



## CIO Special

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Authors:  
Stefanie Holtze-Jen  
Chief Investment Officer APAC

Mayank Khemka  
Chief Investment Officer India

Jason Liu  
Head, Chief Investment Office APAC

Sagar Singh  
Investment Officer APAC

# Asia H2 Outlook: external headwinds to test domestic resilience

## Key takeaways

### 01 Introduction

### 02 China: more reopening and more stimulus

### 03 India: economy robust, but high oil prices keep policymakers nervous

### 04 Southeast Asia: in the middle of higher inflation and rate hikes

- Asian economies in general are expected to see several headwinds in H2 in the form of continued inflationary pressures and central bank policy tightening, global growth slowdown due to geopolitical stresses and supply imbalances
- Amidst the testing global environment, individual economies will also face their own unique challenges. China, is expected to emerge from a grinding Covid-19 wave while India and nations in Southeast Asia battle high oil prices and rising inflation.
- We remain cautiously optimistic on Asian equities, particularly China. However, Asia fixed income may remain volatile due to a rising interest rate environment.

## 01 Introduction

Asian economies could see further external headwinds, as many of them need to tackle the inflation risks caused by higher oil prices. With inflation elevated, most Asian economies are likely to tighten their monetary policies by raising rates following the path of the Fed. Meanwhile, the external demand slowdown along with the softer DM growth could also affect Asia's growth. On the other hand, China should see more tangible recovery with more reopening and more stimulus measures. We remain cautiously optimistic on Asian equities (particularly Chinese equities), with the economic recovery and regulations on tech and property sectors likely to be eased. However, Asia fixed income may remain challenging due to the higher interest rate environment with Fed's steadfast rate hikes.

## 02 China: more reopening and more stimulus

**Shanghai's reopening since June:** On June 1, Shanghai substantially widened its reopening allowing a majority of Shanghai residents to leave their neighbourhoods. Traffic became busy again in Shanghai and there were reported traffic jams during the peak hours. There were long queues for many popular restaurants, as people went to dine out to satisfy their pent-up consumption needs. Employees went back to offices to work. This full-scale reopening could clearly become a key driver to economic recovery in the broader Shanghai area from June. As more workers return to work, the manufacturing sector recovery could gain further momentum in June and supply chain bottlenecks could start to ease with the lifting of travel restrictions. Cargo truck freight to and from Shanghai, a key indicator for tracking supply chains, declined more than 80% YoY during the peak of the lockdown in April and May. However, it could improve significantly starting from June and the growth could likely turn positive in late Q3 or in Q4, in our view. In the middle of June, there were newly reported Covid-19 clusters in Shanghai and the local government restarted the mass testing measures. While these infections became new concerns to the economy, we do not see any risk of returning to the lockdown situations back in April/May.



