NUS INVESTMENT SOCIETY

# Global Macro Department – China (UNDERWEIGHT)

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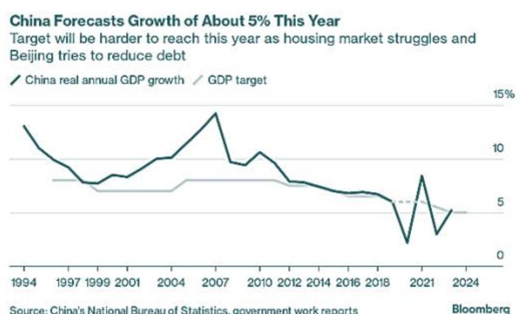
Basic Information

| | |
|---|---|
| GDP | CN¥126.0trn, +5.2% y/y |
| CPI | 100.2 |
| PPI | 97.0 |
| M2 | CN¥292trn, +9.7% |
| Unemployment | 5.2%, -0.4% y/y |

Chart info

Figure 1: China GDP growth




Source: Bloomberg

Figure 2: Global M2 supply growth

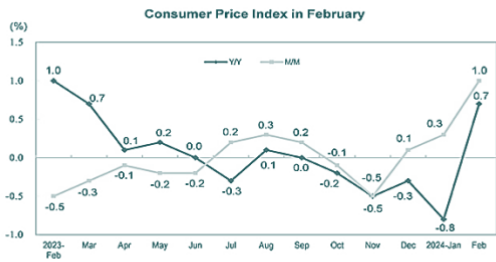
Source: Bloomberg

Figure 3: China CPI change m/m


**Summary:**

Given that 2023 was a covid-recovery year for China, GDP growth of 5.2% was mediocre. This was complicated by lagging consumer and investor confidence, property crisis, and local government debt, despite government efforts on both monetary and fiscal ends. In short, Chinese economy is undergoing a transition away from infrastructure investment growth model.

China continues to grapple with a prolonged battle against deflation, with subdued consumption and investor sentiments exacerbating the challenge, evident in the low CPI and PPI figure. While the country saw a temporary rebound in prices during the Chinese New Year festivities, the overall deflationary trend persists, posing significant risks to China's economic and fiscal health. The property sector, a key driver of economic activity, remains mired in instability, with declining investment and credit stress affecting not only the industry but also regional banking institutions and the broader economy. Despite government interventions aimed at stabilizing the market, such as rate cuts and loan extensions under "Project Whitelist," the underlying structural imbalances persist, necessitating a comprehensive and sustained approach to address the sector's challenges. Looking ahead, the outlook remains uncertain, with the resolution of these issues expected to take several years, underscoring the need for continued vigilance and proactive measures to safeguard economic stability.




Source: National Bureau of Statistics

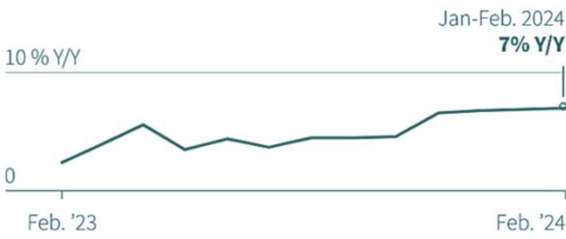
Figure 4: China PPI change m/m

Source: National Bureau of Statistics

Figure 5: China industrial output m/m

**Industrial output**

*Feb. 2023 to Feb. 2024*




Source: Reuters

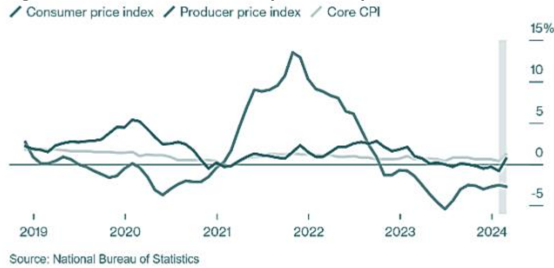
Figure 6: China retail sales m/m

**Retail sales**

*Feb. 2023 to Feb. 2024*

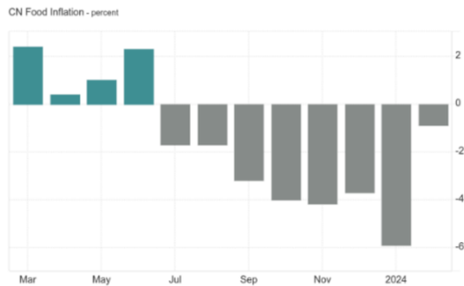
Source: Reuters

Figure 7: China Inflation year-on-year




Source: National Bureau of Statistics, Bloomberg

Figure 8: China Food Inflation

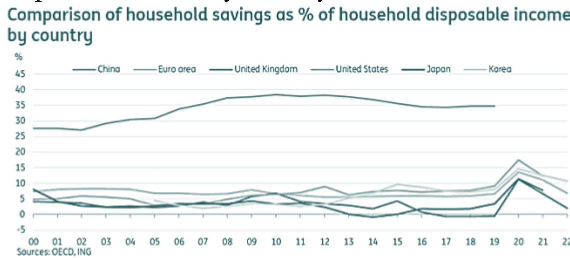



Source: tradingeconomics

Figure 9: Sustained Hog Prices Deflation in China

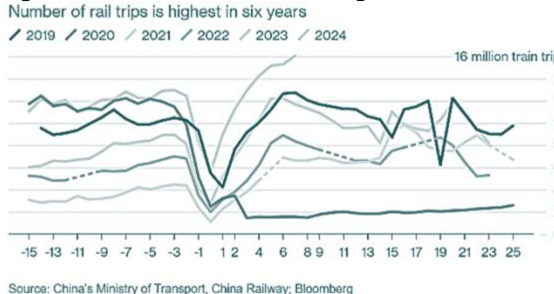
Source: Fitch Rating, National Development and Reform Commission

Figure 10: Household Saving as % of Household Disposable Income by Country




Source: OECD, ING

Figure 11: Train travel hike during Chinese New Year




Source: China's Ministry of Transport, China Railway, Bloomberg

**Depressed Consumption: A Battle Against Deflation**

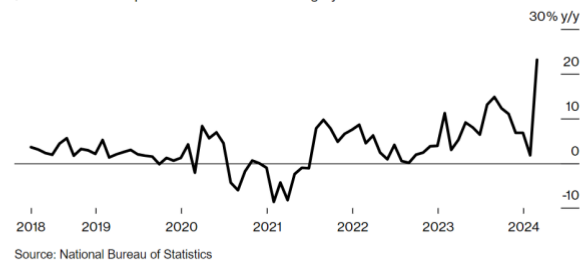
In 2023, deflation cast a shadow over China as it grappled with its longest deflationary period since the Asian Financial Crisis, despite its economic recovery following the end of Covid restrictions. As the economic rebound wanes in 2024, China is poised to continue struggling with deflationary pressures, stemming from subdued consumer and investor sentiments. In January, China CPI experienced a substantial drop of 0.8%. This is mainly attributed to the significant downturn in food prices which constitute about one-fifth of the CPI baskets. The food prices have remained depressed since July 2023 and experienced a notable decline of 5.9% in January. The disappointing performance in the first month further dampened the already low economic confidence, underscoring the huge challenge faced by the Chinese government in the year ahead. However, the CPI year-on-year deflation data in January could be overstated due to a high base of comparison as the Chinese New Year fell in January in 2023.

One crucial component of the food basket is the hog prices, given that pork is a staple food in China. Due to oversupply, the pork price has been under deflationary pressure since 2023 and it declined by 17.3% in January. In response to this ongoing challenge, Beijing conducted 3 rounds of pork purchase for its strategic reserves in 2023 and cut down retention of sows from 41mn to 39mn recently. Despite the efforts, the deflationary pressure on hog prices is likely to persist in 2024.

The persistent deflation in China stems from the muted consumer sentiments. With the current pessimistic economic outlook, consumers in China are very hesitant to spend with a high saving rate of about 35% of disposable income according to OECD data. The figure starkly contrasts with other major economies, where savings rates range from 7% to 13%.. Moreover, the high unemployment rate further diminishes consumers' purchasing power, exacerbating the challenges of subdued consumption. As a result, consumption only contributes to 53% of China's GDP, which ranked 156th out 168 countries according to the Economists. The Economists also highlighted that China needs to ramp up consumption by about ten percentage points of GDP to rebalance its economy.

Ater the disappointing performance in January, China finally welcomed its long-awaited price rebound in February, buoyed by robust consumer spending during the Chinese New Year. To markets and policymakers' delight, CPI climbed by 0.7%, marking its highest growth in the past 11 months. The primary driver of the inflation was the travel boom as this is the first Chinese New Year with no Covid restrictions or widespread infections since 2019. Thus, tourism prices surged by 23%, accounting for nearly 0.9 percentage point of increase in CPI. Another main factor for the CPI uptick was a smaller decline in food prices from -5.9% in Jan to -

Figure 12: Tourism Prices Soar during CNY




Source: National Bureau of Statistics, Bloomberg

0.9% in Feb because of increased food consumption during the festivals and heightened food costs due to adverse weather conditions. However, the CPI inflation value could be overstated owing to base effects as Chinese New Year occurred in January in 2023.

While the Chinese New Year provided a temporary relief from deflation, it is ultimately unsustainable thus the challenge for China to meet its ambitious 3% inflation target remains. As the holiday period ends, the boost from tourism prices is expected to stabilise to 0.4 percentage point in March according to Ping An Securities. Nomura projected that the inflation would moderate to 0.4% in March while the International Monetary Fund forecasted China's CPI inflation to be 1.3% in 2024.

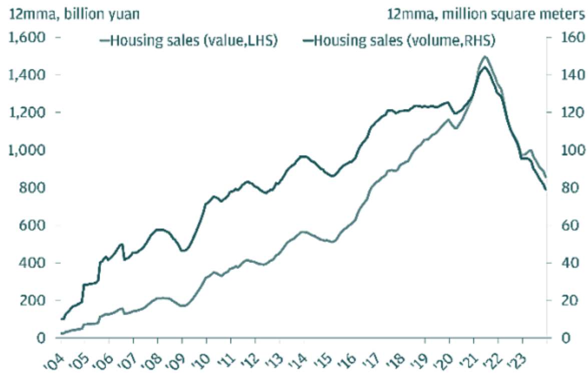
Nevertheless, there remain avenues for unlocking consumer potential in China. The decline in housing prices could potentially alleviate the burden of saving for consumers as the cost of saving for a down-payment and servicing a mortgage is estimated to fall from 11% of disposable income in 2021 to 6% in a decade. However, the benefits are unlikely to materialise in the near future.

Furthermore, during the recent annual meeting of National People's Congress, Beijing has vowed to implement more fiscal stimulus to bolster China's economy and restore confidence. This includes the issuance of 1 trillion yuan ($139 billion) of ultra-long special central government bonds this year. In addition to the fiscal support, People's Bank of China (PBOC) has also lowered the benchmark five-year loan rate from 4.20% to 3.95%. However, these measures fail to address the fundamental structural imbalance in the economy, which requires a radical reform, but Beijing seems reluctant to make such bold moves as for now.

