MEDIA STATEMENT
BY WELLIAN WIRANTO, ECONOMIST, OCBC BANK

*Demystifying the Top Market Concerns of 2014*

Kuala Lumpur, 10 March 2014 – Stepping into just the third month of the year, global markets have already seen a fair share of interesting developments year-to-date. From concerns about how the US Federal Reserve's monetary policy path would affect global economies to fear of another bout of emerging market crisis as well as renewed worries about a potential hard landing in China, there has been quite a number of 'bogeymen' lurking in the shadows, ready to spook global sentiments when markets least expect it.

We argue, however, that while these fears would inevitably bring market gyrations every now and then, they are largely unfounded and should not derail the global economy from posting a respectable recovery this year.

Wellian Wiranto, Economist, OCBC Bank

To begin with, the fear that the Fed will be hiking its interest rate from rock-bottom level soon – and potentially by a lot, as well – does not stand up to close scrutiny. The US economy is indeed recovering, but hardly at the pace that would permit Fed officials enough comfort to declare "Mission Accomplished" just yet.

For one, while the US unemployment rate has been declining rather steadily from the 10% post-Lehman crisis highs to recent lows of 6.6% or so, there are some reservations about how indicative this measure is of the fundamental strength of the jobs recovery. In particular, there is a chance that the unemployment rate has been pushed down by a large decline in labour force participation rate, so much so that the Fed has shied away from its previous dependence on this single indicator to a broader set of data for a more accurate read on the health of the US economy.

On that note, the Fed may increasingly pay more attention to how the US housing market is doing. After all, the crash in home prices was one of the main catalysts leading into the 2008 crisis, and the recent strong recovery has been one of the main fodders of strength for the economy. To that end, the mixed nature of recent housing data will be keenly watched by the US policymakers. While the latest S&P/Case-Shiller index shows that home prices are still on the rise, the pace of improvement has slowed compared to what we saw previously. Moreover, while recent wild snowstorms and such might have been the chief culprit, the drops in existing home sales and housing starts data would nevertheless make the Fed that much more cautious, as well.

All in all, there is very little impetus for the Fed to risk nipping the nascent US economic recovery in the bud by rushing things, especially given that inflation remains rather low. To be sure, the Fed is likely to continue the path of tapering that it has already begun and we see the QE3 program finishing its course by end of this year. However, the Fed will choose to tread very gingerly when it comes to the real exit from its ultra-easy monetary policy. At the end of the day, they do not want to impose an abrupt cold-turkey treatment for an US economy that has gotten so used to so much liquidity, for so long. Rates will go up, but not until mid-2015 and even then by just small magnitudes rather than huge jumps that some have feared.

Having said that, even as we argue that US rate hikes will not happen any time soon, every time the US data improves unexpectedly, there is always the risk that EM assets might get hit by capital outflow concerns. However, it is important to note that – outside of basket-case economies like Argentina – the vast majority of EMs have strengthened their fundamentals quite rapidly of late.

Take Indonesia, for instance. Faced with current account deficit and inflationary pressures, ASEAN's largest economy fell into the so-called Fragile Five countries of similarly challenged countries. Still, with the help of proactive actions by Bank Indonesia – which hiked rates by a sizable 175bps in the second half of last year – it managed to narrow its current account deficit to under 2% of GDP by end of 2013. While challenges remain, the fact that the Indonesian Rupiah is one of the best performing currencies year-to-date speaks of the fact that emerging markets can weather storms better if it pursues the right course of actions. The ebbs and flows of global market sentiment is always going to be a feature that could hit EM now and then, but hardly causing the fatal wound that some fear.

Apart from concerns about Fed policies and EM crisis, another bogeyman that continues to bug sentiment lately is the recurring idea that China's economy is about to face a crash landing. Our sense is that growth is likely to stabilize at 7.5% this year, in line with government target. More important than the 'quantity', however, is the 'quality' of growth. The government's declaration of "war against pollution" alludes to the realization that past decade's breakneck speed of growth is simply not sustainable and has exacted too much unseen costs.

No less importantly, the Chinese authorities appear to be busy preparing the grounds for multi-front financial reforms. Just like how Deng Xiaoping first opened the trade sector in the 1980s, China is undertaking reforms of the financial sector by testing the waters. For instance, in the Shanghai Free Trade Zone that has been recently created, banks are now allowed to set foreign currency interest rates freely. A baby step, for sure, but an important one nonetheless on the way to eventual full interest rate liberalization. To the same end, the recent weakening of RMB can be seen as the result of PBoC's intention to introduce two-way volatility in preparation for capital account liberalization. The depreciation has not been due to capital outflows as those who fear China's hard landing have speculated, judging from the still-flush onshore liquidity.

Turning our attention to Malaysia, we see an economy that can continue the recent favourable momentum to clock growth of around 5% this year. Private consumption has proven to be more resilient than initially expected, supported by what Bank Negara has described to be "stable employment conditions and sustained wage growth." On the external front, trade balance is looking more favourable than before, with exports staging a more significant recovery on the back of improving global outlook. Interestingly, exports to China have started to pick up more forcefully, helped by stabilizing demand there as well as uptick in CPO prices. Indeed, China is quickly becoming a contender to replace Singapore as the top destination for Malaysian exports.

Overall, the exports turnaround would help to alleviate concerns that Malaysia's current account surplus is thinning. Should there be an EM-wide investor sentiment rout, the improvement in current account outlook will act as an useful buffer for any capital outflow fear.

On the inflation front, while prices have picked up recently, we see them as part and parcel of fiscal adjustment process, as the government cuts back on subsidies. For instance, the upside surprise in recent headline inflation prints can be attributed to the hike in electricity tariffs. While the price uptick will undoubtedly compel Bank Negara to be more vigilant on the risk of inflation pass-through, we doubt that it is enough to force the central bank to hike its Overnight Policy Rate in the near term just yet. Recall for instance, that even as headline inflation jumped to around 8% in early 2008, the BNM did not react, judging – correctly – that it was more cost-push than demand-led.

When it comes to the currency, we see a good chance that the Malaysian Ringgit may see some further depreciation. The degree to which it will do so is going to be relatively small, however, with us pencilling in a forecast of USD/MYR level at 3.34 by end of this year. Essentially, since the MYR escaped the brunt of EM currency weakness on a relative basis last year, some catch-up is in store this year against the background of a generally strong US dollar.

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