CENTENNIAL ASIA ADVISORS
policy and strategic advisors

WEEKLY INSIGHTS
18 May 15

Monetary policy: easing bias to continue
China: Economy in a state of torpor, downside risks persist

Manu Bhaskaran
Seng Bingxun
Jason Tan
Asees Bajaj

Asian monetary policy outlook: results of our Taylor Rule-based model

- China is behind the curve and needs to ease more aggressively.
- The Philippines is behind the curve and needs to tighten.
- India and Malaysia are ahead of the curve and need not hurry to ease in our view.
- In general, an easing bias is likely in Asian monetary policy.

China: Growing risks to economic growth even though more easing is expected

- The world's second largest economy is going through a difficult patch, and languid performance of economic indicators for April 2015 further reflected the marked deceleration.
- The outlook for manufacturing, industrial output and exports remain dim due to the relative strength of the RMB and the generally lacklustre external demand. Domestic demand is also faltering as retail sales weakened to a nine-year low and FAI plumbed the depths by recording the lowest growth since 2000. Loans and credit growth have also missed expectations.
- The cooling growth has forced the central bank to act in cutting the benchmark interest rate and lowering the required reserves ratio. More aggressive easing from both the central bank and the government is also expected in the later part of 2015 should the economy look to be missing the 7% growth target.
- Downside risks will continue to plague the Chinese economy in 2015, with ongoing economic reforms inflicting short-term pain. The strong RMB will be a drag on exports while easing measures thus far seem to be ineffectual in spurring expansion and growth. Finally, financial risks are higher than ever as irrational exuberance in inflated asset markets fuel the inflation of asset bubbles which will eventually burst.

Key Drivers of Asian Economies

Variable	Development/Assessment
Global developments positive	
Trans-Pacific Partnership (TPP) on track again	<u>US Senate bills provide impetus for the conclusion of TPP</u> ▪ The US Senate voted 65-33 to initiate the process of granting President Obama Trade Promotion Authority (TPA), which is needed to "fast-track" TPP through Congress once talks end. If the TPA is passed soon, the final bargains for TPP to conclude will proceed quickly and we could have a TPP deal by mid-year. ▪ <u>Implications</u>: TPP will hugely boost trade for the developing Asian partners in the TPP such as Malaysia, Singapore, Brunei and Vietnam.

Variable	Development/Assessment
US – weakness continues into 2Q15	<u>Most data points showed little pick up</u> ▪ Except for small business confidence which rebounded, other data was poor: the Michigan consumer confidence index fell sharply in April while retail sales remained weak. Industrial production fell in March, mostly due to falls in utilities and mining production but even manufacturing was flat. ▪ However, the ECRI Weekly Leading Indicator continued rising, suggesting that activity will improve in coming months. We remain confident of a pick-up in US growth.
Eurozone showing more signs of modest recovery	<u>Eurozone GDP strengthens</u> ▪ Eurozone 1Q15 GDP grew at its fastest pace in almost two years, at 1% y/y, up from 0.9% y/y in 4Q14. Large Eurozone countries such as France and Italy which had caused the greatest concerns, performed better than expected.
Geopolitical risk in Asia	
North Korea – Regime is weakening	<u>Execution of high level officials reveals more cracks in regime</u> ▪ South Korean intelligence has reported that North Korea leader Kim Jong-un has purged his defence minister, Hyon Yong Chol, and quite possibly executed him in a ghastly fashion. Hyon was Kim's fifth defence minister since taking power in Dec 11. ▪ South Korean intelligence suggested that Hyon was just one of many senior officials who have been purged in recent weeks. Kim is clearly reducing the military's political heft in favour of the Korean Workers' Party and removing an entire layer of once-influential leaders. It is not clear if he can pull off such a risky gambit of taking on powerful groups within the regime.
US challenges China in South China Sea	<u>US to deploy ships, aircraft in areas where China has been assertive</u> ▪ In a significant challenge to China, the US military will deploy ships and surveillance aircraft to patrol reefs and rocks where China has recently undertaken land reclamation. ▪ At their weekend meeting, Chinese Foreign Minister Wang Yi and US Secretary of State John Kerry clearly failed to agree on a common approach to prevent an escalation of tensions. ▪ <u>Implications</u>: China under-estimated the Obama Administration's resolve in responding to its increasingly aggressive posture, assuming that a US distracted by crises in Ukraine and the Middle East would chose to avoid an entanglement with China. ▪ However, the US reaction shows that China had crossed a red line in the ongoing South China Sea dispute by building up facilities which would enable it to project naval and air force power deep into Southeast Asia, something that would threaten the US military position in the region.