**Ongoing Property Crisis: A Chronic Disease Yet Unresolved**

Despite multiple interventions by the government, the property sector in China continues to exhibit instability. In the months of January and February, property investment witnessed a significant year-on-year decrease of 9%, which, although less severe than the 23% decrease observed in December 2021, still reflects ongoing challenges. The decline in housing prices has not spared tier-one cities, with Beijing experiencing a notable drop of 10-30% in real estate transaction prices compared to the previous year. Additionally, Nomura's reports highlight a concerning backlog of 20 million units of unconstructed and delayed pre-sold homes, exacerbating the sector's woes. The credit stress faced by Vanke, China's second-largest homebuilder with connection to the municipal government of Shenzhen, underscores the broader challenges, as evidenced by Moody's downgrade of its credit rating from Baa3 to Ba1. These developments collectively indicate the persistent fragility within China's property market despite governmental efforts to stabilize it.

Figure 13: China housing sales value and volume y/y

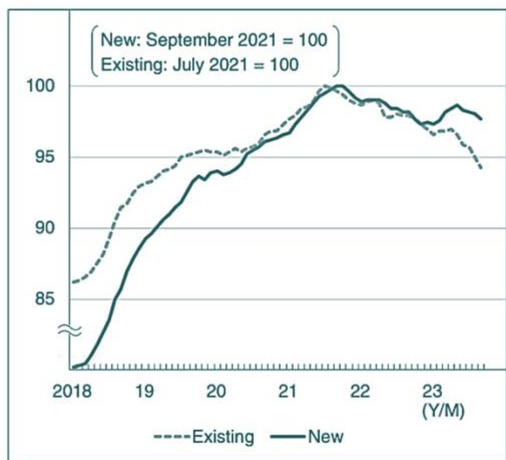



Source: JPMorgan

Figure 14: Housing price index in Shanghai y/y

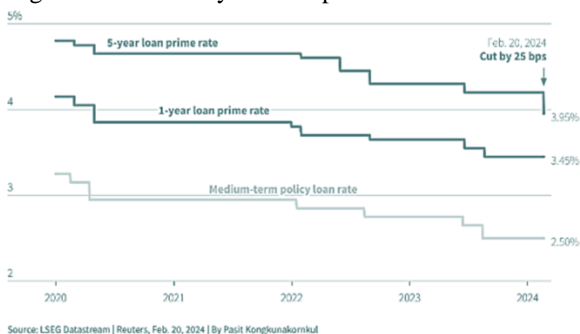
Source: Financial Times

Figure 15: Price of new and existing homes in China




Source: Japan Research Institution, CEIC

Figure 16: China 5-year loan prime rate




Source: Reuters

The turmoil within the property sector is not contained solely within the industry itself but is also affecting banking institutions, particularly regional mid-sized banks. Everbright Bank, for instance, experienced a notable 9% decline in its annual net profit, amounting to CN¥40.8 billion. Similarly, Bank of Communications, one of the big four state banks of China, witnessed a concerning rise in its property bad loan ratio, escalating from 2.8% to 5%. These developments further disincentivize banks from extending loans to the property sector, fearing increased risks of defaults. Such reluctance from banks could potentially exacerbate the existing challenges within the property market, creating a ripple effect of financial strain across various sectors of the economy.

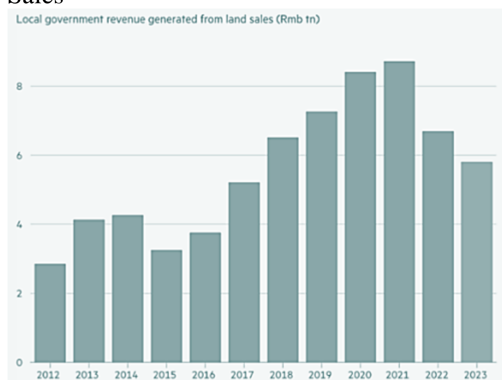
In response to the escalating challenges within the property sector, the government has implemented several measures aimed at stabilizing the market, despite limited outcomes so far. Notably, the 5-year loan prime rate saw a significant decrease from 4.2% to 3.95%, marking the largest reduction since the introduction of the reference rate in 2019 and surpassing analysts' expectations by a considerable margin. This move suggests that the government now believes a benchmark mortgage rate cut would not adversely affect banks' net interest margins, hinting at the possibility of more rate cuts in the future. Concerningly, the government has refrained from considering bailouts for larger developers. Instead, it focuses on initiatives such as "Project Whitelist." Under this program, Chinese state banks have approved loans totalling $17.2 billion and extended the maturity of some existing loans, covering 5300 projects in 214 cities, in a bid to alleviate financial strain. However, challenges persist at the local level, with the loss of revenue from land sales and a high level of infrastructure debt crippling the ability of regional governments, particularly in the Midwest, to support their housing markets effectively. Some municipal governments, like Zhengzhou and Zhumadian, have even failed to provide property purchase subsidies as they did in previous years, further complicating efforts to stabilize the market. Overall, these responses underscore the complexity and multifaceted nature of the challenges facing China's property sector and the ongoing efforts to address them.

Looking ahead, the challenges facing China's property sector are likely to persist, with resolution expected to take several years at the very least. These issues pose significant downside risks to China's fiscal, economic, and institutional strength, further complicating efforts to boost consumer and investor confidence amid a recessionary environment. The combination of restricted credit access and stalling demand is anticipated to lead to a rise in the number of defaults in the foreseeable future. Despite this increase, the absence of bankruptcy proceedings or restructuring initiatives is unsustainable in the long term and poses worrying alarm to the sector.

While the effects of the property turmoil are spilling over into the broader economy, particularly impacting household consumption,

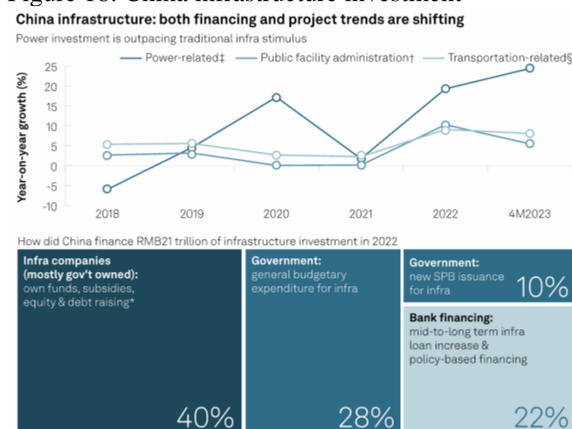
the likelihood of triggering a full-blown financial crisis remains low. Factors such as the relatively high interest rates on mortgages and the requirement of a substantial down payment (approximately 20% of the property purchase price but differs by provinces) mitigate the risk of mortgages turning into non-performing loans. Additionally, government policies, the influence of state-controlled banks, and the implementation of more stringent mortgage terms are playing crucial roles in ongoing mitigation efforts. As the situation evolves, continued vigilance and proactive measures will be essential to navigate the complexities of China's property market and safeguard the broader economic stability.

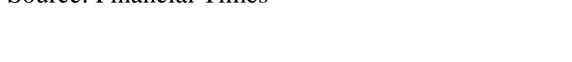
Figure 17: Local Government Revenue from Land Sales




Source: Financial Times

Figure 18: China infrastructure investment



Source: Financial Times

## Infrastructure: Cautious Optimism Amid Fiscal Risks

China's infrastructure investment outlook reflects cautious optimism amidst economic and fiscal challenges. With the World Bank projecting growth to slow from 5.2% in 2023 to 4.5% in 2024, China faces hurdles from a sluggish real estate sector, global demand softness, and structural constraints like ageing demographics and reduced productivity gains. Local government off-balance sheet debt, including liabilities from off-balance sheet entities like local government financing vehicles (LGFVs), has soared to RMB 94 trillion ($13 trillion), according to Goldman Sachs. This situation is exacerbated by reduced revenue from land sales. Moody estimated there is a looming public bond repayments of RMB 3.2 trillion by the end of 2024. Despite this, immediate default risks have been addressed, shifting focus to long-term debt management of LGFVs.

For local governments, off-balance sheet debt can be particularly concerning because it represents a form of indebtedness that is not immediately apparent to policymakers, the public, or credit rating agencies. This can lead to underestimating the government's total financial obligations, potentially compromising its ability to fund new projects or investments.

The infrastructure sector is set for growth in the high single digits in 2023 but anticipates a deceleration in 2024, mirroring the broader economic slowdown. Weakness in property investment will continue in 2024 as developers' sales and liquidity are under pressure. Stress in the property market undermined local governments' financial positions, which will constrain their ability to boost spending on infrastructure.

Moreover, this moderation aligns with strategic shifts towards disciplined spending and sustainability, particularly in urban infrastructure, to lessen debt concerns. State-owned entities are expected to spearhead investments, notably in power and utilities, emphasising renewable energy in line with China's carbon neutrality ambitions. This strategic pivot underscores a commitment to projects offering both returns and contributions to sustainable development.

## Foreign Investment: A Struggle Against Capital Flight

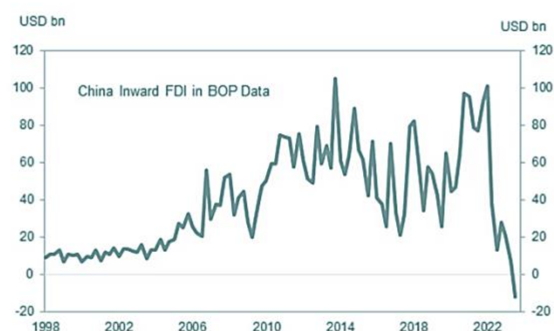
In 2023, China saw a noticeable retreat of foreign capital. While Fixed Asset Investment (FAI) experienced a modest overall growth of 4.2% year-on-year and reached RMB 5.08 trillion (approx. US$705.62 billion), FAI attributed to foreign companies plummeted by 14.1% year-on-year, highlighting a stark withdrawal of foreign investment in physical assets within China. Moreover, inward FDI fell into negative territory for the first time since records began in 1998, signifying an 82% decline from the previous year and marking the lowest annual figure since 1993. Factors contributing to this downturn included geopolitical uncertainties, regulatory crackdowns on foreign consultancies, and the allure of higher interest rates in other markets.

In early 2024, China's Foreign Direct Investment (FDI) landscape showed signs of a nuanced recovery despite a year-on-year decrease of 11.7% in the use of foreign capital in January. A notable month-on-month increase of 20.4% coupled with a significant surge in the establishment of new foreign-funded enterprises (FIEs) by 74.4% in January 2024 heralds a potentially more favourable climate for FDI. This shift suggests the beginning of a stabilisation or even a revival phase in FDI inflows, indicating an improved environment for foreign company establishments within China.

In 2023, facing FDI challenges, China launched the strategic 24-point Action Plan to rejuvenate foreign investment by enhancing the business landscape, simplifying administrative processes, and broadening market accessibility. Key focus areas include improving government procurement, facilitating cross-border data flows, and ensuring competitive fairness. China also seeks to diversify its FDI sources, establishing new investment pathways from the Middle East and building partnerships with major financial entities. It includes collaboration with GCC countries and the establishment of a Kuwaiti sovereign wealth fund office in China These measures are designed to increase investor confidence, introduce new investment avenues, and support growth in sectors like manufacturing and high-tech.

