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WEEKLY INSIGHTS
6 Jul 15

Japan is changing faster than people think – and ASEAN is a huge winner
Philippines: Weak 1Q15, but poised for strong growth

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Changes in Japan underway, with ASEAN a huge winner

- On the cyclical front, Japan is on a recovery path – the BOJ Tankan survey recorded stronger than expected results with large manufacturers and service companies all reporting an improvement in business conditions and strong investment plans.
- Other economic indicators on the whole reflected concurrent weakness but the forward looking indicators are showing an uptick in the near-term.
- A key structural change is occurring – more females are choosing to enter the workforce since 2003. On the back on "Womenomics", this trend is set to intensify. The addition of Japanese women to the workforce will likely accelerate the economic recovery.
- ASEAN stands to benefit greatly should Japan become resurgent – the ASEAN-5 countries with the exception of Singapore, plus Vietnam, ship a significant proportion of exports to Japan. Additionally, Japan contributes a sizable amount of FDI to these countries as well.

Philippines: Weak 1Q15, but poised for strong growth

- Philippines growth came in at a disappointing 5.2% y/y in 1Q15, reflecting weaknesses in export performance and below par government expenditure.
- However strong fiscal consolidation amidst strong economic fundamentals – low debt levels, strong remittances and large foreign exchange reserves – leaves ample space for fiscal injections to boost economic growth.
- With presidential elections on the horizon, sustained growth levels into the decade will largely depend on the continuation of reform efforts.

Key Drivers of Asian Economies

Variable	Development/Assessment
Greece: a lack of good options, negative for riskier Asian assets	
Greek referendum	<u>Greeks vote 61%-39% against terms of bail out</u> ▪ Clarity on the way forward now depends on the Eurozone leaders summit on 7th July and the European Central Bank (ECB)'s willingness to provide funding to Greek banks. **Implications:** ▪ Eurozone leaders will calculate the costs and benefits of conceding a large debt haircut and softer reform conditions to Greece, something that they had so vociferously ruled out. The costs of conceding would be high – loss of credibility with their own voters, weakening the disciplines which underpin the Euro and undermining governments in Spain and Portugal who had played by the Eurozone's rules. ▪ Against this are real benefits. First, a reduced chance of an outright

Variable	Development/Assessment
	and immediate loss on the huge loans extended to Greece. Second is the geo-political dimension, the need to retain Greece as part of the Western camp, something the US has been pressing the Eurozone leaders to consider. ▪ Two factors, however, complicate a rational, calculated decision. The first is European leaders' mistrust of the Tsipras government. German Chancellor Merkel's deputy, Sigmar Gabriel, who had originally been more sympathetic, reacted badly to the Greek vote, saying Tsipras had "torn down the last bridges on which Greece and Europe could have moved towards a compromise". The Dutch Finance Minister who heads the Eurogroup dealing with Greece has also put the ball in Tsipras's court. Second, Tsipras himself is in a bind: the large vote against concessions to the Eurozone creditors strengthens the extremists in his own party, limiting his room for concessions. ▪ This means that there is no good outcome. While the Eurozone leaders may buy some time by letting the ECB provide limited support for Greek banks, this will not last long. Neither side is in a mood to make the concessions needed to avoid an outright crisis. <u>The chances of a Grexit are now very high.</u> ▪ Markets are nervous and weakening but there is yet no sign of outright panic, perhaps in the hope that a compromise will be worked out and that the ECB will contain contagion through aggressive monetary actions. Asian markets will be highly vulnerable should compromise fail, with Indonesia and Malaysia most at risk.
New economic architecture taking shape in Asia	
Trans-Pacific Partnership (TPP)	<u>Obama secures Congressional support for fast track trade authority</u> ▪ With "fast track" authority to negotiate a trade treaty which Congress can only accept or reject but not amend, the other TPP members are now likely to feel confident about making their final compromises with the US, especially Japan. Once Japan and the US finalise their negotiations, the other partners will then have to decide whether or not to proceed with the TPP. While negotiations will still be fraught and domestic opposition will still have to be managed in the remaining countries, most will go ahead because the opportunity to gain access to a market equivalent to 40% of world GDP ahead of their competitors will prove too enticing. ▪ At the geo-political level, the TPP is a centrepiece of the US' pivot to Asia. Its successful passage will underline the US's continued influence in the Asia-Pacific and underlines its ability to remain a balance against a rising China.

