP (IDR, % YoY)	9.6	9.2	7.8	7.5	7.9
Other data					
Industrial production	4.3	4.3	3.3	3.2	3.8
Unemployment (% y/e)	6.4	6.5	6.6	6.7	6.7
Population (millions)	264.4	267.8	271.3	274.8	278.3

Note: % YoY rates unless otherwise stated. Ross external financing requirement is current account deficit plus debt amortisation Policy rate changed from 1-yr BI to 7-day repo rate effective August 2016. Source: IMF, CEIC, CLSA estimates, Bank Indonesia

Consumption estimates are likely understated; national accounts data do not capture on-line retail.

Private investment upswing is contingent on policy signals that lift confidence in the private sector.

Commodity down-cycle will contribute to the two year delay in regaining trend GDP growth.

Global disinflation and improved domestic food supply management will keep average inflation below 3%.

Forex exposure arises from high corporate share of external debt and high foreign ownership of government bond market.

BI had cut rates by only 75bp by September 2019. We expect a further 100bp cut to 4.25% by end-2020.

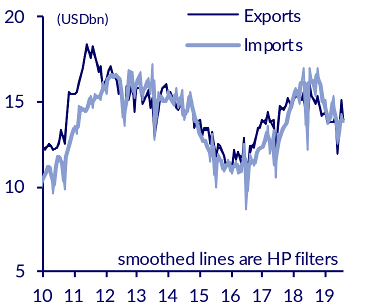
Persistent current account deficit above 3% of GDP reflects structural factors. The appropriate policy is to target the financial account.

FDI inflows need to double in order to comfortably cover the current account deficit.

Bank credit growth dropped below 10% YoY in June-July 2019 justifying BI's recent shift to a bolder policy easing stance.

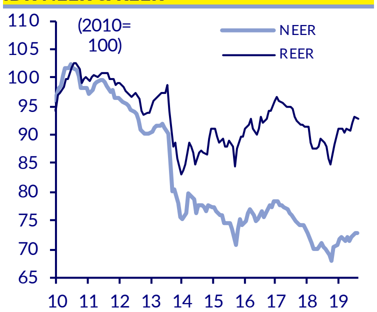
The fiscal deficit was contained at 1.8% of GDP in 2018. We expect a looser fiscal stance in 2019-2020. Public debt remains low at 31% of GDP but is on a gradually rising trend.

Exports & imports



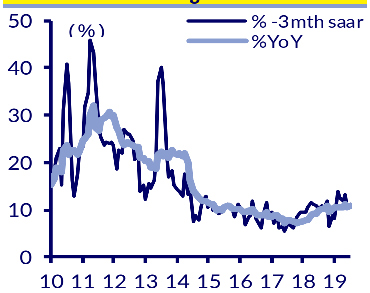
Source: CLSA, CEIC

IDR NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

Monetary policy: Bolder easing stance

Bank Indonesia had to wait until July 2019 before initiating the easing cycle, lowering rates by a cumulative 75bp to 5.25% in August. BI had been constrained by exchange rate instability but has become more confident.

The recent spate of rate cuts across Asia and subdued average inflation this year (3% headline and 3.1% core in the first eight months) has allowed Bank Indonesia to speed up the pace of easing. The exchange rate will be shielded by US Federal Reserve easing with prospects of another cut in December and a further 100bp cut in 2020. In Indonesia, we forecast another 25bp cut to 5% by end-2019 and a 75bp cut to 4.25% by end-2020. This is contingent on balance of payments stability. Increased foreign capital flows on the financial account will be needed to offset the current account deficit. BI's target for the current account deficit is 2.5-3% of GDP in 2019 and in 2020. Our forecast is above 3% of GDP in both years.

The policy rate remains high in real terms, above 2%, considering that the investment cycle is not yet underway. On our inflation projections, Indonesia's real policy rate will remain high at 2.3% at end-2019 but decline to 1.7% at end-2020. The implication is that our interest rate forecast is conservative.

Current account: Here to stay

The trade balance will swing into deficit this year as the commodity down-cycle confers a terms of trade loss. (Indonesia is a net oil & gas importer but an overall net commodity exporter). Import growth will be supported as investment gradually picks up. Along with the structural services and net income deficits, this will keep the current account deficit above 3% of GDP.

Faced with a largely structural current account deficit, appropriate policy will be to attract higher foreign capital inflow on the financial account. Indonesia has requested that China set up a special fund within its Belt & Road Initiative, not contingent on government guarantees. Mr Jokowi has also been pushing for increased FDI from Japan (LNG projects, electric vehicle and battery plants) and from the Middle East (refinery, petrochemicals and port projects).

Forex exposure

Indonesia's forex exposure arises from various factors. Reliance on external financing has lifted the corporate sector share of total external debt to over 40% (mitigated though, by regulations on corporate hedging). High foreign ownership (39%) of the government bond market provides a ready exit for foreign portfolio capital during bouts of emerging market risk aversion.

Exchange rate exposure underlines the biggest risk factor for Indonesia, namely reform failure. Without higher foreign capital inflows to offset Indonesia's current account deficit, monetary easing will be constrained. This would delay the economy regaining trend GDP growth beyond the two years that we predict.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
IDR/USD	13,548	14,481	14,325	14,700	15,000	14,325	14,450	14,517	14,600
IDR/Yen 100	12,021	13,201	13,774	14,700	14,286	13,774	14,307	14,517	14,600
IDR/GBP	18,307	18,469	17,190	19,110	19,500	17,190	18,063	18,872	18,980
IDR/Euro	16,264	16,605	15,328	16,905	16,500	15,328	16,618	17,420	17,082
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

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Cyclical headwinds recognised

- **The economy continues to weaken despite 2019 having an expansionary fiscal stance. A repeat should be expected for 2020: weaker growth despite looser policy.**
- **Inflation hit zero in August. This is temporary but core inflation is low and falling. This and weak consumption is symptomatic of a widening output gap.**
- **The KRW will be weak while global growth is slowing but expectation of a 2H20 recovery in world trade should allow it to begin to outperform its regional peers.**

Fiscal-driven 2Q bounce

Korea's 2Q19 GDP was better than expected. GDP growth rebounded to 1.1% QoQ (sa) in 2Q19 reversing the 0.4% QoQ contraction in 1Q. As a result of the sequential rebound YoY growth improved to 2.1% in 2Q19 from 1.7% in 1Q19. Exports of goods & services increased by 2.3% QoQ (sa) in 2Q19 but this follows two quarters of sequential contraction and 2Q19 exports were down on a YoY basis. Imports also increased on the quarter after falling for three of the preceding four quarters (they rose 0.1% YoY). This is symptomatic of weak facilities investment (private investment fell in 2Q for the fifth consecutive quarter). Net trade made a negative contribution to QoQ growth for the third consecutive quarter.

Domestic demand jumped 1.3% QoQ (sa) in 2Q19, recovering from the 0.4% decline in the prior quarter. All of this was driven by fiscal spending. Public consumption and investment combined rose 6.1% QoQ, mainly driven by a jump in civil engineering investment. Private sector demand remained weak and contracted 0.2% QoQ in 2Q19, following a similar sized decline in the preceding quarter. Measured as contributions to growth government demand was the source of 1.2ppts of the 1.1% QoQ GDP growth. On a year-on-year basis the government was the source of 1.7ppts of the 2.1% YoY GDP increase.

The government recognises the challenges

Korea is an economy highly correlated with world trade (89% over the last 40 quarters) so the willingness and ability of the government to recognise the challenges and act aggressively is welcome. The August supplementary budget revised the 2019 government deficit to 2.2% of GDP (on the MoFE's estimate, we expect that the outcome will be a fraction higher than this). This represented a discretionary fiscal loosening from 2018 equivalent to 1.6ppts of GDP. Without it Korea's GDP growth in 2019 would be around ½%.

Even with the government stimulus the outcome for 2019 will be weak. We estimate a growth rate of 2%. This is the lowest calendar year total since the GFC.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	3.2	3.2	2.8	2.9	3.2	2.7	2.0	1.9	2.7
Domestic demand (contr. to growth)	1.9	2.6	3.5	3.8	5.3	1.6	1.6	1.7	3.3
Nominal GDP growth	4.2	4.1	6.1	5.0	5.5	3.1	1.8	2.2	4.6
Consumer prices (y/e)	1.1	0.8	1.1	1.3	1.4	1.3	0.8	0.8	1.3
Call rate (% y/e)	2.50	2.00	1.50	1.25	1.50	1.75	1.25	0.75	0.75
KRW/USD (y/e)	1,055	1,099	1,173	1,206	1,067	1,116	1,250	1,160	1,100
Money supply M1 (y/e)	11.3	13.4	19.6	12.4	6.9	1.9	6.2	5.9	5.9
Current account balance (USD bn)	77.3	83.0	105.1	97.9	75.2	76.4	54.9	53.6	83.7
- as a % of nominal GDP	5.6	5.6	7.2	6.5	4.6	4.4	3.3	3.2	4.6
Central gov't balance (% GDP)	0.9	0.5	(0.0)	1.0	1.3	1.6	0.1	(1.6)	(1.3)

Note: % YoY rates unless otherwise stated. Source: IMF, World Bank, Bank of Korea, CEIC

It is unchanged from our 3Q19 *EoAE* forecast but below the Bank of Korea's estimate despite the latter having been cut (to 2.2%) at the July policy meeting.

Korea is not just facing the "usual stuff" of weak global demand. It is also suffering the effects of the misjudged minimum wage hikes of 2017, 2018 and 2019 which curtailed employment growth and reduced, rather than boosted consumer spending. These should not be recurrent. A much more moderate 2.9% YoY increase is legislated for 2020. However the international headwinds are likely to be worse if world trade contracts, as we expect, by 1% in 2020. Korea's trade war with Japan is also having a depressing influence (Korea formally removed Japan from its export controls whitelist on 18 September). Given the deep-seated issues at its root, it is difficult to see a resolution.

The government certainly recognises the challenges. The draft 2020 budget plans an addition Keynesian boost with the deficit targeted at 3.6% of GDP, a discretionary easing of 1.4ppts. Spending is specifically focussed on reducing Korea's dependence on imported technologies, an obvious response to the tensions with Japan. The outcome will again be worse (we expect a deficit of 3.9% as tax revenues fall short of expectations). But we fear insufficient to accelerate Korea's growth. We have cut our 2020 forecast from 2.2% three months ago to 1.9% on the downgrade to our global growth forecast. This would be the second year in which growth is below trend. Korea does not boast the greatest labour market data (unemployment dipped sharply in August, but this is surely an aberration) but an emerging output gap, historically, has been quick to appear in weak household spending data. 2020 is therefore likely to be another year in which private consumption growth is below historical norms.

Record low rates to come

The Bank of Korea was initially reluctant to ease, but this is now history. Given inflation it has little option. The headline rate fell to zero in August. Korea operates an inflation targeting framework of 2% +/- 0.5ppts. It has been below this band since end-2018. The exceptionally low August print reflected an elevated base (food prices) and was flagged by Bank of Korea but core inflation is also declining and is now less than half the bottom of the BoK target range (it has been below 2% since mid-2017).

Minutes of the last (August) meeting suggest that the central bank is increasingly concerned about the growth environment. Governor Lee indicated after the August meeting, which left rates unchanged, that there was room for monetary policy to respond to economic situations if necessary. This is hardly a commitment to bring rates down immediately (he would hardly have said anything else) but the BoK governor has shifted stance on the economy in recent months and reportedly has ordered the central bank to prepare for a "worst case" scenario.

GDP growth forecasts

Government (BoK)	
Updated:	Jul
2019:	2.2
Consensus	
Updated:	Sep
2019:	2.0
CLSA	
2019:	2.0

The CLSA difference

GDP growth

- We are below the BoK forecast but in line with consensus. Our expectations for 2020 are bearish relative to the market reflecting our weaker global outlook.

