

An overview of Asian economies in 1Q15
'Infrastructure wars'

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Asian economies set to put behind lacklustre 1Q15

- Lacklustre economic conditions in the US in 1Q15 hurt Asian growth but we see this first quarter slowdown as an ephemeral quirk caused by one-off factors. As the US economy enters a sweet spot with housing, credit and labour markets all strengthening, there will be positive spillovers into the European Union, Japan and China, which will in turn result in secondary effects driving demand into the regional supply chains in Southeast Asia.
- Most Asian economies underperformed in 1Q15 due to weak external demand. Political headwinds which might derail economic growth are also gathering in some countries. However, robust investment growth in several countries suggests that an improvement in business confidence is emerging.

'Infrastructure Wars': China, Japan offer largesse but it is governance failures that obstruct progress in infrastructure

- Japan is offering USD110bn for Asia's infrastructure needs, competing with China-backed AIIB and NDB in providing such funds.
- Asia gains from the power-play in light of its much needed infrastructure upgrade. But until weaknesses in governance are tackled, the vast funds on offer will have little impact.

Key Drivers of Asian Economies

| Variable | Development/Assessment |
|---|---|
| Global economy: improving but financial risks remain high for Asia | |
| US economy | <p><u>Shaking off early 2015 torpor: Fed risks rise</u></p> <ul style="list-style-type: none"> ▪ New home sales grew 26.1% y/y in Apr 15 and pending sales grew 14% y/y in Apr 15. Capital spending also showing signs of recovery, credit is flowing more strongly to small businesses. ▪ Currently, slack in the labour market has reduced the Fed's motivation to raise rates in the near future but this is likely to change. (See below) |
| Eurozone: Greek risks rise | <p><u>A deal has to be done by this week to avoid a crisis</u></p> <ul style="list-style-type: none"> ▪ The deadlock continues, with Greek Premier Alexis Tsipras accusing his creditors of making "absurd" demands and seeking "harsh punishment" on Greece. Senior Eurozone and International Monetary Fund officials have quietly expressed despair on the inability or unwillingness of the Greek government to negotiate seriously. ▪ The two sides remain far apart on three critical issues: Greek pension reform, labour market liberalization and privatisation, all of which fly in the face of the Tsipras government's ideological beliefs. ▪ The European Central Bank has added to pressure on Greece by leaving the ceiling on emergency funding for Greek banks unchanged for the first time since Feb 15. |

| Variable | Development/Assessment |
|--|---|
| | <ul style="list-style-type: none"> ▪ Implications: The risk that a miscalculation by either Greece or its creditors leads to an unintended Greek exit from the Euro is rising. Financial markets are complacent, assuming that a last minute deal would be reached, opening the way for market shocks. |
| Emerging economies cast a pall on Asian emerging markets | <p><u>Emerging economies: risks of contagion especially for Indonesia</u></p> <ul style="list-style-type: none"> ▪ Brazil's economy likely shrank 1.4% y/y in 1Q15, worse than the 0.2% contraction in 4Q14. 98,000 jobs were lost in Apr 15. President Rousseff is under pressure from corruption scandals. ▪ Russia's economy contracted 1.9% y/y in 1Q15, down from an already meagre 0.4% y/y growth in 4Q14. ▪ South Africa's economy, however, grew 2.1% y/y in 1Q15, up from a 1.3% y/y expansion in 4Q14 but this was boosted by a low base created by labour unrest in 1Q14. Unemployment remains elevated at 26.4% in 1Q15 as consumer spending and sentiment remain weak. ▪ Turkey has seen its lira weaken in recent days as the 7th June elections approach. Consumer confidence has fallen to lows last seen at the depth of the global financial crisis in March 2009. ▪ Implications: Weakness in the currencies and growth prospects of large emerging economies focuses investor concern on Asian emerging economies as well. Indonesia could be particularly vulnerable to contagion. |
| Asian economies tilted to the downside for now, but growth should pick up | |
| Asian manufacturing sectors | <ul style="list-style-type: none"> ▪ Only India and Vietnam showed strong numbers for their manufacturing PMIs at 52.6 and 54.8 respectively in May 15. Japan's saw a moderate increase to 50.9 in May 15. ▪ Taiwan, China and Indonesia manufacturing PMIs edged up but remained in contractionary territory. Korea further contracted from 48.8 in Apr 15 to 47.8 in May 15. |
| China's slowdown | <p><u>Stimulus efforts not showing results yet</u></p> <ul style="list-style-type: none"> ▪ While both the official as well as HSBC manufacturing PMIs edged up a tad, the HSBC survey found that "operating conditions in China's manufacturing sector continued to deteriorate". ▪ The ANZ-Roy Morgan China Consumer Confidence Index fell 0.5pt to 144.0 in May 15, reaching a new record low. ▪ The default of a profitable private sector company after banks refused to roll over loans reflects the growing financial stresses in China. ▪ Implications: The economy continues to edge down gradually, with more evidence of financial stresses emerging, although mostly localised and not sparking a loss of confidence. Soaring equity markets have helped maintain confidence but the low quality of the equities boom, driven by extremes of margin financing, raise doubts over the equity boom's durability and the confidence it has sparked. |