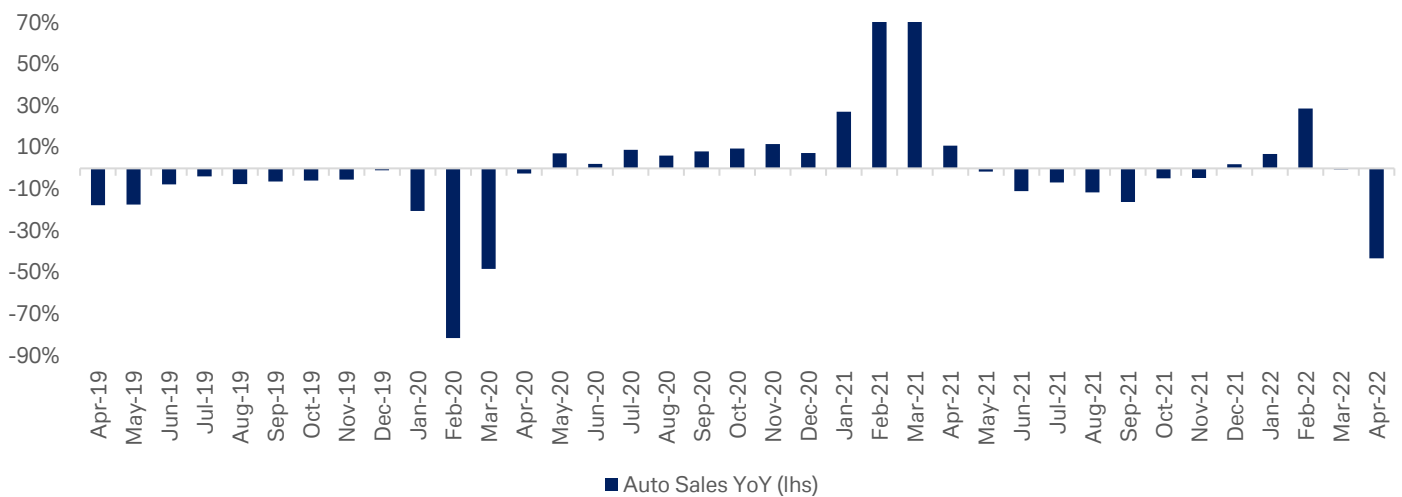
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**Domestic reopening to support growth in H2:** With daily Covid-19 infections reaching around 200 cases recently, China could be working towards further domestic reopening in H2 this year. Currently, many inter-city and inter-province journeys were discouraged with strict testing requirements and local government guidance in place. However, we think the central government could possibly introduce more streamlined policies in order to reduce the impact of local restrictions on the economy. A speedy recovery in consumption may not happen soon, due to higher urban unemployment rates and slower household income growth. However, the fiscal support measures, including tax repayment and consumption subsidies, may bolster pent-up demand, in our view. China's retail sales declined 11.1% YoY in April, compared to -3.5% in March and +6.7% in February. It was the most severe decline since early 2020 when the Covid-19 pandemic had just started. Among all items, auto sales declined sharply by 43% YoY in April due to the lockdown measures in different cities, particularly Shanghai. With tax subsidies now for car purchases, especially of electric vehicles, we think auto sales could likely rebound quite visibly from June.

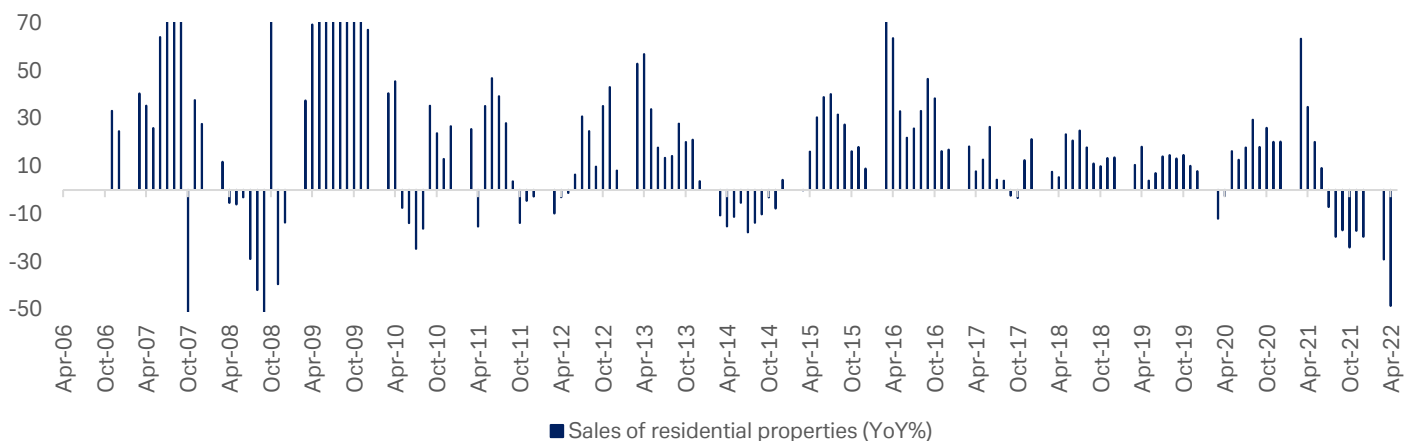
**Property sector could stabilise in H2 with supportive policies:** China's property sales declined substantially in recent months. In April, property sales fell by 48.6%, the most severe decline since the 2008 global financial crisis. However, many supportive policies have been implemented recently. Mortgage rates were lowered quite substantially from more than 5% to now nearly 4% in many cities. More than 100 Chinese cities announced the loosening of property purchase restrictions. While the macro environment was not ideal for property markets with tougher labour market conditions, we think some housing demand could be released with this policy support. Previously, in some cities, there was strict quota system which limited the number of properties each household could hold. With the relaxation of quota for buying properties now implemented in many cities, there is likely to be rising demand to upgrade, in our view. We think the worst is over in regards to property market tightening. Property transactions could gradually stabilise and improve in coming quarters, in our view. We remain positive on China's property market in the long term. We think continuing urbanisation and rising household incomes could drive structural housing demand.