Inflation

- Low inflation this year is largely discounted but our forecasts are below consensus for 2020. Increasingly the BoK will see inflation as an active reason to cut rates.

Interest rates & exchange rate

- The KRW has been a regional underperformer. It will remain soft to end-2019 but should be able to share in a softer USD in 1H20 and outperform its regional peers in 2H20 and 2021.

Korea by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	2.8	2.8	2.0	1.9	2.3
Public consumption	3.9	5.6	6.3	5.2	4.9
GFCF	9.8	(2.4)	(3.5)	(0.4)	4.7
Domestic demand (contr. to growth)	5.3	1.6	1.6	1.7	3.3
Exports, goods & services	2.5	3.5	(0.4)	(0.7)	2.2
Imports, goods & services	8.9	0.8	(1.7)	(1.3)	4.0
Real GDP growth	**3.2**	**2.7**	**2.0**	**1.9**	**2.7**
Prices					
Consumer prices (y/e)	1.4	1.3	0.8	0.8	1.3
Consumer prices (average)	1.9	1.5	0.7	0.5	1.0
Producer prices (y/e)	2.2	0.9	(1.0)	(2.5)	0.2
Currency & interest rates					
KRW/USD (y/e)	1,067	1,116	1,250	1,160	1,100
KRW/USD (average)	1,130	1,101	1,176	1,191	1,128
Call rate (% y/e)	1.50	1.75	1.25	0.75	0.75
Avg household lending rate (% y/e)	3.61	3.61	2.75	2.25	2.25
External sector					
Exports (USD, % YoY)	13.4	7.8	(10.2)	(9.9)	1.8
Imports (USD, % YoY)	18.0	10.0	(5.9)	(10.5)	(2.5)
Trade balance (USD bn)	113.6	111.9	77.9	73.1	93.2
Current account balance (USD bn)	75.2	76.4	54.9	53.6	83.7
- as a % of nominal GDP	4.6	4.4	3.3	3.2	4.6
FDI (USD bn)	(16.2)	(24.4)	(25.4)	(26.1)	(27.9)
CA + net FDI (% GDP)	3.6	3.0	1.8	1.7	3.1
International reserves (USD bn, y/e)	389.3	403.7	403.2	400.7	426.5
Money supply					
Money supply M1 (y/e)	6.9	1.9	6.2	5.9	5.9
Money supply M2 (y/e)	4.7	6.8	6.3	4.9	4.9
Private sector credit (y/e)	5.7	6.0	3.5	2.9	7.6
Private sector credit (% GDP)	83.1	85.4	86.0	86.5	88.0
Government sector					
Central gov't balance (% GDP)	1.3	1.6	0.1	(1.6)	(1.3)
- excl social sec funds (% GDP)	(1.0)	(0.6)	(2.3)	(3.9)	(3.6)
Central gov't debt (% GDP, y/e)	34.2	34.4	36.2	40.0	42.5
Nominal GDP					
Nominal GDP (USD bn)	1,623.9	1,720.5	1,638.4	1,653.1	1,826.9
Nominal GDP per capita (USD)	31,617	33,339	31,652	31,841	35,084
Nominal GDP (KRW tn)	1,835.7	1,893.5	1,927.2	1,969.3	2,059.8
Nominal GDP (KRW, % YoY)	5.5	3.1	1.8	2.2	4.6
Other data					
Industrial production	2.9	1.4	0.0	1.0	2.5
Retail sales	3.7	5.6	2.0	1.9	3.1
Unemployment (% y/e)	3.7	3.8	4.1	4.4	4.2
Population (millions)	51.4	51.6	51.8	51.9	52.1

Note: % YoY rates unless otherwise stated.
Source: IMF, World Bank, Bank of Korea, CEIC

Consumption is cyclically sensitive in Korea meaning weak in 2019 and 2020. The drag from misjudged minimum wage policy should however not be recurrent.

Despite tax incentives and lower interest rates facilities investment is likely to be weak. Would be weaker still but for government projects.

Weak investment suggests weak imports allowing net trade (perversely) to make a small positive contribution.

2019 is already on track to be the slowest post-GFC growth. 2020 to be no better.

Headline inflation is commodity price sensitive and core inflation is weak.

The minute the bottom of the cycle becomes visible is the time to buy KRW.

Recent comments suggest the BoK is prepared to take rates to new record lows.

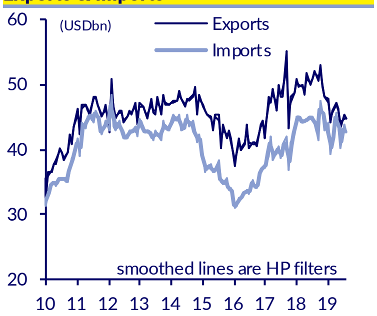
The cyclicality of import demand keeps the current account surplus robust.

2019 has already seen a substantial Keynesian boost. 2020 will see a repeat despite typically conservative budget management.

Early months to 2019 have seen some very weak industrial production data. That said the underlying trend is hardly robust.

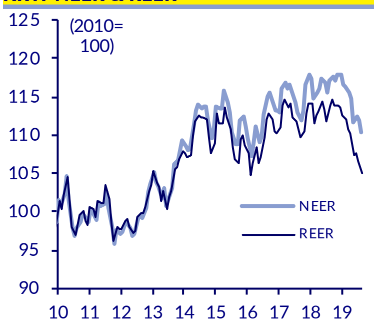
The unemployment data are often unsubtle indicators of output gap (look instead at PCE). BoK estimates trend growth at 2.5-2.6% so 2019 and 2020 is below trend.

Exports & imports



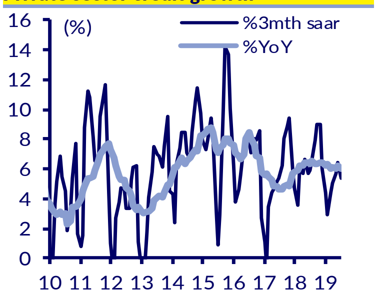
Source: CEIC, CLSA

KRW NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

Despite the erratics in the August inflation data they increase the chance that BoK will cut again at its October policy meeting. This would take the policy rate to 1.25%, equalling the low set in mid-2016. Further cuts should be expected in 2020. We pencil in 2x 25bp easings, likely before the middle of the year, taking the policy rate to 0.75%. Given the low growth and inflation environment a lower-still forecast is possible. However the BoK has indicated that it believes that government spending has positive multiplier effects (though we suspect smaller than most market participants think, the BoK estimate is 1.3x accrued over five years). Given Korea's history of fiscal conservatism our forecast does not assume a supplementary budget in mid-2020 but one is certainly possible.

Global growth and CNY risk to weigh on KRW

The KRW has been in a depreciating channel versus the USD since early 2018 and for the immediate future this is likely to continue. Two factors continue to be critical. First the health of the world economy: Korean equities include some of AxJ's most liquid cyclical stocks and portfolio flows are unlikely to favour the KRW while global growth expectations are being downgraded. Second, the CNY. Here too we see reason to pessimism (see p31). Consequently our end-2019 KRW target is KRW1,250/USD. If achieved this would be a new low for the post-GFC period (though in times of real global stress the KRW has been *much* weaker).

In common with other Asian currencies we expect the KRW to perform better in the first half of 2020. In reality this is a USD forecast. As the USD forward curve falls in recognition of declining US growth the USD, which is expensive on nearly all measures, can depreciate. However, though we anticipate that this weak USD period will be over by mid-year, we are optimistic that the KRW can continue to outperform. This is because we expect portfolio flows into Korean assets to resume when signs of global economic stability appear in 2H20 and throughout the forecast period we expect that the current account surplus will remain supportive. We expect the KRW to be around KRW1,160/USD by end-2020 appreciating further, as growth confidence strengthens, in 2021.

A glimpse at 2021: better but easy on the tightening

Both growth and inflation will bottom in 2H20 and we expect Korea's economic performance in 2021 to be the best since 2017 with GDP growth a fraction over 2.7%.

This is a little above trend (estimated by BoK to be 2.5-2.6% for 2019-2020, potentially slightly lower in 2021 because of demographics) but after three years of below-trend growth, the output gap will not close immediately. Consumer spending on our forecast picks up in 2021 but is below historical norms. Accordingly we see policy rates left at 0.75% even though the BoK is cautious about the risks posed by Korea's high levels of household debt. Stronger growth and a return of private facilities investment should, however, allow the government to begin to rein in the government deficit. It needs to be cautious. Both real and nominal growth will be better in 2021, but not that much better.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
KRW/USD	1,067	1,116	1,250	1,160	1,100	1,250	1,200	1,180	1,180
KRW/JPY 100	947	1,017	1,202	1,160	1,048	1,202	1,188	1,180	1,180
KRW/GBP	1,442	1,423	1,500	1,508	1,430	1,500	1,500	1,534	1,534
KRW/EUR	1,281	1,280	1,338	1,334	1,210	1,338	1,380	1,416	1,381
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

CLSA

Malaysia

EoAE Forecasts - 4Q19

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Calm before the storm

- **Infrastructure spending has not provided the same offset to the manufacturing investment slump that occurred in previous years.**
- **Confronted by a global trade slowdown and oil and commodity risk, Malaysia has re-initiated Chinese-driven infrastructure projects.**
- **Fiscal options are constrained by GST withdrawal and the high public debt. Monetary easing will be accelerated in 2020.**

GDP growth has held up in 2019
Malaysia impressed with 4.7% real GDP growth in 1H19 notwithstanding a 4.4% YoY contraction in nominal export growth (USD terms). The steeper contraction in imports provides part of the explanation. Net exports contributed 1.1 percentage points to the 4.7% GDP growth in 1H19. Even so, the downturn in the export manufacturing sector would have been expected to have a negative impact on domestic demand through weaker employment and wage growth.

Private consumption provided the big surprise with growth sustained at 7.7% YoY in 1H19, not far below the 8% pace in 2018. This was a surprise because consumption growth had been boosted by GST withdrawal in June 2018. With spending brought forward, we had expected a subsequent sharp slowdown. This may still happen but will still leave private consumption growth buoyant at 7.6% in 2019. We forecast a moderation though, to 5.4-5.5% in 2020 and 2021.

Investment contracted by 2% YoY in 1H19 which was more in line with export contraction. As a result, there was a decline in the investment to GDP ratio to 24% in 1H19, way down from the 26.5% of GDP peak in 2013. Investment contraction in 1H19 (after weak 1.4% growth in 2018) was an indication that infrastructure spending has not provided the same offset to the manufacturing investment slump that occurred in previous years.

Weaker prospects for 2020 and 2021
Going into 3Q19, monthly indicators have generally been weak. The downtrend in industrial production since April 2019 continued in July. The downtrend in capital goods imports, likewise, persisted in July. Bank credit growth continued to slow to 3.9% in July, down from 7.7% growth at end-2018.