| Variable | Development/Assessment |
|---|---|
| Japan's monetary policy | <p><u>IMF urges Japan to expand its monetary policy</u></p> <ul style="list-style-type: none"> ▪ Inflation ticked up to 0.3% y/y in Apr 15, with the Bank of Japan remaining upbeat over its ability to achieve its 2% inflation target. However, the IMF has called for more aggressive monetary policies as it is less optimistic, noting that poor labour market conditions and muted domestic consumption show room for bolder monetary actions. ▪ But economic data is gradually turning around, supporting the BOJ view to some extent: Household expenditure is up 1.3% y/y in Apr 15, after falling 8.5% y/y in Mar 15. Exports continued to grow, up 8% in April after 8.5% in March. The labour market has continued to tighten with the unemployment rate falling to 3.3% in April. ▪ Implications: The BOJ will not make an early move to further loosen monetary policy. The added weakening of the JPY this week in effects helps to loosen monetary conditions. The BOJ will watch and wait. |
| Taiwan – Effects of weak global economy hurting | <p><u>Taiwan affected by weak growth in neighbouring economies</u></p> <ul style="list-style-type: none"> ▪ Taiwan's 1Q15 economic activity remained strong as it expanded 3.4% y/y, down marginally from a 3.5% y/y growth in 4Q14. ▪ However, recent data suggests potential slowing: Industrial production slowed to 1.1% y/y in Apr 15, down from a 6.7% y/y expansion in Mar 15, as electronics demand from China weakened. Domestic trade also fell 2% y/y in Apr 15, dropping further after a 0.7% y/y fall in Mar 15. ▪ Business confidence for both the manufacturing and services sector fell 1.45 and 0.99 percentage points respectively. |
| Singapore Economy | <p><u>Modest improvements, no policy change likely</u></p> <ul style="list-style-type: none"> ▪ GDP grew 2.6% y/y in 1Q15, up from a 2.1% increase y/y in 4Q14 with investment spending recovering further as well. ▪ However, industrial production fell 8.7% in April. Non-oil export growth fell sharply to just 2.2% in April after a strong rebound in March which proved to be unsustainable. A 7.4% y/y drop in visitor arrivals in Mar 15, due to a sharp falls in the two largest markets for visitors, China and Indonesia attests to Singapore's growing problem of lost cost competitiveness. ▪ CPI inflation fell 0.5% y/y in Apr 15, after a decrease of 0.3% y/y in Mar 15, raising fears of deflation in the economy. ▪ Implications: The central bank sees an improving global economy supporting economic growth and, having eased policy in January, is unlikely to do so again in the near-term. |
| East and South China Sea disputes: no progress | |
| US-China tensions | <p><u>Expect more tense moments in region</u></p> <ul style="list-style-type: none"> ▪ This year's Shangri La Dialogue saw the US and China articulating their growing differences in more restrained language. Still, the reality is that the US has decided that it must take some risks to confront what |

