India and Southeast Asia: Country by Country Outlook

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India Outlook

India's growth rate accelerated to 8.2% in the second quarter of 2018 as the shocks from demonetization and the imposition of the Goods and Services Tax (GST) wore off, supported by inventory restocking and a low base of comparison. The principal drivers of growth were government and private spending. Investment remains anaemic on modest corporate credit growth as the banking sector's balance sheet repair remains a work in progress.

Inflation accelerated as the output gap narrowed and will get an additional boost as the impact of the Minimum Support Price (MSP) hike filters through, while higher oil prices (and the impact of the Iran sanctions) push the current account into a wider deficit. In response to pressure added by Emerging Market volatility, the Reserve Bank of India (RBI) hiked rates. Despite this, the U.S. dollar (USD)/Indian rupee (INR) rate rose to a historical high of 72. RBI policymakers have shown tolerance for a weaker currency, providing a shock absorber for the external account while preserving international reserves and improving manufacturing competitiveness. In the near term, India's economic growth may be mixed but should improve after the 2019 national election when there should be less political uncertainty.

Equity returns have been resilient amid net foreign outflows. The deepening local investor pool has responded to the government's policy reforms (GST, bankruptcy law, state bank recapitalization) and sustained earnings growth momentum. Equity valuations have thus re-rated to the high end of the past five-year range.

Key risks are: 1) higher oil prices, putting pressure on the current account deficit, inflation and compromising fiscal stability; and 2) election outcomes, since a change in government to a less stable coalition could deflate Indian valuation premiums.

Indonesia Outlook

The macro environment has improved steadily this year, with GDP growth reaching 5.3% in 2Q18 as private domestic demand rebounded. The improvement in growth momentum, however, was interrupted by a bout of external volatility related to Turkey. The central bank has raised interest rates by 125 basis points (1.25%) since May, making Indonesian rupiah (IDR) assets more attractive to investors and dampening IDR volatility, but also pushing borrowing costs higher. Fiscal policy will also tighten in 2019, as the government moves toward a balanced primary budget in 2020. Inflation has moderated and should ease going forward, providing support to low-income purchasing power.

Political noise around the upcoming presidential election is expected to increase, but presidential ticket nominations have eased concerns of a drawn-out campaign with only two tickets—those of President Jokowi and Opposition candidate Prabowo Subianto. Jokowi's choice of a senior Muslim cleric as VP candidate should help to deflect extremist racial and religious attacks seen in the 2017 Jakarta gubernatorial election, reducing potential volatility during the campaign.

The Indonesian stock market has struggled so far in 2018, with the Jakarta Stock Exchange Composite Index down 16.5% YTD as of September 18 in U.S. dollar terms. Underperformance has been due in part to IDR depreciation, as the unwinding of developed market monetary stimulus and rising U.S. rates has spurred portfolio outflows, leading investors to focus on the vulnerability of current account deficit (CAD) economies such as Indonesia. IDR depreciation is a potential near-term headwind for corporate earnings, as many Indonesian corporations rely on imports as their input costs. Valuations are at 13.9X forward price-to-earnings (P/E), below the average of the past five years.

Key risks are: 1) higher oil prices leading to wider CAD, higher inflation and/or loss of fiscal stability; 2) a sharp reduction in foreign holdings of local currency bonds (bond yields are correlated with P/E multiples); and 3.) a volatile parliamentary/presidential campaign that may raise risk premiums on Indonesian assets.

Thailand Outlook

Growth has accelerated over the past several quarters, with domestic demand finally hitting its stride. 2Q18 GDP was 4.6% year-over-year, with private consumption leading the way on stronger durables consumption and a bounce in farm income. This was the strongest report in the Association of Southeast Asian Nations (ASEAN) space in 2Q18. Sustained momentum from exports should continue to drive improvement in manufacturing employment and wage growth, although this will be balanced by widespread flooding that could dampen farm income growth. Encouragingly, a broad-based recovery in loan growth for the first time since 2013 points to a more sustainable growth upswing. With the closure of the output gap likely to start fueling inflationary pressures into 2019, monetary policy is likely to tighten gradually even as overall conditions remain accommodative.

Within the Asia region, Thailand has far less “external vulnerability risk.” Underlying Thailand's defensiveness are three factors: 1) a large current account surplus of around 10% of GDP (resulting in excess liquidity that is funnelled into the equity market); 2) easy monetary policy backed up by very low inflation; and 3) low foreign portfolio positioning (investors have sold a net US$14 billion of stocks over the past five years and foreigners own just 15% of local currency government bonds). Valuations reflect this resilience, with 12-month forward P/E above its five-year average and the premium to the region having risen. Nonetheless, improving domestic economic momentum and earnings growth revisions provide the potential for a return of foreign portfolio flows.

Key risks are: 1) a sharp slowdown in global trade activity; and 2) increased volatility ahead of planned elections in mid-2019.