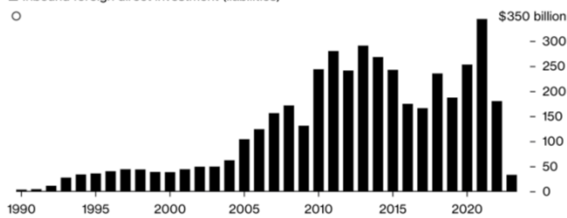
However, considering China’s current macro performances and an expected longer economic recovery period, the confidence of foreign investors remains low. The market situation is still uncertain despite the implementation of new FDI-attracting policies as we are still to ensure to what extent the market would respond to the stimulus.

Figure 19: China Inward FDI in BOP




Source: CEIC, Goldman Sachs

Figure 20: China’s Inbound FDI



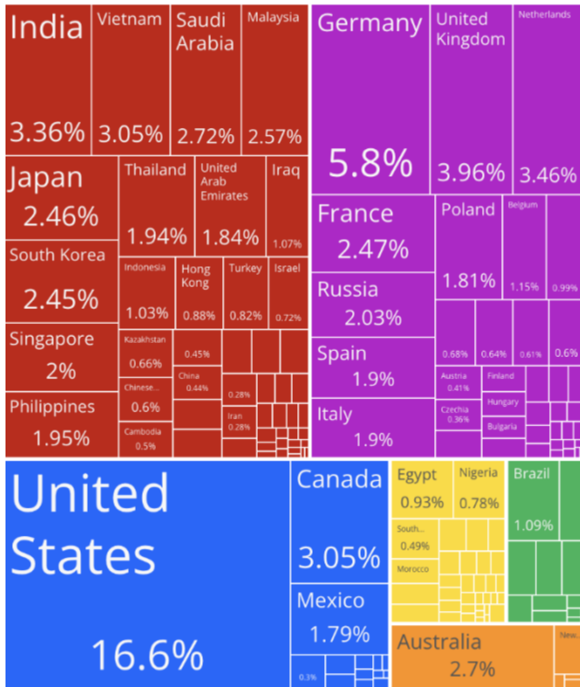

Source: China’s State Administration of Foreign Exchange, Bloomberg

## Exports Recovery: China’s Uncertain Future with the World

China’s exports declined in 2023 but have been recovering since the second half of the year. There are both short-term cyclical factors as well as long-term geopolitical risks.

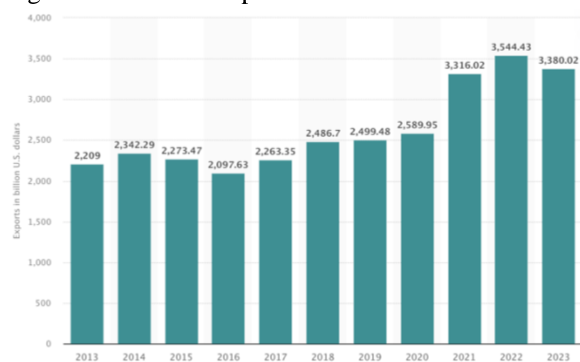
In 2023, overall exports declined by 4.6% to $3.38 trillion. China's exports last year contracted for the first time since 2016 in dollar terms, underscoring sluggish global demand amid tight financial conditions. As China’s major trading partners have been raising interest rates to combat inflation since 2022, global economic growth slowed and demand for China’s exports fell. China’s major trading partners are the US, the European Union and Southeast Asia and most of them experienced slower economic growth. Southeast Asia’s GDP growth in 2023, was a modest 3.7 percent, lower than the advanced estimates of 3.8 percent and significantly lower compared to the 8.7 percent growth in 2022. For the year 2023, GDP only increased by 0.4% in both the euro area and the EU, after +3.4% in both zones in 2022. The US imported from China less and more from Mexico, mainly for geopolitical reasons. Exports rose for unwrought aluminium and aluminium materials (0.5%), household appliances (20.8%), ICs (24.3%), cars (12.6%), ships (173.1%), plastic products (22.9%), and LCD flat panel display modules (13.2%). By contrast, exports dropped for rare earth (-44.7%) and steel (-10.0%). Despite the overall weak growth, exports of the so-called new three – electric vehicles, lithium-ion batteries and solar cells – hitting a record high with a combined rise of 29.9 per cent year on year in 2023.

Figure 21: China’s Trading Partners




Source: OEC World

Figure 22: China’s Exports in Billion USD

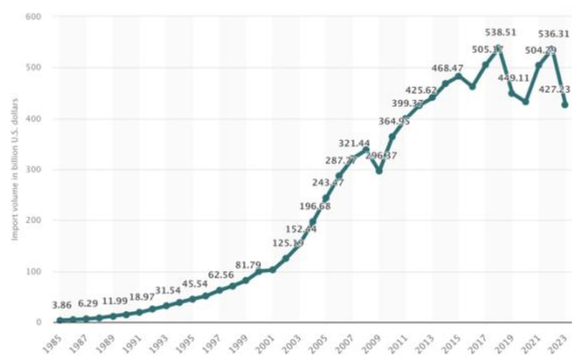



Source: Statista

Figure 23: US’s imports from China

Despite the overall decline in 2023, China’s exports have been under recovery since the second half of 2023. The decrease has been narrowing since July and saw the first positive growth in November by 0.5%. China's export and import growth in the January-February period in 2024 is 7.1% higher than a year before, beating forecasts of 1.9%. Global monetary easing expectations may also offer some relief Demand for Chinese automobiles and automotive parts increased by 27% and vehicles shipped abroad in 2023 increased by 58% in 2023. However, the sustainability of the momentum might not last because the rise in overseas sales was partly due to the price wars among China’s EV companies, especially BYD, in order to capture greater market share.

Although the short-term demand condition is recovering, the long-term structural change and geopolitical risks are concerning. Among key trading partners, exports to the U.S. led the decline, down 13% from the previous year. Demand from the European Union and Southeast Asian countries also shrank. China has been losing ground to other developing countries that offer lower costs and are less exposed to geopolitical risks. China’s important role as the world factory has become a concern for Western countries in view of possible geopolitical risks. Thus, many trading partners are decoupling from China and reshore and friendshore instead. For example, despite global macro headwinds, Mexican exports to the United States were roughly the same as in 2022 at $475.6 billion. While foreign direct investment in developing countries fell 9 per cent in 2023, the flow of such investment to Mexico surged 21 per cent last year. Biden administration’s 2022 climate law and



Source: Statista

geopolitical tensions stemming from the war in Ukraine were both factors pushing companies toward Mexico.

Russia is an exception among China's trading partners. Export to Russia grew 47%. China's imports from Russia also expanded, resulting in a 26% growth in bilateral trade. This was mostly due to the Western sanctions on Russia after its invasion of Ukraine while China remained friendly. Since Russia's invasion of Ukraine in February 2022, the US, UK and EU, along with countries including Australia, Canada and Japan, have imposed more than 16,500 sanctions on Russia.

Looking ahead to 2024, we anticipate that China will adopt a more conciliatory approach to strengthen its ties with trading partners, particularly focusing on improving relations with the EU. There are indications that China is considering lifting sanctions imposed on the EU, contingent upon the EU's ratification of the China-EU investment agreement. Additionally, since 2023, China has initiated measures to ease border restrictions, such as expanding unilateral visa-free travel to six additional European countries and establishing bilateral visa-free arrangements with Singapore and Malaysia in early 2024. This shift towards a more accommodating foreign policy stance aligns with China's urgent need to revitalise its economy.

Figure 24: ECNS Daily Chart

Source: TradingView

## Trade Idea: Short iShares MSCI China Small-Cap ETF (ECNS)

Entry: $24.56
Take profit: $23.11
Stop loss: $25.51
Risk reward ratio: 1.53

Catalyst:

1. Deflationary pressure persists as China is still plagued by subdued consumer sentiments.
2. Property sector remains shaky despite government interventions while the government is reluctant to go further to bail out larger developers.
3. Local governments are burdened and handicapped by loss of revenue from land sales and high infrastructure debt.
4. Exports are vulnerable due to uncertainties over future US-China relationships arising from the US presidential election.

Risk:

1. Return from the trade is limited as the market has mostly priced in.
2. The Chinese government might be able to address the structural issues and effectively conduct economic transition this year to achieve higher than expected performance. However, considering the complexity of the challenges and Beijing's resistance to radical structural reform, we believe that the transition is unlikely to occur soon.

Technical Analysis:

1. Since September, ECNS has been on a downward trend, breaking through the support level multiple times.
2. The current price is above 50 days moving average thus it is likely the price will fall further towards the MA50.

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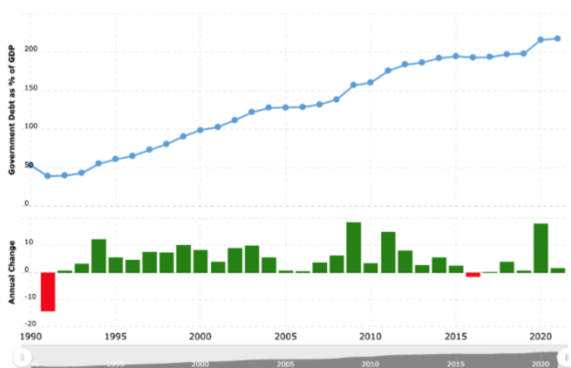
**Basic Information**

| | |
|---|---|
| Annual GDP YoY | 1.91% |
| Q4 GDP YoY | -0.4% |
| CPI Mar 2024 | 2.6% |
| PPI Feb 2024 | 2.1% |
| February Trade Balance (JPY) | -377.8Bn |
| JXY | 65.97 |
| Stock Index | Nikkei 225 |
| Currency | JPY |

**Chart info**

**Figure 1: GDP Quarterly Growth Rate (%)**
*Source: Trading Economics, Cabinet Office, Japan*

**Figure 2: Japan Debt to GDP Ratio**




*Source: Macro trends*

## Overview

Known as The Land of the Rising Sun, Japan is the third largest economy in the world, boasting one of the most developed, advanced, and educated economies. The Japanese economy is helmed by the Services and Industry sectors at 69.89% and 28.8% respectively. Japan is also part of many global associations such as G7, G10 and Organisation for Economic Co-operation and Development (OECD), that allows for global recognition and boosts global relations.

***More Debt?***

Despite the rising debt and uncertainty, investor confidence in Japan is still holding strong, mainly driven by the safe-haven characteristics of the JGB market and the Japanese Yen. Japan ranks second, just behind the US in terms of absolute debt amount, but ranks first when it is measured as a percentage of GDP. With a staggering debt to GDP ratio of 244.26%, highest in the world. This unprecedented amount is mainly fuelled by multiple governmental initiatives under the Kishida administration, as well as the Bank of Japan's (BoJ) massive asset purchase program.