| Variable | Development/Assessment |
|---|--|
| | <p>it, Japan and many Southeast Asian nations, see as China escalating tensions through its land reclamation activities in disputed territories.</p> <ul style="list-style-type: none"> ▪ The US has made clear that it will continue its patrols over Chinese-controlled islets and rocks where reclamation activities continue. The Chinese have warned that they may declare an Air Defence Identification Zone around these disputed territories if it judged that risks to its security had grown. ▪ Implications: Neither side is likely to back down, therefore there will be more episodes of US surveillance aircraft challenging China's unilateral claims in the South China Seas. An accidental clash is possible, things will get worse before they get better. |
| Political uncertainty in Southeast Asia grew | |
| Thailand - Elections pushed back | <p><u>Referendum for draft charter extends military junta's reign</u></p> <ul style="list-style-type: none"> ▪ Following its decision to hold a referendum on the draft charter, the military junta has postponed elections, to around September 2016. ▪ Implications: The delay prolongs political uncertainty, deterring foreign investors and by raising allegations that the military junta is seeking to extend its rule, raises the risk of protests. |
| Indonesia - Uncertainty looms for KPK | <p><u>Judgement undermining KPK is a challenge to President Jokowi</u></p> <ul style="list-style-type: none"> ▪ In a controversial ruling, the South Jakarta District Court found the KPK's investigation of Hadi Poernomo to be invalid as the commission had misused its powers by hiring investigators from outside the ranks of police and state prosecutors. Based on a new rule by the Constitutional Court, the KPK must only use investigators that are seconded from the police or the Attorney General's office. ▪ The verdict is likely to undermine 371 KPK-prosecuted graft cases that have been confirmed by the Supreme Court and is likely to spark appeals from hundreds of graft convicts. ▪ Implications: The adds to growing challenges to the efficacy of the KPK and raises severe questions about President Jokowi's ability to overcome the entrenched vested interests who are clearly mounting a vigorous pushback to his reformist efforts. |

Global context: Expected recovery in the US is a boon to Asia

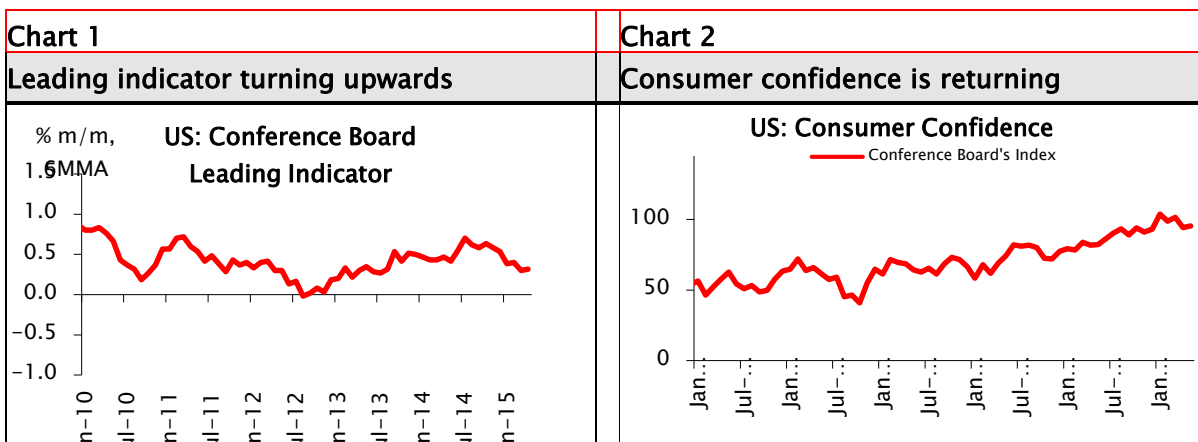
The economic performance of the US economy was unusually weak in 1Q15, dragged down by exceptionally wintry conditions, the dollar strength, West Coast port strikes and the initially negative impact of lower oil prices. This lacklustre growth depressed consumer confidence and contributed to the dismal retail sales figures in March: American consumers seem to be saving the "oil dividend". The weakness continued into the early second quarter even as the weather improved and the strikes ended.