Figure 1: Auto sales shrink at fastest pace in more than a year



Source: Refinitiv Eikon, Deutsche Bank AG. Data as of June 2022.

Figure 2: Property sales drop worst in more than a decade



Source: Refinitiv Eikon, Deutsche Bank AG. Data as of June 2022.

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**Keeping our above-consensus GDP forecast at 4.5%:** After the severe lockdown measures were implemented in Shanghai in April, the consensus forecast for China's 2022 GDP declined quite substantially from above 5% to now around 4%. It was moving further away from the government's previous target of "around 5%" early this year. Despite the market downgrades, we maintain our 2022 GDP forecast for China at 4.5%. We believe that China's growth recovery in H2 this year will be strongly supported by reopening and stimulus. On the external front, China's exports outperformed market consensus year to date, but growth may slow down on the back of slower DM growth in H2.

**Chinese equities – more upside backed by domestic recovery:**

We believe that there is opportunity for Chinese equities to outperform global equities in H2 this year. The key positive drivers for Chinese equities include the following

- 1) More visible growth recovery. We believe that the upcoming economic recovery will likely support equity market sentiment. While the U.S. and Eurozone could see a further growth slowdown in coming quarters, China could deliver a growth resurgence backed by reopening and stimulus. Against this backdrop there could be increased more capital inflows into Chinese equities.
- 2) Any easing of regulations on the tech and property sectors. China already relaxed the approvals for online game companies in recent months. It was signal that the regulators may want to loosen the strict regulations on tech industry. On the property front, while the high-level guidance on deleveraging continues, policymakers were more willing to ease the restrictions mildly in order to facilitate the recovery of the economy and avert a repeat of the liquidity events experienced by developers in H2 last year. The easing of regulations could possibly become a driver to Chinese equities.
- 3) Any reductions to the U.S. tariffs on Chinese imports: While the geopolitical tensions between China and the U.S. may not ease any time soon, the U.S. Biden administration may consider cutting the tariffs on Chinese imports due to domestic inflation concerns. We think any progress on tariff reductions could support market sentiment on Chinese equities.

Meanwhile, we believe that the risks to Chinese equities in H2 include 1) any worsening of global market conditions caused by the Fed and ECB rate hikes and Russia-Ukraine conflict, 2) any new escalation of U.S.-China tensions in the run-up to the U.S. mid-term elections, 3) any uncertainty over higher oil prices which could cause inflation risks in China leading to reduced capacity for stimulus.

**China credit – the worst could be over for property credit, but bumpy climb to recovery:** With the relaxation of property sector policies last month, we believe that the worst of the China high yield property problems is behind us. Bond prices already increased from the bottom on the back of the policy support and slightly positive corporate earnings. However, they were still down quite substantially compared to the start of the year. There are more challenges for privately owned developers, as their funding conditions could remain relatively tough due to banks' unwillingness to increase their exposures in the property sector. On the other hand, state-owned developers could remain quite resilient due to their capability to access domestic funding including onshore bond issuances. Idiosyncratic risks could still confront certain developers. A more careful and diversified

approach to China credit is therefore recommended.