Variable	Development/Assessment
	▪ While a stepped up US military presence could potentially escalate tensions, or lead to accidental clashes, we believe that both China and the US will be careful to contain these risks.
China-India ties improve	Modi in China: no breakthrough but foundation for progress built ▪ Modi had high level meetings with both President Xi and Premier Li. A total of 24 agreements were signed and business deals worth USD22bn were also signed. ▪ Both Modi and Li alluded to remaining obstacles to resolving major obstacles such as border disputes. Modi asked China to "reconsider its approach on some of the issues that hold bilateral ties back from realizing full potential" while Li said China and India needed to do more to strengthen mutual political trust, a point China's state-controlled media repeated in commentaries. ▪ Implications: While there was no major breakthrough in advancing a resolution to the border dispute, the visit helped to build a solid foundation for future progress. Modi is determined to attract Chinese investment and also knows that better ties with China would improve its ability to deal with Pakistan.
Asian economies: divergent trends	
Japan - Largest current account surplus in 7 years	Weak yen and low oil prices behind strong current account surplus ▪ Driven by cheaper energy imports and more competitive exports, Japan's current account balance stood at JYP2.795tr in Mar 15, up from JPY1.44tr in Feb 15. ▪ While the widening surplus will provide a boost to Japan's economy, structural reforms and the successful implementation of the TPP will remain the key to Japan achieving sustainable economic growth.
China's debt swap	Slower economy but financial risks being contained ▪ Economic data continued to disappoint, raising risks of a deeper slowdown than markets anticipate (see below). ▪ Chinese policy makers are stepping up efforts to ensure that economic weakness does not result in financial stresses. The finance ministry will allow local governments to swap USD1tr worth of high-interest debt for lower cost bonds, reducing the interest costs paid out by RMB40-50bn. ▪ While creditors may face lower returns from the exchange of higher-yielding to lower-yielding assets, they are compensated with higher certainty that they will be repaid. Main creditors such as banks will be able to treat the new bonds as lower risk assets and reduce their capital charges, giving them leeway to transfer lower costs to Chinese citizens.
Indonesia – improved external	Current account deficit fell to 1.8% of GDP in 1Q15 ▪ The basic balance of payments deficit also improved but a sharp fall

Variable	Development/Assessment
resilience	in foreign direct investment was a concern. ▪ Policy credibility remains the key to external resilience. With Bank Indonesia now on an appropriate policy track (see below), the main issue will be the overall thrust of government policy towards investors.
Malaysia – economy on sound track despite political bickering	<u>Stronger than expected 1Q15 GDP growth</u> ▪ GDP grew a credible 5.6% y/y in 1Q15, down only slightly from 5.8% y/y growth in 4Q15. ▪ Growth was artificially boosted by households ramping up purchases in the run-up to the new goods & services tax on 1st April. ▪ However, private demand remained strong and construction activities also rebounded. The strength of private investment is particularly positive, attesting to continued business confidence. ▪ Despite the political infighting within the ruling party, the economy remains on a solid if unexciting track.
Singapore – restructuring progressing but downside risks from global demand	<u>IMF's 2015 Article IV: Singapore's susceptibility to global conditions</u> ▪ The IMF's regular review found that Singapore's economy is doing well but that slow global recovery and economic restructuring will exert a drag on activity. ▪ The new growth model has led to a permanent increase in real wages relative to the cost of capital. MAS's implementation of a lower nominal effective exchange rate is judged to be appropriate with respect to the current economic outlook. ▪ However, Singapore's economy is more exposed to the downside due to high exposure to external conditions such as global financial volatility and the slowdown in China's growth.
Hong Kong – economy grows modestly	<u>Weak trade but domestic investment supported growth</u> ▪ Investment grew by 7.3% y/y while private and public consumption also boosted growth.