Variable	Development/Assessment
The AIIB is formally established	<u>China wields a de facto veto in the AIIB</u> ▪ The framework for the Asian Infrastructure Investment Bank (AIIB) was signed by 50 out of the 57 prospective founding members. Beijing will not have a formal veto in the AIIB, but its 26% voting share means that it will have a de facto one in the Bank's decision making. ▪ Three ASEAN nations (Philippines, Malaysia, and Thailand) deferred their signing of the agreement because the legislative processes to enable them to sign were not in place but will do so soon. ▪ **Implications**: The official formation of the AIIB marks a significant geostrategic triumph for China as it accords China productive avenues to invest its USD4 trillion worth of foreign reserves and creates connectivity in developing Asia centred on China. Signatory nations also stand to benefit from investment opportunities and the improvements to infrastructure which could potentially boost trade and investment flows.
Overview of global manufacturing PMIs	
Manufacturing PMIs	<u>US, Eurozone looking up, weakness in China, contraction in Taiwan</u> ▪ Manufacturing PMIs for Jun 15 from the US and Eurozone were upbeat. The US PMI turned in a strong showing, increasing from 52.8 in May 15 to 53.5 in Jun 15 while the Eurozone PMI rose from 52.2 to 52.5. ▪ However, Chinese manufacturing PMI indicated continued weakness (49.2 to 49.4) while Taiwan had a surprisingly large contraction as PMI fell from 49.3 to 46.3 in Jun 15. This contraction was the strongest in 33 months, reflecting a souring of confidence by manufacturers.
Brighter outlook for the US economy	
US economy	<u>Data is mixed but forward looking data suggest pickup</u> ▪ **Labour market strong enough to bring unemployment down to full employment level**: Although nonfarm payroll growth of 223,000 coupled with downward revisions of past months was seen as a disappointment, the average rise in payrolls is still more than double the number needed to absorb new entrants to the work force. Thus, the unemployment rate continued to fall, from 5.5% to 5.3% in June, just above the 5%-5.2% level which the Federal Reserve considers as full employment. While the fall in unemployment was partly due to a 0.3% decrease in labour force participation rate to 62.6%, the lowest since October 1977, there are doubts about the quality of this data. ▪ **But capital spending remains weak**: Factory orders fell 1.0% m/m in May 15, while new orders for core capital goods fell 0.1%. ▪ **Manufacturing sector gained traction**: The ISM manufacturing index rose from 52.8 in May to 53.5 in June, with a strong rise in its employment component.

Variable	Development/Assessment
	▪ **Construction spending** grew 0.8% m/m in May 15, down from a revised increase of 2.1% m/m in Apr 15. **Implications**: ▪ Despite the consensus being disappointed, the fact remains that labour demand in the economy is more than mopping up the slack in the labour market, with the unemployment rate set to go below full employment levels in coming months. The Federal Reserve will therefore not defer monetary normalisation because of this data: we are still looking at a September rate rise, so long as the contagion from the Greek crisis is contained. ▪ Until capital spending in the US economy takes off, the spill over benefits of US growth for Asian exporters will remain limited as our analysis shows that it is capital spending which is more important as a driver of Asian exports.
China: Stock markets tumble precipitously, may portend further trouble	
Chinese markets rebound on policy actions	<u>Policy makers are scared, pulling out all the stops</u> ▪ With Chinese stocks now down by around 30% from their 12th June peak, policy makers have responded ferociously. The central bank has cut interest rates and the reserve requirement while the China Securities Regulatory Commission (CSRC) relaxed margin rules. As these failed to calm the market, the CSRC also allowed brokers to securitise their margin loans, boosting the ability to increase margin lending while mobilising the brokerage industry as well as the asset management industry to establish funds to invest immediately in Chinese stocks on a large scale. Regulators are also cracking down on short sellers and using moral suasion to get institutions to buy shares. **Implications**: ▪ The massive policy response and mobilisation of funds has stabilised the market. However, the damage to investor psychology will not disappear quickly and markets will remain nervous. ▪ Moreover, the policy response could well be creating problems for the future. Artificially boosting the valuation of still-overvalued shares can only help for a while. Eventually, the downward pressures will resume and the damage will only be greater because the policy response is actually increasing leverage in an over-leveraged market.
Korea: Economic fundamentals degenerate	
Continued weakness in Korea	<u>Exports continue slide, inflation dangerously low</u> ▪ **Exports remain subdued due to a slowing China**: Exports fell 1.8% y/y in Jun 15, up from a 10.9% y/y decline in May 15. Demand from China slowed but exports to the U.S. and EU picked up. ▪ **Paltry consumption in the country**: Korea retail sales were flat in May