Malaysia Outlook

Malaysia reported 2Q18 GDP growth of 4.5% year-over-year, below consensus expectations. The main driver of the weaker performance was a combination of slower exports and faster imports as external sector activity slowed against a more robust domestic consumption backdrop. With consumption likely having been front-loaded by the abolition of the unpopular GST (before being replaced with a sales and services tax in September), growth is likely to decelerate into year-end 2018, particularly as government spending will be hamstrung by weaker revenues. Increased proceeds from oil and government-linked corporations (GLC) and cuts to large infrastructure projects are necessary to fund the revenue gap, so much will depend on the trend of oil prices. A key turning point for Malaysia is when government focus shifts from the clean-up of the old political economy structure to one that shapes and supports growth in the medium term.

Following the change in government in 2Q18, the outlook for Malaysian equities will depend to a large extent on delivery of reforms that have already been partly discounted (GLCs constitute over half of Malaysia's local index market capitalization). Beyond this, Malaysia is a play on oil prices, given its status as Asia's only net exporter.

Key risks are: 1) a sharp slowdown in growth due to cancellation of Chinese-funded mega infrastructure projects and restructuring of GLCs; 2) a rise in oil prices (upside risk).

Philippines Outlook

Despite growth slowing to 6% year-over-year in the second quarter of 2018 (from 6.6% in the prior quarter), the Philippines remains the exemplar of investment-driven growth in the region. Infrastructure spending continues to ramp up, helping to drive investment to GDP to a historical high of 27.2% in the first half of 2018. Consumption has moderated due to the twin drags of inflation and tax reform, but should strengthen as overseas remittances are set to accelerate when growth in the Middle East recovers.

Amid the healthy growth story, Philippine equities have been the second-worst performers after Indonesia, due in large part to investor perceptions of a slow policy response to overheating pressures as manifested by a widening current account deficit and inflation breaking out of the upper end of the central bank's target range. Some sharp rate hikes and hawkish rhetoric, however, have improved policy credibility, while still leaving real interest rates at a significantly accommodative level. Interestingly, net FDI has increased during this period in contrast to short term portfolio outflows. Rising inflation and currency pressure remain as near-term headwinds. Underlying demand strength, meanwhile, is likely to be sufficient to absorb higher interest rates without significantly slowing the rate of growth.

With equity valuations at the low end of the five-year range and the historical premium to the region having narrowed sharply against a robust growth backdrop, the Philippines is attractive.

Key risks are: 1) continued deterioration in the CAD against a backdrop of falling FDI; and 2) political volatility stemming from potential changes in the vice presidency.

Singapore Outlook

Singapore's externally fueled growth recovery over the past two years is causing spillover effects in domestic demand. Net employment turned positive in the third quarter of 2017 and has continued to make gradual gains. Supplemented by wage growth, this is translating into more buoyant private consumption. Although the labor market has been improving, the pace is moderate, so inflationary pressures are unlikely to build very quickly. That said, Singapore's position as a regional entrepot makes it highly trade-reliant and vulnerable to disruptions caused by the developing trade conflict between the U.S. and China. Further, the central bank's recent move to cool real estate demand could slow the wider economy.

With inflation turning up, the central bank may tighten policy at its October 2018 meeting and local interest rates are rising. That said, these measures are likely to cause growth to stabilize rather than slow drastically as the household sector's net cash position is at an all-time high and any impact from global trade tensions and property-cooling measures will take time to unfold.

These concerns have already been foreshadowed in a recent sharp valuation de-rating, placing the MSCI Singapore Index at a discount to both its five-year average and relative to the MSCI World Index. The key risk to Singapore is an all-out trade war, which would undermine the external demand growth lynchpin.

Vietnam Outlook

Vietnam's economy is well-insulated from external volatility given its significant trade and services surplus annualizing nearly 18% of GDP. As well, the consolidated fiscal position has improved in 2018, on slower spending by state owned enterprises (SOEs) and increased privatization proceeds. Vietnam ran both a current account surplus of US$8.6 billion, as well as a state budget surplus in 1H18. These events contributed toward a more stable Vietnamese dong and drove international reserves to all-time highs above US$60 billion.

The strong external sector has supported domestic demand, with private consumption and investment growing at a healthy pace. Vietnam is viewed as a potential beneficiary of trade diversion and capacity relocation from China when the U.S.—China trade war runs its course. Even if the trade tensions abate, we believe that foreign direct investment (FDI) investors will continue to diversify concentration risk in China to Vietnam's benefit. In addition to improving the basic balance surplus from rising net FDI, this suggests that the income shift driven by the export sector will persist and strengthen.

Although premium valuations reflect Vietnam's elevated status among growth economies, stock market performance has weakened recently despite the strong underlying economy, with relatively high volatility due to trading activity being dominated by retail investors (around 90%). Key index bellwethers have pulled back as country ETFs have scaled back during the recent episode of Emerging Market volatility, providing a positioning opportunity for long-term growth investors.

Key risks are 1) a sharp slowdown in China and depreciation of the renminbi that would likely lead to a steep devaluation in the Vietnamese dong (as China is both a major competitor for and consumer of Vietnamese products); and 2) rising leverage, with credit/GDP now at a historic high of 130%, with the recent growth acceleration led by the private banks.

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