Monetary policy outlook: Bias towards easing to continue

The Taylor Rule analysis provides guidance as to how Asian central banks might move.

We have applied our Taylor Rule-based model to provide some guidance as to how monetary policy might change in the months to come. The Taylor Rule serves as a guideline for setting interest rate based on the divergences between actual and expected inflation rates and the economy's output gap. However, central banks do not have to strictly follow Taylor estimations because of up/downside risks that are not captured in output gap estimations. Table 1 summarises our findings and forecasts.

Table 1: Near Term Monetary Policy Outlook

Countries	Current policy rate	Policy rate (end-2015)	Remarks
China	5.10%	4.85%	▪ Taylor Rule implies that China is behind the curve. ▪ We expect further easing, especially if the domestic economy looks to miss the 7% growth target.
India	7.50%	7.25%	▪ Taylor Rule implies that India is ahead of the curve. ▪ The economy is recovering and inflation is moderating. However, forecasts for the monsoon suggest risks to both growth and inflation. ▪ On balance, we expect the RBI to continue with its strategy of cautious easing.
Indonesia	7.50%	7.25%	▪ Bank Indonesia is tracking the Taylor Rule. ▪ Weak 1Q15 GDP growth suggests the economy is losing steam but BI's scope to cut rates is limited by a current account deficit that remains a tad too high and inflation which picked up in Apr 15 moving further away from the 4% target.
Korea	1.75%	1.50%	▪ Korea is enduring a difficult patch with exports losing steam. There are also concerns by the central bank over falling inflation levels. ▪ Should the economy deteriorate significantly in coming months, a further 25bps rate cut is likely by 3Q15. Rate cuts will be modest and restrained on account of the BOK's concern over the elevated levels of household debt in Korea.
Malaysia	3.25%	3.25%	▪ Malaysia stands ahead of the curve with no change expected in its policy rate as GDP and inflation remain on target barring political risks. ▪ Inflation is expected to rise due to the impact of GST. Growth will moderate as private consumption loses some momentum but will be supported by a steady rise in income and employment.
Philippines	4.00%	4.25%	▪ The policy rate is behind the curve. A 25bps hike is likely by end-2015. ▪ The central bank stated that inflation expectations remain within the Central Banks target band of 2-4%. However, risks to inflation remain in the expanding economy.
Singapore[1]	N.A.	N.A.	▪ Central bank will maintain its policy of a modest

[1] Singapore targets the nominal exchange rate (SNEER) instead of interest rate. In Chart 7, we use year on year growth in SNEER as a proxy for interest rate in order to estimate the Taylor Rule.

			and gradual appreciation of the Singapore Dollar trade-weighted index policy band. After the unexpected easing in January 2015, the MAS is reluctant to make further changes to policy. ▪ However, as the economy weakens under the impact of a deflating real estate sector and the headwinds of domestic restructuring, the chances of further easing will depend on the strength of global recovery and how well it translates into stronger demand for Singapore exports.
Taiwan	1.875%	2.125%	▪ Exports have slowed but consumption increased on the back of low oil prices. ▪ The negative output gap, mild inflation outlook and lingering uncertainties in the global economy will keep rates unchanged until the Fed raises rates, since the TWD is tied to the USD.
Thailand	1.75%	1.50%	▪ Thailand's economic prospects continue to decelerate. Fiscal disbursements are delayed, exports and inflation are in negative territory. ▪ The central bank has cut rates twice in 2015 already, and is likely to cut once more this year.