## Summary of Events in the Past 6 Months

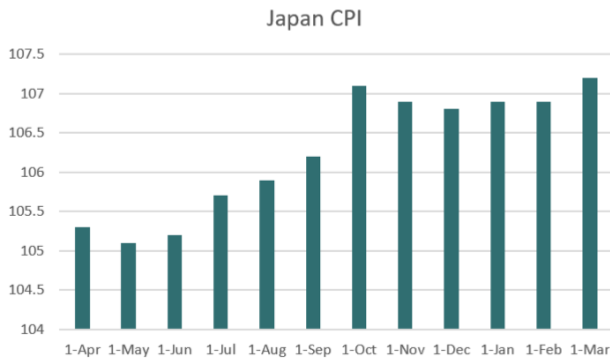
- BoJ ended it's negative interest rate policy (NIRP) and raised rates by 10 basis points to a range of 0.0%-0.1%, marking the end of the world's last negative rate policy. Additionally, the BoJ announced the end of it's 14 year ETF programme buying.

- Amidst Kishida's sluggish support rates, the administration announced a cabinet reshuffle in September 2023. Introducing two additional female participants in the parliament bringing the total number of female ministers to five, joint highest record in Japanese politics.

- Kishida announced a JPY17 trn (USD113bn) stimulus package to cushion the economic blow from the inflation price hikes, including tax cuts. The main aim of this package is to stimulate consumers spending that was dampened by inflationary pressure. Additionally, this could be seen as Kishida's attempt in alleviating the administration's poor approval ratings.

- Japanese exports mainly includes cars (18%), electronic integrated circuits/equipment (16%), machinery (19%) and commodities (6.4%). Overall exports decreased by 1.1% m/m in October. This is a consequence of a slowdown in global recovery and a drop in global demand, with an 8.5% and 4.3% drop in exports to Europe and Asia respectively.

**Figure 3: Japan CPI (%)**

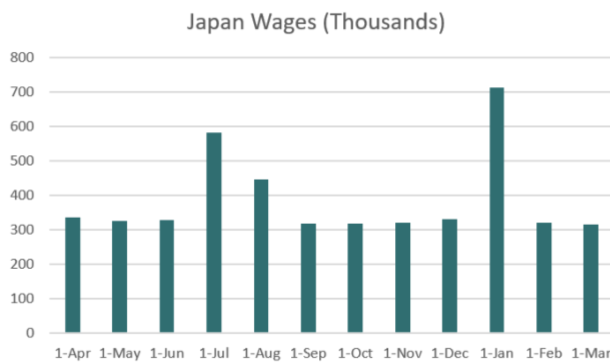



*Source: Trading Economics*

**Figure 4: JGB 10 Year Yields (%)**

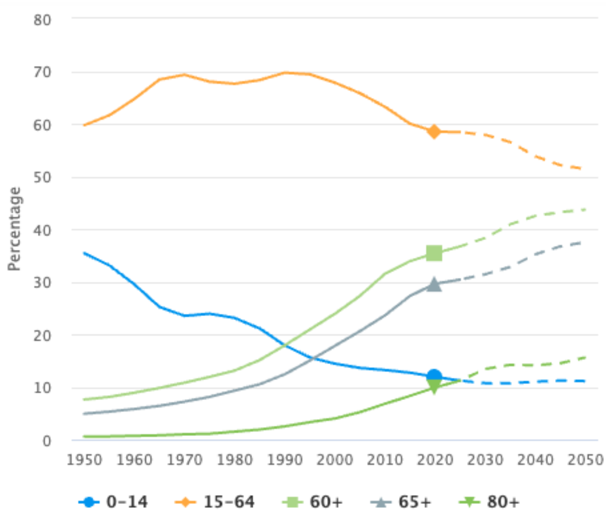
*Source: Trading Economics*

**Figure 5: Average Monthly Wages (Yen)**




*Source: Trading Economics*

**Figure 6: Japan Demographics**




*Source: ESCAP*

**Figure 7 : Crude Oil WTI Prices**

## Bank of Japan's Narrative

### New Era of Japanese Economic Policy

In the past, Japan was faced with a very low inflation, prompting the BoJ to adopt an ultra-dovish policy in an attempt to spur economic growth with aggressive rate cuts in the 1990s. By late 1999, rates were pushed to zero, but despite efforts, Japan still went into deflationary environments. Further on, BoJ introduced Quantitative Easing by aggressively purchasing Japanese Government Bonds (JGBs), increasing liquidity in the market.

In 2016, BoJ introduced the framework of Quantitative and Qualitative Easing with Yield Control Curve (QQE with YCC). Since then, BoJ has been actively using the YCC to guide long term targets for the 10-year JGB yields at around 0% with a bandwidth of ±10 basis points.

In recent times, Japan has seen inflation above the BoJ's target of 2% for well over a year and with the stronger than expected Shunto negotiations results, BoJ embarked on policy normalisation, ending it's negative interest rate policy (NIRP) and raised rates by 10 basis points to a range of 0.0%-0.1%, marking the end of the world's last negative rate policy.

### In The Next 6 Months

Japan's monetary policy is expected to remain ultra loose as Ueda has highlighted that monetary policy would "remain as accommodative as possible". This is in line with the market's expectations, with the 2 year OIS futures prices at 0.523%.

## Domestic Developments

### Employment Rate and Ageing Population

In terms of age distribution amongst a country's population, Japan tops Asia with 28% of the population aged 65 and above. Coupled with the declining birth rates, this poses a serious problem for Japan as the working population is dwindling. The decline in working population would directly lead to a shortage of manpower as well as hindrance in economic expansion.

In February, unemployment rate rose by 0.2% to 2.6% from 2.4% in the preceding month. Slight decline in jobs offers-to-applicant ratios to 1.29 in february. This could be a negative signal as it hints that the tightness in the Japanese labour market is nearing its peak. This may not be beneficial as a tighter labour market is necessary for spurring wage growths.

### Inflation

A combination of significant cost pressures, structural tightening of the labour markets and the changes in governmental policies would shift Japan's inflation dynamics. The sharp rise in resource prices due to the war in Ukraine and numerous other global events has resulted in sharp rises in energy and food prices even in Japan. Furthermore, with the weakening Yen, it would be more expensive for importers which directly translate to higher prices.

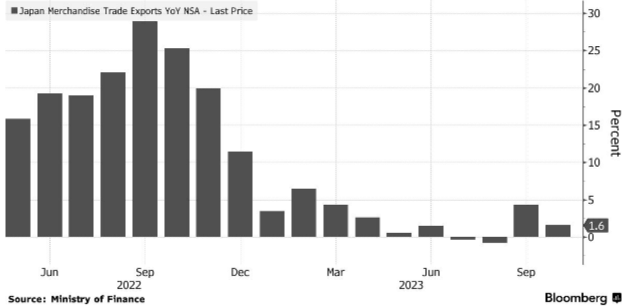
The changes in inflation dynamics driven by rising prices and increasing wages pressure would alter the economic structure of Japanese firms. Firms are increasingly required to raise prices or reduce other costs to protect profitability. With the tighter labour markets, firms are forced to offer wage growths to better attract and retain talents.

### Imports and Exports

Main trading partners of Japan includes China (19.4%), the United States (18.7%), and South Korea ((7.2%). Japan exports picked up from November to January before slumping in February, with exports increasing to 11.9% YoY January. The increase in January exports were led by cars, ships and construction machinery shipments. Despite

*Source: Trading Economics*

**Figure 8 : Japan Exports Slowing Down**




*Source: Bloomberg*

this, the trade balance swung to a deficit of 337.5bn yen (USD 2.2bn). The slowdown in exports suggest more uncertainty for Japan, with the current times of sticky inflation and limited wage growths keeping a lid on domestic demands.

Exports to Japan's largest trading partner, China fell by 4% leading the decrease in Asia exports, as recovery dampens. The decrease was offset by the increase in exports to the United States and Europe by 8.4% and 8.9% respectively. However, the rise in automotive exports to the US and Europe could potentially ease as recovery slows surrounding uncertainties in these regions.

**Japanese Equities**

Japanese equities boomed in the first half of 2024. The Nikkei reached 41173, the highest level since July 1990, breaking its psychological resistance of 38,915.87 set during the "bubble economy" period. The rally is mainly driven by the ongoing easing of monetary policy. With BoJ keeping a dovish stance, financing conditions in Japan remains benign allowing for corporations to delay restructuring. Furthermore, Kishida's new capitalism policies have not enforce comprehensive structural changes to firms, which could potentially drawback on corporate profitability.

Another important factor for consideration is the Tokyo Stock Exchange's (TSE) call for companies to focus on achieving sustainable growth and enhancing corporate values, particularly targeting companies with a Price-to-Book Ratio (P/B Ratio) of below 1. With a P/B Ratio of less than 1, it means that markets are valuing companies below their what their assets are worth, suggesting for potential to be re-evaluated at a higher price.

General market consensus is that there is still a 10% upside potential for the Japanese stock market through 1H2024. However, a potential downside risk would be the acceleration of policy normalization. The potential of a less Dovish BoJ by 1H2024 would mean a less accommodating financing environment for firms.

Figure 10: USDJPY Daily Chart

## Trade Idea: Long USDJPY

We would like to propose a long USDJPY trade idea, with a time horizon for the next 2 months. Given the stronger than expected US economic data and hawkish comments by the Feds. It is likely that the Feds will embark on 2 rate cuts instead of 3 rates cuts this year. Additionally, the BoJ is known to be conservative and would likely wait for a slew of data before embarking on any rate hikes.

Hence, the large interest rate differentials between the US and Japan would be prolonged, leading to more upside for USDJPY.

Catalyst

Stronger economic data from the US would reaffirm the "sticky inflation" narrative and lead to the reduction of rate cuts from the federal reserve. Additionally, with commodities rallying in 1H2024, this would translate to a higher CPI, reaffirming the "sticky inflation" narrative.

Risk

The Japanese government has raised concerns over the weakness of the Yen and may intervene in the markets, pushing the price of USDJPY down to a healthier level.

