WEEKLY INSIGHTS
25 May 15

China: Growing cyclical risks
Thailand: Political uncertainty still a drag on economy
Malaysia: The 11th Malaysia Plan

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Growing cyclical risks in China

- **Broad-based slowdown**: Flash Manufacturing PMI showed output contracting and new orders falling. Investment growth was the lowest in 15 years while the 1Q15 balance of payments deficit of USD80bn resulted from a record quarterly net capital outflow offsetting a huge current account surplus.
- **Policy shift focuses to cyclical risks**: The severity of the cyclical downturn has prompted policymakers to turn their sights on spurring cyclical growth drivers, and could distract from the long-term economic restructuring.
- **Growing external risk**: The investment rate is likely to decline faster than the savings rate, meaning that China's current account surplus could rise substantially, which could prompt a backlash from the US and other deficit countries.

Thailand: Political uncertainty likely to worsen, hurting economic recovery

- The contentious nature of the draft Constitution has unified political parties, academics and the media in their opposition to the new charter. The junta has therefore conceded a referendum but this means delaying elections and a return to constitutional normalcy.

Malaysia: The 11th Plan – modest aspirations, key is execution

- The 11th Malaysia Plan (11MP) was released last week with a central focus on taking the country across the high-income status threshold by 2020. Aiming for 5%-6% growth a year until 2020, the Plan correctly makes raising productivity growth a centrepiece of its strategy while also emphasising boosting consumer spending and investment.
- The key assumptions in the Plan are sensible and it is cautious about how much support the Malaysian economy will receive from export demand. However, the lack of detail on key aspects such as how to improve human capital leaves observers unsure as to how effective the Plan is likely to be.

Key Drivers of Asian Economies

Variable	Development/Assessment
Mixed developments in global economy	
US economy	Data points to potential upside surprise ▪ **Lead indicators rising**: The composite lead indicator surged 0.7% in April, its fastest rise since Jul 14. Other forward looking indicators also rose: housing starts boomed, rising 9.2% y/y in Apr 15, up from a decrease of 2.5% y/y in Mar 15. ▪ **But current indicators weak**: Industrial production fell 0.3% in April, with manufacturing output flat. Capacity utilisation weakened to 78.2% in Apr 15, from 78.6% in Mar 15. The Markit flash Manufacturing PMI fell to 53.8 in May 15 from 54.1 in April.

Variable	Development/Assessment
	▪ **Inflation was well-behaved** at just 0.1% m/m in April. Core inflation (ex-food/energy) rose to 0.3%, the highest rate in several months.
US Federal Reserve Bank Policy	Rate rise in September now highly likely ▪ Federal Reserve Chair Yellen gave the clearest indication of the likely trajectory of monetary policy normalisation. She sees the economy picking up after the recent weakness which she ascribed to transient factors and statistical noise. Thus, she argued that a rate rise was appropriate sometime this year. However, because US growth will remain restrained, the pace of normalisation would be slow and it would be many years before Fed policy rates returned to normal. ▪ At their April meeting, the majority of the Federal Reserve's policy making committee, the FOMC, remained reluctant to signal an imminent rate rise because of downside risks from Dollar strength, depressed capital spending in the oil sector and the labour market losing momentum. However, they also believed that inflation would move gradually back to their 2% target. A minority of members still argued for a June rate increase. ▪ Implications: The strength of the lead indicators and continuing strength in labour markets and access to credit persuade us that US growth will shake off its first half torpor to produce a sharp upside surprise from early 3Q15 onwards. When that happens, financial markets will recalibrate expectations of FOMC policy abruptly causing significant volatility in financial markets.
European recovery	Eurozone, UK recovery on track but muted ▪ Eurozone manufacturing activity expanded, offset by slower services. The flash manufacturing PMI edged up to 52.3 in May 15 from 52 in Apr 15, while the flash services PMI dropped to 53.3 in May 15 from 54.1 in Apr 15. ▪ Eurozone inflation was flat in Apr 15 from a year ago after a 0.1% y/y decline in Mar 15. Its trade surplus increased to EUR23.4bn in Mar 15 from a revised EUR21.4n in Feb15. ▪ The UK experienced outright deflation for the first time in 50 years. CPI fell 0.1% y/y in Apr 15. Retail sales in the UK are starting to pick up as it grew 4.7% y/y in Apr 15 after expanding 4% y/y in Mar 15.
Japanese economic rebound	GDP growth remains weak but manufacturing activity strengthens ▪ GDP expanded 0.6% q/q but fell from a year ago, weighed down by the sales tax rise in Apr 14. Worryingly, Japan's economy would have been flat if not for higher inventories which contributed 0.5% to GDP. ▪ The flash PMI was at 50.9 in May 15 from 49.9 in Apr 15 as higher domestic and external demand boosted output and new orders. ▪ Bank of Japan left its monetary stimulus unchanged despite the weak underlying inflation but BOJ Governor Kuroda left the door open for

