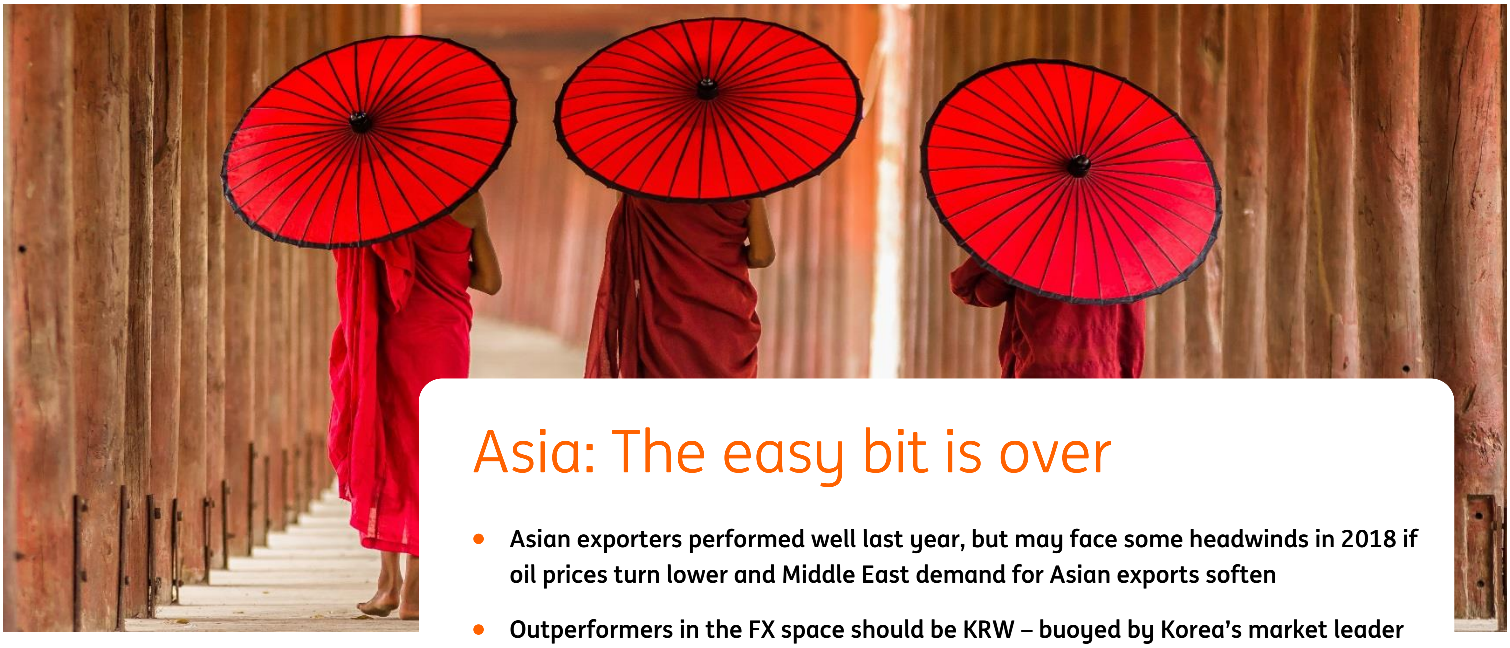


Asia: The easy bit is over

- **Asian exporters performed well last year, but may face some headwinds in 2018 if oil prices turn lower and Middle East demand for Asian exports soften**
- **Outperformers in the FX space should be KRW – buoyed by Korea's market leader position in the semi-conductor sector. MYR should continue its recovery**
- **The INR and, in particular the PHP, should prove the underperformers as their external positions deteriorate through 2018**

Rob Carnell
Chief Economist & Head of Research, Asia-Pacific
Singapore +65 6232 6020
robert.carnell@asia.ing.com

Prakash Sakpal
Economist, Asia
Singapore +65 6232 6181
prakash.sakpal@asia.ing.com