These negative signals leave our estimate for a 2% investment contraction in 2019. Private consumption though, will keep real GDP growth at 4.4% in 2019. As the consumption support fades, we forecast a slowdown in real GDP growth to 3.1% in 2020, with only a modest rebound to 3.6% growth in 2021.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	4.7	6.0	5.0	4.4	5.7	4.7	4.4	3.1	3.6
Domestic demand (contr. to growth)	8.7	6.8	5.7	4.6	7.5	5.5	3.6	5.3	5.8
Nominal GDP growth	4.9	8.6	4.9	6.2	9.8	5.5	4.4	3.4	5.2
Consumer prices (y/e)	3.2	2.7	2.7	1.7	3.5	0.2	1.4	1.2	2.3
Overnight policy rate (% y/e)	3.00	3.25	3.25	3.00	3.00	3.25	2.75	2.00	2.00
MYR/USD (y/e)	3.28	3.50	4.29	4.49	4.06	4.14	4.23	4.34	4.38
Money supply M1 (y/e)	13.1	5.7	4.1	5.6	11.0	1.2	3.4	2.9	4.6
Current account balance (USD bn)	11.2	14.9	9.1	7.1	9.0	7.6	11.5	5.2	2.4
- as a % of nominal GDP	3.4	4.3	3.0	2.4	2.8	2.1	3.2	1.4	0.6
General gov't balance (% GDP)	(3.7)	(3.3)	(3.2)	(3.1)	(2.9)	(3.7)	(3.4)	(3.5)	(3.2)

Note: % YoY rates unless otherwise stated. Source: CEIC, Bank Negara Malaysia, IMF, Bloomberg, CLSA estimates

Temporary reprieve for oil prices
As an export driven economy, Malaysia will be vulnerable to the contraction in global trade volume that we expect in 2020. Malaysian economic growth correlation with global trade volume growth is among the highest in Asia. The headwind of a global electronics downturn will be compounded by its exposure to declining oil and commodity prices. Malaysia is a net oil and commodity exporter and will suffer a terms of trade loss from declining prices.

The oil price outlook has been complicated by geopolitical events, specifically, the drone attack on the Saudi oil facility. The extent and duration that this holds up oil prices will provide an unanticipated windfall for Malaysia, both for oil and gas related fiscal revenues and balance of payments support. However, looking beyond volatile geopolitics, we maintain our fundamental economic argument that global trade contraction will drive down oil and commodity prices.

Belt and road re-embraced
This risk was recognised by Dr Mahathir who reversed his pre-election stance by re-embracing Chinese-backed infrastructure projects in early 2019. The East Coast Rail Link project resumed in late July after a one year suspension.

The government has also been pro-active in attracting manufacturing companies to Malaysia in order to benefit from the relocations sparked by the US-China trade conflict. It has set up an investment committee to fast-track investments with the authority to immediately approve incentives (details have not been disclosed).

In perspective, relocation will provide only a modest offset to the export manufacturing slump anticipated in 2020. What are the options for fiscal and monetary stimulus?

Fiscal options are limited
The 2020 budget will be released in October with fiscal options curtailed by GST withdrawal and the need for fiscal rationalisation given the already high public debt. Political consideration will require sustained high spending on social welfare and civil sector wages. This will limit funding for public infrastructure spending reinforcing Malaysia's increased reliance on Chinese-backed infrastructure projects.

Fiscal constraints mean that the request by the Federation of Malaysian Manufacturers for a cut in the corporate tax rate, currently at 24%, is likely to be disappointed. The 2020 fiscal deficit will be targeted close to 3% of GDP but we forecast a deficit closer to 3.5% of GDP. There is an incentive for increased SOE disinvestment but no official signals that this is being considered.

Accelerated monetary easing
Monetary easing was initiated with the 25bp policy rate cut to 3% in May 2019. Bank Negara declined to cut rates at its September meeting but recognised the downside risks from both external and domestic uncertainties. Specifically, BNM cited the risk of extended weakness in commodity related sectors.

GDP growth forecasts

Government (BNM)	
Updated:	Sep
2019:	4.3-4.8
Consensus	
Updated:	Sep
2019:	4.5
CLSA	
2019:	4.4

The CLSA difference

GDP growth
- BNM maintained its 4.3-4.8% GDP forecast at its September meeting. Our increased forecast (after high 1H growth) is now within BNM's target range.

Inflation
- Like BNM, we expect inflation to remain subdued. Our average inflation forecast is 1.3% for 2020 and 1.9% for 2021.

Interest rates & exchange rate
- BNM declined to cut rates at its September meeting, contrary to our expectation. We still expect a 25bp cut this year (in November). Easing will be accelerated in 2020.

Private consumption growth will not be sustained at the heady rates of 2018 and 2019.

Increased reliance on Chinese-backed infrastructure projects to offset declining investment in the manufacturing sector.

Along with global deflation, weakening domestic demand will keep inflation low.

Exchange rate will be more vulnerable with a narrowing current account surplus in 2020 and 2021.

Low inflation will facilitate a faster cut in interest rates to 2.0% by end-2020.

Continued export contraction in 2020 due to weakening global demand and falling commodity prices.

Slowing export growth and terms of trade loss will lower the current account surplus to 1.4% of GDP in 2020 and to 0.6% of GDP in 2021.

Lower rates will not significantly boost bank credit growth as weak external environment reduces investment demand and high household debt curbs consumer lending.

Fiscal consolidation will be delayed by the need for fiscal stimulus to support economic growth.

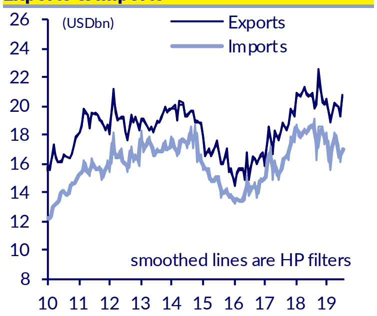
These estimates are general government debt. Federal government debt was 51.9% in 2018 (regulatory cap is 55%).

Malaysia by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	6.9	8.0	7.6	5.4	5.5
Public consumption	5.5	3.3	2.0	4.6	2.8
GFCF	6.1	1.4	(2.0)	3.4	4.6
Domestic demand (contr. to growth)	7.5	5.5	3.6	5.3	5.8
Exports, goods & services	8.7	2.2	(0.3)	(0.7)	2.5
Imports, goods & services	10.2	1.3	(1.3)	1.7	4.8
Real GDP growth	**5.7**	**4.7**	**4.4**	**3.1**	**3.6**
Prices					
Consumer prices (y/e)	3.5	0.2	1.4	1.2	2.3
Consumer prices (average)	3.8	1.0	0.8	1.3	1.9
Producer prices (y/e)	0.3	(3.7)	(1.5)	(2.0)	1.6
Currency & interest rates					
MYR/USD (y/e)	4.06	4.14	4.23	4.34	4.38
MYR/USD (average)	4.30	4.03	4.16	4.28	4.36
Overnight policy rate (% y/e)	3.00	3.25	2.75	2.00	2.00
Base lending rate (% y/e)	6.68	6.91	6.41	5.66	5.66
External sector					
Exports (USD, % YoY)	12.6	10.6	(3.8)	(1.8)	2.6
Imports (USD, % YoY)	12.8	11.0	(5.0)	1.0	4.0
Trade balance (USD bn)	27.3	29.6	30.6	25.4	23.6
Current account balance (USD bn)	9.0	7.6	11.5	5.2	2.4
- as a % of nominal GDP	2.8	2.1	3.2	1.4	0.6
FDI (USD bn)	3.8	2.9	3.5	2.2	3.3
CA + net FDI (% GDP)	4.0	2.9	4.1	2.0	1.5
External debt (total, USD bn)	212.9	221.8	225.0	230.0	240.0
Debt service ratio (% exports)	22.2	22.5	22.3	22.8	23.1
International reserves (USD bn, y/e)	102.4	101.4	104.5	103.5	102.3
Money supply					
Money supply M1 (y/e)	11.0	1.2	3.4	2.9	4.6
Money supply M3 (y/e)	4.9	9.1	4.3	3.6	5.3
Private sector credit (y/e)	4.1	7.7	3.6	3.4	5.7
Private sector credit (% GDP)	115.2	117.6	116.7	116.8	117.3
Government sector					
General gov't balance (% GDP)	(2.9)	(3.7)	(3.4)	(3.5)	(3.2)
General gov't debt (% GDP, y/e)	67.4	69.6	70.7	72.1	72.0
Nominal GDP					
Nominal GDP (USD bn)	319.6	358.7	363.3	364.7	376.9
Nominal GDP per capita (USD)	9,971	11,072	11,076	10,984	11,219
Nominal GDP (MYR bn)	1,372	1,447	1,511	1,562	1,644
Nominal GDP (MYR, % YoY)	9.8	5.5	4.4	3.4	5.2
Other data					
Industrial production	3.8	2.5	2.7	1.3	2.6
Unemployment (% y/e)	3.3	3.3	3.4	3.6	3.5
Population (millions)	32.0	32.4	32.8	33.2	33.6

Note: % YoY rates unless otherwise stated.
Source: CEIC, Bank Negara Malaysia, IMF, Bloomberg, CLSA estimates

Exports & imports

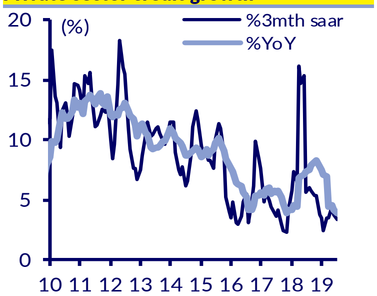


Source: CEIC, CLSA

MYR NEER & REER

Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

We still expect another 25bp rate cut this year, which will be delivered at the final policy meeting in November. The urgency for looser policy will increase as the global downturn intensifies next year. We forecast a further 75bp interest rate cut to 2% by end-2020.

Faster rate cuts in 2020

BNM was reassured by sustained domestic financial stability in 1H19. Household debt at 82.2% of GDP was covered 2.2 times by household financial assets. BNM did recognise pockets of risks though, with higher incidents of default among home loan borrowers exposed to income variability. While the mismatch between housing supply and demand would take time to resolve, BNM expected that firm demand for affordable housing would mitigate risks of a sharp decline in house prices.

Inflation will not be a constraint on monetary easing. Inflation was at 1.4% headline and 2% core in July 2019, despite robust private consumption growth in 1H19. (The distortion from the GST withdrawal has dropped out of the YoY estimate). We forecast average inflation at 1.3% in 2020 and 1.9% in 2021. Our predicted 100bp rate cut will still leave the policy rate positive in real terms. Policy will be accommodative but still relatively conservative.

Exchange rate more exposed in 2020

The balance of payments will not be an immediate constraint on monetary policy but will be much less supportive for the exchange rate over the next two years. Trends in 1H19 point to a widening current account surplus to 3.2% of GDP in 2019, from 2.1% of GDP in 2018. However, export contraction reinforced by a terms of trade loss from declining oil and commodity prices, will lead to narrowing current account surplus to 1.4% of GDP in 2020 and 0.6% of GDP in 2021. On this basis, we forecast a 2.5% MYR/USD depreciation in 2020 and a 1% depreciation in 2021.

Political undercurrents

There are political undercurrents with uncertainties over the leadership succession from Dr Mahathir to Mr Anwar. There are tough challenges that remain to be addressed, notably a structural shift from over-reliance on the public sector in order to free up economic resources for the private sector.

The government has also committed to address the flaws of the Bumiputera policy. The objective is to evolve to a national development policy that is needs-based rather than race-based. The government will need to convince ethnic Malays that they will still be the biggest beneficiaries of the new approach. The risk though, is that a backlash against the government stalls reform efforts even before they get off the ground.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
MYR/USD	4.06	4.14	4.23	4.34	4.38	4.23	4.25	4.28	4.31
MYR/JPY 100	3.60	3.77	4.07	4.34	4.17	4.07	4.21	4.28	4.31
MYR/GBP	5.49	5.28	5.08	5.64	5.69	5.08	5.31	5.56	5.60
MYR/EUR	4.88	4.75	4.53	4.99	4.82	4.53	4.89	5.14	5.04
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

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Dual stimulus: Fiscal and monetary

- **Spurred by combined fiscal and monetary stimulus, the economy will regain 6% real GDP growth in 2020 and 2021.**
- **Low inflation, subdued money supply and rising reserves provide scope for more rate cuts; BSP should be wary though, of re-igniting excessive credit growth.**
- **Threats to the POGO industry are implicit risks for growth, employment and balance of payments support; investors in peso assets should factor in currency risk.**

Regaining 6% growth in 2020

Real investment contraction (QoQ, seasonally adjusted) for three consecutive quarters has put the brakes on GDP growth, slowing to 5.5% in 1H19 from 6.2% in 2018. Delayed passage of the 2019 budget halted infrastructure projects. Infrastructure has gradually restarted but will not gain sufficient traction to lift growth above 6% this year. Our estimate for 2019 real GDP growth is 5.9%.

