WEEKLY INSIGHTS
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Forecasting global growth: Our lead indicator for a lead indicator
South Korea: Fragile economy made weaker by the MERS outbreak

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Lead indicator for a lead indicator

- The OECD's Composite Leading Indicator (CLI) is a reasonably good predictor of global economic activity. Centennial has developed a measure, the Global Excess Liquidity (GEL) indicator, which we find is a predictor of turning points in the OECD CLI. While the GEL does not pinpoint the magnitude of change, it proves to be a good indicator of the direction of the OECD CLI.
- The GEL provides additional confirmation of a pickup in the global economy in 2016.

South Korea: MERS outbreak brings out the vulnerability of the economy

- The outbreak of MERS has intensified an economic downturn in Korea that has already been evident in weak consumption and exports. Now, tourism has also fallen and the gloomy outlook has caused the government to slash the growth forecast for 2015.
- The slowdown in China and the weak recovery in the Eurozone have knocked exports which have contracted for five consecutive months and by double-digits in May 2015. The relative strength of the won has also done export competitiveness no favours, either.
- Policy makers have reacted swiftly. Monetary policy has been eased four times in less than a year by the central bank while the government has announced a massive fiscal stimulus.
- However, the downside risks are aplenty as the turbulence over Greece shows. High levels of household debt constrain further room for monetary stimulus. The impending Fed hike may cause financial volatility to spike while the lack of a strong political consensus on key issues may also compromise economic confidence.

Key Drivers of Asian Economies

Variable	Development/Assessment
Greece: financial markets in uncharted territory	
Eurozone: Greece in crisis	<u>Massive uncertainty in Eurozone transmitted to emerging markets</u> ▪ Greek Premier Tsipras rejected the final offer from Greece's creditors, thereby ending the last hope for an orderly resolution of disagreements over conditions imposed by creditors on Greece. Tsipras has now called a referendum for 5th July on whether Greece should accept the creditors' demands, vowing to campaign against a Yes vote in favour of the creditors' proposals. ▪ The European Central Bank then announced limits on its funding support for Greek banks. As Greeks rushed to withdraw their savings from banks, the Greek authorities shut banks down till after 5th July, imposed limits on cash withdrawals from ATMs and selective capital controls to prevent funds from flowing out of the country. The Greek economy is now likely to grind to a halt. ▪ **Implications:**

Variable	Development/Assessment
	▪ In early Monday trading, financial markets are down but the falls have been contained, suggesting that investors still think that the worst effects can be contained. In coming days, that assumption will be severely tested. ▪ The simple fact is that financial markets are in uncharted territory – there is no precedent or even legal channels for a country to exit the Eurozone. There is no clarity as to how the referendum will go, even whether it will even be held. While commentators can make their best guesses as to how things will pan out, no one really knows. That makes financial markets nervous and highly risk averse, meaning that emerging market assets of all kinds will remain under pressure. ▪ In Asia, the vulnerable countries remain those with stubborn current account deficits, a history of financial and monetary weaknesses, governments whose policy directions are unclear or where there is substantial political uncertainty. While there will be some pressure on the Indonesia Rupiah and the Malaysian Ringgit, we believe that these pressures can be contained.
China: monetary easing is a sign of weakness	
China's economy	<u>Weekend rate cuts reflect worsening in China downside</u> ▪ The People's Bank of China cut the one-year lending rate by 25 basis points to 4.85%. In addition, it reduced reserve ratio for selected banks by 50 basis points. These moves are not surprising given the worsening downside risks as shown by recent data as well as the sharp fall in equity prices on Friday. ▪ **China Containerised Freight Index** fell to 862 at the start of Jun 15, 17% lower than during the Asian crisis in 1998, indicating a deep decline in demand for Chinese manufactured goods. ▪ **The Entrepreneur Confidence Index** stood at 58.3 in 2Q15, down 0.9 points from 1Q15, falling 6.6 points y/y. ▪ **PBOC's loan demand index** fell to a record low of 60.4 in 2Q15 following 68.8 in 1Q15, with the sub-index for manufacturing loan demand registering its worst ever reading. ▪ The equity bull market has reversed, with stocks down almost 20% from its peak in mid-June. ▪ Yet, the **China Beige Book** was inexplicably more positive, suggesting a broad based recovery with a resurgence in the property sector. **Implications**: **Our take is that risks are weighted to the downside.** ▪ Diminished entrepreneur confidence in the economy could hurt investment demand and since investment was around 47% of GDP in 2014, this could undermine growth severely. ▪ Lower loan demand means that the central banks' monetary easing may not be as effective in spurring growth as in the past.

