Global Macro Department – North Asia, China (UNDERWEIGHT)

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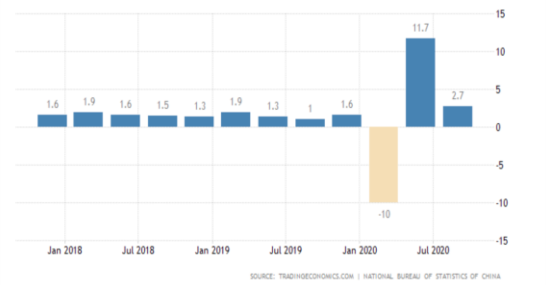
Basic Information

Real GDP(US$)	$14.4 Trillion (2019)
M2(US$)	$32,539 Billion
CPI	111.40
PPI	106.00
Con. Confidence	120.5
Stock Index	SSE Composite
Currency	RenMinBi(CNH)
10Y Yield	3.32%
Unemployment	5.4%
Inflation Rate	0.5%
Interest Rate	3.85%

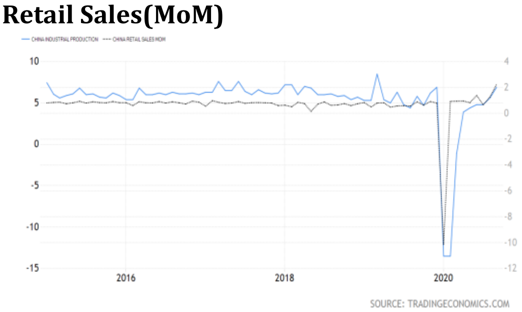
Chart info

Figure 1: China's Quarterly GDP Growth



Source: Trading Economics

Figure 2: China's Industrial Production & Retail Sales(MoM)



Source: Trading Economics

Figure 3: China's Exports and Imports

Growth gravitating towards Asia: China's V-Shaped Recovery

The optimism of China's recovery from the pandemic has been evident in the capital markets as well as its economic data. IMF forecast suggests China as the only country to emerge from 2020 with positive GDP growth upgrading their previous forecast from 1% to 1.9%. Our last coverage in July has correctly predicted China's continued economic growth through the end of 2020 and into 2021. We continue to hold optimism in China's growth narrative but believe that in the longer-term China will focus on more sustainable and subdued growth as evident in their 14th five-year plan (which will be elaborated on below). We believe that growth is likely to gravitate towards Asia in the next 5 years. The proportion of worldwide growth contributed by China is also expected to increase from 26.8% in 2021 to 27.7% in 2025, according to Bloomberg calculations using IMF data, which is more than 15 and 17%, respectively, higher than the U.S share of expected global output.

While our previous coverage suggested that China might be heading for a U-shaped recovery, we now see evidence that China has successfully directed a V-shaped rebound since Q2'20. China's Q3'20GDP data released on 19th October showed the economy expanded by 4.9% YoY, up from 3.2% YoY in Q2'20 and a major reversal from Q1'20 when the economy slumped by -6.8% YoY during the height of the pandemic in China. China's economic rebound has also been broadening to different sectors.

November's activity data was published showing industrial production rose by 7% YoY up from 6.9% YoY in October, retail sales increased by 5% YoY compared to 4.3% YoY in the previous month and fixed-asset investment expanded by 2.6% YoY versus 1.8% YoY in October. China's exports jumped in November by the most since early 2018, totalling up to $268 billion, the most for any single month and a 21% growth YoY.

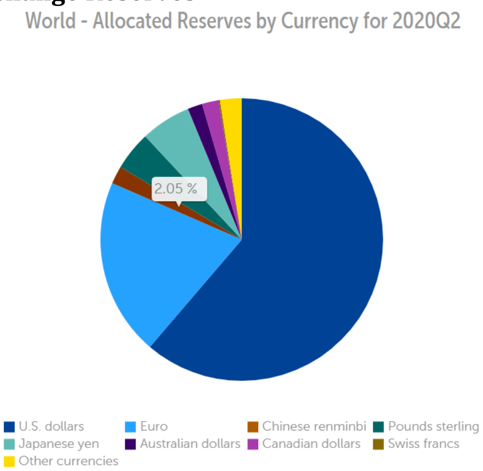
The Caixin China General Manufacturing PMI rose to 54.9 in November 2020 from 53.6 in October and beating market estimates of 53.5. This was the seventh straight month of growth in factory activity and the strongest since November 2010, indicating factory activity maintained its recovery momentum in the wake of the COVID-19 epidemic. We feel that this supports our view that China will continue its path of recovery with its successful curb of the spread of the pandemic. While we previously thought that a vaccine was necessary for China's economy to return to pre-COVID levels, it has shown itself to be resilient in the face of travel and mobility restrictions.

While China's recovery was initially led by a pick-up in industrial and manufacturing activities, we see indicators from retail sales that consumption is beginning to pick up. Looking ahead, we believe that China's economic growth should revert to its long-term trend as recovery broadens in domestic demand. Despite uncertainties in the global economic environment, China's export performance has had a surprised upside in recent months. Economic reopening in the global economy might also boost Chinese exports and further support growth.

Source: Bloomberg

Given these bullish economic fundamentals, we believe that China's economy is set to strongly outperform its peers over 2020 and 2021, benefitting the CNH.

Figure 4: Currency Composition of Foreign Exchange Reserves



Source: International Monetary Fund

PBOC: Digital Yuan and No Further Rates Cut

Accelerates the Push for Digital Yuan

China expects to issue a new digital currency before the Beijing Winter Olympics in 2022. Testing of the digital yuan (DCEP) would be conducted in 28 cities, including major metropolitan areas such as Beijing, Tianjin, Shanghai, Guangzhou and Chongqing. It is also working on new features like fast money transfers and better security. On 23 October, the PBOC published draft legislation to turn the digital yuan into legal tender and ban the private sector from issuing cryptocurrencies.

We anticipate that the introduction of an e-RMB would accelerate the internationalisation of the Yuan. Amidst the US-China trade tensions in recent years, US' hard-line policies on China serve as a warning bell for China to seek alternative funding besides the dollar. Ideally, if an adequate number of countries adopts the digital yuan for international transactions eventually, this could proliferate international use of the RMB. Furthermore, digital yuan enables China to track money flows electronically, which would be useful in combating money laundering and other illegal activities.

Nonetheless, we do not believe that the RMB will replace the dollar's reserve currency status any time soon. On one hand, for the RMB to gain a reserve currency status, it requires an open capital account and afloat exchange rate system, as opposed to China's strict capital controls. Moreover, it requires the PBoC to operate independently, as opposed to its current state-regulated status. On the other hand, as of Q2 2020, the yuan only accounts for about 2% of global foreign exchange reserve, compared to the US' 61.3%. This stark contrast suggests that China still has a long journey to go before gaining a reserve currency status.

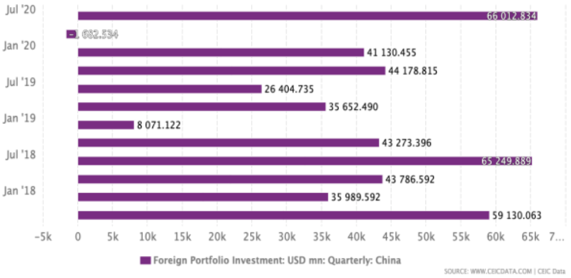
Normalizes Monetary Policies Amidst Economic Recovery

The PBoC is seeking to normalize monetary policy as the Chinese economy recovers steadily. Any cuts in interest rates and reserve ratio, or monetary easing are unlikely for the rest of 2020, as the Bank aims to make monetary policy more precise and targeted. These include vowing to achieve a long-term balance between stabilizing growth and preventing risks that arise from increasing debt. We believe that given China's residential property bubble (concentrated in major eastern cities) post-2008 Global Financial Crisis, which was mainly the result of excessive domestic credit expansion in 2009, China will tap the brakes on property prices and cut the availability of mortgage loans to spur households to spend instead of repaying debt, as policymakers try to ignite private consumption and stimulate the pandemic-stricken economy.

On October 28th, the automatic CNH reaction was pessimistic after reports suggested the PBoC would remove the countercyclical capital factor (CCF) from the USDCNY fixing. Rather than signalling a desire for RMB weakness by China, we feel that the removal of CCF is a signal of favouring a more flexible exchange rate subjected to market movements, which is in line with Beijing's internationalisation of the RMB.
The CCF was previously put in place to slow down the depreciation of RMB. Taking it off means that PBoC thinks RMB is not in a depreciation trend anymore and there is no need for such a measure. We feel that this is a similar message that was sent across when PBoC eliminated the FX forward reserve requirement on October 11th.

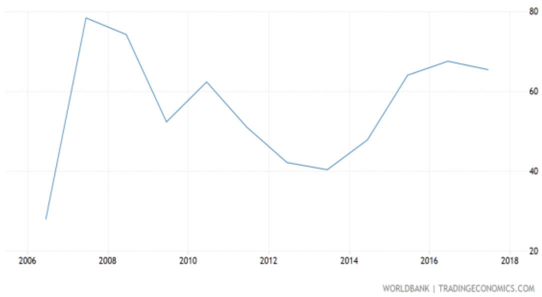
Overall, we expect China's central bank to pull back from major quantitative easing and shift its focus to maintaining the current interest rate. China's recovery without significant inflationary

Figure 5: Foreign Portfolio Investment into China (2018-2020)



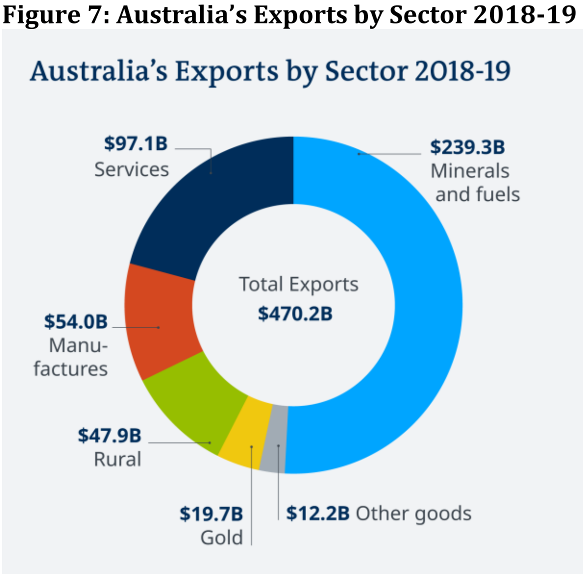
Source: CEIC

Figure 6: China's Stock Market Cap-to-GDP (2006-2018)



Source: Trading Economics

Figure 7: Australia's Exports by Sector 2018-19



Source: Australian Department of Foreign Affair and Trade

pressures thus far should further convince the PBOC to maintain rates. It will also strengthen financing support to manufacturing and small firms, through making loans to SMEs more easily available, and opening up its domestic financial markets to foreign investors

Capital Markets: Accelerated Opening

Scraping Quota Limits on QFII, RQFII Foreign Investment

China has recently expanded the range of investment options available to foreign investors. The latest reforms involve combining the Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors programs (RQFII) into a single "qualified foreign investor" regime, specifically by:

1. Expanding the derivatives market by letting foreigners use financial futures, commodity futures and options;
2. Allowing foreigners to repurchase bonds, pledge notes they hold for cash, and potentially re-invest the funds in bonds;
3. Opening the National Equities Exchange and Quotations (NEEQ) to foreign investors; and
4. Giving foreigners a channel to private investment funds.

We believe that these reforms will ease access to China's capital markets and promote further internationalization of the Yuan. Moreover, with derivatives and futures creating room for neutral strategies, instead of just passive investment, there will be more active investment opportunities for foreigners as opposed to long-only. This would accelerate the development of China's derivatives market and attract more capital inflows, giving rise to bullish sentiments for the Yuan.

Nonetheless, we would expect the immediate impact of these measures on the market to be limited as China's futures market is arguably underdeveloped. These reforms may also be a warning bell for local institutions to improve their investment strategies, as they are less competitive compared to the more established foreign funds.

Homecoming of ADRs

The hawkishness of the Trump administration towards China companies listed in the US has slowed the pace for Chinese companies with American Depositary Receipt (ADR) listings to seek secondary listings on the Hong Kong and China Stock Exchange.

Since the Luckin accounting scandal, we expect more scrutiny on China ADR listings. Currently, US-listed entities are given a transition period till January 1st 2022 to comply with new standards, failing which might result in future delisting.

Starting with Alibaba, JD.com and Netease, we expect to see the homecoming of at least 20 China ADRs over the coming year. With increasingly stringent criteria for US listings, China companies will see China, Hong Kong and Singapore exchanges as alternative destinations, especially as the investment landscape and eco-system in Asia matures and expands to include vibrant futures, derivatives and private markets. We believe that China still has room to grow with a stock market capitalization to GDP ratio of 0.65:1 (Figure 6), the ratio in developed markets such as the US have shown to exceed 100%. We believe that China's deepening equity markets will ultimately increase capital flow into Beijing, further supporting the RMB.

Furthermore, we feel that the inclusion of Chinese onshore government in the flagship World Government Bond Index (WGBI) and the emergence of vehicles allowing offshore investors access to China's onshore capital market, will prompt further increases in foreign investor holdings. This will also shift the primary investor base from domestic retail investors to include more institutional investors, providing stability to the equity and bond markets.

Crackdown on Tech Giants Including Ant Group Co.

On 5 November, China abruptly halted Ant Group's blockbuster initial public offering (IPO) just two days before it was scheduled to take place in Hong Kong and Shanghai. Ant Group's IPO was set to raise about $34.5 billion, which would have been the world's largest to-date. China's top banking watchdog cited that fintech firms should be subjected to the same supervision and risk management as banks. Analysts estimate that new rules could reduce the fintech giant's value by as much as $140 billion.

China's State Administration for Market Regulation also drafted a 22-page regulatory proposal designed to reign in the duopoly of Alibaba Group Holding Ltd. and Tencent Holdings Ltd., which are among the most valuable companies in the world. The new rules may prevent them from acquiring promising startups and force them to sell stakes in other companies.

We believe that the impact of these new regulations benefits mostly state-backed banks such as China Merchants Bank Co. -- known domestically as the retail bank king. Short-term financial risks are unlikely to be since China continues to exert profound influence on its financial market. However, the volatility in regulation could substantially impact the plans of Chinese companies expecting recent listings in the market. Moreover, the apparent disarray and lack of transparency in China's decision-making may lead to global investors adopting a more cautious attitude toward investing in the country.