Strengthened Congress support for Mr Duterte following the mid-term election will enable faster passage of the tax reform package. Specifically, tax revenue raising measures will provide some offset to ramped up public infrastructure spending without the fiscal deficit rising too far above the 3% of GDP target.

Fiscal stimulus will be reinforced by monetary easing with Bangko Sentral's new governor Diokno adopting a pro-growth stance. BSP has started to reverse the 175bp interest rate rise triggered by the sharp inflation spike in 2018, with rates cut by 50bp since April 2019. At the policy meeting on 26 September, the BSP cut the overnight reverse repurchase facility by 25bp to 4%. We expect a further 50 bp rate cut to 3.5% by mid-2020. Rate cuts will be reinforced by reserve requirement ratio cuts, already down 2ppt to 16% in August, with the aim of lowering the ratio to single digits by 2021.

Combined fiscal and monetary stimulus will lift real GDP growth to our 6% forecast in 2020. Our forecast has been tempered by the risk of a clampdown on the Philippine Offshore Gaming Operations (POGO) industry, due to direct or indirect pressure from China. POGOs had provided an effective offset to the business process outsourcing (BPO) sector where fears of losing its special tax status, as part of the tax reform package, has deterred new investment.

Scope for more rate cuts

Conditions were favourable for the 25bp cut on 26 September. The inflation spike last year was reversed by reform of the rice policy, preventing shortages for lower

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	7.1	6.1	6.1	6.9	6.7	6.2	5.9	6.0	6.0
Domestic demand (contr. to growth)	9.7	5.1	9.1	11.8	7.4	9.0	5.4	7.9	8.5
Nominal GDP growth	9.3	9.5	5.4	8.7	9.2	10.2	7.3	8.4	8.9
Consumer prices (y/e)	3.8	1.9	0.7	2.2	2.9	5.1	2.0	2.4	3.0
Overnight repo rate (% y/e)	3.50	4.00	4.00	3.00	3.00	4.75	4.00	3.50	3.50
PHP/USD (y/e)	44.41	44.62	47.17	49.81	49.92	52.72	52.60	53.90	55.00
Money supply M1 (y/e)	27.3	13.3	15.2	15.1	15.7	9.5	7.0	11.0	15.0
Current account balance (USD bn)	11.4	10.8	7.3	(1.2)	(2.1)	(8.7)	(6.8)	(10.4)	(12.4)
- as a % of nominal GDP	4.2	3.8	2.5	(0.4)	(0.7)	(2.6)	(1.9)	(2.7)	(3.1)
Public sector balance (% GDP)	(1.4)	(0.6)	(0.9)	(2.4)	(2.2)	(3.2)	(2.1)	(3.2)	(3.4)

Note: % YoY rates unless otherwise stated. Overnight policy rate repositioned from 4% to 3% effective June 2016.
Source: IMF, IFS, CEIC, CLSA estimates, National Statistical Coordination Board, Philippines, IIF

food inflation. Along with falling commodity prices and slowing domestic demand growth, inflation fell dramatically from 6.7% in September 2018 to 1.7% in August 2019. It will fall further to 1% but, as the high 2018 base effect drops out, will rise again to 2% by end-2019. On our forecast for 2.4% at end-2020 and 3% at end-2021, inflation will not be a constraining factor for monetary policy over the next two years.

Recent balance of payments trends have also been favourable for monetary easing. The current account deficit narrowed to 1% of GDP in 1H19, a notable decline from the 2.6% of GDP deficit in 2018. This was primarily due to the narrowing trade deficit, a reflection of weakening domestic demand (in particular the investment fall). A renewed investment upturn in the fourth quarter will still leave the current account deficit below 2% of GDP in 2019.

BSP will have been reassured by the second consecutive month of rising foreign reserves which contributed to the cumulative USD6.4bn reserves increase in the first eight months to USD85.6bn in August.

Monetary policy acts with a lag. It is only recently that money supply and bank credit growth (likely) bottomed following last year's interest rate increase. Broad M3 money supply growth, which was in double digits in 2016-1H18, may have troughed at 6.4% in May 2019 before edging up to 6.7% in July. Bank credit growth has decelerated from the near 20% peak in April 2018 to 10.5% in June 2019, edging up slightly to 10.7% in July. BSP can comfortably cut interest rates but, from mid-2020, should be wary of re-igniting excessive credit growth.

Accelerated infrastructure spending and firming private sector demand will see late cycle pressures re-emerging in 2021. In anticipation, BSP would be prudent in moving to a neutral monetary policy stance in 2H20. Real GDP growth will remain capped at our 6% forecast for 2021.

FDI link with POGOs

While the balance of payments data provided reassurance with a narrowing current account deficit, there was disappointment from declining FDI. Net FDI at 1% of GDP in 1H19 was down from 1.8% of GDP in 2018. FDI inflows fell to 2.1% of GDP in 1H19, down from an average annual 3% of GDP in the three previous years. FDI inflows were substantially boosted by Chinese foreign investment in offshore gaming. This underlines the concerns raised by threats to the POGO industry.

Beijing disapproves, where does this leave POGOs?

There were over 109,000 Chinese work permit holders in 2018, the largest share of expatriate workers in the Philippines (*Reuters*, July 2019). The number is much larger including undocumented workers. The Philippines had licensed around 56 POGOs but realised that, along with unlicensed operations, there were substantial untapped tax revenues. However, around the time that the authorities stepped up tax registration of POGO operators and workers, China expressed its disapproval.

GDP growth forecasts

Government (NEDA)	
Updated:	Aug
2019:	6-7
Consensus	
Updated:	Sep
2019:	5.9
CLSA	
2019:	5.9

The CLSA difference

GDP growth

- The weak 1H19 has put 6% growth out of reach in 2019, a view which we share with consensus. The government is hanging on to the lower end of its 6-7% target.

Inflation

- BSP is confident of containing inflation within its 2-4% target. We agree. However, low inflation should not deflect BSP from other late cycle risks.

Interest rates & exchange rate

- BSP has signaled further interest rate and RRR cuts. Following the 25bp cut on 26 Sep, we expect another 50bp by mid-2020. Immediate currency risk revolves around the fate of the POGOs.

Philippines by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	5.9	5.6	6.0	6.4	6.5
Public consumption	6.2	13.0	7.2	7.8	5.0
GFCF	9.4	12.9	2.0	8.8	11.5
Domestic demand (contr. to growth)	7.4	9.0	5.4	7.9	8.5
Exports, goods & services	19.7	13.4	4.6	3.1	3.5
Imports, goods & services	18.1	16.0	3.7	5.4	6.5
Real GDP growth	**6.7**	**6.2**	**5.9**	**6.0**	**6.0**
Prices					
Consumer prices (y/e)	2.9	5.1	2.0	2.4	3.0
Consumer prices (average)	2.9	5.2	2.4	2.3	2.8
Producer prices (y/e)	(1.1)	0.2	2.6	(1.0)	1.2
Currency & interest rates					
PHP/USD (y/e)	49.92	52.72	52.60	53.90	55.00
PHP/USD (average)	50.40	52.66	52.15	53.30	54.40
Overnight repo rate (% y/e)	3.00	4.75	4.00	3.50	3.50
Prime lending rate (%y/e)	5.78	7.02	6.25	5.75	5.75
External sector					
Exports (USD, % YoY)	21.2	0.3	(0.5)	(0.3)	1.1
Imports (USD, % YoY)	17.6	11.9	0.7	7.5	8.3
Trade balance (USD bn)	(40.2)	(51.0)	(52.0)	(59.9)	(68.6)
Current account balance (USD bn)	(2.1)	(8.7)	(6.8)	(10.4)	(12.4)
- as a % of nominal GDP	(0.7)	(2.6)	(1.9)	(2.7)	(3.1)
FDI (USD bn)	7.0	5.9	8.4	9.0	10.2
CA + net FDI (% GDP)	1.5	(0.9)	0.5	(0.4)	(0.5)
External debt (total, USD bn)	73.1	79.0	87.5	96.0	105.8
Gross external financing requirement % GDP	6.4	6.0	5.6	5.7	6.0
International reserves (USD bn, y/e)	81.6	79.2	86.0	85.3	84.8
Money supply					
Money supply M1 (y/e)	15.7	9.5	7.0	11.0	15.0
Money supply M3 (y/e)	11.9	9.5	6.8	12.0	16.0
Private sector credit (y/e)	18.4	14.8	12.0	14.5	18.0
Private sector credit (% GDP)	47.3	49.3	51.4	54.3	58.9
Government sector					
Public sector deficit (% GDP)	(2.2)	(3.2)	(2.1)	(3.2)	(3.4)
National gov't debt (% GDP, y/e)	42.1	41.8	41.5	42.0	42.5
Nominal GDP					
Nominal GDP (USD bn)	313.6	330.9	358.4	380.4	405.7
Nominal GDP per capita (USD)	2,981	3,084	3,276	3,409	3,566
Nominal GDP (PHP bn)	15,808	17,426	18,694	20,272	22,069
Nominal GDP (PHP, % YoY)	9.2	10.2	7.3	8.4	8.9
Other data					
Industrial production	7.1	6.7	3.6	3.4	3.8
Unemployment (% year average)	5.4	5.3	5.1	5.1	5.0
Population (millions)	105.2	107.3	109.4	111.6	113.8

Note: % YoY rates unless otherwise stated. Overnight policy rate repositioned from 4% to 3% effective June 2016.
Source: IMF, IFS, CEIC, CLSA estimates, National Statistical Coordination Board, Philippines, Treasury, IIF.

Consumption rebound expected given supportive jobs and real wage trends.

Delayed passage of the 2020 budget halted infra-structure; resumed rollout will lead to a renewed investment upswing.

Weak 1H will keep GDP growth below 6% in 2019. Services sector risks (POGOs, BPO) hold back our forecast at 6% in 2020.

Inflation will drop to 1% but then rebound as high 2018 base drops out. Subdued inflation will persist in 2020-2021.

We see scope for another 50bp rate cuts. However, from 2H20, BSP will need to be wary of reigniting excessive credit growth.

Imports will rebound with an investment upswing.

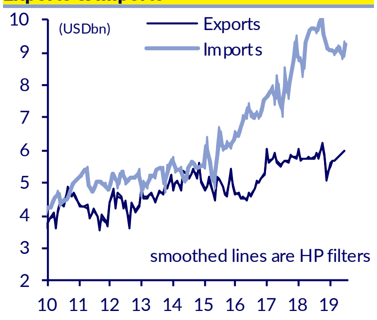
Narrowing current account deficit in 2019 will be a temporary reprieve. The deficit will widen with renewed investment.

POGO threat argues for policy to open other sectors to foreign investment.

Delayed budget curbed expenditure for a lower fiscal deficit in 2019. Roll out of infrastructure and social spending will lift the deficit in 2020 and 2021.

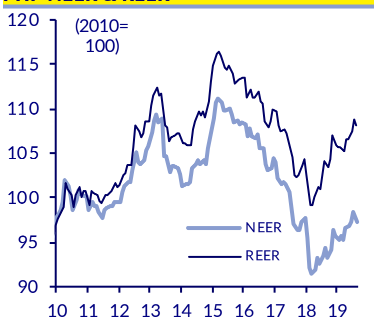
With rising fiscal deficits, the public debt ratio will start to rise again in 2020.