**CNY – with more balanced risks:** After the rapid depreciation of CNY against USD in late April, CNY started to stabilise in recent weeks at around 6.7. We think that the upside and downside risks are more balanced now for CNY. On one hand, we think CNY could be supported by the improving economic conditions and equity market sentiment. In the event of any escalation in the Russia-Ukraine situation, CNY could be one of the safe-haven currencies. On the other hand, with the upcoming further Fed rate hikes, the interest rate differentials between USD and CNY could lead to downside risks to CNY. Our 12-month target for USD/CNY is at 6.75.

## 03 India Macro – economy robust, but high oil prices keep policymakers nervous

For the Indian economy, higher oil prices has a negative influence primarily on trade terms as well as the balance of payments (BoP). India is the world's second largest net importer of crude, with over 80% of its requirements met via foreign supplies. There are also secondary effects, namely weaker global growth amid the geopolitical escalation, foreign capital outflows and tightening of financial conditions to counter inflation. These, however, are expected to have a lesser near-term impact.

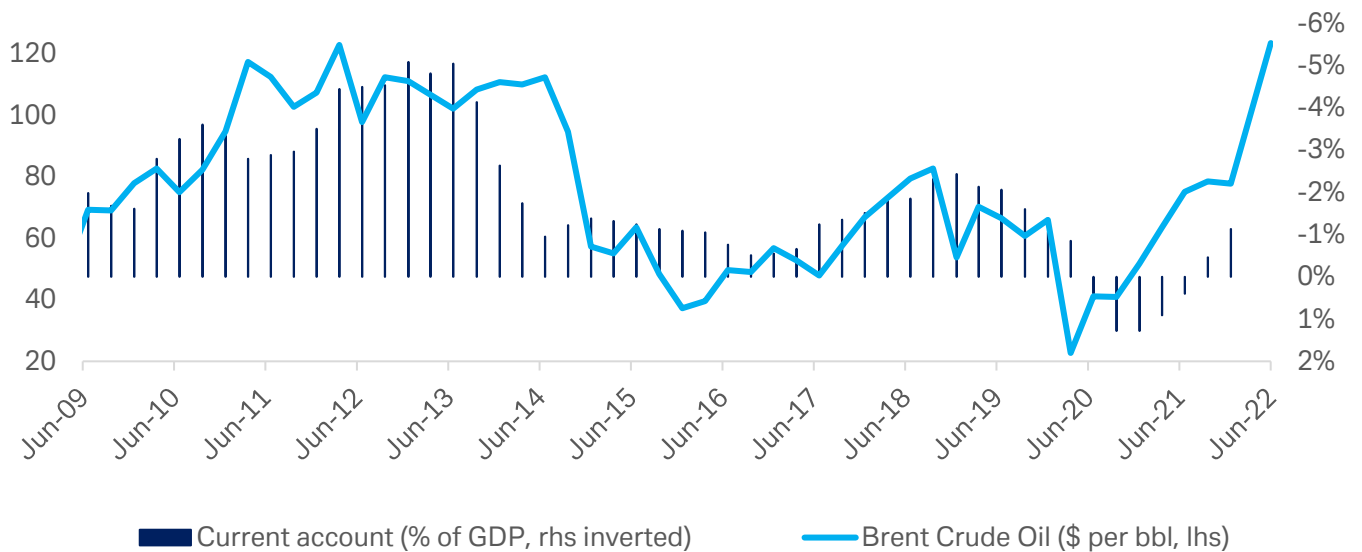
High oil and commodity prices in general have also meant that inflation has increasingly become broad-based (CPI came in at +7.8% YoY in April) with the spotlight firmly on food prices. In order to tackle domestic inflationary pressures, the government recently implemented several measures related to the import of edible oils, limiting exports of wheat and sugar and at the same time lowering excise duties on petrol and diesel.