Variable	Development/Assessment
	further easing measures.
US: Trans-Pacific Partnership	President Obama closer to securing trade promotion authority ▪ The Senate passed the Trade Promotion Authority (TPA) bill 62 to 37. Most Republicans but just 14 Democrats supported it. The bill is now with the House of Representatives, where resistance to it is high. ▪ The debate on TPA showed a worrying polarisation within Obama's Democratic Party. Obama will have to lobby hard in order to ensure passage in the House. ▪ Implications: Other negotiating countries will wait for TPA to be passed before revealing final bargaining positions. We remain confident that TPP can be sealed before the end of this year.
Greece: looming crisis	Greece's talks with its creditors reaching critical point ▪ Talks between Greece and its creditors have made little progress over Greece's insistence on rolling back agreed labour and pension reforms. Greek Prime Minister Alexis Tsipras continues to play brinksmanship with his letter to IMF chief, Christine Lagarde, warning of a default causing alarm while others saw it as a feint to scare creditors into making concessions. ▪ Implications: The Greek imbroglio is reaching a crisis point as Greece has substantial payments due 5th June which it simply cannot make on its current resources without creditors extending further support. The general assumption in financial markets that there will be a last-minute compromise that avoids a full-blown crisis is probably correct but the risks of miscalculation remain high.
Policies in Asia	
China's economy and policy response	Policy shifting from structural reforms to cyclical growth concerns ▪ China's flash manufacturing PMI stood at 49.1 in May 15, up from 48.9 in Apr 15 but still in contractionary territory. ▪ See below for extended discussion
Indonesia: external vulnerability	Indonesian monetary policy constrained by external concerns ▪ Despite weak 1Q15 GDP numbers, Bank Indonesia (BI) left its key benchmark policy rates unchanged. BI governor Agus Martowardojo explained that the weak currency and the likelihood that the current account deficit will widen again required rates to be kept high for now. Rising troubles in other large emerging economies such as Brazil where last week saw the Real under more pressure make investors nervous about Indonesia. ▪ Implications: BI is correctly prioritising external resilience over growth. Given the growing likelihood of a Fed rate rise by third quarter, continuing challenges in other large emerging economies and the recovery of the US Dollar, which has caused the Indonesian Rupiah to weaken again, this is appropriate.

Variable	Development/Assessment
India seeks to placate foreign investors	New Faces to Deal with Controversial Minimum Alternate Tax (MAT) ▪ The recent re-interpretation of the MAT aroused concerns of foreign investors that, despite Modi's reform efforts, tax policy remained unpredictable and that bureaucracy remained hostile to them. ▪ The government has held off applying MAT to foreign gains from April 2015 onwards. It has now appointed a committee led by former judge A P Shah to examine ways to resolve the controversy. ▪ Assessment: We are confident that the issue will be resolved and a more certain investing environment created for foreign investors. Modi and his cabinet realise that their ambitions for Indian resurgence will be compromised if they fail to do this.
Political developments in Southeast Asia	
Indonesia – New KPK Selection Committee	Jokowi attempts to regain reform momentum ▪ President Jokowi has appointed nine new members of the Corruption Eradication Commission (KPK) selection committee. All are known for their professional integrity while being free from political affiliations. ▪ Assessment: Jokowi is likely to succeed in re-establishing the KPK's credibility. A cabinet reshuffle in late July, after the fasting month to remove poorly performing ministers will demonstrate his decisiveness, and allow him to re-assert his damaged authority.
Philippines – Mindanao peace accord making progress, slowly	Passage of BBL advances Mindanao peace ▪ The House Ad Hoc Committee voted 50-17 to approve the draft of the Bangsamoro Basic Law which will formalize the creation of a new political entity. The measure now goes to House committees, and then to the full House for debate and approval. ▪ Assessment: Passage of the Bangsamoro Basic Law is crucial to seal the peace accord ending a conflict which killed over 120,000 people and which made it difficult to exploit Mindanao's massive agricultural and mineral riches. Peace will make the region a powerful new driver of growth for the Philippines.