Variable	Development/Assessment
	▪ Fiscal stimulus and the easing of macro-prudential regulations are likely to be needed soon.
TPA passage means TPP will go ahead	
Trans-Pacific Partnership	US Congress passes the TPA bill, brings TPP to the next level ▪ The Senate passed the Trade Promotion Authority (TPA) bill 60-37, completing the legislation needed to give President Obama fast track authority to negotiate trade agreements without intrusive Congressional involvement. ▪ **Implications**: Passage of the TPA is a momentous step. Japan and the US are now likely to complete their TPP negotiations: tricky areas between the US and Japan such as farm subsidies and the opening up of the agricultural sector in Japan still remain, but we think that the Japanese government will eventually strike a deal. ▪ Then the other countries involved (Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam) will have to decide whether to go ahead or pull out. We think there is a risk that Malaysia could pull out of the TPP process, as the embattled Premier Najib Razak might judge that domestic political opposition to TPP would be just too great.
A new growth story emerging in Japan	
Abe's new growth and fiscal strategy	Abe's new plan banking on growth rather than fiscal cuts to curb debt ▪ Abe opted to depend on economic growth rather than aggressive expenditure cuts to attain fiscal sustainability. The government will limit annual increases in spending but Abe is really counting on growth above 2% to reduce the primary deficit to 1% of GDP by 2018. Abe also reiterated his goal of hitting a budget surplus by 2020. ▪ **Implications**: Many commentators criticised Abe's target of 2% growth as unrealistic. Whatever the feasibility of the growth target, it is also clear that if Abe does not have the stomach for strict fiscal discipline, the only way he can put Japan on a path to fiscal sustainability is through the kind of structural changes that the TPP will force Japan to undertake. That makes Japan's agreement to the changes that the TPP will demand more likely.
Japan labour market reviving	Don't under-estimate the turnaround in Japan ▪ The jobs-to-applicant ratio surged to 1.19 in May 15, the highest level in 23 years while unemployment fell to 3.32%. ▪ **Implications**: 1Q15 growth was driven primarily by an uptick in investment. With the labour market also looking healthy, consumption could recover and even spur some inflationary pressure. In addition, the Yen's weakness and the US recovery will help exports.
India: more positives	

Variable	Development/Assessment
Indian reforms	Better governance can drive growth ▪ The smack of firm government is gradually translating into economic benefits. The Modi government's more disciplined approach to state enterprises is helping Coal India, for example, to substantially improve deliveries of coal to the power sector, with theft and other leakages substantially reduced in recent months. ▪ In rural India, the introduction of "Lok Adalats" (mass courts) in May resulted in 900,000 land-related cases being resolved. The efforts have reduced backlog of cases filed, some stretching back a decade, and awarding agricultural land back to its rightful owners. ▪ **Implications**: That a few small reforms can be almost wildly effective underlines our argument that the hundreds of seemingly small-scale administrative reforms can drive growth higher in India. Over time, the benefits of many more governance reforms will be felt, and will drive growth more powerfully.
Monsoon	Rainfall higher and monsoon ahead of schedule ▪ The monsoon has covered the entire country as of 26 Jun, ahead of the normal 15 July timing. Overall rainfall is 28% above normal, defying predictions of a poor monsoon. ▪ **Implications**: If the monsoon continues at this rate, food prices will be lower and economic growth higher than expected. With less inflation risk, RBI will find it easier to ease monetary policy.
Vietnam gears up for greater investments	
Vietnam's investment	Most significant easing of business regulations in 25 years ▪ A rash of deregulation measures and the accelerated sale of state owned firms will substantially improve the attractiveness of investing in Vietnam. ▪ The nation's economic situation looks encouraging given that inflation has remained very much under control and GDP expansion is forecasted at 6.11% y/y for 1H15 – a growth rate not seen since 2010. ▪ However, until the government tackles the underlying problems of corruption, weak state banks and under-performing state-owned enterprises, the economy will not truly gain traction.
But ASEAN partners languishing behind…	
Singapore economy	Seventh consecutive month of deflation, manufacturing production weak ▪ CPI fell 0.4% y/y in May 15, the seventh consecutive monthly fall while core inflation was just 0.1% y/y, a new five-year low. The Monetary Authority of Singapore (MAS) and the Ministry of Trade & Industry (MTI) explained the limp inflation numbers as due to the impact of budgetary measures on services costs. ▪ However, non-tradable inflation (inflation in goods and services that are less subject to global market influences) fell 0.1% y/y in May 15 and