However, we think that this slowdown is an ephemeral quirk and the US is poised for a strong surge ahead; bright spots in the housing, labour and credit markets buttress our view.

- **The housing sector has shrugged off its lethargy:** New home sales rose 6.8% while housing starts came in at an impressive 9.2% y/y in Apr 15. Home prices are also trending upwards, according to the latest iteration of the S&P/Case-Shiller indices.
- **Job creation at a robust pace:** While a recent Fed survey showed signs of underemployment in the US economy, new jobs are being created at a steady clip. Except for an unexpected blip in Mar 15 (85,000), nonfarm payrolls have consistently been above the 200,000-mark, registering at 201,000 in Jan 15, 266,000 in Feb 15 and 223,000 in Apr 15.
- **Credit is flowing more strongly to small firms.** The Federal Reserve Bank’s survey of banks’ loan officers showed that banks were easing lending standards, boosting small firms’ demand for commercial and industrial loans.

Our view is that we are now entering this sweet spot in the US economy where momentum is gathering and the economy poised for a strong surge in growth:

- **US CLI shows upturn:** The composite lead indicator continued its uptrend (as shown in Chart 1), and this suggests that growth will increasingly gather pace.



Source: Calculated by Centennial Asia Advisors using CEIC Database

- **Capital spending is rebounding:** Capital spending, which has been weakening for several months since late last year, has started to rebound with new orders for core capital goods – a metric for future business spending – increasing by 1.0% m/m in Apr 15, following an upwardly revised 1.5% m/m increase in Mar 15.
- **Consumer confidence is firming, but at a gradual pace,** as shown by the increase in the Conference Board Consumer Confidence Index in April (refer to Chart 2). The recovery in the housing market will serve to boost consumer confidence and spur domestic demand while the tightening labour market will result in an upward pressure on real wages, improving household finances and disposable incomes.

Thus the US economy is likely to gain momentum going forward, adding significantly to global demand for Asian exports, and this represents a boon to Asian economies, many of which are heavily dependent on export demand for growth. The recoveries in Europe and Japan will receive a fillip as well from the US recovery, and as the G3 economies become increasingly resurgent, their demand for Asian products will also rise – leading to a virtuous circle.

Implications: a September rate rise now more likely

- Improvements in employment are not strong enough to convince the majority of Federal Reserve officials to shift towards a near-term rate rise. Officials such as Minneapolis Fed President Kocherlakota are pushing for a delay in rate rises while San Francisco Fed President John Williams, whose views on policy are seen as close to Fed Chair Janet Yellen, said the Fed was likely to raise interest rates later in 2015.
- However, as the US economy continues to regain momentum, we are likely to see a progressive shift in Fed thinking, with a rate rise by September now more likely and a steeper trajectory than expected thereafter a rising possibility as well, despite the strong consensus against that view.

Asian economies have turned in a lacklustre 1Q15

The temporary weakness in the US, the uncertainty over Greece's problems in the Eurozone, and the marked deceleration seen in China have resulted in Asian economies registering uninspired growth figures for the first quarter. External demand has been weak, while inflation levels worldwide have been generally depressed due to the low global oil prices.