Industrial Recovery: Bullish for Commodities

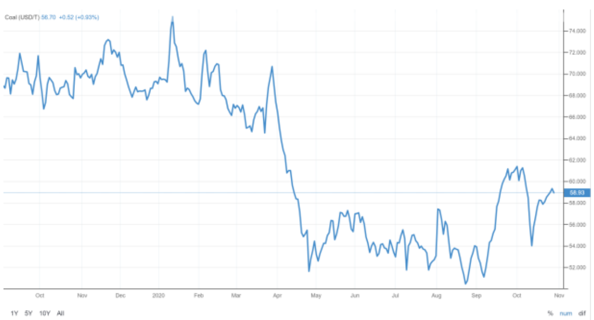
Figure 8: Iron Ore Prices (USD/T)

As mentioned by our analysts for commodities, China's reviving industrial activities are driving global commodity prices higher.

Iron Ore

Iron ore, a raw material for the making of steel, rose on 30 October 2020, as a decline in steel inventories in China rekindled optimism over demand for the industrial metal. Previously, iron ore prices lost considerable ground and fell sharply in recent weeks as rising port inventories outweighed strong demand from China, the world's top steel producer and consumer. Stockpiles remained high in early September as congestion at Chinese ports eased.

Figure 9: Coal Prices (USD/T)



We believe that with China's hope of stimulating the COVID-19 hit economy, prices of iron ore should remain elevated since the country's steel sector is facing a pipeline of new construction and infrastructure projects

Coal

Coal futures were trading above $58 per tonne for the second consecutive session on 30 October, recovering slightly from a one-month low of $54 per tonne reported in the middle of October on supply concerns.

We expect the coal market to remain under pressure as natural gas and renewable energy generation take over fossil fuels, especially amid China's pledge to go Carbon Zero by 2060. Nonetheless, China still remains the world's largest coal consumer and its high dependence on coal may give rise to bullish sentiments in the short run.

Figure 10: Copper Prices (USD/T)

Copper

Copper prices have crashed earlier this year amid the COVID-19 pandemic. A 26-month high was reached on September 18th. The significant bullish trend since April is supported by growing demand from top consumer China and an overall decline in global copper production.

We expect copper prices to continue rising as China, the world's largest consumer of copper, has outlined plans for new infrastructure projects. These include the government's commitment to invest in copper-intensive 5G networks, ultra-high voltage power grids and electric vehicle charging stations as well as auto and home appliance subsidy plans.

A Multi-Polar World: China and the World

China & APAC: 15 Nations Signed World's Largest Trade Pact

On November 15, fifteen Asia-Pacific nations signed a free trade deal, known as the Regional Comprehensive Economic Partnership (RCEP). Launched in 2012, RCEP is a trade pact between the 10 ASEAN nations, along with China, Japan, South Korea, Australia and New Zealand. India had been due to sign but pulled out last year. The deal includes 2.1 billion people, with RCEP's members accounting for around 30% of global GDP. The RCEP aims to lower tariffs, open up trade in services and promote investment in emerging economies.

We see a significant impact of this trade agreement as it expands China's geopolitical impacts in the region, where it has faced reduced competition from the US since President Donald Trump pulled out of the Trans-Pacific Partnership (TPP). Enhanced investment rules and regulations will deepen globalisation, amidst a tide of protectionism. These new rules will help improve transparency and provide investors with guarantees against prohibited performance requirements by governments. Businesses in the region can have wider access to regional value chains by consolidating the various existing rules into a single rulebook and accelerate their post-COVID recovery efforts.

China-Hong Kong: The National Security Law

On June 30, China passed the National Security Law to end the months-long protesting and uproar in Hong Kong. The law targets four categories of offences: secession, subversion, terrorist activities, and collusion with a foreign country or external elements to endanger national security. Persons or entities within or outside Hong Kong might commit an offence by inciting, assisting or providing support for the above four categories of offences. Critics said the law may crush freedom of speech in Hong Kong, where mere criticisms of the central party of China could amount to "subversion". Others in support of the law cited that the months-long protests in Hong Kong need to be stopped so as not to disrupt business activities or deter foreign investments.

The U.S. responded to the law saying that it can no longer see Hong Kong maintaining a high degree of autonomy from China. It would start removing Hong Kong's trade privileges, including lower trade tariffs and a separate customs framework in its dealings with the U.S. These advantages were jointly enjoyed by mainland China since Hong Kong's return in 1997.

With the enactment of the National Security Law, we believe that Hong Kong's status as a financial hub may come under threat as it is less able to play a facilitating role between the US and China. This may Impede flows of FDI into China since 65% of China's FDI go through Hong Kong. Furthermore, Hong Kong's future may tie up more with China,

Figure 11: Map of the Guangdong-Hong Kong-Macau Greater Bay Area

Figure 12: Map of the China-India Border Clash Area

especially if the U.S., the U.K and other key partners sacrifice their relationships with Hong Kong in the interests of shifting to a more hard-line China policy.

On the other hand, we also recognize some grounds for optimism in light of the Guangdong-Hong Kong-Macao Greater Bay Area. As part of China's key strategic plan, it aims to develop the Greater Bay Area into an international innovation and technology hub, facilitate the development of industries in which Hong Kong's strengths lie in the Greater Bay Area, and allow China to capitalise on Hong Kong's strengths to serve the country's needs. The Greater Bay Area does offer a plethora of growth opportunities for Hong Kong and the mainland, since it has a cumulative area of 56,000 km^2(3x > the San Francisco Bay Area), a total population of 72 million (10x > the San Francisco Bay Area) and a GDP per capita of USD 23,371 that is two times the United Nations' minimum requirement for high-income economies.

Lastly, we expect Hong Kong's separate financial system to be maintained, as it serves China's interests in engaging with the global economy as highlighted in the "dual circulation". The rapid growth of Hong Kong's hinterland in the Greater Bay Area could provide the city with new development opportunities, such as acting as an innovation hub for R&D, robotics, Fintech and smart-city applications.

China-India: Bid to De-Escalate Tensions

In September, the two powerful neighbours agreed to stop sending troops to the front line of their disputed Himalayan border. The two governments will refrain from unilaterally changing the situation on the ground. In May this year, the nations started to increase their troop strength along the 3,488-kilometer border known as the Line of Actual Control. Gunshots were fired for the first time since 1975, resulting in the deaths of 20 Indian soldiers (including an officer) and casualties of 43 Chinese soldiers (including the death of an officer).

We believe that the de-escalation of border tension between the two major economies would give rise to better prospects for bilateral trade and two-way investments. It also prescribed investment from China in India's highway projects and small and medium enterprises.
Furthermore, Indian start-ups may have better prospects to emulate China's mobile-first evolution of the Chinese market.

China-US: Tit-for-Tat

Our team covered the U.S.-China relations in July 2020, iterating that the Phase 1 deal remains as the baseline for their current trade war and that verbal exchanges without serious actions would continue between both nations.

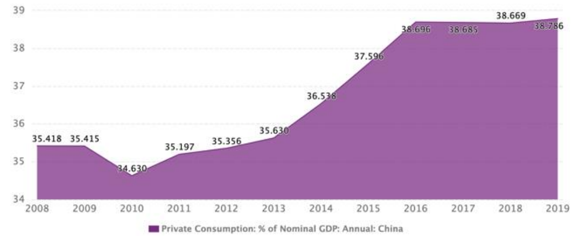
However, the past few months has shown that tensions have transcended trade disputes, into a "Tech-War" where both sides are refusing to step down. Following US sanctions on a broad range of China's tech companies including Huawei and social media apps TikTok and WeChat, China has released more details of measures that would allow it to punish blacklisted foreign entities deemed as hurting China's national interests, widely seen as a warning of potential retaliation against US firms operating in China if the government chooses to act. The expanding dispute is particularly troubling against a backdrop of slowing economic recovery momentum and raises concerns about the reshaping of global supply chains and the associated impact on long term growth.

On 26th September, the U.S. government-imposed restrictions on US technology exports to China's top chipmaker, Semiconductor Manufacturing International Corp (SMIC), citing concerns that its products may be linked to military use. If these restrictions were to broaden to include China semiconductor memory players and other Chinese foundries, we believe that a short-term dent in China's ambitions at localisation would be probable.

In recent time, Australia's trade balance has also been caught in the flames between the U.S. and China. China is an immensely important trade partner of Australia, accounting for a third of Australian exports in 2019. Iron ore, coal and gas — the country's biggest exports — made about 60% of those sales. On October 19th, Beijing made moves against Australian coal and cotton imports after a meeting of the Quad, which includes Japan, Australia, India and the U.S. While political tensions have been apparent between Australia and China since 2017, the spill-over effects on trade have been a recent development. Considering Australia's over-reliance on China we see this hurting Australian exports in the medium to long term, given China's penchant for using economic levers to settle political scores. Ultimately, the trade retaliation appears to convey Beijing's displeasure that a regional united front appears to be forming to contain its ambitions. We believe that we might see further ratcheting of relations with other trade partners by China should they take side with the US.

Biden's ascend to presidency will provide less antagonistic measures for China. However, we expect US-China tensions to remain despite Biden's more strategic and less erratic (compared to Trump) diplomatic approach. We expect China and the US to unite on the front of climate change but remain divided on issues related to Taiwan and Hongkong. In response to Beijing imposing a controversial national security law in Hong Kong, Trump's administration placed sanctions on officials connected to the crackdown, downgraded the city's special customs status and warned financial institutions against conducting "significant" transactions with anyone deemed to have undermined Hong Kong's autonomy. In Taiwan, the US has sent high-level government visitors, drawn recrimination from Beijing, increased military exercises in the region and launched a new economic dialogue with Taipei. A Pew Research study found that unfavourable views on China in the US are at record high of 73%, double of 2002's 30%. Our team does not see a miraculous avenue for the two great powers to resolve their differences. However, Biden will differ from Trump in his approach to China. Specifically, Biden has pledged to work with allies to pressure China through the multilateral organisations that Trump has eschewed. We see the possibility of less confrontational policies and more space for China to manoeuvre regarding trade, with less punitive tariffs imposed under the Biden administration. Furthermore, Biden's focus on fiscal policies such as the American Procurement Plan, we believe, might be supportive of Chinese exports in the medium to long term.

Figure 13: China's Private Consumption as % of Nominal GDP (2008-2019)

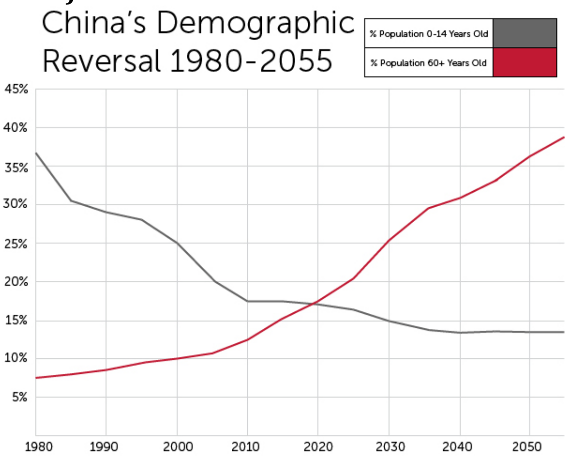


Source: CEIC

Figure 14: China's Nominal Residential Property Price Index (2010-2019)

Source: CEIC

Figure 15: China's Aging Population (1980-2050)



Source: Collective Responsibility

Looking ahead: 14th Five-year Plan (2021-2025)

China's five-year plan (FYP) is one of the most important policy blueprints that sets medium-term goals for the country's economic and social development. We see the next 5-years for China to be shaped by a more challenging external environment. With US-China decoupling coming under pressure as well as stricter US technology restrictions on China, we see higher probability in supply chains restructuring in the coming years. Domestically, aging demographics, technology bottlenecks, and low efficiency in some areas remain as key headwinds for China's long-term growth. We expect lower growth targets (5-6%) in the coming 5 years as China transitions from an emerging market economy to a developed market status.

China's focus on "Dual-circulation" should see further restructuring and improvements to the quality of economic growth. The theme adds new urgency to many existing government policies on boosting domestic demand in the coming years, including fostering urbanization of Hukou, continued infrastructure investment, measures to support SME employment and improve social safety net, and in return boosting domestic consumption. We believe that despite the urge to re-shore supply chains and boost domestic demand, it does not mean that China will close itself away from the world. As proposed by the FYP, China is poised to join the IMF's basket of reserve currencies, making the Yuan an exchangeable and freely usable currency. We see China's "Dual Circulation" a pathway to hedge against future capital flight and geopolitical tensions while the country establishes itself as a global economic power with the internationalization of the Yuan.

China's plan to develop its rural regions will lead to an expanding middle class, further supporting domestic consumption. UBS estimates China's total consumption to reach $12 trillion in 2025, $4 trillion larger than in 2020. We see a higher likelihood that the country's economy from the transition from material to intellectual sectors, with higher contribution from sectors in services, healthcare, technology, and eCommerce. Furthermore, there should be an upgrade in private consumption as a percentage of GDP as China seeks self-reliance over the next decade.

China also announced plans to develop an open, transparent, and healthy capital market. This would include continued reforms of the system for issuing and trading stocks and bonds as well as ensuring the renminbi steadily achieves capital account convertibility. We expect China to further open domestic markets for foreign investors in most sectors and lower import tariffs and non- tariff barriers in the coming 5 years. These measures, along with China's large and rapidly growing market, and attractive yield spreads in a low-interest-rate environment, should help to attract foreign direct investment and portfolio investment flows in the coming years.

Another key macro theme that will be pivotal in China's growth model is the focus on sustainability. Under international pressure to do more to address global warming, Xi Jinping made a surprise commitment to drastically reduce emissions, with a plan to be carbon neutral by 2060. Already, Beijing has pledged to support green and clean production, continue transforming traditional manufacturing, as well as developing green financing systems and create green development funds. Meeting the environmental objectives will also reduce international criticism against China and would benefit China's international relations with the EU and other global powers, including the US.

Overall, we see a few headwinds that might obstruct China's growth. Specifically, a continued trade war under Biden's administration , property price inflation crowding out consumer spending and an

Figure 16: China 10-Year Yield vs US 10-Year Yield

Figure 17: Short USD-CNH

Source: Tradingview

ageing demographic. We feel that the Chinese government would stay vigilant and implement policies to prevent potential property bubbles.