Chart 1: China

China is behind the curve

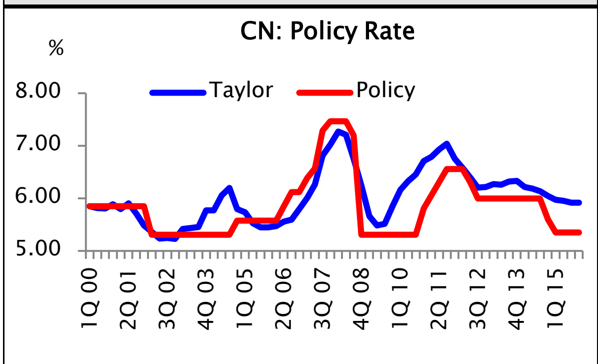


Chart 2: India

Rate cut expected sooner than later

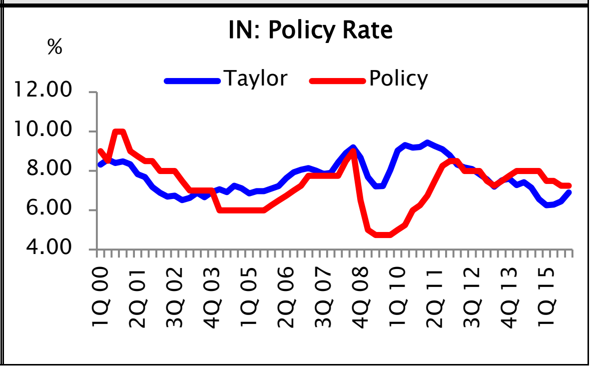


Chart 3: Indonesia

Rigorous policy, little room to ease

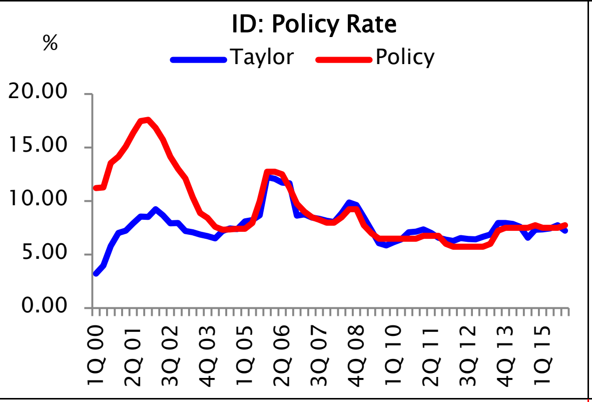


Chart 4: Korea

Korea on a easing path to spur growth

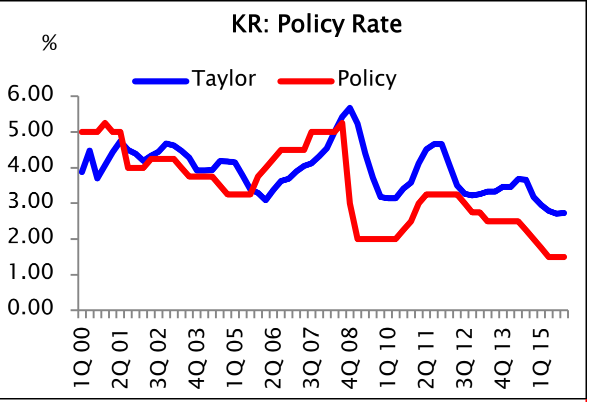


Chart 5: Malaysia

Malaysia ahead of the curve

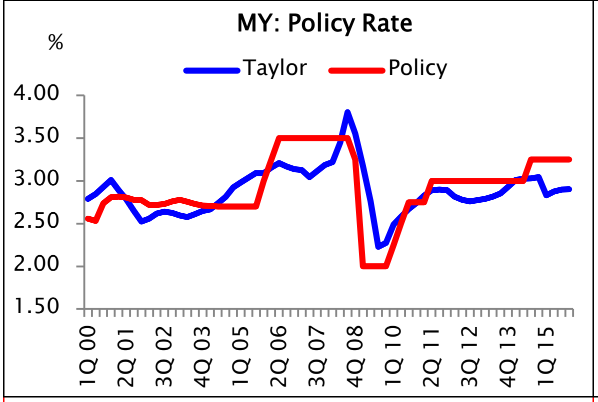


Chart 6: Philippines

Raise rates sooner than later

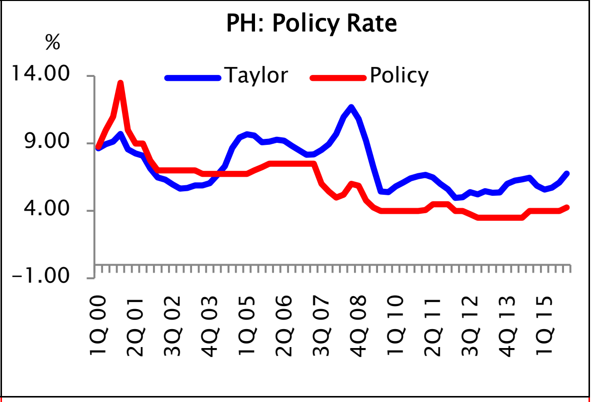


Chart 7: Singapore

Will stand pat on monetary policy

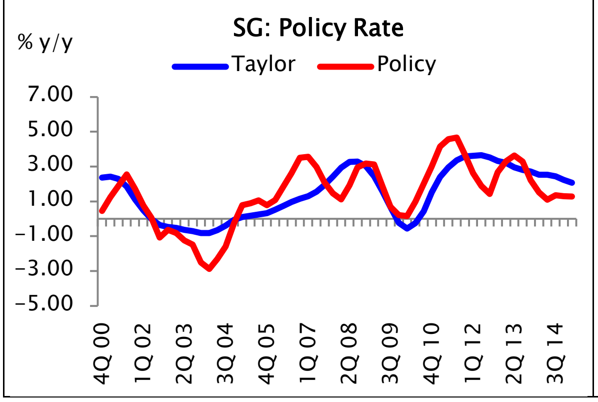