Trade

**Entry: 151.86**
**Take Profit: 155.00**
**Stop Loss: 149.00**
**Reward Risk Ratio: 1.10**

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NUS INVESTMENT SOCIETY

Global Macro Department – South Korea (OVERWEIGHT) Date: 22nd April 2024

**Analysts**

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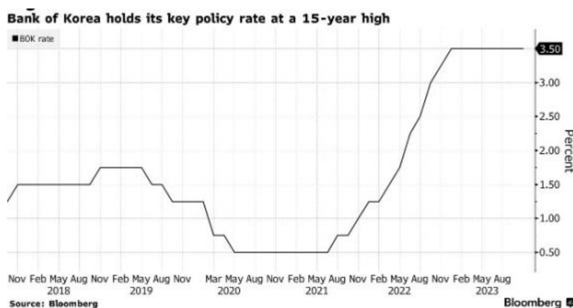
**Basic Information**

| | |
|---|---|
| Annual GPD YoY | 1.34% |
| Q4 GDP YoY | 2.2% |
| CPI March 2024 | 3.1% |
| PPI March 2024 | 1.5% |
| October Trade Balance (KRW) | 6.86Bn |
| Stock Index | KOSPI |
| Currency | KRW |
| USD/KRW | 1,355.34 |

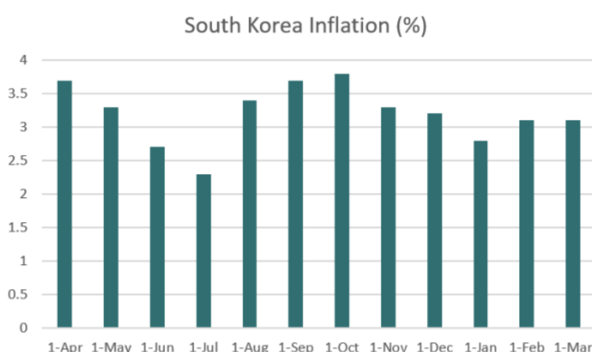
**Chart info**

## Figure 1: BoK's Key Policy Rates




*Source: Bloomberg*

## Figure 2: South Korea Inflation




*Source: Trading Economics*

## Overview of South Korea

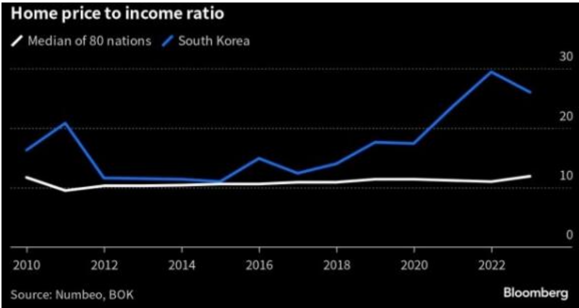
South Korea achieved economic growth at unprecedented speed after majority of its industrial facilities were destroyed in the Korean War. Observers call this the "Miracle of the Hangang River". South Korea is heavily export oriented economy, specializing in Manufacturing, Services and Agriculture. Additionally, South Korea is constantly expose to geopolitical risk from their counterpart – North Korea, with periods of tension and cooperation throughout the years.

South Korea holds membership in world organizations such as, Organization for Economic Cooperation and Development (OECD) and G20.

## Summary of events in the past 6 months

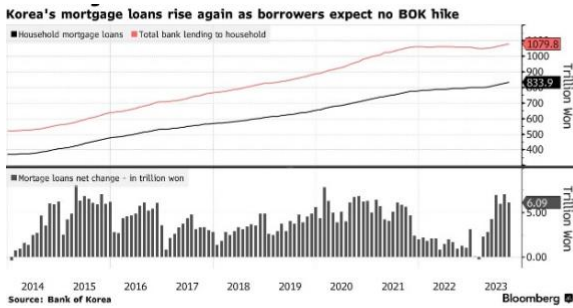
- Bank of Korea (BoK) maintains hawkish stance on interest rates, holding the key policy rate at a 15-year high at 3.5%.
- Inflation remains sticky, hovering around 3% for the past 5 months. Well above BoK's 2% target.
- Housing prices in South Korea declined since December 2023 driven by the reduction in government-sponsored finance for real estate and by the high interest payments burden. Sentiment indicators, including the housing price forecast Consumer Sentiment Index (CSI), also slowed since October last year, falling below the benchmark in December.
- Growth in nationwide leasehold deposit (jeonse) prices decelerated as the Seoul metropolitan area saw prices rise at a slower pace, and prices fell in the rest of the country. Meanwhile, the risk related to real estate project financing (PF) still remains.
- South Korean economy continued to improve at a modest pace, particularly in exports. Real GDP growth in the fourth quarter of 2023 increased by 0.6% from the preceding quarter (+2.2% year-on-year). By sector, private consumption saw weakened recovery momentum due to a continuing slump in goods and a slowdown in services affected by elevated inflation and interest rates
- Financial Services Commission (FSC) announced the ban of equities short-selling at least until June 2024, citing the need to "level playing field" for retail and institutional investors.

## Figure 3: Price-to-Income Ratio (PIR)



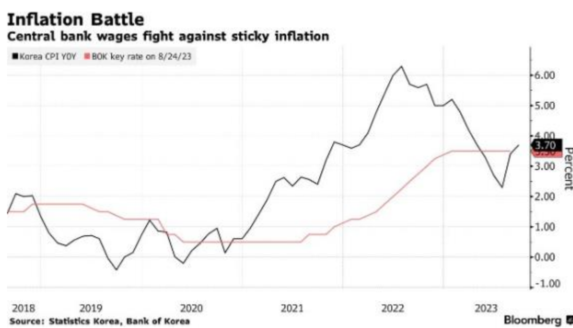

*Source: Bloomberg*

## Figure 4: South Korea Mortgage Loans



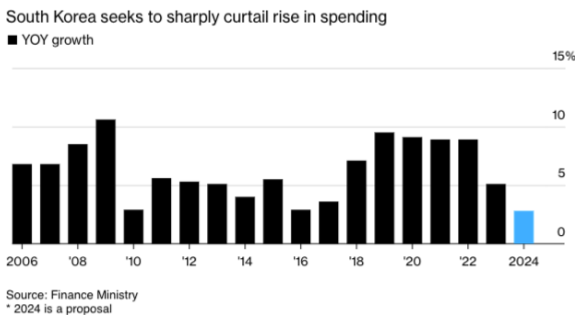

*Source: Bloomberg*

## Figure 5: BoK's key policy rate / CPI




*Source: Bloomberg*

## Figure 6:  Percentage increase in budget




*Source: Bloomberg/Korea Finance Ministry*

## South Korea's GDP

South Korean exports are heavily reliant on the manufacturing and industries sector, consisting of semi-conductors, and automobile exports. The top export product, semi-conductors continued to recover due to improvements in the global semiconductor industry and increased eco-friendly and infrastructure investments in major countries. Export growth continued to improve from January onward, driven mainly by IT products. The trade ministry expects chip demand to maintain strong growth in the coming months, fuelled by strong demands from smartphone and AI developers.

Despite the positive March trade figures, BoK still revised the 2024 GDP growth rate downwards. This indicates that the slump in South Korea's number 1 trading partner and geopolitical tensions such as the Israel-Hamas conflict which could potentially affect energy prices are outweighing the gains in trade figures. Additionally, the United States could also see their consumption waning as supports from fiscal investment programs dissipate. On the flip side,  a potential shift in global monetary policy could benefit the export dependent country.

On the consumer front, retail sales are used as a gauge of private consumption. Private consumption grew 0.2% over the periods of October to December. Sales of non-durable goods such as food and groceries fell by 3.1%, and sales of semi-durable goods such as clothing added 4.3%. One possible explanation for this shift could be due to a continuing slump in goods and a slowdown in services affected by elevated inflation and interest rates.

Additionally, the global semiconductor and chip demand is seen to have bottomed out and is on track to a recovery with a forecasted 13.1% rebound in 2024. This is a bullish view for a country that is heavily reliant on chip exports. The revival in chip demand could be attributed to the growth in demand for artificial intelligence related products and personal mobile devices such as computers and smartphones demanding higher performance capabilities.
Furthermore, countries such as the United States, Japan and Korea are pledging more support for the industry in terms of monetary and regulatory support.

## South Korea's legislative Election

On 10 April, South Koreans will go to the polls for parliamentary elections, aiming to elect the 300 seats of the National Assembly. Of those, 254 are constituency seats, while the remaining 46 are elected by proportional representation. Each voter's choice counts for both the constituency candidate of their electoral districts and the proportional seats. Members of the National Assembly are elected for a four-year term and set the agenda mainly for domestic policy.

Recent polls suggest it will be a neck-and-neck race between the two major parties, but there are still a large number of undecided voters. The results could, therefore, swing towards one side or the other. If the PPP and other conservative parties win, it could add momentum to President Yoon Suk Yeol's major reform agenda – including health care, education, and national pensions. However, if the DP and associated parties win, it will further weaken Yoon's leadership, and his policies could be negotiated with the opposition coalition.

Regardless of which party wins the race, what will be more closely watched is how many seats the winner will take. Constitutional amendment is possible if 200 seats are secured. 180 seats can take control of legislative power, including promoting the fast track alone. If 150 seats are secured, various bills, including the budget bill and the motion for appointment of the Prime Minister, Constitutional Judge, and Supreme Court Justice, can be passed.

Since both parties are calling for some kind of fiscal stimulus – the DP argues for a cash transfer program, while the PPP prefers a reduction in VAT – and fiscal policy may, therefore, turn more supportive for growth in the second half of this year. At the same time, this could hold inflation at an elevated level a bit longer than expected. In our base case scenario, government efforts to curb inflation will continue with tight monetary conditions, and inflation is expected to cool down gradually.

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### Bank of Korea's Narrative

In the last meeting, the BoK has decided to maintain its higher for longer stance. BoK will keep key policy rate at 3.5%, in line with market consensus. The BoK remains wary of sticky inflation, citing the need for softer economic data before embarking on rate cuts.

A slightly more hawkish tone indicates that BoK officials are attempting to push rate hikes discussions past the 1H2024. Implying that a potential rate cut could only occur in Q32024. BoK could potentially consider rate cuts in tandem with the US Feds if inflation falls towards the 2% target. Additionally, another potential risk could be with a higher for longer stance on key policy rates, it could directly translate to higher interest rates for mortgages which can further fuel the housing market. Our views are in line with the general market consensus that BoK would be holding rates steady for the first half of 2024. There is less incentives for BoK to cut rates now as they have not achieved the target inflation rate, a premature rate cut could potentially bring about another round of inflation.

## Korean Housing Market

The housing market in South Korea uses a unique system where landlords and tenants could choose the way they contract their tenancy structure. Tenants could choose the traditional rental method where they pay a fixed monthly fee to the landlord or they could opt for "Chonsei". Chonsei is essentially an interest free loan tenants offer to the landlords in exchange for the lease. Tenants often pay an upfront lump-sum of typically 50-70% of the property's value and in exchange they do not have to pay monthly rentals, additionally, they receive the full deposits back at the end of the lease. This forms a strong line of credit which allows landlords to either pay off existing loans or finance new properties, thereby building up their portfolio.

The attractiveness of Chonsei runs inversely with the interest rates. For context, when interest rates fell between the periods of 2012- 2020, Chonsei deposits were seen to grow by 60%. The main reason for this was that tenants could obtain a cheap loan from the bank to finance the Chonsei. This cycle of Chonsei created a strong flow of loans for landlords who are

able to create a highly leveraged rental housing portfolio. The problem is that this cycle is highly susceptible to interest rate risks. Problems arises when interest rates are high and it disrupts the cycle of Chonsei. When tenant leases are up, landlords would receive a lesser volume of deposits as it is more expensive for tenants to fund these loans. This ultimately caused a cashflow problem causing defaults to arise.

The BoK narrative to keep rates higher for longer would have significant impact on the housing market. In the early parts of 2023, the government eased financial regulations on homebuyers as well as introducing temporary policy mortgage loans in efforts to cushion the falling housing market. With the recent hold on policy rates, homebuyers are believing that the period of rate hikes are over thus causing a slight rebound in demand for housing in South Korea. However, the risk still remains as the BoK may choose to delay any rate cuts as the world faces reinflation.