The aging trend in China is expected to accelerate in the coming years, with the share of elder age group (>65 years) jumping from 12% in 2020 to 27.5% in 2050, as projected by the the UN. We expect that China would increase spending on elderly care facilities as well as larger social spending given the grey wave. This would reduce the amount of money directed to infrastructure development and other investments in the economy.

Short USD-CNH

With the U.S. dollar expected to weaken in the medium term, the PBoC should have more flexibility in allowing the Chinese yuan to appreciate. While this may seem to undermine China's export competitiveness, a stronger yuan would also imply cheaper imports of consumer goods, raw materials and manufacturing components. Moreover, Beijing is looking to attract more international capital into its financial markets, both in equities and fixed income. A modest appreciation would help to enhance the appeal of Chinese assets for international investors.

Furthermore, China's yield advantage relative to the US remains an important source of support for the CNH against a strong China economic backdrop. (Fig. X) Bond inflows from foreign investors are likely to remain strong given China's yield advantage and should also benefit index inclusion for the onshore bond market. FTSE Russell will add Chinese government bonds to its flagship World Government Bond Index (WGBI) starting in 2021. Goldman Sachs estimates there is $2.5 trillion of global cash following the WGBI, and China's inclusion could drive $140 billion into mainland bonds over the inclusion period. We believe that bond inclusion will further the agenda to internationalise the Yuan and reduce the reliance on USD. As tensions grow between the US and China in a multipolar world, we believe there will be a growing demand for Yuan, boosting its strength.

We feel that PBoC stance on currency's strength is likely to change and enable greater appreciation of the Yuan. For a long time, PBoC has been keen to maintain USDCNY stability in light of recent trade wars and macro uncertainties. However, recently, PBC Governor Yi Gang mentioned that PBC intends to "maintain for as long as possible a normal monetary policy and a upward yield curve, to provide the right incentives to economic entities, … which is good for the competitiveness of RMB assets globally, helping us to utilize international resources and markets". We feel that this shows Beijing's contentment of higher domestic interest rate and open to the idea of more capital inflows. Along with an agenda to internationalise the Yuan, we expect PBoC to allow greater exchange rate flexibility and appreciation.

We expect the downward trend of USD weakness to continue, against a backdrop of a lower interest rate (for longer) environment, aligned with the Fed's Average-Inflation-Targeting (AIT) policies. Furthermore, a global recovery in 2021 will also diminish the appeal of holding "safe-haven" USD. China's onshore corporate USD selling could bring about the next leg lower in USDCNH given a Biden win in the US presidential election, with more stringent tax and emission regulation likely to emerge. Additionally, less volatile US-China trade relations should also attract foreign portfolio inflow to China manufacturers. We thus expect greater appreciation of the Yuan against the bearish greenback.

The rate of Yuan's appreciation has strengthened for appropriate economic fundamentals and should not be of worry. Immediate support for USDCNH is around 6.5122/6.5355.

Using the 1-hour chart for the pair, we are looking to enter a short position for the pair at 6.52547, where the MACD and signal lines are converging suggesting an opportunity to enter.

From here, USD could weaken further but any decline is likely limited, testing the support at 6.5122 The current movement is viewed as the initial stages of a consolidation phase. From here, USD could trade between 6.5122 and 6.5355 for a period.

However, in view of previous oversold conditions, there are prospect for USD/CNH to move lower than 6.5122, at least within these couple of months. Overall, the outlook for USD/CNH remains weak and only a break of the declining trend-line would indicate that the weakness has stabilized. With Beijing's strong economic fundamentals against a dovish Fed, we have confidence that the yuan would further appreciate in the next 6 months. We thus suggest a take profit at 6.4700 with a risk reward of 3.38.

Entry: 6.52547

Take Profit: 6.4700

Stop Loss: 6.5400

Risk Reward: 3.82

NUS INVESTMENT SOCIETY

Global Macro Department –Hong Kong (UNDERWEIGHT)

Date: 27th December 2020

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Basic Information

GDP:	USD366 billion
GDP Growth Rate:	-3.5%
USDHKD:	7.75
HKMA Rates:	0.86%
Interbank Rates:	0.36%
CPI:	110.9
Inflation Rate:	-0.2%
Manufacturing PMI:	50.1
Unemployment Rate:	6.3%
Foreign Reserves:	USD486bn

Chart info

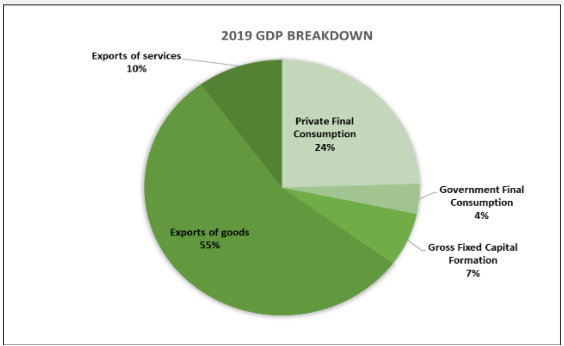
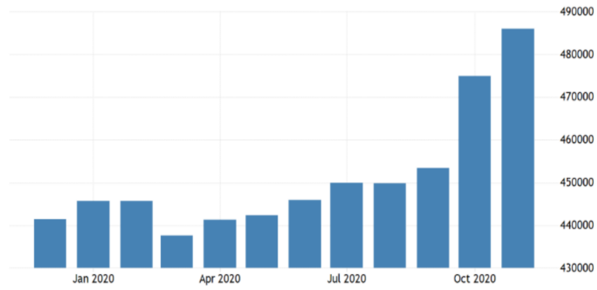


Figure 1: Hong Kong Foreign Reserves



Source: Tradingeconomics, HKMA

Overview

Hong Kong is a global financial hub in Asia with a free market economy. Hong Kong is highly dependent on international trade, with reexports making up 99% of her total exports. As seen by the breakdown of GDP in 2019, exports make up more than 50% of Hong Kong's GDP.

The nature of its economy has made Hong Kong extremely susceptible to global macro events. In this case, the spread of Covid-19 added to woes to Hong Kong's economy which was already in a bad state due to persistent social unrest in the country.

Over the course of the pandemic, total relief provided by Hong Kong's government totalled to more than HKD300 billion. The economic stimulus aims to retain jobs, provide relief to sectors affected greatly due to the pandemic, concessions, and waivers.

In the past 6 months

Hong Kong's economy recently announced their performance for Q3 of 2020. Despite a rise in GDP by 3% in real terms based on a seasonally adjusted quarter-to-quarter comparison, Hong Kong's economy fails to escape yet another decline in GDP. The economy shrank 3.5% YoY in Q3 2020, putting Hong Kong into a 5th straight quarter of recession.

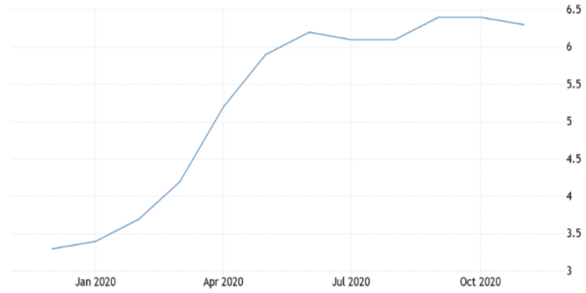
This improvement in GDP in Q3 is largely attributed to the strong expansion in China, stabilising local pandemic situation and stronger global markets activity. Amongst the factors affecting GDP, only exports managed to resume growth. Consumption, investment, and exports of services continues to decline although at a less alarming rate.

Other economic indicators are also bearish for Hong Kong's economy. Prices remain weak as headline inflation continues to decline in November at –0.2%. This is expected to continue as local and global economic conditions remains weak with COVID-19 looking to stay till next year minimally.

Labour market also continues to worsen as unemployment rates reached the highest levels since January 2005, standing at 6.3% in November. This is despite the measures put in place by the government to relief the pressure on the labour market.

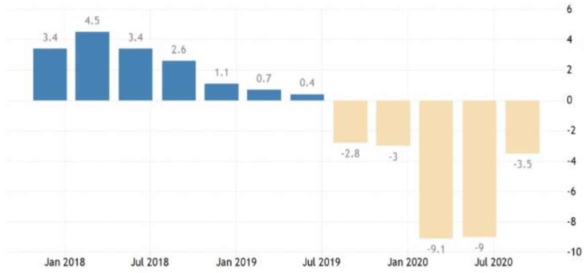
The announcement of the National Security Law (NSL) earlier this year also contributed to increased headwind against Hong Kong's economy. The NSL is a broadly defined law that allows the government to prosecute an individual or remove one to Mainland China for charges. This law applies to everyone in the world, giving the Chinese government the right to arrest any individual who violates it the moment they set foot in Chinese jurisdiction. The newly setup Committee for Safeguarding National Security is not subjected oversight, and the Office for Safeguarding National Security is not within Hong Kong's jurisdiction. These investigating authorities wield tremendous power, striking in fear in the Hong Kong people. This led to the view from U.S. that Hong Kong is no

Figure 2: Hong Kong Unemployment Rate



Source: Census and Stats, HK

Figure 3: Hong Kong GDP Growth Rate

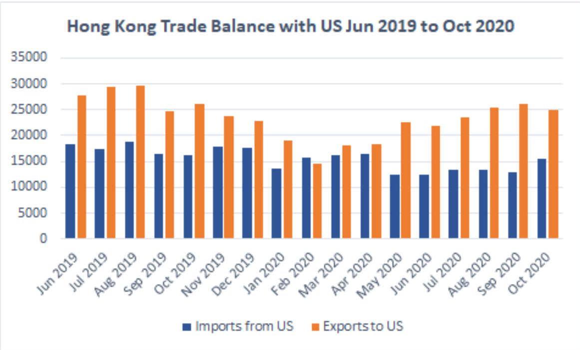


Source: Tradingeconomics, Census and Stats, HK

longer having clear autonomy from China, resulting in Hong Kong losing their special treatment from the U.S.

Major overhaul of the Hang Seng Index may come in the future as Hang Seng Index Co. considers options to dilute influence of largest companies. Potential changes include fixing the number of constituents as Hong Kong companies, increasing the number of companies and capping weightings at 8%. It is noted that proportion of mainland companies within the index increased from 41.6% in 2005 to 79% this year. These potential changes could prove to be important given the increasing possibility of mainland companies listing in Hong Kong as they get blacklisted in U.S and ousted by U.S stock exchanges.

Figure 4: Hong Kong Trade Balance with U.S



Source: Central Bank of the Republic of China

"U.S-China-HK"

After China implemented the NSL, Trump swiftly made a statement to renounce Hong Kong's special status. This creates a series of impacts to U.S., Hong Kong, and China.

From Hong Kong's perspective, where her trade is dominated by re-exports, the loss of lower U.S tariff exposure will damage her re-exports to U.S. which are worth HKD 300 billion. This amount accounts for 7.6% of Hong Kong's re-exports. Hence, Hong Kong will inevitably lose her viability as a re-exporting hub for exports to the U.S.. Eventually, Hong Kong's port and logistics businesses will take a big hit.

Relations between U.S. and Hong Kong worsen recently as U.S. placed sanctions on 15 of Hong Kong's senior officials including Chief Executive Carrie Lam. This left the leader sitting on piles of cash at home as she no longer has access to banking services.

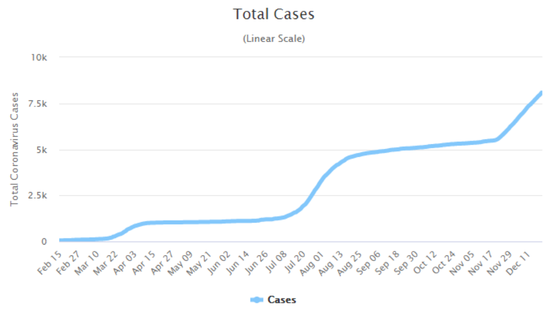
In the eyes of China, the economic trade-off for more control over Hong Kong is advantageous. Despite Hong Kong's position as an important bridge between China and the rest of the world, its significance on China's balance of trade is greatly reduced. China's exports to or through Hong Kong has decreased from 45% in 1992 to 12% in 2019. This trend is expected to continue as China's development of technology and growth of domestic economy has made her far less dependent on foreign capital and technological inflows.

Finally, while the U.S is able to 'punish' China via the revoking of Hong Kong's special status, there are downsides to the U.S. as well. It is true that Trump's order will not have immediate impact on U.S exports (worth $30-$40billion) to Hong Kong. However, this act will likely invite retaliation from China, possibly reducing U.S exports to Hong Kong in the future. Furthermore, there are additional social and economic implications to this new order as more than 1,300 U.S firms (including 300 headquarters) are based in Hong Kong and 85,000 Americans reside in there.

<u>Increasing Pressure on Chinese Companies by U.S</u>

Attempts to restrict Chinese companies this year has escalated recently, where the U.S. Commerce Department confirms their blacklisting of more than 60 Chinese companies including SMIC to safeguard national security. Furthermore, U.S. President Donald Trump recently signed the Holding Foreign Companies Accountable Act into law. This requires foreign (but more importantly Chinese) companies listed in U.S. to comply with U.S. auditing rules within 3 years or risk being delisted from U.S. stock exchanges. This includes Chinese companies listed in U.S. stock exchanges such as Alibaba and Baidu.