Variable	Development/Assessment
	has been negative since Jan 15, suggesting that local businesses are losing pricing power as business costs remain elevated, forcing them to restructure – downsize, relocate, reduce operating hours, squeeze their workers and suppliers or exit their businesses. ▪ Manufacturing production fell 2.3% y/y in May, the 4th consecutive monthly decline. There was weakness across the board suggesting that structural forces such as a loss of competitiveness may be at work, not just transient cyclical factors. **Implications**: ▪ The corporate restructuring is basically deflationary and reinforces our concern that the economy could be at a tipping point, especially when this deflationary adjustment is compounded by deflation in the property market. The apparent loss of manufacturing competitiveness also raises concerns about growth and possible hollowing out. ▪ The case for easier monetary and fiscal policies is becoming stronger.
Malaysian economy	<u>Prospects appear to weaken</u> ▪ The official leading index fell to 118.6 in Apr 15 from 119.3 in Mar 15. The Coincident Index, indicating current activity also surprised on the downside falling to 122.5 in Apr 15 from 123.9 in Mar 15. ▪ **Implication**: The economy will continue growing but more slowly.
Political reforms pushing on	
Jokowi opposes controversial bills	<u>Jokowi defies parliamentary majority in bid to clamp down on corruption</u> ▪ President Jokowi has spoken out against a parliamentary proposal for 'Aspiration Funds', which would provide each parliamentarian IDR20bn to spend on projects in their district. ▪ **Implications**: Jokowi's stance suggests that he will also oppose the proposed revision of the 2002 law establishing the anti-corruption commission (KPK), which would have severely limited its effectiveness. ▪ Given the strong backlash from vested interests intent on killing reforms, he needs to restore his reformist credentials through such actions, failing which there is a growing risk that his presidency could dash the expectations of voters.
Thailand: Amendments to draft constitution	<u>CDC reviews amendments to draft</u> ▪ The Constitution Drafting Committee (CDC) retained the clause permitting a non-elected prime minister. One adjustment to the constitution details the candidate having to attain votes from at least two-thirds of all MPs for his position to be secured. ▪ The clause which would have given the Prime Minister authority to implement important bills, if oppositions did not launch a no-confidence motion, was abolished. ▪ The powers of senators have been reduced, but draft charters insist that a majority of senators be indirectly elected.

Getting global prospects right: a lead indicator for a lead indicator

The OECD's Composite Lead Indicator (CLI) has become the best available predictor of year-ahead prospects for the global economy. We have found a correlation between Centennial's Global Excess Liquidity indicator (GEL) and the CLI, giving us a way to predict movements of the CLI. At the very least, we now have an instrument by which we can predict future economic movements and turning points.

CLI vs GEL

Chart 1 plots the two indicators against each other while Chart 2 adjusts the CLI by a period of 12 months – GEL data on Jan 1989 with CLI data on Jan 1990. With the introduced time-lag of 12 months, the GEL appears to be a decent predictor of the CLI with the correlation coefficient between the two indicators at 0.48[1].