Exports & imports



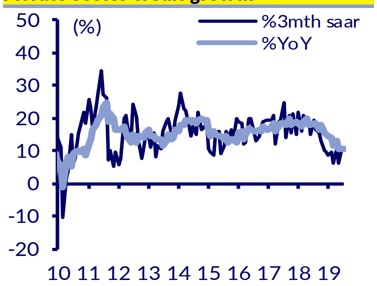
Source: CLSA, CEIC

PHP NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

Undocumented capital flows, money laundering, diversion of gaming revenues from Macau may all be concerns for China which made its disapproval clear to the Philippines. While Mr Duterte has resisted pressure from Beijing citing the economic importance of POGOs for growth and employment, China could apply direct sanctions to the Chinese operators in the Philippines. This was evident from its explicit statement, 'opening casinos overseas to attract citizens of China as primary customers, is illegal'. It is not clear how this issue will be resolved and where it will leave the Philippines POGO industry.

BPO losing its tax incentive

A decline in the POGO industry would be unfortunate timing given the uncertainties surrounding the business process outsourcing (BPO) sector. As part of the tax reform initiative to lower the corporate tax rate from 30% to 20% by 2029, the current tax incentive for BPO operators (5% on gross income earned) will be withdrawn. This will be negative for the BPO industry even if the potential impact has been exaggerated in order to delay the shift to the corporate tax regime.

From a broader policy perspective, there is an argument to reduce reliance on the POGOs. This means promoting other services sectors by opening the economy to more competition and minimising restrictions on foreign investment.

Fiscal deficit rebound in 2020 and 2021

Delayed passage of the budget held back fiscal expenditure (marginal contraction YoY) in the first seven months of the year, with fiscal revenues rising by 9.6% YoY over this period. Even as expenditure rises over the rest of the year, the fiscal deficit will be contained at our 2.1% of GDP estimate for 2019. The deficit will rise again though, with increased infrastructure spending in 2020 and 2021. The government has allocated PHP63bn (0.3% of GDP) for right-of-way acquisitions in order to speed up infrastructure projects in 2020.

The tax revenue raising measures (alcohol, tobacco and property) will raise new revenues equivalent to 0.9% of GDP. This will keep the fiscal deficit from rising too far above the 3% of GDP target for 2020 and 2021.

Factor in PHP depreciation

Will the exchange rate remain stable as interest rates continue to fall? The lower current account deficit in 2019 will provide only a temporary reprieve. As investment picks up, we forecast a widening current account deficit to 2.7% of GDP in 2020 and 3.1% of GDP in 2021. This reinforces the urgency for policy reforms that remove the barriers to foreign investment.

The immediate uncertainty revolves around the fate of the POGOs. Beyond that, there are balance of payments challenges. Investors in peso assets should factor in a 2-2.5% PHP/USD depreciation in each of the next two years.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
PHP/USD	49.92	52.72	52.60	53.90	55.00	52.60	53.00	53.34	53.60
PHP/JPY 100	44.30	48.06	50.58	53.90	52.38	50.58	52.48	53.34	53.60
PHP/GBP	67.46	67.24	63.12	70.07	71.50	63.12	66.25	69.34	69.68
PHP/EUR	59.93	60.46	56.28	61.99	60.50	56.28	60.95	64.01	62.71
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

Singapore

EoAE Forecasts - 4Q19

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Softest growth since GFC

- **Weak external demand has spilled over to domestic demand. Labour market is loosening. We have downgraded 2019 GDP growth to the lowest level since the GFC.**
- **We expect the 2020 budget to be an expansionary one, ahead of the general election that is expected to be held around mid-2020.**
- **Growth is weak enough to justify a policy easing in the MAS meeting in October. Inflation is low. Prospects of MAS easing will cause SGD NEER to fall.**

Weak 2Q GDP

Second quarter GDP figures confirmed that deteriorating external demand was the main reason for the slowdown in Singapore's economic growth. Exports of goods and services contracted on a YoY basis for the second quarter. In volume terms they fell by 1.4% YoY, following a 2.2% YoY decline in 1Q. Private consumption contracted by 0.2% QoQ (sa), although in YoY terms (3.4% YoY) it was still stronger than expected and required us to lift the full-year PCE estimate to 3% from 2.7% in the previous *Eye on Asian Economies*. However, we have retained our expectation for a falling trajectory for household spending growth in 2020 on a slowing labour market.

The unemployment rate remained steady at 2.2% for the overall economy while rising to 3.1% from 3% for residents in 2Q. Employment growth (excluding foreign domestic workers) dropped sharply to 5.5k from 13.4k in 1Q and 15.9k in 4Q18. Employment in manufacturing contracted for the third quarter. More alarming, however, is the decline in services employment. Job growth in the services sector fell to 4.7k from 16.4k in the previous quarter. This is strong evidence that slowing external demand has spilled over to non-trade sectors. Average monthly earnings growth eased to 2.1% YoY in 2Q from 3.4% YoY in 1Q and 2.8% YoY in 4Q18. This was the slowest growth since 1Q17. The weakening of the labour market puts further downward pressure on private consumption, of whose growth we expect to be 2.8% in 2020, down from 3% (est.) in 2019.

Singapore is on the downward phase of an investment cycle. Gross fixed capital formation fell for the sixth consecutive quarter in 2Q, although the YoY rate of decline moderated compared with that in 2018. Construction and works, the largest segment, dropped by 0.2% QoQ (sa) and rose by 1.4% YoY. Investment in transport equipment, highly volatile, dropped by an average of 3% YoY in the last four quarters up to 2Q19. Investment in machinery and equipment have contracted for three consecutive quarters. In 2Q, it contracted by 4.8% YoY (1Q: -7.2% YoY).

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	4.8	3.9	2.9	3.0	3.7	3.1	0.6	1.0	1.5
Domestic demand (contr. to growth)	3.6	1.6	0.3	4.0	4.9	0.8	1.5	1.4	2.0
Nominal GDP growth	4.4	3.7	6.1	3.8	6.3	5.1	1.5	0.5	1.8
Consumer prices (y/e)	1.5	(0.1)	(0.6)	0.2	0.4	0.5	0.6	0.6	0.5
3-month SIBOR (% y/e)	0.40	0.46	1.19	0.97	1.50	1.89	1.65	1.00	1.12
SGD/USD (y/e)	1.27	1.32	1.41	1.45	1.34	1.36	1.42	1.37	1.42
Money supply M1 (y/e)	9.9	3.6	0.1	7.7	6.3	0.4	2.7	2.4	4.1
Current account balance (USD bn)	48.3	56.5	53.0	55.9	55.4	65.1	59.0	51.2	60.0
- as a % of nominal GDP	15.7	18.0	17.2	17.5	16.4	17.9	16.3	13.9	16.5
Government balance[1] (% GDP)	1.3	(0.0)	(1.6)	(1.4)	2.1	0.4	(0.7)	(1.5)	0.8

Note: % YoY rates unless otherwise stated. [1] Fiscal years beginning 1 April.
Source: CEIC, MAS, MTI, Bloomberg, CLSA estimates

Expect an expansionary budget in February

In early September, Prime Minister Lee Hsien Loong has formed a committee to review electoral boundaries, the traditional precursor to an election being called within months. We expect that the election will be held after the 2020 budget statement to be delivered in February and that the government will announce an expansionary budget in the midst of a slowing economy. We anticipate a number of policies that will involve increased government spending in the 2020 budget, in contrast to the conservative 2019 budget. We have adjusted our expectation for the fiscal balance in 2020 to a deficit of 1.5% of GDP from a fiscal surplus of 0.5% published in the 3Q19 *Eye on Asian Economies*.

Revising 2020 outlook downward

Reflecting the weak GDP numbers and continued deterioration of the global economic environment, the Ministry of Trade and Industry (MTI) cut its 2019 GDP growth forecast range to 0-1% from 1.5-2.5% previously, with growth expected to come in at around the mid-point of the range. This is close to our forecast, which we revised downward as a result of the weaker-than-expected 2Q GDP figures. We have downgraded our 2019 GDP growth estimate to 0.7%, from 2% previously. This will be the lowest GDP growth since 2009. Weak carry plus the cut in our global trade forecast reduces our 2020 growth forecast to 1% (from 2.2% in the 3Q19 *EoAE*).

There is one more nuance that underlies our outlook for 2020 growth. For most of 2019, the US was the only major export destination (12% of total exports) that contributed positively to non-oil domestic exports (NODX). In the first seven months of the year, shipments to the US increased by 6% YoY whereas exports to the rest of the world dropped by 12% YoY. However, in August, exports to the US contracted by 15% YoY, indicating that the robust trend in exports to the US may soon be reversing. This means that Singapore's exports will lose further support as demand from other markets such as the EU and China is expected to remain soft.

MAS to ease in October

Headline and MAS core inflation converged in July and in August, after having moved in opposite directions in 2Q19. Headline CPI inflation eased to 0.5% YoY, from 0.6% in June. This was driven by a fall in private road transport costs. MAS core inflation, which is the MAS' target inflation measure and which drives its monetary policy decision, excludes both private road transport and accommodation. Core inflation continued to ease in 2Q. It fell to 0.8% YoY in July and August mainly driven by bigger falls in clothing & footwear and fuel & utilities and smaller rises in certain services. This reflected both YoY declines in global oil prices as well as the weaker wage growth pressure that we discussed above.

GDP growth forecasts

Government	
Updated:	Aug
2019:	0-1
Consensus	
Updated:	Sep
2019:	0.7
CLSA	
2019:	0.6

The CLSA difference

GDP growth

- Soft external demand weighs on Singapore's trade-exposed economy. The government expects 2019 growth to be in the middle of the 0-1% range.

Inflation

- Weakening employment growth means wage pressure will ease further. In consequence we expect core inflation to continue to drop away from the unofficial policy target of 2%.

Interest rates & exchange rate

- We expect the MAS to reduce the slope of the SGD NEER policy band in October. A weaker CNY also puts downward pressure on Asian exchange rates. We expect SGD/USD depreciation in 4Q19.

Singapore by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	3.4	2.7	3.0	2.8	3.0
Public consumption	4.5	4.1	3.0	5.7	2.7
GFCF	6.4	(4.0)	0.0	1.6	2.7
Domestic demand (contr. to growth)	4.9	0.8	1.5	1.4	2.0
Exports, goods & services	5.7	5.1	(1.1)	1.3	1.9
Imports, good & services	7.5	4.7	(1.2)	1.8	2.5
Real GDP growth	**3.7**	**3.1**	**0.6**	**1.0**	**1.5**
Prices					
Consumer prices (y/e)	0.4	0.5	0.6	0.6	0.5
Consumer prices (average)	0.6	0.4	0.6	0.5	0.5
Domestic supply prices (y/e)	0.7	0.4	(2.6)	(8.0)	(2.3)
Currency & interest rates					
SGD/USD (y/e)	1.34	1.36	1.42	1.37	1.42
SGD/USD (average)	1.38	1.35	1.38	1.36	1.40
3-month SIBOR (% y/e)	1.50	1.89	1.65	1.00	1.12
External sector					
NODX (USD, % YoY)	8.9	6.7	(5.9)	(2.1)	(0.8)
Retained imports (USD, % YoY)	22.7	17.4	5.8	0.9	2.0
Trade balance (USD bn)	92.5	98.4	76.3	69.6	59.4
Current account balance (USD bn)	55.4	65.1	59.0	51.2	60.0
- as a % of nominal GDP	16.4	17.9	16.3	13.9	16.5
FDI (USD bn)	51.0	45.6	52.6	50.6	50.3
CA + net FDI (% GDP)	31.5	30.4	30.8	27.7	24.6
External debt (total, USD bn)	0.0	0.0	0.0	0.0	0.0
Debt service ratio (% exports)	0.0	0.0	0.0	0.0	0.0
International reserves (USD bn, y/e)	279.9	287.7	269.4	276.2	283.7
Money supply					
Money supply M1 (y/e)	6.3	0.4	2.7	2.4	4.1
Money supply M2 (y/e)	3.2	3.9	3.4	2.4	4.1
Bank credit (y/e)	5.6	3.0	4.1	3.8	2.7
Bank credit (% GDP)	139.5	136.8	140.2	144.8	146.0
Government sector					
Government balance[1] (% GDP)	2.1	0.4	(0.7)	(1.5)	0.8
Nominal GDP					
Nominal GDP (USD bn)	338.4	364.1	361.7	368.1	364.7
Nominal GDP per capita (USD)	60,297	64,579	63,587	64,141	63,012
Nominal GDP (SGD bn)	467.3	491.2	498.5	501.1	510.1
Nominal GDP (SGD, % YoY)	6.3	5.1	1.5	0.5	1.8
Other data					
Industrial production	10.4	7.0	0.7	0.5	3.0
Retail sales	1.5	(1.0)	0.5	0.5	2.0
Unemployment (% y/e)	2.1	2.2	2.3	2.3	2.2
Population (millions)	5.6	5.6	5.7	5.7	5.8

Note: % YoY rates unless otherwise stated. [1] Fiscal years beginning 1 April.
Source: CEIC, MAS, MTI, Bloomberg, CLSA estimates

First half consumption was better than expected but growth rates are falling. Employment growth is falling in both manufacturing and services.