Figure 5: Total Number of COVID-19 Cases in Hong Kong



Source: Worldometer

Figure 6: Chief Executive Carrie Lam Support Rating

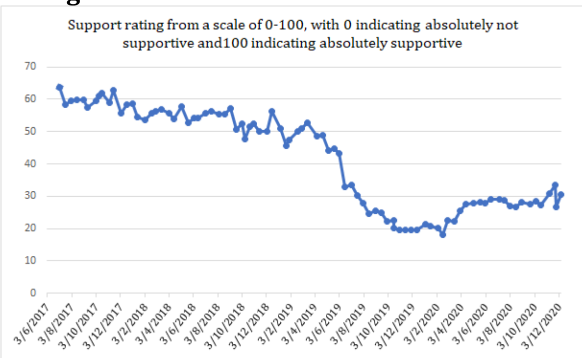
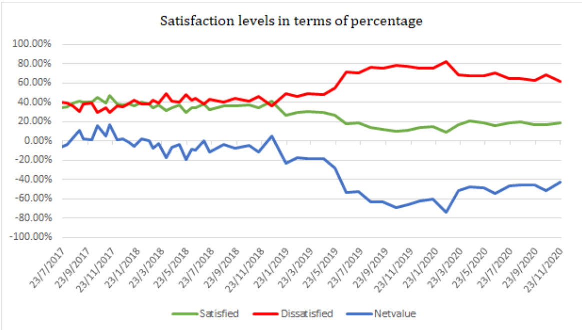
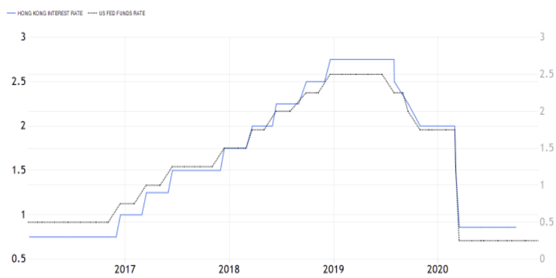


Figure 7: Satisfaction Levels of the HKSAR Government's Performance



Source: Hong Kong Public Opinion Research Institute

Figure 8: Hong Kong Interest Rates & U.S FED Funds Rates



Source: Tradingeconomics

Challenges of Covid-19 & Protests

Just like most countries, Hong Kong has not been the best in stemming the spread of COVID-19. From Fig. 5, we can see that Hong Kong is currently facing the fourth wave of the pandemic, resulting in a surge of the total number of Covid-19 cases to 8153. In response to the rising pandemic cases, Hong Kong government reimplements fresh restrictions that limits social gathering to 2 and bans dining-in at restaurants. Furthermore, the planned Air Travel Bubble between Hong Kong and Singapore has been cancelled as well.

At the same time, on November 11, China's National People's Congress passed a resolution making it possible for Hong Kong to remove lawmakers seen as endangering national security. Beijing disqualified four opposition legislators immediately and the remaining 15 opposition members resigned. As Beijing continues to consolidate their power over Hong Kong while promising to save the ailing economy (according to Carrie Lam), it is insufficient in mending the political rifts and unhappiness within the community. From Fig. 6 and 7 we can see that support for Chief Executive Carrie Lam remains extremely low and satisfaction levels towards the performance of the Hong Kong Government remains deeply negative. Political unrest and hence protest will likely continue into 2021 since there is no clear resolution to this arduous political situation.

Going into 1H2021, vaccines from Pfizer & BioNTech and Sinovac Biotech should arrive in Hong Kong. Assuming the Sinovac's vaccines to be effective as well, the 15 million doses of vaccines would serve to vaccinate more than 5 million individuals. This equates to more than 65% of the population being vaccinated. However, despite the optimism in the COVID situation, continued protests and political unrest will likely persist within the country given their citizens' unhappiness and resent towards the Hong Kong government.

<u>Monetary Outlook</u>

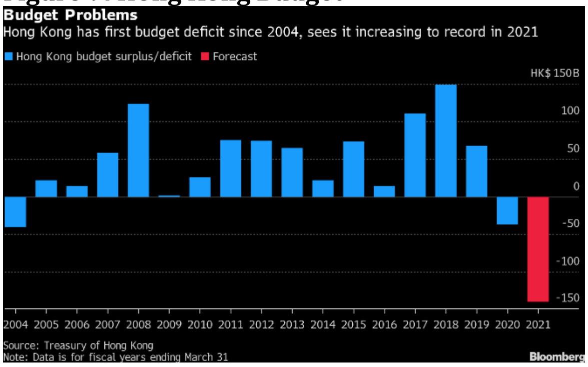
Due to the USDHKD peg, HKMA's base rate highly affected by the monetary policies conducted by the FED. The widespread Covid-19 in U.S resulted in an emergency 100 bps rate cut by the FED to prevent a recession. This rate cut by the FED in March forced HKMA to lower their base rate by 65 bps to 0.86%. Since then, HKMA's base rates remains low as U.S continues to keep FED funds rate low to stimulate borrowing and spending in their economy. Furthermore, the FED has repeatedly mentioned that they will continue to keep rates low through 2023 to support the recovery of the U.S economy. Hence, it is expected that HKMA base rates will remain low at 0.86% for the foreseeable future unless HKMA decides to abandon the USDHKD peg. The suppressed low interest rates should also benefit Hong Kong's economy as low cost of borrowing should help to stimulate investments and spending in the country.

<u>Fiscal Spending</u>

In 2020, fiscal spending has been high due to the need to support given to their economy which has been battered by political unrest and the pandemic. By April, total relief provided by the government reached HKD290 billion, equivalent to 9.5% of Hong Kong's GDP. These fiscal expenditures aimed at providing support to specific sector hit hard by the pandemic, fees wavier & loan repayment deferrals as well as job creation. Subsequently in September, the Hong Kong government launched another virus relief stimulus at HKD24 billion which targets to help finance the affected industries, virus prevention measures and rent concessions.

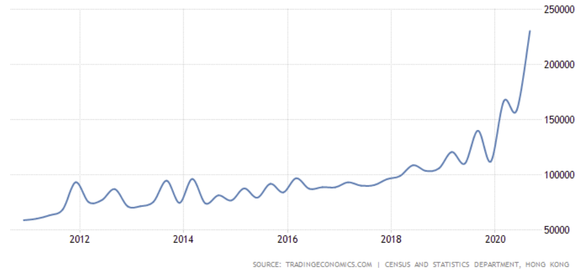
Despite running into budget deficit this year (for the first time since 2004), many economists believe that Hong Kong government could afford to inject more fiscal stimulus into the economy given their large fiscal reserve. The fiscal reserve was last reported at HKD976.6 billion

Figure 9: Hong Kong Budget



Source: Bloomberg

Figure 10: Hong Kong Fiscal Expenditure



Source: Tradingeconomics

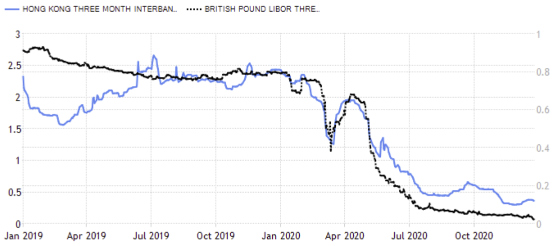
Figure 11: Hong Kong Tourism Arrivals

on 31st July 2020. Looking ahead, budget deficit is likely to worsen given the Hong Kong government's need to tackle high unemployment rates, recession and political unrest. This will likely be the case as the all-time high fiscal expenditure in 2020 has yet to be effective in overcoming the challenges.

<u>Tourism Sector</u>

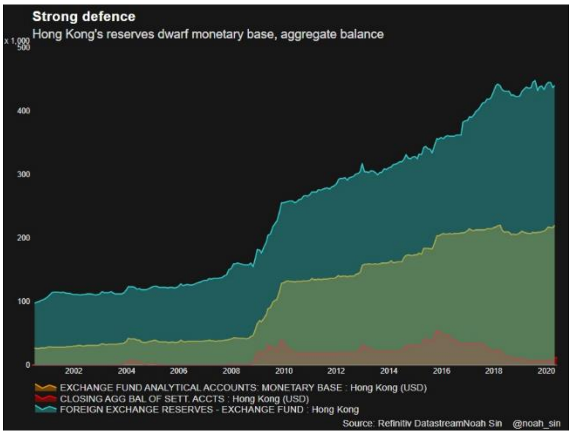
The tourism sector is a major pillar to the Hong Kong economy, contributing to around 4.5% of Hong Kong's GDP and 6.6% of total employment. Like most countries in the world, tourism sector has been hit hard by the spread of Covid-19. Total number of visitors fell 88.2% YoY to 3.5 million in the first 5 months of 2020. Over the same of period, hotel room occupancy rates were at 38% which is 52% lower than in 2019. Globally, the airline industry is expected to burn USD300,000 in the 2H 2020. Despite the optimism of vaccines deployments around the world, it is largely unclear when will the travel industry can fully recover. There are expectations of losses continuing into 2022. This is highly possible since it will require time and money of deploy vaccines to countries all over the world. Furthermore, it will also take time for countries to fully open their borders to the world as seen in the quick cancellation of Singapore-HK travel bubble when Covid-19 cases surged in Hong Kong recently.

Figure 12: 3 Month HIBOR-LIBOR Rate



Source: Tradingeconomics

Figure 13: Hong Kong's Reserves



Source: Bloomberg

"USDHKD Peg"

Since 1983, the USDHKD trades in a tight band of $7.75 - $7.85. This is supported by the HKMA who buys and sells currency in the foreign exchange market to maintain the peg. The 1992 act states that U.S. will allow USD to be 'traded freely' with the HKD.

Following the implementation of NSL, there has been threats by the United States, specifically the Trump administration, to strike the USDHKD peg. One of the possible proposals considered includes limiting Hong Kong's ability to buy the dollar, and hence the ability to defend the peg. However, by doing so, Hong Kong markets will essentially be isolated from Wall Street. This will result in immense damage to both the Hong Kong markets and Wall Street since many U.S. firms have businesses setup in Hong Kong.

The USDHKD peg is at $7.75 currently, the strongest value of HKD against USD the band allows. Despite the protest, COVID recession and loss of "special status", the HKD is still strong against the USD. Besides the weaknesses of the greenback attributing to this trend, mega IPOs and positive HIBOR-LIBOR spreads are also contributing factors.

The recent mega IPOs such as JD and Netease have attracted investors into the Hong Kong markets. This creates strong capital inflow, strengthening the HKD. Furthermore, the positive HIBOR-LIBOR spread might also result in more money flowing back into HKD. Hence, thus far this year, the Hong Kong Monetary Authority (HKMA) has interfered the exchange 40 times, selling a total of HK$132 billion.

In the event the peg breaks below $7.75, it is likely made possible by limiting the ability of American and potentially other foreign banks to sell USD to Chinese lenders. As the HKD appreciates above the $7.75 levels, investments into Hong Kong by U.S companies becomes more costly. Hong Kong exports will be less competitive. Foreign investments and export revenue will fall as a result. Eventually, this creates net capital outflow from Hong Kong which will hurt the economy. This outcome is unlikely since a strike against the peg by U.S. will force U.S. companies, especially banks, to stop operating in Hong Kong. This is huge stakes as U.S banks will not want to give up access to China markets.

In the event the peg goes above $7.85, it would mean that the HKMA does not have sufficient foreign reserves to defend the peg. A breach of the peg would possibly impair Hong Kong's global financial status and hence result in capital exodus. However, this is highly impossible since Hong Kong has $440 billion of dollar-denominated foreign currency reserves with the additional option of borrowing from China's central bank who has $3 trillion reserves.

Figure 14: Hang Seng Index Daily Chart

Source: Tradingview

Short Hang Seng Index (HSI)

Based on the above analysis on the peg, it is unlikely that HKMA would stop defending the lower band of $7.75 for now.

The dollar is likely to remain weak in 2021 due to the commitment by the FED to keep interest rates low and the idea of average inflationary targeting. The success and distribution of 2 vaccine candidates have also resulted in more funds shifting to riskier assets and away from safe haven like the USD. Furthermore, with a positive HIBOR-LIBOR spreads, the USDHKD will likely remain at the lower band in 1H 2021. Hence, remaining square on the USDHKD while watching if the pair eventually breaks the peg would be recommended.

Headwinds to the Hong Kong markets in the future will likely bring about a bearish outlook for the HSI.

The HSI has been benefiting from the listing of Chinese companies in Hong Kong as well as global investors who invest into Chinese companies via Hong Kong. However, the introduction of Chinese stock exchanges, with the latest being Shanghai Stock Exchange STAR market, it would mean that there is decreasing reliance for Chinese companies to go public in Hong Kong to raise capital. The recent suspension of Ant Group listing has also spooked (fintech) companies with the increase regulations by China.

The NSL, which has led to Hong Kong's loss of special status, made Hong Kong a less favourable country for global investors. The loss of tax-free regimes with the U.S will possibly deter companies from setting up businesses in Hong Kong as well. This is apparent especially amongst global investors or companies looking to expand into Asia. Singapore is seen as a viable substitute for the global financial hub Hong Kong.

Therefore, the increasing competition in the Asia space coupled with decreasing favourability of Hong Kong as a global financial hub, will lead to slower growth in the equities markets or even capital outflow in Hong Kong, which will harm the HSI. That said it should be noted that with the worsening of U.S-China tensions recently, further sanctions on Chinese companies might possibly result in delisting of Chinese companies that are listed in U.S. This might be beneficial for the Hong Stock exchange if these Chinese companies choose to list in Hong Kong as an alternative. This should not affect the trade idea to short the HSI as the whole process of removing Chinese companies from U.S and listing of Chinese in Hong Kong will be a lengthy process.

The recent bullish trend in Asia has benefitted the HSI as well. This is an opportunity for entry to short the HSI. The entry of 26855 would be near the downward sloping trend line. Using the Fibonacci retracement levels to get the support and resistance levels, the SL would be at 28530. There is also another strong support at 22576 levels. Hence, TP levels should near that level would be recommended. Furthermore, the RSI has been decreasing recently after peaking during end November. However, with an RSI of 58, there is plenty of downside for left before reaching the oversold region.