Despite the inflation-related challenges, India regained the title of fastest growing major economy in FY22 (FY ending Mar' 22), clocking GDP growth of +8.7% YoY after Jan-Mar'22 quarterly GDP growth came in at +4.1% YoY – slightly higher than consensus– weighed down by the Omicron wave in January. Recent high frequency indicators point towards robust economic activity as services PMI in April touched an 11-year high at 58.9. Imports are at all-time-highs along with strong export growth and banking credit, which is back to double-digit growth (+11.9% YoY in May).

At its policy meeting on June 8 Reserve Bank of India (RBI) announced that India's FY23 GDP growth is forecast to be 7.2% YoY while FY23 CPI inflation was revised up recently to average 6.7% YoY (based on oil at USD 105). However, with the economy running hot in a supply-constrained world, the risks to inflation still remains to the upside.



Figure 3: India's BoP Current Account Deficit (CAD) tightly correlated with global oil prices



Source: Bloomberg Finance LLP, Deutsche Bank AG. Data as of June 2022.

**RBI kicks in hiking cycle, front-loads rate hikes to battle inflation:**

In complete contrast to this time last year, when RBI had announced a ~USD30bn bond buying programme (G-SAP) amid aggressive repo rate cuts, RBI is now firmly on the path to tighten policy. In April, at a surprise, unscheduled meeting it delivered a 40 bps repo rate hike and followed it up by another 50 bps hike a few days ago to take the repo rate to 4.9%, with the aim of front-loading rate hikes to curb inflation.

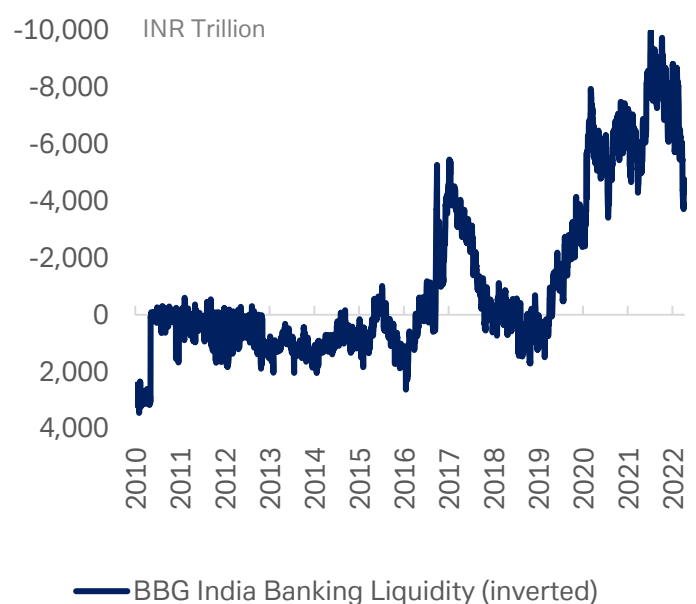
RBI has additionally focused on withdrawing excess liquidity from the system. In the last 6 months or so, banking liquidity has declined by over 50% (Chart 2). The various measures include an introduction of the Standing Deposit Facility (SDF) at 4.75%, 14- and 28-day VRRR's (variable reverse repo rate auctions) and the ad hoc 50 bps CRR (cash reserve ratio) hike in May.

However, with inflation remaining elevated (and above 6%, i.e., higher than RBI's 2-6% tolerance band), we expect RBI to remain in the rate hiking mode and expect further hikes at upcoming policy meetings. We target a terminal repo rate in the range of 6% with risks dependent on the inflation trajectory.

**Fixed income – yields continue to harden:** RBI's liquidity tightening and interest rate hikes have meant that short term rates have moved up significantly. At the same time, the yield curve in general has also shifted up, with hardening across tenors as rising inflation and cyclical growth recovery pushes investors out of bonds. The 10-year G-Sec paper recently broke through 7.5% level, validating our recommendations to stay away from duration. As RBI and the government fight inflation using combined monetary and fiscal policy action, yields may continue to inch up unless a stabilisation of inflation is visible. A potential announcement related to bond index inclusion – sometime during this year – could improve sentiment, but the exact timing remains uncertain. Though mark-to-market losses

have largely offset accruals in the current year due to the aggressive rate hikes, fixed income returns are expected to now clock 6-7% over the next 1-2 years, as portfolios get repriced to the current rate scenario.