Chart 1

OECD CLI vs GEL

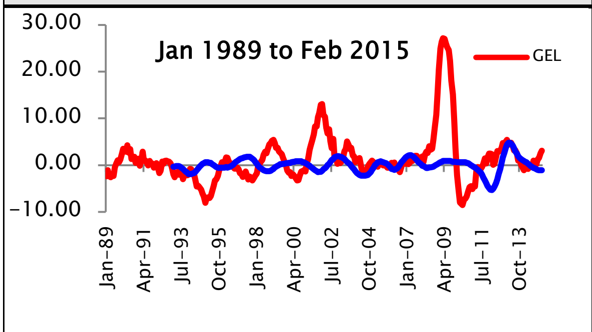
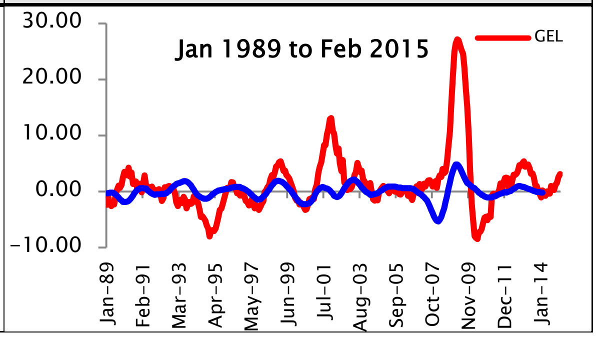


Chart 2

CLI time series adjusted by 12 months



Source: Calculated by Centennial Asia Advisors

We separately assessed 3 time periods, Jan 1989-Apr 1994[2], May 1994-Dec 2006[3] and May 2008-Feb 2014, with the most recent period, May 2008 to Feb 2014 posting a relatively high correlation coefficient of 0.74.

Mar 08 to Feb 14

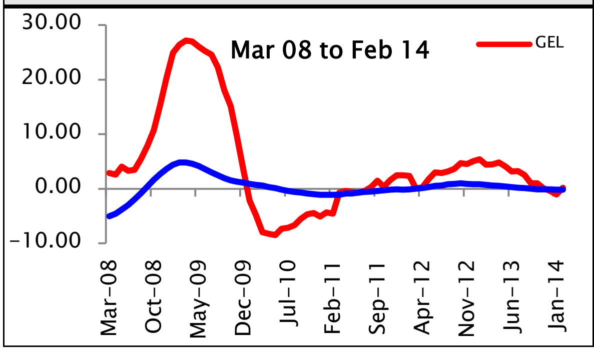
We did note weaknesses over certain periods – a negative correlation in the first period and between Jan 2007 and Feb 2008 reflecting effects from the global financial crisis – and differences in lag adjustments. However, overall we have found that the GEL remains a good indicator of the direction of the OECD CLI but not of the extent of the change. From the sharp rise in GEL we can deduce that there will be a pickup in OECD CLI and hence confidently predict a strong global economy in 2016.

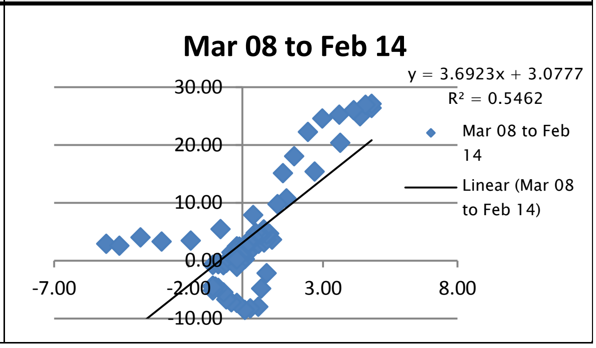
[1] Correlation coefficients have been rounded up to 2 decimal places.

[2] Jan 1989 – Apr 1994 posted a correlation coefficient of -0.59, with the GEL proving to be a poor indicator of the CLI.

[3] The correlation coefficient for May 1994 – Dec 2006 was a low 0.42, but charted results illustrating the GEL as a good indicator of the CLI's direction.

