NUS INVESTMENT SOCIETY

Global Macro Department – China (NEUTRAL)

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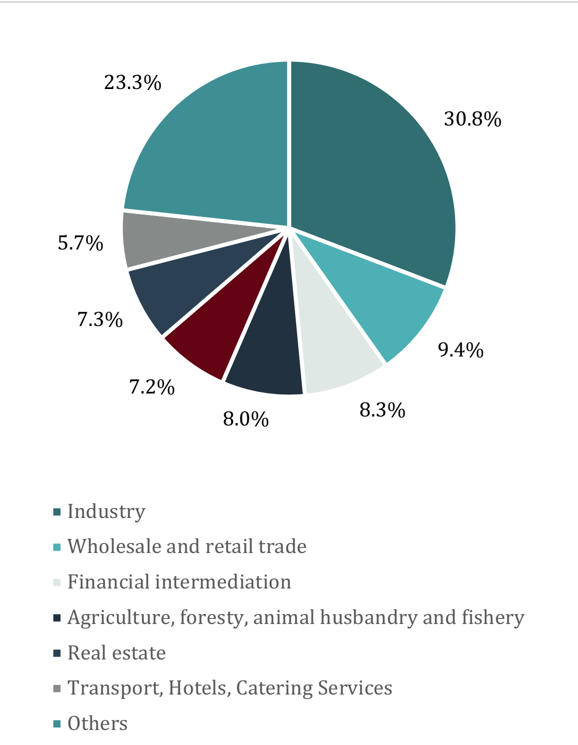
Basic Information

Real GDP (US$)	14.72T
M2 (US$)	233.6T
CPI	101.3
PPI	113.1
Stock Index	SSE Composite
Currency	CNH

Chart Info

Figure 1: China's GDP Composition by Sector in 2020



Source: Statista

The Red Dragon

GDP Contributors

- China has the world's fastest growing major economy and is well on track to overtake the U.S. to be the largest economy in the world.
- As the world's largest manufacturing economy and exporter of goods, the industrial sector generated almost 30.8% of China's GDP. Investments fuel more than 40% of China's GDP, followed by exports (Fig. 1).
- Since the introduction of Deng Xiao Ping's economic reforms, we see that the Chinese Communist Party (CCP) plays a vital role in the decision of the structure of the Chinese economy. This year, China grew 18.3% YoY in Q1, 7.9% in Q2 and 4.9% in Q3. We expect the overall growth for the economy to surpass 6% in 2021. Below are some of the key trends we have observed in the past 6 months.

Summary of Events in The Past 6 Months

Common Prosperity

- Xi Jinping continues to push for Common Prosperity that calls for even distribution of wealth, putting pressure on private enterprise.
- China becomes the last "zero Covid-19 approach" holdout.
- Economic growth is slowing down.

Property Crisis

- As a cascade from the "Three Red Line" policy, Evergrande defaults for the first time. China property developers' fear of default grows.
- New home prices see biggest fall since 2015.
- Beijing is easing on bank credit, trying to prevent a market collapse.
- PBoC raised foreign exchange deposit reserve ratio of financial institutions, with a second raise this year coming soon.

Power Outage

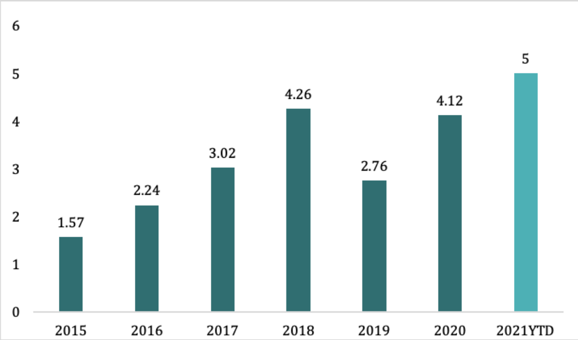
- China struggles with a severe shortage of electricity, with millions of homes and businesses hit by power cuts.
- China's coal imports in October nearly doubled from a year ago. Coal imports reach highest for this year in November.
- China starts round 2 of massive desert renewable energy build.

Geopolitics

- China applies to join Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

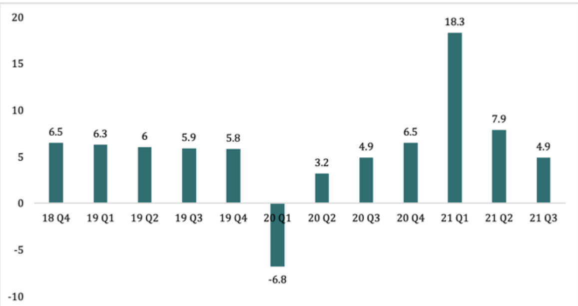
- China’s Regional Comprehensive Economic Partnership (RCEP) trade deal is set to start on 1st January 2022.
- The U.S. issues a new executive order barring the U.S. investment into Chinese firms.
- China-U.S. tension escalates as the U.S. and Taiwan cooperate under a new framework.
- China and the U.S. cooperate on tackling climate change and oil price. President Xi calls for China and the U.S. to “find the right way to get along”.
- Prime Minister Scott Morrison says Australia is to keep a close Eye on China spy ship.

Figure 2: Donation by China's Wealthiest (in Billion USD)



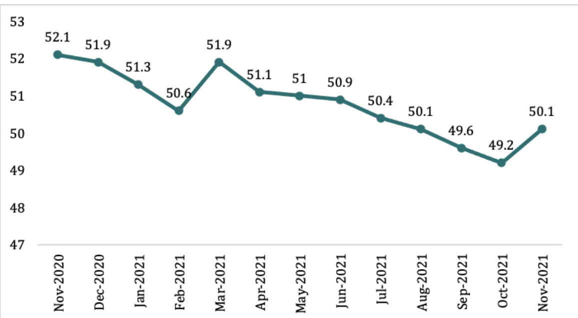
Source: Bloomberg

Figure 3: China GDP Annual Growth Rate (in %)



Source: TradingEconomics.com

Figure 4: China Manufacturing PMI (Seasonally Adjusted)



Source: National Bureau of Statistics of China

CCP minus the 'C': Common Prosperity

The Chinese Communist Party (CCP) has shifted to call for "common prosperity" to conquer income inequality, excess borrowing and speculative investment. In line with this, soon after Beijing started targeting the technology and education industries, the Chinese government launched 5-year plan including stricter regulations on the economy covering areas including national security, technology and monopolies. In pursuit of common prosperity, CCP is expected to focus on improving the social safety net and labour productivity, reducing systemic financial risks, and achieving more balanced growth in the long run. This promises a more equitable society with a bigger, wealthier middle class and companies that can give back to society.

<u>The Wealthy Gives, Alot</u>

Billionaire donations soared under the push for wealth redistribution. Last year's total cash donations by the 100 entrepreneurs on Forbes' China Charity List amounted to CNY 24.51 billion (USD 3.8 billion), a 37% surge on the previous year. The tech industry, with donations of CNY 7.8 billion, 32% of the total, ranked as the country's most charitable sector. In the first eight months of 2021, seven Chinese billionaires directed a record $5 billion to charity, according to data compiled by Bloomberg News, a sum that exceeds by 20% total national giving in 2020 (Fig. 2). This would be expected to help ease income inequality and expand the middle-income group. However, it might hinder entrepreneurship and pose threat on economic growth.

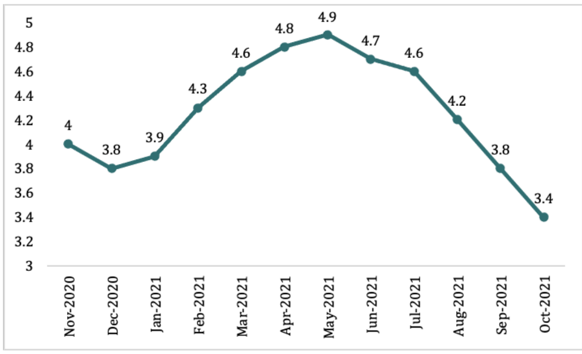
<u>GDP Growth Hinders</u>

This inevitably hinders GDP growth, especially given the complexities of China's power crunch and property market woes, which we will cover later in the report. As highlighted by Premier Li Keqiang, China faces downward pressure for real GDP growth in the short and medium term. China's economy grew by 4.9% in the third quarter of 2021 compared with a year earlier, down from the 7.9% growth seen in the second quarter (Fig. 3). Fitch Ratings has cut its forecast for China's growth in 2021 to 8.1%, while the U.S. ratings agency has also lowered its 2022 GDP growth forecast to 5.2%.

<u>Work, Work, Work</u>

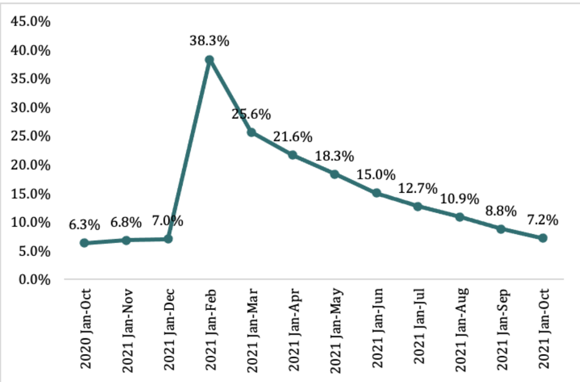
According to China's National Bureau of Statistics, China's PMI was at 49.2 points in October and 49.6 in September (Fig. 4), both indicating a contraction in economic trends in manufacturing. China's manufacturing PMI rebounded to 50.1 points in November, an expansion in manufacturing activity for the first time in two months but still the third lowest in 21 months. Demand from vehicle and home appliances sectors, indicators of consumption-related manufacturing, showed no optimism in November. Although passenger car production is likely to increase in 2022 due to easing semiconductor chip shortages, the growth is likely to be limited since domestic consumption would remain sluggish due to intermittent new Covid-19 cases and slowed economic growth. In addition, overseas orders for Chinese goods were tapering off after overseas factory operations gradually return to normal.

Figure 5: China Newly Built House Prices YoY Change (in %)



Source: National Bureau of Statistics of China

Figure 6: Growth Rate of Investment in Real Estate Development in China



Source: National Bureau of Statistics of China

While China's social reforms aim at long-term growth, we do not hold optimism in China's growth narratives in the short to medium term as domestic consumption and investment continue to be curbed by a variety of policy measures, weakening CNH. Although China might hit a pause for a short while in 2022 to prevent stagflation and address the contraction in credit impulse, we do not expect it to deviate much from its current trajectory on tight policies. Moreover, we expect China's growth to be more balanced and sustainable eventually.

Property Crisis and Deleveraging Policies

Amid President Xi Jinping's push for common prosperity, China's real estate market has been undergoing major reform since last year with the "Houses are for living, not for speculation" campaign and the "Three Red Lines" policy. 8 out of 10 most indebted property developers in the world are based in China and the problem of overleveraging was evident even before the Evergrande crackdown. Previously, China's real estate growth model had engaged with high debt, investment, and growth. It has been shifted to a more sustainable model involving slower growth. The government's work report said deleveraging was one of the "five major tasks" in 2021, with a goal of keeping overall leverage "generally stable". To achieve this, China has been reducing excess housing inventory, deleveraging state-owned companies, cracking down on shadow banking, and imposing restrictions on land auctions.

In August, President Xi Jinping declared that China will "actively and steadily push forward property tax legislation and reform" and carry out a 5-year pilot programme to test the proposal before it is implemented nationwide. However, local governments lack the incentive to push ahead with the tax, as the total value of China's urban housing is estimated at CNY 350 trillion (USD 54800 billion). If taxed at 1% under the new proposal, the annual revenue of CNY 3.5 trillion (USD 548 billion) would be less than half of the annual land sales in 2020, according to an economist of Macquarie Group in Hong Kong. We will closely watch the government's progress on property tax and the market's reaction to it.

<u>Home Prices Take a Toll</u>

The downward trend in home prices has emerged due to tight quotas on home loans, worries about a property tax and weak demand. In October, the national home price fell for the second month in a row, with 64 of the 70 cities in the sample provided by the National Bureau of Statistics showing a decline, up from 52 in September. Average new home prices in China's 70 major cities rose by 3.4% year-on-year in October 2021, after a 3.8% gain a month earlier (Fig. 5). This was the weakest rise in new home prices since January 2016. On a monthly basis, new home prices fell 0.2% in October, the most since February 2015, after a flat reading in September. Average home prices are estimated to fall 1% in the first half of 2022, according to 14 analysts and economists surveyed by Reuters from 26th November to 1st Dec 2021. Dozens of homeowners descended on the sales office of new residential development in Nanyang last month demanding refunds, after the value of their homes depreciated at least 30 per cent in less than a year, Caixin reported.

In addition, both supply and demand for the property are on a downward trend. Spooked by two straight months of price declines, confidence among home buyers is waning. On the demand side, S&P Global Ratings forecasts a 10% decline in China's residential sales next year, and a further 5% to 10% decline in 2023. On the supply side, property investment is expected to shrink in 2022 due to declining new home sales and land purchases at a time of tightened credit borrowing. Output in the real estate and construction industries dropped by 1.6% and 1.8% respectively in the third quarter this year, official data showed. The growth rate of property development investment slowed to 7.2% in the January to October period from 8.8% in the first nine months of the year (Fig. 6). New housing starts for the first three quarters also fell by 4.5% from a year ago. According to Reuter's survey, property investment is expected to drop 3.0% in the first six months of 2022, as compared to a 15% rise in the first half of this year.

Meanwhile, Chinese property developers are suffering. As a victim of the property policies, China Evergrande Group's shares hit a record low on 8th December 2021 after a missed debt payment deadline. This puts the developer at risk of becoming the country's biggest defaulter. Evergrande has proved not to be one of its kind. Overall, Chinese property developers and nearly USD 1.6 billion worth of high-yield dollar bond coupons are due before the end of this year. Refinitiv data shows at least USD 92.3 billion worth of property developers' bonds maturing next year. Evergrande's mid-sized rival Fantasia has also missed a payment in October this year, which was unexpected since it had just weeks earlier assured investors on its liquidity. Modern Land and Sinic Holdings are trying to delay payment deadlines that would still most likely be classed as a default by the main rating agencies. In October this year, higher-rated companies such as Country Garden Holdings and China Vanke were swept up in the sell-off, prompting regulators to act more boldly.

While China's policymakers will likely be able to avoid a market collapse, the overextended property sector will continue to weigh on the Chinese economy, as the real estate sector accounts for more than a quarter of the nation's economy. GDP growth slowed to a worse-than-expected 4.9% in the third quarter amid tightening measures and the Evergrande debt crisis. With the economy's large size and its trade connections with other countries, property crisis in China could lead to deteriorating risk sentiment worldwide and pose threat to global financial markets, affecting the U.S., according to the Fed's 2021 Financial Stability Report in November this year.

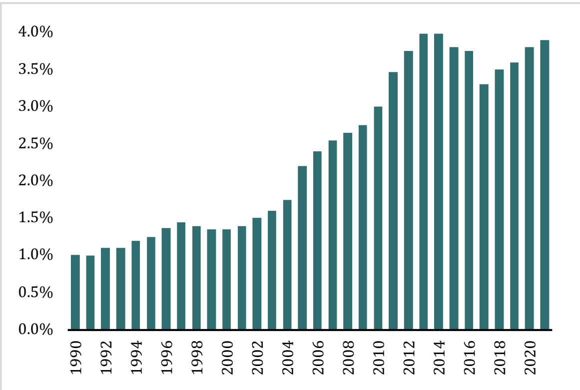
Although China has been trying to reduce the economy's reliance on the real estate sector, authorities have been easing restrictions on lending and home approvals to avoid a market collapse. Bank credit is being rolled out to property firms at a higher level than in any period during the second or third quarters, according to data collected by China Beige Book International, with mortgage lending in October increasing to CNY 200 billion (USD 31 billion) from CNY 150 billion (USD 23.5 billion) the previous month. Chengdu, in the southwest of China, issued a notice in late November to ensure developers receive funds from presold properties and fresh loans. The latest financial system support measures came in early December this year, with China's central bank releasing about CNY 1.2 trillion (USD 188 billion) of liquidity via a cut in the reserve requirement ratio for most banks. The government pledged to support the housing market to better meet "reasonable" needs, adding to signs it will ease real estate curbs.

Figure 7: China's Growth Forecasts Take a Cut

Company	Before Cut (%)	After Cut (%)
Nomura	8.2	7.7
Goldman Sachs	8.2	7.8
Morgan Stanley	8.2	7.9
Bank of America	8.3	8.0
JP Morgan	8.7	8.3

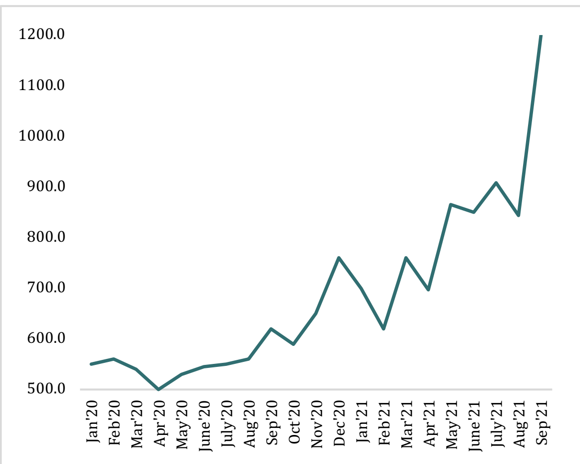
Source: CNBC

Figure 8: Coal Production a Solid Pillar Supporting China's Economic Growth



Source: National Bureau of Statistics

Figure 9: Zhengzhou Thermal Coal Futures Spiked to Record Levels



Source: Bloomberg

Moving Forward

The challenge for CCP is to reach a balancing point with adequate liquidity in the property market meanwhile avoiding reinflation of properties. Recently Evergrande and Kaisa have been officially labelled defaulters, but CCP is not signalling any step-in measures. Despite signs of easing up, we do not expect a U-turn on tight property policy given CCP's longer-term view on the market and "common prosperity" pursuit.

As lower investment in this sector would force some companies who are struggling financially to cut land and construction costs. This will in turn pull down sales and we would also expect many property companies to be kept in a negative credit loop. Therefore, with the overall tight financing policies, there will be less new projects and less cash flow from pre-sales. Liquidity would have to be injected through selling inventories to service debt, pulling property prices further down. We would also expect drop in Chinese consumer spending as quite a significant part of their wealth has been from property investments.

A Power Challenge: Growth, Gain, Goals

From factories to homes, China faced one of their worst energy crises in years. Typically, China turns to large industrial users to limit consumption when supply gets tight. Yet this time in several major cities and provinces, more than half of China's mainland provinces faced curbs in electricity usage. In the northern provinces of Liaoning, Jilin and Heilongjiang, residents suffered blackouts, limited usage of air-conditioners as well as chaos on the roads due to traffic lights being turned off. In Guangdong, a southern industrial hub with an economy bigger than Australia, the energy provincial energy administration issued a notice to the entire city to help with the widespread outages. It requested for office workers to stop using elevators for the first three floors, asked malls to keep advertising signs on for fewer hours in the day, homeowners to use natural light whenever possible and keep their air-conditioners to above 26 degrees Celsius to help conserve power.

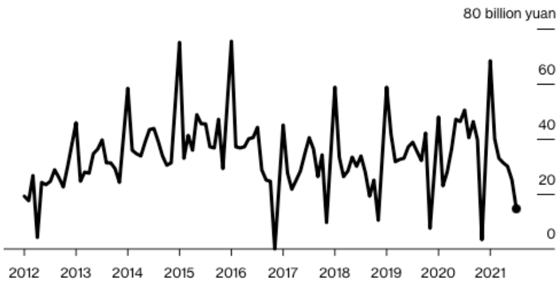
Low Power, Low Growth

Following the electricity shortage, economists warned of lower economic growth in China as businesses are forced to cut back on production. Nomura downgraded their full-year growth forecasts for the economy from 8.2% to 7.7%. Similarly, China International Capital Corp. (CICC) cut China's growth rate to 0.15 percentage point in the third and fourth quarter. Goldman Sachs also lowered their 2021 forecast from 8.2% to 7.8%, and for 2022 to 5.5% (Fig. 7).

Amidst global supply chain disruptions, the energy crisis increased the risk of economic instability to the country. While we expect risks to ease after the coming winter period, unexpected negative events such as policy missteps and rising global tensions may prolong the crunch and its effects to linger for longer. For many years, China's growth is fuelled by credit and carbon (Fig. 8). Having mentioned about the credit aspect earlier in our report, we believe that President Xi Jinping's vision of de-carbonising the economy will continue to jeopardise the country's growth.

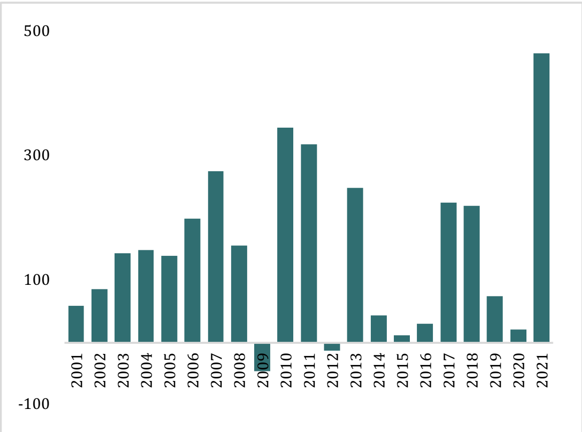
Heating Prices in the Cold

Figure 10: Profits of Companies Generating Electricity or Heat Hits Low



Source: National Bureau of Statistics, Bloomberg calculations

Figure 11: Change in Cumulative Thermal Power Generation Highest in 2021



Source: National Bureau of Statistics

As countries globally approaches sub-zero temperatures in the winter season, demand will continue to rise as China continues to ease a power crisis that started way before winter. The price of natural gas and coal surged to multi-year highs as economies recover from the post-pandemic era (Fig. 9). Analysts from Morgan Stanley spoke to several Chinese power generators and mentioned that they also suffered huge losses due to higher spot prices, with profits hitting a new decade low (Fig. 10). They believe that they may only be able to get some relief in the form of small increases in the price of power they sell. These record high prices have also caused factories in China to trim output despite soaring demand and will in turn affect domestic economy activity even more.