## KOSPI

There are multiple indexes in the Korean Stock Exchange, but most notably is the KOSPI 200, generally referred to as the KOSPI which tracks the 200 largest publicly traded common stock in Korea which comprises of around 70% of the entire Korean Stock Exchange.

The KOSPI showed impressive gains of 5.55% for the past 3 months. This rally could be attributed to the gains in the AI sector with NVIDIA announcing a partnership with Samsung. With South Korean exports heavily reliant on the manufacturing and industries sector, especially the semi-conductor sector, we expect the KOSPI to extend it’s rally till 1H2024.

## The Korean Won

Our overall view on the Korean Won is that we believe there would be overall strength for the Won moving into 2H2024. With the expected demand of semiconductors and chips growing, the Won would be positioned in strong demand. Further coupled with the higher for longer rates, where BoK is expected to keep rates higher for a good half of 2024.

Lasty, another notable catalyst for the Won would be the inclusion of the Korean Treasury Bonds (KTB) into the WGBI Index. This inclusion would signify the recognition of the KTB and potentially attract a huge inflow of foreign investments driving up the Won demand.

**Figure 7: CHFKRW**

*Source: Tradingview.com*

## Trade Idea: Short CHFKRW

We propose a short CHF/KRW trade idea. With a higher for longer narrative by the BoK, policy rates are expected to remain high for the first half of 2024. Since the SNB initiated the first rate cut in March 2024, this could mark the start of more rate cuts, potentially increasing the interest rate disparity.

Additionally, with a positive economic growth forecast for 2024, the potential growth in demand for Korea exports would directly translate to a stronger demand for the Korean Won.

Catalyst

A stronger and more sustainable rebound in the global semiconductor industry could lead to an overall increase in demand for such exports. This would greatly benefit the export reliant country, solidifying the demand for the Korean Won.

An upward revision could be possible with the decrease in trade balance, potentially leading to a stronger Korean economy.

Risk

An uncontrollable increase in household debt could pose a serious risk to the Korean economy. Coupled with a volatile housing market, this could potentially spell a higher degree of risk and uncertainty.

The BoK could be forced to adjust the key policy rates in the wake of the upwards development of the household debt. This could wane demand for the Korean Won.

Trade

**Entry: 1498.00**
**Take Profit: 1444.44**
**Stop Loss: 1536.00**
**Risk-Reward Ratio: 1.41**

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NUS INVESTMENT SOCIETY

Global Macro Department –Hong Kong (Overweight)

Date: 22nd April 2024

**Tok Ee Zen**
Global Macro Analyst
e1155518@u.nus.edu

**Basic Information**

| | |
|---|---|
| Real GDP (USD) | 365.6 billion |
| M2 (USD) | $218b |
| CPI | 107.1 |
| PPI | 113.8 |
| Con. Confidence | 70.6 |
| Stock Index | HSI |
| Currency | HKD |

**Chart info**

## Overview of the Hong Kong Economy

- GDP by sector: 0.1% Agriculture, 6.2% Industry, 93.7% Services
- GDP by component: 68.03% Personal Consumption Expenditure
- (P/CE), 17.24% Business Investments, 12.24% Government Spending, -3.25% Net Imports
- The services sector, especially financial services, is the main driver in the Hong Kong economy
- Hong Kong is a trade-dependent economy and is highly dependent on China as its main trading partner. China accounts for 62% of Hong Kong's exports and 49% of Hong Kong's imports

## Summary of events in the past 6 months

Disappointing Economic Growth

- While the resurgence in tourism from mainland China gave the Hong Kong economy a much-needed boost in 1H2023, the full-year growth of Hong Kong fell short of expectations.
- This is primarily due to the sharp tightening in monetary conditions as Hong Kong's monetary policy follows that of the US.
- The tighter financial conditions has weighed heavily on domestic demand and consumption, especially as higher debt servicing costs cause consumers to forgo large ticket items.

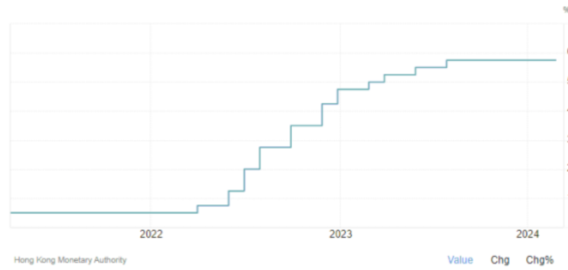
Housing Woes

- Gone are the days of Hong Kong's peak in housing prices back in the late 2010s as Hong Kong's property market stagnates throughout 2023.
- Property prices are down 20% over the past two years and land lease sales have fallen significantly, reaching their lowest levels since 2009.
- The property market slump comes as a result of high mortgage rates, as the Hong Kong Monetary Authority (HKMA's) hiked interest rates in tandem with the US Federal Reserve.
- The Hong Kong government scrapped all property cooling measures in a bid to revitalise the housing market, which has resulted in a greater number of home sales, but prices remain subdued

Ballooning Deficits

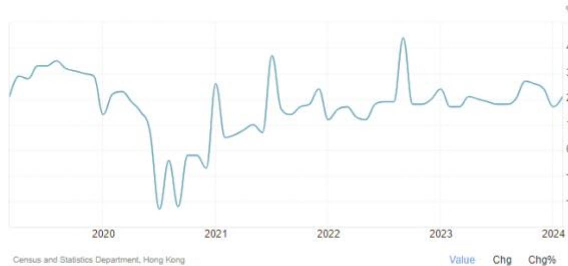
- Amid COVID-19 and travel restrictions, Hong Kong's government had seen been running on a budget deficit for four of the past five years. The city state posted a deficit of $12.98 billion USD for FY23/24.
- Hong Kong has pledged a goal to reduce the budget deficit and restore fiscal balance, though a specific timeframe was not specified.

**Figure 1: Hong Kong's Interest Rate**



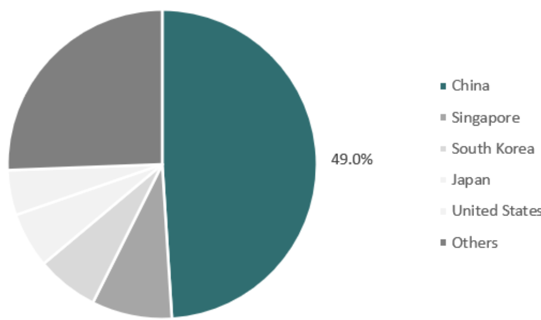

*Source: Trading Economics*

**Figure 2: Hong Kong CPI Inflation (5 year)**



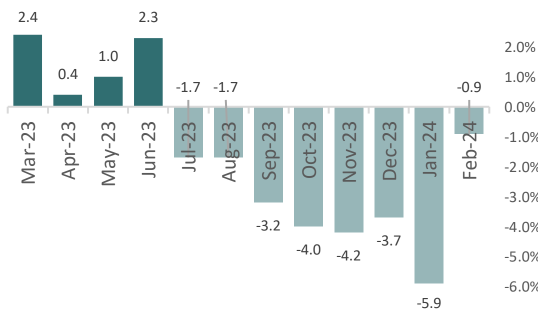

*Source: Trading Economics*

**Figure 3: Hong Kong Imports from China**




*Source: Trading Economics*

**Figure 4: China Food Inflation**




*Source: Trading Economics*

**Figure 5: HKD Movements against the Yuan**

## Monetary Policy: A Stronger HKD

With the Hong Kong dollar pegged to the US dollar through the Linked Exchange Rate System since 1983, the Hong Kong Monetary Authority (HKMA) has shifted its monetary policy in tandem with the US Federal Reserves'. This can be seen with HKMA's rapid rate hike to 5.75% (Fig. 1), its highest level since 2007.

While the US amongst other countries have been struggling with high inflation, CPI inflation within Hong Kong has remained mild, with its highest inflation rates hitting a mere 4.4% in 2022 (Fig. 2)

This trend of mild inflation can be attributed to high interest rates, but more importantly, they are the result of Hong Kong's heavy imports of food and core consumer items from China (Fig. 3) While global food prices has seen significant inflation due to the Ukraine-Russia conflict and erratic weather patterns globally, China's food prices have instead slid into deflation over the same period (Fig. 4). Additionally, due to the currency peg, the increasing US dollar strength has resulted in a stronger HKD as well, allowing the HKD to appreciate against the yuan (Fig. 5). This has made importing items from China cheaper, contributing to the minimal inflationary pressures in the city state.

The stronger HKD, coupled with rising household income and increased tourism numbers has bode well for Hong Kong's local consumption over 2H 2023 and into 2024. Local consumption numbers were strong throughout 2023, with it reaching nearly reaching pre-pandemic levels during Q4 2023 where domestic consumption hit a peak of 510 billion HKD ($65.1 billion USD).

Despite this, optimism for the recovery of Hong Kong's tourism sector seems to be waning moving forward as consumer confidence weakens as higher interest rates outweigh the benefits of a stronger HKD. Additionally, as the Hang Seng Index remains sluggish, Hong Kong's growth momentum seems to be slowing.

<u>Sluggish Stock Market. No More?</u>

Hong Kong has always been seen as a strong competitor to Singapore as a financial hub. However, due to increasing geopolitical uncertainties and the high interest rate environment, Hong Kong's status might be slipping.

For 4 consecutive years, the Hang Seng Index has seen losses Y-o-Y with it currently sitting at 10-year lows (Fig. 7). Further, IPO activity at the Hong Kong Exchange and Clearing Markets (HKEX) has seen issuing volume drop to 8-year lows, reaching a mere $5.91 billion USD in 2023 (Figure 8). Confidence in the Hong Kong stock market has plunged significantly over the past 4 years, due to a variety of reasons mainly stemming from China.

However, there seems to be a reversal in this trend for IPO activity as HKEX expects at least 90 IPOs to raise $12.8 billion USD for 2024. The exchange is aiming to enhance interconnectivity with the Middle East and its associated projects to fuel IPO deals. In addition, spin-off companies from mainland Chinese conglomerates have also contributed to IPO activities with notable examples being Cainiao's IPO after spinning off from Alibaba Group.