Variable	Development/Assessment
	15, down from a 1.4% y/y gain. ▪ **Inflation numbers weak:** Korea's CPI increased 0.7% y/y in Jun 15, up from 0.5% y/y in May 15. Core CPI rose 2% y/y in Jun 15, down from a 2.1% y/y increase in May 15. The outbreak of the MERS virus is depressing consumption in the country, thereby putting downward pressure on prices. ▪ **Industrial activity stuttering:** Industrial production fell 2.8% y/y in May 15, down from a 2.7% y/y decline in Apr 15, as both external and domestic demand remain tepid. ▪ **Implications:** The end of the MERS outbreak should help to boost consumption while the supplementary budget of KRW15tr should bolster the economy. However, economic activity will likely remain tepid in 2H15.
Thailand: Sluggish growth ahead, likely underperformance	
Policy response required to arrest decline	▪ Growth continues to be weak and the expected recovery is slow to take hold. The economy continues to depend on tourism and a nascent pick up in public spending on capital expenditure. Private consumption and investment remains weak while exports also languished. Worryingly, capital imports have fallen and could portend a longer-term slump in manufacturing and exports. ▪ **Implications**: The continued weakness necessitates a strong policy response. There is an urgent need to ramp up monetary and fiscal stimulus to halt the downward spiral of the domestic economy. ▪ However, further monetary easing is limited due to record low policy rate and elevated household debt. This means that fiscal expenditure is needed to crowd in private spending. But the military government is embroiled in the messy promulgation of a new constitution and could be distracted from economic issues. Fiscal stimulus might not be forthcoming until the political imbroglio is resolved.
Malaysia: The ringgit rebound did not last	
The ringgit rebounds on positive report, but soon erases gains	<u>Fitch upgrades Malaysia's outlook but political risks have erupted again</u> ▪ The Malaysian ringgit rebounded from a 10-year low after Fitch upgraded Malaysia's outlook from 'negative' to 'stable'. Fitch said that fiscal finances have improved due to progress on GST and fuel subsidy reform, supported by decent GDP growth and low inflation volatility. ▪ However, these gains were erased and the Ringgit is now below its 3.80 peg to the US Dollar from 1998-2005, following media reports claiming that USD700mn from 1MDB's coffers were remitted to PM Najib's personal account. The accusation has aroused a firestorm of controversy in Malaysia and led to growing feelings that Najib could not survive as Premier for long, especially after Deputy Premier

Variable	Development/Assessment
	Muhyiddin, whose support for the Premier has been lukewarm, called for a full investigation. ▪ But some of the details in the accusations levelled at Najib appear difficult to believe: would a sitting premier already under attack from political opponents really allow mind bogglingly large sums of money to enter his personal account in a Malaysian, not offshore, bank in full view of Malaysians? **Implications**: ▪ PM Najib is a survivor and he is fighting back, threatening to sue media companies that are making these allegations. For the first time, he has directly accused former premier Dr Mahathir of orchestrating the attacks on him. Expect Najib to use the full powers of his office to fend off these attacks. ▪ Still the drip-drip of allegations, whatever their authenticity, will hurt Najib. Political risks remain high in Malaysia and that could keep the Ringgit at its currently under-valued level for some time.
Singapore: Housing prices continue slide	
Both public and private home prices decline	<u>Soft landing for the property sector</u> ▪ URA flash estimates indicated that the private home prices remained in negative territory for the seventh consecutive quarter, falling 0.9% in 2Q15, barely unchanged a 1.0% fall in 1Q15. Private home prices are now down 6.7% from their peak in 3Q13. ▪ Meanwhile, flash estimates of the Resale Price Index for HDB flats showed a 0.4% decline in 2Q15, up from a 1.0% in 1Q15. A semblance of stabilisation could be taking root in the public housing sector.