It is also worth noting that the global energy surge continues beyond China, as prices of natural gas in Europe break record levels.

<u>Keeping Climate Goals on Track</u>

While some areas were forced to shut their power generators due to surging coal prices, some areas proactively halted electricity flows in order to meet energy emission and intensity goals. Prior to this, the central government made each province create an energy intensity target as part of President Xi Jinping's plan to reach carbon neutrality by 2060. In Zhejiang, about 160 energy-intensive companies in the textile, dyeing and chemical fiber industries have been instructed to halt production in early September this year. More than 10 steel mills in Jiangsu, where manufacturing accounted for more than 40% of the province's economy, have completely shut down. Hence, we see that the energy crisis will not derail China's plans to make progress on curbing greenhouse gas emissions in the next few years. Sustainability efforts will continue to be centred on prioritising the use of more renewables and improving energy efficiency. Blue skies ahead of the Winter Olympics? We'll see.

However, while China has concrete plans to ramp up renewables, it is going to continue to rely on coal to support economic growth. China produces more coal than the rest of the world combined and recorded higher emissions in 2020 than a year earlier. With soaring thermal demand causing expected annual volumes to rise again (Fig. 11), and importing coal not being a viable decision due to strained global relations, we think that this major manufacturing power might be a double-edged sword in China's hands, especially with global climate talks in the spotlight after COP26 wrapped up earlier in November. Thus, we do expect the fuel to remain in the energy mix long after President Xi's target of reducing consumption from 2026. Yet we believe that it will be rather tricky for China to keep electricity flowing, but also keep a lid on carbon emissions at the same time.

COVID-19: Zero or Hero?

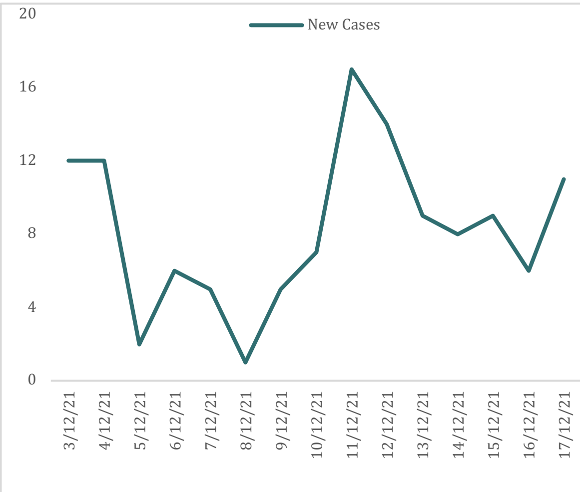
Two years into the pandemic, China chooses to stick to their zero-covid policy as most developed nations gradually open up and learn to live with the virus. Till date, more than 270 million Covid-19 cases have been reported while China has reported less than 100,000 cases and 5,000 deaths. Given that China has the largest population in the world with approximately 1.4 billion people, their caseload pales in comparison with those of many countries. With stringent lockdowns coupled with mass testing, China has been extremely efficient in curbing local outbreaks while keeping their borders tightly sealed

Figure 12: Estimated Daily New Cases if China Abandons Zero-Covid Policy

Country	Population	Estimated lower bound of daily new cases in China
U.S.	332,580,000	637,155
U.K.	67,081,000	275,793
Israel	9,289,800	442,221
Spain	47,330,000	319,969
France	67,347,241	454,198

Source: China CDC Weekly

Figure 13: New Local Cases in China



Source: National Health Commission

and implementing strict port checks.

Capable, Competent Party

Though China's zero-covid strategy has been criticised heavily in the West, the Delta and fresh Omicron variant has proven China's ability to defend against new variants. As proof of success of these measures, China has not reported a single covid-related death since late February 2021. With the spread of the Omicron variant that is causing other countries around the world to scramble, China remains calm with only two cases detected in the mainland as of 15th December 2021. An infectious disease expert in Shanghai also said that the variant would 'not have a major impact on China'. The country's zero-covid policy will be on even higher alert now as several significant events such as the Winter Olympics and the 2022 Party Congress are scheduled in the coming months.

Politically, the zero-covid policy has not only showcased the supposed superiority of its one-party system over Western democracies, but also the institutional strength of the CCP to be able to rally resources to manage unprecedented cases. In recent months, we have seen a single confirmed case send Shanghai Disneyland into a snap lockdown on a Sunday evening, forcing thousands of visitors and staff to get tested before they were allowed to leave the theme park. In a study published in China CDC Weekly by the Chinese Center for Disease Control and Prevention (CDC), mathematicians from Peking University assessed that if China adopted the same pandemic control methods as countries like the U.S, U.K and Spain, China could face more than 630,000 Covid-19 infections a day (Fig. 12). This would almost certainly induce a wearisome burden on the healthcare system. While the zero-covid policy may have its benefits, their findings have also revealed the real but painful truth of the country not being ready to open up just yet.

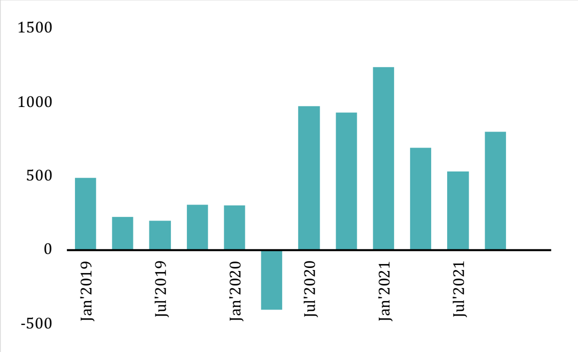
How Long More?

Since October 17, China has reported at least one locally transmitted case everyday (Fig. 13). More than 1.1 billion Chinese people, nearly 80% of the population have been fully inoculated with inactivated vaccines developed by Sinopharm and Sinovac. However, these vaccines are found to have much lower efficacies than the conventional mRNA shots offered by Moderna and Pfizer/BioNTech. A Hong Kong study published in the Lancet mentioned that health workers who received mRNA shots had about 10 times the number of antibodies than those who received Sinovac's vaccine. Hence this limited protection alongside news of delayed approval of western mRNA vaccines continue to serve as a not so friendly reminder that Chinese vaccines are far from sufficient to keep Covid-19 infections at zero in the long run.

In the near-term, we foresee that intermittent local lockdown will continue to hit activity within the mainland directly. When the new Omicron variant was announced, the Dow Jones was down by 905.04 points, the worst for the year while the S&P slipped by 2.27%. The continuous emergence of new variants will continue to add on to the uncertainty and will cause further delays in the reopening of China's borders, in turn delaying a stronger rebound in consumption growth.

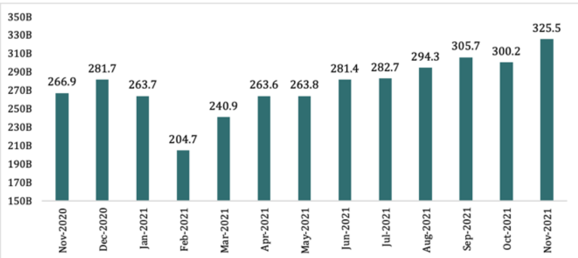
In addition, China's borders have been largely closed for the past 19 months with little to no signs of easing in 2022, clearly contributing

Figure 14: Current Account Balance Boost (in USD HML)



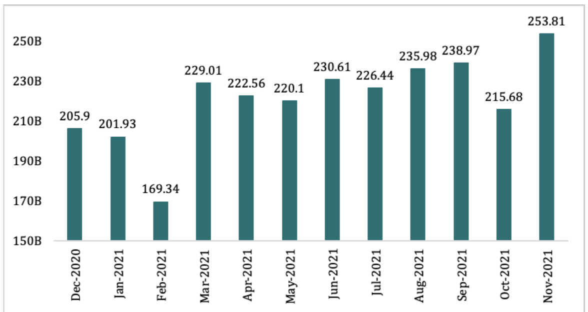
Source: State Administration of Foreign Exchange

Figure 15: China Exports (in Billion USD)



Source: TradingEconomics.com

Figure 16: China Imports (in Billion USD)



Source: TradingEconomics.com

to global supply-chain disruptions and bottlenecks. With the new variant, there is a possibility that China may double-down and further tighten their measures, causing tighter controls on air and shipping crew to place even more limits on their already strained capacity to meet demand. The zero-covid policy has caused China's services trade deficit to increase sharply, boosting its current account balances, balance of payment surplus and the RMB exchange rate (Fig. 14). With the RMB strengthening lately, this might potentially be a drag on Chinese exports as global demand for goods moderates. Significant fiscal spending on maintaining and adhering to the zero-covid policy may have already reduced Beijing's spending in other productive areas of the economy, and prolonged closure of the borders will continue to weigh down on foreign direct investment and flows to China. Hence, we think that this may potentially affect China's ambition to develop its high-tech industry and overall economic growth.

Joining Trade Pacts: Opportunities and Challenges

Exports have been China's single largest growth driver for the past year and a half, according to Nomura's recent report. Growth in export is slowing on the back of a strong yuan, weakening demand due to the emergence of the Omicron Covid-19 variant and higher costs, while imports rose at a faster pace following the easing of the power crunch. Based on data from China's General Administration of Customs released in November this year, China's exports grew by 22% in November from a year earlier, to USD 325.53 billion, down from the 27.1% growth in October (Fig. 15). This was above the median result of a survey of analysts conducted by Bloomberg, which had predicted 20.3% growth. Imports rose by 31.7 % in November from a year earlier, to USD 253.81 billion, up from the 20.6 per cent growth in October (Fig. 16).

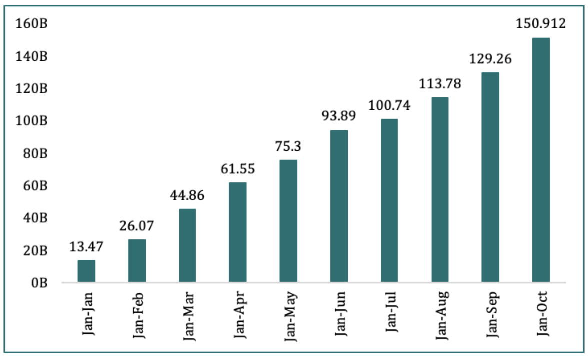
Foreign direct investment into China rose 17.8% year-on-year to USD 150.91 billion in the first 10 months of the year, China's commerce ministry data showed (Fig. 17). Foreign investment into the service sector increased 20.3%, while high-tech industries saw FDI inflow jump 23.7%. Among the main sources of investment, FDI into China from countries along the Belt and Road as well as the ASEAN countries jumped 30.7% and 29.5%, respectively.

Regional Comprehensive Economic Partnership (RCEP)

A new chapter of global trade with RECP will take effect on 1st January 2022. RCEP is expected to elevate China's position in Asian industrial supply chains and ultimately globalisation. First signed in November last year after eight years of negotiations, RCEP will not only expand China's trade for about 30% of the world's population but could also aid in the internationalisation of Chinese Yuan.

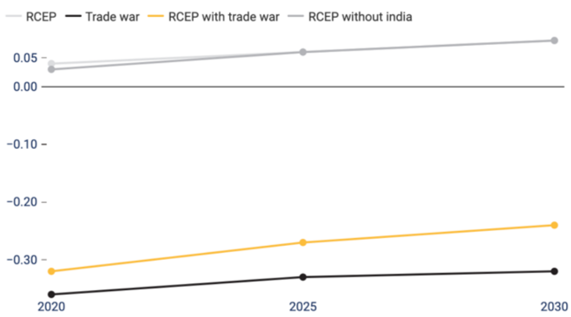
However, although RCEP will add incrementally to China's GDP, damage of the China-U.S. trade war will outweigh the marginal benefit of RCEP. In June, researchers at the Peterson Institute for International Economics (PIIE) found that RCEP would add 0.4% to China's real income by 2030, while the China-U.S. trade war would trim 1.1% if current hostilities persist (Fig. 18). Furthermore, a trade and RCEP specialist at the University of New South Wales warned

Figure 17: 2021 China's Foreign Direct Investment (in Billion USD)



Source: China Ministry of Commerce

Figure 18: Impact on China's Real GDP Growth (Cumulative % Changes)



Source: The World Economy & University of Queensland

that RCEP did not provide enough rules on sanitary and phytosanitary measures, trade remedies, electronic commerce, competition, and government procurement. This might pose an underlying risk for China later.

<u>Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)</u>

China formally applied to join the CPTPP in September this year. The reconfigured trade grouping holds ambitious targets for tariff elimination and high standards on trade and investment liberalisation.

China has led many initiatives to consolidate its economic integration drive, from joining RECP to state-sponsored Belt and Road Initiative and the China-led Asian Infrastructure Investment Bank. If entry into CPTPP were successful, China would build upon those existing initiatives in pushing forward economic integration. It would be more centrally integrated into the world economy and reverse the persistent narrative of economic decoupling. As the U.S. is marginalised from this pact, the membership would be especially valuable for China's lead position in globalisation.

It now remains a question on whether China would be successful to enter. The pact requires members to significantly loosen restrictions on cross-border data flows and end forced labour and special treatment for state-owned enterprises. However, China's policies are moving in opposition to these requirements. The CPTPP is designed not to allow any exceptions. Joining the pact would require China to agree to meet all requirements and to submit a detailed action plan on areas where it falls short.

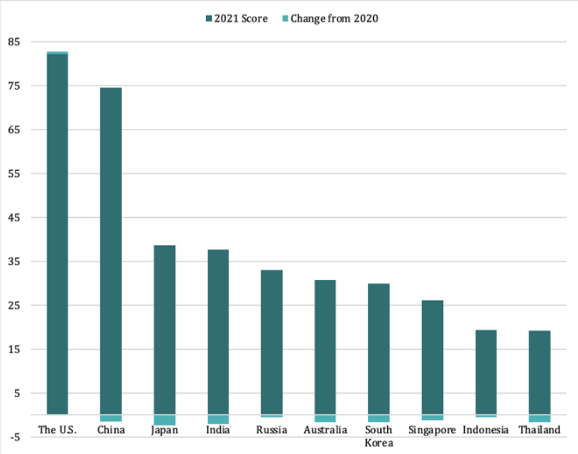
We are not optimistic about China joining the pact. Although existing CPTPP members have a strong interest in deepening trade and investment relations with an economic giant like China, RECP would be an alternative trade platform to gain benefits of trading with China. Six countries are current members of both agreements. In addition, given China's current shortfalls, approval of its entry would mean broad exemptions and would result in a watering down of CPTPP standards. We do not expect many CPTPP members to see the weakening of the rules they have fought hard to salvage.

Political factors are also against China's entry into the pact. Successful entry requires unanimous consent of all active members. Eight countries have ratified the CPTPP, and it will be up to the remaining three signatories to decide on China's membership. Amongst them, Canada, Australia, and Japan have experienced significant tension with China:

- Canada: China's arbitrary detention of its nationals,
- Australia: Calls for inspection on the origins of the Covid-19 in China, coal import ban and claim of Chinese spy ship off Australian cost.
- Japan: Chinese intrusions into the waters of the Senkaku Islands administered by Japan

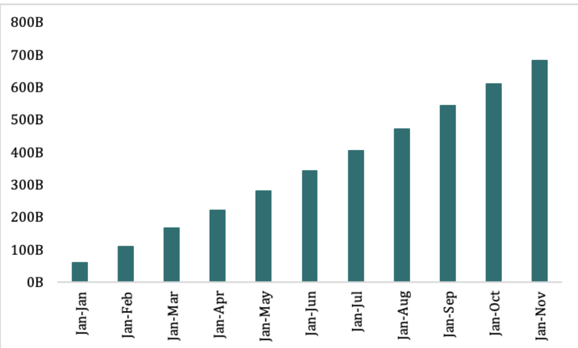
Therefore, China most probably would not benefit from CPTPP in any recent future. Nonetheless, if China were prepared to adopt far-reaching economic reforms like it did to enter the World Trade Organisation (WTO), CPTPP membership could catalyse positive

Figure 19: 2021 Asia Power Index Score (Top 10 Countries)



Source: Lowy Institute

Figure 20: 2021 China-US Bilateral Total Trade (in Billion USD)



Source: China General Administration of Customs

changes for both China and its relations with trading partners.

Geopolitics: China and the World

China's power was hit by Covid-19, and it also lost ground in diplomatic and cultural influence. Meanwhile, it gained on the resilience measure, which shows the ability to deter external danger to its stability. Although China's long-term growth is optimistic, it was found to be more vulnerable than most people believed. According to the Lowy Institute's Asia Power Index 2021, the U.S. was the only major country in the region whose overall power increased this year. China's overall power fell for the first time since the index was first issued in 2018 and has shown "no clear path to undisputed primacy in the Indo-Pacific" (Fig. 19). The power index measures the ability of states to shape and respond to their external environment and defines power as a state's capacity to influence the behaviour of other states, non-state actors, and the course of international events. The report released by Lowy Institute on 5th December 2021 also said that Beijing was now less likely to pull ahead of the U.S. in comprehensive power by the end of the decade.

China and the U.S.: "Economic Heat but Political Cold"

Bilateral tensions have grown as both parties become more defensive towards each other. According to the Sydney-based foreign policy institute, think-tank, Beijing has tried to dissuade South-east Asian countries from joining the U.S. coalition, while upgrading its military exchanges with Russia, Pakistan, and North Korea. The U.S. allies in the region and key balancing powers such as India have never been more dependent on the U.S. capacity and willingness to sustain a military and strategic counterweight in response to China's rise.

The bilateral tension has been complicated by the deepening U.S.-Taiwan relations. In early December this year, the U.S. and Taiwan agreed to set up Technology Trade and Investment Collaboration framework after talks to tackle supply chain and semiconductor issues. It signals Biden's intention to further deepen ties with Taiwan in the midst of soaring tensions with Beijing.

Under the intense relations, in early June this year, the U.S. has issued a new executive order barring the U.S. investment into Chinese firms with purported ties to defence or surveillance technology sectors, hitting 59 Chinese firms, including the communications giant, Huawei. The U.S. investors have been banned from buying or selling publicly traded securities in black-listed companies.

Nonetheless, the U.S. must increase imports from China to tackle domestic supply shortage and soaring inflation. As a result, the U.S. remained China's third-largest trade partner in November, with the bilateral trade value reaching USD 72 billion for that month, based on the latest data released from China's Customs. The total trade from January to November between China and the U.S. hit USD 682.32 billion, a year-on-year increase of 30.2% (Fig. 20). A Beijing-based economist, Tian Yun, predicted a new record number for China-U.S. trade volume in 2021 which is likely to continue in 2022.

Apart from robust bilateral trade, there are signs of cooperation on common interest between the world's two largest economies. A U.S.-China agreement was established at COP26 Climate Conference where they have agreed to boost climate co-operation over the next decade. Both also share the same concerns on sky-high oil price and China is expected to join a U.S.-led tug of war with oil producers. In addition, in November this year, President Xi called for China and the U.S. to "find the right way to get along" in his first virtual summit with President Biden. Xi has expressed that China was willing to engage in talks and cooperation with the U.S. on a wide range of matters covering economic development, energy, militaries, education, technology, cyberspace, and environmental protection.

Despite the political tension, China continues to attract record high foreign direct investment from the U.S. According to the 2021 China Business Report released by the American Chamber of Commerce in Shanghai in late September this year, the U.S. multinational companies (MNCs) are bullish on China. 59.5% of the U.S. multinationals reported increased investment, up 30.9 % compared with 2020. Of manufacturers producing in China, 72% had no plans to move any production out of the country in the next three years. So much for deglobalisation. Almost 78% of companies described themselves as either optimistic or slightly optimistic about the five-year business outlook. On the other hand, only 9.8% of companies were pessimistic, versus 18.5% in 2020 and 21% in 2019.

As for portfolio flows, the U.S. holdings of Chinese equity and debt securities surged from USD 765 billion in 2017 to USD 1.2 trillion in 2020, helped by the relaxation of rules on foreign access. This trend has been accelerated by index providers including more Chinese securities in global and regional indices, causing passive funds automatically to increase their exposure to China.

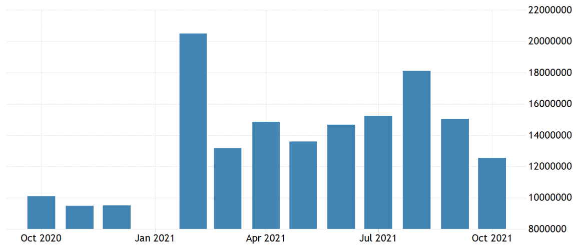
However, there are signs of nervousness due to the following reasons:

1. China's travel restrictions and the regulatory environment on both the U.S. and China sides, which narrows the space in which companies can operate, according to American Chamber Commerce in Shanghai President Ker Gibbs.
2. In Many regulatory changes were enacted only after the American Chamber of Commerce survey closed. These regulatory changes were announced with little or no warning, which has unsettled companies. Thus, responses in the survey might not reflect the most up-to-date business sentiment.
3. Rising competition from nimble Chinese businesses in the e-commerce space also concerns many U.S. companies. Some 55% of retail respondents said local rivals had better digital strategies than they did; 70% said locals are faster to market.

Alarmingly, we still see a strong likelihood that the U.S. will further curb investment in China under political pressure. According to the latest annual report of the US-China Economic and Security Review Commission, an independent U.S. agency, nominal financial "opening" in China is a carefully managed process, designed to reinforce state control over capital markets and channel foreign funding towards fulfilling national objectives. The commissioners further worried that U.S. capital could be helping advance China's military modernisation, facilitating human rights abuses, or subsidising unfair trade practices by U.S. companies.