Chart 3	Chart 4
GEL a good indicator of CLI direction	Strong positive correlation between recent data





Source: Calculated by Centennial Asia Advisors

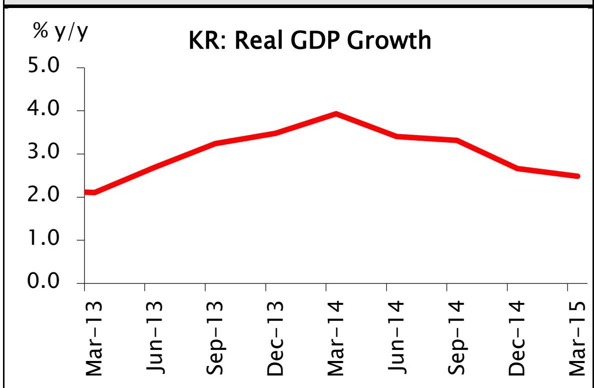
South Korea: Fragile economy made weaker by the MERS outbreak

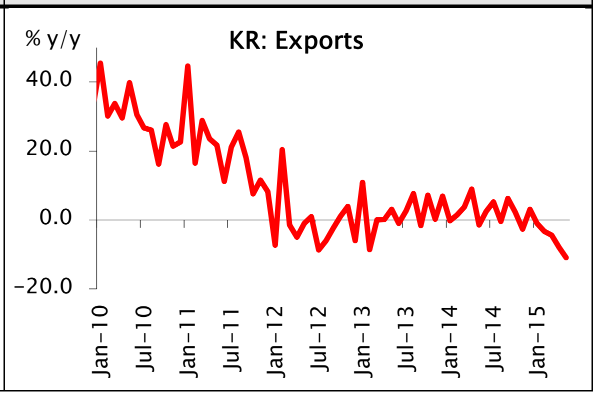
The South Korean economy is in bad shape. Consumption was hard hit by muted consumer sentiment in the wake of the Sewol ferry disaster in April last year and has barely recovered. On the external front, the export-oriented economy has been impacted by weak global demand and the strength of the Korean won. The recent outbreak of the Middle East Respiratory Syndrome (MERS) compounded Korea's problems; growth prospects are bleak.

Economy floundering on the back of weak consumption, sluggish exports

The South Korean government slashed the growth forecast from 3.8% to 3.1% for 2015. Growth prospects have been severely curtailed by a confluence of factors:

Chart 5	Chart 6
GDP is trending downwards steadily	Exports have slumped dramatically



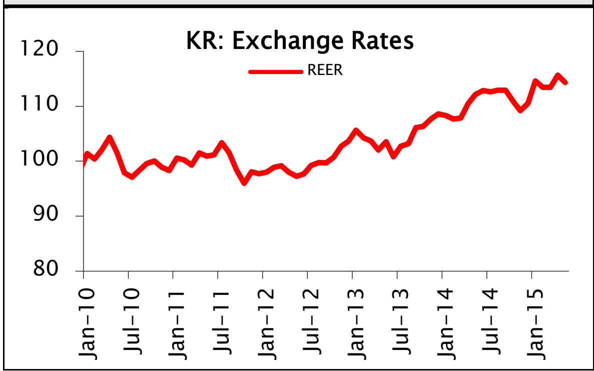


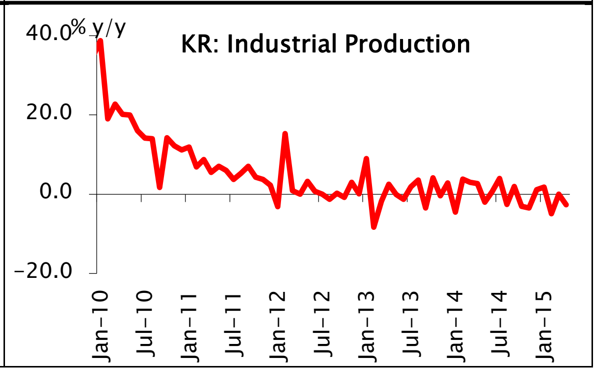
Source: Calculated by Centennial Asia Advisors using CEIC Database

- **Mediocre 1Q15 GDP growth**: Economic activity has been dampened by weak exports and the dearth of domestic demand. Consequently, the economy has decelerated and grew by 2.5% in 1Q15 – the slowest rate of growth in two years (Chart 5).