Japan is changing faster than people think – and ASEAN is a huge winner

Japan's economy appears to be finally emerging from the doldrums, with cyclical conditions clearly improving and some signs of progress in structural areas as well. While Japan's shrinking population will remain a problem for the foreseeable future, the progress in increasing female participation in the workforce provides an offset to this demographic headwind and could translate into higher growth, with benefits for Asia.

The BOJ Tankan survey was better than expected.

On the cyclical front, an uptick is underway. The headline index in 2Q15 for all companies was unchanged from the 1Q15 survey at +7 with large manufacturers and service companies all reporting an improvement in business conditions and strong investment plans.

- The index for large manufacturers rose from a reading of 12 to 15 and their outlook rose from 10 to 16.
- Index for large service companies rose from 19 to 23, the highest reading in five quarters. Their outlook moved up from 17 in March to 21.
- Firms project investment spending to soar by 9.3% y/y in the coming fiscal year, up from a projected 1.2% fall in the April survey and the highest figure since the final months of 2007.

Other indicators were mixed: concurrent weakness but forward looking indicators better

- **Industrial production** fell 2.2% m/m in May 15, more than offsetting April's 1.2% gain.
- **Core machine orders** rose 3.8% m/m in April, from +2.9% in March. Orders rose 3% y/y versus 2.6% in March.
- **Retail sales** rose 3.0% y/y in May 15 after April's strong 5% gain and March's 9.7% decline. The spring wage negotiations resulted in steady gains to wages, which has translated into stronger spending.
- **Job openings per applicant** rose to highest level in a generation (23 years) to 1.19 jobs open for every applicant in May 15, compared with 1.17 in April.

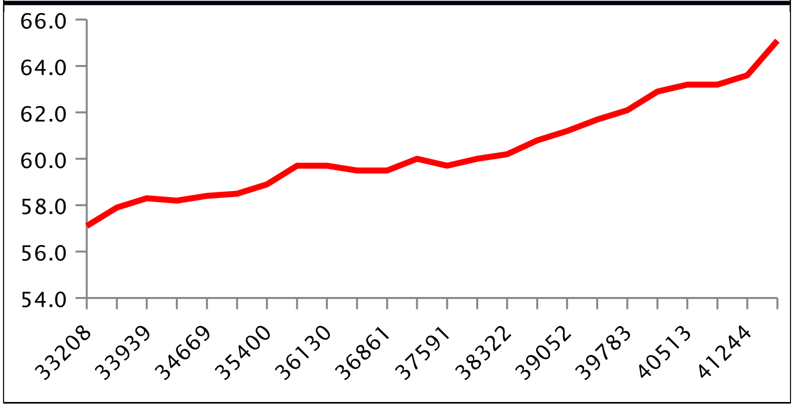
Structural change: a sizable increase in the proportion of females choosing to work

Japan's harsh corporate environment, with long working hours considered the norm, a cultural preference for women to focus on their family roles and work place discrimination against women, kept female labour force participation lower than in other developed countries for a long time. According to the World Economic Forum Global Gender Gap Report 2014, Japan was ranked 104th in the world for female participation and opportunity, despite attaining parity in education levels between the two genders. Despite the poor ranking, evidence of improvement in female labour force participation portends a positive future as the country seeks to cope with the consequences of an aging population. The labour force participation rate (LFPR) for females aged 15-64 has improved significantly, increasing from 57.1% in 1990 to 65.1% in 2013. Clearly, a higher proportion of women are choosing to go back to work, thereby helping to negate the effects of a declining labour force.

Even more significantly, the upward trend in the female LFPR has been taking effect even before Abe's unleashed his 'Womenomics' reform plan. His push to boost employment among females began only in 2013, when he vowed to provide in excess of USD3bn in order to address women's participation in society, while the improving trend has been taking root since 2003. While Japan is no longer starting from such a low base, Abe's economic policies are likely to reinforce and sharpen the upward trend in female LFPR and further narrow gender inequality.