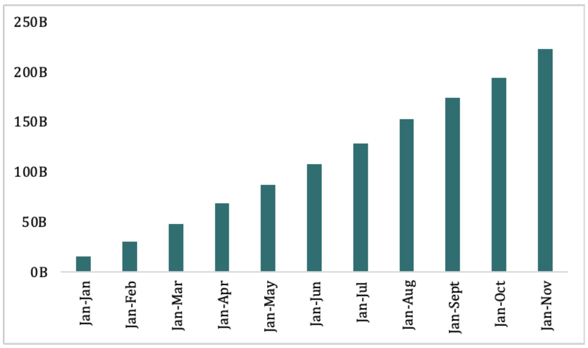
Considering all the above factors, we do not hold optimism in growth

Figure 21: China Imports from Australia (in USD)



Source: TradingEconomics.co

Figure 22: 2021 China Australia Total Trade (in Billion USD)



Source: China General Administration of Customs

of FDI inflows from the U.S. to China. This might further weaken CNH in the coming year. To continue attracting U.S. businesses and investment, China will need to create a stable business environment, as President Ker Gibbs commented.

Moving forward, we expect the current landscape of China-U.S. being "economic heat but political cold" to continue in 2022 as it is pragmatic for both countries to cooperate for common interest while political tension shows no sign of waning. It might also be possible for the U.S. to remove the punitive tariffs on Chinese products since it would help relieve the U.S. inflationary pressure, as highlighted by the U.S. Treasury Secretary Janet Yellen. Meanwhile, it would also increase China's export to the U.S., resulting in a win-win.

China and Australia

The China-Australia conflict is approaching a two-year mark and has grown worse this year. In September this year, Australia joined a new Indo-Pacific security partnership with the U.S. and the U.K. that will allow it to acquire nuclear-powered submarines. This has further agitated Beijing. In late November this year, the White House's Indo-Pacific coordinator said that China was conducting "dramatic economic warfare" against Australia and has tried to "break" the US ally, contributing to increased anxiety about Beijing in the region.

Under the ongoing bilateral trade war, several Australian export goods, including timber, coal, and lobsters, have been informally banned from China on top of impositions of duties on barley and wine. 12 key non-iron-ore commodities, such as coal, barley, beef, timber, lobster, and wine, has been heavily affected by the souring bilateral relations. According to a recent report by the Australia-China Relations Institute at the University of Technology Sydney, Australia's exports across these 12 commodities plummeted by USD 17.3 billion in the first nine months of 2021, compared with 2019. Australia sued China at the World Trade Organization (WTO) over tariffs on barley and wine. In November this year, WTO has agreed to establish a dispute-settlement panel to address Canberra's complaint over Beijing's imposition of anti-dumping duties on imports of wine from Australia.

Amid the trade war, Australia may be losing share in the Chinese market to other countries. Although China's imports from Australia maintained a fast pace in November, the growth rate slowed for a 2nd consecutive month, according to Chinese official data (Fig. 21). In October, the growth rate of China's imports from Australia slowed for the first time in 2021, down almost two percentage points from the growth rate in the first nine months, data from the General Administration of Customs (GAC) showed. The slowing growth might be due to decline in iron ore imports and Australia's weakening export ability due to Covid-19.

Another factor that comes into play is coal trading. China stopped buying coal from Australia late last year after Australia called for an international inquiry on the origin of Covid-19 in China. New customs data in late October showed that much of the coal came from Russia and Indonesia but not Australia. As a result, every million tonnes of coal have recently been costing China's steel mills more than USD 400 million, compared with around USD 250 million paid by steel mills everywhere else. Since China's mills use almost 2 million tonnes of coal every day, the premium it pays above coal costs in the rest of the world adds up to about USD 2 billion a week, according to the Australian Strategic Policy Institute.

On top of the economic costs, China also faces energy shortage resulting from soaring domestic demand. As covered earlier, China suffered from severe power cuts and the government is determined to avoid more. As such, in October, China relaxed its ban on Australian coal and smaller shipments of coal that had arrived in China but not been allowed through customs were released. However, the embargo still applies and there has been no policy change to allow coal to be imported. We do not see this event as a sign of China opening its arms to Aussie coal, considering the tight tension between these two countries, availability of alternative coal suppliers, and China's own mass coal mining projects. Broken Hill Propriety Company Ltd, a large mining company, believe that the unofficial ban will last for years to come.

On a side note, bilateral tension has been intensified by the presence of a ship deemed as Chinese spy ship. It had been detected circling Australia's coast in August and September for three weeks, collecting intelligence from military installations. Australian Prime Minister Scott Morrison warned the presence of the spy ship, which showed there was "a very serious situation in the Indo-Pacific."

Overall, China-Australia tension will persist. Nonetheless, the economic complementarity between China and Australia has underscored trading cooperation. Total trade between China and Australia reached USD 193.65 billion from January to October, up 38.4% year-on-year and higher than the overall trade growth recorded by China, the Chinese customs data showed (Fig. 22). As RCEP comes into force in January 2022, countries that have ratified RCEP, including China and Australia, are expected to embrace a fantastic opportunity for economic and trade development. Australia's then trade minister Simon Birmingham said in November 2020 that Australia hoped the RCEP would help reset economic relations with China. Moreover, despite political headwinds, some Australian companies are optimistic about China market and are trying to increase presence in China. The Victorian state government of Australia paid for dozens of Victoria-based companies to attend the fourth China International Import Expo (CIIE), according to a report by the Daily Mail in early November this year.

We see a high chance of China and Australia growing more cooperative in 2022, boosting bilateral trade and investment, although cooperation opportunities could be non-utilised in the case of deteriorating political tension.

Trade Idea: Long USDCNH

Narrative

With the Fed's expected three rate hikes in 2022 which will further support the Dollar, China, on the other hand, is seen to adopt a more supportive monetary policy in the short to medium term, amid its property crisis and slowing growth. For the second time this year, PBoC raised their foreign reserve ratio from 7% to 9% on 9th December 2021. A rather rare central bank toolkit to be used, this could result in a slower speed of Yuan appreciation, adding more downside pressure for CNH. If this divergence between China and US policies continues, it could erode the yield differential that currently favours the renminbi over the US dollar, thus favouring USD against CNH.

Moreover, the pair has hit 2016 and 2018 support levels and remains near its lowest levels of the year, providing an attractive opportunity to enter.

Catalysts

However, we do acknowledge the following risk factors thus far. Despite serious concerns in the property sector and soaring energy prices, China being the world's top manufacturer may continue to see strong export growth that will continue to support CNH. Latest stimulus measures including a cut to banks' reserve requirement ratio may also help to prop the cooling economy. Furthermore, China is the only nation that adopts the Covid-19 zero approach, a stark contrast from the U.S. and Europe. Though some have mentioned their concerns over the approach's economic feasibility and sustainability in the long run, the new Omicron variant may have proved that this approach might pay off for the Chinese. However, this approach is a double-edged sword. The zero-covid approach might have to go extreme lengths, beyond China's unique set of calculations if Omicron proves to be highly contagious. Risk thus lies in the fact that the zero-covid policy has been acknowledged by the market and in the event of a surprise turnaround in this policy, this could potentially impact both the Chinese and global economy adversely. This is because relaxed restrictions in China would help to ease supply chain pressures, reducing the need for the Fed's hawkish stance while supporting the Chinese economy, therefore smashing USDCNH. Currently, we see a low chance of the policy taking a U-turn.

Furthermore, Corporate conversion of FX receipts into Yuan that typically happens in year-end may remain heavy to support the currency. With these factors, USD/CNH may expect to see a new range between 6.3300 and 6.3700, with a downside bias.

Technicals

We are looking to enter a long position for the pair at 6.3516, as we see the MACD and signal lines converging with MACD about to cross over signal line, suggesting an opportunity to enter before reversal. It recently traded above key support level of 6.3748 and see it potentially challenging the bulls ahead.

Using Fibonacci Retracement to find entry point and key levels: the downtrend is likely to reverse as it hits 6.35052 (0.786 Fibonacci level), where we will enter. Stop loss is set at 6.25938 as it is a strong support level judging from past data. For take profit, 0.236 Fibonacci level lies in a strong resistance region, at 6.5919.

In a case where the pair dominates below and tests the support at 6.3450, we will reconsider buying of the pair.

Trade

Overall, with divergence of monetary policies in both economic powerhouses, we remain long on the pair and suggest a take profit of 6.593 with a risk reward of 2.6.

Entry: 6.3516
Take Profit: 6.593
Stop Loss: 6.2577
Risk Reward Ratio: 2.6

Global Macro Department –Hong Kong (UNDERWEIGHT)

Date: 15th December 2021

Analyst

Chermine Tong
Global Macro Analyst
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Basic Information

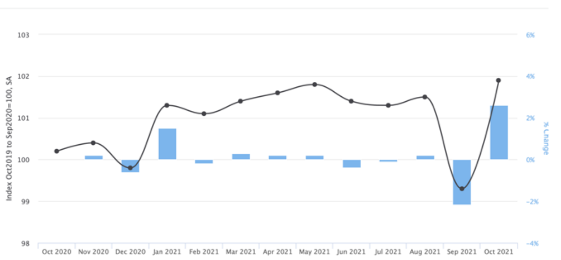
GDP	USD 347 billion
GDP Growth Rate	-6.08%
HKMA Rates	0.86%
Inflation Rate	0.33%
Unemployment Rate	4.5%
Foreign Reserves	USD 492 billion

Chart info

Figure 1: Hong Kong's annual GDP growth

Source: The World Bank

Figure 2: CPI



Source: Moody's analytics

Overview of Hong Kong

Operating under an open market policy, the Hong Kong economy is externally oriented and heavily reliant on trade with other countries. The value of imports amounted to HK$4,269.8 billion, around 158% of its GDP whereas the value of exports was measured to be HK$3,927.5 billion, around 145% of GDP. Following the gradual yet uneven global economic recovery, Hong Kong's exports of goods recorded significant year-on-year growth in Q3 2021, with real GDP growing by 5.4% year-on-year in the same quarter. However, the risks of transmission of mutant strains of the coronavirus such as the Omicron variant coupled with global supply chain bottlenecks will weigh down on the growth prospects of the Hong Kong economy.

Hong Kong's labour market saw improvements in the past few months. The seasonally adjusted unemployment rate dropped from a recent high of 7.2% in February to 4.7% in August. Moving forward, the resumption of economic activities should take some pressure off the labour market, albeit some services related sectors will still face challenges given the bumpy economic recovery. Accounting for 93% of Hong Kong's GDP in 2019, the services sector is crucial to the health of the economy. Due to rigorous travel and quarantine restrictions in place, the low levels of inbound tourism hinders the pace of Hong Kong's economic recovery. Locally, on top of improving employment conditions, the rising vaccination rate and the Consumption Voucher Scheme worth nearly HK$30 million spurred consumers' spending sentiments and provided support to consumption related sectors.

Hong Kong's economic recovery driven by strong exports and improving domestic demand

Hong Kong's real GDP grew by 7.9% in Q1 2021 compared to the previous year, marking its first economic expansion after weathering six consecutive quarters of recession. The economic rebound was supported by strong imports and exports, with overall trade reaching record highs in some months. Following which the economy recorded a growth rate of 5.4% year-on-year in Q3 2021, losing momentum from the 7.6% expansion in Q2. Domestic demand showed a sustained recovery in Q3 2021, evident from the growth of private consumption expenditure by 6.5% year-on-year in Q3 2021. However, retail sales are abating and tourism remains bleak, limiting the extent of recovery of Hong Kong's economy. As the recovery from the pandemic-induced downturn of 2020 begins to wane, long term economic prospects of Hong Kong hinge on its zero-COVID policy.
The consumer price index saw an inflation of 1.7% for October year-on-year, marking 10 straight months of increases. Notably, electricity, gas and water bills surged 28.1%, while prices of clothing and footwear went up by 6.1%. Moving forward, inflation pressure on upstream prices is likely to stay in the near term as the economy recovers and import prices rise. Meanwhile, underlying inflation

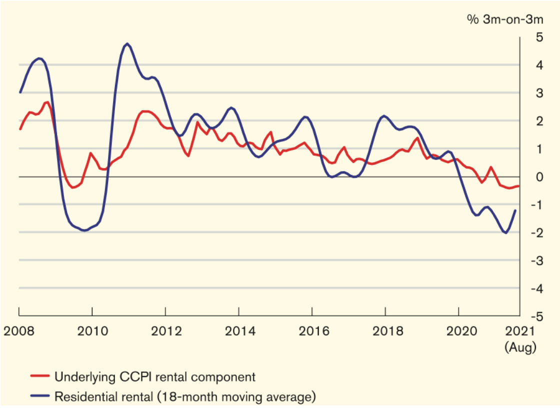
Figure 3: Manufacturing PMI

Source: Statista

should remain in check as domestic cost pressures are still tame. The seasonally adjusted unemployment rate dropped by 0.2 percentage point from the period of July – September 2021 to 4.3% in August – October 2021. This is occurring in the context of Hong Kong's continued economic recovery.

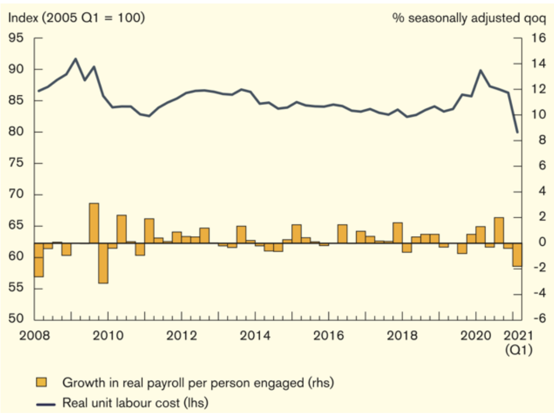
The local stock market underwent a sharp correction in the third quarter. Factors weighing down on the stock market include: uncertainties over the US monetary policy, the regulatory crackdown by Beijing, the proliferation of various COVID-19 strains globally and the associated disruption in transportation and supply chain networks. Dominated by Chinese companies, the Hong Kong market recently recorded a lacklustre earnings season, especially from bellwethers such as Tencent Holdings, Alibaba Group Holding and Meituan. The Hang Seng Index (HSI) fell to 24 099 on September 20, before closing the third quarter at 24 576, down markedly by 14.8% from end June. The residential property market remained generally active in Q3 2021, supported by the low interest rate environment, firm end-user demand and the local economic recovery. Flat prices rose by 1% on average and rentals largely stayed firm in the third quarter.

Figure 4: CCPI rental component and market rental



Source: C&SD and Rating and Valuation Department (R&VD)

Figure 5: Unit labour cost



Source: C&SD and HKMA

COVID-19 Fallout

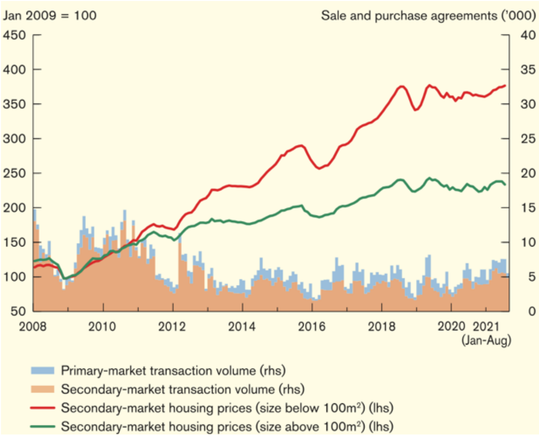
The city's recent economic recovery gained traction in Q3 2021, increasing by 5.4% compared to last year, according to the Census and Statistics Department. This was recorded against the backdrop of strong export growth and buoyant private consumption supported by the government's e-voucher rollout. However, owing in part to the disruption of global supply chains, the city faces growing pressure from inflation as a result of high overseas energy and commodity prices, and shipping costs. This similarly reflects the experience on the Mainland, which is a principal source of Hong Kong's fresh food supplies, where events like severe flooding and power cuts have contributed to inflationary pressures.

Private consumption growth improved further from 2.1% YoY in 1Q to 6.5% in 2Q. Retail sales rose by 10.4% in May. Discretionary spending such as jewellery experienced more notable growth of 55.1%, suggesting improving local consumption sentiment. CPI stayed positive at 0.7% in June. Following the easing of the pandemic and resulting recovery of consumption demand, the prices of meals out, takeaway food, footwear, clothing recorded faster increases. Conversely, the housing rental component of the CCPI remained on a downward trend, consequently limiting the overall inflation increase. Real unit labour costs moderated in Q1 2021 due to a decrease in the payroll per person in real terms. The seasonally adjusted unemployment rate fell from an 18 year-high of 7.2% in Dec20-Feb21 to 5.5% in Q2. The unemployment rate of the retail, accommodation and food services industries decreased from 11.1% to 8.5%. Looking ahead, while local inflation will likely pick up further in the near term alongside the economic recovery, overall price pressures should remain mild for 2021 due to the decline residential rentals and constrained local labour costs.

With the Hong Kong economy operating beneath capacity, cost pressures for business stayed manageable, with wages experiencing moderate annual growth and commercial rentals remaining soft. On the other hand, external price pressures rose further in view of elevated inflation experienced by some major import countries due to rising demand and supply constraints. Elevated international commodity and energy prices, also contributed to a faster year-on-year increase in prices of some merchandise import items. Exports of goods grew by 20.3% YoY in 1Q and 33.0% in June. Outward shipment to the Mainland China jumped by 36.6% in June amid the recovery of its economic activities. Although China's export-led industrial activities are likely to moderate in the months ahead, that of the advanced economies such as US and Germany should improve further amid a recovering global economy. Looking ahead, the vaccination rollout currently underway worldwide will support Hong Kong's re-exports.

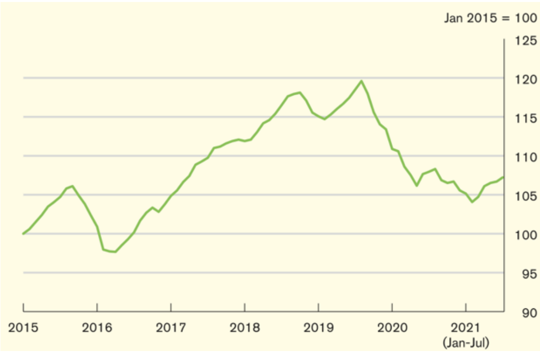
Under such an environment, the government will probably withhold further fiscal stimulus. Fiscal balance is projected to continue to be at a deficit at 3.6% of GDP in 2022 from 9.4% in the past year. The growth in government spending eased from 7.0% in Q1 2021 to 2.9% in Q2. Fiscal reserves stabilized at HKD907 billion in May, 7.1% higher than the lowest reading amid the pandemic recorded in October 2020. With the government front-loading the i-bond (retail government bond) issuance in June, the issuance of government bond

Figure 6: Residential property prices and transaction volumes



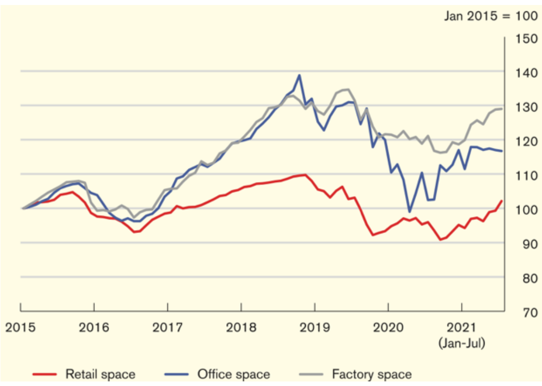
Source: R&VD Land Registry

Figure 7: Housing rentals



Source: R&VD

Figure 8: Non-residential property price indices



Source: R&VD

is projected to slow in the coming months. Since the Hong Kong dollar is pegged to the greenback, Hong Kong bond yield movements largely tracked the rate movements of United States (US) Treasuries. The US bond yield curve shifted upward due to inflation fears and expectations that the US Federal Reserve will quicken tapering following news of the US consumer price index rising 6.8% YoY in November, the fastest pace the country has seen in almost 40 years.

<u>Performance of Banking Sector</u>

As one of the key financial centres of the Asia-Pacific region, the banking industry plays an essential role in the Hong Kong economy. In 2020, Hong Kong's banking sector boasts a contribution to GDP of 14.3%, with more than 70 banks in the world having a presence and more than 29 multinational banks basing their regional headquarters in Hong Kong.

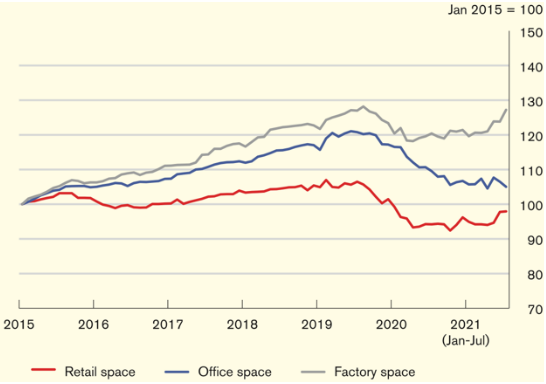
Despite visible economic recovery in the first half of 2021, retail banks registered thinner profits as their net interest margins narrowed further amid the low interest rate environment. The fall in profits was mainly driven by a decrease in net interest income, which more than offset the impact of an increase in non-interest income and a notable decrease in loan impairment charges. As a result, the return on assets fell to 0.69% in the first half of 2021 compared with 0.94% in the same period of 2020.

Capital and liquidity positions of the banking sector also stayed healthy, offering buffers for banks to mitigate shocks. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) stood at a high level of 19.8% at the end of the second quarter of 2021. Customer deposits continued to be the primary funding source for AIs, underpinning a stable funding structure in the banking system. At the end of June 2021, the share of customer deposits to all AIs' total liabilities increased to 57.2%, from 56.1% six months ago. Regarding the liquidity positions, the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions also maintained at high levels of 154.0% (well above the statutory minimum requirement of 100%) and 58.1% (well above the statutory minimum requirement of 25%) respectively in the second quarter of 2021. In addition, the latest ratios under the Net Stable Funding Ratio requirement stayed at levels well exceeding their statutory minimum requirements.