Chart 8: Taiwan

Maintain rates unless growth falters

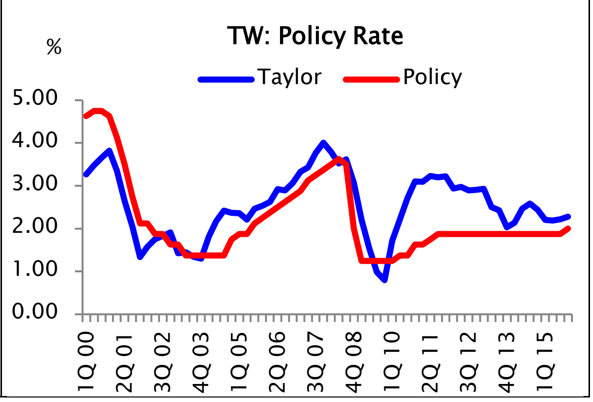
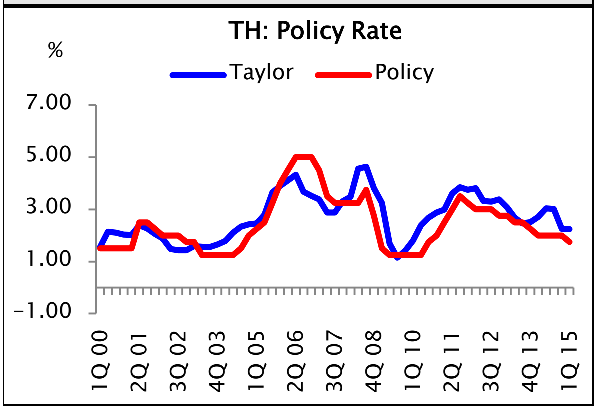


Chart 9: Thailand

Could cut rates further if economy cools



Source: Calculated by Centennial Asia Advisors using CEIC Database

China: downside risks persist

The slew of economic data released by China in the middle of May painted a picture of widespread torpor in the domestic economy. Virtually all economic indicators either 1) fell short of expectations; or 2) decelerated sharply; or 3) languished in negative territory. Many indicators were also at multi-year lows. (See Table 1)