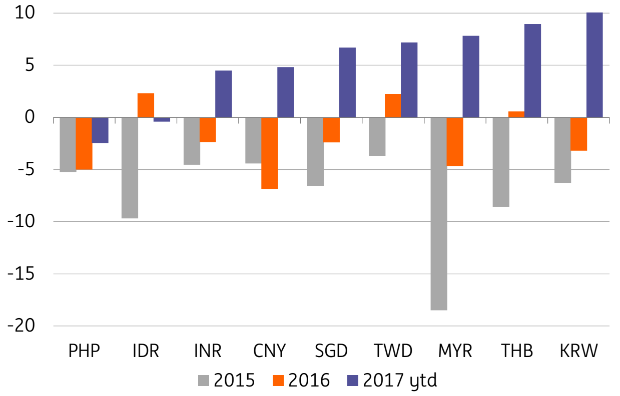
If 2016 was the year when Asian trade crashed and burned and Asian FX came under weakening pressure, 2017 for the most part was about recovery. But scratch below the surface and the positive story for 2017 was not all that it first appeared. Moreover, the very favourable backdrop for much of the year brought many factors into alignment to deliver a healthy Asian FX result. We forecast some of these factors to persist into 2018, others not. But even lacking perfect foresight, the reality is that the coming year may prove a more challenging one for Asian FX than the last one unless the stars once again come into perfect alignment. We think that is unlikely.

First crash – then recovery

Analysts spent much of the early part of 2017 talking about the Asian "export growth boom". And certainly, year-on-year export growth rates for many economies were extremely impressive. At their peak in September 2017, Korean exports, for example, hit 35%YoY. Taiwanese export growth topped 28%YoY in the same month. The reality though, was less good. 2016 saw Asian exports dip in absolute terms, the reasons for which we will return to shortly. Viewed in levels, exports in 2017 recovered to pre-2016 levels, but not much more. And having recovered the easy lost trade, the going since then has been tougher.

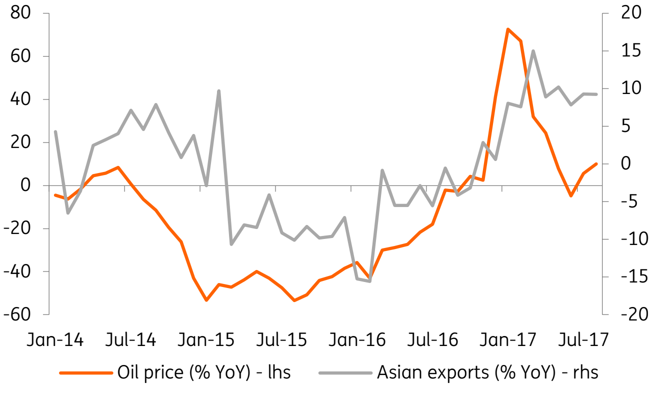
This recovery was certainly an excuse for currency firmness in 2017, but without exports breaking out into new ranges, it was not an excuse for much more. So what was going on?

Fig 1 Asian FX – 2015-17 YTD (%)



Source: Bloomberg

Fig 2 Asian exports and oil prices (%YoY)



Source: CEIC

Contrary to received wisdom, weaker oil prices did not help Asia in 2016

We believe that one of the main headwinds and tailwinds for Asian export strength over recent years has been fluctuations in the oil market. The received wisdom has much of Asia suffering during upticks in the price of oil, and certainly, some economies (most notably India) are vulnerable to high oil prices. But the collapse of oil at the end of 2014 and 2015 and stagnation in 2016 was a substantial terms-of-trade shock to the oil exporting nations, in particular the Middle East. Their collapsing purchasing power is one possible explanation for the crash in Asian and in global trade volumes. The steady firming up of oil prices since then has been a source of returning purchasing power and Asian export strength. This isn't a perfect explanation for what happened by any stretch, but we believe it does provide some insight into recent trends in Asian export demand.

Oil is likely to head back towards US$50/bbl through 2018

Forecasting oil prices is far from straightforward. But our commodity team believe that a likely failure of the OPEC supply agreement to hold, plus some further output gains from the US shale industry and structural shift in demand away from oil for the autos sector, should see crude moving back to the US$50/bbl range. This is not enough to wreck the Asian export outlook, but it does remove one source of support that was present through much of 2017. With nothing else changing, we would look for slower export growth in 2018, but possibly also some higher inflation too, bringing central bank tightening back into play.