Growing cyclical risks in China

Chinese factory activity corroborated the view of a persistent and widespread deceleration shown in the previous week's slew of disappointing data. The PMI figure stood at 49.1 in May 15, marginally stronger than April's 48.9 but still suggesting contraction. The output sub-index languished in negative territory for the first time in five months, registering at 48.4 – the worst in 13 months. New orders have also decreased at an increasing pace – a worrying sign that industrial production will continue to lose momentum.

Data released in Apr 15 had shown that Chinese investment growth fell to the lowest in nearly 15 years.

China also registered a balance of payments (BOP) deficit of USD80bn in 1Q15, reflecting the largest quarterly net outflow on record. China's trade surplus remained robust over the first three months of 2015 – the current account surplus stood at near five-year high of USD79bn. However, this growing surplus is attributed to exports decreasing at a slower pace than imports in recent months. The fall in imports can be traced to declining confidence in future economic performance. President Xi's crackdown on corruption has adversely impacted business confidence, resulting in declines in imports of capital goods.

Table 1: China's trade performance in 2015

% y/y	Jan-15	Feb-15	Mar-15	Apr-15
Exports: fob	**-3.3**	**48.3**	**-15.0**	**-6.5**
Food and Live Animals	-6.0	54.4	-19.3	-8.2
Beverages and Tobacco	0.2	42.7	22.6	25.8
Crude Materials, inedible, except fuels	-13.3	44.6	-23.5	-15.1
Mineral Fuels, Lubricants & Related Materials	-18.1	-36.2	-16.4	-10.8
Animal and Vegetable Oils, Fats and Waxes	5.5	51.8	-20.9	7.7
Chemical and Related Products	0.7	36.7	-9.8	-6.1
Manufactured Goods	4.3	82.3	-19.8	-5.7
Machinery and Transport Equipment	-1.8	32.3	-7.8	-2.9
Misc Manufactured Articles	-10.0	72.3	-27.4	-13.4
Others	35.9	219.0	-3.6	16.9
Imports: cif	**-20.0**	**-20.8**	**-12.9**	**-16.4**
Food and Live Animals	-6.0	-6.3	-11.8	-2.6
Beverages and Tobacco	-26.8	-26.8	-26.9	74.7
Crude Materials, inedible, except fuels	-29.8	-28.8	-23.7	-29.4
Mineral Fuels, Lubricants & Related Materials	-42.7	-39.6	-35.8	-39.1
Animal and Vegetable Oils, Fats and Waxes	-29.3	-56.7	-32.9	-18.1
Chemical and Related Products	-20.5	-24.1	-2.4	-8.9
Manufactured Goods	-19.3	-31.4	-16.3	-14.4
Machinery and Transport Equipment	-4.3	-2.6	-2.4	-8.3
Misc Manufactured Articles	-4.1	-1.2	1.1	-8.4
Others	-33.8	-43.7	-15.8	15.7

Source: Calculated by Centennial Asia Advisors using CEIC database

Capital account deficit is significant: But the whopping USD159bn record deficit seen in the capital and financial accounts for 1Q15 has wiped out the record surplus accrued in the current account. According to estimates by the Royal Bank of Scotland, China has seen more than USD300bn in financial outflows from Sep 14 to Mar 15. The central bank's foreign reserves holdings have also dropped for seven consecutive quarters, the longest ever run of declines.

The outflow of funds from China can be attributed to various factors:

- **China needs to invest abroad**: At the macro level, China has been aggressively increasing its outbound investment so as to bolster its clout on the international stage. At the micro level, Chinese companies have now reached the stage where they need to expand overseas in search of greater market opportunities, to diversify their revenue drivers, and to acquire technology.

- **Capital flight**: President Xi has been deadly serious in his efforts to curb graft, even going after "tigers" including even top military leaders and once-respected heads of some of the biggest state enterprises. This has caused much panic among officials and businessmen who have made their money in illicit ways, encouraging them to push money abroad so as to hide their ill-gotten gains.