Entry: 25930

Take Profit: 22576

Stop Loss: 27244

Risk Reward Ratio: 2.55

NUS INVESTMENT SOCIETY

Global Macro Department – TAIWAN (OVERWEIGHT)

Date: 27th December 2020

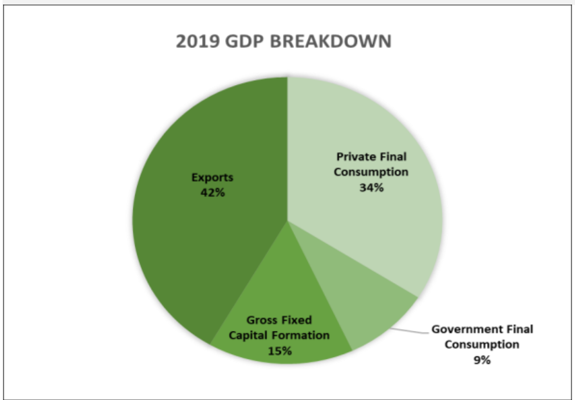
Analysts

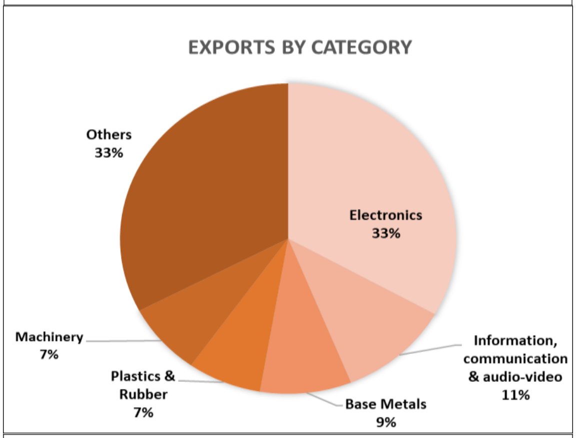
Chessneth Chua
Global Macro Analyst
chessnethchua@gmail.com

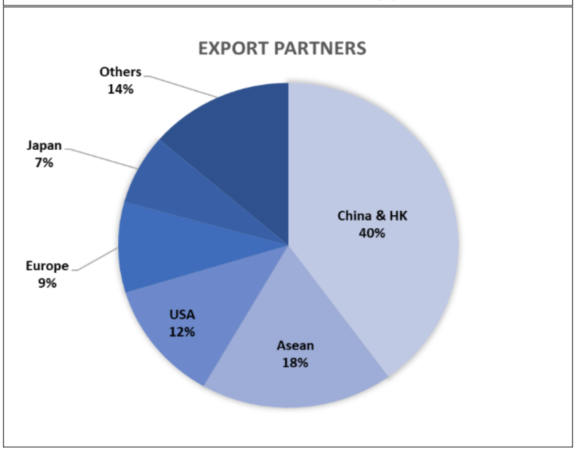
Basic Information

GDP:	USD605 billion
GDP Growth Rate:	3.92%
USDTWD:	28.109
CBC (TW) Rates:	1.125%
Interbank Rates:	0.48%
CPI:	102.69
Inflation Rate:	0.09%
Manufacturing PMI:	56.9
Unemployment Rate:	3.77%
BoT:	USD5.27 billion

Chart info







Overview

Taiwan, officially the Republic of China, is a small yet significant country in Asia. Due to a small surface area, Taiwan is one of the most densely populated country in the world. With a fully developed economy, IMF considers Taiwan as an advanced economy after witnessing Taiwan as a technology manufacturing powerhouse.
As a result of Taiwan's population and manufacturing capabilities, the main drivers of Taiwan's economy are the service and manufacturing sector. Electronics is also seen taking up 33.1% of Taiwan's total export. This source of export revenue to crucial to Taiwan as exports takes up 42% of Taiwan's GDP.

Taiwan's main export partners are mainly in Asia as more than 50% of their exports goes to Asian economies. Importing the biggest portion of Taiwan's export would be China & HK taking up 40%, followed by Asean countries taking up 18%. Coupled with the GDP breakdown, Taiwan's economy is highly sensitive to events and changes in the Asia region. An example would be the escalation of U.S-China tension which has allowed Taiwan's exports and hence the economy to benefit greatly.

Events in the past 6 months

Like the rest of the world, Taiwan's economy was weighed down by the pandemic. In bid to combat the pandemic, Taiwan's government announced 3 stimulus packages thus far totalling to about NT$1.2 trillion. Besides the usual efforts to support employment and provide financial relief to individuals and businesses, Taiwan's most recent stimulus package titled "Tripe Stimulus Voucher Program" creates a forced stimulation of the economy by increasing domestic consumption. This program allowed Taiwanese citizens to purchase NT$3000 worth of spending vouchers, that can be used on a myriad of purposes, for only NT$1000.

The pandemic has also pushed Taiwan's 2020 fiscal expenditure to 3075.8 TWD billion. This amount is only slightly lower than the previous high in 2000.

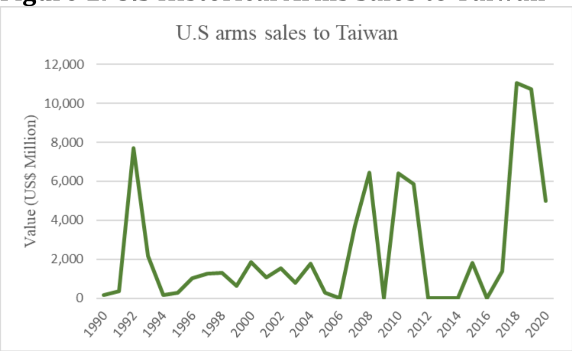
With the effective measures to prevent the spread of COVID-19 and recovering of global economies, Taiwan's economy managed to expand 3.92% YoY in Q3 2020 following a small expansion in the previous quarter.

Looking at the 3Q performance, exports of goods and services grew by 3.64%, largely attributed by the strong foreign demand for electronic products part, Info-Comm and Audio-Video products. At the same time the growth is offset by the contraction on the demand side where private consumption fell 1.48% in Q3 following a 5.21% decrease in 2Q. The improvement for private consumption is likely to be buoyed by the government stimulus that aimed at boosting domestic consumption. The continued contraction does show that there is still room for further growth in 2021 although it will probably require more government stimulus for that to happen.

Taiwan currently holds the longest record for having zero local transmission of the Covid-19. Having a record of 200 days without a local transmission, Taiwan is ranked 2^{nd} on the Bloomberg's Covid Resilience Ranking. Although Taiwan's record is now broken, the government is swift and strict in handling the locally transmitted cases.

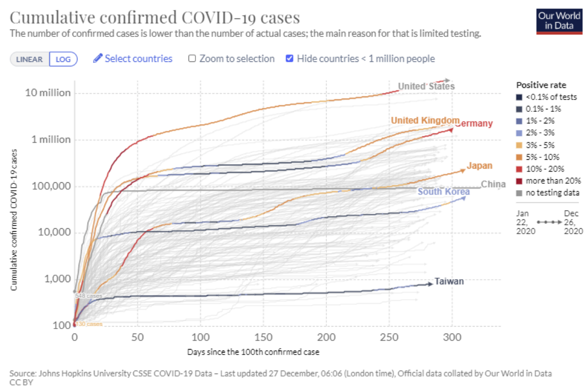
The recent local transmission due to a pilot has caused the pilot to lose his job. Furthermore, the Taiwan Tourism Board cancelled an annual New Year celebration event after receiving the news as well. This shows that the Taiwan authorities are not tolerant of any offenders and they are trying hard to prevent a second wave from occurring in their country. Currently the total number of cases in Taiwan stands at 785 with a total of 7 deaths.

Figure 1: U.S Historical Arms Sales to Taiwan



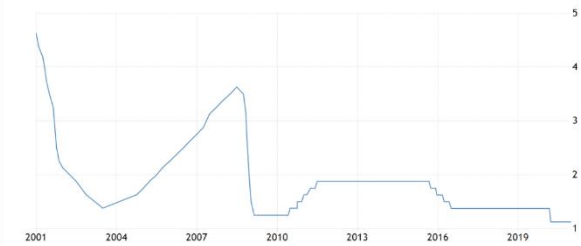
Source: FAS

Figure 2: Taiwan's COVID cases as compared to the world



Source: Johns Hopkins University, Our World in Data

Figure 3: Taiwan's Interest Rates



Source: Tradingeconomics, CBC (TW)

Figure 4: Taiwan's Unemployment Rates

Source: Tradingeconomics, National Statistics (Republic of China)

Strengthening Defense and U.S Ties

Earlier this year in August, Taiwan formally signed an agreement with U.S for a purchase of 66 latest model F-16 jets built by Lockheed Martin Corp. Subsequently in September, U.S announced that they are set to make a $7billion arms deal with Taiwan. And mostly recently, in October, U.S has officially approved an arms sale to Taiwan valued at $1.8 billion. This deal includes 3 weapon systems namely rocket launchers, sensors and artillery.

Over the years, since 1990, Taiwan has been consistently increasing their military budget in a bid to strengthen their defence capabilities. We can see that U.S has been actively supplying arms to Taiwan over the years. This number increased during Trump administration where prior to the potential $7 billion deal, U.S has sold an estimated of $15 billion worth of arms to Taiwan. This is a considerably huge jump in amount compared to the total of $14 billion arms sales conducted over 8 years of Obama administration.

The multiple agreements between U.S and Taiwan come at a time where U.S-China tensions are rising and China's repeated military threat against Taiwan.

"Taiwan not a country" - China

This historical relations between China and Taiwan dates back to the time when Chiang Kai-Shek and the remnants of Kuomintang (KMT) fled to Taiwan after they were defeated by Mao Zedong in a civil war. Since then, China has been trying to establish a "one country, two systems" approach towards Taiwan just like how they did with Hong Kong.

However, following the election in 2000, Taiwan's president continually steered clear of the idea while backing independence. This is further championed after President Tsai was elected in 2016 to lead the Taiwan towards eventual independence from China.

Recently, during Taiwan's National Day, the Indian Media was reminded by the Chinese Embassy in India, not to violate the 'One China' principle. It was stated that Taiwan should not be referred to as a country or 'Republic of China' and President Tsai should not be referred to as President or leader of Taiwan. This backfired as Taiwan's Indian friends reacted by telling China to 'Get Lost'. This is possibly attributed to the fraught China-India relations after 20 Indian soldiers were killed in a clash with Chinese troops in June.

Subsequently, despite President Tsai's calls for peaceful dialogue with China, Beijing responded with announcements of live firing drills in the Taiwan Strait. It should also be noted that on the 11th of October, yet another Chinese military aircraft entered Taiwan's air defense identification zone (ADIZ), marking the 17th time such incursion happened in less than a month.

Economic Outlook

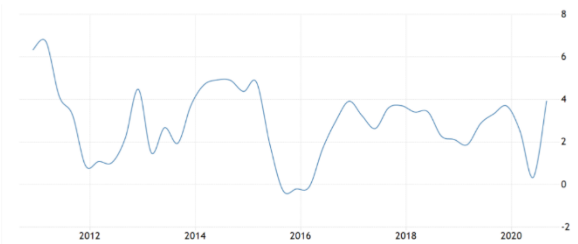
<u>Covid-19</u>

Holding on to the record as country with the longest duration without domestic infection, Taiwan ranks 2nd in the Bloomberg's Covid Resilience Ranking. Taiwan has been one of the most efficient country in dealing the pandemic with only 766 total number of cases thus far. This has been advantageous for the Taiwan economy as investors and fund managers have been attracted to the assets in Taiwan given her optimistic pandemic recovery outlook. However, with the success of leading vaccines and more upcoming vaccines candidates, the recovery (within developed countries) is largely optimistic. This may possibly result in decreased bullishness of the Taiwan economy as the

Figure 5: Taiwan's Balance of Trade

Source: Tradingeconomics, Ministry of Finance (Republic of China)

Figure 6: Taiwan GDP Annual Growth Rate



Source: Tradingeconomics, National Statistics (Republic of China)

Figure 7: Taiex Daily Chart

Source: TradingView

Figure 8: China Imports from Taiwan

Source: Tradingeconomics, China Customs

gap between countries highly affected by COVID-19 and Taiwan is expected to narrow across 2021.

<u>Monetary Outlook</u>

The widespread Covid-19 in the world has led the Central Bank of the Republic of Taiwan to cut their key discount rate to record low of 1.125% in March this year. The central bank has most recently kept interest rates at the record low level on the 17th of December, continuing to provide excess liquidity in the markets as widely expected. This is probably due to expectations that global economic recovery will still take some time, which will affect Taiwan's export-oriented economy. Looking further ahead into 2021, key factors affecting Taiwan's monetary outlook will include the effectiveness of the vaccines and U.S-China relationship.

Zooming into other economic indicators and policies, Taiwan's recovery looks promising. The unemployment rate has also declined steadily to 3.77% in November 2020, which is only 0.04% higher than the same period last year. Furthermore, the Balance of Trade (BoT) surged and remain strong since May 2020, providing higher export revenue to the economy than in 2019. In particular, the trade surplus widened to USD5.27 billion in November 2020 as compared to USD4.27 billion last year. GDP annual growth rate remains positive at 3.92% in Q3 2020 with projections for an overall growth of 2.54% in 2020. The forward guidance by CBC also included an upward revision of economic growth in 2021 to 3.68% as well as improving exports and domestic consumption. The TAIEX also showed relatively strong rebound in equities with current YTD up 19.46%.

<u>Semiconductor Exports</u>

Being part of Taiwan's largest export category, electronics, the growth of semiconductor industry in Taiwan is a trend that should be closely watched. Taiwan total semiconductor exports in 2020 is set to hit USD103 billion, with expectations that it will continue growing in 2021.

The sector expects further tailwind heading into 2021 as U.S-China tension worsens. In the first 8 months of 2020, accumulated semiconductor equipment imports hit a record of USD14.28 billion, up 9.3% YoY. This is a leading indicator of the demand of Taiwan's semiconductor products as it is expected that this increase in equipment import is a result of meeting the demand from China. In particular, this trend has Taiwan is importing high-end equipment from Japan and Europe to improve the competitiveness of their products. This is essential to act as an alternative to U.S semiconductors.

The tightening U.S sanctions on China recently worsened where fresh sanctions on China's SMIC further creates benefits to Taiwanese semiconductor industry. Taiwanese semiconductor companies that stand to benefit includes, United Microelectronics Corporation (UMC), VIS, Powerchip, Macronix, Winbond and TSMC.

Looking further ahead, though it has been said that Biden administration might allow for an improved U.S-China relation, it is unlikely that Biden will unwind all the previous sanction imposed on China. In the event Biden does decide to continue his predecessor's efforts, this trend will likely continue into the whole 2021.

Furthermore, while China announced their plans to become a tech powerhouse in the coming years, they are limited by their capabilities to produce cutting edge hardware for areas such as 5G technology. Despite China's investments into the technology space, it will be unlikely for China to be self-reliant on developed advanced chips by 1H 2021.

Statistics from the Bureau of Foreign Trade showed that almost 30% of Taiwan exports went to China, and Chinese importers have bought up more than 1/3 of the $32.9 billion of Taiwan exports from the category that covers semiconductor in the 3rd quarter. This shows that Chinese demand for Taiwan's semiconductor hardware constitutes to a significant portion of Taiwan's exports.

Therefore, judging from the global macroeconomic and political outlook, Taiwan semiconductor industry will likely continue to gain in the 1H 2021 with possibility of this trend stretching into the 2H 2021 as well.

Figure 9: USDTWD Daily Chart

Source: Tradingview

Trade Idea: Short USDTWD

The basis to the short USDTWD is due to the above-mentioned macroeconomic outlook and geopolitical factors. First, the key indicators and statistics of Taiwan's economy painted an optimistic view of Taiwan's strong recovery extending to 2021. Coupled with an effective containment of the COVID-19, where Taiwan is seen as one of the best countries in managing the spread of Covid-19 pandemic. The resurgence of the pandemic is also occurring across multiple countries currently such as Germany, South Korea and Japan. Although there are multiple vaccines in the making with 2 obtaining approval from the U.S FDA, it will be unlikely for other countries to shrug off the COVID-19 completely by the 1H 2021. Hence, Taiwan's economy will attract more investments as they continue to outshine other Asia and global economies going into 2021. Therefore, the increase the demand of TWD or keep it at high levels, which will create further strength in the TWD in 1H 2021.