> *"We would look for slower export growth in 2018, but possibly also some higher inflation too, bringing central bank tightening back into play"*

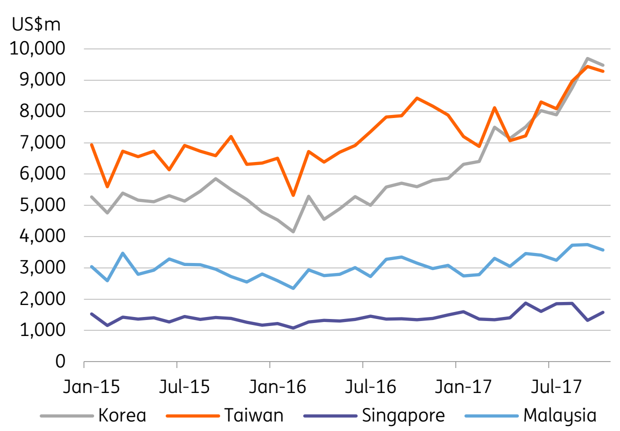
Export strength narrowly based in semi-conductors

The second element of export strength has been most clearly evident from the narrow recovery of electronics exporters, though not universally even amongst them. Electronics, and in particular, semiconductors have seen exports surge in year-on-year terms, and also in absolute levels. Our thesis is that this has been linked to the replacement cycle for some flagship mobile devices, whose production was ramped up in advance of the festive buying season in the West. So far, this strength has been concentrated in electronics parts. But for 2018, we anticipate handset exports themselves picking up as semiconductors fall back. This will provide a second leg of growth, though one that may favour end-supply-chain economies, such as China, rather than parts manufacturers, such as Korea and Taiwan. It is notable that even within the electronics space, not all economies have fared equally well, with the Singaporean electronics industry notably lagging behind.

Replacement cycle support for parts to give way to handsets in 2018

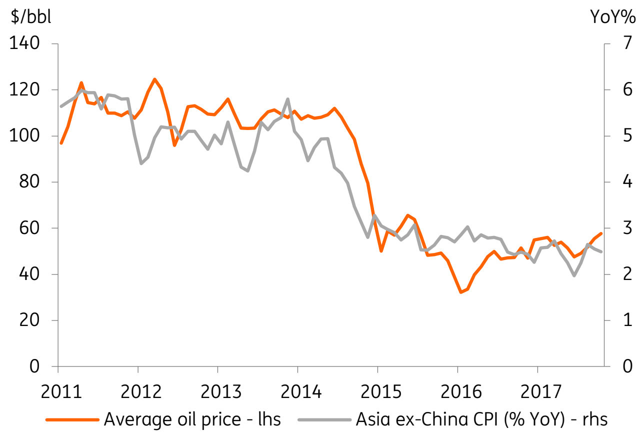
This replacement cycle story is not a straightforward one for Asian exports or FX. But if we are right, then we expect to see a rotation of export strength away from parts producers and towards end-supply chain producers, eventually losing strength overall as seasonal patterns of weaker demand re-assert themselves from 2Q18.

Fig 3 Uneven semiconductor export success



Source: CEIC

Fig 4 Oil prices and Asian inflation



Source: CEIC

Benign USD weakness persisting?

The weakness of the USD has helped keep Asian inflation and rates low...

Our FX strategy team had a good call on USD weakness during 2017. The result of this has been that Asian FX has been buoyed in terms of the USD, and with much of international trade dollar-denominated, this has kept Asian import prices and inflation rates low, and often lower than the central banks' targets.

The relevance of this is that this weak dollar background through much of 2017 provided a very benign backdrop for inflation that has enabled central banks in the region, Korea proving the very recent exception, to leave monetary policy alone.

...had the USD been strong as the Fed had hiked, Asian growth might have been considerably weaker

In a few instances, rates have even been cut further (RBI and BI). This has been an important additional tailwind, since despite the relatively good export performance (subject to the previous caveats) domestic demand has not been strong across the region. Had Asian central banks been obliged to follow the Fed, as they might have done more slavishly in the past, this weak domestic demand backdrop would have weakened still further, resulting in even more unbalanced growth.