Figure 4: RBI has focused on draining surplus cash from system as part of tightening



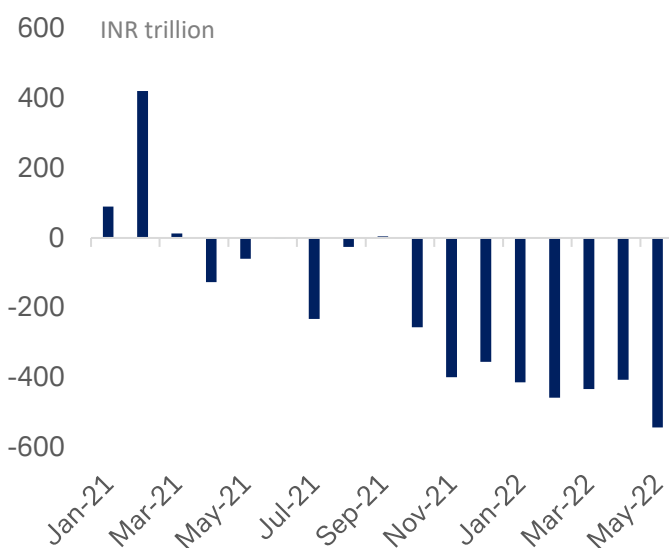
Source: Bloomberg Finance LLP, Deutsche Bank AG. Data as of June 2022.



**Equities – earnings growth still supportive; foreign investor selling absorbed by domestics:** Foreign investors have continued their persistent selling of Indian equities. The May sales total was the second highest ever at USD5.4bn after the March 2020 capitulation. The YTD number of USD22bn+ is already the highest in any year. Domestic investors continue to offset this as buyers, led by rising SIP inflows as well as lumpsum investments. Given this dynamic and structural story around reforms, formalisation of the economy and digitalisation trends, Indian equity markets have outperformed peers globally, both in the bull market since March 2020 as well as the bear market YTD.

The outperformance has been supported by robust fundamentals, as seen in the March quarter earnings. While operating margins have taken a hit – both in manufacturing (as raw material costs escalate) and in services (wage inflation, operational costs), sales growth compensated for it (Nifty 50 sales grew +25% YoY in March quarter) boosting profits (Nifty 50 PAT grew +21% YoY). Nifty EPS for the FY23 currently stands at INR 888, implying FY23 earnings growth of +17%, valuing the market at 18.3x price to earnings.

**Figure 5: Foreign portfolio investors withdrew capital for the 8th consecutive month**



Source: NSDL, Deutsche Bank AG. Data as of June 2022.

## 04 Southeast Asia: in the middle of higher inflation and rate hikes

With higher energy and food prices, economies that rely on energy and food imports to feed their populations are in a weaker position. Demands for higher wages, particularly from lower-income groups, can accelerate a vicious inflation cycle, putting pressure on governments to break the cycle by price regulation and direct transfers to those hit hardest – both

weighing on fiscal budget, and hence economic growth prospects going forward. On the other hand, if growth worries in DM increase in H2 2022, the resulting headwinds to the region's growth prospects would help dampen inflation, hence enabling Southeast Asian central banks' tightening cycles to be less restrictive.

In its most recent policy move in mid-April, the Monetary Authority of Singapore (MAS) strengthened the SGD against the USD by re-centering its policy band higher and raising the slope of the currency's appreciation, the first time both tools have been used simultaneously since 2010. Going forward, ongoing inflationary pressures due to the narrowing output gap, diminishing labour market slack, the pass-through from rising cost pressures into core goods' inflation, and higher global commodity prices, point to an additional tightening at MAS' next bi-annual meeting in October 2022.