Table 2: Broad-based deceleration in the Chinese economy

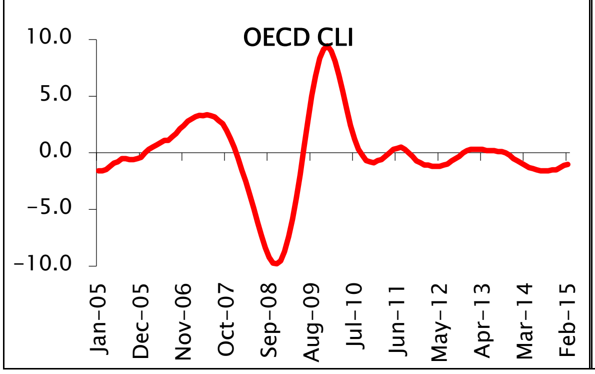
Economic indicator	Jan 15	Feb 15	Mar 15	Apr 15
HSBC Manufacturing PMI	49.7	50.7	49.6	48.9
Industrial output (% y/y)	6.8	6.8	5.6	5.9
Exports (% y/y)	-3.3	48.3	-15.0	-6.5
Retail sales (% y/y)	N.A.	N.A.	10.2	10.0
Fixed asset investment (ytd) (% y/y)	14.4	14.4	13.8	12.3
Money supply M2 (% y/y)	10.6	11.1	9.9	N.A.

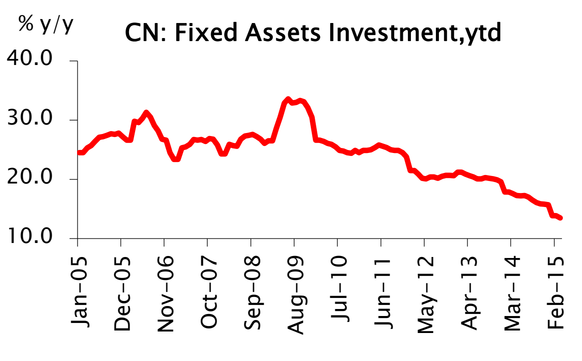
Source: Collated by Centennial Asia Advisors using CEIC Database

- **Dim outlook for manufacturing and exports**: The combination of a real effective exchange rate that has appreciated 12.3% over the past 12 months and lacklustre global demand has taken its toll on exports, with particular damage being done to manufacturing activity.
- **Consequently, manufacturing extended its slide** as new orders shrank, pulling the HSBC Manufacturing PMI down to 48.9 in Apr 15, the second consecutive month of sub-50 performance. Not surprisingly, industrial output only improved marginally in April 2015, after recording its weakest growth since 2008 in March 2015.
- **Retail sales were at a nine-year low,** rising by just 10.0% y/y, the slowest since Feb 06, a puzzle given the still-firm labour market and continued rise in wages and employment. The loss of momentum in consumer spending will make government efforts to spur demand and transition to a consumption-led economy even more difficult.

- **Fixed asset investment (FAI) lowest since end-2000**: While government infrastructure investment in rail and highways has boosted FAI, the downturn in the property market has dragged FAI down to its lowest growth since 2000.
- **Growth in money supply M2 has also fallen to a record low**, despite the central bank's easier monetary policy which has yet to spur credit growth, partly due to the uncertainty going forward, as well as the debt overhang. Possibly, funds have been diverted to speculative activities in the rapidly advancing stock market in China, instead of being channelled to productive activities in the real economy.

Chart 10	Chart 11
Lead indicator shows negative momentum	FAI decelerating relentlessly





Source: Calculated by Centennial Asia Advisors using CEIC Database

Sliding growth prospects has prompted the central bank to act

- **Waves of monetary easing**: The People's Bank of China (PBOC) is shifting away from its cautious monetary policy to a more active one, combining rate cuts with lower bank reserve ratios. The benchmark interest rate has been slashed three times in six months, from 6.00% prior to November 2014 to 5.10% currently.
- **Alleviating the burden of local government debt**: The PBOC has also taken control of the RMB1tr debt swap, which aims to ease financing conditions of heavily indebted local governments through the swapping of local government bonds with the central bank.
- **More policy easing is expected**: More aggressive easing measures are likely, as the economy looks set to fall short of Premier Li Keqiang's 7% target for 2015. The government is also expected to ramp up spending on large-scale infrastructure projects.