Assessment: Shift in focus towards boosting cyclical growth drivers

- While initially more focused on ensuring long-term economic restructuring, Chinese policymakers have been caught out by the extent and pace of deceleration in the domestic economy and are increasing shifting their energies to combating the short-term cyclical downshift and its debilitating effects on social stability.
- Increasingly, rumblings of social unrest have become louder; most recently, a group of more than 30 taxi drivers from Heilongjiang imbibed poison in a protest held in central Beijing. This means that as the common folk find it harder and harder to make ends meet in a downshifting economy, social stability will begin to deteriorate.
- The central bank has already taken the lead in injecting monetary stimulus with a series of rate cuts and RRR reductions, but to no avail thus far. We expect further monetary easing in the near term as Chinese officials scramble to check the down-trending economy.
- There is a risk that the increasing threat of the cyclical downturn might prompt government policy to revert to the easy path of boosting growth through debt-fuelled stimulus, foreign investments and export growth, instead of the harder and riskier process of raising productivity through human capital improvements and economic restructuring while also enhancing social safety nets to spur domestic demand.

Global implications: Burgeoning current account risks ire of the US and other trading partners

- The current account, which is also defined as the difference between the national savings and investments, is forecast to trend upwards, according to in-house estimates. Over the next five years, assuming that gross fixed capital formation continues to trend downwards at about 6% on average, national savings rate remain sticky at current levels and the nominal GDP growth stays at approximately 9% on average, the current account surplus as a proportion of GDP will grow from 2.1% in 2014 to more than 6.0% in 2020.
- With rising tensions between the two heavyweights as they jostle for regional dominance, there could be accusations of currency manipulation by the US and this may result in protectionist measures by the US on China.

Thailand: Political uncertainty still a drag on economic prospects

A year after the military coup that toppled the democratically elected government of Yingluck Shinawatra, the country is peaceful and the economy is beginning to recover. However, the underlying political malaise has yet to be resolved, with the political calm relying excessively on the government's tough security crackdown. The junta has produced a draft of a new constitution which will now go to the people for a vote but its restrictive clauses appear to create a semi-democracy which is a disappointment to many across the political spectrum. Despite signs of recovery in the economy, this remaining political uncertainty is clearly holding back a stronger rebound. The Thai economy continues to languish in the doldrums – weakening exports, lagged fiscal disbursements, and tepid domestic demand due to the fall in farm incomes and the household debt overhang – appear to be beyond the military government's ability to turn around.

The draft Constitution has polarised opinions and could spell trouble ahead

The Constitution Drafting Committee (CDC) has written a draft Constitution whose approval by the National Reform Council (NRC) is a precursor to holding democratic elections in the country. However, the contentious nature of the draft charter has unified major political parties, academics, and the media in their criticism of and opposition to the Constitution.

- **An unelected Prime Minister**: The new charter allows for the Prime Minister of Thailand to be appointed, which means that he or she need not be an elected Member of Parliament (MP). According to a nationwide survey by the Office of National Statistics, 70 percent said they did not want a non-elected PM. With this clause, the current government is probably looking for a candidate who they can trust, instead of leaving it to politicians, a class which the establishment has a deep-seated distrust of.
- **A mixed-member proportional (MMP) representation system**: The CDC has mooted a new electoral system, in the mould of Germany's political system. The MMP representation electoral system will prevent large parties dominating the Parliament and accord more weight to smaller parties. However, the fear is that when brought into the context of Thailand, weak governance will ensue due to the formation of weak coalition governments made up of multiple partners.
- **A Senate with a majority of appointees**: Additionally, a majority of senators will be appointed (77 elected, 123 appointed) in the new 200-member Senate. Politicians view this as a diminishing of political power and the strengthening of unchecked executive clout.

Assessment: Referendum or not, political tensions are rising, again

Political observers across the spectrum are finding it hard to accept this draft Constitution, which they feel gives excessive power to the old establishment and reflects a clear distrust of democratic politics. Our concern is that the Constitution could culminate in more rather than less political contention:

- **The draft Constitution could lead to confrontations** between pro-democracy supporters and the government: the political parties have lain low since the coup, hoping that they could make a comeback when elections are finally held. Now as the new constitution seems to entrench the old establishment in power and sideline traditional politicians of all colours, the pro-Thaksin factions in particular may feel that there is less to lose by switching to a more aggressive and perhaps even violent strategy to confront the junta.