We expect a more expansionary budget in February ahead of the 2020 general election.

Growth slows to the lowest since 2009 in 2019 and continues to be weak in 2020 as the US enters a shallow recession.

Core inflation falls further away from the MAS' inflation target. This should facilitate a small adjustment to the slope of the SGD NEER band.

Export prices have been falling on oil prices.

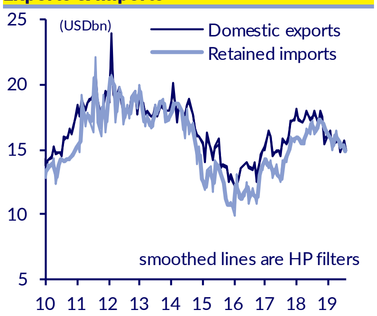
Lower oil prices and lower demand for electronics will cause nominal export growth to slow.

A more expansionary fiscal position in the 2020 budget to be delivered in February.

Soft external demand weighs most notably on Singapore's manufacturing sector…

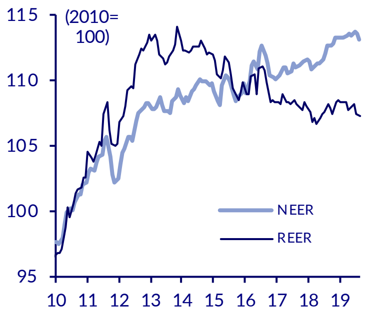
…which has been reflected in manufacturing employment data.

Exports & imports



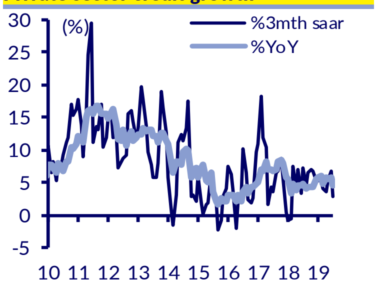
Source: CLSA, CEIC

SGD NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

In the quarterly brief that provides a summary of recent economic developments, the MAS stated that core inflation would come in within the lower half of the 1-2% range in 2019. We would argue that core inflation will fall further given the absence of both external and domestic price pressure. In addition, we maintain that weak global growth will return to be the main driver of oil prices, as the rise in oil prices following the drone attacks on Saudi Arabia's oil facilities will be reversed.

Expectations for the MAS to ease is building. With GDP growth falling to sub-1% level, we believe that monetary easing is almost a done deal at the monetary policy meeting in October. We maintain our expectation for the MAS adopting a more accommodative stance by lowering the gradient of the SGD NEER policy band. We estimate the slope to be lowered to 0.5% per annum from 1% per annum currently. The last time the MAS adjusted policy was in October 2018, when the central bank increased the slope of the band as the Fed continued to increase interest rates.

SGD and SIBOR dynamics

After depreciating in July and August the SGD NEER has moved back towards the top of its policy band. It therefore looks exposed. A flattening in the gradient of the policy band is likely to be accompanied by the SGD NEER moving to the lower half of the targeted range. This, together with our expectation for more CNY weakness towards end-2019 (**China: Infrastructure uplift**, p40), suggests some near-term downside risk for the SGD.

On the back of this, we forecast SGD/USD depreciation to SGD1.42/USD by the end of this year. Subsequently, we expect to see SGD/USD to appreciate as the USD weakens around the turn of the year or early 2020 (**Global and regional overview**, pp30-31). We forecast SGD/USD to appreciate to SGD1.33/USD by mid-2020. In 2H20, SGD/USD depreciation is likely to resume on a firmer USD in 2H20. We expect SGD/USD to end 2020 at SGD1.37/USD.

US short-term rates have been falling since the start of this year. As we forecast one more rate cut in the Fed funds rate in December, followed by four in 2020, more downside in USD LIBOR rates is expected from now on until the end of next year. There will be an incomplete pass through to Singapore interest rates. Maintaining a small positive spread over USD LIBOR, we expect three-month SIBOR to end 2020 at 1%.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
SGD/USD	1.34	1.36	1.42	1.37	1.42	1.42	1.37	1.33	1.35
SGD/JPY 100	1.19	1.24	1.37	1.37	1.35	1.37	1.36	1.33	1.35
SGD/GBP	1.81	1.73	1.70	1.78	1.85	1.70	1.71	1.73	1.76
SGD/EUR	1.60	1.56	1.52	1.58	1.56	1.52	1.58	1.60	1.58
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

Taiwan

EoAE Forecasts - 4Q19

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Benefiting from the trade war

- **Companies shifting production from China to Taiwan to avoid US tariffs have boosted exports and investment in an otherwise unfavourable external environment.**
- **Our outlook for 2020 is less positive due to a slowing US economy. Export growth will slow. The investment cycle is maturing and consumption will remain flat.**
- **The CBC maintained neutral policy stance despite low inflation, making Taiwan an exception in Asia. The TWD will track CNY movement and weaken towards year-end.**

Reshoring boosting exports and investment

Taiwan's 2Q GDP growth was stronger than expected at 2.4% YoY (1Q: 1.8% YoY). The government raised 2019 full-year GDP growth forecast to 2.5% from 2.2%. While a number of Asian export-driven economies have reduced growth projections due to the slowing world trade trajectory, the increase in Taiwan's GDP growth estimate against this wider trend is rather exceptional, given the 84% correlation between Taiwan's GDP growth and world trade growth (our estimate).

It reflects the benefits to the Taiwan economy of firms relocating production from Mainland China to avoid US tariffs, a theme that we have been exploring for a few quarters. This was suggested by the performance of Taiwan's exports to the US compared with those to the rest of the world. Year-to-August, goods exports to the US increased by 19% YoY while those to China fell by 7% YoY. On the back of stronger than expected goods exports in 2Q, we have raised 2019 full-year export volume growth estimate to 2.5% from 1.7% published three months ago.

While companies with existing factories in Taiwan are believed to have started operation and shipping out of Taiwan fairly readily, fixed capital continues to be added to expand production capacity. Gross fixed capital formation increased by 7.6% YoY in 2Q from 6.9% YoY in 1Q and 2.5% in 2018. We have lifted the 2019 full-year GFCF estimate to 5.3% from 3.4% in the 3Q19 *Eye on Asian Economies*. This will be the strongest GFCF growth since 2013.

According to the Ministry of Economic Affairs, the number of companies that applied to move production back to Taiwan has increased to 134 as of 11 September from 73 in June. The total projected amount of investment has risen to TWD584bn (USD19bn, 3% of GDP) from TWD375bn (USD12.2bn). The DPP government will continue to implement policies to facilitate the return of companies in the next two quarters. Tsai Ing-wen will count the return of Taiwanese firms and increased investment as a major policy success in her election campaign, ahead of the Presidential election in 1Q20.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	2.2	4.0	0.8	1.5	3.1	2.6	2.3	1.3	1.6
Domestic demand (contr. to growth)	1.9	3.4	1.7	2.2	0.9	2.9	2.2	1.5	1.7
Nominal GDP growth	3.7	5.8	4.1	2.4	1.9	1.7	1.9	0.6	1.2
Consumer prices (y/e)	0.3	0.6	0.1	1.7	1.2	(0.1)	0.8	0.3	1.0
Discount rate (% y/e)	1.875	1.875	1.625	1.375	1.375	1.375	1.375	1.375	1.375
TWD/USD (y/e)	29.72	31.35	32.79	32.00	29.95	30.59	32.00	32.00	32.00
Money supply M1b (y/e)	8.5	6.9	6.4	6.0	4.0	5.7	6.2	5.2	5.3
Current account balance (USD bn)	49.9	60.5	73.1	71.6	83.5	72.0	68.0	63.2	56.6
- as a % of nominal GDP	9.7	11.4	13.8	13.4	14.5	12.1	11.7	10.9	9.8
General gov't balance (% GDP)[1]	(3.2)	(2.7)	(1.8)	(2.2)	(2.0)	(1.9)	(1.9)	(1.9)	(1.9)

Note: % YoY rates unless otherwise stated, [1] DGBAS data on NIPA definitions.
Source: CEIC, CLSA estimates, Central Bank of China, DGBAS

But 2020 isn't all rosy

The government has a bullish GDP growth forecast of 2.6% for 2020. The CBC projects 2.4%. We are less positive. First and foremost we argue that the support to Taiwan's exports from the US will peter out as the US enters a shallow recession in 2020 (**Global and regional overview**, p14) and US investment growth and demand for imports will weaken. Headwinds from world trade will therefore strengthen. The benefits from the shift in production from China have been front-loaded in 2019.

Second, we expect GFCF growth to abate into 2020. Boosted by expansion in infrastructure capex, public investment was strong at 11.9% YoY in 2Q (1Q: 6.1% YoY, 4Q18: 12.2% YoY), compared with 6.5% YoY growth in investment by the private sector. The budget for the second phase of the Forward-looking Infrastructure Development Program is going to be approved. However, the budgeted TWD400bn accounts for only 2.2% of nominal GDP. In addition, the government does not plan for an increase in the fiscal deficit. This suggests that the rise in public investment and consumption will not be substantial.

Apart from export volume, export prices are expected to continue to be under downward pressure hurting corporate profits. Taiwan's highly commoditised products (electronics) have been subject to falling export prices through the post-GFC period. This is a structural issue for the Taiwan's economy that we have discussed previously. In 2016-17, there was a small rebound in export prices; however, the decline resumed in 2018. By August, the USD export price index had dropped by nearly 4% from the end of 2018. Falling exporters' profits do not bode well for business capex and wage growth.

The labour market shows some signs of slackening even as the unemployment rate remained at 3.7% in July, the level it has been for the past two years. Manufacturing employment has slowed since the start of the year and is at odds with the increase in production and shipments, as suggested in the 2Q GDP growth data. The deceleration of manufacturing employment suggests that, first, weakening world trade growth has taken a toll on Taiwan's export sector, which would have been our expectation; second, that the increase in production due to reshoring is facilitated by higher capital not labour utilisation.

Wage growth has remained fairly stable in the first eight months of the year. Average monthly regular earnings rose by 2.4% YoY in July (1Q19: 2.2% YoY, 4Q18: 2.4% YoY). However, continuously falling export profits and the expected decline in Mainland tourist arrivals due to China's ban on individual Mainland tourists visiting Taiwan are likely to weigh on manufacturing and services wage growth respectively.

