CIO Special

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Emerging Markets

Asia: testing its economic resilience

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Key take aways

- Growth in most Asian economies is slowing down due to falling exports and weak domestic demand, as the U.S./China trade dispute continues.
- In response, we expect more Asian countries to apply monetary and fiscal stimulus. Some economies are more exposed to international trade than others.
- We are cautious on Asian equities in the short term, due to the likelihood of continued trade tensions and the risk of earnings downgrades.
- We are however constructive on Asian credit thanks to Fed rate cuts and resilient credit fundamentals.

01 China's growth deceleration likely to continue

China's GDP growth slowed to 6.2% YoY in Q2, the lowest level in 27 years, and appears to have kept falling in Q3. In August, China's manufacturing PMI index eased to 49.5, down from 49.7 in July. It was the fourth consecutive month that the PMI stayed in negative territory, i.e. below 50. The PMI indicator of new export orders remained a drag at 47.2 in August, showing how exports are stifled by trade tariffs.

We expect China's growth rate to keep decelerating in the rest of this year, for three main reasons. First, export growth could slow down further or even contract in Q4 as the recent hikes in U.S. tariffs make themselves felt. Secondly, subdued consumer sentiment and softening labour markets are putting the brakes on personal consumption. Thirdly, investment in property is unlikely to pick up because the government is reluctant to fuel a further increase in household debt.

Well aware of these concerns, China has just announced a new round of monetary stimulus. On September 6 the reference Reserve Requirement Rate (RRR) interest rate was reduced by 50 bps. There will be a further cut for some commercial banks by 100 bps in two stages later this year. In total, the People's Bank of China (PBoC) will inject RMB 900bn of liquidity into the banking system. Fiscal stimulus could follow soon, especially measures aimed at easing the financing conditions of small and medium-sized companies. Additionally, the government could increase the quota for local government debt issuance in order to boost infrastructure investment and aid poverty reduction programmes. For these reasons, we expect China's GDP growth to decelerate to 6.1% in H2 of this year, down from 6.3% in H1. Our full-year GDP forecast for 2019 is 6.2%.

02 Korea/Japan trade tensions could prompt BoK rate cuts

Since July this year, trade tensions between Japan and Korea have escalated. On July 4, Japan implemented a 90-day application process for exports of three kinds of high-tech materials (polyimide, etching gas and resist) to Korea. It also removed Korea's preferential treatment status on export procedures from August onwards. Korea retaliated by removing Japan from its own list of trading partners with preferential treatment. Korea has put Japan into a newly created bracket in which Korea's 1735 strategic export products to Japan require stringent documentation and longer application processes.

These non-tariff trade barriers are detrimental for Korea's trade with Japan. Exports to Japan account for 1.8% of Korea's GDP, while imports from Japan make up 3.1% of its GDP. Polyimide, etching gas and resist are important materials for the production of semiconductors and flexible displays; 40-90% of Korea's imports in these materials come from Japan. These tightened trade measures could severely hurt Korea's production chain of semis and displays.

We think that Korea is one of the economies most exposed to global trade tensions. Exports and imports represent 35% and 32% of Korea's GDP, respectively. For this reason, we consider further rate cuts by the BoK (Korea's central bank) to be likely.

03 India's downside surprise on growth prompts fiscal support

India's GDP growth slowed to 5.0% YoY in Q2 2019, down from 5.8% in the previous quarter, undercutting market expectations of 5.7%. The main drag on growth came from consumption, which grew by a paltry 3.1% in Q2, the lowest level in over four years. Sales of passenger vehicles have been declining for 13 consecutive months and exports have born the brunt of the recent escalation in global trade tensions.

As a result, the RBI (India's central bank) has already cut its reference rate four times by accumulative 110 bps this year. In August, the policy rate was cut by 35 bps to 5.4% due to slow growth and low inflation, exceeding market expectations of a 25 bps rate cut. We think that the RBI could keep cutting rates in coming quarters, as downside risks to growth are increasing while inflation remains subdued.

On the fiscal side, the Finance Minister announced several measures to stimulate growth in August, including efforts to improve the transmission of monetary easing and tax cuts for foreign portfolio investments and start-ups. Additionally, specific support measures for the car industry such as deferred registration fees and depreciation allowances on all vehicles have been announced.

However, we think that these measures are unlikely to turn around the fortunes of the Indian economy and therefore expect a continued slowdown of India's growth in the second half of this year.

04 Indonesian growth relatively unaffected by trade tensions

Indonesia's GDP growth remained largely steady at 5% YoY in Q2 this year, slightly below the 5.1% reached in the previous quarter. A rundown in inventories is what held back the expansion, because otherwise personal consumption proved to be resilient, growing at 5.4% YoY in Q2. Government consumption rose even more sharply, by 8.2% YoY. Fixed investment was up 5.0% YoY. Exports and imports were down -1.8% YoY and -6.7% YoY, respectively.

Compared to other export-oriented economies in the region, Indonesia is less affected by the escalation of U.S.-China trade tensions because its economy is more domestically driven. Exports only make up 21% of GDP compared with 44% in Korea and 50% in Taiwan.