“ Our FX strategy team had a good call on USD weakness during 2017 ”

Our FX strategy team sees further USD weakness in the coming year, based on returning capital inflows as European government yields converge on those of the US. As a result of this, we have mostly modestly stronger Asian FX against the USD during 2018.

But again, FX forecasting is a hazardous business. Even if the story is ultimately right, the timing may be off, and there are other versions of this story that see a resumption of USD strength. If that is the case, then we will need to see more and sooner Asian CB tightening of monetary policy, but possibly weaker domestic demand and not necessarily any stronger currencies against the USD.

North Asia

KRW, weakness to give way to strength relative to Taiwan and TWD...

The KRW has seen some pressure for most of 2017 from political tensions stemming from North Korea's nuclear ambitions. It is impossible to say for certain that tensions will not flare up again, resulting in some additional risk premium on the KRW. But assuming not, then of the two big electronics exporters in the region, the other being Taiwan, we see a better future for Korea and the KRW than for Taiwan and the TWD.

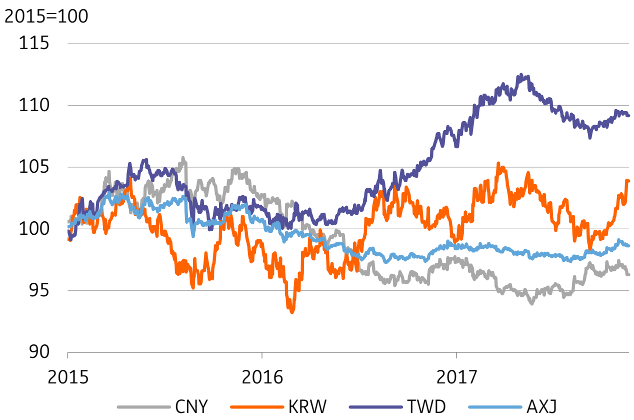
...helped by dominant semiconductor position...

In the first instance, we believe Korea's semiconductors are the market leaders in next-generation products currently in production. But it is in the domestic economy that we see the biggest differences. Whilst Taiwan's domestic demand remains very weak, South Korea's President Moon has embarked on a stimulus plan that boosts public sector jobs, social benefits and minimum wages. Whilst this does put the public sector deficit under some pressure, Korea has a relatively good starting position, and room for fiscal manoeuvre, and so is unlikely to see stimulus punished by financial markets.

“ Tighter monetary policy, and looser fiscal policy should see the KRW outperform the TWD during 2018 ”

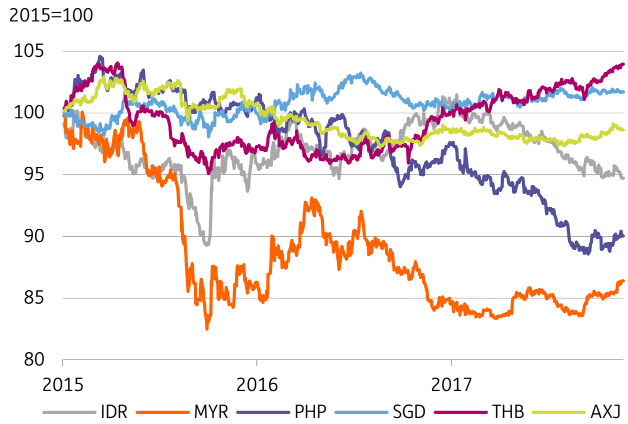
Moreover, the BoK has been one of the first central banks in Asia to resume tightening with a 25bp hike to 1.50% on November 30th. We look for another 25bp hike in 2Q18. In contrast, the Bank of China, Taiwan, will likely leave rates on hold throughout 2018 due to its very weak inflation. Tighter monetary policy, and looser fiscal policy should see the KRW outperform the TWD during 2018.