<u>Higher for longer – until when?</u>

The HKMA has hiked rates in tandem with the US Federal Reserve looking to negate any incentives for carry trades and to maintain the USD/HKD peg

*Source: Trading Economics*

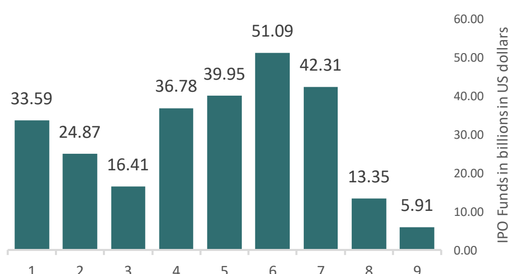
**Figure 6: Hong Kong Consumer Spending**

*Source: Trading Economics*

**Figure 7: Monthly Chart of HSI**

*Source: Tradingview*

**Figure 8: HKEX IPO Volumes**




*Source: Trading Economics*

**Figure 9: HIBOR Rate**

within the 7.75-7.85 range. The interbank rates (HIBOR) have increased accordingly, with the overnight rate climbing to highs of 5.76% in Sep 2023, before lowering back down to 4.6% in April 2024 (Figure 9)

US markets and the Fed have been flirting with the idea of multiple rate cuts first in Q4 2023, then early 2024. The Fed's dot plots have also indicated a much slower rate cut process, with
However, there seems to be a reversal in this trend for IPO activity as HKEX expects at least 90 IPOs to raise $12.8 billion USD for 2024. The exchange is aiming to enhance interconnectivity with the Middle East and its associated projects to fuel IPO deals. In addition, spin-off companies from mainland Chinese conglomerates have also contributed to IPO activities with notable examples being Cainiao's IPO after spinning off from Alibaba Group.

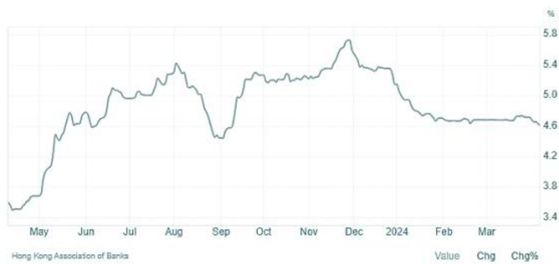
## Fiscal Policy: Road to Surplus

The Hong Kong government has a long track record of fiscal discipline, with debt-to-GDP ratios remaining under 3% since 2018. This is strong culture of saving for the rainy season paid off as Hong Kong was forced to increase expenditure amid the COVID-19 pandemic (Fig. 10). However, as Hong Kong grappled with a weaker economy and lower land sales coming out of the pandemic restrictions, tax revenues remain subdued. Revenues from land sales in Hong Kong were much lower than expectations in FY23/24, with it being only $2.48 billion USD compared to the originally estimated $8.38 billion USD.

However, Hong Kong's government officials do not seem too bothered by the debt-to-GDP ratios given that the city's current ratio only stood at 4.3%. Instead, some argue that Hong Kong could be more progressive with taking on debt, allowing the debt-to-GDP to increase up to 10% so long as it is to fund infrastructure and land creation projects. Afterall, such projects would in turn generate societal and economic benefits that more than pay off the initial capital. Ultimately, Hong Kong's fiscal policy hinges on its ability to raise land sales back to pre-pandemic levels to restore balance.

## Merging into the Mainland

Since the 2019-2020 Hong Kong protests, China's officials have had an increasing say in the decisions that are made by Hong Kong. This can be seen in the introduction of the National Security Law as well as the selection of John Lee as the Chief Executive of Hong Kong in July 2022. There have also been other efforts by Beijing to further integrate Hong Kong into the mainland. These efforts manifest themselves not just in terms of increased backing to join national level research and development projects, but also in terms of multi-billion dollar residential and infrastructure projects that physically connects Hong Kong to the mainland. The flagship Northern Metropolis project which has cost Hong Kong taxpayers some $13 billion USD thus far, is a residential development along the Shenzhen-Hong Kong border spanning nearly 75,000 acres.
While these plans to bring Hong Kong into the mainland are well within China's rights, critics have called into question the validity of the "one country, two systems" agreement in light of such efforts especially when Hong Kong has historically served as an intermediary between western capital and the mainland.

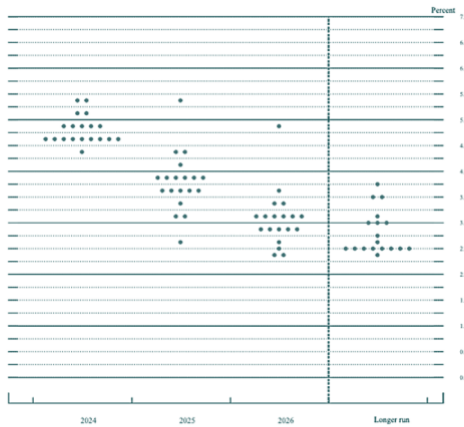



*Source: Trading Economics*

**Figure 10: Hong Kong's Budget Surplus And Deficits**

*Source: SCMP*

**Figure 11: Fed's March Dot plot**




*Source: Trading Economics*

This increasingly close relationship between Hong Kong and China means that Hong Kong's economic growth will become gradually more dependent on that of China's which investors may not appreciate.

**Figure 12: Monthly Chart of Hang Seng Index**

*Source: Trading View*

## Trade Idea: Short Hang Seng Index (HSI)

Narrative

Based on our above fundamental analysis, the two main drivers of our trade idea are the slow recovery of the Hong Kong economy as well as delayed cuts to interest rates by the HKMA. We believe that the Hang Seng Index will be on a downtrend over the next 3 months.

For the former, despite the improved performance of Hong Kong's GDP and economic performance in 2H2023 and better-than-expected Chinese PMI numbers, we maintain a bearish outlook on the recovery of the Hong Kong economy. We believe that as the Chinese holiday season has ended, Hong Kong is likely to see retail sales and domestic spending remain the same, if not decline moving into Q2 2024. Falling consumer spending combined with the slowing Chinese economy does not bode well for the stock market index. Furthermore, while there have been plans by both the Hong Kong and Chinese government to boost the stock market, we believe that these plans will introduce more volatility into our trade over the coming quarter rather than fundamentally altering our analysis.

As for the latter, the US Federal Reserve has maintained a "data-dependent" outlook on rate cuts thus far with most board members forecasting 2-3 rate cuts (Fig. 11). Further, as the possibility of a June rate cut drops to 56.1%, we foresee that the HKMA will only cut rates in 2H2024 at the earliest, meaning that Hong Kong will most likely remain under this high interest rate environment for the next quarter. As high interest rates continue to dampen company growth and profit margins, it is likely that the Hang Seng Index will continue its downtrend (Fig. 12)

Catalysts

A decline in consumer sentiment and demand, especially in China will be an important catalyst.

A sharp decline in either will put greater pressure on Hong Kong's economy as both are currently the main drivers of its growth as we have seen in our fundamental analysis above. Either of these declining would imply that the better-than-expected numbers were due to the Feb to March holiday seasonality rather than a systemic improvement in Hong Kong's economy.

While arguments can be made that China's March PMI and inflation numbers have grown into expansionary territory and indicates a shift in trend towards a growing economy, we are unconvinced of this given that it is only a single

data point and the coincidence of these numbers with the Chinese holiday season.

Given so, we expect the HIS to experience increased volatility and another round of selloffs over Q2 2024.

Technicals

Taking entry at its current support level, the stop loss is set at the 17500 while take profit is set at the 15000 psychological barrier. From the RSI level, the HSI is trending upwards towards overbought territory and signalling increased optimism which we are betting against. Our risk reward ratio is 2.125 for this trade.

**Entry: 16700**
**Take Profit: 15000**
**Stop Loss: 17500**
**Risk Reward Ratio: 2.125**

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**Basic Information**

| | |
|---|---|
| Real GDP (USD) | 1.277 trillion |
| M2 (USD) | $1901b |
| CPI | 107.26 |
| PPI | 109.42 |
| Con. Confidence | 73.51 |
| Stock Index | TAIEX |
| Currency | TWD |

**Chart info**

- Taiwan has a population of 23.9 million people and is the 20th largest in the world based on nominal GDP.
- GDP per sector: 1.8% Agriculture, 36% Industry, 62.1% Services. Main contributors in the service sectors are hospitality, Information Technology (IT) and retail sales.
- Central Bank of the Republic of China (CBC) is the central bank of Taiwan.
- Taiwan is a heavily trade reliant country, with international trade constituting 111.25% of nominal GDP (64.63% exports, 47.17% imports). Taiwan's top exports include semiconductors, petrochemicals, electronics, and automobile parts. Brazil's top imports include natural gas, steel and refined chemicals.
- Domestic spending constitutes 46.50% of GDP, thus a strong currency has helped limit the yearly inflation to 3% compared to the rest of the globe over the past 2 years.
- Main trading partners: China (35.2%), ASEAN (17.6%), United States (15.7%)

## Summary of events in the past 6 months

Cross-Strait Tensions

- Cross-Strait tensions have remained high with China expanding its military exercises near Taiwan resulting in near-daily incursions into Taiwanese airspace by China.
- While such tensions remain ever-present, the CBC made a rare move to reassure investors back that there were no signs of panic outflows back in Jan 2024.

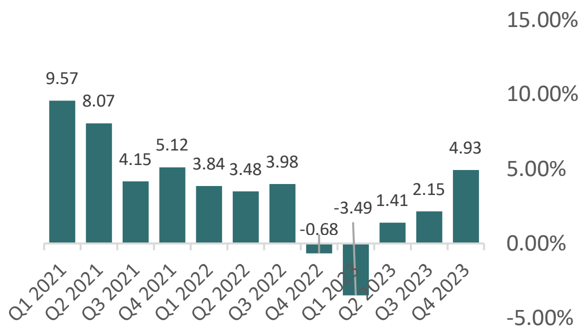
DPP Remains in Power

- Taiwan held elections for its presidency in Jan 2024, with William Lai, the Democratic Progressive Party's (DPP) candidate ultimately coming up on top against Hou Yu-ih from the more China-friendly Kuomintang (KMT).
- Taiwan saw large capital outflows amidst the election period, likely due to the near-term risks of the elections and tensions with China.

Historic Earthquake

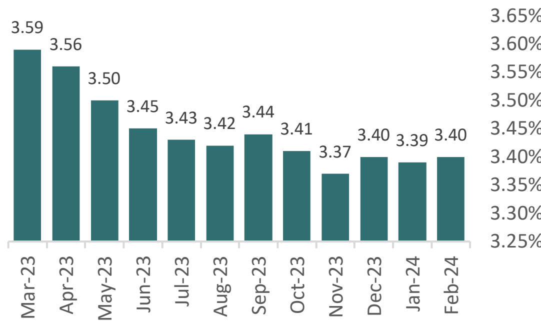
- Taiwan was hit with a 7.4 magnitude earthquake off its east coast, with the city of Hualien at its epicentre. Nearby factories and most notably, TSMC's foundry were evacuated.
- Markets shrugged it off as the earthquakes were unlikely to have significant impacts on the global electronics supply chain.