Chart 1

Steady increase in female participation rate since 2003



Source: CEIC database

Female labour force participation bolsters Japan's economic recovery

For Japan, the benefits of higher female employment are not merely restricted to the addition to the workforce. Japan's education system is among the best in the world with Japanese women topping many education league-tables. The OECD PISA survey ranked Japanese women 2nd for reading and mathematics and 3rd for science. The return of educated females to the workforce will raise productivity and accelerate the country's gradual economic recovery.

The IMF estimated in 2012 that if Japan were able to raise its female LFPR to that of its G7 compatriots excluding Italy, its per capita GDP would rise by approximately 5%. OECD estimates also show that closing the gender gap by 50%, a figure that would still be below than the OECD average, would add 11.2% to Japan's nominal GDP in the next fifteen years.

Abe's estimation may seem overly optimistic, but definitely achievable

The recent fiscal strategy announced by Abe's government is betting that high economic growth can help to restrain the large public debt of the country. Abe is banking on GDP growth to be above a healthy 2% in order to keep the primary deficit below 1% of GDP. While the growth numbers may seem overly optimistic considering that growth averaged a tepid 0.6% over the past decade, the potential from an increased female participation rate is but one of many factors that gives ground for Abe to believe that higher growth is attainable.

Assessment: Benefits of Japan's revitalised economy will be mixed among Asian countries

Japan's potential revival has effects that extend beyond its borders and will help to drive sustained, long-term economic growth among Asian economies. The table below (Table 1) shows the value of imports, exports and FDI from Japan to various Asian countries and Japan's contribution to the respective country's exports, imports and FDI.

We note two key observations from Table 1:

- The ASEAN-5 countries, sans Singapore and with the addition of Vietnam, ship a significant portion of their exports to Japan, a share that is higher than for Chinese and Korean exports to Japan.
- Japan also contributes a large proportion of inbound FDI into ASEAN. This proportion is also lower for China and Korea.

Table 1: Exports, Imports and FDI from Japan (2013)

Country	Exports from Japan (USD mn)	Imports to Japan (USD mn)	% of Exports to Japan	% of Imports from Japan	FDI (USD mn)	Contribution to FDI (%)
China	162,245	150,132	6.8	8.3	9,104	7.3
India	10,523	6,755	2.2	3.3	3,296	27.0
Korea	60,029	34,662	6.2	11.6	2,155	7.6
ASEAN	**117,001**	**122,800**	**9.7**	**9.6**	**23,619**	**18.8**
Indonesia	19,285	27,086	14.8	10.3	3,907	21.2
Malaysia	17,896	25,147	11.0	8.7	1,265	10.3
Singapore	20,391	17,629	4.3	5.5	3,545	5.6
Thailand	41,008	21,894	9.7	18.8	10,174	78.6
Philippines	5,224	12,049	21.3	8.4	1,242	32.2
Vietnam	11,558	13,544	10.2	8.7	3,266	36.7

Source: Calculated by Centennial Asia Advisors using CEIC database, UNCTAD and JETRO

ASEAN economies will be the biggest winners from Japan's renaissance: In 2013, 9.7% of ASEAN total exports went to Japan. Apart from Singapore, the main countries in ASEAN ship a significant proportion of their total exports to Japan. Additionally, Japan contributes a sizable amount of foreign investment to these countries as well. Japan's economic revival will help to boost the country's export values and FDI, thereby supporting and lifting the growth rates for these ASEAN nations.

However, rising geopolitical tensions could dampen the benefits to North-East Asian countries: Both China and Korea are likely to remain shielded from Japan's economy and spillover benefits from the country's recovery are unlikely to surface. Territorial disputes with China and Korea have led to soured bilateral relations with both countries and it was a key reason why Japan's FDI to China fell 26% in 2014. The rise of ASEAN as an attractive investment destination, coupled with escalating tensions between China and Japan, means that FDI from Japan is unlikely to return and will remain at depressed levels for the near future.