Bank credit resumed expansion at a notable pace in the first half of 2021, mainly driven by the improved domestic economic environment, coupled with a tangible increase in IPO-related loans straddled at the end of June. On a half-yearly basis, total loans and advances of all AIs increased markedly by 7.2% in the first half of 2021, after declining by 1.8% in the second half of 2020. Loan growth was mainly driven by growth in domestic lending (comprising loans for use in Hong Kong and trade financing), while loans for use outside Hong Kong increased mildly.

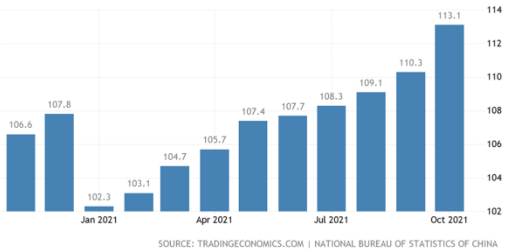
Climate change is soon becoming a significant risk to financial stability. For instance, a disorderly transition to a low-carbon economy could have a destabilising effect on the financial system. According to the HKMA, research conducted on a sample of

Figure 9: Non-residential property rental indices



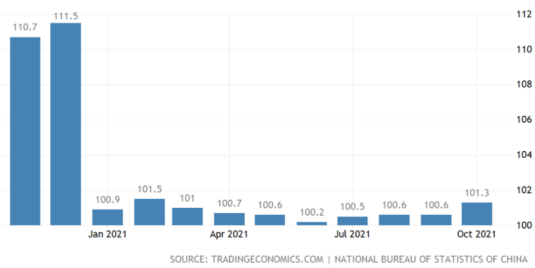
Source: R&VD

Figure 10: China PPI



Source: Trading Economics

Figure 11: China CPI



Source: Trading Economics

syndicated loans in Asia Pacific finds that banks in the region have started to price-in climate transition risk for loans to emission-intensive sectors since the Paris Agreement, suggesting that banks have begun to incorporate climate risk considerations in their existing risk management framework. In view of the highly challenging task in managing climate risks given their distinctive nature and data gaps, the HKMA has actively engaged with the banking industry to facilitate AIs' inclusion of climate risk management practices in their operations.

Looking ahead, uncertainties related to the US Federal Reserve (Fed)'s monetary policy, may heighten volatility in fund flows. For instance, should the US inflation continue on an upward trend, a recalibration of the US monetary policy may be initiated. Expectation of tightened monetary conditions has exerted an upward pressure on Treasury yields and the US dollar, which will serve as headwind for the economies of emerging markets. The higher yields on US assets will prompt capital inflow and increased volatility arising from global portfolio rebalancing, resulting in a decrease in external funding flowing into emerging markets. Currencies of emerging market economies will also experience sharp depreciation while domestic asset prices and credit to the private sector will drop. As such, countries with external imbalances are more susceptible to the impact of higher US interest rates. Nevertheless, given its ample foreign reserves and robust banking system, it is expected that Hong Kong will be able to withstand the volatilities in fund flows without compromising its financial stability.

<u>Upward Momentum in Residential and Non-residential Property Markets</u>

Hong Kong's property market is an important part of its economy, with housing being the most significant share of households' wealth. As of 2021, residential mortgage loans account for 68% of Hong Kong's household debt, while leans for other private purposes and credit card advances contribute 27% and 5% respectively. Fluctuations in property prices and rents affect consumer price inflation while land sales and stamp duties on property transactions are notable sources of government revenue.

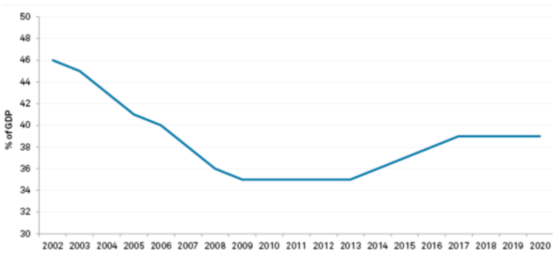
The residential property market has regained some upward momentum since the start of this year, underpinned by better economic prospects, improving market sentiment and mortgage interest rates that are still low. The average monthly transaction volume bounced up by 23% to 6,657 units in January–August, compared with an average of 5,434 units in the second half of last year. In particular, transactions in the secondary market climbed to a nine-year high in the second quarter, and many new property launches recorded brisk sales. Secondary-market housing prices also resumed growth, rising by 4.3% in January–July to just below the historical peak in May 2019.

Housing affordability became more stretched, reflecting higher housing prices but weak growth in household income. The housing price-to- income ratio climbed to 19.6 in the second quarter of 2021, compared with the peak value of 14.6 in 1997. Alongside positive market sentiment and a decline in the unemployment rate, housing

Figure 12: China GDP growth by consumption, investment and net exports

Source: National Bureau of Statistics of China

Figure 13: Percentage of China's household consumption in GDP



Source: National Bureau of Statistics of China

rentals picked up by 1.6% in the first seven months, albeit still 10.3% below the peak reached in August 2019. As the cumulative rise in housing prices was larger than the pick-up in rentals, the positive buy-rent gap enlarged further in January–June. In tandem with the widening of the gap, residential rental yields remained low at 1.9–2.3% in July. Despite stretched housing affordability, the macro-prudential measures implemented by the HKMA since 2009 helped contain household leverage and safeguard banks' resilience. The average LTV ratio for new mortgages was 56% in July 2021, below the 64% before the measures were first introduced, while the debt-servicing ratio also stayed low at around 37% in January–July. Over the longer term, the outlook for the housing market will depend on the supply-demand gap. The Government projects that private housing supply will remain high in the upcoming years.

The non-residential property market saw some signs of recovery along with the revival in economic activities. Average monthly transactions picked up in the first eight months, while speculative activities stayed inactive. While prices of office space flattened recently, prices of retail premises and flatted factory space went up by 7.3% and 8.7% respectively between January and July, though still below their respective peaks in 2018 or 2019. In the leasing market, rentals of industrial properties recorded a notable increase amid strong growth in Hong Kong's merchandise trade[40], while rentals of office and retail shop spaces remained soft, partly because of vacancy rates that stayed at a high level. Meanwhile, rental yields across segments stayed low at 2.5–2.9% in July. Looking forward, the performance of the non- residential property market will depend on the pandemic developments, as well as the domestic and external economic environments. In particular, the rising vaccination rate, further relaxation in social-distancing measures, eventual border reopening, as well as continued expansion in domestic consumption and external trade would help the commercial and industrial property markets recover further.

China stagflation risk

The trade-oriented city has been benefiting from mainland China's swift recovery from the COVID-19 crisis. Out of Hong Kong's major export partners, the Mainland was the first few to recover economically from the pandemic, becoming a key factor in driving up Hong Kong's exports. In the first quarter of 2021, the mainland's GDP surged by 18.3% YoY in real terms.

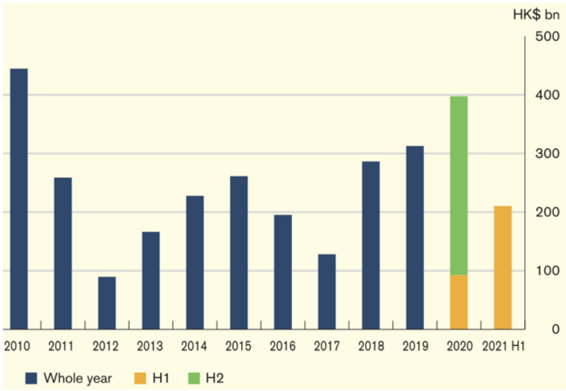
<u>China's persistent problem of weak consumption</u>

However, Beijing's zero tolerance policy in response to the COVID-19 pandemic will be a drag on future growth as outbreaks of variants strains prompt stringent travel restrictions and lockdown measures, spooking consumers and forcing businesses to shut, dampening economic activities.

In 2020, China's per capita consumption spending experienced a real decrease of 4% after deducting price factors. Despite the rebound in the first three quarters of this year, its August retail data is underwhelming, increasing by only 2.5% from a year ago, well below

Figure 14: USDHKD

Figure 15: Hong Kong's IPO market



Source: HKEX

the 7% growth expectation. This can be traced to China's "zero tolerance" policy response to Covid-19 infections and the corresponding lockdowns implemented so as to rein in the highly transmissible Delta variant. These measures exerted a downward pressure on retail sales. Unfortunately, there is no telling when these restrictions will be relaxed in the short term. Thus, the occasional discovery Covid-19 clusters, coupled with the strict zero-Covid policy constitute a risk to the economic growth of China.

The issue of weak domestic consumption in China weighs on the growth trajectory of its economy. Total consumption contributed -0.5 percentage point of China's GDP in 2020. Thus far, the China's economic recovery from the pandemic has been led largely by debt-fuelled investment and industrial exports. National statistics revealed that household consumption in China merely accounted for 39% of GDP in 2020. This is in contrast with 55% and over for other large economies. Factors that contribute to this issue of weak consumption is the slow income growth for Chinese households, especially the lower income group, as well as the high savings rate due to the inadequate social welfare coverage. The inability of the government to boost consumption contrasts with the developed economies of the U.S., European Union, Japan and U.K., which are projected to benefit from a surge in consumer spending as inoculation rates rise and service industries reopen. Nevertheless, the 14th Five-Year Plan announced in March unveils a new "dual circulation" strategy aimed at supporting domestic demand and technological development. This comes as good news as it is projected to create considerable business opportunities for Hong Kong exporters targeting the mainland market, especially in the high-tech sector.

<u>China's economic growth slowdown</u>

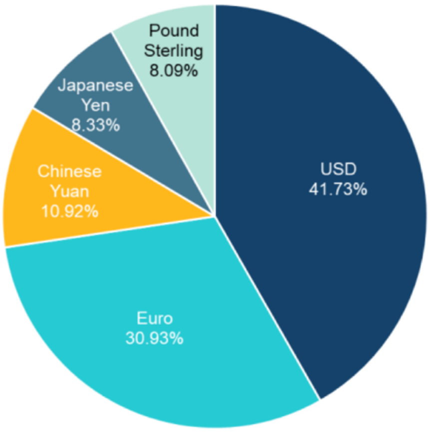
With power shortages restricting industrial activity and an over leveraged property sector, China's economic growth is experiencing a slowdown. Beijing's resolute stance towards deleveraging its property sector will be a drag on China's economic growth in the upcoming months, with real estate and related industries contributing nearly 25% of GDP. Tightened credit in the property sector may result in decreased industrial demand and consumption.

China's factory gate inflation reached a 26 year peak in October 2021 following the surge in coal prices during the power supply crisis China recently faced. The producer price index rose to 113.10 points in October, up from 110.30 points recorded in September. Similarly, the consumer prices also saw an increase in growth, while lagging behind factory gate prices. The consumer price index climbed 1.3% YoY in October, up from 0.6% recorded in September. Unable to continue absorbing the surging costs, some Chinese food giants such as Jiangsu Hengshun and Fujian Anjoy have made the decision to raise retail prices. Consequently, China's rising inflation and economic slowdown have sparked concerns over stagflation.

<u>Hong Kong squeezed by China's slowing growth</u>

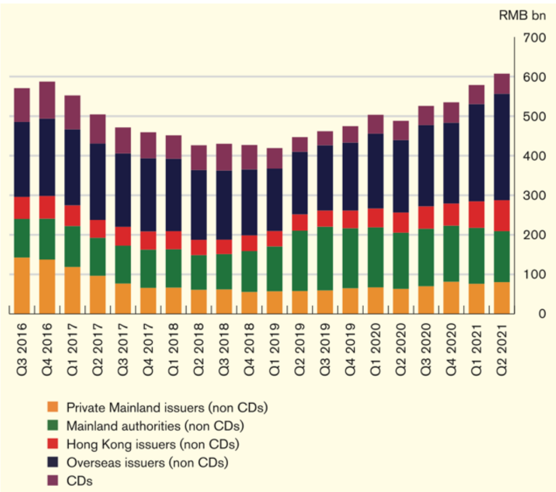
Hong Kong's role as an international financial hub and a services base for the Mainland , coupled with its high degree of reliance on trade, suggest that the city is especially vulnerable to the Chinese economic

Figure 16: Currency weightings in the SDR currency basket



Source: IMF

Figure 17: Outstanding CNH debt in Hong Kong



Source: Newswires and HKMA

slowdown. For the past decade, the Mainland was both Hong Kong's largest destination of total exports of goods and supplier of imports of goods, on average making up 54.1% and 46.9% of Hong Kong's total exports and imports respectively. In 2021, China's export growth slowed in July following COVID-19 outbreaks, while imports similarly lost momentum, hinting at a slowdown in the country's industrial sector in H2 2021 despite expectations that easing global lockdowns will boost commerce.

Hong Kong as an Important Gateway to the International Financial System for China

The factors underlying Hong Kong's position as a key financial hub include its rule of law, independent judiciary, low taxes and minimal capital controls as well as huge concentration of financial and legal service providers, among other things. The city's access to mainland China and proximity to other countries in the region has also worked in its favour. Despite the growing significance of places like Shanghai and Shenzhen as China's financial centres, Hong Kong remains a key gateway connecting mainland China with global financial markets. The reason is because Mainland China retained extensive capital controls and actively manages in its financial system through intervention. Conversely, Hong Kong boasts an economy that is one of the most open globally and a large market for equity and debt financing. As a result, international firms often use Hong Kong as a base to expand into mainland China. Data reveals that Hong Kong originates and intermediates more than half of China's inward foreign direct investment and outward direct investment. Furthermore, under Beijing's 14th Five Year Plan, the Mainland government has reinforced longstanding priorities for Hong Kong such as continuing to provide support for further development of the city as an offshore RMB business hub, international financial, shipping, and trading centre.

The Hong Kong dollar remained in the strong side of the Convertibility Zone and continued to trade in a smooth and orderly manner. The Hong Kong dollar softened slightly against the US dollar in March and early April due in part to weaker buying interest from the southbound Stock Connects. Lower buying interest registered by the southbound Stock Connects and the repatriation of IPO earnings both resulted in the Hong Kong dollar weakening slightly against the US dollar in March and early April. The Hong Kong dollar then firmed again in Q2, due to the resumption of the southbound inflows with net buying through the southbound Stock Connects continuing in Q2 after its record-breaking level of HK$310.6 billion in January. Also, corporates' needs to pay dividends added to the strength of the Hong Kong Dollar. In July, the Hong Kong dollar weakened as a result of risk-off sentiment in the local equity market. Despite that, the strong IPO pipeline prevented further weakening of the Hong Kong dollar.

Hong Kong's primary market saw its strongest- ever first half in terms of funds raised in 2021 amid a global boom in listings. There were 46 IPOs raising a total of HK$210.4 billion, a year-on-year increase of 126.7% compared with the same period last year. In the first half of 2021, the HKEX ranked third among global IPO rankings in terms of the funds raised, after NASDAQ and the New York Stock Exchange. The surging amount of new-share financing was mainly

Figure 18: Flows of renminbi trade settlement payments

Source: HKMA

attributable to the blockbuster listings of Mainland enterprises. Six sizeable Mainland tech and logistics company listings raised a total of HK$139.6 billion, representing two-thirds of the total funds raised during the first half. The near-term outlook for the local equity market remains uncertain. In terms of the IPO market, the "homecoming" of US-listed Mainland companies would continue to lift the city's capital market. However, market sentiment in the second half may be weighed down by the performance of recent IPO stocks, as 20 out of the 46 companies newly listed in the first half slumped in their trading debuts.

<u>Hong Kong's importance in RMB internationalisation</u>

The forces driving foreign investor inflows into Mainland fixed income, including the Mainland government's commitment to liberalise the onshore bond market, the internationalisation of the renminbi, global bond index inclusion and the high interest rate premium in the current low rate environment, remain in place and will continue to drive foreign inflows in the coming years. The demand for Mainland onshore bonds is likely to be structural in nature and an allocation to this asset class will be a strategic decision that is increasingly difficult to ignore. According to the Global Public Investor 2021 report[5], 30% of central banks are planning to increase their exposure to the renminbi over the next 12–24 months, compared with just 10% last year. As capital inflows into the Mainland onshore bond market is projected to remain on an upward trend, the Northbound Trading turnover is also expected to grow. The scheme will continue to play an important role in helping foreign investors access the onshore bond market and raising bond market depth and liquidity, thereby strengthening Hong Kong's role as an offshore renminbi business centre.

Additionally, FTSE Russell's addition of Chinese government bonds to its flagship World Government Bond Index beginning October 2021, similarly carried out by the Bloomberg-Barclays Global Aggregate Index and the J.P. Morgan Government Bond Index (Emerging Markets) in April 2019 and February 2020 respectively, signal to the trend that Mainland onshore bonds will be increasingly held by foreign investors

The offshore renminbi banking business saw consistent growth. The offshore renminbi (CNH) liquidity pool expanded further, with the total outstanding amount of renminbi customer deposits and certificates of deposit rising to RMB854.7 billion at the end of July. Within the total, renminbi customer deposits picked up by 13.7%, more than offsetting the 4.4% decline in the outstanding amount of CDs. The increase in renminbi customer deposits mainly came from corporate customers. Meanwhile, renminbi lending and renminbi trade settlement continued to pick up. Transactions handled by banks in Hong Kong amounted to RMB4,020.0 billion during the first seven months , up 7.9% compared with RMB3,724.4 billion during the same period last year. The growth in trade settlement transactions was predominantly due to a rise in inward remittances to Hong Kong.

Looking ahead, Hong Kong's offshore renminbi business is poised to benefit from the continued liberalisation of the Mainland's capital account through the various Connect schemes, international investors' increasing demand for renminbi assets, and deepening regional economic integration made possible through the Belt and Road and the Guangdong-Hong Kong- Macao Greater Bay Area policies. The cross-border wealth management connect pilot in the Greater Bay Area has reported transactions worth more than 200 million yuan (USD 31.3 million) since it was launch on October 19 earlier this year. The Cross-boundary wealth management connect is expected create new business opportunities for the financial industries in the three places, facilitate cross-boundary investment and provide more options of wealth management products for residents in the GBA, thereby further promoting the cross-boundary circulation and use of renminbi. Also, with the planned launch of China's central bank digital currency (CBDC), Hong Kong, as the biggest offshore centre, can potentially take a leading role in its eventual wider deployment.

The Hong Kong flashpoint in US-China tensions

Following last year's imposition of a national security law for Hong Kong, the overhaul of the electoral system marks another step by Beijing towards strengthening its management of the city. This trend is projected to sustain over the next few years, amid rising concerns that the systematic undermining of Hong Kong's political freedom could severely diminish its attractiveness as an international financial and business hub.

Indeed, the growing deviation away from the "one country, two systems" model may turn away from foreign companies. However, Hong Kong's role as a key gateway between China's financial market and the global markets remains unthreatened in the short to medium term. Furthermore, the China's 14th five-year plan detailed the authorities' priorities in maintaining Hong Kong's commercial stature. This is evident from the mainland's decision to shelve the anti-sanctions law for Hong Kong in the near term. The anti-sanctions law is based on legislation passed on the mainland in June 2021, which conferred the Chinese government broad powers to seize assets from entities that implement United States sanctions, potentially placing companies in Hong Kong in the cross-hairs of an ongoing conflict between the world's two largest economies. The law was China's response to a series of sanctions by the U.S. on dozens of Hong Kong and mainland Chinese officials involved with the national security law Washington proclaims is being used to crush dissent in the city. In 2020, the U.S. imposed sanctions preventing American companies and non-U.S. banks from doing business with several Chinese and Hong Kong officials whom it deemed implemented Beijing's national security law on Hong Kong. In 2021, a separate U.S. ban on investments in firms the authorities deem to be related to China's military compelled U.S. banks in Hong Kong to eliminate dealings with some Hong Kong-listed Chinese telcos. Under the planned law, if financial institutions in Hong Kong implement U.S. sanctions, they may be exposed to legal risk in Hong Kong for doing so, financial sector executives and lawyers said. Imposing such legislation on Hong Kong could destabilise the city's financial sector and cause foreign investment to flow towards rival Asian finance centre Singapore.

Figure 19: Short Hang Seng Index

Short Hang Seng Index (HSI)

In the aftermath of the passing of the national security law, antipathy towards the government is widespread, but the risk of large protests has been reduced by the threat of prosecution under the law, bringing an end to the prolonged protests that have plagued Hong Kong. On another front, the rapid spread of the Omicron variant threatens to push back travel reopening in Asia, injecting uncertainty into Hong Kong's short-term economic outlook. In Hong Kong, the variant will trigger the strict travel policies maintained under a "zero-covid" policy, possibly setting back plans for the partial reopening of the China-Hong Kong border by end of this year.

The HSI has been one of the worst-performing of the leading global indexes this year, at a time when other stock markets are reflecting optimism for a recovery from the pandemic. It remains a long way off its all-time high close of 33,224, reached in January 2018. By contrast, the S&P 500 index in the US hit an all-time high on November 18th this year. The relatively weak performance of Hong Kong's benchmark index is owing to its exposure to mainland Chinese stocks. While the Chinese government has imposed antitrust guidelines on the internet and technology companies, limiting the growth potential of these firms, it is projected that the authorities will manage to balance between restricting monopolistic activities while not stifling the innovation that drives the growth of the sector. Furthermore, targeted easing measures and softer energy curbs implemented by the Chinese government will remedy the growth slowdown in 2022.

Using the 1 week chart for the index, the HSI has been trading within the 23252 and 26058 range since August, recently closing at 23420. We are looking to enter a short position at 24088, where the MACD line crosses below the signal line, indicating a bearish signal. This is preceded by the MACD's brief move higher within a broader downtrend, providing us with a bearish confirmation.