- **A referendum will extend political uncertainty**: While PM Prayut has explicitly stated that a referendum to allow the masses to vote on the draft Constitution is not a sure thing yet, the Cabinet has agreed to a referendum to accord legitimacy to the charter. Yet, should a referendum be called, this will lengthen the roadmap to democratic elections by three months and prolong the timeframe for elections to May 2016, further perpetuating the uncertainty which has clouded economic growth. Should the draft be accepted, political parties will be up in arms over their diminished role and further struggles will lie ahead, especially if Thaksin mobilises the support of the Red Shirts. Should the draft be rejected, the pro-establishment Yellow Shirts could emerge to bolster support for the current government.

All scenarios point to greater tensions among the military government, political parties and the masses in the next 12 months. The potential political dislocation will continue to cloud the outlook for Thailand and crimp the current government's ability to react to short-term economic shocks. Investors and businesses have been and will continue to hold off large-scale investments and sit on the sidelines as the political gyrations play out.

Malaysia: A review of the 11th Malaysia Plan

Malaysia released its 11th Malaysia Plan (11MP) - set to run from 2016 to 2020 - with development aims outlining Malaysia's road to achieving high-income status by 2020. With 2020 inching closer, it is crucial for plans going forward to be transformative - an aspect clearly lacking in the 11MP. The newly released plan, while sizeable, merely expands and builds upon targets met in the 10th plan.

Assessment: are proposed growth drivers realistic?

The plan aims for economic growth of 5%-6% annually. Taking a closer look at the proposed growth drivers, we assess the possibility of achieving the hyped 2020 target.

- **Private consumption and investment are to be the key driver**: We took a closer look at private investment in Malaysia, tracking it back to the 1990s, where it hit a high of around 30% of GDP in 1995, compared to the 16.7% of GDP at which private investment now stands. Private investment's contribution to GDP is hoped to reach 20% by 2020. The 11MP however, does not detail complementary policy and regulatory changes to improve Malaysia's enabling environment.

- **Unlocking productivity as a basis for sustained economic growth**: The plan seeks multi-factor productivity (MFP) to contribute 40% of the increment in GDP, while the contributions of capital and labour are expected to fall to 44% and 16% respectively. The reduced dependence on inputs from capital and labour are somewhat contradictory as MFP combines labour, capital, land and intermediate inputs – thus placing higher expectations on land and intermediate inputs to make up the slack.

- Despite plans to accelerate human capital development, Malaysian schools and universities are falling in standard and the move away from English-medium education has exacerbated the quality of human capital.
- There has been another noticeable trend in Malaysia's tertiary education system: regulations prohibiting more public universities in Malaysia have been complemented with the government offering student loans. Fresh graduates will enter the workforce in debt, which is more likely to promote a savings culture rather than driving growth through private consumption – a clear fault and mismatch of policies.

- **Services and exports**: Service sector contribution to GDP is expected to increase from 53.8% in 2015 to 56.5% in 2020. The growth thrust will be underlined by service sector shifts to modern services – Islamic finance, ecotourism, ICT, halal industry and oil and gas. Coupled with this, the plan also outlines hopes for increased exports to improve the trade balance. With no mention of the TPP or plans to regulate consequent flows from thrusts in exports and services, it is questionable if the shift to modern services is enough to bridge the gap between middle-income and high-income status for Malaysia.

- **Enhancing fiscal flexibility**: Of the growth drivers, our positive outlook remains limited to Malaysia's fiscal consolidation. Earlier revisions to the budget and further efforts will ensure the government enough room to manoeuvre in light of risks to its economic health from global volatility.

- **Income growth** also deserves mention. The government has shifted its inequality approach, now looking at relative poverty with measures to boost the bottom 40% of the population. Narrowing the income gap is crucial to achieving high-income status however we are yet to see how this pans out in a society where income has always been concentrated amongst the top 10-20% of the population.

While Malaysia posted 5.6% growth in 1Q15, the plan's central focus on achieving high-income status through the laid out growth drivers and increasing average household income looks unrealistic without addressing development as a whole. With 1MDB and political malaise continuing to plague the Malaysian economy, we believe measures to address governance and transparency will be key alongside economic strength in order to take the country to its envisioned developed status.

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