Private consumption rose by 1.6% YoY in 2Q, slightly stronger than 1.5% YoY in 1Q. The consumption boosting measures that the government announced in 1Q were

GDP growth forecasts	
Government	
Updated:	Aug
2019:	2.5
Consensus	
Updated:	Sep
2019:	2.0
CLSA	
2019:	2.3

The CLSA difference

GDP growth

- The official forecast of 2.6% for 2020 is too positive. Deteriorating US growth is a major headwind for Taiwan's exports and the investment cycle boosted by reshoring and infrastructure is maturing.

Inflation

- We are not too different from consensus for CPI forecast for 2019 but we are much lower (consensus: 1.1%) for 2020 as we expect stronger disinflationary forces from weaker growth and commodity prices.

Interest rates & exchange rates

- The CBC maintains the view that fiscal policy is better at spurring domestic demand than monetary policy. We expect the TWD to weaken following CNY, which will not be stopped by the CBC.

Households are not benefiting from reshoring of industries. Consumer confidence continues to be depressed and employment growth is slowing.

We expect infrastructure investment and capex by returning manufacturing firms to remain decent in 2020 but the growth rates will flatten out.

Exports to US have been strong but will weaken in 2020 as the US economy slows. Slower service exports in 2020 because of Chinese visa ban (though the contribution to GDP growth from services exports is relatively small).

Subdued core inflation is common to Asian economies.

The CNY continues to dominate the TWD forecast. Weaker GDP growth in 2020 also puts pressure on the exchange rate.

Big drop in export prices in 2Q. Falling terms of trade hurt corporate profits.

Corporate loan growth is slowing. We expect it to remain subdued in 2020 on weak economic growth.

The property market is picking up with prices rising in the past twelve months. We expect the CBC to maintain macroprudential measures to curb price increases.

There is no increase in the budget deficit. We do not expect significant and sustained growth in public investment.

GDP deflator is persistently negative.

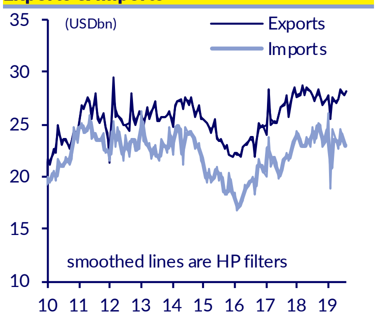
Realignment of supply chain triggered by the trade war attracts high-tech electronics to move back to Taiwan, where there is existing capacity and technological know-how. Reshoring does not seem to require hiring more labour.

Taiwan by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	2.5	2.0	1.6	1.6	1.7
Public consumption	(0.6)	3.7	1.4	2.3	1.9
GFCF	(0.1)	2.5	5.3	2.3	2.0
Domestic demand (contr. to growth)	0.9	2.9	2.2	1.5	1.7
Exports, goods & services	7.6	3.7	2.5	1.3	1.8
Imports, goods & services	5.4	5.0	2.3	1.5	2.1
Real GDP growth	**3.1**	**2.6**	**2.3**	**1.3**	**1.6**
Prices					
Consumer prices (y/e)	1.2	(0.1)	0.8	0.3	1.0
Consumer prices (average)	0.6	1.3	0.7	0.2	0.8
Wholesale prices (y/e)	0.3	0.8	(1.6)	(0.5)	0.8
Currency & interest rates					
TWD/USD (y/e)	29.95	30.59	32.00	32.00	32.00
TWD/USD (average)	30.41	29.84	31.23	31.50	32.00
Discount rate (% y/e)	1.375	1.375	1.375	1.375	1.375
Overnight rate (% y/e)	0.18	0.18	0.20	0.20	0.20
Base lending rate (% y/e)	2.63	2.63	2.63	2.63	2.63
External sector					
Exports (USD, % YoY)	12.9	0.7	(5.4)	(4.3)	1.3
Imports (USD, % YoY)	12.4	5.9	(3.6)	(4.0)	2.3
Trade balance (USD bn)	80.9	67.4	58.7	55.4	53.3
Current account balance (USD bn)	83.5	72.0	68.0	63.2	56.6
- as a % of nominal GDP	14.5	12.1	11.7	10.9	9.8
FDI (USD bn)	(8.3)	(11.1)	(9.3)	(9.1)	(10.1)
CA + net FDI (% GDP)	13.1	10.2	10.1	9.4	8.1
External debt (total, USD bn)	181.9	191.2	200.9	211.0	221.7
Debt service ratio (% exports)	1.9	2.3	2.2	1.8	1.8
International reserves (USD bn, y/e)	451.5	458.4	460.2	456.3	444.9
Money supply					
Money supply M1b (y/e)	4.0	5.7	6.2	5.2	5.3
Money supply M2 (y/e)	3.6	3.1	3.3	3.6	3.5
Private sector credit (y/e)	5.0	5.6	5.7	3.4	4.2
Private sector credit (% of GDP)	132.1	137.2	142.5	146.6	150.8
Government sector					
General gov't balance (% GDP)[1]	(2.0)	(1.9)	(1.9)	(1.9)	(1.9)
General gov't debt (% GDP, y/e)	35.5	35.0	33.9	32.9	31.9
Nominal GDP					
Nominal GDP (USD bn)	575.5	596.3	580.3	578.5	576.4
Nominal GDP per capita (USD)	24,432	25,290	24,583	24,451	24,297
Nominal GDP (TWD bn)	17,501	17,793	18,122	18,224	18,444
Nominal GDP (TWD, % YoY)	1.9	1.7	1.9	0.6	1.2
Other data					
Industrial production	5.7	1.6	(1.7)	1.5	3.2
Retail sales	0.3	1.1	2.2	1.8	2.3
Unemployment (% y/e)	3.7	3.7	3.7	3.8	3.8
Population (millions)	23.6	23.6	23.6	23.7	23.7

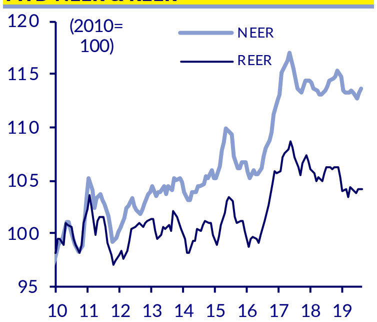
Note: % YoY rates unless otherwise stated. Source: CEIC, CLSA estimates, IMF, Central Bank of China, DGBAS

Exports & imports



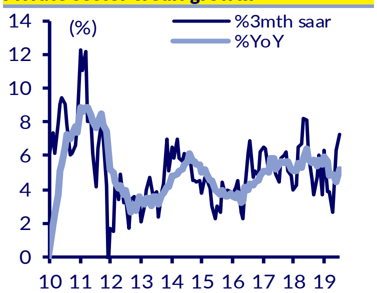
Source: CEIC, CLSA

TWD NEER & REER



Source: BIS, CLSA

Private sector credit growth



Source: CEIC, CLSA

limited in scope and depth and thus are expected to provide only a marginal boost to household spending. The Consumer Confidence Index remained low at 79.7 in August, down from 80.1 at end-2018 and 86.1 at end-2017. As slowing global growth remains a big overhang on business sentiment and wage growth is unlikely to accelerate from current levels, we have maintained our expectation for private consumption growth to remain flat for 2019 and 2020 (at 1.6%). With softer growth in all other components, we forecast GDP growth to slow to 1.3% in 2020 from 2.3% in 2019.

Contained core inflation

Taiwan's CPI inflation shows a similar trend to most of Asian economies. Core inflation is soft given weakening domestic economic activity. Flat inflation in key services sectors has kept core CPI inflation, which fell consistently through 2018, low and stable. Core inflation, at 0.4% YoY in August, remained below 2014-2018 levels (average 1%) and the CBC's unofficial inflation target (2%). We continue to expect core inflation pressure to remain contained for Taiwan for the rest of 2019 and in 2020 on weak demand and wage growth. The headline CPI may stay above core CPI in the next one or two quarters due to higher food prices.

WPI inflation has been sliding since the second half of 2018. It turned negative in May and has been more so through August. Our weak commodity price forecast will reinforce the weakness in wholesale prices in Taiwan.

But don't count on easing by the CBC

Nevertheless, broad-based soft inflationary pressure does not encourage the CBC to cut interest rates. The CBC did not indicate any intention to ease monetary policy at the policy meeting on 19 September, which makes Taiwan the exception in Asia. Again, the CBC insisted on fiscal policy to generate real demand in the economy. The benefit of rate cuts in Taiwan is minimal as interest rates are at historical low levels.

TWD trailing CNY movement

The TWD followed the sharp, by CNY's standard, depreciation in the CNY in the first week of August. However, the TWD has been stable through the month of August, in contrast to the CNY which weakened further. In September, the TWD strengthened and returned to levels that prevailed before the two CNY depreciation episodes in May and August. Optimism on resumed trade talks and Taiwan's relatively strong growth supported the 2% appreciation in TWD/USD from early August to the current spot rate of TWD31/USD.

As we argued in the China section: **Infrastructure uplift,** p40, we are sceptical that the current improvement in market sentiment with regards to the trade war will persist. As a result, we see the CNY weaker by end-2019. Weaker exports due to a slower US economy means further support to the TWD. We expect the TWD to remain soft at TWD32/USD by end-2020.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
TWD/USD	29.95	30.59	32.00	32.00	32.00	32.00	31.50	31.00	31.50
TWD/JPY 100	26.57	27.89	30.77	32.00	30.48	30.77	31.19	31.00	31.50
TWD/GBP	40.47	39.01	38.40	41.60	41.60	38.40	39.38	40.30	40.95
TWD/EUR	35.95	35.08	34.24	36.80	35.20	34.24	36.23	37.20	36.86
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

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Confidence slump, depressed drivers

- **Thailand's major economic drivers, exports and tourism, are in a slump with bearish prospects given weak global trade and the risk of slowing Chinese outbound tourism.**
- **BOT is striving to curb household debt while, at the same time, under pressure to cut rates in order to spur domestic demand and curb THB appreciation.**
- **The exchange rate looks exposed despite the large current account surplus as weak growth and ineffective government policy undermine sentiment.**

Growth drivers in a slump

Exports and tourism are the major economic drivers in Thailand. Both are in a slump with bearish prospects given the weak global trade outlook and risk of moderating outbound tourism from China. Export contraction in 2019 will likely persist in 2020. Sharply slowing tourist arrivals growth this year (led by China tourist arrivals contraction) may not rebound convincingly in 2020.

Ever since the Eastern Economic Corridor was introduced in late 2016 with plans to build the largest special economic zone in the region, the expectation was that stepped up infrastructure spending would provide an effective offset to the downturn in the export manufacturing sector. The major disappointment in Thailand is that the anticipated large infrastructure spend, going into 4Q19, has still not materialised.

Infrastructure has been held back by combined financing constraints and implementation failure which has limited the effectiveness of fiscal stimulus. This has shifted the onus for providing economic support onto monetary policy. However, interest rate cuts, from already low levels, will not significantly lift domestic demand, a view that we share with the Bank of Thailand.

Policy impotence

Monetary easing will be ineffective, moreover, as long as the tight credit stance in the banking sector is maintained. There has been no indication of the commercial banks loosening their credit stance.

Fiscal stimulus efforts aimed at boosting consumer spending are unlikely to have a prolonged effect given the persistently high level of household debt. Repeated fiscal support for low income households exacerbates the fiscal constraint on infrastructure spending.