Entry: 24088

Take Profit: 21566

Stop Loss: 25858

Risk Reward Ratio: 1.42

NUS INVESTMENT SOCIETY

Global Macro Department – Taiwan (UNDERWEIGHT)

Date: 15th December 2021

Analyst

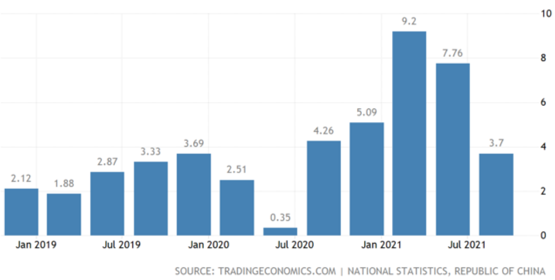
Chermine Tong
Global Macro Analyst
chermine.tong@u.nus.edu

Basic Information

GDP:	USD 668.16 billion
GDP Growth Rate:	3.70%
USDTWD:	27.70
CBC (TW) Rates:	1.125%
CPI:	105.39
Inflation Rate:	2.58%

Chart info

Figure 1: Taiwan GDP growth YoY



Source: Trading Economics

Overview of Taiwan

As one of the top 25 economies in the world in terms of GDP, Taiwan is an important export oriented economy in global and regional trade. A central hub for shipments and transshipments in East Asia, and a major centre for advanced research and development, Taiwan occupies a vital role in global supply chains. In 2020, manufacturing accounts for just under 30% of Taiwan's GDP and a roughly equivalent share of job creation. However, when downstream effects such as the economic and employment multiplier effects of Taiwan's manufacturing and export sectors are considered, exports accounts for nearly 70 percent of the country's GDP.

Since March 2021, exports have recorded high double-digit growth. Investment has gained momentum with the return of Taiwanese businesses and rise in investment in areas like semiconductors, 5G, and green energy facilities. Locally, the COVID-19 situation worsened from May to July 2021. The warning levels for epidemic prevention was raised, and domestic consumption saw a dip. In addition, the circulation of the new strain of the coronavirus further exacerbates the bottlenecks faced by global supply chains, potentially limiting the growth in exports that Taiwan has enjoyed in 2021. On top of disruptions to shipping and goods distribution systems, rising prices in commodities have contributed to the world-wide problem of inflation, limiting the demand for end products in the US and Europe, which will prove to be a problem for Taiwan.

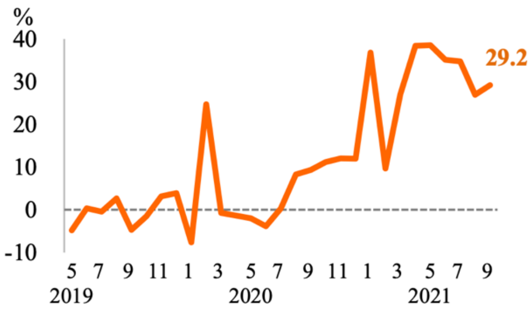
Strong economic growth supported by strength of global tech demand

GDP expanded by 7.43% in Q2 2021, down from 8.92% in Q1, weighed down by a partial lockdown imposed to control domestic COVID-19 infections from spreading. The main industry driving the growth of Taiwan's GDP is its semiconductor industry. Semiconductor factory investment resulted in an increase in overall investment by 27.97% YoY, accounting for more than six percentage points in the quarter. Meanwhile, consumption detracted 2.62 percentage points from GDP in the third quarter.

In October 2021, Taiwan's exports rose by 24.60% YoY. This comes after a series of double-digit growth for the past 8 months. The continued global recovery, strong market demand for ICT parts and components and other merchandises, rising prices for raw materials coupled with low base effect due to impact of the COVID-19 pandemic, were responsible for the strong growth. On the other hand, Taiwan's imports in October 2021 grew by 37.22% YoY, with the main factor of the jump attributable to low base effect.

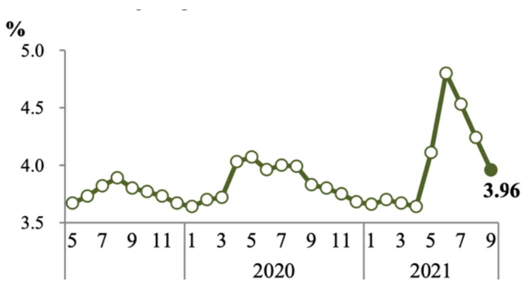
Real private investment grew by 13.70% in Q1 2021. Affected by the US-China trade war and the ongoing pandemic, companies are

Figure 2: Taiwan exports



Source: NDC

Figure 3: Taiwan's unemployment rate



Source: NDC

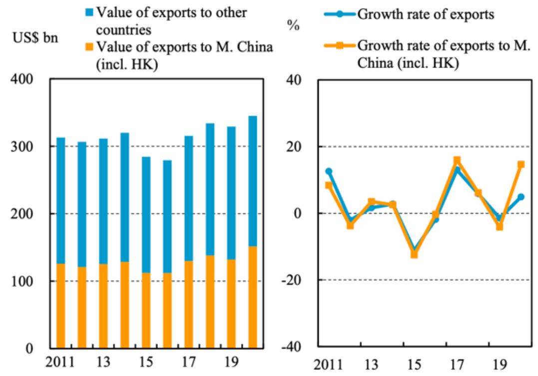
Figure 4: Taiwan's unemployment rate

Source: National Statistics Bureau

reanalysing their vulnerabilities in global supply chains. The shipping industry is enlarging its equipment base and 5G network construction is intensifying while capital expenditures of manufacturers are rising. Capital equipment imports increased by 29.16% in H1 2021, signalling that investment in Taiwan saw an upward trend. Furthermore, considering the government's plans to ramp up development of urban renewal and social housing, as well as offshore wind power and other green energy public works, it is projected that fixed capital formation in 2021 will grow by 7.54%.

Taiwan's consumer price index increased by 2.58% YoY in October 2021, while core inflation rate rose by 1.43% YoY in October 2021. On the other hand, the wholesale price index went up by 14.78% YoY in October 2021, the seventh straight month that recorded double digit increase. Taiwan's businesses are experiencing a rising pressure of surging input costs. Meanwhile, Taiwan's unemployment rate fell by 0.28 percentage points from a month earlier to 3.96% in September 2021, decreasing for three straight months, as the impact of an outbreak domestically transmitted COVID-19 subsides. Nevertheless, the number of employed persons remained below the pre-pandemic level, with the services sector reportedly losing more jobs compared with the other sectors.

Figure 5: Total value and annual growth rates of export



Source: MOF

Figure 6: CPI change rate

Source: National Statistics Bureau

Taiwan's economic recovery supported by twin pillars: exports and private investment

From mid 2021, Taiwan's exports sustained its upward trend owing to strong demand for tech products and traditional manufacturing goods. Regarding external demand, rising global demand and high raw material prices significantly boosted export performance of major products 2021, with an increase by over 20% for exports to each major market. In terms of domestic demand, private investment recorded steady growth as local tech giants and related supply chain firms stepped up capital expenditure. Investments are focussed on 5G network technology, maritime and air transport equipment. Demand from government consumption was stable and investment by state-owned enterprises saw an increase. The three major programmes implemented by the government in 2019, with the objective of drawing overseas investment by Taiwanese firms back to Taiwan, encouraging increased investment locally by domestic corporations, served to boost private investment.

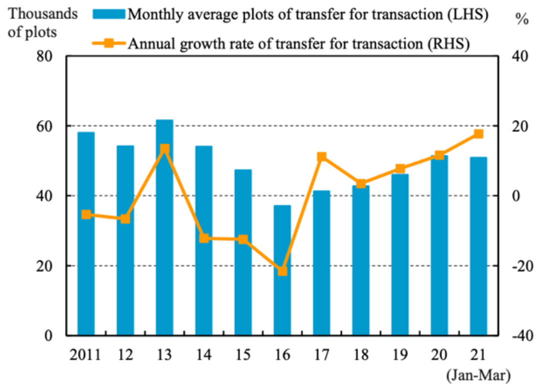
Despite private consumption falling sharply by 5.6% YoY in Q3 due to restrictions to control the pandemic, compared to the decrease of 0.42% recorded in Q2, the Q3 GDP growth rate of Taiwan managed to reach 3.7% YoY. The relaxed public health measures in place after the downgrade of the health alert in response to the easing pandemic situation, consumer confidence moderately increased. In view of Taiwan's major trading partners, the growth rate of exports to Mainland China (including Hong Kong) turned positive, climbing by 14.64%, mainly due to a larger increase in exports of integrated circuits to Mainland China.

<u>Prices surge amidst strong economic growth</u>

As of August 2021, global prices for crude oil and other raw materials remained inflated, and domestic vegetable prices surged due to reduced supply from torrential rain, bumping up the annual growth rate of consumer price index to 2.34%. However, the rise was attributable to short-lived forces like poor weather conditions. Additionally, due to the low base effect wearing off, annual CPI inflation is projected to decrease at a gradual pace. The core CPI recorded a yearly growth rate of 1.33%, which is perceived to be mild. In the year so far, raw material price uptrends and shipping fee surges hiked up import prices and resulted in imported inflationary pressures, although showing signs of moderation in the upcoming months. On the other hand, Taiwan's November producer price index increased by 0.06% compared with the month. Indices tracking poultry and livestock products, petroleum and coal products, and fabricated metal products grew by 3.72%, 2.32%, and 1.16% respectively. On the contrary, indices for farm products, as well as electronic parts and computers dropped 4.62% and 0.67%, respectively, counteracting a portion of the increase. In 2022, provided with a stable outlook for global oil prices predicted by international institutions, the CBC expects that both the yearly growth rates of the CPI and the core CPI would both decline to 0.92%.

Locally, the banks' real estate lending had taken up an increasingly larger portion of total bank lending. Of all the components, the leading contributor would be a rising share in construction loans due to rising land loans, whereas the share of housing loans changed modestly. As real estate developers were keen on buying more land,

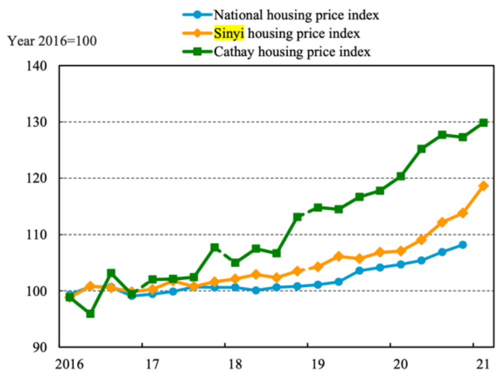
Figure 7: Land transfers for transaction and annual growth rate



Note: Figures are the monthly average of each year. Data of 2021 are the monthly average for the period of January to March.

Source: Monthly Bulletin of Interior Statistics, MOI

Figure 8: Housing price indices



Notes: 1. In 2018 Q1, the Cathay housing price index model's parameters were revised, and from January 2017 the opening price, transaction price, and index of each quarter were recalculated. In 2021 Q1, the time variable was removed from the model for potential transaction prices.
2. For comparison purposes, all three indices use the same base year of 2016 (2016 average = 100).

Source: MOI, Cathay Real Estate, and Sinyi Real Estate Inc.

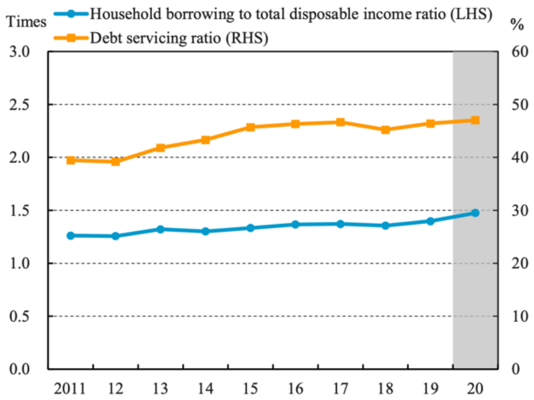
the ensuing land price hikes also pushed up housing prices. The upside pressures on housing and land prices have been partially fuelled by the low interest rate environment and surging raw material prices and wages that fed into the cost of building and construction. A buoyant housing market, coupled with stronger demand for factory buildings owing to firms' expanded investment, the eager purchase of vacant land by firms in the real estate industry, as well as increased domestic real estate investments by life insurance companies, led the total number of land ownership transfers for transaction to rise by 11.62% year on year. Looking beyond 2021, Taiwan's banking sector is expected to experience deterioration in asset quality due to the easing of relief lending and offshore exposure. This will be manageable considering Taiwan's economic resilience in terms of healthy corporate profits and low unemployment, which will alleviate operational pressures on banks' asset quality, capitalisation and profitability.

Since the start of 2020, the national housing price index increased gradually. It hit a record high of 108.17 towards the end of Q4, rising by 3.87% YoY. Similarly, the Sinyi housing price index trended upward in 2020 and peaked in Q1 2021. On top of the increases seen in housing prices and housing loans, Taiwan's household debt to GDP ratio had also risen, with real estate purchases the primary use of this debt build up. Total household borrowing grew and hit NT$17.63 trillion at the end of 2020, amounting to 89.15% of the GDP for 2020. The purchase of real estate accounted for 62.72%, a substantial share of household borrowing. The ratio of household borrowing to total disposable income increased to 1.48 in 2020, reflecting a rising household debt burden. Moreover, the debt servicing ratio also climbed marginally to 47.03%, thereby indicating that short-term household debt servicing pressure tightened. Nonetheless, household net worth in Taiwan has been remarkable over the past decades, which has been held at more than 8.3 times the GDP in recent years, suggesting that the financial position of households in Taiwan remains healthy with good debt servicing capacity. Considering the imminent trend of monetary policy normalisation in major economies, the resulting upside pressure on Taiwan's interest rate may increase the cost of household debt servicing. On the other hand, as the economy recovers and employment and income growth picks up, households should be in a good position to mitigate the risk of debt defaults.

Financial conditions

Market liquidity was strong in 2021. Short-term interest rates fluctuated within a tight range as the pandemic eased. Banks' average excess reserves remained around a level of more than NT$60 billion in recent months. Taiwan's banking sector plays an important role in its economy, with the sector's assets representing 285% of GDP at the end of 2020. In terms of bank credit conditions, strong export performance continued to support corporate demand for funds while banks' policy loans to pandemic-impacted small and medium-sized enterprises similarly grew. Thus, total bank lending and SME lending both recorded steady growth. Asset quality remained sound and exposures to Mainland China continuously decreased, while concentration in corporate loans and loans related to real estate increased slightly. The estimated value at risk (VaR) of market risk

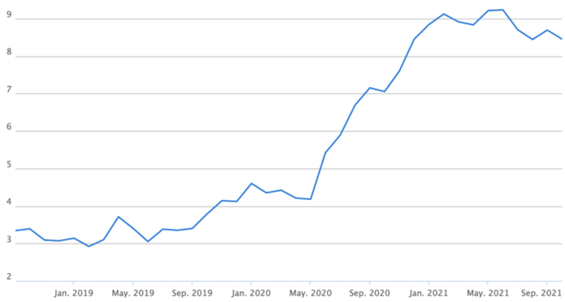
Figure 9: Household debt and debt servicing ratio



Notes: 1. Total disposable income in shaded area is a CBC estimate.
2. Debt servicing ratio = borrowing service and principal payments/total disposable income.

Source: CBC, JCIC, and DGBAS

Figure 10: M2 growth rate



Source: National Statistics Bureau

exposures increased, but the impacts of market risk on capital adequacy ratios were limited. The impact of the COVID-19 pandemic resulted in the decline in domestic banks' profits. Moving forward, the rising financial vulnerabilities of distressed firms and individuals after the withdrawal of the Taiwan's government's financial relief measures may weaken banks' asset quality and thus further undermine their profits. This, together with accommodative monetary policy stances expected to be continued by major economies, will affect those domestic banks with net interest income as a major revenue resource and dampen growth momentum for their future profits. However, Taiwan's tendency to support systematically important banks is notable. Taiwan's robust economic performance has enhanced the credit strength of the government, enabling greater capacity to aid those issuers.

Regarding money supply, the annual growth rate of M2 trended down in August owing to a higher base effect and slower growth in transaction deposits. Looking ahead, with the local pandemic situation under control, the eventual recovery of the services sector and stabilizing private consumption are expected to keep the economy on track for mild growth in 2022.

CBC's Monetary policy

To alleviate the impact of the pandemic on the domestic economy and employment, the Bank cut the discount rate, the rate on refinancing of secured loans, and the rate on temporary accommodations each by 25 basis points in March 2020. Besides this, the Bank initiated a special accommodation facility for SMEs from April 2020 onwards, and successively conducted rolling reviews on the contents of the facility as needed in order to facilitate banks' financial intermediary function and funding access for SMEs. To maintain sufficient liquidity of the financial market, the Bank conducted open market operations, and flexibly adjusted the issuance frequency and total amount of negotiable certificates of deposit from April onwards. With the aim of precluding an excessive flow of bank credit into the real estate market, the Bank adjusted targeted macroprudential measures twice in December 2020 and March 2021, respectively.

Monetary policy outlook

During the Monetary Policy Meeting held on September 2021, the bank arrived at the decision to keep policy rates constant, with the rate on refinancing of secured loans, and the rate on temporary accommodations being 1.125%, 1.5% and 3.375% respectively. Mild inflation and uncertainties over the global economic outlook were the main reasons cited by central bankers for the policy position.

A major factor behind the persistent low interest rates in Taiwan was ample liquidity, shaped by excessive saving and deficient investment. Given an environment already flush with funds, a rate hike could prod saving further up and induce capital inflows with some of those funds potentially flowing into the real estate sector, carrying adverse implications for the sound development of the housing market. Meanwhile, recent appreciation in the NT dollar was built on solid fundamentals of Taiwan's economy, evident in the continued strong growth momentum in external demand. However, considering that pandemic-hit SMEs, which had been given better funding access under the Bank's NT$400 billion-worth low interest facility in response to COVID-19, were also susceptible to exchange rate pressures, it would not be appropriate to raise the policy rates at the current juncture. Further, considering that Taiwan's domestic consumer price trends were relatively steady, a rate hike out of step with major economies could strengthen the NTD. Instead, the Bank will deliberate a gradual rate liftoff next year in tandem with the US Fed's rate hikes.

Strong performance of corporate sector

In 2020, the corporate sector in Taiwan faced the challenge of the global spread of the COVID-19 pandemic, and foreign demand for some traditional manufacturing products waned significantly. However, the COVID-19 pandemic drove up remote business opportunities, inducing demand for semiconductors, information and communication technology, and 5G applications. As a result, the average ROEs of TWSE- and OTC-listed companies rose to 14.60% and 13.95% from 12.62% and 12.23% the past year, respectively.

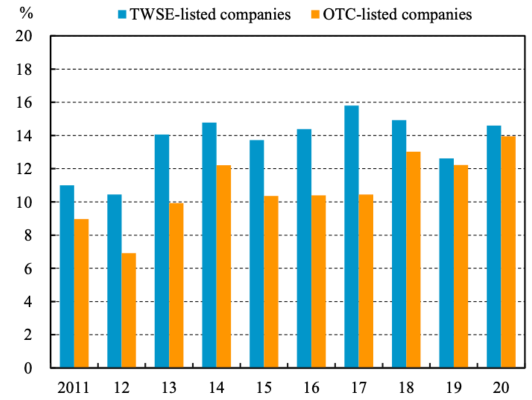
The profitability of TWSE- and OTC-listed companies significantly improved in 2020, owing to the outstanding performance of the electronics industry supported by strong demand for emerging technology applications. Meanwhile, their financial leverage ratios elevated, but short- term debt servicing capacity stayed adequate. Although the NPL ratio for corporate loans granted by financial institutions rose slightly, the credit quality for the corporate sector stayed satisfactory. In the beginning of 2021, induced by the economic relief plans in the US and the better- than-expected economic performance domestically, the TAIEX went up steadily, surging by 19.24% in the first four months of 2021. However, with imminent interest rate hikes by the Fed and the outbreak of variant strains of the virus across countries, the TAIEX experienced a sharp drop before rebounding and stabilising.

Moving forward, industrial production is expected to slow in the months ahead due to higher base effects as well as supply side issues as a result of the limit in production capacity. Industrial production growth in October dropped for the fourth month straight to 11.3% YoY from 11.6% YoY in September, falling far below the peak of 18.0% YoY in July 2021. Manufacturers have struggled to cater to the increase in export orders as shortages restricted output growth. Electronic export orders decreased to 13.2% YoY in October from 21.5% YoY in September whereas telecommunications products export orders dipped to 8.7% from 39.1%. In response, manufacturing companies are investing in new production lines in order to meet the demand for chips, but most of the new lines will not be operational until late 2022. Until then, a sharper moderation in export growth for Taiwan is expected in 2022.

Record of Prudent Fiscal Management

In response to the impact of the COVID-19 pandemic on the domestic economy and society, Taiwan's government launched economic relief measures sequentially with a total of NT$1.26 trillion, equivalent to 6.1% of GDP. The Bank also launched the special accommodation facility to support SMEs to access the working capital needed to weather the pandemic. Thanks to the effectiveness of those economic

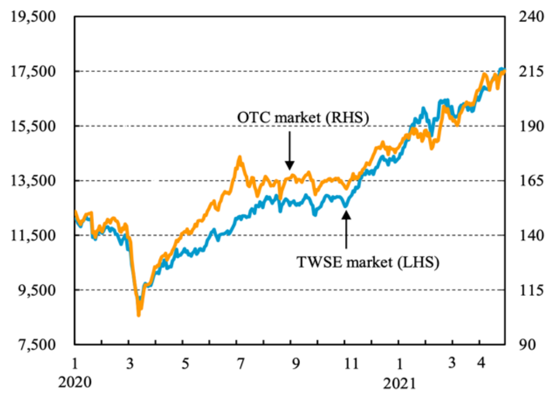
Figure 11: Return on equity in corporate sector



Note: Return on equity = net income before interest and tax/average equity.