Table 1: Overview of 1Q15 GDP in Asian economies

| % y/y | CN | HK | KR | TW | IN | ID | MY | PH | SG | TH | VN |
|---------|-----|-----|-----|------|------|------|------|------|------|------|-----|
| GDP | 7.0 | 2.1 | 2.4 | 3.4 | 7.5 | 4.7 | 5.6 | 5.2 | 2.6 | 3.0 | 6.1 |
| PCE | | 3.5 | 1.5 | 2.5 | 7.9 | 5.0 | 8.8 | 5.4 | 2.8 | 2.4 | |
| GCE | | 3.5 | 3.1 | -2.2 | -7.9 | 2.2 | 4.1 | 4.8 | 4.7 | 2.5 | |
| GFCF | | 7.3 | 2.5 | 0.4 | 4.1 | 4.4 | 7.9 | 10.1 | 2.6 | 10.7 | |
| Exports | | 0.2 | 0.0 | 5.9 | -8.2 | -0.5 | -0.6 | 1.0 | 4.7 | 1.0 | |
| Imports | | 0.5 | 1.8 | 2.5 | -8.7 | -2.2 | 1.0 | 4.6 | -0.1 | 2.3 | |

Source: Calculated by Centennial Asia Advisors using CEIC Database

- GDP figures insipid for most countries:** External vulnerabilities such as weak export demand and low inflation led to most countries falling short of expectations. China's marked deceleration has prompted government authorities to slash benchmark interest rates to spur lending and growth, as the economy barely scraped the 7%-target set by Premier Li Keqiang. Philippines also came up short, with growth moderating from 6.6% in 4Q14 to 5.2% y/y in 1Q15 – the slowest since 4Q11 – as government spending and exports faltered. Indonesia also saw slowing GDP growth, with 1Q15 growth registering at 4.7% y/y on the back of weaker consumer spending, a tumbling rupiah and stalled government spending.

- **Investment levels are revving up** in Hong Kong, Malaysia and Thailand – a positive sign that business confidence is strengthening and that investments into the country will continue to bolster economic growth.

Table 2: Investment trends of selected countries

| % y/y | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|
| Gross Fixed Capital Formation (GFCF) | | | | | | | | |
| Hong Kong | 7.1 | 1.8 | 4.9 | 3.9 | -6.0 | -1.7 | 3.4 | 7.3 |
| Malaysia | 5.9 | 8.8 | 6.1 | 6.7 | 6.9 | 1.3 | 4.3 | 7.9 |
| Thailand | 3.5 | -3.2 | -11.6 | -10.7 | -5.1 | 2.6 | 3.2 | 10.7 |

Source: Calculated by Centennial Asia Advisors using CEIC Database

- **Exports are mostly insipid and have contributed little to growth:** The weakness seen in the G3 economies have led to tepid global demand for Asian exports, and the slowdown in China has flowed downstream, affecting also regional supply chains which are largely based in Southeast Asia. With the exception of Taiwan, whose electronics exports are a key growth driver given the boom seen in IT products, the contribution of most countries' export growth to GDP has been insipid.
- **Need to cultivate strong consumer base domestically:** While foreign investments and exports are still important growth drivers, especially for developing economies, countries must look to nurture a robust consumer base to undergird growth, as external vulnerabilities and uncertainties mount. The positive effects of having strong domestic demand can be seen in Malaysia: despite political gyrations over the mismanagement of 1Malaysia Development Berhad (1MDB), economic growth has chugged on smoothly; growth in private consumption expenditure stands at 8.8% y/y in 1Q15.
- **Political headwinds are brewing:** With impending elections in the Philippines, Singapore and Taiwan, economic concerns could take a backseat as political parties jostle for electoral supremacy at the ballot box. Also, in Hong Kong and Thailand, important decisions on reforming their respective political systems are about to made; if mishandled, political strife could disrupt the smooth functioning of the economy.

Going forward, a gradual recovery, led by the US, is expected

Generally, the US, Eurozone, China and Japan have seen uptrends in the new orders category under May 15's flash PMI reports, pointing to a near-term acceleration.