Philippines: Weak 1Q15, but poised for strong growth

Philippines, once Southeast Asia's fastest growing economy in 2014, surprised on the downside in 1Q15 with GDP growth of 5.2% y/y. Marked declines in export performance and below par government spending have hampered growth prospects with a future pickup looking to be dependent on fiscal measures channelled appropriately into competitive sectors. Despite these weaknesses, resilient domestic demand and fiscal consolidation brighten the prospects for Philippines to achieve its target growth of 7-8% by year-end 2015.

Despite weak growth, domestic demand remains strong

- Real GDP growth in 1Q15 came in at 5.2% y/y, sharply down from 6.6% in 4Q14. CPI inflation is also adrift from the Central Bank's 2-4% target, at 1.6% y/y in May 15 on the back of low fuel prices and a stable food supply.
- The economy's inflation looks to be well anchored, but the Central Bank remains cautious as oil price movements remain volatile and threats of El Nino persist. Current low inflation however, bodes well for household consumption - Philippines' domestic demand has been remarkably stable and is a primary growth driver. Going forward, strong domestic demand will be crucial alongside increased government spending to boost growth.

Chart 2

Growth surprised on the downside

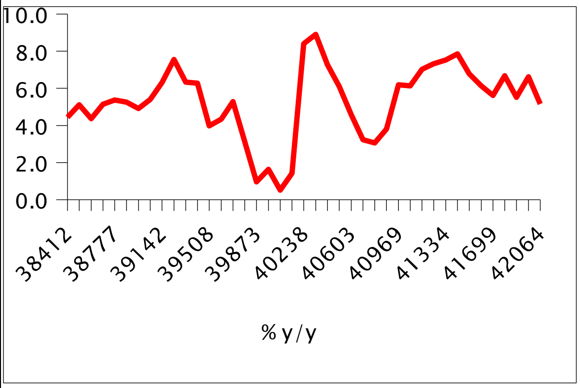
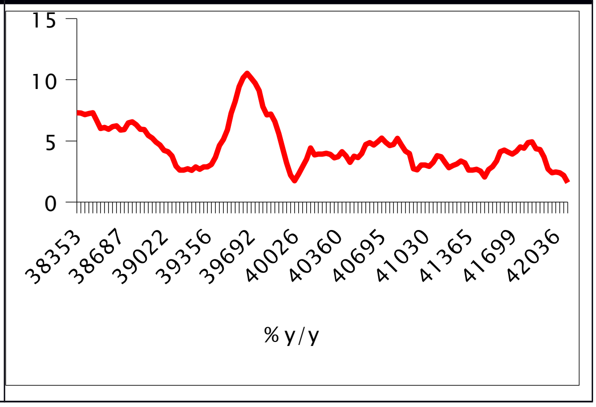


Chart 3

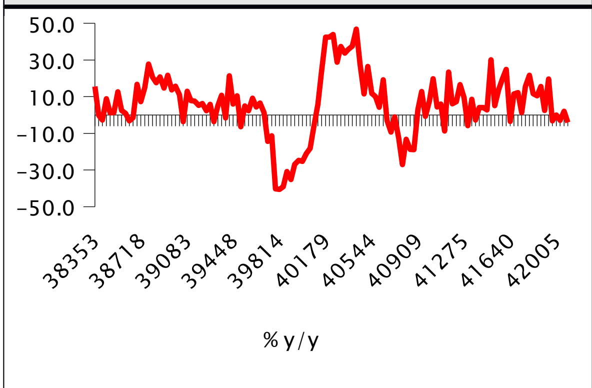
Inflation drops below target

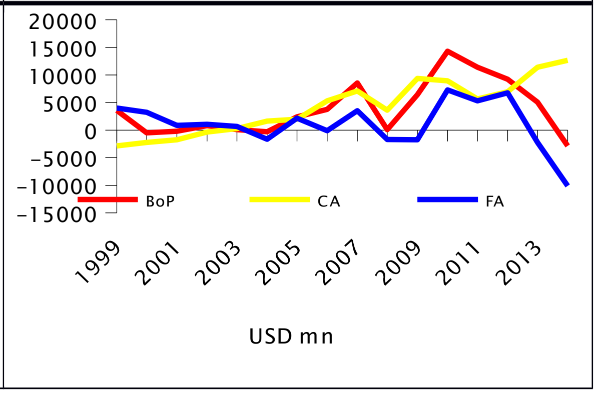


Source: Calculated by Centennial Asia Advisors using CEIC database

- Adding to weaknesses, exports declined 4.1% y/y in Apr 15, down from 2.1% y/y in Mar 15. Uneven global recovery and a relatively strong peso - which has also led to slimmer remittances in 1Q15 - have triggered this downward trend.