Second, the U.S-China tension is expected to continue into 2021 even after Biden takes over as the new president of United States. This means that the sanctions on Chinese companies and bans on American companies from providing goods and services to Chinese chip making companies will likely continue. As a result, China will have to continue to import advanced semiconductor chips to fill the void for Chinese's demand. Furthermore, continued sanction will also create delays in China technological advancement plans as well as their ability to be self-reliant on developed advanced chips. This trend might also deepen if Biden decides to further target Chinese technological companies after he officially takes over Trump in January next year. Hence, the continuation of this trend will continue to provide tailwind for the growth of Taiwan's exports especially within the semiconductor space. This means that demand for Taiwan's exports will grow and thus creating bullish strength in the TWD as well.

Finally, besides the above factors that will lead to increase in demand for the TWD, the dollar bear cycle in the works helps with the short on USD. The dollar is likely to remain weak in 2021 due to the commitment by the FED to keep interest rates low and the idea of average inflationary targeting. Furthermore, the success and distribution of 2 vaccine candidates have resulted in more funds shifting to riskier assets and away from safe haven like the USD. Therefore, my trade idea to short the USDTWD.

The USDTWD has recently closed at the 28.10 new support level. Like the previous support level at 28.51, the USDTWD pair should consolidate and fluctuate around this support for some time. RSI at 28.55, showing oversold indication. Although the likelihood of a stimulus is expected in the coming week, it seems that the recent dollar weakness has already priced in that event. The next support line is at 27.40 levels established in 1990-1998. In such an outlook. Looking past the stimulus bill with the ongoing low interest rate environment in U.S till 2022 and above-mentioned macro factors, there is more room for the USDTWD to fall further. Hence, unless there is malfunction of the approved vaccines in the world which might cause a rush to the USD in a risk-off move, the potential for a greater fall in the USDTWD pair give rise to a further short trade idea. However, it would be ideal to enter at a higher price of 28.30 with any news of the stimulus bill delaying. The pair is also in the oversold region which suggests the possibility of a slight rebound upwards during the consolidation period at this new support. There is also a possibility of further adding shorts nearing the TP levels if the macro-outlook supports the trade idea. An example would be the increase in sanction on Chinese companies after Biden takes over as the new President. In this event, the new TP level would be at the 27.40 support.

Entry: 28.3

Take Profit: 27.85

Stop Loss: 28.60

Risk Reward Ratio: 1.50

NUS INVESTMENT SOCIETY

Global Macro Department – Japan (UNDERWEIGHT)

Date: 27th December 2020

Analysts
Poh Yong Quan
Global Macro Analyst
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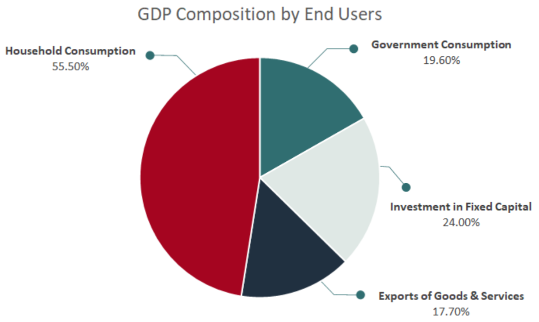
Basic Information

Real GDP(USD)	USD 5.08 Tril.
Real GDP Growth Rate Q3	1.9%
CPI	102
PPI	93.5
Con. Confidence	33.6
Nikkei	24325.33

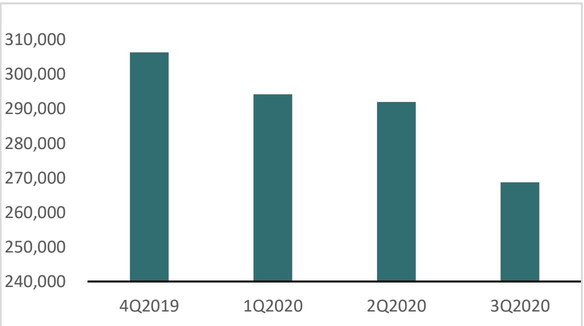
Chart info

Figure 1: GDP Composition by End Users



Source: theodora.com

Figure 2: Japan Consumer Spending



Source: Trading Economics | Cabinet Office, Japan

Overview of Japan

Japan is the third largest economy in the world where its nominal GDP is worth USD 5.08 Trillion in 2019. The economy is mainly composed by household consumption at 55.5%. The top export goods in Japan includes Vehicles at 21.3%, Machinery at 19.4% and Electrical machinery at 14.6%. The services sector which stand at 56.8% of the whole industry is driving the whole economy, followed by the industry sector at 33%.

PM Suga to take over the Ex-Pm Abe

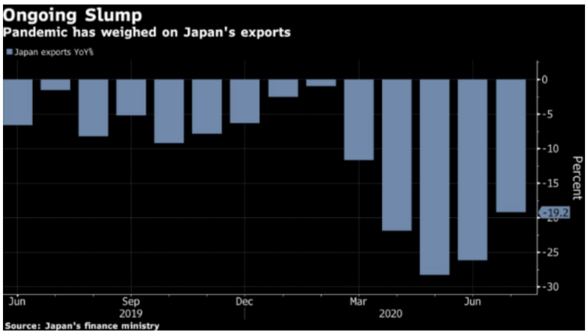
Ex-PM Abe has retired due to ill health and Suga, at the age of 71 who was the chief cabinet secretary in Abe's government, has been chosen as the leader of the ruling Liberal Democratic Party and would take over the PM seat. PM Suga said that he will aim to continue practising 'Abenomics' and his top priority is to get Japan out the pandemic slump. PM Suga has been a spokesman for Abe, and defended decision made by the government, especially when Japan hike sales tax in 2019. He has also pushed for several landmark policies which includes relaxing the restrictions on foreign workers which is vital for Japan's aging population.

Economy Picking Up

Pandemic Effects

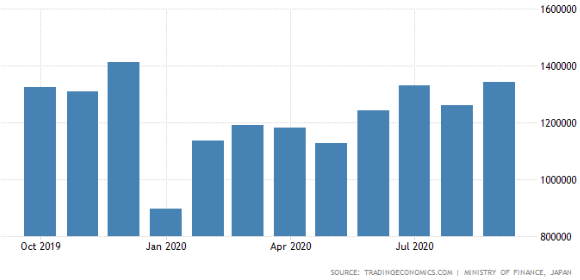
The pandemic first hit Japan back in April, where number of Covid-19 cases spike to above 500 per day, and with its close proximity to China which is the source of the outbreak, combined with a large aging population, Japan was ravaged by the pandemic. In addition, there was outbreak on the Diamond Princess cruise liner which was asked to dock in Yokohama, and the people onboard was asked to quarantine on the ship and 2,664 passengers were confined to their staterooms which was rather worrying as the aircon system on the ship was a central one, therefore this has accelerated the spread of the virus on the ship, which it was reported that when 61 couples got tested and got off the ship at the start, 25% of the people onboard were already tested positive. The Government however did not do a country wide lockdown during when a national state of emergency was declared on April 15. The government requested that people refrain from going out and restaurants and bars were suspended. This has led to a significant drop in the consumer spending for 1Q2019, 2Q2020 and a drop of 12.3% from the peak in 1Q2019 to the current low in 3Q2020. Expenditure on cultural activities and recreation has dropped 21.2% leading the overall decline in the spending data. Outlays for domestic and oversea package tours tumbled 87.3%, and spending on airplane and train tickets has also plummeted by 95.9% and 79 %, respectively. Separate data showed that the nation's inflation-adjusted real wages fell 1.4% in August from a year earlier, down for the sixth straight month. In addition, cash and deposits held by household reached a record 1,030 tril. yen (USD 9.76 tril.) at the end of June, therefore

Figure 3: Japan exports YOY%



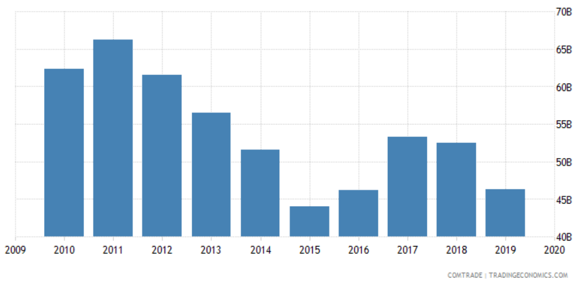
Source: Bloomberg

Figure 4: Japan exports to China



Source: Trading Economics | Ministry of Finance, Japan

Figure 6: Japan Exports to South Korea



Source: Trading Economics

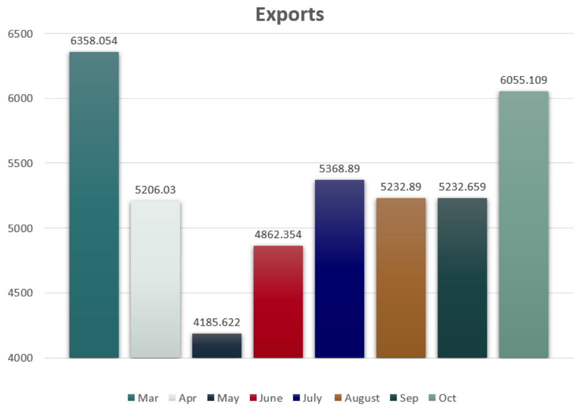
household savings rate has surged in the month of June by 62.1%. Hence, the Japanese who are known to be thrifty in their spending are saving more now due to the pandemic. Consumer spending makes up 55.5% of the economy, with the slowing down in domestic consumption, the GDP growth rate has been adversely affected.

Furthermore, global demand for goods and services has entered a slump since the pandemic has started. China, U.S. and Korea, all of which are major trading partners of Japan, have reported low or even negative growth rates in the first quarter of 2020. U.S. has also reported lower levels of import month on month dropping the top in January 2020 of $253.9 bil. to the lows in April at $200 bil., a drop of 25%. Japan's exports slumped the most in 10 years in May, only receiving 4.1 tril. yen, down from 36.3% from pre-pandemic levels and Japan's overall shipments overseas slid 26.2% in June from a year earlier. Out of the all the exports, vehicle and vehicle parts were affected the most, nosediving by 64.1% and 57.6% in May year on year. U.S. bound shipments, another key market for Japanese goods such as cars and electronics, fell 16.5% YOY in March, this was due to the lower demand for cars, airplane motors, construction and mining machinery. Economist Takeshi Minami said that the exports seem to be bottoming up, but the pace of recovery is likely to be slow, as rising infection rates in the U.S. and elsewhere hamper efforts to reopen.

<u>Trade dispute with Korea</u>

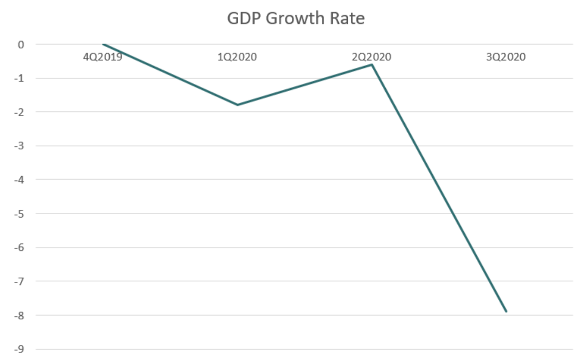
Japan and Korea trade disputes have not been dissolved as of yet. In Jul 2019, Japan tighten controls on exports of hi-tech materials to South Korea caught Seoul off guard and vulnerable as South Korea tech giants such as Samsung Electronics, SK Hynix and LG display depended on the few materials that Japan has placed restrictions on. The Japanese cabinet has also approved the removal of South Korea from the "White Countries" which are countries that have most-favoured status as trading partners. The South Korean court decision had ordered Japanese firms to compensate the victims of forced labour during World War II, and Japan was angered by this as it believes that the matter was settled by the 1965 treaty that normalised ties with South Korea. Japan's then Chief Cabinet Secretary, now PM, said "restricting the imports had become necessary on 'national security' grounds after South Korea failed to find a 'satisfactory solution' to the wartime labour issue.' However, analysts stated that although this is bad news for South Korean tech giants, which are heavily reliant on Japanese products, they could very swap out for U.S. or Chinese made component which will definitely hurt Japan in the long run as Korean companies contribute to a considerable share of their earnings. As far as of now, we feel that the Japan and Korea dispute have no end in sight, and we believe that the relationship between the two nations will improve in the near term.

Figure 6: Japan exports



Source: Trading Economics

Figure 7: Japan's GDP Growth Rate



Source: Trading Economics | Cabinet Office, Japan

<u>Japan's second half of the year</u>

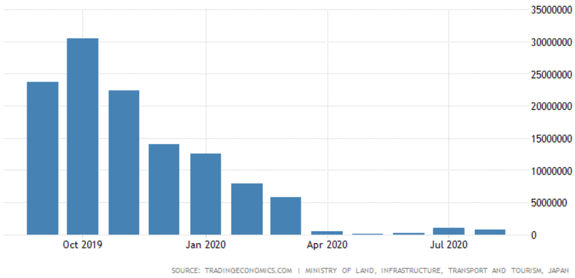
As we are moving into the fourth quarter, economies around the world has reopen their borders and global trade demand has started picking up. Japan's top trading partner, China has warranted two positive growth for the second and third quarter of the year, and this definitely spells good news for Japan. Additionally, the U.S. economy expanded by a whopping 33.1% in 3Q2020, beating the forecast by 2%. With Japan's top two trading partners posting bumper results in terms of GDP growth rate, it is a key indicator for exporters for Japan post their 1st trade surplus in 4 months, garnering 11.6 bil. yen goods trade surplus, which is helped by the increase in exports to China and U.S. As a result, Japan's exports level is recovering back to pre-pandemic levels, which was averaging around 6.5 tril. yen., exports level is now currently at 6.06 tril. yen in September. However, the large increase in exports might be due to pent up demand during pandemic, and some analysts questioned whether this level of exports could be sustainable as some countries are seeing a resurgence of the Covid-19 virus such as countries in the Europe and in U.S.