Table 3: Manufacturing PMIs

| | Mar 15 | Apr 15 | May 15 (Flash) | |
|--------------|--------|--------|----------------|---|
| US (ISM) | 55.7 | 54.1 | 53.8* | ↓ |
| Eurozone | 52.2 | 52.0 | 52.3 | ↑ |
| China (HSBC) | 49.2 | 48.9 | 49.1 | ↑ |
| Japan | 50.3 | 49.9 | 50.9 | ↑ |

Source: HSBC Markit and ISM

* US Flash PMI for May 15 from Markit, ISM does not publish flash estimates

- A resurgent US will lift economic sentiment in the global economy. As the US snaps out from its temporary, first-quarter funk, it will drive a cyclical uptick in global export demand with the European Union, China and Japan being among the biggest beneficiaries. Asian manufactured exports are expected to rise in line with the US recovery. As China and Japan hitch onto the economic up-cycle, other countries in East and Southeast Asia, plugged into regional supply chains, will rise in tandem.
- Asian countries which export manufactured goods will gain substantially – especially Southeast Asia, Korea and Taiwan. Within Southeast Asia, Malaysia and Singapore are likely to be the big winners as the region ramps up production and exports in response to the expected upturn in global economic conditions.

‘Infrastructure wars’

With the Asian Infrastructure Investment Bank(AIIB) and New Development Bank(NDB) pioneering China’s regional and global influence in the development sphere despite US opposition, Japan announced a USD110bn injection to the Asian Development Bank(ADB) to finance Asian infrastructure over the next five years. The question is how this geo-political power-play and surge in infrastructure spending will deliver gains for Asia?

Asia certainly needs funds for infrastructure

- Asia is in urgent need of infrastructure to support economic and social development. Of the Asian countries, high quality infrastructure is limited to China, Singapore and Japan. The vastness of Asian economies has led to infrastructure developments primarily concentrated in urban areas with the lack in peripheral areas curbing the advancement of economies such as Philippines, Indonesia and Malaysia.
- The ADB estimates USD8tr is needed to finance Asia’s infrastructure expenditure over the course of this decade. Asia’s potential provides much scope for infrastructure development and investible projects and thus it is important to analyse the dynamics of the recent surge in infrastructure investment.

Assessment: Can Chinese financing separate itself from self-interest?

- China’s regional influence is extensive, with project engagements in the Greater Mekong Subregion, Indonesia, Pakistan and Sri Lanka amongst others. Chinese-backed projects however, have had their fair share of difficulties with quality and delivery. Sri Lanka has recently pushed back, calling a halt on the Chinese-backed construction of ‘Colombo Port City’. China’s role in the project was said to be plagued by corruption and a lack of transparency amounting gains skewed in favour of China.
- The World Bank found China to be the largest financier of infrastructure projects in Africa. However, Chinese infrastructure projects in Africa are often accompanied by Chinese migrants executing the construction. The lack of skill transfer to the domestic population

has led to the under utilisation of implemented infrastructure and as a consequence, development and growth is not realised.

- These instances question the ability of China to separate the spearheading of Chinese foreign policy vs. necessary infrastructure development given its recent dominance in the financing sphere.

Japan adds to the mix...

- Japan's recent initiatives bring about important implications for the quality of Chinese infrastructure delivery. Competition between the two Asian powers to assert their influence in Asia will hopefully bring about increased transparency, efficiency and progressive transformation in recipient countries. As a pioneer of high quality infrastructure, Japan is setting the tone for positive spillovers to complement infrastructure development efforts in the region. However, there are concerns surrounding Japan's ability to deliver on the promised USD110bn capital injection, as it has been experiencing slows in its own development.

But the real constraint on Asian infrastructure is not funding, it is domestic capacity

- Indonesia devotes a sizeable amount of its budget to infrastructure development with complementary bilateral arrangements to help boost investment in the economy's much needed upgrade. However the failure of private infrastructure initiatives can be pointed back to the government's dismal efforts to provide an enabling environment for investors.
- Pakistan's debt-ridden energy sector has enough capacity to meet power demand but fails to do so because of the policy environment. Monies due to power producers from the government have not been paid, deterring many from producing at all. Ineffective law enforcement means that theft of power is on a grand scale.

It is poor governance that obstructs efficient infrastructure delivery and deters investors. While increasing competition between the big powers as they offer help on infrastructure could sift out these inefficiencies, the ultimate realisation of benefits lies in domestic governments' ability to manage the surge of financing and appropriately reform policies to ensure efficiency.

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