Assessment: Downside risks to growth persist

As the economy shifts from investment-led, export-fuelled growth to a more sustainable consumption-driven growth, it is inevitable that economic growth will decelerate. Short-term pain stemming from the economic restructuring will ensue, as the economy embraces its "new normal" of quality growth instead of growth in copious quantities.

- **First, while required for long-term viability, economic reforms are inflicting short-term pain on the economy.** Supply-side structural reforms to boost investments in innovative industries, support SMEs and build infrastructure have been ongoing. As the supply of migrant workers has slowed, reflecting a structural demographic change, the next stage of growth must wean the economy off an unhealthy dependence on an influx of cheap labour from rural areas and aim to optimise growth through the harnessing of innovation and technology in a shift up the value chain.

- **Second, the strong renminbi will continue to hurt exports.** PBOC Vice Governor Yi Gang stated that the RMB trading band will not be altered. China want to demonstrate a stable currency as it bids for the RMB's inclusion into IMF's Special Drawing Rights.

- **Third, the policy transmission mechanism for monetary policy seems to be ineffectual.** The failure of monetary easing so far to boost credit growth suggests that demand for credit has slackened as businesses realise that over-capacity means that less investment is needed.

- **Fourth, new sources of growth must be unearthed in order to maintain long-term economic success.** In recent months, China has unilaterally advanced regional economic cooperation agreements in a bid to unearth new sources of growth. China has rolled out ambitious plans such as the One Belt, One Road (OBOR) initiative which will connect Asia to Europe through overland and sea channels, with China acting as a key node in the trade routes. Complementing the OBOR is the creation of the Asian Infrastructure Investment Bank (AIIB) aimed at plugging the infrastructure gaps in developing Asia. The AIIB is seen as a viable way for China to productively invest its immense foreign reserves under the aegis of a multilateral institution. It is also hoped that the increase in infrastructure investments and subsequent connectivity will grow the demand for China's capital goods.

- **Fifth, easy money has inflated asset markets and could result in financial dislocation.** Monetary easing through lower interest rates and less stringent lending conditions has driven up both the property and equity markets. While the property market has corrected to a small extent, the bubble continues to inflate in equities. The Shanghai Composite Index has doubled over the past 12 months and continues to assume an upward path. Already, irrational exuberance has gripped investors, with margin financing increasing exponentially, and funds being diverted from productive investments to speculative punts in the stock market. This is a pertinent risk as frothy stock market presents real risks of financial turmoil when the bubble eventually bursts. The fallout will then negatively impact private consumption and depress business conditions.

Disclosures

This document is not research material.

Centennial Asia Advisors Pte Ltd (the "Company") is incorporated in Singapore as a Private Limited Company.

This document is being distributed for general information and is for general evaluation only.

It does not constitute a recommendation, solicitation to enter into any transaction or adopt any hedging, trading, investment or business strategy.

It does not take into account the specific investment objectives, financial situation, particular needs of any particular person or class of persons or organisation.

Opinions, projections and estimates are solely those of the Company as at the date of this document and may be changed without prior notice or explanation. Past performance does not guarantee or predict or indicate future performance. No representation or warranty is made regarding future performance. Any forecast contained in this document constitutes an opinion only.

The Company makes no express or implied representation or warranty of any kind regarding, but not limited to, the accuracy of this document or the completeness of any information contained or referred to in this document. This document is distributed on the express understanding that, whilst the information in it is believed to be reliable, it has not been independently verified by us. The Company accepts no liability and will not be liable for any loss or damage arising directly or indirectly (including any loss, damage or expense arising from, but not limited to, any defect, error, imperfection, fault, mistake or inaccuracy with this document, its contents or associated services, or due to any unavailability of the document or any part thereof or any contents.

This document must not be forwarded or otherwise made available to any other person without the express written consent of the Company.