- **Consumption and tourism has been adversely affected by the MERS outbreak**: Consumer sentiment was hard hit by the Sewol ferry sinking last year and was only just recovering as the MERS virus hit the country. More than 120,000 foreign tourists have cancelled their trips to South Korea since the outbreak began on 20 May. Coupled with the tendency for consumers to stay home, the MERS outbreak has hit the already fragile economy hard. According to the Finance Ministry, department store sales fell by 17% and 9% respectively in the first and second week of June 2015 while theme parks reported markedly lower visitor numbers. This will continue to depress consumption levels in the Korean economy.

Chart 7	Chart 8
Rising REER eroding export competitiveness	





Source: Calculated by Centennial Asia Advisors using CEIC Database

- **Exports have slumped dramatically**: The economic decline was led chiefly by the sharp declines seen in export levels (Chart 6) – the country's key growth engine. The 10.9% decrease in exports for May marks the fifth consecutive month of export contraction and this does not bode well for an export-oriented economy such as South Korea. This export weakness is attributed to China's economic slowdown and the sputtering Eurozone recovery. Furthermore, the strength of the Korean won (Chart 7) has eroded the export competitiveness of Korean goods and services. The weakening of the Japanese yen due to massive quantitative easing by the Bank of Japan (BoJ) has also impacted the demand for Korean exports. This has resulted in a downtrend in industrial production (Chart 8).

Policy easing unleashed by the government to spur economic activity

Increasingly, anaemic economic conditions have intensified the pressures on the government. To their credit, the authorities have taken swift and decisive actions in implementing policy measures aimed at curbing the economy's dive.

- **Aggressive monetary easing by BOK in slashing benchmark rates**: The Bank of Korea (BOK) has been alarmed by the rate of deceleration in the domestic economy and has implemented a series of rate cuts to spur economic activity. Four rate cuts since August 2014 has led to the policy rate reaching an unprecedented low of 1.5%.

- **A fiscal stimulus of more than KRW15tr (USD13.5bn)**, including a yet undetermined supplementary budget, has been announced by the government. This stimulus package is focused on supporting MERS-hit businesses and financing local exporters, as well as propping up the jobs market, in a bid to support flagging economic growth through expansionary fiscal policy.

Assessment: Downside risks aplenty, economic performance likely tepid in 2015

The near-term economic outlook does not look rosy for South Korea with a number of downside risks.

- **There remains limited room for further monetary easing**, should the economy decelerate further on the back of exogenous shocks. Household debt stands at elevated levels – it exceeds 100% of nominal GDP – and continues to rise dangerously high as BOK cuts policy rates to unprecedented lows. The household debt overhang is a longstanding issue and has crimped consumer spending. While the surge in household and corporate debt could drive economic momentum in the short-term, this poses a potential risk to South Korea's financial stability and is an existential threat to the economy should defaults spike. Macro-prudential measures to rein in debt are sorely needed.

- **The impending US rate hike could cause financial market gyrations** and have a material impact on the real economy. As the US dollar rises in line with the expected rate liftoff, households and corporate in Korea could be exposed to higher real debt burdens and possibly trigger potential credit events.

- **Political capital for President Park is running low**: President Park Geun-hye's administration has been plagued by a series of national crises (Sewol ferry sinking, MERS outbreak) which her opponents have used to undermine her popularity. Furthermore, President Park's support is waning as she struggled to replace her Prime Minister amid fierce politicking by rival political parties. Such political infighting has undermined business confidence and could delay the onset of any recovery.

- **Structural reforms required to lift economic potential**: In the long run, what South Korea needs is to overhaul its economy and implement structural reforms to put the economy on a reinvigorated growth path. Archaic employment practices need to be scrapped while cash-rich chaebols must be compelled to stop hoarding money and distribute the cash to the rank-and-file in order to spur greater consumption and strengthen domestic demand.

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