<u>Could we see positive GDP growth rate for 4Q2020?</u>

Japan fell into recession back in the second quarter of the year, having two succession of negative growth rate, -1.8 % for Q1 and -0.6 for Q2. Job vacancies in Japan has reached the peak in 23 years and unemployment rate has increased from 2.4% in January to 3% in September. Japan's unemployment rate is considered modest as compared to other Asian countries such as Indonesia, with unemployment surged to its highest level at 7.07%. The Japanese government has urged employers to retain their employees, they have rolled out an employment adjustment subsidy. This subsidy is eligible for companies that saw revenue drop by more than 10% as compared year on year. The scheme requires the company to make its employees to go on leave at once or by turns and pay 60% or more of the average wages to such employees. The government will then provide a subsidy up to 100% depending on the size of the firm with the cap of 8370 yen (USD 80.72) intended to end in June 2020. However, the Labour Ministry in August has decided to extend the employment adjustment subsidy plan to the end of this year and raised the cap to 15,000 yen (USD 144.6). In addition, the government has provided a one-off virus relief handout of 100,000 yen (USD 940), in hopes to boost domestic consumption.

Ex-PM Abe's cabinet approved a new $1.1 tril. stimulus package that includes direct spending to cushion the impacts from the pandemic on Japan. The total spending by the government to combat the virus slump is now at $2.18 trill. Which stands around 40% of the GDP. Japan will issue an additional 31.9 tril. yen in government bond to fund the total cost of the stimulus. Japan's government debt ratio in 2019 was at 230% of GDP. This is largely concerning because high public debt can affect the sovereign credit rating of the country, if Japan's ratings were to drop, this will send a shock to the debt market, and investor would unload their Japanese government bond, sending the yields up and counteracting the efforts of the government.

Figure 8: Japan Tourism Revenue



Source: Trading Economics | Ministry of Land, Infrastructure, Transport and Tourism, Japan

Japan tourism revenue took an unprecedented dropped by 97% from the peak of October 2019 to the current level in August. Tourism has continued to remain low in the third quarter as the foreign visits to Japan per month is only averaging around 5,000 as compared to 2.5 million visitors in August 2019, which is a 99.8% plunged YOY. Given that there are no readily available vaccines for the masses as of yet, the international tourism is not likely to recover anytime soon. Despite that, the government has introduced a policy to boost domestic tourism, where it accounts for 70% of the tourism revenue in Japan, which has taken a plunged during the pandemic period where cities went into lockdown. The new campaign termed 'Go to Travel', is a Japanese government subsidy that subsidies up to 50% on transportation, hotels, restaurants, tourist attractions and shopping, all within Japan from July onwards. The budget is limited to 20,000 yen per person per night or 10,000 yen per person per day trip. Analysts questioned the prudency of the government to roll out such a campaign during the time where resurgence of the virus could happen. Therefore, we are likely to see a slight boost to the tourism market with the new policy. As for international tourism, the Olympics is scheduled to open in Tokyo on the 24th of July 2021, therefore, we might see international tourism recover leading up to that date, however, in the near term, international tourism would likely stay in the low levels.

Moving on to tax rates, Japan hike its sales tax in October 2019 from 8% to 10%. The last time Japan raised its taxes was in Apr 2014, and Japan was thrown into recession. Leading up to this 2014 sales tax hike, the economy was already in a bad shape, they were not hitting the inflation target and GDP growth rate was barely positive, averaging around 1%. Similarly, Japan export was affected by the trade war between China and U.S. and GDP growth rate for 2019 ranged from 0% to 0.7%. This sales tax hike was to support the government's spending on pensions and health care for the growing aging population. However, Japan might have shot itself in the foot as the Covid-19 virus came right after the hike, which resulted in the Japanese economy getting hit by a double whammy.

We believe that Japan's GDP growth rate will remain in the lower regions given the fact that the tourism market will not recover fully in the near term and consumer spending will likely to remain low as well as compared to that of pre-pandemic levels.

Interest Rate

Abenomics

Figure 9: Japan Inflation Rate

Source: Trading Economics | Statistics Bureau of Japan

Japan has employed an extremely easy monetary policy where the Bank of Japan decided to lower their rates to 0% on several occasions such as the Asian Financial Crisis in 1997 and also the Global Financial Crisis. It was also part of ex-PM Abe economic policies termed 'Abenomics', which was to get Japan out of low or negative growth and to hit the target inflation of 2%. His policies were intended to increase competition, expand trade, and raise the rate of employment and also the quality of the employees in the economy which are dubbed as the Three Arrows. A major problem that Japan is facing is the shortage of labour and aging population, people will eventually retire and leave the workforce as they start to age, and currently, there are not younger workers in Japan to fill this vacuum. The Japanese government approved a bill to urge businesses to let employees work until the age of 70, with the aims of increasing the working population to retiree ratio. However, raising the retirement age is just a temporary solution, Japan requires a solution that is more durable, for example, relaxing its striction controls on foreign workers which ex-PM Abe intended to do. The Japanese government decided back in May 2018, to welcome more than 500,000 foreign workers through year 2025, this is done to offset the labour shortage in industries such as agriculture and construction. We believe PM Suga will continue this line of policy and

Figure 10: Japanese 10-Year Bond Yield

Source: Investing.com

not deviating from 'Abenomics', however, as PM Suga plans to expand on the foreign labour inflow, this would definitely help the shortage of labour in Japan. We could also possibly see foreign capital inflow to expand their business here in Japan with more relax foreign labour policies. The Japanese government will also open an English-speaking support office for foreign asset management firms seeking to do business in the country in January, which will boost Japan's standing as a global financial centre.

<u>Negative Interest Rates</u>

Japan has been struggling to hit their inflation rate target of 2%, where the highest that it has ever reach in 5 years was around 1% and there were only two separate occasions when inflation did manage to hit 2%, one was during 2007 and the other in 2014. An aggressive monetary policy was adopted to boost the economy and help it growth. The Bank of Japan first lowered their interest into the negative region in 2016, in addition, the Japanese government bought a huge amount of government bonds to drive long-term interest rates down, which can be seen by the huge decrease in the 10-Y bond yield and even crossed the negative region in the year of 2016. Japan was not the first country to adopt the negative interest rates policy. The negative interest rate was to encourage banks to put their money to more productive use than holding their unused cash at the central banks. As with negative interest rates, it means that depositors will now have to pay money to save their money which is a reverse from the norm.

The Swiss were the first to adopt such a policy. It was during the aftermath of the war in 1970s, and Swiss franc was considered a safe-haven currency, therefore there was tons of money flowing into Swiss franc, strengthening it in the process. They believed that by having negative interest, it could halt capital inflows and stop their currency from going too strong. The Swiss economy is dependent on its exports such as precision tools and watches. The Swiss government first imposed a 12% 'negative interest rate' on non-residential deposits. However, this did not stop the inflows of money which caused the Swiss franc to be propped up even further. As a result, the export sector stumbled, and Switzerland was thrown into recession. Japan is somewhat in a similar state, where its currency is also considered a safe haven and exports is a key driver of growth. Carry trade in using Japanese Yen is very common, as interest rates are low in Japan, investors would utilise the cheap loan available in Japan and sought to find investment with high returns. However, during a financial crisis or risk-off period, there is a roll-back of carry trade and Yen would strengthen in the process and hurting its export, which negates what the policy intended to do. One of the senior IMF officials commented on Japan easy monetary policy, "Interest rate cuts may do more harm than good to Japan's economy hit by fallout from the coronavirus pandemic", referring to anymore easing of their monetary policy might lead to the increase buying of risky assets by investor and causing a bubble. Therefore, we do not expect any further cuts by the Japan and considering that the inflation target is far from met, we believe that the Bank of Japan would not hike rates in the near to medium term. However, we are certain that BOJ will still utilise quantitative easing in order to boost the current economy up.

Figure 11: CNYJPY Daily Chart

Source: Tradingview

Trade Idea: Long CNYJPY

The Chinese economy has been growing for the past two quarters and is projected to grow at 8.1% for the year 2021 by the IMF. Consumption level in China has been picking up as retail sale rose 3.3% YOY in September which is above the estimates. In addition, industrial production went up by 6.9% which marks the biggest gain in 2020. We believe that China's GDP growth rate is likely to be the first to reach pre-pandemic levels. As compared to Japan, although exports level are recovering, the possibility of dissolving dispute with South Korea is very slim within this year, therefore this might hinder the exports recovery rate. Japan household consumption has been hit by a double whammy, a sales tax hike and the pandemic, even though the Japanese government has given a relief pay-out to the residents, the level of consumption will only go back to pre-pandemic level if there is solid job security in the country, which is now dampened by the pandemic. We believe that the Japanese economy would grow much slow than that of the Chinese economy. Furthermore, China 14th five-year plan includes opening up their equities market to foreign investor and also having a more transparent system for trading stocks and bonds, which we feel that it will increase capital inflows into China. On top of that, VIX, a risk index, is ranging around the 24.9 level which is the average for this year, we could see that more investors are risk on. Investors should carry smaller amount of safe currencies which includes Japanese Yen and more carry trade should happen in the medium term. Therefore, we are bullish on CNY and bearish on JPY.

The price is retracting back to the support level at 15.563 painting a bearish evening star. However, the RSI does not show that CNYJPY is oversold and therefore we feel that this retracement is only short term. The aroon indicator which indicates the current trend shows that the current trend is still bullish with the bullish signal line still above the bearish signal line. The price is still above the 9-period moving average which shows that price is still bullish overall. Therefore, we suggest a buy limit at the near support.

Entry: 15.55

Take Profit: 15.822

Stop Loss: 15.381

Risk Reward Ratio: 1.61

NUS INVESTMENT SOCIETY

Global Macro Department – Korea (OVERWEIGHT)

Date: 27th December 2020

Analysts

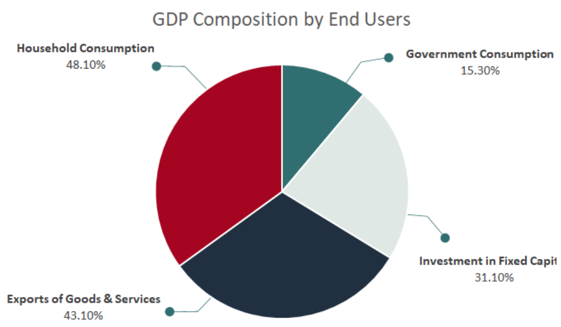
Poh Yong Quan
Global Macro Analyst
e0415620@u.nus.edu

Basic Information

Real GDP(USD)	USD 1.642 Tril.
Real GDP Growth Rate Q3	1.9%
CPI	105.61
PPI	103.35
Con. Confidence	91.6
Kospi	2357.39

Chart info

Figure X: GDP Composition by End Users



Source: theodora.com

Overview of South Korea

South Korea is the 4th largest Asian economy in the world. sitting at of USD 1.642 Trillion in nominal GDP in the year 2019. The majority of the end-users composition of GDP in South Korea is made up of private consumption and exports at 48.1% and 43.1% respectively. The top few South Korean exports includes electrical machinery & equipment at 28.3% of the whole exports, machinery including computers at 13.1% and vehicles at 11.6%. The drivers of the economy includes the services sector at 56.8%, industry at 33% and machinery at 10.3%.

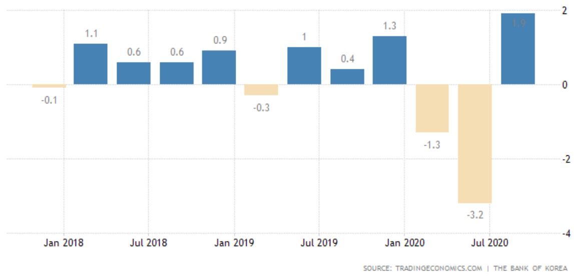
Resurgence of Covid

The number of Covid-19 cases seemingly fell in the month of Apr to late Jun, where number of cases was steady and under control. In August, the number of cases started picking up, reaching 3 digits cases. These outbreaks have continued to erupt at churches, offices and medical facilities. Korean Centres for Disease Control and Prevention (KCDC) has identified more than 1,000 cases that are traced to the Sarang Jeil Church in Seoul, which is at the centre of the new wave of infections. The Government has put in place a few measures to clamp the outbreak. South Korea in June adopted a social-distancing system in 3 levels, where level 2 of social-distancing rules are already in place in South Korea. Level 2 restrictions forbid gatherings of 50 or more people indoors, and 100 or more outdoors, this limit is applied to weddings, church services and sports games. Level 3 prohibits meetings and events of 10 people or more, business hours at shopping malls and retail stores are limited. Although the number of Covid-19 cases has decreased significantly from the level of August, there are fears on the resurgence of Covid-19 clusters. This has placed a toll on the confidence of consumers and business. Consumer confidence fell from by 8.8 from the previous month to 79.4 level and it is currently now at 91.6 level. The neutral level is at 100, therefore, the signals that the consumer are concerned with the pandemic and would probably hold back their spending. Until the vaccine is widely available for all, there would not be significant improvements in the market as the number of Covid-19 cases are still trending up for other continents.

Government halted short selling

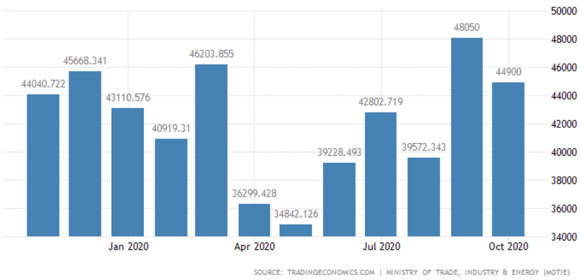
During the midst of the pandemic outbreak, the equities market in South Korea has been facing heavy short selling due expectations that the market is not going to perform well during this period. Kospi, the market index for Korea, dropped by 35% from the highs of December 2019. Therefore, the Government prohibited shorting selling stocks on the Kospi, and this was implemented on 16th of March, which was when the Kospi plunged more than 8%. South Korean regulators then extended the ban till March 2021. The Financial Services Commission, a government agency with statutory authority over financial policy, stated, “Considering the rising volatility in markets with fresh waves of Covid-19, we decided to extend the six-month short-selling ban imposed since March”. This spells good news for retail investors, as this will reduce the volatility in the markets, however, market neutral funds will suffer. Without a hedging tool for the long-short funds, we could see many of these funds flowing out from South Korea and liquidity could be a problem in South Korea equity markets.