Chart 4	Chart 5
Exports continue to decline...	**...but current account surplus increases**

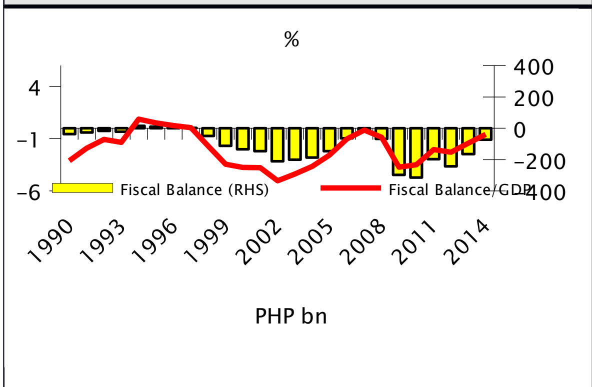


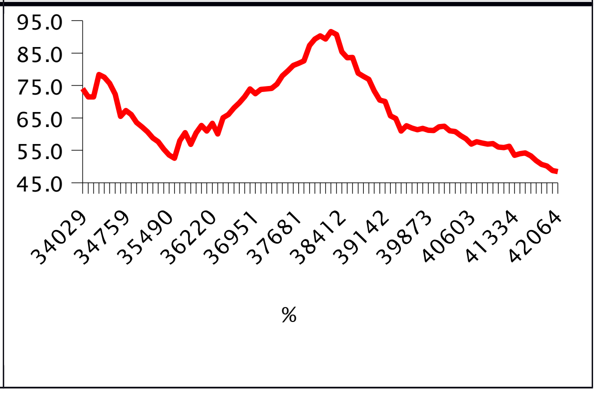


Source: Calculated by Centennial Asia Advisors using CEIC database

- On the upside, a widening current account surplus, low public debt levels and prudent fiscal consolidation, which are solidifying economic fundamentals, leave ample space for the government to carry out much needed fiscal injections to boost growth.

Chart 6	Chart 7
Fiscal deficit continues to narrow...	**...complemented by low debt levels**





Source: Calculated by Centennial Asia Advisors using CEIC database

- Stable governance has largely decreased bureaucratic inefficiencies seeing government revenues up by about 18% y/y in 1Q15. However, in the same quarter, government expenditure was 13% short of its PHP582.2bn target.
- State spending is a crucial driver of economic growth, with contractions likely to weigh heavily on growth rates. Bottlenecks to public investment and disbursement of funds remain a key obstacle, but as reforms continue to unwind red-tape, productive investment should resume to fill infrastructural gaps currently holding back the promising economy.

2016 presidential elections loom in the background, Aquino to set the tone for 2016

- 2016 Presidential elections loom in the near future with the political scene heating up as Jejomar Binay resigned from his cabinet position to form a new political party. A clear front-runner is yet to be determined with recent polls suggesting Grace Poe as a credible threat to Binay.
- The resilience of Philippines' economy hinges on the continuity of current policies and prudent reformation. Governance dominated by corruption will create an uncertain outlook for investors and diminish the efforts of Aquino's administration.

President Aquino's term has not been without its setbacks – the recent mishandling of the Mamasapano incident greatly hurt Aquino's credibility, intensifying the spotlight on how the Bangsamoro Basic Law (BBL) will play out in Congress. Efforts of the BBL and government spending in the final stretch of Aquino's term will largely impact the sentiment surrounding 2016 elections. While effective government expenditure is crucial to achieve this 7-8% growth in 2015, sustained growth into the decade is largely dependent on the outcome of Presidential elections. Should results play in Aquino's favour, his Presidential nomination rising ahead in the elections is a strong, and positive, likelihood.

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