The BI (Indonesia's central bank) has already cut its policy rate by 50 bps so far this year, to 5.5%. Due to easing external financing condition amid rate cuts in the U.S., we think that the BI could reduce interest rates further in coming quarters. Rate cuts will be boost domestic demand, in particular household consumption and corporate investments.

Additionally, we think that Indonesia's economy is supported by the re-election of President Jokowi that should reduce policy uncertainty and hence support business sentiment. Further, the government's fiscal stimulus should increase in coming quarters, particularly in the shape of infrastructure investment. We forecast Indonesia's growth to be steady at 5.2% this year, compared to 5.2% in 2018.

05 Malaysian growth slowdown in H2 expected after strong Q2

Malaysia's GDP growth was at 4.9% in Q2 this year, an improvement over the 4.5% in Q1 and higher than market expectations. This uptick was mainly driven by net exports with exports rising by 0.1% while imports declined by 2.1%. Private consumption grew strongly at 7.8%, while fixed investment contracted by 0.6%. Public consumption growth slowed to 0.3%.

Despite the upside surprise, Malaysia's economy is likely to slow down in the second half of this year. Exports may well be hurt not just by the trade dispute between the U.S. and China, but also by lower oil prices. Secondly, fixed investments are likely to suffer from weak business sentiment and ongoing fiscal consolidation.

The BNM (Bank Negara Malaysia, the central bank) cut the reference interest rate by 25 bps in May and we believe that further rate cuts are likely to follow as a consequence of the slowing economy and uncertainty about global trade.

In 2019, we forecast Malaysia's GDP growth to be 4.5% compared to 4.7% in 2018.

06 Singapore's trade exposure may lead to currency response

Singapore's economy is severely affected by the escalation of the U.S.- China trade war. Singapore's GDP rose by a paltry 0.1% YoY in Q2 after 1.1% in Q1, the weakest growth rate in nearly 10 years. On a QoQ basis, Singapore's GDP contracted 3.4% (seasonally adjusted annual rate) in Q2, the second decline in the past 12 months. All manufacturing, construction and service sectors contracted QoQ in Q2.

As an export-oriented economy, Singapore faces further downside risks in growth in H2. Even though construction investment could recover on the back of major infrastructure projects, it is unlikely to fully offset the negative impact from external headwinds.

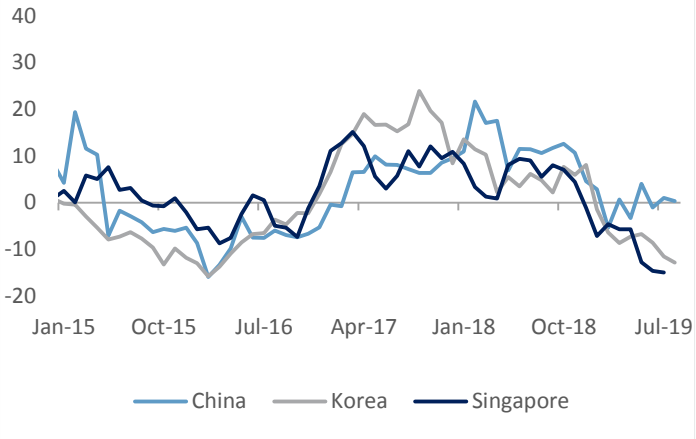
Therefore, we think that the Monetary Authority of Singapore (MAS) is likely to ease monetary policy by lowering the nominal effective exchange rate slope in H2. The MAS uses its currency as its policy tool. Hence, Singapore's domestic interest rate is determined by global interest rates and market expectations of the SGD exchange rate. As the Fed is more likely to cut rates further, we think that Singapore's domestic rate could see downward pressure in coming months. We forecast Singapore's GDP growth to be 1.0% in 2019, down from 3.1% in 2018.

07 Portfolio implications

Due to slowing economic growth in Asia, we remain cautious over equities in this region in the near term. Downside risks in coming months are the escalation of U.S.-China trade tensions, corporate earnings downgrades and the uncertainty of the Fed's monetary policies.

Meanwhile, we are constructive on Asian bonds thanks to resilient economic fundamentals in in the region. Besides, this asset class could be supported by likely Fed rate cuts and monetary loosening in Asian central banks in H2. The easing monetary environment both externally and domestically should be favorable to Asian bonds. Apart from the monetary easing, the Asian governments are also actively using fiscal stimulus measures to support the economies, particularly in China, Indonesia and India. These pro-growth measures should help Asian economies achieve a soft landing in H2 this year despite trade-related uncertainties.

Chart 1: Export growth (% YoY, 3 month moving average)



Source: Datastream, Deutsche Bank AG.
Data as of September 12, 2019.

Glossary

The Bank Indonesia (BI) is the central bank of Indonesia.

The Bank Negara Malaysia (BNM) is the central bank of Malaysia.

The Bank of Korea (BoK) is the central bank if Korea.

The Federal Reserve is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Monetary Authority of Singapore (MAS) is the central bank of Singapore.

The People's Bank of China (PBoC) is the central bank of the People's Republic of China.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

The Reserve Bank of India (RBI) is the central bank of India.

Reserve requirement ratios (RRR) determine the proportion of banks' deposit liabilities that must be held as reserves.

SGD is the currency code for the Singapore dollar.

USD is the currency code for the U.S. Dollar.

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