Long-run history and forecast summary

	2013	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP growth	2.7	1.0	3.1	3.4	4.0	4.1	2.8	2.6	3.1
Domestic demand (contr. to growth)	1.5	(2.3)	2.1	0.1	4.5	6.5	4.1	3.6	4.0
Nominal GDP growth	4.5	2.4	3.9	5.9	6.2	5.6	3.8	4.2	4.7
Consumer prices (y/e)	1.7	0.6	(0.9)	1.1	0.8	0.4	1.5	1.3	1.6
1-day repo rate (% y/e)	2.25	2.00	1.50	1.50	1.50	1.75	1.25	1.00	1.00
THB/USD (y/e)	32.34	32.90	36.01	35.81	32.67	32.71	30.90	31.50	31.75
Money supply - Narrow (y/e)	4.0	1.3	5.7	4.8	9.4	2.8	4.1	3.6	4.3
Current account balance (USD bn)	(8.8)	11.6	27.8	43.4	44.1	32.4	30.3	26.9	21.6
- as a % of nominal GDP	(2.1)	2.9	6.9	10.5	9.7	6.4	5.6	4.7	3.7
Public sector balance (% GDP)[1]	(1.8)	(2.3)	(2.6)	(2.6)	(3.5)	(3.0)	(3.0)	(3.3)	(3.3)

Note: % YoY rates unless otherwise stated; [1] Fiscal year ending September.
Source: IMF, IFS, CEIC, CLSA estimates, Bank of Thailand

No GDP acceleration without private investment

Exports contracted by 3% YoY in the first seven months of the year. Average capacity utilisation over this period was 67.8%, down from the 69.7% average in 2018. Capacity utilisation in July was below this year's average. There is little indication that real investment, which contracted QoQ (seasonally adjusted) in 2Q19, has rebounded in 3Q19.

Private consumption growth, similarly, is likely to have remained sluggish in 3Q19 after the QoQ slowdown in 2Q19. Rural income did pick up in June-July but off low levels. The auto sales trend, which had been rising, very gradually, turned down over the three months to August.

Overall, the weak signals for 3Q19 will keep 2019 real GDP growth below 3%, our estimate is 2.8%. Confronted by the global trade slowdown, GDP growth will slow further to our 2.6% forecast in 2020 with a modest rebound to 3.1% growth in 2021. Private investment would be needed for faster growth over the next two years but, until now, has proved elusive.

Banks maintain tight credit stance

The BOT Senior Loan Officers' Survey confirmed the tight credit stance in the banking sector in 2Q19. This was both for corporate and consumer loans. Demand for credit from SMEs and corporates was sustained but, for both, the commercial banks have maintained a tight credit stance.

The most striking aspect of the survey, albeit unsurprising, was the extreme tightening credit stance for housing loans. This was in response to the BOT mortgage regulations (minimum down-payments and lower LTV ratios) introduced in April 2019.

The banks are unlikely to relax their tight credit stance anytime soon. The BOT has repeatedly expressed concern about high household debt, estimated at 78.7% of GDP in March 2019. In addition to tightened regulations on mortgages and autos, BOT has railed against zero interest unsecured loans prompting a commitment from the Thai Bankers' Association to reduce promotional campaigns for nonessential unsecured loans.

External liquidity boost but no lending

Bank credit growth slowed to 4.4% YoY in July 2019, the slowest in eighteen months. Broad money supply growth has fallen below 4% YoY despite the external liquidity boost. This was reflected in the cumulative USD14.5bn increase in foreign reserves over the first eight months to a record high USD220.2bn in August 2019. Money supply has not expanded because liquidity has not been channelled by the commercial banks into increased lending.

GDP growth forecasts	
Government (NESDB)	
Updated:	Aug
2019:	2.7-3.2
Consensus	
Updated:	Sep
2019:	3.0
CLSA	
2019:	2.8

The CLSA difference

GDP growth

- We think that 3% consensus forecast for 2019 GDP growth is out of reach. The official forecast has been revised down with official comments leaning to sub-3%.

Inflation

- Our 2019 average inflation forecast, at 0.7%, is below BOT's 1-4% target. Inflation will rise in 2020 and 2021 but remain at the lower end of the target.

Interest rates & exchange rate

- BOT is striving to curb household debt while, at the same time, under pressure to cut rates in order to spur domestic demand and curb THB appreciation. We predict another 50bp cut.

Fiscal support for low income households will need to be maintained in order to support private consumption growth.

The infrastructure ramp up needed to crowd in private sector investment has not materialised.

The export drag will persist for slowing GDP growth in 2020 and only a modest rebound in 2021.

Average inflation will be contained below (2019) and at the lower end of (2020 and 2021) BOT's 1-4% inflation target.

Current account surplus has remained buoyant due to weak domestic demand curbing imports.

BOT will reluctantly cut interest rates by another 50bp by mid-2020.

Export contraction in 2019 will persist in 2020 due to global trade volume contraction.

Large outward investment by Thai companies in neighbouring countries will keep net FDI negative.

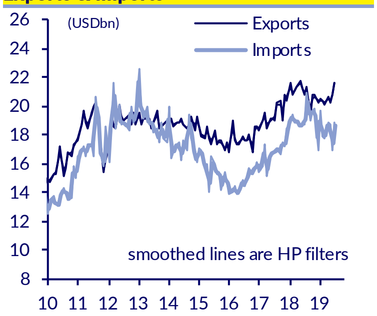
Increasing demands on fiscal expenditure from infrastructure spending and low household income support will keep public debt on an upward trend.

Thailand by numbers

	2017	2018	2019E	2020F	2021F
Breakdown of real GDP					
Private consumption	3.0	4.6	4.2	4.1	4.4
Public consumption	0.1	1.8	2.4	4.0	3.2
GFCF	1.8	3.8	2.0	3.9	4.9
Domestic demand (contr. to growth)	4.5	6.5	4.1	3.6	4.0
Exports, goods & services	5.4	4.2	(4.0)	0.3	2.8
Imports, goods & services	6.2	8.6	(2.0)	1.8	4.3
Real GDP growth	**4.0**	**4.1**	**2.8**	**2.6**	**3.1**
Prices					
Consumer prices (y/e)	0.8	0.4	1.5	1.3	1.6
Consumer prices (average)	0.7	1.1	0.7	1.4	1.5
Producer prices (y/e)	(0.6)	(0.5)	1.0	(1.4)	1.0
Currency & interest rates					
THB/USD (y/e)	32.67	32.71	30.90	31.50	31.75
THB/USD (average)	33.92	32.30	31.25	31.15	31.60
1-day repo rate (% y/e)	1.50	1.75	1.25	1.00	1.00
Minimum lending rate (% y/e)	6.32	6.32	5.75	5.25	5.25
External sector					
Exports (USD, % YoY)	9.5	7.5	(3.0)	(0.7)	2.1
Imports (USD, % YoY)	13.2	13.7	(3.6)	1.2	4.8
Trade balance (USD bn)	32.6	22.4	22.9	18.6	12.9
Current account balance (USD bn)	44.1	32.4	30.3	26.9	21.6
- as a % of nominal GDP	9.7	6.4	5.6	4.7	3.7
FDI (USD bn)	(10.6)	(7.3)	(4.7)	(2.5)	(1.5)
CA + net FDI (% GDP)	7.4	5.0	4.7	4.3	3.4
External debt (total, USD bn)	149.0	164.0	175.0	190.5	206.0
Debt service ratio (% exports)	5.7	5.8	6.0	6.3	6.2
International reserves (USD bn, y/e)	202.6	205.6	219.8	219.0	220.0
Money supply					
Money supply - Narrow (y/e)	9.4	2.8	4.1	3.6	4.3
Money supply - Broad (y/e)	5.0	4.7	3.4	3.2	3.6
Private sector credit (y/e)	4.2	5.6	3.9	3.7	4.1
Private sector credit (% GDP)	113.4	113.3	113.5	112.9	112.2
Government sector					
Public sector balance (% GDP)[1]	(3.5)	(3.0)	(3.0)	(3.3)	(3.3)
Public sector debt (% GDP, y/e)	41.9	41.7	42.9	44.5	45.8
Nominal GDP					
Nominal GDP (USD bn)	455.6	505.1	542.2	567.0	585.2
Nominal GDP per capita (USD)	6,659	7,359	7,873	8,204	8,439
Nominal GDP (THB bn)	15,452	16,318	16,942	17,662	18,493
Nominal GDP (THB, % YoY)	6.2	5.6	3.8	4.2	4.7
Other data					
Industrial production	2.2	2.7	0.3	0.1	2.0
Population (millions)	68.4	68.6	68.9	69.1	69.4

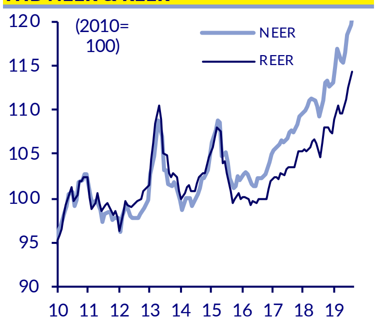
Note: % YoY rates unless otherwise stated; [1] Fiscal year ending September.
Source: IMF, IFS, CEIC, CLSA estimates, Bank of Thailand

Exports & imports



Source: CLSA, CEIC

THB NEER & REER



Source: BIS, CLSA

Private sector credit growth

Source: CEIC, CLSA

Short lived consumption boost

In August, the government unveiled a THB316bn stimulus package (equivalent to 1.8% of GDP) aimed at supporting farmers and low income households and boosting tourism. This may provide, at best, a short term consumption boost.

There will be pressure for further rate cuts, both in response to sluggish domestic demand growth and to curb trade-weighted exchange rate appreciation. While doubting the effectiveness of further rate cuts, BOT may be impelled to cut again after its 25bp cut in August. We have another 50bp cut in our forecast, to 1% by mid-2020.

Across the region, inflation will not be a constraint on central banks opting to cut interest rates. Inflation in Thailand fell to 0.5% YoY in August, reflecting the absence of domestic demand pressures. Coming off a lower base in late 2018, inflation will rise to 1.5% at end-2019. Our average inflation forecast at 1.4% in 2020 and 1.5% in 2021 is at the lower end of BOT's 1-4% target.

THB exposed despite current account surplus

Thailand's large current account surplus has contributed to upward pressure on the THB exchange rate. Weak domestic demand has curbed import growth keeping the current account surplus high, notwithstanding declining tourism revenue growth.

The current account surplus will remain buoyant at our 5.6% of GDP estimate for 2019, narrowing gradually to our 4.7% of GDP forecast in 2020 and 3.7% of GDP in 2021 (tracking our forecast for only a gradual rise in investment growth).

The current account surplus will be partly offset by negative net FDI (reflecting large investment by Thai companies in neighbouring countries). The strong currency therefore looks exposed; we forecast modest depreciation in 2020 and 2021.

Confidence slump

The new government, still led by General Prayut, has failed to inspire confidence. Quite the contrary. Consumer confidence has fallen to its lowest level in over three years. Business sentiment has also fallen sharply this year. Stimulus policies that prove to be ineffective could destabilise the coalition government. This would reduce Thailand's FDI appeal conferring an additional risk on the exchange rate.

Currency forecast

Period-end	Annual					Coming 12 months by quarter			
	2017	2018	2019F	2020F	2021F	4Q19F	1Q20F	2Q20F	3Q20F
THB/USD	32.67	32.71	30.90	31.50	31.75	30.90	31.00	31.10	31.30
THB/JPY 100	28.98	29.81	29.71	31.50	30.24	29.71	30.69	31.10	31.30
THB/GBP	44.14	41.71	37.08	40.95	41.28	37.08	38.75	40.43	40.69
THB/EUR	39.22	37.50	33.06	36.23	34.93	33.06	35.65	37.32	36.62
Memo: USD/EUR	*1.20*	*1.15*	*1.07*	*1.15*	*1.10*	*1.07*	*1.15*	*1.20*	*1.17*
Memo: JPY/USD	*112.7*	*109.7*	*104.0*	*100.0*	*105.0*	*104.0*	*101.0*	*100.0*	*100.0*

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