Fig 5 North Asia FX (NEERs)



Source: Bloomberg

Fig 6 SE Asia FX (NEERs)



Source: Bloomberg

SE Asia

MYR to outperform THB as former recovers lost ground whilst latter remains overvalued…

For two economies at opposite ends of the spectrum in SE Asia, you can't do much better than Malaysia and Thailand. Malaysia has growth, inflation, and an improving trade balance. The political calendar that had led us to put rate hikes on hold no longer seems to be a binding constraint to BNM and we now anticipate some tightening in 1Q18. Moreover, upcoming elections are likely to bring with them additional fiscal giveaways to spur additional growth. From a currency perspective, the MYR has a long way to go to make up the lost ground following the commodity-related currency weakness of 2015, and remains undervalued relative to other Asian FX.

…with BNM likely one of the first Asian CBs to hike in 2018

Thailand also has growth, but this is predominantly rooted in inventory accumulation, and seems unlikely to be sustainable for much longer. Moreover, its current account surplus, arguably a source of current currency strength, at double digits, is more likely a symptom of extreme domestic demand weakness and economic imbalance. Having been one of the strongest currencies in the region, the THB has also kept inflation subdued at under 1%, meaning that the BoT will not be required to hike rates at all in 2018 in all likelihood. With considerable THB overvaluation to unwind, and little in terms of monetary or fiscal policy to support the THB, we expect to see the MYR outperform the THB this year.

> *“For two economies at opposite ends of the spectrum in SE Asia, you can't do much better than Malaysia and Thailand”*

India

A sudden reversal of fortune for the INR

The Indian economy continues to feel ripple effects on private spending and GDP growth from the demonetisation that took place at the end of 2016, and to the uncertainty stemming from the implementation of the Goods and Services Tax in July last year. Nonetheless, the net result was good for local financial markets and the Indian rupee (INR) until August, with a 22% rally in the BSE Sensex stock index and 6% appreciation in the INR against the USD from the start of 2017. A spate of bad economic news thereafter, of slowing growth, rising inflation and likely fiscal slippages caused a sudden reversal of fortune for the INR.

Moody's update comes at a right time

Structural reforms have gained traction under the current administration. The announcement of an INR2.11tr (US$32bn) recapitalisation plan for public sector banks over the next two years is the latest measure. As a vote of confidence, Moody's recently delivered the first sovereign rating upgrade in 14 years, to Baa2, reducing some stress on local markets. The euphoria, however, has been short-lived, with the INR and government bond returning to weakening trends.

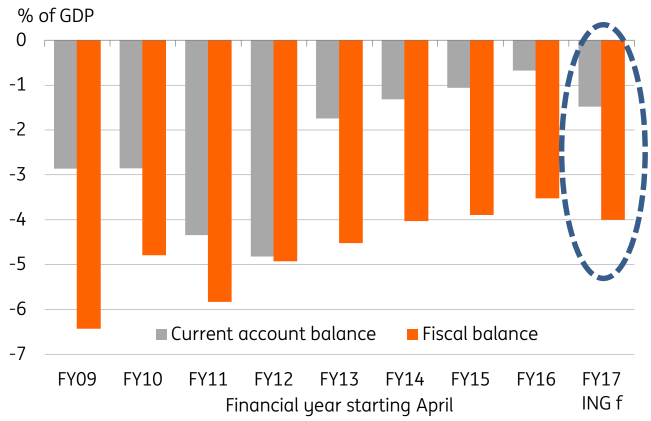
Little to no scope for macro policy stimulus in 2018

GDP growth is likely to remain below potential over the rest of the FY2017/18 (financial year runs from April to March) and well into the next financial year. We also expect inflation to continue to grind upward due to a rising global oil price, the weaker INR and wider fiscal deficit. The risk of a twin deficit (fiscal and current account) has resurfaced. There will be little to no scope for increased fiscal or monetary policy accommodation to support growth in the near term. The announcement of the FY2018/19 Budget in February 2018 will be a key event risk, a delicate act for the government to raise spending before elections in 2019 without pressuring fiscal deficits.