**Figure 1: Taiwan's Annual GDP Growth Rate (Y-o-Y)**



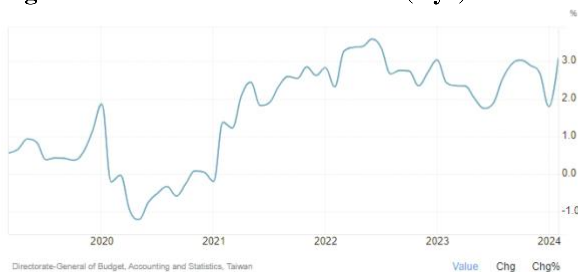

*Source: Trading Economics*

**Figure 2: Taiwan's Unemployment Rate**




*Source: Trading Economics*

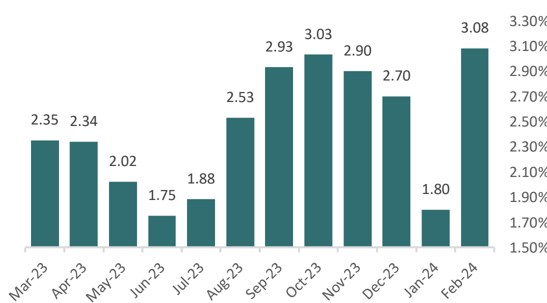
**Figure 3: Taiwanese Inflation Rate (5 yr)**




*https://tradingeconomics.com/taiwan/inflation-cpi*

*Source: Trading Economics*

**Figure 4: Taiwanese Inflation Rate (1 yr)**




*Source: Trading Economics*

**Figure 5: Taiwan Wage Growth**

## Taiwan's Recovery

After GDP growth sunk to a 14-year low in Q1 2023, Taiwan has seen consistent growth year-on-year over the rest of 2023. This recovery has been driven by a rebound in exports and strong domestic consumption.

<u>GDP growth</u>

From Fig.1, Taiwan has seen strong economic growth since Q2 2023, hitting a peak of 4.93% in Q4. Q4's GDP growth, which beat forecasts, was attributed to two main factors: trade and domestic consumption.

Taiwan's Department of Statistics, the Directorate General of Budget, Accounting and Statistics (DGBAS), attributed the surprising growth to an end-of-year spending spree that saw Q4 revenues for the retail and F&B industry rise by 4.42% and 8.88% year-on-year respectively.

Riding on the coattails of the AI hype and other electronics, the demand for Taiwanese electronic components, information communication as well as audio and visual products have grown, adding to Taiwan's strong GDP numbers.

<u>Unemployment rate</u>

The labour market (Fig. 2) has remained tight and unemployment has been on a slight downtrend since Q2 2023. The seasonally adjusted unemployment rate in Nov 2023 hit a five-year low of 3.37%.

## Monetary Policy – a hawkish stance

Despite the rest of the world experiencing high bouts of inflation for the past one to two years, Taiwan has managed to keep its inflation rate around 3% and below (Fig. 3). This is primarily through slower wage growth (Fig. 5) which has in turn allowed for lower CPI inflation.

However, Feb 2023 saw a jump with CPI inflation hitting 3.08% (Fig. 4), a 19-month high due to higher food prices during the Lunar New Year holiday. Inflationary woes were further fuelled by plans to raise electricity rates by an average of 11% in April to September.

In a bid to pre-emptively curb inflation and expected inflation in the coming months, the CBC surprised markets by hiking interest rates to 2.0% during their latest March meeting. The 12.5 basis point increase in interest rates brought the key rate to its highest since 2008, though the surprise hike seems to be a once-off event rather than the start of a rate hike cycle going forward.

The CBC, in contrast to the Federal Reserve, does not put out forward guidance. However, the CBC's Governor Yang indicated that rates will remain at their current levels, barring any major changes to inflation.

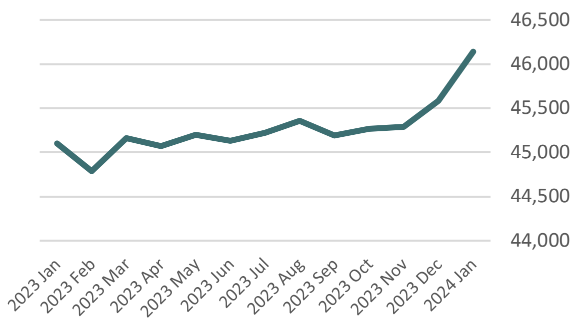
<u>Taiwanese weakness against the Greenback</u>

Despite encouraging exports since Q2 2023 into Q1 2024, the Taiwanese Dollar has depreciated significantly against the Greenback (Fig. 6).

The depreciation of TWD can be attributed to two main factors: unfavourable interest rate spreads and the Fed's delayed interest rate cuts.

The CBC's interest rates being kept at 2.0% and below since the start of the year, making it one of the lowest in the APAC region. The low interest rate combined with heightened geopolitical risk along the strait has caused investors to seek better risk-adjusted opportunities elsewhere. The interest rate spread between TWD and other safe haven currencies such as the USD is hence seen as unfavourable. As investors sell off Taiwanese assets, we have seen an accompanying depreciation of TWD.

The Fed's delayed interest rate cuts has also played a huge factor in the relative depreciation of TWD. Though markets anticipated rate cuts to begin in 2024, we have seen the Fed delay and scale back its benchmark federal funds target rate for 2024 amid sticky CPI inflation in the US. The latest Federal Reserve Dot Plot shows the majority of officials expecting 2 to 3 rate cuts for 2024. This is in stark contrast to the 4 to 5 rate cuts expected by officials back in September 2023. As such, as markets start to




*Source: Bloomberg*

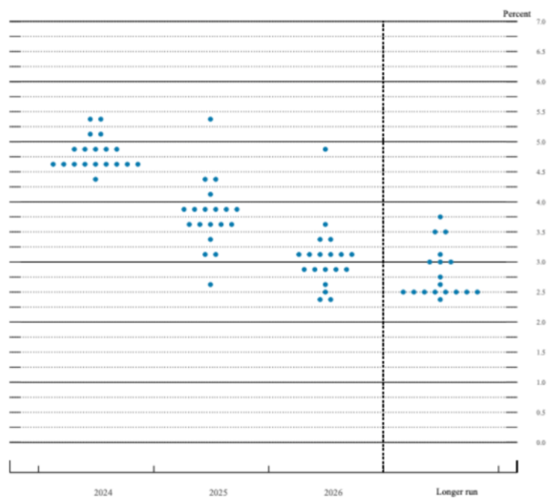
**Figure 6: USD/TWD Rates**

*Source: Trading Economics*

**Figure 7: Correlation between Interest Rate Spread vs USD/TWD**

*Source: Refinitiv*

**Figure 8: Federal Reserve's Dot Plot (March 2024)**




*Source: Trading Economics*

**Figure 9: Foreign Direct Investment (FDI) into Taiwan**

accept the Fed's "higher for longer" rhetoric, the dollar has exhibited modest strength against TWD, resulting in a higher USD/TWD rate.

As the interest rate spread is correlated with the USD/TWD (Fig. 7), we have seen how both factors have led to a relatively weaker TWD, resulting in the spike in the USD/TWD exchange rate this year. However, we foresee little upside to the strength of the dollar and are expecting a reversal in USD/TWD rates.

## Foreign Investment Into Taiwan

With the aim of luring back overseas capital for investment in Taiwan, the government launched three major action plans back in 2019: the Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan, Action Plan for Accelerated Investment by Domestic Corporations, and Action Plan for Accelerated Investment by SMEs.

The government's major action plans have successfully increased foreign direct investment (FDI) into the country, with capital inflows consistently higher after the launch of the three action plans in 2019 (Fig. 9). These plans are expected to bring in $7.35 billion USD worth of investment into Taiwan in 2024.

Many of these investments are within the country's semiconductor industry, which Taiwan leads the world in. Semiconductor equipment giants such as ASML and Applied Materials have made great investments in Taiwan, boosting Taiwan's ability to further capture a larger part of the semiconductor supply chain.

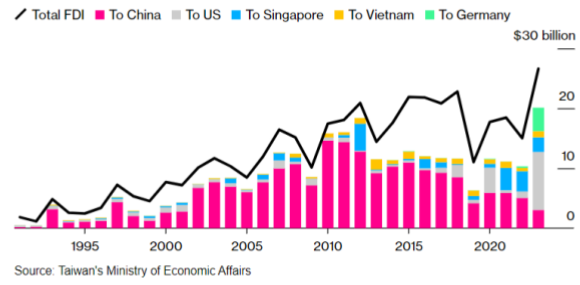
However, this concentration of the global semiconductor supply chain in Taiwan has raised concerns especially considering the recent earthquakes off the east coast of Taiwan and growing cross-strait tensions. To this end, Taiwan has seen investments into foreign countries beyond China soar (Fig. 10). The most obvious of these investments would be TSMC's new Arizona and Dresden plants, which are in the US and Germany respectively.

The Taiwanese government has also launched the New Southbound Initiative which aims to enhance cooperation and exchange between Taiwan and 18 other Southeast Asian and Australasia countries. As US-China's chip war starts to heat up, Taiwan is seeking to reduce its own reliance on the giant across the strait, all while deepening engagement and cooperation with countries around the world. This is especially important given the ability of China to coerce small countries to cut ties with Taiwan. The Taiwanese government faced this stark reminder as Nauru switched diplomatic recognition from Taiwan to China, prompted by China in response to the DPP's victory earlier this year.

Therefore, while Taiwan's economy has seen strong growth and encouraging exports, the economy at large still faces surmountable geopolitical challenges. It remains to be seen how the new Taiwanese government led by Lai will tackle these challenges, and how markets will respond.

*Source: CEIC Data*

**Figure 10: Taiwan Investment into Foreign Countries**




*Source: Bloomberg*

**Figure 11: Monthly Chart of USD/TWD**

*Source: Trading View*

## Trade Idea: Short USD/TWD

<u>Narrative</u>

Based on our above fundamental analysis, we believe the Taiwanese Dollar will be on a term uptrend against the US Dollar over the next 3 months. As Taiwan's exports and domestic demand remains strong, the USD/TWD rate will largely be determined by the US dollar strength. Taiwan's exports have seen encouraging growth boosted by the AI hype as well as better-than-expected PMI numbers from China.

Additionally, despite US growth and labour market running hot, we see minimal upside to the Greenback's strength. The market consensus is two to three rate cuts by the end of 2024, meaning that the hotter US economy is not likely to further add to the dollar's strength. As the Federal Reserve remains hesitant to cut rates given the surprisingly resilient economy, rate hikes are still off the table. This means that the interest rate differential between the USD and TWD are likely to remain as it is if not smaller if the Fed cuts or the CBC hikes within the next 3 months.

In either case, we foresee TWD gaining against the Greenback over the coming quarter.

<u>Catalysts</u>

We are expecting the Chinese demand of Taiwanese exports to be sustained and grow over the next quarter. As China grapples with its domestic housing market crisis and chip war with the US, we expect to see a surge in China's demand of electronic components from Taiwan. This would be in a bid to develop its own domestic chip manufacturing supply chain as well as to feed its growing EV production market.

This surge in demand for Taiwanese exports will in turn generate demand for TWD, catalysing its appreciation against the Greenback.

<u>Technicals</u>

The price of TWD broke the psychological barrier of 32.0, with that serving as the current resistance level. From the RSI level, USD/TWD is in overbought territory, indicating a possible reversal in price as prices continue to encounter the 33.0 barrier. My profit taking and stop loss areas would be 30.3 and 33.0 which are also areas of support and resistance respectively. Our risk reward ratio is 1.84 for this trade.

**Entry: 32.05**
**Take Profit: 30.3**
**Stop Loss: 33.0**
**Risk Reward Ratio: 1.84**

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