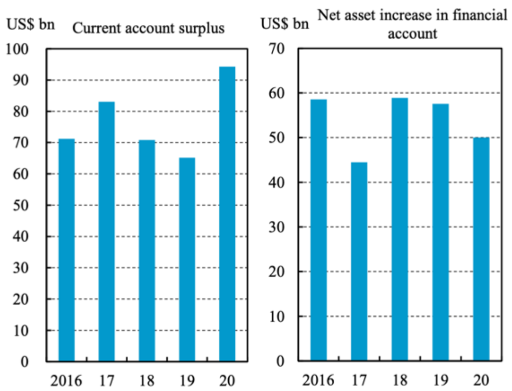
Source: TEJ

Figure 12: Taiwan's stock market indices



Source: TWSE and TPEx

Figure 13: Current account surplus and net asset increase in financial account



Source: CBC

relief measures, Taiwan sustained economic growth at 3.11% in 2020, better than major economies in Europe, North America, and Asia. The unemployment rate gradually declined from its peak, and the number of employees who agreed on negotiated reductions of working hours with their employers also decreased significantly.

<u>Current account saw a surplus, FX reserves remained ample</u>

In 2020, the merchandise trade surplus expanded, and service trade turned to a surplus. Additionally, Taiwanese nationals inwardly remitted more income from overseas direct investments, contributing to an expansion in the income surplus. As such, the annual current account surplus rose to US$94.3 billion, a sharp increase of 44.68% compared to 2019. An increase in foreign securities investments by the banking sector and insurance companies boosting foreign assets, coupled with the reduced holdings of Taiwanese stocks by foreign institutional investors, resulted in a decrease in foreign liabilities. Hence, Taiwan's financial account posted an increase of US$50 billion throughout 2020.

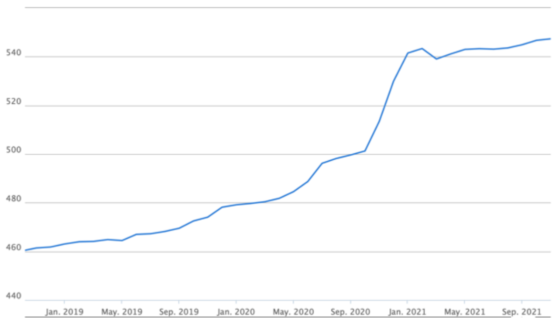
FX reserves rose to US$529.9 billion at the end of 2020, increasing by 10.83% from the previous year, mainly supported by the accumulation of earnings from portfolio investment operations of FX reserve assets, and the intervention operations by the Central Bank due to the large amount of capital inflows that caused excessive volatility in the FX market. At the end of April 2021, the FX reserves climbed to US$541.1 billion.

As for exchange rate, the NTD went stronger due to the relatively weaker USD in October. The NTD/USD stood at 27.82 in late October 2021, indicating a 0.17% appreciation, whereas the NTD has still been one of the strongest Asian currencies in the first nine months of 2021. Regarding the interest rate, it still remained low and steady in October 2021 due to the continued loose monetary operations by the CBC; the lowest and highest over-night call rate in October 2021 was at 0.081% and 0.094% respectively. With the Fed poised to tighten credit faster than expected out of mounting concerns about high inflation, the NT dollar faces growing headwinds from foreign outflows. Robust exports and trade surplus fueled the NT dollar's outperformance but since October 2021, it has fallen behind some of its peers as foreigners sold $2.3 billion of local equities in that month, up from $440 million in September. The equity outflows can be attributed mainly to the expectation of the Fed's quickened pace of tapering and imminent rate hikes. As such, the CBC may also have to adjust and align their policy with the tightening trend and move forward its timeline for interest rate hikes.

<u>Strong debt-servicing capacity</u>

Primarily because of an increase in the long-term external debt of the banking sector, Taiwan's external debt rose to US189.9 billion at the end of 2020, increasing by 2.82% compared to a year earlier. The largest share of external debt went for the private sector, registering US188.4 billion, while the share of the public sector only reached US$1.5 billion. Taiwan's external debt stood at 28.37% of the year's

Figure 14: Taiwan's foreign exchange reserves

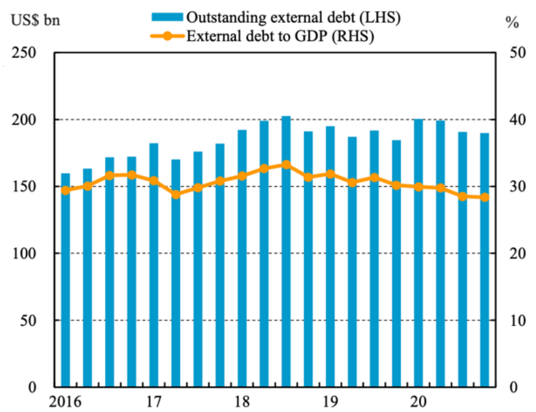


Source: National Statistics Bureau

Figure 15: USDTWD

Source: Trading economics

Figure 16: External debt servicing capacity



Notes: 1. Figures for outstanding external debts are on an end-of-period basis.
2. Figures for GDP are on an annualized basis.

Source: CBC and DGBAS

GDP at the end of 2020, lower than the internationally recognized alert threshold, and much lower than those in the US, Japan, and Malaysia (Chart 2.25). Owing to the increase in FX reserves and the decline in short-term external debt, the ratio of FX reserves to short-term external debt rose to 3.02 as of the end of 2020. This number is significantly greater than the internationally recognised alert threshold, signalling that Taiwan's FX reserves retain a robust capacity to meet payment obligations.

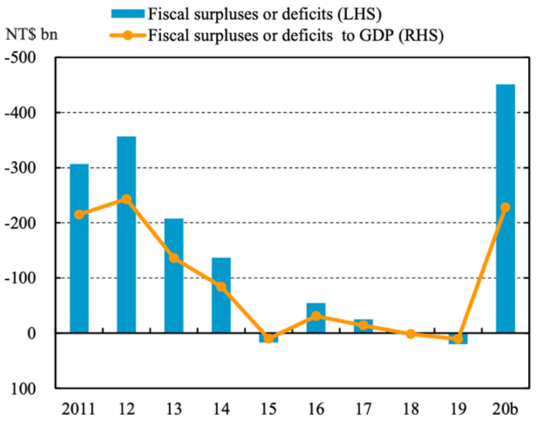
In 2020, the government compiled a special budget of about NT$420 billion to mitigate the impact of the pandemic, and actively promoted several measures, such as the *Forward-looking Infrastructure Development Program*, leading to an expansion of annual expenditures. As a result, the government budget turned to a deficit of NT$451 billion or 2.28% of GDP for the year, from a surplus of NT$20.2 billion recorded in the previous year. With fiscal deficits expanding, the outstanding public debt at all levels of government rose to NT$6.68 trillion at the end of 2020, increasing by 7.86% year on year. Despite the ratio of total public debt to the year's GDP also rebounding to 33.76%, government debt still stayed within a manageable level. Looking ahead, as the global economy eventually recovers from the devastation of the pandemic, tax revenues are expected to increase, strengthening Taiwan's fiscal position.

Deteriorating Cross-strait Relations

The tensions between Taiwan and China are rapidly worsening. In commemoration of the founding of the People's Republic of China in October 2021, China flew a record number of military aircraft into Taiwan's air defence zone. In the recent years, the People's Liberation Army (PLA) expanded military activity, with sorties into Taiwan's air defence identification zone almost everyday and recurring military drills in surrounding maritime areas. Tracking data of the sorties details changes in the PLA air force missions. Surveillance aircraft used to be the most frequently sent, recently fighter jets dominate. The use of bombers with the capacity of transporting nuclear weapons, has also increased.

China asserts that Taiwan is part of its own territory, placing military and political pressure on the island to submit to Beijing's rule. This has been met with resistance put up by the Taiwan government under Tsai, a strong proponent of the democracy and sovereignty of Taiwan. Furthermore, China is in the midst of a major military modernization campaign, which is projected to complete by 2035. As such, China's military assertiveness over Taiwan will likely continue tensions between the two sides intensify. According to a Pentagon report, China may have the capacity to launch a "credible" military operation against Taiwan. Responding to China's increased military spending, especially on advanced fighters and amphibious warfare ships, and stepped-up Chinese air force and navy activity near Taiwan, Taiwan is reviewing a TWD240 billion ($8.6bn) special defence budget bill. With approximately two-thirds of the budget to be used on anti-ship weapons like land-based missile systems, inclusive of a TWD148.9 billion plan to manufacture homegrown

Figure 17: Fiscal deficits



Notes: 1. Fiscal position data include those of central and local governments.
2. Figures for 2020 are final accounts for the central government and budgets for local governments.

Source: MOF and DGBAS

missiles and advanced military ships.

Following the escalating tensions between Taiwan and China, US President Joe Biden has stated that the US has a rock solid commitment to support Taiwan in the event of an attack. Formal US policy of strategic ambiguity stops short of promising to defend Taiwan. Conversely, the 1979 Taiwan Relations Act states that the US will "make available to Taiwan such defence articles and defence services" to enable its self-defence in the face of an attack, language Washington has implemented through large weapons sales. Allies of the US have also hinted at their support of Taiwan. Japan resolutely backs Taiwan, with Former Japanese Prime Minister Shinzo Abe stating that a Taiwan incursion by China would constitute a significant threat to Japan and Japan would not "stand by". Australia's government has similarly suggested it would response the same after announcing the AUKUS trilateral security pact with the United States and United Kingdom in mid September 2021. The newly established AUKUS security arrangement is widely perceived as a response to a rising China. Thus, as Taiwan courts strategic alliances amid increasing Chinese hostility, the risk of a security crisis stemming from an accidental miscalculation in the Taiwan Strait cannot be ignored.

Reshoring of Supply Chains Globally

An increasing number of countries—including Japan, South Korea, Australia, the U.S., and the United Kingdom—have recently devoted more resources to policies that encourage supply chain reshoring. This trend is only intensified by current transitions to 5G networks and numerous advancements in technology created an enlarged demand for semiconductors. Adding to the impact on supply and demand is the fallout from the COVID-19 pandemic, which has hurt global supply chain dynamics while also ramping up demand to accommodate an increasingly online economy.

Under Japan's COVID-19 economic stimulus package rolled out in April 2020, the government handed out 220 billion yen to aid manufacturers in onshore production capabilities, along with a separate 23.5 billion yen package meant for Japanese companies looking to relocate production to countries other than China. Similarly, in May 2020, the United Kingdom unveiled "Project Defend," with the aim of diversifying the UK's imports of critical goods beyond China, including pharmaceuticals and personal protective equipment (PPE). Meanwhile, China's "Made in China 2025" push included a goal to domestically produce 70 percent of the chips demanded by domestic firms, in a bid to ensure self-sufficiency in semiconductor technology. Such a drastic shift would certainly exert a downward pressure on Taiwan's exports and GDP growth. In 2020, China, including Hong Kong, received nearly 44% of Taiwan's exports, 12% higher than 2019. Cross-strait trade is predominately electrical machinery trade, accounting for 64% of total exports. Semiconductors makes up the most significant product item in the electrical machinery trade, accounting for 78% of electrical machinery exports. As such, China is one of the most important trading partners of Taiwan and an essential source of trade surplus. However, China's progress toward that goal has been underwhelming despite the billions poured into the industry. Currently, China's prevailing domestic capacity can only supply 15 to 20% of semiconductor demand

Taiwan has historically had a high overseas production ratio in the ICT industry, with over 90 percent of electronics industry-related products, including ICT, optical equipment, and electronic (components) products being manufactured offshore, and over 60% of Taiwanese-listed companies having factories in China. U.S. firms have been the same, investing seven times as much in China (and four times as much in Hong Kong) as they have in Taiwan. Following this, in order to encourage manufacturing relocation from China to Taiwan, the Taiwanese government rolled out the "Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan," which from its launch through April 2021 had approved over 200 enterprises' reinvestment plans. The programme—which is only eligible for companies that have invested in China for a minimum of two years and are looking to incorporate smart manufacturing technologies into their new or expanded production lines in Taiwan—offers preferential loan terms and concessions while catering to considerations such as financing, water, electricity, and manpower in a single service window.

As of September 2020, over a year after the implementation of Taiwan's reshoring programme, Taiwanese companies had reinvested $38 billion in Taiwan. In addition, two other incentive programs target local manufacturers that have never invested in China: one for large corporations and the other for small- and medium-sized enterprises. Together, the three programs have generated NT$1.18 trillion ($42 billion) in investment from 783 companies since their 2019 launch, with more than two-thirds of that total, NT$792.5 billion ($28 billion) attributable to Taiwanese firms returning from China. In view of the Biden administration's stance on technology and trade with China, Taiwan has taken this opportunity to ramp up cooperation with developed countries in R&D and technology and simultaneously relocating production to countries under its New Southbound Policy. Taiwan's capabilities in high-value-added manufacturing, especially in the ICT sector, make it an attractive alternative for foreign tech companies aiming to reduce the exposure of their production processes to China. Hence these strategies will aid Taiwan in securing its position in the global economy amid the reshuffling of supply chains worldwide.

Figure 18: Long USDTWD

Source: National Statistics Bureau

Trade Idea: Long USDTWD

Looking toward 2022, Taiwan will retain its comparative advantage in manufacturing advanced semiconductor chips. Simultaneously, production bottlenecks will become more obvious in terms of yearly growth. Domestic expenditure is not expected to increase until Taiwan's reopening of borders, the date of which is uncertain following the emergence of new variants. Production and exports of semiconductors could again be offset by growth in imports of equipment to build factories in preparation for future production of semiconductor as seen in H2 2021. Lastly, the risk of a military operation by the Mainland is small but poses a tail risk to Taiwan's economic growth in 2022.

Compared to many other central banks, such as the US Federal Reserve, the Central Bank of the Republic of China has kept policy very steady since 2015. This trend is likely to continue in 2022, with the policy rate remaining at 1.125%. The CBC's stable policy rate offers a predictable backdrop for capital flows. With imminent US rate hikes, the overall trend of Taiwan's dollar will still likely be dominated by the strong US dollar.

Since mid April this year, the USDTWD pair has been trading within the 27.530 and 28.135 range, recently closing at 27.736. The stochastic indicator at 18.84, indicating that the pair is in the oversold region and trading near the bottom of its high-low range. The increasing %K line is poised to cross above the decreasing %D line in an oversold region, generating a buy signal for the currency pair.

Entry: 27.70

Take Profit: 28.00

Stop Loss: 27.50

Risk Reward Ratio: 1.50

Global Macro Department – Japan (NEUTRAL)

Date: 15th December 2021

Analyst

Jonathan Audie Widjaja
Global Macro Analyst
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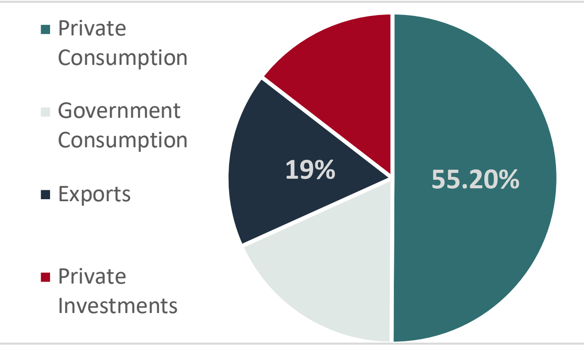
Basic Information

Real GDP (USD)	USD4.975 Tril.
Real GDP Growth Rate Q3	1.4%
CPI	99.9
PPI (Oct)	107.8
Con. Confidence (Nov)	39.2
Nikkei	28029.57

Chart info

Figure 1: Breakdown of GDP by Component



Source: JapanMacroAdvisors.com

Overview of Japan's Economy

The Sleeping Giant

Japan has a mature, service-oriented economy, the third largest in the world by nominal GDP (USD4.975 Trillion in 2020). As seen from *Fig.1*, By component, private consumption makes up 55.2% of GDP, followed by government consumption at 20%, exports at 19%, and private investments at 16%. By sector, Japan's service sector makes up 69.3% of GDP, with Industry and Agriculture making up 29% and 1.2% respectively.

A Deflationary Mindset

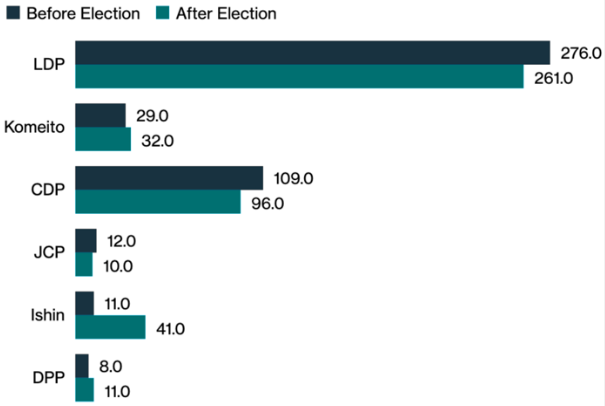
Historically, Japan is notorious for being deflation-prone. This was a feature of Japan's Lost Decades, an amalgamation of unfortunate and untimely events that crushed Japan's dominant rise as an economic power. Low interest rates, which were further exacerbated by the effects of the Plaza Accords, had led to a real estate and stock market bubble. This came crashing down in 1989 as Japan abruptly raised interest rates in an attempt to curb inflation. What started off as debt deflation spiralled into a credit crunch, even as the country cut interest rates in 1991. Japan's already ageing population then fell into an inflation expectations trap, which led to muted consumption spending. The Japanese populace have become very accustomed to deflationary pressures, which has contributed to a high national savings rate of 23%. However, we believe that Japan is decently positioned to see solid real GDP growth in the following year, barring some risks.

Summary of Events in The Past 6 Months

- Amidst increasing public dissatisfaction over the handling of the COVID-19 pandemic and management of the delayed Tokyo Olympic Games, Yoshihide Suga signalled the end of his tenure as Japan's Prime Minister after just a year. His shock departure following all-time low approval ratings has ushered the nation into a state of hopeful anticipation with regards to the direction that his successor will take, especially in such trying times. Enter Fumio Kishida, the Liberal Democratic Party's newly appointed leader whose landslide victory in the recent elections (*Fig.2*) will see him take on the hefty task of tasked to guide Japan into a post-pandemic world as the new Prime Minister.

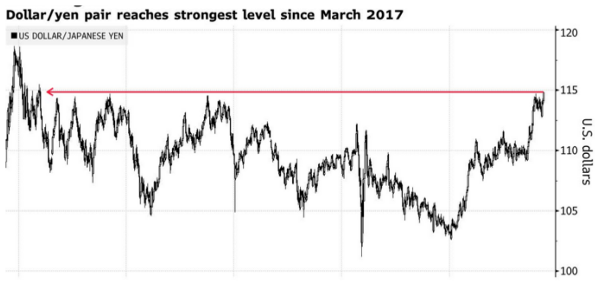
- Japan's fragile recovery in the pandemic has been spearheaded by a robust display in its exports. However, their balance of trades has deteriorated over the course of the year, and has seen three straight months of unexpected trade deficits leading up to the month of November. This comes as Chinese growth slows commodity costs overheat, leading to imports rising steeper than exports.

Figure 2: Landslide Victory for Kishida's LDP



Source: Bloomberg

Figure 3: Yen Slides to a 4-Year Low



Source: Bloomberg

- To mark the end of September, Japan's COVID-19 task force announced that the entire nation will emerge from their state of emergency, marking the first time in almost 6 months that all regions in Japan return to normalcy – somewhat. But even as the nation's vaccination program ramps up and number of infections fall, Japan's leaders remain cautious with the removal of other restrictions such as those on large-scale events.

- Japan's gross domestic product saw an annualized contraction of 3% in the three months following September from the previous quarter, far exceeding the forecasted 0.7% decline. This was a direct consequence of the resumption and extension of emergency restrictions due to COVID-19, as well as supply-side bottlenecks that hindered export growth and held off investments. Private consumption saw a 4.5% dip from the previous quarter, and capital spending dropped 14.4%.

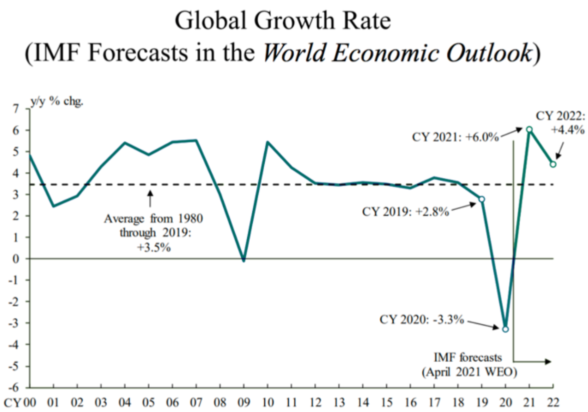
- As observed in *Fig.3*, The Yen slipped to a 4-year low against the greenback, having crossed the psychologically important ¥115 mark. This comes as the U.S. continues to display upbeat economic data that reinforced expectations of asset purchase tapering, diverging from Bank of Japan's extremely dovish stance. What was once favoured by policymakers due to the benefits it brought to the export-driven economy has now become a threat to household consumption due to surging energy costs.

- Japan has been taking a more active stance with its involvement in global affairs. Aside from hinting at assisting Washington in the defence of Taiwan should Chinese aggression escalate, Japan has been quietly working to secure more robust supply chains with the U.S., European Union, Australia, and India. They have also been working to speed up innovation in key technologies like semiconductors. This is to decrease economic reliance on China at a time where U.S. economic foreign policy looks doubtful.

- At the time of writing, PM Kishida recently unveiled the much-anticipated fiscal stimulus totalling approximately USD$487 billion to help cushion the blow from COVID-19. Such a move was hit with backlash from sceptics that question the necessity of such measures given how household consumption is showing signs of a robust recovery.