In a move that most analysts were not expecting, the Bank Negara Malaysia (BNM) raised its key policy rate by 25 bps to 2.00% on May 11, after holding it at a record low of 1.75% since July of 2020. While underlying inflation is expected to trend higher, BNM also noted that upward pressure on prices would be partly contained by price controls and spare capacity. With CPI inflation stable at a comparatively low level between 2.2% to 2.3% YoY (Jan-Apr), the hike was largely about getting the cycle going and starting to reverse the Covid-era accommodation. However, should CPI gain momentum on the back of strong domestic demand and MYR/USD remain under pressure, gradual monetary policy adjustments, e.g., by 25 bps hikes each in Q3 2022 and Q4 2022, cannot be ruled out.

Recently, the Philippines' central bank (BSP) raised its key rate by 25 bps to 2.25%, the first increase in borrowing costs since 2018. Policymakers noted that a strong economic rebound and labour market conditions provided scope to continue rolling back pandemic interventions. Inflation could breach the BSP's 2%-4% target this year on the back of supply-side price pressures from commodities, particularly inputs into food, wage increases and ongoing improvement in demand conditions. This could lead to a further 25 bps hike in June, and possibly more in H2 2022.

On May 24, Bank Indonesia (BI) recently kept its set of policy rates unchanged as it expects headline inflation to remain within its 2%-4% target band in 2022 and 2023 following the government's move to increase the energy subsidy budget in 2022, guaranteeing no hike in subsidised fuel and electricity prices. Going forward, a stable Indonesian rupee, a low current account deficit within the range of 0.5% to 1.3% of GDP on the back of higher global commodity prices, and still-contained inflation should give BI some room to decide when to begin policy normalisation – possibly in Q3 2022.

And finally, on June 8, the Bank of Thailand (BoT) kept its policy rate at a historic low of 0.5% at its June meeting. However, three out of seven monetary policy committee members voted in favour of a rate hike at the June meeting, due to the rising inflationary pressure in the country. Thailand CPI inflation rose to a 14-year-high at 7.1% in May. While the BoT remains accommodative for now with its efforts to stimulate growth recovery, it continues to seriously consider rate hikes later in the year given rising inflation. The BoT raised its inflation forecast for this year to 6.2% from 4.9%.



## Glossary

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The **Bank Indonesia (BI)** is the central bank of the Indonesia.

**BOP** refers to Balance of Payment.

The **Bank of Thailand (BoT)** is the central bank of the Thailand.

The **Bangko Sentral ng Pilipinas (BSP)** is the central bank of the Philippines.

**CNY** is the currency code for the Chinese yuan.

**CRR** stands for Cash Reserve Ratio.

The **consumer price index (CPI)** measures the price of a basket of products and services that is based on the typical consumption of a private household.

**DM** stands for Developed Markets.

**Earnings per share (EPS)** are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The **Federal Reserve (Fed)** is the central bank of the United States.

**Gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

**G-Sec**, short for Government security is an instrument of indebtedness (a bond) issued by the Government of India.

**INR** is the currency code for the Indian Rupee.

The **Monetary Authority of Singapore (MAS)** is the central bank of Singapore.

**MYR** is the currency code for the Malaysian ringgit.

The **NIFTY 50 Index** is a benchmark Indian equity index representing the weighted average of 50 stocks over 12 sectors.

**PAT** refers to profit after tax.

**Purchasing manager indices (PMI)** provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

The **Reserve Bank of India (RBI)** is India's central bank and regulatory body under the jurisdiction of the Government of India.

**SIP** stands for Systematic Investment Plan.

The **Standing Deposit Facility (SDF)** is a liquidity window through which the RBI gives entities an option to park excess liquidity with the RBI on an overnight basis.

**SGD** is the currency code for the Singapore dollar.

**Government Security Acquisition Programme (G-SAP)** is an open market operation through which RBI buys sovereign papers to infuse cash into the banking system.

**USD** is the currency code for the U.S. Dollar.

**VRRR** refers to variable rate reverse repo.



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