65.0-6.5 USD/INR trading range for 2018

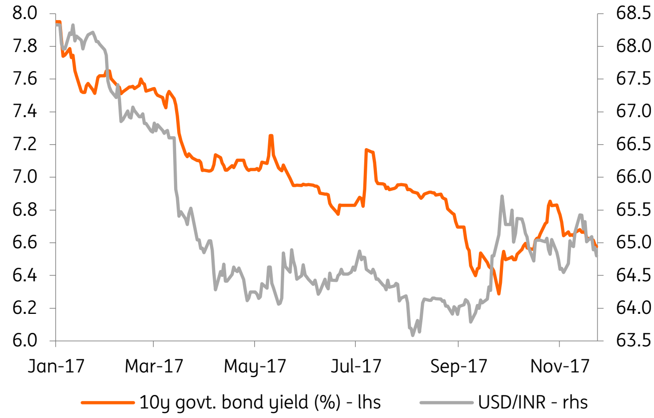
We think the RBI will remain cautious on inflation as global oil prices edge higher, while the weak INR and fiscal slippages complicate policy making. We forecast on-hold RBI policy through 2018 and a 64-66 USD/INR trading range for 2018.

Fig 7 Re-emergence of twin deficit issue



Source: CEIC, ING

Fig 8 Stalled rally in government bonds and USD/INR



Source: Bloomberg, ING

The Philippines

Joey Cuyegkeng
Senior Economist, Philippines
Manila +63 2 479 8855
joey.cuyegkeng@asia.ing.com

We see the Philippine Peso (PHP) as the clear under-performer in the region – largely as the Balance of Payments continue to deteriorate. USD/PHP could trade as high as 53.

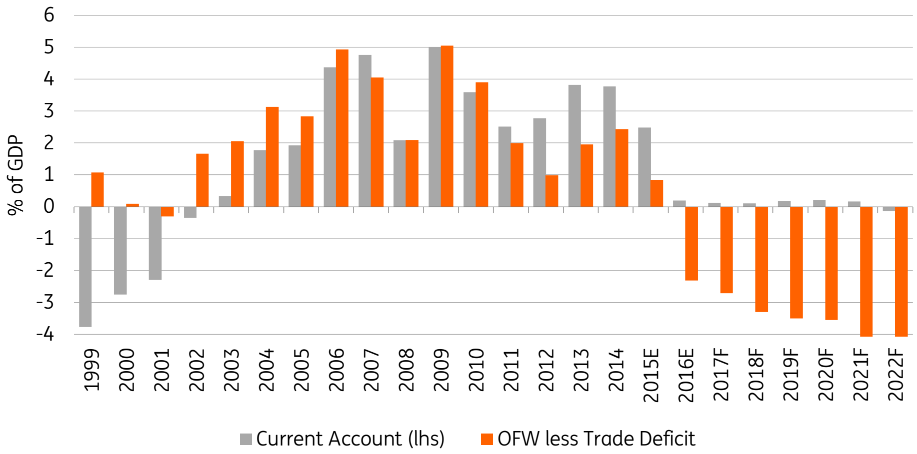
The cycle of imports of capital equipment is likely on an uptrend in 2018 from last year's slow growth. This comes after two years of strong growth in 2015 at 19% growth rate and 2016 at robust 48% increase. Domestic demand would continue to bring about higher import growth in 2018 once the government's ambitious infrastructure programme gets underway in early 2018.

Overseas Filipino Worker remittances, which in the past have more than financed the wider trade deficit would be unlikely to cover the further deterioration of the trade deficit in 2018 and 2019.

" USD/PHP could trade as high as 53 "

Pressures on outsourcing revenues continue with headways made in artificial intelligence and in the near term increased competition from other Asian outsourcing sites. These inflows together called structural inflows would barely cover the trade deficit and bring about sustained pressure on the current account. The central bank expects the current account to post a mild deficit in 2017 and 2018 after 15 years of surpluses. This economic fundamental drives our weak PHP forecast. Local political developments had contributed to some weakness of PHP in the last 12-18 months. We expect uncertainties to persist and keep investors cautious.

Fig 9 Philippine external position deteriorates



Source: ING

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank NV ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group NV and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

 The producing legal entity ING Bank NV is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank NV is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank NV, London Branch. ING Bank NV, London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank NV, London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA.

For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.