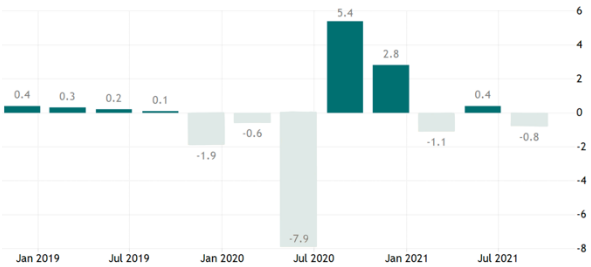
- Japan is chairing The Comprehensive and Progressive Agreement for Trans-Pacific Partnership, of which the recent simultaneous accession bids from Taiwan and China have put it in a difficult spot due to the existing hostilities between each party and the potentially damaging implications of their decisions.
- Japan appears to show no signs of pivoting towards policy normalisation, which is very unlike the hawkish stances that other global economies are adopting.

Figure 4: Forecast of Global Growth Rate



Source: IMF

Figure 5: Japan GDP Growth Rate



Source: Tradingeconomics.com

Same Old, Same Old – Leadership Into the Future

Kishida's Appointment as Prime Minister

To mark the beginning of October, former foreign minister Fumio Kishida was formally elected to lead Japan's ruling Liberal Democratic Party (LDP) and thereby to serve as the country's 100th prime minister. This change in leaderships comes at a tumultuous time as the country grapples the severe and prolonged slowdown in economic activity caused by the COVID-19 pandemic, which sent the 3rd largest economy into a contraction of 4.7% in 2020. All eyes are on Kishida's cabinet to see if he is capable of revitalising the economy and have something to show for relative to the other G7 countries that have seen healthy progress in their post-pandemic recoveries. As seen in *Fig.4*, the IMF forecasts the global growth rate to be at 4.4%. And as a comparison, Japan has averaged an uninspiring GDP Growth Rate of just 0.43% from 1980 through 2021, where the only time growth hit an all-time high was in Q3 of 2020 due to the pandemic rebound. Where Abenomics had failed to spur consumption spending and pull Japan out of their deflationary trench, it is not PM Kishida's turn to have a go at catalysing change.

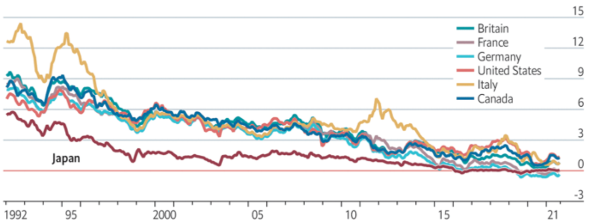
To aid in the pursuit of economic growth and stable prices, Kishida has delivered his first extra budget, funding Japan's biggest-ever fiscal package, in line with what was touted and expected for months on end. The approval of the ¥55.7 trillion, or USD487 billion, stimulus package seem to be designed to bolster private consumption, with more than a trillion yen in cash handouts for households with children, as well as several trillion for businesses affected by the pandemic.

Kishida's election campaign spelled a focus on policies that aim to spur growth through a more equitable redistribution of wealth. These include higher capital gains taxes, tax incentives for companies who realise wage increases of over 3% during *shunto* wage negotiations in Spring 2022, and taxation on investment income. However, while has publicly expressed his criticisms of *Abenomics*, the policies that defined the Japanese economy for almost the past decade, it remains evident that Kishida's utmost priority is to breathe life into a sluggish Japanese economy that has shown uninspiring recovery and growth that has lagged that of other advanced economies globally. We believe that, given how the economy's GDP growth rate has remained flat and even contracted in the past 3 quarters (-1.1% in Q1 and -0.8% in Q3 as seen in *Fig. 5*), Kishida's government can be expected to proceed full steam ahead with policies to aid economic growth. We believe that this not only entails the massive fiscal stimulus that is being rolled out, but also the continuance of aggressive easy monetary policy.

Bank of Japan's Obsession with Quantitative Easing

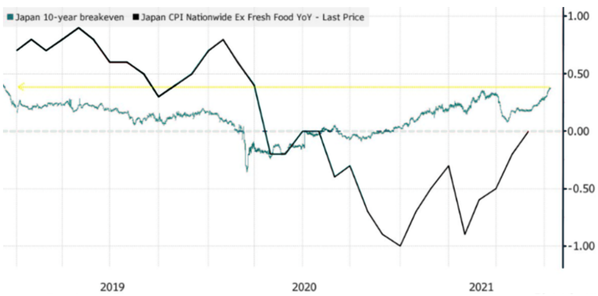
Japan's central bank is historically notorious for being dovish and unconventional in their use of policy tools to influence the economy, having pioneered quantitative and qualitative monetary easing (QQE) from the late 90s to resuscitate the economy from economic stagnation. These include maintaining negative interest rates, as well as increasing the volume and broadening the scope of asset purchases. We see that their historical bias continues to hold steadfast despite other advanced economies already pivoting

Figure 6: Ten-Year Govt Bond Yields, %



Source: The Economist, OECD

Figure 7: Inflation Expectations in Japan



Source: Bloomberg

Figure 8: Core Inflation Rate

Source: Statistics Bureau of Japan

towards policy normalisation. This is directly observable from *Fig.6* illustrating the yields of 10-year government bonds.

BOJ Governor Kuroda insists that inflationary trends overseas and cautionary moves by central banks around the world will not sway BOJ's monetary policy. They have cited the tendency for Japanese firms to absorb higher input costs rather than pass them on to consumers in the form of higher price tags, which highlights deflationary mindset that pervades the Japanese economy. BOJ also insists that pent-up demand in Japan has limited the extent of inflation. Furthermore, BOJ has expressed that the slight weakening of the Yen is a positive for the economy as it bolsters exports.

Japan will continue to firmly maintain their extremely accommodative interest rate environment in a decision expressed by PM Kishida to be necessary for the country's recovery. We believe that BOJ will maintain yield curve control through 2022, where short term rates are kept at -0.1% and long term rates at around 0%. We can expect the central bank to continue purchasing Japanese Government Bonds (JGBs), Exchange-Traded Funds (ETFs), and J-REITs. This policy divergence will see the Yen depreciate further against the currencies of countries that have begun to take a more hawkish stance with their policies. Additionally, the weaker Yen is bound to exacerbate the effect of rising commodity prices globally, which may worsen net exports, increased consumer prices. and dampened spending. This likely sequence of events is not ideal for an economy whose fragile economic recovery thus far has relied primarily on exports and household spending.

Land of the Rising Inflation – A Turning Point?

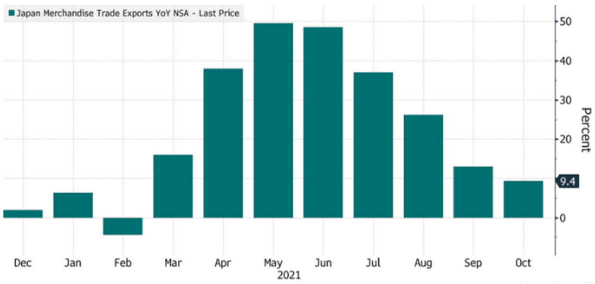
<u>Skyrocketing Input and Commodity Prices</u>

Across the globe, supply chain bottlenecks coupled with the release of pent-up demand from the mass resumption of economic activity has led to surges in input and commodity prices. While cost-push inflation has been brushed off by many as transitory, it has come to a point where even the deflation-prone Japanese economy is beginning to experience inflationary pressures, a rare occurrence.

As the 5th largest importer in the world, Japan's inflation expectations have climbed to its highest in 3 years. From *Fig.7*, The 10-year breakeven inflation (BEI) rate, which highlights the gap between inflation-linked bonds and conventional bonds, have risen past 0.36%. As a proxy for market-based long-term inflation expectations, it highlights inflation in Japan is expected to average that amount in the next 10 years. This is the highest reading since September 2008, and is in stark contrast to inflation expectations of just 0.07% in mid-July and around 0% at the end of 2020.

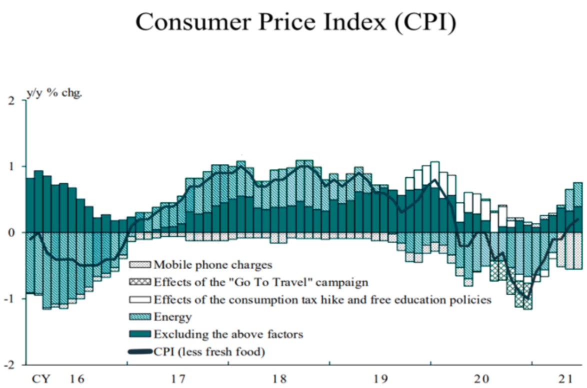
There are tentative signs that price pressures are building, with the surges in energy prices like natural gas and oil feeding directly into Japanese consumer prices. The shutdown of crucial SEA component factories and semiconductor shortages are contributed to the surges in input prices while simultaneously stalling growth. In September, consumer prices in Japan have rose for the first time in 18 months by 0.1% y/y (*Fig.8*). However, we foresee inflation climbing moderately heading into 2022Q1. Firstly, the inflation figures preferred by BOJ are artificially depressed by the sharp reduction of up to 60% on

Figure 9: Slowing Export Growth



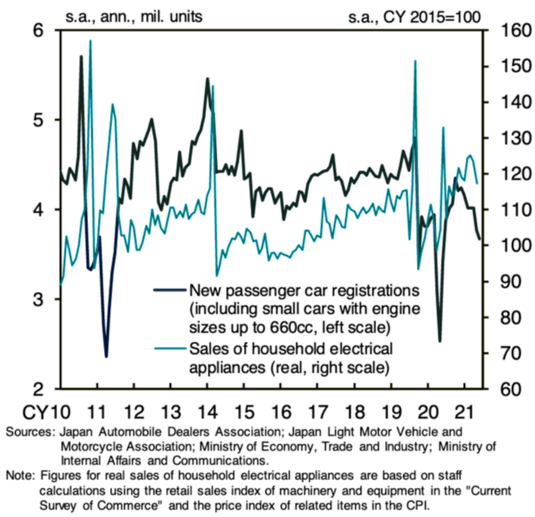
Source: Ministry of Internal Affairs and Communication, Japan

Figure 10: Consumer Price Index



Source: Ministry of Internal Affairs and Communication, Japan

Figure 11: Consumption of Durable Goods



Source: Ministry of Internal Affairs and Communication, Japan

mobile phone charges, a government-initiated cut. After the removal of slashed mobile phone fees, core inflation is shown to be closer to 1.4%, something that the Japanese government is well aware of. Secondly, we believe that the supply-side constraints responsible for this bout of cost-push inflation will briefly persist into the near future, especially with the resurgence of infections due to the Omicron variant.

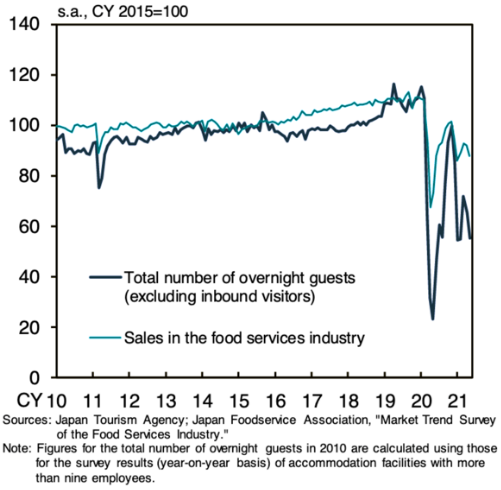
Rising prices have also led to a worsening balance of trade, which is further exacerbated by the weak Yen. Exports of high technology products have been the engine of Japan's growth since the 60s, accounting for 19% of GDP. From *Fig.9*, in October, export growth rose 9.4% y/y, slowing from a 13% growth in the prior month. This reflected the weakest increase in 8 months, ending double digit growth in the past 7 months amidst softening global demand and persistent supply-chain bottlenecks. In contrast, imports rose by a much steeper 26.7%, leading to a third straight month of trade deficits for Japan.

As observed in *Fig.10* on the Consumer Price Index, there are clear signs that inflation is looming over Japan as the CPI has been rising steadily, being artificially deflated by the lower mobile phone charges. And yet, Kishida and the BOJ are bent on maintaining yield curve control and keep the Yen weak. We believe that this bold decision aligns with a long-term strategy to spur consumption spending and hence economic growth in the economy. For the past decades, the bane to Japan's economy has always been weak consumption spending. Consumers would rather save than spend due to expectations of lower prices in the future, and now there is an opportunity to drag the economy out of this deflationary mindset. Shortages of key manufacturing components and surges in key input prices, alongside the weak Yen, are squeezing profits from firms that were already beaten down due to the pandemic. It places pressure on firms to consider passing on these costs to consumers, something that we are starting to see, albeit very modestly. This comes at a time when the country has just emerged from their state of emergency, where we can expect pent-up demand to boost consumption spending. On top of that, the timely cash handouts to households as part of the massive fiscal stimulus, alongside the rare increase in consumer prices, all work towards incentivizing consumption spending. Furthermore, the annual growth in broad money, a key inflationary variable, saw a 7.5% increase in 2020. This is in stark contrast to the miniscule 0.85% growth rate over the past 2 decades. If this upward trend were to persist post-pandemic, Japan could very well hit the elusive 2% target. We believe that this multi-pronged approach bodes well for Japan in the near future.

<u>Back to Normalcy</u>

Japan most recently emerged from their prolonged state of emergency on October 1st, the last of all major restrictions that have dampened economic activity and hence growth over the course of the pandemic. Despite possible hindrances like the Omicron variant threatening to disrupt the recovery, we believe that Japan's return to economic normalcy will be robust. 75% of the country is fully vaccinated, which spells a positive outlook for the economy going forward as economic activities are more likely to resume full steam ahead.

Figure 12: Consumption of Services



Source: Ministry of Internal Affairs and Communication, Japan

The economy has shrunk in 5 of the past 8 quarters, and the world's 3rd largest economy has lagging its peers amongst G7 nations in its post-pandemic recovery trajectory heading into 2022. *Fig.11* and *Fig.12* illustrate this weakness in demand due to consumers exercising caution amidst uncertainty. However, we believe that the patchy growth is about to reach a turning point and become more robust. As part of the reopening of the domestic and international borders, Japan is looking to restart their "Go To Travel" program, one that is crucial for the recovery of tourist locations and the local economy. As part of the nation's efforts to restart the economy, this campaign subsidizes up to 50% of each travellers' expenses, with the overall discount capped at 20000 Yen per person per night. We believe this is crucial in spurring the pent-up demand that has yet to emerge in Japan, unlike what we've observed in other advanced economies.

Japan has some structural limitations that directly hinder their growth potential. Since the peak of its economy in 1989, Japan entered The Lost Decades that was characterised by deflation and economic stagnation. Inflation expectations were non-existent in Japan, which led to households and corporations saving instead of spending or investing. Time and time again, even prior to the pandemic, it was shown that even aggressive pursuit of easy monetary policy has a muted effect on the economy if Japanese firms have low demand to invest and consumers have low incentive to spend. On top of this, Japan faces the pressing issue of an ageing population where it has seen a reversal in its population growth. With less people in the workforce, there will be a diminished middle class and hence less robust consumption spending in the economy.

With these in mind, Kishida has cited long-term policies designed to incentivize consumer spending and promote wage growth. The simultaneous employment of fiscal and monetary policy in the midst of a unique inflationary environment may set off some sparks when it comes to economic growth in the short term. However, we believe that long-term trends in Japan's growth trajectory are largely dependent on how consumer and business sentiment will shift and adapt in response to this temporary bout of inflation brought about by very unique circumstances.

In The Eye of The Storm – Japan's Noisy Neighbours

Chairing the CPTPP

Consider the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), one of the world's largest free trade areas by GDP, with the combined economies accounting for approximately 13.4% of global GDP at USD$13.5 trillion. Currently, its 11 members include advanced economies like Australia, Canada, and Singapore. In September, China formally submitted an accession bid into the trade agreement after President Xi Jinping expressed prior interest at the Asia-Pacific Economic Cooperation (APEC) summit. This was followed by a duelling bid from Taiwan just 6 days faster. And as chair of the trade agreement, such circumstances place Japan in a sticky situation.

Beijing has been extremely adamant in acknowledging Taiwan as an independent country, pushing the "One China" ideology beyond. Kishida's government is tasked to cautiously navigate the hostility between Beijing and Taipei. Should Japan turn China down, she will experience a diminished scope for diplomacy, which will add to the brewing hostilities between both countries. There have been growing concerns over Beijing flexing its economic and military might to expand its sphere of influence over the past decade. Most recently, Chinese President Xi Jinping has stepped up military provocations toward Taiwan to showcase Beijing's desire for unification. Furthermore, they have also challenged Tokyo's control of the Senkaku Islands in the East China Sea. While Japanese defence spending is still capped at 1% of GDP, Tokyo has been slowly unwinding constitutional constraints on its ability to project military power. Japan's alliance with America articulates anti-Chinese sentiment, evident from Japanese air and naval forces patrolling maritime flashpoints alongside U.S. forces.

All things taken into consideration, we believe that Taiwan's bid will materialise over China's. It is undisputable that having the huge Chinese market in the trade agreement would be beneficial. After all, with the withdrawal of the United States courtesy of former President Donald Trump, smaller economies see no other choice but to look to China as a pivotal source of economic growth. However, we don't believe that Japan will yield. Firstly, China's intentions and sincerity are dubious. The Chinese government has doubled down in putting up new trade barriers, imposing trade sanctions, as well as other policies that directly conflict with the CPTPP. Secondly, the CPTPP operates via unanimous consent, hence with members like Australia who are undergoing a trade war with China, it is hard to see them agreeing to China's accession. We expect this decision to adversely affect Japan's economy. Exports make up 19% of GDP, and by value, China accounts for 24% of Japan's total exports. Should trade frictions arise from China's exclusion from the CPTPP, Japan will face more obstacles in its economic growth in the long-term. However, the timeline of such escalations are vague, and is thus an element of risk that we are baking into our assessment of Japan's outlook.

Trade Idea – Long NIKKEI225

The Bank of Japan and Kishida's government have made their alignment of economic policies for the foreseeable future very clear; that is to maintain yield curve control. Boosting economic growth is of utmost priority, and keeping the Yen weak will continue to be favoured by policymakers to make Japanese exports off high tech products and components more competitive against the likes of South Korea and China. The cheap Yen make investments into Japanese equities more attractive. We can expect capital flows into Japan to increase as global economic outlook strengthens and as the Yen, a safe haven currency, remains cheap against the greenback.

Additionally, we anticipate that the cash handouts to businesses and households will bode well for Japanese equities. Japan's Nikkei 225 has risen 7.89% in 2021where the S&P500 has soared more than 24%.

From the chart, two resistance levels can be identified, with one at 27500 from February 2021, and another upward sloping level from November 2020. Alongside a support level from mid-September, the Index appears to be making higher lows and lower highs, a symmetrical triangle pattern that is indicative of consolidation amidst anticipation of future events and economic reports. In the short term, it is ideal to enter at a level slightly above the resistance and current price, at 28000, to confirm the upward price movement towards the support level. The rationale behind this is that the PSAR indicator highlights that there is still downward pressure on the price. Simultaneously, the Bollinger Bands are starting to show signs that prices are low on a relative basis. The MACD Indicator indicates how selling strength is weakening despite the divergence between the signal and MACD line equalling that in mid-October, confirming that the price action respects our resistance level. Our take profit will be at 29521, harnessing a 5.47% return over the next quarter. Our stop loss will be at 27250, yielding a Risk/Reward of 2.07

Entry: 28000
Take Profit: 29521

Stop Loss: 27250
Risk Reward Ratio: 2.07

NUS INVESTMENT SOCIETY

Global Macro Department –South Korea (NEUTRAL)

Date: 15th December 2021

Analyst

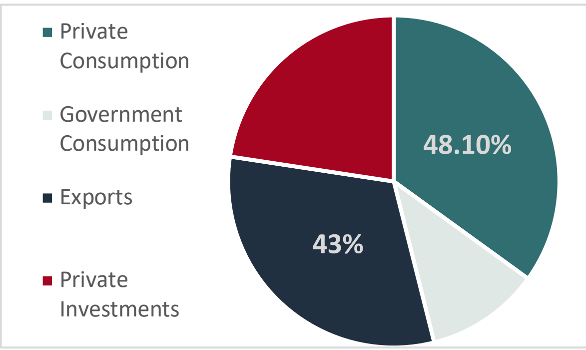
Jonathan Audie Widjaja
Global Macro Analyst
e0758673@u.nus.edu

Basic Information

Real GDP (USD)	USD1.631 Tril.
Real GDP Growth Rate (Q3)	4%
CPI (Nov)	109.41
PPI (Oct)	112.21
Con. Confidence (Oct)	107.6
KOSPI	2968.33

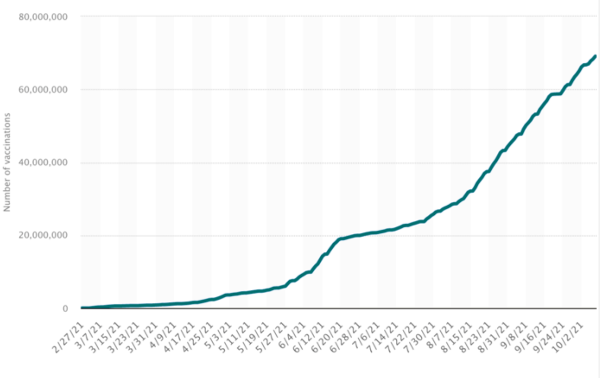
Chart info

Figure 1: Breakdown of GDP by Component



Source: Trading Economics

Figure 2: Vaccination Rates in South Korea



Source: Ministry of Health and Welfare, South Korea

Overview of South Korea

Another Asian Success Story

As Asia's 4th largest economy and 10th largest in the world, South Korea has come a long way since its transformation from an underdeveloped, agrarian economy into an industrial powerhouse that boasts a highly skilled labour force. Her economic growth has been described as the "Miracle on the Han River", where South Korea still remains as one of the fastest growing developed countries in the world. From *Fig.1,* by component, private consumption makes up 48.1% of GDP, followed by Exports at 43.1%, Investments at 31.1%, and Government Consumption at 15.3%. By sector, South Korea is a fairly mixed economy with 57% of GDP in the Service sector, with 32.8% and 1.7% in the Industrial and Agriculture sectors respectively.