Figure 1: South Korea's GDP Growth rate



Source: Tradingeconomics.com | The Bank of Korea

Figure 2: South Korea's Exports



Source: Tradingeconomics.com | Ministry of Trade, Industry & Energy

Potential Recovery of GDP

Effects of COVID-19

Covid-19 pandemic was a hard hit on major trading export partners of Korea such as U.S. and China as global demands have suffered a blow from the start of 2020. U..S imports level month on month has seen a drop from the peak in Jan 2020 of $253.9 bil. to a low in Apr of $200 bil. which comes down to a 25% drop, this is due to weakening consumer demand in the U.S. as the pandemic started, in conjunct with lock down on the whole economy. In addition, China seen a -6.8% GDP growth for 1Q2020 and South Korea's exports to China has reached the lowest at USD 8 bil. ever since 2015. As such, South Korea's exports level has significantly weakened a since the start of the year by 20%. Given that export is one of South Korea's driver of growth, taking up 43.1%, it is very vulnerable to global slowdowns. Therefore, this pandemic slump has adversely impacted its GDP growth rate for 1Q2020 and 2Q2020 which are at -1.3% and -3.2% respectively, where the second quarter's 3.2% contraction marked the country's worst quarterly decline in 22 years. Bank of Korea estimated that GDP would likely contract by 1.3% in 2020 revised down from the previous forecast of -0.2%, citing double-digits declines in exports in May and June. In comparison, the International Monetary Fund (IMF) has revised the GDP growth rate forecast for South Korea to be at -1.9% year on year from -2.1%.

Recovering from COVID-19 Slump

Although South Korea had a rough start out of the year, the economy has picked up since September and has showed signs of recovery. Global demand has strengthened slightly, with many economies opening up. In particulary, China GDP growth rate has significantly improved in 3Q2020 at 4.9% and imports has jumped to an all-time high of USD 202.8 bil. in September, a 13.2% increase which beat market expectations by 0.3%. The bodes well for South Korean exporters from Samsung Electronics CO to Hyndai Mobis Co. China is the biggest buyer of South Korean goods used in assembly of products sold globally. In addition, South Korea has sold more than $10 billion in healthcare-related products for the first time this year thanks to booming exports of testing kits, with Healthcare exports soaring by 47%. This is reflected by the steady increase in South Korea's exports level from June to October from $34.8 bil. to $44.9 bli., garnering a 29% increase in exports, the strongest export rebound in decades. The Ministry of Trade said Korean exports saw gains for the first time since COVID-19 pandemic outbreak, citing optimism for the months ahead. South Korea is one of the first few countries that managed to pull out of recession, having a 1.9 growth rate for 3Q2020.

Bumper Economic Data

Three of the major indicators of growth in South Korea, which includes industrial output, consumer consumption and corporate investments saw an improvement in the month of September. This could signal that the economy is back on track to a recovery from the Covid-19 Pandemic economic slump, which Finance minister Hong Nam-ki said that the 'Triple Improvement' of production, consumption and investment means that South Korean economy can expect a bright forecast for the fourth quarter. The nation's overall industrial production sank by 0.8% on-month in the August and saw a major improvement in September by 2.3% on-month for the first time in 5 months. This is mainly driven by the automobile, electronics, and semi-conductor industry where the bumper figures are mostly attributed to the recovering global demand as U.S. and China open their economy. The top few semiconductor manufacturing companies in the world includes South Korea companies namely Samsung and Hynix, taking up 23.6% of the total market share in the global market. Samsung recently reported a net profit of $8.2 Bil. In the July to September quarter and operating profits at semiconductor division surged 82% year on year attributing to emergency chip orders from Huawei due to stricter U.S. sanctions. During the month of August, the U.S. department of commerce stated that it would impose sanctions on any foreign company that sold chips to Huawei without obtaining a license. The Chinese company is believed to have stocked up about six months of inventories prior to a U.S. ban. Samsung expects higher demand for mobile chips in the fourth quarter on growing order from Chinese smartphone makers, therefore, this could potentially provide a boost towards the GDP of South Korea.

Policies by the Government and Bank of Korea (BOK)

Figure 3: Bank of Korea Base Interest Rate

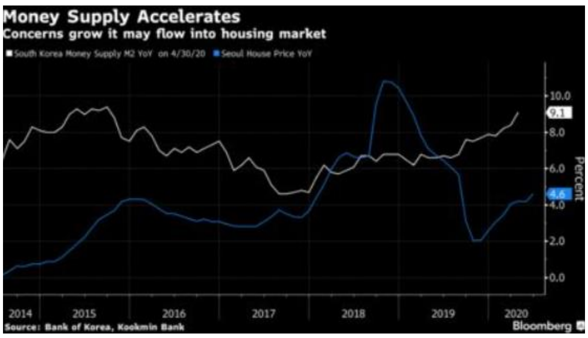
Source: The Bank of Korea

Amid of the growing concerns over COVID-19 impacts on the economy, Bank of Korea dropped interest rate in March by 50 basis points to a record low of 0.75% which happened for the first time in history. As Korea looks for the FED for guidance on its interest rate policies, the decision to cut interest rates came hours after the U.S. Fed slashed its benchmark interest rate to near zero. Another round of interest rate came in May, reducing the interest rate to 0.5% Well, BOK cut its rate only after U.S. cuts its rate drastically, BOK hesitated to reduce rate back in February, where they keep the rate steady at 1.25% in its monetary policy meeting in Feb 27. The money supply has shown a considerable correlation with Seoul house price growth. Therefore, the hesitation of lowering rates comes from the fear that easy monetary policy would encourage more money to inflate the already-heated housing market.

<u>Is there a housing market bubble?</u>

Affordable housing has been one of South Korea President Moon Jae-in's key policy objectives since taking office in May 2017. However, South Korean President Moon's approval rating fell to its lowest level in July as many respondents are blaming his government for not doing enough to slow down the soaring real estate prices. Many cities, in particular Seoul has seen a large increase in prices since 2017, with average prices of houses in Seoul increasing from 607 mil. KRW to 925 mil. KRW, a drastic 52% increase. One potential cause of this would be due to the increases in foreign hot money flowing into the housing market, pushing the prices up. It was reported that the number of home purchases by foreigners has increased year on year from 5,300 in 2017 to 7,300 in 2019.

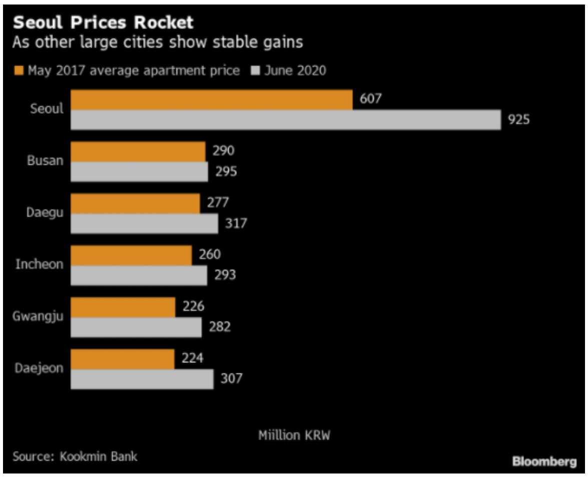
Figure 4: Corelation Between Money Supply and Seoul house price growth



Source: Bloomberg

In addition, according to Kim Ju-ho of the Citizens' Coalition of Economic Justice, the tax system in South Korea is favourable to multiple-house owners and tenants' right are not well protected. Diving into South Korea's real estate market, there exists a unique rental system called jeonse which makes the investment into real estate even easier. The tenants usually have a lease agreement of 2 years, and the tenants is required to put down a massive deposit of around 70% of the value of the home. In which, the tenants do not need to make any other payments to the landlord, who will return the entire deposit at the end of the lease. Therefore, instead of making money from monthly rental from the tenant, the landlord usually makes money by reinvesting the borrowed deposit for the duration of the least. This essentially means that the landlord is borrowing money from the tenant at no interest. The system is the outcome of South Korea's rapid growth, and of which they lacked the platform to perform a credit check for the tenant and could not count on to make regular payments. Jeonse is the most dominant form of lease agreement, siting at 71% of all lease transactions happening in Seoul.

Figure 5: Average Prices of Houses in different Cities

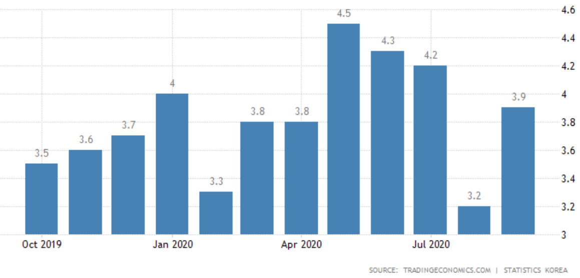


Source: Bloomberg | Kookmin Bank

Given that the choice of investment a local could make in South Korea would be either in the stock market or the real estate market. However, many investors choose to diversify into the real estate markets as Samsung makes up 31% of the Kospi index, and therefore very vulnerable to the swing of Samsung. Hence, the other option would be invest in South Korea's real estate bubble, and with the addition of cheap money made available through the response of BOK to COVID-19 by slashing rates to 0.5%, this trend has only gotten worse. This is also known as gap investment, leveraging a house to buyer another pricey house. However, this is very much dangerous as a landlord' bankruptcy could potentially wipe out hundreds of people's jeonse deposits, which the current situation in South Korea mirrors very closely to what happened to the US housing market in 2007. As CDOs tied the bad debt together with good debt to reduce the risk of the CDO. However, when many debtors defaulted on the loans in the CDO, this created a wave of selling which crashed the U.S. housing market. Similar, if many landlords are overly leveraged, and the housing market sees a correction, this might set a trend of selling houses and defaulting on jeonse deposit and set forth a chain of defaulting on deposits.

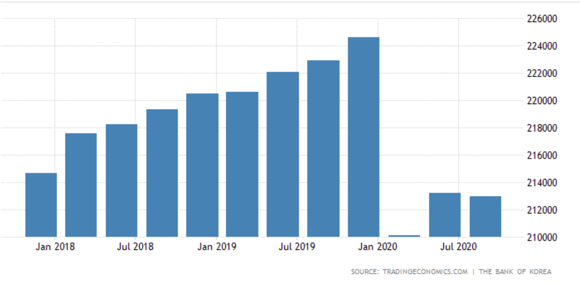
However, Moon's administration has placed a few measures in order to curb the heated housing market. In July, laws were passed to increase taxes for non-residential real estate investors, and also property taxes for those owning multiple homes was raised from 3.2% to 6%. However, considering that the percentage returns on a gap investment could go up to 60% and more over two years, these taxes are considerably small. The administration also plan to clamp down on loan made to people who buy a house without intending to live in it and proposed a bill for imposing acquisition taxes of 20% on foreigners who do not live in their homes for six months after purchase.

Figure 6: South Korea Unemployment Rate



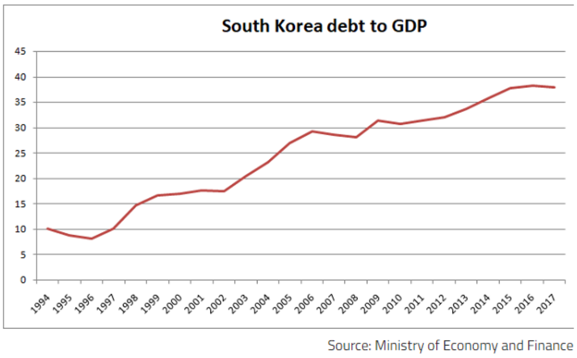
Source: Tradingeconomics.com | Statistics Korea

Figure 7: South Korea Consumer Spending



Source: Tradingeconomics.com | The Bank of Korea

Figure 8: South Korea debt to GDP



Source: Ministry of Economy and Finance

Fiscal Policies

In the early stages of the crisis, South Korea unveiled a 11.7 tril. KRW (US$13.7bil.) stimulus package on March 4, this fiscal package consists of funding for healthcare costs, and to cushion the impacts from the pandemic on small and medium enterprises. Out of the 11.7 trillion won, 3.2 trillion won will make for revenue deficit of the enterprises, aiming to encourage these firms to retain their employees. The South Korean government also plan to ask parliament for about 7.5 trill won injection to battle the resurgence of COVID-19 back in September. The South Korean government plans to revitalizes the consumer market as it makes up the majority of the GDP at 48.1%. The labour market has been hit hard as many of the firms cut employees in order to save cost and stay alive during this period of low demand and revenue. South Korea's unemployment rate has hit the highest in 10 years at 4.5% back in May. Although the labour market did improve slightly in the month of August, dropping by 1% from the previous month, it seems like it is going back to pandemic levels of 3.9%. South Korea saw 392,000 people lost their jobs in September, where sectors that are highly dependent on private consumer such as wholesalers & retailers and hospitality saw the biggest cut. One possible explanation for such huge unemployment in the service sector could be due to the lockdown imposed by the government to ensure everyone to stays at home and borders were closed to any tourists which results in a large decrease in foreign arrival by 97.9%. Therefore, consumer spending has fell sharpy from the highs of 224 tril. KRW to 212 tril. KRW and on top of that, tourism revenue shrank nearly 70% from pre-pandemic levels. The government has placed stimulus that is worth around 4% of the current GDP, however this has inevitably brought their debt-to-GDP ratio up to 42.2% from 38.1% last year. This is still under the to the forecast 'AA' category median of 46.5%. However, the debt-to-GDP ratio has been trending upwards, and it has certainly increase due to the negative growth of GDP for the first two quarter, and the government has funding its spending with the use of bonds. South Korea administration need to make sure that the debt does not spiral out of control and stimulus is spent wisely.

Figure 9: Kospi Daily Chart

Source: Tradingview

Trade Idea: Long Kospi

South Korea is one of the first few countries to pull out of recession, with many economic indicators like exports and manufacturing data improving. The global demand is slowing recovering to pre-pandemic levels, therefore we would expect exports to recover in the near future, and GDP to continue growing at a stable rate. Given that the administration is starting to clump down on the overheating housing market in South Korea and introduced more policies for it, we are hopeful that the housing market would stay below dangerous levels.

On the daily chart, the price recently reversed from the support level of 2272.86 level, in addition a bullish harami formed which signals bullish momentum. The next candle formed was a bullish candle which broke through the support level of 2332.82 and also closed above the 9-period moving average. RSI has not gone to oversold level as of yet, therefore, we do not expect any retraction. The aroon indicator indicate the current trend of the assets, and it is currently showing that KOSPI is bullish.

Entry: 2537.39

Take Profit: 2421.16

Stop Loss: 2326.61

Risk Reward Ratio: 2.07

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