An Export-Reliant Economy

South Korea is an extremely export reliant economy, with total exports of goods and services accounting for almost 50% of its GDP. In fact, robust exports have been the key driver in its recovery through the pandemic. To grasp the weight that exports have on South Korea's GDP, when their exports tumbled by 10.3% in 2019 due to trade frictions between China-U.S., Japan's restrictions on their chips, Brexit, as well as the Hong Kong protests, their GDP tumbled very noticeably as well, hitting a 10-year low.

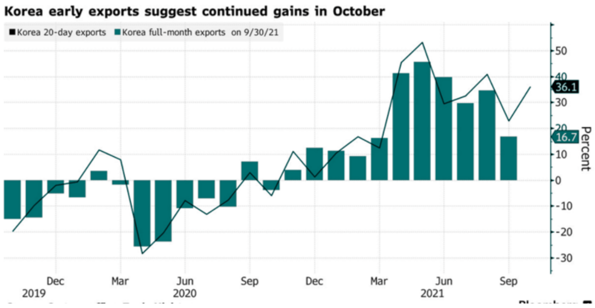
Summary of Events in The Past 6 Months

- Inflation in South Korea saw an unprecedented acceleration to a decade-high heading into November, amidst more-than-persistent supply chain bottlenecks. As Asia's fourth-largest economy struggles with surges in consumer prices, its post-pandemic recovery trajectory heading into 2022 appears to be rife with challenges.

- As seen in *Fig.2*, South Korea boasts a vaccination rate of 83%, which warrants the slew of reopening plans that are underway. They have pivoted their approach in tackling COVID-19 by doing away with the "No COVID" strategy in favour of "living with COVID". Such measures include lifting restaurant curfews, opening designated vaccinated travel lanes, as well as introducing vaccine passports for bars, nightclubs, and gyms.

- The Bank of Korea, in line with the majority of central banks across the globe, have begun raising interest rates. In August, BOK raised their base rates to 0.75%. In November, this was raised by another 25 basis points. Another rate hike is expected to come in 2020Q1.

Figure 3: An Export-Led Recovery



Source: Customs Office, Trade Ministry Korea, Bloomberg

- Throughout the pandemic, South Korea's economy has relied heavily on exports to bolster growth, evident from *Fig.3*. Export performance has been surprisingly robust amidst very intermittent removal and reinstatement of COVID-19 restrictions throughout the year. Semiconductor chip sales, the country's cash cow jumped 40% in November.

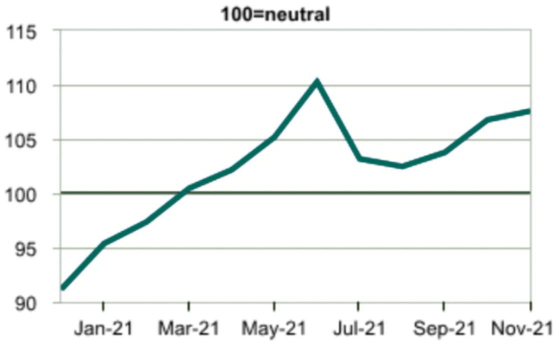
- The Won dropped below the 1,200 won per dollar barrier, placing 2nd after Thailand's baht as one of Asia's worst performers. This slide comes as there is bullish sentiment around the greenback due to expectations of the Federal Reserve tapering soon. Furthermore, with mounting pressure on global semiconductor stocks, Korea saw record foreign outflows out of the world's 2 largest chipmakers – Samsung and SK Hynix, which put more downward pressure on the Won.

- South Korea's KOSPI saw large outflows of capital in September over fears of a Beijing-style regulatory crackdown, which sent investor confidence plummeting.

- Service exports show promising growth potential, with the "K-Wave" making strides beyond Asia. South Korea's entertainment industry continues to boom, increasingly contributing to GDP growth and employment, as well as having trickle down effects on tourism, food, and fashion.

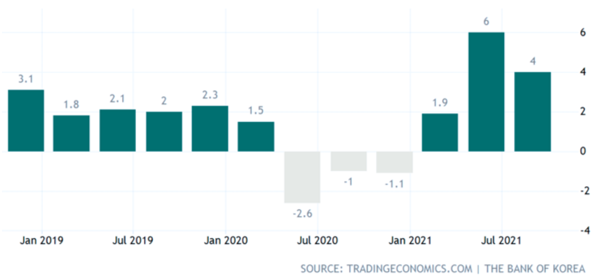
- The arms race in Asia is heating up as South Korea has been making advancements in military missile capabilities as well as their space program, of which they recently launched their home-developed Nuri rocket. Plans to develop a nuclear arms program are not beyond the realm of possibility, and doing so may escalate existing tensions within the region, especially with the North and with Japan.

Figure 4: Consumer Confidence Index



Source: Moody's Analytics

Figure 5: Annual GDP Growth Rate



Source: The Bank of Korea

COVID Begone

Back Home

Mirroring the progress observed in other advanced economies, South Korea has continued on a healthy recovery trajectory despite the spread of COVID-19 variants. As a country, the South has been fairly successful in managing the pandemic without the extreme lockdowns and fatalities observed in other parts of the world. This public health and economic success can be attributed to intensive and timely testing, tracing, and distancing. Not to mention, this robust recovery has been supported by accelerated and thorough vaccination programmes, of which 70% of its people have already been fully inoculated against the virus. Furthermore, in late October, South Korea revealed a three-phase strategy to return to normalcy from the coronavirus. Should things go as anticipated, all pandemic-related restrictions like limits on gatherings and distancing will be fully removed by February 20th, with the exception of mask-wearing mandates.

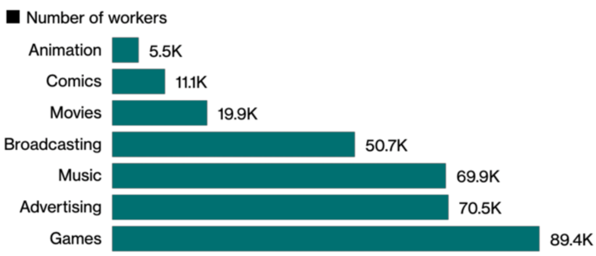
From *Fig.4*, the Composite Consumer Sentiment Index has been on an uptrend since July 2021, rising by 0.8 points to a 5-month high of 107.6 in November 2021. Alongside government policies to usher the economy into the post-pandemic era, this is indicative that the population is also gradually beginning to put the virus behind them. This is happening despite the resurgence of COVID-19 in the form of the Omicron variant, where sentiment remains above the 100-threshold which indicates healthy and sustained optimism. This was also likely bolstered by the government's fiscal handouts starting in early September to more than 80% of Korea's households. On top of that, South Korea's finance ministry has indicated their intentions to increase fiscal spending by 8.3% heading into 2022, proposing a ₩600 trillion (USD523 billion) fiscal package to cushion the fallout from the pandemic.

With the recovery in consumer confidence, fiscal handouts, and the gradual removal of operating-hour curbs on restaurants, cafes, and other businesses, we can expect private consumption spending to boom amidst robust domestic demand, particularly in the services industry. Despite the scare from the Omicron variant, we believe that South Korea's management of the virus has shown us that they have the capacity to handle such hurdles effectively and systematically such that the effects on economic activity and social welfare are muted. While it is true that the virus is showing no signs of simmering down, the robust vaccination programme can be believed to allow the country as a whole to take the virus more in stride. Therefore, having showed resilience in attaining an annualized GDP growth rate of 4% in 2021 (*Fig.5*), we believe that the outlook for household spending remains bright, and that it will continue to strengthen and contribute to economic growth that is projected to be approximately 3%.

Opening of International Borders

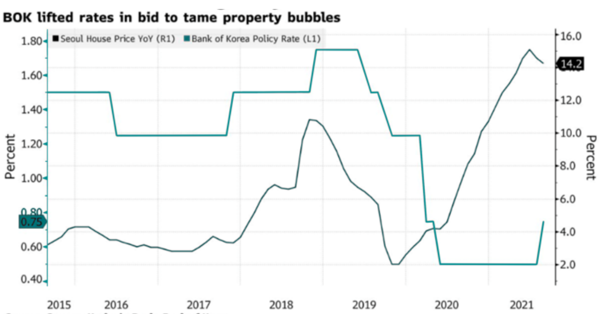
South Korea's primary exports include autos, electronic products, machinery, and ships. They are an export-reliant economy built on the backbone of huge family-owned conglomerates called chaebols, in the form of Samsung, SK Group, and Hyundai who at one point produced about two thirds of South Korea's exports and attracted a significant portion of the country's foreign capital inflows that gave it

Figure 6: The South's Cultural Workforce



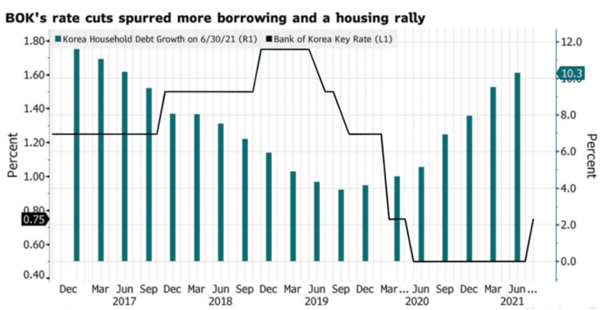
Source: Bloomberg

Figure 7: South Korea's Rate Increase



Source: Kookmin Bank. Bank of Korea, Bloomberg

Figure 8: Household Debt Growth



Source: Bank of Korea, Bloomberg

the boost it needed to transform into the technological powerhouse it is today. Yet, there is another potential source of growth brewing for South Korea.

Entertainment is one of the fastest growing sectors in South Korea, alongside tech. While their traditional engine for economic growth, manufacturing, saw a 20% boost in the level of employment within the industry, the creative and artistic services saw an impressive 27% growth within the same period of 10 years. Netflix alone added 5.6 trillion won (USD$4.7 Billion) to the economy between 2016 and 2020. This economic contribution courtesy of the rapidly growing entertainment industry has a broad impact on other industries like tourism, food, and fashion, and its effects can be observed in *Fig.6* Tourism itself accounted for 4.7% in 2018 and supported approximately 1.4 million jobs, representing 5.3% of total employment. Travel exports represent 15.5% of total service exports.

We are confident that with international borders opening up alongside the coordinated reopening of economic engines globally, South Korea will see service exports expand rapidly heading into 2022. Admittedly, the growth being driven from tourism and other related sectors will not be able to hit its fullest potential until China fully opens up its borders. As of now, China remains adamant on their zero-tolerance policy towards Covid, imposing travel restrictions harsher than any other countries. Considering how China is South Korea's leading market by value and by volume, the extent to which this will prop up Korea's economy is largely dependent on China's moves going forward. We do not see them easing their travel restrictions anytime soon.

"It's Transitory" – BOK's Policy Normalisation

The Bank of Korea (BOK) has displayed timeliness and flexibility in its utilisation of monetary policy to influence the economy when circumstances necessitate intervention. Back in August, it was the first major developed economy to hike interest rates in the pandemic era. It raised base rates from 0.5% to 0.75% (*Fig.7*).

Through the months, they have articulated a very clear pivot towards policy normalisation, having been explicitly hawkish in all of their press statements. The most recent hike was announced at the end of November, as expected, where BOK raised the Base Rate by 25 basis points, from 0.75% to 1.00%. This is the second rate hike in the second half of the year in an attempt to curb soaring household debt, asset-price bubbles, and inflationary pressures. And yet, inflationary pressures appear to be spiralling beyond expectations.

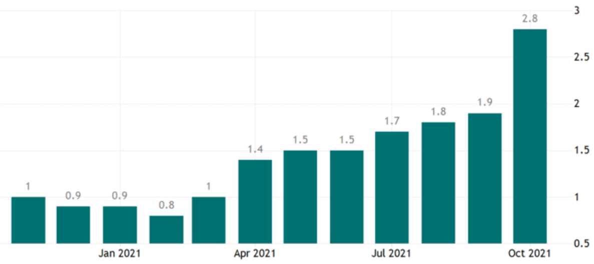
<u>Record Household Debt</u>

A highly contentious topic in South Korea is the overheated real-estate market that has led to sky-high home prices. *Fig.7 and 8* show how such price movements stem from the accommodative monetary environment in the country, with the exponential increase in debt growth being a direct consequence of this. Courtesy of the low interest rate environment, people have been rapidly buying up real estate in the region surrounding the capital of Seoul, which houses more than 50% of the country's population, causing prices in the area to spike more than 13.11% just this year. This comes as the largest surge in the past 15 years as there is exceedingly large demand for medium to low priced apartments in the areas adjacent to Seoul. Infrastructure development projects there have fuelled demand, and

Figure 9: PPI and CPI Skyrocketing

Source: Bank of Korea, Bloomberg

Figure 10: Core Inflation Rate



Source: Tradingeconomics.com, Bank of Korea

the low interest rate environment has made it all the more attractive to lend and buy houses.

As a counter measure, the government has put in place about 26 sets of real estate measures in an attempt to cool the heated market, such as heavier taxes on multiple-home owners. Banks have also been tweaking their mortgage lending screening procedures and requirements to help put the brakes on the nation's snowballing household debt, which is seen as a future threat to consumption spending and hence economic growth into the future. Surging property prices and household debt are a huge issue in Korea. In 2020, household debt grew to 7.9% on-year. While the country aims to bring the annual increase to below 6% in 2021 and below 5% in 2022, it is showing no signs of letting up. Outstanding bank loans to households grew by 6.5 trillion won on-month to 1,052.7 trillion (USD$877.9 billion) as of the end of September. The tightening of credit conditions, particularly in the housing space, has a muted impact on credit growth in other parts of the economy. Hence, we believe that the effects of the rate hike will begin to surface over time, and that the effect on consumption spending will not be significant enough to derail South Korea's path to achieving a GDP growth rate of 3% in 2022.

Not-so-Transitory Inflation

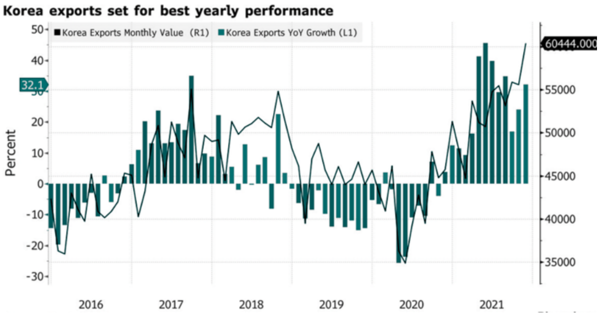
Like other advanced economies in Europe and the U.S, inflation has made its way into the South Korean economy. While inflation had been hovering about the 2.3%~2.6% range from April 2021 through September 2021, which is just above the inflation target of 2%, this was not the case in November. As seen in *Fig.9*, headline inflation has blown up to 3.2% in October, which then accelerated to a decade high of 3.7% in November. The Producer Price Index is also reaching new highs of 8.9%, which spells worry for the economy.

And as seen in *Fig.10*, core inflation (excluding food and energy prices) sitting at 2.8% in October, well above the expected range. The inflationary pressures can be seen to be fairly broad-based as it affects all things from transport, to housing and utilities, to food.

Currently, the South Korean government has temporarily slashed domestic taxes on key oil products for 6 months. This is a move pre-empting expectations that international crude oil prices are not expected to abate in the near future. Given how consumer prices have risen 3.2% in October, especially with a 10.4% spike in transportation costs due to energy prices. Currently, taxes account for 55% of the retail gasoline price, and domestic oil taxes are included in the driving tax, transport tax, consumption tax, education tax, and value added tax. This 20% reduction will there serve to ease the consumer burden from surging retail prices such that private consumption is not hindered especially in this crucial stage of their recovery where pandemic-related restrictions are being lifted gradually. Doing so is not the first time South Korea has lowered taxes, having explored this option back in 2018 due to similar reasons

The persistence of inflationary pressures validate the two previous rate hikes from BOK, and we believe that such pressures will continue to persist heading into 2022 where inflation will remain in the high 2% to low 3% range. Inflation expectations have also spiked to 2.7% compared to the constant 2.4% figure that was observed throughout the 3 prior months. We anticipate that as inflation persists at current levels, the Korean populace will demand for faster wage increases that may lead to broader pressures across the

Figure 11: Korea Export Gains ($Million)



Source: Customs Office, Trade Ministry Korea, Bloomberg

economy. Allowing inflation to run rampant would threaten South Korea's economic growth by hampering household purchasing power and eroding corporate profits. As such, we believe that BOK will follow through with yet another rate hike in 2022Q1 in an attempt to tame inflation. BOK cannot afford to have something like that unravel, especially when the economy is already rife with record levels of household debt and a weak Won. Doing so will hurt the outlook on consumption and investments in the short-term, especially with the unabating uncertainty surrounding the ongoing pandemic.

Global Headwinds?

Supply Bottlenecks and Reliance on China

South Korea's economic recovery in the pandemic-era has been spearheaded by very strong trade performance, which gave it the cushion it needed to explore policy tools to manage financial risks. However, there are signs of this slowing down, albeit moderately in the near future. South Korea has been running a consistent trade surplus throughout 2021, but the figures appear to be waning as the manufacturing industry is beginning to feel the strain from severe bottlenecks that have yet to abate, as well as slower than expected growth from China, to which 25% of their exports by value go to. Trade surplus has been plummeting since July, with the most recent figures showing imports increase by a steeper 31% in comparison to the 16.7% y/y growth in exports. Evidently, slowdowns in Chinese growth and supply chain bottlenecks have hampered the growth of exports.

Chokeholds in global supply chains have affected economies across the world, and South Korea is no exception to that. South Korean trade data serves as an early indicator of global economic activity as its manufacturers are positioned widely across supply chains. Despite the slowdown in growth, we believe that the trend will continue to uphold the same trajectory of positive growth, especially as the world is taking down restrictions and supply chains worldwide are inching closer towards a full recovery unrestricted by the pandemic. As seen in *Fig.11*, November still marked the 12th straight month of expansion on sales due to resilience on foreign demand. To cap off 2021, South Korea's exports are poised to post an annual record even amidst supply chain bottlenecks.

Exports spiked 32.1% y/y in November where this record-breaking month saw overseas shipment being on track to reaching the highest annual value in the country's trade history. This performance was a combination of rising prices and volumes, where export prices rose 22.1% and volume gained 8.2%. We see these figures improving continually, especially as global economies begin to run full steam ahead in a post-pandemic world. While there is a risk that the economic slowdown in China may impact exports more negatively in 4Q2021, it will not be enough to strip away export momentum from South Korea, especially when we take into consideration how the country exports high-demand products like semiconductors and gadgets. In fact, sales to China jumped 30.9%, indicating that South Korea's biggest trading partner still has strong demand for its parts and components. Exports to other key markets also continue to post double-digit gains. Hence, we expect South Korea's exports to display the same level of resilience going forward and continue on this trajectory.

Figure 12: USD/KRW Movement

Source: Bloomberg

The Weakening Won

In October, the Korean won slid to a 15-month low against the greenback due to inflationary fears. This slide in value, observed in *Fig.12*, was inevitable as accelerating inflation amidst surging oil prices only worked to strengthen expectations that the Fed will be tapering off their asset purchases sooner and more aggressively, which led to the dollar strengthening. Additionally, fears of a Chinese-style crackdown on South Korea's tech giants prompted significant stock market outflows from the KOSPI. Speculation regards to this was later dispelled by antitrust regulators who clarified that that the agency's priority is to prevent companies from abusing their dominant market power and hurting competition. Additionally, the highly trade-dependent nature of the economy means that escalating trade tensions between China and the U.S, as well as trade restrictions from Japan, continue to apply downward pressure on the Won.

We believe that as the Fed grapples with the idea of an early taper, there will be a persistent underlying momentum accompanying the greenback, which we see pushing down the Won further entering. For this reason, South Korea's central bank have raised interest rates partly to prevent further depreciation of the Won, as well as to curb import prices. However in doing so, they run the risk of hampering export growth, of which their economy is reliant on for economic growth.

Trade Idea – Short KRW/CNY

Given South Korea's interconnectedness to the global supply chain, the Won is Asia's most risk-sensitive currencies, often serving as an indicator for currencies in neighbouring countries. In the past 6 months, the Won has been on a downward slide due to several reasons. Firstly, increasing energy prices. Secondly, stock outflows due to decreased investor confidence. Thirdly, downward pressure from COVID-19 variants that threaten to slow global growth, particularly in China.

As observed from the chart, the price movement has consistently shown that the currency is bounded in a predictable downward movement that we anticipate to resume until inflation in abates in South Korea. At this juncture where it is making lower lows and lower highs, the MACD indicator shows how the signal line is still diverging from the MACD line in a downtrend, a bearish signal. This corresponds to the price action as well as the Parabolic SAR that reflects bearish sentiment as well. Furthermore, the RSI indicates that is just heading downwards from overbought territory, thus confirming the downtrend.

Therefore, we believe that it is profitable to open a short position at 0.005378, priced slightly below the current price. We will take profit at 0.005279 for a quick and sure swing trade, with stop loss placed at 0.005421 which is just above the current resistance level, just in case it breaks out of the downtrend. This trade has a risk/reward ratio of 2.84.

Entry: 0.005378
Take Profit: 0.005279
Stop Loss: 0.005421
Risk Reward Ratio: 2.84

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